

Why The Markets Can't Fix Themselves

George Soros, *The New Republic Magazine*, August 25, 2002

Busted

The whole country is up in arms about corporate abuse and financial wrongdoing. Our outrage is coupled with amazement: How could it have happened? Yet we shouldn't be amazed. The excesses of the 1990s boom and the clamor for reform that has accompanied the current bust are in fact a recurring feature of financial markets. What is truly amazing is that after so many boom/bust cycles we still do not properly understand how financial markets operate.

The prevailing wisdom holds that markets tend toward equilibrium--i.e., a price at which willing buyers and sellers balance each other out. That may be true of the market in widgets, but it is emphatically not true of financial markets. In financial markets a balance is difficult to reach because financial markets do not deal with known quantities; they try to discount a future that is contingent on how they discount it at present. What happens in financial markets can affect the economic "fundamentals" that those markets are supposed to reflect--which is why recent years have produced such a dramatic and seemingly irrational stock market rise, followed by an equally dramatic and seemingly irrational fall. Instead of a one-way connection between supply and demand via market prices, there is a two-way connection: Market prices can also alter the conditions of supply and demand in a circular fashion. In my 1987 book *The Alchemy of Finance*, I called this two-way connection "reflexivity." And I think it better explains the current turmoil in financial markets than the more commonly accepted idea of equilibrium.

Due to this two-way connection, it is impossible to determine where the equilibrium lies. Participants have to anticipate a future that is not only unknown but unknowable. The theory of reflexivity does not offer a new way of determining the outcome; it holds that the outcome is impossible to determine. For instance, it was predictable that the Internet bubble would burst, but it was impossible to predict when. There is a decision fork at every point along the way, and the actual course is determined only as the decisions are taken. Such a view undermines the scientific pretensions of economists. Scientific theories are supposed to explain and predict. Accepting reflexivity requires acknowledging that social science in general and economics in particular cannot provide scientifically valid predictions. This is a paradigm shift that has not occurred.

But even if reflexivity cannot yield firm predictions, it does have considerable explanatory power. First, it explains how the bias prevailing in financial markets can be either self-reinforcing or self-defeating. To create a bubble, the prevailing bias must be first self-reinforcing until it becomes unsustainable and turns self-reinforcing in the opposite direction (and thus self-defeating). All boom/bust sequences follow this pattern. Second, by recognizing that financial decisions cannot be based on firm predictions of the outcome, reflexivity draws attention to the formative role misconceptions play in the development of boom/bust sequences. In the conglomerate boom of the 1960s, for instance, the misconception was that growth in earnings per share is equally valuable whether it is achieved by internal growth or acquisitions. I remember vividly how, after the conglomerate boom's collapse, the president of Ogden Corporation (to whom I had sold my brother's engineering business) told me at lunch that the company's earnings were falling apart because "I have no audience to play to"--with the stock price down, he could no longer use that stock to acquire companies and thus magically boost earnings.

We are now in a similar situation. During the recent boom, corporations used every device at their disposal to boost earnings to satisfy the ever-rising expectations that sustained ever-rising stock

prices. Clever financial engineers invented ever-new devices--and when they ran out of legitimate ones, some corporations turned to illegitimate ones. When the market turned, some of these illegitimate practices were exposed. For instance, Enron, like many companies, used special purpose entities (SPEs) to keep debts off its balance sheets. But unlike many other companies, it used its own stock to guarantee the debt of its SPE. When its stock price fell, the scheme unraveled and Enron was pushed into bankruptcy, exposing a number of other financial misdeeds the company had committed. The Enron bankruptcy reinforced the downtrend in the stock market, which led to further bankruptcies and news of further corporate and individual misdeeds. Both this downtrend and the clamor for corrective action gathered momentum in a self-reinforcing fashion--just as reflexivity envisions.

There is nothing surprising about this course of events. It has happened many times before. The real surprise is that we are surprised. After all, many of the practices that are now condemned were carried on quite openly. Everybody knew that the best companies, such as General Electric and Microsoft, were massaging the numbers to maintain the appearance of a steady progression of earnings. Indeed, investors put a premium on management's ability to do just that. SPEs could be bought off the shelf, and investment banks maintained structured finance departments to provide custom-made designs. Tyco's management proudly proclaimed that they could generate earnings growth by acquiring companies, some of which could be moved offshore by virtue of Tyco's Bermuda incorporation, and investors put a high multiple on its earnings. Stock options were not only accepted but considered a useful device for boosting shareholders' values since they provided executive compensation without incurring any costs and encouraged management to focus on the stock price above all other considerations.

If there is a major difference between today's crisis and, say, the late '60s conglomerate boom--where investors also rewarded per-share-earnings growth without regard to how it was achieved--it is a difference of scope. The conglomerate boom involved only a segment of the stock market--the conglomerates and the companies they acquired--and a segment of the investing public, spearheaded by the so-called "go-go" funds. When the conglomerates began to threaten the overall financial establishment, that establishment closed ranks against them. By contrast, the '90s boom encompassed the entire corporate and investment community, and today's establishment, including today's political establishment, was fully complicit. Enron, WorldCom, and Arthur Andersen could not have gotten away with their nefarious activities without encouragement and active reinforcement from virtually all sectors of American society--their corporate peers, investment professionals, politicians, the media, and the public at large. Whereas the conglomerate boom ended because of resistance from the establishment, in this case the boom was allowed to run its course, and the search for corrective measures started only after the collapse. Even now, a pro-business administration is trying to downplay the damage. In looking for remedies, it is not enough to make an example of a few offenders. We are all implicated and must all reexamine our view of the world.

According to the theory of reflexivity, misconceptions or flawed ideas are generally responsible, at least in part, for most boom/bust sequences. Analyzing what went wrong in the '90s, we can identify two specific elements: a decline in professional standards and a dramatic rise in conflicts of interest. And both are really symptoms of the same broader problem: the glorification of financial gain irrespective of how it is achieved. The professions--lawyers, accountants, auditors, security analysts, corporate officers, and bankers--allowed the pursuit of profit to trump longstanding professional values. Security analysts promoted stocks to gain investment-banking business; bankers, lawyers, and auditors aided and abetted deceptive practices for the same reason. Similarly, conflicts of interest were ignored in the mad dash for profits. While only a small number of people committed acts that actually qualify as criminal, many more engaged in activities that in retrospect appear dubious and misleading. They did so thanks to reassuring legal opinions, Generally Accepted Accounting

Principles (GAAP), and the comforting knowledge that everybody else was doing the same. When broad principles are minutely codified--as they are in the GAAP--the rules paradoxically become easier to evade. A whole industry was born, called structured finance, largely devoted to rule evasion. Once a financial innovation was successfully introduced it was eagerly imitated, and the limits of the acceptable were progressively pushed out by aggressive or unscrupulous practitioners. A process of natural selection was at work: Those who refused to be swayed were pushed to the sidelines; those leading the process could not see the danger signs because they were carried away by their own success and the reinforcement they received from others. As a source told *The Financial Times*, "They couldn't see the iceberg because they were standing on top of it."

Underlying this indiscriminate pursuit of financial success was a belief that the common interest is best served by allowing people to pursue their narrow self-interest. In the nineteenth century this was called "laissez-faire," but since most of its current adherents don't speak French, I have given it a more contemporary name: market fundamentalism. Market fundamentalism became dominant around 1980, when Ronald Reagan was elected president in the United States and shortly after Margaret Thatcher was chosen as prime minister in the United Kingdom. Its goal was to remove regulation and other forms of government intervention from the economy and to promote the free movement of capital and entrepreneurship both domestically and internationally. The globalization of financial markets was a market-fundamentalist project, and it made remarkable headway before its shortcomings were exposed.

Market fundamentalism is a false and dangerous ideology. It is false on at least two counts. First, it profoundly misapprehends the way financial markets operate. It assumes that markets tend toward equilibrium and that equilibrium assures the optimum allocation of resources. Academic economists have proceeded far beyond general equilibrium--multiple equilibriums are all the rage now--but market fundamentalists continue to believe they have solid science behind them, not just economics but also Charles Darwin's theory of survival of the fittest. Second, by equating private interests with the public interest, market fundamentalism endows the pursuit of self-interest with a moral quality.

But if financial markets do not tend toward equilibrium, as the theory of reflexivity maintains, private interests cannot be equated with the public interest. Left to their own devices, financial markets are liable to go to socially disruptive extremes.

The fallacy of endowing the market mechanism with a moral quality goes deeper still. What distinguishes markets is exactly that they are *amoral*--that is to say, moral considerations do not find expression in market prices. That is because efficient markets by definition have so many participants that no single one can affect the market price. Even if some participants are held back by moral scruples, others will take their place at only marginally different prices. For instance, moralists cannot prevent alcohol and tobacco companies from raising capital on more or less the same terms as not-so-sinful enterprises. As a consequence, anonymous market participants need not be overly concerned with the social consequences of their actions because those consequences are so marginal. The amorality of financial markets is one of the factors that contribute to their efficiency: It allows participants to be single-minded about maximizing their returns without regard to the social consequences. (Of course the concept of efficient markets is only an abstraction. In reality many large participants are not anonymous and their decisions may sway others.) It is exactly because markets are amoral that we cannot leave the allocation of resources entirely to them. Society cannot hold together without some consideration of the common interest. If private interests cannot be equated with the public interest, the public interest must be given expression in some other way than through the market.

Here we must draw a distinction between rulemaking and playing by the rules. As market participants, we may pursue our self-interest as long as we play by the rules. But as rulemakers we must be guided by the common interest--and in a democracy we are all rulemakers. By claiming that the public interest is best served by allowing people to pursue their self-interest, market fundamentalists have erased the distinction. Those who subscribe to this convenient ideology have no compunction about bending the rules to their own advantage. The result is not perfect competition but crony capitalism, where the rich and powerful feel morally justified in enjoying their privileged position.

The dangers of market fundamentalism are particularly evident in the international arena. The development of our international financial institutions has not kept pace with the growth of global financial markets. As a result we have seen several major international financial crises since 1980. Their impact on our economy has been relatively modest because whenever a crisis threatened our prosperity the Federal Reserve intervened aggressively--as with the Long Term Capital Management crisis in 1998. But many other countries--Argentina, Brazil, Mexico, Thailand, Indonesia, Korea, Russia--have been devastated, some more than once. Instead of recognizing that financial markets are inherently unstable and bigger markets require stronger public institutions to maintain stability, market fundamentalists have reached the opposite conclusion: They blame the International Monetary Fund (IMF) for the instability. They claim that the IMF rescue packages have created a "moral hazard" by encouraging markets to extend more credit than they would have otherwise. Yielding to market-fundamentalist pressure, the IMF has reversed its policy from bailouts to "bail-ins"--in which the private sector must make concessions as well. Since investment banks are not motivated by charity, they want to be paid for their part of the bail-in burden--which means higher interests, which further undermines a developing country's economic growth.

The change in IMF policy in the aftermath of the emerging-market crisis of 1997 to 1999 has increased the cost of capital going to debtor countries. As a result, recent years have seen a reverse flow of capital from the periphery to the center as demonstrated by America's ever-increasing current account deficit, which now exceeds \$400 billion or 4 percent of GDP. This has the makings of another bubble that must eventually burst, although the timing cannot be predicted. The recent weakening of the dollar is an ominous sign, especially as the main alternatives--the euro and the yen--are not particularly attractive. The financial crisis in Brazil is even more threatening. From the market-fundamentalist perspective, Brazil has done everything right; yet its bonds today yield more than 20 percent in dollar terms, and no country can live with such high interest rates. After the Bush administration reversed its previous opposition, the IMF recently put together a large, \$30 billion bailout package, but the markets were not impressed. Having been told about moral hazard and private-sector burden-sharing, they are determined to avoid it. After a brief rally, yields settled back at more than 20 percent. By imposing such high interest rates, financial markets are engaging in a self-fulfilling prophecy that is making Brazil insolvent. If Brazil fails, the international financial system as currently constituted has failed. Global financial markets have created an uneven playing field that cannot be sustained in its present form.

There is an urgent need to reform the system by strengthening the IMF's function as lender of last resort to countries that cannot get private-sector credit and by encouraging developing countries to pursue more domestic-led growth, which will lessen their dependence on U.S.-led growth. This will require far-reaching institutional changes, but there is no sign that the Bush administration and others in economic authority recognize the need--partly because they remain beholden to market-fundamentalist thinking.

In the international arena, as in the domestic, market fundamentalism assumes that the collective pursuit of private interest produces economic stability. But as today's turmoil shows, the lack of ethical

principles and social concerns--whether among governments or accountants--creates enormous *instability*. Values are shaped by exactly the same reflexive process as market prices. As I explained earlier, there is a two-way connection between values and economic fundamentals (the economic performance of companies and governments) on the one hand and market prices on the other. There is the "normal" connection studied in economic theory by which the supply and demand curves determine prices; there is also an inverse, reflexive connection by which market developments have repercussions on the participants' values and the so-called fundamentals. The more susceptible the participants' values are to market developments, the more unstable the system becomes. Firmly held ethical, professional, and social principles serve as an anchor, keeping financial markets stable. Conditions then approximate those stipulated by economic theory: The values are more or less independent of markets, and the outcome is a more or less stable equilibrium. But when people pursue financial success without regard for other considerations, they become willing participants in initially self-reinforcing but eventually self-defeating processes.

This is exactly what has happened in the recent boom/bust cycle. Warren Buffett and a few others refused to be swayed by the irrational exuberance of the '90s and continued to base their decisions on the fundamentals of economic performance. But the vast majority of investors were swept away by a self-reinforcing tide, and many people who had never previously invested in stocks got sucked in. The removal of restrictions stimulated entrepreneurial and inventive talents; shareholders' interests took precedence over other considerations. The exuberance was not entirely irrational. Only when the fundamentals could not keep up with the expectations did the process become unsustainable. That is when ethical and professional principles failed to keep the process within bounds.

The argument about stability is relevant not only to financial markets but to society at large. As we have seen, financial markets are amoral, whereas society cannot remain stable without some shared values. Although amorality renders financial markets efficient, it also renders them inhuman. Some sense of humanity must be introduced through the political process--even if it means sacrificing some efficiency, as measured in GDP. That is the fundamental insight that American politics has been missing. Market fundamentalists have managed to convince themselves and others that the proper objective of policy is to protect markets from regulation in the interests of efficiency and economic growth. They point to the failure of socialism in all its forms. But this argument is based on faulty logic. It does not follow from the fact that regulations are imperfect that unregulated markets are perfect. The fact is, all human constructs, including markets, are imperfect in one way or another; perfection is beyond our reach. That is where fundamentalist beliefs, including market fundamentalism, are always wrong: They lay claim to ultimate truth.

To be sure, in developing a new regulatory framework we must remember that regulations are liable to be even more imperfect than markets. They need a feedback mechanism that allows mistakes to be corrected. That is what makes regulated markets superior to central planning. In the absence of feedback either from markets or from free speech and free elections, there is no limit to how far governments can go wrong. But democracy can keep the excesses of government within bounds, just as government can contain the excesses of the financial markets.

In the last two decades or so--and particularly since the '90s--we have given financial markets too much free rein. We have allowed corporations to maximize profits to the detriment of considerations like equality of opportunity, environmental protection, and maintenance of the social safety net. Professional standards have broken down, and conflicts of interest have proliferated. Correcting these deficiencies will require stronger government intervention. Interestingly, the measure that is likely to be most effective in clearing the air is the recent directive issued by the SEC requiring the chief executive and financial officers of the 947 largest companies to certify their accounts dating back to the

beginning of the previous fiscal year. The officers could be held criminally liable if the accounts do not give a fair representation of the company's financial condition--even if they are in conformity with the GAAP . The directive is sufficiently vague so that the officers are likely to err on the side of caution and reveal all questionable practices. It reasserts the supremacy of broad principles over particular rules. In doing so it harks back to the glory days of the SEC pre-dating Mike Milken when principles like insider trading and stock manipulation were not yet codified by court decisions.

Legislation is only part of the answer. Changes in the law must be accompanied by a fundamental change of attitude. In the last analysis, professional standards can be maintained only by the professions themselves, and conflicts of interest can be avoided only if people recognize a common interest other than self-interest. Without such a change of heart, new regulation and new legislation will only encourage more evasion.

It is unrealistic to expect that all market participants will suddenly undergo such an ethical conversion. But public opinion and public discourse--as we saw in the '90s--can have a dramatic impact on individual behavior. Americans must relearn the difference between a collection of individuals each pursuing his or her self-interest and a society of people guided by the public interest. How well Americans relearn that difference may well determine whether this country and the world return to economic stability and prosperity in the months and years to come.

GEORGE SOROS is chairman of Soros Fund Management and founder of the Open Society Network.