book review

The crash of 2008 and what it means: the new paradigm for financial markets

by George Soros

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In his latest book, the famously successful hedge fund operator, George Soros, explains and analyses the catastrophic crash of world financial markets. This is the tenth book he has written on financial market operations. Academic, professional and government policy makers will find the study of great benefit and interest.

SOROS BRINGS EXTENSIVE EXPERIENCE and analytical skills to his examination of financial market operations and proposals to reform them so that they do not involve the boom/bust cycles that have regularly occurred. He argues that this cycle is not merely a repetition of previous ones; rather the crash is a 'culmination of a super-boom that has lasted for more than twenty-five years' (p. VII). It is the worst one experienced since the Great Crash on Wall Street in October 1929, which was followed by the Great Depression of the 1930s. He argues that we must learn from those tragic events.

Soros calls into question the underlying mode of contemporary financial markets theory and operations, and argues that an appropriate system of regulation should be developed by governments. He challenges the validity of the efficient markets hypothesis (EMH) and shows how, and why, it is not valid. Rather, he argues that 'financial markets never reflect the underlying economic reality accurately; they always distort it … and the distortions find expression in market prices. Secondly, these distortions can, occasionally, find ways to affect the fundamentals that market prices are supposed to effect' (p. VII). His analysis of the events occurring over recent years is based on these two premises, and he provides an alternative explanation in terms of his theory of investors' reflexive behaviour.

Soros sets the stage for his analysis of the investment cycles by enumerating an extensive list of financial institutions in the United States, United Kingdom and Europe, which experienced severe liquidity problems and risk of bankruptcy as from February 2007. For example:

- The large UK bank, HSBC, in February announced losses of $10.8 billion on its US mortgage lending business.
- Two large mortgage hedge funds of the US investment bank, Bear Stearns, collapsed in June. The bank itself collapsed in March 2008, and was taken over by JP Morgan with substantial credit assistance provided by the Federal Reserve Board.
- The French bank, BNP Paribus, suspended three investment funds in August, which operated in the US sub-prime mortgage sector. This caused short-term credit markets in Europe to freeze and the European Central Bank pumped over 200 billion euros into successive tranches to the banking system to keep it operating.
- Northern Rock, the largest UK mortgage bank, became insolvent in September and was bailed out by the UK Government through nationalisation.

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The flow of bad news continued over July and August and the financial markets took fright. The panic continued through 2008, and Lehman Brothers collapsed in September. But unlike the collapse or major falls in other large investment banks – such as Bear Stearns, Citigroup and Merrill Lynch – it was not rescued by the Federal Reserve Board. The crescendo of financial crises rapidly spread throughout world financial markets and governments and reserve banks felt obliged to provide major resuscitation measures. For example, the new US Government provided budget stimulus packages amounting to $1 billion and financial assistance to the banking sector of about $1 trillion.

Soros then examines reasons for the boom/bust cycles in terms of the use of complex financial instruments or structured investment vehicles (SIVs) by the financial institutions, and the ready availability of vast amounts of idle funds in US markets arising from the export surpluses of other nations being left there. Two of the most widely used SIVs comprised collateralised debt obligations (CDOs) and credit default swaps (CDSs). SIVs lack transparency and hide their risk attributes. Ratings agencies found them difficult to evaluate and frequently gave them the high rankings of the issuing institution. Most investors did not understand them. Their losses on SIVs were catastrophic and they became known as 'toxic waste'.

CDOs were used extensively to bundle up sub-prime property mortgages and resell them to financial investors around the world, frequently with AAA ratings, when they were really junk bonds. During the housing property boom in the United States, many mortgage loans were made to 'ninja' borrowers (no income, no jobs and no assets) on honeymoon interest rates and principal repayments. The stated intention was to promote the socially desirable government policy of home ownership. However, the underlying motivation of lenders was to repossess the property when borrowers defaulted once repayments became due, and then to sell them at good capital gains in the booming housing market. The issuing institutions were aware of the mortgage risks, so they packaged them into complex CDOs and endeavoured to dispose of them as quickly as possible to pass on the risks to unsuspecting investors.

CDSs were developed ostensibly as a mechanism for loan insurance by banks, and they quickly became the largest of the synthetic instrument markets. By 2008, there were some $45 trillion of CDSs in the United States. This was equal to almost the entire US household wealth and three times the capitalisation of the stock markets. They played a major role in the collapse of the American International Group (AIG), the world's largest insurance company, in September 2008. However, the US Government felt obliged to bail it out of bankruptcy (incurring the risk of moral hazard).

Surplus liquidity in the US market was the third factor underlying the financial markets' bubble. This arose from the substantial export surpluses of the OPEC nations' oil exports, and the manufacturing export surpluses of China, Japan and Germany, being left in the United States. After funding the Federal Government's budget deficit, the large financial institutions were only too willing to assist in investing the idle funds. Federal Reserve Board policy of reducing interest rates to almost zero made them attractive for borrowing. Residents were encouraged to borrow heavily for houses, shares and consumption purposes, and asset price bubbles resulted, along with enormous consumer debt.

Because of the above combination of factors, the boom differed from earlier boom/bust cycles and, in Soros' opinion, became a super-bubble. Unlike earlier bubbles, this one flowed through to the core of the US economy and caused widespread business bankruptcy and unemployment. Its rapid spread through world financial markets and economies was facilitated by the globalisation of world financial markets.

Soros analyses the super-bubble in terms of his theory of reflexivity of investors' behaviour in which he relates investors' views of financial markets with the actual state of affairs in them. He correctly emphasises that investors' knowledge of future share prices and business performance suffers from uncertainty. They can only form expectations of them and they must continually adapt their expectations, decisions and behaviour in the light of actual experience. Reflexive behaviour involves a circular, or two-way, feedback loop between investors' behaviour and the actual state of affairs. This is in contrast to traditional economic theory, which assumes away the existence of uncertainty with its assumption of complete knowledge (or bounded rationality in more recent versions). Furthermore, it assumes that the objective of all investors is wealth maximisation and that they will not be engaged in speculative behaviour. These assumptions, together with the belief in the efficiency of free markets, underlie the efficient markets hypothesis (EMH) of modern finance theory. Thus, there is no scope in this theory for the exercise of 'animal spirits' by investors, which the great economist JM Keynes (1936) believed was a major cause of the October 1929 crash on Wall Street and which ushered in the Great Depression.

On the basis of his analysis, Soros proposes a range of changes in the operation of financial markets that would prevent serious asset price bubbles reoccurring in the future. These include governments, through their regulatory authorities, accepting responsibility to manage systemic risks in them. Thus, credit creation must be regulated along with the money supply; financial instruments must be kept simple so that investors can readily understand their roles and risk characteristics while complex ones should be abandoned (such as the present formats of CDOs and CDSs); limits to leverage and borrowing should be imposed on business and on consumers so that they are required to put some equity funds into the

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assets; and the mortgage system should be modified so that mortgage lenders cannot pass on the risks to security holders where the mortgages are securitised, as occurs in Denmark. As well, he supports the use of fiscal stimulus packages and recapitalisation of the banking system as being necessary to overcome the present crisis. Finally, he advocates that the international financial system must now be amended to recognise the global nature of financial markets and the rise of new economic powers such as China and the European Union, together with the decline in US power and influence.

The crash of 2008 is a thought-provoking and rigorous analysis of a severe financial crisis in world economies, which has resulted in disastrous business crashes, unemployment and acute government debt. Soros has been a successful participant in financial markets over many years and he has gained great insights into their strengths and weaknesses. Moreover, he examines their operation from the viewpoint of the nation rather than from that of wealth-seeking firms operating in the markets, so that macroeconomic management and social considerations are given the highest priority in the formulation of the regulatory policies for financial market regulation. His views are in accord with those formed by the great economist John Maynard Keynes in his analysis of the Great Depression and its causes. Academic, professional and government policy makers will find the study of great benefit and interest.

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