

## **Crisis Is Endemic to the Financial System**

**GEORGE SOROS**, the financier and philanthropist, is author most recently of *The New Paradigm for Financial Markets: The Credit Crisis of 2008 and What It Means*. He spoke with NPQ editor Nathan Gardels in November.

**NPQ** | Let's talk first about the nature of the crisis. Thanks to low interest rates, global liquidity and deregulation, we have had a 25-year, self-reinforcing credit expansion bubble, leading to "irrational exuberance," as it was once said, in financial markets. Now we have the self-reinforcing crash of the stock and credit markets.

How does this pattern fit your theory of reflexivity and your new paradigm for understanding finance?

**GEORGE SOROS** | The key to understanding this crisis—the worst since the 1930s—is to see that it was generated within the financial system itself. What we are witnessing is not the result of some exogenous shock that knocked things off balance, as the prevailing paradigm, which believes markets are self-correcting, would suggest. The reality is that financial markets are self-destabilizing; occasionally they tend toward disequilibrium, not equilibrium.

The paradigm I'm proposing differs from the conventional wisdom in two respects. First, financial markets don't reflect the actual economic fundamentals. Expectations by traders and investors are always distorting them. Second, these distortions in the financial markets can affect the fundamentals—as we see in both bubbles and crashes. Euphoria can lift housing and dot.com prices; panic can send sound banks tumbling.

That two-way connection—that you affect what you reflect—is what I call "reflexivity." That is how financial markets really work. Their instability is now spreading to the real economy, not the other way around. In short, the boom-bust sequences, the bubbles, are endemic to the financial system.

The current situation is not just about the housing bubble. The housing bubble was merely the trigger that detonated a much larger bubble. That super-bubble, created by the ever-increasing use of credit and debt leverage, combined with the conviction that markets are self-correcting, took more than 25 years to grow. Now it is exploding.

**NPQ** | What ought to be the "circuit breaker" that short-circuits the distortions that inevitably destabilize financial markets?

**SOROS** | If bubbles are endemic in the system, then government regulators have to intervene to prevent bubbles from getting too big. Governments have to recognize that markets are not self-correcting. It is not enough to pick up the pieces after the crisis.

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**NPQ** | Does the presence of the 24-hour global financial news cycle amplify and exaggerate distortions in the financial markets?

**SOROS** | Without question, they accelerate the process. At the same time, I wouldn't overstate it. At the end of the 19th century, you didn't have 24-hour cable, but nevertheless you had the same kind of bubbles. Throughout the 19th century, when there was a laissez-faire mentality and insufficient regulation, you had one crisis after another. Each crisis brought about some reform. That is how central banking developed.

**NPQ** | How come all the efforts of the United States government during the Bush Administration—the \$700 billion rescue package, low federal interest rates, backstopping deposits and commercial paper—had so little effect in stemming the crisis?

**SOROS** | The US authorities under Bush bought into market fundamentalist ideology. They thought that the markets would ultimately correct themselves. US Treasury Secretary Henry Paulson epitomized this. He thought that six months after the Bear Stearns crisis the market would have adjusted and, "Well, if Lehman (Brothers) goes bust, the system can take it." Instead, everything fell apart.

Since they did not understand the nature of the problem—that the market would not correct itself—they did not see the need for government intervention. They did not prepare a Plan B.

As the shock of the Lehman failure set in, Paulson had to change his mind and rescue AIG. The next day there was a run on the money markets and commercial paper markets, so he turned around again and said we need a \$700 billion bailout. But he wanted to put the money in the wrong place—taking the toxic securities out of the hands of the banks.

They finally came around by October—with the government buying equity in banks—because they saw the financial system was on the verge of collapse.

There are five major elements to ending the immediate financial turmoil, only some of which have been implemented.

- First, the government needed to recapitalize the banking system by buying equity stakes in banks, which it did.

- Second, interbank lending needed to be restarted with guarantees and bringing LIBOR (London Interbank Offered Rate) in line with fed funds. This is in the works. It is happening.

- Third, the mortgage system in the US needs to be reformed, minimizing foreclosures and renegotiating loans so that mortgages are not worth more than houses. Stemming foreclosures will cushion the fall of housing prices.

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■ Fourth, Europe has to fix the weakness of the euro by creating a safety net for its banks. While initially resisting this, it found religion and has done this.

■ Fifth, the International Monetary Fund must deal with the vulnerability of countries at the periphery of the global financial system by providing a financial safety net. This is also in the works. The Japanese have already offered \$200 billion for this purpose.

These five steps will start the healing process. If we implement these measures effectively, we will have passed through the worst of the financial crisis.

But then, I'm afraid, there is the fallout in the real economy, which is now gathering momentum. At this point, repairing the financial system will not stop a severe worldwide recession. Since, under this circumstance, the US consumer can no longer serve as the motor of the world economy, the US government must stimulate demand. Because we face the menacing challenges of global warming and energy dependence, the next administration should direct any stimulus plan toward energy savings, developing alternative energy sources and building green infrastructure. This stimulus can be the new motor for the world economy.

**NPQ** | At the end of the day, won't we be looking at a vastly different global financial landscape? The US will decline as the top power. It will have, along with parts of Europe, socialized banks and loads of debt. Communist China will be the new financial power globally, flush with capital and a major investor in the West.

**SOROS** | US influence will wane. It has already declined. For the past 25 years, we have been running a constant current account deficit. The Chinese and the oil-producing countries have been running a surplus. We have consumed more than we produced. While we have run up debt, they have acquired wealth with their savings. Increasingly, the Chinese will own a lot more of the world because they will be converting their dollar reserves and US government bonds into real assets.

That changes the power relations. The powershift toward Asia is a consequence of the sins of the last 25 years on the part of the US.

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