Journal of Education and Vocational Research
Vol. 5, No. 1, pp. 28-32, Mar 2014 (ISSN 2221-2590)

Book Review

George Soros (2010). The Soros Lectures at the Central European University (New York: Public Affairs), pp. 127, U.S. $ 16.95 (h/b), ISBN 978-1-58648-885-7

Reviewed By

Shiva Kumar Srinivasan
IIPM Chennai, India
sksrinivasan2008@hotmail.com

1. Introduction

The Soros Lectures were originally delivered at the Central European University at Budapest, Hungary, in 2009. Soros is himself the founder of this university, which was set up as a part of the reconstruction efforts following the collapse of the Soviet-backed Hungarian regime at the end of the Cold War. These lectures were delivered as an attempt to explore what went wrong during the financial crisis of 2008 - not only in terms of how the markets functioned, but also in terms of the theoretical frameworks that are of consequence in the fields of economics and finance. The Central European University specializes in teaching programs in the humanities and the social sciences. Soros argues that these areas are important because they help us to develop the intellectual perspectives that are necessary to understand the world, given especially the increasing levels of complexity both in the financial markets in particular and the society at large. These lectures then are an attempt on his part to develop such a sense of perspective *vis-à-vis* the financial crisis of 2008, and the events that came in its wake. Soros, as most readers will know, is the chairman of Soros Fund Management. He is best known for having bet against the Bank of England and in having made a huge killing in the process; but, what these lectures reveal pertain to the more intellectual aspects of his personality.

2. Soros on Karl Popper

This is an aspect of his intellectual life that only die-hard fans of Soros know or bother to appreciate. The essence of this Soros is his intellectual transference to the philosophical work of Karl Popper, the logician and philosopher of science, whom he met at the London School of Economics. Soros himself spent a number of years trying to do philosophical work that would emulate the spirit of Popper before he moved on to finance and philanthropy. But, nonetheless, Soros has a way of returning to Popperian themes from time-to-time. This is one such occasion when he feels that the theoretical clarity that is represented by certain philosophical themes in Popper's work could have helped different stakeholders to think through the crisis with greater clarity. The task of these lectures is to spell out exactly how this could have been done. Soros has written a number of books before, but distills the essence of his hard-won wisdom in these lectures. While Soros is occasionally apologetic for having given up on his attempts to become a philosopher, he overlooks important assets that he does possess: immense amounts of both knowledge and experience along with oodles of money. Soros is the only philosopher that I know of who can answer McCloskey's Question with aplomb. McCloskey's Question, as American philosophers, stuck in a materialist society knows quite well, is this: 'If you are so smart, how come you are so poor?' At least, Soros does not have to answer this question!

3. Theory as Provisional Knowledge

The main theoretical preoccupation in the themes that Soros touches upon in this series of lectures pertain to the fact that there is a contradiction between the fundamental assumptions of economic theory, its forms of theoretical validation, and its relationship to the political structure of open societies (as articulated by Popper). This contradiction revolves around the idea that scientific theories cannot be decisively validated through a process of verification since even an endless number of verifications do not rule out the possibility of a falsification. It is therefore not a good idea for a scientific theory to set itself up as an exemplar of truth; it is better to take the more modest position of 'provisional knowledge'. The implication of this idea is the need to make socio-political arrangements in society, where it is politically possible for people to have their disagreements, without becoming dysfunctional. An 'open-society', in Popper's understanding, is a society where this is possible; the urgency of this assertion for Popper, and for Soros, arose from the fact that they had lived through political tyranny in closed societies, which forbid free speech and political action. This is because the tyrants were working on the assumption that they had worked out the ultimate truth of the political process; which, according to them, was to culminate in communism. The sudden collapse of these closed societies however was like a Popperian falsification of those forms of socio-political and economic arrangements. It is not only communist societies that make this mistake; democracies are flawed as well since they are not only subject to periodic crises, but work on socio-economic postulates like absolute knowledge, perfect competition, self-correcting mechanisms in the market, and so on that Soros goes on to critique in these lucid lectures.

Cognitive and Manipulative Functions

The two important philosophical constraints that are commonly overlooked, but which create problems for our understanding of the socio-economic domain, are fallibility and reflexivity. The former term means that the world is beyond our comprehension and the latter means that market participants or social actors cannot be understood as though they were material particles in a scientific experiment; after all, they are human beings who can think and reflect on the significance of their actions. This creates a sense of uncertainty in human behavior that is analogous to Werner Heisenberg's notion of the uncertainty principle in physics. The notion of equilibrium in economic theory, for instance, function mainly within Newtonian assumptions that are linked to classical mechanics, but don't work effectively if the notion of reflexivity is introduced into the situation. If financial markets were as Newtonian as all that, economists will not even attempt to talk-up the markets and invoke confidence multipliers, as is often the case, in terms of both policy making and economic commentaries. Soros also differentiates between the cognitive function and the manipulative function; the former pertains to our attempts to *understand the world*, and the latter relates to our attempts to *intervene in the world*. The causative model in these situations, as Soros is fond of pointing out, is different in these functions.

Direction of Causation

In the cognitive function, 'the direction of causation is from the world to the mind', but in the manipulative or participative function, 'the direction of causation is from the mind to the world'. This may seem like a common sense observation, and, in a sense, it is; but there are important theoretical implications to this seemingly simple observation that are often overlooked both in the construction and deployment of theories. Soros argues that these functions work at cross-purposes and deprive each other 'of the independent variable that would be needed to determine the value of the dependent variable'. Or, as Soros puts it, 'when the independent variable of one function is the dependent variable of the other, neither function has a *genuinely independent variable*'. So here neither the cognitive function nor the manipulative function per se can serve as a basis for human action since neither can determine the situation in its entirety; hence, the need to factor in the notion of uncertainty in the social sciences through the aegis of reflexivity. This is also the constraint that prevents economics and the social sciences from becoming hard sciences; the empirical objects that these sciences set out to describe are themselves the subject of the theoretical description.

Reflexivity in Economics

Economics then is now going through the problems of reflexivity that have already been successfully traversed by the mathematical and physical sciences in the early part of the twentieth-century. Soros' conclusion then is that the structure of social phenomena is different from that of natural phenomena and that they should therefore have different methodologies of study. To summarize, then, 'in natural phenomena, thinking plays no *causal* role and serves only a cognitive function', but 'in human affairs thinking is *part of* the subject matter and serves both a cognitive and a manipulative function'. It will not be possible to make sense of the behavior of financial markets if economists hold on to Newtonian postulates such as rational expectations. Instead, they must boldly work with alternate methodologies given that 'the symmetry between prediction and explanation' in scientific theory is missing in economics, and leads to what is known as physics envy in the social sciences. Soros attempts to apply his theory of reflexivity to the financial markets by taking aim at the efficient market hypothesis, which is the prevailing orthodoxy. Here, the main assumption is that 'markets tend towards equilibrium', and that 'deviations', if any, 'occur in a random fashion and can be attributed to extraneous shocks'. Soros disagrees with this model categorically, and goes as far as saying that either the efficient market hypothesis or his theory is right, but not both. As opposed to the prevailing view on the relationship between prices and the ability of the markets to factor in all the relevant information, Soros argues that 'market prices always distort the underlying fundamentals'. Furthermore, financial markets 'can *affect* the so-called fundamentals they are supposed to reflect'. So, unlike behavioral economics, which has understood only half the problem but not the problem in its entirety, and is content to work only with the 'mispricing of financial assets', Soros demands that we think through the implications of such a mispricing 'on the fundamentals'; hence the huge amount of discussion that has been generated on the problems of excessive leverage, feedback loops, asset bubbles, and the lack of self-corrective mechanisms in the financial markets.

Implications for Regulation

There have been a number of financial crises in recent years and it was not the self-correcting propensity of the financial markets, but 'the intervention of the authorities that saved the system'. It is therefore important to have in place effective credit controls in addition to the usual regulation of money supply through monetary policy. The most effective ways of doing so are by using tools such as 'margin requirements' and 'minimum capital requirements'. In order to prevent asset bubbles from going out of control, it is important to '*vary* margin and minimum capital requirements', since the moods of the financial markets are not stable but fluctuate, and also restrict bank lending to those sectors of the economy that are most prone to speculative bubbles. Countries which use such credit controls, Soros argues, were less affected by the recent crisis. Additional regulatory tools and measures include systemic risks which individual participants may sometimes ignore in the belief that they can liquidate their positions; but this is something that regulators have to worry about since not too many positions can be liquidated simultaneously without upsetting the system. Furthermore, it is important to subject both ordinary and synthetic securities to strict regulation along with controls on the activities and compensation of those involved in proprietary trading 'to ensure that risks and rewards are properly aligned'. While Soros does not believe that it is easy to re-institute the Glass-Steagall Act of 1933, it may still be possible to set up 'internal compartments keeping proprietary trading in various markets separate from each other'. In the context of the Basel Accords, for instance, Soros argues that it is not necessarily the case that a security held by a bank is less risky than a loan to a bank's customer. A part of the crisis was caused by the fact that the regulatory scope of the Basel Accords 'ignored the systemic risks attached to concentrated positions in securities'. It is therefore important to discourage excessive securitization of all types of loans in the banking sector by producing more accurate and effective 'risk ratings of securities held by banks'. These then are some of the things that must be done. But *when* exactly should these things be done? Opinions vary on this; some commentators feel that new regulations should be in place before the crisis is forgotten. Soros however argues that it is not easy or desirable to initiate a new regulatory regime when the economy is 'far from equilibrium'; it might be better to wait until the system becomes more stable through the interventions of the state, and by the expansion of the monetary base. But when the markets stabilize, 'the monetary base must be shrunk as fast as credit revives – otherwise deflation will be replaced by the specter of inflation'. The lesson for financial markets then is that it is not business as usual as far the efficient market hypothesis is concerned; it is important to move on to new ways of thinking. As a part of this effort, Soros is not only putting forth his own contributions in theoretical economics, but is also funding an Institute for New Economic Thinking to find alternative frameworks to understand and regulate the functioning of financial markets. Among the institutions involved in this effort include King's College, Cambridge and the Central European University, Budapest.

3. The Open Society

The attempt to set up such educational think-tanks for Soros is a part of a larger effort to institutionalize the idea of an open society. While the notion of such a society was not defined exactly by Popper, it is a society that is marked by the norms of democracy albeit without a naïve notion of markets. Popper had surveyed the history of political theory from the time of the Platonic frameworks in ancient philosophy down to the moderns, and had concluded that the notion of an open society is always under some kind of a threat. Soros' philanthropic interventions in Europe in the aftermath of the Cold War is to make the funding available to set up educational, political, and socio-economic institutions that are sorely needed to make this possible. But this does not mean that Soros believes that the production of knowledge is both necessary and sufficient to set up the sort of institutions that is the object of study in institutional economics. He is therefore always haunted simultaneously by both the possibilities and limitations of reason and knowledge in the wake of the Enlightenment. Soros argues that the role of reflexivity has not been sufficiently incorporated into its epistemology, and, that furthermore, the 'Enlightenment fallacy is also at the root of the efficient market hypothesis and its political derivative, market fundamentalism'. The implication of this for Soros is important because the notion of an open society presupposes the importance of the cognitive function, which cannot be taken for granted given the ubiquity of the manipulative function in the political discourse of all societies. The attempt to correct the mistakes of the Enlightenment, which did not recognize the importance of the manipulative function over the cognitive function, led to a situation where the manipulative function tried to displace the cognitive function altogether in the context of postmodern thought. Neither of these frameworks can account for more than half the socio-economic phenomena in question. What Soros seeks to do then is to *combine these two functions* through this theoretical framework, which recognizes the importance of the 'twin principles of fallibility and reflexivity'.

Capitalism and the Open Society

What is the relationship between market values and social values? This is a question that has been addressed by a number of political commentators including, most notably, Robert Reich. This is a question that interests Soros as well; he is also interested in the agency problem given that it affects not only the administration of firms, but those of governments in the context of a representative democracy. It is common in political discourse to look back at the founders of a nation as men of virtue who were somehow exempt from acting like agents unlike contemporary politicians who are asked to take all the blame. But what interests Soros is not blaming anybody in particular, but in understanding how market values percolate into social values such that it becomes increasingly difficult to differentiate between them leading inevitably to market fundamentalism, where what is good for the market is mistakenly thought to be good for society. This is a simple but commonplace mistake; the difference between financial capital and social capital is neither appreciated nor understood. The old moral conundrum in Adam Smith on whether individuals can further the social good by pursuing their interests or not is re-visited here under the aegis of general equilibrium theory, which does not factor in reflexive loops and the 'visible hand of the political process', and, if I may add, the 'regulatory process' while describing the mechanisms of the market. These lectures then are yet another way of resolving the traditional conflict between the frameworks in the *Wealth* *of Nations* and the *Theory of Moral Sentiments* albeit in the language of general equilibria; hence perhaps the propensity to periodic crises in the system. Soros however points out that the notion of market fundamentalism is not the same as that of the efficient market hypothesis even though it dominates many departments of economics and finance because of 'the financial support given by capitalists and foundations committed to market fundamentalism'. What then is a more effective way of conceiving of the relationship between capitalism and democracy?

4. Conclusion

The solution then is to move away from the notion of a 'political marketplace' to differentiating between the values of the 'economic and political spheres'; the citizens at large should not conflate what they do as 'market participants' with what they do as 'political participants'. While in the locus of the former, citizens should pursue their self-interest, but while in the locus of the latter, they must focus on the common interest since systemic inefficiencies will affect all parties in the political process. Soros himself has practiced this ethic: 'As a hedge fund manager I have played by the rules and tried to maximize my profits. As a citizen I try to improve the rules, even if the reforms go against my personal interests'. And, finally, Soros attempts to show readers 'the way ahead', given the recent crisis, the need to re-vamp the regulation of financial markets, and disentangle the confused relationship between market values and social values, along with the growing shift in the global economy from international capitalism to state capitalism by urging nations to move towards a more open society, to which, he hopes, the Soros lectures will be an important contribution.