Business Economics
Vol. 48, No. 2

A Dialog with George Soros

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Business Economics (2013) **48,** 89–95.
doi:10.1057/be.2013.11

Keywords: *economic theory, reflexivity, fallibility, euro crisis, sovereign debt, boom-bust cycle*

In lieu of a formal address, George Soros participated in a dialog with his colleague, Anatole Kaletsky. What follows is an edited version of a transcript of that dialog.

Anatole Kaletsky: NABE is about the application of economics in business and in the public policy arena. By any standards, George Soros has been unusually, if not uniquely, successful in doing precisely that: understanding and anticipating economic events in his business, in his philanthropy, and in his support for the tremendous political and economic changes—especially in Central and Eastern Europe—in the late 1980s and 1990s.

George, much of your life has been spent in trying to understand economic events. Paradoxically, you have not found textbook economics as taught in universities and graduate schools to be very useful in that endeavor. In many cases, it has been actually counterproductive. So what is it about your experience that has led you to a very different conception of economics?

George Soros: Basically, I found that there is a fundamental flaw in economic theory as it currently is disseminated in academic circles because it models itself on natural science, particularly on physics. However, human affairs are fundamentally different from natural phenomena because they have participants who have their own will, and their actions are based on their interpretation of reality, not on the actual state of affairs. Thus, participants' actions introduce an element of uncertainty that is actually absent in the behavior of physical objects.

Kaletsky: This has led you to advance two key concepts: reflexivity and fallibility. I understand that the concept of reflexivity is that people's expectations change the reality on which those expectations are based. That reality in turn, changes their expectations again. The result is a self-reinforcement between reality and expectations. How does that differ from the idea of rational expectations, which also claims to deal with the same thing by saying, "Well, these are the expectations, and this is how we build them into the economic model?" I think that is where your concept of fallibility comes in.

Soros: Classical economic theory started out with the assumption of perfect information, which of course is unsustainable; and then it became the presupposition that the markets always know more than any individual. I think that is a false assumption, which led to a false interpretation that in turn led to an axiomatic system that does not resemble reality very much.

Kaletsky: So it is really the interaction of these two concepts of fallibility and reflexivity that creates a very different conception of economics.

Presented on the occasion of George Soros being given NABE's Adam Smith Award at the NABE Annual Meeting on October 15, 2012.

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Anatole Kaletsky is the Chairman of the Governing Board of the Institute for New Economic Thinking and a columnist for Reuters. He is an award-winning journalist and financial economist who has written for *The Economist*, the *Financial Times*, and *The Times of London*. His recent book, *Capitalism 4.0*, about the reinvention of global capitalism after the 2008 crisis, was nominated for the BBC's Samuel Johnson Prize, and has been translated into Chinese, Korean, German, and Portuguese.

Soros: Yes, because if people's understanding was not fallible, then you would not have reflexivity, which is a two-way interaction between perceptions and the actual state of affairs. There has to be some divergence between them. If you assume that there is no divergence, then there is no two-way interaction. However, the assumption of no divergence between perception and the actual state of affairs does not hold up.

Kaletsky: The reason I wanted to bring that up is that it is obvious that there is no precise model of the economy, but the strange thing is that in theoretical economics—at least for the last 30 years—there has been the assumption that somewhere out there, there is a correct model. If you assume that correct model, then your whole idea of reflexivity becomes irrelevant, but if you assume that there is no correct model, then a totally different world opens up.

Soros: Yes. Basically, my conceptual framework is actually common sense, and it is a framework that is difficult for people to understand because it is so simple. In theoretical economics, you have developed an axiomatic system in order to rival the achievements of Newtonian physics, of having universally valid generalizations that can be used interchangeably both to predict and to explain events. That can be done in physics but not economics because of economics' uncertainty, which is inherently impossible to calculate—Knightian uncertainty [Knight 1921]. Since Knight discussed it over 90 years ago, there is nothing new about this concept.

Kaletsky: Perhaps the reason that this is called the Adam Smith Award is that in many ways there are not too many new things in economics. A lot of economics is about rediscovering ideas that were forgotten or deliberately suppressed over the last one or two generations. Could you give us some concrete instances of how the concepts of reflexivity and fallibility have helped you operate? Maybe you could give us an example of how it has helped you to understand some important phenomenon in the financial markets. Also, I would like to come to more of a geopolitical issue, like what is going on in Europe today.

Soros: Well, actually, you can combine the two because the euro crisis is the most convincing demonstration of how misconceptions can create a situation that has the qualities of a nightmare. These misconceptions are having a tremendous impact on the actual state of affairs. They are pushing the European Union into a lasting depression. And it is almost entirely self-generated.

First, look at how this situation came to be. Let us say you go back to the financial crash of 2008, when private financial credit collapsed and required the substitution of sovereign credit, either through the actions of the central bank or of the government through fiscal deficits. This made sovereign debt very important, and that revealed some flaws in the construction of the euro that were until then hidden.

The architects of the euro were fully aware that they were creating an incomplete currency, that they created a central bank but did not have a central treasury. But they believed that when this deficiency became important, they would be able to generate the political will to take the next step forward in introducing the next phase in the integration. That is actually how the European Union was formed, starting with the Coal and Steel Community, step by step, taking one step at a time, generating the political will, having a timetable, and knowing that when you take that next step, it would not be sufficient. It would require another step and then you would slowly build up.

This was a feat of what Karl Popper called piecemeal social engineering. It was perhaps the most successful—at least temporarily successful—feat of piecemeal social engineering in modern economic history. That is how the process was created: it was a dynamic disequilibrium moving forward toward greater and greater integration.

Kaletsky: So, this process actually worked very well, with flawed concepts over time correcting themselves and leading to other flawed concepts. So why is it no longer working? What happened to change it?

Soros: The process culminated with the reunification of Germany and the introduction of the euro, which were connected. Reunification was a very big step forward, which was then followed by a period of digestion. You might call it stagnation in moving further because you had to digest this important step. Then, following the financial crisis of 2008, you had the beginning of a process of disintegration, which could be identified clearly—at least I did—when the finance ministers of the

European Union left the meeting of the IMF in October 2008. They declared that no other major financial institution—after Lehman Brothers—would be allowed to fail. However, Chancellor Merkel of Germany said that this guarantee had to be carried out by each state individually, not by the European Union collectively.

The emphasis on individual states rather than the European Union collectively was the first step toward the process of disintegration, which has been gathering speed ever since. This whole process has a strange resemblance to a boom-bust model, which I had constructed for the financial markets. It happened to be a political process, but it shows that this reflexive interaction is not only characteristic of financial markets; it is a characteristic of all human situations, including politics.

Kaletsky: For those people here who have not read your book [Soros 2008], what do you mean by this boom-bust process? What is your structure of the boom-bust cycle?

Soros: One's thinking can be divided into two functions. The first is a cognitive function, where you try to adjust your interpretation or perception of reality to the actual state of affairs, so you try to understand the world. The second is the participating or active function, or manipulating function, where you want to change the world to meet your objectives.

The two functions work in opposite directions and they create a feedback mechanism connecting perceptions and the actual state of affairs. That feedback can be either positive or negative. So as long as there is a divergence and you do not have perfect knowledge between the two, then a positive feedback reinforces both the prevailing trend and the divergence of perception from that trend, and the negative feedback corrects.

Kaletsky: Your classic example of that is the credit cycle. Perhaps you could describe how that process works in the credit cycle with collateral and so on. Then, perhaps, you could relate it to Europe.

Soros: The most typical crisis has to do with real estate, where, when you have an increase in credit, it has the effect of increasing the value of the collateral supporting the credit. It is self-reinforcing in the sense that the performance of loans tends to improve during the boom. This implies that credit conditions generally are relaxed rather than tightened until you develop a feedback where people invest and buy based on their anticipation of an increase in value rather than on their actual ability to service the debt. When that happens, you have a boom-bust process that eventually becomes unsustainable. Then you have acceleration on the downside, where unsound collateral has to be liquidated, depressing its price.

Kaletsky: This is very similar to a Minsky cycle. Now, the interesting thing is that you also apply it in politics and geopolitics. So going back to the case of the euro, I understand you to say that during the buildup of the European unity cycle there was a belief that European unity would become closer and closer. Therefore, even when flawed constructions like the euro ran into trouble they would be corrected and reinforced. Then, at that point in October 2008, Chancellor Merkel—reacting to German public opinion—said that each state would act independently. From this point on, Europe entered the disintegration phase.

Soros: Angela Merkel is a very capable democratic politician who read the prevailing views of the German public correctly, and those views had changed. At the time of the reunification, Chancellor Kohl recognized that to reunify Germany, it could only be done in the context of a stronger European Union to make it acceptable and to make it happen. So, Germany was the leader for greater integration, which Mitterrand used to get German agreement to the introduction of a common currency, much against the resistance of the Bundesbank at the time. Finally, however, the Bundesbank realized that they could not stop the common currency, so they tried to introduce certain conditions that made the euro have all the characteristics of the Deutsche mark itself, which was quite understandable. That, however, created some serious problems when the financial crisis broke out.

During the integration phase, however, Germany was always willing to do a little bit extra, to add a little bit to the part so that everybody could strike bargains—when, for example, Margaret Thatcher raised objections—and make the euro move forward.

Also, you had the cost of paying for the absorption of Eastern Europe—especially the reunification Eastern Germany on a one-to-one basis into West Germany, which was very expensive.

Therefore, Germany had to tighten its belt and introduce structural and labor market reforms and so on—increasing its competitiveness.

The introduction of the euro, which had some flaws in it, led to the European Central Bank accepting government bonds and lending 100 percent to banks. This set up a tremendous, false incentive for commercial banks to buy up the bonds of the weaker countries, narrowing the intercountry differential. This generated a boom in what are now called the periphery countries, the weaker countries, which had the benefit of lower interest rates, creating a housing boom and a consumption boom, thus reducing the competitiveness of those countries.

Kaletsky: So the integration cycle came to an end or was reversed by German public opinion. This is a classic process like the collateral phenomenon. As the spreads narrowed, it made it appear as if Spain and Italy were doing just as well as Germany, while the reality was that actually, fundamentally they were getting less and less competitive. Now, the moment of truth has come, and we are in the bust phase of the cycle.

I think that is another very good, concrete example of how reflexivity combined with what you call the bias, the inherent errors in assumptions, lead to long swings on the way up and down and all sorts of errors.

Soros: There is also a remarkable similarity between the international banking crisis that occurred in 1982 and the euro crisis, where the international financial institutions—led by the IMF—had to protect the banking system. In order to do that, they were lending just enough money to the debtors to enable them to service debt; and they exerted pressure on the banks to renew loans in order to keep the system from collapsing. It worked, but the effect was to push Latin America and South Korea into what is called a lost decade, and something very similar is now happening in Europe.

Kaletsky: Yes, and the point that you made in your article in the *New York Review* [Soros 2012] is that the most likely outcome of what is going on in Europe is that it will just manage to maintain the *status quo*. It will just manage to muddle through in terms of not breaking up the euro; but that will have the effect of increasing the fundamental macroeconomic divergences and cause a lost decade, if not more, in Southern Europe.

Soros: The line of least resistance leads to Germany doing the minimum to keep the euro together. But the minimum is not enough to allow the debtor countries to work their way out of their situation. Effectively what the euro did—and this was totally unexpected by everybody, including me—was to actually turn the debtors countries into the equivalent of a less developed country that has borrowed in a foreign currency because it has given up the right to print money. Therefore, the possibility of default—which normally can be disregarded in a country borrowing in its own currency—became a reality. Thus, you have credit risk. Whereas the whole euro system was built on the false assumption that a government is riskless, some governments turned out to have very serious credit risk. And that is really the fundamental flaw that has now been uncovered and needs to be corrected, basically by introducing euro bonds.

However euro bonds are politically unacceptable in Germany, which does not want to be the deep pocket for the rest of Europe. That is the tragedy of this situation: Germany is not acting with bad will, but the net result is that the divergence between creditors and debtors is getting wider and is likely to become permanent.

Kaletsky: Your emphasis on the flaw in the concept of sovereign debt, its default risk, and so on is a good segue into the last theme that I want to talk to about—a sort of boom-bust cycle of ideas—which is what led to the formation of the Institute for New Economic Thinking (INET). When we first discussed it, I suggested to you that something like INET could be created after the 2008 crisis. One of the arguments was that economics itself, as an academic discipline and an intellectual activity, has also been subject to a kind of boom-bust process. For the 25 or 30 years up to 2008, there was an intensifying boom in a conception of economics that had been created based on the rational expectations hypothesis and the efficient markets hypothesis, with various identifiable exceptions. This conception, it has been held, could totally explain the world and could actually deliver the sort of detailed analytical, theoretically rigorous mathematical results that had always eluded economics in the past.

That conception, which we agree was clearly false, was actually reinforced for about 20 years by the apparent success of central banks and public policymakers, who appeared to be implementing that concept of economics and creating this wonderful period of 20 years of stability—The Great Moderation, and so on. In a way, this was the same kind of reflexive process that made people more and more confident in the theories on which The Great Moderation was based. And that, in turn, reinforced The Great Moderation. Now, of course, that all blew up in 2008.

Soros: Right. The Great Moderation led to the crash.

Kaletsky: Also, I think it undermined—or at least should have undermined—the confidence that economists had in the theories that had been behind The Great Moderation. The strange thing is, though, if you observe the way that economics is taught and to a large extent practiced, the reinvention of economics has not happened.

Soros: I agree with that. I think there is now a recognition that something is fundamentally flawed, but exactly what should take its place has not yet evolved. INET has been created in order to explore the possibilities, and I take great pleasure and pride in being the founder of INET. However, I am in a somewhat peculiar position that I also am a contender for an alternative interpretation that has not yet been developed. In other words, there is the kernel of a conceptual framework, but it is not yet anything like a developed discipline. In fact, when I originally proposed it, I called it the alchemy of finance because it does not meet the standards and criteria that apply to natural science; and I argue that those standards and criteria actually cannot be met.

This is where I differ from my spiritual mentor and actual mentor, Karl Popper, who proposed the doctrine of the unity of science. I take the opposite point of view that there is a very fundamental difference between natural science—say physics—and economics or politics. However, this divergence is not quite as sharp as I draw it because it is only with physics. If you take, let us say, evolutionary systems like the biology, the mutation of genes plays the same role as false doctrines play in human affairs. So it is a more gradual transition from the study of the natural world to the social world.

Kaletsky: I agree that there is a gray area, and the big mistake that economics made for a while was trying to mathematize itself to the point of imitating physics rather than other social or even natural sciences, which are closer to economics. I think medicine is a good example, where there is—by its very nature—a constant combination and interaction of hard scientific fact and judgment about human nature.

This concludes the dialog between Soros and Kaletsky. The session then turned to questions from the audience.

Kaletsky: We will try to summarize these questions and touch on as many of them as possible. The first one concerns what economics should be doing and what INET is doing. What schools of thought or lines of inquiry are promising for developing the discipline? A related observation and question says: "It seems to me that 50 years ago, graduate programs had a much greater emphasis on economic history. Do you believe that this de-emphasis is part of the problem?"

I think that I can answer that on behalf of both of us. Yes, the de-emphasis on economic history is part of the problem, and that is partly why we created INET and the kind of directions that we are supporting in INET—the recognition of economic history and much greater study of the history of economic thought, so that people are not either reinventing the wheel, or if they are, are aware of it.

On the other end of the scale, INET is supporting the study of complexity economics, using advanced computing simulations for agent-based models, an area called imperfect knowledge economics. This is very closely related to the concepts of inherent fallibility that George has been talking about. Also, INET supports institutional analysis and the way that relates to economics and psychological and sociological analysis, not just behavioral economics, which has been very useful. In a way, however, behavioral economics is trying to just come up with a different form of rational expectations. We believe that it is important to support research in economics that does not make any *a priori* assumptions about the way that people will behave, because that behavior is changing.

Soros: I would add the importance of political economy, economic history, and an emphasis on the context-related hypothesis rather than the universally valid hypothesis. I also think that behavioral economics represents or contains one half of reflexivity, namely the divergence between the actual state of affairs and people's behavior, which is full of bias. However, it does not study or account for the impact of the bias on the actual state of affairs, which is what you need to complete the picture.

Kaletsky: Now we will go to other themes. What are your thoughts on the Chinese economy as a prospect for one of your boom-bust cycles?

Soros: Well, it is very interesting because the Chinese growth model, which has worked, is running out of steam because consumption as a percentage of the GDP has fallen from about 50 percent to one third, which is too low. Of course, in the United States, it is two thirds, which is too high. In China, the household sector has been subsidizing the state-owned enterprises and their investments through negative real interest rates. This cannot continue forever. It could continue for another year or two, but not for 10. And now you have a change in leadership, which is supposed to last for a decade. Its task is to modify the growth model and somehow allow the household sector to have a bigger share of GDP. How to get there is the big question.

Kaletsky: Do you think that they can deliver? You are a great observer of the breakup of the Soviet system. Do you see similarities there or not?

Soros: Right now, the most burning question is what happens to the euro. For the future of humanity, however, what happens to China—whether it will become a more open society or a more repressive society—is the most important question. I do not know which way it will go. Therefore, I do not know whether there will be similarities to the break-up of the Soviet system. But whether the path of the future is dominated by a trend toward open or repressive societies is one of the most important issues confronting, not just China, but the world.

Kaletsky: Another question concerns the general, broad liquidity environment? Are central banks, through their commitment to maintaining low interest rates for a very long period and the provision of high liquidity, contributing to growing financial imbalances? Do you see signs that the current expectations of future monetary policy are going to cause future problems, or do you think that what the central banks are doing is necessary and right in these circumstances?

Soros: I think that what the central banks are doing is actually necessary to prevent a depression. However, they are engaged in a very delicate two-phase maneuver. First is to increase the quantity of money available. Second, eventually, they will have to reduce it when the economy resumes a faster rate of growth. Right now, we are in the first phase.

How you will complete the second phase is the big, open question. It is conceivable that it can be done, but it has not yet been done. Until then, the possibility that eventually you could have much greater inflation is a very real one.

Kaletsky: Is the breakup of the euro now an existential threat, not just to Europe, but to the whole global financial system?

Soros: I think that there is a real danger of the euro destroying the European Union. There are two ways to escape this outcome. One is for Germany to accept the hegemonic position that it currently occupies and accept a greater collegiality or commitment to helping, not only looking after Germany's interest but also looking after the interests of the debtor countries. This means that it must play the role of a benevolent hegemon, the same way as the United States became a benevolent hegemon of the free world after the Second World War by engaging in the Marshall Plan.

Now, of course, the Germans would say that the Marshall Plan took 3 percent of U.S. GDP, whereas the euro bonds would expose 150 percent of Germany's GDP, which is a serious consideration. I think if Germany taking this role is successful, it would not cost anything or very little; but if it failed, it would drag down Germany. So that is one possibility.

The other possibility would be—and this is rather a shocking proposal—for Germany to leave the euro. Then the euro problem would simply disappear into thin air, because the euro would go down in value. Therefore, the non-euro value of the debt would go down with the euro, and the debtor countries would become much more competitive. Thus, they would grow their way out of their debt. This would mean that all the burden of adjustment would then shift to Germany because the value of its currency relative to the euro would go through the roof, and it would also suffer financial losses in having investments denominated in euros. So, instead of all the burden of adjustment being on the debtor countries, and creating this deflationary debt trap, it would then shift to Germany.

The surprising thing is that the fiscal indicators for the Eurozone, even without Germany, would not be any worse than they are for the United States and the United Kingdom.

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