The Crisis of Global Capitalism. By GEORGE SOROS. New York: PublicAffairs, 1998. Pp. xxx + 245.

George Soros—immigrant, billionaire speculator, philanthropist, philosopher—thinks he has a lot to tell us about the problems of global capitalism, by which he mostly means international capital flows. His thesis is that financial markets are prone to instability from destabilizing speculation and that this instability threatens the global capitalist system unless reforms—some form of global governmental regulation or national capital controls—are immediately adopted. No details on possible solutions are presented, however. The book is full of long-winded philosophy and a naive critique of economics but lacks detailed proposals for reform or analysis of the mechanics of financial markets. There is very little to recommend it.

Part 1 of "The Crisis of Global Capitalism" lays out Soros' conceptual framework, beginning with what he considers to be a critical difference between the natural and social sciences (e.g., economics). Soros believes that progress in the social sciences is "impossible" because of a phenomenon that he calls "reflexivity." Reflexivity means that economic agents' perceptions and expectations influence events, which, in turn, influence expectations. Soros calls the differences between perceptions and reality "bias." In financial markets, reflexivity and bias create destabilizing speculation; international capital markets will allocate too much or too little capital, destabilizing societies. Soros briefly discusses how trend-following trading rules, risk management techniques and delta-hedging might also contribute to destabilizing speculation.

The second part of the book attempts to apply the conceptual framework to current events. Although Soros lauds the international monetary authorities for preventing disaster in 1982, 1987, 1994 and 1997, he argues that international regulations have not kept pace with the pace of integration of international financial markets. Consequently he asserts that countries with free capital mobility have fared worse in the current crisis than those that maintained capital regulation. Two factors are cited as exacerbating the effect of the crisis on debtor countries: the IMF-recommended austerity programs and the traditional “rules of the game” that favor lenders over borrowers in an international debt crisis.

The book argues it is likely that the global capitalist system will fail the current test or the next one, unless its deficiencies are corrected. Such corrections would ideally include an international body/lender of last resort to regulate or insure capital flows—although he acknowledges the moral hazard created by past IMF bailouts. If such action is not taken, Soros foresees the widespread emergence of national capital controls. Soros is vague on the details of solutions:

> *“This is about as far as I want to go in prescribing solutions. Perhaps I have already gone too far. All I wanted to do was to stimulate a discussion out of which the appropriate reforms may emerge.”* (Soros, p. 194)

During the latter parts of the book Soros discusses the events of the Asian and Russian crises but provides little in the way of new information or insight.

It is not clear whether it was more difficult to read Soros’ turgid prose or to distill it in some sensible fashion. Soros spends long chapters explaining how his view of financial markets is informed by his knowledge of modern philosophy, especially his study under the philosopher Karl Popper in London. This book is very unpleasant to read; Soros never uses one word where three or four will do. The verbosity is put to work creating a new vocabulary of new terms for common or ill-defined concepts:

> *“A regime is a set of social conditions that hang together sufficiently so that they coexist in reality, although in accordance with my working hypothesis there is bound to be something deficient or missing in their relation, so that they sow the seeds of their own destruction.” (Soros,*

p. 67)

“Market fundamentalist,” for example, is Soros’ emotive term for advocates of laissez faire policies.

> *“This phrase [market fundamentalists] is better because fundamentalism implies a certain kind of belief that is easily carried to extremes.” (Soros, p. 127)*

Soros rebukes these anonymous agents for foiling attempts at reasonable market regulation; he believes that “market fundamentalism” poses a great threat to “open society,” by which he means non-totalitarian society.

In Soros’ view the “market fundamentalists” have been intellectually buttressed by an economics profession that has elevated efficient outcomes above all other values. The chief failing of the economics profession allegedly has been to ignore the concept of “reflexivity”—the idea that expectations can influence outcomes—in favor of the static concept of equilibrium. Soros contrasts his own success in financial markets with the failure of Long-Term Capital Management and cites this as evidence of the irrelevance of financial economics.

Soros is not specific about who the market fundamentalists are or what, precisely, they favor. For example, the only “market fundamentalist” Soros names is Milton Friedman and—rightly or wrongly—Friedman’s views do not govern public policy. In the real world, government intervention in and regulation of financial markets is the rule rather than the exception and proposals for controlling international capital movements have been advocated by prominent mainstream economists like Paul Krugman and Jagdish Bhagwati. It is even harder to imagine Robert Rubin or Larry Summers being described as a “market fundamentalist.”

Unfortunately, this is not the only area in which Soros is maddeningly ambiguous about his argument or evidence. Soros’ failure to discuss specific and detailed solutions to capital flow instability is particularly disappointing. Although he mentions capital controls and his proposal for an international lending guarantor, he doesn't delve into the details of such a solution. In his discussion of capital controls, he mentions that his fund found it almost impossible to short the Irish punt in 1992 due to capital controls. Given the consensus of the academic literature on the ease of evading capital controls during a speculative attack, I eagerly awaited Soros' apparently contrary views on how to construct useful controls on capital outflows. No details were forthcoming, however. I also found some of Soros' discussion of the sources of trend-following, destabilizing behavior to be tantalizing, but these too, were far too cursory. While blaming international capital mobility for the crisis, Soros pays practically no attention to prudent regulation of the domestic financial sectors of the debtor countries or the proper sequence of economic reforms.

Having rationed his views in his area of expertise, Soros uses the space to criticize financial economics, a discipline that he admits to know little about:

> *"I have to confess that I am not familiar with the prevailing theories about efficient markets and rational expectations. I consider them irrelevant and I never bothered to study them because I seemed to get along quite well without them…" (Soros, p. 41).*

Many people would hesitate to critique a subject they were not familiar with; perhaps this boldness helps explain his financial success. Unfortunately, Soros—a 1950s graduate of the London School of Economics—is not only unfamiliar with efficient markets but also with more basic economic concepts: He consistently depicts equilibrium as a static concept.

> *"Equilibrium itself has never been observed in real life—markets have a notorious habit of fluctuating." (Soros, p. 36)*

The idea that equilibrium prices change in response to constantly changing information about fundamentals is never considered. Neither does he understand the role of uncertainty:

> *"Let me cite an obvious example from the world of finance. If people could act on the basis of*

scientifically valid knowledge, then different investors would not be buying and selling stocks at the same time." (Soros, p. 6)

Of course, the "obvious" statement is not true. Heterogeneous investors—e.g., a young one and an old one—will voluntarily trade assets even in a world of perfect information and no uncertainty about future returns.

Although Soros knows of Keynes' beauty contest analogy, he inexplicably seems to think that economists ignore expectations ("reflexivity") and imperfect/asymmetric information and are unacquainted with phenomena such as band-wagon effects, fads, trend-following behavior and multiple equilibria. It is difficult to conceive of a more mistaken understanding of the profession's research in the last 10-15 years. Several counterexamples come immediately to mind. Frankel and Froot (1990) speculated on the role of trend-following behavior in the rise of the dollar in the 1980s, Shleifer and Summers (1990) examined the risks of speculating against bubbles and Obstfeld (1997) studied models with multiple equilibria. Soros also seems to think that the danger of off-balance sheet derivative activities of banks was exposed for the first time by the Russian default in August 1998. This misconception might have been put to rest by reading Mishkin's (1997) standard text, *The Economics of Money, Banking and Financial Markets*, written well before the Russian default. More trivially, Soros credits Brian Arthur for recently developing an old idea: Frank Graham's (1923) research on the optimality of tariffs under increasing returns.

"Brian Arthur and others have developed the concept of increasing returns... This theory has undermined one of the most hallowed conclusions of economic theory, namely, the optimality of free trade" (Soros, p. 39).

Soros does not explain why the failure of Long-Term Capital Management—an enormously levered hedge fund during a major default—is damning to financial economics. The helpful advice that financial economics has provided for millions of ordinary investors, to buy and hold a diversified portfolio, goes unrecognized by Soros.

Despite misunderstanding simple concepts like equilibrium, Soros is aware of some sophisticated concepts like the difference between risk aversion and loss aversion. This puzzles me. How does Soros get enough information to cite *Econometrica* articles and yet grossly misunderstand elementary economics?

"The Crisis of Global Capitalism" was very disappointing. Instead of providing the reader with his vast experience and expertise in the practice of finance and the mechanics of speculative attacks, Soros has deluged us with windy amateur philosophy and a profoundly mistaken critique of economics. The great danger of the book is that non-economists will take seriously his ill-founded criticism of economic research. Don't buy this book.

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