GEORGE SOROS

The Alchemy of Finances
Reading the Mind of the Market

Second Edition.
John Wiley & Sons, New York 1994.
378 pages, 83 figures, 39 tables.
ISBN 0-471-04313-3 (cloth), -4 (paper)

The book of George Soros, a pound sterling billionaire who started from scratch as a 1946 emigree from Budapest to London, is concerned with both theory and practice of money-business and with his ideas on the New World Order. It consists of 5 parts, which will be reviewed in sequence.

I. **THEORY: The Theory of Reflexivity, Reflexivity in the Stock and Currency Market, The Credit and Regulatory Cycle.** The Soros' theory starts with notion of *reflexivity*, using the world *as a verb whose subject and object are the same.* Soros continues: *Using simple mathematics, reflexivity can be depicted as a pair of recursive functions:* $y = f(x)$ *...cognitive function,* $x = \phi(y)$ *...participating function. Therefore* $y = f[\phi(y)], \quad x = \phi[f(x)]$. *This is the theoretical foundation of my approach. The two recursive functions do not produce an equilibrium but a neverending process of change. The process is fundamentally different from the processes that are studied by natural sciences.* So Soros rediscovered the feedback explicitly used, at least from the time of Bode's Network Analysis and Feedback Amplifier Design, Princeton 1945. We may go back even to Newton's Principia, 1687 where on the difference to Galileo's explicit solutions of some simple problems the implicit equations are introduced. Preceding the Soros' model were also the Forrester-Meadows' global models of the world dynamics from 1960s and 1970s. We continue quoting Soros: *... theory is a kind oj dialectic. It can be interpreted as a synthesis of Hegel's dialectic and Marx's dialectical materialism.* Soros then applies reflexivity to the stock market. He continues: *... it is the market I am most familiar with: I have been a professional investor for more then 25 years... I replace the assertion that markets are always right with two others: markets are always biased in one direction or another; markets can influence the events that they anticipate.* Then Soros applies reflexivity to the currency market. Here he presents some qualitative model described by some steno. His currency model have 4 quantities: N nonspeculative capital flow, S speculative capital flow, T trade balance, B government budget, and 4 rates: e nominal exchange rate (number of foreign currency units for one domestic currency unit), i nominal interest rate, p domestic versus foreign price level, v level of economic activity. Further he uses $\uparrow$ for increase, $\downarrow$ for decrease and $<$, resp. $>$ for showing order of magnitude. E.g., the simplest model of a freely floating exchange rate system is: $(\downarrow T + \uparrow N + \uparrow S) \rightarrow \downarrow e$. In next, Soros remarks: *Financial history is best interpreted as a reflexive process in which there are two sets of participants instead of one: competitors and regulators.* Reviewer's comments: is is advantageous to invest on information and/or supervisory regulation on future regulation.

II. **HISTORICAL PERSPECTIVE: The International Debt Problem, The Collective System of Lending, Reagan's Imperial Circle, Evolution of the Banking System, The "Oligopolarization" of America.** The international debt problem is treated as narrative, starting form 1972. The colossal uncertainties of free-world market economy are stressed. Soros opposes Friedman's monetarism and supports interventions from legislators, governments or central banks. The collective system of lending continues in the narrative style and critics, now even self-critics. Reagan's imperial circle is Soros name for *self-reinforcing process ... in which a strong economy, a strong currency, a large* *budget deficit mutually reinforced each other to produce noninflationary growth... Reagan, despise his intellectual limitations, seems to had a better understanding of what was possible than did his economic advisers.* Evolution of the banking system – we quote the last sentiences: *Now that the regulators have put to uncontrolled expansion, many of the excesses are beginning to surface. Only the decline in interest rates has saved us from an avalanche of insolvencies.* By the "oligopolarization" of America are meant mainly the consequences of "mergermania", involving the largest entities in corporate America. Reviewer consists this part of Soros sad narrative paradoxically refreshing – with respect the reading of Samuelson, Friedman and hearing official calming broadcasting from BBC, VoF and RFE which the reviewer did in 70s and 80s.

III. **THE REAL TIME EXPERIMENT: August 1985 – November 1986.** This 156 p. part is the crucial real data part for the whole book, full of graphs and tables. Nevertheless, instead of describing in detail how successful was Soros as an investor, we quote some of his notes: *The fatal flaw of a free market system is its inherent instability. The belief that financial markets are self-regulating is simply false.[...] Fortunes are made in financial deals and shareholders wield more power than at any time in the last fifty years; at the same time, bankruptcies are also at a fifty-year high, in both size and numbers.*

IV. **EVALUATION: The Scope for Financial Alchemy – An Evaluation of the Experiment, The Quandary of the Social Sciences.** We will restate Soros' Alchemy in our our terms: stock speculation is the antagonist, zero sum game played against the other speculators. It has nothing to do with physical economy growth.

V. **PRESCRIPTION: Free Markets Versus Regulations, Toward an International Central Bank, The Paradox of Systemic Reform, The Crash of '87.** Soros starts: *I examined various financial markets as well as macroeconomic developments and showed that they exhibits no tendency towards equilibrium. Indeed, it makes more sense to claim that markets tends towards excesses, which sooner or later become unsustainable.* The dilemma for Soros have been Open Society versus Closed Society: up to now Soros was strong advocate of the open society. The term have been coined by Bergson, then much publicized by Popper, lately applied in praxis by Popper's former student Soros. The main advocate of the closed society was Plato in his Republic (Constitution), the main advocates of open society are the liberals, incl. Popper and Soros. Bluntly speaking, a land with the open society is the land which is controllable from abroad by the flux of money. It is the first time in this book that Soros is afraid of the openness of the society as the source of the unstability. He suggest to cure this by the central banks and more over by the International Central Bank.

Only at the very end of the book, at the last rows of the back envelope, there is characterization of Soros which gives at least partial explanation of Soros' success – in the economic term of the comparative advantages: headquarters of Soros' investment firm Quantum Fund are based in Manhattan, N.Y. (so with best connections with the rest of the world), nevertheless Quantum Fund is registered in Çuraçao. We add, that this Antilles island in the Caribbean, the colony of Netherlands, is free from any state financial control.

The reviewed book, written by both practicizing, theoretizing, and philosophizing economist, is concerned with very interesting theme. Nevertheless, the author is not avare neither of the control theory nor of the dynamical systems. In both there is the fundamental notion of the state of the system. It is likely over the intellectual power of any person to start construct some (deterministic) chaos theory without the system-theoretical notion of the system state.

Antonín Vaněček