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Why I agree with (some of) Hayek

By: George Soros
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Friedrich Hayek is generally regarded as the apostle of a brand of **economics** which holds that the market will assure the optimal allocation of resources — as long as the government doesn't interfere. It is a formalized and mathematical theory, whose two main pillars are the efficient market hypothesis and the theory of rational expectations.

This is usually called the Chicago School, and it dominates the teaching of economics in the United States. I call it market fundamentalism.

I have an alternative interpretation — diametrically opposed to the efficient market hypothesis and rational expectations. It is built on the twin pillars of fallibility and reflexivity.

I firmly believe these principles are in accordance with Hayek's ideas.

But we can't both be right. If I am right, market fundamentalism is wrong. That means I must be able to show some inconsistency in Hayek's ideas, which is what I propose to do.

Let's start with Hayek's influence on the twin pillars of my interpretation. I was a student at the London School of Economics in the late 1940s and read the great methodological controversy between Karl Popper and Hayek in Economica, the school's periodical.

I considered myself a disciple of Popper. But here I was on Hayek's side. He inveighed against what he called "scientism" — meaning the slavish imitation of Newtonian physics. Popper took the opposite position. He argued in favor of what he called the doctrine of the unity of science — that the same methods and criteria apply to all scientific disciplines.

I was drawn to this controversy by my interest in Popper. I had read his book, "Open Society and its Enemies," in which he argued that the inconvertible truth is beyond the reach of the human intellect, and ideologies that claim to hold this truth are bound to be false. Therefore, he argued, they can be imposed on society only by repressive methods.

This helped me see the similarity between the Nazi and communist regimes. Having lived through both in Hungary, it made a great impression.

This led me to Popper's theory of scientific method. Popper claimed that scientific theories can never be verified — they can only be falsified. So their validity is provisional — they must forever remain open to falsification by testing. This avoids all the problems of needing to prove scientific theories beyond any doubt and establishes the importance of testing. Only theories that can be falsified qualify as scientific.

While I was admiring the elegance of Popper's theory, I was also studying elementary economics. I was struck by a contradiction between the theory of perfect competition, which postulated perfect knowledge, with Popper's theory, which asserted that perfect knowledge was unattainable. The contradiction could be resolved by recognizing that economic theory cannot meet the standards of Newtonian physics.

That is why I sided with Hayek — who warned against the slavish imitation of natural science and took issue with Popper — who asserted the doctrine of unity of method.

Hayek argued that economic agents base their decisions on their interpretation of reality, not on reality — and the two are never the same.

That is what I call fallibility. Hayek also recognized that decisions based on an imperfect understanding of reality are bound to have unintended consequences. But Hayek and I drew diametrically opposed inferences from this insight.

Hayek used it to extol the virtues of the invisible hand of the marketplace, which was the unintended consequence of economic agents pursuing their self-interest. I used it to demonstrate the inherent instability of financial markets.

In my theory of reflexivity I assert that the thinking of economic agents serves two functions. On the one hand, they try to understand reality; that is the cognitive function. On the other, they try to make an impact on the situation. That is the participating, or manipulative, function.

The two functions connect reality and the participants' perception of reality in opposite directions. As long as the two functions work independently of each other they produce determinate results. When they operate simultaneously they interfere with each other. That is the case not only in the financial markets but also in many other social situations.

I call the interference reflexivity. Reflexivity introduces an element of unquantifiable uncertainty into both the participants' understanding and the actual course of events.

This two-way connection works as a feedback loop. The feedback is either positive or negative. Positive feedback reinforces both the prevailing trend and the prevailing bias — and leads to a mispricing of financial assets. Negative feedback corrects the bias. At one extreme lies equilibrium, at the other are the financial "bubbles." These occur when the mispricing goes too far and becomes unsustainable — boom is then followed by bust.

In the real world, positive and negative feedback are intermingled and the two extremes are rarely, if ever, reached. Thus the equilibrium postulated by the efficient market hypothesis turns out to be an extreme — with little relevance to reality.

Frank Knight was the first to identify the unquantifiable uncertainty inherent in financial markets. John Maynard Keynes and his followers elaborated his insight.

Classical economists, by contrast, sought to eliminate the uncertainty connected with reflexivity from their subject matter. Hayek was one of them.

The methodological debate in Economica took place in the context of the larger political controversy over the role of the state in the economy. Hayek was on one side, Keynes and socialist planners on the other.

But Hayek subordinated his methodological arguments to his political bias. That is the source of his inconsistency. In the Economica, he attacked scientism. But after World War

II, when the communist threat became more acute, he overcame his methodological qualms and became the apostle of market fundamentalism — with only a mild rebuke for the excessive use of quantitative methods in his Nobel Prize acceptance speech.

Because he was fighting communism, a scientific theory that proved that market participants pursuing their self-interest assure the optimum allocation of resources was too convenient for him to reject. But it was also too good to be true.

Human beings act on the basis of their imperfect understanding — and their decisions have unintended consequences. That makes human affairs less predictable than natural phenomenon. So Hayek was right in originally opposing scientism.

At the time of the Economica articles, Popper was between Hayek and the socialist planners. He was just as opposed as Hayek to communism's threat to individual liberty, but he advocated what he called piecemeal social engineering rather than laissez-faire.

Here I sided with Popper. But Popper and Hayek were not that far apart. I was influenced by both — and I also found fault with both.

By identifying Hayek's inconsistency and political bias, I do not mean to demean him — but to improve our understanding of financial markets and other social phenomena. We are all biased in one way or another and, with the help of reflexivity, our misconceptions play a major role in shaping the course of history.

Because perfection is unattainable, it makes all the difference how close we come to understanding reality. Recognizing that the efficient market hypothesis and the theory of rational expectations are both a dead end would be a major step forward.

As in that earlier time, the political controversy on the role of the state in the economy is raging today. But the standards of political discourse have greatly deteriorated. The two sides used to engage in illuminating arguments; now they hardly talk. That is why I was so pleased to accept this invitation to the Cato Institute.

As I see it, the two sides in the current dispute have each got hold of one half of the truth. which they proclaim to be the whole truth. It was the hard right that took the initiative by arguing that the government is the cause of all our difficulties; and the so-called left, in so far as it exists, has been forced to defend the need for regulating the private sector and providing government services.

Though I am often painted as the representative of the far left — and I am certainly not free of political bias — I recognize that the other side is half right in claiming that the government is wasteful and inefficient and ought to function better.

But I also continue to cling to the other half of the truth — namely that financial markets are inherently unstable and need to be regulated.

Above all, I am profoundly worried that those who proclaim half truths as the whole truth, whether they are from the left or the right, are endangering our open society.

Both Hayek and Popper, I believe, would share that concern. Those of us concerned with the protection of individual liberty ought to work together to restore the standards of political discourse that used to enable our democracy to function better.

George Soros is the founder of the Open Society Foundations and author, of "The Crash of 2008 and What It Means: The New Paradigm for Financial Markets." This is an excerpt of a speech Soros is giving at Cato Institute on Tuesday. The event is being livestreamed at www.cato.org beginning at 4 p.m. Tuesday, and will be available on the site after.