

## **Bruce Caldwell** **George Soros: Hayekian?**

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## George Soros: Hayekian?

Bruce Caldwell

The title is intentionally provocative. In his 2010 book *The Soros Lectures at the Central European University*, George Soros wrote that the Austrian Nobel laureate Friedrich A. Hayek “became an apostle of the Chicago School of Economics, where market fundamentalism originated” (Soros 2010, p. 22).<sup>1</sup> Given that Soros has long been a severe critic of market fundamentalism, it would seem that Hayek and he must be on opposite ends of the spectrum. For precursors, Soros looks to economists like J. M. Keynes and Frank Knight, to the sociologist Robert Merton, and to the philosopher Karl Popper, all of whose writings in various ways anticipated certain key Sorosian ideas.

In the first two sections of this paper I will show that in fact F. A. Hayek and George Soros share many views in common, some of them ontological (having to do with the nature of reality) and others methodological (having to do with the appropriate way to study and represent economic phenomena). I will then point out some differences between them, though we will see that, even here, they are closer than one might initially expect.

If at the end of the day George Soros still rejects the label of Hayekian, perhaps he will not mind if we instead describe Hayek as an ontological and methodological Sorosian, *avant la lettre!*

### Some Fundamental Elements of the Sorosian Vision

In his paper George Soros offers an account of how humans make their way in the world. The starting point is to recognize that we inhabit a complex environment. We use various methods of

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<sup>1</sup> A similar sentence appeared in the first draft of his paper for JEM, but it was dropped in the final version. It may be that Soros at some point independently reached a similar view to the one that I advance in this paper!

simplification to try to make sense of the complex reality we face: “generalizations, dichotomies, metaphors, decision rules, and moral precepts, to mention just a few” (Soros 2013, p. 5). These mental constructs often take on a life of their own, which obscures our understanding of reality. The structure of our brain provides another source of distortion, something that Soros claims substantiates David Hume’s insight that reason is the slave of passion (ibid). Finally, there is the simple but significant observation that we cannot know what other people know; different people have different perceptions of the world. In the end these limitations imply that the knowledge that humans possess is inherently fallible: our view of the world for a variety of reasons simply does not, and cannot, correspond with reality (ibid., p. 4).

It is also the case, however, that our views of how the world works inform our actions, and these can affect the world. This is captured through the concept of reflexivity. Soros describes thinking humans as possessing a cognitive function (which is operative when they try to understand the world in which they live) and a manipulative function (which is operative when they try to affect that world). The two functions can interfere with each other – when the actions of people affect the world, that interferes with our understanding of it; similarly, attempts to affect the world bring no guarantee of success, and that may feed back into our knowledge. When the cognitive and manipulative functions collide, uncertainty increases.

The way that this plays out in the world is via feedback loops: “participants’ views influence but do not determine the course of events, and the course of events influences but does not determine the participants’ views” (ibid., p. 9). Negative feedback loops bring the participants’ subjective views ever closer in alignment with objective reality; the limiting case of this sort of process is captured by the notion of movement towards equilibrium. Positive feedback loops occur when the participants’ subjective views become ever more removed from reality, yet are self-reinforcing. In this case, reality eventually intervenes, and that produces a spiral in the opposite direction.

Soros' description of how the world works is obscured rather than illuminated by the methods that the social sciences have adopted. Though Soros admires and respects the philosopher Karl Popper's emphasis on testing and the symmetry between explanation and prediction, he feels these insights apply most directly to the natural sciences, where reflexivity does not come up. They are less applicable to the social sciences, so Popper's unity of science thesis fails. Economists, hoping to imitate the successes of the physical sciences, adopted their methods. This is exemplified by such constructs as the efficient market hypothesis and the theory of rational expectations. These attempts to copy the methods of the natural sciences reflect little more than physics envy, or scientism. Soros first began to suspect that the models that economists were using were deficient when as a student he learned the theory of perfect competition, which seemed to have no connection to real competition as it exists in the world (ibid., p. 2).

All of this has implications for our understanding of financial market bubbles. If the efficient market hypothesis is correct, markets tend towards an equilibrium in which market prices reflect underlying objective reality. Positive feedback loops are ruled out by definition. But "that postulate has no resemblance to reality":

In practice market participants' expectations diverge from reality to a greater or lesser extent and their errors may be correlated and significantly biased. That is the generic cause of price distortions. So equilibrium, which is the *central* case in mainstream economic theory, turns out to be an extreme case of negative feedback, a *limiting* case in my conceptual framework (ibid., p. 29).

Crucially, the very *belief* that the efficient market hypothesis is true exacerbates the self-reinforcing positive feedback aspect of a bubble: reflexivity at work. Thus those who believe in the hypothesis think that the system is self-stabilizing and that therefore no regulation of it is necessary. If regulators are among those who believe in it, this prevents them from taking steps to halt the bubble.

When a bubble bursts, it typically leads to regulatory reform; but such reform is itself a reflexive process, because both market participants and regulators are plagued with imperfect information.

The theory of rational expectations is similarly problematical and misleading. Real market participants have to try to anticipate the future when they make decisions today. But the future is uncertain, and the decisions they make introduce further price distortions.

In short, current economic theory is of little use for understanding and counteracting financial bubbles. This is why economics requires new economic thinking.

#### Some Fundamental Elements of the Hayekian Vision

As it was for Soros, the starting point for Hayek is that we live in a complex environment. Hayek's description of how humans interact with that environment also has many things in common with that of Soros.

First, there is the fact that humans (and indeed other animals) adopt often simple decision rules in trying to deal with a complex environment. As Hayek put it, "Man is as much a rule-following animal as a purpose-seeking one" (Hayek 1973, p. 11). Interestingly, Hayek would often invoke David Hume's writings about the limitations of reason in seeking the origin of some of these (and particularly the moral) rules: Hume's statement that "The rules of morality are not the conclusions of our reason" is one of three epigrams that Hayek chose to place on the title page of his last book, *The Fatal Conceit* (Hayek 1988). Hayek also wrote about the structure of the brain and how its operation gives rise to the phenomenal or sensory order we experience, which natural science tells us is different from the underlying physical order (Hayek 1952).

Perhaps most fundamentally, an essential element of the Austrian vision is its emphasis on subjectivism. In his appropriately named “The Facts of the Social Sciences,” Hayek insisted that the concepts we employ in the social sciences

refer not to some objective properties possessed by the things...but to views which some other person holds about the things. ...we could say that all these objects are defined not in terms of their “real” properties but in terms of opinions people hold about them. In short, in the social sciences the things are what the people think they are (Hayek [1943] 1948, pp. 59-60).

The “facts” of the social sciences, then, are all interpretations.

That our interpretations of reality may be different from objective reality is the starting point for Hayek’s discussion of the problems of equilibrium theory in his 1937 piece, “Economics and Knowledge.” In that seminal paper Hayek notes that equilibrium theory assumes that all agents in the economy have the same, objectively correct knowledge. In reality, of course, different people have access to different bits of knowledge – knowledge is dispersed – and some of what people think they know is in fact incorrect, due to the subjectivity of our beliefs and to the fact that we base our actions in the present at least in part on what we expect to happen in the future. Hayek ties this all together by defining equilibrium in terms of compatibility of expectations:

...the concept of equilibrium merely means that the foresight of different members of society is in a special sense correct. It must be correct in the sense that every person’s plan is based on the expectation of just those actions of other people which those other people intend to perform and that all these plans are based on the expectation of the same set of external facts... Correct foresight is then not, as it has sometimes been understood, a precondition which must exist in order that equilibrium may be arrived at. It is rather the defining characteristic of a state of equilibrium (Hayek [1937] 1948, p. 42).

Hayek recognizes that this is a very strict condition that raises more questions than it answers: “the question why the data in the subjective sense of the term should ever come to correspond to the objective data is one of the main problems we have to answer” (ibid., p. 39.) To answer the question, we must examine the conditions under which a tendency towards equilibrium might exist, and also the process by which individual knowledge gets coordinated.

Significantly, in a later paper Hayek pointed out that the dispersion of knowledge implies that the standard theory of perfect competition, because it assumes that market participants have access to complete, objectively correct knowledge, is unhelpful for understanding how actual markets work:

I shall attempt to show that what the theory of perfect competition discusses has little claim to be called ‘competition’ at all and that its conclusions are of little use as guides to policy.  
...competition is by its nature a dynamic process whose essential characteristics are assumed away by the assumptions underlying static analysis (Hayek [1946] 1948, pp. 92, 94).

Thus Hayek too was dissatisfied with the theory of perfect competition, and contrasted it with the dynamic market process that represents competition as it exists in the real world.

Like Soros, Hayek was wary about the dangers of scientism, a phrase that he coined in his paper “Scientism and the Study of Society.” And like Soros, he initially drew the contrast in terms of the differences between the natural and the social sciences, defining scientism as the “slavish imitation” by the latter of the methods of the former (Hayek [1942-44] 2010, p. 80; cf. [1943] 1948, pp. 57-58).

Hayek was a great friend of Soros’ teacher, the philosopher Karl Popper, and in the 1950s Hayek began to accept Popper’s argument about the unity of the sciences. This would seem to undermine Hayek’s earlier argument that the social sciences must not try to imitate the methods of the natural sciences. As was mentioned earlier, Soros criticizes Popper’s unity of science thesis in his paper, so surely here is an area where he differs from Hayek (and from Popper).

But as it turns out, that is not the case, for Hayek's position differs from that of Popper in just those points where Soros' does. In the 1950s Hayek began to drop the natural science-social science distinction and instead began to differentiate among sciences that study simple versus those that study complex phenomena. Because it studies complex, structured orders, economics is one of the latter. For Hayek, all sciences follow the same method. But for those that study complex orders, prediction will be more difficult (only pattern predictions will be possible) and as a result the clean falsification of theories will be undermined (Hayek [1955] 1967; [1964] 1967). So though Hayek endorsed the unity of science thesis, he also thought that fields that study complex orders are unable to follow the strict falsificationist philosophy that Popper had developed with the natural sciences in mind. In this regard, Hayek and Soros again agree about the limits of Popper's methodology when applied to social sciences like economics that study complex phenomena.

By the end of his life Hayek became more and more critical of equilibrium theory for explaining the workings of a market economy. In a talk he gave at the London School of Economics in February 1981 to mark the 50<sup>th</sup> anniversary of his "Prices and Production" lectures there, Hayek said that the metaphor of a stream (or, rather, "countless interlocking and intertwined flows") might be more apt for describing the structure of production in a market economy. At one point he even states

The achievement of an equilibrium is strictly impossible. Indeed, in a literal sense, *a stream can never be in equilibrium*, because it is disequilibrium which keeps it flowing and determines its directions (Hayek [1981] 2012, p. 338, emphasis in the original).

Thus Hayek shared Soros' concerns about the adequacy of equilibrium theory. As we saw above, Hayek also emphasized the importance of expectations and forward-looking behavior. He never wrote about the theory of rational expectations. But in general Austrians think of current market prices not as representing reality but merely as summaries of recent economic conditions, or recent economic history (see, e.g.,



Mises [1934] 2012, p. 326). They also endorse the Knightian/Keynesian distinction between risk and uncertainty.<sup>2</sup>

So Austrians would share George Soros' view that "new economic thinking" requires that we go beyond the current mainstream theories. Where would they go? For Hayek, author of such papers as "The Theory of Complex Phenomena" and "Rules, Perceptions and Intelligibility," I suspect that recent advances in complexity theory would be very attractive. Others working in the Austrian tradition have endorsed the comparative analysis of political and economic institutions, both economic and political, in search of those that are robust in the face of opportunistic behavior and the dispersion of knowledge (Pennington 2011).

So Where Do They Differ?

So where do Soros and Hayek differ? The most stark difference concerns the notions of positive and negative feedback loops. Clearly Hayek, as distinct from Soros, focused more on the latter, in emphasizing the coordinative effects of changing (product) market prices. For Hayek, the price structure is a constantly changing panorama. Price changes signal market participants about recent changes in relative scarcities, but they are simultaneously the result of the daily decisions of millions of market participants, who are acting on the basis of their own "knowledge of the particular circumstances of time and place" (Hayek [1945] 1948, p. 80). Given the complexity of the system (which both Soros and Hayek recognize and emphasize), clearly people can be and often are wrong in their interpretations of and reactions to the ever-changing array of prices; mistakes are ubiquitous. But for Hayek, and the Austrians generally, when people are wrong, that presents a profit opportunity for others, and the actions of those who are alert to the opportunity tend to move the market in the "right" direction. For the Austrians, there is no *systematic* tendency for entrepreneurial errors to persist (see, e.g., Kirzner 1997, pp. 81-82).

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<sup>2</sup> The literature on the ways that the Austrians differ from the mainstream is vast; perhaps the best summary is Kirzner 1997.

It is quite different for Soros. The essential property of a positive feedback loop is that errors persist and indeed feed upon themselves. How can this happen? Soros discusses this in his paper, and to supplement his discussion I would further recommend a recent article by Richard Bronk (2013).

Bronk highlights the importance of narratives and mass psychology in situations of radical uncertainty, and how narratives that emphasize the coordinative function of prices can mislead people into thinking that price movements reflect actual relative scarcities rather than a bubble. In doing so he refers to the work of the British economist G. L. S. Shackle's on radical (Shackle's phrase was "kaleidic") uncertainty in describing how things might go wrong. Shackle was for a time a student of Hayek's at LSE. A later "Austrian" (whose heritage was actually German) economist, Ludwig Lachmann, used Shackle's ideas to criticize Mises and Hayek for an over-emphasis on the coordinative tendencies of markets and specifically for failing to extend subjectivism to the formation of expectations (see, e.g., Lachmann 1976). Lachmann's work led to his being labeled a "radical subjectivist" by some Austrians; it led other scholars (the present author among them) to envisage a rapprochement of sorts between post-Keynesians and Lachmann-influenced Austrians in the 1980s, a movement that unfortunately came to naught.

When Hayek wrote about the coordinative aspects of markets, he had product markets in mind. He was not so sanguine about the effects of money and credit (as he put it more than once, money is a "loose joint" in the market system; see, e.g., Hayek [1960] 2011, p. 452) and fully understood the role they could play in creating cycles: the title of his first book, after all, was *Monetary Theory and the Trade Cycle* (Hayek [1933] 2012). Hayek's early writings on the cycle utilized an equilibrium theory framework, and indeed his framework was identified as a precursor by Robert Lucas (Lucas [1977] 1981). This could be the source of, or evidence for, the idea that Hayek shared certain views in common with Chicago School economists. Others, though, have pointed out the tensions between Hayek's writings on the cycle and his later work on complex phenomena (e.g., Rosner 1994, Witt 1997; for more on this, see Caldwell 2004, pp. 224-30).

So Hayek was no Pollyanna when it came to the stability of the financial system. What policies did he favor? Hayek was good at describing his preferred policy in general terms: he wanted money to be neutral, so that changes in relative prices had the best chance of actually reflecting changing relative scarcities. Unfortunately, he was much less clear as to how this general dictum could be operationalized.

Given that the Austrian story about the origins of the cycle invoke low interest rate regimes that distort the structure of production, he was wary of policies that called for increasing the money supply to counteract the cycle, thinking that this would simply further delay the return to the appropriate structure. This is quite consistent with Soros' argument that "the intervention of the authorities to deal with periodic financial crises played a crucial role in the development of a 'super bubble' that burst in 2007-08" (Soros 2013, p. 33). Other parts of Soros' account, though, are absent from Hayek's theory, such as the role of conventional narratives in contributing to the positive feedback loop that generated the bubble, and in particular the performative aspects of a belief in market fundamentalism.

## Conclusion

I have shown that there are many compatibilities between the views of George Soros and Friedrich Hayek. But what of Hayek's alleged embrace of market fundamentalism? In his Central European University lectures George Soros criticized the arguments that market fundamentalism makes against government intervention. Market fundamentalism

...could have argued that all human constructs are imperfect and social choices involve choosing the lesser evil, and on those grounds government intervention in the economy should be kept to a minimum. That would be a reasonable position. Instead, it claimed that the failures of government intervention proved that free markets are perfect. That is simply bad logic. ...I condemn market fundamentalism as a false and dangerous doctrine, but I am in favor of keeping

government intervention and regulations to a minimum for other, better, reasons (Soros 2010, p. 86).

Hayek was no market fundamentalist. He insisted that there was a role for government in providing a framework in which a market system could operate. He did not think free markets were perfect, and he was no anarcho-capitalist. He would, in short, agree with Soros' statement in its entirety. I suspect Hayek's "better reasons" for placing constitutional limits on government intervention and regulations might differ in some details from those of Soros. But given the points they share in common regarding ontological and methodological commitments, perhaps the difference here is small as well.

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