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The Alchemy of Finance: Reading the Mind of the Market

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The New Paradigm for Financial Markets

THE CREDIT CRISIS OF 2008 AND WHAT IT MEANS

PublicAffairs
NEW YORK

2008

CHAPTER 7

My Outlook for 2008

In *The Alchemy of Finance* I conducted a real-time experiment where I documented my decision making as a hedge fund manager at the same time as I was making those decisions. I will repeat the exercise here.

JANUARY 1, 2008

The theory of reflexivity does not offer any firm predictions. It does help, however, to formulate some conjectures on what the future may hold in store.

1. A sixty-year period of credit expansion based on the United States exploiting its position at the center of the global financial system and its control over the international reserve currency has come to an end. The current financial crisis will have more severe and longer-lasting consequences than similar crises in the past. Every crisis involves a temporary credit contraction. The central banks will be able to pro-

vide temporary liquidity, as they did in the past, so that the acute phase of the crisis will be contained as usual; the international banking system will not break down as it did in the 1930s. But on previous occasions each crisis was followed by a new period of economic growth stimulated by easy money and new forms of credit growth. This time it will take much longer for growth to resume. The ability of the Federal Reserve to lower interest rates will be constrained by the unwillingness of the rest of the world to hold dollars and long-term dollar obligations. Some recently introduced financial instruments will have proven unsound and will go out of use. Some major financial institutions may yet prove insolvent, and credit will be harder to get. The extent of credit available for a given collateral will definitely shrink, and its cost will rise. The desire to borrow and take risk is also likely to abate. And one of the major sources of credit expansion, the United States' current account deficit, has definitely peaked. All this is bound to affect the U.S. economy negatively.

2. One can expect some longer-lasting changes in the character of banking and investment banking. These have been growth industries since 1972, launching ever more sophisticated new products and enjoying ever looser regulation. I expect this trend to be reversed. Regulators will try to regain control over the activities of the industry they are supposed to supervise. How far they will go will depend on the severity of the damage. If taxpayers' money is used, Congress will get involved. Finance constituted 14 percent of U.S. stock market capitalization at the end of the 1980s, 15 percent at the end of the 1990s, and peaked at 23 percent in

2006; I expect the percentage to be significantly lower ten years from now. On March 14, 2008, it was 18.2 percent.*

3. There are no grounds, however, for predicting a prolonged period of credit contraction or economic decline in the world as a whole because there are countervailing forces at work. China, India, and some oil-producing countries are experiencing dynamic developments which may not be significantly disrupted by the financial crisis and a recession in the United States. The United States recession itself will be cushioned by an improvement in the current account deficit.

4. The United States during the Bush administration failed to exercise proper political leadership. As a result the United States has suffered a precipitous decline in its power and influence in the world. The invasion of Iraq has much to do with the rise in the price of oil and the unwillingness of the rest of the world to hold dollars. A recession in the United States and the resilience of China, India, and the oil-producing countries will reinforce the decline in the power and influence of the United States. A significant part of the monetary reserves currently held in United States government bonds will be converted into real assets. This will reinforce and extend the current commodity boom and create inflationary pressures. The decline of the dollar as the generally accepted reserve currency will have far-reaching political consequences and raise the specter of a breakdown in the prevailing world order. Generally speaking, we are liable to pass through a period of great uncertainty and destruction of financial wealth before a new order emerges.

*Factset Research Systems Inc (analytical database). Finance includes major banks, regional banks, savings banks, finance leasing, investment banks, investment managers, financial conglomerates, insurance companies, and real estate investment trusts.

These insights are too general to be of much use in practical decision making, but the theory itself, combined with known facts, does not carry us any further. Indeed, I was pushing the limits to get this far. To be more specific one needs to engage in guesswork.

As we enter the new year I find financial markets too preoccupied with the liquidity crisis and not sufficiently aware of the long-term consequences. The central banks know how to provide liquidity and will do so, whatever it takes. They have already provided larger amounts against a wider range of collateral than ever before. So the acute phase of the crisis is bound to abate, but the fallout is yet to come. Both investors and the general public suffer from a misconception. They believe that the financial authorities—the Federal Reserve and the administration—will do whatever it takes to avoid a recession. I believe that they are not in a position to do so partly because of the commodity boom and partly because of the vulnerability of the dollar (the two are mutually self-reinforcing). The world's willingness to hold dollars has been shaken. There are already too many dollars sloshing around, and the holders are eager to diversify. The major alternative reserve currency, the euro, has already been bid up to unsustainable levels, yet it is still under upward pressure. The fact that the Chinese renminbi has appreciated less than the euro has created tremendous trade frictions between China and Europe, and something has to give. I believe the renminbi will be allowed to appreciate at a faster rate. The forward premium on the renminbi is already over 8 percent per

annum, and I believe the actual appreciation will be higher, although I cannot tell by how much. The Chinese authorities are hard to read, but there are a number of reasons why they should move in that direction. Most important is the threat of protectionism in the United States and now in Europe. An appreciating currency helps to moderate the irritation caused by a large trade surplus. It also helps moderate price inflation, which has become a problem for China. Since the inflation is driven mainly by the cost of imported fuel and food, currency appreciation is a direct antidote. In the past, there was resistance to a higher renminbi from the agricultural sector; with the rise in food prices, that consideration will carry less weight. All this is to the good. But a rising renminbi creates problems which are not properly understood.

The problem for China is that the real cost of capital is already negative, and faster currency appreciation pushes it further into negative territory. This creates an asset bubble. The process is already underway. Real estate is booming, and the Shanghai stock market index appreciated by 97 percent in 2007 and altogether by 420 percent since July 2005* when a four-year bear market ended. For reasons I shall explain in greater detail later, the bubble is still in an early stage, but it may be difficult to avoid a financial crisis later.

The problem for the United States is that a rising renminbi will cause prices at Wal-Mart to rise. A little inflation in a recessionary environment might be a good thing, but the Federal Reserve has to be concerned about the stability of the currency. I believe the Fed will continue to lower interest

*420 percent is the percentage change from the low close on July 11, 2005, to end 2007.

rates at a measured pace—1/4 percent every Open Market Committee meeting, probably without interruption—but a point will come when long-term interest rates will rise in response instead of falling. At that point the Fed will have reached the limits of its ability to stimulate the economy. Again, I do not know when this point will be reached, but I suspect it will be sooner rather than later.

There is much uncertainty about the prospect for a recession. Most economic forecasts still rate the chances at less than 50 percent. I cannot understand that. Housing prices will have to fall at least 20 percent over the next five years to get back to a normal relationship to household income. My boom-bust theory tells me that prices have to temporarily fall below the normal relationship in order to clear the market. This means that prices would have to fall by more than 20 percent within a year or so, or the market will not clear for years. At present the market is not clearing, as the latest statistics show. A decline of such magnitude is bound to affect consumer spending, employment, and overall business activity. The only countervailing force is the strength in exports, but that is bound to abate as the rest of the world slows down. Consumer spending has been remarkably resilient, and expectations are definitely erring on the positive side, with 65 percent of house owners expecting the value of their houses to moderately appreciate. My boom-bust theory tells me that participants will have to err on the negative side before the economy can turn positive. Whether we are in a recession now is questionable; that we shall slip into recession in the course of 2008 I consider a certainty.

The unraveling of the financial institutions has not yet run its course either. Year-end results are bound to contain some

unpleasant surprises, and a recession is bound to cause further deterioration. There may be some additional shoes to drop. Collateralized debt obligations based on commercial real estate, particularly shopping malls, could easily unravel. Banks sold credit default swaps against their balance sheets, and as the recession progresses there may be some defaults. Markets will not be fully reassured until all the hidden liabilities are fully disclosed. The major investment banks have been very diligent in replenishing their balance sheets by raising capital, mainly from sovereign wealth funds, which hold out the promise of becoming the banking industry's salvation, but their appetite may soon become satiated. This may be yet another case where risks are transferred to those who understand them less well, and the prices paid by the first investors may prove to have been too high.

Europe is liable to be affected almost as badly as the United States. Spain, with its own real estate bubble, and the United Kingdom, given the importance of London as a financial center, are particularly vulnerable. European banks and pension funds are even more heavily weighed down with assets of doubtful value than American banks, and the overvaluation of the euro and sterling is going to hurt European economies. The Japanese economy is also doing poorly. The developed countries, taken together, make up 70 percent of the world economy. Nevertheless, I question whether the global economy will go into recession because of the very favorable dynamics that prevail in the oil-rich countries and some of the developing economies. Conventional wisdom says that when the United States sneezes the rest of the world catches cold. That used to be true, but no longer.

China is undergoing a radical structural transformation, and the asset bubble engendered by negative real interest rates is facilitating the process. State-owned enterprises are being transferred into private hands, and managements usually end up with significant stakes. Skillful managers used to make money on the side; now they find it advantageous to make money for the companies they manage and, to an increasing extent, own. Stocks listed on the Shanghai Stock Exchange may appear overvalued by conventional yardsticks (over forty times next year's earnings), but appearances may be deceptive when the motivation of management changes. No doubt a bubble is in formation, but it is in a relatively early stage, and there are powerful interests at work to keep the bubble going. The economic elite are eager to convert the perks of office they currently enjoy into ownership of property that they can pass on to their heirs. There is a long queue of companies whose managers are eager to get rid of state ownership, and they do not want to see the process interrupted. Nothing is quite as profitable as investing in an early-stage bubble.

I visited China in October 2005, and although I was no longer actively making investments, I saw greater opportunities there than at any time in my career. The Chinese economy had been growing at better than 10 percent a year over the past decade, but corporate earnings were not keeping pace with growth, and, after the initial euphoria that is characteristic of newly established stock markets, stocks had been in a bear market for the preceding four years. The government had just announced a scheme whereby all state-owned shares would become tradable within twenty-four months. I

saw the opportunity of a lifetime, but I was not willing to go back into active money management, and I could not find a suitable Chinese partner. We did put some money to work in China, but, as always in these cases, not enough. The Shanghai index has risen by more than 400 percent since then.

China is exerting considerable influence on other emerging economies. It has shown an insatiable appetite for raw materials, and it has been the main motor of the boom in commodities and dry cargo shipping. In spite of the expected slowdown in the world economy, the price for iron ore is expected to rise at least 30 percent next year, with China as the largest customer. China has embarked on a shopping spree for mining, oil, and other raw material–producing companies. It is also ready to extend long-term credit on concessionary rates to African countries. It has come to rival the West as the source of capital inflows into Africa. China has also become the major trading partner of many Asian countries. (It is also becoming the largest producer of greenhouse gases in the world, but that is not the topic of discussion here.)

Undoubtedly, the recession in the developed world will adversely affect Chinese exports, but the domestic economy, and investments in and exports to the developing world, could take up much of the slack. The rate of growth will slow down, but the bubble, fueled by negative real interest rates, will continue to grow. The stock market index will certainly not continue to rise at the rate at which it did last year. Indeed, it may not rise at all, but the volume of new issues and the total size of the market will continue to grow unabated. The structural transformation of the economy will become more pronounced. Loss-making state-owned enterprises will more or less disappear, and what I call super state-owned

enterprises—spin-offs from state-owned enterprises which are well managed and justify their high stock prices by absorbing additional assets from their mother company—will become a dominant feature of the market. The process will be somewhat similar to what I described as merger mania in the chapter "The 'Oligopolarization' of America" in *The Alchemy of Finance*, but much more dramatic. It may or may not come to a bad end, but in any case the end is several years away. In my judgment, China will sail through the current financial crisis and subsequent recession with flying colors and gain considerable relative strength.

The longer-term outlook for China is highly uncertain. It would not be surprising if the currently developing bubble ended in a financial crisis several years down the road. I said long ago that communism in China is likely to be brought to an end by a capitalist crisis. Alternatively, the transformation of China into a capitalist economy may be accomplished without a financial crisis. Either way, China is likely to challenge the supremacy of the United States much sooner than could have been expected when George W. Bush was elected president. What an ironic outcome for the Project for a New American Century! How to accommodate a surging China within the world order will be one of the most challenging tasks for the incoming administration.

I visited India at Christmastime in 2006, and I was even more positively impressed from an investment point of view than with China because India is a democracy with the rule of law. Moreover, it was technically easier to invest in India than in China. Market averages have more than doubled since that time. India used to grow at 3.5 percent per annum, barely higher than the population growth. The growth rate

has now more than doubled. The groundwork of economic reforms was laid by the present prime minister, Manmohan Singh, when he was finance minister more than a decade ago, and it took some time for the dynamics of the economy to change. Information technology outsourcing served as the catalyst. Its growth was phenomenal. Last year India accounted for more than half the new jobs in that industry worldwide, but even today it represents less than 1 percent of total employment in India. The industry has passed its peak of profitability. There is a shortage of qualified labor, and profit margins are hurt by the appreciation of the currency. But the dynamics have spread to the rest of the economy.

The most spectacular has been the rise of the Ambani brothers. When their father, the founder of Reliance Industries, died, the brothers divided his empire among them and are now trying to outdo each other. Their activities range from oil refining, petrochemicals, and offshore natural gas production, to financial services and cellular telephones. The discovery of offshore natural gas promises to make India energy self-sufficient within the next few years. Mukesh Ambani is using the cash flow from its oil and gas business to set up Reliance Retail, bringing food directly from the grower to the consumer—a bold project that seeks to cut the differential between consumer and producer prices by more than half.

India's infrastructure lags far behind China's, but infrastructure investment is beginning to pick up, helped by domestic savings and capital inflows from the oil-rich Gulf States, which have large expatriate Indian populations. In these circumstances, I expect the Indian economy to perform well, although, after its stellar performance, the stock market may be vulnerable to correction.

Another source of strength for the world economy is to be found in some of the oil-producing countries of the Middle East (I don't discuss Russia because I don't want to invest there). These states are accumulating reserves at an impressive rate, by $122 billion in 2006 and by an estimated $114 billion in 2007, to a reserve level of $545 billion.* They are eager to diversify out of dollar denominated bonds and have all set up sovereign wealth funds whose assets are growing rapidly. The Gulf States have decided to invest in developing their own economies by exploiting their access to cheap energy, building oil refining and petrochemical plants, aluminum smelters, and other heavy industries at a rate which is limited only by the shortage of labor and equipment. Due to their competitive advantage, they are likely to become dominant factors in these industries. Abu Dhabi has decided to establish a metropolis to rival Dubai. With over a trillion dollars in reserves and a population of 1.6 million (80 percent are expatriates), they can afford to do so. The forced pace of development has created inflationary pressures and there is a strong case for unpegging the currencies from the dollar. Kuwait has already done so, but the other states, particularly Saudi Arabia, have been dissuaded from following Kuwait's example by strong political pressure from Washington. The dollar pegs, coupled with domestic inflation, have brought about negative real interest rates. The stock markets of the Gulf States are emerging from a severe crash that followed

*International Monetary Fund World Economic and Financial Surveys, October 2007. The countries behind these numbers include: Bahrain, Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. Saudi Arabia's gross reserves include investments in foreign securities, which are excluded in the reporting of official reserves.

the initial euphoria, and negative real interest rates are attracting capital inflows from abroad, just as in China. That is the perverse effect of dollar pegs, although in the case of the Gulf States—with the exception of Kuwait—the peg is not crawling. I believe the dynamics are strong enough—despite the political risks posed by Iran—to withstand a worldwide slowdown. Any lowering of interest rates in the United States would increase the pressure to break the peg.

Sovereign wealth funds are becoming important players in the international financial system. Their current size is estimated at about $2.5 trillion, and they are growing rapidly. They have already invested $28.65 billion in ailing financial institutions.* China has allocated $5 billion to investing in Africa. Sovereign wealth funds are likely to emerge as lenders and investors of last resort similar to the role that Japan sought to play after the stock market crash of 1987. But the sovereign wealth funds are more diverse than the Japanese financial institutions were, and they are likely to follow divergent paths. The financial crisis is likely to make them more welcome in the West than they would have been otherwise. It will be recalled that a Chinese state-owned oil company, China National Offshore Oil Corporation, ran into political opposition when it tried to acquire Unocal, as did a Dubai company, DP World, when it sought to take control of American port facilities. To the extent that one can generalize, sovereign wealth funds are likely to favor investing in the developing world,

*July 13, 2007, Temasek Holdings, $2.0 billion in Barclays PLC; November 26, 2007, Abu Dhabi Investment Authority, $7.5 billion in Citigroup Inc.; December 10, 2007, Government of Singapore Investment Corp., $9.75 billion in UBS AG; December 19, 2007, China Investment Corp. $5.0 billion in Morgan Stanley; December 24, 2007, Temasek Holdings, at least $4.4 billion in Merrill Lynch.

limited only by the absorptive capacity of those countries. That is likely to reinforce the positive performance of the developing economies. Sovereign wealth funds are also likely to become significant stakeholders in the United States economy unless prevented by protectionist measures.

Whether the global slowdown will turn into a global recession is an open question. One can, however, predict with a fair degree of certainty that the developing world will perform much better than the developed countries. This may set up an eventual reversal, when the investments in raw material production will have created overcapacity.

In 2007, being long in emerging markets and short in the stock markets of the developed world was a rewarding investment strategy. I expect that this will continue to be the case in 2008 but with a significant shift of emphasis from being net long to being net short. Due to the change in character of my fund from a pure hedge fund to an endowment fund, and my reduced role in managing it, I do not consider it appropriate to give a detailed account of our investment positions as I did in the real-time experiment published in *The Alchemy of Finance*. I can, however, summarize my investment strategy for 2008 in one sentence: short U.S. and European stocks, U.S. ten-year government bonds, and the U.S. dollar; long Chinese, Indian, and Gulf States stocks and non-U.S. currencies.

January 6, 2008

The real-time experiment is off to a better start than I expected. We are making money both with our longs and shorts, and currencies. Only our short position in ten-year

U.S. government bonds is working against us, but this was to be expected; bonds and stocks tend to move in opposite directions. I took on the position knowing that I may be early, but with a depreciating dollar I believe it will eventually prove to be right, and in the meantime it reduces the volatility of the portfolio. In keeping with our character of an endowment fund rather than a regular hedge fund, our exposure is relatively modest: less than half our equity in any one direction. Nevertheless, the fund is up more than 3 percent in three trading days.

I started thinking about when to cover my short positions. Certainly not yet. The market has just started to recognize that a recession is in store; it has to fall below the lows of 2007. For the next six months the surprises are likely to be on the negative side. I do not expect this administration to be capable of producing any policy measures that would meaningfully improve the situation. The market may, of course, establish a tradable bottom sooner than six months—I am not very good at picking bottoms.

March 10, 2008

I got the big picture right in my predictions for 2008, but there were some minor deviations which have had a major impact both on the course of events and on our investment performance.

- The disruption of the financial system has been worse than I expected. Markets that I did not even know existed—such as the auction-rated municipal bond market—fell apart. Credit spreads continued to widen, and losses continued to mount. Banks and brokers have recently raised their margin requirements, and leveraged hedge funds are forced to deleverage. Some are being liquidated. There are still some shoes left to drop; the gigantic credit default swap market has yet to unravel. Write-offs are likely to peak in the first quarter of 2008. There may be further losses in later quarters, but not at the same rate.
- Commodity markets stayed stronger than I expected. The rise in iron ore prices was 60 percent, not 30 percent. Gold is approaching $1,000 an ounce.
- The Federal Reserve swung around more violently than I expected. It dropped the federal funds rate by an unprecedented three-quarter percent in an emergency meeting on January 22 and moved another half percent at its regular meeting on January 30.
- In spite of its dramatic turnaround, the Fed was unable to bring down mortgage rates, but for a different reason than the one I anticipated. It was the widening of credit spreads, not the steepening of the yield curve, that pushed up mortgage rates. The yield on ten-year government bonds dropped sharply, and our short position turned out to be very costly.
- The Indian market had a big fall. We had failed to cut back on our long positions and took it on the chin. Losses in these two positions (China has not hurt us much) offset most of our gains in the macro-account. As a result we are barely ahead for the year.

Having increased our short positions in the dollar and in U.S. and European stock indexes and financial stocks, and

slightly reduced our government bond shorts, we seem to be well positioned for the period immediately ahead. I expect a re-test of the January stock market bottom with financial stocks making new lows but the market as a whole holding above. This may lead to a tradable rally, but I foresee lower lows in the months ahead.

A new chief investment officer joined me recently; this will allow me to distance myself from the markets. We intend to cover some or most of our financial shorts in the re-test and maybe go long in some stocks that will benefit from a lower dollar and then establish new shorts on the rally. The new CIO knows the bond markets well. He is accumulating some of the higher-grade mortgage indexes and intends to increase our shorts in long-term government bonds in due course.

March 16, 2008

This has been a dramatic week. The deleveraging of hedge funds continued, and some are being forcibly liquidated, putting downward pressure on securities and upward pressure on credit spreads. The dollar is making new lows, with the euro breaking through $1.55 and the yen breaking 100 to the dollar. Pressures in the currency markets are intensifying. Both the Chinese and the Gulf currencies are straining against their dollar pegs. On Thursday, Bear Stearns came under suspicion as a counterparty, forcing the Fed to come to the rescue on Friday by opening the credit window to Bear through the intermediation of JP Morgan. The panic is palpable. We continued to add to the dollar shorts, but we started going against the decline in the stock

market and the continued rise in government bonds. We also bought some Bear Stearns shares and sold some Bear Stearns credit default swaps on Friday (the first time we traded in that market) in the expectation that Bear Stearns will be auctioned off by the Fed over the weekend. This is a short-term, finite bet that either pays off on Monday or has to be taken off the table. The result to date is a standoff; the fund continues to tread water, with the macro-account making money and the rest of the fund losing. Our only consolation is that the portfolio is much less volatile than the markets. It would be better to show a profit.

March 20, 2008

Another eventful week. Bear Stearns was not auctioned off but forced into the hands of JP Morgan at $2 a share. We were half right: made money on the credit default swaps but lost on the shares—a wash. The shareholders of Bear are squealing, but are probably powerless. We forgot to take into account that Bear is disliked by the establishment, and the Fed would use the occasion to deal with the moral hazard by punishing the shareholders.

The markets were shocked by the Fed's action, and we had some kind of a selling climax on Monday. We used the occasion to cover our remaining shorts in financial stocks, and we were almost neutral in our stock exposure by Tuesday morning, betting that Lehman Brothers, which came under siege on Monday, would be able to withstand the onslaught. We were right, and after the Fed cut rates by another 75 basis points stocks staged the best rally of the year. This ought to

have been a tradable rally, lasting at least a few weeks, but the stock market broke all the rules and reversed itself on Wednesday. In every boom-bust sequence people come to believe that the normal rules do not apply, but they usually do. This time it really is different, confirming my thesis that this crisis is not like the other ones. To top it off, the dollar staged a sharp rally on Thursday morning, causing some damage to the macro-account. The fund is now under water for the year. I ascribe the dollar rally to the liquidation of speculative positions, some forced and some technical. I intend to hold my positions, but I am prepared to see further losses. One of the advantages of low leverage is that I can afford it.

I have to end the real-time experiment because the manuscript has to go to the publisher. I would have preferred to end it with a profit for the overall fund, not just the macro-account, but this result may be more appropriate for the purposes of this book. We are in a period of forced deleveraging and the destruction of financial wealth. It is difficult to escape it.

March 23, 2008

In writing the conclusion to my book I gained a new insight into what is to be expected for the rest of 2008. It will guide my investment decisions. I shall conclude the real-time experiment by quoting the key passage:

> Eventually, the U.S. government will have to use taxpayers' money to arrest the decline in house prices. Until it does, the decline will be self-reinforcing, with people walking away from homes in which they have negative equity and more and more financial institutions becoming insolvent, thus reinforcing both the recession and flight from the dollar. The Bush administration and most economic forecasters do not understand that markets can be self-reinforcing on the downside as well as the upside. They are waiting for the housing market to find a bottom on its own, but it is further away than they think.