ship were the years the locusts ate.

Sam Rayburn was five feet six inches tall. Yet his bulk looms far larger over American politics of the past half century than O'Neill's. The partisan character of the office of Speaker was apparently intended by the Founding Fathers, as was demonstrated by Mary P. Follett's *The Speaker of the House of Representatives* (1896), the classic work on the history of the office. This represented a clear break from the British tradition that the Speaker should be a non-partisan presiding officer. In gathering power to the office, Clay and Reid and Cannon reinforced its partisan character. The power and the partisanship went together. But even men as partisan as Cannon and Longworth, both Republicans, used their power to bend and educate their own party, just as Rayburn did. In the end, O'Neill had the partisanship, but he did not have confidence in the power of the House, and of his office.

HENRY FAIRLIE

# WHEEL OF FORTUNE

## The Alchemy of Finance: Reading the Mind of the Market by George Soros

(Simon and Schuster, 350 pp., $22.95)

George Soros is an investment manager. But he is not your run-of-the-mill Wall Street gnome. He has made it like no one has. For those of us who wince when the Dow Jones average interrupts our daily television news, the jacket blurb describes Soros's spectacular success. The Quantum Fund, over which he presides, has grown from $4 million in 1969 to over $2 billion today; it has yielded a dizzying annual compound growth rate of 45 percent over nearly two decades. *New York* magazine, in an unaccustomed lapse into cultivated penmanship, was moved to describe Soros as the "Michelangelo, Renoir, and Beethoven of Wall Street all wrapped into one."

Now that Soros has made his fortune, he is eager to tell all. But his aspirations as a writer soar above a simple narrative of his financial dealings. He wants to think big, to speculate about the differences between scientific method in economics and in the natural sciences. He wishes to develop a theory that would embrace equally his mundane financial activities and grander themes such as the reform of the international economic system. It is tempting to treat Soros's analytic ambition as a manifestation of what sociologists call the Sanskritization process: wealth seeks status by acquiring the attributes of the higher classes—in this instance, their intellectual pursuits. But for Soros, the sequence has been exactly reversed.

A Hungarian émigré to the United States, Soros claims to have acquired his thirst for intellectual accomplishment en route, at the London School of Economics. He credits the influence of Karl Popper, but surely an economics undergraduate in England cannot have failed to note that financial and philosophical speculation have been combined in some of the great masters of the discipline. David Ricardo—to whom we owe the theory of gains from trade through specialization, a theory that Adam Smith sketched and Richard Gephardt foolishly (if unwittingly) rejects—was a successful stockbroker. Even John Maynard Keynes, as first bursar of King's College at Cambridge from 1924 to 1946, managed two investment funds to great advantage. Indeed, of these, the Chest Fund, where Keynes had a free hand, considerably outperformed the *Banker's Magazine* Ordinary Share Index. Here was the stuff on which dreams are made. Success on Wall Street has given Soros the sangfroid, and wealth the wherewithal, to pursue his dream. This book is the consequence. Alas, it prompts the question: Money talks, but can it write?

The core of Soros's book is concerned with what he wrongly (indeed, astonishingly) considers to be a major new discovery: the Theory of Reflexivity. If you wish to be bamboozled, consider his algebraic formulation. Let $x = f(y)$ and $y = g(x)$—that is, x is a function of y, and the other way around, too. In classrooms we call this a system characterized by simultaneity. I have successfully conveyed what it means to my students by recalling the country where men are bad lovers and women yet worse cooks. Reflexivity arises because poor lovers are penalized by bad food, and bad food is rewarded with indifferent love.

Soros uses reflexivity, however, with an important but familiar twist, central to his argument. Economic analysis must reckon, he thinks, with the fact that agents or "participants" understand and act in light of the economic situation. This defines a "cognitive" relationship. But their perceptions, in turn, can affect the situation itself. This defines a "participating" relationship. And these cognitive and participating functions (which correspond to Soros's algebraic equations), acting recursively (in sequence, that is), define "the theoretical foundation" of Soros's approach. "The two recursive functions do not produce an equilibrium but a never-ending process of change." Hence, "the outcome tends to diverge from expectations, leading to constantly changing expectations and constantly changing outcomes."

Of course this is not really a "theory" but a way of thinking, an analytical framework that draws attention to the critical role of feedback from subjective expectations to objective events. Economists have been considering such feedback for decades. The precise way in which the objective reality can be affected depends naturally on the nature of the feedback. Consider the classic case of a self-fulfilling prophecy: the analysis of exchange rates dating back to the 1960s. Let the objective reality initially be that the dollar will not depreciate. But suppose that speculators expect the opposite, and move out of the dollar, depreciating it. If the reality were independent of the actions of the speculators, the dollar would go up again, and the market would have chastised and ruined the speculators. But it may well be that as the dollar falls initially with the speculation, wages and hence prices rise in sympathy. If so, the objective reality would itself have changed, legitimating the devaluation of the dollar in view of the speculation-induced rise of prices. Such self-justifying speculation shapes its own reality.

Soros regards the stock market as an ideal place for such feedback effects.

Stock prices can influence "underlying values," or "fundamentals" in Soros's language, in important ways. An unjustifiably high stock valuation, for example, can reinforce a firm's ability to raise finance and validate in turn the valuation. As the research of Lawrence Summers and Robert Shiller on asset pricing suggests, an unduly low valuation may lead to managerial shakeouts aimed at short-run profits and causing long-run neglect, which once again legitimates the initially inappropriate valuation. Evidently, booms and busts also can follow, for a vicious circle can arise in which one mistake, duly rewarded, leads to another until some overriding, unshakable constraint interrupts the process. Such reversals can come easily in financial markets, where confidence can evaporate as rapidly as it arises.

I HAVE NO quarrel with Soros when he reminds us that the analysis of the stock market must occasionally reckon with such reflexivity. I find it difficult to follow him completely, however, in his different, and far more debatable, view that his superior grasp of reflexivity is what gives him the edge over his rivals. Yes, he made a great deal of money during the conglomerate boom of the 1960s when reflexivity was working, with indiscriminately high stock valuations feeding the ballooning acquisition process. But so did many others.

Or take the fascinating case of Soros's "killing of a lifetime." After the Plaza Hotel meeting of the Group of Five in September 1985, Soros expected the yen to rise; he bought into yen and earned in one fell swoop more than enough to offset handsomely his accumulated losses on currency trading in the previous four years. Was this the result of reflexivity? Surely Soros owed this good fortune to guessing right about what these governments would do rather than to the reflexive effects of that deed in the market, or his better grasp thereof.

Perhaps Soros has just been plain lucky rather than smart. Having made money, he is in no mood to attribute his success to luck. But luck could well be what made Soros's fortune, if we are to believe the academic proponents of the so-called "random walk" or "efficient markets" theory of the stock market. That theory holds that the market fully discounts all future developments, and hence the individual's chances of over- or underperforming the market are even. Soros asserts that this theory "is manifestly false—I have disproved it by consistently outperforming the averages over a period of 12 years." Indeed, Warren Buffett, who managed Berkshire Hathaway Inc., has outperformed the Standard & Poor 500 for each of 29 years.

As it happens, however, the random walk theory permits Buffett and Soros to have an impressive string of successes without being in possession of better gray cells. To understand this theory, consider the analogy of tossing a coin: over a large number of trials, heads will come up as often as tails. But this does not rule out the possibility that Soros has had an unmitigated succession of heads in *all* trials. From the scientific point of view, it is simply impossible to decide between Soros's self-congratulatory "I-am-smart-because-I-understand-reflexivity" explanation and the rival "random walk" explanations of his success just by reading his accounts of his successes and failures. The issue remains as open and contentious among professors as it is among investors.

In *The Alchemy of Finance*, Soros goes beyond the stock market to larger issues. Though he offers an abundance of views, on matters ranging from currency reform to the American budget and trade deficits, he reminds me of another distinguished Hungarian émigré, Lord Balogh, of whom his foes said that his conclusions were more obvious than his arguments. Financial specialists, though, will be intrigued by the conclusion that Soros draws concerning the need to regulate financial markets, ever susceptible (thanks to reflexivity) to "excesses, which sooner or later become unsustainable." In his view, "after nearly half a century of what now appears as excessive regulation, we have been moving towards excessive deregulation. The sooner we recognize that some kind of regulation is necessary in order to maintain stability, the better are our chances of preserving the benefits of a nearly free market system." Here he parts company with Walter Wriston, who cheerfully led us into the Third World debt crisis, and walks over to Henry Kaufman's and Felix Rohatyn's corner. I believe rightly so.

JAGDISH BHAGWATI

Jagdish Bhagwati is Arthur Lehman Professor of Economics and professor of political science at Columbia University. His new book, *Protectionism: Interests, Ideology, and Institutions*, will be published by MIT Press in 1988.

### THE PALM AT THE END OF THE MIND

After fulfilling everything
one two three he came back again
free, no more prophecy requiring
that he enter the city just this way,
no more set-up treacheries. It was
the day after Easter. He adored
the egg-shell litter and the
cellophane caught in the grass.
Each door he passed swung with
its own business, all the witnesses
along his route of pain again
distracted by fear of loss or
hope of gain. It was wonderful
to be a man, bewildered by
so many flowers, the rush
and ebb of hours, his own
ambiguous gestures—his
whole heart exposed, then
taking cover.

KAY RYAN

CORRESPONDENCE, *from page 6*

ago—opposing an assistant professor candidate on the grounds of his noble family background and good looks. Of course this is absolutely untrue. It is hard for me to take it too personally, though, because the poor author doesn't even remember how to spell my name.

THEDA SKOCPOL
*Cambridge, Massachusetts*

*M.P. replies:*
Ms. Skocpol, whose name was misspelled by a typesetter, distorts my comments. I did not say that she opposed a candidate because of his noble family background or his good looks but that, in view of these traits, his achievements were "less than they appeared." Hers was an argument against someone comparatively advantaged, which is the reductio ad absurdum of arguments for those comparatively disadvantaged.