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THE THEORY OF REFLEXIVITY: A NEW WAY TO ANALYSE FINANCIAL CRISIS

Resume. *The purpose of this research is to understand the financial crisis, applying the theory of reflexivity. The theory of reflexivity, which was introduced by George Soros, proposes a different outlook on financial crisis. According to the theory of reflexivity, prior to financial crisis, financial analytics and brokers could not react to the changes in the economy without reflecting their own thoughts, because they are part of the system and they are the participants. Therefore, according to this concept supply and demand curves cannot freely meet at the point of equilibrium, because supply and demand cannot be regarded as separate items. In order to understand the current crisis, a new theory is needed which can look at it from a different perspective. In this article, the world financial crisis of 2008 is regarded through the prism of the theory of reflexivity.*

Current financial crisis cannot be compared to any other crisis that occurred in the past. This crisis is unique due to nowadays globalization, technological progress and expectations of individuals. The world financial crisis has not arisen suddenly and accidentally, it is rather an outcome of malfunctioning economic mechanisms. This study aims to regard current crisis, its causes and consequences with the help of modern economic theory--the theory of reflexivity. Regarding crises in general, many scientists observe and analyze them through the prism of different classical economic theories which lack philosophical components. Modern economists, such as G. Soros, regard crisis from a different point of view.

The followers of classical economics use precise scientific methods to prove the validity of their arguments. In contrast to precise sciences, social sciences also use a philosophical approach to problems. Economics is regarded by many as a social science and can carry a philosophical character in the matter of analyzing world economic crisis. In order to acquire a better understanding of current crisis it is necessary to take into consideration the role that citizens of each country play in this crisis. The citizens of one or another country are the participants of the market and cannot be disregarded during analysis of the economic crisis.

The main objective of the paper is to analyze the world financial crisis through the prism of the theory of reflexivity. The theory tells us that we are part of the events that happen and we cannot stand aside, we are the participants and we cannot separate ourselves from the world that we live in, therefore decisions that we make reflect our thoughts and understanding of the crisis. According to the theory of reflexivity, prior to financial crisis, financial analytics and brokers could not react to the changes in the economy without reflecting their own thoughts, because they are part of the system and they are the participants. The theory of reflexivity is a contradiction to the equilibrium theory.

The equilibrium theory tells us that supply equals demand at the point of equilibrium. And in order for the market to come to an equilibrium point, according to this theory, information has

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to be clear and easily accessible to the participants of the market and government does not intervene. In other words, the equilibrium theory predicts that the market will reach equilibrium on its own. Regarding the situation through the prism of the theory of reflexivity, the market cannot reach equilibrium without the participants. In classical theories of economics, the supply and demand curves are regarded as given, but according to G. Soros, such situation is not realistic and cannot take place in real life.

Supply and demand have to be formed under a great number of factors; one of the main factors is participants' expectations. Different expectations of market participants resulted in such massive and rapid burst of the crisis. Modern look on the development of the current crisis brings new opportunities to analyze structure and causes of the current crisis. If supply and demand curves are regarded as not given, than the movement of these curves can be regarded as an outcome of the participants' actions. Supply curve and demand curve depend on the results expected by the participants. The expectations of the participants on the other hand depend on information and self measures of the expected market outcome. Every market participant does not have the exact information about the behavior of other participants and expectations of other participants. Entering the market, the participants themselves, create market outcome based on their personal experience and expectations of the outcome. Based on acquired information, which can be either right or wrong, the participants of the market make their decisions.

According to G. Soros, current crisis takes its roots in the US real estate market. Regarding the US real estate market from the point of view of new modern economic theory, the market could not reach equilibrium on its own. The US real estate market started experiencing difficulties after the government provided public with easily acquirable credits on good terms and conditions. Consumers were taught that in case of crisis the market will be able to return to equilibrium on its own. Everyone who received credit expected that in case of a bad outcome, the market will rehabilitate on its own, but consumers' expectations turned out to be not so true. The participants made their choices based on earlier acquired experience, when in case of lack of liquidity the government injected liquid assets using monetary instruments and was able to stabilize the economic situation.

Due to lack of clear information and previous positive credit experience, consumers continued receiving loans expecting a perspective outcome. Positive expectations increased the number of people desiring mortgage during the beginning of crisis. The US citizens spread confidence to foreigners and foreign countries regarding loan policies. Information about positive loan experience had an influence on Ukrainians as well. The real estate market in Ukraine flourished without bad forecast before the breakdown of the crisis. Ukrainians continued receiving mortgage, expecting positive outcome on the real estate market in Ukraine and abroad. Ukraine, being an exporting country expected inflow of capital from abroad. Ukrainian participants of the market expected stable situation on the US market and expected to receive money from abroad that could be later injected into economy in order to stimulate the real estate market in Ukraine. Expectations were navigated towards two aspects at the same time: stable situation on the national market and stable situation abroad.

Range of unreasonable expectations is also shaped by globalization. Capital dependency between countries led to such downfall in expectations by national consumer as well as national seller. Now it is time to regard another part of market relations in which the seller on the real estate market plays an important role. Constructing the price of one square meter, seller expected stable situation on the market, clear information and demand on the supplied good. The seller had certain expectations in mind. Analyzing behavior of a seller through the prism of the equilibrium theory, the optimal price had to be formatted by the market. But it did not, because

the factor of expected result was not taken into consideration, which is also integrated in the formation of price of one square meter.

The hypothesis of one theory contradicts the hypothesis of the other. This principal is rooted in the thinking of G. Soros, he states that the theory of reflexivity contradicts the equilibrium theory and two theories cannot simultaneously co-exist. Attending to the concept of one theory, we automatically reject the possibility of existence of the other theory. The theory of reflexivity analyzes behavior of players on the market, relying on the psychological aspects of their behavior. Each participant will behave depending on available information and on personal intentions and expectations. Each participant wants to maximize most favorable outcome regardless of other's expectations of the market outcome.

In regarding the causes of the crisis, it is worth to note such aspect of the crisis, as globalization which worsened the situation in countries, other than the United States. On the eve of the world financial crisis, based on the estimations made by IMF, the markets of developed countries were fully integrated in the financial globalization and up to 30-50% of national financial markets of developing countries. Uncertainty and inequality of the processes of financial globalization were reflected in the acceleration of structural changes of financial markets, and also in the growing number of mergers and take-overs in the world economy. In conditions of globalization, cyclical processes are not restrained by national borders, their volatility influences most of the countries in the world.

Current stage of globalization has started recently and was engendered by planned politics, partly related to elimination of trade and investment barriers and partly related to establishment of international norms and institutions. Globalization has opened possibilities for exchange of information and capital inflow. Comparing earlier crises and current crisis, a strong interdependency between countries is observed during current crisis. International relations and high level of globalization pushed countries toward close relations, trade and exchange. At the current stage of globalization, countries are closely dependent on each other, which was not the case in the 1930s.

Specificity of globalization is accumulation of financial resources in the developed countries and circulation of cash flow in the center of the world financial system. Until 2009, the US used to be the economic center with the end point of capital flowing there from periphery. However, the world financial crisis demonstrates us the impossibility of this country to restrain crisis and fight with it within the country, not letting it spread out around the globe.

It is also necessary to analyze not only the cause of the crisis, but also its progression. It is wrong not to consider the psychological aspect of crisis. The nation starts to panic. If until the beginning of crisis, expectations of market participants in the US and in Ukraine were positive, during the crisis the situation changes completely. Panic takes control over people and their actions, behavior of people reflects the real situation on the market. The theory of reflexivity cannot be ignored during analysis of current financial crisis. Actions of participants reflect their fear, believes and intentions and influence the result. People stop spending money and making investments. People expect improvements and wait for better conditions to invest. Savings increase and inflow of capital to any segment of economy sharply decreases. Investors that have partially invested stop investing due to fear of losing even more than was already invested. At the same time arises the problem of unpaid credits. Inability to payoff mortgage leads to lack of liquidity. The current account deficit that experiences the United States worsens the consequences of the world financial crisis. The theory of reflexivity explains people's behavior and their desire to save more during the crisis. Behavior of market participants is based on intentions of individuals. From G. Soros' point of view, the way to fight the consequences of world financial crisis is to receive help from the government.

Countries should not expect the market to return to equilibrium on its own. Current world financial crisis proves the actuality of the theory of reflexivity and obsoleteness of the equilibrium theory. If the market worked according to the equilibrium theory, then by the end of the first wave of crisis, supply and demand curves would have moved towards equilibrium. But reality proves the opposite the market cannot recover on its own. The government needs to play an active role in the formation of market equilibrium and regarding the US market, the government indeed influenced the US financial system. In the pre-crisis times, the US government injected liquidity in the US economy, bringing the market to equilibrium.

The theory of reflexivity cannot predict the outcomes of the current crisis, but it gives us the base to analyze the causes of crisis, participants' behavior during crisis and possible solutions to end the crisis. The theory of reflexivity pushes individuals to reject analyzing crisis through the prism of classical economic theories. The true outcomes of the crisis, we will be able to analyze only after the end of this crisis abroad and in Ukraine. The theory of reflexivity is the theory of the future, in demand, but is not yet as widely spread out as the equilibrium theory. This topic needs further post-crisis analyze, in which it will be possible to analyze the consequences of the government actions, outcomes of the crisis and ways to prevent future crises. The theory of reflexivity has its downfalls, it cannot prevent crisis and it cannot provide the exact answer on how to get out of it, but it can certainly shade light on the evolution of this financial crisis.

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