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"The system is at the Tipping Point"

Haiko Lietz 16.10.2008

For the physicist Didier Sornette the financial crisis was predictable in principle

Prof. Didier Sornette provoked the financial science with the assertion that price developments on the stock exchange were in a certain way **predictable**. Using statistical methods, which are also in earthquake research may be used, he had the 2004 peak of the U.S. real estate bubble correctly at mid 2006. Currently, the financial system at its critical point, the **Tipping Point**, in which small causes can have big effects. In an interview, the owner of the **Chair in Entrepreneurial Risks** at the ETH Zurich to causes and mechanisms of financial crisis.

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- ▶ How do you assess the financial market currently?

Didier Sornette: I have my shares about a year ago sold. It is clear that we are not currently on the market wants to be, because we have a cascade of confidence loss experience. It's like the time when all are overoptimistic and a financial bubble formed. Now everyone is überpessimistisch. This is herd behavior. Recently my mother called me, whether their friends all their money from the bank should fetch. That would obviously be insane, because if everyone does collapse the entire financial system. The banks operate so precisely that they the money we deposited with them, not retained, but different reinvest to the whole economy to keep unnecessary.

- ▶ What should be done?

Didier Sornette: It takes a very strong antibiotic. Politicians need very strong measures such as adopting regulations. Technically, these are much less effective than is often thought, but their main task is to restore confidence.

- ▶ In your research did you Scale measured in stock market data. Firstly, what is Scale?

Didier Sornette: Scale means that a system itself looks like when it is at different size scales considered. We call such systems often fractals. For example, the fractal coast of Brittany. If you look at a map appeared in various resolutions, one always sees the same kind of muddled roughness. Trade developments in financial bubbles are discreetly skaleninvariant. That means properties remain only for specific magnification factors equal. Matroschkas are an example of discrete Scale, because the larger figures differ from the smaller only by a specific magnification factor.

Social hierarchies affect stock prices

- ▶ Scale enables the diagnosis of financial bubbles?

Didier Sornette: In economics, there is a big dispute, which is a bubble actually is. They say it was an exponentially growing rate. But in the economy is growing exponentially everything. We say that a bubble is something that grows faster than exponentially. That means that growth itself grows. This is, of course superexponentielle growth by a noise. But in this noise we find a regularity, a vibration is accelerating. And you can show that it is indeed a fractal structure, described by specific magnification factors. In the stock market data, we find the discrete equivalent of the Scale of the coast of Brittany in time, if you will.

- ▶ What could be the cause of the Scale of his financial Blowjob?

Didier Sornette: One reason could be that the social networks of stock traders and investors are hierarchically organized. My colleagues have increasingly for advice. So you have two or three very close people around them, then typically nine to ten sympathy makers, at a higher level, around 30 people, approximately 100 still higher, etc. There seems to be a discrete magnification factor of three to give. In fact, even now, not only for people but also for mammals have been shown. This is a clear example of discrete Scale in social networks.

- ▶ How would such social hierarchies affect the financial market?

Didier Sornette: We do not make decisions like a computer, but by the news, interviews with employees, exchanges and so on the Web influences. If we imagine that there exists a kind of imitation, does the hierarchical organization of social already on

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cascades of stock purchases made. These interactions should focus on price patterns show.

- ▶ How could fractal price developments have created?

Didier Sornette: Scale can also dynamically in a system arise, the a priori is not skaleninvariant. There are three ingredients. First, inertia and the fact that investors in the past, look to have to make decisions today, tomorrow, the impact on the market will have.



Adressleiste sehen

The other ingredients are two competing market strategies. One is called fundamental analysis. It is evaluated how much one shares to its fundamental value is overstated. The problem however is that the fundamental value estimate may be virtually impossible because markets stochastic and complex and thus very uncertain. In the chart analysis on trends Factory, which will then be extrapolated. But trends are not obvious. Both market strategies mean that we are in the market only moves when a certain threshold is reached, if one shares overvalued or a clear trend is clearly identified. Investment decision-making processes are not linear.

The combination of these three ingredients leads to discrete Scale, as it comes to oscillations, whose frequency in the hierarchical level accelerates, as in the bladder to price regimes accelerated.

Unstable systems can be fast in one direction or another tilt

- ▶ Can financial bubbles with the Fraktalmethode früherkannt be?

Didier Sornette: Early not, but in its history. The patient must, as it were clear signs of a cold show to a cold diagnose them. We have the climax of the British real estate bubble a year ahead clearly diagnosed, just two years previously in the U.S. real estate bubble, culminating we correctly to mid-2006 had laid.

- ▶ Can you say how long a bubble will hold before it implodes?

Didier Sornette: In fact, this is the big question. For example, Alan Greenspan, in autumn 2004 issued his famous warning that the market is overheated. The bubble was still stood four years. That is the big problem of arbitrage traders and analysts fundamentals. If they expect a value loss and act accordingly, they may lose their shirt, because the bladder can hold for many years. We therefore need a method to estimate how a sustainable price trend is. That is, I think what we have to existing methods can supply.

- ▶ As usual, is fractal analysis in the financial sector?

Didier Sornette: In finance, science is the method either not known or it is refused, they seriously. One reason is that it strongly differs from the standard approach. A major reason is but surely, that the allegation that successfully diagnose and predict to be politically incorrect is, I would almost say. But among experts in banks and our work is well known, I would say.

- ▶ How long will the crisis last?

Didier Sornette: That is very difficult to predict, because the system is at the tipping point. We learn from the nature of mathematical models, as we develop that such unstable systems on the wings of a butterfly stroke in one direction or the other can tilt. There is a very strong sensitivity and responsiveness to small things. My impression is, in any case that we suffer a big hangover and that it will take a while, the system cleaned. I think that the system until after 2009 will suffer.

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