Why economic sociology matters to understand the financial crisis (and what should be done accordingly to overhaul finance)

Lordon, Frederic
Economics and sociology, CNRS, CSE (Centre de Sociologie Europeenne)
Ville d'Avray, France

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The failure of mathematical finance to prevent a crisis of such magnitude points at the inability of quantitative economics approaches alone to deliver not only efficient risk control but also a clear understanding of financial phenomena. An economic sociology view is especially relevant to underscore the three main causes that have paved the way for this crisis - and then to propose a radical overhaul of finance :

1) The irresistible forces of "greedy competition". The combination of stellar returns and fierce competition in the field of asset management creates forces no agent can resist. Even those who have a clear view of the growing risks have no option but follow the stream unless losing market shares. Risk taking biases created by the external forces of the financial field are reflected within the trading rooms through a shift in the balance between the front office and the back office, detrimental to the latter.

2) The essential flaws of risk control. Value-at Risk models rely on the flawed assumption that asset prices are driven by an objective density of probability, and that quantitative methods will eventually identify it. They miss the fact that the current density of probability is contingent and temporary because it is immanent to the interactions of the agents. As soon as this interactions incur a sudden shift, which is typically the case in liquidity crises, the models are wrongfooted and unable to deliver correct risk assessment. These shifts are completely unpredictable ex ante, and the new arising density of probability as well.

3) "Financial innovation" as a social belief. Beyond their technicalities, financial innovations also have a social effect within the financial community. Actually it is necessary to invoke an external "event", generically named "innovation", to believe in the sustainability of outstanding returns and consider them normal while they are clearly not. Innovation then should be analyzed as a collective self-delusion social device.

If financial crises are to be prevented, it can only be by addressing these structural issues, along a "blueprint" that the paper will sketch.