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## Article

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# Towards an Economic Sociology of the Subprime Crisis?

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Although nobody can say at the moment when we will see an end of the current crisis, what we can say is that it has already led to financial, institutional and discursive changes simply beyond what could have been imagined two years ago. Yet what we currently experience seems to parallel past incidents. The subprime crisis, like previous crises, tells a story of how new investment opportunities emerged, followed by excessive credit expansion. Here, too, we witnessed a constant rise of prices that did not only decouple financial from any real value (if there is such a thing), but also let speculative motives dominate investment decisions. Ultimately, the bubble burst, which led to wide-reaching changes (Minsky 1980; Kindleberger 2000; but see also Bieling 2009). From this perspective, the current crisis can be seen as part of a story that started with the famous Tulip crisis in Amsterdam in the 1630s and the South-Sea bubble of 1720 and reaches to the Great Depression of the 1930s and the currency crises of the 1990s (Mackay 2003; Krugman 1994). There is certainly much to this story.

On the other hand, the subprime crisis differs from past experiences: the pooling of mortgages and their dicing into senior, mezzanine and equity tranches<sup>1</sup> was made possible by modern securitization practices involving *new* actors like credit rating agencies and hedge funds (Committee on the Global Financial System 2008, 2005; Sinclair 2005). Rating agencies provided credibility and thereby not only guided investment strategies, but provided false security. The demand for equity tranches was in particular generated by hedge funds and banks in their search for high returns. Insofar, the subprime crisis is not just another example of economic crises, but it is a crisis of the entire modern financial system.

In this contribution, I argue that further analysis of the subprime crisis does not only require a better understanding of hedge funds, rating agencies and the employment of derivatives and complex financial instruments, a task that is increasingly taken up within the academic literature as

well as in official documents. The crisis also raises a more conceptual problem concerning the notion of *systemic risk*. In the first section I outline how official documents, and the economics literature which nourishes them, have framed the problématique of systemic risk in static terms. Underlying this framework is a naturalistic concept of contingency focusing on uncertainty as something which needs to be reduced or absorbed to allow for informed and rational decisions. This understanding feeds current attempts devoted to increasing transparency and disclosure requirements. However, such an approach neglects the evolutionary and open quality of finance and, in my view, is insufficient for the stabilization of financial markets. In contrast, the second part seeks to outline a more process-oriented alternative.

## I

Within the current debate on the crisis, there seems to exist an implicit agreement on how financial stability ought to be restored. A common sense that is probably best encapsulated by the Financial Stability Forum (FSF) when it notes that “sound disclosure, accounting and valuation practices are essential to achieve transparency, to maintain market confidence and to promote effective market discipline” (FSF 2008a: 22). Of course, many objections could be raised about this focus on *transparency*. For example one could ask how transparency is to be maintained given that innovation of models, instruments, products and practices in financial markets will certainly continue. What is more surprising, however, is that there is no theoretical or empirical discussion about what problems transparency actually tries to solve. There are many references to turmoil, chaos and instability, but not much discussion on why and how transparency (or the lack of it) came to constitute a problem. Neither do we find much discussion on how transparency and systemic risks might be interlinked. Although a theoretical discussion of how systemic risks emerge and are reproduced by the conditions of modern finance seems eminently important, one searches in vain for conceptual or theoretical discussions in official reports. For example, the IMF’s Global Financial Stability Reports from April and October 2008 only provide a graph that

measures the stability of the financial system by measuring specific risks like *credit risk* (IMF 2008a, 2008b). There is a general idea of what stability means (for example the absence of bank runs), but the focus is on the regulation of specific risks like credit risk, liquidity risk etc., particularly where these reports draw on a predominantly economics-informed literature. In other words, what transparency is said to accomplish is somewhat presupposed and not openly discussed or problematised.

As Gerald Schinasi (2006) has pointed out, one of the reasons for the absence of discussion lies in the negative definition of stability used by economists.<sup>2</sup> Here, stability is defined as the *absence of risk* which has important implications for further analysis. Economists tend to treat stability in static terms, as something which can be 'achieved' and *obtained* and equated with *equilibria* and *steady states*.<sup>3</sup> Already at this stage, the further debate is divided into either individualistic (expected utility) or structuralistic (market forces, equilibrium, arbitrage based) modes of explanations.

Consequently, the current debate on the sources of the subprime crisis is characterised by a specific bifurcation: one camp attributes the collapse of trust to the personal greed of bankers. Here, the talk is of bankers having lost their societal function and responsibility (Bitner 2008; Doo-ley, Folkerts-Landau and Garber 2008) or that "Wall Street was drunk" (Bush 2008a: 1). To only pursue this scapegoat strategy however leads to a simplistic description as it neglects the systemic and structural aspects of the crisis. Without the innovation and global dispersion of securitized debt and derivatives, supported by a specific constellation of hedge funds, rating agencies and private banks, the subprime crisis would not have been possible. The other camp blames the existence of these specific practices and advocates their prohibition. This approach is equally insufficient as the possibility of short selling, leveraging and hedging per se is neither good nor bad. To call for abolition not only neglects the potential benefits of innovation, but actually makes the same mistakes from yesteryear: the focus is maintained on already existing risks and it is forgotten that finance is a dynamic system that constantly changes and will therefore inevitably produce new practices and systemic risks. Top-down regulation with static laws will be as vulnerable as previous stabilization efforts.

Almost ironically, what is not addressed is the dynamic interplay of risk and regulation – how attempts to regulate or reform current practices give rise to new practices that

produce new risks and thereby generate new regulatory demand. The main reason for this silence, in my opinion, lies in the theoretical presupposition shared by both modes of explanation: both individualistic and structuralist modes of explanation are derived from economic models where the contingent situation is ontologically prior to interaction and framed in fixed and static terms (Kessler 2008b). Contingency, in other words, is understood to be a product that somehow occurs *naturally*. This inherently realist position comes with three interrelated limitations: first, there is only a limited understanding of uncertainty. In fact, the focus is only on the absorption and reduction of uncertainty, and its transformation into risk, to allow for rational decision-making. This fosters a realist perspective, as it treats reality (or institutional constraints for that matter) as objective forces. Uncertainty is then often treated synonymously with risk and subjected to the same calculus (Hirshleifer and Riley 1992; Savage 1954). Second, assuming that data represent reality, one cannot adequately differentiate between data, information and knowledge, and exactly this conceptual blind spot now translates into the attempt to solve problems of information and (non)knowledge by fostering simply the provision of more data – as if numbers would speak for themselves.<sup>4</sup> Thirdly, the current approach is blind for qualitative changes. For example, when the G20 discussed possible ways out of the current turmoil on 15th and 16th November 2008, it used the recommendations by the FSF as a blueprint (G20 2008; G7 2008a, 2008b; FSF 2008a, 2008b). The FSF recommendations however only expand, revise or change single rules of Basel II and its three pillars. But as §20 of the Basel II accord reads: "This Framework will be applied on a consolidated basis to internationally active banks." Basel II does not even envisage the possibility that an energy company might appear and act like a bank without actually being one. Taken together, these limitations essentially assume away the processes and practices that made the subprime crisis possible in the first place.

To conceptually capture the complexity and open quality of financial risk, it is necessary to leave behind static understandings of stability. A framework needs to be developed that seeks to capture how systemic risks prevalent in financial markets do not simply follow the logic of natural facts or economic mechanisms, but realises that these systemic risks are social phenomena insofar as they emerge and are processed by a changing net of observations among actors that continuously reproduces itself via the employment of specific calculative technologies (MacKenzie and Millo 2003). In the following paragraphs, I cannot fully develop

such an alternative framework, but only point at a different concept of uncertainty that such an avenue would entail.

## II

As long as contingency is seen as a natural phenomenon, theoretical questions can only focus on how uncertainty is absorbed or reduced to *risk* to allow for informed and rational decisions. Positions can differ here with regards to what cognitive capabilities are required and whether actors actually evaluate uncertain situations as theory *predicts*. But what is structurally excluded is the question of why uncertainty needs to be produced, managed and maintained. To conceptually grasp the openness and changing complexity of the financial markets, it is necessary to leave these economic confines behind and take seriously the social character of contingency. Social contingency stands for the interconnections between societies, institutions, practices, and modes of regulation (Boyer 2000; Clam 2004; also Aglietta 1976). It draws attention to how institutions and practices stabilise, structure, and naturalise interaction. Systemic risks and crises do not occur *naturally*, but each order produces its own crises (also Baecker 1988). The social nature of contingency provides a basis for the development of a dynamic understanding of financial orders where crises, risks and regulatory responses mutually condition one another. Faced with a specific crisis, the regulatory response produces the very conditions of possibility for new crises. Whether specific loopholes in Eurodollar markets in the 1970s, or the bubble in the American real estate market in the aftermath of the Asian crisis, crises are not due to *asymmetric information* or exogenous shocks, but result from the endogenous reproduction of uncertainty (also Best 2005). A dynamic and more socially informed concept of stability needs to take into account that uncertainty absorption and production go hand in hand. The production of new knowledge instantly produces new unknowns (non-knowledge) in face of unintended consequences, problems and contingencies, and thus new uncertainty (see also Japp 1999; Luhmann 1984: 436ff; Luhmann 1993: chapter 2; Willke 2001). There is a genuine part of uncertainty that cannot be erased (also Keynes 1936; Hayek 1942). Exactly this genuine uncertainty provides an entry point for an economic sociology of the crisis, especially as mainstream economists have built their modern techniques on the very exclusion of radical or genuine uncertainty (Beckert 1996; Kessler 2008a).

From such a perspective, the economic reading of the crisis seems to be not only incomplete, but based on a categorical mistake: treating data, information and knowledge synonymously, the (mainstream) economic reading fuses two very different modes of observation. First order observation refers to the differentiation and indication of something in opposition to something else (what is observed). Labour, for example, can be differentiated from unemployment, leisure or capital; the public can be differentiated from the private; the national from the international etc. What can be seen depends on the distinction used and is thus relative to other possible observations. Second order observations refer to how other observers observe 'the world' (how something is observed) (Luhmann 1990: 72-87).

These two modes of observation entail very different notions of uncertainty absorption and uncertainty production. Within first order observation, risk management techniques structure a previously unstructured reality by constructing classes, cases and probabilities. Uncertainty absorption and production refer to the employment of risk models and risk instruments and to how, for example, decisions are made on the basis of limited information and information processing capacity. First order observation is blind to its own operation or the way risk models and instruments structure and form reality. These require second order observation where a different kind of uncertainty is addressed: the observer finds himself in the context of other observers and tries to reconstruct their modes of observation and *models*. Uncertainty refers here to the improbability of first order observation where questions of right or wrong decision, of truth and failure depend on the system of mutual observations (Luhmann 2000: 61-62). What can be considered to be the *right* investment strategy or *sound* risk management depends on what others do. An investment in a sound company that nobody else cares about might nevertheless be individually irrational when other possible investments could lead to a significant higher return simply because everybody else invests in that company and thereby raises share prices (see also Baecker 1991).

In this sense, market dynamics are not simply the aggregation of first order observations, but result from the system of mutual observations and expectations. Markets as institutionalised second order observation allow actors to observe themselves in the context of their competitors. Markets are an internal mirror, as Harrison White (1981) aptly pointed out taking on board a central insight of Keynes'

beauty contest. Only on the level of second order observation can dynamics associated with the *breakdown of trust* and of *mutual expectations* be addressed. Trust or expectations are social phenomena and not simply psychological or individual properties. At the same time, the empiricist epistemology underlying the current debate frames the problem as a lack of measurement that then can be solved by increasing disclosure requirements. To frame the crisis as a crisis of measurement focuses only on the level of first order observation and, thereby, cannot adequately address the way information is processed or how actors know and do not know about themselves and others. Such questions require a more sociologically informed conceptual apparatus. The empirical consequence of this conceptual problem can be widely felt: major bailouts and governmental guarantees failed so far to restore institutional trust with the consequence that we find ourselves on the brink of a new round of bank failures.

## Conclusion

The subprime crisis not only demonstrates the failure of some economic theory dogmas, but it raises also important questions for economic sociology: from the performativity of risk models and the sociology of organizational risk management to the sociology of trust and credit. An economic sociology of the subprime crisis could differ from mainstream economic readings by differentiating between first and second order modes of observation and by taking seriously the dual process of uncertainty absorption and production. From this perspective, risk is not simply a technique or rationality. Risk is not a thing independent of practices and theories, it does not tell us something of the world. Rather risk names the boundary of what is known and what is unknown and how the uncertain and unknown is made known. What this short contribution implies, is that key economic terms change their meaning when second order observation is taken into account and that economic sociology therefore needs to continue its endeavours to develop a distinct conceptual apparatus by which economic practices can be made understood. Economic sociology needs to construct its own memories and historical narratives of how financial markets work and have worked in the past. Any alternative to economic modelling will prove incomplete when basic categories and semantic distinctions are shared with economics. That does not mean that economic sociologists should be ignorant of economics. But economists do not have a better understanding of economic processes – only a different one.

They construct their own world and nourish public debates by providing them with crucial distinctions which are in need of being further analysed.

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## Endnotes

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<sup>1</sup>The distinction between senior, mezzanine and equity tranche is based on their different risk-return profiles and the order of repayment in case of bankruptcy. A senior tranche received payments first, as it was being perceived as very safe. A senior tranche usually received an AAA rating. The mezzanine would receive payments once the obligations of the senior tranche were satisfied. This leaves the equity tranche as the investment with the highest risk which at the same time, however, promised the highest yields. See Kiff and Mills (2007).

<sup>2</sup>Of course, in this short contribution I do not suggest that all economists are alike. However, there is a specific epistemology underlying modern economic reasoning, i.e. criteria that make an argument an economic and not a political one. These criteria also provide meaning to the scientific vocabulary, that is to what is regarded as a good or bad argument, a failure, mistake, theoretical innovation etc. Of course, I cannot develop a full picture of the contours of economic model theory, but in mainstream economics, the economic problem is defined by a trade-off associated with some inefficiency. The disciplinary identity of mainstream economics is not defined by its subject matter but by a specific kind of (formal) reasoning. And it is this kind of formal reasoning with its focus on rationality, consistency and the implied ontological and epistemological presuppositions that delimit the range of possible questions and the framing of *empirical* problems, such as the problem of maintaining financial stability, restoring trust etc. See Kessler 2008b.

<sup>3</sup>Nobody denies the existence of *dynamic* methods in economic modelling. However, the distinction of static/dynamic differs in the context of physical theory (applied in economics) and social systems theory (used in sociology). The notion of *dynamic* as used in mainstream economics is taken from classic natural science, (and thus irremediably linked to ideas of moving equilibria, and it is based on Bayesian Algebra. From a perspective of social systems

theory, these *dynamic* models are still *static* as these models are still based on the idea of 'one' ordering principle. For social systems theory, dynamic modelling trespasses the confines of classical logic, and thus Boolean Algebra, on the operative level, and is associated with a shift of the relation between different ordering principles. For a further discussion see Mirowski (1988, 1989).

4 That data is not information, signalling models notwithstanding, can easily be seen when we remember that the same data means different things to different observers. While data is apparently *objective*, information is always linked to some cognitive framework. Or as Gregory Bateson argued, information is a difference that makes a difference (Bateson 1981: 582). Knowledge and information differ insofar as knowledge is inevitably linked to practices. See Hayek (1942), Polanyi (1958), and Luhmann (1990). For further discussions on the distinction between data, information and knowledge see for example Willke (2001: 73ff).

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