



**André Orléan**

## Beyond transparency

The current consensus is that the financial sector needs more regulation. This perspective sees markets as sound in principle, merely distorted by concealed risks. However transparency is no guarantee against bubbles and crashes. It is the rationale for the universal interconnection of capital that needs to be disputed, argues André Orléan.

From heads of the state to the humblest of commentators, one word has been on everyone's lips of late: regulation. There is something pernicious about such an abrupt turnaround, which in its unanimity recalls the financial sector's own logic, namely its propensity to encourage agreement by stifling conflicting opinion. "Worldly wisdom teaches that it is better for the reputation to fail conventionally than to succeed unconventionally", said Keynes of the excessive influence of market conformity.

In other words, contrary to the received wisdom, stock markets do not produce conflicting opinions. They unduly favour mimicry among investors, not for obscure reasons of crowd psychology, but because that is what good sense dictates. Going against long-term market developments is too risky. Everyone wanted the exorbitant profits procured through the sub-prime market and its derivatives. If they hadn't, they should have been in another line of work. When everything is going well, conformity creates periods of euphoria and speculative bubbles; when everything is going badly, it creates widespread suspicion and a refusal to invest in anything except the safest assets. One can observe in both cases the same inability to think outside the box dictated by the market. The intellectual consequences of mimicry are no less perverse than the financial consequences. Media-friendly reasoning squashes debate and, as has been seen on numerous occasions, intellectual independence is its first victim.

### **A unanimous demand for regulation**

Take deregulation. Much has been said about it, yet very rarely does anyone ever bother to explain precisely what regulatory principles should be applied. "Regulation" in itself is absolutely meaningless. It serves only to expunge opposing positions taken in the past.

To understand this, one obvious fact should be recalled first: the deregulated financial system is the result of a policy, i.e. a prescriptive model for society. That policy was competition. In *Naissance de la biopolitique [The Birth of Biopolitics]*, a discussion of liberal thought, Michel Foucault wrote:

Pure competition can only be the result of a long effort and, in reality, pure competition will never be achieved. Pure

competition must and can only be a goal, a goal which therefore supposes an indefinitely active politics. Competition is thus one of the traditional aims of government. It is not a natural phenomenon to be respected.<sup>1</sup>

Financially speaking, market efficiency lies at the heart of this politics of competition. The efficiency theory argues that stock markets always produce the best possible valuation of securities, in other words valuations which integrate all the available information. The accounting standards being criticised so harshly today, which require the valuation of balances be carried out in conformity with market prices, are a direct consequence of the efficiency argument. Since the market provides the real value, it is logical that accounting procedures take their lead from it.

It is wrong to believe that deregulation is synonymous with a comprehensive *laissez-faire* attitude. Just consider the stock markets themselves. They are the result of a complex set of rules specifying the stakeholders and the conditions governing their involvement, such as the rationale behind the formation of prices and many other parameters. These rules are entirely determined on the basis of a particular analysis of the competition. Let us remember too that liberalization was actively encouraged in France under the Bérégovoy Government. Liberalization was the response to an explicit strategy to abolish the restrictions limiting separations between markets, precisely so they could allocate capital efficiently. The explicit strategy was to create a single financial market where all stakeholders (banks, funds, companies, individuals, states) could share in all maturities (short-term, medium-term and long-term) using all the instruments available (stocks, bonds, derivatives and currencies). It was a world of universal interconnection and perfect, unhindered liquidity.

This utopia is perfectly logical. It is the product of theoretical, highly mathematical work which has been supported for decades by hundreds of economists at the most prestigious universities. It is known as "neoclassical finance". In other words, the norm of efficiency has a power that is simultaneously political, economic and intellectual. This is important because the deregulation issue cannot avoid it. It is at the heart of the debate. Depending on whether the idea of efficiency is supported or criticized, profoundly different regulatory policies will be promoted. Take speculation: clearly it is viewed positively by this conceptual approach, since it is due to speculation that information is transmitted to value. Speculation cannot be banned in this kind of theoretical context. To do so would be completely incoherent. In this view, speculation is judged to be perfectly stabilising, an idea staunchly defended by Milton Friedman.

### **What are markets for?**

Personally, I hold a different position, inspired by Keynes. Note that, although Keynes has been quoted a great deal recently, there is nothing like a Keynesian finance comparable to the neoclassical finance taught and studied in universities. Rather, a few researchers and professionals have taken a personal stance. The specificity of the Keynesian approach is to view the financial markets with suspicion. Keynes definitely did not believe in financial efficiency.

Following his line of argument, I would even say that such a concept had no meaning for him. Keynes's basic position was that, if the future is entirely unknown, the idea of a correct valuation disappears. There are only subjective

valuations. Moreover, for him the purpose of the markets was not to provide correct valuations, which do not exist, but to make investments liquid; in other words, to ensure that the securities they represent can be traded from stable foundations. Liquidity is very useful because the immobilization of capital is a certain obstacle to investment.

By making investments liquid, in other words negotiable, investment is encouraged. Nonetheless, liquidity is also dangerous because it is a transgression, insofar as capital itself remains immobilised in the form of factories and machines. Moreover, liquidity can easily become separated and disconnected from the real economy. Liquidity is at the root of peaks and troughs, creating what Keynes calls the "liquidity dilemma": some liquidity is required, but not too much and only under certain circumstances. The primary outcome of such a conceptual framework is prudence. Unlike neoclassical finance, Keynes continually repeats that the financial markets cannot be trusted entirely.

One issue provides a good illustration of the difference between the neoclassical and Keynesian approaches: transparency. For supporters of the efficiency paradigm, crisis is above all about opacity. The securitization of credit fails because it produces opaque securities whose risks cannot be assessed. To resolve a crisis there must be a return to transparency, they argue, and this is what regulation must impose on those involved. In other words, it is not the financial mechanisms themselves that are intrinsically at fault but securities, which were badly designed at the outset. This analysis does not question markets' efficient allocation of capital. The rationale behind universal interconnection allowing totally free movement of capital in all forms is not disputed.

Today, despite the current crisis, the same schema is being proposed with a little more control (so they tell us), partly because the intellectual tools needed to consider an alternative policy are sorely lacking. But this idea is arguable. Transparency is not sufficient to ensure financial stability, because it is the financial mechanism itself that produces instability. Bubbles can form with absolutely transparent securities. The Internet bubble was a good example of this. During that episode, we witnessed the formation of an entirely transparent speculative bubble. Investors were well aware that they were buying securities from companies that had high deficits, but these deficits were interpreted by the markets as proof of their dynamism. Similarly, perfectly transparent sub-prime securities allegedly created a bullish bubble.

Staying with this analysis, an alternative way emerges to combat the excessive stranglehold of liquidity on financing and investment decisions: separate channels and players in order to limit contamination, in the manner of the Glass Steagall Act of 1933, which prohibited commercial banks from participating in the financial markets in order to protect them from market booms. It is universal interconnection that has turned a crash with restricted reach (the sub-primes) into a major crisis, through the spread of the property market into the securitised debt markets, the stock markets and finally the interbank market.

On the other hand, the effectiveness of regulatory separations in impeding financial crises is well known. No banking crises were triggered by the separations introduced following the Great Depression during the period from 1945 until the start of the 1970s. Neither did they have any impact on growth, which had never been so strong. This principle must be applied in a manner

appropriate to the current conditions. However this will require a real intellectual revolution, the foundations for which are not visible at the moment since the liquidity model is wholly dominant. Clearly, these measures will create inflexibility, which will have an impact on financial profits. However, if the uninterrupted series of crises produced by unregulated markets for the last twenty years is to be halted, there is no choice but to open up this debate and be truly innovative.

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<sup>1</sup> Michel Foucault, *Naissance de la biopolitique. Class at the Collège de France, 1978–1979*, publication prepared under the direction of François Ewald and Alessandro Fontana, by Michel Senellart, Paris, Gallimard/Le Seuil, coll. "Hautes Études", 2004, p. 124.

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