Restoring the credibility of the legal and economic foundations of financial stability: The need for incorporation of economic theories?

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11 May 2013

ABSTRACT

To what extent can monetary and financial crises and cycles be explained through economic theories? This paper is aimed at highlighting why a reliance on economic theories may be necessary given certain flaws which have been revealed from the recent Financial Crisis. Namely, that economic and legal foundations of financial stability cannot always be considered to be credible. Further, the paper aims to accentuate on why despite the valid argument (that a reference to economic theories may be required to explain causalities of financial and monetary crises), causalities could also be explained from other perspectives – even though these perspectives may sometimes, not be as accurate.

Key Words: Theory of Economic Time (TET), Efficient Markets Hypothesis, financial stability, Currency Theory, Euro crisis, Austrian, Keynesian or Quantitativist-monetarist, Random Walk Theory

Restoring the Credibility of the Legal and Economic Foundations of Financial Stability: The Need for Incorporation of Economic Theories?

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A. Introduction

The first lines of the communication I had with an incredibly strong supporter and advocate of economic theories is that "When studying monetary and financial crises, the first thing you should look at is economic theories." The message also had the following bold print:

CAUSALITY OF ECONOMIC CYCLES (THEORIES)

I then responded by adding that:

" Immense thanks for the message. I also have something to add: when studying monetary and financial crises, one should also not solely attribute these to the Efficient Markets Hypothesis (EMH) or ECMH." Thereafter I kindly referred him to a recent publication.

Even though I had openly declared in a most recent book publication, "Recovering from the Global Financial Crisis: Achieving Financial Stability in Times of Uncertainty "[1] that I was not an advocate of the Efficient Markets Hypothesis or the Efficient Capital Markets Hypothesis – for many reasons which were highlighted in the publication, I was compelled to visit the website referred to by this advocate of economic theories, to gain some insight into the contributory factors responsible for the driving force (behind his conviction). Hence I visited Carlos Bondone's website to read his kindly (referred to) publication on the "Currency Theory".[2] On the website, other theories were also listed: Theories such as:

- Theory of Money

1 Business Express Press, ISBN 978-1-60649-700-5, June 2013 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2245208

2 See C Bondones, „Currency Theory: The Crisis of Currency Financial Theories" Chapter IV Currency Financial Institutions, page 35 http://www.carlosbondone.com/en/theory-of-economic-time/aplication/currency-theory.html (last accessed 11 May 2013)

- Theory of Economics
- Theory of Interest (Interest theory)
- Theory of Capital (Capital Theory)
- Macro Economic Theory
- Theory of Monetary (Currency) Crisis

(amongst other theories).

Before embarking on reading his publication, I still wasn't convinced that there could or should be such a dominant focus on an economic theory perspective. In my opinion, there is, to a greater extent, a dual or tripartite perspective in viewing or explaining many events more accurately – for example a legal, financial, economic or accounting perspective. Naturally other perspectives also exist. Furthermore, close linkages usually exist between many of these perspectives.

B. Can one also make reference to the study of monetary and global crises without some reference to some of the legal foundations of financial stability?

Bondones interestingly also adds that contrary to the view that legal foundations are pivotal to financial and economic stability, that „it is precisely postulated that existing legislation are the consequence of the crisis - however such legislation is based on poor economic fundamentals.“

Such criticisms are definitely valid. Many firms (for example Northern Rock) were operating within the stipulated and recommended capital requirements of the Basel capital adequacy requirements but still crashed whilst other factors such as maturity mismatches (particularly relating to liquidity requirements) had not previously been accorded adequate focus. Hence the need for the introduction of the two new Basel liquidity requirements, namely the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR).

Even with the two new liquidity standards, although some progress has been made in relation to the re-dress of liquidity risks, more efforts are still required - hence Bondones is justified in highlighting the fact that inadequate regulations and rules, also in respect of focus of such rules, were also contributory to the recent crisis. However, this also highlights the importance of enacting the most appropriate legal and regulatory requirements - thereby underlining the importance of rules and legal requirements in averting financial crises, as well as the fundamental role of legal foundations in fostering financial stability.

Hence the present rules and regulations aimed at ensuring financial stability are not only criticised for having weak based economic foundations, but a lack of adequate theoretical basis in attributing more precisely, the causes and consequences of monetary and financial crises in relation to studies on these.

In judging the effectiveness of stress testing techniques as well as other economic indicators used by various federal regulators and supervisors, could such techniques be considered to be credible enough in averting another financial crisis? Are the current stress testing techniques really based on more credible foundations than those capital adequacy rules which firms such as Northern Rock were relying on (and complying with) but neverthess, still crashed?

Further Carlos Bondone argues that „ the currency and financial institutions that govern our daily life have a close relation with the theories derived from the dichotomies of Böhm-Bawerk and Wicksell which TET (Theory of Economic Time) so often refers to.When humans act without previous theories we say they apply "techniques", if the opposite is true, we say their actions are based on science. But acting according to science does not necessarily mean it is an adequate science, and when a science cannot explain facts and events it is necessary to revise it."[3]

The following section attempts to illustrate how the Theory of Economic Time relates to financial occurrences that have recently taken place: more specifically, to the ongoing Euro-zone crisis.

C. The Theory of Economic Time (TET)

Bondone "presents as proof of what TET teaches", extracts from the book :[4]

> *Considering the theories presented in this work, one should anticipate serious difficulties in the attempt to unify currencies among states acting according to current theories, i.e. with irregular monetary systems. This is so because, as we have shown, it is impossible to have central banks really independent from political government in irregular currency systems. In other words, adopting a single currency with irregular currency systems means the countries forming the currency union must have identical political systems. If this reality is not considered, there will be very serious political*

3 See C Bondones, „Currency Theory: The Crisis of Currency Financial Theories" Chapter IV Currency Financial Institutions, page 35 http://www.carlosbondone.com/en/theory-of-economic-time/aplication/currency-theory.html (last accessed 11 May 2013)

4 See *The Theory of Economic Relativity – Solution to CURRENCY CRISES – A CRITIQUE OF CURRENT ECONOMIC THEORIES – Austrians, Keynesians, and Quantitativists*, chapter XIX, last paragraph under the subtitle *One Currency* ibid at page 51 of 73

> *and economic conflicts among those countries in a very short time, which will be more or less important for each country and the union as a whole according to the relative weight of each country.*

He adds that this text which "clearly explains political events in Europe in the search for a leading nation, is even more relevant considering it was written between 2004 and 2005, years in which the Euro was considered an exemplary currency, the currency institution of reference." Further he highlights the importance of "stressing that the Euro crisis confirms the idea derived from TET that not all countries can use a currency of the same quality. Just as different types of motors require different lubricants, the same occurs with currencies."[5]

Even though the Theory of Economic Time is also considered to be consistent with such economic theories as Adam Smith's invisible hand[6] in confirming the importance of such a theory, it conflicts with certain other economic theories.[7] Hence the Theory of Economic Time certainly has its merits as well as its criticisms. This is however, not a peculiar and isolated case given the fact that many economic theories often conflict with each other.

In highlighting and accentuating the importance of the Theory of Economic Time (in explaining the causes and consequences of monetary and financial crises), Bondone draws attention to three different types of crises, namely, currency-financial crises:[8]

- *Currency crisis*: currency crisis without a financial crisis
- *Financial crisis*: financial crisis without a currency crisis
- *Currency-financial crisis*: currency crisis and financial crisis

He makes reference to *twin asymmetries*, which in his view, "guarantee inevitable and recurring currency-financial crises, as long as economic democracy can survive them; that the world is immersed in recurring and inevitable currency-financial crises that capitalism suffers as a consequence of the *twin asymmetries*."

5 „A circumstance that ratifies that first you must establish the common characteristics of the motors to use the same lubricant, if not the use of a "common" lubricant will be more painful, because several motors will "break down", until the right lubricant for each motor is found. Any similarity between motors and countries, and lubricants and currencies, is not a mere coincidence."ibid

6 See ibid at page 61

7 For example, Bondone adds that conclusions derived from (Theory of Economic Time) TET contradict the Keynesian idea of a "barbarous relic". See ibid at page 45 of 73

8 See ibid at page 44 of 73

D. Conclusion

What can be concluded from all that has been discussed is that whilst economic theories certainly have the capacity to explain causes and consequences of monetary and financial crises, gaps still remain in certain respects – particularly with regards to inconsistencies which still exist between certain economic theories. It is certainly true that monetary and financial crises and cycles cannot be explained solely from one perspective. It is also true that fundamentals relating to legal and economic, as well as financial foundations have proven to be flawed – as evidenced from the recent Financial Crisis. Fiscal, monetary policies as well as financial regulation (amongst other factors) are crucial in addressing required responses as well as a consideration of legal and economic aspects – be they foundational principles or economic theories. As re-iterated previously, I'm not a strong proponent of economic theories such as the Efficient Markets Hypothesis (even though I consider the Random Walk Hypothesis to be more credible) – given the fact that markets are certainly and absolutely not perfect. Furthermore, a combination of numerous factors have also contributed to the recent Financial Crises. It would therefore be unjustified to attribute the cause of the recent Crisis entirely to the Efficient Markets Hypothesis or the proposition that an undermining of the need for regulation (owing to the assumption that markets are efficient) solely contributed to the Crisis.

Collaboration between financial regulators and supervisors, standard setters and external auditors would greatly improve market efficiency through an allocation of responsibilities in matters regarding the obtaining of information and channels through which such information should be distributed. In relation to cost reduction of the monitoring process – as well as agency costs, it could be said that an enhancement of the value of information which is accessed in markets would automatically result in a reduction of costs involved in monitoring certain channels through which such information is distributed.

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