

Systemic Fragility in the Global Economy

A Theoretical Perspective. Part 5 and Conclusion

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To understand how the nine trends contribute to, or are associated with, systemic fragility it is necessary to define further what is meant by contribution. How do the nine trends differently cause fragility and therefore financial instability? What are the qualitative differences among the trends in the determination of systemic fragility? To begin with, some causal factors are precipitating a crisis. Other causal factors are best understood as enabling, both in the build up to the financial crash and in the immediate post-crash contraction. Still other causes are fundamental and originating in nature. And not only the nine trends but fragility itself becomes a cause of fragility, as the development of systemic fragility results in feedback effects described in more detail shortly.

Of the nine trends, those that qualify as ‘fundamental’ are the explosion of liquidity within the global economy since the 1970s, the accompanying escalation of debt, the relative shift to financial asset investing that follows as real investment slows and financial asset investing and speculation in financial securities rises, and the accelerating disparity between incomes of the several hundred thousand new finance capital elite and those of the hundreds of millions of wage earners.

The important ‘enabling’ trends and factors would include the restructuring of both financial and labor markets globally and the contribution of government policy (fiscal, monetary, and other)—as both restructuring and policy enable, encourage and assist the expansion of debt and stagnation of incomes.

‘Precipitating’ causes of financial instability events (market crashes, banking system crashes, severe credit crunches, major financial institution insolvency and bankruptcy events, wars, natural crises, etc.) are not among the nine trends. What precipitates, or sets in motion, a major financial crisis is typically associated with a major shift in investor-agents’ psychological mindset and expectations. Here the price system, especially the acceleration of financial asset price deflation, plays a close supporting role in that expectations shift by investors.

To briefly recapitulate the nine trends and their relationship to fragility and financial instability: the explosion of liquidity since the 1970s, attributable to central banks creation of ‘money credit’ plus internal changes in the financial structure that has increased ‘inside credit’ liquidity, has led to a corresponding excess growth of debt, especially private sector debt. The availability of debt has led to its general leveraging in the purchase of financial assets. Financial asset investment profitability has diverted money capital from real asset investment alternative opportunities. Excess liquidity has become far greater in any event that might be employed in real asset investment.

Fragility is a basic function of rising debt and slowing or declining growth of incomes

required to pay for debt, plus a set of group variables that affect payment capabilities as well. Financial restructuring has produced a corresponding new structure comprised of shadow banks, deep shadow banks, and integration of commercial and shadow banks, an expanded global network of highly liquid markets for transacting financial assets, and proliferating forms of financial securities traded in these markets. This new structure and the unprecedented financial incomes it has generated for professional investors has created a new finance capital elite of no more than 200,000 very high net worth individuals. This new structure, the new elite, and the development of systemic fragility are components which must be included in the proper definition of 'financialization'. Concurrent with the financial restructuring has been a fundamental restructuring of labor markets on the real side of the economy. Labor market restructuring has produced a stagnation and decline of real wages and therefore household consumption fragility from falling incomes and related rising household debt. This occurs simultaneously as financial restructuring has raised debt and financial fragility. These are long term secular trends. However, financial crises and consequent real economy contractions intensify the mutual effects of financial and consumption fragility on each other in the post-crash period and deep contraction period. Government fragility also rises long term secularly due to policies that reduce government income sources even as government subsidizes the private sector and government debt rises. Government debt accelerates with cyclical crises, financial instability and real contractions, as government transfers private debt to its own balance sheets as well. Systemic fragility renders government fiscal-monetary policies less effective as it negates multipliers and reduces elasticities of interest rates on consumption and investment. In crises and post crises periods, the mutual feedback effects between three forms of fragility intensify as well. Financial asset price volatility plays a key role in the growth of systemic fragility, in intensifying the financial and real crises when they erupt, and in reducing the effectiveness of traditional government fiscal-monetary policies from stabilizing the crises.

Measuring the Three Forms of Systemic Fragility

As already noted, the three forms of fragility are financial fragility that affects private sector investment, consumption fragility that impacts households, and government balance sheet fragility that has consequences for government policy effectiveness and government ability to prevent deeper than normal real economic contractions and to generate a sustained recovery from those deeper contractions.



The three forms of fragility may be aggregated to estimate systemic fragility. Since debt levels and liquidity are potentially measurable, each of the three forms of fragility should in theory be capable of producing a fragility index. Systemic fragility in turn should be capable of representation by means of an aggregated index based on the three indices. However, the aggregation of the three forms of fragility cannot be created by a simple addition of each of the three fragility forms. Systemic fragility is more than just the 'sum of the parts'. The magnitude of systemic fragility is the product of the many, complex interactions and feedback effects that occur between the three forms of fragility. This feedback contribution makes the creation of a systemic fragility index more problematic.

Within each of the three forms of fragility the major determining variables are debt, income available for debt payments, and a group variable of elements that affect payment of debt from available incomes.

The debt and income variables include not only levels or magnitude of debt but the rate of change in levels and magnitudes. How thoroughly debt and income is defined is also important.

For example, forms of basic income with which to pay debt may include cash flow for financial institutions and businesses and wage income for households. While these are the basic definitions as per Minsky's analysis of fragility, they are not sufficient.

For determining financial fragility, Minsky's cash flow variable is too narrow a concept. The income variable influencing financial fragility should be defined as cash flow plus other forms of near liquid assets held by businesses that may in a crisis be relatively quickly converted to cash in order to make debt payments. Moreover, the rate of change in this broader income variable, and not just its level, should also be considered.

For households and consumption fragility, the proper income variable should be wage earning households' real disposable income plus income in the form of transfer payments to these households. Both levels and rates of change of income are important. Since the vast majority (90% or more) of households' income is from wages and transfer sources, adopting the real disposable income as the wage income variable is acceptable. However, insofar as the wealthiest households (especially the top 1% and the even more especial 0.1%) constitute a share of overall investor households whose income derives in part (rising with income level) from financial investment and capital gains incomes, a distinction might also be made between the two when assessing the development of consumption fragility.

And for government units, it is not just tax revenues that constitute 'income' but the ability to quickly sell bonds in markets as well. Another major factor related to government fragility is the ability of the national or federal government to essentially create substitute income quickly and when necessary in the form of printing of money that it can then 'lend' to itself when income from tax revenue and bond sales to private investors (and other governments) is insufficient. Since only national governments are legally allowed to 'create income' for themselves, it is probably important to distinguish between national government fragility and state-province-local government unit fragility, where in the case of the latter direct income creation is not an option.

Minsky's approach is also undeveloped in assuming that financial fragility's internal variables of debt and income operate for financial institutions (banks, shadow banks, etc.) in the same way as for other non-bank businesses. Insufficient distinction is made between the two, given that financial asset deflation impacts banks more severely and rapidly in a crash than it does non-bank business. Financial asset price collapse causes a collapse of bank cash flow + near liquid assets, and thus raises bank real debt much faster than for non-banks whose cash flow is affected negatively by falling real goods prices which decline much slower. This is a critical distinction. Minsky's failure to account for it reflects his general underdevelopment of the two-price theory factor, as he himself acknowledges. Also undeveloped is the intermediate form of bank-nonbank business institution—i.e. the multinational corporation that today is a hybrid of bank and nonbank, or what we've called 'deep shadow' bank, where its business model is based on both real asset and significant financial asset investing activity. And then there is the related question of whether, and if so how, shadow banks in general are potentially more fragile than commercial banks and how is that explained by the basic variable duality of debt and income?

On the debt side of the fragility definition, the sources and kinds of debt incurred are

probably important as well, not just the total debt levels or rates of change. For example, there are a number of different kinds of business debt (corporate bonds, paper, bank loans, etc.) that are important due to the terms and conditions associated with payments in the different instances. In the case of banks and financial institutions, bank fragility may be higher when there is a greater weight of 'repurchase agreements or repos' in their total debt portfolio while the proportion of junk bond debt to total debt impacts non-bank fragility. Similarly, composition of debt is important for consumer households (mortgage, credit card, student loan, payday loans, etc.) And even government debt, especially at the local government level where debt composed of derivatives like interest rate swaps is involved.

Here is where the third key variable defining fragility becomes important—i.e. what might be called the 'terms and conditions' of debt servicing (T&C variable) that interacts in important ways with both debt and income to jointly determine fragility.

Minsky's view is undeveloped with regard to the T&C variable. T&C is a group variable that is composed of various elements that may exist in different combinations and 'weights' associated with a particular debt. T&C as a group variable may include elements such as the level of interest charged on the debt; the term structure of the debt (short term v. longer term debt); whether the debt interest payment is fixed or variable and thus subject to volatility in interest amount; penalties, fees and other charges on missed payments; provisions of the debt that define under what conditions default may occur when principal and/or interest is not paid on time; post-default obligations; time limits for defining default (30, 60, 90 days?); powers of the lender of the debt when default is declared; bankruptcy processing, and other provisions that are called 'covenants' that define payment options for the borrower; alternatives to payment (e.g. option to pay 'in kind'), refinancing conditions, and so on.

The T&C variable is thus complex, and its composition and effects may vary considerably between different forms of debt (e.g. investment grade v. high yield 'junk' corporate bond debt, corporate commercial paper debt, securitized debt, national government sovereign (T-bond) debt, local government municipal debt, household installment, credit card, or student loans, leverage loans made by private equity shadow banks to businesses, and so on). The difficult to quantify character of the T&C variable makes estimating a fragility index for each of the three constituent forms of fragility especially difficult. But the T&C variable's important influence on fragility nonetheless increases greatly when a financial instability event is precipitated and a rapid change in financial asset price deflation occurs.

Thus within the three forms of fragility—financial, consumption, and government—that determine systemic fragility are three critical variables—debt, income, and terms and conditions of debt servicing. The interaction between debt, income and T&C variables determine what might be called a first approximation of the level of each form of (financial, consumption, government) fragility. But this would be a first approximation only, since the levels of fragility—and their aggregate summation as systemic fragility—are the consequence as well of the various feedback effects between the three fragility forms. And those feedback effects are enabled, in turn, by transmission mechanisms or processes that also constitute the equation of systemic fragility.

Fragility Feedback Effects

A major differentiation between the theory of systemic fragility introduced here, compared to other theories based on fragility as a determinant of financial instability, is the

acknowledgement of what might be called 'feedback effects'. The term is shorthand for the recognition that fragility is a dynamic and not a static concept. And that its development does not occur in a linear manner.

By 'feedback' and dynamic is meant that there exists a complex web of mutual determinants involved in the development of the aggregate condition called Systemic Fragility. Mutual causations between variables are at work, occurring at various levels.

As several examples have already indicated, there are mutual determinations between the three forms of fragility—financial, consumption, and government balance sheet. The internal variables of debt, income, and T&C also mutually impact each other—in some cases offsetting and reducing fragility and in other cases exacerbating it within each of the fragility forms. And there is a third, still more general level of interaction and determination—between financial asset and real asset investment as a consequence of growing fragility in general.

Within each form of fragility, the three variables involved—debt, income, and T&C—interact in various ways. For example, slowing or declining income with which to pay debt may result in higher debt, as a nonbank business resorts to borrowing more in order to service the debt. Or, its T&C may worsen as it rolls over the debt at a higher interest rate and/or shorter payback term, or with a loss of previously favorable 'covenants'. Rising debt in turn reduces available income for investment, as more of future income must be assigned to paying the higher debt. When debt term expires, lower income flow and higher debt levels may result in debt refinancing on worse terms than previously, which reduce the ability to make future payments. There are various combinations of mutual interactions between debt, income, and T&C over time.

A similar scenario applies to consumption fragility. Declining consumer real disposable income and/or reduction in transfer payments may force households to take on more debt to maintain living standards. Debt levels rise, and in turn higher total interest and principal must be paid on the debt. That means less future real disposable income after the higher payments are made. The higher a consumer's debt load and debt payments as a percent of disposable income, the worse the credit terms that consumer receives when borrowing. Higher indebtedness and lower income results in having to pay a higher interest rate for a home mortgage or auto loan. The quality of that indebtedness also affects payment terms. Excess credit card debt, for example, may force a household to resort to payday loans, obtainable only at excessive interest rates.

And within government units, especially local government, a fall-off in tax revenue affects a credit rating so that the municipality, school district, or other government agency is forced to pay higher interest rates on bond issues it offers. Higher interest payments due to more debt and higher rates means a reduction in future income. Income and debt mutually exacerbate each other, and government fragility rises.

Even national level governments may face similar difficulties. A good example is Greece.

In the Greek case, like many Euro periphery governments after 1999 and after the creation of the Euro currency, Greece borrowed heavily from northern European banks. Its sovereign debt levels rose steadily from 2000 to 2008. When the great recession in 2008-09 depressed Greece's real economy, its tax revenue income declined. Its ability to finance past debt

therefore was not possible. Northern European governments, and cross-government institutions, thereafter restructured and refinanced (rolled over and added to) Greek debt in 2010. That added further to the total debt levels to be paid. T&C were made more unattractive as well. As part of restructuring, Greece was forced to divert its tax income to pay for the higher debt. So its debt rose and its income available for the higher debt payments simultaneously declined. Debt and income decline were exacerbating each other and fragility growing for all three reasons, including deteriorating T&Cs. Government income diverted for debt payments, as a consequence of austerity policies, had the further effect of reducing Greek GDP, which further lowered tax income, and made Greece even more fragile. A second European recession in 2011-12 repeated the process, and debt was restructured a second time in 2012 with the same general effects. A third debt restructuring in 2015 is in progress. It too will raise debt levels, total debt payments due, and reduce Greece's income from tax sources still further as Greek GDP collapses once again.

The possible feedback effects between the three key variables within each of the forms of fragility are numerous. The intensity of these interactions serves to raise the level of fragility within each form. Moreover, that intensity rises during and immediately after a financial instability event, which accelerates the development of fragility within each form.

Increasingly fragility within each form leads in turn to greater feedback effects between the three forms of fragility as well.

Several examples have been shown previously of how financial fragility may interact and intensify household consumption fragility—and vice-versa. When a financially precipitated recession occurs, interactions between forms of fragility intensify and the processes become generalized. A 'race to the bottom' then ensues, leading to generalized price reduction (goods deflation), labor cost cutting and more household consumption fragility.

In the case of the financial fragility of banks and financial institutions, this feeds back on both nonbank businesses and households, raising the fragility of both. This typically occurs as collapsing financial asset prices for banks results in a freezing up of bank lending, both to nonbank businesses and consumer households. With new loans frozen banks' new income generation does not occur. They cannot sell financial securities, since no one wants to buy securities when financial asset prices are collapsing. Bank fragility then translates into nonbank fragility, as nonbank businesses, unable to obtain day to day business operating loans from banks, must resort to the cost cutting with the effects previously noted. In this way a nonbank business, that is not necessarily fragile to begin with, may be quickly forced into a fragility condition by the banking system and have to cut costs and/or take on more debt from other sources at less attractive rates and terms. The freezing up of bank lending has a similar effect on households. Bank layoffs mean declining income and rising fragility for employees associated with the banks. Nonbank cost cutting due to lack of bank loans produces the same effect for households. Bank financial asset price collapse may mean loss or reduction of pension retirement income to households. It also typically results in a decline in interest income earned by households. Mortgage refinancing as a means of increasing household income also dries up as banks freeze lending. There are various conduits by which bank fragility translates directly or indirectly (via nonbank fragility) to household income stagnation, decline, and therefore rising consumption fragility. Bank lending freeze up may also force households, like nonbank businesses, to seek credit elsewhere on worse T&C arrangements, also contributing to household consumption fragility.

Bank fragility also feeds back, directly and indirectly, on government balance sheet fragility.

The freezing up of bank lending results in a decline in real investment and household consumption that slows economic growth and thus government tax revenue. Government also ends up spending more in recession situations (discretionary and non-discretionary spending typically rise). The combination of more spending and less tax income means rising budget deficits which must be 'financed' by raising more government debt. Thus government fragility rises due to both declining income and rising debt.

Government also transfers debt from the private sector—especially from banks and strategic nonbank businesses it bails out—following financial crashes and deep recessions. Government may buy the bad assets on bank balance sheets and transfer it to its own—either its central bank or to what is called a nationalized 'bad bank' which holds the various toxic assets until the government can resell them. Massive government direct loans, subsidies, and loan guarantees to strategic nonbank businesses may also occur. Banks' ability to sell bad mortgage debt to government agencies also amounts to an offloading and transfer of debt, and fragility to an extent, to government. By enacting deep bank and business tax cuts, government indirectly also transfers private sector debt and fragility to itself. Banks and business income is raised as a consequence of less taxes to pay, while government income declines and thus its own fragility is raised.

Government units may also absorb debt from households in a similar fashion, in effect subsidizing mortgage refinancing for homeowners facing foreclosure or experiencing 'negative equity' value in the homes. However, this occurs far less than the much more numerous and generous debt transfer programs provided to banks, financial institutions and investors. More typical is government subsidizing household income, in effect reducing its own income, transferring debt and fragility to its own balance sheet. Secularly over the long term, but especially in post-financial crash crises, government may fund an increase in its transfer payments to households bolstering household income at the expense of its own deficits and debt. The rise in household consumption fragility is to an extent thus offset, while government's own fragility from more spending, deficits and debt is in turn raised.

Thus far the examples of 'feedback' direction have been from financial fragility, and especially bank fragility, to household consumption fragility and even government balance sheet fragility. But consumption fragility may also 'feedback' on both financial and government fragility.

As household income stagnates or declines due to many of the labor market structural changes noted, there is less consumption and therefore less household demand for nonbank business goods and services. That may result in less business revenue and therefore less business income. This feedback effect may be reduced to the extent that households, despite declining income, do not reduce their consumption but instead take on more consumer debt to maintain consumption levels. However, there is a limit to how much extra debt households are able, or may want, to take on to maintain consumption. Household debt accumulation has upper limits.

Consumer debt reduces future disposable income, as more interest on the debt must be paid. Stagnating-declining household incomes (and fragility) feed back to both further nonbank financial fragility as well as more future household consumption fragility.

Consumption fragility also feeds government balance sheet fragility. Reductions in household income and/or rising debt have the consequence of less consumer spending. Less household spending means less sales tax revenue; that especially impacts local

governments highly dependent on this particular form of tax revenue income. In the US economy, deep recession conditions are associated with significant loss of household incomes due to layoffs, wage cuts, etc., which may translate into mortgage failures, foreclosures, and falling local property values. That results in less property tax revenue income for local governments, raising their fragility. Dependent on local government and property tax revenues, Public Education services are then cut unless national governments spend more in order to maintain such services. In this manner, rising consumption fragility indirectly forces an increase in local government fragility via tax revenue income decline as well as national government fragility via more spending, deficits, debt and national government balance sheet fragility. Less household consumption impacts income tax—as well as local sales and property tax—revenues similarly. Less consumption means less business production and less hiring, both of which reduce taxable income that would otherwise accrue to governments. And there is a secondary, derivative effect on government fragility. Not only may government debt levels rise, as government has to borrow more in order to offset tax income loss, but the terms on which the additional debt is borrowed may raise debt costs as well. State and local governments running large budget deficits pay higher rates of interest for the municipal bond debt they sell in order to finance their high deficits due to tax income decline.

Financial fragility feeds into consumption fragility, and vice-versa. Financial and consumption fragility feed government balance sheet fragility in various ways. But the feedback direction may also occur from government balance sheet fragility to financial and household consumption fragility. This is where fiscal austerity policies play a particularly significant role. Austerity is about offloading actual, and/or potential, government debt onto households. Government balance sheet fragility is reduced at the expense of rising consumption fragility. Austerity means a deep reduction in government spending. That means more retained government income. But spending in the form of household transfer payments means less household disposable income. Less government spending means lower deficits and less debt to finance as well. Austerity also means government selling off public assets, which raises temporarily government income levels. But it forces households to turn to private, higher priced, alternatives to the once government provided services and programs. What were once perhaps free public services and goods must now be paid for by households, reducing their disposable income and raising household fragility. Austerity also means raising taxes and reducing government pensions and retirement payments, or national healthcare services or payments. All that raises government income or reduces government costs, while lowering household disposable income and raising household costs. In austerity, most of the tax increases are local government fee increases, sales taxes, and other 'regressive' taxation impacting median and below households the most. Occasionally, the tax hikes also affect investors and businesses. And the pension, retirement, and health care cuts are significantly directed at middle income households.

What the foregoing reflects is that there are numerous ways and 'paths' by which fragility in each of the three forms in turn 'feeds back' upon one or more of the other forms. Sometimes the feedback is direct—i.e. from government to households, or banks to nonbank businesses and households, or households to government or nonbank businesses. Sometimes it is transmitted via income declines, sometimes debt, or other times both simultaneously more or less. The feedbacks may also occur indirectly: i.e. rising financial fragility leading to consumption fragility and thereafter to government fragility as the latter responds. Or financial to government to households. Or many of the other possible combinations involving two or more.

But the major point is that feedback effects do occur. Fragility does not develop within each of the three forms independently of the other. It 'accelerates' overall as the intensity of the feedback effects grows during periods of financial instability events and subsequent deep and rapid decline in the real economy. There are not only 'accelerator' effects, but also what might be called 'elasticities of response' between the different forms of fragility feedbacks. Perhaps a minor change in financial fragility generates a significant feedback effect on consumption fragility—i.e. a big further rise in consumption fragility. But a rise in consumption fragility produces less of a significant change on financial fragility.

Transmission Mechanisms of Systemic Fragility

A final, but very important, topic to consider is the importance of 'Transmission Mechanisms' (TXMs) or processes with regard to fragility. This is an area that has been left particularly undeveloped in other analyses that attempt to explain the relationship between fragility, financial instability, and economic cycles.

Transmission mechanisms operate at several levels in the process of determination of systemic fragility. Feedback effects—i.e. mutual determinations—occur between the three internal variables—debt, income, T&Cs. At a higher level, between the three forms of fragility—financial, consumption, government balance sheet. And at the most general level between financial asset investment and real asset investment. All the mutual determinations require some kind of transmission mechanism between them.

At least three key transmission mechanisms appear essential to Systemic Fragility. They are: 1) the price system, 2) government policy, and 3) investor agents' psychological expectations.

Price Systems as TXM

The neoclassical view is that there is only one price system and all prices behave the same—that is, all prices respond in the same way to supply and demand forces. Whether financial asset prices, goods & services prices (output prices), input prices (wages as price for labor, real capital goods, land), or money prices (interest rates) are involved, the response to supply and demand is similar. Supply interacting with demand adjusts prices to return the economy back to equilibrium. In other words, one price system thus fits all and the price system is the key to economic system stabilization.

This neoclassical view does not conform to reality, however. In the case of financial assets, demand plays a much greater role; the role of supply is almost negligible. With financial asset price inflation, demand induces still more demand, driving prices ever higher so long as prices continue to rise. Supply does not moderate asset price inflation. And financial asset prices 'adjust' rapidly and abruptly downward (i.e. deflate) only when investors conclude that further price appreciation is not possible and price stagnation or decline is imminent. It is thus a psychological perception or expectation of imminent price shifting that precipitates the reversal and price deflation, not supply side forces. The shift to deflation is unrelated to extra supply or rising costs, as in goods prices, since 'cost of goods' for producing financial securities is virtually negligible.

Financial asset price deflation is a mechanism within a form of fragility that intensifies and exacerbates the effect of one fragility variable upon another—i.e. debt on income, income on debt, T&C on debt, and so on. Take the example of growing financial fragility among

banks. Financial asset deflation reduces bank income available to make bank debt payments to another bank from which it may have borrowed. When asset deflation begins, investors do not buy new assets from the bank. Bank revenue falls. Income from the sale of bank equity declines as well. This general income decline occurs, moreover, at a time when banks actually need to increase their income in order to cover the asset losses from falling asset prices as well as make payment on their own debt. Less income plus falling asset values plus rising real debt translate into an increase in bank financial fragility.

How then does this greater bank fragility transmit to another form of fragility, i.e. from financial to consumption and/or government fragility? Here again the price system serves as transmission mechanism, as financial asset deflation spills over into goods deflation and even to wage deflation thereafter. Here's one scenario of bank to nonbank to household fragility transmission enabled by price systems:

Banks are capitalist businesses like any other, but they are also different in that they are the capitalist institutions that provide credit to the rest of the system. They function based on a 'fractional reserve' basis. When bank asset prices deflate and bank losses grow, banks stop lending to ensure they retain sufficient reserves. They hoard available income (cash assets) as much as possible in an asset deflation situation in order to offset losses. When financial asset deflation is moderate, banks respond with what's called a moderate 'credit crunch' (lending interest rates escalate); when asset deflation is more serious, a 'liquidity crunch' occurs (bank lending dries up temporarily as banks impose administrative obstacles to prevent lending as well as raise lending rates); when banks default on a debt payment due it's an even more serious scenario, a 'solvency crisis'. An insolvent bank is a candidate for bankruptcy and court distribution of its remaining assets at auction.

The degree of bank financial asset collapse thus corresponds roughly to the degree of bank lending contraction. And as bank lending contracts, so too does the real economy. Nonbank businesses cannot obtain operating loans to keep their businesses going. Banks just won't lend. Nonbanks are then forced to raise more revenue income by lowering their product prices and/or by reducing their labor prices (wages) to cut costs, or both. In this scenario, what starts as financial asset deflation for banks 'transmits' to the rest of the economy as nonbank businesses institute goods and/or wage deflation. That goods and wage deflation reduces income for nonbanks and for households, in turn raising their fragility. The transmission is from asset prices to goods prices to wage prices. But the process starts with financial assets.

An alternative to nonbanks lowering their goods and/or labor prices is to cut production and/or layoff workers. The production cuts and layoffs result in less government tax revenue and thus raises government fragility. The layoffs amount to an aggregate wage reduction, with the same effect on consumption fragility.

Transmission by price system can also occur in the opposite causal direction. Forces behind declining goods or labor prices unrelated to financial asset deflation can transmit nonbank or household fragility to banks and financial asset deflation. However, that reverse direction of causation does not typically precipitate financial asset deflation as often or as dramatically as the latter precipitates goods and wage deflation. That's because financial asset prices are, by their nature, far more volatile for reasons stated. So what is more often observed is financial asset deflation transmitting financial fragility to nonbanks and consumption fragility to households.

Just as there are multiple ‘feedback’ effects between forms of fragility, so too are there multiple ways price systems can transmit income decline and debt rise, and thus fragility, between the three different forms of fragility. The steeper the asset price deflation that occurs after a financial crisis erupts, the more intense the transmission from one form of fragility to another. Also, the more fragile the other forms are when the crisis and asset deflation begins, the stronger the transmission from one fragility form to another. For fragility grows secularly and steadily over the long term, and then accelerates when a financial crisis erupts and the real economy contracts sharply in response to the crisis.

Government policy changes also function as transmission mechanisms, causing fragility to intensify among variables within a form of fragility as well as between forms of fragility. Here one might argue that government ‘prices’ serve as a transmission mechanism.

In the wake of a major financial instability event like a stock market crash or banking insolvency crisis, for example, the government central bank takes monetary action to pump massive liquidity into the banks to offset their financial asset collapse and losses. To do this the central bank drives down its lending rate to banks and bank-to-bank lending rates to zero, as has happened throughout the advanced economies since 2008 and continues now for the seventh year. Lowering the ‘price’ of money (i.e. interest rates) by government action lowers costs for banks and raises bank incomes by means of cost cutting. Banks can also rollover and refinance their previous debt by borrowing new debt at virtually no cost. That income support and debt interest (T&C) reduction together reduces banks’ fragility.

However, it also reduces income for households and raises therefore consumption fragility. Interest income previously earned by households from higher interest savings rates disappears. Households’ fixed income is reduced and consumption fragility thus rises due to the lower income. In effect, central bank zero interest monetary policy results in a de facto transfer of income from households to the banking sector. Households subsidize the banks. From a fragility analysis standpoint, it means fragility is transmitted from banks to households.

The lower interest rates also reduce central banks-government fragility by lowering the government’s debt financing costs. So both banks and governments like a zero interest policy. That’s one key reason why it has continued for so long and is favored over fiscal policy throughout the advanced economies still, after seven years. Greater reason, no doubt, is that keeping rates low for a long duration simply provides low-no cost liquidity with which to invest in accelerating financial asset prices or to use to leverage to finance expanding offshore real investments by multinational corporations. The purely economic reasons also provide geopolitical advantages as well. Low rates in order to stimulate the real economy are more a justification, and certainly a secondary objective.

The shift in government monetary and interest rate policy is a fragility transmission mechanism enabling feedback from one form (bank financial) to another form (household consumption). Or, it might be argued that the price for money is the transmission mechanism.

Another government price mechanism by which fragility is transmitted from one fragility form to another is government taxation—i.e. taxes as the ‘price’ for government services. By reducing taxes on banks or nonbank businesses, the government in effect frees up more income for business (reducing its fragility) while lowering its own tax revenue income and raising its own fragility. Lower tax revenue and income may have a ‘knock-on’ effect

requiring the government to take on more debt to offset the business tax cut and government revenue income loss. So government debt rises, income declines, and its fragility rises as that of business falls. This amounts to a transfer of fragility from the business-bank side (i.e. financial fragility) to government balance sheet fragility.

Government might do the same for households. However, such parallel fragility transfer is often only token in magnitude and effect. More often since 2008, governments have responded with austerity, shifting its greater debt and lower income (fragility) due to bank and nonbank bailouts to households. In other words, austerity tax policy amounts to a transfer of debt/income and fragility from banks and nonbanks to households and consumers, through the medium of the government.

Other types of government policy may also serve as transmission mechanisms bringing about a shift of fragility from one of the three forms to the other by lowering debt/raising income in one form and lowering income/raising debt in another. For example, free trade policies raise business revenue income at the expense of households' wage income. That means a shift of fragility from business to households, all things equal.

Government policies that aim at privatizing pensions and retirement systems, or privatizing and de-collectivizing (Obamacare in the US) health insurance systems, result in major cost savings for business that reduces their fragility, but also results in lower deferred wage incomes and benefits compensation for wage earning households.

The trend throughout the advanced economies in recent years is to implement what is called 'labor market reforms,' policy that aims at reducing unions, collective bargaining, and employment rights to help business cut costs and raise income. It also results in lower wage income. Fragility is offloaded from business and on-loaded to wage earning households.

A third transmission mechanism that increases fragility within a particular form, as well as between the three forms, is Investor-Agents Expectations.

Expectations among the global finance capital elite as to where financial asset prices are going in given markets are critical to the direct transmission of fragility between financial and consumption, and indirectly to government fragility as well. Consensus expectations among the elite as to whether financial asset prices in a given market are about to peak typically set in motion the selling of assets in that market. The selling then accelerates as second tier investors follow suit. Asset price deflation may thereafter turn into a rout, as 'retail' investors then provide further momentum and financial asset deflation accelerates. Members of the finance capital elite thus precipitate a reversal of asset price inflation.

This may occur by collusion between major shadow bank institutions or even commercial banking institutions. For example, in recent years evidence of such collusion has repeatedly appeared—as in the case of fixing of Libor interest rates and derivatives trading on London exchanges. Or it may occur as the result of more tacit signals by major buying or selling by well known traders of the big institutions, shadow or commercial. A pattern appears to repeat, where money capital and credit flows from shadow banks and big investors into a particular market, where the asset prices rise appreciably, then assets are sold in growing volume, financial profits are taken, and the global money parade moves on to another financial securities market.

One day it's Asian stock and equity markets, then its corporate junk bonds, then Exchange

Traded Funds, then oil commodity futures price changes, then it's Japanese or Euro currency speculation as QE programs are about to be introduced. The sea of liquid capital awash in the global economy sloshes around from one highly liquid financial market to another, driving up asset prices as a tsunami of investor demand rushes in, taking profits as the price surge is about to ebb, leaving a field of economic destruction of the real economy in its wake. Financial asset bubbles build and then collapse, accelerating financial fragility. When the pullout occurs, financial losses negatively impact the availability of money capital and credit for nonbank businesses, raising fragility among nonbank enterprises and the households dependent on them for wage income. Investor-agents' expectations alternately drive financial asset prices to bubble ranges, and then cause them to collapse as money is moved out again and sent elsewhere, almost instantaneously and electronically to other liquid markets which now have more asset price appreciation potential.

What results is stock markets appreciating to levels that have nothing to do with fundamental earnings of the companies in them, an unrelenting chasing of yield by investors in ever riskier markets, and a growing volatility of currency exchange rates—to name but a few of the more recent negative effects. What moves the markets in terms of major shifts and swings are not the common investor, but the major 'institutional' (read: shadow bank) investors who buy and sell in large blocks of securities.

Decisions of the big investors, the finance capital elite, are at the center of these major shifts in direction (up or down) involving financial securities prices. And their decisions are heavily influenced by their expectations as to where a given financial market's price level is reaching a top or approaching a nadir. Investors outside this elite may trade once a shift in direction has occurred (thus making few profits or taking major losses for 'getting in late' and 'getting out late'). But it is this global elite that drives the major shifts in asset prices, which is where the real money is made.

Their expectations and decisions have implications for financial fragility and its transmission to nonbanks, households and even government balance sheets.

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