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REVIEW ON *SYSTEMIC FRAGILITY IN THE GLOBAL ECONOMY* BY JACK RASMUS

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Abstract: Global central banks are unwinding their balance sheets, flattening the yield curve, and inverting it; with global trade tensions, appreciating dollar (liabilities), and emerging capital market stress (bond sell off/capital outflows), the global economy is extremely fragile and could experience a financial crisis and recession by 2020 (the consensus is by 2021). Systemic fragility is caused by policy mistakes, made by central bankers. These decisions make the financial system more fragile, as current central bank ideologies and orthodoxy are deficient, and unorthodox. Central bank policies are making matters worse, by driving costs of capital to zero (negative), replacing real for financial assets, printing trillions to bail out banks, and purchasing bad debt and defective financial products, allowing massive leakage of capital to flow unregulated (shadow banking) across globe platforms, etc.; and all with no effect on real economic growth, wage growth, labor participation, inflation, and more importantly, standards of living and social welfare.

Key words: global financial crisis; financial fragility; macroeconomics; monetary policy; financial institutions

Systemic Fragility in the Global Economy, by Jack Rasmus, Atlanta, GA: Clarity Press, 2016, 400 pp., $29.95 (Paperback), ISBN: 9780986076947

Introduction

Most major monetary, fiscal, and macroeconomic economists, and financial institution and capital market experts agree, the global economy and financial system

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is more systemically fragile than ever before: $13 trillion negative interest rate policy (NIRP),[1] rotating financial bubbles[2] (Rasmus 2017).[3]

As the global central banks unwind their balance sheets, flattening the yield curve and potentially inverting it, along with global trade tensions, appreciating dollar (liabilities), and stress on emerging economies (bond sell off) and capital markets (capital outflows), the global economy is extremely fragile and could experience a financial crisis and recession as soon as 2020 (Cooper 2008).

Global financial fragility (FF) is positively related to: total financial asset investment in the system, and with interest rate maturity optimization, elasticity of inside (shadow banking) credit, and available income to service total debt levels; with inflation expectations to the change in total debt levels; with credit default and reinvestment risk; and with fiscal and monetary government subsidies, support, credit facilities, quantitative easing (QE), bailouts, etc.

Financial instability in the global system is reflected in: dueling QE/QT (quantitative tightening) and currency wars, trouble with large systemic banks (Italian/Deutsche), government and corporate bond bubbles, emerging markets dollarization of corporate debt/liabilities, oil and commodity deflation, energy junk bonds, massive flows into ETFs (exchange traded fund) and US equity markets, flash crashes and high speed trading systems, on-line and peer-to-pear shadow banking-lending networks, yuan/US dollar devaluation–revaluation and appreciation–depreciation volatilities, Brexit, EU Entropy, US populous election outcomes, global GDP and trade volume secular downward decline, CAPEX (capital expenditures) under investment, labor productivity collapse, real wage-income decline-stagnation, commodity goods deflation, etc.

Dr. Jack Rasmus's book *Systemic Fragility in the Global Economy* (2016) is another example of the continuing growth of literature showing how fragile the global economic and financial system really is. Dr. Rasmus (2016) builds a methodical case of the systematic fragility of the global financial-economic system, and how current central bank economic ideologies and orthodoxy have been deficient and unorthodox.

The consensus is most contemporary economic financial-real cycle analysis is poor (Mauldin 2011), the reliance on the Phillips curve as a policy rule is flawed, there is linearity bias, measurements of debt-income feedback effects are underdeveloped, there is a misunderstanding of financial asset price determination, and most models are missing finance transmission mechanisms, as these factors are being ignored.

Contemporary economic central bank policies have made matters worse, by driving the cost of capital to zero (negative), replacing real assets for financial assets, printing trillions to bail out and purchase bad debt and defective financial products,

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allowing massive leakage of capital to flow unregulated (shadow banking) across globe platforms, etc.; and all with no real effect on real economic growth, wage growth, labor participation rates, inflation rates, and more importantly standards of living or social welfare (Cooper 2008; Rasmus 2017; Steiner 2016).

Overview

The first part of *Systemic Fragility in the Global Economy* (Rasmus 2016) is an overview of the five major economies: Europe, Japan, China, emerging markets, and the US. Its second part addresses the nine major variables that drive systematic fragility. These factors are the definition of fragility:

1) The relationship between debt (levels, rates of change, etc.),
2) The ability to service debt (forms of income and price as a determinant of income),
3) Terms and conditions of debt servicing (covenants and term structure of rates).

Fragility is the mutual inter-determination of these three variables; moreover, the variables function within the three main sectors of the economy: household consumption, business (financial and non-financial), and government sector.

The debt–income terms of servicing mutually determine each other within the three sectors. The three sectors are also mutually determinative of each other; there are feedback effects between the three sectors, as well as within them.

Fragility is measured as a quantitative index variable. By producing a leading index of fragility, it can forecast imminent systemic instability events. A time series (cross-section, factor analysis, data mining, simultaneous equation) regression analysis is needed of all nine (three within each of the three sectors) to determine the weights, and causal interactions. This can be done via machine learning (artificial intelligence) and neural network analysis.

Stagnation and Instability in the Global Economy

In the US, China, Japan, Europe there is a coordinated effort to correct the failures of global capitalism (under investment, employment, consumption, price stability, etc.), and the response by all central banks have been the same, a constant injection of massive amounts (trillions of US dollars, yen, euros, pounds, yuan, pesos, rubles, etc.) of liquidity (credit) to back-stop, set a support, drive (nominal/real) interest rates to zero (even negative), and artificially prop up asset prices (bank balance sheets).

However, this leads to asset price volatility (risk), bubbles and asset price collapse (financial/currency crisis/stagnation/deflation/ under employment-investment), and

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crisis more frequent since 1995 (Peso Crisis, Thai Baht, Russian Default, Housing Bubble, Financial Crisis, etc.) (Kindleberger and Aliber 2015).

Now global central bankers (governments) do not have the balance sheets to deal with future crisis, they have run out of options and monetary policy tools, they have not fixed the real problems underlying the economy, they have only created a monetary illusion of policy effectiveness: dead-cat bounce recoveries, emerging market currency collapses, Japanese perpetual recessions, Europe's stagnations, and China's asset price hyper-inflation (Bonner and Wiggin 2009).

The perfect example of this financial-economic fragility is Japan.

Japan's Perpetual Recession

Over the last 17 years (1990–2017), the Bank of Japan (BOJ) implemented aggressive forms of unorthodox monetary policy (negative nominal/real interest rate policy/quantitative easing): printing massive amounts of money, buying massive amounts of sovereign-corporate (infrastructure) bonds, driving bonds yields negative, and driving domestic investors/savers (negative effective rates), and financial institutions (disintermediation), literally crazy.

Japan will be the ultimate experiment in monetary-fiscal policy mistakes, as they will have to resort to even more extreme measures to try to get themselves out of their existential structural crisis. The ultimate fiscal-monetary response could be—with unintended political–economic–cultural consequences—a massive and coordinated debt forgiveness, by both fiscal/monetary authorities.

Japan is extremely fragile, as at some point they will not have the tax revenues to service the sovereign debt payments, and will theoretically fall into default, and will ask for forgiveness, not from bond holders, but from the BOJ, which owns the majority of the debt.

The consequences of massive sovereign debt forgiveness are unknown and untested in global modern monetary history, and what scares most economists and policy makers is that it could become a precedent, in the face of massive monetary overaccommodation (money printing), sovereign (fiscal) debt financing, and monetization (inflating away) of fiscal debt. Hyper-inflation, if used by some countries, will lead to a collapse in standards of living and social welfare, and rise of populism, social unrest, and revolution.

Not only is Japan's economy and financial system extremely fragile, but so is Europe.

Europe's Chronic Stagnation

The actual European Central Bank (ECB) structure (dominated by Germany Bundesbank) is a major impediment in its ability to respond to the current crisis:

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fiscal austerity, inability to devalue the euro, fear of hyper-inflationary trends, and misspecification of monetary policy targets (inflation, productivity, employment, wages, and exchange rates).

Poor performance (contagion), bank crisis (runs on banks), social unrest (extreme right-wing populism), massive debt issuance, and deflation (liquidity trap/collapse of money velocity) is the costly (stagnation) result of policy mistakes. This—along with the lack and hesitant response to bank runs in Spain, Greece, and other EU countries—has had a significant negative impact on ECB independence and credibility, in regards to the ability to respond to future financial and economic crisis.

In conjunction with monetary and economic paralysis, Europe is also going through a cultural-political crisis with the emergence of populism (Germany, England, Italy, Spain, Portugal, Turkey), due to mass migration from North Africa and the Middle-East due to wars and poverty (Syria, Libya, Iraq, etc.); and Russian aggression in Eastern Europe (Ukraine and Georgia)—NATO (North Atlantic Treaty Organization).

Systematic fragility is not only experienced at the microeconomic (country/market) level, but manifests at the macroeconomic (systemic/systematic/institutional) level.

Trends in Systematic Fragility

Systematic fragility is made up of financial, consumption and government fragility; and intra-sector fragility, is caused by debt levels (rate of change), income (servicing of debt), and terms and conditions of servicing of debt. Transmission mechanisms between these factors and sectors are price systems (financial/commodity), government policy (monetary/fiscal), and psychological expectations (investors/consumers) (Akerlof and Shiller 2010).

What is important is understanding the fundamental forces and enabling factors driving fragility: the end of Bretton Woods, central bank managed float systems, ending of international capital controls, the liquidity explosion, debt escalation, financial asset investment shift, and the rise of the new global finance capital elite; and financial deregulation, global digital-network technology, financial engineering (derivatives) revolution, highly liquid financial markets, financial restructuring and emergence of the open, unregulated, high-speed telecommunication driven shadow banking system.

Globalization, technologicalization and deregulation/integration are accelerating capital flows and accumulation, and concentration of capital to targeted and non-targeted markets across the world, fundamentally restructuring markets and institutions. This process is continuing at a rapid pace, and depending on the recipients, is

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economically, financially and politically (institutionally) destabilizing, destructing and deconstructing liberal-democratic-capitalism.

Financial product innovation and advancements in the use of technology for trading purposes, is accelerating the shift from real to financial asset investment—and with the rise of global equity, debt, and derivative markets—is changing the institutional structure, and exacerbating the fragility and instability, of the global financial system.

Central Banks and Fragility

Central banks bailed out the private banking system, and will again—along with other strategic affiliated institutions, corporations, businesses and brokerages—by printing massive amounts of fiat currency (seigniorage), to buy (defective/defaulted) securities product (derivatives), accumulate more sovereign-corporate-personal debt, with even more crowding out effects, and with no real eventual long-term impacts on real economic growth, wages, and productivity; and social welfare or standards of living.

Only asset prices bubbles and a massive redistribution and concentration of wealth will occur. Global capital markets, financial institutions, governments, businesses, and consumers are sitting on an extremely fragile system. This is obvious when looking at the level of government debt, service.

Government Debt and Government Fragility

It is estimated, between the US Federal Reserve Bank, Bank of England, and European Central Bank, $15 trillion direct liquidity injections, loans, guarantees, tax reductions, direct subsidies, etc. have been used. If you add in China and Japan, the total gets to as high as $25 trillion, and if you add in other emerging country (Asian, Latin America, and Middle East) central banks, the total gets as high $40 trillion. Add in inter-temporal substitution (opportunity costs) over 40 years, we are looking at hundreds of trillions of dollars of debt, and debt service.[4]

What perpetuates this reliance on debt, and debt service, is the misconception of valid economic theory and analysis, and its real application.

Failed Conceptual Frameworks of Contemporary Economic Analysis

It is obvious, global monetary and fiscal policy responses have made the global financial and economic system even more fragile, and eventually insolvent and bankrupt, and modern central banking is ineffective and has put us into a perpetual liquidity trap, the velocity of money has collapsed. There is no money going into

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real long-term (capital budgets) assets, only short-term financial assets (equity, fixed-income, ETFs, derivatives, structured products, crypto-currencies, etc.).

This has led us into the contradiction of macroeconomic theory, monetary policy and central banking: liquidity-debt-insolvency nexus, the moral (immoral) hazard of perpetual bail-outs, growing concentration of wealth at the extremes, growing perception that negative/zero interest rate Policy (N/ZIRP) can fix under-investment in capital (human/physical) and deflationary (disinflationary) trends, and that current banking regulation-supervision is bad for the economy, financial services (institutions) industry, and for institutional and retail investors (savers) in the long run.

And unfortunately, these techniques and tools have been used by other global central governments and banks, with similar, disastrous, and disappointing outcomes. The focus is on saving the financial institutional system in the short-run, using extreme and un-orthodox monetary policies (tools), with a lack of concern or understanding of long-run economic, social, cultural, and political consequences and outcomes. This is the true reflection, of failed conceptual frameworks, of contemporary economic analysis (Harvey 2005, 2011; Posner 2011).

A Theory and Application of Systematic Fragility

The true theory (model), of systematic fragility, is a proxy for instability, a measure and quantitative score, used to forecast financial instability events, measuring pre-post-crash-recession cycle phases, it is a simultaneous equation-solution, the weights and factors are non-linear relationships, and are determined through the use of machine-learning (AI) algorithms, that adjust the factors, equations, and outcomes in real (continuous) time.

For example, over the last 10 years, the Fed accumulated over $4.5 trillion in bank reserves/balance sheet (bonds), made up mostly of mortgage backed securities and US government Treasury notes and bonds, the average size of the balance sheet prior to the financial crisis was approximately $700 billion.[5] Since these were mainly reserves creation, and an addition to the monetary base, and not really the money supply, the policy effects (QE or zero-negative real interest rate policy) have been mute.[6] This is reflected in the inability to constantly reach GDP, inflation, real wage, capital expenditure, etc. targets. There needs to be a total restructuring of the global regulatory and financial institutional framework.

The real cause of deficient real-macroeconomic performance, is a collapse in the velocity of money, driven by alternative forms of money creation and flows across the globe (cryptic-digital currencies-shadow banking, etc.); the lack of fiscal labor market policy to lower under-employment and raise labor market participation rates; and resolve to solve other social, cultural, political and economic disruptions. This makes it now impossible to conduct monetary policy.

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With the US fiscal debt totaling over $21 trillion (interest payments + $260 trillion per year), the Feds Balance Sheet totaling $4.3 trillion, the potential for continued-perpetual war (defense spending) and entitlement expenditures, and political and policy uncertainty (next Federal Reserve President), there is little room for monetary and fiscal solutions to fight the next financial and economic crisis.[7] Also, having so much debt outstanding, the rising cost to service this debt creates a massive crowding out effect, which will eventually lead to secular deflation as it sucks investment and consumptive capital out of the system.

Neoliberal new-classical macroeconomic theory is flawed (Harvey 2005, 2011; Lewis 2010), at best, as it ignores financial-fiscal-monetary factors, and relies on the primacy of central bank monetary policy, tax structure shifts, free trade theory, running of twin deficit systems, allows for major labor market restructuring, leading to wage compression, drives toward privatization of public goods and institutions, and fiscal austerity, and financialization-fiscalization of elites, institutions and products.

Conclusions

Most major monetary, fiscal, and macroeconomic economists, and financial institution and capital market experts agree, the global economy and financial system is more systemically fragile than ever before.

Global financial fragility (FF) is positively related to total financial asset investment in the system, and with interest rate maturity optimization, elasticity of inside (shadow bank) credit, and available income to total debt levels; with inflation expectations to change in total debt levels; with credit default and reinvestment risk; and with fiscal and monetary government subsidies, support, credit facilities, QE, bailouts, etc..

Government policies have made matters worse, by driving the cost of capital to zero (negative), replacing real assets for financial assets, printing trillions to bailout and purchase bad debt and defective financial products, allowing massive leakage of capital to flow unregulated (shadow banking) across the globe, etc.; all with no real effect on real economic growth, wage growth, labor participation, inflation, standards of living or social welfare.

These failures and fragility are reflected in increased volatility in social and economic indicators, capital market pricing and investment risk, and resulting reductions risk-adjusted returns, inefficient allocation investment capital and resources, and falling employment and real income growth rates, standards of living and overall social welfare.

In conclusion, if this system of unorthodoxy continues—and I believe it is too late to address the systemic and systematic risks associated with the economy, government, and central banking—it will expose the economy, financial institutions and capital markets to failure, again, at an ever higher social price.

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The reality is our economic and financial systems are extremely fragile, and we are facing ever higher systematic-systemic credit default (illiquidity) risk, and another severe financial crisis, great recession and depression, as our tools and systems are ineffective and broken.

Notes

1. See https://www.forbes.com/sites/investor/2016/09/15/the-folly-of-economists-negative-interest-rates/#a0547dc217dd, and https://www.brookings.edu/blog/ben-bernanke/2016/03/18/what-tools-does-the-fed-have-left-part-1-negative-interest-rates.
2. See https://www.cnbc.com/2016/10/06/global-debt-balloons-to-all-time-high-of-152-trillion-imf-warns.html.
3. See https://www.usatoday.com/story/money/economy/2018/04/19/global-debt-tops-164-trillion-imf-warns/530893002.
4. Data are collected and calculated from https://libertybuzznews.com/2018/06/15/the-central-bank-party-is-already-over/.
5. See http://www.thefiscaltimes.com/Columns/2014/11/04/45-Trillion-Balance-Sheet-What-s-Next-Fed
6. See https://www.federalreserve.gov/monetarypolicy.html.
7. See https://www.treasurydirect.gov/govt/reports/pd/pd_debttothepenny.html.

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