Credit Derivatives, Leverage, and Financial Regulation's Missing Macroeconomic Dimension

Erik Gerding

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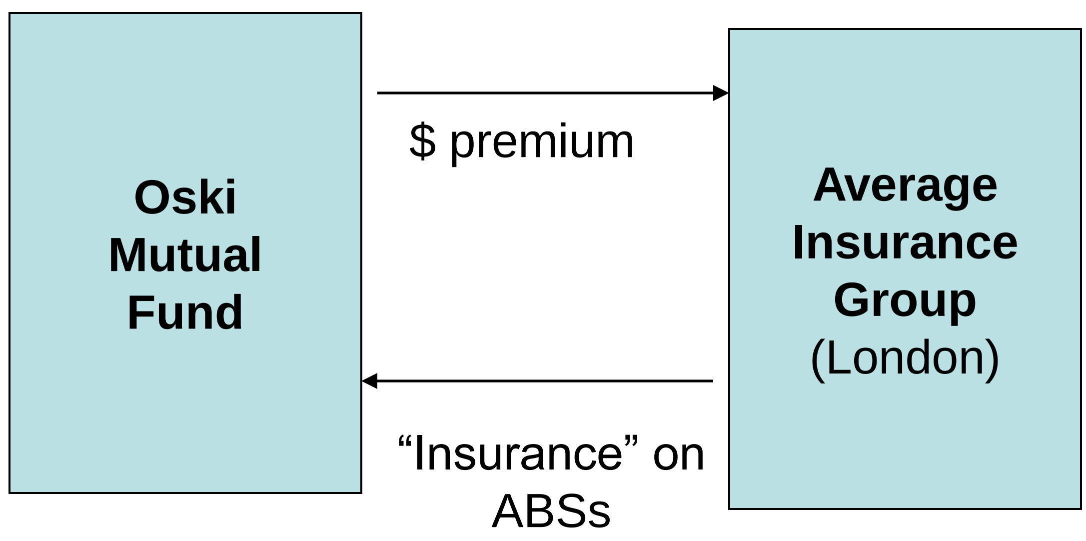
Basic Credit Default Swap



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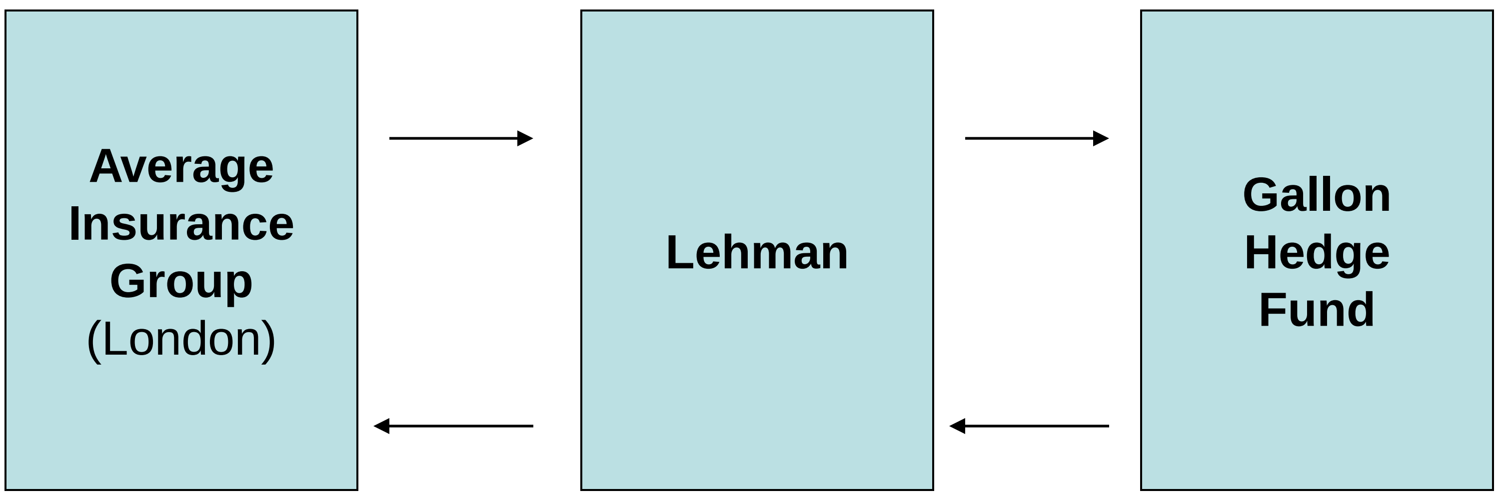
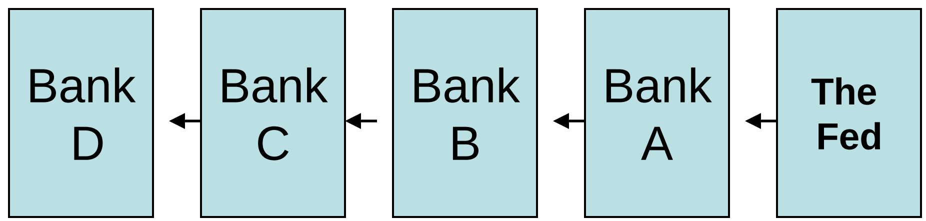
Hedging Credit Default Swaps



The Bank Channel



The Bank Channel

Money multiplier effect with 10% reserve

$1,000 (original amount loaned from Fed to A)
+$900 (amount that A loans to B while holding 10% in reserve)
+$810 (amount that B loans to C while holding 10% in reserve)
+$729 (amount that C loans to D while holding 10% in reserve)
$3,439

Money multiplier effect with 5% reserve

$1,000.00 (original amount loaned from Fed to A)
+$950.00 (amount that A loans to B while holding 5% in reserve)
+$902.50 (amount that B loans to C while holding 5% in reserve)
+$857.38 (amount that C loans to D while holding 5% in reserve)
$3,709.88

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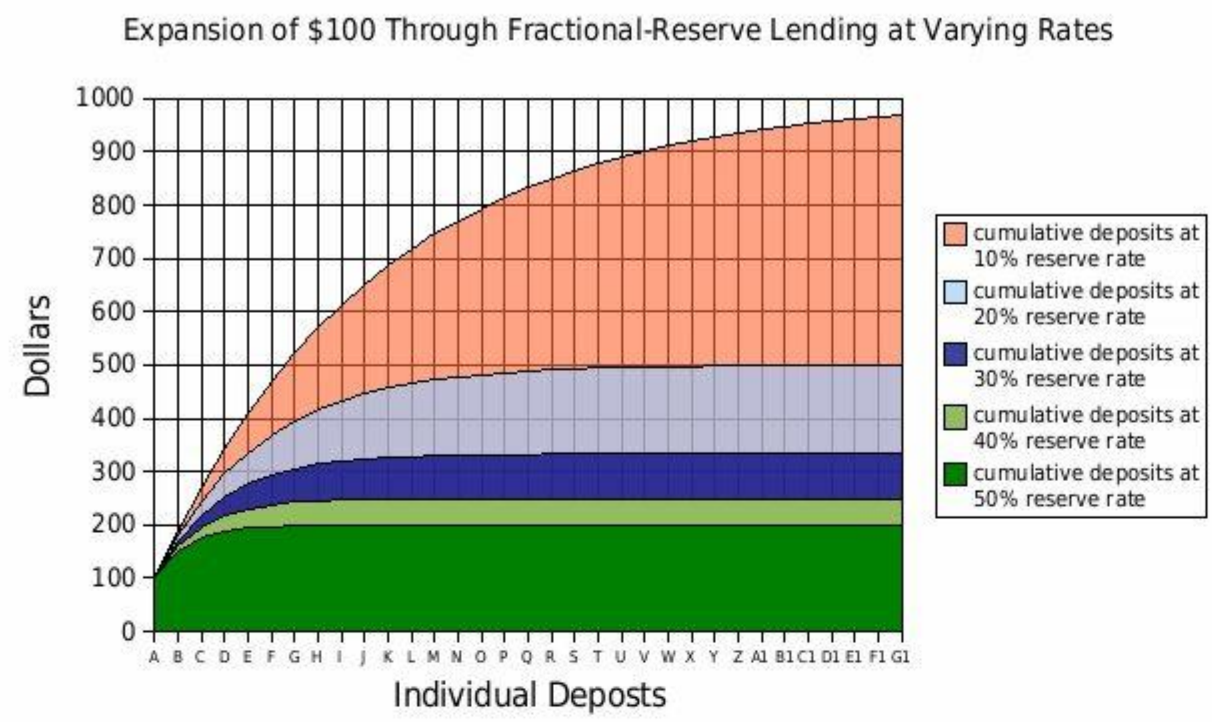
Money Multiplier



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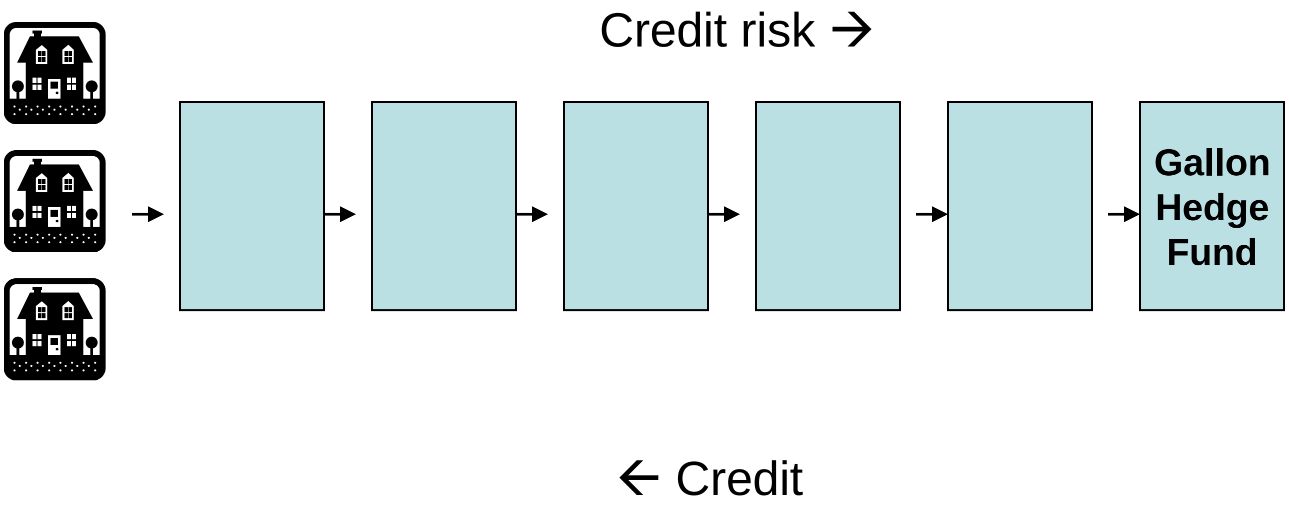
Credit derivatives link to underlying asset markets



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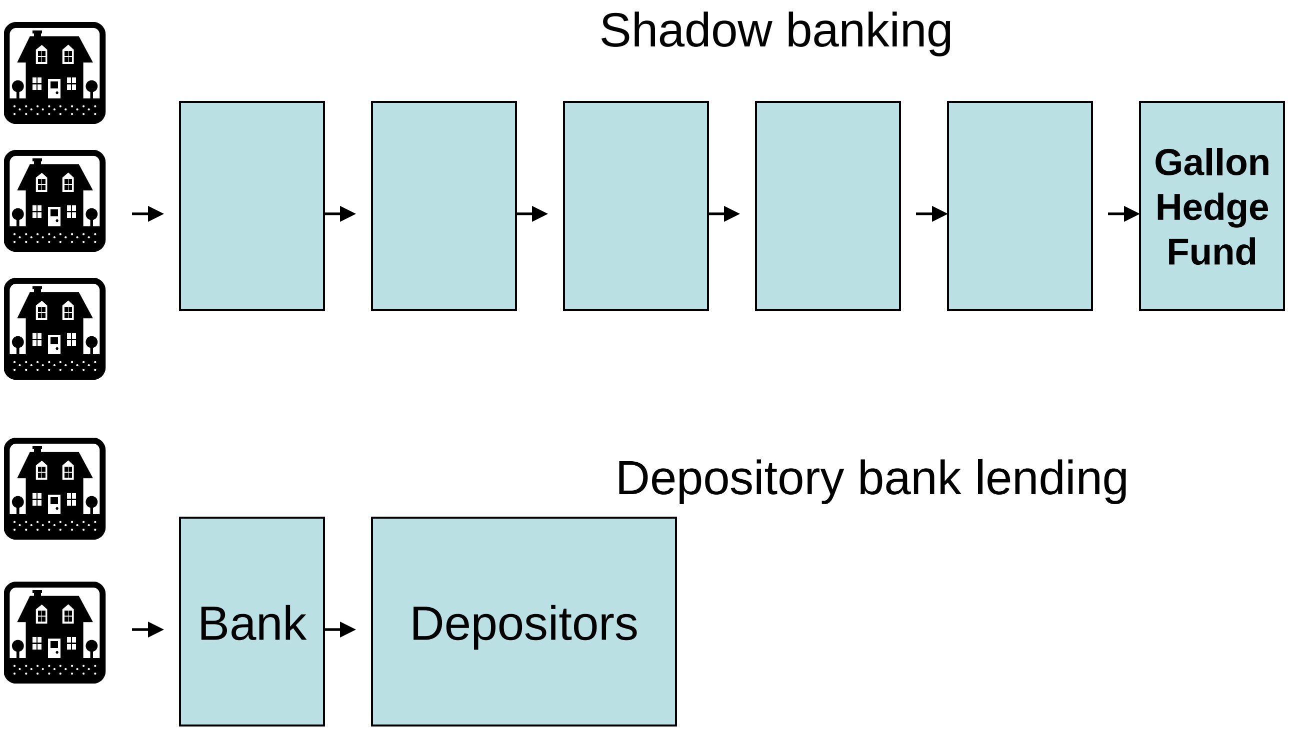
Bypassing the bank channel



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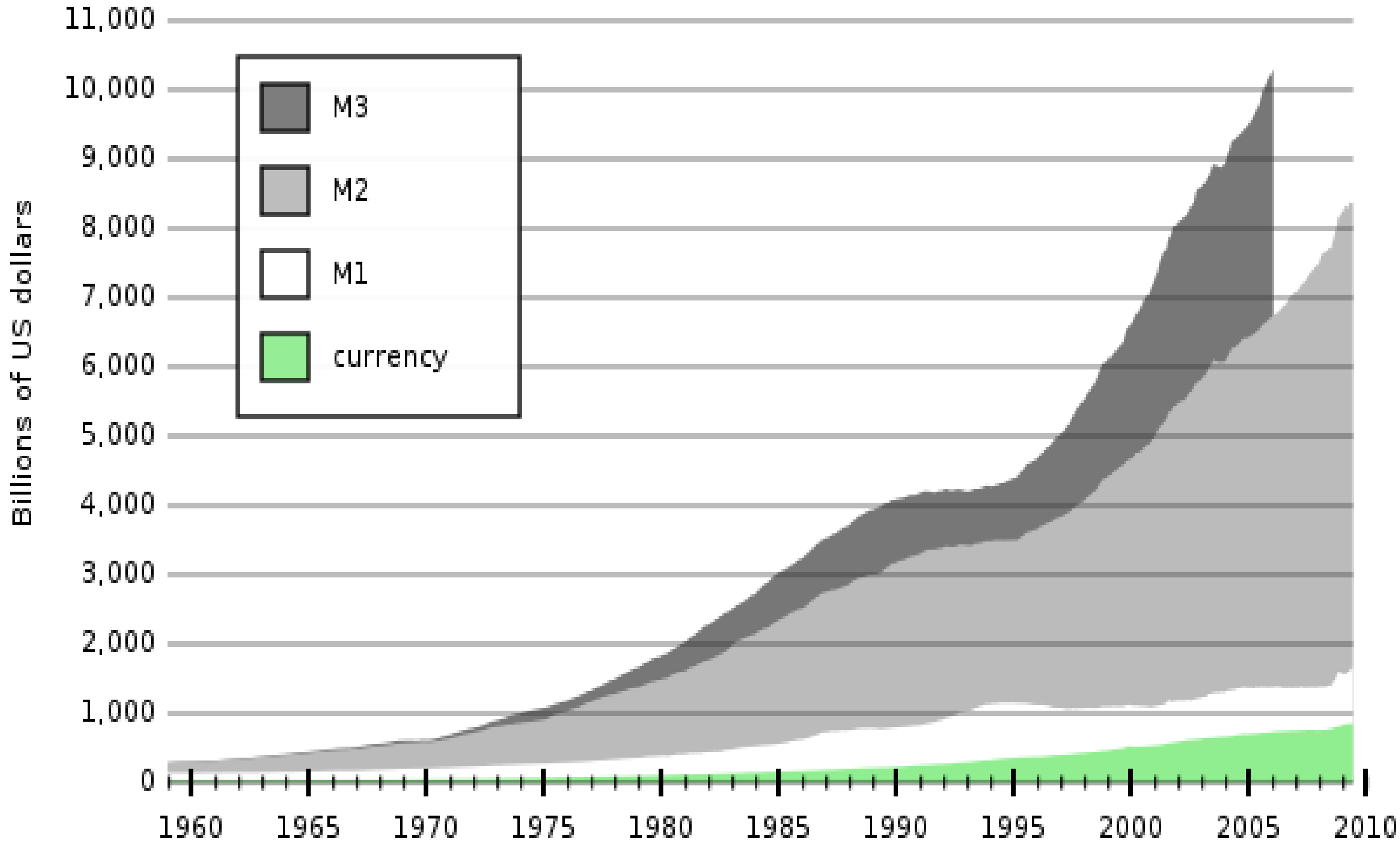
Measures of the money supply

M1: currency, checking accounts, travelers' checks.

M2: M1 plus time deposits, savings accounts, bank CDs.

M3: M2 plus large time deposits, institutional money market funds, repurchase agreements.

U.S. Money Supply 1960-2010



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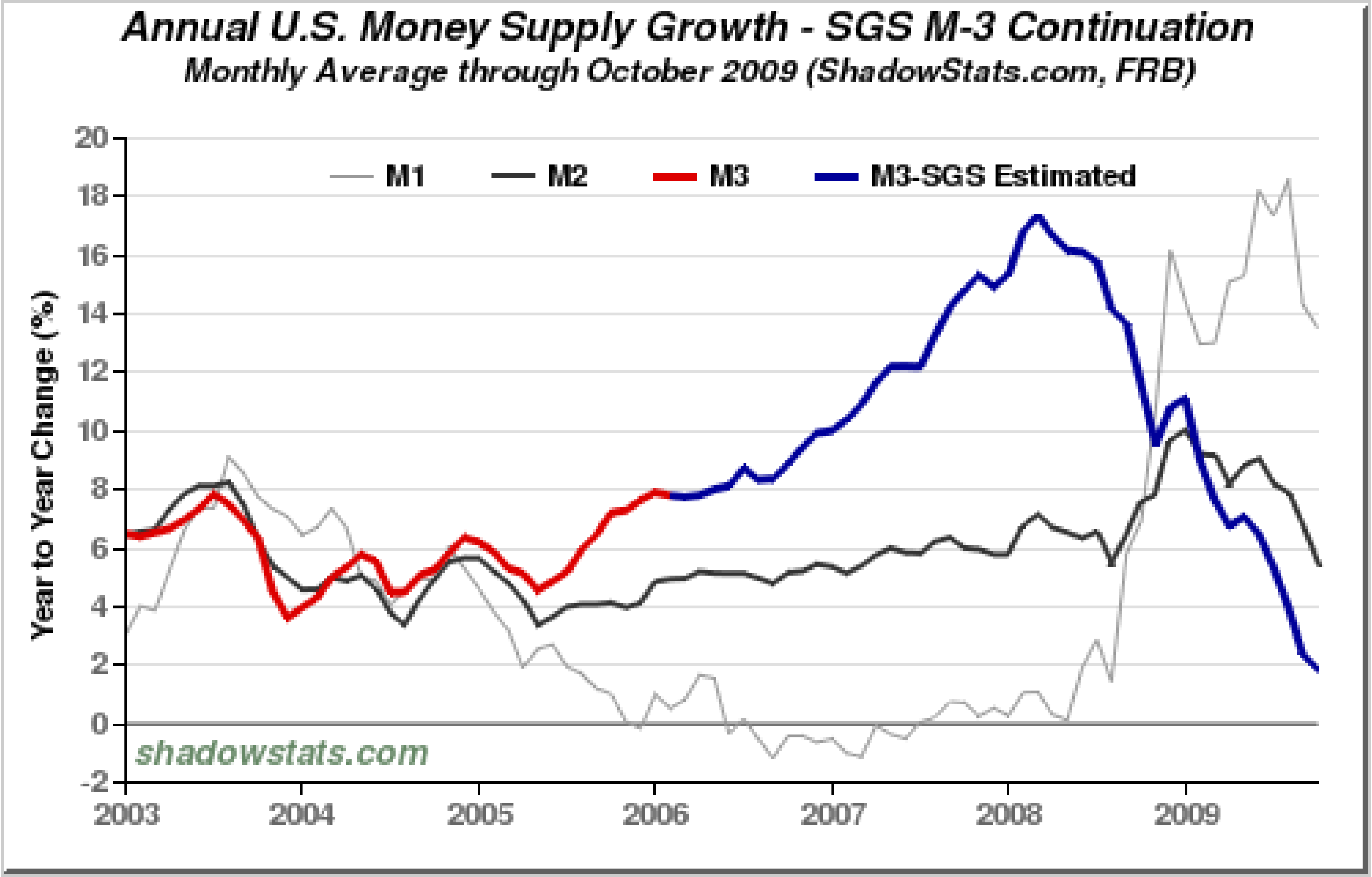
An estimate of M3



Surgery with a Sledgehammer

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