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

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Basic Credit Default Swap

Oski Mutual Fund

$ premium

“Insurance” on ABSs

Average Insurance Group (London)
Hedging Credit Default Swaps

Average Insurance Group (London) \(\rightarrow\) Lehman \(\rightarrow\) Gallon Hedge Fund

\[\text{UNM School of Law}\]
The Bank Channel

Bank A <- Bank B <- Bank C <- Bank D <- The Fed
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
Money Multiplier

Expansion of $100 Through Fractional-Reserve Lending at Varying Rates

- Cumulative deposits at 10% reserve rate
- Cumulative deposits at 20% reserve rate
- Cumulative deposits at 30% reserve rate
- Cumulative deposits at 40% reserve rate
- Cumulative deposits at 50% reserve rate

Individual Deposits vs. Dollars
Credit derivatives link to underlying asset markets

Credit risk →

Gallon Hedge Fund

← Credit
Bypassing the bank channel

Shadow banking

Depository bank lending

Bank ➔ Depositors ➔ Gallon Hedge Fund
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
An estimate of M3
Surgery with a Sledgehammer