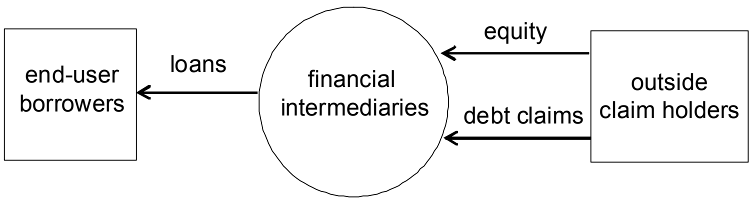
market prices. We return to this issue later in our paper, when we comment on the implications of our study for the conduct of monetary policy.

## 2. Financial System Perspective: Theory and Recent US Case

A simplified analytical framework for our analysis can be given in the diagram below. The financial intermediary sector channels funds from equity holders and ultimate lenders ("outside claim holders") to the ultimate users of those funds ("end-user borrowers").

The identity of the end-user borrowers depends on the particular case studied. In the US mortgage boom and bust, the end-user borrowers are households who have borrowed to buy residential property. In the case of the 1980s bubble in Japan, the group of borrowers who figure in the story will be mainly corporate borrowers.




The constituents of the financial intermediary sector itself will depend on the context. For the US mortgage boom and subsequent crisis, the intermediary sector includes the originating banks, but also includes the entities such as the GSEs and GSE mortgage pools that were involved in the securitization process.

In the case of the 1980s bubble in Japan, the financial intermediary sector includes the banking system as a whole, but we will argue below that non-financial companies became incorporated as part of the financial intermediary sector.

Irrespective of the context, at the aggregate sector level (i.e., once the claims and obligations between leveraged entities have been netted out), the lending to ultimate borrowers must be funded either from the equity of the intermediary sector or by borrowing from creditors outside the intermediary sector. To see this, consider a simplified balance sheet of an individual bank, as follows: