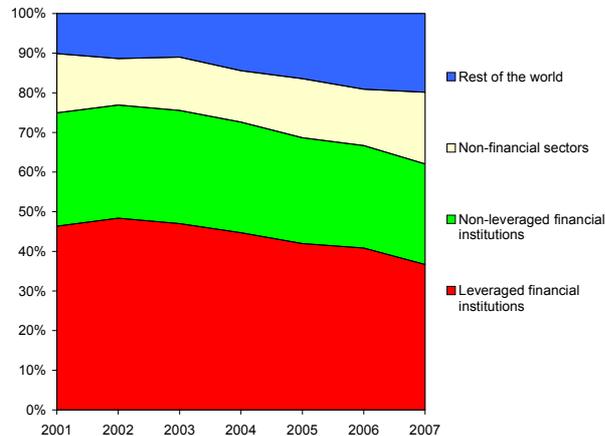


world” category indicates foreign creditors, especially foreign central banks or other official sector holders. The figure below charts the holders by percentage holdings.

Figure 2. Holdings of GSE-Backed Securities (percentages)



Source: Flow of Funds Accounts, Federal Reserve.

The key series for our illustration is the proportion held by other entities than leveraged financial institutions. US leveraged institutions have been holding a declining proportion of the total. At the end of 2002, leveraged financial institutions held 48.4% of the total, but by the end of 2007, that percentage had dropped to 36.7%. There has been a consequent increase in the funding provided by the non-leveraged sector. Notably, the holdings of the “rest of the world” category (which itself is mostly accounted for by foreign central banks) have more than tripled from \$504 billion at the end of 2001 to \$1,540 billion at the end of 2007. In this sense, foreign creditors have been an increasingly important funding source for residential mortgage lending in the United States.

According to the picture painted here, the subprime crisis has its origin in the increased supply of loans – or equivalently, in the imperative to find new assets to fill the expanding balance sheets. In this way, it is possible to explain two features of the subprime crisis: first, why apparently sophisticated financial intermediaries continued to lend to borrowers of dubious creditworthiness, and second, why such sophisticated financial intermediaries held the bad loans on their own balance sheets, rather than passing them on to other unsuspecting investors. Both facts are explained by the imperative to use up slack in balance sheet capacity during an upturn in the credit cycle.