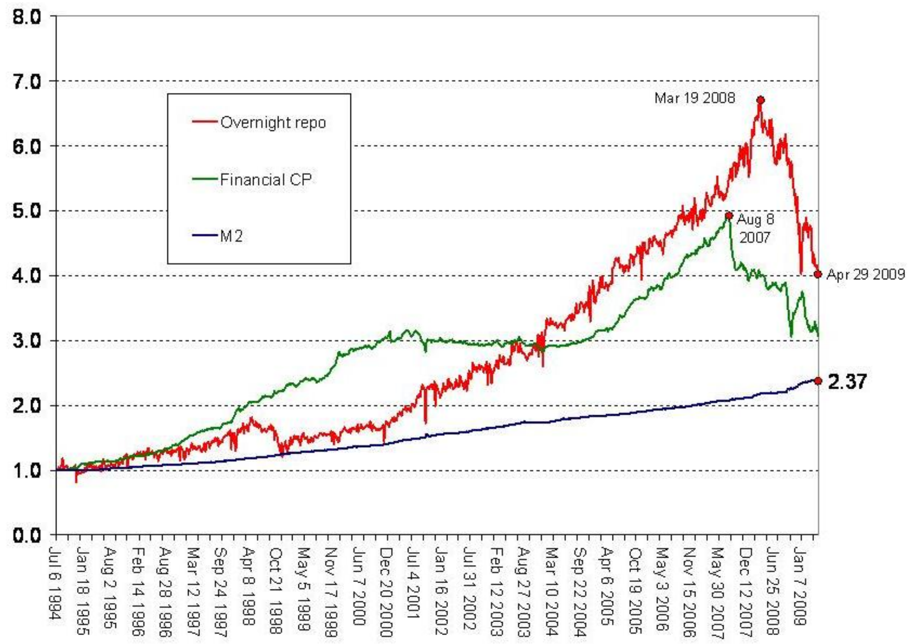
Figure 4
Overnight repos, financial commercial paper and M2

(normalized to 1 on 6 July 1994)



The ultra-short nature of the financial intermediary obligations to each other can be better seen when plotting the overnight repos component of the overall repo series. Figure 4 plots the size of the overnight repo stock, financial commercial paper and M2, normalized to be equal to 1 on July 6th, 1994 (the data on overnight repos are not available before that date). The stock of M2 has grown by a factor of around 2.4 since 1994, but the stock of overnight repos grew almost seven-fold up to March 2008. Brunnermeier (2009) has noted that the use of overnight repos became so prevalent that, at its peak, the Wall Street investment banks were rolling over a quarter of their balance sheets every night. What is evident from Figure 4 is that the rapid growth and subsequent collapse of the overnight repos cannot be easily explained by the demand for short-term liquid claims of retail depositors.

2. An accounting framework

Consider a stylized financial system for the allocation of credit in the economy depicted in Figure 5. The financial system channels savings from the lenders to ultimate borrowers. The ultimate lenders are households, either directly or indirectly through institutions such as pension funds, mutual funds and life insurance companies.

Some credit will be directly provided from the lender to the borrower. Treasury bonds or municipal bonds are a good example of such direct credit where the lender holds a direct claim on the borrower. However, the sizeable borrowing of the household sector - either mortgages or consumer debt - is almost always intermediated through the banking system, broadly defined. At the end of 2008, US household sector mortgage liabilities amounted to around $10.6 trillion, and consumer debt accounts for another $2.5 trillion.