Credit Creation and Social Optimality

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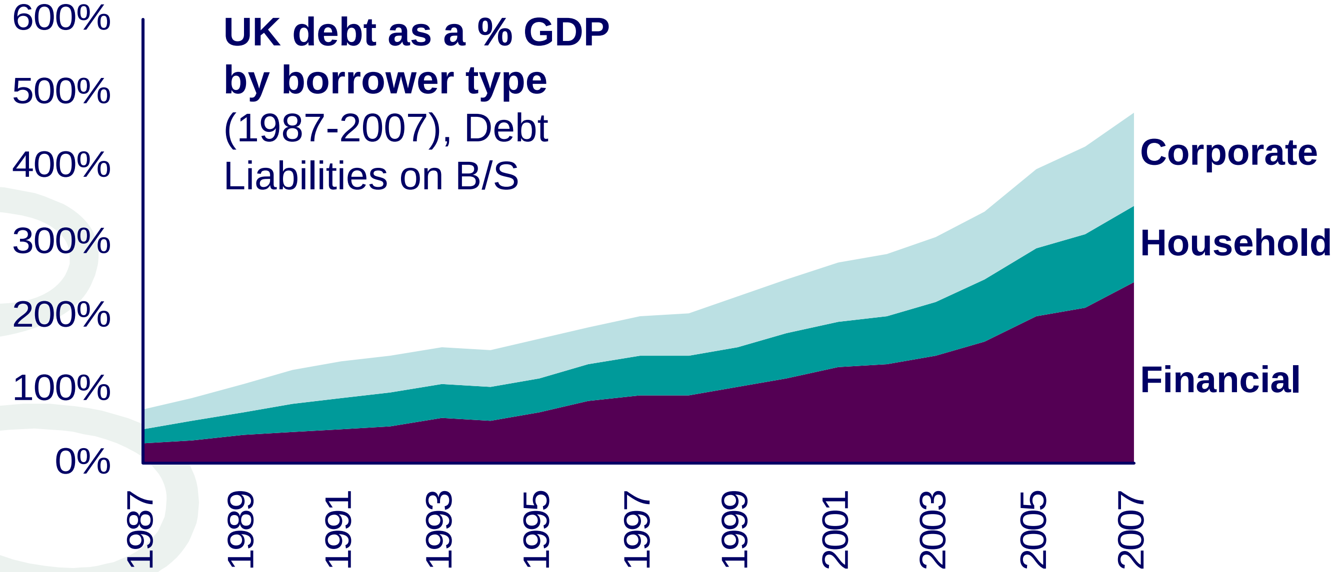
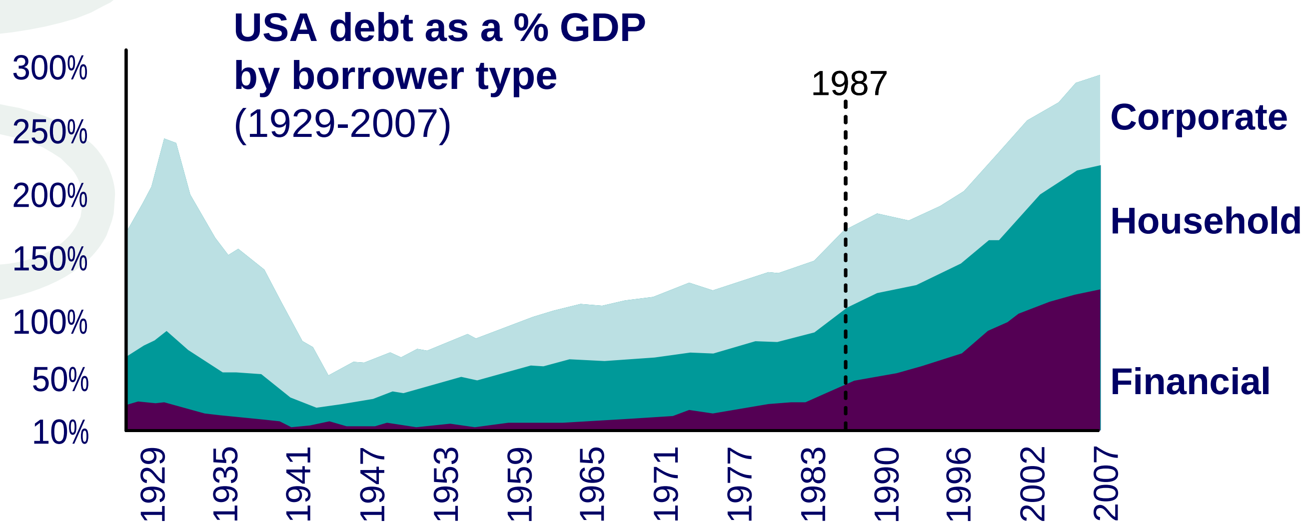
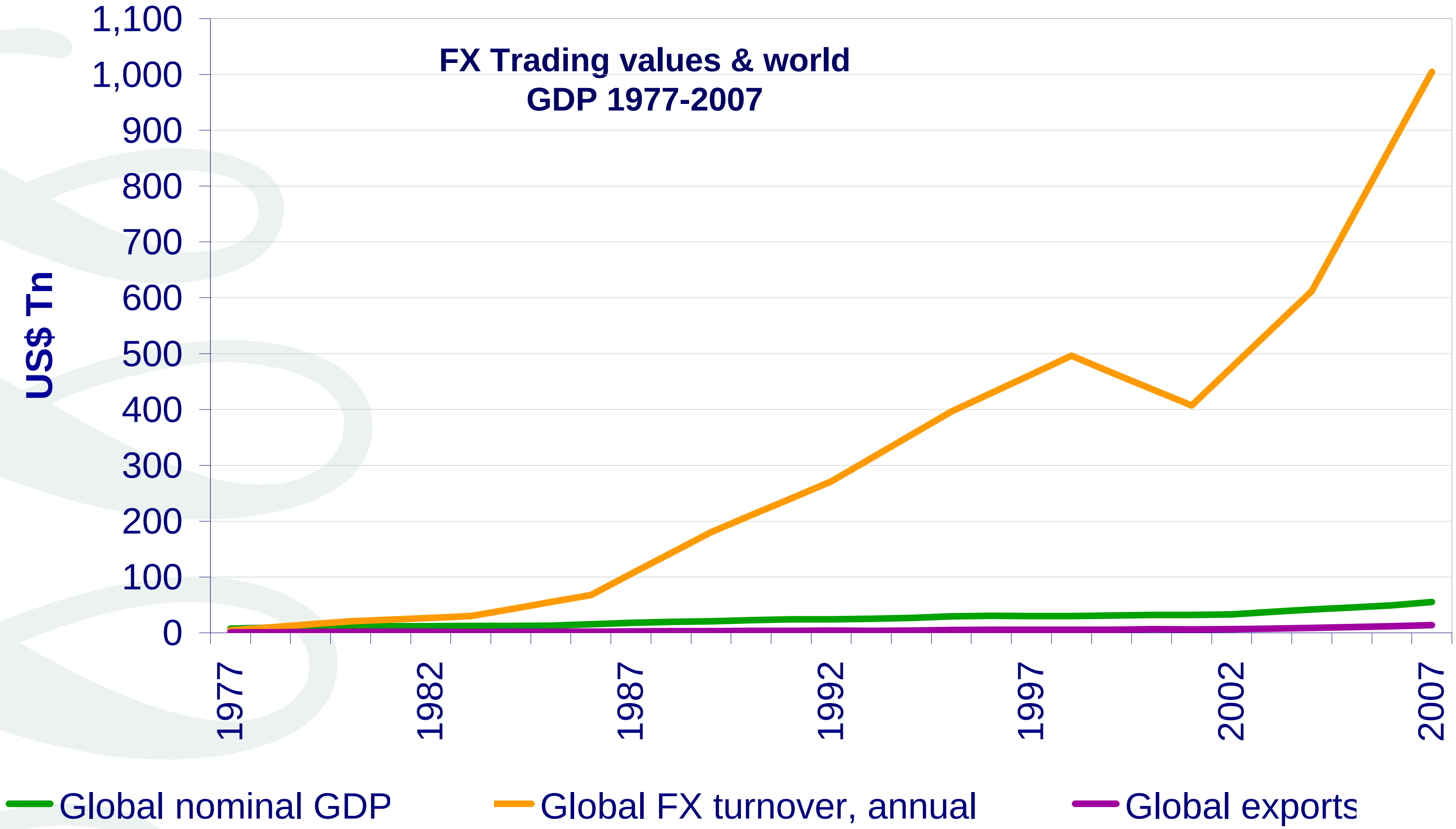
The growth of the financial sector





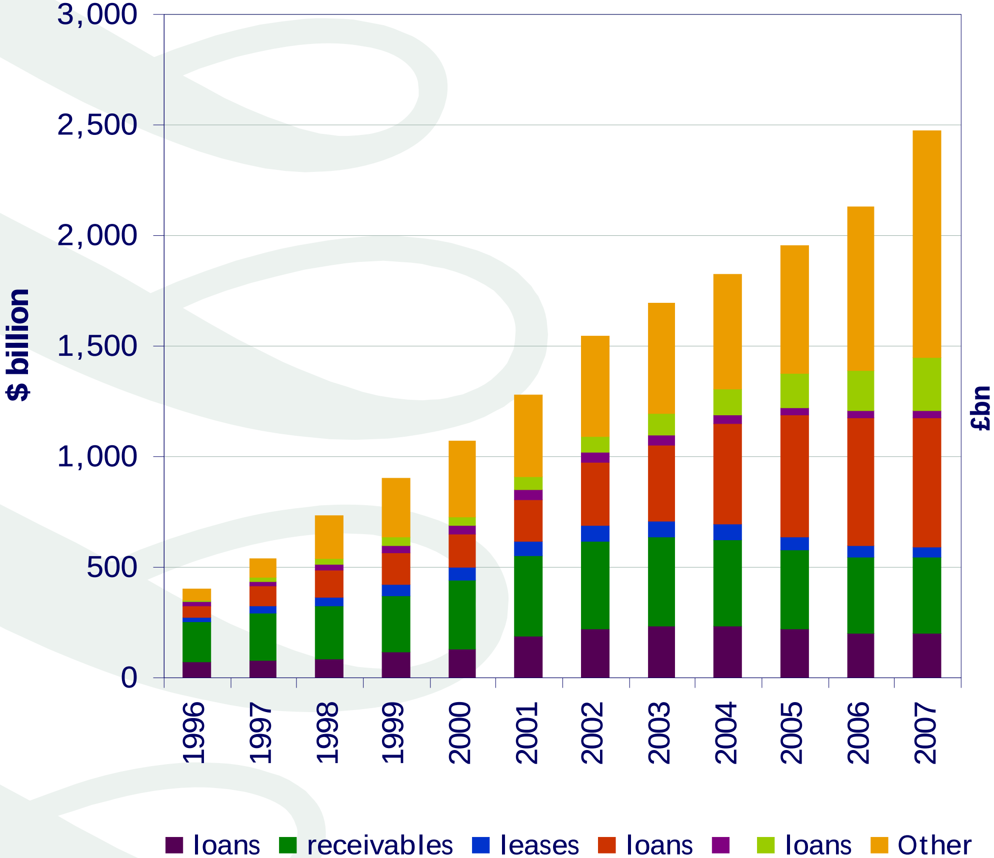
Source: Oliver Wyman

Measures of increasing financial intensity



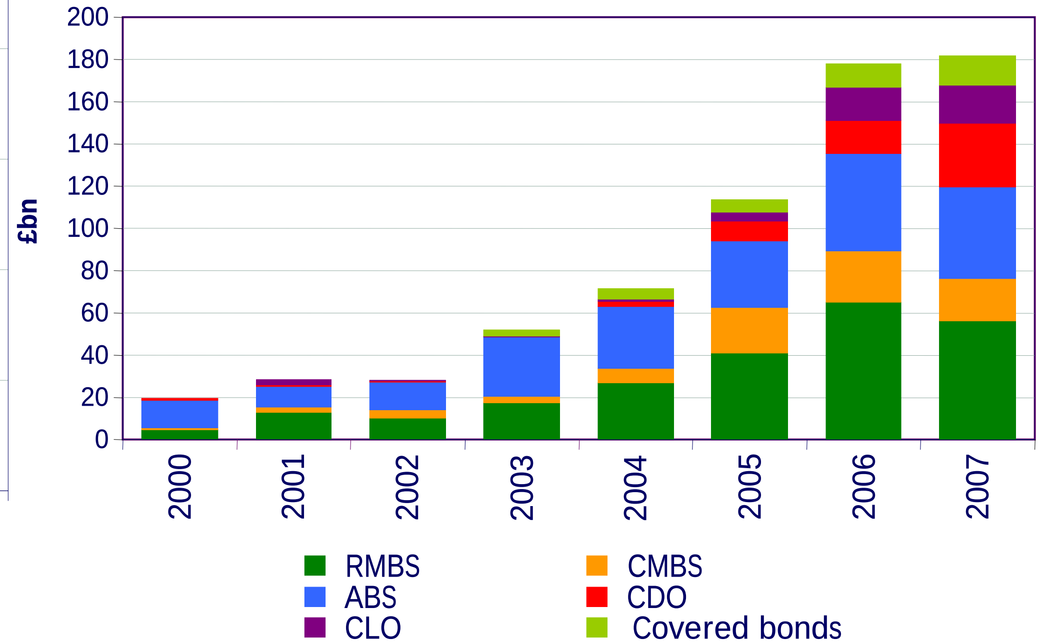
The growth of securitised credit

ABS – volumes outstanding, US



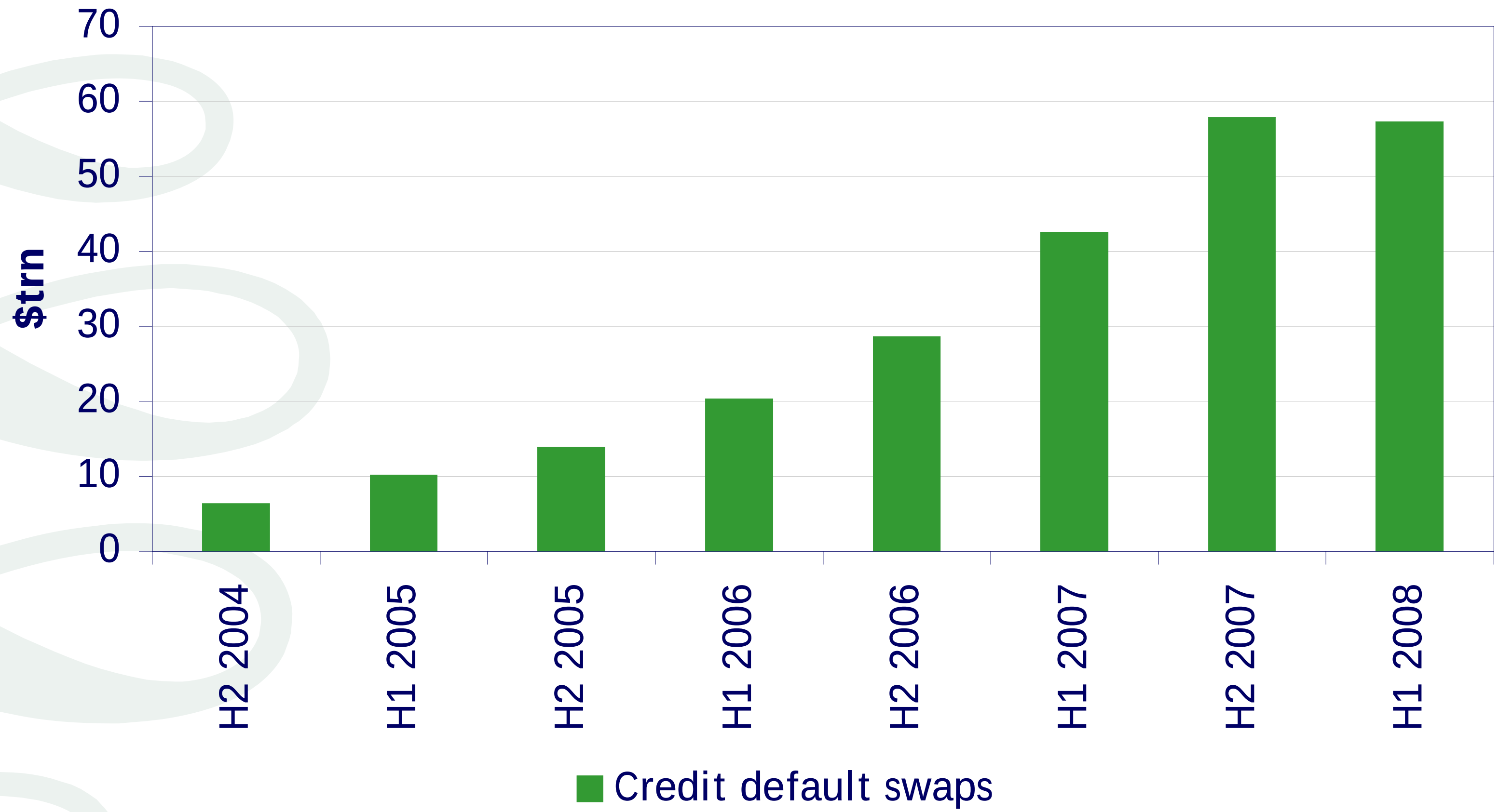
Source: SIFMA

Securitisation issuance trends in the UK



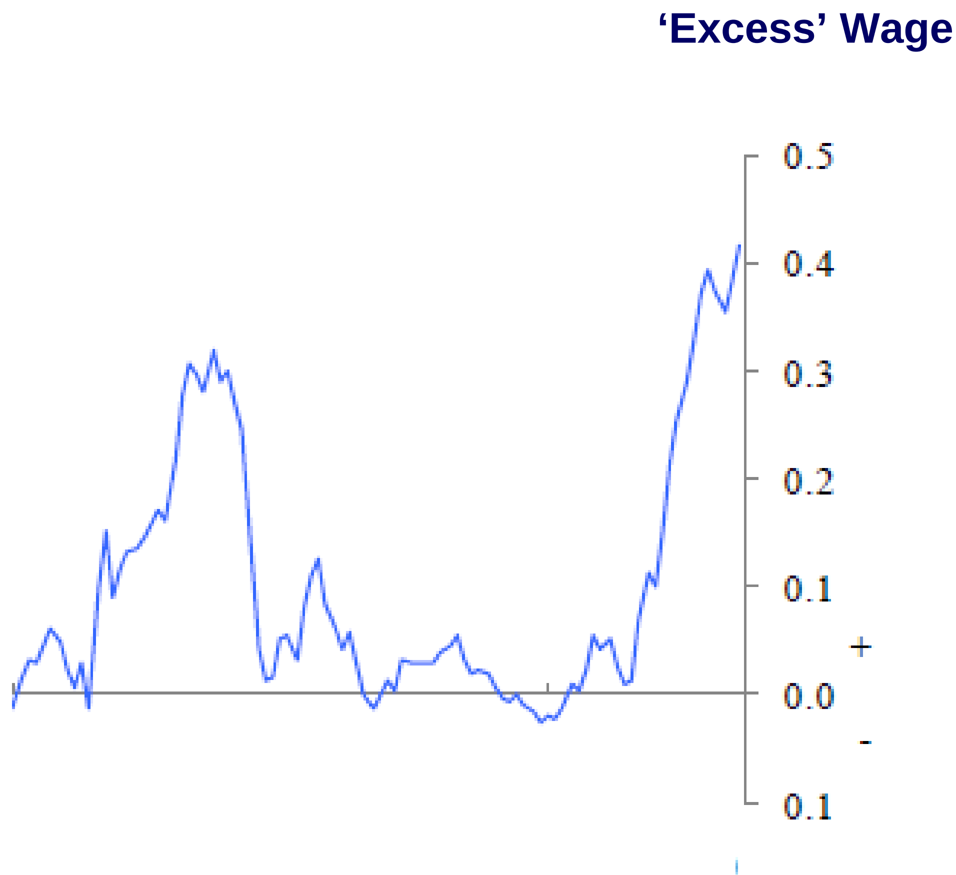
Source: Oliver Wyman

Growth in outstanding credit default swaps



Source: BIS Quarterly Review, December 2008

Historical ‘excess’ wage in the US financial sector



Source: Andrew Haldane, *What is the contribution of the financial sector: Miracle or mirage?,* Chapter 2, The Future of Banking, LSE Report 2010

From Goldsmith to Bank (i)

Liabilities			Assets	
Depositor A (100 paper money if receipt transferable)	← Receipt for gold coin	**100**	**100**	Gold coin in safe

From Goldsmith to Bank (ii)

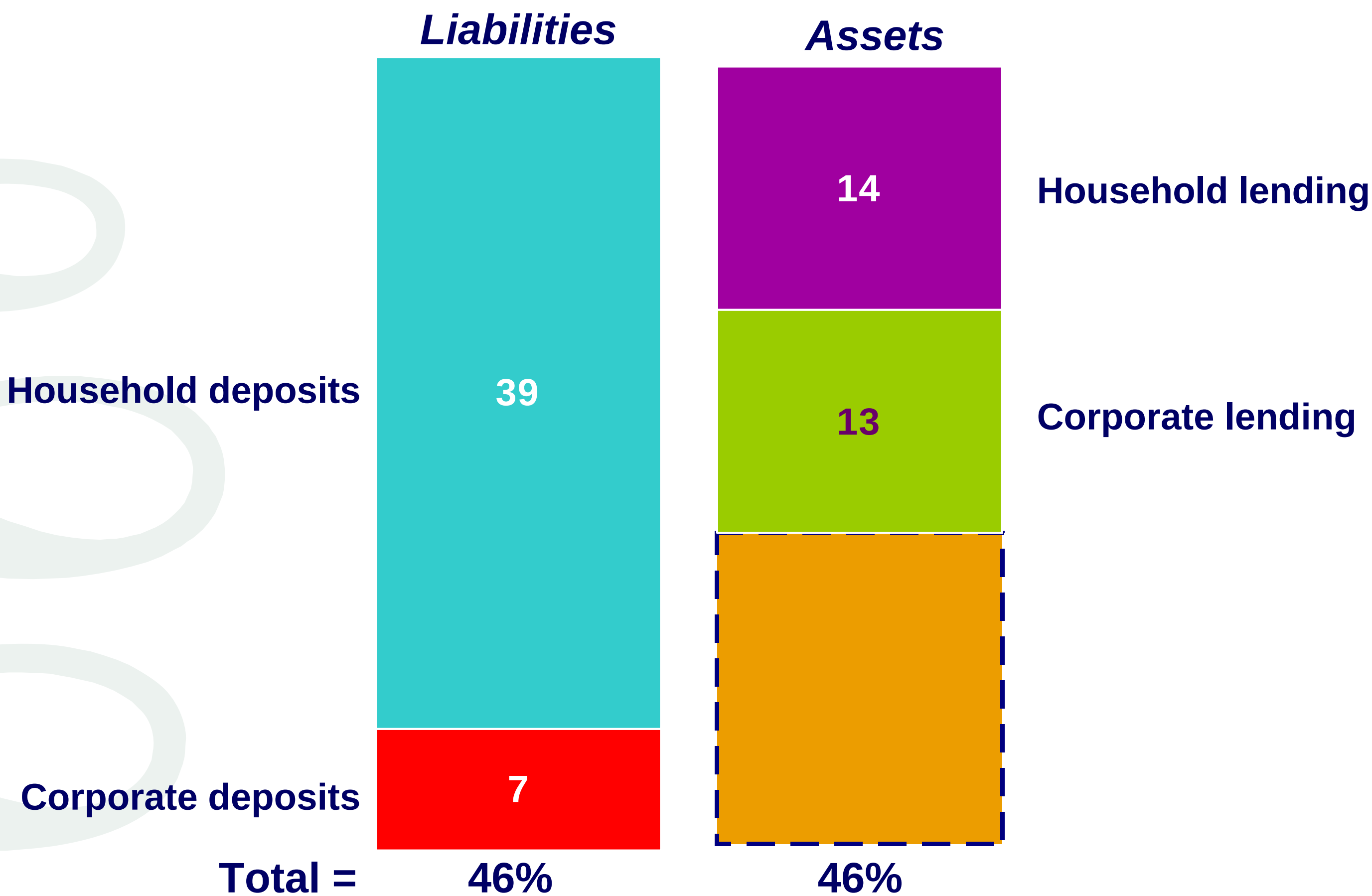
Liabilities		/	Assets	
Depositor A (100 paper money if receipt transferable) ← Receipt for gold coin	**100**		**50**	Gold coin in safe
			50	→ Loan of gold coin → **Borrower B** 50 gold coin money

From Goldsmith to Bank (iii)

		Liabilities	Assets		
Depositor A (100 paper money)	Receipt for gold coin	**100**	**100**	Gold coin in safe	
Borrower / Depositor B (100 paper money)	Receipt for gold coin	**100**	**100**	Loan of receipt for gold coin	**Borrower B**

What the UK banking system did: 1964

% of GDP

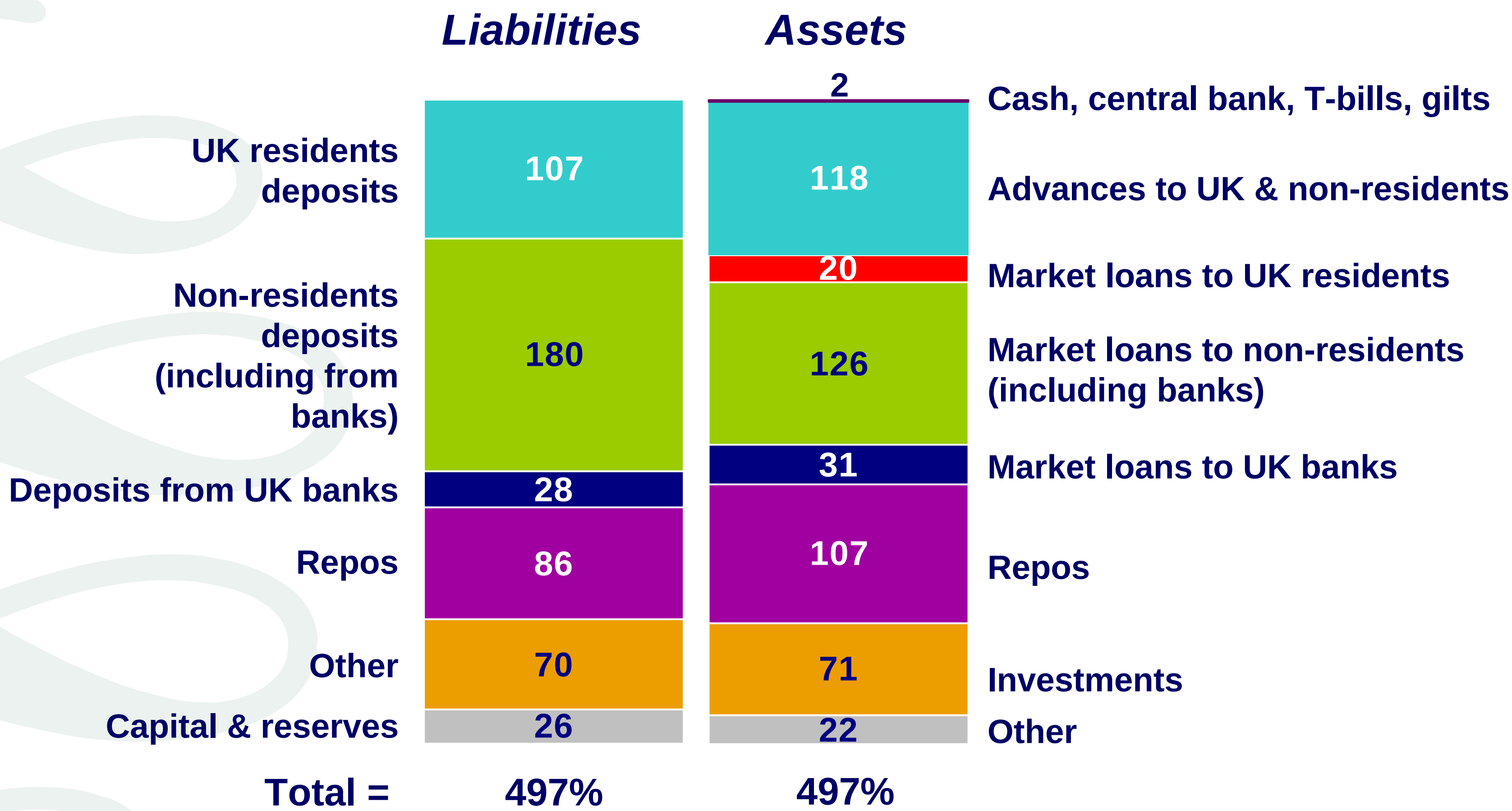


Note: Includes Banks & Building Societies' £ lending and deposits

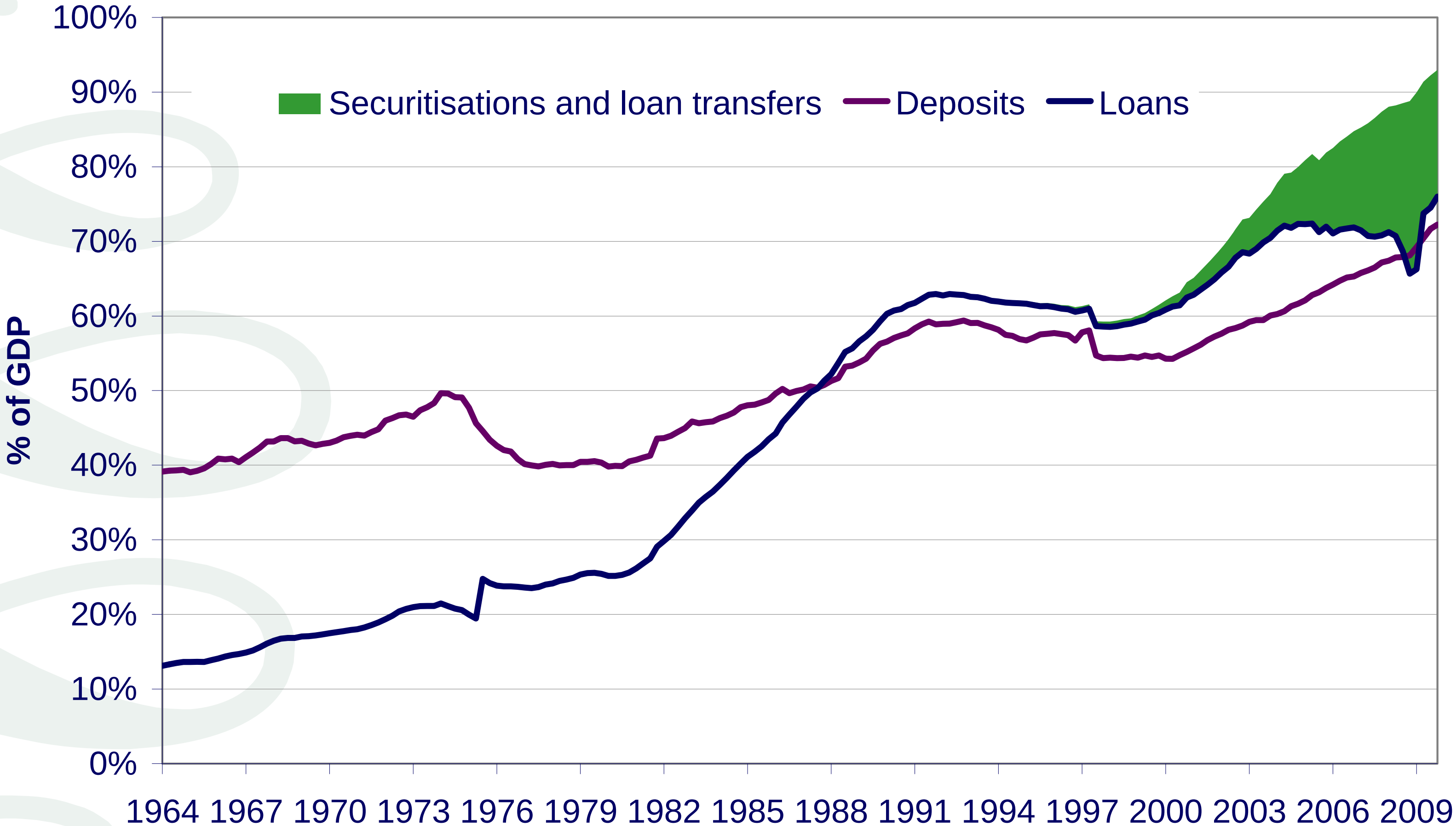
Source: Bank of England

UK bank balance sheets – 2007

% of GDP

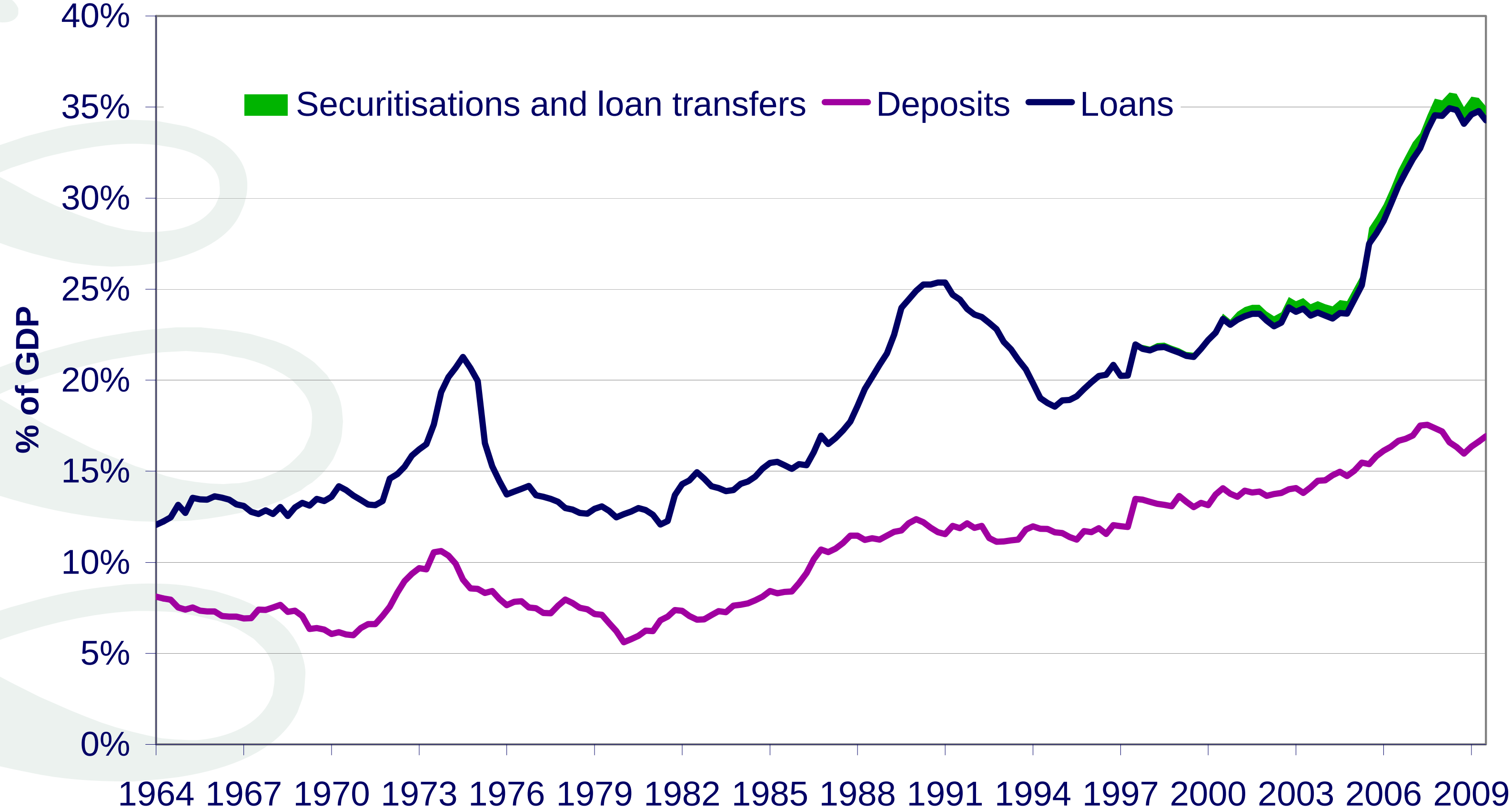


Household deposits and loans: 1964 – 2009



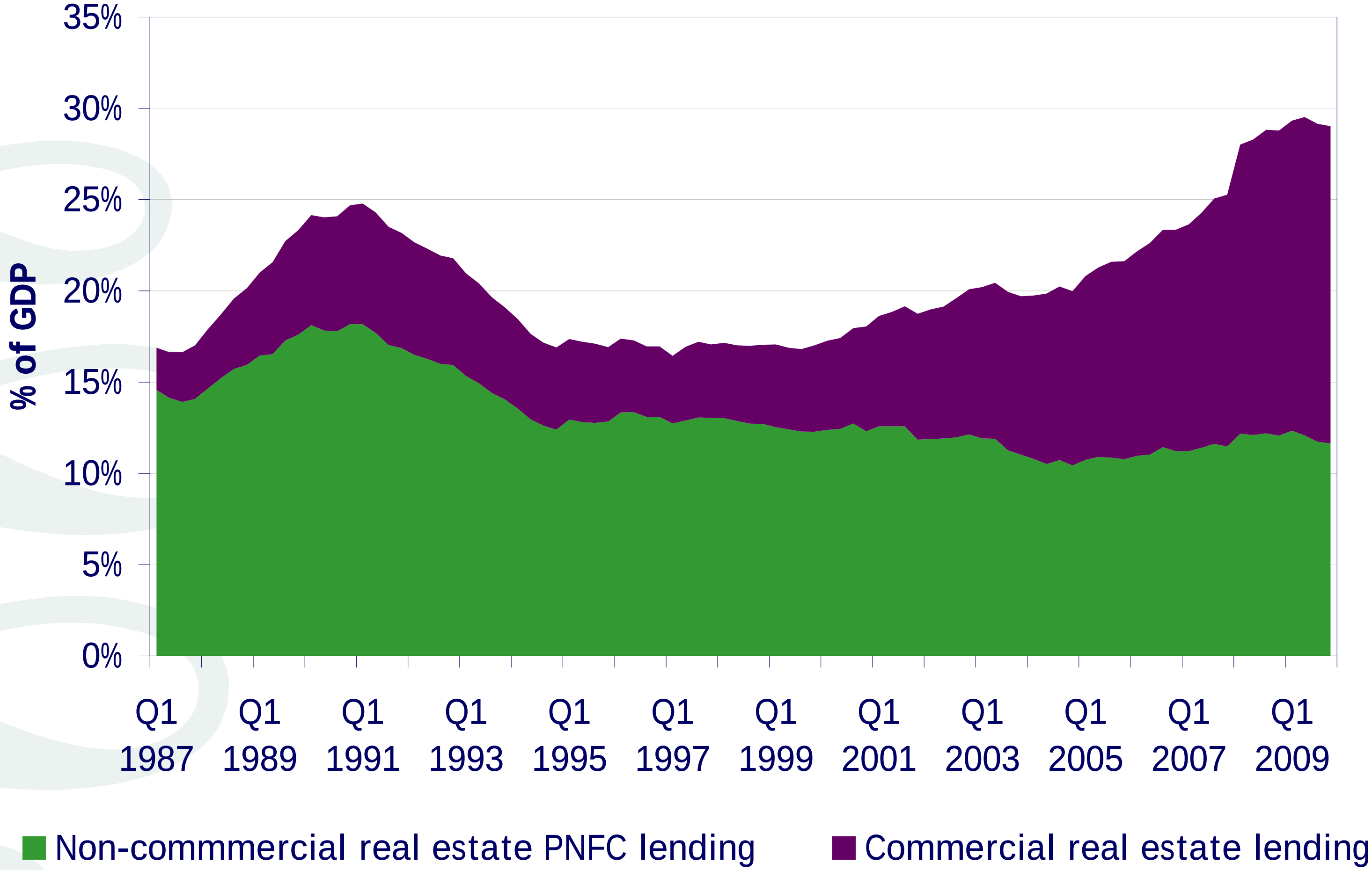
Source: Bank of England, Tables A4.3, A4.1

Private non-financial corporate deposits and loans: 1964 – 2009



Source: Bank of England Tables A4.3, A4.1

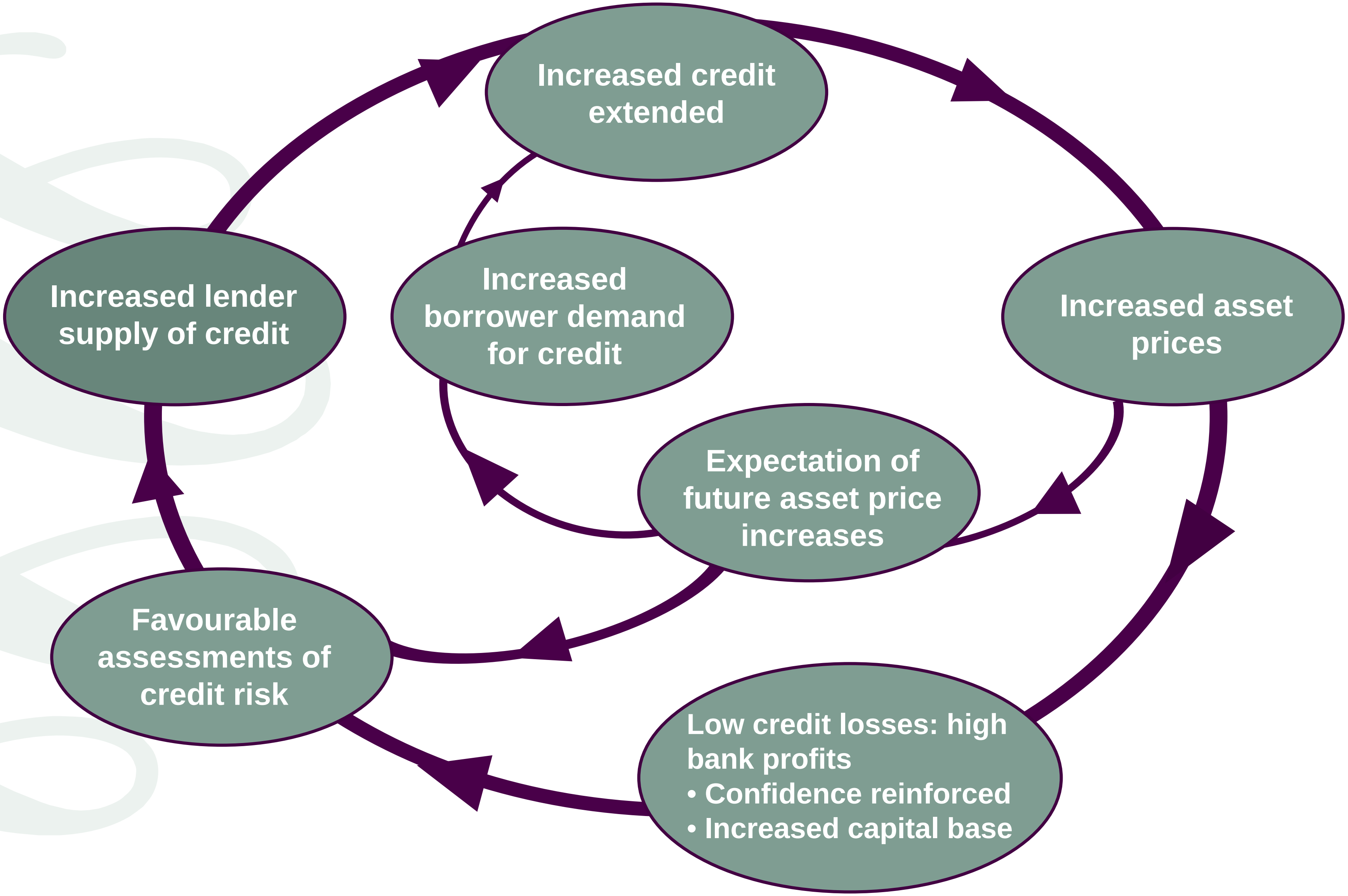
Corporate loans by broad sector: 1987 – 2008



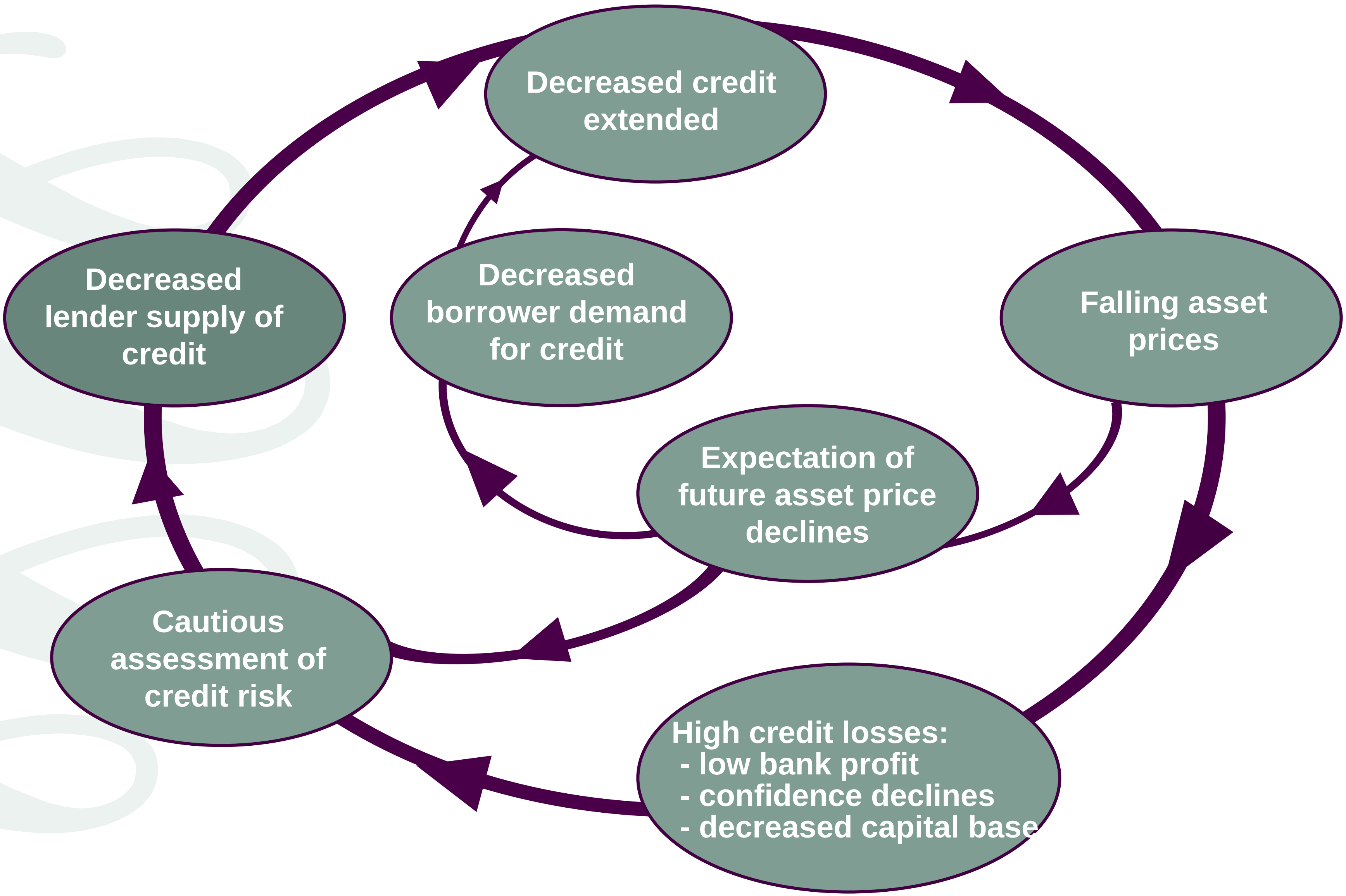
Note: Part of the increase in real estate lending may be due to re-categorisation of corporate lending following sale and lease-back of properties and PFI (public finance initiative) lending, but we do not think these elements are large enough to change the overall picture. Break in series from Q1 2008 due to inclusion of building society data. Sterling borrowing only.

Source: ONS, Finstats

Credit and asset price cycles: The upswing



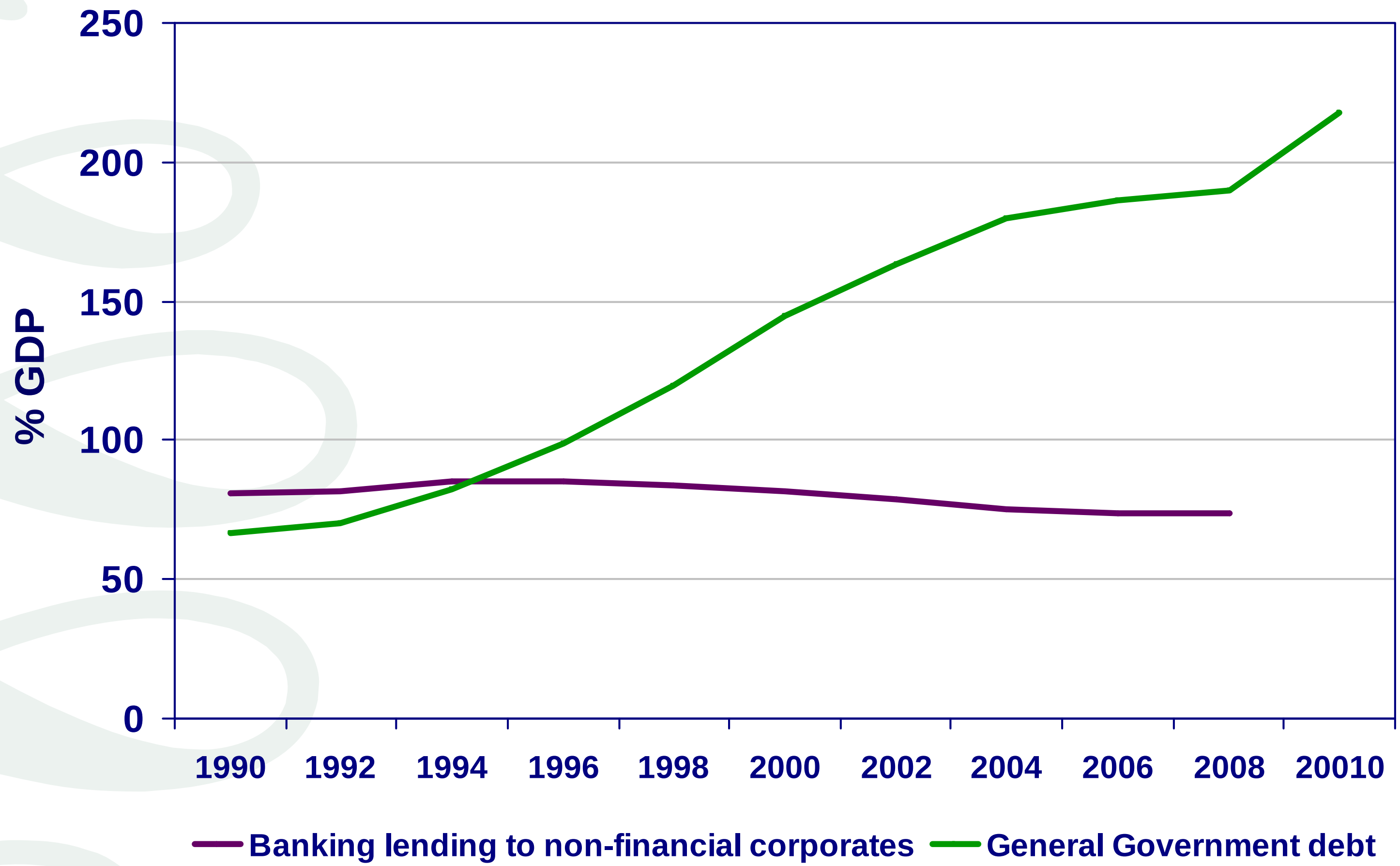
Credit and asset price cycles: The downswing



Fisher's debt-deflation dynamics: Nine key features

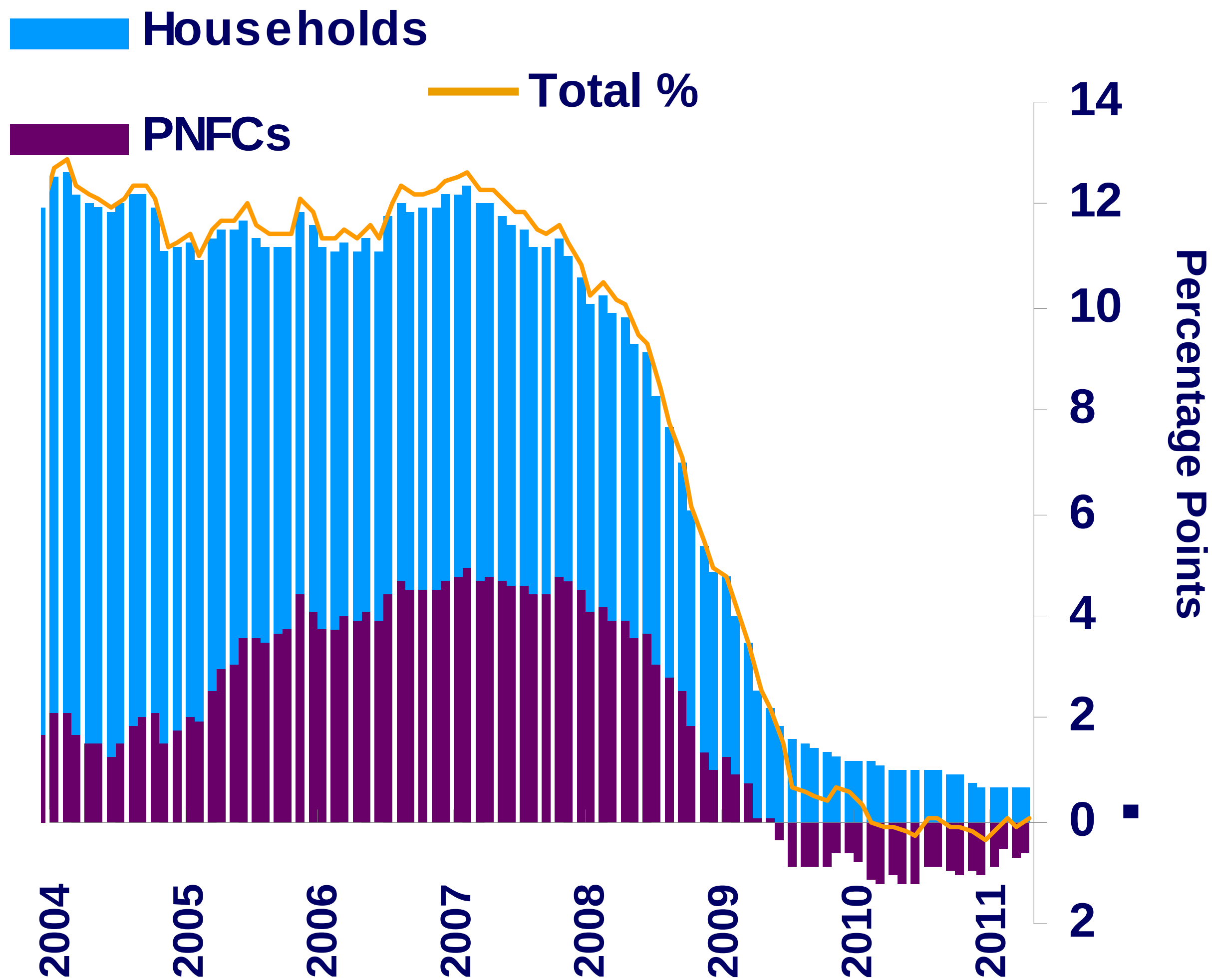
1. Debt liquidation leads to distress selling
2. Contraction of deposit currency (i.e. bank money)
3. Fall in the level of prices
4. Still greater fall in the networths of businesses, precipitating bankruptcies
5. A like fall in profits
6. Reduction in output, in trade and in employment
7. Pessimism and lack of confidence
8. Hoarding and slowing down still more the velocity of circulation
9. Complicated disturbances in rates of interest – fall in nominal rates, rise in real rates

Japanese government and corporate debt: 1990-2010



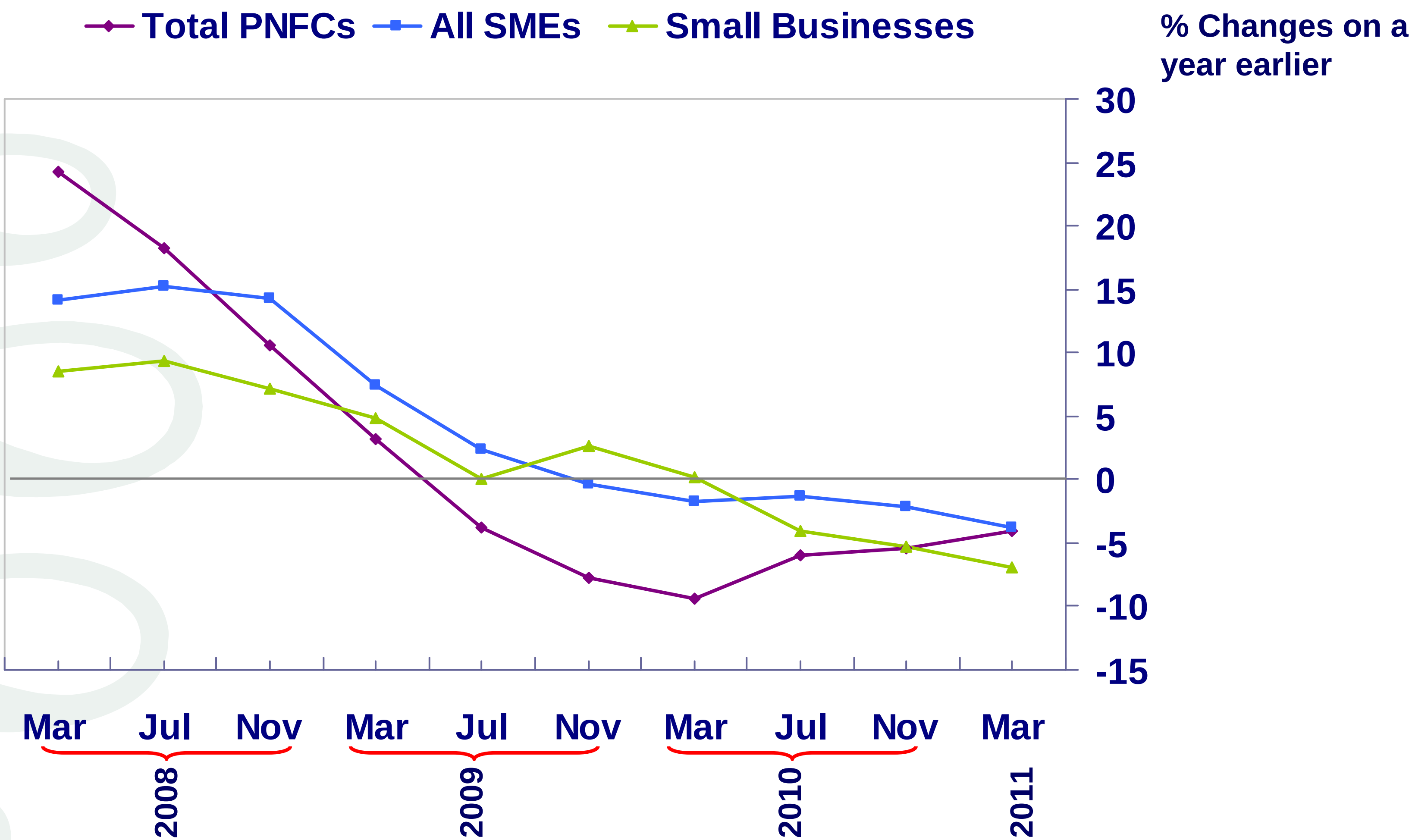
Source: BoJ Flow of Funds Accounts, IMF WEO database (April 2011), FSA calculations

Contributions to growth in lending to UK households and corporates



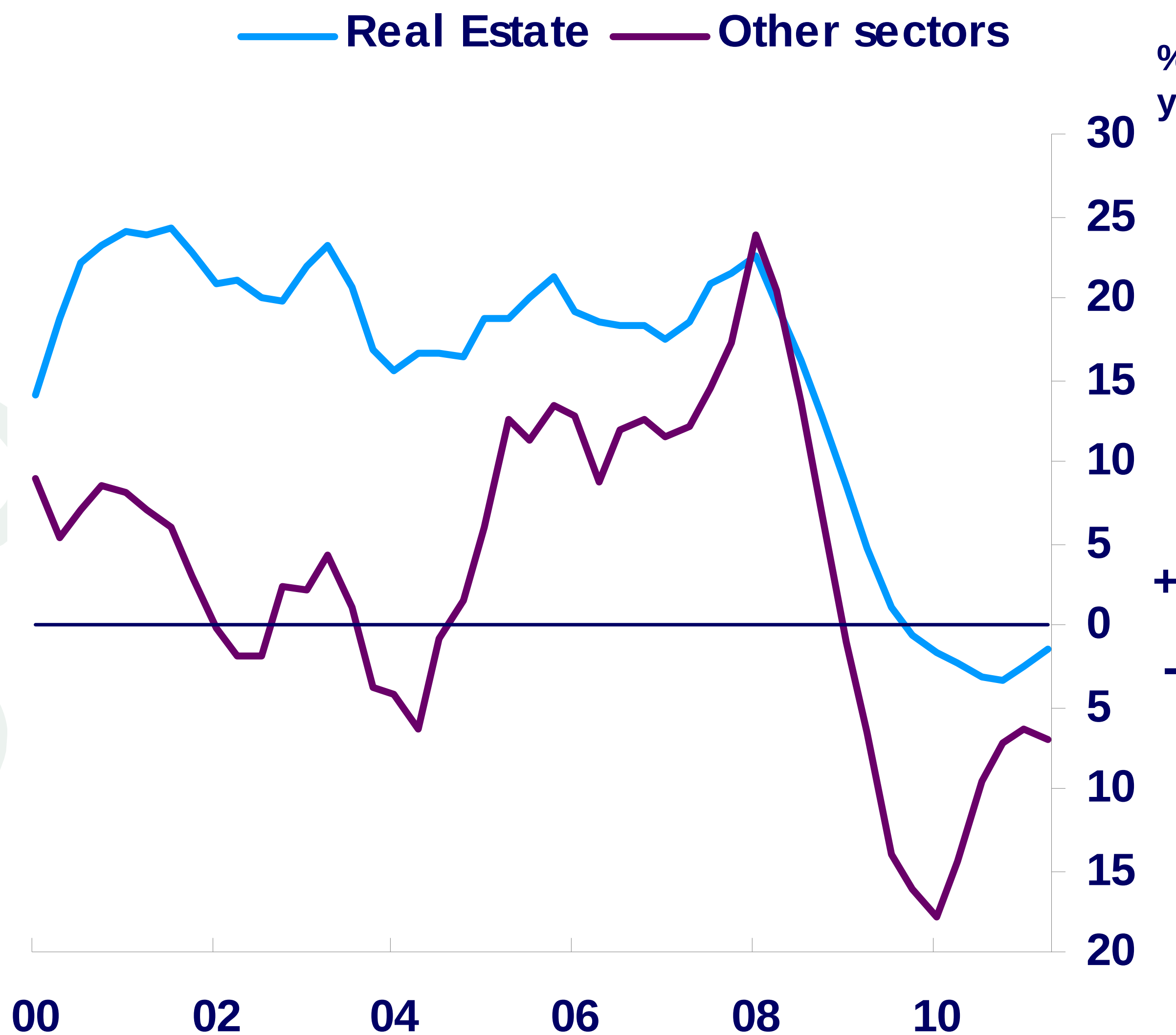
Source: Bank of England Financial Stability Report 2011

Lending to small and medium-sized enterprises



Source: Bank of England Trends in Lending, 2011

Stock of UK Monetary Financial Institutions' lending to Private non-financial corporates



Source: Bank of England

Impact of higher capital requirements on cost of funds supporting different categories of lending – illustrative figures

		5% Equity % requirement as % RWA			10% equity requirement as % RWA			
	Risk Weight	Equity as % total assets	Cost of funds elements	Average cost of funds	Equity as % total assets	Cost of funds elements	Average cost of funds	Change
Mortgage Lending	0.2	1.0%	1.0% @ 15%* 99.0% @ 5%	5.10%	2.0%	2.0% @ 15% 98.0% @ 0.5%	5.20%	+0.10%
Corporate Lending	1.0	5.0%	5.0% @ 15% 95% @ 5%	5.5%	10%	10% @ 15% 90% @ 5%	6.0%	+0.5%

Mortgage lending: Cost of funds +0.10% ← 1.0% additional equity requirement x (15% - 5%)

Corporate lending: Cost of funds +0.5% ← 5% additional equity requirement x (15% - 5%)

But with effect offset if cost of funds and cost of equity decline as banks become lower risk

*** Assuming cost of equity = 15%; cost of credit = 5%**