

1 Introduction

It is a cliché that the world has become more connected, but the financial crisis and the boom that preceded it have renewed attention on the global factors that drive financial conditions worldwide. Calvo, Leiderman and Reinhart (1993, 1996) famously distinguished the global “push” factors for capital flows from the country-specific “pull” factors, and emphasised the importance of external push factors in explaining capital flows to emerging economies in the 1990s. Policy discussion has revolved around the notion of “global liquidity” whereby permissive credit conditions in financial centres are transmitted across borders to other parts of the world (BIS (2011)). More recently, Miranda-Agrippino and Rey (2013) and Rey (2013) have highlighted the highly synchronised nature of financial conditions across borders and the co-movement in debt flows and credit growth that accompanies it.

In tandem with the discussion of global factors, the dramatic increase in gross capital flows has posed a challenge to the traditional approach to international finance based on *net* capital flows where financial flows are seen only as the counterpart to the current account. In his Ely lecture, Obstfeld (2012b p.3) concludes that “large gross financial flows entail potential stability risks that may be only distantly related, if related at all, to the global configuration of saving-investment discrepancies.” One reason for the caution is that the growth in gross capital flows was associated with increased leverage and the size of the banking sector as a whole, as emphasised by Borio and Disyatat (2011), Gourinchas and Obstfeld (2012) and Schularick and Taylor (2012). In this way, gross capital flows (especially through the banking sector) have received a great deal of recent attention from researchers.¹

The objective of our paper is to shed light on the role of the international banking system in the propagation of global liquidity. We make two contributions.

Our first contribution is to construct a model of global liquidity built around the operation of international banks. We build on recent advances in understanding the leverage cycle of banks in which leverage builds up in booms and falls in busts. The leverage cycle mirrors the fluctuations in collateral requirements (increased “haircuts”) during downturns. Geanakoplos

¹See Forbes and Warnock (2012), Lane and Pels (2011), Obstfeld (2012a, 2012b), Rey (2013) and Shin (2012).