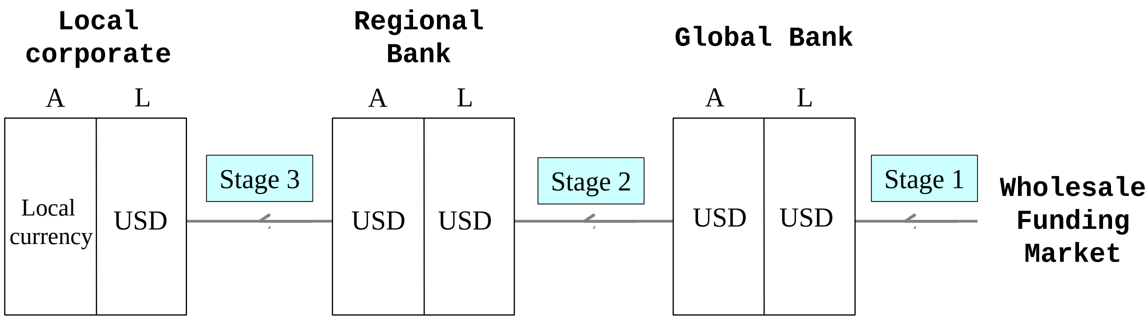

Figure 3. Cross-border bank lending in US Dollars

over 30% of GDP.

In the next section, we formulate our model of cross-border banking by first laying out the institutional backdrop for the global banking system. Our model then builds on this discussion. We follow up with our empirical investigation.

2 Model of Bank Capital Flows

2.1 Background

A schematic of the global banking system is sketched in Figure 3. The direction of financial flows goes from right to left to uphold the convention of having assets on the left hand side of the balance sheet and liabilities on the right. In Figure 3, global banks raise wholesale US dollar funding and then lend to local banks in other jurisdictions. The local banks draw on cross-border funding (stage 2) in order to lend to their local borrowers (stage 3). Although the banks are hedged in their currency exposure, the ultimate local borrower has a currency mismatch, financing local currency assets with US dollar borrowing. The motive for the currency mismatch could be to hedge US dollar receivables when costs are in local currency, or the mismatch may be due to speculative motives. In practice, distinguishing hedging from speculation will be challenging.

Our model addresses the pre-eminent role that the US dollar plays in global banking. Figure 4 plots the foreign currency assets and liabilities of banks globally, as measured by