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Article

The Dollar as a Mutual Problem: New Transatlantic Interdependence in Finance

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Abstract
When the 2007 global financial crisis hit financial markets, European leaders were quick to point the finger at US markets, excessive risk-taking, and insufficient regulation. However, it soon became apparent that European banks were more exposed than their Wall Street counterparts. With massive dollar liabilities, European banks were dependent on the US to act as a global lender of last resort. The crisis revealed a level of transatlantic interdependence that had been unknown to most observers and policymakers prior to the crisis. We argue that this represents a paradox, given that the project of the European Monetary Union was partly motivated by a desire to make Europe more independent from the US dollar. The euro was a response to the challenge of "it's our dollar, but it's your problem." In this article, we examine how the European vulnerability to the US dollar that began post-Bretton Woods did not, in fact, disappear with the creation of a European currency. Instead, through financialization and deregulation, European financial markets developed new, complex interactions with US financial markets. This financialization of transatlantic banking flows created a new type of interdependence. As European banks were so heavily invested in US markets, this gave the US authorities a direct interest in bailing them out. While cross-border banking flows have decreased since the crisis, the interdependencies remain, and currency swaps were used once again to handle the economic fallout from Covid-19. In the area of financial and monetary policy, the transatlantic relationship remains strong and stable within a dollar hegemony.

Keywords
central banks; dollar hegemony; financial crisis; financial interdependencies; swaps; transatlantic banking flows; US power

Issue
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1. Introduction

On 16 September 2008, the day after Lehman Brothers filed for bankruptcy and global financial markets went into a tailspin, the Federal Open Market Committee (FOMC) of the US Federal Reserve (Fed) convened a meeting. The top item on the agenda for the meeting was the impending collapse of the world's largest insurance company—the American Investment Group (AIG). That morning, however, AIG was moved down to second place, superseded by the unfolding situation in European markets. What in the initial months of the crisis appeared to be an American problem in origin and consequence turned out to be a more severe threat to Europe. Large financial institutions in Europe were revealed to have invested in riskier assets than their American counterparts, and they had done so with more leverage. This meant that European banks had large, risk-filled balance sheets, with massive dollar liabilities. When credit and currency markets started to freeze in 2007, European financial institutions faced an existential threat. They needed dollars to roll over their short-term debts, but their own central bank could only provide liquidity support in euros. While converting currencies through swaps and other financial instruments is unproblematic in stable times, the cost of such currency operations skyrocketed when the crisis hit, creating a "financial avalanche" for European banks (Tooze, 2018, p. 154).

During the global financial crisis of 2008–2009, the American central bank would go on to make billions of dollars available to European financial institutions, effectively rescuing the European financial system from collapse. This help was provided directly, with the unprecedented move of giving foreign banks with branches in the US access to American liquidity facilities. Another channel was indirect, with the Fed opening up what became an unlimited currency swap with the European Central Bank (ECB). This enabled the ECB to provide dollars to its financial institutions.

These events raise a series of important questions: First, how did European financial institutions end up in a situation where they had to rely on American help to survive the crisis? Second, why did the Americans so generously provide this help, given the domestic political risk this entailed? Third, why did the Europeans initially decline the American offer? Finally, what does this story tell us about the transatlantic relationship in the realm of financial and monetary affairs?

We argue that the events of 2008 and 2009 represent a paradox. An important motivation behind the establishment of a common currency in Europe was to reduce Europe's vulnerability to fluctuations in the value of the dollar. Yet, 2008 showed that financial globalization had created increased interconnectedness with and vulnerability to US financial markets, through the creation of a "European banking glut" (McCauley, 2018), with large cross-border banking flows running across the Atlantic. This banking glut brought the European financial system to the brink of collapse, from which it was only saved with American help. While European efforts in the 1980s and 90s to escape the negative effects of the dollar's hegemony on intra-European exchange rate stability were a success, Europe's autonomy vis-à-vis the US was undermined by a process of financialization that entwined US and European financial stability to a degree never seen before.

In terms of the conceptual scheme upon which this thematic issue is based (Riddervold & Newsome, 2022), these developments tied the economic material interests of the US and the eurozone closely together, creating a more symmetrical kind of interdependence than in the 1970s, when Treasury Secretary Connally could boast that "it's our dollar, but it's your problem." The mutual financial vulnerabilities this interdependence created were handled by employing existing institutions in new ways. On the ideational level, Europe's ambitions of independence arguably fed into an initial response of denial, before the brute facts of Europe's reckless banking practices caught up with the eurozone's decision-makers.

We examine the transatlantic financial relationship as it developed through different historical periods: from the immediate post-Bretton Woods era in the 1970s and 80s, to the first decade of the euro and the 2008 global financial crisis. We show that policymakers on both sides of the Atlantic were unaware of the vulnerabilities that were building up in the European banking system. When the crisis broke, Fed officials quickly realized that a range of bankruptcies in Europe would threaten the stability of US financial markets and saw it as being in the interest of the US to offer Europe help. At first, the Europeans clung to the notion that this was primarily an American crisis and hesitated to accept this assistance. Eventually, however, they did accept the help offered by the Fed.

In contrast with other transatlantic issue areas covered in this thematic issue, we see great stability in monetary and financial affairs. In terms of meaningful actions, the relationship was strengthened by an unprecedented financial crisis. While the creation of the European Monetary Union was an attempt to create more exchange-rate independence for Europe, developments in financial markets paradoxically created new, stronger, and more mutual financial vulnerabilities between the US and Europe. In terms of financial markets and currencies, the relation between Europe and the US remains one of hierarchy (see Smith, 2022), yet it is a somewhat different hierarchy than that which characterized the Bretton Woods period.

The American rescue of Europe during the global financial crisis can be explained through an analytical lens of material, if enlightened, self-interest. Transcripts from FOMC meetings show Fed officials arguing explicitly that the multitrillion-dollar rescue of Europe was in the US' national interest. When the Europeans overcame their pride and accepted the dollars they were offered, they ended up receiving more help from the US than all other countries combined. Theoretically speaking, American self-interest alone is not a sufficient explanation. We also have to inquire into self-interest as defined by whom, and equally important, whose permission was needed to dole out the trillions involved. The key here is that financial cooperation is to a large degree decided by technocrats; therefore it can often fly under the radar of high politics, and evade democratic processes and nationalistic posturing. It is difficult to picture George W. Bush or Barack Obama going to Congress asking for trillions of dollars to bail out European banks.

In reality, the help was shaped in cooperation between technocrats in two independent central banks, relying on an institutional arrangement originally developed in the 1960s for a different purpose (these technocratic relationships have clear parallels to the policy area of space; see Cross, 2022). Thus, we also see how lasting institutional arrangements and connections between the EU and the US facilitated a relatively quick response to what was a new problem for both. When the Covid-19 pandemic erupted in 2020, the currency swaps between the Fed and the ECB were immediately reinstated, successfully calming European markets with the promise of an ample supply of dollar liquidity.

The article is structured as follows: The next section gives a brief historical overview of how the EU member states attempted to achieve currency stability and greater independence from the dollar in the decades following the 1971 break-up of Bretton Woods. Section 3 discusses the emergence of the European banking glut and the creation of new transatlantic vulnerabilities. Official documents show that policymakers were, apparently, unaware of these developments. Section 4 discusses the cooperation between the Fed and the ECB during the 2008 crisis and its implications for the financial and monetary relationship between the EU and the US. Section 5 briefly discusses developments in cross-border banking after 2008 and what these entail for transatlantic relations, including the handling of the economic fallout from Covid-19. Section 6 is the conclusion.

2. Post-Bretton Woods and the Struggle for European Dollar Independence

The conceptualization of the American bailout of Europe as a paradox comes from an understanding of the European monetary integration project as one motivated in a large part by the desire to achieve more independence from the US—and protect the European economy from fluctuations in the relative value of the dollar.

Exchange rate policy and exchange rate cooperation can mobilize different types of interests and conflicts. This was the case both between the US and Europe, internally in Europe, and within EU-member states themselves. We can distinguish, firstly, between issues related to over- and undervaluation and hence export performance (see Schwartz, 2022). Secondly, we have the link between exchange rate policy and interest rates, that is, the capacity to set interest rates at a level that suits the state of a given economy, i.e., monetary autonomy. Thirdly, economic sensitivity to exchange rate fluctuations is a variable that we can understand as a function of the ratio of exports to GDP. Finally, degrees of exchange rate stability influence financial markets in multiple ways. Currency instability stimulates financial innovation, which in turn puts pressure on attempts to regulate capital flows. The combination of exchange rate cooperation and relatively free capital movements across borders intensifies the link between exchange rates and interest rates.

After WW2, the stability provided by the Bretton Woods fixed currency order allowed Europe to play catch-up in economic terms. Although not all European countries benefitted equally from this regime, the general picture is that in the post-war decades Europe was allowed to grow within a regime where the value of the dollar was stable and not undervalued, at times even overvalued relative to European currencies. This benefited European economic growth and facilitated the export-oriented growth model which partially persists today (see Schwartz, 2022). While the US did enjoy seigniorage privileges from holding the key currency in the global system, they also bore the cost of having the one currency in the system that could not adjust. Secondly, the negotiable but fixed exchange rates of the Bretton Woods regime provided a large degree of exchange rate stability among EU member states; this facilitated intra-European economic integration and helped make possible the Common Agricultural Policy. Thirdly, the capital controls associated with the Bretton Woods order gave European states greater monetary autonomy than they were to enjoy later.

When the Bretton Woods regime ended in the early 1970s, fluctuations in the value of the dollar would become a major source of instability for Europe. When Nixon suspended gold convertibility, the dollar depreciated, negatively impacting EU exports. Then the dollar rose sharply under the stewardship of then Fed chairman Paul Volcker (the so-called "monetarist experiment"), before being talked down again after the Plaza Accord of 1985, before the "reverse Plaza" in 1987 adjusted it upwards again. This instability created all kinds of problems for the EU, especially for the politics and execution of its largest single budget, the Common Agricultural Policy. The EU sought to recreate a fixed currency regime through various arrangements such as "the snake" and the European Monetary System, but they all failed because European currencies fluctuated too much in relation to one another. Empirical studies have found that fluctuations in European exchange rates were associated systematically with the dollar (Giavazzi & Giovannini, 1986, p. 456). The clear tendency was for the Deutsche Mark to overshoot, that is, it tended to be pushed up much higher than could be accounted for by real economic trends. This happened whenever the dollar was weak, reflecting speculation and "hot money" on the move (Calleo, 1999). Partly for this reason, European policymakers decided to establish the most fixed currency regime imaginable, a single currency.

The euro was enacted in 1994 and rolled out in 1999, despite warnings from a diverse group of economists. These economists argued that it was a dangerous experiment precisely because European economies were so structurally different while lacking compensating mechanisms through fiscal and labor market integration (e.g., Friedman, 1997). There were, however, economic arguments for the euro too (see, for example, the Delors Committee, 1988). The desire for real economic integration through trade and fatigue from trying to keep up with German (dis)inflation performance were important arguments that were marshaled in the discussion around the euro. Sensitivity to exchange rate fluctuations provided a third pro-euro argument, which also highlighted the relevance of transatlantic relations at the time. The logic is simple. The US' comparatively autarkical economy (in 1997 exports constituted 10% of

US GDP) made the US relatively insensitive to the effects of the currency gyrations of the dollar. This was famously reflected in the statement of US Treasury Secretary John Connally saying to the world in 1971 that "it may be our dollar, but it's your problem." Europe, on the other hand, was shaken each time the dollar value changed dramatically. It was believed that the euro would solve these problems. Given the patterns of intra-European trade at the time, the European Monetary Union would produce a similar (euro-external) trade to GDP ratio to that of the US, thus promising to deliver the kind of imperviousness to world currency fluctuations that the US had enjoyed since 1973 (Calleo, 1999, p. 9).

Independence from the US and the dollar was thus a key motivation driving further European monetary integration. The first eight years of the euro were marked by triumphant commentary from its guardians in the ECB, exactly for its (perceived) ability to deliver the kind of stability that had eluded Europe between 1973 and 1999 (e.g., Issing, 2008). Taken together, these European attempts at creating exchange rate stability reveal a pattern where the US was arguably retreating from its hegemonic responsibility for providing stability at the system level, while Europe first unsuccessfully and then with apparent success sought to establish stability on its own terms.

3. The Creation of the Euro and the Emergence of a "European Banking Glut"

How did Europe, aiming to develop its financial markets and currency area and to achieve greater independence from the US, end up smack in the middle of a dollar-denominated financial crisis less than ten years after the introduction of the euro? In the creation of the so-called European banking glut, in which European banks had amassed large dollar liabilities, we can identify both push and pull factors. We may start with the sheer size of the European banking sector. Throughout the history of the EU, Europe has been "overbanked"—that is, it has had too many and/or too big banks for the size of its economy when comparing Europe to the US and other regions of the world. Over the past 50 years, European banks have therefore struggled more or less continuously to find sufficient areas of profits to sustain their existence. In 1955, the European ratio of bank assets/GDP was slightly below the US ratio, at around 0.6. European bank assets since grew to three times the European GDP by 2005, more than doubling throughout the 1970s and 80s (Langfield & Pagano, 2015). While Europe was at three times its GDP in 2005, Japanese bank assets were only at 1.5, and the American bank asset to GDP ratio was still below one. Perversely, European bank assets had undergone this dramatic growth at the same time as productivity growth on the continent was falling (Mody, 2018, p. 159). The result was more and more bank assets chasing fewer attractive investment opportunities at home.

This problem was exacerbated both by US competition and by a series of regulatory changes within Europe. Competitive pressures sprang from changes in US financial markets in the 1960s. Limited as to the interest rates they could offer by Regulation Q, American banks lost corporate deposits in competition with money market funds, and increasingly had to turn to money market funding instead of the more secure deposit funding. This turn to what has been termed "market-based banking" (Hardie & Howarth, 2013) would profoundly change the practice of banking. As Beck (2021) has skillfully shown, adjusting to the conditions of money market funding, which was more expensive and more volatile, required banks to develop what Beck terms "liability management." The banks developed extensive securitization of loans to secure flexibility, moved assets off their balance sheets, and were thus able to extensively expand their lending. With this business model and their easy access to the more liquid USD market, American banks not only expanded their domestic lending but, starting in the 1960s, also successfully began competing for European corporate business. European banks were doubly disadvantaged in that they were then still based on a deposit-funding model, and further disadvantaged by the fact that their deposits were in less liquid currencies than the dollar. When attempts to build competing European financial structures proved unsuccessful, European banks began adopting the US model of market-based banking. They sought to access US money markets to secure dollar funding in the 1990s and 2000s, in a turn that Beck (2021), referring to the structural power of the US, calls "extroverted financialization."

European regulatory changes amplified these developments. Germany's banking system is composed of three pillars: private, co-operative, and public banks. Among the public banks, the regional Landesbanken and the local Sparkassen have historically enjoyed a privileged status with state guarantees securing them cheaper funding. For a long time, these banks had avoided EU competition policy requirements that had promoted broad-scale privatization in other sectors such as aviation, telecom, and railways. But in the early 2000s, Brussels directed its attention to the Landesbanken and ordered Germany to remove the guarantees (Döring, 2003), forcing these banks to compete for yield on European and international markets. Within a few years, some of these banks would become major players in the riskiest part of the US subprime market, including Sachsen WestLB, IKB, and the Dresdner Bank (Tooze, 2018, p. 74).

The relatively high savings rate in several Northern member states, such as Germany, is a result of a series of factors, including labor market, pension reforms, and an aging population (Felbermeyr et al., 2017). New rules about pension portfolio diversification in the Netherlands also forced Dutch pension funds to invest abroad to a greater extent (van der Zwan, 2017). During this period, bank deregulation was underway at the Basel

Committee for Banking Supervision, which coordinates the global standard-setting for international banking. A 2004 change in the risk-weights through which bank capital requirements are measured made it attractive for banks to invest in securitized mortgages. The US markets had more securitized mortgages to offer investment-hungry global banks. In this period, large European banks were in the midst of massively growing and internationalizing their balance sheets, a process which European policymakers appear to have largely supported. Criticism of the new Basel II rules was voiced in the US, including by Sheila Bair as head of one of the top US regulatory bodies, the Federal Deposit Insurance Corporation. Nevertheless, the rules were quickly and enthusiastically adopted in Europe. European members of the Basel Committee fiercely opposed a proposal for an international cap on leverage ratios (Mody, 2018, p. 167). Europe's adaptation to the Basel rules also ensured that their banks could hold even less capital if they insured their portfolios with credit default swaps (Tooze, 2018, pp. 85–86).

Low growth and productivity rates in Europe, combined with a high savings rate in several countries, contributed to pushing European financial institutions to look outside the continent for higher returns; but what pulled them to the US? Above, we have discussed why the US money markets were attractive as a source of funding, but European banks increasingly also invested their borrowed money in the US. The US had experienced continued productivity growth since 1995, making it a more attractive investment location than Europe, which was experiencing sluggish growth. In addition, US financial deregulation had permitted larger-scale private securitization of riskier mortgages than what had historically been brought to the market by the government-sponsored entities Fannie Mae and Freddie Mac. These collateralized debt obligations also managed to get AAA credit ratings, making them eligible for purchase even by most pension funds. High yields plus high credit ratings proved a tempting combination for banks and institutional investors all over the world. By 2008, a quarter of all securitized US mortgages were held by foreign investors (Bertaut et al., 2011). The borrowing of funds from US money markets and investment of funds into dollar assets created a dollar "round trip" across the Atlantic.

A review of policy speeches in the decade preceding the financial crisis shows that central bankers were concerned with the vulnerabilities arising from what was termed the "Asian savings glut"—that savings in Asian countries were being invested into US financial securities, leading to a large increase in net financial flows from Asia to the US. While Bernanke (2005) in one speech says that the high German savings rate was a potential problem for the US economy, this is a rare exception compared to the frequency with which the Asian savings glut was discussed. There was thus a stark contrast between the financial imbalance policymakers were concerned with pre-2008 and the imbalance that turned out to be the actual problem. McCauley (2018) has termed the increase in cross-border banking flows between Europe and the US in the years leading up to the crisis the "European banking glut," precisely to highlight the contrast with the Asian savings glut that policymakers were worried about. Measured in gross financial flows, the European banking glut was in fact much larger.

In 2002, the gross cross-border bank claims running from Europe to the US increased by more than $850 billion, while flows in the other direction from the US to Europe amounted to $462 billion (Avdjiev et al., 2015). At the same time, the Asia-to-US flows were $436 billion, with $87 billion going from the US to Asia. By 2007, the Europe-to-US banking claims had grown to a massive $2.6 trillion while $1.6 trillion ran from the US to Europe. At this point, Asian claims on the US had only grown to $935 billion, with $206 billion worth of claims running from the US to Asia. Furthermore, Asian investment into US mortgage markets was primarily limited to safer, GSE-issued mortgage bonds, while the Europeans were buying the riskier ends of the market. Finally, while Asians were funding these investments with domestic savings, European financial institutions were borrowing short-term from US financial institutions to invest in US mortgages securities. On the eve of the crisis, euro area banks alone had just shy of $5 trillion in liabilities, while holding almost as much in USD assets (Shin, 2012, p. 12). Money-market funding was only one of several sources of these dollar liabilities, but one for which it is hard to get good data on from the European side. What we do know from the reported holdings of the 15 largest US money market funds in mid-2008, is that over 40% of their asset holdings were in European banks, amounting to approximately $878 billion (Baba et al., 2009, p. 67).

Reviewing central bank speeches from the decade prior to the crisis, American policymakers were not concerned with any threat to financial stability stemming from Europe, and the European policymakers were equally unconcerned. The European "obsession with stability" was interpreted in terms of convergence of member state macroeconomic indicators, with attention to inflation, trade, and budget discipline (Mody, 2018, p. 84). The challenge of financial (in)stability was not given particular attention. As former IMF chief economist to Europe Ashok Mody has argued, European policymakers believed they were less susceptible to financial instability and irrational exuberance than the Americans (Mody, 2018, pp. 157–158). First, because Europeans had a higher savings rate and second, the eurozone had maintained a current account surplus since 2001. Additionally, precisely because the European financial system was so dominated by banks rather than "fickle" equity and bond markets, European policymakers believed it to be safer than the American financial system.

In this blind spot, a massive financial imbalance was allowed to develop. European banks had amassed large multicurrency balance sheets, borrowing short and investing long, buffered by far less equity than American banks. Economists at the Bank for International Settlements (BIS) have estimated that before the crisis the large American banks operated with leverage ratios averaging 20:1, while this average was 40:1 for the large European banks. The UBS and the Deutsche Bank even had ratios of 50:1 right before the crash (Cecchetti, 2013). European banks had also got involved further down the supply chain in US subprime markets, wanting to also make money from the mortgage origination and packing process. Deutsche Bank's cooperation with the loan originator Countrywide is a case in point. With its dollar round-tripping, multicurrency balance sheets, high leverage ratios, and maturity mismatches, Europe was acting like an "international hedge fund" on the eve of the crisis (Bertaut et al., 2011).

4. The 2008 Crisis and the Fed as the Global Lender of Last Resort

When credit markets started to stress in the summer of 2007, European financial institutions quickly ran into trouble. Under normal market conditions, managing multi-currency balance sheets is relatively risk-free. However, panicking markets demand higher premiums, and starting in mid-2007 European banks had to pay 2–3% of transaction volume for various currency instruments. Given that many of these banks had balance sheets into the trillions of dollars, these percentages amounted to a "financial avalanche" (Tooze, 2018, p. 154). The BIS has estimated that as early as mid-2007 the funding gap for European banks, i.e., the gap between how many dollars these banks needed and how much they had access to, was in the range of $1.1 to $1.3 trillion (McGuire & von Peter, 2009, p. 48), far exceeding the ECB's dollar reserves of $200 billion.

Fed officials quickly realized the trouble European financial institutions were in and understood what a European banking collapse would entail for the US. European banks were heavily invested in US financial markets and had borrowed this investment money in part from American banks and money market funds. According to transcripts from the FOMC that have since been released, the Fed proposed to establish a currency swap with the ECB as early as August 2007 (FOMC, 2007). Currency swaps had been used in the Bretton Woods era to help to smooth currency fluctuations and stabilize the Eurodollar market, but these swaps had been retired in the late 1990s due to a lack of demand (McDowell, 2017). In 2007, the Fed proposed to restart them, but now to provide foreign central banks with dollars so they could give these to their distressed domestic financial institutions.

The ECB allegedly declined this initial offer of help. Because the ECB does not have many of the transparency measures associated with central banks today, we only have access to information from the Fed and news reporting of the events, yet both these sources suggest that the ECB was offered a swap arrangement in August 2007, which it declined. "It's a dollar problem, it's your problem," one ECB official is said to have told his counterparts at the Fed (Wessel, 2009, p. 141).

According to Ben Bernanke, Fed chairman at the time, the ECB was worried that if they accepted the currency swap arrangement, they would be accepting blame for the financial crisis (FOMC, 2008a) which was being framed as a crisis the US has brought on the world. The Fed eventually managed to convince the ECB to agree to a small swap arrangement in December 2007. When problems escalated following Lehman's collapse in September 2008, and the dollar shortages for European banks became evident, the swap lines were quickly restarted and expanded to a cap of $620 billion. By October that year, the swaps limits were lifted, and the ECB now had unlimited access to US dollars (Irwin, 2014; McDowell, 2017; Tooze, 2018). The Fed would make available close to $10 trillion through swap agreements with 14 central banks, of which $600 billion were drawn at the height of the crisis. The ECB was by far the largest recipient of these funds, with their swap agreement making up more than 80% of the total.

The ECB supposedly only agreed to the swaps on the condition that European banks could also have direct access to the Fed's own emergency funding facilities (FOMC, 2008a; Wessel, 2009), as this was seen as a way to at least share the blame for the crisis. While one FOMC member voted against this, arguing that giving foreign banks access to US government funding facilities would create a political backlash if it became public knowledge, the rest of the FOMC voted in favor. Foreign banks with branches in the US could access several of the Fed's crisis funding facilities, such as the TAF and the TSLF. For certain facilities, more than 70% of the funds went to non-US banks, primarily European ones.

Why did the Americans decide to provide dollar liquidity to the world, and primarily to the European financial markets? The "global lender of last resort" actions from the Fed are easily explained by material self-interest. Given the interconnectedness of US financial markets with financial institutions in other countries, a banking collapse elsewhere would have ultimately threatened financial stability at home (Broz, 2015; Tooze, 2017). A fire sale of dollar-denominated assets would have further crashed these markets, and bankrupt European banks would have brought massive losses to their creditors, primarily US money market funds which were in danger of "breaking the buck" (McDowell, 2017, pp. 151–152), which means that the net asset value of a mutual fund falls below $1 per share, with shareholders taking losses on their principal. That the Fed officials understood rescuing European banks as being in the national interest of the US is clear from the meeting transcripts:

> Another way to think about this is that the privilege of being the reserve currency of the world comes with

> some burdens. Not that we have an obligation in this sense, but we have an interest in helping these guys mitigate the problems they face in dealing with currency mismatches in their financial systems. (Timothy Geithner, as cited in FOMC, 2008b)

The fact that some countries that applied for swap arrangements were refused, and that the Fed authorities used the arguments that US financial markets were not under threat in these cases, further shows how these rescue operations were not acts of altruism but of perceived economic interest. The Fed chose to give this help, despite the risk of political backlash—a risk that was openly discussed in the meetings. In fact, when the nature and extent of these swaps were publicly revealed in 2013 (Fed transcripts are released after five years), this triggered reactions from Congress, including a Republican bill proposal to "Audit the Fed" (Broz, 2015).

The European side of the equation is harder to explain. That the ECB eventually accepted the dollars the Fed was offering when the European banking system was on the brink of full collapse due to a shortage of dollars does not need explaining from a rational self-interest perspective: You do not turn away the fireman when your house is on fire. What does need explaining, however, is why the Europeans came to need this help in the first place, and why it took the ECB several months to acknowledge a problem that the Fed had already identified and accept help from the Americans. Here a material explanation alone does not get us very far, and we need to look at the ruling ideas of European financial and monetary independence and how these ideas would come to collide with the realities of the financial crisis and the exposure European banks had built up. Even after the swap arrangements were in place, and while European financial markets were effectively being bailed out by the Fed, European policymakers continued to frame the crisis as an American one, and one that Europe had been "dragged" into (Angela Merkel, as cited in "Merkel Says Washington Helped," 2008). As this was a cooperation that occurred at the technocratic level among independent central banks, it is not inconceivable that European policymakers were unaware of the American monetary bailout. Yet, even after the swaps had been initiated, ECB President Trichet gave public speeches about how the crisis had proven the critics of the euro wrong, and that the euro held "a well-recognized status worldwide as a stable anchor in turbulent times" (Trichet, 2008). These public speeches occurred at the same time as other ECB officials spoke off the record to journalists and described the ECB as simply having become "the 13th district of the Federal Reserve" (as cited in Irwin, 2014).

5. Transatlantic Financial Relations After 2008

The events discussed above may be viewed as a rude awakening for European policymakers, who were, through the global financial crisis, made to realize that the economic and monetary union had not secured independence from the US or the dollar. Instead, through a peculiar process of "European-style" financialization, new transatlantic vulnerabilities had emerged, leaving the eurozone reliant on the US for help when a major crisis broke out in 2008. In contrast to the post-Bretton Woods era, however, the vulnerabilities were more mutual this time. It was no longer simply "it's our dollar, but it's your problem." While American banks were not dependent on euro funding to anywhere near the same extent that European banks needed dollars, the European investments in dollars assets were large enough to threaten US financial stability. The US perceived it as in their direct national interest to rescue the European banking system. While ECB officials initially resisted this help, they eventually recognized the dire situation Europe was in.

Where are these transatlantic financial and monetary relations at, in 2022? The European "banking glut" diminished after 2008 in the wake of regulatory reform. In fact, the dramatic decline in cross-border banking flows since 2009 has led analysts to discuss the possibility of having passed "peak finance" and whether we now are in a period of financial de-globalization (e.g., Caruana, 2017). Cross-border banking flows as a percentage of world GDP declined from around 60% in 2007 to below 40% in 2017. Nevertheless, further analysis shows that it is primarily European banks deleveraging that accounts for this "global" trend. Facing much higher capital requirements in the years following the 2008 crisis, large European banks have had to shrink their balance sheets and have sold off many of their riskier US assets (McCauley et al., 2017). After the crisis, the Basel Committee pushed for re-regulation of international banks, whereas they had advocated deregulation in the decade prior to the crisis. The political dynamics were similar to previous rounds of the Basel process, where concerns about the relative competitiveness of different national banking systems characterized the negotiations. Germany opposed parts of the proposed new capital requirements and argued for them to be introduced more gradually, to allow European banks more time to be able to meet the new standards (Howarth & Quaglia, 2016). Even with the concessions given to Germany and the other European countries, European banks underwent a large deleveraging process to be compliant with the new capital requirements, large enough to make a significant dent in global banking flows.

Despite the shrinking of cross-border flows relative to their pre-2008 level, there is little to indicate that the relationship described between the two continents on this issue area has changed fundamentally. European growth has remained sluggish compared to the US', Europe continues to be overbanked, US financial markets remain a liquid and attractive investment area, and the dollar remains unchallenged as the global reserve currency. Indeed, some claim that we are seeing a gradual "dollarization" of the eurozone, arguing that the positioning of Europe firmly within a US dollar hegemony will have serious implications for the level of autonomy the EU can have over its own economic, monetary, and regulatory policy going forward (Grahl, 2020). The currency swaps also appear to have become a regular feature in global crisis management. When the Covid-19 pandemic broke, the Fed swap arrangements were immediately re-started to stem a financial panic over global dollar shortages, this time without any hesitation from the ECB. When asked in a 60 Minutes interview whether there was any limit to the amount of dollars the US was willing to provide the world, Fed chairman Jay Powell simply replied that “there’s no limit” (“Fed Chair Jerome Powell’s 60 Minutes,” 2020). The source of financial instability in 2020 was dollar shortages in emerging markets, not in European banks, yet this normalization of dollar swaps as a stabilization mechanism for Europe in times of financial stress underscores the continued central role of the dollar and of the Fed in European financial markets.

In the decade since the crisis, Europe has not made any serious attempts to change the nature of this structural relationship. The ECB has not significantly increased its own dollar reserves like the Asian central banks did in the wake of the financial crisis in 1997–1998. While there have been developments in the European banking union, the practices of wholesale funding on the money markets and securitization are still permitted, and the “push” factors that we identified above continue to make it attractive for European banks to go outside Europe for both funding and investments. Finally, there have been no developments to suggest that the euro is on a path to becoming an international currency that may in any way rival the dollar (Germain & Schwartz, 2014). Dollar-denominated financial markets remain the most liquid and thus the most attractive for market-based banking practices. However, to claim that these developments in European financial markets and the Fed acting as a global lender of last resort in times of crisis is a sign of increased US power is not straightforward. The expansion of the external balance sheets of US financial markets can be argued to have increased the international importance of US markets, and these are dollar-denominated; however, these developments can at the same time have reduced the monetary autonomy and thus the power of the US government (see, for example, Hardie & Maxfield, 2016; Hardie & Thompson, 2020). The position of the Fed as the global lender of last resort is therefore perhaps less of a strategic policy choice and more of a forced response to market developments.

6. Conclusion

This case reveals that the Fed committee members quickly understood the interlinkages between European banks and US financial markets and saw the threat that a widespread European banking collapse would pose to US financial stability. Given the global position of the dollar and US financial markets, it was in the US’ material interest to ensure that the problem of dollar shortages abroad was solved because these problems would cause financial instability at home. What are the empirical implications? The creation of the economic and monetary union successfully decreased one form of dollar dependence for Europe, that of vulnerability to fluctuations in the relative value of the dollar. But due to a series of deregulatory measures, the development of market-based banking, and securitization, combined with diverging growth and savings rates, another form of dollar vulnerability developed. European banks had become deeply involved in risky parts of dollar-denominated financial markets, funded in part through US money market funds. When the crisis broke, and European banks had trouble managing their sizable multicurrency balance sheets, they needed dollar liquidity to avoid collapse. Only the Fed, directly or through swaps with the ECB, could therefore act as a lender of last resort. The level of integration in transatlantic financial markets was such that it was in the US’ interest to help, and in the EU’s interest to accept—re-establishing a new form of interdependence and one that required cooperation in times of crisis.

While the amount of cross-Atlantic banking flows decreased considerably in the first decade after the 2008 crisis, the structural relationship we have described has not changed. The European banking system continues firmly embedded in a US market-based and dollar-denominated financial system. We, therefore, conclude that in the financial sphere, transatlantic relations are stable with ties that are stronger than ever. It is theoretically significant that relationships embedded in technocratic circles and the institutional practices of the two central banks appear to be robust, also in the face of increasing polarization and episodes of political grandstanding.

However, we should be wary of drawing conclusions about the relative power balance between the US and the EU, or the individual European member states. Any analysis of the power implications of this case needs to account both for the changing power relations between states and markets on the one hand, and the power relations between different states on the other. Deregulating financial markets was very much a political choice, but the complex consequences of global, financialized markets were not fully understood at the time. In a pre-financialized era, the US could hold the world reserve currency and still confidently state that the dollar was not their problem; however, in a world where the dollar forms the core of a large, integrated, and highly leveraged global financial system, the problem is mutual.

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Conflict of Interests

The authors declare no conflicts of interest.

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