Dynamic-Nexus between Cross-Border Dollar Claims and Economic Growth

Subjects: Economics

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The term "Eurodollar" first appeared in the public realm in 1960 when William Clarke gave name to a fledgling market. Nowadays, the terms "Eurodollar", "Eurodollar system", "ledger money", "shadow money" and "ghost money" are all used interchangeably to describe U.S. dollars that exist offshore, that is, outside the U.S. domestic currency system and out of sight of its primary regulator, the Federal Reserve.

Keywords: eurodollar ; cross-border dollar claims ; economic growth ; global trade

1. Introduction

The term "Eurodollar" first appeared in the public realm in 1960 when William Clarke gave name to a fledgling market (Clarke 1960). Nowadays, the terms "Eurodollar", "Eurodollar system", "ledger money", "shadow money" and "ghost money" are all used interchangeably to describe U.S. dollars that exist offshore, that is, outside the U.S. domestic currency system and out of sight of its primary regulator, the Federal Reserve.

The precise origin of the Eurodollar market remains a topic of debate. Some authors trace it to post-war U.S. trade deficits, political or regulatory factors, the petrodollar and oligarchs attempting to create haven asset pools outside the United States. Ultimately, as its name suggests, it found its footing in Europe, primarily in the City of London. However, other financial centres worldwide are also cited as key contributors to its proliferation (Friedman 1971, 1993). Nowadays, the Eurodollar market exists everywhere and touches practically every part of the global economy.

Despite the U.S. economy's declining share of global GDP, its currency remains dominant as the medium of exchange in international trade, debt issuance and financial transactions. Thanks to its liquidity, almost 90% of foreign exchange transactions worldwide involve the U.S. dollar. At the heart of this dollar internationalization is an "offshore" banking and currency system referred to as the Eurodollar system. The Eurodollar market is about short-term deposits denominated in U.S. dollars at banks outside U.S. territory. The growth of the Eurodollar market has been linked to the Bretton Woods agreement and the emergence of capital control measures in many nations.

The expansion of the Eurodollar system ran parallel with post-war economic growth. The abundance of dollars globally was likely a significant contributing factor to growth. As money primarily functions as a medium of exchange and does not contribute to economic growth, it is reasonable to assert that the availability of dollars did not act as a limiting factor for global growth and globalization during the post-war period, at least until 2007. Whilst a review of the academic literature would suggest widespread recognition that the U.S. dollar has played a significant role in post-war growth and globalization, there is scarce empirical analysis in this area.

During the GFC in 2007–2008, there was a significant impact on cross-border financial flows and claims. Financial institutions faced liquidity and solvency issues, leading to a sharp reduction in cross-border lending. Many banks faced a decline in their capital positions, and the interbank lending market experienced disruptions. Cross-border dollar claims, particularly loans and financial instruments were affected as financial institutions became risk averse. Central banks and international organisations took measures to stabilise financial markets and prevent a systemic collapse (Cavallino and De Fiore 2020). However, the crisis highlighted the interconnectedness of global financial markets and the potential for contagion.

Furthermore, the COVID-19 pandemic had widespread and profound effects on the global economy, financial markets and cross-border financial activities (Adrian et al. 2022). The pandemic led to disruptions in international trade, supply chains, and economic activities, affecting various sectors. Governments worldwide implemented measures such as lockdowns and travel restrictions to contain the spread of the virus, which had cascading effects on financial markets. During the early stages of the pandemic, there was a flight to safety, with investors seeking refuge in traditional safe-haven assets such as the U.S. dollar. The latter contributed to an appreciation of the dollar and affected cross-border funding conditions. The economic downturn and the pandemic-related uncertainties also led to increased credit risk and financial market volatility. Globally, central banks responded with monetary and fiscal measures to support their economies and stabilise financial markets (Cavallino and De Fiore 2020). Regarding cross-border dollar claims, the impact varied depending on the exposure of financial institutions and the sectors they were involved in. Some countries and businesses faced challenges in servicing their dollar-denominated debt, particularly if the pandemic severely hit their economies.

2. Theoretical Background

The relationship between the U.S. dollar and global economic growth has been a topic of significant interest and debate among economists, policymakers and researchers. However, there is a lack of academic literature examining the role of the U.S. dollar as the global reserve currency on global economic growth.

The U.S. dollar is often considered a haven, especially during periods of global economic uncertainty. Eichengreen and Flandreau (2012) discuss the role of the dollar as a safe haven and its implications for financial markets and economic growth and, in this context, point out that changes in global economic conditions that affect the demand for the U.S. dollar as a safe asset are crucial for anticipating its impact on the broader economy.

The dominance of the U.S. dollar as the world's primary reserve currency has been a defining feature of the international monetary system. Obstfeld and Rogoff (2000) and Eichengreen (2011) have explored the benefits and challenges associated with the dollar's status as a global reserve currency. They argue that the use of the dollar in international trade and finance provides the U.S. with significant advantages but also creates vulnerabilities for the global economy.

Furthermore, on the impact of dollar claims on global trade patterns and exchange rates, Gopinath and Stein (2018) examine the dollar's role in facilitating international trade, emphasising its importance in pricing and invoicing. Additionally, Goldberg and Tille (2008) suggest that "the U.S. dollar appears to be important in the invoicing of world trade both because the U.S. is an important consumer and producer in world markets, and because of its use in invoicing the many products that are traded via organised exchanges or using reference pricing" (p. 185).

Many emerging market economies face challenges related to dollar claims, such as high levels of dollar-denominated debt and the risk of currency crises. Jeanne and Rancière (2006) provide insights into dollarization in these economies, examining its impact on economic stability and growth. The authors highlight the potential benefits and risks associated with adopting the U.S. dollar to reduce transaction costs and gain access to international capital markets. In another study, Frankel and Saravelos (2012) analyse the dollar's role in predicting financial crises, emphasising its significance as a leading indicator. They argue that understanding the dynamics of financial crises and the role of the U.S. dollar is crucial for policymakers seeking to enhance global economic stability.

The literature on financial globalization explores how the growth of international financial markets, often dominated by the U.S. dollar, influences economic development. Reinhart and Reinhart (2008) analyse the relationship between financial globalization, dollar claims, and economic crises, emphasising the role of currency mismatches and the potential for contagion. Their work contributes to understanding the complex interplay between global financial integration and economic growth.

From a U.S. perspective, the dollar's hegemony has enabled the country to run perpetual trade deficits for decades (Bernanke 2005). Heightened demand for dollars increases the dollar's exchange value and reduces the competitiveness of U.S. exports while reducing the relative cost of imports. Likewise, insatiable global demand for dollar assets, particularly U.S. Treasury Bills, has permitted the U.S. Federal Government to run sustained budget deficits without incurring punitive rates (Bernanke 2010).

The supply of Eurodollars is discretionary and determined by the global banking system, influenced by factors largely outside the control of the individual countries it impacts. Small emerging economies, in particular, have had little choice but to accept the encroachment of the dollar into their economic system. In the post-war period, this granted them access to global trade and cheap dollar credit, exposing them to significant currency risk. Bordo et al. (2009) empirically demonstrate that increasing foreign debt elevates the probability of both currency and debt crises. The authors also find that these crises lead to permanent losses in economic output. The Mexican 'tequila crisis' (1994), the Russian ruble crisis (1998) and the 'Asian Flu' can all be largely attributed to significant U.S. dollar liabilities (Eichengreen and Hausmann 1999).

The existence of the Eurodollar presents some challenges for central banks, particularly in the context of the monetarist doctrine. In the monetarist view, control over the supply of money is seen as the most effective means to control the price level (McClam 1980). The emergence of a fractions-on-fractions reserve-based system, and subsequently a reserveless system, would undoubtedly be an affront to monetarists. Eurocurrencies are both challenging to locate and to quantify.

Frydl (1982) admits that the Eurodollar poses a conundrum for the Federal Reserve, both in terms of setting policy based on monetary aggregates, which are exclusive of Eurodollars, as well as from a lender of last resort perspective, should the Fed be required to lend to non-U.S. banks. Interestingly, Frydl (1982) puts the Eurodollar's continued expansion down to its past stability, i.e., survivorship bias. Then, it is worth exploring whether this survivorship bias attached to Eurodollar growth could be derailed by an exogenous event such as the GFC.

Bernanke (2010) alludes to a shadow banking system offshore dollar reserve balances (Bernanke 2005) and even identifies that during the crisis, "heavy foreign demand for dollar funding began to disrupt money markets and squeeze credit availability in the United States" (Bernanke 2010). Snider (2013) demonstrates that after removing the reserve requirements of Eurodollar deposits in 1990, the U.S. financial system quickly moved from being a net lender into the Eurodollar system to being a net borrower. Snider (2013) also shows that what occurred during the GFC was not a supply problem but rather one of flow caused by fragmentation in interbank wholesale markets. Immediately after the GFC, both U.S. domestic and foreign banks' participation in Eurodollar markets collapsed (Snider 2013).

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