The Euro and Latin America

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On January 1, 1999, a new era of European economic and monetary union (EMU) began when 11 of the 15 member countries of the European Union (EU) replaced their national currencies with a single currency, the euro. Will the introduction of the euro have real economic effects, or will it be primarily an accounting phenomenon? As far as the countries of Latin America and the Caribbean are concerned, the euro will probably affect their trade with Europe only slightly, but it will have a somewhat greater impact on their financial markets and debt-management policies over the short and medium terms.

Economic relations

Trade between the European Union and developing countries is important. About 22 percent of the European Union's exports go to, and 20 percent of its imports come from, developing countries. Over the past two decades, Latin America's exports to the European Union have tripled, to \$38 billion a year. Imports from the European Union have quadrupled since 1977 and continue to climb, rising from \$27 billion to \$54 billion a year between 1990 and 1997.

How will the introduction of the euro affect trade between the two regions? One clear, if minor, advantage is that Latin Americans will be able to invoice in a single currency when trading with different European partners. A more important—although less certain—effect is that if European economic growth picks up as a consequence of increased efficiency and competition in Europe, demand in the euro area for imports from Latin America and the Caribbean will increase.

The euro is already seen as making Italy, Spain, and even France safer for investors and as reducing risk premiums. The decline in risk premiums is, in turn, reflected in lower interest rates and should therefore boost growth rates in these countries. Furthermore, the euro reinforces financial deregulation. As a result, it should spur the development of broader, deeper capital markets in Europe that would more closely resemble U.S. capital markets, thereby contributing to improved corporate governance and better performance by European companies. However, the euro's direct contribution to European growth and employment will probably not be very significant, because the gains in competition and efficiency are likely to be small. Therefore, the euro is likely to have only a slight—albeit positive—impact on trade with Latin America and the Caribbean.

The introduction of the euro will affect foreign exchange and financial markets and economic activities around the world. What risks and opportunities does the euro represent for Latin America and the Caribbean?

On the other side of the ledger, it is theoretically possible that an improvement in euro area competitiveness could occur, partly at the expense of exporters from other regions, including Latin America and the Caribbean. The elimination of exchange rate risk and transaction costs within Europe could result in trade diversion and a reduction of imports from non-European countries. The only exports from Latin America and the Caribbean that would be negatively affected, however, would be the small number that are in direct competition with goods produced in Europe. Thus, both the expansionary influence from possibly faster European growth and any dampening impact from trade diversion are likely to be relatively slight.

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Capital flows

Even though most private investment in Latin America and the Caribbean continues to be financed by domestic savings, foreign capital is increasingly important. Indeed, the Latin America and Caribbean region has been the largest recipient of foreign direct investment among developing regions; in 1997, it accounted for nearly 40 percent of all foreign direct investment flows to developing countries ($45 billion out of a total $120 billion).

European foreign direct investment in Latin America and the Caribbean has increased dramatically over the past decade. It is believed to have been highly beneficial to the region, both because foreign direct investment is typically more stable than portfolio investment and because it usually involves a transfer of technology and managerial know-how as well as of funds. Moreover, it has forced domestic companies to become more competitive. The main forces driving the increase in foreign direct investment include privatization (notably in Brazil), improved economic performance, and continued progress with financial sector liberalization.

With the introduction of the euro, Latin America and the Caribbean may benefit from enhanced investment inflows from Europe. The managers of the growing pools of savings in European countries with aging populations will continue to seek higher returns by increasing their investments in faster-growing developing countries, including those in Latin America and the Caribbean. (Additionally, savings in Europe should increase if growth accelerates there.) Private institutions in the euro area, such as pension funds and insurance companies, may shift a larger share of their portfolios into developing countries once investments within the euro area are no longer classified as foreign investments for exchange-risk-management purposes and currency-exposure limits cease to apply to them. Furthermore, if investors wish to continue diversifying, the Latin American region may benefit. Latin America and the Caribbean could also benefit if companies in the euro area feel squeezed competitively and seek new locations for their expanding operations, either through mergers and takeovers or through new investments.

Value and volatility of the euro

The financial challenges facing EMU are real. Exchange rate volatility could lead to portfolio shifts both into and out of the euro. Economists' views on the effect of EMU on long-term exchange rate volatility vary considerably. As of April 1999, the euro had depreciated against the dollar, contrary to earlier predictions that it would appreciate in the short term; some economists had expected national savings in Europe to increase (in part for demographic reasons), resulting in a current account surplus.

Clearly, the policies and credibility of the new European Central Bank (ECB) and the strength of its determination to pursue price stability have an important influence on the euro's international value. Uncertainty about the ECB, and especially about European politics, weakened the euro in the early days of EMU. A weaker euro would probably stimulate demand for labor in a region where high unemployment levels have been a source of grave concern for more than a decade.

Financial implications

What implications will the euro's introduction have for banking systems, foreign debt, and reserve management in Latin America and the Caribbean?

Banking systems. The introduction of the euro will work as a catalyst for the development of integrated money and bond markets in Europe. It will spur competition among banks and between banks and other sources of funds. Furthermore, the increased competitiveness of banks and financial systems in general will lead to more efficient resource allocation and ultimately stimulate investment and job creation.

As for how these developments in European banking systems affect Latin America and the Caribbean, the short-term and long-term effects may go in opposite directions. In recent years, the involvement of European banks in Latin America has expanded considerably. In the immediate future, this trend may slow, as banks that have traditionally been nationally based give top priority to expanding their base across the euro area. In the longer term, however, as competition within Europe heats up and margins narrow, banks may once again find the prospect of expansion into non-European markets attractive.

Management of foreign debt. All countries have to decide how much public foreign debt to take on and how to diversify the currency composition and maturity structures of this debt. The currency composition of foreign debt should be related to the composition of earnings from foreign trade. As trade between Europe and Latin America and the Caribbean grows, euro-denominated debt may well account for a larger share of the latter's total foreign debt. Hence, countries in the region need to reassess their hedging strategies. In the longer term, a shift in euro interest rates will have an effect on the foreign debt service of countries in Latin America and the Caribbean because part of their debt will be denominated in euros. In the near term, however, the impact will be minor because only about 8 percent of Latin America's external debt is currently denominated in the national currencies of euro area countries. Furthermore, countries in Latin America and the Caribbean could offset the adverse effects of economic shocks by changing their debt-management policies. This will be easier to do with a single European currency. But the emergence of the euro and major European capital markets is not expected to greatly change Latin America and the Caribbean's access to capital.

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Reserves. The European Union's intention is that the euro will become a major reserve currency competitive with the U.S. dollar; there has been considerable controversy among observers as to whether this will indeed occur and to what extent. Will countries in Latin America and the Caribbean substantially diversify their reserve holdings? This is both an economic and a political question. If Europe succeeds in making the euro competitive, the euro could cut into the seigniorage currently accruing to the United States (this gain would, however, have to be balanced against domestic policy considerations, such as employment levels). The forces of inertia (and uncertainty about the new currency) will at first act in the dollar's favor. Latin Americans are familiar with the dollar, and many in both the private and public sectors may be influenced by established personal, cultural, business, and political links to the United States. Countries in the Western Hemisphere are increasingly, if haltingly, moving toward greater economic integration. But if the euro proves to be a stable currency, some investors in Latin America and the Caribbean may diversify their portfolios by increasing their euro holdings. Nor should one ignore Latin America's ambivalence toward the United States or the desire of some Latin American leaders for closer ties with a stronger Europe. But the tendency toward increasing dollarization in Latin America indicates that, in the short and medium terms, the euro will not prove to be a counterweight to the dollar's dominance in the Western Hemisphere.

Conclusion

The launch of the euro will affect Latin America and the Caribbean in a number of small ways, but it is unlikely to precipitate a major change in the near term, given that many economies in the area are highly dollarized. Moreover, no structural change in the trade between Europe and Latin America and the Caribbean is expected, although increased competition and efficiency in the European Union should spur economic growth, which, in turn, should stimulate demand for imports from Latin America and the Caribbean. But the main impact of the unified European market and the single currency is likely to come through financial linkages and to be positive, if limited.

• The deepening of European capital markets could boost Europe's growth rates, leading not only to increases in the European Union's imports from Latin America and the Caribbean but also to increases in financial flows between the regions.

• Because much of Latin America and the Caribbean's debt is denominated in U.S. dollars and the euro is not expected to appreciate significantly in the short term, the immediate impact of the introduction of the euro on the value of the region's debt and debt service should be small. The euro will, however, create an opportunity to realign the currency composition of foreign exchange reserves if realignment becomes necessary to service trade flows or other transactions or—in the longer term—if political considerations or a desire for portfolio diversification require it.

• Countries in Latin America and the Caribbean may become more attractive as destinations for European investors as the latter seek portfolio diversification and higher returns, and as returns within Europe begin to converge.

A prosperous EMU is expected to contribute to greater trade and financial flows between the European Union and Latin America and the Caribbean. Reduced foreign exchange risk, low inflation, increased trade, and more efficient markets all promise large benefits for the European Union, as well as some benefits for Latin America. Furthermore, a successful EMU requires sound financial structural policies, including reforms of both labor markets and public spending. Over the longer term, this should also benefit other countries, including those in Latin America and the Caribbean. F&D

The author is managing studies of the euro's impact on Africa and Latin America and the Caribbean. The findings will be published in the fall of 1999.

Suggestion for further reading:

Robert A. Feldman and others, 1998, The Impact of EMU on Selected Non-European Union Countries, *IMF Occasional Paper No. 174 (Washington: International Monetary Fund).*