

Lain America & Europe: Future perspectives

Challenges for strengthening Mercosul financial integration process Lessons from the European experience

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**Central Bank of Brazil
Brasilia, 24 October 2012**

Este documento não representa necessariamente a opinião do Banco Central do Brasil

World monetary system in turbulence



**Searching for a pilot:
EM role?**



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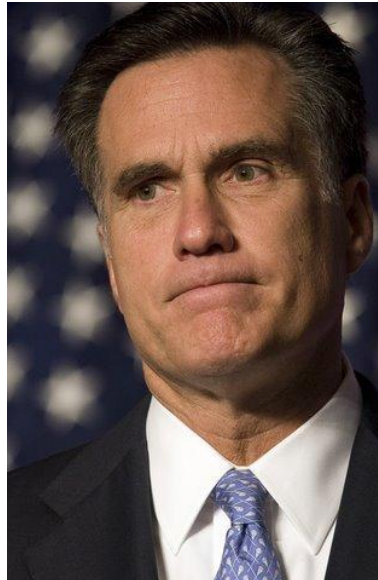
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US – strong, but no longer what it was



No
real
answers

What was
the question?



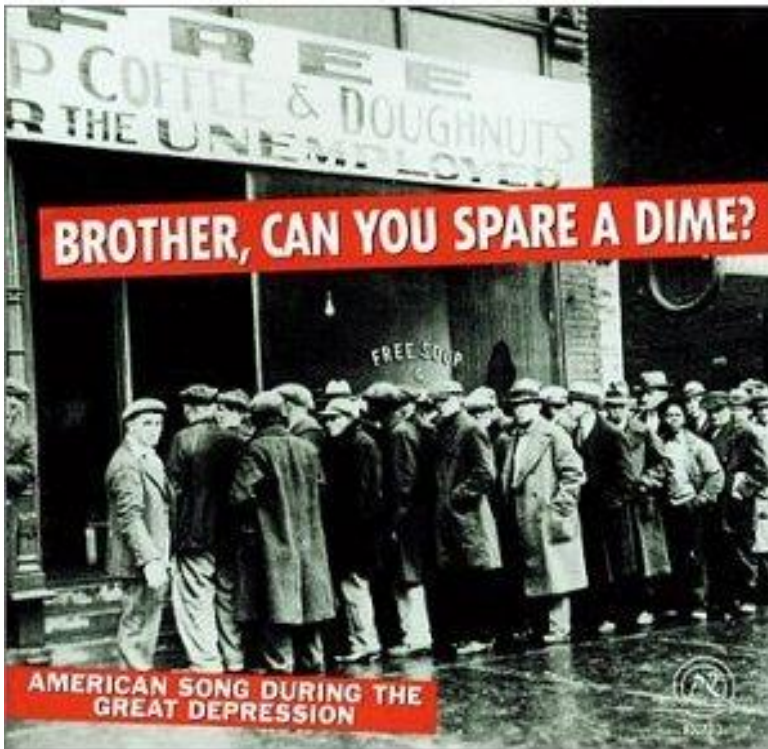
Europe / US disarray - Latin America precepts

Examples of possible economic, monetary advance

- Low intra-region trade integration is a challenge but also an opportunity - absorb lessons from Europe and Asia
- Latin America can learn from Asia's Chiang Mai initiative on swap lines, reserve pooling and mutual monetary assistance
- Amro research organisation in Singapore could become embryonic model for Latin America
- Greater use of domestic currencies in trade invoicing, public bond issues, reserve transactions – but need to proceed cautiously
- More sophisticated capital market instruments /savings institutions
- Towards heightened role in international institutions & governance
- Despite everything, US role is crucial – but “work round” Europe

Europe's turnaround – looking to EM for help

China discomfort: Bankers to Europe?



Asking world for
rescue funds



Sarkozy and Hu
October 2011



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The paradox of European value

Good corporate values (low euro) despite political vacuum



Henry
Kissinger's
question still
unanswered

“Who do I dial if I want
to dial Europe?”



Industry more attractive than politics

Results of EMU were predictable and predicted

Pleasure gives way to pain: Pinocchio's Pleasure Island



D/W/W



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Objectives and outcomes of euro experiment

The four reasons for the euro

- Underpin European Single Market by eliminating exchange risks
- Complete Franco-German post-war political rapprochement
- Create a rival/complement to the dollar as world money
- Shackle united Germany in a constructive European community

Results have not lived up to expectations

- Trade integration held up by poor macro-economic picture
- Franco-German ties weakened under Merkel-Sarkozy-Hollande
- Dollar is still the world's dominant currency
- Germany is stronger than ever as a result of export surge

Reasons for the euro dream

Goal No. 1 – Complete Europe's single market



Jacques Delors
single currency for single market



Reasons for the euro dream

Goal No. 2 - Forge European political union



Franco-Prussian war 1870-71



President Mitterrand, Chancellor Kohl, eastern France, 1984



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Reasons for the euro dream

Goal No. 3 – Provide rival for the dollar



Both France and Germany wanted in different ways to curb dollar's 'exorbitant privilege' permitting 'deficits without tears'



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Reasons for the euro dream

Goal No. 4 – Keep the Germans under control



Ex-President Giscard d'Estaing:

“We need an organised Europe to prevent German domination”



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What's worse? German dominance....



Angela Merkel in driving seat



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.... or German Angst?

**Fear that Germany
loses Triple A rating**



**Fear of 1920s-style
inflation and social unrest**



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Lessons learned from EMU in Europe

Sobering outcome for countries mulling similar action

- EMU has resulted in considerable euro area fragmentation
- Some improvement in EMU governance in 2012
- Late start towards political union – no implementation for years
- EMU expansion put on hold
- ECB liquidity moves buy time, not more
- One size fits all interest rate nearly always causes bubbles
- Living standards rose in periphery – now reversed
- Bipolar economic development as North-South divide widens
- “Winner takes all” outcome on capital markets as spreads widen
- A political project - but economics wins out in the end
- Politicians didn’t grasp danger of credit crisis within monetary union

Landmark points of Greek 2012 bankruptcy

Greek restructuring altered sovereign bankruptcy rules

- Five times bigger than previous largest sovereign bankruptcy in history (Argentina in 2003)
- First rich country bankruptcy since 1930s
- Threatened a monetary union involving the world's second reserve currency, the euro
- Large mismanagement by IMF and official creditors
- Greece bankrupt in its own currency, which it didn't control
- New bonds fell sharply, indicating more restructuring ahead
- Bondholders formed committee for first time since 19th century
- Bankruptcy went ahead relatively smoothly despite lack of sovereign bankruptcy law



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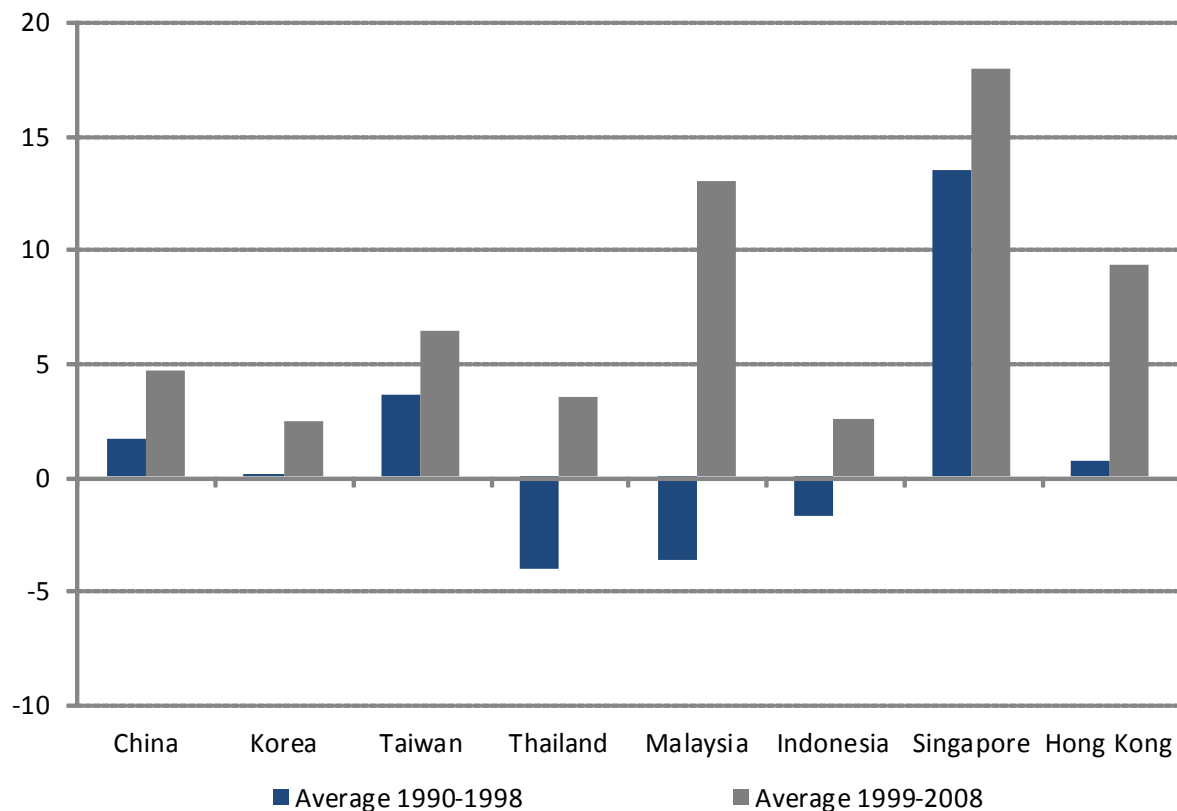
Latin American, Asian and European crises

Europe 2010-12: Partial re-run of EM crises

- Common theme: search for scapegoats
- Current account deficits in Europe sent warning signals
- Competitive pressures maintained by lack of devaluation
- IMF / official lenders more compliant with Europe – mismanagement over Greece
- Pain, resentment will last longer in Europe than Asia & Latin America

Asia registers large surpluses after crisis

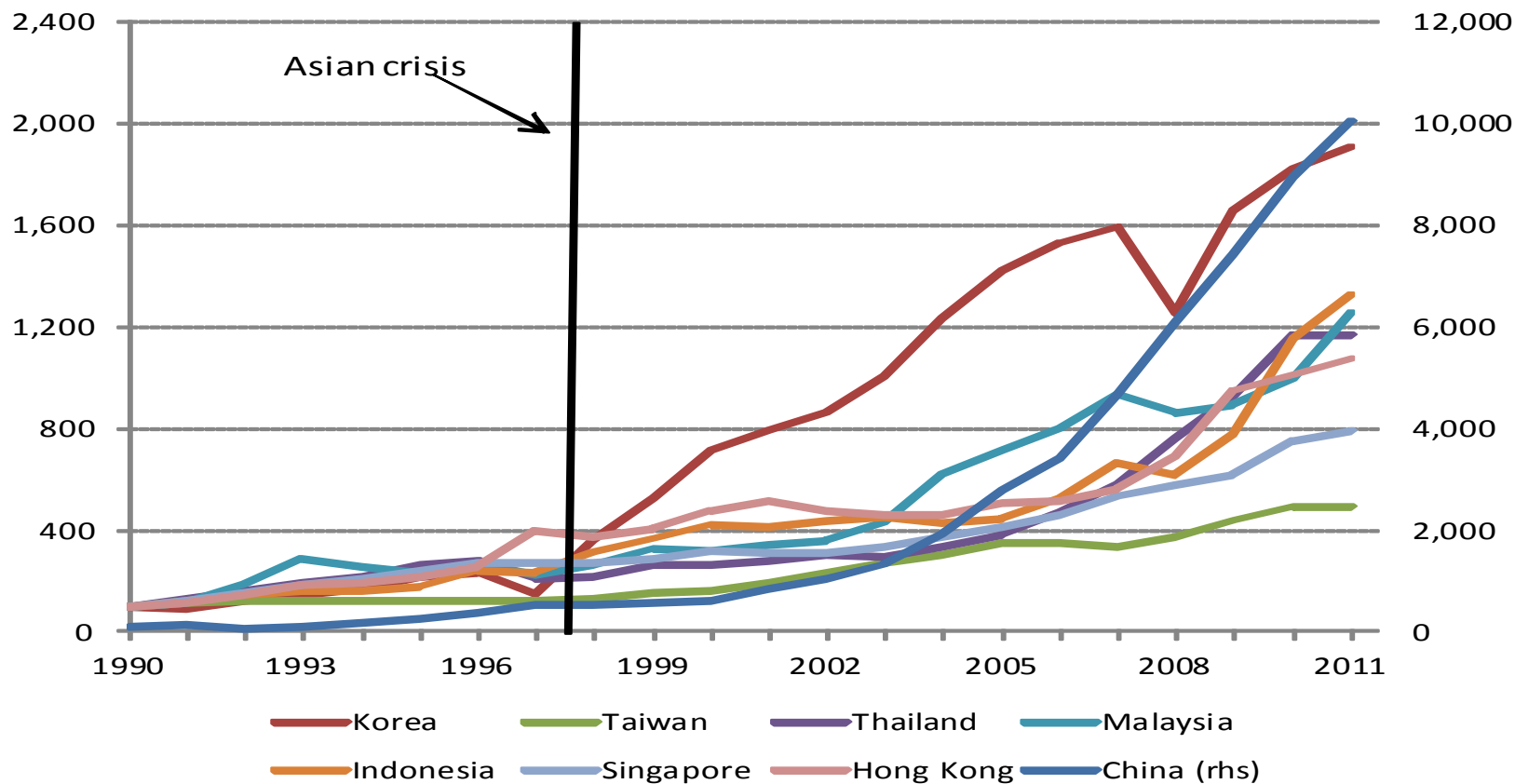
Currency flexibility drove return to competitiveness



Current account balances, key Asian economies (% of GDP)

Asia builds currency reserves as insurance

Reserves rise on intervention to hold down currencies



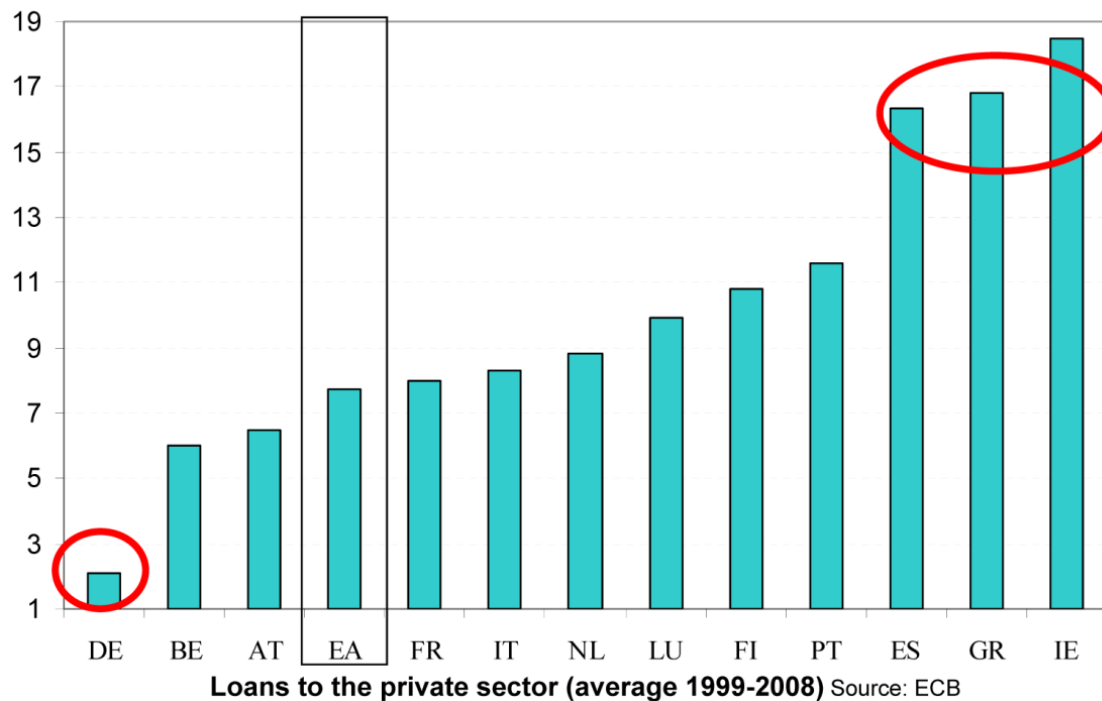
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SDRS, Index 1990 = 100

Europe's “one size fits all” monetary policies

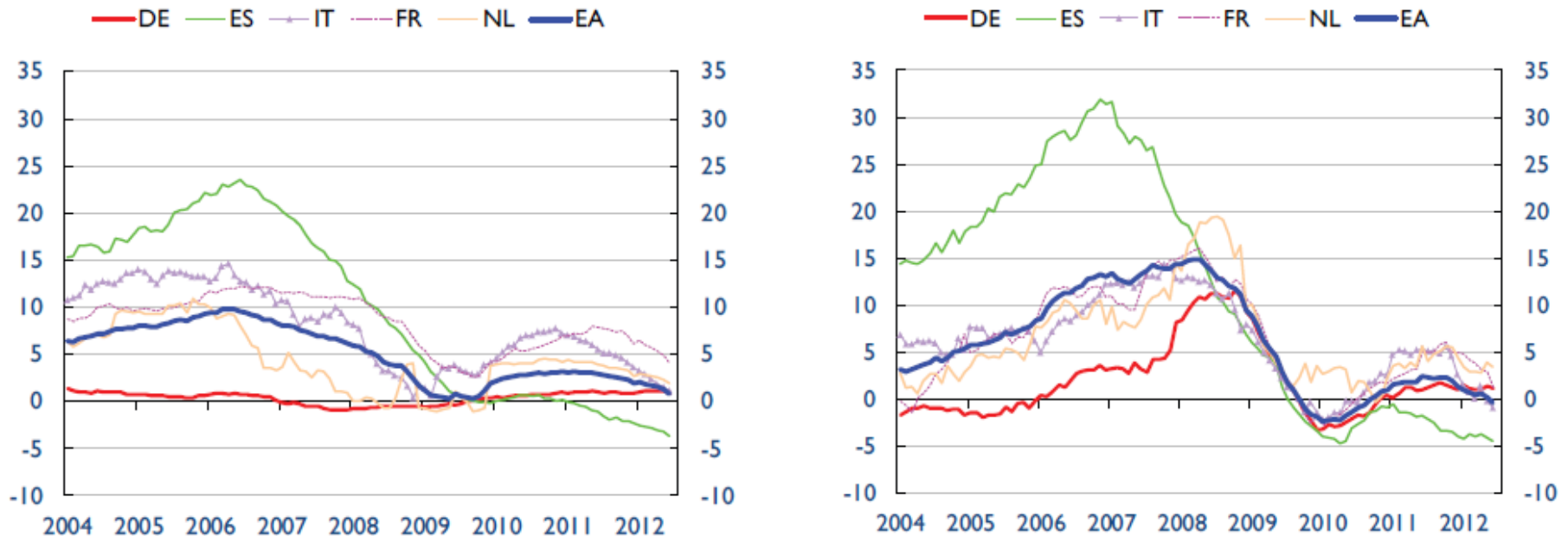
Excess credit growth in periphery to 2008



“One size fits all” interest rate brings bubble-like distortions unless accompanied by fiscal adjustment

Huge disparities in euro area lending levels

Unitary monetary policies caused boom & bust

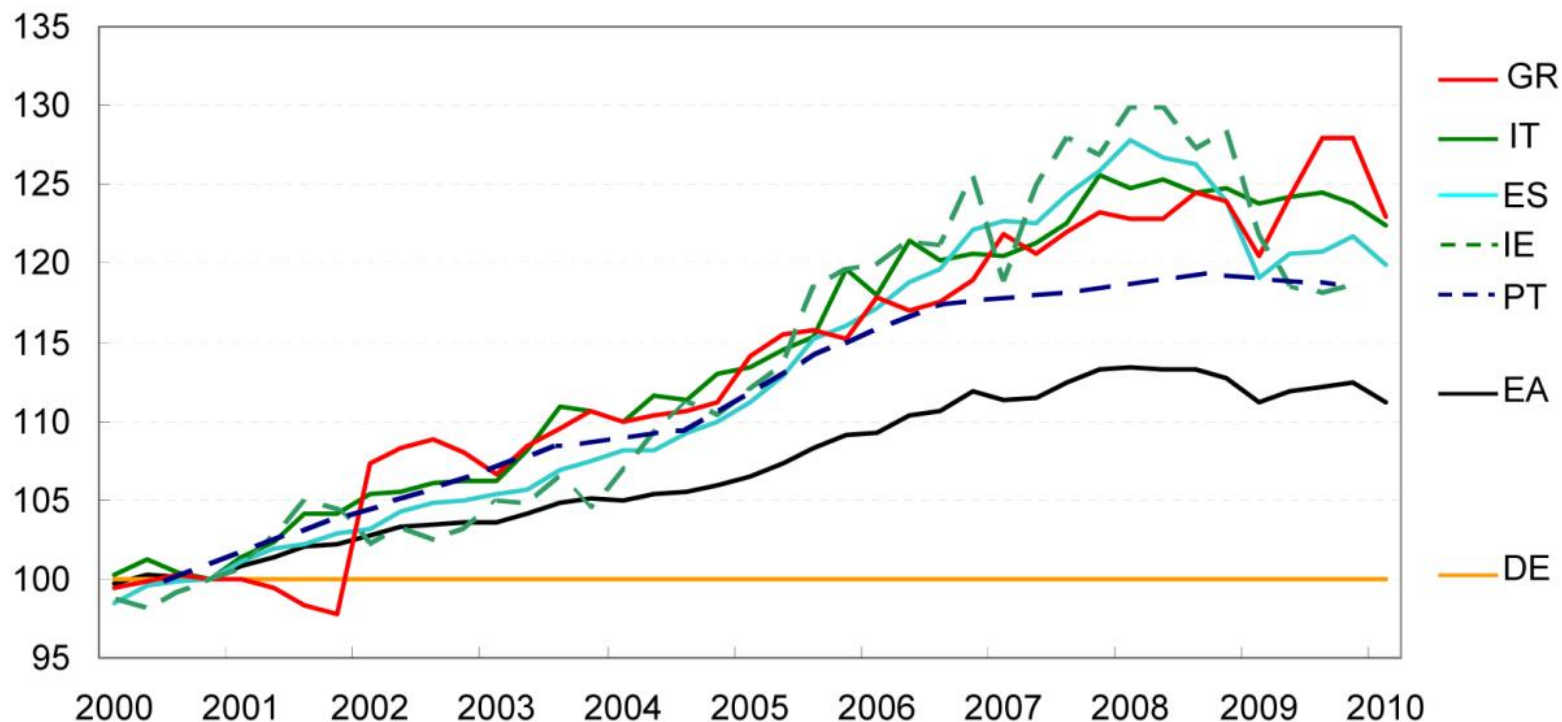


*Note: Latest observation is for June 2012.
Source: ECB and ECB calculations.*

Lending to non-financial corporations and households in euro area

Europe unable to manage currency adjustment

Diverging real exchange rates & competitiveness



Competitiveness gaps - growth in unit labour costs

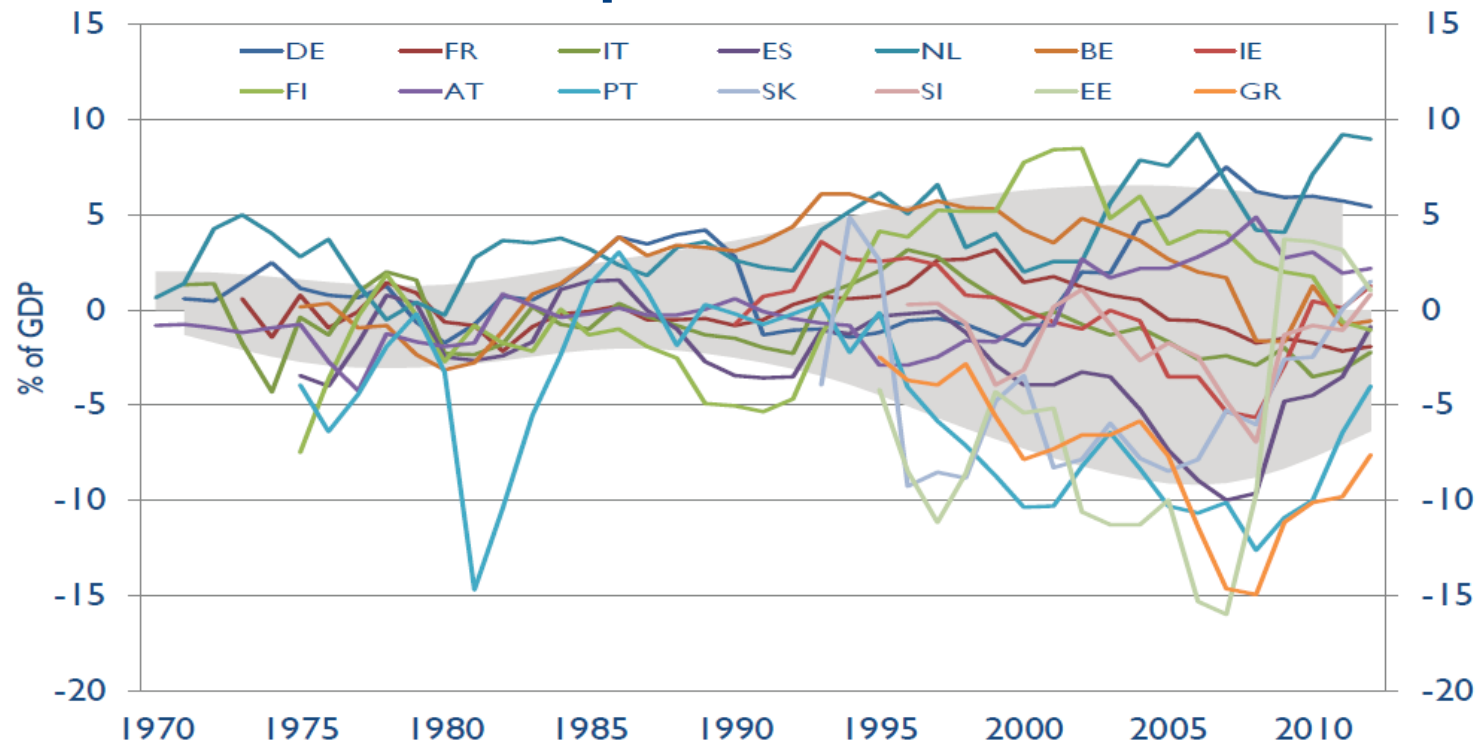


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Severe current account imbalances in Europe

Inevitable effect of competitive distortions



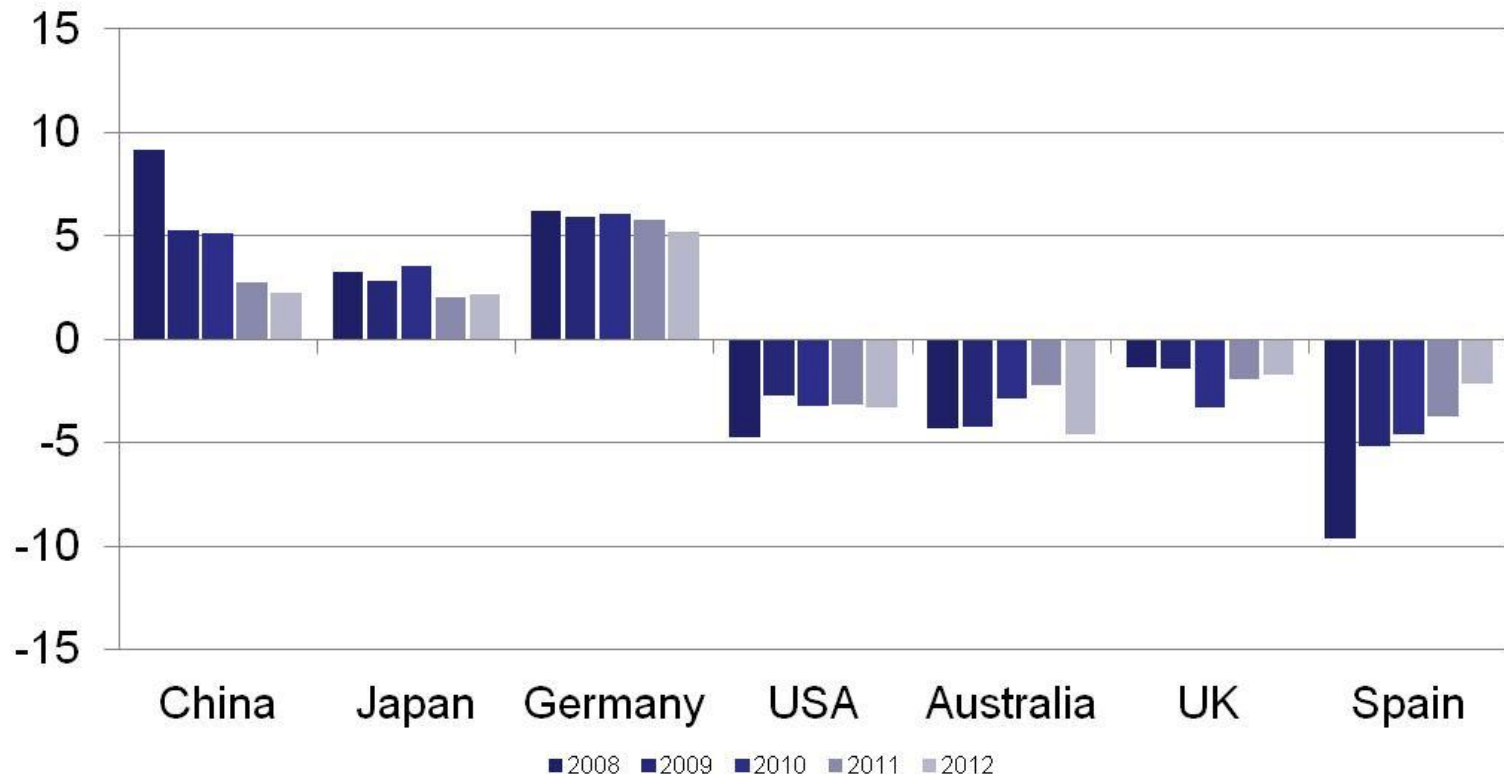
Note: The grey area represents the difference between the HP filtered trend of the 90th and 10th percentile of the current account balances across countries.

Recession drives reversal of imbalances after 2010

Source: OECD and ECB calculations.

Current account imbalances not confined to Europe

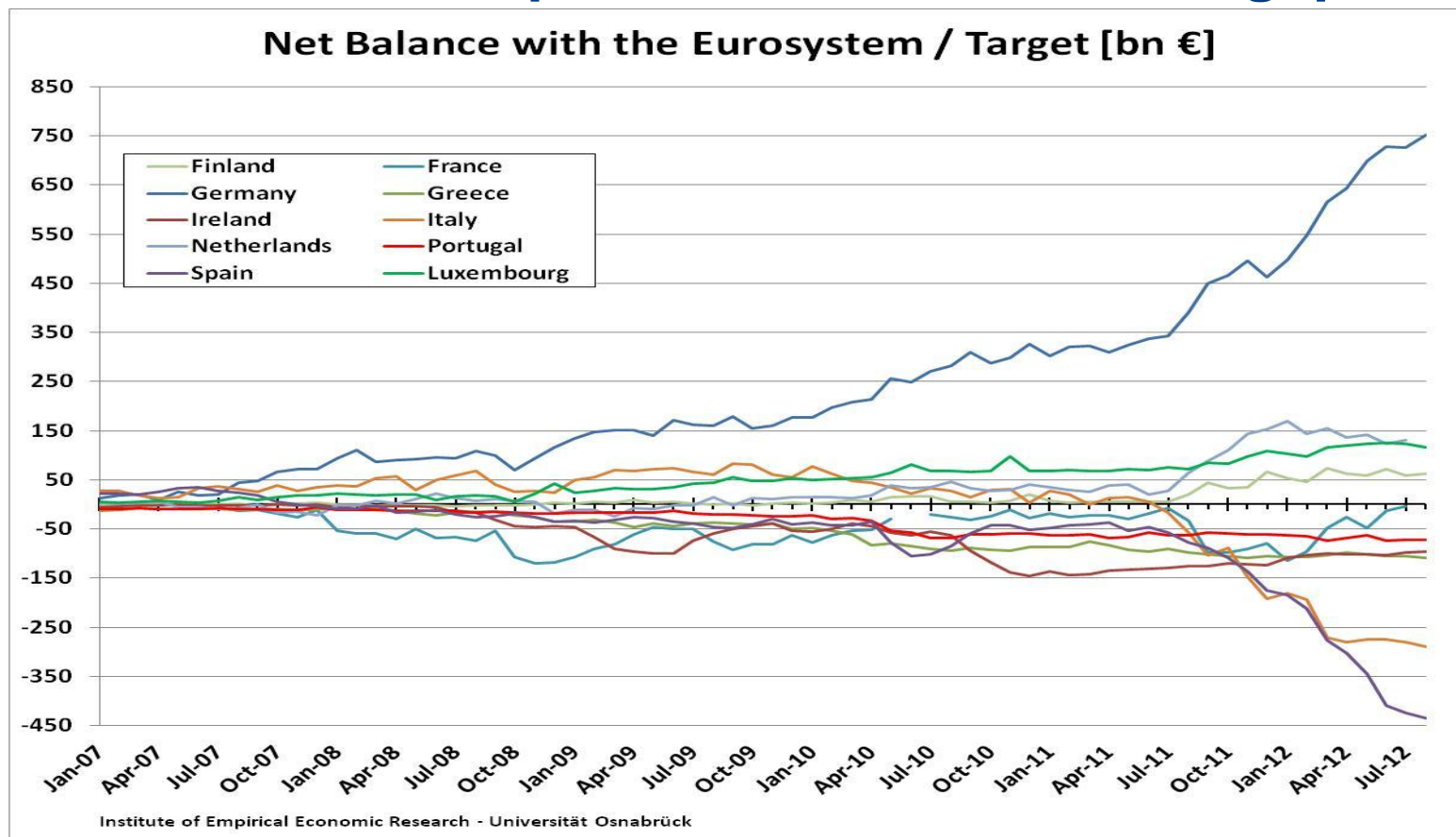
US, Australia, UK joined Spain as deficit countries



Current account balances, % of GDP 2008-2012 (2012=IMF forecast, April 2012)

Financing capital flight through Target 2

ECB mechanism helps deficit countries fund gaps

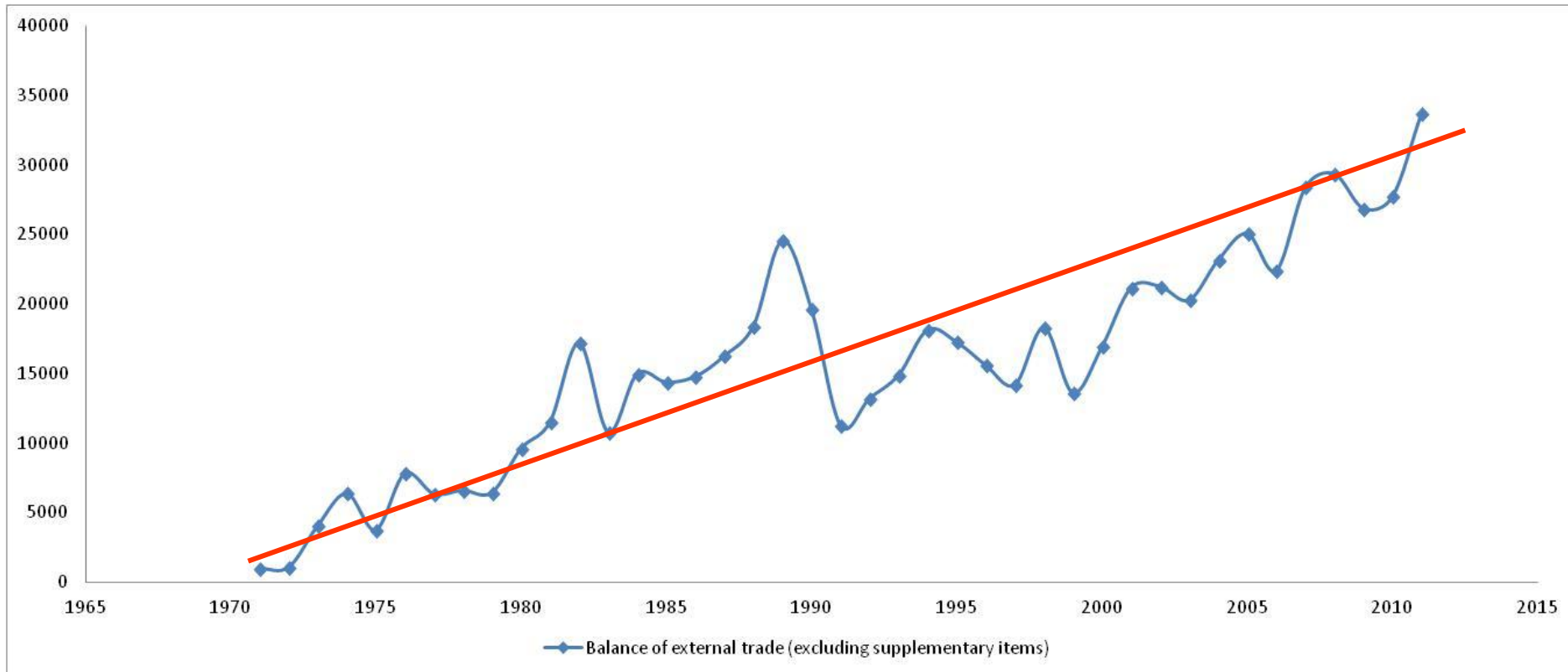


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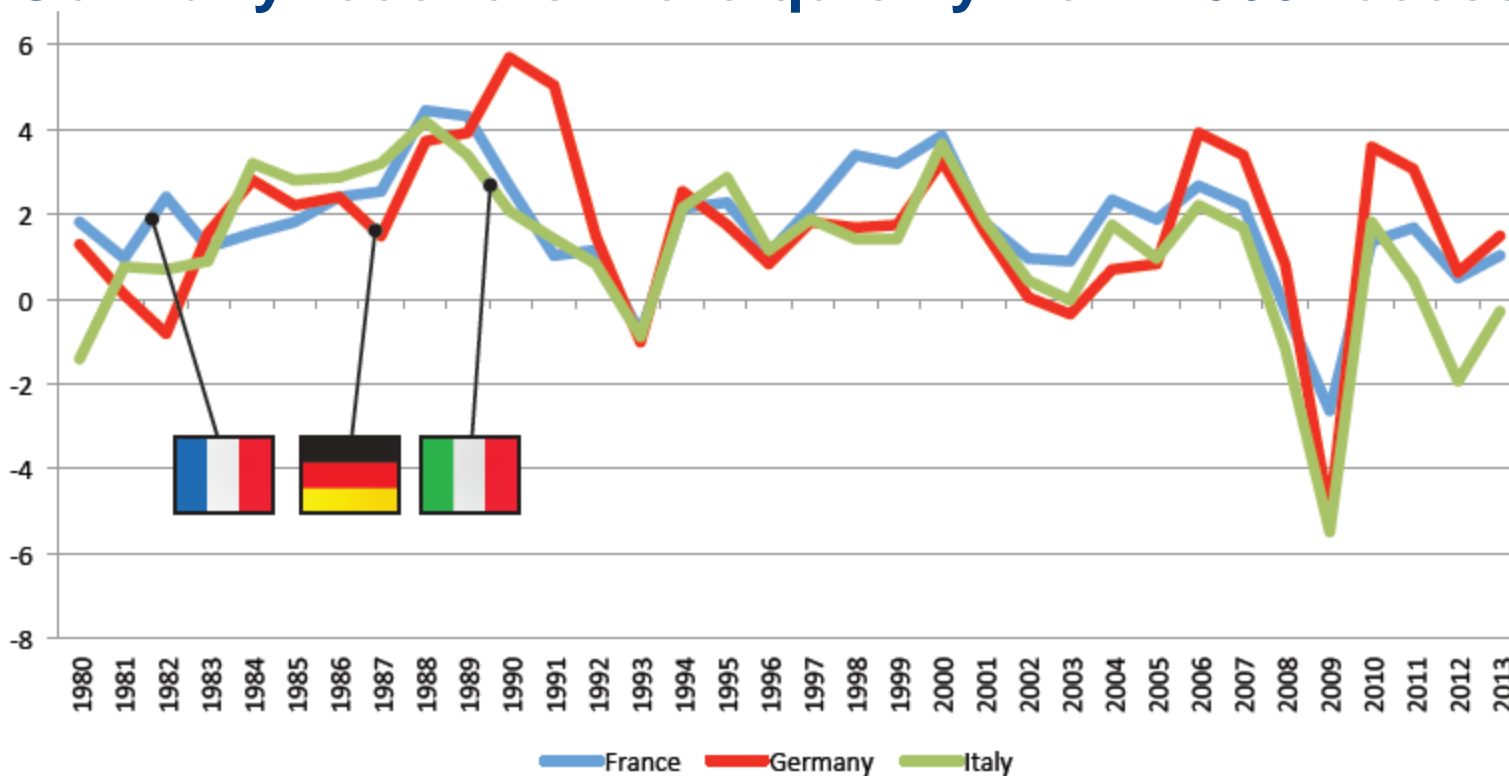
France and Germany move apart

Unstoppable rise of German trade surplus with France



German GDP growth forges ahead of rivals

Germany recovers more quickly from 2009 recession

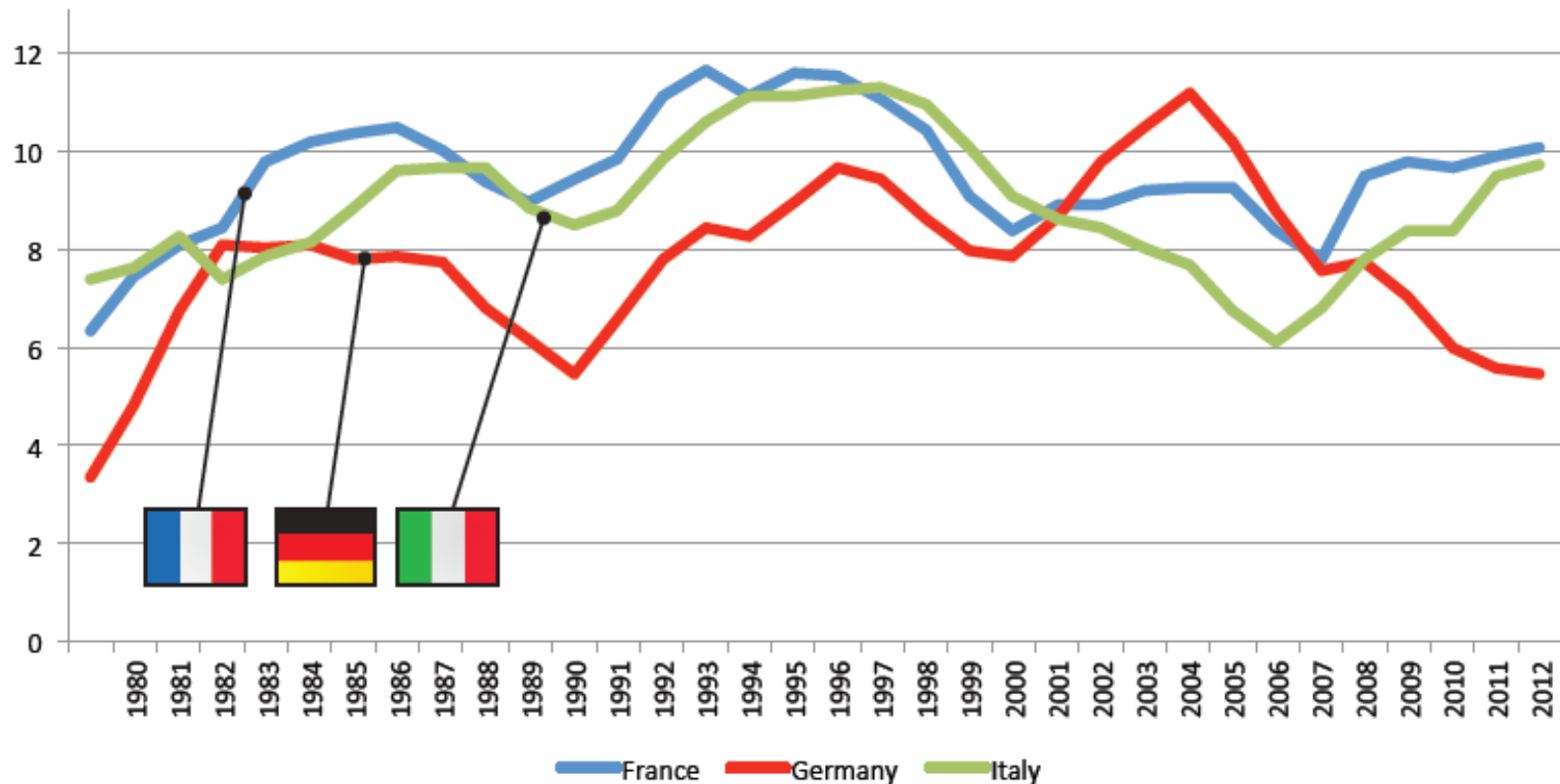


Source: IMF (2012-13 figures are projections)

Annual GDP growth 1980-2013 (%)

German unemployment outperforms the others

Labour reforms revitalise German jobs after 2004

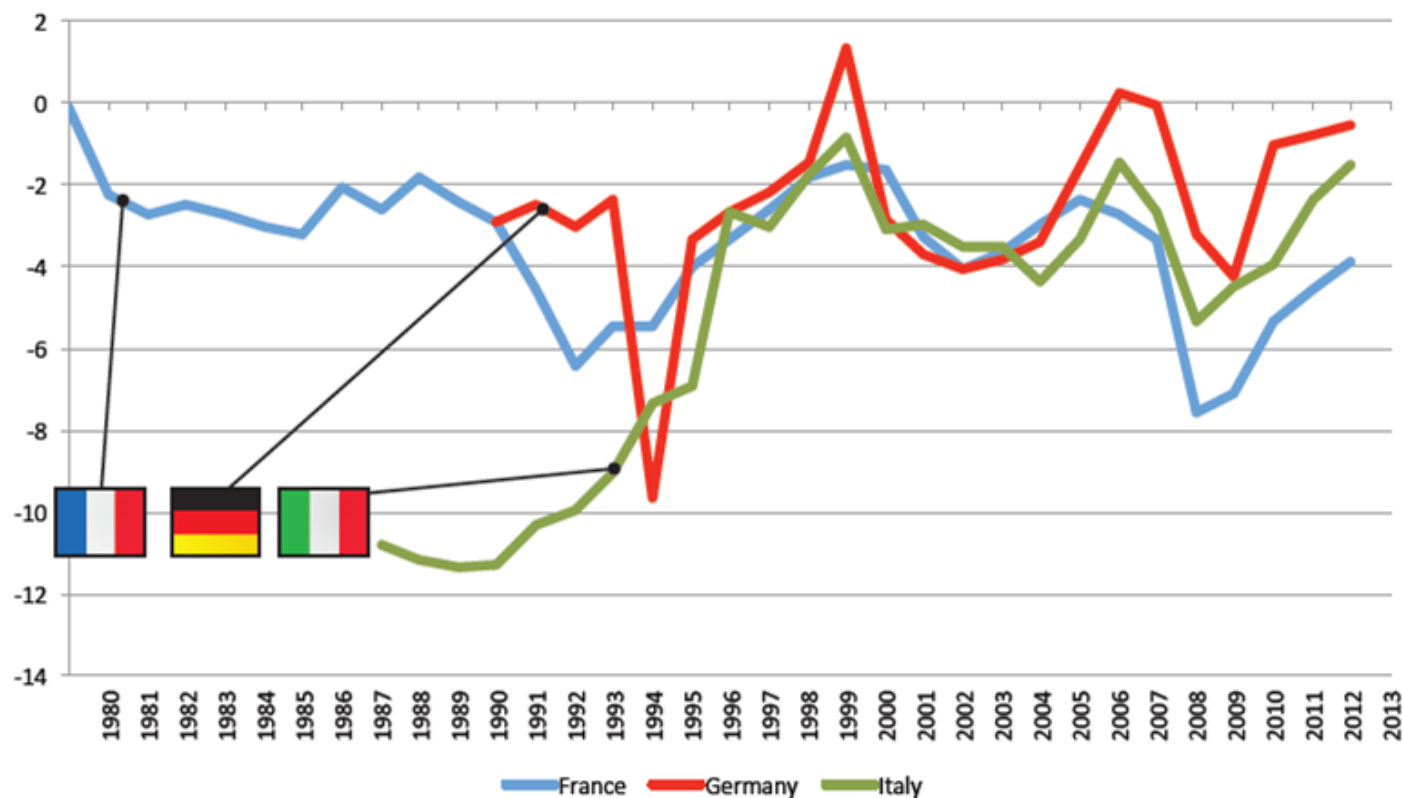


Annual unemployment 1980-2013 (% of labour force)

Source: IMF (2012-13 figures are projections)

Germany gets government deficits under control

German spending cuts early in cycle pay off

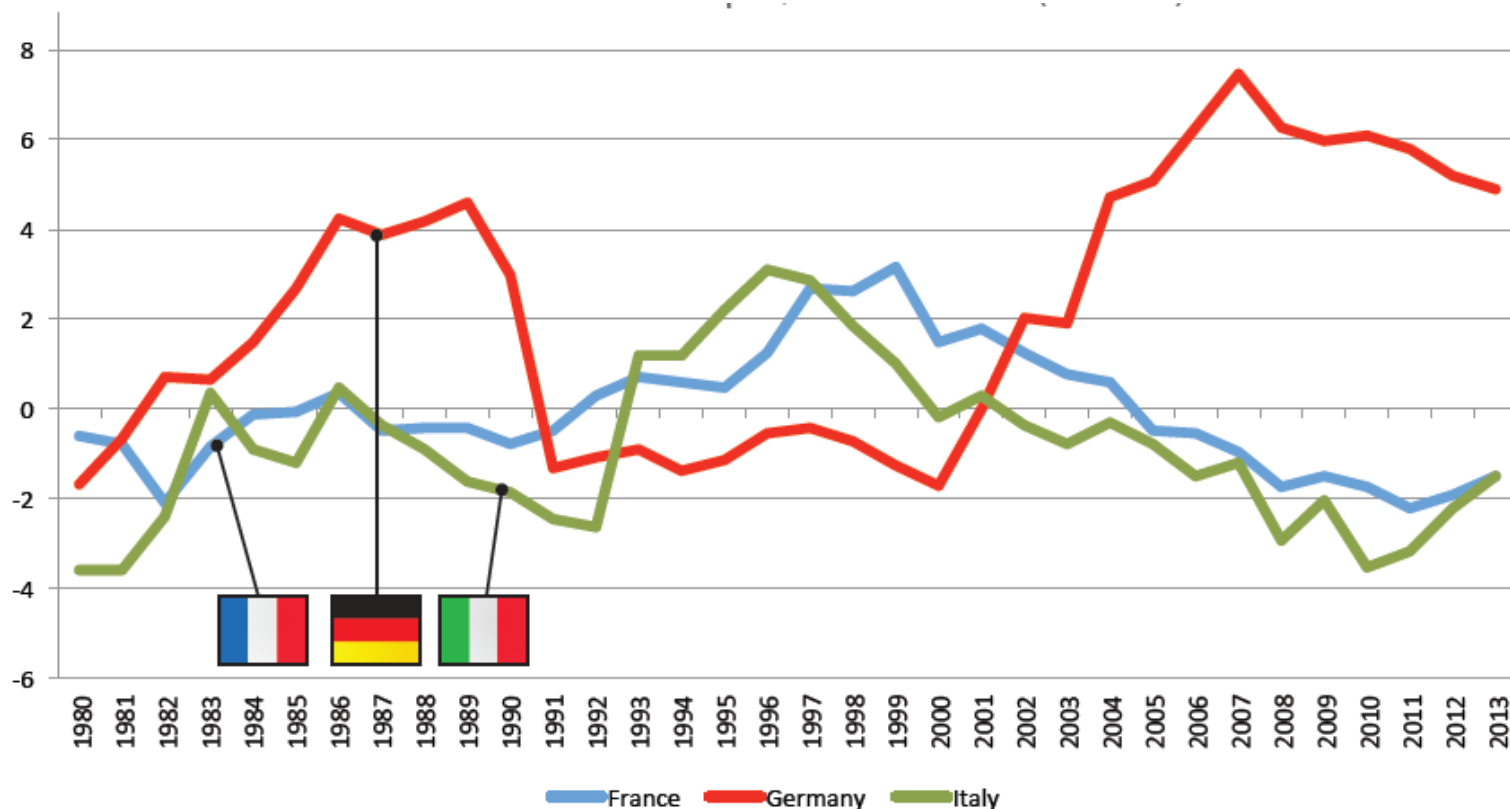


General government net borrowing (% of GDP)

*Data series for Germany and Italy starts from 1991 and 1988 respectively.
Source: IMF (2012-13 figures are projections)*

German current account surplus remains high

EMU enlarges German surplus



Source: IMF (2012-13 figures are projections)

Overall conclusions for Latin America & the world

- Starting monetary union without fiscal union is unwise
- Gradual trade/financial integration preferable to “grand scheme”
- Start with smaller group you can trust
- Work out lines of command and responsibility before crisis hits
- Get used to multi-polar world
- Learn from others’ mistakes
- Cooperate with neighbours
- but keep control of your own policies