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Is the Euro-zone on the Mend? Latin American examples to analyze the Euro question ☆

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ABSTRACT

Several European countries face challenges reminiscent of those faced by the emerging economies of Latin America. The economic booms in some peripheral Euro-zone countries financed by large capital inflows; the credit and asset price booms and then the busts including Sudden Stops in capital flows; the strong interaction between sovereign debt and domestic banking systems; the role of foreign banks and contagion; and all in the context of a fixed exchange rate, are familiar plotlines for Latin American audiences. For those Euro-zone countries that built up large Euro-denominated external liabilities, Latin America's experience is particularly relevant and worrisome. Still, Europe may be in a better position to navigate a path out of the crisis given cooperative mechanisms that were absent in Latin America, particularly the availability of massive liquidity support. Nonetheless, while such support buys time, it does not guarantee success. This paper argues that reflecting on Latin America's experience provides useful lessons for Europe to improve the chances for a successful resolution.

1. Introduction

Many peripheral Euro-zone countries are suffering from financial and competitiveness problems reminiscent of previous Latin American challenges. Drawing on these experiences, our aim is to provide a comparative analysis with a focus on Sudden Stops, competitiveness and growth issues, the relation between sovereigns and banks and the resolution of debt problems – all areas where unfortunately Latin America has considerable history (see Table 1 in the Appendix for a list and taxonomy of crises in Latin America).

We conclude that relevant and useful lessons can be drawn, although we are fully aware that there are also significant differences between the challenges on the two continents. While some Latin American countries adopted hard currency arrangements there is no close analogy to the common currency and its associated set of institutions. We argue below that while the currency union may complicate the recovery, those institutions provide a set of strategies and instruments to address the crisis that were not available to Latin American countries. A case in point is the powerful European Central Bank (ECB). The IMF, and in some cases bilateral lending, provided assistance during some Latin American financial crises, but the ECB (and Euro-system financing more generally) has played a wider and deeper role in financing Sudden Stops in private capital flows and maintaining lower interest rates

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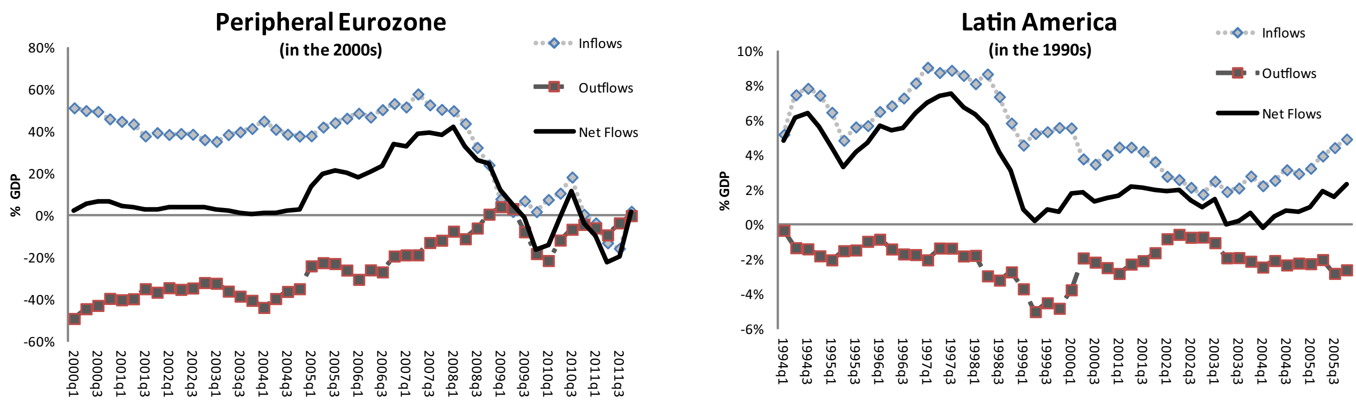

Fig. 1. A comparison of capital flow dynamics in selected Latin American (*Source*: International Monetatry Fund, IFS Database Countries: Argentina, Brazil, Chile ,Colombia ,Costa Rica , Mexico , & Peru) and Euro-zone countries (*Source*: International Monetary Fund, IFS Database Countries: Greece, Ireland, Italy, Portugal & Spain).

in the Euro-zone, which we argue has been critical to the survival of the common currency itself.

Our analysis suggests that while current crises in Europe are more complex and potentially more perilous than previous crises in Latin America, Europe also stands a better chance of successfully navigating the dangers due in large part to the availability of better tools to tackle the problems. Nevertheless, the path is uncharted, and success is by no means guaranteed. Our contribution is to highlight the areas in which the Latin American experience may be useful in shedding light on current European policy challenges.

Disentangling the underlying factors responsible for a crisis is a difficult task. The Argentine crisis of 2001/2002 provides perhaps the closest analogy to the current dilemmas facing some countries in Europe's periphery, in terms of overall complexity and certain features such as the Sudden Stops in capital flows, currency rigidity and the relation between banks and sovereigns. The crisis in Argentina has been the object of numerous and diverse retrospective analyses concerning its diagnosis and, a fortiori, applicable treatment.[1] In particular, whether the main cause of the collapse was fiscal unsustainability, a lack of competitiveness related to the rigidity of the currency board, or other factors remains contested. It has been suggested that there were multiple equilibria, and a particularly bad one emerged due to the interaction of the anticipation of a potential break of the currency board, low growth, concerns regarding fiscal sustainability and vacillation from the international official sector about continuing financial support.[2] Diagnosing the underlying factors of the European crises with precision while events are still unfolding is ill-advised. Furthermore, the political support needed in democratic societies may impose critical limitations on feasible policy responses, both in crisis and core countries. To ensure effectiveness of the policy responses, it may be prudent to control risks on all fronts, without disregarding any of them a priori, and bear in mind political economy limitations on policy decisions. It is in this agnostic spirit that we recommend the reader to consider the relevance of the Latin American experience analyzed below.

The paper is organized as follows. In the next section the experience and implications of Sudden Stops in capital flows are outlined. In particular, a model that is motivated by the Latin American experience, which illustrates the links between Sudden Stops, required adjustments and debt sustainability, is calibrated to a set of Euro-zone countries. This then leads to a discussion regarding underlying competitiveness and growth in Section 3. The link between banks and sovereigns is discussed in Sections 4 and 5 pulls the various strands together to consider the resolution of debt problems as may be required Section 6 concludes.

2. Facing the challenge of sudden stops

2.1. Calibrating a Latin American model to Europe

In common with several economies of the Euro-zone in the 2000s, Latin American countries in the 1990s ran current account deficits and built up large external liabilities. On the one hand such periods of strong capital inflows are to be welcomed as they fuel investment and higher growth. However, at the same time they may give rise to vulnerabilities and in particular to the risk of a Sudden Stop or a reversal in capital flows. Sudden Stops occur when foreign investors reduce holdings of domestic assets (collapse in gross capital inflows) and/or when local investors suddenly accumulate foreign assets (surge in gross capital outflows). Regardless of how they materialize, Sudden Stops affect the financing of the overall balance of payments. As a result, an affected country that was running a current account deficit has to abruptly close it. This is usually done through large real exchange rate depreciations.

In this section we review some of the dimensions of the vulnerability to Sudden Stops and compare the Latin American and the Euro-zone cases. We argue that, while there are clearly differences in institutions and available policy responses, the vulnerabilities in the Euro-zone in this regard are analogous to those in Latin America and hence the Latin American experience should be of considerable interest both in terms of the analysis, to gain an understanding of the true nature of the problem, and in terms of implications and hence potential remedies.

Fig. 1 plots capital inflows into Latin America in the 1990s and selected peripheral Euro-zone countries in the 2000s. There were considerable net capital inflows to Latin America in the 1990s, of around 6% of GDP, fueled by gross inflows of around 8% of GDP. The drop in 1995 is the Tequila crisis which hit Mexico and Argentina in particular and, as can be seen, net flows fell to below 4% of GDP that year; a forewarning of things to come. Gross inflows to the peripheral countries in Europe dwarfed those of LAC but net inflows were about the same order – around 5% of GDP – until about 2005. From 2005 and until the financial crisis, net inflows rose dramatically, particularly for the case of Ireland but also in other peripheral countries, and the average for this group reached over 30% of GDP. Several Latin American countries suffered a Sudden Stop in net flows in the late 1990s driven mostly by a fall

[1] For a review of the Argentine crisis, see Cline (2003).
[2] See Powell (2002).