

Latin American examples to analyse the European question. Comments

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- **Latin American crises provide a relevant reference for Europe**
 - Euro stressed determined by a massive sudden stop, leading to the fragmentation of the euro area markets
 - Difference: Monetary Union among advanced economies
 - *Scale of the financial integration*
 - *Concept of foreign exchange*
 - *Nature of adjustment*

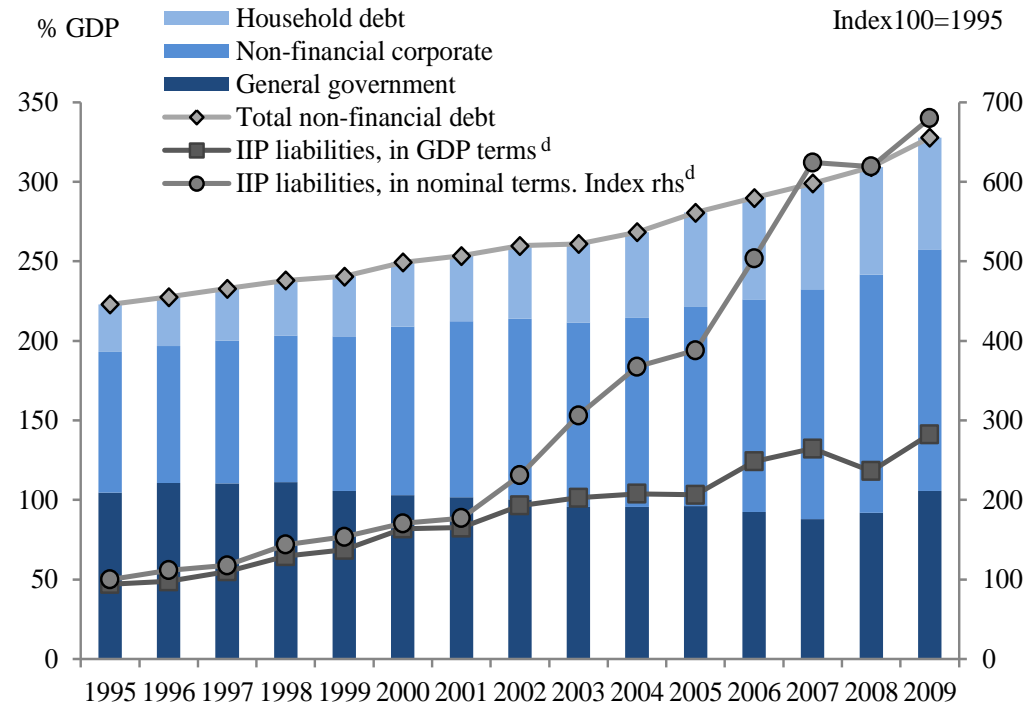
ON THE SCALE OF FINANCIAL INTEGRATION

- Financial integration and development in AE is much deeper
- EMU was a huge shock to financial integration within the euro area

Country	Gross External debt/GDP (2012)
France	239%
Germany	162%
Spain	170%
UK	249%
US	100%
Japan	45,5%
<i>Brazil</i>	<i>21%</i>
<i>Rusia</i>	<i>30%</i>
<i>Turkey</i>	<i>46%</i>
<i>Chile</i>	<i>44%</i>

IMF-WB External Debt Database

Internal debt and external liabilities in financially stressed euro area countries

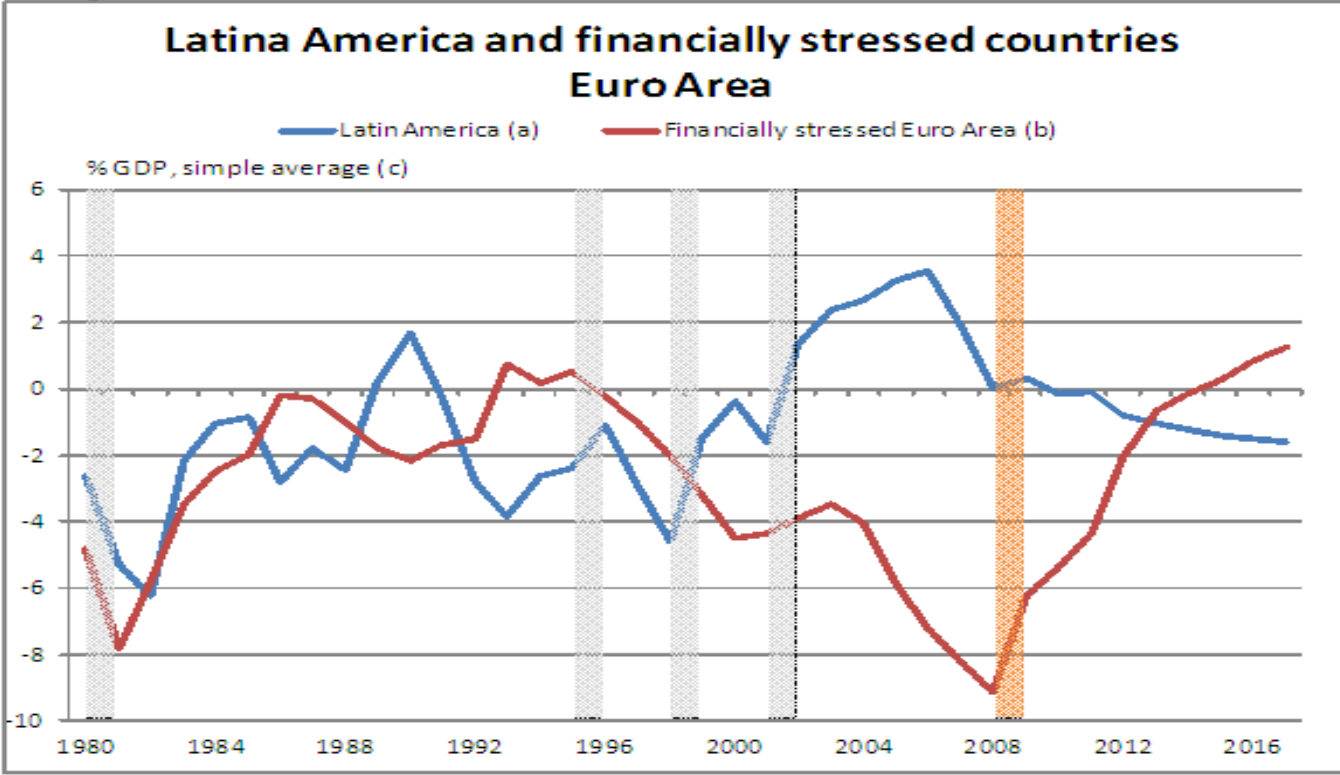


ON THE SCALE OF FINANCIAL INTEGRATION



- Larger integration and integration shock
- New economic regime
- Scope for much larger imbalances

Graph 3. Current Account



Source: IMF (WEO October 2012)
(a) Latin America: Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela
(b) Financially stressed Euro Area: Greece, Italy, Ireland, Portugal and Spain
(c) The grey bars shows crises in Latin America. The orange, global crisis of 2008

ON THE NATURE OF THE ADJUSTMENT



“It is clear that having euro debt is just like having debt in external currency” p.8

⇒ ...[countries] would suffer in a similar fashion to the economies in Latin America and a real depreciation would have a negative impact on debt sustainability

+ Sudden stop requires a depreciation which is magnified by the need to make up for worsening of debt sustainability

- **Really?**

- **YES**

- Sudden stops of capital require adjustment
- The value of euro is not determined by Spain’s particular circumstances
- The magnitude of nominal adjustment is higher **if** there is a devaluation
 - *Exchange rate or relative prices/costs?*

- **NO**

- Reasoning is contingent to exchange rate devaluation: NOT in a monetary union
 - *The paramount deterrent to euro breakup)*
 - *Dissipated even as a tail risk*

- **BUT**

- Makes the adjustment more painful in real terms
- Exacerbated by the size of the sudden stop and the reversal of financial integration

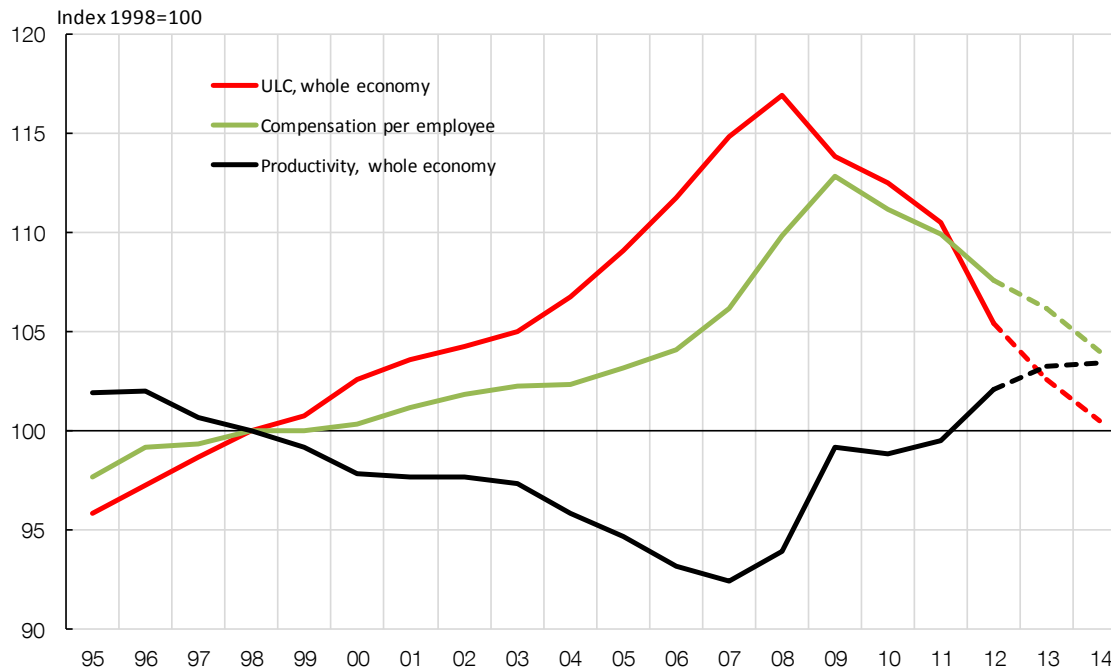
⇒ The exercise is useful, should be rephrased

ON THE NATURE OF ADJUSTMENT. THE CASE OF SPAIN



- Real adjustment and internal devaluation
 - Improvement in competitiveness through:
 - *Cost reduction*
 - *Productivity gains <<< employment destruction*
 - *Non-price competitiveness <<< limits*

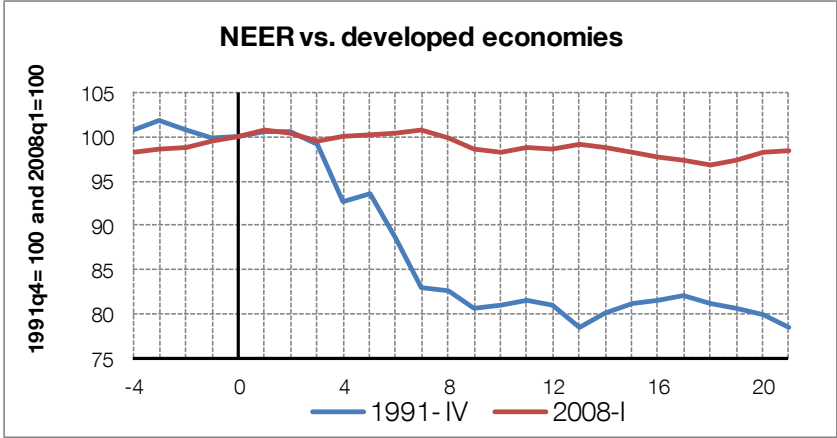
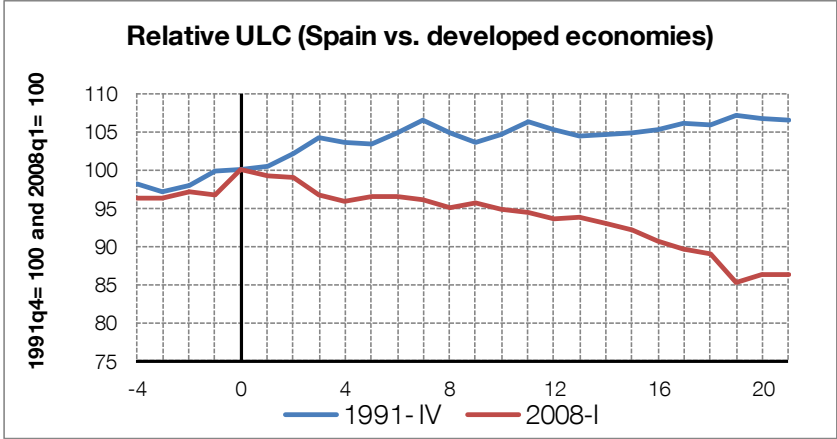
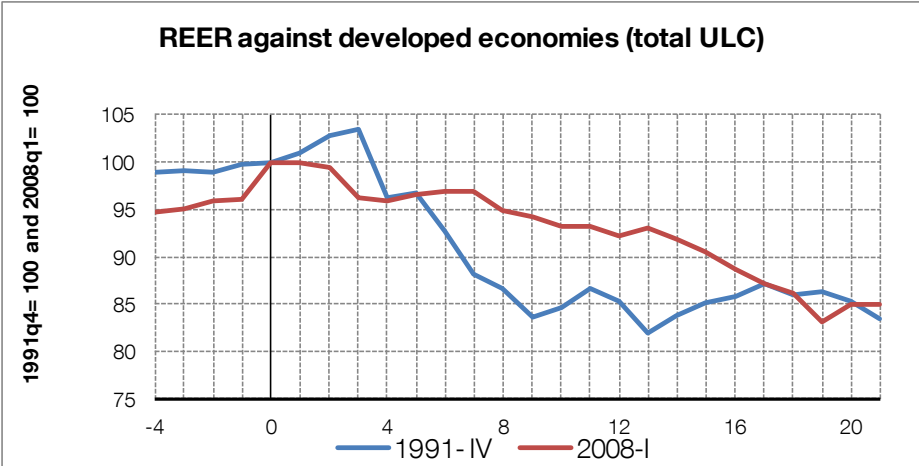
RELATIVE ULC: Spain versus Euro area



ON THE NATURE OF ADJUSTMENT. THE CASE OF SPAIN



- Real adjustment and internal devaluation
 - Cost reduction v. nominal depreciation
 - Non-inflationary = No debt deflation

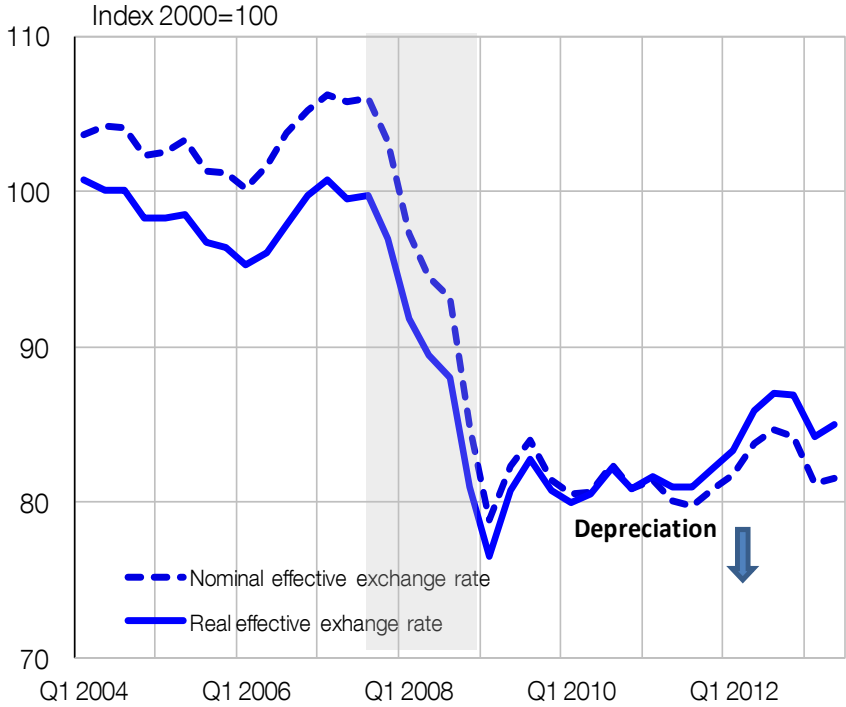


ON THE NATURE OF ADJUSTMENT. THE BRITISH CASE

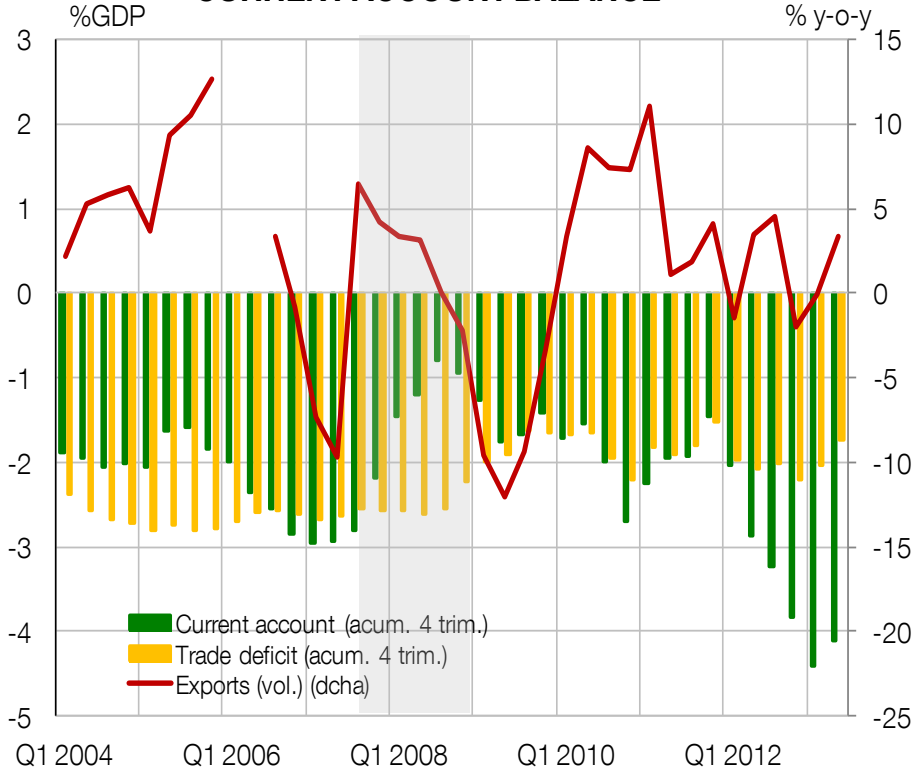


- Conventional adjustment through exchange rate devaluation
 - Disappointing impact on external accounts

EXPORTS AND EXCHANGE RATE



CURRENT ACCOUNT BALANCE



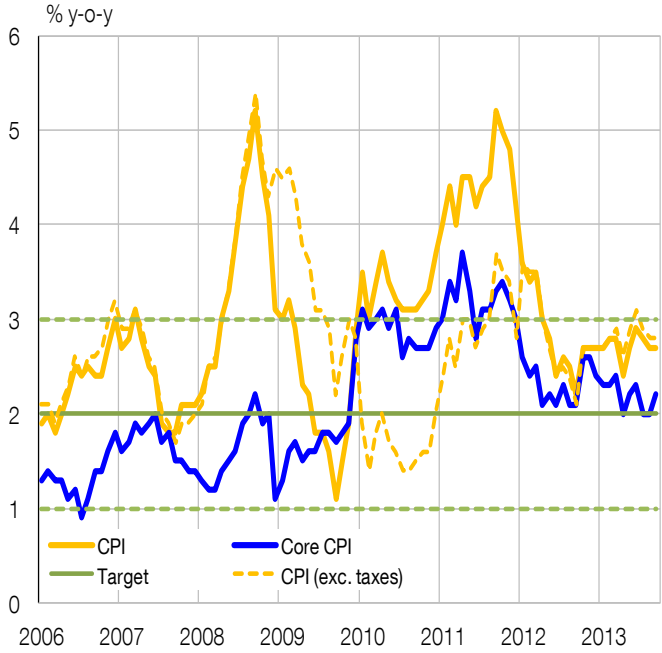
Fuentes: ONS, JP Morgan y Datastream.

ON THE NATURE OF ADJUSTMENT. THE BRITISH CASE

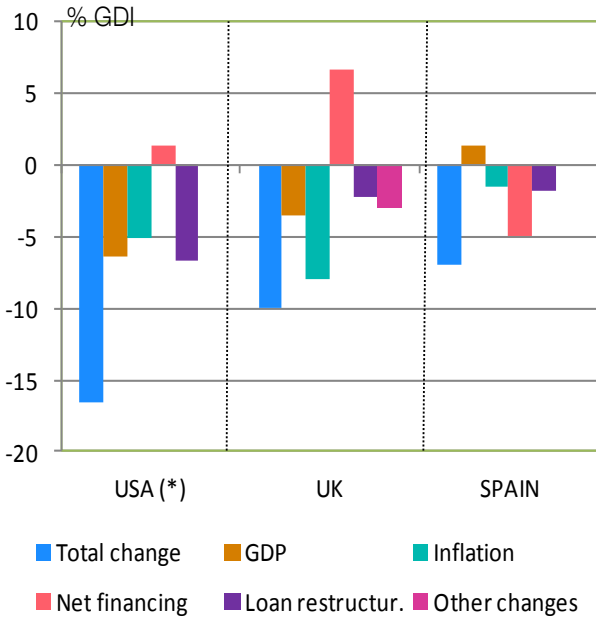


- The key to adjustment related to the active role of the Central Bank, rather than to the currency correction
 - Inflation eases adjustment: deleveraging, real adjustment,...
 - Downside (inflationary expectations, risk premia) mitigated by CB credibility
 - ...in spite of the link gilts- BoE

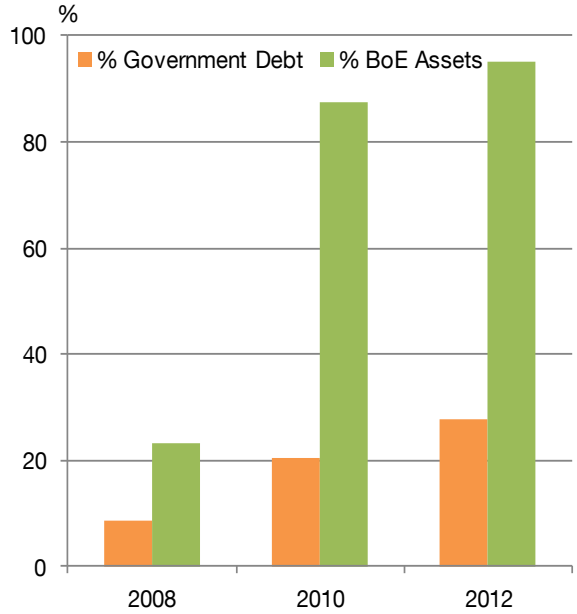
CONSUMER PRICES



HOUSEHOLDS DEBT RATIO
change: max- 2012.Q4



BANK OF ENGLAND GILTS

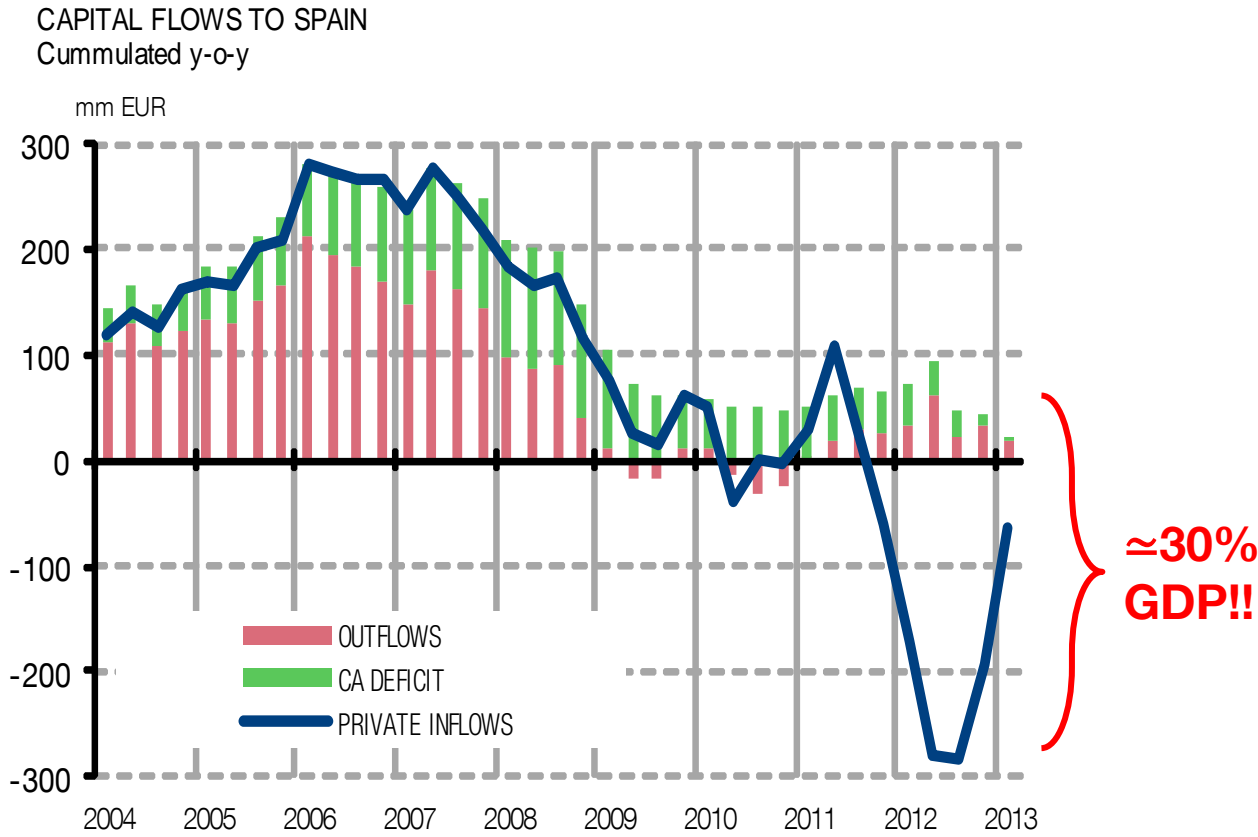


ON THE NATURE OF THE BOP ADJUSTMENT. THE CASE OF SPAIN AND THE ROLE OF THE ECB



⇒ Gross private inflows = CA deficit + Gross private outflows + Δ Reserves + ...

Sudden stop inflows = CA correction + Retrenchment outflows + ?



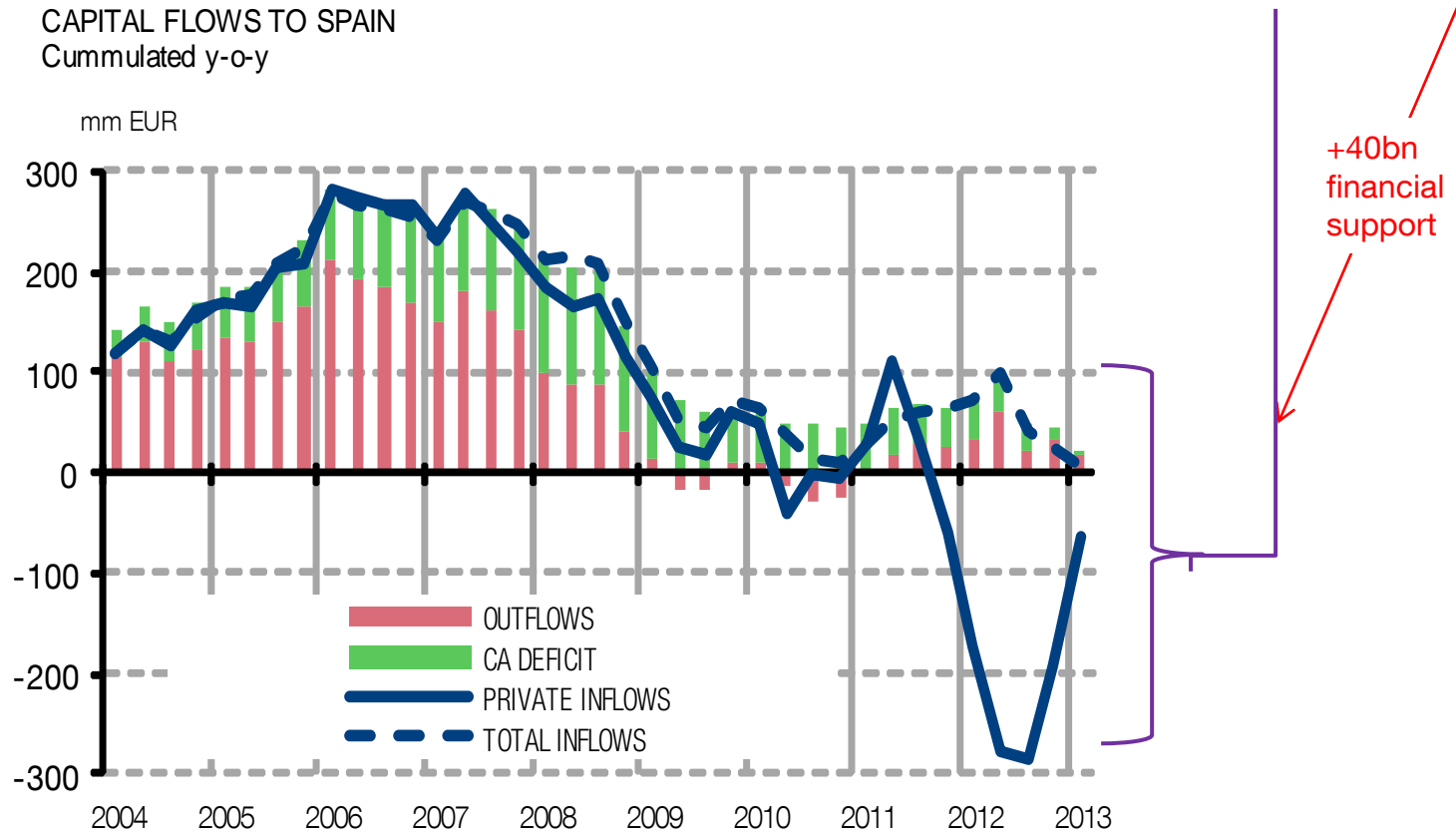
Source: Bank of Spain

ON THE NATURE OF THE BOP ADJUSTMENT. THE CASE OF SPAIN AND THE ROLE OF THE ECB



⇒ Gross private inflows + ECB liquidity = CA deficit + Gross private outflows + ΔR

Sudden stop inflows = CA reversal + Retrenchment outflows + ECB liquidity +



Source: Bank of Spain

CONCLUSIONS



- Useful reflection
 - Emphasises the consequences and adjustments required in sudden stops
 - Stresses the difficulties in reducing external debt
- Some points to reassess
 - What is external debt?
 - The relative importance of exchange rate and monetary+ policy independence
 1. *E-r is not always effective*
 2. *Having a CB devoted to overcome domestic financial stability problems more relevant*
- So, in certain dimensions the stressed economies in the euro area have it more difficult
 - Scale of the sudden stop
 - By definition, ECB focus on domestic conditions cannot be fully fulfilled