Economic Research Department

The EU and Latin America: Economic Ties

EU and Latin American Relations Seminar

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Main messages

- **Past:** along with sounder macroeconomic policies and better resilience against external shocks, **the region has strengthened its integration in the international economy**. On this regard, **Western Europe has been able to increase its economic exchange with Latin America**, even if we account for the irruption of **Asia** as a key trade and investment partner.
- **Present.** At the end of 2008 Latin America faced **three external shocks**:
  - a sharp reduction in exports due to the crisis abroad,
  - a correction in commodity prices and
  - a rapid spike in global risk aversion.

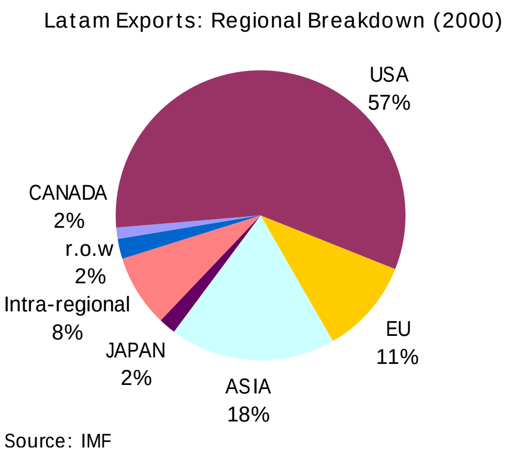
  But in a dramatic contrast to previous episodes of instability, **economic policy has become an effective mechanism to buffer the impact of the crisis**.
- **Future:** going forward, Latin America is well positioned to increase its **long-term GDP growth**, which in turn should foster the arrival of **foreign capital**. There are however several factors, largely related to the **institutional endowment**, that still act as deterrents for international trade and investment flows.

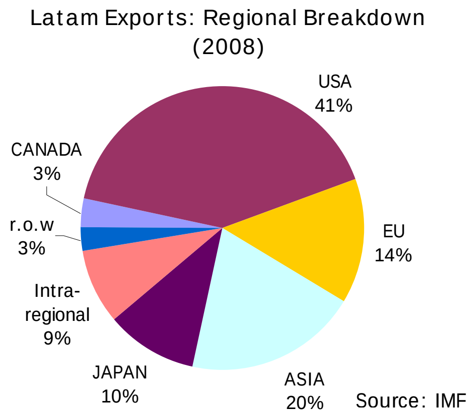
Structure

- Recent trends in Euro-Latin American economic ties.
- Latin America under the current financial crisis.
- The way ahead: towards greater potential growth, despite challenges

Trends in Euro-Latin Economic Ties.

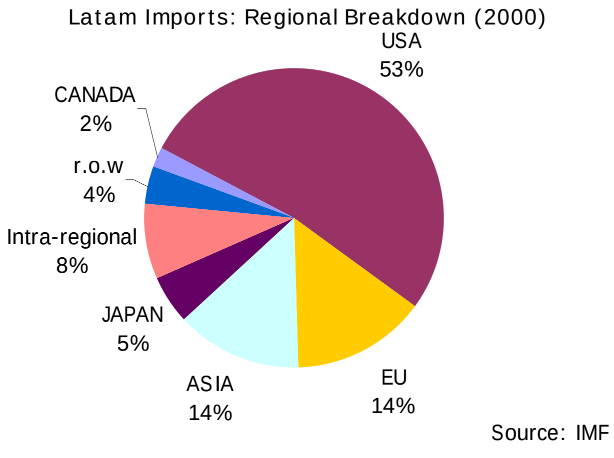
Despite the ever-increasing importance of Asia as a trade partner with Latin America, Europe has been able to increase its trade exchange with the region.

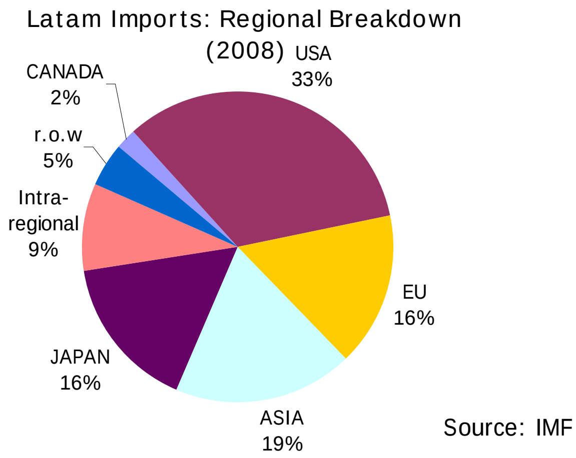




Exports from Latam to the EU have actually increased in relative terms, in sharp contrast to the decline of exports to the US.

On the other hand, the share of imports from Europe remains stable, despite the strong increase of Asia.

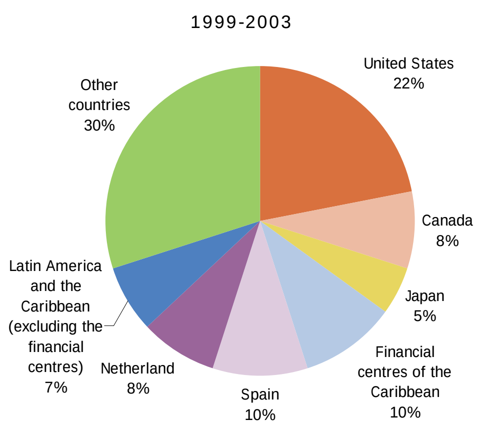


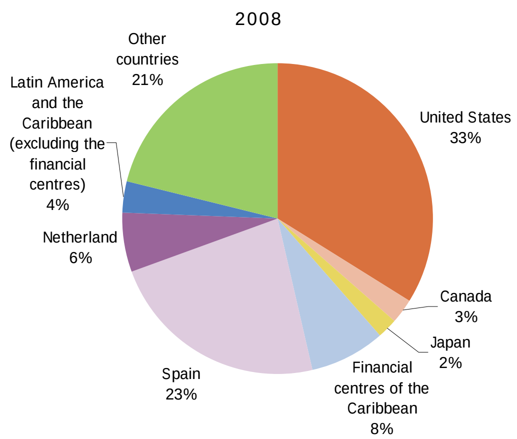


BBVA Trends in Euro-Latin Economic Ties.

Regarding FDI, recent years have strengthened the dominant position of Spain as the main European source for FDI flows to the region, getting closer to the traditional dominance of the US as the main provider of foreign capital.

Latin America: Origins of foreign direct investment



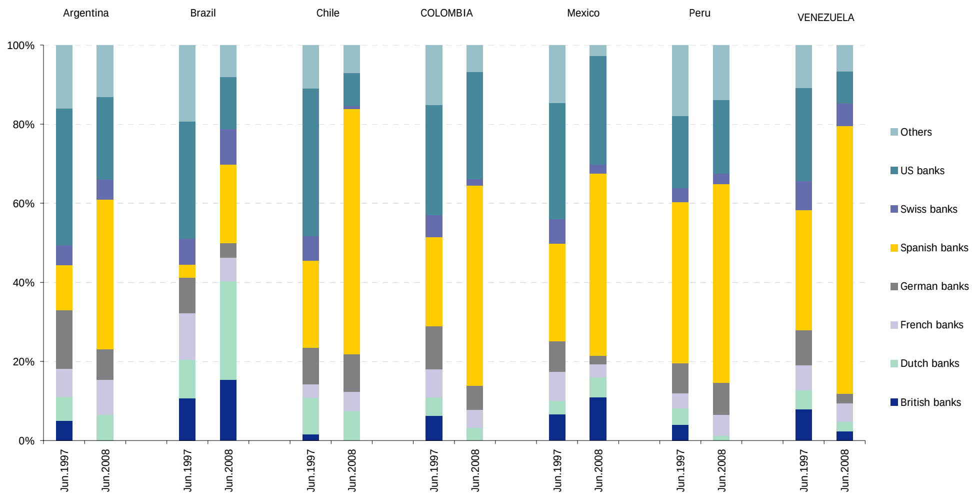


Source: Economic Commission for Latin America and the Caribbean (ECLAC)

BBVA Trends in Euro-Latin Economic Ties.

The presence of Spanish FDI is particularly relevant in the financial sector, in detriment of a declining share of US banks.

Total Banking Foreign Liabilities by Origin



Source: BIS

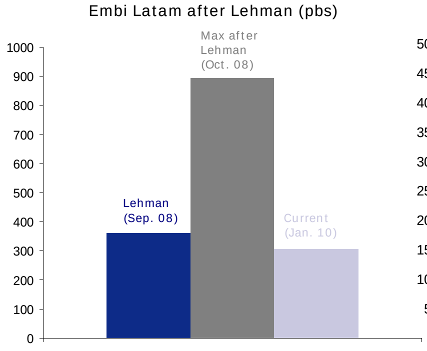
BBVA Structure

- Recent trends in Euro-Latin American economic ties.
- Latin America under the current financial crisis.
- The way ahead: towards greater potential growth, despite challenges

Latin America under the current financial crisis

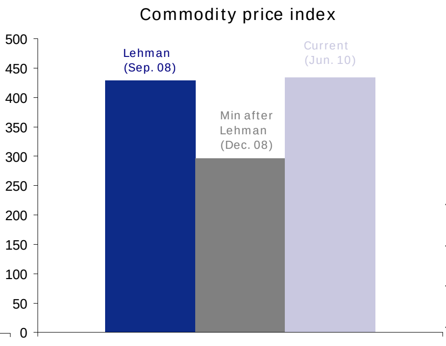
Latin America faced three large external shocks at the same time

1 A significant increase in risk aversion



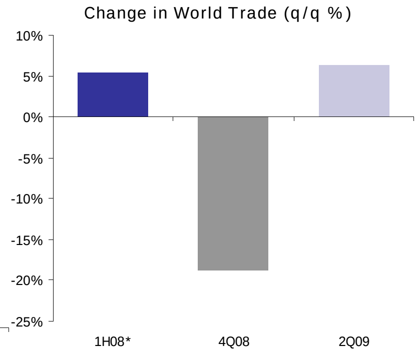
Source: Bloomberg

2 The collapse in commodity prices



Source: CRB

3 The collapse in world trade

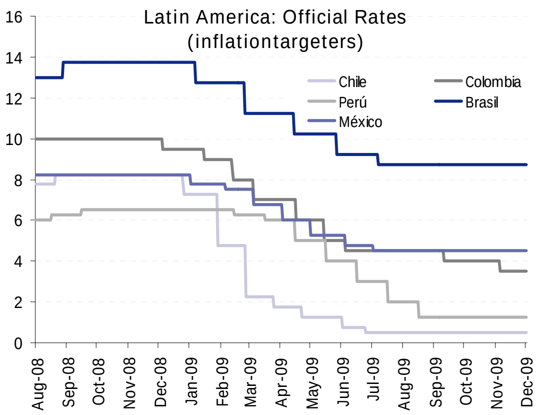


Source: WTO. * average of 2 quarters

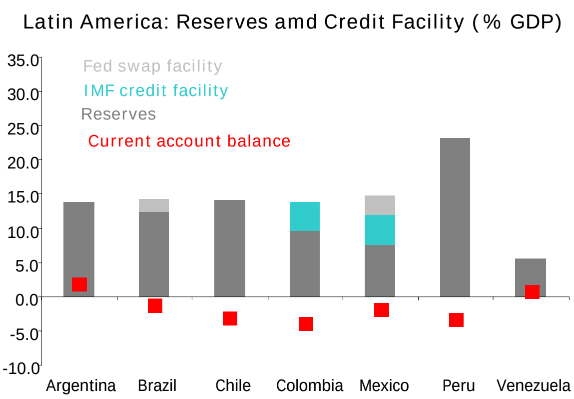
Strong negative impact over business and consumer confidence, and activity

Latin America under the current financial crisis

The impact of the crisis is proving to be much milder than in the past, largely due to the existing room for policy action, both regarding monetary and fiscal.



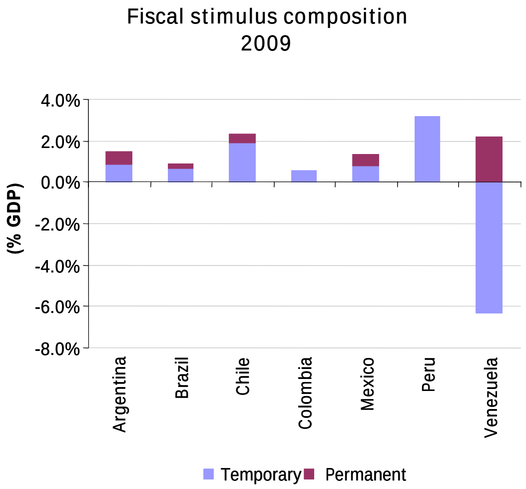
Fuente: Bloombertg



Central banks credibility is a new asset for monetary policy making in many Latam countries. It has certainly helped central banks pursue aggressive monetary policies.

Large international reserves and the additional buffer of multilateral organizations have also been key

In a similar fashion, fiscal policy has for the first time been used as a countercyclical tool. Chile and Peru implement the most notorious impulses.



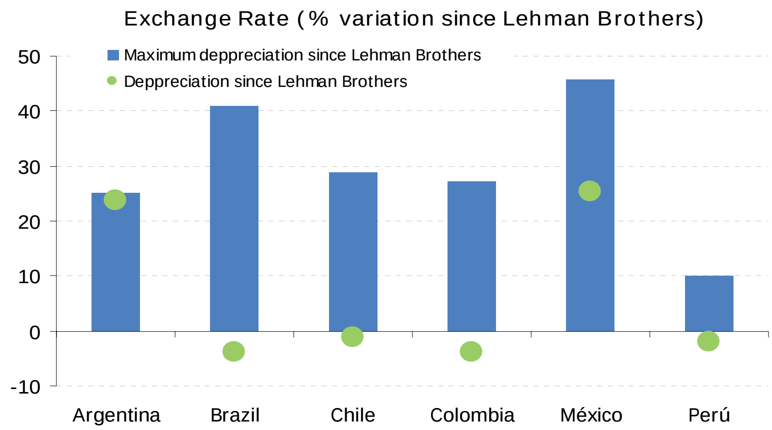
Composition of Fiscal Stimulus in 2009 (% GDP)

	Current Expenditure	Investments	Taxes	Total
Argentina	0.5%	0.8%	0.2%	1.5%
Brazil	0.2%	0.0%	0.7%	0.9%
Chile	1.0%	0.5%	0.8%	2.3%
Colombia	-0.5%	1.0%	0.1%	0.6%
Mexico	0.7%	0.5%	-0.1%	1.1%
Peru	1.3%	1.8%	0.0%	3.1%
Venezuela	-4.3%	0.2%	0.0%	-4.1%

Most stimuli have allowed temporary programs, focused on expenditure rather than income and with a strong focus on investment.

Most government's financial needs covered by domestic sources

Unlike previous financial crisis, the generalization of flexible exchange rates have allowed the exchange rate to cushion part of the impact of the crisis.

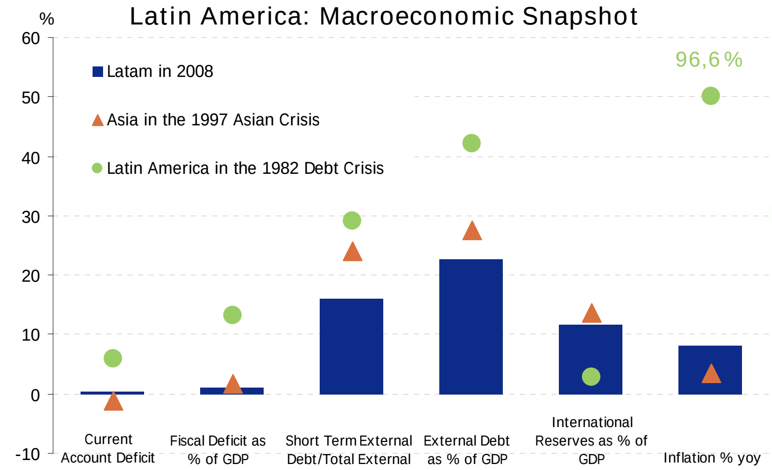


Source: Bloomberg and BBVA.

But they have been short-lived, with the exception of Argentina –and just this week, Venezuela-; countries that suffer from a higher inflation differential.

In the coming economic cycle, fundamentals will be crucial in determining the recovery of emerging economies

No "Lost Decade" for Latin America this time

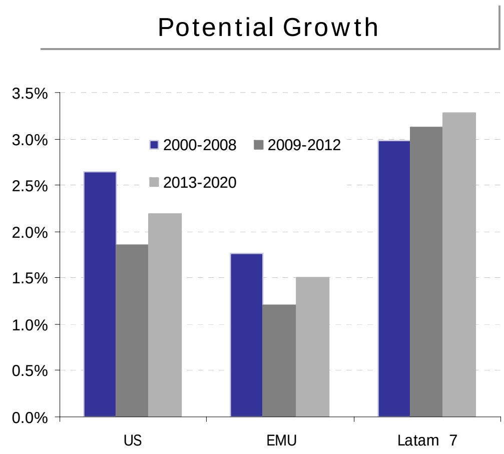


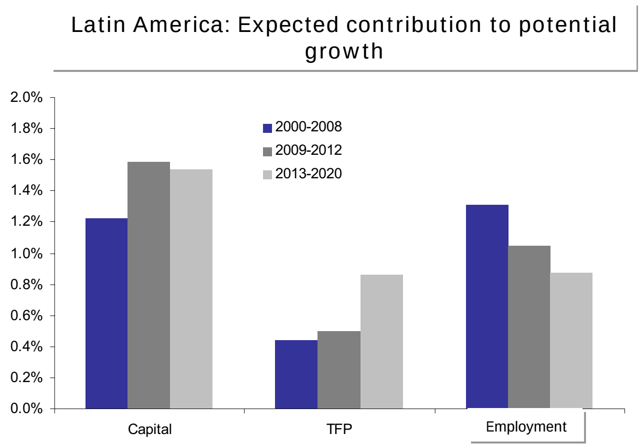
Sources: IIF, WEO, National Sources and BBVA. Note: positive values for CA and fiscal balances imply deficit

Compared to the large imbalances characteristic of Latin America at the onset of the Debt Crisis, or Emerging Asia during the 1997 crisis, this region shows a dramatic improvement

- Recent trends in Euro-Latin American economic ties.
- Latin America under the current financial crisis.
- The way ahead: towards greater potential growth, despite the challenges

Better macroeconomic environment justifies the expected increase in potential growth for Latin America. This should in turn foster the attractiveness of the region as a destination for international trade and investment flows.

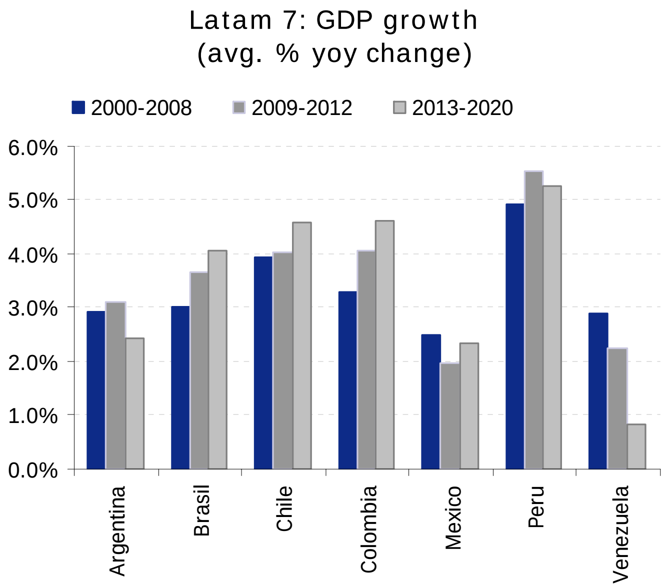




At a regional aggregate level, the future end of the "demographic dividend" derived from the fall in in birth rates will not be large enough to eliminate the expected positive contributions from capital and productivity. The convergence process should accelerate.

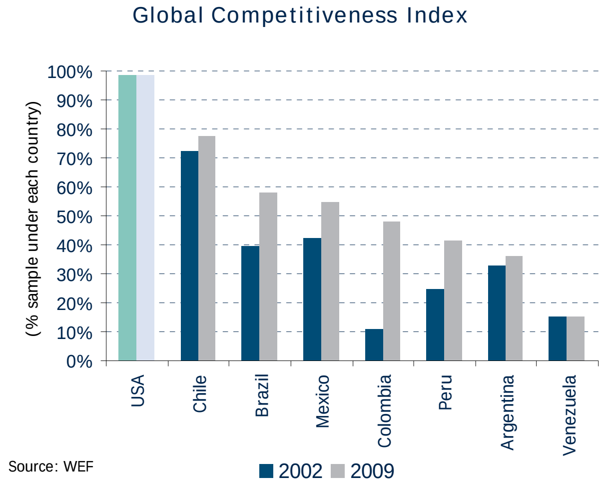
BBVA Going forward: Potential growth on the rise

The previous generalization is by no means extensible to all countries. At the country level, however, there are significant qualifications, as we expect greater differences in potential growth within the region.



- Countries with greater potential growth: Brazil, Colombia, Chile and Perú.
- Countries with stable growth: México (facing a stronger negative impact from the crisis).
- Countries moving towards lower potential growth: Argentina and Venezuela.

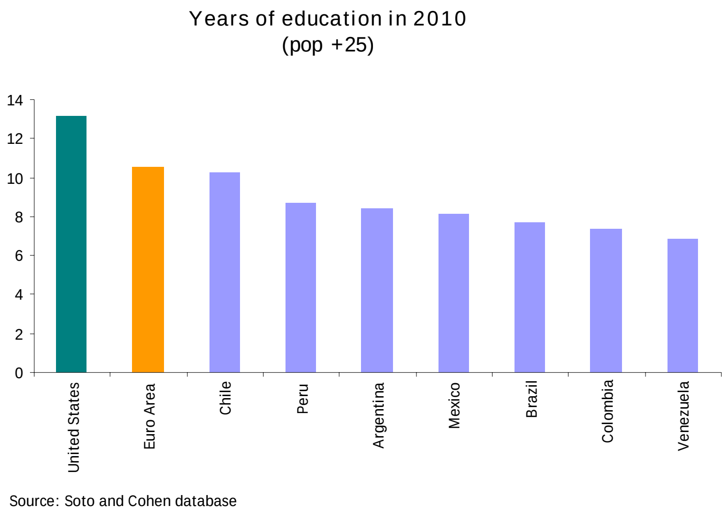
Overall, greater potential growth should be weighed against other challenges that could deter an intensification of economic ties of Latin America with Europe.



- For Latin America to become a robust recipient of investment flows from Europe, the creation of an institutional endowment that protects and stimulates private investment stands as a critical requirement.

- The region has made some progress during the current decade on this account, but some countries remain far behind the usual standard for European firms.

Human Capital improvement is another pending challenge.



- Latin American countries have a decent record regarding educational coverage but, for most of them, their human capital levels are still far away from advanced economies.
- Standardized international tests (e.g., OECD's PISA) shows that the best-performing Latin American countries (Chile, Uruguay) do as good as Turkey or Thailand, whose income per capita is far below the Latin American average.

- Despite the increasing relevance of **Asia** in trade flows and capital movements with **Latin America**, **Europe** has maintained or even increased its share in **exports, imports and foreign direct investment**.
- **Several challenges** ahead for the EU and Latin-America economic ties for the next decade:
  - **Europe has to improve its international competitiveness** in order to maintain its exports flows to Latin America, given the increasing competition of other emerging markets -> **a new Lisbon strategy**.
  - **Latin America has to face the increasing competition from other emerging markets** as a destination of foreign direct investment. Structural reforms, institutions that improve the economic environment and better human capital will be key factors.
- A **successful** achievement of these objectives will result not only in strong economic ties between the EU and Latin America but also in **higher welfare** for the citizens of our countries.

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