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Latinoamericano y del Caribe
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# The euro zone crisis and its impact on the European integration process and bi-regional relations between Latin America and the Caribbean and the European Union. Lines of action from the Latin American and Caribbean perspective

*XXXVIII Regular Meeting of the Latin American Council*
*Caracas, Venezuela*
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# The euro zone crisis and its impact on the European integration process and bi-regional relations between Latin America and the Caribbean and the European Union. Lines of action from the Latin American and Caribbean perspective

**Extra-Regional Relations**

*Permanent Secretariat*
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# C O N T E N T S

# *F O R E W O R D*

*This document, prepared by the Permanent Secretariat of SELA in line with Activity III.1.3 of its Work Programme for the year 2012, approved at the XXXVII Regular Meeting of the Latin American Council, is intended to analyze the current scenario of the European economy and its effects on the economic relations with Latin American and Caribbean countries, and also to propose some lines of action within this context, while taking into account the forthcoming bi-regional Summit, to be held in Santiago de Chile.*

*Following the introduction, the second chapter outlines the serious crisis undergone by the countries of the European Union, in particular those belonging to the euro zone. Such crisis has been labelled as a systematic crisis due to its global consequences. The measures adopted to solve the different economic problems in Europe are also examined.*

*The third chapter analyzes the economic and cooperation relations between the SELA Member States and the European Union, which have deteriorated since 2008, in consonance with the global economy, featuring highly unstable flows of foreign investment from Europe, asymmetries in by-regional trade, and limited participation of the EU in trade partnerships in comparison with other economies. This chapter also deals with the changes in remittance flows and cooperation from the EU, which suggests that the crisis continues in Europe.*

*In the fourth and final chapter, lines of action are proposed for the upcoming bi-regional Summit that will be held in the city of Santiago de Chile.*

*The Permanent Secretariat of SELA wishes to thank Doctors Christian Ghymers and Carlos Quenan for their work as consultants for the conduction of this study.*

## EXECUTIVE SUMMARY

Since the First Bi-regional Summit, held in Rio de Janeiro in 1999, to the latest high-level meeting, which took place in Madrid in May 2010, diplomatic endeavours at summits between LAC and the EU have become a key element in the political and economic strategies of the countries in both regions – regardless any judgment as to the relevance thereof. The summits have shaped up a bi-regional agenda which, in a non-linear manner, has paved the way towards a strategic partnership between both regions.

The Madrid Summit was held against the backdrop of the global threats and challenges posed by the global financial and economic crisis, and within the framework of the commemoration of the independence bicentennials of many Latin American countries. As for results, the Madrid Summit was rich in concrete resolutions; although many insufficiencies keep undermining the dynamics of the bi-regional relation.

Over the two years following the latest summit, the spread of the international crisis has led to an economic emergency and the worsening of the sovereign debt crisis in Europe. Indeed, the European economy – which seems to be globally balanced – features great divergences resulting from inner governance problems. Those divergences aggravate the impact of the world economic and financial crisis. The euro zone crisis poses a "prisoner's dilemma" in Europe, which hinders attempts to reach a consensus on communitarian solutions. Meanwhile, responsible authorities are under pressure to find cooperative solutions as soon as possible, as the consequences of the crisis continue and the risk of its continuation in Europe increases if major disagreements arise.

After more than a year of stalemate and distortions – from the emergency crisis in Greece during the first half of 2010 – the risks resulting from the serious economic downturn in Europe, with very negative global effects, increased dangerously since mid-2011. Following many summits and not quite effective resolutions, the measures adopted in September 2012 – despite ongoing resistance – especially the decision of the European Central Bank (ECB) of buying bonds from countries entering bailout plans through the ESM, have started another chapter of the crisis. Indeed, a provisional massive monetization of national bonds by the ECB, in return for complying with credible national programs implying fiscal reforms and structural changes favouring growth and budgetary sustainability (irreversible decisions leading to a progressive implementation in the medium term), constitutes the first step to avoid the intensification of the crisis.

However, there is still a long way ahead to consolidate the measures adopted in September 2012. Within the governance reforms, the creation of a European debt agency is essential. This agency would issue "blue bonds" (Eurobonds) guaranteed by the 27 countries of the EU, and priority bonds ("*seniority clause*"), with the purpose of establishing a separation from the issuances of government debt, called "red bonds," which would be "subsidiary," and whose prices would depend on the credibility of each National Treasury. This would imply the establishment of (positive or negative) market sanctions customized for each country. This system would allow for making each national Treasury responsible in return for solidarity measures in case of shocks or serious problems.

Although prospects of a triple crisis are less likely (meaning the risk that the intensification of the sovereign debt crisis might lead to a generalized banking crisis resulting – in the framework of growing mistrust – in a monetary crisis that would jeopardize the euro's future), the factors hampering growth in Europe remain. Besides widespread austerity policies that hinder an immediate substantial recovery of the economic activity, Europe must also face structural problems that hamper its growth in the long term.

The negative effects of the EU crisis spread to LAC. As Europe – in the best scenario – is expected to record limited levels of growth in the upcoming years, the economic and cooperation relations between Europe and LAC are adversely affected by the crisis. A significant reactivation of Official Development Assistance at global levels is unlikely in the current international context. In Europe's case, particularly in Spain, recession or poor growth in addition to budgetary restrictions will keep hitting cooperation flows. This outlook entails that LAC must be intended – more than ever – to optimize the remaining aid flows related to the objectives and instruments set forth in the 2014-2020 multi-annual programming in the area of cooperation.

Moreover, since 2008, European remittances inflows towards LAC have also recorded a considerable fall. Spain has great influence on this decrease, as most remittances from Europe to LAC come from that country. As remittances from Spain go through a new contraction period similar to the period of aggravation of the world crisis following the Lehman Brothers collapse, it seems that remittance levels received by LAC from Europe will not recover in the near future.

As for trade exchanges, there is no denying that the underlying trends that bi-regional trade have been featuring over the last two decades are and will continue to be adversely affected by the European crisis, particularly, the reduction of its relative weight – although it remained stable over the first decade of the 21st century. However, since the relative weight of the total trade exchanges of LAC with Europe ranges between 13% and 14% of the region's total trade, direct trade effects of the European crisis on Latin American and Caribbean economies are not quite relevant in general terms.

Conversely, European investment, recovered after the 2009 fall, should remain as a driving factor for the economic bi-regional relations. The most relevant driver of such dynamism is the European crisis itself. A substantial number of European transnational companies, especially Spanish companies, reinforce its presence in the region in order to settle the consolidated balance sheets of the parent companies and offset the negative effects of reduced growth levels registered in Europe. Many European medium-sized enterprises featuring great dynamism have established, or are seeking to establish branches in the region to make the most of its dynamism at global or sectoral levels. LAC should optimize the contribution of those inflows. Note the interest of LAC in fostering rapprochements and partnerships between European firms and Latin American multinational companies, increasingly present in Europe, and – as it will be further discussed in the fourth part of this paper – promoting investment for sustainable development, the central topic of the Santiago de Chile Summit.

Against the backdrop of the European crisis and its impact on bi-regional relations, on the one hand, and the results and commitments resulting from the Madrid Summit, on the other hand, the countries of LAC should prioritize the following five lines of action in the next bi-regional summit to be held in January 2013: implementing the Caracas Action Plan in the framework of the preparation for the Summit, with the purpose of reinforcing the organization of the Community of Latin American and Caribbean States (CELAC) and make the most of its cooperation method; conducting an integral assessment regarding the implementation of the Madrid Action Plan; starting a sectoral dialogue in the macro-financial ambit with a view to agreeing on the reforms of the international financial architecture; making progress in the identification of sectors and activities likely to attract investments for social inclusion and environmental preservation; and strengthening the bi-regional relation in the scientific and academic areas.

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## I. INTRODUCTION

Since 2005, the Permanent Secretariat of SELA has been analyzing and monitoring the status of the relations between Latin America and the Caribbean (LAC) and the European Union (EU) and has supported the Latin American and Caribbean governments in their preparatory process preceding the bi-regional Summits. As a result, a series of studies and reports showing the progress and obstacles characterizing the relationship between the two regions has been conducted.[1]

Since the First Bi-regional Summit, held in Rio de Janeiro in 1999, to the latest high-level meeting, which took place in Madrid in May 2010, diplomatic endeavours at summits between the EU and LAC – regardless any judgment as to the relevance thereof – have become in fact a key element in the political and economic strategies of the countries in both regions, especially in the issues of international cooperation and regional integration.[2] Thus, the summits have shaped up a bi-regional agenda which, in a non-linear manner, has paved the way towards a strategic partnership between the two regions. However, certain obstacles continue to hinder relations between the two regions as well as the organization of an efficient regional strategy by LAC, so as to express itself with one single voice when its interests so recommend it, thereby enhancing its achievements vis-à-vis the European bloc.

The Madrid Summit was held against the backdrop of the global threats and challenges posed by the global financial and economic crisis that reinforce the need for reflection and joint efforts to move ahead towards the reform of the international monetary and financial architecture. Discussions about the issue of migrations and continued protectionist temptations came in parallel to the goal to reinforce trade partnerships between the EU and different LAC countries and sub-regional groups and to put technology and innovation to the service of sustainable development and social inclusion. Similarly, this summit took place amidst the commemoration in 2010 of the independence bicentennials of many Latin American countries, which provided a fertile ground for the reinforcement of LAC-EU relations and for a rapprochement among peoples and participants of the Summits. As for results, the Madrid Summit was rich in concrete resolutions; although many insufficiencies keep undermining the dynamics of the bi-regional relation.[3]

Over the last two years, the spread of the international crisis has led to an economic emergency and the worsening of the sovereign debt crisis in Europe. Thus, against the backdrop of the ongoing European crisis, this document has the purpose of continuing to monitor the results of diplomatic endeavours launched at Summits, which are a vital link in the LAC-UE relationship, and at the same time, contributing to the discussion on lines of

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[1] Part of the papers prepared as well as the resolutions adopted at the various seminars and meetings conducted have been compiled into an electronic book published by the Permanent Secretariat, edited by Christian Ghymers, Carlos Quenan and Antonio Romero, entitled "Latin American and Caribbean – European Union Relations: Analysis and prospects", Caracas, May 2008. Subsequently, the following papers have been prepared: SELA, Evaluation of the results of the V Biregional Summit of Latin America and the Caribbean and the European Union: Prospects and opportunities within the context of the international crisis; Caracas, Venezuela, 26 February, SSP/RR-ERVCALC-UE/DT N° 2-09/Rev.1; SELA, Recent Economic Relations between Latin America and the Caribbean and the European Union ahead of the Madrid Summit, *Caracas, Venezuela, 25 February 2010 Caracas, SP/RR-ERVCALC-UE/DT N° 2-1; and* SELA, Relations between Latin America and the Caribbean and the European Union: Results from the Madrid Summit and impact of the economic crisis in Europe, Caracas, Venezuela, 22 March 2011*, Caracas,* SP/RR:VICBM-DRPEPREALC-UE/DT N° 2-11.

[2] Carlos M. Jarque, María Salvadora Ortiz, Carlos Quenan (Ed), *América Latina y la Diplomacia de Cumbres*, Ibero-American General Secretariat, Madrid, 2009.

[3] SELA, Recent Economic Relations between Latin America and the Caribbean and the European Union ahead of the Madrid Summit, Caracas, Venezuela, 25 February 2010, Caracas, SP/RR-ERVCALC-UE/DT N° 2-10.

actions to be adopted by the region in preparation of the forthcoming Summit in Santiago de Chile.

Within this framework, three main objectives are established. First, assessing the recent economic developments in the European Union, the factors that ignited the current crisis, the policies implemented to tackle this situation, and the possible impacts of these developments on LAC economies. Second, summarizing the major trends and recent developments in economic and cooperation relations between the EU and LAC. Third, this paper is aimed at identifying the main lines of action the LAC countries might implement to face the effects of the European economic crisis and make the most of the preparation of the forthcoming bi-regional summit that will take place in Santiago de Chile in January 2013.

## II. MACROECONOMIC SITUATION IN THE EUROPEAN UNION: THE CURRENT SCENARIO SUBJECT TO THE EVOLUTION OF THE EURO CRISIS

### 1. Brief description of the macroeconomic situation for 2012-2013

***The macroeconomic outlook for the EU seems gloomier than ever...***

Within the framework of exhaustion of the traditional instruments of economic policy, both fiscal and monetary, the crisis in the euro zone and the EU becomes increasingly challenging due to inappropriate economic governance.

The convergence of the governance crisis in the euro zone with a "double dip recession" in 2012 confirmed that the economic rebound registered throughout 2010 and early in 2011 was artificial and fragile, and that the underlying causes of the European crisis had not disappeared. On the contrary, since April 2012, it has been remarked that the measures adopted from the outset of the sovereign debt crisis (which ignited with the aggravation of the difficulties in Greece early in 2010) had been insufficient or inappropriate. Thus, the euro zone has not managed to avoid the vicious circles created by lack of macroeconomic and fiscal discipline during the first decade of the single currency, as mistrust in banks continues and the credibility of the budgetary adjustments and bailout programs is still into question. Worse still, the public opinion and the markets are increasing sceptical about the existence of an effective "pilot," raising doubts about the economic governance of the EU and its architecture.

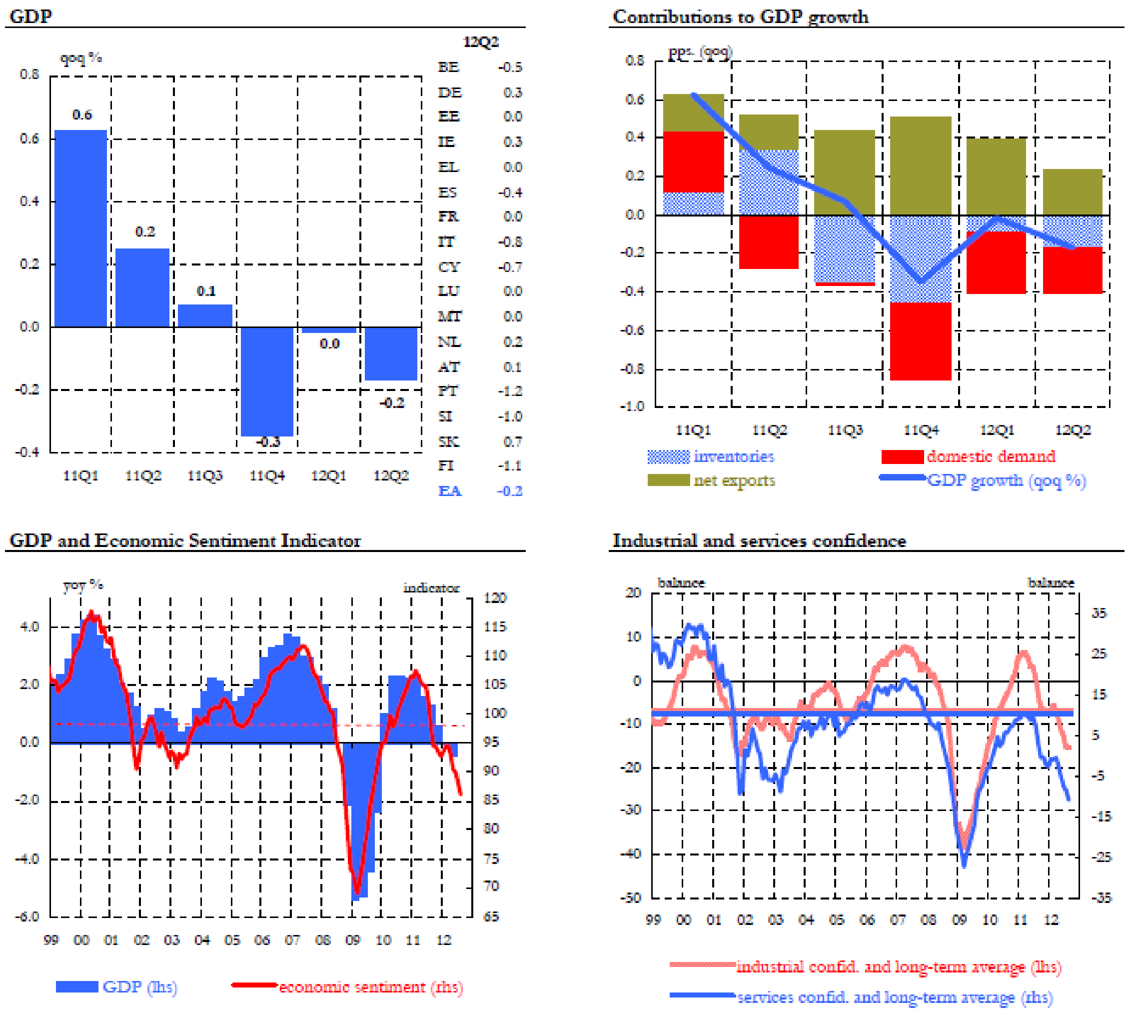
In particular, it is clear that the euro zone established the only currency in the world that does not count on a "lender of last resort," since its political feasibility implied the prohibition of rescue mechanisms to make the Member States "responsible" and avoid the risks of "moral hazard." Nevertheless, there is increasing evidence that the euro zone will not overcome this "balance-sheet recession" with "liquidity trap" without monetization of the public debt and without restoring a path for sustainable growth allowing the progressive reduction of both public and private over-indebtedness.

Following an upturn of about 2% annually in 2010 and the first half of 2011, the EU recorded a negative growth during the second half of 2011 and the first half of 2012. There is no doubt that 2012 will be a year of recession, despite overly optimistic projections announced by the European Commission early in May, and by the International Monetary Fund (IMF) in April barely forecasting stagnation in the EU for 2012 (a slight -0.3%

contraction in the euro zone), that would be followed by a small rebound in 2013 (1% in the euro zone).[4]

Such outdated optimism was grounded on the hypothesis that European economic activity would be sustained by the net external demand, and from 2013, by a slight recovery of European domestic demand. The recent developments in the European economies have discarded these projections (Chart 1, several charts).

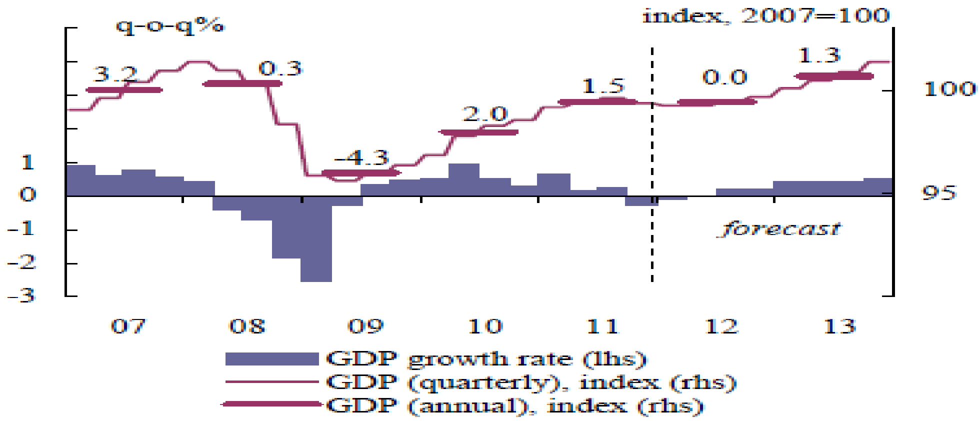
**CHART 1**
**Situation indicators for the Euro zone**




*Source: European Commission*

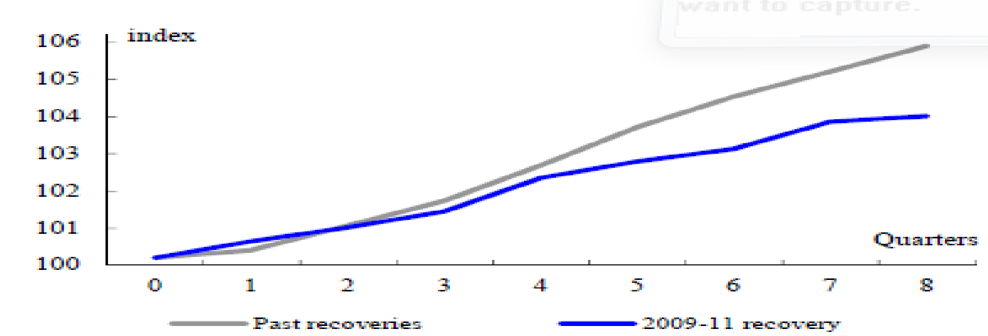
[4] European Economic Forecasts, Spring 2012, European Commission, May 2012, http://ec.europa.eu/economy_finance/publications/european_economy/2012/pdf/ee-2012-1_en.pdf

*Graph I.1:* **Real GDP, EU**



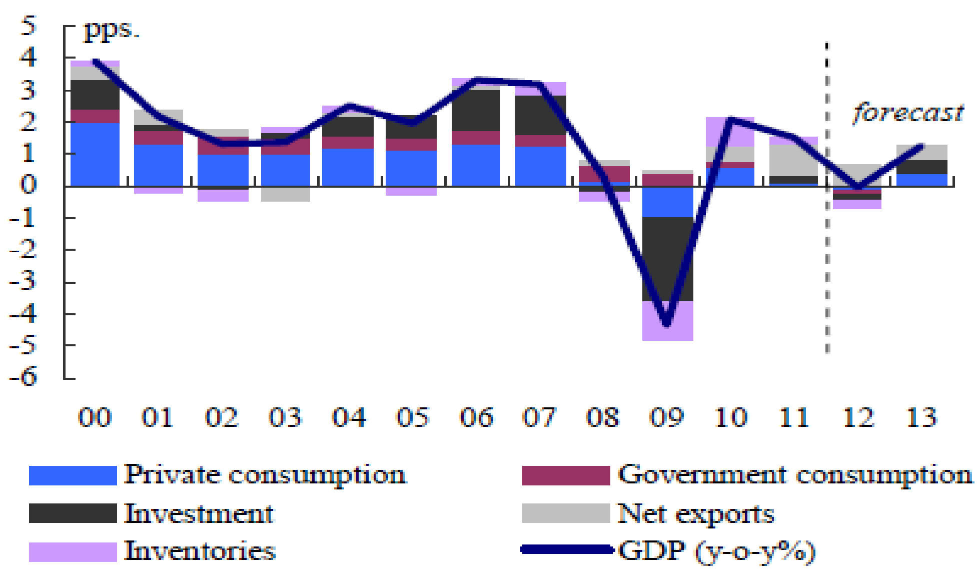

*Figures above horizontal bars are annual growth rates.*

*Graph I.3:* **Comparison of recoveries, the 2009-11 recovery against past average - GDP, euro area**




*Note: Real GDP following the recessions of the mid 1970s, early 1980s and early 1990s*

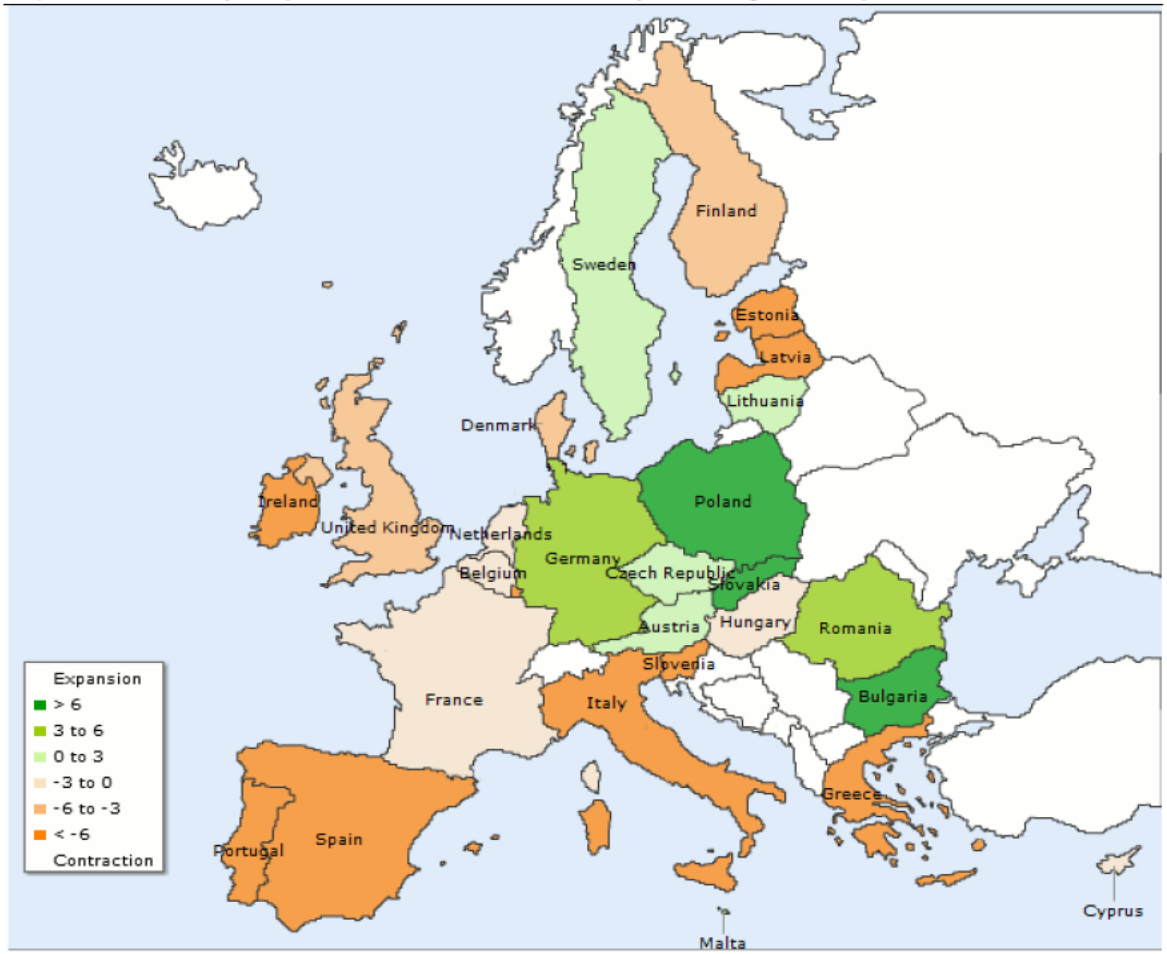
*Graph I.16:* **GDP growth and its components, EU**




*Source: European Commission, DG ECFIN.*

**Map of EU economies according to variation of per capita GDP since 2008**

Map I.1: Real GDP per capita in the EU Member States, 2008-12 (cumulated growth rates)




*Source: European Commission*

***... and reveals the systematic nature of the European crisis***

As usual after a serious financial crisis, growth shrinks for a longer period than following a regular recession. However, in order to understand the challenges in the matter of economic policy that both the responsible authorities and the European citizens must face, it is pertinent to discuss the causes of this crisis that arouse in the most integrated economic zone worldwide, and whose institutional environment had been hitherto considered an exemplary model. This matter is fundamental for the Latin American and Caribbean responsible authorities in order to learn lessons to make their own choices of economic policies and also to anticipate the upcoming European economic trends and its effects on the bi-regional relation.

A previous report by SELA foresaw that without a radical chance, the relapse of the euro zone into a greater systematic crisis would be inevitable. "*Thus, the inherent contradiction in a monetary union without prior consolidation of budget and competitiveness aims – ceteris paribus, i.e. with no radical advance in community governance – to the euro zone entering an even greater systemic crisis. This crisis is the result of domestic policy mistakes* *combined with a lack of independence of the European Commission and Council of Ministers, which are 'judges and parties'*".[5]

Before presenting an assessment of the recent developments in the European scenario, it is worth to remember in summary that the European crisis takes places within the framework of a wider global crisis.

## 2. The systemic global crisis: A phenomenon striking both the European Union and Latin America and the Caribbean

The systemic European crisis is an aggravating factor of the world crisis, whose causes are also systemic. More than two years ago, in a report by SELA focused on the relations between Europe and LAC, the following thesis statement was discussed: *"The present world financial and economic crisis is one of the expressions of the systemic defects and inconsistencies of the world economy, based on an asymmetric monetary system which lacks an objective monetary anchor."* [6]

Hence, these two types of causes should be taken into consideration: exogenous factors outside Europe and LAC that multiply the global macroeconomic imbalances through the ill-functioning of the International Monetary System (the role of the dollar as main international monetary standard, also known as the "Triffin dilemma");[7] and also endogenous causes within Europe, i.e. economic governance mistakes in the EU and especially in the euro zone (the macroeconomic mistakes leading to the bubbles and inner imbalances of the euro zone).

Let us briefly highlight the analysis offered in previous papers,[8] which underscore that the system based on the use of the U.S. dollar as the main international monetary standard leads to global monetary "waves" and external imbalances that foster the creation of a "credit-boom" with speculative bubbles. The mechanism is simple and it was explained on a recurring basis by Belgian economist Robert Triffin since 1974 until his death in 1993: In fixed parities systems as well as in floating exchange rate systems, the U.S. dollar, being the main international payment instrument, creates asymmetries or external effects from the monetary policy of the United States towards the other economies. Those asymmetries have maintained the demand for reserves in this currency, and for U.S. Treasury Bonds, which leads to a *lack of control on the creation of liquidity worldwide*. This situation perpetuates the dilemma and the "exorbitant privilege" granted to the U.S. economy. This privilege consists in having an unparalleled macroeconomic autonomy; i.e. it doesn't face true foreign restrictions, since it can become indebted at a lower cost, and with no exchange risks, by issuing its own currency or paying with its Treasury Bonds, which facilitates foreign financing of fiscal and balance of payment imbalances, discouraging both public and private savings. Thus, global macroeconomic imbalances tend to perpetuate, creating the risk of global inflation due to a lack of an effective nominal anchor. The Triffin Dilemma characterizes, although with different modalities, both the extinct fixed exchange rate system of Bretton Woods, as well as the present floating

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[5] SELA, Relations between Latin America and the Caribbean and the European Union: Results from the Madrid Summit and impact of the economic crisis in Europe, Caracas, Venezuela, 22 March 2011, SP/RR:VICBM-DRPEPREALC-UE/DT N° 2-11, op. cit.

[6] SELA, Recent Economic Relations between Latin America and the Caribbean and the European Union ahead of the Madrid Summit, *Caracas, Venezuela, 25 February 2010, Caracas, SP/RR-ERVCALC-UE/DT N° 2-10, op. cit.*

[7] See Boxes 1 and 2 in the 2010 report by SELA, "Economic Relations between Latin America and the Caribbean and the European Union and the VI Bi-regional Summit of Madrid" Caracas, 25 and 26 February, 2010.SP/RR-REALCUE-VICBM/DT N° 2-10.

[8] Directly based on the Triffin Dilemma (1947, 1959, 1991) and summarized in Ghymers, Christian, "Résister à l'emprise du dollar". Chapter 1, in Aglietta, Michel & others, *L'Ecu et la vieille dame*, Ed. Economica, Paris, 1986. See also SELA, 2010, op. cit.

system, as a national currency is given a key international role. Both systems are based on the demand for reserves by the Central Banks of the world, from public assets of the U.S., which leads to an excessive indebtedness of this economy, which some day will destroy the trust in the dollar, which precisely lies on its condition as international currency. In any event, in such a system, the creation of international liquidity cannot be optimal and leads to excesses in the indebtedness policies, especially in the most developed countries. Nowadays, out of those countries, many have incurred over-indebtedness and resort to "over-issuance" of liquidity in order to avoid a global depression.

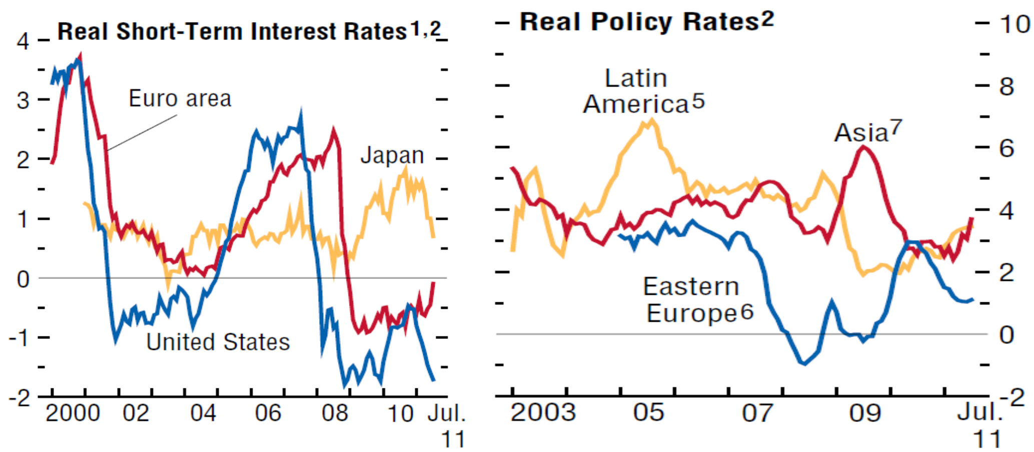
In the last three decades, a succession of at least five international crises with increasing amplitude – and with exchange rate instabilities that induced wide fluctuations in real exchanges – have shaken the world economy, causing exponential social-economic damage:

1. The debt crisis of developing countries in 1979-82
2. The financial crisis that affected particularly the stock exchange bubble in Japan in 1987
3. The Asian crisis of 1997
4. The "dot-com" bubble of 2000
5. The 2007-08 global bubble and the great recession of 2009

Although each of these crises have had its own characteristics, and can generally be explained separately, all share the negative effects of the same asymmetry and lack of objective anchoring that comes from the dollar standard on which the world economy relies, in the monetary scale.

Certainly, this asymmetry also allowed for the acceleration of growth in emerging economies, and has recently avoided (temporarily?) the fall into a deeper depression – which prevented the same mistakes made in the economic crisis of the 1930s. However, the issue concerning the external effects caused by the dollar and the optimum regulation of the issuance of global liquidity remains unsolved and potentially threatens the international monetary stability (Chart 2).

**CHART 2:**
**The Triffin Dilemma explains the global monetary "wave"**

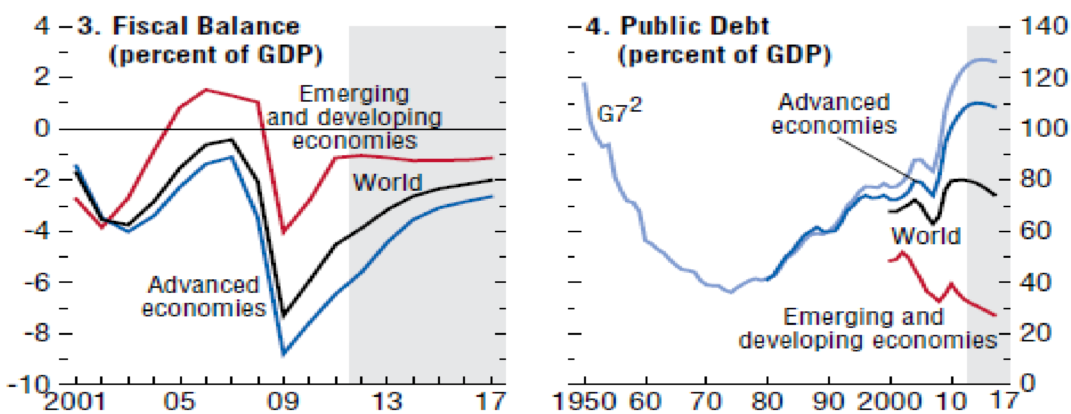



Source: IMF World Economic Outlook, April 2012

The recent global bubble that emerged in the 2000s demonstrates that the principle of the monetary "wave" spread worldwide, with negative or widely contracted real interest rates in dollars (see Chart 2). Not even the euro and its European Central Bank, which is immune against political interferences, could prevent it. This risk clearly shows *the lack of a nominal anchor worldwide*: if the U.S. FED issues too many dollars, the drop in its exchange rate with respect to the euro and the Latin American currencies becomes excessive, which means a restriction in the monetary policy of the European Central Bank (ECB) or the central banks of LAC with respect to its internal inflation goals (in terms of real goods and services), forcing the ECB and other central banks to partially follow the FED in its monetary laxity, which reinforces foreign surpluses in emerging countries and their demand for reserves, thus worsening the global monetary "wave".

The consequences of the Triffin Dilemma also hit fiscal policies, as clearly shown in Chart 3: the arrangement of the deficits and public debts of the most developed countries is diametrically opposed to that of the emerging or less developed countries. Note that, paradoxically, the developed countries did not comply with the Washington Consensus, whereas the emerging countries were partially forced to comply with it due to the financial globalization, conquering a certain freedom at the macroeconomic and financial levels by means of such globalization.

**CHART 3:**
**The Triffin Dilemma explains the paradox of public over-indebtedness in the most develop economies, while the least develop economies record debt reduction**




Sources: Bloomberg Financial Markets; and IMF staff estimates.

Taking into account the destabilizing mechanism linked to the external effects resulting from the use of the U.S. dollar as the main international monetary standard, an analysis of the European crisis and the euro system can be carried out.

### 3. The systemic crisis of the euro zone

At first glance, the EU and the euro zone do not seem to be factors in the emergence of global macroeconomic imbalances. Indeed, from an overall perspective, there are no significant imbalances between savings and investment in Europe: the balance of the current account is moving into a position that is close to equilibrium. In the euro zone, however, since the late 1990s, the external balance was covering up, under the common currency, an explosive polarisation between the core economies of the area (Germany, Austria, Finland, the Netherlands), which accumulate current account surpluses, and the less advanced periphery countries (Spain, Greece, Ireland, Portugal), which run growing external deficits.

This process was the result of the acceleration of European integration (real convergence) and has been facilitated by the single currency as it eliminated external financing constraints nationally, and by providing abundant external capital and cheap credit. As explained in detail in the analytic charts presented in the aforementioned 2011 SELA report,[9] this process allows for a better distribution of regional capital, moving it from the core, where performance was lower, to the periphery where it performed better, thus creating an attractive "win-win game", due to the higher growth backed by productivity progress through additional investments made in this periphery. Therefore, it was logical not to worry in the immediate term for external imbalances which accelerated convergence and integration of the area by generating more investment in the lagging periphery. This idea of "decoupling" national savings and investments was the purpose of the single currency, to achieve the goal of the EU Treaty, which is to ensure a higher real convergence by increasing living standards in the periphery without decreasing it in the core countries ("catching-up process").

The problem is that easy and automatic success in the early years (how not to support massive capital inflows in the periphery, when they come at low interest rates for the first time in these economies?) gave too much confidence to policymakers, who became too complacent. The overall complacency combined with the overwhelming doctrinal paradigm of market efficiency, quieted the voices of cautious technicians, and the rules emerging from the treaties establishing the euro zone were followed, i.e., countries needed to adhere to a much stricter macroeconomic discipline.

Two similar arguments should have prompted a closer monitoring from policymakers and economists:

1. By channelling capital inflows into the periphery, *real exchange rates* would inevitably increase in these economies in the euro zone; but between economies that share the same currency, this inevitable evolution meant that important cost and price differentials would automatically lead to necessary adjustments in real rates, rather than changes in nominal exchange rates (as was the case in the euro zone periphery, composed of East European countries).

2. Therefore, differences in inflation would mean greater divergence in real interest rates in the euro zone, thus creating a perverse mechanism that undeservedly gives *a pro-cyclical character to the single currency policy* in the periphery, which has a destabilising effect in a monetary union. In fact, under these conditions of divergence of inflation, setting a single nominal interest rate implies imposing mechanisms of accumulation of imbalances. Divergent real rates encourage spending, reduce savings and favour a "credit-boom" and bubbles in the periphery, while having the opposite effect in the economies of the zone core. In these economies, higher real interest rates lead to more savings, lower inflation, and more competitiveness. This consolidates a mechanism that accelerates divergence which generates growing macroeconomic imbalances within the monetary union. In addition, excess spending and credit, and the resulting bubbles in the periphery, allow for raising unsustainable tax revenue, thus creating the illusion of moderate deficits or even budget surpluses when in fact there were structural deficits.

[9] See Boxes No. 1 and No. 2 of the SELA report, op. cit (SP/RR:VICBM-DRPEPREALC-UE/DT N° 2-11).

To prevent this risk, a complete monitoring of external positions and relative competitiveness of each economy was planned before the creation of the euro, in addition to budgetary and public debt surveillance. Unfortunately, the hypothesis of a spontaneous convergence relaxed defences, and attention was focused only on fiscal discipline. But also, monitoring of fiscal discipline was not fully performed because of "europtimism" and the impotence of the European Commission against the Council of Ministers and the pressure of public opinion which favoured spending and cheap borrowing.

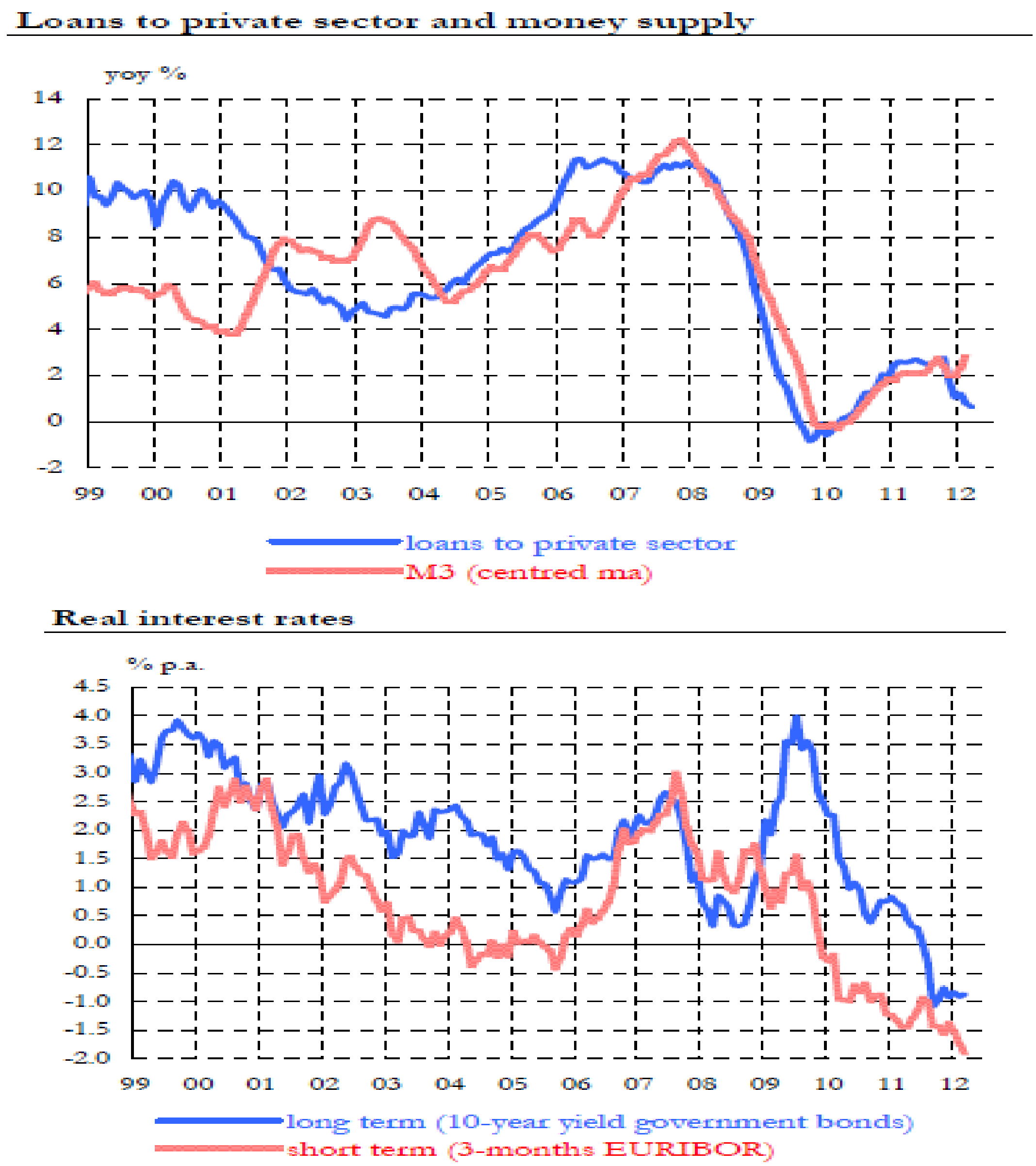
In short, the *problem was not just a lack of fiscal discipline* but a lack of widespread macroeconomic discipline. This fostered and maintained a fatal loss of competitiveness of the euro zone periphery compared to the core and the rest of the world. The crisis became visible when the transfer of funds from the core to the periphery was blocked with the Greek bond crisis: as capital inflows that financed overspending slowed down, fiscal unsustainability became apparent. The inability of the authorities to recognise the problem and agree on an appropriate response triggered a contagion that spread a liquidity crisis in sovereign bond markets, and hence, to the banks and the credit market in euros. Through the "snowball" effect (when real interests exceed real GDP growth) illiquidity crises quickly became crises of sustainability and solvency.

The following charts (Chart 4) clearly show the process of *endogenous imbalances created by the single currency* when there is no counterbalancing independent monitoring:

1. The combination of a global monetary expansion created by the asymmetry of the dollar (see chapter II.2 above) together with the expansion of interest rate without risk premium to the entire area, especially to countries which for decades were used to high levels of nominal interest rates, generated an excess supply of loans: "easy money" for most Member States. In the periphery of the area, the euro meant an unprecedented process of access to loans at low interest rates and generally negative rates in real terms (after deducting inflation). This encouraged excessive private and public borrowing and delayed plans of structural budget adjustment.

Chart 4 shows the cause of the formation of bubbles based on the money supply which translated into private loans, while the left part shows the constant drop in low real interest rates until 2006, when the results of the bubbles became noticeable. Faced with this situation, the European Central Bank, wrongly accused of rigorousness due to the valuation of the euro against the dollar, reacted too late, as did the other central banks of industrialised countries.

**Chart 4**
**Loans to the private sector, money supply, real interest rates**

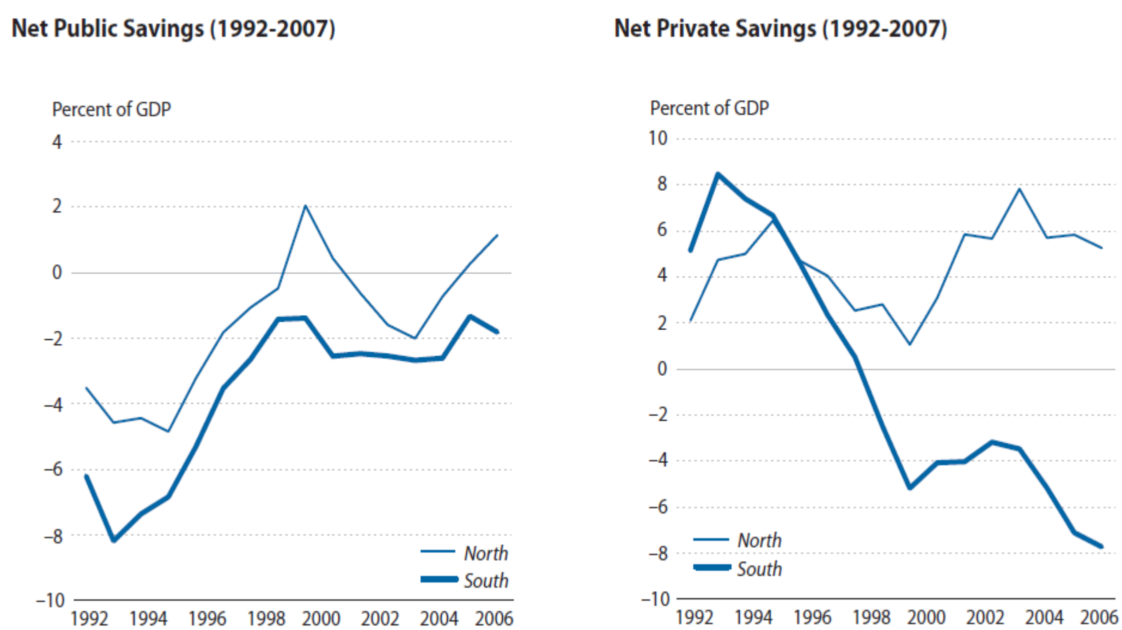



2. The next set of graphs – taken from an analysis of the Federal Reserve of the United States[10] – shows the scheme of the formation of macroeconomic imbalances between the core and the periphery of the euro zone. To make the nature of the problem even more visible, the core groups Germany, Austria, the Netherlands and Finland (designated as North on the graphs), while the periphery includes Spain, Greece, Ireland, Portugal (designated as South). Italy and France were left out as they are considered special cases, which, however, does not change the conclusions of the analysis.

[10] Holinski, Nils, Koo,l Clemens, and Muyskens, Joan; *Persistent Macroeconomic Imbalances in the Euro Area: Causes and Consequences*, Federal Reserve Bank of St. Louis Review, January/February 2012.

Figure 5 shows, firstly, that the problem lies mainly in the periphery and not in the core, and secondly, it is mainly a collapse of net private saving in the periphery, rather than a drop or lack of net public savings. This indicates that the problem is much greater than the fiscal side alone. While it is true that a portion of the periphery did not complete the fiscal adjustment it started in order to be accepted into the "euro club," and that after benefiting from the credibility of the euro since 1998 they made no efforts to clean up their budgets ("free-riding"), the fall in net private savings during the early years of the single currency reached 16% of GDP without being compensated with public contributions.

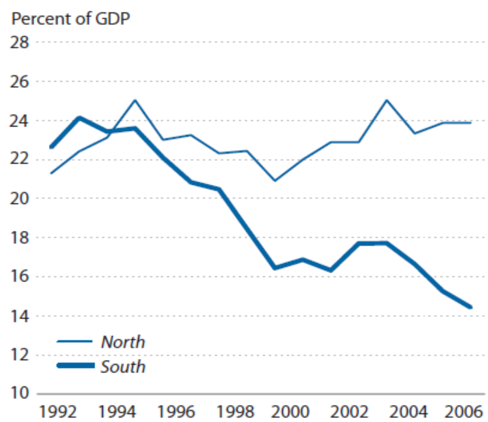
**CHART 5**
**Public and private savings in the core and the periphery of the euro zone**




This confirms that the imbalance originated in the periphery of the euro zone, as they reduced their savings while increasing investments. In this process, an imbalance of 16% of GDP in the periphery occurs during the period from the Maastricht Treaty until 2007, after a 10% fall of gross private savings and a 6% rise in gross private investment. This imbalance is reflected in a 10% deterioration of the balance of current account in the periphery (Chart 6).

**CHART 6 a**
**Gross private savings and investment in the core and the periphery of the euro zone**

**Gross Private Savings (1992-2007)**




**Private Investment (1992-2007)**

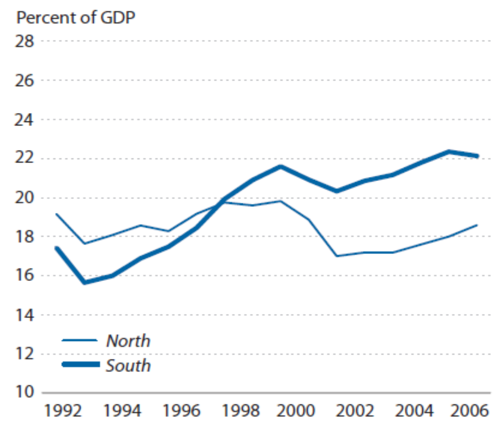
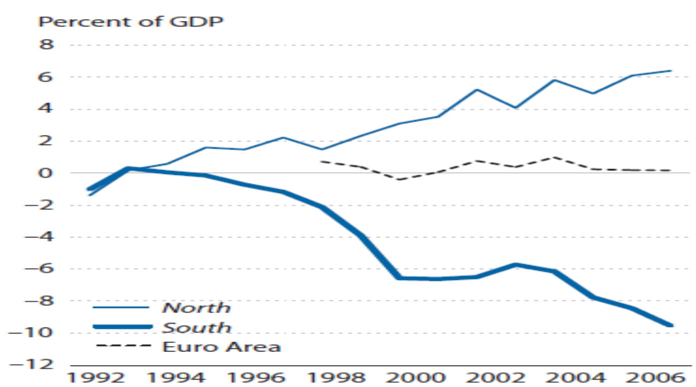
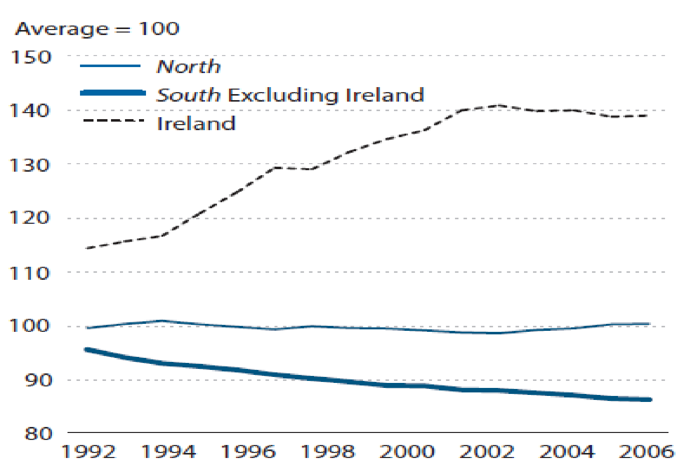



**CHART 6 b**
**Current account balance and total factor productivity**




**Relative Total Factor Productivity (1992-2007)**



According to the hypothesis of spontaneous real convergence, this external imbalance is natural and allows investment to escape the confines of availability of domestic savings in order to increase productivity of the most backwarded economies.

In the real case of the euro zone, no progress on the periphery is observed, but, on the contrary, with the exception of Ireland, we witness a real divergence with the core economies. This shows a complete failure of the euro project, which aimed at the "bottom-up" convergence of productivity in order to reduce the differences in per capita income within the EU.

### 4. The reaction of the European Union to the global crisis and the sovereign debt crisis in the euro zone

Authorities of both the EU and its Member States reacted in a quick, efficient and coordinated manner to the global depression that began after the bankruptcy of Lehman Brothers in September 2008, with the rapid implementation of the European Economic Recovery Plan in November 2008. In coordination with the G-20, these reactions allowed the EU to reduce the extent of the 2009 depression and promote the recovery in 2010.

However, given the dual limitation of anti-cyclical fiscal policies derived from the very narrow manoeuvring margins resulting from the lack of previous fiscal discipline (associated with non-compliance with the Stability and Growth Pact once the euro was created), and the prohibitions established by the European Union Treaty on the existence of a lender of last resort (the non-existence of a true central bank in the euro zone that could directly fund public entities – Article 123 § 1 – or to prohibit any bailout of a Member State – Article 125), the governance of the euro zone and the EU seemed paralysed at the time of the unfavourable reaction of financial markets to the Greek crisis in early 2010.

Instead of solving the Greek crisis and preventing contagion, the distortions and differences between national authorities confirmed the fear of an institutional failure due to the rigidity of a treaty conceived voluntarily (with deterrent purposes) to make it impossible for a Member State to be bailed out by the EU or by other states. The agreed need to create the euro was to provide firm guarantees to Germany (mainly) that the EMU would not become indirectly a system of massive budgetary transfers that are not legitimately voted by national parliaments. This, in the unforeseen exceptional situation of 2010, weakened all alternative plans negotiated by Germany with its partners by demonstrating that the euro is the only currency in the world with no real central bank (lender of last resort). This simple institutional fact is enough – in the peculiar circumstances of a global financial crisis – to trigger self-fulfilling expectations in financial markets, considering that the Central Bank is not authorised to act as a lender of last resort which may buy sovereign bonds in case of panic. That is the big difference between the crisis in the United States, England, Japan or other more indebted countries and the euro zone, in which liquidity crises were tackled by their central banks by buying their national bonds.

Therefore, the crisis in Greece was quickly followed by crises in two other Member States (Ireland and Portugal) as a result of mistrust of financial markets, which had a brutal impact on the price of government bonds of these countries. This resulted in a liquidity crisis in these markets, which automatically spread to banks as large holders of these devalued bonds. As a result, an initial agreement was reached in May 2010 to create a European Financial Stability Fund, with the mandate of buying bonds of these three countries with funds secured by the treasuries of nations with an AAA rating (see tables in Annex). Unfortunately, the provided and possible funds, based on the degradation of the ratings, were insufficient and the conditions of the loans were too restrictive, which worsened the crisis and increased the risk of transforming the liquidity crisis into a solvency crisis, thus contaminating large countries such as Spain and Italy.

A sort of domino effect started a vicious cycle between the fall of bond prices and liquidity of banks, which were forced to sell their depreciated assets and request assistance from the state, which downgraded government debt levels and government guarantees (see Chart in Annex at the end of the document) granted to financial institutions (or the issuance of public debt to bail them out). This affected the sovereign bond prices, which led to more sales of government securities, in a vicious circle that may again jeopardise the interbank market. In this context of crisis, fiscal policies became restrictive in order to try to restore the credibility of national treasuries, but at the cost of triggering a process of reduction of public spending, prompting more recession and less tax revenue, while the interest spreads on the bonds of affected countries increased expenditure, which further raised market panic.

The only positive aspect – in the historical line of European integration built in response to successive crises – has been the (slow) progress in governance, by adopting several successive reform plans that strengthen cooperation and coordination between Member States: the competitiveness pact, the Euro Pact, the governance Six-pack (reforming and strengthening coordination of national policies), the Fiscal Compact which imposed rules of thumb at the national level (balanced national budgets), the Extension of the Stability Fund and the creation of the European Stability Mechanism (ESM), the Two-Pack, reinforcing the ex ante budgetary coordination and monitoring by the Commission and the Council, etc. (See tables in Annex). All these successive measures go in the right direction and correct the shortcomings of the original architecture. However, they also made more visible the little room for manoeuvre of the Member States and the lack of *political consensus* to take the final step to transform the ECB into a true central bank.

Despite being in a better financial situation than the U.S., the UK or Japan, the euro zone has been hit by financial markets due to the lack of a lender of last resort. In this context, the expectations of economic agents contributed decisively to the decrease of productive activity: the situation was dominated by the recessionary trends starting in the second half of 2011. In July 2011, the ECB reached a political agreement between Italy, Germany and the EU to buy Italian bonds in exchange of reforms in this country, but the Italian leaders did not keep their end of the pact, prompting a new crisis of liquidity and governance in the EU. In October 2011, the German option of rejecting any agreement that would imply a larger role of the ECB won over the French proposals to use Article 123 §2 to finance the purchase of government bonds through an ESM transformed into a public bank of the 27 members of the EU. This would have been legal under the treaties and would have put the ECB in an equal footing with the Fed or other central banks, generating an immediate effect on the markets, of putting a floor to the drop of the bonds.

From that date, the euro zone entered a typical "balance-sheet-recession", i.e. a recession triggered by the excessive borrowing that forced both private and public sectors to cut their spending or investment plans, either to reduce debt levels, or due to the "credit-crunch" resulting from the correction, by banks, of past excesses in leverage.

Now, in such a situation, with characteristics reminiscent of the 1930s crisis, *the only way to prevent depression is a massive monetisation of public debt*, with the so-called operations of quantitative flexibilisation (or non-conventional monetary policy) so that the public sector can *temporarily* alleviate the lack of private demand. This is what the United States, the UK, Japan and other countries with a real central bank do. This is what the EU cannot do because of the opposition of Germany, since in the current institutional framework, Article 123 § 2 could be invoked as stated above. This position of Germany, which opposes the monetisation of government debt due to the effects it may have, may be seen as meddling in ECB's decisions, in violation of the Treaty, which makes it independent of governments. In reality, in the current context, this monetisation would not be inflationary, since the European interbank market was blocked and it was trying to offset, on the monetary base, the fall of the monetary multiplier under a deflationary process. Therefore, a *temporary* monetisation could be in compliance with the legitimate institutional objective of the ECB to maintain price stability to prevent 1930s-like deflation. In turn, the German position is based on the fact that partners in difficulties do not offer, from Germany's point of view, a clear guarantee of programmed fiscal adjustments and structural reforms.

This "deadlock" prevailing in the euro zone in October 2011 may be summarised as follows. Policymakers were caught in a *new prisoner's dilemma*, caused by an internal failure of the governance of the Treaty which prevents a solution to the liquidity crisis due to lack of credibility regarding respect of fiscal discipline by over-indebted countries:

- The ECB cannot create liquidity without guarantees of medium-term budgetary sustainability, so it is not accused of irresponsibility;
- this fiscal sustainability is impossible and questionable without a mechanism of lender of last resort to prevent contagion in case of speculative attacks when limits of short-term budget cuts are reached (but not in the medium term through tax reforms, which requires temporary liquidity).

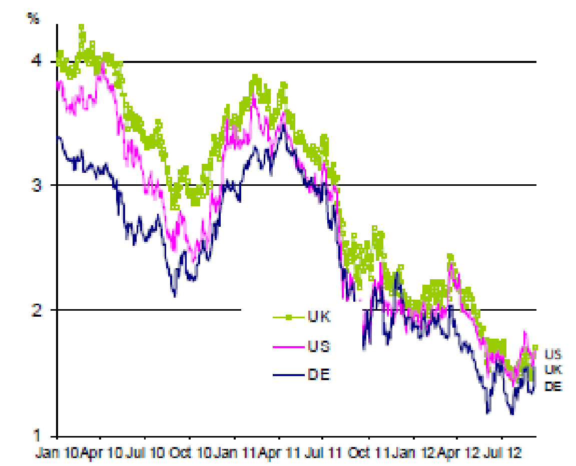
On the one hand, the problem is internal and it relates to EU institutions, suggesting that there are simple solutions if significant progress is made towards effective respect of a common discipline. But on the other hand, EU institutions showed that the Council of Ministers is "*judge and jury*" and that, sequestered by the most powerful countries, has not acted in the best interests of the EU.

In this context, the EU was self-condemned to repeat past mistakes and produce very harmful external effects for the world insofar as the worsening of its own crisis fuelled a global crisis. To avoid the worst, the ECB was pressured to implement in November and December 2011 an indirect means to alleviate the liquidity crisis in the interbank market caused by the sovereign debt crisis. Politically unable to perform a "quantitative flexibilisation" as in the United States, the ECB injected massive liquidity into banks from November 2011 to February 2012. In less than three months, one billion euros were loaned to banks at a three-year term under the LTRO method. This operation consists of giving banks unlimited liquidity for three years, at an interest rate of 1% per year. These loans can be used to buy bonds at much higher rates, which contributes to the recapitalisation of banks.

The effect was notable. It reduced the risk in the interbank market and brought down the spreads on the bonds of over-indebted countries. However, this indirect method is less effective than a direct purchase of bonds by the ECB. Besides, banks used 80% of this liquidity to re-deposit it as reserves in their accounts with the ECB (paying the difference between the cost of the loan at 1% and the 0.25% interest given by the ECB to these deposits). This meant that the monetary base was not "useful" for the economy (and did not cause inflation).

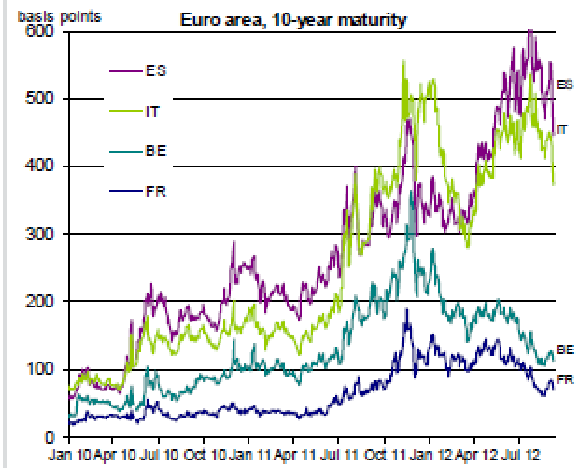
The following charts (7, 8, 9 and 10) show the differential impacts on long-term bonds and spreads regarding Germany. We see downward effects from April 2012 except in the cases of Spain and Italy.

**Chart 7: Benchmark 10-year government bonds**




Source: EcoWin

**Chart 8: Sovereign bond spreads to German bund**




Source: EcoWin, own calculations

**Chart 9: Sovereign bond spreads to German bund**

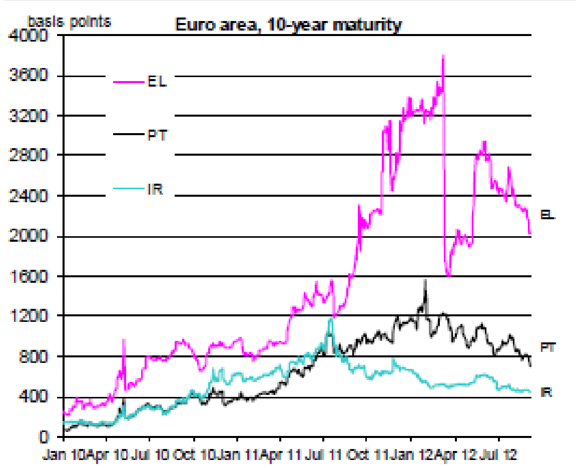
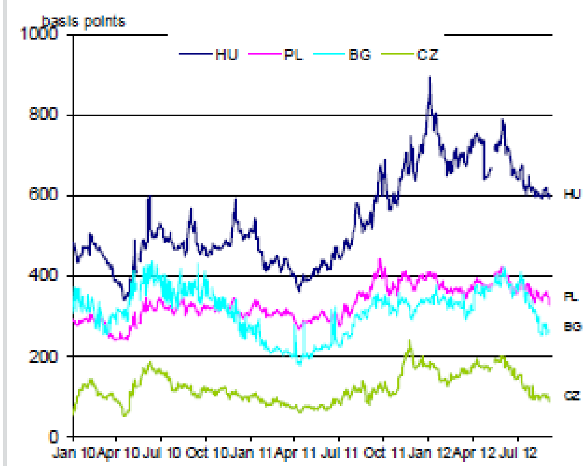



**Chart 10: Sovereign bond spreads to German bund**




Source: DG ECFIN, European Commission, ECOWIN (latest data: 7 September 2012)

In turn, Charts 11 and 12 describe the changes in monetary policy as well as the difference between the interventions of the ECB and the major Anglo-Saxon central banks (Fed and Bank of England). We can see that from mid-2009, the Fed starts a massive bond purchase in quantitative flexibilisation operations, while the ECB injects funds to banks in exchange for collaterals (“repo”) and very few bond purchases. Also, Chart 13 shows that while in 2007/2008, the European monetary authority gave loans mainly to banks in Germany, Luxembourg and Belgium, from 2009 its interventions were aimed at banks affected by the sovereign bond crisis in Greece, Ireland, Italy, Spain, Portugal and France, causing increased exposure to risk by the ECB.

**CHART 11**
**(Revised) Balances of Central Banks, % of GDP**

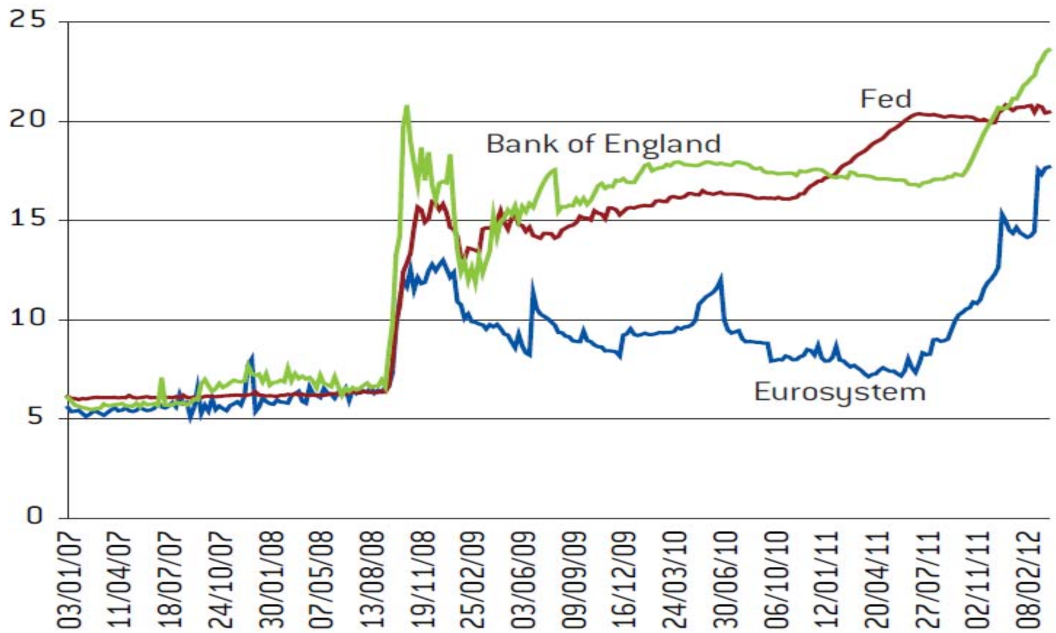
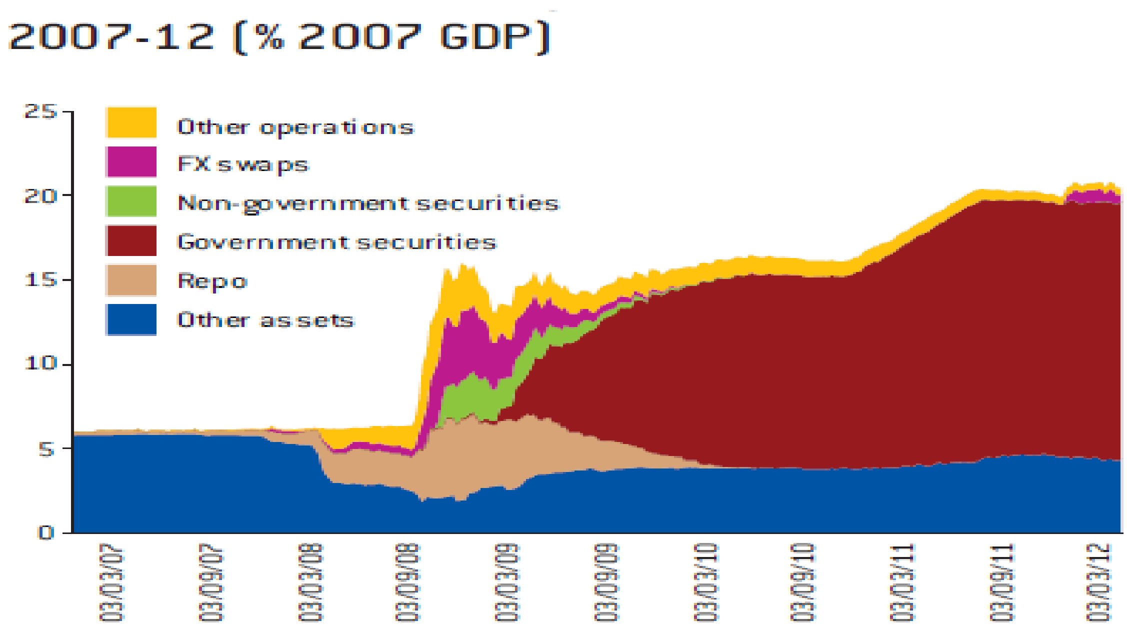
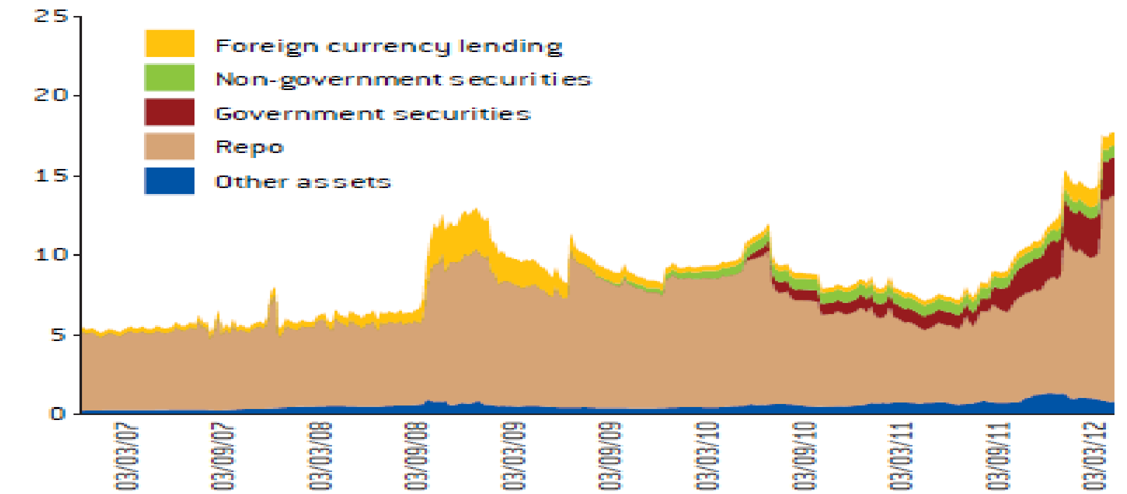



**CHART 12**
**Assets of the Fed (left) and ECB (right), % of GDP, 2007**

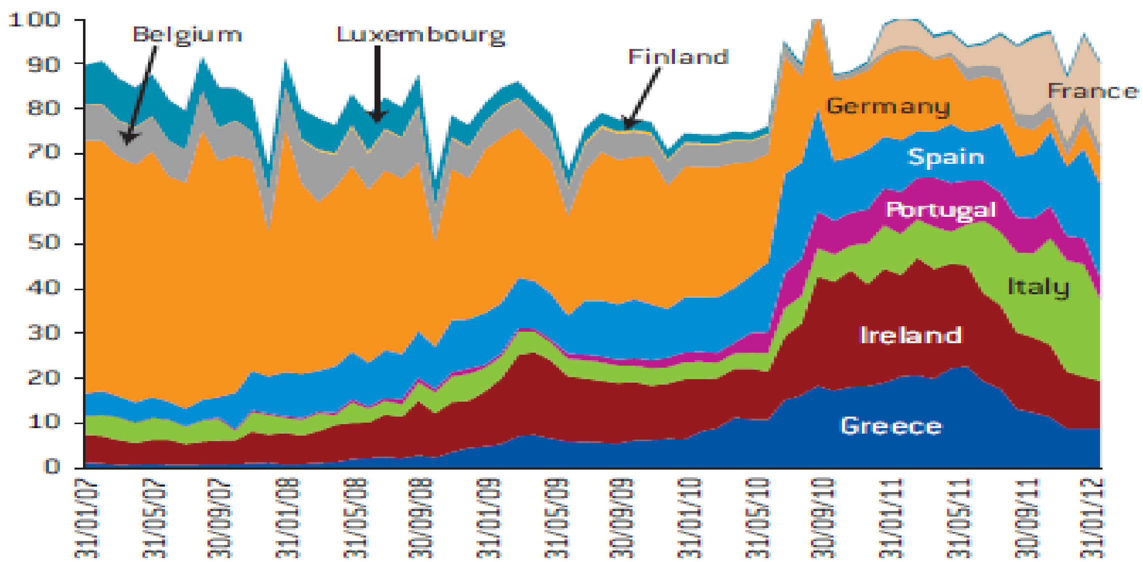





Source for Figure 4, 5 and 6: Bruegel based on Fed Cleveland

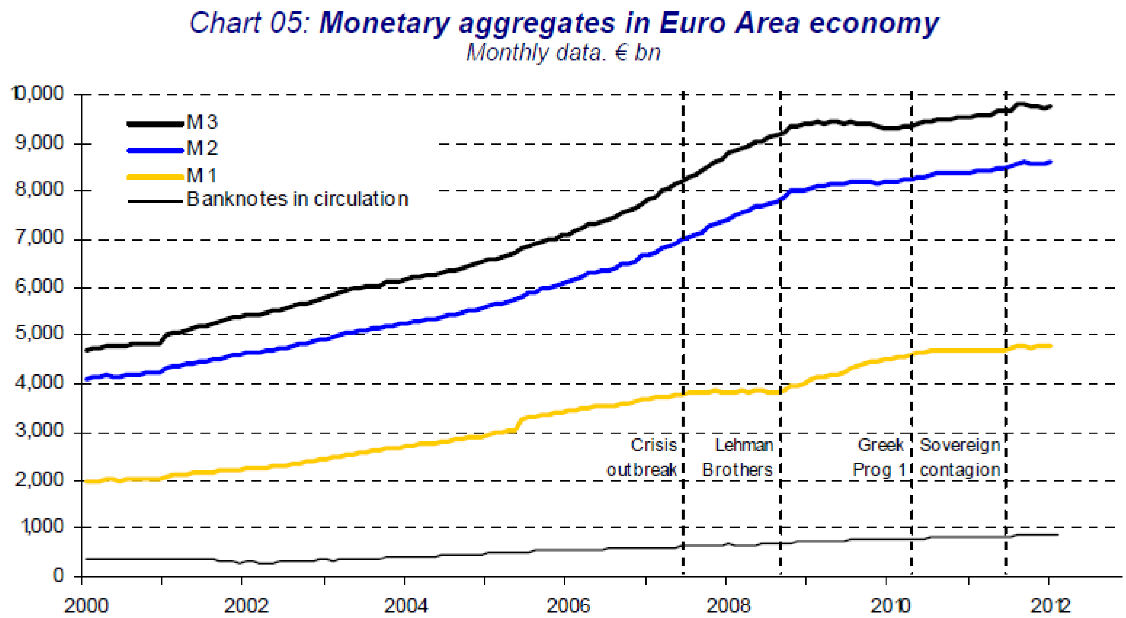
Source: Pisani-Ferry, J. & Wolf, G. 'Propping up Europe?' Bruegel, Brussels, April 2012

**CHART 13**
**Refinancing of banks by the ECB**




Source: Pisani-Ferry, J. & Wolf, G. 'Propping up Europe?' Bruegel, Brussels, April 2012

**Chart 14**
**Monetary aggregates in the euro zone**




Source: ECB

In turn, Figure 14 shows that the money supply has remained relatively stable since the ECB's interventions are offset by the falls in the money multiplier of the monetary base affected by the paralysis of the interbank market.

In short, the experience of recent months has shown that, caught in the dilemma described above, the EU reacts only when the situation becomes unsustainable.

After the position assumed by the ECB (in the context of the limited room for manoeuvring of its new President Mario Draghi) in late 2011, the European interbank market normalised against the dollar and the pound (Chart 15) and the risk tension (measured by the spread between the Euribor and the “overnight index swap”), which had rebounded between August 2011 (failed attempt to agree on the Italian debt, mentioned above) and early January 2012, was reduced. Chart 16 shows the “normalisation” of risk in the euro interbank market from March 2012 through July 2012. Tensions reappeared with differences of positions between Germany/Netherlands/Finland and the rest of the euro zone on the Spanish and Italian cases, but the determination of the ECB and the prospect of a final agreement on the adoption of the European Stability Mechanism (ESM) and the possibility to buy sovereign bonds, brought calmness to markets.

**CHART 15**
**LIBOR rates of €, $ and £**

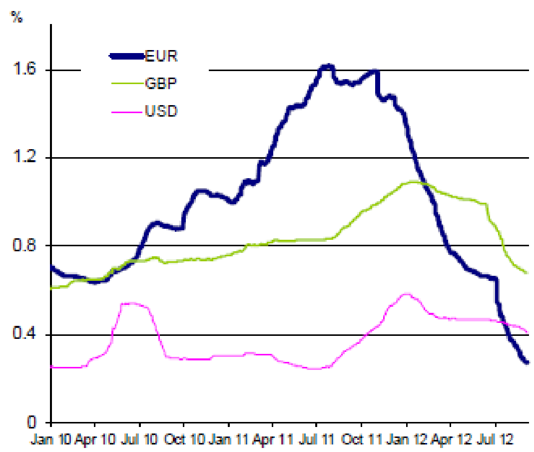
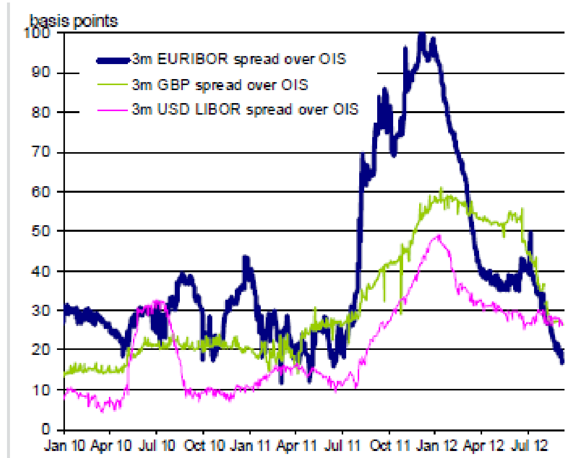



**CHART 16**
**Risk indicator measured by the differential with the covered swap *("Overnight Index Swap")***




Sources: DG ECFIN, European Commission, (latest data: 7 September 2012)

The decisions of the European Council in late June 2012 (to create a single oversight mechanism of banks in the euro zone, the possibility of recapitalisation of Spanish banks, enhanced coordination agreement etc.), and especially the ECB's decision of 6 September 2012 to buy bonds of countries that accept bailouts via ESM (i.e. under strict conditions), confirmed this positive outlook. Another factor contributing to the easing of tensions in the markets was the ruling of the German Constitutional Court of September 12, which upholds the constitutional character of Germany's participation in the ESM under budgetary limit conditions (190 billion euros) and transparency to the German Parliament, and the political initiative of the President of the Commission, adopted on the same day, proposing new developments in the perspective of the Federation of the European Union.

The positive aspect is that these recent decisions or proposals provide respite and time to adopt the guidelines that aim at decisive progress in terms of governance of the euro zone. But such relief could be counterproductive if it slows down the dynamic progress of the indispensable process of reform in European institutions.

### 5. Summary and conclusions on the euro zone crisis

The analysis of SELA's report on bi-regional relations 2011[11] led to the conclusion – which was still fully valid thereafter – that "*the European economy, which seems to be globally balanced, suffers from profound differences due to internal problems of governance that aggravate effects of the global financial and economic crisis. Such problem has the advantage of being fully endogenous, i.e. Europeans just need to agree and new forces of growth and progress would be released immediately. Technically, there are simple solutions that would not require major institutional changes to be implemented. Nevertheless, the euro zone crisis traps policymakers in a new prisoner's dilemma, as was the case before the 1990s, making it difficult to agree on common solutions. On the other hand, the consequences of the crisis and the risk of its expansion in Europe in case of serious disagreements, place policy makers under intense pressure to find cooperative solutions as soon as possible*."

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[11] SELA, op. cit (SP/RR:VICBM-DRPEPREALC-UE/DT N° 2-11).

After 20 months of paralysis of the EU, it is clear that the risks resulting from the collapse of the European economy into a serious depression with very negative global effects increased dangerously from mid-2011.

The measures adopted in September 2012 (after much resistance which still persists), in particular the decision of the ECB to buy bonds of countries that accept bailouts via ESM, have opened a new chapter in the crisis. Indeed, a provisional massive *monetisation* by the ECB of national bonds *in exchange for credible national programs* (irreversible decisions that lead to a medium-term progressive implementation) of fiscal reforms and structural changes which favour growth and budget sustainability, is the first step to prevent the aggravation of the crisis.

But much remains to be done to consolidate the way paved by the measures of September 2012. As part of the governance reforms, it is essential to create a *European Debt Agency*, which would issue “blue bonds” (Euro-bonds) guaranteed by the 27 EU member countries and priority bonds (“*seniority clause*”) to create a differentiation of domestic debt issues, called “red bonds” which would be “subsidiary” and whose price would depend on the credibility of each national treasury. This would imply the creation of (positive or negative) market penalties, individualised by country. This type of system would hold each national treasury liable in exchange for solidarity measures in case of shocks or serious problems.

But if the prospect of a triple crisis in the short term has receded (i.e. the worsening of the sovereign debt crisis leading to a generalised banking crisis that, in the context of greater mistrust leads to a monetary crisis that would jeopardise the future of the euro), there are still factors that weaken European growth. Apart from widespread austerity policies that prevent the immediate substantial recovery of the activity there are also structural problems that affect European growth in the long run.

With respect to the main long-term problem in Europe – the stagnating total productivity of factors – there is no miracle solution that would quickly produce positive effects. There is, however, a ten-year plan proposed by the European Commission in 2010 (Europe 2020) which seems to be the only reasonable solution. According to this plan, to overcome stagnation, unsustainable trends in debt, cumulative imbalances and competitiveness problems, the EU should accelerate the consolidation of public finances, reform its financial sector, and prioritise structural reforms towards a new economic model based on knowledge, low-carbon, high-employment economy. The European Commission has identified three key growth engines that should be implemented through concrete actions at national and EU levels: smart growth (fostering knowledge, innovation, education and digital society), sustainable growth (promoting a more resource-efficient production, which should boost competitiveness) and inclusive growth (increasing participation in the labour market, skill learning and the fight against poverty).

Noteworthy is that while it is true that the EU crisis entails negative effects for Latin America and the Caribbean – insofar as European growth will be mediocre at best in the coming years – it will also open new perspectives for the strengthening of economic and cooperation ties in a more balanced relationship between the two regions, as discussed in the next chapter.

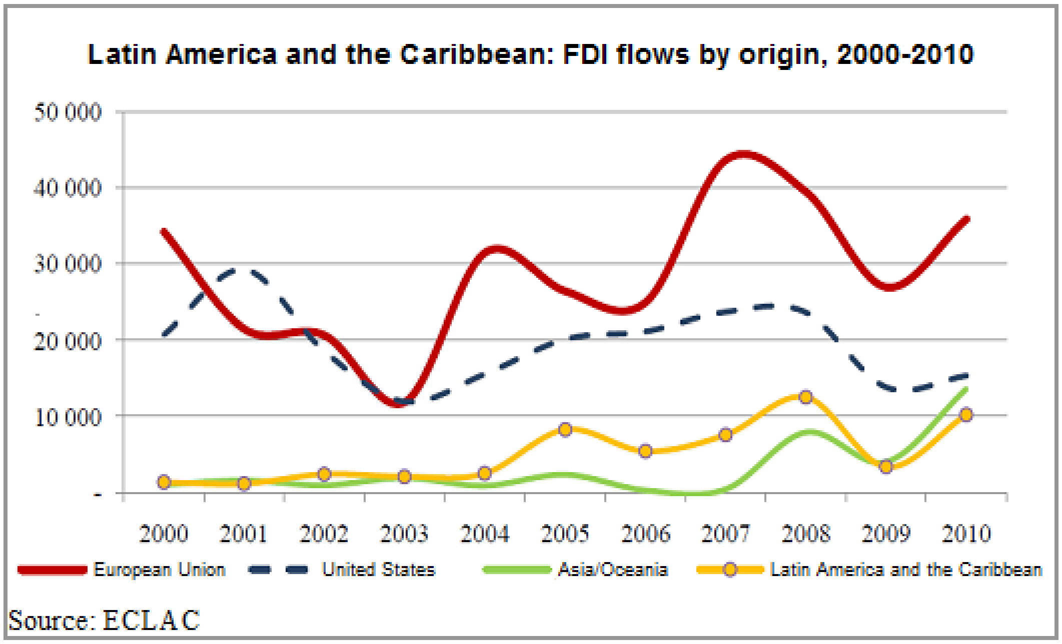
## III. ECONOMIC AND COOPERATION RELATIONS BETWEEN THE EUROPEAN UNION AND LATIN AMERICA AND THE CARIBBEAN

After a dynamic phase in the 1990s, economic affairs between the European Union (UE) and Latin America and the Caribbean were curbed in the early 2000s, followed by recovery in 2002-2008. Afterwards, trade, investment, remittances, and cooperation-related flows have been adversely affected by the global economic crisis and particularly by the European crisis after 2010.

### 1. Foreign Direct Investment (FDI) flows

Europe has remained the main source of FDI in the 2000s (Chart 17). Characterized by high volatility, in the last decade, FDI flows from Europe average US$ 30 million, or 40% of the overall investment in Latin America and the Caribbean (ECLAC, 2012).

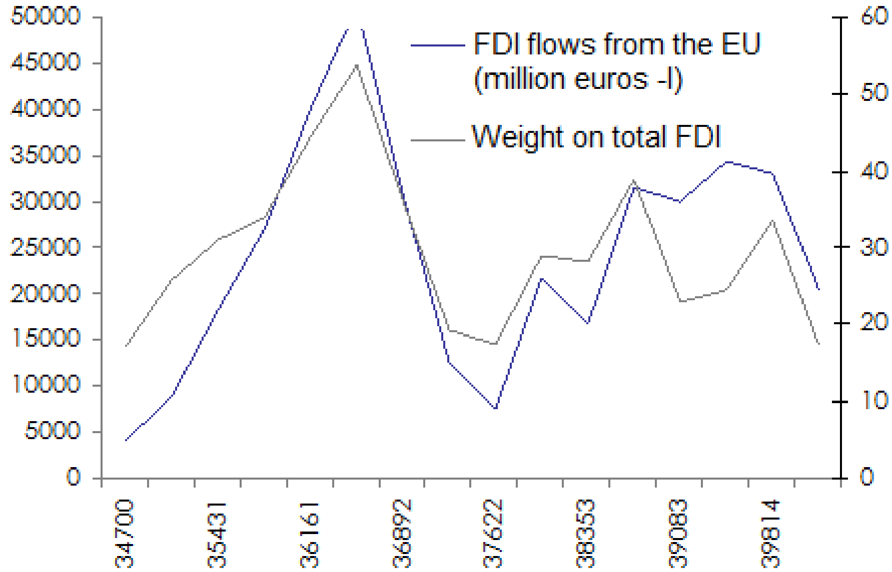
**CHART 17**




The predominant role of the EU as an investor in Latin America and the Caribbean dates back to the 1990s, when European firms took an active part in the privatizations *en masse* in several countries in Latin America and the Caribbean. Mostly the result of larger Spanish interest, European investments focused on energy and public services in MERCOSUR Member States Brazil and Argentina. Later on, from the late 1990s through the early 2000s, when several Latin American and Caribbean countries went through deep monetary and financial crises and a backlash in economic growth, FDI overall flows from Europe towards Latin America and the Caribbean plummeted below U.S. investments in 2001. Nevertheless, from 2003, European investment flows towards Latin America and the Caribbean took a breath of fresh air. Foreign investment was abruptly interrupted due to a worsening global crisis in 2009. However, after a drop of almost 30% that year, FDI flows recovered together with European investments in 2010.

Despite a dynamic European FDI, Latin America and the Caribbean has lost ground in the 2000's relative to other regions, such as Eastern Europe and Asia. After accounting for more than 15% in 1997, the weight of Latin America and the Caribbean in European FDI flows outside the EU stood at 6-7% in 2003-2008. The relative position of Latin America and the Caribbean in the total amount of European investment has lately recovered. Nonetheless, it has not reached the peak of the 1990s (Chart 18).

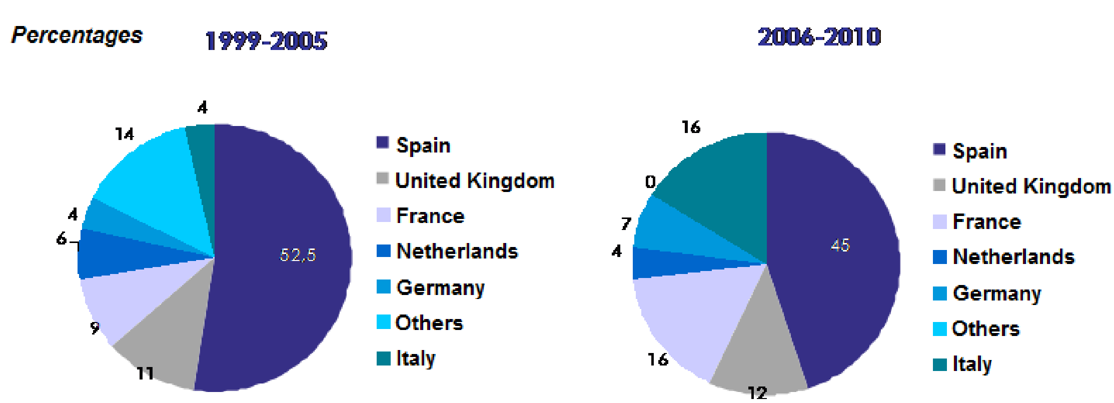
**CHART 18**
**Latin America and the Caribbean: Evolution of European FDI flows**




Source: EUROSTAT, UNCTAD

In the 2000s Spain remained the major European investor in Latin America and the Caribbean, despite a drop relative to the previous decade. Spanish investments in Latin America and the Caribbean stand for 45% out of total investments from the EU in LAC in 2005-2010,[12] followed by investments from France, Italy and Germany (Chart 19). In 2000-2010, some more than 85% of Spanish investments went to services. Industry (mainly in Brazil) and the primary sector have received 12% and 2% out of total investments, respectively (ECLAC, 2012).

**CHART 19**
**Latin America and the Caribbean: FDI from the EU per country of origin**
(Excluding financial centres)




Source: ECLAC

[12] Except for investment flows in off-sore financial sectors.

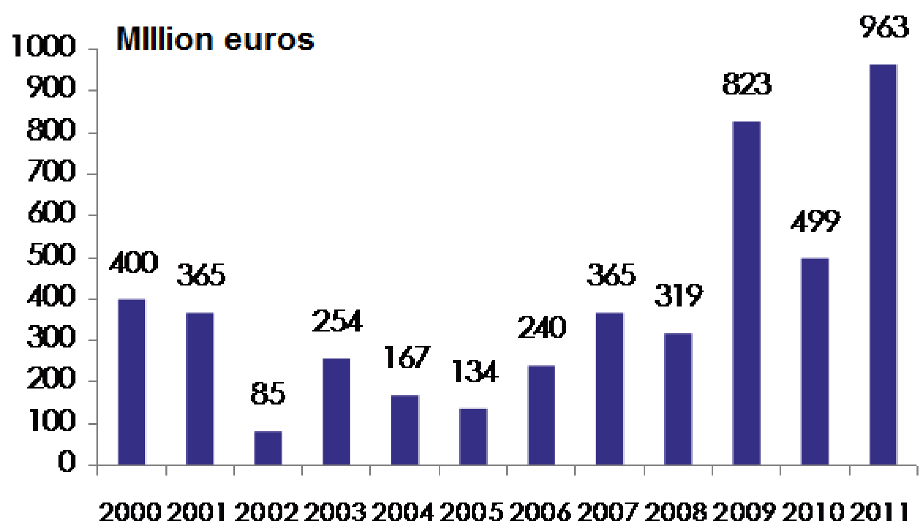
European investment, recovered after a drop in 2009 (cf. Chart 10) ought to continue being a dynamic component of bi-regional economic relations, based on two factors.

Firstly, some facilities favour and help stabilize the European FDI in Latin America and the Caribbean, such as the European Investment Bank (EIB). The EIB operations, a body of the EU, are a powerful mechanism for cooperation through investment flows and financing of projects in developing countries. Based on pluri-annual mandates from the European Commission, the EIB grants loans under flexible conditions to recipient countries for the purpose of their development. Each mandate – with specific features and priorities – sets a subvention top for each region and each term of implementation of the project.

The EIB has operated in Latin America and the Caribbean since 1993, when the Latin American and Asian program (ALA)[13] was endorsed by the EU Council. The program grants loans for projects in Latin America and the Caribbean in the medium and long term, hedging the political risk. The EIB gives ancillary funding of up to 50% of the total cost of an investment project. The program also foresees indirect loans through local financial institutions for minor projects.

Pursuant to the current mandate (ALA IV) for 2007-2013, the EIB may afford Latin America and the Caribbean up to 2.8 billion euros in loans. ALA IV priorities include environmental protection, efforts against global warming and energy security. In addition, the EIB may finance high-quality projects with the status of investment over the amount set by the mandate, through its facility for energy sustainability and reliable supply. The EIB dynamics as to funding of investments in Latin America and the Caribbean has been enhanced since 2009 (Chart 20). Telecommunications, industry and energy are usually the most benefitted sectors (Chart 21).

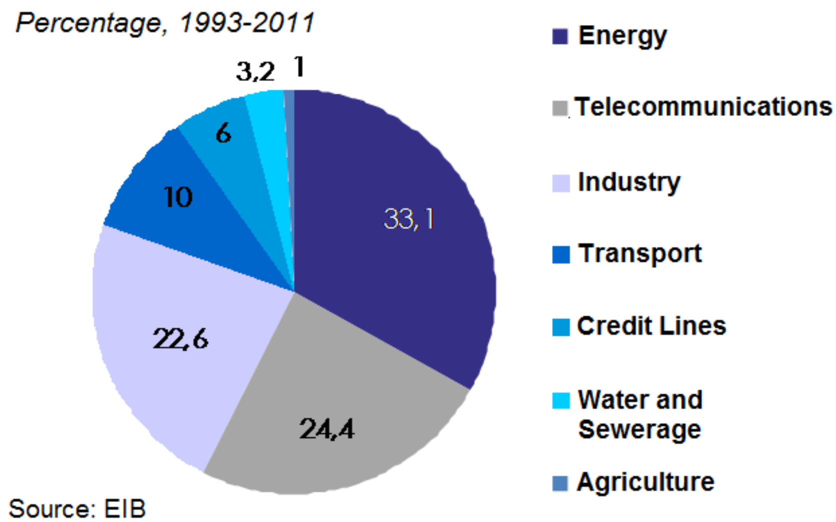
**CHART 20**
**Latin American and the Caribbean: Loans approved by the EIB**




Source: EIB

[13] This program is aimed at keeping the European presence in Latin America based on the EIB funding to secure the transfer of European technology and knowhow.

**CHART 21**
**Latin American and the Caribbean: Apportionment by sector of EIB loans**




The second factor comes from the European economic crisis. For European transnational companies – and even high-performing medium-sized enterprises – Latin America and the Caribbean makes a significant contribution to offset the consolidated balances of parent companies. As a matter of fact, the activities and new investments of European firms in Latin America could help increase the sales and volume of their businesses to offset, at least in part, the untoward situation in their countries of origin.

As multiple observers and analysts have commented,[14] this is particularly true for Spain. Over the past few years, Latin America and the Caribbean has been the main source of resources for many Spanish firms. Furthermore, many Spanish firms have made new investments and redirected their activities to cash in on the growth of LAC. Latin America and the Caribbean is nowadays particularly important for Spanish investors. Over the past 20 years, Spain has taken root as the second investor in Latin America and the Caribbean, behind the United States. In 2011, three out of the five largest Spanish firms got more significant benefits in Latin America and the Caribbean than in their country of origin. The presence of Spanish companies will continue and it is likely to get stronger despite the slowdown of LAC economics and whatever troubles these companies may face, namely: capital shortage and unstable legal frameworks, among others.

Therefore, Latin America and the Caribbean should capitalize on such flows. The policies in furtherance of FDI should be supplemented by development, industrial and sectoral strategies (ECLAC, 2012). In addition, the promotion of European FDI, from the standpoint of Latin America and the Caribbean, should focus on sustainable development, the central topic of the next bi-regional summit.

[14] See, for instance, http://excelsior.com.mx/index.php?m=nota&seccion=dinero&cat=13&id_nota=833849.

## 2. Bi-regional trade relations

**Within a context of asymmetric and concentrated exchange, bi-regional trade has made progress...**

Previous reports have summed up the main features of trade between the two regions.[15] Bi-regional trade, which has undergone different stages over the past few decades, is asymmetric and concentrated.

Asymmetry is apparent as to the traded goods. Latin America and the Caribbean mostly imports from the EU industrial products, whereas primary commodities prevail in EU imports of Latin American and Caribbean goods. Over 90% of total LAC imports of European products comprise industrial goods; almost half of them are of high-tech content. For their part, primary commodities account for more than 1% out of total LAC imports from the EU. Conversely, primary commodities and basic industrial goods or finished products account for over 60% of total LAC exports to Europe. Such a situation has barely changed since the nineties. In the meantime, LAC exports to other developed regions, such as the United States and Canada, have significantly diversified over the past 20 years.

Moreover, trade relations between Europe and Latin America and the Caribbean focus on a small number of countries. Argentina, Brazil, Chile, Colombia and Mexico stand for more than 75% of trade to or from the EU. Similarly, Germany, Spain, France, the United Kingdom and Italy are the main customers (and suppliers) for the region, accounting for more than 60% of exports and almost 55% of imports to and from the EU.

Another major feature of trade between the two regions, in terms of dynamism, is the fact that trade relations have skyrocketed in the past half century, for an annual growth rate of 16% in 1970-2010. Such trade has passed through several stages (Chart 22), from a substantial expansion in the 1970s, arrested by the general debt crisis in the 1980s in LAC. Sure enough, the "lost decade" substantially depressed LAC imports, resulting in a positive balance of trade for Europe.

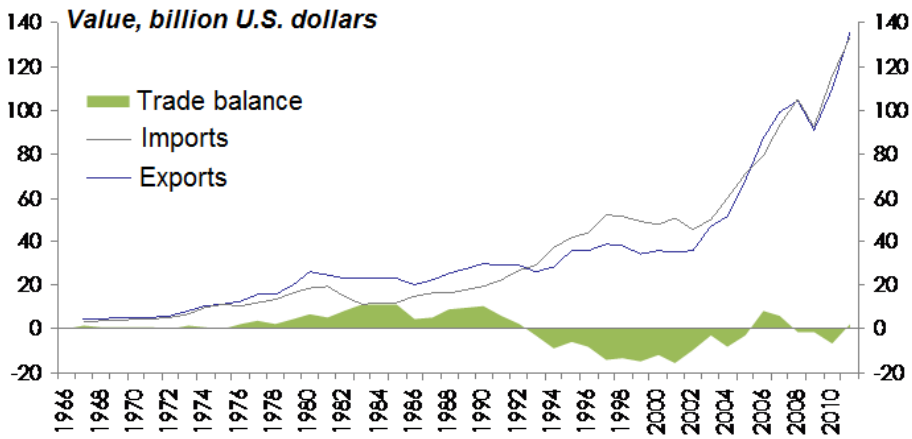
In the early 1990s, trade between the two regions accelerated, particularly LAC imports of European countries. Nonetheless, the economic and financial crash in Latin America and the Caribbean in the second half of that decade – from the "Tequila Crisis" in Mexico in 1994 to the Argentinean crisis in 2001 – curbed the dynamic trend of bi-regional trade. The removal of "import replacement," a model implemented in Latin American countries until the mid-1980s, boosted regional imports. European exports to Latin America and the Caribbean benefitted from such increase in regional imports, for a positive balance of trade for Europe in the 1990s. In the 2000s, LAC exports and imports to-from the EU significantly sped up. Bi-regional trade was particularly strenuous in 2003-2008, with a yearly increase of exports by 22% on average and 16% for imports. This period matched up with a cycle of strong economic growth in LAC (near 5% for the region as a whole), basically spurred by consumption and private investment and the reason for rising imports. Similarly, 2003-2008 was characterized by a surge in international prices of raw materials due to the larger Chinese demand. This meant a significant increase of the value of LAC exports to the EU.

The worsening of the global financial crisis after the crash of Lehman Brothers in September 2008 arrested the development of bi-regional trade. Latin American and Caribbean exports[16] to the EU shrank almost 30% in 2009, particularly stricken by the

[15] See SELA 2011, op. cit.
[16] From the database of Chelem-CEPII, in current US dollars.

sudden fall of world prices of primary commodities and the economic recession in the EU. LAC imports of European products downsized around 25%, concomitantly with the diving economic activity in the region, shrinking at 1.8%[17] as a result of the standoff. Available data for 2010 suggest a subsequent recovery of bi-regional trade, with rising LAC exports to the EU around 25% compared to 2009, and some more than 15% of LAC imports from the EU. Afterwards, in 2010, EU/LAC trade rebounded, with a virtually even balance of trade.

**CHART 22**
**Latin America and the Caribbean: Historical evolution of trade with the European Union**




**Source: ECLAC-Paninsal, CHELEM**

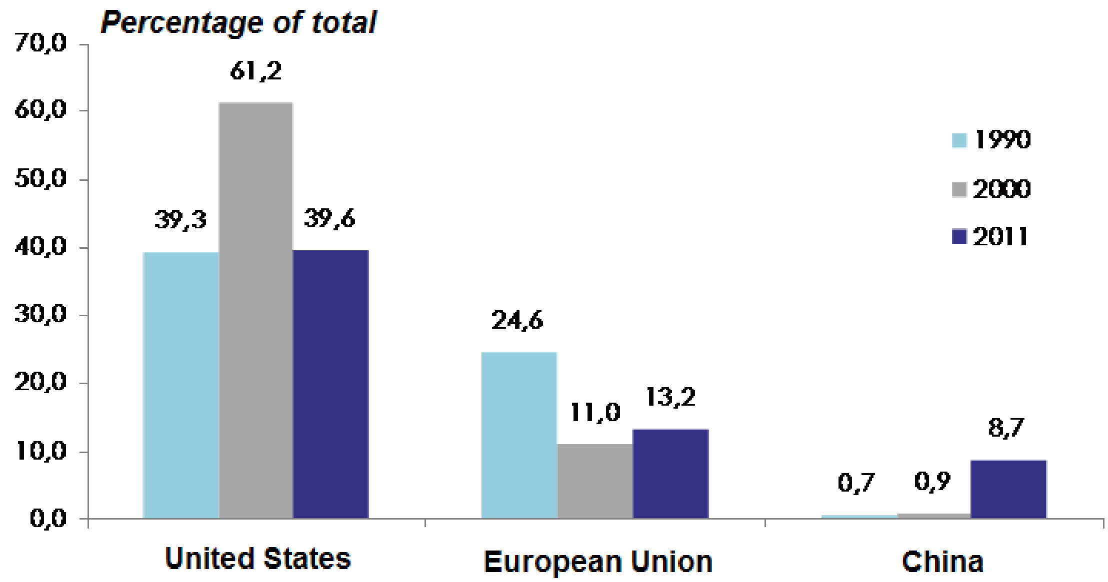
**... yet the EU has lost ground as a trade partner ...**

Despite the development of bi-regional trade, the profile of Europe as a trade partner of Latin America and the Caribbean has weakened over the past 20 years. Its share in LAC overall exports-imports slid from almost 25% (20%) in 1990 to 13.2% (13.6%) in 2011 (Charts 23 a and b). Interestingly, such relative losing weight of Europe in LAC foreign trade has essentially taken place in the 1990s.

This significantly contrasts with the development of LAC-China trade relations. China's share in LAC foreign trade has steadily expanded (Charts 23 a and 23 b; Table 1). In 1990-2008, LAC imports from China went from 0.6% of LAC overall exports to more than 10%. Nowadays, China is the third supplier to the region, after the United States and the EU. In addition, formerly the 17th destination of LAC exports in 1990, China moved up to the third place, accounting for 9% of LAC overall exports. China has reinforced its clout in Latin American and Caribbean foreign trade in the first decade of this century, particularly at the expense of the United States, the major LAC trade partner, and it has become the main destination of Brazilian and Chilean exports (Table X2).

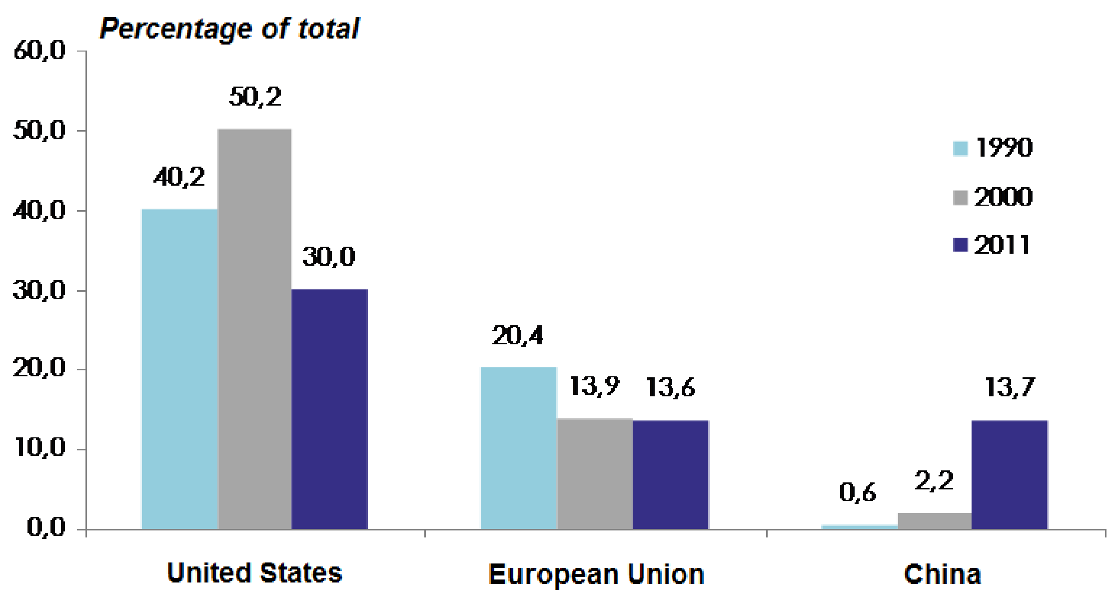
[17] Based on ECLAC data.

**CHART 23 a**
**Latin America and the Caribbean: Destination of exports**




Source: ECLAC, Bulletin

**CHART 23 b**
**Latin America and the Caribbean: Origin of imports**




Source: ECLAC, Paninsal 2008-2009

**TABLE 1**
**China takes hold as a major trade partner in the LAC region**
**China in the ranking of trade partners per country**

| Country | Destination of exports | | Source of imports | |
|---|---|---|---|---|
| | 2000 | 2009 | 2000 | 2009 |
| Argentina | 6 | 4 | 4 | 3 |
| Brazil | 12 | 1 | 11 | 2 |
| Chile | 5 | 1 | 4 | 2 |
| Colombia | 36 | 6 | 9 | 2 |
| Peru | 4 | 2 | 9 | 2 |
| Venezuela | 35 | 2 | 18 | 3 |
| Costa Rica | 30 | 2 | 15 | 3 |
| Mexico | 19 | 7 | 7 | 2 |
| *Gained market presence in:* | 14 out of 17 countries | | 17 out of 17 countries | |
| *Among the top 5 partners of:* | 7 out of 17 countries | | 16 out of 17 countries | |

**Source: ECLAC**

**...this might become more noticeable as a result of the world and European economic crisis**

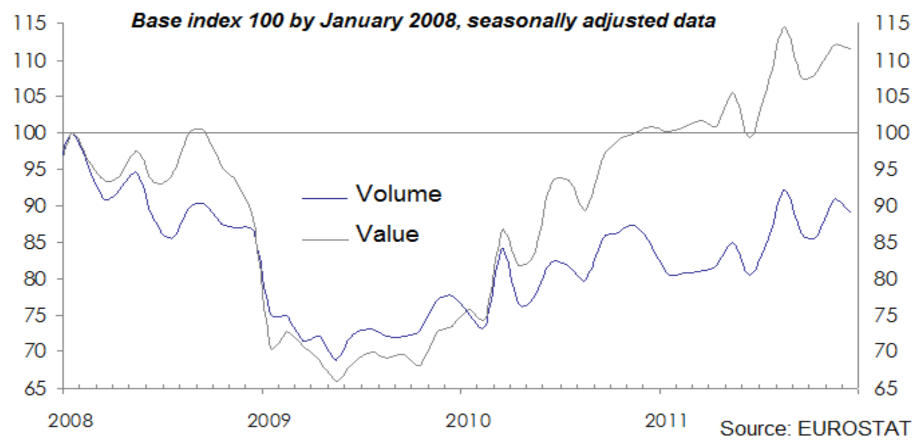
The global financial crisis unleashed by the crash of Lehman Brothers in September 2008 significantly damaged bi-regional trade. Latin American and Caribbean exports[18] to the EU shrank, as already mentioned, almost 30% in 2009, particularly hit by plummeting world prices of primary commodities and the economic recession in the EU (Chart 24). Monthly data of LAC exports to the EU reveal that exports significantly downsized in the first quarter of 2008, declining more in terms of value than volume. In other words, the "price" factor of exports played a key role in losing momentum. Such a plunge would stop at the beginning of 2009, clearing the way to relative stabilization of exports, with no marked dynamism throughout that year.

In the first quarter of 2010, LAC exports to the EU would be strenuous again, basically prompted by shot-up prices of raw materials. As from the second quarter of 2010, there was a mismatch between exports expressed in value and volume as a result of the continued valuation of world prices of primary commodities, foodstuffs and energy products. As a matter of fact, since 2010, LAC exports to the EU, expressed in volume, have slowed down, concomitantly with the feeble growth in Europe and the several stages of the European debt stalemate. Such a profile is likely to continue in the near future, as appears from the prospects of slow growth or recession in Europe and the trend towards a strong appreciation of currencies in major Latin American countries, at least through the middle of 2011.

LAC exports to the EU are glaringly dynamic and have surpassed since the beginning of 2011 their pre-crisis level, pushed up by higher prices of raw materials. While this can be regarded in principle as positive for bi-regional trade, it could also be a source of risks. In a scenario of depreciation of the euro versus major Latin American currencies –as verified in the first half of 2012- together with the valuation of primary commodities, the symptoms of the "Dutch disease" could get more serious in some LAC countries. This directly endangers the exports to the EU of manufactured products and, therefore, the development of the industrial sector in Latin America and the Caribbean, pivotal in production diversification and economic development of the region.

[18] From the database of Chelem-CEPII, expressed in current U.S. dollars.

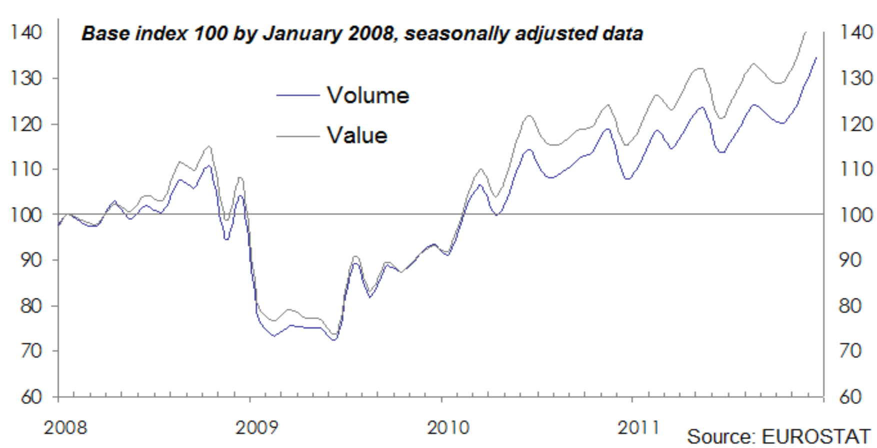
**CHART 24**
**Latin America and the Caribbean: Exports to the European Union**




LAC imports of European products were influenced by the world economic crisis in the third quarter of 2008. Both in value and volume, total imports were tightened by 32% in October 2008-January 2009. Note that the difference between imports expressed in value and imports expressed in volume is much shorter than exports. Again, LAC imports from the EU are mostly industrialized products. The price of such products is less volatile than the price of raw materials, thus reducing uncertainty as to their performance.

The lively recovery of LAC imports mirrors the swift way out of the crisis in the region. In addition, the hike of prices of raw materials skyrocketed LAC exports and favoured growth. From 2010, LAC growth of imports cemented; private consumption and investment gathered momentum, enlarging the demand of foreign products. Clearly, LAC imports of European products followed the overall trend of total exports in the region. After plummeting following the crash of Lehman Brothers, LAC imports resurged in the middle of 2009 (Chart 25). The rebirth nailed down in 2010-2011, even surpassing, on a monthly basis, the peak reached before the crisis, both in volume and value.

**CHART 25**
**Latin America and the Caribbean: Imports from the European Union**



Undoubtedly, the bottom-line trends that have characterized bi-regional trade for two decades, particularly the LAC lower profile, are and will be hampered by the European crisis, with two corollaries.

Firstly, as postulated in a report prepared by ECLAC (ECLAC, 2010), it is likely that the EU will be overtaken as the second trade partner of the LAC region in 2015, at the very latest. Secondly, the EU downward trend as LAC trade partner, taking its relative share in the regional trade down to 13-14% in the aggregate, has lessened the direct effects of the European crisis on LAC economies. Econometric tests performed in a recent work confirm that, based on trade effects, the cycle of Brazil and other South American economies is more and more influenced by the cycle of China and the performance of commodity prices. In the meantime, Mexico and the economies of Central America and the Caribbean mostly rely on the United States.[19] Therefore, in the trade context, the current recession in Europe makes an indirect impact on the LAC region via United States and Asia.

### 3. Remittance flows and cooperation between the European Union and Latin America and the Caribbean

#### Remittances: moderate global recovery and persistent atony of the flows coming from Europe

Firmer flows of remittances received by LAC countries have been notorious in the region foreign financial affairs in the first decade of the current century. Transfers from emigrants doubled in 2002-2008, almost tantamount to FDI flows and eight-ten times the amount of Official Development Assistance (ODA) at the end of such period (Table 2).

**TABLE 2**
**Net capital flows to Latin America and the Caribbean, 2001-2010**
(billion US dollars)

| Indicator | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|---|---|---|---|
| Net public and private flows | 86,2 | 52,6 | 59,8 | 57,9 | 93,8 | 68,7 | 208,3 | 181,9 | 173,7 | 318,6 |
| Net private flows | 65,6 | 40,2 | 55 | 68 | 125,2 | 88,6 | 209,4 | 175,4 | 155,8 | 297,2 |
| Net FDI | 74,4 | 56,8 | 46,2 | 66,3 | 85,8 | 83 | 139,3 | 120,4 | 119,9 | 153,9 |
| Net portfolio investment | 71,8 | 55,3 | 42,9 | 66,8 | 73,5 | 72 | 110,4 | 130 | 78,3 | 112,6 |
| Net debt flows | 2,5 | 1,4 | 3,3 | -0,6 | 12,2 | 11 | 28,8 | -9,7 | 41,6 | 41,3 |
| Official lenders (incl. WB & FMI) | 11,9 | -4,2 | 13,5 | -8,4 | 8,1 | -14,3 | 69 | 61,6 | 53,8 | 164,7 |
| Private lenders | 20,6 | 12,4 | 4,7 | -10,1 | -31,3 | -19,9 | -1,1 | 6,5 | 17,9 | 21,4 |
| Migrants' remittances | 24,7 | 27,9 | 36,6 | 43,4 | 50,1 | 59,2 | 63,3 | 64,6 | 56,9 | 58,1 |
| Net ODA | 6,0 | 5,0 | 6,1 | 6,8 | 6,7 | 7,3 | 7,0 | 9,3 | 9,0 | 10,8 |

Sources: World Bank, DAC/OECD

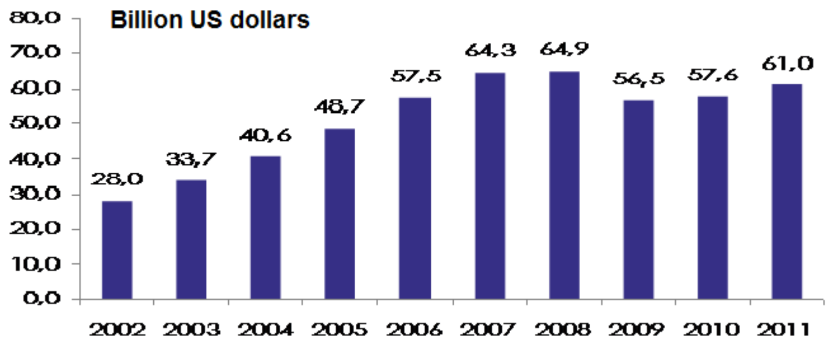
Nevertheless, because of the global economic crisis that lambasted the main destinations of significant contingents of LAC emigrants, namely, the United States and Spain, among others, in major employers of foreign labour, remittances slumped (Table 2). Based on IADB data, remittances to Latin America and the Caribbean sagged by 15% in 2009 [20] and the levels prior to the crisis would not be attained no matter the recovery in 2010. In 2009-2010, resources significantly dwindled, between -0.5% and -2.4% of the GDP, for the

[19] Bénédicte Baduel, Juan Carlos Diaz and Carlos Quenan, "Decoupling or not decoupling: the cases of Brazil and Mexico." Flash N° 953-12, Natixis, Paris, December 2012.
[20] IDB, Remittances in Latin America and the Caribbean in 2009: The impact of the global financial crisis. IDB/MIF FOMIN, Washington D.C., 2010.

largest recipients of remittances in the LAC region, including Colombia, Ecuador, El Salvador, Guatemala, Jamaica, Mexico and the Dominican Republic.

Certainly, in 2011, remittances from emigrants to the LAC region were 6% firmer at US$ 61 million.[21] While surpassing US$ 60 million, such amount does not help the comeback of pre-crisis levels (Chart 26).

**CHART 26**
**Evolution of remittances to Latin America and the Caribbean**




**Source: IDB**

Furthermore, the total amount of remittances has recovered despite the lethargy of the transfers from Europe.

As a matter of fact, remittances from Europe sank after 2008. Remittances from Spain are a relevant pointer of the impact of falling European remittances to the LAC region. Spain, together with Germany and France, are the largest sources of remittances from the EU to foreign countries. As much as 56.4% of total remittances from Spain go to Latin America and the Caribbean. Spain is the second source of remittances to LAC after the United States.

Remittances from Spain in 2009-2010 significantly slipped (over 9% in 2008-2010), lambasting in a similar proportion the main recipients, that is, Colombia, Ecuador and Bolivia (Table 3).

**TABLE 3**
**Ranking of destinations of remittances from Spain in 2010**
Data in thousand €, according to BdE and Remesas.org
Remittances from Spain in thousand euros. Difference in 2008-2010

| Ranking | Destinations | 2008 | 2009 | 2010 | million euros | % |
|---|---|---|---|---|---|---|
| 1 | Colombia | 1422 | 1298 | 1286 | -135,6 | -9,5% |
| 2 | Ecuador | 1058 | 963 | 920 | -138,3 | -13,1% |
| 3 | Bolivia | 727 | 663 | 611 | -115,6 | -15,9% |
| 4 | Romania | 403 | 364 | 381 | -21,8 | -5,4% |
| 5 | Paraguay | 308 | 299 | 323 | 15 | 4,9% |
| 6 | Morocco | 387 | 299 | 295 | -92 | -23,8% |
| 7 | Dominican Rep. | 292 | 292 | 287 | -5,2 | -1,8% |
| 8 | Peru | 205 | 257 | 259 | 53,7 | 26,2% |
| 9 | China | - | 70 | 252 | - | - |
| 10 | Brazil | 387 | 250 | 252 | -135 | -34,9% |
| 11 | Pakistan | 134 | 121 | 122 | -12,3 | -9,2% |
| 12 | Senegal | 182 | 128 | 108 | -73,6 | -40,5% |

Note ( - ) Data not available
Source: Remesas.**org**

[21] IADB, Remittances in Latin America and the Caribbean in 2011: Regaining Growth. IDB/MIF FOMIN, Washington D.C., 2012. (See: http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=36723460)

Data of 2011 show that in the context of the current European crisis, with Spain among its main focuses, no significant recovery is foreseeable in the short and medium term. Spanish remittances are far from getting back to normal. Still, the worsening economic crisis has resulted in a new drop in the fourth quarter of 2011, amidst increasing unemployment and decline at 2% of the immigrant population last year.[22]

Preliminary data of the first quarter of 2012 show that remittances from Spain amounted to 154 billion euros, that is, 14.4% less than in the same term the previous year (1.85 billion euros).[23] Thus, the transfers of workers from Spain have tumbled for three quarters in a row, resulting into a “second crisis” as to remittances from that country (Chart 27).

**CHART 27**
**Remittances from workers in Spain: A comparison of the annual % variation between the first* and the second crises** of remittances**


Source: EDB, Remesas.org

## EU-LAC cooperation: A discouraging outlook

In the first decade of the 21st Century European cooperation – mainly through the Official Development Assistance (ODA) – has undergone important changes. As a matter of fact, extending a dynamics that had been present since the 1990s, early this century, the position of Europe as the first provider of assistance to the LAC region nailed down. But also, this phenomenon, in line with a significant reduction of the share of some non-European donors (namely the United States, Japan and Canada) was concomitant with a deep change in the European cooperation. While its evolution showed the changes occurred in the 2000s in the global development agenda (particularly, the higher profile of the Millennium Development Goals, MDGs) with regard to the fight against poverty and “securitization” of aid, which have influenced the apportionment of resources among LAC countries), the rank of European donors has substantially changed.[24]

As a matter of fact, in the 2000s – namely until 2008 – the amounts supplied by Italy, the Netherlands and the United Kingdom would sink, whereas the proportion of the EU jumped together with the Spanish aid. In this way, in 2008, Spain reached for the first time the first place in the ranking of donors, by providing nearly US$ 2 billion, almost 30% out of the total ODA received by the LAC region.[25]

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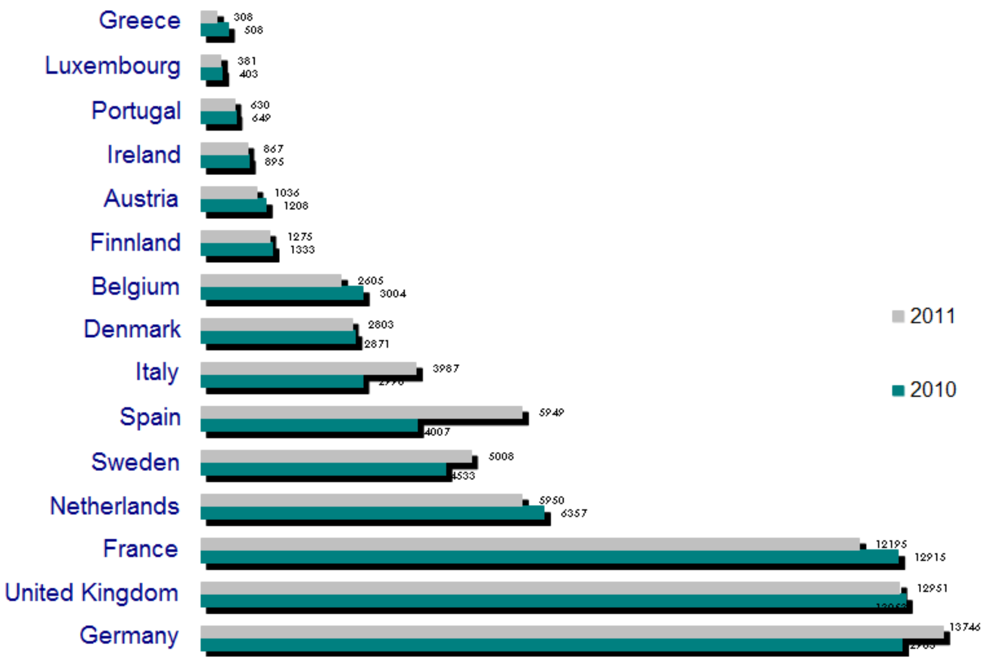
[22] See IADB, op. cit. (IADB, Remittances in Latin America and the Caribbean in 2011: Regaining Growth. IDB/MIF FOMIN, Washington D.C., 2012).
[23] See http://eleconomista.com.mx/economia-global/2012/07/04/remesas-espana-baja.
[24] José Antonio Sanahuja, “La política de desarrollo de la UE y América Latina: estrategia e instrumentos de cooperación para la asociación regional”, Cuadernos CeALCI, Fundación Carolina, Madrid, 2011.
[25] J.A. Sanahuja, op. cit.

However, the world economic crisis and, in this context, the situation of the European countries most stricken by the sovereign debt crisis in Europe, has adversely affected the ODA since 2009. Thus, in the case of Spain, the falling ODA for Latin America and the Caribbean in 2009 would be recorded again in 2010. In this way, the Spanish share (44% out of its ODA to the LAC region) in the total ODA received by Latin America and the Caribbean flunked to less than 20%.

Recently released preliminary data on ODA in 2011 show, on the one hand, that the global crisis, the feeble growth and tax constraints in most developed countries hamper the flow of ODA, and, on the other hand, that short-term prospects are not enticing.[26]

**CHART 28**
**ODA in net terms**
(million U.S. dollars)




*Source: OECD*

In 2011, the net ODA from the members of the OECD Development Assistance Committee (DAC) amounted to US$ 133.5 billion, falling for the first time since 1997. While the European Union, with US$ 73.6 billion, remains the major donor followed by the United States – which has provided US$ 30.7 billion, a slight decrease at 0.9% compared to 2010 – the ODA flow of most European countries has diminished. From all of the 15 countries listed in Chart 28, only Germany and Sweden increased their contributions.[27]. The most drastic reduction occurred in the cases of Greece and Spain, the most stricken countries due to the crisis which have curtailed their resources available for aid and cooperation.

A substantial reactivation of the global ODA is unlikely against the backdrop of recession or feeble growth of developed countries.[28] Therefore, the curtailed ODA from Europe and

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[26] See: http://www.oecd.org/document/8/0,3746,fr_21571361_44315115_50061704_1_1_1_1,00.html
[27] Italy's increase is mostly the result of cancellation of debts.

[28] See: http://www.oecd.org/document/8/0,3746,fr_21571361_44315115_50061704_1_1_1_1,00.html

particularly from Spain will make an impact on Latin America and the Caribbean in the next few years. As stated in a recent report on the EU policy of development assistance to Latin America prepared by the European Parliament,[29] the austerity measures and shorter ODA could jeopardize the goal of expanding the ODA set forth in the "European Consensus" of 2005, as well as the MDGs. Everything indicates that the EU will not succeed in attaining the goal of 0.7% by 2015 in the ODA/GDP ratio (only 0.42% versus the goal of 0.56%) and that the risks of a lesser DOA for Latin America and the Caribbean are enormous.[30]

Furthermore, in this context of quantitative constraint and European retreat, there is the challenge of keeping the contribution for the eradication of poverty as pivotal in the EU-LAC cooperation relations. This means to keep the commitment of the European ODA to middle-income countries, most of the LAC region; make headway with a better division of labour between Member States and community agencies, and discuss the role to be played by the MDG-8 in the EU-LAC cooperation relations.[31] Such matters should be the core of the discussions between the two regions with a view to setting the objectives and defining the tools of the pluri-annual programming for 2014-2020.

## 4. Summary and conclusions on bi-regional economic and cooperation relations

In short, bi-regional economic and cooperation relations have suffered the effects of the global crisis and, most recently, the European crisis.

Again, a substantial reactivation of the global ODA is unlikely in the current world context. As regards Europe, particularly Spain, the recession or sluggishness will blast cooperation flows. This means that the LAC region is set to capitalize more than ever on the dwindling aid as to the objectives and tools of the pluri-annual programming for 2014-2020 in terms of cooperation.

European remittances to Latin America and the Caribbean have also tumbled since 2008. As known, Spain plays a key role, as the remittances from that country are a constituent element of the European flows to the LAC region. In the face of a "second crisis" of Spanish remittances, that is, a new phase of significant drop like the fall occurred after the crash of Lehman Brothers, it seems that European remittances to the LAC region will not be back to normal in the near future.

Undoubtedly the bottom-line trends of bi-regional trade for two decades, namely the relative lower profile – yet stabilized in the first decade of the 21st Century – are and will be hit by the European crisis. However, since the relative weight in the LAC-EU trade is around 13.14% out of total trade, the direct effects of the European crisis on Latin American economies are not relevant.

In turn, the European investment, recovered after the crash of 2009 should keep on energizing bi-regional economic relations. The very European crisis contributes to such dynamism. Multiple European transnational firms, particularly from Spain, take roots in Latin America and the Caribbean to offset the consolidated balances of the parent companies and the untoward effects of the lethargy in Europe. Even many medium-sized

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[29] European Parliament, Directorate General for External Policies, A new cooperation policy of the European Union for Latin America, Expo/B, DEVE/FWC/2009-01/Lot5/18, Brussels, December 2011.

[30] They have even grown as a result of the political and economic crises in North Africa. European Parliament, op. cit, p. 8.

[31] Goal No. 8 of the MDGs is to "develop a global partnership for development." See: European Parliament, op. cit, p. 40.

European companies with great dynamism are settling or seeking to settle in the region in order to take advantage of its global or sectoral vigour.

Again, Latin America and the Caribbean ought to cash in on these inflows. Note the LAC interest in promoting partnerships between European firms and Latin American multinationals increasingly present in Europe, as well as fostering, as shown in the fourth section of this paper, investment for sustainable development, the central topic for the Santiago Summit.

## IV. LINES OF ACTION FOR THE SANTIAGO SUMMIT

The lines of action that Latin American and Caribbean (LAC) countries should be leaning towards are a result of a double context made up from, on the one hand, the European crisis and its effect on bi-regional relations, and on the other hand, the results and commitments derived from the Madrid Summit.

As has already been underscored in this document, the decisions of the European Council of the end of June 2012 (creating a single supervising entity for euro zone banks, the possibility of recapitalization for Spanish banks, reinforced coordination agreement), and the decisions made by the ECB on 6 September 2012 to purchase bonds from countries willing to follow ESM rescue plans lead us to think that the immediate threat of a serious financial and monetary crisis was taken off the table. However, beyond this short term reprieve, there is the risk that persistent austerity policies and the difficulty in implementing a new economic growth model may lead Europe to get caught in a chronic stagnation cycle.

Within this framework, one should not expect in the short or medium term that bi-regional trade exchanges become more dynamic, and as has already been mentioned, it does not look very plausible that European remittances, especially coming from Spain, sent to Latin America and the Caribbean, once again reach the levels of 2008. And, it also seems very possible that due to the recessive condition or very limited growth and very severe budgetary restrictions that will prevail in Europe, cooperation flows will continue to be affected negatively. This supposes that, under these conditions, the LAC region should try to optimize European help flows as related to objectives and the 2014-2020 pluriannual program instruments in matters of cooperation. And that, in more general terms, LAC must assume that the crisis that is plaguing the Old Continent must favour a more balanced bi-regional relationship, in context of the international economic crisis and limited advances toward a "fragile"[32] multilateralism.

In this perspective, it is in the interest of the region to *strengthen the effects of the new reality which implies the emergence of the Community of Latin American and Caribbean States (CELAC), that may favour the possibility to establish common stances in the region and that it be expressed in a single voice.* At the same time, if the region is reinforced, not only will new cooperation perspectives be opened in a more balanced bi-regional relation, but topics that up until now have not been subject to dialogue and effective cooperation may be addressed. In fact, *the global and systemic crisis, and more specifically, with respect to Europe, within the framework of a more balanced relation, should open the door for a bi-regional strategic association to pursue an effective and structured macroeconomic dialogue.* This dialogue would allow for the contemplation of

[32] As stated in S. Stavridis, R. Diamint, J. Gordín (Coord.), América Latina – Unión Europea / Unión Europea - América Latina: Integración regional y birregionalismo, Prensa de la Universidad de Zaragoza, Zaragoza, 2012.

possible cooperation with third parties and international institutions, especially in the area of world financial architecture reform.

On the other hand, when creating action lines, resolutions adopted at the Madrid Summit must be taken into account. As was analyzed in the SELA report of 2011, despite its shortcomings, this Summit produced a number of concrete resolutions in three areas.[33]

In the first place, in accordance with the main issue, the creation of a Latin American investment facility (LAIF), that intends to have a "leverage effect" (stemming from a European contribution of € 100 million until 2013) to move resources from financial institution looking to promote project financing in areas such as inter-connectivity and infrastructures associated to energy efficacy. In the second place, despite existing difficulties (especially with respect to Mercosur/EU negotiations), important achievements were reached at the bi-regional association level between the EU and the different sub-regional groups, that were mentioned in the II title of the Declaration ("Reinforce our bi-regional association", points 22 to 37). In the third place, the Madrid Summit adopted two correct initiatives of great importance, although of a different nature. In point 34 of the Madrid Declaration, the decision to create the EU-LAC Foundation, which was proposed at the Lima Summit, is explained. This foundation, which is "conceived as a useful instrument for reinforcing bi-regional association and as a measure to promote debate on common strategies and actions, as well as to bring them more into the light." It began to function in November 2011. On the other hand, annexed to the Madrid Declaration, the EU-LAC Action Plan was adopted[34] to cover two major issues on the bi-regional agenda and the priorities established at the VI Summit.

Within this framework, one of the lines of action that must be considered in perspective of the Santiago Summit should be the *evaluation of what was achieved in the implementation of the Madrid Action Plan*.

Two supplementary topics should be considered among the five lines of action that the countries of the region should be leaning towards leading up to the Santiago Summit. On the one hand, *the region should be moving forward in identifying the sectors and activities in which investment can be deployed for sustainable development,* the main issue at the Santiago Summit. On the other hand, in a juncture characterized by serious difficulties, strategic associations should reinforce themselves in the areas that, from a more structural perspective, can strengthen the ties between the two regions. In this sense, LAC *should take advantage of the fact that,* within the framework of the Santiago Summit, *the first bi-regional academic Summit is being carried out to promote relations at the level of higher education.*

**1. Implement the Caracas Action Plan in the context of preparing for the Summit with the purpose of reinforcing the CELAC organization and take advantage of its cooperation method**

Initiated at the Mexico meeting in February 2010, the CELAC was created at the Caracas Summit held in December 2011. This organization, which fuses together the Rio Group and the Summit of the Latin America and the Caribbean Unity, constitutes a very important entity for the preparation of Summits, offering the ideal instrument to negotiate positions and be able to speak with a single voice. In previous works of the Permanent Secretariat of the SELA, concrete proposals aimed at structuring a true organization in this sense were examined. One could consider that the CELAC emerged from the outlines

[33] SELA Report 2011, op. cit.

[34] See : http://www.eu2010.es/export/sites/presidencia/comun/descargas/Summit_UEALC/may18_actionES.pdf.

created by those works, and constitutes a decisive step forward in being able to get the most out of Summits with the EU as well as other forums with third parties.

The CELAC can help to reinforce a pragmatic method of integration and cooperation. Parting from common principles (democracy, human rights, sustained development through cooperation…), the CELAC proposes a flexible method with voluntary participation in the initiatives that makeup the action plan established by its 33 members, and in complementarity with already existing sub-regional organizations or instruments. This is how the CELAC looks to make integration more dynamic through achieving consensus and the priority given to possible synergies between policies or sectors at the regional level. In fact, the Caracas Action Plan, organized into 9 priority topics (world crisis and new financial architecture, synergies between regional and sub-regional mechanisms, physical integration infrastructure, social development and eradicating poverty, environment, humanitarian assistance, migrant protection, culture, information technology), shows the region’s capacity to reach a consensus with respect to their action priorities in order to structure a true integration strategy. Public opinion in the region as well as international observers, should value in just measure the potential jump forward that the CELAC represents despite the fact that its Action Plan is still in the declarative stage.

Therefore, it is of utmost importance to take advantage of the preparations for the Santiago Summit in order to demonstrate the efficacy of the CELAC’s cooperative methods, looking for synergies between the Caracas Action Plan and the Madrid Action Plan, which topics have important convergences. The main objective is to get the most out of the Caracas Plan, reaching consensus on positions in order to carry out the Madrid Action Plan and to have a greater influence on the Santiago Summit agenda.

For the CELAC, and the strengthening of common stances of Latin America and the Caribbean, the Santiago Summit represents an important historic opportunity. On the one hand, the CELAC will be able to demonstrate that it is an important piece in achieving regional integration by being able to offer an efficient method by which to communicate, with a single voice, common issues; and also be able to interconnect two agendas (both planes). The CELAC could play a bigger key role than it has in the past.

For this to happen and be successful, repeating statements made in past reports, it is essential to be able to implement *networks of national administration experts* of the 33 member countries to build inside the CELAC a real organization of “technical collegiality” between its member States and regional and sub-regional organizations. The sector networks should cover the areas of cooperation for the Caracas Plan and well as the Madrid Plan for bi-regional cooperation. The objective is to *create a permanent space for dialogue between high level officials* of the region in charge of executing different policies in all countries and organizations, aimed at establishing, de facto, an informal but permanent regional cooperation system that is not dependent of institutional requirements or of the ups and downs of political and economic junctures of the region or its sub-regions. Furthermore, this system should be directly useful for each participant, each administration, each ambassador, and each Minister in charge of an issue, maintaining each one of these relations with its counterpart, and ensuring a certain amount of continuity with respect to regional common reflection at each level.

On the operational plane, the aim is to intensify the “technical collegiality” method in two dimensions:

1. creating sector or thematic networks (in other words, feeding a permanent informal exchange between Latin American and Caribbean national experts and their regional organizations) that Foreign Affairs Departments could take advantage of (for the Caracas Action Plan as well as the Summit Action Plans), and even be able to open up new areas of dialogue under the initiative of the national administrations, and
2. establishing two different levels: first, between high Latin American and Caribbean officials (including all national and sub-regional experts of a topic) and second, a bi-regional level with its EU counterpart. This way, Foreign Affairs officials and Ambassadors in charge of the Summit, would use these technical networks to promote their initiatives, review their ideas, put together their agendas, and thereby have a permanent access available to experts that may be required from the beginning of a project. Without costs or creating a new institution, Latin America and the Caribbean would instantly have available the operative technical capacity of all its thousands of experts, motivated only by the fact that they will be able to evaluate their knowledge of the field, benefit from the experience of their counterparts, and be able to influence, in this way, the agenda of the Summits and their implementation.

This is how exchanges in common interest topics could be promoted, through networks established to prepare, manage and implement Summits. This could generate the opportunity to form a Latin American-Caribbean consensus on a number of diverse topics and suggest common strategies before the EU. This *complementary informal space* for institutions or existing mechanisms does not pretend to reach a level that is making decision or establishing official positions, or making institutional changes, it is simply looking to open direct and continuous cooperation between national experts through a dynamic of exchange, technical analysis of problems, or common interest challenges. Improving the knowledge of experts could become a valuable tool for building consensus about the makeup of policies of each country. The regional network could build a tool directly useful for each expert in their area of responsibility, thereby contributing to the integration of the region. Furthermore, a technological network of this type would offer an efficient channel to permanently clarify and monitor respective national policies directly useful for each Minster and Head of Government.

**2. Carry out an integral evaluation of what has been done with respect to the implementation of the Madrid Action Plan**

As already mentioned, in the annex of the Madrid Declaration the Action Plan of the EU-LAC was adopted [35] which, in line with the more important issues of the bi-regional agenda and the priorities established in the VI Summit, identifies instruments and activities that should contribute to produce concrete results in six areas. These are: 1) Science, research, innovation and technology; 2) Sustainable development, environment, climate changes, biodiversity, energy; 3) Regional integration and inter-connectivity to promote integration and social cohesion; 4) Migrations; 5) Education and jobs to promote integration and social cohesion; 6) The world problem with drugs.

The Madrid Action Plan was conceived as *a process to develop which results crucially depends on the implication of the countries in both regions*. The countries in the region have positioned themselves as coordinators or at the head of the line of the different axes: Argentina for axis 1, Costa Rica for axis 2, Venezuela for 3, Ecuador for 4, Peru for 5, and Colombia for 6. In addition, after the EU/LAC High Officials meeting of January 2011, the priorities, activities schedule, and the expected results from the different axes and work groups were defined.

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[35] See : http://www.eu2010.es/export/sites/presidencia/comun/descargas/Summit_UEALC/may18_actionES.pdf.

All axes have held meetings and carried out activities and shown great dynamism. For example, in the case of axis 1, with respect to science and technology, a new instrument baptized "EU/LAC Joint Initiative for Research and Innovation" has been launched, combining existing devices in both regions for the purpose of promoting synergies. A roadmap has been initiated and has been the topic of discussion in the meetings of the High Officials group of both regions. Within this framework, contacts have been made, networks established, and seminars and workshops organized regrouped as almost a dozen actions and initiatives:

-Establish a regular bi-regional dialogue about science, research, technology and innovation to consolidate EU-LAC cooperation, update common priorities, encourage mutual political learning, and insure the correct and effective implementation of cooperation instruments.

- Explore the possibility of carrying out joint projects with other institutions relating to issues having to do with innovation and knowledge, applied research, and innovative technology.

-Begin the development and the implementation of a new mechanism, the "EU-LAC Joint Initiative for Research and Innovation," which combines instruments at the national, regional, and bi-regional level, as the case me correspond, serving as a complementary function and taking advantage of synergies.

-Establish or strengthen thematic networks on issues that have already been agreed to and are of mutual interest, which could facilitate exchanges between universities and research centres of both regions, as well as networks of institutions from the private and public sector.

-Strengthen the integration of the two regions in the Information Society and support the development of the information and communications technology sector and reduce the digital gap and illiteracy by increasing the inter-connectivity between research and education networks within and between the EU and Latin America and the Caribbean in order to improve access and use of resources;

-Develop and intensify dialogue and cooperation about information societies, strategies, regulation models for the communication sector and in the audiovisual field;

-Develop an interface between research and innovation through a network of knowledge and innovation centres in order to facilitate social appropriation of knowledge and technology, especially keeping in mind micro and small-sized enterprises.

- Promote the expansion of scientific and technological cooperation in all the LAC sub-regions, as well as the adoption of innovative instruments to strengthen cooperation with especial attention being paid to countries with limited participation in Science and Technology cooperation between the EU and Latin America and the Caribbean;

- Promote cooperation to develop human and institutional capacity and promote the return of researchers to their home countries.

An equally high number of actions and initiatives are being implemented in the framework of the other axes of the Madrid Action Plan. *An integral evaluation of the progress of said plan is an essential requirement so that a common diagnostic will allow for the optimization of its results for the entire region.*

**3. Open up a sectoral dialogue in the macro-financial area aimed at reaching a consensus of positions on reforms of the international financial architecture**

This line of action, which has been introduced in previous SELA reports, has not been retained until now. Among other arguments, the one that is underlines is that this issue has been taken up at the G-20. The fact that the G-20 is working on this issue justifies the need to incorporate it in the agenda of the next Summit. The role of the G-20 would be reinforced if its four members from the EU and its three members from Latin America and the Caribbean had the possibility of being backed-up in certain issues by the whole group of the sixty countries from both regions. Leaving the G-20 to stand alone regarding this universal issue lowers the chance of moving forward in necessary reforms in a number of areas that are of mutual interest to the LAC/EU.

In a *first stage,* the idea would be to only use at the regional level of Latin America and the Caribbean, the network method of the high officials from the treasury, central banks, and macro-economists from existing regional/sub-regional organizations, in order to examine the risks that threaten Latin America and the Caribbean stemming from the already unleashed "war of the currencies." Depending on the results obtained, an effort would be made to define possible common stances and present them to EU experts. The *second stage,* invoking the formula approved at the Lima Summit (of 2008) of opening bi-regional sector dialogues, as well as, in response to the references specifically dealing with this issue presented in a Communiqué form the Commission to Parliament and the European Council of September 2009.

The ultimate goal of this second stage could seem a bit ambitious: *looking for common LAC/EU stances in view of a reform of the international monetary system.* However, the important thing here is not so much achieving the final goal, but to initiate this type of discussion with the EU stemming from concerns that affect the complete range of governments of both regions. And, by breeching a subject that is so systemic with the EU, this would generate the catalytic effect of having established *a previous cooperation dynamic* between the governments of Latin America and the Caribbean (despite their political divergence). The reason is simple: no Latin America and Caribbean country can have a decisive impact if they only express themselves in the international arena (even the three G-20 members from the region).

Therefore, Latin America and the Caribbean (thanks to the credibility they earned in matters of macroeconomic issues mainly from how these countries resisted the international crisis) would have to move forward and establish a position of consensus, which could be achieved at the Santiago Summit, given the severity of international monetary and financial problems. Despite the fact that of dealing with a multilateral issue (the reform of the International monetary system), the bi-regional Summit could become the appropriate place, in terms of a preparation stage, to achieve, first an intra-LAC dialogue, thereby creating *an accumulative process of reciprocal interests* in order to fence in positions due to the weight they carry; which in turn could attract the interest of the EU. This has an obvious interest, getting the backing (albeit minimum) of the 33 countries of the LAC region. This would then allow them to try to get the backing of Asia and Africa, in a progressive gravitational process, which would allow for a firmer advance towards the goal of an international reform of the financial and monetary architecture.

**4. Make strides towards the identification of sectors and activities most likely to attract investment for social inclusion and the preservation of the environment**

This line of action is indispensible considering that it is related to the *central topic of the Santiago Summit*: to foster "an alliance for the sustained development, from the specific area of promoting a type of investment focused on social and environmental qualities."

This topic also has to do with one of the dimensions of bi-regional relations, which, as we have seen, are very dynamic, mainly due to the European crisis that is pushing a number of companies to reinforce their presence in Latin America and the Caribbean in order to compensate for the negative effects of the climate of recession that looms over the Old Continent.

Within the framework of this dynamics, there exists a great potential for cooperation between the two regions with respect to this issue. *The Latin American and Caribbean region needs investments that promote production diversification,* so as to generate quality and well paying jobs in order to fight poverty and inequality, and allow for the appreciation of biodiversity without deteriorating it. Europe needs to promote investment, including the association among companies of both continents (not only the large European and LAC multinational ones, but also the small and medium-sized companies of both regions), which translates into the creation of jobs in European countries in order to kick-start economic growth.

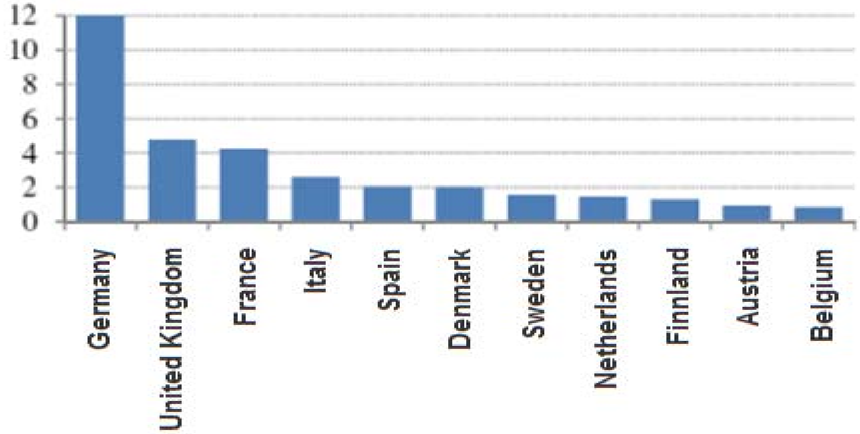
There is a wide range of possibilities to promote socially responsible investment and trade (generate jobs), environmentally, (low carbon emissions), and which allow for the sharing of economic progress (distributing profits from production), and this could contribute to reinforce the association of producers and researchers, the endeavours to promote companies and bi-regional initiatives and networks regarding issue such as state-of–the-art technology and sources of renewable energy.[36]

The interest of Latin America and the Caribbean to enter into a closer and more involved association with Europe on this plane is clear. Another reason to want this is that the European Union, since the year 2000, has been characterized for being the region in the world that generates the highest number of patents in environmental technologies.[37] (Chart 29)

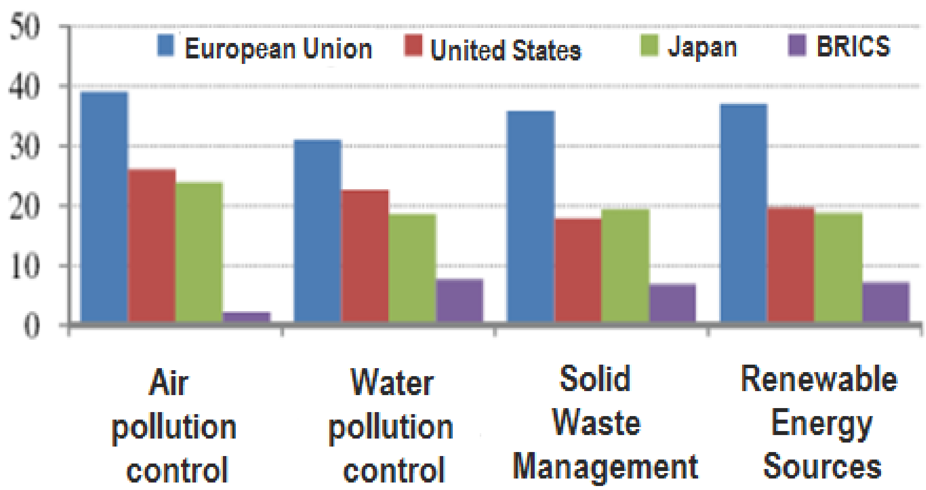
The region must make strides towards the identification of sectors and activities that are most likely to attract investment for sustainable development. There is an ongoing study by ECLAC that identifies relevant and positive investment opportunities, in tune with environmental issues, in the sectors of energy-infrastructure, hydrocarbons, mining and agro-industry, which must be considered a good place to start and base discussions, in order for all countries in the region to better prepare for the bi-regional Summit.

[36] Alicia Bárcena, «América Latina y el Caribe – Unión Europea: Inversiones para el crecimiento económico, la inclusión social y la responsabilidad ambiental», Presentation at the SOM CELAC/EU, Santa Cruz (Chile), 7 July 2012.
[37] Alicia Bárcena, op. cit.

**CHART 29**
**Main Innovative countries of the European Union: Participation in patents of environmental technologies**
*(Percentage of world total between 2004 and 2006)*




**The European Union, the United States, Japan and the BRICS countries: Participation in patents of environmental technologies**
*(Percentage of world total between 2004 and 2006)*




**5. Reinforce bi-regional relations in the areas of science and academics**

Bi-regional Summits have led the development of dynamic relations that go beyond governmental authorities. This is how spaces have been created and consolidated which allow for rapprochement, around the presidential Summit, of actors and instances of civil society, of the industrial sector of both continents, etc.

Within this framework, university sectors of both continents, with the support of the Chilean government, began to exchange ideas in 2010, with the aim of reinforcing academic and scientific community ties and joint actions. These contacts led to convening the first Europe/Latin America and the Caribbean Academic Summit that will be held in Santiago, Chile on 22 and 23 January 2013. With this event in mind, two preparatory seminars for the

Summit have been carried out, on 7 June 2012 in Paris and on 8 and 9 October 2012 in Lima).[38]

The pillars to reinforce bi-regional relations on this plane have deep historic roots. European and Latin American university systems have a long shared history of cooperation. Born in the beginnings of bi-regional relations, they share many traditions and values that serve as a base for their collaboration.

Not so long ago, after the first bi-regional Summit in Río de Janeiro in 1999, the first meeting of Ministers of Education from the European Union and Latin America and the Caribbean was held in Paris in 2000. Back then, education was considered a pillar of bi-regional relations, so that it would not only have trade, economic, and political dimensions, but also a cultural and intellectual one.

Afterwards, academic and scientific ties between both regions were reinforced and the countries of Latin America and the Caribbean followed with great interest the implications of the implications of the Bologna academic integration process and the achievements made in the construction of the European Space for Higher Education and its six main objectives:

1. Adopting an easy-to-read and comparable system for degrees
2. Adopting a system based on three cycles (bachelor's, master's and doctorate degrees)
3. Establishing an international system of credits: the European Credit Transfer System (ECTS)
4. Promoting the mobility of students, professors, researchers, administrative and service personnel, and overcoming the obstacles that make said mobility difficult
5. Promoting European cooperation in order to guarantee the quality of higher education
6. Promoting a European dimension of higher education.

Latin America and the Caribbean must strengthen the process of developing its human resources, and Europe can increase its participation in said process, in a mutually beneficial dynamic. The countries in the region must decidedly support the Academic Summit, which may constitute a decisive step towards entering a new stage of cooperation with respect to higher education. This new stage points to the establishment of "Trans-Atlantic Bologna," in other words, a LAC-EU academic space that builds common objectives and basic curriculum, favours the mobility of students, professors, and contributes to promote innovation and scientific and technological development.

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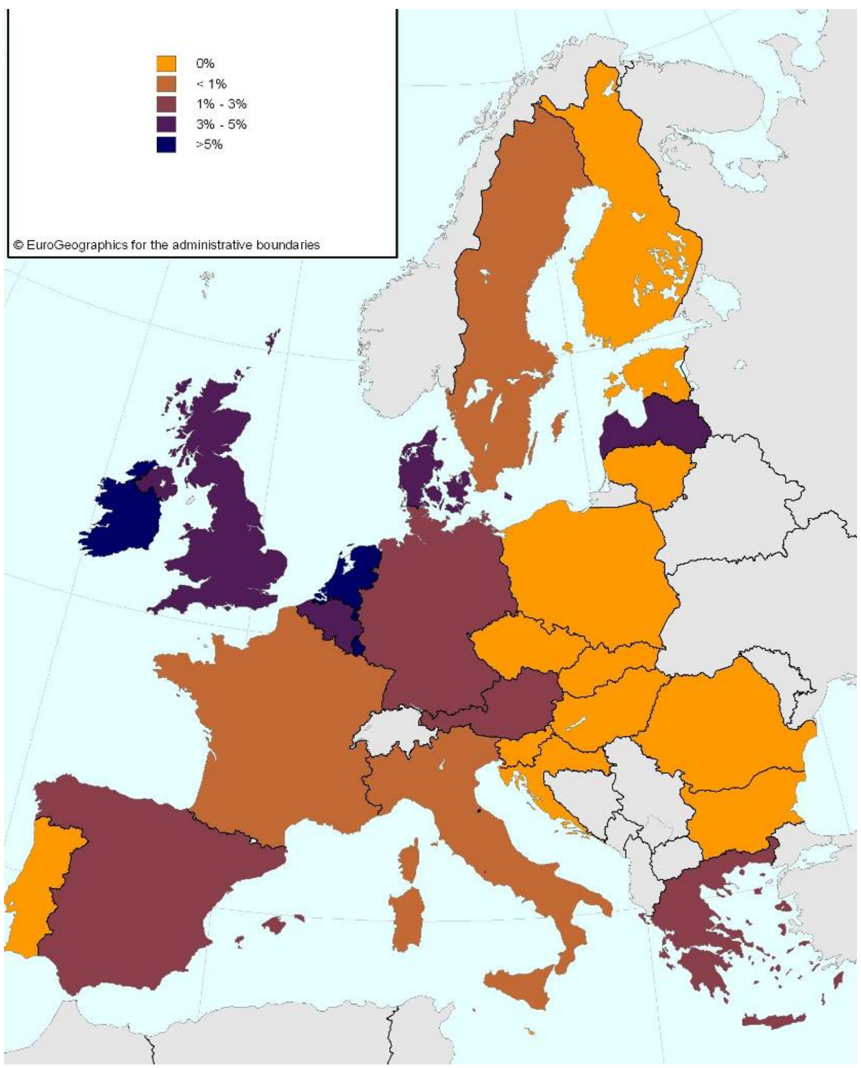
[38] About the preparation of the Academic Summit see: http://www.institutdesameriques.fr/page.jsp?id=87&mois=8&annee=2012&id_actu=271.

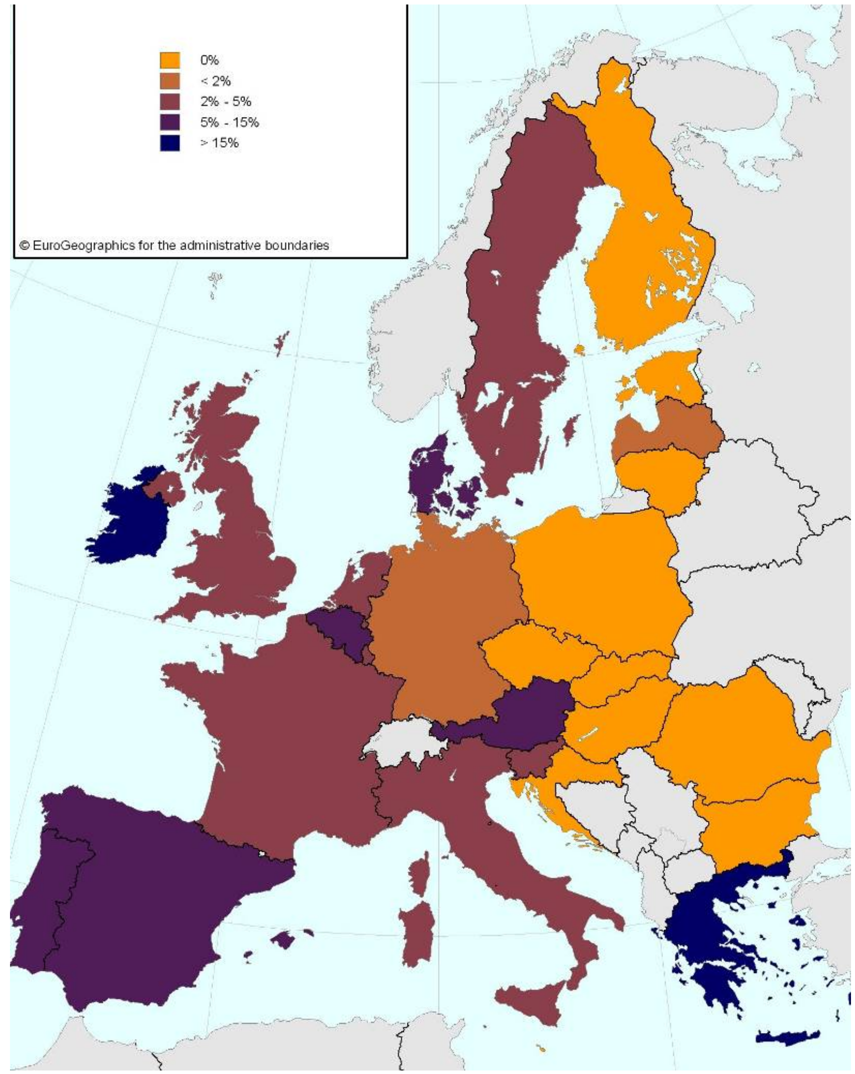
# *A N N E X E S*

| | BdP Instrument (Article 143 TFEU) | EFSM (Article 122(2) TFEU) | EFSF (7 June 2010) | ESM (July 2012) |
|---|---|---|---|---|
| **Possible beneficiaries** | MS outside the euro zone | All MS of the euro zone | All MS of the euro zone | All MS of the euro zone |
| **Legal basis** | Art. 143<br>Regulations of the Council | Art. 122 (Exceptional circumstances) | Inter-governmental decision | Inter-governmental decision |
| **Organization** | Community instrument | Community instrument | Private institution guaranteed by the MS of the euro zone | Inter-governmental organization based on a treaty |
| **Financial capacity** | € 50 billion | € 60 billion | € 440 billion | € 500 billion |
| **Instruments** | Loans, credit lines | Loans, credit lines | Loans, purchase of sovereign bonds in primary markets, preventive programs, bank recapitalizations, interventions in secondary markets | Loans, purchase of sovereign bonds in primary and secondary markets, preventive programs, bank recapitalizations |
| **Approval procedure** | The Community issues recommendations to the Council, which makes a decision by qualified majority. The Community negotiates the MoU, upon consultations with the Economic and Financial Council (EFC) | The Community issues recommendations to the Council, which makes a decision by qualified majority. The Community negotiates the MoU, upon consultations with the Economic and Financial Council (EFC) | The Community negotiates the MoU, based on the recommendations pursuant to Article 136. Disbursement decisions are made by the MS of the euro zone by unanimity | The Community negotiates the MoU, based on the recommendations pursuant to Article 136. The ESM management Committee approves the MoU. Disbursement decisions are made by the management Committee |
| **Mechanism** | The Community contracts loans on behalf of the EU | The Community contracts loans on behalf of the EU | The EFSF contracts loans | The EMS contracts loans |
| **Duration** | Permanent | Exceptional circumstances | Temporary, until mid-2013 | Permanent<br>In force since mid-2012 |

*Source: GGECFIN, European Commission*

**Support operations for the EU banking sector in % of GDP of each country (in capital and guarantees)**




**Capital Injection**

**State guarantees**