

# Implications of the euro for Latin America's financial and banking systems

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## Abstract

This paper explores the impact of the euro on Latin America. We disregard both trade and changes in optimal debt strategies as important transmission channels. However, we present evidence suggesting that capital flows into and out of Latin America may be influenced by movements in European interest rates to a far greater extent than previously expected. We conclude with a discussion of the implication of the euro for the Latin American banking system. We argue that the euro will accelerate the internationalization of banking in Latin American creating potential solvency problems during the transition which should be addressed through a tightening of prudential regulation. © 2000 Elsevier Science B.V. All rights reserved.

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## 1. Introduction

Monetary union in Europe is widely acknowledged to be one of the most important economic events of the century, likely to have a broad influence over financial and banking systems of participants and neighboring countries as well as across the world. Not surprisingly, a rapidly growing literature examines the real

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and financial impact of a decline in intra-EMU transaction costs, the elimination of exchange rate risk across EMU members, and greater competition on European markets as a whole. Similarly, although to a lesser extent, the political and economic consequences of the launching of EMU for developed European outsiders, non-European industrial economies, and European transition economies with increasingly tighter links to countries in the euro zone, have already been the subject of a number of studies. However, to our knowledge, no systematic analysis has been conducted on the effect of EMU on regions with fewer apparent links with Euroland.<sup>1</sup>

This applies to Latin American (LAC) countries and the reasons for this are manifold. On the one hand, real and financial links between Latin America and Europe are not so obvious as in the case of Eastern European economies, where intra-European trade accounts for more than half of the total, where exchange rate regimes, as well as financial intermediation in general, are typically tied to the Deutsche mark, and where in many cases stabilization experiments have depended in a significant way on the promise of future EMU membership. Nor are Latin American countries comparable to neighboring Mediterranean countries with substantial commercial ties with Europe, or to CFA countries that belong to a monetary system based on the use of the French franc.

Although LAC themselves display substantial heterogeneity that limits the analysis of the effects of EMU on the region as a whole, in general they present similarities in various fronts. Whereas they remain relatively closed in real terms, LAC are for the most part fairly open financially and, partly as a result, highly vulnerable to changes in the direction of international capital flows. Accordingly, the discussion of the influence of EMU should necessarily center on the financial channel, as opposed to the 'trade' channel.

An analysis of the financial channel should discuss the impact on debt service flows arising from changes in the euro exchange rate level and volatility. On this front, the relevant questions point at optimal debt composition. However, it also has to contemplate the effect of more liquid European financial markets that will derive in lower financial transaction costs and risks, as well as in a lesser scope for diversification. Will the former dominate the net effect, with Euroland becoming an attractor of international flows at the expense of other markets, or will investors favor reasonably developed emerging markets as a source of risk diversification?

Finally, in the context of globalized financial markets and open Latin American economies, increased financial competition in the Euro zone is likely to accelerate the trend towards banking consolidation and concentration, the impact of which is already being reflected by the ongoing process of internationalization of financial intermediation in Latin America. Thus, the launch of EMU brings to the forefront a number of important questions. What should be the position of local authorities regarding foreign participation in the banking sector? Is full internationalization of the banking industry à la New Zealand a blueprint for small economies in a world

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<sup>1</sup>An exception is Cohen (1999).

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