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The Euro and its Impact on International Economic Relations: Implications for Latin America and MERCOSUR

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Abstract

The creation of the Euro on January 1st 1999 is one of the major economic events of the end of the 20th century. The emergence of the European monetary union is likely produce significant transformations in international monetary and financial relationships. In the case of Latin America, the importance of the single European currency will depend mainly on the speed at which its financial links with the Euro-zone intensify. This paper studies the long-term implications of this process of intensification of the financial relationships between Europe and Latin America, with a particular view to the question of exchange rate regimes.

Keywords: monetary union, international economic relations, financial relationships, Euro, European Union, Latin America, MERCOSUR

Resumo

A criação do Euro em Janeiro de 1999 constitiu um dos maiores eventos económicos do fim do século XX. A emergência da União Monetária Europeia é capaz de produzir transformações fundamentais nas relações económicas e financeiras internacionais. No caso da América Latina, a importância da moeda única europeia dependerá sobretudo da velocidade à qual se intensifiquem as suas relações financeiras com a zona Euro. Este artigo estuda as implicações a largo prazo deste processo de intensificação das relações financeiras entre as duas regiões, com particular destaque para a questão dos regimes câmbiais.

Palavras-chave: união monetaria, relações económicas internacionais, relações financeiras, Euro, União Europeia, America Latina

Introduction

The creation of the Euro and its coming into force on January 1, 1999, completed by February 2002 with the physical introduction of the new notes and coins and the replacement of the national currencies in twelve countries of the European Union (so called “Euroland”), is one of the utmost economic landmarks in recent history. A decisive step of a long process of economic integration, the materialization of the European Monetary Union introduces important transformations in the international financial and monetary relations. The economic relevance of the Euro zone and the willingness of the authorities not to block the process of internationalization of the new currency let us speculate that the irruption of the Euro may generate important changes in the international monetary and financial levels.

Latin America is not the region with the strongest links with the Euro zone. In fact, the US dollar is the unquestionable reference currency in the area. However, the non trivial economic ties of many Latin-American countries with the Old World and the interest on the construction of the European Monetary Union constitute the grounds for a twofold discussion.

On the one hand, the European trajectory to the monetary union is, since long ago, a source of know-how for Latin America. Even when it is not possible to transplant the experience which is, to a great extent, unique, the analysis of the logical sequence followed and the convergence criteria adopted by Europe prove useful for the different Latin American country agreements (Capítulos del SELA, 1998; Giambiagi, 1999; Heymann, 1999; Irela, 1999; Levy Yeyati and Sturzenegger, 1999a; Zahler, 1999). The interest on the European Union (EU) integration process is reinforced now when the formerly dominant “one country, one currency” principle is being challenged (Alesina and Barro, 2000). However, the crisis affecting many Latin American (LA) countries makes it difficult to think that progress towards a monetary union can be accomplished in the short run.

On the other hand, the probable direct and indirect effects that the creation of the Euro may have on the international monetary and financial economic relations and their implications for Latin America have brought a growing interest. Nonetheless, the task of analyzing the future effects of the new European currency on other regions of the world in the median run is complex. These effects will depend on the intensity of the economic relations between EU and LA. In turn, the consequences that the Euro will have on EU countries are not easily foreseeable and will be key determinants of its degree of expansion in the world transactions (for instance, the effects of Euro on the development of financial markets in the Euro zone). Its impact on other economies will be a function of the process of internationalization of the new currency.

In a recent study conducted as part of ECLAC research projects (Miotti, Plihon and Quenan, 2002; Escaith and Quenan, 2003), this second dimension has been explored. It is worth pointing out that given the relative short existence of the Euro, the analysis of its implications for LA in the median and long run can only provide temporary results and is essentially based on hypothesis and conjectures which are to be adjusted with upcoming events.

In this presentation the main ideas of this study are resumed, emphasizing, in the final section, the implications for Mercosur member countries. The presentation is organized as follows: in the second (and next) part some theoretical aspects of the international use of currencies are briefly reviewed. In the third part the main factors which may enhance the process of internationalization of the Euro in the median and long run are presented. In the fourth section a balance of its first three years of existence is made. The implications for Latin America are put into evidence in the last section, together with some final thoughts for Mercosur.

A Typology of the International Use of Currencies: Theoretical Framework

The impact of the creation of the euro on international monetary relations will depend largely on the degree of internationalization of the European monetary unit. It is useful, therefore, to begin by distinguishing between the different private and public uses of currencies at an international level, and then present the conditions required to achieve the internationalization of a currency as they are formulated and analyzed in the economic literature. This will make it possible to use these analytical tools to evaluate the extent to which the euro is likely to become an internationally used currency.

On the basis of the typology proposed by Krugman (1991) and following the presentation made by Bénassy-Quéré, Mojon and Schor (1998), we can distinguish six types of international uses of a currency as a function of a twofold criterion: (1), the three traditional functions of currencies, and (2) the private and public use of currencies on an international scale (**table 1**).

Table 1: International uses of a currency

Function	Private use	Public use
Medium of exchange	Means of payment / vehicle currency	Intervention currency
Unit of account	Price-setting / invoicing currency	Reference currency (anchor)
Store of value	Investment and financing currency	Reserve currency

Source: Krugman (1991)

An international currency is used by non-residents as a medium of exchange in trade transactions and capital movements. Private agents use an international currency as a vehicle, i.e. as an intermediary between two second-ranking currencies. Thus, transactions between Brazil and Thailand are broken up into two separate moments: *real*/dollar and dollar/baht. In turn, monetary authorities also use international currencies as a medium of payment in their interventions in foreign-exchange markets.

Secondly, an international currency is used as a unit of account by private agents to invoice their trade or financial international transactions. This function is different from that of a medium of payment in the sense that one transaction can be denominated in one currency and then paid in another (distinction between invoicing currency and medium of payment). Monetary authorities also make use of the unit-of-account function in implementing their exchange policies when they decide to anchor their currencies to an international reference currency. This has to do with exchange system issues.

As a store of value, an international currency is used by private agents with the aim of preserving the value of their assets. They place their assets in different international currency denominations as part of their strategies to optimize their risk/yield ratio. In turn, monetary authorities manage the composition of their international reserves as a function both of their objective of optimizing their risk/yield ratio and of the nature of their interventions in the foreign-exchange market.

These different international uses of currencies are separable but interdependent. Schematically, the interaction between these different uses can move along various channels. For example, the decision adopted by the monetary authorities to give priority to certain currencies in the composition of international reserves (store-of-value function) can be conditioned in part by the choice of an anchoring mechanism with regard to these currencies (unit-of-account function).

Another channel has to do with transaction costs. If a currency is used as a vehicle currency, transaction costs are low and the monetary authorities will tend to use it in their interventions, while private investors will try to procure assets denominated in that currency.

The degree of use of an international currency by a country can be very different depending on the above-mentioned functions: thus, the dollar may be chosen as the anchor currency by monetary authorities due to the overwhelming weight of the U.S. financial markets, even though the trade transactions of that same country may be denominated in other currencies. Likewise, it is possible to consider these functions hierarchically, i.e., the international medium of payment function is frequently considered to be the most important. According to Bourguinat (1987), two criteria should be taken into account:

- Stability—predictability of the currency;
- Acceptability—liquidity: In order to be international, a currency must be universally accepted; it should be a "vehicle" currency, in the sense that it is used by other countries in transactions that do not involve a direct relationship with the issuing country.

Tavlas (1991) proposes two complementary criteria:

- The country issuing the international currency should have a major weight in international trade, thus reinforcing the use of this currency by the other countries.
- The country issuing the international currency should have free, broad and deep financial markets, thus guaranteeing the liquidity of the currency and making it possible for the currency to play a store-of-value role for private and public participants.

These conditions are necessary but not sufficient to explain the reasons why international operators tend to favor one currency as a key currency. Some authors emphasize the role of transaction costs, economy of scale phenomena, positive externalities (Kenen, 1992) and network effects (Aglietta & Deusy-Fournier, 1994). These approaches make it possible to demonstrate the existence of self-reinforcing and inertial processes in the international use of currencies. From this point of view, the progress of the euro as an international currency should be gradual. In other words, the dollar should maintain its supremacy for a long while yet.

The Internationalization of the Euro

The weight of the euro zone relative to the American and the Japanese economies is one the first empirical criterion to consider for the future role of the European currency in the international monetary system. If we compare the relative weights of the United States and the euro zone in the world economy, we can see that the euro zone has a greater weight in terms of population. At the same time, the weights of the euro zone and the United States are similar in terms of international trade, as shown in **table 2**.

Table 2: Weight of the United States and the euro zone in the world economy

	Population	GDP	Stock-market capitalisation		External openness
	(1)	(2)	(2)	% GDP	(3)
Euro Zone	302.80	5875.60	3709.80	56.80	19.00
United States	273.70	8590.10	11596.50	121.50	14.80
Japan	126.80	4223.20	2263.40	48.20	9.90

(1) Millions of inhabitants (2000) (2) Billions of dollars (2001)
(3) Exports/GDP in % (2000) *Source: World Bank, Eurostat, OECD*

On the other hand, if we adopt GDP and stock exchange capitalization as criteria, the weight of the U.S. is greater. These basic statistical data can lead us to consider that the euro has a strong potential to increase its share as an internationally used currency in the world economy.

Another relevant factor to be considered is the position of the European authorities with regard to the internationalization of the euro. Knowing that history and economic theory show that progress in the international use of a currency has to be gradual, the European officials are not actively seeking to promote the internationalization of the euro. Unlike Japan, however, which has also resisted internationalizing the use of the yen (because the Japanese consider that it might disrupt the behavior of their monetary policy), the European authorities do not oppose a growing internationalization of the euro. Their position is that the zone's strategy in terms of monetary policy is sufficiently strong to face the implications of an increasing internationalization of the Eurocurrency (Duisemberg, 2000). Their position is, therefore, "neutral", and this in fact favors an increasing international use of the euro.

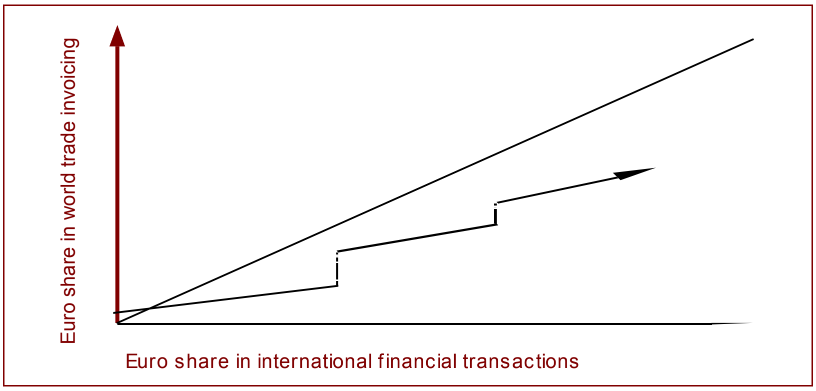
In this context, many authors expect a rise of the euro as an international currency. A majority of these studies emphasize that the financial role of the euro (that is to say, as a borrowing and lending currency) will develop much more rapidly than its international trade function (i.e. as an invoicing currency). Monetary history shows that the emergence of key currencies—i.e. internationally used currencies—is a slow process because they are subject to inertia of various sorts. The inertia is particularly strong with regard to the unit of account and medium-of-payment functions of the currency. Conversely, the internationalization of a reference currency can progress more rapidly when it is used in financial functions. In the case of the euro, this was observed in some analyses made before the Eurocurrency actually emerged. Several papers have highlighted the possibility of a greater use of the euro in financial operations as well as the impact this can have on the development of the IMS (Bergstein, 1997; Mc Cauley, 1997; Portes and Rey, 1998; Artus 2000a). A greater use of the euro by private agents in financing operations (investment and borrowing) could be the channel through which to progress toward an increasingly bipolar IMS. The first four years of existence of the euro appear to confirm these analyses. The initial stage of the new currency has been characterized by a significant expansion of euro-denominated international bond issues and the emergence of the Eurocurrency as a borrowing currency (Detken and Hartmann, 2000; BCE, 2000; BIS, 2000; BIS 2001; Galati and Tsatsaronis, 2001).

On the other hand, some authors indicate that the progress of the "trade" euro might occur in "steps", with qualitative leaps, that should quicken the internationalization of the Eurocurrency (de Boissieu, 2000) (**figure 1**). The same authors, however, also argue that an excessive delay in the development of the trade function of the euro could work against the establishment of its financial role: a "complete" international currency should not be subject to excessive or too protracted a divergence between its financial and trade roles.

With regard to the evolution of the IMS in the medium to long term, it is possible to distinguish at least three scenarios (Miotti, Plihon and Quenan, 2002). The first is an IMS that will long continue to be dominated by the dollar, which implies that the initial progress observed in terms of the financial function of the euro will be followed by back sliding and that the eurocurrency will fail to win definitive acceptance on that role. Second is the exact opposite scenario: the financial function of the euro becomes firmer and its trade role develops at a faster than expected rate. This would lead to an increasingly symmetrical dollar-euro duopoly. The last and seemingly most plausible scenario, taking into account the first steps of the euro in the international arena and the teachings of economic theory, is a duopoly that gradually decreases in asymmetry. A slow but growing bipolarization of the IMS, however, also entails the development of the Euro's role as an anchor currency in the exchange systems of other countries.

Within the framework of this most likely scenario, it seems clear that the volatility of the dollar-euro exchange rate is unlikely to decrease. On the contrary, as suggested by theoreticians on the role of leadership (such as Kindleberger), asymmetry and the existence of a clearly hegemonic currency are conditions that favor stability. Historic experience shows that the co-existence of two dominant currencies (as occurred with the pound and the dollar in the 1930s) can be a destabilizing element and lead to unfavorable effects in third countries.

Figure 1: Theoretical path of the internationalisation of the euro



Source: de Boissieu (2000)

The Development of Euro as a Financing Currency

When the euro officially appeared on the scene, the dollar was by far the dominant international currency. The dollar is still, in fact, the most widely used medium of payment, and represents a decisive proportion (around 50%) of all transactions in the foreign-exchange markets.

With regard to invoicing of trade transactions, the dollar also plays a decisive role, representing around 45% of the total. Although the differences are less relevant if we consider the financial roles of the currencies, the dollar was also dominant on this level at the time the euro was introduced. Prior to the creation of the euro, 56% of all international bonds issues were denominated in dollars, while the eurocurrency share (i.e., the total of all its component currencies) was 36%, taking an average for the 1996-1998 period.

The creation of the euro has had two direct and immediate positive effects on the capital markets in Europe: (1) it has put an end to the fragmentation of national markets; (2) it has eliminated the exchange-rate risk between the European currencies.

The different components of the euro zone's financial market—the money and foreign-exchange markets, the stock market and the bond market—have been affected by the creation of the eurocurrency in 1999. Up to now, the private-sector bond market has been by far the most dynamic (BCE, 2000).

Four main factors explain the vitality of the bond market in euros:

1. The fall in financial intermediation: euro-zone companies are increasingly using the bonds market to get into debt, hence a reduction in financing through bank loans (disintermediation). The financial structures of the euro zone companies, increasingly reliant on direct financing, are approaching that of the Anglo-Saxon countries.

2. The scale of corporate restructuring: these operations (mergers, acquisitions, etc.) involved a strong demand for private corporate funds that was satisfied in large measure by the issuance of bonds denominated in euros, in amounts unprecedented in the history of the European financial markets. Mergers and acquisition: involving companies with head offices or target companies located in the euro zone have risen strongly in the last two years

3. The dynamic role of investors, which becomes manifest in two ways: First, foreign investors (mainly U.S. and Asian) have increased their presence in the euro zone markets to take advantage of its development. Second, the euro-zone is experiencing an increase in the combined amount of savings managed by institutional investors (mutual funds, pension funds, insurance companies). This results in a growing demand for investments in the form of securities negotiable in euros. In principle, investors want to diversify. Here, the prospects offered by the European markets are contradictory: the creation of a unified financial and monetary space eliminates the possibility of diversifying by country. However, the recent development of new segments of the euro-markets—in particular high-yield, high-risk debts—contributes to opening up an array of options for investors. Another important factor for foreign investors is the matter of the correlation of asset yields in euros and dollars. If we consider what has been

suggested in numerous recent studies, this could lead to greater synchronization of the economic cycles between the U.S. and Europe.

4. Finally, the emergence of new instruments and segments contributes to vitalize the bond market. This is the case of the high-yield bond market (i.e., bonds issued by establishments that have low agency ratings), reinforced by an increase in merger-acquisition operations and by the demand for high-yield bonds by institutional investors. This market, which is also open to relatively modest-sized companies, has a considerable development potential (its weight is significantly lower than that of U.S. markets with similar characteristics).

But the euro is not yet a currency of investors. In the last years the dollar represented over 60% of the international reserves of central banks, against slightly over 12% in the case of the euro (the yen was a distant third, with only 5% of the total). The hegemony of the U.S. currency has become even stronger in the last few years, representing almost 70% of international reserves in 2000, against the Euro's slightly over 11%.

Implications for Latin America and Mercosur

As it has already been mentioned, the effects of the Euro on the different regions of the world (and specifically on LA and Mercosur) will depend on the reach and scope of its internationalization process. Likewise, these effects will rely on the intensity of the economic relations between Europe and Latin America. Before referring to the MERCOSUR we present the main conclusions for LA of Miotti et al. (2002).

Regarding trade, the European Union is an important partner of Latin America but its relative importance has diminished throughout the decade of 1990 and its participation in Latin-American foreign trade is still considerably below that of US. In fact, the trade channel should not be expected to become the key element of the impact of the Euro on the UE-AL relations. Additionally, as some authors have pointed out, the changes generated by the variation of real exchange rates, by the reduction of transaction costs and by the fluctuation of output of European countries may not have a significant effect on Latin America growth rate due to the low degree of trade openness of a considerable fraction of LA countries, and, in particular, of those showing the strongest commercial links with the Euro zone (Levy Yeyati and Sturzenegger, 1998b).

On the contrary, the UE-AL financial relations have experienced a marked strengthening during the same years. There exists widespread consensus on the fact that the influence of the Euro on LA will be much stronger through the financial channels. One of the more relevant aspects of the intensification of these relations is the expansion of bank loans from Europe to LA. In the context of European banks' geographical diversification strategy, this expansion came along with the sudden increase of foreign direct investment. The banking channel could favor an increase of the international use of the Euro. So far, the main part of international loans has been issued in US dollars. However, the articulation between bank funding and FDI originated in Europe could also lead to a broad use of the Euro. An extensive use of the European currency as mean of exchange between main branches and their subsidiaries and an increase in Euro-denominated loans could be expected, leading to a reduction of exchange rate risk both for banks and firms.

The intensification of the financial links between Europe and Latin America, which may generate better opportunities to attract resources, has led to a sustained increase in the proportion of Euro-denominated bonds, mainly from the LA public sector. This is one of the distinctive features of the dynamics of the UE-AL relations along the 90's. On the contrary, the issuing of Euro-denominated bonds from the private sector is still small, despite a noticeable increase in 1999 and 2000. The rise of Euro-denominated obligations has several important consequences. Firstly, it favors an increase in liquidity and deepness of Euro-denominated emerging market obligations; however, this process is just beginning. Secondly, the increasing weight of debt issued in Euros calls for the definition of a debt policy for each currency. In the cited study we explored the plausible outcomes of the introduction of the Euro for the function of money as unit of account (public use), that is, as reference or anchorage currency. For this reason the de facto determination of monetary anchorages (as opposed to official anchorages, that is, those published by the IMF in the Annual Report on Exchange Arrangements and Exchange Restrictions) was studied in first place. Following the approach presented by Bénassy-Quéré and Coeuré (2000), we showed some results about de facto exchange regimes applying the generalized method of moments to estimate a model using weekly data for 111 implicit anchorages before and after the financial crisis of 1997 and 1998.

Next, we studied the real and financial determinants of the decisions developing countries made regarding de facto anchorages. For this we performed an econometric analysis for 93 developing economies. Table 3 shows the correlations between anchorage coefficients and trade, financial and geographical variables.[1]

From Table 3 it can be seen that the anchorage coefficients are correlated with the trade and financial variables. The use of the Euro as de facto anchorage currency is significantly correlated with its use as debt-denomination currency (0.197) and with the geographical structure of foreign trade (0.458), that is, the cases in which Europe is the main buyer and lender vis-à-vis the considered countries. Consequently, it should not be surprising to verify that (Central, Eastern and Southern) European countries together with the African economies belonging to the French Franc zone have a strong correlation with the use of the Euro as anchorage currency (either as unique currency or as main currency in a basket).

This econometric study, completed with a typology of the countries and an exploration of the channels for the generalization of the use of the Euro as anchorage currency in Latin America, leads to the following conclusion: the analysis of the generalization of the use of reference currencies as anchorage currencies shows that the higher the proportion of foreign debt denominated in Euros, the lower the probability of fixing a national currency to the US dollar. If LA economies continue to increase their debt in Euros and if this leads to a greater diversification of their foreign reserves, some of them may consider the introduction of the Euro within the anchorage currency basket. However, the US dollar should maintain a prevailing position given its main role in the region. The consequences in the median and long runs in terms of monetary regimes should be reconsidered in the context of the new international situation. The factors which seem to favor the setting of an anchorage based on a currency basket, at least for some of the LA countries, could be enhanced by the international scenario in the median run, the main focus of this presentation. An increasingly bipolar but asymmetric SMI assumes the existence of a high volatility between the dollar and the Euro. In these circumstances, a dollar-centered anchorage, which in principle generates

[1] The anchorage coefficients are taken from Bénassy-Quéré and Coeuré (2000). The following binary variables were added: Dolbin=1 if the coefficient is equal or greater to 0.5 and Dolbin=0 otherwise; Eurobin=1 if the coefficient is equal or greater to 0.3; Yenbin=1 if the coefficient is equal or greater to 0.1; the dummy variable “petroleros” refers to the countries for which oil exports exceed 10% of total exports; Dolarizados=1 for the economies with a high participation of US Dollar in M1, according to IMF classification. Geographical distance between ports or capital cities is measured in km.

important gains in terms of credibility, could prove to be counterproductive for those countries with strong financial and commercial relations with the Euro zone.

Table 3: Trade, debt and de-facto anchoring arrangements

Correlation table

	Dollar	Euro	Yen	Dolbin	Eurobin	Yenbin
Dollar	1.000	-0.969	-0.612	0.911	-0.937	-0.589
Euro	-0.969	1.000	0.396	-0.859	0.884	0.393
Yen	-0.612	0.396	1.000	-0.634	0.649	0.927
Dolbin	0.911	-0.859	-0.634	1.000	-0.865	-0.602
Eurobin	-0.937	0.884	0.649	-0.865	1.000	0.652
Yenbin	-0.589	0.393	0.927	-0.602	0.652	1.000
Debt structure by currency						
In Dollars	0.019	-0.044	0.069	-0.032	-0.021	0.096
In Euros	**-0.272**	**0.197**	**0.378**	**-0.356**	**0.292**	**0.350**
In Yens	**0.205**	**-0.144**	**-0.292**	**0.213**	**-0.142**	**-0.251**
Degree of dollarisation of the economies						
Dollarised	0.089	-0.016	**-0.276**	**0.166**	**-0.154**	**-0.206**
Oil exports						
Oil-exporting	**0.140**	**-0.129**	-0.104	**0.144**	**-0.202**	**-0.155**
Foreign trade structure						
With United States	**0.355**	**-0.352**	**-0.195**	**0.370**	**-0.371**	**-0.198**
With Japan	**0.251**	**-0.240**	**-0.164**	**0.226**	**-0.222**	**-0.178**
With Europe	**-0.451**	**0.458**	**0.211**	**-0.465**	**0.439**	**0.159**

Geography and anchoring arrangements

Correlations table

	Dollar	Euro	Yen	Dolbin	Eurobin	Yenbin
Geographic distances						
kmUS	0.017	-0.019	-0.005	-0.032	0.020	-0.043
kmJapan	-0.089	0.017	**0.274**	**-0.143**	0.092	**0.241**
kmEurope	**0.446**	**-0.468**	**-0.162**	**0.454**	**-0.415**	**-0.174**
Geographic areas						
LATIN AMERICA	**0.341**	**-0.331**	**-0.208**	**0.398**	**-0.360**	**-0.179**
CENTRAL	**0.202**	**-0.199**	**-0.112**	**0.276**	**-0.195**	-0.032
SOUTH	**0.245**	**-0.234**	**-0.162**	**0.240**	**-0.278**	**-0.210**
ASIA	**0.312**	**-0.284**	**-0.252**	**0.299**	**-0.287**	**-0.261**
MIDDLE EAST	**0.153**	**-0.132**	**-0.146**	**0.139**	**-0.161**	**-0.122**
EUROPE	**-0.358**	**0.456**	**-0.127**	**-0.209**	**0.273**	-0.087
AFRICA	**-0.364**	**0.253**	**0.539**	**-0.506**	**0.424**	**0.481**
AFRICA-CFA	**-0.532**	**0.365**	**0.805**	**-0.668**	**0.578**	**0.765**
AFRICA-NCFA	0.047	-0.029	-0.085	0.001	-0.017	**-0.118**

Sources: Trade: DOTS-IMF (2000), Debt: World Bank (WDI 2000), Dollarisation: IMF 174 (1998), Exchange arrangements: Bénassy-Quéré (2000)

Notes: Figures in boldface indicate statistically significant correlations

CFA: CFA franc zone CNFA: other African countries

The countries forming Mercosur have intensified the financial links with Europe throughout the decade of 1990. Additionally, the Euro zone is an important trade partner (22%/23% of total imports and exports, including Chile and Bolivia). It can be argued that Mercosur members rank first among those economies which may consider the possibility of fixing the exchange rate to the value of a basket including the Euro. This point may also be considered from the perspective of the coordination of macroeconomic policies, as long as one of its objectives is the reduction of exchange rate volatility among member countries and between them and the rest of the world.

Before undertaking a coordination policy scheme it is absolutely necessary to regain the economic stability for the region – in special for the two main members – and then, to generate a new – and realistic – regional agenda. For the present, the continuation of the crisis stresses some tendencies with negative effects on the economic relations between EU and LA.

The recent evolution of the financial relations let us pose some questions. The first one refers to the reversion of the dynamism observed during the 90's. In a situation of a general reduction of international investment flows to the area, the FDI coming from Europe to LA is now lower than in the past decade. The crisis in the Mercosur member countries, especially in Argentina, strengthens this tendency.

Secondly, in a context of gloomy perspectives for the world economy and growing risk aversion, investors' decaying interest on Latin America has led to a decrease in the international issuing of financial obligations from this region. The significant drop in the issuing of bonds started in 2000 coexists with an even higher reduction of Euro-denominated debt, reflecting the rate differential with the US Dollar (Escaith and Quenan, 2003) which had benefit the Euro until 1999, disappearing in 2001.

Additionally, even when the FDI made by European firms in Mercosur may have positive consequences on trade volumes, it is not possible to foresee an improvement in the commercial relations between the two regions in the short run. In contrast with Mexico and Chile, which have signed free trade and cooperation agreements with the EU, the negotiation process between EU and Mercosur are to be more sluggish and difficult.

In a nutshell, the importance of the European unique currency for Mercosur will depend on the speed of development of trade and financial links between the two areas. Many important factors (discouraging international situation, investors' growing risk aversion, present situation and expectations in terms of financial costs and Euro exchange rate risk, EU own priorities, crisis of Mercosur, difficult negotiations) have a negative effect, in the short run, on the intensification of the economic relations between EU and Mercosur.

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