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Thinking ahead for Europe

Brazil and the EU in the Global Economy

Daniel Gros, Cinzia Alcidi and Alessandro Giovannini

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Abstract

The structure of the world economy has been changing quickly during the last decade. The emerging global economy is much more fragmented than in the past and characterised by different global actors, each one with specific features and roles. In this setting, both Brazil and the European Union play role.

This paper, without pretending to provide a full analysis of the European and Brazilian economies, offers a description of their main international economic features to understand their current and future role in the global order.

Section 1 looks at the macroeconomics: it first focuses on Brazil and assesses arguments that international exchange rate misalignments represent a real grievance for Brazilian policy-makers in their struggle to get the economy onto a satisfactory trajectory. The attention is then turned to Europe, and especially to the euro area, with a focus on the still-unresolved crisis and its position vis-à-vis the rest of the world.

Section 2 analyses the place of the euro area in the international financial institution system. It assesses how far it may be both overrepresented in terms of the weight of the sum of its member states, while being underrepresented as such institutionally as a major monetary union. While this issue may be seen as relevant only for Europe, the analysis shows that it has significant implications for emerging economies, Brazil included.

The conclusions explore macro-policy options for improving the EU-Brazil partnership and suggest that a new initiative launched by them would be economically desirable.

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1. The macroeconomics of Brazil and the EU in the global economy

Over the last ten years, Brazil and other developing countries (notably the BRICs club – Brazil, Russia, India and China) have been attracting growing attention as a consequence of their rising role in global trade and financial transactions as well as the expectations that sustained future growth would that ensure that this trend would continue or even increase in the future.

However, when it comes to the macroeconomic indicators, it emerges that Brazil is a relatively closed economy. The share of trade, both exports and imports, in the economy is remarkable low compared to other, much larger economies, such as the euro area or China. Current data suggest that Brazil is even less open than the US, which is usually characterised as a large closed economy. On the other hand, interestingly, Brazil seems to be relatively more open on the financial account: indeed, since 2000, Brazil has received a substantial amount of foreign direct investment (FDI) that is likely to have contributed to growth. Comparing the relative size of its trade and financial accounts, Brazil emerges as pursuing the opposite of the 'new Washington consensus' approach, according to which trade liberalisation should come before financial liberalisation. Indeed there is no assertive prescription about full financial opening for emerging market economies.

When it comes to Europe, the main element currently able to determine its role in the global economy is certainly represented by its still-unresolved sovereign debt crisis in the eurozone: there is no doubt that it has significantly impacted growth and unemployment of the entire region, and this is expected to continue for quite some time. It is less clear whether the impact has been significant also on the rest of the world and on Brazil in particular. Indeed, on the one hand, international trade recorded its largest fall in 2009, mainly driven by the post–Lehman crisis rather than by the debt crisis in the euro area. As will be shown later, Brazil's exports to the EU, as a share of the total exports, have been on a declining trend for years and it is difficult to isolate the effect of the crisis, but in level terms they have been increasing in 2010 and 2011, after the trough of 2009. Similar arguments hold for FDI, there is no evidence in the data to suggest that the crisis had an impact on on-going trends.

1.1 Brazil compared with the other major global economies

Together with China, India and Russia, Brazil is deemed to be part of the group of emerging, newly advanced economies that will represent in the future the largest share of the world's GDP, as opposed to the G7. Despite the prominence now being given to the BRIC as a group, these economies are very heterogeneous in terms of size of population and GDP (see Table 1), while Brazil seems to display high specificities.

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The authors express gratitude to Michael Emerson for insightful comments.

Table 1. Comparative figures in 2010

	Population (millions)	GDP ($ trillion)	Openness*	Average tariff rates
Brazil	193	2.14	23	13.4
Russia	143	1.49	51	8.1
India	1,191	1.68	50	11.5
China	1,341	5.93	57	7.7
Euro area	332	12.21	45	1.9
US	310	14.45	29	2.9

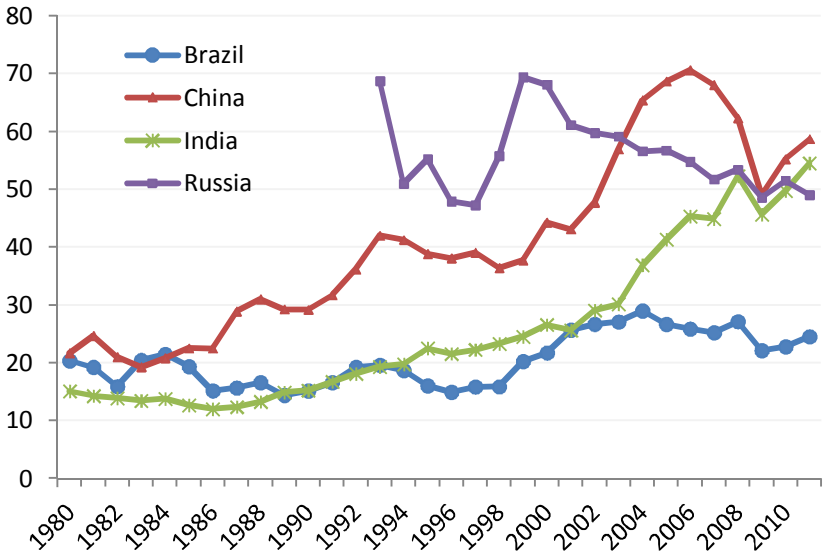
* Openness is measured as the sum of imported and exported goods and services as a percentage of GDP.

Source: World Bank Indicators, IMF (WEO) and Eurostat for euro area openness indicators.

A relatively closed economy

Table 1 is indeed quite revealing for assessing Brazil's role in the global economy. The country emerges as a relatively closed economy, even if compared to the others, which have a much larger GDP, like the US. This feature is even more striking if compared to the other BRIC economies which appear as very open and (for China and India) exhibit an increasing opening trend over time (see Figure 1).

Figure 1. Trends in openness in the BRICs



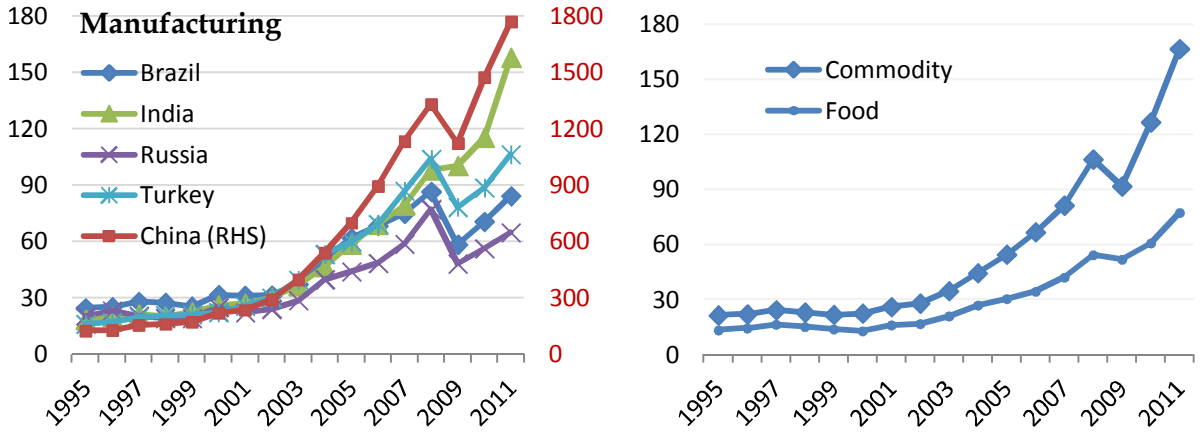
Note: As above, openness is measured as the sum of imported and exported goods and services as a percentage of GDP.

Source: World Bank Indicators.

As illustrated in Figure 1, despite a similar starting point, Brazil experienced a completely different path in connecting its economy to the global trade system, especially in the last ten years during which its trade openness index has showed a slightly declining trend. Brazil is rather special within the group also with respect to its import tariffs, which on average are higher than all the other countries in the table. The current rate is even higher than in India, which has a strong record of trade protectionism.

Against this background, it is valid to wonder to what extent trade can be expected to work as a growth engine for Brazil, under the existing conditions. To get a better grasp of the role of the exports in the economy, one should look at the relative size of export goods.

Figure 2. Manufacturing exports (LHS): Brazil commodity and food exports (RHS) ($ billion)



Note: Commodities also include food items.

Source: UNCTAD, merchandise trade matrix.

Figure 2 (LHS), which shows the amount of manufacturing exports of the BRIC countries and Turkey,[1] suggests that the levels for Brazil, India, Russia and Turkey were very close until 2001 (China, which on a different scale, was already almost ten times larger), but that patterns then started to diverge. If one excludes Russia, whose trade patterns (surpluses) are largely dependent on exports of natural resources with manufacturing accounting for less than 15% of total exports (in 2011), Brazil is the country with the smallest progress achieved during the last decade in terms of an increase in manufacturing exports. In fact, relative to total exports, the share of manufacturing goods has declined by more than 50% since 2000, reaching now only 33% of the total in 2011.

It is often argued that while Brazil has weak performance as a manufacturing exporter, it is a champion in the export of agricultural goods. Data confirm that in relative terms, Brazil has the largest export values among the BRIC. However, as shown in Figure 2 (RHS), in terms of value, the amount of such exports is even smaller than manufacturing exports. In fact, what the figure highlights is the impressive rise in commodity exports, which at the end of 2011 represented about 65% of total exports. While commodity-driven exports usually deliver large benefits, these tend to be temporary and unsustainable. When the ongoing 'commodity super-cycle' ends, the Brazilian economy may be severely hurt and find it difficult to create alternative sources of growth.

A trade closure resulting from deliberate policies

Overall the main problem with trade in Brazil can be ascribed to the existence of high tariffs on imports. While this form of protectionism usually aims at protecting the national industry from external competition, it may in fact result in a policy that is harmful for domestic industry. The main argument to support this assertion reads as follows. In a general equilibrium framework, an import tariff is equivalent to an export tax, where equivalence means that an import tariff has the same effect on the terms of trade as an export tax of the same rate (see among others Gros, 1987). The argument is based on the proof that an export tax does not affect the elasticity of demand; as in the same way a (uniform *ad valorem*) import tariff does not affect the price elasticity of domestic demand for importable goods. This implies that the international equilibrium conditions for consumers at home and abroad as

[1] We added Turkey because the pattern of manufacturing exports for the country and the BRICs has been almost identical in level terms between 1995 and 2006 (despite the size of the country); after that Turkey outperformed Brazil.

well as the trade balance supported by an export tax or an import tariff are basically the same. The main differences will materialise in terms of wages and tax revenues.

This relative closure in trade poses the question how such a marked feature of the country fits into the debate about the US as a currency manipulator, through multiple rounds of quantitative easing put in place by the Federal Reserve, vis-à-vis emerging market economies, and Brazil in particular. While it is true that US expansionary monetary policy is likely to engender upward pressure on Brazil's currency and an appreciating currency affects the competitiveness of the country, this is unlikely to be the central issue for a rather closed economy. In particular, under these circumstances, on the one hand, it is dubious that currency appreciation makes the country significantly worse off and, on the other hand, it is unlikely that a weak currency (achieved either by foreign exchange market intervention or capital controls) can boost the economy considerably. One key reason for the low weight of trade in the Brazilian economy lies in the relatively high tariff rates the country still applies. As already argued, this not only affects trade openness through imports but also through exports.

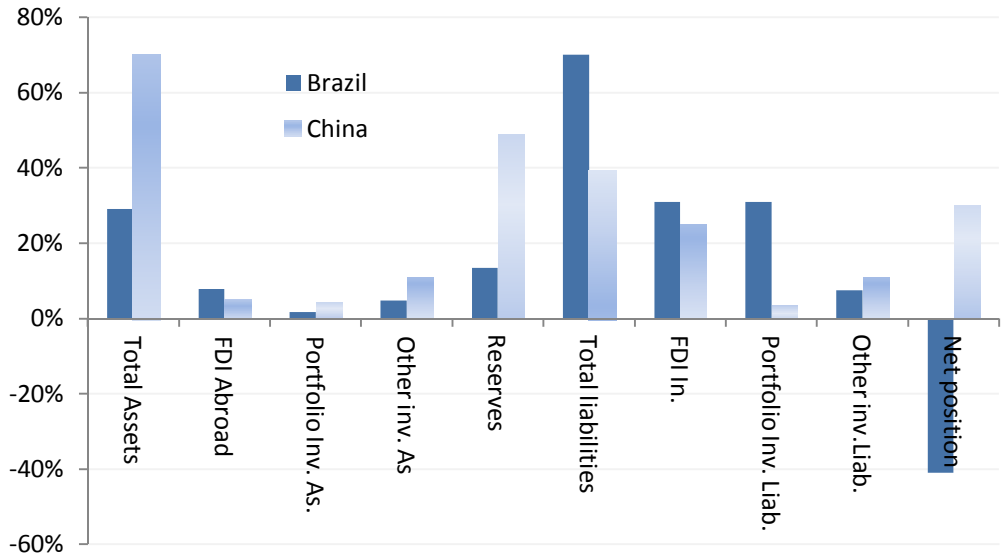
Following this argument, in order to boost trade and then growth, Brazil should consider reducing import tariffs rather than focusing on policies aiming at external devaluation, which is likely to have only a limited effect on the real economy.

The financial account: A negative external position as a source of economic growth?

When moving to the analysis of the financial account, a rather different picture of Brazil emerges. Indeed, in contrast with trade, the country appears rather open to financial flows. In what follows we focus on stocks rather than flows in order to provide a static picture of the country, relative to China: it emerges how Brazil's current negative international investment position (IIP) is the result of about one decade of growing financial inflows coming from the rest of the world, looking for profitable investment opportunities in the country.

Figure 3 shows the main items of the IIP of China and Brazil in 2010. While both countries share the appellation of emerging market economy, they appear different in many respects.

Figure 3. China vs. Brazil: international investment position (IIP) in selected items as % of GDP (2010)



Source: IMF, International Financial Statistics.

The first difference relates to the net position, which is positive and very large for China (30% of GDP), while negative and very large for Brazil (41% of GDP). This negative net position is the result of little gross assets, with about half of them represented by reserves and another third by FDI, and large gross liabilities (70% of GDP). The latter, in terms of GDP, are much larger than in the case of China.

However, the distribution of liabilities between debt and equity is rather similar. Combining portfolio equity and FDI, on the one hand, and portfolio debt and investment debt, on the other, delivers a proportion of about 3 to 1 in both cases, with each class larger for Brazil than for China.

Overall, this suggests that while Brazil manages to attract international investors in a long-term perspective in the form of FDI, the country is also accumulating debt through portfolio borrowing. To some extent this is consistent with the features of an emerging economy: a know-how-poor country is expected to be an importer of capital to develop production processes, which implies current account deficits, ideally funded through FDI. Furthermore, underdeveloped or repressed financial markets make it necessary to rely on external funding. When considering the flows behind Figure 3, it also emerges how, after 2000, Brazil has received a substantial amount of FDI, most likely facilitated by the cheap money the US Federal Reserve injected into its economy. In reality, given the features of the Brazilian economy, FDI is likely to have had stronger impact on growth than currency devaluation. Yet, the problem of Brazil is that its current account deficits have been larger than the FDI inflows, implying that the country has been accumulating a substantial amount of external debt. The cumulated current account balances over the last 30 years, which provide an approximate measure of the net external debt of the country, delivers a negative position of close to $300 billion, i.e. 15% of GDP.[2] This trend, if it continues, may become a significant source of vulnerability, especially if combined with the fact that exports are largely dependent on commodities.

Another specific problem with FDI in Brazil is related to the fact that it is a closed economy. Indeed, there is a question of whether it is good for a country to open up to financial flows when the real economy is closed and distorted, as is the case in Brazil. Under these conditions, the most likely outcome is that resources are allocated in the most protected sectors and not necessarily the most productive ones, feeding a rent-seeking system, which is unable to ensure sustainable growth. If this is the case, Brazil may be fated to end up in a different category than the rest of the BRICs.

1.2 Europe in the midst of crisis

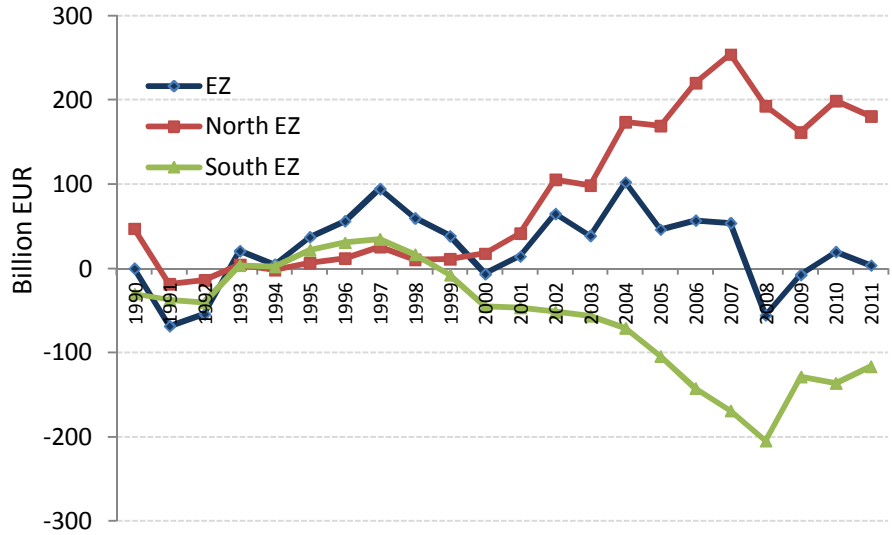
To address the question of the existing and future role of the EU in the global economy, the consideration of the still-ongoing euro-area crisis is central. To put it simply, this crisis has been the result of two interdependent economic problems: i) persistent macroeconomic imbalances within the monetary union, despite a balanced external position of the area as a whole; and ii) the increase in public debt in peripheral countries driven by country-specific financial weaknesses and/or structural problems in the competitive structure of the economy. The Greek crisis, with its surge in interest rates demanded for sovereign bonds and, subsequently, the spread of similar problems to other peripheral countries, has placed the emphasis mainly on the second element at the expense of the former. However, the correction of internal macroeconomic imbalances is fundamental to the resolution of the crisis.

[2] While this may sound low by European standards, one should not forget that when Argentina defaulted in 2001 it had zero external debt.

External balance at the price of internal imbalances

Europe has almost systematically remained out of the debate on the global imbalances throughout the financial crisis. The main reason for this has been that Europe (and there is little difference here between the euro area and the EU-27), has almost always displayed a rather balanced position vis-à-vis the rest of the world (see Figure 4). This has been in sharp contrast with the US and China, which have exhibited persistent and growing deficits and surpluses, respectively.

Figure 4. North-South savings gap in the eurozone (EZ)



Note: North EZ includes Austria, Germany, Belgium, Luxembourg, the Netherlands and Finland; South EZ includes Greece, Italy, Spain, Ireland, Malta, Cyprus and Portugal. France is left deliberately out of the sub-grouping, as it does not display the features of either the north or the south.

The north EZ and south EZ are computed as the simple sum of current account balances of each country vis-à-vis the rest of the world. This implies that intra-area trade is included.

Source: Own calculations based on European Commission Services (Ameco) data.

An almost balanced position makes the euro area different from Brazil, China or the US, which are net borrowers or lenders. A balanced current account means that the area, taken as a whole, has sufficient resources to fund the financial needs of all the member countries, including those of governments. This may sound odd given the sovereign debt crisis that is plaguing several eurozone member states. In fact, it is just evidence of the heterogeneity problem within the union against aggregate figures.

Indeed, the key problem of the euro area is the distribution of savings within the region. While there is an excess of savings north of the Alps (mainly Germany, the Netherlands, Finland and Belgium), northern European savers fear to cross the Alps to finance southern countries such as Italy, Spain and Greece.

The relative high and unequally distributed savings rates, which are behind the euro area's balanced current account, also imply that the debt crisis is not hitting all the countries in the same way. In general, euro-area savers are looking for investment opportunities and they are usually reluctant to invest in foreign currency. Moreover, most regulated intermediaries, such as investment funds and insurance companies, have little choice but to invest in government securities denominated in euro. This means that there is a structurally strong demand for euro-area government debt securities and while investors can decide to favour

safe countries (like Germany) and to stay away from the paper of the less safe countries like Greece and Portugal, which accounts for about 10% of the total euro government securities market, the strike cannot hit all the less safe countries. This implies that capital will start to flow again towards the south (at least some parts of it): a process that, as the fall in the sovereign spreads of Ireland, Spain and Italy suggests is already happening.

The evolution of the euro crisis and prospects for its resolution

As anticipated in the introduction, there is no doubt that the euro area debt crisis has significantly impacted the economy of the entire region and it is very likely that its effect will still take some time to be fully absorbed. The main reason for this is that the euro-area crisis had multiple causes, including fiscal profligacy (Greece), housing bubbles (Spain and Ireland) and structural problems (Portugal and Italy), and one central, systemic element that worked as amplifier and transmission channels across countries and sectors: a deep fragility of the banking sector, largely ascribable to excessive leverage. Furthermore the clear-cut division of the Union between creditor and debtor countries increased the complexity of the problem, from both an economic and a political point of view. After almost three years of crisis management which have delivered the creation of the permanent European Stability Mechanism (ESM), the first building block of a banking union (the single supervisory mechanism) and numerous changes in EU governance aiming at strengthening coordination among countries and reducing the gap of a missing fiscal and political union, the crisis is still going on but with a low degree of intensity.

Since the summer of 2012, while several economies are still in recession and financial integration is much lower than before the crisis, pressure on financial markets has significantly declined and sovereign bond yields of (some of the) troubled economies, which had risen to patently unsustainable heights, are now back to pre-crisis levels.

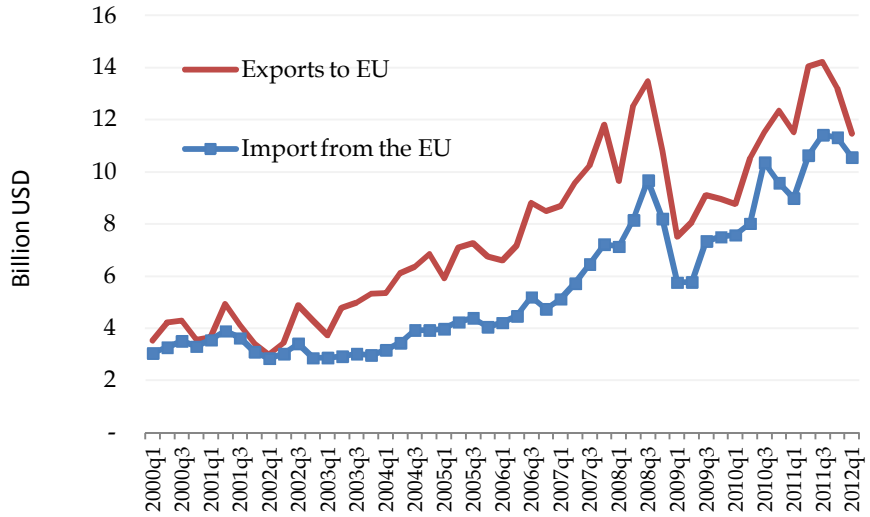
This has been the result of the intervention of the ECB, which has promised to do everything necessary to eliminate the risk of a break-up of the euro area, but also of a slow process of convergence within the euro area that is taking place through a gradual reduction or elimination of internal imbalances. This aspect is indeed the key economic element in view of overcoming the crisis.

1.3 EU-Brazil mutual relevance

The two sections above have highlighted some of the main features of Brazil and the euro area relative to other countries, focusing on their external and trade position. By contrast this section intends to focus on aspects of mutual relevance for Brazil and Europe.

Figure 5 shows Brazil's imports from the EU and exports to the EU in levels. The data show an upward trend for both exports and imports, with a big slump for both in the first quarter of 2009 (after the collapse of Lehman Brothers), but after then trade seems to have resumed. However when it comes to measuring EU-Brazil bilateral trade relative to total trade flows of Brazil, data show that after 2000 both flows have been declining and most recently converged at around 20%. This suggests that part of the importance of the EU trade has been replaced by other partners. The Box below investigates more in detail ongoing trends in Brazil's exports to the EU.

Figure 5. Brazil-EU bilateral trade: Brazilian imports from EU and exports to EU



Source: IMF, Directions of Trade, October 2012.

When it comes to FDI, Brazil seems to be among the preferred destinations for euro-area investors. As shown in Table 2, if one excludes advanced economies, Brazil represents the largest share among the BRIC, with about €180 billion. This seems to be consistent with the characteristic of Brazil as an economy with a rather open financial account (unlike China). This is confirmed by the figures in Table 2. Similar to the outflows, once advanced economies are excluded, Brazil is the main source of incoming FDI to the euro area among the BRIC countries, with a clear upward trend.

Table 2. Euro area FDI abroad, by destination (% of total outward FDI)

	Brazil	Russia	India	China	Switzerland	UK	US	Rest of the World
2010	3.7	2.1	0.4	1.3	10.0	20.7	18.8	43.0
2006	2.7	1.1	0.3	0.8	10.1	25.8	20.2	39.1

Source: ECB, Statistical Warehouse.

Table 3. FDI in the euro area by destination (% of total inward FDI)

	Brazil	Russia	India	China	Switzerland	UK	US	Rest of the World
2010	1.69	0.97	0.10	0.12	8.10	31.41	24.88	32.73
2006	0.39	0.40	0.04	0.11	8.53	38.29	23.05	29.18

Source: ECB, Statistical Warehouse.

Interestingly enough, multinational companies investing in Brazil may be among the greatest beneficiaries of an economy that is open on the financial account and closed/protected economy on the trade account. The goods they produce *in loco* are most likely to benefit from the advantage of existing import tariffs on competing goods.

Overall, the figures about commercial and financial partnership between Brazil and Europe seem to be consistent with the picture of Brazil we have depicted earlier. Financial accounts are more open than the current account and seem to matter increasingly in the relationship with the EU.

Against this background, a question arises about whether the euro area contributes in any substantial way to the global excess of external savings, which makes it more difficult for emerging markets and Brazil in particular, to strengthen their exports. In broad terms one

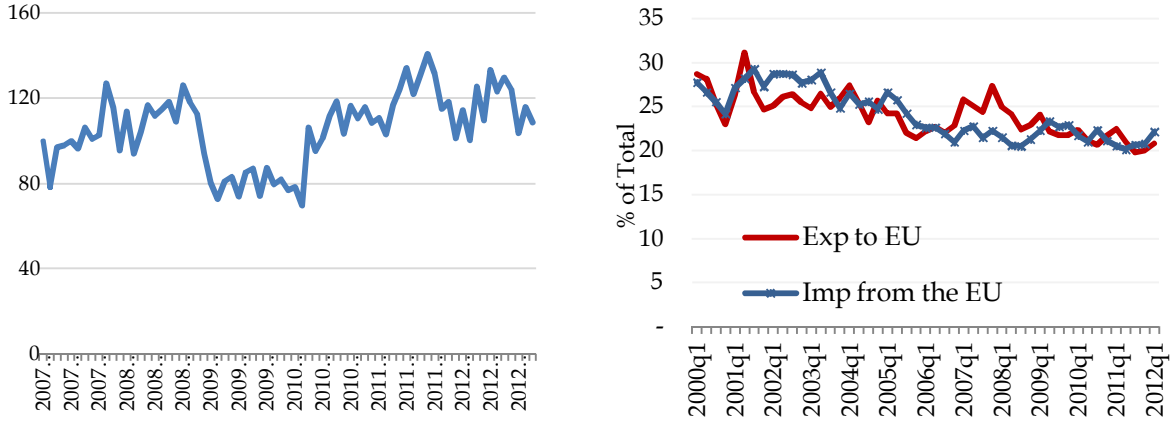
can say that until now Europe was rather neutral from this point of view, but the external adjustment required in many peripheral euro-area countries, which experienced current account deficits over years, may lead in the future to more systematic external surpluses of the euro area. This is indeed the direction to which the IMF forecasts point. Under such a hypothesis, the euro area would become a net contributor to the global excess of savings, which would not help Brazil to improve its external position.

Box 1. Did the sovereign debt crisis in the euro area affect Brazil's exports to Europe?

There is a question of whether the prolonged sovereign debt crisis in the euro area has affected Brazil's trade with Europe and in particular whether the weak demand in Europe has hit Brazil's exports. If one looks at changes that occurred over the year 2012, it seems that indeed the effect of the euro area crisis have reached Brazil. In November 2012 (latest data reported by Eurostat), Brazil's exports to the EU had fallen by 8% (in nominal terms) relative to November of the previous year, and 6% relative to the previous month. If one takes the cumulated exports over the year, in order to get rid of possible seasonal components, the negative sign remains but le drop is smaller, -4.4% relative to previous year. Hence there seems to be no doubt about falling Brazilian exports to the EU (and at the same time increasing imports), however these data are insufficient to establish a causal relation with the euro crisis.

In order to address this issue, Figure B1 (LHS) shows Brazil's exports to the EU-27 on a monthly basis between January 2007 and November 2012.

Figure B1 Brazil's exports to EU-27, 2007M1=100 (LHS) and Brazil's imports from EU and exports to EU as a % of Brazil's total imports and exports (RHS)



Sources: Eurostat (LHS) and IMF, Directions of Trade, December 2012 (RHS).

In the figure, 2007M1 was set equal to 100 to get a better visual representation of the export movements since the start of the global financial crisis. It emerges that the fall of 2012 has no exceptional feature and similar drops have happened at least three times (2008, 2009 and 2011) already during the last few years, with subsequent rebounding. In principle there is no reason to believe this will not happen again.

In addition, and more importantly, if one takes data on Brazil's imports from and exports to the EU as a share of Brazil's total imports and exports (we use IMF data as Eurostat does not provide data on Brazil's total exports and imports) over a quite long period of time, no detectable effect of the euro-area crisis can be discerned (see RHS of the figure). As shown in the chart, the share of Brazil's exports to the EU (together with imports from the EU) has been falling steadily at least since 2000 and, if anything, with a less pronounced downward trend after 2008.

Overall, the data do not seem to support a causal relationship running from the euro area crisis to falling Brazilian exports.

2. The eurozone and the EU in the international financial institutions

Having set out the economic foundations of Brazil and the EU's role in the global economy, it is worth analysing in some detail the place of the two economies in the international financial institutional system. Notably, how the euro area and the EU are represented in international financial institutions (IFIs) compared to the rest of the world and in particular the main emerging economies. While this section specifically deals with the EU's role, the analysis provided shows how this debate is highly relevant also for Brazil, as a possible reform of euro-area representation in the IFIs could deeply alter the power balance inside these institutions, at the expense, or possibly not, of other emerging economies.

At the moment, the EU's representation in the IFIs is subject to a double dynamic: on the one hand, the pressures for making more room for the voice of rising economic powers, and on the other hand the case for shifting the intra-European representational roles from member states to the euro area or the EU. Taken together these two dynamics are a source of double pressure on individual member states to cede space, in favour of a single European representation as well as in favour of other countries. This explains why the process is so sensitive and sees much procrastination. The enhancement of the role of the euro area in the international system assumes that the present grave crisis is going to be overcome, which in important respects will depend on a strengthening of the euro area's own governance structures.

Institutional representation of the EU and the euro area in the international system

Following entry into force of the Lisbon Treaty, the EU's role as international actor has been enhanced in a number of respects (role of the High Representative for foreign and security policy, who now chairs the foreign ministers' Council, role of EU Delegations as embassies throughout the world, etc.). However, the institutional place of the EU in multilateral organisations is moving only very slowly,[3] largely because of the conservatism of member states that wish to hold on to their international roles. As regards the global economic governance, the range of situations that sees an EU representation is highly diverse, and the euro area is particularly weakly represented.

Table 4 summarises the status quo. The EU is fully represented in G20 as the 20th party. However in the IMF, as at the World Bank, the EU and European Central Bank are just observers at some meetings. This situation is anomalous and obsolete, indeed, for the IMF, the European Central Bank has a global significance comparable to the US Federal Reserve and, as regards the World Bank, the EU is the world's biggest donor of aid.

If the institutional place of Europe appears fossilised, this is not the case of the global economy. The financial crisis has accelerated the rebalancing of the global economy towards emerging economies. This situation strengthens the case for a common euro area voice in a world, in which European countries have smaller influence and are likely in any event to lose progressively the weighty positions they have been accustomed to.

[3] One of the few examples on can point to is its 'enhanced' place at the UN General Assembly.

Table 4. Current representation of the euro area and the EU in selected international financial institutions

<table>
<tr><th></th><th>MEMBER STATES</th><th>EURO AREA</th><th>EU</th></tr>
<tr><td rowspan="3">G-20</td><td rowspan="3">3 euro area MS: Germany, France and Italy
1 EU non-euro area: UK
Another euro area MS is a 'permanent guest': Spain</td><td>Euro Group is not represented</td><td>EU is a member and is represented by the President of the European Commission and the President of the European Council at the level of heads of government or state
President of the ECOFIN participates in the meetings of Finance Ministers and Central Bank Governors</td></tr>
<tr><td colspan="2">Commissioner for Economic and Monetary Affairs participates in the meetings of Finance Ministers and Central Bank Governors</td></tr>
<tr><td colspan="2">ECB participates in the meetings of Finance Ministers and Central Bank Governors and deputies meetings</td></tr>
<tr><td rowspan="3">IMF</td><td rowspan="3">All euro area and EU MS</td><td>Euro Group is not represented</td><td>EU is not a member
ECOFIN Presidency presents its opinion on behalf of the Union in the International Monetary and Financial Committee (IMFC)</td></tr>
<tr><td colspan="2">European Commission is an observer in the IMFC</td></tr>
<tr><td colspan="2">ECB is part observer in selected Board meetings and observer in the IMFC</td></tr>
<tr><td rowspan="3">WB</td><td rowspan="3">All euro area and EU MS</td><td>Euro Group is not represented</td><td>EU is not a member</td></tr>
<tr><td colspan="2">European Commission is an observer in the Development Committee of the World Bank</td></tr>
<tr><td colspan="2">ECB participates in the annual meeting of the Board of Governors of the World Bank and the IMF</td></tr>
<tr><td rowspan="3">FSB</td><td rowspan="3">National financial authorities from 5 euro area MS: France, Germany, Italy, the Netherlands and Spain
National financial authorities from the UK</td><td>Euro Group is not represented</td><td>EU is not a member</td></tr>
<tr><td colspan="2">ECB is a member</td></tr>
<tr><td colspan="2">European Commission is a member</td></tr>
<tr><td rowspan="2">BIS</td><td rowspan="2">15 euro area central banks
25 EU central banks</td><td>Euro Group is not represented</td><td>EU is not a member</td></tr>
<tr><td colspan="2">ECB is a member of the General Meeting</td></tr>
</table>

This poses the question how to go about enhancing the voice and power of the euro area in the IMF, given the conservatism of member states. One possibility is that, in the short term, there would be enhanced coordination between finance ministers of the euro area, with preparatory meetings in Brussels to determine positions on the agenda. The process of institutionalisation of the euro-area ministers of finance is already an issue on the table as a result of the euro-area crisis. In the longer term, more than just coordination could be achieved in the euro area by using the European Stability Mechanism (ESM) as the institution to represent the governmental (fiscal) aspects of euro-area members' relations with the IMF. A first step would be represented by giving observer status to the ESM in the IMF Executive Board: as a result, both the ECB (on monetary issues) and the ESM (a politically accountable institution on fiscal matters) would fully represent the euro area. A further step would consist of merging all national quotas of euro members into a single common membership: the ESM (on behalf of the whole euro area) would then be represented at the IMF by its Managing Director or by a Commissioner with enhanced responsibilities for the euro. This would raise a specific issue of voting weight, which is discussed in the next section in the broader context of IMF quota reform.

The IMF quota reform

The issue of IMF reform on the voting weights and Executive Board representation of emerging economies has received new topicality because of the euro crisis. The new financial resources that Managing Director Christine Lagarde has secured, amounting to $438 billion as of June 2012, relies heavily on the monetary reserves of several emerging economies, first of all China but also including Brazil (while the United States declines to contribute). These new resources have been put at the disposal of the IMF to make possible an intervention in case an emergency plan for a large euro area country is required. Since May 2010, around €60 billion has been disbursed by the Fund to the distressed euro-area countries, in addition to the internal resources mobilised by the euro area member states. This situation has contributed to calling into question the position of euro area member states inside the IMF, as well as a call for a review of the mechanism that links the contribution to the Fund and the representativeness of contributing states. Brazil has been the most outspoken in calling for enhanced voting weights for large contributors.

IMF quota reform is a key mechanism for translating the continuously changing structure of the world economy into the concrete modalities of global governance. Claims of over- and under-representation are typically referring to both voting weights in the IMF and to the allocation of places as executive directors.

However the process of revising quotas in the IMF is solidly established both historically (14 such revisions so far) and methodologically. According to the last quota formula, four macroeconomic indicators are combined to provide an objective basis to the weight of the countries in the global economy: GDP, openness, economic variability and international reserves (each with different weight).[4] On 15 December 2010, the Board of Governors approved the last revision, doubling quotas from approximately 238.4 billion SDR (Special Drawing Rights) to approximately 476.8 billion SDR (about €560 billion). This reform also allowed for a shift of a little more than 2.5 percentage points of quota shares from over-represented to under-represented member countries, especially emerging markets and developing countries.

[4] For more details, see http://www.imf.org/external/np/exr/facts/quotas.htm

Table 5. Voting shares before and after implementation of reforms agreed in 2008 and 2010 (as a % total IMF voting shares)

	Post-2008 reform	Post-2010 reform	Hypothesis: Post-2010 and eurozone pooling
Advanced economies	**57.9**	**55.3**	**49.3**
United States	16.7	16.5	16.4
EU-27	30.9	29.4	23.6
Of which eurozone	22.4	21.2	15.0
Other advanced economies	10.3	9.4	9.5
Emerging & developing countries	**42.1**	**44.7**	**50.7**
Of which:			
China	3.8	6.0	7.1
India	2.3	2.6	3.2
Brazil	1.7	2.2	2.5
Russia	2.3	2.6	3.0
TOTAL	**100**	**100**	**100**

Source: IMF Finance Department and authors' own calculations.

Table 5 shows the pre- and post-2010 reform weights[5] (the latter not yet been fully introduced), as well as in the last column the change in the shares that would be implied by a reform in the euro-area representation. If the euro area were unified for the purpose of representation at the IMF, the logical consequence of this would be to cut intra-euro area trade out of the measures used. If this were hypothetically done alongside the 2010 reform (i.e. applying the same quota formula), it would see a further redistribution of 6 percentage points the weights from the euro area to other countries. If it were decided to make the BRICs and developing countries the only beneficiaries of this redistribution, as assumed in Table 5, this would give them collectively the majority of the voting shares of the IMF.[6]

Clearly this computation represents a mere intellectual exercise. However, interestingly enough, among the BRICS, Brazil remains the country with the smallest voting share. This is due to two main reasons: the fact that Brazil is part of a larger constituency on which the share is computed, but also openness – on which Brazil lags behind the rest of the group.

Conclusions

This paper has intended to offer both a description of the main international economic features of Brazil and EU as well their institutional role in the global economy. Against this background we attempted to elaborate macroeconomic policy considerations about possible interactions and forms of partnership between them.

[5] While in the text we refer to quota shares, for which the formula is known, given our interest in the representation in IFIs, the table considers voting shares. Due to a correction mechanism that allows very small countries to vote, there is no one-to-one correspondence between the two indicators; however, the picture they provide is consistent.

[6] For a detailed explanation of these calculations and of the broader set of issues raised in this section, see a report prepared by CEPS for the European Parliament: "External Representation of the Eurozone – Study" (Giovannini et al., 2012).

From the point of view of Brazil, we have provided the needed grounds for the analysis of the key, but often overlooked, aspect of the growing debate about exchange-rate movements. While current Brazilian policies (interest rate cuts and barriers of capital inflows) may well be preventing appreciation or favouring depreciation of the real, it remains to be seen how effective they are for the real economy. In particular it is not evident how they could work as an engine of growth when the economy is in fact relatively closed. The economy should be much more open, but this is unlikely to happen if high import tariffs remain in place.

As far as Europe is concerned, it has been pointed out that if the macroeconomic adjustment in the periphery of the euro area continues, the area could move from a balanced external position to a surplus current account. This would imply that Europe will contribute to the accumulation of global savings that makes it more difficult for emerging economies, including Brazil, to foster their exports.

In this framework, two relevant questions arise in the context of the EU-Brazil partnership:

- Do the potentially substantial current account surpluses in the euro area make it more difficult for emerging markets to strengthen their exports?
- Can we envisage a more strategic form of partnership between Brazil and the EU?

As far as the first question is concerned a more persistent surplus of the euro area is likely to materialize over the coming year, with the burden to absorb it on the rest of the world. For the second question, given the strategic interest of Europe in trade partnerships/agreements and the potential for the Brazilian economy associated with a greater opening up of the economy, a bilateral free trade agreement could be valuable. Leaving aside political considerations and given the stalled state of the negotiations between Mercosur and the EU, a new EU-Brazil initiative would be economically desirable.

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