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Eurozone Crisis and its Impact on India

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ABSTRACT *The sovereign debt problems of the Eurozone have started to pose a serious threat to the main economies of the Europe and perhaps to the future of the Euro itself. Such a situation is a far cry from the optimism and grand vision that marked the launch of Euro. This paper shows that the crisis are not merely related to sovereign debt and bank financials but also rooted in the real economy with structural problems. This paper is an attempt to understand the implications of the ongoing Eurozone crisis on India and the factors that make it somewhat unique as the contradictions of a monetary union without a fiscal union are coming to fore. For India, in particular, these are testing times from different perspectives. The Eurozone crisis has wiped out the benefits of a weak rupee, which is down 20 percent in a year*

Background

To overcome from the financial crisis of 2008 and bring quick recovery in the economy, governments of many countries had initiated several stimulus dosages in form of cash subsidies, cash infusion, equity bail out, reducing borrowing rates, lowering tax rates etc. Idea was to boost confidence and drive consumption. This was mainly funded by printing money or/and public borrowing program. Already some of these countries were high on Debt to GDP ratio and the stimulus packages made it even higher. The assumption was – as the economies start recovering, consumption would drive production and thereby increase the GDP of their nation. GDP would be then sufficient enough to service the increased debt. The assumption went wrong and the plan misfired for few countries. As some European countries never recovered & their GDP failed to rise, they started falling short of funds to service their debt obligations. To service their earlier debt they raised new debt and then some more. The debt balloon expanded out of proportion with respect to GDP. Credit rating agencies became skeptical about the rising debt scenario and capability of these sovereign states to service their debts. As repayment guarantee came under question, rating agencies started downgrading bonds of these countries. E.g. Greece bonds were downgraded to junk category. Greek government asked the International Monetary Fund and the European Union to put together a rescue package. The European Central Bank moved to shore up Greece, and the E.U. and IMF settled upon a $145 billion bailout, conditioned on Greece adopting austerity measures worth a staggering 13 percent of GDP. The E.U. also created the European Financial Stability Facility, a body intended to streamline future country bailouts. Countries carrying these threats of default are Portugal, Ireland, Italy, Greece and Spain (PIIGS).

Many experts argue that the E.U.'s model, which concentrated monetary policy in the European Central Bank (ECB) while leaving fiscal policy to individual member states, is inherently unsustainable, as it denies member states monetary policy levers with which to help their recoveries. This also makes deficit-funded fiscal stimulus harder, as monetary policy can be used to keep borrowing costs low. When different countries are hit differently by a recession, as has happened now, the common monetary authority will act in ways that help some countries but not others. The ECB has pursued tight monetary policy that may prevent inflation in high-growth states like Germany but could also be worsening the recession in Greece, Spain, and other struggling states.

Most view one of two options going forward as likely. One is that the euro zone will lose members like Greece, Spain and Italy, either by them just leaving or by a default by any one of them, which could unravel the whole monetary union. Many economists believe that this would lead to a huge bank run and the "mother of all financial crises." Another option is closer European fiscal union, so that fiscal policy can be coordinated at the continent level as well as monetary policy, bringing the European Union closer to being a sovereign state

Impact on India

Indian economy has lot to do how world economy does as US and Europe are our major trade partners. US financial institutions hold considerable European financial assets that could plummet in value if the euro zone enters a full-on crisis. For example, European debt makes up almost half of all money-market fund holdings. Direct exposure to the so-called PIIGS countries profiled above is limited, but exposure to France and Germany is high, and given, for example, France's tight linkages with the Italian financial system, an Italian default could roil France and the US in turn. The crisis is also leading to heavy spending cuts and reduced borrowing that hurt our exports to Europe & US, further endangering the Indian recovery.

The European Union is a major trade partner for India and accounts for 20 percent of India's exports and 13 percent of imports. European Union countries imported roughly € 37.2 billion worth of Agriculture products, Fuel and mining products, machinery and transport equipment, chemicals, semi manufactured textile and clothing products in 2012 from India. European Union investment in India has quadrupled in last ten years. The European Union exports to India amounted to €38.4bn, majority of which was machinery, chemical products and semi manufactured items which was almost 2.3 percent of European Union exports. Bilateral trade between the two grew on an average of 9.6 per cent during 2006-10. European Union services exports to India during 2011 was €11.4 billion and European Union imports from India was €10.8 billion. That apart, the total FDI from European Union during 2012 amounted to €3.0 billion while India also invested about €0.6 billion in the European Union. In other words, a slowdown in the Eurozone and the European Union is likely to have a major adverse impact on India's exports.

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EU'S TRADE BALANCE WITH INDIA

European Union, Trade with India

millions of euro, %

Period	Imports	Variation (%, y-o-y)	Share of total EU Imports (%)	Exports	Variation (%, y-o-y)	Share of total EU Exports (%)	Balance	Trade
2008	29,540	11.1	1.9	31,349	7.5	2.4	1,809	60,889
2009	25,413	-14.0	2.1	27,477	-12.4	2.5	2,064	52,890
2010	33,308	31.1	2.2	34,866	26.9	2.6	1,559	68,174
2011	39,683	19.1	2.3	40,558	16.3	2.6	876	80,241
2012	37,295	-6.0	2.1	38,468	-5.2	2.3	1,173	75,764
2012Q1	9,661	-	2.1	10,012	-	2.5	350	19,673
2012Q2	8,732	-	2.0	9,282	-	2.2	551	18,014
2012Q3	9,185	-	2.0	9,327	-	2.2	142	18,512
2012Q4	9,718	-	2.2	9,848	-	2.3	130	19,565
2013Q1	-	-	-	-	-	-	-	-
2013Q2	-	-	-	-	-	-	-	-
2013Q3	-	-	-	-	-	-	-	-
2013Q4	-	-	-	-	-	-	-	-
Average annual growth (2008-2012)		6.0			5.2			5.6

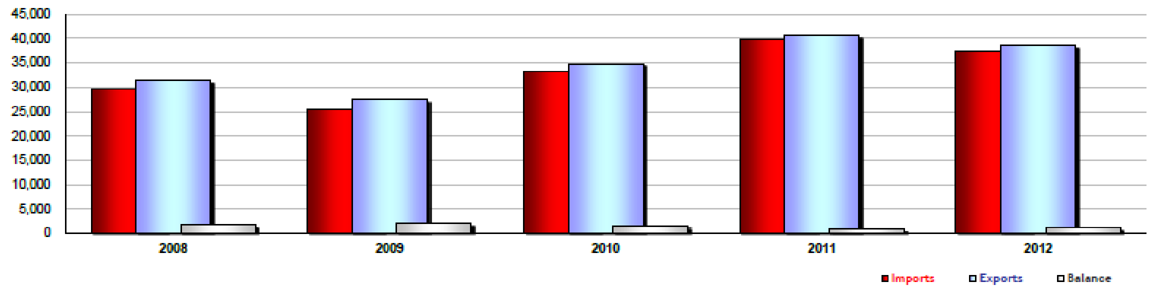

Figure-1: India's Trade with European Union

In India, the economic growth rate has slowed since the European sovereign debt crisis began, declining from 10% in 2010 to 6% in 2011. In fact, India's economy contracted for several consecutive quarters from 2010 to December 2012. India's economic growth rate has also slowed due to declining foreign investment into India, though the European Union still has more foreign investment in India than in any other country, which is a general consequence of investors fleeing to safety in the time of crisis. This decline in investment has, in turn, led to a depreciation of the Indian rupee. However, the depreciation of the rupee has boosted Indian exports, which rose by almost 20% in 2012 compared to 2011.

Although decreased foreign investment in India's economy partially contributed to its slowdown, lower domestic demand has been a much larger cause. Domestic demand in India has fallen due to high interest rates that give Indian businesses and consumers an incentive to save their money rather than spend or invest it. Despite slower economic growth, the Reserve Bank of India raised interest rates thirteen times between March 2010 and November 2011 to reduce high inflation. India's inability to reduce inflation has discouraged foreign investment. In some ways, India is in a uniquely precarious position because it imports nearly 80% of its oil needs. Therefore, while a recovery in Europe will boost India's exports and foreign investment in India, it will also increase the global demand and, therefore, the price for oil, potentially increasing India's deficit and causing prolonged inflation as the government pumps money into the economy in the form of subsidies.

India has said that it would prefer to assist Europe through the IMF rather than make direct loans to troubled countries or purchase EFSF bonds. Interestingly, as European leaders were soliciting funds throughout Asia in late October 2011, they did not approach India, perhaps because it lacks the foreign reserves that countries like China, Japan, and Brazil have. After the IMF contributed to the European bailouts, India expressed what it perceives as double-standards under which European countries can more easily obtain assistance from the IMF than developing countries. As a result of this dissatisfaction, India has led a proposal for the BRICS (Brazil, Russia, India, China, and South Africa) to set up an alternative to the World Bank (which is usually led by an American) and the IMF (which is usually led by a European) to better finance the developing world. The BRICS officially proposed this bank on March 27, 2012, and the World Bank president supported the plan.

Conclusion

The European sovereign debt crisis has affected countries throughout the world. Although Europe's ties to some countries (e.g., China and the U.S.) are stronger than others, in the age of globalization no country has escaped Europe's problems. Already, the global economic growth is down from 3.9% in 2011 to 3.1 in 2012 and just over 3% in 2013 (est.). In a worst-case scenario for the Eurozone, the World Bank estimates global GDP could contract further. No one knows exactly when and how the European sovereign debt crisis will be resolved, but the entire global community has plenty at stake.

In India, we have been proactive in addressing the challenges posed by the uncertainties in the global economy, particularly in the Eurozone. As capital inflows to our economy have turned volatile, financing of our large current account deficit has become a challenge. In this context, various policy measures have been undertaken by the Reserve Bank and the Government to moderate imports and to improve capital inflows.

Oil and gold are the two major items of our imports. With regard to oil, the domestic pricing has increasingly been made market determined. It is expected that this will help economizing the domestic oil consumption. Recently import duty on gold has been raised and bank finance against pledge

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of gold has been restricted. The efficacy of these measures, however, is yet to be tested. We have also introduced inflation indexed bonds which should help contain gold demand to the extent these bonds are used as an investment hedge against inflation. Notwithstanding these measures for a fast growing economy like ours, import demand is bound to be high. Hence, we have to step up exports to narrow the trade gap. But in a phase of sluggish global economy, it is difficult to push up exports. Nevertheless, initiatives have been taken to diversify trade towards emerging markets. On balance, however, the current account deficit remains high thus needs to be financed through capital inflows. The policy measures taken to encourage capital inflows include liberalization of the interest rates on non-resident deposits and external commercial borrowings, rationalization of norms related to foreign institutional investment (FII) in infrastructure debt and allowing foreign direct investment (FDI) in multi-brand retail. The sectoral limit for FII investment in government securities and corporate bonds has been hiked.

To sum up, while national authorities are taking steps, international financial institutions (IFIs) like the IMF need to be more proactive to suggest ways to limit the spillover and prompt actions to be taken to arrest further deterioration in global economic condition. In this context, speedy implementation of a complete banking union in the euro area with an integrated regulatory and supervisory structure assumes importance. In this scenario our economies need to strive for increasing resilience while being prepared to deal with the negative spillovers from the crisis. The immediate concern for India is to reduce the current account deficit from its present high level. Over the medium-term, efforts made to diversify trade towards emerging market and developing economies should be stepped up.

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