DEBT CRISES IN EUROPE AND ITS IMPACT ON INDIAN ECONOMY

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Abstract

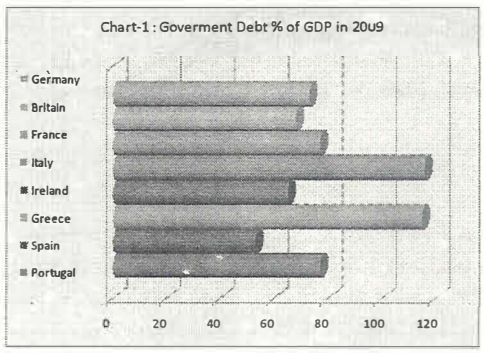
The Euro crisis, which strikes at the heart of the world's largest trading block In Europe which omprises one-fourth of the world export. The debt crises started from Greece, now many countries are experiencing troubles due to excessive sovereign debt specially Portugal, Italy, Ireland, Greece and Spain (PIIGS). The current turbulence in Euro area persists due to pressure over huge public deficits of governments. Because of this bond market in these countries become panic and borrowing cost of these counties rising and investors are not showing confidence in their securities. Greece has become a symbol of government indebtedness .The crises is said to be sovereign debt crises. This Paper reveals that root causes for debt crises in Portugal and its effect on euro and other countries like America and India.

Introduction

The Euro crisis, which strikes at the heart of the world's largest trading block In Europe which comprises one-fourth of the world export. The debt crises started from Greece, now many countries are experiencing troubles due to excessive sovereign debt specially Portugal, Italy, Ireland, Greece and Spain (PIIGS). The current turbulence in Euro area persists due to pressure over huge public deficits of governments. Because of this bond market in these countries become panic and borrowing cost of these counties rising and investors are not showing confidence in their securities. Greece has become a symbol of government indebtedness

Sovereign Debt

A government bond is a bond issued by a national government, and often denominated in the country's domestic currency. Bonds issued by national governments in foreign currencies are normally referred to as sovereign bonds. Government bonds are theoretically risk-free bonds, because governments can, up to a point, raise taxes, reduce spending, or simply print more money to redeem the bond at maturity. Investors in sovereign bonds denominated in foreign currency have the additional risk that the issuer may be unable to obtain foreign currency to redeem the bonds.

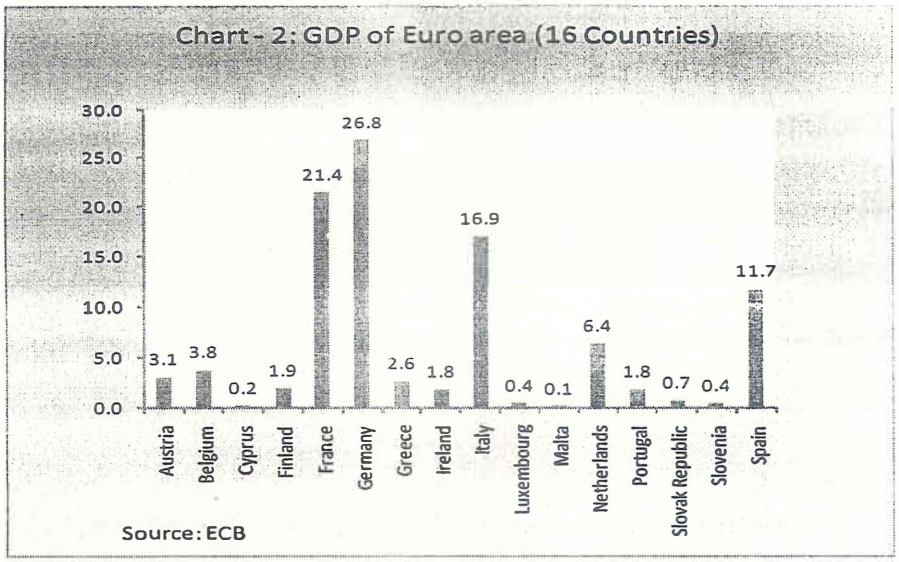


India's Debt-GDP Ratio (per cent)			
Year	Centre	State	Combined
1990-91	55.2	22.5	64.7
1995-96	50.9	20.9	61.0
2004-05	63.3	32.7	81.3
2005-06	63.1	32.7	80.4
2006-07	61.2	30.2	77.0
2007-08	61.5	28.4	77.0
2008-09	57.7	27.4	73.3
2009-10	65.97	28.6	80.0
Source: Budget document			

Root Cause for Debt Crises in Portugal

Small Economy

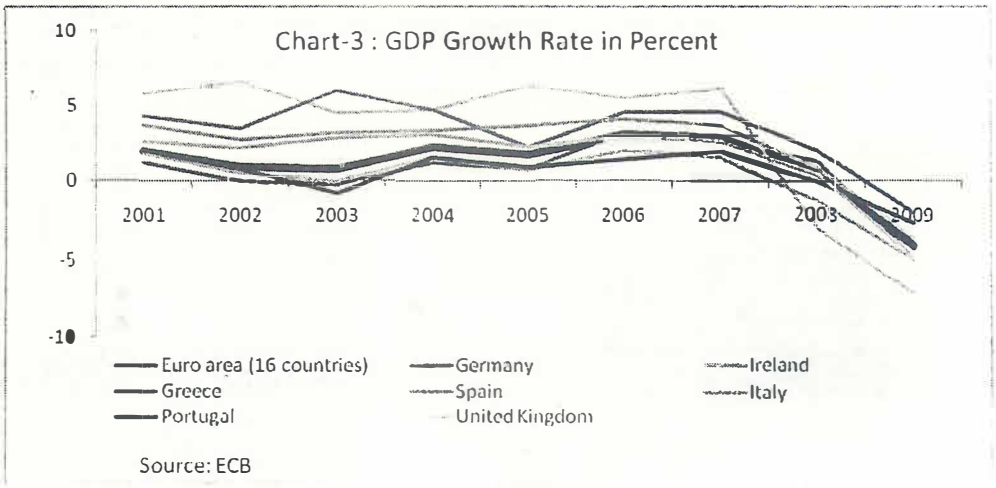
First, its economy is small accounting for 2% of euro-area GDP. It offers investors very little diversification. Those who want safe claims in Euros can simply lend to Germany or France, and save themselves any worries about economy like Greece and Portugal's.



A second weakness is competitiveness

Portugal has exhausted the benefits of the euro before the currency was born. It grew healthily in the late 1990s as its interest rates fell to converge on Germany's in the run-up to the euro's creation. But it has never recovered convincingly from the downturn that followed. GDP grew by an annual average of less than 1% between 2001 and 2009

(Chart 3); productivity growth was weak. Nominal wage growth of 3% a year further undermined competitiveness.



Fiscal Discipline

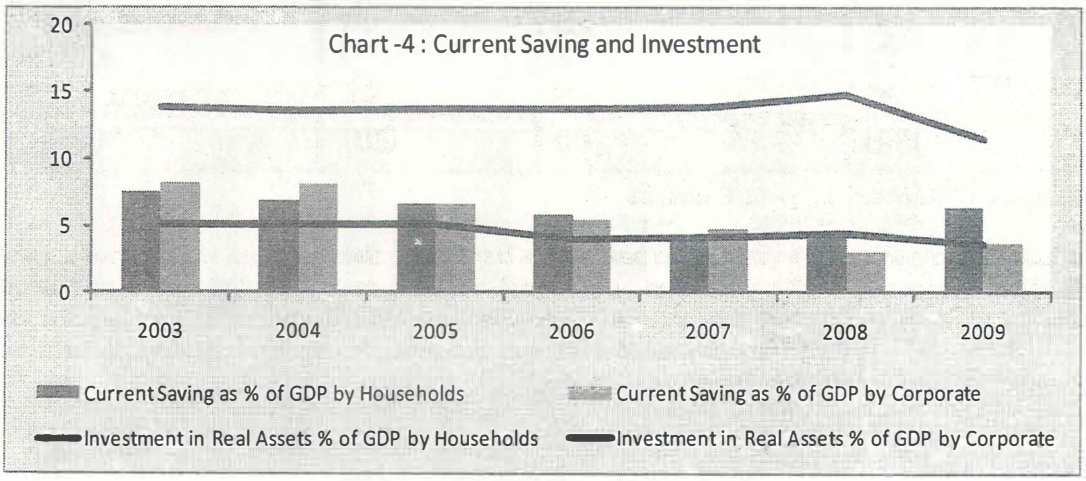
Portugal has got by on a drip-feed of foreign capital. Its current-account deficit averaged 9% of GDP in 2001-09. The cumulative impact of those deficits is behind the third weakness it shares. Real GDP growth rate in Portugal was almost lower than Euro area (16 countries) which is shown in Chart 3. A good chunk of the gross debt is held by foreign banks (Table-1) due to these small countries like Portugal, Greece are more vulnerable to a sudden change in sentiment.

Table: 1 Foreign Banks' Holding of Portugal's assets,Q4 2009

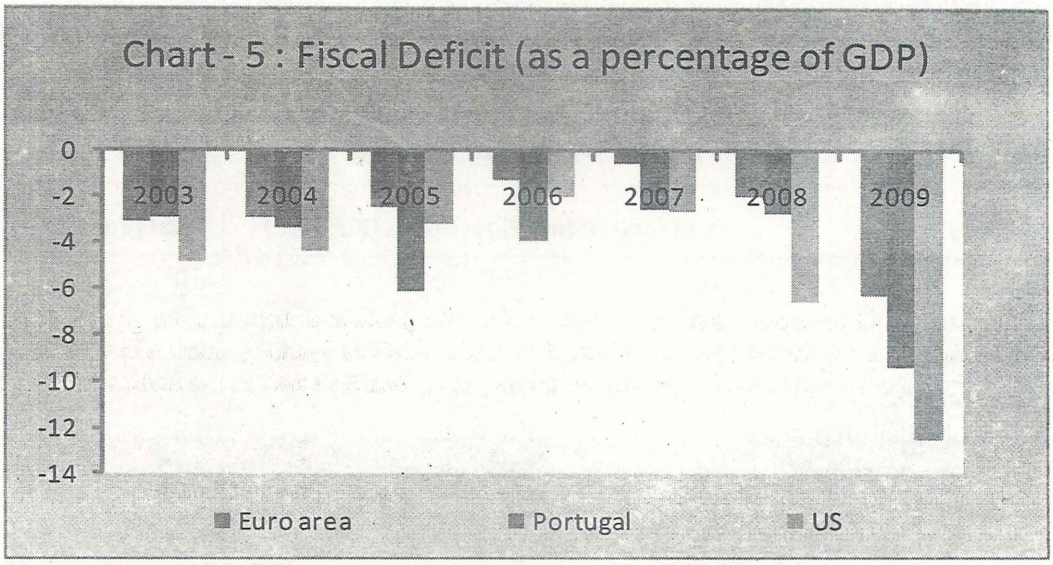
Country	% of total Debt	Govt Bonds (Euro Bn)	Total (Euro Bn)
Spain	30	13	60
Germany	17	7	33
France	16	7	31
Netherlands	4	2	9
Rest of the Euro area	7	3	15
Total Euro area	**74**	**32**	**147**
Britain	8	4	17
Rest of worlds	17	8	35
Total	**100**	**44**	**198**

Source: Bank of International Settlements

As with Portugal, the bulk of public debt is held abroad and the country's low saving rate means it too depends on foreign buyers of fresh debt. Households indebtedness was 75 as percent of GDP in 2003 which increases 99 as percent of GDP. Corporate are also suffering with the high indebtedness. Investment in real assets by Household and corporate are also deceasing constantly (Chart-4).

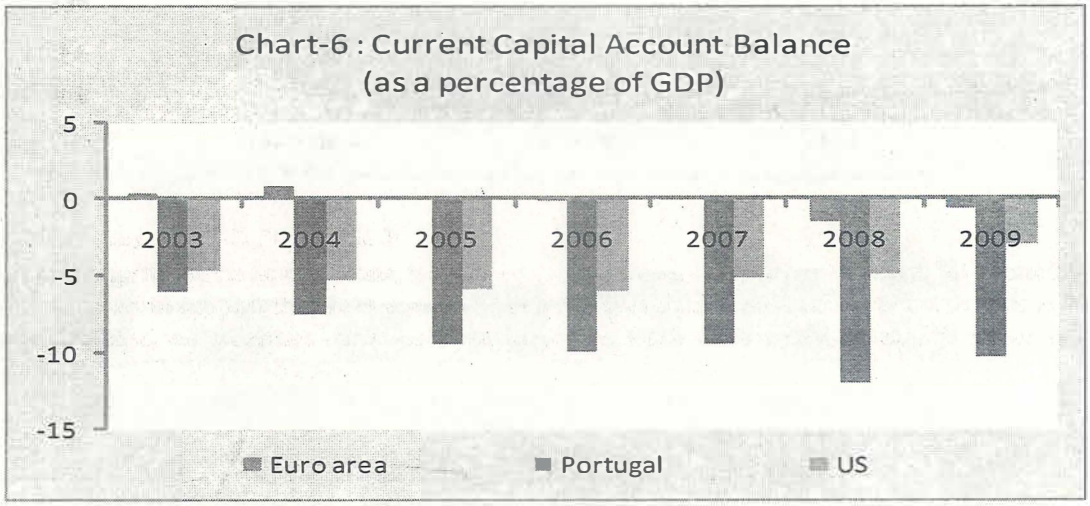


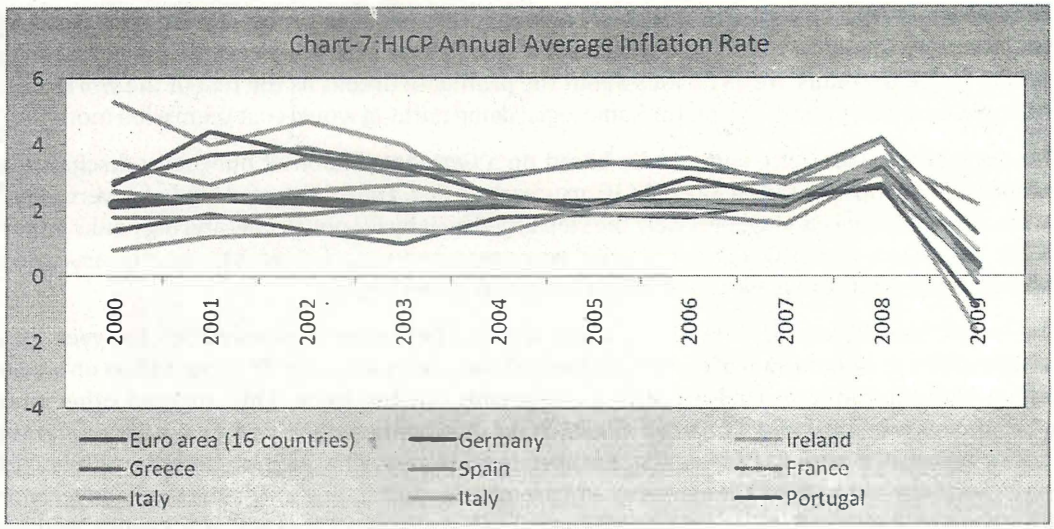
Fiscal Deficit of the Portugal was always the more then Euro area countries. This was beyond the sustainability of economy (Chart-4). Fiscal deficit of Portugal was 9.4 percent of GDP. However, US had and Euro area fiscal deficit was 12.5 and 6.5 as percent of GDP respectively (Chart -5).



Political and Economic Failure

The chief culprit is Germany. All along, it has tried to have it every way to back Greece, but to punish it for its mistakes; to support the Greek economy, but not to spend any money doing so; to treat this as just a Greek problem, when German banks and German citizens, who lend to Greece, stand to lose money too.





The European politicians lay all the blame on speculators, hedge funds, rating agencies and the rest for "unwarranted" attacks on the euro. Such thinking has informed Germany's decision to ban "naked" short-selling of government bonds. The German regulator itself admits that this practice played little part in the Greek mess. The ban will apply only in Germany, whereas most short-selling happens in London. If it has any impact at all, it will merely make it harder to sell government bonds.

European Economic and Monetary Union (EMU) limit its options for adjustment. IMF-EU bailouts have bought time but are conditional on fiscal austerity, which will have negative effects on growth. Offsetting exchange rate depreciation is not possible in a union. Debt restructuring is also difficult, given that many countries could line up for similar adjustments, and the absence of any sovereign debt restructuring facility.

This is why preconditions are required for a monetary union. One such is free labour mobility, but cultural barriers are strong in Europe. Countries within a union should have similar structures and be subject to similar shocks. But in the EMU, Germany has higher productivity; to survive with the same exchange rate, others must have lower wages and prices. But nominal wages are notoriously difficult to reduce; German phobia about hyperinflation that guides the ECB precludes inflationary stimuli that could reduce real wages. The EU is slow to react to crisis, and the reaction is biased towards conservatism. Germany is worried about the European Central Bank (ECB) buying bonds of troubled governments, diluting monetary tightening.

Monetary policy in the Euro area and in industrialized countries more generally, remains expansionary and, if anything, the crisis pushes back the time when tightening can occur safely. As a result of the problems in Europe, the world economy has become even more exposed to the three mega-vulnerabilities

The adoption of the euro was accompanied by a large fall in interest rates and a surge in confidence as institutions and incomes expected to converge to those of Europe's northern core economies.

Domestic demand surged, bidding up the price of non-tradables relative to tradables and of wages relative to productivity. Growth accelerated, driven by domestic services, construction, and an expanding government, while exports stagnated as a share of GDP, and imports and the current account deficit soared amid abundant foreign capital. The result was that indebtedness public, private, or both surged.

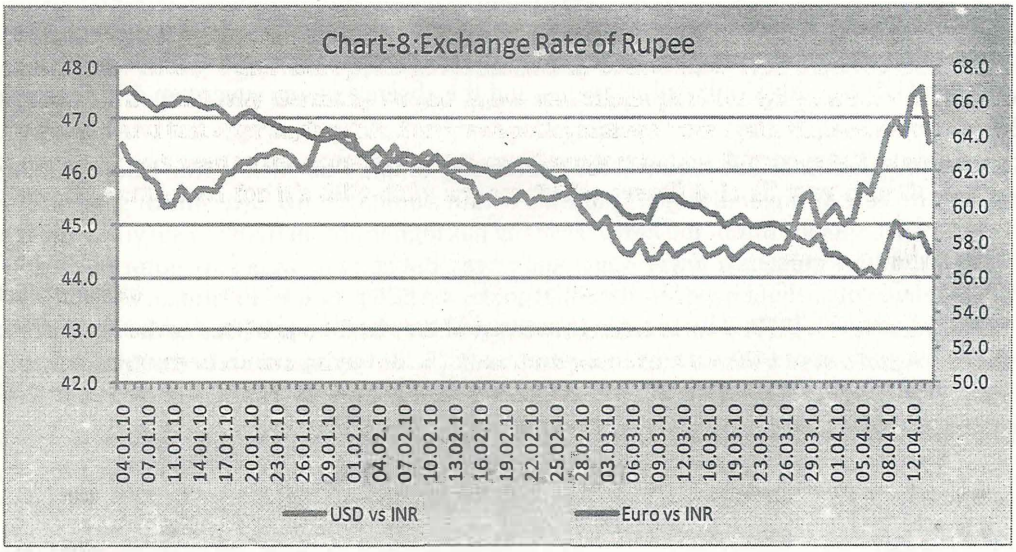
Germans are worried about the risks to their banking system and their prosperity. They need to understand that stemming Greece's debt crisis is less an act of charity than of self-interest. However, unfair it seems and the frugal Germans are as furious about the profligate Greeks as the rest of the world was about bankers a bail-out is justifiable on the same logic: doing nothing would cost them even more.

The rules of the euro zone supposedly based on a Germanic vision of budgetary discipline and an independent European Central Bank (ECB) are clearly in flux. The ECB started buying government bonds on the financial markets May; precisely the step urged on it by EU politicians and big banks. Allies of the ECB's boss, Jean-Claude Trichet, insist he was reacting to market pressures, not assaults on his independence. But the episode caused angst in Germany, and beyond.

The recent events show the situation is quite severe. There is little coordination between European policymakers as daily edition of eurointelligence shows. Germany recently imposed ban on naked short selling without taking other European governments in confidence. This angered other European governments who said why Germany should make standalone policies when we are all fighting this crisis together. And just after saying this, European policymakers have again showed resolve to fight this crisis. Germany was seen as the economy which could support falling Eurozone but its government has been severely criticised for it's dilly-dally approach. So, overall it is all very chaotic and complex at the moment.

Effect on Euro

Portugal's borrowing costs jumped. Spain's debt was downgraded, along with Portugal's and Greece's, and Italy came worryingly close to a failed debt auction. European stock markets have slumped and the euro itself fell to its lowest level in four year against the dollar.



Effects on Other Countries

Good Time for America: In America, paradoxically, the PIIGS crisis has, if anything, removed the pressure for deficit reduction, by reducing bond yields. America's structural budget deficit will soon be bigger than that of any other OECD member, and the country badly needs a plan to deal with it. But for now, lower bond yields and a stronger dollar is the route through which American spending will rise to

counter European austerity. The population growth and the dollar's role as a global currency, America has more fiscal room than any other big-deficit country. It has been right to use it.
America has the great advantage of issuing the world's reserve currency. In crises, scared investors rush into American Treasuries, which are additional increase for their liquidity. That is why Treasury yields fell this week as Greece's soared. That hunger for American assets has lifted the dollar against the euro (and the yen, sterling and the Swiss franc) since the start of the year. That at least is some comfort for members of the euro zone. When countries accounting for more than a third of its GDP are struggling in export markets that is exactly what they need.

The rest of the world will feel the effects of the Euro crisis via six important channels: first, the crisis will lower growth in Europe, a market toward which about a quarter of world exports are destined. Second, it will lead to further euro depreciation, sharply reducing profits from exports to Europe while also increasing competition from the continent. Third, by keeping policy rates low in Europe and potentially other industrialized countries as well, the crisis may encourage capital surges into emerging markets. Fourth, the crisis will add greatly to the volatility of financial markets and will lead to bouts of risk-aversion. Fifth, and potentially most important, the crisis could deal a mortal blow to many fragile financial institutions. Sixth, a failure to contain the crisis will raise the alarm on sovereign debt in other industrial countries and, inevitably, in any exposed emerging market.

Effect on India: How European crisis could impact India?

Direct Impact

Trade Channel: When an economy falls into a recession, it impacts the affected country's trading partners too. Falling household and business demand in the slump-hit economy hits the exports/ imports of its trading partners.

The share of exports to EU (excluding UK) and imports from EU has fallen over the years. In 1987-88, exports to EU constituted about 18.6% of total exports. This has declined to 17.5% by 2008-09. The decline of imports is higher from 25% in 1987-88 to 12% in 2008-09. Hence, total trade between India and EMU is about 29.5% and could be impacted due to the crisis. (Source: **RBI**) However, trade channel can impact Indian external sector indirectly as well. When the recent crisis gripped the world 2008, most policymakers, economists and experts put forth the view that India would be only marginally affected. Two reasons were cited for that.

First, India was a virtual non-entity in global trade as its share was less than 0.5%-0.7% of the total global trade volumes. Hence, it was assumed that its economy was largely insulated from the turmoil.

Second, share of developed economies in trade had declined. In 1987-88 developed economies contributed 59% of exports and in 2008-09 their share has declined to 37%. The share of developing economies has increased from 14% in 1987-88 to 37% in 2008-09. In case of imports developed economies share has again fallen from 60% in 1987-88 to 32% in 2008-09 while developing economies has risen from 17% to 32%. (Source: RBI).
Because of this shift it was felt that impact of global crisis on Indian economy would be limited. As crisis originated in US and developed economies with developing economies still growing, it was felt Indian trade will continue to grow. However once the crisis struck in September 2008, Indian trade sector declined sharply and growth was negative for 13 straight months from Oct- 08 to Oct-09. The above analysis looks at trade in goods. What about trade in services? We do not have country-wise data of trade in services so we just analysed the broad trend. Unlike trade in goods which declines immediately, we see a decline in services trade with a lag. It declines visibly in Jan-Mar 2009 quarter when the global crisis started in September 2008. Software exports decline marginally from USD 11.2 bn levels to 10.4 levels which is great given the global nature of the crisis. Hence, impact of crisis was more

on goods and muted on services.

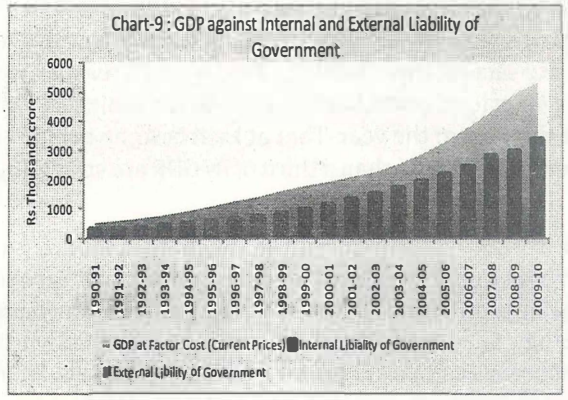


Table-2 : India's services Trades		
(in USD Billion)	India Services trade	Software Receipts
Jan – Mar 2008	10.8	10.9
Apr – Jun 2008	11.6	11.3
Jul – Sep 2008	14.4	11.2
Oct-Dec 2008	13.9	10.7
Jan - Mar 2009	11	10.7
April - June 2009	9.7	10.6
Jul - Sep 2009	7.2	10.4
Oct - Dec 2009	7.7	12.7

Note :Software exports are more than services trade as we import more in case of other services like travel, transport etc Source: RBI

Moreover, World Trade volumes declined for the first time in 60 years. IMF says the decline in world trade in 2009 was around 12.3%. The Indian government had to intervene and provide stimulus to exporters. Trade volumes declined as world economy is far more integrated than we assume it to be. Demand in developing economies also declined leading to overall slump in world trade. So, the overall impact of European crisis on Indian trade could be much more than direct linkage indicates.

Financial Channel: The current crisis has shown the power of finance channel (though trade channel was also very strong as above analysis points). The impact of turmoil in one economy's financial markets is not merely transmitted to other markets, the quantum and direction of the movement is also more or less similar (decline in equity markets, rise in corporate bond spreads and depreciation in currency). This is because cross border financial linkages have increased substantially over the years. Besides, the correlation between assets too has been rising across the world. If you plot the BSE Sensex with other advanced economy stock indices, you more or less see the same trend. So much so, one can determine the trend in the Indian equity market by just looking at movements in other global indices. Confidence channel: This channel shows confidence declines in business and households seeing the global uncertainty. So even if an economy's macroeconomic conditions and outlook look favorable, the decline in confidence can disrupt the economic conditions. Decline in confidence is also one of the reasons for decline in business investments which led to decline in overall Indian GDP growth. Credit growth also declined because of decline in business investments.

RBI Governor Mr Subbarao has stressed on this channel on numerous occasions in his speech "Increasing integration of India with global economy" in 2009. RBI Executive Director Deepak Mohanty in his speech explained the increasing correlation:

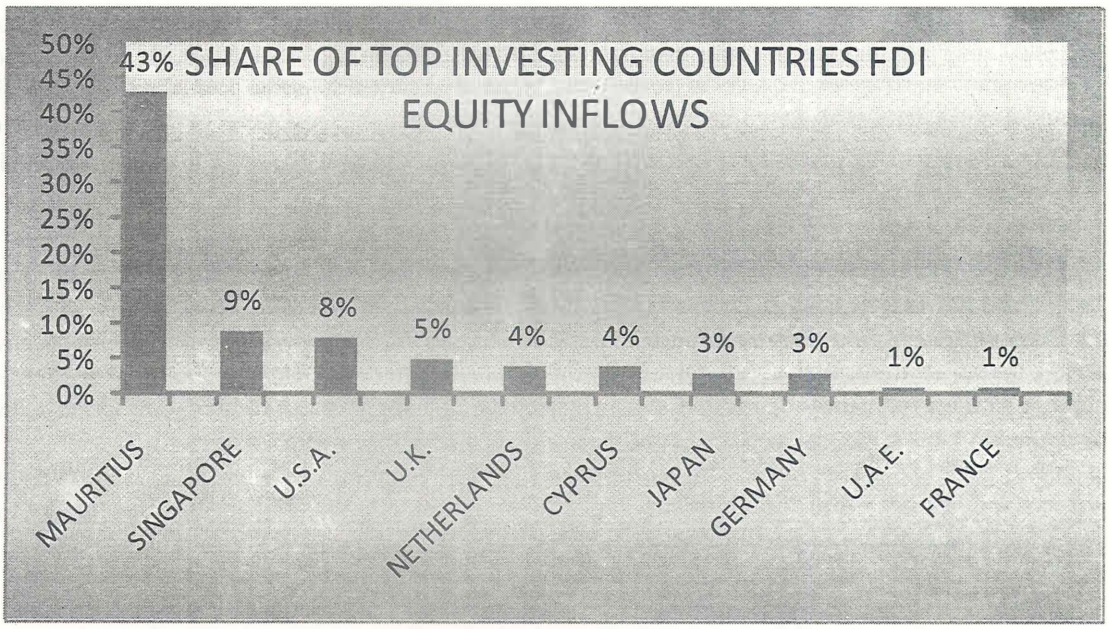
"With increased global integration, the Indian economy now is subject to greater influence of global business cycles. The correlation between the cyclical component of the index of industrial production (IIP) of the advanced economies and India has risen to 0.50 during the period 1991-2009 from 0.20 in during the period 1971-1990.

The traditional conduit of transmission of global shocks is through trade cycles. The cyclical movement in India's exports and world imports during the earlier period 1970-91 was not significantly synchronized with a relatively low correlation of 0.38. However, with rising exports along with a transition from primary article exports to manufacturing exports, the correlation between India's exports and world imports has increased significantly to 0.80 during the recent period 1992-200." Indirect Impact It is a cautionary tale of the dangers of free debt inflows, and non-productive government borrowing. Indian government expenditure must efficiently induce growth and revenue expansion. Markets do not

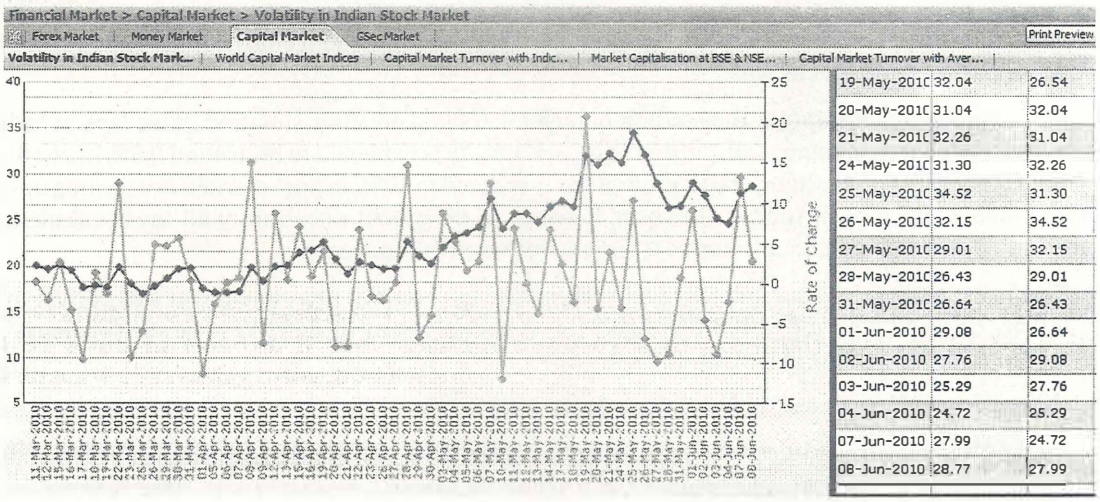
forgive a emerging market's mistakes. Despite some exposure to Europe, Indian growth will survive, even if the Greek infection spreads to the PIIGS and to Hungary, and Europe slows further. Diverse sources, including an infrastructure cycle, sustain growth here. Domestic demand has reached sufficient scale. Infrastructure requires a thriving debt market, but it is possible to encourage this internally, while continuing to be cautious about foreign participation. Now world economy more global with many complex interlinkages. Hence, if the European crisis continues to spread, it could impact Indian economy via other indirect linkages as well.

Given this global uncertainty, it puts Indian policymakers in a peculiar situation. If we look at Indian economy alone fundamentals look quite strong. GDP growth is expected to be around 8.5% in 2010-11, IIP is increasing in double digits, credit growth has increased to 17%, export markets are picking up and capital inflows have been robust. However, because of the global uncertainty all these calculations can easily go wrong. Infact, sentiment has already reversed in some cases:

* The investments might not increase seeing the global uncertainty. Investment was a key driver in Indian 9% growth period (2003-08). Again it is expected to play the key. We have seen business confidence evaporating in thin air quick time
* IIP could again decline as it did post September 2008 crisis.
* Credit growth could decline both because of banks becoming uncertain and business not demanding credit
* Foreign capital inflows could reverse to an outflow position. Infact this has already started to happen with FII showing outflows worth USD 1.65 billion in May from equity markets. Till April 2010, we had nearly USD 6.65 billion of capital inflows.
* The decline in inflows along with global uncertainty has led to decline in equity markets. The xpectations of BSE Sensex reaching soon to 21,000 levels are being revised downwards.



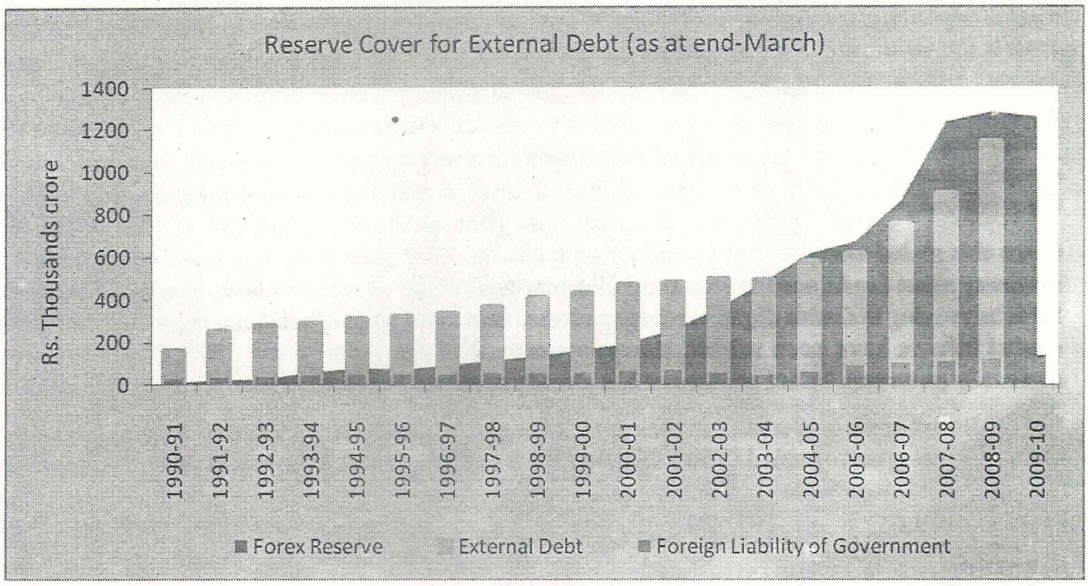
The volatility is again increasing. If we see the NSE VIX index. It had increased from 20 level in Jan 2008 to 85 levels in Nov-08. It then declines to go back to pre-crisis level of 17-18. It has again started increasing to touch 34 levels now.



19-May-2010	32.04	26.54
20-May-2010	31.04	32.04
21-May-2010	32.26	31.04
24-May-2010	31.30	32.26
25-May-2010	34.52	31.30
26-May-2010	32.15	34.52
27-May-2010	29.01	32.15
28-May-2010	26.43	29.01
31-May-2010	26.64	26.43
01-Jun-2010	29.08	26.64
02-Jun-2010	27.76	29.08
03-Jun-2010	25.29	27.76
04-Jun-2010	24.72	25.29
07-Jun-2010	27.99	24.72
08-Jun-2010	28.77	27.99

- Yields in bond markets have eased considerably to 7.35% levels looking at the global crisis. This is quite a turnaround as most market participants expected yields to touch 8-8.25% levels after April Monetary Policy. The market participants were also expecting RBI to increase interest rates even before its monetary policy in July 2010. This crisis has reversed the sentiment and most now expect RBI to keep interest rates unchanged in July policy.
- If the crisis situation worsens, Indian government might again have to intervene to ease the crisis situation. Though the probability is remote, but it is till there. There are expectations that fiscal deficit and government borrowing program could be lower than budgeted amount. This is because of the higher than expected proceeds from 3-G auctions. If crisis worsens, the government borrowing and fiscal deficit could get worse.
- Oil and commodity prices have declined as well. This could be a positive factor as inflation might just become lower.

Before the crisis in Sep-08 we kept saying we will not be impacted because of the global crisis for all kinds of reasons. This was especially the case for financial market players. And then the crisis hit and hit them hard with equity markets declining from 21000 levels to 8000 levels. And again, it rose not because of some Indian economy wonders but because global financial markets started picking up (or stopped declining). Infact much of the gains in Indian economy did not come from some economy wonders but government wonders. As global crisis eased, we preferred to call it a one time event etc.
Again the people expressing same set of confidence over Indian economy that we are safe ....etc. And now we are seeing some strains on equity markets, capital inflows etc. We may not be impacted by the European crisis as much as previous crisis.



In my observation if dollar will be strong it will direct affect our import. Of course Indian Economy is driven by domestic demand. At certain instant we can say that we are safe but we are **highly dependent on Oil and metal import**. We are not felling pressure because oil prices are not rising. Further, China has reported record export which is major importer of oil, indicates that oil prices can go up in near future. We should have also thought about alternative sources about energy like oil and natural gas etc.

Now question are also rising about emerging economy like India and China whether our debt is sustainable for economy or Not? Recently, China has revised his wage structure which will lead to inflation also reduce the real value of debt.

Concluding Observations

The impact on India will depend on the nature of European crisis. We still do not know where the crisis is headed. Comparisons have been made on how the crisis is similar to earlier US crisis but we have a far more complex problem here. In US you have one government and here you have 16 governments who are trying to resolve the issue. The recent events show the situation is quite severe. There is little coordination between European policymakers as daily edition of euro intelligence shows. Fiscal consolidation can by itself help reduce domestic demand and moderate wages.

The main challenge in developed countries is that population are aging, putting severe strain on welfare benefit. Incidentally, Spain is proposed to retirement age from 65 to 67; but those types of reform are urgently necessary, but rather difficult to implement. (The issue was discussed in RBI Platinum Jubali International Conference).

Even in the best of circumstances where the adjustment is politically feasible and financing is stable reestablishing competitiveness, fiscal sustainability, and a more balanced growth model will take several years. As a rough guide, countries have to engineer a fiscal adjustment of 5 to 12 percent of GDP, and claw back a unit labor cost disadvantage of between 15 and 30 percent, though the precise figures vary by country. Bearing in mind that the imbalances have built up over a decade or longer, at least three or four years will be required to affect the necessary reforms and, during that period, domestic demand will decline or, at best, stagnate.

Even with the recent support packages for Greece and other vulnerable countries, these adjustments will be deflationary. Nominal GDP in the adjusting countries could decline, compounding the challenge of stabilizing the debt-to-GDP ratio, unless the deflationary effect is offset by a combination of the following: a continued recovery of world trade; expansionary monetary policy; a lower euro; and expanding domestic demand in Europe's surplus countries, including Germany and the Netherlands, which are likely to benefit most from a lower euro. Since European countries trade predominantly with each other and the least competitive countries tend to be most oriented toward other European markets, most of the competitiveness and aggregate demand realignment needs to occur within Europe. Most importantly, this crisis shows countries outside the Euro area that they need to rely more on domestic demand and on the demand of emerging markets and be even more cautious when formulating macroeconomic policy. In addition, prospective euro joiners should take heed and delay entry until they have dealt with their lack of competitiveness. Based on the experience of the GIIPS, if and when they enter, they must discourage a flood of investment from going into non-tradable sectors and they must maintain large fiscal surpluses.

The Euro crisis experience has also reinforced the message that strictly pegged exchange rates, combined with open capital accounts and the ability to borrow abroad (as in the GIIPS and the Baltics), can be dangerous. Countries with flexible exchange rates or pegged exchange rates but tight capital controls have dealt with the dislocation caused by the Great Recession better.

Last but not least, the Euro crisis has exposed the limitations of regional mechanisms even among countries with deep pockets in dealing with financial crisis and underscored the vital role that a global lender of last resort, in the form of the IMF, can play. Not only can the institution bring more resources and broader expertise than would plausibly be available to a regional institution, but its distance from potentially divisive regional politics can represent a big asset.

While the fiscal consolidation efforts have enabled a reduction in key deficit indicators, the level of States' outstanding liabilities continue to remain high as compared with many emerging and developing countries. Although there has been some reduction in the debt- GDP ratio due to debt consolidation and relief measures, the States continue to hold a large chunk of high cost debt. A few States have prepaid high cost debt on account of comfortable cash balance position.

The economic expert called on EU to implement common and integrated fiscal and economic policies to deal with the situation to save the euro.

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