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Euro Zone Crisis and Its Impact on the Indian Economy

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Abstract
The economic crisis which swept across the euro zone economies is commonly called the euro zone crisis. It resulted mainly from the excessive debt position and heavy government deficits of certain European countries. The debt crisis which began first in Greece quickly engulfed the whole Europe and later threatened the global economic system. The euro zone crisis has now become a threat even to the developing economies. Even the continued existence of euro as a single currency for many European countries is now being questioned. As a result of the crisis the European Union and International Monetary Fund had to interfere with heavy bailout packages. The affected countries had to adopt several austerity measures resulting in massive popular upsurge. Many economists started to rethink on the very fundamentals of economic theories. The crisis has exposed the fragility of existing global and economic policy tools.

Keywords: Bailout Package, Economic Policy, Euro Zone, Euro Zone Crisis, Global Economic System.

Introduction

Euro zone is an economic and monetary union (EMU) of 17 European Union (EU) member states that have adopted 'euro' (€) as their common currency and sole legal tender. At present the euro zone member countries are-Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxemburg, Malta, Netherlands, Portugal, Slovakia, Slovenia and Spain. The last country to join the euro zone was Estonia. Out of the 27 member EU countries the UK, Denmark, Sweden, Bulgaria, Czech Republic, Hungary, Latvia, Lithuania, Poland and Romania do not participate in euro as their national currency and are therefore not treated as euro zone nations. Among the euro zone nations, Germany is the largest economy, followed by France as the second largest and Italy as the third largest.

Euro Zone Crisis

The economic crisis, which swept across the euro zone economies during the period 2009-2011 is called euro zone debt crisis. It resulted mainly from the excessive debt position and heavy deficits by certain European countries. As the excessive debts were, own by the sovereign states, the crises are also known as the euro zone sovereign debt crisis. The crisis resulted in the near insolvency position of certain European countries, large scale unemployment, salary cuts and job cuts, low production and exports, lowering of debt rating of the countries and severe austerity measures and massive bailout packages announced by the International Monetary Fund (IMF) and European Union (EU).

Development of the Euro Zone Crisis

During November 2009, following the Dubai sovereign debt crisis, concerns started to grow about some EU member states high debt burden. In December 2009, Greece admitted that its debt reached 300 billion Euros amounting to 113% of GDP- the highest in modern history. International rating agencies like standard & poor (S&P) started to downgrade Greek banks and government debt. Concerns started to build about all the heavily indebted countries in Europe, viz. Portugal, Iceland, Greece and Spain. EU promised to act over Greek debts and

told Greece to make further spending cuts. The Greek borrowing costs reached further record heights. The euro continued to fall against Dollar and the pound. On 2nd May 2011, the euro zone members and IMF agreed on a 110 billion euro bailout package to refuse Greece. The euro continued to fall and other EU member states debt started to come under scrutiny, starting with the Republic of Ireland. During November 2011, the EU and IMF agree to a bailout package to Irish Republic totalling 85 billion Euros. The, Irish Republic soon passed the toughest budget in the country's history. Speculation started to grow that Portugal will be next for a bailout. In February 2011, the euro zone finance ministers setup a permanent bailout fund called the European Stability Mechanism worth about 5400 billion Euros. In May 2011, the EU and IMF approved 78 billion euro bailout for Portugal. Talks abounded that Greece will be forced to become the first country to leave the euro zone. Euro zone agreed for further bailouts package of 109 billion euro to resolve the Greek crisis and prevent contagion among other European countries In August 2011, European commission president Jose Manuel Barroso warns that the sovereign debt crisis is spreading beyond the periphery of the euro zone. The European Commission also predicted that economic growth in the euro zone will come 'to a virtual standstill' in the second half of 2011. The yields on government bonds from Spain and Italy rise sharply and Germany's falls to record lows – as investors demand huge returns to borrow. During September 2011, Spain passed a constitutional amendment to add in 'a golden rule', keeping future budget deficits to a strict limit. Italy passed a 50 billion euro austerity budget to balance its budget by 2013. The standard & poor lowered Italy's debt rating from A+ to A. The IMF in its World Economic Outlook cut growth forecasts and warned that countries are entering 'a dangerous new phase'. The sense of urgency is heightened on October 23, 2011, when the IMF head Christine Legarde urged countries ' to act now and act together' to keep the path to economic recovery on track. US Treasury secretary Timothy Geithner told Europe to create 'a firework' around its problems to stop the crisis spreading.

It became almost certain that Greece would fail to meet its budget cut targets. Then there were also signs of 'a euro zone rescue plan emerging' to write down Greek debt and increase the size of the blocks bailout fund. On September 2011, the EU head Jose Manuel Barroso warned that the EU 'faces its greater challenge'. Speculation intensified that European leaders were working on plans to recapitalize the banking system.

On October 21, euro zone finance ministers approve the next, 8 billion euro tranche of Greek bailout loans potentially saving the country from default. On 26th October EU leaders reached 'a three prolonged agreement' described as vital to solve the regions huge debt crisis. On December 9, 2011 after another round of talks in Brussels, French president Nicolas Sarkozy announced that euro zone countries and others will press ahead with inter-governmental treaty enshrining new budgetary rules to tackle the crisis. Attempts to get all 27 EU countries to agree to treaty, changes the fail due to objections from UK and Hungary. The new accord is to be agreed by March 2012.

The Three Prolonged Deal

The key elements of the deal which the EU leaders reached to solve the euro zone crisis are:

1. Restructuring of Greek debt: Private Banks holding Greek debt will accept a write –off of 50% of their returns. This move expected to cut the nations external debt burden to 120% of its GDP in 2020. Without the reduction, it would have increased to 180%.
2. Increase the firepower of the bailout fund: The corpus of the main bailout fund, the European Financial Stability Facility (EFSF) will be boosted from euro 440 billion to euro 1 trillion. It is also proposed to leverage its balance (estimated at euro 250 billion) by 4 to 5 times.
3. Finally, bank recapitalization: European banks will be required to raise about euro 106 billion in new capital by June 2012. It was expected that with this additional capital, they would be better equipped.

Aftermaths of the Crisis- The Austerity Measures

The debt crisis, which first affected Greece, Portugal and Ireland, whose relative economies, it was hoped, could be mended through a combination of domestic sacrifices and external support was sought to solved by taking certain rigorous measures. The domestic sacrifices – almost all of them through severe austerity measures including job cuts, pay freeze and so on. The EU decided that the government of EU countries should gradually bring their nation's budget deficit under 3 per-cent of its GDP by 2014-2015 from over 30 per cent at the end of 2010.

With this end in view the individual member countries took several austerity measures, which included the following:

a. U.K: U.K decided to make job cuts of about 4.9 lakhs in public sector, retirement age to be fixed at 66 by 2020, to reduce government expenditure by € 8000 crores(i.e. 5.59 lakhs crores)
b. France: They decided to reduce government spending by 2.72 lakh crores (€4500 crore), to fix the retirement age full pension at 67 and to increase income tax rate by 1%.
c. Ireland: Ireland decided a bailout package of €4500 crores to save the banks, to reduce government spending by €400 crores and to reduce the budget deficit from present 32% to 2.9% by 2014.
d. Netherlands: They decided for a compulsory reduction of €1800 crores in the government budget.
e. Spain: It was decided to have a higher rate of tax for the rich, 5% reduction in salaries and 8% cut in government spending.
f. Greece: With a debt burden of € 1.9 trillion, Italy was considered too difficult to bail out and a default would probably dry out and bring Europe to recession. To bailout Greek banks, an assistance of €1100 crores from EU and IMF. Pension age is fixed at 63.5 and a budget reduction by about €3000 crores.
g. Italy: Financial discipline measures aimed at reducing government spending by €2400 crores for 2 years. No pay revision, freezed new appointments-when five persons retire, only one will be appointed; no retirement during 2011.

h. Germany: They have rather comfortable economic position; however, there will be a reduction of 10000 government vacancies**.**

Unsurprisingly the austerity measures triggered protests from the people of all affected countries. In Greece, pharmacists and doctors went on strike on plans to reduce health spending and reduce profit margins on the sale of medicines. In Rumania, even the police came out with protests and the home minister had to resign. Italian premier Mr. Silvio Berlusconi offered to step down once the parliament passed economic reforms demanded by EU, to prevent Italy from being swept up further into European's debt crisis. European leaders had to call on China which has largest foreign exchange reserves (i.e. at $3.2 trillion) to invest in the bailout fund i.e**.** the European Financial Stability Facility.

A Second Recession in Europe

European leaders are confronted by the ugly prospect of a second recession in 3 years, after figures showed that manufacturing output across the euro zone declined in December, 2012 for a fifth consecutive month. German Chancellor Angela Markel said that Europe was experiencing its 'harshest test in decades'. In Italy and Spain exports declined along with domestic orders after the euro zone crisis deepened during July 2011 and worries surfaced regarding the solvency of Italy and Spain. Such is the size of the euro zone debt crisis that stability of the entire global financial system, not just the portion relating to Europe is at stake.

Impact on Banking Sector

Banks in Europe have become extremely vulnerable. Most of them are undercapitalized and face a severe short fall in funding. These have made them pull out funds from around the globe. Due to the acute crisis, on 21st December 2011 the European Central Bank had to provide an unprecedented €489 billion three year loans to euro zone banks. The banks are borrowing at 1% from the ECB and then lending at.25%. The ECB has pumped an astonishing amount of new loans in to banking system and yet there are some banks out there still short of cash and are unable to borrow it from other banks, financial institutions and commercial customers. In addition, given the way they are being forced to live hand to mouth in this way, dependant on Central Bank support, they can be seen as zombie banks. European banks have practically stunned commercial lending and are now frantically managing their portfolio by trying to replace the worst performing bonds of different countries with those that are performing well.

Downgrading by S & P and Others

On account of the euro zone crisis, Standard and Poor's(S&P) stripped most lending euro zone countries including France and Austria of their top credit grades, citing insufficient policy steps to combat the debt crisis; only Germany was left with the euro areas stable AAA rating economy. According to German Chancellor Markel ' the euro zone downgrades by S&P reinforce Germany's stance that European leaders must redouble their efforts to resolve the debt crisis as governments prepare to sell more debt in the coming weeks'. French President Nicolas Sarkozy in his first reaction to the credit rating down grade by S&P, vowed to carry out more reforms to lead the country out of crisis. According to him- 'this is a test, we have to resist, we have to confront it, we have to fight, we must show courage and we must remain calm'.

Britain, Austria and France also could lose their AAA ratings as rating agency – Moody's International has placed the countries on negative watch, while lowering the ratings of six other Euro zone nations namely; Italy, Malta, Portugal, Slovakia and Slovenia.

Dim Outlook of Euro

The Euro (€),the dream of many a politician in the years following World War II, was established in Maastricht by the European Union (EU) in 1992. On 1st January 1999, the euro currency officially came into existence and on 1st January 2002, euro currency notes and coins were introduced.17 member countries of EU (including Estonia) accepted euro as their official national currency.

When the euro was introduced just after midnight on January 1, 2002 celebratory, fireworks exploded above the European Central Bank headquarters in Frankfurt. People from EU nations lined up at ATM to get their hands on new bills that would be daily reminders of the project of European Integration and unity. By many measures, the euro has been a success, replacing the German 'mark' as the world's second largest reserve currency.

However, ten years later the word 'euro' in a lead line is usually paired with the world 'crisis'. Instead of hosting celebrations for the 10th year anniversary, policy makers appear to be staying as quiet as possible, as if hoping not to upset the brief calm that has come with holiday season after the European Central Bankers injected nearly $640 billion into the European banking system in December 2011. For more than celebrations, what stuck in the minds of consumers after changing over to euro was the rounding up of prices at supermarkets restaurants and bars. Perception is widespread in the euro zone that cost of living has increased significantly after adoption of euro.

Chances for a Break up of Euro

Even the breakup of the single currency once considered unthinkable is now freely talked about. German Chancellor Ms. Angela Markel also admitted that Greece may have to leave the euro currency – the country whose crash heralded the crisis. This crisis has put the very worst behind it. However, it is hard to imagine the EU's single market in goods, services, capital and labour – the foundation stone of European prosperity – remaining intact if countries quit the euro, thereby triggering disorderly devaluations and chaotic financial flows. The cost to any country of leaving the euro zone would be so high and the damage that an exit would inflict on the currency and the remaining members would be so great that no governmental would rationally

choose to secede or push another out. The exit of a state such as Greece, Ireland or Portugal would cause immense bitterness and could revive national conflicts that European unification was meant to bury forever. Germany, which sells more than 50% of its exports to the euro zone would lose vital markets and is likely to end up with an overvalued currency that would impede its international economic competitiveness. Leaving the euro zone require lengthy preparations which, given the anticipated devaluation, would trigger the mother of all financial crisis. Households and companies would shift deposits to other euro zone banks or countries to protect their savings. Fleeing investors would create a bond market stampede.

Impact of the crisis on the Indian Economy

The Indian media is full of stories about an imminent doom and gloom caused by a worsening Euro Zone debt and continuing economic slowdown in the US. Every day one hears about a lower GDP growth for India, though most forecasts give it a growth rate of 7 percent or so. Major crises have always been followed by the emergence of new international institutions. The Great Depression saw the downfall of Great Britain and the rise of the US as the economic super power. After the recent global economic crisis, the global recovery is being led by Asian region where India and China have emerged as the autonomous growth poles. The current crisis has indicated the rise of G-20 as the premier forum for international co-operation and India can play a major role in it. The crisis is also paving the way for shift of power balance from advanced countries to emerging Asia. The two main countries are India and China. Even amidst the global crisis, India's financial markets have shown admirable resilience. This is in large part because India's banking system has remained sound, healthy, well capitalized and prudently regulated. India has also built a network of social safety programmes including the flagship rural employment guarantee scheme, which has shielded the poor and migrant workers from the extreme impact of global crisis. However global rating agency Moody's Investor Service has revised its outlook for India's banking system to negative from stable.

Since an economy exposed to foreign markets through trade, the impact of the euro zone crisis can be assessed by analyzing India's independence on Europe and US for its exports. Table I below shows the percentage change in India's exports by destination and Table II shows the market share of EU and US in India's exports.

Table I: India's Export by Destination

Region	2000-01	2010-11	% Growth
Asia	25.2	32.5	29.00
Europe	28	21.2	-24.30
West Asia	11.4	19.8	73.70
US	21	9.8	-53.30
Africa	5.3	8.3	56.60
Latin America	1.8	3.2	77.80
BRICS Region*	10.99	15.72	43

Source: CMIE & DGF *Includes China and Hong Kong

Table II: Market Shares of EU and US in India's Export

Export Product	%Share of the Item in India's Overall Export	% Share in India's Export of the Item	
		Europe	US
Refined Crude Products	16.9	21.1	2.3
Organic Chemicals	3.7	28.7	13.5
Pharmaceuticals	2.6	15.4	27.1
Readymade Garments	4.5	48.6	25.4
Gems & Jewellery	15.95	8.3	13.2
Iron & Steel	3.8	28.7	5.1
Machinery & Mechanical Appliances	3.6	23.1	13.1
Electrical Machinery & Equipment	4.3	36.3	12.3

Source: DGFT

Areas of Opportunity

Latin America and West Asia are the fastest growing export markets for India. China, including Hong Kong, accounts for 12% of India's export and is the largest export market for engineering goods. The BRICS region, as a whole, now accounts for one-sixth of India's merchandise exports. Among Asian Tigers, Taiwan and South Korea are key export markets to fall back on in times of crisis. In Europe, a non-EU fast growing country, Turnkey, has become an important export destination for India and witnessed an export growth rate of 79.1% in 2010-11. The acceptance of Russia into the WTO fold will further open up this high-potential market for Indian businesses.

Among the key export items with more than 2% share in India's overall exports, only a few items such as organic chemicals and pharmaceuticals, readymade garments, iron

and steel, machinery and mechanical appliances and electrical machinery and equipment have high (more than 30% share in India's export of an item) exposure to Europe and the US, taken together. Again, only two product categories- readymade garments and electrical machinery and equipment- have very high exposure to Europe. Given the slow progress of WTO talks, India can use bilateral routes under PTAs/FTAs to secure improved market access for heavily protected textiles and clothing items.

Service

India's export to GDP ratio is about 25%(16% in goods and 9% in services).When it comes to export of services, IT and ITES is the most important category, accounting for approximately 40% of the export of all services and with high exposure to Europe and the US. But luckily it will benefit from the decline in rupee. Besides, the crisis in developed countries presents an opportunity to explore inward (domestic market) and high growth emerging economies for supplying IT services. The BRIC region, with a combined population of 3 billion and GDP of $4.6 trillion, is a huge market to tap. So why not take this crisis as an opportunity

The composition of India's GDP is a source of resilience. Private final consumption expenditure accounts for roughly 60% of India's GDP compared with China's 35%or so. Thus, India's dependence on the external sector is still not very high though it has increased over the years. India is primarily a consumption story and with rising income and expanding middle-class it will remain so. Increasing income of rural population will further generate demand for industrial products and keep the economic wheel moving.

Hurdles to Cross

But even though India has reduced its dependence on Europe and the US by diversifying towards non- traditional markets in emerging economies, challenges to its economic performance remain.

Internal Challenges

India's lackluster performance on the policy front – be it land acquisition, speedy environmental clearance, allowing FDI in special sectors or checking fiscal deficit and inflation or tackling corruption is making investors,domestic and foreign, nervous. India has already expressed deep concern over the excessive outflow of foreign exchange and admitted that the Euro Zone debt crisis is likely to make the third and the fourth quarter of the current fiscal "very difficult". India's foreign exchange reserve stood at $293.5 billion as on 6th January 2012, down from $296.7 billion as of December 3o, 2011

However, the IMF chief Ms. Christine Legarde warned that the world risked plugging into a "Downward Spiral" of financial instability and urged Asian economies to be on their guard. According to her "we are all in it together and our fortune will rise o fall together. If we do not act together, the economy around the world runs the risk of downward spiral of uncertainty and financial instability'. According to Mr. George Saros, Hungarian-American investor and philanthropist "we are in a more dangerous situation than 2008; if a large European bank fails, it will have global financial implications. The European crisis is a direct consequence of over use of the sovereign credit. What is missing In Europe is a Central Bank, which is important to handle such crisis. The need of the hour is to re-think on the 'very fundamentals of economic theories; the axioms on which they have been built bear very little resemblance to the real world'. The crisis has exposed the fragility of existing global financial and economic policy tools.

In this context, the World Bank in its latest Global Economic Prospectus 2012 report has warned of an impending global economic crisis as grave or graver than 2008-2009.The World Bank asked developing counties 'to evaluate their vulnerabilities in view of dimming global growth prospectus and the Euro area problems'.

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