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   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

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- Bowersox, Donald J., Closs, David J., (1996), "Logistical Management." Tata McGraw, Hill, New Delhi.
- Hunker, H.L. and A.J. Wright (1963), "Factors of Industrial Location in Ohio" Ohio State University, Nigeria.

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**UNPUBLISHED DISSERTATIONS AND THESES**

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**WEBSITES**

- Garg, Bhavet (2011): Towards a New Natural Gas Policy, Political Weekly, Viewed on January 01, 2012 http://epw.in/user/viewabstract.jsp

# EURO ZONE CRISIS: IMPACT AND IMPLICATION FOR INDIA

*NEHA ARORA*
*RESEARCH SCHOLAR*
*DEPARTMENT OF COMMERCE*
*UNIVERSITY OF DELHI*
*DELHI*

**ABSTRACT**

*The global economy is still being buffeted by the effects of sovereign debt crisis which hit the Euro-zone. The crisis is the result of increasing property prices, credit growth which got translated into a buildup of debt. The after effects of the Euro zone crisis have been felt not only by Euro zone countries but also by developing countries who were trying to put in place the plans to recover through the US Sub-prime crisis of 2007. The European Union has since its inception been a vital economic and trade partner for Asian countries. It has been an important absorbent of exports of Emerging and developing economies (EDEs), and also a key provider of large amount of foreign direct investment and capital flows into the EDEs especially India. Europe and US accounts of a third of India's export. The euro-zone crisis following the global financial crisis will jeopardize the recovery plan and macroeconomic variable of India. The present paper tries to review the underlying causes of the European Sovereign debt crisis and analyses the impact and implications of European crisis for Indian economy.*

## KEYWORDS
Emerging economies, Euro zone, India, Sovereign Debt Crisis.

## INTRODUCTION
The euro zone debt crisis is yet another external shock which has its origin in large developed economies, however creating its ripples of its effect on the emerging economies. After the global financial crisis of 2008-2009, the euro zone sovereign debt crisis has led to a crisis of confidence in the financial markets of the world in the midst of increasing global turmoil and uncertainties of recovery from the global crisis. The Euro zone is under pressure of high level of indebtedness, budget deficits and fragile growth, thereby affecting the macroeconomic structure of other economies. The continuing insecurity in the euro zone has affected the expansion prospects of both developed and emerging economies as now globally financial markets are well interconnected with each other. On a global level, vigilance is needed to ensure that accommodative monetary policies and an extended period of low rates do not give rise to fresh credit excesses. The policymakers all over the world have to play a proactive role to tighten the financial supervision and to check the risk stemming from the increased global capital flows and vulnerabilities it brings along. None of the peripheral economies that have been reliant on bailouts and supplements from the troika of the European Central Bank (ECB), the European Union (EU) and the IMF are sure of rebounding. In the second section the paper gives a brief on the background of creation of Euro-zone and further section 3 analyses the causes for occurrence of euro zone crisis. Further the section 4 discusses the impact of sovereign debt crisis on India and section 5 provides the implications of euro debt crisis for India. Last section, details out the lessons learned by Indian economy from the crisis.

## THE EURO-ZONE: BACKGROUND
The euro zone came into existence on 1 January 1999, when eleven European countries namely, Belgium, Germany, Ireland, Spain, France, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland came together and declared Euro as their official currency by replacing the old national currencies – such as the Deutschmark and the French franc – in two stages. The European Union (EU), founded in 1957 is a political union of 28 member states who were determined on creating a 'common market' for trade. However, over time it became clear that closer economic and monetary co-operation was needed to develop the internal market and for the whole European economy to flourish and perform better. To achieve this goal, in 1991 the Member States approved the Treaty on European Union (the Maastricht Treaty) leading to formation of the European monetary union (EMU). The treaty established budgetary and monetary rules for countries wishing to join the EMU called the 'convergence criteria" (Table1). The criterion were designed to be a basis for qualifying for the EMU and pertained to the size of budget deficits, national debt, inflation, interest rates, and exchange rates (Anand, Gupta, & Dash, 2012). One of the criteria was that the Member States must keep their government and debt deficits under specified limits (3% and 60% of GDP, respectively), according to the Treaty and the rules set out in the Stability and Growth Pact. The aim is to ensure sound and sustainable public finances in the Member States of the EU and the euro area.
In 1999, when the euro was introduced, the euro area was made up of 11 of the then 15 EU Member States. Greece joined in 2001, followed by Slovenia in 2007, Cyprus and Malta in 2008, Slovakia in 2009 and Estonia in 2011. Today, the euro area has 17 EU Member States. Denmark and the United Kingdom choose to have 'opt-outs' from joining for reasons of economic sovereignty, although they can join in the future if they so wish. Sweden has not yet qualified to be part of the euro area.
The responsibility of formulating economic and monetary policy for the "Euro System" is not handled by a single institution but by a group of actors. The European central Bank (ECB) along with national central banks (NCBs) of the euro-area Member States, manages the monetary policy for the Euro area. The decisions on monetary policy in the euro area are only taken by the Governing Council of the ECB, which comprises the governors of the national central banks of the euro-area Member States and the members of the ECB's Executive Board. Member States outside the euro area coordinate their monetary policy with the ECB.
The Council coordinates economic policy-making and takes decisions on the operations of the Stability and Growth Pact and the application of the Treaty. The Stability and Growth Pact (SGP) was adopted by the Council in 1997 (later revised in 2005). The SGP is the cornerstone of fiscal policy coordination within the EMU and ensure sound and sustainable public finances . The Council also decides whether a Member state may adopt the euro.
European Commission monitors the performance of the Member states and compliance with the Treaty and the Stability and Growth Pact. It also makes assessments and recommendations to the Council on decisions to be taken.
The European Parliament works together with the Council to formulate legislation, and subject's economic governance to democratic scrutiny in particular through the new Economic Dialogue.

## REASONS FOR EURO
The overarching justification for the Euro was not merely economic, but political. The motive of creating euro as a single currency for European Union was to propose various advantages and benefits over the use of different currency by each Member States. Not only are fluctuation risks and exchange costs eliminated and the single market strengthened, but the euro also means closer co-operation among Member States for a stable currency and economy to the benefit.[1] The benefits of creation of Euro zone can be seen on both micro and macro-economic level. At microeconomic level, with the single currency, doing business in the euro area is more cost-effective and less risky. The single currency brings new strengths and opportunities arising from the integration and scale of the euro-area economy, making the single market more efficient and reduced transaction cost.
At the macroeconomic level, use of single monetary policy in the euro area was anticipated to be positioned to help improve economic stability and growth.

[1] http://ec.europa.eu/economy_finance/euro/why/

**TABLE 1: THE FIVE CONVERGENCE CRITERIA**

| | | | | | |
|---|---|---|---|---|---|
| **What is measured:** | Price stability | Sound public finances | Sustainable public finances | Durability of convergence | Exchange rate stability |
| **How it is measured:** | Consumer price inflation rate | Government deficit as % of GDP | Government debt as % of GDP | Long-term interest rate | Deviation from a central rate |
| **Convergence criteria:** | Not more than 1.5 percentage points above the rate of the three best performing Member States | Reference value: not more than 3% | Reference value: not more than 60% | Not more than 2 percentage points above the rate of the three best performing Member States in terms of price stability | Participation in ERM II for at least 2 years without severe tensions |

Source: European Commission: Economic and Financial Affairs.

The Euro system was committed to economic and price stability which would strengthen long-term stability and creditability of the euro area and attract new opportunities in the global economy for trade and investment. Prudent economic management makes the euro an attractive reserve currency for third countries, and gives the euro area a more powerful voice in the global economy. The size and strength of the euro area make it better able to absorb such external shocks without job losses and lower growth.

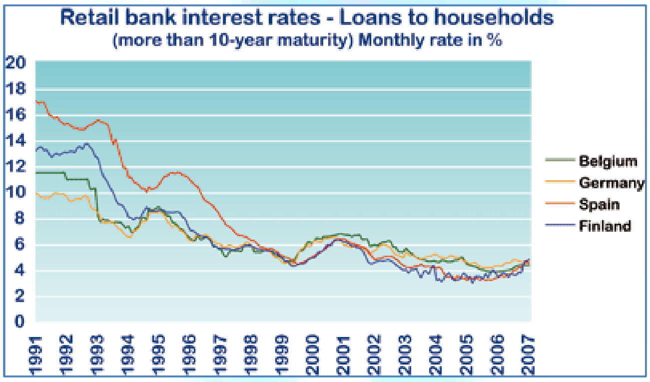
The EU Member states in the euro area would coordinate their economic policies with the overall objective of maintaining economic stability. ECB would conduct an independent monetary policy to maintain low inflation i.e. below but close to 2% in the euro area. The Economic stability and low inflation is a necessary condition to achieve sustainable long-term growth in the euro area and benefit the members and their citizens.

Bank (ECB) conducts an independent monetary policy with the objective of maintaining low inflation in the euro area (below but close to 2%). Economic stability and low inflation create the necessary conditions for sustainable long-term growth, which benefits the euro-area Member States and their citizens.

The euro came came into use in physical form as bank notes and coins on 1 January 2002. The use of euro currency by Member states has generated benefits for both business and consumers. With use of single currency Euro by Member states has brought price transparency in the market by making it easier for consumer to compare prices of different products and services across borders. The Euro has also brought inflation down to lower and stable level. Since euro's introduction the level of inflation has come down to 2% from the previous high level of 20% in 1970's and 80's. Price stability and lower inflation increases the purchasing power of the citizens, their value of savings which makes future certain. Thus, the euro area saw rapid changes in the financial markets with lower inflation resulting in lower interest rate making loan cheaper and easily available to consumer and future payment more predictable. Mortgage rates have fallen from a high level of 8%-14% to 5% on an average, saving more money with the borrower.

The EU is one of the world's key economic players, accounting for about 30% of global GDP and 20% of global trade flows, while the euro has emerged as a key international currency. The EU's experience has a unique experience in terms of regional economic integration.

**FIGURE 1: RETAIL BANK INTEREST RATE- LOANS TO HOUSEHOLDS**




Source: http://ec.europa.eu/economy_finance/euro/why/consumer/index_en.htm

## EURO-ZONE CRISIS BUILD-UP

The global financial crisis of 2008-09 emerged in US, an advanced economy, spreading throughout the world, severely affecting other developed economies. The global financial crisis initiated in the US subprime mortgage market, spreading its ripples across the Atlantic to Europe because of huge exposure of European banks to US subprime assets. The developing countries were able have an easy and speedy recovery from the crisis as compared to developed economies that had a weak recovery. The growth momentum in the recovery of global economy was geared towards the developing economy higher than the developed economy after the financial crisis. Banks in emerging markets are normally considered high risk, while banks in developed countries are generally thought to be robust and well regulated — but the 2008 global financial crisis suggests the opposite. Emerging-market economies have been considerably strengthened since the 1997 Asian financial crisis, through better macro-stabilization and other reforms. Exposure to cross-border risks and doubtful sovereign debt has been limited, and high-leverage, short-term funding and risky endogenous expansion of balance sheets — which led to the global financial crisis have been absent.

In 2009 the global economy was trying to recover from the US subprime crisis when the world economy was again confronted with another major financial crisis from a developed economy i.e. Europe. The Euro-zone sovereign debt crisis halted the recovery of global economies by posing the biggest downside risk to the global outlook.

However, the euro-zone crisis differs from the US subprime crisis in the sense that the US is unaffected by the euro zone crisis due to lack of exposure of US banks to European government sovereign debt. However, from the point of view of developing countries, both crises represent external shocks to their economy from advanced economies. The euro crisis is essentially a fiscal crisis associated with governments borrowing too much and taking on unsustainable levels of debt. In contrast, the global crisis was a banking crisis resulting from banks lending too much money to borrowers with poor credit histories. The euro crisis is a public sector crisis whereas the global crisis was a private sector (Lee, Park, Abdon, & Estrada, 2013).

The Euro-zone sovereign debt crisis has its roots in the unsustainably large public debts of EU countries and the exposure of European banks to such debt. The widespread fear of growing government deficits and distressing debt levels across the globe after global financial crisis was beckoned with downgrading of European governments' sovereign debt supplemented the apprehension in the financial markets.

The euro area crisis caught the eyes of the world economies in 2009 when Portugal, Ireland, Greece and Spain receded into recession with exceptionally high budget deficits (Mohanty, 2013). The possibility of default on government sovereign debt along with unstable macro-economic variables like recession led budget deficits, fiscal measures to bailout debt-ridden economies, hurt the sentiments and confidence in European countries. This led to threatening of existence of euro as a single currency of EU.

The introduction of euro as a single currency created various benefits for the Euro area like increased competition, common benchmark and lower transaction cost in inter-region area. This led to narrowing of yield and spreads across regions thereby increasing liquidity across borders. Thus similar debt instruments issued in different national regions were perceived as close substitutes. As the interest rate lowered in euro area, the risk premium diminished and increase in bank borrowing abroad became easy. Availability of loans at low rate of interest led to splurge in construction and financial services thereby increasing macro-economic vulnerability. Increase in borrowing abroad translated into a swelling of debt of euro area. Thus in 2009, the gross public debt of Greece was 113% of GDP far more than euro zone limit of 60%. The euro zone entered into recession in third quarter of 2008 and officially confirmed on 1 January 2009. The EU was in negative growth for the second, third and fourth quarters of 2008 and the first quarter of 2009.

The euro-zone crisis prompted a number of bailouts packages and reforms measure to bring back the euro zone countries to life after the sovereign debt default of member states. This was a u-turn on the EU treaties which rule out any bailout for euro member state to persuade them to manage their finances better. However, with Greece along with member states struggling with high debt and to restore their finances, it was agreed to devise a temporary bailout package in the form of a special purpose vehicle (SPV). The European Commission (2012) proposed a three stage approach: first, the establishment of a Single Supervisory Mechanism (SSM); second, the establishment of a Single Resolution Mechanism (SRM); and third, in the indefinite future, some sort of common, euro-area deposit guarantee scheme (CDGS).

On 2 May 2010, to restore confidence of investors, the EU and IMF collectively issued €110bn bailout package for Greece which was on conditional to implementation of austerity measures. On 9 May 2010 the decision was made by 27 member states of the EU to create a special purpose vehicle, the European Financial Stability Facility (EFSF), to preserve financial stability in Europe by providing financial assistance to euro zone states in difficulty. The EFSF was empowered to sell bonds and use the money to make loans up to a maximum of € 440 billion to euro zone nations. The bonds were to be backed by guarantees given by the European Commission representing the whole EU, the euro zone member states, and the IMF. The EFSF combined the € 60 billion loan coming from the European financial stabilization mechanism (reliant on guarantees given by the European Commission using the EU budget as collateral) and a € 250 billion loan backed by the IMF in order to obtain a financial safety net up to € 750 billion. The agreement allowed the ECB to start buying government debt which was expected to reduce bond yields. As per the conditions, Greece was to mobilise $ 70 billion by way of privatization of its state enterprises. In November, 2010 EU and IMF agree to bail-out the Irish Republic with 85 billion Euros. The Irish Republic soon passes the toughest budget in the country's history.

The measures taken in May 2010 had a palliative effect. Serious doubts remained on the ability of Greece to service its debt and bond yields started to spike again. In April 2011, Portugal admitted that it could not deal with its finances and asked the EU for help. In May 2011, European finance ministers approved euro 78 billion rescue loans to Portugal. Meanwhile, Moody's lowered Greece's credit rating to junk status on June 1 2011 (to Caa1 from B1).

An extraordinary summit was again convened on 21 July 2011 in Brussels. The leaders decided to take measures to stop the risk of contagion. They agreed on a further bailout for Greece for 109 billion euros with the participation of the IMF and voluntary contribution from the private sector in order to cover the financing gap. The EFSF was indicated as the financing vehicle for the disbursement with regular assessment by the Commission in liaison with the ECB and the IMF.

The agreement included extending the loan repayment periods and a cut in interest rates. To prevent the possible contagion, the leaders agreed to increase the flexibility of the EFSF to be able to lend to states preventively on the basis of a precautionary programme. The EFSF was empowered to recapitalize financial institutions through loans to governments even in those countries that were not under any programme. Further the EFSF was allowed to intervene in the secondary markets to deal with exceptional financial market circumstances and in the event of a risk to financial stability.

While massive and forceful liquidity support by the European Central Bank (ECB) since December 2011 has temporarily calmed the financial markets, the euro crisis still awaits a more fundamental resolution (Aizenman, Jinjarak, Lee, & Park, 2012).

## IMPACT OF SOVEREIGN DEBT CRISIS ON INDIA

The euro has traditionally been an important economic partner for India. The euro zone absorbs a major share of India's exports which was 13% of total exports in 2012. India receives a large amount of foreign direct investment and other capital flow from the euro area. The close economic linkages between India and Euro zone makes it imperative to study in detail the effect of euro-zone sovereign debt crisis on Indian economy. India is primarily a domestic country with its sovereign debt denominated in Indian rupees and mostly purchased domestically. This means that its sovereign debt is purchased by its financial sector, which is not relaxed in terms of its foreign exposure given the capital controls by RBI on banks. Therefore, if India's fiscal deficit doesn't decrease in near future, the economy would be at a higher credit risk, increasing India's vulnerability to a decrease in its GDP growth.

India clocked an average growth of 9.5 per cent in the three year period before the global financial crisis (2005-08). Today, there is a sharp reversal. Growth has decelerated, inflation is still high and stubborn, the investment rate has declined sharply and the external sector is beset with a record high current account deficit.

International investors are withdrawing money from Indian markets due the indication of withdrawal of US Federal Reserve Quantitative easing(QE) signaling a tighter monetary policy and higher interest rates regime in the US. International investors have withdrawn net $11.6 billion of Indian debt and equities from India's markets since late May, 2013.

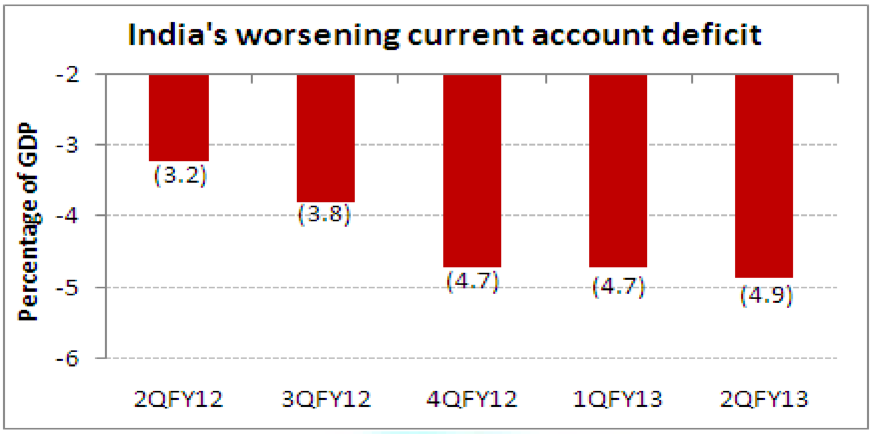
The development and effect of euro crisis penetrated in Indian economy through five major channels. The channels are namely, trade, currency, investment, banking and commodity prices.

**1. TRADE AND SERVICES CHANNEL**

India is significantly connected with euro zone area in terms of trade. India's export to euro zone in 2012 was 13% of total Indian exports. The Indian trade gap widened during Q1 of 2013-14 compared with Q1 of 2012-13. Exports contracted in Q1, while gold imports increased significantly. Reflecting global demand conditions, exports contracted in May and June 2013 after recording growth for five consecutive months (since December 2012). With global growth remaining weak, world trade has remained subdued. India's exports to worst affected countries of EU were expected to decline after the crisis. The exports to Euro zone has contracted since Q1 of financial year 2012 till Q1 of financial year 2013(Table 2). However, exports to Euro zone in Q2 of financial year 2013 showed a positive number indicating positive growth in euro zone. Around one-fifth of India's merchandise exports and around 10 per cent of India's commercial services exports are to EU 27 countries. However, the share of those countries worst affected by the crisis-Greece, Portugal and Spain is relatively low in India's export. Europe has seen a decline in its share in India's export, down to 19% in 2011-12 from 24.8% in 2001-02. The trade deficit increased to US$ 190.3 billion (10.3 per cent of GDP) in 2012-13 as compared to US$ 183.4 billion (9.8 per cent of GDP) during 2011-12.

Europe accounts for more than one-third of total tourist arrivals in India. Travel receipts have also suffered because of lower tourist arrivals from the euro zone, particularly from the affected countries. The improvement in the trade can be seen due to various policy measure taken by the RBI. India's exports to Europe and USA have registered a growth of 0.8 per cent and 3.1 per cent respectively in Q1 of 2013-14. : The share of services exports to total exports improved from 31.5 per cent in 2011-12 to 32.2 per cent in 2012-13. Growth of exports from services declined from 30.2 per cent in 2010-11 to 13.1 per cent in 2011-12 and 3.4 per cent in 2012-13.

FIGURE 2: INDIA'S WORSENING CAD



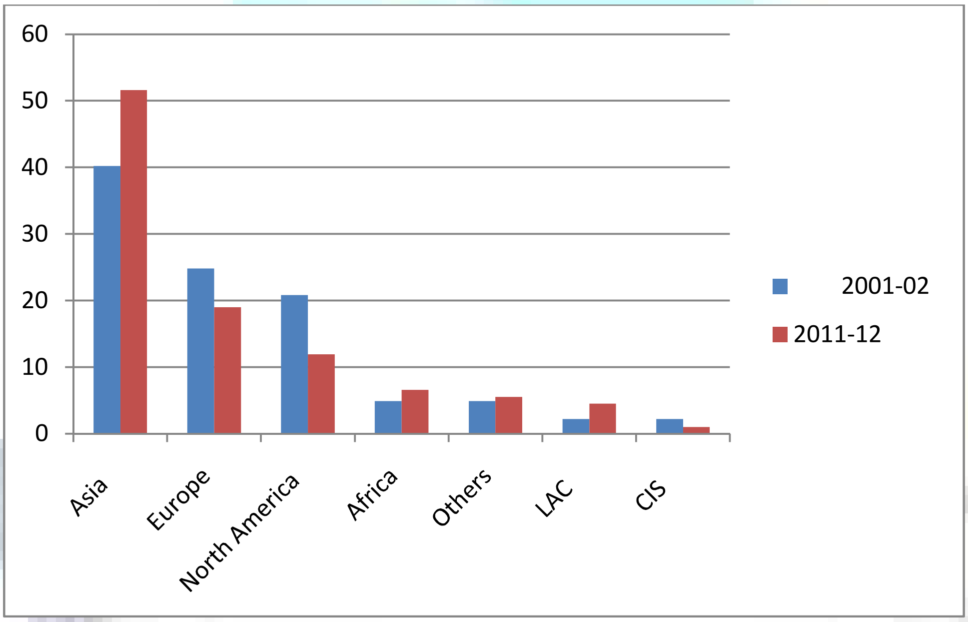

The share of European countries in India's exports of readymade garments, machinery and chemicals is significant. Around 25 percent export of IT/ITES services are to European countries but the exposure to the worst affected countries is relatively less.

TABLE 2: COUNTRY-WISE MERCHANDISE EXPORT GROWTH

| Countries | 2012 | | | | 2013 | | |
|---|---|---|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 | Q1 | APRIL | MAY |
| Brazil | 7.5 | -7.4 | -11. | -6.1 | -7.7 | 5.4 | 6.0 |
| Hong Kong | -1.1 | 2.1 | 4.3 | 7.4 | 4.0 | 9.0 | .. |
| China | 7.6 | 10.5 | 4.5 | 9.4 | 18.4 | 14.7 | 1.0 |
| Euro Area | -3.0 | -12.5 | -12.1 | -3.4 | -3.2 | 2.5 | .. |
| India | 4.0 | -4.0 | -8.5 | 0.7 | 4.7 | 1.7 | -1.1 |
| Indonesia | 5.3 | -8.1 | -12.9 | -7.2 | -6.1 | -5.2 | .. |
| Malaysia | 3.5 | -0.4 | -4.7 | 0.7 | -3.2 | -3.3 | -5.8 |
| Russia | 16.3 | -1.5 | -3.6 | -3.2 | -4.9 | -2.3 | |
| Singapore | 6.0 | -0.6 | -5.9 | -0.1 | -6.8 | 2.7 | 1.6 |
| Thailand | -2.9 | 0.7 - | 6.4 | 16.1 | 4.4 | 4.2 | .. |
| UK | 2.5 | 3.6 | 0.3 | -2.9 | -3.9 | 1.2 | .. |
| US | 8.7 | 5.7 | 1.1 | 2.7 | 0.5 | 1.8 | .. |

Source: International Financial Statistics, IMF and respective statistical agencies.

FIG. 3: INDIA'S EXPORT DESTINATION

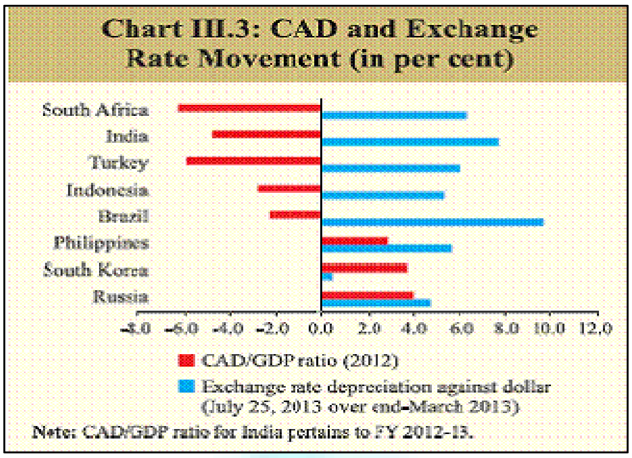



The global factors (such as unfolding of euro zone crisis, the austerity measures in advanced economies, recession in many euro zone countries, risk on/ risk off behaviour of investors and the uncertainty surrounding the future of euro zone) and domestic factors (such as halt in mining activity, supply side bottlenecks in manufacturing) have adversely affected India's balance of payments.

**2. CURRENCY CHANNEL**

The adverse impact of euro zone crisis would be felt by Indian economy if the Euro depreciated against major world economies including the rupee. In such situation the profit margins of Indian exporters would be negatively impacted. On the other hand, imports would relatively be cheaper and Indian importers especially of machinery and equipment from the European countries would benefit. The appreciation of rupee could also undermine India's export competitiveness. The rupee has fallen 12% against the US dollar since May, 2013. India's current account deficit has increased to 4.9% of India GDP in second quarter of FY13.

**FIGURE 4: CAD AND EXCHANGE RATE MOVEMENT**




Source: www.rbi.org.in

3. **INVESTMENT CHANNEL**

Euro area is a very significant source of foreign direct investment (FDI) to India. Around 18 per cent of the total FDI into India in 2012-13 was from Euro Zone. As FDI are considered more stable than the foreign institutional investment (FII) flows, therefore the crisis has had a minimal impact on the FDI flows to India. In the initial phase of the crisis, the FDI inflows from euro zone economies dropped from about US$ 3.5 billion in 2009-10 to about US$ 3.1 billion in 2010-11. However, it recovered to US$ 4.2 billion in 2011-12 and around US$ 3.5 billion in 2012-13.

4. **BANKING SECTOR**

The crisis has posed serious challenges for the banking sector. Though trade channel is the dominant channel of transmission of the euro crisis contagion to India, but there will be negative spill overs on India's financial sector as well (Swamy, 2013). The eurozone is an important source of foreign bank loans for developing Asia. The direct impact of the Eurozone crisis on Indian banks is expected to be limited as the Indian banking sector is largely dominated by domestic banks with foreign banks accounting for only 8 per cent of total banking sector assets and 5 per cent of banking sector credit. However, there could be indirect impact on Indian banks due to their exposures to other countries, especially in the Eurozone. According to RBI data, at the end of September 2011, there are only 37 branches and 3 subsidiaries of Indian banks in the European Union, and none of them is in Portugal, Italy, Greece and Spain.

## CONCLUSION

Indian and other emerging economies have always suffered because of turmoil in developed economies. The continuous bearish market environment since 2007 sub-prime crisis and growing uncertainties in the euro-zone is hampering the global growth prospects. The negative impact of such crisis on India is creating negative investor sentiments about the performance of Indian economy. India has started taking steps to wave off these negative sentiments and spread a wave of positivity about Indian economy in global market to attract foreign investors. The limit on inflow of foreign direct investment in Indian companies has been increased in a phased manner since 2012 to revive the growth in the economy. The government is also undertaking other initiatives to address structural and infrastructural bottlenecks in the country to boost domestic saving and investment. 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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