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   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

   FINDINGS

   RECOMMENDATIONS/SUGGESTIONS

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EURO ZONE CRISIS: ITS GENESIS AND IMPLICATIONS ON INDIAN ECONOMY

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ABSTRACT

The Eurozone crisis which emanated in the background of global financial crisis gripped the whole Europe into its fold. The crisis made it difficult or impossible for some countries in the Eurozone to repay or refinance their government debt without the assistance of third parties and thus hinted at vulnerability of modern day capitalist system. The problem started with the fall of Greece and exhibited a chain of failure across the southern Europe. The countries like Italy, Ireland, Portugal and Spain were soon turned into the economic quagmire for the one decade old Eurozone. Not only the Europe but the impact was also seen at far off laces like India and other emerging markets which traditionally enjoyed strong economic ties with European markets. The present study examines the genesis and spread of Eurozone crisis through case studies of GIIPS nations. The impact of crisis on Indian economy has also been analyzed through changes in various macroeconomic parameters.

KEYWORDS

GIIPS, European central Bank, Sovereign debt, Optimum Currency Area.

1. INTRODUCTION

The eurozone (a currency union of 17 European countries) has been going through a major crisiswhich started with Greece but spreaded rapidly to Ireland, Portugal, Spain, Italy and very recently to Cyprus.While it got sparkedoff by fear over the sovereign debt crisis in Greece, it went on to impact the peripheral economies as well, especially those with over-leveraged financial institutions.[1] The crisis has it genesis in a series of policies followed by countries in response to the economic challenges. These policies can be traced to the period 2000-08 when access to the easy credit paved the way for high risk lending and the borrowings. Subsequently, the period 2007-12 saw the emergence of global financial crisis, starting with 2007 sub-prime crisis in the US and soon turning into the global recession and now has become the sovereign debt crisis in Europe. This crisis has not just challenged the European vision of economic unification but it has also serious implications for its other global dreams and ambitions.[2]

2. OBJECTIVES AND METHODOLOGY

The present paper aims to understand the roots of Euro zone crisis and study the subsequent impact of crisis on Indian economy. An attempt has been made to trace the genesis of Eurozone crisis along with the historical background of Eurozone. The organization of the paper is in the form of case studies of five nations viz. Greece, Italy, Ireland, Portugal and Spain (GIIPS) nations which were worst affected due to euro zone crisis. The implications of Euro zone crisis on Indian economy has been gauged through changes in the different macroeconomic parameters viz. trade/ current account deficits, foreign direct investment, fluctuations in currency and foreign exchange reserves.

3. GENESIS OF EUROZONE CRISIS

The Eurozone is an economic and monetary union (EMU) of 17 European Union (EU) member states that have adopted the euro (€) as their common currency and sole legal tender. It was founded on January 1, 1999 when eleven European countries decided to denominate their currencies into a single currency. It currently consists of Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain. Other EU states are obliged to join once they meet the criteria to do so. Though the call for some type of monetary union has been made since the last nineteenth century, various authors have attributed various reasons for the economic unification of Europe.

Thirwall (2012) has cited the formation of Euro as a culmination of a long-standing quest of European countries for currency stability. However the beginning was made by signing treaty of Rome and establishment of European Economic Community (EEC) on 1 January 1958. The stable exchange rate was supposed to be a stronger case for growing intra-European trade and at policy level steps were taken to control exchange rate swings by adopting 'snake in a tunnel policy' in 1972 which was further replaced by European Monetary System (EMS) in 1978 and European Exchange Rate Mechanism (ERM) in 1979. Mundell (1961) in his famous 'Theory of optimum currency area' also vouched for economic integration of nations and adoption of common currency.

Further, a single currency was perceived as a symbol of political and social integration in the post WW II Europe and a catalyst for further integration in other spheres. At the micro level, the use of a common currency was expected to increase cross-border competition, integration and efficiency in the markets for goods, services and capital. At the macroeconomic level, a single monetary policy in the euro area was expected to be geared to price stability. The Euro system's commitment to price stability was expected to contribute to the long-term stability and credibility of the euro and promote its attractiveness as a trading and investment currency. In the long run, the development and integration of the euro area financial markets was expected to enhance the attractiveness of the euro. The Euro was also expected to become an important currency in the foreign exchange markets.[3]

The European monetary union (EMU) was conceived later in 1988–89 by a committee consisting mainly of central bankers which led to the Maastricht Treaty in 1991. The Maastricht set the completion of European Monetary Union (EMU) as a final objective. It also established the need for a degree of economic and policy convergence in European economies as a precondition for a successful union, setting out a series of convergence criteria for prospective members:[4] The key components of convergence criteria were:

- Inflation would have to be no more than 1.5 percentage points higher than the average of that prevailing in the three best-performing member states;
- Long-term interest rates could be no more than two percentage points above the average rate of the three best-performing member states;
- The budget deficit had to be less than 3% of GDP;
- Public debt had to be less than 60% of GDP
- Ensuring interest rates to be within limits for at least 2 yrs to gain admittance to EMU.

In January 1999, parities between the 11 countries then participating in the euro and meeting the Maastricht criteria were fixed, and a new European Central Bank (ECB) took over responsibility for monetary policy. Then, in January 2002, euro notes and coins were introduced. The creation of Eurozone altered the economic as well as financial landscape of the region and led to the convergence of prices, interest rates and yield in bond markets in the initial years. By the year 2005, the general growth momentum was in place, perhaps waiting for a trigger.

3.1 IMPRUDENT FISCAL POLICIES

Increased competition, the establishment of common benchmarks and lower transaction costs led to narrowing of yield and spreads and market liquidity across borders. These changes were facilitated by the TARGET-2[5] system that linked large-value national payments in the EU. Thus similar instruments traded in the different national markets came to be perceived as close substitutes. The convergence in interest rates meant a fall in nominal rates in the peripheral economies of GIIPS countries (Greece[6], Ireland, Italy, Portugal, and Spain) towards the lower German levels and Europe's northern members (EUN)—Austria, Belgium, France and the Netherland. Credibility of the monetary policy on price stability and the accompanying economic growth were seen as a positive outcome of a single market and a seemingly stable common currency.

Low interest rates and improved confidence fueled a domestic demand surge partly financed by foreign lending. The growth in credit was concentrated in the housing sector. The GIIPS' economies realigned away from manufacturing and industrial sectors and toward services and housing construction: 4 percentage points of GDP shifted from industry to financial services, real estate, and business from 1997 to 2007, compared to a shift of 2 percentage points in the EUN.[7] Construction and financial services grew rapidly thereby increasing macroeconomic vulnerability. The boom in the property prices[8] and resultant credit growth got translated into a buildup in debt. Faster growth hid the weakness in the fiscal system that got revealed with the worsening in the fiscal deficit and public debt. Growth was also accompanied by a rise in demand for imports and, in turn, a larger current account deficit from 2003. The rise in the twin deficits were financed largely through debt, especially, in the case of Greece. Over the same period, per capita employee compensation rose by an average annual rate of 5.9 percent in the GIIPS, considerably faster than the EUN's average of 3.2 percent. These increases were not matched by improvements in productivity and as a result unit labor costs rose by 32 percent in the GIIPS from 1997 to 2007, compared to a 12 percent increase in the EUN.[9] So long as growth was strong, it was hard to make out whether there had been an improvement in the fundamentals, or it was a bubble.

In all of the GIIPS, lower borrowing costs and the expansion of domestic demand boosted tax revenues and tempted governments to expand spending as well. Rather than recognize that the revenue increases from the boom were windfall gains that should be saved, the GIIPS accelerated government spending. From 1997 to 2007, public spending per person rose by an average of 76 percent and government's contribution to GDP rose by 3.5 percentage points. In the EUN, average per capita spending increased by 34 percent and the government's contribution to GDP stayed constant. The credit boom from 2003 lasting till early 2007 was supported by falling interest rates. But from 2006, interest rates across euro zone started to diverge, marking out the weak from the strong economies. Excessive lending had left banks with bad debts and governments with large fiscal deficit and public debt in the peripheral economies.[10] From late 2009, fears of a sovereign debt crisis developed among investors as a result of the rising private and government debt levels around the world together with a wave of downgrading of government debt in some European states. Causes of the crisis varied by country.

3.2 MONETARY UNION WITHOUT A FISCAL UNION

The structure of the Eurozone as a monetary union without fiscal union contributed to the crisis and harmed the ability of European leaders to respond. The creation of the Euro zone had an inherent contradiction of being a monetary union but not a fiscal union. The introduction of the euro in 1999 explicitly prevented the European central bank (ECB) or any national central bank from financing government deficits.[11] As a consequence the central bank has no power to monetize deficits. The spending authorities remained national and subject to their own political compulsions. So long as growth across the region was strong, the fiscal capacity was not a source of worry. Given the differences in the structure and competitiveness of the peripheral economies, it is not surprising that their compliance to the stability and growth pact (SGP)[12] was often in breach. The countries like France and Germany ran budget deficits more than 3% of GDP without paying any fines and without making any commitment to return to smaller deficits in the subsequent years. And this weakness got further exposed in the after math of the global crisis due to the operation of fiscal stabilizers, a rise in the unemployment compensation and a fall in tax revenues. The member states had no option to improve the competitiveness of the economy through exchange rate depreciation as enunciated by SGP.

Had there been a fiscal union, with a system horizontal transfer and controls, the deficit and debt ratio of the peripheral economies may have been contained. But in the present case, a fiscal crisis in the periphery automatically translated into zonal monetary and financial crisis with the central monetary authority not empowered to act as the lender of last resort. This brings home an important lesson that setting up pacts and codes of conduct by themselves are not enough, unless, the underlying incentives to adhere to them are also reasonably well aligned. It has also been argued that the fiscal criteria proved difficult to enforce but generated a false assurance that as long as there was a criteria, all was well. They failed to see that other structural problems were far more dangerous to economic stability of the euro zone that included the lack of control and regulation over national financial institutions.[13]

3.3 UNEQUAL SIZE OF THE MEMBERS

One prerequisite for the successful monetary union is equal size of the member nations. Within the euro zone, there is substantial variation in terms of productivity. The peripheral economies of GIIPS have lower labor productivity compared to Germany which clearly stands out in terms of unit labour costs. Only France and Ireland are comparable to Germany on this count. The Global competitiveness index for the Euro zone countries also shows vast differences in terms of the ranking and score. On account of differences in the labor market conditions the unemployment rates are also vast divergent. As compared to the peripheral economies, Germany has the lowest rate of unemployment rate due to its short-time working scheme and flexible time arrangements in the manufacturing sector.[14] The fact that there has been persistence different in the unemployment levels show that labour mobility remained far more limited as compared capital mobility despite there being a monetary union. The above differences in a currency union could get sharply exaggerated, as they did, when countries are subject to asymmetric shocks[15].

3.4 EXTERNAL EXPOSURE

The large share of public debt held across borders with European banks (German, French, British and others) made these countries vulnerable to external factors. Data from the Bank of International settlements gives an indication of the magnitude of exposure for major economies in the euro zone. Germany, France and non euro economies like UK and US have substantial exposure to bank debt of the peripheral economies. In respect of the US, the indirect exposure is several times larger than the direct exposure.

TABLE 1: PERCENTAGE OF BONDS HELD ABROAD

Country	Percentage of debt held abroad
Greece	58
Ireland	54.2
Portugal	66
Spain	38.7

Source: Economist January 15, 2011, p. 72.

3.5 OPTIMUM CURRENCY AREA DEBATE: EURO ZONE Vs. USA

The benefitsfrom joining a currency union comprise the gain in monetary efficiency arising fromavoiding all of the uncertainty and transaction costs created by exchange rate volatility. These gains are likely to be greater, the greater is the degree of economic integration between the joiningcurrency and the rest of the membership. This is because closer integration implies (1) a largershare of a country's trade will benefit from exchange rate stability within the currency area; and (2) if labour and capital mobility across the currency union is high, the resultant increase inpredictability in investment returns and wage rates will be quantitatively more important.The plan to move to a European Monetary Union via the adoption of the euro saw many economists turn to the OCA literature as a way of assessing the workability of the scheme.

Since this literature did not provide any absolute guide as to what constituted an OCA, the most common approach wasto benchmark Europe against an already functioning continental currency area in the form of theUnited States. Thus economists compared the two across the various criteria outlined above – theirrelative degree of exposure to asymmetric shocks, relative degree of factor mobility, and the scopefor fiscal federalism.On all three counts, they tended to find that the putative Eurozone did not measure up to the United States:[16]

• European economies seemed to be more exposed to asymmetric shocks than were USstates;
• European economies demonstrated a much lower degree of labour mobility than did US states; and
• US fiscal federalism was far more extensive than that of Eurozone.

4. CASE STUDY OF GIIPS NATIONS

4.1 GREECE

In the early mid-2000s, Greece's economy was one of the fastest growing in the eurozone and was associated with a large structural deficit. After averaging annual GDP growth of 1.1 percent from 1980 through 1997—the slowest in eventual Euro area countries—Greece's economy expanded at an average rate of 4.1 percent over the next ten years, the fourth fastest rate in the Euro area. As tax revenues rose, the government rapidly expanded spending, especially in social transfers and public sector wages. From 1997 to 2008, Greece increased government spending per capita by 140 percent, compared to 40 percent in the Euro area.[17]

As the world economy was hit by the global financial crisis in the late 2000s, Greece was hit especially hard because its main industries - shipping and tourism - were especially sensitive to changes in the business cycle. The government spent heavily to keep the economy functioning and the country's debt increased accordingly.With debt ballooning from 96 percent of GDP in 2007 to 115 percent in 2009 far more that the euro zone limit of 60 % and the IMF projecting it to reach nearly 150 percent by 2012 even under the assumption of draconian fiscal measures—Greece's borrowing costs skyrocketed. In late 2009, Greece admitted that its fiscal deficit was understated (12.7 % of GDP, as against 3.7 % stated earlier). Ratings agencies downgraded Greek bank and government debt.

A few days later Standard & Poor'sslashed Greece's sovereign debt rating to BB+ or "junk" status amid fears ofdefault, in which case investors were liable to lose 30–50% of their money. Stock markets worldwide and the euro currency declined in response to the downgrade. On 1 May 2010, the Greek government announced a series of austeritymeasuresto secure a three-year €110 billion loan. This was met with great anger by the Greek public, leading to massive protests, riots and social unrest throughout Greece. The Troika (EC, ECB and IMF), offered Greece a second bailout loan worth €130 billion in October 2011, but with the activation being conditional on implementation of further austerity measures and a debt restructure agreement.

TABLE 2: GDP, GOVERNMENT DEFICIT/SURPLUS AND DEBT IN GREECE

	2008	2009	2010	2011	2012
GDP mp (in million euro)	232920	231 642	227318	215 088	212139
GDP Growth rate	-0.2	-3.1	-4.9	-7.1	-7.0
Government deficit (-) / surplus (+) as a % of GDP	-9.8	-15.6	-10.3	-9.1	-9.0
Government debt as a % of GDP	113.0	129.4	145.0	165.3	156.9

Source: Eurostat newsrelease euroindicators, accesed from europa.eu/rapid/press-release_STAT-12-62_en.doc.

All the implemented austerity measures, have helped Greece bring down itsprimary deficit - i.e. fiscal deficit before interest payments - from €24.7bn (10.6% of GDP) in 2009 to just €5.2bn (2.4% of GDP) in 2011, but as a side-effect they also contributed to a worsening of the Greek recession, which began in October 2008 and only became worse in 2010 and 2011. The Greek GDP had its worst decline in 2011 with −6.9%, a year where the seasonal adjusted industrial output ended 28.4% lower than in 2005, and with 111,000 Greek companies going bankrupt (27% higher than in 2010).

4.2 IRELAND

From 1995 to 2000, growth in Ireland accelerated to an average of 9.6 percent per year, and interest rates fell below German levels by 2005. Irish wages grew nearly five times faster than the Euro area average from 1997 to 2007, resulting in the real effective exchange rate (REER) increasing by 36 percent from 1999 to 2008, compared to an average increase of 13 percent in the other GIIPS. This rapid growth and a European monetary policy that was far too loose for Ireland fueled the enormous overleveraging of the financial sector. As property prices showed a downward movement from 2007 Irish banks stood exposed and came under severe pressure.

TABLE 3: GDP, GOVERNMENT DEFICIT/SURPLUS AND DEBT IN IRELAND

	2008	2009	2010	2011	2012
GDP mp (in million euro)	179 990	160 596	155 992	156 438	158865
GDP Growth rate	-2.2	-6.4	-1.1	-2.2	-0.2
Government deficit (-) / surplus (+) as a % of GDP	-7.3	-14.0	-31.2	-13.1	-8.2
Government debt as a % of GDP	44.2	65.1	92.5	108.2	117.4

Source: Eurostat newsreleaseeuroindicators, accesed from europa.eu/rapid/press-release_STAT-12-62_en.doc.

The property price crash by the first half of 2009 broadly coincided with the tightening of credit control. By mid-April 09, there was a marked increase in Irish bond yields and the government had to nationalize banks and take on the liabilities. In September 2010, government support for six banks had risen markedly to 32 per cent of GDP. In November 2010, the government decided to seek a €85 billion "bailout" from the ECB and the IMF. Thus the problems of Ireland stemmed from an excessive build up of bank lending rather than public debt as in the case of Greece. But, the banking crisis turned into a fiscal problem. In terms of unemployment, Ireland with an unemployment rate of 13.7 percent is among the worst-affected, after Spain which also witnessed a collapse in the property sector.

4.3 SPAIN

Spainlike Ireland was considered a dynamic economy and till 2005 and attracted significant foreign investment. The economy witnessed a real estate boom with construction representing close to 16 per cent of GDP. This changed with the global crisis. In cumulative terms, housing prices fell significantly from 2007. As the real estate boom collapsed there was a rise in the levels of personal debt. On the public finances front, tax revenues collapsed, deficits soared and the budget position moved to a deficit of over 11 per cent in 2009. Interest rates on lending to companies and other categories showed an upward turn and financing continued to decline indicating weakness of the economy.

TABLE 4: GDP, GOVERNMENT DEFICIT/SURPLUS AND DEBT IN SPAIN

	2008	2009	2010	2011	2012
GDP mp (in million euro)	1 087 749	1 047 831	1 051 342	1 073 383	1094290
GDP Growth rate	0.9	-3.8	-0.2	-0.1	-1.6
Government deficit (-) / surplus (+) as a % of GDP	-4.5	-11.2	-9.3	-8.5	-10.6
Government debt as a % of GDP	40.2	53.9	61.2	68.5	86.0

Source: Eurostat news release euro indicators, accessed from europa.eu/rapid/press-release_STAT-12-62_en.doc.

The one difference that marks out Spain is that its public debt at about 60 per cent of GDP (in 2010) is low by euro zone standards. But the problem is on account of foreign exposure to its private debt. The Spanish banks have relied heavily on whole sale finance from abroad. Spain also has a very high rate of unemployment in comparison to the rest of the euro zone. Unemployment among youth is particularly high in Spain and remains a potential source of unrest.

4.4 PORTUGAL

While the Financial Crisis affected the Portuguese economy on account of which its fiscal deficit and public debt deteriorated from -3.1 per cent and 68 per cent of GDP (in 2007) to -10 per cent and 83 percent in 2009, the down turn in GDP growth for Portugal was one of the mildest (only -2.5 %) compared to a sharper decline in the rest of the euro zone. Public debt and deficit is also lower than Greece. In that respect, the situation of Portugal is unlike the other peripheral economies that witnessed a boom-bust situation. Portugal, however, has a significantly large external current account deficit and external debt fuelled largely by private sector borrowing. In terms of other social indicators that are critical for productivity, Portugal ranks low. For instance, as per the OECD surveys, Portugal has one of the lowest percentage of population

TABLE 5: GDP, GOVERNMENT DEFICIT/SURPLUS AND DEBT IN PORTUGAL

	2008	2009	2010	2011	2012
GDP mp	171 983	168 504	172 670	171 015	168286
GDP Growth rate	0.0	-2.9	1.9	-1.3	-3.2
Government deficit (-) / surplus (+)	-3.6	-10.2	-9.8	-4.2	-6.4
Government debt	71.6	83.1	93.3	107.8	124.1

Source: Eurostat news release euro indicators, accessed from europa.eu/rapid/press-release_STAT-12-62_en.doc.

With at least upper secondary education in the age group of 25 to 64 as compared to the EU average. Alongside, Portugal has also shown an increase in the structural rate of unemployment right from 2000. In other words, Portugal faces a somewhat different problem from some of the other peripheral economies, that is - of chronic low rate of growth.

4.5 ITALY

Italy is the eighth-largest economy in the world and the fourth-largest in Europe in terms of nominal GDP (in 2010). It has been a slow growth economy with GDP growth averaging just about 1 per cent per annum over 2000-07 as compared to close to 2 per cent for the euro zone.

TABLE 6: GDP, GOVERNMENT DEFICIT/SURPLUS AND DEBT IN ITALY

	2008	2009	2010	2011	2012
GDP mp	1 575 144	1 519 695	1 553 166	1 580 220	1617155
GDP Growth rate	-1.2	-5.5	1.7	0.4	-2.4
Government deficit (-) / surplus (+)	-2.7	-5.4	-4.6	-3.9	-3.0
Government debt	105.7	116.0	118.6	120.1	132.9

Source: Eurostat news release euro indicators, accessed from europa.eu/rapid/press-release_STAT-13-62_en.doc.

While its fiscal deficit at -4.6 per cent of GDP in 2010 is lower than the - 6 per cent for the euro zone, Italy's public debt and external debt ratios at 119 and 108 are rather large. Even though much of the public debt is held by its residents, it has large private tradable debt which makes it very difficult to rescue. While its unemployment rate at 8.4 per cent is lower than the average for the euro zone, Italy has always been characterized by north- south divide with the southern parts witnessing chronically high unemployment rates.

5. IMPLICATIONS OF EUROZONE CRISIS ON INDIAN ECONOMY

The 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 have adversely affected the globaleconomy. The euro zone and EU account for about 19 and 25 per cent respectively of global GDP. The EU is a major trade partner for Indiaaccounting for about 20 per cent of India's exports and is an important source of foreign direct investment (FDI). A slowdown in the euro zone can eventually impact the EU and the world economy as well as India.

5.1 THE RISING TRADE DEFICIT AND CURRENT ACCOUNT DEFICIT

The global financial crisis, turned debt crisis, has seen a steep rise incommodity prices, especially gold. The increase in prices of the yellow metal ismostly been driven by themeteorically increasing demand for safe havens to park the world's savings. This observation, in line with global trends, is easily explained by the declining real returns on thegamut of financial instruments available to the investor and soaring ones on gold (23.7 per cent annual average returnbetween April 07 and March 2012 versus 7.3 per cent return on Nifty and 8.2 per cent on savings deposits.[18] This has contributed to the high import bill and widening of the trade deficit.The trade deficit, as a result, increased to US$ 189.8 billion in 2011-12, which was 10.2 per cent of the GDP. With invisiblesurplus of US$ 111.6 billion (6.0 per cent of GDP), the current account deficit widened to record 4.2 per cent of GDP and further to 6.7% in the last three months of 2012.. This is unlike the situation during the 2008 crisis, when the high trade deficit of 9.8 per cent of GDP in 2008-09, was partly offset byan invisible surplus of 7.5 per cent, lowering CAD to 2.3 per cent of GDP.[19] However, the situation has turned better in 2012-13 and 2013-14 (See table 7).

TABLE 7: TRENDS IN TRADE DEFICITS AND CURRENT ACCOUNT DEFICIT AS A % OF GDP

Year	Trade deficit	Current account deficit
2007-08	-7.4	-1.3
2008-09	-9.8	-2.3
2009-10	-8.7	-2.8
2010-11	-7.4	-2.8
2011-12	-10.2	-4.2
2012-13	-	4.7
2013-14	-	1.8

Source: Economic Survey, 2012-13, The Guardian 28 march, 2013, Livemint 28th March, 2013.

India's total external debt stood at $376.3 billion at the end of December compared with $345 billion six months earlier. Higher debt means higher interest payments, which deepen the current account deficit.[20] Further the uncertainty in euro markets and other parts of the world has led to deceleration in exports and a slowdown in GDP growth. Import demandhowever has remained resilient because of the continued high international oil prices that did not decline, unlike whathappened after the Lehman meltdown of September, 2008. The country has negative trade balance with as many as 110 countries including China, Singapore, Germany, Indonesia, Australia and the UK.[21] The high CAD has hadimplications for rupee volatility and business confidence in the economy. The finance minister in his budget speech 2013-14 has hinted at focusing on FDI, FII and ECBs to finance current account deficits. This however may make capital account vulnerable to a 'reversal' and 'sudden stop' of capital, especially in times of stress. And that fall in the growth rate of imports is greater than that of export is evident from the declining trade deficit in 2012-13 and 2013-14 which have been instrumental in lowering down of current deficit.

TABLE 8: INDIA -EU TRADE

Year	Exports (US $ Million)	Percentage Change	Imports (US $ Million)	Percentage change
2006-07	26831	15.51	29856	14.84
2007-08	34535	28.71	38450	28.72
2008-09	39351	13.95	42733	11.14
2009-10	36028	-8.45	38433	-10.06
2010-11	46819	29.95	44540	15.89
2011-12	52570	14.1	57295	28.6
2012-13	50320.3	-4.28	53067.5	-7.37

Source: Economic Survey of various years

TABLE 9: INDIA'S MAJOR DESTINATIONS OF EXPORTS (% OF TOTAL)

Country	2009-10	2010-11	2011-12
EU Countries	**20**	**18.6**	**17.3**
Africa	5.8	6.5	8.1
North America	11.6	10.7	11.9
ASEAN	10.1	10.9	12.0
EUROZONE 17 COUNTRIES			
Netherland	3.58	3.09	3.0
Germany	3.03	2.69	2.6
Belgium	2.10	2.51	2.4
France	2.17	2.02	1.5
Italy	1.90	1.81	1.6
Spain	1.14	1.02	1.0
Austria	0.14	0.43	0.1
Malta	0.40	0.30	0.3
Portugal	0.21	0.21	0.2
Greece	0.25	0.14	0.3
Ireland	0.15	0.11	0.1
Finland	0.12	0.10	0.1
Slovenia	0.11	0.07	0.1
Slovak Republic	0.02	0.02	0.02
Estonia	0.02	0.02	0.02
Cyprus	0.03	0.02	0.01
Luxemburg	0.12	0.11	0.1

Source: Economic Survey of various years

5.2 THE WEAKENING OF INDIAN CURRENCY

A sharp fall in rupee value may be explainedby the supply-demand imbalance in the domesticforeign exchange market on account of slowdown inFII inflows, strengthening of the US dollar in theinternational market due to the safe haven status ofthe US treasury, and heightened risk aversion anddeleveraging due to the euro area crisis that impactedfinancial markets across emerging market economies (EMEs).[22]

The rupee has been under pressure since August 2011, when US sovereign rating was downgraded and the euro zone crisisescalated. The currency went steadily downhill till the end of July, 2012, except for intermitted respite and appreciation inJanuary-February 2012, mainly due to European Central Banks Long Term Refinancing Operation (LTRO) that injected more than euro 1 trillion in three-year loans to banks and created a risk-on environment.The rupee fell due to decline in exports on account of euro-zone crisis and widening of trade deficit, as imports remainedresilient due to high oil prices and gold imports. The widening of trade deficit to 10.2 per cent of GDP in 2011-12 had upset the supply-demand balance in the domestic foreign exchange market, placing downward pressure on the currency.[23]

TABLE 10: AVERAGE EXCHANGE RATE- RUPEE PER FOREIGN CURRENCY

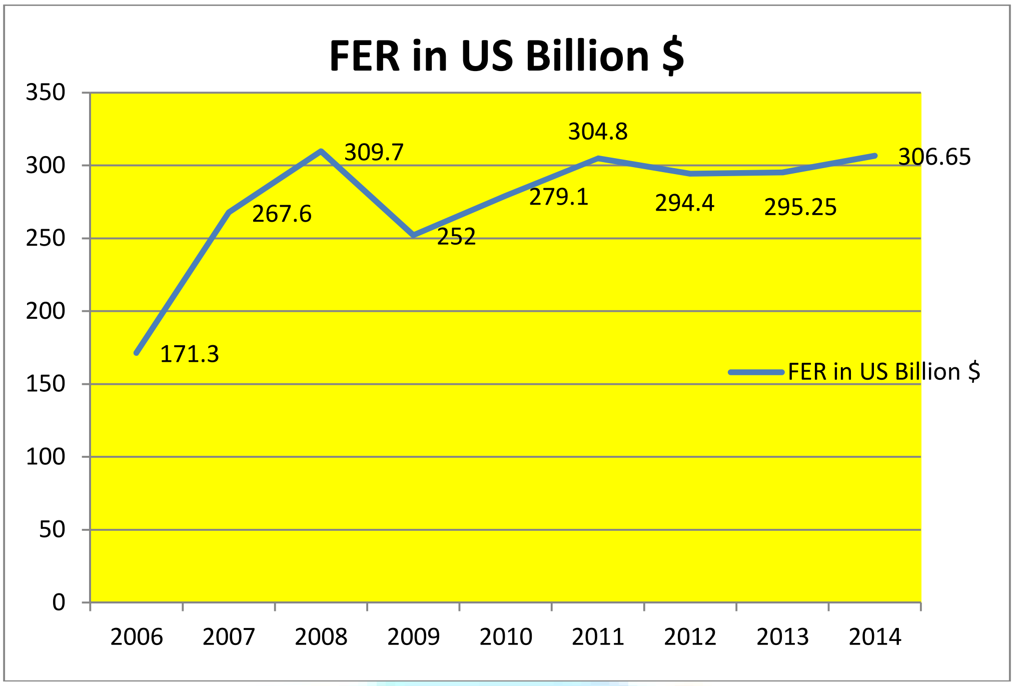
Year/Month	US $	Euro	Year/Month	US $	Euro
2010-11 (Average)	45.56	60.21	**Dec -12**	54.65	71.67
Apr- 11	44.37	64.25	**June-13**	60.76	80.95
Sept. -11	47.63	65.47	**Oct- 2013**	61.53	84.86
Dec -11	52.68	69.29	**Dec-2013**	61.8194	85.37
April -12	51.81	68.19	**Mar-2014**	61.95	82.56
June -12	56.03	70.31	**April 18**	60.31	83.58

Source: Economic Survey: 2010-11, 2011-12, http://www.ecb.europa.eu/, http://fx-rate.net/USD/INR/

5.3 THE STAGNATION IN FERS

Foreign currency assets are maintained inmajor currencies like the US dollar, euro, poundsterling, Canadian dollar, Australian dollar andJapanese yen etc. Both the US dollar and the euroare intervention currencies, though the reserves aredenominated and expressed in the US dollar only,which is the international numeraire for the purpose. The twin objectives of safety and liquidity have been the guiding principlesof foreign exchange reserves management in Indiawith return optimization being embedded strategy within this framework. Following the BOP crisis of 1990-91 that was essentially due to depletion of foreign exchange reserves, there was a consciouseffort by the RBI to build up FER. This was done through buying foreign currency in the market during periods of surge incapital flows. As a result, FER levels increased from US$ 5.8 billion in 1990-91 to US$ 314.6 billion at end May 2008.The sharp decline in rupee in 2011-12 however led the RBI to inject foreign exchange to the extent of US$ 20.1 billion to stemthe rupee slide. The pressure on currency has continued in the financial year 2012-13 because of the ongoing euro-zone crisis. The import cover of FER, as a result, has declined from 14.4 months of imports in 2007-08 to 7.1 months in 2011-12. Thereare costs to intervention. The main cost is the release of corresponding rupee liquidity, when RBI intervenes in the market tobuy foreign exchange. This may stoke inflation, which may not appeal in the current inflationary situation.[24]

DIAGRAM 1: INDIA'S FOREIGN EXCHANGE RESERVES



Source: RBI report on currency and finance, 2012, The Economic Times, April 8, 2014.

Further there were concerns that ongoing crisis in eurozone would have dampening effects on FDI inflows in India. However the present study shows that the four nations of euro zone viz. Netherland, Cyprus, Germany and France constitute a major share (14%) of total FDI inflows in the country. Therefore it can be expected that euro zone slowdown would not have a significant impact on the inflow of FDI into India. The share of other euro zone countries has been marginal. Indeed the bleak economic scenario of euro zone and better growth prospects in India may however tilt the wave of FDI flows in India's favor and of course much depends upon how fast India pushes its reform process.

TABLE 11: FDI FLOWS FROM EUROZONE (In Rs crore)

Country	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
UK	-	3840	3094	12235	36428	5797
Netherland	2780	3922	4283	5501	6698	10054
Cyprus	3385	5983	7728	4171	7722	2658
Germany	2075	2750	2980	908	7452	4684
France	583	2098	1437	3349	3110	3487

Source: Department of Industrial Policy and Promotion website accessed on 31 March, 2013 and 17 April, 2014.

6. CONCLUDING REMARKS AND SUGGESTIONS

The global financial crisis demonstrated that the globalised banking system played a crucial role in transmitting the crisis from the advanced economies to various parts of the world, including the emerging markets. The eurozone crisis further exhibited how far sovereign debt and fiscal imprudence can lead to economic disasters. The manner in which the current crisis is dealt is important for the Euro zone, Europe and rest of the world. For dealing with the Eurozone crisis, three possible alternatives are being suggested.

1. The first is the route of fiscal prudence. Austerity will have some social and political costs but the house should be set in order first. While fiscal consolidation is desirable, the question is whether, at all, this choice will lead to sustained growth in the near future, since the compression at this juncture would be extreme. Real growth is stagnating and prospects of exports leading growth appear dim. The peripheral economies are subject to a large mismatch between revenues and expenditure at the level of the government and at the household level leading to unsustainable governments and private debt. The possibility that these economies will grow themselves out of the problem seems remote. In any case, this choice does not address the structural problems faced in the peripheral economies. Therefore, the current strategy of announcing short term palliatives such as further bail outs along with sharp fiscal consolidation may only prolong the agony but not deal with the uncertainty prevailing in the euro zone.
2. The Eurozone budget is just 1% of European Union GDP. The second choicewould be to go in for a closer fiscal union and a substantially enlarged European budget with a limited system of fiscal transfers from rich countries to the poor countries, a common form of protection for employment on the German lines with more flexibility, greater cross border investment even if this implies takeover of sick and ailing public sector units by companies from the richer Euro zone states. The role of ECB needs to be redefined so that it could act as a pure central bank. It is necessary to build an institutional framework that permits a multi speed Europe on the lines of US which confirms to the tenets of OCA.
3. In the short term, it may still be possible to come up with a set of policy measures that can put the eurozone on track like a more generous ECB, more action on debt and bank resolutionsincluding more debt write-downs, and some steps towards greater risk-sharing via a move towards abanking union.

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15. If a symmetric shock, hits the currency union that is common to all members the common currency will adjust (depreciate) appropriately and there will also be scope for a common monetary policy response. However in case of an asymmetric shock, since the rest of the currency zone is unaffected, the common currency will not adjust, and the new country will therefore have to get by without the benefits of an exchange rate adjustment or of a monetary policy adjustment.
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