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EUROPEAN DEBT CRISIS: IMPACT ON INDIA & LESSONS LEARNED

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ABSTRACT--*Financial Crisis in any economy leads to losing of confidence of investors in the currency and financial assets of that economy leading to withdrawal of investments by the international investors. The sovereign debt crisis of Europe commenced with collapsing of banking system of Iceland resulting to collapse of many financial institutions of repute which further spread to many other European economies. Prime finding of study leading to European Debt crisis were, a) growing saving available for investment with high expectation from investors which was fulfilled by the developing nations lead to diversion of investment from US Treasury bonds to internal capital market b) EU member countries committed to restrict their debt levels & deficit spending, but number of countries failed to follow the terms & conditions of the treaty c) Inflexible Monetary Policy d) Structural Problem of Eurozone System e) Trade deficits f) Trade imbalances g) loss of confidence h) change in credit rating etc., Further the study looked into the impact of crisis where in it found that decrease in GDP, increase in interest rates, depreciation of rupees, higher import bills, fiscal deficits. The prime lessons learned from the crisis were too much leverage, too much liquidity, too much complexity & too much greed should not be there which have led to the European debt crisis, reduce public expenditure, and introduce measures to increase the efficiency in tax collection, minimizing big subsidies, steady monetary integration and international financial integration, financial market enforcement can be some of important steps that can be taken to avoid such kind of financial crisis.*

Key words-- *Financial crisis, Debt market, Sovereign bonds, European Union, GlobalEconomies,Deprication***.**

I. INTRODUCTION

Financial Crisis in any economy leads to losing of confidence of investors in the currency and financial assets of that economy leading to withdrawal of investments by the international investors. This kind of situation arises when demand for money is greater than the supply available, leading to quick exhaust of liquid cash or assets to meet the withdrawal demands of account holders expecting the quick downfall of asset values of those assets they hold. Market value of financial institutions will be at stake forcing the institutions to write off their assets to meet the demand or collapse.

The severities of European financial crisis lead the entire global economies to confusion and European Union itself into doubt about their sustainability. Results of crisis lead to collapse of many financial institutions of repute, rising in yield spread of the government securities and increasing of high government debt.

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The sovereign debt crisis of Europe commenced with collapsing of banking system of Iceland in 2008, spread across Portugal, Greece, and Ireland in 2009. European business and economies were under the clutches of crisis leading to low confidence of investors.

The need for third parties assistance for their debt management has risen in some economies in Europe making it difficult or to great extent impossible to repay their government debts.

Due to non-repayment of sovereign debts by some member countries of European Union, Euro zone and Euro currency were in great trouble.

Some countries which were already facing some other troubles like Cyprus, Ireland and Portugal, added to this crisis become worst in financial administration and started downgrading their credit ratings and impending threat.

Then countries like Ireland, Cyprus and Portugal which were already in tremendous trouble and have already started seen downgrading of their credit ratings. Others countries were also facing the impending threat.

The sovereign debt crisis of Europe had become one of the most burning issue which threatened the different countries globally and India was a not exception to this. By looking into the ups and downs of European Union due crisis, this paper seeks to understand the causes for crisis, its impact on India & also emphasis on the lessons learnt from the crisis

II. BACKGROUND

In 1992, European Union (EU) members signed a treaty known as the Maastricht Treaty. Another name by which treaty was known was Treaty of European Union. This treaty was revision to earlier treaties of Rome, Single European and Paris. Political integration and unions of member states come close each other were the outcomes of the treaty.

The Maastricht Treaty was signed on 7th Feb, 1992 by the European Community members, but came to enforcement on 1st Nov, 1993. Later on enforcement of European Union and on agreement to have Euro as a common currency, the initial aim of the member states of European Union was to have common market. This was the prime object of the treaty.

Under this treaty European Union members promised to put limits on their deficit spending & their debt levels also. But, in early 2000s, most of European Union member stated failing to keep up their promises done under of the treaty and started management of their debts and deficits by securitizing their future government revenues. On other hand Sovereign states (independent states) started selling their rights to receive future cash flows. They allowed governments to raise funds without violating debt and deficit targets. But, in due course they ignored certain practices and internationally agreed standards. The sovereign states were able to cover their debt & deficit levels.

Germany raised € 15.5 billion during 2005-06 by securitizing payments related to pension from Deutsche Post bank, Deutsche Post, and Deutsche Telekom and also guaranteed payments. Investors then has to bear German Government’s credit risk only, as all the transaction were recorded as Government borrowing instead of sale of assets in “Europe’s fiscal statistics”.

Late 2009 onwards, fear among investors developed about the sovereign states debt crisis as government and private debt levels started growing across the world economies with degradation in government debt of some of the European countries.

Crisis causes varied from country to country. Due to banking system bailouts and government responses, it was witnessed that most of property crisis arising from private debts were transferred to sovereign debt leading to slow down of economy in post crisis. Debt levels that were increased in Greece were able to control due to high level public sector wages and commitment to pensioners. The major contribution to the crisis and reason that harmed the ability of leaders of European Union to respond was due to the structure of monetary union that is, one currency for Eurozone without uniting of tax and public pension rules i-e fiscal union. A significant amount of sovereign debt was managed by European banks so that they can manage the solvency of sovereign and banking systems that may negatively reinforce anytime.

European nations implemented a series of measures towards better financial management through European financial Stability Facility (EFSF) and European Stability Mechanism (ESM) towards continued concerns in 2010 and later. The European Central Bank lowered the interest rates on deposits and lend loan at a cheap rates for an amount of more than 1 Trillion Euro's to maintain the flow of money among European banks and this was one of measure taken up with all other political measures.

Greece was suffering from huge debt of around Euro 340 billion after taking all the precautionary measures. The rating agencies declared this huge debt to be junk and has a high chance of getting default. Even Italy and Spain were also loaded with high debt, bad debt and highest unemployment in European Zone.

The crisis majorly had political impact on the ruling government in European countries namely, Ireland, Greece, Portugal, Italy, Slovenia, Spain, Netherlands and Slovakia apart from the adverse economic effects on these economies, because of which investors were worried to invest in European nations and other parts also.

Further, this paper through light on the root causes for the crisis….

III. CAUSES

1. 2000-2007 Crisis:

"Sovereign debt crisis in the Europe has started with increase in investment of growing savings available for investment significantly during 2000-07 periods. During that period income from the fixed-income securities have increased approximately to $70 trillion by 2007 from $36 trillion in 2000. This pool of savings money was generated from developing nations of high growth rate. Those investors started penetrating for higher yield securities than those offered by U.S Treasury Bonds & which made investors to enter global capital market".

The savings that were readily available strongly affected the regulatory control & policy mechanism in almost all the counties. Borrowers & lenders took advantage, the prices of housing & commercial properties were declined which created a liquidity crunch in the economy & generated a question regarding the solvency of government & their banking system.

Many European countries also involved in debt crisis. The tax payers and the government of Ireland anticipated private debts as Ireland Bank had lent the money to the property developers. The public works commitment was increased in the form of exceedingly huge wage and benefits by the Greece government. French Banks were owed by the Italian borrowers to the extent of $366 billion which affected the France creditors in turn and this was referred as “Financial Contagion” in October 2010. Greece banks hided its growing debt & deceived EU officials by entering into credit default swap (derivative) contacts.

2. *Rising household & Government Levels:*

In 1992, EU member countries signed the Maastricht Treaty in which EU member countries committed to restrict their debt levels & deficit spending, but number of countries failed to follow the terms & conditions of the treaty.

Before crisis period, the adoption of the Euro as a common currency led many countries to charge very low rate interest on their bonds & private credits. The result of which creditors in the country with weak currencies enjoyed much more favorable credit terms which created property crisis. This is considered as one of the fundamental cause for European debt crisis. Most of the economists commented & said increased debt levels were mostly because of large bailout packages provided to the financial sectors during late 2000’s financial crisis. The fiscal deficit grew to 7% from 0.6% which was in the European area in 2007 during the crisis. The average debt of the government also rose to 84% from 66% of GDP during this period.

During crisis, the average fiscal deficit grew to 7% in the European area which was only 0.6% during 2007 & in this period, the average government debt increased to 66% to 84% of GDP

3. *Inflexible Monetary Policy:*

A single monetary policy was established by EU to prevent each member countries acting independently. From then members were not allowed to create their own Euro currency towards paying creditors & therefore eliminate their default risk. As single currency is accepted in Eurozone, further devalue of their currency to make their export cheaper was not possible.

In opposite to that “the assets held in a currency which had devalued & suffered loss on account of those holdings. At the end of 2011, there was fall in exchange rate by 25% & 5% rise in inflation because of which Eurozone investors in Pound Streling had suffered an approximate 30% cut in the repayment value of their debt”.

4. *Trade Imbalances:*

During the period of crisis Ireland, Portugal, Spain & Italy had far worse Balance of Payment positions. The relative change in the labor costs with was due to trade deficit left Southern nations comparatively less competitive leading to increase in trade imbalances. The labor unit cost roused to 32% high in Italy in comparison to Germany. The decrease in competitiveness was witnessed as they allowed growing wages faster than productivity.

Increase by 32% in labor unit cost was witness in Italy since 2001, compared to Germany. Most of the EU nations endorsed wages growth which was faster than productivity leading to loose competitiveness.

Apart from that, the gap between Germany & Greek productivity increased because of flow of capital which was to be invested towards increasing productivity were utilized for consumption & consumptive investments.

Further, trade surplus of Germany within the European zone was declining in 2011 as the trading partners were less able to find financing facilities which was very much necessary to finance their deficits.

5. *Structural Problem of Eurozone System:*

There was paradox on structure within the Euro system as there is only a monetary union without fiscal union (taxation, pension & treasure functions). Though some agreements related to monetary policy were there but member countries were not be able to follow it & it became difficult to control & regulates financial institutions of nation.

Further, the problem was that the European zone system had a difficult structure for immediate and fast responses. European zone, which had 17 nations as its members, don't have common agreement towards decision making process & it become challenging for the Eurozone to respond immediately to the problems.

6. Loss of Confidence:

Before the happening of crisis the banks and the regulation has assumed that the "sovereign debt" the European Zone were safe. Banks were holding considerable share of bonds of weaker economies as Greece which fetched small returns. The bonds offered by the Greek and other countries were becoming more risky with the development of this crisis. Lack of proper information relating to risk aspect of "European sovereign debt" instruments lead for conflict of interest among banks. Investors also lost confidence in market which was marked by rising sovereign debt.

Further, investor also doubted possibilities of the quick handling of crisis by the policy makers. This was because the European zone countries used Euro as a common currency, and had inflexible monetary policy & "European Central Bank" also had inflation control mechanism but not the employment mechanism. Hefty bank withdrawals were witnessed in weakening European zone states such as Spain and Greece. Deposits in bank in Eurozone were insured by agencies of each member government, failing to which it is unlikely that the government will not be in position to fully and promptly honor their commitments.

European Banking Systems witnessed stress particularly Spain, as banks capital was blocked in funding markets in June 2012 and interbank lending & investors were worried that the banks are hiding losses or were losing trust in one another.

Euro hit new low in June 201. From "June 2011 to June 2012 Italy & Spain alone have lost 235 billion and 286 billion Euros". Mediterranean countries together have lost asset worth 10% of GDP.

7. Change in Credit Ratings:

During the crisis period many rating agencies like Moody, S&P, and FITCH etc downgraded the sovereign ratings of the Euro nations due to low leverage and the creditworthiness of its Member States, increased bailout loans, political instability, lack of monetary control etc. THE EUROZONE'S new permanent bailout fund has been stripped of from AAA to AA1. The downgrade follows a similar move for France, the fund's second-largest contributor, which had also lost its AAA rating.

"On 5th December 2011, S&P assigned its long-term sovereign ratings on 15 member countries of the Eurozone on CreditWatch with negative implications". **This is because of the following five interrelated factors:**

1) "Credit conditions tightened across the Eurozone.

2) Higher risk premiums on a growing number of Eurozone sovereigns including some that are currently rated 'AAA'.

3) Ongoing differences between European policy makers on tackleing the immediate market confidence crisis and, longer term, how to ensure greater economic, financial, and fiscal convergence among Eurozone members.

4) High levels of government and household indebtedness across a large area of the Eurozone.

5) The rising risk of economic recession in the Eurozone as a whole in 2012".

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IV. IMPACT OF EUROPEAN DEBT CRISIS

The markets are swaying to the ripple effect of developments across the global. The Indian economy's growth & inflation numbers are struggling hard to cope with the problems of debt default, hike in oil price & economic crisis of nations.

After the American subprime crisis that began in US, the Eurozone crisis is the next big cause of concern for global economies. The present European debt crisis threatens to impact economies of all most all the nations even with healthy domestic growth. The sever debt crisis in Euro nations could spread to other nations, affect the financial health of developed economies & hindering the economic recovery of developing nations like India. The increased oil price at an international level has added fuel to the fire.

Impact of European Debt Crisis on India

- ***Increase in Inflation:***

The continued uncertainties in the global economy as illustrated by the rising Credit Default Swap (CDS) spread slowdown in European economic activities, has an adverse effect on Indian inflation rate. As the Europe has more foreign investment in India than in any other country. FII investment pattern is associated with high volatility. A sudden increase in investment pattern is as detrimental as an unannounced withdrawal. Increase in FII investment lead to surge Purchasing Power which in turn caused inflation to increase. Domestic inflation for the month of Oct 2011 stood at 9.7%, ever highest rate during crisis period.

- ***Decrease in GDP:***

In India, economic growth has slowed since the European sovereign debt crisis started, declining from 9.9% in 2010 to 7.4% in 2011 & even more to 5.3. % in 2012-13. India's economic growth rate has slowed due to decline in foreign investment which is caused by increased inflation & inability of the RBI monetary policy to control high inflation. This decline in the investment has in turn, led to a depreciation of the Indian rupee against Euro which has touched a record high of Rs. 72.18 in Jan 2013 as compared to Rs. 56.72% in Jan 2010.

Beside FII withdrawal domestic demand in India has fallen due to high interest rate that gives Indian businesses & consumers to incentive to save their money rather than to spend or invest it.

- ***Increase in Interest Rate:***

Beside the slow economic growth, the RBI raised interest rates 17 times since March 2010 to reduce inflation (of around 10 %). India's inability to control inflation has discouraged the foreign investments.

- ***Depreciation in Rupee:***

Volatility in the exchange rate is increasingly being recognized as a concern for the Indian economy. During 2011 the rupee has depreciated 10.41% against the Euro & has touched high of Rs. 70.07 v/s Euro on Nov 23, 2011. Rupee depreciation has an impact on exports, imports, GDP, inflation, debt burden, current account deficit etc

- ***Higher Import Bills:***

A depreciation of local currency generally causes high import costs for the domestic economy. India imports 80% of oil from foreign country. Increased oil price in the international market which is $108 per barrel in 2013 as compared to $88 per barrel in 2010 May. Increased oil price & other commodity prices caused India's current account deficit to increase which is $31 bn at present as against $22.3 bn in 2011 & which was only $4.45 bn in 2011.

India's import has increased from around Rs. 1100 bn in 2012 to Rs. 2475.94 bn in Feb 2013

- ***Fiscal Deficit:***

The fiscal deficit for 2012 was budgeted at 4.6% of GDP in Feb, with the average oil price $110 per barrel. Increased oil price in the international market has become burden on the shoulders of government. Oil subsidy during 2012 was Rs. 24000 cr. This caused highest cost of oil which is being borne by the government.

- ***Increased Burden on Borrowers:***

Higher rates will come in the way of potential borrowers. In present day, interest rates are different in domestic & global market. With the depreciating rupee, people who have to services their loans will have to bear the higher cost of debt service.

- ***Impact on Indian Stock Market:***

Investors anxious about the Greece debt crisis impact on global economic, sent indications to the stock market sink & extended the losses in early 2010. The benchmark indices Sensex & Nifty touched a low of 16823 & 5037 in March 2010. Selling pressure gathered momentum following weakness on fears that Greece's sovereign debt crisis might spread to the other countries including India. Due to heavy selling pressure the most heavily & market leaders Reliance, Infosys, SAIL, SBI, and BPCL etc ended in negative.

- ***Impact on Corporate:***

Few of the Indian firms, which opted for investment in Europe, have been hit by the sovereign debt crisis & they witnessed fall in business prospects. According to the statement of Industry Chamber Federation of India Chambers of Commerce & Industry (FICCI) nearly 75% of industrialists posted fall in their business prospects & also loss of more than 20% in business generation from Europe.

V. LESSONS LEARNT FROM EUROPEAN DEBT CRISIS

Too much leverage, too much liquidity, too much complexity & too much greed- they all have led to the European debt crisis. It had hit the European economy & worsens the situations at European nations & across the global. This crisis has taught that building up excessive debt without credible solution causes heavy penalty to the government. Therefore, the governments should take precautions at the time of rising debt from the international markets.

Apart from precautions one should try to reduce public expenditure, introduce measures to increase the efficiency in tax collection & must find ways to minimize the big subsidy bills that are incurred every year.

"There has been no rest for European policymakers from the debt crisis as the yield on Italian bonds jumped alarmingly. Italy has very high level of indebtedness with an estimated $2.6 trillion outstanding, which is 120% of its GDP; it has the largest amount of sovereign debt for any European country & the third largest in the world. If bond yields were to go up again, Italy's cost of borrowing will climb to unacceptably high levels.

The most important lesson from the crisis is that any dependence on private capital for financing public expenditure can create stress & strains on the national economy. Fortunately for India, policymakers learnt that lesson long ago".

Too much of social security in the western nation made them avoid savings & encouraged to live beyond their means. But India does not have system for such social security, while it has its own problem of high fiscal deficit, increased inflation, currency pressure, cost of lending, falling growth etc which have contributed to economic slowdown & policymakers are targeted towards soothing the markets, volatility etc.

Beside the above mentioned measures one should be keen on maintaining political stability, changing ministers of the states, role & mandates of central bank & financial stability in the economy.

Apart from above mentioned some other learning's for regional financial and monetary integration and cooperation among the different countries are as follows…

(1) Monetary integration to be done steadily.

(2) Reconsideration of international financial integration benefits and costs.

(3) Development of prevention and resolution mechanism and strengthen it before the rise of next Crisis that hits the region

(4) Financial markets reinforcement and monitoring.

VI. CONCLUSION

This paper troughed light on European debt crisis, what went wrong in Europe which has troubled & caused European nations to face great difficulties. Rising debt, trade imbalances, inflexible monetary policy, stringent structure of European Union, loss of confidence etc are the major aspects which had hit European countries badly.

It also provides brief information that how European debt crisis has impacted India. The Indian economy's growth & inflation numbers are struggling hard to cope with the problems of debt default, hike in oil price, economic crisis of nations etc this has happened because of pressure on currency & other related factors which is basically from the European nations.

Beside causes & impact it also highlight few lessons which others should learn the mistakes of European Union & nations. The governments should take precautions at the time of rising debt from the international markets. one should try to reduce public expenditure & subsidy bill, policymakers should be cautious while drafting policies, should maintain political, social & economic stability etc.

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