

## The Eurozone Crisis: A Lesson for India?

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**Abstract:** *The Sovereign Debt Crisis in Europe, better known as the Eurozone crisis, is a continuing crisis that has engulfed the eurozone countries, causing severe macroeconomic effects since 2009.*

*With special reference to the Eurozone crisis, objective of this paper is to theoretically and quantitatively analyze the possibility of a debt crisis in the current backdrop of sluggish growth of Indian economy. Research Methodology that has been used is a combination of secondary data collection from public sources and quantitatively analyzing them using Line Graphs and Bar Diagrams. Findings suggest a myriad of economic indicators, demonstrating conflicting trends, typical characteristic of a fast growing economy – lower than five percent GDP growth rate, increasing gross fiscal deficits and trade deficits, slowly rising debt-GDP ratio, steady debt service ratio, increase in domestic capital formation, diminishing NPA as percentage of gross advances of banks, increase in bank credit to all sectors including the real estate sector and escalating foreign investments and foreign exchange reserves. The paper concludes that though the current scenario does not point out to an approaching debt crisis, but factors like GDP growth rates, budget deficits, disbursement of housing credit, foreign investments should be kept under scrutiny to avoid future financial instability.*

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### INTRODUCTION

In midst of the framework of an economy, the Financial Sector is considered to be the backbone of every economy- be it a developed or developing economy. A strong and steadily growing financial sector is always a key element behind growth of an economy. Any disturbance in this sector has ripple effects on the whole economy and can bring it down to its knees. In today's era of globalisation, all countries in the world are interconnected through inter-country capital flows through the financial sectors. Capital flows take the form of investments, disinvestments, borrowing, lending and aids. Borrowing and lending of funds lead to development of debts. Government debt, categorized as internal (domestic debt in home currency) and external debt (debt issued in foreign currency), can sometimes prove to be highly unsafe especially in case of developing nations. Inability of any government to repay its debt can lead to a sovereign debt default.

Sovereign debt is coined as bond issued in foreign currency. Countries encourage sovereign debt as it is used to fuel economic growth through higher investments. Sovereign debt is a safe investment in case of developed countries, but is risky for developing nations. Developing nations have a higher risk of facing fiscal, monetary, trade and currency imbalances, which can make a country vulnerable to sovereign defaults. A Sovereign Debt Crisis occurs when a debtor nation is unable or unwilling to pay back its debts. The causes of a sovereign debt crisis has a huge spectrum. Sudden changes in exchange rates, rising indebtedness of debtor countries, prevalence of illiquid assets, change in political scenario (change of power), illogical debt payment structuring, corrupt government norms and regulations (like overestimation of revenues from economic growth, overvaluation of payback from projects that is financed by the debt<sup>1</sup>), higher percentage of short term debts, are some of the major factors that can lead to a sovereign default. A Sovereign Debt Default can lead to various types of crisis at the macro-economic level. Primarily, it leads to a banking crisis, since banks have to write down its credit as there remains no direct means of receiving funds back. A sovereign default also leads to an economic crisis. Call back of capital leads to capital outflow followed by a decrease in aggregate demand and dampening of economic growth. Lastly, a devaluation of home currency required for debt restructuring can lead to a currency crisis.

Sovereign debt crisis started as early as 1557 in Spain and thereafter almost all countries of the world have faced a sovereign default or a debt restructuring at some point of time or the other. Countries which have faced sovereign debt defaults are Austria-Hungary (1796), France & Sweden (1812), Denmark (1813), Netherlands

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(1814), Germany (1932), Romania (1933), Mexico (1982), Yugoslavia (1983), Russia (1998), Argentina (2001) and Greece (2012)<sup>2</sup>.

With reference to the Eurozone crisis, objective of this paper is to theoretically analyze the possibility of a sovereign debt crisis in India.

### **THE EUROZONE CRISIS-CAUSES**

28 states in Europe formed Eurozone. 18 member states of the Eurozone signed the Maastricht treaty in 1992 and an unique currency “Euro” was established. The treaty obliged the states to keep inflation rates below 1.5% points higher than average three best performing states of European Union (EU), no more than 3% government deficit to GDP ratio, no more than 60% gross government debt GDP ratio, maintaining currency level and long term interest rate not exceeding 2% points higher than three lowest inflation states of the EU<sup>3</sup>. Although Maastricht Treaty and European Monetary Union led to currency union, but there was no fiscal union, i.e. independent taxes, wages, pensions, expenses e.t.c. From early 2000, many member states were unable to stay within the treaty and started covering up their higher budget deficits and debts using corrupt accounting practices and out of balance sheet transactions. In 2009, the new Greek government revealed much higher budget deficits and debt-GDP ratios which were covered up by the previous government. Such a disclosure struck panic among the investors, and loans were called off and interest rates increased. Many countries revised their deficits and debts, and it created a situation of chaos- outflow of funds, high interest rates, low growth, inflation, unemployment, fiscal imbalances, high taxes, low wages and pensions and so on. It led to beginning of sovereign default and sovereign debt crisis. After Greece asked for a bailout, the crisis spread to Ireland, Portugal, Italy, Spain and all other EU states.

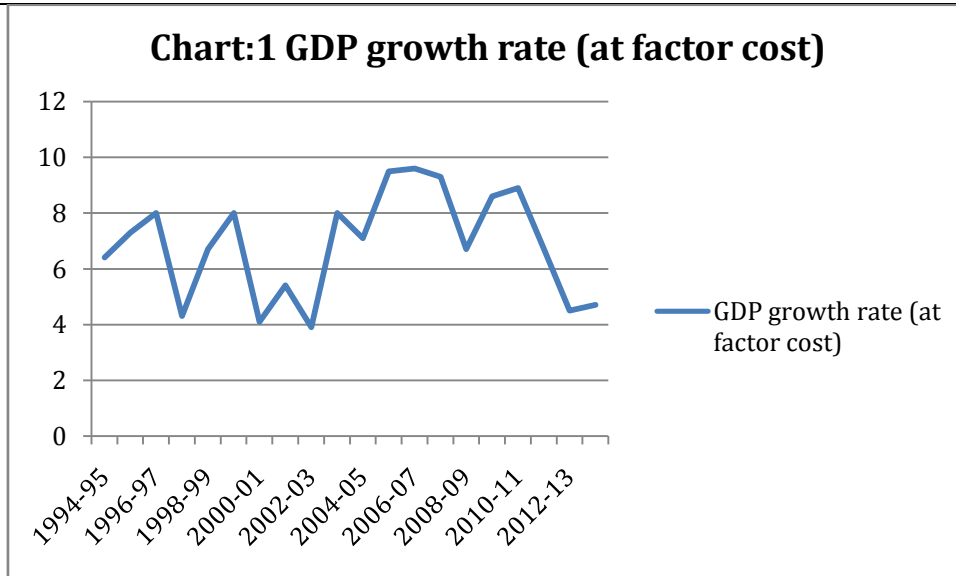
The major cause of the crisis were globalisation of finances, poor GDP growth, low export growth, high debt-GDP ratios, high risk lending and borrowing, real estate bubbles, fiscal and trade imbalances, speculation, undercapitalisation and liquidation of banks and poor investment rating by credit rating agencies<sup>4</sup>.

### **RESEARCH METHODOLOGY & ANALYSIS**

This paper analyses certain macro-economic indicators of India for fulfilling the objective. The paper has made use of secondary data from year 1994 to 2013-14 as per availability from various credible sources. Sources such as RBI, IMF, World Bank, Department of Industrial Policy & Promotion of India, Planning Commission of India has been used for data collection and references. Data analysis has been performed using line graphs, bar diagrams, etc.

#### **Gross Domestic Product (GDP) Growth Rate**

Ever since 1950's, growth rate has been fluctuating immensely, showing negative rates in some years. Post 1991, growth rates demonstrate positive trends, from 1.4% to rates above 5%. Rates have been soaring in most years, except 1997-98 (4.3%), 2000-01 (4.1%) and 2002-03 (3.9%). Post 2005-06, growth rates have been mostly above 8%. However due to contagion effects of the eurozone crisis, growth rate was lowest in 2012-13 i.e 4.5%, increasing marginally to 4.7% in 2013-14.

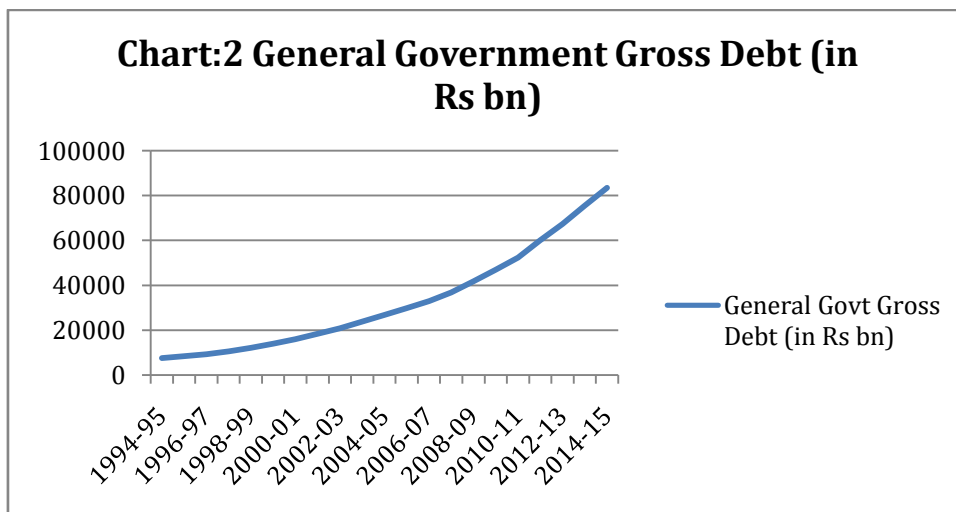


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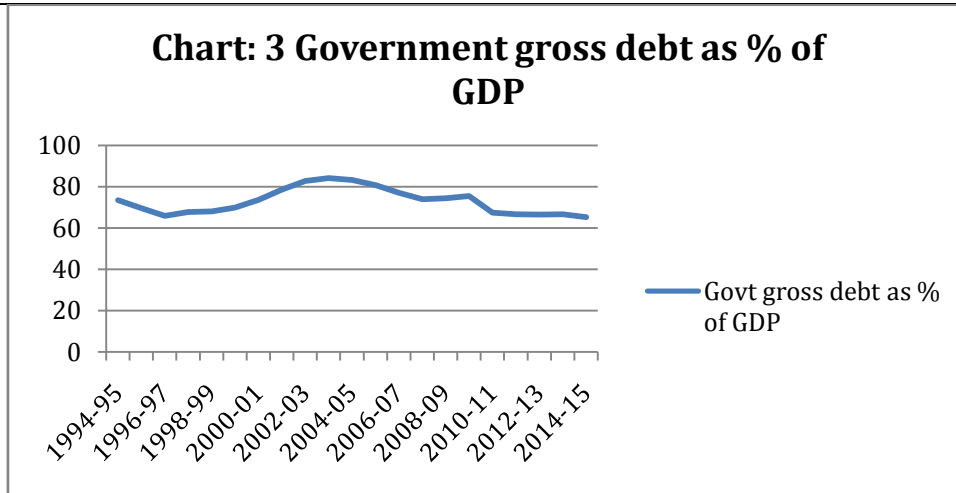
**Total Debt, Debt-GDP ratio, Debt-Service ratio**

Post liberalisation, India’s General Gross Government Debt has been increasing steadily. From Rs. 5,076.44 billion in 1991, it increased to Rs. 83,551.19 billion in 2014.

Debt-GDP ratio is the ratio between the country’s national debt and GDP. A lower debt-GDP ratio implies, that the country produces and sells enough goods and services to pay back its debt, without accumulating further debt. The graph of total gross debt as a percentage of GDP shows a fluctuating trend. In 1991, it was 75.33%, increased for consecutive 2 years. It started declining from 1994 to 1996 and went down to 65.97%. 1997 onwards, it started rising for the next 7 years and was at 84.24% in 2003. Consequently, it declined and was at 66.7% in 2013 and 65.3% in 2014.

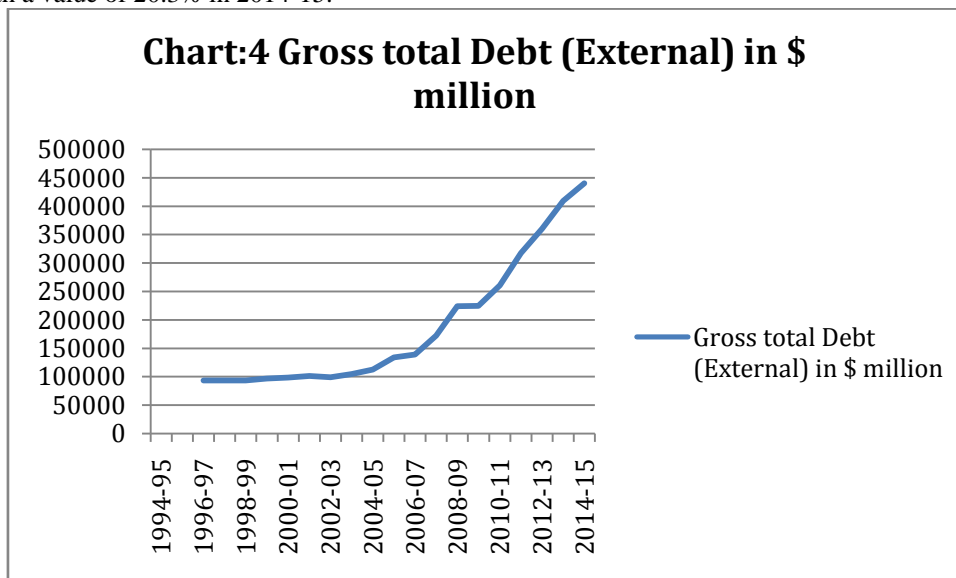


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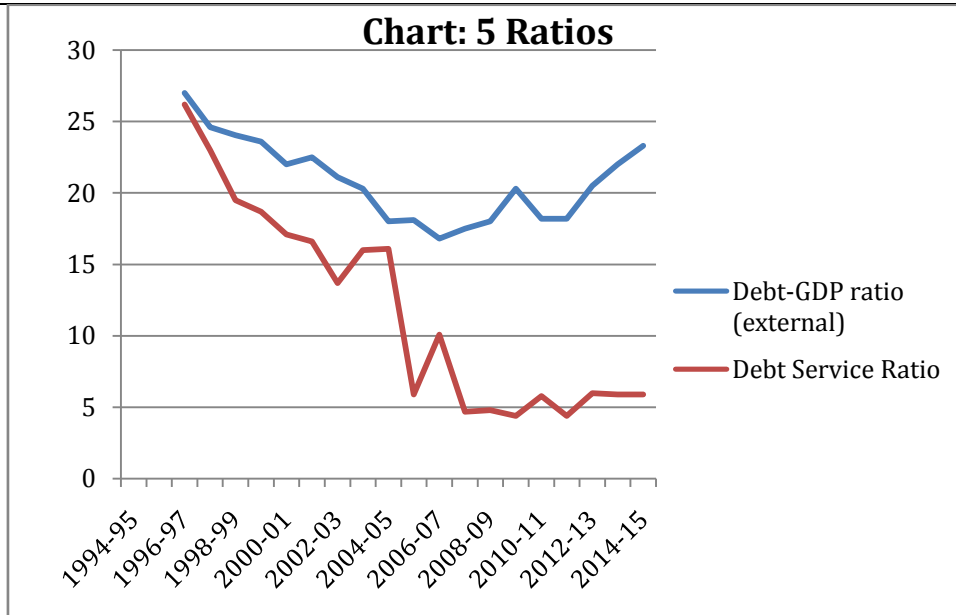


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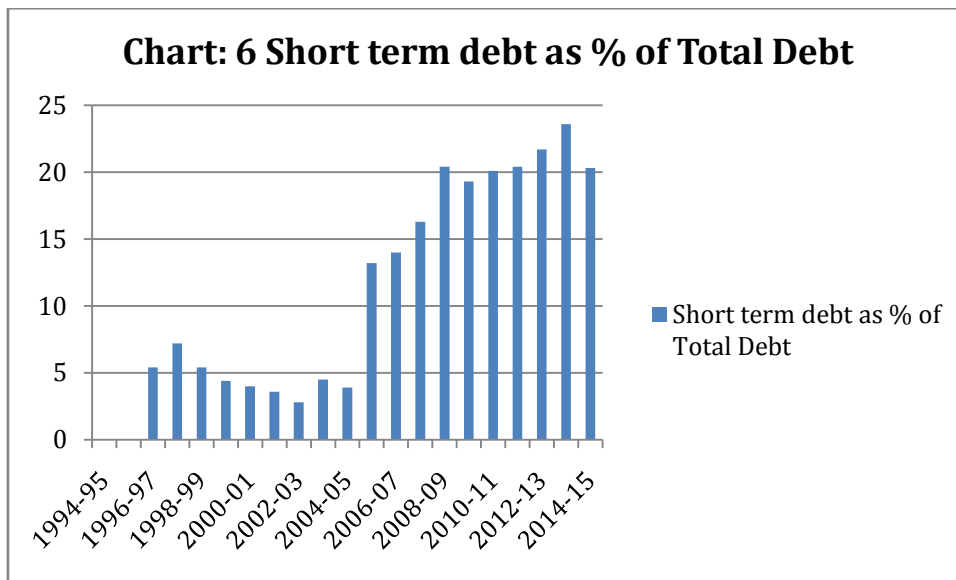
Data on India's external debt shows a steady escalation. External debt-GDP ratio declined from 27% in 96-97, to 18% in 2008-09. Thereafter, there has been a minor escalation to 20.5% in 2012-13 and to 23.3% in 2014-15. Debt-service ratio shows the ratio of debt payments to country's earnings. A low value of the ratio implies good financial health. External Debt-service ratio was 26.2% in 96-97 and declined till 2002-03. Thereby, the rate has been fluctuating till 2006-07. From 2007, there was a steady decrease and it was 5.9% in 2014-15. Short-term external debt as a percentage of total debt was 5.4% in 1996-97 and 7.2% in 97-98. It declined to 2.8% in 2002-03 but shot up to 13.2% in 2005-06. The increase was predominant till 2013-14 when it was 23.6%, with a value of 20.3% in 2014-15.



Data Source: rbi.org.in



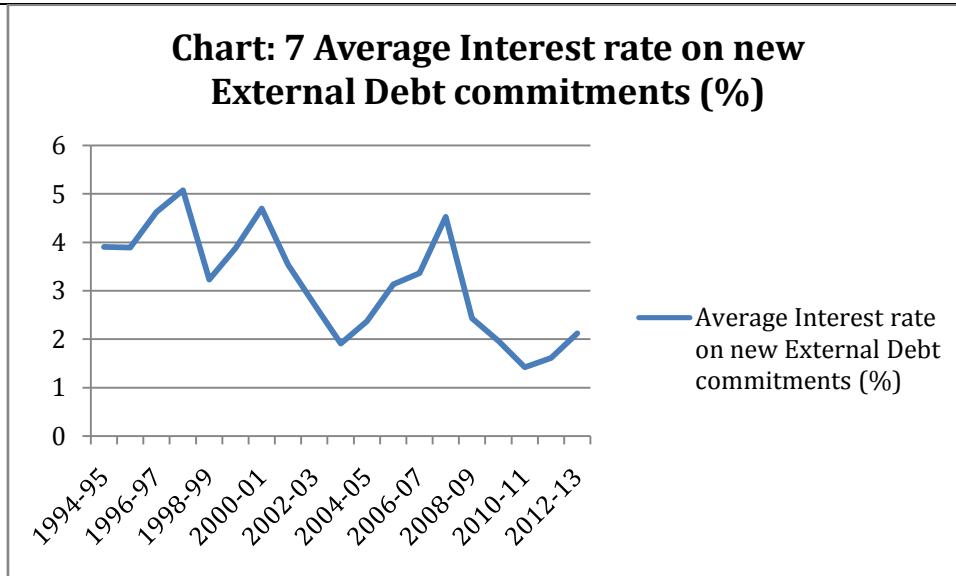
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**Average Interest Rate**

Interest rate on new external debt commitments was 5.844% in 1991 and remained in the range of 3-5% till 2001. It declined to 1.908% in 2003 and slowly increased to 4.527% in 2007. 2008 onwards, interest rates were in the range of 2-1%.



Data Source: www.imf.org

**Exports as a percentage (%) of GDP**

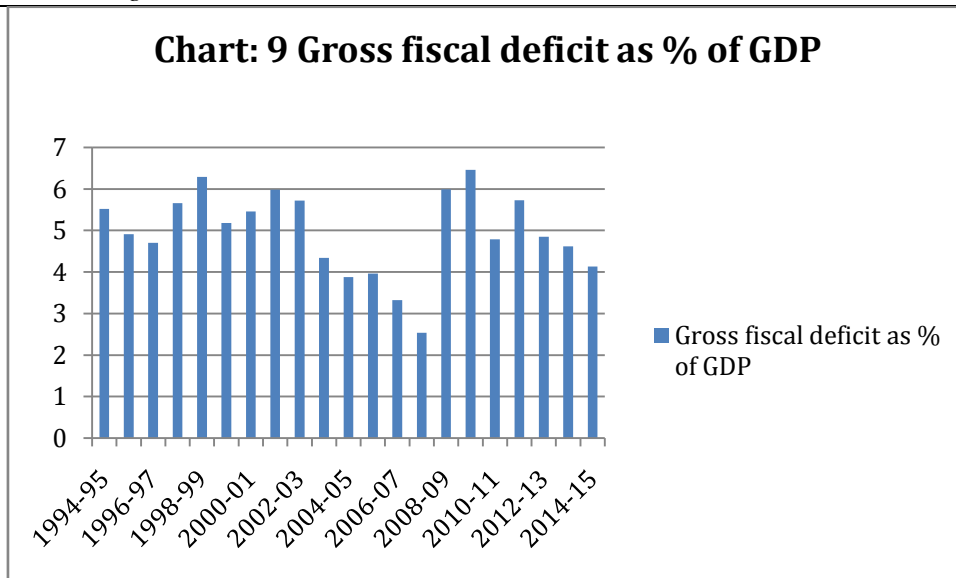
Exports as % of GDP was 8.3 in 1994-95 and was in the range of 8-10 till 2001-02. It revealed an upward trend from 2002-03, with a slight dip in 2009-10 and stood at 17% in 2013-14.



Data Source: rbi.org.in

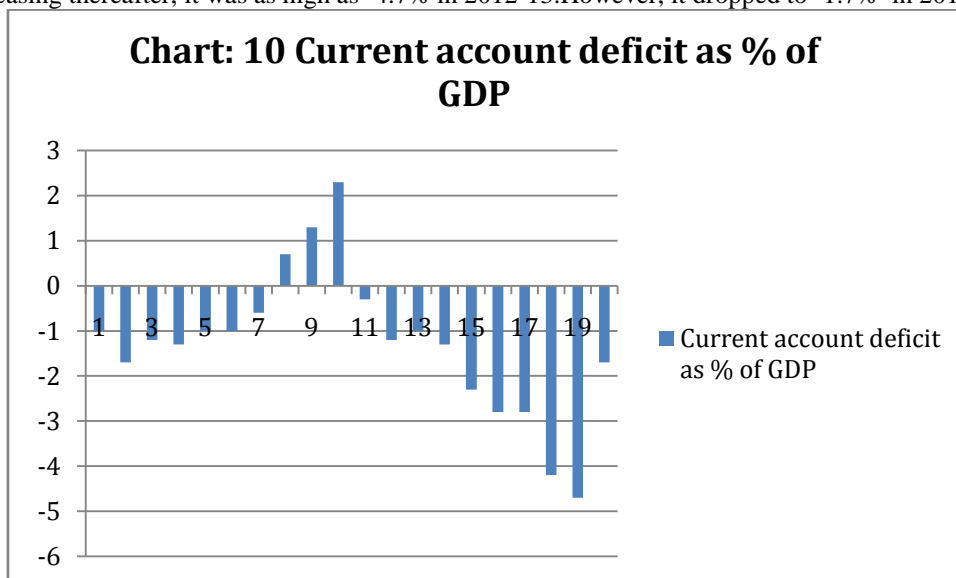
**Deficits as percentage of GDP**

Fiscal Deficit occurs when government expenses exceeds revenue. High fiscal deficits leads to increased borrowing by government, increase in interest payments, increase in taxes, increased demand leading to inflation. Though it has been argued that high fiscal deficits may act as a catalyst to economic growth, but, the repercussions outweigh the positive effects. Graph shows that gross fiscal deficit was 5.52 % of GDP in 1994-95. With minute fluctuation, it was in the range of 5-6% of GDP from 1999-2000 to 2002-03. It declined to 2.54% in 2007-08, but started rising thereafter and was 4.13% of GDP in 2013-14.



Data Source: rbi.org.in

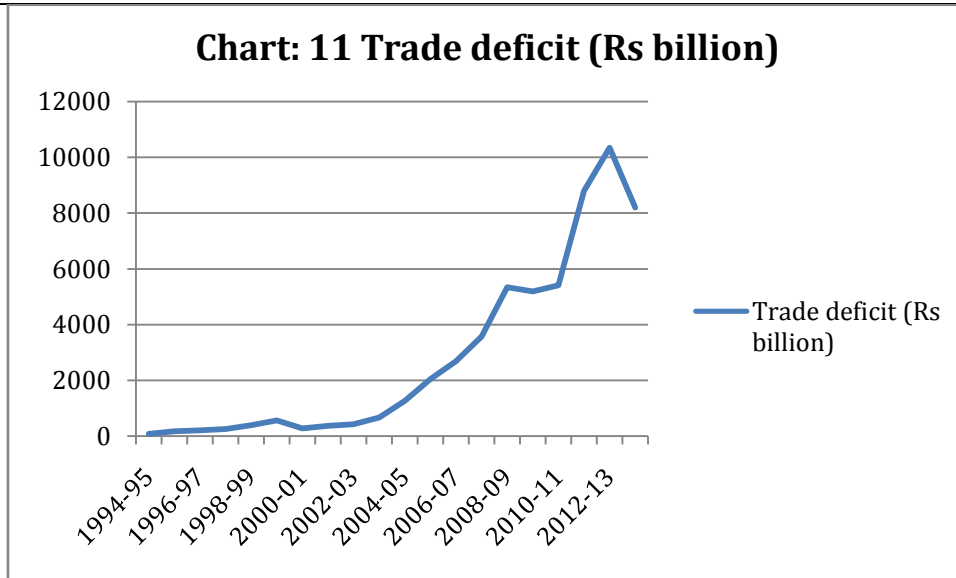
Current account deficits as percentage of GDP was -1% in 1994-95. It showed positive figures from 2001 to 2003, increasing thereafter, it was as high as -4.7% in 2012-13. However, it dropped to -1.7% in 2013-14.



Data Source: rbi.org.in

#### Trade Balance

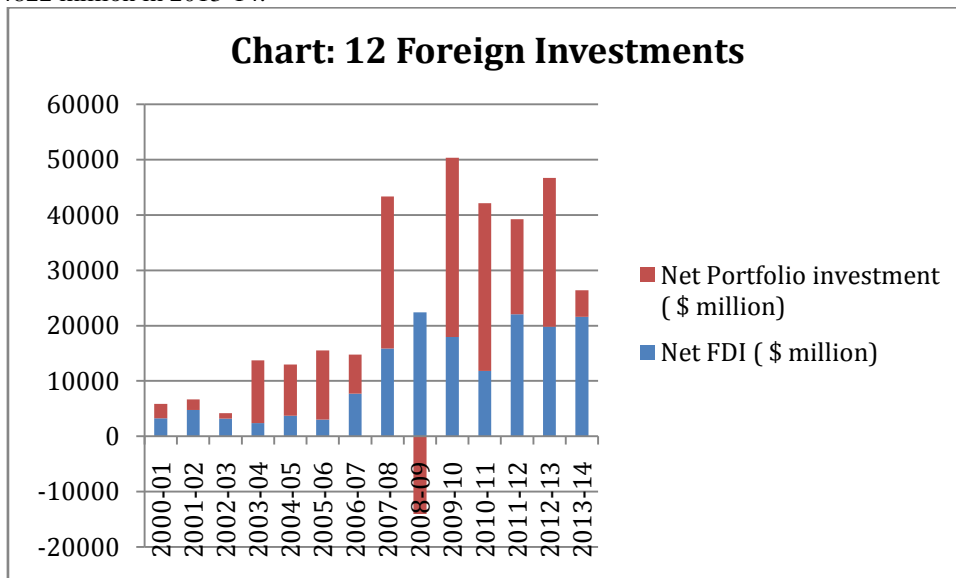
The balance of trade of India has always been negative. It was -72.97 billion Rs in 1994-95 and the figures were progressively rising thereafter and was highest in 2012-13 at -10348.43 billion Rs. It was recorded at Rs -8200 billion in 2013-14.



Data Source: rbi.org.in

### Foreign Investments and Foreign Exchange Reserves

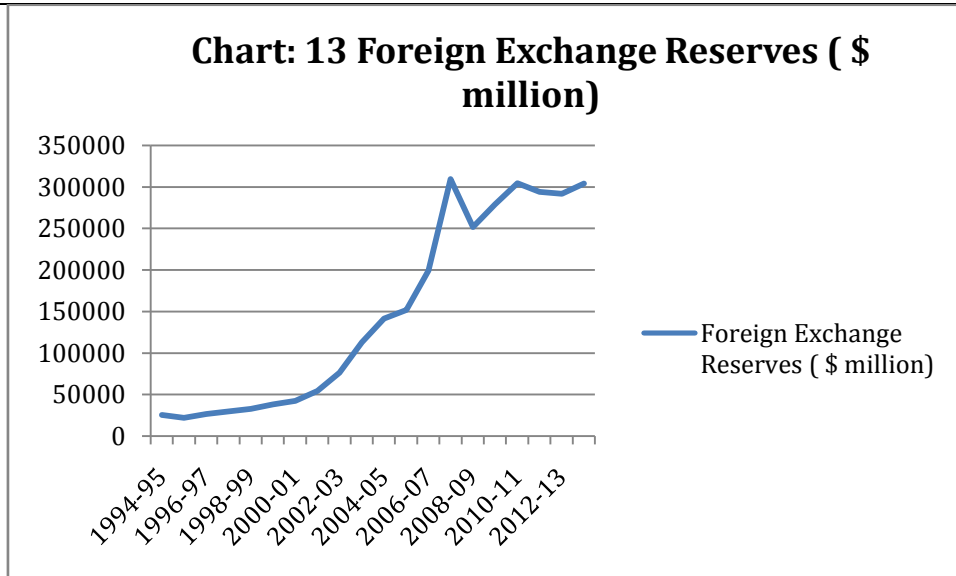
India's foreign investment policy was very restrictive before liberalisation. Post liberalisation, since 1991, India was much more open to foreign capital with the prevalence of certain restrictions. Chart shows that in 2000-01, net Foreign Direct Investment (FDI) was \$ 3272 million. Though there were some fluctuations, FDI showed an upward trend and was highest in 2008-09 at \$22372 million. With ups and downs, it was \$ 21564 million in 2013-14. Net Foreign Portfolio Investment(FPI) was always representing prominent ups and downs with outflow in 2008-09. It was highest in 2009-10 (\$ 32396 million). From \$ 26891 million in 2012-13, it came down to \$ 4822 million in 2013-14.



Data Source: rbi.org.in

India's foreign exchange reserves include gold, SDR's, foreign currency assets. Forex reserves were \$ 25186 million in 1994-95 and was \$ 304223 million in 2013-14.

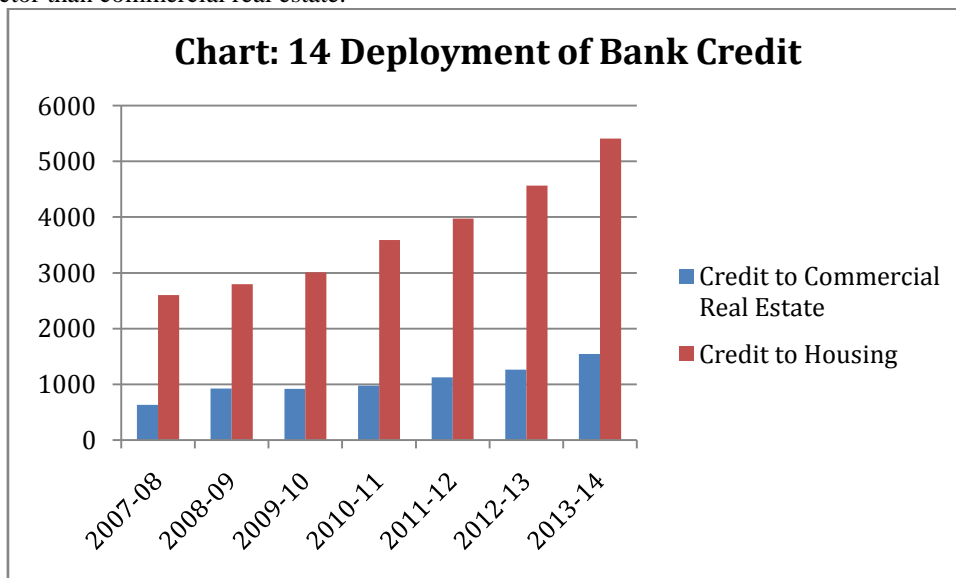




Data Source: rbi.org.in

### Deployment of Bank Credit to Real Estate Sector

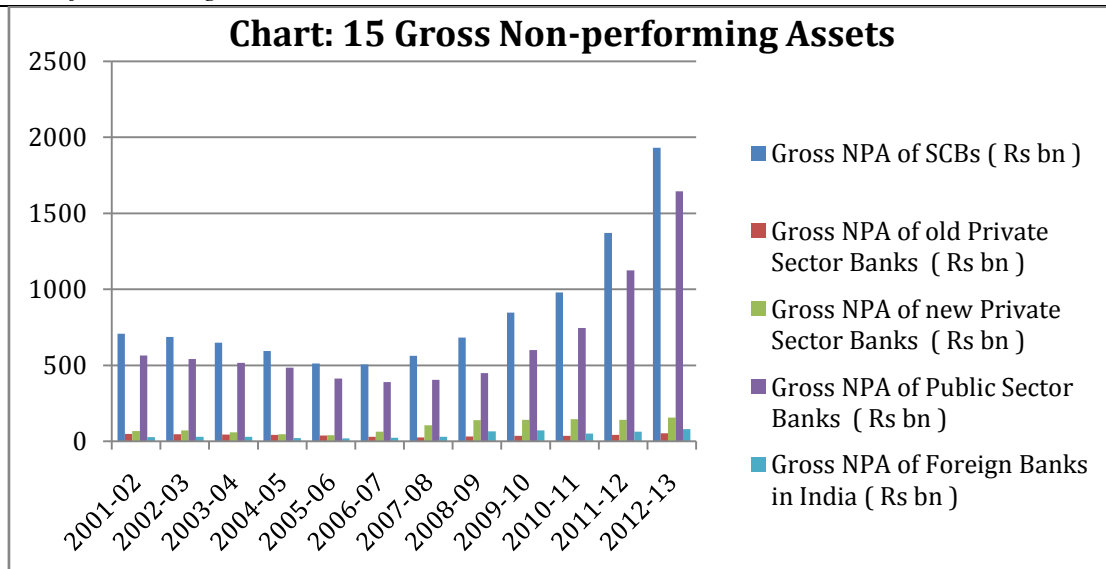
Data for the above is available from 2007-08 to 2013-14. Credit to commercial real estate was Rs. 631.68 billion in 2007-08 and gradually rose to Rs. 1543.56 billion. Similarly, credit to housing sector was Rs. 2603.06 billion and stood at Rs. 5408.19 billion in 2013-14. The bar diagram shows a higher credit disbursement to housing sector than commercial real estate.



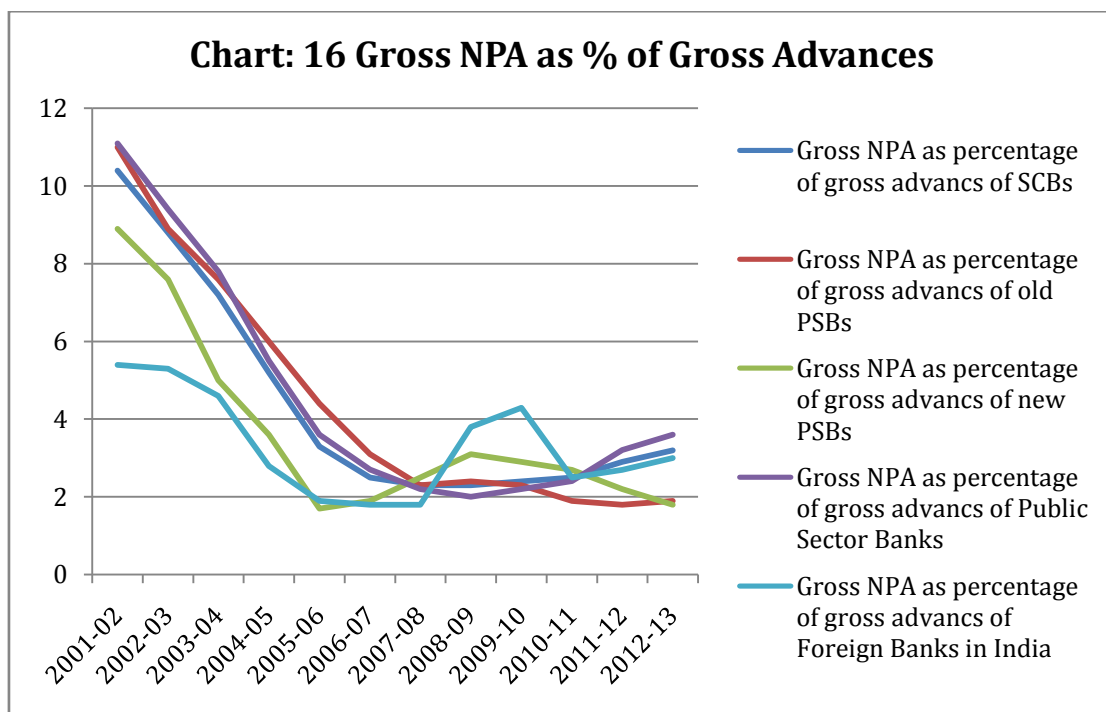
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### Non-performing Assets (NPA) of Banks

The chart depicts gross NPA of scheduled commercial banks (SCB), public sector banks, new private sector banks, old private sector banks, foreign banks in India. Gross NPA of SCBs are the highest, followed by that of Public sector banks. From 2001-02, gross NPA of SCBs and old private sector banks decreased till 2007-08, and started increasing thereafter. Gross NPA of new private sector banks, public sector banks and that of foreign banks declined till 2006-07, but shows an increase from 2007-08. Gross NPA as percentage of gross advances shows a declining trend for all the banks. However, contagion effects of Eurozone crisis have led to increase in NPA's and NPA as percentage of advances in 2012-13.



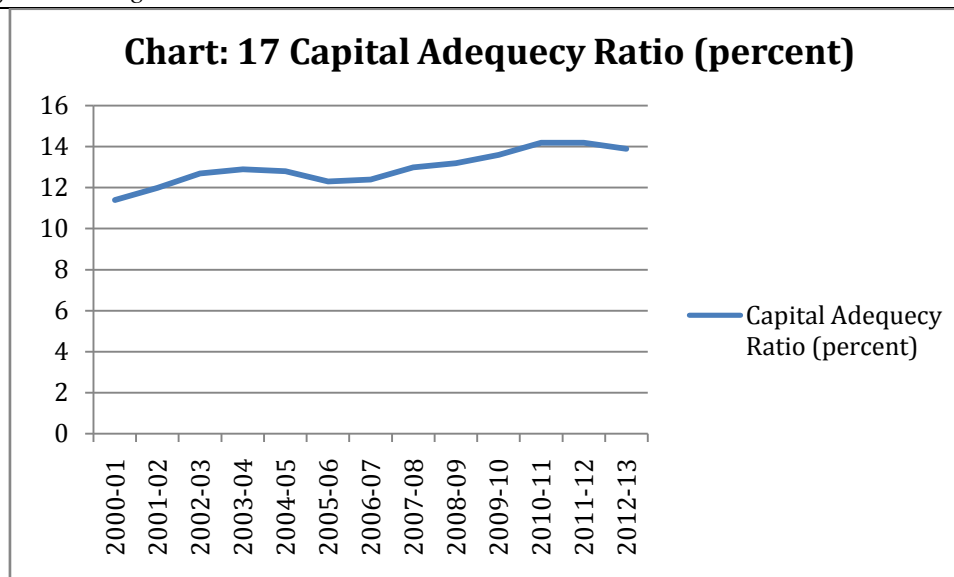
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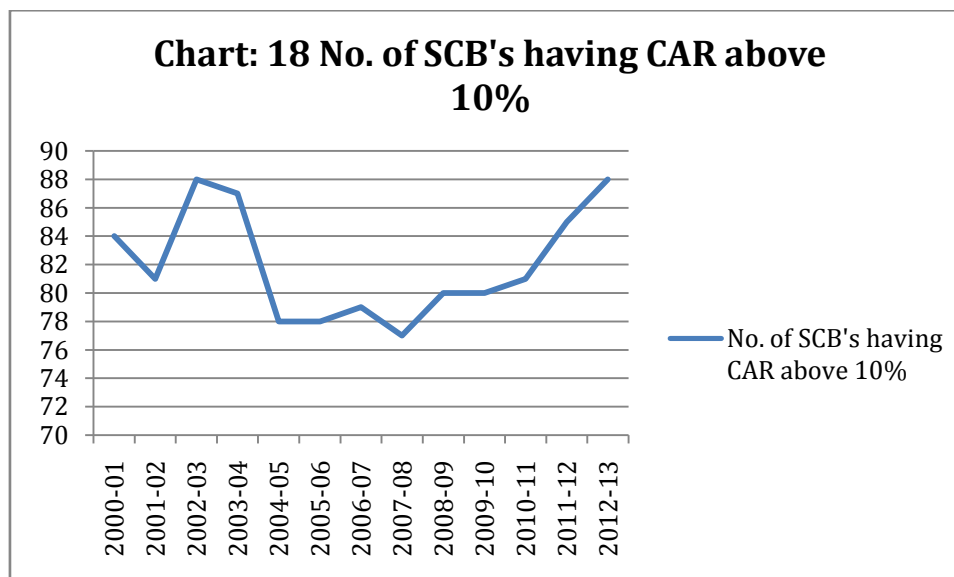
#### Capital Adequacy Ratio (CAR)

Bank capital to assets ratio determines the bank's capacity to meet the time liabilities and other risks<sup>5</sup>. Data shows that CAR of banks was 11.4% in 2000-01, rose to 12.9% in 2003-04. It gradually went up to 14.2% in years 2010-12 and was 13.9% in 2012-13.



Data Source: rbi.org.in

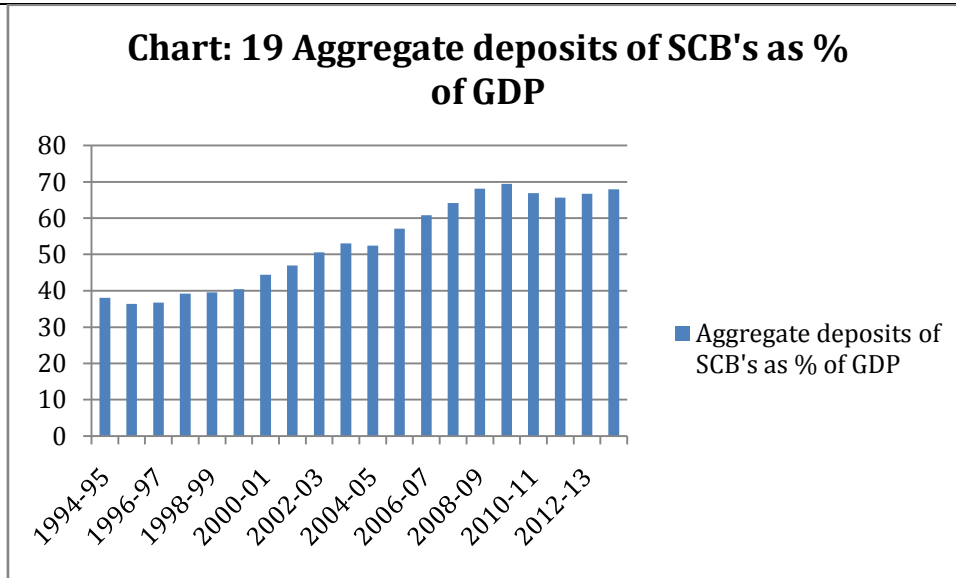
Number of scheduled commercial banks having CAR above 10% is also on a rise. It was 84 in 2000-01, rose to 88 in 2002-03, but fell to 78 in 2004-05. Since then, the number shows an upward trend and was 88 again in 2012-13.



Data Source: rbi.org.in

#### Aggregate deposits of Scheduled Commercial banks (SCB) as percentage of GDP

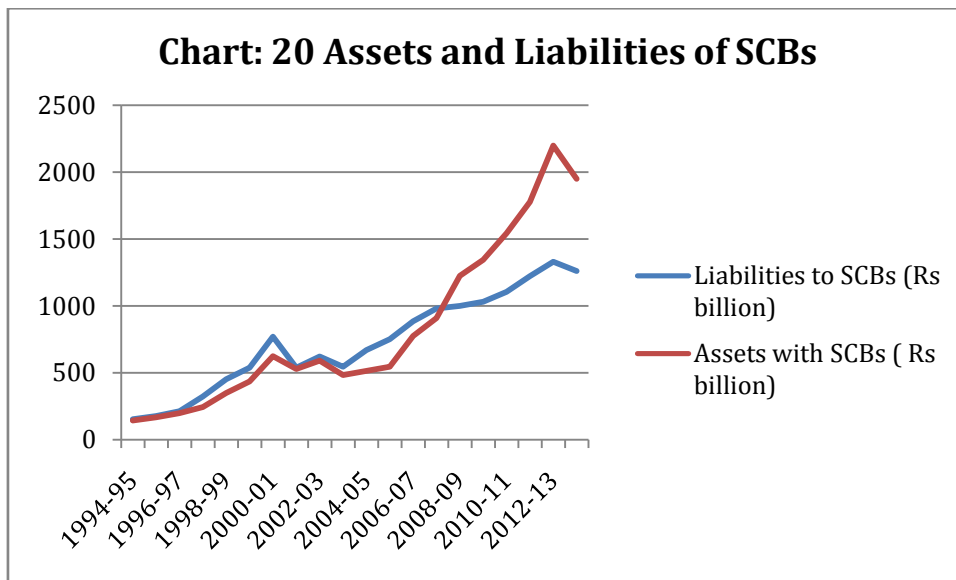
The aggregate deposits of SCB's was 38.1% of GDP in 1994-95. With minor ups and downs, the percentage shows an increase in the later years, with the highest of 69.4 in 2009-10. Though the deposit percentage declined by few points in next two years, it pulled up to 67.9 in 2013-14.



Data Source: rbi.org.in

**Assets and Liabilities of Scheduled Commercial Banks**

From Rs 13.2 billion, the liabilities of SCBs increased to Rs 770.88 billion in 2000-01. With some fluctuations for the next three years, liabilities started increasing from 2004-05 and was Rs 1331.01 billion in 2012-13. Assets with SCBs was Rs 142.77 billion in 1994-95 and went up to Rs 623.55 billion in 2000-01. Assets decreased a little and again started increasing from 2004-05. Assets stood at Rs 2199.48 billion in 2013-14.



Data Source: rbi.org.in

**FINDINGS**

- GDP growth rate is low, but definitely showing an improving trend, and growth rates for 2015 is forecasted to be 6.7%<sup>6</sup>. However, rising gross fiscal deficit as percentage of GDP and high values of Current account deficits as percentage of GDP does not show a very positive picture to the investors and general public.
- Though gross government debt and total external debt is increasing, a decline in total debt-GDP ratio and external debt-GDP ratio implies that India is producing and selling enough to payback its debt. A declining debt-service ratio shows that the economy's earnings are good enough to service existing debts. Escalating

short term debt as a percentage of total external debt is a reason of concern as higher proportion of short term debt makes it more vulnerable to default.

- Low interest rates on new external debt commitments shows that there isn't much apprehension of default, and gives an optimistic scenario to future investments. Although there is a non-stop rise in trade deficits, increase in exports as percentage of GDP and accumulating foreign exchange reserves shows a ray of hope, and doesn't put India to much risk.
- In spite of ceilings and restrictions, India is increasingly welcoming FDI and FII in various sectors and industries of the economy. Though foreign investment is essential to promote economic growth, proper scrutiny and monitoring of such flows, and cost benefit analysis of the repercussions of any capital outflow should be done in advance. Escalating credit deployment to the real estate sector, especially to the housing sector is a serious cause of concern, since an asset price bubble makes an economy extremely susceptible to crisis.
- The banking sector shows multiple healthy signs – high CAR, more number of SCBs having high CAR, increasing aggregate bank deposits as percentage of GDP, higher rate of increase of bank assets than its liabilities.

### **CONCLUSION**

Post liberalisation, the Indian economy has widened its doors to the world – with reduction of tariff on exports and imports and openness of the economy to foreign capital. The country fell into the trajectory of rapid economic growth with a number of economic reforms which started during the liberalisation phase. Huge infrastructural development, increased per-capita income and growing share of service sector in India's GDP, were some of the factors which helped the economy to attain growth. In the 21<sup>st</sup> century, India is in trading relation with almost 80 countries in the world. Major export partners of India are The European Union, USA, UAE, China and Singapore, while the major import partners are China, EU, UAE, Saudi Arabia and Switzerland. India was experiencing a high growth rate of around 9% in some years after 2000. However the Eurozone crisis dampened India's economic growth and pushed it down to 4.7% in 2012-13. There was also a decline in foreign portfolio investments due to contagion effects. Nevertheless, with the change in political scenario in India, the economy is expected to take a U-turn towards high rate of economic development and become a major investment destination for foreign capital. As of now India's GDP growth rate is forecasted at 5.6% in 2014, with public debt at 66.7% of GDP, budget deficit at 4.8% of GDP and service sector contributing to 64.8% of GDP<sup>7</sup>. According to Goldman Sachs' chief Indian economist Tushar Poddar, India's economic recovery is evident from rising demand, higher commercial vehicle sales, shrinking credit spreads, downward trend of long end bond yield and financial markets touching record highs<sup>8</sup>. A stable (BBB-) investment rating for India provided by rating agency Standard & Poor also gives an optimistic picture for future capital inflows. India should better watch out for plight of deficit indicators, increasing short-term debts, escalating housing credit and diminution of foreign portfolio investments.

In conclusion, we can say that, though the macroeconomic indicators do not signal an impending disturbance, India should be exceedingly alert and calculative about the factors that are precarious by nature.

#### **End Notes**

- [1]. investopedia.com
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- [3]. Masstricht Treaty, en.m.wikipedia.org
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