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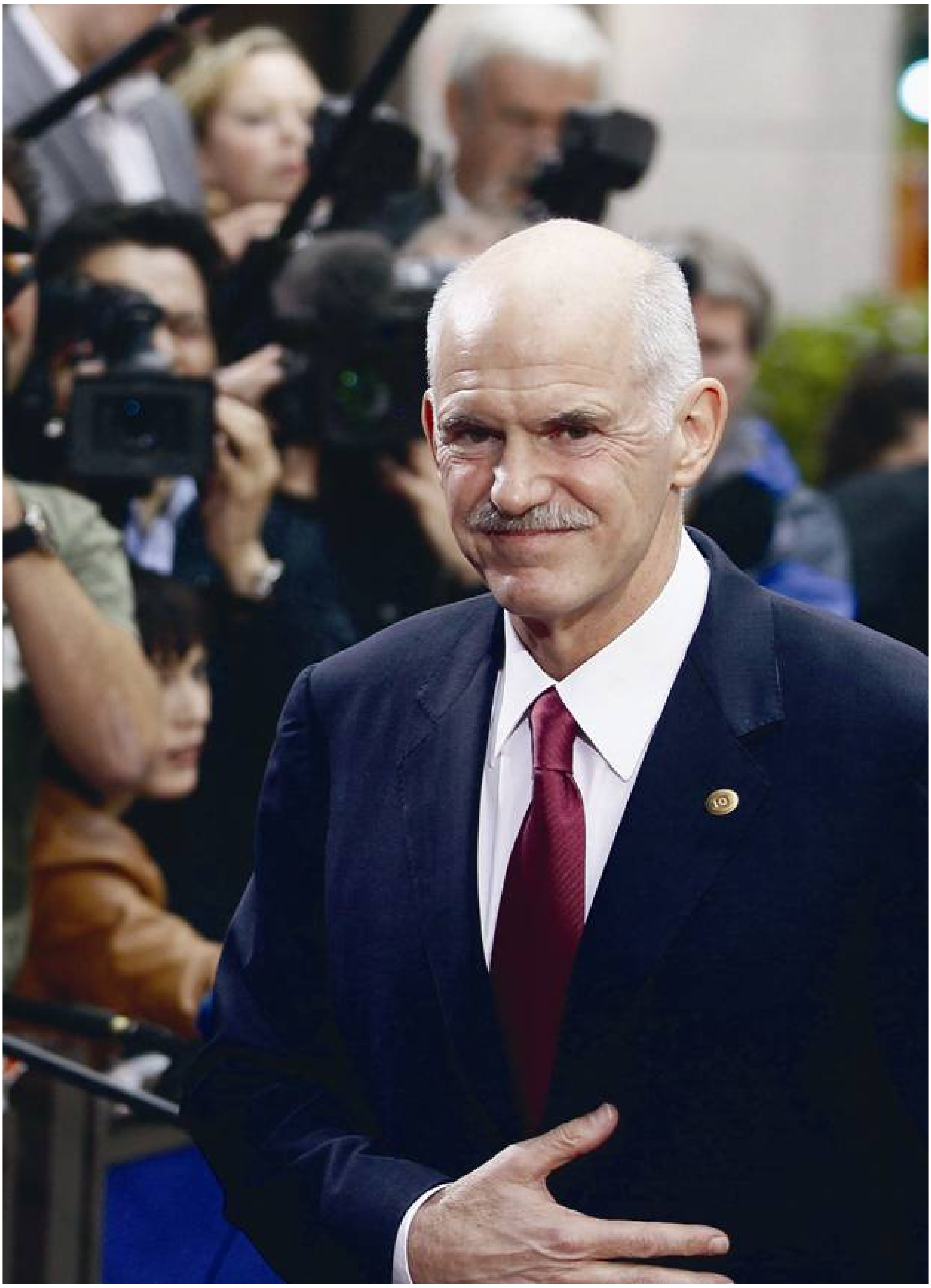
“The expansion of the European financial crisis and its deepening into a political crisis has followed a clear causal chain produced by a series of missed opportunities.”



Eurozone refers to the Economic and Monetary Union of member states of the European Union. Members of the Eurozone have adopted the Euro as their common currency and sole lender. The monetary policy of the Eurozone is laid out by the European Central Bank (ECB). Fiscal Policy, however, is the domain of individual member countries. The eurozone currently consists of Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain. The roots of the ongoing economic crisis in Europe began in early 2009, as a knock-on effect from the 2008 global financial crisis, which had already claimed Iceland as a victim. Iceland was not an institutional issue for the EU, but in 2009 Eastern members of the EU not using the euro began to have balance-of-payments problems. They suffered effective devaluations of their national currencies and sought help from Brussels to resolve their mounting budget deficits. In response, the EU doubled the funds in an existing facility to address balance-of-payments problems. Among the European countries that are affected mainly by the ongoing Eurozone crisis are Portugal, Ireland, Greece and Spain (PIGS countries). Iceland, the country which experienced the largest crisis in 2008 when its entire international banking system collapsed has emerged less affected this time as the government was unable to bail the banks out. In the EU, especially in countries where sovereign debts have increased sharply due to bank bailouts, a crisis of confidence has emerged with the widening of bond yield spreads and risk insurance on credit default swaps between these countries and other EU members, most importantly Germany.

The debt crisis affecting Europe has come to a fore. Called the Sovereign debt crisis, the issue started around the beginning of 2009. By 2010 eurozone members Greece, Ireland and Portugal and some other EU countries outside the area were affected. In simplified terms Eurozone countries in question are faced with the risk of running out of money to pay back the loans that they have taken out in past. As a result the countries are being refused loans for the future. The crisis began from Greece, which amassed a huge pile of debt from years of statistical fraud in its public-accounts sector. In lay terms, debt crisis was triggered by over-borrowing. Countries borrowed beyond their means and then struggled to pay off these debts. This led to a dramatic rise in borrowing costs for these countries, worsening the problems further. What started off two years ago in Greece has now spread to Portugal, Ireland, Spain and Italy. Other European countries are also feeling vulnerable. Those lending money to these countries are charging higher interest rates since they are now seen as risky – and hence prone to default. So we have country after another country in eurozone being dubbed as not good risk, and are therefore charged more for loans via bond issues. This is very much the same as someone who has failed to pay back a past mortgage and would be refused, or charged more for a loan by a bank, in the future. European zone countries face a similar dilemma. The Euro as a common currency of countries with disparate political and fiscal policies has meant the crisis has spread across the Eurozone. If each of these countries would have had a separate currency and monetary policy, the crisis would have been localized instead of having spread across the Eurozone. With slowing GDP growth, large welfare budgets and popular opposition to measures towards curbing entitlements, the situation in Europe is extremely difficult. At present, Germany is the only large Eurozone country with a sound economy, and it cannot be expected to bail out all of Eurozone on its own.

On wrong track: When the EuroZone formed in the late 1990's, Germany and France were the economic powers and every other country was clearly in an economically subservient position. When the poor countries of Europe wanted to build roads, fund schools, and do various other large-scale projects, they funded these activities by issuing debt in the form of government bonds. Countries that are economic powers are able to borrow this money for pretty cheap. However, countries that are not in excellent financial shape have to pay more to finance their debt by offering investors a higher yield. Economically-weak PIGS countries were paying quite a bit to be able to borrow money. By joining the EuroZone, they were magically allowed to borrow money at very close to German bond yields. So the grand idea when the EuroZone started was that these weak countries like Greece would be able to borrow money at cheap rates in order to economically develop their countries in a responsible manner. This would help them close the gap with stronger countries like Germany and France, and then all of Europe would grow more powerful. It is clearly evident now that this grand idea has failed drastically and the whole Eurozone is facing the worst economic crisis of this century. Well, of course Greece, Portugal, Spain, Italy, and Ireland borrowed money. It's what they did with the money, and how much they borrowed that became a problem. Instead of using the money to develop strong economic infrastructure in their respective countries, they went on reckless spending sprees. These countries have spent so much money and developed such irresponsible fiscal agendas that they are now having trouble paying back all those loans. To make it worse, investors are now demanding more yields in order to hold the debt of these countries.

Euro was introduced in 1999 and the unified interest rates allowed its members to borrow heavily and recklessly. Bonds issued by southern European nations were taken to be as safe as German ones. The money created a huge boom into the real estate in PIGS countries. The US housing bubble busted in 2008 and this affected real estate business all over Europe. The big EU countries and IMF came to rescue but did not able to stop the spread to other EU countries. If Greece were to default on its 370-billion-euro debts then the European banks that lent to Greece at the height of the borrowing binge would certainly be hit especially the French banks. The budgetary deficit of Greece in the eight months to the end of August has widened to 22 per cent to 18.9 billion euros, more than the target of 18.1 billion euros for the period. Greece has pledged to reduce its general government deficit to about 7.5 per cent of gross domestic product this year from 10.5 per cent in 2010.

Sovereign states and large debts: First, investors start worrying that the debt may not be sustainable, concerns rise over the ability of the state to pay back capital and interests by generating budget surpluses in the future (that is, fiscal revenues in excess of expenditures). In this case, investors require higher interest rates to subscribe new public debt as a compensation for the risk of insolvency. This in turn increases the risk of insolvency as it worsens public sector balance sheets. At some point, there may no longer be an interest rate able to compensate investors for the risk of insolvency; then they just stop subscribing the public debt. This is a situation of fiscal crisis and has only two possible outcomes:

- (a) Government default followed by a renegotiation of the debt.
- (b) Monetization of the debt, which is effectively bought by the central bank. This represents an injection of money in the economy and thus generates inflation and exchange-rate depreciation.

Euro depreciating: In the last few days we have witnessed the sudden depreciation of the Euro. A possible answer is that as the financial crisis spreads to other large Eurozone countries, the risk of monetization of the public debt becomes more concrete. Even if Greece has been bailed out by other countries in the Eurozone, this would not be feasible for the much larger public debts of other debt ridden European nations. In the scenario of a widespread crisis, the possibility that the ECB will monetize the debt of weak Eurozone countries exists, and fear of the implied inflation can explain the depreciation of the euro. However, a massive monetization is an unlikely scenario, as it would eventually undermine price stability in the Eurozone and imply a substantial transfer of resources from strong to weak Eurozone countries.

Measures to curb crisis:

- (a) The 27 member states of the European Union have created the EFSF (European Financial Stabilization Mechanism), a legal instrument to preserve financial stability in Europe by providing financial assistance to Eurozone states in difficulty. The facility is jointly and severally guaranteed by the Eurozone countries' governments.
- (b) The steps taken by ECB to reduce volatility in the financial market and improving liquidity include: (i) it began open market operations buying government and private debt securities. (ii) It announced two 3-months and one 6-month full allotment of Long Term Refinancing Operations (LTRO's). (iii) It reactivated the dollar swap lines with Federal Reserve support.
- **(c) The Euro Plus Pact:** The Euro Plus Pact was adopted in March 2011 under which the countries of the EU make concrete commitments to a list of political reforms intended to

improve the fiscal strength and competitiveness of each country. The Euro-Plus Pact has four broad strategic goals along with more specific strategies for addressing these goals. The four goals are: (i) Fostering competitiveness. (ii) Fostering employment. (iii) Contributing to the sustainability of public finances. (iv) Reinforcing financial stability.

- (d) Eurozone leaders agreed to extend the maturity of current bailout loans to Greece to 7.5 years, doubling the repayment deadline. They also agreed to lower the interest on their bilateral loans to Greece by 100 bps.
- (e) Euro zone leaders have agreed that the EFSF will be able to buy troubled countries' bonds on the primary market — that is, when they are auctioned by the sovereign. The purchases will be possible only for countries which have agreed on an emergency aid programme with the euro zone, such as Greece or Ireland. Greece's parliament has passed a law to expand the powers of the European Financial Stability Facility (EFSF), which renders the euro zone's bailout fund more flexible. The EFSF increases the rescue fund's effective lending capacity to 440 billion euros ($603 billion) and allows it to lend euro zone governments money to recapitalise their banks. The fund is also empowered to provide precautionary loans to countries under attack in the markets and to buy sovereign bonds. Further, German Chancellor Angela Merkel has suggested that parts of a planned new 109-billion-euro ($148.6 billion) rescue for the debt-laden country could be reopened, depending on the outcome of the troika's audit.
- (f) Greek Prime Minister George Papandreou's Socialist Pasok party has won the parliamentary backing by 155 to 142 for a property tax to meet deficit-reduction targets required to avoid default. But the implementation of the measures is the biggest challenge for the government as the trade unions and parts of the civil service will protest against this decision. The property levy, to be collected via electricity bills, will provide an annual yield of 1.1 per cent of GDP. It will generate as much as 1.8 billion euros.

The Government has announced an additional 20 per cent wage cut, on top of 15 per cent for the civil service and 25 per cent in the wider public sector. Pensions are being reduced 4 per cent on average, in addition to previous cuts of 10 per cent. A lowering of the tax-free threshold to 5,000 euros will mean higher taxes for all Greeks.

Possible solutions to the crisis:

- (a) **Creation of Common European bond:** If a common Euro bond is created it will allow the weaker countries to share Germany's credit rating and hence they will be able to borrow at lower rates. However, for this, Germany would have to guarantee other countries' debt which is highly unlikely.
- (b) **ECB buys bonds of weak countries**: One of the solutions to cope up with the meltdown is that ECB buys bonds of the heavily indebted Eurozone members. The ECB has earlier bought Greek, Irish and Portuguese bonds and is now buying Italian and Spanish bonds. But this is not a bottomless pit and purchases would have to stop at some point.

- (c) **IMF should come to rescue Eurozone:** International Monetary Fund should organize a global rescue package worth trillions of euros. Europe's debtor nations could borrow at low rates with long maturities. Once a debt pressure is relieved, Europe could follow more pro-growth economic policies.

- (d) **Developed nations can write off the debts:** A solution to the ongoing eruozone crisis can be achieved if the developed nations negotiate and write down on their debts or defaults on them. Superficially, this seems a solution. But it would create other problems. Defaults would inflict huge losses on banks, insurance companies and will lead to collapse of many European banks and finally the global economy will fall into Great Recession II.

Thus we can analyze the fact that there are no easy solutions to the crisis confronting Eurozone. However, the urgency for solid steps to confront the issue is also increasing day by day.

European crisis and the American economy: Both, the USA and the Eurozone are witnessing the economic crisis almost at the same time. The 2008 global financial crisis was triggered due to failure of the American economic system and in 2011 the world is witnessing the failure of European economic policies. The fear about the failed Eurozone economy has raised concerns about rising government deficits and debts across the globe. This has worsened the situation and has created alarms in world financial markets and expectations of recession in developed countries including the United States. Let us analyze briefly the impact of European crisis on American economy:

- (a) **Impacts on US Banks:** The U.S.' gross direct exposure to European banks through loans and bonds amounts to $678 billion. This does not include less direct exposure through financial derivatives, loan guarantees and other financial connections such as credit default swaps. While a collapse of a European bank as major as Societe Generale or BNP Paribas will not have much impact on the U.S. economy, a financial contagion in Europe will, however, have a palpable impact on the U.S. and the global financial system through the loss of confidence in banks.
- (b) **Euro devaluation:** The European sovereign debt crisis will trigger a devaluation of the euro against the U.S. dollar, which would impact U.S. exports. Europe is the largest export market for the United States. Depreciation in the euro will make American exports to Europe more expensive, which would significantly weaken the only remaining engine of growth for U.S. economic recovery after the U.S. government ended its stimulus package.

- (c) **Threat to Euro viability:** The weakening of the euro versus other global currencies and spread of contagion from small European countries, such as Greece and Portugal, to the larger countries, such as Germany and France, may threaten the viability of the euro, potentially paralyzing global credit markets in a way similar to what happened after the collapse of Lehman Brothers in the United States.
- (d) **Loss of wealth:** The European crisis has affected U.S. capital markets other than the banking sector. It has unraveled stocks and increased fears of a new crash in the stock market. The crisis has also jolted hopes of a strong recovery in the United States. There could be a global loss of wealth, one way or the other, and the loss could be huge. Thus we can say

that if the US economy is again hit by recession, this time it will definitely come from Europe and whenever it happens it may be called Great Recession II.

Implications of Eurozone crisis for Indian Economy: Any deceleration in software exports due to the Euro zone debt crisis and the poor economic conditions in the US will affect India's GDP growth. In 2009-10, the US alone accounted for 61 per cent of India's total software exports. European countries (including the UK) followed with as much as 26.5 per cent. If these two regions are the first to be hit by the recession, it is unlikely that software export revenue would remain unscathed. Moreover, over the period 2004-05 to 2009-10, services accounted for 66 per cent of the increment in India's GDP. Revenues from software services amounted to 9.4 per cent of this (excluding public administration and defence). According to balance of payment data, gross revenue from exports of software services amounted to as much as 24 per cent of the gross revenue from merchandise exports. But by and large, India is not going to be affected directly due to PIGS crisis as in 2010, Portugal and Greece had a share of about 1.3 per cent each in India's exports to the EU and Ireland had about 0.7 per cent. Italy and Spain had 11.5 per cent and 6.8 per cent respectively.

Let us now examine some potential scenarios:**(a) Impact on foreign trade:** First of all, the EU (excluding UK) accounts for roughly 30 per cent of the country’s merchandise foreign trade (export and import). A slowdown in Europe would naturally have a negative impact on our foreign trade and lead to loss of revenue as well as jobs in export-oriented industries. The impact of a slowdown would be much more severe in the service sector (particularly BPO and software) where trade is in India’s favour.

(b) Impact on domestic economy:

If the European meltdown spreads and leads to a global slowdown, this will definitely worsen India’s trade with other countries and thus hit our domestic economy directly as well as indirectly. The income of exporters will reduce drastically, unemployment will rise, etc. thus our domestic demands will fall drastically and our growth rate will have to comprise.

(c) Bearish stock market:

More importantly the impact of the crisis would be felt in the financial market. The first signs of this may already be visible, with the Indian markets declining by nearly 4 per cent in last week September, 2011.

(d) Fall in commodity prices:

In addition to decline in security markets, one can expect to see a rise in gold prices and fall in commodity prices (due to lower demand), and depreciation in currency (due to flight of capital).

(e) Currency depreciation:

If the Eurozone crisis hangs on for a longer time it will result in deprecation of Indian Rupees due to fligh to capital from the market.

(f) Foreign remittances will suffer:

Slowdown could impact the flow of remittances and NRI deposits in India. In the wake of a crisis, remittances from abroad could slow down and a significant number of expatriates might even lose jobs and move back to India, thus straining the local economy.

The impact of Eurozone meltdown will be felt seriously by emerging economies like India. In addition to the possibilities outlined above, the Indian economy could be affected in numerous other ways, as it is practically impossible to identify all the interlink-ages between India and the global economy in this day and age of increasing integration. But there is another side of the story which can also become possible. The slowdown in Europe and the USA could benefit the emerging economies due to fall in commodity prices and flow of capital from those countries to countries such as India. In order to reap fruits from the crisis the developing nations need to fasten their economic growth and change the overall climate of crisis of governance.