GREXIT – AN ILL-TIMED TRAGEDY FOR INDIAN ECONOMY AND MARKETS

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Introduction

- The European sovereign debt troubles, of which the Greek crisis is the most severe manifestation, have been festering since 2010.
- Now the situation in Greece appears to be coming to a head.
- Depending on how a slew of events pan out, Greece could default on its debt obligations as early as in end-June or early-July

The genesis of this crisis

- The genesis of the crisis lies in the birth of the Euro zone and its structure.
- At the time of the formation of the zone in 1993, a Stability and Growth Pact was formulated that imposed strict limits on the fiscal and monetary conduct of member nations: inflation had to be maintained below 1.5 per cent, budget deficit below 3 per cent, and debt-to-GDP ratio below 60 per cent.

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How did the Eurozone crisis build up?

- These norms were observed more in the breach: member nations, including the biggest and the most prosperous ones like Germany and France, flouted them with impunity from the beginning.
- Once the Euro zone was formed, the credit ratings of even the weaker nations (what have come to be known as PIIGS) shot up. Rating agencies felt that since they were now part of a currency union, they would not be able to devalue their currencies (a major risk) to repay their debt. A default was considered highly improbable.

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How did the Eurozone crisis build up?

- Private sector lenders then went overboard in lending to these countries, without taking risks into account.
- The peripheral euro zone nations, on their part, absorbed the capital inflows but did not invest them in setting up productive assets which would have enabled them to raise their exports, enjoy sustainably high growth, and repay their debts.
- In some, the capital was used to fuel a consumption binge while in others it created a real estate boom.

What brought Greece to this pass?

- The tide turned with the financial crisis of 2008. The easy flow of capital to these countries dried up, the boom ended, asset values plummeted, and unemployment soared.
- Beginning 2010, Greece and subsequently other economies admitted to their sovereign debt troubles.

What brought Greece to this pass?

- Once the crisis began, the flip side of a currency union came to the fore – chiefly, the loss of an independent monetary policy.
- In India, when the economy slows down, the central bank cuts rates. This remedy is not available to a country that is part of a currency union.
- In a union, the larger economies dictate interest rates. Since they were still doing well, they would not allow interest rates to be lowered for fear of stoking inflation in their countries.

What brought Greece to this pass?

- When a country's current account deficit becomes large, its currency comes under pressure (as is happening in India today).
- That does create problems regarding how to pay for imports.
- But the positive aspect of currency depreciation is that many of the goods produced by the domestic economy then become competitive in the export market. This helps revive growth.
- This option too is not available to Greece.

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What brought Greece to this pass?

- Since the crisis began, Greece has received financial aid from the International Monetary Fund (IMF) and the European Union (EU) to help it repay its debt and avoid a default. In return, IMF and EU (under duress from Germany) have demanded that Greece should adopt a fiscal austerity programme that would reduce its debt in due course.
- According to Keynesian economists such as Paul Krugman, to adopt austerity measures during a slowdown is a recipe for disaster.

What brought Greece to this pass?

- In such times, the govt. needs to spend on large infrastructure projects to create employment and stimulate demand.
- Ever since the austerity programme in Greece and other economies began, Krugman has been warning that it would prove disastrous.
- He has been proved right. These economies have slowed down further, unemployment has risen, and social unrest has got worse.

What is holding back the revival of Greece?

- In crisis fiscal transfers from the central union to the member states help fight a slowdown and stimulate growth.
- Such transfers can’t happen in Europe because they have only a currency union and not a fiscal union.

What is holding back the revival of Greece?

- The current mix of austerity, slowing economy and growing social unrest is untenable.
- Greece needs higher growth, employment, and higher government revenues to extricate itself from the debt crisis.
- The current policy mix offers no panacea on this count.

Why the panic button?

- According to recent opinion polls, three-fourth Greeks don't want to quit the euro zone, but the course of events over the next couple of months could well make it inevitable.
- In the elections held recently, the parties that were part of the last coalition – New Democracy and Pasok – and had agreed to the aid-for-austerity deal with IMF and EU could not regain majority. No other group could muster a majority either. So elections have been called again on June 17.

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Why the panic button?

- As the political impasse continues, Greeks are withdrawing money, fuelling fears of a run on banks. Citizens are also withholding tax payments, thereby worsening the government’s fiscal plight.
- It is feared that after the next elections the Coalition of the Radical Left, called Syriza, could come to power. This party could renege on the previous government’s promises to implement austerity measures.

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When will Greece exit?

- The EU-IMF duo would then have no option but to stop payment of the next tranche of aid due in June. If Greece does not receive aid, it will default on its debt repayment obligations and could then exit the currency union. This could happen as early as in July.
- If the New Democracy-Pasok combine forms a govt., the current impasse could continue for longer. Greece's exit might get postponed to 2013 or 2014 but is unlikely to be averted.

Will an exit be disastrous for Greece?

- Fears have been raised that Greece's exit from the euro zone would prove cataclysmic for its economy. This might well be so. The drachma would suffer a steep devaluation, inflation would skyrocket, banks and corporates might go bankrupt, and unemployment might soar. But only in the short run.
- In the long run, the devaluation of the drachma would provide just the incentive that Greece needs for boosting its exports and hence its GDP
growth rate.

Will an exit be disastrous for Greece?

- It has been argued that Greece is not an export-oriented economy and hence will not benefit from the drachma's depreciation.
- This may not hold true. When an incentive such as this becomes available, economies can and do re-orient themselves.
- The Indian economy raised its exports in the aftermath of the 1991 external debt crisis.

Will an exit be disastrous for Greece?

- Moreover, as Arvind Subramanian of the Peterson Institute for International Economics has pointed out, countries like Korea, Indonesia, Russia, etc. which defaulted on their debt in the nineties suffered recessions that lasted for one or two years, but then saw growth of 5 per cent and higher for sustained periods.
- Thus, contrary to popular perception there is life after a debt default.

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Will Greece's exit unravel the Euro zone?

- Greece's exit could prove calamitous if it results in a contagion. But if it is perceived as a one-off event, then the turbulence may only be short-lived.
- Once Greece exits, the magnitude of the problem will be driven home starkly. The IMF, EU and ECB will do their best. Germany too will shed its reluctance (to allow more LTRO like programmes) in the face of danger.

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Will Greece's exit unravel the Euro zone?

- The ECB will expand its bond buying programme to prevent yields of bonds of other suspect economies (Spain, Portugal and Italy) from soaring.
- Banks that have suffered steep losses due to their exposure to Greek debt will have to be recapitalised.
- Swift and timely action could, after an initial upheaval, prevent the contagion from spreading.

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Will Greece's exit unravel the Euro zone?

- Realisation has now dawned within Europe that the austerity policies of the past are not working.
- Francois Hollande, the newly-elected President of France, is pushing for spending to stimulate growth.
- Such policies too should have a positive impact.

Will Indian economy and markets suffer severely?

- The Indian economy has slowed down because of a number of factors.
- Fiscal deficit has ballooned because the UPA I and II govts expanded social spending programmes vastly. The government had thought that growth would continue to be robust and would provide the revenue flow required to fund these programmes.
- That hope has been belied.

Will Indian economy and markets suffer severely?

- A slowing economy and policy paralysis have resulted in private investment – so essential for reviving growth – slowing down.
- The current account deficit has widened due to slowing exports and inelastic imports (especially of crude and gold).
- The foreign capital flows that India needs to fund its current account gap have slowed down.

Will Indian economy and markets suffer severely?

- The rupee has depreciated because of the paucity of dollar flows. A weak currency will result in imported inflation.
- In this fragile situation, an external shock to the economy could prove very negative.
- Greek's exit will definitely create a risk-off environment that could cause more capital outflows. The rupee will depreciate further and the stock markets may touch new lows.

Will Indian economy and markets suffer severely?

- The Indian economy has substantial exposure to Europe in the form of loans.
- Data available for the end of September 2012 shows that European banks then had total loans outstanding against India of $146.6 billion (much larger than the $68 billion loans owed to US banks).
- The private sector's borrowings from European banks amounted to $97.7 billion; the public sector's debt amounted to $12.8 billion, and that of banks amounted to $35.4 billion.

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Will Indian economy and markets suffer severely?

- Not all of the European borrowings are at risk. Of the $146.6 billion loans, $81.8 billion were from UK and $22 billion from Germany, which are safe economies.
- But in a liquidity-starved environment, it is difficult to predict which institutions will get into trouble and demand their money back.

Will Indian economy and markets suffer severely?

- When the last crisis (2008) had occurred, there was coordinated policy action from central banks and governments around
  the globe.
- Rate cuts, liquidity infusion, tax relief and expenditure programmes had helped stem
  the crisis.

Will Indian economy and markets suffer severely?

- But weakened by the last crisis, both governments and central banks around the world have less ammunition for dealing with a new one.
- The promptness and magnitude of their response will determine how severe a blow the Greek crisis deals to our already-tottering economy and markets.

Conclusion

- The Greek crisis comes in a background of a weakened Indian economy
- The high fiscal and current account deficits, declining IIP nos, GDP slowdown to 5.3% in Q4FY12 and stalled policy making already pose a challenge to India
- An early exit of Greece will freeze the financial sector worldwide. A delayed exit will allow ring fencing
- Capital flows and risk appetite will suffer in both situations.
- A delayed exit will be in India's favour so that some more resilience can be built in the economy

Sources

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