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EXECUTIVE BRIEFINGS
ECONOMY AND POLITICS: Euro Crisis

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When Angels Fall

Over the past few weeks, a number of our clients have written to me seeking our perspective on the possible impact upon India, of a worsening crisis in the Euro zone. It is difficult to pinpoint what this will be, as the variables are several. Frankly, the Euro zone has been in a crisis for several months and the most obvious impact was the flight of capital from India and other emerging markets. Clearly, if Greece failed and Italy and Spain too defaulted, the markets will go into a panic and it is hard to determine the turn of events that may follow.

As things stand, I do not believe there is any 'Euro deal'. This is not only because Greece still needs to get its political act in order and come up with a credible proposal on austerity measures; it is also because the original deal proposed by the Euro zone authorities was based on inappropriate assumptions. First, the hair cut of 50% announced by the authorities is voluntary, which means banks don't have to take it. Making it mandatory would have triggered billions of credit default swap (CDS) derivatives. Second, Euro zone members would need to contribute Euro 30 bn to Greek debt. Strangely, these countries are not willing to write down their existing debt in order to convince their citizens that they would not have to fund it. Third, raising the Euro Stabilisation Fund to Euro 1.4 tn involves another Euro 1 tn to be produced. This may involve the issue of ESFS bonds. The point is, who would buy such bonds and who would guarantee them? What would the value of such guarantees be? Eventually I believe Euro zone authorities will have no choice but to amend their existing charter and allow the European Central Bank to monetise some of the outstanding debt.

The initial euphoria that followed when bank stocks recovered, I suspect, was misplaced. Ultimately whatever happens, the only way out of this financial mess is economic growth. But as I have argued previously in several papers (including the one on Global Rebalancing), this growth is unlikely to happen. Europe is not prepared politically or socially to pay for it i.e. to accept lower salaries, longer working hours, higher retirement ages and so on.

In terms of the way forward, the best case scenario is one where an amicable solution is agreed upon for Greece's debt. Banks that have exposure are prepared to take a hair cut and Greece is able to implement the austerity measures that lenders have demanded. Additionally, the European Central Bank is able to raise the Euro 1 tn that it believes it would need to prevent the crisis from spreading. This scenario clearly assumes that the crisis is contained and Italy and Spain and other countries are spared. In such a case, the impact on external markets in general, and India specifically, would be limited. Greece is a small economy and the exposure of the banking system is moderate. However, under the current set of circumstances I do not think this is a likely scenario.

The worst case scenario is one where the crisis is not contained. If the rescue package announced by the Euro zone - Euro 1 tn in any case is too little - cannot be raised, then the crisis will slowly spread - first to Italy and then to Spain. The cost of sovereign debt in these countries and in others will become so high that their economies will simply be unable to sustain them. So when the time comes to repay or roll over and the countries fail to do either, sovereign defaults will begin to happen. Under such a scenario, the financial markets globally would panic and banks would go into a complete shell. They would refrain from lending and global liquidity would evaporate. In any event, when they begin the process of write-offs against sovereign debt, they will simply not have the capital to lend further. Whilst the process of recapitalising these banks will have to take place, this is usually a longer term affair with serious consequences for short term lending. The actual outcome may well be somewhere in the middle of these two scenarios. For now, Indian business managers need to be conscious of the following:

Firstly, liquidity. When financial markets go into a crisis, liquidity dries up. India's external debt coming up for repayment in the next 9-12 months is ~USD 130 bn. Of this, short term and export credit constitutes USD 87 bn. In a banking crisis, it is unlikely that this debt would be refinanced or rolled over, and therefore, borrowers would have no choice but to raise money in local markets to settle offshore repayments. The consequences of such a scenario would be profound. Liquidity within India will be squeezed and the Rupee, already under pressures in the foreign exchange markets, will come under a bout of bear hammering. Inflation will rise and economic growth may begin to falter.

Secondly, capital. Another global financial crisis (GFC 2) would stir a flight of capital from India, as we noticed in 2008. Investors usually return to the comfort of home currencies in times of global uncertainties. A lot of the foreign capital inflows into emerging markets are by hedge funds and other institutional investors who have raised money through the dollar carry trade. When markets panic, the carry trade reverses. The consequences are falling currency values, evaporating liquidity, falling stock markets and a decline in other asset values.

Thirdly, exports. India's exports to the European Union are a sizeable fraction, but declining. As this note went to print, the Government released the latest data on trade which suggested that total exports grew by 12.4% in October (much slower than the 36% in September and the 52% in the Apr-September period). The trend is clearly declining and a crisis will further affect this. I believe that Asian countries will in the coming years work towards reducing their trade reliance on advanced economies in favour of Regional trade within Asia. India will therefore, have to do the same. In the meantime however, the derailment of Western demand will force Chinese companies to look aggressively for substitute markets within Asia, specifically India. For instance, capital goods suppliers will come with lucrative financing packages; consumer goods companies will set up distribution networks; and so on.

Cleary every crisis comes with a silver lining. Cash rich Indian companies seeking to acquire assets abroad will be able to do so at competitive rates within the Euro zone countries. Coupled with this, we suspect that commodity prices, which have already shown a tendency to moderate, will begin to correct in the months ahead. In the shorter term, the Rupee may weaken further (offsetting some of the gains in commodity price moderation) but in the longer term, after the initial panic has subsided, capital flows into India will resume and the currency will strengthen. Ultimately, India's ability to recover from a crisis is more dependent on how its domestic economy is managed. A well managed economy would ensure the return of capital flows; new investments; trade; and effectively, buoyancy. Investors would look towards India's fiscal deficit; inflation; and key aspects of governance. A proactive Government within India will ensure a quick recovery; a Government in denial will ensure the opposite. The weeks ahead will be interesting.

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