Editorial

Euro-Zone Debt Crisis and Resurgence of the East

The ongoing sovereign debt crisis, originally erupted in quick succession to the financial meltdown of mid-2008, is taking its toll and is destined to bring a sea-change in the world economic order. The meltdown evolved out of Euro-US fiscal mis-management has almost destabilized the economies of the west beyond revival. The crisis, after having led to the near death of big Euro-US financial titans, has eroded investments worth trillions of dollars due to worst ever repetitive falls in the stock markets, dampened industrial output world over and led to massive job losses. The catastrophe initially believed to be confined to the US, has been blowing country after country, from US to Iceland, Greece, Ireland, Portugal, Italy, Spain and so on. Other Euro-zone countries are also experiencing the tremors sending shivers down their spines. The trouble originally believed to have evolved in the mortgage backed securities market, has acquired epic proportions, sending central banks, across the globe, within a year in a never-seen-before fire fighting mode, to improve and inject liquidity in the banking system and to bailout not only financial titans but sovereign economies as well by pouring billions of dollars. Notwithstanding these massive bailout packages, and huge public spending initiatives coupled with the lowest ever interest rates, the recession is bound to get deeper and deeper to stay for several quarters to come. The scale and the sectoral and global penetration of the crisis is so vast to render the entire sovereign financial system including the global financial stabilizing agencies viz. the IMF and the World Bank also helpless.

Indeed, the contagion has spread in such a quick succession, that none of the country could even foresee the crisis, at least to think of any safeguards in time. The de-regulation of financial markets, and integration of economies, through purposefully calibrated neo-liberal economic policies aimed at economic globalization, has facilitated rapid spread of the contagion in all parts of the world ruthlessly. The financial volcano was originally believed to be confined to the once revered investment bankers, fondly called as the high priests of finance, viz. the top Wall Street investment banks - Merrill Lynch (acquired by Bank of America), Bear Stearns (acquired by J.P. Morgan) and Lehman Brothers (filed for bankruptcy) which have ceased to exist. Goldman Sachs and Morgan got converted into commercial banks and more than 50 banks in the U.S. alone had filed bankruptcies then only. The giant AIG (American Insurance Group), world's largest insurance company with 7 crore customers, had to be nationalized along with the two government sponsored mortgage finance giants, Fannie Mae and Fraddie Mac, in multi-billion dollar bailout packages. Federal Reserve had to lower the interest rates from 3.5 to 1.5 percent and then almost zero. The total bailout package in the U.S. alone exceeded $1 trillion then. On the jobs front, US has suffered worst ever job losses after 1945.

Now, after the recent debt crisis in the US, it has even lost its AAA credit rating and resulted in the USD to loose its sheen of being the international reserve currency. The European counterparts, which were altogether ignorant of the situation, even after the U.S. had been fully engulfed by the crisis and started announcing the bailouts in 2008 are now in the worst shape. Rather, initially the European Central Bank (ECB) altogether ruled out to think of any U.S. style bailout packages at the onset of crisis in 2008. The European governments at that stage, dubbed the crisis as "Made in America" and the Italian Premier Silvio Berlusconi ridiculed it as the "Crisis of Capitalism of Adventurers in the U.S.". But, soon in a clear volte face, the ECB as well as the European governments started announcing rescue packages and now entire EU is reeling under severe crisis. The problem with the European banks was then found to be too big to be saved even by the sovereign European nations. The total liabilities of Deutsche Bank, whose leverage ratio was over 50 amounting to € 2 trillion, more than 80 percent of the GDP of Germany. This was too big to be taken care of by the Bundesbank (the German Central Bank) or the German government. Similarly, the liabilities of Barclays were then around £ 1.3 trillion with a leverage ratio of 60 and almost equal to the GDP of the U.K. The liabilities of the Fortis bank were 3 times the GDP of Belgium, the home country of Fortis. But now sovereign debt crisis in Greece, Portugal, Ireland, Spain, Japan, Italy and other OECD members of the industrialized world including the US is so vast to blow off the entire Euro-US economies. The exposure of European banks as on date is so vast, which is enough to rattle the entire banking sector in the Europe.

Iceland, the worst victim of the first phase of the meltdown and the first sovereign victim of the crisis (once the wonder of riches and one of the sunniest economies of the rich OECD countries) had turned into a fiscal black hole in the first phase itself. But, now the contagion has spread to Greece, Ireland, Portugal, Italy and Spain to the extent that the entire 17-nation Euro-zone is reeling under crisis, threatening the survival of the zone itself.

Euro-Zone is having most tough time for its survival. If, the Greece goes bankrupt, would blow other weak links and bring down the Euro. If it expels the sinking constituents like, Greece, Ireland and Portugal, then the financial titans and treasuries of all Euro-zone countries having big exposures in these countries shall have to pay the price. Rescue packages given to Greece, Ireland, Portugal and Spain have not yet secured them from second attack. Even Italy's crisis is too large to be bailed out. Its public debt burden of 1.9 trillion Euros is equal to 120 percent of GDP second only to Greece. Even the Greece cannot be either bailed out fully or be expelled (even if it quits) from the Euro-zone without a annihilating cost to the bloc as the French and German banks are having heavy exposure. Italy would also line up where the Euro-zone banks have a greater exposure.

In nutshell, the Euro-US recklessness in borrowings and allowing unlimited leverage to their banks shall take its toll and they shall have to accept the new reality of emergence of the East, almost after one and half centuries.

In India, the government has repeatedly asserted from the beginning of the crisis in 2008 till 2011, in the post European debt crisis that, India is immune to this financial contagion. But, on both the occasions the impact had been severe. In 2008, when the FIIs withdrew just $ 13 billion, a fraction of their foreign portfolio investment, the rupee soon fell by almost 25 percent and the exchange rate vis-a-vis USD went lower than Rs. 50, worst ever fall in our history. To avert a further fall in the Re, the RBI then, had to sell almost 25 percent of its forex reserves, and as a result the foreign exchange reserves had slipped from an all time high of $ 311 billion in April 2008 to $ 253 billion in December 2008. This starved the country of its liquidity, to the worst ever extent, in the monetary history of the country. Government had to raise a supplementary demand of Rs. 1, 47, 000 crores in the parliament that raised the fiscal deficit to 5 percent of our GDP, just double the budgeted target of 2.5 percent and 40 percent above the limit of 3 percent, set in the Fiscal Responsibility and Budget Management Act. Likewise, the trade deficit too breached the $100 billion mark, in view of the falling exports, in spite of sharp decline in crude prices. The current account deficit too had gone all time high, even worse than that of the 1991-92 crisis, when India had to pledge gold to the Bank of England to borrow money to meet our regular import bill. The day was saved for the government of India then, just by a sharp decline in the crude prices.

On the internal front, scores of industries like IT, ITES, textiles, iron & steel, cement, ceramic, plastics, financial sector and so on had severely suffered. By the end of 2008, in plastics alone 40 lacs people have lost their jobs, in IT more than 1.5 lacs were shown the exit doors, 150 sponge iron units had to down their shutters, 7 lacs had then lost jobs in textiles and soon the figure reached over a million, ceramic manufacturers had to resolved to cease production for a month. The list of industrial closures was long and consequent job losses were massive.

This time again in 2011 as well, the exchange rate in India has gone down to near Rs. 50 per USD, current account deficit is breaching 3 percent of our GDP, fiscal deficit is reaching to 5 percent of the GDP and the interest rates have totally derailed the new projects and the Government had to desperately open up Yuan dominated credit line for the Indian industry. Thereby the Indian core sector and capital goods sector is drying up as most of the hardware is being sourced from China to avail cheap Yuan denominated credit lines. China has already emerged as the global manufacturing hub leading to widespread industrial closures worldwide, including India. By virtue of its Forex earnings, the Chinese currency is also making headway to take over the US Dollar as the international reserve currency.

Chinese (Yuan denominated) treasury bonds have begun to give early signs of replacing USD, British Pound, Euro and Swiss Franc denominated bonds. China, with its ill repute in human rights violation in Tibet and Africa, worst ever record of environmental degradation, and gross disregard to the global public opinion, can also lead to serious geo-strategic imbalances. So, if it emerges as the world economic power of the first order with Yuan as the international reserve currency. This apprehension might distance the world markets away from China in the near future and a different scenario may acquire shape.

In view of it, India with its demographic dividend of being home to highest number of youth and half the population being under 25 years of age, can over-take the ageing China, if the economic policies are brought into order by curbing trade and current account deficits, bringing down the inflation and interest rates, improving tax GDP ratio and stepping up investment in agriculture, manufacturing, infrastructure and technology up-gradation.

Moreover, the likely trade war between the US and China on dispute related with the exchange rate of the Yuan and the Chinese warnings to scare India, Vietnam, South Korea, Australia, Taiwan etc. away from the international waters of the South China Sea, would sooner or later dampen their bilateral trade with China, which is the largest trading partner of all of these countries. India can derive further trade dividend, if their trade relations sour with China.