

IMPACT OF EURO CRISIS AND GLOBAL SLOWDOWN ON INDIA

Key takeaways:

Global Economy

- Euro zone debt problem is likely to remain a concern in the near future. Further, the European banks withdrawing credit in order to shrink their balance sheet would deepen impact of the debt crisis on the other economies.
- Near zero level interest rates are to continue in the advanced countries in the immediate future.
- Rising fiscal deficit in US and uncertainties over the economic conditions in most developed countries are adding to the worries.

Impact on India:

- Though India is primarily a domestic economy, India's exports are positively linked to the global economic growth. This is likely to adversely impact India's export growth in the coming months. However, growth will be only marginally affected by the slowdown in the euro region debt stricken countries as our exposure is low.
- Software services and other export oriented sectors would benefit from the rupee depreciation.
- FDI has not been significantly affected by the crisis while the FIIs are showing outflow in the last couple of months.
- International commodity price moderation is not being translated in domestic prices. Further, exchange rate depreciation would worsen the inflationary conditions in the economy. Therefore, the RBI would have to continue with its anti-inflationary stance in the near term if domestic conditions do not improve.

Introduction:

The current global economic slowdown has its epicentre in the Euro-region but the contagion is being witnessed in all major economies of the world. Several countries are seeing a slowdown in their economic activities and overall pace of investments.

Despite the strong growth delineated by the Indian exports sector in the last few years (CAGR 2005-11 of 20.2%), India continues to be a domestic economy with the share of exports to its GDP being around 11% on an average for the last 5 years.

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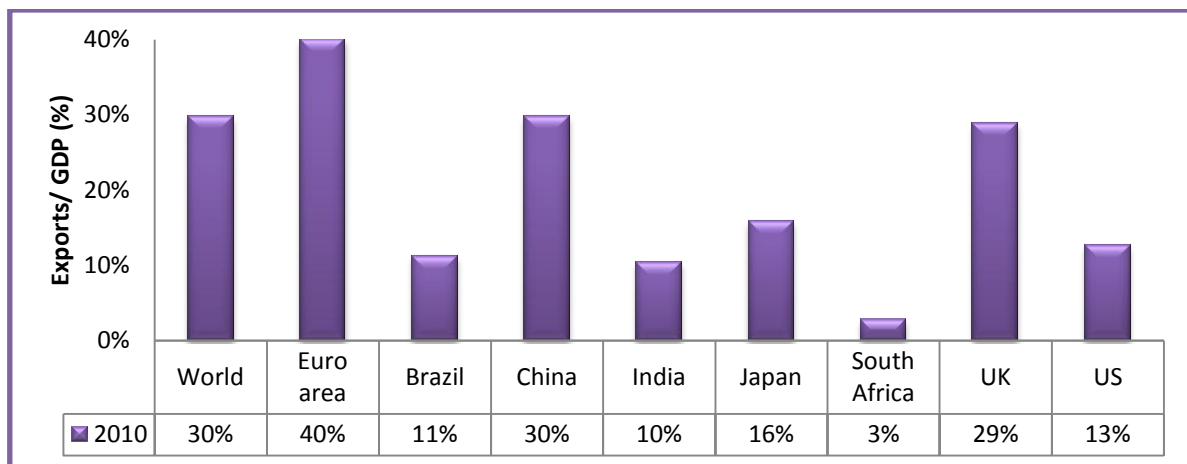
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Graph 1: Share of Total Exports in GDP



Source: World Bank, Ministry of Commerce, Government of India

Graph 1 shows that the share of the euro zone exports to their GDP was around 40% in 2010 and has been around 39% on an average since 2005. This was followed by China at 30% and UK at 29%. India's exposure to the global markets through foreign trade was restricted to 10% in 2010. *However, the impact of the rising global uncertainty and volatility in the exchange rate movement has been seen in the business climate prevailing in India.*

What is happening around the world?

Credit Default Swaps (CDS) provides a unique window of viewing the state of uncertainty in any country. Table 1 provides information on the CDS for a set of countries at two points of time. Table 1 shows *the severity in the crisis which has eroded the creditworthiness of various countries as the euro crisis spread*. The CDS spreads have increased for countries which have now come in the forefront of the crisis like Italy, Hungary and Spain. They have increased 4-fold in case of Greece and remained at higher levels for the others. This reflects that the crisis is still some way from being resolved.

Table 1: Credit Default Swap Rate for a select few countries

CREDIT DEFAULT SWAP RATES		
%	1 st August 2011	30 th November
Greece	18.56	77.2
Portugal	9.06	10.86
Ireland	7.75	7.47
Hungary	3.06	6.18
Italy	3.03	5.34
Spain	3.56	4.66
Belgium	1.95	3.78
France	1.20	2.36
Austria	0.92	2.22
Germany	0.62	1.1
UK	0.72	0.99
US	0.75	0.54

Source: CNBC

An important outcome of the developments in this area and the solution being worked out is that European banks have to improve their capital ratios and would have to either: raise new equity, use retained profits or shrink the balance sheet. Raising new capital is a challenge given the rising distrust amongst investors continuously. Increasing profits is difficult as the outlook deteriorates as illustrated by the CDS spread. Therefore, the banks appear to be left with little choice but to shrink their balance sheet. *This would lead to lowering credit which will further exacerbate the crisis.*

Concerns in Developing countries remain:

The rather unsatisfactory outlook of the advanced economies on account of:

- Maintenance of interest rates at near-zero levels
- Uncertainties over the euro region sovereign debt crisis
- Rising US fiscal deficit problems and slowing economic growth

has had an impact on the developing countries.

In the recent past, investors were venturing into the emerging markets that offered attractive returns. This brought about increased flow of funds into the emerging markets and in turn increased economic activities in these countries. However, in the last couple of months with the inability of the emerging economies to tame inflation clubbed with rising uncertainties over the euro-region and the volatility in the exchange rate, investors have been rushing to 'safe haven' assets like the US Treasury, US Dollar or Gold.

Purchasing Managers Index (PMI) is an indicator of the economic health of the manufacturing sector of any country. The PMI index is based on five major indicators namely, ***new orders, inventory levels, production, supplier deliveries and the employment environment*** in a country. A PMI of more than 50 represents expansion of the manufacturing sector, compared with the previous month. If the PMI is below 50 then it represents a contraction, while a PMI at 50 indicates no change in the manufacturing sector.

Table 2: Monthly Trends in PMI (manufacturing)

%	PMI						
	Apr	May	Jun	Jul	Aug	Sept	Oct
Brazil	50.7	50.8	49.0	47.8	46.0	45.5	46.5
China	51.8	51.6	50.1	49.3	49.9	49.9	51.0
India	58.0	57.5	55.3	53.6	52.6	50.4	52.0
Russia	52.1	50.7	50.6	49.8	49.9	50.0	50.4
HK	55.3	53.2	52.6	51.4	47.8	NA	NA
South Korea	51.7	51.2	51.1	51.3	49.7	47.5	48.0

Source: HSBC

The above table reveals that the PMI has been declining since April reflecting the effect of the slowdown on the developing economies. However, the PMI has remained above the 50 mark for most of the countries till Jun 2011. *In Aug 2011, when the PMI for all the 5 countries in the table illustrated a contraction in the manufacturing sector, India continued to be over the 50 mark.*

The PMI for the month of Oct 2011 shows an improvement over the previous months and could be partly attributed to the growth indicators for the US economy that are showing modest improvement as well as the stable German performance. In core European countries confidence improved a little in France and Belgium. Among the indebted peripheral countries confidence improved in Spain and Portugal (from low levels).

Impact on the Indian Economy:

a. Export Profile of India

Table 3: India's Exports Profile (Share in total)

%	FY10	FY11
EU countries	20.2	18.6
Africa	5.8	6.5
Asia	21.8	22.7
WANA	22.0	22.6
ASEAN	10.1	10.9
North America	11.6	10.7
<u>Euro zone (17 countries)</u>		
Netherlands	3.58	3.09
Germany	3.03	2.69
Belgium	2.10	2.51
France	2.14	2.02
Italy	1.90	1.81
Spain	1.14	1.02
Austria	0.14	0.43
Malta	0.40	0.30
Portugal	0.21	0.21
Greece	0.25	0.14
Ireland	0.15	0.11
Finland	0.12	0.10
Slovenia	0.11	0.07
Slovak rep	0.02	0.02
Estonia	0.02	0.02
Cyprus	0.03	0.02

Source: Department of Commerce

India's exports are fairly well diversified across countries. The share of West Asian and North African (WANA) is the most followed by the other Asian countries. While UAE was the most important destination in 2010-11 with a share of 13.7% followed by US at 10.2%, East Europe has a share of only 0.06%. The 27 EU countries have a share of 18.6% in India's exports. The share of EU countries in India's total exports has declined from 20.2% in FY10 to 18.6% in FY11 on account of the sovereign debt crisis in major economies of this region.

The 17 nations that comprise of the Euro zone together contribute around 14.6% to India's exports. Of which Netherlands (2.1%), Germany (2.7%), Belgium (2.5%), France (2.0%), Italy (1.8%) and Spain (1.0%) contribute around 13% of the India's exports in 2011. The gross domestic product of the euro region for 2011 was 1.6% and countries like Greece (-7.5%), Italy (0.6%) and Spain (0.6%) have

illustrated a slowdown. *However, the share of these countries in India's exports is quite low at around 3% and will not directly have an impact on our growth prospects in exports.*

It is observed that in 2010-11, India's exports to the European region and US moderated. However, our exports to the Asian and the African region, which have a greater share in India's exports, grew during this period.

b. Growth in India's Exports as product of growth in economic activities

Table 4: Indian Exports and World GDP

%	India's Export growth	GDP growth		
		World	Adv. Countries	Euro Region
2000	19.0	4.8	4.2	3.8
2001	2.3	2.3	1.4	2.0
2002	13.8	2.9	1.7	0.9
2003	16.3	3.6	1.9	0.7
2004	31.4	4.9	3.1	2.2
2005	31.3	4.6	2.7	1.7
2006	21.9	5.3	3.1	3.2
2007	21.6	5.4	2.8	3.0
2008	32.4	2.8	0.1	0.4
2009	-15.3	-0.7	-3.7	-4.3
2010	33.6	5.1	3.1	1.8
2011*	5.6	4.0	1.6	1.6

Source: IMF and Department of Commerce

* Estimates

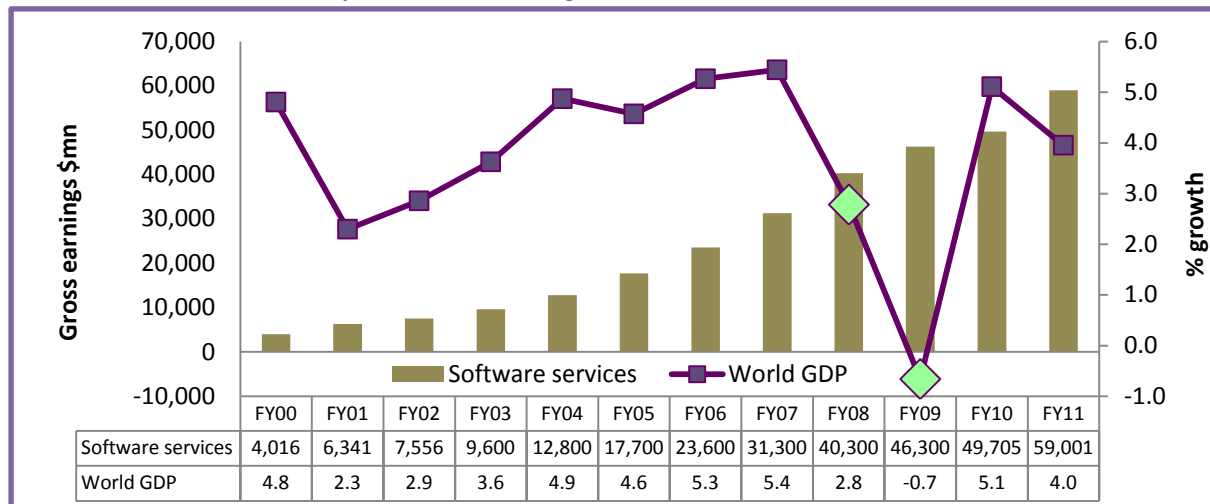
The above table shows a positive relation between the growth in world economic activities and India's exports. It is observed that in majority cases (9) there is a positive relation between the world economic growth and India's export growth. Any decrease (increase) in the world GDP has been reflected in India's trade with a fall (rise) in the exports. Two exceptions were 2006 and 2007 where the two variables were moving in opposite directions, albeit marginally. However, it comes to one's notice that the movement of India's export is directly correlated to the economic growth in the advanced economies and the euro region.

Despite the positive relation between India's exports and the world's economic activities, taking a look at the average elasticity between the two parameters shows a different picture. The average elasticity between India's exports and the word GDP is 0.29 which indicates positive low elasticity. Similarly, average elasticity between India's exports and the advanced nations or the euro region's GDP is 0.18.

Therefore it can be concluded that, with the advanced economies showing a slowdown on account of the US fiscal problem, Euro region debt crisis, Japanese unstable economy post the earth quake & tsunami and the rising inflation in the emerging economies, *India's exports are likely to be affected and the growth rate will slow down.*

c. Indian Software Sector:

Graph 2: Gross earnings from the software services



Source: IMF, CMIE

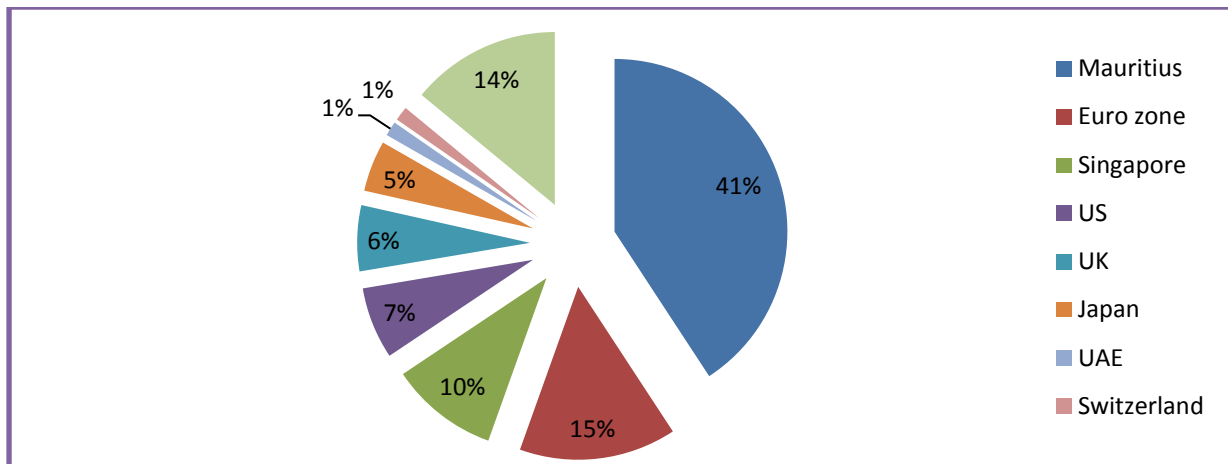
India's earnings from the software sector have been increasing steadily over the years at a CAGR of 27.7%. In FY09, the world economic growth slowed to -0.7% but software services continued to increase, albeit at a slower rate. Net software earnings growth rate declined from 28.8% in 2007-08 to 14.9% in 2008-09 and further to 7.4% in 2009-10.

In the first eight months of 2011, the rupee had been stable in the range of Rs. 44-45 per Dollar. A depreciating trend became stark since Aug 2011. The rupee has depreciated by 18% against the Dollar and by around 9% against the euro since Aug 2011. *This trend is likely to improve the competitiveness of this sector. The negative impact, if any, will be marginal.*

d. Impact on Foreign Direct Investment (FDI)

FDI inflows in India during 2011-12 (Apr-Sept) increased by 74% to \$19,136 mn from \$11,005 mn for the same period last year. FDI inflows peaked to \$5,656 mn in Jun 2011 and declined thereafter.

Graph: Country-wise FDI inflows from Apr 2000 to Sept 2011



Source: DIPP

Mauritius has been the top investing country in India through FDI in equity, with a historical share of around 41%. Considering the share of euro zone in FDI equity inflows for cumulative period of Apr 2000 to Feb 2011 was 14.7% with share of Netherlands, Cyprus and Germany has been around 4.4% and 3.7% and 2.9% respectively. The share of the other euro zone countries has been marginal. Further, the share of the euro countries in distress namely, Italy (0.7%), Spain (0.6%) and Greece (0%) together contribute a marginal share of 1.3% to India's FDI flows. Hence, it can be drawn that euro zone slowdown would not have a significant impact on the India economy.

The share of India's FDI in the emerging and developing markets is low at 5.2% in 2011. Therefore, the FDI flows have been less volatile to the global slowdown.

e. Impact on Foreign Institutional Investment (FII)

On the other hand, FII have been moderating with the rise in the global uncertainties. The following table gives a trend in the FII flows in India.

Table 5: FII movement

Us mn \$	FII Flows
2000-01	1,847
2001-02	1,505
2002-03	377
2003-04	10,918
2004-05	8,686
2005-06	9,926
2006-07	3,225
2007-08	20,328
2008-09	-15,017
2009-10	29,048
2010-11	29,422

Source: CMIE

FII inflows increased in 2009-10 to \$29,048 mn and the high levels of FII inflow were sustained in 2010-11 as well with \$29,422 mn flowing into the Indian economy. FII illustrated a net outflow of \$15,017 mn in 2008-09, which can be attributed to the global financial crisis. The share of India's FII

in the emerging and developing markets has declined from 19.2% in 2010 to 3.8% in 2011 as a consequence of the global slowdown.

The current financial year has seen a decline in the momentum of FII inflows with approximately \$1,881 mn flowing into the economy so far of which \$1,390 mn were in Debt and \$491 mn in Equity.

Therefore, it can be observed that the FII flows are positively related to the global investment sentiments. With the global uncertainties warming up the FIIs are expected to withdraw from the riskier assets like the emerging market assets and drift towards safe haven assets.

f. Inflationary scenario:

Global inflation (CPI) in 2011 so far increased to 4.2% from 3.3% seen for the same period in 2010. Inflation in the advanced economies rose sharply from 1.6% in 2010 till Jul to 2.6% in 2011. Similarly, inflation in the emerging economies increased to 6.5% in 2011 from 5.8% in 2010.

Since May 2011 with an exception in July 2011 international commodity prices and metal prices in particular are moderating. Compared with Apr 2011 the international metal index showed a decline of 19.7% with copper declining by 22%, aluminium 18% and zinc 21%.

Headline inflation in India (WPI) has been outside the comfort zone of the Indian Central Bank since late 2010. Therefore, the RBI has been increasing interest rates in order to curtail the rising inflation. RBI has increased interest rates 5 times (175 bps) in the current financial year. The RBI has maintained time and again that the high headline inflation would start to decline from Dec 2011 and would settle at 7% by the end of the fiscal.

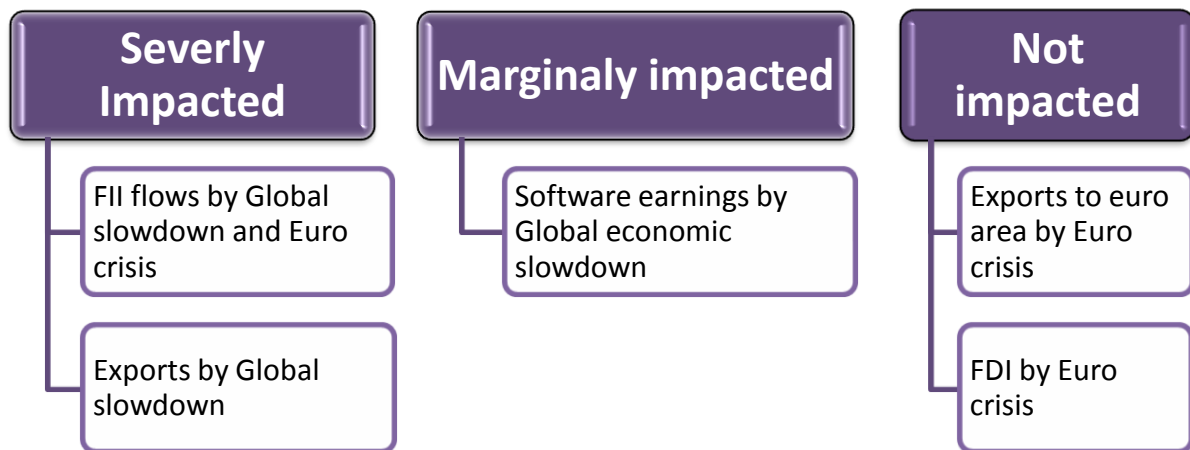
Domestic inflation for the month of Oct 2011 stood at 9.7%, while the international commodity prices were moderating. This implies that the moderation in the international commodity prices has not been translated in to the domestic commodity prices.

g. Exchange Rate Depreciation could worsen the outlook:

Since the global uncertainties aggravated, the Indian exchange rate has depreciated 17.4% against the US Dollar during the current financial year. This has been higher than that observed in other markets like Euro and Pound depreciated by around 5.3% each against the Dollar during the same period.

The depreciating rupee is likely to add further pressure on domestic inflation and India's import bills. The rupee depreciation will particularly hit the industrial sector and put higher pressure on their costs as items like oil, imported coal, metals and minerals would get affected. However, it is believed that the IT services sector, textile sector and other such export-oriented industries in India are likely to benefit from the depreciating rupee.

Conclusion:



Assessing the impact of the global activities on India, we can conclude that with the continued uncertainties in the global economy as illustrated by the rising CDS spread, slowdown in economic activities pressure is felt on the FII inflows in India. The exports and the software services earnings are marginally impacted by the slowdown in the world GDP. On the other hand, export oriented sectors are likely to benefit if the rupee continues to depreciate or remains in the current band. FDI flows have been less volatile to the euro zone crisis.

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