BACKGROUND NOTE
on
"Global Economic Turmoil: Implications for India"

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Introduction

The Q2 GDP numbers, trade figures, depreciating exchange rate of rupee - unfortunately, all these numbers are now pointers to an increasing consensus that India is in the midst of slowdown. What is more important that India which had emerged relatively unscathed after / from the 2008 crisis, may not be lucky this time around. It is in this context, that the macro-economic impact of the spillovers from the Euro crisis on India assumes importance. In economic parlance, there are primarily 3 channels through which the spillover impact from the Euro crisis can impact India. These are the credit channel, trade channel and financial channel. Let us explore these one by one.

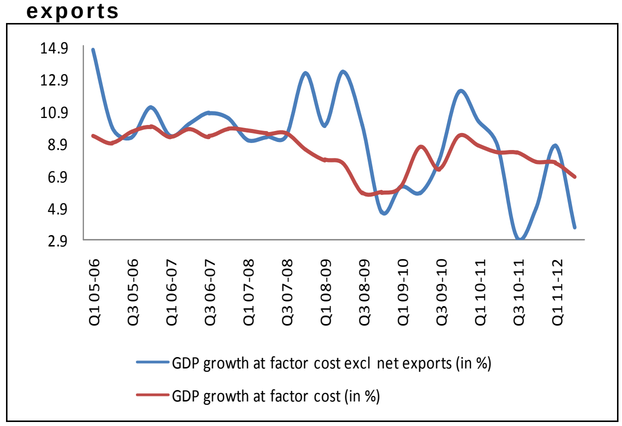
Credit Channel:

Perhaps, the depreciation of the Indian rupee by 17% (RBI monetary policy review-Dec 16) since the precipitation of the US crisis following the rating downgrade, brings into sharp focus the spillover of contagion risk through the credit channel. In particular, the Emerging Markets (EM) in Asian economies (India included) have widely tapped foreign funding sources over the last decade to take advantage of low interest rates in advanced economies (read European). However, it has now become a source of contagion risk. In fact, the Institute of International Finance lending conditions survey for Q3 2011, reveals that overall funding conditions for banks has tightened significantly across the globe, with banks in Asia particularly experiencing significant adverse shift in international funding conditions. This is because European banks have been mandated to increase the core capital to 9.0% by June 2012. Subsequently, European Banking Authority estimates that the total bank recapitalization needs is around $150bn. This we believe has already resulted in European banks starting to squeeze in credit lines on EMs, etc for striving to meet the mandated 9% ratio. India is no exception to this, as the claims of EU and US banks on India is now nearly 12% of India's GDP (as on Jun'2011), a decline from 13.5% just before the Lehman crisis!

Trade Channel:

Even after the latest $9 bn downward revision in export data, India's exports still remain the enigma of many. In the first seven months of the current fiscal, exports have risen by 46% YoY to $180 bn. As the graph below shows (Exposition 1), India's GDP growth excluding new exports have declined to less than 4% in Q2 of current fiscal. Clearly, a slowdown in exports post EU crisis could only pull down India's GDP growth significantly.

Exposition 1: GDP growth of India excluding exports



Source: CSO and FICCI Research

Even as a slowdown in exports is envisaged post EU crisis, one good thing is that the continuous stress in advanced economies since 2008 did not have a significant impact on India's export growth in the last 2 years as India has managed to explore new markets through export diversification. For example, exports to OECD countries, Latin American countries have witnessed a progressive jump during this period, while the share of EU in India's export basket actually declined from 21.3% to 18.4% for the 3 year period ended 2010-11. However, even then as Table 1 shows, exposure to PIIGS (Portugal, Ireland, Italy, Greece and Spain) was 3.8% during Apr-July'11. At this rate, we estimate that the share of these countries will be roughly 4% in total exports projected ($300 bn) for the current fiscal ($12 bn, roughly). Clearly, the impact of trade channel on India cannot still be underestimated (recall, Indian exports have registered a measly 11% y-o-y growth in October, down from 82% in July).

Table 1: Top 10 India's trading partners in EU

$mn	2010-11	Share in total exports		Apr-July 2011	Share in total exports
Netherlands	7761	3.1	Netherlands	3808	3.4
UK	7214	2.9	Germany	3160	2.8
Germany	6774	2.7	UK	3143	2.8
Belgium	6303	2.5	Belgium	2458	2.2
France	5067	2.0	Italy	2280	2.1
Italy	4566	1.8	Turkey	1434	1.3
Turkey	2749	1.1	France	1396	1.3
Spain	2565	1.0	Spain	1222	1.1
Russia	1600	0.6	Russia	718	0.6
Austria	1082	0.4	Austria	592	0.5
Exposure to PIIGS	8301	**3.3**		4221	**3.8**

Source: CMIE & FICCI Research

Financial Channel:

The impact is primarily through repatriation in bond markets following a withdrawal of investor position, and a spill over from global market volatility in the domestic equity market (for example, as per the ADB Capital Monitor, during the period 1994-2010, the %of variance of Indian market equity explained by global factors was as much as 12%). Interestingly, portfolio flows in the current fiscal has declined significantly. Additionally, in the first half of the current fiscal, nearly 25% of the FDI flows (India's top ten FDI partners) were from EU economies, and it only but natural that FDI flows will take a hit, in the event of a prolonging of the crisis.

Table 2: Top ten FDI partners

$mn	2009-10	2010-11	2011-12 (Apr-Sept)
Mauritius	10376	6987	6463
Singapore	2379	1705	3211
USA	1943	1170	570
UK	657	755	2563
Japan	1183	1562	1823
Netherlannds	899	1213	825
Cyprus	1627	913	629
Germany	626	200	1306
France	303	734	392
UAE	629	341	140
Total FDI Inflows	25834	19427	19136

Source: DIPP

In the end, the EU crisis coupled with the limited flexibility of the Indian policy makers on the fiscal front is likely to pose an enormous challenge to the Indian economy in the next fiscal. Increasingly, political cycle will play a dominant part of over the budget making cycle. The only point of solace is still, Indian banking system remains still a safe bet. As a matter of fact, India's exposure to systemic risk (the risk of collapse of a behemoth) remains significantly low at 0.89% of GDP, though the figure has increased since 2009. A comparison with China reveals that this systemic risk component in China is 4 times higher compared to India!