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INDIA AND THE EUROZONE: A COMMENTARY ON THE POLITICAL ECONOMY OF ADJUSTMENT AND CORRECTION

BY SHAILAJA FENNELL, AMANDEEP KAUR AND AJIT SINGH

Abstract
This commentary focuses on the interaction between Eurozone and India with a particular focus on the relationship between changes and economic conditions in these two jurisdictions. In the pre liberalization world, India and the Eurozone were regarded a priori as having little interaction with each other. This story changes with globalization and relatively free capital movements. We highlight some of the important changes which have occurred in the Eurozone and Indian economies and discuss the implications for other regions and countries. The commentary sets out a number of hypotheses and uses broad-brush data to provide the intellectual foundations for our analysis.

The interactions between India and the Eurozone

This commentary is concerned with the evolution of the Eurozone and India in the context of globalization and the current serious economic crisis facing the two jurisdictions. A careful review of the progress of these two entities in fighting or accommodating the global recession is likely to throw some light on the political economy of development in other countries and regions. The significance of the Eurozone for the politics and economics of Europe cannot be exaggerated. Similarly the experience of India, a mixed economy democratic country with all its faults deserves to be reviewed. In the pre liberalization world, India and the Eurozone may be regarded a priori as having little interaction with each other. However the story changes with globalization and relatively free capital movements. In this commentary we will highlight some of the important changes which have occurred in the Eurozone and Indian economies and discuss the implications of these changes for other regions and countries. The paper will also set out a number of hypotheses which our analysis suggests require further explanation. This commentary is not an econometric exercise but rather it uses broad- brush data to provide intellectual foundations for the more important hypotheses which emerge from our analysis.

The Indian economy has done extremely well between 1990 and 2010. It has been one of the fastest growing economies during that period. Recently, it has been growing through an uneven patch and its growth rate has declined from over 9 per cent per annum between 2006 and 2007 to 5.5 per cent per annum in 2012. Although the Indian growth rate is still respectable by any relevant international standards, the rating agencies based in New York (the Standard and Poor, as well as Moody's) have been very critical of the lack of deeper reforms in the Indian economy.

A new pattern of international economic growth is being revealed by the data for the first twelve years of the 21st millennium. Despite India's recent decline in economic growth, developing countries in general have been growing at a much faster rate than the developed countries. During 2006 to 2011 which includes the deep recession year of 2008, the advanced country economies grew at an average rate of 1.63 per cent per annum for France, 1.36 per cent for Germany, 0.79 per cent for Japan, 1.9 per cent for UK and 1.8 per cent for US. Developing countries, particularly, the leading emerging markets expanded at a much faster corresponding rate of 3.6 per cent for Brazil, 10.2 per cent for China, 7.1 per cent for India, 3.5 per cent for South Africa and 5.2 per cent for Russia. France and Germany are among the fastest growing economies in the Eurozone.

Even this small sample of countries reveals the extraordinary transformation which has occurred in the world economy. It used to be an article of faith among scholars that in a global economic downturn it is the periphery which suffers while the centre is able to take care of itself. The statistics cited above however reveal an entirely different pattern; it is opposite to what has traditionally happened in the past.

The main issues for this commentary are the reasons for the Eurozone's and India's economic downturn and how these may be related. The two jurisdictions are closely linked by trade and capital movements and these links must affect their economic performance. One main concern in this paper is to estimate how the economic downturn in the Eurozone affects an emerging country like India. This question acquired some notoriety during the last two or three years when empirical data showed that the economic cycles in emerging countries are more or less synchronized. Similarly the data seems to indicate that the advanced countries also had synchronized cycles but of a different kind than that in emerging countries. It was speculated that this will help emerging countries to decouple their economies from that of advanced countries. Emerging countries were thought to have reached a stage where they could control the cyclical fluctuations in their economies. However, the Great Recession changed this whole perspective as developing countries were directly affected by the fall in aggregate demand in the economic downturn which began in its acute form in 2008 with the demise of the Lehman brothers, an important US financial institution. However, it must be noted that the slowdown in leading developing countries in response to the current recession was short lived.

How economic downturn in the Eurozone affects economic outcomes in India? India, it should be noted now has many close ties with Eurozone countries. For this elementary exercise, we take Germany and France as the typical Eurozone members and attempt to measure the effects of the economic downturn in the Indian economy. The story is complicated as India has close relationships in trade and capital movements with Eurozone countries. Associated questions which need attention are 1) when is the Eurozone crisis likely to end 2) what steps can governments like India's take to ensure that the economic downturn is as short as possible.

We start with a broad-brush description of the Indian economy. India is the second most populous country in the world and overall during the last quarter century, it has had an excellent economic record. It has been on an accelerated growth path which has allowed it to achieve growth rates of about 9 per cent during the first half of the first decade of the new millennium. This fast growth has enabled millions of people to grow out of poverty. Although India is the third largest economy in the world in purchasing power parity terms, its per capita income is 140th in the world.

From among one of the most closed developing country economies in the 1960s and 70s India has become a far more open economy as the following statistics indicate. India's merchandise trade rose by more than three hundred percent between 2006 and 2012. Both exports and imports have tripled during this period, with the trade-GDP ratio increasing from 30.2 percent to 42.9 percent in 2012. Exports to GDP ratio increased from 12.4 percent in 2006 to 16.5 percent in 2006 (Exim bank data). Equally significantly, India's capital account liberalization has led to a large investment of FDI in India and to equally large Indian multinational investments abroad. For example, the biggest private sector employer in the UK today is the Indian company Tata, employing 45,000 people.

The Eurozone is a big trade partner for India and a fifth of India's exports find their way to the Eurozone region and a sixth of India's imports come from this region. The nature of exports range from agriculture, through manufacturing to services and the Eurozone is also important in relation to both incoming and outgoing FDI flows (Anand, Gupta and Dash 2012). The Netherlands, the United Kingdom and Germany contributed approximately US $9 billion each to India's total exports of US $ 26 billion going to the European Union in the financial year of 2012, while the total exports to the OECD countries was $46 billion (RBI Monthly Bulletin, June 2012). The Netherlands and United Kingdom also benefit from ODI outflows from India, receiving 7 and 6 per cent of India's total outflows of FDI in 2012 (Exim Bank data).

The important question that we are asking in this commentary is how would the economic crisis in the Eurozone affect Indian economic growth? For purposes of exposition and the value of comparison there will also be an examination of the individual impacts of the US and the UK. This commentary is not intended to provide a rigorous econometric examination of these issues but rather to outline some useful hypotheses and outline an intellectual framework to address these questions. We would also like to try to provide a serious answer to the question posed by the Indian governor of the Central Bank, 'when will the Eurozone crisis end?' His answer that it will end on the date of his retirement is amusing but not very helpful.

The serious answer is that this will depend most importantly on the politics of the situation. In many discussions of the current crisis, the politics of the Eurozone countries is overlooked. Yet politics was central to the origin of the Eurozone and in the practical day to day working out of the crisis. The design of the Eurozone did not conform to the economists' theories of optimal currency areas. Rather it was the product of the political project of the leaders of new Europe after the end of the Second World War. They had two principal aims: one was Franco-German reconciliation and the second the necessity of abolishing war between nation states in Europe. These aims could only be realized as a process that emerges from the rising political costs associated with the growing severity of the crisis which the policy makers are concerned with (Glyn et.al. 1998). To illustrate with a concrete case, the United States government ushered in the Marshall Plan to deal with the communist threat to their interest in Europe. They were of course extremely successful in achieving this objective. The cost of the Marshall Plan amounted to 4 percent of US GDP at the time. This was also the foundational argument for the design and implementation of the European Common Market, based on the need to ensure growth as a way to reduce the possibility of future conflict (Anand, Gupta and Dash 2012). The explicit need for political negotiation and accommodation made the economic need to cooperate paramount after World War II.

<u>The Existing Analysis of the Impact of the Financial Crisis on Developing Countries</u>

In the first round of analysis on the financial crisis authors agreed that one primary cause of the global financial crisis was the under-pricing of risk between 2003 and 2007 that was largely generated by the operation of the sub-prime mortgage market in the United States. A secondary factor that led to the problem of under-pricing was the inaccurate valuation of risks by credit rating organisations. The correction of this under-pricing was regarded as the key to resolving the crisis in the early years, and it was felt that while the United States was beginning to get this process underway by the end of 2009 there was still a major problem of under-pricing risk that needed to be addressed in the Eurozone countries, particularly in the United Kingdom (Buiter 2009).

The initial evaluation of the centrality of the sub-prime mortgage crisis was followed by a broader discussion of the financial crisis that manifest itself in 2006-07 and the nature of global imbalances in financial flows that were in evidence in the 2000s. The focus in this second round was on the political economy of the increased government spending to obtain electoral gains alongside a demand for reduced regulation by corporates. The analysis indicated that there was a decidedly political nature to domestic policy considerations in this decade (Rajan 2011). The use of cheap borrowing to finance macroeconomic balances was commonplace in the economic policies followed by OECD countries in the 2000s. The nature of economic distortions brought about by these domestic policies, led subsequently to a transmission effect through global financial markets to the developing countries (Obstfeld and Rogoff 2009).

The conventional wisdom of the time regarded the foremost impact of advanced economy country policies of the 2000s on developing countries through transmission effects in international trade. This was in keeping with the mainstream trade model that regarded the trade balance as a measure of competitiveness of national economies, and therefore regarded a fall in financial and trade flows within the global economy as the major cause for the reduced growth rates of developing countries. This is also the official rationale for the establishment of the Eurozone in 1999, that there was an economic imperative to introduce a common currency to improve competition. The political need for integration was not explicitly stated in the initial justification of the Eurozone (Anand, Gupta and Dash 2012), in a manner strongly reminiscent of the setting up of the European Union half a century earlier.

The changes in the trade flows on account of the Eurozone crisis have been examined by international financial institutions such as the OECD and World Bank, as an increased deficit on the current account balance for developing countries is taken as indication of faltering growth. A simulation using OECD data estimated that a drop of 1% in export growth in the Eurozone could reduce growth rates in low and lower-middle income countries between 0.4% - 0.5% a year (Massa, Keen and Kenan, 2012). A second set of data examined on the impact of the Eurozone on developing countries is the remittance flows out of the OECD countries to developing countries. Remittance flows are regarded as an important transmission mechanism for the financial crisis as this source of financial inflows into developing countries is an additional source of investment funds. This is regarded as particularly significant for the BRICS, where the inflows are regarded as facilitating an investment boom and increasing growth rates (Lin 2008). The fall in remittances to developing countries after the deep financial downturn raised concerns about the transmission mechanism through which the financial crisis would result in lower growth, even diminishing incomes and rising poverty in developing countries (Ratra and Mohapotra 2009, Cali 2009). The thinking was that the lessening of the growth impetus in the advanced economies would have a knock-on negative impact on incomes and economic growth in all developing countries.

The treatment of all developing countries as a homogenous group located in the periphery and linked to the centre through trade and financial flows in an identical manner is a gross simplification of the impact of countries such as China and India on the global economy. A common limitation of the current evaluations is that they do not take into account the possibility of any impact of developing country domestic policies on the Eurozone or OECD countries. Despite the explicit evaluations in the second round of analyses on the financial crisis that indicated that the BRICS, and particularly China's growing saving rate and investment in US debt was an important feature, the statistical analysis has tended to look at a unidirectional international impact that goes from advanced economies to developing countries.

The contrast of financial flows from OECD countries to developing countries against the impact of developing country contributions on the capital or current accounts to OECD countries could provide an additional direction to understand the impact of the Eurozone crisis on India. The reluctance to examine the specific relationships that BRICS, and in particular the case of India, have with individual countries within the Eurozone and OECD is a consequence of the conventional narrative that regards the global impact of the crisis as identical between advanced and developed economies. The limitation of using such a narrow conceptual framework is also visible in the analysis of the Eurozone itself, where the conventional focus has been of the benefits of a monetary union within the Eurozone, without adequate evaluation of the limitations imposed on individual countries by a complete inability to use any form of fiscal intervention to improve competitiveness with the Eurozone (Dash 2012).

The reality of the Indian contribution to the Eurozone is becoming evident from recent statistics released in the Reserve Bank of India. This indicates that the contribution of India to global outflows of FDI has seen a considerable increase, from the low number of 37 projects in other countries prior to 1990, to 415 projects in 2011. Furthermore, the percentage of India's outgoing FDI is the second highest among emerging economies and even more than the outflows of Austria, Greece and Ireland within the Eurozone group in

2011 (Arockia Baskaran and Charrias, 2012). These statistics underline the importance of estimating the contribution of individual BRICS to the trade and financial sectors of Eurozone countries. The value of separating out the contribution of individual BRICS countries was already signalled by the particularly significant role played by China in global financial markets in the 2000s. There has, however, been little commentary on the possibility of a reverse flow from BRICS contributing to the adjustment witnessed in advanced economies after the financial crisis.

Furthermore, the global literature on the financial crisis has tended to regard the increased savings rates witnessed in developing countries in the 1990s as an additional reason for the increased availability of global funds in the years leading to the financial crisis of 2006 (Obstfeld and Rogoff 2009, Rajan 2010). There was no consideration given to the possibility that the deepening of reserves and counter-cyclical policies adopted by the BRICS in response to the earlier financial crisis of the late 1990s might be the reason that these countries avoided a full-blown financial crisis in the years following 2006. This buffer built by the BRICS could also act as an additional lever to would improve the economic condition in the Eurozone and might hasten the introduction of a correction to the Eurozone crisis.

A recent debate on the ability of developing countries to weather the financial crisis more effectively than advanced economies has shed some light on the changing relationship between the OECD and Eurozone groups, with groups of developing countries. The IMF has identified the possibility that good domestic economic policies are part of the explanation for why the periphery has done better than the centre. On the other side, the chief economist of the South Centre in Geneva, Yilmaz Akyuz, argues that the good performance is due to favourable external factors, such as commodity prices and remittances in the 2000s (Singh 2013). The positing of these new arguments about the independent ability of developing countries, particularly the savings oriented counter-cyclical macroeconomic management evident in the BRICS, does point to the need for more disaggregated analysis of the trade and financial flows between BRICS and the Eurozone to understand of the financial crisis currently facing the Eurozone and the possible role that India might play in future correction and adjustment.

Finally, the current statistical analysis examining the impact of the Eurozone crisis on trade flows and remittances to developing countries, takes an en-bloc approach to all developing countries that obfuscates the particular tendencies of low, low-middle and middle income countries. Such an aggregation feeds back into the homogenising assumption in conventional trade theory that does not recognise structural specificities at the national level. The descriptive statistics provided in the next section show the trends in international flows between OECD, Eurozone and developing countries, with a particular focus on BRICS. The disaggregation of statistics to the level of groups of countries, as well as individual country data, permits an analysis of country level trade and financial flow specificities that indicate particular structural relationships in relation to both domestic and bilateral policies of trade and investment.

Descriptive Statistics of Financial and Trade Flows

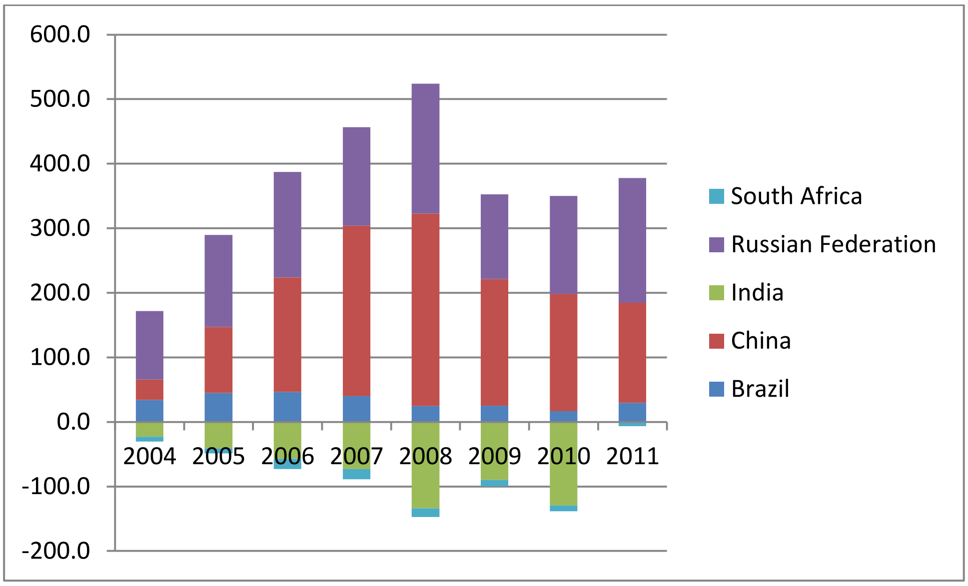
Global Trade

The global trade statistics for the BRICS countries (see Table 1) indicate that while there was a considerable downturn in global trade (both goods and services) in 2008-2009, there has been a slight improvement between 2010 and 2011. The country that has been most adversely affected in India, which has a negative trade account (no data available for 2011). In the case of the Chinese economy, there was a major reduction in trade in 2008-09 and the trade figures have continued to shrink for 2010 and 2011. There is a sharp contrast with the Russian Federation, which has seen the best recovery with the 2011 figure for trade being comparable with that for 2008.

Countries	2004	2005	2006	2007	2008	2009	2010	2011
Brazil	33.8	44.9	46.5	40.0	24.7	25.3	16.9	29.8
China	32.1	102.0	177.5	263.9	298.1	196.1	181.8	155.0
India	-23.1	-40.5	-57.0	-72.7	-133.9	-89.6	-129.6	..
Russian Federation	106.0	142.7	163.4	152.5	200.9	131.0	151.4	193.3
South Africa	-7.3	-8.0	-15.9	-15.8	-13.6	-9.9	-8.7	-6.8

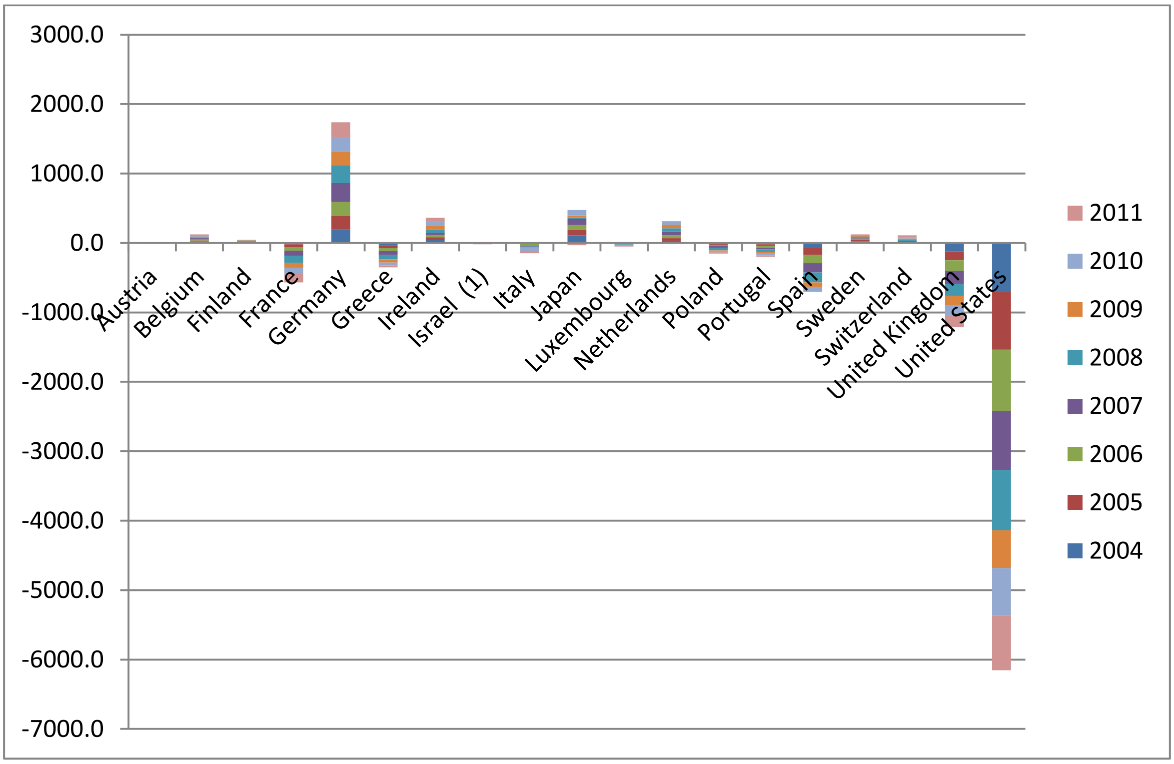
Table 1: Global Trade for BRICS countries, Source: OECD Factbook

Graph 1 below shows that the cumulative trade for BRIC countries in 2011 is almost reaching the 2006 level, indicating possible returns to higher trade based growth figures in the near future. This descriptive statistic also indicates that the BRICS are recovering while the Eurozone is still in recession, making an argument for looking at bidirectional flows between the BRICS and the Eurozone and OECD group of countries.



Graph 1: Global trade for BRICS countries, Source: OECD Factbook

Graph 2 shows that the global trade data with the OECD shows a predominantly negative trade balance, and the United States continues to have the largest trade deficit. Germany, Japan, Ireland and Netherlands baulk the trend, with Germany leading the group with regard to maintaining a trade surplus over the entire period. There does not appear to be any driver that is pushing this group of countries into recovery, and this descriptive statistic is in sharp contrast to the recovery evident in the BRICS in Graph 1.

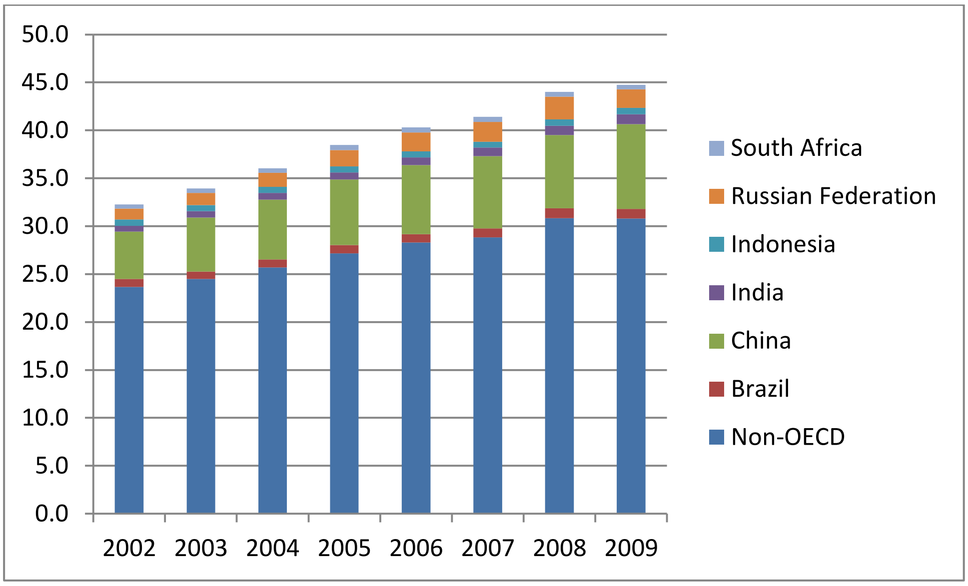


Graph 2: Global Trade for OECD countries, OECD Factbook

While the global trade statistics already begin to reveal a more heterogeneous story at the level of groups of countries, a further disaggregation of the trade balance into merchandise and services provides a more detailed picture of the impact of goods and service flows on these economies.

Trade in Goods as a percentage of total OECD merchandise trade

Graph 3 shows that there has been a continuing growth in the flow of merchandise goods between OECD and emerging economies over the period. The graph shows that the greatest increase has been in the share of merchandise trade between the OECD and China during the period 2005-2009. The trade with India has recovered by 2009 to 2003 levels. The overall share of trade with the expanded BRICS has risen from just under 25 per cent in 2003 to just over 30 per cent in 2009.



Graph 3: Merchandise trade with Non-OECD (also showing individual country percentages), OECD Factbook

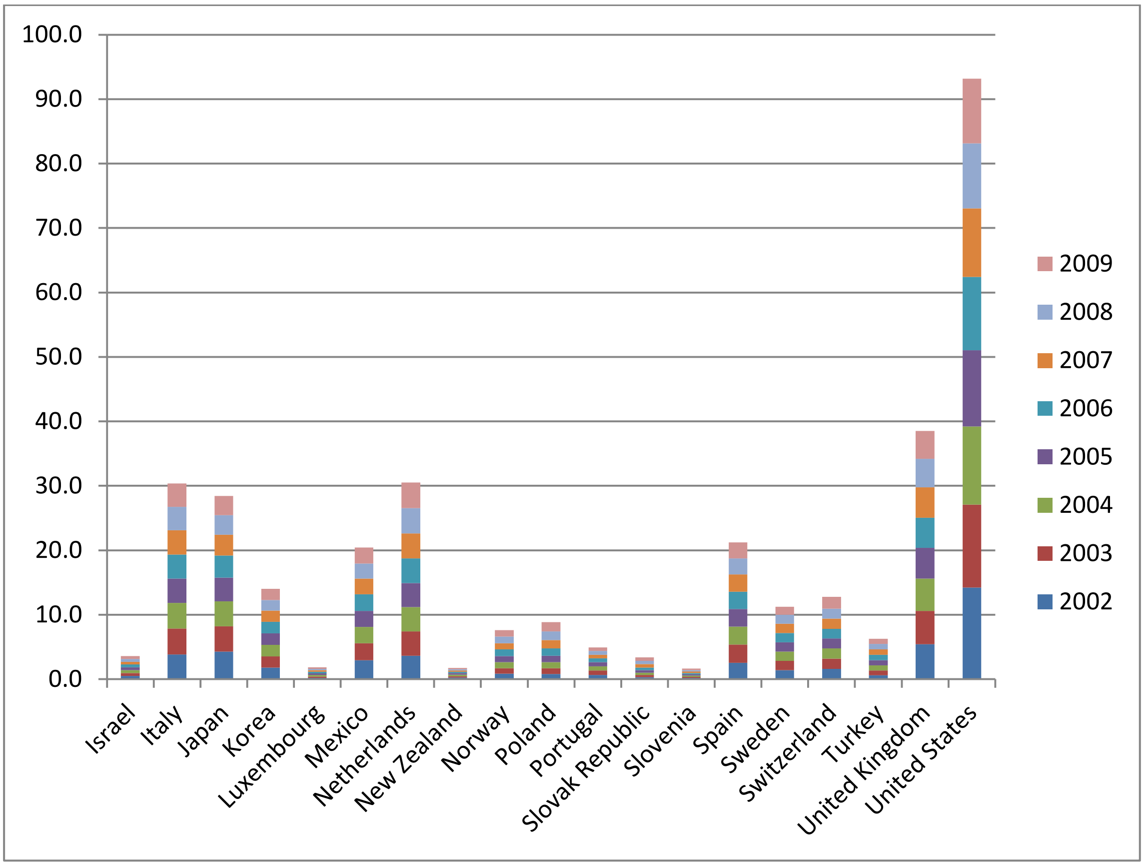
Table 2 shows that, in contrast to the growth in trade in merchandise between the OECD and BRICS, there has been a fall in the level of merchandise trade within the OECD between 2002 and 2007. This has also been followed by a stagnant share in merchandise trade during 2008-2009. This trend is also mirrored at the level of individual countries within the OECD.

Country	2002	2003	2004	2005	2006	2007	2008	2009
Israel	0.5	0.4	0.5	0.4	0.4	0.4	0.4	0.4
Italy	3.9	4.0	4.0	3.8	3.7	3.8	3.6	3.6
Japan	4.3	4.0	3.8	3.7	3.5	3.2	3.1	3.0

Korea	1.8	1.7	1.8	1.8	1.8	1.7	1.6	1.7
Luxembourg	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Mexico	2.9	2.6	2.5	2.5	2.6	2.4	2.3	2.5
Netherlands	3.7	3.8	3.8	3.7	3.8	3.8	4.0	3.9
New Zealand	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Norway	0.8	0.9	0.9	1.0	1.0	1.0	1.1	1.0
Poland	0.8	0.9	0.9	1.0	1.1	1.3	1.4	1.4
Portugal	0.7	0.7	0.7	0.6	0.6	0.6	0.6	0.6
Slovak Republic	0.3	0.4	0.4	0.4	0.4	0.5	0.5	0.5
Slovenia	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Spain	2.6	2.8	2.8	2.7	2.7	2.7	2.5	2.4
Sweden	1.4	1.5	1.5	1.4	1.4	1.5	1.4	1.3
Switzerland	1.6	1.6	1.6	1.5	1.5	1.5	1.6	1.8
Turkey	0.6	0.7	0.8	0.8	0.8	0.8	0.8	0.8
United Kingdom	5.4	5.2	5.0	4.8	4.6	4.7	4.4	4.3
United States	14.2	12.9	12.1	11.8	11.4	10.6	10.1	10.0
OECD total	**75.3**	**74.6**	**73.4**	**71.7**	**70.7**	**70.2**	**68.1**	**68.3**

Table 2: Merchandise trade within OECD countries (percentage), Source: OECD Factbook

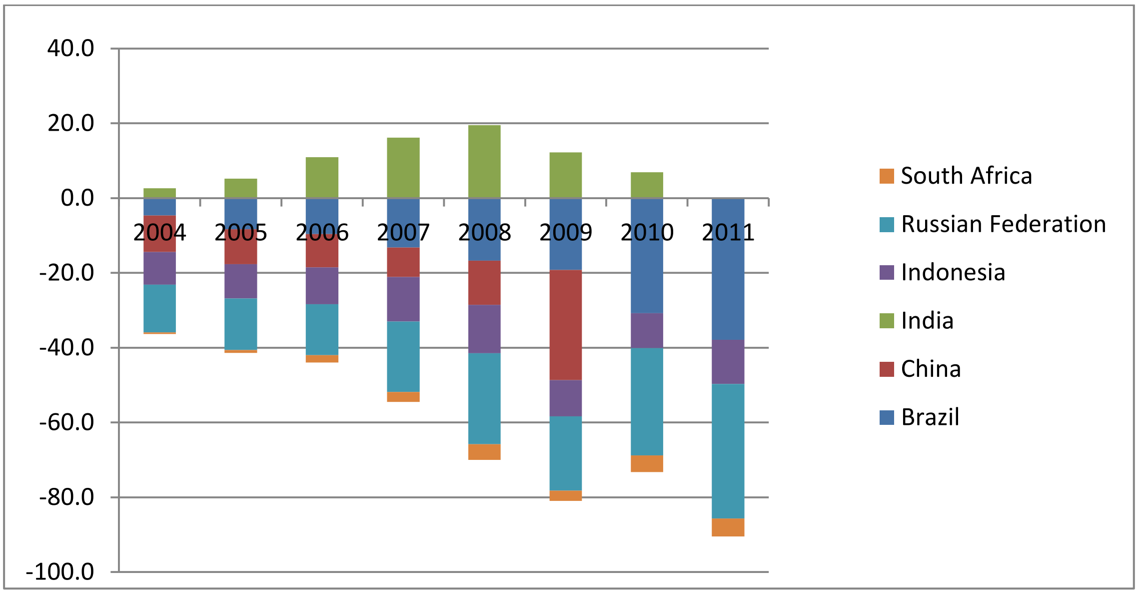
Graph 4 shows the continued dominance of the United States in the within OECD merchandise trade category. The United Kingdom continues to be the second largest beneficiary though it has seen a relative contraction since 2006. Italy and Netherlands are next in importance, and slightly outperforming the share of the Japanese share of merchandise trade. The inability of individual countries to improve the merchandise trade within the OECD indicates that there is a weaker ability of domestic trade policies to improve trade performance in the United Kingdom, Spain and Portugal than in the BRIC countries of China and India.



Graph 4: Merchandise trade within OECD countries (percentage), Source: OECD Factbook

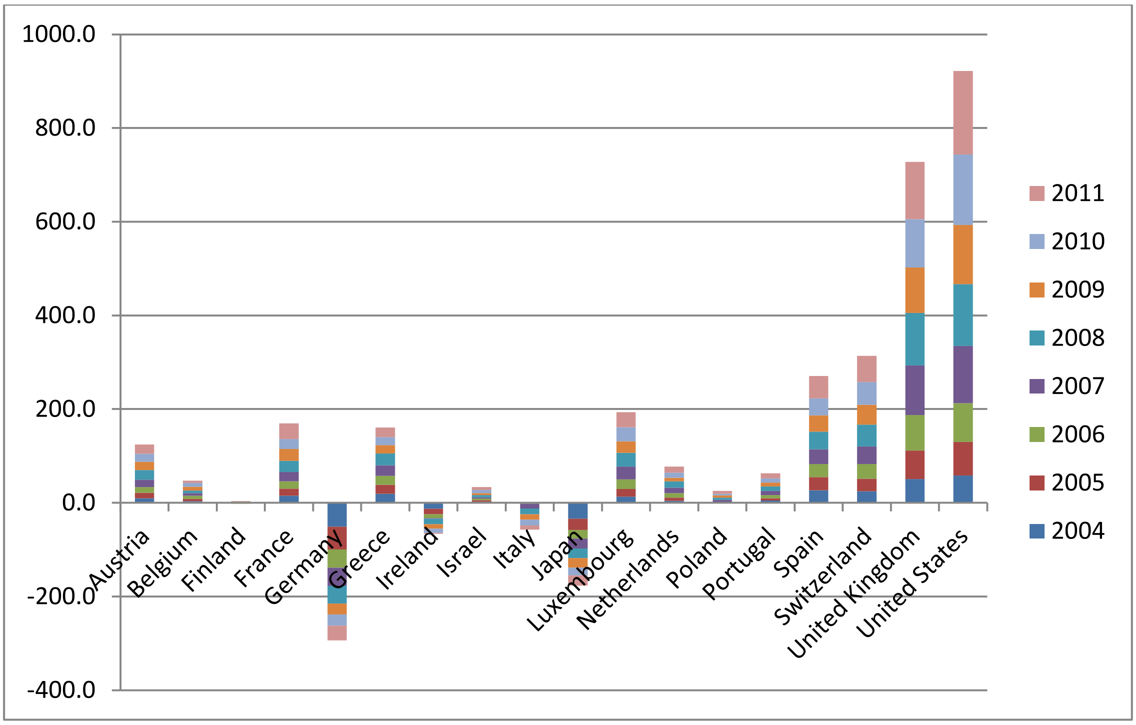
Trade in Global Services

Graph 5 shows the flow of global trade in services for BRICS countries. The most distinctive feature is that India is the only country that has been able to show a trade surplus in services. There is clear evidence of fall in the trade surplus after 2008 (no figures available for 2011). The global service trade for other countries shows that Brazil and China increased their deficit on global service trade (no figures available for China for 2010 and 2011).



Graph 5: Global trade in services (net) for BRICS countries, Source: OECD Factfile

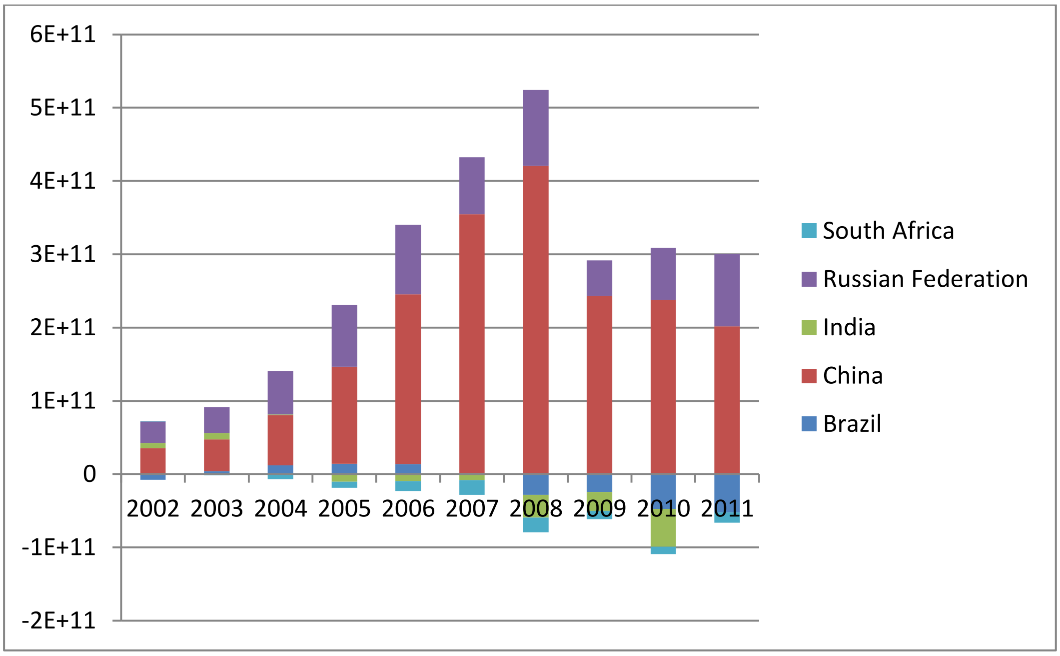
Graph 6 shows the corresponding figure for net trade in global services in OECD countries. The trends indicate that a majority of OECD countries have a trade surplus in services. The United States and the United Kingdom show increases in surplus in 2010 and 2011, while Germany and Japan show deficits in net trade in global services.



Graph 6: Global trade in services (Net) in OECD countries, Source: OECD Factbook

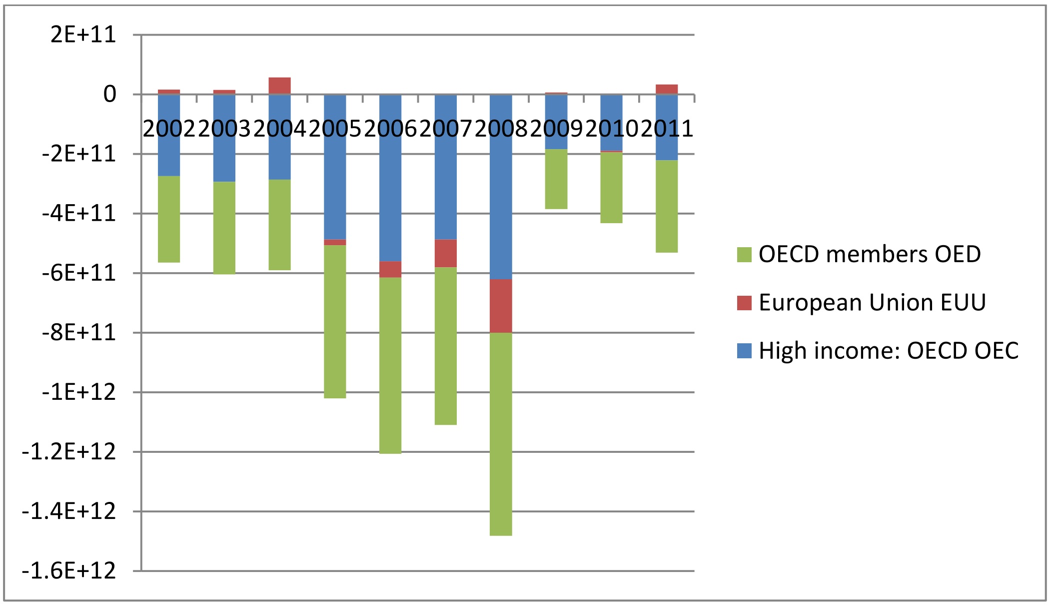
Current Account

Graph 7 shows that the current account for BRICS countries saw a significant fall after 2008. The Indian, Brazilian, and South African economies show a deficit from 2008 (no figures for India for 2011). The Chinese economy sees a significant fall in 2008 and a continued contraction thereafter, but the Russian Federation sees an improvement in 2011 after the impact of a fall in 2008.



Graph 7: Current Account for BRICS countries, Source: OECD Factbook

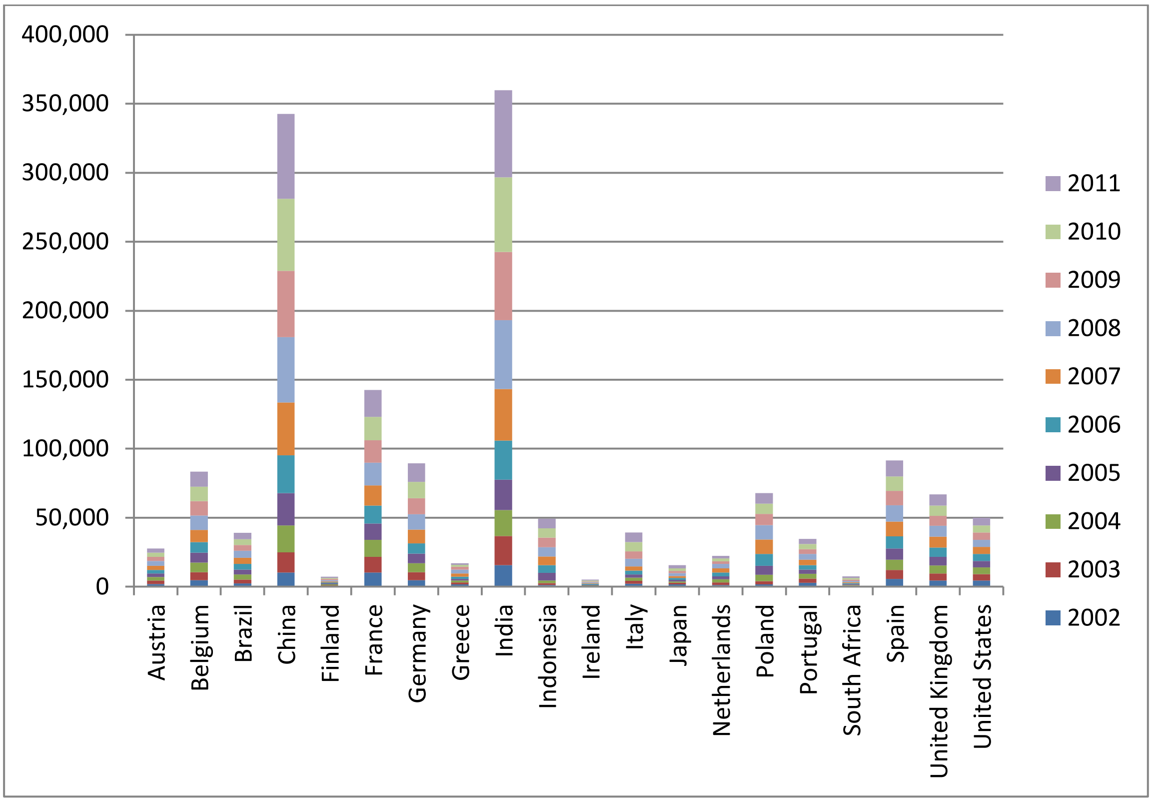
Graph 8 shows that the current account for EU countries was negative during 2005-2008, and has turned to a surplus in 2011. The figures for the OECD show that there has been a negative balance throughout the last decade. In the period after 2008, when there was a sharp reduction in the magnitude of deficit, there has been a slow rise in the deficit on the current account. For the High Income countries in the OECD, the trend is similar to that of the EU. The slightly better performance of the Eurozone countries over that of the OECD indicates that there are different bilateral relations with regard to import and export partners within these groups of countries. In our earlier discussion we have already indicated that particular relationships between individual European countries and India have not been adequately identified in the aggregative analysis of statistics that is currently in vogue. To provide a serious answer for the nature of the relationship between Eurozone countries and India it is important to example bilateral trade relations explicitly.



Graph 8: Current Account for OECD and EU countries, Source: OECD Factbook

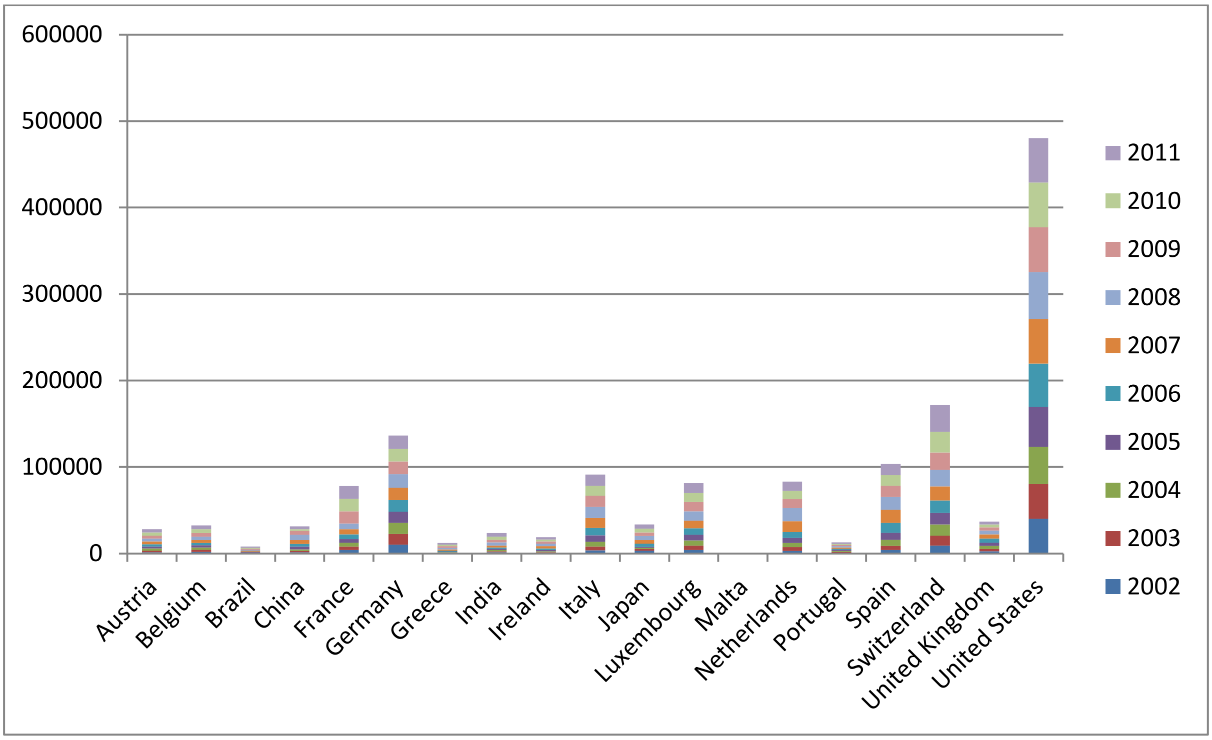
Impacts on Remittances

Graph 9 below uses data provided by the World Bank and shows that India and China were not adversely affected by the financial crisis in terms of size of remittance flows during 2008-2011. Contrary, to the generally gloomy prediction on remittances at the level of all the developing economies, these two countries have seen a healthy contribution by inflow of remittances. It would appear that there is a particular need to look at financial flows between BRICS and Eurozone and OECD countries as a two way process: where flows from BRICS can have a significant effect on growth rates and employment in the Eurozone and OECD.



Graph 9: Remittances Inflows, World Bank Data

Graph 10 shows that with regard to outflows of remittances the United States continues to be the largest source for remittances and while there has been a slight reduction in the contributions in 2010 and 2011, it continues to provide the largest absolute amount in both these years. These results differ from the estimates for all developing countries, particularly for low income countries, where there was a fall in remittances from the US.



Graph 2: Remittances outflows, World Bank data

The negative transmission mechanisms associated with falling remittances need to examined in relation to individual country characteristics. In the case of India, the comparison of the set of remittance figures with that of trade in services for the Indian economy provide indication of two differently directed flows. The importance of services is indicative of income earned by Indian nationals by providing services to other countries, while operating within the domestic economy. In contrast, remittances figures provide an estimate of the earnings from overseas, being sent into the domestic economy of India. These differently-directed flows, the former in trade and the latter in financial transfers, is another indication of how different data series need to simultaneously scrutinised to understand how there could be different possibilities of correcting the financial crisis in the Eurozone. The provision of services ($218 billion in 2012) and software exports ($62 billion in 2012), that have not fallen throughout the crisis (Reserve Bank of India) could be the result of counter-cyclical macroeconomic policies in India that made a marginally positive contribution to the correction and adjustment impetus to the OECD, particularly US, and Eurozone regions. In contrast, the remittance flows that are still healthy for both the Chinese and Indian economies do not appear to be holding up due to correction and adjustment in the Eurozone.

The limited evidence, however patchy, on Indian FDI also indicates that it would be pertinent for global datasets used by international financial organisations such as the World Bank and OECD to provide consolidated tables for outward FDI as increasingly significant flow that impacts on the Eurozone, could continue to counter the falling employment levels in the Eurozone by providing increased investment.

Implications of the Commentary

The significant difference between the conventional analysis of the financial crisis in the Eurozone on developing countries and the political and descriptive statistical analysis provided by this commentary indicates that it is no longer useful to work with a conceptual model that regards the impact of the Eurozone crisis at homogenous on all developing countries.

The case of India illustrates the significance of specific trade and financial relationships with Eurozone countries. The Eurozone countries are important trade partners and source of services and investment. India is also increasing its presence as outward FDI to the Eurozone. This new pattern of growth where India's growth and investment has implications for individual countries in the Eurozone indicate that the BRICS countries are increasing their economic impact of advanced economies. The ability of these countries, previously regarded as the periphery to have a significant impact, and even change the growth rates of countries at the centre is an important structural feature in the changing nature of global growth and its relationships to the current financial crisis.

The early commentaries on the impact of the Eurozone on developing countries did not disaggregate the evaluation to individual countries, not even for the BRICS despite evidence that China was a significant player in the 2000s. The need to recognise that China, and now India, are capable of changing the characteristics of growth and employment in the advanced economies is a major lesson coming out of both more recent reviews of the financial crisis as well as the result of our descriptive statistics.

The more difficult problem that emerges from our analysis is that the overtly political nature of the negotiations that led to the formation of the European common market as well as the recent construction of the Eurozone in 1999 have not been explicitly discussed in the literature on the impact of the financial crisis and the Eurozone on developing countries. The evidence that these cooperative actions were developed to reduce the political costs of future war and fallout needs to be brought to the centre stage as Eurozone countries try and find a solution to the current crisis. The intransigence of Germany and France to come to an economic solution that is based on a building a political solution that prevents a breakdown of the Eurozone arises due to their unwillingness to recall the mechanics behind the negotiations of the 1940s, including the cost of the Marshall Plan. The need to put in 6-10 per cent of the combined GDPs of France and Germany to ensure such a political pact does not seem too high a price to pay if once does revisit the 1940s and its results for creating a Golden Age.

The current terms of income reduction and the associated fiscal squeeze has forced a very high degree of austerity on countries such as Greece. This extreme condition of austerity might be counterproductive as it could further reduce confidence within these countries.

Rather than the extreme fiscal measures resulting in a correction in the economic fundamentals this could result in protests on the streets due to the further reduction in employment caused by extreme fiscal reduction. The fundamental structural problem that faces Eurozone countries needs to be addressed head on- the case of the German banks and their need for returns on investment needs to be explicitly recognised as a political reality. The continued drumming out of existing economic instruments cannot bring about a correction in the financial crisis in the Eurozone. There needs to be a revisiting of the original rationale for the Eurozone and an explicit analysis of the political price of not ensuring an adjustment.

To provide a serious answer to the question of when the Eurozone crisis will end in relation to the impact on India, the beginnings of a solution lies in the new balance of inflows and outflows that India has with individual countries in the Eurozone. The examination of disaggregated trade and services balances, and the undertaking of a fuller analysis of the current account with key movements complemented by introducing an analysis the capital account of the Indian economy would be the first statistical step. The second new feature would be an explicit recognition of the political dimensions involved in not taking on board the evidence that BRICS are playing an increasing significant role in the economic growth story of advanced economies. The future willingness to admit the explicitly political nature of international flows and transmissions mechanisms will also be helpful in building negotiations within the Eurozone that fully calculate the political costs of not building a cooperative solution to the current economic crisis. The under-pricing of risk that was evident in the early 2000s was the direct consequence of disregarding the political demands made by both governments and large corporate players in the OECD and Eurozone countries. If these political costs continue to be undervalued, even dismissed, then it will be a very long time before we have a solution, taking it far beyond the end of the tenure of the current head of India's central bank.

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