

ICRIER

REGIONAL INSIGHTS

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Crisis dampens French *wheelocity*



Doom and gloom that looms over the USA has left no country unscathed. Increased trade integration and herd behaviour in financial markets have eased the transmission of the crisis across borders, sending the world reeling in its wake.

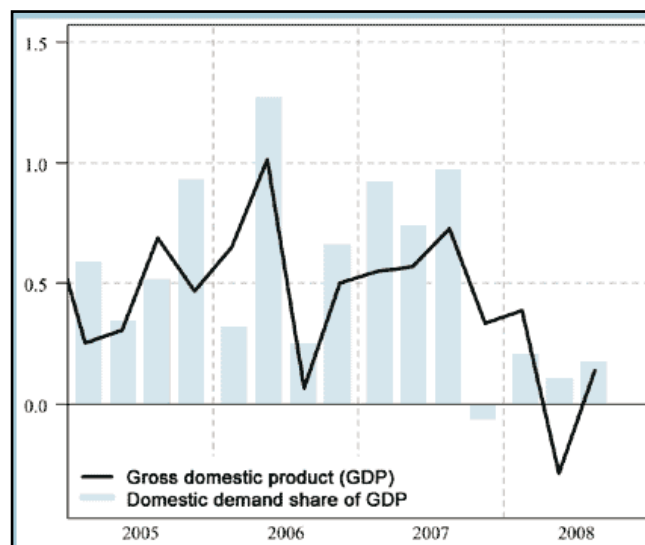
Eurozone officially entered recession as GDP of 15 euro nations fell 0.2% in Q2 and Q3. The French economy, however, grew by 0.14 per cent in Q3, bringing it out of recession.

But this rise doesn't mean that all is well for France. Hazard lights are flashing over the auto giants of Euro zone's second largest economy. The automobile sector is the key driver of this 2 trillion dollar economy that screeched to a halt in Q2 with zero growth.

Auto industry in tailspin: The automakers that have been battling high fuel costs are now facing credit freeze which has hampered the sector's ability to finance daily operations and made car buyers increasingly hesitant to make new purchases.

Fast Facts:

- France is Europe's second largest car maker (accounting for 17.1% of total European production) and world's fifth largest (after US, Japan, Germany and China).
- Its automotive sector is the leading national employer providing 2,98,000 direct jobs and employing a further 4,00,000 people in related parts supply and service sectors.
- Automotive products account for 15.4% of French exports.
- Leading national manufacturers, PSA Citroën and Renault, are the largest private investors in R&D in France (investing 5% of their turnover).
- Past decade has seen creation of 40,000 jobs by foreign investment projects bringing in valuable FDI.



Graph of French GDP and domestic demand (Source: INSEE)

As a result, auto sales declined precipitously in Q3. Peugeot-Citroen reported 5.2% fall in Q3 revenue to €13.3 billion compared with the same period last year and slashed its full-year targets. It has planned “massive” production cuts in Q4 amounting to 30-percent. Its rival across town, Renault SA also announced that its Q3 revenues fell 2.2 percent to €9.15 billion (\$11.75 billion). The company said it is cutting production by 20 percent in Q4. It presented a plan for the voluntary exit of its 4000 employees in France by April 2009 and cut additional 2,000 jobs across Europe in a bid to save 350 million euros in 2009 and 500 million euros in 2010, which sparked strike calls from the trade unions.

The impact is also evident on France’s deteriorating trade balance. In September, the trade deficit hit record high at €6.25 billion (\$8.0 billion) in the face of plunging exports of vehicles and auto parts to Spain and Britain.

EU legislators are actively working on strict environment regulations that would require manufacturers to cut the average CO2 emission of new vehicles to 130g/km by 2012. But deepening recession has made it hard for the auto makers to sustain high level of investment needed for transmission to such low emission vehicles, and they require more time to make complicated and capital extensive adjustments. Hence France, which currently holds the EU presidency, has pushed for leniency on CO2 targets and suggested a 3 year phase-in period rather than a strict 2012 deadline, with full compliance only by 2015. The negotiations with the European Parliament have entered the last round and the final outcome is awaited.

When Americans agreed on a \$25 billion low-cost loan package to help Detroit-based carmakers, France initiated an EU version of the US scheme demanding 40 billion euros loan package from the European Commission. The idea was to source the money from European Investment Bank (EIB) in the form of low interest-rate loans to help develop cars that would meet tighter European Union CO2 emission targets. It has been backed by EU but is facing the ire of environmental organisation, Greenpeace, which believes that automakers would claim undue benefits by inflating costs for low emission vehicles and milk the tax payers by seeking government subsidies. However, it is essential that EC moves quickly to get credit flowing to the auto industry to avert long term damage to the real economy.

The French Connection in India: The strength of French connection in Asia’s third largest automobile market can be gauged by the fact that Renault has six separate entities in India involved in different projects, viz. Mahindra & Mahindra and Renault JV (which makes, markets and sells the Logan) and the Bajaj Autos JV (which has been inked to compete with \$2500 Tata Nano). Peugeot is looking at re-entering India (after 1995 PAL debacle) through a component sourcing JV. For crisis, it’s déjà vu as the Indian auto sector is experiencing similar gloom and expecting single digit growth rates to continue in 2009-10, but its impact on the Indo-French auto trade is yet to be seen.

Export Diversification in India's Trade with Japan



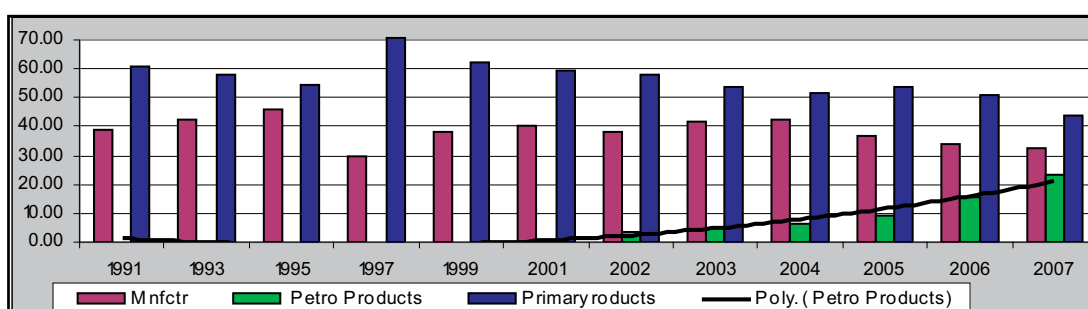
The importance of export diversification to sustain economic growth and to enhance per-capita income is well recognized (Al-Marhubi, 2000, and Agosin, 2007, etc). Since export baskets of developing countries are largely constituted of primary and low value added manufactured goods, export diversification has special importance to them. This is particularly true for large economies like India. Both the horizontal and vertical diversifications of exports not only boost growth but also prevent the instability in export earnings and potential deterioration in terms of trade (Athukurola 2000).

With economic liberalisation in India, in early 1990s, it was expected that this strategy would boost exports. Trade liberalisation was expected to lead to restructuring of economic activities in such a way that it would ultimately result in enhancing India's share in world markets in those products in which it has comparative advantage. Also, the MNCs would locate their production bases in India and make it as a hub for manufacturing products. These processes were expected to ultimately result in diversifying the structure of Indian exports.

This article is an attempt to enquire the nature and trends in export diversification in Indian exports to Japan. To look into the horizontal diversification, changes in share of broad sectors (based on UNCTAD classification) are analysed. And, to enquire into the vertical diversification, movement within manufactured exports is examined. Based on UNCTAD's classification, manufacture is categorized into four broad categories, namely labour/resource-intensive products, low-skill/low-tech/low-capital-intensive products, medium-skill/medium-tech/medium-capital-intensive products and high-skill/high-tech/high-capital-intensive products. If the share of low value-added manufactured products, in total manufacture exports, is declining in favour of relatively high value added products, export structure can be said to be diversified. Vertical diversification can also be examined by looking at number of products (at disaggregated level- 6 digit) being exported over the period.

In the post economic reform period, especially in the years after 2001, the volume of India's trade with world has increased tremendously. Japan has been one of the biggest trading partners, and trade between the two has been growing at a fast pace. During 1997 to 2007, Indian exports to and imports from Japan have increased from USD 1.88 billion to USD 3.24 billion and USD 1.92 billion to USD 5.71 billion respectively. However, despite this substantial increase in volume of trade, the share of Japan in India's total merchandise exports and imports has significantly declined from 5.43 percent to 2.36 percent and 5.16 percent to 2.51 percent respectively, during the same period. Moreover, due to increasing degree of economic reforms in recent years, one would expect that there would be diversification in Indian exports to Japan. If one looks into horizontal diversification (in terms of share of various sectors in total merchandise exports to Japan), there has been continuous decline in share of primary sector, especially after 1997 (Figure1). However, performance of the manufacturing sector has also not been satisfactory, and its share has not only fluctuated, during 1991 to 2007, but has declined over the period, especially after 2003. Recent decline in the share of manufactures in total merchandise exports can mainly be attributed to sharp increase in the exports of petroleum products. During 2002 to 2007, the share of petroleum products in total merchandise exports to Japan has increased from less than 4 percent to more than 23 percent. Hence, Indian exports to Japan are getting horizontally diversified but in favor of petroleum products.

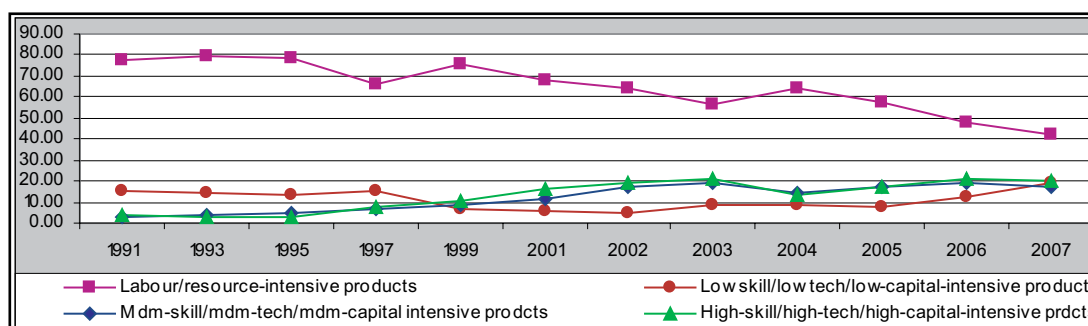
Figure1: Share of different Sectors in Total Indian Exports to Japan:



Source: WITS Database

To look into the vertical diversification, the relative share of high value added products in comparison to low value added products within a sector is examined (Figure2). The share of labour/resource-intensive manufacture has continuously been decreasing during the post liberalisation period, especially after 1995. At the same time shares of high-value-added and medium-value-added manufactured products have continuously been increasing, particularly during post 1995 years. However, in the last few years, the share of low skill/low-tech/low-capital-intensive manufactured exports has been increasing at a fast pace and reached to the level of high skill/high-tech/high-capital-intensive manufactured goods in 2007. This has mainly been due to rapid increase in the exports of two product groups: iron & steel and metal manufactures. In terms of number of products being exported to Japan also, there is sign of vertical diversification, as the number has increased from 971 in 1991 to 2163 in 2007.

Figure2: Share of Various Categories in Total Manufacture Exports to Japan:



Source: WITS Database

To conclude, although there is substantial increase in Indian merchandise exports to Japan, horizontal diversification is not as expected, as there has been a substantial decline the share of manufacture in total exports. There has been vertical diversification in India's exports but the last few years have witnessed an upward trend in the share of low skill manufactured products and it has almost become equivalent to that high skill intensive products.

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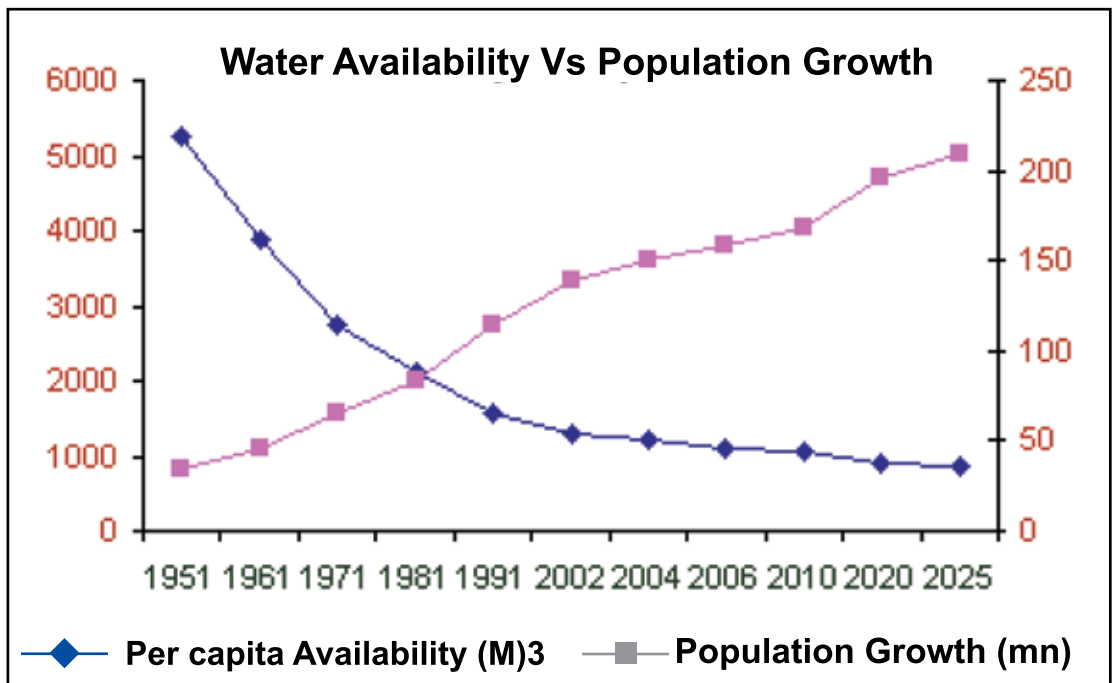
Pakistan: A Wakeup Call for Water!

“By means of water, we give life to everything”.



Throughout history human progress has been dependent on access to clean water and on the ability of societies to harness the potential of water as a productive resource. It is a source of interdependence serving multiple constituencies, agriculture, industry and households to the environment. Water underpins all aspects of human society, and it has no substitute. Cooperation in optimal use of water resources can reduce the potential for conflict and unlock benefits by improving the quality of water, generating prosperity and more secure livelihoods. However, failure in this area can produce outcomes that generate inequality, environmental unsustainability and wider social and economic losses.

In recent years Pakistan has experienced periods of extreme drought (2001-2003) as well as periods of excessive water flow that led to the extensive floods of 2006-2007. Falling groundwater levels coupled with pollution caused by industrial and public waste water, has resulted in a scarcity of fresh water and has given rise to health problems and decreasing agricultural production. Moreover, Pakistan has reached the



Source: Water & Power Development Authority, Pakistan

water scarcity threshold of 1,000 cubic metres per person a year and has been ranked among the worst performers in Asia in terms of water use, capacity and quality.

While all provinces of Pakistan are suffering from water shortages, Sindh appears to bear a disproportionately higher share of the burden. The diversion of water upstream has resulted in the decline of water availability downstream. As a result, the discharge of water into the sea is diminishing and the intrusion of seawater into the mainland is going up. Sea intrusion has destroyed 1.5 million acres of farmland, led to the extinction

of certain species of fish, and the loss of revenue to large numbers of farmers and fishermen. About 75 per cent of Sindh's groundwater resources are brackish with salinity and water logging is affecting about 88 per cent of agricultural land. According to one Study, Pakistan will face a deficit of 12 million tons in total grain production in the year 2012-13, which is 31% of target. Such a large scale deficit cannot be bridged simply by improving farming practices and technology. The irrigation supplies scenario, by the year 2012-13, would be critical, and it will become increasingly difficult year-by-year thereafter. Thus, water security is of utmost importance for Pakistan.

So, what is the way for Pakistan to seek water security? Cooperation with India in developing an Indus Water Treaty-II on the foundations of the 1960 Indus Water Treaty would probably yield Pakistan better and surer dividends, at less cost and sooner. It seems that now is the right time for Pakistan to make a determined move forward. The return of a popular elected government is a positive factor, and it must engage India proactively to optimise the gains from cooperation on water and come out of water woes. Article VII in the Indus Water Treaty on Future Cooperation points to a "common interest in the optimum development of the Rivers" and calls upon both sides "to cooperate, by mutual consent, to the fullest possible extentin undertaking engineering works in the Rivers". The 1960 Treaty has served its purpose but leaves behind a possibly large untapped potential in the upper catchments of the three western rivers that are allocated to Pakistan but are in Indian territory. Article XII of the Treaty provides that its provisions "may from time to time be modified by a duly ratified Treaty concluded for that purpose between the two governments". Thus, exploration of the idea of Indus Water Treaty-II has come and it could add a most useful and creative dimension to the current India-Pakistan peace process, covering land use, sediment control, agriculture, forestry, hydro energy, transmission and eco-tourism on both sides.

This potential needs to be thoroughly appraised and could thereafter be realized by both sides undertaking investment, construction, management and control. Pakistan needs to recognise the advantage to itself of the benefits and the urgency of cooperation on water issues. It could help stabilise the country and enable it to grasp what could be a far larger prize by way of additional storage, flood moderation and hydro-power, which both could share. Equally pertinent is the fact that, the effect of climate change could enhance glacier melt and thawing permafrost could increase flows in the Indus basin for some decades before declining sharply thereafter as the body of ice shrinks. This may be accompanied by shifts in rainfall patterns with a possibility of episodic bursts of precipitation in some areas. This uncertainty underlines the need for maximizing conservation and storage within the limits of prudence and sustainability. Climate change does not respect national boundaries and therefore, neighbouring countries need to develop mutually supportive approaches for firm action for the common good.

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A New Path to Improved Bilateral-Relations



The United Kingdom (UK) has been one of India's Bilateral Development Partners since 1958. The Department for International Development (DFID) has identified various priority sectors in India, of which education is one, specifically Primary Education. India had tied up with three international partners to fund the Sarva Siksha Abhiyan (SSA). The UK, through DFID contributed £210 million in 2001 to SSA. In a press release (4 March 2008, DFID), Prime Minister Gordon Brown has further pledged £150 million towards SSA to train 3,00,000 teachers and build 3,00,000 classrooms by 2011 to cater to almost four million children.

UK's focus in India is slowly changing towards higher education and research. The number of Indian students opting to study in the UK has been increasing steadily, doubling over the last decade. The Higher Education Statistics Agency, UK, says that the figures increased from 19,205 in 2005-06 to 23,835 in 2006-07, a 24 per cent rise. For the 2009 undergraduate entry alone, there is an increase in applications from India of 7.7 per cent (Source: UCAS, UK). Second only to China, Indian students constitute the largest populace of international students in the UK. Data, however, also indicate that the most favoured international destination for Indian students still remains USA. Last year alone, between October 2007 and April 2008, close to 50,000 USA student visas were issued, an increase of 38 per cent from the previous year October 2006-September 2007 (Source: '38% rise in Indian students going to US', Daniel P George and Hemali Chhaphia, 9 June 2008, Times of India). With growing numbers and incomes, the Indian middle-class is in a position to afford the expenses of studying in the USA. But, in the wake of the global crisis, there is a fair chance of this changing.

The global crisis has had various consequences, decrease in job opportunities and salary corrections, depreciation of the Indian rupee against the American dollar, the decline of the pound, to name a few. The rupee depreciation against the American dollar has caused educational expenses in the USA to rise for the Indian student. With the exchange rate not showing any immediate signs of stabilising, the situation is only expected to worsen. Those students who have already spent lakhs of rupees, through self financing or educational loans, to enter US universities, today, have serious concerns about the available job opportunities in the US and in India. With salary corrections taking place simultaneously across industries in both countries, students are beginning to feel the pressure.

The UK has utilised these developments to attract Indian students to UK Universities. The decline in the exchange rate of the pound has caused expenses in the UK to drop by almost 10 per cent for the Indian student (Source: 'Pounds decline seen to lure foreign students', by Miles Johnson, 17 November 2008, Financial Times). The UK Prime Minister Gordon Brown has already pledged £800 billion for improving education in India (Source: Press Release 4 March 2008, DFID). This announcement came subsequent to the Joint-Statement issued after the India-UK summit on 21st January 2008. The statement, which details various areas for improved bilateral relations, states that the UK government is keen to promote collaborations between British Universities and the premier educational institutions in India, including the establishment of at least one new IIT, one new Indian Institute of Science Education and Research and one Central University proposed in the 11th Five Year Plan. Though the UK government-funded scholarships have been reduced

(Chevening Programme is to see a funding fall from £27.3 million to £18.8 million), the good news for Indian students is that these scholarships will cater more to Indian and Chinese students. David Miliband, Foreign Secretary, UK, stated on record that India and China will be very important to the UK in the coming years, from a foreign policy point of view (Source: 'UK sees 24% rise in Indian students'. By John Gill, 27 March 2008, The Times).

While UK becomes more competitive in terms of cost of education, the UK government is using the higher education sector to pave the path for soft diplomacy with India. Going by the success of SSA and UK's assistance to India in the education sector, there is little doubt about the success of the various possible collaborations in higher education and research as detailed in the Joint-Statement. Collaborations in higher education and research is the new route to improved bilateral relations, with spill over effects that will trickle down to every other sector. In today's crisis ridden world, UK is competing closely with USA for the attention of the Indian student looking to study abroad. India-UK bilateral relations will receive a fresh impetus as UK's popularity as a higher education destination rises, and as higher education and research collaborations between the two countries commence.

THE UK-INDIA EDUCATION AND RESEARCH INITIATIVE

Higher Education and Research

The two principal activities will be promoting research partnerships between centres of excellence in science and social sciences, and developing joint and dual course delivery. The initiative has an emphasis on creating institution to institution links - establishing durable channels and vehicles for collaboration in the years ahead.

By 2011, the following minimum targets will have been met:

- 70 new collaborative research projects linking centres of excellence
- 40 new UK award programmes delivered collaboratively in India with 2,000 Indian students enrolled
- 300 additional Indian research students, postdoctoral researchers and staff will have worked in the UK
- 200 UK researchers worked in India and 200 UK undergraduate students supported for studies in India

2,000 Indian research students completed research degrees in the UK through collaborative delivery

Schools

The schools strand will bring together clusters of schools in the UK and India for joint curriculum projects and professional development. School leadership, management and ICT in the classroom have been identified as priorities. By working through clusters and networks, the initiative will be the first UK collaboration to reach significantly into the state sector in Indian schools, as well as building on and expanding existing collaborations with private sector schools. We aim to reach half a million students through networks of teachers, head teachers, national educational bodies and government.

By 2011, the following minimum targets will have been met:

- 300 Indian schools linked with a similar number in the UK and 300 teacher/head teacher exchanges
- 50 international projects by school clusters providing a huge educational resource for both countries

250,000 students directly participated in the project and another 250,000 indirectly benefitted.

Source: <http://www.britishcouncil.org/india-common-ukieri-conference-delhi.htm>

WHAT WENT WRONG, WHAT LIES AHEAD?



WHAT WENT WRONG?

This was not in the script! China and India were expected to chart their own courses through the global downturn given their large domestic markets. Yet, in the last month or so what has surprised many has been the alarming signs emerging from these two economies that they are likely to slow down much more than anticipated. In both China and India exports have already turned sharply negative, industrial production has slowed markedly, and freight traffic has decelerated.

While the channels through which the global financial crisis and the slowdown were well anticipated, it was the ferocity and speed at which the crisis affected these two economies that was surprising. While China was less affected by the global financial turmoil, the economic slowdown has already begun to leave its mark. To some extent in the case of China it was perhaps more to do with the perception that it would be able to rebalance growth away from investment for exports to investment for domestic consumption, such that overall growth would be preserved. But this is a difficult task. China's remarkable 10-11 percent sustained growth over the last decade was largely driven by ever increasing investment. With household consumption—at less than 40 percent of GDP—unable to keep pace with the production capacity created by investment, exports have had to continually find new markets. Indeed, last year China sold 10 percent of GDP more to foreigners than it bought from them. With its main customers—US and Europe—cutting back demand, a significant portion of the exports need to be consumed domestically to keep growth apace. Despite a very large fiscal stimulus package, it is likely that China's economy will slow appreciably given the structural factors restraining consumption.

What about India? Given its relatively close economy, it was expected to shrug off the global shock. But this has been overplayed as a factor buffering India from global shocks. India's GDP growth for long has been strongly correlated with that in its major trading partner countries. On first blush this seems odd given the small contribution of net exports to GDP. However, consider a hypothetical economy that runs balanced trade—net export is zero—exporting all its domestic production and importing all consumption and investment goods. If growth in trading partners fall so would consumption and investment as these depend entirely on exports. In India too, consumption and investment depend, in part, on exports and expected export earnings. If the latter slows, as is the case now, so will consumption and investment.

Beyond the real sector linkages, the financial crunch in the last two months has also underscored that India's capital account is more open than meets the eye. For some time now, Indian firms and banks have been raising funds in global market as it was cheaper.

So when global financial crisis deepened in September, the sudden stop in external financing forced Indian firms to turn to domestic banks for liquidity. This triggered a chain reaction, as the spike in demand for bank credit sharply increased lending rates, forcing corporates to redeem their investments in nonbank financials and mutual funds. Faced with redemption pressures, the latter entities began to sell their equity holdings. Equity prices—which were already declining rapidly as foreign institutional investors sold holdings, pressed by their own liquidity difficulties at home—plunged further. This shut off the stock market as source of funding. Meanwhile, corporate bond yields rose sharply as concerns grew over the ability of firms to survive the liquidity crunch. With alternative conduits virtually shut off, banks became the only viable source of financing. But as credit growth was already running at 29 percent, banks could not meet the sharp and sudden rise in demand. Short term interest spiked and as corporates and banks converted the funds raised domestically into foreign currency to meet their external obligations and pay for imports, the exchange rate depreciated sharply. The central bank sold foreign currency to stem the depreciation, but this reduced domestic liquidity further exerting more pressure on interest rates and soon the real economy was plunged into a severe liquidity crisis.

WHAT LIES AHEAD?

Across the globe, authorities have acted aggressively to ease monetary and fiscal policies. While the US and Europe loosened monetary and fiscal policy early given that they were hit first, emerging market countries have recently begun to do the same. This is the right approach given that the world is facing a recession-deflation nexus. It is also important for the easing to come early rather than late; not doing so was a significant factor in Japan's decade-long depression in the 1990s.

In India, the RBI has moved on several fronts to ease monetary conditions aggressively: cut policy rates, reduced the cash reserve requirement, lowered the statutory liquidity requirement (the share of deposits a bank has to hold in the form of government securities), effectively expanded the repo window and repo-eligible assets for specific sectors, including non-bank financials, mutual funds, and housing finance companies, reduced capital charge and loan provisioning requirements, established dollar swap arrangements with domestic banks, provided incentives for debt restructuring, and eased controls on capital inflows.

The government has also proposed nearly 0.8 percent of GDP of additional fiscal impulse in this fiscal year. The fiscal package, however, appears cobbled together with some added expenditures and some cuts in indirect taxes, along with some help to infrastructure financing. With only 3 months for this fiscal year remaining, additional expenditure does not appear to be an effective tool to boost demand as this is unlikely to be fully spent. A more effective tack might have been to cut taxes more sharply and using IIFCL to borrow abroad to help the large PPP infrastructure projects.

So along with the rest of the world, China and India will slow down appreciably. How large and long this slowdown will last depends on how deep and protracted the recession is in the advanced economies. If the global recession is short-lived, investment in China and India is unlikely to be affected that much. On the other hand, if investors expect the recession to be protracted then they might hold back projects. Both countries' fundamentals remain strong, and when signs of recovery in advanced economies take shape, the investment cycle in China and India will turnaround quickly.

Of course, for the investment turnaround to happen lending rates need to be sufficiently affordable. In the absence of a sharp upturn in the commodity cycle, inflation in India is likely to be quite low a year ahead. At current lending rates, the real expected interest rate is too high and clearly much higher than expected growth. In the last five years when India grew at 9 percent, the gap between growth and interest rate was positive by around 4 percentage points. Today it is negative and needs to be reversed quickly. This needs more aggressive policy rate cuts, stabilization of liquidity outlook, and reduction in credit risk.

There is also more space to increase fiscal deficit. In the short run, private sector credit is likely to wane off, such that crowding out private investment is unlikely to be an issue. In the medium term, the government can always sell assets – which it needs to do for efficiency reason in the first place – to reduce the stock of debt.

Equally importantly, India needs to reform its financial sector regime which at present effectively segments asset classes, reducing the diversity of investors in these markets. The events of September-October showed how dangerous this can be. As the various markets were segmented, each market had to undergo very large price declines to adjust to liquidity crunch. Greater substitutability across assets will allow each market to have greater investor diversity, thereby reducing the need for large price adjustments.

Icelandic Saga: Melting into Thin Air



The underlying conventional logic of economics is shaken when a country with one of the highest per capita income in the world; with exceptional positive social conditions and great egalitarian index (Gini coefficient), could collapse due to the contagion of the financial crisis that sprang up in United States of America. But was it really the contagion effect or inherent systemic flaws that blew the economy? This article explains that both inherently unviable banking system along with a loss of credit confidence due to the financial crisis in US propelled the present crisis in Iceland.

This crisis enlivens and makes Marx relevant who had been rooted out from the conventional economic thinking and who provides a succinct logic of the present crisis. In his Communist Manifesto he described the character of a capitalist society as “a society that has conjured up such gigantic means of production and of exchange that it is like the sorcerer, who is no longer able to control the powers of the nether world that he has called up by his spells”.

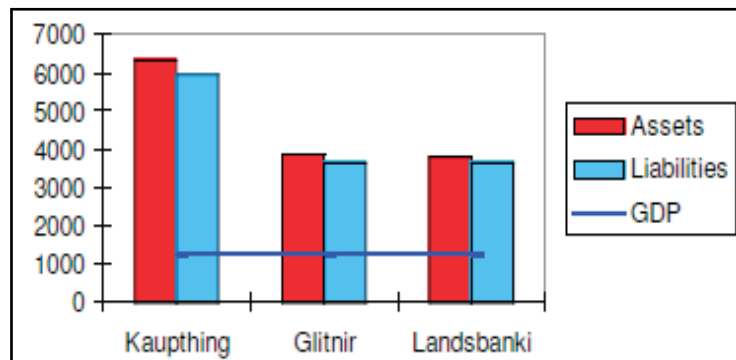
Iceland’s economy was like a sorcerer who thought that having an inordinately active banking system and an internationally active financial sector larger than its GDP and fiscal capacity would spell prosperity for the country. The present crisis that has precipitated in Iceland due to its banks going bust is a result of its excessive dependence on international finance. The banks didn’t borrow toxic mortgage based assets in US but the problem lay in their banking model which was also leveraged beyond its capacity. As Willem Buiter has asserted “*the fundamental reason was that Iceland was the extreme example in the world of a very small country, with its own currency, and with an internationally active and internationally exposed financial sector that is very large relative to its GDP and relative to its fiscal capacity*”.

Saga of Inconsistent Banking Model and Globalization

Iceland bloated banking sector was the major reason behind the crisis. This can be gauged by looking at the total assets to GDP of the only three internationally active banks (Landsbanki, Glitner and Kaupthing) including their foreign subsidiaries at the end of the first quarter of 2008 which was around ten times (See chart 1). As some critics have thoughtfully asserted that Iceland was like a large hedge fund which got paralyzed due to its heavy leveraging and excessive exposure to foreign denominated assets. Most of the assets and liabilities of Iceland’s bank were in foreign currency with only 21 percent of all assets and 15 percent of all liabilities in Iceland’s krona. There was a currency mismatch problem as share of assets in foreign currency was less than share of liabilities denominated in foreign currency. With huge amount of short maturity foreign liability they required a credible lender of last resort which Iceland’s Central bank was not. The central bank of Iceland could be an effective lender of last resort in Icelandic krona, as it can print the stuff in unlimited quantities. It can be a lender of last resort in other currencies only to a limited extend because Icelandic krona is not a global reserve currency and Iceland’s government had limited fiscal capacity. Without having lender of last resort which can provide sufficient liquidity in the required currency when needed, a robust solvent banking system can crumble due to its funding liquidity crisis or market liquidity crisis. The easily available foreign exchange resources of the Icelandic government were much less than short term maturity of its bank’s liabilities.

1. Karl Marx and Friedrich Engels, “The Communist Manifesto”, 1848.
2. Buiter, Willem and Anne Sibert, “The Icelandic Banking crisis and what to do about it: The lender of last resort theory of optimal currency areas” CEPR Policy Insight. 26 (October 2008)
3. Total assets of the three banks amounted to 14,069,370 million króna about eleven times the Ministry of Finance’s estimate of 2007 GDP of 1,319,200 million króna and equals about \$176 billion (80 kr./\$). Total liabilities of the three banks amount to 13,265,311 million króna, or roughly \$166 billion.
4. Funding liquidity crisis mostly happens due to conventional bank runs by depositors and other creditors. Whereas market liquidity crisis happens where illiquidity arises due to freeze in inter bank lending and other assets.

Chart 1 - Assets and Liabilities of three major banks relative to the GDP



Source: Iceland's Ministry of Finance

Iceland's banking crisis is just a repetition of what happened to the investment banks in US which were highly leveraged, whose assets were mainly long term and illiquid, whereas the liabilities were mostly short term prone to massive credit collapse.

The banking crisis in Iceland was precipitated by Glitner bank. All the major three banks including Glitner had been solvent and all had robust capital adequacy ratios. The collapse of Lehman in US which was allowed to fail by the US government led to loss of confidence in the world markets. The uncertainty which was created due to the failure of Lehman Brothers led to freeze in lending in the money market and inter bank lending froze. Glitner was ensnared by the crisis when short term foreign credit lines closed. Glitner didn't get credit from the Central bank due to latter's limited resources but its imminent collapse was averted by its nationalization. But Glitner nationalization shattered investor confidence leading to Icelandic krona plunging more than 20 percent against the dollar in a week. This nationalization of Glitner by the government by obtaining 75 percent equity stake could also lead to sovereign default as the total assets and liability of the bank were larger than the GDP of Iceland. But Glitner went into receivership before the equity stake could be handed over.

A vicious collapse had started with sovereign debt downgrade which then led to freezing of short term lending to other banks also. Pressure on banks started due to this negative news, and banks were unable to meet their commitments. But things got aggravated as the central bank governor refused to meet the obligations of UK depositors in Kaupthing. Britain's taking over Kaupthing's subsidiaries Singer and Friedlander by trying to freeze the UK assets exacerbated the downside.

The economic scenario was worsened more by erroneous policy making by the Central bank of Iceland. On October 7th 2008 Central bank announced a currency peg for the Icelandic krona at a rate well above the market rate. This was abandoned the very next day as it had insufficient foreign exchange reserves and they had also not imposed any capital controls. The collapse of the banking system has devastated the economy and some proper restructuring plan has to be undertaken to bring the economy back on track. To bring some credibility to its currency Iceland has asked for help from IMF and its Nordic neighbours. It is the first developed country to ask financial assistance from IMF in the last 30 years.

The most effective long term strategy for Iceland in the future would be to join as a member of EU to restore its credible lender of last resort problem. EU membership would help Iceland to have a global reserve currency i.e. Euro as its national currency. This would help it to borrow abroad using instruments denominated in Euro rather than the foreign denominated currency. But immediately this would not be possible because it has first to adhere to the guidelines of Maastricht Treaty, which doesn't seem to be a possibility in the near future. But still initiation of the process would help in restoring some level of confidence which is sorely needed.

Indo-Canada Trade: The Beginning of New Era



After a decade of cold and static relations, India and Canada are once again set to scale new heights of bilateral relations. A series of high profile political visits with many encouraging announcements that follow such visits have created a conducive environment for better economic and political engagement between the two countries. One of the most significant initiatives that had a major impact at ground level and brought the business communities of both the nations on one stage took place in 2005, when the premiers of India and Canada supported the CEO roundtable and entrusted it with the task of making recommendations for improving economic ties. After two rounds of meetings, the CEO roundtable recently recommended that India and Canada should enter into negotiations for a Free Trade Agreement (FTA). However, given the Canada's excessive trade reliance on USA, one question that strikes is whether Indo-Canada FTA will improve the trade between the two countries or is it going to be just another addition to the number of trade agreement signed by India? Against this backdrop, this paper makes an attempt to analyze the Indo-Canadian trade and identify the trade complementarity between the two countries.

India and Canada share a number of similarities. Apart from sharing a common heritage of the commonwealth, both these countries also have a longstanding faith in democratic values along with a multi-ethnic and multi-religious society. However, despite all these commonalities, their economic engagement or trade relations have remained far from satisfactory. Table 1 summarises the Indo-Canadian trade in merchandise over the last decade. It shows that the Indo-Canadian two way trade has increased in value terms but has declined in terms of share. Though both exports to and imports from Canada have grown continuously, the growth of imports has remained significantly higher than the growth in exports. Specifically, imports from Canada have increased vertically after 2005-06. Due to this rapid surge in imports from Canada, the trade balance, which was in India's favor till 2005-06, turned adverse thereafter?

Table 1: Trends of Indo-Canadian Merchandise Trade

Year	Exports to Canada		Imports from Canada		Total Trade with Canada	
	Value	Share	Value	Share	Value	Share
1997-98	427.82	1.22	420.91	1.01	848.73	1.11
1998-99	473.01	1.42	385.57	0.91	858.58	1.14
1999-00	578.27	1.57	380.51	0.77	958.78	1.11
2000-01	656.47	1.47	397.07	0.79	1053.54	1.11
2001-02	584.82	1.33	529.43	1.03	1114.25	1.17
2002-03	698.27	1.32	566.29	0.92	1264.56	1.11
2003-04	763.20	1.20	725.89	0.93	1489.09	1.05
2004-05	866.80	1.04	775.72	0.70	1642.52	0.84
2005-06	1021.58	0.99	919.87	0.62	1941.45	0.77
2006-07	1110.40	0.88	1777.41	0.96	2887.81	0.93
2007-08	1265.25	0.78	1972.19	0.78	3237.45	0.78

Source: Director General of Foreign Trade

Table 2 summarises the indo-Canadian trade in services. It shows that the Indo-Canada trade in services has increased in value terms but has remained stagnant in terms of share. It is startling to know that despite India's rise as a major hub of services, its share in Canada's total imports of services has remained almost negligible. More surprising is the fact that the composition of India's services exports to Canada has been mainly dominated by the travel and transportation services rather than commercial services, in which India has emerged as the global leader.

Table 2: Indo-Canada Trade in Services.

Year	Canada's Exports to India		Canada's Imports from India		Canada's Total Services Trade with India	
	Value	Share	Value	Share	Value	Share
1997	189	0.43	162	0.31	351	0.36
1998	165	0.33	175	0.31	340	0.32
1999	207	0.39	151	0.25	358	0.31
2000	249	0.42	168	0.26	417	0.33
2001	286	0.48	248	0.37	534	0.42
2002	283	0.45	214	0.31	497	0.38
2003	254	0.43	244	0.34	498	0.38

Source: Canada's Trade in Services, 2006, Statistics Canada

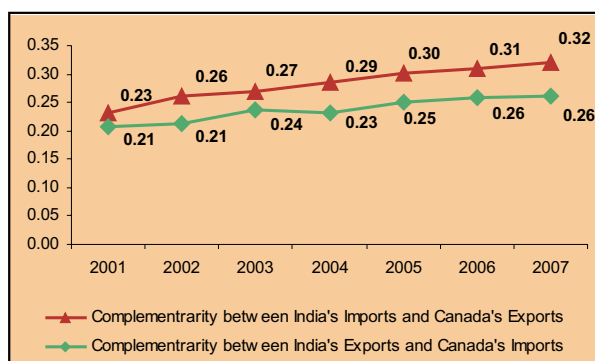
Note: Values are in Canadian \$ millions

It is clear from the above description that the volume of trade between India and Canada has remained very low and hence efforts such as preferential or free trade agreements are required to boost the bilateral trade. Nevertheless, for success of any such agreement, it is important that trade profile of countries involved should match i.e. the goods exported by one country should be imported by the other. One measure that shows such a match is the Trade Complementarity Index (TCI). It takes the value of zero when no good exported by one country is imported by the other and one when export-import shares exactly match. Thus, a higher value of TCI indicates more favorable prospect for successful trade arrangement between countries and vice-versa.

Using the United Nations/COMTRADE trade data at 6 digit level, we estimated the trade complementarity between India and Canada for last seven years. Figure 1 shows that the trade complementarity between India and Canada, both in terms of exports and imports has increased over time. This strongly indicates that if implemented, FTA has the potential to boost the bilateral trade between the two countries. However, apart from trade complementarity, the success or failure of FTA also depends on its coverage. As a free trade agreement with a limited coverage or a long negative list will have a limited scope for success, India and Canada should try to limit the number of items under negative list as much as possible. Moreover, the scope of FTA should not be just restricted to merchandise; services should also be brought under its ambit.

In a nutshell, India and Canada have a huge trade potential and the proposed FTA between the two countries will certainly improve their economic engagement. However, given India's protective attitude towards its agricultural sector and Canada's towards its services sector, it will be interesting to see how much of this trade potential will actually be realized.

Figure 1: Trade Complementarity between India and Canada



Book Review



Abhyankar, R M (ed.). 2008. *“West Asia and the Region: Defining India’s Role”*. Academic Foundation, New Delhi in association with Centre for West Asian Studies, Jamia Millia Islamia, New Delhi. 747 pages.

While a lot has been, and is being, written on West Asia in the West, there are sadly only a few books that deal with the region from India’s perspective, despite it being of crucial strategic significance to the country.

West Asia and the Region: Defining India’s Role is a recent and welcome addition to this rare corpus. It grew out of the papers presented by a host of academics, analysts as well as policymakers at the ‘National Conference on West Asia’, organized by the Centre for West Asian Studies, Jamia Millia Islamia, in 2006.

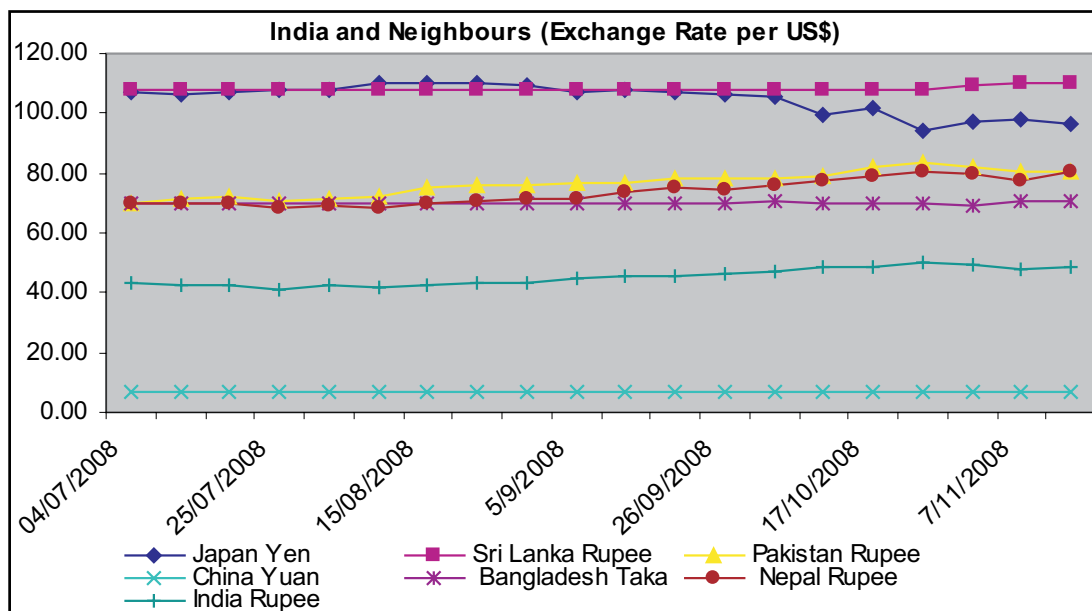
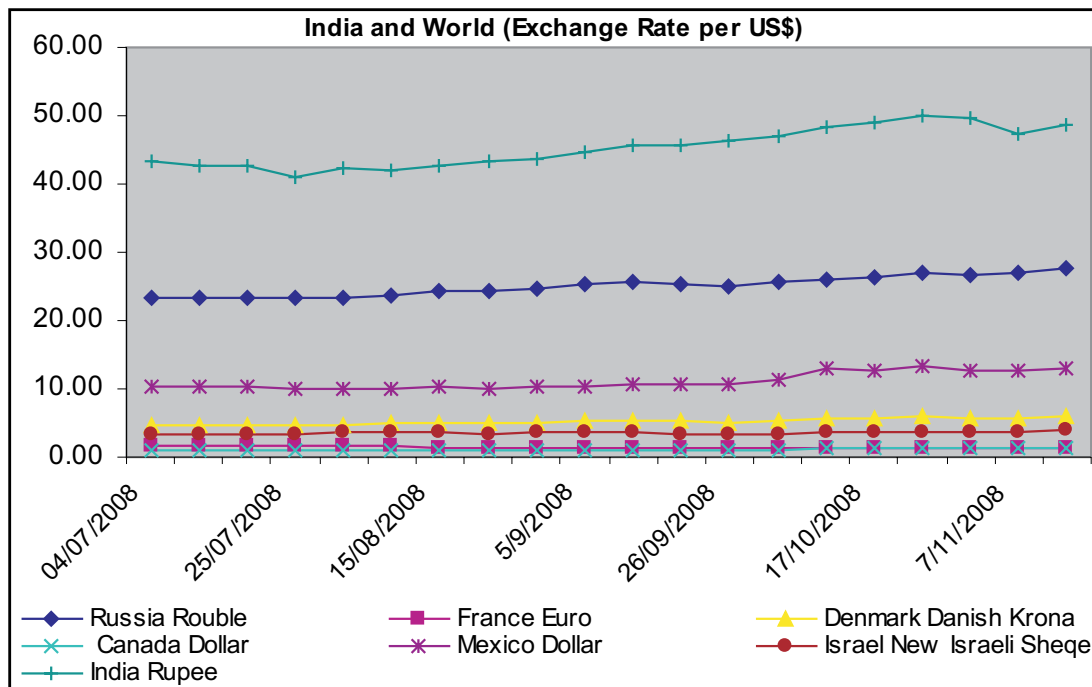
Two criticisms here about the book being recent and rare. While the published volume is recent, the papers contained in it were presented in 2006 and have therefore not been able to cover the recent events that might have had an influence on their analyses. Too much changes too fast, and area studies need to be as updated as possible. Secondly, because it belongs to that rare corpus of initial books that try to look at the region from an Indian perspective, it is quite generalized and attempts to cover many issues and many countries in a volume. It deals with “the larger picture” and with a few exceptions, largely provides an overview of political, economic and other aspects, relevant for an introductory reader.

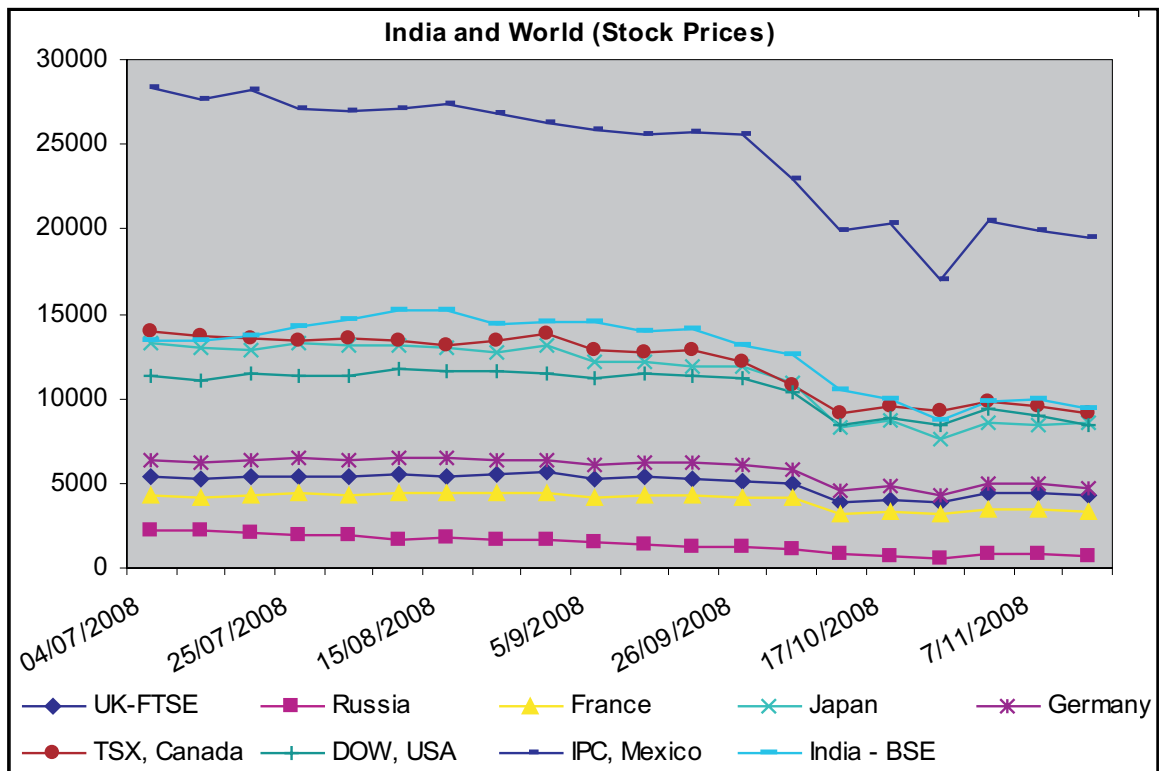
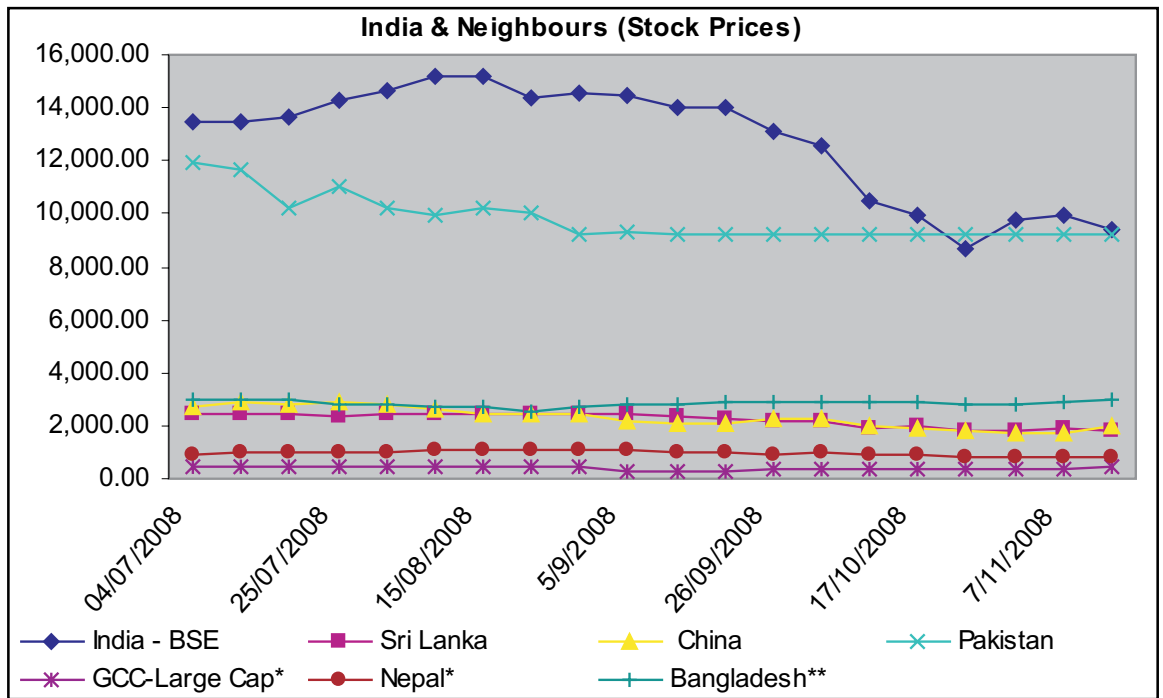
Nevertheless, the book is noteworthy for trying to look at the complexity of the region and not taking it as a monolith. Perhaps, this is why it not only tries to cover the region as a whole, but makes assessments of and presents views about important individual countries in the region. Also, it tries to define the region as “a geographically neutral West Asia” to move away from the “Euro-centricity of the Middle East.” And this is one of the central principles on which the book rests – emphasizing the need to assess what is happening in West Asia from an Indian perspective and what it means for India in the coming decades.

Unlike many books on West Asia that dwell on India’s historical, civilizational links with the region, the book under review not only attempts to understand the present dynamics in the region from an Indian perspective, but also aspires to put forth “a plausible future scenario for the region in which India and Indian interests have to locate themselves.” In doing so, it criticizes the complacency of the Indian establishment regarding the security of its interests in the region, without being bothered much about the US dominance or the increasing influence of Russia and China there. India cannot stay happy with being a part of the Annapolis, rather its long-standing relations and exchanges with the region make it most suited to not only understand it more appropriately than others, but also to leverage its goodwill in promoting stability and securing its interests in the region. For example, it is perhaps the shared historical values that make it possible for Prof Mehtab Alam Ansari to empathize with the Iraqi conflict and suggest the utilization of the spiritual connection of the Naqshbandi order to get Iraqi Kurds take up the Shia-Sunni reconciliation in Iraq.

The book hints, and rightly so, that India should play a leading, independent role in West Asia in the coming future, the research and policymaking for which has to start from now on. The book, as well as the Centre, seem to be an important step in this direction.

Data Sheet





About ICRIER

ICRIER, established in August 1981, is an autonomous, policy-oriented, not-for-profit research institute. ICRIER's research and related activities focused on the following six thrust areas:

- i. Trade openness, restructuring and competitiveness
- ii. WTO related issues
- iii. Regional and Bilateral Issues between India and other countries
- iv. Macroeconomic management in an open economy;
- v. Financial sector liberalization and integration; and
- vi. Strategic Aspects of India's external relations

These six thrust areas have provided the necessary focus as well as flexibility for ICRIER to undertake research relevant for pushing forward the reform agenda and for contributing to policy formulation in the country. The focus of ICRIER's work is to support India's interface with the global economy.

ICRIER's highly qualified in-house team of researchers includes several Ph.Ds from reputed Indian and foreign universities. At present the in-house team has 20 Senior Economists and 28 Research Associates and Research Assistants. In addition, ICRIER encourages external researchers to work on specific assignments and maintains a network of external consultants. ICRIER's working papers are available for downloading on the website, www.icrier.org.

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Research on India's relations with other countries will also have to take on board the increasing demand being placed on India for a major role in international discussions on evolving a new global social, economic, financial and environmental architecture.

In this context, ICRIER created the Regional Desk Team in 2008. Each researcher has adopted a country/region. The Team will be tracking and monitoring developments in the major countries, regions, economic blocks and India's neighbours. ICRIER Regional Desk Team's in-house publication 'Regional Insights' will provide articles on many of these countries/regions and will also contain a guest article by a renowned expert.

Dr. Isher Judge Ahluwalia	Chairperson, ICRIER
Dr. Rajiv Kumar	Director & CEO, ICRIER
Dr. Shrawan Nigam	Regional Desk Coordinator
Ali Mehdi	West Asia Desk
Debosree Banerjee	Russia Desk
Deepika Wadhwa	Sri Lanka Desk
Dony Alex	Germany, Scandinavia, Holland, Belgium & Luxemburg Desks
Durgesh Kumar Rai	South Korea & Japan Desks
Gunajit Kalita	SACU Desk
Loknath Acharya	China & Taiwan Desks
Manjeeta Singh	Nepal Desk
Nirupama Soundararajan	United Kingdom Desks
Pankaj Vashisht	NAFTA Desk - Canada & Mexico
Rashmi Rastogi	Bangladesh & Myanmar Desks
Sanjana Joshi	South Korea & Japan Desks
Sirjjan Preet	France, Italy & Spain Desks
Sneha Bakshi	Pakistan & Afghanistan Desks
Swapna Nair	NAFTA Desk - U.S.A

Regional Desk Team



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ICRIER was established in August 1981, and it has successfully completed 27 years as an autonomous, premier policy-oriented, not-for-profit research institution.