An Approach to the Crisis in the Euro Zone

Dr.Sitharam Gurumurthi IAS

Member Planning Board Bharathidasan University Tiruchirapalli

The euro currency is used by 19 out of 29 countries in Europe. But, the developments in countries like Greece during the last six years have provided enough room to speculate on the possible extinction of the euro in the foreseeable future. . According to Werner Bonadurer, Professor of Finance, at W.P. Carey School of Business at Arizona State University in Tempe, the likelihood of a full scale collapse of the euro remains very remote but the impossible has become possible, and it is necessary to think about the unthinkable. A total collapse, though remote, in Bonadurer's view, could lead to multi-year depression in Europe and several years of recession in the U.S. Terry Connelly, Dean Emeritus of the Ageno School of Business, at Golden Gate University, San Francisco, holds that the impact of collapse of the euro on the U.S. economy could be much worse than the Great Depression since it would have the potential of triggering even a greater one worldwide. "A rush of financial assets out of the euro zone would play havoc with currencies and the price of oil." A collapse, Connelly predicts could destroy interbank lending worldwide. "A run on banks around the world would freeze credit markets, making it difficult for businesses to borrow money." [1] According to James Sagner, Associate Professor in the School of Business at the University of Bridgeport, Connecticut, uncertainty about the euro's future is driving down the currency's value relative to the dollar.[2] With the euro trading in the region of $1.08, the day may not be far off when the dollar and the euro trade at 1 to 1 ratio.

This paper looks at efforts over the years towards economic integration of Europe in general and a single currency in particular culminating in the birth of the euro on January 1, 1999, analyzes the developments during the last seventeen years that have contributed to its current state of affairs and suggests a possible solution to ensure survival of the euro as the single currency for the European Union. It is divided into three parts. Part I looks at the efforts toward economic integration of Europe since the end of the Second World War from 1944 to 1973 .Part II of the paper covering the period from 1973 to 1999 dwells upon the efforts at evolution of the single currency,. The third and final part looks at the developments that have taken place since 2004 leading to steady decline of the euro and suggests a possible solution to make the euro survive as a viable single currency in the medium term.

Part I

Aftermath of the Second World War

In the wake of the end of the Second World War, France's Jean Monnet argued that elimination of intercontinental conflicts could be achieved only through economic integration. In 1951, he emerged as the chief architect of the *European Coal and Steel Community*, which was probably the most significant step taken towards economic integration. According to him it was only through monetary and economic union that "the political union which is the real goal" could be achieved.[3]It was realized that political boundaries were not necessarily coterminous with the geographical boundaries of coal and steel and that the bargaining power for striking commercial deals could considerably be enhanced if the countries having these raw materials could form a regional bloc rather than negotiate commercial deals as individual countries. Franco Pavoncello, President of Rome-based John Cabot University, wrote in May 2011: The way to build the new union was through incremental steps toward economic integration that would one day lead to political integration."[3]

The Second World War left behind such s great devastation that led all the countries in Europe to think on the need for greater economic and political union in Europe that culminated in the Treaty of Rome signed in 1957. Under this Treaty France, Germany, Italy, Belgium, the Netherlands and Luxembourg established the *Common Market* and the *European Economic Community* (EEC), abolished trade tariffs between members. The *Single European Act* in 1986 which was the first revision of the Treaty of Rome facilitated the development of an internal European market, allowing for free exchange of capital, goods and people. Though the same year also witnessed introduction of euro dollars, the European Commission did not contemplate a single currency for Europe. By 1970, the Werner Report to the Council and the Commission on the Realization by Stages of Economic and Monetary Union in the Community, which saw monetary union as the key step towards political union, proposed a single currency by 1980. The Report approved in 1971 envisaged linking the various currencies of Europe through the '*snake in the tunnel'*, the first attempt at European monetary cooperation; April 1972 saw launching of the currency alignment, nicknamed "the snake "setting a limit of 2,25 percent on deviations between members. Though Britain was a founder member of the 'snake', it was forced out of the system in just six weeks against the backdrop of its devaluation (1967) coupled with insufficient reserves to defend the parity Since Germany's *Bundesbank* held vast reserves, the 'snake' finally ended up more of a Deutsche Mark currency bloc than a distinct single currency. France left the union in 1974, rejoined in 1975 and withdrew again in 1976. Sweden and Norway left the currency bloc in August 1977 and September 1978 respectively. In 1978, Sir Donald McDougall's report warned that it would be reckless to create a single currency unless Europe was first given an all-powerful government with the power to tax and to make a massive transfer of resources from the richer states to the poorer.

Part II

Evolution of the Euro

The seeds for the euro were sown on March 1, 1973 when the then West German Chancellor Willy Brandt, during a meeting in Bonn with the British Prime Minister Edward Heath, took everyone by surprise when he came up with the idea that the member states of the European Community should join a "common float" against the dollar, linking their currencies and pooling their reserves to defend their parities. This should be seen against the backdrop of U.S. President Nixon's unilateral announcement on August 15, 1971 that the United States would no longer exchange gold at the fixed rate of US $ 35 for an ounce of gold. It also needs to be understood that since the gold standard was too inflexible and served to deepen economic crises, the Breton Woods system had established parity in terms of both gold and the US dollar. While the parity of the dollar had been pegged only in terms of gold, initially at $35 per ounce of gold, other currencies were defined in terms of both gold and the dollar. For example the parity of the British pound was set at 12.5 pounds per ounce of gold. This implied an official exchange rate of $2.80 per one pound. When one currency went out of line with the “fundamental value’, the parity was adjusted. While the German mark was adjusted upward or downward on several occasions, the British pound was devalued from $2.80 per one pound to $2.40 per one pound in 1967. As Samuelson correctly noted, “The ability to adjust exchange rates when fundamental disequilibrium arose was the central distinction between the Breton Woods system and the gold standard…..”[4]

In 1971, the United States faced balance of trade deficits for the first time since the First World War. Left with no other alternative, on August 15, 1971 the world was taken by surprise by the unilateral announcement by President Nixon that the United States would no longer exchange gold for the dollar. The international monetary system of the Breton Woods system had been founded on the firm commitment by the United States to redeem international dollar holdings for gold at the fixed rate of $35 per ounce. Nixon had o taken any of the capital powers into confidence while taking such a momentous decision making a major departure from the agreement concluded at the Breton Woods in 1944.

The next important stage was the establishment of the European Monetary System (EMS) in 1978, which limited exchange rate fluctuations between member countries. Kindelberger noted, “It introduced the European Currency Unit as a parallel currency, provided two measures to aid in narrowing fluctuations of national exchange rates, constituted a European Monetary Fund, and provided a system of credit facilities for mutual payments support”.[3] Since the membership of the EMS was voluntary, the system witnessed Britain joining the system and leaving it in 1982 while France remained with the EMS but wanted to leave it in 1982 when Francois Mitterrand was elected. President. Greece joined the European Monetary System in 1984, while Portugal and Spain joined in 1988. The net result was a bunch of currencies that were strongly tied to the Deutsche Mark, like the Belgian Franc, Dutch Guilder, and several peripheral currencies, like the Italian Lira which had problems in maintaining their currency's peg to the Deutsche Mark.

It was the Delor's report (1988) recommending a gradual move towards a single currency provided the basic framework for the Maastricht Treaty, signed in 1992, which established the timetable for the putting the euro in place on January 1, 1999. This could not have been accomplished without the strong political leadership provided by Francois Mitterrand and Jacques in France and Helmut Kohl in Germany. Seventeen of the twenty seven EU members are part of the euro zone, while other EU members, including Bulgaria, the Czech Republic, Hungary, Poland and Romania, are required by the Treaty to join later. Demark and the United Kingdom were exempted from joining the euro zone.

Under the Maastricht Treaty *convergence criteria* and the *Stability and Growth Pact* of 1997, member states had to ensure inflation below 1.5 percent, fiscal deficit below 3 percent of GDP and the debt to GDP ratio of less than 60 percent. While several countries had to undertake strict budgetary reforms in order to meet these criteria, in practice, however, these criteria were more honoured in their breach than observance. This was attributable to the over enthusiasm of the EU authorities to expand the membership of the euro zone, overlooking such serious lapses. In his book *Greece's Odious Debt* Jason Monolopoulos, notes

…….There was shockingly weak due diligence in assessing the suitability for the entry into the euro and equally weak application of the few rules that were supposed to police its operation…[6] September 1992 witnessed a speculative attack on the European Rate Mechanism (ERM) caused by the rejection of the Maastricht Treaty by a Danish referendum leading to devaluations by Britain and Italy resulting in Britain withdrawing from the system. Though Britain, Denmark and Sweden had opted out of the single currency, both Britain and Denmark had decided to fix their currency to the euro and retained their right to join the euro zone at a later date. The speculative attack reinforced the desire of Italy and other countries to join the stability of the euro rather than be left to the uncertainties of a floating currency.

Birth of the euro and its early success

The European Commission claimed that adoption of the single currency, euro, led to a savings of 0.5 percent of GDP within two years of its launch as compared to use of multiple currencies. The developments during the last twelve years are quite significant. Till the birth of the euro, there was no alternative to the dollar... When the euro was in place in 1999, its value was fixed at 1.1743 dollar to a euro. Even though there is not much oil in the euro region, policy makers in Europe had taken care to see that the euro was backed by a significant amount of gold. Therefore when the gold price was rising, there was corresponding strengthening of the new currency. The euro got an unexpected boost when Saddam Hussein, President of Iraq converted US$2 billion, received from the United Nations under the food-for-work program, into euros in November 2000 purely to avoid the money from being frozen. This was quickly followed by countries like Iran and Venezuela who started demanding euros for their oil. As a result the value of the dollar registered a steep fall and around mid-2002 the exchange rate stood at US$ 1.5 to one euro. This possibly led to the U.S. attack on Iraq in early 2003. When Baghdad was attacked, the euro was available for 92 cents just for a day. That support for the US operations in Iraq came only from the non-euro UK, with the entire euro region keeping cool, should also not be overlooked.[7]

The euro's value depends on three factors; 1) ECB's interest rate 2) Debt levels of individual countries like Greece 3) Strength of the European economy. When growth is strong and when interest rates are rising, the foreign exchange traders push up the price but some other traders who also read the same data bid the price down on the premise that its value will decline. The complex interaction of these factors determines the value of the currency at any given point of time. Despite its volatility the EU allows the euro's value to be decided by the foreign exchange market.

In 2002, the euro was worth $ 0.87 As the US debt grew 60 percent, the dollar fell 40 percent and by December 2007, one euro was equal to $1.44. In 2008, the dollar strengthened 22 percent businesses were hoarding dollars during the global melt down and by end of the year the euro was equal to $ 1.39. During 2009, the dollar fell

20 percent due to debt fears and by December the euro was equal to $1.43. After the Greek debt crisis broke out in 2009, the dollar started strengthening to $1.32 in December 2010 and to $ 1.2973 in /December 2011. The trend, however, was reversed in 2012 and 2013 when the dollar weakened and it declined to $ 1.3186 in December 2012 and to $ 1.3779 in December 2013. In 2014 when investors started fleeing the euro zone the dollar strengthened to $1.21 in 2014 and $1.05 in March 2015.

The euro/US dollar lost 0.0867 or 7.35 percent during the last twelve months from 1.18 in January 2015 to 1.08 in January 2016. Though the euro was introduced as the common currency on January 1, 1999, synthetic historical prices using a weighted average of the precious currencies have been computed to show that the euro /US dollar reached an all time high of 1.87 in July, 1973 and an all time low of 0.70 in February 1985.

The euro touched an all time of $1.60 to one euro on April 22 2008.Since then the euro has weakened considerably. This is because the future of the European Union as well as the euro was in doubt during the Greek debt crisis. Further the European Central Bank lowered its interest rates. This lowered interest rates for any one saving or lending in euro lowered the value of the currency itself. When ECB announced its version of quantitative easing the euro plunged to $ 1.10In March 2015.

In 2007, the European Union surpassed the United States as the world's largest economy. Between 2002 and 2008 the euro rose 63 percent against the dollar. While the decline of the euro started once the ECB raised interest rates rather prematurely fuelling fears of a deep recession, the euro-zone debt crisis accelerated the euro's downward trend. The euro did recover in 2013 but by the end of 2014 the euro declined to $1.20

Greece's Debt Problem

The euro worked satisfactorily as long as long as the eleven countries that joined the euro zone in 1999 kept their fiscal deficit within the parameters of the Maastricht Treaty, namely, three percent of their respective GDP. The problem for the euro started when countries like Greece were admitted into the zone. On November 15, 2004, Greece admitted it joined the euro in 2001 on the basis of figures that had shown its budget deficit to be much lower than it really was. In fact Greece had already declared that its public debt had breached the European Union cap between 2000 and 2003, since the cost of hosting the 2004 summer Olympics had touched 7 billion euros.

Since the potential exit of Greece from the euro zone or what is popularly called Grexit; might have had disastrous consequences for the entire euro zone, in May 2010, the European Commission, European Central Bank and the International Monetary Fund established the *European Financial Stability Facility* to provide a bailout loan of $163 billion to Greece in exchange for strict austerity measures coupled with tax hikes. A second bailout plan for roughly $ 178 billion was made available to Greece in October 2011. Under this package private holders of Greek debt accepted a fifty percent write off. The fall out of the austerity measures was that the Prime Minister George Papandreou had to step down in favour of the Technocratic National Government in 2012. In November 2012 the bailout terms were again renegotiated that included lower interest rates for Greece's loans.

When the IMF approved a loan package of euro 45 billion in 2010 for Greece all the developing countries on the IMF Executive Board had argued that the banks should also share the costs of the crisis and they should cancel some of the debt, rather than bailing out the banks but they were ignored by Europe and USA. Managing Director of the IMF Christine Lagarde had also repeated her call for debt relief. According to Sarah -Jayne Clifton, since 2010, IMF, European governments and the European Central Bank had lent 252 billion euros to Greece out of which, 232 billion euros were spent on debt payments, bailing out Greek banks and paying 'sweeteners' to speculators to get them to accept the 2012 debt restructuring, an obvious reference to the commission paid to Goldman Sachs for the swap deal.[8] Greek lawmakers have recently approved the economic reforms demanded by its international creditors that include rising retirement age, cutting pensions, liberalizing the energy market, opening cosseted professions, enlarging property tax base and pushing forward the dormant program to privatize state assets. Even as this program was contemplated in July 2015, the former Finance Minister Yanis Varoufakis had fore-warned:"the programme will go down in history as the greatest disaster of macroeconomic management ever." According to former Chairman of Federal Reserve Prof.Ben Bernanke, failure of European economic policy had played a significant role in the Greek debt crisis.

While this package was expected to pave way for Greece to receive the first 2 billion euros from the bailout program, it has already the road block. Since Greece's debt crisis began in 2010, most international banks and foreign investors had sold their Greek bonds and other holdings they are no longer sensitive to what now happens in Greece. At the height of the crisis a few years ago it was thought if Greece were to exit the euro zone it might trigger a global financial disaster whose dimensions could be larger than the collapse of the Lehman Brothers in September 2008. According to the *New York Times,* if the ***"Grexit"*** were to happen now, the consequences may not be all that catastrophic.[9] .In a way the euro zone could even be better off without a country that leans constantly on its neighbour's support In the circumstances it is high time Greece is permitted to leave the euro zone and issue its own currency.

Other euro zone countries affected by the crisis

The banking crisis which was at the root of the global meltdown in the United States in 2008 did not spare Ireland whose banks suffered heavy losses from the housing sector when the Government decided to support the financial system. In November 2010, Ireland sought $112 billion package from the EU-IMF in exchange for several austerity measures. This led to one of the worst severe recessions in the euro zone when output declined by 10 percent and unemployment rose from 4.5 percent 10 13 percent in 2010.

In the case of Portugal since foreign debt- financed deficit amounted to 10 percent of GDP in 2009, the country would collapse once the foreign investors withdrew their money. The country needed $116 billion bailout package. As the country had to implement severe austerity measures, it fell into its deepest recession in its history.

By the end of 2011, the debt crisis spread to Europe's third largest economy, Italy. Since bail out was not feasible for Italy's $2.6 trillion in public debt, Italy's Prime Minister Silvio Berulsconi had to step down making way for the Economist Mario Monti credited with carrying out several reforms in the fiscal sector. In the 2013 general elections, the Democratic Party won the elections narrowly and had a number of leaders including Matteo Renzo, the youngest Prime Minister Italy ever had but they found it impossible to pull out Italy from recession.

Like Ireland, Spain faced a problem in its housing sector and required a bail out. In 2012, euro zone funds to the tune of $123 million were made available to Spain by EU leaders. In the case of France unemployment rose to 11 percent which weekend its competitive positions. In early 2013, Cyprus's banking collapsed in the wake of the flight of foreign capital that left bulk of the financial sector insolvent. The problem got compounded since the Cypriot Banks were holding the devalued Greek bonds. In March 2013, Cyprus received $13 billion bailout that resulted in the closure of the country's largest bank, Laiki, and several wealthy depositors lost all their money.

Most politicians in the euro zone are keen, nay, desperate to stay together since the euro represents their political ideal that will ensure peace and prosperity throughout Europe. The political protagonists of the euro visualize the zone evolving into a federal state with greater political power, As for economic reasons, while hard – working German voters may resent the transfer of their tax money to other countries that enjoy early retirement and shorter work-weeks, the German business community supports paying taxes to preserve the euro as it recognizes that German businesses benefit from the fixed exchange rate that prevents other euro-zone countries from competing with Germany by developing their currencies.

In fact several investors had been quietly diversifying their investment funds to euros before the crisis began in Greece. They eventually recognized that the problems of the peripheral countries were not a problem for the euro and should be reflected in country-specific interest rates rather than in the euro's value. The result was a rising euro and a renewed shift of portfolio balances to euros from dollars.

Pedro Solbes, Executive Chairman of FRIDE (a European think tank for global action (and former Spanish Minister of Economy) chose to hail the euro as a joint success that enabled a long period of growth and price stability in Europe. Without the euro, Europe might have witnessed an increase in protectionism, which would in turn have aggravated the impact of the crisis in Europe and elsewhere... According to Hans-Werner Sinn, President of Germany's Ifo Institute of Economic Research, survival of the euro depends on whether European countries implement political and private debt constraints that effectively limit capital flows[10].

While huge capital exports brought a slump to Germany, the countries at the southern and western peripheries overheated with the bust and boom resulting in current accounts and surpluses and deficits respectively. According to Sinn, what Europe needed a crisis mechanism that would help to prevent a crisis in the first place and mitigate it when it occurs. Such a system was proposed five years ago at the European Economic Advisory Group at the Centre for Economic Studies and the Ifo Institute for Economic Research. The plan envisaged a three-stage rescue mechanism that distinguishes between a liquidity crisis, impending insolvency, and offered specific measures at each stage. The system was expected to allow Germany to gradually appreciate in real terms by living through a boom that generates higher wages and prices and thus reduces the country's competitiveness, while cooling down the overheated economies of the south such that the resulting wage and price moderation would improve their competitiveness. As a result European trade imbalances would gradually reduce.

According to Barry Eichengreen, Professor at the University of California Berkeley, Europe's budget deficits were largely a result of the continent's "festering banking crisis."The whole euro area would benefit from stronger discipline on borrowers and lenders. He had cautioned that this could not be achieved by imposing

German debt ceilings continent-wide. He held that ECB could refuse to buy more Greek, Irish and Portuguese bonds only if the banks were adequately capitalized. [11]

Root cause of the crisis in the euro zone

Though the euro has been in circulation for sixteen years, the fundamental weakness of the euro right from the beginning has been the absence of a central fiscal mechanism. Prior to launching of the euro, Marco Congiano and Eric Mottu, had argued that as monetary union would generate pressures for closer economic integration, there would be need for a central fiscal authority for the euro zone area.[12]In early 2011, the then European Central Bank President Jean Claude Trichet even floated the idea of a common European Finance Ministry armed with veto powers for European institutions over national budgets.

. Martin Feldstein, Chairman of the US Council of Economic Advisers under President Reagan and currently George F. Baker Professor of Economics at Harvard is of the firm view that the creation of the euro was an economic mistake. Right from the start it was clear that imposing a single monetary policy and a fixed exchange rate on a heterogeneous group of countries would lead to higher unemployment and persistent trade imbalances. [13]Further, the single currency coupled with independent national budgets produced massive fiscal deficits in countries like Greece, while the sharp drop in interest rates in several countries in the wake of the launch of the euro caused excessive private and public borrowing that eventually created banking and sovereign debt crises in Spain, Ireland and elsewhere.

Julian Knight has. Envisaged several possible scenarios for the euro. The experiment with the euro has shown that economies of varying dimensions like Germany and Greece cannot stay together. While economists would like weaker countries like Greece, Portugal and Ireland to leave the euro zone and reintroduce their own currencies. politicians, prefer all the countries in the euro zone to stay together in which case stronger countries like Germany would come to the rescue of weaker countries and the European Central Bank which administers the euro, would buy the government debt of the most troubled countries like Greece, Portugal, Ireland and more recently Italy, [14]

In the limited break up scenario for the euro, Greece, Portugal and Ireland would leave the euro zone and reissue their own currencies, In the substantial break up scenario, countries like Belgium and Italy would also leave the euro zone, As Julian Knight rightly notes, “although all members of the euro zone are meant to be equal, some are more equal than others”:With the presence of giants like Germany and France in the euro zone, small economies like Malta and Estonia could exert very little influence on events in the euro zone. Once the weaker countries leave the euro zone, France and Germany would remain in the euro zone. Even though the survival of the euro will require large fiscal transfers from countries like Germany and France to those euro zone countries with large debts and chronic trade deficits, the euro, according to Professor Feldstein, is likely to survive for both political and economic reasons.

In my view, the euro has still a future if the membership of the euro zone could be confined to the eleven countries that joined the euro zone on January 1, 1999 namely, Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain and show its door to Greece. If other members like Slovenia, Cyprus, Malta, Slovakia, Estonia, Latvia are able to contain their fiscal deficit below three percent they could be permitted to continue in the euro zone. Countries that are not able to contain their fiscal deficit should be allowed to leave the euro zone and issue their own currencies.

In this connection one should note that it may not be possible for the euro to emerge as a major reserve currency replacing the dollar. Since the mid-20th century, the U.S. dollar has practically been the de facto world currency. 1996, the dollar accounted for approximately two thirds of the world’s foreign exchange reserves.

Further, several of the world's currencies are pegged against the dollar. In spite of all the precautions taken by the European Union for the euro like sufficient quantity of backing of gold, the fact remains that the dollar continues to dominate the global currency reserves and the oil producing countries in the Gulf like Saudi Arabia prefer to price all the petroleum products only in the US dollar. The euro zone has hardly any oil reserves. It is not therefore surprising that even after the introduction of the euro in 1999, the US dollar accounts for nearly 64 percent of the global currency reserves as compared to 27 percent held in euros. According to Robert Gilpin, 40 to 60 percent of international financial transactions are denominated in dollars[15]. As long as the oil continues to be priced in US dollars, the chances of the euro becoming a rival reserve currency to the US dollar are extremely thin.

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