EURO CRISIS

Solutions and pitfalls

The real task before the eurozone is to raise financial market confidence so that sovereigns can refinance themselves from the market. The steps taken have failed because leaders have hoped that longer-term solutions would convince the markets to provide short-term financing

DILIP PARAMESWARAN

The European debt crisis remains the key concern for global economic growth as well as financial markets. After much effort and hard cash thrown at it, the problem remains as intractable as ever. One key reason is that the long-term and the short-term aspects of the problem have not been separately addressed adequately.

Earlier last week, Klaus Regling, CEO of European Financial Stability Facility, and I were co-speakers at a conference in Thailand. When I was chatting with him before the conference, he complained that the financial markets were too focused on the short term. But my point was that we need to cross the short term before we reach the long term!

The European debt problem has returned as the key issue for the global economies and the financial markets in the new year, even as signs are spreading that the US economy is healing. The European problem has the potential to rock the US and Asia not only through trade and investment links, but also through financial-sector contagion. But after an unending series of summits, meetings, announcements and agreements, and even after much hard money has been thrown at the problem, the European crisis remains as difficult to solve as ever.

Short-term fixes

While there are several structural issues that need to be solved in the eurozone, the very survival of the currency union depends on finding successful financing for the indebted countries over the next few years. Although many short-term fixes have been proposed, each of them faces a challenge.

The idea of issuing Euro bonds, which will be a joint liability of all the eurozone countries, will be welcomed by the market. But stronger countries are wary of creating a permanent link between the fiscal positions of the different countries. Germany, with its strong credit rating, is staunchly opposed to it, as it fears that such a pooling of liabilities would dilute pressure for reforms in troubled countries. Even if strict fiscal rules were put in place, the idea evokes the fear of handing over a country's tax revenues to unknown and profligate strangers.

The other source of intermediate financing is the European Central Bank, which has an unlimited capacity to provide financing to troubled countries. Germans, however, believe that the central bank should not finance fiscal deficits directly (which is prohibited by the EU constitution anyway). They are also opposed to unlimited purchases by ECB of sovereign debt in the secondary market to bring down the yields (which is permitted). In their minds, direct financing by central banks of government debt raises the spectre of potential hyperinflation, irrespective of where actual inflation might be at the moment. For them, it is a sacred line that is best not crossed. They are also afraid that financial backstopping by the ECB will reduce the pressure for structural reforms.

The third possibility is for more loans from the stronger to the weaker countries. Having already announced loans of several billion euros—110 billion euros of EU/IMF loan for Greece (May 2010), 68 billion euros for Ireland (November 2010), 78 billion euros for Portugal (May 2011) and 109 billion euros for Greece (July 2011). Part of these bailout funds have been provided by EFSF, IMF and other official sources—the stronger countries may not have the financial wherewithal for more. Already, Standard & Poor's has cut the ratings of several eurozone countries, including France, in response to the deepening crisis.

The IMF has already provided funds to Greece, Ireland and Portugal. One advantage of getting the IMF involved is that it has the expertise and experience required to impose structural reforms and to supervise their implementation. But this idea runs up against limits on IMF's lending capacity. The Bundesbank is against the ECB routing its funds through the IMF. The other problem with IMF financing is that the IMF would have a preferred creditor status, thus subordinating private sector loans and potential imposing larger losses on them in the future.

The proposed solution for Greece includes a provision for write-downs of the sovereign debt held by private investors, including banks and others. While the net present value (NPV) of the private sector debt was to be written down by 21% in the previous round, the current plan envisages a haircut of 50% of the nominal value through a bond exchange and a potentially larger cut in the NPV. There are many issues to be resolved in this plan. Europe would like to keep the bond exchange "voluntary" in order to ensure that the credit default swaps would not be triggered. (It is not clear why this insistence on a "voluntary" exchange, since only about 4 billion euros of credit default swaps remain outstanding.) It still remains to be seen whether the 50% nominal haircut will gain a 100% acceptance. The last time, with a 21% NPV haircut, the acceptances inched close to 90%. Although Institute of International Finance, an association of banks, has said that the haircut would be accepted, we will know the actual acceptance level only when the exchange takes place later this quarter; many hedge funds and other investors are not members of IIF and may have no incentive to abide by the negotiations. As the ECB has purchased the bonds in the secondary market, just as many of the other holders have, how will Greece be able to foist losses on one set of bondholders but not on the other? Ultimately, it is not clear how the non-participating investors would be dealt with. One possibility is that a "collective action clause" might be bolted on to the non-participating bonds issued under Greek law (91% of the total), but such a coercive action would trigger the credit default swaps. If there is no such coercion, then why would any investor take a haircut voluntarily?

The Euro problem has the potential to rock the US and Asia not only through trade and investment links, but also through financial-sector contagion. But after an unending series of summits, meetings, announcements and agreements, and even after much hard money has been thrown at the problem, the crisis remains as difficult to solve as ever

The European Financial Stability Facility (EFSF), a special purpose vehicle set up to raise funds for eurozone rescues, has a lending capacity of 440 billion euros, of which it has uncommitted amounts of about 250 billion euros. Although the European summit has raised the possibility of leveraging the EFSF to provide 1 trillion euros, it is doubtful whether the market would accept such leveraging. Leveraging EFSF through a "first loss insurance" idea would raise the risk of contagion from one distress to another, as every default would leave less in the kitty to cover the remaining outstanding insurance, generating doubts over the value of the remaining insurance. EFSF's ability to leverage and to raise resources would be further curtailed if another rating agency were to cut its top rating (following S&P, which recently cut EFSF to AA+ from AAA).

At one point, there was some talk about attracting large contributions for a bailout fund from China, India, Brazil and other emerging countries, but it is not clear why it would be in their interests to contribute. The only possible answer is that a collapse of the eurozone would lead to a severe shrinkage of their export markets and would also unleash powerful risk aversion that would damage the emerging economies. But this is just another way of saying "Europe is too big to fail"—not enough to persuade the emerging countries to part with hard cash. Even if they did, some of the emerging countries may seek a quid pro quo, which may not be acceptable to developed countries (such as China's desire to be recognised by Europe as a market economy under WTO rules).

Long-term repairs

Quite apart from the immediate financing needs, the eurozone needs to address the structural issues that have given rise to the current set of problems. Underlying the crisis is the fact that the countries making up the union differ widely in terms of language, culture and economic structure. Hence, their currency union depends to some extent on the calculations by the different countries on the costs and benefits of the union. It also depends on adherence to a set of rules with adequate supervision, even though that may sound like a mechanical rule-bound marriage that takes away the spontaneity.

A lack of fiscal discipline was not the only cause of the current crisis (Italy has a primary surplus; Ireland's troubles arose from a real-estate and banking crisis; Spain had low debt levels). The recent summit has proposed a "fiscal compact". All the countries would incorporate strict fiscal rules into their constitutions or legal systems. The rules would include a limit on the annual "structural" deficit of 0.5% of GDP, debt/GDP ratio of 60%, automatic consequences for exceeding 3% deficit, automatic sanctions and fines unless a qualified majority waives it, and European Court of Justice jurisdiction over the implementation of the 0.5% rule. An immediate question is whether all the countries would be able to obtain approvals from their respective parliaments and courts. But more importantly, a strict interpretation of the rules would remove the flexibility for counter-cyclical fiscal support; and if the rules provide for breaches in "extraordinary" circumstances, then there is likely to be interpretation problems, leading to market worries. It is also worth remembering that the current eurozone crisis started when Greece owned up to cooking its books to reflect a lower deficit. Ultimately, a rule is only as good as the intentions.

There is an element of truth in the argument that the southern European countries ran a current-account deficit, eagerly financed by northern European capital, until the lack of competitiveness caught up. In the absence of actual labour mobility, the southern countries face a mammoth task of improving their competitiveness. How are they to quickly restore competitiveness—through internal cost reductions through recession-producing austerity, or perhaps exit from the euro followed by a devaluation of their national currency? Equally, while Germans have been happy to prescribe austerity to the southerners, they also need to relax and start consuming more.

Separating the two

One of the problems with the various approaches to solving the euro crisis has been the confusion between short-term and long-term solutions. For instance, France's and Germany's focus on the "fiscal compact" is laudable for its longer-term objective, but it cannot obviate the need to find financing solutions for the present needs. Of the two, it is the short-term financing that is proving to be more problematic, since it involves finding real money, as opposed to being more comfortable task of discussing long-term principles.

In a way, it may be argued that the real task before the eurozone is to raise the financial market confidence sufficiently such that sovereigns can refinance themselves from the market. The steps taken and the solutions discussed so far have singularly failed to boost market confidence, partly because the leaders have wrongly hoped that longer-term solutions would convince the markets to provide short-term financing.

Over the long term, the eurozone either needs to move towards closer fiscal integration (and being a fiscal transfer union), or it would have to face further near-death crises. In the meantime, it needs a funding mechanism that could be tapped from time to time. Unfortunately, none exists in a sufficient scale, and that is the reason for the market nervousness. Until that is addressed directly and forcefully, expect more turbulence.

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B-schools at crossroads

Increasing numbers of B-schools and increased awareness among students will result in below-par schools shutting down or changing hands

AJAY SRINIVASAN

The decreasing return on investments and increasing awareness amongst students about the quality of education provided across business schools has significantly dimmed the allure of management education. Consequently, the utilisation of intake capacity has been falling, particularly in tier-4 B-schools. CRISIL Research estimates the average capacity utilisation across B-schools to be around 65% in 2011-12. This trend can be attributed to a significant increase in the number of seats offered over the years, a shortage of quality faculty, absence of industry link-ups, and several companies increasingly preferring to recruit graduates and train them. As a result, we foresee a number of B-schools either closing down or changing hands over the next couple of years. B-schools that focus on imparting quality education, developing the all-round skill sets of students and forging relevant partnerships with industry, however, would continue to thrive owing to the strong demand for quality education.

According to CRISIL Research, there are around 3,500-4,000 B-schools in the country, offering over 4 lakh seats. With the increasing demand for management education, there have been several institutes mushrooming all over the country. This is reflected in the fact that the number of AICTE-approved institutes has grown by more than 16 times since 1988.

Of the total institutes operating in the country, we estimate around 82% to be either affiliated to AICTE (All India Council for Technical Education) or to be state universities in India. The remaining 18% constitute autonomous institutes, which are private colleges not affiliated to AICTE or any other university, and deemed universities. Despite being affiliated with AICTE, however, most colleges in India fall under the tier-3 and tier-4 bucket.

According to CRISIL Research, in terms of intake capacity, around 36% of the B-schools fall under the tier-4 category; around 52% under the tier-3 category and the remaining 12% fall under the tier-1 and tier-2 categories. The key differentiators between colleges are quality of infrastructure and faculty and opportunities for self-development offered to students, which ultimately manifests in higher placements and salaries for students.

CRISIL Research estimates that the average utilisation rates have declined over the years, and were at around 65% in 2011-12. Tier-3 B-schools have a capacity utilisation rate of 70%, which is slightly higher than the industry average. On the other hand, tier-4 B-schools have the lowest capacity utilisation rate of 50%. This can be attributed to decreasing returns on investment for students joining tier-4 B-schools (owing to lower salaries received as opposed to fees charged by schools) and increasing awareness amongst students about the quality of education offered by different institutes. B-schools with low utilisation rates are also found to be wanting in respect of infrastructure and faculty, as well as industry link ups.

The demand for seats in tier-1 and tier-2 B-schools continues to remain strong despite the fact that the fees charged by these colleges has increased sharply over the last few years. This is primarily on account of students being increasingly alert and conscious about quality education. Also, the number of B-school aspirants, as reflected in CAT entrance exam-takers, is higher as compared to total enrollments across business schools in the country.

The reasons for poor utilisation levels are varied:

- Students are getting increasingly aware of the merits of quality education. This alertness has helped them recognise the inadequate return on investments they get after passing out from a tier-4 college.
- The lack of adequate faculty members is the key challenge for most B-schools in India. Consequently, it is difficult to impart quality education. According to our interaction with industry sources, at least 25% additional faculty is required at B-schools in India, indicating the shortage of permanent faculty members with business schools. Also, a lot of lower-rung colleges do not have a strong curriculum aimed at developing the overall skill-set of students.
- Most of the smaller rung B-schools do not have sufficient industry tie-ups to give students practical experiences and thus develop their skill sets. As a result, a number of corporates have started their own professional courses in order to attract students and train them accordingly. A large number of top companies increasingly prefer to recruit graduates and train them for the job, rather than recruit post graduates. This has diminished the attraction of management courses for students, particularly from small towns. In some cases, salaries of graduate students are equivalent to that of management graduates.

The increasing proportion of the working age population, together with economic growth, is expected to lead to increasing demand for management education in India. B-schools that focus on imparting quality education, developing the all-round skill-sets of students and forging relevant partnerships with industry would, therefore, continue to be in demand. On the other hand, B-schools that do not improve the quality of education provided are either expected to close down or change hands, as students increasingly become aware of the quality of education being imparted and the likely return on investments.

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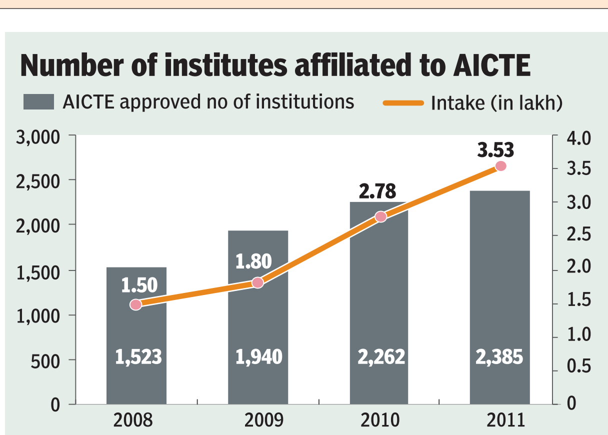

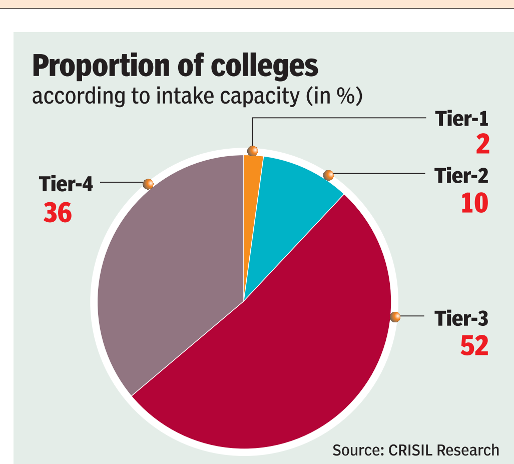

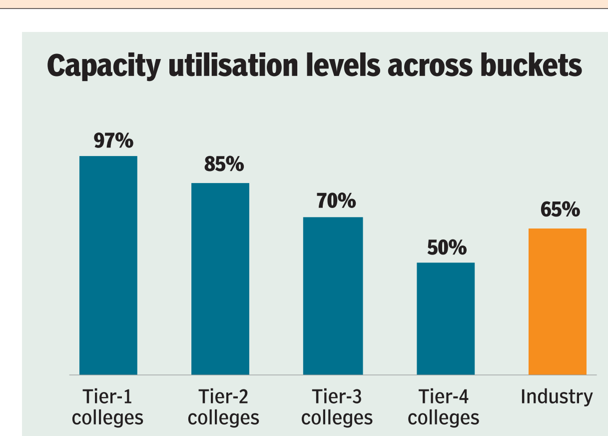

Categorisation of B-schools*

Buckets	Capacity utilisation	No of students placed (2010)	Average salary offered (2010)
Tier-1	95-100%	98-100%	> ₹9 lakh
Tier-2	80-95%	80-98%	₹5-9 lakh
Tier-3	70-80%	60-80%	₹3-5 lakh
Tier-4	<70%	<60%	<₹3 lakh

*Business schools have to fulfil the requisite criteria for all three parameters considered—capacity utilisation, average salary offered to students and percentage of students placed—to fall in a particular bucket. For instance, for a business school with the capacity utilisation rate of 98%, with 100% of the students placed but with an annual average salary to students of ₹7 lakh would classify as a tier-2 college and not a tier-1 college.

Source: CRISIL Research