IAFEI Quarterly

35th Issue

2017 January

46th IAFEI World Congress
It was a success!

iafei
INTERNATIONAL ASSOCIATION OF FINANCIAL EXECUTIVES INSTITUTES

INTERNATIONAL ASSOCIATION OF FINANCIAL EXECUTIVES INSTITUTES

LETTER OF THE CHAIRMAN

Dear Colleagues,

We are proud to have brought for the first time the annual Congress IAFEI to Africa and are very satisfied for the excellent organization of the event and the high-level of the program, thanks to speakers of elevated standing, with meaningful international representation.

A sincere thank you is addressed to SAIBA, from the Board to all the staff, for the profuse commitment and the demonstration of being an efficient and harmonious organization, with strong incentives to compare with the world's best benchmarks to improve the professionalism of its own members and guarantee future development and growth. This positive participation transpired every day of the event and is also a good sign for the social and economic growth of the African continent.

On the IAFEI website there is a detailed report of the event with many photos and videos of the most significant moments.

During the Congress, IAFEI's representatives held their meetings: the Executive Committee was reconfirmed for 2017 with the addition of SAIBA's CEO, Nicolaas van Wyk, a new member, appointed Africa Area President (for the first time!). This is another symbolic event for our Association.

I take advantage of the opportunity granted by our Quarterly to thank the member Institutes that have confirmed their trust in me and I guarantee my commitment to be at the height of everybody's expectations!

IAFEI is increasing its own influence to a global level and new Institutes are planning

their adhesion. We have a lot of work to do to reach our targets but with dedication and commitment from all the members we can really make a breakthrough.

Thank you to all those who have given their best towards the development of IAFEI, for the spirit of service and for having the satisfaction of seeing an Institute grow that has been operational for almost 50 years !

As for the 2017 Congress, the Brazilian institute has expressed its wish to organize the event: therefore thank you to our Brazilian friends

All the best for 2017!

Fausto Cosi
IAFEI Chairman

LETTER OF THE CHIEF EDITOR

Dear Financial Executive,

You receive the IAFEI Quarterly XXXVth Issue.

This is another issue of the IAFEI Quarterly, the electronic professional journal of IAFEI, the International Association of Financial Executives Institutes.

This journal, other than the IAFEI website, is the internal ongoing professional information tool of our association,

destined to reach the desk of each financial executive, or reach him, her otherwise, at the discretion of the IAFEI member institutes.

This issue is the Fifth One under the regime of the New Start for the IAFEI Quarterly. This new start has been backed up by the IAFEI Board of Directors decision of October 13, 2015, to establish an Editorial Board consisting of now 11 IAFEI representatives from all continents.

Most articles of this issue are from inside IAFEI sources. Also it is user-friendly in a state of the art manner. But still: More member institutes should contribute articles. Let us jointly strive for this.

Once again, the layout and the visual design have been further improved by the Italian IAFEI Member Institute ANDAF, for what we are grateful.

I repeat our ongoing invitation, to all IAFEI member institutes, and to each of their individual members, to send us articles

for inclusion in future IAFEI Quarterlies, and to also send to us your suggestions for improvements.

With best personal regards

Helmut Schnabel
Chief Editor

TABLE OF CONTENTS

IAFEI QUARTERLY 35TH ISSUE, JANUARY 2017

Articles

TABLE OF CONTENTS

IAFEI QUARTERLY 35TH ISSUE, JANUARY 2017

"ON THE 46TH IAFEI WORLD CONGRESS, CAPETOWN, SOUTH AFRICA, NOVEMBER 9 TO 11, 2016, AND ON THE STATE OF IAFEI"

Interview with Mr FAUSTO COSI, Chairman IAFEI, from magazine Finance & Gestion, Novembre 2016, article provided by DFCG, the French IAFEI Member Institute

Fausto, what did you get out of this IAFEI 46th Congress?
There are many important aspects to consider: the eagerness of the participants, the quality of each speaker during the IAFEI 46th Congress in Cape Town and the determination of each participant to enhance their professional performance through sharing experiences

with their colleagues coming from different countries.
Everybody is well aware of the dangers of the current global situation; in our organization, many members are ready to do anything in their power to change and improve this situation. I think IAFEI is taking the necessary steps to implement changes that will result in improvement: I am extremely proud of it!

During this Congress, there have been many papers from South Africa Administration's representatives. What image do they have of the Chief Financial Officer's role in a company from an economic point of view?
During the past few years, the CFO's role has become more and more crucial; particularly considering the current crisis we are all experiencing. He is the first person who faces the company's stakeholders. He represents the company. He symbolizes its strategy, its financial success and its budget... He is the cornerstone of the company and the key to improving its performances.

How did the DFCG get the chance to make the 46th Congress in Cape Town possible?
The DFCG is the most important participating Institute in IAFEI. DFCG is an association that is extremely active within IAFEI's Technical Committee thanks to experts such as Frédéric Doche, Dominique Chesneau, or Jean-Luc Michel. Armand Angeli does a lot for IAFEI as president of the European and Middle- East Area and – up until 7th November – the African area.
The DFCG has been crucial for this Congress in South Africa. Indeed, Armand is the one who made possible the integration of SAIBA – the South African Institute, which promoted this Congress – together with IAFEI two years ago.

Since our last meeting in 2015, what changes has IAFEI experienced following the World Congress in Milan?
A relatively small number of Institutes are actually active and operative within IAFEI but I hope that this number will increase. I wish every Institute would do its best as well: there is still a lot to do in order to work all together in the same direction.
We are now experiencing a positive phase as we have created contacts with new member Institutes in Asia, Latin America, Africa, and Europe. Lately we have added institutes from Russia, Brazil, Portugal, Tunisia, South Africa, and now Morocco. I hope Spain will follow soon.
This is very important for two main reasons: firstly as an international association, we must unite as many countries as we can. Secondly, there are also some purely financial aspects that merit consideration: we strive to increase our external resources, thanks to initiatives like partnerships, in addition to the annual contribution requested from every IAFEI Member institute. Greater financial resources will allow us to improve our activities and render the organization more attractive and influential.

What will be the theme of the next Congress in 2017 be?
It will take place in Brazil, in São Paulo, at the beginning of October 2017. Here in Cape Town I met one of the Brazilian association's directors, who aims to organize a top quality event characterised by a high level of technical content prompting good practice exchanges from a global perspective.
These meetings represent a vital resource for members, and I would like to share them with the countries with weaker economies, who probably have most to gain from shared best practices.

The interview was made by Bruno de Laigue, Editorial Director of Finance & Gestion, the DFCG Magazine
Responsible for English translation: ANDAF, the Italian IAFEI Member Institute

THE FINANCIAL DIRECTORS
46TH IAFEI WORLD CONGRESS,
CAPE TOWN, SOUTH AFRICA

by **BRUNO DE LAIGUE**, Editorial Director, magazine Finance & Gestion of DFCG, November 2016, article provided by DFCG, the French IAFEI Member Institute

“Africa driving global change”: such was the theme of this 46th IAFEI congress (International Association of Financial Executives Institutes) of which the DFCG is one of the founder members.

Fausto Cosi reelected president of the IAFEI on November 7th, on November 8th opened a congress gathering 300 financial directors and CFO coming from all over the world in these terms: “it is the first time since the creation of the IAFEI that we have come to Africa; it is thus, a big day for us all. South Africa’s delegation, a member of the IAFEI for one year now, knew how to meet the challenge of organizing this congress in a short space of time. May they be thanked for it!” Armand Angeli, member of the DFCG and reelected president of the IAFEI region Europe and the Middle East has worked a lot to enable this congress to actually happen.

All the company directors present during the two days of this congress unanimously recognized the potential of the African continent and the place South Africa should occupy on the international scene.
“The CFO has a strategic position in the company and has to be the mainspring in the change in a South Africa open to business “so underlined Professor Douhani Thakhathi - president of SAIBA.

Many more participants exchanged views on the profession of financial director and management control; but also on the world’s economic state.

Just as Daniel Silke, the foremost politico-economic analyst the most known on the scene, presented a picture of the fast-changing world with the repositioning of China and Russia. As well as his instinctive reaction to the American election (“it is dramatic for the United States and its allies”), D. Silke presented the profound upheavals that Africa will undergo in the next decades: an explosion of the population (Niger going from 182 million inhabitants in 2015 to about 400 million in view for 2050), which will be more and more urban; another gripping example: in 2017, 97 % of the African population will have a mobile phone contract, whilst only 30 % will actually own a smartphone…

Mr Manenshe, financial director of the South African Parliament, asserts as for him, that the CFO has to be the mainspring of the change in the company. Fausto Cosi, president of the IAFEI, indicates that the Bréxit - the causes of which are essentially migratory- is dangerous for the European Union; but not necessarily for the Europeans.

Cyber safety was also one of the subjects approached during this 46th congress of the IAFEI. "It is a vital necessity to manage and to anticipate the cyber risk" underlined Linda de Beer, director of the IT committee of Sasfin Bank Ltd. Conchita L. Manabat, from the Philippines, points out that a company's reputation can become dismantled very quickly on the Web: from where lies the necessity to have the tools to protect it.
Good internal procedures are the basis for an effective cyber safety completes Kris Budnik, director of PwC Africa.

The technological innovation also has a strong impact on our professions. Michael Jordaan, founder and CEO of Montegray Capital, admits that Twitter is a great means of communication. Fédéric Doche asserts, as for him, that the CFO has to transform the risk of new Technologies into opportunities while Carl Wocke, analyst, does not hesitate to say that it is up to the CFO "to put in the flow" the new Technologies into the company.

Armand Angeli livened up a round table discussion on the CSP, Dominique Chesneau intervened within the framework of a round table discussion when he made several proposals so that the CFO manages at best foreign exchange risks; then in a conference where the theme was " The uberisation of the treasurer's function. "

The tax system was also a subject approached during this congress; integrity and responsibility are the two key words on the subject according to Conchita L Manabat, mediator of the workshop in which Mohamed El Fezzazi participated, the new president of the association of the financial directors of Morocco (AMMFG). The latter not hesitating to underline that the business will manage from now on the tax system and not the opposite. David Lermer, director of the international taxation at PwC Africa, asserts that the CFO is responsible for the fiscal policy with its board.

During this congress Frédéric Doche presented the outcome of the annual survey of the International Observatory of Management Control. From this annual investigation, it appears that the management controller spends less and less time on the reporting and that he dedicates a large part of his work to analysis and to budgetary revisions; if the large Data projects are " targeted " by the management controller, they must be implemented in the Finance domain. The management controller faces a turning point because he becomes more and more a manager of performance, and thus is required to make the best use of the new Technologies in order to be more efficient and bring added value to the company's management.

Many themes were approached during these two days of conferences and networking, which were particularly dense on a tray of subjects which concern the CFOs of today's world. "I find that the organisation, the quality of the participants and the richness of all exchanges were wonderful" commented with pleasure Fausto Cosi at the end of this 46th congress of the IAFEI .

Responsible for English translation: ANDAF, the Italian IAFEI Member Institute

Front picture of article on page 8, from left to right:

Bruno De Laigue Editorial Director, magazine Finance & Gestion of DFCG (France)
Mohamed El Fezazi - President AMMFG (Morocco)
Armand Angeli IAFEI Area President for Europe and Middle East - DFCG (France)
Fausto Cosi IAFEI Chairman - ANDAF (Italy)
Beatrice Lebouc Déléguée Générale DFCG (France)
Frédéric Doche Chairman International Observatory of Management Controller IAFEI Committee (France)
Luis Ortiz- Hidalgo IAFEI Advisory Council Member (Mexico)
Conchita L. Manabat Chairman of IAFEI Advisory Council (Philippines)

THE CFO AND ROLE OF THE COMPLIANCE GURU

by **ISABELLA MIGLIORINI**, consultant at Andato, a Global Consulting Firm with expertise in Latin America countries and **LUIZ ROBERTO CALADO**, Vice-President of the Brazilian IAFEI Member Institute, IBEF, and Partner at Andato

After a year full of crises, 2016 leaves its legacy: awareness of adherence to constant monitoring procedures and good practices. History shows that it is no longer possible to continue without the applicability of regulation and self-regulation of markets and without adherence to compliance, an issue that has risen due to the numerous scandals involving politics and consequently the economics of companies and countries. Based on these facts, the compliance guru arises, expression generated to identify the new finance professional who decides to follow a specialized career in compliance.

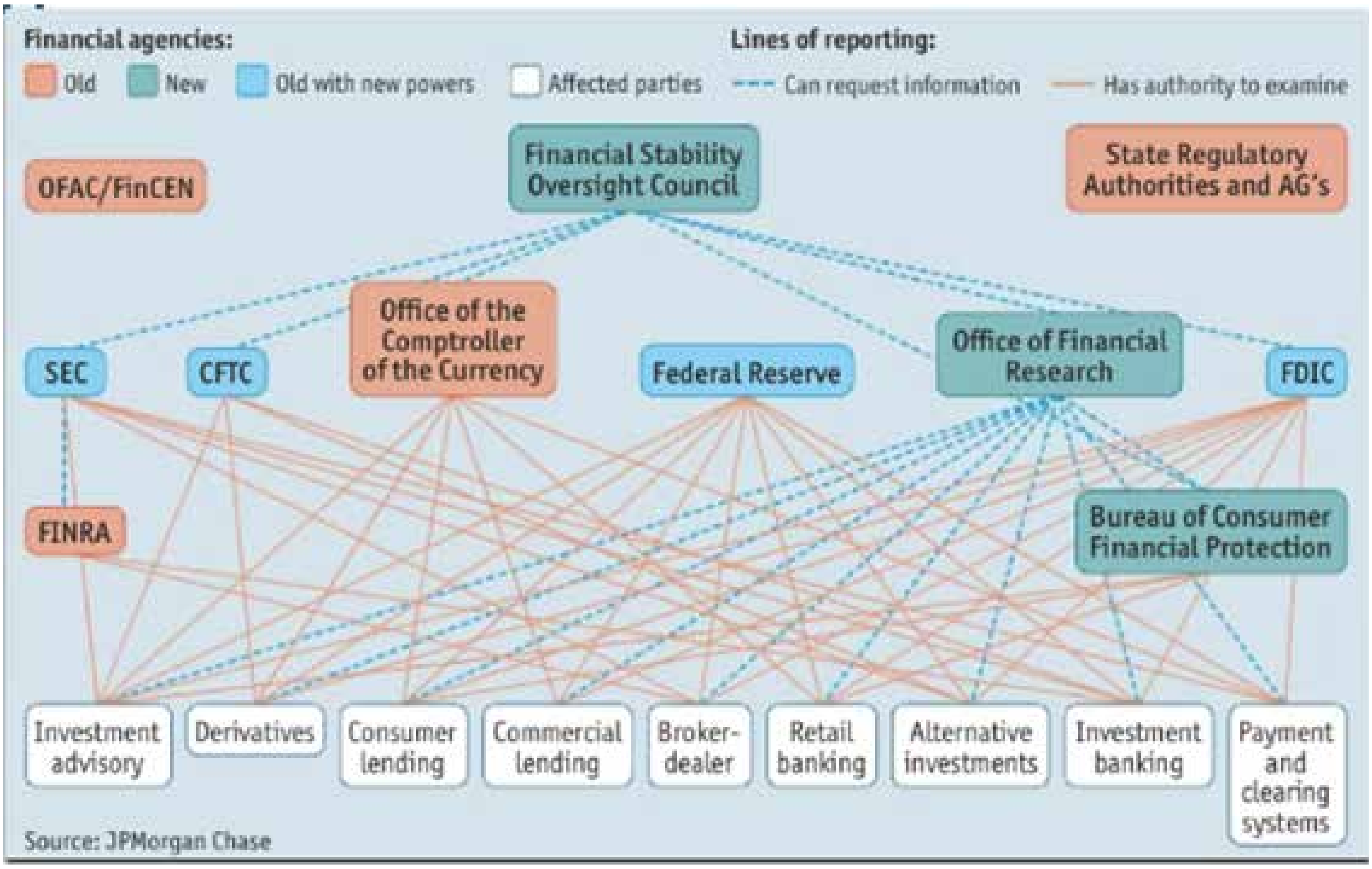
However, the great challenge to this professional is to show to the firm that his role is different from a internal control freak." Because the finance professional has access to firm financial data, he is well placed to avoid fraud-related problems.

In Brazil, in particular, 2016 marked the year in which there were the largest number of companies sued and paying billions of dollars as fine, including to US courts. Large global Brazilian corporations, such as Embraer, Petrobrás, Odebrecht, Braskem, Camargo Correa and others, had to explain to justice on the other side of the continent. Apparently, this is the new normal, and no exception. The United States courts already have global jurisprudence, as has shown the arrest of several members of FIFA, the football federation. Strategically, these actions reinforce the cash position of the United States Treasury, since the fines are of considerable size, though this is not the focus of this paper.

According to the CEO of a large global bank "In the old days, a bank operating in the US dealt with a regulator when there was a problem, maybe two." Now it's five or six. This makes it very difficult and very complicated. "After the Dodd-Frank act, the hierarchy of regulators in that country started looking increasingly confusing.

See chart on next page.

At banks, it is clear that the effect of regulation was the increase in expenses with internal compliance personnel, as well as external consultants. There was a lack of participation of private initiative in the discussion of the new rules, which generated excessively high costs to observe the regulation. In companies, the situation is not so different, and post publication of the Sarbox act, more



commitment was required to avoid fraud and deviations from rules.

Compliance, in terms of career, has been a real growth business area since 2000, there is definitely no shortage of opportunities in this career. The professional is usually involved with all the more relevant decision makers of the company and his visibility is enormous.

When you work accordingly, these numbers add up to job security. Better still, regulators are seducing law-abiding people and determined to follow up with allegations of nonconformities. In April 2015, the US Securities and Exchange Commission announced an award of at least $ 1.4 million to a compliance officer. No details, not even the name of the company, are public, to protect the officer.
According to a report from an international law firm, the estimated cost of regulatory compliance in the last three years for companies in the United States, Europe and Asia has passed USD 1 trillion annually. This cost can stifle innovation and lead companies to relocate some or all of their operations if compliance is not well implemented. The research piece called "The speed of business" points out that globally, regulation represents an average of 6% of all company expenses. A survey conducted in 2015 with CEOs and executives from 250 companies in 10 countries found that US companies spent in compliance by the end of that year, more than USD 557 billion. Companies in Europe spent roughly USD 309 billion and Asian companies hit roughly USD 311 billion.

Executives said that regulation is affecting decisions about where to move their operations; 44% said their companies were considering changing all or part of their operations to benefit from a lighter regulatory environment. This actually resemble the processes that took shape during the 70s and 80s, when many industries from the more developed world relocated production heavily to countries such as the Asian tigers, in no small part to avoid regulatory costs of maintaining industrial jobs in a context of strong unions, in what would become known as a defining characteristic of globalization. Nearly 60 percent of Asian companies said they were prepared to make such a move, although most respondents in China seem more happy to stick to standards.

Regulatory costs were seen as stifling corporate creativity as a result of regulation. However, many real estate executives found the opposite. When asked whether it has been easier or harder to innovate in the last five years as a result of regulation, 65% chose the former. This was also the sector estimated to be spending more on regulatory compliance (USD 320 billion). By comparison, only one-third of the financial services companies felt that the regulation was having a positive impact on their operations.

Within companies, attitudes toward compliance are generally fluid and reflect economic sentiment. Culture can overcome compliance, and in very good economic times, companies are willing to take risks. In tough economic times, the tone of the top is very different. It is now a transformation in corporate media in the US and Europe. And this transformation is far from the radar of the great majority of top Brazilian executives.

Migration from CFO (Chief Financial Officer) to CCO (Chief Compliance Officer) or the compliance guru, is now commonplace. This executive has the additional responsibility to become CECO, or Chief Ethics & Compliance Officer. The jobs are said to pay well in part because people who adhere to the law take a considerable risk. The flip side of these denunciation awards is that depending on the country government, the compliance professional can hold those responsible for compliance for lapses in its programs, which in a way guarantees the commitment of this professional to compliance with the rules.

These changes are not just a makeup, and the CFO's competencies make all the difference at the moment. They demonstrate a powerful transformation underway in the "existential" format of a company and understand that such changes are crucial and dealing with a possible crisis makes the finance professional the new guru of the corporation. Historically CFOs already face three distinct challenges. First, to manage your short-term needs in terms of credit and cash. Second, to position and use your assets effectively in a time of economic downturn, ensuring the financial health and survival of the organization. The third challenge is to navigate in an environment of greater market risk filled with several variables, such as exchange rate volatility, inflationary pressure, customer defaults, and now, more clearly, the operational risks including governance and fraud.

In disclosing the amount of USD 788 million in corruption paid by Odebrecht and Braskem to obtain contracts, the US government has listed 12 countries in which the contractor has admitted to having committed active corruption through public agents. The overall fine to be paid by the company is $ 3.5 billion. Investigation will now focus on individualizing the conduct of each one who has been tipped. And it is scandals like this that put organizations at the mercy of effective compliance programs, or rather, professionals fully dedicated to them.

The guidelines for federal judgments in the United States, the statements of the Organization for Economic Cooperation and Development (OECD) Good Practice Guide and the booklet "Integrity Program: guidelines for private companies", prepared by the General Controller of the Brazilian Union, recommend that companies develop effective compliance mitigation programs and safeguards to protect themselves against internal and external threats of corruption and fraud. However, despite decades of experience in developing such practices, the results appear to remain at best irregular, which is extremely worrying at a time when risks are increasing. therefore, the abilities of the new guru are fundamental to the success of this whole process.

One can have a sense of what lies ahead, with a proposal by the US Federal Reserve to protect taxpayers from an expensive rescue of a bank. The field is broad, covering everything from bribery to lending standards. And accounting for the cost is tricky. How do you measure the benefit of preventing fraudulent activity that did not happen? It really starts running when prevention fails. JPMorgan settlements and fines cause Siemens to look like a rounding error. The USD 36 billion that have been delivered since the financial crisis would pay for a lot of compliance gurus.

Anti-regulation groups, however, are more than willing to quantify the horrors. The American Action Forum, which calls itself a "center-right" policy institute, says beefing up "Dodd-Frank" capitalism will cost USD 895 billion in gross domestic product losses from 2016 to 2026. The SEC, Commodity Futures Trading Commission, the Office of the Controller of the Currency, and other regulators are knocking out about 400 new rules required by the Dodd-Frank Wall Street and Consumer Protection Act, which was signed into law by President Barack Obama in July 2010 in response to the excesses of the previous years. The new US president has already made clear he wants to revoke part of Dodd Frank, and the republican led Congress and in particular its powerful head of the House Financial Services Committee has pointed in the same direction.

But 2017 has already begun. And it brings with it the challenge of aligning compliance and regulation with every system, and it will be up to the new finance professional, the new guru, this important mission. Finally, in times of governments of laws rather than of men, no doubt opting for this path is a sure bet.

ISABELLA MIGLIORINI, consultant at Andato ; A Global Consulting Firm with expertise in latin américa countries

LUIZ ROBERTO CALADO, Vice-President of the Brazilian IAFEI Member Institute, IBEF and Partner at Andato

DEUTSCHE BUNDESBANK EUROSYSTEM

Speech Frankfurt am Main | 16.11.2016
Carl-Ludwig Thiele Member of the Executive Board of the Deutsche Bundesbank

Internationalization of the Renminbi - Prospects and Challenges

Keynote Speech at the 3rd European-Chinese Banking Day

Ladies and gentlemen

I am delighted to have this opportunity to deliver the keynote speech at Euro Finance Week's European-Chinese Banking Day, which is already in its third year. In September 2015, I had the privilege of giving the opening speech at the opening ceremony of the Sino-German Center for Finance and Economics in Beijing. Although this event was not a long time ago, the internationalisation of the renminbi has progressed rapidly since then.

1 Where does the renminbi currently stand from an international perspective?

The timing of our meeting and the subject of my speech - the internationalisation of the renminbi (RMB) and the opportunities and challenges that this presents - could not be more topical. It was only weeks ago, on 1 October 2016, that the Chinese currency was officially added to the International Monetary Fund's basket of currencies. It has therefore joined the ranks of the US dollar, Japanese yen, pound sterling and, last but not least, the euro as one of the five most-used currencies in the world. This is a major political triumph for the People's Republic of China, as well as for the IMF, as China is the world's second largest economy, with growth of more than 6 per cent per year.

The Chinese government had been resolutely pressing ahead with the process of including the renminbi in the Special Drawing Right Basket since the year 2009. In doing so, it had more than just the prestige of being included in the IMF's basket of currencies in its sights - in actual fact, the internationalisation of the renminbi is closely linked to the opening-up of the capital markets in China as a whole and to the advancement of the Chinese economy. China's objective here is to morph from "the world's workshop" into a modern, service-oriented economy, with the international financial markets and the renminbi both having an important role to play: the former as a source of financing for economic activities and the latter as a lubricant for imports and exports.

2 Has the renminbi already established itself as an international key currency?

Three criteria come into play when assessing a currency's significance at the international level. The currency's use

- in the settlement of transactions, ie as a trading currency;
- in the capital markets, ie as an investment currency;
- and as an investment vehicle for central banks, ie as a reserve currency.

Let's examine the individual criteria in a little more detail now.

The renminbi has already firmly established itself as one of the world's most-used trading currencies. While the share of global payments made in renminbi was no more than 0.25 percent in January 2012, making it the world's 20th most-used trading currency, this share had climbed to 1.86 percent by August 2016 - an increase of more than sixfold. Behind the US dollar, which remains the undisputed number-one trading currency in the world, the euro, the pound sterling and the Japanese yen comes the Chinese currency in fifth place - and there are signs that it will rise through the ranks.

The second step towards securing the renminbi's position as an international key currency is to strengthen its role as an investment currency. The greater the number of liquid, renminbi-denominated securities that are issued, the more foreign investors will also be interested in investing in renminbi. The prerequisite for this is that the Chinese capital markets are sufficiently deep and receptive to foreign capital. What's more, the Chinese markets need to be opened up to foreign investors. The Chinese government has recently made several efforts in this direction. Various programmes enable investors to make investments with fixed quota restrictions on the onshore bond market. Another option open to foreign central banks, sovereign wealth funds and offshore renminbi clearing banks is the China Interbank Bond Market (CIBM). Since mid-2015, the only prerequisite for access to this market has been prior registration with the People's Bank of China (PBoC), eliminating the need for the quota system.

Nowadays, the Chinese bond market is the third-largest in the world after the US and Japanese bond markets. However, only 2 percent of bonds are currently held by foreign investors. Holding a share of around 70 percent, the largest investors remain the Chinese commercial banks. Consequently, it is vital that further reforms are implemented in the future to open up the financial markets for foreign investors so that the renminbi can gain a foothold among the flexible and internationally used investment currency elite. One example of such necessary reforms would be to eliminate obstacles hindering access to the capital market, such as the quota model for investment in the bond market.

The final step towards becoming a globally recognised key currency is for a currency to be used as an international reserve currency. The renminbi's inclusion in the IMF's Special Drawing Rights basket has provided the framework for this. It is now expected that a wider range of market participants will invest capital in renminbi-denominated securities. These participants will likely be joined by an increasing number of central banks that will, in the future, invest parts of their reserve assets in corresponding securities, mostly government bonds.

3 What is the role of the Frankfurt financial centre in the internationalisation of the renminbi?

The renminbi's internationalisation strategy does not culminate with the currency's inclusion in the IMF's basket of currencies, however. On the contrary, the Chinese government is currently focusing on a whole raft of measures. One of these is the Cross-border Interbank Payment System (CIPS). It was launched in October 2015 and is the sole provider of settlement services for offshore renminbi payments. The People's Bank of China designed CIPS to provide an infrastructural buffer for the expected growth in renminbi transactions and to stem the disadvantages with regard to settlement efficiency vis-à-vis other currencies (particularly the US dollar).

Other measures include bilateral cooperation agreements that aim to further promote use of the renminbi as a trading and investment currency. The potential for efficient renminbi clearing is significant to enterprises that operate internationally. As China's largest European trading partner, Germany is of crucial importance in this context.

It was not for nothing that the first renminbi clearing hub located outside Asia was established in Frankfurt. Since 2014, it has been possible to settle renminbi-denominated payments via the Frankfurt branch of the People's Bank of China. This service provides attractive opportunities for small and medium-sized enterprises, for instance, to establish and expand business relationships with Chinese enterprises while at the same time settling payments with China within their own local time zone and jurisdiction.

The China Europe International Exchange, or CEINEX, is another collaborative initiative. This joint venture of the Deutsche Börse Group, the Shanghai Stock Exchange and the China Financial Futures Exchange was opened exactly one year ago and is the first trading venue outside China for Chinese investment products in renminbi. CEINEX uses the Deutsche Börse's infrastructure and provides investors with the enticing option of gaining access to the Chinese capital market during European and US trading hours.

In addition to the formation and expansion of close and dynamic economic ties, activities that promote mutual understanding are another integral part of the renminbi's internationalisation strategy. Mutual trust is established by regularly exchanging information in the fields of politics, business and academia, and this is an important factor for successful cooperation with Chinese partners.

In mid-October this year, for example, a delegation of members of the Renminbi Initiative Group Frankfurt headed by the Deutsche Bundesbank and the Hessian Ministry of Economics travelled to Beijing and Shanghai for talks. This was in connection with a workshop in

Beijing organised by the Sino-German Center of Finance and Economics, which boasted high-ranking participants from the People's Bank of China, academia and the financial sector. The Sino-German Center, which is part of the Goethe University in Frankfurt, is a research centre that conducts independent research and promotes interaction and improved mutual understanding by means of education and training. The Sino-German Center opened in September 2015 and I am proud of the fact that the Bundesbank, as a member of its Board of Trustees, is actively contributing to its success.

4 What conclusions can be drawn?

Ladies and gentlemen

The inclusion of the renminbi in the IMF's Special Drawing Rights basket marks a milestone in the internationalisation of the Chinese currency. There can be no doubt that this is a great political and economic triumph for China as well as an endorsement of the path to openness that the country has been treading with great determination since the end of the 1970s.

However, there is still some way to go if the renminbi is to become as important as the other four key currencies. Foreign investors' access to the onshore capital markets in China, which is still restricted, is a case in point and underscores the necessity for Chinese policymakers to continue to resolutely press ahead with the opening-up and liberalisation of the Chinese markets.

Thank you very much for your attention.

*   *   *

Deutsche Bundesbank | Communications Department | Wilhelm-Epstein-Strasse 14 | 60431 Frankfurt am Main
www.bundesbank.de | E-mail: presse@bundesbank.de
Tel: +49 69 9566-3511 | Fax: +49 69 9566-3077

RISK AVERSION, WOMEN ON BOARDS AND THE GEN PAY GAP

By **MIREIA GINÉ**, Assistant Professor of Financial Management, IESE Business School, from Echanges, January 2017, article provided by DFCG, the French IAFEI Member Institute

150 years since Susan B. Anthony advocated for equal pay in 1868, women are still earning less than men. In the United States, full-time female employees earn 79 cents to every dollar earned by male employees, resulting in a gender pay gap of 21 percent. According to the latest figures available from Eurostat, the average gender pay gap in the European Union is slightly less at around 16 percent, but with a significant amount of variation between member states (e.g. Estonia has the starkest gender pay gap at 28 percent, while Slovenia has the smallest at 3 percent. France is closer to the EU average, with a pay gap of around 15 percent.).

The reasons behind why the gender pay gap persists are still disputed, but one of the more common explanations given is that women tend to dominate professions that pay less – simply as a rule – than those dominated by men.

However, if that were the only factor holding women back when it comes to equal pay, then it would surely mean that those female executives who are highly qualified, highly paid and at the top of their game would be exempt from the effects of the gender pay gap. Nevertheless, according to research I conducted with Mary Ellen Carter of Boston College and Francesca Franco of London Business School, even in the rarefied air of corporate boardrooms, women are still earning less than men for the same work.
How much less depends on a number of factors. Running the numbers on a large sample of executives working for U.S. publicly traded companies from 1996 to 2010, we examined how women's apparent aversion to risk and their underrepresentation on corporate boards may play into the statistics. Homing in on these two factors, it seems that the second may be easier to fix than the first.

In fact, our research findings suggested that boosting female representation on corporate boards may actually help equalize pay for all.

Equal pay for equal work?

While the pay gap between male and female employees is frequently covered in the mainstream

press, the reasons for it remain unclear and difficult to untangle. This is why we feel our research is particularly pertinent: one of the first steps to tackling the equal pay issue effectively is to look objectively at data, using quantifiable measures to assess the current state of firms in regards to the gender pay gap. Otherwise, biases and assumptions can end up clouding the issue, preventing real progress.

Focusing our efforts exclusively on executive pay, we found that women did receive significantly lower salaries and total compensation compared to men. Salary and compensation gaps were about 7 and 15 percent, respectively, even after controlling for tenure, job responsibilities and other factors.

In fact, controlling for outside factors -- such as age, job tenure, title, firm size, firm performance and more -- was central to the study. This was to ensure that we could zero in on whether the gender pay gap did really exist. One challenge in documenting the existence of executive gender pay gaps is establishing the counterfactual pay rate -- that is, the pay female executives would have earned had they been males, all else equal.

In an attempt to eliminate bias, the study also used a statistical technique called propensity-score matching, which involved pairing thousands of female executives with a subsample of male executives, selected for their similarities. The samples were drawn from executives working at S&P 1500 companies – in other words, at 1,500 publicly held companies trading on U.S. stock exchanges.

Moreover, we found that lower pay did not stem from educational differences either. When 4,769 male-female pairs were compared, matching their attendance of ivy-league schools and MBA degrees, gender pay gaps remained.

Interestingly, after examining the results of executive turnover, we found that when female executives replaced male executives, compensation was negatively affected, whereas when the change was female to male, compensation went up.

The Risks of Risk Aversion

After drilling down deeper into the differences between compensation for male and female executives, we discovered another potential contributing factor for the gender pay gap: risk aversion. After all, executives do not just receive a salary; their compensation package typically includes equity incentives. These incentives carry potentially greater rewards, but also greater risk. Female executives were found to hold significantly lower equity incentive levels than their male counterparts, suggesting that they show, on average, a greater aversion to risk.

This equity gap is partially compensated for by additional “safe” pay, such as salary; however, taking both salary and overall compensation into account, women still received lower total pay compared to their male colleagues. It seems risk aversion explains part of the continuing gap, but is not the only factor.

Safety in Numbers

If risk aversion lowers a female executive’s compensation, keeping company with other women can work to counter that trend as well.

When the study turned its sights on gender diversity within the board of directors, results showed that more female representation on the board resulted in smaller pay gaps. For example, we found that for a firm with sample average proportion of female board members (9 percent), the gender pay gap in total compensation is approximately 5 percent lower than the 21 percent gap for firms with no females on the board.

To illustrate this with a real example, one of the female executives we analysed in the study was Carol Meyrowitz, the former CEO of TJX (parent of T.J. Maxx, Home Goods and other apparel and home goods retailers). Since 2006, the proportion of female directors at the company has been roughly 30%. We found that Meyrowitz was paid fairly in comparison to executives of similar companies as she rose through the ranks.

We also found that the effect of smaller pay gaps due to having higher levels female board representation is not just confined to top executives but flows down throughout the firm, resulting in better pay for females throughout the company.

This outsize effect on the pay gap by having more women on the board could be due to a number of reasons. It may be that increased board diversity means deeper discussions in the boardroom around executive pay, and more awareness about potential gender biases.

However, the effect of encouraging more women on boards can be startling – our research indicates that even just one single female board member could help level the playing field in terms of pay.

Encouraging more women on boards

It is clear there is a long way to go before there is gender parity on boards. According to a report released in June 2016 by research firm Catalyst, women currently hold only 19.9% of board seats at S&P 500 companies. Even more strikingly, less than 5 percent of Fortune 500 companies have a woman as CEO.

It is sometimes argued that one of the factors hindering higher levels of female board representation could be a lack of supply of suitable candidates. However, a perceived lack of suitable candidates may be more due more to a lack of visibility or knowledge of suitable female candidates at board level, rather than any real talent drought. Regardless, given the significant impact having more women on boards can have, it seems evident that firms should look at addressing this as a key step towards reducing the pay gap.

Indeed, there are a number of measures that businesses can adopt to encourage higher levels of female board representation. For example, my IESE Business School colleague professor Nuria Chinchilla says setting clearly defined targets for female board members, tailored to what the company needs at the particular time – so-called “self-quotas” – are better than merely following arbitrary quotas imposed on the outside, which may have little relevance to the individual needs and realities of a certain company. PepsiCo and Shell have both made progress with similar methods (albeit to address gender equality throughout the company, not just in the boardroom.) For instance, Shell has various talent management practices and policies that champion gender diversity, such as making sure female candidates make the short list for senior level positions in specific regions and business areas.

Meanwhile, women’s reluctance to go for stock- or option-heavy compensation packages may be harder to control. The data indicates the phenomenon is real, but the remedy is unclear.

The detailed study can be found at: http://ieseinsight.com/doc.aspx?id=1841&ar=7&idioma=2

“THE FINANCIAL LEEWAY WE WOULD HAVE”

THE CFO OF SAP GROUP: SAP IS IN A POSITION, TO SHOULDER A LARGE ACQUISITION - AT PRESENT, MINOR ACQUISITIONS ARE IN THE PLANNING STAGE - HIGH EXPECTATIONS FROM INDUSTRY 4.0- NOT AFRAID OF TRUMP.

Interview with **Mr LUKA MUCIC,** CFO of SAP Group, Börsen-Zeitung, December 3, 2016, article provided by GEFIU, Association of Chief Financial Officers Germany, the German IAFEI Member Institute

Mr. Mucic, the British people, in a referendum have decided against the European Union. Donald Trump has been elected as new US – President. Which effects has the wave of populism on SAP ?

The large political shifts so far do not have material effects on SAP. In the past years and in a climate of often insecurity, we have almost always done well. The customers especially in uncertain times do invest in our technologies, for instance to improve their efficiency. Since the Brexit – referendum almost half a year has passed, and the customers continue to purchase - in Great Britain as well as in the other countries of Europe. As to the agenda of Trump, one cannot yet say much. He seems to support an active investment policy. I am sure, that the USA, under his leadership, will not want to lose their lead role in digitalisation. As to us, we must not be worried.

There are not only effects on operations. In the financial markets, rising interest rates are expected since the election victory of Trump. The US Dollar is appreciating.

These are two different subjects. We are benefitting from the development of the Dollar. The Dollar for us is by far the most important currency. Some analysts are expecting, that the Dollar will move beyond the parity to the Euro. For SAP this would be positive.

But for the Mexican Peso this certainly would not be so ?

This is true. But the Peso, for us, because of significantly lower sales volumes, is not playing a prominent role.

Then still remains the risk of rising interest rates ?

We expect still in this year 2016 an interest rate measure in the USA. And I consider it as probable, that there will be further interest rate steps in 2017.

Would it make sense, against this situation, to raise, before, once again debt capital ?

When it comes to debt financing, what matters for us, is not the interest rate level, but whether we have a strategic need for liquidity. Our policy has always been, that a debt financing is only necessary for us for large acquisitions. We had, at the end of the third quarter 2016, a group liquidity of 4,5 billion Euro and a minimum liquidity of 2.5 billion Euro. If we would further enlarge these positions, we would have quite different problems in the presently low interest rate situation for deposits. Possibly the outcome might even be a negative carry. This absolutely makes no sense from our point of view. We have a stable "A" Rating, and at Standard & Poor`s even with a positive outlook. We see no need for action.

As you are just talking about your liquidity cushion: It is since a decade, that SAP not at the latest after three years of abstaining has again made an acquisition by the billions. 2017 is the third year after the acquisition of Concur.

We are not planning our acquisitions by the calendar:

But would you not be ready for it ?

Whether we make something ourselves, or whether we enter into a partnership, or acquire something, we do decide on a case by case basis - depending on strategic priorities and of whether our product portfolio at a specific point has gaps, to be filled. We have never acquired, in order to withdraw competitors from competition, or in order to consolidate the market. Our portfolio in the meantime is well rounded. Therefore most of the acquisitions, about which we are thinking, rather are in the direction of smaller acquisitions.

About which order of size are we talking here?

It is acquisitions, which we can finance from our cash flow. We have made in this year a number of such acquisitions, and we will have spent for this until yearend not quite 100 million Euro. Such acquisitions we shall certainly also make in 2017, without already now wishing to define the areas of themes. If a chance for a larger acquisition arises with an attractive logic, we can imagine also greater numbers. But this should be absolutely complementary, and should not have overlaps with our existing portfolio for solutions. However, I presently have no fantasy, to imagine what this could be. The financial leeway we would have.

Once again to politics: In the USA Trump is planning tax reliefs and investments into the infrastructure. Also in Germany, because of the discussions about Industry 4.0, the infrastructure is being discussed. Can Trump here indirectly push on investments ?

Investments in digitalisation and not least in infrastructure should be a very essential task of domestic policy. Chancellor Angela Merkel is also having this view. The consumer internet we have already left since long to the Americans. With the industrial internet we now have a great chance. Therefore, we are already advocating for investments in this area - as well on behalf of the private economy as well as on behalf of the state sector. To this belongs especially the further build-up of the glass fibre network. Germany presently is here neither globally nor in a Europe wide area in a leading position.

What do you think about the objective, to being able to offer till 2018 countrywide 50 Mbit per second ?

This is not enough. We should set higher objectives for ourselves. Especially we need as quickly as possible a complete coverage by glass fibre. There are a few regions, which are stepping ahead in this regard. In the German region Rhine/Neckar we have set a clear emphasis and have heavily invested in in glass fibre infrastructure. As a result, we here have a good coverage. But this is also necessary in large scale territory. We therefore welcome the initiative by the federal government, to create E-Hubs and to pay more attention to the subject of digitalisation.

What does SAP undertake itself, in order to push in advance the digitalisation of the industry ?

We attempt to move forward the subject Industry 4.0 with our own technology, for instance with our Hana-Cloud-Platform and related software solutions. A great role play for us industry partnerships - for instance with Siemens and Bosch. With Sapphire Ventures we have in addition a great venture-capital fund which is around in this area for investment possibilities, not only in the USA, but equally in Europe and Germany. But we also need political support in this area. Investments in excellence clusters and the mentioned build-up of the glass fibre network are here important factors.

The rural population has made the election successes possible for Trump and the Brexit proponents. Do you see, that industry politics are also having the duty, to prevent, that the rural areas digitally are being left behind ?

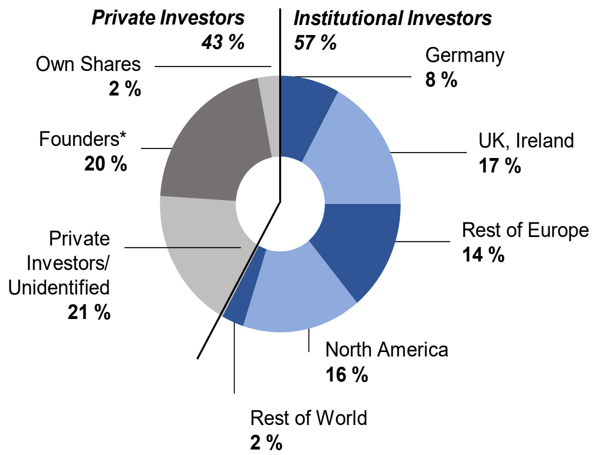
I see this less as a fight against the risk of descent, than as a fight for chances for an advance. In Germany we have less the problem of dieing parts of the country. We have here a very strong industry and we are not just depending on the service sector. This is especially true in the country area outside the cities, where many innovative "Hidden Champions" are located. They naturally are also depending on that the infrastructure is available to them which they need in the competition.

SAP at a glance

Group, January to September 2016

	2015	2016
Total Sales in million Euro	14,5	15,4
Sales in the Cloud in million Euro	1654	2166
Operating Profit in million Euro	2552	3184
Profit after Tax in million Euro	1778	2108
Free Cash-flow in million Euro	2817	2962

Shareholder Structure



*Messrs, Plattner, Hopp, Tschira

Market Capitalization
Status January 13, 2017
101,3 bill. Euro

Source: Corporation, Thomson Reuters

Industry 4.0 could also bring new competitors. Industrial Groups like Siemens and GE are in the meantime themselves acquiring Software-Know-How. Will the partners of today be the competitors of tomorrow?

As regards digitalisation it is necessary for survival for traditional industrial corporations, to provide know how for themselves in this area. We welcome, that corporations are reinforcing themselves digitally, because we can help them on their way into digitalisation. It is the essence of the digital economy, that rather not a single corporation can create alone the total value added chain. When one is looking more closely at the digital acquisitions by the large industrial corporations, then one realises, that thus very few overlaps are realised with us. Siemens, recently, with Mentor Graphics, has taken over a software producer the products of which are being used for the design of electronic building components. In this area we are not active.

We are providing products and services with which corporations are steering their business processes - increasingly also in the area of Industry 4.0. This is very well accepted by the market. We expect, that the area Industry 4.0 will grow strongly.

Also your Cloud offers are well accepted. How well is the Cloud – Model equipped against crises, or is it susceptible to volatility?

In the past years, the business environment was very disquiet - for example with regard to Europe and the Euro-crisis. The average maturity of Cloud contracts is presently roundabout 3 and a half years and thus not quite as short-term, as is sometimes said. For the extension of such contracts we must naturally work, as well as for the supplemental business in the Cloud. Theoretically the Cloud-Model is more volatile. In practical terms this is so far not playing a role. And also, the Cloud business in many ways hardly differs from the classical Licence business with follow up maintenance agreements.

For instance?

The cash flows, for example, are very similar. The Cloud customers are usually paying once per year in advance their annual fee. Therefore, our Cloud competitors, as regards the cash flow, are in a very good position, even though they are still not profitable. Related to the gross margin, the Cloud business is also very profitable. The general profitability is depending on our growth. A smaller growth of the Cloud business would even be positive for the margin, because then typically the share of the less profitable new business would decline. This one was able to see at Salesforce.com, the profitability of which has increased in the last crisis.

Growth in the Cloud is thus effectively costing you profitability. Which share at SAP has now the new business in the Cloud?

As of today, the existing business is at around 60 %, the new business is at 40 %. In our medium term planning till 2020 we anticipate, that the relationship moves to 80 to 20. However, this naturally depends on how the dynamics of the new business will develop. Even though it might displease observers with a pure focus on the margin, I honestly am rather a CFO of a corporation with over 20 billion Euro of sales and a somewhat lower margin, than manager of a corporation with roundabout 10 billion Euro turnover and a higher margin. Because below the bottom line, I can in a bigger corporation dividend out significantly more to the shareholders. Therefore we are pushing our Cloud business as much as we can. Sometime down the road and with increasing market satiation, the growth rates will decrease automatically, and then the profitability will increase again.

SAP is not the only one enjoying a nice development in the cloud. Which competitor has managed best the change from the classical to the Cloud-Model in your view?

In my opinion Microsoft has done a very good work - especially since Satya Nadella has taken on the steering wheel, the corporation has been re – oriented well. Especially with the Cloud-Infrastructure software Azure, Microsoft is moving ahead well. Microsoft also appreciates us. Therefore we are partners.

At a number of firms, the definition of the notion Cloud seems to be very vague.

There, you are right. It is not always quite clear at Cloud suppliers, what goes into the Cloud revenues. We are here adhering to the US Accounting Standard GAAP, although we are accounting according to IFRS. With Cloud revenues the US Standard has the longer experience, and also the better definition. When a customer agrees to running the software on our servers, and when he has no right to withdraw the software, then it is Cloud revenues. Everything else is on premise turnover.

Do the revenues from a Private Cloud not at all appear at your Cloud revenues ?

This depends. When a customer purchases his software and then operates it with SAP Hana Private Cloud on our servers, then the software revenues are not accounted for as Cloud revenues. This would only be the case, when the software would be delivered by way of a subscription from the SAP Hana Private Cloud. This, however, is the case at only very few customers. The operation of the Private Cloud and the providing of the infrastructure, however, are in any case treated as Cloud revenue.

Your business software S/ 4 HANA is also set up for the theme Industry 4.0. Which turnover do you attain with this?

So far we attain here a three digit million turnover. But the potential here is naturally much larger.

Another theme for the future is very controversial: The new European Union Data Protection Basis Directive. What is SAP´s opinion on this?

The here expressed Principles of using data sparingly and the utmost possible avoidance of data are running counter to global development. Consumers and corporations are increasingly generating data and they exchange them. I think, we should find the right balance, in order not to give away chances in the areas like Big Data. The requirement of a renewed agreement to analysing data, which have already been made available, is a requirement, which does not exist in other country jurisdictions. Here we are making for ourselves an obstacle against the development of new business models.

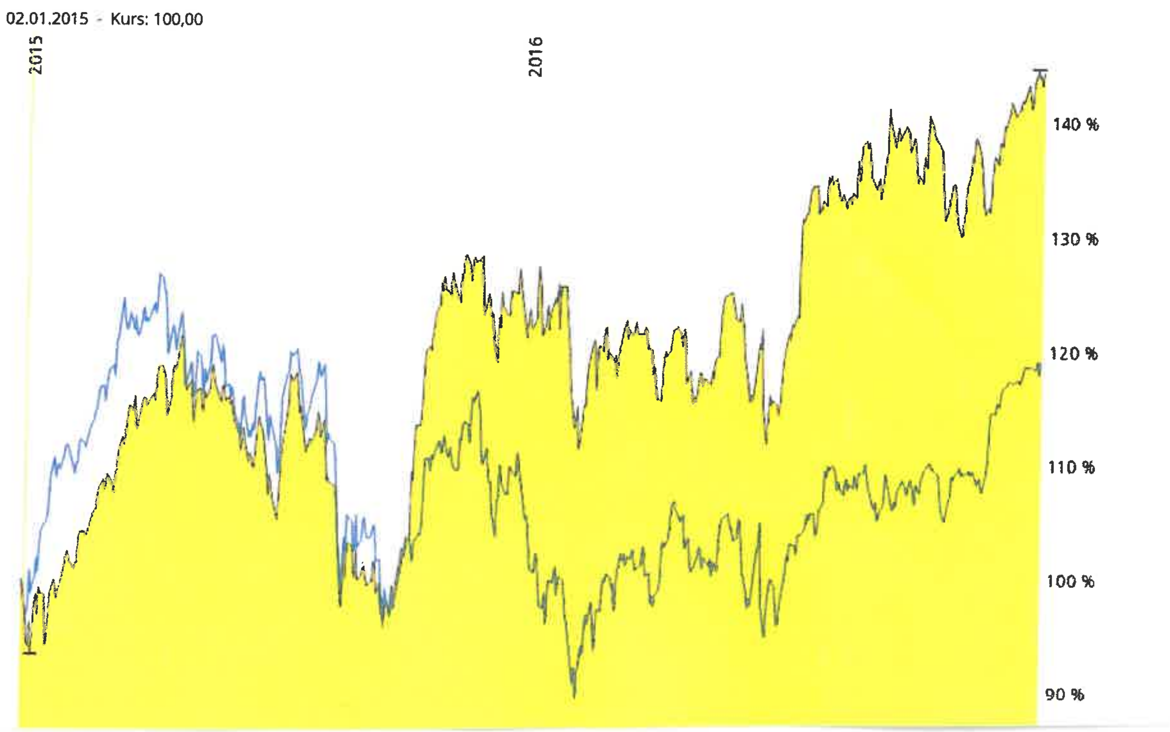
Some people are afraid of the new business models, because not rarely they lead to a loss of jobs. How do you evaluate the concerns that in future less people can participate in the job market?

I do not share these concerns. It is true, that ever more we can substitute simple jobs. But the solution should not be that we walk away from technology, but that we move towards more education and training. In the financial area of SAP we now spend ten times more for the continued education than three years ago. Also in the other business units the expenses for continued education have risen significantly, because we have disconnected them from the cost centres. When it is about savings measures, the theme is: Training measures are untouchable.

SAP SE Share 84,18 Euro Share Price as of January 13, 2017, German Stock Exchange Xetra

Index Price Chart, Index-base as of January 2, 2015 = 100

-Upper black line: SAP SE Share
-Lower blue line: DAX German 30 Companies Large Cap Stock Index



At these expenses, certainly your strong capital cushion is helpful. How do you invest cash in times of low interest rates, wich is not being invested ìor dividend out?

Very conservatively. By way of a broad portfolio spreading we have achieved pretty well up to now, to avoid negative interest rates. For me, however, still holds true: Return of Capitals is more important than Return on Capital. Security in every case comes first before Return.

In 2016, US technology groups - Apple ahead of all - have been in the focus, because of their tax optimisation strategies. Do you consider yourselves here at a disadvantage vis a vis the Americans?

At us the majority of the profits is generated in Germany, because here is the biggest part of our intellectual property. So we pay roundabout two thirds of our taxes in Germany - and we are among the best tax payers in the country. With a view to our US competitors we are having an obvious tax disadvantage: Our effective tax rate is on average 5 percentage points higher. In the United States, though, the corporate tax rate in absolute numbers is very high. But the US foreign areas tax law has the character of a Swiss Cheese, so that especially large corporate groups by far do not have to pay this corporate tax rate. So here I can understand Donald Trump, who wants to bring the tax rate especially for medium sized corporations to a competitive level. However, then also the tax loopholes must be addressed.

How does the situation look in Germany ?

As to the foreign areas tax law, there exists in my view a reasonable tax framework. Here Germany is a good example. However, we have not even so far achieved in the European Union, that the tax law has been unified. As long as this is not the case, one cannot protest, when corporation groups are using the tax loopholes outside the European Union.

About the Person

Finance Teacher

"When it is about savings measures, the theme is: Training measures are untouchable", says the software corporation group SAP CFO, Luka Mucic. Finally, the employees are said to be the capital of the corporation, and here one must not save at the wrong end, he says. In the finance division, the investments in training have been increased ten times in the last three years, and also in the other business units of SAP they have been increased significantly. The key for this is said to have been, that the costs for this have been segregated from the cost centres and added to his division. Thereby the incentive goes away, to cancel trainings measures for the purpose of cost savings.

Although the only 45 years old CFO still can have many years at the top of the corporation, he also already has an idea for the time thereafter. Whereas other managing directors of corporations of the German DAX stock index, like to decorate themselves with a number of mandates in supervisory boards of corporations, Mucic would rather in the long term future like to return to the university, in order to give his knowledge as lecturer back to the next generation. The CFO who was raised not far away from the corporate headquarter has himself studied in the nearby Heidelberg university, and since his professional start at SAP two decades ago he has held positions in risk management, the finance department and the legal department.

THE INTERVIEW WAS MADE BY SEBASTIAN SCHMID, BÖRSEN-ZEITUNG,

RESPONSIBLE FOR ENGLISH TRANSLATION: GEFIU, THE ASSOCIATION OF CHIEF FINANCIAL OFFICERS GERMANY, TRANSLATOR: HELMUT SCHNABEL

THE US DOLLAR UNDER TRUMP'S FIRST YEAR

By **Eduardo Garza Castillon Segovia**, Engineer, National President of the Treasury Technical Committee of **IMEF,** the Mexican IAFEI Member Institute

Since the US election the US Dollar (USD) strengthened slightly more than 5%, both on the DXY and the BBDXY Dollar Indexes, against a basket of 6 and 10 currencies respectively. The DXY index reached levels not seen since 2002 while the BBDXY, which came about in 2004, is basically at all-time highs. Though both of these dollar indexes reflected a 1% weakening of the USD during the first week of 2017, it should continue to strengthen as Donald Trump's presidency gets underway.

The strengthening of the USD has been contrary to what was initially expected, since before the election it was thought that Trump's protectionist policies would provoke a recession in the USA which in turn would cause the Fed to raise its reference rate even more slowly than previously anticipated, thus weakening the USD. However, just the opposite occurred. Trump's promises of applying fiscal stimulus by lowering taxes to stimulate economic growth and to bring in more USD's from abroad, where most US Corporations have left Trillions of Dollars from reaching the US to avoid high repatriation taxes, as well as plans of spending heavily in infrastructure projects and of deregulating much of the economy, have increased the likelihood of US economic growth, the spur of inflation and therefore the need for the Fed to increase their rate at a faster pace than anticipated. Though the markets had accepted that the Fed would increase their reference rate twice next year, on their December meeting they even mentioned the possibility of hiking three times if market conditions warranted such a move on their part.

The strengthening of the USD after Trump's unexpected win is basically the market's interpretation of what will happen once Trump comes into power on January 20. Though most experts agree with this interpretation, there are various opinions that differ with this now generally accepted view.
Bond guru, Bill Gross, says there's an overreaction to this view and believes the USD will lose a good part of its recent gains once the markets come to realize

that this initial simplistic view is not as easily brought into fruition as most would believe. He believes it won't be too easy to lower taxes enough as to create the kind of growth most believe will be generated as of 2017. Democrats are now formulating a stance to prevent Trump and the Republicans from lowering taxes as much as they'd like and as quickly as they now foresee and of expanding the nation's debt ceiling to allow more infrastructure spending. This type of spending won't happen as quickly either nor will they be able to deregulate as fast as the Republicans say they will. All in all there's quite a bit of uncertainty as to where the dollar will be heading once Trump assumes power.

Before answering what can or will happen to the USD once Trump becomes the next President of the US, we should first review what are the main drivers that make it move throughout the spectrum. In simplistic terms, the USD does well (strengthens) when the US Economy and the Global outlook are doing well (growing). Positive US data that result in the Fed's need of having to hike or increase their reference rate at a faster pace strengthen it while negative or weak US data that delay such hikes, or that provoke the Fed to lower their reference rate tends to weaken it. As the US Economy grows and inflationary pressures arise, the need for the Fed to tighten their monetary policy also increases, thus strengthening the USD too. Possibly the biggest driver for USD strength comes from FED rate hikes which in turn make US Treasury rates and US investments more attractive to the world's large investors, resulting in these investors funds buying USD's to acquire US assets.

However, the USD (and a few other global currencies like the Japanese Yen and Swiss Franc among others) also strengthens when geopolitical and global economic conditions deteriorate, hampering global stability and global growth that create a need for big global Capitals and global funds to move into safe havens while the risky factors loom, at times often called "Risk On" environments. As these risk factors decrease and the environment return to more normal levels ("Risk Off" environment) these large Capital and / or Funds return or fly into riskier investments that yield better return rates for these big monies. As monies pour into safe haven assets, like USD investments, the USD strengthens on the larger demand for USD denominated investments and as they leave the USD in search of higher returns, the USD weakens.
Trump made lots of illogical and even eccentric promises during his campaign. Too many of his proposals were highly unpopular within the US electorate but also within the International Community, including many traditional US allies, basically because they oppose what has defined US policy during the last 30 to 70 years, like free global commerce and even standing up to other world powers like Russia and China. Though these promises got him elected, it's unlikely he will be able to carry every one of them exactly as he voiced them because doing so would have bad economic and political implications for the US economy and the global world order that would debilitate the US instead of fortifying it.

One such promise was that he would raise protective trade barriers for China and Mexico in an effort of bringing down the trade deficits that the US has with both of these nations, especially with China. However, doing so would not only provoke these two counties to retaliate similarly, raising trade barriers that would hurt US exports and ultimately slow the US economy that would eventually result in undesired job losses. Trump also wants the USA to become a manufacturing powerhouse once more, so that as many as 25 million workers can reenter the workforce within the next 10 years. Yet, if this were to happen, US consumers would be paying much more for goods manufactured in the US simply because wages are much higher than in other parts of the world, which in turn would increase inflation and become unpopular for him. As we can see, keeping his promises and campaign proposals are not so easy to enact, since trying to fix certain issues elicit undesired effects in other areas of this wildly complex and interconnected world.

Therefore, Trump will encounter that he will not be able to achieve many of his promises. No politician is expected to carry out every promise made in campaign. At the end they have to compromise and enact many of them to a certain degree, but not necessarily in their strictest form. This is precisely what the world is waiting to see, which Trump promises get prioritized, which get enacted and which are toned down to become actual policy. Until that happens we will not know what economic impact they will have in the real economy, nor will we know for certain how these policies will affect the USD in the short and midterm.
The USD in itself is an important economic factor, one to keep tabs on, as it's one of the main economic variables that affect global economic conditions in today's economy. A strong USD creates havoc in most world economies, especially in developing nations

and emerging market economies that mainly export commodities as a source of income, since commodity prices tend to diminish as the USD strengthens, thus providing less income and usually incrementing those nations trade deficits, creating inflationary pressures and weakening their economies. A very strong USD, like the one we have now and which is more likely than not to increase its value in the near future may also weaken the American economy, so that's another element to keep in mind.
Of all emerging countries, it is China that Trump needs to be more careful with. Being the world's second largest economy and one of the world's top manufacturers it's also one of the main global importers. If China's economy slows too much, the global economy falters. China is Asia's main importer, as well as one of Europe's, the Middle East's, Africa's and Latin America's top importers. So if China's economy slows too much, the rest of the world slows down as well. Even though China is not one of the US main export markets, other top US clients do export lots to China and if the Chinese economy weakens the US will also hurt itself by slowing their own main client's economies.

Therefore, Trump needs to be extra careful when applying commercial tariffs to China. If Trump rocks the boat too much and hurts the Chinese economy, it would be wronging themselves and the rest of the world. In fact, having the big trade deficit with China has allowed the US to maintain a global stable economy were their own economic recuperation has been able to take hold. If Trump is too rough with China in applying steep trade tariffs, the world economy would make the US feel the pain of these bad moves in a matter of 6 to 12 months, provoking a likely recession for the US and even to the global economy. Unfortunately, Trump has surrounded himself with several pro protectionists' counselors and the probability that he does affect China's economy is higher than what anyone would like to accept.

Trump will inherit an economy that's currently growing at over 3% per year, though the US will likely post a 2016 result of a bit over 2% as a whole. If he is able to implement his fiscal stimulus and to partially deregulate the economy within the first 100 days of his administration, the economy could easily maintain the 3 to 3.5% growth rate it probably actually has today, even up it towards 4% per annum. That would mean that the Fed would indeed need to raise its rate at least two and possibly three times during this year.

But this all depends on how Trump carries out his protectionist measures towards China, Mexico and other nations. It would be hard for Trump not to raise any tariffs on these two countries, since it was such a big part of his agenda during his campaign. But if he can only implement "cosmetic" tariffs, so he can claim he did keep his promises, instead of wide spread and steep tariffs, the status quo in the global economy could suffer only momentarily, but not in an overly fashion.

People that know Trump say he's a pragmatist. Being more of a business man than a politician, he must know and understand the interrelated economic consequences of the few examples I've just mentioned. However, we've all seen how Trump is also very competitive and he likes to have his way, even if his opinions and ways hurt him, as we saw in the debates with Hillary Clinton. His character sometimes gets in front of his own best interest. Yet it's very different taking decisions that affect yourself or your own companies than deciding on national and global issues with global or national implications. That's why he was deemed a threat to global stability. If he can control himself, to quiet all his doubters, and handle himself in a more statesmanlike fashion, many of his proposals could really benefit the US and the rest of the world.

As I mentioned earlier, many of his economic proposals could be good for the US and the world as long as he can balance these policies without hurting the global economy with some of his other policies. Being able to better balance world trade by improving relations with both China and Russia, showing both of them that the US stands firmly behind a sustainable win – win long term relationship, while taking care of some of the bad effects of a globalized world, Trump could be good for global economy. This is not precisely what he has shown the world, but he has certainly positioned himself to be listened to, to negotiate different terms in a new world order and to cause effective positive change if he wanted to.

We shall soon find out if he will be a good world leader or just another self-centered bully looking only for his self-interest. One thing is for sure, the USD and the world economy will feel his ways and policies immediately. One cannot preside over the world's main economy and not be felt, especially if he is bringing new policies into play and when he tweets daily on national and international issues.
Personally, I believe the USD will keep strengthening this year to reach even higher levels. The last time

a US President deregulated its economy was when Ronald Reagan was president. During his term the USD strengthened so much they even had to artificially deflate it through an international accord called the Plaza Accord, back in 1985.

It's not clear how much the USD can strengthen but it's likelier than it does strengthen much more since his pro-growth policies should help the US to sustain and even increase its growth at least through the first half of 2017. Trump has also surrounded himself with pro-growth, non-Washington establishment people in his cabinet so I believe the US economy can and will thrive this year, taking the USD to levels not seen since the mid to late 1990s, or even to levels not seen since the mid-1980s. The big question is whether Trump plays it well in the international arena or not.

Here there are two scenarios: If he does play it well and he doesn't hamper emerging economies, especially China, emerging economic growth could provide enough growth so that commodity prices don't fall too much, even with a stronger USD. Growth outside the US could actually prevent the USD from climbing too much as monies exit the US to support economic growth elsewhere, usually with better returns. Europe and Japan may grow more on their weaker currencies, because of USD strength. Global economic expansion could get a boost, for another 2 or 3 years since the world is still coming off its worst economic downturn since the end of World War II (the Great Recession of 2008 – 2009). If this world economic expansion takes hold, the Fed would have to increase their reference rate at least three times in 2017, strengthening the USD with such moves.

However, if Trump's policies are not adequate outside the US, which would mean he does raise trade tariffs in China broadly and excessively (instead of only "cosmetically"), then the markets will consider that the world economy, and thus the US too, will enter a recession sooner than later, thus affective the USD negatively. So even if his domestic policies generate internal growth in the US during most of 2017, China's growth would suffer as a result of the tariffs they would need to pay to export to the USA and thus would sell less to them and therefore would have a lesser need to import raw materials from other emerging and developing economies.

This interrelated effect would slow global growth and since the USA is not an island, even though Trump has expressed a desire to close themselves to the world, their economy would end up slowing as well, and instead of possibly achieving 2 or 3 more years of growth, they would probably enter a recession within 12 to 18 months after raising tariffs to China. Under this scenario, the USD may start losing steam even before the USA would start slowing down, as the markets many times anticipate outcomes even before they come about, just like they have done so by interpreting that Trump's policies will be good for the US economy.

This year will also be complicated because of elections in Europe and because of the strong likelihood that British Prime Minister, Theresa May, will finally invoke Article 50 to start the Brexit process after the United Kingdom voted to leave the European Union last June. These events, along some other geopolitical factors we may face, will certainly strengthen the USD too.

Because of all of these Risk On factors, added to the Trump effects, expect a stronger USD throughout all or most of this newly started year.

BEPS AND EMERGING ECONOMIES. HOW GLOBAL IS THE BEPS PROJECT?

by **PIERGIORGIO VALENTE**
Chairman IAFEI International Tax Committee, Managing Partner of Valente Associati GEB Partners, January 10, 2017

Introduction: the BEPS Project

The international tax system is undergoing complete renovation. Base erosion and profit shifting (BEPS) is the evil that must be curbed, reduced, most desirably totally eradicated on a worldwide scale.

To this end, the OECD and the G20 crafted the BEPS Project, launched in 2013 with the OECD's report "*Addressing Base Erosion and Profit Shifting*"[11]. It targets identified deficiencies in national and international tax rules leaving room for loopholes and mismatches[2]. These are exploited through aggressive tax planning by taxpayers wishing to minimize their tax burden with the (obvious) consequence that countries' taxable bases are minimized as well.
The Project signals the determination of such countries – having recognized the international reach of the issue – to coordinate their actions for the elimination of the deficiencies. Two years after the Project was launched, i.e., by 2015, specific recommendations had been issued by the OECD on the appropriate measures at national and international level to effectively counter BEPS[3]. In November 2016, a multilateral instrument envisaged to amend at once the more than 3,000 existing double tax treaties, was also released; it consisted of provisions which had been negotiated and agreed by more than 100 jurisdictions, including both advanced and emerging economies, comprising the inclusive framework for the implementation of BEPS Actions[4].
All countries are equally invited to implement the recommendations and ratify the multilateral instrument; the adherence of a large number – or hopefully all – tax jurisdictions around the world will determine the success of the Project.

Arguable Relevance for Emerging Economies

There is no question that the international tax world's very foundations have been shaken; the degree to which this "shaking" affects individual tax jurisdictions is however rather difficult to assess – and understandably so – in view of the differences characterizing the economic contexts of advanced vs. emerging economies.
The issue was raised during the 46th IAFEI World Congress "Africa Driving Global Change". According to the OECD, BEPS affects both advanced and emerging markets[5]. Furthermore, it is highlighted that more than 80 emerging economies engaged with the BEPS Project through various mechanisms, forums and bodies, including the Global Forum on Tax Treaties, the Global Forum on Transfer Pricing, the Task Force on

1 OECD, *Addressing Base Erosion and Profit Shifting*, 2013.

2 OECD/ G20, *Base Erosion and Profit Shifting Project. Information Brief*, 2015.

3 OECD, *2015 Final Reports*. Available at: http://www.oecd.org/tax/beps-2015-final-reports.htm; Gilleard M, T*he end of the (tax) world as we know it? OECD delivers final BEPS recommendations*, in International Tax Review, 2015.

4 OECD, *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS*. Available at: http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm

5 Valente P., *Analyzing the Latest Developments in Base Erosion and Profit Shifting (BEPS)*, 46th IAFEI World Congress, November 2016, video participation.

Tax and Development and regional networks[6].At the other side of the spectrum, non-governmental organizations (NGOs) argue that "BEPS sidesteps some important issues for developing countries and that poor countries are not at the decision-making table[7]."
In any case, it cannot be denied that the instability, corruption and ethnic conflicts forming the current situation for most emerging economies cannot but undermine the prioritization of BEPS issues in their political agenda. Furthermore, no African country is a member of the OECD, only South Africa is part of the G20, while the vast majority of African countries is classified as "emerging economies[8]".

What is Different About Emerging Economies

The answer to the aforementioned question necessitates examination of the potential impact of BEPS and BEPS Project on emerging economies in light of the distinctive features of their tax systems[9]. It is well known that at least most of them are characterized by significant capital import and foreign ownership of the businesses operating within the tax jurisdiction[10]. They constitute source rather than residence jurisdictions, implying that they rely on tax revenues from income earned within the jurisdiction, i.e., not fromcross border activities of tax residents.

Furthermore, they suffer from tax administrations' inefficiencies, due also to the lack of tools to collect information, analyze acquired data and inspire taxpayers' cooperation and voluntary compliance. Their inherent inability to correctly and definitively assess taxpayers' transactions and determine the tax due is amplified by lack of comparable indicators[11]. In principle, emerging economies dispose of a limited tax treaty network, including agreements for the exchange of information with other countries, leading to severe lack of the information needed to understand taxpayers' cross-border activities.

Other remarkable factors are: a) lack of adequate legislation; b) weak political will, if any, to remedy it; c) weight attached to withholding or consumption taxes, which collection is more straightforward[12].

This often causes double taxation and unavoidably incentivizes tax planning involving offshore jurisdictions for its avoidance. Finally, the diverse functional profile that multinational enterprises entering emerging markets need to adopt should not be underestimated; it demands differentiation of the applicable transfer pricing rules.
From the above, it follows that intrinsic deficiencies of the national tax system in emerging economies are highly likely to hinder the effectiveness of BEPS Actions, while simultaneously requiring a different prioritization of the reforms to be introduced.

BEPS Project: Emerging Economies' Perspective and Priorities

Notwithstanding the differences, emerging economies seem to share BEPS concerns and to have welcomed the Project, as they confirmed in relevant questionnaire of the competent UN Subcommittee[13].
The respondent jurisdictions put forward the hazards of transfer pricing for their taxable bases, eroded, mainly, by the payment of extraordinary management fees or passive income to other jurisdictions. Harmful tax competition by low tax jurisdictions or through preferential regimes was also a significant source of concern.
The lack of legislation and the limited capacity of national tax administrations causes such deficiencies rather difficult to be remedied. Hence, the BEPS Project is more than welcome.

Action 12 on mandatory disclosure of aggressive tax planning strategies, and Action 13 on transfer pricing documentation are prioritized by the majority of respondents, as capable of addressing lack of information issues.

---

6 Heike Buss, OECD Centre for Tax Policy and Administration, *The BEPS Project and the Engagement with Developing Countries*, June 2015.

7 Actionaid, *The BEPS Process: failing to deliver for developing countries*, September 2014. Available at: http://www.francophonie.org/IMG/pdf/beps_16th_sept_2014_actionaid.pdf; Tax Justice Network, *Developing Countries and BEPS: an equal footing?*, September 2015.
Available at: http://www.taxjustice.net/2015/09/23/developing-countries-and-beps-an-equal-footing/

8 United Nations (UN), *World Economic Situation and Prospects*, 2012. Available at: http://www.un.org/en/development/desa/policy/wesp/wesp_current/2012country_class.pdf; Despite the lack of a commonly agreed definition of "developing countries" / "emerging economies," a typical classification criterion used by the UN is HDI or Human Development Index, referring to longevity, education and income. L. Nielsen, Classifications of Countries Based on Their Level of Development: How It is Done and How It Could be Done, IMF Working Paper, 2011.

9 Heike Buss, OECD Centre for Tax Policy and Administration, *The BEPS Project and the Engagement with Developing Countries*, Bonne, June 2015.

10 Peters C., *Developing Countries' Reactions to the G20 / OECD Action Plan on Base Erosion and Profit Shifting*, Bulletin for International Taxation, June / July 2015.

11 No more than 50 holding companies are incorporated in the entire African continent, according to Lermer D., as panelist in 46th IAFEI World Congress, November 2016, *Analyzing the Latest Developments in Base Erosion and Profit Shifting (BEPS)*.

12 WHT in African countries is at least 10% and on top of VAT and custom charges according to Engel K., as panelist in 46th IAFEI World Congress, November 2016, *Analyzing the Latest Developments in Base Erosion and Profit Shifting (BEPS)*.

13 Subcommittee on Base Erosion and Profit Shifting Issues for Developing Countries, Note. Available at: http://www.un.org/esa/ffd/tax/BEPS_note.pdf

Similarly, Actions 8 – 10 are also deemed important to enable proper transfer pricing and taxation of the value actually created within the emerging markets.

Actions Outside the BEPS Project Scope

Nevertheless, of the utmost relevance for emerging economies seem to be actions taken or envisaged beyond the BEPS framework.

The opening of the Convention on Mutual Administrative Assistance in Tax Matters in 2010 for such countries provides a good example[14]. Today 107 jurisdictions are parties to the Convention, including a large number of emerging ones. Setting the framework for enhanced cooperation between the tax authorities of its parties, the Convention enables not only the sharing of information but also cooperation to enforce national tax laws.

To the same effect, the CRS Multilateral Competent Authority Agreement (MCAA)[15] – already signed by 87 jurisdictions – allows information exchange on financial accounts. These instruments have the potential to effectively address the common problem of lack of information in emerging economies[16].

Moreover, remedying the inefficiencies of their tax administrations is the target of an innovative program launched by the OECD in 2015 – namely "Tax Inspectors Without Borders" (TIWB). It shall enable the onsite cooperation between tax experts from advanced countries with tax administrations in emerging ones, allowing effective sharing of expertise and know-how[17].

Other initiatives are more region-specific. For example, in Africa, the African Tax Administration Forum (ATAF) has released a new Model Double Tax Convention, which takes into account the particular characteristics and needs of African countries. It should facilitate the expansion of the tax treaty network of such countries.

Even if the BEPS Project might have less potential for emerging markets in comparison to advanced ones, action is taken to cure the former's deficiencies and respond to their needs.

Working on an equal footing is an essential pre-condition to successfully implement and enforce BEPS recommendations and ultimately attain a fully renovated, equitable and efficient international tax system.

---

14 OECD, Convention on Mutual Administrative Assistance in Tax Matters. Available at: http://www.oecd.org/tax/exchange-of-tax-information/convention-on-mutual-administrative-assistance-in-tax-matters.htm
15 OECD, Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information. Available at: http://www.oecd.org/tax/automatic-exchange/international-framework-for-the-crs/multilateral-competent-authority-agreement.pdf
16 Roeleveld J., *Analyzing the Latest Developments in Base Erosion and Profit Shifting (BEPS)*, 46th IAFEI World Congress, November 2016.
17 OECD, *Launch of Tax Inspectors Without Borders,* July 2015. Available at: http://www.oecd.org/tax/launch-of-tax-inspectors-without-borders.htm

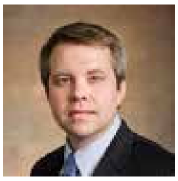
T. Rowe Price®

INVEST WITH CONFIDENCE

PRICE POINT

October 2016

Timely intelligence and analysis for our clients.



Chris Kushlis
Fixed Income Sovereign Analyst, Asian Markets

China

CHINA'S RISING DEBT: WHEN DOES A BUBBLE BECOME TROUBLE?

KEY POINTS

- China's spiraling level of debt is an increasing source of concern. The investment-intensive growth model that has driven spectacular economic gains in China in past decades is no longer working, yet authorities continue to increase debt and investment in pursuit of evermore difficult growth targets.
- The combination of rising debt and slowing growth has pushed China's debt-to-GDP ratio to unprecedented levels. With capital efficiency declining, many believe that China may be facing a full-blown debt crisis.
- However, while China's high debt is concerning, we do not subscribe to the view that a crisis is imminent. Importantly, liquidity risk remains low in our view, with the government ready and able to step in, if required, to ensure that liquidity is maintained.
- While efforts to reduce China's growing debt have been made in recent years, the overriding priority for authorities has been to deliver targeted economic growth. As such, they have been relatively content to allow debt to accumulate in pursuit of this aim. However, there are various measures that authorities can implement to put growth on a more sustainable path and, in turn, work through problem loan issues.

Global markets are growing increasingly nervous about China's spiraling level of debt. Over the past decade, China's investment-driven growth has become increasingly credit funded, and the double-digit results have been quite spectacular. However, in recent years, this formula seems to have stopped working. Despite rapidly rising credit growth in China, the economy continues to stagnate. With cracks in the system beginning to appear, could China be looking over the edge of a potential debt crisis?

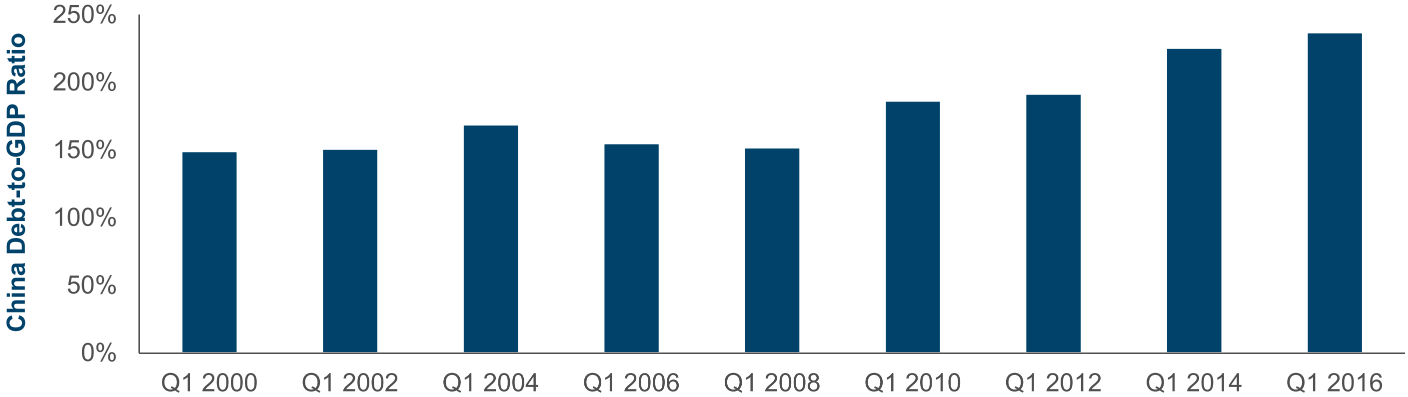
DEBT RATIO HAS RISEN TO UNPRECEDENTED LEVELS

The scale and pace of China's debt buildup in recent years has been breathtaking as authorities have looked to engineer a debt-fueled stimulus to offset weak global export demand. However, the hoped-for turnaround has failed to eventuate and, with China's debt-to-gross domestic product (GDP) ratio rising to unprecedented levels, some are speculating that a full-blown credit crisis is all but unavoidable.

Although we agree that China's high level of debt needs to be addressed, and some tough decisions taken, we do not subscribe to the view that a crisis is imminent. While authorities have generally been content to let debt accumulate in the pursuit of growth, if necessary, they have various measures that can be implemented to ensure that a debt crisis is avoided.

Exactly how China got to this point is largely attributable to two factors. First, in the wake of the global financial crisis in 2008, the government turned on the stimulus taps in order to support growth and, at the same time, ordered banks to lend aggressively. However, once the immediate threat had passed, the taps were never turned off with credit growth essentially rising continuously ever since. The second is the deceleration of the Chinese economy. GDP growth in China is decelerating as the economy becomes more mature and returns on past investments decline. The government's response to this has been to throw more and more money at the problem, with limited results. The combination of these two factors has seen China's debt-to-GDP ratio balloon to almost 250%,[1] raising fears of an impending crisis.

Figure 1: **The rise and rise of China's debt**



Sources: Bank of International Settlements, PBOC, and IMF, as of March 31, 2016.

LIQUIDITY RISK APPEARS LOW

It must be remembered that China's economy is not like most others. China has huge foreign currency reserves, a strong balance of payments position, and a low level of external debt. China also boasts one of the world's highest savings rates. The fact that China is still a relatively closed system, with administrative barriers limiting the free outflow of capital, is also significant. As long as a degree of control over capital outflows is maintained, policymakers will have the flexibility to bail out companies and individuals where necessary, thereby preventing a potential run on the system. If you consider what has triggered financial crises in the past, it has most often come down to issues of liquidity, not solvency. If the central bank can ensure ongoing liquidity, then the risk of a financial crisis is modest in our view.

HOWEVER, CAPITAL EFFICIENCY IS FALLING

In analyzing China's debt, it is clear that the real area of concern is the corporate sector, where ever-rising leverage is coupled with a declining capacity to pay. Nonfinancial corporates have seen a sharp rise in leverage in recent years, particularly within industries plagued by excess capacity, such as construction and property development, and in the commodity and energy sectors. As leverage continues to rise, these companies are borrowing more just to cover their debt obligations, some of the worst offenders being large state-owned enterprises, many of which are unproductive or failing. The result is a vicious economic circle, with increasing

[1]Bank of International Settlements, as of March 31, 2016.

amounts of capital being allocated to the most inefficient borrowers, which inevitably leads to lower productivity and growth. Consequently, despite credit expanding at a rapid rate, its contribution to new growth-generative investment is diminishing. Capital efficiency in China is clearly declining, and if there is any prospect of this situation being reversed, the government cannot continue to shore up these struggling enterprises. Clearly, reform of some kind is necessary, be it consolidation, mergers, or allowing them to fail.

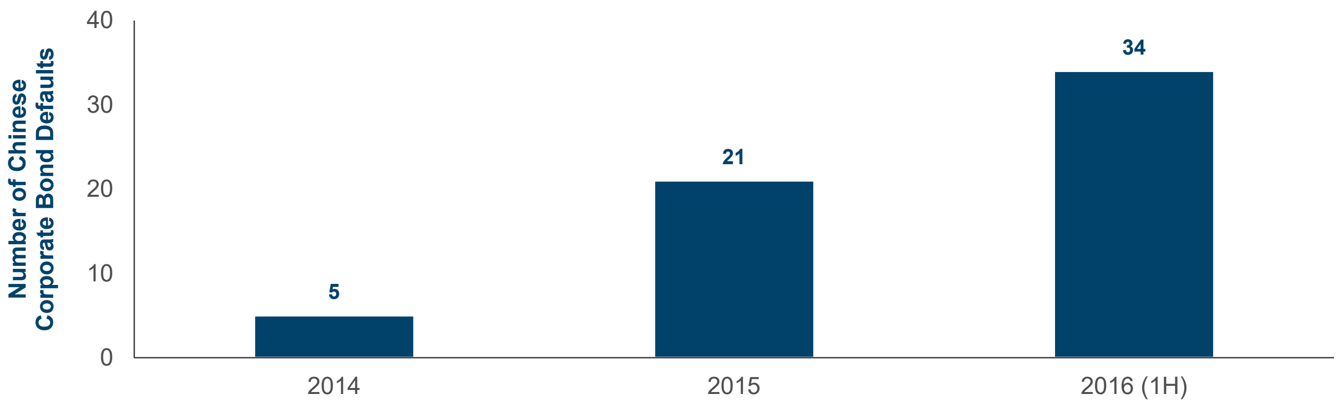
TACKLING THE DEBT PROBLEM

While Chinese authorities acknowledge the financial risks associated with the country's growing debt stockpile, they remain reluctant to aggressively tackle the problem, given the negative implications for growth. What we have seen instead is a stop/start pattern: The government tries to contain credit growth, causing economic growth to threaten to fall below the official target. This alarms authorities, so they engineer a loosening of policy to jump-start growth again. Nevertheless, authorities have various tools that they can draw upon to try and rein in spiraling debt. Some of the measures currently being tested are detailed below, along with our view on their likely effectiveness.

1. Recapitalizing China's banks

The most effective means of addressing China's debt problem, but also the most economically painful in the near term, is for the government to recapitalize the banking sector. Bad loans to state-owned enterprises are rising at a rapid pace, putting increasing pressure on the banking system. However, while instances of the government providing support to individual banks are rising, a widespread recapitalization of China's banking system is unlikely anytime soon, given the negative implications for the economy. While few doubt that a state-funded recapitalization would put China's banking system on a sounder footing, most also believe that any such action would only be a partial solution if the underlying causes of the original bad lending were not addressed. In the past, Chinese lenders have also relied heavily on government-controlled asset management companies (AMCs) to buy up nonperforming loans, often at face value. However, in recent years the level of bad loans, many of them from failing state-owned enterprises—so-called zombie companies—has exceeded what the AMCs are able to absorb (See Figure 2).

Figure 2: **Chinese corporate bond defaults are rising**



Source: Wind Analysis, as of June 30, 2016.

2. Securitizing loans/debt-to-equity swaps

Securitizing nonperforming loans is another option that authorities are testing. In 2016, the securitized debt market in China reopened, some eight years after being shut down by regulators. Pooling nonperforming loans and selling them as securities is certainly an effective strategy in the short term, allowing companies to rid the debt from their balance sheets. Chinese banks, for example, are under constant pressure to dispose of distressed/at-risk debt. However, the longer-term implications are harder to gauge. Given that a lot of the bad loans in question come from struggling state-owned enterprises in distressed industries, it is arguable that these companies should be allowed to go bust rather than be propped up by securitization of bad loans. Moreover, a lack of transparency means that it is difficult to accurately assess the risks associated with these securities, leading to potential problems down the road.

Chinese authorities have also singled out debt-for-equity swaps as a way to reduce corporate leverage. The proposed exchange would allow China's commercial banks to swap the debt they hold in underperforming companies for stock holdings. Such an arrangement would help cut banks' debt levels and lessen their capital reserve requirements. However, many see such debt-for-equity swaps as a bad deal for banks, effectively swapping bad loans in zombie companies for bad equity in those same companies. The equity stock will have little value given the zombie companies will not pay dividends, the equity will not be attractive to buyers, and capital charges are high for bank equity holdings. Once again, this means the least productive companies are being propped up rather than being allowed to fail. This does not make for an efficient capital market.

3. Evergreening loans

Chinese authorities have so far shown little inclination to make the hard decisions that will lead to tangible improvement in China's debt situation. What we continue to see are measures that, instead of dealing with the problem, simply push it down the road. A prime example of this is the practice of "evergreening" loans. Rather than cutting off lending to troubled companies or penalizing them for defaults, banks are instead being directed to extend these problem loans, or provide new ones, in order to support the companies in question. Increasingly, we are seeing instances of companies defaulting on payments and nothing happens, with the owed interest and capital possibly being paid at some point in the future. This evergreening of loans once again allows unprofitable companies to remain afloat, which keeps excess capacity high and contributes to falling prices. The practice also impacts the profitability of China's banks and is a contributing factor in the rise in banks' nonperforming loans seen in recent years.

ISSUES OF TRANSPARENCY

While signs of stress in China's system are evident, the opaque nature of official data makes it very difficult to assess just how serious the problems might be. Manipulation and misrepresentation by authorities is an ongoing problem and makes any official data unreliable. The China Banking Regulatory Commission, for example, recently announced that the ratio of nonperforming loans within China's commercial banking sector rose to 1.81% in the second quarter of 2016. Despite this being the highest level since the global financial crisis, it is still widely regarded as significantly understating the actual level of nonperforming loans in China, with some observers placing the true figure as high as 20%.

CHINA'S SHADOW BANKING SYSTEM—MIRACLE OR MENACE?

At least some of the potential discrepancy between official and actual nonperforming loan data, for example, can be attributed to the increasing amount of lending being carried out on China's shadow banking system, much of which is simply not captured in official data. The shadow banking system—an intermediary network actively lending under the official radar—emerged in direct response to companies and individuals looking for more informal and flexible financing options, outside of official channels. The system flourished, in part, because the traditional banks also saw benefits in evading capital requirements and charging higher fees. The authorities initially took a tolerant view, seeing it as a form of financial innovation and a means of broadening China's financial system. However, over time the investment structures have become increasingly complex and opaque, with growing instances of bad loans and increasing levels of risk.

Claims that the shadow banking network is a serious structural threat to China's financial system seem extreme. While concerns about transparency and regulation are valid, nonbank financing offers an additional source of credit to individuals and businesses in an environment where formal banking is either expensive or absent. Prior to the development of shadow banking, China's financial system was dominated by a handful of large state-owned banks supported by a network of provincial banks. These banks were discouraged from lending to certain industries and mandated to offer frustratingly low interest rates on deposits. The initial function of the shadow banking sector in China was to provide investors with an alternative to the banks for deposits. In this way, it is important to distinguish between the type of shadow banking that genuinely represents a broadening of financial alternatives (money market-like funds, the development of a corporate bond market, private lending) and that which is designed to deliberately evade regulations—either to hide bad loans or engage in aggressively speculative activity.

China faces a challenging period ahead. Despite the best efforts of policymakers, economic growth continues to generally disappoint. China's debt burden has already risen well beyond prudent levels as authorities continue to chase seemingly unrealistic growth targets. Financial pressures are rising, and this will inevitably impact longer-term growth prospects. Clearly, there are some hard decisions that authorities need to make over the coming years in order to address China’s spiraling debt problem. While periodic attempts have been made, and some measures implemented, reform on a larger scale is necessary at some stage. However, for now, the negative implications for growth make this an unpalatable option for Chinese decision makers. Despite the high level of debt, we believe that warnings of an imminent crisis are overdone as authorities have the means and the will to ensure such a scenario is avoided. In our view, it is more likely that China will continue to maintain a high level of debt, muddling through over the coming years, with growth slowly declining over an extended period.

Important Information

This material, including any statements, information, data and content contained within it and any materials, information, images, links, graphics or recording provided in conjunction with this material are being furnished by T. Rowe Price for general informational purposes only. The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price. The material does not constitute a distribution, an offer, an invitation, recommendation or solicitation to sell or buy any securities in any jurisdiction. The material has not been reviewed by any regulatory authority in any jurisdiction. The material does not constitute advice of any nature and prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. Past performance is not a reliable indicator of future performance. The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The views contained herein are as of October 2016 and may have changed since that time.

Australia—Issued in Australia by T. Rowe Price International Ltd. (ABN 84 104 852 191), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. T. Rowe Price International Ltd. is exempt from the requirement to hold an Australian financial services licence in respect of the financial services it provides in Australia. T. Rowe Price International Ltd. is authorised and regulated by the UK Financial Conduct Authority under UK laws, which differ from Australian laws. For Wholesale Clients only.

Canada—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

DIFC—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd. by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

EEA—Issued in the European Economic Area by T. Rowe Price International Ltd., 60 Queen Victoria Street, London EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

Hong Kong—Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 21/F, Jardine House, 1 Connaught Place, Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

Japan—Issued in Japan by T. Rowe Price International Ltd., Tokyo Branch (KLFB Registration No. 445 (Financial Instruments Service Provider), JIAA Membership No. 011-01162), located at GranTokyo South Tower 7F, 9-2, Marunouchi 1-chome, Chiyoda-ku, Tokyo 100-6607. This material is intended for use by Professional Investors only and may not be disseminated without the prior approval of T. Rowe Price International Ltd., Tokyo Branch.

Singapore—Issued in Singapore by T. Rowe Price Singapore Private Ltd., No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

Switzerland—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH ("TRPSWISS"), Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

USA—Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

2016-GL-4900

10/16

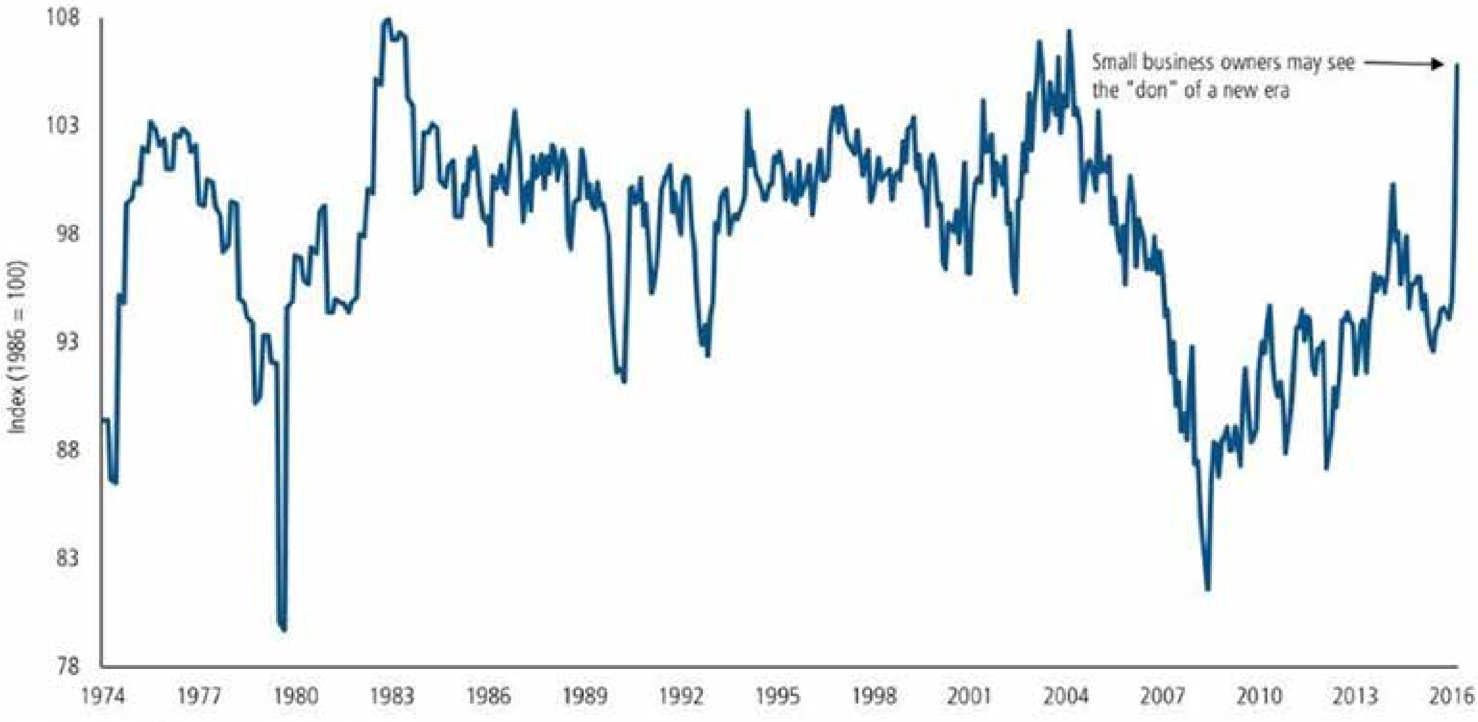
CHART OF THE WEEK

Payden&Rygel
Investment Management

"Don" of a New Era?

NFIB Small Business Optimism Index

For The Week Ending 01/13/17



Source: National Federation of Independent Business

An index of US business optimism compiled by the National Federation of Independent Business (NFIB) skyrocketed in December. The index's one-month increase was the best since 1980. As a result, small business optimism is at its highest level since 2004—a sign that John Maynard Keynes's famous "animal spirits" may once again stir in the hearts of American business owners. The index hovered in depressed territory for much of the last decade. Whether good feelings translate into a real increase in capital spending and hiring remains to be seen—much depends on the mix of fiscal and regulatory changes put forth by the incoming administration. Historically, business profits tell us more about future capex than sentiment alone. If profits pick up, investment should follow.

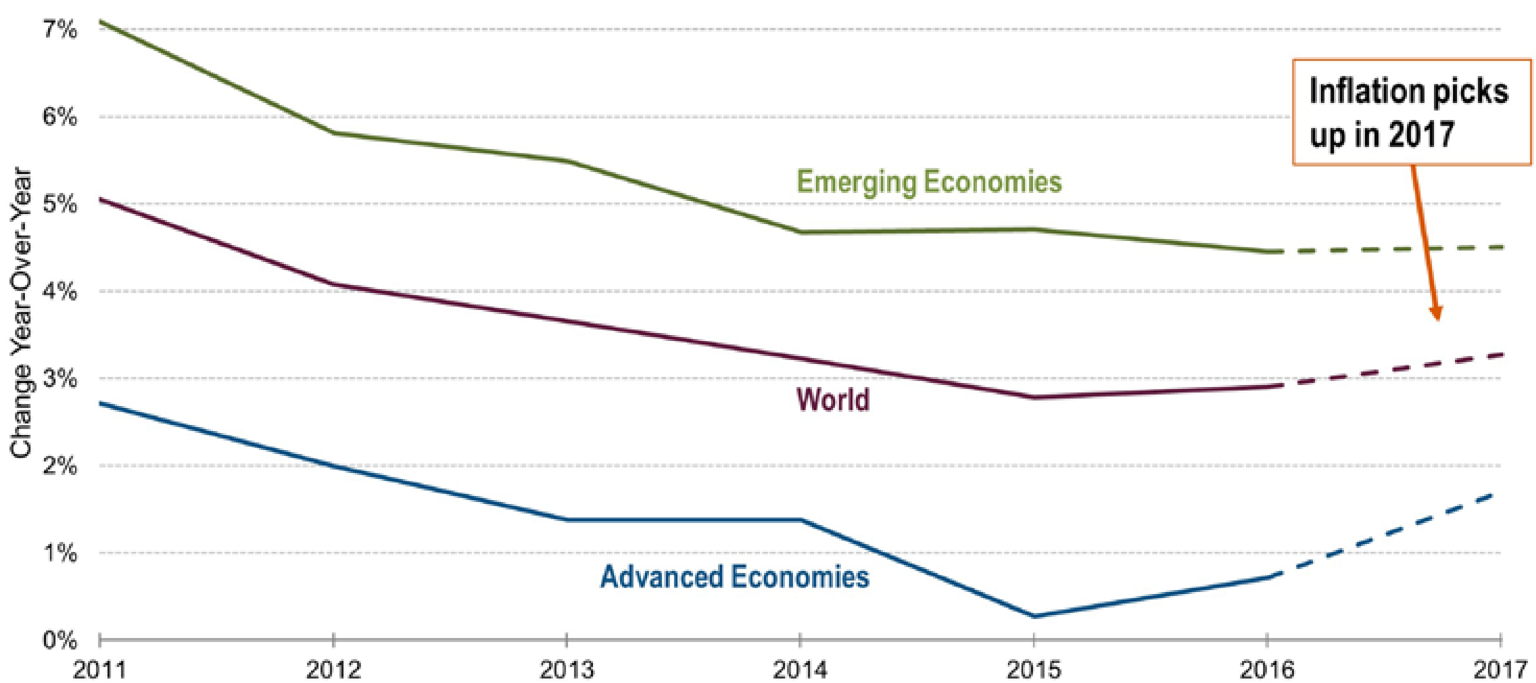
CHART OF THE WEEK

Payden&Rygel
Investment Management

Inflated Optimism?

Consumer Price Indices in Regions Around the World

For The Week Ending 1/20/17



From 2011 to 2015, the world inflation rate fell year after year. By 2016, the world was abuzz with deflation mania, fearing a further decline in the rate of inflation. Instead, as commodity prices recovered and global growth found its footing, consumer prices actually perked up in 2016. For 2017, there is reason to believe the deflation fear may be behind us, as updated forecasts released by the International Monetary Fund (IMF) this week show an expected annual pick-up in prices for the second time in the last five years.

Some pictures from 46th IAFEI World Congress

Some pictures from
46th IAFEI World Congress

Some pictures from
46th IAFEI World Congress

IAFEI MEMBER INSTITUTES

ARGENTINA	Instituto Argentino de Ejecutivos de Finanzas
BELGIUM	Financial Executives Institute of Belgium
BRAZIL	Instituto Brasileiro de Executivos de Finanças
CHINA	China Association of Chief Financial Officers
CHINESE TAIWAN	Financial Executives Institute of Chinese Taiwan
FRANCE	Association Nationale des Directeurs Financiers et de Contrôle de Gestion
GERMANY	Gesellschaft für Finanzwirtschaft in der Unternehmensführung e.V.
GREECE	Ellenic Institute of Financial Management
INDONESIA	Indonesia Financial Executive Association
ITALY	Associazione Nazionale Direttori Amministrativi e Finanziari
JAPAN	Japan Association for Chief Financial Officers
MOROCCO	Association Marocaine des Métiers de la Finance et de la Gestion
MEXICO	Instituto Mexicano de Ejecutivos de Finanzas
PHILIPPINES	Financial Executives Institute of the Philippines
POLAND	Stowarzyszenie Dyrektorów Finansowych
PORTUGAL	Portuguese Association of Financial Executives
RUSSIA	Russian Club of Financial Directors
SOUTH AFRICA	Southern African Institute for Business Accountant
TUNISIA	Association Tunisienne des Contrôleurs de Gestion et des Responsables Financiers
VIETNAM	Vietnam Chief Financial Officers Club

IAFEI SECRETARIAT

Corso Genova, 6
20123 Milan - Italy
Email: secretariat@iafei.org
Telephone Number: +39 02 83242288
Fax Number: +39 02 58118093