IAFEI Quarterly

39th Issue
2018 January

Digital Currency Increasing CFO Attention
Consumers, particularly Millennials, are increasingly preferring companies that accept bitcoin

CFO Global Survey
Optimism remains strong but CFO struggle with work/life balance

EU Black List, a New Perspective on Tax Havens
One more step in the worldwide fight against tax avoidance and evasion

INTERNATIONAL ASSOCIATION OF FINANCIAL EXECUTIVES INSTITUTES

LETTER OF THE CHAIRMAN

Dear Colleagues,

all indicators show that the worldwide economy is improving and it seems we are finally out of the period of the global crisis of 2008.

Employment grows, stock market values reached their all-time high, commodities are generally increasing and, after many years, finally we start to talk again of inflation and interest rates growth.

There are still some international political tensions that cause concern and still have consequences on transactions and international trade. In this context, the CFO must take advantage of the experience gained in the last few years and support the company activity with competence and safely.

The new year will bring significant changes for IAFEI. In fact, we are starting some partnerships with important companies at a global level to enrich the contents offer in favour of the all Institutes members, and the over 20,000 CFOs associated in the world.

Shortly, the new website will be launched for improving our Association image. During the year, the renewal of the logo will also be finalized, with a more modern and readable brand.

We are very confident about the outcome of these initiatives that, together with the ones already launched, have the main objective to increase the IAFEI value proposition and the relative image for improving the number of member Institutes and our global influence.

I wish to all of you a 2018 full of serenity and professional successes.

Yours sincerely

Fausto Cosi
IAFEI Chairman

LETTER OF THE CHIEF EDITOR

Dear Financial Executive,

You receive the ***IAFEI Quarterly XXXIX th 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 associations.

This issue is the ninths 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 10 IAFEI representatives from all continents.

The IAFEI Global CFO Survey Quarter 4, 2017, included in this issue, reports that optimism remains strong, but CFOs struggle with work/ life balance. Their firms are conscious of the rapid change of innovation. Tight labour markets are a top concern.

More IAFEI member associations should contribute articles.

Therefore I repeat our ongoing invitation, to all IAFEI member associations, and to each of their individual members, to send us articles for inclusion in future IAFEI Quarterlies,

With best personal regards

Helmut Schnabel
Chief Editor

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"SURVEY OF CFOs ACROSS THE WORLD FOR THE 4TH QUARTER 2017"

OPTIMISM REMAINS STRONG BUT CFOS STRUGGLE WITH WORK/LIFE BALANCE

IAFEI AND A GROUP OF PARTNERS AMONG WHICH DUKE UNIVERSITY, USA, AND GRENOBLE ECOLE DE MANAGEMENT, FRANCE, SURVEY CFOS ACROSS THE WORLD. FOR THE FOURTH QUARTER 2017, THE SURVEY WAS RUNNING FROM 22ND NOVEMBER TO 8TH DECEMBER 2017.

- CFOs spend two-thirds of their waking hours working and would prefer to be working only half the time, according to a new survey.

- The survey also finds that the difficulty companies are having hiring and retaining qualified employees is at a 20-year high.

Work-life balance

The survey suggests finance chiefs work nearly 70 hours per weekly. At the same time, the CFOs say the ideal work-life balance would involve working closer to 50 hours per week. The preference to work fewer hours is pervasive, regardless of the current number of hours worked. Most CFOs who currently work 80 hours per week would prefer to work between 50 and 60, while CFOs who currently work 50 hours would prefer to work 40 or fewer. The role of the CFO has widened over the last two decades. CFOs are accountable for the bottom line as well as helping shape corporate strategy. One hopes that finance chiefs are not overworking themselves to the point of jeopardizing their health, which in turn could put the financial health of the company at risk.

These trends hold across industries and around the world. The typical Asian CFO works 73 percent of his or her waking hours, slightly higher than CFOs in Europe (72), Africa (70), and Latin America (69). CFOs from all regions indicate that they would prefer to work about 20 percent fewer waking hours per week.

Current work-life balance in % per day

Country	CURRENT work-life balance
Germany	75.65
France	73.91
China	73.75
Netherland	73.75
Japan	72.86
Singapore	72.86
Italy	70.83
Brazil	70.76
South Africa	70.74
Mexico	70
Australia	70
Spain	68.75
Chile	68.06
Peru	67.22
US	66.89
Canada	66.06
Nigeria	65
UK	63.08

Continent	CURRENT work-life balance
Asia	72.63
Europe	71.55
Africa	69.81
Latam	69.48
US	66.89
Canada	66.06

US Industry	CURRENT work-life balance
Energy	76.25
Communications/Media Media	73.33
Manufacture	69.18
Banking	68.53
Transportation/Pub Util	67.78
Tech Soft Hardware/Bio Bio	67.14
Healthcare/Pharm	66.67
Mining/Construction	66.36
Admin	64
Retail/Wholesale	63.45
Service/Consulting	61.89

Rapid pace of innovation

Sixty-two percent of the US CFOs indicate that the pace of innovation at their firms has grown faster in the past three years. Among these companies, 63 percent indicate that the rapid pace of change has caused their firms to focus more on the near-term and 40 percent say that they now choose projects with shorter lives. Given the acceleration in innovation, firms don't want to be shackled by longer-term investments, especially in technology that can quickly become obsolete. You expect companies to pivot, and shorter-term projects allow for flexibility and speed.

Among these firms, 76 percent indicate that their capital spending has increased as a result of more rapid innovation. Forty-six percent say they have increased research and development in response, with 31 percent saying they will tackle ambitious "moon-shot" projects.

Tight labor market, Top Concerns

The proportion of firms indicating that they are having difficulty hiring and retaining qualified employees is at a two-decade high, with 43 percent of CFOs calling it a top concern. The median U.S. firm says that it plans to increase employment by about 2 percent in 2018. Due in part to the tight labor market, U.S. companies expect to pay higher wages, with median wage growth of about 3 percent over the next 12 months. Wage growth should be strongest in the tech, energy, and retail/wholesale industries.

After the labor market, the next largest concern among US CFOs is the cost of benefits, with health care costs expected to rise by more than 8 percent next year. Nearly half of US companies indicate that the cost of employee health benefits crowds out their ability to spend on long-term corporate investment. Data security issues rose to 3rd on the list of top concerns, its highest ranking ever.

Optimism Remains Strong all over the world

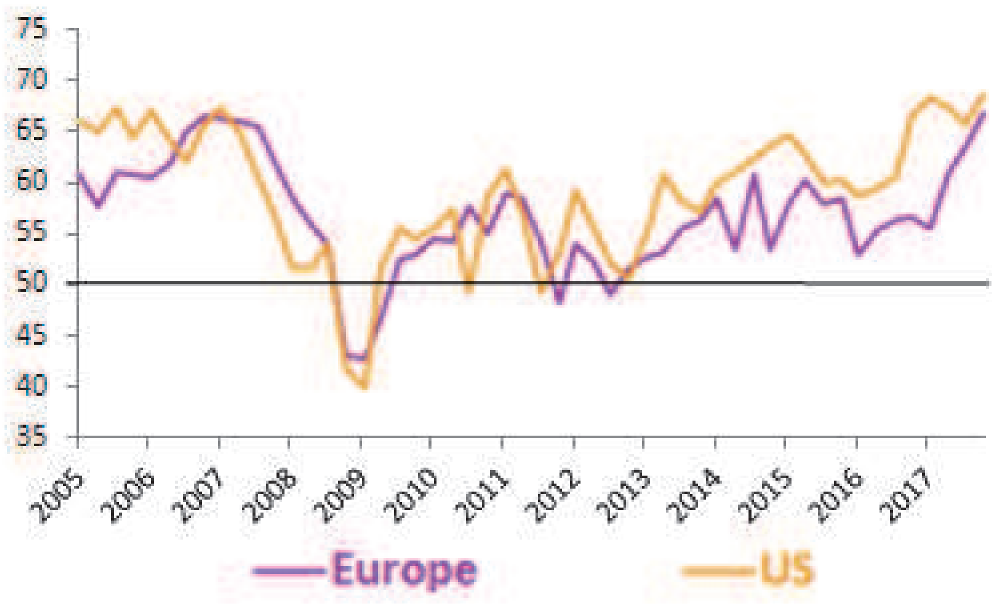
North America

The Optimism Index in the **US** increased jumped to 69 on a 100-point scale this quarter. Among CFOs who responded to the survey after the Senate passed their version of the tax reform bill, optimism spiked to 73, which is the highest U.S. optimism ever recorded in the history of the survey. The extremely high level of business optimism is tied to the long-awaited corporate tax reform currently moving through Congress. More broadly, optimism is up around the world. Our analysis of past results shows the CFO Optimism Index is an accurate predictor of future economic growth and hiring, therefore 2018 looks to be a very promising year for the world economy. In **Canada,** optimism remains strong at 64. Capital spending should increase by about 4 percent and employment by about 2 percent in 2018.

Europe

Optimism in Europe jumped to 67 this quarter, the highest level in a dozen years. The **UK** has the lowest optimism among responding European countries, at 58. Capital spending is expected to grow 4.8 percent in 2018, and median employment should grow 1 percent. For the second consecutive quarter, and only the second time ever, the top concern among European CFOs is attracting and retaining qualified employees, followed by regulatory requirements, government policies, and data security. Nearly 60 percent of European companies say that the pace of change and innovation has quickened in the past three years. Of these companies, three-fourths indicate that they have increased capital spending in response, and nearly two-thirds have increased R&D. Fifty-five percent of European CFOs say their firms focus more on the early years of the planning horizon due to the fast pace of innovation. Less than one-third indicate that they now require a shorter payback period or have shortened the horizon of their investments, the smallest percentage in the world.

CFO survey: Optimism index



Asia

Optimism is also strong in Asia, at 66. Difficulty attracting employees, economic uncertainty, and regulation and government policies are top concerns. Median 5 percent growth in capital spending and 2 percent employment growth are expected in 2018. Nearly three-fourths of Asian firms indicate that the pace of innovation has quickened over the past three years. Among these firms, 71 percent say they have increased capital spending in response, 65 percent have increased R&D spending, and 56 percent have increased moonshot projects. 86 percent of Asian firms indicate that the fast pace of change has led them to focus more on the early years in their planning horizons, and 55 percent have formally reduced the length of their long-range plan. Forty-three percent of companies indicate that spending on shorter-term projects has crowded out spending on long-term projects, and 43 percent say that regulations stifle long-range spending.

Latin America

Latin American optimism continues to rebound in most countries, up to 73 in **Mexico**, 71 in **Peru,** and 61 in **Brazil**. In stark contrast, optimism is only 28 in **Ecuador**. Economic uncertainty is the top concern among Latin American CFOs, with 62 percent of firms listing it as a top four concern. They are also concerned about governmental policies, weak demand, and productivity. Median capital spending growth will be 5 percent, while median employment will be flat in 2018. Sixty-three percent of Latin American CFOs indicate that the pace of innovation has increased in the past three years. Among these firms, two-thirds have increased capital spending and 52 percent have increased R&D in response, and 40 percent have increased spending on moonshot projects. Sixty-five percent of Latin firms indicate that the fast pace of change has led them to focus more on the early years of their planning horizons, and 55 percent have formally reduced the length of their long-range plan. Corporate taxes and regulations are the two factors that most hinder long-term spending in Latin America.

Africa

Business optimism in Africa increased 1 point to 53 this quarter, still the lowest in the world. Capital spending (employment) should increase by about 1 percent (3 percent) in 2018. The biggest concerns for African CFOs are economic uncertainty, governmental policies, and currency risk. Seventy-one percent of African CFOs say that the pace of innovation has quickened, and among these firms 85 percent say they have increased capital spending in response and 62 percent have increased R&D. Nearly two-thirds of African companies indicate that the rapid pace of change has led their firms to focus more on the short-term. Fifty-five percent say that adhering to regulations crowds out long-term corporate investment.

Table 1: During the past quarter, which items have been the most pressing concerns for your company's top management team?

	Europe	Latin America	Asia	U.S.A.
Economic uncertainty	**28.6**	**61.6**	**34.6**	**22.4**
Currency risk	19.0	16.7	20.3	4.2
Weak demand	18.4	37.7	19.6	13.5
Government policies	29.3	52.9	29.9	29.3
Access to capital	12.9	18.1	18.2	17.0
Regulatory Requirements	30.6	23.9	26.6	28.6
Difficulty attracting / retaining qualified employees	**42.9**	**13.0**	**33.9**	**42.9**
Employee productivity	17.7	25.4	23.0	25.9
Rising wages and salaries	10.2	4.3	11.6	19.7
Employee morale	13.6	8.7	15.7	17.0
Cost of borrowing	4.8	13.8	10.1	6.9
Data security	**29.3**	**5.1**	**15.8**	**31.7**
Geopolitical / health crises	13.6	5.1	6.9	5.4
Deflation	0.7	0.7	2.5	0.0
Rising input or commodity costs	12.2	14.5	17.0	10.0
Cost of benefits	10.9	15.9	10.6	33.6
Corporate tax code	7.5	21.7	8.4	20.5
Inflation	0.7	3.6	8.1	3.1
Other	9.5	6.5	12.1	6.2

Table 2: Relative to the previous 12 months, what will be your company's PERCENTAGE CHANGE during the next 12 months? (mean by region)

	Europe	Latin America	Asia	U.S.A.
Revenue	**5.6**	**7.0**	**6.6**	**5.9**
Inflation (Change in prices of own-firm products)	1.1	3.1	3.1	2.7
Capital spending	**4.8**	**4.5**	**8.0**	**3.2**
Technology spending	**3.0**	**4.3**	**6.3**	**4.8**
R&D spending	6.3	3.2	3.6	3.3
Advertising and marketing spending	0.9	4.0	2.8	3.0
Employment – full-time	3.9	0.4	0.7	3.2
Wages and Salaries	2.6	3.5	1.1	4.4
Health Care Costs	1.3	5.0	2.2	8.3
Earnings growth	3.5	11.2	4.0	6.5

About the survey: The survey has been conducted for 87 consecutive quarters and spans the globe, making it the world's longest-running and most comprehensive research on senior finance executives. This quarter, more than 800 CFOs responded to the survey including nearly 300 from North America, nearly 100 from Asia, 148 from Europe, 215 from Latin America and 55 from Africa.

DIGITAL CURRENCY INCREASING CFO'S ATTENTION

by **LUIZ ROBERTO CALADO**, VICE-PRESIDENT AT BRAZILIAN INSTITUTE OF FINANCIAL EXECUTIVES (IBEF-SP) AND CHIEF-ECONOMIST AT MERCADO BITCOIN, LARGEST DIGITAL CURRENCY EXCHANGE IN LATIN AMERICA, ARTICLE PROVIDED BY IBEF, INSTITUTO BRAZILIERO DE EXECUTIVOS DE FINANZAS, THE BRAZILIAN IAFEI MEMBER INSTITUTE

The year is 2008, the world is facing its latest financial crisis, and in the very same year something new is being created: bitcoin. Fast forward to 2017, the year when this particular digital soared more than 1500%, and chances are that if you use the internet, you've heard of bitcoin. But the first fully decentralized digital currency is just one of the numerous cryptocurrencies created over recent years, other examples being Litecoin, Ethereum and Ripple.

A number of companies are starting to accept payments in this digital currency, thus increasing the CFO's interest on this matter. As a sign of this, even real estate developers have started accepting it in some countries, though it is fair to assume they will convert it to traditional currency due to cash management reasons.

Financial professionals try to reduce uncertainty, so when a currency has volatility that pales that of traditional currencies, the challenge is bigger. How to predict the exchange rate of bitcoin in November 2018, for example? A tough challenge on unregulated markets, the good news is two big exchanges (CME Group Inc and Cboe Global Markets Inc) are now trading futures on Bitcoin, and Nasdaq already announced it will do the same sometime in 2018. Being traded in regulated markets allow institutional investors and companies to participate.

Although one should note that there is liquidity only for the three first maturities of the future contracts, much because the Bitcoin prices are still unpredictable for any longer term.

“Banking the unbanked”

In Brazil, where I live, the perspectives are great. Tens of millions inhabitants do not even have a Banking account, so they are not able to participate in a lot of initiatives in the internet, paying for goods or services available online. Bitcoin could be a solution for this scenario, allowing even those that do not have a banking account to pay throug the internet environment.

On the other side, legislation in Brazil prohibits the merchants to have different prices depending on how you decide to pay: in other words, if your consumer pays by credit, your product or service must cost the same as if it was payed using money bills. For merchants and clients, the situation in unfair, since there is a cost to accept payment on credit and debit cards. Bitcoin could benefit both sides, since the cost is lower. I know the situation is the same in some countries.

Consumers, particularly Millennials, are increasingly preferring companies that accept bitcoin. They can choose where to spend their money, and they are increasingly opting to make their purchases if bitcoins are accepted.

Shares rocketed after blockchain announcement

Kodak shares announced using the blockchain on January, and its stock rocketed 44% on the news. Other small-cap companies — Rich Cigars to Long Island Ice Tea — when, somehow, they also managed to embrace digital currency during the past few months.

Millenials’ survey on Bitcoins

A survey conducted Blockchain Capital, 70% of the 10,000 millennials who were polled claimed that they are not content with the bank’s interest rates and 65% said that their money is safer in Bitcoin because they personally control it.
Other highlights of the survey slightly less than 50% of the millennials surveyed said that they are also looking for a more convenient form of banking and 45% stated that they want their banks to integrate Bitcoin wallets in their operation so that they can directly invest in digital currencies through their existing bank accounts.

Probably we are going to see more regulation on bitcoin. Japan went ahead allowing the use of Bitcoin. The country, traditionally regarded as conservative, appears to be opening its mind on financial innovation. And countries are increasingly investing on image to attract investors and companies. As a Brazilian, bearing in mind that the country spent billions of USD bringing in the World Cup (2014) and the Olympic Games (2016), I would be more than satisfied seeing in the news that my country now understands and accepts bitcoin. I wish I could have more data to compare and show my point, comparing that allowing payments in Bitcoin in one country costs much less than bringing world class events, and in the end, you will not have a lot of empty arenas …

Japan – more than 10 exchanges have government approval to operate digital coins
in Japan and Bitcoin is considered a Legal Tender by law: accepted by merchants.

Some people do not understand and destabilize the market

JPMorgan chief executive Jamie Dimon said at a conference

“The currency isn’t going to work. You can’t have a business where people can invent a currency out of thin air and think that people who are buying it are really smart”.

It is fair to assume he later regretted having called bitcoin a “fraud”. The buzz generated by Dimon’s comments spurred more interest in the digital currency. Bitcoin rose around 35 per cent in one month following Dimon’s speech.

According to the Wall Street Journal, EY was the first audit firm to accept Bitcoin on its office in Switzerland, and PwC was the second, after announcing its acceptance in Hong Kong.

There are still challenges for companies to accept bitcoins on their products or services. I have no doubt that it could be one of the next big things for CFOs for the short term. Understanding the pros and cons in using bitcoin would be a priority.

More about digital currency

A digital currency is a type of virtual or digital currency, an example of which is bitcoin. Unlike a fiat currency, which derives its value from an authority of law recognising it as a legal tender, a digital currency derives its value from the relationship between supply and demand of such currency (depending on the price participants are willing to trade for them). As a consequence, these currencies are highly volatile by nature.

They are designed as peer-to-peer payments network which acts as a 'distributed public ledger' (essentially being data spread heterogeneously across data centres arround the world), a platform for using and trading the digital currency without relying on financial intermediaries. In the jargon these public ledgers are more commonly referred to as 'blockchains'. These blockchains are used to verify transactions, with the order and authenticity of each blockchain strictly encrypted for securing the anonymity of the transactions.

Governments and central banks across the world control the supply of their currencies in the form of physical banknotes or by backing other financial institutions which hold asset value measured in it. A cryptocurrency in general and bitcoin in particular, can be obtained by a user in three ways (i) mining (i.e. process of discovering or creating new cryptocurrencies); (ii) purchases on an exchange; and (iii) as a consideration for goods and services.

Critics of digital currencies raise concerns of potential misuse being a direct consequence of the anonymity associated with transactions involving digital currencies. Since these transactions are independent from formal banking systems, with: (i)no legal, central authority monitoring these transactions; and (ii) no possible means of enforcing self-reporting by recipients to established revenue / tax authorities, these transactions can be used for tax evasion and money laundering.

WHAT IS IMPORTANT TO KNOW OR TO UNDERSTAND WHILE WORKING IN FRANCE?

BY **GEOFFROY DE LASSUS**, FORMER INTERNATIONAL BANKER AND WRITER
ARTICLE PROVIDED BY **DFCG**, THE FRENCH IAFEI MEMBER ASSOCIATION

We know this famous sentence "Every man has two countries - his own and France", and indeed France is a specific country and a specific culture. However, for foreigners working in France, French people, in their way of working, are surprising and not always easy to understand. In this article, the author explains the main roots of the French mindset and the French behaviour.

What a fantastic country France is: country which made the Revolution, country of the Decla-ration of the Rights of Man and of the Citizen, a country which guillotined its last king but isorganized like a Republican monarchy, a centralized country, country of literature, country of the equality but elitist at the same time, country which likes new technologies, country which has a superiority complex, country of fashion, gastronomy, arts, romance, country of cheese and wine… and so on.
But what are the genuine roots of the French society, the French mind, and the French behav-iour? I see five important roots which explain not all, but many things: Education, he top-down organisation model, The Cartesian system, the importance of words and culture.

Education

As in many countries, education is very important in France. French educational system used to be one of the best in the world, and is frequently described as a system producing French elites. This system is not based on accumulation of knowledge, but focused on analysis, syn-thesis, general culture, and judgment. But this system is also based on individual competition. Competition is hard, and the stakes are high, as many things will depend on the diploma you get.

One consequence of this system is the importance of the diploma. Very often, the diploma will determine the salary. Beyond that, the diploma you get is a kind of stamp you will keep for many years. As you know, we have the system of grandes écoles in France which is im-portant. In the public sphere, it's not by chance that the majority of ministers graduated from the ENA.

Given the competition to get the best diploma, there is a hierarchy between the diplomas. Someone who graduated from ENA will feel himself superior to someone graduated from HEC.

Another interesting result of this educational system is the autonomy, or to put it more pre-cisely, is the individuality. In our educational system we are not requested to do team work-ing. Working alone, in fact, comes from the French educational system, which from the early years of primary school instructs children to work by themselves and even against others competitively. This has consequences in the working environment, and this is a real weakness.

From the top-down France organisation model to the Hierarchy

The French hierarchical system goes far beyond the business world. It's linked with France history. For many centuries, kings ruled France. During the French Revolution, monarchy was abolished and Louis XVI guillotined. But, we created the Republic, which is, since de Gaulle, a kind of Republican Monarchy. Our President, according to the French Constitution, has many powers. And his legitimacy derives from the universal suffrage.

In France, hierarchy is respected, not only be-cause it has the power, but also simply because it is an integral part of our history.

Unlike most of the other European countries, the French President is the real chief of the executive and is not dependant on the Parliament. We have guillotined Louis XVI, but when there are extraordinary meetings of the Parliament (National Assembly and Senate), they are held in Château de Versailles…

France, as a territory and as a nation, is organized and centralised. Centralisation means that central power is in Paris. This is not new. Regarding the territory organisation, we still live on the legacy of Napoleon, who created the French départements. So, we have Paris, the region with departments, and the small cities and villages.

So, the French organisation model is clearly a top-down one, with a long habit, with the kings, Napoléon, de Gaulle, to have the power at the top, in Versailles or in Paris. And, not surpris-ingly, we meet the same in the companies.

In France, hierarchy is respected, not only because it has the power, but also simply because it is an integral part of our history.

Cartesian system

René Descartes was a French philosopher, mathematician and writer. Descartes laid the foundation for 17th-century continental rationalism. In his Discourse on the Method, he attempts to arrive at a fundamental set of principles that one can know as true without any doubt. To achieve this, he employs a method sometimes referred to as methodological skepticism: he rejects any ideas that can be doubted, and then reestablishes them in order to acquire a firm foundation for genuine knowledge.

In my mind, this explains the usual French skepticism for many things. Something could be good news, but as we are not 100% sure, we doubt. And this explains also the French pessimism.

On the other hand, this Cartesian system has also developed a scientific culture, an ingénieur culture. We like things which can be demonstrated and we like technologies and new technologies such as the Concorde, the Minitel, the TGV (high-speed train), Airbus…

Another consequence of this Cartesian system is that French people always like to understand things before making any action; very often, in companies, foreigners are surprised when they give direction and instructions because French will always make questions.

I see, at last, another feature deriving from this Cartesian system; it is the esprit de synthèse, ability to synthesize, which is something important in the way of working and thinking.

The importance of words

In the business world, someone pointed out a fundamental difference between U.S. and French decision-making: Americans tend to focus on execution, whereas the French are more likely to emphasize the deliberative process. French like to talk, to discuss, to debate and sometimes too much.

French people, whatever the situation is, cannot refrain from issuing their opinion and their judgment

This comes from our political history and also from our education system. The fact to express its own view and its own opinion is considered as a right, even as a duty. French people, whatever the situation is, cannot refrain from issuing their opinion and their judgment.

Culture, arts and creativity

The French are creative, probably influenced by a long history of artists, and possess an avid interest to visit museums and artistic expositions. This is culture.
Each year we have the famous “Journées du Patrimoine” (Heritage Day); in last September, the Heritage Day had 12 million visitors in France.
We mentioned before the literary culture of French people; if you look at the list of Nobel prices of literature, France ranks first with 15 laureates, followed by the USA with 11 laure-ates.

Conclusion

If the French mindset is very specific, France remains an open-minded country. The 90-year-old academician and ¬novelist Jean d’Ormesson hit the proverbial bullseye when he noted: « France is not only a matter of contradiction and diversity. She also constantly looks over her shoulder, towards others, and towards the world which surrounds her. More than any other nation France is haunted by a yearning towards universality ».

About the Person:

Geoffroy de Lassus is a banker who worked in Canada, Brasil, Korea and India. In the last years, he wrote several books on the international history of BNP Paribas (India, Australia, Gulf Countries, Netherlands and Poland). He published in 2013, an essay on India « Indiagblognote, comprendre l’Inde » (Editions Persée) and is the author of the blog www.indiablognote.com. He is consultant in intercultural training.

"WE HAVE A FINANCIAL BUFFER FOR ACQUISITIONS"

THE LUFTHANSA-CFO WANTS TO STABILIZE THE DIVIDENDS – TALKS WITH FRAPORT AG ABOUT COST RELIEFS AT THE FRANKFURT AIRPORT ARE STILL IN THE EARLY STAGE.

INTERVIEW WITH **MR. ULRIK SVENSSON,** CFO OF LUFTHANSA,
FROM BÖRSEN-ZEITUNG, FRANKFURT AM MAIN, GERMANY, NOVEMBER 11, 2017,
ARTICLE PROVIDED BY **GEFIU**, THE ASSOCIATION OF CHIEF FINANCIAL OFFICERS GERMANY, THE GERMAN IAFEI MEMBER ASSOCIATION

Mr. Svensson, you have told the shareholders that there will be a significantly higher dividend for 2017, what do you exactly mean with this?

It is our dividend-policy to annually pay out 10 – 25 % of the ebit to our shareholders. The earnings before interest and taxes (ebit) is developing well in this business year and from this alone there results a higher dividend. How high it will exactly be, this we will only be able to be said at the beginning of the next year.

The highest dividend of the last decade was 1,25 Euro for the business year 2007. Will Lufthansa exceed this for 2017?

As I said, the exact amount I cannot yet tell you by now. But we will attempt to make the dividend more stable, so that there will not be major fluctuations such as that – like in the recent past – in one year a dividend will be paid and in the following year there will be no dividend.

For this, however, you must then be able to estimate the development in 2018, don't you?

Quite exactly.

There are corporations – for example the Deutsche Telekom – which commit themselves already for 3 business years in advance as to the amount of the dividend. What do you think of that?

This is not an alternative for Lufthansa, because air traffic is a volatile industry which is strongly influenced by external factors. We shall continue to give the outlook for one year.

There is still not any detailed forecast for the result. As per the half year 2017 you were cautious, because you have seen risks like sinking ticket prices and similar factors, but in the meantime the view should be clearer.

When publishing the nine-months-figures we have increased our forecast for the earnings per unit in the first quarter, because of the good booking situation. The earnings per unit are now slightly above the value of the previous year. This is a safe indication for that we have got more confident since the last forecast, and that we expect a very good result.

And 2018?

The earnings per booking, meaning the earnings per kilometre of each chair, are regularly difficult to forecast. But from today's point of view we see at least a strong demand for the remaining time until the end of 2017 and for the beginning of 2018. For the rest of 2018 we cannot yet say much. However, it remains in any case our objective to lower the costs further. This is the prerequisite for that we can safeguard the earnings development in a sustained way and for increasing the profitability in a sustained manner.

Are your plans for cost reduction also maintained after the Air-Berlin-deal?

For the short-term, to such a take-over, when it will be approved, there naturally will be costs, which in this case we have estimated to be roundabout 50 mio. Euro in 2018. However, already for 2019 we are expecting a positive ebit contribution from the transaction. For the long-term, the takeover of parts of Air-Berlin will help us to lower the costs. Because as well the airline Walter as also the Austrian Niki have favourable cost structures. In addition, with increasing growth, there are positive economies of scale.

As to lowering the costs, there especially Eurowings has things to do, the costs are intended to be lower until 2020 by further 20 %. At this, a great lever is the harmonization of the plane fleets. How is fitting to this the addition of Dash-8 of the Air-Berlin subsidiary LGW?

The costs at Eurowings have already been lower by 10 % in 2016, in the first nine months of 2017 they have been lowered by further 10 %. Therefore, we are on a good way, to reach our goal to lower the expenses between 2016 and 2020 by 20 %. The airplanes which now will be added by purchase of the airline Walter and Niki are partly, effectively, from the point of view of costs in long run not ideal. Here, we have made use of short term savings and have preferred this over a fast growth of Eurowings. In the longterm, however, these Dash-8-machines will surely be substituted by Airbus A 320 in order to unify the plane-fleet. And this with today's employees and the cost structures of the airline Walter. In addition, this transaction, and our own capital expenditure, are a total package: The airline business with its employees and there with existing rights for starts and landings as well as the airplanes.
(A few weeks after this interview, the co-acquisition of Niki, subsidiary of Air Berlin, was disapproved by the Antitrust Agency.)

When it comes to your efforts for cost cutting, you have also approached the airport operator Frankfurt Fraport. At the present, there are negotiations how the situation for Lufthansa at its most important site Frankfurt could become less costly. How far have you advanced there?

The costs in Frankfurt on average are by 20 % higher than at our other airport locations. As long as this is so, we shall grow, instead of at Frankfurt, at our other hubs – Munich, Zurich, Vienna. We have started a good dialogue with Fraport, but we still are at the beginning of the way.

You have presently liquid assets of more than 6 billion Euro. So far, you had the plan to have a minimal liquidity of 2,3 bill. Euro. What will you do with the excessive cash?

There are two greater cost blocks which are coming at us. On the one hand there is the purchase of parts of Air-Berlin and our capital expenditures that go with this, which have a volume of 1.5 bill. Euro. In addition, 1,6 bill. Euro are flowing into the pension fund about which in the past year we have reached an agreement with the cabin personel union Ufo. Then, we still have a liquidity of roundabout 3 bill. Euro. We have a certain financial buffer for additional acquisitions, and we also need it because we have ordered many planes. Further, consolidating steps in Europe will come and we want to participate in this process actively.

As to consolidation, the Lufthansa has expressed interest in Alitalia, about which corporate capital expenditure volume we could talk here?

We have presented in Italy a concept for a completely new Alitalia. About the volume I will not say anything but the 500 mill. Euro which have been reported in some media are not right. That our plans would promise success, this has shown the example Swiss. All participants – shareholders, employees, clients – have profited from the takeover of Swiss by Lufthansa. But the Swiss was a restructured enterprise when the Lufthansa took it over, which had come out of the old Swissair. I know this very well because at that time I was CFO of Swiss. The way was very painful. Also at Alitalia at first the costs must be lowered.

And you have reason for optimism that your plans in Italy will have a positive reception?

Difficult to say. To the analysts I have still recommended at present to not yet include an eventual Alitalia deal in their models.

In view of the present liquidity situation, the question must be allowed: Why according to Lufthansa chairman Carsten Spohr the financing of the Air-Berlin parts which have been taken over has only been secured until year end.

We have planned for the financial means for maintaining the flight business only till year end, independently from how many liquid assets we have. At some point, such a deal must still be finalized. At present, we assume that the interim phase, during which we contribute money and wait for the entire trust approval, will last till year end.

Is your objective still a gearing – that is a relationship of net-debt to equity – of 40 – 60 %?

No, we are orientating ourselves in the meantime among other things at the equity quota, and there is our objective to reach over the medium term 25 %. Presently, we are at 22,3 %, so that we can reach the target value very soon. It is naturally also important that we have an investment-grade-rating. After Moody's had increased its evaluation of us two months ago, we now again have at both big rating-agencies an investment grade rating, and we want that this remains like this.

What changes in the financing of Lufthansa, by the fact that you now have an investment grade-rating at both Moody's and S & P?

Our cash-flow-situation presently is so good that there is no need to issue bonds or take up larger bank loans. Presently, we can finance everything from our liquidity. But should we still return in two years to the market, then these investment-grade-ratings are naturally helpful. And we can say that Lufthansa also – so far – has been a strong name in the market, so that presently, starting from this situation, the conditions for us in the market are not dramatically changing.

Lufthansa at a glance

Lufthansa

Group in the first nine months 2017

Sales in million Euro

2016	23,9
2017	26,8

Adjusted Ebitda* in Mio. Euro

2016	1677
2017	2560

Earnings per Share in Euro

2016	3,98
2017	3,95

Free Cash-Flow in Mio. Euro

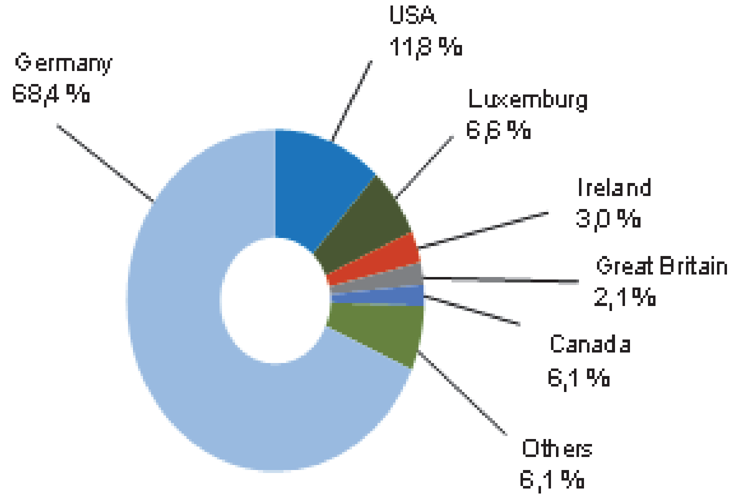
2016	1518
2017	2790

Long Term Rating

Moody's	Baa3
Standard & Poor's	BBB-

* Earnings before interest, taxes

Shareholders by Region



Market capitalization
Status January 12, 2017
14,3 Billion Euro

Source: Corporation, Thomson Reuters

The capital expenditure-plan so far for 2017 shows roundabout 2,7 bill. Euro, for 2018 and 2019 each 2,2 bill. Euro. Will this remain like this?

The group is growing and therefore we have adapted the plans to the upside. The capital expenditures will also in 2018 and 2019 be at each 2,7 bill. Euro. These are approximately 8 % of total turnover, this is a value which is the average for the industry.

Your net debt has decreased to a good 500 mio. Euro, how will the indebtedness develop over the medium term?

This is only a picture for the moment. We have the capital expenditures for growth of Eurowings and the payments into the pensions funds for our cabin personel before us, than things shall increase quickly again. The objective is that net debt will not exceed a factor 3.5 of the earnings before interests, taxes and depreciation.

Deutsche Lufthansa AG, 30.42 Euro Share Price as of January 12, 2018, German Stock Exchange Xetra

Index Price Chart, Index-base as of December 30, 2015 = 100

-Black line: **Deutsche Lufthansa Share**
-Blue line: **DAX German 30 Companies Large Cap Stock Index**

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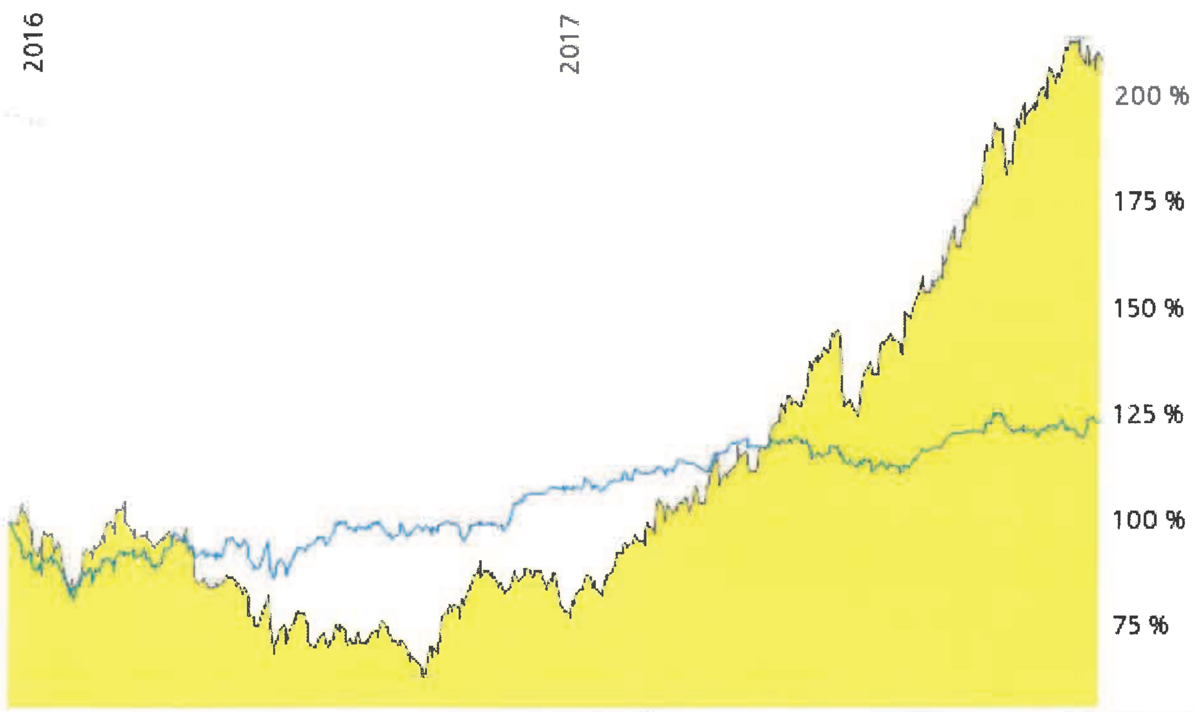


Lufthansa is hedging itself against fluctuations of the oil price and it practises for this extensive hedging measures. How are the plans for these hedgings of fuel costs? According to Carsten Spohr the hedging system will be put on a review scheme in the second half of the year.

The hedging system, as to the details, is permanently under review. But basic aspects we shall
not change. In my view, hedging policy is one of the strengths of Lufthansa. This is a mathematically defined system and not a bet on the market. In Europe, almost all airlines are hedging themselves, in the US nobody is doing this. In the USA, the fluctuations can be passed on easier to the customers. But at the end it matters to all airlines, when the oil price is increasing, and therefore, in the longterm, in the competition, it is not so decisive. We assume, for 2018, increasing cerosine expenditures.

What will change for Lufthansa through the accounting standards IFRS 15 (revenues from contracts with customers), IFRS 16 (Leasing-situations) and IFRS 9 (financial instruments)?

The biggest effects on the airline industry as a total, has IFRS 16, but Lufthansa by comparison has leased relatively few airplanes. However, on a worldwide basis we have leased many buildings. What exactly will be the effect on us we shall know by the middle of next year. In any case, this is a lot of work. The other IFRS regulations, as a principle, will lower our revenues, but also our costs. The net effect has no significant influence on our ebit. However, our margin through this will be improved.

The change of the corporate pension scheme for the cabin crews has brought a relief in 2016 for the Lufthansa with a high 3-digit million Euro amount. What do you expect after the deal with the pilots? The cost lowering thereby has already been planned for 2017, hasn't it?

Yes, and the effect will already come in this year 2017. The pilots will vote until December about the wage deal and then – in the case of approval – this will still flow into our yearly financial statements. We expect thereby a cost reduction by 1,1 bill. Euro as to our pension obligations and a one-off effect by 600 mio. Euro in ebit. The exact amounts depend on the then applicable interest rate at the time of the approval.

Which consequences has the long low interest rate phase for a corporation like Lufthansa?

At present, we are calculating at our pension liabilities with a discount rate of 2,1 %. Should that remain like this for a long time, then we can maintain the earnings situation thanks to the pensions burden which will have decreased to 5 bill. Euro. Due to the change of our corporate pension scheme this has become doable for us. We have today a completely different situation than 1 year ago. And should the interest rates increase again, then with our strong balance sheet we will be in a good situation because we can hold the indebtedness at the low end.

In the past, there have again and again been requests for a streamlining of the portfolio. Partly, this has already been executed. Do you still have businesses or participations which you might divest in your opinion?

We are looking permanently at the portfolio, we are checking, whether everything is still strategically fitting together and making financial sense. But at present, nothing is planned.

Are there considerations to give away parts of Eurowings over the medium or longer term, for example by way of IPO?

We are satisfied with our present development of Eurowings. We are, hardly we have started with the new Eurowings, already number 3 in point-to-point-traffic in Europe. The corporation already this year will have black numbers as to operating profit. We still have many plans with Eurowings, there it would not make sense to get other shareholders into the boat. I am very optimistic about what relates to the further development of Eurowings.

But you will probably remain above the cost level of Ryanair, even when this one must pay more for its pilots in the future?

Their costs are going up, ours are going down. But yes, probably there will remain a gap. But at the end not only the prices are counting, but also the offer. This relates not only to the product. Our passengers also appreciate our good flight-net and the high frequency of flights, for example in the direction of London. They want to have more choice, and not only one flight per day.

According to Bernstein, the airline-industry in Europe has reached its peak with an ebitda-margin of 12 %, because the offer by way of the many new airplanes is growing stronger than the demand. Do you share this estimate?

At present, there are quite different estimates by analysts. From today's point of view I am already more optimistic than Bernstein, at least as it relates to Lufthansa. The improvements in our profits we have reached thanks to structural changes in the group, will help us also in the future. We have reached wage agreements, so that we do not have to expect any more strikes. The economic situation over all in Germany is naturally also a support for us.

Analysts, in the meantime are expressing a share price target of 30 Euro per share. How realistic is this value in your view?

When I started to work in the finance area more than 20 years ago, one has given the advice to me, never to evaluate the own share price. And I have respected this every time. But as you can see from what I have expressed as to our business development, I am very optimistic that we can further develop Lufthansa and its profitability as well in an upturn as well as in down turn phases. This will then at the end also be honoured by the financial markets.

The interview was made by Lisa Schmelzer and Heidi Rohde.

About the Person:

For All Tasks Well Prepared

At the moment Ulrik Svensson speaks German only with his secretary. "She corrects my grammar." But he got already accustomed to one word, indispensable at the Lufthansa Group: "final vote by the unionised workforce". A corporation like Lufthansa, at which there are, again and again, tough wage tariff negotiations, there are then many final votes by the unionised workforce, just now there is one at the pilots. For this, the new CFO in office since January 1, 2017, has already assumed the necessary vocabulary as working tool. The word "old burden" he by the way also knows, which is helpful, when it is once more again about the Group wage contract, and the thereby resulting high personel costs. Because cost reductions are in the focus of the CFO, as he again and again points out.

Working tools as to the airline industry, the 56 year old Swiss must not acquaint, because for a part of his professional career he has already been in the industry. From 2003 to 2006 he was CFO of Swiss, which at the time was restructured and streamlined by the Chairman and later on Lufthansa Chairman Christoph Franz, and subsequently been taken over by the German airline. 2 million Swiss Francs the Swiss was said to have lost every day, remembers Svensson. From this period he knows well some of his today`s board of management colleagues, who remembered Svensson, when looking for a successor of CFO Simone Menne. He was then chairman of the Swedish investment firm Melker Schörling AB. His home has the three times father still in Stockholm, there lives his family, and to there he commutes every weekend.

From Börsenzeitung, Frankfurt am Main, Germany, November 11, 2017. Responsible for English translation: GEFIU, the Association of Chief Financial Officers Germany, translator: Helmut Schnabel

"WE SHALL GROW MORE STRONGLY WITH ACQUISITIONS"

THE CFO OF THE SUPPLIER MANN + HUMMEL ABOUT THE MANAGEMENT OF THE GROUP, ITS STRATEGIC OBJECTIVES, AND WHY IN FUTURE THERE WILL BE NO ACCOUNTANTS ANY MORE

INTERVIEW WITH **MISSIS EMESE WEISSENBACHER**, CFO OF MANN + HUMMEL, GERMANY, FROM BÖRSEN-ZEITUNG, FRANKFURT AM MAIN, GERMANY, DECEMBER 12, 2017,
ARTICLE PROVIDED BY **GEFIU**, THE GERMAN IAFEI MEMBER ASSOCIATION

Missis Weissenbacher, Mann + Hummel in October 2017 as the first supplier to the automobile industry, has issued a Green Bond. Into which projects is flowing the 400 million € money raised by the issue ?

Sustainability is an important column of our strategy. With the electro mobility the car industry has a major challenge. We are convinced, that we can transfer our expertise in filtration also into other segments, like into the filtration of buildings and of water. Both does fit well to the subject of sustainability. With the money raised we shall finance projects and products in these two areas.

For which time period are you planning these products ?

We do finance projects, which we have already started, as well as future projects.

Originally you wanted to raise 250 mio €. Is your pipeline fully financed by the now raised higher amount ?

We have also smoothed our maturity profile with the money raised. We already in October 2015 had raised 1,1 billion € by way of a debt certificate (The German Schuldschein financing instrument), for the takeover of the filtration business of Affinia.We now could swap the variable part of the financing into a fixed portion, and we have thus decreased the interest rate risk.

Do you need, in the foreseeable future, new financial means ?

The subject of refinancing has been solved thereby quite beautifully. In addition to the Green Schuldschein we have a syndicated credit line for 5 years, which we can extend by 2 years. With this we are well positioned, in order to finance our business and takeovers.

Do you have concrete takeover plans ?

We are in negotiations. If it would work as we wish, it will be realised this year. But in any case in the next year.

The acquisition of the filter business of Affinia with a purchasing price of 1,4 billion US dollar was a large transaction. How do you get along with the integration ?

This is right. With this we have dared to make a great step, because we have acquired a volume of one third of our previous turnover. The integration is working according to plan. At this we now have chosen a strategy different from former acquisitions.

What does this mean?

The business of Affinia was successful and profitable without us, and this should remain like this. We therefore do not want to impose our processes everywhere, without thinking about, whether this makes sense at all. We can raise synergies particularly on the purchasing side, by concentrating the suppliers. In addition we have defined activities, where a concentration does make sense, and we are consolidating these step by step.

Where do same processes not make sense ?

At sales and at development. The Affinia businesses does work in the markets like previously, because we have not been in such markets so far. In development, the processes are different, because we are coming from the first time equipment and therefore follow up on this with our spare parts business. Affinia, instead, is not in the first time equipment business. It would have been a mistake, had we simply superimposed our processes.

How relates the profitability of Affinia to yours ?

This is very comparable. And in terms of operations, these segment develop in line with our expectations.

Is this true also for the Group level ?

We are pretty satisfied, but we had also supporting wind from the market, in all of our markets.

What does this mean for the targets for the year, of small increase of sales and improvement of the adjusted operating earnings in the middle of one digit percent range ?

This is developing according to plan.

And when shall you be again debt free ?

We do not have to become completely debt free. The indebtedness, however, we are now decreasing as per the plan. Soon we want to be below the indebtedness factor of 1,5, in order to be able to grow further.

You want to reach until 2030, that one third of sales will be outside the automobile business. How do you want to achieve this ?

The market for water and air filtration is pretty much fragmented, with many small corporations. We shall grow more with acquisitions, than in the traditional area, in order to reach the target 2030. The market shall consolidate, and we want to join in pushing this. We have a portfolio of corporations, which fit to our strategy, and which we diligently observe.

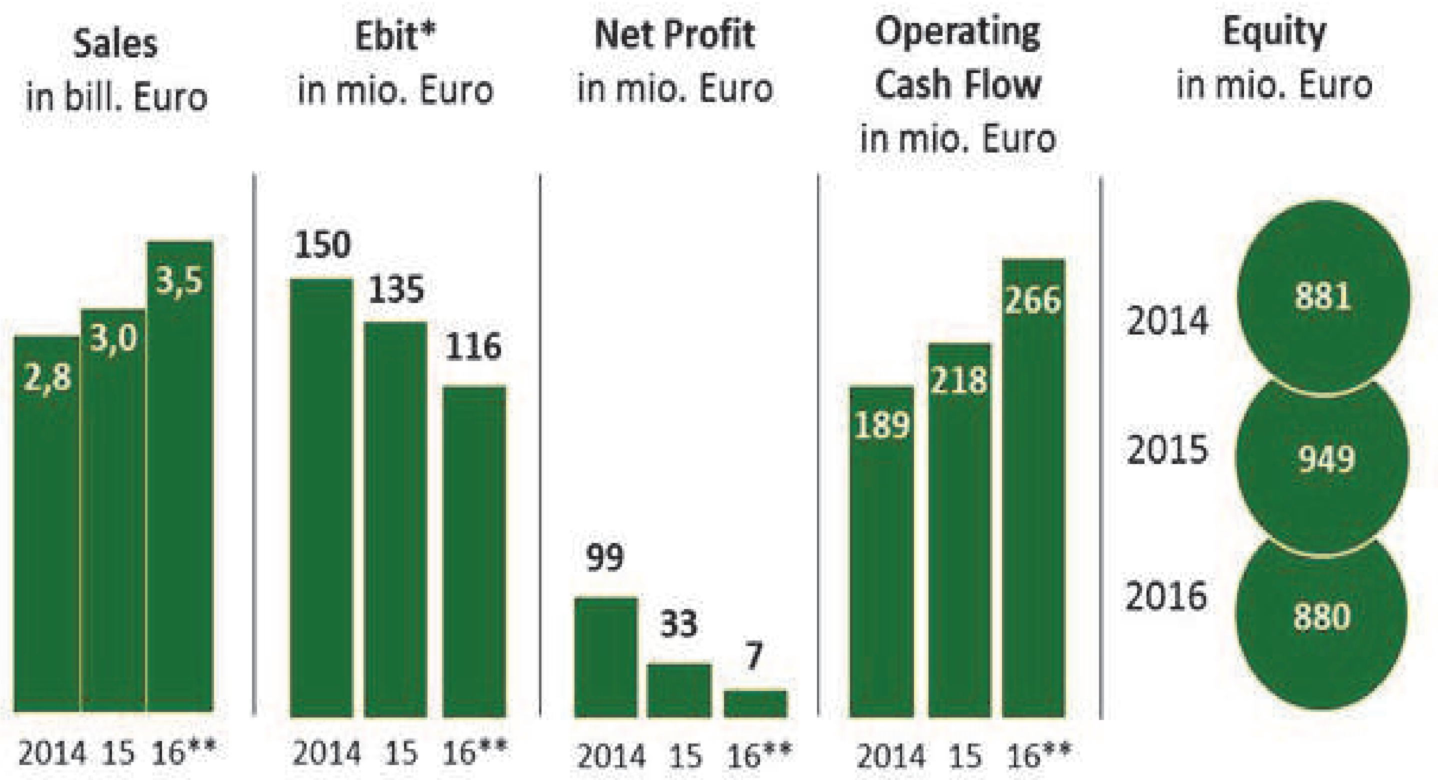
Which budget have you given to yourself for making takeovers ?

We have our limit as to the available cash, especially after the takeover of the Affinia filtration.

You have lately repositioned your treasury department. How has it been changed as a consequence of the takeover ?

Through the takeover we changed from a debt free group to a indebted group. Also, our treasury with a focus on Germany had been set up very regionally and thereby was not any longer state of the art. Due to these two points we decided to get the corporation consultant Ley & Greiner into the house and to check the situation jointly.

Mann + Hummel at a glance



© Börsen-Zeitung * Earnings before Interest & Taxes **Filter Business included since May 2017 vSource: Corporation

With which result ?

We have created an internal rating-impact model, within which all the elements of treasury concepts are liaised, which is currency and interest rate risks, counterparties, our cash position, as well as our asset management. For this we have taken over the rating model of Moody`s for the automobile supplier industry.

How are you steering this model ?

We have at our steering three fundamental principles: We want to remain liquid and financially independent, and we want to be an investment grade company. This reqires specific values for predefined performance rations. So we know, what we have to attain, with a view to cash and operating earnings in order to be able to quickly reduce our debt.

Since when is this structure in place?

Since approximately the middle of the year. From the model the operating targets for the next year are derived, which we then brake down to the regions and the divisions. When we achieve these targets, then the official rating which we are hoping for, should result from this.

The changes in the automobile industry due to electro mobility and digitalisation will also have an effect von your produkt portfolio. How do you want to react ?

E-mobility and digitalisation are our two further strategic drivers next to sustainability. We are looking at e-mobility as a longterm development and we are not moving into excessive action. The numbers for new auto licenses show, that it will take time, until this form of transmission will have a breakthrough.What is decisive: When is the market turning ? When we shall be there, then our positioning will help us, because in the spare parts business the turnaround will come later. In addition, and since years, we are involved in the discussions and the studies of the industry. An electro motor, regardless whether with batteries or with combustion cells, has air and liquidity circuits, and for this we have products in the portfolio.

Are there overlappings for burner motor autos and for electro autos ?

The air filter for battery electro autos is comparable with the air filter for burner motor autos. As well, both car types need filters for the inner person cabin. Otherwise there are predominantly different products.

This means, you have to newly develop all products and, as the case may be, you have to change the production mode. How high will be the need for capital expenditure ?

We are planning capital expenditures for three years ahead. With the new strategic planning cycle for the coming year we shall establich for the first time what-if scenarions. And then we shall consider as to how we have to spread capital expenditure as to the traditional and the new businesses and what will this mean for us exactly and specifically.

The second big trend is digitalisation. What is changing for you, internally and externally?

We have established in the past year in Singapore an IoT (Internet of things) Lab, where we deal with sensors, apps and clouds. Through the dates, which sensors are reading from filters, we can further improve our products and can make proposals to the applier for better utilisations for the respective application.

Shall you produce sensors in the future?

No. But as to sensors, we are also pushing the theme Verure Capital ahead. This is saving ressources and time, particularly when it is about sensors for a specific applications. These we partly purchase from startups. Otherwise we are purchasing them quite normally from the market.

Into which startups do you invest otherwise?

We only have started with this two months ago, so sofar now large sums have not been expensed. We exclusively are looking for startups, which are supplying to us ideas and solutions, about which we have not yet thought.

Where is your focus at the internal digitisation?

Internally we are dealing with industry 4.0, which is at least as important. In the spare parts business, for example, the calls for delivery are on very short notice. This makes it difficult, to adapt the production to it. By way of forward looking big data analyses nad correlations with external market factors we can extend the preview time, and we can achieve a better production steering and a significant inventory reduction. We are also dealing with real time data which are provided from production to the development units and departments. With this we improve the product quality already at or before the switching on of the production.

Until when shall you produce in a network mode?

This will happen gradually and depends on, how quickly we can lift up our production system to the next level and can there standardise it, in order to then subsequently digitalise it. This also relates to my business area.

Which changes do you expect in your business area through digitalisation?

I expect, that the type of profession of the accountant will disappear in a few years. Also the finance departments will become more digitalised and automated. At one day, the manager will be able to put questions to a computer or robot which then supplies the needed numbers and reports. The Controlling will then be a kind of co-pilot for the treasury department. We are working step by step at our digital map. At this we identify new processes, which can be automated and digitalised.

Is this also true for the theme of financing?

Selfevidently. After the Germen LBBW bank has issued for Daimler a Schuldschein on the basis of the blockchain technology, we have made a direct contact to the LBBW bank.

The interview was made by Isabel Gomez.

About the person

A Forerunner

Under the regime of Emese Weissenbacher the filtration specialist Mann + Hummel in October, as the first automobile industry supplier, has issued a Green Bond and has thereby acted as forerunner. This requires courage for risk on unknown territory, which the 1964 born in Hungary, now CFO of the family owned Group in Ludwigsburg, has already shown in her career so far. For instance, by way of having her first child a few months before the beginning of her studies, and her second one immediately before her batchelor diploma. " To trust in life" is one of her lead slogans - and this one has carried her very far so far.

Raised in Roumania, Weissenbacher came, after her study of business administration in Stuttgart, Germany, with the emphasis on Controlling and on Strategic Corporate Planning, as trainee in the personel department of Mann + Hummel. After a few months she got a full job in the department of controlling. Starting 2000, she was head of the air filtration production in the work Ludwigsburg, and subsequently until 2009 of the then newly establiahed product area utility automobiles. Starting 2010, she was responsible as Group Vice President for seven European works and 3000 emplyees. In July 2015 she was promoted to the managing board, responsible for financing, controlling and IT. Apart from this, she is engaged as mentor for women in their career planning, and is regarded as well asked for speaker on business subjects, and subjects around profession and family. She is as well advisory council member of Deutsche Bank.

From Börsenzeitung, Frankfurt am Main, Germany, December 12, 2017. Responsible for English translation: GEFIU, the Association of Chief Financial Officers Germany, translator: Helmut Schnabel

WHAT'S GOING ON IN EUROPE?

SPEECH AT THE HONGKONG MONETARY AUTHORITY, HONGKONG, 16.01.2018
BY **DR. ANDREAS DOMBRET**, MEMBER OF THE EXECUTIVE BOARD OF THE DEUTSCHE BUNDESBANK
EUROSYSTEM/ GERMAN CENTRAL BANK

1 Introduction

Dear Norman Chan
dear Eddie Yue
dear colleagues
It's a pleasure for me to be invited back to the Hong Kong Monetary Authority. I value very highly the excellent cooperation, not only between the Hong Kong Monetary Authority and the Bundesbank, but also more generally between our two countries. This contributes to the strong friendship of Hong Kong and Germany.

In my remarks today, I will give you an overview on what's going on in Europe.

Some of you may have become used to quite negative news from the European continent, as we not only endured the global financial crisis but also witnessed how it triggered the euro area crisis. As a result, the last ten years were something of a dry spell for the EU's economy.

But things have actually changed for the better of late: the economic recovery is gaining momentum and has spread to all EU countries. Today, I will paint a positive picture of the current development and will also talk about the positive outlook.

Yet in my remarks I will also focus on the two big challenges the EU faces, namely Brexit and euro area reform. My main point is that we now have a vibrant economic situation that gives us an opportunity not only to manage but to master these challenges such that the recovery becomes a sustainable story.

2 Finally, a broad-based recovery of the EU economy

Until last year, the economic recovery following the financial crisis was rather disappointing – and that despite extensive monetary easing by the European Central Bank. Entering the second half of 2017, however, growth momentum began.

Recent figures for the third quarter of 2017 show **a sound GDP growth of 0.6%, quarter on quarter – after 0.7% in the preceding quarter. Euro area unemployment stood at 8.8% in October – well down from its peak of 12.1% in 2013 and the lowest level since January 2009. And a recent study by Ernst & Young expects 1.8 million new jobs to be created over the course of 2018.**

What is important is that the upswing has become more broadly based – across countries as well as sectors. And this is also reflected in the positive economic sentiment. In December last year, the European Commission index reached a 17-year peak to record the highest value since October 2000.

And at the same time, inflation is slowly rising. The Eurosystem staff macroeconomic projections forecast annual HICP inflation of 1.5% in 2017, 1.4% in 2018, 1.5% in 2019 and 1.7% in 2020. There is some indication, then, that the volume of expansionary monetary stimulus could be lowered.

The euro area recovery is in considerable part driven by the healthy upswing of the German economy, which is ongoing: 2017 was the fourth consecutive year in which GDP growth outpaced potential output. And the Bundesbank expects a further rise of 2.5% for 2018, while growth in 2019 is seen at 1.7%.

3 A solid outlook for the EU economy

Coming back to the euro area and looking ahead, the very high level of confidence among firms and households suggests, moreover, that the upswing will continue well into 2018. The outlook for the euro area's economy is quite solid. This is in considerable part due to the robust projection for the world economy. The World Bank recently estimated that growth will be 3.1%; this means that the world economy's growth potential will be fully or almost fully reached for the first time since 2008.

The strongest driver of global growth will be the East Asian economies, China in particular. The World Bank sees emerging markets growing by 4.5% in 2018 and by 4.7% in 2019.

The global and emerging market growth has positive effects on the euro area economy as well. And I am convinced that the strong ties between the euro area and Asia, notably between Germany and Asia, will contribute to the success stories of both Asian and European countries. With this in mind, we should further deepen our political and economic relationships. And this should be based on the principles of free trade and market economies, while leaving some room for legitimate differences in rule-setting.

Both the IMF and the ECB staff recently upped their growth expectations for the euro area.[1] According to the December 2017 Eurosystem staff macroeconomic projections, the annual real GDP is set to rise by 2.3% in 2018, 1.9% in 2019, and 1.7% in 2020. Compared with the September projections, the outlook for GDP growth has been revised upwards substantially.

The Eurosystem expects the economic expansion to continue, as private spending and consumption growth are reinforced by lower deleveraging needs and better labour market conditions.

Furthermore, the recovery in business investment is supported by improvements in corporate profitability and the very favourable financing conditions. At the same time, euro area exporters are benefiting from the ongoing global economic expansion.

These figures give some comfort as to the EU's economic future. And I personally am confident that this trend can and will continue. However, challenges are looming: two particularly serious ones are Brexit and euro area reform. The current, upbeat trajectory has to be harnessed as we set about mastering these historical challenges.

4 Brexit looming

The first challenge, Brexit, began in June 2016, when the majority of UK voters decided to leave the EU. Where are we now? Brexit is definitely happening, and it is more and more likely to be a hard Brexit – by which I mean that there will be a complete exit rather than a partial one. The UK and the EU will go their separate ways.

Since December of last year, there is a better chance of reaching a sensible agreement before the deadline of March 2019. The EU Council agreed in December on the Brexit divorce issues: basic compromises were reached on three fundamental questions, namely the rights of EU citizens in the

UK after Brexit (and vice versa), the border between Ireland and Northern Ireland, and the UK's financial contributions to the EU budget over the coming years.

This compromise allows us to move forward to negotiate the terms of our future partnership. But let's keep in mind that substantial progress has yet to be made on the details of the three separation issues I just mentioned.

Now, since negotiations have been going rather slowly, there may be a transition period of two years from 2019 to 2021 – during which the old rules would still apply and the terms of the new partnership could be implemented. What kind of economic partnership this will be has yet to be determined. If no solution is found, the EU and the UK will trade under rules set by the World Trade Organization – which is in nobody's interest, but is likely to be particularly harmful to the UK economy, while the economic impact on Europe will be limited by comparison. Take Germany for instance. The UK is an important export market, accounting for ca. 7% of German exports. But this implies only 2% of value added to the German economy.

My hope is that all the parties involved will be able to negotiate an economic partnership that underscores the close political amity between the UK and the EU.

With a view to future economic relations, we must work hard to reach a deal that, on the one hand, minimises frictions in trade and supply chains. In that context, I also think that a substantial transition period is in the interest of both economies. On the other hand, however, this deal must also give the UK and the EU the freedom to develop their own agendas in economic policy and rule-setting – this would ensure the possibility of institutional diversity, where each society can develop rules according to its own specific, historically grown circumstances and current preferences.

5 Euro area crisis and reform

Mastering Brexit is probably the biggest mid-term challenge facing the European economy, and we all need to take a pragmatic approach. Much is at stake. Yet as is always the case in life, problems and challenges never come alone, but in groups, or at least in pairs. The second big economic challenge we need to focus our attention on in 2018 is the reform of the euro area. This is also emphasised by the weight that this topic has in the current negotiations to build a new government coalition in Germany. I will come back to this in a moment.
The euro area will remain vulnerable as long as one fundamental stumbling block remains in place: its asymmetric institutional design. Member states surrendered sovereignty in monetary policy matters to the ECB on the one hand, but retained ownership of their fiscal and economic policies on the other.

This creates two major problems: first, a common monetary policy for economies that are at different developmental stages – compare France and Greece, for instance – and at different stages of the business cycle. Second, the moral hazard that arises when governments, firms and households borrow too much to take advantage of lowered interest rates as a result of averaging in the currency union.

We need answers to both these problems. For the economic convergence of the euro area will take time. Currently, the potential German coalition partners are debating quite sensible approaches on how to foster social inclusion, limit a race to the bottom in tax policies, and foster the convergence of the euro area economies. It's too early to judge these positions.

The second problem – excessive debt, and high borrowing by governments in particular – could, in theory, be solved much more easily. However, the necessary political reforms have seen little progress so far. But here, again, the recent proposals of the potential German coalition partners are promising. The creation of a European Monetary Fund seems to go in the direction that we, the Bundesbank, have been advising for quite some time.

Formally, the EU has a set of fiscal rules that restrict public borrowing – the Stability and Growth Pact. Yet these were regularly violated before the financial crisis, without any meaningful consequences. In response, the EU reformed the Stability and Growth Pact in 2005, but the outcome was to expand the discretionary scope even further.

The European Commission, despite its role as guardian of the Stability and Growth Pact, has already exploited its scope on several occasions and interpreted the rules rather generously in doing so. Indeed, some euro area countries have been breaching the rules for nine years now.

What is needed to strengthen the fiscal rules is a simple and transparent design and implementation of the rules.[2] The transfer of responsibility for fiscal surveillance from the European Commission to an independent institution would be a big step towards a less political approach. One promising measure would be to strengthen the role of the European Stability Mechanism, ESM for short. Thus far, the ESM has been tasked with providing financial assistance to euro area countries experiencing or threatened by severe financing problems.

However, if member states retain their fiscal autonomy, the sustainability of public finances will need further safeguards beyond rules alone.
It is therefore essential that the binding force of the rules be additionally shored up by the disciplining effect of the market. In other words, interest rate levels and, therefore, financing costs have to be realigned more closely with the risks in government budgets.

The only way to achieve that, however, is to restore the credibility of the no bail-out clause in the Maastricht Treaty. Investors have to perceive a more credible threat of losing money if they buy bonds from governments that have unsound public finances. One proposal put forward by the Bundesbank envisages changing the contractual terms for sovereign bonds in the euro area by introducing an automatic maturity extension for them as soon as the issuing government applies for an ESM programme.

Up to now, a large part of the assistance loans have ended up being used to pay off the original creditors. This means that the original creditors, such as banks, are then let off the hook – at the taxpayers' expense.

In contrast, extending maturities would leave the original creditors on the hook, and they could still be held liable if debt restructuring became necessary at a later point in time.

6 Conclusion

To sum up, the European Union has entered a period of broad-based, stable economic growth and, having done so, has overcome the economic repercussions of the financial crisis and the euro area crisis.

Yet it would be a huge mistake to consider our mission successfully accomplished. It is a solid basis on which the EU needs to build its efforts in 2018 to tackle not only the political challenges it faces but also the two biggest economic challenges in the shape of Brexit and the reform of the euro area.

We must do all we can to achieve a close and friendly political and economic partnership between the UK and the EU after Brexit – anything else is in no-one's interest.

With regard to the euro area, it is crucial that we improve the asymmetric institutional design to prevent another euro crisis.

If we take these challenges seriously, the euro area will become an economic success story.

Thank you for your attention.

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Footnotes

1. GDP projection by IMF: 2017: 2.1% (+0.2 pp); 2018: 1.9% (+0.2 pp).
2. Deutsche Bundesbank (2017), Design and implementation of the European fiscal rules, Monthly Report, June 2017.

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ECONOMIC ACTIVITY, PRICES, AND MONETARY POLICY IN JAPAN

SPEECH AT A MEETING WITH BUSINESS LEADERS IN HYOGO
BY **TAKADO MASAI**, MEMBER OF THE POLICY BOARD, BANK OF JAPAN, DECEMBER 6, 2017

I. Developments in Economic Activity and Prices

I would like to start my speech with a look at developments in economic activity and prices.

At the Monetary Policy Meeting held on October 30 and 31, 2017, the Bank of Japan published the *Outlook for Economic Activity and Prices*, or the Outlook Report. In this report, the Bank presented its projections for Japan's economic activity and prices through fiscal 2019.

I will explain developments in economic activity and prices by presenting the main content of the Outlook Report.

A. Overseas Economies

Let me first touch on developments in overseas economies. The Bank's assessment is that overseas economies have continued to grow at a moderate pace on the whole.

In terms of the outlook, advanced economies are projected to continue growing steadily, and a recovery in emerging economies is likely to take hold on the back of the steady growth in advanced economies and the effects of policy measures taken by emerging economies. A similar view was presented in the *World Economic Outlook (WEO)* released in October 2017 by the International Monetary Fund (IMF). In recent years, the IMF has often revised downward the projections for global growth, but from early fiscal 2017, it has revised them upward.

Looking at developments by major region, the U.S. economy has continued to recover, mainly in household spending, owing to a steady improvement in the employment and income situation. As for the outlook, the economy is expected to continue to see firm growth driven by domestic private demand.

The European economy also has continued to recover steadily and it will likely follow a moderate recovery trend.

The Chinese economy will likely continue to broadly follow a stable growth path as the authorities conduct fiscal and monetary policy in a timely manner.

Other emerging economies and commodity-exporting economies have picked up on the whole, particularly reflecting an increase in exports, the past bottoming out of commodity prices, and the effects of economic stimulus measures in those economies. The growth rates of these economies are likely to increase gradually, due mainly to the spread of the effects of steady growth in advanced economies.

In my view, the downside risks to the global economy have been diminishing on the whole, partly because concerns over the financial sector in Europe have abated. In this situation, I am paying particular attention to firm international commodity prices; namely, crude oil prices. While uncertainties regarding the global economic outlook have been easing, it is likely that commodity-related fixed investment, which has been curtailed over the last few years, will start increasing. I expect there to be a strong possibility of the global economy continuing its steady growth through fiscal 2018.

B. Japan's Economy and Price Developments

1. Current situation

Now I would like to discuss developments in economic activity and prices in Japan.

The Bank's assessment is that Japan's economy is expanding moderately, with a virtuous cycle from income to spending operating. In fiscal 2017 to date, the Bank has revised up its economic assessment twice. Industrial production has been on an increasing trend, reflecting the increases in demand both at home and abroad, and labor market conditions have continued to tighten steadily. As a result, the output gap -- which captures the utilization of labor and capital -- has improved steadily.

On the domestic demand side, business fixed investment has been on a moderate increasing trend with corporate profits and business sentiment improving. According to the September 2017 Tankan (Short-Term Economic Survey of Enterprises in Japan), business fixed investment plans for fiscal 2017, especially those of large enterprises, showed firms' solid stance. This is evidenced by, for example, the fact that fixed investment on a basis close to GDP definition saw a year-on-year increase of 6.9 percent -- a level clearly exceeding the past average of 4.9 percent for the September *Tankan* surveys during the period of fiscal 2004-2016. Private consumption has increased its resilience against the background of steady improvement in the employment and income situation, and housing investment has been more or less flat. Exports have been on an increasing trend on the back of the growth in overseas economies that I mentioned earlier.

One of the features of the ongoing expansionary phase is that the economy has been growing across a wide range of regions, firm sizes, and industries in comparison with past expansions. In the latest September 2017 *Tankan*, the diffusion index for business conditions in small firms reached its highest level in almost 26 years. In the *Regional Economic Report*, many regions have revised their economic assessments upward in 2017. Indeed, the Kinki region, which includes Hyogo Prefecture, has revised up its assessment in the two previous reports released in July and October.

On the price front, the year-on-year rate of change in the consumer price index (CPI) for all items less fresh food is in the range of 0.5-1.0 percent.

2. Outlook

I will now look at the outlook for Japan's economy during the projection period, which covers from fiscal 2017 through fiscal 2019. The economy is likely to continue its moderate expansion. Domestic demand is likely to follow an uptrend on the back of highly accommodative financial conditions and fiscal spending through the government's large-scale stimulus measures. Exports are expected to continue their moderate increasing trend along with the growth in overseas economies. Reflecting this outlook, Japan's economy is likely to maintain growth during this projection period at a pace above its potential, mainly through fiscal 2018. In fiscal 2019, it is expected to continue expanding, although the growth pace is projected to decelerate due to a cyclical slowdown in business fixed investment and the effects of the consumption tax hike scheduled in October 2019. Looking at the medians of the Policy Board members' forecasts in the October 2017 Outlook Report, the real GDP growth rate is projected to be 1.9 percent for fiscal 2017, 1.4 percent for fiscal 2018, and 0.7 percent for fiscal 2019.

Let me explain the outlook in detail by major component. First, business fixed investment is likely to continue increasing moderately. This is because, in a situation where extremely stimulative financial conditions are maintained, fixed investment will be positively affected by (1) an improvement in corporate profits, (2) the materialization of the effects of projects conducted under the Fiscal Investment and Loan Program, and (3) moderate improvement in growth expectations. Specifically, an increase is likely to be seen in investment, particularly (1) that related to the 2020 Olympic Games and urban redevelopment projects, (2) that aiming at improving efficiency and saving labor in order to deal with the labor shortage, and (3) in research and development for growth areas. Private consumption is expected to follow a moderate increasing trend, due mainly to an increase in employee income as well as replacement demand for durable goods, and housing investment is expected to remain more or less flat. Exports are likely to be firm as a trend for the time being, underpinned by those of IT-related goods and capital goods, in which Japan has a comparative advantage. Thereafter, they are expected to continue their moderate increasing trend, due mainly to the improvement in overseas economies. Industrial production will likely continue to increase firmly for the time being, and thereafter is projected to continue on a moderate increasing trend.

The year-on-year rate of change in the CPI (all items less fresh food) is likely to increase toward around 2 percent. This is because, although upward pressure of energy prices is likely to wane gradually, firms are likely to gradually shift their stance toward raising wages and prices with an improvement in the output gap, and inflation expectations are expected to accelerate moderately. In the short run, the rate of increase in prices of food products and goods related to daily necessities in particular is expected to accelerate gradually with a moderate increase in private consumption, and moves to pass on the increase in labor costs to prices of general services, including dining-out and housework-related services, are likely to prevail. Looking at the medians of the Policy Board members' forecasts in the October 2017 Outlook Report, the year-on-year rate of change in the CPI (all items less fresh food) is projected to be 0.8 percent for fiscal 2017, 1.4 percent for fiscal 2018, and -- on a basis excluding the effects of the scheduled consumption tax hike -- 1.8 percent for fiscal 2019.

I believe that there are the following upside and downside risks to the outlook. Risks to Japan's economic activity are developments in overseas economies, such as the U.S. economic policies and geopolitical risks, firms' and households' medium- to long-term growth expectations, as well as fiscal sustainability in the medium to long term. Risks to prices are developments in firms' and households' medium- to long-term inflation expectations, the fact that there are items for which prices are not particularly responsive to the output gap, as well as developments in foreign exchange rates and international commodity prices going forward. I hold the view that, while downside risks to Japan's economic activity are limited, those to prices are fairly significant. This is particularly so because of the considerable uncertainty as to how far firms will adopt a shared attitude toward raising prices.

II. The Bank's Monetary Policy

Next, I will talk about the Bank's monetary policy. With a view to achieving the price stability target of 2 percent, the Bank has been maintaining highly accommodative financial conditions by pursuing strong monetary easing.

A. Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control

The framework of QQE with Yield Curve Control the Bank has adopted consists of two major components.

The first is an "inflation-overshooting commitment" in which the Bank commits itself to continuing to expand the monetary base until the year-on-year rate of increase in the observed CPI exceeds the price stability target of 2 percent and stays above the target in a stable manner. It aims at raising inflation expectations by demonstrating the Bank's unwavering determination. I will come back to this point again later.

The second component is "yield curve control," in which the Bank controls short-term and long-term interest rates. In the current framework, it sets the short-term policy interest rate and the target level of the 10-year Japanese government bond (JGB) yields as its operating targets. At present, in the guideline for market operations, the Bank sets the short-term rate at minus 0.1 percent and the target level at around 0 percent, and conducts JGB purchases so as to achieve this target level.

B. The Aim of Strong Monetary Easing

Since the introduction of QQE in April 2013, the basic mechanism of monetary easing itself has not changed; that is,[1] (1) pushing down the entire yield curve through the Bank's large-scale purchases of JGBs and (2) raising inflation expectations through the Bank's strong commitment to the 2 percent price stability target. These factors lead to a reduction in real interest rates.

Now, why does the Bank think that it is necessary to reduce interest rates to extremely low levels? The basic mechanism of monetary easing consists of driving real interest rates below the interest rate neutral to economic activity and prices; that is, the natural rate of interest. Japan's natural rate of interest has followed a downward trend, mainly reflecting the deceleration in the potential growth rate.[1] The estimation results obtained by the Bank's staff suggest that the natural rate of interest has been at around 0 percent recently. Given that estimates of the rate differ depending on the methodologies employed, they should be regarded as being subject to a considerable margin of error; however, the results show that the rate has been at an extremely low level. Therefore, in order to realize accommodative financial conditions with such a low level of the natural rate of interest, it is necessary to bring interest rates down further. I consider that the current highly accommodative financial conditions -- created by the yield curve control in this way -- have strongly supported Japan's economic activity from the financial side.

C. Toward Changing the Norm for Prices

Japan's economy has suffered from deflation for more than 15 years, since the late 1990s, with the year-on-year rate of change in the CPI being about zero or slightly negative. One likely reason why it has been taking time for the deflationary mindset to be dispelled in Japan is that households and firms have been adaptive to the deflationary environment. Despite the strong monetary easing being pursued for almost five years, the 2 percent price stability target has not been achieved. This confirms that the deflationary mindset was more persistent than initially had been assumed, although there were external factors such as the substantial decline in crude oil prices. Having said that, it is still necessary to pursue strong monetary easing; that is, to drive real interest rates sufficiently below the natural rate of interest. Meanwhile, almost five years have passed since the Bank introduced QQE, and I believe that the positive effects and side effects of QQE continue to warrant careful examination.

Recently, price increases around the world have been relatively weak, and many have been pointing out that the factors behind this are the deepening of globalization and digitalization. As research on these factors is still in progress, the empirical evidence has not yet yielded conclusive results.[2] I consider it important to fully take into account the effects of such changes in the economic structure on prices. However, even if the effects stemming from globalization and digitalization have been pushing down prices in advanced economies to some extent, I think price developments in Japan are quite different from those in the United States and Europe. This is because inflation expectations seem to be anchored at around 2 percent in the United States and Europe, with the price indexes showing that the underlying trend has been at around 1.5 percent, despite the past experience of the substantial decline in crude oil prices. On this point, in Japan, the year-on-year rate of change in the CPI (all items less fresh food) remains in the range of 0.5-1.0 percent -- as I mentioned earlier -- and that in the CPI (less fresh food and energy) is still in the range of 0.0-0.5 percent.

1 Such a downward trend in the natural rate of interest is not unique to Japan, but rather is a global phenomenon. This is one element behind the fact that, since the global financial crisis, interest rates in Japan, the United States, and Europe have declined to lower levels than ever before.

2 The well-known argument that a global approach should be taken into account in the basic determinants of inflation is one made by Claudio Borio, Head of the Monetary and Economic Department of the Bank for International Settlements (BIS). For the recent empirical analysis, see the following: Auer, Raphael, Claudio Borio, and Andrew Filardo. "The globalisation of inflation: the growing importance of global value chains." BIS Working Papers no. 602 (January 2017). https://www.bis.org/publ/work602.pdf. Meanwhile, there has been no confirmation of any noticeable, direct influence of global slack on domestic inflation, according to the analysis conducted by economists from the Federal Reserve Board. For details, see the following: Ihrig, Jane, Steven B. Kamin, Deborah Lindner, and Jaime Marquez. "Some Simple Tests of the Globalization and Inflation Hypothesis." International Finance vol. 13, issue 3 (December 2010): 343-375. Federal Reserve Board staff have updated the latter analysis using data through early 2017, and have confirmed that their argument remains valid.

In order to achieve the 2 percent price stability target in Japan, it is necessary that (1) the deflationary mindset be dispelled, and (2) the perception that prices of goods and services as well as wages are supposed to go up every year by around 2 percent becomes firmly entrenched in society as a whole -- or, in other words, the 2 percent inflation takes hold as a norm for prices. In this regard, it is essential that the Bank be committed in its conduct of monetary policy so as to achieve the price stability target, as I mentioned earlier. In the meantime, maintaining effective communication between the Bank and the government is crucial. Furthermore, nationwide changes are needed in the overall behavior and awareness toward prices. Of firms that have raised prices of their products and services recently, many have done so for the first time in more than two decades, and at present, firms themselves have limited experience in terms of raising prices. Moreover, consumers are not yet accustomed to an environment where both wages and prices increase at a certain pace. Thus, a change in the norm does indeed mean changes in various aspects of society. Financial literacy -- the next topic I will touch upon -- may seem unrelated to economic activity and prices or monetary policy at first, but I believe it does in fact have a connection with changing the norm I just described.

III. Initiatives to Improve Financial Literacy

A. Global Awareness of the Importance of Financial Education

The importance of financial education has been reaffirmed worldwide in the wake of the global financial crisis. In 2012, the Organisation for Economic Co-operation and Development (OECD) developed the High-Level Principles on National Strategies for Financial Education, which was then endorsed by the G-20 at their summit in Los Cabos later that year. According to the OECD, financial education is not merely the dissemination of financial knowledge, but "the process by which financial consumers/investors improve their understanding of financial products, concepts and risks and, through information, instruction and/or objective advice, develop the skills and confidence to become more aware of financial risks and opportunities, to make informed choices, to know where to go for help, and to take other effective actions to improve their financial well-being."[3] There has been widespread progress in initiatives to improve financial education, based on the principles endorsed by the G-20 leaders. It has been reported that the number of governments that have adopted national strategies for financial education has increased to almost 60.

B. Importance of Improving Financial Literacy in Japan

As part of this global movement, Japan's Financial Services Agency (FSA) and Central Council for Financial Services Information (CCFSI) established the Committee for the Promotion of Financial Education in 2013, and have been strengthening their initiatives to promote financial and economic education.[4,5] Let me also mention the government's growth strategy, the Investments for the Future Strategy 2017, approved by the Cabinet in June 2017. The strategy refers to the Nippon Individual Savings Account (NISA), a tax-free small-lot investment program introduced in 2014. It states that, in order to promote households' stable formation of assets, the government will further disseminate and promote the NISA system, including the introduction in January 2018 of the installment-type NISA, and enhance the financial and investment education that leads to improved practical knowledge of investment among households. I believe that it is crucial to improve financial literacy given the situation where many people feel somewhat uncertain about the future. Moreover, as I mentioned earlier, the Bank of Japan aims to achieve the 2 percent price stability target, and in a society where wages and prices rise in a stable manner, financial literacy becomes even more important. Therefore, I believe that the promotion of financial education in Japan is now particularly significant.

3 OECD, "Recommendation on Principles and Good Practices for Financial Education and Awareness" (2005). http://www.oecd.org/finance/financial-education/35108560.pdf.

4 Since 1950, efforts to encourage voluntary and proactive savings, with the aim of realizing economic autonomy, were led by the Local Councils for Savings Promotion. The Central Council for Savings Promotion was established in 1952 as the focus for private organizations related to this movement. This was then reorganized as the Central Council for Savings Information to concentrate on public relations activities providing accurate knowledge and information regarding the economy, finance, and currency. The council was then renamed as the CCFSI (Secretariat: Public Relations Department, Bank of Japan) in 2001.

5 As suggested by the April 2013 report of the Study Group on Financial Education under the FSA, the Committee for the Promotion of Financial Education (Secretariat: CCFSI) was established to address challenges facing the promotion of financial and economic education.

A number of surveys on financial literacy have been conducted in Japan, with their results revealing many challenges. One such survey is the Financial Literacy Survey conducted in 2016 by the CCFSI. In international comparisons, Japan ranked 24th out of 31 countries and economies in terms of the percentage of correct answers given to common financial questions.[6] According to another survey, the percentage of correct answers given to a question about the meaning of deflation was slightly above 20 percent.[7] Obviously, it is no wonder that we face many challenges in financial education, as is the case with education in general. My concern, however, is the possibility that there is not sufficient recognition in Japan of the necessity for financial education in the first place. For example, in a survey of adults conducted in 2016 by the FSA, about 70 percent of respondents answered that they "have not participated in investment education," and about two-thirds of these respondents stated that they "do not wish to acquire financial or investment knowledge." This means that nearly half of all respondents in the survey indicated such unwillingness. My impression is that investment, in particular, is still perceived as something that wealthy people do.[8]

While this may be partly due to the prolonged period of deflation, I believe it is important that the necessity of financial education gain more recognition in Japanese society. I feel that an increase in such awareness is similar to a rise in public acceptance of a certain degree of increase in prices. It seems to me that both are indicative of a social norm where it is taken for granted that wages and prices rise in a stable manner.

6 The Financial Literacy Survey is Japan's first large-scale survey covering 25,000 individuals chosen in proportion to Japan's demographic structure. The comparison with overseas was done in terms of the simple average for the percentage of correct answers given to six common questions in the OECD survey, which was conducted in 30 countries and economies in 2016.

7 The multiple-choice question asked: "Which of the statements is correct in times of deflation, where prices continue to decline?" There were three answer choices: (1) "Borrowing is profitable because the value of money increases"; (2) "Borrowing is unprofitable because the value of money increases"; or (3) "Borrowing is unprofitable because the value of money decreases." The survey covered men and women living in Japan, aged from 20 to 69, with 1,000 people providing valid responses to the questions. The results were published in The Nikkei on September 2, 2017.

8 According to the National Survey on Securities Investment conducted in 2015 by the Japan Securities Dealers Association, about 30 percent of respondents answered that securities investment was "something that wealthy people do." The survey was conducted on 7,000 men and women living in Japan who were at least 20 years of age.

Bank of Japan

Takako Masai - ***Member of the Policy Board***

(English translation based on the Japanese original)

CORPORATE POLICY: LOST IN TRANSLATION?

BY **MARIEL BARCLAY**, EDITOR EUROFINANCE, UK, JANUARY 2018,
ARTICLE PROVIDED BY **DFCG**, THE FRENCH IAFEI MEMBER ASSOCIATION

You might want to implement the same finance and treasury structures globally but the way and extent some countries resist can take you by surprise. In a series of interviews, leading multinationals reveal how corporate policies are understood and implemented depending on the cultures. What are the most effective ways of overcoming resistance?

Global policies, local communication style

While treasurers make efforts to gain efficiency and improve processes all over the world, they can easily forget that cultural differences and not just tax and regulatory restrictions, will impact the way people perform and prioritise activities. Indeed, cultural misunderstandings are often at the heart of the delays and frustrations in implementing projects.

But what do we mean by culture? One way of understanding it, is as a set of shared values, beliefs, symbols and norms that influence the way a group of people think, feel and behave. These are deeply engrained. To complicate things further, cultures are not just national but also regional, corporate and personal. Companies cannot change them, only carefully tailor communication to help build bridges.

The EMEA regional treasurer of a $20 billion company that prefers to remain anonymous notes: “In Germany people listen and act. In the Middle East they have a view on how things should be done and I have to listen to them. Although in the end we do what the corporate dictates, I have to adopt different communication styles.”

Communication is often put to the test by cultural resistance when companies decide to centralise and standardise processes globally.

“If you think that you are going to centralise and everybody is going to fall into line, you are being unrealistic. A good communication and change management process is fundamental” says Alfredo Elespuru, Corporate Treasurer at Gloria who helped centralise treasury at Belcorp and Oriflame.

Managing cultural differences: Mind the gap

Subsidiaries typically resist as they see their wallet and their autonomy being taken away. However, reaction and time taken to comply with corporate requirements vary with every culture. Understanding how to build trust and to communicate with each is fundamental to succeed.

Nicolas Levet´s first task as Group Treasurer at Damart Somfy Group was to ensure that subsidiaries implemented policies established three years prior to his arrival, which until then had been ignored. The corporate had over 100 bank partners (over 700 bank accounts) and required the closure of local ones, sticking to a few core international banks. Most subsidiaries had argued that local banks were better but when Nicolas Levet approached them with a clear mandate from the corporate to enforce the policy, cultural differences became apparent in the way each country reacted. "Although all resisted initially, when the Nordic subsidiaries understood that there was no going back they were rapid to comply. Latin Americans tried to negotiate but faced with the corporate´s refusal to compromise, they had to agree. However, close follow up and controls were necessary to ensure full compliance. China was prompt in agreeing but when auditors went to check, the local accounts were still in place."

So what is an effective way to communicate with different cultures? "To manage cultural differences you have to start by understanding your own culture in a non-judgemental way and link it to the operation at hand" says Alex Schuster, Managing Director at consulting firm Mentavis.

Understanding resistance to change

Fons Trumpenaars, a Dutch-French author in the field of cross-cultural communication created a seven-dimension model to show what distinguishes people between one culture and another.
The first dimension is universalism, the belief that ideas and practices can be applied everywhere without modification. Laws, rules, values and obligation are given high importance. People try to deal fairly with others based on these rules, but rules come before relationships. At the other end of the spectrum, particularist cultures believe that each circumstance and each relationship, dictates the rules that they live by. Their response to a situation may change, based on what's happening in the moment, and who's involved. Typical universalist cultures include the U.S., Canada, the U.K, the Netherlands, Germany, Scandinavia, Australia, and Switzerland. Particularistic cultures include Russia, Latin-America, and China.

So what happens when universalist cultures, such as the Swiss try to impose the same practices everywhere without modification? How do they manage in Latin America or Russia where a particularistic outlook prevails?

Elespuru's experience at Swiss multinational Oriflame convinced him that "It is important to have a model that has been tried and tested. If you intervene in subsidiaries and you make a mistake, you undermine the project, people start questioning it. When there are no clear roles or processes, each situation, each subsidiary becomes a model in itself. In my experience, the best way to mitigate cultural differences and the resistance to change is to create a centralisation team. They should go to the countries, collate information on how they manage daily operations, contrast that with the model and bridge the gap."

Individual cultures in the melting pot

You should also consider how multicultural your centralisation team is. "You might want to keep some diversity within the team but not so much that more noise could be generated during the centralization process." concludes Elespuru.

Beyond country and company cultures, leaders also make their mark. Miguel Premoli, VP Talent Management at Pepsico Europe explains: "I have been at the EU HQs of a company where the leader was from the UK and that culture clearly dominated until he was replaced by someone from Spain. The dynamics and the way of doing things changed, even if policies and corporate culture remained the same."

"You also need to think about where you locate a hub. Some countries can have cost advantages but if the culture is very risk averse they will need to test things over and over again until they feel sure they will work. Those are not great places for innovation, which demands risk taking," adds Elespuru.

Another important factor to consider is how different cultures deal and engage with time. Improving efficiency often involves prioritising and time management. This varies widely among countries, potentially becoming a source of misunderstanding. The language you use is important. "I need this ASAP" might mean very different things depending on who you talk to.

To avoid confusion you must be clear and specific about deadlines.

M & As: Integration or power struggle?

Mergers and Acquisitions are also testing occasions and show the power dynamics at play when different cultures meet. Pepsico´s Premoli, says: "One has to understand that mergers are never between two equals, there is always one culture that predominates".

This was allegedly the case in the Nokia Siemens initial joint venture. An ex-employee recalls how difficult it was for the proud employees of an iconic German firm such as Siemens to accept Nokia´s lead. Within three years most treasury staff from Siemens had left. Nokia eventually bought out Siemens shares, taking total control.

For Pepsico´s Miguel Premoli the best outcome in a merger or acquisition is to "extract the best of each team and bring them together".

This of course requires an appreciation of the other culture, be it national or corporate. It is not uncommon for cultures that have traditionally been on the acquiring side to find it difficult to accept being bought and managed by firms from emerging markets. Maria Loria, Corporate Treasurer at Jose Cuervo, a leading tequila company from Mexico, had a taste of this when they started buying companies around the world. Some countries initially had reservations about being led by a Mexican company but her recognition of what the other cultures could bring to the table was helpful. Her aim was to look for synergies and to find a win-win situation.

Cuervo allows people to get involved in decision making and understands that acquired companies with individualistic cultures operate more efficiently if they are given the opportunity to use their initiative. Loria explains: "You need to spend time with the people in the companies acquired and build interactive teams, making them participate in your objectives and participating in theirs. I am going to achieve my goals if they achieve theirs."

Conclusion: building bridges

Tony Osentoski, Head of Corporate Treasury & Insurance, Asia Pacific at Solvay agrees that focusing on building relationships is important in Asia too. "If you want a homogeneous approach you have to make the team come together, make it a priority so that everybody understands what is happening in different locations. This will help deliver corporate objectives. We regularly have calls in which we give people a platform to present an update on their countries. They highlight a regulatory change or something that is happening and how it impacts them. That raises awareness among the rest of the group of what it means to manage treasury in other countries, the tasks they face every day. "

Treasurers worried about achieving maximum efficiency, integration and control should know that treasury is not just about visibility of cash but also about visibility of people´s values and feelings. These dictate the way they understand the world and their approach to work. Treasury is not only about reconciliation of accounts but about reconciliation of cultures, managing financial risks and cultural sensitivities, investing time in listening and communicating, borrowing the best of each cultural system to achieve synergies

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EU BLACK LIST, A NEW PERSPECTIVE ON TAX HAVENS

by **PIERGIORGIO VALENTE**
Chairman IAFEI International Tax Committee, January 2018

IIntroductory Remarks

The European Union recently took one more step in the worldwide fight against tax avoidance and evasion with the release of the common EU list of non-cooperative tax jurisdictions. The EU black list – the first such list at EU level - includes seventeen offshore countries: American Samoa, Bahrain, Barbados, Grenada, Guam, South Korea, Macao SAR, Marshall Islands, Mongolia, Namibia, Palau, Panama, Saint Lucia, Samoa, Trinidad and Tobago, Tunisia and United Arab Emirates.

The black list is intended primarily as driver for non EU countries to improve their tax systems and fully align them with international standards. Thus, the EU actively pursues the ambitious objective to streamline the international tax framework on the basis of a (wishful race-to-the-top) convergence. At EU level, the list seeks to coordinate Member States' policies vis-à-vis non-cooperative tax jurisdictions. Hence it addresses an important impediment to cross-border investment in the EU, since divergent national rules imply heavier administrative burdens for business in an otherwise Single Market.

In an ever-evolving international framework demanding further evidence of multinationals' tax compliance, it is crucial especially for tax risk management purposes, that the latter be fully aware of any and all relevant measures. Specifically, the herein examined black list is considered as a factor triggering increased reporting obligations in the context of public Country-by-Country reporting – if and when adopted. Equally the black list seems to be connected with additional obligations in respect of mandatory reporting of tax schemes by professional intermediaries, currently under discussion at European Parliament level and expected to come into force in 2019. In view of the above, the present article shall give an overview of the listing criteria and process as well as of the core features of the EU list and its implications.

Compilation of the Black List: Procedure

In view of the relevant backdrop, the compilation of a common list of non-cooperative tax jurisdictions was provided in the External EU Strategy for Effective Taxation and was formally approved by the Council in the aftermath of the Panama Papers' leaks, in May 2016. The Code of Conduct Group for Business Taxation, comprised of Member States' tax experts, undertook the compilation mission in cooperation with the European Commission and in continuous contact with the OECD.

The process started with a pre-selection, i.e., review of all non-EU tax jurisdictions by the European Commission with regard to the risk for their legal framework to favor tax avoidance. Outcome of the review was a scoreboard of such jurisdictions based on (i) their economic relations with the EU, (ii) their financial activity, (iii) the level of stability of their legal and institutional framework and (iv) the applicable tax governance principles.

The scoreboard served for Member States to select the jurisdictions to be further reviewed (screening) on the basis of pre-agreed criteria by Member States. This second-stage review involved formal communications and meetings with representatives of ninety two selected jurisdictions, ensuring that the latter were given a real opportunity to present their case. The outcome of the screening was notified to each jurisdiction screened. The tax framework of seventy two of the jurisdictions was found not to be compliant with international standards. These jurisdictions were then invited to remedy such non-compliance or to commit to do so in the near future.

At a third stage (listing) the black list was drawn, including the seventeen jurisdictions that did not respond positively to the above invitation, i.e., that did not commit to take action to remedy identified deficiencies in their tax framework. For eight jurisdictions, under conditions of emergency, finalization of the process has been postponed to early 2018.

Black List Criteria

The aforementioned screening of jurisdictions was effected on criteria agreed by Member States in light of the international standards to which the latter abide. Such criteria are divided into three categories related to (i) transparency, (ii) fair tax competition, and (iii) so-called BEPS compliance.

In terms of transparency, the jurisdictions included in the black list were found:

(i) not to implement any information exchange, automatically and on request, with EU Member States; and/or

(ii) not to be parties to the Multilateral Convention on Mutual Administrative Assistance in Tax Matters; and/or

(iii) not to be members of the Global Forum on Transparency and Exchange of Information for Tax Purposes or to have been assessed as being "non-compliant" thereby.

From the perspective of fair tax competition, jurisdictions were black listed where:
(a) their legislation favored offshore structures without economic substance; and/or

(b) they had in place harmful tax regimes, i.e., rules to attract foreign investment on purely tax-related considerations.

In relation to compliance with the OECD's Base Erosion and Profit Shifting (BEPS) Project, jurisdictions were assessed against implementation of the four BEPS minimum standards, regarding harmful tax practices, legislation to curb tax treaty abuse, introduction of country-by-country reporting and the framework of tax dispute resolution.

Gray List

A major part of the screened jurisdictions (forty seven) were not included in the black list but in a so-called gray list. Although deficiencies were identified in their tax systems under the above criteria, the distinguishing factor is that they committed to cooperate with EU Member States within strict timeframes. In other words, they undertook to eliminate such deficiencies by the end of 2018 (or 2019 in case of developing countries). The prompt fulfillment of such obligation shall be verified in due course and their exclusion from the black list shall be affirmed along with it.

Implications of Black Listing

The impact of the EU black list depends largely on the extent and the way it will be used by Member States, and the legislative measures they will adopt by reference to the list. Nevertheless, certain consequences are also provided at EU level.

Most importantly at the current stage, the EU black list is connected to EU funding, originating from EFSD (European Fund for Sustainable Development), EFSI (European Fund for Strategic Investment) and ELM (External Lending Mandate). Thus the EU aims to ensure that no such funding shall end up in non-cooperative jurisdictions. Furthermore, the list is envisaged to be used in future EU legislation as threshold of enhanced tax reporting obligations, in particular from multinationals and tax intermediaries.

At national level, Member States have been strongly encouraged by the EU Council to adopt legislation by reference to the list in order to protect their tax bases. From the perspective of EU business taxpayers, such national measures may define significant implications. Specifically, potential measures encompass inter alia (i) enhanced controls over transactions involving black-listed jurisdictions and/or (ii) assessment of increased tax risk for taxpayers using or benefiting from harmful tax regimes of such jurisdictions.

In any case, it is important to note that Member States may always adopt other measures at domestic level to defend their taxable bases. Such measures may be different, or additional to the ones suggested above. Hence, national black lists cannot be excluded, provided their scope be broader than that of the EU black list.

Tax havens' de-listing

The black list shall be subject to regular revision and update by the Council of the EU, following respective report by the Code of Conduct Group. This implies that black-listed jurisdictions may be removed from the list, once found compliant with the aforementioned criteria and any future international standards of tax good governance. Equally, jurisdictions currently excluded from the list (or even from the screening process, e.g., due to lack of financial activity) may be included therein, for example, if they adopt practices abstaining from such standards. However, black listed jurisdictions shall always be promptly notified as to the reasons for listing as well as any expected actions for their removal therefrom.

Conclusions

The release of the EU black list is a remarkable step against tax avoidance as well as a strong signal of the potential of Member States' coordination. For the business world, it implies a clear need to keep an eye on structures and transactions involving black-listed jurisdictions and to ensure that all necessary tools are in place to manage related tax risk. Simultaneously, any and all legislative developments, at national, EU and international level should be closely followed, especially in view of the regular updates envisaged. The transformation of the international tax arena seems to have still a long way to go. The business world cannot but be fully alert thereto.

Press, Journal Article

Payden&Rygel
POINT of VIEW
FALL 2017
Our Perspective on Issues Affecting Global Financial Markets

GREENPIECE: THE BIRTH OF "GREEN BONDS"

Is top-down government action the only way to address global environmental issues? Not at all. In fact, despite the focus on one global power's exit from a key climate accord, a burgeoning, bottom-up movement is taking shape, with the bond market—yes, you read that right—leading the "green" charge.

Payden&Rygel

GreenPiece:
The Birth of "Green Bonds"

President Donald Trump threatened to withdraw the United States from the Paris Climate Accord, but don't think America has turned its back on the planet. Instead, a bottom-up response to environmental concerns is well underway, and the capital markets appear poised to play a crucial role in the effort. In particular, individual cities and corporations can support climate protection by issuing so-called "green bonds."

As an investment manager, our goal is neither to support nor criticize the United States' economic or climate policies. Instead, we intend to provide a lively introduction to the world of green bonds.

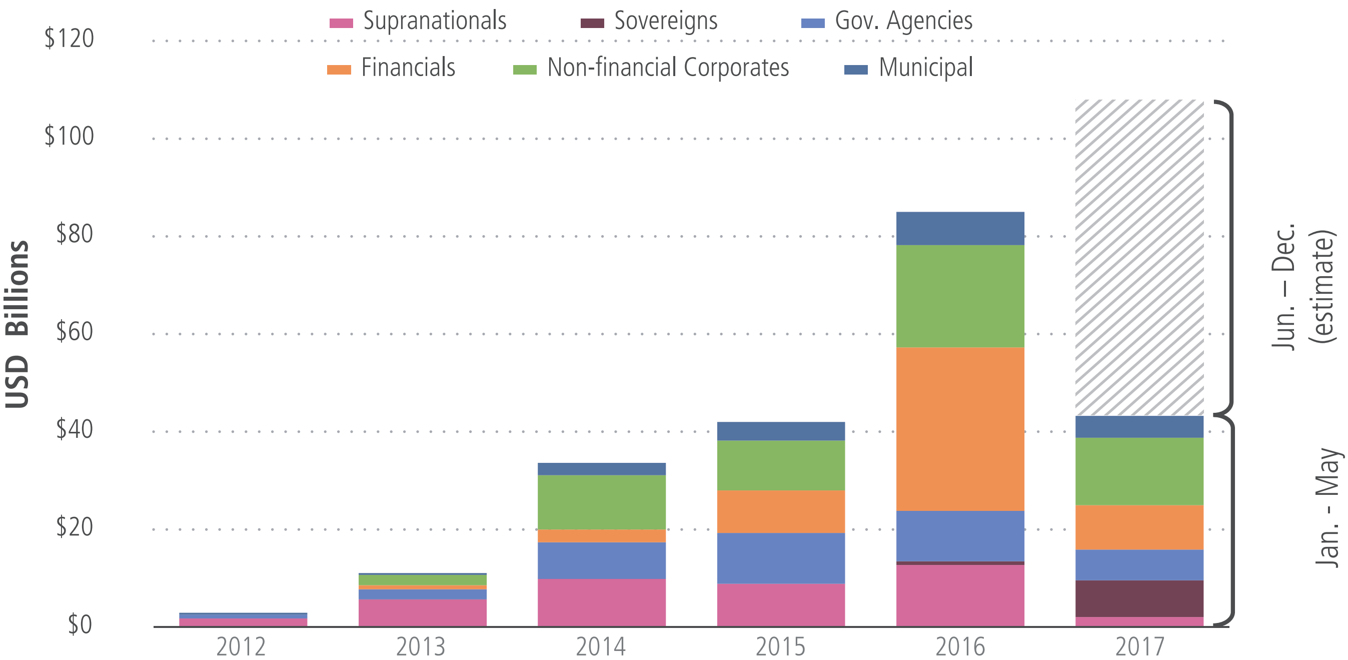
For those feeling a bit "green" when it comes to sustainable finance, let us clear up definitions first: a "green bond" is a financial instrument that signifies a commitment to use the proceeds to finance or re-finance projects that deliver positive environmental impact. Green projects include, but are not limited to: renewable energy, clean transportation, sustainable land use, and energy efficiency.

Green bonds are well-suited for large-scale sustainability projects and enable cities, states and corporations to secure large amounts of capital. These "do-good" investments are becoming more popular as corporations and municipalities build brands around "sustainability" and as fund managers increasingly create vehicles to direct capital toward these projects. Perhaps we should not be surprised by these trends: Millennials are nearly twice as likely to invest in funds that target environmental or social outcomes.[1]

«WE THINK GREEN BONDS CAN THRIVE AS A KEY COMPONENT OF THE BOND MARKET IF A UNIFORM DEFINITION IS ADOPTED AND IF INVESTORS KEEP A KEEN EYE ON THE USE OF BOND PROCEEDS. »

The issuance of the green bond market is expected to exceed USD 100 billion by the end of 2017 *(see Figure 1)*, though will remain small and immature, accounting for less than 1% of the worldwide bond market. We think green bonds can thrive as a key component of the bond market if a uniform definition is adopted and if investors keep a keen eye on the use of bond proceeds.

fig. 1 GOING GREEN: ANNUAL GREEN BOND ISSUANCE BY ISSUER TYPE



Source: Bloomberg New Energy Finance

> «CORPORATIONS COVET THE "GREEN" LABEL AS AN OPPORTUNITY TO DELIVER SUSTAINABLE NARRATIVES AND TO EXPLICITLY MARKET THEIR BONDS AS ENVIRONMENTALLY AND SOCIALLY CONSCIOUS INVESTMENTS.»

GOING GREEN: HOW GREEN BONDS STARTED

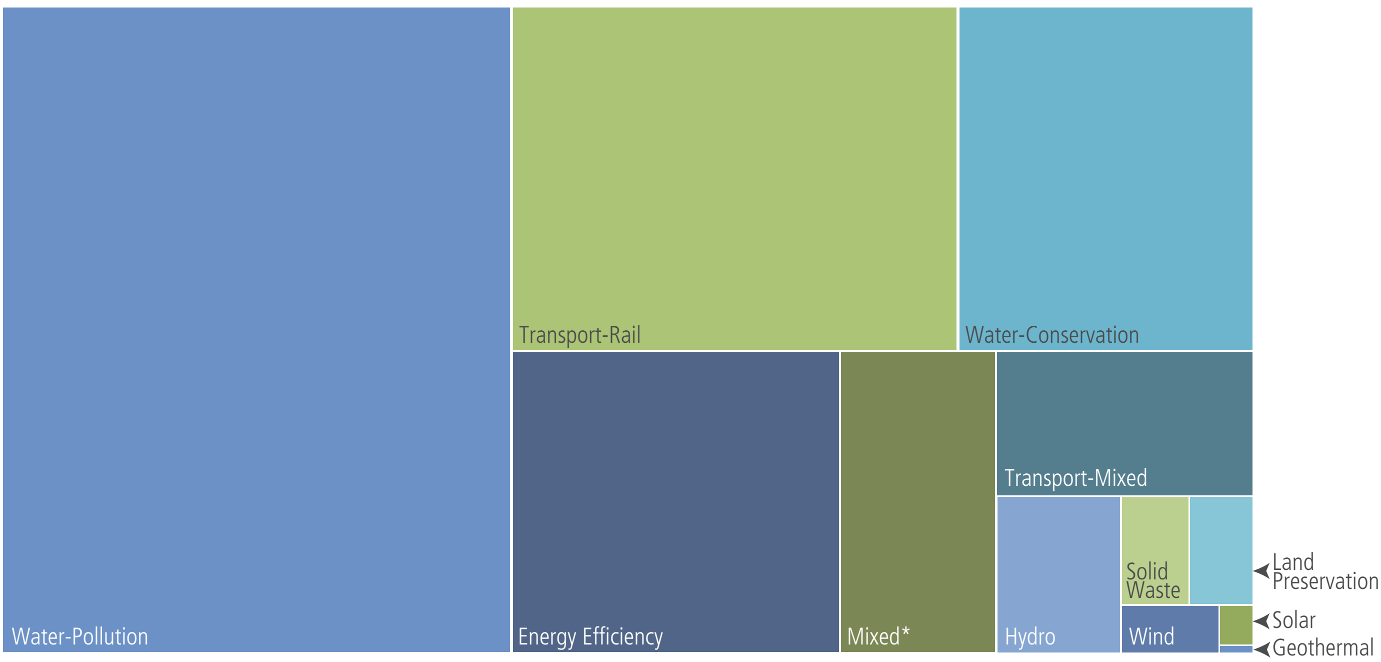
Green bonds have only developed in the last decade, but they have been growing at a fast pace. In 2007, the European Investment Bank issued the world's first green bond, followed in 2008 by the World Bank. These multilateral development banks were the sole issuers of green bonds until the first corporate green bonds were issued in 2013 by EDF, Bank of America, and Vasakronan. Specifically labeled green bonds attract investors as the securities enable them to invest directly in sustainable projects. Corporations covet the "green" label as an opportunity to deliver sustainable narratives and to explicitly market their bonds as environmentally and socially conscious investments.

The green bond market expanded greatly in 2015 when 195 countries signed the Paris Agreement—a commitment to cut emission levels and to hold the increase in global average temperature below 2 degrees Celsius above pre-industrial levels.[2] To meet the aggressive temperature goal by 2030, an estimated USD 93 trillion in infrastructure investment is needed. In response, many cities and municipalities around the world turned to debt financing for low-carbon development projects, especially for renewable energy infrastructure. As of February 2016, green bonds have been issued in 23 currencies and 14 markets of the G20.[3]

As a result, by the end of 2016, global green bond issuance more than doubled from one year prior, with nearly USD 97 billion in fresh financing. China accounted for USD 32 billion, as one of the leading countries issuing green bonds.[4] Approximately 40% of the proceeds from new issuance financed clean energy, while nearly 25% went to buildings and industry, and around 10% to transport.[5]

As for 2017, the total green bond issuance haul year-to-date (as of May 5th, 2017) reached USD 45 billion, putting the market on track to best its 2016 total and reach USD 111 billion by year end.[6] There is a growing trend for green projects, as more institutions support initiatives aimed at preserving the environment. However, the green bond trend goes beyond recent climate initiatives. Emerging markets, in particular, face a growing need for energy-efficient and clean technology. As the cost of constructing clean tech infrastructure falls, countries are shifting towards renewable energy. For example, in South Korea, newly-elected President Moon temporarily shut down all coal power plants and mandated more investment in renewable energy power plants as Seoul, the country's capital has recently become one of the world's most polluted cities.

fig. 2 IT'S NOT JUST ABOUT RENEWABLES: U.S. MUNICIPAL GREEN BOND ISSUANCE BY USE OF PROCEEDS, 2014-2017 YTD



Source: Bloomberg New Energy Finance

*Mixed use of proceeds

Some emerging markets still do not have a strong banking or capital markets foundation to help finance high-cost infrastructure projects. In the energy sector, countries with the greatest need for power plants are the ones that rely heavily on international financing. These countries issue project-specific green bonds backed by single or multiple projects to finance high-cost projects. For example, the Philippines financed a geothermal power plant by issuing green bonds, the first local currency green bond in the power sector. By issuing green bonds, emerging economies can enhance the growth of their debt markets and reduce the infrastructure-investment gap.

GREEN BONDS MARRY MUNICIPAL BONDS: GREEN MUNICIPAL BONDS

The U.S. lags the rest of the world when it comes to green bond issuance. Green bonds comprised a mere 0.061% of the total U.S. bond market, a smaller share than that of China, India, and many European nations. The slow pace of development is due to relatively small offering sizes and sporadic deal flow, which leads to a lack of liquidity and stunted growth of the market. Demand also remains mostly retail-driven, through SRI (Social Responsible Investing) funds.

In the U.S., green bonds are most intimately related to municipal bonds, both regarding features and issuance, as most green projects are financing renewable energy power plant and energy-efficient transportation. Similar to the U.S. municipal bond market, key investors for green bonds are individual municipal bond investors who seek tax-exempted income. A growing number of investors, who tend to be of the "buy-and-hold" variety, span a wide range including institutional clients to individual investors.

Over USD 3.7 billion worth of new municipal green bonds were issued in the second quarter of 2017, making one of the busiest quarters of municipal activity (Q1 2017 saw USD 1.5 billion in issuance). As long as the current pace of green municipal bond issuance continues throughout the year, it is estimated that annual U.S. green municipal bond issuance will hit USD 10.4 billion in 2017, according to Bloomberg. State-run entities like infrastructure and public transportation entities are the largest issuers, and green municipal bonds are mostly used for managing water-pollution and rail transportation *(see Figure 2 on previous page)*.

CHALLENGES: SHADES OF GREEN

The overall purpose of a green bond sounds great—it facilitates financing for long-term, capital-intensive infrastructure projects and encourages people to be aware of the environment. However, at the same time, green bonds face critical challenges to enhance market transparency.

> **«ONE OF THE MARKET BARRIERS IS THAT THERE IS NO UNIVERSAL DEFINITION AND STANDARD FOR GREEN BONDS.»**

One of the market barriers is that there is no universal definition and standard for green bonds. Try and evaluate the "greenness" of a bond from the following two examples:

- The City of Long Beach, California, issued bonds to pay and/or reimburse the Harbor Department for capital expenditures incurred or to be incurred at the Port of Long Beach. This bond is considered "green" because the proceeds are expected to be used to reduce air emissions at the Port by reducing the number of trucks.
  - » Why does the City of Long Beach need financing when it is not *adding* but rather reducing required facilities? Does "reducing the number of trucks" count as a green project? Can investors accurately monitor changes in emissions around the port?
- The Maryland Economic Development Corporation self-labeled its bond as green bonds based on the Green Bond Principles. The Issuer believes that its project is green because it results in a 16.2-mile light rail transit line that falls under "clean transportation" category.
  - » Since green bonds can be self-labeled, how reliable is this "green" label? What makes a project green?

Likewise, different countries have their distinct definitions, challenging the green bond market to conform to a common understanding. This self-labeled "green" has broad meanings that confuse investors and put issuers at risk of "greenwashing," which is using the proceeds from green bonds for non-green uses. China, for example, counts clean coal is "green." For these reasons, investors should be cautious when evaluating the "greenness" of a bond.

One solution to this issue may be to prompt all countries and corporations to adopt a single, rigorous definition of a green bond. However, if it were this simple, you might think, "Why did issuers not pursue this option in the first place? Do people even want to agree to a common definition?"

Issuers face the dilemma of either having a strict or loose definition of a green bond. A specific definition could limit market growth due to selectiveness but gives clarity on the use of proceeds to investors, whereas a "loose" standard would accomplish the opposite. Even knowing the potential downside of having a strict definition, to enhance the credibility of the "greenness" of a bond, we still believe having a unified and clear definition of the green bond is needed.

CHALLENGES: THIRD-PARTY EXTERNAL "REVIEW"

Currently, the market is trying its best for transparency. Rating agencies such as Moody's have promoted green bond ratings that assist investors in understanding overall risk factors. These third-party external reviews help investors verify the requirements of the Green Bond Principles of a bond. However, the third-party verification process is still in its infancy. As of October 2015, only 60% of total green bond issuance was officially audited by a third party.[7] Also, the third-party verification process is costly, with prices that range from USD 10,000 to USD 100,000.[8]

Ratings reviews, like green bonds themselves, bring different approaches for assessment from each rating agency. Each reviewer has her own standard and criteria, challenging investors' ability to effectively compare and measure.

Learning from FASB (Financial Accounting Standards Board), with its goal to improve financial accounting and reporting standards for investors, SASB (*Sustainability* Accounting Standards Board) was founded in 2011 with a similar purpose but with a focus on material sustainability features. SASB addresses public companies' disclosure of material, reliable, and comparable data to investors so that they can make decisions with an awareness of environmental, social and governance (ESG) factors. This helps investors to assess a company in a comparable, rigorous way.

DID YOU KNOW?

California, New York, and Massachusetts issued the largest amount of green municipal bonds, with California leading the charge. However, on average, green municipal bonds by state only constitute 0.6% of the total outstanding municipal bonds. Vermont is the greenest state regarding the total amount of outstanding green municipal bonds. The proceeds of the most recent green bonds issued by the Vermont Municipal Bond Bank are expected to be used to install energy-saving equipment, including water heating and heating control systems.

Why not apply this to fixed income? The external reviewer should review the "greenness" of a bond based on a common and well-structured standard created by an independent third-party. Such a development will enhance the transparency and quality of the green bond market, boosting market growth.

«BY 2020, IT IS ESTIMATED THAT GREEN BONDS COULD ENABLE $120 BILLION IN INCREMENTAL ANNUAL INVESTMENT.»

CLARITY BRINGS SERENITY

By 2020, it is estimated that green bonds could enable USD 120 billion in incremental annual investment.[9] As long as there is uniformity in the definition of "green" and rigorous evaluation of the use of proceeds, green municipal bonds have a high potential for further growth and transparency, becoming more diversified across geography and credit quality while targeting a wide range of investors. Cities and states may have their way on climate initiatives whether or not the U.S. federal government supports it.

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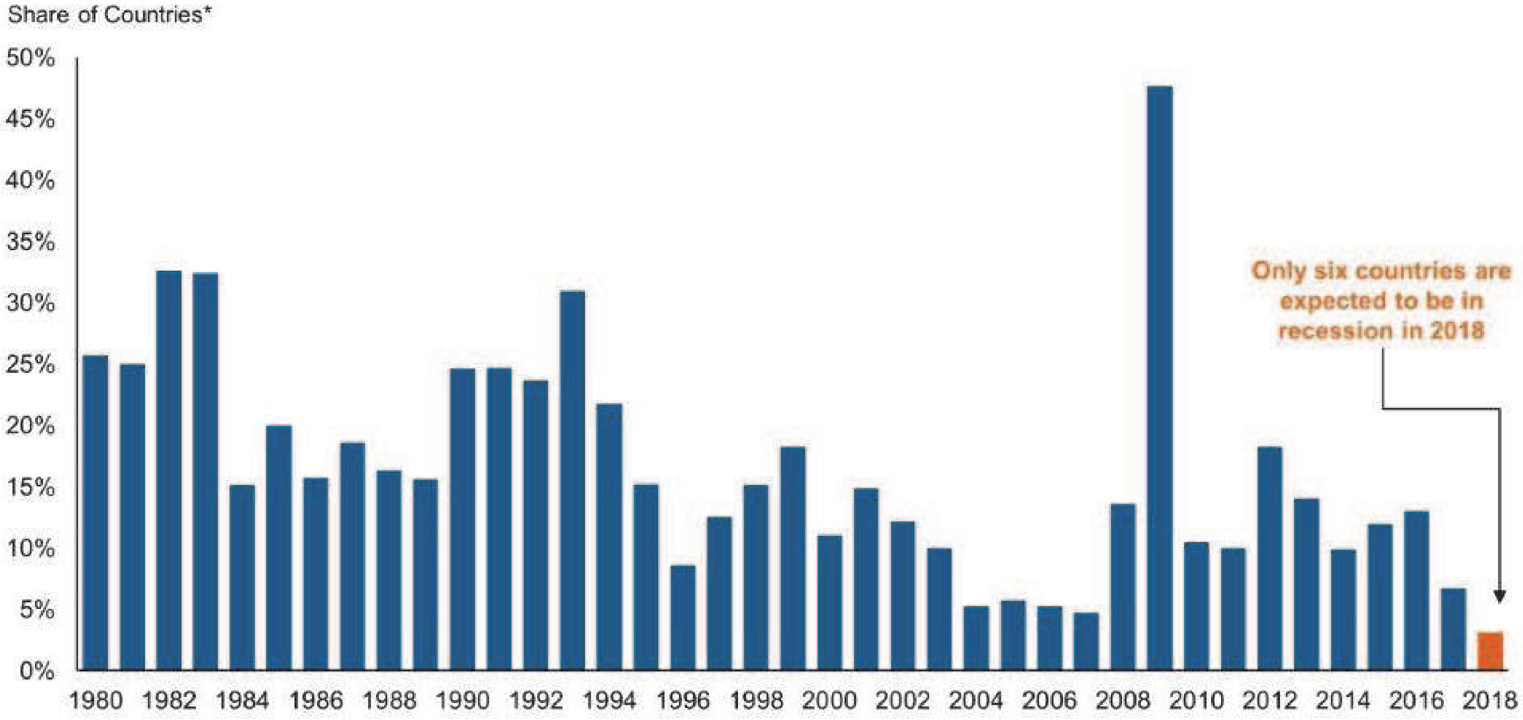
CHART OF THE WEEK

Payden&Rygel
Investment Management

2018: The Best Year for The Global Economy on Record?

Share of Countries In Recession By Year

For The Week Ending 1/5/18



Source: International Monetary Fund, Payden Calculations — **The share of countries that contracted in a given year*

At least according to one measure, 2018 might be the best year for the global economy since 1980. We expect to see the fewest countries in recession on record (the data goes back to 1980), with just 3% of the world's economies expected to be contracting in 2018. Contrast 2018 with, say, 2009, when nearly 50% of the economies on Earth contracted in the Great Recession. Or, compare 2018 to an average year in the 1990s, when in any given year around 20% of the world's economies were shrinking. Further, the 3% figure for 2018 translates into just six countries, whom together produce a mere 0.4% of world output. So global growth is not only picking up, but doing so across the board in a way we haven't seen in at least four decades. Get optimistic for the New Year!

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