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# IAFEI Quarterly

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(International Association of Financial Executives Institutes)*

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### Dear Financial Executive,

You receive the **Thirteenth 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 information tool of our association, destined to reach the desk of each financial executive, or reach him, her otherwise, at the discretion of the national IAFEI member institutes.

We have just started into the calendar year 3, after the world financial crisis, which achieved its high point with the collapse of Lehman Brothers in September 2008. Taking notice of new, or discussions about new regulations in the aftermath of this century – crisis, continues to be one of the day to day activities of the financial executive.

Consequences to be observed in debt and in equity markets continue to be massive, as well as interactions between new regulations and market responses. Financial corporations, as well as non financial corporations, are impacted by the resulting ongoing and challenging changes.

At the same time, the weights within the global economy continue to be redistributed by the massive growth in the emerging markets economies, not few of which are gradually being moving towards a developed industrial country status.

This issue of the IAFEI Quarterly is again a reflection of this present global situation.

IAFEI held its 40<sup>th</sup> IAFEI World Congress in Rome, Italy, October 2010, one of its very best congresses in IAFEI's history. At this occasion, the annual physical IAFEI Board of Directors meeting took place, and officers were elected for the calendar year 2011. For details see chapter "IAFEI News".

In November, 2010, the Instituto Mexicano de Ejecutivos de Finanzas, IMEF, has rejoined IAFEI, and in November 2010, Mr. Luis Ortiz Hidalgo, Vice Chairman for International Affairs of IMEF, was elected as IAFEI Area President The Americas. IAFEI again warmly welcomes IMEF as new member institute and looks forward to mutual benefits from this membership.

In February, 2011, the Israeli CFO Forum has rejoined IAFEI. IAFEI again warmly welcomes the Israeli CFO Forum, as new member and looks forward to mutual benefits from this membership.

The 41<sup>st</sup> IAFEI World Congress will be held in Beijing, China, September 16 to 19, 2011. Shortly, from now, the Congress Program and the Registration Form will be available on the IAFEI website, [www.iafei.org](http://www.iafei.org).

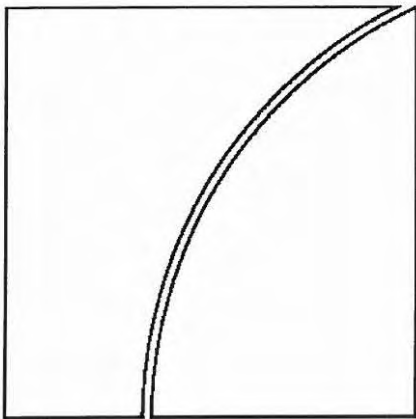
This will be the first IAFEI World Congress in the history of IAFEI to be held in China. I encourage as many of you as possible to attend this Congress in China, and I look forward to meeting you there.

Once again, I repeat our ongoing invitation to IAFEI member institutes, and to their members, to send us articles for inclusion in future IAFEI Quarterlies, and to also send to us your suggestions for improvements.



Helmut Schnabel

Basel Committee  
on Banking Supervision



**The Basel Committee's  
response to the financial  
crisis: report to the G20**

October 2010



**BANK FOR INTERNATIONAL SETTLEMENTS**

# The Basel Committee's response to the financial crisis: Report to the G20

## Executive summary

The Basel Committee on Banking Supervision and its oversight body, the Group of Governors and Heads of Supervision<sup>1</sup>, have developed a reform programme to address the lessons of the crisis, which delivers on the mandates for banking sector reforms established by the G20 at their 2009 Pittsburgh summit. This report, which the Committee is submitting to the G20, details the key elements of the reform programme and future work to strengthen the resilience of banks and the global banking system.

The depth and severity of the crisis were amplified by weaknesses in the banking sector such as excessive leverage, inadequate and low-quality capital, and insufficient liquidity buffers. The crisis was exacerbated by a procyclical deleveraging process and the interconnectedness of systemically important financial institutions. In response, the Committee's reforms seek to improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spill over from the financial sector to the real economy.

The reforms strengthen bank-level, or micro prudential, regulation, which will help raise the resilience of individual banking institutions in periods of stress. The reforms also have a macro prudential focus, addressing system wide risks, which can build up across the banking sector, as well as the procyclical amplification of these risks over time. Clearly, these micro and macro prudential approaches to supervision are interrelated, as greater resilience at the individual bank level reduces the risk of system wide shocks.

Collectively, the new global standards to address both firm-specific and broader, systemic risks have been referred to as "Basel III". Basel III is comprised of the following building blocks, which have been agreed and issued by the Committee and the Governors and Heads of Supervision between July 2009 and September 2010:

- Raising the quality of capital to ensure banks are better able to absorb losses on both a going concern and a gone concern basis;
- Increasing the risk coverage of the capital framework, in particular for trading activities, securitisations, exposures to off-balance sheet vehicles and counterparty credit exposures arising from derivatives;

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<sup>1</sup> The Basel Committee on Banking Supervision provides a forum for regular cooperation on banking supervisory matters. It seeks to promote and strengthen supervisory and risk management practices globally. The Committee is comprised of central bank and supervisory authority representatives from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The Committee's Secretariat is based at the Bank for International Settlements in Basel, Switzerland.

The Basel Committee's governing body is the Group of Central Bank Governors and Heads of Supervision, which is comprised of central bank governors and (non-central bank) heads of supervision from member countries.

- Raising the level of the minimum capital requirements, including an increase in the minimum common equity requirement from 2% to 4.5% and a capital conservation buffer of 2.5%, bringing the total common equity requirement to 7%;
- Introducing an internationally harmonised leverage ratio to serve as a backstop to the risk-based capital measure and to contain the build-up of excessive leverage in the system;
- Raising standards for the supervisory review process (Pillar 2) and public disclosures (Pillar 3), together with additional guidance in the areas of sound valuation practices, stress testing, liquidity risk management, corporate governance and compensation;
- Introducing minimum global liquidity standards consisting of both a short term liquidity coverage ratio and a longer term, structural net stable funding ratio; and
- Promoting the build up of capital buffers in good times that can be drawn down in periods of stress, including both a capital conservation buffer and a countercyclical buffer to protect the banking sector from periods of excess credit growth.

The Committee is also working with the Financial Stability Board to address the risks of systemic banks. On 12 September 2010, the Governors and Heads of Supervision agreed that systemically important banks should have loss absorbing capacity beyond the minimum standards of the Basel III framework.

The Committee's reforms will transform the global regulatory framework and promote a more resilient banking sector. Accordingly, the Committee has undertaken a comprehensive assessment of Basel III's potential effects, both on the banking sector and on the broader economy. This work concludes that the transition to stronger capital and liquidity standards is expected to have a modest impact on economic growth. Moreover, the long-run economic benefits substantially outweigh the costs associated with the higher standards.

Going forward, the Committee will concentrate its efforts on the implementation of the Basel III framework and related supervisory sound practice standards. It is also conducting work in the following areas:

- A fundamental review of the trading book;
- The use and impact of external ratings in the securitisation capital framework;
- Policy response to systemically important banks;
- The treatment of large exposures;
- Enhanced cross-border bank resolution;
- A review of the *Core Principles for Effective Banking Supervision* to reflect the lessons of the crisis; and
- Standards implementation and stronger collaboration among bank supervisors through supervisory colleges.

In 2009 the membership of the Basel Committee doubled in size to 27 jurisdictions. It is now represented by senior officials from 44 central banks and supervisory authorities. The greater diversity of supervisory views and practices shared among members has enriched the Committee's discussions. The broader representation has also served to enhance the Committee's legitimacy as a global standard setter.

In the course of its standard-setting process, the Committee regularly solicits public comments on its proposals. For example, its December 2009 proposals on capital and



liquidity generated close to 300 comments from bankers, academics, governments, other standard setters and prudential supervisors, and various other market participants and interested parties. Such comments are carefully reviewed by the Committee and its working groups and proposed standards are modified as appropriate. Together, the transparent public consultations and comprehensive impact assessments help ensure that the Committee is developing standards on a well informed and inclusive basis.



## Annex 1: Phase-in arrangements

Shading indicates transition periods - all dates are as of 1 January

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Leverage ratio	Supervisory monitoring		Parallel run 1 Jan 2013–1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1	
Minimum common equity capital ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital conservation buffer						0.625%	1.25%	1.875%	2.50%
Minimum common equity plus capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials )				20%	40%	60%	80%	100%	100%
Minimum Tier 1 capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum total capital plus conservation buffer			8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital			Phased out over 10 year horizon beginning 2013						
Liquidity coverage ratio	Observation period begins				Introduce minimum standard				
Net stable funding ratio		Observation period begins						Introduce minimum standard	

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## FATCA : a tsunami for the financial services industry... and beyond !

Stéphane Jourdain

The Foreign Account Tax Compliance Act (« FATCA »), which is part of the HIRE act signed by president Obama on March 18, 2010, has been designed to prevent US citizens and businesses from evading US tax by holding income-producing assets through offshore structures. We have highlighted below the key features of a legislation that will have major consequences worldwide on a going forward basis.

### Introduction

Under the new act, a punitive 30% withholding tax will be imposed on qualifying US source payments, unless tough information requirements are complied with. The new regulation will come into force as of January 1, 2013. FATCA

will have a broad impact on businesses all over the world as they will likely need to make modifications to their internal systems, control frameworks, processes and procedures for timely compliance. One indeed currently estimates that FATCA will generate approximately 10 billion dollars on a yearly basis, during a 10 years period. Though the act has been signed into law, the regulations clarifying the implementation of the status are expected to be issued in pieces over the next 12 to 18 months. In parallel, the US tax authorities have asked any interested party to provide them with comments and remarks regarding the new regime; so far, a number of lobbies have already used this opportunity.

### In scope entities

All foreign entities receiving income from US source are likely to be impacted by FATCA. The new legislation distinguishes between two classes of foreign entities.

The first class includes the « Foreign Financial Institutions » (« FFIs »). An FFI is defined as any foreign entity :

- Accepting deposits in the ordinary course of a banking business ; or
- Holding financial assets for the accounts of others as a substantial portion of its business; or
- Engaging (or holding itself out to be) primarily in the business of investing, reinvesting or trading in securities, partnership interests, or commodities.

The definition of FFI is quite broad,

and appears to include virtually all foreign investment vehicles regardless of being offered or traded publicly. FFIs thus include banks, insurance companies, clearing organisms, custodians, hedge funds, private equity funds and alike. We will not focus on the FFIs in this article, because they are a more specific class of taxpayers.

The second class includes the « Non Financial Foreign Entities »

(« NFFE »). An NFFE is any foreign entity that does not meet the definition of an FFI, and generally includes privately held operating businesses, professional services firms, and any other non-publicly traded foreign entities not involved in banking or investment management.

It is expected that the US treasury may exempt entities such as certain holding companies, research and development subsidiaries, or financing subsidiaries within an affiliated group of non-financial operating companies from treatment as an NFFE. Currently, there are numerous carve-outs for entities that are not considered NFFEs and thus are not subject to complying with the NFFE requirements, as they pose a low risk of US tax evasion, including but not limited to:

- Corporations whose stock is regularly traded on an established securities market ;
- Corporations where an affiliate that is regularly traded owns more than 50 percent of the value and vote;
- Any foreign central bank of issue.

### Income subject to withholding

The new rules generally apply to payments made after December 31, 2012, and define as withholdable payment any payment of interest,

dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, if such payment is from sources within the United States. While not specifically enumerated, royalties are also included as withholdable payments, including royalties for the use of patents, copyrights, secret processes and formulas, and other like property.

In two significant departures from the current withholding regime the term also covers any gross proceeds (so not only the capital gain) from the sale or other disposition of any property of a type which can produce interest or dividends from sources within the United States, and treats interest earned on deposits of foreign branches of US banks as US source income.

There is an exemption from withholding if any of the income is effectively connected with the foreign entity's US trade or business. Foreign individuals and foreign entities receiving rents from real property in the United States often make elections to treat that income as effectively connected with a US business, and thus exempt from withholding.

Also, the new law does not require withholding on any payment from any obligation outstanding on March 18, 2012, or from the gross proceeds from any disposition of such an obligation. This is the so-called "grand-fathering" clause. The term "obligation" will be further clarified when regulations are issued and will mean any legal agreement that produces or could produce withholdable payments. While not specifically defined for these purposes, other guidance and sections of the code use the term



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obligation to include any bond, note, debenture, certificate, bill receivable, account receivable, note receivable, open account, or other evidence of indebtedness.

### Requirements

For Belgium, FATCA will have a double direct impact.

For FFIs, no withholding for FATCA purposes is required if an agreement is in effect between an FFI and the US Treasury. Generally, the agreement requires a determination of which accounts are United States accounts (i.e. beneficially owned by qualifying US holders), and then annually reporting on those United States accounts to the US Treasury.

For NFFEs, any withholdable payment made to an NFFE generally after December 31, 2012 will be subject to 30 percent withholding unless the beneficial owner or payee provides the withholding agent (a withholding agent is the person responsible for collecting and submitting withholding and includes any business or entity making withholdable payments, such as



corporations, partnerships, trustees, banks and brokers) with either:

- Certification that they do not have any substantial US owners; or
- With the name, address, and taxpayer identification number ("TIN") of each substantial US owner.

Only specified US persons owning more than 10 percent of the NFFE, considered as substantial US owners, need to be reported to the withholding agent. However, this threshold is reduced to 0 percent if the sole purpose of the entity is for investment (e.g. holding company). Specified US persons subject to reporting include:

- Citizens or residents of the United States, which include foreign persons holding green cards;
- US partnerships;
- Non-publicly traded US corporations;
- Any trust controlled by US persons and able to be administered by a US court.

The US persons whose ownership interests in an NFFE do not need to be reported to the withholding agent include:

- Any corporation whose stock is regularly traded on an established securities market;
- Any corporation where an affiliate that is regularly traded owns more than 50 percent of the value and vote;
- Most tax-exempt organizations (e.g. pension funds);
- Banks;
- Real estate investment trusts (the equivalent of a Belgian SICAFI);
- Regulated investment companies (the equivalent of a Belgian SICAV).

Such information will be used by the Internal Revenue Service to verify that the US (in)direct owners of the NFFE respect their tax filing obligations in the United States. If the conditions imposed by FATCA are not complied with, a punitive 30% withholding tax will be levied.

Such withholding cannot be reduced based on double tax treaties, and it is expected that any refund procedure will be burdensome, time-consuming and complex.

## Examples

### 1<sup>st</sup> example

A privately held Belgian technology company, the NFFE, has three owners and receives \$100,000 of US source interest income. Owner 1 is a publicly traded US company owning 40 percent of the company and Owners 2 and 3 are privately held Belgian companies each owning 30 percent. Owner 1 certifies to the NFFE that it is a publicly traded corporation and is not a US person. Owner 2 certifies that it does not have any substantial US owners. Owner 3 has decided not to certify that it does not have any substantial US owners as it does not want to report its ownership.

Because the NFFE cannot certify that it does not have any substantial US owners, the full \$100,000 payment is subject to 30 percent withholding.

### 2<sup>nd</sup> example

A US biotech company pays a privately held Belgian company a \$1,000,000 royalty for licensing a medical device patent. No withholding applies under the Belgium – US double tax treaty, resulting in a \$1,000,000 net payment.



If the Belgian company, an NFFE, does not certify to the US biotech company whether it has any substantial US owners and provide the appropriate documentation, the \$1,000,000 payment will instead be subject to 30 percent withholding resulting in a \$700,000 net payment.

### 3<sup>rd</sup> example

A Belgian paper company (Paperco) organized as a corporation has a bank deposit account with the London branch of a large US head-quartered bank. Paperco has three legal owners : Owner A, a Belgian natural person, Owner B, a Belgian natural person that holds a green card and Owner C, a US trust equally owned by a husband and wife who are US citizens.

Paperco qualifies as an NFFE and, in order to avoid 30 percent withholding on an interest payment from its bank, will need to provide the bank with the name, address and TIN of the following owners:

- Owner B, since he or she holds a green card and owns more than 10 percent of the NFFE;
- Owner C, since the trust is a US person directly owning more than 10 percent of the NFFE ; and
- Husband and wife of Owner C, since they each indirectly own more than 10 percent of the NFFE.

### 4<sup>th</sup> example

An attorney from the Brussels office of a US law firm spends one week in the United States working on a legal proceeding and the Brussels office is paid \$10,000 by the US firm for the work.

Unless the Brussels office, a foreign entity and an NFFE, provides the

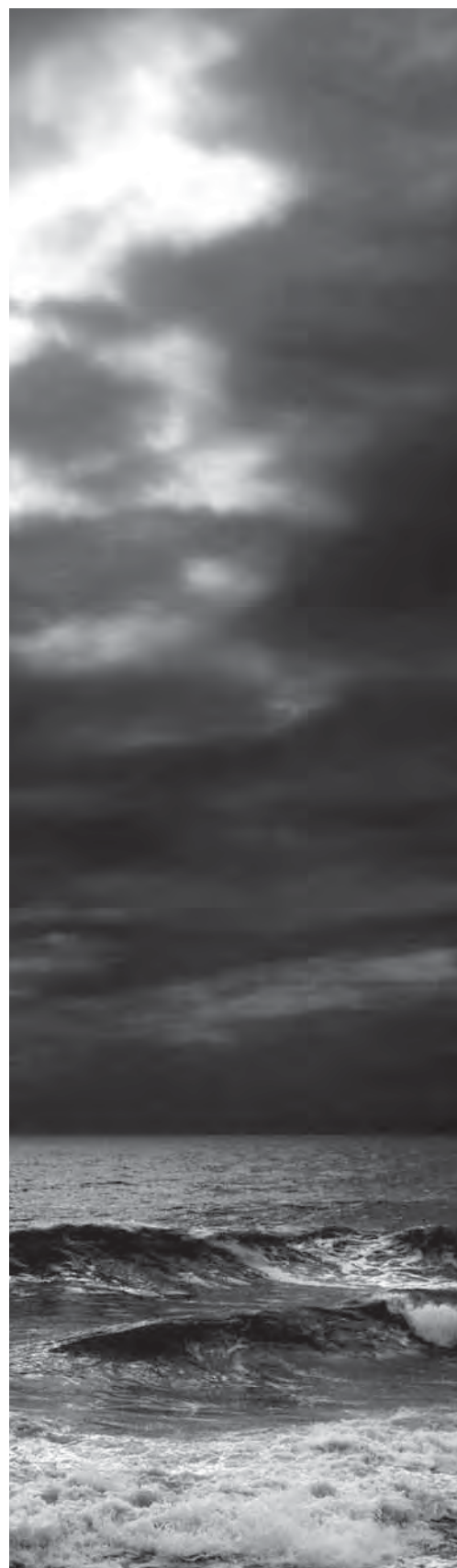
proper certification, the US firm will need to withhold 30 percent.

## Impact

It is fair to say that FATCA will create multiple challenges, which can be a.o. of a legal (e.g. compatibility with data protection legislation), technical (e.g. adaptation of IT systems to the new requirements) or tax (e.g. qualification of certain payments) nature. As such, it will require a multi-disciplinary approach to ensure appropriate compliance. In order to keep track of developments and in order to help businesses to become FATCA compliant, it is highly recommended that corporations liaise with their tax advisors, which can provide services such as tax analysis, tax risk management, assistance with IT implementation, legal analysis, trainings or assistance in communication.

Market players aiming towards full compliance with FATCA must be prepared to invest heavily in systems, reporting, training, etc., which to some may be extremely onerous. This is however the price for avoiding the punitive withholding tax, thus remaining attractive for US investors without penalizing the non US investors.

Businesses should not wait until these rules come into effect to begin assessing their needs and associated costs for compliance. By performing the proper compliance risk assessment now and evaluating necessary modifications to their existing systems, organisations will be armed with the level of risk intelligence required to address compliance with FATCA's new withholding and reporting regime.



**Brazil, Commentary:      Brazil's Blossoming**  
by **Carl Moses**, Buenos Aires

At the presidential elections of Brazil (on October 3, 2010) the candidate of the government, Dilma Rousseff, is the clear favorite. Even though the opposition, at late, has gained some ground, Rousseff is expected to be the winner in possibly the later second election at the end of October. The outgoing president, Luiz Inácio Lula da Silva, who after two periods of office cannot be re-elected again, is using his immense popularity for helping his political foster-daughter. The chances for a victory of the more technocratic Rousseff are based exclusively on the high support of Lula by almost 80 percent of the population. This support results to a large extent from the phenomenal economic upturn which Brazil has experienced in the eight years of the government of Lula.

When Lula was elected as president for the first time in 2002, the country was at the brink of insolvency. Because of fear from the former blue colour worker leader, investors by way of panic had withdrawn capital from Brazil. But contrary to all fears, Lula stuck to the stability anchors, which had been put in place by his predecessor Fernando Henrique Cardoso. These were and are a level headed fiscal policy, a flexible exchange rate, as well as the orientation of the monetary policy at an inflation target, which is pursued rigorously by an "administratively" independent central bank. The economy came quickly on its feet and set out to a long lasting upturn, which was only briefly dampened two years ago by the global economic crisis.

Today, the Brazilians are much better off than before eight years. The most benefitting, however, are the poor. At first, by extending the social programs which had already been introduced by Cardoso, at last even stronger through intense economic growth. During Lulas office term, 21 million Brazilians have escaped from poverty. The economy in 2010 is probably growing by 7,5 percent. This is the highest rate since 25 years. Strong backwinds were brought by the good economic development of China and of other emerging markets. Because Brazil is world market leader for raw materials like iron, soja, meat and sugar, which are feeding the growth of Asia. The discovery of huge offshore-oil reserves outside the Brazilian atlantic coast could make Brazil, in a few years, to one of the largest oil producing countries – at the condition, that the immense technical challenges of producing oil from up to now unreached depths in the sea can be mastered.

On the other hand, Brazil is since long not only exporting raw materials. Also cars, mobile/cell phones and jet planes belong to the export portfolio. The Amazonas land is almost an energy giant, which produces the largest part of its own consumption from renewable resources. Most of the cars are driving with alcohol made from sugar cane. The electricity comes by three quarters from water power, also the wind energy is going through a strong upturn.



The export boom, as well as extensive capital investments from abroad, do continuously increase the foreign exchange reserves. In the global financial crisis, it has been shown impressively, how little vulnerable Brazil therefore today is. Whereas the international monetary fund had to support Brazil in 2002, still, with record loans, the South-Americans today are lending money to the fund for helping the financially weak member states of the European Union.

With all export successes, the exports are just about amounting to ten percent of the gross domestic product. Its dynamics gets Brazil's upturn increasingly from its inner energy. This stability, a better availability of credit, social climbing up on the ladder, have the huge internal market with its almost 200 million consumers almost woken up from a long sleep. In the past six years, 36 million Brazilians have moved up into the middle class and the upper class. Many of them are buying now their first car, are travelling for the first time with a plane, or are moving into a better apartment. The sale of luxury cars is blossoming as well as the construction of subsidized apartments for the lower wages classes. Income and employment are growing rapidly. The confidence of the consumers is as high as never before.

No wonder, that the voters want first of all continuity. Without corrections, however, Brazil's blossoming cannot continue in this way. High taxes, and the appreciation of the Real are putting pressure on the competitiveness of the industry. The Brazilians are saving too little, in order to finance the necessary investments into the building up of the run down infrastructure. Alone for the soccer world championship 2014 and the Olympic games 2016 in Rio de Janeiro, more than 60 billion US-Dollars have to be raised.

The government would have to improve the conditions for private investments, rather than, like under Lula, extending the influence of the state over the economy. If Brazil wants to grow in the long term, like in 2010, reforms must be brought on their way as regards the inefficient tax system, the paralyzing bureaucracy, and the underfinanced pension insurance and the old still existing labour laws. However, these Hercules-jobs not even Lula has carried out.

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**Euroland, Interview: Asia Wants to Save the Euro**  
**by Lei Lei Song, Economist of the Asian**  
**Development Bank, ADB**

Lei Lei Song explains, why the Chinese and the Japanese are purchasing Euro-bonds, even Greece-bonds.

*Mr. Song, China and Japan have announced, to increasingly buy government bonds, also from the crisis countries. We like this, because we want to get out of these papers.*

The two countries are purchasing the bonds, because they want to stabilise the Euro. In this they have a big economic interest. In the end, Europe is one of the most important trading partners. If the Euro is weakening, then the Asian exports are becoming more expensive and this deteriorates their competitive chances.

*This cannot be the only reason.*

One has to see the purchase of the Euro-Bonds also against the background of the huge currency reserves of China and Japan. These two states are owning 40 percent of the worldwide currency reserves. A quarter of them is invested in Euro, in European bonds and in a few European corporate bonds. If the Euro decreases in value, also these investments are suffering.

*Then these countries must anyway buy European government bonds, and the great announcement was pure marketing, at least the President of China travelled this week to Washington.*

On this I will not make a judgment. But there are at least strong economic reasons for the purchase of the bonds.

*Would the view change, if Portugal and Spain would also need support loans from the European Union-Partners and if Greece would perhaps have to recapitalise its debt.*

China and Japan are no short term oriented hedge-funds. With regard to their currency reserves they are thinking very long term, in periods of 20 to 30 years. They are not panicking, even when all others would fall into panic. They are also purchasing, although there is now a crisis, because they believe, that the Euro-Area will solve the problems and will thereby even more strongly grow together. The political will in Europe seems to be there. Then even a Greece-bond can become a good business.

*What's in for Asia, from a unified Europe, does it hope for common Euro-Bonds jointly from all European States?*

I know the resistance against this in Germany. But for Asia, Euro-bonds would be very good. They would then have markedly greater volumes than the many bonds from the individual countries. With this, they would be a genuine alternative to the US-American government bonds.

***For what is this necessary?***

Community-bonds, and very generally an economically strong Europe, would reduce the dominance of the USA. This is in the interest especially of China. It regards the present currency system, which is only oriented at the US-Dollar, as a system of the past.

***Why?***

It is fragile, because it depends on the economic situation of one country. How negative this can be, one has seen.

***Because of this, China has renewed its idea of a new world currency system with a stronger role of its own renminbi. Is this not a little bit exaggerated?***

It is not the renminbi that should take over the dominant role of the dollar. But with the growing position of China, its currency will also increase in importance – in a system with several important currencies – to which will belong in any case a stronger Euro. China would like to invest a higher portion of its currency reserves in Euro, and a lower one in US-Dollar. Large liquid Euro-bonds of all Euro-States would facilitate this. More competition among currencies would also increase the economic discipline of countries.

***Are the renminbi and China already in a position, to take over a stronger role?***

No, China must liberalise its financial system and must make the renminbi freely tradable.

***Will this happen soon?***

I am expecting strong changes in the coming five years. This is also in the interest of China, because it is strengthening its own economy.

***Then the currency will revalue strongly, and the world is already asking for this since long?***

Already in this year China will revalue the renminbi more than in the past years. This helps in the fight against the increasing inflation.

***Will this fight suffocate the economy, as one is fearing again in this week? This would hurt the exports of Germany and its equity market.***

We are expecting a slight cooling off of the just published 10,3 percent growth for 2011. In this year, we are expecting 9,1 percent. This would not be a terrible message for the world economy.

***Is the inflation increasing further?***

Stronger than the 3,3 percent in 2010, but less than five percent. Because the measures against price increases are effective, for instance the limitations to making new loans. Over five percent it would become difficult for the country. This would produce social unrest.

***Then German investors must not be afraid of the worst. How will the rest of Asia fare during 2011?***

India will grow by at least 8 to 9 percent and could even exceed China for the first time. Also Indonesia, Thailand and South Korea are growing strongly. Pakistan is the big question mark and Vietnam is fighting with a double digit inflation.

***Is the high capital inflow from western investors a problem?***

At the present no. When shortterm too much money is coming in, then this can of course increase inflation and interest rates. But in the long term Asia needs capital. For the improvement of the infrastructure alone, eight trillion US-Dollars are necessary until 2020.

***Will Asia remain the motor for growth for the world also in the next decade?***

Yes, but the continent is standing before great challenges. It is comparatively easy, to get from a low income level to a middle income level. But to then attain a level like the industrial countries, great efforts are necessary. Then one must, for instance, modernise the labor law and the health care system, the capacity for innovation and the productivity have to be increased, and environmental protection has to be improved. This will be difficult for several countries.

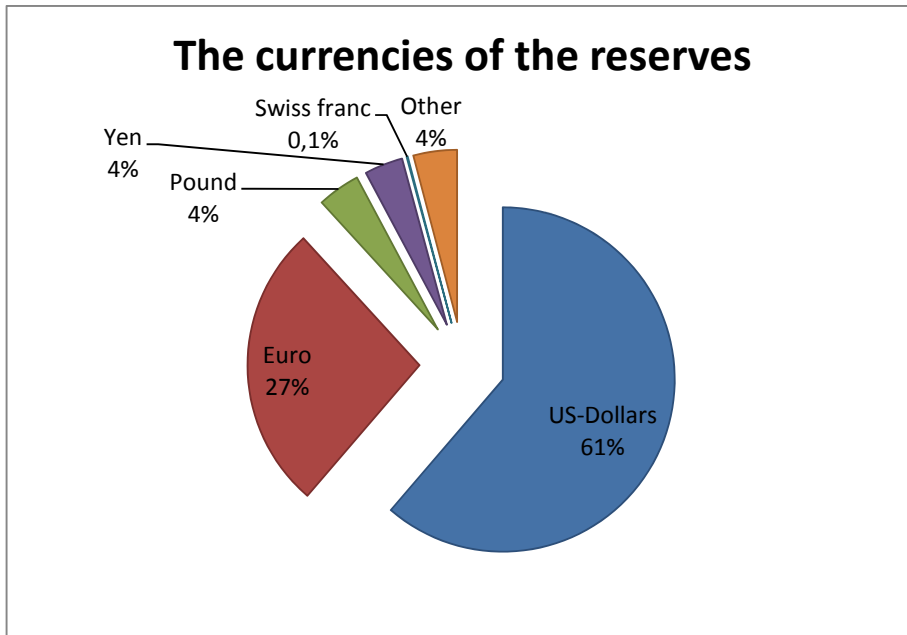
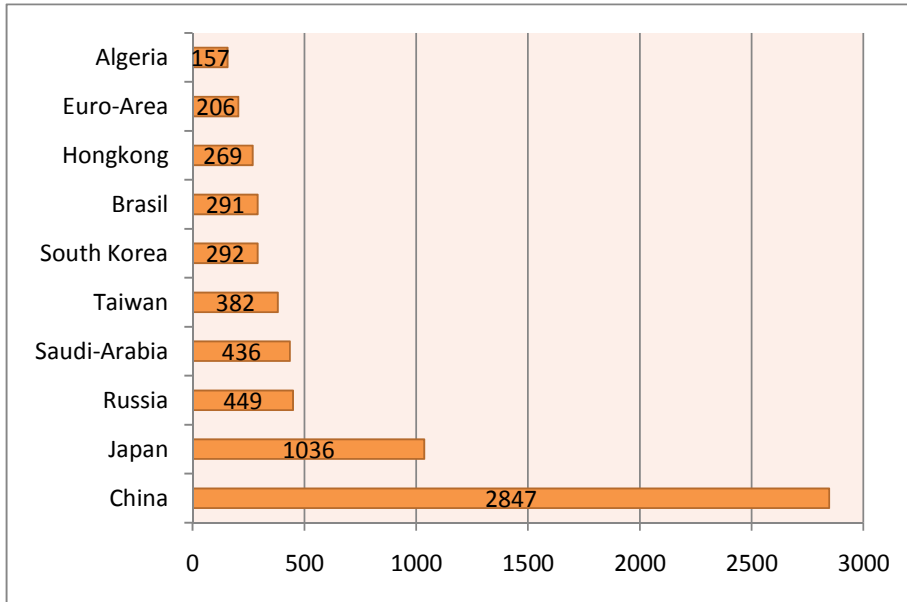
***Is it easier for China, to master these challenges?***

More difficult. The population is huge, it is growing older faster than for instance in India, and it is used to an always high growth. It will not be easy to maintain this in the next decades.

***The interview was made by Dyrk Scherff.***

## The Currency Reserves of the World

The countries with the greatest reserves  
2010, billion US-Dollar



sources: IMF; Bloomberg, deviation from 100 % due to rounding./F.A.Z Graphics Niebel

## **The Asian-Expert**

**Lei Lei Song** is senior economist of the Asian Development Bank, ADB. Its a small worldbank for Asia. This means, it makes loans to its member countries, which have lower interest rates and which have longer maturities than loans which are taken up in the free market. It finances itself from the contributions of its member states and through its own bond issues.

Song works since 4 years in Manila in the ADB. He has 14 years experience in macro economic analysis, and also in the international research. The 44 year old born Chinese has studied in Shenzen and in Australia.

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## **Euro-Land, Interview: Some Countries Should Take a Euro-Timeout“**

**Interview with Kenneth Rogoff**, Professor at the Harvard-University, USA, and former Economist of the International Monetary Fund, IMF

The former IMF-Chief Economist Kenneth Rogoff is sharply criticising the European Union bailout policy. He requests a debt cut by 30 to 40 % for the Euro-peripheral states. Some countries should leave the Euro for 10 years.

*Prof. Rogoff, Europe`s answer to the debt crisis is: More money, in order to protect the governments from the capital market. Is this reasonable ?*

No. There must be some debt restructuring in the peripheral states, of private debt and of public debt. A blank guaranty for the debt is simply not a suitable system for the economy. It is a wrong conclusion, that risks and costs can be avoided, when one is borrowing money and giving it to Greece, in order that it will not become immediately insolvent. To disguise a problem, does not reduce the risks, it makes them only larger. An end game must have a plan for debt restructuring. Some debts will not be able to be repaid. People who have lent money to Greece, have received for this an interest rate premium of 2 to 3 percentage points, in order that they did assume this risk.

*Why does the blank guaranty by Europe increase the risks ?*

First, the moral risk is absurdly high, if one gives a blank guaranty not only for one year, but for a decade. This only creates incentives for the governments, to even take up more debt. Secondly, Germany, France and Italy already have high indebtedness of their own, not catastrophically high, but still very high. Would Germany assume the debt of the Peripheral-States, its indebtedness could increase by 10 percentage points of the gross domestic product. 10 percentage points more of indebtedness, for a country like Germany, which already has more than 70 % indebtedness, is not insignificant.

*What is so bad about high debt ?*

In my work with Carmen Reinhart, we have looked together at the indebtedness of dozens of states over several centuries. For developed countries it is surprisingly seldom, that their debt is exceeding the threshold of 90 % of gross domestic income, and even more seldom is it more than 120 %. Even when our empirical work does not prove any cause, we have found out, that high indebtedness goes together with significantly lower growth rate.

*Why is the growth lower, when the indebtedness is high?*

Our supposal is, that with growing indebtedness at a special point the risk is getting always bigger, that the markets will ask for higher interest rates. If then finally comes the day, at



which a country is confronted with higher interest rates, it will almost certainly have to increase taxes and to lower expenses. It is this fiscal adaptation, which finally is lowering growth. At one point one must make the belt tighter. This is certainly the reason, why, historically, one sees so seldom such high indebtedness.

***How should a debt restructuring in Europe look like?***

Europe needs a comprehensive plan, which debt is to be restructured how, and which debt should remain untouched. This will not be nice, Europe will be forced into a uniform solution. The Brady-Plan for Latin America, in the eighties, had a pretty uniform debt cut. Such a model is plausible for Europe perhaps in a more differentiated way. I can imagine a cut by 30 to 40 %, although that might especially not be sufficient for Greece. After that the tax payers in Germany and France basically have to stand up for everything else. This is evident: If one would not guarantee the remaining debt, then there would be a panic.

***Europe's governments are afraid, that the debt restructuring would hit their banks.***

Naturally, Europe would have to bail out a few of its banks, when the government debt will be restructured. It is an open question, by how much. The ridiculous stress tests of June 2010 have here brought only little clarification. In some cases, the governments will have to take over up to 100 % of the debt and will have to sell it again later. Some of the numbers, which are quoted as charges for the banks for the case of a state insolvency, however, are overdone. Governments will not become insolvent by 100 %, probably we talk about 30 to 50 %.

***Europe wants to force the governments, which are protected from the capital markets, to a better economic, fiscal and social policy.***

A good idea, but a political system can only subdue to a certain degree of austerity for a certain time. One can require from countries, to go into a recession for one year, perhaps even for two years. But the peripheral states would go into a recession for four or five years, would they execute the fiscal adaptations which are being discussed. This is not especially credible. For certain, a debt restructuring for Greece, Ireland, and for Portugal will be painful, but probably a lot less painful and significantly shorter in time than the savings programs of tightening, which are being deliberated. Even when they will be excluded, temporarily, from the capital market, this will not last for four or five years. Look only at Argentina's coming back to the market, and this case is hardly unique.

***Would a state debt restructuring be the end of the Euro?***

No, naturally not. But it would make sense, to encourage some countries to a Euro Timeout. They would leave the Euro-Area with an exactly defined way for re-entry, perhaps in ten or fifteen years. Said openly, I see no other way, how one can re-install competitiveness in countries like Greece and Portugal otherwise. Yes, even without this, wages would sink, and the state debt would increase relative to income. But there is no easy way out. Europe can only buy time. In my work with Reinhart we are showing, that there is a large number of countries,

to which the IMF, International Monetary Fund, gave a loan, and perhaps another one, and at the end there had to be a debt restructuring. It looks like Europe is moving along this way.

***Do you expect a debt crisis in the United States, like in Europe?***

The debt of California, and of other states is, relative to income, relatively small. The big problem for the states are the pensions for their employees, which are huge and deplorably underfinanced. Some states do look like Greece, for instance Illinois. But, overall, the problem of the United States is the opposite of the European one. In Europe, the center is solid, and the periphery faces bankruptcy. In the United States, the center has an unbearable debt development. Unfortunately, no politician can any more propose tax increases and expense reductions and remain in office, since Ronald Reagan has brainwashed the people and made them believe in a “perpetuum mobile”.

***Is there enough political endeavour in the United States, to tackle the indebtedness?***

Certainly not. Whenever there is a problem, the voters in the United States believe, that taxes have to be lowered, or expenses to be increased, or both. That is the opposite of the German voter. I do hope, that after 2012, if Obama will be reelected, he will tackle the problem - but do not expect too much.

***The central bank Federal Reserve has been sharply criticized for the second quantitative easing (QE2) and the purchasing of 600 billion US Dollar government bonds. Do you share this critique?***

No. I think, that the Fed has done the right thing. But there is the risk, that this will end terribly. QE2 means an increase of the money supply in six months by 60 percent, this is an unusual experiment, and in the core a not proven policy. I am teaching this idea of quantitative easing since 15 years. Unfortunately, economic models are not perfect. It is therefore not totally inadequate, that the German finance minister and his colleagues in the world are complaining and saying: “We have made you to the center of the world currency system, we do not want, that you blow it up. We want to be asked, when you enter into such a risk.” This is a justified position. The United States say: “This is our policy. Why should we ask you?” Naturally, this is not quite right. The Dollar is the world reserve currency, and the entire world is built around it.

***Are today`s interest rates too low, are they creating new bubbles ?***

We presently have too low interest rates, there is no doubt about it. The low interest rates transform not yet into inflation, because the financial system is paralysed. But exactly in such countries, which previously had no real estate bubbles, one is now developing.

The questions were asked by Patrick Welter.

## **Expert for government indebtedness**

Kenneth Rogoff knows debt crises like only few others. Together with Carmen Reinhart he recently got big attention with a comprehensive study about historical financial crises. What is new, is that they have carried together data of eight centuries, and have analysed them. One conclusion is: Europe`s banking and financial crisis is not extraordinary.

Rogoff`s scientific work goes far beyond research about indebtedness. The 57 year old American is also an excellent theorist of monetary policy. The Jury of the Center for Financial Studies, which awarded to him the “ Deutsche Bank Prize in Financial Economics 2011 “, is hailing his writings about international financial theory and macro economics. The former chief economist of the International Monetary Fund and grand master of chess is teaching and researching at the Harvard university.

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**Germany, Article:        Danger for the Stability**

by **Otmar Issing**, who, for eight years, was member of the executive board and the first chief economist of the European Central Bank, ECB, and who is regarded as the architect of its monetary policy

**The analysis of the causes of the present crisis is leading back to two fundamental questions, which already had been discussed before the start of the European Currency Union. Which conditions must be fulfilled by the countries, in order that the Euro will be a sustained success? And can a Currency Union exist at all without a Political Union?**

In the fall of last year, the new government in Athens informed the public, that the deficit in the public state budget was, other than so far assumed to be at round about three percent, instead now almost at 13 percent (and in the mean time increased to 15percent), and this news hit politics and markets like a shock. Such a revision so far is a one time event. The dimension of the correction surmounted not only the anyway existing doubts about the correctness of Greece's statistics, but the extent of the fiscal catastrophe resulted beyond that in doubts, whether the country could remain at all in the long term member of the Currency Union. Since then Greece had not anymore disappeared from the headlines, in addition to that, however – this is to be mentioned here already – with astonishing news about dramatic reforms, which until then were barely imaginable.

The worry reached very soon other members of the Currency Union. A blamably false terminology spoke of a “danger of contagion” as if other “patients” would not have shown, since long, similar, even though weaker symptoms. To formulate it differently: The case of Greece is one that on the one hand is sticking out significantly by way of its dimensions from the other fields, but on the other hand, it fits into the picture of wrong developments, which with their causes already started with the beginning of the Currency Union and which have built, over the years, into a threatening scenario. From this end, the situation, which has to be taken notice of today, is everything else but a surprise.

To be mentioned here, are not only the violations of the Stability and Growth Pact, but also the continuing divergencies in the unit labor costs with the consequences of grave divergencies of unit labour costs and losses of competitiveness as well as exaggerations in the construction sector of individual countries. Wrong developments in these areas characterise in essence the present state of the Currency Union respectively of individual countries. What sounds like a provocation, only relates to the facts: The crisis came everything else but unexpected, it is, quasi, a crisis with announcement.

In the “normal case” of history, a state area and a currency area are the same. In the case of the European Currency Union this is obviously not the case. At the start eleven, and in the mean time 16 member states, do not represent a Political Union. Against that does exist only one currency, the Euro, and one central bank, the European Central Bank, ECB. To this one, under the treaty, the duty has been given, to guarantee the price stability in the Euro Area. This objective applies for the Euro, the Currency Union as a total. Therefore exists only one uniform monetary policy, the interest rates set by the central bank do apply for all countries, from Ireland to Greece, from Finland to Portugal. “One size fit’s all” – the monetary policy suit must fit for all. Politics, however, have missed also after the start, to complete the necessary prerequisites for this.

With the entry into the Currency Union, the conditions for the individual countries have been changed materially. Countries, which in the past have been inflation-friendly, could now enjoy, under the roof of a common stable currency, lower interest rates, which until then they only knew from hearsay. With this, among others, an incentive had been created for a substantial extension of the construction activity. This, at the beginning admittedly desired development, then, however, soon misdeveloped into an overheating, which could not be maintained at the time. The monetary policy could not, and was not allowed to, do anything against such wrong developments in individual countries. It’s duty relates to the Currency Union as a total. Therefore, the national economic policy had been challenged. Especially tax measures – which continue to be the responsibility of national states – could have stopped the boom decidedly. In spite of earlier, numerous, and continued warnings, not least from the part of the ECB, these national governments had not followed these demands because of understandable, but in no way excusable reasons. In a comparable way the divergence of the units labor costs has developed. The crisis – which would not have been necessary to show it – therefore made a material construction mistake of the Currency Union visible: Relying on good economic policy in the member states was unjustified; continued mistakes of national politics not only damaged the own economy and population, but had to shake up into heavy weight problems for the Union.

With the Stability and Growth Pact one has tried in an important field, namely the fiscal policy, to meet the demands of a Currency Union. The basic idea was, that the national sovereignty as regards tax policy was not touched, but that when it comes to shaping the budget balance as well as the state debt, a fiscal policy should be guaranteed which is in line with the objective of stable money. Reconciling the national sovereignty with European control was the basis of the Pact.

At the latest in the year 2003, when the two largest member states, Germany and France organised a political majority in the council of the finance ministers, in order to prevent the application of the rules against their own violation, the Pact had to be considered as failed in its ambitions. Had to be expected something else from a jury, in which potential sinners had to judge about present ones? Still, the Stability Pact is not just a good will declaration, but a binding agreement under international right. But when one can rely so little on ratified treaties, which have passed all parliaments, how can one then expect

improvement from the future? In the meantime one has to assume, that the European financial market stability facility, which has been initially limited to three years, in one way or the other will become a form of a permanent institution. At least it seems, that in “Brussels” there is to a large degree acceptance, to establish a permanent aid fund as an indispensable element of a stabilisation of the Currency Union and as expression of European Solidarity. In this regard, there is not only very much money at stake, especially money of the tax payer of the more solid countries, but here it is a matter of the basic constitution of the European Currency Union. The No-Bail-Out-Principle, that means the exclusion of liability for the debt of other states, is reaching far beyond the use of financial means. It is expression of the fact, that this is not a kind of a state, but an association or a however called get together of states, which continue to be sovereign, and which at first have “only” passed on their monetary solvency to a European Institution. For extraordinary exogen shocks like natural catastrophes a help by the community is written into the treaty. For all “homemade” mistakes each country is liable itself. If this principle is undermined or even destroyed, then one has to expect after all theoretical considerations and practical experiences substantial wrong incentives (Moral Hazard): Individual States could have the temptation, when relying on help from outside, to pursue a fiscal and economic course of action, which will then also make the financial support a probability.

In political economical terms, the giving up of, respectively the diminishing of the No-Bail-Out-Principle, constitutes a kind of invitation, to live beyond ones means and at the expense of others. In nothing else results the request, to build the Currency Union in the direction of a transfer union. With this, however the character of the existing Currency Union would be essentially changed. The hint, that the union is said to be, since long, a transfer union, is leading, with or without intention, in the wrong direction. The transfers between member states, say in the form of agriculture payments, are limited as to their sum and are determined as to their purpose. Transfers however as a consequence of wrong development of fiscal policies or of other makroeconomic divergences embody in every regard an uncontrollable dynamic and threaten to reach dimensions, which can seriously reduce the public finances and the standard of living in the paying countries.

The remark, though, is true, that in the case of help by the European financial markets stability facility, respectively of the requested permanent institution, one is dealing only with loans and not with transfers. The case of transfer, however, will then come inevitably, when loans are not adequately serviced with interest and are not being repaid fully. Little is speaking, for that one has not to expect this.

If one takes the representatives of the view by word, a help fund would be necessary, in order to meet “unjustified attacks” on a member state – the speculation is considered to be the culpable – then one would have to take first all measures, that things will not develop into such “justified attacks”. Nothing at all can be recognized in this regard. Also the mention of the necessity of strict prescriptions when giving means to such a fund does not look credible. At the end, an emergency situation is only arising, when, before, a country has violated the regulations of the Stability and Growth Pact, which at least are meant to be strict prescriptions, or if it has violated other warnings.

The analysis of the causes of the present crisis is leading back to fundamental questions, which since long have already been discussed in the beginning of the Currency Union. First: Which conditions countries must fulfill, in order that the Currency Union can be a sustained success? And second: Can a Currency Union live without a political union?

As to the second issue, the then chancellor Helmut Kohl, under the uniform applause by the German parliament in his government declaration of November 6<sup>th</sup>, 1991, said: “One cannot say it often enough. The Political Union is the indispensable counter part to the Economical and Currency Union. The recent history, not only the one of Germany, is teaching us, that the view is false, one could maintain an Economic and Currency Union without a Political Union in the long run. “

Whatever may be meant with “Political Union”: From the start of the Currency Union on January 1<sup>st</sup>, 1999, nobody will be able to say, that these conditions had been fulfilled even only marginally. Therefore, at this point of time and in reality, a real test started, as to whether the judgment of Mr. Kohl was wrong, or whether with this date a process in the direction of Political Union was started.

The present discussions at all levels – from politics to science – are reflecting the different answers given to these questions. As an association of states which have subdued to a system of rules under international contracts, this Currency Union is resembling to a Club. The purpose of the charter of association, the “Stability Area” is intended to be secured on two levels. The stability of the Euro is guaranteed by the independent Central Bank ECB and it is set free from the influence of the member states, that means of politics. The Euro by its definition and intention has been created as an “unpolitical money”. The Federal Constitution Supreme Court of Germany has by the way stated in its Maastricht-Judgment, that only the joining of a Currency Union, with the price stability as the prime target, is to be regarded as in line with the Constitution.

The responsibility for the second column, the solidity of public finances, must be transferred, under the construction, to a European Super Revisory System on the European Level and without state competency. As an equivalent to the de-politicised money this European control would have to be subdued to an equally as far as possible de-politicised procedure. In pure theory, one could think about an automatism, which by exceeding certain macro-economic limits (for instance three per cent deficits), would be triggered. The, by its intention, objective statistical function, would without doubt be overextended with this. Still, with a really independent statistical administration with clear hierarchical priorities vis-à-vis national administrations, at least the data situation could be made objective and de-politicised. A body of independent experts which would issue an independent public judgement about compliance with respectively violation of the regulations, has often been asked for in the past, could also provide an important contribution.

The discussions and the actions on political switches as to the reform of the Stability and Growth Pact are announcing nothing good. Now, that especially Germany, the country,



which has insisted on an efficient pact as entry condition into the Currency Union, obviously is supporting a continuation of the decision procedure dominated by political majority decisions, there exists little hope, that the community has really learned from the crisis. As before, there has been no consensus about the sense and the necessity, to meet and maintain the prescriptions of the Pact, there is now increasingly building up resignation or even a consensus that such regulations cannot be enforced or that they are even not necessary.

When, however, even the European supervision and control of the current budget policy cannot be managed, how can one then trust, that the access to financial helps in case of crisis – from which funds ever – will be tied to strikt prerequisites? The lax application of the prescriptions of the Pact, subdued to the political calculus day in day out, and then the hard conditioning of the help in the case of crisis, are both representing a contradiction in themselves.

With the failure before the tasks, to get the fiscal policy of sovereign states in line with the conditions of a uniform currency area, politics is not only damaging the function of the Currency Union, but also puts at stake its existence as such. In any case and in the long run, stable money goes hand in hand with solid public finances. This holds true for a national state, but even more so for an association of sovereign states, as does represent the Currency Union. Serious divergences in the macro-economic politics, especially in the state indebtedness, create tensions and pressure on financial transfers, in order to prevent the breaking up of the Currency Union. From this arises the potential for attempts to extort from the more solid countries payments to member states with high indebtedness. This mechanism even exceeds a wrong incentive system called Moral Hazard by economists. The request, that the stronger countries should have to support the weaker ones in the common interest, is perverting the much praised thought of “financial solidarity”. The thought about solidarity is been put upside down. This holds true also, because in this financial transfer, caused by major economic divergences, less rich, more saving and conforming to the regulations countries, can be forced to transfers to countries with a higher living standard but no solid fiscal policy.

The wrong orientation of a Currency Union with a defective frame work, which is not punishing violations of regulations, but which is honoring them, creates a need for transfers, which can neither economically nor socially be justified. It looks more than questionable, to expect from this process acceptable political structures with characters of forming a real state. Even before the beginning of the Currency Union one could dismantle this thought as a fantasy. In the year 12 of the Euro, this has developed into a widely recommended project. In so far it seems, that the opinion, that the common currency will be of help to attaining political union, is proving itself in a sinister way: “L’Europe se fera par la monnaie ou ne se fera pas.” (Europe will make itself by the money, or it will not make itself.) This thesis by Jacques Rueff from the year 1950 has since many supporters. As a representative of the money value stability, however, Mr. Rueff will certainly have not thought of this “scenario”.

One can only warn from a project, to create a political union quasi through the back door of the constraints from a common currency in a uniform monetary policy. The quasi automatic subsidy of bad politics within Europe would push the democratic process in the member states into the wrong direction, possibly even in a corrupt way. One cannot base on such a forced construction a Europe of stability and closeness to the citizen.

How can one create by this way a stable political union? Most of all, however: How can this process be democratically legitimised? Finally stands at the beginning of the state form of western democracy the control of the state finances by the parliament. When both German federal chambers, the federal parliament and the federal council had agreed to the "Saving Umbrella", this has been done under high pressure – the consequences of a No would have been not imaginable. The deputies of parliament were conscious to know about how unpopular – to express it mildly – this decision had been. This event can not be repeated. And against a creeping extension of the inner community transfer would soon arise opposition inside and outside the parliament. The appeal to a further reaching "financial solidarity" of any kind, and especially in its perverted form, is miles away from the opinion of the citizens – in any case of the countries, which are eligible as payers, and which partly have an even lower living standard than potential recipients.

With a refusal, to improve the abiding to regulations for solid fiscal policy decisively, increases the probability of transfers, but at the same time, the public denial, to be held liable for the wrong doing of other countries.

Who wants the Political Union - and for this there are good reasons - should put the project openly, with all consequences, on the table. An European government, controlled by an European parliament, elected according to the rules of democracy, would be the clearest manifestation. But also all other imaginable mixed forms respectively transition forms do require a democratic legitimacy. Political Union, which as a democratic form of government deserves this name, cannot be created by forced fiscal transfers of common money under the table.

Who nevertheless wants to go this way, exposes the community to the highest thinkable risk – the denial of the citizens. If this occurs on a broad front, it will not last long, until not only extreme parties will make opposition to the Currency Union – and possible beyond that – to their agenda. The failed referendums of the past should be sufficient as a warning.

Every crisis also offers a chance. For Greece, for example, recognition, that the country was standing at the brink, is opening the way to reforms, about which one even lately was not even daring to think. The crisis of the Currency Union which, as exposed, came everything else, but unexpectedly, is showing the weakness of the existing arrangement and is offering thereby the chance, to improve the regulations decisively. In the present situation it is to be feared, that this chance at best will be used marginally and will be thrown away in its essence. The look back into the past could advise, to take a relaxed position. At the end, "Europe", to stay by this notion, brought many crisis behind itself and has emerged from each crisis in a strengthened way. For the successful continuation

of this method, however, there is no guaranty, even though there exists no reason, to insist on disaster scenarios. On the other hand, the character of the crisis, is changing with each further institutional build up of the Community. The members of the Currency Union may once more stand back from a decisive reinforcement of the set of regulations. After the experiences of the first twelve years, however, the breaking out of a new crisis in the not too distant future is programmed. The question is, whether the Community will then be willing to make basic reforms under eventually even bigger pressure. The seemingly unstoppable march, under the present conditions, into further financial transfers, will in the meantime, create economic and especially political tensions to such a degree, that the existence of the Currency Union is the more in danger, the longer this process is characterised by the non solid behaviour of individual member states. We could therefore also say: The hour of truth has only been deferred.

**Otmar Issing** is classified as the architect of the monetary policy of the European Central Bank and was eight years long its chief economist.

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## **Japan, News:            Japan's Debt is Becoming a Problem**

The rating agency Moody's is worried about the political blockage and lowers the creditworthiness

cag. Tokio, February 22<sup>nd</sup> 2011. The financial markets are reacting to the growing state indebtedness of Japan with increasing worry. After almost nine years, also the rating agency Moody's has lowered its forecast about the creditworthiness of the eastern Asian country for the first time. The outlook for the rating "Aa2" was lowered from "stable" to "negative", Moody's released on Tuesday in Tokio. The background of this evaluation is the political blockage in the parliament, in which the opposition, and parts of the governing party of prime minister Naoto Kan, refuse to agree to the budget 2011 and to the new tax laws. Kan is planning a tax reform, with which he wants to intensify growth and increase the government income. The political blockage in the parliament is reducing the chances, that Japan is really attacking the shrinking of its huge mountain of debt, it is said in the opinion of the agency. The rating agency Standard and Poor's had already lowered Japan's rating to "AA-", because of doubts as to the capability of politics, to get hold over the debt crisis.

Japan, today, is indebted by more than the double of its annual economic performance. The country, with this, and with a big distance, is the highest government indebted country among all industrial countries. That this, other than in some countries in the Euro-Area, has not yet had consequences, is caused by the fact, that more than 94 percent of the state debt of Japan is being held by domestic investors.

Because of the rapidly aging population, and the high number of young people in badly paid jobs, Japan, however, will be forced in a few years already, to finance its debt abroad. Then, so warns Kan since several months, situations like in Greece are threatening. He has therefore set the objective for himself, to reduce the new indebtedness step by step, and to attain a balanced budget by 2020. The budget 2011, about which the parliament is debating since weeks, should therefore not have a higher state indebtedness than the budget 2010.

In the past year, the government financed the state expenses by more than 50 percent by way of the issuance of government bonds. For the medium term, in addition, Kan is planning for a tax reform, with which the corporate taxes will be lowered, which are high by international comparison, and with which, by contrast, however, the consumer tax will be doubled from five to ten per cent.

For the issuance of new government bonds in the budget 2011, and for the tax reform, the government needs votes from the opposition in the parliament, which holds the majority in the upper house, the second chamber of the parliament. Especially the liberal democratic party, which has been put aside by Kan's democratic party after almost half a century of uninterrupted government, only in September 2009, is openly working on

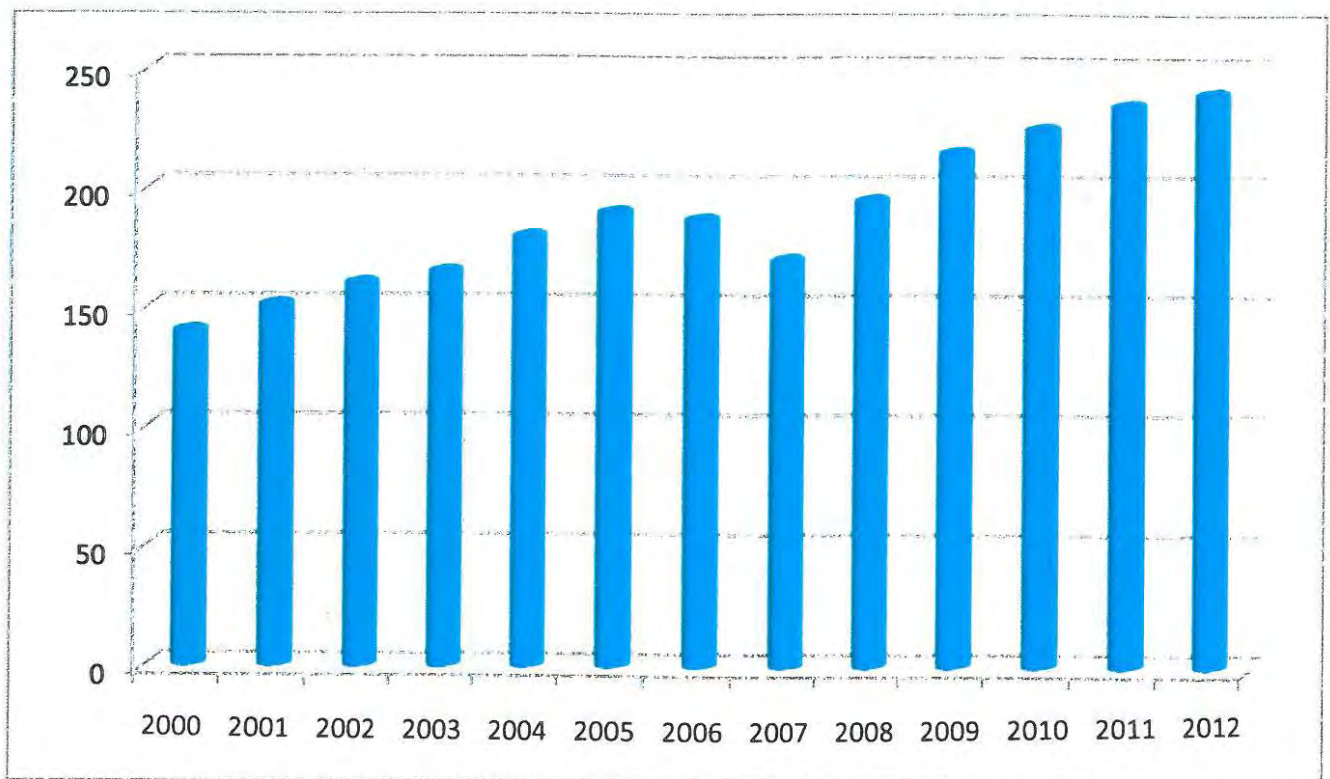
overthrowing the government and is hoping for new elections. Kan is already the 5<sup>th</sup> prime minister in Japan in only four years. For Kan, the new warning shot by Moody's is therefore also rather a support. The Japanese politics are said not to be able to afford, now to remain in the standstill, it is said in government circles. Kan is therefore hoping, that the opposition will give up its blockage in the last moment. The new budget must be elected at the latest on April, 1, 2011.

Surprisingly clearly, now, the Japanese industrial association Keidanren is now standing up along side of Kan. Keidanren-Chief Hiromasa Yonekura is hailing Kan's economic and financial policy and said, he wishes, that the government remains at least in office until Kan will have put into practise the intended tax and social reforms.

P.S. For Moody's rating action on Japan see [www.Moodys.com / Frontpage/Ratings-Highlights/](http://www.Moodys.com/Frontpage/Ratings-Highlights/) "Japan's Aa2 Government Rating Outlook Changed negative"

### Japan's Debt Mountain

State indebtedness in percent of gross domestic product



Years 2010, 2011 and 2012: Estimate; Source: International Monetary Fund

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# Envisioning Finance

Finance chief Pierre-Jean Sivignon explains how the finance function has helped boost Philips' performance, and why Vision 2015 will bring about yet another transformation of the Dutch company.

By Steven Arons

>> Mr Sivignon, Philips has changed profoundly in the five years that you've been CFO here. How much is it still the company that you began to work for?

<< I joined Philips because of its brand and this brand hasn't changed, only become stronger, especially in emerging markets. In today's world, the countries with low public and private debt are the countries with potential, and you want to have a strong brand in them – which we do thanks to our history going back more than a century. That hasn't changed, though, yes, the rest has (laughs).

>> You've done lots of acquisitions and disposals. Has your transition to a so-called "health and well-being" company been completed?

<< I think we've done 45 acquisitions and around 15 to 20 divestments – the most important of which was the sale of our

semiconductor business. That marked the end of our high-volume electronics and components era and was one of the key decisions bringing down the number of business sectors from five to three. We're very comfortable with this current set-up.

>>

A lagging indicator looks at the past whereas a leading indicator anticipates the future.

>> So the recently adopted five-year plan called Vision 2015 is more about where you want to go geographically rather than with products?

<< With a big company like ours, there is always the possibility of fine-tuning the portfolio. But all the fundamental changes have taken place. Our focus is now on maintaining our strong footprint in the

developed markets while exponentially increasing our already sizeable base in emerging markets. We've already taken the revenue share from emerging markets from originally around 20 per cent to 34 per cent in the last quarter. According to Vision 2015, it will be 40 per cent by the end of 2015, although I think it might even turn out to be 50 per cent.

>> What was your role in devising the "health and well-being" strategy?

<<

<< The finance function including the IT responsibility made new tools available. One important step has been a shift from lagging to leading indicators. A lagging indicator looks at the past, for example by looking at your income statement at the end of each quarter. A leading indicator, in contrast, is designed to anticipate the future. Examples are net promoter scores, which is an indicator for our future market share, or customers' inventories, which tells us





something about their future demand for our products.

>> That sounds nice, but how easy is it really – aren't those data more difficult to gather?

<< Yes, but we've put in place the necessary sensors. There really is no alternative. Lagging indicators only function in a stable world where the past is a reliable guide to the future. But in an uncertain world like ours, you need to have leading indicators.

>> How has this new methodology changed the way you do financial planning at Philips?

<< We've introduced four-quarter rolling forecasts, which has been a massive change for Philips. Our budget for next year will be adopted at the beginning of January when we do the forecast for the four quarters lying ahead of us. We're also running a strategic review with a much stronger geographical focus than before, meaning that we've got individual stra-

## ■ The CFO and his company

Pierre-Jean Sivignon worked in various finance positions at Peat Marwick Mitchell, an auditing firm, oilfield services group Schlumberger and car supplier Faurecia before joining Philips as CFO in 2005. He holds a degree from the Ecole Supérieure des Sciences Economiques (ESSEC) in Paris and a French CPA. He is married, with two children.

Based in Amsterdam, Royal Philips Electronics has recently concluded its Vision 2010, an extensive restructuring programme aimed at streamlining its business units. Its new strategy, labelled Vision 2015 and unveiled in September 2010, promises to grow sales at an average pace of at least 2 percentage points above global economic growth over the next five years, helped by an accelerated expansion in emerging markets. In 2009, Philips achieved sales of EUR 23 billion and employed 116,000 people.

tegic review teams in the big three emerging countries Brazil, China and India. And we've developed a tool that shows us the margin on each product category at the country level. So instead of managing the business along product lines alone, we've added a y-axis to the x-axis that aligns each margin with a country, thus enabling our country people to make decisions a lot faster without a detour through headquarters.

>> How do you know these changes are having the sort of positive effect that you want them to have?

<< The results speak for themselves: we've delivered on cash and costs. The company of five years ago was achieving an adjusted EBITA margin of 4 to 5 per cent. This year, it will be around 10 per cent – even though the like-for-like revenue base hasn't increased as much. However, we haven't yet ticked the most >>



The Philips transformation: from its beginnings - here a plant in Eindhoven 100 years ago - as a lamp manufacturer ...



... to its current status as "health and well-being company" in its well-lit headquarters in Amsterdam.

important box on the test form: growth. Most of our growth in recent years has been on the back of M&A even though we implemented the tools to speed up decision-making, which is a prerequisite for faster growth. Here, the jury is still out.

>> Philips correctly forecast its profitability in V 2010. What was the role of finance?  
 << Its role is to supply the tools and do the modelling. We drastically improved our modelling capabilities in the wake of the crisis. In such a volatile world, we would do a forecast and the next day, we had to do it all over again. Today our modelling tools are quicker and more accurate, enabling us to predict the margins and cash flows on any given revenue scenario for each business unit.

>> Working capital improvements were key in helping Philips through the crisis. What exactly did you do there?  
 << We had a balance sheet that was a little inefficient in terms of working capital. We totally decentralised receivables management by empowering each country to go after their overdues themselves because our local representatives are in a better position to call their customers to ask about late payments than we at headquarter-

ters. At the same time we completely recentralised payables.

>> Didn't decentralisation mean that the central finance function lost control?  
 << No, because we put in place tools that allow us to track overdues down to the country level. It is still up to us to give the people at the country level the information that they need to carry out the necessary reminder phone calls to their customers.

>> And payables saw the opposite move?  
 << Yes, because it has helped us realise synergies in purchasing. We now have significantly fewer people renegotiating payment conditions with suppliers. These opposing moves have had a dramatic impact on our figures, improving our working capital by 3 percentage points in 18 months.

>> However, working capital performance eroded during the third quarter, especially for inventories. Does this mean your gains will be transitory?  
 << But performance didn't erode. In fact, our working capital ratio, i.e. the ratio of inventories plus receivables minus payables to revenues, continued to sink.

But you're right, inventories did go up, and we'll certainly need to work on this during this fourth quarter.

>> You also had lay off 6,000 people last year. How did you decide who had to go?  
 << Well, the decision to lay off people is probably the most difficult one any executive has to make. It must be based on a very thorough performance analysis. First you need to decide what the company can afford, then measure its performance and set a strategy, and finally you decide how to execute that strategy with as little pain to your employees as possible.

>> What are the components of worker performance? Mostly labour costs?  
 << No, it's much more than that. If you run a company with cheap labour but low productivity, you end up with higher costs. You need the best people in order to have the lowest costs. But the best people aren't the cheapest labour of course.

>> Did most cuts occur in mature markets?  
 << No, we improved productivity everywhere. Take Brazil where, just a couple of weeks ago, we consolidated our country headquarters, which was spread out over an expensive neighbourhood in Sao Pao-



lo, into one building. It's a nicer building, everybody is close together, and yet it saves us quite a bit of money.

>> One important risk in plant closures is bad press. There was surprisingly little of that when Philips announced the actual places where people would be made redundant. Would you call this a success?

<< Restructuring is always part of a business as it ages. However, the magnitude of the recent downturn was simply unheard of. Nobody had ever experienced anything close to it – and I have been a finance executive for over 30 years. It was something we had to do to protect the company but it's nothing we feel happy about. We take pride in having restored the company's competitiveness, but we don't take pleasure in all the measures we had to take.

>> Philips is now back on a growth path and people are beginning to ask for share buy-backs. Which conditions would have to be fulfilled for you to do one?

<< Vision 2015 contains very clear priorities on what we want to do with our cash. Number one is our A rating. Liquidity can disappear with the bat of an eyelid if you don't have a rating starting with an A. Number two is dividends, and we have the most generous dividend policy in our peer group. Number three is M&A. Will we do larger acquisitions than in the past 24 months? Maybe, if they make sense, although we're not guiding on it. A share buy-back programme is priority number four.

>> Is it now generally a good time for M&A in view of low price tags and the strong euro?

<< From a cycle point of view, there are currently more opportunities than at other points in the cycle. That being said, it still needs to make sense in terms of strategy for your own company. We at Philips take pride in the fact that our return on invested capital, including goodwill, has been 2 per cent above the weighted average cost of capital for three quarters, which means we're solidly in value-creating territory – even though a large chunk of our acquisitions happened in the earlier half of 2008, just before the onset of the crisis.

>> How much did you have to write down on your investments as a result of the crisis?

<< Knock on wood, Philips has only had to take a single impairment in the last four years, on Lumileds. And that business has rebounded, although IFRS does not allow you to reverse your impairment if there's a recovery.

>> Fitch recently upgraded you from A- to A. How important was that to you?

<< There was a time during the crisis when even BBB companies were unable to tap fresh liquidity. At BBB+, you always have access to liquidity but it can be costly. A rating above that level, at A-, gives you permanent access at a decent spread. That's where we feel comfortable, and that's where Moody's and S&P see us.

>>

Guiding the markets on a five-year period gives an enormous amount of inspiration to our organisation.

>> In Vision 2015, you changed your growth target from a fixed target to one tied to global GDP growth in order to prevent missing the target again should another massive downturn occur. Have you learned from your mistakes?

<< You always have to be humble and capable of acknowledging where you can improve. Vision 2010 was a success but in hindsight this growth target is something where we could have done even better. The absolute growth target in Vision 2010 boxed us into a narrow GDP scenario. As the world has become very uncertain, we think it is better to guide shareholders on Philips' performance relative to the macroeconomic development rather than on absolute numbers.

>> Not many companies give guidance on five-year periods. Why does Philips put itself in such a straitjacket in the first place?

<< It gives an enormous amount of inspiration to our organisation. In the old days, you would do your internal budget and then guide the markets on something that was a tad lower, thus creating a cushion

for yourself. But as the world has become ever more transparent, this is no longer possible. All our managers can read my quotes, they look at the analysts' reports, and a good chunk of them even have access to the consensus. By committing to the market, we're not just talking to shareholders; we're also talking to our own organisation.

>> So the ostensible purpose of Vision 2015 is to guide shareholders, but in reality it serves to impose internal discipline?

<< It inspires. It tells everybody what exactly the company has committed to and where it wants to go. Besides, we didn't lay down Vision 2015 from the top down, but from the bottom up. The numbers in there come from these same people.

>> How do you make sure your people don't set lower targets than they think are realistic to make sure they will overachieve?

<< Their potential incentives go up if they commit to more challenging targets. And don't underestimate the power of models and benchmarks.

<<

>> A new CEO will take over at the beginning of next year. Now that the product transformation of Philips has been completed and a new five-year strategy adopted – how much space is left for Frans van Houten to put his personal stamp on the company?

<< The strategy direction is there, but the portfolio is always something to look at. More importantly, the goal set out in Vision 2015, to achieve growth of global GDP plus 2 per cent, is a significant step up even in comparison to the period before the crisis, giving the new CEO plenty of room to show what he is capable of.

>> Recently there's been much talk about an impending currency war. How worried are you?

<< We have a balanced transaction risk at the group level due to the fact that the renminbi is pegged to the dollar. If the renminbi were to be unpegged, we would feel it a little as we're a little bit short on the currency. It is different with respect to the translation risk. A weakening dollar affects our P and L as it reduces our earnings expressed in euro. ||

## **Switzerland, Article: Credit Suisse Reinforces Equity with Coco-Bonds**

The Swiss bank gives the starting shot for a new species of bonds. Barclays bank estimates the market volume in Europe to be 700 billion Euros.

maf. Frankfurt, February 14<sup>th</sup> 2011. The Swiss big bank Credit Suisse will reinforce its equity by way of placing Contingent Convertible Bonds (“Coco-Bonds”) of over six billion Swiss Francs. The market volume of this new species of securities is being estimated by the analysts of the British investment bank Barclays Capital to be 700 billion Euro. Contingent Convertible Bonds (“Coco-Bonds”) will play a big role in the future equity regulations of the Basel III, because they have a higher loss absorbing capability than conventional bank bonds.

The Coco-Bonds can have various covenants, but essentially they are linked to the equity ratio of the bank. This ratio is reflecting the relationship between hard core equity (nominal equity and retained earnings) to risk assets (loans and securities). Once a certain level is undercut, then the Coco-Bonds, as a rule, will be converted into equity. In this way, too, the Coco-Bonds of Credit Suisse, will be converted into shares, when the hard core equity ratio will fall below the minimum level of seven percent, which is prescribed by Basel III, starting 2019.

Another variation of the bond type has been chosen by the Dutch Rabobank: Its contingent convertible bond issue of 1,25 billion Euro, issued in March 2010, is being depreciated by 75 percent, if the equity ratio will fall under seven percent. Above that, there is also the possibility, that the Coco-Bonds will be written off only temporarily, in order to be again written up, after a recovery. However, this kind of a Coco-Bond will have problems, to be accepted by supervisory agencies.

So far, there are only Coco-Bonds with a volume short of 12 billion Euro issued to the market. The British big bank Lloyds converted, in the fall of 2009, outstanding bonds of nine billion pound into convertible bonds. To that comes the ten year Coco-Bond of Rabobank. The two bonds of Credit Suisse will be placed, at the earliest, in October 2013. However, the bank has already a contract with the two large shareholders, Qatar Holding and Olayan Group, a Saudi-Arabian conglomerate group. The Qatar Holding holds 6,2 percent and Olayan holds 6,6 percent of the Credit Suisse shares. The Coco-Bond issue of Credit Suisse is subdivided into a Dollar tranche and a Swiss Franc tranche. The Dollar tranche with 3,5 billion U.S. Dollar is to bear interest of 9 percent, the Swiss Franc tranche of 2,5 billion Swiss Francs of 9,5 percent.

This split-up is equivalent to the one of Hybrid-Bonds placed in 2008, the last repayment option date of which is October 2013. Then the Credit Suisse will substitute its Hybrid Bonds by the Coco-Bonds. Hybrid Bonds are only bearing interest, when the corporation makes a profit. And yet, the banks, in spite of an operating loss, have created a profit for

the year by carrying back reserves from the balance sheet to the profit and loss statement, in order not to suffer a loss of reputation in the capital market by way of not paying interest on the Hybrid Bonds. The new Basel equity regulations, however, do not accept Hybrid Bonds anymore as hard solid core equity. It is still unclear, what the covenants of the Contingent Convertible Bonds, accepted by the supervisory agencies, have to be. The final definitions have not yet been made. However, the features, chosen by Credit Suisse, for the conversion into shares, when falling below a certain equity ratio, will come pretty close to the final definitions. And this, as well, as the bank has closely cooperated with the Swiss financial market supervisory agency Finma. The Finma applies to the two Swiss big banks Credit Suisse and UBS significantly tighter regulations, than would be necessary, according to Basel III. UBS and Credit Suisse must fulfill a core equity ratio composed of nominal equity and retained earnings, of ten percent instead of seven percent. In addition to this, both institutes must show an additional buffer of nine percent, which must be composed of Contingent Convertible Bonds.

The analysts of Barclays Capital estimate the potential issuance volume of Coco-Bonds by European banks up to the year 2018 at 700 billion Euro. The rating agency Standard & Poor's estimates the volume across the whole world at one trillion U.S. Dollar. These credit worthiness examiners express doubts about a sufficient interest of investors. Because for the classical investors in bank bonds – insurance companies and investment funds – these papers are expected to be too risky.

### The European Market for Contingent Convertible Bonds

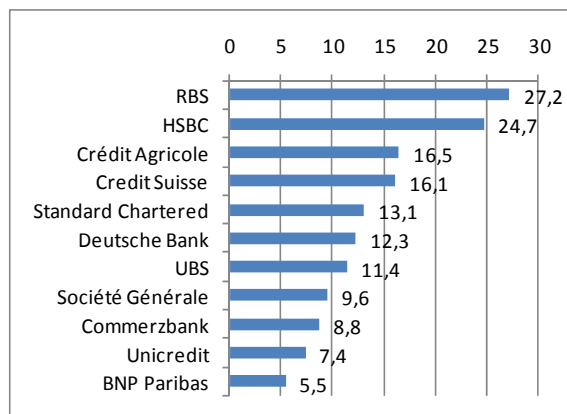
#### Market Potential

Issuance Volume in billion Euro<sup>1</sup>

700			~ 700
600		~ 200	
500	~ 500		
400			
300			
200			
100			
0			
	till 2013	2013-2018	bis 2018

#### Demand of Big Banks for Issuance

Volume 2013 in billion Euro<sup>2</sup>



<sup>1</sup> Prognosis of Barclays

<sup>2</sup> Source: Barclays Capital/

F.A.Z.-Graph Brocker

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# THE VIEW FROM PRINCETON

*Market Commentary ♦ February 2011*

## MORE

**EXPECTATION  
OF EXTENDED GROWTH  
MUST UNDERLIE  
INVESTMENT  
STRATEGIES**

After two years of bold share price appreciation and eight consecutive quarters of rising earnings for most large industrial companies (and now early in the ninth consecutive quarter) what is to be expected hereafter? MORE: End of memo! Yet, not so fast; for is it not commonly regarded that fulfillment of readership value requires words, words, and more words? Even directionless soliloquies are too often fashioned as value rendered. Hence, the following memo that explains reasons for a continuation of highly supportive circumstances for equity investing provides pages of words (as customary in the trade). The paragraph headings in the margin allow a quick skip through.

Economists, as they describe the cyclical patterns of national production, largely agree that the American economy has emerged from the recovery phase from the 2008-09 abyss into a growth phase. These are typically the longer lasting phases; however, the growth phase entered recently will be slow (3% or less), burdened as it is by chronic unemployment in certain industries and certain locales. The important aspect is this: The improvement has become self-regenerative, and probably durable — in totality, generally supportive to equity investments.

And now, with help from a second cocktail, or extra strength Tylenol, expect herein a few mind benders and a return glimpse into the dangerous absurd, as an alert to the greatest of foreseeable hazards.

**EXTREMELY LOW RISK  
IN SHARES  
OF REDOUBTABLY  
STRONG ENTITIES  
DISCIPLINES  
SELECTIONS  
FROM LESSER  
ENTERPRISES**

There are two quite opposite considerations for risk aversion. First, from the affirmative side of life, the most basic of considerations is presented by a question: Why should one assume incremental risks when the safest of equities promise, as now, a total investment return (dividends plus appreciation) well above the overall American experience of long-term investment in shares? These first and foremost of considerations are seen in the very evident undervaluations of major telecommunications providers, for which dividend yields range from 5% to 7% from clearly safe companies in America, Canada, Germany, Spain, and other nations. The fundamental assurance stems simply from the life-long evidence that message sending is ever increasing.

Additionally, shares of most electric utilities provide high dividend yields, as the depressed prices reflect anxieties over adverse regulatory decisions, the sponsored use of alternately sourced electric energy, and encouraged societal constraints upon energy use (the cheapest of energy is that saved by disciplined use). The share prices seem to show no intent to capitalize the prospects for the transition toward electrically powered automobiles (and other vehicles) that will be plugged in at night for battery regeneration — at night, when other use is sleeping and electric generation capacity in underused. This is one of the importantly large aspects of innovation and change. It could be money in the bank broadly throughout the electric utility industry, which, the facts would seem to indicate, will be augmented by prospective reductions in fuel prices (oil, gas and coal).

**WORRISOME  
CONSIDERATIONS**

On the opposite (sobering) side, there are worrisome factors that dispose investors toward risk aversion. And, as the most horrendous of mind benders, there is a concerted effort most earnestly pursued by the financial industry to secure their formerly assumed privileges. If politicians and the agencies of government allow again such unbridled wantonness of large private funds and financial institutions, you can predict another financial collapse, delivered by the same friends who gave us this last one.

**WILL WE  
LEARN FROM  
LOOKING BACK  
TO A FOREST  
OF HORRORS**

If the thought of going back to the inherently disastrous model (with its conjured instruments, practices and permissiveness) doesn't tend to keep you sleepless, try reading the enclosed report from the New York Times (Saturday, January 1) regarding massive computerized trading organizations. Or, for deeper and morose thinking, try the just released Congressional Panel's report. This compilation of probing (and sometimes deceptive) comments was acquired for our staff as worthy keepsakes for historical perspective, and much more. If you would like a copy, call us and ask. If there be a return to the market's former model and mode, it would be just as easy to foretell the inevitability of a disastrous collapse as it was difficult to perceive the timing, or the vastness of the outer limits of the consequences of the 2007-8 experience. Put this aside for the time being; that is, on a wait list not to be forgotten.

Except for farmers and speculative traders, another negative influence that recently gained in scale is found in the rise in agricultural product prices, following the advances in oil and many material prices. Such agricultural price advances can have widespread implications, owing to the cost increases for processors, the distorting of trade balances between nations, the pressuring of currency valuations, and the preemptively compressing of household spending everywhere. Moreover, to the extent the price advances in materials and farm produce are driven by financial speculation, both financial assets and materials are diverted from flowing orderly through trade channels into more productive applications. Thus, this all becomes a deterrent to social growth at a time when growth is too slow.

**SUPPORTIVE  
CARDINAL  
CONSIDERATIONS**

The most protrusive of supportive factors and forces for investor consideration as perceived are these:

Large corporations in America (say the Fortune 500) and those elsewhere are driving the world's economic growth. Most observers give too little emphasis to this. American companies have never had so much money to spend. They have the sophistication, the presence and the incentives to spend for strategic expansion. Management can never leave cash idle for long.

Large private funds and certain financial institutions are driving prices of materials and produce upward to employ their abundant sums. Equity shares also sit in the pathways of their interests, which will claim more of their attention as material prices become less attractive.

The American stock market requires very little, or no, additional help from external circumstances to sustain a long general advance in prices. In contrast, long advances in stock prices usually have the benefits of inflowing money, a vigorous economy, and an optimistic populace.

Our stock market seems to be filled with self-sufficiency owing to (1) growth in corporate earnings, (2) their huge cash balance positions which will be deployed to buy their own shares or shares of others for enhancement of their growth, (3) the cheapness of so many shares (and excessive valuations of only a few) and (4) a relatively cheap dollar, which entices foreign capital into shares and into lowered priced real estate, and, further, aids American business in selling their products beyond our shores.

**BASIC  
THESIS**

Our investment thesis reiteratively expressed throughout 2009 and 2010 (after the full interventions by governments had effectively buttressed against systemic collapse) can be distilled into the simple phrase, “physical factors will prevail over negative emotional factors to effectively elevate prices of equities of sound and thriving enterprises.” Events have validated that thesis. The thesis is still as valid as it has been from the bottom of the 2008 market; notwithstanding the portion of prospective gains already attained as share prices have risen.

Though it is never possible to know what will happen, it is always necessary to have a course of action in addressing the future: Act bullishly. It is not necessary to feel bullish, that is the beauty of this moment, as for months past. Act bullishly because there are still so many mispriced marketable securities still remaining, and such a redundancy of money within the marketplace dominated by professional investors. There are attractively priced equities aplenty. There are overvaluations of high quality credits because of extremely low rates of interest still encouraged necessitously by the Federal Reserve System. That will end during the ensuing months.

**STAY WITH  
A POSITIVE  
COURSE OF ACTION**

As interest rates rise for short-term items, high quality long-term credits will be in a downward pricing pattern. This is not expected to be very severe, because the total of demands on the capital markets from all sources is much reduced, irrespective of all that you read about the Federal deficits and the deficits of state and local governments. On a consolidated (net) basis, self-sufficient corporations supply funds into the market. This began several years ago. This is truly extraordinary, for in virtually every previous year since World War II American corporations had been net users of capital drawn from the capital market. Their contemporary huge cash balances, and generalized prosperity, now act to return capital to the marketplace through purchase of money market items, through purchasing of their own stock, through buying in of shares of others for mergers, acquisitions, or for investments. In all of these instances, they circulate money from their product sales toward the capital markets. Those who do not perceive this as a fundamental will doubt our expectations.

**REPAYMENT  
OF HOUSEHOLD DEBT  
IN EXTRAORDINARY  
SCALE**

Household debt repayments have for months exceeded new extensions. For short-term installment debt there is nothing unusual about this for a recessionary period. This happens because of the short duration of debt, and scheduled repayments override reduced new extensions. But do make note of this: For the first time since the 1930's, residential mortgage repayments began to exceed creation of new mortgage obligations. The financing of residences has ever been the largest (by far, greatly) of net users of long-term credit.

**PLENTY  
OF FINANCIAL CAPITAL  
TO FINANCE  
GOVERNMENTS**

Financing the deficits of the Federal government and of state and local governments poses no prospective stress upon the markets, nor an enduring effective lifting factor on interest rates. The reductions in total residential mortgages is the most extraordinary of changes — from an aberrantly large expansion of mortgage debt in the first decade of this century to a shrinkage in the use of mortgage debt owing to repayments, foreclosures, and in some instances, a tightening of lending terms. This has not happened before. So, do not worry about the markets ability to cope with the outpouring of debt from state and local governments, and from further Federal deficits. The rise in public debt, and reduction in scale of household debt, seems to be set in circumstances that will endure for months, possibly a few years.

It seems probable that the American dollar has entered the bottom ranges of its substantial decline. Further weakness would very likely bring more problems than benefits for investors.

The ferment of popular dissent through Mediterranean and more eastern states has the potential to rattle markets for stocks and currencies everywhere, which analysis and expectations cannot fathom. The equanimity in which the American stock markets have withstood such uncertainties seems to represent the extent to which investor attitudes had shifted toward optimism.

## **Systemically Important, Article: How Beautiful, to Be Systemically Important**

Large Banks Get Capital Easier. Because They Never Go Bankrupt. Thanks to Father State.

Who are the largest recipients of subsidies in the country? The peasants? Formerly the coal mines, today the solar industry? Ever more economists are discovering, that indeed the large banks are on one of the top places of the list; they have already before the crisis profited from an invisible subsidy. What is meant, is the not spoken out guaranty by the state, not to let go under allto large and interconnected financial institutes. „Too big to fail“ (TBTF) is the term in the language of the economists.

Would one let go bankrupt a TBTF-Bank, a systemic crisis of the financial sector would threaten, and also the real economy would suffer seriously. Therefore, the TBTF-banks can build on being bailed out - with the consequence, that bank managers can enter into bigger risks. Thereby the dangers of a bankruptcy and of an instability of the financial system is even increasing, but the states are watching helplessly. They „are taken hostage by the financial sector“ is warning the Council of Economic Advisers ( to the Ministry of Economy of the Federal Republic of Germany ).

Several economists have tried since the crisis, to determine the value of the TBTF subsidy. The analysts Dean Baker and Travis McArthur have produced a quite general computation for the Center for Economic and Policy Research, which is still giving an idea about the order of size. Their method: They are measuring the difference of interest rates for bonds of small and large banks. When a small bank is failing, then nobody is looking after it, its creditors are loosing their money. A large bank can build on being saved, and therefore its creditors are asking for a lower interest rate.

The so called interest rate spreads have drastically widened in the crisis after the Lehman bankruptcy in the fall of 2008. Baker and McArthur argue, that the difference of almost one half percentage point is due to the state guaranty. For the 18 largest banks, the hidden subsidy according to their calculations in the highest scenario is 34 billion US Dollar per year, on average 1,9 billion US Dollar per large bank. In the lowest scenario it is still 6,3 billion US Dollar for all 18 banks together. The broad difference of estimates is due to different refence values for the spreads before Lehman.

Already before the crisis, the banks and their creditors are sniffing, that their TBTF-status could be of help to them. The implicit guaranty for the largest is not only distorting competition, it is also a fatal incentive for excessive growth.

Elija Brewer of the De-Paul-University in Chicago and Julapa Jagtiani, who is researching for the Federal Reserve Bank of Philadelphia, have written a study with the title „ How much have banks paid, for becoming too big to fail and systemically important.“ For this, they have analysed the wave of mergers, which since the early nineties have led to an ever higher concentration in the financial sector. 411 mergers they did statistically analyse from the years

1991 to 2004. As TBTF limit they set, like Baker and McArthur, a balance sheet total of more than 100 billion US Dollar or a market capitalisation of the bank of more than 20 Billion US Dollar.

It is being shown, that with mergers which are lifting the merged group above 100 billion US Dollar, significantly higher merger premiums have been paid than in ordinary mergers. The takeover price for the bank was hugely above its market value before the merger. After a complicated regression analysis, which is observing a lot of other factors, which can determine the market capitalisation of a bank, the two economists got the following result:

For the eight mergers, from which the TBTF banks were created, the overtaking bank paid a premium of 14 to 17 billion US Dollar over and above normal takeover premiums. The 14 Billion US Dollar are said to be with certainty the low end limit of the „Too big to fail“ subsidy, are pointing out Brewer and Jagtiani. Their estimates go as high as 25 billion US Dollar. The effective value of the TBTF-status is said to still be significantly higher, because not only the shareholders, but also the depositors and the creditors of the large banks are benefitting.

A study of Priyank Gandhi and Hanno Lustig from the University of California in Los Angeles has researched an interesting aspect to this: Shareholders in the United States have obviously been ready over almost four decades and with an equal risk profile, to accept, from large banks, a significantly lower return than from publicly listed small banks. Why?

Their situation is as well pointing strongly towards the direction of the implicit state guaranty against a „financial disaster“. The lower return is being equalized by that in the case of a crisis the TBTF large bank will be bailed out by the state safety net, whereas small banks disappear without noise and tone from the market.

Since the middle of 2008, according to the information of the depository insurance FDIC, still 316 American banks have slid into bankruptcy - without having been bailed out.

From large banks it is instead expected because of the TBTF guaranty, that they survive financial crises and that they can recover from it. According to the calculations of Gandhi and Lustig the guaranty by the state is equivalent to a state guaranty of proud 4,7 billion US Dollar per bank.

Even in the years before the crisis, they say, the problem of competition distortion has been exacerbated, they are warning: From 2000 to 2005 as an example, the hidden subsidies for the Bank of America, the Citigroup, or Wells Fargo did increase by a third up to almost a half, only exceeded by the deplorable Fannie Mae, the economists are saying. This they say also corresponds to the enormous increase of the bank balance sheets.

The calculations also reflect the increasing concentration in the financial industry. In the seventies, the top 10 banks collectively represented roundabout 50 percent of the market capitalisation; in the last decade it was already 90 percent.

After the crisis, the problem of the TBTF banks has probably further exacerbated, are warning Brewer and Jagtiani. „Our results make us worried and cautious, because the number of assisted mergers between weak TBTF financial institutions during the financial crisis, which began in the middle of 2007, is increasing further and thereby TBTF bank organisations are being created, which are even bigger than before the crisis.“



What to do? The German Council of Economic Advisors is requesting, that in exchange for the subsidies, a levy, depending on the size, should be introduced. The Swiss are planning for higher equity requirements for their large banks. In this way, striving for a size would be stopped, which could become dangerous for society.

Dean Baker/Travis McArthur: The Value of the „Too Big To Fail“, Big Bank Subsidy, Center for Economic and Policy Research, Issue Brief, September 2009

Elijah Brewer/ Julapa Jagtiani: How Much Did Banks Pay to Become Too-Big-to-Fail and Become Systemically Important, Working Paper 09-34, Federal Reserve Bank of Philadelphia, December 2009

Priyank Gandhi/ Hanno Lustig: Size Anomalies in U.S. Bank Stock Returns: A Fiscal Explanation, NBER Working Paper 16553, November 2010

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**IAFEI Board of Directors Meeting, Rome, Italy, October 12, 2010**

Traditionally a physical IAFEI Board of Directors meeting is being held on the occasion of the annual IAFEI World Congress. The 40th IAFEI World Congress took place in Rome, Italy, October 13 to 15, 2010. The concomitant Board of Directors meeting took place on October 12, 2010. This Board of Directors Meeting made the following elections/ reelections of IAFEI Officers, for 2011:

**Elections, reelections of IAFEI Officers, for 2011:**

Hiroshi Yaguchi, Japan	Chairman IAFEI
Richard Vanham, Belgium	Vice Chairman IAFEI
Alfredo Parungao, the Philippines	Secretary IAFEI
Emilio Pagani, Italy	Treasurer IAFEI
Liu Changkun, China	Area President Asia, IAFEI
Armand Angeli, France	Area President Europe, Africa, Middle East, IAFEI

**The next physical IAFEI Board of Directors Meeting  
will be routinely held on September 16, 2011,**

**on the occasion of the 41<sup>st</sup> IAFEI World Congress, Beijing, China,  
September 16 to 19, 2011.**

Please turn over

## **IMEF, Instituto Mexicano de Ejecutivos de Finanzas, re- joined IAFEI as new member, in November 2010**

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In November 2010, IMEF, the Instituto Mexicano de Ejecutivos de Finanzas, re-joined IAFEI. IMEF has been one of the founding members of IAFEI in 1969. It left the association in 2002, and it has rejoined in 2010.

IAFEI has given a warm welcome to IMEF.

Election for Officer IAFEI Area President The Americas, Mr. Luis Ortiz-Hidalgo, Vice President IMEF, Mexico, for International Affairs, January 2011

IAFEI has given a warm welcome to Mr. Luis Ortiz-Hidalgo.

## **The Israeli CFO Forum , re- joined IAFEI as new member, in February, 2011**

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In February 2011, the Israeli CFO Forum re-joined IAFEI. It left the association in 2005, and it has rejoined in 2011.

IAFEI has given a warm welcome to the Israeli CFO Forum.

## **41st IAFEI World Congress, Beijing, China, September 16 to 19, 2011**

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**Cacfo**, the Chinese IAFEI member institute, will organise and host the 41<sup>st</sup> IAFEI World Congress, in Beijing, China, in September 2011. Program and Registration Form will be available soon.

September 16, congress registration, evening reception

September 17, full day conference program. Evening Gala Dinner

September 18, full day conference program

September 19, optional tours to sites of interest