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IAFEI News

Letter of the Editor **June 28, 2012**

Dear Financial Executive,

You receive the **IAFEI Quarterly XVII th Issue**.

This is another issue of 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.

This issue, like its predecessors, offers a broad range of articles on financial subjects.

The world economy continues to be exposed to a number of tensions and stress factors. And the more so, consequently, the financial markets.

The Euro crisis is dragging on and on, and so is the state overindebtedness in several countries, not only in Europe, but also in Asia and the Americas. This produces uncertainty, and volatility. Conservatism in managing the real economies and corporations is the right answer given everywhere worldwide. Financial Executives are well advised to act within this philosophy, and they predominantly do so.

The articles in this Quarterly cover a number of aspects of this challenging reality.

Enjoy reading this IAFEI Quarterly.

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.

With best personal regards Helmut Schnabel

Helmut Schnabel

Magna

// Mr Schönhofer, Magna has a lot of cash and very little debt. Is that just a temporary exception or is this your preferred financial structure?
Magna is a conservative company which is also reflected in our accounting principles and our financial strategy and structure. This attitude has actually been affirmed and reinforced through the global financial crisis, which struck the car industry particularly hard in 2009. We definitely do not consider a higher leverage ratio as a goal in itself, just to optimise some theoretical cost of capital ratios or the like. For us, the question whether more leverage would be desirable or not is purely related to acquisition opportunities or other Capex requirements that might arise and require external funding, based on strict return-on-investment guidelines.

// But having cash sitting on one's balance sheet is certainly not returning any good value these days.

"WE WILL NOT CHANGE OUR DNA"

When the automotive industry tanked in 2009, Magna's turnover shrank by 25 percent. Today, the car supplier is back on its feet again, but there is a big gap between its strong recovery in North America and persisting problems in Europe. Peter Schönhofer sees problems in politics, but admits that internal issues have to be addressed as well.

By Armin Häberle

We have bought back a number of shares recently along with reforming our shareholder structure. The multiple-vote shares owned by our founder and chairman Frank Stronach were turned into ordinary shares to eliminate this dual-class share structure. This was an example of when we put some of our cash to a very meaningful use, in my perspective.

In addition, we continue to deploy capital to grow our footprint in developing markets (40 new facilities between 2011 and 2014) as our customers continue to expand in new regions, and we have been selective with several key acquisitions to complement our current business and/or our product portfolio. To give just one example of a recent acquisition: BDW in Europe provides us with low-pressure and high-pressure casting technologies.

// Does that mean Magna is shifting its regional presence?

We are allocating our capital to help us grow in developing markets, where our customers are also expanding their presence. In the automobile industry, these are in particular the Asian and Latin American markets. That means we not only try to increase sales, but also our capital expenditure in all of these regions.

// Do you only produce car parts in these new markets or do you also offer complete-vehicle assembly, which is part of your business model in develeoped markets?

As a global parts supplier, we have a full range of capabilities. That we offer OEMs complete vehicle manufacturing is just one aspect. Our approach to growing in developing markets depends on the needs of our customers as well as the local markets.

// Could this mean a general farewell to vehicle assembly?

Again, our complete vehicle assembly capability is fully dependant upon the wants and needs of the customer. Right now, we run several successful complete-vehicle assembly programs out of our Magna Steyr facility in Graz. It is a proven business model that can be duplicated in other regions of the world if our customers require it.

// Looking at your latest annual report, the North American part of Magna came back very strongly after the crisis, whilst the European operation still struggles. Why?

Let's not generalise too much. It is not the entire European operation that lagged behind, but individual divisions or sites that have had some problems in Europe, such as a few Exteriors & Interiors divisions. But it is not correct to say that all of Magna Europe was ailing.

// Is there an explanation for this?

In some cases, there might have been very aggressive target pricing strategies in or- »

The CFO...

Peter Schönhofer was promoted to CFO and executive vice president finance at Magna Steyr in February 2011. He was previously vice president Europe of Magna Electronics Europe and executive vice president finance of Magna International Europe. Before joining the automobile supplier, Mr Schönhofer worked as CFO for Nokia Siemens Networks, Siemens Austria and red-star.com data. He holds a degree in business administration from the University of Economics in Vienna.

» der to fulfil plan targets and keep capacity utilisation, which in retrospect appear to have been rather unfortunate. This is particularly true since we face a buyer's market in Europe these days. But we have identified the affected divisions and have already started to address their problems.

Also, remember that in Europe, unlike North America, there has been no real structural market consolidation during the crisis because of many state-sponsored programmes that have kept many car suppliers alive to support employment targets by governments. This also keeps pressure on the prices today and negatively affects our profitability in the region.

// But the biggest government support was still the way OEMs in the United States were supported.

That's correct. But my feeling is, without having exact figures, that in North America there has been a much stronger market consolidation and capacity reduction amongst suppliers than in Europe.

// But there were voices saying that you waited too long with addressing problems at your European division nevertheless.

It is up to our general managers at the division level to do their homework on their own initiative. And even if we waited a bit too long in some cases, we have now identified all the issues and are addressing them.

// Is this decentralised structure a global organising principle or more European?

That is our leading global principle. We are a very entrepreneurial company. It's first and foremost up to our general managers at the individual sites to identify and address issues of efficiency or capacity.

// Is this entrepreneurial approach being questioned after the recent experiences?

No. Entrepreneurship is in our very DNA. We cannot question this. We have reassessed certain processes and decisions, but we will not question the overall principle. As I said, the analysis focuses, for example, on the rather aggressive target pricing in some divisions that look, in retrospect, rather unfortunate.

// Do you feel better prepared now for unfavourable developments than you were in the past?

Of course we have learned our lessons from the latest economic crisis, though I would say that overall we were quite well-prepared back then as well. But we have developed various scenarios for the coming years so we can continue to react quickly and boldly. This includes making sure our flexible costs are truly flexible, for example through temporary work placements, but it also goes down to preparing plans on how to swiftly reduce costs that would normally be considered fixed.

// Your investment strategy means more investments in emerging markets. What does this mean for the finance department?

First and foremost, in terms of asset allocation, we are increasingly operating outside of hard currency areas . This means our financing specialists are working on new solutions to deal with inflation risks, currency risks and so on. At the same time, the stronger we get in a new market, the more we try to source locally in order to build a natural hedge.

// This will not work, however, with natural resources.

That's true, but most input prices fluctuate in a range that can be also covered by flexible agreements in our contracts. We certainly could not deal with any of these issues without having some flexibility and security already explicitly formulated in our contracts.

// Do OEMs agree on that? Common knowledge has it that OEMs squeeze suppliers to the last drop.

It's a learning process on both sides. In North America, this is no problem whatsoever, and even in Europe suppliers can increasingly include flexible elements in their contracts as well. OEMs have learned that they cannot let their suppliers run into elevated risk positions unprotected. This would only result in them pricing this risk directly into their products, making them more expensive. And OEMs also know that they depend on a supply chain that will not fall apart at the first sight of another crisis.

// Big car companies reportedly push you to buy weaker suppliers. Are there any attractive targets?

There are always attractive targets out there and if we were interested in an acquisition, we could certainly handle its integration as well. But I would rather not expand on such a topic at the moment.

// Do you fear a double-dip as many economists do these days?

I wouldn't call it a double-dip, but we can see that many countries have very poor growth prospects due to their sovereign debt problems. This will obviously be a drag on consumption. In the automotive industry Germany is doing pretty well, but countries with severe sovereign debt problems show negative growth rates in car sales. In Europe, we saw sales in the first quarter of 2012 go down by approximately 6 percent compared to the first three months of 2011. That is still a far cry from a double-dip, but it is certainly not how we would like things to be.

// Would you say that austerity has been taken too far and that it is choking off the recovery?

I don't think loosening austerity is an option. To my mind, public budgets simply do not allow for this. However, there is a need to stimulate growth in Europe as well. But the problem is that European governments have gambled away most of their ability to do so by being too lavish in the past. It would be beneficial if the austerity measures were properly enacted and enforced, rather than watered down and delayed, in order to give governments new room for stimulus measures sooner rather than later. «

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... and the company

Magna Steyr is a supplier to the automobile industry based in Graz, Austria. It comprises engineering services, a vehicle contract manufacturing division, which provides solutions from niche to volume production; fuel systems and roof systems. Magna Steyr became part of the Magna Group in 1998, which had a turnover of USD 28.7 billion (EUR 22.3bn) in 2011. The group is listed on the stock exchanges in Toronto and New York.

A question of trust

STEPHEN NORTON AND **CARMEN LAI** SAY THAT THE TRUST MODEL OFFERS UK CORPORATES A POWERFUL TOOL FOR FURTHERING THEIR CHINA INVESTMENTS.

When David Cameron visited Barack Obama in March, he presented the US president with a table tennis table produced by Dunlop. A spokesman for the prime minister said: "Founded in 1886, Dunlop is a truly British company, which operates in over 70 countries. It is the most successful sports brand of the 20th century, and a fitting gift for the occasion as we approach the London 2012 Olympics." Unfortunately, although the table was "designed and branded" in the UK, it was actually made in China.

A great many things are, of course, made in China. Last year the country ended the century-long dominance of the US in world manufacturing, accounting for 19.8% of the world's production of goods compared with 19.4% chalked up by the US. That, plus China's booming economy, makes it an attractive place for UK corporates to buy into.

In a cross-border acquisition or strategic investment, whether for part or all of a business, the trust model can be used in a multitude of different ways for the benefit of both seller and investor. A trust enables the transaction to proceed or gives one or both of the parties the assurance that they would not have otherwise. This may be particularly important if the investor is investing in another country for the first time and wishes to have the assistance of a reputable third-party provider of trust services.

Treasurers of companies seeking to invest in China are likely to be aware already of the value of such services in the light of their corporate activity in more familiar jurisdictions, whether in providing practical solutions to commercial problems, addressing regulatory issues or future uncertainty. Now for the first time such services are available to foreign investors in mainland China under the country's trust law through Law Debenture's co-operation agreement with Jiangsu International Trust Corporation.

Law Debenture is a trust and escrow services provider, while JSITC is China's fifth largest trust company and 98%-owned by the government's Jiangsu Guoxin Investment Group.

China is changing fast. The middle class is growing in size and prosperity, and over 50% of the population now live in cities. It has an increasing number of private sector businesses that are keen to expand. One recent survey estimated there are over 2,000 companies in China that want to list on the stock exchange.

However, China is also considered to be a hard market for foreign businesses to enter. Lack of government support, restrictive practices and cultural issues and – above all – the regulatory environment are seen as significant barriers to entry. Foreign investment in some key sectors, such as financial services, internet businesses and real estate, is still restricted and may even be prohibited. Even in industries and sectors earmarked for investment, the process involved in setting up an onshore presence is complex and time-consuming. That said, the potential is huge and few corporates focused on growth can afford to ignore it.

Given this business climate, we believe that UK corporates investing in China require the following:

- protection against future uncertainty or risk where possible;
- retention of key staff in the target business;
- the ability to comply with regulation without compromising underlying commercial objectives as far as possible; and
- risk minimisation, particularly where joint ventures are concerned.

While UK corporates will be experienced investors in their existing markets, established business practices in China and its underlying regulatory environment are likely to be different from what they are used to. Our experience suggests that treasurers may wish to consider the following scenarios when contemplating investing in China.

ACQUISITION WHERE THE CONSIDERATION IS HELD BACK – ESCROW ACCOUNT

- **Requirement**. A foreign company acquiring or investing in a business in China may be required to place the investment funds in a segregated bank account pending regulatory approval. Alternatively,

an investor may wish to hold back some of the payments due to the vendor until certain conditions are met at a future date – perhaps warranties need to be satisfied or operating profits must increase by 10% in the next two years. In each case neither party wants the other to have control over the money representing the deferred payment until the outcome has been settled to their satisfaction.

■ **Solution**. The practice in China has been to place funds with a notary or to use a bank account under the dual control of both parties. Now, however, as is standard practice with Law Debenture in the UK, JSITC can act as escrow agent for cash, documents and title documents, pending the fulfilment of warranties.

ONE RECENT SURVEY ESTIMATED THERE ARE OVER 2,000 COMPANIES IN CHINA THAT WANT TO LIST ON THE STOCK EXCHANGE.

ACQUISITION WITH REGULATORY ISSUES – VOTING TRUSTS

■ **Requirement**. Depending on the sector involved, regulations in China may place a limit on the maximum percentage of the shares in a Chinese company that may be held by a foreign investor. This may be to limit the voting rights of foreign investors in such companies so as to restrict their influence on the company's business. Equally, other authorities in China may wish to limit the voting rights of foreign investors in specific Chinese companies.

In such cases voting trusts can be used to make a commercial agreement possible between the owners of a company and the outside investor whose investment or technology the owners wish to use in return for an agreed share of the profits but a correspondingly lower share of the voting rights.

■ **Solution**. The shares that exceed the permitted holding by a foreign investor are transferred to JSITC as trustee and held under a declaration of trust. Under the terms of the trust all of the economic benefits, such as dividends, pass to the foreign investor but the underlying voting rights would be exercised by the trustee in accordance with the instructions received from someone approved by the regulator. This allows the foreign investor to acquire the share of the regulated business it wants without breaching regulations that limit potential voting rights.

Law Debenture has undertaken this role for numerous companies in the UK, and used the voting trust model in Hong Kong to facilitate an investment by Anheuser Busch in China's Tsingtao Brewery a few years ago when Tsingtao had H shares listed in Hong Kong. Anheuser wanted to acquire 27% of Tsingtao; it duly acquired 20% and the remaining 7% was held by Law Debenture as a share trust. Under the terms of the trust any dividends on the 7% held by Law Debenture would be transferred to Anheuser, and we would only exercise voting rights as directed by the board of Tsingtao, failing which no votes would be cast.

RETAINING KEY STAFF – EMPLOYEE SHARE TRUSTS

Requirement. Where a foreign investor is acquiring a controlling stake in an existing business in China or setting up a new business, it will be essential to retain and motivate key staff, particularly in the early stages of ownership. The same might also apply where a new employer wished to incentivise staff in advance of an initial public offering (IPO).

Solution. Shares in the company that is acquired are transferred to JSITC as trustee to be held for a defined period of time on trust. They would then be released to the relevant employees as beneficiaries of the trust, but only if specified conditions such as profit targets are met or if they remain employees of the company after a specified period. Sometimes such shares will be distributed to employees free of charge, or they will be entitled to receive them at a discounted price below market value.

JOINT VENTURE WITH A WEAKER PARTNER – SHARE TRUSTS

Requirement. A foreign company (FCo) wishes to form a joint venture company with a Chinese company (CCo) but is concerned that its investment in the joint venture could be jeopardised if CCo became insolvent. In such circumstances FCo would wish to be able to buy out CCo's interest in the joint venture quickly and on the basis of a predetermined formula rather than have to negotiate with the liquidator of CCo and/or compete with other potential and competing purchasers for the shares in the joint venture.

Solution. Under a shareholders' agreement relating to the joint venture, if either company becomes insolvent then the other will be entitled to exercise a call option over its shares in the joint venture at a predetermined price. So that the call option can be exercised without fail or challenge (any liquidator would be bound by its terms), the shares of each company in the joint venture are transferred to JSITC and held in separate trusts. Each company is given a power of attorney allowing it to exercise all its rights in relation to the shares held for it, while the other company is appointed as its delegate to operate the power of attorney given by the trustee under the trust. In this way, FCo obtains the protection that it requires.

UNFAMILIAR TERRITORY China is a dynamic market offering considerable opportunities, but it operates quite differently and at different levels from the environment many UK corporates are familiar with for cross-border M&A or strategic investments. However, rather like the table tennis table presented by the prime minister, Law Debenture can offer solutions designed, branded and developed in the UK – and implemented in China.

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READ THE SIGNS

Emerging risks in emerging markets

According to some calculations, the Mayan calendar predicts that the world will end in 2012. While this is unlikely to happen anywhere outside of a Hollywood film studio, 2012 might indeed mark an end to the unconditional attraction to emerging markets. Latin America, the historical home of the Maya people, stands out as a warning for CFOs.

By Armin Häberle and Anne-Kathrin Meves

CFOs across Europe face a huge dilemma. They know that developed markets, and European ones in particular, will not yield any significant growth rates for years to come. Political talk about a new growth pact is the flavour of the month (see our guest commentary on page 64), but few CFOs will want to base their corporate growth strategies on the spending plans of their governments.

This leaves emerging markets as the force to count on for many corporations' revenues and profits. But the more CFOs invest in these markets, the more they are exposed to a plethora of risks that they are not used to from their developed markets bases. This has become shockingly obvious in recent weeks. It is thus time for CFOs to read the signs and reassess their international investment plans.

Indeed, several risks of investing in emerging markets have become alarmingly evident in recent weeks. They range from straightforward expropriation to tax legislation and exchange rate hikes, and they cover all kinds of different industries.

Argentine President Christina Fernández nationalised YPF, the Argentine subsidiary of Spain's Repsol; Bolivian President Evo Morales nationalised TDE, the Bolivian subsidiary of Spain's Red Electrica; ThyssenKrupp is looking to sell its Brazilian steel plant before it is even running at full capacity due to a change in economic fundamentals; Hugo Chavez threatened to nationalise foreign banks if they appear to lend too little to local businesses; and the Indian government imposed retroactive taxes on foreign takeovers that may cost Vodafone upwards of EUR 3 billion and performed other policy U-turns such as on retail regulation and oil royalties. And the list continues.

Feel the (S)pain

As the examples in India show, Latin America is not alone in causing foreign investors headaches, but it has recently stood out in many respects and might be a harbinger of what is to come in other regions. For CFOs, it is extremely difficult to assess these looming risks. At the same time, as more and more western companies rely more and more on emerging markets for their success, the stakes get higher each day.

> **» The more companies invest in emerging markets, the more uncertainty they need to allow for in their business plans.«**

Due to their close ties with Latin America, Spanish companies are amongst the first to suffer. According to calculations by Reuters, Spain's blue chip companies generated roughly EUR 115 billion, or one-quarter of their revenues, from their Latin American operations last year. This means Spanish companies derive much more of their revenues from Brazil, Argentina and the like than their German competitors, for example. CFOs from other European companies, however, should not sit back and relax as their Spanish colleagues try to sort out this reliance. They might be the next in line to run into unexpected troubles in the regions where they are more heavily engaged.

First and foremost, the expropriations in Argentina and Bolivia have shown that politics can take unpleasant turns. "In fact, I think the main difference to industrial countries is that even in the large and highly attractive emerging markets political and institutional circumstances can change rapidly," says Maria Laura Lanzeni, head of emerging markets at Deutsche Bank Research. Christoph Witte, head of Germany at credit insurance company Delcredere, confirms that "political risk should not be underestimated, not even in well-established democracies such as Brazil."

Ironically, one enormous risk might lie in participating in privatisation schemes. Many western companies enter emerging markets through such schemes because they have a less-risky appearance than Greenfield investments do. But they might quickly become a liability if and when politicians decide that investors have received the assets too cheaply or had underinvested in them afterwards. To "recover what is ours" was the exact argument used by both Mr Morales and Ms Fernández. That Argentina, for example, had strictly regulated gas prices for years and was hence largely responsible for natural gas over-consumption by households and under-investment in local gas fields matters little in such reasoning. »

»There is an increasing interest in insurance solutions for emerging markets, and not just from the usual suspects from energy and telecoms but from a broad range of industries.«

» The backdrop to these renationalisations is a shift away from the neoliberal ideals of the 1990s and represents the latest trend of bringing the state back into the economic sphere with renewed strength. Reversing fundamental policy choices is not uncommon in emerging markets. The problem with political risk, however, is that "while it is perceived to be amongst the most important risk factors in the medium and long run, it does not play a prominent role in the shorter term," says Olivier Lambert of the World Bank's Multilateral Investment Guarantee Agency (MIGA). Hence, shorter term considerations such as macroeconomic growth and access to funding can distort the long-term assessments of investment risk. Mr Lambert also notes that, in order to mitigate political risk, investors typically choose local partners with specific profiles (i.e. good connections into politics). However, this alone has not proven successful in avoiding expropriations, he finds. "Instead, companies need to design good contracts with host governments that are perceived to be transparent, well-balanced and fair."

Industries such as natural resources, where few people are employed and the notion of "robbing the land" is ready at hand, and telecoms, where radio frequencies seem to cost nothing (just like the air) and then foreign companies return big profits from them, are in particular danger. Thus, it is no surprise that Repsol/YPF and Red Electrica/TDF have been direct victims of the latest nationalisations. But Tobias Federkeil of Marsh GmbH says Marsh registers an increasing interest in assurance solutions for emerging markets, and not just from the usual suspects but from a broader range of industries. "Individual transactions can be covered even to volumes of 1.5 billion US dollars," he says. "However, insurance markets for emerging economies easily run into capacity issues. It's often not the pricing, but simply the capacity on the insurers' side that is the limiting factor." In addition, markets for political risk can collapse quickly, leaving investors out in the rain just when they most need assurance. Therefore, Marsh strongly encourages clients to lock in multi-year programmes to ensure they are covered when unexpected events occur.

Victim to success

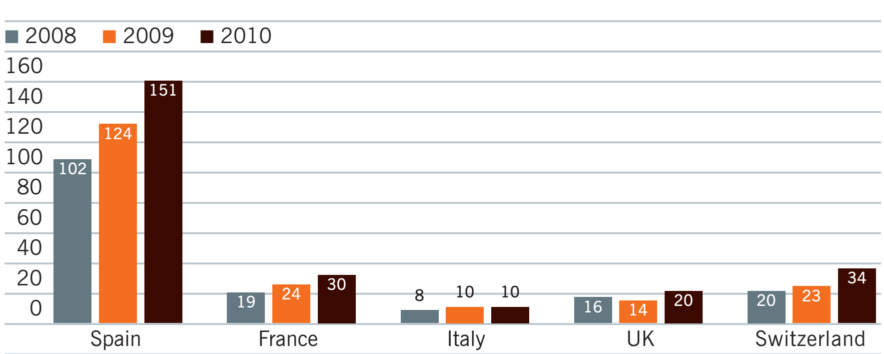
However, the risks run much deeper than blunt expropriations. "Emerging markets tend to be much more cyclical than developed ones," warns Mr Witte. This makes it hard to properly assess market potential and growth over the medium term. It also makes appropriate resource allocation tricky as CFOs cannot rely on stable cash flows from their investments. This is a problem that Jay Nibbe, partner at Ernst & Young, pointed to in the spring edition of CFO Insight. CFOs should keep resource allocation in line with realistic revenue expectations, he warned, and should not neglect developed markets as a core source of profitability and cash flows.

A prominent example of the vagaries of emerging market prospects is ThyssenKrupp's notoriously problematic steel plant in Brazil. Planned in 2007 as a low-cost site for producing crude steel, it is now up for sale before it has even run at full capacity. Costs for the Brazilian site have risen to well over EUR 5 billion, far more than the EUR 3 billion it was originally planned to cost. Together with a site in Alabama in the United States, ThyssenKrupp has invested more than EUR 12 billion in the two projects which are now both to be had. Two things have made the low-cost strategy in Brazil unviable: wages and the exchange rate have risen considerably, making inputs more costly and exports less competitive.

"The different rates of growth in the two regions [Brazil and the US] are calling this strategy into question," the company explains. What is remarkable about this explanation is that different rates of growth between emerging and developed markets are exactly the stuff that executives talk about when hashing out their visions for exploiting the potential of these emerging markets. Higher growth, however, is almost always associated with rising labour and input costs as well as higher exchange rates.

The main problem for ThyssenKrupp was that it entered Brazil not as a market for its final products but as a production site.

Foreign Direct Investment of European Economies in Latin America (in EUR billion)



Source: Eurostat

This made the combined price and currency effects particularly painful. Others who focus more on Latin America for its market potential might not be bothered so much. Nevertheless, the bottom line is that ThyssenKrupp has fallen victim to the economic success of the very emerging market in which it invested. That the steel giant could get its math on this central part of its corporate strategy so fundamentally wrong should serve as a warning sign to others.

Go with(out) the flow

Calculating cash flows from emerging markets investments is another source of uncertainty. "Just recently we experienced considerable problems with our transfers from Argentina to our headquarters," says Andreas Herzog, CFO of Bühler Group. The Swiss process engineering company has an annual turnover of approximately EUR 1.7 billion, 20 percent of which comes in from South America. The company has been active in Argentina for over 80 years, so Mr Herzog is not fundamentally reassessing his investment in the country. "But you have to learn how to live with negative surprises such as these new capital controls," he says. In addition, in Argentina and in Venezuela, for example, companies can experience considerable and totally unpredictable delays in payments from clients, says Andreas Tesch, chief market officer of Atradius, a leading credit insurance company. This adds another source of uncertainty to the equation.

If push comes to shove, a company can even run into default for no direct fault of its own. Argentine conglomerate Grupo Petersen found this out the hard way on 17 May when, according to a Dow Jones newswire, Credit Suisse notified the group that a USD 400 million loan was in default and immediately due for payment. Grupo Petersen had pledged shares in YPF as collateral for the loan (over time, it had acquired 25 percent in the company mostly through borrowed money) and was counting on sizeable dividends to pay back its loans. But the Argentinean administration announced it would reinvest all earnings and pay no dividends. Partly as a consequence, Grupo Petersen missed a USD 400 million loan payment, which triggered the default.

In summary, the more that companies invest in emerging markets, the more uncertainty they need to allow for on their balance sheets (expropriations), their profit-and-loss statements (volatility and unreliability) and everywhere in-between. This might not always be the case, as many companies introduce efficiency programmes within their finance departments in parallel to ramping up their presence in emerging markets. Implicitly considering investments in emerging markets as qualitatively equal to those in developed markets, however, can become a problem when getting money back out is impossible, even if just temporarily.

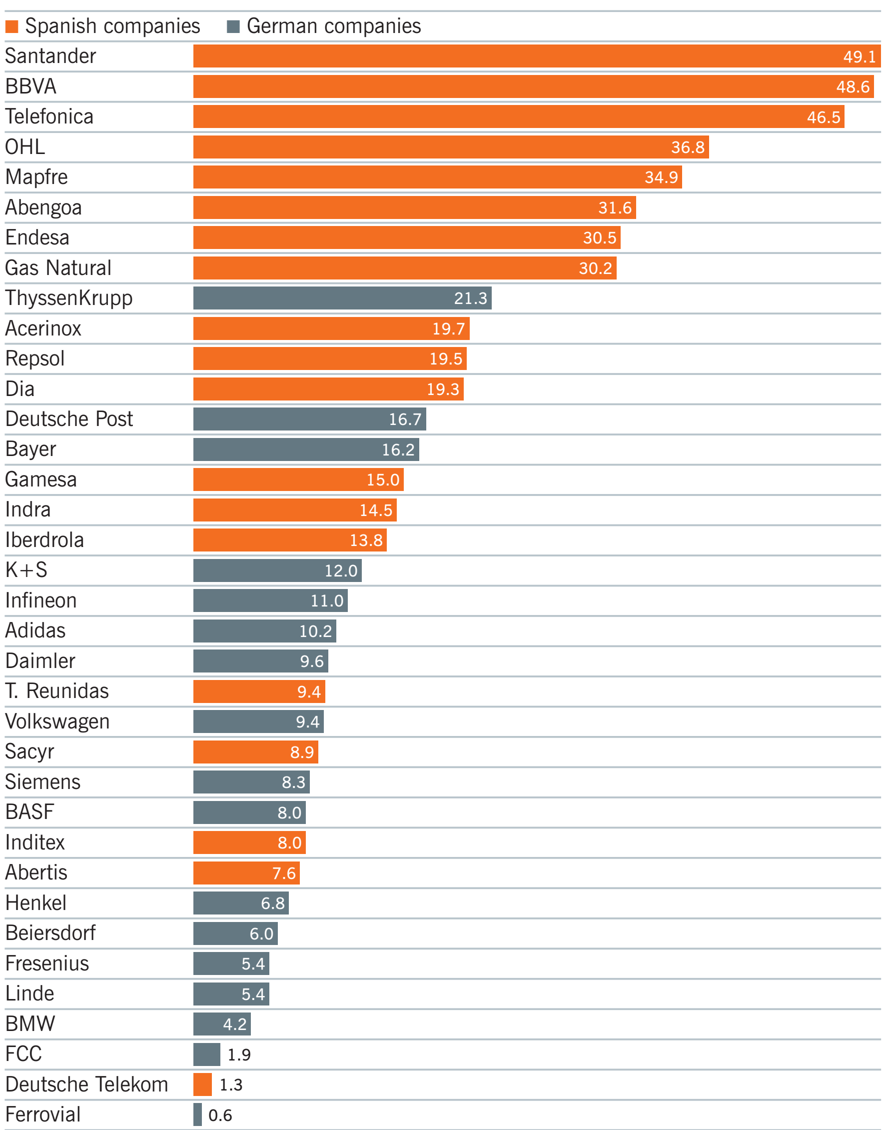
But not just getting money back out of emerging markets can be tricky. The case of Brazil's increasingly strict controls on capital inflows shows that it also works the other way around and local subsidiaries that depend on centralised funding can easily run into problems. Unfortunately, simply »

» shifting to local funding is often not an option. "In many emerging markets, local funding is hard to get or is prohibitively expensive," says Mr Witte of Delcredere. This is a direct function of shallow and underdeveloped financial markets. According to the World Bank, 78 percent of the capital stock of businesses in the developed world is in movable assets and only 22 percent in property. "In economies with a modern secured transaction system, these movable assets can easily be used as collateral. But in most developing economies movable property would probably be unacceptable to lenders as collateral." This matters because borrowers with collateral get, on average, nine times as much credit, repayment periods that are eleven times longer and 50 percent lower interest rates than those without.

In Brazil, for example, the annual interest rate for a secured loan is about 16 percent and up to 170 percent for an unsecured one, says Torsten Rosenboom of law firm Berger, Steck & Partners. This also means that local M&A transactions there are virtually never funded through the local market but either through the national public investment bank BNDES or via funding that is secured abroad. In India, the return on foreign investor's equity is 8 percent, which is below the cost of capital in the country, according to calculations by the Economist.

Unless local financial markets in emerging markets take a leap forward soon, large subsidiaries in these markets are in danger of big financing problems, especially if political attitudes shift towards restricting capital flows. At the same time, unfortunately, most emerging markets do not only lack the depth of retail deposits that would make for a solid base of any financial market. Many governments also lack the drive to improve property rights and credit information systems that are essential for a development of a liquid credit market, as shown by the World Bank.

Revenues in Latin America for leading Spanish and German companies (in percentage of total revenues*, 2011 or latest)



Source: Reuters, research by CFO Insight, based on company statements

*Note: Not all companies report separately on the region, in this case, estimates are based on available data.

One hub, no spokes

Finally, a further problem of investing in emerging markets is that you can only rarely access various markets through one hub. Again, Latin America is a warning example. It boasts all kinds of economic unions such as Mercosur and the Andean Community of Nations. But they do not work. "Mercosur is a joke," says Mr Herzog. "You need to have a separate subsidiary in every single country. Cross-border business from, say, Brazil to Argentina is simply impossible." This means that even if markets look appealing in aggregate terms – Mercosur is proud to encompass 244 million people and a combined GDP of EUR 1.6 trillion – it is extremely hard to leverage economies of scale by hopping for cross-border activities in them.

CFOs have been aware of many of these problems before, but it is time for them to revisit the fundamentals on which they base their investment strategies. Assuming that 2012 will not actually see the end of the world, reading the signs that come not from an ancient Mayan calendar but from the latest moves in emerging market politics and economics will be a key factor for success in the next decade. «

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France, Article: **The Ten Eternal Truths of Finance**
by Pascal Quiry, Author of Vernimmen,
and **by Yann Le Fur,** director at Mediobanca, and professor at HEC, Paris

1 Risk and profitability or the marriage without divorce

It is one of the best possible indicators of a coming crisis, that at a given time there is the belief, that it is possible to obtain a very good rate of return for a low risk. It has been like this, when the CPDO, invented in 2006 by ABN Amro Bank, and rated AAA by complacent or incompetent rating agencies, offered a higher rate of return by 1 - 2 % above the rate for AAA rated government bonds. It was in fact the credit default swaps, repackaged with a leverage effect, which in 2008 had lost at least 30 % of their value.

The risk must be compensated for, otherwise it will only be taken by burned heads, which is not sufficient for the development of the economy. The remuneration of the risk comes from the mechanism of discounting expected future cash flow, which makes that expected future flows are purchased/ evaluated at a discount to their nominal values, discounted the more so, the more the flow is distant in the future/ or that the uncertainty about the amount is higher.

In the same way, one should be aware, that high returns can only come with high risks. Let us consider as an example the profitability of the equity capital of the investment bank UBS in 2006:

	2001	2002	2003	2004	2005	2006
Return on equity	6%	9%	25%	26%	29%	29%

If one believes, that one can sustainably return twice one`s cost of capital, without taking risk more than average, except in an area with formidable barriers to entry and with real competitors (which is not the case in the investment banking business)then one is wrong completely, as illustrates the development of the return thereafter of the investment banking division of UBS:

	2007	2008	2009	2010
Return on equity	-63%	-126%	-24%	9%

It is true that its subprime losses were about 50 billion US$.

Evidently, we would all like to have good returns with small risks, and as we all are looking for this, by investing in these pockets of Nirvana or by buying them, and thereby we lower the future returns and restore the equilibrium…..logically.

2 Return sought and return achieved, or the obligatory convergence

As a consequence from the previous, it is permanently not possible to earn a return on the invested capital (economic profitability), higher or lower than the required return as weighted with its risk (the weighted average cost of capital).

Michelin is nicely being the world leader in its business sector, with a trademark of established reputation, having invented revolutionary products and having filed many patents, which are barriers to entry, but its return, through good years and bad years, equals its cost of capital.

This is the more so true, when the business sector of the company is mature. The reason is the competition in this area, as the saying goes: " there is no impregnable fortresses, there is only the poorly guarded fortresses."

It is inevitable, that one day the profitability of Facebook resembles that of Michelin today, as IBM, Microsoft, and thereafter Google have taken this path.

Conversely, if Profitability is sustainably insufficient, actors will go bankrupt, and will leave the sector, and this one will be restructured by mergers and acquisitions. Our readers will remember the state of the steel industry in the 1980ies (in bankruptcy), and its rebound in the 2000nds with the regroupings: Sacilor – Usinor – Aceralia – Arbed, British Steel – Hoogovens, and others.

3 Debt, in itself, does not create value, or the illusion of the leverage effect

If the debt would create value, by reducing the weighted average cost of capital, how it it that the best world companies, the operational performance of which is such that they do not fear bankruptcy(Apple, l` Oréal, Hermès, Google, BMW, Nestlé….) have almost no d debt, and on the contrary have most of the time net cash.

There are, however, two exceptions to this principle:

- When in the economy the real terms interest rates are negative because the debt is having fixed rates and the inflation rate goes up in an unexpected way like in the 1960ies and 1970ies in Europe and in the United States: There is a dispossession of money lenders, by way of reimbursing monkey money to them which cannot last very long. The innovation and spreading of loans at variable rates make it doubtful, that this phenomenon will re-occur in the future.

- In the LBO´s, where the debt serves as a prod (the high debt to be repaid, is pushing the company for being more efficient, in order to generate disposable cash flows), and as a stick (

the fear of bankruptcy avoids laxity), and as a carrot (the impact of the leverage effect of debt on the value of management compensation packages).

4 The cash is the Truth

Because a company technically goes bankrupt, when it is at a given moment not able to find the necessary cash for its activity, when the cause of the problem is upstream.

Because holding cash permits to buy assets at run down values when a crisis arises (Peugeot and Citroen, Fiat and Chrysler, recently).

Because the scamps are always unmasked by the cash (otherwise Madoff would probably still be in service, given the efficiency of the American regulator), that is a disconnect between proclaimed figures (performance, assets under management), and the reality of the cash position in the evening and in the morning.

Because the financial analysis of a complex problem always resolves itself more easily, when looking at the cash.

As the Americans say, when they only have disadvantages: cash is king.

5 The invested capitals can only be valued above book value when the effective return is higher than the required return

Even if there is little hope for the sustainability of an excess return, then only a temporary disconnection of the two can create additional value.

6 The diversification in itself creates no value

In emerging markets, diversified groups are frequent, because the relative underdevelopment of the financial markets is the cause for this organisational structure being a substitute for them: The group of companies allocates capital within itself, as if it were itself a financial market. But when financial markets develop, this type of organisation must demonstrate that it is still efficient. In face of several successes (Bouygues, Berkshire Hathaway) history shows an abundance of examples of refocusing and of concentration on just one business: Schneider, Daimler, Hanson, BTR, ITT, Gulf and Western, Lagardère, Accor, etc.

It is not because one is good in one sector, that one is good also in another one, as unfortunately illustrated by the grouping of Arnault with Carrefour, Allianz with ‘Dresdner, etc.

One might think, that groups of LBO´s (Carlyle, Wendel, KKR, Eurazéo, PAI…..) are the new diversified groups of today, but this would be the victim of an optical illusion: Their strategy changing all the time, they do not have a core business except buying companies with a leverage effect, and then to re-sell them.

7 The cost of capital is only a function of the risk of assets.

The cost of capital, in summary the weighted average cost of capital, is the rate of return required by all providers of funds of the company, be it shareholders, lenders (banks, bond market, bill market) on their funds invested in the company. In other words, the cost of capital corresponds to the cost of re-constituting the equity and liability side of the balance sheet of the company. As this finances the economic assets of the enterprise, the rate of return required altogether by the fund providers (cost of capital) corresponds therefore to the required rate of return on the economic assets as weighted with their risk.

Taxation is of no relevance therein, and to believe the contrary is a dangerous illusion. If it would be sufficient, to indebt oneself in order to lowering one´s cost of capital by benefitting from the deductability, taxwise, of the financial charges, why then companies, which are not afraid of bankruptcy, like Apple, Nestlé, Maroc Télécom, General Electric, Hermès, etc., are they so little indebted`?

8 The accounting is not finance

Unlike accounting, finance takes into consideration and account the future and therefore the risk. One might even say, that finance is interested almost solely in the future, and that accounting, by definition and construction, is only interested in the past. Therefore, it cannot take into account the risk, a dimension non existing as to the past, but essential for the future.

Which says two things:

That one cannot be a good financier, if one is not first of all a good accountant, in order to understand, how the past has been translated (betrayed?) in the past.

That accounting criteria like earnings per share, the returns on the invested equity have to be examined with caution. An increase of these criteria is not synonymous with an increase of value, if it is obtained in exchange of an increase of risk, of which the accounting criteria give no insight by definition.

Thus, if one is indebting itself for the repurchase of one´s own shares and then cancel them, leads then more often to an increase of earnings per share, but does not correspond to an increase of value, except if the shares could be re-purchased at a price inferior to their value.

9 Paying attention to the tax fascination

Paying taxes has never been particularly enjoyable, and many businesses and investors spend much time to use the existing regulations to pay the least tax possible. Our experience has shown us, that this time would be better used, to think in financial terms than in fiscal terms.

Indeed, we have often seen financial decisions made on the basis o0f fiscal criteria,that resulted, ultimately, in stronger losses of substance, than the economics of taxes saved beforehand. Thus, some will want to hold on to a participation a few months longer, which they had decided before to sell, in order to benefit from a lower tax rate applicable to a longer holding period. But if in the meantime values declined by 25% like in the fall of 2011, the tax gain was more than compensated by the loss of value.

One therefore better takes a financial decision first and foremost, before optimizing taxes on this basis.

10 The crisis, the only mode of efficient regulation of capitalism

We are all human beings , with feelings of hope and of fear, which carry us into alternating phases of optimism and pessimism, which translate themselves in Booms and crises. This is so.

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Responsible for translation: GEFIU; translator: Helmut Schnabel

Germany, Article: **Europe in Trouble – Germany in Danger**

The Point of View of:

Ottmar Issing,

the former chief economist of the European Central Bank is president of the Centre for financial studies in Frankfurt on Main

Since now almost three years, the news about the crisis of the European Currency Union are not tapering off. After Greece and Ireland, now Portugal and Spain with their debt- and bank-problems, have now moved into the focus. Also the existence of the currency unit itself is now questioned.

The attempt, to identify speculators or rating agencies as the culprits, has since long been dismantled as a maneuver to side track attention. The recognition can be suppressed less and less, that the problems, almost without exception, in each country are caused by own mistakes. Excessive wage increases over many years, not least in the public sector, in not few cases an unsolid fiscal policy, in other cases an unrestrained giving out of loans by the banks, had to end up into a crisis. Rigid regulations in the labour market, closed labour markets almost to the degree of a guild, have proven to be a brake against sustained growth and is the cause for the extremely high unemployment. The present unemployment rate of young people of up to 50 % in some countries makes forget easily, how deeply rooted this scandal is since long in the respective societies.

There is much agreement about this diagnosis. There is also agreement in principle, that in all these areas the national politics must resolve the situation with highly efficient reforms. Without doubt, already many right measures are being taken, which in the past had almost not been possible.

Since over two years the European Union is providing all kinds of financial help to countries in trouble. This relates to the bailout umbrella ESFS and the planned ESM. The European Central Bank contributes an essential contribution with immense, low interest bearing loans, also with measures beyond its mandate.

Large parts of European politics, the European Commission included, not to talk about the financial industry and the media, are not any longer satisfied with these extensive helping measures. Requests for Eurobonds, for a fiscal union and recently for a banking union are opening up a totally new dimension.

These proposals have one thing in common, namely the taking over of liability for the debts, respectively for wrong political decisions of other states by those states, which have themselves abided to the European regulations and have acted economically in a relatively solid way. Eurobonds, this is bonds of other countries, for which Germany would be held liable in the first place, would make Germany lose quickly its status as prime debtor. The inevitable consequence would be: higher interest rates for German bonds, and later on massive losses for the German state, when the case of being held liable becomes a reality – which is becoming the more so probable, as the promise to take over the liability leads to looser politics by those, who cannot stand up for their own debt. This will then here certainly lead to strongly increased taxes and reduced performances by the state.

How can one explain this to the German citizen, who has no influence whatsoever on the decisions of those national parliaments, for which he is now held liable and asked to pay for? Similar consequences have to be expected from the other proposals about the co-liability for debts of other countries. How can one further justify, that for instance solid banks and saving banks should stand up with their retained capital for the deposit insurance of banks in other countries, which have proven to have practiced an irresponsible business conduct? Why should German, French or Finish savers be held liable indirectly for mismanagement and exaggerated bonuses of bankers in other countries?

All proposals of this nature have in common, that they imply the intention, to put member states or banks under the European supervision and control. But for this, however, extensive changes of the treaties are necessary, which – if they would at all become reality – would take years to be negotiated and signed. But how can one trust such promises, when the same institutions and politicians have broken treaties and liabilities of all kinds of sort again and again?

How can one expect from the European Commission an objective and efficient control, when this institution is again and again participating in initiatives, contrary to agreements, or is veiling problems, thereby making their solutions more expensive?

The principle, that each country is held liable for the mistakes of its own policy (no-bail-out-clause), was not only a constituting component at the foundation of the Currency Union, it is, and remains, an inalienable element of a Union of sovereign states. As the currency will not be, for long, a fully established political union, the way to this is long and full of stones, it contradicts diametrically the democratic principle and every economic rationale, to make citizens liable, who have no influence whatsoever on the responsible parliaments. Financial help must therefore limit itself to the existing mechanisms. It must be precisely limited, and it must only be pursued on the basis of credible commitments by the recipient countries. To ask for more under the headline of “solidarity” is a disgrace to this principle and leads into a Europe, in which states, which permanently live beyond their means and disregard signed contracts, can roll over the resulting costs on other states. A state, which ever again is calling for new help, but which permanently is not fulfilling commitments, it had entered into, has no place in the Currency Union.

Germany is well advised, to hold on itself to the treaties and to ask for the same from the others. A Germany, which by way of falsely understood solidarity and by assuming unclear liability for others will at the end drown in indebtedness, will solicit the anger of its citizens and will remove them even further from the European idea, as this, in the meantime, unfortunately, has already become the case. To the future of Europe, Germany would thus do a disservice.

Responsible for translation: GEFIU; translator: Helmut Schnabel

Chief Economist's Comment

23rd April 2012

A Great Challenge for Economic Thinking

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The financial crisis represents a turning point in many ways. A new tune is also finding a sympathetic ear in economic sciences. The task for the new economic theory is to discover in which phase of the economic cycle the theory of efficient markets applies, and when phenomena deviating from this theory occur. In this way extreme volatilities in the capital markets could be better anticipated and it might even be possible to prevent future financial crises.

Financial crisis as turning point

The financial crisis represents a watershed in many ways. This turning point began in 2007 with the subprime crisis in the US. After a long period of carelessness in the capital markets, risk premiums were demanded once again. Starting with derivative financial products, a readjustment took place for all asset classes in the years that followed.

Regulation en vogue

In addition, the zeitgeist has also changed substantially when it comes to regulatory aspects. While far-reaching deregulation was seen as the measure of all things until the outbreak of the financial crisis, national and supranational authorities are currently trying to outdo each other in their regulatory efforts. Recently the US President even raised the issue of a tighter regulation of the oil market. In France, too, President Sarkozy and his Socialist challenger Hollande are trying to attract voters in the presidential election with regulatory and protectionist slogans. Confidence in free market mechanisms seems to be eroding.

New tune in economic sciences

The new tune is finding a sympathetic ear also among economists. The doctrine that is currently still dominant in most universities of individuals always behaving rationally in always perfect markets – packaged as it is in models divorced from reality – is coming increasingly in question. In 2009 the Institute for New Economic Thinking (INET) was founded in New York. The goal of this organization is to draw lessons from the financial crisis and to rethink economic theory. While no representative from Germany was involved at the time, the third annual conference took place in Berlin recently. The "new thinking" has thus also reached German soil.

Kahneman as pioneer

However, the demand that economic doctrine open itself up to reassessment is not really new. For example, already in 2002 the psychologist Daniel Kahneman was awarded the Nobel Memorial Prize in Economics for "his groundbreaking work in applying psychological insights to economic theory, particularly in the areas of judgment and decision-making under uncertainty." Especially uncertainty has been running through the financial crisis like a golden thread for years. Thus, some decision makers would surely have liked to take advantage of these insights. But even though this particular Prize was awarded ten years ago, these insights have not yet made their way into the day-to-day life of the universities. As a result, advisors on economic policy lacked this understanding during the difficult phase of the financial crisis.

Behavioural science no argument for nationalisation

Does this mean that one should completely dismiss the insights of the doctrine that prevailed for decades? By no means! Especially the monetarist foundations of Milton Friedmann were crucial to the period of prosperity, after a policy strongly focused on demand-side management in the seventies led to sustained stagflation. However, in the last phase before the financial crisis, the belief spread that economic cycles had become obsolete. Consistently strong growth with corresponding returns and no risk seemed possible. Because of the assumption of rational expectations, any risks were ignored and that is precisely when the system went off the rails. Confidence in market mechanisms was profoundly shaken and the call for the state as the "saviour" gained ever more adherents. But the fact that a human being is not always a "homo oeconomicus" does not mean that individuals do not know what they want and what is good for them. That is why they should not be stripped of the freedom to make decisions through state regulations. Granted, the pressure from market movements and high volatility would be eliminated. However, the movements of the market would then be left to the state and the individual citizens would lose their autonomy. This must not be the path that is taken once aspects from behavioral science find their way into economic thinking.

Right mix of economic approaches

Instead, the task for the new economic theory is to discover in which phase of the economic cycle the theory of efficient markets applies, and when phenomena deviating from this theory occur. In this way extreme volatility in the capital markets could be better anticipated and it might even be possible to prevent future financial crises.

Commentary published in *Die Welt*, April 21, 2012. %

Japan, Interview: **"America and Europe are increasingly becoming like Japan"**

Interview with Richard C. Koo, Chief economist of Nomura Research Institute, Tokyo, Japan

When a credit finance bubble is bursting, corporations and private persons must often save. Richard Koo calls this balance sheet recession. Here, several traditional wisdoms do not hold true anymore. And this can last long.

Mister Koo, you have coined the notion balance sheet recession. What is this?

A balance sheet recession is characterised by a situation, in which corporations and private households after a speculative bubble must reduce their indebtedness even when interest rates are near the zero-percent-mark. This means, the private savings are increasing significantly. In this situation, many normal economic contexts do not apply any more. So, in a balance sheet recession, the corporations are not any longer maximising their profits. Instead they are forced to minimize their often too high indebtedness, because otherwise they would be threatened to loose their credit worthiness. In Japan, we have seen a balance sheet recession after the bursting of the real estate price bubble in the year 1990. In America and parts of Europe we see it since the breakout of the latest crisis. The parallels are overriding.

You distinguish between an usual financial crisis and a balance sheet recession. How?

In a financial crisis the creditor is in the centre of the situation. In a balance sheet recession the debtor is in the centre of the situation because he is fearing to loose his solvency and credit worthiness.

What has to be done in a balance sheet recession?

At first, one must recognise, that in a balance sheet recession the monetary policy is not functioning anymore properly. In normal cases, the monetary basis, the money quantity and the credit volume are in a relationship. This has been so in Japan until the burst of the real estate price bubble 1990 and in the United States as well as in Europe until the collapse of Lehman Brothers in the fall of 2008. Since then, the relationship is disturbed. The Central Banks had strongly increased the monetary basis in Japan, the United States, Great Britain and in the Euro-Area. However, this is not going along with a concomitant growth of the money quantity, and the credit volume has often developed negatively. After the past exaggerations, the corporations and the private households have to reduce their indebtedness. In such a balance sheet recession, the demand for additional loans in the private economy is necessarily weak. Therefore there is no strong growth of loans, and therefore the inflation is not a serious danger. If there are not sufficiently enough potential entities which take up loans, then the monetary policy cannot function properly.

And what is then to be done ?

The state must absorb the high savings of corporations and private households. In the worst case, otherwise is threatening a heavy depression like in the 30ies of the twentieth century. Many foreigners have reproached to Japan, that our economic stimulus programs had achieved nothing. This is not true. We have prevented, in a heavy and long lasting balance sheet recession a collapse of the business cycle and we have even achieved a small economic growth. With this we have made possible for the private sector, to achieve income, in order to repair its balance sheets. However, we have twice started austerity policy too early, for which we have paid dearly, because thereafter we were forced to stimulate the economy with high additional state indebtedness in order to protect it from a renewed collapse.

This sounds Keynesian, or?

No. I’m definitely no Keynesian. I’m not calling, at every weakness of the business cycle, for an expansive fiscal policy. I’m calling for more state loans exclusively for the case of a balance sheet recession when the corporations cannot indebt themselves, but when they have to save. A balance sheet recession, however, occurs perhaps only once every 70 years. When after that normal situations return to the private sector, one can begin, to reduce the state indebtedness.

In many countries the return for government bond investments has fallen in recent years. Many market participants are saying, it is a speculative bubble. Do you agree?

No. It is not a bubble. When the governments remain as the only borrowers, then the providers of money must buy government bonds. The strong demand for government bonds makes prices rising and the returns decreasing. Where should large institutional investors invest their money in a balance sheet recession? Equities, and assets denominated in foreign currencies, are risky, and not for everybody. When the corporations are reducing their indebtedness, the offer of corporate bond issuance is tight. A state bond is, as relatively safe and liquid investment, in such a situation very attractive, even when it is not producing a high return.

How do you explain the high returns for instance in Spain and Portugal?

This is a consequence of the Currency Union. An investor in Spain or Portugal can buy Euro-State bonds without having to buy domestic papers, when he regards them as unsafe. He can for instance buy German government bonds and this is also happening. I have recently asked at a conference in Madrid the present asset managers: "Who of you has recently invested in Germany?" All hands were raised – without exception. The participants themselves where surprised about this. The capital flight is the big challenge for the Currency Union.

Is the Euro-Area in a balance sheet recession?

Countries like Spain, Portugal and Ireland are in a balance sheet recession because their private economy is saving money at interest rates close to the zero-percent-mark and because there has been in the past a loan financed speculative bubble in these countries.

Germany, Italy and Greece are not in a balance sheet recession. The causes for the problems of Greece are not speculative bubbles.

How do you see the role of the European Central Bank?

I regard the policy of the ECB under the leadership of Mario Draghi as good because he has lowered the financing difficulties of banks by way of a generous distribution of liquidity. But one must not expect too much from ECB. Because the monetary policy can do nothing against the balance sheet recession. This must be done by the fiscal policy.

From your point of view, is the request to Spain, to consolidate the state budget, wrong?

It is wrong, to force Spain into a sharp budget consolidation, as long as the balance sheet recession is there still going on. Only after its end must the consolidation of the state budget be tackled. An alternative to fiscal policy impulses is export growth, but not every country can free itself from a crisis by way of exports.

Are you also very critical towards the new equity capital requirements in Europe. Why?

I had responsibility in two banking crises and I know: When banks are not in a position, to make loans, then no economy can recover. Tightened equity capital requirements in the present situation are acting pro-cyclically. Because many banks cannot get equity capital from the market, they are reducing their business. At present businesses are being sold by European banks around the globe at selloff prices. This is detrimental for the entire banking market. The banks should instead be encouraged, to continue to remain in the market.

How this?

In 1982, I was responsible at the Federal Reserve Bank of New York for syndicated loans, when the Mexican debt crisis broke out. At the time many banks wanted to get rid as quickly as possible of Mexican bonds and loans, which was understandable from the individual point of view of each bank. However, a collapse of the prices for Mexican assets had put many banks into difficulties. We at the Fed had at that time, under the leadership of Paul Volckers, induced the American banks, to maintain their engagement in Mexico, although we all knew, that Mexico was insolvent. Other industrial nations at the time have followed the American example and have asked their banks, to equally remain invested in Mexico. With this, heavy market turbulences have been prevented, and time has been won for an orderly debt restructuring of Mexico, which lasted round about 10 years. From this example one can learn.

What can we learn from this?

The problem of the European banks is not limited to individual banks. All banks have the same assets in their books and all are afraid about the maintenance of their value. In such a situation, the regulator must not follow an orthodox policy and force the banks by way of regulation to the sale of assets, because all banks will suffer from the fall of prices. In this kind of a systemic banking crisis there is nothing more important than to win time, in order to solve the fundamental problems.

What would have to be done in the Euro-Area?

From a short term point of view it would be necessary – be it by the European Union, be it by the ECB – to issue a blank guarantee for the safety of the deposits in the European banks. In addition to that temporary infusions by the state into the equity capital of banks must not be a taboo, such as the Americans have done it with their large banks after the collapse of Lehman Brothers. For the long term, I would have a very unconventional proposal: All members of the Eurozone must indebt themselves exclusively in their own countries. Foreigners must not any longer hold state bonds. With this, the potential for a state debt crisis would be strongly decreased.

How does this proposal fit to the idea of a common market?

Productivity gains from the internal market only flow into the private sector. My concept will maintain all profits, because the fundraising of the private economy will not be affected.

You have presented your concept to many governments and Central Banks. What are their reactions?

The reactions show a greater openness. This holds true for instance for Ben Bernanke and the leadership of the Fed.

Recently you have also presented this at the Bundesbank, the German Central Bank. How was it?

As you see, I’m still alive.

The interview was done by **Gerald Braunberger**

Please turn over

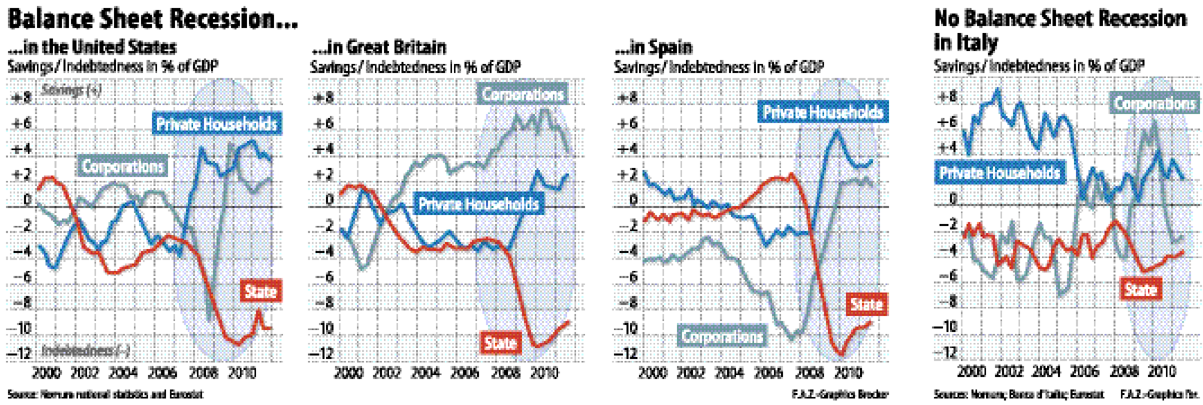
Japan: Before the balance sheet recession there is a boom in an asset market.

At the end of an asset bubble like in Japan at the end of 1990, the monetary policy is becoming difficult, when corporations, households and banks start, to reduce their indebtedness (balance sheet recession). In normal times, there is a somewhat reliable relationship between the monetary basis (cash plus deposits by the banks at the Central Bank) on which the monetary policy has the most direct grip, and the broader defined money quantities like M2 or M3 (which stands for the monetary base of corporations and private households) as well as the loans that have been made in a country to corporations and private persons. This relationship existed in Japan until the end of the boom in the real estate market in the year 1990 and in the United States as well as in the Euro-Area until the collapse of Lehman Brothers in the fall of 2008.

With the breakout of the crisis, the Central Banks in Tokyo, Washington, Frankfurt and London have increased the monetary base significantly – for instance by way of securities purchases or additional loans to banks. But the broader defined monetary volume and particularly as well as the amounts of loans do not properly react to such stimuli. Therefore, the inflation rates have barely increased since.

As a measure for the money devaluation serves among economists the often used but also criticized core-inflation. It describes the inflation rate, after the deduction of energy prices and indirect taxes, because Central Banks have no influence on these. However, many experts are of the opinion, that an expansive monetary policy in the West does contribute to higher energy prices. gb.

Please turn over



<u>Spain:</u> Dramatic adaptation processes in a short period

The economist Richard Koo, born 1954 in Taiwan and educated in the United States, has coined the notion “Balance sheet recession” in the second half of the 90ies when studying the crisis in Japan. Today its phenomena can be observed in other countries. <u>In the United States</u> many corporations and private households have indebted themselves permanently on a net basis over many years. The private households then started in 2006 – that is shortly before the breakout of the financial crisis – to save. The American corporations followed in the year 2008 after the collapse of Lehman Brothers. Corporations and private persons are saving in spite of record low interest rates, because they regard their indebtedness as threatening high. Savings are being absorbed by the state, which enlarges its deficits significantly.

<u>In Great Britain</u> the corporations have reduced their indebtedness already since 10 years. Since the crisis, now the private households are saving as well.

Almost dramatic look the adaptation processes <u>in Spain</u> in the graph. Here, the corporations, with the outbreak of the crisis, have finished their high propensity for indebtedness and, within a short time, they have started to reduce their indebtedness. To put it differently, they saved. Also Spanish private households were forced in the crisis to start to save, instead of indebting themselves much longer. By contrast, the indebtedness of the Spanish state, which was decreasing before the crisis, has increased hugely.

From a macroeconomic point of view, the savings created by the corporations and the private households must not necessarily be taken up by the state. One could invest these savings at least partly abroad. A net capital export of one country, however, goes along with a trade balance surplus. The improvement of the often negative trade balance is a target of the reform policy practised in the European periphery. But not every country will be able to free itself in a short time from the crisis by way of additional exports.

Differences in the periphery shows <u>Italy</u>. There, as well as in <u>France</u>, no signs of an extensive balance sheet recession are to be seen. In Italy and in France private households are saving traditionally, and in both countries there has not been a large speculative bubble. Gb

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Responsible for translation: GEFIU ; translator: Helmut Schnabel

Mexico, Interview: **IMF must eventually cancel the loan to the Greeks**

Interview with Agustín Carstens, Governor of the Central Bank of Mexico

The Governor of the Central Bank of Mexico is calling for a tougher course of action of the International Monetary Fund. When the conditions that where contracted with the loan, would not be fulfilled, the loan should be cancelled. His own country he sees well equipped to cope with the Euro-crisis.

Mexico-City, June 14, 2012. The International Monetary Fund, IMF, must be ready, to cancel the loan to Greece, if the future government shows no willingness, to fulfil the conditions, that go along with the loan. This has declared Governor Agustín Carstens of the Central Bank of Mexico in an interview with this newspaper. “When the conditions of the loan by the fund will be openly rejected, when there will be no readiness for discussion, no readiness, to fulfil the conditions, then the fund has to take a tougher course of action”, said Carstens. He is hoping, though, that the dialogue between the International Monetary Fund and Greece will go on and that the fund will continue to be a part of the solution of the Greek problems. But also in other countries the fund has already been forced to cancel to pay out loans because the conditions had not been fulfilled. ”For the cohesion and the cooperative spirit in the fund it is of utmost importance, that countries, which receive support, fulfil the conditions going along with it”, he emphasized. Carstens, in the past year, was in competition for the top job at the International Monetary Fund, but did fail, because the Europeans had enforced the French Christine Lagarde for the top job.

His warnings come two days before the Greek will elect a new parliament on Sunday. The leftist party Syriza has announced, that it does not accept the conditions of the second bailout package which had just been decided in April by the European Union and the IMF. It is calling for renewed negotiations. It would be utmost unusual, if the fund would accept changes only a few months after agreeing on a program for reforms. In the fund, there is hesitation particularly from Brazil, that the institution, with its second loan package for Greece, is entering into too great risks.

Mexico can look back to a long history of failed attempts, to fix its currency exchange rate more or less. Sometimes the currency exchange rate policy failed because of the missing fiscal discipline, like in Greece, in other cases it failed because of the lacking help of the banking system, like now in Spain. In the “Tequila-Crisis” end of 1994/1995 the country then concluded, to let the currency exchange rate of the Peso fluctuate freely, with only occasional, rule-driven interventions. With this, Mexico has faired well.

Carstens is shying away from making conclusions from this for the Euro crisis states, which, with the common Euro currency, have chosen the most extreme form of currency exchange rate fixing. ”It is up to the Europeans to evaluate, whether they are ready to have the necessary discipline, in order that the Currency Union may function”, he said. In the short run, however, it is said to be mandatory, that the Europeans try everything, in order to stabilize the situation. ”At the present time it would be very destructive, if the political currency arrangement would be cancelled”, says Carstens.

The proposals for a European deposit insurance, a banking union or a fiscal union, are being considered desirable by the 54 years old Governor of the Central Bank. With this, the probability will be increased, that other preconditions for the maintenance of the Currency Union can be maintained. The economic history is teaching, that the European Central Bank must serve as lender of last resort, for banks and governments, is teaching Carstens, who has studied macroeconomics at the university of Chicago. This, in the end, necessitates the readiness for fiscal engagements. “It would, however, be irresponsible, to use the safety valve of a creditor of last resort without creating at the same time a fully functional fiscal union, in which the countries have an influence on the fiscal policy of the other Euro-States”, is warning Carstens. Prerequisite is further a centralised supervision and the regulation of the financial system.

Carstens is heading the Central Bank of Mexico since 2010. He sees only limited risks that the banking crisis in Spain will swap over into Mexico. The Spanish banks Santander and BBVA are heavily invested in the Mexican financial system and they hold round about 1/3 of bank assets.

Carstens emphasized, that these two banks belong to such Spanish institutes, which are better off. They are on the best way, to fulfil the higher capital requirements in Europe – financed by their own profits. “This is a sign of strength”, said Carstens. Mexico, he said, has by the way properly protected both banks. Santander and BBVA (Bancomer) are maintaining in Mexico independent subsidiaries, not branches. Their financing is nourished from strong local sources, explains Carstens. They are financially not dependent from the head office and apart from that they are holding excess reserves. Mexico has further on exacerbated the regulation, so that banks can only move in a very limited way financial means to associated companies. With this, according to the opinion of Carstens, it is adequately safeguarded, that the Mexican subsidiaries must not stand up for eventual financial holes of the Spanish parent companies.

The risks for the world economy through the Euro-crisis have increased the will of the Mexican government to maintain a consistent macro-economic framework, underlines Carstens. As a proof for this he mentions, that the economic policy has not changed before the presidential elections on July 1.

He sees the country well equipped for eventual storms. The economy will grow this year by round about 4 % - “a respectable growth rate, particularly as our most important trade partner USA is growing below potential”. The budget deficit and the inflation from, forecast, round about 2,5 and 3 % are low. Mexico has accumulated since 2009 currency reserves of 155 Billion Dollars and did not need to draw down the flexible credit line of the IMF. Carstens emphasizes that the equity capital position of the banks is at round about 15 %.

As the first country in the world Mexico and its banks will probably in this year totally meet the new equity capital standards of Basel III, he says with visible pride.

The interview was done by **Patrick Welter.**

Responsible for translation: GEFIU ; translator: Helmut Schnabel

Switzerland, Article:

What Europe might look like without the Eurozone and EU

by Prof. Dr. Bruno S. Frey, University of Zurich, 3 Feb 2012

What will happen if the Euro collapses? For many people, the answer is unmitigated disaster. But this column argues that to identify the Euro, the EU, and Europe as one, as many politicians like to do, is totally misleading. A possible demise of the Euro and the EU can be seen as a chance for the evolution of a better future Europe.

Politicians devoted to the European cause are fond of proclaiming: "If the Euro falls, the EU falls, and then falls Europe". The German Chancellor Angela Merkel keeps repeating this statement. This is an example of what Carmassi and Micossi (2010) call "careless statements".

The major problem is that people do not see any alternative to the presently enacted European unification. The Europe-minded politicians even insist that, if the euro and the EU collapse, complete chaos will break out. The European continent will go back to the situation before World War II. The various nations will isolate themselves economically, and they will even start to fight each other. A war within the core of Europe, in particular between France and Germany, is taken to be a real possibility lurking in the background.

This view disregards the fact that the European unification process was made possible only because Germany and France stopped considering each other as enemies. They then saw themselves as the 'motor' of the European integration process, which started with the establishment of an economic union and then expanded to the political sphere. It is certainly wrong to think that the only thing that was needed to bring peace to Europe was a formal international treaty.

The claim that the downfall of the Euro and the EU would produce chaos and war may be interpreted to be just a strategy necessary to get support for helping the highly indebted nations such as Greece, Portugal, Spain, or Italy with ever more financial support. However, conversations I have had with persons from various European countries suggest that many people really believe that Europe will disintegrate and that wars are looming if the EU dissolves. I hold this view to be seriously mistaken.

The Euro, the EU, and Europe are far from being identical. Some important countries are members of the EU but kept their own currency (such as the UK, Sweden, or Denmark). In contrast, there are some non-EU countries (such as Switzerland) that are nevertheless members of certain European accords – in particular the Schengen Agreement and the various treaties in the area of scientific research. With respect to culture, science, sports and – above all – the economy, countries like Norway or Switzerland are without any doubt an integral part of Europe. To identify the euro, the EU, and Europe as one, as many politicians like to do, is totally misleading.

Even more important is the fear that a destruction of the Euro and the EU would lead to a catastrophe pushing all European nations into an abyss. However, no chaos leading to an economic and political collapse of Europe is to be expected. Such a view is far too pessimistic.

The individual countries in Europe will quickly form new treaties among themselves. Collaboration will be maintained in all those areas where it has worked well. Some countries will remain in a newly formed and smaller Eurozone, for which the appropriate treaties will be designed. A similar reconstitution will take place with respect to Schengen, which will then encompass different members. Only those countries that find it advantageous will join a new convention on the free movement of persons. In contrast, those nations that do not find such new treaties attractive, or that are not admitted to them by the other members, will not join.

The result will be a net of *overlapping contracts between countries*, which the various nations will join at will. These contracts will not be based on a vague notion of what ‘’Europe’ may mean, but rather on *functional efficiency*. Crucially, the individual treaties will be stable because they will be in the interest of each member.

This concept has been called FOCJ, following the initials of its constitutive characteristics: Functional, Overlapping, Competing Jurisdictions (Frey and Eichenberger 1999). The term ‘functional’ is to be interpreted in a broad, non-technocratic way. The functions should be designed so as to strengthen the citizens’ involvement and commitment to specific public activities. Thus, for example, citizens’ intrinsic motivation to protect the natural environment should be reflected in jurisdictions catering for these preferences. Similarly, FOCJ should be designed to fulfill citizens’ conceptions of fairness.

A new formation of European cooperation may well happen along these lines, in particular because the EU is already partly organized in functional units. It is most likely that all the present members of the EU will participate in a free trade area since this has proved to be very productive. On the other hand, the democratic deficit of the EU, which is epitomised by the Commission, will be counteracted. Similarly, the ever-growing bureaucratic apparatus in Brussels is likely to be substituted by more flexible institutions and more democratic decision-making mechanisms.

Some might consider such a flexible net of contracts and jurisdictions to be too complicated and cumbersome, and therefore undesirable. But this is only at first sight. The essence of ‘Europe’ is *variety* and *diversity* rather than *étatisme* and bureaucracy. A net of contracts of which each one serves a particular functional purpose is open to all countries at the border of Europe and beyond. Thus, for example, Turkey could participate in contracts with an economic orientation and would in that role certainly be welcomed by the other European nations. At the same time, it might be excluded from political contracts if the other European members feel that Turkey does not (yet) fulfil the necessary requirements with respect to human rights. This allows for blurred distinctions: Turkey would be part of Europe in some respects, but not in others. This exactly mirrors reality, the only distinction being that the existing EU does not include Turkey but is entangled in what one might call a stalemate.

An association of European states using flexible and overlapping contracts based on functions can be considered *desirable* as the existing problems would be efficiently addressed while the essence of Europe would be strengthened. A possible demise of the Euro and the EU can be seen as a chance for the evolution of a better future Europe.

References

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Source: Vox, research–based policy analysis and comment from leading economists

Transparency the top priority

THE RELATIONSHIP BETWEEN BANKS AND THEIR CLIENTS HAS CHANGED IN THE POST-CRISIS PERIOD, WITH COUNTERPARTY RISK NOW A CORE CONCERN FOR TREASURERS. A COMMITMENT TO TRANSPARENCY BY BOTH PARTIES – COUPLED WITH A RIGOROUS METHODOLOGY FOR ASSESSING COUNTERPARTY RISK – IS A SOUND BASIS FOR A MUTUALLY BENEFICIAL RELATIONSHIP, SAY **RICHARD KING** AND **MATTHEW DAVIES**.

The principal concerns of treasury departments remain broadly the same, regardless of the macro-economic environment, massive regulatory reform or any of the other dramatic changes that have been thrust on the world's corporations in recent years. That is what European, US and Asian treasurers told Bank of America Merrill Lynch's annual survey, conducted throughout March.

Cash management and forecasting and operational risk management remain the main focuses for treasurers, while managing counterparty risk has also assumed importance. More surprising is that, despite the turmoil of the past year and the work done by banks and companies to develop contingency plans for a departure from the euro zone or a collapse of the euro, so few respondents consider euro contingency planning to be very important. More predictably, the Single Euro Payments Area (SEPA) continues to underwhelm respondents.

The survey also charted how treasurers' views of what is important to them have changed over the past 12 months. Again, perennially important topics such as cash management and forecasting and working capital management have become more essential than ever. But there was a significant gain in importance for two other areas: banking relationships and the closely linked area of counterparty risk.

Having the right mix of banks in a group of providers is now essential for corporates. Whereas many companies' bank groups used to resemble a who's who of the banking world, now they are based far more on the geographical and capability needs of the company. What is important is to ensure that the company's needs are met and that there is sufficient wallet available to make it worthwhile for a bank to maintain the relationship. After all, the new regulatory environment means that banks' capital commitments must now deliver returns on that valuable investment.

Anecdotal evidence from Bank of America Merrill Lynch's global multinational customers confirms many of the findings of the survey. For example, ensuring access to liquidity is important and many companies have been prefunding themselves during recent strong market conditions in the expectation of renewed volatility. More generally, in Europe there is a continuing move away from bank debt finance towards a US-style capital markets model.

Equally, risk management – of foreign exchange (FX), working capital, interest rates, commodities and pensions funds – is a top priority. However, counterparty risk – just as in the survey – has grown in importance. Among the global multinationals canvassed informally by Bank of America Merrill Lynch, it now ranks third in the list of topics treasurers consider most important to the wellbeing of their companies.

UNDERSTANDING COUNTERPARTY RISK
Counterparty risk has always been a consideration for treasurers. In the pre-crisis era – when many banks were triple-A rated – the choice of bank to work with depended on the capabilities and attributes of banks rather than their financial viability: risk assessment was based on ratings. Now, with many banks downgraded to a single-A rating and the entire US and European banking system on review for a future downgrade by ratings agency Moody's, the security of the sector is somewhat different.

THE POST-CRISIS WORLD HAS INCREASED COUNTERPARTY RISK FOR CLIENTS AND MADE THE CHOICE OF BANK PROVIDER MUCH MORE IMPORTANT.

Moreover, the credibility of ratings agencies has come under fire in the intervening years while the pace of change in the banking sector makes it impossible to rely solely on credit ratings as an indication of financial stability. As a result, in the last few years many companies have endeavoured to find new ways to understand the types of risk they are taking on when working with banks. Corporations have also been trying to find ways to track and manage that risk across the many areas where they interact with banks, such as deposits, loans, derivatives, FX and trade finance.

The challenge is a large one: even small multinationals work with multiple banks, and the largest global companies may have more than 100 bank relationships, despite the bank relationship rationalisation that has gathered momentum in recent years. Scrutinising such a large number of financial institutions is necessarily time-consuming and difficult.

Any analysis of banks must use a number of parameters in addition to credit ratings, including share price, changes in share price over a set period, market capitalisation, size of net assets compared to risk-weighted assets (indicating the level of gearing), credit default swap (CDS) spreads (to give an indication of market perception of credit risk), tier one common equity ratio, and (less tangibly) an assessment of how systemically important an institution is to the markets it serves (and therefore the likelihood of it being supported by the government in the event of a calamity).

THE CHALLENGES OF ASSESSING COUNTERPARTY RISK The disparity between banks' ratings can be hard to understand – some European banks have experienced difficulty gaining access to US dollar liquidity but are rated more highly than US banks that do not have similar problems. However, the CDS market can tell a more detailed story: spreads on those European banks may be double that of some US banks, indicating the market's perception of greater risk.

Interpreting CDS spreads can be complex, as the market is often distorted by technical factors or trading volumes. More generally, the level of scrutiny of banks now required can be difficult for smaller companies with fewer resources. However, many companies do not continually assess banks' share prices, gearing or CDS spreads. Instead, they simply analyse their bank group once a month or even once a quarter. In addition, they may set trigger points (perhaps based on CDS spreads, although given volatility these must be treated with caution) at which a more rapid reassessment of bank relationships would occur.

What is essential in assessing the strength of banks is to view no single factor in isolation. Banks should be willing to help their clients better understand their financial position by ensuring that they have timely access to information, not only about rating changes, but also about capital ratios and how they will change under new regulatory requirements such as Basel III.

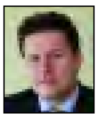
The scale of the change in some clients' thinking on the issue of bank financial stability is demonstrated by a recent request for information (RFI) from a global company in preparation for a request for proposal (RFP) to provide cash management services in Europe. In the past, an RFI might have focused on the product, service, technical and geographical capabilities of the invited banks so that a shortlist could be invited to submit an RFP. But this recent request focused solely on factors that would let the company assess the banks' counterparty quality. Only once the strongest banks had been shortlisted were their cash management capabilities taken into consideration.

The importance of correctly assessing bank risk is reinforced by corporations' concerns about money market funds (MMFs). Earlier this year, during one of the euro zone's frequent crises, some investors were worried to learn that their triple-A rated MMFs held European bank debt. With preservation of capital paramount for companies, some clients took funds out of MMFs and deposited them with their banks, knowing that they could at least assess the risk of their banks more accurately than the risk in an MMF.

RELATIONSHIPS CENTRAL TO DECISION-MAKING Ultimately, any decision about the level of exposure a company is willing to take on for a given bank must be subjective. Factors such as the potential damage to the company were a bank to cease operating and the breadth and depth of the services it provided can aid that decision.

However, inevitably limits are also set based on other, less tangible, factors – most notably the bank/client relationship. The post-crisis world has increased counterparty risk for clients and made the choice of bank provider much more important. However, the new regulatory regime has made it essential for banks to choose to work only with clients that reward them appropriately for their commitment. The key to both requirements is transparency and honesty so that both corporations and banks understand fully the risks they are taking on and the strategy of the other party.

For more on counterparty relationship management, download the Measure to Manage article in the February 2012 issue of Middle East Treasurer at tinyurl.com/d6eeplp



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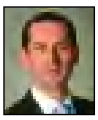

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August 3, 2012, Tokyo, Japan
IAFEI Executive Committee Meeting

42nd IAFEI World Congress, Cancun, Mexico, November 14 to 17, 2012

IMEF, Instituto Mexicano de Ejecutivos de Finanzas, will organise and host this 42nd IAFEI World Congress.

On the occasion of this IAFEI World Congress, the next physical IAFEI Board of Directors meeting and an IAFEI Executive Committee meeting will take place.

2013 IAFEI World Congress

Hosting member institute will be FINEXA, the Financial Executives Institute of Poland, in cooperation with Financial Gates GmbH, Germany/ CFO-Insight magazine
Location: Warsaw
Exact date not yet determined, but probably in October 2013.

2014 IAFEI World Congress, The Philippines

Hosting member institute will be the Financial Executives Institute of the Philippines, FINEX. The exact location and date have not yet been determined.