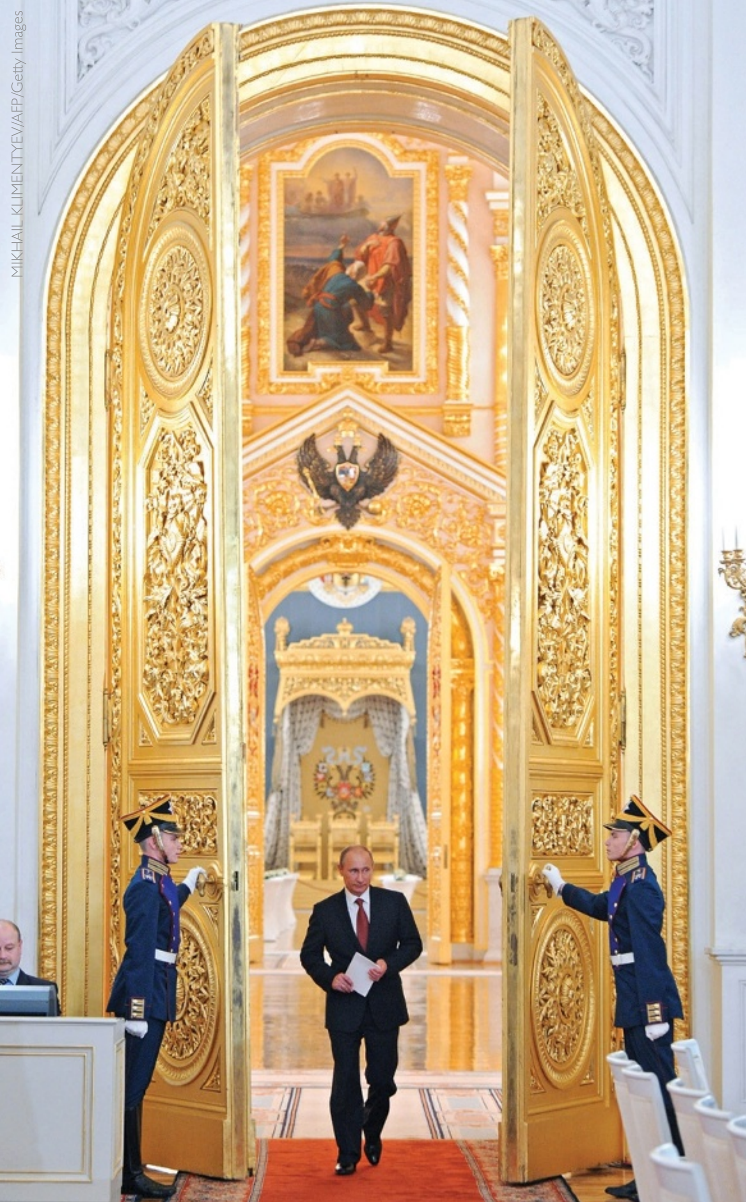

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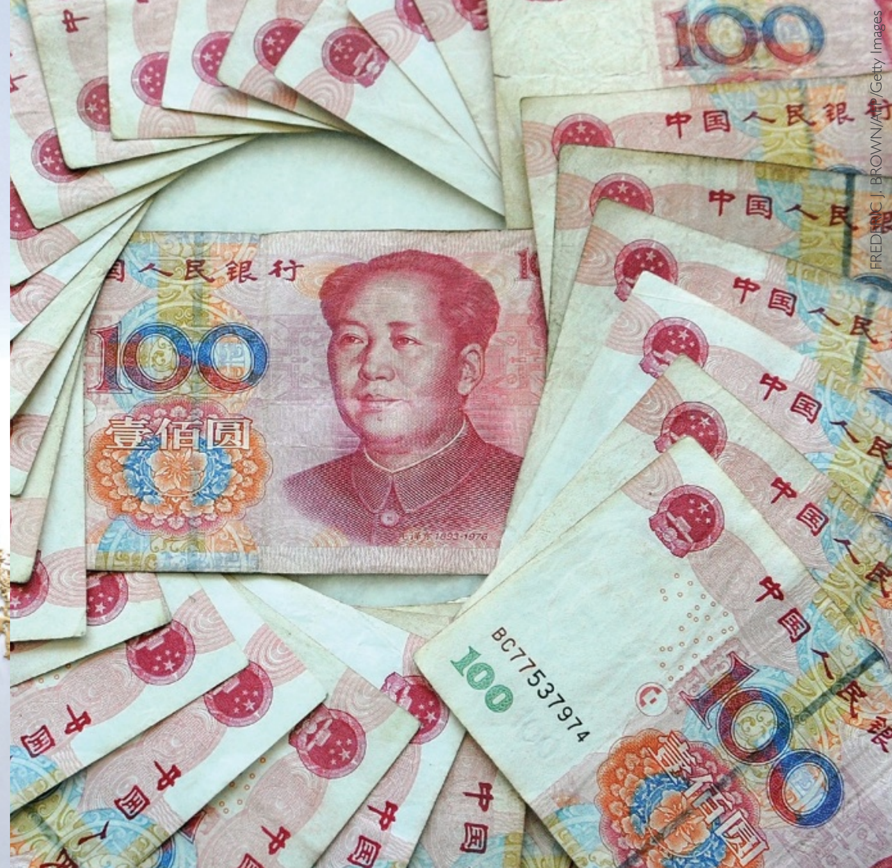

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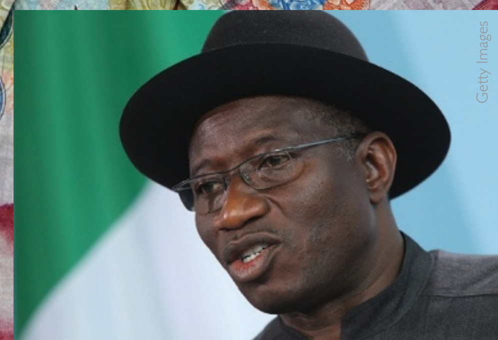

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EXECUTIVE INTELLIGENCE BRIEF

May 2014

STARR COMPANIES

GLOBAL INSURANCE & INVESTMENTS

Executive Highlights

The May edition of the *Executive Intelligence Brief* presents the following in-depth, strategic analyses:

CHINA MONTHLY REPORT

China's leaders are under pressure to step up monetary stimulus as decelerating industrial output and a deflating property market threaten an economic crunch. At the same time, flexing their geopolitical muscles, they have ratcheted up an offshore conflict with Vietnam and enhanced cooperation with a similarly assertive Russia.

RUSSIA/UKRAINE WATERSHED

President Putin's actions throughout the Ukraine crisis have been unusually aggressive and mark a turning point in post-Soviet East-West relations. Putin is convinced that regime change in Kiev sprang from a fundamental US and EU hostility toward Russia. Henceforth, he will maintain vital economic links with Europe while looking to build alternative trade and investment ties, especially with China.

NIGERIA/EMERGING GIANT

Nigeria is now Africa's largest economy, with telecoms and other services outstripping oil and gas as components of GDP. Yet for all its huge potential, Nigeria is underperforming. Reforms have stalled in the runup to elections next February. Moreover, the militancy of Boko Haram, instability in the energy-rich south, and rampant corruption pose considerable risks for investors.

CHINA/GLOBAL RENMINBI

China's leaders see internationalization of the renminbi as a way to boost the country's role in global commerce and finance while furthering efforts to develop a more market-driven economy. Steps toward permitting the currency to ultimately trade freely on global exchanges will be cautious and incremental. Still, global companies that do business in or with China should prepare now for benefits that will accumulate over time.

PERU/ECONOMIC EXPANSION

Peru is one of Latin America's fastest-growing economies, and yet citizens have little faith in political leaders. The next president, to be elected in 2016, will need to address wealth disparities, the victims of which include those who live close to mining operations. Undeterred by social stresses, Chinese and other investors are committing heavily to the extractive sector.

GLOBAL/WMD PROLIFERATION

Multilateral arms-control regimes, buttressed by political, diplomatic and military pressures, have made it much more difficult to transfer weapons of mass destruction (WMD) technology to rogue states or terrorist groups. Currently, therefore, the risks are low that US firms will encounter the threat of a WMD attack either at home or abroad in the foreseeable future.

China
Global Renminbi

May 5, 2014

Beijing is proceeding cautiously to advance the global role of China's currency.

KEY FINDINGS

- Chinese leaders see internationalization of the renminbi as a way to boost the country's role in global trade while furthering efforts to develop a more market-driven economy.
- Loath to risk losing financial control domestically, Beijing will allow only incremental moves toward permitting the currency to ultimately trade freely on global exchanges.
- Still, multinational companies that do business in or with China should begin preparing to capitalize on the benefits that international renminbi trading will deliver over time.

ANALYSIS

Competition for offshore renminbi (RMB) trading is intensifying among financial centers in Europe and Asia as the Chinese currency internationalizes. In mid-April, data released by the Swift global payments system showed that Singapore had overtaken London to become the largest offshore trading hub for the RMB outside Hong Kong. In late March, in conjunction with President Xi Jinping's European visit, the Chinese central bank signed agreements with Germany's Bundesbank and the Bank of England enabling companies to clear RMB-denominated payments in Frankfurt and London, respectively. Last October, the UK government became the first in the West to reach an agreement with Beijing allowing investors in London to apply for a license to invest directly in RMB-denominated Chinese stocks and bonds. The UK Treasury has been orchestrating efforts to make London the principal center for RMB transactions outside Asia.

Earlier this year, a European Central Bank Executive Board member said the process of internationalizing China's currency is in its early stages but is rapidly moving forward — adding that authorities and investors need to prepare for a world in which the RMB will play a much more important role. Nonetheless, while the RMB is seeing increased use in international trade and financial transactions, for now it has only a minor role for international investors seeking to store wealth.

What do currency movements say about Beijing's RMB game plan?

China's closely managed currency has been on a downward trajectory since the beginning of 2014, reversing the trend of gradual appreciation against the US dollar for most of the past eight years. In the past three months, Beijing has employed a range of tools including heavy central bank intervention in currency markets to curb movements of 'hot' money. In March, the central bank widened the RMB's permissible trading range, and since mid-April it has resumed pushing downward the midpoint of the daily trading band.

It is unclear how much of the RMB's recent decline reflects market participants' concerns about China's economic slowdown, and how much is a result of policy decisions as Beijing looks for ways to keep financial reforms on track while fending off destabilizing effects of speculative capital movements. Moreover, widening of the daily trading band within which the currency can fluctuate — and thus making

Renminbi, an increasingly influential player on the global stage

the RMB more flexible — is consistent with Beijing's longer-term objective of enhancing its use in international commerce and finance.

Why is Beijing seeking a greater global role for the currency?

Chinese leaders believe internationalization of the RMB would boost China's role in global trade while furthering their efforts to develop a more market-driven economy. Premier Li Keqiang has propounded a 'proactive opening-up strategy' for transforming the economy through retooling the financial sector and promoting capital inflows. Beijing, moreover, has plans to make Shanghai an international financial center, which is feasible only with much more openness to global capital flows.

Even though China is no longer a command economy, firm control of financial activity is a central element of the ruling Communist Party's system of governance. Thus, Chinese leaders' ambitions for RMB internationalization will continue to be hobbled by their reluctance to allow full convertibility of the currency. This would entail removing capital account restrictions and surrendering many domestic financial controls Beijing relies on for key economic and political purposes — in particular, by allowing the government to maintain a firm grip on money and credit domestically.

What will it take to fully internationalize the RMB?

The history of other major currencies points to gradually accumulating prominence in two key roles before winning international acceptance as a reserve currency:

- **The trade role** is important, since widespread use of a currency for trade invoicing and settlement is a principal factor in determining which among several investment currencies will emerge as a preferred reserve asset held by central banks.

- **The finance role** is central to establishing the appeal of a currency as an investment medium, initially involving bank deposits and bonds, but eventually expanding to a broader range of financial products.

The RMB's potential to advance in these two roles is mixed. As the world's leading exporter and second-largest economy, China does have in place the foundation for a broad transactional network, and the share of its trade that is settled in RMB — while still low — is almost certain to increase in the coming years as a result. But in meeting the preconditions for playing a financial role internationally, the RMB is on shakier ground.

China's onshore asset markets are still rudimentary; its domestic financial structure is far from adequate to provide the liquidity and predictability required by global market participants; and the RMB remains essentially inconvertible for both Chinese citizens and nonresidents. Furthermore, fundamental national attributes that shape a currency's appeal as a store of value — a well-established legal tradition, and transparency in governance and regulatory decision making — have not yet reached levels in China that would inspire a high level of confidence among potential RMB users.

How do other countries view RMB internationalization?

Views differ among China's principal trading partners regarding potential repercussions of RMB internationalization:

- Given their expectations of China's growing presence in the global economy, combined with misgivings about the soundness of US macroeconomic policies, European governments and central banks generally view the prospect of a globalized RMB with guarded acceptance. They see a limited reserve currency role for the RMB as a potentially constructive development.
- US monetary authorities have no incentive to reduce the global primacy of the dollar, but Washington nonetheless has supported the principle of Beijing's assuming greater international responsibilities commensurate with China's growing economic clout.


PETER MACDIARMID/Getty Images

New-look London aims to be major center for RMB trading

Beijing's efforts to accelerate use of the RMB outside China's borders for trade transactions are attracting the attention of authorities in neighboring countries seeking to diversify away from the US dollar. Indeed, several states in the region have announced plans to invest a portion of their foreign exchange reserves in RMB-denominated financial instruments. In the past three years, China has signed more than 20 swap-line agreements with foreign central banks offering them access to liquidity in the Chinese currency.

What will be the next steps?

Beijing has proceeded incrementally to advance internationalization of the RMB, and its caution almost certainly will continue in the near term. China's leaders are loath to risk losing financial control domestically by liberalizing interest rates, allowing the currency to float freely, or opening the country's capital account. So long as capital controls remain essentially intact, there is scant likelihood of the RMB achieving a substantial share of global portfolios or becoming a major reserve currency.

Although the challenges are daunting, China does have a path available to it for meeting the preconditions for RMB internationalization. A phased program of freeing up both the capital account and domestic financial markets could liberalize interest rates and the exchange rate simultaneously. This should prevent the sort of misalignment of domestic interest rates that would spark destabilizing hot money capital flows. And promised adaptations of monetary policy, including development of domestic bond markets, could foster the deeper, more liquid and better-regulated financial markets required to underpin an internationalized RMB.

What will be the impact on US businesses?

The recent widening by the central bank of the RMB's trading band, along with its rising share of trade invoicing, will give further impetus to internationalization in the coming months. Even though full convertibility and opening of the capital account almost certainly are years away, recent surveys of western businesses highlight expectations that some 30% of cross-border trade with China will be settled in RMB by 2015. Moreover, the RMB will likely supplant the US dollar as the dominant currency for China trade and investment during the next five to ten years.

Given such expectations, global companies that do business in or with China — either directly or through affiliates — can begin laying the groundwork now for integrating RMB holdings into corporate-wide financing or investment operations. The ability thereby to tap RMB deposits could entail several potential advantages for US businesses:

- For companies exporting to China, simplified rules for cross-border trade settlement in RMB will enable cost savings through faster invoicing.
- By taking advantage of changes in regulations governing RMB credit remittances, companies sourcing from China can create efficiency gains from streamlined payment processes.
- Improved foreign-exchange risk management should be possible as payments to suppliers and trade settlement in RMB are facilitated, reducing the number of hedging operations needed for conversion into US dollars.
- Offshore parents or affiliates of cash-rich Chinese entities will have greater ability to engage in inter-company lending of onshore RMB, ultimately allowing corporate treasurers to integrate their China operations into company-wide cash and risk management.

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