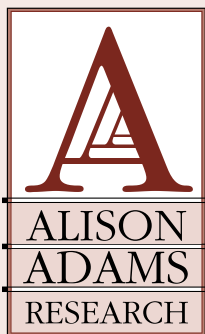


Alison Adams, PhD

617-388-9817

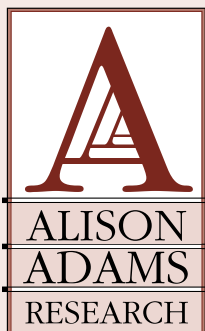
research@alisonadamsllc.com

Week 30: July 28, 2011

New regulations hit currency hedging, taxing currency derivatives! In July, Brazil's banks cut their dollar short positions by nearly half on higher capital requirements. *Even as the real hit a 12-year high against the dollar, banks have been forced cut their short-dollar bets. Other emerging market countries might benefit from implementing similar policies that combine higher interest rates with efforts to reduce the domestic risk-taking by EM banks.*

Brazil's MoF Mantega once again promised more measures to stem the appreciation of the real and the government delivered with a tax on currency speculation! The 1% tax on dollar short positions could be raised as high as 25%. But what is even more important is that the minister and other technocrats in Brazil are acutely aware of the numerous risks building up in Brazilian bank and corporate balance sheets. Over the past year I have argued that Brazil has the best policy intervention for managing the negative aspects of strong capital flows. Higher interest rates alone are not enough to cool the credit bubble. Resurrecting bank limits on short-term wholesale bank borrowing from foreign lenders has helped reduce bank access to cheap money. Other target taxes on short-term capital flows have been helpful. The Brazilian government does not want to keep capital out of the country but does want it to stay for the long-term investment.

For Brazilian banks, rules on currency speculation went into effect in June and the impact has been significant. In that month, Brazilian banks had $14.7bn in dollar short positions. In July,



Alison Adams, PhD

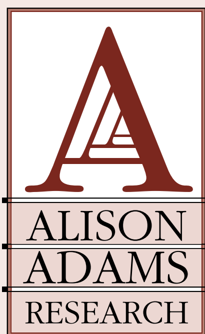
617-388-9817

research@alisonadamsllc.com

they cut their bets to $8.3bn. For foreign investors such meddling might seem imprudent. But in the crisis of 2008, many solid companies in EMs were destroyed by losses from their currency bets. Many had taken currency positions for profits rather than any legitimate hedging activity. The rules requiring 60% deposits for dollar short positions for a position exceeding $1bn might see further modification. MoF Mantega has repeatedly promised that more measures will be forthcoming. And Brazil will continue to use targeted measures to reduce risk in the system. Sadly, investors misunderstand such macroprudential measures as undue interference, wherein the intent is to make all investment safer by reducing specific risks. No doubt the *WSJ* and the *FT* will run more "articles" about policy risk in Brazil when in fact they ought to be applauding the government for its restraint and targeted policies.

India: Were experts really surprised by the 50bps hike? RBI should follow Brazil and tax short-term foreign borrowing by the private sector. *As I expected, India—like China—is in full inflation-fighting mode and growth could suffer even as inflation persists. The RBI will need to go much higher if it wants its monetary policy to kill inflation. Indian companies borrowed nearly $5bn from foreign lenders in May and June. The government's fuel subsidy burden will continue to rise as inflation pressure will mean fuel price increases must be delayed.*

Inflation hit 9.4, meaning that real interest rates are negative for savers and near zero for domestic borrowers. The RBI hike of 50bps will do nothing to cool inflation—does the central bank really believe that it will? Indian corporations are borrowing on the foreign markets and



Alison Adams, PhD

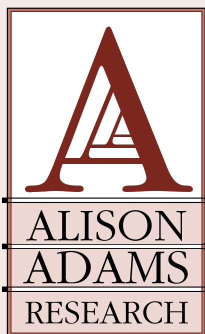
617-388-9817

research@alisonadamsllc.com

unless the RBI takes steps to cool this trend, leverage and risk will continue to build and fuel inflation. Meanwhile, the savers will earn nothing but credit for trapped SMEs, and individuals will dry up completely.

The Indian government has not extricated itself from the fuel subsidy dilemma. Even though higher interest rates were supposed to give the government room to increase domestic fuel prices in order to reduce the subsidy burden, they have been inadequate. For now, I do not see how New Delhi can increase domestic fuel prices with inflation running ahead of the central bank. In March 2010, WPI inflation was at 10.4% after 10 interest rate hikes, delayed fuel price increases, and administrative measures to discourage some commodity exports; inflation stood at 9.4% a year later. The government lacks credibility when it states that inflation will be at 7 percent by the end of the year. It is practically impossible—unless we have another global crisis and sudden stop.

More policy tightening will be needed: Chinese banks work around loan-to-deposit rules through wealth management products. *China's regulators are one step behind, as banks use wealth management products to create capital pools for loans. Chinese depositors, who want more than the official "negative-real rate" of interest on deposits are especially attracted to these wealth management products, unaware that they are highly speculative and risky.* Caixing *reports that the CBRC will be issuing rules regarding these products that highlight the risks.*



Alison Adams, PhD

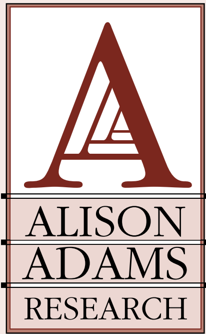
617-388-9817

research@alisonadamsllc.com

Wealth management products could be worth trillions of yuan worth of credit to speculative real estate and manufacturing loans.

China's PMI indicates that the economy is slowing. The shibor interbank lending rate has fallen even though credit is reported to be in short supply. This may partially stem from the fact that the new daily and weekly deposit-to-loan ratio rules have made banks much more cautious about lending to other banks. The PBOC has been raising interest rates and capital requirements for months. On the face of it, reserve requirements are at an all-time high with big banks now holding an RRR of over 20%. Since the crisis, banks have been officially limited to lending only to officially approved development projects and industries. Then there were the "green" rules that purported to deny bank loans to polluting industries and businesses slated to undergo official consolidation. Real estate lending has been on a very tight schedule for over 18 months. On the face of it, it appears that China's policy tightening was all but complete.

But there are new concerns about off-balance-sheet bank loans that have been meeting a pent-up demand for credit. There have been many calls for more risk management and attention to the SIVs of local governments, as well as their stock of bad loans and bankrupt projects. These local government debts will have to be paid either by their banks, the governments, or the national government itself. Originally financed through capital raising and bond issuance, many of the SIVs are now believed to be insolvent.



Alison Adams, PhD

617-388-9817

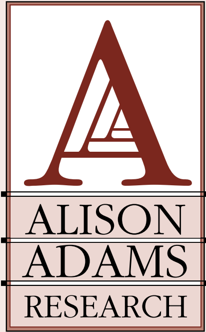
research@alisonadamsllc.com

Monetary policy tightening in China is far more complicated than just raising the official interest rate. Beijing has had to use a wide variety of policy tools to help soak up excess liquidity in the system. Officially, interbank loans are increasingly more difficult to get, especially at the end of the month. Credit conditions are tight and SMEs are reporting that they have hardly any access to bank credit.

I continue to recommend China proxy plays rather than holding Chinese companies directly. Barring another global crisis, demand for commodities will certainly increase in 2012 as Beijing ramps up for its big political transition, which includes a new president and premier. Affordable housing will add to FAI demand as part of the new five-year plan. Agriculture will also continue to benefit from state largesse. But the speculative excesses of 2009 and 2010 (which were so crucial in restarting global growth after the crisis) are a significant overhang for Chinese companies.

Hong Kong: New mortgage underwriting standards hit mortgage loans. *New mortgage applications fell 30% in June compared with May. Loan approvals for new property fell 33.7%. Refinancing loan approvals were also down over 30%. Will the property bubble burst entirely? Underwritten mortgages are shifting towards "best rate" reference rather than HIBOR.*

Is this the sort of "soft landing" hoped for in China? If so, it will be a hard soft landing. In Hong Kong the government has kept pace with Beijing in curtailing real estate speculation through



Alison Adams, PhD

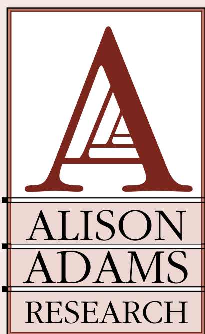
617-388-9817

research@alisonadamsllc.com

ever-tighter lending standards. Administrative measures do work, but the new rules in Hong Kong took immediate effect and the impact could be more than regulators wanted. Perhaps other factors have helped cool mortgage loans and even applications this past month, but the drop is significant. The Hong Kong Monetary Authority released data showing that property speculation is receding.

WTI Discount: Venezuela's crude trades at a premium too. Is it really our pipelines? *When Chavez threatened to sell his crude to China, refiners in the U.S. laughed in confidence that global crude was fungible. Crude was crude. But now the distance from Oklahoma to Houston—which any self-respecting Texan can drive in less than a day—is responsible for a massive WTI discount?*

Crude is fungible and the price is set on the margin. Or is it? Bottlenecks are a huge issue in emerging markets. The infrastructure needs are simply massive! And in many cases they must be built from scratch. I have heard many sophisticated and compelling arguments about why WTI is trading at a significant discount. A discount that in recent weeks has hovered around 1/5 of the price of Brent—and surely a $20 discount ought to be enough to cover the price of crude moving from Cushings to the coast. Venezuela's PDVSA crude oil price is trading above WTI! Do we suddenly have a shortage of barges and truck and trains? Ethanol can move to the coast, why not crude?



Alison Adams, PhD

617-388-9817

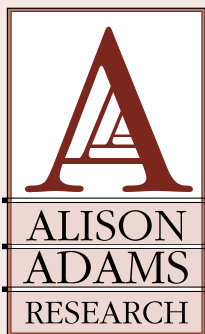
research@alisonadamsllc.com

Developed market policy risk: EM policy makers have more clarity. (Included is a country breakdown for EMs.) *It's true that in EM policy, risk is endemic, but policy makers in emerging markets have more clarity regarding their policy choices and a much better chance of addressing their respective policy challenges. Developed market economies are now at risk from worse than second-best policies. The U.S., EU, and Japanese economies are too weak to shake off third-rate policies from politicians.*

Rahm Emanuel made famous the slogan "Never Waste a Crisis." But governments in the developed world seem intent on manufacturing crises rather than preventing them in the first place. Old political ideas and ideologies are no match for the frustrating "economic recovery."

Over the spring, I wrote about the policy challenges for Bernanke and a low-growth environment that is too strong for more stimulus, but too weak for serious private-sector investment. The troubles have since expanded to elected governments and the banalities of election-oriented policies. Normally, such political blundering has little long-lasting economic impact. But the weak economic conditions are putting investors at risk of severe suffering under third-rate policy making in the U.S., Japan, and the EU. In emerging markets, economic conditions are healthy enough for even second-rate policies from EM politicians.

There are countries that definitely need austerity in government spending and cuts in entitlements. Under any macroeconomic measure, the United States is far from the top of that



Alison Adams, PhD

617-388-9817

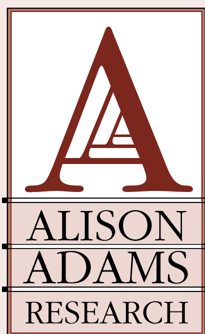
research@alisonadamsllc.com

list. I have not written about the debt ceiling “crisis” because it’s largely a politically constructed event. A “manufactured crisis” is not the same as a real crisis. In Europe, the same kind of brinksmanship fostered contagion across the region’s banks and interbank lending and cross-border funding is at a near standstill. Experts are concerned that M2 has fallen to levels that indicate another recession. In Japan, the ruling PM has been trying to resign for months—now he may stay on until the reconstruction bill is passed. But that too seems to be on permanent delay.

In emerging markets, high food and fuel prices continue to push headline inflation higher. In some markets where FX appreciation has been considerable, capital flows have contributed to additional pressures for central banks. Brazil, Hong Kong, S. Korea, India, and China have all benefited from foreign bank lending but this has added additional liquidity pressures. In general, unemployment is falling in most emerging markets but South Africa, Mexico, and some countries in EMEA still have high unemployment rates. *I would argue that the macroeconomic conditions faced by emerging market policy makers will be more responsive to traditional policies.*

Policy Challenges for EM Politicians

Asia	Interest rate hike	FX appreciation	Asset bubbles	Bad banks	Consumer credit	Gov’t. austerity
China	possible	no	yes	concerns	no	cuts
Hong Kong	no	no	yes	no	yes	no
India	possible	yes	possible	no	some	yes
Indonesia	possible	yes	no	no	no	cuts



Alison Adams, PhD

617-388-9817

research@alisonadamsllc.com

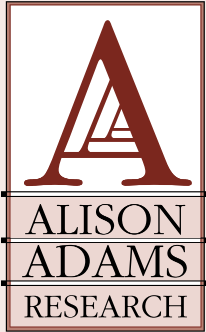
	Interest	**FX**	**Asset**	**Bad**	**Consumer**	**Gov't.**
Malaysia	possible	yes	no	no	no	no
Philippines		not yet	no	no	no	no
Singapore	stronger FX	some	possible	no	no	no
S. Korea	possible	yes	yes	concerns	yes	cuts
Taiwan	possible	some	possible	concerns	yes	no
Thailand	definitely	yes	no	no	possible	needed
Vietnam	needed	problems	yes	yes	possible	needed
Latin America						
Argentina	needed	no	yes	yes	yes	yes
Brazil	possible	yes	yes	no	yes	cuts
Chile	possible	yes	no	no	no	no
Colombia	possible	yes	possible	no	no	no
Peru	possible	yes	no	no	no	no
Mexico	not clear	no	no	no	no	no
Venezuela	needed	no	yes	yes	yes	needed
EMEA						
Czech Rep.	not clear	yes	no	no	no	some
Egypt	not clear	yes	no	no	no	no
Hungary	not clear	no	no	yes	no	yes
Poland	not clear	yes	no	no	no	no
Kazakhstan	possible	yes	no	yes	no	no
Russia	needed	yes	possible	yes	no	no
S. Africa	possible	yes	no	no	no	no
Turkey	possible	some	no	no	possible	needed

Alison Adams Research

Mobile: 617-388-9817

Office: 617-475-5295

Email: research@alisonadamsllc.com



Alison Adams, PhD

617-388-9817

research@alisonadamsllc.com

The information in this report has been taken from sources believed to be reliable by the authors of Alison Adams Research who do not warrant its accuracy or completeness. Any opinions expressed herein reflect the authors' judgments at this date and are subject to change.

Alison Adams Research does not assume any liability for any loss which may result from the reliance by any person or persons upon any such information or opinions. These views are given without responsibility on the part of Alison Adams Research. No part of this report may be reproduced or circulated without the prior written permission of the issuing company.

This document is for private circulation and for general information only. It is not intended as an offer or solicitation with respect to the purchase or sale of any security or as personalized investment advice.