Alison Adams, PhD

617-388-9817

research@alisonadamsllc.com

Week 31: August 4, 2011

China's top leadership confirms priority on price stability, investigation of local government liabilities and SIVs; banks pass stress tests. *Real estate prices are softening, bank stress tests are reassuring, the price of pork is falling, and forecast steel production has been revised down, but the leaders are still focused on killing inflation! Leadership could signal stimulus for Octobers' next leadership meeting.*

The Central Committee of the Chinese Communist Party is set to fight inflation. And the official statements from the meeting confirm my call that Beijing *will* fight inflation rather than fuel growth. The political goal is to create enough room to engineer an upswing in growth next year as a backdrop for the 2012 leadership transition. The CBRC, the bank regulator, created new rules for targeted bank lending for SMEs. President Hu and PM Wen both touted price stability as the number one goal for the 2H11. Wen also announced that the government is going to investigate and audit local government SIVs and pass new regulations for these vehicles. The audit will include local government debts and liabilities.

According to regulators, China's banks are healthy and can tolerate a 50% decline in real estate prices. Given the correction underway in Hong Kong, the possibility of a burst bubble in China's real estate sector could be truly disruptive. However, given the anecdotal evidence of special lending and the speculative activities of Chinese banks, I remain cautious about the robustness of

Alison Adams, PhD

_617-388-9817_

research@alisonadamsllc.com

the stress tests. But, as I have argued previously, banks' official balance sheets will enjoy the backing of the national government.

Near-zero interest rates will persist in the U.S., forcing EM policy makers to implement more policy responses. *Over the next 12 months, the evils of cheap money from the U.S. will persist and EM policy makers will remain vigilant. BIS data confirms that banks in the U.S. and EU have continued to shrink their lending activities in home markets.*

In case you doubted the evils of QE3, the most recent data out of the Bank of International Settlements supports my argument, and those of many EM central bankers—that cheap money in the U.S. was finding its way into EM banks and non-banks. The latest BIS report on bank lending confirms that a dollar-lending surge to EMs has continued for the 8th consecutive quarter:

> *Emerging markets: Cross-border lending activity with emerging market countries grew for the eighth quarter in a row (+$172 billion). Most of the increase ($122 billion) was concentrated on the Asia-Pacific countries, including China (accounting for 66% of the increase in claims on the region), Malaysia (9%), Korea (7%), Chinese Taipei (6%) and India (5%).*
>
> *Funding: The increase in banks' cross-border liabilities in the first quarter of 2011 was almost entirely denominated in US dollars. Net new issuance of debt securities by banks totalled $160 billion, after the previous quarter's decline of $66 billion. Local liabilities in foreign currency also rose significantly, with the increase in US dollar liabilities more than accounting for the additional increments.*

Alison Adams, PhD

617-388-9817

research@alisonadamsllc.com

The current turbulence in the global bond markets makes a strong conviction call more difficult. The possibility of a U.S. debt downgrade could materially and negatively impact BBB-rated debt, as asset managers rebalance the risk profiles of their portfolios. China's growth could be slower than most models assume and the near- and medium-term demand for commodities could hit commodity producers. Risks are everywhere. But extremely low costs of financing the dollar carry trade will drive risk appetite once again, when the dust settles, big multinational banks will continue to lend to EM banks and non-banks.

Brazil's president makes good on her promise to address the strong currency through trade measures. *Brazil's economy has not been that open, like many other emerging markets, but the new trade measures are designed to mitigate accelerating Dutch Disease and the erosion of domestic production of consumer goods. I argue that the measures are a sensible solution given the challenges of the global economy. We should remember that this government is quite open to FDI by international companies and has had a clear message: "If you want to sell to Brazilians then manufacture in Brazil." (If only the U.S. had that policy.)*

The Brazilian currency has advanced even as technical tax derivatives rules have choked off a good deal of domestic speculation on the appreciation of the real. Unlike many of the Asian tigers, which must rely in part on competitive currencies to support exports, Brazil's economic model has largely been domestically driven. But the strength of the real is bringing Dutch Disease and Brazilian consumers are importing more and more cheap goods from abroad.

Alison Adams, PhD

617-388-9817

research@alisonadamsllc.com

Domestic industry is suffering as a consequence. The government's plan, which some pundits are labeling "Buy Brazil," is a positive for foreign investors interested in the long-term economic development of the country.

When I lived in Brazil I had several friends who made a good living driving to Paraguay to buy cheap—and tariff-free—goods for resale in Brazil. Computers, software, and electronics made up the bulk of their trade. With rising incomes and higher employment rates, Brazilians are buying more consumer goods than ever before. A few years ago the weaker real kept demand for foreign goods to a minimum, as did the tariffs. But now, Brazilian consumers are richer and their money buys them more imports—even with tariffs.

The new measures will include more trade inspectors, subsidized loans and relief for struggling industries, and better enforcement of existing tariffs.

Judge a government by its ability to address its economic challenges: A healthy economy requires far less from politicians. *Emerging Market technocrats, familiar with sovereign bailouts and the banking crisis, used their new clout to warn the IMF and EU politicians about serious flaws in the Greek bailout. In that same week, the cost of insuring U.S. debt was more costly than insuring Brazilian debt! Beijing's official media outlet states that the U.S. debt ceiling is only a reprieve. It's about time that the developed world starts listening to emerging market policy makers.*

Alison Adams, PhD

617-388-9817

research@alisonadamsllc.com

“In the thinly traded market for credit-default swaps, the cost of insuring €10 million ($14.4 million) of U.S. Treasurys for one year hit €80,000 ($115,000) on Thursday. By comparison, the cost of insuring a similar amount of Brazilian bonds for a year was $45,000.” —The *Wall Street Journal*, August 1, 2011

Political risk for investing cannot be separated from the macroeconomic backdrop. When I write about political risk, the key measure of risk is proportional to a government’s ability or inability to address the challenges in the economy. When I write about Brazil’s government, I would say that it is strong and disciplined enough to address its economic challenges. I would argue that in Russia, the government is unable to meaningfully address its economic and development challenges. Government cannot be judged in a vacuum.

In the U.S., Japan, and Europe, politicians are simply outstripped by the massive forces of deleveraging and a balance sheet recession. Household debt levels are too high. Entitlements are too high. Growth is too low. The banks, which are still deleveraging, are not reinvesting funds in their home economies. The governments of these countries are not significantly worse than they were before the crisis. They are just as mediocre. But the economic challenges are beyond their ability to solve. Old ideologies and political posturing will fail.

Brazil is a safer bet than the U.S. Are our indexes even correctly balanced anymore? The world has flipped. There are still considerable political and economic risks in emerging markets. But thanks to some discipline and traditional banking sectors free from much of the egregious glut of leverage in the developed markets, politicians have manageable economic challenges. In general,

ALISON ADAMS RESEARCH

Alison Adams, PhD

617-388-9817

research@alisonadamsllc.com

emerging market governments paid down their debts and built up serious self-insurance capacities in the form of forex reserves.

The military in emerging markets: Egypt, Turkey, Thailand, Pakistan (and *caudillos* in Peru and Venezuela). *In some emerging market countries the role of the military is still unfolding. Civilian governments and maturing democracies demand less martial control. Military leaders have trouble ceding power even as they recognize political change. The creation of civil society and democracy requires that armed forces serve civilian interests rather than their own, as they generally do in the developed world.*

The military as an institution in a modern nation state begins as a founding force, but must—as civilian rule of law extends from democracy—lose political power and influence. A modern military in a modern nation state is controlled and regulated by an elected executive. This process remains incomplete in several EMs and many frontier markets.

1. Egypt's military is still facilitating a political transition. At this point, the military has retained its credibility with most Egyptians. It will facilitate elections this fall and hand off power once the new parliament is elected. The new parliament will write a new constitution.
2. In Thailand, the landslide election in favor of Thaksin's party and the rise of his sister as the new PM make another immediate military coup unlikely. But over time, should

ALISON ADAMS RESEARCH

Alison Adams, PhD

617-388-9817

research@alisonadamsllc.com

Thaksin himself attempt a return, the military may sit on the sidelines. Thailand has the worst record for military interventions in the EM universe.

3. Nigeria's generals are still kingmakers and their political backing is critical for elected presidents. But they have stepped back from former threats to enforce the power-sharing agreement between the North and the South.
4. Turkey's military is under siege by the courts for its role in the deep state and attempts to undermine and even overthrow the AK party since 2003. The current climate of high-profile arrests of officers has put the military under pressure. Their attempts to destabilize democracy have been public as well as covert. Before 2003, the military was frequently involved in high-level political interventions and influence. The EU process has repeatedly called on Turkey to modernize its military and place it under civilian control. Even NATO has been involved in a constant pressure on Turkey to streamline its military. The recent resignations of military leaders, in protest of the trials, is troubling but ultimately the military will be forced to modernize and depoliticize.

Phases on military power in governing the modern nation state in emerging markets:

I. The military as nation founder and builder: Most modern militaries trace their roots to the founding of their countries. In early national histories, the military is often the leading voice of modernity and systems-based government, whether that country shakes off colonial rule or forms a modernizing democracy.

Alison Adams, PhD

617-388-9817

research@alisonadamsllc.com

II. During the Cold War (and in the Middle East) the military held the balance between the communist/socialist forces and the reactionary and religious forces. The military is often the guarantor of “secular” and nationalistic government. In the 1960s and 1970s, military coups in the name of national sovereignty and interest were common. The role of the neutral military in NATO was particularly important. But militaries had yet to achieve a truly professional and apolitical agenda.

III. The cult of military personalities often presided over pseudo-democracies and civilian institutions remained weak. Chile, Brazil, Indonesia, Egypt, and Nigeria were all examples of this. Today, in Peru, Venezuela, and Nicaragua the military leader has been recast as a populist democrat.

IV. In EMs military power is losing control as democracies strengthen. The path is not without its troubles. Turkey, Thailand, Egypt, and Nigeria are all countries in the halting process of building civil society.

Country	Constitution Defense	Secular State	Terrorists	Coup History	Military President	Rule of Law	Democratic Elections	Corruption Rank
Egypt	yes	yes	yes	no	yes	weak	no	98
Nigeria	no	yes	yes	yes	yes	very weak	poor	134
Pakistan			yes	yes	yes	very weak	poor	143
Thailand	yes		yes	yes	supported PM	weak	somewhat	78
Turkey	yes		yes	yes	supported PM	moderate	yes	56

Alison Adams, PhD

617-388-9817

research@alisonadamsllc.com

Alison Adams Research

Mobile: 617-388-9817

Office: 617-475-5295

Email: research@alisonadamsllc.com