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Global

Outlook

The Global Monetary Analyst

On Different Sides of 'Neutral'

Investors tend to paint Australia and New Zealand with the same brush, but these neighbouring economies have had very different experiences during the Great Recession. While Australia avoided a recession thanks to its aggressive policy stimulus, the New Zealand economy contracted for five consecutive quarters starting in 1Q08. Consequently, their central banks have chalked out very different exit strategies. In this week's lead piece, our Australia and New Zealand economists, Gerard Minack and Manoj Pradhan, discuss exit strategies for the RBA and RBNZ. The RBA is likely to raise rates 1-2 times this year, taking its policy rate into slightly restrictive territory. Its ability to raise rates further will likely be constrained by the coming slowdown in consumption and also in part as the 'neutral' policy rate is itself lower. The RBNZ, on the other hand, is in no hurry to breach restrictive territory for its policy. Recognising that the neutral rate has fallen in New Zealand as well, it is likely to raise rates slowly and allow them to stay below neutral at least for the rest of 2010, and for part of 2011 as well. p 2

Central Bank Watch

Key Central Bank Risk Events

Date	Country	Event
08 Apr	**Euro Area**	Rate decision: Expect on hold
08 Apr	**UK**	Rate decision: Expect on hold
08 Apr	**Norway**	Gov Gjedrem speech
08 Apr	**Peru**	Rate decision: Expect on hold
09 Apr	**Euro Area**	ECB's Trichet to speak in Milan
09 Apr	**Colombia**	Monetary Policy Meeting minutes
09 Apr	**Korea**	Rate decision: Expect on hold
10 Apr	**Euro Area**	ECB's Trichet to speak in Parma
12 Apr	**Sweden**	Riksbank Executive Board Meeting
13 Apr	**Turkey**	Rate decision: Expect on hold
15 Apr	**Chile**	Rate decision: Expect on hold
16 Apr	**Mexico**	Rate decision: Expect on hold

What's Changed?

	Forecast Changes Since Last Week
UK	Policy rates: 0.5, 2% end-4Q10, 4Q11 (prev. 1.25, 2.25%)
Australia	Policy rates: 4.75, 5% end-4Q10, 4Q11 (prev. 4.5, 4.75%)
US	CPI: 1.8% in 2010 (prev. 2.3%)
UK	CPI: 1.5% in 2011 (prev. 1.7%)

Where Do We Differ Most from the Market?

Fed expected to raise rates by more than markets expect (page 14)
BoJ expected to cut rates in 2Q10, markets expect no cuts (page 14)
Riksbank expected to raise rates by less than markets expect (page 15)

On Different Sides of 'Neutral'

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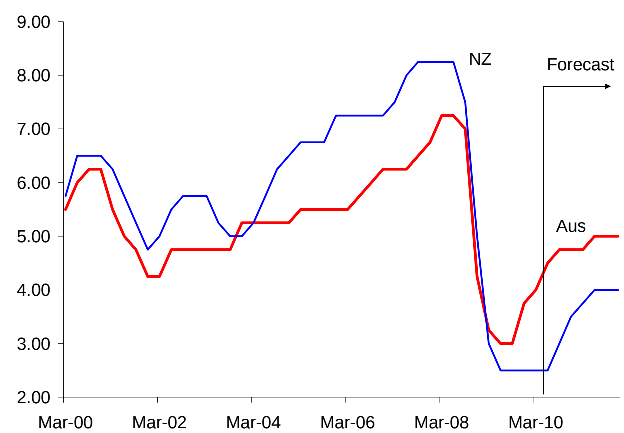
- Investors tend to paint Australia and New Zealand with the same brush, but these neighbouring economies have had very different experiences during the Great Recession. While Australia avoided a recession thanks to its aggressive policy stimulus, the New Zealand economy contracted for five consecutive quarters starting in 1Q08. Consequently, their central banks have chalked out very different exit strategies
- The RBA is likely to raise rates 1-2 times this year, taking its policy rate into slightly restrictive territory. Its ability to raise rates further will likely be constrained by the coming slowdown in consumption and also in part because the 'neutral' policy rate is itself lower.
- The RBNZ, on the other hand, is in no hurry to breach restrictive territory for its policy. Recognising that the neutral rate has fallen in New Zealand as well, it is likely to raise rates slowly and allow them to stay below neutral at least for the rest of 2010, and for part of 2011 as well.

The RBA hiked its policy rate on April 6 for the fifth time in six meetings. In contrast, the RBNZ struck a dovish tone in its monetary policy statements. Investors have tended to paint both economies with the same brush. They share many characteristics, but their experiences during the Great Recession were very different. While Australia avoided a recession thanks to its aggressive policy stimulus, the New Zealand economy contracted for five consecutive quarters starting in 1Q08. Consequently, their central banks have chalked out very different exit strategies. On one hand, we estimate that the RBA policy rate is already at neutral, and the 1-2 further hikes we see for the rest of the year will push monetary policy into slightly restrictive territory. On the other hand, the RBNZ will keep its policy rate below neutral this year and is likely to move towards neutral only some time next year.

Australia and New Zealand have seen their trading partners race out of the global recession, and improving terms of trade could amplify the benefits for both economies. Both have benefitted from very low interest rates and expansionary fiscal policy and both face the prospect of dwindling stimulus as rate cuts are unwound and fiscal consolidation starts.

But there are considerable differences between the two, notably on inflation. Core inflation in Australia is uncomfortably high, one factor behind our forecast for the cash rate to be pushed into slightly restrictive territory (see Exhibit 1). We think that another 1-2 increases will be sufficient, in part because we expect weaker consumer growth due to *domestic* factors, in part because we have a below-consensus estimate of the neutral policy rate. In New Zealand, inflation is likely to be much better behaved. The RBNZ will therefore pay more attention to ensuring that the fledgling recovery is entrenched. The 'neutral' real rate of interest has likely fallen in New Zealand as well, suggesting that fewer hikes are required to take interest rates into neutral territory.

Exhibit 1
Policy Rates on Either Side of Neutral



Source: Haver Analytics, Morgan Stanley Research forecasts

The vastly different exit strategies of these two neighbouring and interlinked economies have interesting implications for other G10 economies. The US has a reasonable growth trajectory in place and inflation is expected to pick up only slowly according to our economics team. In the UK and the euro area, however, there are still significant headwinds to growth but inflation is already tugging at the reins. It is likely that the exit strategies there will fall somewhere between those of the central banks down under.

Even with a strong recovery, the RBA will likely be constrained when it comes to raising rates, given that neutral rates themselves are lower. The RBNZ will also have an eye on its own neutral rate when it comes to raising rates since it will not want to push rates to neutral territory too quickly.

When it comes to fighting inflation, the RBA has been able to push rates higher quickly because of the strong economic backdrop. With consumer growth expected to moderate, it will be interesting to see whether it can stay committed to aggressive tightening of monetary policy. For the moment, it is likely that both the RBA and the RBNZ will aim to be on different sides of 'neutral'.

Australia: On its Way to a Restrictive Stance

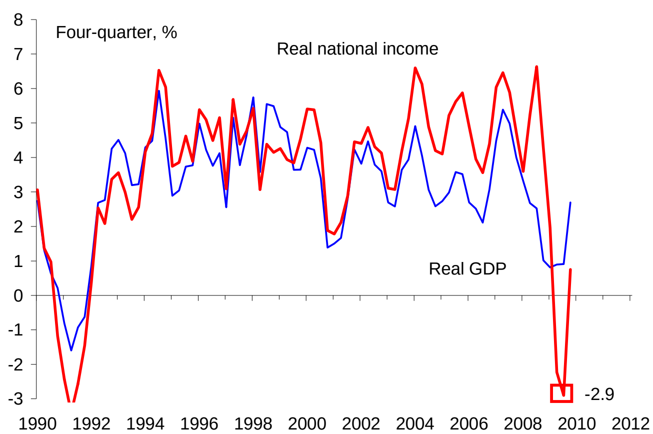
Gerard Minack (61 2) 9770 1529

The Reserve Bank faces a difficult balancing act. On the one hand, it seems clear that Australia will see a renewed surge of resource-centred growth: both higher terms of trade (export prices relative to import prices) and resurgent mining-related investment spending. On the other hand, the massive policy stimulus from the past 18 months is fading, and there is good reason to think that the 'neutral' cash rate level is lower than it has been. On balance, we think that the RBA will have to tighten 1-2 more times this year.

The mining boom faced a serious setback in 2009. Certainly, we do not think that 'China saved Australia' from the global recession. Australia's mining exports fell by 38% through 2009. Overall exports fell by 25%. The prior worst-ever four-quarter decline was 15% way back in 1960. However, the quick recovery in Asian growth, and ongoing supply blockages, point to resurgent export prices and mining-related investment spending.

Exhibit 2

National Income: A 1990-Like Decline, but Set to Rebound



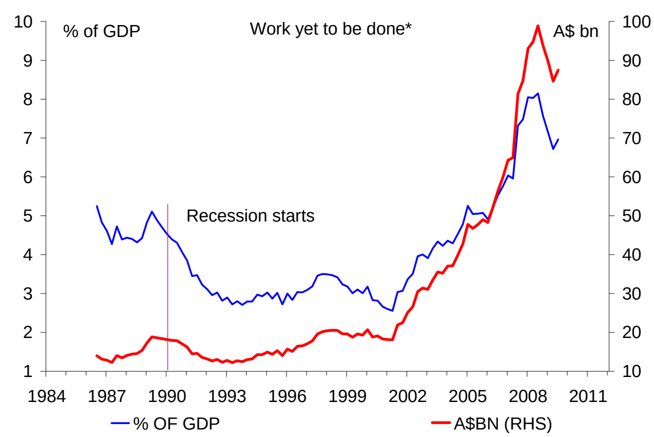
Source: ABS, Morgan Stanley Research

Exhibit 2 shows Australia's real GDP and national income growth. The latter adjusts GDP for the real income effects of changing terms of trade. The fall in national income in this cycle almost matched that in the 1990s recession. However, the terms of trade are set to rebound smartly this year due to the higher price of bulk commodity export prices. The prospect is for national income to return to high single-digit percentage growth heading into next year.

In addition to the terms of trade effect, the already-bulging investment pipeline is about to see another surge. Miners expect to increase investment spending to over A$60 billion in FY2011. Exhibit 3 shows the unprecedented surge in non-residential investment seen over the past decade.

Exhibit 3

Capex Pipeline about to Re-Fill



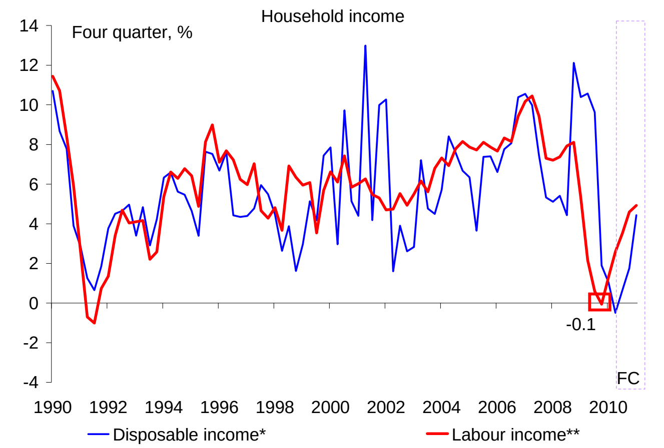
Source: ABS, Morgan Stanley Research; *At period end, building plus engineering

All this argues for the RBA quickly returning policy to a restrictive setting, given the already-low unemployment rate and relatively high CPI (the average of the RBA's two 'core' CPI measures was at 3.4% over the year to December quarter 2009).

However, there are two important offsetting considerations. First, the massive domestic policy stimulus – which I think was the key to Australia avoiding recession – is reversing.

Exhibit 4 shows the growth in disposable household income. It peaked at 12% early in 2009, largely due to policy effects (lower interest rates and fiscal handouts). Labour income fell almost as far in the last year as in the last recession. (More evidence, as an aside, that China did not 'save' Australia.)

Exhibit 4
The Policy Stimulus Reverses



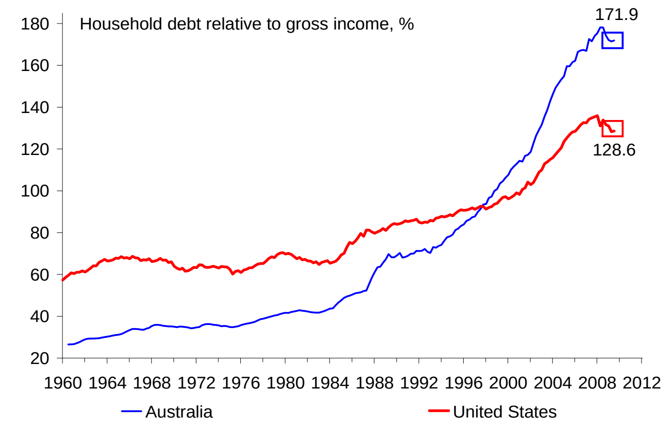
*Equals gross income less direct taxes and other expenses, including interest payments
**Pre-tax compensation
Source: ABS, Morgan Stanley Research forecasts

The policy stimulus is now reversing. Consequently, we expect that household income will stagnate this year, despite stronger labour income.

The RBA also has to take into account two factors suggesting that the 'neutral' cash rate is now lower than it has been historically. First, household debt is significantly higher relative to household income (see Exhibit 5). Most household debt is mortgage debt, and most mortgage debt is floating-rate (tied to short-end interest rates). Higher debt means that any given change in effective interest rate has a bigger impact on household income. Second, the spread between the mortgage rate and the cash rate target has widened, thereby amplifying the impact of cash rate hikes felt by households who pay the mortgage rate, not the cash rate. We estimate that this spread has widened by around 200bp since mid-2005.

Adding the long-run average real cash rate target (3.25%) and the inflation target of 2.5% puts the simple measure of the 'neutral' cash rate at 5.5-6%. In fact, we think that neutral cash is probably around 4-4.5%. The current cash rate is now 4.25%, so the RBA is almost at neutral, in our view. Another 1-2 25bp increases this year would put the target into the (marginally) restrictive zone – hence our forecast for that increase this year.

Exhibit 5
Higher Household Debt Points to a Lower 'Neutral' Rate



Source: ABS, Federal Reserve, Morgan Stanley Research

Domestic factors will drive policy: We think that the two key drivers of policy this year – the risk factors that could push rates higher than we are now forecasting – are both domestic. The first is employment. The peak for unemployment in this cycle was not far from the trough seen in prior cycles. The Australian labour market is likely to hit pinch points in selected areas if employment growth doesn't moderate soon.

The second driver is house prices. The RBA has for some time, *sotto voce,* been concerned about Australia's elevated house prices. Now it is signaling its concerns loud and clear. If house prices continue to rise at their recent pace – double-digit gains in the capital cities – expect the RBA to push rates quickly into the restrictive zone.

New Zealand: On the Other Side of Neutral

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The situation is far more clear-cut for the RBNZ, and the slow and steady path it is taking towards raising policy rates is likely to continue even after it starts hiking rates.

The New Zealand economy is again growing after a long recession, but the sustainability of that recovery is far from assured. The inflation profile is fairly benign and unlikely to worry the RBNZ. Finally, markets have jumped the gun quite a few times already in trying to anticipate a start to rate hikes, which has helped the RBNZ by allowing it to have higher front-end rates without even raising the Official Cash Rate (OCR). We hold our long-standing call for the first rate hike to arrive at the July meeting, with four rate hikes (possibly three) of 25bp this year, depending on the response of the economy to the hikes.

Spot the difference: The difference in the policy rates in Australia and New Zealand could arguably be justified by looking at one simple comparison: the relative economic performance during the Great Recession. While the Australian economy avoided recession and surprised everyone by showing robust employment throughout the Great Recession, the New Zealand economy shrank for five consecutive quarters and began growing only in 2Q09.

The growth picture remains quite mixed: In the case of New Zealand, this is true almost too literally. Going by the 4Q09 GDP report, only four of eleven industry groups had recuperated all the output lost since the peaks in 2007. However, the four groups (including the heavyweight Finance, Insurance and Business Services industry which accounted for nearly 29% of GDP) make up nearly half of GDP in New Zealand.

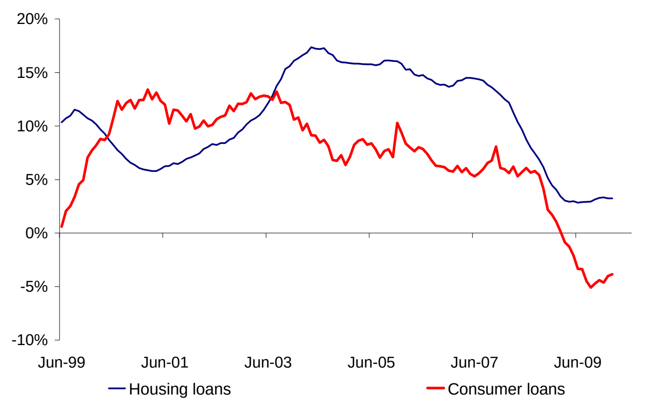
Some upside risks… Like Australia, New Zealand stands to benefit from favourable terms of trade as well as the improved global (and particularly Australian and Asian) growth outlook. The top three destinations for New Zealand's exports – Australia (23% of exports), China (10%) and the US (9%) – have all shown better-than-expected growth and the booming Asia ex-Japan region accounts for a whopping 27% of New Zealand's exports according to February 2010 data.

…but downside risks dominate: Risks to the downside, however, are still evident from the 4Q09 GDP report. While house prices have rebounded smartly, household loan activity has been positive but flat at around the same level as 2009. Consumer loans, on the other hand, are still negative and not far off their lows (see Exhibit 6). This is not surprising, considering that full-time employment is still weak and has a way to go before it can catch up with the 2007 level (see Exhibit 7). And the weak labour market also reflects weak investment spending on fixed assets (see Exhibit 8). How much of the higher private consumption spending and the resumption of residential investment can be sustained without a policy stimulus will obviously be something that the RBNZ will pay a considerable amount of attention to.

What of inflation and rates? If the growth picture shows considerable reason for the RBNZ to prefer a slow exit, the inflation outlook and a lower level for the 'neutral' rate only serve to make this strategy an optimal one.

Exhibit 6

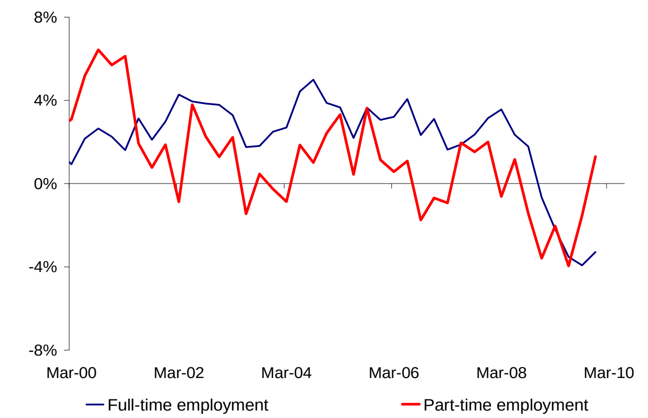
Household Loan Activity Is Still Weak



Source: RBNZ

Exhibit 7

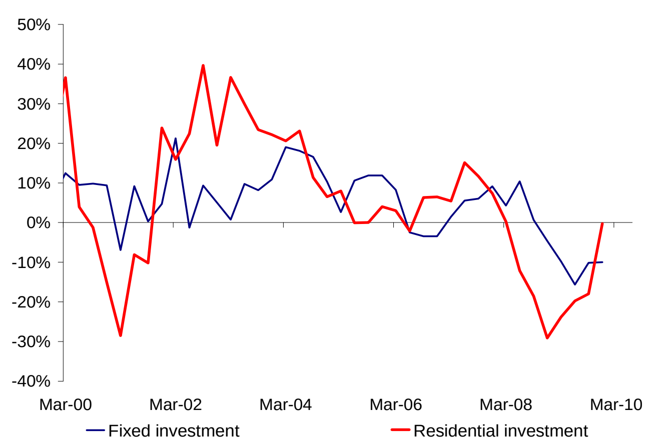
Full-Time Employees Still Feeling the Pinch



Source: Statistics New Zealand

Exhibit 8

Capex Needs to Rise from Current Levels

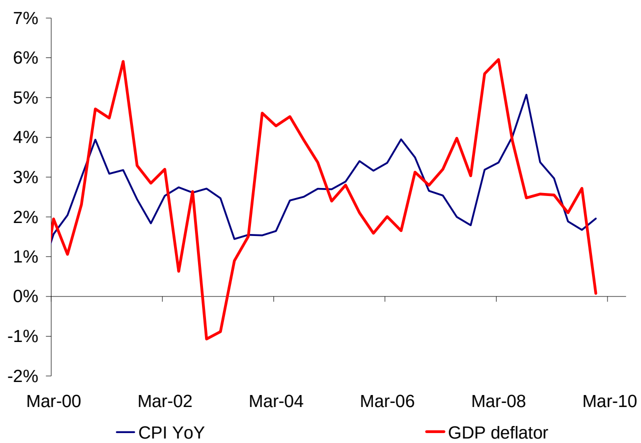


Source: Statistics New Zealand

CPI versus GDP deflator: In its last policy statement, dated March 11, the RBNZ explicitly conveyed to markets its willingness to look through near-term rises in the CPI measure (which it believes will be due to technical factors). The 4Q09 reading for the GDP deflator showed flat prices on a YoY basis for New Zealand's output even as the basket of consumer goods ticked up to nearly 2%Y (see Exhibit 9). This will give the RBNZ further conviction in its decision to raise rates slowly, in our view.

Exhibit 9

GDP Deflator Suggests Prices Are Generally Stable



Source: Statistics New Zealand

Lower 'neutral': And finally, the 'neutral' rate and twitchy markets have also helped the RBNZ to keep the OCR low. Given the recession in the NZ economy, we believe that both potential output and its companion, the 'neutral' real rate of interest, have fallen. We estimate that the neutral real rate of interest is around 2-2.5% – at least 1% lower than it is likely to have been prior to the global recession. Thus, much like the RBA, which likely already has a neutral policy stance, the RBNZ will not have very far to go before it takes away monetary policy accommodation. It must therefore raise rates with caution. And markets have helped. By attrubting the same policy rate profile to both Australia and New Zealand, markets have pushed up front-end rates. This has ironically worked in the favour of the RBNZ as it has benefitted from higher front-end rates without actually raising its Official Cash Rate.

Of course, there are risks that the RBNZ may not always be as frugal in its withdrawal of policy stimulus. For one thing, a lower neutral rate also means lower potential output and a smaller output gap. This takes away some of the sand in the inflation mechanism. For another, the bigger risk in the world economy is that of upside surprises to growth. If the New Zealand economy benefits a lot from global growth, the RBNZ may just have to raise rates faster. Despite these risks, we think that the domestic scenario we have painted will allow the RBNZ to stay on the other side of neutral from its neighbour.

Inflation Target Monitor & Next Rate Move

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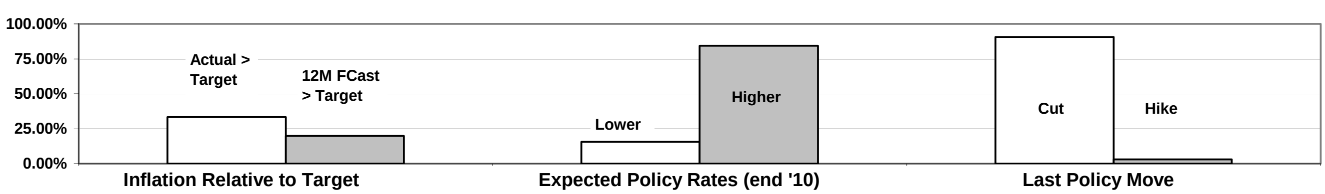
	Inflation target	Latest month	12M MS fcast	Next rate decision	Current rate	Market expects (bp)	MS expects (bp)	Risks to our call
United States	1.7-2.0% PCE Price Index	1.3%	1.8%	28 Apr	**0.125**	3	0	Extremely dovish language should start to change in April
Euro Area	< 2% HICP (u)	0.9%	1.9%	08 Apr	**1.00**	0	0	EONIA to stay below refi rate until July
Japan	0-2% CPI (u)	-1.2%	-0.3%	30 Apr	**0.10**	0	0	Risks tilted towards further easing
United Kingdom	2% CPI	3.0%	1.4%	08 Apr	**0.50**	0	0	QE could be re-started in double-dip
Canada	1-3% on CPI	1.6%	1.7%	20 Apr	**0.25**	3	0	Weaker-than-expected US demand is main downside risk
Switzerland	<2% CPI (u)	1.4%	0.4%	17 Jun	**0.25**	4	0	-
Sweden	2.0% CPI	1.2%	1.5%	20 Apr	**0.25**	9	0	Balanced
Norway	2.5% CPI	3.0%	2.5%	05 May	**1.75**	12	25	Very close call between May and June
Australia	2-3% over the cycle	2.1%	1.9%	04 May	**4.25**	8	0	An increase
New Zealand	1-3% CPI	2.0%	1.8%	29 Apr	**2.50**	2	0	Very low risk of a hike
Russia	none	6.5%	7.7%	-	**8.25**	-	-25	-
Poland	2.5% (+/- 1%) CPI	3.1%	2.5%	28 Apr	**3.50**	-	0	-
Czech Republic	3.0% (+/-1%) CPI	0.6%	2.0%	06 May	**1.00**	-	0	-
Hungary	3.0% CPI	5.7%	2.6%	26 Apr	**5.50**	-	-25	-
Romania	3.5 (+/-1%) CPI	4.5%	4.8%	04 May	**6.50**	-	-25	-
Turkey	6.5% CPI end '10	9.6%	5.7%	13 Apr	**6.50**	-	0	-
Israel	1-3% CPI	3.6%	2.4%	26 Apr	**1.50**	-	0	BoI might hike
UAE	-	-	8.6%	-	**1.00**	-	-	-
South Africa	3-6% CPI	5.7%	4.9%	13 May	**6.50**	-	0	Significant easing in food prices prompts another 50bp cut
China	-	2.7%	3.2%	-	**5.31**	-	27	Balanced risk
India	8.5% WPI	9.9%	6.0%	20 Apr	**3.50**	0	50	Growth weaker than expected
Hong Kong	-	2.7%	2.5%	-	**0.50**	-	0	Premature US tightening upon global inflation uptick
S. Korea	2-4% CPI	2.3%	3.3%	09 Apr	**2.00**	-	0	Political influence may delay rate hike cycle
Taiwan	-	1.3%	2.0%	25 Jun	**1.25**	-	12.5	Rate hike may be delayed due to mild inflation pressure
Singapore	1.5% (long-term CPI) (u)	1.0%	2.9%	April	**0.65**	-	NA	Changes in the FFTR and SGD appreciation pace
Indonesia	5% +/- 1.0%	3.4%	6.0%	05 May	**6.50**	-	0	Evenly balanced
Malaysia	-	1.2%	1.7%	13 May	**2.25**	-	+25	Evenly balanced
Thailand	0.5-3.0% core CPI	3.4%	3.3%	21 Apr	**1.25**	-	+25	Evenly balanced
Brazil	4.5% +/-2.0% IPCA	4.8%	4.7%	28 Apr	**8.75**	50	50	Copom will hike in April, question is how much
Mexico	3% +/-1% CPI	4.8%	3.6%	16 Apr	**4.50**	0	0	Inflationary impact of tax reform in 2010
Argentina	15.5-24.2% M2 growth	9.1%	10.5%	NA	**8.81**	-	-	-
Chile	3% +/-1% CPI	0.4%	2.8%	15 Apr	**0.50**	0	0	Earthquake hit may delay first hike
Peru	2% +/-1% CPI	0.8%	2.3%	08 Apr	**1.25**	0	0	Slower recovery leading to rates on hold for longer
Colombia	3% +/-1% CPI	1.8%	4.2%	30 Apr	**3.50**	0	0	Slower recovery leading to rates on hold for longer

(u) = unofficial
Notes: Inflation numbers in red indicate values above target; MS expectations in red (green) indicate our rate forecasts are above (below) market expectations;



Source: National Central Banks, Morgan Stanley Research
Notes: (u) = unofficial target; Interest rate expectations are implied by overnight indexed swap (OIS) curves and may differ from those implied by other instruments; where adequate OIS data are not available, FRAs, foreign exchange swaps, and/or interbank cash rate futures are used; due to varying risk premia (such as liquidity, basis, credit, term, reserve management, calendar turns, etc.), these figures should be used as estimates only; where such instruments are not available, we have inserted our best guess of what markets expect based on consensus estimates.

Central Bank Balance Sheet Monitor

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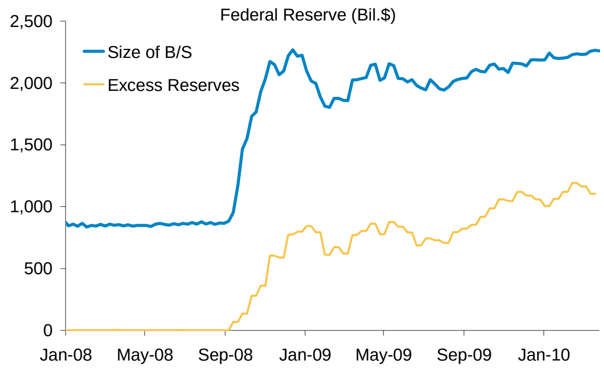
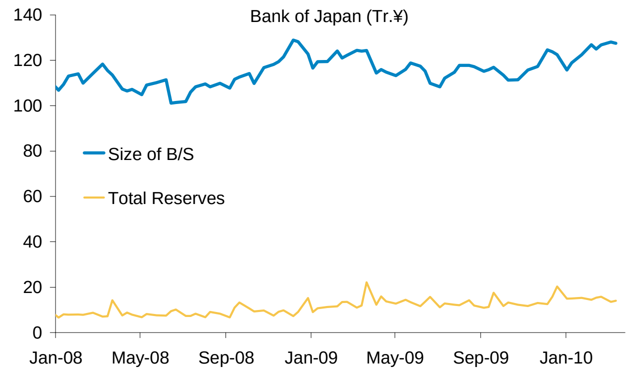
US



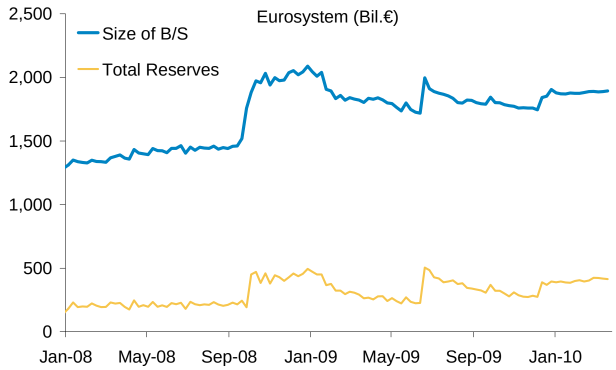
Source: Haver Analytics

Japan



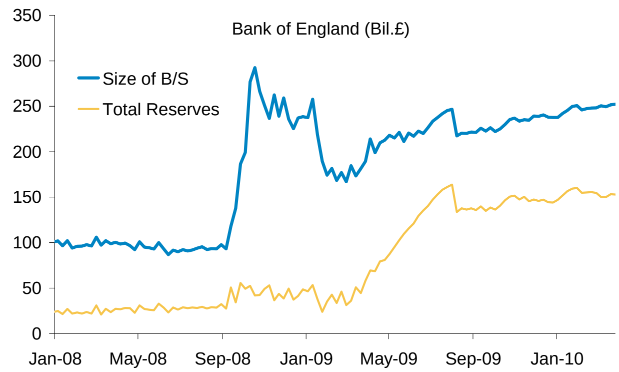
Source: Haver Analytics

Europe



Source: Haver Analytics

UK



Source: Haver Analytics

What's New This Week?

US: Growth Outlook – Upside Risks

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Baseline unchanged but it's getting more cyclical: Three factors are contributing to upside risks to our US growth outlook: (1) New foreclosure mitigation proposals could dramatically improve prospects for housing; (2) The administration appears likely to extend current tax rates for all but upper-income taxpayers; and (3) Incoming data have been stronger than expected, supporting our view that a spring snapback from harsh winter weather is underway.

Game-changer for housing: Two policy changes – a new 'earned principal forgiveness' initiative in HAMP, and the short refinance program through the FHA – will reduce the downside tail risks to home prices and housing. If implemented effectively, these changes, by strongly encouraging principal write-downs, will help reduce the 'shadow inventory' of yet-to-be foreclosed homes and the likelihood of strategic defaults.

Tax breaks for consumers: We have long assumed that the administration would end the Bush tax cuts and increase the tax rate on dividends and capital gains on January 1, 2011, resulting in a US$120 billion tax hike for individuals. But the president proposes to end tax cuts only for upper-income taxpayers; if Congress approves, the extra income could add 0.5pp to 2011 growth.

Hearty incoming data: 1Q growth looks 0.5pp stronger than we forecast a month ago and upside risks dominate going into 2Q and beyond. Winter storms depressed the economy by less than we thought; healthy March levels for orders suggest additional momentum; there is scope for inventory accumulation; and we see wage and salary income beginning to sustain both gains in consumer spending and a rise in thrift.

For details, see *US Economics: US Growth Outlook: Upside Risks*, April 5, 2010.

US: FOMC Minutes Recap

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The tone of the minutes (released on April 6) was dovish, but no more so than anticipated. In particular, the minutes contained an interesting discussion of policy guidance that emphasized the contingent nature of the "extended period" reference. Also, there was an important reference to the risk/reward associated with exiting too early versus too late. Here is the key passage from the minutes:

"A number of members noted that the Committee's expectation for policy was explicitly contingent on the evolution of the economy rather than on the passage of any fixed amount of calendar time. Consequently, such forward guidance would not limit the Committee's ability to commence monetary policy tightening promptly if evidence suggested that economic activity was accelerating markedly or underlying inflation was rising notably; conversely, the duration of the extended period prior to policy firming might last for quite some time and could even increase if the economic outlook worsened appreciably or if trend inflation appeared to be declining further. A few members also noted that at the current juncture the risks of an early start to policy tightening exceeded those associated with a later start, because the Committee could be flexible in adjusting the magnitude and pace of tightening in response to evolving economic circumstances; in contrast, its capacity for providing further stimulus through conventional monetary policy easing continued to be constrained by the effective lower bound on the federal funds rate."

From our standpoint, this discussion doesn't really provide any firm guidance on timing of the exit, but it does tend to reinforce a curve-steepening market outcome.

Also, the minutes indicated that Brian Sack briefed the FOMC on operational aspects of the exit strategy – including reserve-draining techniques and ways to tighten the link between IOR and the effective fed funds rate. However, the minutes did not include any mention of a follow-up discussion of these issues among the members. In fact, the minutes merely indicated that: *"No decisions about the Committee's exit strategy were made at this meeting, but participants agreed to give further consideration to these issues at a later date."*

Finally, it's important to recognize that the data has strengthened noticeably since the March 16 meeting. Bernanke, Dudley and other key Fed officials have a number of public appearances scheduled in coming days and it will be interesting to see if there is any change in tone.

UK: The Only Way Is Up? The Potential for Higher Inflation after a Temporary Reprieve

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Investment conclusion: Beyond the next two years, we *should* be worried about high inflation outcomes. While pension fund demand means that UK inflation protection is already demandingly priced relative to the MPC's inflation target, we think that the downside risk of being long protection is limited due to the persistence of this demand.

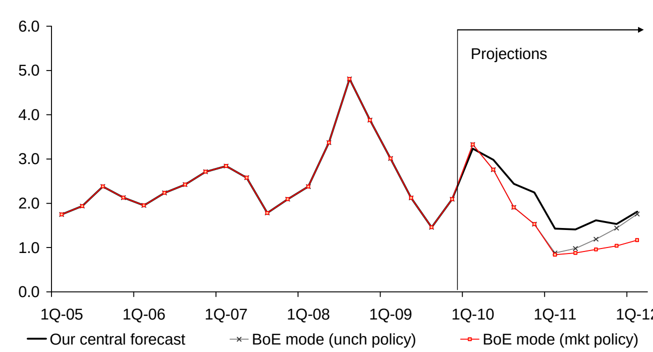
In-depth look at UK inflation prospects: We take a fresh look at UK inflation prospects at two different time horizons: over the next two years and beyond two years. Downside risks to our inflation forecast over the coming year lead us to push back the date for the first BoE rate rise to 1Q11, but there is plenty of scope for further 'inflation shocks' and these seem to be largely on the upside. Prepare for a bumpy ride.

In the longer term, we identify largely upside risks. We don't think that the inflation target will be raised *by choice*, but we see a relatively high risk that several pressures will make the 2% target untenable. These include longer-term pressures on commodity prices and demography.

Consensus may be too complacent on the upside risks: Consensus for 2011-14 is for inflation to average 2.0%. We raise our own average forecast for 2011-15 from 2.0% to 2.4%, reflecting the expectation that some of these inflation pressures will come through, with the Bank of England ultimately steering inflation back to target. However, it is the period beyond 2014/15 where we are most concerned about a scenario where the inflation target becomes untenable.

For further details, see *The Only Way Is Up? The Potential for Higher Inflation after a Temporary Reprieve*, March 31, 2010.

UK: Our Central CPI Forecast Compared to the BoE



Source: BoE Inflation Report (February 2010), Morgan Stanley Research forecasts

Canada: Hikes on the Horizon

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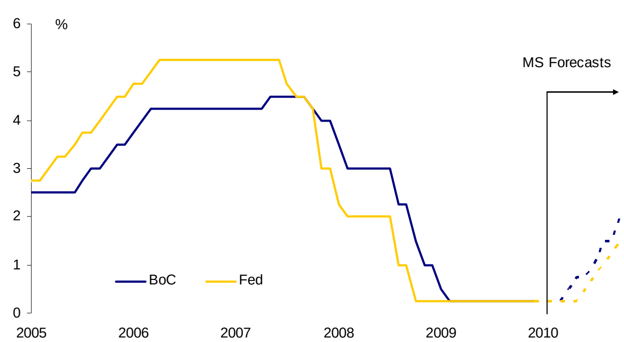
We expect a first hike in June: After maintaining rates at a historical low of 0.25% for over a year, the BoC is gearing up to start its tightening cycle. We expect the first hike to come in June, ahead of market expectations and before the majority of other G10 central banks, notably the Fed. We expect a steady pace of hikes thereafter, to end 2010 at 2.00%.

Growth on a tear: Our expectations for the BoC are based on shifting growth and inflation outlooks. On the heels of the torrid 4Q GDP print, Canadian growth kicked off this year on a strong note, with January GDP at 0.6% versus 0.5% expected. This marks the fifth consecutive month of increase and, importantly, revealed continued strength in consumer activity and the housing market. If the current pace is sustained, 1Q GDP will easily surpass the BoC's forecasts for 3.5% growth this quarter and even suggests upside risks to our own forecast for 4.3% GDP. Meanwhile, price pressures have proven much stickier than the BoC's expectations.

Countdown to tightening: We have had a long-held view that markets are overly complacent about the possibility that the BoC hikes before its conditional commitment to low rates until end-2Q. Admittedly, the April meeting seems too soon for tightening, but we see June as fully in play. The BoC is already moving towards the exit by shifting its assessment of inflation risks from "tilted slightly to the downside" to "roughly balanced" (March 2 statement). The economic backdrop has improved significantly since last March 2009, when the BoC made its pledge to hold rates low. Moreover, real rates are currently negative in Canada. With price pressures creeping back up towards target, the risks of a hike are tilted to sooner rather than later. It is important to remember that the BoC has consistently stressed the conditionality of its pledge to low rates, and if conditions change, so will the BoC, we think.

Canada: BoC to Lead the Fed in Rate Hikes



Source: Bloomberg, Morgan Stanley Research estimates

Turkey: No Hike but an Exit

Tevfik Aksoy (44 20) 7677 6917

No rate hike at this time: Following the March CPI inflation print of 0.58%M, the annual rate dropped to 9.6%Y, in line with our expectations and slightly higher than the consensus view. But the rise in core inflation triggered some concerns on the part of market participants and analysts that the CBT might decide to act fast in order to pre-empt a deterioration in future pricing behaviour and stem the slide in expectations so the inflation target could be achieved. We have reservations and objections to this view and maintain our stance that a tightening at this stage (MPC on April 13) is not on the cards. We expect other monetary measures to precede a rate hike and the details to be released at the CBT's public announcement (April 14).

Inflation remains high and our 8.1%Y year-end forecast had been one of the most pessimistic figures among banks. We expect CPI inflation to remain at 9-10% for most of the year and we see risks on the upside, with oil and other commodity prices remaining elevated with only marginal support from the currency appreciation. However, given the fact that the source of inflation had mostly been unprocessed food, base effects and only marginally the demand conditions, we do not believe that an early rate hike will help control inflation noticeably. In fact, an early attempt might result in a premature slowdown, leading to various other problems associated with the recovery. The CBT had been openly communicating its view that inflation would remain distant from the official target for most of the year but converge gradually as the base effects dissipate and the unprocessed food prices normalise. Recently, it even warned that the core inflation measures would also rise due to the base effects (the removal of the tax cut effects of 2009 being replaced with new data). Hence, the developments on the inflation front brought no or a minimum amount of surprise to the central bank.

Exit and other monetary measures before a rate hike: We expect the CBT to raise the reserve requirement ratio by 1pp to 6% (drawing around TRY 3 billion from the market) and quite possibly alter the amount and/or tenor of the funding it provides via repos. In fact, it would not be surprising to see the CBT completely removing the funding it provides via 3-month repos. While the headline effect might not sound as dramatic as raising the policy rate, the impact could be noticeable, especially given the fact that the majority of the T-bills and bonds are being held by local banks that are short in cash.

Rate hikes to arrive later: We expect the CBT to start hiking in July and the total tightening to reach 150bp by year-end. Depending on the tone of the CBT, the impact of the other tightening measures and of course the upcoming data, we might bring forward the timing in the coming months.

India: Export Growth Accelerates Sharply in February

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Export growth (in dollar terms) accelerated in February on an improving global macro environment: Export growth (in dollar terms) accelerated sharply to 34.8%Y in February compared with 11.5%Y in January. On a seasonally adjusted sequential basis, exports (in dollar terms) jumped 12.3%M (versus +0.1%M in January). In rupee terms, export growth picked up to 26.7%Y compared with 4.9%Y in January. In other Asian countries, export growth (in dollar terms) accelerated to 36.3%Y in February compared with 30.2%Y in the previous month.

Imports continued to accelerate on strong domestic demand and a low base effect: Import growth (in dollar terms) accelerated to 66.4%Y in February compared with 35.5% in the previous month. On a seasonally adjusted sequential basis, imports (in dollar terms) were up 13.6%M (versus -0.5%M in January). In rupee terms, import growth was up 56.4%Y compared with 27.6%Y in January. While oil import growth (in dollar terms) accelerated to 97.4%Y in February (versus 56%), non-oil import growth (in dollar terms) picked up further to 55.6%Y (from 28.8%).

Monthly trade deficit grew 187.3%Y in February: This compares with a growth of 93.4% in the previous month. The trade deficit stood at US$9 billion (9.8% of GDP, annualised) in February. On a trailing 12-month basis, the trade deficit widened to 9.1% of GDP, compared with 7.8% in January.

Need for quick policy action from the RBI: The three-month trailing trade deficit remained high at 10.8% of GDP, annualised as of February, compared to the trough of 4% of GDP, annualised as of March 2009. We maintain our view that the RBI will have to continue to lift policy rates quickly to manage the transient risk of rising non-food inflation and a widening trade deficit.

India: Trade Data Trend

	Feb-09	Dec-09	Jan-10	Feb-10
Exports (US$m)	11941	14606	14343	16091
– YoY growth	-21%	9%	11%	35%
Imports (US$m)	15062	24753	24705	25057
– YoY growth	-28%	27%	36%	66%
Trade balance (US$m)	-3121	-10147	-10362	-8966
– YoY growth	-45%	67%	93%	187%

Source: Ministry of Commerce, Morgan Stanley Research

Hong Kong: Monetary Conditions Monitor

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We launched the Hong Kong Monetary Conditions Monitor in early February to help keep track of monetary trends, as policy exits around the globe and possible reversal of capital flows pose great uncertainty to Hong Kong's economic recovery in 2010, which has been predominantly asset market-led thus far. To recap, the HK$-denominated financial system not only serves the local economy, but also functions as a key channel of financial intermediation between Chinese enterprises and international investors. This subjects the financial system, and hence the Hong Kong economy, to volatile cross-border capital flows, which are driven by factors unrelated to local economic conditions. Ironically, these capital flows have, in turn, become an unpredictable and volatile component of Hong Kong's macro fundamentals.

Summarising developments in the past month: There is certainly anxiety in the market with regard to the possible reversal of capital flows from Hong Kong upon policy tightening across the globe in 2010, overturning the impressive gains in asset prices that underpinned domestic demand recovery last year. Signs of fragility have surfaced since end-2009, as suggested by the cessation in capital inflows, asset price correction as well as the relative weaker exchange rate. Nevertheless, to date, we have not yet witnessed actual outflows from the monetary base, although our proxy of the total liquidity stock has retreated as banks run down their aggregate net foreign asset position (down mildly by US$1.5 billion in February). Financial markets readily react negatively to any announcements that signal the onset of policy tightening, which could take place well before solid evidence of capital outflows. Nevertheless, we reiterate that the stock of excess liquidity accumulated since late 2008 is large, offering a meaningfully sizeable buffer for outflows before interest rates see significant upward pressure.

Interest rates: Although capital inflows have ceased since early December, while the relatively weaker HK$ suggests that there had been some outflows from HK$ since mid-December, interest rates have remained at record-low levels. This is consistent with our view that, as the stock of excess liquidity is very large, the buffer for outflows could be quite big before HIBOR has to see significant upward pressure.

Indonesia: Rate Pause Continues

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Policy rate on hold at 6.5%: Bank of Indonesia (BI) continued with its rate pause stance on April 6, holding the policy rate at 6.5% for the eighth consecutive time. This was in line with our and consensus expectations. During the easing cycle (December 2008 to August 2009), the policy rate was cut by a cumulative 300bp.

What was in the monetary policy statement? While other countries in the region (e.g., Australia, India, Malaysia and Vietnam) have already embarked on the policy exit path, the monetary policy statement reiterated that Indonesia is not in a rush to do the same. Indeed, BI's assessment of growth and inflation conditions appears to be moving towards a 'Goldilocks' type of scenario. On the growth front, BI expects the domestic economy to "continue to forge ahead on the strength of more conducive performance in the global economy". Indeed, 2010 GDP growth is now expected to come in at 5.5-6.0%, higher than the earlier forecast of 5.0-5.5%. Meanwhile, on the inflation front, BI expects inflationary pressures to remain benign, noting that "no significant inflationary pressure will emerge at least during the first half of 2010". In fact, while BI expected inflation for 2010 overall to be within the targeted range of 5%+/-1% in the March statement, BI is now of the view that "inflationary pressures will remain low, with inflation on track for the lower limit of the 5%+/-1% targeting range". The central bank also made a reference to import-led inflation, saying that "inflationary pressure eased mainly on subdued inflation expectations, which have benefited from the appreciating trend".

Monetary policy outlook: We think that currency appreciation and its positive externality on inflation have helped to delay the actual policy rate tightening until 2H10. We forecast the policy rate to reach 8% by end-2010. In terms of the risk profile, with inflation remaining benign so far, we think that risks are skewed towards BI starting the rate hike later and raising rates by a lower quantum. Indonesia's interest rate cycle has already been seeing lower lows and lower highs. Should the risk scenario pan out, this would more strongly reinforce our long-term constructive view on Indonesia of the improvement in macro fundamentals supporting a structural decline in the cost of capital.

Mexico: The Case for the Doves

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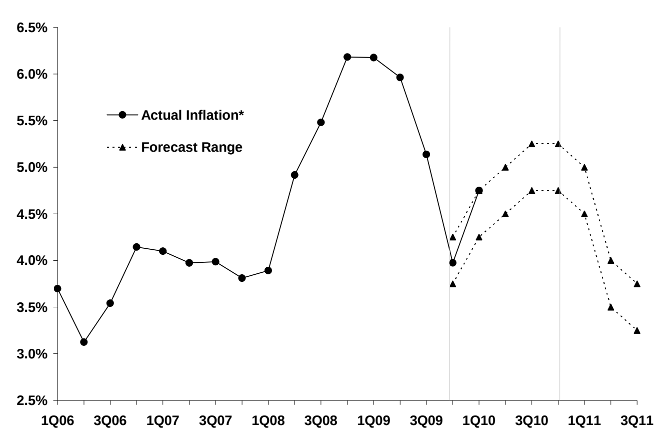
Hike speculation on the rise: When Mexico releases the March inflation figures on April 8, the expected high reading is likely to once again fuel speculation that Banco de Mexico will hike interest rates at some point this year. If the consensus view for a monthly increase of 0.70% materializes, then average annual inflation for 1Q would rise to 4.75%, matching the upper limit of Banco de Mexico's quarterly forecast path (see Exhibit). And even though the central bank maintained rates unchanged at 4.50% on March 19, the policy statement contained some hawkish undertones as the authorities stressed that they were "carefully" watching medium and long-term expectations, as well as signs of potential second-round effects on inflation from higher taxes and administered prices.

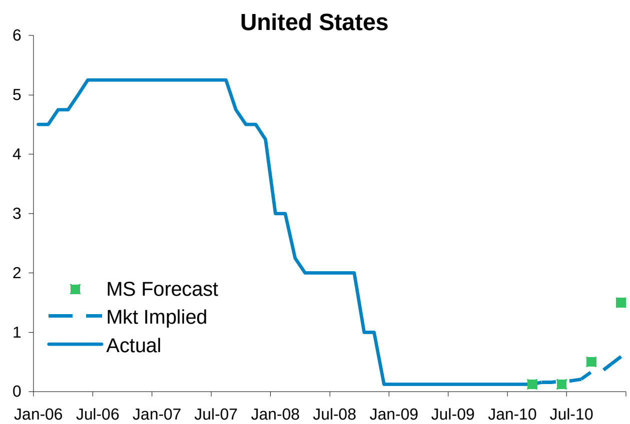
Despite the 1Q spike in inflation, we find the talk about forthcoming rate hikes premature and continue to expect Banco de Mexico to remain on hold this year. Persistently high inflation, which could eventually lead to an upward move in medium and long-term expectations, represents a risk to our call that overnight rates will stay unchanged at 4.50% in 2010. However, there are several key factors that should provide Banco de Mexico with sufficient room to accommodate the ongoing inflation shock without hiking rates. First, the recent real strengthening in the exchange rate has translated into a meaningful tightening of monetary conditions. Second, after last year's wrenching recession, there is plenty of slack in the economy. Third, even though labor markets are on the mend, the rate of unemployment remains very high. And, last, one of the key transmission channels of monetary policy, credit, has yet to show tangible signs of recovery. Put together, these factors make a strong case for the doves, in our view.

Mexico: Banxico Inflation Forecast Path (Qtr avg, %Y)

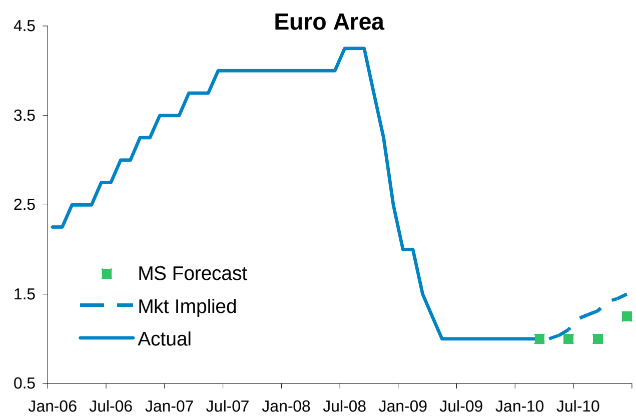


Source: Banxico; *Assumes market consensus for March Inflation (+0.70%M)

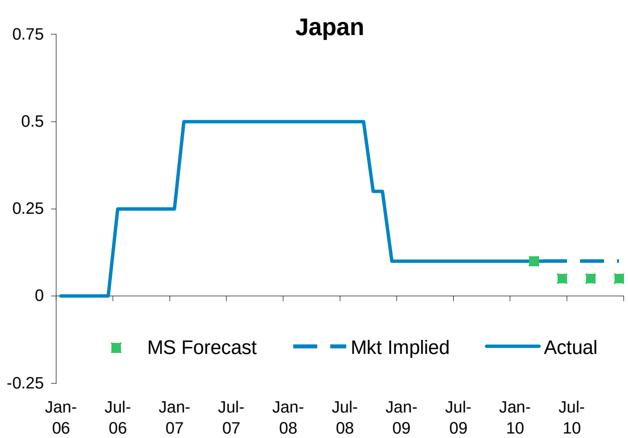
Monetary Policy Outlook – Morgan Stanley versus Markets



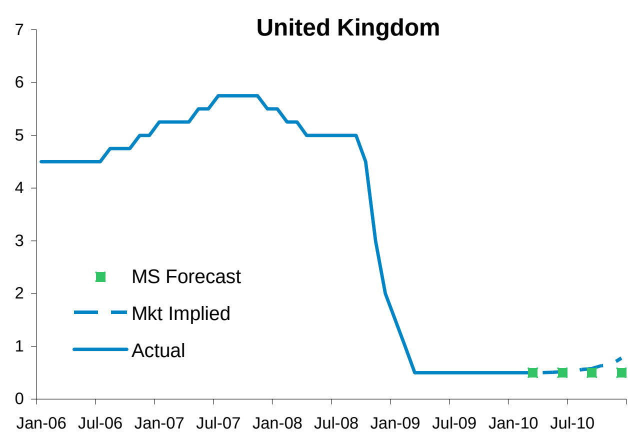
- We expect reverse repos and term deposits to add to SFP reserve draining in the summer.
- Rate hikes should begin in 3Q, and we expect a much more aggressive start to tightening than the market is pricing in.



- ECB to gradually reduce maturity of its liquidity operations over the summer.
- For now, full allotment MRO will keep EONIA close to the deposit rate.



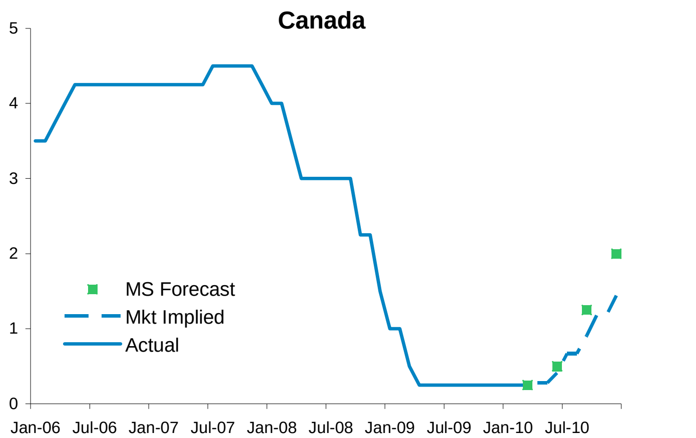
- The government has made beating deflation its priority, and we believe tightening is unlikely to be a discussion item this year.
- We pushed back the expected timing of exit by six months from Jul-Sep 2011 to Jan-Mar 2012.

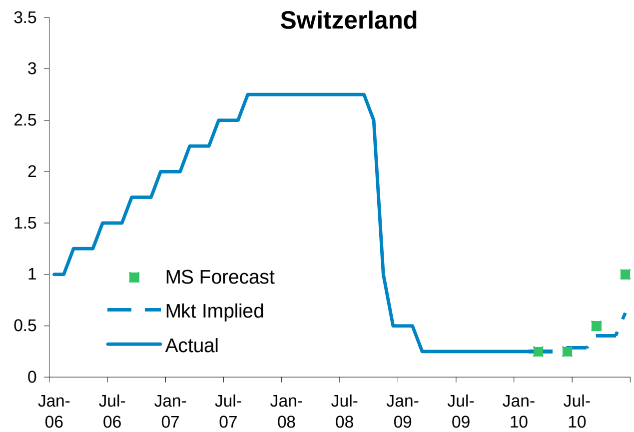


- We think that the MPC will start raising rates in early 2011. Markets seem to be pricing in a similar outcome.
- Fiscal policy decisions and the election will likely complicate decisions on timing/pace.

Source: National Central Banks, Morgan Stanley Research
Notes: (u) = unofficial target; Interest rate expectations are implied by overnight indexed swap (OIS) curves and may differ from those implied by other instruments; where adequate OIS data are not available, FRAs, foreign exchange swaps, and/or interbank cash rate futures are used; due to varying risk premia (such as liquidity, basis, credit, term, reserve management, calendar turns, etc.), these figures should be used as estimates only; where such instruments are not available, we have inserted our best guess of what markets expect based on consensus estimates.

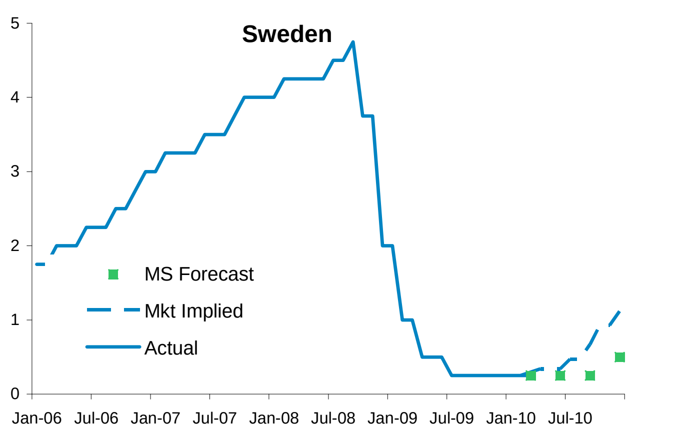
Monetary Policy Outlook – Morgan Stanley versus Markets

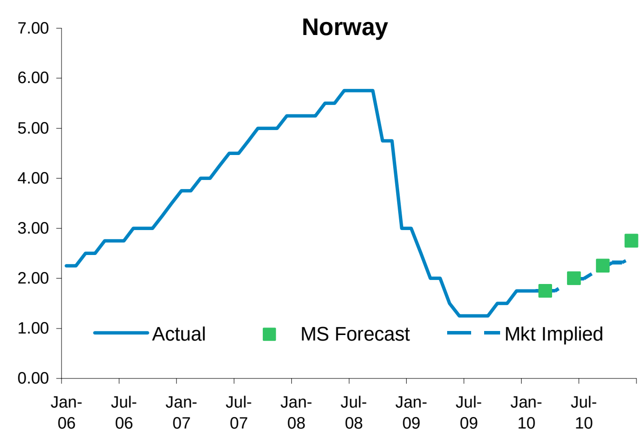




- The risks to both growth and inflation lie north of the Bank of Canada's forecasts.
- We believe the BoC will need to begin removing accommodative policy sooner rather than later. We forecast a rate hike in June 2010.

- SNB starting to prepare stimulus withdrawal – we expect a first rate hike in 3Q10.
- SNB likely to stay committed to preventing excessive Swiss franc appreciation versus the euro through intervention, if needed.



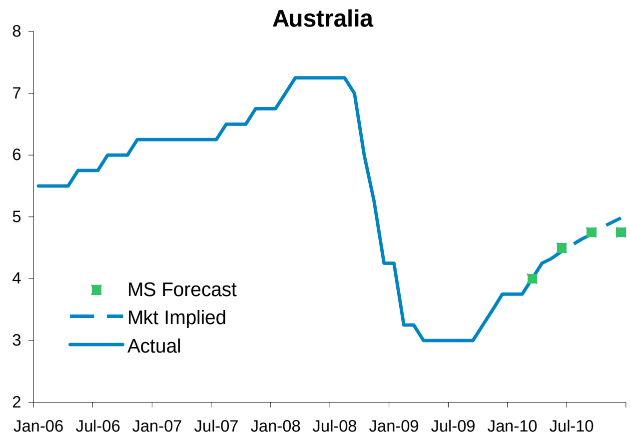


- Marked downside risks to the Riksbank's growth forecasts push first rate rise back into the autumn.
- Watching the dissenting votes on the Executive Board closely for indications of a shift in consensus.

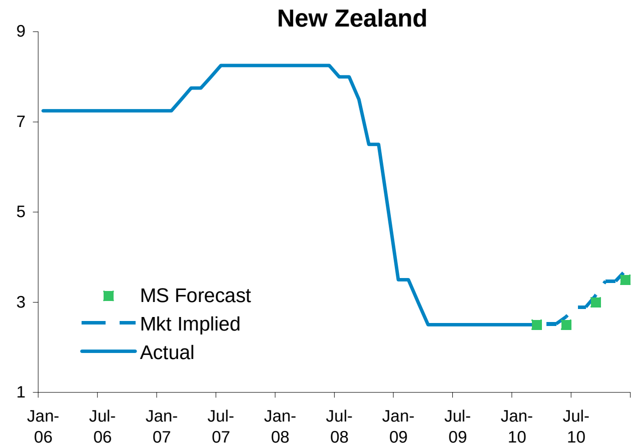
- Our forecast for this year's terminal rate is slightly above market expectations.
- Norges Bank's dovish outlook indicates downside risks

Source: National Central Banks, Morgan Stanley Research
Notes: (u) = unofficial target; Interest rate expectations are implied by overnight indexed swap (OIS) curves and may differ from those implied by other instruments; where adequate OIS data are not available, FRAs, foreign exchange swaps, and/or interbank cash rate futures are used; due to varying risk premia (such as liquidity, basis, credit, term, reserve management, calendar turns, etc.), these figures should be used as estimates only; where such instruments are not available, we have inserted our best guess of what markets expect based on consensus estimates.

Monetary Policy Outlook – Morgan Stanley versus Markets



- The RBA continues to tighten. We now think that policy is at neutral; further increases will take it to restrictive.
- We expect another 1-2 25bp increases this half-year, but see the RBA on hold through most of 2H10.



- We continue to expect a first rate hike in July, though there is a risk of a hike in June.
- RBNZ guidance has policy rates at or below 2.5% through the latter half of 2010, but this is conditional on inflation.

Source: National Central Banks, Morgan Stanley Research
Notes: (u) = unofficial target; Interest rate expectations are implied by overnight indexed swap (OIS) curves and may differ from those implied by other instruments; where adequate OIS data are not available, FRAs, foreign exchange swaps, and/or interbank cash rate futures are used; due to varying risk premia (such as liquidity, basis, credit, term, reserve management, calendar turns, etc.), these figures should be used as estimates only; where such instruments are not available, we have inserted our best guess of what markets expect based on consensus estimates..

Global Monetary Policy Rate Forecasts

Global Economics Team

	Current	2Q10	3Q10	4Q10	1Q11	2Q11	3Q11	4Q11	Last change (bp)	Since peak/ trough (bp)	Since Dec 06 (bp)
United States	0.125	0.125	0.50	1.50	2.00	2.00	2.00	2.00	-87.5 (16/12/08)	-512.5	-512.5
Euro Area	1.00	1.00	1.00	1.25	1.50	1.75	2.00	2.25	-25 (07/05/09)	-325	-200
Japan	0.10	0.05	0.05	0.05	0.05	0.05	0.05	0.05	-20 (19/12/08)	-40	-40
United Kingdom	0.50	0.50	0.50	0.50	1.00	1.50	1.75	2.00	-50 (05/03/09)	-525	-450
Canada	0.25	0.50	1.25	2.00	2.50	2.75	3.00	3.25	-25 (21/04/09)	-425	-400
Switzerland	0.25	0.25	0.50	1.00	1.25	1.50	1.75	2.00	-50 (11/12/08)	-250	-175
Sweden	0.25	0.25	0.25	0.50	0.75	1.25	1.50	1.75	-25 (01/07/09)	-450	-275
Norway	1.75	2.00	2.25	2.75	3.00	3.25	3.50	3.75	+25 (16/12/09)	+50	-100
Australia	4.25	4.50	4.75	4.75	4.75	5.00	5.00	5.00	+25 (06/04/10)	+125	-200
New Zealand	2.50	2.50	3.00	3.50	3.75	4.00	4.00	4.00	-50 (29/04/09)	-575	-475
Russia	8.25	7.50	7.50	7.50	8.00	8.00	8.50	9.00	-25 (26/03/10)	-475	-275
Poland	3.50	3.50	3.75	4.00	4.25	4.50	4.50	4.50	-25 (24/06/09)	-250	-50
Czech Republic	1.00	1.00	1.25	1.50	2.00	2.25	2.50	2.75	-25 (06/08/09)	-275	-150
Hungary	5.50	5.00	5.00	5.00	5.00	5.25	5.50	5.75	-25 (29/03/10)	-600	-250
Romania	6.50	6.25	6.25	6.25	6.25	6.25	6.25	6.25	-50 (29/03/10)	-375	-225
Turkey	6.50	6.50	7.25	8.00	9.25	9.75	9.75	9.75	-25 (19/11/09)	-1100	-1100
Israel	1.50	2.00	2.75	2.75	3.25	3.50	3.75	4.00	+25 (26/1109)	75.00	-325
UAE	1.00	1.00	1.50	2.50	3.00	3.00	3.00	3.00	-50 (28/01/09)	-425	-425
South Africa	6.50	6.50	6.50	6.50	7.00	7.00	7.00	7.00	-50 (25/03/10)	-550	-250
China	5.31	5.58	5.85	6.12	6.12	6.12	6.12	6.12	-27 (23/12/08)	-216	-81
India	3.50	4.00	4.25	4.50	4.75	5.00	5.25	5.50	+25 (19/03/10)	-250	-250
Hong Kong	0.50	0.50	1.00	2.00	2.50	2.50	2.50	2.50	-100 (17/12/08)	-625	-625
S. Korea	2.00	2.00	2.50	3.00	3.50	3.75	4.00	4.25	-50 (12/02/09)	-325	-250
Taiwan	1.25	1.38	1.50	1.75	2.00	2.13	2.25	2.38	-25 (18/02/09)	-238	-150
Singapore	0.65	0.80	1.00	1.30	1.80	1.80	1.80	1.80	-	-	-
Indonesia	6.50	6.50	7.25	8.00	8.00	8.00	8.00	8.00	-25 (03/08/09)	-300	-325
Malaysia	2.25	2.50	3.00	3.00	3.00	3.00	3.00	3.00	+25 (04/03/10)	-125	-125
Thailand	1.25	1.75	2.25	2.75	3.25	3.75	3.75	3.75	-25 (08/04/09)	-250	-375
Brazil	8.75	9.75	10.25	11.00	12.00	12.00	12.00	12.00	-50 (22/07/09)	-500	-500
Mexico	4.50	4.50	4.50	4.50	5.25	6.00	6.00	6.00	-25 (17/07/09)	-375	-250
Chile	0.50	0.50	0.75	2.00	3.25	4.00	4.00	4.00	-25 (09/07/09)	-775	-475
Peru	1.25	1.25	3.25	4.75	5.00	5.00	5.00	5.00	-75 (06/08/09)	-525	-525
Colombia	3.50	3.50	4.75	5.50	5.50	5.50	5.50	5.50	-50 (23/11/09)	-650	-550
Global Policy Rate	2.1	2.1	2.3	2.7	3.0	3.2	3.3	3.4			
std. deviation	2.9	2.6	2.6	2.6	2.7	2.7	2.7	2.7			
# countries above	15	14	17	19	18	19	19	19			
# countries below	17	18	15	13	14	13	13	13			
G10 Policy Rate	0.5	0.6	0.7	1.3	1.6	1.8	1.9	2.0			
std. deviation	1.4	1.4	1.5	1.4	1.4	1.4	1.4	1.4			
# countries above	3	3	4	4	4	4	5	7			
# countries below	6	6	5	5	5	5	4	2			

Source: National Central Banks, Morgan Stanley Research
Note: Global policy rates are GDP weighted averages of national policy rates

Global GDP and Inflation Forecasts

	GDP			CPI		
	2009E	2010E	2011E	2009E	2010E	2011E
GLOBAL	**-1.0**	**4.4**	**4.0**	**2.0**	**3.3**	**3.4**
G10	**-3.4**	**2.2**	**2.1**	**0.0**	**1.4**	**1.8**
United States	-2.4	3.2	2.8	-0.3	1.8	2.3
Euro Area	-4.0	0.9	1.1	0.4	1.3	1.8
Germany	-5.0	1.4	1.2	0.3	1.0	1.4
France	-2.2	1.4	1.4	0.1	1.4	1.7
Italy	-5.0	0.7	1.1	0.8	1.1	1.4
Spain	-3.6	-0.7	0.8	-0.3	1.1	1.4
Japan	-5.2	1.8	1.6	-1.3	-0.9	-0.2
United Kingdom	-5.0	1.0	1.2	2.2	2.7	1.5
Canada	-2.6	3.4	3.0	0.3	1.9	1.9
Sweden	-4.9	1.5	2.3	-0.3	1.5	1.9
Australia	1.1	3.0	4.4	1.8	2.1	2.4
Emerging Markets	**1.9**	**7.1**	**6.0**	**4.4**	**5.4**	**5.2**
CEEMEA	**-5.6**	**3.8**	**3.0**	**8.1**	**5.9**	**6.4**
Russia	-7.9	5.3	2.8	11.7	6.5	8.7
Poland	1.7	3.3	2.7	3.5	2.2	2.6
Czech Republic	-4.2	1.1	2.1	1.0	1.3	1.9
Hungary	-6.2	-0.9	1.7	4.2	4.3	3.0
Romania	-7.1	1.1	2.9	5.6	4.8	4.3
Ukraine	-15.0	4.5	3.0	16.0	12.1	14.2
Turkey	-5.0	4.0	4.2	6.3	9.2	5.8
Israel	0.7	3.7	3.2	3.3	2.5	2.4
UAE	-4.8	1.0	2.6	1.7	0.4	1.5
South Africa	-1.7	3.0	3.6	7.2	5.2	5.0
Asia ex Japan	**5.8**	**8.9**	**7.8**	**2.4**	**4.6**	**4.1**
China	8.7	11.0	9.0	-0.7	3.2	3.5
India	6.4	8.5	8.4	10.8	10.1	6.7
Hong Kong	-2.7	4.5	3.5	0.5	2.8	2.5
Korea	0.2	5.0	4.3	2.8	3.3	3.0
Taiwan	-1.9	4.6	3.7	-0.9	0.5	2.0
Singapore	-2.0	5.0	5.0	0.4	2.9	1.3
Indonesia	4.6	5.5	6.3	4.8	6.0	6.5
Malaysia	-1.7	4.8	4.8	0.6	1.7	1.9
Thailand	-2.3	4.6	4.8	-0.8	3.3	3.0
Latin America	**-1.9**	**4.9**	**3.7**	**6.2**	**7.0**	**7.4**
Brazil	-0.2	5.8	4.0	4.9	5.0	5.5
Mexico	-6.5	5.2	3.3	5.3	4.8	3.6
Chile	-1.5	5.0	4.4	1.5	1.2	2.4
Peru	0.9	4.9	5.5	2.9	1.1	2.5
Colombia	0.5	4.1	3.8	4.2	2.9	2.9
Argentina	0.9	4.6	2.4	5.2	10.5	10.7
Venezuela	-1.9	0.3	3.5	27.1	34.7	41.8

Source: National Statistics Offices, IMF, Morgan Stanley Research estimates

Note: Figures in parenthesis indicate the country's or region's weight (in %) in global GDP, using PPPs.

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