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Global

Outlook

The Global Monetary Analyst

Debtflation Temptation

We expect public and private sector leverage to be an important constraint on central banks' ability to deliver price stability going forward. The temptation to inflate away debt – debtflation temptation – depends on several factors; some of the most important ones are: the public (and private) debt overhang; the average maturity of outstanding government debt; the proportion of debt held abroad; the proportion of foreign currency-denominated debt; and the proportion of inflation-proof debt. On the basis of these metrics, we find the temptation to inflate to be higher in the US and the UK than in the euro-zone – if monetary policy is conducted for the 'average' euro-zone member – and lowest in Japan. p 2

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Key Central Bank Risk Events

Date	Country	Event
05 Apr	**Chile**	Monetary policy minutes
06 Apr	**Australia**	Rate decision: Expect on hold
06 Apr	**United States**	FOMC minutes
06 Apr	**Indonesia**	Rate decision: Expect on hold
07 Apr	**Japan**	Rate decision: Expect on hold
08 Apr	**Euro Area**	Rate decision: Expect on hold
08 Apr	**UK**	Rate decision: Expect on hold
08 Apr	**Norway**	Gov Gjedrem speech
09 Apr	**Korea**	Rate decision: Expect on hold

What's Changed?

	Forecast Changes Since Last Week
US	GDP: 2.5% in 1Q10 (prev. 2.6%)
UK	CPI: 2.7% in 2010 (prev. 2.5%)
Russia	Policy rates: 8.25% end-1Q10 (prev. 8%)
Hungary	Policy rates: 5, 5.75% end-4Q10, 4Q11 (prev. 5.5, 6%)
Romania	Policy rates: 6.25% end-2Q10 (prev. 6.5%)
Israel	Policy rates: 1.5% end-1Q10 (prev. 1.25%)
S. Africa	Policy rates: 6.5, 7% end-4Q10, 4Q11 (prev. 7, 8%)
Singapore	Policy rates: 0.65% end-1Q10 (prev. 0.7%)

Where Do We Differ Most from the Market?

Fed expected to raise rates by more than markets expect (page 16)
BoJ expected to cut rates in 2Q10, markets expect no cuts (page 16)
Riksbank expected to raise rates by less than markets expect (page 17)
RBA expected to raise rates by less than markets expect (page 18)

Debtflation Temptation

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- We expect public and private sector leverage to be an important constraint on central banks' ability to deliver price stability going forward.
- The temptation to inflate away debt – debtflation temptation – depends on several factors; some of the most important ones are: the public (and private) debt overhang; the average maturity of outstanding government debt; the proportion of debt held abroad; the proportion of foreign currency-denominated debt; and the proportion of inflation-proof debt.
- On the basis of these metrics, we find the temptation to inflate to be higher in the US and the UK than in the euro-zone – if monetary policy is conducted for the 'average' euro-zone member – and lowest in Japan.

We have argued for some time now that there are substantial upside risks to the medium-term inflation trajectory globally. One of the main reasons – but not the only one – is the dire fiscal outlook in developed economies. We think that central banks may generate, allow or acquiesce to higher inflation in order to help overlevered public – but also private – sectors with their debt burdens: debtflation. A rational, forward-looking central bank may decide to generate or live with a controlled amount of higher inflation now, rather than find itself in a more difficult position a few years down the line because of unsustainable debt evolutions.

Regular readers will be familiar with the 'debtflation debate' – see *The Global Monetary Analyst: Debtflation*, October 21, 2009, *The Global Monetary Analyst: The Return of Debtflation?* February 10, 2010, and *The Global Monetary Analyst: Debating Debtflation*, March 3, 2010, for our arguments and *US Economics: We Can't Inflate Our Way Out*, Richard Berner, February 19, 2010, and *The Global Monetary Analyst: Default or Inflate or…*, Gerard Minack, February 23, 2010, for pushback from our colleagues. Irrespective of where one stands on this debate, we think that a look at the laundry list of some of the most important factors regarding the temptation to inflate is instructive.

The obvious metric is of course the total amount of public debt – the higher, the bigger the incentive to inflate. This is borne out by ample historical and statistical evidence on the link between sovereign fiscal positions and inflation. But there are further factors which determine the incentive to inflate: the average duration/maturity of the debt; the currency denomination of the debt; the share of domestic versus foreign ownership; and the proportion of inflation-proof debt in the total amount of outstanding debt. This is how each of these factors affects the incentive to inflate:

- **Public debt overhang:** The higher the outstanding amount of government debt, the greater the burden of servicing it. Hence, *the temptation to inflate increases with the debt*.
- **Maturity of the debt:** The longer the maturity of the debt, the easier it is for a government to reduce the real costs of debt service. To take an extreme example, if the maturity of the debt is zero – i.e., the entire stock of debt rolls every period – then it would be impossible to reduce the debt burden if yields respond immediately and fully to higher inflation. Hence, *the longer the maturity of the debt, the greater the temptation to inflate*.
- **Currency denomination of the debt:** Own currency debt can be inflated away easily. Foreign currency-denominated debt on the other hand cannot be inflated away. Worse, the currency depreciation that will be the likely consequence of higher inflation would make it more difficult to repay foreign currency debt: government tax revenues are in domestic currency, and the domestic currency would be worth less in foreign currency. So, *the temptation to inflate increases with the share of debt denominated in domestic currency*.
- **Foreign versus domestic ownership of debt:** The ownership of debt determines who will be affected by higher inflation. The higher the foreign ownership, the less will the fall in the real value of government debt affect domestic residents. This matters not least because only domestic residents vote in elections. Note that unlike domestic owners, foreign owners may not necessarily be interested in the real value of government debt since they consume goods in their own country. But they will nonetheless be affected by the inflation-induced depreciation. So, *the temptation to inflate increases with the share of foreign ownership of the debt*.
- **Proportion of debt indexed to inflation:** By construction, indexed debt cannot be inflated away. Hence, *the higher the proportion of debt that is indexed to inflation, the lower the temptation to inflate*.

To these purely fiscal arguments we add another dimension; private sector indebtedness:

- **Private sector debt overhang:** An overlevered private sector may generate macroeconomic fragility and pose a threat to public balance sheets. Hence, *high private debt also increases the incentive to inflate.*

We have compiled data on these factors in Exhibit 4 at the end of the article for the US, UK, Japan and some euro area sovereigns. We also look at past inflation performance, measured by average and peak inflation rates for the period 1960-2008. These are – admittedly rough – proxies for the attitude towards inflation in the respective societies. How do these countries compare on our metrics?

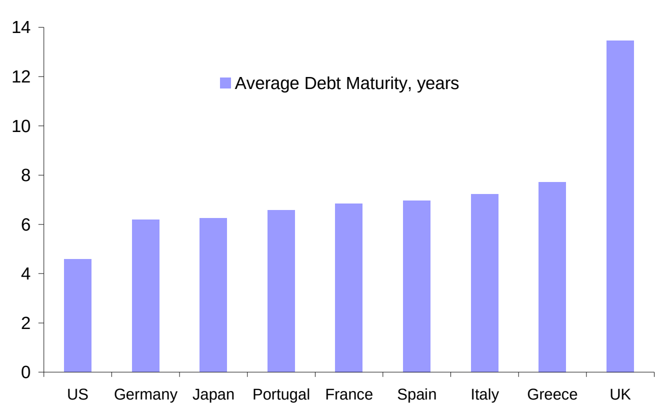
The public debt situation is familiar and requires no elaboration that the euro area as a whole has a similar level of gross debt as the US and the UK – though the average masks the familiar core-periphery divide in sovereign balance sheets.

On the private debt front, the standouts for household indebtedness are the US and the UK (as well as euro-zone members Spain and Portugal). Japan has highly levered corporates, both financial and non-financial, while the UK has a highly indebted financial sector. Euro area corporates are more indebted than US corporates. Overall, high levels of debt, to the extent that they indicate macroeconomic fragility and a threat to public sector balance sheets, are a problem everywhere in the G4 economies. Taking into account both public and private sector balance sheets, the temptation to inflate is substantial in all these economies.

There is also little to separate the countries in our sample with respect to currency denomination. All have debt that is almost in its entirety denominated in their own currency. In terms of the average maturity of the debt, the UK is a clear outlier at 13.5 years – suggesting a significant temptation to inflate (see Exhibit 1).

Exhibit 1

Longer Debt Maturity Increases Incentive to Inflate

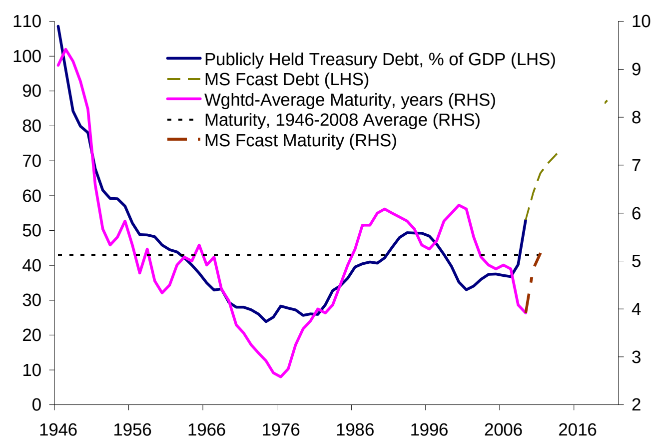


Source: Debt Offices, Bloomberg

In the US, on the other hand, the outstanding maturity is the lowest in our sample. However, average maturity of Treasury debt is set to rise quickly to post-war average levels on our US team's forecasts – and possibly beyond, if the historically strong positive correlation between the debt ratio and average maturity is anything to go by (see Exhibit 2).

Exhibit 2

Maturity of US Treasury Debt Short, but Increasing



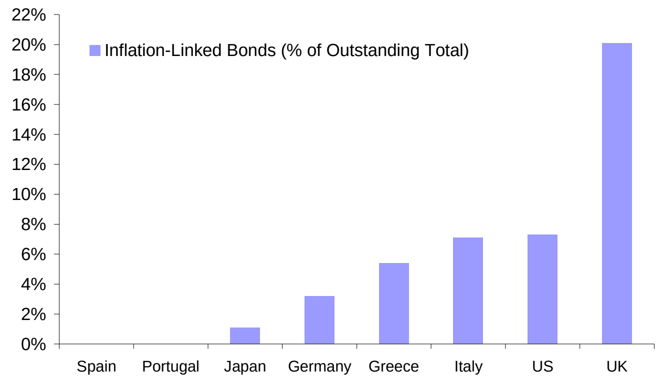
Source: US Treasury, Aizenman and Marion (2009), Morgan Stanley Research estimates

With regards to foreign ownership of debt, the euro area sovereigns have a very high degree of foreign ownership. However, because of cross-euro area holdings, what matters in this context is the share of debt held outside the euro area rather than outside an individual euro area country. Even though we have no hard data to back this up, anecdotal evidence suggests that most of the government debt is held within the euro area – due to the high degree of financial market integration. This would moderate any temptation to inflate, since euro area sovereign debt is mostly held within the euro area. Leaving the euro area aside, the US has the highest proportion of foreign-owned debt (nearly 50%) – a reflection of the dollar's global reserve currency status – and Japan the lowest (around 7%), with the UK somewhere in the middle (28%). Bearing in mind the caveat about the euro area, the US certainly stands out along this dimension of inflation temptation.

Finally, the proportion of debt indexed to inflation is low in Japan, the euro-zone and the US but very high in the UK, where inflation-proof debt makes up 20% of total debt. This provides an important counterweight to the debtflation temptation arising from high debt and ultra-long debt maturities (see Exhibit 3).

Exhibit 3

Temptation to Inflate Decreases with Share of Inflation-Proof Debt



Source: Debt Offices, Bloomberg

So, which economies stand out with respect to overall inflation temptation? We think the temptation is higher in the US and the UK than in the euro-zone – if the ECB conducts monetary policy for the average – and lowest in Japan. Here's why:

From our bird's eye view of the numbers, Japan probably has the worst balance sheet, followed by the UK and the US – assuming that what matters for the euro-zone is the average and not its weakest link(s). On the other hand, Japan's public debt is mostly held domestically and its debt maturity is relatively short. These factors moderate the temptation to inflate arising from high public and private indebtedness. Indeed, the fact that the Japanese economy as a whole is a net foreign creditor to the tune of 50% of its GDP[1] is another indication that much of the leverage of individual sectors is debt held by other domestic sectors – public debt for example being held by households and financial institutions. This means that the temptation to inflate is ultimately very low, despite high leverage.

The euro-zone seems to occupy the middle ground in our inverse beauty contest on just about all metrics. Risks to (price) stability for the euro area arise to the extent that the average masks some vulnerable economies. For example, there have been calls recently for the ECB to generate higher inflation because this would help the struggling periphery: expansionary policy would stimulate demand, and regaining competitiveness for the peripherals would require fewer outright nominal wage cuts. The incentive to inflate for the ECB would, in our view, arise to the extent that it perceives higher inflation to be conducive to rebalancing the euro-zone; this would make a hypothetical break-up less likely, thereby preserving the status – or even the very existence – of the Frankfurt institution. We attach a very low probability to this scenario, however, not least because the institutional set-up of the ECB ensures that no particular (group of) countries' interests prevail.

How about the US and the UK? We've already noted that both public and private sectors are highly levered. In the US, foreign ownership of public debt is very high, and the share of inflation-proof debt is relatively low (though higher than any of the euro area countries in our sample) – factors favourable to inflation. Debt maturity is short by international standards, but rising quickly towards the US historical average – and possibly beyond, if the historical correlation between debt and maturity is anything to go by (see Exhibit 2). In the UK, debt maturity is very long but the share of inflation-proof debt is elevated. However, the UK has had a much worse inflation performance historically: average and peak inflation rates have been substantially higher than in the US. Overall, while the temptation to inflate in the two countries is higher than in the euro-zone or Japan, it is difficult to distinguish between the two.

Of course, our list of factors is far from exhaustive. In particular, it does not capture the 'soft' aspects of the problem. Reputation is clearly a factor in this context. A reputation for stability – in the central bank context this means achieving low inflation on a sustained basis – takes a long time to build but very little to lose. This speaks against inflation as a course of action for central banks.

How about timing – when are we likely to see inflation if the risks were to materialise? Clearly, variations in the pace of cyclical recovery imply a different near-term inflation outlook for different economies. Our US team expects the inflation outlook to start turning towards the middle of the year; in the euro area, inflation will likely remain subdued for a while longer, given the tepid recovery; and Japan will likely remain mired in deflation for some time. Hence, inflation is unlikely to become a near-term worry. Returning to our debtflation framework, incentives also suggest that it is too early for the authorities to generate inflation. Some clients have pushed back – and we agree – that, for practical purposes, the duration of debt is shorter than meets the eye because large current deficits mean large immediate financing needs. From a strict 'rational debtflation' point of view, the optimal timing for inflation would be when the bulk of borrowing is behind us (and maturities are longer in the US). On our forecasts, deficits will be slow to come down (see *Global Forecast Snapshots: What Fiscal Tightening?* March 10, 2010). Hence, inflation may still be a good 2-3 years off. But if we are right about output gaps being smaller than commonly appreciated, or if strong EM economies put pressure on commodity prices, then inflation may appear sooner than many think.

[1]IMF data (International Financial Statistics), 2008.

Exhibit 4

Debtflation Temptation: Factors Determining the Temptation to Inflate

	Gross general govt. debt (% of GDP)	Private sector leverage (% of GDP)			Past inflation performance, CPI (%), 1960-2008		Average maturity of outstanding govt. debt (yrs)	Proportion of govt. debt held abroad	Proportion of govt. debt in foreign currency	Proportion of inflation-indexed govt. debt
		H'holds	Non-fin. corp.	Fin. corp.	Average	Peak				
US	83.9	95.6	77.7	112.8	4.2	13.5	4.6	51.4%	0.0%	7.3%
UK	71.0	106.6	87.5	235.4	5.8	24.2	13.5	28.3%	0.0%	20.10%
Japan	189.3	76.4	141.6	187.4	3.5	23.2	6.3	7%	7.0%	1.10%
Euro Area	81.8	63.8	101.3	118.5	–	–	–	–	–	–
- Germany	77.4	63.6	65.3	101.6	2.9	7.0	6.2	51%	0.6%	3.2%
- France	84.5	51.7	109.2	103.6	4.8	13.7	6.9	46%	0.0%	N/A
- Italy	123.6	48.9	84.2	93.4	6.8	21.1	7.2	42%	2.9%	7.1%
- Spain	59.3	85.4	137.2	62.7	7.6	24.5	7.0	59%	1.4%	0.0%
- Portugal	83.8	95.9	133.2	40.2	9.9	33.1	6.6	73%	0.3%	0.0%
- Greece	114.9	50.5	62.4	5.6	9.8	26.5	7.7	63%	0.4%	5.4%

Source: OECD, Statistical Offices, IMF, Debt Offices, US Treasury, Bloomberg

Inflation Target Monitor & Next Rate Move

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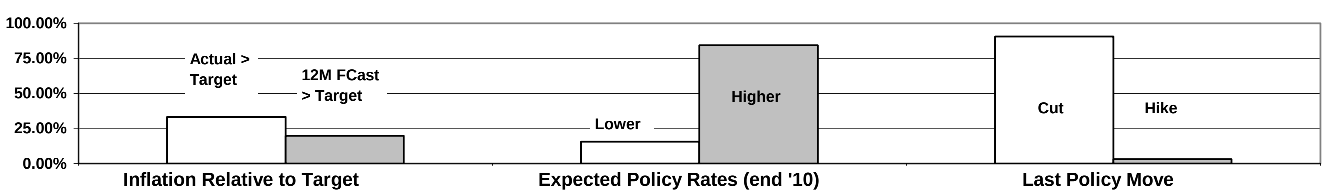
	Inflation target	Latest Month	12M MS FCast	Next Rate Decision	Current Rate	Market Expects (bp)	MS Expects (bp)	Risks to our call
United States	1.7-2.0% PCE Price Index	1.3%	1.8%	28 Apr	**0.125**	2	0	Extremely dovish language should start to change in April
Euro Area	< 2% HICP (u)	0.9%	1.9%	08 Apr	**1.00**	0	0	EONIA to stay below refi rate until July
Japan	0-2% CPI (u)	-1.2%	-0.3%	07 Apr	**0.10**	0	0	-
United Kingdom	2% CPI	3.0%	1.6%	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**	1	0	Weaker-than-expected US demand is main d'side risk
Switzerland	<2% CPI (u)	0.1%	0.4%	17 Jun	**0.25**	3	0	-
Sweden	2.0% CPI	1.2%	1.5%	20 Apr	**0.25**	3	0	Balanced
Norway	2.5% CPI	3.0%	2.5%	05 May	**1.75**	12	25	Very close call between May and June hike
Australia	2-3% over the cycle	2.1%	1.9%	06 Apr	**4.00**	16	0	An increase
New Zealand	1-3% CPI	2.0%	1.8%	29 Apr	**2.50**	3	0	Very low risk of a hike
Russia	none	7.2%	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	10.1%	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 further 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%	2.8%	-	**0.50**	-	0	Premature US tightening upon global inflation uptick
S. Korea	2-4% CPI	2.7%	3.3%	09 Apr	**2.00**	-	0	Political influence may delay rate hike cycle
Taiwan	-	2.4%	2.0%	25 Jun	**1.25**	-	12.5	Bigger rate hike possible on excessive liquidity
Singapore	1.5% (long-term CPI) (u)	1.0%	2.9%	01 Apr	**0.65**	-	NA	Changes in the FFTR and SGD appreciation pace
Indonesia	5% +/- 1.0%	3.8%	6.0%	06 Apr	**6.50**	-	0	Evenly balanced
Malaysia	-	1.2%	1.7%	13 May	**2.25**	-	+25	Evenly balanced
Thailand	0.5-3.0% core CPI	3.7%	3.3%	21 Apr	**1.25**	-	+25	Evenly balanced
Brazil	4.5% +/-2.0% IPCA	4.8%	4.7%	28 Apr	**8.75**	0	0	Start of hiking cycle is matter of time
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	**8.875**	-	-	-
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%	07 May	**1.25**	-	0	-
Colombia	3% +/-1% CPI	2.1%	4.2%	30 Apr	**3.50**	-	0	-

(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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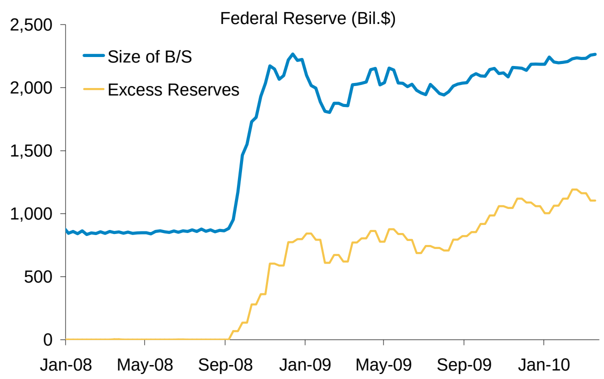
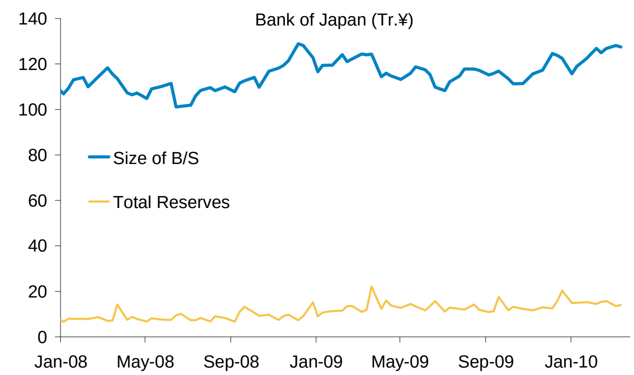
US



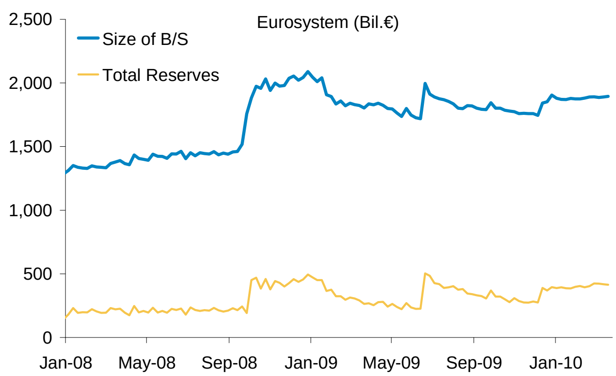
Source: Haver Analytics

Japan



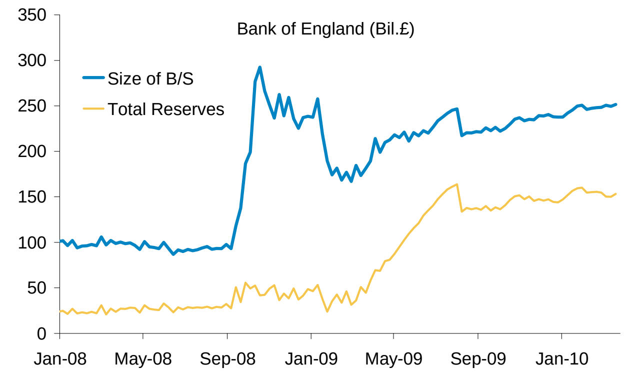
Source: Haver Analytics

Europe



Source: Haver Analytics

UK



Source: Haver Analytics

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US: Reiterating the Case for Higher Real Rates

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Sticking to our guns: We reiterate our call for higher real rates. We expect real 10-year Treasury yields to rise above 3% and nominal yields to rise to 5.5% by year-end. Key factors we expect: (1) Heavy Treasury coupon issuance will run up against a revival in private credit demand. (2) Fiscal and inflation uncertainty will boost bond risk premiums. (3) A renewed rise in inflation expectations will trigger a change in Fed rhetoric and action.

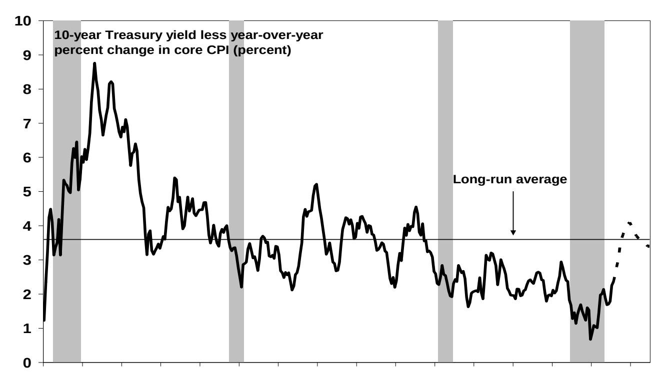
Key drivers falling into place: Treasury supply is starting to weigh on bond prices as concerns are growing that healthcare reform and other spending will add to budget deficits; companies are on the cusp of accumulating inventory; consumer credit appears to be stabilising; and slack in the economy and housing markets is ebbing.

Checklist for the market: Slightly less onerous Treasury borrowing reflects stronger-than-expected tax receipts. Bank lending to consumers is still falling but such footings probably understate credit demands. Inflation and fiscal policy uncertainty seems to be rising; term premiums are rising and market volatility appears to have bottomed.

Checklist for the Fed: For our call to work, we also need clear signals – persistently rising inflation expectations, evidence that the economy is growing sustainably above trend, and a shift in the inflation outlook – that will turn Fed rhetoric hawkish. Distant-forward breakevens appear to be rising and signs of stronger growth are emerging.

For details, see *US Economics: Reiterating the Case for Higher Real Rates*, March 26, 2010.

US: Real Rates Heading to 3%+



Note: March 2010-December 2011 values represent Morgan Stanley Research estimates.
Source: Federal Reserve Board, Bureau of Labor Statistics, Morgan Stanley Research

Euro Area: The Sovereign Crisis and the Euro

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Sovereign risk crisis is key investment theme for 2010 and beyond: Two important decisions came through late last week. First, the euro-zone created a ‘lender of last resort’ facility for sovereign borrowers. The facility combines IMF lending and bilateral intergovernmental loans. But before the facility can be used, all other means (such as market funding) have to be exhausted. The actual disbursement of funds still needs a unanimous decision of all euro area governments. Second, the ECB announced that it would leave its broader collateral pool, which comprises securities with credit ratings up to BBB-, in place in 2011 (previously it had planned to revert to A- at end-2010). To protect its balance sheet, the ECB will announce a haircut schedule next week. The decision removes the potential cliff-effect at year-end for banks holding Greek government bonds and funding them at the ECB. It also defuses, at least for now, a political minefield for the ECB.

These decisions remove the short-term liquidity risk, i.e., the risk of a government not being able to roll over its debt: Hence, the market will not be able to force a euro area government into default. However, the solvency risk, relating to whether a country can carry its debt load in the long run, remains. Greece is in a unique situation in terms of debt, deficit and demographic time-bomb. Greece has not managed to reduce its debt, not even when it was bailed out by the EU in the mid-1980s. Next year, it will face an even tougher environment: the redemptions will be bigger, the economy weaker, and unemployment higher. Yet, the government has to push through additional austerity measures. For now, however, once the redemptions in April and May are out of the way, Greece will likely enter calmer waters. And markets will focus on other countries: the UK, where a general election is to be held on May 6, and Spain, which faces €30 billion of redemptions in July.

Europe is trailing in terms of growth, and there are concerns that the crisis will force drastic fiscal tightening: With the exception of a few small countries, this is unlikely, in our view. We see at most a modest fiscal tightening this year and next. On our estimates, total tightening in the euro area this year will be about one-third of a percent, and next year close to 1%. That said, the need for fiscal tightening is one reason behind our below-consensus forecast for growth of 1.1% next year.

Japan: A Turning Point in Prices?

Takehiro Sato (81 3) 5424 5367

Accelerated year-on-year fall in underlying prices comes to a halt: The nationwide core CPI hit bottom last August, at -2.4%Y, but we now think the steep downtrend in underlying prices excluding energy has also come to a halt, though we expect the improvement to be a slow process.

What’s changed: Reviewing the core-of-core (our definition of underlying prices), the February nationwide core-of-core was -1.36%Y (+0.07pp in year-on-year growth) and the March Tokyo metropolitan figure was -1.48% (-0.07pp). While these point in different directions, both seem to have bottomed, the nationwide in January 2010 and Tokyo metro in December 2009. Also, the February US-style core indicates that the nationwide figure (-1.1%Y versus -1.2% last month) showed some improvement from record declines last month, and so did the March Tokyo metro (-1.2% versus -1.3%). Further, the February 10% trimmed-mean estimator was at -0.95%Y (+0.07pp month to month), in which the nationwide figure continued to improve from the -1.17% bottom in November 2009. Note that the BoJ focuses on this to indicate basic price trends.

Pricing by purchasing frequency: Items purchased at least 15 times per year (mainly food) fell 1.1%Y (January: -2.0%), and items purchased fewer than 5 times per year (mainly consumer durables) were down 2.4% (January: -2.9%), indicating that the accelerated year-on-year fall has come to a halt in December 2009-January 2010. We think the downward pressure of lower wages on prices of daily items has cycled through for now, as also suggested by some anecdotal evidence. That said, we still see makers and retailers far from being able to aim for profits through price hikes.

Outlook on prices: We look for the nationwide US-style core CPI to push even deeper in 1H10, to around -1.5%Y, given the impact of various institutional factors on prices – such as free high school tuitions from April – though we think that underlying prices excluding such institutional factors may have bottomed in January, at around -1.4%Y. Ahead, we look for a slower year-on-year decline, at a 3-4-quarter lag to the improvement in the output gap. Prices continue to be relatively insensitive to fluctuations in the output gap, and thus we expect underlying prices to turn to year-on-year growth no sooner than by end-2013. That said, we now look to have passed the turning point of the underlying prices in terms of year-on-year margins, which may well have some impact on the market sentiment.

Russia: Stronger RUB, GDP and Lower Rates

Oliver Weeks (44 20) 7677 6302

CBR board meeting cut rates 25bp: The overnight repo rate was cut to 5.5% on March 26. At the same time, the CBR took the decision to resume overnight deposit operations at 2.75%. Our forecast was for a 50bp cut in the overnight repo rate, but the recent stabilisation of the RUB strengthened arguments for a 25bp cut. The CBR points to the possibility of rising volatility on the domestic exchange rate market, and we see significant further scope for medium-term RUB strength. The next meeting is set for April. We expect more rate cuts to come in 2Q10 (75bp in total), with the CBR keeping the reference rate at 7.50% until end-2010. CPI growth in the third week of March slowed to 0.1% on Rosstat's preliminary estimate, leaving the full-month reading on track to slow to around 6.4%Y, from 7.2%Y in February. We continue to see short-term cost pressure on inflation as very low, with wholesale food prices subdued and industrial unit labour cost growth negative, but see long-term risks building as money supply growth accelerates and domestic liquidity remains abundant.

February growth slow, but risks still to upside, in our view: Although February output growth surprised us on the downside, with the Economy Ministry estimating monthly GDP down 0.9% on a seasonally adjusted basis, we still see upside risks to our 5.3% real GDP growth forecast. We expect Rosstat's publication of 4Q09 real GDP data to come with revisions to 1Q-3Q. The current profile and the 4Q growth implied by the annual release of -7.9% imply a very strong carryover of around 5% into 2010. We expect 1Q to be revised stronger and 4Q weaker, slightly reducing this, but still pointing to upside risks to our 2010 forecast. We remain much more cautious on 2011, still at 2.8% growth, as fiscal and likely monetary tightening finally begin, and temporary drivers such as inventory and gas production normalisation fade.

Still more bullish RUB: We have also revised still stronger our end-2010 RUB forecast against the basket, from 33.0 to 31.0. We continue to expect strong appreciation pressure from the BoP this year, though much less in 2011. If, as we expect, the EUR continues to weaken against the USD, and the RMB is revalued, appreciation against the basket can be achieved with less movement on the more sensitive RUBUSD and RUBRMB axes. Stronger GDP data will also likely temporarily weaken political resistance to appreciation. The Finance Ministry is already assuming RUBUSD at 28.0 in its revenue assumptions. We expect appreciation, but not enough to prevent inflation rebounding in 2011.

Poland: NBP Watch – On Hold, Neutral Bias Stays

Pasquale Diana (44 20) 7677 4183

The National Bank of Poland kept rates unchanged at 3.50% today, as universally expected: The central bank kept rates unchanged, in line with Morgan Stanley and market views. The official statement did not contain major surprises: the broad global macro discussion added that: "negative consequences of those (expansionary) policies, mostly related to debt accumulation, are becoming increasingly visible". On domestic macro, the statement noted weaker-than-expected growth in 1Q10, as suggested by recent retail sales and construction data. It added, however, that adverse weather may have played a role.

Still in neutral bias, for a while: The MPC kept its neutral bias, saying that the probabilities of above and below-target inflation in the medium term are balanced. The sentence (present in February statement) on the improvement in global macro activity and previous policy easing returning to economy to potential growth was dropped, but we do not think that this is a material change. On the margin, it may signal that there are some incremental growth concerns, but this is not obvious from the statement. The concluding paragraph mentioned some rather obscure "resolution changing the resolution on creating and unwinding provisions against the FX risk of the zloty against foreign currencies at the NBP". This probably refers to changes in the FX 'risk reserves' by the central bank, which, as things stand, reduce overall NBP profit. Governor Skrzypek estimates NBP profits at PLN 4.2 billion in 2009, but these changes (which he fought against) would in all likelihood boost the share of NBP profits that can be appropriated by the MoF. While exact magnitudes are unclear, the battle between the MoF and NBP (Skrzypek and other PiS appointees in particular) continues, with the latter fighting against greater disbursement of NBP profit to the government.

Rates on hold for several months to come: Tentative signs that growth is easing and continued aversion to fast-paced PLN gains argue against a change in language any time soon. We would therefore expect a continuation of the current neutral bias in the coming months. Late summer (after CPI has troughed and starts heading back up) is the most likely time to get the first hike this year, in our view (50bp in total in 2010).

Czech Republic: On Hold, with Dovish Undertones

Pasquale Diana (44 20) 7677 4183

'On hold' decision with a more dovish tone: The CNB board voted 4-2 in favour of the motion, with two dissenters voting for a 25bp cut. Mr. Holman, who was absent, would have probably voted to keep rates on hold, we think. Note that at the February meeting, the bank had voted unanimously to keep rates unchanged and Governor Tuma had mentioned that the next move would likely be a hike. There was a subtle but clear change at this meeting towards a more dovish tone: the governor said that, while he still expects rates on hold and tightening in 2H as a baseline scenario, he can also imagine a scenario in which the next move is a cut. This scenario (another cut) would have been less likely six weeks ago.

In February, inflation risks were balanced overall: At last week's meeting, they were described as "slightly to the downside". This is essentially because near-term inflation is tracking a bit lower than forecast. Also, 4Q GDP was a bit softer than expected. The bank continues to neglect the wage data for now (higher than expected in 4Q09), as it believes that it is due to changes in the employment structure (i.e., layoffs of low-paid workers), rather than 'true' wage pressure. Risk to the implied rate trajectory is also down, due to the change in the outlook for foreign rates compared to the February forecast.

Tuma mentioned that no significant attention was paid to CZK at the meeting: At the same time, appreciation was noted, but the governor observed that it was over a "relatively short period of time". If this persisted, Tuma added, it would move risks further towards an anti-inflationary direction. Note that at 25.3 versus EUR, the koruna is broadly where the bank expects it to be at year-end (clearly, the EUR is weaker than expected versus USD, so this is not true on a trade-weighted basis). This is why a move stronger in CZK would increase downside risks relative to the CNB forecast of inflation and rates. Following our Prague trip, we downgraded our 2010 rate hike expectations from 100bp to 50bp, starting in 3Q. Last week's decision and tone is consistent with our recently revised view, we think.

Hungary: A More Dovish NBH Suggests Rates Can Go Lower

Pasquale Diana (44 20) 7677 4183

The NBH cut rates by 25bp, to 5.50%, and left the door wide open to more easing: In line with expectations, the NBH reduced interest rates to 5.50%, which was also the terminal point in our forecast. Two elements though introduced a clear dovish element to the March 29 decision. First, the NBH statement removed the reference to a reduced scope for manoeuvre. Recall that last month the statement read "the Council judges that the room for manoeuvre in interest rate policy has narrowed, due to increased uncertainty in international financial markets". This reference was omitted from the March statement, which only said that "even if justified by the outlook for inflation and the economy, interest rates may only be reduced further if changes in perceptions of risks associated in the economy allow it". In addition, while we saw some risks of a 50bp cut, we were rather surprised to see that the decision between 25 and 50bp was "tight", according to Simor (nobody voted for unchanged rates this time). The minutes will be published on April 14.

More easing in store: While we always thought that worries of a contagion from Greece to CEE were exaggerated (see "Greece and CEE Contagion", *MS CEEMEA Macro Monitor*, February 15, 2010), we were genuinely surprised by not only the resilience, but also the improvement in Hungary's risk indicators (CDS spreads, FX, yields). Simor touched on the very same points in the press conference, and our sense is that, provided we can hold onto these levels, more easing is likely. As the NBH noted, the CPI and GDP outlook certainly suggest that further rate cuts are warranted. Also, those who favoured a larger cut are unlikely to move to a neutral stance any time soon. The elections next month are not an issue for the MPC, said Simor, as long as the new government does not take decisions that influence the economic outlook, which we think is unlikely until the summer at the earliest.

We revise our rate call lower, and see the trough at 5%: We see further easing ahead, with rates likely to fall to around 5% (or possibly even a touch lower). This is a call that incorporates our strategy team's constructive view on risk appetite in the near term, but also the chance of a meaningful correction in 2Q (see *Macro Strategy Update: Timing a Spring Fall*, March 29, 2010). Further out, we think that the NBH is overestimating the scope for disinflation in the months ahead, and this will ultimately push the central bank to reassess its CPI forecast later this year. But at present, barring a significant near-term correction in risky assets, there does not seem to be anything major in the way between the NBH and further rate cuts.

Romania: The NBR Brings Rates to a Record-Low of 6.50%

Pasquale Diana (44 20) 7677 4183

The National Bank of Romania cut the policy rate by 50bp to a record-low 6.50% on March 29: This was in line with our and consensus expectations, though some local analysts predicted a smaller cut. The bank also left the minimum reserve requirements on both RON and FX unchanged, at 15% and 25%, respectively. This rate cut brings total easing in this cycle to 375bp. Note that Romania started easing 1-2 quarters later than its CEE peers, and generally from a much higher level of rates; it is therefore in the process of 'catching down' to official rates elsewhere.

The statement noted slowing inflation, RON gains: As expected, the statement noted that adjusted core inflation (i.e., CPI excluding administered and volatile prices, alcohol and tobacco) has continued to ease; the NBR added that an appreciating leu is helping the disinflation process; there are some signs of improvement in private consumption and exports (this is new), but credit dynamics remain in negative territory. The bank also noted with some concern that despite an improvement in banking sector liquidity and the recent NBR cuts, deposit and loan rates have remained relatively high, i.e., the transmission mechanism is rather weak.

More rate easing likely, but we are not far from the trough: The next meeting will be on May 4, and will coincide with the publication of the new Inflation Report. We are now very close to our long-standing call of rates reaching 6.25% or lower by the summer, and if the risk environment stays positive, we may even breach 6%. However, note that, with inflation unlikely to fall below 4.0-4.5% in our forecast, real rates are already at around 2%, a level that is already quite stimulative for the economy. Also, inflation does not have much further to fall, in our view. Given how tightly linked the rate outlook is to the CPI outlook in Romania, this is another reason why rates are probably not massively away from the trough, we think.

Turkey: CBT Not in a Hurry to Tighten Anytime Soon

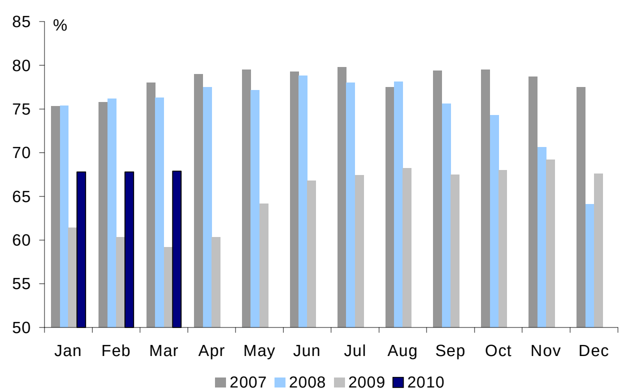
Tevfik Aksoy (44 20) 7677 6917

Low capacity usage… Recent data still show that capacity utilisation in the manufacturing sector remains weak at below 70%. Since mid-2009, capacity usage had been stuck at around 67-68%, an indication of no meaningful pick-up in external or domestic demand.

…keeps central bank comfortable with the inflation outlook: While the downside risk associated with the excess capacity would be lower growth potential in the short term, the persistence of the output gap is likely to keep the central bank more or less comfortable with the inflation outlook. That said, despite some marginal improvement in inflation expectations as reported by the CBT, the credibility gap (i.e., the difference between the central bank's inflation target and the consensus inflation expectation) remained substantially high. In line with our year-end forecast of 8.1%Y for CPI inflation, the consensus expectation is 8.06% (down from 8.17% from early March), but the 12-month forward looking expectations stand at 7.2%Y, followed by 6.8%Y for the 24-month horizon. We expect CPI inflation (which stood at 10.1%Y as of end-February) to ease marginally to mid-9% due to base effects and some slowdown in food prices. However, we expect inflation to remain in the 9-10% band for most of 2010.

CBT is in no hurry to tighten: In its latest assessment of the inflation and rates outlook, the CBT made it clear that it would be in no hurry to tighten monetary policy, which we concur with. We maintain our stance and expect monetary tightening to take place in the form of a hike in the reserve requirement ratio before actually seeing a hike in the policy rates. We maintain our view that the CBT will raise rates by 150bp during the course of 2H10.

Turkey: Excess Capacity or Lack of Utilisation?



Source: CBT, Morgan Stanley Research

Israel: A Hike a Month Earlier than Expected

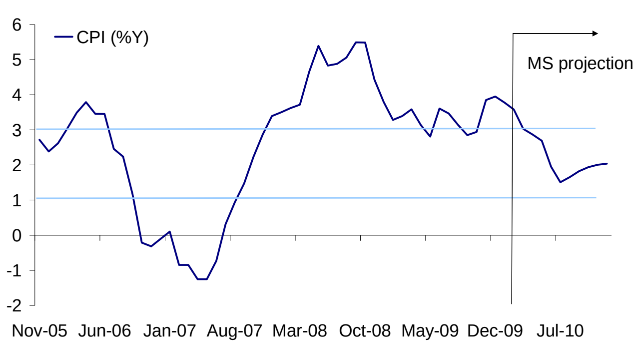
Tevfik Aksoy (44 20) 7677 6917

Policy rate hiked by 25bp to 1.50%: The move was a month earlier than we had expected, but we believe that Governor Fischer did the right thing by moving ahead with the monetary tightening in order to allay concerns surrounding inflationary pressures – anticipated to return amid strengthening in the economy. As we mentioned in *CEEMEA Macro Monitor*, March 29, 2010, inflation is likely to enter the official target range soon: A series of positive surprises on the inflation front over the past few months led to a noticeable decline on an annual basis, despite the presence of strong base effects. From a high of nearly 4% at end-2009, inflation eased to 3.6% in February, and we expect it to ease to 3% and finally enter the target zone. In the absence of a shock in food prices and/or the currency, we expect CPI inflation to trend lower to around 1.5%Y in mid-2010 and not rise above 2% until year-end.

Tightening will likely continue, but maybe not sequentially: The BoI is likely to feel no pressure to hike from an inflationary point of view, especially in the near term. However, as demand conditions strengthen, especially on the domestic front, the possible overheating in the economy might jeopardise the benign inflation outlook. While short-term inflation expectations remain inside the target band, they are still close to the upper limit. We expect the monetary tightening to continue, but it is quite likely that it will not be in a sequential form.

We maintain our view that the BoI will have to tighten monetary policy and rates will be 2.75% at year-end: While this remains our forecast, we need to point out that the risks seem to be on the downside as Governor Fischer is likely to maintain the rates differential broadly in check with other central banks, especially the Fed, and avoid taking any risks of applying the brakes prematurely.

Israel: Inflation to Enter the Target Range Soon



Source: Haver, Morgan Stanley Research projections

South Africa: SARB Cuts 50bp

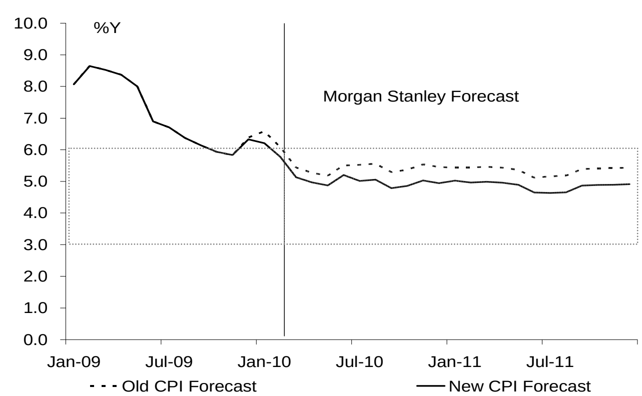
Michael Kafe, CFA (27 11) 507 0891

Improved inflation outlook ushers in 50bp rate cut: The South African Reserve Bank (SARB) cut its policy repo rate by 50bp to 6.50% on March 25. This was contrary to consensus expectations but was not entirely surprising to us (see *South Africa: Policy Rates to Fall Further?* February 25, 2010). In our opinion, this was the right thing to do, given the consistent downside surprises in inflation, and the fact that even the most conservative assumptions on food and energy prices still pointed towards an acceptable inflation outcome. The MPC statement confirmed that the policy outcome was motivated by lower electricity tariffs at the municipality level, "favourable food price developments as well as lower-than-expected inflation outcomes".

Easier money unlikely to stoke inflation risks: As we had pointed out in the above note, "the SARB's own modelling suggests that each 100bp cut in policy rates stimulates inflation by no more than 0.4pp over the policy horizon. A 50bp cut in an environment of weak pricing power appears tolerable to us". We therefore welcome the SARB's admission that "the improved inflation environment has provided some space for an additional monetary stimulus to reinforce the sustainability of the upswing without jeopardising the achievement of the inflation target".

Further downside inflation surprises likely: The SARB expects inflation to reach a low point of 4.9%Y only in 3Q10. While we also have a 3Q10 average forecast of 4.9%Y, we see a dip to 4.8%Y as early as next month (see *South Africa: Insurance Costs Prop Up February CPI*, March 24, 2010). Hence, we believe that there could be further downside inflation surprises in store for the SARB.

South Africa: Old versus New CPI Forecasts



Source: Census and Statistics Department, CEIC, Morgan Stanley Research

Asia-Pacific: Strong Growth Trend to Continue Even as Policy-Induced Demand Moderates

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Gradual policy exit has begun: India, Malaysia and Vietnam have already initiated their policy rate hike cycle. We expect China, Taiwan and Thailand to follow soon before mid-2010. We forecast average policy rates to rise to 5.4% by end-December 2010 from the current 4.5%. We continue to see this as normalisation from highly accommodative monetary conditions, rather than tightening.

Some moderation in policy-induced discretionary spending ahead: A strong fiscal and monetary policy response was most evident in discretionary consumption, property and public spending on infrastructure investments. While fiscal- and administrative-related measures to control the property market have already resulted in the moderation of transactions, we believe that the rate hike cycle, removal of tax benefits and reduced transfers by the government to households would result in further moderation in discretionary spending ahead.

Exports to cross pre-crisis levels soon: On a three-month moving average basis, seasonally adjusted exports by China, Korea, Singapore, Taiwan and Thailand, as of February 2010, are just 3% below peak levels of July 2008, compared to 7% and 10% during the previous two months.

Rising capacity utilisation to revive private capex ahead: We expect private corporate capex to recover in 2010, led by India, Korea and Indonesia, which should compensate for any slowdown in policy-induced discretionary spending, sustaining strong overall domestic demand in 2010.

Inflation risk skewed to the upside: We assign a 70% probability to our base forecasts, 20% to a high inflation scenario, and 10% to a low inflation scenario. A combination of strong domestic demand, a faster-than-anticipated rise in external demand and slow policy exit could lead us to the high-inflation scenario of 6.0%Y in 2010 versus our base case forecast of 4.6%.

For details, see *Asia-Pacific Economics: Strong Growth Trend to Continue Even as Policy-Induced Demand Moderates*, March 25, 2010.

China: Inflation Tracker

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Milder CPI inflation in March: After incorporating the price data of the week (March 22-28) into our model, we expect March CPI inflation to contract by 0.4pp on the month-on-month sequential base, leading to growth of +2.5%Y versus +2.7%Y February. Both food and non-food inflation fell from the seasonal high created by CNY in February. In contrast to a softening CPI, PPI keeps gaining momentum and we expect it to leap to +6.8%Y in March (versus +5.4%Y in February). Carryover effects in March explain 1.1pp and 4.3pp of CPI and PPI inflation, respectively.

Continued weakness in edible agricultural food (EAF) prices (week-over-week): The slackness in edible agricultural food prices has lasted for five consecutive weeks after sliding 0.13%W last week. This should help to soothe the worries that the heavy drought in southwestern China will drive up food inflation significantly. The evolution of the sub-categories continued the trend of the previous week of ‘non-crop products down, crop products up’. Meat, aquatic and edible oils fell 1.3%, 0.4% and 0.1%, respectively, while eggs and poultry slid 0.3% each. Vegetables, grains and fruits rose 0.5%, 0.5% and 0.3%, respectively.

Upstream inflation escalated (week-on-week): The upward momentum of producer product prices remained strong by growing +1.2%W last week. Except for 0.4% of decline of non-ferrous metals, all other major producer commodities were marked up. Probably spurred by the news that Japanese steel producers have accepted the almost 100% price increase of iron ore, mineral products and ferrous metals led the upstream inflation by growing +3.9% and +2.1%, respectively.

Inflation outlook: The yield gap between 10-yr and 1-yr T-bonds, a proxy for inflation expectation of the market, remained tame in recent weeks. We reiterate our view that the heavy drought in southwestern China should have a limited impact on the headline inflation, given its relatively secondary position in the country’s food supply system.

The first quarterly monetary policy meeting after the fresh appointment of three non-government-background scholars was held yesterday. Although no official announcement was released after that, we believe that more voices from the academia should help to improve the manoeuvrability of monetary policy of the central bank, especially when the PBoC is facing extremely complex macroeconomic environments domestically and abroad this year.

Taiwan: Sticking to Loose Monetary Conditions; Asset Prices Continue to Be Supported

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No change in interest rate: The CBC's 1Q monetary policy meeting on March 25 was slightly more dovish than we thought. In line with our and consensus expectations, the bank kept its policy rediscount rate unchanged at an historical low of 1.25%. It cited high unemployment, uncertainty over global growth, a mild recovery in domestic demand and mild inflation as reasons to keep rates on hold. In our view, liquidity conditions in Taiwan should remain abundant, inflation expectations could rise and asset prices should be supported.

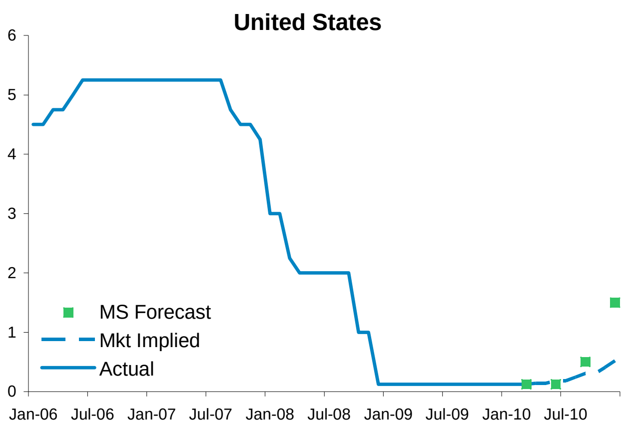
No change in the required reserve ratio (RRR): This came as a surprise to us and many others. We had believed that the CBC would hike the RRR this year to reverse the cut in September 2008 following Lehman's collapse. We believe that RRR hikes should not hurt the real economy, as Taiwanese banks are still flooded with liquid reserves. Also, raising the RRR could serve as a tightening signal to the public and help to anchor inflation expectations.

Yet, the CBC will continue to drain liquidity through open market operations: The bank announced that it will issue longer-maturity NCDs or CDs to drain excess liquidity. NCD issuance is a more costly measure than RRR hikes to drain liquidity as the CBC pays more interest on NCDs than on required reserves. Since 4Q09, the CBC has been draining liquidity through daily open market operations. The outstanding amount of NCDs has been rising since October, meaning that the bank has been issuing more NCDs to absorb liquidity.

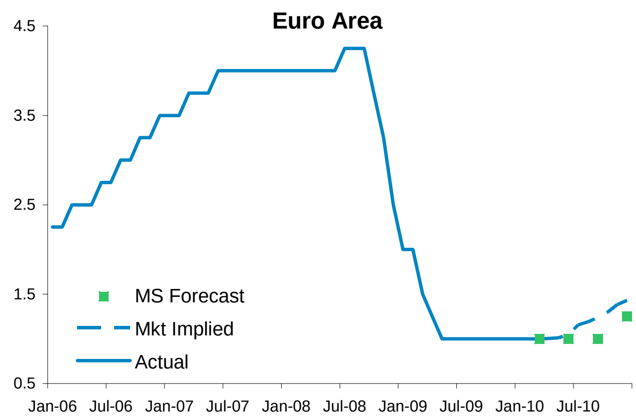
No new property measures announced: We were surprised that the CBC only reiterated its measures taken in the past few months, which were more of verbal warnings, in our view. We believe that they may not be enough to offset the investment appetite due to the loose monetary conditions.

Updating our interest rate forecasts: We still expect mild and gradual normalisation of monetary policy over this year and the CBC to raise rates at its 2Q meeting at end-June, by a mild 12.5bp. If it does not hike in 2Q, then it will need to wait until 3Q, i.e., end-September, at which time the CBC may fall behind the curve as we expect most central banks in the region to begin their rate hikes in 2Q. We now change our interest rate forecast to a total 50bp hike in 2010 to bring the rediscount rate to 1.75% by year-end. It should take some time for Taiwan's interest rate to return to neutral levels. Meanwhile, RRR hikes are still likely in the rest of the year.

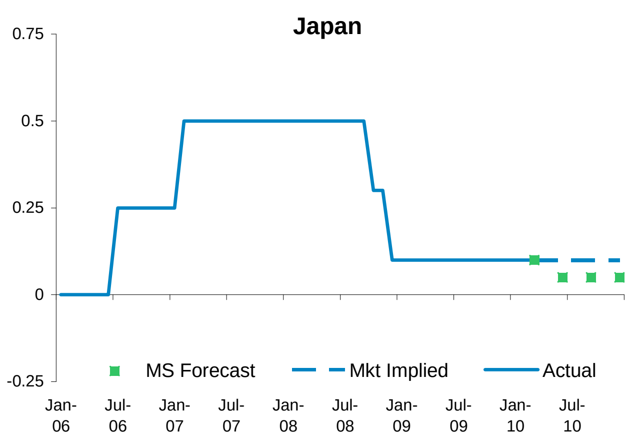
Monetary Policy Outlook – Morgan Stanley versus Markets



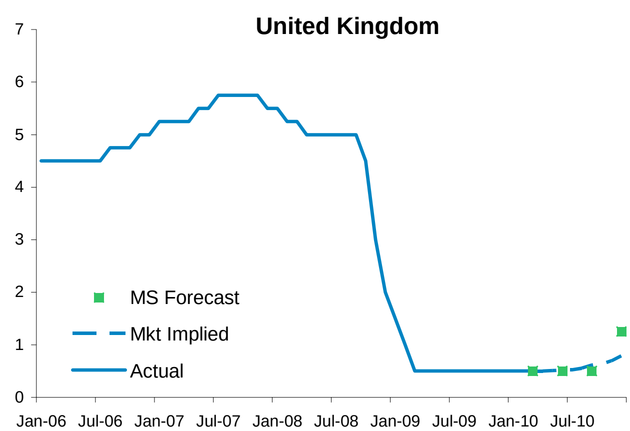
- We expect reverse repos and term deposits to add to SFP reserve draining in summer.
- Rate hikes should begin in 3Q, and we expect a much more aggressive start to tightening than the market is pricing in.



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



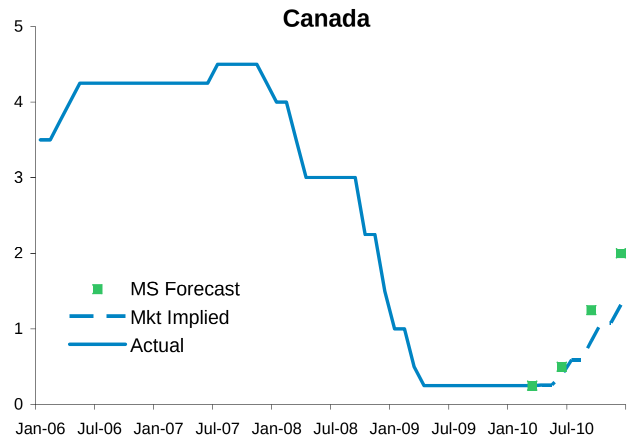
- The government has made beating deflation its priority, and we believe tightening is unlikely to be a discussion item this year.
- We pushed back the expected timing of exit by six months from Jul-Sep 2011 to Jan-Mar 2012.



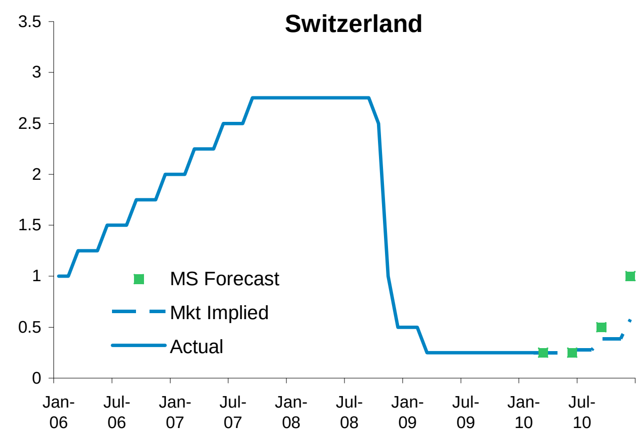
- We think that the MPC will start raising rates in late 2010. Markets seem to be pricing in a similar outcome.
- Fiscal policy decisions and the election will likely complicate decisions on timing/pace.

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.

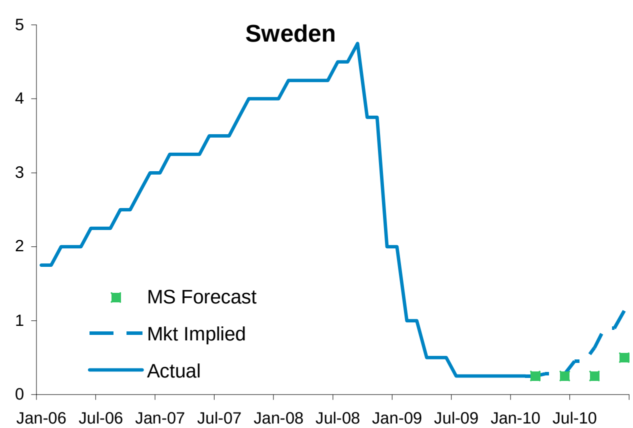
Monetary Policy Outlook – Morgan Stanley versus Markets



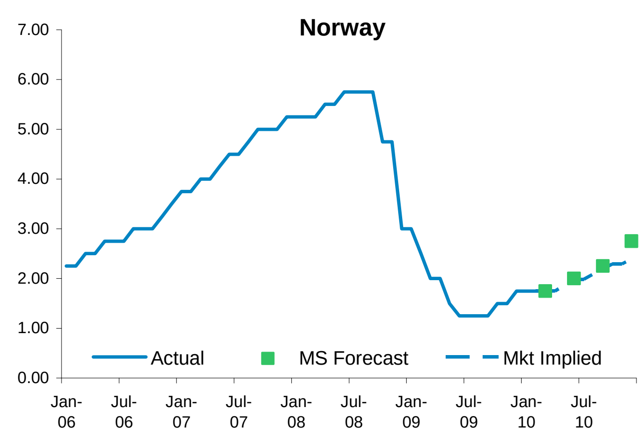
- The risks to both growth and inflation lie north of the Bank of Canada's forecasts.
- We believe the BoC will need to begin removing accommodative policy sooner rather than later. We forecast a rate hike in June 2010.



- 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.



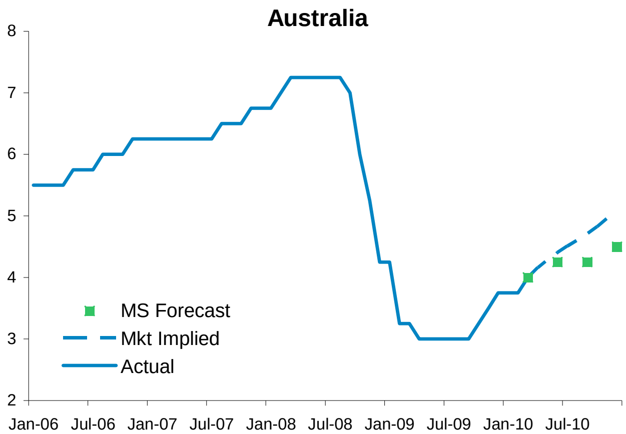
- Marked downside risks to the Riksbank's growth forecasts push first rate rise back into the autumn.
- Watching the dissenting votes on the Executive Board closely for indications of a shift in consensus.



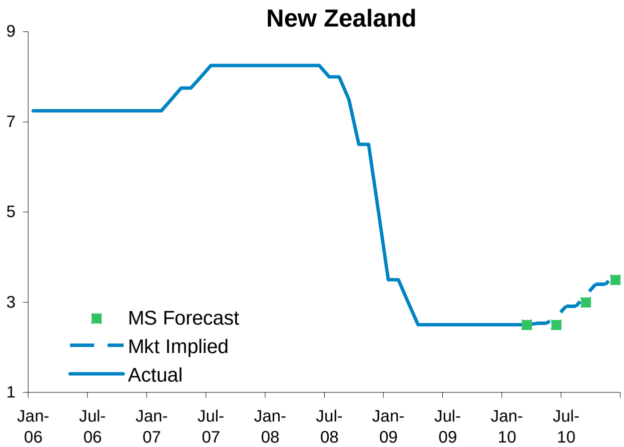
- Our forecast for this year's terminal rate is slightly above market expectations.
- Norges Bank's dovish outlook indicates downside risks.

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



- RBA resumed tightening, but we doubt that it is planning to tighten at consecutive meetings going forward.
- We expect another 1-2 25bp increases this half-year, but see the RBA on hold through most of 2H.



- 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	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	3Q11	4Q11	Last change (bp)	Since peak/ trough (bp)	Since Dec 06 (bp)
United States	0.125	0.125	0.125	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	1.00	1.25	1.50	1.75	2.00	2.25	-25 (07/05/09)	-325	-200
Japan	0.10	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	1.25	1.50	1.75	2.00	2.25	-50 (05/03/09)	-525	-450
Canada	0.25	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	0.25	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	0.25	0.50	0.75	1.25	1.50	1.75	-25 (01/07/09)	-450	-275
Norway	1.75	1.75	2.00	2.25	2.75	3.00	3.25	3.50	3.75	+25 (16/12/09)	+50	-100
Australia	4.00	4.00	4.25	4.25	4.50	4.50	4.50	4.75	4.75	+25 (03/03/10)	+100	-225
New Zealand	2.50	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	8.25	7.50	7.50	7.50	8.00	8.00	8.50	9.00	-25 (26/03/10)	-450	-250
Poland	3.50	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	1.00	1.25	1.50	2.00	2.25	2.50	2.75	-25 (06/08/09)	-275	-150
Hungary	5.50	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	6.50	6.25	6.25	6.25	6.25	6.25	6.25	6.25	-50 (29/03/10)	-375	-200
Turkey	6.50	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	1.50	2.00	2.75	2.75	3.25	3.50	3.75	4.00	+25 (28/03/10)	+75	-325
UAE	1.00	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	6.50	7.00	7.00	7.00	7.00	-50 (25/03/10)	-550	-250
China	5.31	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	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	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	2.00	2.50	3.00	3.50	3.75	4.00	4.25	-50 (12/02/09)	-325	-250
Taiwan	1.25	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	0.65	0.80	1.00	1.30	1.80	1.80	1.80	1.80	-	-	-
Indonesia	6.50	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	2.25	2.50	3.00	3.00	3.00	3.00	3.00	3.00	+25 (04/03/10)	-125	-125
Thailand	1.25	1.25	1.75	2.25	2.75	3.25	3.75	3.75	3.75	-25 (08/04/09)	-250	-375
Brazil	8.75	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	4.50	5.25	6.00	6.00	6.00	-25 (17/07/09)	-375	-250
Chile	0.50	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	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	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	2.0	2.1	2.3	2.8	3.1	3.2	3.3	3.4			
std. deviation	2.9	2.6	2.6	2.6	2.6	2.7	2.7	2.7	2.6			
# countries above	15	14	14	17	16	18	19	19	19			
# countries below	17	18	18	15	16	14	13	13	13			
G10 Policy Rate	0.5	0.5	0.5	0.7	1.3	1.6	1.8	1.9	2.0			
std. deviation	1.3	1.3	1.4	1.3	1.3	1.3	1.3	1.3	1.3			
# countries above	3	3	3	4	4	4	4	6	7			
# countries below	6	6	6	5	5	5	5	3	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**	**1.6**	**1.8**
United States	-2.4	3.2	2.9	-0.3	2.3	2.4
Euro Area	-4.0	0.9	1.1	0.4	1.3	1.8
Germany	-5.0	1.4	1.2	0.3	1.1	1.5
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	1.7
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**	**5.3**	**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	4.5	3.6	-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**	**6.8**	**7.2**
Brazil	-0.2	5.8	4.0	4.9	4.6	5.0
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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