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MORGAN STANLEY RESEARCH

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Global

Outlook

The Global Monetary Analyst

The Great Rebalancing

Global rebalancing has been ongoing. Alan Taylor and Manoj Pradhan point out that there were some harbingers of it before the Great Recession, but the crisis accelerated the process, and we expect it to continue. We expect four key trends to assert themselves: (i) Pent-up investment demand in DM and EM economies to rebound; (ii) EM public saving (aka FX reserves) to grow more slowly; (iii) EM private saving flows should moderate; and (iv) DM saving flows are likely to be flat or falling over the next 18-24 months. The implications we see for the global landscape are threefold: (i) Global rebalancing will continue. The investment rebound and the flattening of the saving rate (especially in EM) imply that the investment drought and the 'global saving glut' of the last decade are likely to be reversed; (ii) EM currencies should appreciate further in real terms with more nominal appreciation along with a continuation of higher inflation in EM economies; and (iii) Global real interest rates should rise in response to the global excess of investment over saving. p 2

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Key Central Bank Risk Events

Date	Country	Event
16 Feb	**US**	FOMC Minutes
17 Feb	**Norway**	Gov. Olsen address to NB Supervisory Council
17 Feb	**Australia**	Speech by RBA Assistant Gov., Philip Lowe
17 Feb	**Chile**	Rates decision: **Expect 25bp hike**
18 Feb	**Sweden**	Riksbank's Nyberg speech in Stockholm
21 Feb	**Hungary**	Rates decision: Expect on-hold
21 Feb	**Israel**	Rates decision: **Expect 25bp hike**
22 Feb	**Euro Area**	ECB publishes Consolidated Financial Statement
23 Feb	**UK**	MPC Minutes
25 Feb	**Colombia**	Rates decision: Expect on-hold

Forecast Changes Since Last Week	
US	GDP tracking est: 3.8% in 1Q11 (prev. 4.4%)
UK	CPI: 3.7% in 2011 (prev. 3.6%)
Turkey	Policy rate: 6.25% in 1Q11 (prev. 6.00%)
Turkey	CPI: 5.4, 5.6% in 2011, 2012 (prev. 6.0, 5.7%)
Poland	CPI: 3.6% in 2011 (prev. 3.4%)
Czech Rep.	CPI: 2.1% in 2011 (prev. 2.3%)
Hungary	CPI: 4.4% in 2011 (prev. 4.0%)
Romania	CPI: 5.5% in 2011 (prev. 5.9%)
Indonesia	CPI: 5.5% in 2012 (prev. 6.5%)

Where Do We Differ Most from the Market?

ECB likely to hike rates later than markets expect (p 17)

For important disclosures, refer to the Disclosures Section, located at the end of this report.

The Great Rebalancing

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We gratefully acknowledge the contribution of Richard Berner and Joachim Fels to this report.

- Global rebalancing has been ongoing. In this note, Alan Taylor and Manoj Pradhan point out that there were some harbingers of it before the Great Recession, but the crisis accelerated the process, and we expect it to continue.
- We expect four key trends to assert themselves: (i) Pent-up investment demand in DM and EM economies to rebound; (ii) EM public saving (aka FX reserves) to grow more slowly; (iii) EM private saving flows should moderate; and (iv) DM saving flows are likely to be flat or falling over the next 18-24 months.
- The implications we see for the global landscape are threefold: (i) Global rebalancing will continue. The investment rebound and the flattening of the saving rate (especially in EM) imply that the investment drought and the 'global saving glut' of the last decade are likely to be reversed; (ii) EM currencies should appreciate further in real terms with more nominal appreciation along with a continuation of higher inflation in EM economies; and (iii) Global real interest rates should rise in response to the global excess of investment over saving.

A more detailed version of this note can also be found in our Emerging Issues publication today.

Global imbalances have been falling. But does this reflect the ongoing impact of the Great Recession, or is it part of a deeper trend? While cyclical factors are apparent, we believe that fundamental drivers are playing a more important part in the global rebalancing story.

Going forward, we expect four key trends: (1) Pent-up DM and EM investment demand will re-surface, though to a lesser extent in DM economies; (2) EM reserves are likely to build at a slower pace once EM central banks feel they have an adequate war chest to protect them; (3) Lower private saving flows in EM economies as strategies to enhance consumption and domestic demand gain traction; and (4) Flat or declining saving flows, even in DM economies. Despite deleveraging, total saving may be flat or falling in the US where deleveraging is more serious, and potentially declining in other DMs.

Global sum of parts – what will it all mean? These trends have major implications, we believe. The slow but steady move from current account deficits to current account surpluses in DM (and vice versa in a large part of the EM world) will likely be accompanied by continued EM currency value appreciation in real terms (i.e., this is likely to happen through a combination of nominal appreciation of currencies as well as a wedge between EM and DM inflation). Finally, global real yields will likely rise as aggregate investment demand booms relative to saving supply.

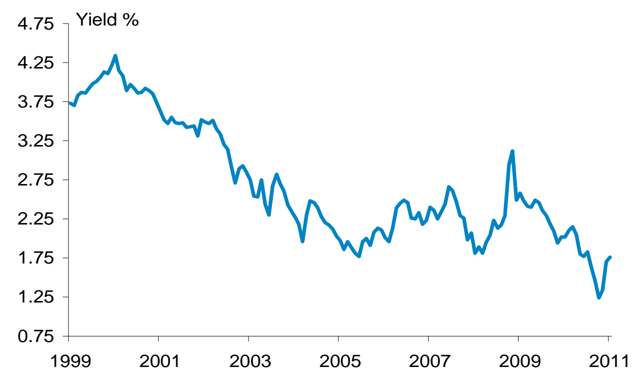
The next global growth cycle. EM will be looking to push ahead with its investment-growth model, and yet change the mix and magnitude of its current safety-first saving model. DM will be looking to reinvigorate and reinvent its investment-growth strategy and delever, but will face structural headwinds.

How Did We Get Here?

Global trends drove real yields lower… The global imbalances of the last 10 to 15 years reflected trends in underlying saving and investment behaviour at the national, regional and global levels. With the majority of coarse capital controls easing worldwide in the 1980s and 1990s, first in DMs and then in EMs, an increasingly integrated global capital market therefore began to reflect aggregate EM and DM saving and investment trends through the equilibrating movement of a global real interest rates. The message from these yields (proxied by inflation-adjusted real yields) was that saving exceeded investment globally, resulting in a steady downtrend in real yields (see Exhibit 1).

Exhibit 1

Real Interest Rates



Source: *WSJ*/Haver

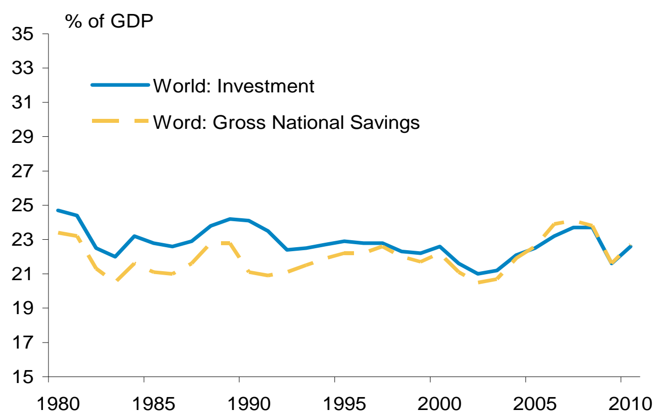
…and exacerbated global imbalances. While both investment and saving worldwide have been on inexorable downward trends since the 1980s, in EM they have been buoyant, and saving has generally been higher, except in the early 1990s (see Exhibit 2). In the DM world, the downtrends in these variables have been sharp, and saving has trended below investment. This resulted in current account surpluses in the excess-saving EM world and current account deficits in the saving-deficient DM world. As the macroweight of DM has been so much larger than that of EM until now, the rising EM saving and investment trends have not yet been outweighed by falling DM trends, but that is already changing.

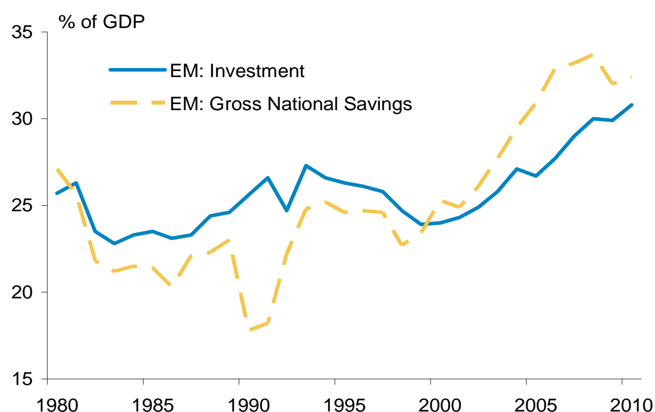
New trends in town. The new trends we outline below will change the global landscape going forward, with implications for global rebalancing, real yields, exchange rate appreciation and inflation.

Exhibit 2

Global Imbalances

Saving and Investment Rates in EM





Note: Differences between world saving and investment are purely due to errors and omissions.
Source: IMF/WEO and Haver

Trend 1: Pent-Up Investment Demand – Trend and Cycle?

The drought is over. We can anticipate upward pressure on investment demand from both the EM and the DM economies. We argue that, in the years ahead, the 'investment drought' epoch of the last 10-15 years may come to an end.

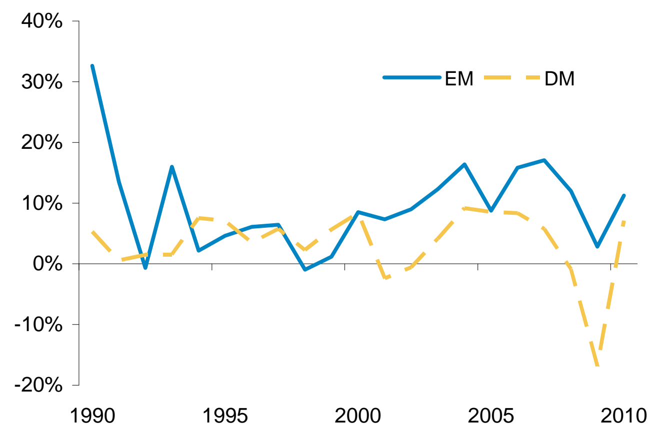
Cyclical rebound. Investment activity was postponed as the uncertainty of the financial crisis made itself felt via a 'real option' as firms took a wait-and-see attitude towards new capex decisions. Now the EM world is in the capex upswing and the DM world is poised to follow. This aspect of the story is essentially cyclical, but given the prolonged depth and length of the Great Recession, it is a phase that may take several years to play out (see Exhibit 3).

Rising share of EM in global investment demand. The EM share of total global dollar-weighted investment rose from 25% in 1980 to 43% in 2009, just as EM dollar-weighted GDP rose from 24% to 31%. As EM economies continue to grow more rapidly than DM, we expect the EM shares to grow further. In a nutshell, DM investment demand will start to matter less, while EM investment demand becomes more important.

Exhibit 3

Severe Investment Downswing

EM and DM aggregate real investment %YoY



Source: Haver Analytics

Trend 2: EM Reserve Accumulation – Beyond the Step Change?

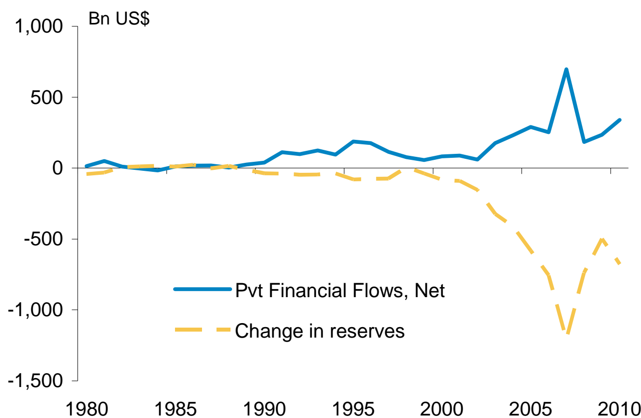
One key trend that has helped to drive the EM region's current account surpluses in recent years has been a high level of public saving, whereby policy-makers accumulated substantial foreign reserves as a 'rainy day' fund.

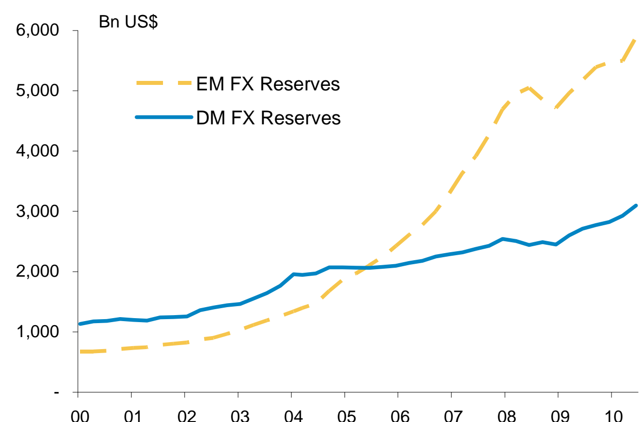
Mother of all war chests. We understand these developments as reflecting a necessary 'step change' in reserve holdings following the unpleasant shocks of the 1990s and 1997 Asian Financial Crisis. EM economies were exposed as woefully lacking in reserves, and so had to rely in a crisis on fickle global capital markets prone to 'sudden stops', or else unsympathetic or inadequate official assistance from the likes of the IMF. The subsequent policy reaction was to steer a course towards 'self insurance', but this would require time and effort to amass the necessary backstop – and it has. Over the past 15 years, this build-up of reserves has overshadowed the seemingly natural 'downhill' direction of capital flows from rich to poor countries (see Exhibit 4).

Exhibit 4

EM Economies, Official Reserves

(a) Flows and (b) Stocks





Source: IMF IFS, Haver

Was this a wise move for the EM economies? FX reserves played a crucial role in demolishing the 'high-beta' price tag of EM investment. Indeed, we have still not seen any manifestation of any form of crisis in the EM world (banking, currency or sovereign) and the rapid recovery of EM growth stands in stark contrast to the sluggish performance of the DM world. This experience will only reinforce the conviction of EM policy-makers regarding the need to keep reserves on hand, for economic as well political reasons.

But how large a pile of reserves is 'enough' to provide this kind of insurance to an EM country? The very fact that all EMs had sufficient reserves on hand to survive the worst global crisis since the 1930s probably tells us as much. The 2008 shocks were a very bad tail event – close to or even on a par with the shocks seen in the Great Depression. *We suspect that EMs have now mostly 'caught up' with where they needed to be in terms of reserves – the pace of accumulation is therefore likely to slow down to keep pace with GDP or M2 growth going forward.* This represents an important insight into the new dynamics of global imbalances going forward: there will be receding pressure on EMs to acquire reserves; that is to say, reduced official sector saving in EM going forward relative to trend.

Trend 3: Lower Private Saving Flows in EM Economies

The lower flow in the build-up of EM public saving is likely to be mirrored in EM private saving flows as well – for very different reasons. There is likely to be a lower precautionary motive for saving due to gradually improving safety nets, financial development, rising wealth, etc. And consumption growth should also find support in demographic trends as many EMs start to confront some of the same aging populations as the DMs. Economic history shows a tendency for saving rates to climb during early phases of development and then peak as countries transition through the middle income stage, and the EM world now finds itself nearing this critical inflection point.

Trend 4: Flat or Declining Saving Flows in DM Economies

In DM, we already see rapid consumer deleveraging, although in some cases the extra saving of the private sector is being offset by additional borrowing in the public sector. This is especially true in the US but less true in Europe, where austerity is now more the norm. However, much of these patterns are cycle-related and not long term, and we might expect most of these adjustments to taper off as recovery takes hold. In order to be convinced, however, we take a closer look at saving in the major developed economies.

Several cross-currents will likely net to a flat US saving picture in next 18-24 months. We expect personal saving as a share of disposable income to rise in 2011 and fall back in 2012 as new fiscal stimulus temporarily adds to saving this year. However, we don't believe that consumer deleveraging is over – far from it. Rather, it can now proceed at a much slower pace. We expect the saving rate to rise to a 7-10% range over time.

The fiscal stimulus should also boost after-tax corporate saving (undistributed corporate profits) in 2011 at the expense of 2012. Apart from that seesaw pattern, however, pre-tax profit margins are flattening, so earnings growth is beginning to converge to growth in nominal GDP. This is a big deal, as the US federal deficit (or dissaving) will likely peak in the current fiscal year, at US$1.3 trillion or 8.9% of GDP, and decline to US$1.15 trillion or 7.1% of GDP in fiscal 2012. Likewise, state and local deficits as measured in the national income accounts have moved into surplus, although the numbers are small (about 0.4% of GDP this year).

Euroland saving declines. In the euro area, where private households have traditionally been much thriftier than their US or UK counterparts, the personal saving rate looks likely to decline slightly over the next year or two. With unemployment having peaked and job prospects improving, households are likely to reduce precautionary saving and consume a larger fraction of their income. Similarly, the corporate sector, which built up large cash balances over the past couple of years, is likely to save less in the next few years as the focus shifts increasingly towards expanding capacity, hiring and returning cash to shareholders through dividends.

Outside the peripheral countries in crisis, we don't see any major fiscal tightening on the horizon. Most governments in Europe are in fairly weak positions domestically, with either slim or no majorities, or major elections on the horizon, which makes it difficult for them to push through tough spending cuts or tax increases, even if they wanted to.

Japan flat. In Japan, the personal saving rate should also decline somewhat this year and next, from 5.8% of disposable income in 2010 to 4.8% next year, on our team's latest forecast. This should be roughly compensated for by lower public dissaving as the budget deficit looks set to shrink.

Global Sum of Parts: What Will it All Mean?

Our three major calls highlight the implications of the great rebalancing story:

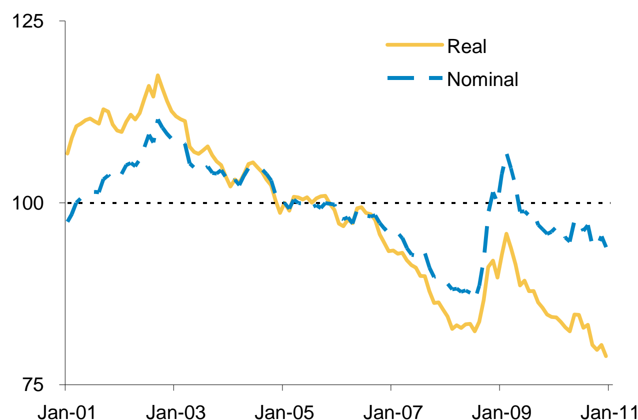
1. Global imbalances should continue to moderate. EMs excess saving (i.e., the excess of saving over investment) is likely to moderate, as their growth dynamics push continued investment demand. The origins of demand will shift from export-led to domestic-driven. National saving will fall as (i) households spend more, with less precaution and more demographic pressure, and (ii) central banks pile up reserves but at a more modest rate. From a longer-run perspective, EMs survived the worst global crisis in 80 years with nothing more than a scare. And with all their backstops in place, we believe that EMs are now positioned to exploit the more robust and less externally dependent growth environment they have created.

In the DMs, the situation is very different, and growth dynamics are more sluggish in the longer term. Investment there should still rebound, and after the urgent deleveraging of the last couple of years we think the augmented saving rate flattens off under demographic pressure and ongoing fiscal policy support. The investment drought and saving glut dynamics of the last decade are therefore likely to reverse.

Exhibit 5

EM Real and Nominal Exchange Rates 2001-10

EM baskets per US basket, decrease = appreciation



Source: Morgan Stanley Research

2. Real EM exchange rates should continue to appreciate… The second call concerns real exchange rates, and it entails a surprise that's more backward- than forward-looking. Despite all the talk that EMs have not been allowing exchange rates to adjust to rein in global imbalances, the data indicate otherwise. Since 2003, real appreciation has been the norm, reversing the prior trend, and we think at a rate that is much larger than productivity alone might suggest (see Exhibit 5). For sure, the crisis and the Great Recession interrupted this aspect of the rebalancing process, via the

transitory flight to the US dollar, but the fundamental drivers that started the rebalancing process since 2004 have proven strong enough to re-initiate the longer-term trend.

This trend is likely to intensify as EM takes a greater weight in the global economy and switches to a less export-led model. Now EM will bid for more DM goods, and the DM currencies will depreciate in real terms to permit this: it will not be, and has not been so far, a so-called immaculate transfer, where global imbalances adjust without corresponding price movements.

…but through a different mix. EM economies could achieve real appreciation in their currency values through nominal appreciation or they could allow inflation to stay above DM inflation (or both). While the overall need for global rebalancing is satisfied by real exchange rates being moved by either nominal exchange rates or inflation, the mix is clearly important for markets. The bulk of the movement in the real exchange rate so far has been more through the inflation channel than the nominal exchange rate channel, but that trend might change. To the extent that nominal currency values appreciate, inflation will have less work to do.

The most likely outcome seems to be a combination of nominal appreciation as well as inflation. But EMs face a perfect storm of added inflationary pressures in the near term, owing to cyclical recoveries being inflationary, and given extra-fast relative growth with an DM-EM two-track recovery, transitory food and raw material price shocks, and the added longer-term forces working through the global rebalancing channel. Given the potential for social and political disruption from high inflation, EM policy-makers may be forced to rethink the inflation-appreciation trade-off. Thus, EM nominal appreciation may be closer at hand, especially among surplus economies with very little slack in the economy (read AXJ), with China likely to be the strategic ‘first mover’ in that bloc.

3. Global real yields to rise. The last 10 to 20 years of global macroeconomic evolution have been characterised by falling real yields, as seen in Exhibit 1. But this remarkably supportive environment of abundant and cheap global capital could be nearing an end. We highlight the confluence of forces and what they mean.

Our first trend was pent-up DM investment demand. Once this capex cycle is eventually unleashed, the cost of capital will rise as DM economies return to growth and compete with EM economies for investible funds, raising the real interest rate, all else equal. Our second trend was a possible tapering off in EM public saving. Should that occur, as the pace of EM reserve accumulation tapers off, then global saving supply moderates and, specifically, the DM government bonds previously absorbed now start to crowd out global investment by raising the real interest rate, all else equal. Our third trend only exacerbates the first and second: private saving is likely to move lower in some EMs as consumers moderate their precautionary tendencies, and we could see expanding private investment in other EMs – with both factors serving to reduce the excess supply of saving. For all three reasons, the real interest rate seems likely to rise.

Thus, our medium-term prediction is for a reversal of all of the notorious macroeconomic and financial tendencies of recent years: no more saving glut or investment drought, no more bond conundrum or cheap capital. In many ways, then, we anticipate something of a return to the pre-2000s normality, with positive and rising global real yields.

Conclusion

The trends we have outlined have very clear implications: we believe that they will lead to further moderation in global imbalances, further real currency appreciation for EM, and higher real interest rates globally. Higher investment and lower saving in the EM world are likely to draw capital there to pursue higher returns. In our view, these sustained capital flows and EM economic outperformance set the stage for further appreciation of EM currencies in nominal and real terms.

Global imbalances have been falling for some time. While cyclical factors have clearly played a role of late, we believe that deeper fundamental drivers are still the more important factors in the global rebalancing story. The trend in real exchange rates is a key supporting point for our thesis.

Finally, we argue that wider investment-saving gaps in the EM as well as DM economies means that competition for loanable funds will be more intense. A direct consequence will be higher real rates. Real rates could also rise because of higher macro risk premia, but we highlight the change in investment and saving trends as a benevolent driver of higher real rates. Importantly, this would represent a break from the 30-year trend of falling investment and the consequent fall in real interest rates.

Given that the rise in real yields will represent an increase in productive capacity in EM and DM economies, rather than a rise in macro risk premia, we believe that higher real yields will not prove disruptive for the global economy and will allow the rebalancing we have mentioned to proceed.

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
US	1.5-2.0% PCE Price index	0.7%	1.5%	15 Mar	**0.125**	0	0	None
Euro Area	< 2% HICP (u)	2.4%	1.6%	03 Mar	**1.00**	2	0	Tilting towards an earlier hike
Japan	0-2% CPI (u)	-0.3%	0.1%	15 Mar	**0.05**	0	0	-
UK	2% CPI	4.0%	2.2%	10 Mar	**0.50**	5	0	May rate rise looking more likely
Canada	1-3% on CPI	2.4%	1.7%	01 Mar	**1.00**	3	25	If CAD strength persists, BoC may slow tightening
Switzerland	<2% CPI (u)	-0.4%	0.6%	17 Mar	**0.25**	1	0	-
Sweden	2.0% CPI	2.3%	1.5%	20 Apr	**1.50**	53	50	Downside risks to April decision
Norway	2.5% CPI	2.0%	NA	16 Mar	**2.00**	5	0	-
Australia	2-3% over the cycle	2.7%	2.4%	01 Mar	**4.75**	0	0	Low risk of any change
New Zealand	1-3% CPI	4.0%	1.8%	10 Mar	**3.00**	0	0	Later hikes possible from dovish RBNZ
Russia	6-7% CPI	9.6%	7.5%	-	**7.75**	0	25	-
Poland	2.5% (+/- 1%) CPI	3.8%	3.3%	02 Mar	**3.75**		25	-
Czech Rep	2.0% (+/-1%) CPI	1.7%	2.5%	24 Mar	**0.75**		0	-
Hungary	3.0% CPI	3.9%	4.4%	21 Feb	**6.00**		0	-
Romania	3.0 (+/-1%) CPI	7.0%	4.4%	29 Mar	**6.25**	-	0	-
Turkey	5.5% CPI end '11	4.9%	6.0%	23 Mar	**6.25**	0	0	CBT might cut
Israel	1-3% CPI	3.6%	2.6%	21 Feb	**2.25**	-	25	BoI might hold
South Africa	3-6% CPI	3.5%	5.3%	24 Mar	**5.50**		0	-
China	-	4.9%	4.5%	-	**6.06**	-	0	Balanced risk
India	NA	8.2%	7.0%	17 Mar	**6.50**	0	25	Low inflation and domestic demand
Hong Kong	-	3.1%	3.8%	-	**0.50**	-	0	Premature US tightening upon global inflation uptick
S. Korea	2-4% CPI	4.1%	3.6%	10 Mar	**2.75**	-	25	Rate could be left unchanged as it was just raised in January
Taiwan	-	1.1%	2.0%	25 Mar	**1.63**	-	12.5	Upside surprise possible with rising inflation pressures
Indonesia	5% +/- 1.0%	7.0%	6.5%	04 Mar	**6.75**	-	25	Evenly balanced
Malaysia	-	2.2%	2.3%	11 Mar	**2.75**	-	0	Evenly balanced
Thailand	0.5-3.0% core CPI	3.0%	3.5%	09 Mar	**2.25**	-	25	Evenly balanced
Brazil	4.5% +/-2.0% IPCA	6.0%	5.2%	02 Mar	**11.25**	50	50	-
Mexico	3% +/-1% CPI	4.4%	3.8%	04 Mar	**4.50**	0	0	Food inflation could prompt hike
Argentina	15.5-24.2% M2 growth	10.6%	10.5%	NA	**9.1**	-	-	-
Chile	3% +/-1% CPI	2.7%	3.3%	17 Feb	**3.25**	25	25	FX strength could lead to another pause
Peru	2% +/-1% CPI	2.2%	2.5%	10 Mar	**3.50**	0	0	Policy tightening in response to scorching recovery
Colombia	3% +/-1% CPI	3.4%	4.7%	25 Feb	**3.00**	0	0	CB underestimating inflation risk as recovery proves stronger

(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. Japan policy rate is an interval of 0.00%-0.10%.

Central Bank Balance Sheet Monitor

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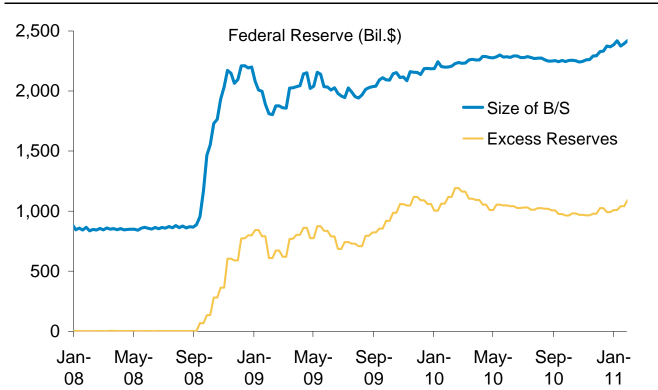
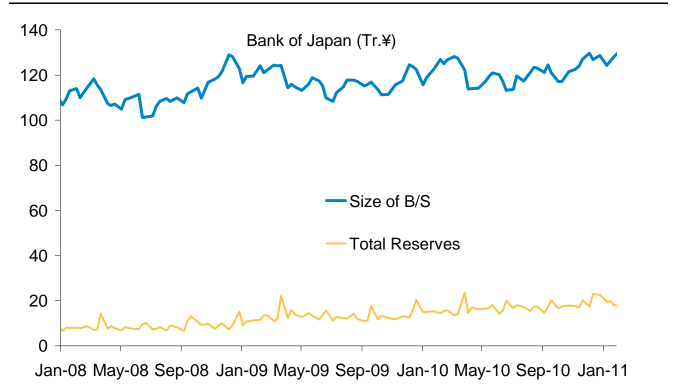
US



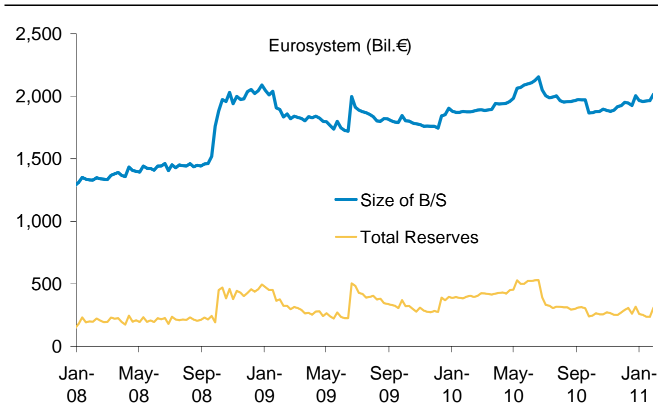
Source: Haver Analytics

Japan



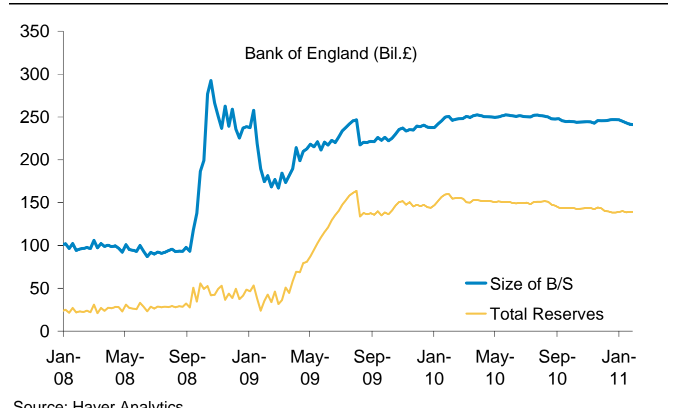
Source: Haver Analytics

Euro Area



Source: Haver Analytics

UK



Source: Haver Analytics

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UK: Inflation: In Line…at 2pp Above Target

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Inflation now 2pp above the BoE's 2.0% target: As expected, January CPI inflation rose to 4.0%Y (in line with our and consensus forecasts). The rise was driven primarily by further increases in petrol prices and likely slightly stronger pass-through of the increase in VAT (compared to last year). Despite yesterday's number coming in line with expectations, our 2011 CPI inflation forecast is one-tenth higher (3.7% from 3.6%). This largely reflects that a month ago we had been expecting inflation in January to come in somewhat lower (we revised up our forecast two weeks ago following higher-than-expected petrol prices in the second half of January). We still think CPI inflation will slow sharply in early 2012 as 2011's VAT rise drops out of the year-on-year comparison. But, as our central case, inflation doesn't fall *below* target at that point. We still think the near-term balance of risk to our forecasts is to the upside and we remain worried about high inflation longer term. The BoE still stands out from other developed economy central banks, with current inflation *well* above target.

Near-term upside risks: We continue to see upside risk to our near-term forecasts: Inflation expectations have risen; there is some evidence of a pick-up in wage settlements; we still see particular upside risks for food and clothing from higher commodity prices; and we expect further VAT pass-through in February, which may be stronger than we expect.

Further out: As some 'temporary' factors such as lagged inflation effects from past sterling depreciation fade, we expect inflation to drift a little lower over most of 2011. However, we continue to think that inflation will not decline below target in early 2012 when the VAT rise rolls out of the year-on-year comparison.

Implications for the MPC: The MPC's near-term inflation forecast (revealed in today's Inflation Report) is substantially higher than it had been (as had been well flagged by the MPC). Over the medium term, its forecasts look consistent with our expectation of two rate rises this year from the BoE. We still expect the first rate rise in August, with a good chance of a rise as early as May. The tone of the Inflation Report and press conference certainty did not suggest, to us, that the BoE was on the verge of an immediate rate rise. The key risk for an earlier rise continues to be sharp pick-up in wage growth, in our view.

For full details on our inflation outlook, see *UK Economics: Inflation: In Line...at 2pp Above Target*, February 15, 2011.

Central Bank Watch

Sweden: Repo Rate Raised to 1.50%

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25bp hike: As expected by us and the market, the Riksbank raised the repo rate by 25bp to 1.50% on February 15. Looking ahead, the Riksbank is forecasting that it will raise the repo rate again by 25bp in 2Q11. Further out, the bank has revised its repo rate profile upwards. The revised profile is in line with our long-standing expectation and what the market has recently priced in. The changed repo rate profile rests on the projection of rising energy and commodity prices currently feeding into inflation as well as on the assumption that resource utilisation remains under control. But, the Board has indicated that if the momentum in commodity prices carries on leading to even higher inflation, the rate path might have to be revised upwards even more. Similarly, the Riksbank has indicated that a further strengthening in the SEK or stronger productivity growth could cause the rate path to be revised downwards. The Riksbank currently forecasts the repo rate at 2.5% at the end of 2011, in line with our own forecasts.

Our expectations are based on the sentiment indicators still pointing towards strong momentum in economic activity, an improvement in the global growth outlook, especially core EMU, rising inflation pressures and, more importantly, the strong momentum of house prices and mortgage debt. Deputy Governor Barbro Wickman-Parak noted recently that the repo rate increases are an effective instrument in managing the growth in household debt. We expect the Riksbank's Executive Board to continue to focus on this issue going forward.

Again, Lars Svensson and Karolina Ekholm entered their dissent against the majority rate decision and repo rate forecast: Their continued dissent suggests that the decision to raise rates was a finely balanced one and the discussion on Board is still leaning towards the dovish side compared to the statement. While Svensson and Ekholm would have preferred a repo rate of 1.25% and a more gradual rise in repo rate path to 3.25% at the end of forecast period, the difference with the majority of the Board who went for 3.55% is small. Their reservations were based on the assumption that such a repo rate path implies CPIF inflation closer to 2% and a faster reduction of unemployment to a longer-run sustainable rate.

The strongest EU growth story: The Riksbank has previously revised its growth forecasts upwards, estimating 5.5% growth in 2010 and forecasting 4.4% in 2011 and 2.4% in 2012. The Riksbank estimates are slightly above our expectations for 2011 and just below for 2012. In addition, the bank has revised up its near-term inflation forecasts markedly, raising its CPI estimate from 2.2% to 2.5% and its underlying inflation projection for CPIF from 1.7% to 1.9% in 2011.

Russia: The Ruble – How High Can it Go?

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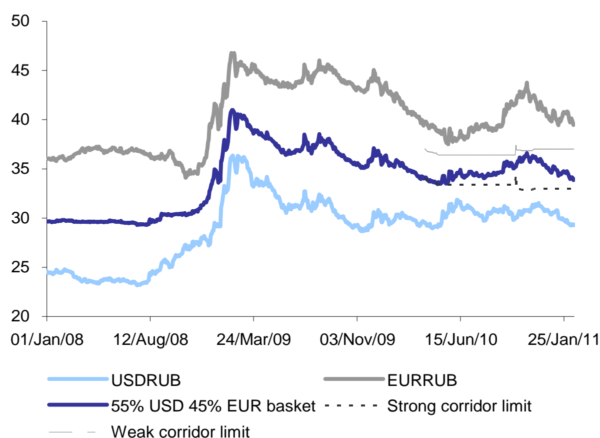
The ruble surpassed our year-end forecast of 34 versus the basket this week: Since November 2010, the ruble has been increasing steadily, fuelled by a rising oil price, and the consequent strong position on the current account. It has risen against the basket to 33.95, a rise of 7% in nominal terms and 11% in real terms.

We still expect the ruble at 34 to the basket by end-2011, implying a slight further 3.5% real appreciation, given different inflation rates. Based on balance of payments fundamentals and central bank statements, we do not see a strong reason to change this call. Total reserve accumulation in the year to February 4 was only US$7.6 billion, or about half what we expected from the forecast US$40 billion 1Q current account surplus. This implies ongoing capital outflows offsetting the current account. The CBR does not like excessive short-term volatility in the exchange rate, and will we think increasingly lean against the rate as it rises closer to the edge of the intervention band of 33.

We expect a 25bp hike in the deposit rate with high conviction, a 50-100bp hike in reserve requirements and a 25bp hike to all other active policy rates (repo, refinancing) in February: Our call is that the CBR will tighten further at the policy meeting at the end of February, given inflation well above target, robust recent indicators of growth and hawkish language.

For full details, see *Russia Economics: The Ruble – How High Can It Go?* February 16, 2011.

Russia: EURUSD Basket Approaches Strong Corridor Limit



Source: CBR, Morgan Stanley Research

Central Bank Watch

Romania: Well Supported

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No change in rates, NBR constructive on disinflation: As expected, the NBR kept rates on hold at 6.25% at its February 3 meeting. The central bank remains constructive on disinflation, and thinks that following the reversal of the VAT-induced spike in CPI, inflation will resume its downtrend. The main driver of disinflation remains the output gap, in the NBR's opinion. The central bank also published its revised inflation forecast: end-2011 inflation was revised somewhat higher, to 3.2%Y (previously: 3.0%), but the medium-term trajectory has not changed meaningfully.

Soft post-meeting commentary: Vice-Governor Popa observed in the press conference that the current level of 6.25% allows the bank to adjust rates (presumably downward) if inflation falls within the estimated limits. Our own forecast is less optimistic than the bank's, mostly because we take a more sceptical view of the extent to which slack will tame inflation in the quarters ahead. Also, we see risks for some fiscal expansion ahead of the 2012 elections, which will not be constructive for disinflation.

More support if needed: The IMF mission concluded on February 8, and agreed to disburse €1 billion at the end of March. However, the Romanian authorities announced that they would not draw on this tranche, so the disbursements under the current SBA stay at €12.4 billion. More importantly, the IMF agreed on a new 24-month precautionary SBA of €3.6 billion. This, in conjunction with similar precautionary support from the EU of €1.4 billion and World Bank (€0.4 billion) would create a handy €5.4 billion 'buffer' should Romania run into liquidity constraints during the year. Clearly, there is conditionality to this credit line, which we think is in fact a positive (i.e., it keeps the country on a responsible track). And the authorities intend not to draw on this facility unless necessary.

Bank Coordination Initiative – extended? The IMF also stressed that the Romanian banking system remains well-capitalised, with CAR (capital adequacy ratio) at 14.7% for the system as a whole, and all banks above 11% (requirement is 8%). In March, the Fund said that a new Bank Coordination Initiative will be discussed with the large foreign banks, with a view towards continuing the stabilising effect of the previous agreement (part of the Vienna Initiative). Recall that this initiative was instrumental in maintaining foreign banks' exposure to the CEE region, and proving doomsayers' wrong. Therefore, its extension would further boost stability of the financial sector, even amid the challenges posed by a rising NPL ratio (near 12% at end-2010).

Turkey: The Monetary Policy Joystick

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The new policy tool is a policy mix: The CBT hosted a conference on the Turkish economy (with specific emphasis on monetary policy) on February 7. The English version of the presentation in full can be downloaded at www.tcmb.gov.tr, which might not only be useful for the assessment of the situation in Turkey: some conclusions and methodology could be drawn for other countries as well, in our view. Our main takeaways from the conference are as follows: the old policy tool was the weekly repo rate (and prior to that it was the o/n rate). The new policy rate is a policy mix, i.e., weekly repo rate and the macro prudential measures such as the required reserve ratio (RRR). The CBT is currently happy with the use of the policy mix and likely to hang on to the unorthodox approach in the foreseeable future while watching the data closely to decide how to alter the mix to achieve a few of the objectives at the same time. There are clear policy challenges that the CBT pinpoints: the composition of growth has so far been mixed, with external demand being weak but domestic demand very strong. Capital inflows had been substantial (not anymore) but are mostly parking in the short term. Credit expansion has been strong, leading to further rise in the current account deficit. Looking at these policy challenges, the CBT decided to 'act' and went for the policy mix, believing that not acting now could pose a bigger risk than taking the risk of implementing an unorthodox approach. At least this is our impression.

Monetary policy joystick: CBT Governor Yilmaz has stressed various times that the overall intention of the bank is to tighten monetary policy via the use of the mix, which we label as a 'joystick monetary policy'. The aim is to keep inflation expectations at bay, prevent core inflation from rising noticeably, control credit growth and achieve a more moderate current account deficit. This will entail the use of a policy mix (policy rate and RRR) but also fiscal discipline and regulatory measures (banking regulator). The policy-makers are intending to use the joystick method to approach the target(s), rather than more conventional or orthodox methods.

Risks are in place: The risks to going unorthodox are various and mostly external. Euro periphery issues, Middle East tensions, oil prices, US growth and a possible slowdown in EM are all exogenous factors. The CBT is aware of these risks and gives the impression that it is ready to change the policy mix to shield the economy from these risks as much as it can. However, were certain risks to materialise, it might require a larger backwards step that could be quite costly.

Central Bank Watch

South Africa: January CPI as Expected – Watch Food Inflation

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CPI registered 3.7%Y in January, in line with consensus and our estimates: The January data show that goods inflation has passed its trough and has started tracking higher, registering 2.8%Y from 2.0%Y in December. On the services line, seasonal declines in airline tickets resulted in some disinflation, from 5.1%Y to 4.7%Y. The real story is not so much in the headline, however, but in the detail.

Sharp acceleration in food inflation: Our long-held fear of a sharper-than-generally-anticipated acceleration in domestic food inflation was realised this morning, with the food component of CPI accelerating by 2.3%M versus our 1.2%M estimate. The jump in food prices was led by a 7.0%M spike in fruit prices, which may be seasonal and is in no way unique to South Africa. But, with regulatory-related interventions clearly behind us (see *South Africa: CPI Ends 2010 as Expected*, January 19, 2011) and bread inflation rising 0.5%M, together with meat spiking by 4.0%M, it is difficult to see how South Africa side-steps the global food price surge.

Our CEEMEA economics team investigated the pass-thorough from global to domestic food prices in "*CEEMEA: Food CPI on the Rise – Does it Matter for Central Banks?*" *CEEMEA Macro Monitor*, November 29, 2010. The analysis suggested that for South Africa, about half the movements in global food prices usually find their way into local food prices within 12 months. With South Africa's 14.3% weight of food in its CPI index, the eventual pass-through into headline inflation is some 7%. Looking forward, we believe that the risk to our food inflation estimates of 3.5% for 2011 and 6.7% for 2012 is to the upside.

Pockets of good news: Elsewhere in today's CPI release, two key downside surprises provided sufficient offset to keep our overall headline CPI forecast in line with the actual outcome. First was insurance on buildings and household contents, which printed flat on the month versus our 0.9%M forecast. Second was public transport costs, which contracted by a sharp 1.7%M versus our forecast of -0.2%M.

Inflation outlook: Today's reading came out in line with expectations, leaving our inflation forecasts unchanged at 4.5% in 2011 and 5.5% in 2012. At the core level, CPI excluding food, energy and electricity remains well contained for now, at some 3.1%Y on our estimates. As we progress through 2011, however, we believe that both headline CPI and core inflation will track progressively higher, giving the SARB enough motivation to initiate policy normalisation by November 2011. We maintain our view that a sequence of three 50bp hikes in the repo rate will begin at the November 2011 MPC meeting.

Asia/Pacific: The Story of AXJ Inflation – The Past, Present and Future

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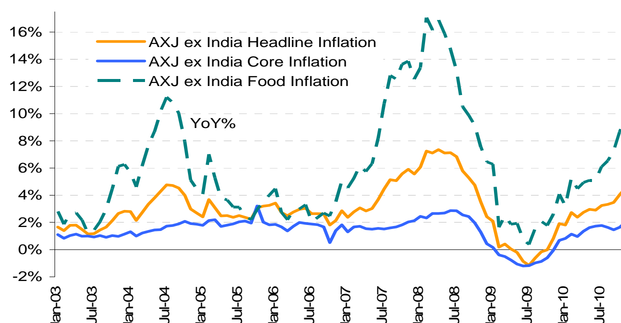
Inflation continues to be the most important macro issue concerning investors in the region: As we have been highlighting for a while, the region has continued to achieve strong growth with an attendant rise in inflation pressure and risk of asset price bubbles. Rising inflation expectations in some of the region's key countries are intensifying core inflation pressures.

Need to remove policy supports faster: Within the region, strong aggregate demand pressures are now pushing against tighter supply conditions. Hence, we believe that policy-makers should quicken the pace of exit and remove policy supports for domestic demand. For monetary policy, real policy rates for the majority of countries in the region are still negative, and we believe that policy-makers will accelerate the pace of rate hikes in 1H11 in tandem with the pick-up in core inflation.

Upside risks to inflation remain high: As we have been highlighting for some time now, the key to the inflation outlook for the region is external demand and the trend in oil prices. The recent sharp rise in exports and commodity prices has significantly increased the upside risks to our inflation forecasts. Moreover, weather conditions will be the wild card, determining whether we will see a fresh wave of food supply shocks. In this context, we are monitoring export data and oil price movements closely, as they may serve as good indicators for potential disruptive policy tightening actions.

For full details, see *Asia Pacific Economics: The Story of AXJ Inflation – The Past, Present and Future*, February 11, 2011.

Asia/Pacific: AXJ ex India Headline Inflation Moving Higher, Driven by Food as Well as Core Inflation



Source: CEIC, Morgan Stanley Research; Note: We have used AXJ ex India as India has experienced a different inflation cycle from the rest of the AXJ countries.

Central Bank Watch

China: Prudent Monetary Policy Took Effect in January

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Lower-than-expected new loan creation in January: New loan creation of Rmb1.04 trillion in January (versus Rmb480.7 billion in December 2010) was lower than our expectation and market consensus of Rmb1.2 trillion. While consistent with the seasonal pattern of banks rushing to lend in the first month of each year and following every quarter, the lower-than-expected reading does make a meaningful difference compared with Rmb1.39 trillion in January 2010 and Rmb1.53 trillion in January 2009. It was reported that new loan creation had exceeded one trillion in the first two weeks of January. This explained the unexpected RRR hike announced on January 14. We believe that some banks stopped making new loans in the second half of January due to liquidity shortage (reflected in surging SHIBOR rates) and fear of potential penalty (such as differentiated RRR).

Noticeable slowdown in M2/M1 growth: M2 growth slowed to 17.2%Y in January from 19.7%Y in December, recording the lowest reading since December 2008, disappointing our forecast of 19.2% and market consensus of 19% by a big margin. M1 growth saw a much larger decline, plunging to +13.6%Y in January from 21.2%Y in December. The noticeable deceleration of M2/M1 growth may be explained by the unusual decrease of corporate deposits by Rmb1.27 trillion in January. In addition, we believe that continued RRR hikes which should have reduced the monetary multiplier noticeably also contributed to the unexpected shortfall. M0 grew Rmb1.35 trillion, or 45.2%Y, in January, which was interpreted by the PBoC as the Chinese New Year effect. In addition, the sharp contraction of Rmb1.27 trillion of corporate (non-financial & other enterprises) deposits may be related to the depressed new loan growth in January, which might have forced the corporates to finance their investments or working capital by consuming their own deposits.

Policy implications and outlook: We think the PBoC should have been well communicated of January's below-consensus CPI in advance by the NBS. In this context, the hike announced on February 8 demonstrates the PBoC's firm determination in keeping inflation in check upfront. The lower-than-expected new loan creation and M2 growth in January helped to unveil the true face of the 'prudent monetary policy', featuring stricter credit control and a gradual normalisation of policy rates, in our view. In this context, we expect more rate hikes (two more in 1H11) coupled with RRR hikes (or differentiated RRR) in the pipeline to keep inflation in check upfront.

China: Liquidity Condition Eased After Lunar New Year; Inflation Rose in January

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PBoC open market operations: After a suspension of two weeks, the PBoC re-launched its bill issuance last week. However, with only Rmb1 billion of bills issued against Rmb79 billion matured, we see the issuance as symbolic, without too much material meaning. After 13 weeks' continued net injection, up to Rmb920 billion of liquidity has been released into the system through the PBoC's OMOs. In light of aggressive RRR hikes since last November, we believe that the PBoC is veering to more effective but less costly RRR to replace OMOs to lock in liquidity during the tightening cycle.

SHIBOR fell back noticeably after the Lunar New Year: Short-end SHIBOR rates with tenures of 3m or less fell sharply on February 1, led by the 7d rate, which corrected 485bp to 3.37% (versus 8.22% on January 31). Despite the fall in short-end rates, long-end SHIBOR rates continued to edge up marginally on February 1. Against the backdrop of envisaged 'front-loaded' tightening in 1H11 to control inflation, we believe that SHIBOR rates may be elevated with rather volatile short-end rates but trending-up long-end rates in the coming months.

Lower-than-expected January CPI: After the temporary easing in December as a result of the carryover effect phasing out, CPI rebounded to +4.9%Y in January (versus +4.6%Y in Dec-10), lower than our expectation of +5.2% and market consensus of +5.4%. On a sequential basis, CPI gained +1%M in January. However, the sequential increase was reduced to +0.2%M after seasonal adjustment. Food inflation rebounded together with escalating non-food CPI. Also, there is heightened upstream inflation with PPI rebounding to +6.6%, as heightened international commodity prices and robust domestic demand help to explain the stubbornly increase of upstream inflation, in our view. Given the gradual pass-through mechanism from the upstream to the downstream sectors, we believe that CPI will receive more upward traction from non-food CPI in the coming months.

Prudent monetary policy surfaced: Unlike the unexpected RRR hike announced on January 14, the first rate hike in 2011 was in line with expectations and should manage inflation expectations. In addition, reports suggest that the PBoC has imposed different RRR on certain smaller banks, especially city commercial banks last week. The PBoC's recent moves are consistent with our call that the tightening to control inflation would be front-loaded in 2011.

Central Bank Watch

India: Headline Inflation Remains High in January

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WPI headline inflation decelerated marginally in January 2011 but was still above our expectation: The headline inflation rate (WPI) decelerated to 8.2% in January from 8.4% in December 2010. The seasonally adjusted WPI index was up 1.1%M in January (versus +1.5%M in December). Inflation for November was also revised upwards to 8.1% from 7.5% reported previously. The headline inflation in January was above our and consensus expectations (as per Bloomberg survey) of 8.1%.

Monthly food inflation accelerated in January but decelerated on a weekly basis: Food inflation (primary and manufactured) accelerated further in January versus the previous month on high vegetable prices. However, weekly data indicate that primary food inflation decelerated as of the week ended January 29, 2011, largely due to the recent decline in fruit and vegetables and milk prices. Non-food inflation decelerated partly on the base effect.

Monthly WPI inflation will likely show moderation from February: We expect WPI inflation to decelerate to below 8% in February, as vegetable prices will likely cool off quickly as crop duration is short. We believe that the full impact of the moderation in food inflation as reported in weekly numbers for the second half of January will be fully reflected in February's monthly inflation data (to be reported by mid-March).

Rise in oil prices could compound the inflation problem: Global commodity prices have continued to rise. Crude oil (Dubai light) has come closer to US$100/bbl due to problems in the Middle East. In our view, this means that headline WPI inflation is unlikely to come down to the RBI's comfort zone of 5-5.5% soon. We expect WPI inflation to remain at or above 7% for most of 1H11 unless global commodity prices pull back meaningfully.

Inflation expectations still remain high: Rising inflation expectations have taken away the benefit of going slowly on policy rate hikes very quickly. Low real rates meant households held back from bank deposits. This caused tight interbank liquidity, forcing banks to hike deposit rates by 175bp cumulatively to 9.5% since the first week of December 2010. If inflation expectations remain high, hampering deposit growth, we believe that banks will be forced to keep deposit rates close to the current 11-year high levels for a longer period and, in turn, take lending rates higher – hurting growth.

India: SBI Hikes Deposit Rates by 25bp

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The State Bank of India (SBI, India's largest public sector bank) hiked deposit rates again: The SBI again hiked deposit rates by 25bp to 9.25% for the 1-2 year bucket on February 11, having raised deposit rates by 150bp since December 6. The 3m commercial paper (CP) rates have also crossed 10%.

Small hike but concerning message: Though small in magnitude, we believe that this 25bp rise in the deposit rate suggests that the possibility of a cut in rates from the current high levels is some time away. Interbank liquidity has remained tight: after showing an improvement for a few days, net liquidity in the banking system (repo less reverse repo balance) moved into deficit of US$18 billion as of February 11, compared to the average deficit of US$14 billion during the week ending February 9, 2011. This compared with a deficit of US$20 billion in January and US$26 billion in December.

Gap between credit and deposit growth persists: As we have been highlighting, liquidity conditions are tightening because of the persistent gap between bank credit and deposit growth. As of January 28, 2011, bank credit growth was 23.2%Y versus 15.9%Y deposit growth. Deposit growth has risen marginally since the deposit rate hikes began in December 2010 but not enough. Banks' credit-deposit ratio (C/D ratio) remained extremely high, at 75% as of January 28, 2011, compared with 74.5% as of end-November (before the recent deposit rate hikes). This level of C/D ratio is high, considering that banks also need to statutorily invest 24% of deposits in government securities (SLR requirement) and park 6% of deposits with the RBI as cash reserve ratio (CRR).

Deposit growth slower than expected: After the second round of aggressive deposit rate hikes in January, we were of the view that the deposit growth would revive and start to reduce the tightness in interbank liquidity. However, we believe that this slower-than-expected recovery in deposit growth reflects that inflation expectations remain high.

Why bank deposit rates are important to track? Typically, policy rates either lead or move concurrently with deposit rates. However, in the current cycle, the RBI has been very slow to lift policy rates. Indeed, we believe that it is this delay in policy rate hikes which may have pushed inflation expectations to a level that bank deposit growth remains relatively slow. Hence, we believe that the more accurate measure of the trend in cost of capital and tightness in the banking system is as measured by bank deposit rates.

Central Bank Watch

Korea: BoK Leaves Rate on Hold for Now but More to Come

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Rates unchanged: The Bank of Korea (BoK) decided to keep its policy rate unchanged at 2.75% at its meeting on February 11. This came as a surprise as both we and consensus were looking for a 25bp hike. The decision was not unanimous among the monetary policy committee. Although the outcome was a surprise, comments by the BoK were pretty much in line with our expectations, with the focus on inflation risks and the growth outlook remaining intact. In fact, the economic conditions this month are not much different to last month's, except that the stock market was more buoyant last month when the BoK lifted the rate.

Maintaining our view for more hikes this year: Since the BoK conducts its monetary policy meeting on a monthly basis, we should not read too much into one month's decision. We believe that the course of rate hike is not changed, i.e., the policy agenda is still focused on combating inflation and the interest rate needs to be normalised. We keep our view of a cumulative 75bp rate hike for the rest of this year, to bring the policy rate to 3.5%.

BoK likely does not want to appear too hawkish: Not raising rates for two months in a row probably means that the BoK does not want to appear too hawkish. It cited household debt as a concern against rate hikes. We currently expect two more rate hikes in 1H11 and one in 3Q11, which in our view is not aggressive, especially considering that Korea's real interest rate will likely remain negative even under this interest rate projection. As a result, not raising rates this month means not hawkish, but it does not mean that the BoK will become dovish. The BoK mentioned that inflation could stay around 4% for some time, which means that inflation will exceed or stay at the max of the BoK's target range of 2-4%. Thus, there is no reason for interest rate hikes to be delayed for too long, and we think that a rate hike next month is still likely.

Taiwan: Inflation Still Mild with Stable Food Supplies

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January inflation below expectations: Taiwan's consumer price index increased by 1.1%Y in January, below the consensus (1.6%Y) and our forecast of 1.8%Y. It was also below December's 1.2%Y. On a sequential basis, CPI declined by 0.01%M in January, after a decline of 0.7%M in December. After seasonal adjustment, CPI increased by 0.4%M. Core CPI (CPI excluding food and energy) increased by 0.8%Y in January.

Stable food supplies ensured the mild consumer price inflation: Despite rising demand ahead of the Chinese New Year, food price inflation remained low in Taiwan. Overall food prices increased by 2.0%Y in January, below December and November's figures. The lower food inflation was mainly a result of the good winter harvest of fruits and vegetables in Taiwan. Food accounted for 26.1% of the total CPI basket. We also note that transportation prices rose in January. The rising transportation cost reflects higher crude oil prices in the international market.

WPI and import price inflation also contained: The wholesale price index (WPI) increased by 1.6%Y in January, below 2.2% in December. Mineral products continued to rise fast at 14.0%, while the prices of agriculture products and manufacturing products were up as well. Import prices increased by 3.3%Y in January, with higher food and mineral prices. We think that higher commodity prices in the international market could drive up WPI and import prices in a greater magnitude in coming months.

Inflation not yet a problem, but rate normalisation to continue: As central banks in the AXJ region are hastily lifting policy rates to curb inflation, Taiwan stands out as a fast-growing economy with limited inflationary pressures, at least so far. Food was the biggest inflation stabiliser for Taiwan, as the winter harvest ensured mild price pressures in vegetables and fruits, even ahead of the Chinese New Year. The higher commodity prices could drive up Taiwan's headline inflation in the coming months, but their impacts are yet to be seen. Despite the low inflation pressure, we expect the CBC to continue to stay on a rate normalisation path to anchor pre-emptive inflation pressures. Taiwan's abundant liquidity and strong domestic demand, coupled with higher international commodity prices, are ingredients for higher inflation down the road, in our view.

Central Bank Watch

Indonesia: The US$100 Billion War Chest

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Reaching the US$100 billion mark: The pace of FX reserves accretion in Indonesia has picked up since 2009. Reserves are now just US$5 billion shy of the US$100 billion mark.

What's driving FX reserve accumulation? Rather than merely capital flows, the more significant driver of reserves build-up is stable flows from basic balance (CAB surplus and FDI). Cumulative basic balance flows was 68% of cumulative BoP flows in 2009-10.

Why is this an important milestone? We have been highlighting the bullish story of structural decline in cost of capital since 2009. FX reserves are an important part of this. External funding linkages and their collateral impact on IDR during risk-aversion periods have been Indonesia's Achilles' heel. A sturdy war chest of foreign reserves should help to break the vicious loop that tends to go from capital flight to liquidity dry-up to currency depreciation to import-led inflation and then to forced policy tightening. Macro volatility is reduced, driving lower lows and lower highs in capital cost. Also, with FX reserves reaching a comfortable level, policy-makers will be able to reduce their dependence on hot money flows such as into SBI bills, in our view.

Structural story is still alive – but cyclical pressures remain: The structural story remains intact but cyclical inflation pressures are still a concern for now. With unusual weather, elevated commodity prices, a planned fuel subsidy rollback, healthy domestic demand and rising inflation expectations, we do not expect the inflation peak to pass until after 2Q11. BI has begun normalising policy rates since February. but we think that it needs to do more. We expect another cumulative 75bp hike, taking the policy rate to 7.5% by May 2011. In part courtesy of the structural improvement, inflation is unlikely to go back to previous highs, and hence we believe that this rate hike cycle will be comparatively less aggressive. The rate tightening will prevent the cycle from becoming overheated, but we do not expect a growth-disruptive hard-landing scenario.

For details, see *ASEAN MacroScope: Indonesia: The US$100bn War Chest*, February 14, 2011.

Chile: Monetary Policy Meeting Preview

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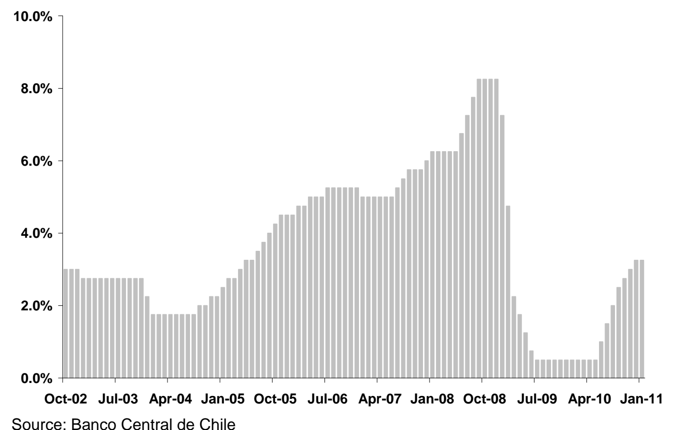
25bp hike likely: Chile's February monetary policy meeting will be held on February 17. Both Morgan Stanley and the consensus expect rates to increase by 25bp to 3.50% at this meeting.

After making a 'transitory pause' in its tightening cycle, Chile's central bank is likely to resume hiking rates: In fact, January's policy statement reiterated the need to "continue reducing the monetary stimulus in coming months".

Since the last policy meeting, inflation expectations have deteriorated and energy costs pushed January inflation higher, in a context of still robust demand momentum.

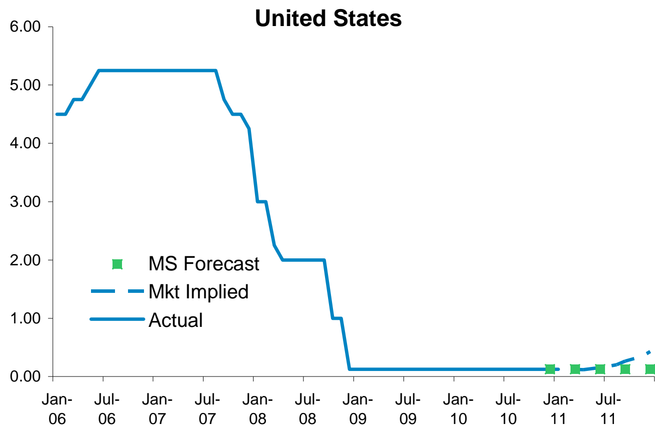
Though concerns about peso appreciation – which after an initial post-intervention sell-off has regained material ground – are likely to keep the pace of tightening at 25bp, we would not be surprised if the authorities consider accelerating the pace of tightening in February.

Chile: Central Bank Target Interest Rate (Annual rate)

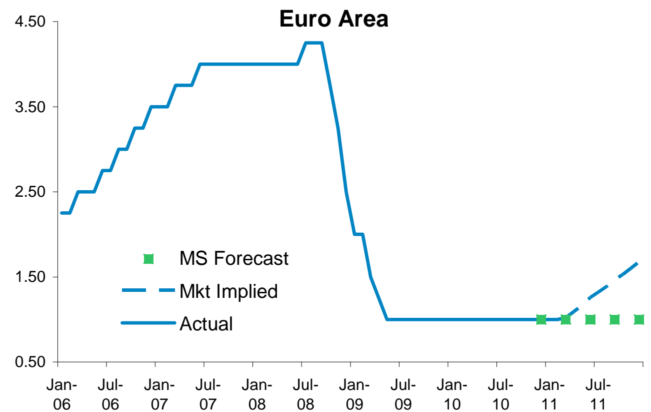


Source: Banco Central de Chile

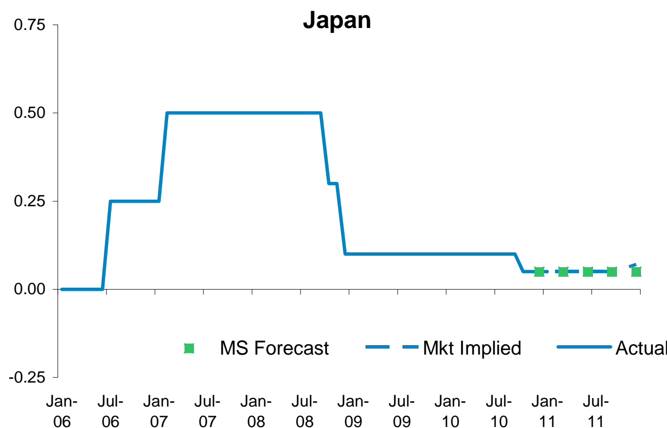
Monetary Policy Outlook – Morgan Stanley versus Markets



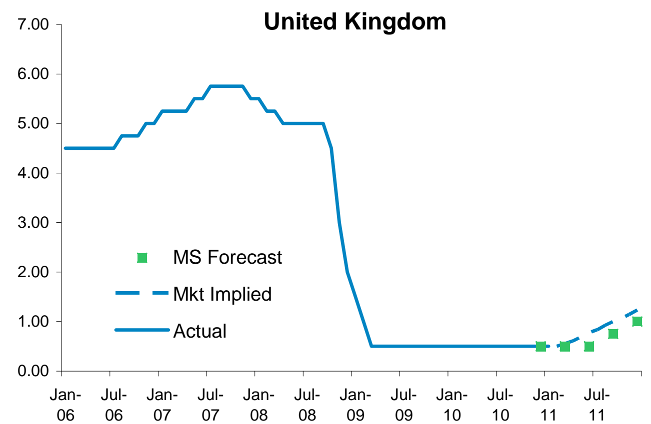
- With the fiscal policy boost to 2011 growth and inflation bottoming, we expect no extension of QE beyond June.
- Market pricing of hikes through end-2012 recently quickly moving up towards our 2.5% fed funds target forecast.



- Markets are currently pricing in first hikes in 2011 – too early, in our view.
- President Trichet was careful not to escalate the hawkish language further.



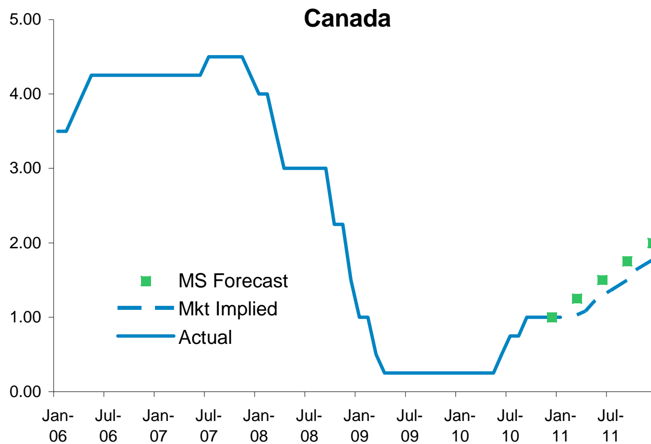
- The possibility of the BoJ expanding asset purchases during March has retreated somewhat as the BoJ is more confident about the economy.
- Yet pressure to bolster easing policy, led by politicians, is likely to continue amid prolonged deflation.



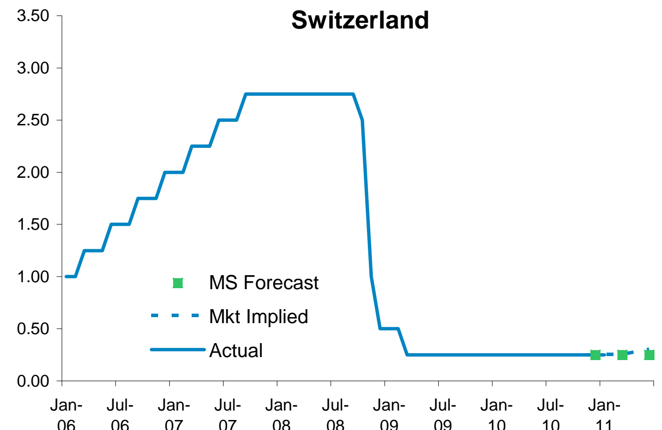
- We think that the MPC will start raising rates in August 2011. Markets are now pricing in an earlier start.
- Triggers for an earlier rate rise include sharply rising inflation expectations/wages.

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.

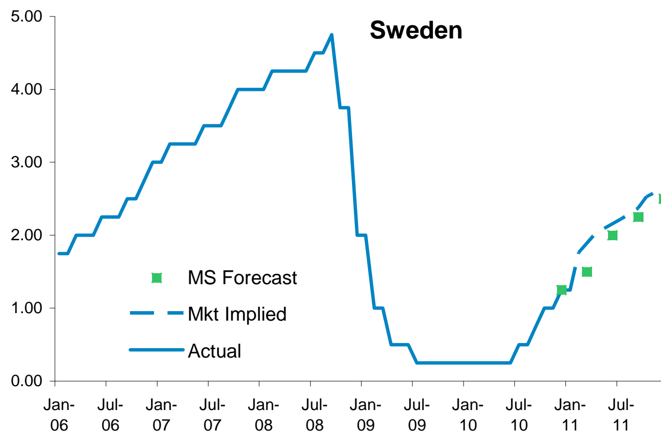
Monetary Policy Outlook – Morgan Stanley versus Markets



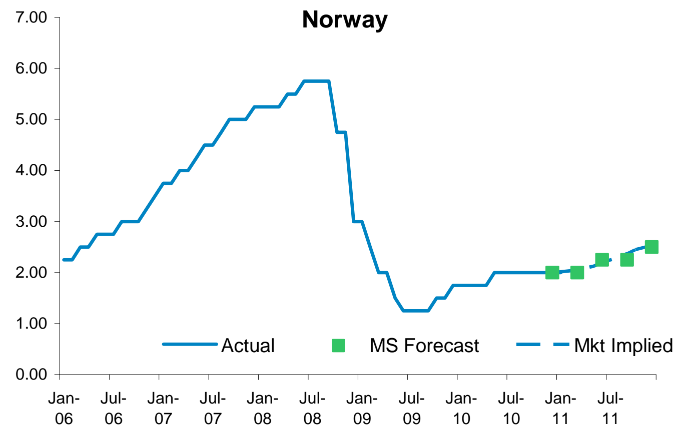
- The BoC should continue to remove stimulus, albeit at a more gradual pace, given remaining global uncertainties.
- The risks lie to both sides. On the upside, the BoC may speed up its tightening if there is further indication that domestic price pressures are heating up. On the downside, the BoC may slow hikes if CAD strength persists and weighs on exports.



- SNB now expected to keep rates on hold through 2011.



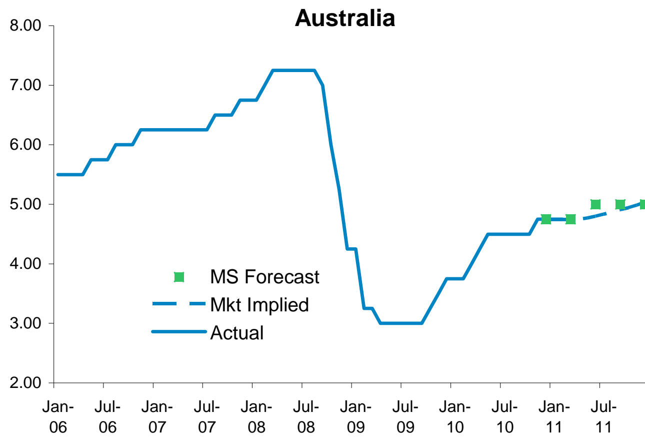
- Riksbank may revise its repo rate forecast upwards again if the commodities continue to surge at the moment.
- Faster wages increase and a decline in spare capacity should trigger further repo rate hikes.



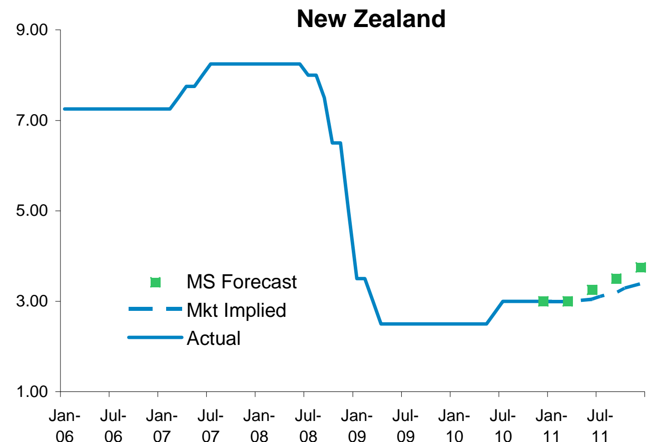
- We expect Norges Bank to resume hiking in May – the market expects later hikes.
- Latest statement suggests risks now tilted towards later hike – March Monetary Policy Report crucial.

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



- We think that the RBA is now on hold until late 2Q11.
- RBA will look through CPI impact of floods, but rebuild increases risk of a 2H hike.



- We're expecting hikes to resume in 2Q11 as global conditions improve.
- Market expectations are in line with our call.

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	1Q11	2Q11	3Q11	4Q11	1Q12	2Q12	3Q12	4Q12	Last change (bp)	Since peak/ trough (bp)	Since Dec 06 (bp)
United States	0.125	0.125	0.125	0.125	0.13	0.50	1.25	2.00	2.50	-87.5 (16/12/08)	-512.5	-512.5
Euro Area	1.00	1.00	1.00	1.00	1.00	1.25	1.50	1.75	2.00	-25 (07/05/09)	-325	-200
Japan	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	-5 (05/10/10)	-45	-45
United Kingdom	0.50	0.50	0.50	0.75	1.00	1.25	1.50	1.75	2.00	-50 (5/3/09)	-525	-450
Canada	1.00	1.25	1.50	1.75	2.00	2.25	2.75	3.25	3.50	+25 (8/09/10)	+75	-325
Switzerland	0.25	0.25	0.25	0.25	0.25	0.50	0.75	1.00	1.50	-50 (11/12/08)	-250	-175
Sweden	1.50	1.50	2.00	2.25	2.50	2.75	3.00	3.25	3.50	+25 (15/2/11)	+125	-150
Norway	2.00	2.00	2.25	2.25	2.50	2.75	3.00	3.25	3.50	+25 (05/05/10)	+75	-150
Australia	4.75	4.75	5.00	5.00	5.00	5.00	5.00	5.00	5.00	+25 (2/11/10)	+175	-150
New Zealand	3.00	3.00	3.25	3.50	3.75	4.00	4.25	4.50	4.50	+25 (29/07/10)	+50	-425
Russia	7.75	8.00	8.00	8.25	8.50	8.50	8.50	8.50	8.50	-25 (31/05/10)	-525	-325
Poland	3.75	4.00	4.25	4.50	4.50	4.75	5.00	5.25	5.25	+25 (19/01/11)	+25	-25
Czech Republic	0.75	0.75	1.00	1.25	1.50	1.75	2.00	2.25	2.25	-25 (06/05/10)	-300	-175
Hungary	6.00	6.25	6.50	6.75	6.75	7.00	7.25	7.25	7.25	+25 (24/01/11)	+75	-200
Romania	6.25	6.25	6.25	6.25	6.25	6.50	6.75	7.00	7.25	-25 (05/05/10)	-400	-250
Turkey	6.25	6.25	6.00	6.00	7.00	7.50	8.50	8.75	9.00	-25 (21/1/11)	-1175	-1175
Israel	2.25	2.50	3.00	3.25	3.50	3.75	4.00	4.25	4.50	+25 (24/01/11)	175	-175
South Africa	5.50	5.50	5.50	5.50	6.00	7.00	7.00	7.00	7.00	-50 (18/11/10)	-650	-350
China	6.06	6.31	6.56	6.56	6.56	6.56	6.56	6.56	6.56	+25 (09/02/11)	+75	-6
India	6.50	6.75	7.25	7.25	7.25	7.25	7.50	7.50	7.50	+25 (25/1/11)	+175	-75
Hong Kong	0.50	0.50	0.50	0.50	0.50	1.00	1.75	2.50	3.00	-100 (17/12/08)	-625	-625
S. Korea	2.75	3.00	3.25	3.50	3.50	3.75	3.75	3.75	3.75	+25 (13/01/11)	+75	-175
Taiwan	1.63	1.75	1.88	2.00	2.13	2.25	2.38	2.38	2.38	+12.5 (30/12/10)	+38	-113
Indonesia	6.75	7.00	7.50	7.50	7.50	7.00	7.00	7.00	7.00	+25 (04/02/11)	+25	-300
Malaysia	2.75	2.75	2.75	2.75	2.75	2.75	2.75	2.75	2.75	+25 (08/07/10)	+75	-75
Thailand	2.25	2.50	2.75	2.75	2.75	2.75	2.75	2.75	2.75	+25 (12/01/11)	+100	-275
Brazil	11.25	11.75	12.50	12.50	12.50	12.50	12.50	12.50	12.50	+50 (19/01/11)	+250	-200
Mexico	4.50	4.50	4.50	4.50	4.50	4.75	5.50	6.00	6.00	-25 (17/07/09)	-375	-250
Chile	3.25	3.50	4.25	5.00	5.50	5.50	5.50	5.50	5.50	+25 (16/12/10)	+275	-200
Peru	3.50	3.50	3.50	3.75	4.00	4.00	4.00	4.00	4.00	+25 (09/02/11)	+225	-100
Colombia	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.50	-50 (30/04/10)	-700	-450
Global Policy Rate	2.4	2.5	2.6	2.6	2.7	2.9	3.1	3.4	3.6			
std. deviation	2.8	2.8	2.9	2.9	2.9	2.9	2.9	2.8	2.8			
# countries above	18	19	19	19	19	17	17	17	17			
# countries below	14	13	13	13	13	15	15	15	15			
G10 Policy Rate	0.6	0.6	0.6	0.7	0.7	0.9	1.4	1.8	2.1			
std. deviation	1.5	1.5	1.6	1.6	1.6	1.6	1.5	1.5	1.4			
# countries above	5	5	5	6	6	6	6	5	5			
# countries below	4	4	4	3	3	3	3	4	4			

Source: National Central Banks, Morgan Stanley Research
Note: Global policy rates are GDP weighted averages of national policy rates. Japan policy rate is an interval of 0.00%-0.10%.

Global GDP and Inflation Forecasts

	GDP				CPI			
	2009A	2010E	2011E	2012E	2009A	2010E	2011E	2012E
GLOBAL	**-0.9**	**5.0**	**4.4**	**4.6**	**2.0**	**3.3**	**3.7**	**3.2**
G10	**-3.6**	**2.7**	**2.6**	**2.6**	**0.0**	**1.4**	**2.1**	**1.9**
United States	-2.6	2.9	3.5	3.5	-0.3	1.6	2.4	2.3
Euro Area	-4.0	1.7	1.5	1.7	0.3	1.6	2.0	1.8
Germany	-4.7	3.6	2.3	2.0	0.3	1.1	2.2	1.7
France	-2.5	1.6	1.8	2.0	0.1	1.5	1.7	1.6
Italy	-5.1	1.1	1.2	1.5	0.8	1.5	2.1	1.9
Spain	-3.7	-0.2	1.0	1.5	-0.3	1.8	2.6	1.8
Japan	-6.3	4.4	2.0	1.9	-1.3	-1.0	0.0	0.1
United Kingdom	-4.9	1.4	1.4	2.0	2.2	3.3	3.7	2.1
Canada	-2.5	2.9	2.6	2.9	0.3	1.8	2.2	2.4
Sweden	-5.5	5.5	4.1	3.2	-0.3	1.3	2.5	1.9
Australia	1.3	2.8	3.1	3.6	1.8	2.9	2.8	2.6
Emerging Markets	**2.3**	**7.5**	**6.4**	**6.6**	**4.3**	**5.4**	**5.5**	**4.5**
CEEMEA	**-4.7**	**3.8**	**4.1**	**4.1**	**7.7**	**5.8**	**6.4**	**5.8**
Russia	-7.9	3.8	5.0	4.5	11.7	6.9	9.5	8.0
Poland	1.6	3.8	4.3	4.1	3.5	2.6	3.6	3.1
Czech Republic	-4.1	2.4	1.6	2.9	1.0	1.5	2.1	2.2
Hungary	-6.3	1.2	2.9	2.8	4.2	4.9	4.4	3.8
Romania	-7.1	-1.7	1.1	2.8	5.6	6.1	5.5	4.3
Turkey	-4.7	7.4	4.7	4.5	6.3	8.6	5.4	5.6
Israel	0.7	4.0	3.8	3.5	3.3	2.7	3.3	2.8
UAE	-3.5	0.9	2.3	3.3	1.6	-0.7	0.7	1.8
Saudi Arabia	0.6	3.0	3.4	4.1	5.1	5.4	5.1	4.6
South Africa	-1.7	2.7	3.5	3.5	7.1	4.3	4.5	5.5
Asia ex Japan	**6.2**	**9.2**	**7.8**	**8.0**	**2.4**	**5.0**	**5.0**	**3.7**
China	9.1	10.3	9.0	9.0	-0.7	3.3	4.5	3.0
India	6.7	8.7	8.2	9.0	10.8	12.0	7.5	6.2
Hong Kong	-2.8	6.8	5.0	4.0	0.5	2.4	3.8	3.0
Korea	0.2	5.8	4.5	4.0	2.8	3.0	3.6	2.9
Taiwan	-1.9	10.5	3.8	4.2	-0.9	1.0	2.0	1.6
Singapore	-1.3	14.7	6.0	6.5	0.6	2.8	2.9	2.7
Indonesia	4.6	6.1	6.5	6.5	4.8	5.1	6.5	5.5
Malaysia	-1.7	7.2	5.0	5.5	0.6	1.7	2.3	2.2
Thailand	-2.3	8.0	4.8	5.3	-0.9	3.2	3.5	3.5
Latin America	**-1.9**	**6.1**	**4.2**	**4.6**	**6.3**	**6.3**	**6.1**	**6.0**
Brazil	-0.2	7.5	4.0	5.0	4.9	5.0	5.6	5.2
Mexico	-6.1	5.2	4.2	4.1	5.3	4.2	3.7	3.6
Chile	-1.5	5.5	5.6	4.5	1.5	1.4	3.0	3.0
Peru	0.9	8.3	5.9	6.2	2.9	1.5	2.5	2.4
Colombia	0.4	4.4	4.9	5.1	4.2	2.2	2.0	3.2
Argentina	0.9	8.6	5.0	5.0	7.7	11.0	10.7	11.3
Venezuela	-3.3	-1.8	0.3	1.6	25.1	28.1	22.9	22.0

Source: Morgan Stanley Research

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