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Global

The Global Monetary Analyst

QE: What's Different This Time?

The Fed appears on course to deliver another round of QE. Manoj Pradhan explains what's different this time. First, the Fed's dovish message so far despite decent data shows a pre-emptive streak absent in the previous two editions. Second, if QE is pre-emptive, asset markets and inflation expectations should find support from fundamentals as well. Finally, disinflation due to slower domestic demand and currency appreciation should allow EM policy-makers to ease some more, but they will likely remain wary of inflation risks, particularly from commodity prices. These concerns would intensify if QE is pre-emptive. Active QE gives a clearer signal of central bank intent than passive QE. Accordingly, it seems better designed to deal with the base case for the economy while passive QE works better in dealing with tail risks, though an overlap clearly exists. Tail risks in the euro area are now smaller, but it is active QE from the Fed and the ECB that will help the global economy get closer to sustainable growth, in our view. p 2

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Key Central Bank Risk Events

Date	Country	Event
09 Feb	Euro area	Rates decision: Expect on-hold
09 Feb	UK	Rates decision: Expect on-hold
09 Feb	S Korea	Rates decision: Expect on-hold
09 Feb	Indonesia	Rates decision: Expect 25bp cut
09 Feb	Peru	Rates decision: Expect on-hold
10 Feb	US	Bernanke to speak to homebuilders conference
14 Feb	Euro area	ECB to publish Consolidated Financial Statement
14 Feb	Japan	Rates decision: Expect on-hold
14 Feb	Chile	Rates decision: Expect 25bp cut
16 Feb	Sweden	Rates decision: Expect 25bp cut
16 Feb	Norway	Governor Olsen to speak

Forecast changes since last week

Hungary	Policy rate: 7.00, 6.00% in 1Q12, 4Q12 (prev. 7.50, 6.25%)
Indonesia	Policy rate: 5.75% in 1Q12 (prev. 5.50%)
Colombia	Policy rate: 5.25, 6.00% in 1Q12, 4Q12 (prev. 5.00, 5.00%)
Colombia	GDP: 6.7, 4.7% in 2012, 2013 (prev. 4.1, 5.1%)
Colombia	CPI: 4.1% in 2012 (prev. 3.1%)

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

QE: What's Different This Time?

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- Despite better data, the Fed appears to be on course to deliver another round of QE, in line with our US team's expectations.
- What's different about QE this time? First, the Fed's dovish message so far despite decent data shows a pre-emptive streak that was absent in the previous two editions. Second, if QE is pre-emptive, asset markets and inflation expectations (the domestic channels of QE transmission) should find support from fundamentals as well. Finally, on the external front, disinflation due to slower domestic demand and currency appreciation should allow EM policy-makers to ease some more, but they will likely remain wary of inflation risks, particularly from commodity prices. These concerns would intensify if QE is pre-emptive.
- Active QE (where the central bank controls the size, design and exit) gives a clearer signal of central bank intent than passive QE (where, like the LTROs, private institutions determine the size of the balance sheet expansion). Accordingly, active QE seems better designed to deal with the base case for the economy while passive QE works better in dealing with tail risks, though an overlap between the two clearly exists. Tail risks in the euro area are now smaller, but it is active QE from both the Fed and the ECB that will help the global economy get closer to sustainable growth, in our view.

QE was introduced because the transmission mechanisms of traditional monetary policy were broken, and was designed to best take advantage of the parts that still worked. At the risk of oversimplifying things, we would argue that passive QE (where private institutions call the shots) is better equipped to deal with tail risks while active QE (where the central bank dictates terms and hence delivers a clear policy signal) is better placed to deal with the base case, though an overlap between the two clearly exists. Seen through this lens, the ECB's LTROs (passive QE) have reduced tail risks, but more needs to be done to stimulate the euro area economy, as Joachim Fels and Elga Bartsch have argued. 'QE à la Fed' – active QE-mandated purchases of assets – remains the gold standard, in our view. The arrival of its latest edition in the US

(particularly if it is pre-emptive in that it arrives before growth weakens) and also in Europe could help to push global growth closer to a sustainable trajectory. Both the timing and the design of these packages are important, and the key players – investors and emerging markets – are readying themselves.

The way QE works has not changed, but many of the parameters around its transmission have, and so has our understanding of how QE works – through domestic asset markets and inflation expectations domestically and via EM growth externally. What's new – the Fed's new pre-emptive attitude, the support for asset prices and inflation expectations from the real economy and our experience of a few rounds of two types of QE (passive and active) from various central banks. But perhaps the critical difference this time is the state of emerging markets. While they welcomed QE in 2009 with open arms, the embrace was a little less warm in 2010. This time around, the relationship might be ambivalent at best. EM economies that have shown resilient growth will likely worry about capital inflows pushing growth even higher. Others that have just fought off inflation will likely worry about what QE does to commodity prices.

QE: Active or passive? Does it matter? In a passive QE operation, it is the private institutions that call the shots. Their need to fund themselves or their illiquid assets determines how much liquidity the central bank ends up pushing into the banking system – think of the LTROs or the Fed's various programmes in 2008 and 2009. Importantly, how these funds are used, when they are no longer needed and hence when the central bank's balance sheet shrinks are all determined by private institutions, not the central bank.

Active QE is when the central bank is in the driver's seat. The central bank determines the size of the purchases and the expansion of its balance sheet. It also determines how and when these assets are to be sold, thereby allowing the balance sheet to shrink again to a 'normal' size. Most importantly, active QE is as clear a signal of the central bank's intention as a policy rate cut. The Fed's MBS and Treasury security purchases as well as gilt purchases by the BoE exemplify active QE. In the case of the SMP, however, the signal is muddled because of the ECB's explicit mandate for the programme to respond only to market 'dysfunction'.

Passive policy helps to reduce tail risks, active policy supports the base case: Passive QE policies, by construction, are best designed to give private institutions the liquidity that they need but can't get in the market. They are

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best at reducing tail risks in the economy but cannot provide a signal about the central bank's intentions in the way that active QE can. Active QE is the central bank's monetary policy instrument of choice and is designed to use existing transmission mechanisms in order to support asset markets and the economy. Active policy thus aims to support the base case in much the same way that policy rate cuts do.

Is there an overlap between the two? Yes. Just as policy rate cuts are designed to address economic growth but do also reduce tail risks, active QE is better suited to mimic conventional monetary policy easing but also reduces funding costs and financial risks. Similarly, passive QE can help asset market performance, as has been clearly evidenced by the recent experience with the ECB's LTROs, but still fall short of giving the economy a clear signal about the monetary policy intent of the central bank.

Timing matters: Our US economics team has been expecting the arrival of the next edition of active QE from the Fed in 2Q12 well in advance of the FOMC's January meeting (see [Fed Thoughts for 2012: Into the Heart of Darkness](#), December 27, 2011). What surprised everyone, however, was the dovish statement from the FOMC in its last meeting, when it opened the door for further easing by highlighting downside risks to growth. Chairman Bernanke's testimony to Congress yesterday provided an unchanged assessment of economic conditions, despite the strong payroll numbers on Friday, implying that QE3 remains on the cards.

Whether QE arrives as and when growth slows down or whether the Fed acts before a slowdown is apparent will be important for markets, in our view.

The FOMC's dovish outlook in January came at a time when the data were strong and beating expectations, compared to the 2009 edition when the world was on the brink of a second great depression or even QE2 in 2010 when Chairman Bernanke's Jackson Hole speech had been preceded by successive poor payroll prints. According to our Chief US Economist, Vincent Reinhart, it may be that the Fed intends to foster the 'green shoots' that it sees after a period of concern about the sustainability of growth. Another possible explanation is that it wants to conduct QE at a time when underlying growth and market sentiment would aid rather than hinder the impact of QE. In previous episodes, QE was introduced when growth and market sentiment were weak, which likely created headwinds for the effectiveness of monetary policy as one would expect.

How will QE work? We believe that QE, when it is announced (and particularly if it is pre-emptive in the above sense), will be like its predecessors – a game-changer. While the risk is that QE becomes successively less effective (see [The Global Monetary Analyst: QE Coming of Age](#), February 1, 2012), we are not there yet. Looking at past episodes, QE has worked, and will likely still work, through two theatres: domestic and external.

Domestically, the announcement of QE pushed up risky asset prices as well as inflation expectations. Inflation expectations, in particular, exploit traditional monetary transmission mechanisms by pushing real interest rates lower. In past episodes, asset prices and inflation expectations rose despite significant headwinds from weak economic fundamentals. If QE3 is pre-emptive, asset prices and inflation expectations should find additional support from the economy, making the Fed's job easier and things more difficult for the naysayers.

Externally, QE worked primarily by tethering onto EM growth. A large-sized QE programme (particularly a pre-emptive one) should push capital flows into EM economies. In 2009, EM output gaps were very wide and negative – less so in 2010. QE was thus a welcome development since it provided monetary stimulus without EM policy-makers having to lift a finger. However, as EM economic growth recovered, the capital flows that kept coming (partly because of continuing stimulus from DM policy-makers) created two kinds of problems. In some places, EM currencies appreciated under the watchful eye of policy-makers. In other places, the resistance to currency appreciation pushed capital into the real economy and raised credit growth (see [The Global Monetary Analyst: QE-20](#), October 13, 2010). In both instances, the monetary and fiscal stance was highly accommodative. Things may be different this time around.

EM economies and QE3: Starting points matter. Unlike 2009 and (to a lesser extent) 2010, when growth was weak with downside risks universal in the EM world, starting points are very different in the EM world this time around. EM economies at this point in time can be split into those that need cooling more than stimulus, those that should welcome QE3 because they have been constrained and those that should welcome relief on the growth front but worry about inflation.

Will QE3 be welcomed in the EM world? A large part of the EM world will likely find that QE3 will help by providing 'implicit' easing at a time when downside risks to growth are still present. However, as capital flows, currency appreciation and rising commodity prices hit policy-makers' radars, the ambivalence in the EM world may start to rise.

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How will the EM world greet QE3? Again, timing matters. If QE3 comes after a downdraft in growth, EM policy-makers would have more time to follow lower inflation with some more easing. However, if the Fed introduces QE3 earlier rather than later, policy-makers would likely become much more cautious in easing, particularly due to concerns about the impact of QE on commodity prices and hence on EM inflation.

• **QE3 should be welcomed by economies worried about downside risks to growth:** QE3 will likely provide welcome relief to economies concerned about the external environment. China, India and Poland – all intent on making sure that inflation is curbed – have been reluctant to ease policy in order to stimulate growth lest they let inflation rise again. QE3 should help by effectively easing monetary policy there. In Brazil and Indonesia, concerns about DM growth in addition to a desire to renormalise rates to a lower level have led to aggressive easing of monetary policy despite the downside seen in currency performance in 2H11. Chile eased rates despite higher inflation prints, highlighting its concern about growth. Here too, QE3 should bring welcome relief. However, in the case of Brazil and Indonesia, the aggressive action by the domestic central banks in conjunction with the effects of QE3 would likely mean that policy-makers need to keep a watchful eye on growth and inflation. Finally, in the singular case of Hungary, a resumption of capital flows to the EM world is likely to bring much needed relief.

• **On the other hand, in other parts of the EM world, QE3 might bring more concern than assistance:** In Russia, Colombia and Peru in particular, growth continues to be strong and further implicit policy easing could simply mean that domestic policy-makers will begin to worry about overheating.

QE3, commodity prices and EM economies: Besides asset prices, the impact of QE3 will likely spill into commodity prices directly and indirectly (whereby commodity prices also rise because of better growth prospects thanks to QE3). The likes of India, China and Poland will have to worry about the inflationary impact of higher commodity prices. Having just cooled down their economies to avoid overheating and inflation, they should have some leeway as inflation trends down but are unlikely to let their guard down. Should QE3 be both pre-

emptive and large, much of the easing that the Reserve Bank of India may have desired to conduct may be put at risk on the back of higher oil prices. A similar situation (but to a much lesser extent) could arise for Turkey, where growth and inflation are en route to a sizeable slowdown. Higher oil prices may put the CBT in a difficult situation in 2H12.

Commodity exporters, on the other hand, should find the situation reversed. Besides the capital inflows from QE3, higher commodity prices should mean better terms of trade. Our Latin America team is already worried about a return of the 'growth mismatch' which exemplified the two-track growth of strong domestic spending and weak production thanks to a positive terms of trade shock and a strong currency. Russia, South Africa and Indonesia could see a similar dual impact.

How will EM policy-makers respond? Besides the importance of the timing of QE3 for the policy-makers mentioned above, the EM policy response will likely be a combination of liquidity and macro policy actions (see [The Global Monetary Analyst: The Confluence of Liquidity and Macro Policies](#), January 25, 2012). Macro policy will likely be used to cater to the slow changes in domestic demand conditions where necessary. The handful of EM economies already worried about strong growth might tighten policy. Liquidity policy will likely be used to mop up capital inflows if excessive and curb currency volatility as deemed necessary. The combination of these two policy measures should help to address the different speed of developments on the domestic and external front in the EM world.

Summary: The 2009 and (to a lesser extent) 2010 editions of QE were greeted cheerfully by an EM world that still needed growth to be consolidated, but the 2012 version may create some ambivalence among EM policy-makers in 2H12. While this implicit easing by the Fed on behalf of EM policy-makers should help to support growth, the effects on commodity prices will likely mean that policy-makers remain watchful about a return of inflation. Should QE3 be large and pre-emptive, these concerns will likely manifest themselves earlier. For now, EM easing is likely to continue as monetary policy restraints on domestic demand are slowly removed thanks to an ebbing of EM inflation.

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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	2.0% PCE Price Index	1.8%	2.0%	13 Mar	0.08	-1	0	None
Euro Area	< 2% HICP (u)	2.7%	1.7%	09 Feb	1.00	-23	0	ECB already cuts in February
Japan	0-2% CPI (u)	-0.2%	-0.5%	14 Feb	0.05	0	0	-
UK	2% CPI	4.2%	1.9%	09 Feb	0.50	-8	0	Risks balanced around £50 billion call
Canada	1-3% on CPI	2.3%	1.7%	08 Mar	1.00	-25	0	May ease if European risks spill over to global economy
Switzerland	<2% CPI (u)	-0.7%	-	15 Mar	0.00	-11	0	-
Sweden	2.0% CPI	2.3%	1.7%	16 Feb	1.75	-32	-25	Upside risks
Norway	2.5% CPI	0.2%	-	14 Mar	1.75	-43	-25	A 50bp cut
Australia	2-3% over the cycle	3.1%	2.7%	06 Mar	4.25	-15	-25	-
New Zealand	1-3% CPI	1.8%	-	08 Mar	2.50	-1	0	No near-term risk of a hike
Russia	6% CPI	4.2%	6.0%	01-15 Mar	5.25	-	-	-
Poland	2.5% (+/- 1%) CPI	4.6%	2.6%	07 Mar	4.50	-	0	-
Czech Rep	2.0% (+/-1%) CPI	2.4%	2.7%	29 Mar	0.75	-	0	-
Hungary	3.0% CPI	4.0%	4.4%	28 Feb	7.00	-	0	-
Romania	3.0% (+/-1%) CPI	3.1%	4.4%	29 Mar	5.50	-	0	-
Turkey	5% CPI end '12	10.6%	6.2%	21 Feb	5.75	0	0	-
Israel	1-3% CPI	2.2%	2.2%	27 Feb	2.50	-	0	-
South Africa	3-6% CPI	6.1%	5.7%	29 Mar	5.50	-	0	SARB opts to ease rates further at the March MPC
Nigeria	NA	10.2%	12.4%	20 Mar	12.00	0	150	CBN abstains from tightening on growth concerns
China	-	4.1%	3.4%	-	6.56	-	0	Balanced risk
India	NA	7.5%	6.3%	15 Mar	8.50	0	0	Downside risk from lower domestic and global demand
Hong Kong	-	5.7%	5.0%	-	0.50	-	0	-
S. Korea	2-4% CPI	3.4%	2.7%	09 Feb	3.25	-	0	Rate cut as growth in domestic demand decelerates fast
Taiwan	-	2.4%	1.0%	29 Mar	1.88	-	0	Rate cut as external uncertainties intensify
Indonesia	5% +/- 1.0%	3.7%	5.5%	09 Feb	6.00	-	-25	Evenly balanced
Malaysia	-	3.0%	2.2%	09 Mar	3.00	-	-25	Evenly balanced
Thailand	0.5-3.0% core CPI	3.4%	3.2%	21 Mar	3.00	-	0	Evenly balanced
Brazil	4.5% +/-2.0% IPCA	6.5%	5.5%	07 Mar	10.50	-50	-50	Downside risk on global financial crisis
Mexico	3% +/-1% CPI	3.9%	3.7%	16 Mar	4.50	0	0	-
Argentina	15.5-24.2% M2 growth	9.5%	10.6%	NA	15.75	-	-	-
Chile	3% +/-1% CPI	4.2%	2.9%	14 Feb	5.00	0	-25	Cut heavily dependent on inflation print
Peru	2% +/-1% CPI	4.2%	2.7%	09 Feb	4.25	0	0	-
Colombia	3% +/-1% CPI	3.6%	3.9%	24 Feb	5.00	0	0	-

(u) = unofficial

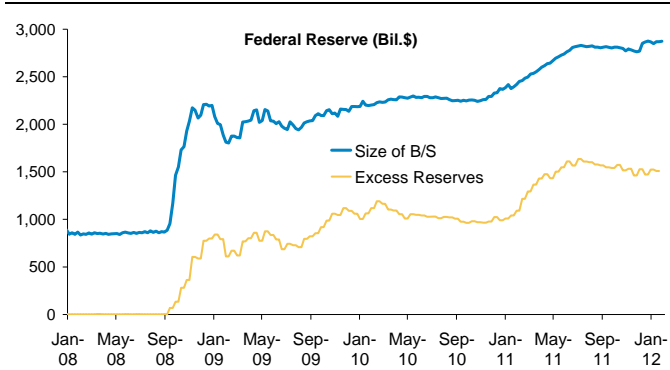
Notes: Inflation numbers in red indicate values above target; MS expectations in red (green) indicate our rate forecasts are above (below) market expectations. Japan policy rate is an interval of 0.00-0.10%.

Source: National central banks, Morgan Stanley Research

Central Bank Balance Sheet Monitor

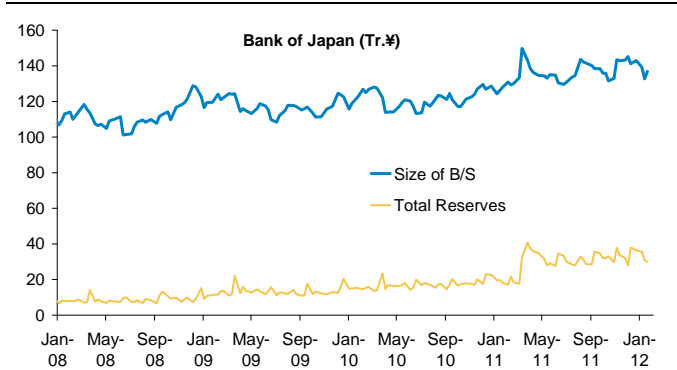
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US



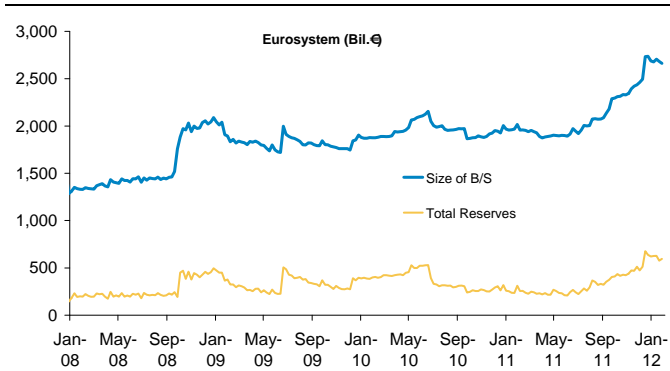
Source: Haver Analytics

Japan



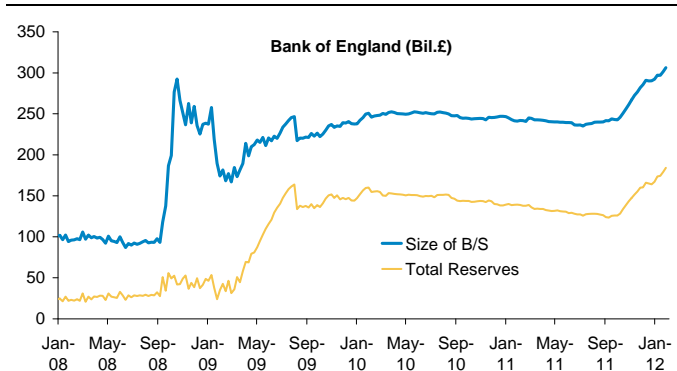
Source: Haver Analytics

Euro Area



Source: Haver Analytics

UK



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US: Fed Likely to Stay QE Course

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A little less certainty about QE3... We still believe that the very dovish FOMC statement and subsequent comments from Fed officials indicate that the bar to additional QE is very low. So we think the Fed would likely need to see a continuation in incoming data of the sort of upside seen in Friday's jobs report to prevent it from pulling the trigger on additional easing in coming months. But we, along with most fixed income investors, were seeing QE3 as looking increasingly highly likely prior to Friday and thinking more about timing and composition than whether it would actually happen, and there is clearly less certainty after the employment report strength on top of the other improved January data. We raised our 1Q GDP forecast slightly over the past week back to our prior long-standing +2.2% estimate. Our forecast for all of 2012 also remains a sluggish +2.2%, which would likely mean slow further progress in bringing down the unemployment rate after the surprisingly rapid decline seen the past few months.

...but without substantial outlook improvement, Fed likely to stay the course: Even if incoming data were to suggest a somewhat better trajectory, the FOMC's higher central tendency growth forecasts of 2.2-2.7% this year and 2.8-3.2% in 2013 were accompanied by expected misses on both sides of its dual mandate over the next few years, with the Fed seeing inflation ranging below its 2% target over the next few years and unemployment far above its 5.2-6% estimate of NAIRU for many years. It would take a substantial improvement in the outlook to change the dual-mandate case for more easing. Note that the Fed Chairman doesn't receive the employment report until late in the afternoon on the day prior to release, but he does get the results for the manufacturing sector earlier in the week. The manufacturing data were the strongest parts of a very strong employment report, and yet this did not dissuade Bernanke from delivering a very dovish message to Congress. And the Fed remembers the past two years when the economy seemed like it might be getting on track early in the year, the FOMC responded by starting to talk about tightening policy – the April FOMC meetings in both 2010 and 2011 included detailed discussions on how to normalise policy and shrink the Fed's balance sheet through asset sales in coming years – the early improvement gave way to mid-year weakness, and within a few months the FOMC had done a reversal from focusing on policy normalisation to implementing new easing measures. Additionally informed by that experience, the Fed still seems a lot more likely to try to nurture any continued 'green shoots' this time than step back from prior moves towards additional easing.

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Japan: Bank Lending Recovers, but More Easing to Come

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Slight rise in bank lending: Total bank lending has now increased (+0.6%Y) for four straight months, even after adjusting for loan write-offs (+0.9%Y). By bank type, the year-on-year decline narrowed at major banks while local banks posted a mild year-on-year increase. Overall, lending is gradually recovering, and we expect the uptrend to continue on demand for post-quake rebuilding funds and lending to electric utilities as well as funding demand related to large corporations' M&A activity. However, the BoJ's Senior Loan Officer Opinion Survey on Bank Lending (January, response period: December 9-January 12) showed a somewhat noticeable decline in SME funding demand among corporate borrowers, despite loan demand DIs staying in a flat range since October. Banks are growing more cautious about extending credit, regardless of borrower size, as stock market slumps hurt bank asset holdings and European sovereign and other issues drag down the economic outlook. Given that yen strength may lead to slow domestic capex ahead, and considering the tendency for delays in disaster-hit areas' reconstruction plans, brisk growth in funding demand looks unlikely, and we expect the lending recovery to be a mild one.

Tighter credit stance on SMEs avoided: The greatest immediate concern had been the expiration of the so-called Moratorium Act (designed to facilitate SME financing). Previously slated to expire at end-March 2012, it has now been extended for another year to end-March 2013 (as announced on December 27, 2011). This allays concern that its lapse would cause a squeeze on SME finances. Critics of the legislation say that it will lead to banks putting off recognition of potential bad debts, but we think that the political decision to extend it was unavoidable amid a global economic outlook that is more uncertain than ever.

BoJ to follow the Fed: As the BoJ grows increasingly concerned about the risk of economic downturn, we believe that it is highly likely to stay on course for further monetary easing in 2012. Particularly if the Fed goes ahead with QE3, which can be expected to increase upward pressure on the yen, we believe that the BoJ will be unable to avoid additional easing in response. The list of possible easing options includes expanding the asset purchasing fund and extending the duration of JGBs purchased. And depending on forex market trends, foreign bonds may be newly added to the fund's purchasing menu.

UK: £50 Billion QE Likely from the BoE

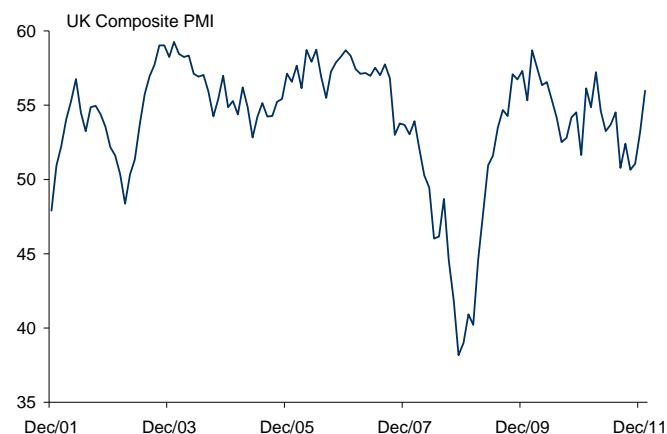
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We now expect the MPC to increase asset purchases by £50 billion tomorrow, rather than the £75 billion we previously forecast: The improved tone emanating from the continent in the aftermath of the ECB's December LTRO and the better-than-expected high-frequency domestic data suggest to us that this has a greater likelihood than a £75 billion move. Indeed, given the existence of a split of views on the committee, this may be a sensible compromise.

The case for further QE remains compelling though: Crucially, the 0.2%Q decline in 4Q GDP was worse than the BoE expected and (like us) it is forecasting flattish growth in 1Q12 (although obviously the risks to this are now to the upside) – the upshot being that increasing spare capacity will put additional downward pressure on prices in the medium term. Moreover, recent inflation-related data have generally reinforced the view that inflation will fall sharply further over coming quarters. In addition, one should not forget that large downside risks remain with regards to developments in the eurozone. Against this backdrop, we think it is very unlikely that the MPC will want to take any risks with the economy at the current juncture.

Going forward, we continue to expect another £50 billion of QE in May, although obviously much will depend on external developments over the coming months.

UK: PMI Surveys Pointing to a Pick-Up in Growth



Source: Haver Analytics

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Australia: RBA Outlook

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Another one to two 25bp rate cuts still seem on the cards, despite yesterday's on-hold outcome from the RBA.

Yesterday's RBA statement confirmed that the bank is broadly happy with how the domestic economy looks – growth not too far from trend, and inflation in its target zone:

This was also how it characterised things in November, when it cut. That cut looked like an insurance move, given worsening events in Europe. With tail risks in Europe fading, clearly the bank sees no need to ease further. As it is, policy is now around neutral. All this implies that further rate cuts will depend on either renewed deterioration in the global outlook, or weaker domestic data. We think both are possible by mid-year.

Tightening bank funding or fatter tail risks... Our macro team expects slower growth in the US, recession in Europe and a moderate slowing in Asia. Given Australia's Asian focus, a vanilla recession in Europe wouldn't be sufficient for the RBA to cut rates, in our view. The way Europe can affect Australia is by tightening bank funding, or if the tail risks start to fatten. Our European team's view is that while the ECB's LTRO reduces stress on bank funding, European banks will continue to delever and – more the point – there remain serious tail risks. The most obvious (and proximate) are Greece and Portugal.

...as well as labour weakness could prompt more easing: Domestically, the domestic data have improved a little from a soft mid-2011. However, the trends in employment and retail sales remain soft, in particular as corporate retrenchment continues. Australian consumers aren't used to job insecurity. In 2008 – when, for sure, the risks were far higher – the result was a sharp lift in household saving. As consumers react to the ambience of labour weakness, we believe that they will be cautious enough that the RBA will feel the need to provide more easing.

The most important indicator to watch remains employment, but also keep an eye on housing: If home buyers respond to the 50bp easing at the end of last year, then presumably they're confident enough to keep spending. If there's little or no response, then that will likely go hand-in-hand with growth unacceptably below-trend.

Rate markets are now at the stage of pricing in two cuts by mid-year: This was always our base case. What markets were pricing late last year – five rate cuts – was only likely in a bear scenario of US/European recession, with clear recession risk here. That was possible, but not the most likely outcome. Market pricing seems about right to us now.

Russia: Rates on Hold as Expected, Watch Liquidity Management

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The CBR kept rates unchanged on February 3, in line with the consensus and our view.

Inflation victory and inflation fears: The CBR pointed to the significant slowdown in inflation from 6.1%Y at end-2011 to 4.1%Y at end-January, below this year's inflation target of 5-6%. Moreover, RUB strength in January might have a disinflationary effect in the coming months, according to the statement. However, the CBR also acknowledged that tariffs and regulated prices hikes have been postponed until June, and said that it will therefore focus on the medium-term inflation forecast.

Strong household demand and weak industrial production: The statement highlighted that December consumption was robust as a drop in unemployment, high income and lending growth supported growth in retail sales. Fixed investment growth also accelerated. Still, industrial production growth slowed down from November due to the weather conditions, and business confidence eased in recent months. The CBR believes that current interest rates are adequate in order to balance out major macroeconomic risks *in the nearest months*.

Main tool (to tighten) in 2012 – liquidity management, we think: We think that the CBR sees inflationary risks ahead from the tight labour market, robust growth and potential DM monetary easing, and has a bias to tighten monetary conditions overall. However, with inflation currently running under target and the banking system adjusting to positive real rates on a sustained basis for the first time, we think that communicating the rationale for a rate hike effectively could be a challenge. We thus argue that the CBR would prefer to tighten monetary conditions quietly, by managing the provision of liquidity, rather than using rate hikes. In 2H, when we see inflation picking up, we think that the CBR will again prefer to tackle inflation through liquidity tools rather than rate hikes, this time to avoid exacerbating capital inflows (for more details, see [Russia Economics: The Quiet Hawk](#), January 30, 2012).

February 8, 2012
The Global Monetary Analyst

Czech Republic: CNB Embraces Bear Case and Sees Recession in 1H

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On hold, growth forecast marked down significantly: The Czech National Bank kept rates unchanged at 0.75% on February 2 as universally expected. All six board members who were present at the meeting voted to keep rates on hold (Vice-Governor Hampl did not attend). The CNB also released the contours of its new forecast, which will be presented in full on February 10. The staff significantly lowered their GDP projections, and now see zero growth this year (previous: 1.2%) and 1.9% next year (previous: 2.7%). The downgrade came in response to a more negative view on the external environment, and is now consistent with GDP falling at an average 0.75% annualised pace in 1H12, recovering in 2H.

Inflation pressures should abate quickly after near-term increase: As in the previous projection, the new forecast sees CPI slightly higher in the near term than in the old forecast, but falling sharply afterwards. The 1Q13 CPI average is now 1.5% (previous: 1.6%) and the 2Q13 average is 1.5% (unchanged). Therefore, the inflation story has not changed meaningfully. And core inflation (ex tax) is still very muted. Note that both headline and core inflation are *below* the 2% target at the monetary policy horizon.

Modest CZK gains in the pipeline, chances of easing ahead: Consistent with the forecast is some firming in CZK, though not as pronounced as in the previous projection. The CNB now assumes EURCZK at 24.5 in 4Q12, up from 22.7 in the previous forecast. This is not far from current trading levels of 25. The implied exchange rate trajectory consistent with this macro framework sees broad stability in the near term, followed by some rate cuts later this year. In other words, assuming the currency trades broadly sideways from here and both growth and inflation pan out as forecast, the CNB could be cutting rates by about 50bp between now and year-end.

Bottom line: While the CNB forecast may look rather bearish, we note that the bank was far better at calling the downturn than the market was in 2008-09. The bank describes the risks around its forecast as balanced overall. Since the cut-off date (probably January 20), EURCZK is about 1% lower, which boosts the doves' case on the margin. But as Governor Singer said in the press conference, a rate cut could cause unease with some board members. Overall, we still see rates on hold in 2012, with the recent move stronger in CZK raising the risk of some marginal easing from current levels (0.75%).

Hungary: Budapest Trip Notes

Pasquale Diana (44 20) 7677 4183

Current disagreement on NBH Council revolves around probability of IMF deal: The decision to leave rates on hold in January was probably the result of a 4-3 split on the board. The February 15 minutes will offer greater insight, but we believe that the disagreement stemmed from the subjective probability assigned to an IMF deal. The doves seem to implicitly assume a deal *will* get done, which implies no reasons to hike rates further as the assistance package will be sufficient to reduce refinancing risks (and by extension currency risks). The hawks likely favour a more conservative approach, and saw no reason to halt the tightening cycle until words are followed by action on the part of the government.

Conditions for rate cuts later in the year are falling into place: We think that the recent rate hikes in November and December were entirely justified: the NBH believed that the combination of near-term CPI risks and financial stability concerns related to HUF depreciation warranted a rise in rates. That said, while near-term CPI risks remain elevated, it is also true that the medium-term picture remains benign, with the staff projection showing inflation easing to sub-3% in 2013. And assuming an assistance package eases concerns around the currency, the NBH can be more relaxed on this front also.

Assuming a deal is struck by April at the latest, we think interest rates have peaked at 7% (previously: 7.50%). Also, we think that the NBH is likely to gradually move to an easing bias in the coming months. Growth risks remain firmly tilted to the downside, and the core inflation picture is not a concern. Assuming external risks are capped by a sizeable (€15-20 billion) precautionary SBA, we think that the NBH will be able to take back at least the recent 100bp of rate increases by the end of this year. We thus see rates at 6% by end-2012.

A step closer to normality – FX sensitivity set to decrease: Assuming a high participation in the provisional exchange rate fixing programme (which runs to 2016), most households would no longer see monthly repayments on FX mortgages fluctuate with the exchange rate. Rather, the difference between the real FX rate and the fixed rate will accrue in a buffer account which is payable (at no interest to the borrower) starting in 2017. Obviously, the currency moves still matter. That said, the NBH should be able to ignore short-term volatility to a greater extent, as the monthly repayments will not fluctuate. Overall, it seems fair to say that the December scheme would *reduce* the near-term sensitivity of the economy to FX swings. This would grant the NBH more degrees of freedom than it currently has. Hence, it is supportive of easing later this year.

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Turkey: Has Inflation Peaked?

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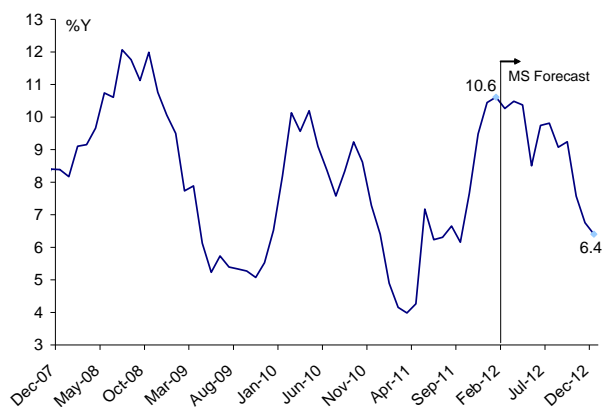
With inflation at a 39-month high, we are revising our year-end forecast a notch higher: January CPI inflation at 0.56%M exceeded both our and consensus expectations and pulled the headline annual inflation rate to 10.6% – a 39-month high. On the back of the higher-than-expected January CPI print, we are raising our year-end forecast to 6.4%Y, and we note that our full-year average forecast stands at 9.1%.

Has inflation peaked? In our view, inflation is likely to have peaked at this point and, provided that the currency remains relatively stable, we are likely to see a gradual but faster improvement over the coming months. We expect the first main decline in inflation to materialise in May on the back of base effects (a well-known fact by the market), but the steep decline is likely to take place in the last quarter of the year.

Why was it high? Looking at the components, we see that food prices (especially unprocessed) contributed significantly with a 1.1%M rise, which was more or less expected. But the key contributions came from the utility price hikes (natural gas and water), highway and bridge tolls, transportation services and LPG. These led to a noticeable rise in transportation and housing price inflation. We think that these are somewhat one-off in nature, and their impact will dissipate soon.

Policy impact: We do not think that the January CPI print has come as surprise to the CBT, as it had been preparing the market for an extended period of high inflation. In fact, Governor Basci made it clear that the relatively tight monetary conditions would remain for some time. Hence, we expect the current practice to remain unchanged and the CBT to increase its efforts to close the credibility gap during 1H12.

Turkey: Inflation Near its Peak?



Source: TURKSTAT, Morgan Stanley Research forecast

Nigeria: A Summary of International Investor Views

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Some encouraging interest: We have spent three weeks marketing our views on Nigeria to more than 50 international investors in Europe and the US. On the whole, investors appear to be constructive on Nigeria despite the barriers to entry and the uncertain political outlook – challenges that were seen to be prevalent in most frontier markets and not just Nigeria. We were also encouraged by the greater interest in the country – compared to 2011 – and the extent of detail that investors were willing to discuss/debate.

We received some pushback on our view that USDNGN could trade as high as 168 in 1Q12: Investors generally saw the currency trading sideways in the absence of a significant deterioration in the Boko Haram attacks, with a few arguing that it could in fact appreciate in the coming weeks and months as EMFX in general finds support. With regards to the need for a competitive naira, most clients agreed with our view that a weaker naira is unlikely to have a significant impact on export growth, given the dominance of oil – which is independently priced in the international markets – in the country's export basket. Not surprisingly, most investors were critical of the CBN's decision to devalue the currency by a rather meagre 3% in November 2011, and agreed with our view that this risks sending the wrong message to market participants – who may well push for more.

Debating our off-consensus call on policy rates: Investors were of the view that our call for 150bp of Monetary Policy Rate hikes at the upcoming MPC meeting in March was rather aggressive and certainly out of consensus. Opinions gradually began to change post the January 31 MPC meeting, however, where Governor Sanusi indicated that an expansionary budget, or the emergence of second-round inflation pressures as a result of the increase in petrol prices, would probably result in tighter money – the two key factors (alongside a weaker currency) that drove our rate call.

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Ghana: International Investor Feedback

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We spent the past three weeks marketing Ghana to international clients in the UK, continental Europe and the US, and provide some feedback.

Minimal pushback on our view of currency weakness: We found it interesting that we had very little pushback on our view that, despite the expected uptick in oil production, the cedi is likely to weaken in 2012. The fiscal outlook was often cited as the reason for such bearishness. Towards the end of our trip, however, there was a slim minority of clients who were willing to bet against the consensus view of cedi weakness. These were mostly fixed income clients who pointed out that, at double-digit yields, the country's three-year paper looked attractive, notwithstanding their view on the currency. With most investors looking for (and perhaps positioned for?) a weak cedi this year, we believe that the risks to our USDGHC forecast may well be skewed to the downside.

We did get some pushback on our view of double-digit inflation this year (government estimate 8.7%), as investors felt that we may have overstated the potential pass-through from a weaker FX and higher oil prices (thanks to the removal of the fuel subsidy at the beginning of this year) to headline inflation. As such, most investors felt that our call for policy normalisation to begin as early as 4Q12 was premature. That said, it is also worth pointing out that a minority of clients felt that the Bank of Ghana may have to consider raising interest rates as early as mid-year, if the currency were to depreciate significantly.

Impact on our views: We maintain our view on oil sector prospects, inflation and policy rates. However, given that most investors appear to be positioned for currency weakness, we believe that the risk to our USDGHC call may be skewed to the downside.

Investment thesis: On the whole, Ghana appears set to maximise the macro benefits from its oil find in the years ahead. A deepening of the country's capital markets should go a long way towards attracting investors who wish to play the Sub-Saharan Africa growth theme.

China: Inflation Likely to Fall

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We expect CPI inflation to edge down: The January macro datapack – inflation, monetary and foreign trade – will be released starting from February 9. The January-February data on growth indicators – IP, FAI, retail sales – will be made available together in March, due to the distortion from Chinese New Year. Notably, we should interpret the January-February data cautiously, as different timing of the Chinese New Year makes the year-on-year comparison more volatile (it was in January this year versus February last year). Specifically, we expect CPI inflation to have edged down to +4.0%Y in January (versus +4.1%Y in December) on subdued non-food inflation, despite the substantial sequential gain in food inflation. PPI likely slid further to +0.5%Y in January from +1.7%Y in December as industrial activities and aggregate demand continued to moderate.

On the monetary front, we expect Rmb1,050 billion of new RMB loans in January, taking into consideration the contravening effect from the fewer working days due to Chinese New Year and the seasonal surge in bank lending in 1Q12. Meanwhile, M2 growth will likely have moderated marginally from +13.6%Y in December to +13.4%Y in January, as the backflow to fiscal deposit more than offset the substantial new loan creation and possible revival in capital inflow. On the external front, we expect exports growth to have softened to +8.0%Y in January (from +13.4%Y in December) as the anaemic DM recovery continues to be a strong headwind to China's export growth. Import growth will likely have moderated to +9.0%Y in January (from +11.8%Y in December) due to Chinese New Year distortion.

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India: Limited Scope for Policy Easing Despite Slowing Growth

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Growth under pressure: High and persistent inflation, a slow pace of policy reforms to boost investment, graft-related investigations, weak global capital markets and a weak global economy have begun to weigh on India's growth trend. We see a significant further deceleration in domestic demand in the coming months. Moreover, with further decreases in our global and G-10 growth estimates for 2012, we expect the weaker global growth outlook to accentuate the slowdown in India's growth, meaning that GDP growth should decelerate to 6.9% in 2012 (7% in FY 2013).

Inflation to moderate to 6.8-7% by March 2012: We expect headline inflation (WPI) to decelerate to 6.8-7% by March 2012 on account of base effects in food inflation and global commodity-related products. However, we do not see inflation declining to the RBI's comfort zone of 5-5.5% soon unless commodity prices fall hard. We also see upside risks to our inflation estimates from a further weakening of the rupee.

When will the RBI cut policy rates? In the context of the inflation outlook, one of the key factors identified in the RBI's January 24 monetary policy statement was the government's effort on fiscal consolidation. With the annual budget likely to be presented in March, we believe that policy rate cuts are more likely to be post the budget in March or later in April.

Monetary easing to be slow and limited: Finally, as inflation is unlikely to decline towards the RBI's 5-5.5% comfort zone, we expect only a limited policy response. After the RBI cut the CRR ratio by 50bp at its January 24 meeting, we see it reducing policy rates by a cumulative 100bp from March-April 2012 to 7.5% by end-2012. During the credit crisis, GDP growth decelerated to a trough of 7.2% in 2009 (from 9.5% in 2007) and policy rates were reduced by a cumulative 425bp. However, while GDP growth in 2012 should be below that in 2009, we expect rates to be reduced by about 100bp only.

For full details, see [Asia Insight: India: Don't Bank on Quick Inflation, RBI Policy Windfalls](#), February 6, 2012.

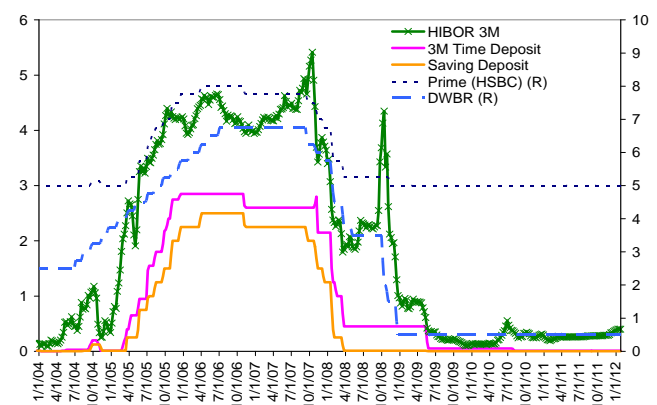
Hong Kong: Monetary Conditions Monitor

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Hong Kong financial markets and monetary conditions maintained relative stability in the past month. The jump in equity fund-raising activities in December drew noticeable inflows into HK\$, evident in the US\$9.1 billion increase in the banking system net foreign asset position (reversing the US\$2.8 billion dip in November) and pick-up in HK\$ deposits (+0.8%M/+3.4%Y) and broad money HK\$M3 (+0.8%M/+4.6%Y). The HK\$ loan/deposit ratio eased to 84.5% (-1pp MoM), as domestic credit growth slipped to 13.2%Y on the high base effect. The total liquidity stock in the Hong Kong banking system recharged to HK\$1.39 trillion (US\$178 billion), sustaining the large buffer against the impact of mild inflows and outflows on money market interest rates.

Interest rates: HK\$ money market rates edged up further in the last month, but maintained a roughly stable spread below their US\$ counterparts. 3M HIBOR rose to an average of 0.4% in January (0.35% in December), while 3M LIBOR reached 0.57%. The 3M HIBOR-LIBOR discount averaged 17bp in January (21bp in December). With regard to mortgage lending rates, the share of HIBOR-based mortgages declined further to only 8.2% of new loans in December (from 19.2% in November, 28.1% in October, 46.2% in September and the peak of 92.2% in January), while the majority of prime-based mortgages continued to be offered below 2.5%. Amid the lacklustre economic performance, our global team expects central banks to maintain a dovish stance for the foreseeable future, and no Fed rate hike through end-2013. For Hong Kong, we see HIBOR (3M) remaining below 0.5% throughout our forecast horizon (until end-2013).

Hong Kong: Interest Rate Trends



Source: HKMA, CEIC, Datastream, Morgan Stanley Research

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Korea: Expecting No Change

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We expect the Bank of Korea to keep the policy rate unchanged at 3.25% at its monetary policy tomorrow:

Headline inflation is easing on a base effect, but we see that the underlying inflation expectation is still rather high due to the abundant liquidity conditions. If not carefully managed, inflation could spike up again easily should there be any supply disruptions in food or commodities. Korea's interest rate is still way below neutral, but the normalisation process is halted by external uncertainties, yet it does not mean that there is an urge to cut interest rates. We expect one rate cut later in the year because we think that the recovery in domestic demand could turn out to be weaker than expected, thus forcing one symbolic cut, but it is unlikely to come imminently.

Taiwan: Slightly Higher Inflation Due to CNY Festival

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Taiwan's consumer price inflation rose to 2.4%Y in January from 2.0% in December due to the Chinese New Year holidays (CNY). It was above our and consensus forecasts of 2.2%Y. The holidays were in January this year, while they fell into February in 2011. Therefore, CPI inflation was pushed higher on a year-on-year basis because of the base effect. Food prices stayed at a high level due to seasonal demand during the major holidays. Housing/utilities prices also went higher because of the higher cost of household keeping services and gas supplies. On a sequential basis, consumer price rose by 0.3%M in January, after the gain of 0.3%M in December. Core inflation (CPI excluding food and oil) increased by 1.9%Y in January (versus 1.2%Y in December) on the higher housing/utilities prices. Despite the uptick in January CPI, Taiwan's headline inflation still ranks the lowest among all AXJ economies, and thus inflation is still not a problem in Taiwan.

Import price inflation slightly lower due to eased commodity prices: Import price inflation moderated to 7.6%Y in January from 8.0%Y in December and 9.3%Y in November, due to eased commodity prices. The eased import price inflation could mean that Taiwan would see less cost-push inflationary pressure during the economic slowdown periods. On the other hand, export prices increased by 4.6%Y in January, compared to 3.0%Y in December, and were at their highest level in 19 months. Hence, Taiwan's terms of trade improved in January.

Inflationary pressure still mild: Despite the uptick in January inflation, we think that Taiwan's overall inflationary pressures remain mild. The relatively high headline inflation in the past two months was pushed up mainly by the poor weather conditions and the holiday effect. Taiwan's inflation should remain the lowest in AXJ region, with low inflation expectations and stable housing rents. Having said that, we think there is little room for the Central Bank of Taiwan to cut the policy rate, as the interest rate is already way below neutral and liquidity is abundant.

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Indonesia: 25bp Cut Likely

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We expect a 25bp cut tomorrow: Although BI has kept the policy rate on hold in the last few MPC meetings, we believe that it is a pause and not a halt. Indeed, following the non-move at the January MPC meeting, BI subsequently announced further “easing of sorts” by reducing the lower band of the interest rate corridor by another 50bp. We believe that downside risks to BI’s 2012 GDP growth forecast of 6.3-6.7% would likely prompt BI to undertake one more 25bp rate cut. The exact timing of the rate cut is slightly harder to predict, but we have penciled in a 25bp cut tomorrow.

4Q11 GDP – sustained momentum: 4Q11 GDP came in at +6.5%Y, in line with consensus expectations but above Morgan Stanley’s +6.1%Y. On a sequential seasonally adjusted basis, the economy rose by a faster 2.2%Q (versus +1.4% in 3Q11). Full-year 2011 GDP stands at 6.5%Y. Overall, domestic demand provided the growth cushion even though exports slowed down in 4Q11 and the external balance posed a drag. Specifically, domestic demand components largely sustained strength or showed acceleration in momentum. Fixed capex was the bright spot, rising by 11.5%Y in 4Q11 (versus +7.1%Y in 3Q11), likely as the structural decline in capital cost filtered through. Private consumption also grew at a healthy pace.

It will likely be a balance between funding risks and inflation risks: Recall that inflation had been a concern for Indonesia in early 2011. However, inflation subsequently subsided as high food prices normalised, quelling cost-push pressures, and funding pressures emerged and the global economy slowed down, softening demand-pull pressures. In this slowdown cycle, BI had been much earlier than other central banks in terms of policy easing. If funding stress arises again and global macro conditions deteriorate from here, BI’s policy action so far should help to provide some buffer, currency vulnerability notwithstanding. However, if the upside surprise in global macro data is sustained amid unconventional easing by DM central banks and fading of funding stress, we think that BI’s pre-emptive dovish stance so far may mean that there could be some cyclical upside risks to inflation.

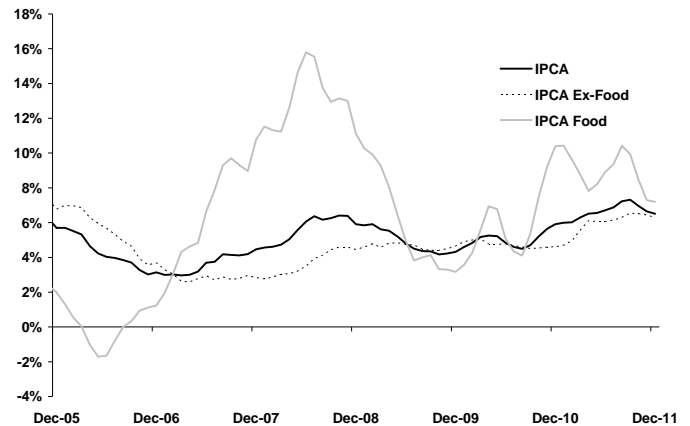
Brazil: January IPCA Preview

Arthur Carvalho (55 11) 3048 6272

January IPCA to be released on Friday: This will be the first IPCA reading with the new weight structure, where autos gained weight while some services such as education lost weight. Seasonal pressures such as food and education are likely to keep sequential readings pressured over the next few months.

On the other hand, compared to a year ago, headline inflation should fall to 6.2% from 6.5% in December 2011.

Brazil: Inflation (%Y)



Source: IBGE, Morgan Stanley Latam Economics

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Mexico: Watching for Broader Price Pressures

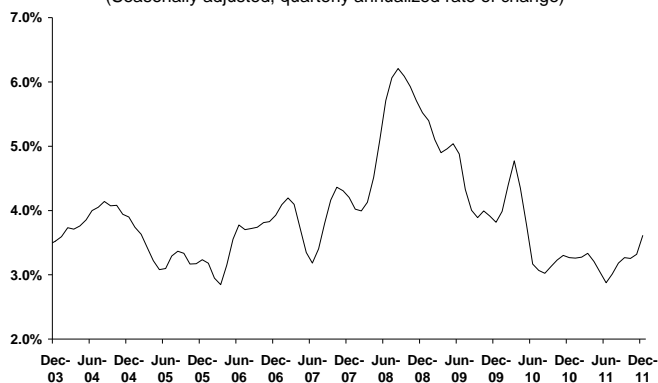
Luis Arcentales (1 212) 761 4913

January CPI to be released on Thursday: The minutes from the January 20 meeting stressed that, in the central bank's view, the recent upturn in inflation – which hit a one-year high of 3.94% in the first half of January – is likely to be transitory in nature and has been caused mainly by non-core components of the consumer price basket.

Accordingly, we will be watching for any signs of broader price pressures, particularly any change in the benign trend in services costs, which may force the central bank to shift its so far dovish stance.

Mexico: Core Inflation

(Seasonally adjusted, quarterly annualized rate of change)



Source: Banxico, Morgan Stanley Latam Economics

Chile: Inflation to Return to Normal?

Luis Arcentales (1 212) 761 4913

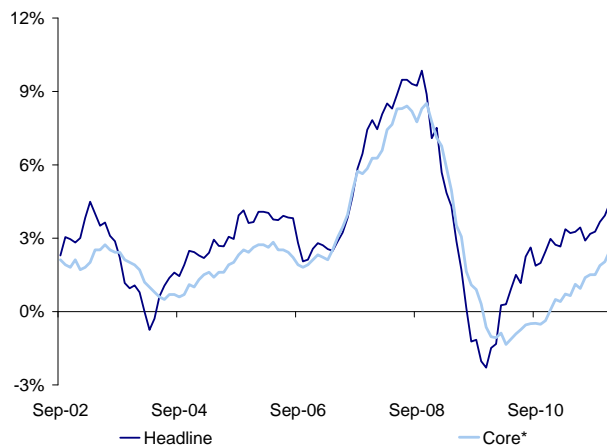
Was December's surprisingly high inflation reading a one-off event or the start of a more worrisome uptrend?

At least based on inflation expectations, which have remained near the 3% central target, Chile watchers are betting that price pressures will be only transitory in nature. January CPI, released today, provided some insight.

There are reasons to think that inflation will remain relatively well behaved during 2012:

The economy, including domestic demand, is cooling off and the exchange rate has regained ground. In addition, medium-term inflation expectations remain well anchored and the central bank – which surprised with a rate cut on January 12 – has signalled that it may stay on hold if inflation trends were to deteriorate. January's inflation reading (+0.1%) came in below expectations, consistent with the central bank's guidance that some of the factors that pushed December's prices higher, such as food prices and transportation costs, were transitory. January's Inflation Report wasn't unequivocally dovish: for example, the policy-relevant CPIX1 core measures (excluding perishables, energy and administered prices) were a bit high (+0.3%), driven by gains in clothing, furniture and appliances, which usually experience seasonal declines in January. Still, with inflation showing signs of normalisation from December's spike, we suspect that the central bank should find enough room to continue easing policy at a gradual 25bp pace.

Chile: Core and Headline Inflation (%Y)



Source: INE; *CPI1X

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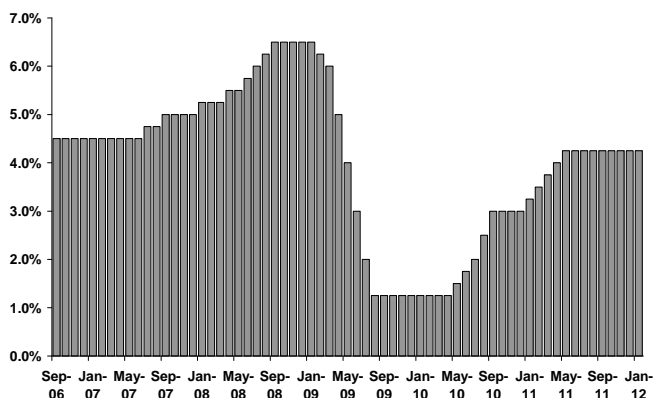
Peru: Rates Likely on Hold

Daniel Volberg (1 212) 761 0124

No move likely tomorrow... While we see upside growth and inflation risks in Peru, we suspect that the central bank is not yet ready to move rates higher. Its assessment seems to be that the recent high inflation is due to a transitory food supply shock.

...but hikes could come from 2Q: We suspect that strong demand growth underpins the inflationary pressure that goes beyond just food. We expect that this dynamic should become more apparent by 2Q, when the central bank may be forced to hike rates.

Peru: Policy Interest Rate (annual rate)



Source: BCRP

Colombia: All Fired Up

Daniel Volberg (1 212) 761 0124

Colombia's central bank once again bucked the global trend of policy easing by hiking interest rates last week, raising questions about the economic and monetary policy outlook in the quarters ahead. Indeed, it appears that with a more constructive tone out of Europe, where ECB-driven bank funding seems to have mitigated the risk of a hard landing, as well as with elevated levels of commodity prices – especially oil – the external backdrop in Colombia remains very favourable. This has allowed policy-makers to focus more on domestic economic dynamics and inflation risks. Given the robust domestic economy and the reduction in external risks, we are upgrading our 2012 and 2013 macro forecasts, including GDP, inflation, the currency and interest rates.

We suspect that there may be three elements within Colombia's domestic macro dynamics underpinning the central banks' move to tighten monetary policy: First, strong expansion in economic activity has raised the risk of overheating. Second, there is the concern about asset bubbles and consequently systemic risks. Finally, there is the risk of de-anchoring of inflation from the inflation target.

Forecast changes: We are moving our GDP forecast for 2012 to 6.7% (from 4.1%), while moderating our 2013 forecast (4.9% versus 5.1% before). We are also revising inflation up for 2012 to 4.1% (from 3.1%) and expect to see a total of 100bp of additional hikes to reach a policy rate of 6% (versus our previous call of no further hikes). Given a more aggressive central bank and stronger growth, we expect more pressure for COP to appreciate and are revising the currency forecast for both 2012 and 2013 to 1,800 (from 1,875). The currency appreciation is likely to be greatest in 1H12, likely prompting a response from policy-makers that could go beyond the US\$20 million a day reserve accumulation programme announced over the first weekend of February.

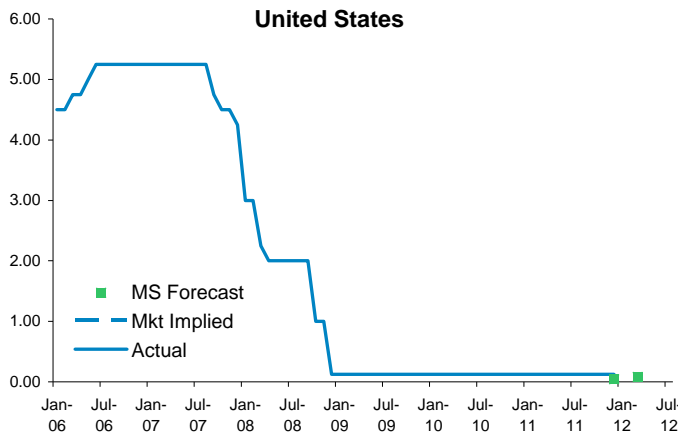
For full details, see "Colombia: All Fired Up", [This Week in Latin America](#), February 6, 2012.

Colombia: Forecast Changes (%Y unless stated)

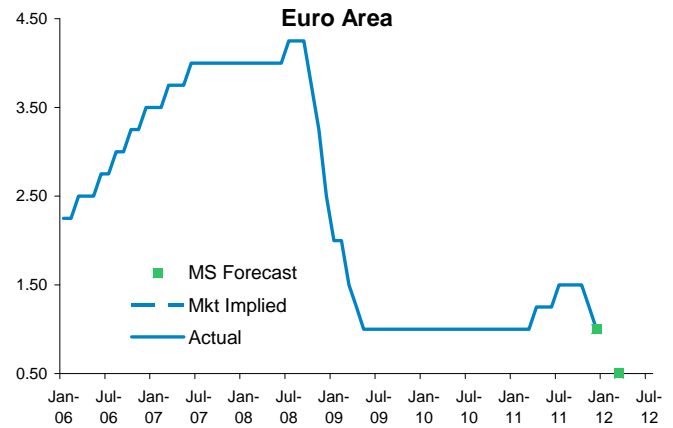
	2012		2013	
	New	Old	New	Old
GDP	6.7	4.1	4.9	5.1
Inflation	4.1	3.1	3.1	3.1
Interest rate (% pa)	6.00	5.00	5.00	5.00
Exchange rate (COP/USD)	1,800	1,875	1,800	1,875
C/A balance (% of GDP)	-0.9	-1.0	-0.9	-0.9
International reserves (US\$m)	36.0	34.0	38.0	36.0
Fiscal balance (% of GDP)	-2.5	-2.6	-1.8	-1.9

Source: Morgan Stanley Latam Economics

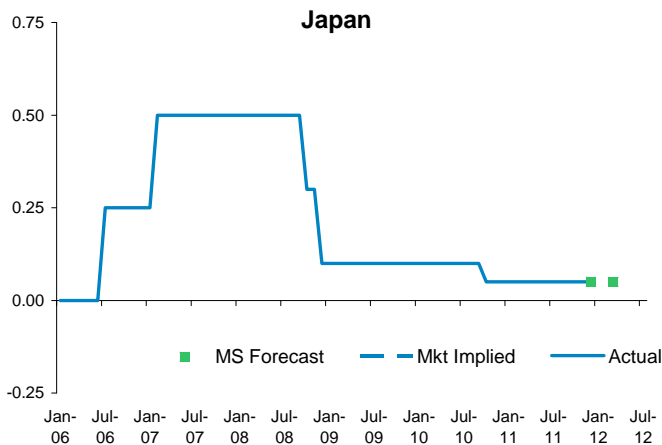
Monetary Policy Outlook – Morgan Stanley versus Markets



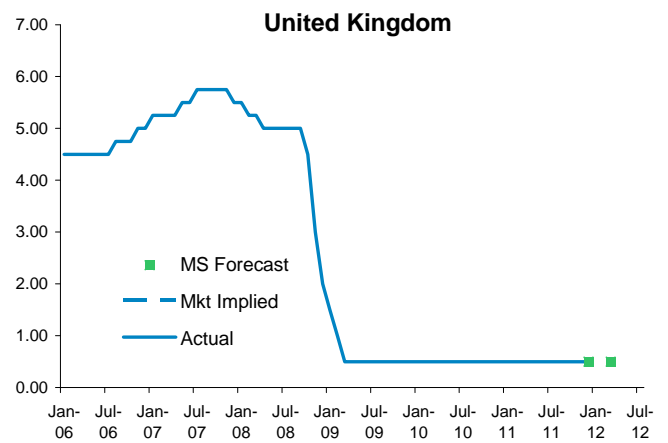
- A little less certainty about QE3 post-employment report, but we still think the bar is very low and we would need to see a continuation of this sort of data upside to prevent further easing.
- Our expectation of GDP growth near 2% over the next two years and little unemployment rate improvement point to zero rates extending beyond 2014.



- Whether or not the ECB will cut rates in February is a very close call.
- While the Council's acknowledgment of "tentative signs of a stabilisation" would argue against a rate cut, the phrase "a very thorough analysis of all incoming data is warranted" would be the same language that preceded the November rate cut.



- The BoJ expanded its asset purchase programme on October 28, but we believe that further monetary easing is likely.
- We expected the BoJ to extend the programme's current two-year limit on JGB maturity and to lower the IoER, though the bank does not see that level of urgency.

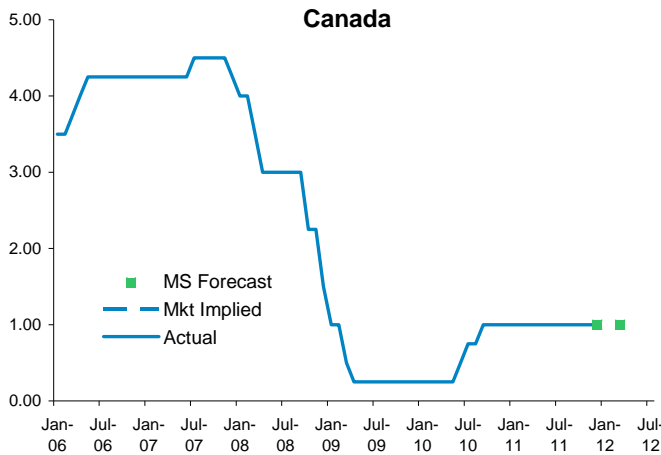


- We expect the MPC to expand QE by £50 billion in February.
- Recent data have been better than expected and the minutes of the January meeting were less dovish than anticipated. Risks are balanced around the £50 billion call.

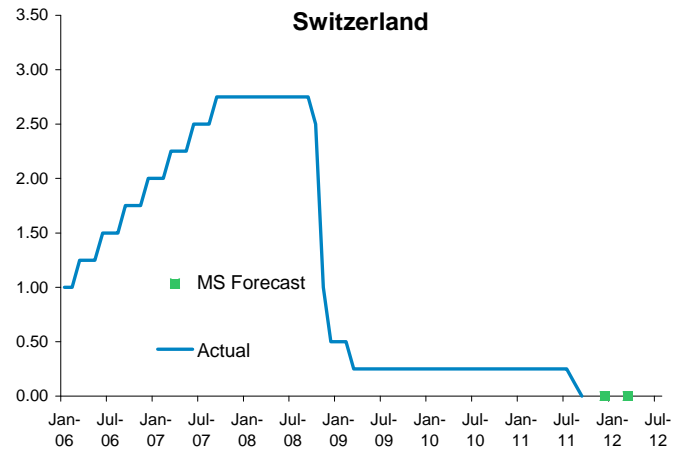
Source: National Central Banks, Morgan Stanley Research

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

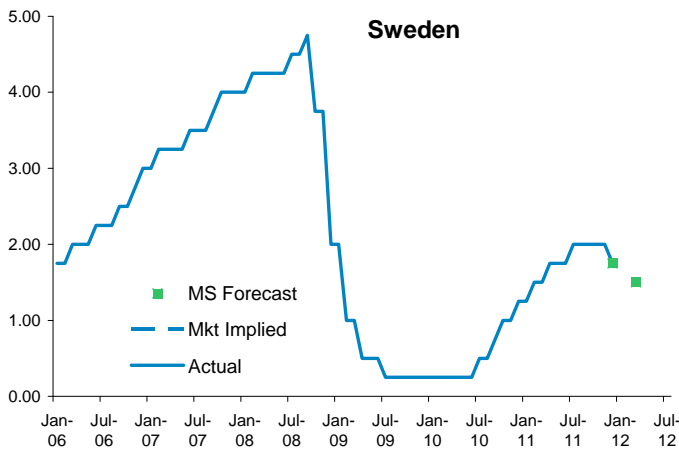
Monetary Policy Outlook – Morgan Stanley versus Markets



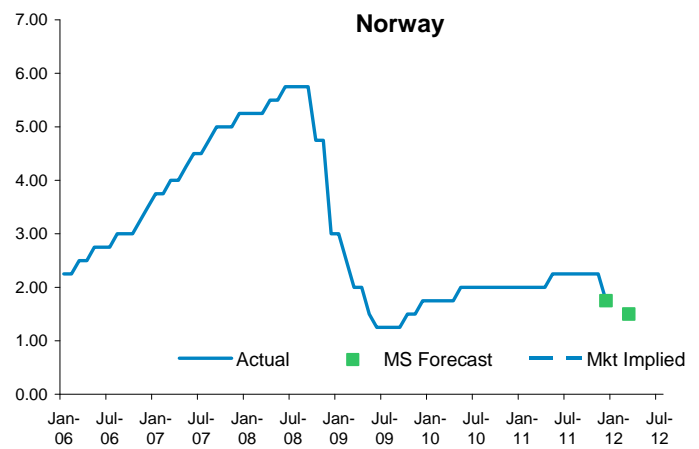
- The BoC is firmly on hold amid heightened global uncertainties. The main risks to the outlook are external – stemming from Europe.
- We believe that the BoC is likely to remain on the sidelines until 2H12. There is no need for a rate cut as domestic conditions are still robust. That said, external risks will likely keep the BoC in a mode of caution for now.



- ZIRP until mid-2012 following August rate cut.



- Markets are pricing in lower repo rate path than we expect in 2012.
- Executive Board's assessment on market tensions will likely determine monetary policy in the near term.



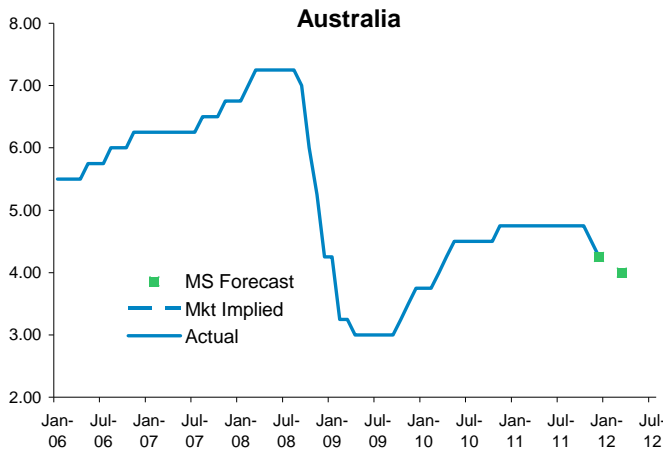
- We expect another 25bp of cuts in 2012 as the global economy deteriorates and the ECB cuts rates to 0.50%.
- Risks are to the downside.

Source: National Central Banks, Morgan Stanley Research

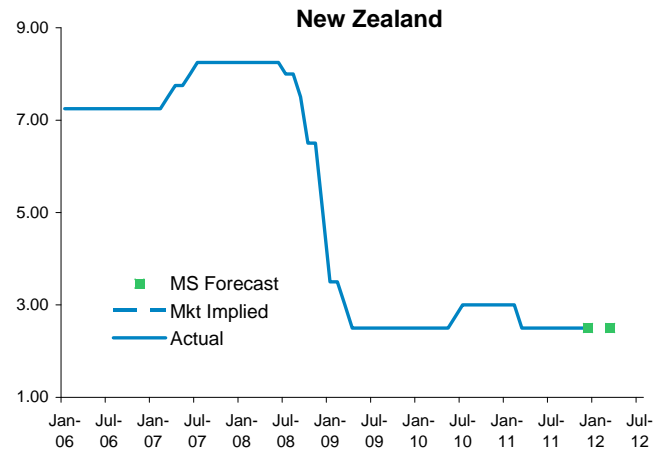
Notes: (u) = unofficial target; Interest rate expectations are implied by overnight indexed swap (OIS) curves and may differ from those implied by other instruments; where adequate OIS data are not available, FRAs, foreign exchange swaps, and/or interbank cash rate futures are used; due to varying risk 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.

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- The RBA has lowered its growth forecasts, and now argues that inflation will be in its target band this year.
- Markets are now pricing around three 25bp cuts by mid-2012.



- In the medium term, the bounce in activity and reconstruction from earthquake relief should be a tailwind for the NZ economy.
- Given the risk to global growth, rate hikes are likely to start only in 3Q12.

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..

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Global Monetary Policy Rate Forecasts

Global Economics Team

	Current	1Q12	2Q12	3Q12	4Q12	1Q13	2Q13	3Q13	4Q13	Last change (bp)	Since peak/trough (bp)	Since Dec 06 (bp)
United States	0.08	0.08	0.08	0.08	0.08	0.08	0.08	0.08	0.08	-87.5 (16/12/08)	-512.5	-512.5
Euro Area	1.00	0.50	0.50	0.50	0.50	0.50	0.75	1.00	1.25	-25 (08/12/11)	-50	-250
Japan	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	-5 (05/10/10)	-45	-20
United Kingdom	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	1.00	-50 (05/03/09)	-525	-450
Canada	1.00	1.00	1.00	1.25	1.50	1.50	1.75	2.00	2.00	+25 (08/09/10)	75	-325
Switzerland	0.00	0.00	0.00	0.00	0.00	0.00	0.25	0.50	0.50	-25 (03/08/11)	-275	-200
Sweden	1.75	1.50	1.25	1.25	1.25	1.25	1.50	1.75	2.00	-25 (20/12/11)	-25	-125
Norway	1.75	1.50	1.50	1.50	1.50	1.75	1.75	2.00	2.00	-50 (14/12/11)	-50	-175
Australia	4.25	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	-25 (06/12/11)	-50	-200
New Zealand	2.50	2.50	2.50	2.75	3.00	3.25	3.50	4.00	4.00	-50 (10/03/11)	-50	-475
Russia	5.25	5.25	5.50	5.50	5.75	5.75	5.75	5.75	5.75	-25 (15/09/11)	-25	-125
Poland	4.50	4.50	4.50	4.25	4.00	4.00	4.00	4.00	4.00	+25 (08/06/11)	100	50
Czech Republic	0.75	0.75	0.75	0.75	0.75	1.00	1.25	1.50	1.75	-25 (06/05/10)	-300	-175
Hungary	7.00	7.00	6.75	6.25	6.00	5.75	5.50	5.50	5.50	+50 (20/12/11)	175	-100
Romania	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.50	-25 (02/02/12)	-475	-325
Turkey	5.75	5.75	5.75	5.75	5.75	6.00	6.25	6.25	6.25	-50 (04/08/11)	-1,225	-1,225
Israel	2.50	2.50	2.25	2.25	2.25	2.75	3.00	3.00	3.00	-25 (23/01/12)	-75	-250
South Africa	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.50	-50 (18/11/10)	-650	-350
Nigeria	12.00	13.50	13.50	13.50	13.50	13.50	13.50	13.50	13.50	+275 (10/12/11)	600	200
China	6.56	6.56	6.56	6.56	6.56	6.56	6.56	6.56	6.56	+25 (07/07/11)	125	44
India	8.50	8.50	8.00	7.50	7.50	7.50	7.50	7.50	7.50	+25 (25/10/11)	375	125
Hong Kong	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	-100 (17/12/08)	-625	-625
S. Korea	3.25	3.25	3.25	3.00	3.00	3.00	3.00	3.00	3.00	+25 (10/06/11)	125	-125
Taiwan	1.88	1.88	1.88	1.88	1.88	1.88	1.88	1.88	1.88	+12.5 (30/06/11)	63	-88
Indonesia	6.00	5.75	5.75	5.75	5.75	5.75	5.75	5.75	5.75	-50 (10/11/11)	-75	-375
Malaysia	3.00	2.75	2.75	2.75	2.75	2.75	2.75	2.75	2.75	+25 (05/05/11)	100	-50
Thailand	3.00	3.00	3.00	3.25	3.50	3.50	3.50	3.50	3.50	-25 (25/01/12)	-50	-175
Brazil	10.50	10.00	9.75	9.75	9.75	10.50	11.00	11.00	11.00	-50 (18/01/12)	-200	-275
Mexico	4.50	4.50	4.00	4.00	4.00	4.00	4.00	4.00	4.00	-25 (17/07/09)	-375	-250
Chile	5.00	4.50	4.25	4.25	4.25	4.25	4.25	4.25	4.25	-25 (12/01/11)	-25	-50
Peru	4.25	4.25	5.00	5.00	5.00	5.00	5.00	5.00	5.00	+25 (09/05/11)	300	-25
Colombia	5.00	5.25	5.75	6.00	6.00	6.00	5.50	5.25	5.00	+25 (30/01/12)	200	-250

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%.

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Global GDP and Inflation Forecasts

	GDP				CPI			
	2010A	2011E	2012E	2013E	2010A	2011E	2012E	2013E
GLOBAL	5.2	3.9	3.5	3.9	3.4	4.4	3.3	3.1
G10	2.8	1.4	1.2	1.4	1.4	2.7	1.8	1.4
United States	3.0	1.8	2.2	1.8	1.6	3.2	2.1	1.8
Euro Area	1.8	1.6	-0.3	0.9	1.6	2.7	1.9	1.3
Germany	3.7	3.0	0.3	1.5	1.2	2.3	1.6	1.3
France	1.4	1.6	0.3	1.3	1.5	2.1	1.8	1.5
Italy	1.2	0.5	-1.7	0.0	1.5	2.8	2.1	1.9
Spain	-0.1	0.6	-1.7	0.0	1.8	3.2	2.0	1.7
Japan	4.4	-0.8	1.1	0.5	-1.0	-0.3	-0.7	-0.5
United Kingdom	2.1	0.9	0.5	1.8	3.3	4.5	2.7	2.0
Canada	3.2	2.3	2.2	2.0	1.8	2.9	2.4	2.3
Sweden	5.6	4.7	1.0	2.0	1.2	3.0	2.1	2.0
Australia	2.7	1.5	3.1	2.8	2.8	3.6	2.8	2.4
Emerging Markets	7.9	6.5	5.7	6.2	5.6	6.2	4.8	4.6
CEEMEA	4.8	4.9	3.6	4.1	6.5	6.8	6.1	5.3
Russia	4.3	4.5	5.0	4.0	6.9	8.5	5.4	5.3
Poland	3.9	4.3	2.5	3.3	2.6	4.3	3.3	2.0
Czech Republic	2.2	1.9	0.5	2.9	1.5	1.9	3.2	1.7
Hungary	1.2	1.4	0.0	2.0	4.9	3.9	4.5	3.7
Romania	-1.3	2.3	1.3	3.5	6.1	5.9	3.0	4.2
Ukraine	4.2	4.8	3.0	4.2	9.4	8.0	7.2	8.0
Kazakhstan	7.0	6.8	6.0	6.0	7.1	8.4	8.0	8.0
Turkey	9.0	8.2	2.0	4.4	8.6	6.5	9.1	6.0
Israel	4.8	4.7	2.5	3.5	2.7	3.5	2.0	2.2
South Africa	2.8	3.0	2.5	3.7	4.3	5.0	6.2	5.4
Nigeria	7.9	7.3	7.2	7.5	13.8	10.9	12.4	11.2
Asia ex Japan	9.3	7.6	6.9	7.5	5.1	5.8	4.0	4.0
China	10.3	9.2	8.4	8.7	3.3	5.4	3.4	3.6
India	8.9	7.3	6.9	7.5	12.1	9.0	6.5	5.9
Hong Kong	7.0	5.0	2.0	4.5	2.3	5.3	5.0	3.5
Korea	6.2	3.4	3.2	4.0	3.0	4.3	2.7	3.2
Taiwan	10.9	4.2	3.1	4.0	1.0	2.0	1.0	1.8
Singapore	14.5	5.2	2.0	5.0	2.8	5.2	3.2	2.0
Indonesia	6.1	6.5	5.6	6.5	5.1	5.4	5.0	5.5
Malaysia	7.2	4.6	3.0	4.7	1.8	3.2	2.4	2.2
Thailand	7.8	2.4	4.5	4.5	3.3	4.0	4.5	3.2
Latin America	6.3	4.4	3.5	3.7	6.3	6.7	6.1	6.1
Brazil	7.5	3.1	3.5	4.0	5.0	6.6	5.6	5.7
Mexico	5.4	3.7	3.2	3.3	4.2	3.4	3.4	3.4
Chile	5.2	6.4	4.1	4.5	1.4	3.3	3.3	3.1
Peru	8.8	5.9	4.9	5.4	1.5	3.4	3.5	2.5
Colombia	4.4	5.3	6.7	4.7	2.3	3.4	4.1	3.1
Argentina	9.2	8.9	3.1	3.0	10.4	9.8	10.2	10.1
Venezuela	-1.5	3.0	2.2	2.0	28.2	26.1	21.9	22.0

Source: Morgan Stanley Research

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