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Global

The Global Monetary Analyst

The Peloton, the 'Elastic Band Effect' and Monetary Policy

Major central banks have recently talked down some of the hikes in policy rates priced in by markets. On our forecasts, the ECB and the Fed will likely hike rates only in 2Q10 and 3Q10, respectively. Other central banks have a choice: join the monetary peloton and hike along with the major central banks or join the breakaway group led by the Bank of Israel. Both strategies carry risks. Hiking early gives central banks more control of their hiking cycle, but it also makes policy less effective and puts pressure on the currency to appreciate. Further, when the major central banks start hiking policy rates, early hikers may have to pause or slow down their tightening campaign. Hiking in tandem with the major central banks allows central banks to exploit local and global excess liquidity, but will likely require rapid adjustments to their preferred policy path. Norges Bank and the RBA are likely to join the breakaway group in 4Q09. The majority of AXJ central banks, despite having the best-performing economies, are likely to hike only in 3Q10.

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Key Central Bank Risk Events

Date	Country	Event
02-Sep	Brazil	Rate decision: Expect on hold
03-Sep	Euro Area	Jurgen Stark, Keynote Address in Frankfurt
03-Sep	Euro Area	Rate decision: Expect on hold
03-Sep	Sweden	Rate decision: Expect on hold
03-Sep	Sweden	Press conf on decision and monetary policy update
03-Sep	Indonesia	Rate decision: Expect on hold
04-Sep	Euro Area	VP Stark & Mr Gonzalez-Paramo in CFS Conf
09-Sep	US	Beige Book
10-Sep	Peru	Rate decision: Expect on hold
10-Sep	UK	Rate decision: Expect on hold
10-Sep	Canada	Rate decision: Expect on hold
10-Sep	N. Zealand	Rate decision: Expect on hold
10-Sep	Korea	Rate decision: Expect on hold
10-Sep	Chile	Rate decision: Expect on hold

What's Changed?

	Forecast Changes Since Last Week
US	GDP: 4.8% in 3Q09 (prev 3.9%)
UK	CPI: -0.4, 1.0% in '09, '10 (prev 1.8, 2.5%)
Sweden	CPI: 1% in '10 (prev 0.8%)
Australia	Policy rates: 3.25, 3.75% end '09, '10; prev 3, 3.5%
S. Africa	Policy rates: 7% 4Q10 (prev. 8%)
India	GDP: 5.5% in 2009, 7.8% in 2010 (prev 6.1%, 7.0%)

Where Do We Differ Most from the Market?

ECB expected to keep rates low for longer than markets expect (p 14)

BoJ expected to cut rates, markets expect no cuts (p 14)

For important disclosures, refer to the Disclosure section.

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The Peloton, the ‘Elastic Band Effect’ and Monetary Policy

Manoj Pradhan (44 20) 7425 3805

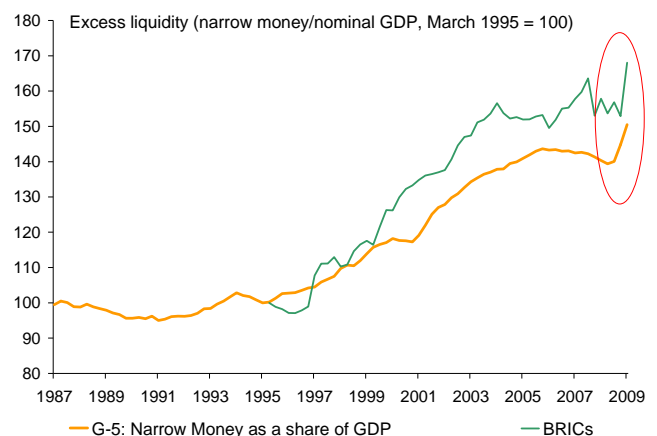
- Major central banks have recently talked down some of the hikes in policy rates priced in by markets. On our forecasts, the ECB and the Fed will likely hike rates only in 2Q10 and 3Q10, respectively.
- Other central banks have a choice: join the monetary peloton and hike along with the major central banks or join the breakaway group led by the Bank of Israel. Both strategies carry risks.
- Hiking early gives central banks more control of their hiking cycle, but it also makes policy less effective and puts pressure on the currency to appreciate. Further, when the major central banks start hiking policy rates, early hikers may have to pause or slow down their tightening campaign.
- Hiking in tandem with the major central banks allows central banks to exploit local and global excess liquidity, but will likely require rapid adjustments to their preferred policy path.
- Norges Bank and the RBA are likely to join the breakaway group in 4Q09. The majority of AXJ central banks, despite having the best-performing economies, are likely to hike only in 3Q10.

Officials at the major central banks have been actively talking down some of the policy rate hikes priced in by markets. Given the fragility of the economic recovery and their benign outlook for inflation, the Fed, the ECB, the BoE and the BoJ will likely find it prudent to wait and watch the path that the economic recovery takes before deciding on when and how quickly they should remove monetary accommodation. On our forecasts, the BoE, ECB and Fed are expected to start hiking rates in 1Q10, 2Q10 and 3Q10, respectively. The choice for other central banks is to either ride with the peloton defined by the major central banks or join the sole breakaway from the pack, the Bank of Israel, in hiking rates earlier. The peloton travels as a unit in order to minimise air drag. Cycling in the middle of a well-developed group can reduce air drag by as much as 40%. Other central banks can similarly exploit the excess liquidity injected by major central banks by hiking in tandem with the latter (see Exhibit 1) or break away and hike

while monetary conditions are still easing in the rest of the world. Both strategies come with their own risks.

Exhibit 1

Major Central Banks Have Injected Significant Excess Liquidity



Source: Haver Analytics, Morgan Stanley Research

Last week, we highlighted the surprise rate hike by the Bank of Israel and suggested that Norges Bank would be most likely to follow the BoI (see “Jackson Hole 0, Jerusalem 1”, [The Global Monetary Analyst](#), August 26, 2009), probably in 4Q09. Since then, the RBA has highlighted its concern that inflation is not likely to undershoot the inflation target for an extended period. Our colleague Gerard Minack now thinks that the RBA will hike its policy rate in 4Q09 as well (see page 9 or [Australia Strategy and Economics: Can Australia Recover When it Didn't Have a Downturn?](#) September 2, 2009). An early exit from easy monetary conditions might be the necessary medicine for economies where inflation does not appear to be benign, or for those where the recovery is robust enough to withstand a less expansionary monetary stance. However, central banks may also have the luxury to allow expansionary monetary policy to remain in place for longer thanks to a benign outlook for inflation and/or a slow recovery.

What does the monetary peloton currently look like?

The Morgan Stanley global economics team collectively covers 34 central banks, five of which are not expected to hike rates before 2011 (see [Interest Rate Forecasts](#) on page 17). Exhibit 2 shows that of the remaining 29 central banks, 19 will likely move in the second and third quarter of 2010.

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While the breakaway group of central banks hiking in 2009 will likely consist of the Bank of Israel, Norges Bank and the RBA, the peloton will likely start tightening policy some time in 1Q10, starting notably with the BoE, the SNB and the RBI. The central banks of Russia and Korea are expected to hike rates in 2Q10 along with the ECB. Finally, the Fed and the PBoC are expected to begin raising policy rates in 3Q10 along with 11 other central banks. Notably, central banks moving in 2Q10 and 3Q10 together represent nearly 74% of the global economic footprint (on a PPP basis).

Exhibit 2

First Moves in Policy Rates

	3Q09	4Q09	1Q10	2Q10	3Q10
G10		Nor, Aus	UK, Swz	Eur	US, Can, Swd, NZ
CEEMEA	Isr		Cze, UAE	Rus	Pol, Tur
AXJ			Ind, Twn	Kor	Chn, HK, Indo, Mal, Tha
LatAm				Peru	Brz, Chl, Col
Total	1	2	6	4	14

Source: Morgan Stanley Global Economics

Unconventional and other policy tools will be an important part of the tightening strategy: Even as active QE purchases by the major central banks are in full swing, passive QE programmes are slowly being wound down. We caution investors against viewing the shrinking of the central bank balance sheet due to an exit from passive QE programmes as a tightening of policy. If anything, moving securities that were part of the passive QE programmes off the central bank's balance sheet and into the market will strengthen the transmission of monetary policy. The unwinding of active QE programmes, however, will unambiguously mean policy tightening. We expect central banks to start unwinding active QE programmes around the same time as they start raising policy rates (see "QExit", [The Global Monetary Analyst](#), May 20, 2009) in order to try and engineer a parallel upward shift in the yield curve.

Other policy tools will play a role in the tightening process as well. Our ECB watcher Elga Bartsch thinks that the ECB will bring the overnight rate, EONIA, from its current level some 65bp below the refi rate back up on par with the refi rate before officially hiking policy rates (see "ECB: A Not So Easy Exit", [The Global Monetary Analyst](#), July 8, 2009). That will mean an implicit tightening equivalent to more than two standard 25bp rate hikes. In a similar vein, central banks like the PBoC could induce tightening by allowing some appreciation in the currency or by raising minimum reserve requirements. Our AXJ economics team has pointed out that central banks are also likely to restrict lending to the property sector in advance of a broad-based tightening of policy via rate hikes.

Monetary policy is still easing globally: Active QE programmes at the major central banks still have a long way to go. Importantly, these central banks still hold the option of expanding or extending these programmes, as the BoE and the Fed have demonstrated recently. In Eastern Europe, central banks are taking advantage of a global recovery to cut policy rates, having had to raise them rapidly to defend their currencies just a few months ago. Finally, the majority of central banks have finished cutting rates – most have done this faster than expected and taken rates to historical lows – and are expected to remain on hold for a considerable period of time.

There are risks to hiking early... Hiking rates while policy is still easing globally raises two concerns. The first is with regard to the efficacy of policy rate hikes. Risky assets have sustained their 'recovery rally' while bond yields have stayed range-bound. The international linkage between markets means that the net impact of a policy rate hike on equity and bond markets in the domestic economy will likely be weaker than usual (see Exhibits 3 and 4). The second concern is the impact on the currency. After its rate hike, the Bol intervened in currency markets in order to prevent a rapid strengthening of the shekel. Should Norges Bank and/or the RBA hike, their respective currencies will likely appreciate. Central banks will therefore have to find a balance between the speed at which they hike rates, the extent to which they can intervene in currency markets on an ongoing basis and by how much they are willing to let their currencies appreciate, in our view.

Exhibit 3

Bond Yields Have Been Range-Bound...

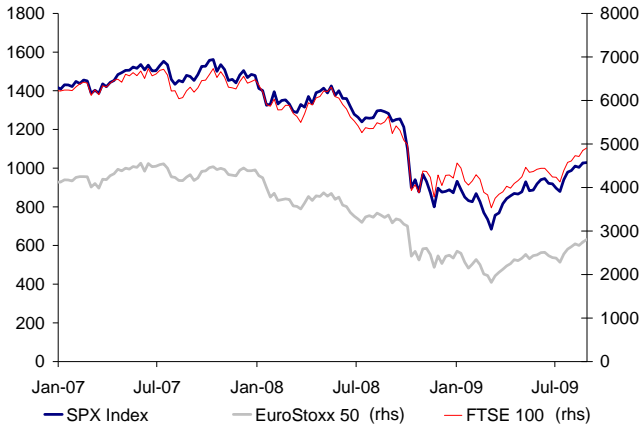


Source: Bloomberg

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Exhibit 4

...While Risky Assets Have Held on to Their Gains



Source: Bloomberg

...and may mean hiking in stages: Early hiking is likely create at least two stages of the hiking cycle. First, the stage we described above where central banks hike against a backdrop of easy monetary policy globally. The second stage will inevitably start when the peloton starts tightening policy. Early-hiking central banks will then likely have to deal with a global withdrawal of liquidity in addition to their own efforts to make policy less accommodative in the domestic economy. The result could be a pause or a slowdown in policy tightening as they assess the impact of these global moves.

But riding with the peloton risks excessive easing and a duel with inflation later on... The vast majority of central banks are likely to start hiking rates around the same time as the major central banks. Despite having the best-performing economies, the majority of AXJ central banks are expected to hike later rather than earlier. The PBoC and four other AXJ central banks will likely hike only in 3Q10 (see Exhibit 2). Other regions have roughly followed suit, looking to benefit from the dual tailwinds of domestic and global excess liquidity for as long as is viable. However, inflation lags both monetary policy and the economic cycle, and such long periods of excess liquidity raise the risk of inflation further down the road.

...and trickier adjustments because of an 'elastic band effect': Positioning within the peloton can be quite tricky and it may be preferable to stay at the front of the peloton for a variety of reasons. Being able to set the speed (to some extent) is one. But a more important reason is the 'elastic band effect'. Riders at the back have to react faster to avoid collisions because changes in speed are amplified from the front to the back. A similar situation holds for the monetary peloton. Leaders within the monetary peloton can take advantage of global excess liquidity while still setting the pace of monetary tightening to a degree. Central banks at the back of the queue bear the risk of having to adjust their preferred policy paths at very short notice as a series of moves by other central banks lead to movements in global financial markets and excess liquidity. As Exhibit 2 shows, central banks are not very well positioned to avoid such complications, with the bulk of them expected to move later rather than sooner.

Inflation Target Monitor & Next Rate Move

Global Economics Team. Contact: Manoj.Pradhan@morganstanley.com

	Inflation target	Latest Month	12M MS FCast	Next Rate Decision	Current Rate	Market Expects (bp)	MS Expects (bp)	Risks to our call
United States	1.7-2.0% PCE Price Index	1.4%	1.7%	23 Sep	0.125	1	0	Rates firmly on hold for foreseeable future
Euro Area	< 2% HICP (u)	-0.7%	1.0%	03 Sep	1.00	1	0	EONIA allowed below refi rate
Japan	0-2% CPI (u)	-2.2%	-0.7%	17 Sep	0.10	0	0	-
United Kingdom	2% CPI	1.7%	2.0%	10 Sep	0.50	-6	0	Could lower rate paid on reserves
Canada	1-3% on CPI	-0.9%	1.7%	10-Sep	0.25	0	0	Next BoC move could be a hike, even before Fed
Switzerland	<2% CPI (u)	-1.2%	0.2%	17 Sep	0.25	-2	0	Focus fully on QE now
Sweden	2.0% CPI	-0.9%	0.7%	03 Sep	0.25	0	0	Riksbank to stay on hold longer
Norway	2.5% CPI	2.2%	2.4%	23 Sep	1.25	0	0	Hike in October possible
Australia	2-3% over the cycle	1.5%	2.7%	01 Sep	3.00	0	0	A hike
New Zealand	1-3% CPI	1.9%	1.8%	10 Sep	2.50	-2	0	Risk of a 25bp cut
Russia	none	12.0%	9.1%	-	10.75	-	-	CBR officially more cautious on rate cut prospects
Poland	2.5% (+/- 1%) CPI	4.1%	2.3%	30 Sep	3.50	6	0	Shift to neutral bias possible
Czech Republic	3.0% (+/-1%) CPI	0.3%	2.1%	24 Sep	1.25	2	0	More easing possible in near term
Hungary	3.0% CPI	5.1%	4.0%	28 Sep	8.00	-49	-50	Watch HUF and risk appetite
Romania	3.5 (+/-1%) CPI	5.1%	3.9%	29 Sep	8.50	-	-50	-
Ukraine	none	15.5%	11.0%	-	10.25	-	-	-
Turkey	7.5% CPI end '09	5.4%	6.8%	17 Sep	7.75	0	-50	CBT might slow the pace of easing to 25bp
Israel	1-3% CPI	3.5%	2.1%	24 Sep	0.75	-	25	Watch inflation and currency appreciation
UAE	-	-	8.6%	-	1.00	-	-	-
South Africa	3-6% CPI	6.7%	5.9%	22 Sep	7.00	4	0	Excessive ZAR strength prompts further easing
China	-	-1.8%	-0.6%	-	5.31	-	0	Balanced risk
India	4-4.5% WPI	-1.0%	1.7%	27 Oct	4.75	-	0	-
Hong Kong	-	-1.5%	0.0%	-	0.50	-	0	Premature US tightening upon global inflation uptick
Korea	2.5-3.5% CPI	2.2%	2.8%	10 Sep	2.00	-	0	Rising risks on early rate hike in 1Q10
Taiwan	-	-2.3%	-1.0%	21-25 Sep	1.25	-	0	Rate hike possible on excessive liquidity
Singapore	1.5% (long-term CPI) (u)	-0.5%	-0.4%	Oct	0.68	-	NA	Changes in the FFTR and SGD appreciation pace
Indonesia	4.5% +/- 1.0%	2.8%	4.8%	03 Sep	6.50	-	0	Evenly balanced
Malaysia	-	-2.4%	0.2%	28 Oct	2.00	-	0	Evenly balanced
Thailand	0.5-3.0% core CPI	-1.0%	-1.5%	21 Oct	1.25	-	0	Evenly balanced
Brazil	4.5% +/- 2.0% IPCA	4.5%	4.1%	02 Sep	8.75	0	0	-
Mexico	3% +/-1% CPI	5.4%	3.3%	18 Sep	4.50	0	0	-
Argentina	15.5-24.2% M2 growth	5.5%	10.5%	NA	12.50	-	-	-
Chile	3% +/-1% CPI	0.3%	2.5%	10 Sep	0.50	0	0	-
Peru	2% +/-1% CPI	1.9%	3.2%	10 Sep	1.25	0	0	-
Colombia	5% +/-0.5% CPI	3.3%	3.8%	25 Sep	4.50	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;



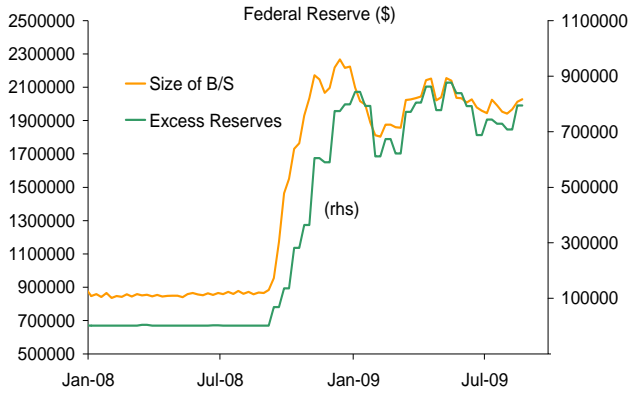
Source: National Central Banks, Morgan Stanley Research

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

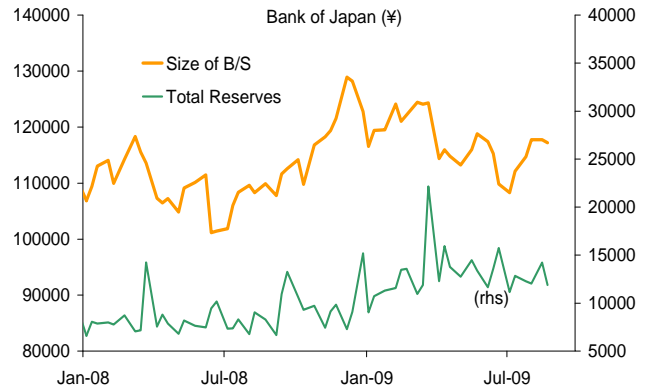
Central Bank Balance Sheet Monitor

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US

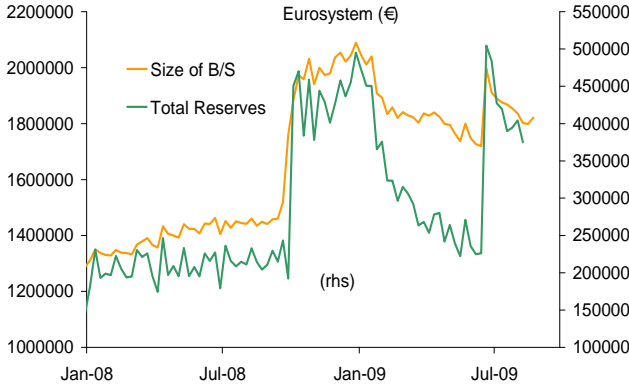


Japan



Source: Haver Analytics

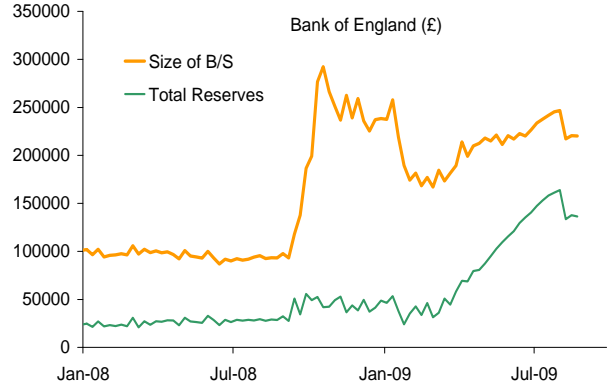
Europe



Source: Haver Analytics

Source: Haver Analytics

UK



Source: Haver Analytics

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Euro Area: Easy Does it for the ECB

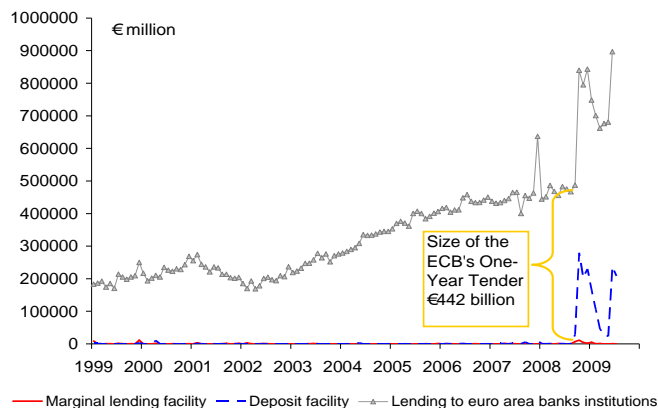
Elga Bartsch (44 20) 7425 5434

We see rates unchanged: We expect the ECB to leave its interest rates as well as its assessment of current monetary policy appropriately unchanged at the upcoming Governing Council meeting. Hence, the Council is likely to affirm the refi rate level at 1% and the monetary policy stance as appropriate.

Growth projections likely to rise: At the same time, the ECB staff will likely revise up its macroeconomic projections, notably those for GDP growth. So far, the ECB staff still expect GDP to contract by 0.3% next year, following a 4.7% decline this year. Against the recently released activity data, these estimates look too gloomy to us. We are forecasting a contraction of 4% this year and a renewed rise of 0.6% next year. At the August press conference, ECB President Trichet already hinted at an upgrade to the growth projections by no longer insisting that the recovery would only start in mid-2010. At the same time, the ECB is likely to stress the risks and uncertainties that still surround the projections going forward. As a result, the Council will likely reiterate that it is still too early to withdraw the monetary stimulus.

In addition, the ECB needs to decide at some point about whether or not it wants to add a spread to the one-year refi operation it will offer at the end of September: Our guess is that the ECB will be willing to offer this tender flat to the refi rate. But there is a risk that a small spread could be added. While the ECB does not necessarily need to announce the terms of the September one-year tender just yet (it still could do so at the non-policy meeting on September 17) or even at the day of the announcement of tender, it will likely field questions regarding the tender in the Q&A.

Euro Area: ECB Lending to the Banking System



Source: ECB, Morgan Stanley Research

Central Bank Watch

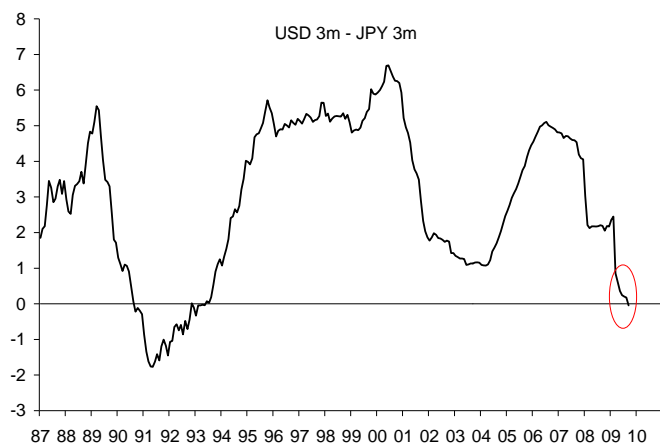
Japan: Libor Spread Inversion Implications

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USD and JPY 3-month Libor spread inverted for the first time in 16 years: As the decline of USD Libor outpaced JPY Libor, the spread eventually inverted in mid-August for the first time since 1993. Our interpretation is that the credit easing worked quite well in the US, which reduced the risk premium in the money market, while interbank credit has not been eased so much in Japan, which has left the term premium high. It can also be said that the degree of monetary accommodation does not seem sufficient in Japan compared with that in the US.

Pressure for additional easing is likely to surface: This could backfire on Japan's monetary policy, especially if the market environment becomes harsh as a result of yen appreciation and/or the weak Nikkei, for example. Indeed, our currency economics team looks for the yen to surge to JPY85/USD towards year-end. If such a forecast materializes under the deeper deflation scenario, the BoJ is likely to be under renewed pressure. Actually, the core CPI rate is likely to drop to around -2.5% towards September. The core of core CPI rate (which excludes both food and energy) is likely to sink to around -1%, and we do not look for any meaningful pick-up in prices in the course of this year. Under such circumstances, it is rather natural to look for additional actions by the BoJ, including the re-introduction of the policy commitment for a certain period and ultimately a rate cut.

Japan: Libor Spread Inverted for First Time in 16 Years



Source: Bloomberg, Morgan Stanley Research

Sweden: Still Softly, Softly

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We expect rates to remain unchanged this week: We expect the Riksbank to leave the repo rate unchanged at 0.25% at its meeting on September 3 and broadly confirm its intention to remain on hold at this level for most of this and indeed next year. While better-than-expected GDP data in 2Q09 will likely cause the Riksbank to revise up its growth estimate for this year, the forecast upgrade is unlikely to make a big difference in terms of the forecasted repo rate profile. So far, the Riksbank had been looking for a fall in 2009 GDP by 5.4% and renewed rise of 1.4% in 2010. Our forecast is for a contraction of 4.8% this year and rise of 1.8% next year.

Riksbank sees first hike in 4Q10... In a recent speech, First Deputy Governor Svante Oeberg said that the upgrade to the growth outlook would not be a reason to change in the monetary policy outlook materially. One reason could be that inflation is currently trailing a tad below the Riksbank's forecast profile. Another might be that the Riksbank already had a relatively bullish forecast for 2010 GDP growth. Thus far, the Riksbank had expected to leave the repo rate at the current 25bp level for most of next year. Only in 4Q10 does the Riksbank think that there is a likelihood of a small rate hike.

...but we think mid-2010 is more likely: While this meeting will not see the release of a complete Monetary Policy Report, updated forecasts will still be published. We continue to think that Sweden has one of the strongest recovery stories in Europe and therefore believe that the Riksbank will start tightening by the middle of next year, slightly earlier than the Riksbank currently reckons. The statement published along with the decision will give us a better sense of whether Lars Svensson still favours further easing and whether more members share Barbro Wickman-Parak's view that the repo rate might have to be raised earlier than is forecast in the main scenario of the Monetary Policy Report.

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Central Bank Watch

Australia: An RBA Hike Before Year-End?

Gerard Minack (61 2) 9770 1529

Today's upside GDP growth surprise probably seals the case for an RBA hike before year-end, barring a run of bad macro news. The June quarter GDP, up by 0.6%, underlines Australia's remarkable outperformance through the Great Recession. Australia did take a hit from the global downturn. Real national income growth fell sharply, from 6%-plus growth at the end of last year, to outright decline now. This decline reflected the fall in the terms of trade.

Several factors insulted the domestic economy, and hence prevented the nasty feedback loops – from initial shock, to financial stress, to job losses, to falling house prices – that exacerbated the cycle elsewhere:

- The public sector took a large share of the pain. By cushioning private sector incomes – and in the case of the household sector, actually lifting income – higher private saving did not require big spending cutbacks.
- While export prices were savaged, export volumes were not. An unprecedented gap opened up between the growth in Australia's trading partners and Australia's export volumes.
- Households benefited from high debt – and, as importantly, the fact that this debt was largely floating and tied to short rates. Consequently, RBA rate cuts had a massive (gross) impact on household income.
- Australia was fortunate to have a financial system that was relatively easy to save because it remained bank-dominated. The government guaranteeing the banks' access to capital markets proved to be sufficient to avert serious systemic risk.

This success carries a sting in the tail: By having averted a sharp downturn, the recovery will likely face headwinds caused by the partial reversal of some of these supports. In particular, today's report points to an RBA rate increase before year-end, as intimated by recent comments from the bank itself. With the emergency over, there's no need to keep policy on an emergency footing. Moreover, it's not just a matter of growth indicators surprising to the upside, both here and overseas, but the RBA has also acknowledged that the prospect of a sustained undershoot in inflation is fading. Our view is that inflation will moderate in the coming quarters, reflecting the lagged impact of the GDP slowdown seen. However, with a shallower-than-expected downturn, there will likely be a shallower-than-expected decline in inflation.

For full details, see [Can Australia Recover When it Didn't Have a Downturn?](#) September 2.

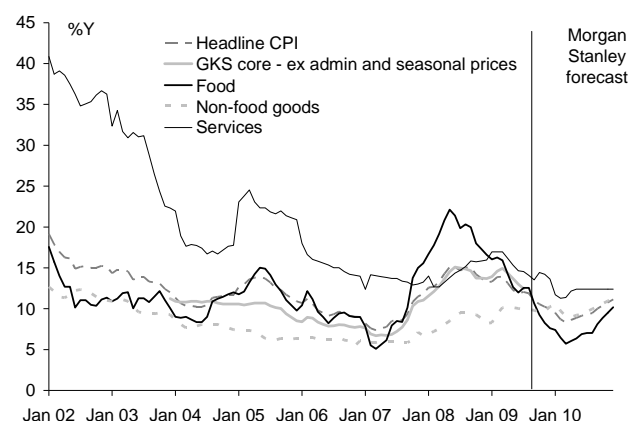
Russia: Anticipating Another Cut – on September 11?

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Inflation in the third week of August finally slowed to zero on Goskomstat's preliminary estimates, the first such week in a year. Sharp falls in vegetable prices, later than we had expected, are finally coming through, partly balanced by continuing rises in fuel and sugar prices. We expect CPI to slow only marginally, to 11.9%Y in August, from 12.0%Y in July. However, we continue to expect headline CPI to fall quite fast in the following few months, reaching around 10.0%Y by December. We expect a further dip in 1Q, given more moderate administered price hikes, but continue to see inflation accelerating in 2H10.

We expect the CBR to cut rates again shortly: Deputy Governor Ulukaev has said that the next decision could be "any day" – but our best guess would be on September 11, after the publication of full monthly CPI data. However, the CBR's move towards a conventional monetary policy does not yet include pre-announced meeting dates. Consensus will be for a 25bp cut after a move of this size last month. We think it slightly more likely that the CBR returns to 50bp, given the relative strength of the RUB and the improving short-term CPI outlook.

Russia: CPI to Resume Falling, Before Rising Later



Source: GKS, Morgan Stanley calculations and forecasts

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The Global Monetary Analyst

Central Bank Watch

Poland: Easing Bias Survives, Not for Long Though

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On hold, more constructive on growth: As expected, the National Bank of Poland kept rates unchanged at 3.50% on August 26. The main differences in the statement since July are found in the references to the growth picture, both in Poland and abroad. The Council pointed to, among other things, “some acceleration in retail sales” and the expected “improvement in the economic situation in the months to come”. Also, a higher-than-expected July wage print was mentioned. On inflation, there were no notable changes, although the statement does dwell longer than the previous one on the fact that the relatively high level of core inflation indicates that weak demand has so far failed to offset the inflationary impact of regulated prices and previous FX weakness.

The official easing bias is still in place, but not for long, we think: The statement mentioned that the probability of below-target inflation in the medium term is higher than the probability of above-target inflation, which is equivalent to an easing bias. Governor Skrzypek was also quick to point out in the press conference that the Council still remains in an easing cycle. However, we think that there will be a building consensus in moving to a neutral bias as the data continue to improve, growth estimates get revised higher and high-frequency data suggest a return to growth (IP growth may move into positive territory already by August, according to the Min Fin estimates). Also, inflation is unlikely to drop this year, and if anything may end the year at around 3.8%, outside the target band. True, inflation should then move towards the target in 1H10, due to base effects. However, with increasing evidence of growth bouncing from the trough, and inflation more stubborn than the output gap would have suggested, the Council is likely to abandon its easing bias in the coming months, we think, possibly as early as September. We see no further room for cuts this year, and modest tightening in 2010 (to 4%).

Turkey: CBT Had to Sound Über-Dovish to Crank the Transmission Mechanism

Tevfik Aksoy (44 20) 7677 6917

Transmission mechanism slow but on the move: The CBT response to the worsening economic outlook has been noteworthy. Not only did the monetary easing start early enough, but the extent of the easing – 900bp from the August 2008 level – has also placed Turkey in a better position to tackle the growth challenges, in our view. As part of the release of the Inflation Report in late July, CBT Governor Durmus Yilmaz delivered a very dovish speech regarding the inflation outlook and rates. Essentially, Mr. Yilmaz’s intention seemed to be as clear as possible to convince local banks and market participants that there was still room for some easing (the CBT delivered a 50bp cut in August) and that the low interest rate environment would be here to stay until end-2010. Following the Inflation Report, we also lowered our policy rate forecast to 7% for 2009 while maintained our expectation that the CBT might have to hike by around 150bp starting mid-2010. We maintain our view that the CBT might ease by some 75bp further in the next couple of months and hold rates steady thereafter for some time. Clearly, the developments on the growth front but more importantly the inflation dynamics and expectations will give the final shape to the CBT’s thinking. While the transmission mechanism has so far borne no results, the recent rise in competition among banks to gain share in consumer lending could be the next driver of growth looking into 2010 and 2011. Essentially, after a period of some 12 months, the wheels might have started to turn in the financial sector and, once the demand side raises its head and ponders spending, the required funding is likely to be there.

Stable inflation and fiscal prudence are key: As had been the case in the past, both lenders and borrowers will be looking for signs that economic stability is there, fiscal dominance would not be an issue and inflation would at least stabilise if not decline further. On the inflation front, we are optimistic for 2009 but for 2010 we tend to believe that it might bottom out and move slightly higher to 6.2%Y at year-end (6.4%Y 2010 average). In fact, we expect inflation to gradually rise towards 7% in the next 12 months due to the strong base year effects. The consensus estimate for the 12-month forward-looking period stands at 6.4%. Recall that the CBT’s inflation forecast for 2010 stands at 5.3%Y, and this is under the assumption that the policy rate would be kept unchanged throughout 2010. This shows that the CBT must believe in a very slow pick-up in growth (as we expect), but perhaps even slower than the consensus, ruling out any aggressive lending campaigns by banks.

Central Bank Watch

South Africa: On-Hold Stance Still Likely in September

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On-hold decision remains likely for September meeting of the Monetary Policy Committee: The July monetary data continued to reflect signs of weak credit appetite on behalf of households, although corporates appear to be drawing on conventional credit facilities as borrowing rates have fallen. In light of recessionary conditions, the former may not be overly disappointing for the Monetary Policy Committee of the SARB just yet, considering the typical 2-4-quarter lag between monetary policy changes and economic activity. Thus, the weak July credit aggregates may not be sufficient to sway the MPC away from what we expect to be an on-hold decision at the September 21-22 meeting. We now believe that the SARB is likely to keep interest rates on hold throughout 2010.

Mortgage contraction caps credit aggregates: Monetary data released by the central bank on August 31 showed that M3 money supply and private sector credit extension slowed to 5.8%Y and 3.4%Y, respectively, in July. We had penciled in readings of 5.7%Y (5.8%Y after revisions to the history) and 3.5%Y, against consensus estimates of 5.5%Y and 3.5%Y. Importantly, mortgage growth has now turned negative, resulting in credit growth to households recovering only marginally following two negative monthly readings in May and June.

Mortgages finally dip into negative: Recording growth of just 3.4%Y in July, private credit extension was capped by net mortgage repayments of R0.6 billion – the first time that mortgages have been a net detractor from credit extension since September 2002. This is a risk we highlighted in [South Africa: Record Contraction in Private Sector Credit Extension in May](#), June 30, 2009. Household mortgage growth must have posted a mildly positive reading in July, while corporate mortgages contracted more meaningfully as a number of building projects were frozen. In fact, we believe that we could see a few more negative prints on the mortgage line before signs of healing emerge towards year-end. The overall small size of the contraction in mortgages suggests that this may have been more of a normalisation in arrears payments than a true step-up in prepayments as borrowing rates declined.

India: Cutting Agriculture Output Estimates Again

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Cutting our F2010 agriculture and GDP growth estimates due to severe rainfall deficiency: With the cumulative rainfall position continuing to be significantly deficient, we are cutting our F2010 agriculture growth estimate to -3% from 1.5% and GDP forecast to 5.8% from 6.4% earlier. This will create a positive base effect for agriculture output next year. Hence, we are revising up our F2011 agriculture output estimate to 5% from 3% and GDP forecast to 8% from 7%. Despite the negative impact of a drought, on a net impact basis we expect non-agriculture GDP growth to be largely unchanged. Indeed, industrial production (IP) growth in June was 7.8%, significantly higher than our estimate of 3-4%.

We believe that the drought-relief measures will add to fiscal pressure: As per media reports, several states are seeking central assistance to tackle drought in their respective districts. This, in addition to the other fiscal support measures, will result in the fiscal deficit increasing by about 0.2-0.3% of GDP in F2010, according to our estimates.

No change in our monetary policy outlook: We maintain our view that the RBI will initiate its first policy rate hike in February-March 2010, as the central bank will likely wait for a sustained economic recovery before normalizing rates. We also believe that the RBI is unlikely to change its path due to food inflation pressure. However, if the robust IP growth trend of 7%-plus is maintained, we think that the RBI will likely to move 1-2 months earlier than our current expectation of February-March 2010. Note that our current growth forecast assumes average IP growth of 6.4%.

Three key factors that we think will influence India's growth outlook in F2010 and F2011: 1) the global growth trend; 2) the government's pace of structural reforms; and 3) the change in agriculture growth outlook, particularly for F2010, based on the rainfall trend in September. Based on this framework, we expect 5.8% GDP growth for F2010 and 8% for F2011 in the base case. We see a bull case at 6.6% in F2010 and 9.5% in F2011 and bear case at 5% in F2010 and 6.5% in F2011.

India: GDP Growth Forecasts

(%)	Financial Year			Calendar Year		
	F2009	F2010E	F2011E	2008	2009E	2010E
Old	6.7	6.4	7.0	7.5	6.1	7.0
New	6.7	5.8	8.0	7.5	5.5	7.8

Source: Morgan Stanley Research; E = Morgan Stanley Research estimates

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Central Bank Watch

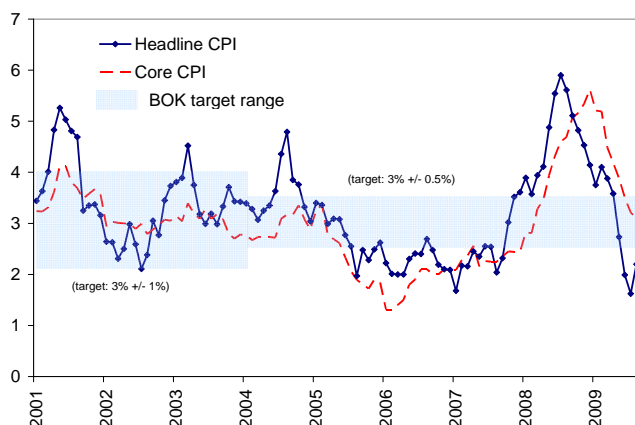
Korea: No Urge for Rate Hikes

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Katherine Tai (852) 2848 8191

Inflation not a near-term concern: As the high base effect has started to phase out, Korea's inflation rate has begun to bottom out. Headline inflation rebounded to 2.2% in August from 1.6% in July, which is still below the Bank of Korea's target range of 2.5-3.5%. Core inflation, on the other hand, eased further to 3.1% in August from 3.2% in July, suggesting that the pick-up in headline inflation is almost entirely due to the wearing out of the base effect from oil prices. We expect headline inflation to remain at around 2% for the rest of this year and thus not be a threat at all.

No urge for rate hikes: With the economy recovering faster than widely expected, we now see a high chance of a rate hike in 1Q10 instead of in 2Q10 as in our previous forecast. However, we believe that the chance for rate hikes within the next three months is still very low. First, growth has come in stronger than expected, but it is not overheating. Second, Korea's liquidity conditions are not as excessive as in neighboring economies. Korea's M1/GDP is at 37% compared to China's 63%, Hong Kong's 46% and Taiwan's 79%. Third, Korea is not seeing any abnormal credit growth that needs to be cooled down. In fact, bank loan growth has continued to slow, to 6.8% in July from the peak of 16% a year ago. Korea is not going for artificial growth this time around. Finally, the only concern is to tame speculation in the property sector, which can be done through administrative measures. After all, with the strictest loan-to-value ratio and mortgages still rising, it means that only the rich are buying houses, so rate hikes will not be effective anyway.

Korea: Inflation to Remain within BoK Target Range



Source: CEIC, Morgan Stanley Research

Malaysia: Beyond the Inventory-Led Rebound

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An inventory-led rebound: Like other economies in ASEAN such as Singapore and Thailand, 1Q09 marked the bottom in terms of percentage year-on-year GDP trajectory for Malaysia. 2Q09 data show that the economy declined at a slower pace of 3.9%Y (versus -6.2%Y in 1Q09). Seasonally adjusted sequential data are not published. However, our calculation shows that Malaysia emerged from a two-quarter-long recession in 2Q09. A few cross-currents are at work in terms of GDP components. The slower pace of decline in 2Q09 was predominantly driven by an inventory snapback. Destocking shaved *only* 1.9pp from headline GDP in 2Q09, while it shaved off a massive 9.7pp in 1Q09. Meanwhile, domestic demand (excluding inventories) also showed a slightly slower pace of decline at -2.3%Y (versus -2.9%Y in 1Q). However, external demand still saw further deterioration at -17.3%Y (versus -15.2%Y in 1Q09).

Deflation and a dovish central bank: On CPI, deflation in Malaysia (-2.4%Y in July versus -1.4%Y in June) is still primarily driven by the transport segment rather than demand destruction per se. Retail fuel constitutes about 7.3% of the CPI basket, and administered fuel prices have been revised downwards by 33-35% since mid-2008. We believe that Malaysia will come out of deflation territory by end-2009 or early 2010 as base effects get washed out. Yet, whether Malaysia would see cost-push pressures from commodities in 2010 depends a lot on whether policymakers are likely to change the fuel subsidy system. Our base case assumption using the oil futures curve is for oil to average about US\$75/bbl in 2010. If the current subsidy system is maintained, we suspect that policymakers will be unlikely to hike retail fuel prices. In this case, inflation will likely rise from 0.2%Y this year to only 1.5%Y in 2010.

Further easing unlikely: On policy response, further easing is unlikely as BNM is keen to keep a balance between reducing the cost of capital for debtors and maintaining the interest income for saving households. Malaysia is after all a net saving economy. On exit strategy, we think BNM will be closely watching for second-round inflation pressures instead of 'first-round' policy-induced inflation from base effects. In this regard, we believe that BNM is unlikely to be anxious with the initial uptick in headline inflation simply on fuel price base effects, and monetary policy normalization is likely to start only in 2H10, which would bring policy rates from 2% to 3%.

Central Bank Watch

Brazil: Fiscal Challenges

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Longer-term fiscal concerns? Brazil's recent fiscal deterioration pales in comparison to trends seen elsewhere in the global economy lately. So, why worry? Brazil's near-term fiscal picture looks comfortably manageable, but observers might start to wonder about the longer-term fiscal outlook if the recent acceleration in federal spending and aggressive credit expansion by public banks become a permanent feature of Brazil's fiscal landscape.

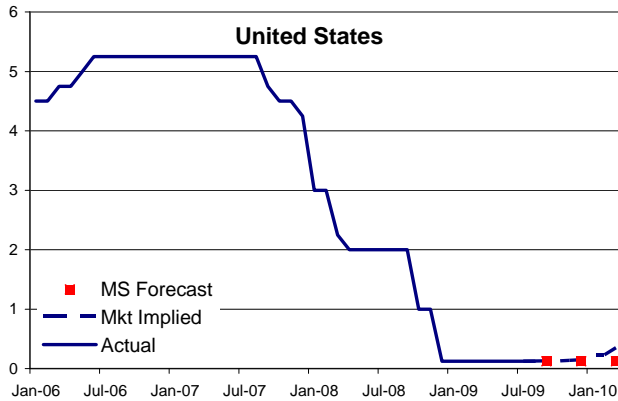
Rising federal spending weakens the fiscal balance:

Brazil's budget balance is worsening. Brazil's headline fiscal concept is the so-called public sector 'primary' balance, which excludes the burden of interest payments. Brazilians call the 'nominal' deficit what elsewhere is often known as the budget balance. While Brazil runs a primary surplus, it faces a nominal deficit. Both measures have weakened lately. The primary surplus declined to 2.0% of GDP in the 12 months through June, from 3.7% at the end of 2008, or a peak of 4.3% last October. This is also below the 2.5% target for calendar 2009 as a whole. In other words, Brazil's primary surplus has weakened by about 2 percentage points in less than a year – this is a fairly fast pace of deterioration by Brazil's standards. The burden of fiscal interest payments has come down, to 5.3% of GDP in the 12 months through June, from 5.7% of GDP at the end of 2008. But declining interest rates are not enough to fully offset the shrinking primary surplus, and the nominal deficit has thus worsened to 3.2% of GDP by mid-2009, from 2.0% at end-2008, or from a record low of 1.3% last October.

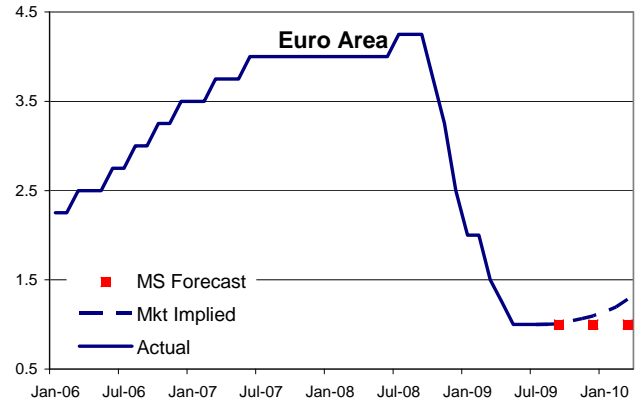
Fiscal policy has implications for monetary policy too:

The looser fiscal policy gets, the relatively tighter monetary policy has to be, for a given overall policy stance. Given the still relatively high level of interest rates in Brazil by international standards, Brazil could benefit from some policy rebalancing – tighter fiscal policy could open room for a relatively looser monetary stance over time. In the near term, by contrast, one risk is that fiscal expansion in 2010 could end up working to accelerate the start of the eventual monetary tightening cycle.

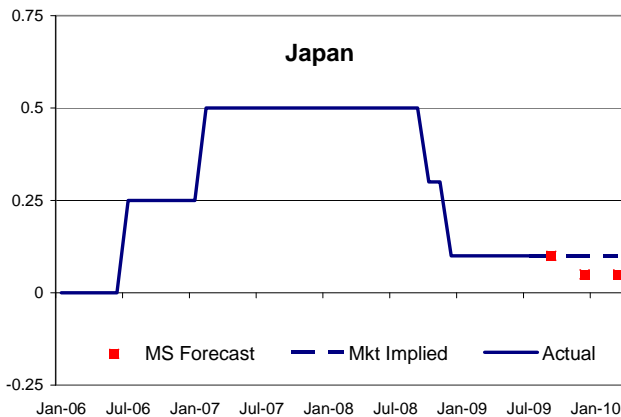
Monetary Policy Outlook – Morgan Stanley versus Markets



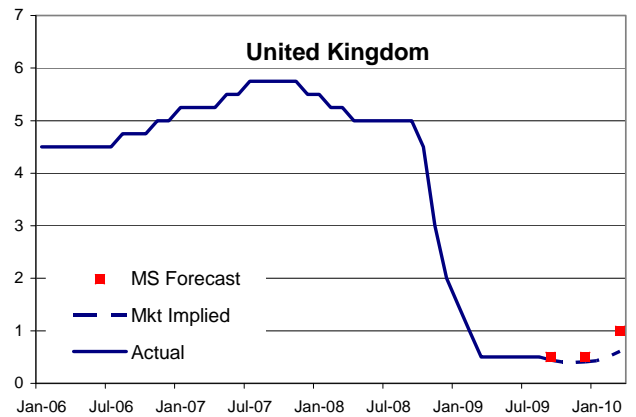
- Futures market pricing has moderated substantially, but we still think the first hike is priced in a bit too early.
- Cumulative hikes priced through 2010 are now in line with our forecast.



- Chances of a refi rate cut remain rather slim. But EONIA likely to stay below refi for a while longer.
- All eyes now are on the September staff projections and the end of the September one-year refi operation.



- We still expect interest rate policy to be eased slightly in Oct-Dec 2009 as the policy rate level is revised to a band of 0-0.10% (0.05% midpoint).
- We are pushing back our forecast for the timing of the policy exit by one quarter to Jan-Mar 2011.

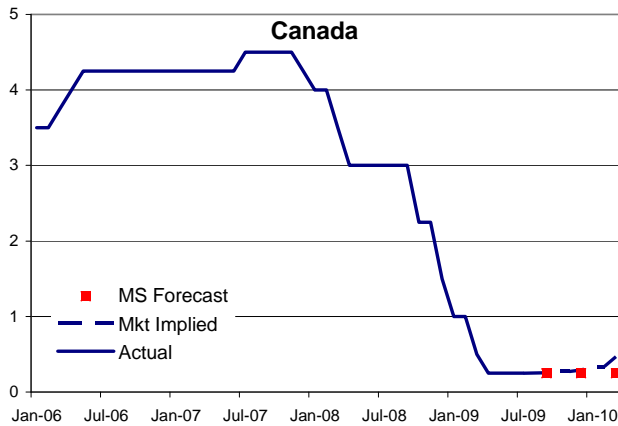


- We think that the MPC will start raising rates in 1H10. This seems to be priced in.
- VAT rate cut reversal and fiscal policy announcements may complicate decisions on timing/pace.

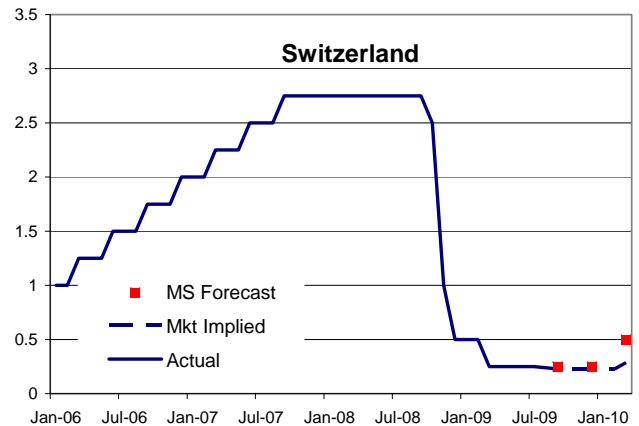
Source: National Central Banks, Morgan Stanley Research

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

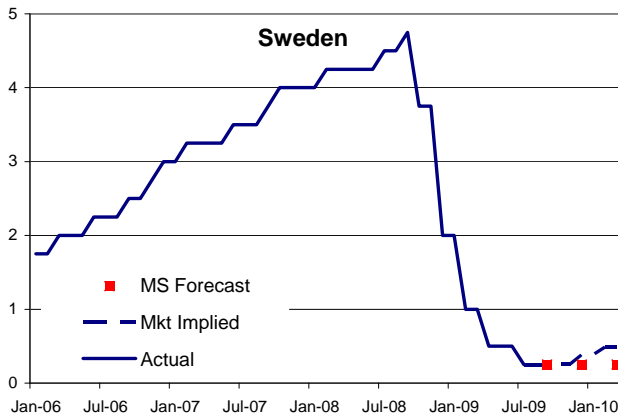
Monetary Policy Outlook – Morgan Stanley versus Markets



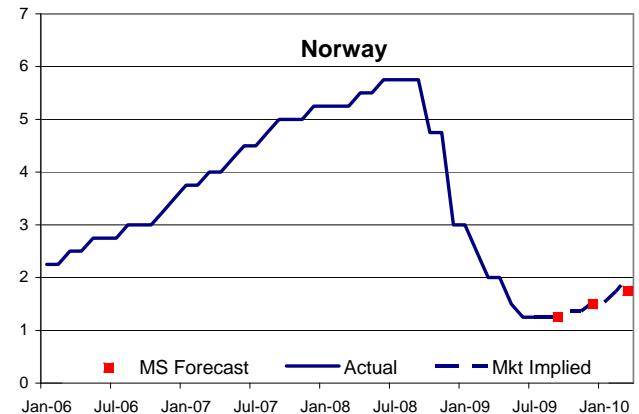
- Canada is sprouting its own green shoots; if data continue to confirm recovery, the need for unconventional policy decreases.
- The BoC has recognised CAD strength as a potential hindrance, but does not look ready to intervene.



- We expect policy rates to stay on hold for the foreseeable future.
- Focus firmly on QE now.



- Riksbank's easing cycle in terms of interest rates has most likely reached its trough now.
- Further unconventional measures such as bond purchases are possible, if needed.

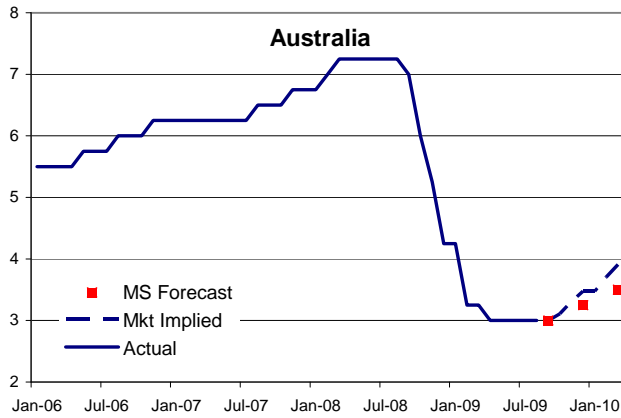


- We are looking for the first hike at the December meeting.
- Balanced risks.

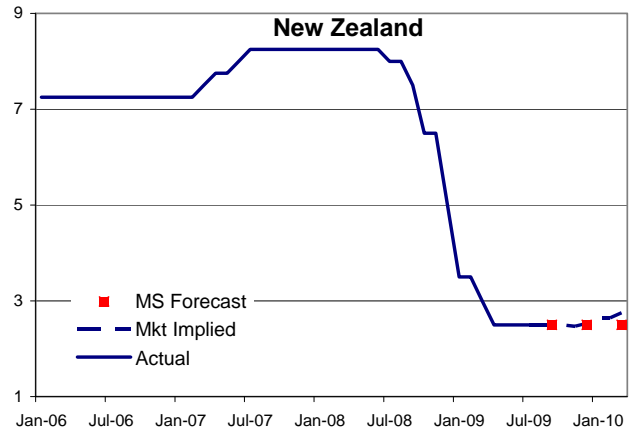
Source: National Central Banks, Morgan Stanley Research

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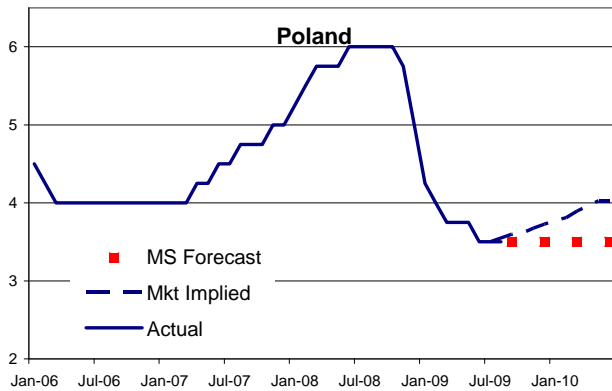
Monetary Policy Outlook – Morgan Stanley versus Markets



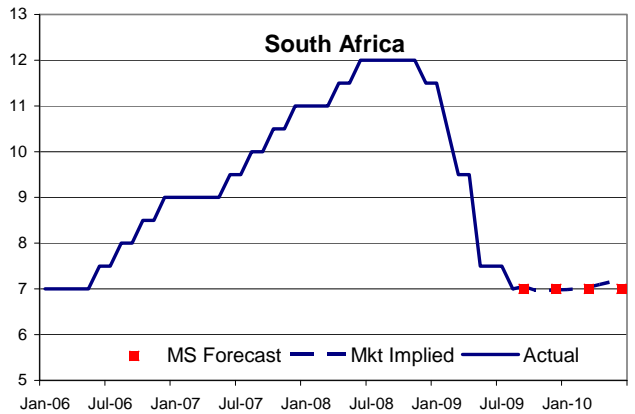
- We have changed our view on policy: we now think that modest increases are coming.
- We continue to disagree with the aggressive pricing in markets. Policy will be less easy, not tight, we think.



- Rates have likely troughed at 2.5% with downside risks.
- RBNZ guidance also has policy rates at or below 2.5% through the latter half of 2010.



- MPC is in wait and see mode now.
- A move to a neutral bias in the coming months seems likely



- We expect no more cuts in policy rates in 2009.
- Risk that growth outlook deteriorates or ZAR strength greatly improves inflation outlook, prompting policy easing.

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	3Q09	4Q09	1Q10	2Q10	3Q10	4Q10	Last change (bps)	Since peak/ trough (bp)	Since Dec 06 (bp)
United States	0.125	0.125	0.125	0.125	0.125	0.50	1.50	-87.5 (16/12/08)	-512.5	-512.5
Euro Area	1.00	1.00	1.00	1.00	1.25	1.50	1.75	-25 (07/05/09)	-325	-200
Japan	0.10	0.10	0.05	0.05	0.05	0.05	0.05	-20 (19/12/08)	-40	-40
United Kingdom	0.50	0.50	0.50	1.00	1.75	2.25	3.00	-50 (05/03/09)	-525	-450
Canada	0.25	0.25	0.25	0.25	0.25	1.25	2.50	-25 (21/04/09)	-425	-400
Switzerland	0.25	0.25	0.25	0.50	0.75	1.00	1.50	-50 (11/12/08)	-250	-175
Sweden	0.25	0.25	0.25	0.25	0.25	0.50	0.75	-50 (21/04/09)	-450	-275
Norway	1.25	1.25	1.50	1.75	2.00	2.25	2.75	-25 (17/06/09)	-450	-150
Australia	3.00	3.00	3.25	3.50	3.50	3.75	3.75	-25 (07/04/09)	-425	-225
New Zealand	2.50	2.50	2.50	2.50	2.50	3.00	3.50	-50 (29/04/09)	-575	-475
Russia	10.75	10.50	9.50	9.00	10.00	11.00	11.00	-50 (10/06/09)	-200	0
Poland	3.50	3.50	3.50	3.50	3.50	3.75	4.00	-25 (24/06/09)	-250	-50
Czech Republic	1.25	1.25	1.25	1.50	1.75	2.00	2.25	-25 (06/08/09)	-250	-125
Hungary	8.00	7.50	7.00	6.50	6.00	6.00	6.00	-50 (24/08/09)	-350	0
Romania	8.50	8.00	7.50	7.00	6.50	6.00	6.00	-50 (04/08/09)	-175	-25
Ukraine	10.25	10.00	11.00	12.00	12.00	12.00	12.00	-75 (12/08/09)	-175	+200
Turkey	7.75	7.25	7.00	7.00	7.00	7.75	8.50	-50 (18/08/09)	-975	-800
Israel	0.75	1.00	1.00	1.00	1.50	2.00	2.00	+25 (24/08/09)	-350	-275
UAE	1.00	1.00	1.00	1.50	2.00	2.50	3.00	-50 (19/01/09)	-425	-425
South Africa	7.00	7.00	7.00	7.00	7.00	7.00	7.00	-50 (13/08/09)	-500	-200
China	5.31	5.31	5.31	5.31	5.31	5.58	5.85	-27 (23/12/08)	-216	-81
India	4.75	4.75	4.75	5.00	5.50	6.00	6.25	-25 (21/04/09)	-425	-250
Hong Kong	0.50	0.50	0.50	0.50	0.50	1.00	2.00	-100 (17/12/08)	-625	-625
Korea	2.00	2.00	2.00	2.00	2.25	2.50	2.75	-50 (12/02/09)	-325	-250
Taiwan	1.250	1.25	1.25	1.50	1.75	2.00	2.25	-25 (18/02/09)	-238	-150
Singapore	0.68	0.70	0.70	0.70	0.80	1.00	1.75	-	-	-
Indonesia	6.50	6.50	6.50	6.50	6.50	7.25	8.00	-25 (03/08/09)	-300	-325
Malaysia	2.00	2.00	2.00	2.00	2.00	2.50	3.00	-50 (24/02/09)	-150	-150
Thailand	1.25	1.25	1.25	1.25	1.25	1.50	2.00	-25 (08/04/09)	-250	-375
Brazil	8.75	8.75	8.75	8.75	8.75	9.00	10.00	-50 (22/07/09)	-500	-450
Mexico	4.50	4.50	4.50	4.50	4.50	4.50	4.50	-25 (17/07/09)	-375	-250
Chile	0.50	0.50	0.50	0.50	0.50	0.75	1.75	-25 (09/07/09)	-775	-475
Peru	1.25	1.25	1.25	1.25	2.00	4.75	6.00	-75 (06/08/09)	-525	-325
Colombia	4.50	4.50	4.50	4.50	4.50	4.75	5.25	-50 (19/06/09)	-550	-275
Global Policy Rate	2.2	2.2	2.1	2.2	2.3	2.6	3.1			
std. deviation	3.3	3.2	3.1	3.1	3.1	3.1	3.0			
# countries above	14	14	14	14	14	15	15			
# countries below	18	18	18	18	18	17	17			
G10 Policy Rate	0.5	0.5	0.5	0.6	0.7	1.0	1.6			
std. deviation	0.9	0.9	1.0	1.1	1.2	1.2	1.2			
# countries above	3	3	3	4	5	6	5			
# countries below	6	6	6	5	4	3	4			

Source: National Central Banks, Morgan Stanley Research

Note: Global policy rates are GDP weighted averages of national policy rates

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Global GDP and Inflation Forecasts

	2008	GDP 2009E	2010E	2008	CPI 2009E	2010E
GLOBAL	2.8	-1.2	3.5	5.3	1.9	3.0
G10	0.4	-3.4	1.6	3.3	0.0	1.5
United States	0.4	-2.6	2.6	3.8	-0.4	2.1
Euro Area	0.6	-4.0	0.6	3.3	0.4	1.3
Germany	1.3	-5.3	1.1	2.7	0.2	0.8
France	0.6	-2.2	0.9	2.8	0.2	0.7
Italy	-1.0	-5.1	0.6	3.3	0.9	1.3
Spain	1.2	-3.7	-0.7	4.1	-0.3	0.5
Japan	-0.7	-5.5	0.7	1.5	-1.2	-0.6
United Kingdom	0.7	-4.2	1.3	3.6	2.0	2.3
Canada	0.4	-1.6	2.5	2.4	0.8	2.1
Sweden	-0.2	-4.8	1.8	3.4	-0.4	1.0
Australia	2.3	-0.6	1.1	4.4	1.3	1.2
Emerging Markets	5.8	1.4	5.7	7.8	4.1	4.7
CEEMEA	4.1	-6.2	2.4	11.8	8.6	7.3
Russia	5.6	-8.0	2.5	14.1	12.0	9.5
Poland	5.0	0.0	1.3	4.3	3.5	2.7
Czech Republic	3.0	-3.9	0.9	6.4	1.1	1.6
Hungary	0.7	-5.7	-0.9	6.1	4.7	5.2
Romania	7.4	-7.4	0.9	7.9	5.9	4.4
Ukraine	2.1	-17.0	4.0	25.3	15.5	14.0
Turkey	1.1	-5.2	3.5	10.4	5.9	6.4
South Africa	3.1	-1.8	2.8	11.3	7.2	5.9
Asia ex Japan	6.9	5.5	7.8	6.4	1.8	3.3
China	9.0	9.0	10.0	5.9	-0.6	2.5
India	7.5	5.5	7.8	8.3	8.2	6.0
Hong Kong	2.4	-3.8	2.5	4.3	0.0	0.0
Korea	2.2	-0.5	5.0	4.7	2.8	3.3
Taiwan	0.1	-6.0	2.2	3.5	-1.0	0.5
Singapore	1.1	-5.0	3.5	6.5	-0.4	0.4
Indonesia	6.1	4.4	5.5	9.8	4.8	6.0
Malaysia	4.6	-3.5	3.8	5.4	0.2	1.5
Thailand	2.6	-3.5	3.1	5.5	-1.5	3.6
Latin America	4.1	-3.0	2.7	7.8	6.6	6.1
Brazil	5.1	-0.5	3.5	5.7	4.9	4.4
Mexico	1.3	-7.0	2.4	5.1	5.4	3.5
Chile	3.2	-1.4	3.8	8.7	1.9	1.0
Peru	9.8	1.8	4.4	6.7	3.6	2.9
Colombia	2.5	-0.9	2.6	7.0	4.9	4.1
Argentina	7.0	-4.4	1.0	8.6	5.6	5.3
Venezuela	4.8	-5.0	0.0	30.9	29.2	36.1

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

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

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