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Asia/Pacific Economics

Inside Asia/Pacific

Asia Pacific: Rising Risk of an Earlier-than-anticipated Policy Exit

Given the sharp acceleration in export growth, coupled with recovering domestic demand boosted by strong fiscal and monetary measures, we see rising risk of an earlier-than-expected policy exit in the AXJ economies. The key two risks to our gradual policy exit are a strong rebound in exports and higher commodity prices; hence, the upcoming trade data will be critical to watch.

China: Rebalancing, Not Overheating

The Chinese economy grew 10.7%YoY in real terms in 4Q09, recovering from the revised 9.1% in 3Q, yet sequential momentum softened a tad to 2%QoQ from 2.5% in 4Q and 4.4% in 2Q. Aggressive policy stimulus has successfully decoupled China from the deep recession in developed markets in the aftermath of the late-2008 financial crisis. The strong economic rebound, which commenced in 2Q09 and was primarily policy driven, has been sustained into 4Q09 and has become more balanced between domestic vs. external, and public vs. private growth drivers.

India: Moving to the “A” of the POTA Cycle

Every major policy/regulatory change in India must go through a one- to three-year cycle of POTA (proposition, opposition, treaty-consensus and action). We believe a number of critical policy changes will reach the implementation stage in 2010. We believe that some of these measures are critical for lifting India’s sustainable annual growth to 9%, which is the government’s target rate.

Morgan Stanley Global Economics Team

	Global Head	
Richard Berner	*Co-Heads of Global Economics Research*	+1-212-761-3398
Joachim Fels		+44 (0)20 7425-6138
	Global Fixed Income	
Joachim Fels	*Global*	+44 (0)20 7425-6138
Manoj Pradhan	*Global*	+44 (0)20 7425-3805
Spyros Andrepoulos	*Global*	+44 (0)20 7425-0528
	Europe	
Elga Bartsch	*Europe, ECB, Germany*	+44 (0)20 7425-5434
Daniele Antonucci	*Italy, Spain*	+44 (0)20 7425-8943
Melanie Baker	*United Kingdom*	+44 (0)20 7425-8607
Cath Sleeman		+44 (0)20 7425-1820
	Emerging Markets Europe	
Oliver Weeks	*Russia, Kazakhstan, Ukraine*	+44 (0)20 7677-6302
Tevfik Aksoy	*Turkey, MENA*	+44 (0)20 7677-0022
	The Americas	
Richard Berner	*United States*	+1-212-761-3398
David J. Greenlaw		+1-212-761-7157
Ted Wieseman		+1-212-761-3407
David Cho		+1-212-761-0908
Gray Newman	*Latin America*	+1-212-761-6510
Marcelo Carvalho	*Brazil*	+55-11-3048-6272
Luis Arcentales	*Chile, Mexico*	+1-212-761-4913
Daniel Volberg	*Argentina*	+1-212-761-0124
Giuliana Pardelli	*Venezuela*	+55-11-3048-6195
	Asia	
Gerard Minack	*Australia*	+61-2-9770-1529
Robert A. Feldman	*Japan*	+813-5424-5385
Takehiro Sato	*Japan*	+813-5424-5367
Chetan Ahya	*Asia Pacific Ex Japan*	+91-22-2209-7940
Tanvee Gupta	*India*	+91-22-2209-7927
Sumeet Kariwala	*Asia exJapan*	+91-22-2209-7929
Deyi Tan	*Malaysia, Singapore*	+65-6834-6703
Shweta Singh	*ASEAN*	+91-22-2209-7928
Qing Wang	*Greater China*	+852-2848-5220
Denise Yam	*Hong Kong, China*	+852-2848-5301
Sharon Lam	*Korea, Taiwan*	+852-2848-8927
Steven Zhang	*China*	+852-2848-6882
Katherine Tai	*China, Hong Kong, Korea, Taiwan*	+852-2848-8191

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January 12, 2010

Asia Pacific Economics

Rising Risk of Earlier-than-anticipated Policy Exit

Morgan Stanley Asia (Singapore) Pte.
Chetan Ahya
Chetan.Ahya@morganstanley.com

Morgan Stanley Asia Limited
Qing Wang
Qing.Wang@morganstanley.com

Sharon Lam
Sharon.Lam@morganstanley.com

Morgan Stanley India Company Private Limited+
Sumeet Kariwala
Sumeet.Kariwala@morganstanley.com

Sharp acceleration in December export growth: Exports by China, India, Korea and Taiwan (accounting for about 65% of region's exports) grew 13% mom seasonally adjusted in December 09. This was extremely strong compared with an average of 2% mom seen since the recovery began in March-09.

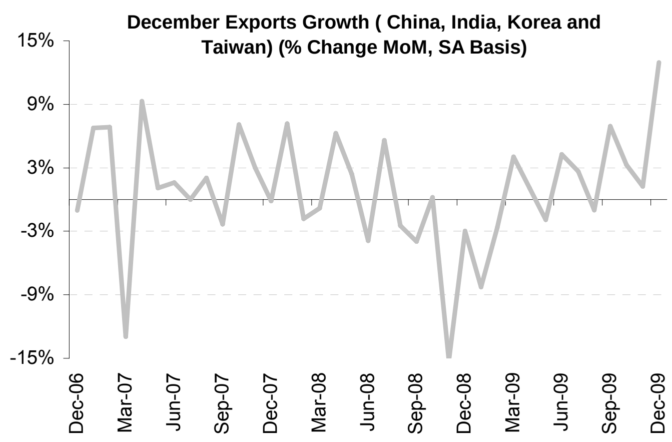
Strong fiscal and monetary measures have already boosted the region's domestic demand: AxJ IP growth has indeed been very strong at 10.9% yoy and 15.3% yoy in Oct-09 and Nov-09, respectively, above the trendline growth of 9% yoy. Uncertainty on outlook of exports has forced the policy makers to be cautious in reversing policy support so far. Indeed, in our forecasts we have assumed a 'gradual' exit on policy support as we have built a moderate pace of exports recovery.

Rising risk of an earlier than anticipated policy exit: The two key risks to our gradual policy exit are a strong rebound in exports and higher commodity prices. December exports for China, India, Korea and Taiwan are now just 10% below peak levels seen in July-08 on a seasonally adjusted 3MMA basis. This compares to exports at 15% and 18% below peak levels as of November and October-09, respectively. Further, crude oil prices have also had a sharp move up rather quickly.

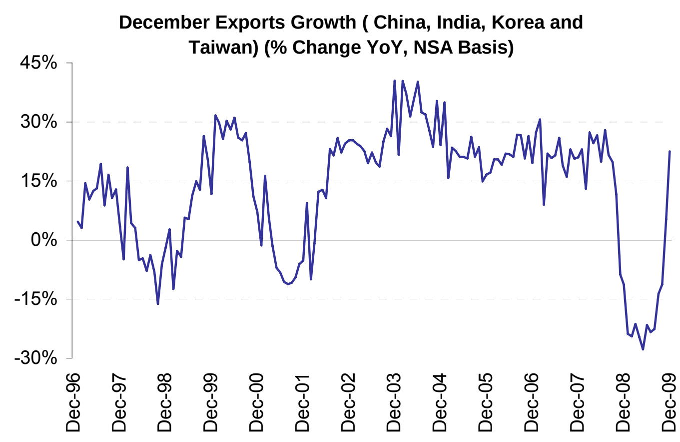
Trade data for the next two months will be critical: The sharp rise in December exports could have been one-off and in this context we believe January export numbers will be critical for policy reversal decision. In case January numbers indicate sustained growth momentum, we believe the capacity utilization could potentially move up much faster than expected warranting faster policy exit than our base case.

Sharp Acceleration in Exports in December

December Exports Growth For China, Korea, India and Taiwan



Source: CEIC, Morgan Stanley Research

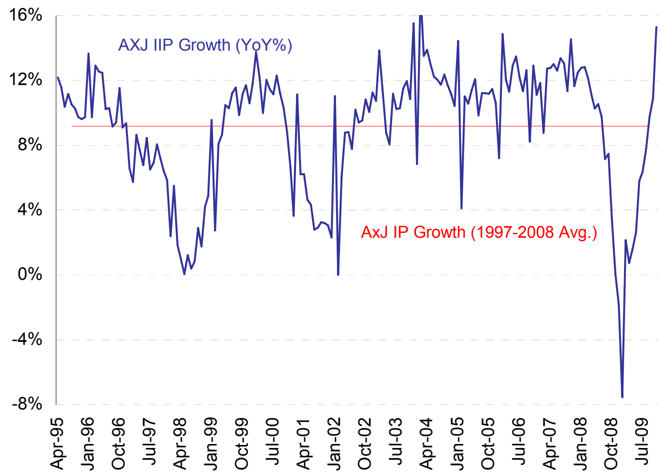


Source: CEIC, Morgan Stanley Research

- **Exports by China, India, Korea and Taiwan (accounting for about 65% of region's exports) grew at 13% mom seasonally adjusted in December 09.** This was extremely strong compared with an average of 2% mom seen since the recovery began in March-09. Korea and China were the clear leaders of the pack, registering a robust 15% and 16% mom growth, respectively, in December on a seasonally adjusted basis. On a yoy basis, non seasonally adjusted exports by these four countries improved to 22.5% in Dec-09 compared to 5.3% and -11.3% in the prior two months.

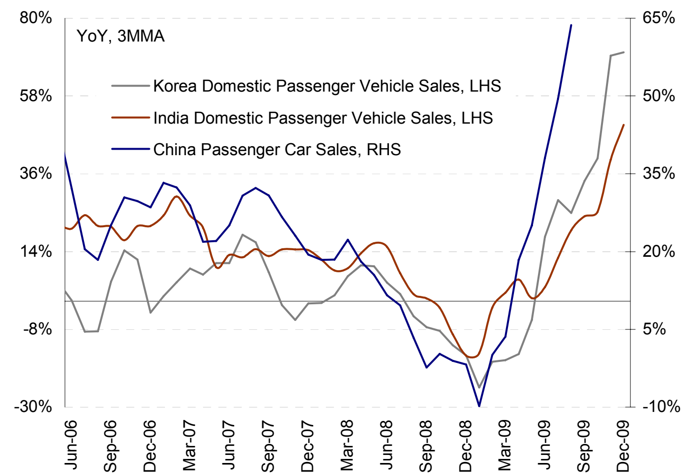
Strong Policy Response Has Already Boosted Domestic Demand

AxJ IP Growth Above Trendline



Source: CEIC, Morgan Stanley Research

Auto Sales in Top 3 AxJ Economies

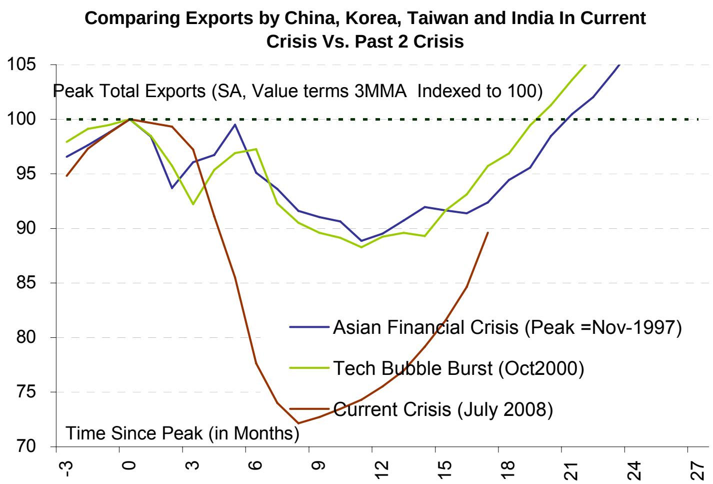


Source: CEIC, Morgan Stanley Research

- **Strong fiscal and monetary measures have already boosted the region's domestic demand.** AxJ IP growth has been strong at 10.9% yoy and 15.3% yoy in Oct-09 and Nov-09, respectively, above the trendline growth of 9%. Uncertainty over the outlook for exports has forced policy makers to be cautious in reversing policy support so far. Indeed, in our forecasts, we assume a ‘gradual’ exit on policy support as we have built a moderate pace of exports recovery.

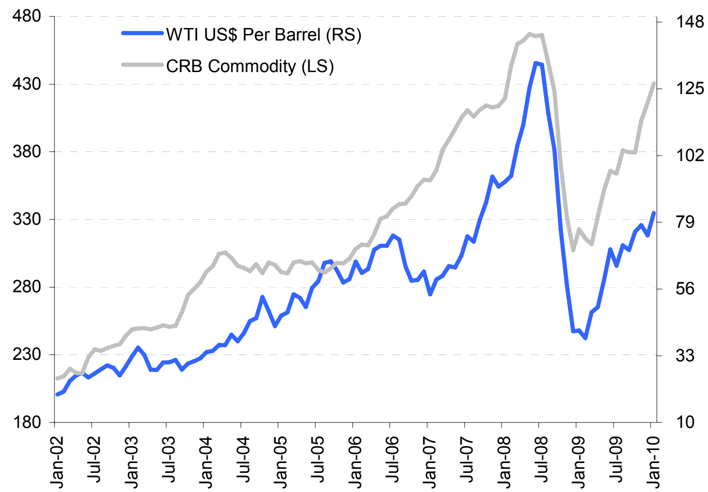
Upside Risk to Our Call of Gradual Rate Rise Materializing?

December Exports (China, Korea, India and Taiwan): % Fall From Peak Levels



Source: CEIC, Morgan Stanley Research

Trend in Commodity Prices



Source: CEIC, Bloomberg, Morgan Stanley Research

- **Our current base case assumes a moderate recovery in exports and moderate rise in commodity prices implying that policy support could be gradual.** In our last note on exit strategy for AXJ, we had highlighted that that the risk to our gradual exit call would be upside surprise in exports and higher commodity prices. Recent December trade data has been very strong. Exports by China, India, Korea and Taiwan in December are now just 10% below peak levels seen in July-08 on a seasonally adjusted 3MMA basis as compared to 28% in Mar-09. This compares to exports at 15% and 18% below peak levels as of November and October-09, respectively. Further, crude oil prices continue to rise, implying rising risk to our call on gradual policy exit.

Policy Exit Strategy: Our Base Case

Rate Hike Cycle To Begin in Q1-2010

	Nominal Interest Rates										
	2Q08	3Q09	4Q09	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	3Q11	4Q11
AXJ	6.96	4.57	4.57	4.69	4.90	5.27	5.58	5.70	5.73	5.82	5.82
China	7.47	5.31	5.31	5.31	5.31	5.58	5.85	5.85	5.85	5.85	5.85
India	8.50	4.75	4.75	5.00	5.50	6.00	6.25	6.50	6.50	6.75	6.75
Indonesia	8.73	6.50	6.50	6.50	7.25	8.00	8.50	8.50	8.50	8.50	8.50
Korea	5.00	2.00	2.00	2.50	3.00	3.25	3.50	3.75	4.00	4.25	4.50
Malaysia	3.50	2.00	2.00	2.00	2.00	2.50	3.00	3.00	3.00	3.00	3.00
Taiwan	3.63	1.25	1.25	1.50	1.75	2.00	2.25	2.50	2.75	3.00	3.00
Thailand	3.25	1.25	1.25	1.25	1.25	2.25	3.25	3.75	3.75	3.75	3.75

Source: CEIC, AP Economics Team, Morgan Stanley Research

AxJ Ex China Reduce Fiscal Deficit in 2010; While China Maintains it at Same Level

Fiscal Balance (% of GDP)	2007	2008	2009E	2010E	2011E
China	0.7	-0.4	-3.0	-3.0	-3.0
Hong Kong	7.5	0.1	-2.4	-1.5	-1.3
India	-5.0	-8.3	-9.9	-8.9	-7.3
Indonesia	-1.5	-0.1	-2.5	-2.5	-1.3
Korea	3.5	1.2	-2.4	-0.5	-0.2
Malaysia	-3.2	-4.8	-7.0	-6.0	-3.5
Singapore	2.5	-0.9	-3.3	-1.5	-0.5
Taiwan	-0.6	-2.0	-2.8	-2.0	-1.5
Thailand	-1.4	-0.9	-4.9	-2.5	-1.9

Source: AP Economics Team, Morgan Stanley Research

- The December exports data and recent quick move up in commodity prices raises the risk of quicker withdrawal of policy support in AXJ. **The sharp rise in December exports could have been one-off and in this context we believe January export numbers will be critical for policy reversal decision.** Assuming the revised trend of growth in exports sustains, It could imply that exports will recover back to precrisis levels in about 22-23 months, similar to that during the Asian financial crisis and tech bubble burst. In case, January numbers indicate sustained growth momentum, we believe the capacity utilization could potentially move up much faster than expected warranting faster policy exit than our base case.

Note: For more detailed discussion on Exit Strategy in AxJ , please refer to our note "'AxJ Exit' Strategy: The Road Ahead" dated November 16, 2009.

Country-wise Sensitivity To Higher Oil Prices and Strong Rebound in Exports

High Oil Prices + Stronger Exports Could Expedite Policy Exit in the Region

Country	Scenario 1: Crude Oil Price Rises Above US$ 100/bbl; While Exports Recovery Is Slow as per Our Base Case	Scenario 2: Crude Oil Price Rises Above US$ 100/bbl; Coupled With Better-Than-Expected Exports Recovery
China (Qing Wang)	Only allow limited pass-through, aided by controls over upstream prices	Interest rate hikes (three), RRR hikes (multiple) and Renminbi appreciation (5-7%)
Hong Kong (Denise Yam)	No response to oil price fluctuations	
India (Chetan Ahya)	We expect faster pass-through of higher crude oil prices to retail fuel prices; Also, RBI may allow some currency appreciation to ward of inflationary pressures.	We expect faster pass-through of higher crude oil prices to retail fuel prices; Also, policy rate hikes could be higher than our base case of 25 bps in Q1-2010.
Indonesia (Chetan Ahya /Deyi Tan)	The targeted retail fuel subsidy system will help to contain inflationary pressures somewhat. However, given that Indonesia is one of the economies likely to register stronger growth, we think cost pass-through could be higher. We think monetary policy renormalization could start in 1Q10 instead of our base case assumption of 2Q10.	Higher commodity prices are conducive to growth for Indonesia. Coupled with stronger external demand, we think that monetary policy renormalization could start in Q1-2010 and the pace of tightening could be quicker.
Malaysia (Deyi Tan/Chetan Ahya)	The targeted retail fuel subsidy system will help contain inflationary pressures somewhat. Moreover, we think BNM is unlikely to react to first-round commodity price pressures. The monetary policy response is likely to be the same as our base case with no rate hike in 1H10.	Monetary policy normalization is likely to be brought forward slightly to 2Q10.
Thailand (Deyi Tan/Chetan Ahya)	We suspect policymakers will attempt to cushion the impact of higher oil prices via fiscal measures. Core inflation will still be the key matrix the Central Bank watches out for. Whilst headline inflation could be somewhat higher than our base case, higher energy prices would dampen disposable income. To summarize, we expect no rate hike in 1H10 as per our base case.	Higher oil prices are likely to be cushioned via the Oil Fund to a certain extent. However, stronger growth momentum could imply a stronger commodity price pass-through. We expect policy rate renormalization to be brought forward to 2Q10.
Korea (Sharon Lam)	Same as baseline projection on interest rate.	Higher chance of steeper tightening cycle to curb price pressure.
Taiwan (Sharon Lam)	The authorities may lower the upper cap limit of the floating pricing formula of domestic petroleum.	Same as baseline projection on interest rates.
Singapore (Deyi Tan/Chetan Ahya)	Based on MAS's past modus operandi and the growth and inflation patterns 3-6 months before past monetary policy reviews in which a gradual and modest appreciation stance was adopted, we would expect MAS to still maintain a zero appreciation stance as per our base case in the next 6-9 months.	Based on MAS's past modus operandi and the growth and inflation patterns 3-6 months before past monetary policy reviews in which a gradual and modest appreciation stance was adopted, we would expect MAS to still maintain a zero appreciation stance as per our base case in the next 6-9 months.

Key Events to Watch In order to Gauge Upside and Downside Risks

Following the RRR hike in China from 15.5% to 16%, we believe the focus will shift to the following events in the region:

- **January 29, 2010:** India Monetary policy meeting (we expect 25bps rate hike).
- **February 1, 2010:** Korea's January trade data. If Korea's exports are good they will confirm that December's strong exports spike was not one-off.
- **February 11, 2010:** Korea monetary policy meeting. Our Korea economist Sharon Lam expects 50 bps rate hike in Q1–2010.
- **Mid February:** China's Credit disbursement and Trade data.

January 11, 2010

Asia Pacific Economics

Rebalancing – On the Right Track?

Morgan Stanley Asia (Singapore) Pte.

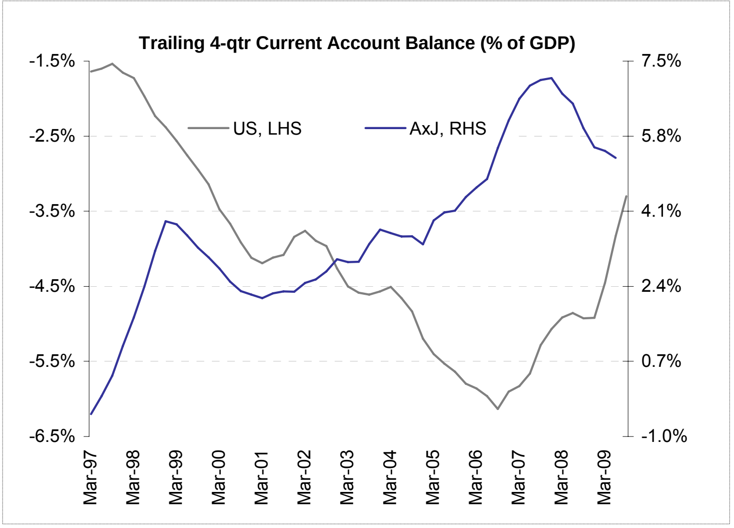
Chetan Ahya
Chetan.Ahya@morganstanley.com

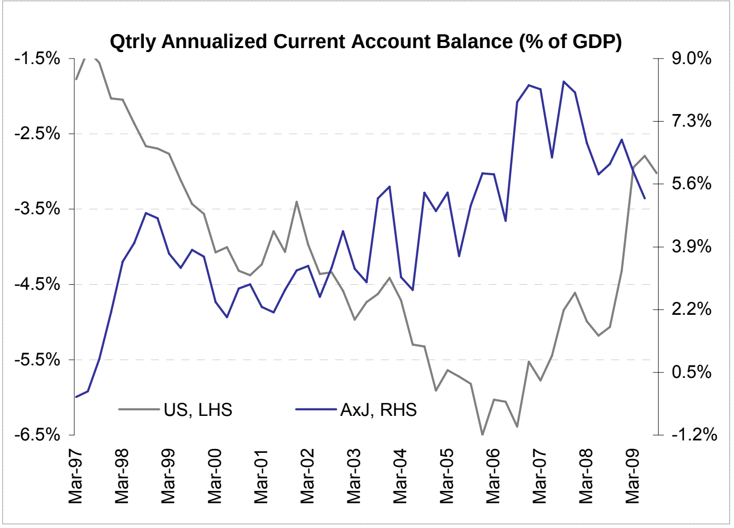
Morgan Stanley India Company Private Limited+

Sumeet Kariwala
Sumeet.Kariwala@morganstanley.com

Credit Crisis Forces Rebalancing

Current Account Balance: AxJ Vs. US



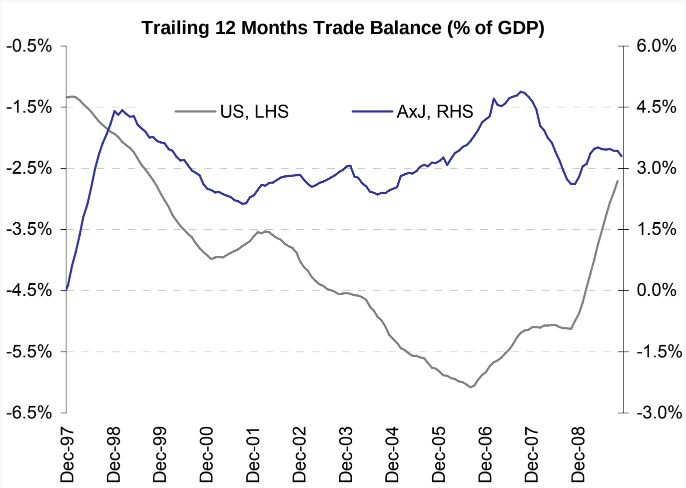


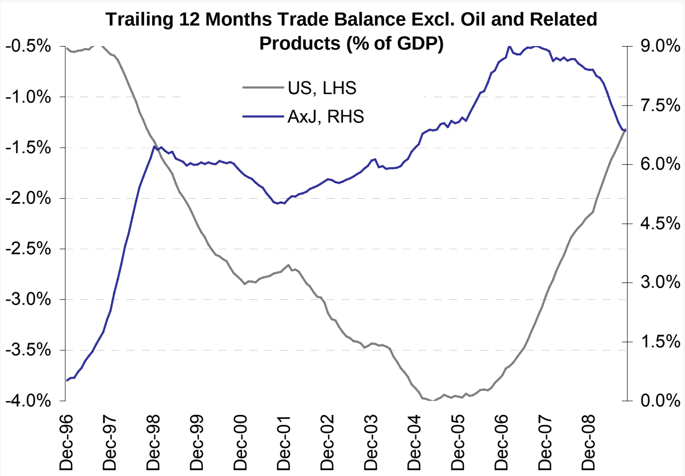
AxJ incorporates China, Hong Kong, India, Indonesia, Korea, Malaysia, Singapore, Taiwan, and Thailand; Source: CEIC, Morgan Stanley Research;

- **AxJ current account surplus has declined to 5.3% of GDP on a trailing 4qtr basis as of June-09, compared to 6.2% of GDP in 2008 and 7.2% of GDP in 2007.** On the other hand, US current account deficit has reduced to 3.8% of GDP in June-09 (on trailing 4qtr basis), vs. 5.1% and 4.9% of GDP in 2007 and 2008 respectively. This has further reduced to 3.3% of GDP as of Sept-09 on trailing 4qtr basis. While the credit crisis has meant a cutback in household consumption leading to lower import demand in the US, the stronger policy response in AxJ has boosted domestic demand implying higher imports and decline in trade surplus.

Adjustment Sharper in the US Compared to Asia

Trade Balance : AxJ Vs. US



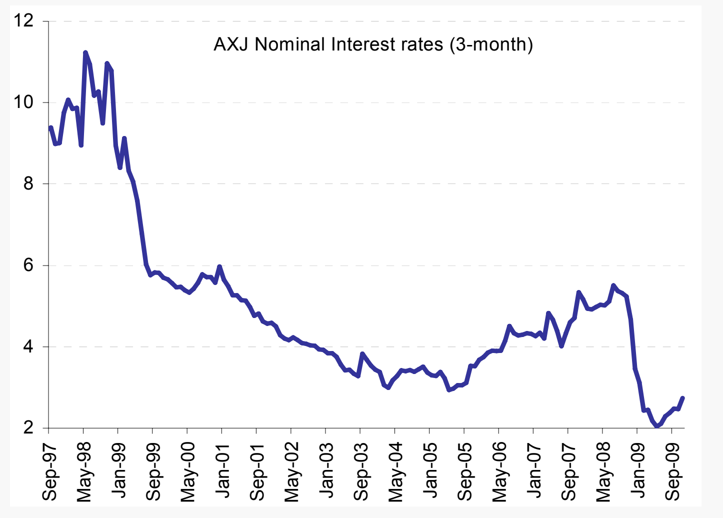


Source: CEIC, Morgan Stanley Research

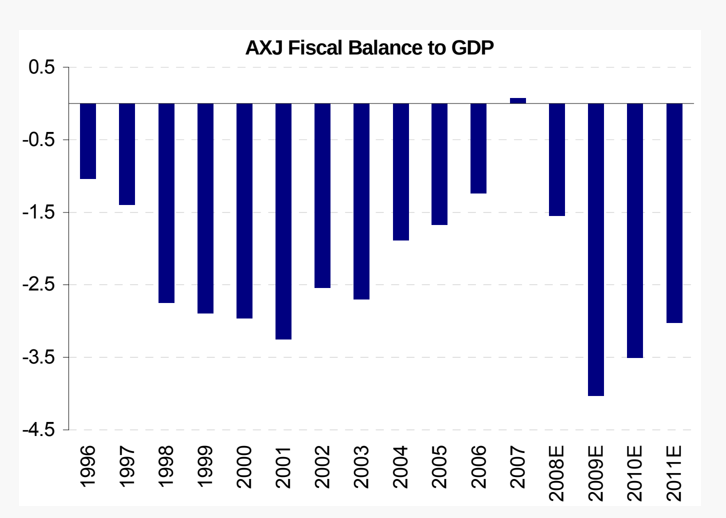
- **While we have seen a simultaneous reduction in the US trade deficit and AxJ trade surplus, the adjustment has been much more in the US as compared to Asia.** On a 12-month trailing basis, AxJ trade balance (excl. oil and related products) has decreased to 6.9% of GDP in Oct-09 as compared to 8.4% of GDP in 2008 and 8.9 % of GDP in 2007. On the other hand, US trade deficit adjusted for oil and related products, has reduced to 1.3% of GDP in Oct-09 (on trailing 12 month basis) as compared to 2.2% of GDP in 2008 and 3.0% of GDP in 2007. This compares to peak trade deficit levels of closer to 4% of GDP during the previous cycle.

Asia's Rebalancing Effort So Far Has Been Largely Driven By Cyclical Measures

Short-term Rates Continue To Remain Accommodative



Governments Have Pushed Fiscal Deficits to a New High

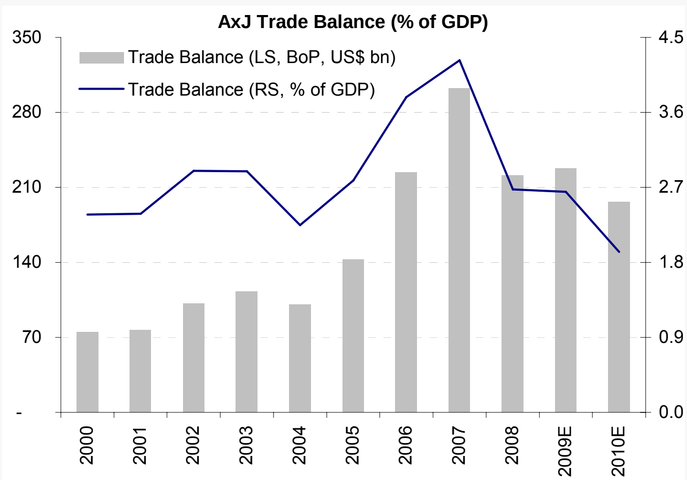


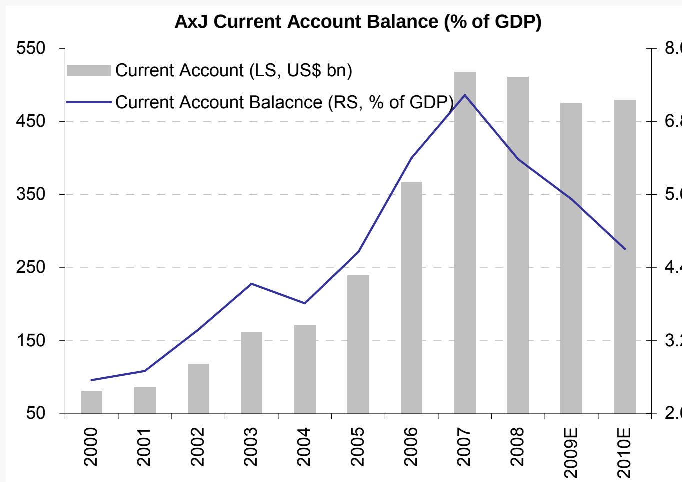
E= Morgan Stanley AP Economics Team Forecasts *Source: CEIC, AP Morgan Stanley Economics Team, Morgan Stanley Research*

- **Rebalancing process in AxJ largely tackled by cyclical measures, while structural measures take time:** Almost all countries in the region have responded by initiating measures to boost domestic demand either through an increase in infrastructure spending, higher transfers to households, encouraging household consumption through various tax incentives and cut in interest rates. The rebalancing process has been also helped by the structural measures taken last year (slide 6), however its contribution still remains low.

Asia's Rebalancing Effort - Expecting Similar Trend In 2010

Further Reduction In Trade and Current Account Surplus Likely





E= Morgan Stanley AP Economics Team Forecasts *Source: CEIC, AP Morgan Stanley Economics Team, Morgan Stanley Research*

- **We expect AxJ trade surplus to continue to decline over the next year:** We expect the trade balance to decline to 1.9% of GDP in 2010 from 2.6% in 2009 (vs. 2.7% and 4.2% of GDP in 2008 and 2007 respectively). So far, we believe the bulk of the rebalancing in AXJ has been driven by the cyclical policy response to the financial crisis rather than the effect of structural measures undertaken to boost domestic demand on a sustainable basis. In the near term, we believe the region’s policy makers will continue to rely on these cyclical measures.

Structural Boost To Demand Needed

Boosting Domestic Demand is a Process, Not a Push Button Event

- ***Strategy To Boost Domestic Demand Differs Across The Region:*** *In order to boost domestic demand on structural and sustainable basis, we see the need to boost private consumption in China, whereas in ASEAN, we see the need to initiate structural reforms to increase investments. Many ASEAN countries, such as Indonesia and Thailand, still have low per capita incomes and favorable demographic trends. Separately, in Malaysia, we see the need to boost private consumption as well as investments. In Taiwan, we think there is scope for some improvement in investment. In India and Korea, there is not much need for adjustment in the domestic demand mix, in our view.*
- ***Boosting Domestic Demand is a Process, Not a Push Button Event:*** *The most important strength as highlighted always in the process of rebalancing has been the high national savings in Asia ex Japan. We believe that even after accounting for the improving demographics, Asian savings are above average compared with in other countries. While aggressive policy measures by policy makers can accelerate the pace of private consumption growth, we believe this change will be a process and not a push button event.* ***The key structural challenges to increasing domestic demand (reducing saving investment imbalance) in AxJ on a sustainable basis in an autonomous manner are:***

1. Rise in savings since early 2000s: largely in corporate balance sheets not households
2. Social security support still lacking
3. Low public health care spending: most countries in region face this challenge
4. Education spending: higher costs for quality secondary and tertiary level education
5. Low household wealth in emerging Asia
6. Financial liberalization: household debt to GDP still low in emerging Asia
7. AxJ's policy makers may not prefer meaningful currency appreciation for rebalancing.
8. Weak investment environment in some countries

Structural Boost To Demand Needed

Tracking the Structural Measures To Boost Domestic Demand In AxJ

China: Social Security and Rural Reforms

- **Healthcare Reform:** China has introduced a healthcare plan with an objective to spend Rmb850bn (US$124bn) over three years to ensure at least 90% of its 1.3bn citizens have basic health insurance by 2011. Other measures include vaccination drives, the essential drug system, pilot reform of state-run hospitals, and improving cooking and sanitary facilities in rural areas
- **Rural Pension System:** The government has initiated a new rural social pension plan to cover 10% rural counties this year.
- **Financial Liberalisation:** Easing of regulations on retail and mortgage lending, removal of loan quota.
- **Land Reform:** In October 2009, the government allowed farmers to lease their contracted farmland or transfer their land use right on a voluntary basis.

India: Going the Rural Way

- **Increasing spending on rural infrastructure and social safety net:** Since the global credit crisis in September-October 2008, the government has accelerated spending programs supporting the rural population. The two key areas in which the government has increased spending are rural employment schemes and rural infrastructure. For the financial year ending March 2010, the government plans to increase rural spending by 20% to US$20bn.
- **Higher public education:** The government recently increased efforts to increase spending on education.

ASEAN: Improving Business Environment and Increase in Infrastructure Spending to Boost Investments

- **Indonesia:** The government has been making steady progress in improving business confidence over the past few months. Recent political changes have further strengthened the business confidence. The government has indicated a plan to spend US$130bn by 2014 compared with US$57bn in 2005-09.
- **Thailand:** Thailand has struggled to lift investment to GDP over the past three years amid political uncertainty. The new government formed in December 2008 has announced an aggressive fiscal stimulus plan (the bulk of which is infrastructure spending) of 18% of GDP to improve private sector confidence. Although there has been acceleration in government spending, we believe political uncertainties could delay the execution.
- **Malaysia:** Over the past few years, Malaysia has lost competitiveness in low value-added manufacturing businesses, which in turn has been reflected in its declining investment to GDP trend. We believe the government needs to implement structural reforms to boost competitiveness in higher value-added activities by improving the domestic supply of talent and also welcoming talent from neighboring countries. The new Prime Minister Najib has recently begun to move in this direction, liberalizing foreign investments and reversing some of the affirmative policy actions.

Note: For more detailed discussion on structural issues on rebalancing in Asia ex Japan, please see "Can Domestic Demand Lift the Burden of Rebalancing?", July 27, 2009. *Asia Pacific Economics: Can Domestic Demand Lift the Burden of Rebalancing?*

January 21, 2010

China Economics
Rebalancing, Not Overheating

Morgan Stanley Asia Limited

Qing Wang
Qing.Wang@morganstanley.com

Denise Yam, CFA
Denise.Yam@morganstanley.com

Steven Zhang
Katherine Tai

4Q09 Economic Report – Strong Yet Moderating Momentum: The Chinese economy grew 10.7% YoY in real terms in 4Q09, recovering further from 9.1% (revised) in 3Q. On a seasonally-adjusted basis, sequential QoQ growth softened a tad further nevertheless, to 2.0% (+8.2% annualized), from 2.5% in 3Q and 4.4% in 2Q.

Growth is becoming more balanced: Aggressive policy stimulus has successfully decoupled China from the deep recession in the developed markets in the aftermath of the late-2008 financial crisis. The strong economic rebound, which commenced and was primarily policy-driven in 2Q09, has sustained into 4Q09, and has become more balanced between domestic versus external, public versus private growth drivers.

Impact on our views: The much stronger-than-expected recovery in exports stands out as the most notable surprise in the December dataset. This trend, if sustained, would challenge one of two key assumptions underlying our base-case 'Goldilocks Scenario', i.e., a tepid recovery in external demand, and heighten some upside risks to our current forecasts for both growth and inflation for 2010. At the same time, we think that the earlier-than-expected RRR hike should not be interpreted as an outright tightening. Concerns about imminent aggressive policy tightening that could derail the current trends are unwarranted, despite that the stronger-than-expected economic activity may potentially bring forward policy measures (e.g., RRR hike, interest rate hike) that are part of policy normalization, in our view. We will likely revisit our forecasts and policy calls soon, after performing a comprehensive review of the entire 4Q09. However, to be sure, we attach a low probability to a full-blown overheating that could trigger a campaign-style tightening, resulting in a boom-bust cycle in the Chinese economy.

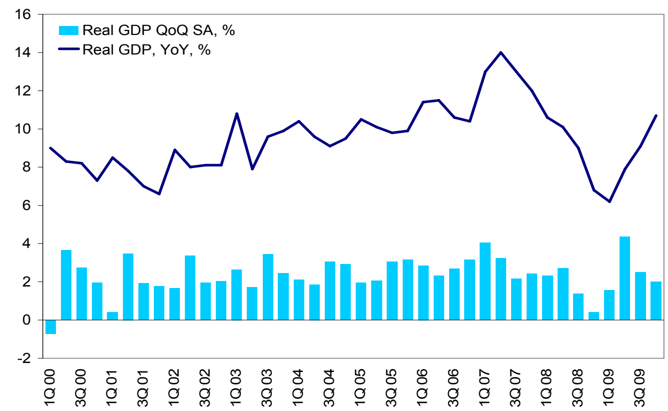
December/4Q09 Economic Statistics Summary

YoY, % unless otherwise stated	Dec 09 Actual	Dec 09 MS F	Dec 09 Con F	Nov 09 Actual
Trade Balance, US$ bn	18.4	-	-	19.1
Exports	+17.7	-	-	-1.2
Imports	+55.9	-	-	+26.7
Value Added of Industry	+18.5	+20.0	+19.6	+19.2
Retail Sales	+17.5	+17.5	+16.3	+15.8
Urban FAI (YTD)	+30.5	+31.5	+31.5	+32.1
M2	+27.7	-	-	+29.7
Loans	+31.7	-	-	+33.8
New Loans, Rmb bn	+379.8	-	-	+294.8
CPI	+1.9	+1.4	+1.4	+0.6
PPI	+1.7	+2.0	+0.5	-2.1
RMPPI	+3.0	+3.0	+0.5	-3.6
YoY, % unless otherwise stated	**4Q 09 Actual**	**4Q 09 MS F**	**4Q 09 Con F**	**3Q 09 Actual**
Real GDP	+10.7	+11.0	+10.5	+8.9
Total FAI	+30.1	+30.0	NA	+33.2

Note: December trade and monetary data were released on January 10 and 15, respectively.
MS F = Morgan Stanley Forecasts
Con F = Consensus Forecasts
Source: National Bureau of Statistics, General Administration of Customs, People's Bank of China, CEIC, Morgan Stanley Research

GDP – Double-digit growth in 4Q09: Riding on the momentum in 2Q-3Q09, the Chinese economy surged further ahead in 4Q09. Real GDP growth rebounded to double-digit pace, at 10.7% YoY, the first time since 2Q08, picking up further from 9.1% (revised) in 3Q and 7.9% in 2Q. On a seasonally-adjusted basis, sequential QoQ growth softened a tad further nevertheless, to 2.0% (+8.2% annualized), from 2.5% in 3Q and 4.4% in 2Q. For the full year, the economy grew 8.7%; though marginally lower than our 9% forecast, the pace was undoubtedly robust. We believe the moderation in sequential momentum, as well as the authorities' pledge to policy continuity and stability should help ease fears of an imminent shift in policy stance towards aggressive tightening.

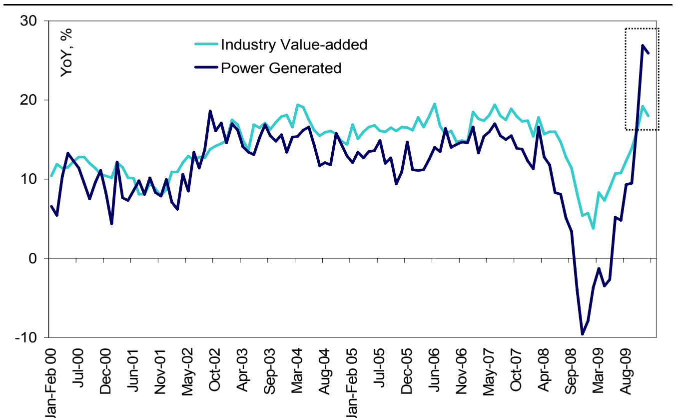
Exhibit 1
Overall Economic Growth



Source: National Bureau of Statistics, CEIC, Morgan Stanley Research

Industrial production – Steady rather than overheating, characterizing growth rebalancing: Industrial value-added grew 18.5% YoY (+0.3% MoM SA by our estimate) in December, surprisingly slower than the 19.2% gain in November, and weaker than our (+20%) and market (+19.6%) forecasts, especially given the sharp rebound in exports in the month (delivery for exports +12.4% YoY in Dec vs +5.3% in Nov). We believe this illustrates the growth rebalancing we have been advocating: as external demand recovers, industrial activity derives much less growth momentum from policy-driven domestic investment. For the full year, the export slump slashed overall industrial output growth to 11%, the weakest since the tech-burst-plagued 2001.

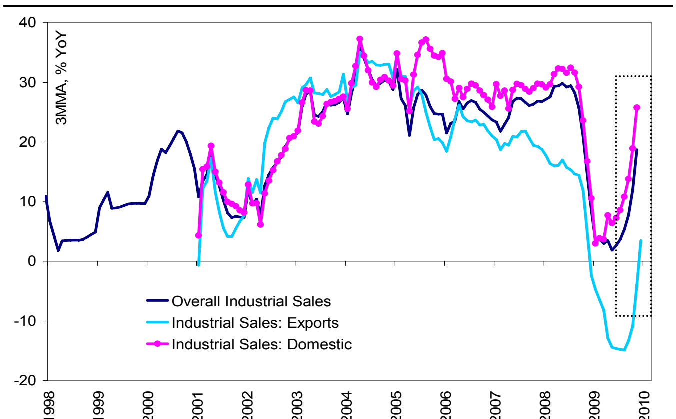
Exhibit 2
Industrial Production and Electricity Generation



Source: National Bureau of Statistics, CEIC, Morgan Stanley Research

… though rebalancing will take time: Needless to say, even though production for exports has reclaimed positive YoY gains, the manufacturing sector still remains dependent on domestic demand for growth. We admit that external demand will take time to recuperate, as evidenced in the continued outperformance of local enterprises (shareholding companies +20.5% YoY in Dec, SOEs +21.7%) over foreign-invested producers (+15.7%), but we are confident that this gap will narrow in the course of this year.

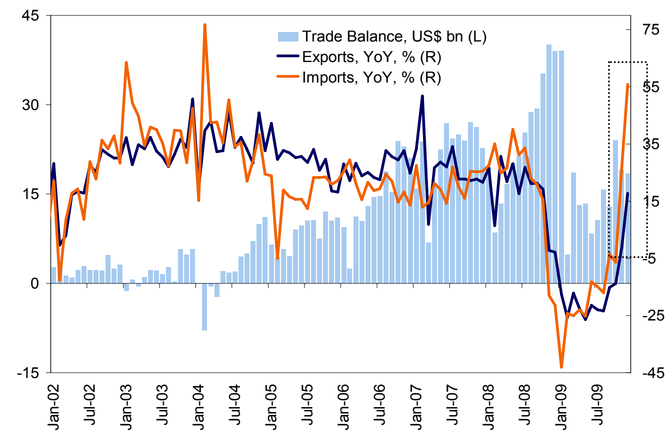
Exhibit 3
Industrial Sales – Domestic vs. Exports



Source: National Bureau of Statistics, CEIC, Morgan Stanley Research

Trade – Much stronger than expected rebound in December: After disappointing for several months, Chinese exports finally staged a stronger-than-expected rebound in the last month of 2009. Exports jumped 17.7% YoY (+5% MoM seasonally adjusted) to US$130.7bn in the month. The surge in imports also surprised on the upside, up 55.9% YoY (+8.7% MoM SA). The strong gains in December served to compensate for the disappointing data in the preceding months, bringing the full-year results close to our earlier forecasts; exports dipped 16% to US$1.2tn in 2009, in line with our forecast, while imports slipped 11.2% to US$1tn, slightly lower than our expectation (-13%). The trade surplus totaled US$196.1bn, the smallest in three years, and was a tad lower than our forecast (US$216bn).

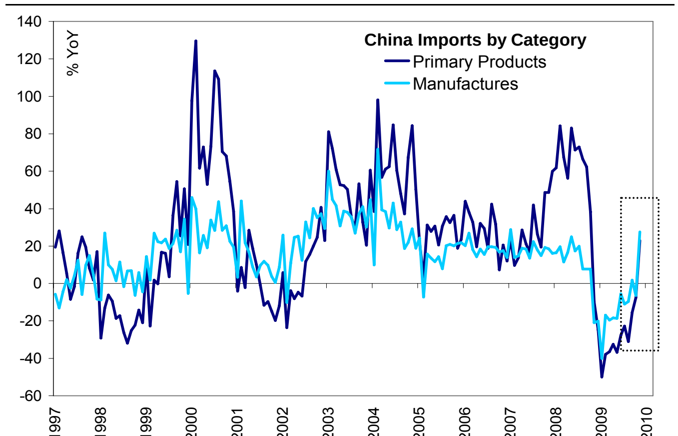
Exhibit 4
Trade Performance



Source: National Administration of Customs, CEIC, Morgan Stanley Research

Trade – Import surge driven mostly by manufactures: The breakdown of imports between the broad categories of primary versus manufactured products is not yet available. Nevertheless, from detailed data on individual import commodities, it was revealed that the 113% YoY surge (in value, contributed by 48% increase in volume and 44% increase in price) in crude oil imports lifted the overall import growth rate by 6.1 percentage points, while the intake of iron ore (+74%) contributed an increase of 2.7 ppts, and other primary products made a relatively small impact on the overall import growth rate. We can hence deduce that most of the pickup in imports came through the manufactured segment.

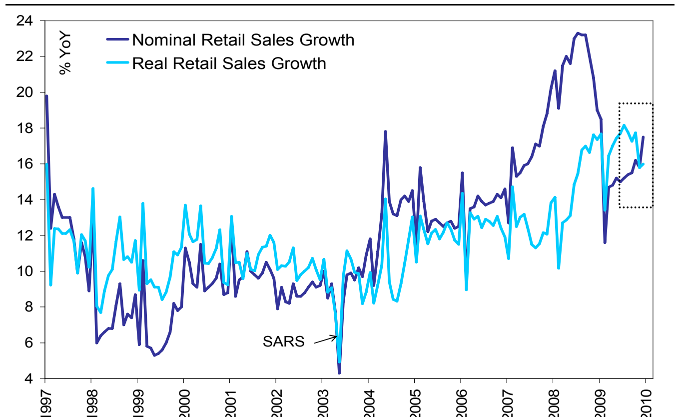
Exhibit 5
Imports: Primary vs. Manufactured



Source: National Administration of Customs, CEIC, Morgan Stanley Research

Retail Sales – Strong growth at year-end: Retail sales growth picked up significantly in December, to 17.5% YoY (+1.4% MoM SA), beating our above-consensus forecast (we forecast +17%, consensus +16.3%), making up for the disappointing result in November (+15.8% YoY, +0.2% MoM SA). Needless to say, the acceleration was partly driven by the pickup in inflation. Nevertheless, we estimate that sales growth in real terms picked up to above 16% YoY in the month. The most noticeable pickup in sales growth was seen in jewelry (+25.4% in Dec vs +11.6% in Nov), medicine (+27.6% vs +22.6%), communications equipment (+11.5% vs +6.9%) and oil (+27.9% vs +16.4%), although autos (+57.7%), furniture (+37.6%) and construction and decoration materials (+53.9%) remain the leaders in terms of growth in sales. For the full year, retail sales growth in nominal terms weakened to 15.5%, from 21.6% in 2008, but actually picked up in real terms, to 16.9%, from 14.8% in 2008.

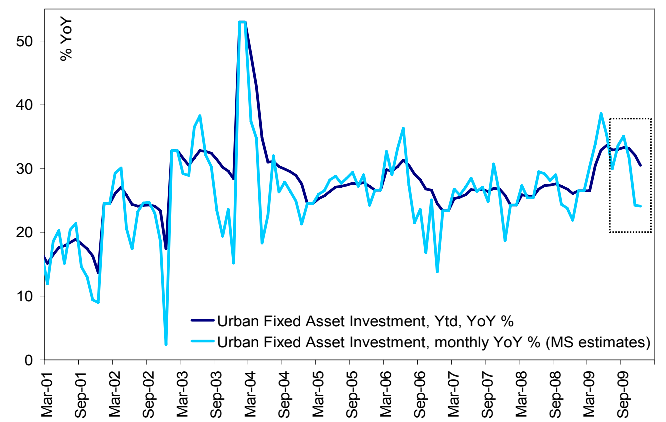
Exhibit 6
Retail Sales Growth – Nominal vs. Real



Source: National Bureau of Statistics, CEIC, Morgan Stanley Research

Fixed Asset Investment – Moderating momentum as growth rebalances: Nationwide FAI grew 30.1% YoY in 2009, while urban FAI gained 30.5%. They both fell slightly below our forecast (+33% and +31.5% respectively), and implied noticeably slower growth towards year-end. Nationwide FAI saw growth slip to 24.5% YoY in 4Q09 (+33.2% in 3Q), while urban FAI growth slipped to 24.1% in December (+24.3% in Nov) and 26.2% in 4Q (+32.9% in 3Q). It appears that as external demand shows signs of recovery, policy-driven domestic investment is easing off promptly enough to help prevent a full-blown overheating in the overall economy.

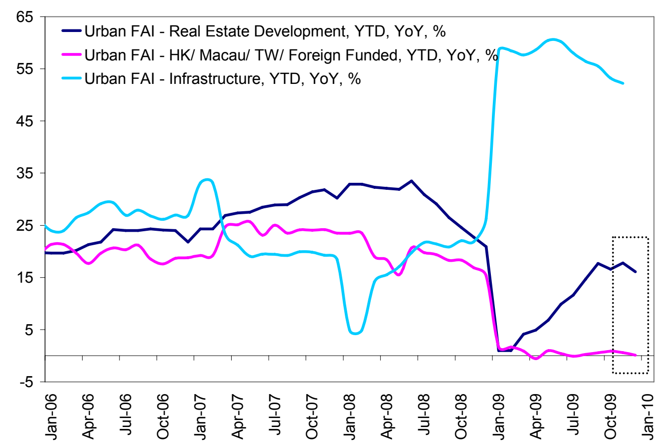
Exhibit 7
Urban Fixed Asset Investment



Source: National Bureau of Statistics, CEIC, Morgan Stanley Research

… with capex in manufacturing recovering: Policy-driven investment projects in primary (+49.9% in full-year vs +51.5% in Jan-Nov) and tertiary (includes infrastructure) (+33% vs +36.6%) had been the main growth driver in 2009 (Exhibit 18), but they are giving way to the recovery in capex in the secondary / manufacturing sector (+26.8% vs +26.1%) as the prospects for exports improve.

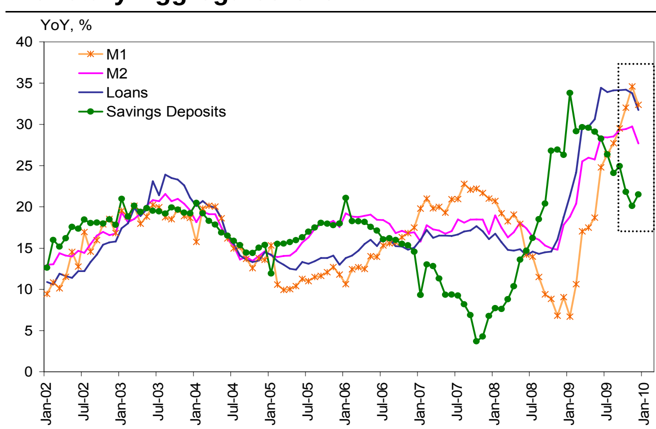
Exhibit 8
FAI – Policy Driven vs. Private



Source: National Bureau of Statistics, CEIC, Morgan Stanley Research

Monetary data – Normalization continued in December: The gradual retreat in monetary growth continued in December, in line with expectations. New loan creation rebounded somewhat to Rmb380bn, from Rmb295bn in November. Though beating our forecast of Rmb310bn, it does not buck the trend of enlarging YoY declines, which came to 51% vs. 38% in November. For full-year 2009, new loans totaled Rmb9.59tn (+95% YoY), while outstanding loan growth retreated to 31.7% (+33.8% in Nov). In line with the normalization trend, bills financing loans decreased for the sixth straight month, by Rmb112bn in December, while short-term loans (to non-financial institutions) also slipped for the third month, by Rmb29bn, suggesting that medium- and long-term loans continue to be the main driver of the ongoing credit expansion, consistent with growth-supporting policy initiatives, and signals enhanced sustainability. Meanwhile, M2 growth also softened in line, to 27.7% (+29.7% in Nov).

Exhibit 9
Monetary Aggregates Growth

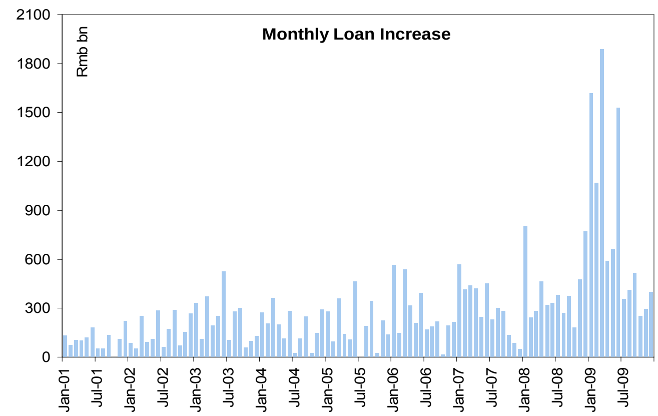


Source: People's Bank of China, CEIC, Morgan Stanley Research

Monetary data – Foreign reserves data support our contention that "hot money" inflows picked up further in 4Q09: Foreign reserves reached US$2.4tn at the end of December (Exhibit 18). Although the US$127bn increase in 4Q was smaller than the US$141bn gain in 3Q, it was partly hurt by valuation losses as the USD strengthened considerably (4.4% against euro and 7.5% against yen) in December. Our proxy for "hot money" inflows, which is the incremental change in reserves, net of the trade surplus and FDI and adjusted for exchange rate movements and interest income, showed sustained positive inflows above US$10bn in all three months in 4Q09, totaling US$38.1bn, beating 3Q's US$25.3bn.

Exhibit 10

Monthly New Loan Creation

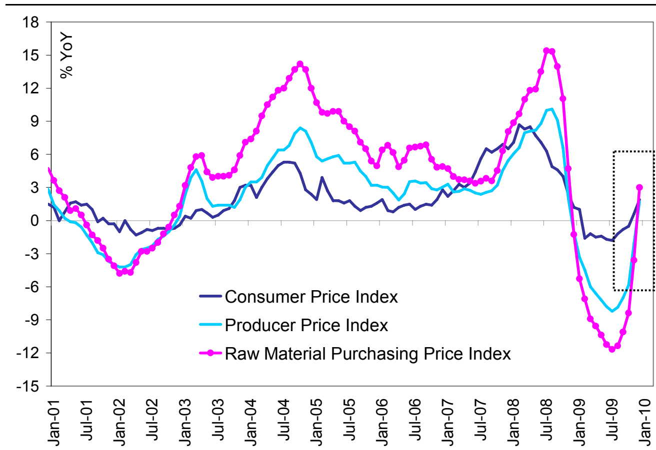


Source: People's Bank of China, CEIC, Morgan Stanley Research

Inflation – Pick-up in upstream inflation broadly in line with expectations: Producer and raw materials purchasing price indices both reclaimed positive YoY gains in December, broadly in line with our expectations. PPI rose 1.7% YoY (-2.1% in Nov), while RMPPI gained 3% (-3.6% in Nov). On a MoM seasonally-adjusted basis, both indices sustained sequential gains, by 1.8% (+0.9% in Nov) and 2.1% (+1% in Nov) respectively. The uptick was driven primarily by the jump in energy prices due to the low base effect. The faster-than-expected turnaround upstream prices and the rapid monetary expansion last year are fuelling fears for high inflation this year. Given the approximately six-month lag effect of accommodative monetary conditions in 2009, the key swing factor in determining inflation is how fast the output gap will close, which is a function of export growth rate (see our report *Worried About Inflation? Get Money Right First,* dated October 20, 2009).

Exhibit 11

Key Price Indices

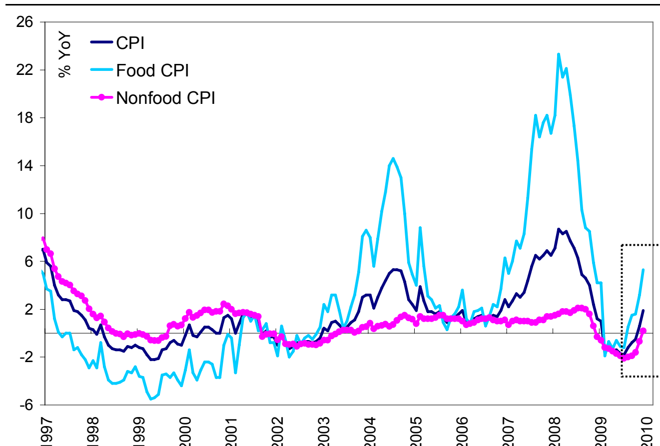


Source: National Bureau of Statistics, CEIC, Morgan Stanley Research

… while higher-than-expected consumer inflation is attributable entirely to food: CPI inflation picked up to 1.9% YoY in December, beating our and market forecasts (+1.4%). Nevertheless, the upside surprise stemmed entirely from the food component (+5.3% YoY, vs our forecast of +3.7%), while non-food inflation still fell below expectations (+0.2% vs our forecast of +0.6%). On a seasonally-adjusted basis, consumer prices rose 0.7% MoM (+0.4% in Nov), the biggest climb since November 2007. The uptick in the final month of the year narrowed full-year CPI deflation to 0.7%, marginally milder than our forecast (0.8%).

Exhibit 12

Consumer Inflation – Food vs Non-food



Source: National Bureau of Statistics, CEIC, Morgan Stanley Research

Concluding the December/4Q09 Dataset – Impact on Our Views

Aggressive policy stimulus has successfully decoupled China from the deep recession in the developed markets in the aftermath of the late-2008 financial crisis. The strong economic rebound, which commenced and was primarily policy-driven in 2Q09, has sustained into 4Q09, and has become more balanced between domestic versus external drivers, and between private versus public sector initiatives.

Entering the New Year, there have been two important surprises. First PBoC raised the ratio for required reserves (RRR) last week, the timing of which was earlier than expected by the market (see our report, *RRR Hike Cycle Kicks off Earlier than Expected*, dated January 12, 2010). Second, China's export growth in December 2009 was very strong (+17% YoY), much higher than our and consensus forecasts. These two surprises, together with the latest 4Q09 datapack that indicates strong sequential growth momentum, beg the question whether the two key assumptions underlying our base case still hold. Specifically, (a) have we been too conservative in forecasting the strength of external demand? and (b) does the RRR hike represent the beginning of an aggressive monetary tightening? We take this opportunity to elaborate our views.

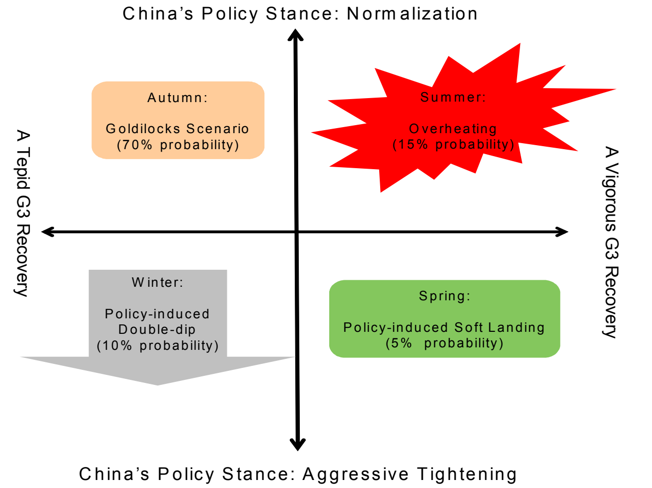
These two surprises, together with the latest 4Q09 datapack that indicates strong sequential growth momentum, beg the question whether the two key assumptions underlying our base case still hold.

A) A Revisit to Our Four-Season Framework

Regular readers of our research may recall that in discussing the outlook for 2010, we envisage two types of uncertainties facing the Chinese economy in 2010: a) **G3 economic outlook**: Is it a tepid recovery, which is our base case, or could it be a vigorous recovery? And b) **Domestic policy stance:** Is there going to be normalization, as we are expecting? Might the Chinese authorities tighten aggressively?

Along the two dimensions of uncertainty, we envisage four potential scenarios in 2010 in a four-season framework (Exhibit 13) (see our report, *A Goldilocks Scenario in '10*, dated November 23, 2009). Specifically, 'Autumn' features a combination of a tepid G3 recovery and normalizing policy stance in China that would deliver a 'Goldilocks Scenario'. We assign a 70% subjective probability to this scenario.

Exhibit 13
Alternative Scenarios in 2010



Source: CEIC, Morgan Stanley Research

'Summer' features a combination of vigorous G3 recovery and normalizing policy stance in China that would result in 'Overheating'. If G3 economic recovery in 2010 were to be much stronger than expected, China's export growth and thus industrial capacity utilization, as well as global commodity prices, could both surprise to the upside, likely resulting in higher GDP growth and stronger inflationary pressure if the policy stance were to remain unchanged. We think this is the most likely alternative scenario and assign it a 15% subjective probability.

'Spring' features a combination of a vigorous G3 recovery and aggressive tightening that would help achieve a 'Policy-induced Soft Landing'. To realize this scenario, the timing and modality of policy tightening would be absolutely key. Given Chinese policymakers' track record, this tends to be difficult to achieve. We therefore assign only a 5% probability to this scenario.

'Winter' features a combination of a tepid G3 recovery and aggressive tightening in China that would lead to a 'Policy-induced Double Dip'. The key headline macroeconomic indicators (e.g., YoY GDP and export growth) may improve rapidly because of the low-base effect in the coming quarters. Subsequently, policymakers may turn complacent and launch a round of aggressive tightening for fear of economic overheating despite only a tepid G3 recovery. This would likely derail a recovery, causing a double-dip in economic growth. We assign a 10% probability to this scenario.

While a consensus has been formed around a 'Goldilocks Scenario' ('Autumn'), the primary concern among market participants in the latter part of 2009 about the downside risks to the Chinese economy seem to have been fear of the 'Winter' scenario, or a policy-induced double dip due to premature tightening. However, developments in the last couple of months, domestic or external, have helped lower the probability of this scenario. First, the key message from China's Central Economic Work Conference, held in early December 2009, reassured the market of policy stability and continuity in 2010, thereby reducing policy uncertainty in the near term (see our report *Policy Priority Shifts Toward Boosting Private Demand*, dated December 8, 2009). Second, there have been more convincing signs for a sustainable recovery in major industrialized economies (see US Economics Report, *Outlook 2010: Higher Rates, Fed Exit and Sustainable Growth*; January 4, 2010, and European Economics Report, *Transition Towards a Tepid Recovery*, January 4, 2010).

…the primary concern among market participants in latter part of 2009…seems to have been fear of the 'winter' scenario

B) Is Tepid External Demand Intact?

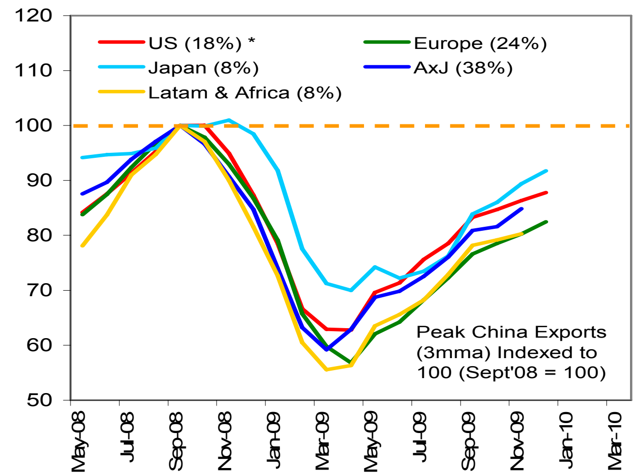
The stronger-than-expected export growth points to upside risk to our baseline forecasts for both growth and inflation. The strong recovery in December 2009 has taken shipments back to a level only about 10% below the pre-crisis peak reached in September 2008. And the recovery has been broad-based across markets (Exhibit 14). Since exports to the US and Europe have not recovered to the same level as aggregate exports have, it suggests that the surprisingly rapid export growth in December must have been due to strong growth in shipments to emerging economies (i.e., AxJ, Latam, Africa), although the latest data points for these regions are not yet available.

…the surprisingly rapid export growth in December must have been due to strong growth in shipments to emerging economies

Under our baseline scenario, we forecast 9% export growth in 2010, a significant bounce back from the 16% decline in 2009. If, however, we were proved to be too conservative, especially vis-à-vis the potential strength of emerging-market demand, China will face significant upside risk to inflation and growth, in our view.

Exhibit 14

China: Broad-based Recovery in Exports

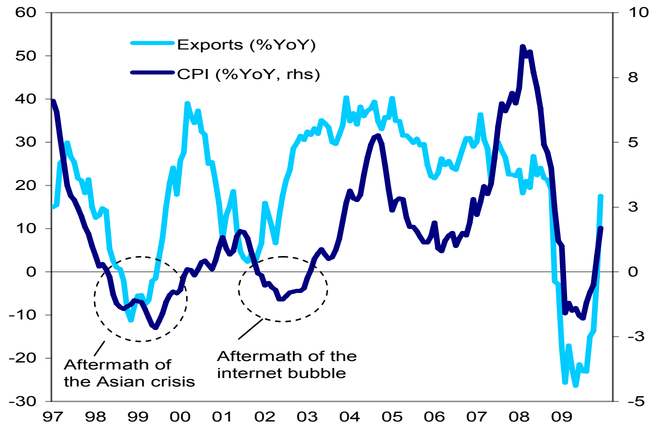


* The percentage in parentheses indicates the share of total exports
Source: CEIC, Morgan Stanley Research

…if export growth were to be sustained at a 15-20% range in 2010, instead of our current forecast of 9%, our forecasts for inflation and GDP growth would need to be revised

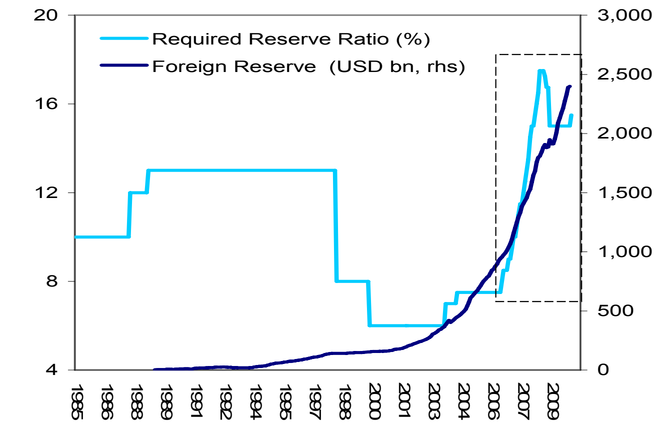
Export growth is an important gauge for inflationary pressures, because it is a useful proxy for output gap, especially in the industrial sectors, in China. Weak exports are disinflationary (Exhibit 15). As we have pointed out, given the approximately six-month lag effect of accommodative monetary conditions in 2009, the key swing factor in determining inflation is how fast the output gap will close, which is a function of export growth rate (see our report *Worried About Inflation? Get Money Right First*, dated October 20, 2009). Therefore, if export growth were sustained at a 15-20% range in 2010, instead of our current forecast of 9%, our forecasts of inflation and GDP growth would need to be lifted.

Exhibit 15
Weak Exports Are Disinflationary



Source: CEIC, Morgan Stanley Research

Exhibit 16
RRR Hike: A Liquidity Management Tool



Source: CEIC, Morgan Stanley Research

C) Is Policy Normalization Intact?

While the exact timing of the RRR hike was a surprise, our call has been that RRR hike would be the first and primary monetary policy tool that Chinese authorities use in 2010. This first RRR hike should not be interpreted as the beginning of outright tightening, in our view, and our call for a policy normalization while maintaining support for growth remains unchanged. Here is why:

RRR hike is typically considered a strong and blunt policy instrument…to tighten monetary policy. This is not the case in China, however

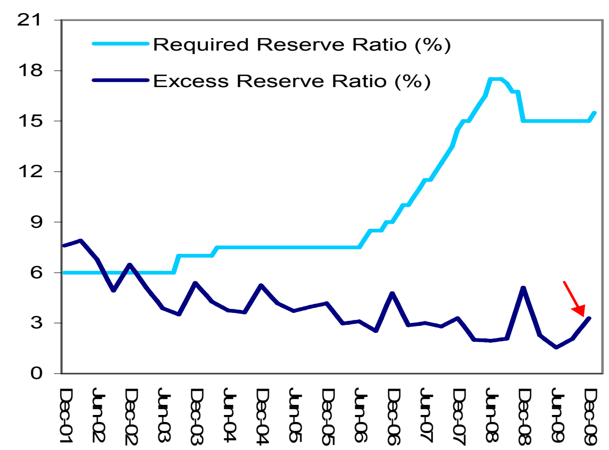
First, the RRR hike is typically considered a strong and blunt policy instrument employed by central banks to tighten monetary policy. This is, however, not the case in China. The RRR more than doubled from 8% in mid-July 2006 to 17.5% in August 2008 through very frequent hikes during this period of time. This coincided with the rapid increase in FX reserves in China (Exhibit 16). RRR hikes should be considered a conventional policy tool for the central bank to sterilize excess liquidity in the system stemming from rapid reserves accumulation. Given the infeasibility of allowing a large-enough renminbi revaluation to help eliminate balance of payment surpluses, RRR hikes become the most-favored among a handful of policy instruments to help mop up liquidity. Given the current exchange rate regime, as long as sizable balance of payments surpluses persist, the PBoC will need to keep mopping up liquidity through RRR hikes (see our report, *RRR Hike Cycle Kicks off Earlier than Expected*, January 12, 2010).

Second, RRR hikes help mop up excess liquidity but do not necessarily reduce the existing liquidity in the system, and therefore do not impose a binding constraint on banks' capacity – even at the margin – to make loans. We had expected the first RRR hike in early 2Q. We believe that the earlier timing has to do with a jump in the excess reserve ratio (ERR) to over 3% at the end of December from 2% in September, reflecting the earlier-than-expected return of external surpluses and the massive drawdown of treasury deposits from the central bank by fiscal budget units in a year-end rush to spend. Therefore, we believe that the RRR hike was in response to this jump in ERR (Exhibit 17). This again suggests that the RRR hike does not affect banks' ability to make loans.

…the availability of credit is always the most important gauge of monetary policy stance in China

Third, the availability of credit is always the most important gauge of monetary policy stance in China. We forecast Rmb7.5tn of new loans in 2010 (with upside risk), implying 18-19% YoY loan growth, which is still quite accommodative. We also estimate that about Rmb1.5tn out of Rmb9.5tn loans made in 2009 has not actually been utilized, but remains available for 2010. So the effective amount of new bank lending in 2010 could be Rmb9tn, vs. Rmb8tn in 2009. In other words, we see monetary and credit conditions remaining supportive of the real economy this year, and we believe credit costs are unlikely to increase substantially.

Exhibit 17
RRR Hike Offsets Higher ERR



Source: CEIC, Morgan Stanley Research

D) Implications
The recent developments on both the economic and policy fronts carry two important implications: a) growth momentum in China is strong, with potentially stronger-than-expected external demand likely providing additional boost. This suggests that demand from China for key commodities will be robust and sustainable, thus benefiting countries/companies with large exposure to China's domestic market. b) Concerns about imminent aggressive policy tightening that could derail the current trends are unwarranted, although stronger-than-expected economic activity could bring forward policy changes that are part of policy normalization (e.g., RRR hikes, interest rate hikes), in our view.

The primary risk to our calls is that full-blown overheating – as envisaged under the 'Summer Scenario' (featuring 12% GDP growth and 5% CPI inflation) – could materialize in the latter part of the year and thus trigger campaign-style tightening, which would result in a boom-bust cycle in the Chinese economy. This scenario, while not impossible, is not probable, in our view.

… full-blown overheating…while not impossible, is not probable

E) What's Next?
We will likely revisit our forecasts and policy calls soon, after taking a comprehensive review of the entire dataset in 4Q09, together with the revised historical GDP data for 2008 and earlier years.

Exhibit 18

Latest Monthly Economic Statistics

YoY, %, unless otherwise stated	Dec 09	Nov 09	Oct 09	Sep 09	4Q 09	2009	2008
TRADE							
Trade Balance, US$ bn	18.4	19.1	24.0	12.9	61.5	196.1	295.5
Exports, US$ bn	130.7	113.7	110.8	115.9	355.1	1201.7	1428.5
YoY, %	+17.7	-1.2	-13.8	-15.2	+0.2	-16.0	+17.2
MoM, NSA, %	*+15.0*	*+2.6*	*-4.5*	*+11.8*			
MoM, SA, %	*+5.0*	*-0.3*	*-9.1*	*+6.3*			
By destination							
US	+15.9	-1.7	-9.9	-14.3	+0.6	-12.5	+8.4
Japan	+5.2	-11.9	-13.5	-9.1	-6.8	-15.7	+13.8
EU	+10.2	-8.0	-14.9	-17.4	-4.9	-19.4	+19.5
Hong Kong	+33.1	+13.4	-9.9	-13.3	+11.2	-12.8	+3.4
Korea	+17.0	-4.0	-22.1	-25.7	-4.9	-27.4	+31.0
Imports, US$ bn	112.3	94.6	86.8	103.0	293.6	1005.6	1133.1
YoY, %	+55.9	+26.7	-6.4	-3.5	+22.3	-11.2	+18.5
MoM, NSA, %	*+18.8*	*+9.0*	*-15.8*	*+17.1*			
MoM, SA, %	*+8.7*	*+22.2*	*+7.3*	*+8.3*			
Primary Products, US$ bn	NA	26.8	25.7	29.3	NA	253.8 (Jan-Nov)	362.7
YoY, %	NA	+23.0	-7.6	-15.5	NA	-26.2 (Jan-Nov)	+49.3
Manufactures, US$ bn	NA	67.8	61.0	73.7	NA	638.7 (Jan-Nov)	770.5
YoY, %	NA	+27.6	-6.4	+1.8	NA	-10.9 (Jan-Nov)	+8.1
PRODUCTION, INVESTMENT AND SALES							
Value Added of Industry	+18.5	+19.2	+16.1	+13.9	+18.0	+11.0	+12.9
MoM, SA, %	*+0.3*	*+1.5*	*+0.8*	*+1.1*			
Output value for export delivery	+12.4	+5.3	-7.3	-9.9	+3.5	-10.1	+11.4*
Electricity Generation	+25.9	+26.9	+17.1	+9.5	+23.3	+7.0	+5.5
Retail Sales, Rmb bn	1,261	1,134	1,172	1,091	3,567	12,534	10,849
YoY, %	+17.5	+15.8	+16.2	+15.5	+16.6	+15.5	+21.6
City	+18.6	+16.5	+16.6	+15.9	+17.3	+15.5	+22.1
Rural	+15.4	+14.4	+15.4	+14.6	+15.1	+15.7	+20.7
Wholesale / Retail	+18.1	+16.4	+16.8	+15.9	+17.1	+15.6	+21.5
Catering	+16.5	+14.4	+15.1	+14.8	+15.4	+16.8	+24.7
*MoM, SA, %**	*+1.4*	*+0.2*	*+1.4*	*+1.4*			
YoY growth in real terms, %	+16.0*	+15.8*	+17.7*	+17.3*	+16.5*	+16.9*	+14.8*
Urban fixed asset investment, YTD, Rmb bn	19,414	16,863	15,071	13,318	6,096	-	14,817
YoY, %	+30.5	+32.1	+33.1	+33.3	+26.2	-	+26.1
Central government	+18.4	+16.4	+18.8	+18.9	-	-	+29.6
Local government	+32.0	+33.9	+34.8	+34.9	-	-	+25.7
Real estate development	+16.1	+17.8	+18.9	+17.7	-	-	+20.9
State-owned & state-holding	+33.8	+37.8	+39.0	+38.8	-	-	+22.8
HK/Macau/Taiwan funded enterprises	+0.3	+1.5	+0.8	+0.1	-	-	+16.7
Foreign funded enterprises	-1.2	-0.1	+1.0	+0.9	-	-	+14.6
Industry breakdown:							
Primary	+49.9	+51.5	+54.1	+54.8	-	-	+54.5
Secondary	+26.8	+26.1	+26.8	+26.9	-	-	+28.0
Coal mining	+25.9	+33.6	+32.5	+33.0	-	-	+33.6
Oil & gas mining	+4.4	-6.5	-5.9	-7.6	-	-	+22.0
Electricity & heating	+22.8	+20.2	+21.1	+21.3	-	-	+14.4
Tertiary	+33.0	+36.6	+37.8	+38.1	-	-	+24.1
Railway transport	+67.5	+80.7	+82.5	+87.5	-	-	+61.2
Source of funds breakdown:							
Domestic Loans	+47.7	+46.4	+49.2	+48.0	-	-	+11.8
Foreign Funds	-15.8	-15.2	-12.9	-13.1	-	-	+2.7
Self-raised Funds	+30.6	+32.2	+32.9	+33.1	-	-	+31.4

Latest Monthly Economic Statistics (continued)

YoY, %, unless otherwise stated	Dec 09	Nov 09	Oct 09	Sep 09	4Q 09	2009	2008
MONETARY							
M2	+27.7	+29.7	+29.4	+29.3	-	-	+17.8
M1	+32.4	+34.6	+32.0	+29.5	-	-	+9.1
M0	+11.8	+15.0	+14.1	+16.0	-	-	+12.7
Total (Rmb + Foreign Currency) Deposits	+27.7	+27.6	+27.5	+27.8	-	-	+19.3
Rmb Deposits, Rmb tn	59.77	59.27	58.69	58.39	-	-	46.62
YoY, %	+28.2	+28.2	+28.0	+28.4	-	-	+19.7
Savings Deposits	+19.7	+20.1	+21.8	+24.9	-	-	+26.3
Enterprise Deposits	+33.8	+38.6	+38.2	+35.4	-	-	+13.7
Foreign Currency Deposits, US$ bn	208.9	204.9	203.5	203.2	-	-	179.1
YoY, %	+16.6	+5.4	+6.6	+7.8	-	-	+12.0
Total (Rmb + Foreign Currency) Loans	+33.0	+34.7	+34.5	+33.8	-	-	+15.2
Rmb Loans, Rmb tn	39.97	39.59	39.29	39.04	-	-	30.35
YoY, %	+31.7	+33.8	+34.2	+34.2	-	-	+18.8
MoM, Rmb bn	+380	+295	+253	+517	+1,296	+9,594	+4,911
YoY, %	-50.8	-38.2	+39.1	+38.0	+26.1	+95.4	+35.2
Rmb Loan-Deposit Ratio, %	66.9	66.8	67.0	66.9	-	-	65.1
Foreign Reserves, US$ bn	2,399	2,389	2,328	2,273	-	-	1,946
PRICES							
Consumer Price Index (CPI)	+1.9	+0.6	-0.5	-0.8	+0.7	-0.7	+5.9
Goods	+2.2	+0.9	-0.3	-0.6	+0.9	-0.6	+7.4
Services	+0.7	-0.4	-1.2	-1.5	-0.3	-1.1	+1.3
Food	+5.3	+3.2	+1.6	+1.5	+3.4	+0.7	+14.3
Clothing	-0.8	-1.2	-1.6	-1.8	-1.2	-2.0	-1.5
Household Appliances	-1.1	-1.1	-1.2	-0.9	-1.1	+0.2	+2.8
Residence	+1.5	-1.2	-3.8	-5.0	-1.2	-3.6	+5.6
Recreation, Education & Cultural	-0.3	-0.6	-0.7	-0.9	-0.5	-0.7	-0.7
Medicines, Medicare and Personal Articles	+2.2	+1.6	+1.2	+1.1	+1.7	+1.2	+0.4
Transport & Communication	-1.5	-2.2	-2.7	-2.6	-2.1	-2.4	-1.0
CPI x-Food	+0.2	-0.7	-1.6	-1.9	-0.7	-1.4	+0.9
MoM, NSA, %	*+1.2*	*+0.3*	*-0.1*	*+0.4*			
*MoM, SA, %**	*+0.7*	*+0.4*	*+0.1*	*+0.2*			
Producer Price Index (PPI)	+1.7	-2.1	-5.8	-7.0	-2.0	-5.4	+6.9
Producer Goods	+2.0	-2.7	-7.2	-8.6	-2.6	-6.7	+7.7
Excavation	+17.6	-4.1	-16.3	-20.3	-0.9	-15.8	+23.2
Raw Material	+3.6	-1.7	-8.3	-10.1	-2.1	-8.1	+8.9
Manufacturing	-0.7	-2.9	-5.6	-6.4	-3.1	-4.9	+5.2
Consumer Goods	+0.8	-0.2	-1.4	-1.8	-0.3	-1.2	+4.1
Food	+2.6	+0.6	-1.2	-2.0	+0.7	-1.4	+8.3
Clothing	+1.7	+1.1	-0.8	-0.3	+0.7	+0.1	+2.2
Daily Use Articles	-0.4	-1.1	-1.5	-1.9	-1.0	-0.8	+3.6
Durable	-1.4	-1.6	-2.1	-2.4	-1.7	-2.3	-0.5
MoM, NSA, %	*NA*	*+0.6*	*+0.1*	*+0.6*			
*MoM, SA, %**	*+1.8*	*+0.9*	*-0.7*	*+0.8*			
Raw Materials Purchasing Price Index (RMPPI)	**+3.0**	-3.6	-8.4	-10.1	-3.0	-7.9	+10.5
Fuels & Power	+10.5	-5.0	-12.5	-14.3	-2.3	-10.8	+20.6
Ferrous Metals	-6.7	-10.4	-15.9	-18.5	-11.0	-13.7	+18.4
Non-Ferrous Metal	+17.1	+3.7	-10.1	-17.0	3.6	-18.9	-1.4
Chemicals	-0.7	-5.0	-9.6	-10.8	-5.1	-8.7	+5.2
*MoM, SA, %**	*+2.1*	*+1.0*	*+0.4*	*+0.7*			

* Morgan Stanley Research Estimates.
Source: National Bureau of Statistics, General Administration of Customs, People's Bank of China, CEIC, Morgan Stanley Research

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January 4, 2010

China Economics
Fear of Inflation to Intensify; Launching Inflation Tracker

Morgan Stanley Asia Limited

Qing Wang
Qing.Wang@morganstanley.com

Steven Zhang
Steven.Zhang@morganstanley.com

What's new: As concerns about downside risks to the growth outlook appear to be easing, capital market participants have become increasingly sensitive to any sign of inflationary pressures, especially given the very loose monetary policy stance in both China and other major economies in the last 12 months.

Conclusion: Headline inflation indicators such as the year-over-year CPI and PPI will likely register a rather rapid increase in 1Q10, which may intensify the fear of high inflation despite the levels of actual inflation remaining relatively moderate. While being keenly aware that the balance of inflation risk is likely tilted to the upside, we caution that extrapolating the inflation rates in the rest of the year from the potential trends for inflation in 1Q10 could overestimate the risk of inflation.

Where we differ: We compare our baseline inflation forecasts — which are derived from analytical modeling — with those formulated by different methods of extrapolation based on the potential trends in 1Q10, with a view to highlighting the wide range of high inflation rates potentially expected by capital market participants.

Market Implications: There will likely be a ‘disconnect’ between the actual inflation rate and thus the policy stance on one hand and strong inflationary expectations on the other. In this context, inflation play trades, featuring long sectors/companies with pricing power and short those with high risk of margin squeeze due to cost pressures, will likely become a useful investment theme.

What’s next: In light of intensified fear of inflation, we launch our *China Inflation Tracker (CIT)*, a weekly research publication in which we provide updates of our latest forecasts of CPI and PPI inflation for the coming month based on detailed high-frequency price data from various sources. Our inaugural CIT indicates that the CPI and PPI inflation prints in December 2009 may have been 1.6% YoY (vs. 0.6% in November) and 1.9% YoY (vs -2.1% in November), respectively.

First Up, A Recap of Our Inflation Call

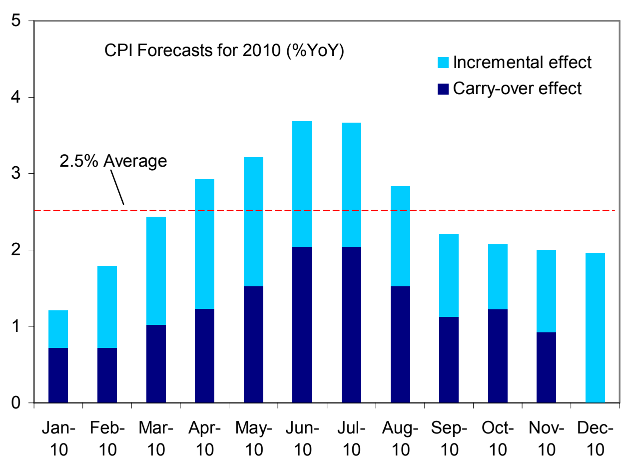
We forecast average CPI inflation at about 2.5% in 2010. Specifically, the inflation rate turned positive in November 2009 and will start to rise rather rapidly to about 2.4% YoY by end of 1Q10 and 3.6% YoY by end of 2Q10, as the lag effects of strong true M2 growth in 3Q09 and 4Q09 are only partly offset by continued weak exports. However, CPI inflation will likely start to moderate in 3Q10 to average 2.9% YoY and in 4Q10 to average 2.1% YoY, as the pick up in export growth since 2Q10 will add to inflationary pressures despite some moderation in M2 growth (see *China Economics: A Goldilocks Scenario in '10*, November 22, 2009).

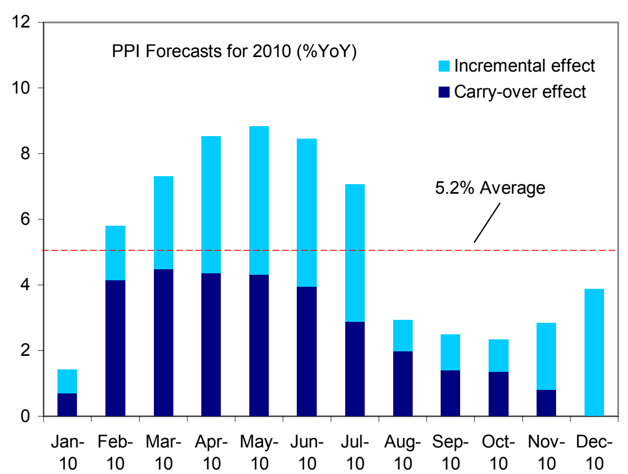
In this context, we caution that predicting high inflation in 2010, based on the strong growth of monetary aggregates so far this year, could err on the side of being too simplistic and mechanical.

- First, the strong headline M2 growth in 2009 substantially overstates the true underlying monetary expansion, as it fails to account for the change in M2 caused by the shift in asset allocation by households between cash and stocks. We estimate that the growth rate of adjusted M2 – the rate that truly reflects the underlying economic transactions – is much lower than that suggested by the high growth of headline M2 (see *China Economics: Worried About Inflation? Get Money Right First*, October 19, 2009).
- Second, generally weak export growth, which we think could be a proxy for the output gap in China, will remain a strong headwind containing inflationary pressures. These two demand-side factors combined would suggest that the 2000-01 situation – featuring relatively high money growth but relatively low inflation – is likely to be repeated in 2010.
- Third, from the supply side, while Morgan Stanley’s commodities research team expects commodities prices to rise steadily in 2010, it does not foresee significant spikes in prices. It projects average prices for crude oil at about $85 per barrel in 2010 (see “*Crude Oil: Balances To Tighten Again by 2012*,” September 13). Assuming the cost pressures stemming from these supply-side shocks are able to pass through the supply chain to be reflected in the corresponding price increase of downstream products, without much constraint from the demand side, we forecast a trajectory of CPI inflation for 2010 that is similar to the one derived from demand-side analysis (see *China Economics: Inflation Outlook in 2010: A Supply-side Perspective*, November 1, 2009).

Fear of Inflation to Intensify
As concerns about downside risks to the growth outlook appear to be easing, capital market participants have of late become increasingly sensitive to any sign of inflationary pressures, especially given the very loose monetary policy stance in both China and other major economies in the last 12 months.

Exhibit 1
Carry-over Effect in CPI and PPI Inflation Forecasts





Source: Morgan Stanley Research

We forecast that headline inflation indicators such as the year-over-year CPI and PPI will register rather rapid increases in 1Q10. Specifically, as mentioned earlier, headline CPI inflation could rise to about 2.4% YoY by end March 2010 from the latest actual reading of 0.6%YoY in November 2008. In the meantime, PPI inflation could surge to 7.3% YoY by March from -2% YoY in November 2009.

It should be noted, however, that the seemingly rapid rise in the headline year-over-year inflation rates have in part reflected the low base effect, because prices in 1Q09 were depressed when activity collapsed amid the Great Recession. For instance, we estimate the carry-over, or low-base, effect contributes 1 percentage point of the 2.4% YoY increase in headline CPI and 4.5 percentage points of 7.3% YoY increase in PPI forecasted for March 2010 (Exhibit 1).

Nevertheless, these forecasts, if materialized, will likely intensify the fear of high inflation among capital market participants, in our view. This is because many capital market participants are already on high alert to the risk of high inflation, despite levels of actual inflation remaining relatively moderate. In this context, any significant uptick in headline inflation rates, technical or real, will only serve to reinforce existing strong expectations of inflation, in our view.

Expectation by Extrapolation
Indeed, if the inflation rates we forecast for 1Q10 were to materialize and market participants choose to formulate their inflation expectations for the rest of the year by simply extrapolating from the trends in 1Q10, the resultant expected inflation rates would be much higher than we have forecasted under the baseline scenario. While being keenly aware that the balance of inflation risk is likely tilted toward the upside, we caution that such extrapolation would substantially overestimate the risk of inflation.

One way of extrapolation could be based on the monthly change in the headline YoY inflation rates

One way of extrapolation could be based on the monthly change in the headline YoY inflation rates. Under our baseline scenario, the headline YoY CPI and PPI inflation will increase by an average of 0.45 and 1.8 percentage points, respectively, per month during 1Q10. If one were to assume this pace of change, or the *delta* of inflation rates, is sustained for the remainder of the year, both CPI and PPI inflation rates would surge, reaching 6.6% YoY and over 20% YoY by year end, respectively, which is illustrated as Alternative Scenario I in Exhibit 2.

However, Alternative Scenario I overstates the risk of inflation, because it fails to discount the change in headline YoY CPI inflation in 1Q10 that reflects the carry-over effect. This is because the carry-over effect is not constant over the course of the year, and the change in the YoY inflation rate caused by the carry-over effect in 1Q10 tends to be larger than that for the rest of the year. In fact, the carry-over effect will start to decline in 2H10 and phase out toward the year end, helping lower the headline YoY inflation rates (Exhibit 1). We estimate that when the carry-over effect is appropriately accounted for, the YoY CPI and PPI inflation would increase at a substantially slower pace, even using the linear extrapolation method, which is illustrated by Alternative Scenario II in Exhibit 2.

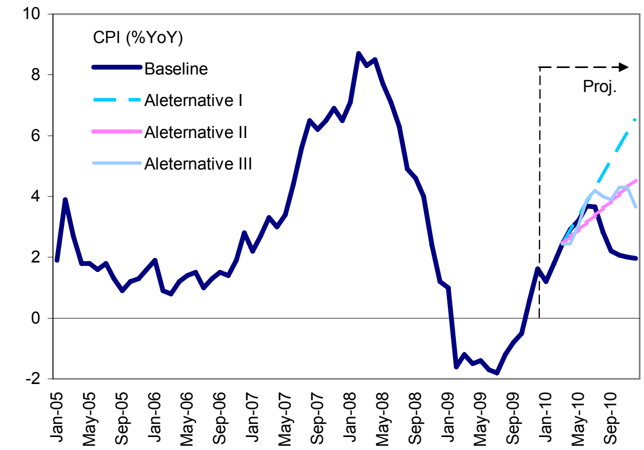
Another way of extrapolation is…that the sequential month-over-month change in inflation rates in 1Q10 will be maintained for the rest of the year

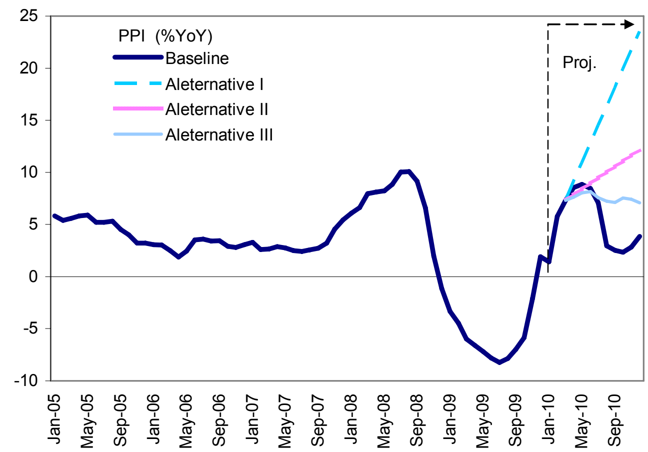
Another way of extrapolation is to forecast the headline YoY inflation rates by assuming that the sequential month-over-month change in inflation rates in 1Q10 will be maintained for the rest of the year, or apply the same MoM change for the rest of the year. This is illustrated by Alternative Scenario III in Exhibit 2, under which the average CPI and PPI inflation would be 3.6% and 7.5%, respectively. However, extrapolating inflation rates for the rest of 2010 based on the sequential change in inflation in 1Q10 tends to overestimate the expected inflation, in part because it fails to take into account the seasonality in 1Q, namely prices tend to register faster month-over-month increases in 1Q than in the rest of the year. We estimate the seasonal factor for CPI usually helps explain additional 0.2-0.3 percentage points in the sequential MoM inflation rates in 1Q.

This exercise above illustrates that if one were to extrapolate inflation rates for the rest of the year from the potential trends of headline inflation in 1Q10, based on either the pace of increase in the headline YoY inflation or the sequential MoM inflation rates, the resulting expected inflation rates could turn out to be much higher than the forecasts we have made under our baseline scenario. In addition to the reasons for overestimation of inflation risk which have already been discussed above, it should be noted that our baseline inflation forecasts are based on a modeling framework which factors in the course of policy action envisaged for the year — featuring in particular a significant deceleration in M2 growth in 2010 from the high level in 2009 — and forecasts of a tepid export recovery and steady rise in international commodity prices (e.g. average crude oil price at US$85 per barrel).

Exhibit 2

Inflation Forecasts by Extrapolation





Source: CEIC, Morgan Stanley Research

That said, to the extent that one's expectation of macroeconomic policy stance and/or global economic outlook differ meaningfully from the corresponding calls that are reflected in our baseline scenario, one may not have as strong conviction of a benign inflation outlook in 2010 as we do. In this context, it should not be a surprise if the potential trends of inflation in 1Q10 will greatly influence inflation expectations formed by some market participants in the way as we have discussed.

Market Implications

Inflation expectations will likely re-emerge and even get stronger in the coming months, despite that actual inflation levels will remain relatively moderate, in our view. At the same time, the timing of anti-inflation policy response in China will likely be a function of actual inflation rates, in our view. And we expect the headline CPI inflation to start to exceed 3% by mid year, which may trigger the first hike of the base interest rates in early 3Q10.

Between now and mid year, there will likely be a significant 'disconnect' between actual inflation rate and thus policy stance on the one hand and strong inflationary expectations on the other hand, in our view. In this context, inflation play trades in the equity markets, which feature long sectors/companies with pricing power and short those with high risk of margin squeeze due to cost pressures, will likely become a useful investment theme, in our view. And this investment theme may remain popular at least through mid 2010 when the monetary authorities are getting close to initiate monetary tightening to contain inflationary pressures, in our view.

Launch China Inflation Tracker

In light of intensified fear of inflation, we launch *China Inflation Tracker (CIT)*, a weekly research publication in which we provide updates of our latest forecasts of CPI and PPI inflation for the next month based on detailed high-frequency price data from various sources. Our inaugural *CIT* indicates that the CPI and PPI inflation prints in December 2009 may have been 1.6% YoY (vs 0.6% in November) and 1.9% YoY (vs -2.1% in November), respectively (Exhibit 3).

Exhibit 3

China Inflation Tracker: Forecasts for Dec'09

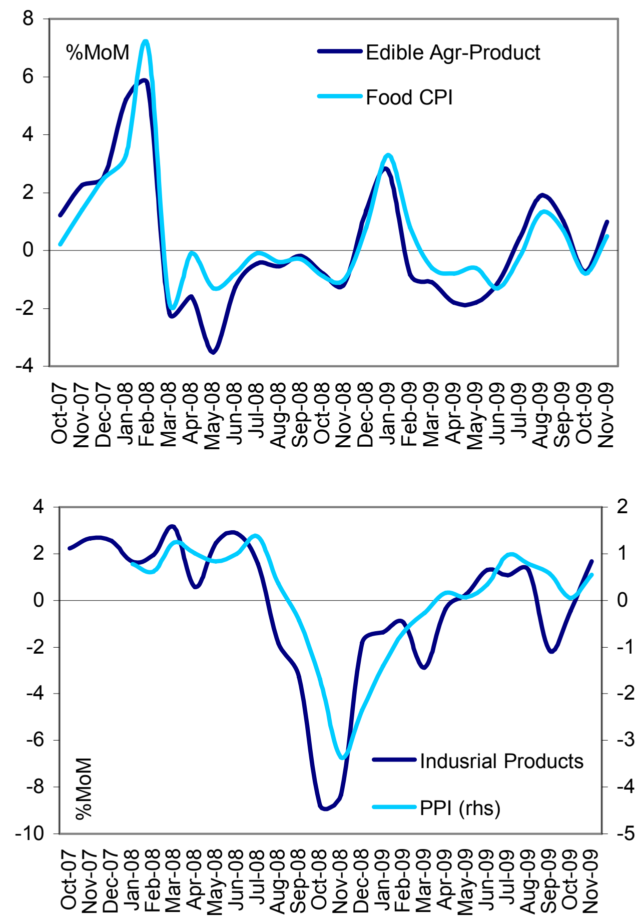
		Dec-09 (E)	Nov-09	Oct-09	Sep-09
CPI	**%MoM**	**0.9**	**0.3**	**-0.1**	**0.4**
Food CPI	%MoM	2.1	0.5	-0.8	0.7
Non-Food CPI	%MoM	0.4	0.2	0.3	0.3
CPI	**%YoY**	**1.6**	**0.6**	**-0.5**	**-0.8**
Food CPI	%YoY	4.4	3.2	1.6	1.5
Non-Food CPI	%YoY	0.3	-0.7	-1.6	-1.9
PPI	**%MoM**	**0.8**	**0.5**	**0.0**	**0.6**
PPI	**%YoY**	**1.9**	**-2.1**	**-5.8**	**-7.0**

Source: CEIC, Morgan Stanley Research

Specifically, we construct two indices – one for Edible Agricultural Products and the other for Industrial Products – to help track the underlying food CPI and PPI inflation, respectively, on a weekly basis (Exhibit 4). Each of the two indices is constructed by aggregating the price indices of a number of specific product sub-categories (see Exhibits 5-12). The price data for these specific product subcategories are available on a weekly basis, and this therefore allows for a weekly update of the two indices. We keep revising our forecasts of food CPI and PPI inflation for the next month, when each additional data point in the two indices is available every week of that month. The non-food CPI is then estimated based on a functional relationship between PPI and non-food CPI. The overall headline CPI is a weighted average of food and non-food CPI.

Exhibit 4

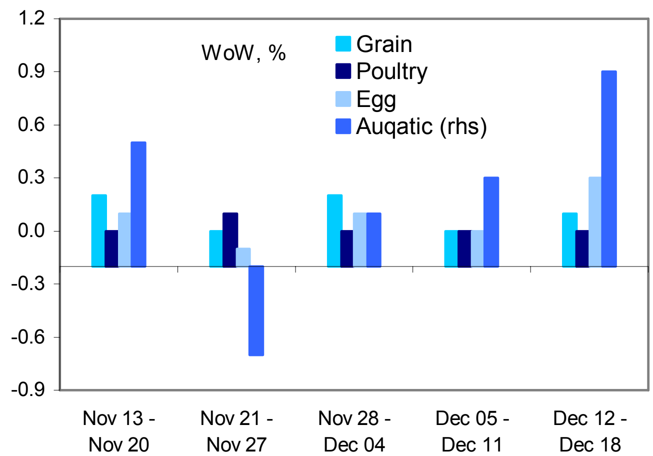
Tracking Food CPI and PPI Inflation



Source: MoCom, WIND, Morgan Stanley Research

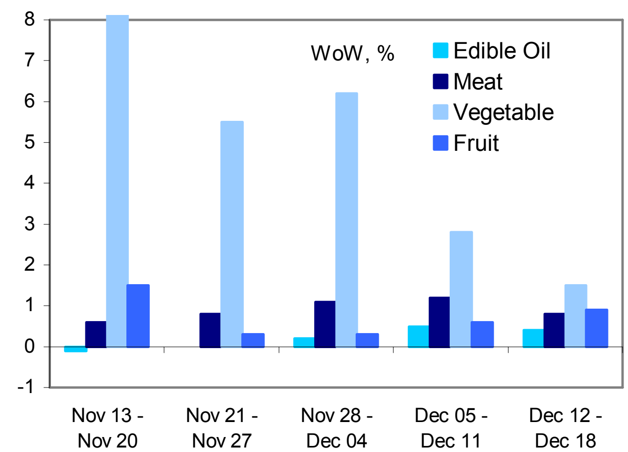
Food Price Monitor

Exhibit 5
Weekly Sequential Growth



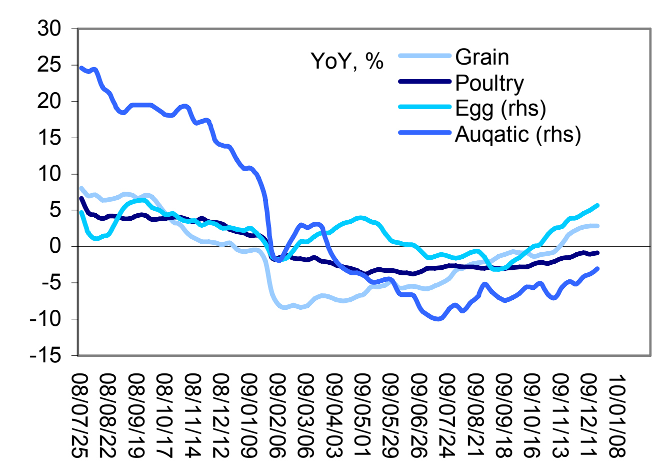
Source: MoCom, WIND, Morgan Stanley Research

Exhibit 6
Weekly Sequential Growth



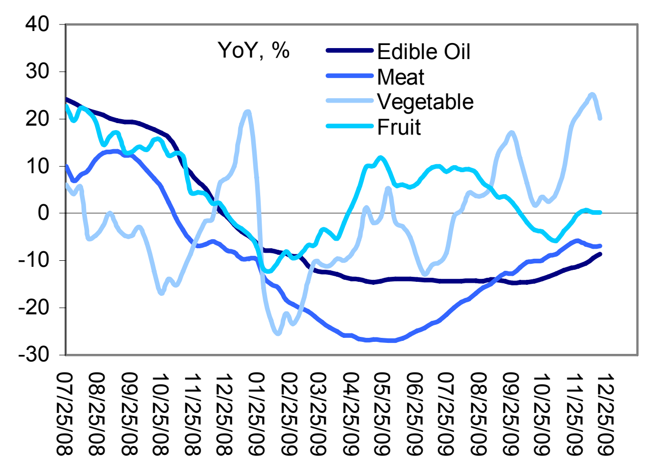
Source: MoCom, WIND, Morgan Stanley Research

Exhibit 7
Year-on-Year Growth



Source: MoCom, WIND, Morgan Stanley Research

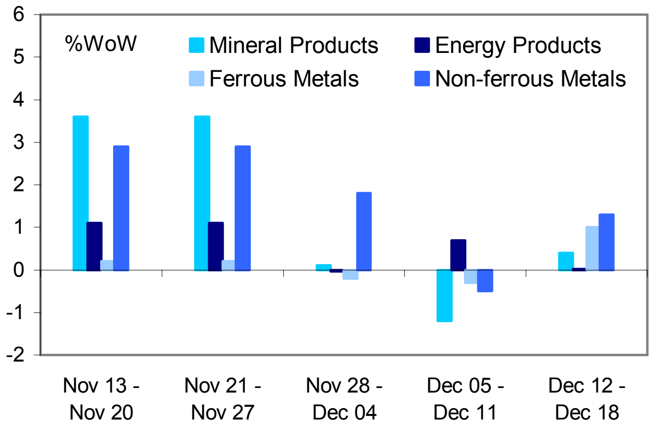
Exhibit 8
Year-on-Year Growth



Source: MoCom, WIND, Morgan Stanley Research

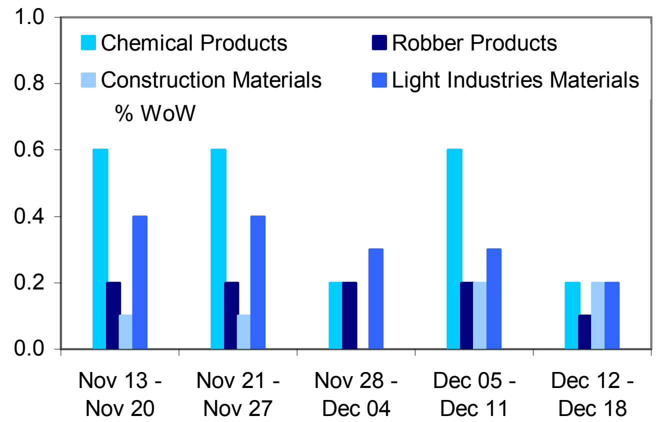
Producer Price Monitor

Exhibit 9
Weekly Sequential Growth



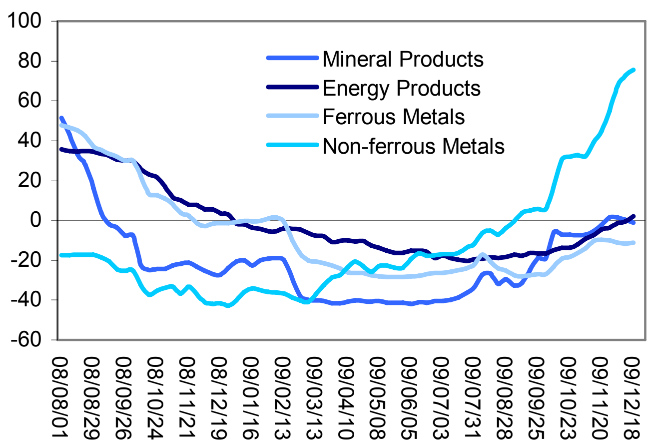
Source: MoCom, WIND, Morgan Stanley Research

Exhibit 10
Weekly Sequential Growth



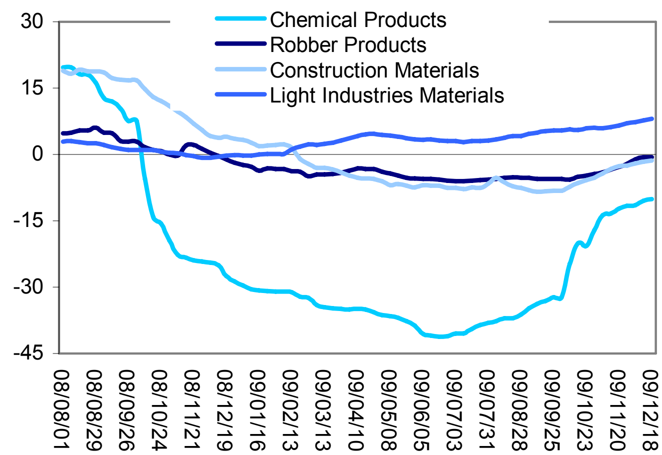
Source: MoCom, WIND, Morgan Stanley Research

Exhibit 11
Year-on-Year Growth



Source: MoCom, WIND, Morgan Stanley Research

Exhibit 12
Year-on-Year Growth



Source: MoCom, WIND, Morgan Stanley Research

January 6, 2010

India Economics
Moving to the "A" of the POTA Cycle

Morgan Stanley Asia (Singapore) Pte. **Chetan Ahya** Chetan.Ahya@morganstanley.com

Morgan Stanley India Company Private Limited+ **Tanvee Gupta** Tanvee.Gupta@morganstanley.com

In this week's EcoView, our spotlight focuses on the potential list of reforms the government could implement in 2010. In the Indian political environment, all major policy changes go through a typical one- to three-year cycle of discussion and debate before they are implemented. We believe a number of critical policy changes will reach the implementation stage in 2010. We believe that some of these measures are critical for lifting India's sustainable annual growth to 9%, which is also the government's target rate.

Elsewhere in this week's EcoView, we summarize the key macro developments, including:

(a) **Strong growth in auto sales:** Auto Sales – two-wheeler and passenger car sales – accelerated to 38.4% YoY and 47.4% YoY in November 2009 (vs. 10.7% YoY and 29.7% YoY in the previous month). Low base, year-end discounts and expectations of price hikes resulted in strong growth across segments.

(b) **Cement dispatches growth picks up marginally:** Cement dispatches growth picked up to 9.1% YoY in November 2009 compared to 7.5% YoY registered in October, notwithstanding a higher base. In our view, this indicates a pickup in growth after a few of months of muted demand, which was impaired by monsoons and slowdown in a couple of larger states.

(c) **Fiscal deficit target seems achievable:** For the period April-November 09, the fiscal deficit has reached 76.4% of the F2010 budget expectation (or 5.2% of GDP). However, as tax revenues will recover, underpinned by higher industrial production growth, and government expenditure growth decelerates from a high base, we believe that the government will be able to achieve the F2010 fiscal deficit estimate of 6.8% of GDP.

Key Points

- **All key policy measures have to go through a POTA cycle:** Every major policy/regulatory change in India must go through a one- to three-year cycle of POTA (Proposition, Opposition, Treaty-Consensus and Action). This is evident in a number of policy changes implemented in the last few years.
- **The good news – many key reforms are moving towards the Action phase:** The most prominent measures likely to see action in F2011 are (a) the Goods and Services Tax system; (b) consolidation of the public sector deficit; (c) meaningful steps towards divestment of the government stake in SOEs; (d) acceleration in infrastructure spending, particularly in roads; and (e) direct tax reforms.
- **Bottom line:** After a long lull, we expect the government to be able to successfully push a number of critical policy changes in 2010. We believe some of these changes are key to lift India's sustainable annual growth to 9%, which is also the government target growth rate.

Five Key Reforms to Watch in 2010

The verdict of the May 2009 general elections had raised hope of acceleration in the pace of reforms, considering that the share of the single largest party in the Lower House of the Parliament had increased to the highest levels since the 1991 elections. However, every major policy decision in India goes through a one- to three-year cycle of POTA (Proposition, Opposition, Treaty-Consensus and Action). The good news is that many of the key reforms are now moving towards the action phase. The most prominent measures likely to see action in F2011 (the 12 months ending March 2011) are:

a) The Goods and Services Tax system;

b) Consolidation of the public sector deficit;

c) Meaningful steps towards divestment of the government stake in state owned enterprises;

d) Acceleration in infrastructure spending, particularly in roads;

e) Direct tax reforms.

Streamlining of Indirect Taxes – GST

The government has already announced its intention to transition to a consolidated nationwide goods and services tax (GST) system from the current system of different types of indirect taxes and multiple rates of indirect taxes. The new law will cover a wider base including all goods and services. The current system taxes production whereas the GST will aim to tax consumption. Indeed, current law levies taxes on movement of goods from one state to other – effectively creating borders within borders. It distorts the allocation of resources and inhibits productivity growth. Transition to GST will be an important milestone from a macro perspective. While the government had earlier announced its intention to implement it from April 1, 2010, it appears that it will most likely be implemented from October 1, 2010.

Consolidation of Public Sector Deficit

The strong growth trend in F2006-F2008 was also accompanied by an increase in the fiscal deficit to double digits as a percentage of GDP and a rise in the ratio of public debt to GDP to 76.1% as of March 2009. In F2010, we expect the combined central plus state government deficit (including off-budget items) to remain high at 10.7% of GDP, with public debt to GDP increasing to 78.6% in March 2010. The current high level of unproductive government expenditure and public debt is weighing on the long-term growth potential.

We expect the government to take the first step towards reducing the deficit to more sustainable levels in the February 2010 budget. The recent report of the 13th Finance Commission will be a good guide for the government to move on this correction path. We see the government cutting expenditure to GDP by 1ppt in F2011. A simultaneous increase in tax to GDP should help cut the combined deficit to 9.2% of GDP in F2011 from 10.7% of GDP in F2010. We expect further reduction in the deficit to 7.7% of GDP in F2012.

Exhibit 1

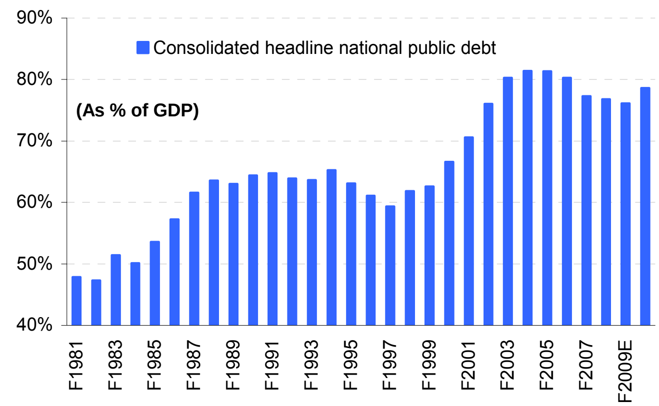
India's Consolidated Fiscal Deficit

(As % of GDP)	F2008	F2009E	F2010E	F2011E	F2012E
Central Fiscal Deficit	2.7%	6.1%	6.8%	5.8%	4.7%
State Fiscal Deficit	2.3%	3.4%	3.4%	2.7%	2.3%
Sub-total	**5.0%**	**9.5%**	**10.1%**	**8.5%**	**7.0%**
Inter-government adjustments	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%
Combined Headline Deficit	**4.9%**	**9.4%**	**10.0%**	**8.4%**	**6.9%**
Major Off-budget expenditure items	*1.9%*	*2.3%*	*0.6%*	*0.8%*	*0.8%*
Overall Fiscal Deficit	**6.8%**	**11.8%**	**10.7%**	**9.2%**	**7.7%**

Note: *Here the off-budget items include expenditure on food, fertilizer and oil. Source: RBI, Economic Survey, Ministry of Finance, E = Morgan Stanley Research estimates.

Exhibit 2

Public Debt to GDP



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

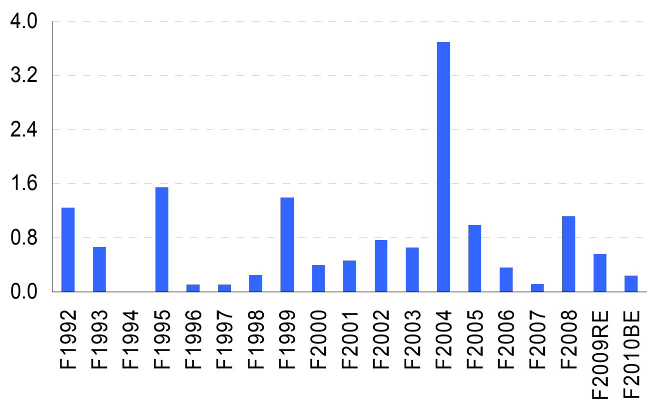
Divestment of State-Owned Enterprises

The current high level of fiscal deficit will likely make it difficult for the government to increase its spending to support economic growth. We believe that in such an environment, the government will need to augment its financial resources though divestment of stakes in state-owned companies. Since the formation in May 2004 of the coalition government led by the United Progressive Alliance, the pace of the divestment in state owned enterprises has been extremely slow (Exhibit 3). The total proceeds from divestments during the five years ending March 2009 were just US$3.1 billion.

We estimate the value of government stakes in the listed state-owned enterprises at about US$320 billion. If we include the unlisted companies, the total value would be approximately US460 billion. We believe the divestment program can play a key role in augmenting government resources for investment in productive areas, such as rural infrastructure, without causing deterioration in government finances.

The government has already announced a plan to raise about US$5.6 billion from divestment by March 2010. The government intends to bring down its stakes in all listed entities to 75%. We expect a significant pickup in the government's divestment from March-April 2010. In 2011, we believe the government could collect US$5-10 billion from divestments.

Exhibit 3
SOE Divestment Proceeds – Poor Record So Far (US$ bn)



RE= Government Revised estimates; BE= Government Budget estimates; Source: RBI, Government Budget Documents, Morgan Stanley Research

Acceleration in Infrastructure Spending
After steadily rising to 5.7% of GDP in F2008 from the trough of 3.7% in F2005, infrastructure spending has been stagnant over the last two years. We expect infrastructure spending to start rising from F2011 again.

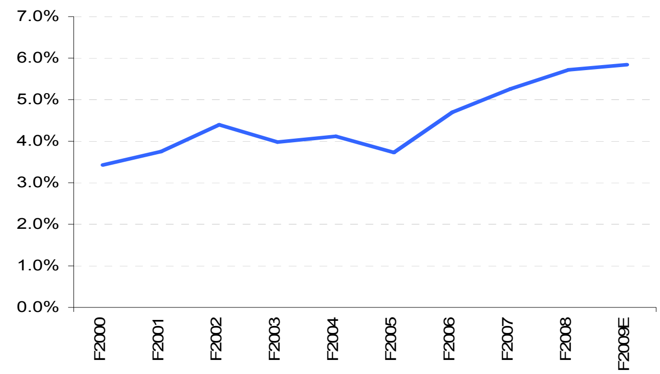
One of the key areas where we expect a meaningful increase in spending is the transportation sector (national highways). The Ministry of Transportation intends to award US$20 billion worth of road contracts on an annual basis over the next three and half years. Our infrastructure analyst, Akshay Soni, believes that the government will be able to issue contracts worth about US$12-13 billion over the next 12 months (the first year) compared with US$6-8 billion worth of contracts issued over the last 12 months.

Similarly, the momentum in implementation of electricity projects is also likely to pick up further (Exhibit 5).

Also, with credit markets improving and capital markets normalizing, private infrastructure spending in general should reaccelerate. We expect infrastructure spending to rise to 7.7% in F2013 from an estimated 6.1% of GDP in F2010.

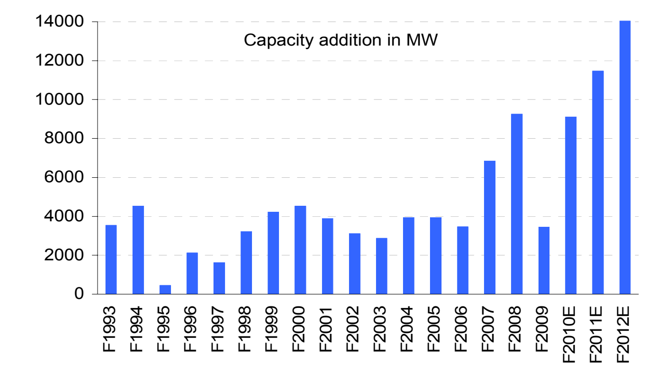
Direct Tax Reforms
The Ministry of Finance has already put out a draft of new code for direct taxation. The thrust of the new code, as its foreword code says, "is to improve efficiency and equity in direct tax system by eliminating distortions in tax structure, introducing moderate levels of taxation and expanding the tax base."

Exhibit 4
Infrastructure Investments (% of GDP)



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

Exhibit 5
Power Generation Capacity



E = Morgan Stanley Research estimates; Source: CEA, Infraline, Morgan Stanley Research

For broadening the tax base, the code will minimize exemptions. The removal of these exemptions will improve tax to GDP and improve efficiency in allocation of resources. The new code will also simplify the language and law to reduce litigation and check tax evasion. Moreover, the new code also aims to encourage long-term savings. The tax incentives for savings will be rationalized. The code aims to follow the Exempt Exempt Tax (EET) rule, under which initial savings contribution and accrual of interest are exempt but on withdrawal, it would be subject to normal taxes.

The Ministry of Finance is likely to start implementing the new code from the February 2010 budget.

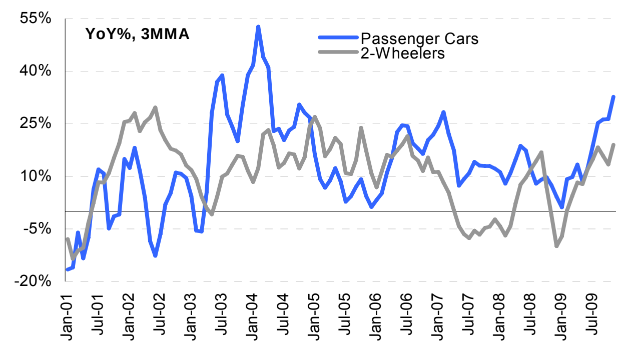
Bottom Line
After a long lull, we expect the government to be able to implement a number of the critical policy changes in 2010. we believe some of these changes are critical to lift India's sustainable annual growth to 9%.

Tracking Macro Developments: Quick Thoughts…

Strong Growth in Auto Sales

- **Auto sales growth accelerates further in November 2009:** Auto Sales – two-wheeler and passenger car sales – accelerated to 38.4% YoY and 47.4% YoY in November 2009 (vs. 10.7% YoY and 29.7% YoY in the previous month). Low base, year-end discounts and expectations of price hikes resulted in strong growth across segments. The second installment of Sixth pay commission payout to government sector employees also contributed to improved sales during the month.
- We expect growth in YoY terms to remain strong over the next two months thanks to a favorable base effect.

Auto Sales Trend

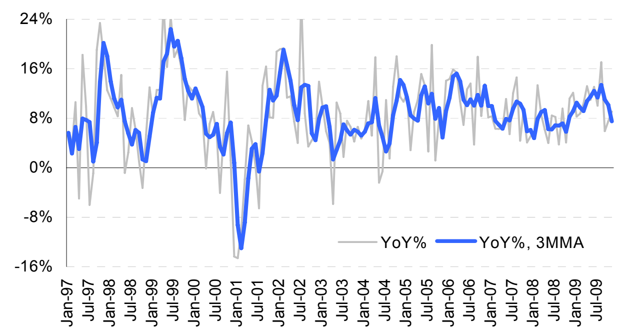


Source: Bloomberg, Morgan Stanley Research

Cement Dispatches Growth Picks Up Marginally

- **Cement dispatches growth picked up to 9.1% YoY in November 2009** compared to 7.5% YoY registered in October, notwithstanding a higher base (11.2% YoY) in November 2008. On a sequential basis, dispatches grew 2.4% MoM in November after registering growth of 4.4% MoM in October and declining by 4.6% MoM in September. In our view, this indicates a pickup in growth after a few months of muted demand, which was impaired by monsoons and a slowdown in a couple of larger states.

Cement Dispatches Growth (YoY% and YoY%, 3MMA)



Source: CMA, CMIE, Morgan Stanley Research

November Public Finances Data Show No Big Improvement, Yet Fiscal Deficit Target Seems Achievable

- **Direct tax collections recovering, indirect tax collections still weak:** The recent data on central government finances for the month of November indicates no major improvement fiscal deficit trend as yet. The central government's aggregate tax collections declined further by 10.1% in the month of November after declining 7.3% in the previous month. Fiscal year-to-date (FYTD) tax collections have declined by 7.8% YoY. Direct tax collection was up 7.7% YoY in April-November 09, driven by higher personal income tax (+9.8% YoY vs. budgeted -8% YoY) collection. Tax collection on domestic production, i.e., excise duties, declined 20% YoY FYTD. This is mainly due to a cut in excise duty rates by the government after the global credit crisis unfolded and domestic sales fell. Customs (import) duty collections also declined 31% YoY in April-November 09 compared with BE of a decline of 9.3% due to fall in imports. Other tax collections (primarily service taxes) declined 8.2% in April-November 09. We expect indirect tax collections to start recovering over the next four months as the base effect turns favorable. Total revenue receipts (including tax and non-tax revenues) declined 11.4% in November and -2.5% FYTD (compared with BE of +9.3%).

- **Revenue expenditure outweighs revenue receipts:** While revenue expenditure declined 7.7% in November, it grew 23.8% FYTD. This compares with the budget expectation of 11.7% growth for the full year. On a FYTD basis, revenue deficit was up 82.4%.

- **Yet the government should be able to achieve the fiscal deficit target:** For the period April-November 09, the fiscal deficit has reached 76.4% of the F2010 BE (or 5.2% of GDP). On a YoY basis, fiscal deficit was up 73.5% during April-November 2009 (compared with BE of an increase of 23% for full year). However, as tax revenues will recover, underpinned by higher industrial production growth, and government expenditure growth decelerates from a high base, we believe that there will be a reduction in the fiscal deficit growth in YoY% terms over the coming months. Note in the last quarter of F2009, the credit crisis affected tax revenues and government expenditure shot up due to fiscal stimulus measures. Hence, on a YoY basis we see a significant decline in fiscal deficit between Dec-09 and Mar-10. We believe that the government will be able to achieve the F2010 fiscal deficit estimate of 6.8% of GDP.

Government Finances: Summary

(% Change YoY)	Fiscal Year to Date (April - November 2009)	F2010BE*
Corporate Tax	7%	16%
Personal income Tax	10%	-8%
Total Direct Taxes	**8%**	**7%**
Excise Duties	-20%	-2%
Customs Duties	-31%	-9%
Total Indirect Taxes	**-26%**	**-5%**
Other Taxes	-8%	0%
Total Tax Collections	**-8%**	**2%**
Total Revenue Receipts	-2%	9%
Total Revenue Expenditure	24%	12%
Revenue Deficit	**82%**	**17%**
Fiscal Deficit	**73%**	**23%**

**BE = Government Budget Estimates; Source: Ministry of Finance, Morgan Stanley Research*

January 1 2010

ASEAN Economics
Inflation Risk or Scare?

Morgan Stanley Asia (Singapore) Pte.

Deyi Tan
Deyi.Tan@morganstanley.com

Chetan Ahya
Chetan.Ahya@morganstanley.com

Shweta Singh
Chetan.Ahya@morganstanley.com

The dust has settled and a downturn à la the 1929 Great Depression has been avoided. However, inflation risks now appear to be rising, potentially scaring but not yet forcing policy-makers' hand in unwinding the aggressive monetary policies that have supported the rebound so far. To be sure, the inflation debate remains a highly polarized one. Believers of inflation are for the most part followers of Friedman, whilst believers of deflation tend to point to the Philips curve and the excess slack in the system. In the near term, we think both camps may be right at the same time, at least for the ASEAN economies.

That said, with the recent robust Asian export data, we think inflation risks look skewed to the upside. In this regard, we thought it would be useful to examine who is most susceptible to inflation risks within **ASEAN** and the tools policy-makers have at their disposal to deal with such pressures. We see Indonesia as most vulnerable to upside risk, followed by Thailand, whilst Malaysia and Singapore generally face lower pressures.

On other key macro developments in ASEAN, November credit growth data for **Indonesia** was released. Credit growth continued to decelerate, but we think the credit cycle is at the verge of bottoming out and 2010 credit growth could come in at 16-26% YoY. Meanwhile in **Malaysia**, policy-makers again floated the idea of a retail fuel subsidy scheme restructuring. We think the fuel subsidy system is one embodiment of the market distortion that has led to the "Dutch Disease" we have been highlighting. In our view, a gradual roll-back would mean a marginal positive step toward more-efficient allocation of resources.

Inflation Risk or Scare? By Deyi Tan, Chetan Ahya, and Shweta Singh

Inflation risk or scare? With break-even inflation breaking higher, long yields backing up, and commodities staging a spectacular rebound, bond and commodity markets appear to be suggesting higher inflation risks. Indeed, one of the five macro themes highlighted by the global economics team (*see Global Forecasts Snapshots: From Exit to Exit, dated December 9, 2009, by Joachim Fels and team*) is heightened inflationary risks. However, the inflation debate remains a highly polarized one. Believers of inflation are typically the monetarists. They point to the aggressive monetary policy stance in the developed world and subscribe to Friedman's catchphrase that "inflation is always and everywhere a monetary phenomenon". On the other hand, believers of deflation tend to be the Keynesians. They point to the inverse relationship between unemployment and inflation embodied by the Philips curve, and the low capacity utilisation rate and high unemployment that is still seen in many parts of the world.

The Keynesian and Monetarist face off – Who's right? Ironically, we suspect both camps may be right in the near term, at least for the ASEAN economies. Global monetary expansion can lead to inflation via two channels: one is asset reflation and the other is demand-pull price pressures from the resurgence in the real economy from easier credit and wealth effect from buoyant asset markets. Although the global economy reached pre-crisis levels in 4Q09, led by EM (which reached pre-crisis peak levels in 3Q09), the fact that developed economies are likely to take longer to rebound (3Q11) may temper the export-led growth recovery seen in many parts of the emerging world. To a certain extent, this will give production capacity more time to catch up with the growth recovery and provide a cushion against demand-pull pressures and pricing power, validating the Keynesian point of view. However, the extent of quantitative easing still means that asset markets, particularly in commodities (which feed into CPI), has staged a far more spectacular rebound at this stage of the cycle than compared to the 2001 cycle, lending support to the Monetarist's argument.

In this regard, we think the inflation debate is really more about the inflation divide, for now. We could see somewhat disparate trends between core inflation and headline inflation and between tradeables inflation and non-tradeables inflation in the near term. The cyclical rise in 2010 inflation is likely to be led first by tradeables inflation and headline inflation before non-tradeables inflation and core inflation follow suit. This is indeed the pattern we are observing in ASEAN. Tradeables inflation is seeing an uptrend whilst the non-tradeables inflation is still moving sideways. Beyond the direct commodity cost-push pressures in CPI particularly in energy quotes, cost pass-through in manufactured goods from producers facing higher input costs has still not surfaced in an substantive way, suggesting still-weak pricing power for most part of ASEAN.

Inflation Risk or Scare?

When inflation risk emerges, who is most susceptible in ASEAN? Having said that, however, with the latest December export datapoints in Asian economies (see *Rising Risk of Earlier than Anticipated Policy Exit,* by Chetan Ahya and Sumeet Kariwala, January 12, 2010) showing extremely strong momentum, the risk may now be skewed to the upside with regard to the Keynesian view on inflation. In this regard, it may be useful to examine which countries are most susceptible to inflation risks in ASEAN and the corresponding policy implications. Overall, we view Indonesia as more susceptible to inflation risks in ASEAN, followed by Thailand, whilst Malaysia and Singapore generally face lower risks.

Our analysis is as follows:

a) Tradeables inflation: We view Indonesia and then Thailand as more susceptible to tradeables/commodities inflation than Singapore and Malaysia. For starters, commodities such as food and energy have higher weights in the CPI basket in Thailand and Indonesia, at 51.3% and 50.1%, respectively. The administered retail fuel price system in Indonesia will help to contain inflationary pressures somewhat. However, other channels of transmission remain. Higher commodity prices tend to depress Thailand and Indonesia's current account balances, which are already relatively low within ASEAN4, thereby increasing currency vulnerability and leading to the possibility of imported inflation. For Thailand, this is because it is a net commodity importer. In this regard, the inflation risk is also more "cost-push" in nature. For Indonesia, on the other hand, its net commodity exporter status and the positive terms of trade from higher commodity prices tend to lead to stronger imports for domestic demand. Thus, the inflation risk is also more "demand-pull" in nature. Moreover, for Indonesia, the degree of "dollarisation" accentuates the currency loop onto inflation. Lastly, infrastructure bottlenecks also tend to accentuate the demand-pull pressures from the positive terms of trade when they happen.

b) Non-tradeables inflation: Non-tradeables/core inflation tends to be influenced by the local output gap, in our view. With Indonesia being the most resilient economy within ASEAN, and Malaysia, Singapore, and Thailand unlikely to return to pre-crisis peak levels until 3Q10, we see Indonesia as more susceptible to non-tradeables inflation. Indeed, where data is available, capacity utilisation stands highest at 75.0% in Indonesia, compared to 69.0% and 62.5% in Malaysia and Thailand, respectively. To be sure, a certain speculative component is embedded in non-tradeables inflation from rental and owner-occupied accommodations. Residential real estate markets have been quick to rebound in Singapore amid a still-nascent macro recovery. The annual values for public housing, which are used as a proxy for rentals in owner-occupied public housing for the CPI basket, were also revised up in Jan-10. However, we think that the pickup in inflation from annual value revisions/imputed rent proxy may overstate the true inflation level since the accommodations are owned rather than rented in any case. Moreover, economies such as Singapore have been undertaking aggressive investment even during the trough of the recession given the lagged nature of construction. This will help provide an offset as the real estate supply that is coming onstream amid a below-trend recovery could cap overhead costs somewhat.

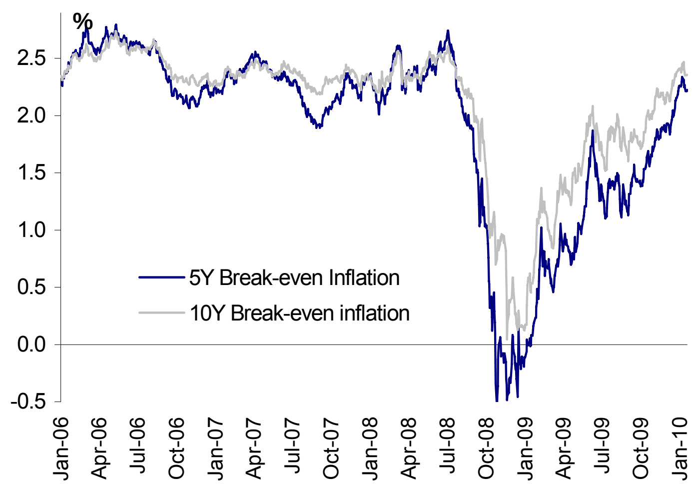
Inflation Risk or Scare?

How could policymakers deal with inflation? To deal with inflation, policymakers have three tools at their disposal, namely, currency, monetary policy, and fiscal measures. In our view, the currency tool is unlikely to do the heavy lifting in terms of curbing price pressures, beyond how other regional currencies are moving. Indeed, too rapid a pace of exchange rate appreciation amid elevated inflation trends could mean higher real effective exchange rate strength and an erosion in manufactured export competitiveness for Indonesia. In Thailand, we believe that the Central Bank will be cautious not to head off any export-led recovery given the domestic political climate. Meanwhile, in Singapore, a gradual appreciation of the S$NEER may be adopted, in our view. Yet, growth/underlying inflation conditions have tended to be higher than what they are currently when MAS undertakes such a move. Hence, we do not think a shift from a zero-appreciation stance to a gradual appreciation stance is likely in the April review.

Monetary policy in the form of interest rate hikes would likely be the tool of choice for economies such as Indonesia, Malaysia, and Thailand. For the latter two, however, we think Central Banks are more likely to react to demand-pull inflation rather than mere commodity cost-push pressures. On the other hand, fiscal policy generally ranks lower as a tool of inflation management. Yet, to the extent to which inflation is a sign of higher aggregate demand, fiscal expansion could be scaled back to reduce the build-up of public sector debt such as in Malaysia and Thailand. In the case of Indonesia, we think that fiscal expansion could, on the contrary, assauge infrastructure bottlenecks, which are a source of inflation in themselves. For Singapore and Thailand, where higher commodity prices pose negative terms-of-trade, we think fiscal measures could be adopted to cushion disposable income in a scenario where higher commodity prices are not accompanied by commensurate macro strength.

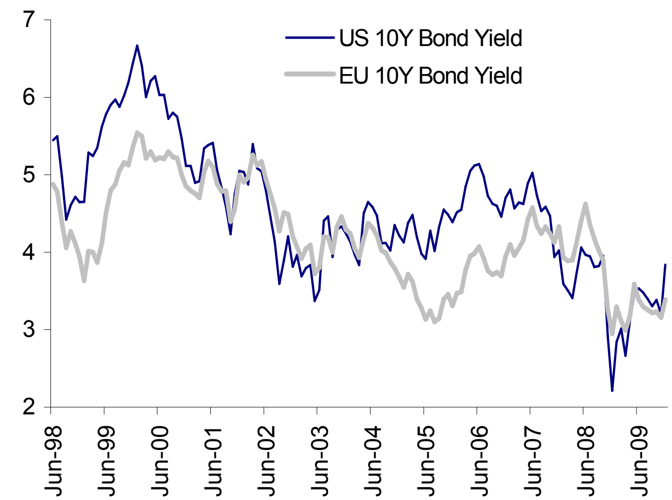
Bond and Commodity Markets Are Telling Us that Inflation Is a Risk

Break-even Inflation Back to Pre-Crisis Levels



Source: Bloomberg & Morgan Stanley Research

Long Yields Backing Up: Heralding the Secular Break to the Bond Conundrum Era?

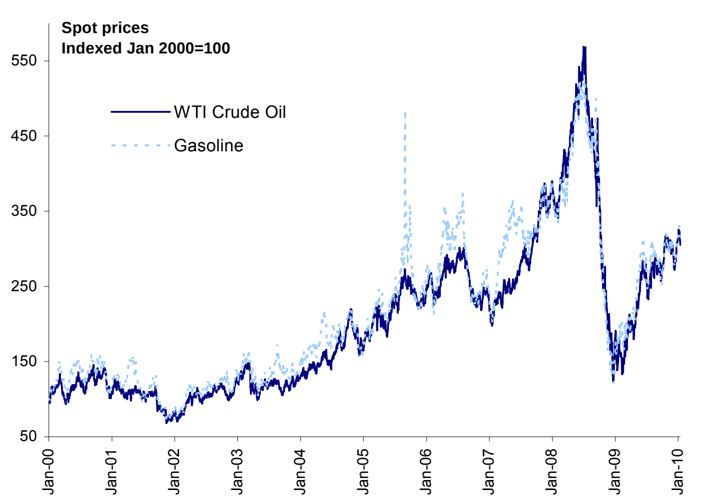


Source: Bloomberg &Morgan Stanley Research

- **Break-even inflation edging higher:** Despite the extent of economic slack still observed in the capacity utilisation and unemployment rates in developed economies, the US 5Y and 10Y break-even inflation levels have moved up from lows of -0.6% (Oct-08) and 0.1% (Nov-08) to pre-crisis levels of 2.2% and 2.4% currently.
- **At the start of a secular break to the bond conundrum era?** Long yields in the US has moved back up by around 150bp from the lows seen in Jan-09 to 3.7%. Our global interest rate strategist, Jim Caron, believes this may herald a secular break to the bond conundrum era given the surge in US treasury supply amid the slowdown of quantitative easing. Our US economist, Dick Berner (*see Outlook 2010: Higher Rates, Fed Exit and Sustainable Rates, dated January 4, 2010*) also highlights this as a reflection of inflation uncertainty.

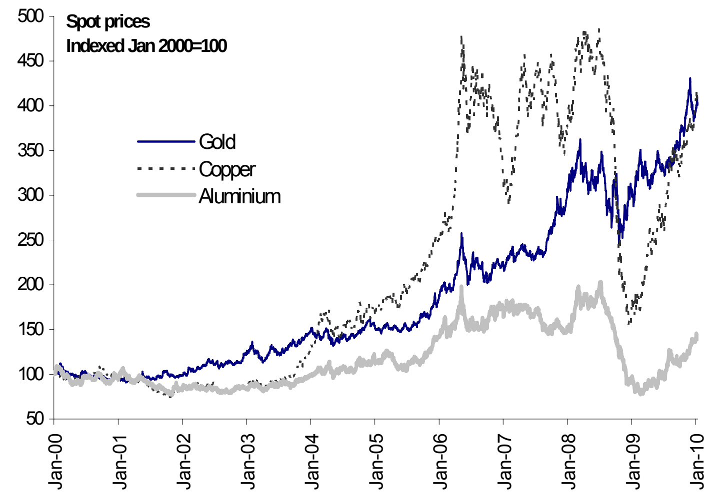
Bond and Commodity Markets Are Telling Us that Inflation Is a Risk

Energy Commodities



Source: Bloomberg & Morgan Stanley Research

Precious & Base Metals

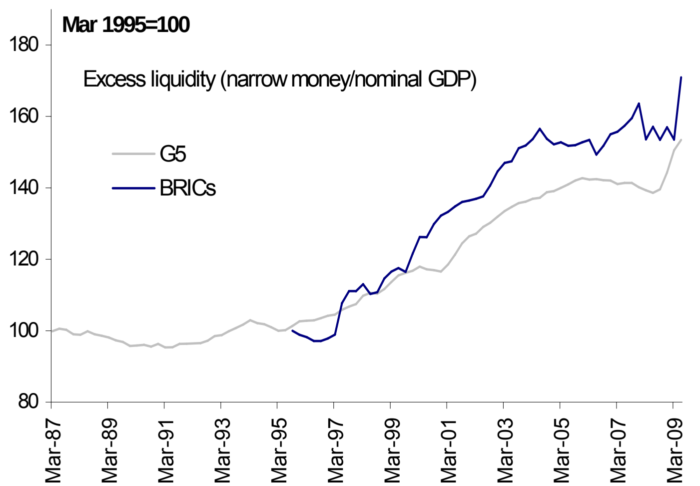


Source: Bloomberg & Morgan Stanley Research

- **Chicken and Egg – A leading indicator of inflation risks or a cause of the inflation to come?** Similarly, the commodity markets, notably for energy and metals, have bounced off their lows of early 2009 amid the macro turnaround and possibly as investors begin to sniff out inflation risks, indirectly adding to the inflation pressures in the pipeline.

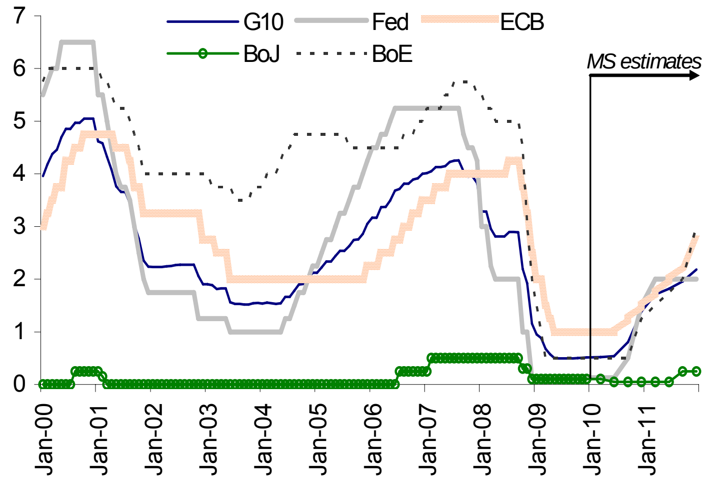
Believers of Inflation Would Say…

"Inflation Is Always and Everywhere a Monetary Phenomenon"



Source: MS Global Economics Team

Moving from Super-Expansionary to Expansionary

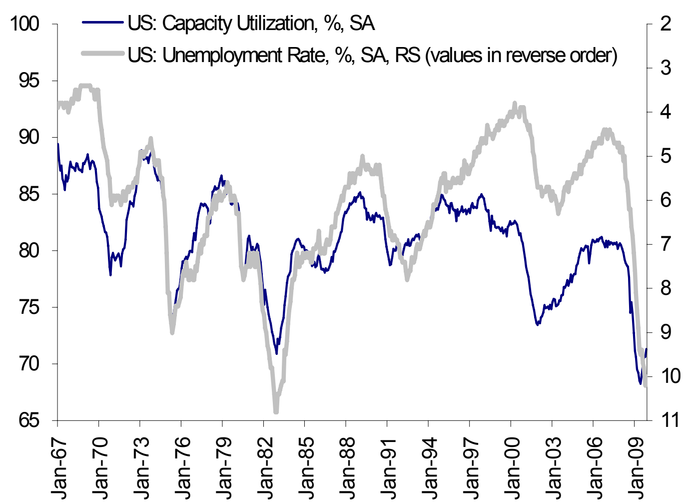


Source: MS Global Economics Team

- **The inflation debate…Friedman's perspective:** Yet, the inflation debate remains a highly polarised one. Believers of inflation point to the monetary expansion and quantitative easing that is underway in many parts of the advanced world and the impact those moves may have. Indeed, our global economics team points out that despite the policy exit strategies that are likely to be implemented in 2010, monetary policy stance is still likely to be relatively expansionary (*see Global Monetary Analyst: Five Themes for 2010,* by Joachim Fels and team, January 6, 2010).

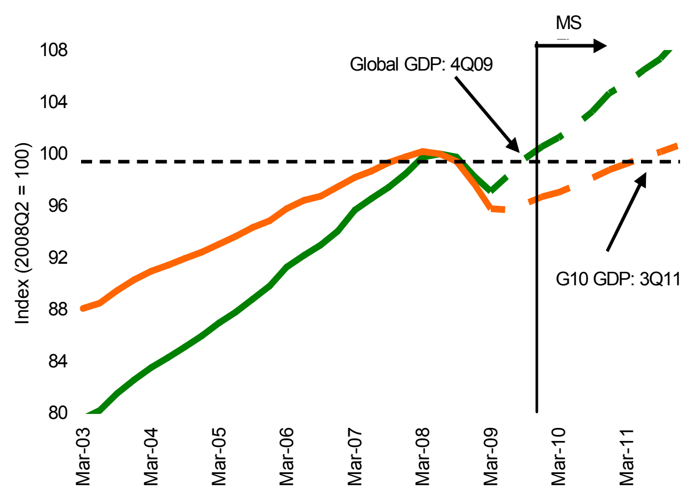
Believers of Deflation Would Say…

Look Ma, So Much Slack!



Source: CEIC & Morgan Stanley Research

G10 Will Take Time to Return to Pre-Crisis Levels



Source: MS Global Economics Team *E=Morgan Stanley Research estimates*

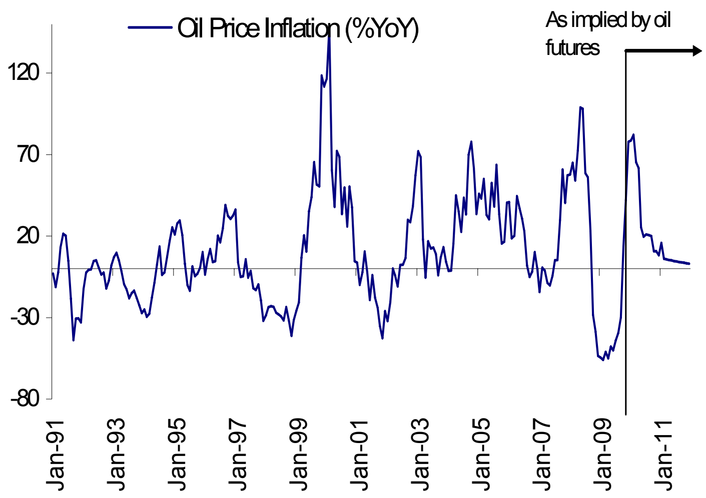
- **"Philips Curve"…The Keynesian perspective:** Believers of deflation subscribe to the inverse relationship between unemployment and inflation, embodied in the Philips curve. Indeed, capacity utilisation in US stands at 71.3%, which is lower than the recent peak of 80.6% (Dec-07). Unemployment is also at an almost 26-year high of 10.0% in Nov-09. The global economy may have returned to its pre-crisis peak levels in 4Q09 led by EM (which reached pre-crisis peak levels in 3Q09). However, that the developed world is likely to take longer to reach pre-crisis levels (3Q11) and that the global economy is likely to average 4%YoY and 3.9%YoY respectively, in 2010 and 2011 (a lower trend compared to the close to 5% seen in the previous cycle of 2004-07) should temper the export-led recovery in many parts of the emerging world and buy some time for productive capacity to catch up with the growth recovery.

Sketching the Different Schools of Thought on Inflation

What are the different school of thoughts on inflation?	Examples	Counter-examples
- The **Keynesian** view is embodied by the **Philips curve,** which points to a short-term trade-off between unemployment and inflation. Lower unemployment is likely to lead to higher inflation and vice versa. - An extension of the Philips curve theory is the **NAIRU,** or non-accelerating inflation rate of unemployment. If the unemployment rate falls below this level, inflationary pressures are expected to climb as the bargaining power tilts toward employees rather than employers. A fall below the NAIRU leads to an accelerating pace of inflation.	- The Philips curve was established due to its empirical veracity. Based on empirical data for UK in the period 1861-1957, Economist AW Philips highlighted the negative correlation between the rate of unemployment and inflation. This finding was later extended to other economies by other economists.	- The stagflationary period of high unemployment and high inflation during the oil supply shocks period in 1973 and 1979 ran contrary to what the Philips curve would have predicted. - Similarly, a period of low unemployment with low inflation is also at odds with the empirical veracity of the Philips curve. Indeed, the boom years of 2004-07 saw a period above-trend global growth but below-trend global inflation rate. - A few factors may explain this. Globalisation and trade allowed economies with excess capacity to export disinflation and, at the same time, raise competitiveness and reduce pricing power. Productivity improvement from technological change was not necessarily met by a concomitant rise in wage amid increased competitiveness. The improving credibility of Central Banks in inflation-fighting may also have served to dampened inflation expectations.
- The **monetarist** view on inflation is embodied by the **quantity theory of money** and by Milton Friedman's quote that "inflation is always and everywhere a monetary phenomenon". The quantity theory of money states that the M*V = P*Y where M = money supply; V = velocity of circulation; P = price level; and Y= output. All else being equal, a rise in M will lead to a rise in P.	The successful reining in of high inflation from aggressive monetary tightening taken by Paul Volcker in the early 1980s lent credence to the monetarist view on inflation. US inflation decelerated from a peak of 14.8% YoY in Mar-80 to 3.8% by the end of 1982.	The pursuit of a zero interest rate policy strategy (1999-2006) as well quantitative easing (2001-2006) did not pull the Japanese economy out of deflation, pointing to the fact that monetary expansion alone, without a concomitant impact on demand, can have little influence on inflation.

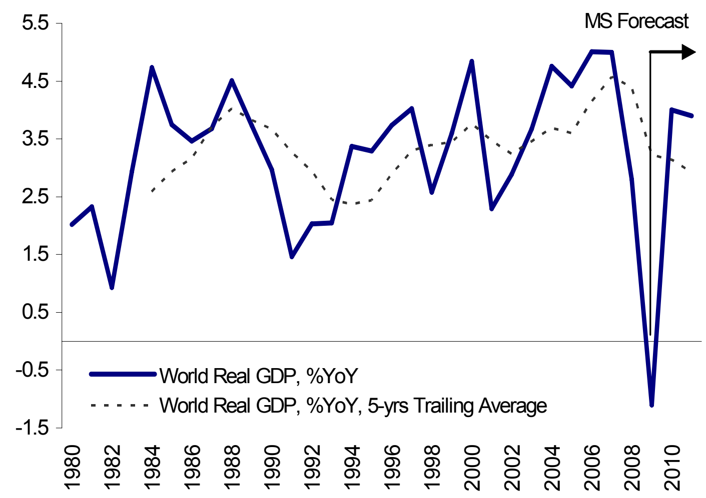
The Inflation Divide Is Likely to Hold for the Near Term

Oil Price Reflation



Source: Bloomberg & Morgan Stanley Research

Global Growth Trend

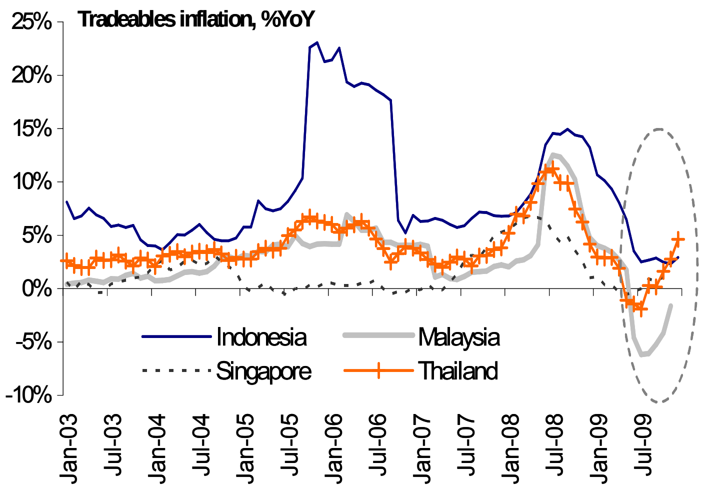


Source: IMF & Morgan Stanley Research

- **Who's right?** We suspect both camps may be right in the near term at least for ASEAN economies. In our view, monetary expansion can lead to inflationary pressures via two channels: first, through asset reflation, and second, through real economy resurgence due to easier credit and wealth impact from asset market buoyancy, which may in turn lead to demand-pull price pressures. In this regard, the monetarist camp would be right in that the aggressive liquidity expansion and the sentiment support it provides has already led to significant asset reflation. In particular, commodity reflation is likely to push headline inflation higher. However, the Keynesian camp would also be right in that even if the liquidity expansion were to fuel real demand with a lag, the buffer afforded by the "Great Recession" and the fact that global growth is likely to average lower than the 5% seen in the last cycle in 2004-07 will help buy some time for productive capacity to catch up with the growth recovery, offering some buffer before demand-pull pressures set in.

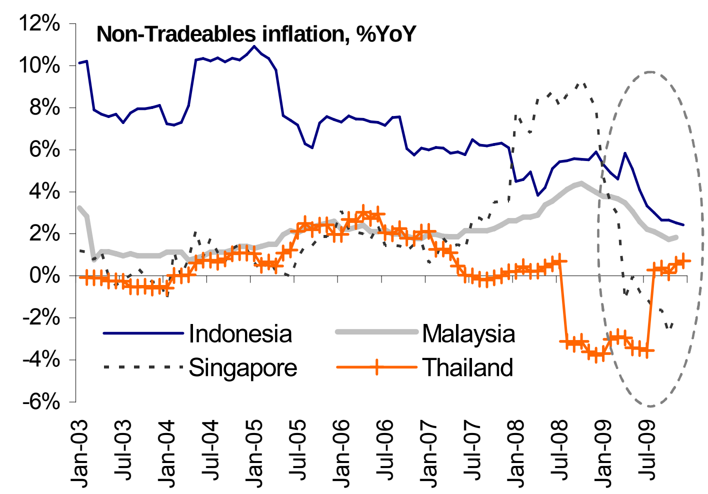
The Inflation Divide Is Likely to Hold for the Near Term

Tradeables Inflation on an Uptrend…



Source: CEIC & Morgan Stanley Research Note: Indonesia's tradables inflation has yet not edged up as significantly as others because it is still enjoying the favourable base effects from previous administered fuel price change. However, the base effects will wear out in the Jan-10 data.

Non-Tradeables Inflation Trend Still Subdued

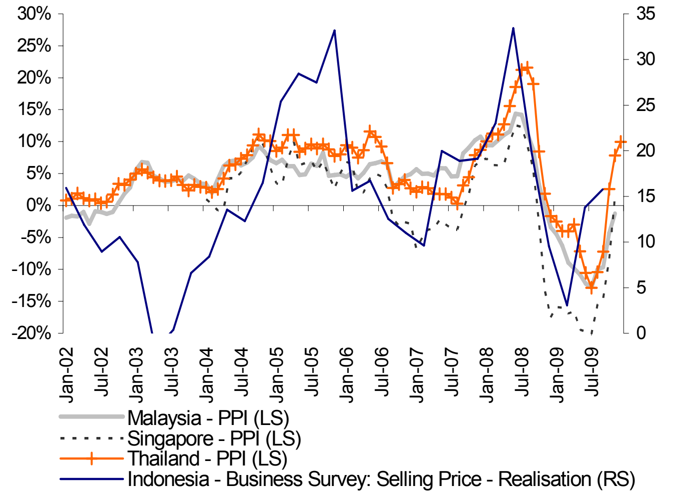


Source: CEIC & Morgan Stanley Research Note: Non-tradeables refer to items that are not easily imported or exported (e.g., services). Tradeables refer to items that can enter into international trade.

- **Inflation divergence:** Hence, we think the cyclical rise in 2010 inflation is likely to be underpinned by non-core inflation or rather, tradables (commodity) inflation before the uptrend in core inflation and non-tradables inflation follow suit. In this regard, the inflation debate is really about the inflation divide. This is what we are observing in the ASEAN economies. Tradeables inflation has already started on an uptrend whilst non-tradeables have lagged behind. (*Note: The turnaround in Thailand's non-tradeables inflation is more a reflection of negative base effects due to the fiscal measures* implemented)

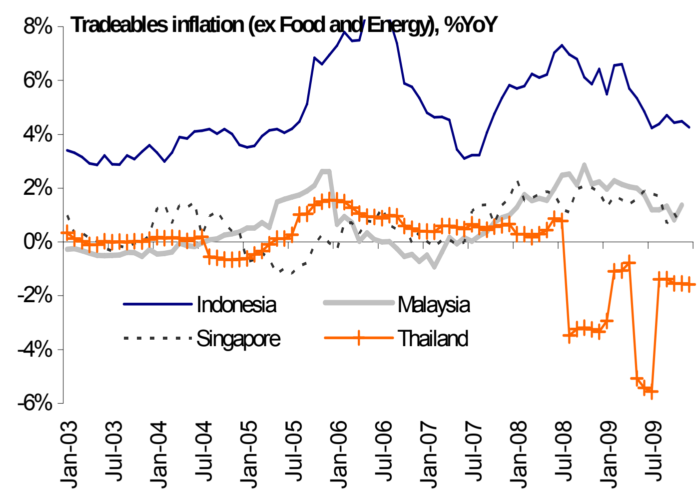
Looking Out for Signs of Input Cost Pass-through and Pricing Power

Producers Are Facing Higher Input Costs



Source: CEIC & Morgan Stanley Research For Indonesia, data for the business survey is collated by the net balance method i.e. calculating the difference between the % of respondents who responds increase and the % responding decrease. Unchanged responses are ignored.

Pricing Power Still Weak? Manufactured Goods Inflation Not Yet Trending Up



Source: CEIC & Morgan Stanley Research We have excluded food and energy components from tradeables inflation so as to approximate manufactured goods inflation

- **Direct commodity cost-push inflation evident but manufacturers' pricing power less so:** The direct impact of high commodity prices on food and fuel-related items in the consumer basket is evident. However, although manufacturers are facing higher input costs, the pass-through of these costs to manufactured products is less clear. Indeed, manufactured goods inflation, proxied by tradeables inflation (excluding food and energy) has not seen a discernible uptick, suggesting that pricing power remains soft at this stage.

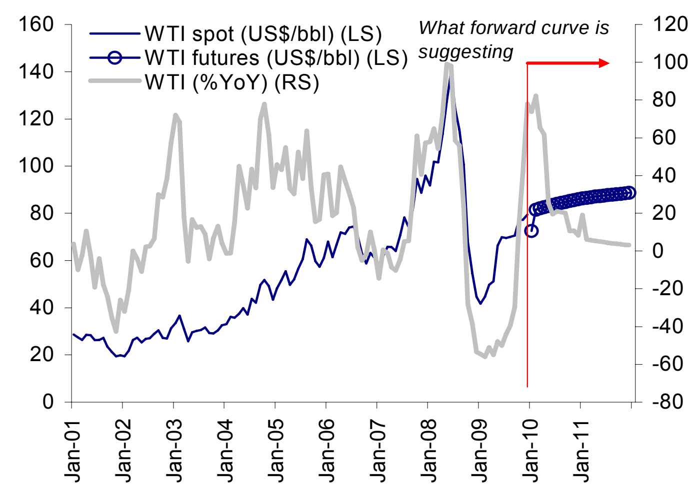
Who Is Most Susceptible to Tradeables/Commodities Inflation?

CPI Weights and Sensitivity

	CPI weights (%)				Sensitivity of CPI (%-pt) to 10% increase in food or oil prices		
	Food	Energy	Energy (Excluding public transport)	Total	Assuming full pass-through to food components	Assuming full pass-through to energy components	Assuming full pass-through to energy components (excluding public transport)
Indonesia	38.0	12.1	7.8	50.1	3.8	1.2	0.8
Malaysia	31.4	12.3	10.8	43.7	3.1	1.2	1.1
Thailand	38.5	12.7	8.5	51.3	3.9	1.3	0.9
Singapore	23.4	9.6	5.3	33.0	2.3	1.0	0.5

Source: CEIC & Morgan Stanley Research

What Are Oil Futures Saying?

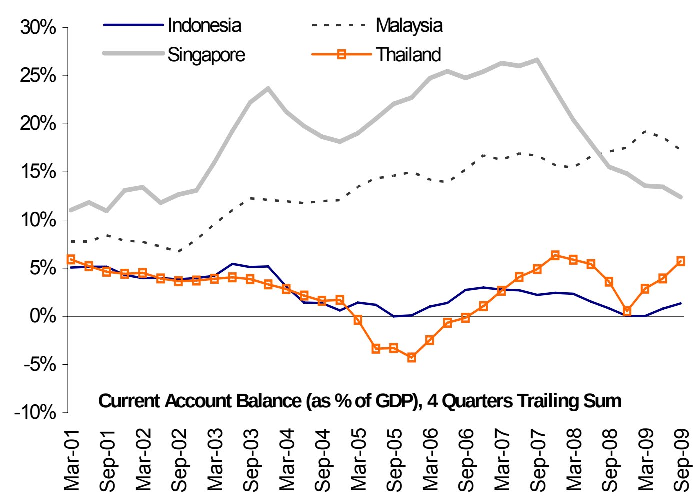


Source: Bloomberg & Morgan Stanley Research

- **Sensitivity rankings:** In view of the recent strong export performance seen in Asia, we are cognizant that inflation risk is skewed to the upside. In this regard, we thought it useful to highlight which countries are most susceptible to such risks within ASEAN.
- **Indonesia is most susceptible to tradeables/commodities inflation:** On tradeables/commodity inflation, we think Indonesia faces the most upside risk, followed by Thailand, whilst Malaysia and Singapore generally face lesser pressures. Indonesia and Thailand have comparatively higher commodity weights in the CPI basket at 50.1% and 51.3% respectively. Whilst the administered retail fuel price system in Indonesia may help to contain such pressures somewhat, other channels of transmission remain alive. Indonesia is a net commodity exporter. Elevated commodity prices confer better terms of trade, raising the possibility of demand-pull pressures. The existence of infrastructure bottlenecks, most notably in Indonesia, also tend to accentuate such inflationary risks when they arise.

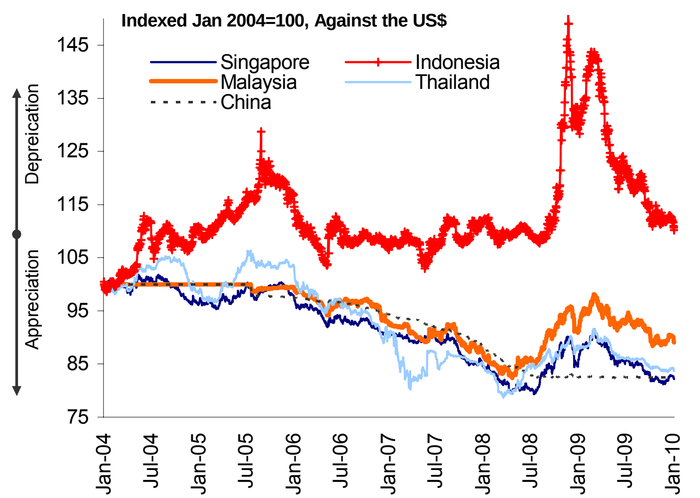
Who Is Most Susceptible to Imported Inflation?

Current Account Balance



Source: CEIC & Morgan Stanley Research

Currency Trends

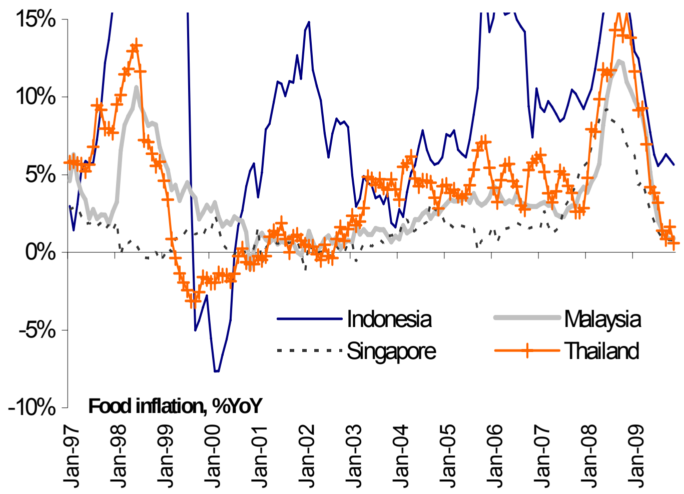


Source: Bloomberg & Morgan Stanley Research

- **Currency vulnerability and imported inflation:** With a narrower current account balance, Indonesia and Thailand also tend to face higher susceptibility to imported inflation. Higher commodity prices depress Indonesia's CAB because of higher imports from stronger domestic demand and Thailand's CAB because it is a net commodity importer. Moreover, in Indonesia's case, the high degree of dollarisation tends to accentuate the currency feedback loop into inflation.

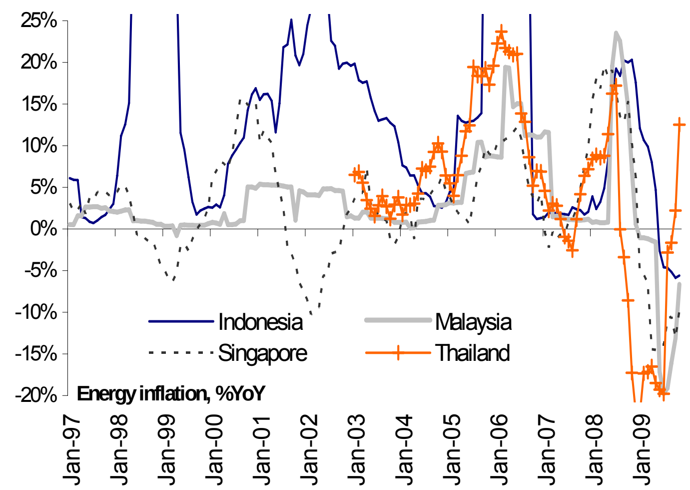
High Inflation Expectations Beget High Inflation

Food Inflation



Source: CEIC & Morgan Stanley Research

Energy-Related Inflation

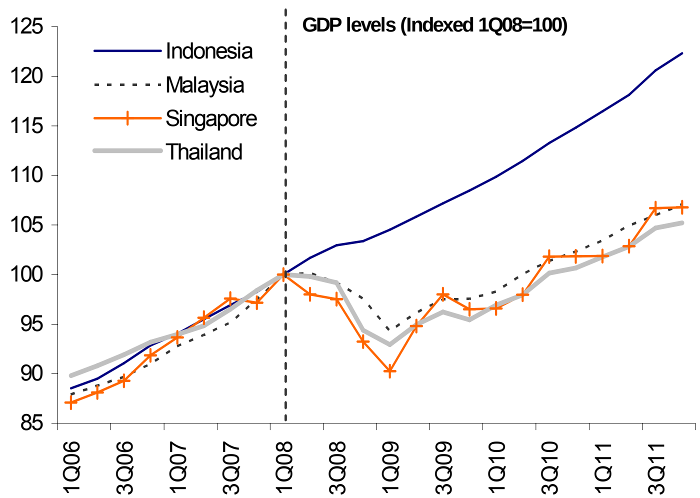


Source: Bloomberg & Morgan Stanley Research

- **Inflation has an auto-correlated component:** The history of high inflation tends to linger in consumers' memories and as a result, high inflation expectations tend to beget high inflation. In this aspect, Indonesia and to a lesser extent, Thailand, will tend to have higher inflation compared to Malaysia and Singapore.

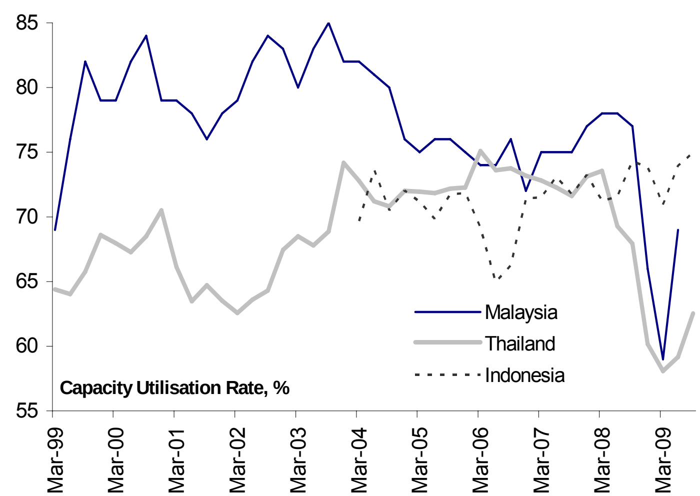
Who Is Most Susceptible to Non-Tradeables Inflation?

How Much Grounds Have Been Recovered?



Source: CEIC & Morgan Stanley Research estimates

Capacity Utilisation Rate

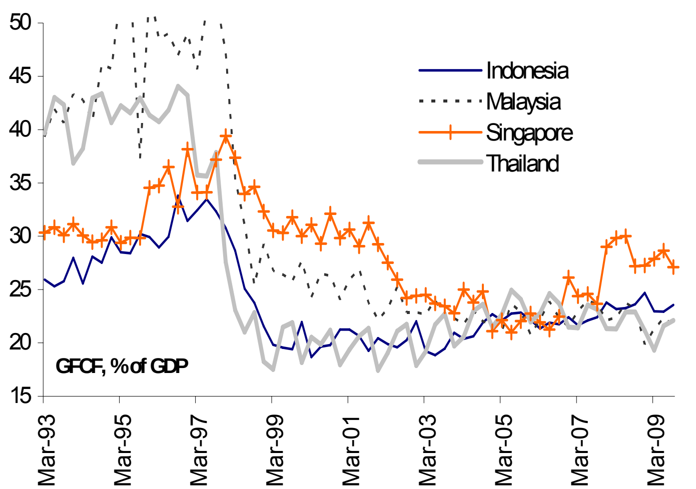


Source: CEIC & Morgan Stanley Research

- **Non-tradeables/core inflation is more affected by local output gap:** The local output gap is the key factor influencing non-tradeables/core inflation, in our view. The ASEAN3 economies, Malaysia, Singapore and Thailand, have rebounded from their lows of 1Q09 but are still 2.0-3.8% below the pre-crisis peak levels in 2008. From this perspective, we think Indonesia is most susceptible to non-tradeables/core inflation as it has been the most resilient economy within ASEAN. Indeed, where data is available, capacity utilisation stands highest at 75.0% in Indonesia, compared to 69.0% and 62.5% for Malaysia and Thailand.

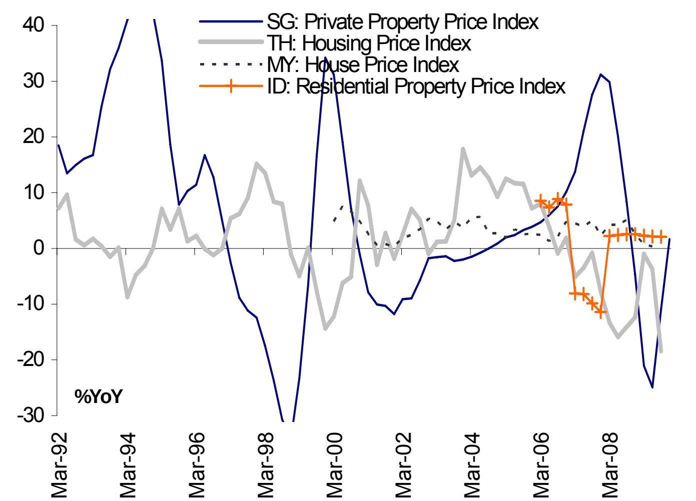
Who Is Most Susceptible to Non-Tradeables Inflation?

Investment Ratios



Source: CEIC & Morgan Stanley Research

The Speculative Element



Source: CEIC & Morgan Stanley Research

- **Real estate market can be an inflationary source but…:** A part of non-tradeables inflation that is somewhat tied to the loose global monetary policy is the inflation in rental or owner-occupied accommodation. The real estate market in Singapore has been quick to bounce back despite the nascent macro recovery. Private residential property prices have risen 24.2% from the lows in 2Q09 and are now 6.7% below the peak in 2Q08. This will feed through to both rentals (with a lag given that rental contracts have a time-frame of 1-2 years) and owner-occupied accommodation, which constitute about 0.7% and 11.1% of CPI, respectively. Indeed, annual values for owner-occupied accommodation in public housing, which are reviewed annually, have already been revised upward this month. However, we think the inflation uptick led by the annual value revision may overstate the rise in true living costs since the accommodation is owned rather than rented.
- **Also a disinflationary source?** Moreover, with economies such as Singapore having undertaken aggressive investment even during the trough of the recession given the lagged nature of construction, we think the real estate supply that is coming onstream amid a below-trend recovery could also cap overhead costs somewhat.

Reassessing Our Inflation Forecasts

	2009	2010E	2011E	2010O	2011O	Reasons for change in inflation forecasts
Indonesia	4.8	6.0	6.5	6.0	6.2	For Indonesia, we think our 2010 number remains intact. We have not factored in any change in retail fuel prices given the latest budget assumptions of US$80/bbl (which is somewhat similar to what oil futures are pricing in), the corrrespondingly higher fuel subsidy and the Finance Minister's statement that retail fuel prices are unlikely to change. For 2011, we have nudged our inflation forecast up from 6.2% to 6.5% to take into account likely higher demand-pull pressures from strong growth.
Malaysia	0.6	1.7	1.9	1.5	1.7	We have nudged up our 2010 and 2011 inflation forecasts to take into account the entry point into 2010 provided by the latest datapoints. Risks to our inflation forecasts lie in the potential change to the retail fuel subsidy system. Policy-makers have touted May as the time when things could be changed. However, given the lack of detail with regard to how the system may be tweaked as well as the uncertainty with regard to the adherence to this timetable, we have assumed constant retail fuel prices in our forecasts.
Singapore	0.4	2.9	1.3	0.8	1.0	The revision of the HDB annual values, which act as a proxy for rental values in owner-occupied accommodations for the CPI basket will put upward pressure on 2010 inflation. Owner-occupied accommodation accounts for 11.1% of the CPI basket and the split between public and private ownership is likely roughly 80:20. The exact revisions were not announced. However, to the extent to which the HDB resale index has moved up by 23.8% since the end of 2007 (which was the last time annual value revisions were made), we estimate that the revision would increase CPI headline by about 2.1ppt. We do not think this is at odds with our assessment that Singapore is likely one of the lower inflation risk economies within ASEAN. Much of this uptick in inflation can be considered notional since it is an imputed value for owner-occupied rather than rented accommodations per se. To be sure, homeowners will have to pay property income tax based on the annual values. However, the tax rate and tax rebates mean the impact on inflation headline could overstate the true impact on household costs.
Thailand	-0.8	3.3	3.0	3.3	2.8	We have kept our 2010 forecasts unchanged at 3.3% YoY. This is a reflection of two trends – the higher entry point of inflation trajectory, which puts upward pressure on 2010 number as a whole, and an offsetting factor given the extension of utility and transport charges waivers and a cap on cooking gas prices. Further extension of the latter will generally reduce 2010 inflation at the expense of 2011 (due to base effects). As such, we have also pushed up our 2011 inflation forecast from 2.8% to 3.0%.

Source: Morgan Stanley Research estimates   O=Original estimates; E=Revised estimates

Policy Implications: What Tools Will Be Used to Counter Inflation?

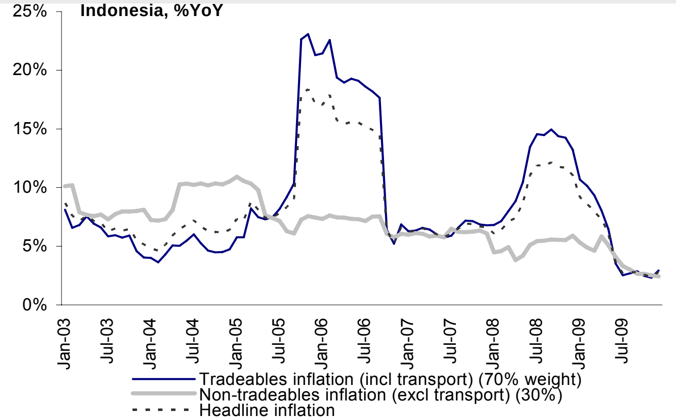
	Currency tool	Monetary policy tool	Fiscal policy tool
Indonesia	We think the currency tool is unlikely to bear the heavy lifting in terms of countering inflationary pressures, beyond how other regional currencies are moving. Moreover, given the relatively higher inflation trend in Indonesia, a too-rapid pace of currency appreciation would erode the competitiveness in terms of manufacturing exports from a real effective exchange rate perspective.	Monetary policy tools such as CRR increase and primarily policy rate hikes are likely to be utilized.	Fiscal policy was never that expansionary and the scope for a scaleback to soften aggregate demand is lesser. On the contrary, we think fiscal expansion to cater to infrastructure build-up could provide long-term benefits in assauging supply bottlenecks, which tend to lead to inflationary pressures.
Malaysia	BNM typically prefers currency movement to be orderly and in line with regional trends. In this regard, we also think the exchange rate is unlikely to do the heavy lifting in terms of countering inflation pressures, beyond how other regional currencies are moving.	Monetary policy renormalisation, both in terms of policy rate hikes and CRR increase, will likely do the heavy lifting. However, BNM is relatively dovish amongst the ASEAN Central Banks. Given the typically gradual adjustment in terms of the delta of policy rates, we do not think a two-tiered approach with "soft tightening" (in the form of CRR hikes) preceding "hard tightening" (in the form of rate hikes) is necessary. Both could happen at the same time. However, we think BNM is unlikely to react to first-round commodity price pressures or policy-driven retail fuel price changes. In our view, second-round demand-pull pressures will be the key matrix they watch out for before reacting with monetary policy renormalisation.	Fiscal policy tools rank lower for inflation management, in our view. However, if stronger growth is the key driver for core inflation upside, fiscal expansion will likely be scaled back.

Policy Implications: What Tools Will Be Used to Counter Inflation?

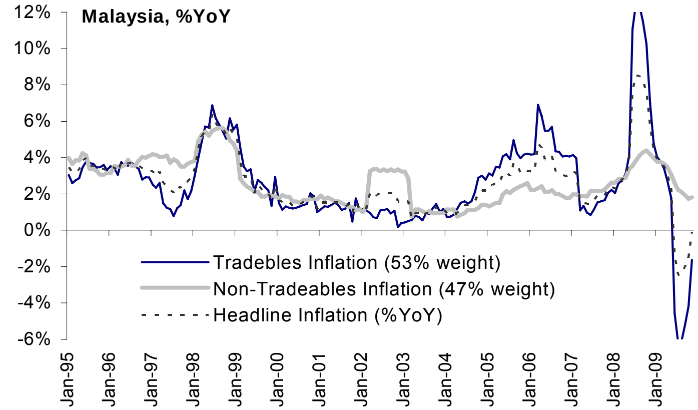
	Currency tool	Monetary policy tool	Fiscal policy tool
Singapore	A shift of the S$NEER policy from a zero appreciation to a gradual appreciation stance could be adopted if core inflation were to edge higher amid stronger growth. However, growth and underlying inflation have tended to be higher in previous episodes when MAS undertook such a move. Hence, in light of current conditions, such a policy move seems unlikely in the next review in April.	The adoption of exchange rate management as a policy tool means that MAS cedes control of the interest rate tool. Interest rates in Singapore will fluctuate depending how other global Central Banks conduct their monetary policy.	If core inflationary pressures were to build up from stronger demand, we think fiscal support measures, previously announced in the stimulus package (such as the risk-sharing initiatives) and recently extended could be truncated ahead of time. However, if inflationary pressures are due to higher commodity prices without commensurate macro strength and to the extent to which higher commodity prices pose negative terms of trade, policy-makers may resort to fiscal measures to cushion consumers' disposable income.
Thailand	Like other ASEAN economies, the currency tool could be utilised to the extent to which it is in line with regional currency movements. In our view, the Central Bank will be cautious not to head off any recovery in export growth with currency moves that are too aggressive, particularly if political conditions were to remain uncertain.	CRR was not changed during the downturn. As such, we think policy rate hikes would be the tool of choice to counter core inflationary pressures when it happens. Like Malaysia, we think the Central Bank is unlikely to want to react to inflationary pressures caused by higher commodity prices that are not accompanied by stronger macro conditions. This is all the more so given that higher commodity prices are negative for the net commodity importer. Core/demand-pull inflation would be the matrix the Central Bank keeps an eye on with regard to its reaction function.	A stimulus package has been planned for 2010-12. To the extent to which core inflation upside is driven by demand, we think fiscal policy could be scaled back somewhat, not necessarily to counter inflation pressures but to help reduce the expected build-up in public sector debt. In the event of higher commodity prices in an environment of still soft growth, we suspect policymakers may attempt to cushion the impact of higher oil prices via fiscal measures or the Oil Stabilisation Fund.

Inflation Trends: Tradeables vs. Non-Tradeables

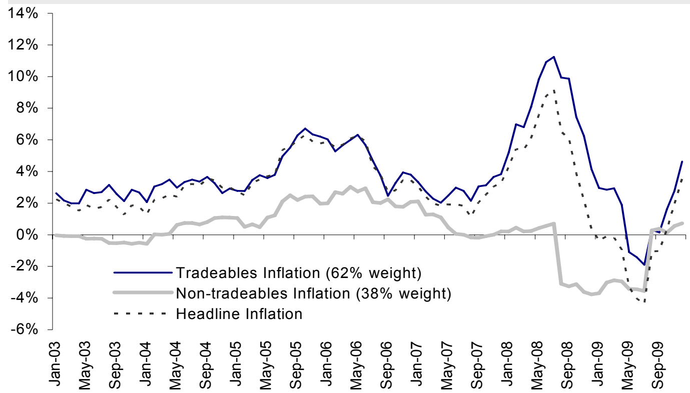
Indonesia



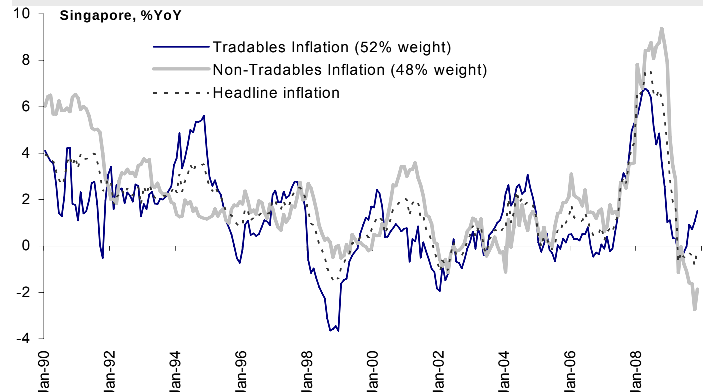
Malaysia



Thailand



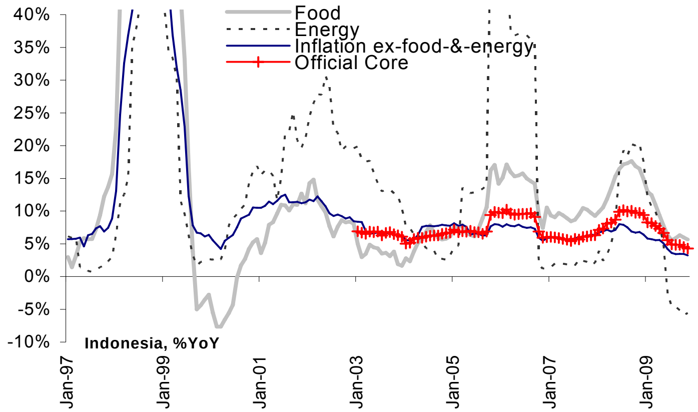
Singapore



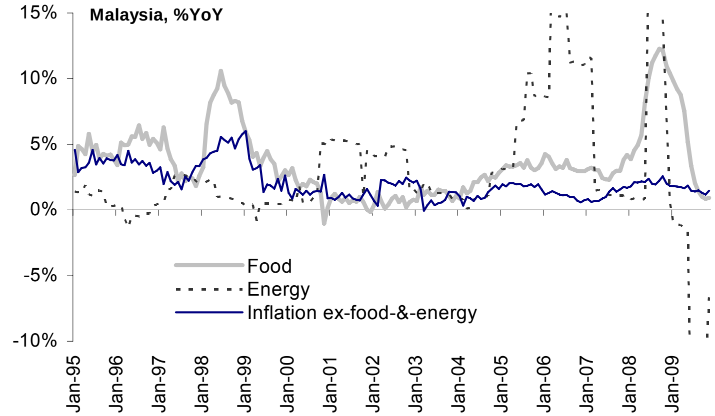
Source: CEIC & Morgan Stanley Research   Note: The level of granularity differs in terms of the breakdown of CPI categories for various countries. We have classified the categories into tradeables or non-tradeables where we deemed more suitable

Inflation Trends: Core vs. Non-Core

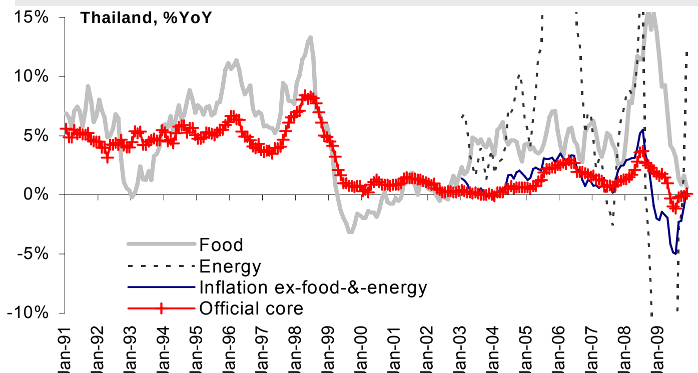
Indonesia



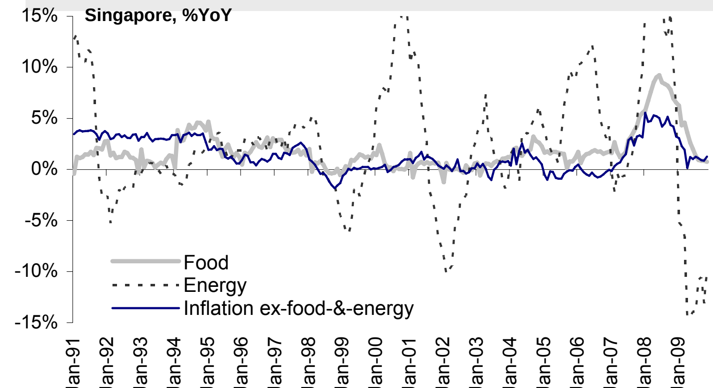
Malaysia



Thailand



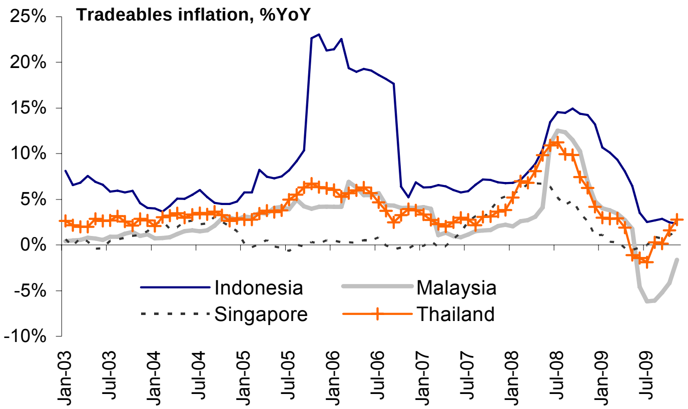
Singapore



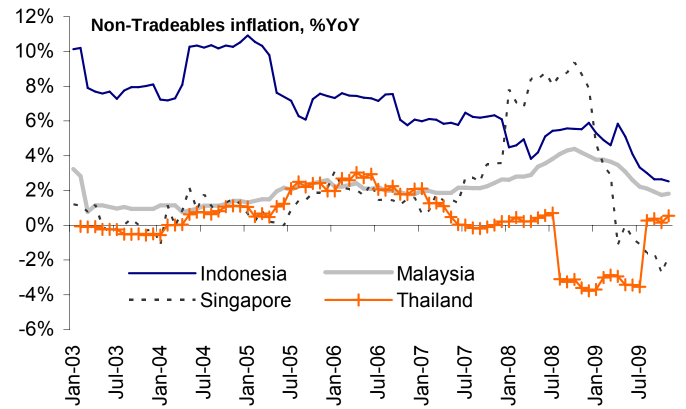
Source: CEIC & Morgan Stanley Research   Note: Food includes non-alcoholic beverages as well. Energy includes utilities, motor fuel and transport services

Comparing Inflation Trends

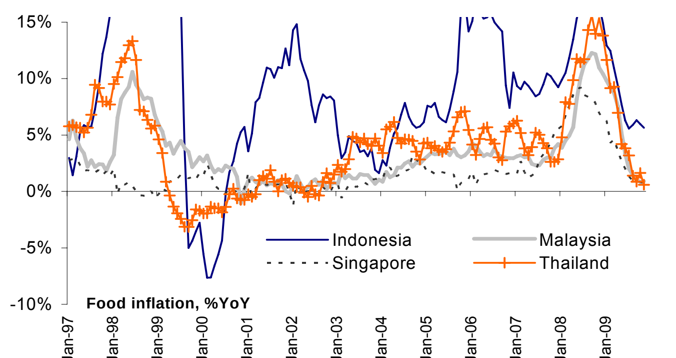
Tradeables Inflation



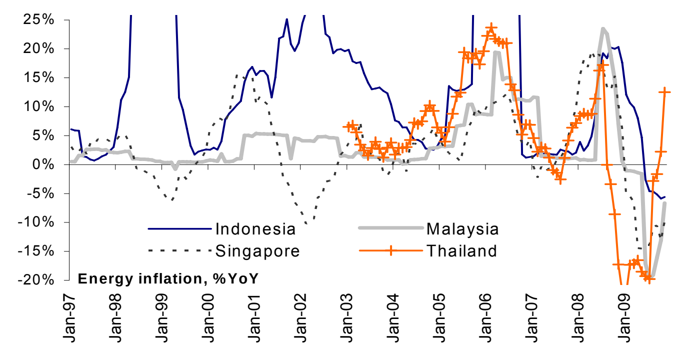
Non-Tradeables



Food Inflation



Energy Inflation



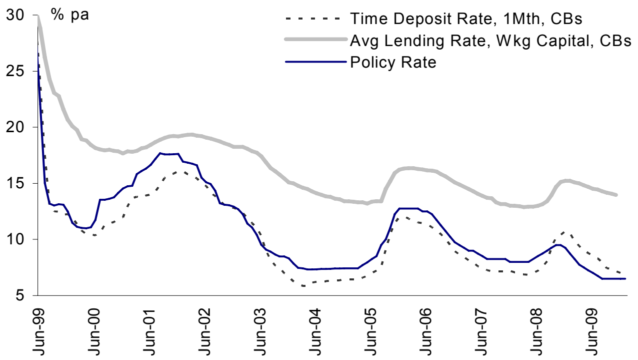
Source: CEIC & Morgan Stanley Research

Tracking Key Macro Developments: Quick Thoughts…

Indonesia: Credit Growth at the Cusp of Bottoming Out

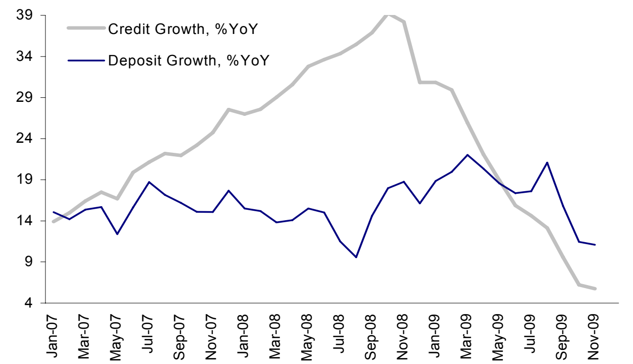
- **What's new?** Latest (commercial and rural banks) data shows credit growth moderating to 5.7% YoY in Nov-09 (vs. +6.3% YoY in Oct-09). This represents a significant moderation from the peak of +39.3% YoY (reached in Oct-08). Separately, deposit growth decelerated slightly but is still showing double-digit momentum at 11.1% YoY (vs +11.4% YoY for Oct-09). The loan-to-deposit ratio stands at 73.3%, similar to Oct-09.
- **Our comments:** The structural decline in the cost of capital has been the differentiating factor in our bullish call on Indonesia. In this regard, the credit cycle is also important to watch. We believe credit growth is on the verge of bottoming out as GDP growth accelerated in 3Q09. We expect credit growth to pick up in 2010, supported by growing investor/consumer confidence and improving domestic demand. Historically, the credit multiplier (i.e., the ratio of credit growth to nominal GDP growth) has tended to average around 0.8 when taking the past 15 years of available history into account and 1.3 when taking the 2001-09 period to exclude the crisis years. Given our nominal GDP forecast of 19.7% YoY for 2010, it then seems likely that credit growth could range between 16% and 26%. As a comparison, credit growth in 2008 and 2007 stood at 30.8% YoY and 27.5% YoY respectively.

Structural Decline in Cost of Capital



Source: CEIC & Morgan Stanley Research

Where Are We in the Credit Cycle?



Source: Bloomberg & Morgan Stanley Research.

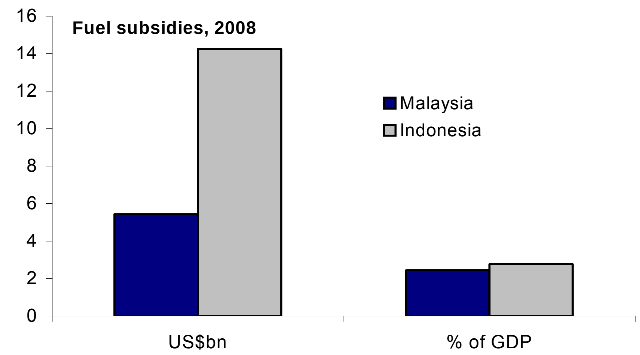
Malaysia: Subsidy Scheme Restructure May Mark an Incremental Move Toward More Efficient Resource Allocation

- **What's new?** Changes to the fuel subsidy system have been proposed and will be effective by May. According to the Domestic Trade and Consumer Affairs Minister, as part of the subsidy system overhaul, only Malaysian citizens will be able to avail themselves of the subsidized fuel. (Earlier, foreigners were allowed access to the subsidized fuel.) Further, within the "eligible" category, quotas will be drawn based on income levels and engine capacity of the vehicles. There are also talks about imposition of tax on foreigners.

- **Our comments:** Fuel subsidies had constituted about 2.4% of GDP in 2008. With oil prices at close to US$80/bbl, we calculate that the retail subsidy rate likely stands at around 30% for gasoline and 26% for diesel. Details are not available at this point and the strictness of the adherence to a change by May is unclear as policy-makers have been talking about rationalising the retail fuel pricing system for some time now. Yet, to the extent to which the subsidy rate is reduced and quotas are introduced, we think this may mark an incremental step toward more efficient resource allocation.

  In our view, the fuel subsidy system is one embodiment of market distortion that contributed to the "Dutch Disease" we have been highlighting. In a way, market distortions such as this and the affirmative action policy have shielded Malaysia from a need to brush up on productivity and competitiveness. As such, a gradual roll-back would be a marginal positive from a structural perspective. Longer term, the subsidy restructure may also release some fiscal space that could be diverted toward developing the weakness in softer infrastructure. It may also aid fiscal consolidation efforts as policymakers try to narrow its fiscal deficit.

Fuel Subsidy Expenditure



Source: CEIC & Morgan Stanley Research

Energy Weights in the CPI Basket

	CPI weights (%)		Sensitivity of CPI (%-pt) to 10% increase in oil prices	
	Energy	Energy (Excluding public transport)	Assuming full pass-through to energy components	Assuming full pass-through to energy components (excluding public transport)
Indonesia	12.1	7.8	1.2	0.8
Malaysia	12.3	10.8	1.2	1.1
Thailand	12.7	8.5	1.3	0.9
Singapore	9.6	5.3	1.0	0.5

Source: CEIC & Morgan Stanley Research

January 8, 2010

US Economics
Say Goodbye to the Job Recession… and Hello to the Census Effect

Morgan Stanley & Co., Incorporated

Richard Berner
Richard.Berner@morganstanley.com

David Greenlaw
David.Greenlaw@morganstanley.com

Ted Wieseman
Ted.Wieseman@morganstanley.com

Key to sustainable growth: The great US employment recession is finally ending, as several signs point to positive job growth very soon. That's critical for our call that growth will be sustainable through 2011, creating a virtuous circle of output, income and spending gains, and collateral comfort for further improvement in credit availability.

Pent-up demand: Our thesis has been simple: Aggressive cuts to payrolls over the past two years have set the stage for a solid rebound, despite only moderate economic growth. One measure of that pent-up demand is provided by a standard relationship between the economy and hours worked. The depth of the job recession confirms it.

Metrics for improvement: Several advance labor-market indicators signal improvement: Initial and continuing claims for unemployment insurance continue to fall, temporary help payrolls are rising consistently, the workweek is rising, and surveys of hiring plans are turning up.

Census a boon, but still a moderate recovery: Hiring of census workers will boost payrolls temporarily in 2010. Yet the underlying employment recovery is still likely to be moderate for three reasons. The economy itself still faces headwinds; companies are still determined to boost productivity; and uncertainty about labor costs, especially healthcare, may restrain hiring.

Say Goodbye to the Job Recession
Richard Berner (New York)

Job growth has yet to show up, but the great US employment recession is finally ending. The jury is still out on our thesis that employers went overboard in slashing payrolls and will start to hire back. At first glance, December's decline of 85,000 in nonfarm payrolls seems to refute that notion, but we believe weather-related headwinds played a significant role in that result. More important, several signs point to positive job growth very soon. We expect job gains over this year of just over 1% (130,000 monthly), along with a consistent rise in the workweek.

It's worth repeating that job and hours gains are critical for our call that growth will be sustainable through 2011. Rising jobs will provide the gains in income and confidence needed to support consumer spending. Rising income will also improve consumer creditworthiness and give lenders collateral comfort for further improvement in credit availability: It will reduce debt/income and debt service/income ratios, raise "cure" rates for delinquent mortgages, and help more consumers qualify for a loan. In short, rising employment will greatly reduce fears of a weak and faltering recovery.

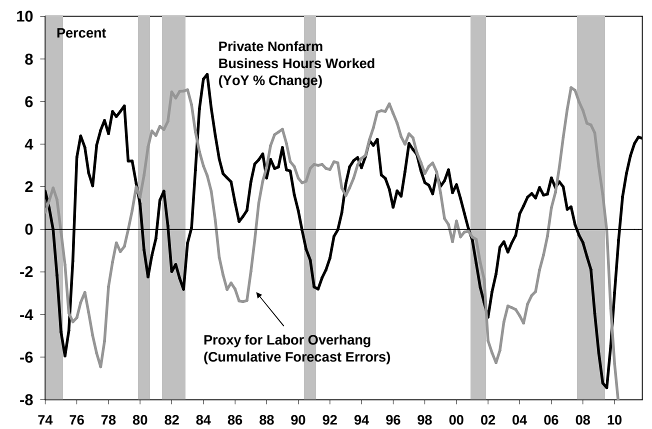
While we don't think this recovery will be jobless, the pace of hiring is still likely to be moderate for three reasons: The economy itself still faces headwinds; companies remain determined to boost productivity; and uncertainty about labor costs, especially healthcare, may restrain hiring. Details follow.

Pent-up demand. Our thesis has been simple: Aggressive cuts to payrolls over the past two years have set the stage for a solid rebound, despite only moderate economic growth. What were minimal hiring excesses are long gone, and a growing economy has produced a hiring deficit. While there are several factors that will mute the hiring recovery, this pent-up demand will overwhelm them.

One measure of that pent-up demand is provided by a relationship between the economy and hours worked (and, with a projection for the average workweek, employment). The explanatory variables include the outlook for output, factors that affect productivity such as the services from capital, other variables aimed at capturing changes in trend productivity, and a dynamic adjustment process that captures the typical pro-cyclical surge in productivity early in recovery (see appendix for equation). If positive, the cumulative differences between actual hours and those predicted by the relationship suggest that there is an overhang of labor to work off. As it turns out, the errors over the course of the expansion that ended in December 2007 were small, reflecting business caution about hiring. And through the second quarter of 2009, the errors cumulate to zero, suggesting that the aggressive job cuts seen in this recession eliminated any excess six months ago. We estimate that declines through the fourth quarter have pushed those cumulative errors sharply negative, implying some underlying pent-up demand for labor that should materialize soon.

Exhibit 1

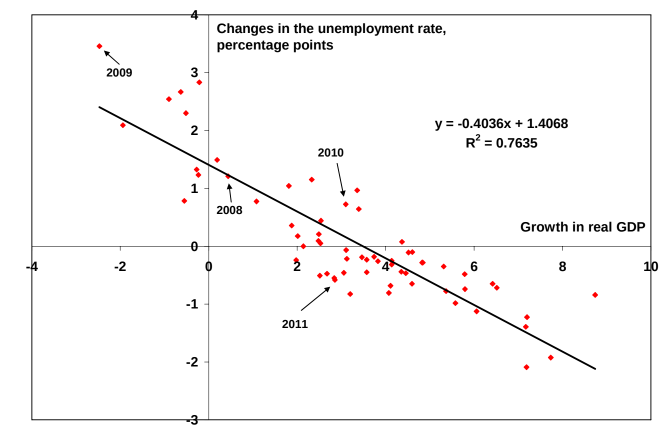
By Our Metrics, Pent-Up Demand for Hiring Gathering Strength



Note: 4Q09-4Q11 values represent Morgan Stanley Research estimates.
Sources: Bureau of Labor Statistics, Morgan Stanley Research

Exhibit 2

Okun's Law: A Changed Economy-(Un)employment Relationship



Note: 2009-2011 values represent Morgan Stanley Research estimates.
Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Morgan Stanley Research

As we see it, the depth of the job recession and unsustainably strong productivity gains confirm this analysis. The economic recession and extraordinary cuts in jobs have taken the level of private payrolls about 610,000 below the trough of the previous recession in mid-2003, while the economy has since grown by about 11%. In addition, productivity has surged over the past nine months in time-honored cyclical fashion; such a surge is a hallmark of the first stages of recovery. But the pace is completely unsustainable. We estimate that nonfarm productivity rose at an estimated 7% annual rate over the three quarters ended in Q4 09 — a pace last seen for brief periods in the 1960s. That hints that even moderate economic growth will trigger a pickup in hiring.

Policy Uncertainty May Delay Hiring. The main risk to our call for positive job gains is timing: Hiring always lags the recovery; the current surge in productivity growth speaks to that lag. This time, uncertainty around a variety of policy actions may further delay the pickup. For example, we suspect that uncertainty tied to healthcare reform restrained hiring at small and medium-sized businesses for part of 2009. Both House and Senate plans would either mandate coverage or boost taxes. Why hire until the dust settles on those proposals? Employers are responding by boosting the workweek and hiring temps. The good news is that Democrats are determined to iron out differences between House and Senate healthcare bills, resolving this uncertainty. The bad news for employers is that either way, hiring will cost more.

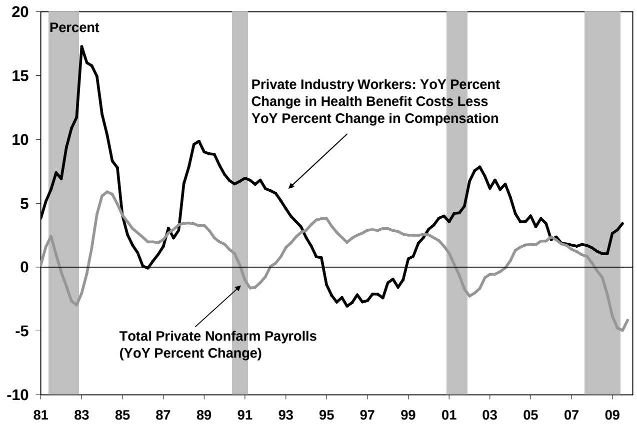
Four factors depressed hiring relative to the economy. Understanding why employers were so aggressive this time in cutting payrolls should help us to analyze the factors that will promote or inhibit recovery. Unfortunately, there is no simple answer. Yet it seems clear that the relationship between the economy and hiring has changed over time. For example, if Okun's Law (a rule of thumb relating economic growth and the unemployment rate) held from the past, given the peak-to-trough decline in the economy in 2008-9 of 3.8%, the unemployment rate should be about 8%, not 10%. Four factors probably changed the relationship: swings in employer-paid healthcare costs, increasing cyclicality of services industries, offshoring, and demographics. In our view, these factors will continue to mute the hiring recovery, but will not preclude it.

1. Swings in healthcare costs. Swings in employer-paid healthcare benefits made hiring full-time workers more or less attractive over the past three decades. The tech bubble and strong economy fueled the late-1990s hiring boom, but controls that brought the growth in healthcare benefits down to zero may also have contributed to it. Since that time, Corporate America's hiring discipline, combined with a rapid escalation of healthcare costs, worked to correct those bubble-year hiring excesses, especially in manufacturing. Over the past fourteen years, according to BLS data on employer costs for employee compensation, total compensation rose at a 3.4% annual rate. In contrast, health insurance costs rose at a 5.2% annual clip.

To keep their benefits and take advantage of their being free of tax, workers have accepted lower growth in take-home pay.[1]

Exhibit 3

Swings in Healthcare Costs Influence the Pace of Hiring



Source: Bureau of Labor Statistics

2. More exposed — and thus more cyclical — services. Second, many traditionally stable services industries have become far more cyclical over the past two decades than in the past. Private services employment has ramped from 55% of total private payrolls to 83% in the past 50 years. In previous cycles, that shift reduced the cyclicality of the overall workforce. But the increased competition from deregulation and technological change has rendered many services industries, such as airlines, wholesale and retail trade, and IT, as cyclical as those in manufacturing and construction. And the financial crisis has promoted record declines in professional business and financial services, which accounted for 28% of private services payrolls at the end of 2007 and have shed 1.9 million jobs (7.2%) in the past 24 months.

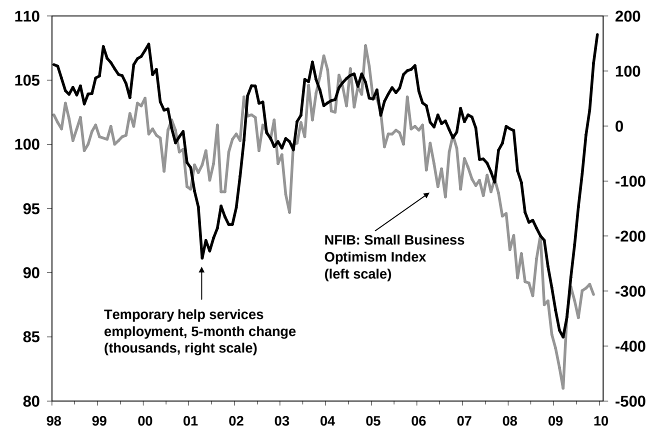
3. Global competition. Third, a more open, globally exposed economy and the outsourcing and offshoring that goes with it have changed the dynamics of domestic hiring, although evidence for direct effects of offshoring on US employment is limited to perhaps half of one percent.[2]

4. Coming demographic change. Fourth, the longer-term unemployment–economy relationship will probably change further as a slower-growing, aging population depresses labor-force participation.[3]

Metrics for improvement. Despite all these headwinds, several advance labor-market indicators signal improvement in employment and hours. Notably, temporary help payrolls, often considered to be a leading indicator of labor demand, jumped by 166,000 in the past five months, the largest such rise on record. In addition, over the past few months the levels for overall payrolls were revised up significantly from what was originally reported; upward revisions are often a sign of improvement.

Exhibit 4

Temp Worker Hiring: Both a Bellwether and a Sign of Uncertainty



Sources: National Federation of Independent Business, Bureau of Labor Statistics

Other leading indicators are also looking up: Initial and continued claims for unemployment insurance benefits have declined steadily since peaking in June, although the decline in the latter overstates the improvement in labor markets because many unemployed workers have exhausted their regular benefits. The rise in federally-funded emergency benefits has mostly offset the decline in regular jobless pay (see box for discussion). The employment components of the two ISM Indexes and stability in the private job openings rate over the past four months now seem consistent with gains in payrolls. Surveys of hiring and hiring plans such as those from our own Business Conditions Survey (the MSBCI) and Manpower, Inc.

[1] See Sarah Reber and Laura Tyson. "Rising Health Insurance Costs Slow Job Growth and Reduce Wages and Job Quality. Working paper, University of California at Los Angeles, August 2004.

[2] See Mary Amiti and Shang-Jin Wei, "Service Offshoring, Productivity, and Employment: Evidence from the United States," IMF Working Paper 5/238, December 2005.

[3] See Stephanie Aaronson, Bruce Fallick, Andrew Figura, Jonathan Pingle, and William Wascher, "The Recent Decline in Labor Force Participation and its Implications for Potential Labor Supply," March 2006, Brookings Panel on Economic Activity.

in the past three months improved noticeably (for more details, see "Business Conditions: Encouraging Outlook for 2010," December 11, 2009). Importantly, factory regular and overtime hours have risen steadily since the spring. That is good news for income, which turned up 0.3% in November, and we expect hearty gains to continue in Q1.

More stimulus coming. Improvement or not, today's 10% unemployment rate is likely to spur policymakers to consider new measures to stimulate job creation. For example, after the September jobs report, talk of enacting a new job tax credit surfaced in Washington. We believe that such a measure — if designed correctly — could be an important temporary source of effective stimulus. However, tax credits are politically unpopular. More likely is a package like the Jobs for Main Street Act of 2010, passed by the House in December. It included extension of COBRA insurance subsidies to 15 months, extension of unemployment insurance benefits, $40 billion of transportation infrastructure outlays, $5 billion for energy/water projects, $27 billion for education grants, and $2 billion for public housing. Such measures won't boost employment significantly, but they would be a plus.

Census a boon but still a moderate recovery. As Dave Greenlaw outlines below, hiring of census workers will boost payrolls temporarily in 2010, perhaps as soon as next month. Yet the underlying employment recovery is still likely to be moderate for three reasons: The economy itself still faces headwinds; companies are still determined to boost productivity in the face of the four factors discussed above; and uncertainty about labor costs, especially healthcare, may still restrain hiring.

Say Hello to the Census Effect

David Greenlaw (New York)

To help conduct the census, the federal government hires hundreds of thousands of temporary employees. The census effect was not a factor in December's employment report, but it is likely to attract a good deal more attention over the course of coming months. Every ten years, the US Census Bureau takes a snapshot of the population, determining how many people reside within the nation's borders, who they are, and where they live. The results of the census help determine the make-up of the Congress and the apportionment of public expenditures.

Conducting the census requires the federal government to hire a large number of temporary employees. In fact, beginning with the 2000 Census, the number of workers was far larger than in the past (even after adjusting for the increase in the overall population). This reflected a court ruling which prohibited the Census Bureau from using statistical sampling techniques and adjustments that had been previously utilized to account for certain types of nonrespondents. In other words, the Census Bureau now must perform a "hard" count — and can't rely on any estimates. The 2010 census forms will be distributed beginning in mid-March and the forms must be returned by April 21. The bulk of the Census-related hires will show up in May when the door-to-door search for nonrespondents gets underway. Most jobs will last for 6 to 10 weeks and pay $10 to $20 per hour depending on the location.

As seen in the table below, we expect the number of census workers to build gradually in the months ahead and peak in May (note that the figures shown for 2010 are our own preliminary guesstimates). The BLS will provide a tally of the number of net new census workers in each monthly employment report, so the impact of this special factor can be quantified precisely — but only after the fact.

We derive our estimates using the Census Bureau's stated objective of hiring 1.2 million individuals to conduct the 2010 Census. We convert this to an estimated impact on payroll employment based on past experience. For example, the government hired 965,000 individuals to conduct the 2000 Census, and the maximum impact on the level of employment in any given month was 530,000. In the 1990 Census, the government hired 550,000 individuals, and the maximum impact in any single month was 335,000. The discrepancy between the announced number of hires and the impact on payrolls reflects the fact that not all of the positions overlap and there are probably some multiple job holders. So, for 2010, we converted the total targeted hiring of 1.2 million to a peak impact of about +700,000 on the level of employment. Then we phased in the hiring and separations according to our assessment of past patterns.

The unemployment rate is also likely to be affected by census workers, but it will be impossible to calculate the precise magnitude (even after the fact) because we won't know how many of the workers are new entrants to the labor force and how many are multiple job holders. However, we can provide some rough parameters. Under the extreme assumption that all census workers are job finders (i.e., individuals previously counted as unemployed), the impact on the unemployment rate would peak at about -0.50 percentage point. Under the more realistic assumption that about 1/3 of the workers are job finders, 1/3 are new entrants and 1/3 are multiple job holders, the peak impact on the unemployment rate should be only about -0.15 percentage point. Of course, these effects will eventually wash away, and if past patterns hold, we should get relatively "clean" readings for the unemployment rate by October.

Exhibit 5

Monthly Change in Census Workers (000's, NSA)

	1990	2000	2010e
Jan	0	17	25
Feb	11	27	35
Mar	53	95	100
Apr	85	27	125
May	182	349	425
Jun	-84	-225	-250
Jul	-72	-73	-150
Aug	-98	-86	-150
Sep	-37	-122	-100
Oct	-17	-13	-30
Nov	-8	-5	-10
Dec	-6	-5	-10

Source: Bureau of Labor Statistics (w/ MS estimates for 2010)

Will the real jobless tally please stand up?
The number of people receiving benefits under regular unemployment insurance programs has dropped sharply from its peak of 6.9 million at the end of last June, signaling improvement in labor markets. This standard continuing claims series declined to a seasonally-adjusted level of 4.802 million in the week ended December 26 — the lowest level since January of last year. However, this metric clearly overstates the improvement, because many workers have exhausted their regular unemployment benefits.

Additional series track extended benefits offered to such workers under two federal programs.[4] The number of people receiving benefits under such programs has surged to 5.4 million in the week ended December 19 (these data are not seasonally adjusted and are reported with a lag of an additional week) from zero last January. In the week ended December 19, the number of benefit recipients under the two extended programs rose by 165,000, and the net increase was revised sharply higher in the preceding week — from 199,000 to 658,000.

It is clearly important to account for both of these developments to assess the state of labor markets. Indeed, the opposing movement of continuing claims compared with Emergency Unemployment Compensation (EUC) benefits makes it tempting to add the two together to arrive at a total pool of unemployed. The result would be a much more dire picture of job market stress and slack in labor markets. But there are two reasons why such a procedure is invalid, and such a total would significantly overstate the current weakness in labor markets:

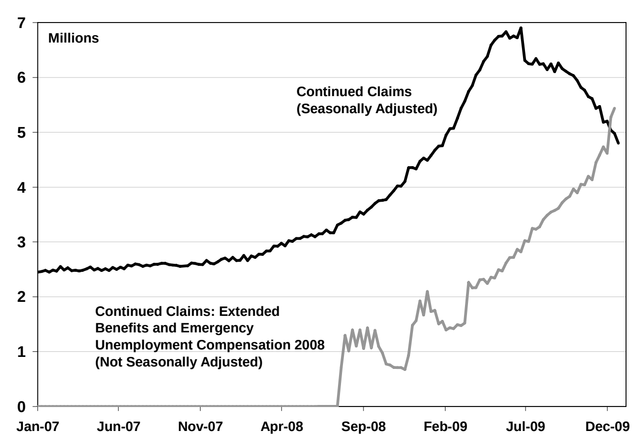
1. The extended benefits series aren't seasonally adjusted, and there is typically a seasonal surge in joblessness around the end of the year. While it is not possible to adjust these data accurately for seasonal variation because the trend is unknowable, the unadjusted data may seriously overstate the weakness. Using the seasonal factors for the standard series is also inappropriate; the seasonality in the two benefits series is not the same because the trend component of the two series is completely different. (The calculation of seasonal adjustment factors involves the decomposition of a series into its trend, seasonal and irregular components, and if the trends are different the multiplicative seasonal factors will be different).

2. More important, the EUC data overstate the weakness in labor markets because they are affected by ongoing increases in the duration of benefits. To start, the EUC program offers benefits to people who were unemployed and not covered by the standard UI program. For example, Congress retroactively extended eligibility to people who were out of work in 2006. Moreover, in most states, recipients are now eligible for 99 weeks of unemployment benefits. Even in the best of times, about 33% of recipients exhaust all the benefits that are available to them. This suggests that there is a sizeable "underground" economy in which beneficiaries will extract all available benefits. So, the extended series is unlikely to start to come down until well after the labor market has turned the corner.

The bottom line: Neither the standard continued claims data nor the extended series provide any real information content at this point and should be ignored. All of the focus should be on initial claims.

[4] Workers who have exhausted their regular state unemployment benefits are eligible for federal benefits under the Emergency Unemployment Compensation (EUC) program, created on June 30, 2008. The program initially provided 26 additional weeks of benefits, but Congress has successively added four "tiers" of extended benefits, bringing the total for regular and EUC to a maximum of 99 weeks. Last week, Congress extended the program to February 28, meaning that those exhausting regular state unemployment benefits between now and the end of February can begin receiving EUC08 benefits, and claimants receiving EUC benefits can access the next tier of the program. Both will receive benefits for an additional 14 weeks, or through mid May.

Exhibit 6
Neither Continued Claims Nor Extended Benefits Give a Clean Read on Labor Markets



Source: Department of Labor

Appendix

The equation we used to derive the estimated labor overhang predicts the change in hours worked in private nonfarm business. Errors from the equation are cumulated and scaled by hours to obtain the overhang estimates.

The equation closely follows that of Macroeconomic Advisers; see their study "Productivity and Potential GDP in the "New" US Economy." They begin with the assumption that output is a function of capital and labor inputs in a constant-returns-to-scale production function. Labor productivity — the ratio of output to labor input, or hours — can be decomposed into three components: technological improvement, which are assumed to be exogenous, the rate of growth of capital services relative to the growth of labor inputs scaled by capital's share, and other cyclical factors. Normalizing the equation on the growth of hours worked makes them a function of the growth of output, capital services, and other factors as seen below.

Dependent variable: Hours worked: private nonfarm business (1)	
Constant (c_0)	-0.006
	(-1.773)
GDP: private nonfarm business less housing (1) (γ_1)	0.862
	(14.878)
Endogenous growth rate of average labor productivity (γ_2)	-0.012
	(-4.877)
Growth of capital services $_{t-1}$ (γ_3)	0.002
	(3.251)
Hourly compensation: private nonfarm business /	-0.444
Adjusted nonfarm GDP less housing: chain price index (1) (γ_4)	(-8.423)
GDP: private nonfarm business less housing (1) -	-0.113
GDP: private nonfarm business less housing $_{t-4}$ (1) (γ_5)	(-3.653)
GDP: private nonfarm business less housing $_{t-1}$ (1) -	-0.039
GDP: private nonfarm business less housing $_{t-5}$ (1) (γ_5)	(-2.539)
GDP: private nonfarm business less housing $_{t-2}$ (1) -	0.012
GDP: private nonfarm business less housing $_{t-6}$ (1) (γ_5)	(1.427)
GDP: private nonfarm business less housing $_{t-3}$ (1) -	0.040
GDP: private nonfarm business less housing $_{t-7}$ (1) (γ_5)	(4.968)
GDP: private nonfarm business less housing $_{t-4}$ (1) -	0.044
GDP: private nonfarm business less housing $_{t-8}$ (1) (γ_5)	(6.605)
GDP: private nonfarm business less housing $_{t-5}$ (1) -	0.025
GDP: private nonfarm business less housing $_{t-9}$ (1) (γ_5)	(2.922)
GDP: private nonfarm business less housing $_{t-6}$ (1) -	-0.017
GDP: private nonfarm business less housing $_{t-10}$ (1) (γ_5)	(-0.785)
Sum of lags	-0.047
	(-0.624)
R-squared	0.905
Number of observations	143

(1) Represents year-over-year percentage change.

January 4, 2010

Europe Economics
Transition Towards a Tepid Recovery

Morgan Stanley & Co.., Incorporated

Elga Bartsch
Elga.Bartsch@morganstanley.com

Daniele Antonucci
Daniele.Antonucci@morganstanley.com

In 2010, the European economy should transition toward a more sustainable, albeit still sub-par, recovery. We expect GDP to expand by a meagre 1.2%. The growth engine will need to shift from inventories towards final demand. This transition is unlikely to be smooth though and investors should brace themselves for potential setbacks. Our quarterly forecast profile assumes a gradual slowdown over the course of the next year.

Exit strategies from the massive monetary and fiscal stimulus will likely be the focus for investors. With a few exceptions (Spain, Ireland, Greece and the UK), we don't expect meaningful fiscal tightening in 2010 though. Monetary policy, by contrast, will likely start exiting its ultra-expansionary stance in the fall of 2010. Central banks will likely start raising rates in 2H, we think, causing higher yields and wider country spreads. Our year-end target for 10-year Bund yields is 4.5%.

The risks to our base case are broadly balanced, but uncertainty remains high. We consider four potential macro surprises that could challenge our outlook and the current market consensus: a late-cycle credit crunch derailing corporate investment, a new commodity price spike causing a deterioration in the terms of trade, ample liquidity pushing bond yields down despite rising inflationary pressures, and the emergence of serious country-specific political risks within the euro area.

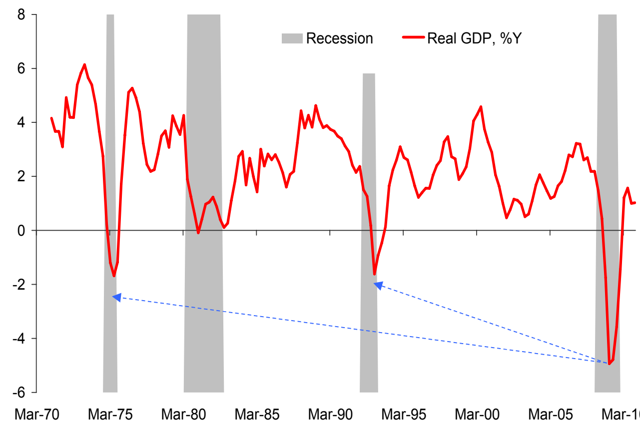
Sweden, Germany, and France to outperform EMU in terms of growth; Spain, Ireland, and Greece to underperform. Germany and Sweden have been hit hard by the global recession and benefit from larger discretionary fiscal stimulus. France has held up surprisingly well thanks to robust consumer spending and large automatic fiscal stabilizers. In Spain, more rebalancing and retrenchment lies ahead, while Italy should still struggle in the aftermath of the crisis.

Key Macro Trade Ideas for 2010

- Prefer equities over bonds and credit in early 2010
- Position for higher bond yields, wider spreads
- Still constructive on credit, notably financials
- EUR to head lower vs. USD, GBP and SEK

Source: Morgan Stanley Research. For more details see page 3 of this report.

Deep recession followed by a tepid recovery



Source: OECD, Eurostat, Morgan Stanley Research

European GDP Growth Forecasts at a Glance

	2006	2007	2008	2009E	2010E	2011E
EU-15	3.1	2.7	0.5	-4.1	1.2	1.2
EMU	3.1	2.7	0.5	-4.0	1.2	1.1
Austria	3.5	3.5	2.0	-3.5	1.4	1.4
Belgium	3.0	2.6	1.0	-2.8	1.0	1.4
Denmark	3.3	1.6	-1.2	-4.6	1.1	1.6
Finland	4.9	4.1	1.1	-7.5	1.5	1.7
France	2.4	2.1	0.6	-2.3	1.8	1.4
Germany	3.2	2.5	1.3	-4.9	1.9	1.2
Greece	4.5	4.5	2.0	-1.0	0.3	1.1
Ireland	5.4	6.0	-3.0	-7.5	-2.5	1.4
Italy	3.5	1.5	-1.0	-4.7	1.2	1.2
Netherlands	3.4	3.6	2.0	-4.0	0.8	1.2
Portugal	1.4	1.9	0.0	-2.8	1.7	2.0
Spain	4.0	3.6	0.9	-3.6	-0.7	0.8
Sweden	4.2	2.7	-0.3	-4.5	2.4	2.2
UK	2.9	2.6	0.6	-4.5	1.2	1.4

E = Morgan Stanley Research estimates
Source: National Statistics, Morgan Stanley Research

An Economy in Transition

We look for more sustainable but sub-par 1.2% GDP growth in Europe. Monetary and fiscal policy will move from triage treatment towards long-term rehabilitation. Exit strategies will become a focus for financial markets.

ECB, BoE, and Riksbank will likely raise rates in 2H. We expect the ECB and the Riksbank to hike by 50 bp and the BoE by 75 bp, causing higher yields and wider spreads. Our target for 10-year Bund yields is 4.5%.

Risks to our base case are balanced, but uncertainty remains high. Credit availability, commodity prices, inflation expectations embedded in bond markets and political issues are key risk factors.

In 2010, the European economy should transition towards a more sustainable, albeit still sub-par, recovery. This economic transition will be reflected by a shift in the engines of growth from a swing in the inventory cycle towards an ongoing recovery in domestic demand and net exports. This transition is unlikely to be smooth, though. Hence, investors should brace themselves for potential setbacks in the course of the next few quarters. Our own quarterly forecast profile suggests a gradual slowdown in growth momentum over the course of next year. Until some domestic demand dynamics start to materialise, the European economy remains in what could be called the *no man's land* of the business cycle.

Monetary and fiscal policy decisions to move from triage treatment towards long-term rehabilitation, we think. Thus, exit strategies will likely be a focus for financial markets. With a few exceptions (the UK, Spain, Ireland and Greece), we don't expect any meaningful fiscal policy tightening next year. Hence, the fiscal policy issue is mainly about preparing the budgets for 2011 and beyond. These are likely to bring more meaningful tightening in order to ensure a return to fiscal sustainability over the medium term. As such, they will be key in shaping medium-term growth expectations too. Monetary policy, by contrast, will likely start exiting its current ultra-expansionary stance in late 2010. The anticipation of the new tightening cycle should cause higher bond yields and wider country spreads.

From an inventory-led bounce in industrial activity to a broader demand-based recovery. As expected, the European economy emerged from recession in mid-2009. The trigger was a turnaround in the inventory cycle, a normalisation in global trade flows and a policy-induced stabilisation of the financial system. With the global economy clearly having turned the corner courtesy of buoyant growth in emerging markets, and with the euro's unrelenting ascent having been stopped for now, a revival in external demand is already coming through in the quarterly GDP reports. The key question for 2010, however, is whether the initial spark that ignited the engine will translate into a broader domestic demand recovery. Until these domestic demand dynamics materialise, the European recovery remains vulnerable. There is no mistaking the considerable headwinds still faced by both consumers and corporates. After a steep decline in 2009, we therefore look for what is probably best described as a stabilisation in domestic demand.

Investment spending still struggles with subdued capacity utilisation and what companies argue are tight financing conditions. Yet, rising business confidence and rebounding corporate profits should suffice to create a small rise in machinery and equipment investment – consistent with repair and replacement and possibly some rationalisation projects – in the course of the year. Construction investment is a much more diverse story, driven by local property prices, public infrastructure projects and excess capacity issues. Public construction investment aside, we expect construction investment to lag behind capital goods investment next year. For the year as a whole, investment spending will likely stagnate due to a negative statistical overhang from 2009.

Exhibit 1

Euroland -- Main Macro Forecasts, 2006-2011E

% yoy (unless otherwise indicated)	2006	2007	2008	2009e	2010e	2011e
GDP	3.1	2.7	0.5	-4.0	1.2	1.1
Private Consumption	2.1	1.6	0.3	-1.0	0.0	0.7
Gross Fixed Investment	5.5	5.1	0.1	-10.2	-0.4	1.7
Machinery & Equipment	7.3	8.3	1.2	-18.4	0.6	2.9
Construction	3.9	2.7	-0.9	-4.3	-1.4	0.6
Inventories (1)	0.1	0.0	0.0	-0.7	0.2	0.0
Net Exports (1)	0.2	0.4	0.0	-1.2	0.6	0.0
Final Domestic Demand (1)	2.8	2.5	0.6	-2.3	0.3	1.1
Employment	1.8	1.9	0.9	-1.6	-1.2	0.0
Unemployment Rate (% of labour force)	8.4	7.5	7.6	9.4	10.4	10.4
Compensation per Employee	2.3	2.6	3.3	1.5	1.8	1.5
Unit Labour Costs	1.0	1.8	3.7	3.9	-0.6	1.2
Gross Operating Surplus	5.8	6.0	2.4	-6.9	2.6	4.5
Inflation (HICP)	2.2	2.1	3.3	0.4	1.3	1.5
Savings Ratio (% of disposable income)	12.9	14.2	14.1	14.5	15.4	15.5
Current Account (2)	-0.1	0.2	-1.5	-0.6	0.5	0.7
Budget Balance (2)	-1.3	-0.6	-2.2	-5.6	-7.1	-6.2
Public Gross Debt (2)	68.6	69.3	72.6	81.3	87.6	90.9

(1) Contribution to GDP growth
(2) % of GDP
e = Morgan Stanley Research estimates; Source: Eurostat, ECB, Morgan Stanley Research

Key Macro Trade Ideas for 2010

Equities: Our European equity strategy team thinks that equities will rise further near-term, but expects MSCI Europe to end 2010 at 1030, 5% down for the year – courtesy of a consolidation in markets associated with the start of tightening and its impact on 2011 growth. Reliable growth and inflation hedges are the main themes for 2010 – the three largest OWs are Energy (+3), Materials (+2) and Staples (+2). For details see *Euroletter – Tougher Times in 2010, November 30, 2009.*

Interest rates: The main theme for interest rate markets is that stimulus and market support facilities will be removed. This is likely to be an uneven process and produce unsynchronised movements in rates. Preferred trades include: Duration – most bearish on EUR 30y and 20y Gilts. Curve – The forward curves should steepen; recommend 2y forward 2s10s steepeners and to buy the belly of the 2s5s10s. Spreads – sovereign CDS asset swap basis in Europe should trade with a widening bias as CDS curves steepen; peripheral spreads should tighten to core. Inflation – large portions of the inflation market are not yet back to 'business as usual'; the team recommends positioning for further normalisation. For details see *2010 Global Interest Rate Outlook – The World Is Uneven, November 30, 2009.*

Credit: Our credit strategy team thinks that, although 2009 was the best year on record for credit by a large margin, the asset class will continue to outperform risk-free rates. Valuations are still historically cheap, fundamentals will improve, and technicals should stay supportive. Within both investment grade and high yield the team recommends buying the tails. Other key trades include long financials as banks continue to shrink balance sheets in the US and Europe, creating a positive technical (reducing funding need) and fundamental (improving capital ratios) backdrop. Financials also trade at historically wide discounts to nonfinancials globally For details see *2010 Global Credit Strategy Outlook – Keep Calm and Carry On, December 11, 2009.*

FX: The main FX call revolves around a rebound in the USD in 2010, as US GDP growth looks set to outpace that of most other developed economies and the Fed exits its super-accommodative stance. Against this backdrop, the team expects a 9% rally in the trade-weighted USD against the major currencies in 2010. In particular, the team projects a 5% decline in EUR against a broad basket of the euro area's main trading partners and sees EUR/USD at 1.32 at end-2010. Among their top trade ideas, our FX strategists recommend short EUR/USD, as rate and growth differentials favour the US. For details see *FX Pulse: Good Night, and Good Buck, FX Pulse, December 17, 2009.*

Consumer spending is to be dampened by a rise in unemployment, modest gains in wages and an increase in inflation. True, in terms of their debt load, balance sheets and savings rate, European consumers are in better shape than their US and UK counterparts. But the lower number of layoffs recorded in Europe since the start of the recession suggests that part of the labour market adjustment is still to come – after all, activity shrank more sharply on this side of the Atlantic. Thus far, tighter employment legislation, voluntary labour hoarding and government-sponsored short-shift programmes have prevented an adjustment in labour costs. We see payrolls being trimmed further and expect the EMU unemployment rate to rise well into 2H10. Against this backdrop, and factoring in the expansionary fiscal policy measures taken by several governments, we forecast broadly stable consumer spending for 2010. After what likely will be a marked contraction in 2009, a stabilisation can already be regarded as an achievement in itself.

After a marked divergence in growth between countries in 2009, we expect to see some renewed convergence in 2010. We expect export-oriented countries with sizeable industrial sectors, such as Germany and Sweden, to outperform in terms of headline GDP growth. However, the bigger bounce-back partially reflects that they were hit harder by the global trade slump than many of their counterparts. We expect other countries, such as Spain and Ireland, which were hit hard by the financial crisis, to continue to underperform as they work their way through the aftermath of a property price bubble, a construction boom and a savings-investment imbalance. Both are making good progress though in rebalancing their economies and should be able to return to positive GDP growth in 2011.

We expect the ECB, the BoE and the Riksbank to start raising rates gradually in 2H. In total, we expect the ECB and the Riksbank to hike by 50bp and the BoE by 75bp by the end of next year (see *UK Economics: Later Rate Rises*, December 2, 2009). In conjunction with raising rates, central banks will also begin to unwind their quantitative easing (QE) measures. This unwinding might at least partially precede the first interest rate hikes, but will unlikely be completed before the start of the new interest rate tightening cycle (see *EuroTower Insights: Executing the Exit*, November 11, 2009). The details of the unwinding of QE are largely determined by the QE strategy pursued during the crisis. The ECB and the Riksbank have resorted to *passive QE* via their various refi/repo operations. Hence, unwinding QE will affect the banking system directly and asset markets indirectly. Meanwhile, the BoE pursued a strategy of *active QE*, where it purchased assets directly in the open market. Unwinding these measures will thus likely affect markets more directly and banks more indirectly.

At this stage, there has been little indication that unwinding of QE or rate hikes are imminent. The ECB signalled that it is no longer willing to offer one-year funding at a fixed rate of 1% – instead opting for a tracker rate reflecting the average refi rate in 2010 – and that it will phase out its one-year and its six-month LTROs next year. The cornerstone of the ECB's QE, the fixed-rate tenders with full allotment (which allow the banking system to draw down unlimited funds from the ECB), will remain in place for as long as it takes though – at least until spring 2010. Under this operational set-up, the overall liquidity entirely depends on the bids submitted by banks – unless, of course, the ECB takes additional action (e.g., reverse tenders). Where the EONIA overnight rate and the EURIBOR money market rates trade relative to the ECB refi rate therefore depends on these bids too. Hence, in addition to the two factors that would normally drive EONIA – the ECB's decision on the refi rate and/or the deposit rate and the ECB's liquidity provision (notably the decision to drain liquidity from the system via conducting reverse tenders or by issuing debt certificates) – we have a third risk factor: the banks' bidding behaviour. Thus far, overbidding by banks has caused excess reserves to swell and pushed market rates well below the policy rate. But this bidding behaviour could change going forward, potentially causing the market rate to jump higher.

The unwinding of QE will likely have marked effects on money markets, bond markets and country spreads. The heavy use of the ECB's refi facilities allowed banks to become big buyers of bonds. Since the start of the crisis, euro area banks have added about €330 billion to their holdings – effectively *indirect QE* via the banks. These purchases have likely helped to lower benchmark bond yields. But the main beneficiary probably was the EMU periphery. Less generous liquidity provision next year is likely to have repercussions on the euro area government bond markets. During the crisis, intra-EMU spreads were characterised by a high degree of co-movement, reflecting systemic concerns; we think that country-specific factors are likely to play a bigger role again in 2010. The start of another ECB tightening cycle should also contribute to wider spreads across the board, as it has done historically. Eligibility for the ECB's collateral pool, which is scheduled to revert back to A- at the end of 2010, could become another country-specific concern for investors in 2010.

Exhibit 2

Euroland - Interest Rate and Bond Yield Forecasts, 2009-2011E

(% per annum)	Current[1]	Mar-10e	Jun-10e	Sep-10e	Dec-10e	Dec-11e
ECB Deposit (Floor) Rate	0.25	0.25	0.00	0.25	0.50	1.50
ECB Main Refinancing (Refi) F	**1.00**	**1.00**	**1.00**	**1.25**	**1.50**	**2.50**
ECB Marginal Lending (Ceiling)	1.75	1.75	2.00	2.25	2.50	3.50
Three-Month EURIBOR	**0.72**	**0.95**	**1.20**	**1.55**	**1.90**	**2.90**
Three-Month Forward Rate		*0.81*	*1.10*	*1.42*	*1.72*	*2.57*
Two-Year Bund Yield	1.34	1.50	1.70	2.35	2.80	3.60
Five-Year Bund Yield	2.45	2.55	2.70	3.25	3.65	4.25
Ten-Year Bund Yield	**3.40**	**3.50**	**3.90**	**4.25**	**4.50**	**5.10**

E = Morgan Stanley Research estimates; [1]As of December 31, 2009
Source: Reuters, Morgan Stanley Research

Exhibit 3

Euroland – Detailed Macro Economic Forecasts 2004-2011E

Growth rates, %	2009E				2010E				2011E											
	1QE	2Q	3Q	4QE	1QE	2QE	3QE	4QE	1QE	2QE	3QE	4QE	2004	2005	2006	2007	2008	2009E	2010E	2011E
GDP Eurostat (qoq)	**-2.4**	**-0.2**	**0.4**	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**	**0.2**	**0.2**								
GDP Eurostat (qoq, annualised)	**-9.4**	**-0.6**	**1.5**	**1.4**	**1.4**	**1.2**	**1.2**	**1.2**	**1.2**	**1.0**	**1.0**	**1.0**								
GDP (yoy)	**-5.0**	**-4.8**	**-4.1**	**-1.9**	**0.9**	**1.4**	**1.3**	**1.2**	**1.2**	**1.2**	**1.1**	**1.0**	**1.9**	**1.8**	**3.1**	**2.7**	**0.5**	**-4.0**	**1.2**	**1.1**
Private Consumption (qoq, ann.)	-1.8	0.2	-0.9	0.0	0.0	0.0	0.4	0.4	0.8	0.8	1.0	1.0	**1.5**	**1.9**	**2.1**	**1.6**	**0.3**	**-1.0**	**0.0**	**0.7**
Government Consumption (qoq, ann.)	2.5	2.6	2.1	2.0	1.8	2.0	1.8	2.0	1.6	1.6	1.6	1.6	**1.6**	**1.5**	**2.1**	**2.2**	**2.1**	**2.4**	**2.0**	**1.7**
Gross Fixed Investment (qoq, ann.)	-18.3	-6.5	-1.4	0.4	0.1	0.6	1.7	1.4	2.0	2.0	2.0	2.0	**2.2**	**3.1**	**5.5**	**5.1**	**0.1**	**-10.2**	**-0.4**	**1.7**
Machinery & Equipment (qoq, ann.)	-41.1	-11.6	0.8	0.0	1.2	2.0	4.1	2.0	3.0	3.0	3.0	3.0	**3.1**	**4.7**	**7.3**	**8.3**	**1.2**	**-18.4**	**0.6**	**2.9**
Construction (qoq, ann.)	-6.5	-5.0	-2.8	-2.0	-1.0	-0.6	0.0	0.8	0.8	0.8	0.8	0.8	**1.5**	**1.6**	**3.9**	**2.7**	**-0.9**	**-4.3**	**-1.4**	**0.6**
Other (qoq, ann)	-7.8	-5.0	0.0	2.0	2.0	2.0	2.0	2.0	4.1	4.1	4.1	4.1	**2.7**	**5.5**	**6.9**	**5.2**	**1.2**	**-4.4**	**1.3**	**3.3**
Contribution to Growth																				
Inventories (qoq, ann.)	-2.9	-2.5	1.3	0.8	0.1	0.3	-0.1	0.1	0.1	-0.1	-0.2	-0.2	**0.1**	**-0.1**	**0.1**	**0.0**	**0.0**	**-0.7**	**0.2**	**0.0**
Net Exports (qoq, ann.)	-2.4	2.7	0.6	0.0	0.8	0.3	0.4	0.2	-0.1	-0.1	-0.1	-0.1	**0.2**	**-0.2**	**0.2**	**0.4**	**0.0**	**-1.2**	**0.6**	**0.0**
Final Domestic Demand (qoq, ann.)	-4.6	-0.7	-0.4	0.5	0.4	0.6	1.0	0.9	1.2	1.2	1.3	1.3	**1.6**	**2.0**	**2.8**	**2.5**	**0.6**	**-2.3**	**0.3**	**1.1**
GDP Gap (actual versus potential)													**-0.5**	**-0.5**	**1.0**	**1.9**	**0.7**	**-4.3**	**-4.1**	**-3.9**
Main Euro Area Countries																				
Germany (qoq, ann.)	-13.4	1.8	2.9	1.9	1.6	1.4	1.4	1.3	1.2	1.2	1.2	1.2	**1.2**	**0.8**	**3.2**	**2.5**	**1.3**	**-4.9**	**1.9**	**1.2**
France (qoq, ann.)	-5.5	1.1	1.1	2.4	2.0	1.8	1.6	1.4	1.4	1.4	1.2	1.2	**2.2**	**1.9**	**2.4**	**2.1**	**0.6**	**-2.3**	**1.8**	**1.4**
Italy (qoq, ann.)	-10.5	-1.9	2.4	1.4	1.2	1.2	1.1	1.4	1.3	1.2	1.0	0.6	**1.4**	**0.8**	**2.1**	**1.5**	**-1.0**	**-4.7**	**1.2**	**1.2**
Spain (qoq, ann.)	-6.3	-4.1	-1.2	-0.8	-0.4	-0.4	0.0	1.0	1.0	1.0	1.0	0.9	**3.3**	**3.6**	**4.0**	**3.6**	**0.9**	**-3.6**	**-0.7**	**0.8**
Employment, Income, Profits																				
Employment (qoq)	-0.7	-0.5	-0.5	-0.4	-0.3	-0.2	-0.1	0.0	0.0	0.1	0.1	0.2	**0.7**	**1.0**	**1.8**	**1.9**	**0.9**	**-1.6**	**-1.2**	**0.0**
Unemployment Rate, % of labour force	8.8	9.3	9.6	9.9	10.2	10.4	10.5	10.5	10.5	10.4	10.4	10.2	**9.0**	**9.0**	**8.4**	**7.5**	**7.6**	**9.4**	**10.4**	**10.4**
Compensation per Employee (qoq)	-0.1	0.5	0.4	0.3	0.6	0.5	0.3	0.4	0.5	0.4	0.3	0.4	**2.2**	**2.0**	**2.3**	**2.6**	**3.3**	**1.5**	**1.8**	**1.5**
Real Disposable Income (qoq)													**1.4**	**1.3**	**1.8**	**1.9**	**0.1**	**-0.4**	**0.8**	**0.4**
Savings Ratio (% of disposable income)													**13.6**	**13.1**	**12.9**	**14.2**	**14.1**	**14.6**	**15.3**	**15.4**
Gross Operating Surplus (qoq)													**4.6**	**4.2**	**5.8**	**6.0**	**2.4**	**-6.4**	**1.4**	**4.3**
Productivity, Costs, Inflation																				
Labour Productivity per capita (qoq)	-1.8	0.3	0.8	0.7	0.7	0.5	0.4	0.3	0.3	0.2	0.1	0.1	**1.3**	**0.8**	**1.3**	**0.8**	**-0.4**	**-2.3**	**2.4**	**1.1**
Unit Labour Costs (yoy)	6.2	5.0	3.6	1.1	-0.7	-0.9	-0.6	-0.1	0.1	0.3	0.6	0.8	**0.9**	**1.2**	**1.0**	**1.8**	**3.7**	**3.9**	**-0.6**	**1.2**
Inflation (HICP), yoy	1.0	0.2	-0.4	0.5	1.2	1.1	1.2	1.4	1.3	1.5	1.6	1.6	**2.1**	**2.2**	**2.2**	**2.1**	**3.3**	**0.4**	**1.3**	**1.5**
Core inflation, yoy	1.4	1.4	1.2	1.0	0.9	0.5	0.6	0.6	0.9	1.2	1.4	1.5	**1.8**	**1.4**	**1.4**	**1.9**	**1.8**	**1.4**	**0.6**	**1.2**
Balance Sheets																				
Current Account (% of GDP)													**0.8**	**0.2**	**-0.1**	**0.2**	**-1.5**	**-0.6**	**0.5**	**0.7**
General Government Balance (% of GDP)													**-3.0**	**-2.6**	**-1.3**	**-0.6**	**-2.2**	**-5.6**	**-7.1**	**-6.2**
General Government Gross Debt (% of GDP)													**69.8**	**70.4**	**68.6**	**69.3**	**72.6**	**81.2**	**87.6**	**90.9**
Interest and Exchange Rates																				
ECB Refi Rate	1.50	1.00	1.00	1.00	1.00	1.00	1.25	1.50	1.75	2.00	2.25	2.50	**2.00**	**2.05**	**2.80**	**3.85**	**3.75**	**1.40**	**1.15**	**2.13**
Three-Month Euro Interest Rate	1.51	1.10	0.75	0.75	0.95	1.20	1.55	1.90	2.15	2.35	2.55	2.90	**2.11**	**2.20**	**3.10**	**4.26**	**4.51**	**1.40**	**1.27**	**2.49**
Ten-Year German Bund Yield	2.97	3.30	3.20	3.20	3.50	3.90	4.25	4.50	4.65	4.80	4.95	5.10	**2.10**	**2.21**	**3.10**	**4.17**	**3.94**	**3.12**	**3.87**	**4.88**
$/Euro	1.28	1.40	1.46	1.45	1.41	1.37	1.36	1.32	1.37	1.38	1.40	1.42	**1.24**	**1.25**	**1.25**	**1.38**	**1.48**	**1.40**	**1.38**	**1.38**

Source: National Statistics, Eurostat, Morgan Stanley Research QoQ = Quarter on Quarter, YoY = Year on Year, e = Morgan Stanley Research estimates

Key Surprises for the European Economy

The consensus, and our base case for 2010, is a lacklustre, sub-par cyclical recovery, subdued consumer price inflation and a hesitant removal of policy stimulus in the second half of the year. With capacity utilisation still extremely low and unemployment set to rise until the second half of 2010, domestic demand dynamics – both consumer and investment spending – should remain muted.

But we see four potential surprises that could affect the European macro outlook in 2010: 1) a late-cycle credit crunch; 2) a new commodity price spike; 3) ample liquidity pushing bond yields down; and 4) the emergence of country-specific political risks. These surprises are designed to challenge the consensus, and, in our view, are more likely than what markets currently seem to price in.

Our base case for the euro area economy in 2010 is that of a lacklustre, sub-par cyclical recovery, subdued consumer price inflation and a hesitant removal of policy stimulus in the second half of the year. We and the consensus expect the European economy to expand by around 1% next year, thus recovering only some of the ground lost when the currency union plunged into the deepest recession in post-war history. With capacity utilisation still extremely low and unemployment set to rise until the second half of 2010, domestic demand dynamics will likely remain rather muted. Overall, we believe that the risks to our baseline forecasts are broadly balanced.

We consider four potential macro surprises that could challenge our outlook and the market consensus. The main surprise element is the qualitative direction in which they would affect the macro outlook, not necessarily the quantitative measure in which they occur. As such, they are not part of our base case and only some are among the factors underlying our bull and bear scenarios. However, none of these surprises seems to be priced into financial markets or much talked about by macro thinkers at this stage. The potential surprises include:

1. A late-cycle credit crunch seriously curtails access to bank lending in the non-financial sector.

2. Brisk growth in emerging economies and/or renewed supply setbacks causes another spike in commodity prices.

3. Ample liquidity helps to keep government bond yields subdued, notwithstanding massive debt issuance.

4. Country-specific political risks replace systemic risk concerns in driving intra-EMU spreads, but matter less than expected in the UK.

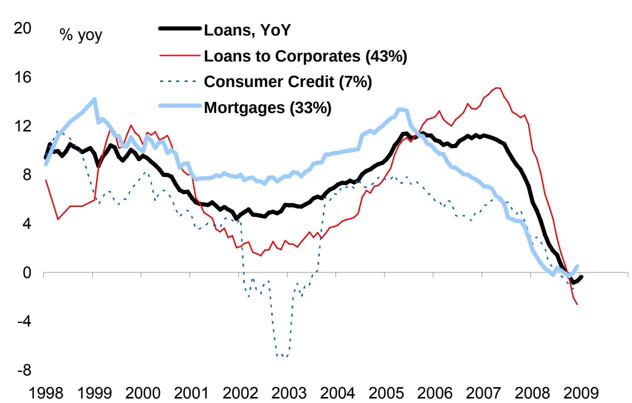
Surprise #1

A late-cycle credit crunch seriously curtails access to bank lending, causing the recovery in investment spending to falter.

A year ago, everyone (ourselves included) talked about the *credit crunch* as a serious risk to the economic outlook. But, what we were debating at the time should probably have been more accurately labelled a *liquidity crunch* for banks and corporates in funding markets. Since then, credit spreads have contracted sharply, corporate debt and more recently equity issuance have surged, and financial institutions have been propped up by a variety of government measures. Lately, euro area and UK banks have projected looser credit standards. Effective interest rates on loans have been falling for a while. Our banks team believes that the provisioning cycle has likely peaked. We ourselves have played down the fact that bank lending is falling on a year-on-year basis, arguing that much of the drop is due to a fall in demand. At this stage, this is probably largely true. But, it could change when the recovery in corporate spending gets under way. While companies will initially be able to draw on internal cash flows, eventually they will likely need external funds to bump up investment spending – even if it is largely to repair and replace – and possibly also for re-stocking. If they cannot obtain these funds, the rebound in activity following a turnaround in the inventory cycle could quickly reverse.

Exhibit 4

EMU bank lending falls. What if it plunges?



Source: ECB, Morgan Stanley Research

At this (vulnerable) stage of the recovery in euro-area domestic demand, the yet-to-be crystallised write-downs, timid recapitalisation and excessive reliance on ECB funding might backfire in a financial system that is still largely bank-based. Such a *credit crunch* could potentially be a particular problem in Germany, which ironically is the only large euro-area country that deleveraged in recent years and which – as its current account surplus shows – enjoys a funding overhang from domestic savings. A credit crunch would spell bad news for growth in the near and medium term and would likely hit investment spending hard. More prolonged feedback effects between bank profitability and economic growth in bank-based financial systems could make the credit crunch a constant feature weighing on euro-area growth in the coming years. In contrast to the earlier *liquidity crunch*, there would be little that the ECB could do, for it cannot boost banks' equity capital buffers. This would need to come from either governments or private investors. Without decisive government action, we would not be able to rule out that euro area banks just shrink their loan books.

Surprise #2

Emerging economies expanding at a brisk pace and/or renewed supply setbacks fuel another spike in commodity prices.

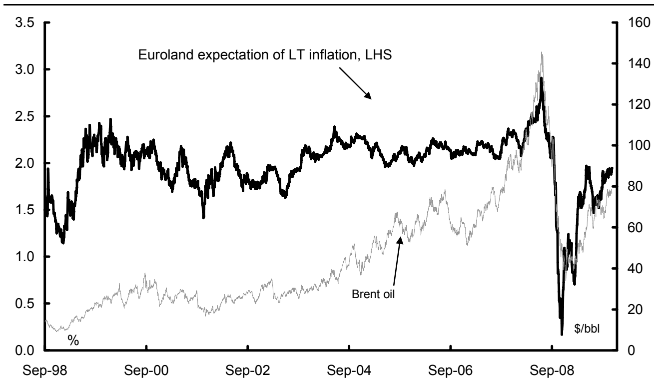
In this scenario, a spike in commodity prices would put additional pressure on companies' profit margins, eat into consumers' purchasing power and potentially force central banks to hike interest rates earlier than expected if higher commodity price inflation spills over into higher inflation expectations. As a result, the composition of nominal growth would likely become more much stagflationary again, at least initially. The commodity price spike could be triggered by further upside surprises on growth, especially in EM, on the back of the unprecedented monetary and fiscal stimulus that has been put into place globally, or by a disruption in the supply chain, say, due to geopolitical events. For example, the price of oil might rise noticeably through the $100/bbl mark, in line with our commodity strategists' bull case and above the $81/bbl implied by the forward curve. Such an overshoot would hit commodity importers particularly hard, such as virtually all the European countries with the exception of Norway and (to a much lesser degree) the UK.

Although this implies stronger European exports to commodity producers, the overall effect on economic activity would be detrimental, for three reasons. First, European companies would face significant pressure on profit margins, which are already under stress, as employment and hence labour costs have not fallen a great deal. Second, European consumers would need to tighten their belts even further, as was the case during the 2008 commodity-driven inflation shock. Third, the feed-through of higher commodity prices into inflation might push inflation expectations – which have remained relatively well-behaved for now – higher. As a result, central bankers could be forced to move earlier and more boldly than our base case forecasts show.

If central bankers didn't act to anchor inflation expectations, a sharp rise in bond yields could equally derail the recovery. In this scenario, money markets would probably start to price in earlier and more aggressive tightening, and risky asset markets would probably be affected too. A sharper tightening of monetary policy – especially if coupled with faster fiscal consolidation in the face of rising interest payments – might well push the European economy into another (this time policy-induced) recession. Eventually, the commodity price shock would likely add to renewed deflationary pressures.

Exhibit 5

Oil is seen as steady. What if it spikes higher?



Source: Bloomberg, Morgan Stanley Research

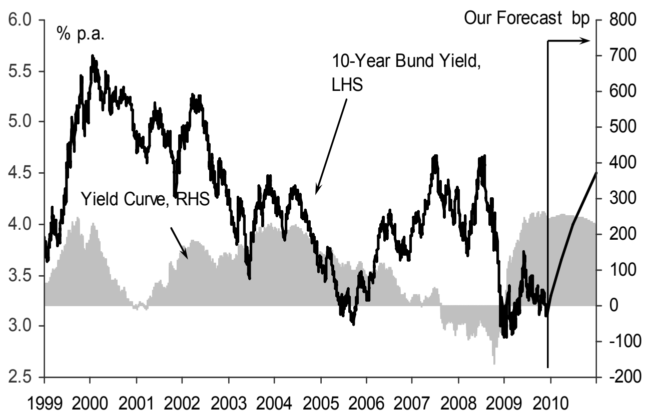
Surprise #3

Ample liquidity keeps government bond yields subdued, notwithstanding massive debt issuance.

Consensus is forecasting benchmark ten-year Bund yields to reach 3.8% in late 2010, some 60bp above the current level of 3.16%. We are even more bearish on bonds and forecast ten-year Bunds to break above 4% in 2H 2010. Our interest rate strategy team would be short the long-end and long forward-curve steepeners (see *2010 Global Interest Rate Outlook,* November 30). The reasons for rising bond yields are not difficult to find: ongoing economic recovery, abating deflation risks, and tightening monetary policy (through traditional interest rate hikes and unwinding unconventional quantitative easing).

Exhibit 6

Bund yields seen to be rising. What if they drop?



Source: Datastream, Morgan Stanley Research estimates

The wildcard in all of this is to what extent the unprecedented excess liquidity created by central banks globally in the past year and still sloshing around the global financial system could find its way into the government bond market. In the euro area, additional demand has come largely from banks, which have added €330bn to their government bond holdings since October 2008. With monetary policy still expansionary and policy rates potentially staying low for longer than our base case forecasts show, government bonds might actually be better bid. Additional demand for bonds could come from asset reallocation away from risky assets and from looming bank regulation on liquidity buffers (the latter particularly likely to provide a natural buyer of bonds in the UK). Finally, if a credit crunch causes deflationary concerns to resurface, bond yields could potentially fall further from current levels – as they did in Japan in the 1990s.

Surprise #4

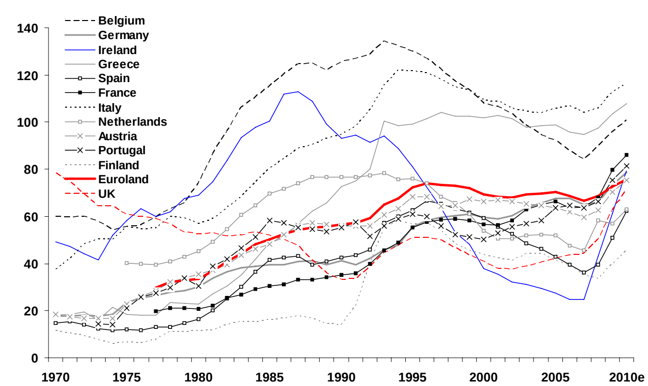
Country-specific political risks replace systemic risk concerns as a driver of spreads in the euro area.

In 2009, spreads in the euro-area periphery were characterised by a very high degree of co-movement, suggesting that systemic concerns were the main driver. Next year, the focus could swing towards country-specific issues. None of the euro-area countries has the option of inflating their way out, something that is still possible for EMU 'outs'. We would argue that the ability of countries to address the fiscal policy challenges ahead crucially depends on the institutions. Of course, these challenges also differ between countries, depending on their fiscal position before the crisis, how hard they were hit by the crisis, and the size of subsequent stimulus packages. But to what extent they can be tackled successfully will very much depend on the institutional set-up. For starters, the extent to which the electoral system generates clear political mandates to rein in budget deficits is important. Where the system generates fragmented coalitions or hung parliaments, matters become more complicated. Whether a clear mandate can be executed also depends on the degree of administrative centralisation. Countries with a federalist structure – one that grants financial independence to lower levels of the administration – might find it harder to successfully implement their budget plans (for example, Germany).

In our view, rich developed countries would only experience a sovereign debt crisis if they became unable to act because of a political stalemate or unwilling to act because the costs of doing so were deemed higher than the benefits. The latter is especially relevant within the euro area, where the disciplining effect of a potential currency crisis is absent. In this case, often a sizeable share of securities held in other euro-area countries and substantial spill-over effects onto the borrowing costs of other countries create incentives for looser policy. Outside the euro area, a sovereign debt crisis could call the independence of the local central bank into question. Within the euro area, the ECB's independence might be put to the test if the government debt of one country were to become in danger of not making the A- cut-off for eligible collateral when it reverted back to the pre-crisis pool at the end of 2010. In this case, the ECB would face a very difficult decision indeed.

Exhibit 7

Debt up everywhere – time to differentiate again?



Source: European Commission, Morgan Stanley Research; e = Morgan Stanley Research estimates

Germany – Taking a Breather Before the Budget Savings Start

Morgan Stanley & Co. International plc

Elga Bartsch
Elga.Bartsch@morganstanley.com

Key Points

Germany is likely to outperform the euro area in 2010. The outperformance is partly due to it being hit harder by the global recession and partly due to the additional fiscal stimulus being implemented. Yet, the recovery in domestic demand is likely to remain muted and tough policy decisions lie ahead.

In 2010, Germany is likely to outperform most other European countries. We expect Europe's largest economy to expand by an above-trend 1.9%, compared to only 1.2% for the euro area. Our forecasts are a tad above the current market consensus (1.7%). But contrary to many other forecasters, we expect the recovery to lose momentum into 2011; when we project growth to ease to the trend rate of 1.2%. The absence of further gains in business expectations and a marked correction in orders and production in October suggest that 3Q09 might already have been the strongest quarter in terms of growth. Germany's outperformance is partially a mirror image of it being hit much harder by the global recession due to its greater export-orientation and its bigger industrial sector. Having contracted a total 6.7% from its 1Q08 peak, German GDP will likely recover a cumulated 3.1% by 4Q10. This would leave activity still 3.6% below the peak and would close most of the gap to the euro area, where GDP should stand 3.2% below the peak, despite a more muted recovery outside Germany.

The outperformance also reflects a larger fiscal support package, which was upped again by another €8.5bn just before Christmas and now totals 2.3% of GDP – an increase of 0.8ppt over the stimulus already implemented in 2009. In addition to cutting income taxes and social security contributions, raising child and healthcare tax credits and investing more in public infrastructure, the new centre-right government decided to lower corporate taxes, raise child benefits further and extend short-shift subsidies. As a result, the budget deficit will likely increase from around 3% in 2009, to more than 5% in 2010 – which would still make Germany's budget deficit one of the lowest in the euro area! While the stimulus will help to support domestic demand, brisk headwinds still lie ahead. These stem most notably from the labour market. Thus far, the labour market has held up surprisingly well thanks to a massive extension in short-shift subsidies and, also, some voluntary labour-hoarding by companies that are concerned about a shortage of skilled workers. The main adjustment came via a marked reduction in the hours worked per employee. As these reductions weren't matched by wage cuts, unit labour costs surged. Looking ahead, we expect a marked reduction in payrolls by a total of 1.4% and a perceptible moderation in wage increases.

From an inventory-led bounce in industrial activity to a broader demand-based recovery. The lack of labour cost cutting, very low capacity utilization rates and a renewed moderation of export demand suggest to us that the recovery in investment spending will likely be muted. This holds in particular for investment in machinery and equipment, where only the phasing-out of the more favourable depreciation rules at end of 2010 add a temporary boost to an otherwise anemic recovery. Similarly, consumer spending will likely be held back by ongoing job losses, a renewed rise in inflation and the prospect of a multi-year fiscal consolidation starting in 2011. Even leaving the pay-back from the car scrapping scheme aside, purse strings will likely remain tight and savings elevated. Domestic demand should expand only moderately, after a sharp contraction in 2009. The main risk to the outlook is a credit crunch as discussed in the previous section.

German policy makers will have to make tough decisions. For starters, the draft budget for 2011 due in July will have to reconcile the election promise to cut income taxes noticeably with the need to rein in the budget deficit. Substantial budget savings are needed to comply with new constitutional "debt brake" and the European Stability and Growth Pact (SGP). In addition, policy makers will have to fend off pressure to revive the car industry, which will likely see sales falling after the end of the car scrapping scheme. Finally, the financial sector, notably the state-owned Landesbanks and savings banks, have to be put back on a healthy financial footing.

Exhibit 8

Germany - Main Macro Forecasts, 2006-2011E

	2006A	2007A	2008A	2009E	2010E	2011E
Real GDP	3.2	2.5	1.3	-4.9	1.9	1.2
Private Consumption	1.3	-0.3	0.4	0.4	-0.2	0.8
Government Consumption	1.0	1.7	2.0	2.6	1.4	1.2
Gross Fixed Investment	8.0	5.4	3.1	-9.4	3.3	2.3
Other	8.9	6.6	5.4	6.9	8.4	5.1
Exports	13.0	7.5	2.9	-15.0	5.7	3.7
Imports	11.9	4.8	4.3	-9.0	4.0	3.2
Contribution to GDP Growth (%)						
Final Domestic Demand	2.5	1.3	1.2	-0.9	0.8	1.1
Net Exports	1.2	1.7	-0.4	-3.6	0.9	0.4
Inventories	-0.6	-0.5	0.4	-0.3	0.2	-0.4
Unemployment Rate (% of Labour Force)	10.8	9.0	7.8	8.1	8.8	8.9
Real Disposable Income	1.2	0.0	0.9	0.5	0.2	0.7
Personal Saving Rate (% of Disp. Income)	10.5	10.8	11.2	11.3	11.7	11.7
Inflation (CPI)	1.6	2.3	2.7	0.3	1.1	1.5
GDP Deflator	0.5	1.9	1.5	1.5	1.3	1.6
Unit Labour Costs	-0.8	2.0	3.9	5.1	-1.7	-0.3
Current Account (% of GDP)	6.5	7.9	6.6	4.2	4.7	5.0
Public Sector Budget Balance (% of GDP)	-1.6	0.2	0.0	-3.1	-5.3	-4.6
Public Sector Debt (% of GDP)	67.6	65.0	65.9	73.1	76.7	78.8
ECB Policy Rate (%, EOP)	3.50	4.00	2.50	1.00	1.50	2.50
3-Month Interest Rate (%, EOP)	2.49	3.73	4.68	0.75	1.90	2.90
10-Year Bond Yield (%, EOP)	3.94	4.34	2.93	3.20	4.50	5.10

E = Morgan Stanley Research estimates
Source: National Statistics, Deutsche Bundesbank, Morgan Stanley Research

France – Saved by Consumers

Morgan Stanley & Co. International plc

Daniele Antonucci
Daniele.Antonucci@morganstanley.com

Key Points

Although France will continue to face several headwinds in 2010, we believe that it will expand at a faster pace relative to the euro area as a whole. Consumer spending, in particular, should remain robust.

Fiscal policy will remain expansionary this year. The so-called national loan might well boost potential growth in the long term, but will aggravate the fiscal position in the short term. The chances are that 2011 will have to see a tightening.

The French economy held up better than the euro area as a whole during the turmoil and is likely to outperform in 2010 too, although to a smaller degree relative to the previous year. This resilience is due, at least in part, to a more rigidly regulated economy. However, this will likely hamper France's long-term growth prospects. We are more bullish than the consensus for 2010, but expect the economy to decelerate in 2011. The two main themes for this year are:

1. Domestic demand will continue to face several headwinds – but will remain more robust than in the euro area as a whole: A housing market correction is now underway. We do not anticipate prices to fall as much as in hotspots such as Spain and Ireland, but with lending conditions still tight and unemployment rising the risks are skewed to the downside. More broadly, France is the major euro area country showing the biggest discrepancy between firms' assessment of order books and inventories. We believe that this gap will close in the coming quarters. This can happen in two ways. The first possibility is that demand starts to improve more visibly, in line with our base case. The second is that firms start seeing their stock of inventories less optimistically. Clearly, there are grounds to remain cautions. However, relative to the other major euro area members, as well as the consensus, we think that the stimulus put in place and some new fiscal measures augur for a better outlook, especially on the consumer front.

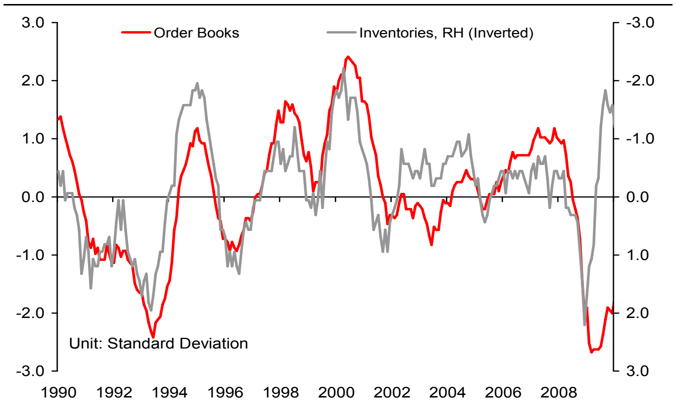
2. Fiscal policy will remain expansionary and aggravate the deficit – tightening to start in 2011: Given the size of the budget deficit, fiscal leeway will be limited in 2010. At the same time, we don't expect a tightening either, at least while the economic outlook remains uncertain.

A national loan plan called the 'Grand Emprunt' will be put in place in early 2010. The amount is around €35bn. Almost €13.5bn in state-aid repaid by the banks will be used to finance the loan. This means that approximately €22bn will be raised by tapping the market. The loan aims to fund investment in sectors that could strengthen France's competitiveness and growth potential in the long term, ranging from higher education and research, to renewable energies and digital technologies. France is pursuing supply-side policies that could even help reduce the deficit thanks to the future 'economic dividends' of a strengthened economy.

In the short term, however, the loan will weigh on France's public finances. Of course, the investments will be spread over several years, thus affecting the 2010 budget only to a limited degree. We think that the impact on government debt will amount to slightly less than 1% of GDP this year. We expect a debt-to-GDP ratio of 82.3% in 2010 and 88.5% in 2011. Although there is no indication of eventual tightening plans, we think that 2011 is likely to see the beginning of fiscal restraint.

Exhibit 9

Unprecedented gap between demand & inventories



Source: Haver Analytics, Morgan Stanley Research

Exhibit 10

France – Main Macro Forecasts, 2006-2011E

	2006A	2007A	2008A	2009E	2010E	2011E
Real GDP	2.4	2.1	0.6	-2.3	1.8	1.4
Private Consumption	2.5	2.4	1.0	0.6	0.5	0.7
Government Consumption	1.4	1.3	1.3	1.6	2.2	1.6
Gross Fixed Investment	5.1	5.0	1.3	-6.8	0.5	2.1
Contribution to GDP Growth (%)						
Final Domestic Demand	2.8	2.7	1.2	-0.7	0.9	1.2
Net Exports	-0.3	-0.9	-0.4	0.1	0.9	0.5
Inventories	-0.1	0.3	-0.2	-1.6	0.0	-0.3
Employment	1.0	1.4	0.5	-1.5	-0.6	1.2
Unemployment Rate (% of Labour Force)	8.9	8.0	7.4	9.4	10.0	8.8
Real Disposable Income	2.6	3.0	0.7	1.3	0.1	1.7
Personal Saving Rate (% of Disp. Income)	15.0	15.5	15.3	16.0	16.1	16.0
Inflation (CPI)	1.7	1.5	2.8	0.1	0.8	1.6
Unit Labour Costs	0.9	0.5	2.4	3.6	-0.6	-0.8
Current Account (% of GDP)	-0.5	-1.0	-2.3	-2.6	-2.2	-1.8
General Government Balance (% of GDP)	-2.3	-2.7	-3.4	-8.3	-8.1	-7.2
General Government Debt (% of GDP)	63.7	63.8	67.4	76.7	82.3	88.5
3-Month Interest Rate (Euribor, %, EOP)	2.49	3.73	4.68	0.75	1.90	2.90
10-Year OAT Yield (%, EOP)	3.67	4.17	3.55	3.44	4.79	5.55

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

Italy – The Aftermath of the Crisis

Morgan Stanley & Co. International plc

Daniele Antonucci
Daniele.Antonucci@morganstanley.com

Key Points

Italy's trend growth is likely to have decreased further – courtesy of the impact of the recession. This implies a lower pace of growth of aggregate corporate profits in the long term.

We expect inflation to remain subdued in 2010, but we don't see outright deflation as a real possibility. In our view, price pressures will emerge sooner rather than later.

The debt-to-GDP ratio will increase further. But that's not a reflection of fiscal profligacy. Italy's fiscal prudence during the crisis should provide markets with some reassurance.

Like other advanced economies, Italy is now expanding again. However, the main issue for 2010 relates to how quickly and to what extent the country will recover, for three reasons:

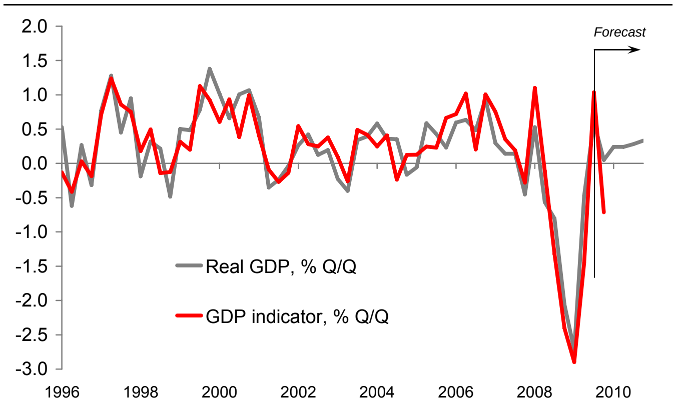
1. Trend growth will be lower than before the crisis: We think that the economic fallout of the financial crisis damaged both labour productivity and the labour force (see *Italy Economics: Assessing the Damage*, October 26, 2009). We estimate that Italy's potential growth rate will be negative this year, and average 1% between 2011 and 2014 – below our pre-crisis estimate of 1.2%. The main takeaway for investors is that extrapolating into the future the pre-crisis growth rate of potential GDP might be too optimistic. If the recession lowered the pace at which the Italian economy can sustainably expand, as we believe, the rate of growth of aggregate corporate profits, over the long term, will be lower too.

2. Period of disinflation ahead, but price pressures might emerge sooner than later: Lower trend growth implies a smaller output gap relative to the pre-crisis baseline scenario. Indeed, the standard measures of the output gap, taken at face value, point to outright deflation. We disagree with that view. If the economy's productive capacity has been damaged by the recession – as we believe – the output gap might not be as big as these calculations suggest. In turn, this implies weaker deflationary pressures. We do believe that the country is likely to go through a prolonged period of disinflation. However, we expect price pressures to emerge sooner rather than later and we maintain our above-consensus call on inflation.

3. Limited ability to carry a higher debt load, but Italy's fiscal prudence during the crisis augurs well: We think Italy's likely return to a slight primary budget surplus, i.e. a surplus in the budget balance excluding interest payments, will help sustain a high and rising debt burden. However, for a swifter reduction of the debt-to-GDP ratio the rate of nominal GDP growth should be higher than the interest rate that Italy has to pay on its debt. With potential growth even more subdued than before, bringing down the public debt to an acceptable level will be more difficult. The good news is that markets don't seem excessively concerned about Italy's fiscal situation – owing to the fiscal prudence the country showed during the crisis.

Of course, none of this means that Italy will not continue to recover: we expect an expansion of around 1.2% in 2010, some 0.4ppt above the consensus view. The short-term outlook, however, remains challenging. After considerable disappointment in the industrial production numbers over the past couple of months, an economic 'double dip' at the turn of the year cannot be ruled out. Indeed, while this is not our central scenario, our GDP indicator – which is based on a numbers of indicators ranging from industrial production to the yield curve – does suggest that this is a real possibility.

Exhibit 11
Risks of an economic 'double dip'?



Source: Haver Analytics, Morgan Stanley Research estimates

Exhibit 12
Italy – Main Macro Forecasts, 2006-2011E

	2006A	2007A	2008A	2009E	2010E	2011E
Real GDP	2.1	1.5	-1.0	-4.7	1.2	1.2
Private Consumption	1.2	1.2	-0.9	-1.6	0.7	0.4
Government Consumption	0.5	1.0	0.6	1.7	1.4	1.2
Gross Fixed Investment	3.2	1.6	-2.9	-12.6	-0.2	1.0
Construction	1.5	0.8	-1.9	-9.8	0.5	1.0
Contribution to GDP Growth (%)						
Final Domestic Demand	1.5	1.2	-1.0	-3.2	0.7	0.7
Net Exports	0.1	0.2	0.2	-1.2	0.5	0.4
Inventories	0.5	0.0	-0.3	-0.3	0.0	0.1
Employment	2.3	1.5	1.6	-1.1	-0.3	0.2
Unemployment Rate (% of Labour Force)	6.8	6.2	6.8	7.5	8.0	7.7
Real Disposable Income	2.5	1.9	-2.2	0.5	-1.9	-0.1
Personal Saving Rate (% of Disp. Income)	15.4	14.7	15.1	17.2	14.6	14.1
Inflation (CPI)	2.1	1.8	3.3	0.8	1.1	1.5
Unit Labour Costs	2.5	2.2	2.2	6.0	-2.0	0.2
Current Account Balance (% of GDP)	-2.6	-2.4	-2.1	-2.5	-2.5	-2.5
General Government Balance (% of GDP)	-3.3	-1.9	-2.7	-4.8	-5.1	-3.9
General Government Debt (% of GDP)	106.5	103.5	105.8	114.7	117.2	117.8
3-Month Interest Rate (Euribor, %, EOP)	2.49	3.73	4.68	0.75	1.90	2.90
10-Year Bond Yield (%, EOP)	4.21	4.59	4.36	4.05	5.48	6.22

E = Morgan Stanley Research estimates; Source: ISTAT, Bank of Italy, Morgan Stanley Research

Spain – More Rebalancing and Retrenching Ahead

Morgan Stanley & Co.
International plc

Daniele Antonucci
Daniele.Antonucci@morganstanley.com

Key Points

We remain bearish on the Spanish economic outlook. We expect GDP to shrink by 0.7% next year, some 0.3ppt below the latest published consensus.

Unlike other European countries, Spain is in the midst of a structural adjustment – particularly in the construction sector. This will weigh on the economy throughout 2010 and 2011.

This adjustment is happening quite quickly. Should productivity growth continue to accelerate, Spain might become more competitive and benefit from an export-led recovery.

We have five reasons for thinking that Spain will contract outright in 2010 – unlike other major European countries – and expand far slower than the euro area as a whole in 2011 (see *Spain Economics: Finding a Balance – Where We Are, What's Next?*, November 25, 2009):

1. Stabilisation in the construction sector still far off: The construction sector is still unlikely to stabilise any time soon. With house prices overvalued by as much as 30% on some metrics, we don't expect a return to positive growth rates in construction investment until end-2011.

2. Consumer spending likely to remain anaemic: Although the job shakeout will be *sharper* but *shorter* in Spain than in the rest of the euro area, we think that a revival in consumer spending next year is too much to hope for. With wage growth set to slow further, private consumption will lack support.

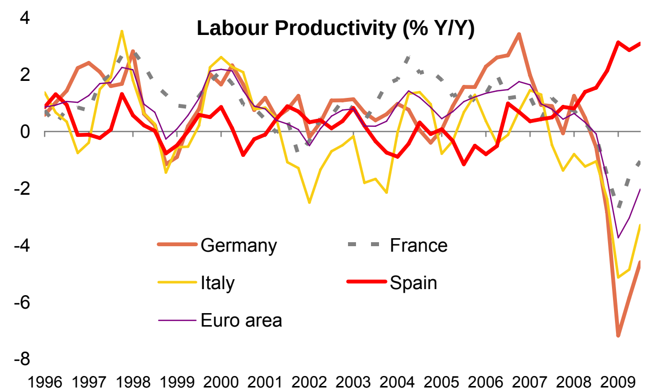
3. Private sector deleveraging to weigh on the economy: Private sector deleveraging will continue for quite some time. The pass-through of lower official and market interest rates to mortgage and corporate loan rates might provide some relief, but it is unlikely to prevent a period of belt-tightening altogether.

4. Constraints to credit availability to remain in place: Credit will continue to remain a scarce resource over the next two years. With still considerable uncertainty over potential losses, banks may remain reluctant to lend, even if the government ensures that they are well capitalised.

5. Fiscal stimulus to be scaled back this year: With a ballooning budget deficit and long-term sustainability problems in its public finances, Spain looks set to be one of the first countries in the euro area to scale back its stimulus measures. Tax hikes are on the agenda as early as next year.

The good news is that Spain's adjustment is happening at a fast pace. With GDP contracting less than employment, labour productivity growth has accelerated. If sustained, these gains will lower Spain's unit labour costs and boost export competitiveness. With export demand likely to be subdued even in our best case, this might prompt an export-led recovery further down the line and help the rebalancing of an economy that has been driven primarily by domestic factors during the boom years.

Exhibit 13
Productivity revival in Spain?



Source: Haver Analytics, Morgan Stanley Research

The main takeaway for investors is that, with its economy still out of balance Spain has to endure a *structural* adjustment. While most of its European neighbours have been affected by the same *cyclical* headwinds – from the commodity-driven inflation shock last year to the economic fallout of the financial crisis this year – they do not have to simultaneously address imbalances of the same scale. Spain looks set to be one of the last economies in the euro area to emerge from recession.

Exhibit 14
Spain – Main Macro Forecasts, 2006-2011E

	2006A	2007A	2008A	2009E	2010E	2011E
Real GDP	4.0	3.6	0.9	-3.6	-0.7	0.8
Private Consumption	3.8	3.6	-0.6	-5.0	-1.3	-0.2
Government Consumption	4.6	5.5	5.4	5.2	4.2	4.1
Gross Fixed Investment	7.4	4.9	-4.2	-16.3	-5.5	-0.7
Contributions to GDP Growth (%)	4.0	3.6	0.9	-3.6	-0.7	0.8
Final Domestic Demand	5.2	4.7	-0.6	-6.6	-1.2	0.6
Net Exports	-1.9	-1.2	1.7	3.5	1.2	0.9
Inventories	0.6	0.1	-0.3	-0.6	-0.7	-0.7
Unemployment Rate (% of Labour Force)	8.5	8.3	11.4	18.1	19.6	18.2
Inflation (CPI)	3.5	2.8	4.1	-0.3	0.6	1.4
General Government Balance (% of GDP)	2.0	2.2	-3.8	-11.1	-10.0	-9.5
General Government Debt (% of GDP)	39.6	36.2	39.5	55.0	62.1	67.0
3-Month Interest Rate (Euribor, %, EOP)	2.49	3.73	4.68	0.75	1.90	2.90
10-Year Bond Yield (%, EOP)	3.97	4.40	3.81	3.90	5.43	6.35

E = Morgan Stanley Research estimates; Source: INE, Eurostat, OECD, Morgan Stanley Research

Sweden – Still the Best Show in Town

Morgan Stanley & Co. International plc

Elga Bartsch
Elga.Bartsch@morganstanley.com

Key Points

In our view, Sweden will deliver the strongest growth in Western Europe in 2010 as monetary and fiscal policy remain highly expansionary, thus supporting domestic demand, notably consumer spending.

On our updated 2010 forecasts, we expect Sweden to deliver the strongest growth in Western Europe. Sweden returned to positive growth in 2Q09. Since then the recovery has gained momentum, most notably in 4Q09. In our view, Sweden is in better shape than most other European countries when it comes to the drivers of growth in 2010.

For starters, the policy stimulus in Sweden is very sizeable both for monetary policy and for fiscal policy with the Riksbank aiming to keep its repo rate at 0.25% until late 2010 and the government implementing additional discretionary fiscal stimulus of 1.2% of GDP in 2010. In addition, an undervalued currency boosts export demand along with the revival in the global economy. Given that industry accounts for nearly a quarter of the Swedish economy – a considerably larger share than in the UK or US – this is a key reason for the outperformance. That said, export demand is likely to be less buoyant than previous recoveries – thanks to an appreciating SEK and relatively sluggish growth in the rest of Europe.

Hence, most of the momentum will come from domestic demand. Consumer spending is being supported by low interest rates, robust real estate markets and additional income tax cuts. In addition, government spending has been upped, notably at the local level. Balance sheets, especially in the household and the government sector, are healthy and banks weathered the storm reasonably well – despite their Baltic exposure. One notable difference with the euro area is that consumer bank lending is still expanding robustly in Sweden. Sweden has experience in successfully handling a financial crisis as it eventually emerged strongly from the banking crisis of the early 1990s. This experience should have a positive impact on consumer/corporate sentiment and on policymakers' willingness to take bold actions, if needed.

Inflationary pressures will likely stay low, allowing the Riksbank to continue its extra-expansionary policy. Unemployment will likely rise further, albeit at a slower pace, and is likely to stay elevated for quite a while. With the output gap remaining wide, pricing power will likely stay low, also for trade unions representing workers in the upcoming wage talks. In addition, a stronger SEK will likely cap imported inflation pressures. Only once the Riksbank starts to hike interest rates is headline CPI likely to pick up noticeably due to the impact on the mortgage interest rate payments.

The Riksbank will only gradually remove some of its policy stimulus in the fall of 2010. We expect it to start raising rates in September 2010, slightly ahead of what its own repo rate forecast shows. As two out of six executive board members continue to expect an earlier tightening, we see little reason at this stage to alter our call for the tightening to start in 3Q10. Subsequently, we expect the Bank to nudge rates gradually higher by another 25 bp in 4Q10.

The Riksbank conducted its unconventional policy measures via its lending to the banking system. These measures will reverse quasi-automatically once the loans mature. Initially loans were offered at three and six-month maturity and later at one-year maturity as well. The Riksbank still offers these loans at a variable rate that is tracking the repo rate, but decided to stop offering fixed rate loans at the December meeting. For variable rate loans, the Riksbank has presented a timetable until the end of February.

We expect the Riksbank to gradually reduce the amount of liquidity in 2010 by allowing the existing loans to roll off. Indeed, the bank has already phased out some emergency measures. After receiving no bids in its corporate CD facility it stopped it. It also ended its USD auctions against Swedish collateral. Finally, it raised the spread for its variable rate auctions in early November, when the bank decided to raise the spread over the repo rate from 15bp to 25bp for maturities below one year and to 30bp for one-year loans. The outstanding loans to the banking system have created a structural liquidity overhang of around SEK 300bn until the fall.

Exhibit 15

Sweden -- Main Macro Forecasts, 2006-2011E

% yoy or annual average	2006	2007	2008	2009E	2010E	2011E
Real GDP	4.2	2.7	-0.3	-4.5	2.4	2.2
Private Consumption	2.5	3.1	-0.4	-0.9	1.4	1.8
Government Consumption	2.3	0.5	1.1	2.3	2.0	2.0
Gross Fixed Investment	9.5	7.7	2.2	-13.7	0.3	5.6
Net Exports (contribution)	0.9	-0.8	-0.7	-0.5	0.1	0.3
Unemployment Rate (% of labour force)	7.1	6.1	6.1	8.3	9.6	9.6
Labour Productivity	2.5	0.2	-1.5	-3.3	2.4	1.7
CPI Inflation	1.4	2.2	3.5	-0.4	1.0	1.7
Unit Labour Costs	-0.7	4.7	3.3	3.2	-0.6	0.9
Current Account Balance, % of GDP	8.5	8.8	9.8	7.9	7.5	8.1
General Government Balance, % of GDP	2.2	3.4	3.1	-1.7	-2.4	-1.8
General Government Debt, % of GDP	45.9	40.4	36.2	39.2	40.1	40.2
Riksbank Repo Rate	3.00	4.00	2.00	0.25	0.75	2.75
3-Month Interest Rate (STIBOR)	3.28	4.67	2.48	0.65	1.20	3.20
10-Year Bond Yield	3.80	4.34	2.38	3.20	4.45	5.05

E = Morgan Stanley Research estimates
Source: Statistics Sweden, Sveriges Riksbank, Morgan Stanley Research

January 20, 2010

Global Economics
Living with the Trilemma

Morgan Stanley & Co., Incorporated

Manoj Pradhan
Manoj.Pradhan@morganstanley.com

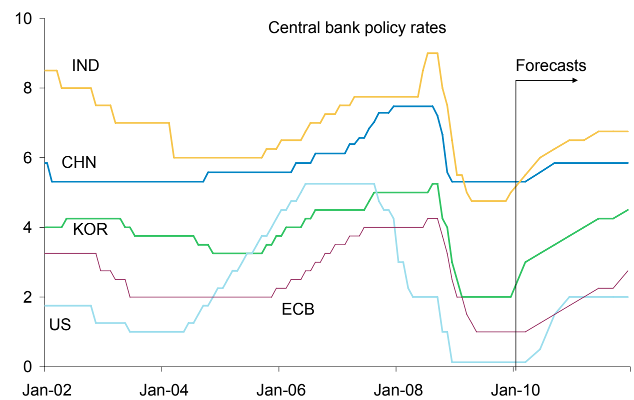
- Recent communication from the major central banks has been dovish, suggesting that an AAA (ample, abundant, augmenting) liquidity regime will remain in place for a considerable period of time. The Asia ex-Japan (AXJ) region, with its economic outperformance and 'soft pegs' for some currencies, is the natural recipient of global capital flows that result from rising risk appetite and easy monetary conditions.
- Further down the road, however, the risk is that AXJ central banks might need to raise policy rates faster than others, which could attract even more capital and put upward pressure on their currencies – the Trilemma of a Sudden(ish) Start!
- AXJ economies could either reinforce the approach they currently have in place for dealing with the Trilemma…or they could relent. Relenting may take the form of allowing their currencies to appreciate meaningfully, or for central banks there to check the rate at which they tighten policy to bring interest rates more in line with those of the major central banks, though the latter would mean less control over inflation.

Living with the Trilemma: Recent data from emerging and developed markets underscore the diverging outlook for these two economic hemispheres. While Emerging Markets (EM) have continued to show robust growth, data in many Developed Markets (DM) have disappointed, especially in Europe and Japan. Unsurprisingly, recent communication from the major central banks has been dovish, suggesting that an AAA (ample, abundant, augmenting) liquidity regime will remain in place for a considerable period of time. The Asia ex-Japan (AXJ) region, with its economic outperformance and 'soft-pegs' for some currencies, is the natural recipient of global capital flows that result from rising risk appetite and easy monetary conditions. As a response to the Great Recession, central banks the world over acted as one in slashing interest rates. Further down the road, however, the risk is that AXJ central banks might need to raise policy rates faster than others, which could attract even more capital and put upward pressure on their currencies – the Trilemma of a Sudden(ish) Start!

The Trilemma is the moniker associated with the balancing act of maintaining a currency peg, an independent monetary policy and free flows of international capital (see box overleaf for more details). A pertinent example of the logic of the Trilemma is when a central bank (typically one in EM, with a preference for avoiding 'excessive' appreciation of its currency) wants to raise policy rates to fight domestic inflation. Rising interest rates could then attract more capital flows, which would put upward pressure on the currency. Exactly this issue was echoed in the Reserve Bank of India's policy meeting in October 2009, when it expressed concern at the possibility of "perverse" capital inflows as a consequence of its efforts to ward off inflation by raising its policy rate. This is particularly interesting since India's currency enjoys considerably more flexibility than that of many of its regional neighbours whose currency values are pegged officially or unofficially to the US dollar.

A tale of two worlds…and central banks: Our base case is that AXJ economies will outperform the G10 region by a wide margin. The BBB (bumpy, below-par and boring) recovery in the major economies will assert itself by prompting central banks there to keep liquidity abundant. Our economists expect the first hikes from the Fed and the ECB to appear in 3Q10. The PBoC is expected to raise policy rates around the same time, but RBI and the BoK are expected to start hiking rates already in the current quarter (see Exhibit 1).

Exhibit 1
The Risk Is That AXJ Central Banks May Have to Tighten Earlier



Source: Haver Analytics, Morgan Stanley Research estimates

What Is the Trilemma?

The Trilemma is the moniker associated with the balancing act of maintaining a currency peg, an independent monetary policy and free flows of international capital.

In a textbook world of perfect capital flows and a fixed exchange rate, a central bank can only choose two of the three. Why? This is easiest to explain with examples. Let's label the emerging market economy as the 'domestic' economy and the country to which its currency is linked as the 'base'.

Now suppose there are strong capital inflows into the domestic economy in response to strong economic growth. The first impact is to create greater demand for the EM currency. With no capital or credit controls, these funds would flow into the banking system and then into the broader economy, augmenting growth and raising the risk of inflation. The central bank of the domestic economy, forever distasteful of inflation, would then try to raise its policy rates. In doing so, domestic interest rates would rise relative to those of the base country, triggering even more capital flows into the domestic economy. Clearly, the central bank has to either (i) directly curb capital flows through capital and/or credit controls, (ii) allow the currency to appreciate, which would reduce capital flows by reducing the expected return on these flows, or (iii) give up monetary independence and allow domestic interest rates to be completely determined by interest rates of the base country.

Evidence from the real world: In the real world, the broad story still holds, but capital flows are restricted to some extent, currencies pegs are generally 'soft' (i.e., unofficial pegs that are allowed to show some appreciation/depreciation) and central banks don't strive for complete independence from the base country as part of their monetary policy strategy. There has been some debate about whether the Trilemma is actually a valid concern in the modern era, but recent research by Shambaugh (2004) and Obstfeld, Shambaugh & Taylor (2008) suggests that the Trilemma is alive and well.

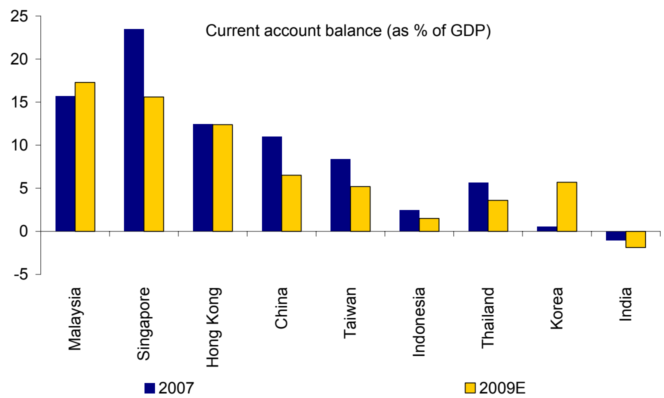
Does having a hard peg, a soft peg or a free float matter? Yes, but not as much as one might think: One would imagine that the Trilemma holds to a much greater degree for countries with a hard peg (i.e., currencies that are officially pegged), to a lesser extent for countries with soft pegs, and not at all for currencies that float freely. Obstfeld et al provide evidence that countries that peg their currencies face more constraints from the Trilemma than non-peggers do. However, the difference between hard pegs and soft pegs and between peggers and non-peggers is not as wide as it first seems in the real world. First, hard pegs are not necessarily perfectly credible, and probably never have been according to research by Mitchener & Weidenmier (2009). This brings them much closer in spirit to soft pegs, which often survive for long periods because the flexibility they provide may be seen to increase the credibility of such a regime. Finally, examples of freely floating currencies are seen mostly for advanced economies or some small EM economies.

In the aftermath of the Asian Financial Crisis of the late 1990s, EM and particularly AXJ currencies were advised to stay away from flexible exchange rates. But the evidence shows that many countries have continued to keep the currency peg with the US dollar quite stable. Calvo and Reinhart (2002) call this development the 'Fear of Floating', as a reference to the uncertainty that a freely floating currency brings to export-oriented economies that depend on international debt markets for funding.

Risks to the outlook have diverged as well: In addition, the risks for the economic outlook are skewed to the upside for AXJ economies, while they are more balanced or even to the downside for developed economies. Asset prices are high in both theatres, but the run-up in house prices in Asia has surprised many and is clearly on the radar for central banks in the region. In all, AXJ central banks face the prospect of having to tighten earlier than expected, while the risk in the major economies is that central banks leave their policy rates lower for longer than markets expect. Therein lies the risk that the Trilemma will reassert itself.

Diverging monetary policy paths are key: Such a divergence in the policy stance is then likely to trigger further capital flows into the AXJ region, putting upward pressure on currencies there. Strong domestic growth in the AXJ economies would raise the risk of inflation (already apparent in India and Indonesia) and some monetary authorities would need to respond with tighter policy. But rising rates could result in even greater capital flows and more appreciation pressure for the currencies – the Trilemma in action.

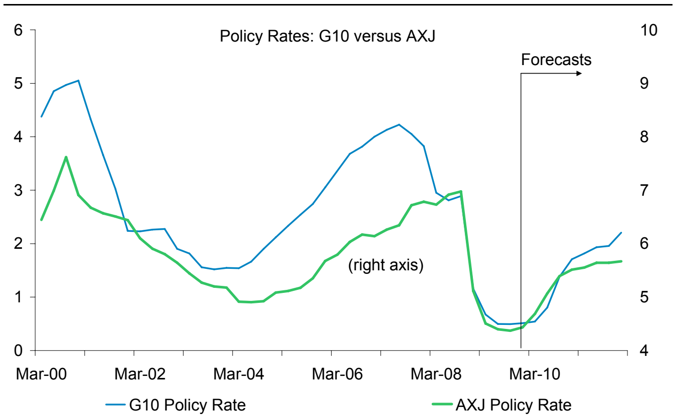
Exhibit 2
Current Account Surpluses Are Lower Today than in 2007



Source: Haver Analytics, Morgan Stanley ASEAN Economic Research estimates

Divergence and the Trilemma may show up as early as 2H10: The Trilemma is not a concern at the moment. Why? For one thing, capital flows are still not as strong as they were before the Great Recession, when the Trilemma was becoming a concern (see *Impossible Trinity Challenge Emerges Again*, Chetan Ahya, October 7, 2007). Second, AXJ countries are running smaller current account surpluses now than they were in 2007 on the back of weaker exports and stronger domestic demand (see Exhibit 2). Core inflation is still at benign levels everywhere in the region. But, most importantly, in our opinion, there is not currently a great amount of divergence in the base case for the expected monetary policy paths of the G10 and AXJ regions (see Exhibit 3).

Exhibit 3
Greater Monetary Divergence Could Trigger the Trilemma

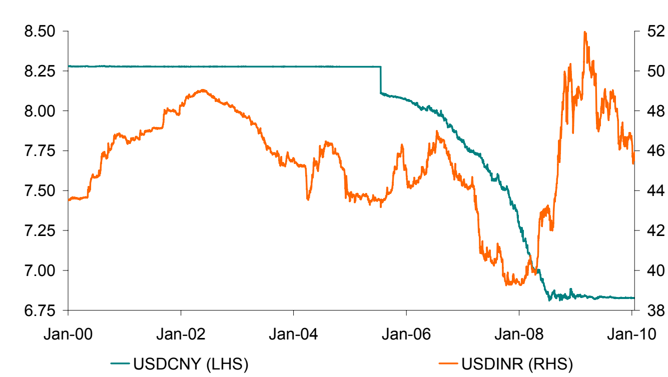


Source: Haver Analytics, Morgan Stanley Research estimates

The response to the Great Recession and to the ongoing recovery has meant that central banks all over the world have acted in a synchronised fashion. If they continue to withdraw stimulus in a synchronised manner, then AXJ central banks will be tightening policy in tandem with the major central banks. In this case, they would not need to assert monetary independence. If the Fed and the ECB start by 3Q10 as we expect, AXJ economies will inherit this tightening (see "The Peloton Holds Firm", *The Global Monetary Analyst*, November 4, 2009). But if the major central banks take on extra growth insurance by postponing rate hikes, then AXJ central banks may find themselves leading the pack and setting the stage for the Trilemma to reappear. AXJ central banks would then have to rely on the tools they have in place to ward off the trade-offs of the Trilemma…or relent.

Different tools for a common concern: The different approaches to dealing with the Trilemma are exemplified by the paths taken by the Chinese and Indian central banks. China, with its 'soft-peg' to the US dollar (see Exhibit 4) has in place capital and credit controls that neutralise the role that capital flows play in the Trilemma. This allows the PBoC to maintain the exchange rate and retain monetary independence if it needs to raise interest rates to fight inflation. The Indian rupee, on the other hand, has considerably more flexibility (see Exhibit 4), but it is difficult to believe that the RBI would be tolerant of excessive appreciation. The flexibility on the exchange rate front provides the RBI some monetary independence, and it now appears that this independence may be called into action soon to fight inflation. Indeed, our India economics team expects a kick-off to the policy rate hiking cycle at the January 29 meeting in the face of inflationary pressures. Most other countries are somewhere in between, allowing some currency appreciation already, possibly to prevent bigger issues later.

Exhibit 4
Different Approaches to Dealing with the Trilemma



Source: Bloomberg, Morgan Stanley Research

The Trilemma really kicks in only when either capital flows become excessive, or monetary policy needs to diverge meaningfully from that of the major central banks in order to fight domestic inflation. So far, capital flows into the AXJ region mean that foreign exchange reserves at central banks are rising again, but these flows have not reached levels that make them difficult to deal with. Inflation too is low almost everywhere in the AXJ region, but strong growth carries with it an inflation warning and central banks are paying attention, particularly in India and Indonesia where inflation is already a concern.

Ironically, rising inflation would help to alleviate the Trilemma somewhat. If nominal exchange rates are held steady, then a rise in inflation in AXJ economies would lead to real exchange rate adjustments which would release some pressure from the Trilemma. How? Allowing inflation to rise clearly requires less action from monetary authorities and hence reduces the need for monetary independence. But a real appreciation of the currency also reduces export competitiveness, thereby reducing the current account surplus. However, rising inflation is clearly not a preference for central banks anywhere in the world, so this manner of adjustment is unlikely to occur. Finally, a large chunk of the foreign exchange reserves that have been built up with Asian and other central banks have found their way back into developed markets, particularly the US (and to a lesser extent, the euro area) fixed income markets. As long as this recycling stays in place, it will continue to alleviate some of the pressure on EM currencies. There too, risks abound, particularly given our US team's forecast for 10-year Treasury yields rising to 5.5% by the end of 2010, creating a sell-off as yields rise from their current level of 3.7% (see *US Economics: The Case for Higher Real Rates*, Richard Berner/David Greenlaw, December 15, 2009).

What if countries do relent? "And if the cloud bursts, thunder in your ear" wrote Pink Floyd many years ago. Giving in to the demands of the Trilemma may not be quite as universally noticeable, but would certainly have quite an impact on markets. Relenting may take the form of allowing AXJ currencies to appreciate meaningfully, or for central banks there to check the rate at which they tighten policy to bring interest rates more in line with those of the major central banks, though the latter would mean less control over inflation. But investor interest is naturally particularly focused on the outlook for China. Our China economics team believes that capital controls in place in China are sufficient to allow the PBoC considerable monetary independence, and that any currency appreciation will likely only take place after interest rates have been raised (see *China Economics: RRR Hike Cycle Kicks Off Earlier than Expected*, Qing Wang, January 12, 2010). Markets also place a very low probability on a move in the renminbi. It would certainly be thunder in our ears if the Trilemma pushed monetary authorities there to allow currency appreciation sooner than expected.

January 6, 2010

Global Economics
Five Themes for 2010

Morgan Stanley & Co., Incorporated

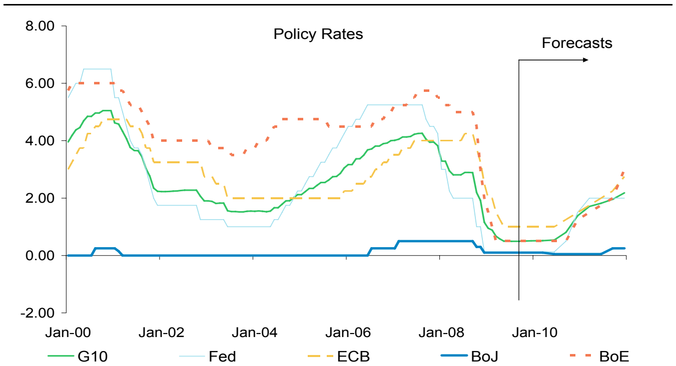
Joachim Fels
Joachim.Fels@morganstanley.com

1. **A tale of two worlds.** Growth in the emerging world becomes more balanced and will by far outpace growth in the advanced economies this year.
2. **'BBB recovery' in the G10.** We expect the recovery in the advanced economies to be creditless and jobless, making it bumpy, below-par and boring.
3. **G3 growth differentiation.** We see the US as the growth leader among the G3, the euro area to lag behind, and Japan to double-dip.
4. **'AAA liquidity cycle' remains intact.** Central banks will crawl rather than rush towards the exit, so global liquidity continues to be ample, abundant and augmenting.
5. **Sovereign and inflation risks on the rise.** The next crisis is likely to be a crisis of confidence in governments' and central banks' ability to shoulder the rising public sector debt burden without creating inflation.

From Exit to Exit

Last year was all about the exit from the Great Recession – and it worked courtesy of massive global policy stimulus, as expected. This year will be all about the exit from super-expansionary monetary policy. As we laid out in more detail in the final issue of *The Global Monetary Analyst* on December 16, we expect the major central banks to start exiting around the middle of this year (see Exhibit 1).

Exhibit 1
Official Rates to Rise from 3Q10



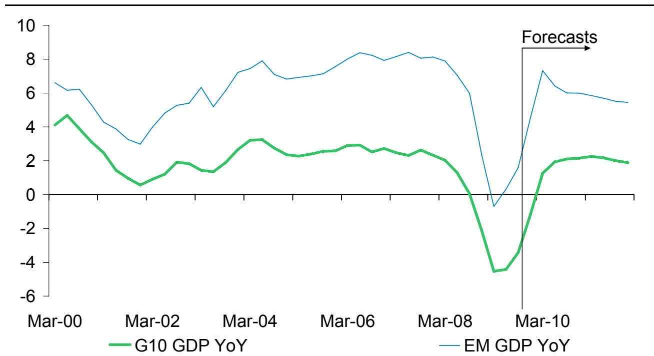
Source: Haver, Morgan Stanley Research estimates

Yes, they will likely be cautious, gradual and transparent, but the prospect and process of withdrawal may have unintended consequences: We think that government bond markets will be the first victim. While the exit will be the dominant macro theme next year, we identify five important economic themes in our global economic outlook that should be highly relevant for investors in 2010.

1. A Tale of Two Worlds

We forecast 4% global GDP growth this year, which would be a fairly decent outcome, especially compared to the doom and gloom that prevailed for much of last year. However, it falls short of the close to 5% average annual GDP growth rate in the five years prior to the Great Recession, and it will be the product of unprecedented monetary and fiscal stimulus, which poses substantial longer-term risks. Importantly, our 4% global GDP growth forecast masks two very different stories (see Exhibit 2). One is a still fairly tepid recovery for the advanced economies, the other a much more positive outlook for emerging markets, where we forecast output to grow by 6.5% this year (China 10%, India 8%, Russia 5.3%, Brazil 4.8%), up from 1.6% in 2009. A rebalancing towards domestic demand-led growth in EM is well underway. Moreover, as our China economist Qing Wang has pointed out, the official statistics are likely to vastly underestimate the level and growth rate of consumer spending in China. In short, we think that the theme of EM growth outperformance has staying power and has even been bolstered by the crisis.

Exhibit 2
A Tale of Two Worlds: EM versus G10



Global Forecasts at a Glance

%	Real GDP 2009e	Real GDP 2010e	Real GDP 2011e	CPI 2009e	CPI 2010e	CPI 2011e
Global economy	-1.1	4.0	3.9	1.9	3.0	3.3
G10	-3.4	1.9	2.1	0.0	1.7	1.7
EM	1.6	6.5	5.8	4.3	4.5	4.9

Source: Morgan Stanley Research estimates

2. 'BBB Recovery' in the G10

In contrast to our upbeat EM story, we forecast barely 2% average GDP growth in the advanced G10 economies this year – a 'BBB recovery' where the three Bs stand for bumpy, below-par and boring. On our estimates, GDP growth averaged around 2% in the G10 in 2H09 and won't accelerate much from that pace this year. The two key reasons why we think the recovery in the G10 will be 'BBB' are that it is likely to be creditless and jobless. Creditless recoveries – where banks are reluctant to lend and the non-bank private sector is unwilling to borrow – are the norm following a combination of a credit boom in the preceding cycle and a banking crisis. Creditless recoveries typically display sub-par economic growth as credit intermediation is hampered. Moreover, we expect a jobless G10 recovery, with unemployment in the US declining only marginally this year and rising further in Europe and Japan. Unemployment may well stay structurally higher over the next several years in the advanced economies as many of the unemployed either have the wrong skills or are in the wrong place in an environment where the sectoral and regional drivers of growth are shifting.

3. G3 Growth Differentiation

Beneath the surface of a lacklustre 'BBB recovery' in the advanced economies lies a differentiated story for the three largest economies – the US, Europe and Japan. Significant growth differentials between these economies in 2010 may well become a topic for currency, interest rate and equity markets again. We see the US as the growth leader among this group, with output expanding by 2.8% (annual average) in 2010. The euro area looks set to grow by less than half that rate (1.2%), while Japan should hardly grow at all (0.4%) and is forecast to actually fall back into a technical recession in the first half of this year. One reason for US outperformance is that the creditless nature of the recovery affects the US less because banks (as opposed to capital markets) play a smaller role in financing the economy than in Europe or Japan. Another reason is that US companies have been much more aggressive in shedding labour last year, so US labour markets look set to recover (albeit slowly) this year, while we expect unemployment to rise further in both Europe and Japan. Further, European and Japanese exporters should feel the pain from last year's currency appreciation, whereas US exporters should benefit from last year's dollar weakness.

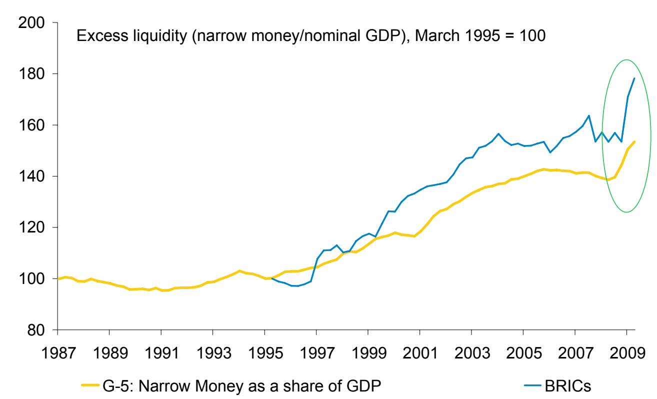
4. 'AAA Liquidity Cycle' Remains Intact

The beginning of the exit from super-expansionary monetary policies will likely be the dominant global macro theme in 2010. We expect the Fed, the European Central Bank and the People's Bank of China to move roughly in tandem and raise interest rates beginning in 3Q10, with the Bank of England following in 4Q. Some, like India, Korea and Canada, are likely to move earlier, while others, such as Japan, will lag behind. Given the remaining fragility in the financial sector, central banks are likely to approach the exit in a cautious, gradual and transparent manner, so any hikes will likely be telegraphed well in advance, partly through twists in the crafted language and partly through cautious draining of excess bank reserves.

The end of easing and beginning of exit can be expected to cause wobbles in financial markets – one reason why we see bonds selling off sharply this year. However, official rates are likely to stay well below their neutral levels throughout 2010 and, probably, also in 2011. Hence, monetary policy is only expected to transition from super-expansionary to still-pretty-expansionary. This would leave the 'AAA liquidity cycle' (*ample, abundant* and *augmenting*) – the main driver behind last year's asset price bonanza and economic recovery – fairly intact this year. The metric we follow to validate or refute this view is our global excess liquidity measure, which is defined as transaction money (cash and overnight deposits) held by non-banks per unit of nominal GDP (see Exhibit 3). This measure exploded last year, and we expect it to rise further, though at a much lower pace, through 2010.

Exhibit 3

'AAA Liquidity Cycle' to Continue



Source: Morgan Stanley Research

5. Sovereign and Inflation Risks on the Rise

We think that sovereign risk and inflation risk will be major themes for markets this year. Greece's fiscal problems are only a taste of things to come in other advanced (not emerging) economies, in our view. Fiscal policy looks set to remain expansionary in all major economies this year, as the 'BBB recovery' still requires support. However, markets are likely to increasingly worry about longer-term fiscal sustainability. The issue is not really about potential sovereign defaults in advanced economies. These are extremely unlikely, for a simple reason: Most government debt outstanding in advanced economies is in domestic currency, and in the (unlikely) case that governments cannot fund debt service payments through new debt issuance, tax increases or asset sales, their central banks can print whatever is needed (call it quantitative easing). Thus, sovereign risk translates into inflation risk rather than outright default risk. We expect markets to increasingly focus on these risks, pushing inflation premia and thus bond yields significantly higher. Put differently, the next crisis is likely to be a crisis of confidence in governments' and central banks' ability to shoulder the rising public sector debt burden without creating inflation.

Economic Update: China

Morgan Stanley Asia Limited **Qing Wang/ Denise Yam / Katherine Tai**

Overview

Real GDP growth rebounded to double-digit pace, at 10.7% YoY, the first time since 2Q08, picking up further from 9.1% (revised) in 3Q and 7.9% in 2Q. On a seasonally adjusted basis, sequential QoQ growth softened a tad further nevertheless, to 2.0% (+8.2% annualized), from 2.5% in 3Q and 4.4% in 2Q. For the full year, the Chinese economy grew 8.7%; although marginally lower than our 9% forecast, the pace was undoubtedly robust. We believe the moderation in sequential momentum, as well as the authorities' pledge on policy continuity and stability should help ease fears of an imminent shift in policy stance towards aggressive tightening. The moderation in industrial output and fixed asset investment reaffirm our view that growth is becoming more balanced, hence, reducing the risk of drastic policy tightening. Meanwhile, retail sales picked up significantly in December, although the acceleration was partly driven by higher prices. CPI inflation surprised on the upside but was attributable entirely to food, whilst non-food inflation still fell below expectations. Rebalancing of growth is underway. Aggressive policy stimulus has successfully decoupled China from the deep recession in the developed markets in the aftermath of the late-2008 financial crisis. The strong economic rebound, which commenced and was primarily policy driven in 2Q09, has been sustained into 4Q09 and has become more balanced between domestic vs. external, public vs. private growth drivers.

YoY, %	3Q09	2Q09	YTD 09	2008
Real GDP	+8.9	+7.9	+7.7	+9.0

Output, Inflation, Trade, Sales, Investment, and FDI

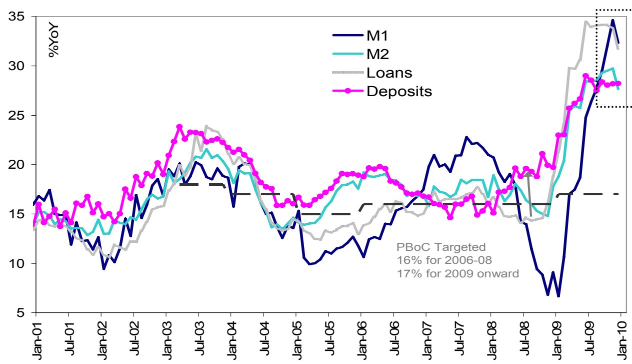
YoY, %	Dec 09	Nov 09	2009	2008
Value-added Industrial Output		+19.2	+10.3	+18.5
CPI		+0.6	-0.9	+5.9
PPI		-2.4	-6.1	+3.1
Trade Balance, US$ bn	18.4	19.1	196.1	295.5
Exports	+17.7	-1.2	-16.0	+17.2
Imports	+55.9	+26.7	-11.2	+18.5
Retail Sales		+15.8	+15.3	+21.6
FDI Utilized, US$ bn	12.1	7.0	90.0	5.3
YoY % Change	-44.5	+32.0	-16.9	+29.7
Urban Fixed Asset Investment		+24.3*	+32.1	+26.1

Money Supply and Reserves

	Dec 09	Nov 09	Oct 09	Sep 09
M2, YoY, %	+27.7	+29.7	+29.4	+29.3
Total Deposits, YoY, %	+28.8	+30.7	+30.6	+30.3
Savings Deposits, YoY, %	+19.7	+20.0	+21.8	+24.9
Loans at all FIs, YoY, %	+31.7	+33.8	+34.2	+34.2
Foreign Reserves, US$ bn	2,399	2,389	2,328	2,273

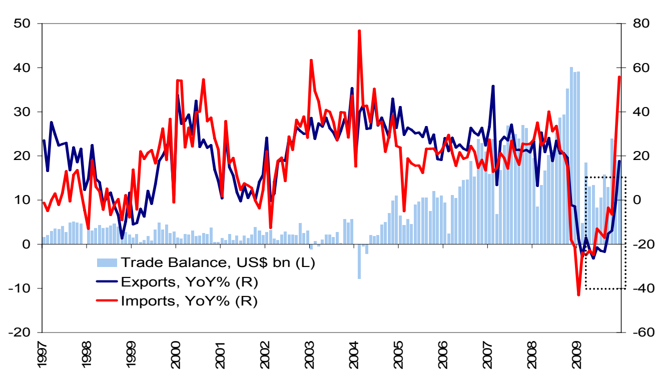
* Morgan Stanley Research estimates Source: CEIC, NBS, Morgan Stanley Research

Monetary Normalization Continues in December: New loan creation rebounded somewhat to Rmb380bn from Rmb295bn in November. For the full year, new loans totaled Rmb9.59tn, up 95% YoY, while outstanding loan growth slowed to 31.7%. In line with the normalization trend, bill-financing loans decreased for the sixth straight month, by Rmb112bn in December, while short-term loans (to non-financial institutions) also slipped for the third month, by Rmb29bn, suggesting that medium- and long-term loans continue to be the main driver of the ongoing credit expansion, consistent with growth-supporting policy initiatives, and signaling enhanced sustainability. Meanwhile, M2 growth softened to 27.7%.



Source: National Bureau of Statistic, CEIC & Morgan Stanley Research

Realizing the Long-awaited Trade Recovery: Chinese exports finally staged a stronger-than-expected rebound in December 2009. Exports jumped 17.7% YoY (+5% MoM seasonally adjusted), beating our and market expectations. The surge in imports also surprised on the upside, up 55.9% YoY. For full-year 2009, exports dipped 16% to US$1.2tn in 2009, while imports slipped 11.2% to US$1tn. The trade surplus totaled US$196.1bn, the smallest in three years and a tad lower than our forecast (US$216bn).



Source: People's Bank of China, CEIC & Morgan Stanley Research

Economic Update: Hong Kong

Morgan Stanley Asia Limited **Denise Yam / Katherine Tai**

Overview

As 2009 drew to an end, it became clear that our expectation that the Hong Kong economy would experience a much shallower recession in the aftermath of the global financial crisis than that following the Asian financial crisis had been met, thanks to the prompt rebound in asset prices in the course of the year, amidst global monetary easing and Hong Kong's unique position as the financial intermediary between China and the rest of the world. Retail sales recorded positive gains for the fourth consecutive month, and November trade finally reported the first YoY growth on a low base effect. In addition, labor market conditions also proved far more resilient compared to previous cycles. The unemployment rate eased for the fourth straight month to 4.9% in October-December from 5.1% in September-November, although we think more data are needed to conclude a solid improvement.

GDP

	3Q09	2Q09	1Q09	2008
Nominal GDP, YoY, %	-2.0	-2.5	-7.4	+3.8
Real GDP, YoY, %	-2.4	-3.6	-7.8	+2.4

Unemployment

	Sep-Aug 09	Nov-Sep 09
Unemployment Rate, seasonally adjusted, %	4.9	5.1
Underemployment Rate, seasonally adjusted, %	2.3	2.5

Retail Sales

	Nov 09	Oct 09	YTD 09	2008
Retail Sales Value, HK$ bn	22.9	22.8	245.3	273.1
YoY, %	+11.7	+9.8	-1.0	+10.6
Retail Sales Volume, YoY, %	+9.8	+8.2	-2.0	+5.0

Money and Reserves

	Nov 09	Oct 09	Sep 09	Aug 09
HK$ M3, YoY, %	+14.1	+14.2	+14.1	+13.3
New Mortgage Loans Made, MoM, %	-11.1	-13.1	-2.5	-8.2
Outstanding Mortgage Loans, HK$ bn	637.3	631.6	626.0	618.0
Foreign Exchange Reserves, US$ bn	256.3	240.1	226.9	226.9

Fiscal

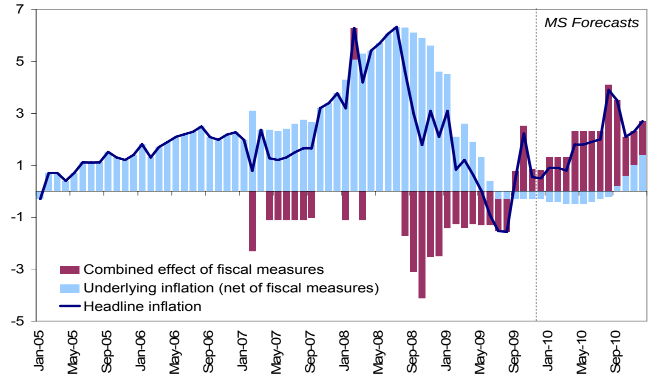
	Nov 09	Oct 09	FY09	FY08
Budget Surplus/Deficit, HK$ bn	17.9	8.0	1.4	123.7

Inflation and Trade

	Nov 09	Oct 09	YTD 09	2008
Composite CPI, YoY, %	+0.5	+2.2	+0.4	+4.3
Trade Balance, HK$ bn	-20.7	-19.2	-169.9	-201.6
Total Exports, YoY, %	+1.3	-13.1	-15.8	+5.1
Re-Exports	+1.9	-12.5	-15.0	+6.0
Domestic Exports	-19.4	-32.9	-39.5	-16.8
Imports, YoY, %	+6.5	-10.7	-15.2	+5.1

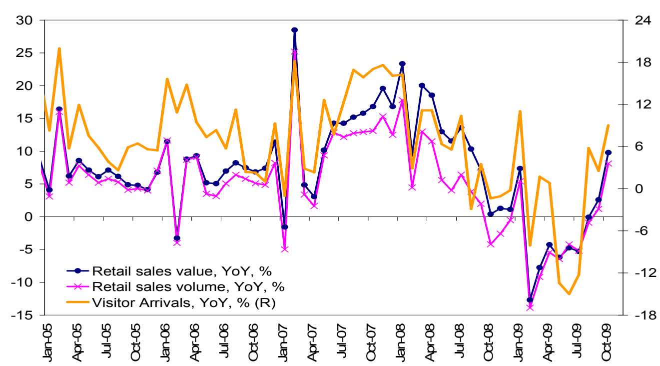
Source: CEIC, Census and Statistics Department, Morgan Stanley Research

Mild Underlying Deflation Lingers: Underlying deflation (netting out distortion from fiscal concessions) remained unchanged for the fifth straight month in November, at 0.3% YoY, further evidence of the stabilization of the economy. The headline figure was again biased upwards by the cancellation of fiscal concessions (the electricity bill subsidy and reduced concession on property rates) and came to +0.5% YoY, broadly in line with our forecast. Whilst we expect mild underlying deflation to linger for a while longer, our headline inflation forecast for 2010 remains unchanged at 2%.



Source: Census and Statistic Department, CEIC & Morgan Stanley Research

November Retail Sales Beats Forecast Again: After reclaiming positive YoY growth in September and powering ahead in October, retail sales beat forecasts again in November, with gains reaching 11.7% in value and 9.8% in volume, beating our (value +7.4%, volume +5.5%) and market (value +8%, volume +6.4%) forecasts. Sales totaled HK$22.9bn in the month. Robust gains in discretionary items, including clothing/footwear (+12% YoY in value), luxury goods (jewelry/timepieces/ valuable gifts) (+26.1%), medicines/ cosmetics (+13.1%) and electrical/photographic goods (+10.9), reflected positive consumer sentiment and a revival in inbound tourism.



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

Economic Update: India

Morgan Stanley India Company Private Limited

Chetan Ahya/Tanvee Gupta

Current Account Deficit Widens Significantly in QE-Sept09
The current account deficit increased significantly to US$12.6bn (4.2% of GDP, annualized) in QE-Sept 09, compared with a deficit of US$5.9bn in QE-June 09. On a trailing 4Q basis, the current account deficit remained stable at 2.25% of GDP as of QE-Sept 09 from 2.3% of GDP as of QE-Jun 09. The trade deficit widened to US$32bn during QE-Sept 09, compared with a deficit of US$26bn in the QE-Jun 09. On a trailing 4Q basis, the trade deficit narrowed to 9% of GDP as of QE-Sept 09 from 9.7% as of QE-Jun 09. Exports remained weak, declining by 13.5% YoY in QE-Sept 09, due to the global slowdown. Imports also continued to decline by 15%YoY in QE-Sept 09 on weak domestic demand and a high base effect. Net invisibles declined 25%YoY during QE-Sept 09, compared with a decline of 10.6%YoY registered in the previous quarter. The capital account balance zoomed to a surplus of US$23.6bn (7.9% of GDP, annualized) in QE-Sept 09, compared with a surplus of US$6bn and a deficit of US$5.3bn in the previous two quarters. The balance of payments surplus increased to US$9.4bn in QE-Sept 09 compared with a surplus of US$0.1bn in the QE-Jun 09.

	F1Q10	F2Q10
Real GDP Growth, YoY, %	6.1	7.9

Inflation

	Oct-09	Nov-09
Wholesale price Index, YoY, %	1.3	4.8

Manufacturing

	Oct-09	Nov-09
Index of Industrial production, YoY, %	10.3	11.7
---Manufacturing, YoY, %	11.1	12.7
---Mining, YoY, %	8.2	10.0
---Electricity, YoY, %	4.7	3.3

External Trade

	Oct-09	Nov-09
Trade Balance, US$bn	-8.8	-9.7
Exports, YoY, %	-6.6	18.2
Imports, YoY, %	-15.0	-2.6

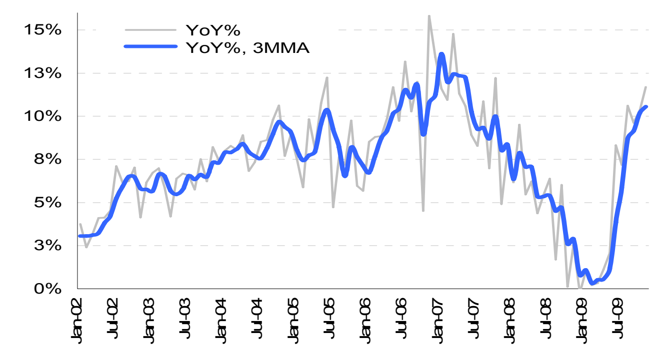
Foreign Reserve & Monetary Aggregates

	Nov-09	Dec-09
Foreign Reserves, US$bn	285.3	282.1
Money Supply M3, YoY, %	18.1	17.5
Bank Credit Growth, YoY, %	10.0	12.2

Source: RBI, CSO, Ministry of Commerce, Morgan Stanley Research

IP Growth: Strong Momentum Continues in November
Industrial production (IP) growth accelerated to 11.7%YoY in November 2009, highest in two years. This compares with growth of 10.3%YoY in October 2009. On a seasonally adjusted sequential basis, IP growth rose 2.2%MoM (vs. -1%MoM in October 2009 on account of the *Diwali* festival holidays). Growth in the manufacturing segment accelerated to 12.7%YoY in November (vs. 11.1%YoY in October). While growth in the mining segment accelerated to 10%YoY (vs. 9% in October), electricity segment growth decelerated further to 3.3%YoY in November (vs. 4.7% in October).

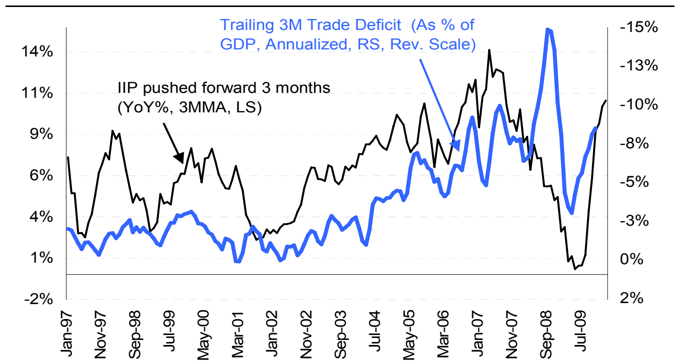
Trend in Industrial Production Growth



Source: CSO, Morgan Stanley Research

November Export Growth Back in Positive Territory
Export growth (in dollar terms) accelerated 18.2%YoY in November compared to the decline of 6.6%YoY in October 2009. Imports (in dollar terms) declined 2.6%YoY in November, compared with -15% in October 2009. The monthly trade deficit widened to US$9.7bn (9.6% of GDP, annualized) in November compared with a US$8.8 billion deficit in the previous month.

Trade Deficit vs. IP Growth



Source: RBI, CSO, CEIC, Morgan Stanley Research

Economic Update: Indonesia

Morgan Stanley Asia (Singapore) Pte.

Chetan Ahya / Deyi Tan /Shweta Singh

Overview

At its monetary policy meeting on January 6, the Bank of Indonesia (BI) maintained the policy rate at 6.5%, in line with our and consensus expectations. We have been highlighting the structural decline in cost of capital as the key differentiation in our bullish call on Indonesia, and this remains intact, given the improvement in macro balance sheet. Indeed, even whilst policy rates had been kept on hold, a further cyclical decline in cost of capital had been slowly panning out, aided by improving liquidity conditions. We think that Indonesia will be the second country (after Vietnam) in ASEAN to embark on the path of policy re-normalisation. Indeed, the BI has had one of the most aggressive easing cycles in ASEAN, and Indonesia has been one of the most resilient economies in ASEAN. Whilst lending growth for 2009 moderated to single-digit territory, higher-frequency data suggests that credit growth possibly has reached a trough and will pick up in 2010 as domestic demand recovers. We expect inflationary pressures to gradually build up as growth recovers, commodity prices remain relatively elevated, and the base effect continues to turn around in 2H10. We look for policy rate hikes to begin in 2Q10 and expect the policy rate to reach 8.5% by 2010 year-end.

GDP

	3Q09	2Q09
Real GDP Growth, YoY, %	4.2	4.0
Private Consumption, YoY, %	4.7	4.8
Gross Fixed Capital Formation, YoY, %	3.9	2.6
Exports of Goods and Services, YoY, %	-8.2	-15.5

Inflation

	Dec-09	Nov-09
Consumer Price Index, YoY, %	2.8	2.4
CPI, MoM, %	0.3	-0.0

Consumption Indicators

	Dec-09	Nov-09
Consumer Confidence Index	108.7	111.0
Motor Vehicle Sales, YoY, %	NA	4.8

External Trade

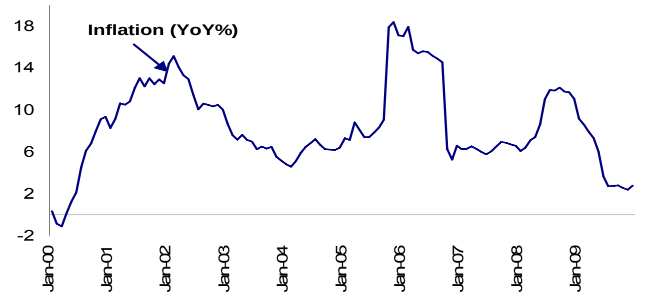
	Nov-09	Oct-09
Trade Balance, US$bn	1.9	2.8
Exports, YoY, %	11.3	13.5
Oil and Gas Exports, YoY, %	61.3	12.0
Non-Oil and Gas Exports, YoY, %	2.5	13.8
Imports, YoY, %	-2.4	-12.1
Oil and Gas Imports, YoY, %	34.8	-3.1
Non-Oil and Gas Imports, YoY, %	-9.0	-14.2

Monetary Aggregates

	Nov-09	Oct-09
Money Supply M2, YoY, %	9.9	11.5
Commercial Bank Loan Growth, YoY, %	5.7	6.2

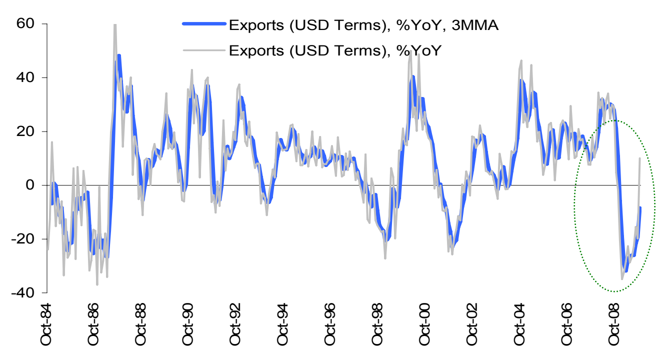
Source: CEIC, Morgan Stanley Research

Prices for December rose 2.8%YoY (vs. 2.4%YoY in Nov-09), below our and consensus expectations of 2.9%YoY. On a sequential basis, prices rose 0.3%MoM (vs. -0.03%MoM in Nov-09). Moderation was observed in almost all segments except processed food and beverages, which accelerated to 7.8%YoY (vs. 7.4%YoY in Nov-09). Other segments, like food (3.9%YoY vs. 4.6%YoY in Nov-09), housing, electricity and gas (1.8%YoY vs. 2.1%YoY in Nov-09), clothing (6.0%YoY vs. 6.2%YoY in Nov-09) and education and recreation (3.9%YoY vs. 4.0%YoY in Nov-09), showed moderation. The transportation and communication segment declined at a lower pace (-3.7%YoY vs. -6.6%YoY in Nov-09), as commodity prices remained elevated.



Source: CEIC & Morgan Stanley Research

The November trade balance moderated to US$1.9bn (vs. US$2.8bn in Oct-09). After having shown a surprise rebound in Oct-09, exports moderated marginally to 11.3%YoY (vs. 13.5%YoY in Oct-09), below consensus (13.1%YoY). On a seasonally adjusted sequential basis, exports declined 6.4%MoM (vs. +20.7%MoM in Oct-09). The moderation was primarily driven by the non-oil and gas segment (2.5%YoY vs. 13.8%YoY in Oct-09), as oil and gas exports accelerated further (61.3%YoY vs. 12.0%YoY in Oct-09), primarily on base effects. Imports decline moderated further to 2.4%YoY (vs. a decline of 12.1%YoY in Oct-09) on the back of both non-oil & gas imports (-9.0%YoY vs. -14.2%YoY in Oct-09) and oil & gas exports (+34.8%YoY vs. -3.1%YoY in Oct-09).



Source: CEIC & Morgan Stanley Research

Economic Update: Malaysia

Morgan Stanley Asia (Singapore) Pte.

Deyi Tan / Chetan Ahya /Shweta Singh

Overview

Industrial production (IP) for November declined 1.3%YoY (vs. +0.7%YoY in Oct-09), below consensus (+2.9%YoY). On a seasonally adjusted sequential basis, IP declined 4.4%MoM (vs. +5.1%MoM in Oct-09). Mining declined by a steeper 7.3%YoY (vs. -2.6%YoY in Oct-09). Other segments, like manufacturing (0.9%YoY vs. 1.6%YoY in Oct-09) and electricity (5.9%YoY vs. 11.0%YoY), showed deceleration in growth.

Separately, foreign exchange reserves for December came in at US$96.7bn (vs. US$96.2bn in Nov-09). Although 2009 (year-end) numbers came in above 2008 (year-end) numbers (US$91.5bn), they were significantly lower than the peak of US$125.8bn (Jun-08). This can be attributed primarily to the fact that FDI and portfolio inflows have been depressed during the trough of the cycle and the overall balance of payment has not recovered by a similar extent since.

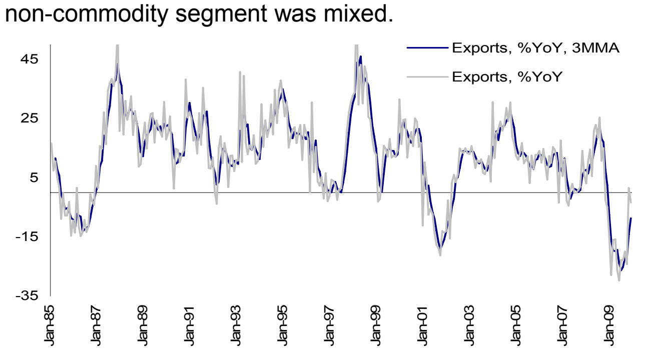
GDP	3Q09	2Q09
Real GDP Growth, YoY, %	-1.2	-3.9
Private Consumption, YoY, %	1.5	0.5
Gross Fixed Capital Formation, YoY, %	-7.9	-9.6
Exports of Goods and Services, YoY, %	-13.4	-17.3
Inflation	**Nov-09**	**Oct-09**
Consumer Price Index, YoY, %	-0.1	-1.5
CPI, MoM, %	0.3	0.1
Consumption Indicators	**Nov-09**	**Oct-09**
Motor Vehicles Sales, YoY, %	10.6	22.9
Consumption Goods Imports, YoY, %	3.1	9.5
Manufacturing	**Nov-09**	**Oct-09**
Industrial Production, YoY, %	-1.3	0.9
Manufacturing, YoY, %	0.9	1.6
External Trade	**Nov-09**	**Oct-09**
Trade Balance, RM Bn	8.9	11.5
Exports, YoY, %	-3.3	1.5
Imports, YoY, %	2.3	-2.3
Monetary Aggregates	**Nov-09**	**Oct-09**
Money Supply M3, YoY, %	10.0	9.2
Loan Growth, YoY, %	7.0	7.5

Source: CEIC, Morgan Stanley Research

November prices declined 0.1%YoY (vs. -1.6%YoY in Oct-09). The decline was milder than the consensus was expecting (-0.3%YoY). On a sequential basis, prices rose 0.3%MoM (vs. +0.1%MoM in Oct-09). In terms of segment-wise distribution, divergent trends were observed. While prices of food and non alcoholic beverages (+0.9%YoY vs. +0.8%YoY in Oct-09), housing, water and electricity (+1.1%YoY vs. +1.0%YoY in Oct-09) and recreation and culture (+2.5%YoY vs. +2.5%YoY in Oct-09) rose further on a %YoY basis, those of household and furnishing (+1.4%YoY vs. +1.6%YoY in Oct-09) and health (+1.7%YoY vs. +1.9%YoY in Oct-09) moderated. Transportation prices declined at a lower pace (-6.8%YoY vs. -13.2%YoY in Oct-09), as base effects have begun to turn around gradually.

Source: CEIC, Bloomberg, Morgan Stanley Research

The November trade balance moderated to RM8.9bn (vs. RM11.5bn in Oct-09). Exports (LCY terms) declined 3.3%YoY (vs. +1.6%YoY in Oct-09), below consensus (+3.0%YoY). On a seasonally adjusted sequential basis, exports declined 6.6%MoM (vs. +16.2%MoM in Oct-09). However, imports (LCY terms) fared better, rising 2.3%YoY (vs. -2.3%YoY in Oct-09), above consensus expectations (+2.0%YoY). On a seasonally adjusted sequential basis, imports gained 1.5%MoM (vs. +7.9%MoM in Oct-09). On the export front, while non-commodity segments, like manufactured goods (-11.2%YoY vs. -4.0%YoY in Oct-09) and machinery and transport (+6.4%YoY vs. +17.0%YoY in Oct-09), worsened, the trend in the non-commodity segment was mixed.



Source CEIC & Morgan Stanley Research

Economic Update: Singapore

Morgan Stanley Asia (Singapore) Pte.

Deyi Tan / Chetan Ahya /Shweta Singh

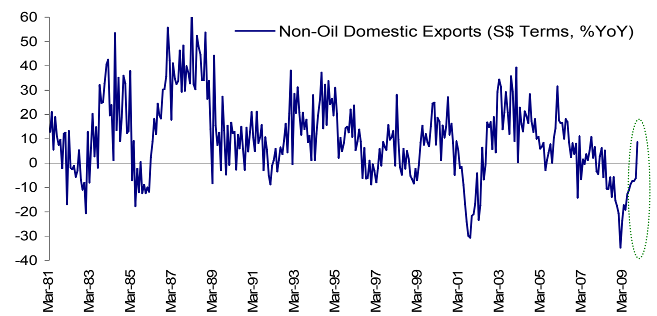
Overview

As per the 4Q09 GDP advance estimate released by the MTI, the economy rose 3.5%YoY (vs. an upwardly revised +0.9%YoY in 3Q09). Although the peak (1Q08) to trough (1Q09) GDP contraction of -9.4% had been significantly worse than the 1998 (-4.5% over four quarters) and 2001 (-6.4% over three quarters) cycles, the subsequent sequential rebound in early 2009 means that 2009 now looks likely to end with a contraction of -2.1%YoY (vs. MS forecast of -2.5%YoY). This is marginally better than the -2.3%YoY in 2001 and a tad lower than the -1.7%YoY in 1998. Yet, we note that the macro deceleration in the downcycle had been spread over two years, with 2008 (+1.1%YoY) bearing part of the slowdown impact as well. GDP now stands 3.4% below the 1Q08 peak. On a sequential seasonally adjusted basis, however, 4Q09 headline GDP contracted 6.8%QoQ. In terms of segments, manufacturing decelerated to +1.0%YoY (vs. +7.9%YoY in 3Q09), primarily on the back of biomed volatility. While construction moderated marginally to +11.2%YoY (vs. +12.8%YoY in 3Q09), services accelerated to +3.7%YoY (vs. -2.2%YoY in 3Q09).

GDP	3Q09	2Q09
Real GDP Growth, YoY, %	0.6	-3.3
Private Consumption, YoY, %	-0.9	-3.4
Gross Fixed Capital Formation, YoY, %	0.3	-7.6
Net Exports, % of GDP	23.9	22.6
Inflation	**Nov-09**	**Oct-09**
Consumer Price Index, YoY, %	-0.1	-0.8
CPI, MoM, SA, %	0.5	0.3
Retail Sales	**Oct-09**	**Sep-09**
Retail Sales Value (S$bn)	2.6	2.6
Retail Sales Index, Constant Price, YoY, %	-4.4	-13.9
Retail Sales Index, Current Price, YoY, %	-4.4	-12.0
Manufacturing	**Nov-09**	**Oct-09**
Manufacturing Output, YoY, %	-8.2	3.2
Electronics, YoY, %	17.5	17.0
External Trade	**Nov-09**	**Oct-09**
Trade Surplus, S$bn	4.3	3.3
Exports, YoY, %	4.5	-8.9
Non-oil Domestic Exports, YoY, %	8.7	-6.2
Re-exports, YoY, %	1.4	-6.4
Imports, YoY, %	-3.7	-16.2
Monetary Aggregates	**Nov-09**	**Oct-09**
Money Supply M3, YoY, %	9.3	8.6
Commercial Bank Loan Growth, YoY, %	1.8	-0.2

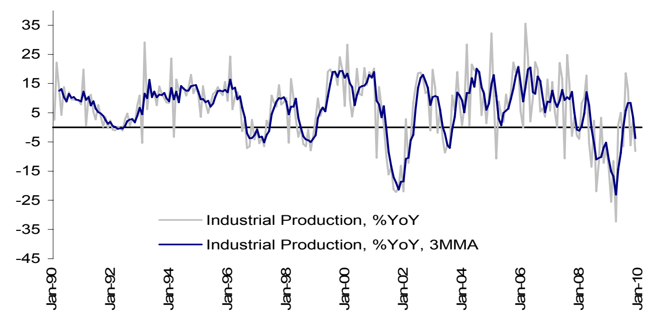
Source: CEIC, Morgan Stanley Research

Total exports (LCY terms) swung into the positive territory (+4.5%YoY vs. -8.9%YoY in Oct-09), primarily on base effects. Improvement was also observed on a seasonally adjusted basis (+10.5%MoM vs. -2.6%MoM in Oct-09), indicative of stabilization in external economic conditions. Imports (LCY terms) showed a markedly lower pace decline (-3.7%YoY vs. -16.2%YoY in Oct-09), once again supported by base effects. On a seasonally adjusted sequential basis, imports rose a moderate 2.6%MoM (vs. -5.7%MoM in Oct-09). When measured in US$ terms, exports (+13.4%YoY vs. -3.8%YoY in Oct-09) and imports (+4.4%YoY vs. -11.5%YoY in Oct-09) show better numbers on account of a weaker US$. Non-oil domestic exports (NODX) also moved into the positive territory (+8.7%YoY vs. -6.2%YoY in Oct-09), helped by base effects. On a seasonally adjusted sequential basis, NODX rose 19.8%MoM (vs. -12.7%MoM in Oct-09).



Source: CEIC. IES, Morgan Stanley Research

November industrial production (IP) slipped into the negative territory and declined 8.2%YoY (vs. +3.2%YoY in Oct-09), below consensus (+3.3%YoY). On a seasonally adjusted sequential basis, production lost 3.6%MoM (vs. -7.2%MoM in Oct-09). However, if we strip out the volatile biomed segment, IP continued to show a sustained pace of second-order-derivative improvement (7.5%YoY vs. 3.8%YoY in Oct-09). On a seasonally adjusted sequential basis, IP ex bio rose 2.4%MoM (vs. 0.9%MoM in Oct-09). In terms of segments, biomed lost 48.8%YoY (vs. +0.3%YoY in Oct-09). However, almost all the remaining segments showed improvement over their previous month numbers.



Source: CEIC & Morgan Stanley Research

Economic Update: South Korea

Morgan Stanley Asia Limited **Sharon Lam / Katherine Tai**

Overview

Most of the recent high-frequency macro data confirmed recovery strength prevailing into 2010, with latest exports, industrial production, capex and retail sales all returning to positive territory. In 2010, we expect to see more domestic growth as the government's fiscal measures remain supportive, with the focus on infrastructure to balance the regional economy and to boost new growth industries. Based on the current budget proposal, the authorities will frontload around 70% of the fiscal expenditure in 1H10 to help support economic growth and will increase spending on areas including health, welfare and R&D. At the first MPC meeting of 2010 on January 12, the Bank of Korea again kept the policy rate unchanged at 2%, which was in line with consensus expectations. We now expect the rate hike cycle to kick off in February, but also see a strong chance of this being delayed until March.

GDP

YoY, %	3Q09	2Q09	YTD 09	2008
Nominal GDP	+4.5	+0.7	+1.3	+5.6
Real GDP	+0.9	-2.2	-1.8	+2.2

Industrial Production and Sales

YoY, %	Nov 09	Oct 09	YTD 09	2008
Industrial Output	+17.8	+0.2	-3.3	+2.9
Producer Inventory	-13.0	-13.0	-11.4	+12.4
Retail Sales, Nominal	+12.2	+10.8	+3.0	+6.5
Retail Sales, Real	+10.0	+9.8	+1.8	+1.0

Unemployment

	Dec 09	Nov 09	Oct 09	Sep 09
Unemployment, NSA, %	3.5	3.3	3.2	3.4
Unemployment, SA, %	3.5	3.5	3.4	3.6

Foreign Reserves and Money Supply

	Dec 09	Nov 09	Oct 09	Sep 09
Foreign Reserves, US$ bn	270.0	270.9	264.2	254.3
Money Supply New M2, YoY, %	NA	+9.7	+10.5	+10.0

Inflation and Trade Account (Customs)

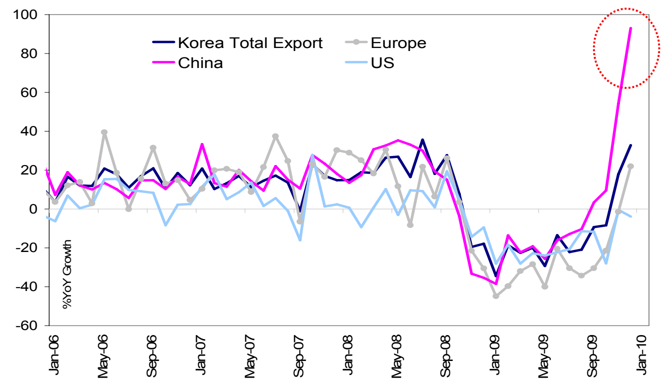
	Dec 09	Nov 09	2009	2008
Consumer Price Index	+2.8	+2.4	+2.8	+4.7
Producer Price Index	+1.8	-0.4	-0.2	+8.5
Trade Balance, US$bn	3.3	4.6	41.0	-13.3
Exports, YoY, %	+32.8	+17.9	-13.9	+13.6
Imports, YoY, %	+23.9	+2.4	-25.8	+22.0

Balance of Payments

US$ bn	Nov 09	YTD 09	2008
Current Account	4.3	41.2	-6.4
Goods Balance	5.8	52.1	4.5
Services Balance	-1.7	-14.4	-16.7
Financial and Capital Account	1.5	24.8	-50.9

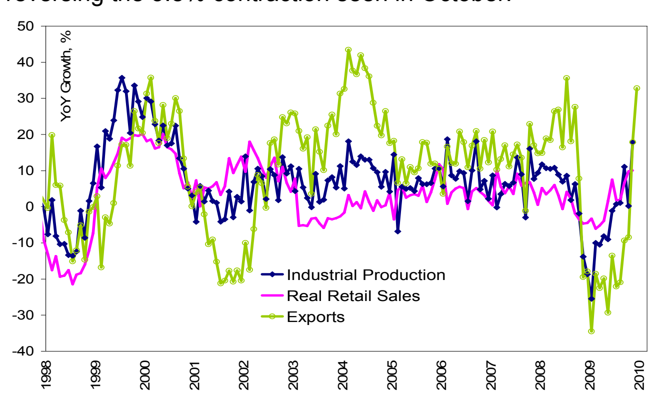
* Jan-Nov 2009 Source: CEIC, Morgan Stanley Research

Export Recovery Momentum Persisted into December: After the strong rebound in November, December export growth continued to surge sharply to +32.8%YoY, marking the strongest pace since August 2008. For 2009 as a whole, Korea export growth averaged -13.9%YoY, slightly below our forecast. Geographical breakdown showed that recovery momentum was still driven mostly by the AXJ countries. In particular, Korea's biggest trading partner, China (+74%YoY), which accounts for approximately a quarter of total shipments, was again the primary growth driver. Exports to Hong Kong (+54%), Taiwan (+113.5%), ASEAN-4 (+52.2%) also registered a solid recovery.



Source: CEIC, Morgan Stanley Research

Output Pick-up on Base Effect and Global Recovery: Ascribable to export resilience, warming domestic demand and the restocking upcycle, Korea's manufacturing activity evidently picked up in 2H09 after having freefallen to a record low in the beginning of last year. After the anticipated slowdown caused by seasonality in October, industrial output growth jumped steeply to +17.8%YoY in November, which narrowed the YTD decline down to 3.3% (vs. +3.1% in 2008). On a sequential basis, November IP grew by 1.4%, reversing the 3.8% contraction seen in October.



Source: CEIC, Morgan Stanley Research

Morgan Stanley

MORGAN STANLEY RESEARCH

January 25, 2010
Asia/Pacific Economics

Economic Update: Taiwan

Morgan Stanley Asia Limited **Sharon Lam / Katherine Tai**

Overview

Similar to its peers in the region, Taiwan has also seen accelerating economic activity in recent months. On the back of base effects and the recovering global economy, many macro indicators registered sharp YoY rebounds, including trade, production, shipment orders and retail sales. Although labor market conditions are usually a lagging indicator, the headline unemployment rate appeared to be slowly receding after peaking in September. As export orders are usually seen as a reliable leading indicator for the island's actual shipment for the next 3-6 months, we believe exports will demonstrate a more substantial recovery in 1H10. At its last quarterly monetary policy meeting on December 24, the CBC kept rediscount rate on hold at 1.25%, as expected. Looking ahead, we project that the rate hike cycle will begin in March 2010, with a 25bps increase in each quarter. In the absence of inflationary pressure, tightening will likely be mild and gradual, in our view.

GDP

	3Q09	2Q09	YTD 09	2008
Real GDP	-1.3	-6.9	-5.7	+0.1

Balance of Payments

US$ bn	3Q09	2Q09	YTD 09	2008
Overall Balance	11.8	11.8	34.5	26.3
Current Account	8.2	10.2	31.1	25.1
Trade Balance	6.8	7.5	23.3	18.5
Services Balance	-0.3	0.5	21.8	34.8
Financial Account	6.5	2.6	8.6	-1.7
Direct Investment	-0.6	-0.8	-2.1	-4.9
Portfolio Investment	-3.9	-0.4	-6.2	-12.5
Other Investment	11.0	3.4	16.4	14.0

Unemployment, Production, and Export Orders

	Dec 09	Nov 09	YTD 09	2008
Unemployment Rate, %	NA	5.86	5.86*	4.14
Seasonally adjusted, %	NA	5.98	5.85*	4.15
Industrial Production Index, YoY, %	NA	+31.5	-12.4	-1.8
Export Orders, US$ bn	31.7	31.3	322.4	351.7
YoY, %	+52.6	+37.1	-8.3	+1.7

Inflation and Trade

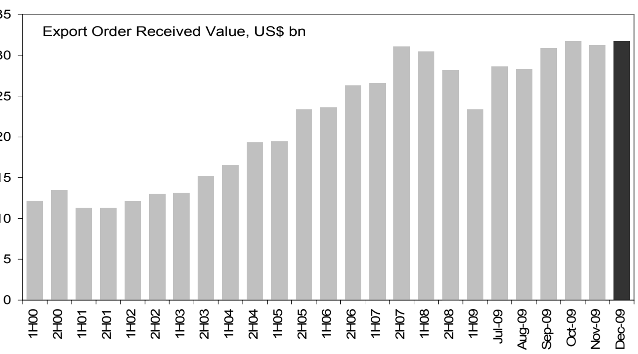
YoY, %	Dec 09	Nov 09	YTD 09	2008
Consumer Price Index	-0.2	-1.6	-0.9	+3.5
Wholesale Price Index	+5.6	+1.1	-8.9	+5.2
Trade Balance, US$ bn	1.6	2.1	29.0	14.8
Exports, YoY, %	+46.9	+19.4	-20.3	+3.6
Imports, YoY, %	+56.2	+17.9	-27.4	+9.9

Money Supply and Reserves

YoY, %	Oct 09	Sep 09	Aug 09	Jul 09
M1B	+25.7	+23.5	+22.1	+20.6
M2	+7.3	+8.3	+8.2	+8.3
Deposits	+6.7	+7.3	+7.4	+7.5
Loans	-1.1	-1.3	-0.8	-0.5
Foreign exchange reserves, US$ bn	341.2	332.2	325.4	321.1

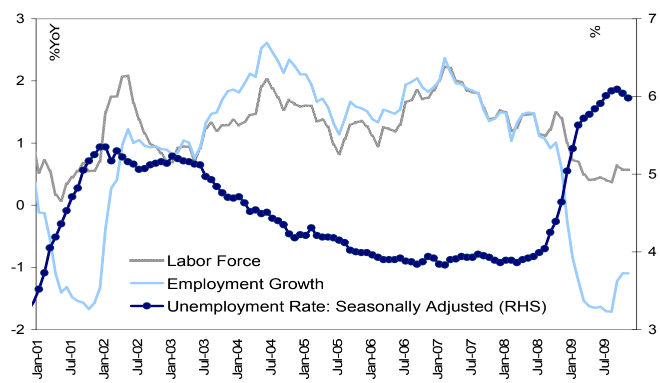
* Jan-Nov 2009 Source: CEIC, Morgan Stanley Research

Export Orders Back to Pre-Crisis Level: Exceeding both our and consensus forecasts, Taiwan shipment orders received continued the recovery uptrend in December, up sharply at +52.6%YoY from +37.1% in November. The decline in full-year 2009 export orders therefore narrowed to -8.3%, compared to the 1.7% increase in 2008. December's steep rebound was attributed to the exceptional low base effect and a gradual pick-up in global demand, as indicated by the sequential improvement. On a seasonally adjusted basis, we estimate that shipment orders jumped +4.4%MoM in December (vs. +2.3% in Nov). Meanwhile, it is noteworthy to point out that the nominal shipment order value has recovered back to pre-crisis level (Dec-09 at US$31.7bn vs. average of 1H08 at US$30.4bn).



Source: Ministry of Economic Affairs, CEIC and Morgan Stanley Research

Second Consecutive Month Moderation in Joblessness: Taiwan saw joblessness easing for the second straight month, given the continual sentiment revival and demand recovery prompting Taiwanese employers to increase hiring. As expected, the seasonally adjusted unemployment rate eased to 5.98% in November from 6.04% in October. On the back of increasing job creation, the labor participation rate also climbed to 58.2% in the month, from 57.9% in November.



Source: DGBAS, CEIC and Morgan Stanley Research

Economic Update: Thailand

Morgan Stanley Asia (Singapore) Pte.

Chetan Ahya / Deyi Tan /Shweta Singh

Overview

At its 13th January monetary policy meeting, the Bank of Thailand (BoT) kept its policy rate on hold at 1.25%, in line with our and consensus expectations. The BoT's monetary policy statement appears to set the tone for an impending exit from currently depressed policy rates. The BoT talks about policy differentials, which may lead to more volatile capital flows, and said "inflation is likely to average higher in 2010 on the back of oil prices, end of government subsidy measures and the economic recovery". Importantly, the reference that the economy "still requires sustained policy support" has been dropped, and the statement that "MPC views the current interest rate level" as "appropriate and supportive of the economic recovery" has now been replaced with the statement that "MPC will continue to closely monitor inflation and economic developments". The shift in tone indicates risk that the policy exit could take place earlier than we expect – i.e., in 2Q10 rather than in 2H10. We believe that February inflation data and January trade data, which will be released before the March meeting, will be important datapoints to watch.

GDP

	3Q09	2Q09
Real GDP Growth, YoY, %	-2.8	-4.9
Private Consumption, YoY, %	-1.3	-2.3
Gross Fixed Capital Formation, YoY, %	-6.3	-10.2
Exports of Goods and Services, YoY, %	-15.0	-21.7

Inflation

	Dec-09	Nov-09
Consumer Price Index, YoY, %	3.5	1.9
CPI, MoM, %	-0.1	0.3

Consumption

	Dec-09	Nov-09
Consumer Confidence Index, Economics	70.4	69.1

Manufacturing

	Nov-09	Oct-09
Manufacturing Production Index, YoY, %	8.9	0.5
Capacity Utilization Rate, %	65.4	66.3

External Trade

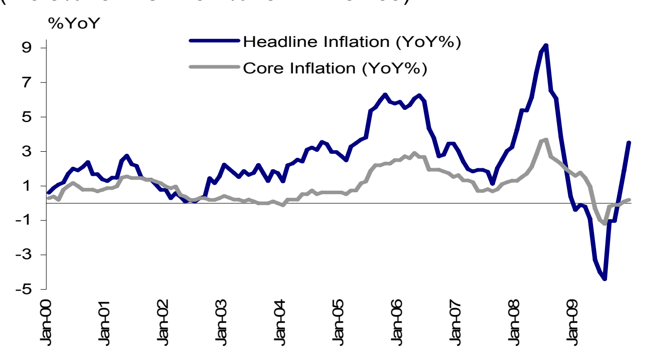
	Nov-09	Oct-09
Trade Balance, Custom basis, Bt bn	30.4	54.1
Exports, YoY, %	14.1	-4.1
Imports, YoY, %	-4.8	-18.4

Monetary Aggregates

	Nov-09	Oct-09
Broad Money Supply, YoY, %	6.5	7.0
Commercial Bank Loan Growth, YoY, %	5.6	4.5

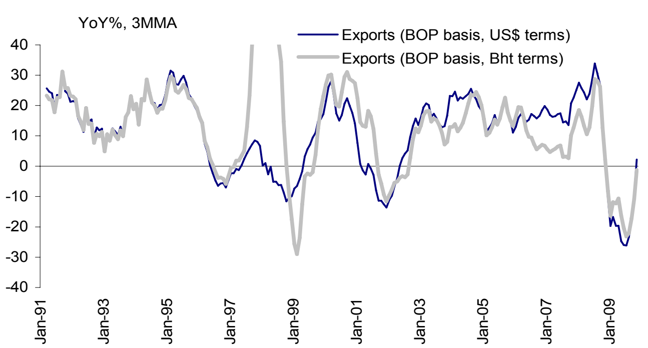
Source: CEIC, Morgan Stanley Research

December inflation accelerated to 3.5%YoY (vs. 1.9%YoY in Nov-09), broadly in line with consensus (3.6%YoY). On a sequentially adjusted seasonal basis, prices declined 0.1%MoM (vs. +0.3%MoM in Nov-09). The acceleration in %YoY is primarily explained by base effects, as transport and communication jumped 9.1%YoY (vs. +4.2%YoY in Nov-09). In terms of other segments, divergent observations were observed. Acceleration was observed in food (+2.2%YoY vs. +0.6%YoY in Nov-09) and housing and furnishing (+3.7%YoY vs. +3.6%YoY in Nov-09). However, while clothing and footwear (-3.4%YoY) and tobacco and alcoholic beverages (+13.6%YoY) remained at their respective November levels, a steeper decline was observed in recreation (-10.3%YoY vs. -10.1%YoY in Nov-09).



Source: CEIC & Morgan Stanley Research

November trade balance (BOP terms) moderated further to US$1.1bn (from US$1.7bn in Oct-09). Exports (US$ terms) moved into positive territory (+17.3%YoY vs. -2.5%YoY in Oct-09), primarily on base effects. On a seasonally adjusted sequential basis, exports declined 1.4%MoM (vs. +1.1%MoM in Oct-09). The decline in imports (US$ terms) moderated to 0.2%YoY (vs. -19.0%YoY in Oct-09). Although imports on a seasonally adjusted sequential basis picked up (+4.4%MoM vs. -4.4%MoM in Oct-09), much of the improvement in the Nov-09 data can be explained largely by base effects. Similar observations on a %YoY basis were observed when measured in LCY terms, albeit at a relatively subdued pace.



Source: CEIC & Morgan Stanley Research

Economic Indicators

Real GDP Growth, YoY, %

	2004	2005	2006	2007	2008	2Q08	3Q08	4Q08	1Q09	2Q09	3Q09
China^	10.1	10.4	11.6	11.9	9.0	10.1	9.0	6.8	6.1	71.9	8.9
Hong Kong	8.5	7.1	7.0	6.4	2.4	4.1	1.5	-2.6	-7.8	-3.8	-2.4
India	7.2	9.2	9.9	9.3	7.5	7.8	7.7	5.8	5.8	6.1	7.9
Indonesia	5.0	5.7	5.5	6.3	6.1	6.4	6.4	5.2	4.4	4.0	4.2
Korea	4.6	4.0	5.2	5.1	2.2	4.4	3.1	-3.4	-4.3	-2.2	0.9
Malaysia	6.8	5.3	5.8	6.3	4.6	6.3	4.7	0.1	-6.2	-3.9	-1.2
Singapore	9.0	7.3	8.2	7.8	1.1	2.5	0.0	-4.2	-9.5	-3.5	0.6
Taiwan	6.2	4.7	5.4	6.0	0.7	5.4	-0.8	-7.1	-9.1	-6.9	-1.3
Thailand	6.3	4.6	5.2	4.9	2.6	5.3	3.9	-4.3	-7.1	-4.9	-2.8
Asia ex-Japan	**8.1**	**8.5**	**9.4**	**10.1**	**7.0**	**8.2**	**7.0**	**4.1**	**3.2**	**4.7**	**6.3**

Consumer Prices, YoY, %

	4Q08	1Q09	2Q09	3Q09	4Q09	Jul-09	Aug-09	Sep-09	Oct-09	Nov-09	Dec-09
China	2.5	-0.6	-1.5	-1.3	0.7	-1.8	-1.2	-0.8	-0.5	0.6	1.9
Hong Kong	2.3	1.7	-0.1	-0.9	NA	-1.5	1.6	0.5	2.2	0.6	NA
India	10.2	9.4	8.9	11.8	NA	11.9	11.7	11.6	11.5	13.5	NA
Indonesia	11.5	8.6	5.6	2.8	2.6	2.7	2.7	2.8	2.6	2.4	2.8
Korea	4.5	3.9	2.8	2.0	2.4	1.6	2.2	2.2	2.0	2.4	2.8
Malaysia	5.9	3.7	1.3	-2.3	NA	-2.4	-2.4	-2.0	-1.5	-0.1	NA
Singapore	6.6	5.4	2.1	-0.5	NA	-0.5	-0.3	-0.4	-0.8	-0.1	NA
Taiwan	1.9	0.0	-0.8	-1.4	-1.2	-2.3	-0.8	-0.9	-1.9	-1.6	-0.2
Thailand	2.1	-0.2	-2.8	-2.2	1.3	-4.4	-1.0	-1.0	0.4	1.9	3.5
Asia ex-Japan	**4.9**	**2.6**	**1.5**	**1.9**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**

US Dollar Exchange Rates

Periods Ending	Feb-09	Mar-09	Apr-09	May-09	Jun-09	Jul-09	Aug-09	Sep-09	Oct-09	Nov-09	Dec-09
China	6.84	6.84	6.82	6.83	6.83	6.83	6.83	6.83	6.83	6.83	6.83
Hong Kong	7.76	7.75	7.75	7.75	7.75	7.75	7.75	7.75	7.75	7.75	7.76
India	49.2	51.2	50.1	48.5	47.9	48.4	48.5	48.4	46.7	46.6	46.5
Indonesia	11980	11575	10713	10340	10225	9920	10060	9681	9545	9480	9400
Korea	1534	1384	1282	1255	1274	1229	1249	1178	1183	1163	1165
Malaysia	3.69	3.65	3.56	3.51	3.52	3.52	3.53	3.47	3.41	3.39	3.42
Singapore	1.52	1.53	1.50	1.46	1.45	1.45	1.44	1.42	1.40	1.39	1.40
Taiwan	35.0	33.9	33.2	32.7	32.8	32.8	32.9	32.2	32.5	32.2	32.0
Thailand	35.3	35.7	35.4	34.5	34.1	34.0	34.0	33.8	33.4	33.2	33.2

*GDP (1993 base year prices) from 1998-2000. GDP (2000 base year prices) from 2001 to present.
^ China Quarter GDP growth are subject to revision.
NA = Not Available
Source: CEIC, Morgan Stanley Research

Money Supply and Interest Rates

	Broad Money, YoY, %		Prime Interest Rates, %		3-Month Interest Rates, %	
	2008	Latest	2008	Latest	2007	Latest
China	17.8 (M2)	27.6 (Dec)	5.3	5.3 (Dec)	1.7	1.7 (Dec)
Hong Kong	-1.2 (M3)	14.1 (Nov)	5.0	5.0 (Dec)	0.9	0.1 (Dec)
India	20.9 (M3)	17.5 (Dec)	12.9	11.5 (Dec)	5.7	4.3 (Dec)
Indonesia	14.6 (M2)	9.9 (Nov)	15.2	14.0 (Nov)	7.4	7.7 (Nov)
Korea	13.1 (M2)	9.7 (Nov)	5.3	5.3 (Dec)	4.0	2.9 (Dec)
Malaysia	11.9 (M3)	10.0 (Nov)	6.5	5.5 (Nov)	3.2	2.0 (Nov)
Singapore	11.6 (M3)	9.3 (Nov)	5.4	5.4 (Dec)	2.4	0.7 (Dec)
Taiwan	7.0 (M2)	6.3 (Nov)	4.5	2.5 (Dec)	1.0	0.9 (Dec)
Thailand	9.2 (M3)	6.5 (Nov)	6.9	6.0 (Dec)	2.1	0.7 (Dec)

Trade, Current Accounts and Reserves (US$bn)

	Trade Balance			Current Account			Reserves		
	2007	2008	Latest	2007	2008	Latest	2007	2008	Latest
China	262.0	297.3	18.4 (Dec)	371.8	426.1	134 (1H09)	1528.2	1946.0	2399.2 (Dec)
Hong Kong	-23.5	-25.9	-2.7 (Nov)	25.5	30.6	3.6 (3Q09)	152.7	182.5	255.8 (Dec)
India	-79.2	-125.0	-9.7 (Nov)	-11.3	-36.1	-5.8 (2Q09)	275.3	253.7	282.1 (Dec)
Indonesia	39.6	32.2	1.9 (Nov)	10.5	0.6	1.7 (3Q09)	56.9	51.6	66.1 (Dec)
Korea	14.6	-13.3	3.1 (Dec)	5.9	-5.8	4.3 (Nov)	262.2	201.2	270.0 (Dec)
Malaysia	29.3	42.5	2.6 (Nov)	29.3	38.8	7.2 (3Q09)	119.5	91.5	96.7 (Dec)
Singapore	36.3	18.4	2.3 (Dec)	39.4	27.3	5.9 (3Q09)	163.0	174.2	187.8 (Dec)
Taiwan	27.4	15.2	1.6 (Dec)	33.0	25.1	8.2 (3Q09)	270.3	291.7	348.2 (Dec)
Thailand	11.6	0.2	1.1 (Nov)	14.0	-0.2	1.3 (Nov)	87.5	111.0	138.4 (Dec)

Exports by Country of Destination, 2008

	Total Exports		By Country of Destination (% of Total Exports)					
	US$ bn	% of GDP	US	Japan	EMU	Asia ex-Japan		
						Total	Greater China	ASEAN
China	1428.5	33.0	17.7	8.1	20.5	38.3	15.2	6.7
Hong Kong	364.4	168.3	12.7	4.3	13.7	61.5	50.5	8.1
India	178.8	14.8	11.1	1.7	15.1	23.6	9.5	10.2
Indonesia	137.0	26.5	9.5	20.3	11.2	45.5	18.8	19.8
Korea	422.0	49.3	11.0	6.7	13.8	44.0	29.1	9.7
Malaysia	191.5	89.6	12.5	10.8	11.3	55.1	16.2	24.1
Singapore	331.3	185.2	7.0	4.9	10.2	65.1	22.4	28.7
Taiwan	255.6	65.2	12.0	6.9	11.0	59.4	39.0	11.9
Thailand	177.8	64.3	11.4	11.3	13.1	53.8	16.3	16.8
Asia ex-Japan	**3,487.0**	**41.7**						

Imports by Country of Origin, 2008

	Total Imports		By Country of Origin (% of Total Imports)					
	US$ bn	% of GDP	US	Japan	EMU	Asia ex-Japan		
						Total	Greater China	ASEAN
China	1133.1	26.2	7.2	13.3	11.7	48.7	10.3	9.9
Hong Kong	390.3	180.2	5.0	9.8	7.6	72.4	53.0	12.9
India	292.9	24.2	5.6	2.5	9.4	24.6	12.8	8.8
Indonesia	128.9	25.4	6.1	11.5	8.6	55.4	21.3	31.8
Korea	435.3	50.9	8.8	14.0	9.2	31.9	20.6	8.5
Malaysia	150.6	70.4	10.8	12.5	11.8	57.1	20.4	22.4
Singapore	313.3	175.2	11.7	8.1	12.4	60.7	16.8	22.5
Taiwan	240.4	61.3	10.9	19.3	8.2	32.7	13.7	10.1
Thailand	178.7	65.3	6.4	18.7	8.0	56.5	15.8	13.7
Asia ex-Japan	**3,263.5**	**39.1**						

Source: CEIC, Morgan Stanley Research

Asia/Pacific: Economic Data Calendar for January 2010

				1
				CH PMI (Dec) **IN** IIP (Nov) **KR** Trade, CPI (Dec)
4	**5**	**6**	**7**	**8**
ID CPI (Dec), Trade (Nov) **SG** Advance GDP Estimate (4Q09), PMI (Dec) **TH** CPI (Dec)	**KR** Foreign Reserves (Dec) **TW** CPI (Dec)	**ID** Monetary Policy Meeting	**HK** Foreign Reserves (Dec) **ID** Foreign Reserves (Dec) **KR** Money Supply (Dec) **MY** Trade (Nov), Foreign Reserves (Dec) **SG** Foreign Reserves (Dec) **TW** Trade (Dec)	**KR** Monetary Policy Meeting **TH** Foreign Reserves (Dec)
11	**12**	**13**	**14**	**15**
CH Trade (Dec) **MY** IP (Nov)	**ID** Money Supply (Nov)	**KR** Labor (Dec) **TH** Monetary Policy Meeting	**CH** Actual FDI, Money Supply (Dec)	**SG** Retail Sales (Nov)
18	**19**	**20**	**21**	**22**
SG Trade (Dec)	**HK** Labor (Dec) **IN** CPI – Rural Worker (Dec)	**MY** CPI (Dec) **TW** Export Orders (Dec)	**HK** CPI (Dec) **CH** GDP (4Q09), CPI, PPI, IP, Urban FAI, Retail Sales (Dec) **TH** Customs Trade (Dec)	**TW** Labor (Dec)
25	**26**	**27**	**28**	**29**
SG CPI (Dec) **TW** IP, Money Supply (Dec)	**HK** Trade (Dec) **KR** GDP (4Q09) **MY** Monetary Policy Meeting **SG** IP (Dec)	**KR** Current Account (Dec)	**MY** Money Supply (Dec)	**HK** Money Supply (Dec) **KR** IP (Dec) **IN** Monetary Policy Review, CPI – Industrial Workers (Dec) **SG** Unemployment Rate (4Q09), Money Supply, Loans & Advances (Dec) **TH** Current Account & Manufacturing (Dec)

Notes: CH = China; HK = Hong Kong; ID = Indonesia; IN = India; KR = Korea; MY = Malaysia; PH = Philippines; SG = Singapore; TW = Taiwan; TH = Thailand;
IPI = Industrial Production Index; CAB = Current Account Balance;
BOK = Bank of Korea; BOT = Bank of Thailand; BSP = Bangko Sentral ng Pilipinas
Source: Government and industry data, Morgan Stanley Research

Asia/Pacific Economic Forecast Summary

	2006	2007	2008	2009E	2010E	2011E
Real GDP Growth (%)						
Asia Ex Japan	**9.4**	**10.1**	**7.0**	**5.7**	**8.2**	**7.3**
AXJ (x-China and India)	**5.6**	**5.9**	**2.8**	**-0.6**	**4.4**	**4.4**
Asia Pacific*	**9.1**	**9.8**	**6.7**	**5.5**	**7.9**	**7.2**
China	11.6	13.0	9.0	9.0	10.0	8.5
Hong Kong	7.0	6.4	2.4	-3.1	3.8	3.5
India	9.9	9.3	7.5	6.0	8.0	7.6
Indonesia	5.5	6.3	6.1	4.4	5.5	6.3
Korea	5.2	5.1	2.2	0.2	5.0	4.3
Malaysia	5.8	6.2	4.6	-2.8	4.3	4.8
Singapore	8.4	7.8	1.1	-2.5	4.0	4.5
Taiwan	5.4	6.0	0.7	-3.5	4.5	3.6
Thailand	5.1	4.9	2.5	-3.5	4.3	4.8
Australia	2.6	4.0	2.4	0.6	1.8	4.5
CPI Inflation (%, Period Average)						
Asia Ex-Japan	**3.4**	**4.6**	**6.4**	**2.3**	**3.6**	**4.0**
Asia Pacific*	**3.8**	**4.3**	**6.2**	**2.5**	**3.5**	**3.9**
China	1.5	4.8	5.9	-0.6	2.5	3.5
Hong Kong/1	2.0	2.0	4.3	0.4	2.0	2.5
India	6.3	6.4	8.3	10.2	7.0	6.1
Indonesia	13.1	6.4	9.8	4.8	6.0	6.2
Korea	2.2	2.5	4.7	2.8	3.3	3.0
Malaysia	3.6	2.0	5.4	0.6	1.5	1.7
Singapore	1.0	2.1	6.5	0.4	0.8	1.0
Taiwan	0.6	1.8	3.5	-1.0	0.5	2.0
Thailand	4.7	2.2	5.5	-0.8	3.3	2.8
Australia	3.5	2.3	4.4	1.4	1.3	2.4
Current Account (% of GDP)						
Asia Ex-Japan	**6.2**	**7.2**	**6.1**	**5.6**	**4.8**	**3.7**
China	9.5	11.0	9.9	6.8	6.1	4.8
Hong Kong/1	12.1	12.4	14.2	12.4	10.4	8.7
India	-1.1	-1.0	-3.0	-1.7	-2.0	-2.0
Indonesia	3.0	2.4	0.1	1.5	1.4	0.8
Korea	0.6	0.6	-0.7	5.7	2.8	1.4
Malaysia	16.2	15.6	17.6	17.3	17.4	16.2
Singapore	21.4	23.5	14.9	15.8	17.7	18.5
Taiwan	7.0	8.4	6.2	5.2	5.4	5.0
Thailand	1.1	5.7	-0.1	3.6	2.0	1.3
Interest Rates (Prime Lending Rate %, Period End)						
China/2	6.1	7.5	5.3	5.3	5.9	5.9
Hong Kong/3	5.3	4.1	3.5	2.6	4.0	4.5
India	11.3	13.0	12.9	11.3	12.3	12.5
Indonesia	15.1	13.0	15.2	12.5	12.9	13.0
Korea/4	5.1	6.2	4.6	3.0	4.0	5.5
Malaysia	6.7	6.7	6.5	5.5	6.5	6.5
Singapore	5.3	5.3	5.4	5.4	5.4	5.4
Taiwan/5	4.0	4.4	4.5	2.8	3.0	4.0
Thailand	7.8	7.0	6.9	6.1	7.1	7.3
Interest Rates (3-Month Interbank Rate %, Period End)						
China/6	1.8	3.3	1.7	1.7	2.3	2.3
Hong Kong	3.9	3.5	1.0	0.2	1.8	2.1
India/7	6.9	7.5	5.6	4.3	6.5	7.0
Indonesia/8	8.7	7.4	11.2	7.5	8.5	8.8
Korea/9	4.9	5.8	3.9	2.8	3.7	5.3
Malaysia	3.6	3.6	3.6	2.1	3.1	3.1
Singapore	3.4	2.4	1.1	0.7	1.3	2.3
Taiwan/10	1.8	2.6	1.8	0.8	2.0	3.5
Thailand/11	4.0	2.1	1.6	0.8	1.8	2.0
USD Exchange Rates (Period End)						
China	7.81	7.31	6.83	6.80	6.55	6.10
Hong Kong	7.78	7.80	7.75	7.75	7.75	7.80
India	44.63	39.44	48.64	47.00	45.00	42.00
Indonesia	9090	9419	10950	11000	11100	10000
Korea	930	936	1260	1150	975	900
Malaysia	3.53	3.31	3.46	3.50	3.35	3.20
Singapore	1.53	1.45	1.44	1.48	1.43	1.36
Taiwan	32.6	32.4	32.9	32.5	31.0	30.0
Thailand	35.5	29.7	34.9	34.5	33.0	31.5
Australia	0.79	0.95	0.57	0.84	0.90	0.87

1) Composite Consumer Price Index (2) 1-Year Working Capital Rate (3) HSBC Best Lending Rate (4) 5-Year National Housing Bond Yield (5) Taiwan First Commercial Bank Prime Lending Rate before 2003, Base Lending Rate since 2003 (6) 91-Day Treasury Bill Rate (7) 3-Month Time Deposit Rate (8) 91-Day Yield on Certificates of Deposit (9) 90-Day Money Market Middle Rate (10) 3-6 Month Time Deposit Rate * GDP and CPI for Asia Pacific includes Asia Ex-Japan and Australia. E = Morgan Stanley Research estimates Source: CEIC, Morgan Stanley Research

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The Americas
1585 Broadway
New York, NY 10036-8293
United States
Tel: +1 (1) 212 761 4000

Europe
20 Bank Street, Canary Wharf
London E14 4AD
United Kingdom
Tel: +44 (0) 20 7 425 8000

Japan
4-20-3 Ebisu, Shibuya-ku
Tokyo 150-6008
Japan
Tel: +81 (0) 3 5424 5000

Asia/Pacific
1 Austin Road West
Kowloon
Hong Kong
Tel: +852 2848 5200