Strategy and Economics

June 11, 2008

Global Economics
The Return of the Hawks

Morgan Stanley & Co. International plc+

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For details see *The Global Monetary Analyst* of June 11, 2008.

Central banks pound the table. Central bankers around the world continue to worry about 'stag', but 'flation' has now become their main concern. This is the loud and clear message sent by monetary policy decisions and hawkish comments over the past week or so. Just consider the following examples:

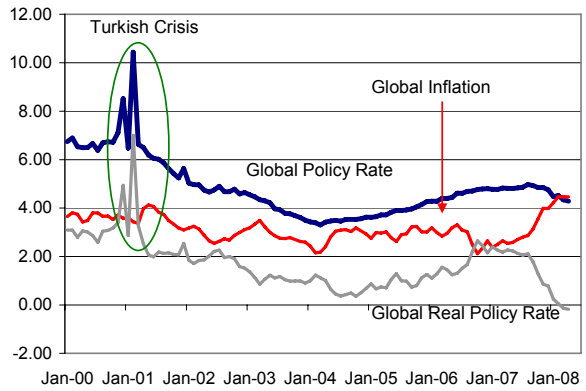
- The **ECB** Council last Thursday adopted a state of "heightened alertness", and its President Jean-Claude Trichet said that a rate hike in July, while not certain, was possible.
- **Fed** Chairman Ben Bernanke in a speech on Monday noted that recent energy price increases had added to the upside risks on inflation and warned that the Fed "will strongly resist an erosion of longer-term inflation expectations".
- The **Bank of Canada** surprised all analysts on Tuesday by not delivering the unanimously expected rate cut. Instead, the bank left the target rate unchanged at 3%, noting that the balance of risks for inflation had "shifted slightly to the upside".
- **Sweden's Riksbank** will phase out CPIX, an alternative measure of inflation, and entirely focus on its target variable CPI, according to an announcement by Deputy Governor Wickman-Parak. CPI inflation is currently running at 4%Y against a 2.9%Y pace of CPIX.
- In EM countries over the past week, **China** announced a rise in reserve requirements by 100 bp, **Brazil** and **Chile** hiked rates by 50 bp, and **Russia**, **Indonesia**, **the Philippines** and **Nigeria** all lifted policy rates by 25 bp. In **Vietnam,** the central bank hiked its base rate by 200 bp, to 14%.

Even if central banks deliver the tightening that's priced in, the global monetary policy stance would still be easy a year from now.

The goal — anchoring expectations. These comments and actions are clearly aimed at anchoring longer-term inflation expectations at a time of surging actual inflation rates. Central bankers know that the going will get even tougher over the next several months as headline inflation looks set to move significantly higher on the back of the recent oil price spike. Our economists expect CPI inflation to rise above 5% in the US and to 4% in the euro area this summer. Against this backdrop, a firm anchoring of inflation expectations would help to contain second- and third-round effects of higher non-core inflation.

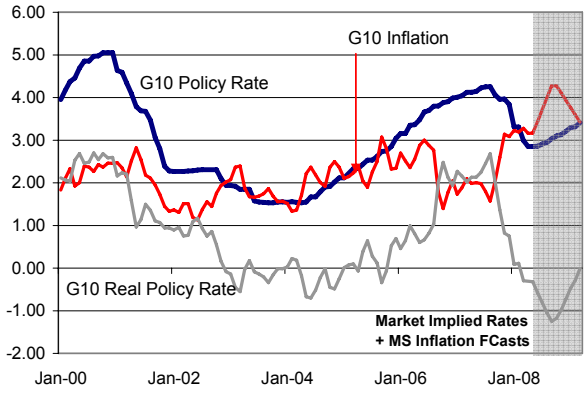
Markets now priced for hikes almost everywhere. The recent price action in money markets suggests that traders and investors are taking central bankers' hawkish rhetoric

Exhibit 1
Global Policy Rate versus Inflation



Source: Haver, Morgan Stanley Research

Exhibit 2
G10 Policy Rate versus Inflation



Source: Haver, Morgan Stanley Research

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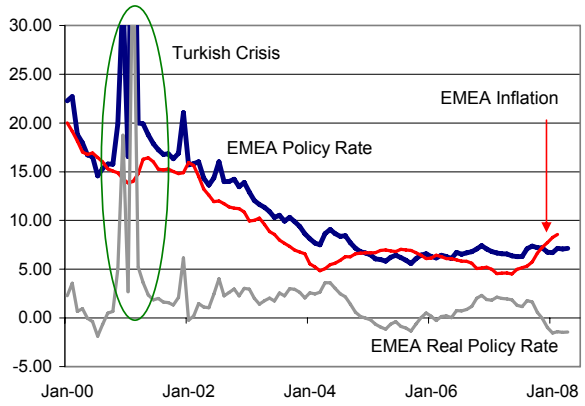
seriously. Markets are now pricing in between two and three hikes of 25 bp by year-end for the Fed, the ECB, the Swiss National Bank, the Riksbank and Norges Bank, and one to two hikes for the Bank of England, the Reserve Bank of Australia, the Bank of Canada and the Bank of Japan. Right now, New Zealand is the only developed economy where markets expect lower policy rates later this year.

Less tightening this year than markets think, except for the ECB. Our central bank watchers around the world remain less impressed by the hawkish rhetoric than the markets. The one notable exception is in the euro area, where Elga Bartsch now expects the ECB to follow up words with action in the form of a 25bp rate hike in July and another one later this year. Yet, in the US, the UK and Japan, our central scenario remains that policy rates will be left unchanged this year (for details on specific central banks, see the June 11 *Global Monetary Analyst*).

Exhibit 3

Emerging EMEA Policy Rate versus Inflation



Source: Haver, Morgan Stanley Research

We are likely to see higher average inflation rates — with higher highs and higher lows — in the next inflation cycle(s).

Also, we don't expect a tightening of monetary policy in Australia and Switzerland this year, even though the risks in these countries are probably skewed towards a rise. Norway and Sweden look likely to hike, but only once, and we maintain our call for 75 bp of rate cuts in New Zealand.

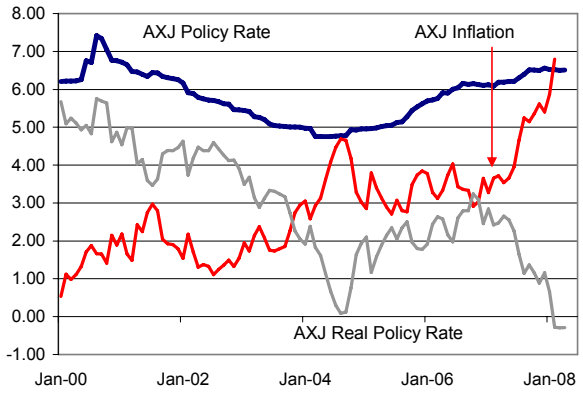
Room for manoeuvre still limited. The main reason why we expect less tightening in most countries than markets price in is that we see growth slowing almost everywhere, and quite sharply in some cases. In the US, our economists look for a double-dip recession in the coming quarters (see the US Economics comment in this issue). In Europe, our euro area team now sees GDP broadly stagnating in the next couple of quarters, and in Japan we also see a sharp slowdown in the current quarter. Moreover, the financial sector crisis is still lingering and further tail events cannot be excluded. Against this backdrop, we think that most central banks will lack the resolve to follow up hawkish rhetoric with (much) action.

Inflation genie is out of the bottle... Investors still appear to give central banks the benefit of the doubt — inflation expectations as (imperfectly) measured by breakeven inflation rates have increased only moderately in recent months. And the recent hawkish rhetoric has halted the increase for now. However, we continue to believe that inflation expectations are likely to rise further, following actual inflation, especially if the hawkish talk is not followed by action in most cases, as we suspect.

…as the global policy stance is very easy. As we discussed in previous publications, the underlying reason for rising global inflation is a very lax global monetary policy stance.

Exhibit 4

Asia ex-Japan Policy Rate versus Inflation



Source: Haver, Morgan Stanley Research

To illustrate this further, we present a series of charts showing weighted nominal and real monetary policy rates, along with inflation, for the global economy and for the main blocs — G10, Asia ex-Japan, Latin America and Emerging Europe, Middle East & Africa. In each of these regions except Latin America, and in the world as a whole, real policy rates are in negative territory. To bring real rates back to neutral or even into restrictive territory, we would thus need to see either massive increases in nominal policy rates or a very sharp decline in inflation. Neither is particularly likely, in our view.

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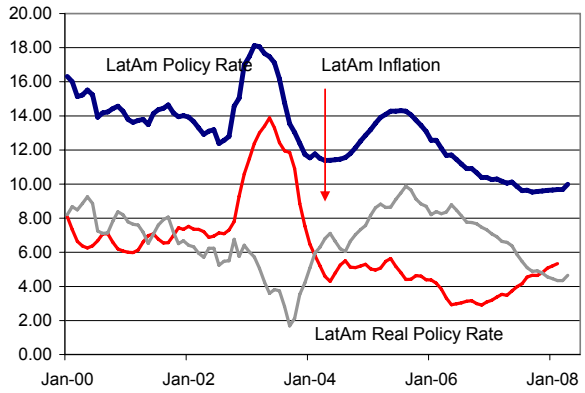
Inflation likely to be persistent. In Exhibit 2, we show what would happen to the real monetary policy rate between now and end-March 2009 if central banks would in fact raise rates as implied by the money markets right now and if inflation behaved as our country economists are forecasting. Initially, the real rate would fall further into negative territory as headline inflation rises sharply in the next few months, but thereafter the real rate increases due to easing headline inflation and the rate hikes that markets expect. However, by end-March 2009, the real policy rate would only go back to zero in this simulation. In other words, monetary policy would still be expansionary at that point, unless one believes that the neutral rate of interest is zero too (we don't). We conclude that inflation is likely to be a persistent problem in the years to come. This is not to say that inflation won't fall after this summer. However, we are likely to see higher average inflation rates and higher peaks and troughs in the next inflation cycle(s).

Exhibit 5

Latin American Policy Rate versus Inflation



Source: Haver, Morgan Stanley Research

From Our Interest Rate Strategy Team: Inflation Breakevens to Rise Despite Rate Hike(s)

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Buy/Hold Inflation Breakevens (BTPei 19s)
Buy/Hold Inflation 2-Years Forwards

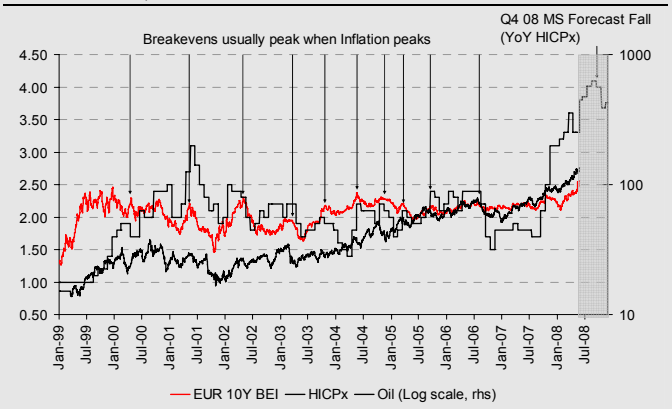
No clear evidence of rate hike(s) causes an imminent fall in breakevens: Breakeven inflation rates have been rising inexorably since the beginning of the year. Does central banks' increased focus on inflation mean that this trend should reverse? We conclude that it does not. The correlation between policy rates and BEI is weak.

Breakevens usually peak when inflation peaks: The correlation between BEI and realised inflation is stronger. The most conclusive evidence that inflation is under control will be the retreat of actual inflation, we believe. Previous spikes in European inflation — be they large or small — have triggered spikes in breakeven inflation (see Exhibit 6).

The same chart shows the sustained rise in oil prices (log scale). Oil has driven breakevens 30 bp higher of late, to no surprise, but we do not believe that the inflation breakeven market has factored in the potential for second-round effects. This time around, headline inflation has remained above 3% for a sustained period, and our economists forecast a peak above 4% in 4Q. Therefore, we think that breakevens have upside potential until then.

Exhibit 6

Peak in Inflation and Inflation Breakevens Is to Come, in Our View



Source: Morgan Stanley, Bloomberg