J.P.Morgan

Economic Research
May 21, 2010

Global Data Watch

- **Our outlook for a strong and resilient expansion is being challenged**
- **Heightened uncertainty about Euro area fiscal and monetary regimes**
- **DM core inflation hits record low in April; further declines lie ahead**

The bounce meets malaise

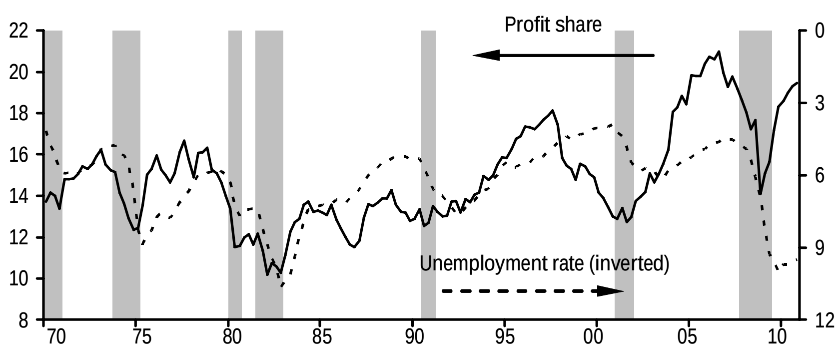
Our outlook for the developed economies incorporates a fundamental tension. On one side are the forces lifting activity from depressed levels, which we judge as powerful and synchronized. Perhaps most important, there appears to be enough fuel to sustain above-trend growth for at least another year as the private sector's shift away from its defensive stance is still at an early stage.

However, on the other side, this cyclical lift is not likely to generate sufficient growth to heal developed-world labor markets and public finances, which have been severely damaged by the recession. What's more, worrisome social pressures are building due to the slow and uneven nature of the healing process. In recognizing these tensions, we have coined the phrase "bouncing towards malaise" to characterize a forecast that is both optimistic about cyclical lift and sober about the medium-term consequences of the policy choices taken in this environment. In the US, the juxtaposition of high and rising corporate profit margins alongside sustained high unemployment increases pressure to steer regulatory and tax policy actions in a direction that could buy stability at the expense of harming incentives for growth. In the Euro area, the sharp divergence in the prospective paths of the core countries and the periphery creates risks for a monetary union that has limited tools and appetite to deal with intra-regional imbalances.

Against this backdrop, the financial market turmoil of recent weeks can be seen as representing a shift in market focus from the forces driving the economic bounce to those likely to generate malaise. Although the catalyst for this shift was narrow—concerns about funding pressures related to financing European sovereign debt—risk aversion has broadened even as Euro area authorities have taken aggressive action to contain these pressures. The European crisis has raised more basic questions about the effectiveness of Euro area policymaking and the sustainability of the euro currency. At the same time, uncertainties about the impact of regulatory legislation in the US have raised questions about growth and where the thrust of policy actions is headed. Taken together with a softer tone to early readings on US economic activity in May, these concerns have fed a fire that challenges our view that the cyclical upturn will prove resilient and long lasting.

US profit share and unemployment

% share of gross value added; J.P. Morgan fcst for 2010 — % sa



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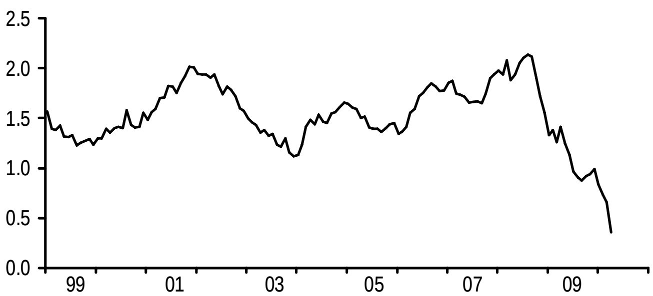
G-3 core inflation

% ch over 12 months; w/ Apr est for Japan



Although our global forecast is little changed, we take this challenge seriously. There are three issues that need to be tracked closely in coming weeks to gauge whether the contours of the cyclical upturn we project remain in place:

• **Confirming private sector lift.** Our view is that private sector demand was accelerating coming into the recent turmoil, led by an expansionary turn in the business sector. This needs to be verified in upcoming activity reports, which are unlikely to have been affected by the recent turmoil, at least outside of Europe. First and foremost will be readings on our global PMI and US payrolls.

• **Assessing collateral damage to credit availability.** A key channel though which risk aversion is transmitted to the economy is through the banking system. It seems highly likely that banks will turn more cautious in Europe in light of recent events. The question is to what degree and whether this will become a more global phenomenon.

• **Risk aversion on Main Street.** It remains to be seen whether financial market fears will be mirrored in a similar shift in household and business behavior. Europe is the most vulnerable, and both Euro area consumer confidence and the business PMI took a step down in May, although the moves were not dramatic. The effect that changes in financial market conditions have on activity also matters. Conditions probably have turned more restrictive on balance, but it is important to note that the plunge in equity prices is somewhat mitigated by the sharp drop in oil prices, lower high-grade corporate borrowing rates, and lower US mortgage rates.

Core inflation is plummeting in the G-3

Core inflation in the G-3 economies tumbled to 0.4%oya in April, based on this week's reports for the US and Euro area and our forecast for Japan (-1.9%oya ex food and energy, due next week). The continued slide has confirmed our belief that the record high amount of resource slack would create a highly disinflationary backdrop in the world's largest economies. Our long-standing call has been that G-3 core inflation will decline to near zero by late this year, with historic lows of 0.3%oya in the US and 0.6%oya in the Euro area (4Q/4Q). (See "Slack attack: G-3 core inflation setting record lows" in this *GDW*.)

A move into core deflation could happen if inflation expectations start to move down, reinforcing the disinflationary impulse from slack. A more adverse growth outcome, in which spillover from the European debt crisis delivers a major blow to global growth, would have the same effect. G-3 central banks are likely to guard against this development by maintaining record support to the economy, including leaving policy rates at their current level of near zero well into 2011 in the US, and until 2012 in the Euro area and Japan.

Euro area institutional uncertainty

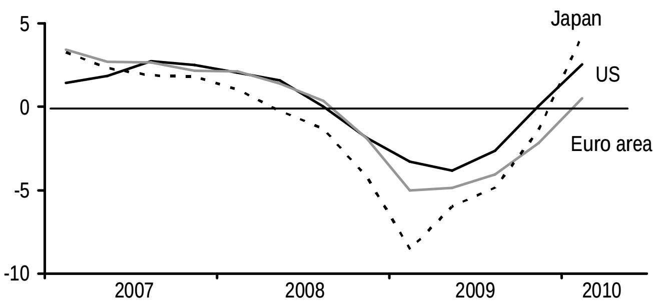
The solvency questions being raised about some Euro area sovereigns have not only created weakness and volatility in asset markets and parts of the banking system; they also have put the institutional structure of the Euro area in flux. The greatest overhaul will undoubtedly come on the fiscal side. Up until now, the Euro area's fiscal structure has involved a small, balanced EU budget and significant autonomy of budgets at the national level. The Stability and Growth Pact was supposed to provide the incentives and sanctions to ensure that national fiscal policy did not destabilize the monetary union.

Where the fiscal structure goes next is unclear. The support package for Greece and the European Stabilization Mechanism represent a significant step toward mutual fiscal support. However, many believe that the region's survival depends on a far greater degree of fiscal integration, which means greater supranational authority over national budget decisions and more cyclical and structural transfers. For now, Euro area policymakers are trying to strengthen the existing fiscal architecture: budget policy still set at the national level, but with more peer review and sanctions for excessive deficits. The European Commission set the ball rolling with some proposals for reforming the Stability and Growth Pact. Today Germany put forward its own views on what should happen, calling for balanced budget mandates across the region and an orderly default mechanism as the ultimate sanction for a lack of fiscal discipline.

There is also institutional uncertainty about the monetary regime. The ECB's decision to start purchasing the debt of sovereigns whose solvency is in question has not only been

Real GDP

%ch over 4 qtrs



controversial within the central bank, but has also raised questions outside about its independence. The ECB has tried to create the impression these purchases are "ring fenced" by highlighting their temporary nature and stressing that they will be sterilized. But, in the event, the auction of one-week term deposits, which can be used as collateral in the ECB's normal tender operations, is not sterilization as we understand it.

UK MPC dogged by high inflation

From the standpoint of inflation, the UK ought to be in the same boat as the G-3, following a severe recession and lackluster recovery. Yet inflation is running far above target, largely reflecting temporary factors the MPC has chosen to look through. Although recent activity data are encouraging, the risks arising from the crisis in the Euro area and the UK's own need to tighten fiscal policy are likely to keep the MPC on hold for now. The persistence of high CPI inflation runs the risk of destabilizing inflation expectations. The good news is that gauges of inflation expectations remain anchored. But the forecast continues to anticipate that the recent history of inflation performance will turn the MPC's mind toward tightening relatively quickly as risks to the growth outlook fade, putting the UK ahead of the US and Euro area in raising policy rates in early 2011.

Japan is the fastest-growing DM economy

Japanese GDP surged 4.9% annualized in 1Q, marking a fourth straight quarter of growth. Taking on board positive revisions to past quarters, Japan's economy expanded at a 4.2% pace over the four quarters ended 1Q10, the fastest in the developed world. That said, the report was a slight disappointment, in that there was less growth in domestic demand than anticipated, and more reliance on net exports. Next week's reports will show how the economy performed in April, while the May Shoko Chukin survey will provide the first clear look at how businesses are responding to heightened uncertainty in the global economy and markets.

The BoJ upgraded its economic assessment again today, while providing an outline of its new lending scheme. Financial institutions will be offered one-year funds at a 0.1% rate if they willing to make loans or otherwise invest in companies operating in targeted industries. The effectiveness of this program may depend on whether the government provides tax advantages or other incentives to spur activity in these sectors when it unveils its new growth strategy next month.

EM policymakers eyeing global turmoil

In the summer of 2008, the EM economies appeared insulated from the economic and financial troubles in the major economies. Most EM central banks were tightening policy to combat an incipient wage/price spiral, only to have to reverse course after the failure of Lehman. Almost two years later, EM policymakers once again are watching a blowup take place in the developed world and wondering what the fallout will be for their economies. As before, the drift of EM policy is toward raising interest rates, which remain at emergency lows despite an impressive pickup in growth and signs that core inflation has bottomed.

Against this backdrop, it seems likely that EM central banks, which have already been reluctant to tighten with G-3 rates on hold, will move even more slowly to normalize than we had anticipated. This week we scaled back our policy calls in Central Europe, which is most directly affected by developments in the Euro area. Rate hikes are now expected to begin later (in all cases in 2011), with end-2011 rates 50bp to 100bp lower than before. We also pushed back initial rate hikes in Turkey and South Africa.

In booming EM Asia, the most important decisions will be taken by China. Amid signs the economy is overheating, Chinese authorities have become increasingly concerned about a potential slowdown in Europe and the US. With more targeted tools at their disposal, officials are likely to hike rates by less this year than currently forecast. For CNY, we changed the year-end target to 6.6 from 6.5, noting the appreciation of the currency this year in REER terms. China's emphasis is on increasing the flexibility of the currency regime, and we look for officials to widen the daily trading band and introduce more two-way volatility going forward. From a political standpoint, the optimal timing for a shift in FX policy is to move by midyear.

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Global economic outlook summary

	Real GDP % over a year ago			Real GDP % over previous period, saar							Consumer prices % over a year ago			
	2009	2010	2011	4Q09	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	1Q10	2Q10	4Q10	2Q11
The Americas														
United States	-2.4	3.5	3.1	5.6	3.2	4.0	4.0	3.5	2.5	2.5	2.4	1.8 ↓	0.9 ↓	1.1
Canada	-2.6	3.6 ↑	2.9	5.0	6.0 ↑	3.3	3.2	3.5	3.0	2.0	1.6	1.3	1.8	2.1
Latin America	-2.9	4.9	3.8	7.1 ↓	2.9 ↓	4.6	3.3	4.4 ↓	4.1 ↑	4.9	5.9	6.4	7.3	7.0
Argentina	-2.0	4.5	3.0	7.9	8.0	8.0	3.0	3.0	2.0	3.0	7.5	8.0	10.0	10.0
Brazil	-0.2	7.0	4.0	8.4	8.7	6.3	4.8	4.0	3.8	4.2	4.9	5.3	5.8	4.5
Chile	-1.5	5.5	5.5	6.2 ↑	-5.9 ↑	8.0	22.0	18.0	-2.0	-6.0	-0.3 ↓	3.3	4.1	3.8
Colombia	0.4	3.0	4.1	4.7	2.7	2.8	2.9	3.1	4.5	4.8	2.0	2.1	3.3	3.6
Ecuador	0.4	2.0	3.0	1.3	2.0	3.5	4.0	4.5	3.0	2.5	4.1	3.9	4.7	4.4
Mexico	-6.5	4.5	3.5	7.9 ↓	-1.4 ↓	3.2	-1.8	4.2	5.7	7.9	4.8 ↑	4.4	5.1	4.5
Peru	0.9	6.5 ↑	6.0	11.5	7.3 ↑	4.5 ↑	4.1 ↓	4.0 ↓	7.0 ↑	6.9 ↓	0.7 ↑	1.0	2.1 ↑	2.2
Venezuela	-3.3	-1.5	2.5	-4.6	-4.0	-2.0	12.5	1.5	1.5	1.5	27.6	31.8	33.7	39.3
Asia/Pacific														
Japan	-5.2	3.5 ↑	2.2	4.2 ↑	4.9 ↓	2.5	2.7	2.7	2.2	2.0	-1.2	-1.4	-0.7	0.1
Australia	1.3	3.1	3.6	3.7	3.0	3.3	3.8	3.9	3.1	4.2	2.5	2.5	2.6	3.0
New Zealand	-1.6	2.6 ↓	2.6 ↑	3.3	1.9 ↓	3.7 ↑	3.7	2.9	1.4 ↑	2.3	2.0 ↓	2.2 ↓	2.3 ↓	2.8
Asia ex Japan	4.6	8.8 ↑	7.3	7.1 ↓	11.1 ↑	6.8 ↓	6.7 ↑	6.8	7.2	7.4	3.9 ↑	4.4	3.8	3.2
China	8.7	10.8	9.4	10.8	13.1	9.4	9.3	9.0	9.1	9.5	2.2	3.2	3.1	2.4
Hong Kong	-2.8	6.8 ↓	4.2	10.0	10.0	4.3	4.0	3.8	4.2	4.3	1.9	2.4	2.3	1.9
India	7.2	8.3	8.5	-2.0	10.4	8.1	7.0	8.7	7.9	7.8	12.7	11.9	6.2	5.5
Indonesia	4.5	6.2	5.8	6.2	5.4	6.0	4.0	5.0	6.5	6.5	3.7	5.3	6.3	4.9
Korea	0.2	5.8	4.1	0.7	7.5	4.0	4.5	3.8	4.0	4.0	2.7	2.8	3.4	3.6
Malaysia	-1.7	7.7	4.8	8.2	5.0	4.0	5.0	5.0	4.9	4.9	1.3	1.7	2.4	2.4
Philippines	0.9	4.5	4.3	3.5	6.0	5.0	3.5	4.0	4.5	4.5	4.3	5.0	5.2	4.9
Singapore	-1.3 ↑	9.6 ↑	4.8 ↑	-1.0 ↑	38.6 ↑	-7.8 ↓	2.0 ↑	4.9	6.6	6.6	0.9	3.4	4.7	3.7
Taiwan	-1.9	9.2 ↑	4.8	16.7 ↓	11.3 ↑	3.3 ↓	3.5 ↓	3.5 ↓	5.0	5.3	1.3 ↑	0.9	2.0	1.8
Thailand	-2.3	7.3	6.6	15.3	5.7	5.3	3.6	3.6	8.0	8.0	4.0	5.5	4.4	3.0
Africa/Middle East														
Israel	0.7	3.0	4.5	4.8	3.3 ↓	3.5	3.0	3.0	4.0	5.0	3.5	3.0	3.0	3.2
South Africa	-1.8	3.0	3.5	3.2	4.5 ↑	4.0	3.5	3.7	3.6	2.8	5.7 ↑	4.9 ↑	5.8 ↑	5.7
Europe														
Euro area	-4.0	1.3	1.9	0.2	0.8	3.0	2.0	1.8	1.8	1.8	1.1	1.5	1.5	0.9
Germany	-4.9	1.9	2.6	0.7	0.6	3.0	3.0	3.0	2.5	2.5	0.8	1.0	1.2	0.9
France	-2.5	1.7	2.1	2.2	0.5	3.0	2.0	2.0	2.0	2.0	1.5	1.8	1.3	0.6
Italy	-5.1	1.4	2.0	-0.2	2.1	2.5	1.5	2.0	2.0	2.0	1.3	1.5	1.5	1.1
Norway	-1.5 ↓	1.7 ↓	2.7 ↓	1.6 ↑	0.6 ↓	2.5 ↓	3.0	3.0	2.5 ↓	2.5 ↓	2.9	3.0	1.6	0.7
Sweden	-5.1	1.9	3.0 ↓	-1.6	4.0 ↑	4.0	3.5	3.0	2.8 ↓	2.8 ↓	1.0	1.4	1.0	1.9
Switzerland	-1.5	2.5	2.8	3.0	2.5	2.8	3.0	3.0	2.8	2.8	1.1	1.0	0.9	0.8
United Kingdom	-4.9	1.4	3.0	1.8	0.8	3.0	3.0	3.5	2.5	3.0	3.3	3.5 ↑	2.6 ↑	1.7
Emerging Europe	-5.0	4.1	4.7	2.5	2.2	4.5	4.1	3.8	4.0	4.4	6.1	5.8	5.9	5.4
Bulgaria	-5.0	-0.5 ↑	4.5	...	...	...	...	...	...	...	...	...	...	...
Czech Republic	-4.2	2.0	4.0	3.0	0.7	3.0	2.5	2.0	3.0	4.0	0.7	1.3	2.8	2.8
Hungary	-6.3	0.8	4.0	0.8	3.6	2.0	2.0	1.5	3.5	4.0	6.0	4.8	3.7	2.8
Poland	1.8	3.2	4.2	5.3	3.0	4.0	2.7	3.0	3.0	4.0	3.0	2.0	2.6	2.8
Romania	-7.1	1.0	4.0	...	...	...	...	...	...	...	4.6	4.4	4.7	4.5
Russia	-7.9	5.5	5.0	2.7	2.2	6.0	5.5	5.0	5.0	5.0	7.2	6.5	7.2	7.0
Turkey	-4.7	5.1	5.5	...	...	...	...	...	...	...	9.3	10.3	8.5	6.6
Global	-2.5	3.6 ↑	3.3	3.9	3.6 ↓	3.8 ↓	3.5	3.4	3.0	3.1	2.2	2.1	1.8	1.7
Developed markets	-3.4	2.7 ↑	2.6	3.3 ↑	2.7	3.3	3.1	2.9	2.3	2.3	1.5	1.3 ↓	1.0 ↓	1.0
Emerging markets	1.0	6.8	5.9	6.2 ↓	7.4 ↓	5.7 ↓	5.3 ↑	5.6	5.8	6.1	4.9 ↑	5.1	5.0	4.4
Memo:														
Global — PPP weighted	-0.8	4.8	4.4	4.6	5.1	4.8	4.4	4.4	4.1	4.1	3.2	3.2	2.8	2.6

Note: For some emerging economies, 2009-2011 quarterly forecasts are not available and/or seasonally adjusted GDP data are estimated by J.P. Morgan.
Bold denotes changes from last edition of *Global Data Watch*, with arrows showing the direction of changes. Underline indicates beginning of J.P. Morgan forecasts.

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G-3 economic outlook detail

Percent change over previous period; seasonally adjusted annual rate unless noted

				2009	2010				2011		
	2009	2010	2011	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q
United States											
Real GDP	-2.4	3.5	3.1	5.6	3.2	4.0	4.0	3.5	2.5	2.5	3.0
Private consumption	-0.6	2.7	2.6	1.6	3.6	3.3	3.0	3.0	2.5	2.0	2.5
Equipment investment	-16.6	11.0	9.5	19.0	13.4	12.0	12.0	10.0	9.0	8.0	8.0
Non-residential construction	-19.8	-12.6	1.5	-18.0	-14.0	-8.0	-3.0	-3.0	0.0	7.0	9.0
Residential construction	-20.5	1.3	15.7	3.7	-10.9	5.0	10.0	15.0	15.0	20.0	20.0
Inventory change ($ bn saar)	-108.3	46.3	49.2	-19.7	31.1	44.2	56.4	53.6	45.5	47.2	50.3
Government spending	1.8	0.4	-0.1	-1.3	-1.8	0.5	1.1	1.4	-0.8	-1.0	-1.0
Exports of goods and services	-9.6	12.2	9.8	22.8	5.8	14.0	12.0	11.0	9.0	9.0	8.0
Imports of goods and services	-13.9	9.6	7.5	15.8	8.9	8.0	8.0	8.0	7.0	8.0	7.0
Domestic final sales contribution	-2.8	2.2	2.9	1.5	2.3	3.1	3.3	3.4	2.6	2.5	2.9
Inventories contribution	-0.6	1.2	0.0	3.8	1.6	0.4	0.4	-0.1	-0.3	0.0	0.1
Net trade contribution	1.0	0.1	0.2	0.3	-0.6	0.5	0.3	0.2	0.1	0.0	0.0
Consumer prices (%oya)	-0.3	1.6	1.1	1.5	2.4	1.8	1.2	0.9	0.8	1.1	1.2
Excluding food and energy (%oya)	1.7	0.8	0.6	1.7	1.3	0.9	0.6	0.3	0.4	0.4	0.6
Federal budget balance (% of GDP, FY)	-9.9	-9.4	-7.8								
Personal saving rate (%)	4.2	3.1	3.4	3.9	3.1	3.0	3.0	3.2	3.2	3.3	3.4
Unemployment rate (%)	9.3	9.6	9.2	10.0	9.7	9.7	9.6	9.5	9.4	9.3	9.1
Industrial production, manufacturing	-11.3	5.3	4.0	5.6	6.6	7.0	5.0	4.0	3.0	3.0	4.5
Euro area											
Real GDP	-4.0	1.3	1.9	0.2	0.8	3.0	2.0	1.8	1.8	1.8	1.8
Private consumption	-1.0	0.0	1.3	-0.2	-1.0	1.0	1.0	1.0	1.5	1.5	1.5
Capital investment	-10.8	-1.7	3.8	-5.2	-3.0	2.0	3.0	4.0	4.0	4.0	4.0
Government consumption	2.3	0.8	1.0	-0.4	0.0	1.0	1.0	1.0	1.0	1.0	1.0
Exports of goods and services	-12.8	7.5	8.1	7.6	6.0	10.0	8.0	8.0	8.0	8.0	8.0
Imports of goods and services	-11.4	4.6	7.7	5.1	1.0	7.5	6.5	7.5	8.0	8.0	8.0
Domestic final sales contribution	-2.5	-0.1	1.7	-1.3	-1.2	1.2	1.4	1.6	1.9	1.9	1.9
Inventories contribution	-0.8	0.2	-0.1	0.4	-0.1	0.7	-0.1	-0.1	-0.2	-0.2	-0.2
Net trade contribution	-0.8	1.2	0.3	1.0	2.1	1.1	0.7	0.4	0.2	0.2	0.2
Consumer prices (HICP, %oya)	0.3	1.4	1.0	0.4	1.1	1.5	1.6	1.5	1.3	0.9	0.9
ex unprocessed food and energy	1.3	0.7	0.7	1.0	0.9	0.8	0.7	0.6	0.6	0.6	0.7
General govt. budget balance (% of GDP, FY)	-6.3	-6.7	-5.5								
Unemployment rate (%)	9.4	9.9	9.5	9.8	10.0	10.0	9.8	9.7	9.6	9.5	9.4
Industrial production	-14.8	6.6	3.2	8.7	16.1	4.0	3.5	3.5	3.0	3.0	3.0
Japan											
Real GDP	-5.2	3.5	2.2	4.2	4.9	2.5	2.7	2.7	2.2	2.0	1.5
Private consumption	-1.0	2.2	1.7	2.7	1.3	2.0	2.3	2.5	1.2	1.8	1.0
Business investment	-19.3	2.8	6.0	5.1	4.2	8.0	8.0	6.0	6.0	5.0	5.0
Residential construction	-13.9	-2.9	9.7	-10.3	1.1	18.0	15.0	10.0	10.0	8.0	5.0
Public investment	8.0	-8.9	-11.6	-4.7	-6.5	-25.0	-15.0	-10.0	-8.0	-10.0	-12.0
Government consumption	1.6	1.5	0.9	2.8	2.0	1.5	0.5	1.0	1.2	0.5	0.5
Exports of goods and services	-24.1	23.5	8.7	25.2	30.5	12.0	11.0	10.0	8.0	6.0	8.0
Imports of goods and services	-16.9	8.6	7.9	6.3	9.6	8.0	9.0	9.0	8.0	6.0	7.0
Domestic final sales contribution	-3.5	1.5	1.8	2.3	1.4	1.8	2.2	2.3	1.7	1.7	1.1
Inventories contribution	0.2	-0.2	-0.1	-0.6	0.4	-0.2	-0.3	-0.2	0.1	0.0	-0.1
Net trade contribution	-2.0	2.2	0.5	2.5	3.0	0.9	0.7	0.6	0.4	0.3	0.5
Consumer prices (%oya)	-1.4	-1.1	-0.1	-2.0	-1.2	-1.4	-1.3	-0.7	-0.5	0.1	0.2
General govt. net lending (% of GDP, CY)	-6.8	-7.5	-8.8								
Unemployment rate (%)	5.1	4.8	4.5	5.2	4.9	4.8	4.8	4.7	4.6	4.6	4.5
Industrial production	-21.8	21.9	10.0	25.9	30.9	15.0	12.0	12.0	8.0	8.0	10.0
Memo: Global industrial production	-11.1	8.7	5.3	10.4	12.3	7.5	6.1	5.4	4.5	4.8	5.6
%oya				-2.8	8.4	9.9	9.0	7.7	5.9	5.2	5.1

Note: More forecast details for the G-3 and other countries can be found on J.P. Morgan's Morgan Markets client web site.

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Central Bank Watch

			Change from			Forecast					
	Official interest rate	Current	Aug '07 (bp)	Last change	Next meeting	next change	Jun 10	Sep 10	Dec 10	Mar 11	Jun 11
Global	GDP-weighted average	1.32	-334				1.35	1.43	1.51	1.59	1.79
excluding US	GDP-weighted average	1.88	-247				1.93	2.05	2.16	2.28	2.39
Developed	GDP-weighted average	0.52	-359				0.52	0.55	0.58	0.63	0.82
Emerging	GDP-weighted average	4.52	-234				4.66	4.94	5.21	5.42	5.63
Latin America	GDP-weighted average	5.99	-294				6.29	6.85	7.31	7.49	7.77
CEEMEA	GDP-weighted average	4.22	-264				4.13	4.12	4.41	4.49	4.82
EM Asia	GDP-weighted average	4.09	-201				4.25	4.53	4.72	4.99	5.14
The Americas	GDP-weighted average	0.78	-481				0.83	0.92	1.00	1.06	1.43
United States	Federal funds rate	0.125	-512.5	16 Dec 08 (-87.5bp)	23 Jun 10	2Q 11 (+25bp)	0.125	0.125	0.125	0.125	0.50
Canada	Overnight funding rate	0.25	-400	21 Apr 09 (-25bp)	2 Jun 10	2 Jun 10 (+25bp)	0.50	1.00	1.50	2.00	2.50
Brazil	SELIC overnight rate	9.50	-250	28 Apr 10 (+75bp)	9 Jun 10	9 Jun 10 (+75bp)	10.25	11.50	12.50	12.50	12.50
Mexico	Repo rate	4.50	-270	17 Jul 09 (-25bp)	18 Jun 10	2Q 11 (+25bp)	4.50	4.50	4.50	4.50	4.75
Chile	Discount rate	0.50	-450	9 Jul 09 (-25bp)	15 Jun 10	15 Jun 10 (+25bp)	0.75	1.50	2.25	3.75	5.00
Colombia	Repo rate	3.00	-600	30 Apr 10 (-50bp)	27 May 10	1Q 11 (+50bp)	3.00	3.00	3.00	4.00	5.00
Peru	Reference rate	1.50	-300	6 May 10 (+25bp)	10 Jun 10	July 10 (+25bp)	1.50	2.25	3.00	3.75	4.50
Europe/Africa	GDP-weighted average	1.29	-323				1.28	1.29	1.33	1.40	1.50
Euro area	Refi rate	1.00	-300	7 May 09 (-25bp)	10 Jun 10	On hold	1.00	1.00	1.00	1.00	1.00
United Kingdom	Repo rate	0.50	-500	5 Mar 09 (-50bp)	10 Jun 10	10 Feb 11 (+25bp)	0.50	0.50	0.50	0.75	1.00
Sweden	Repo rate	0.25	-325	2 Jul 09 (-25bp)	Jul 10	1Q 11 (+25bp)	0.25	0.25	0.25	0.50	0.75
Norway	Deposit rate	2.00	-250	5 May 10 (+25bp)	23 Jun 10	22 Sep 10 (+25bp)	2.00	2.25	2.50	2.75	3.25
Czech Republic	2-week repo rate	0.75	-200	6 May 10 (-25bp)	23 Jun 10	**2Q 11 (+25bp)**	0.75	0.75	0.75	0.75	1.00
Hungary	2-week deposit rate	5.25	-250	26 Apr 10 (-25bp)	31 May 10	**21 Jun 10 (-25bp)**	5.00	4.50	4.50	4.50	4.50
Israel	Base rate	1.50	-250	28 Mar 10 (+25bp)	24 May 10	24 May 10 (+25bp)	1.75	2.25	2.75	3.25	3.75
Poland	7-day intervention rate	3.50	-100	24 Jun 09 (-25bp)	25 May 10	**1Q 11 (+25bp)**	3.50	3.50	3.50	3.75	4.00
Romania	Base rate	6.25	-75	4 May 10 (-25bp)	30 Jun 10	30 Jun 10 (-25bp)	6.00	5.50	5.50	5.50	5.75
Russia	1-week deposit rate	3.25	25	29 Apr 10 (-25bp)	May 10	May 10 (-25bp)	3.00	3.00	3.00	3.00	3.50
South Africa	Repo rate	6.50	-300	25 Mar 10 (-50bp)	22 Jul 10	**2Q 11 (+50bp)**	6.50	6.50	6.50	6.50	7.00
Switzerland	3-month Swiss Libor	0.25	-225	12 Mar 09 (-25bp)	Jun 10	16 Dec 10 (+25bp)	0.25	0.25	0.50	0.75	1.00
Turkey	**1-week repo rate**	7.00	-1050		17 Jun 10	**14 Oct 10 (+50bp)**	7.00	7.00	8.50	8.50	8.50
Asia/Pacific	GDP-weighted average	2.18	-126				2.25	2.41	2.51	2.66	2.74
Australia	Cash rate	4.50	-175	4 May 10 (+25bp)	1 Jun 10	Jul 10 (+25bp)	4.50	5.00	5.25	5.50	5.75
New Zealand	Cash rate	2.50	-550	30 Apr 09 (-50bp)	10 Jun 10	29 Jul 10 (+25bp)	2.50	3.00	3.50	4.00	4.25
Japan	Overnight call rate	0.10	-43	19 Dec 08 (-20bp)	14 Jun 10	4Q 11 (+15bp)	0.10	0.10	0.10	0.10	0.10
Hong Kong	Discount window base	0.50	-625	17 Dec 08 (-100bp)	24 Jun 10	2Q 11 (+25bp)	0.50	0.50	0.50	0.50	1.00
China	1-year working capital	5.31	-126	22 Dec 08 (-27bp)	2Q 10	2Q 10 (+27bp)	5.58	5.85	6.12	6.39	6.39
Korea	Base rate	2.00	-250	12 Feb 09 (-50bp)	10 Jun 10	3Q 10 (+25bp)	2.00	2.25	2.50	2.75	3.00
Indonesia	BI rate	6.50	-200	5 Aug 09 (-25bp)	4 Jun 10	1Q 11 (+25bp)	6.50	6.50	6.50	6.75	7.00
India	Repo rate	5.25	-250	20 Apr 10 (+25bp)	27 Jul 10	2Q 10 (+25bp)	5.50	6.00	6.00	6.50	6.75
Malaysia	Overnight policy rate	2.50	-100	13 May 10 (+25bp)	8 Jul 10	3Q 10 (+25bp)	2.50	3.00	3.00	3.00	3.00
Philippines	Reverse repo rate	4.00	-350	9 Jul 09 (-25bp)	3 Jun 10	3 Jun 10 (+25bp)	4.25	4.75	5.00	5.00	5.00
Thailand	1-day repo rate	1.25	-200	8 Apr 09 (-25bp)	2 Jun 10	14 July 10 (+25bp)	1.25	1.50	1.75	2.00	2.25
Taiwan	Official discount rate	1.25	-188	18 Feb 09 (-25bp)	2Q 10	3Q 10 (+25bp)	1.25	1.50	1.75	2.00	2.25

Bold denotes move since last GDW and forecast changes. Underline denotes policy meeting during upcoming week.

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The J.P. Morgan View: Markets

Q&A on market sell-off

- **Asset allocation:** Keeping risk tight, we're avoiding consensus trades where feasible, but not giving up on medium-term bullish view on risky assets.
- **Economics:** Slightly softer data may unnerve markets but are not enough to change our growth forecasts.
- **Fixed income:** Bond yields to move higher medium term, but remain hostage to market volatility near term.
- **Equities:** Position squaring favors Europe, large versus small caps, and defensive versus cyclical sectors in the near term.
- **Credit:** Flows out of high yield mutual funds have been occurring for three consecutive weeks, pointing to further spread widening near term.
- **FX:** The recovery in commodity currencies looks to be on hold until after G-20.
- **Commodities:** The medium-term direction is still positive.

After another awful week for markets, we would like to present our thoughts around a set of basic questions, acknowledging there is a lot we do not know. What happened? Is it real or just fear? Can the sell-off become self-fulfilling? How bad can it get? What is most at risk? What will stop it? And what can we do in the meanwhile?

1. What happened? A beaten up and jittery market saw economic data that were not as good as hoped and policy actions that were less than helpful. Market participants and makers thus went into full-fledged position squaring, reducing tactical risk, adding cash, and cross-hedging illiquid positions with markets where there was still liquidity. Markets have learned from the 2008 crisis to sell/hedge first and ask questions later. Market turnover fell and bid-ask spreads rose. The weaker economic data—claims, NY Fed, Taiwan exports—are not bad enough to elicit changes to our growth forecasts, but hit those investors, like us, who had held on, on a conviction that fundamentals trumped the market technicals. Policy actions—such as the US Senate bank overhaul bill and German restrictions on shorting its debt—may just reflect widespread frustration with the financial industry, but are not coming at a good time. Draconian fiscal measures in Greece and Spain are being ignored.

2. Is it real or just fear? Price action last week seemed driven more by uncertainty and fear, but this week the sell-off was more "real," with weaker data and less-than-helpful policy actions.

3. Can the sell-off become self-fulfilling? The 2008 crisis reminded us of the negative feedback from markets to economies, through capital destruction and a seizing up of lending flows. The fresh memory of that crisis is leading market participants to the same, self-destructive defensive positioning as two years ago, but is also inducing central banks to flood markets with liquidity, to prevent a repeat of 2008. We observe that wealth losses this time around are mostly in equities and very little in fixed income. As a result, bank capital remains intact. With bank capital intact, bank funding largely unmolested, and bank balance sheets much less leveraged, there seems little risk that banks will transmit the market turmoil into a funding crisis for the real economy.

4. How bad can it get? If we are right that the underlying cyclical rebound remains in place, that banks will not be a source of contagion, and that policymakers will be generally supportive, then risky markets should bottom over the next month or so. But this argument does not tell us how far the knife can fall.

5. What assets are most vulnerable in this sell-off? With our view that investors are largely position-squaring in response to uncertainty, rather than being convinced a double-dip recession is coming, the vulnerable positions are the consensus trades. This is part of why both gold and the dollar suddenly fell this week. Consensus positions (many in our own model portfolio) are still vulnerable, including: cyclicals, small caps, carry-oriented curve steepeners, EM bond longs, HY credit overweights, European bank underweights.

6. What will stop the sell-off? Three signals are most important: (1) confirmation that the nonfinancial sector—companies and households—are not panicking and remain in expansion mode; (2) coordination among policymakers to support markets rather than punish them; and (3) markets cease reacting to bad news and start reacting to good news, something that was clearly not present this week. One can understand the frustration of policymakers in the midst of renewed market panic, but the only solution for overstretched public balance sheets is growth, and that requires coordinated support to markets.

7. What to do in the meanwhile? Keeping tactical risk low is obvious. Investors with staying power should start buying oversold assets, though, without being in a hurry. Remaining positions should be focused on non-consensus exposures.

Fixed income

Bond markets rallied strongly once more, and continued to move in lockstep with equities, sparked by the German ban on short sales and slightly weaker economic data. Euro area high-yielders, heretofore at the epicenter of the crisis, saw spreads widen only slightly, as the ECB kept buying. Private sector buyers remain largely absent, however, and the rising dispersion of bids in Euro area government bond auctions testifies to increased funding stresses (see G. Salford, *GFIMS Euro Cash*). Short-maturity Euro area peripherals are strongly supported in the medium term by the European Stabilization Mechanism, approved today by Germany, while the ECB's backstop bid should limit any near-term spread widening.

The ECB's reintroduction of unlimited term lending has contributed to a further increase in excess liquidity in the Euro area money market. This should keep overnight rates low, meaning that the **very short end of the money market curve should decline further**.

We maintain our bearish medium-term view on duration. The strong bond rally over the past month leaves yields consistent with a significant spillover from falling risky assets to economic weakness; although possible, this is not our central case. We recognize however, that **demand for the safety of government bonds will stay strong until uncertainty diminishes**, not least about Euro area sovereigns.

Any economic spillover would weigh most heavily on the Euro area. The brighter economic prospects in the US underpin our continuing **short position in US Treasuries versus German Bunds**. We are mindful however of the risk of capital flight from Europe to Treasuries; the March TIC data released this week showed near-record foreign buying of Treasuries even at that early stage of the crisis.

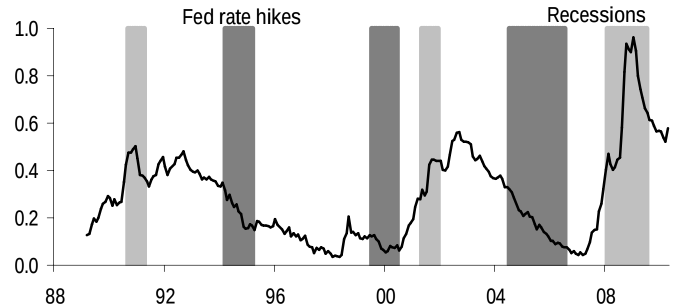
Equities

Global equities declined further this week driven by broad-based risk reduction and position squaring. **Uncertainty and volatility rose** sharply with the VIX and VSTOXX (the Euro counterpart of the VIX index) moving to 46% and 52%, respectively, later in the week, above the levels seen on Friday, May 5, the day before the European Stabilization Mechanism was announced.

Equity markets broke important technical levels with the S&P 500 index falling below its 200-day moving average and testing intraday the 1,066 May 6 spike low. Our **technical** strategist Mike Krauss looks for a volatile range in the near term and sees a support above 950-1,000 for the S&P 500 index.

Slope of the US market risk-return tradeoff line

Required return per unit of risk



Position-squaring is the dominant market theme for the near term. Position-squaring favors Europe across regions. In the Merrill Lynch fund manager survey for May, 34% of respondents said that they were underweight Europe, almost double the previous month's level and the highest since early 2009. Keep a long in MSCI EMU versus MSCI World.

Similarly, we see more near-term upside on **defensive versus cyclical sectors** and on **large versus small caps.** Overweighting cyclical sectors and small caps were consensus trades that have so far retraced only a small portion of their year-to-date outperformance (see charts). The early indications from US and Eurozone business surveys and the decline in Taiwanese export orders for a second straight month suggest a loss of momentum for global manufacturing, which is negative for cyclical stocks. In terms of small caps, their illiquidity cushions them during modest market sell-offs as investors tend to sell their more liquid holdings, but acts a drag during more significant market sell-offs due to flight to liquidity.

Credit

Credit markets sold off this week as investors trimmed positions and as market makers reduced their inventory. US HG spreads widened 6bp while US HY spreads widened by a large 52bp resulting in **credit spreads reaching a new high for the year**.

We believe many real money investors are simply sidelined and see any further sell-off as a buying opportunity. This has the potential to push spreads tighter in the medium term.

Near term, however, the balance of risks is skewed to the downside as uncertainty and volatility remain high. Funds have flowed out of high yield mutual funds for three consecutive weeks. Our trading model based on mutual fund flow momentum suggests that spreads for corporates will continue to widen in the near term. Investors wanting to hedge this near-term risk are likely to use CDS indices rather than selling the cash bonds, keeping demand for protection strong.

Foreign exchange

As the predominant funding currency for longs in commodity FX and emerging markets, **the euro rallied this week with the risk unwind**. Its movements will remain highly erratic. Today's German approval of the European Stabilization Mechanism is positive, but given the risk of additional regulatory policy moves around the G-20 summit in late June, a further risk unwind could prompt additional short covering in the euro. We have been stopped out of short euro trades versus USD, CHF, and Asia, and we recommend staying flat. Assuming risky markets stabilize, we continue to expect the euro to underperform high-yielders and EM due to loose ECB policy, and to range-trade versus USD until US rates start to drift higher.

The past week's deleveraging has slashed **commodity FX** valuations to levels that suggest that short-term positioning is probably flat. And, in view of acute near-term policy risks, a recovery in these currencies looks to be on hold until after G-20. Consistent with this assessment, we have pulled the end-June forecasts for AUD, CAD, and NZD to their current spot levels. Uncertainty about the policy direction in Europe should recede over the summer as already-agreed policy measures are implemented, allowing the global growth backdrop to return to being a boost to the dollar bloc currencies. With the BoC still likely to hike faster than markets anticipate, we forecast USD/CAD at 0.95 by year-end before signals of a shift in Fed policy direction pull the cross back toward parity in the first half of 2011. For AUD/USD and NZD/USD our end-2010 targets are 0.92 and 0.75, respectively, and new targets for June 2011 are 0.88 and 0.71.

Commodities

Commodities are down about 5% this week. Oil is now around $71, one dollar lower than last week's close. Volatility was very high yesterday as June WTI futures saw prices trade in a breathtaking $7/bbl range over the course of the day. Our year-end bullish forecasts now seem hard to reach, but we still believe the medium-term direction is positive. Fundamentals are still positive for prices, even though revisions to supply estimates indicate that production is higher than previously believed. OPEC will however act if prices continue to slide from the current levels. Earlier this year, we were expecting the oil curve to become backwardated in early 2H. While this is still the medium-term trend, it is unlikely to happen until late in the year.

Base metals are higher today, and losses this week were modest compared to energy and precious metals. Signs of a modest improvement in underlying consumption is helping to support base metals. Copper is $100 higher today and it seems that copper has found good buying support around the $6,500 area. Aluminum, zinc, and lead have been at the forefront of the price decline. Aluminum has retreated to a level where analysts and traders are starting to worry about price-driven production cuts.

Ten-year Government bond yields

	Current	Jun 10	Sep 10	Dec 10	Mar 11
United States	3.20	3.30	3.60	4.00	4.25
Euro area	2.67	2.75	3.05	3.15	3.25
United Kingdom	3.55	3.70	3.85	4.00	4.30
Japan	1.24	1.40	1.50	1.55	1.55
GBI-EM	7.00			7.90	

Credit markets

	Current	YTD Return
US high grade (bp over UST)	164	5.1%
Euro high grade (bp over Euro gov)	198	3.4%
USD high yield (bp vs. UST)	711	3.6%
Euro high yield (bp over Euro gov)	746	4.4%
EMBIG (bp vs. UST)	356	2.6%
EM Corporates (bp vs. UST)	369	3.3%

Foreign exchange

	Current	Jun 10	Sep 10	Dec 10	Mar 11
EUR/USD	1.26	1.25	1.25	1.20	1.18
USD/JPY	89.8	87	90	93	96
GBP/USD	1.45	1.44	1.39	1.35	1.34

Commodities - quarterly average

	Current	10Q2	10Q3	10Q4	11Q1
WTI ($/bbl)	70	86	94	93	90
Gold ($/oz)	1177	1150	1250	1200	1175
Copper($/m ton)	6583	8000	7150	6750	6500
Corn ($/Bu)	3.69	3.75	3.90	3.80	4.00

Source: J.P. Morgan, Bloomberg, Datastream

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Economic Research Note

Slack attack: G-3 core inflation setting record lows

- **G-3 core inflation's rapid approach to zero locks in low-for-long policy stances**
- **Inflation and policy dynamics differ elsewhere**

Core CPI inflation is setting record lows in the G-3 economies, reaching an estimated 0.4%oya last month. US core inflation fell to 0.9%oya in April, a level last seen very briefly in the early 1960s. Euro area core inflation declined to 0.7%oya, the lowest level in recorded history dating back to 1991. Japan's core inflation rate (calculated to exclude all food and energy) is expected to hit a new low of -1.9%oya in next week's April report, although the decline from -1.1% in March largely represents a reduction in high school tuition, rather than fundamental forces.

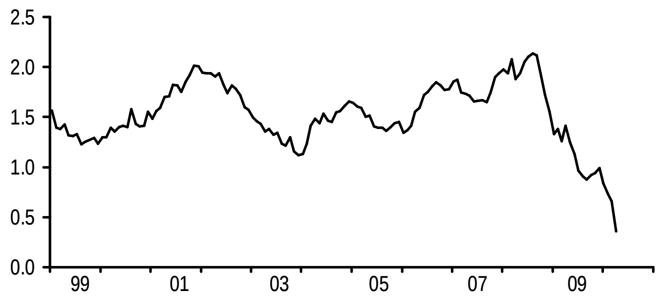
The move down also is broadly based across sectors. Core inflation in the heavily weighted services sector has declined steadily since late 2008. However, this move was tempered by an unexpected rise in goods inflation that owed to extraordinary increases in prices of US tobacco (due to tax increases) and vehicles (partly due to Cash for Clunkers). These transitory influences are now waning, and core goods inflation is moving downward.

Our long-standing forecast has been that G-3 core inflation would fall to near zero in 2010 (4Q/4Q). This forecast was based on a belief that the record amount of resource slack and the depressed level of demand would put strong, downward pressure on wages and prices (See "Slack Attack," *Global Issues*, May 29, 2009). The relationship between slack and inflation is embodied in the Phillips curve, which posits that inflation is a function of slack (or equivalently, the output gap) and inflation expectations. According to the model, when the level of resource usage falls below normal, this puts downward pressure on core inflation. If inflation expectations are well-anchored by past experience or a credible central bank inflation objective, then inflation returns to the level of inflation expectations as resource utilization returns to normal. On the other hand, if inflation expectations are less well-anchored, a return to normal inflation would require a period of elevated resource utilization.

In estimating the Phillips curve relationship, we find that there are significant lags between movements in slack and movements in core inflation. This may reflect lags in the direct transmission of slack to inflation, or that inflation expectations eventually respond to big shifts in core infla-

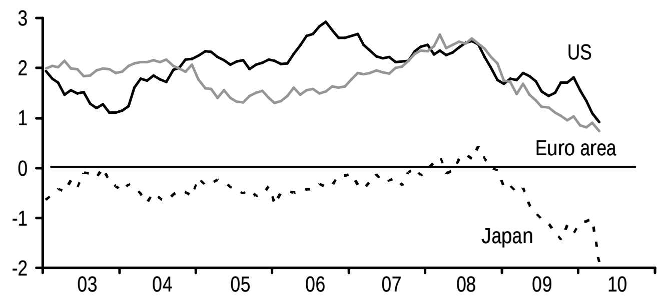
G-3 core inflation

% ch over 12 months; w/ Apr est for Japan



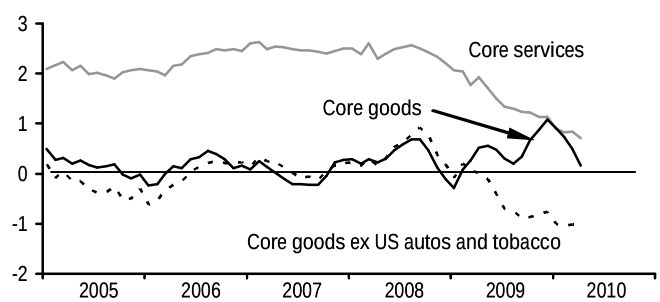
Core inflation

%ch over 12 months; w/ Apr est for Japan



G-3 core inflation by sector

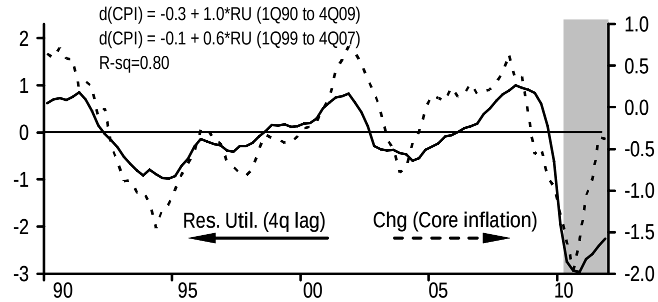
%oya



Resource utilization and the change in core inflation, G-3

Std dev from avg

%-pt; 8q chg in %oya



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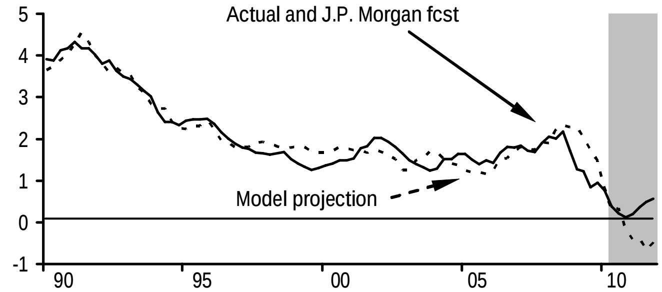
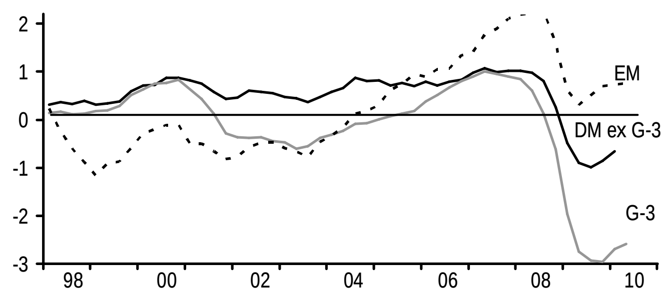
Core CPI, G-3

%oya



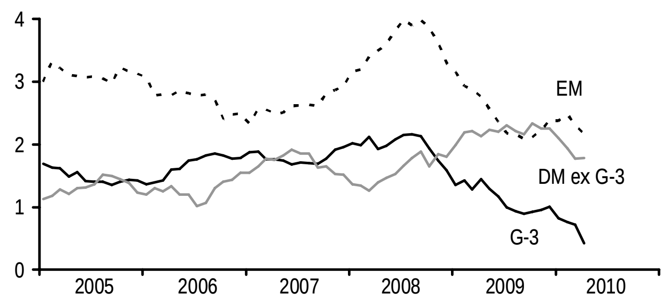
Resource utilization

Std dev from long-term avg



Core CPI

%oya; DM ex G-3 exclude impact of changes in UK VAT



tion. Either way, experience suggests that core inflation will continue to decline even after resource utilization has turned the corner. So we are forecasting that G-3 core inflation will decline further in the next few quarters.

It is worth noting that our top-down Phillips curve model projects a move into outright deflation in the G-3 economies, compared to our country economists' bottom-up estimate that inflation will trough at about 0.1%oya. This may sound extreme, but bear in mind that inflation was quite low before the global downturn began.

A move into deflation would be far more likely if inflation expectations start to move down, reinforcing the disinflationary impulse from slack. Consistent with our long-standing views, G-3 central banks are likely to guard against this development by maintaining record support to the economy, including leaving policy rates at their current level of near zero well into 2011 in the US, and until 2012 in the Euro area and Japan. A more adverse growth outcome, in which spillover from the European debt crisis delivers a major blow to global growth, also would increase the risks of a move into deflation.

Core inflation has bottomed elsewhere

Inflation dynamics differ elsewhere. This explains why central bankers outside the G-3 are moving to normalize policy. However, with the G-3 central banks on hold, the move to normalize elsewhere is happening more slowly than domestic fundamentals would dictate, so that inflation pressures are building in an undesirable way in some countries.

Our calculations show that the level of resource utilization fell sharply across the globe during the past several years. However, there is a clear hierarchy in which resource utilization is extremely depressed in the G-3 economies, moderately low in the remaining DM economies, and slightly above average in the EM economies (the EM reading probably overstates reality because the NAIRU almost certainly has fallen in the EM).

The EM and the smaller DM economies were in a more overheated condition on the eve of the global recession in 2007-08. Moreover, the recession generally was less severe in these economies. Together, these developments mean that the level of demand and resource utilization fell by less and bottomed at a higher level outside of the G-3.

In turn, this suggests that there has been less downward pressure on core inflation, and that the current rate of inflation should be closer to the level of inflation expectations (which is assumed to be at least somewhat stable in all economies, thereby providing an anchor for inflation). In addition, the recovery in commodity prices is buttressing core inflation in the EM, where the potential for passthrough is higher.

Inflation outcomes generally conform to this picture. The decline in G-3 core inflation generally has matched or exceeded that elsewhere. Moreover, core inflation may have already bottomed outside of the G-3 at a level that is low but not too far from central banks' objectives, whereas it already has reached an undesirably low level in the G-3 and is gaining downward momentum. These growing inflation divergences are likely to intensify the dilemma faced by policymakers outside the G-3, where a low-for-long policy is becoming less appropriate (see "Central bank exits and FX performance," *Global Issues*, Dec 18, 2009).

Economic Research Note

The difficult, but not herculean, path to US fiscal sustainability

- **Most of the current fiscal deficit is the result of economic weakness**
- **If the economy continues to recover, the primary deficit should get to 1.6% of GDP by 2014**
- **A shift in political will is needed to close that remaining gap, as well as to address the entitlement issue**

The US fiscal outlook is bad, but it is not apocalyptic. The very large deficit for the current fiscal year, around 9.4% of GDP by our estimate, may lead one to conclude that fiscal sustainability will require policymakers to come up with 9.4% of GDP in tax hikes or spending cuts—and such a political will is entirely absent. However, the active amount of austerity to get to a stable debt-to-GDP ratio is much less, for two reasons. First, for reasons we will discuss later, the relevant measure for sustainability is the primary deficit, or the deficit excluding interest paid on the debt. Second, the depressed state of economic activity is currently adding over 5% of GDP to the deficit, directly or indirectly. As the recovery proceeds, that portion of the deficit should naturally decrease. The primary deficit excluding cyclical factors is a much smaller share of GDP. Indeed, given most forecasters' outlook for the economy, the primary deficit should fall to 1.6% of GDP by 2014. Closing that deficit will require difficult, but not totally unacceptable, choices. To take one example (we'll discuss others later), allowing all the Bush tax cuts to expire as scheduled would alone come quite close to bringing the primary position into balance, hence stabilizing the debt-to-GDP ratio.

Defining sustainability

There are a few definitions of fiscal sustainability, but we will focus on what is arguably the most common: the fiscal policy needed to maintain a stable ratio of public debt to GDP. Because GDP is generally growing, the deficit needed to stabilize the debt-to-GDP ratio is not necessarily zero. When interest rates are close to economic growth rates, which in the long run is generally true in the US, then the necessary condition for fiscal sustainability is a balanced primary fiscal position, i.e., the fiscal position excluding interest payments, is in balance.

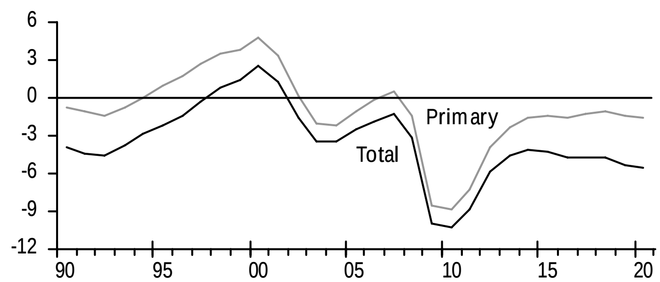
While a balanced primary fiscal position is necessary to stabilize debt-to-GDP ratios (assuming growth and interest rates are similar), a deficit in the primary position is usually tolerated if it occurs for transitory reasons associated with the state of the business cycle. During recessions, tax revenues fall and spending on social support increases. Provided these correct as the economy recovers, this outcome is not a sign of fiscal unsustainability. For this reason, most fiscal analysts focus on the cyclically adjusted primary balance, or the primary structural balance.

The fiscal position can adjust both passively and actively to the state of the business cycle. The passive adjustments will occur without Congress passing any new laws: in a recession, income and income taxes receipts decline while unemployment and social assistance payments automatically increase. Congress also may take active steps to support the economy in a downturn, such as the stimulus bill passed early last year.

CBO's estimate of the President's Budget
Percent of GDP

Year	Deficit	Interest expense	Primary deficit
2009	-9.9	1.3	-8.6
2010	-10.3	1.4	-8.9
2011	-8.9	1.6	-7.3
2012	-5.8	1.9	-3.9
2013	-4.5	2.2	-2.3
2014	-4.1	2.5	-1.6
2015	-4.3	2.8	-1.5

CBO's estimate of the President's Budget
% of GDP



Cyclical influences on the deficit
Percent of GDP

Year	Passive (CBO)	Stimulus bill	Total
2009	-2.0	-1.3	-3.3
2010	-2.6	-2.7	-5.3
2011	-2.4	-0.9	-3.3
2012	-1.8	-0.2	-2.0
2013	-0.9	-0.2	-1.1
2014	-0.4	-0.1	-0.5
2015	-0.3	0.0	-0.3

The Congressional Budget Office (CBO) produces an estimate of the passive cyclical contribution to the budget deficit. For fiscal year 2010, it estimates this component added 2.6% of GDP to the deficit. As a general rule, the CBO estimates imply that each additional percentage point of growth lowers the deficit-to-GDP ratio by about 0.3%-pt. There is no similar estimate of the active cyclical contribution to the deficit, but the CBO has estimated that about $400 billion of the stimulus package will be disbursed in fiscal year 2010, or about 2.7% of GDP. Thus, over half of the current total (not primary) deficit is due to cyclical weakness.

The likely path without major changes

Without any major change in political attitude, we believe the CBO's scoring of the President's Budget is the most reasonable starting point for an analysis of fiscal sustainability. Unlike the CBO's "current law" estimate, the scoring of the President's Budget more accurately incorporates certain political realities, like the ongoing extension of the Alternative Minimum Tax (AMT) patch, and the likelihood that the Bush tax cuts will remain intact for many taxpayers. The CBO's scoring also contains an estimate for interest payments under the President's Budget.

Thanks largely to a recovering economy, the CBO's scoring sees a deficit of 4.1% of GDP by 2014, and a primary deficit in that year of 1.6% of GDP; it sees primary deficits of 1.5% of GDP or less for the remainder of the decade. Much of this improvement simply reflects the fact that stimulus spending is heaviest in 2009-2011 and drops off after that. Moreover, a growing economy should also improve the primary position. One could argue that the CBO's outlook for GDP growth is too optimistic. However, so far it has proven too pessimistic: the 2010 growth outlook, made earlier this year, was for 1.8% growth, while most forecasters now think growth will be above 3% this year.

Options to close the gap

While a primary deficit of 1.6% is a lot smaller than 9%, it still will require some difficult choices if the gap between the forecast primary deficit and a primary balance is to be closed. These choices are difficult, but not totally unacceptable. As we noted, one simple option would be to allow all the Bush tax cuts to sunset as scheduled. Relative to the President's Budget, which would only sunset the cuts for upper-income households, this option would reduce the deficit in 2014 by 1.3% of GDP, closing a significant share of the primary deficit. A more radical option is a value-added tax (VAT): each 1%-pt on the VAT would reduce the deficit by about 0.2% of GDP. The table above lists other options; none is pleasant, but neither are they unachievable.

Cyclically adjusted primary deficit
Percent of GDP

Year	Primary deficit	Cyclical forces	Cyc.-adj. primary def.
2009	-8.6	-3.3	-5.3
2010	-8.9	-5.3	-3.5
2011	-7.3	-3.3	-4.0
2012	-3.9	-2.0	-1.9
2013	-2.3	-1.1	-1.2
2014	-1.6	-0.5	-1.1
2015	-1.5	-0.3	-1.2

Options to close the budget gap
Percent of GDP, relative to baseline of President's Budget, 2014

Option	Improvement in deficit
Sunset all Bush tax cuts	1.3
Drop refundable tax credits	0.2
VAT of 1%	0.2
Drop state and local tax deduction	0.5
Increase OASDI taxable earnings to $245k	0.3
Gas tax of 50 cent/gallon	0.4
Reduce Soc. Sec. and Medicare 10%	0.8
Reduce Medicaid 10%	0.2
Reduce military spending 10%	0.4
Reduce other discretionary spending 10%	0.4

Cautions

The fiscal outlook is bad, but the negativism may be overdone. The gradual recovery of the economy should go a long way toward restoring fiscal sustainability. That said, there are three things that should be of concern to citizens:

- Closing a budget gap of 1.5% of GDP does not look impossible, but the current political climate is not amenable to any sort of fiscal austerity. A shift in the political calculus is needed for this gap to be closed.

- Even if steps are taken to close the primary gap by 2014, that would leave the net debt-to-GDP ratio at around 75%. By international standards this may not be extreme, but it does not leave the US with much flexibility to increase debt if the economy experiences another crisis.

- While the projected primary deficits are around 1.5% for the second half of the decade, the primary deficit is projected to balloon in the following two decades due to the implicit growth in entitlement spending. In addition to closing the current primary deficit gap, policymakers need to put in place entitlement reform policies for the longer run.

Economic Research Note

Hints of improvement in US mortgage delinquencies

- **The share of US mortgages that are delinquent or in foreclosure continued to rise in 1Q10**
- **The share of mortgages becoming newly delinquent is down from its peak, partly due to a better economy**
- **But loans are allowed to remain delinquent longer; pace of foreclosure and other forced sales has slowed**

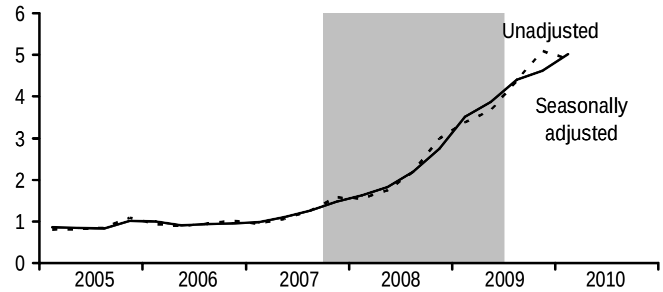
The economic recovery started to generate employment growth in size last quarter, but the headlines of the Mortgage Bankers Association's (MBA) National Delinquency Survey did not show any immediate benefit for the share of mortgage loans that are not current. Indeed, the survey notes that both the share of mortgage loans that are delinquent (sa) and the share in foreclosure (nsa) continued to increase last quarter. The text of the press release highlights difficulties in seasonally adjusting the delinquency data and notes that the unadjusted share of delinquent loans did edge lower. But the best that can be said is that the number of non-current loans seems to be plateauing at a high level.

Beneath the surface, however, there is early evidence that job growth helps. The change in the share of mortgages that are either delinquent or in foreclosure (problem loans) at any time partly reflects the share of loans that become newly delinquent—the flow into the stock of problem loans. And the change in the share of problem loans also reflects the share that exit the stock—through completion of the foreclosure process, forced sales, or homeowners making past due payments.

Recent readings on delinquency and foreclosure rates reflect roughly offsetting declines in the share of mortgage loans becoming newly delinquent and in the share of problem loans that are resolved. The encouraging decline in the share of current loans becoming newly delinquent partly reflects improved economic conditions, especially fewer job losses and more stable house prices. The decline in the rate at which problem loans are resolved reflects a combination of administrative delays in the foreclosure process due to large backlogs, increased patience and modification programs allowed by lenders who are not eager to speed forced sales into soft housing markets, and various government laws and guidelines aimed at helping homeowners to delay or prevent foreclosures.

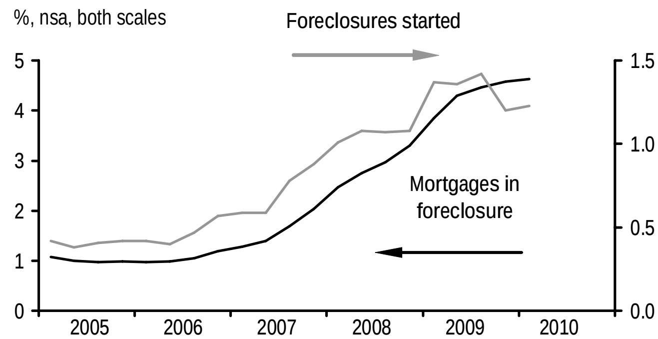
Residential mortgage loans 90 days or more delinquent

Percent



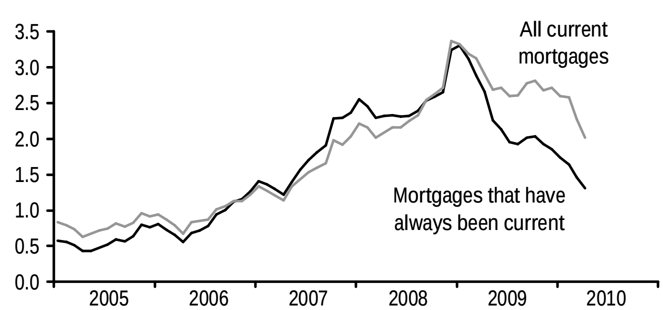
Residential mortgage foreclosures

%, nsa, both scales



Share of current mortgages that become delinquent

Percent, nsa; Loan Performance



Still a huge number of problem loans

One basic message from the Delinquency Survey is that the share of outstanding mortgage loans that are seriously delinquent has not significantly budged from recent peaks. The seasonally adjusted series shows that 5.0% of all US home mortgages were 90 days or more delinquent in 1Q10, another new high for this series. Delinquencies cover only part of the stock of problem loans, since they do not include loans that are in the foreclosure process. The share of mortgages in various stages of foreclosure also increased to a new high of 4.6% nsa in 1Q10. And the share of all US mortgages that are seriously delinquent, loans 90 days or more delinquent or in foreclosure, was 9.5% in 1Q10 (nsa), down a bit seasonally from the 4Q10 reading but dramatically above the 7.2% share in the year-earlier quarter.

Fewer in, fewer out

It takes a microscope to see the imprint of economic recovery on the number of problem mortgages. But the reduction in the rate at which current mortgages are becoming delinquent is quite striking. The third chart on the previous page plots previously released Loan Performance data covering a very large sample of private-label mortgages. The share of mortgages in that sample that were current in the previous month but became delinquent in the current month declined from a peak of 3.4% at the end of 2008 to 2.0% in March 2010. The share of mortgages that have always been current in the past but became delinquent in the latest month declined from a peak of 3.3% in late 2008 to 1.3% in the latest reading. In short, this series shows that the rate of entry into the pool of delinquent loans has slowed substantially.

The MBA delinquency series also shows a substantial decline over the past year in the share of mortgages delinquent 30-59 days, newly delinquent loans. But the drop is not as steep as in the Loan Performance sample and the share was up slightly (nsa) in 1Q10. The larger decline in the Loan Performance sample appears to reflect, at least in part, the larger share of non-prime mortgages (where new problem loans are larger but falling faster).

In short, homeowners with mortgages are becoming delinquent at a slower rate than a year ago. This is partly due to the better economy and decline in the number of monthly job losers. The decline in the rate of newly delinquent loans also reflects the gradually improving quality of the pool of mortgages that are current. The weaker credits that borrowed around the peak of the mortgage boom are, for the most part, already seriously delinquent or in foreclosure.

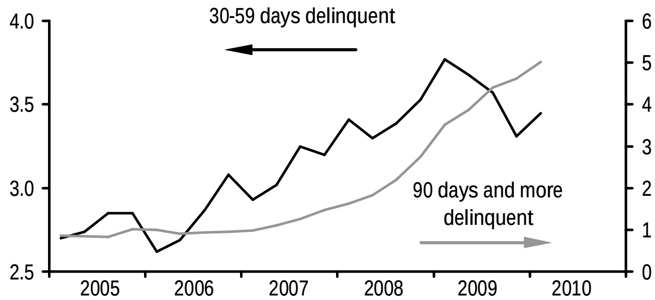
The total number of problem loans is not declining because mortgages are spending more time in the loan modification or foreclosure process. While the share of seriously delinquent loans is substantially higher than a year ago, the rate at which new foreclosures were initiated in 1Q10 (1.23%) was lower than a year ago.

No fun in the sun

The four states of California, Florida, Nevada, and Arizona account for roughly 25% of all residential mortgages in the MBA survey sample, but they account for a highly disproportionate number of problem loans and foreclosures. There has been a slight decline in 1Q10 (nsa) in the share of loans in that are either 90 days or more past due or in foreclosure in California and Arizona. But these numbers have continued to rise in the two states with the most severe problems, Florida and Nevada.

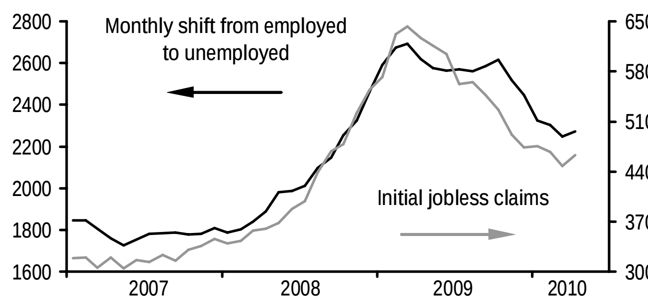
MBA survey: delinquency rates on all loans

%, sa, both scales



Two measures of job losses

'000s, samr, 3mma; household survey — '000s, sawr



Seriously delinquent mortgages by state

% nsa; loans delinquent 90+ days or in foreclosure

	1Q09	4Q09	1Q10
California	10.0	12.5	12.1
Florida	15.7	20.4	20.6
Nevada	13.8	19.0	19.6
Arizona	9.9	13.2	12.8
United States	7.2	9.7	9.5

Foreclosure initiations by state

% of loans, nsa

	1Q09	4Q09	1Q10
California	2.15	1.34	1.34
Florida	2.79	2.41	2.41
Nevada	3.35	3.04	3.23
Arizona	2.52	2.18	2.24
United States	1.37	1.20	1.23

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Economic Research Note

ECB "sterilizes" the impact of its bond purchases

- **Controversial decision to buy government debt**
- **Sterilization doesn't mean much at this stage**

The ECB's decision to purchase government bonds was clearly a difficult one for the central bank to make. According to press reports, Governing Council members Weber, Stark, and Wellink were each unhappy with the decision, although it is not clear whether all three of them voted against it. In any event, the ECB clearly recognizes the risks involved when a central bank starts purchasing the debt of a government whose solvency is in question: it has argued that these purchases will be temporary, that they are motivated by the need to correct malfunctioning markets, that the impact on reserves will be sterilized, and that they are only being undertaken on the understanding that the fiscal authorities around the region will meet the budget objectives that have been agreed.

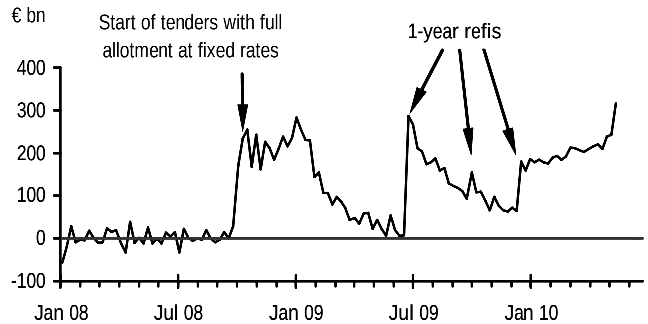
The real danger for the ECB is that it gets drawn into monetizing a significant amount of the outstanding debt of the sovereigns in the southern rim of the Euro area. The Greek support package and the European Stabilization Mechanism are there to deal with the gross financing needs of Greece, Spain, Portugal, and Ireland over the coming three years. But, even with this liquidity support in place, holders of the existing debt might still want to sell if there is significant slippage in the fiscal consolidations. In such a circumstance, it is unclear what the ECB would do. It would either have to let spreads widen significantly, or it could end up buying a significant amount of debt.

Given the excess liquidity created by the central bank's regular unlimited tender operations, we had argued that the commitment to sterilize the purchases was largely symbolic. In the event, the decision to sterilize by way of a one-week term deposit, which can be used as collateral to acquire liquidity in the ECB's regular operations, contained less symbolism than we expected.

Excess reserves since the crisis began

When interbank stresses intensified in late 2008, the ECB began to offer unlimited liquidity to banks at its open market operations. Against eligible collateral, banks would receive all of the liquidity that they bid for. As a consequence, the ECB lost control over the quantity of reserves

Excess reserves at the ECB



Excess reserves at the ECB

The liquidity needs of the banking system come from two sources: First, from the legal requirement on banks to hold a minimum amount of reserves in their current accounts at the ECB (€211 billion currently), and second, from autonomous factors, which are the net of all ECB balance sheet items that are not normally under the direct control of the central bank and are not related to monetary policy (€348 billion currently). Any change in the latter causes an opposite change in banks' reserve balances. Banks end up holding excess reserves if the ECB supplies more liquidity through its open market operations or asset purchases than is needed to meet reserve requirements and to offset autonomous factors.

Full and simplified ECB balance sheets, May 14, 2010
€ bn, non-euro denominated assets are converted into euros

Assets			Liabilities		
Gold	287		Banknotes in circulation	805	
Of non-residents or in FX	267		Bank reserves	527	
Open market operations	807		Current accounts		302
Main refi		100	Deposit facility		226
Longer-term refi		707	Fxd-term deposits		0
Fine-tuning reverse op.		0	Fine-tuning reverse op.		0
Structural reverse op.		0	Margin calls		0
Marginal lending facility		0	Oth. liabilities to banks	1	
Margin calls		0	ECB debt certificates	0	
Asset purchases	69		To non-residents or in FX	115	
Covered bonds		52	Government deposits	109	
Securities Market Prog.		16	Other liabilities	179	
Other assets		634	Capital, incl revaluations	326	
	2063			2063	
Liquidity supply (simplified)			**Liquidity demand (simplified)**		
Open market operations	807		Bank reserves	527	
Asset purchases	69		Banks' required reserves		211
			Banks' excess reserves		316
			Autonomous factors	348	
	875			875	

Note: Autonomous factors include all balance sheet items that are not actively used for monetary policy purposes and are calculated as asset items (which implicitly provide liquidity to banks) minus liability items (which implicitly absorb liquidity). In the ECB's normal definition, autonomous factors include any bank reserves that are "sterilized" via term deposits, but as we argue in this note, it is not clear whether this separation is appropriate.

and the overnight interest rate. However, this liquidity provision was necessary because the interbank money market was no longer distributing funds between banks that had a liquidity surplus and those that had a liquidity deficit; in addition to concerns about counterparty risk, banks wanted to hold a higher level of precautionary reserves at the ECB to guard against unexpected payment shocks. Reducing this liquidity risk was seen as necessary to ensure that banks continued to lend to the real economy. As counterparty risk began to fade in the first half of last year, and the precautionary demand for reserves declined, conditions in the interbank market gradually improved and banks reduced their bids at the ECB's refinancing tenders. Excess reserves, which are remunerated less generously by the ECB than required reserves, declined from a peak of €300 billion at the start of 2009 to almost zero by mid-2009.

Excess reserves rose sharply again after the ECB conducted the first of the three one-year tenders in June 2009. Although these longer-term operations were partly motivated by a desire to flatten the yield curve, their generous terms in effect gave banks incentive to borrow from the central bank and invest in government debt and other assets. Thus, the surge in excess reserves in mid-2009 was not an indication of increased stress in the banking system. Due to the sheer scale (€615 billion) and maturity of these liquidity injections, excess reserves remained high even though financial market conditions were still improving and banks' liquidity risk was falling.

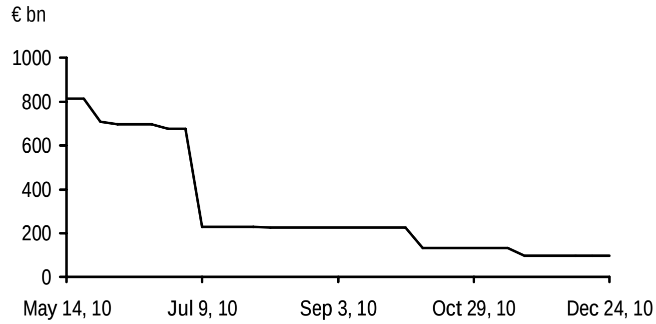
During the second half of last year, excess reserves gradually declined, and the ECB decided to withdraw unlimited liquidity provision at the three-, six-, and 12-month horizons. Unlimited liquidity provision was still planned to continue at the weekly and monthly tenders. But, as the sovereign stress began to build from the end of last year, excess reserves have been going up, as some of the same stresses that were evident during the banking crisis returned.

Sterilizing the outright purchases

In response to the deterioration in financial market conditions, the ECB announced a number of policy measures: reestablishing the FX swap line with the Fed and the unlimited liquidity provision at three- and six-month horizons, and initiating a program of outright purchases of public and private debt. The most controversial move was the decision to buy the debt of sovereigns whose solvency is in question.

In a purely mechanical sense, the ECB pays for the outright purchases by creating new bank reserves. As a result, the level of banks' excess reserves at the ECB increases by the volume of purchases (€16.5 billion in the first week). In order to highlight the exceptional nature of these purchases, the ECB committed to sterilizing the impact on reserves.

Maturity profile of current ECB refinancing operations



There are two main ways in which the purchases could be sterilized so that the reserve holdings of banks would remain unchanged. First, the ECB could sell other assets, which would show up as a fall in autonomous factors on its simplified balance sheet. Second, the ECB could rely on endogenous sterilization, whereby banks bid for less liquidity at the regular open market operations to offset the additional liquidity they received as a result of the ECB's asset purchases. Each of these faces constraints. The ECB does not have a portfolio of suitable assets to sell to offset the purchases, and the endogenous sterilization is not something under the central bank's control at present.

In the event, the ECB chose another method of sterilization. It offered a one-week fixed-term deposit equal in size to the outright purchases that settled in the first week (€16.5 billion). This operation simply allows banks to "lock up" €16.5 billion of excess reserves for one week, rather than depositing them each evening in the ECB's deposit facility. It does not prevent the ECB's balance sheet from increasing, as offsetting asset sales and endogenous sterilization would. And, given that the fixed-term deposits are only for one week and can be used as collateral in the ECB's regular tender operations, it does not constrain banks from making use of this liquidity.

We had argued that in the current environment the commitment to sterilize was largely symbolic, but in the event the symbolism was less than we expected. This likely doesn't matter if the scale of the asset purchases remains modest. However, if the ECB ends up purchasing a significant amount of government debt, it is likely to need to adopt a more aggressive form of sterilization in order to maintain confidence in the currency.

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Economic Research Note

UK fiscal policy: the coming tightening and its impact

- **Coalition government sets "accelerated deficit reduction" as a goal; emergency budget June 22**
- **Office for Budgetary Responsibility replaces Chancellory for growth/budget forecasts**
- **Fiscal tightening will likely weigh on growth, but won't dominate overall growth outturns**

The new coalition government has set a "significantly accelerated reduction in the structural deficit over the course of a Parliament" as one of its key goals. Here we describe the changing fiscal process, our best guess at the likely scale of tightening, and the impact it will likely have on GDP growth. An emergency budget on June 22 will be followed by a comprehensive spending review reporting in the autumn.

The outgoing administration had planned a structural tightening totaling 3% of GDP over this fiscal year and next, with 1% of GDP coming in 2010-11, and 2% in 2011-12. Our forecast has assumed that measures implemented by the new government would take the total over these two years up to around 4% of GDP: 1.3% in 2010-11, and 2.7% in 2011-12. There is much debate about the impact fiscal tightening has on growth, but as a working rule of thumb we typically assume a multiplier of 0.5 (so a 1% structural tightening depresses growth in that year by 0.5%-pt). That suggests that our expected tightening will push growth down around 0.6%-pt this year and close to 1.4%-pts the next. Most, though not all, of that tightening has been anticipated by the MPC as it has built its forecasts for growth. We share its assessment that, despite the drag from tighter fiscal policy, recovering private sector activity will still generate a shift to a near 3% growth pace over the next 18 months.

The old set of plans

The new government's pace of deficit reduction will be "significantly accelerated" compared to the plans of the outgoing administration. Those plans had the following features:

- A reduction in the overall budget deficit from 11.8% in 2009-10 to 4% in 2014-15, with the cyclically adjusted deficit falling from 8.4% to 2.5% over the same period. Public sector net debt was forecast to peak near 75% of GDP.
- Spending restraint accounting for the majority of the tightening, but with no departmental breakdown provided beyond 2010.
- A GDP growth forecast of 1% to 1.5% for 2010-11, but four consecutive years of growth forecast at 3% or slightly higher thereafter.

This set of plans has been criticized along three lines. First is that the pace of deficit reduction is simply too slow. Among the rating agencies, for example, Fitch has suggested that the targeted deficit at the end of the Parliament in 2014-15 was around 1% of GDP too high. Second, the failure to detail planned spending cuts in 2011 and beyond, with explanation only of which areas would be protected

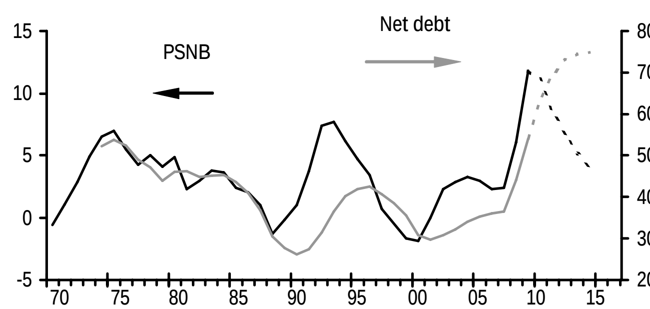
Public finance projections

% of GDP or £, net debt excludes financial sector interventions

	Old Labour government plans					
	Borrowing		Structural borrowing		Net debt (%)	
	£ bn	%	£ bn	%	£ tn	%
04-05	39.8	3.3	37.3	3.1	0.4	34.0
05-06	37.4	2.9	35.4	2.8	0.5	35.3
06-07	30.8	2.3	31.0	2.3	0.5	36.0
07-08	34.0	2.4	37.1	2.6	0.5	36.5
08-09	86.3	6.0	73.3	5.1	0.6	44.0
09-10	166.3	11.8	118.2	8.4	0.8	54.1
10-11	163.0	11.1	107.5	7.3	1.0	63.6
11-12	130.0	8.5	80.7	5.3	1.1	69.5
12-13	109.0	6.7	65.8	4.1	1.2	73.0
13-14	88.0	5.1	52.6	3.1	1.3	74.5
14-15	73.0	4.0	46.0	2.5	1.4	74.9

Old Labour government's fiscal plans

% of GDP, excludes financial sector interventions



from reductions, has attracted criticism. And third, the assumption for an extended period of relatively strong growth from 2011 has been questioned on the grounds of both whether demand growth at that pace can be generated, and whether supply potential would allow such growth without generating inflation.

The new Chancellor gives up forecasting

Members of the incoming coalition government, and the new Chancellor in particular, had been critical of the previous administration's fiscal decisions and the framework within which they were taken. Hence, the new Chancellor's first act has been to create an Office for Budget Responsibility (OBR) headed by Sir Alan Budd (a former member of the MPC). The OBR has been tasked to produce a new set of growth and budgetary projections (including off-balance-sheet liabilities such as public sector pensions), which will inform the emergency budget. At the emergency budget, George Osborne will also lay out the "fiscal mandate, his target for fiscal policy."

Looking forward, the OBR will be responsible for producing the forecasts for growth and budgetary outturns that are presented at each Budget and Pre-Budget report, and will state whether the current set of fiscal plans has a greater than 50% chance of delivering on the Chancellor's "fiscal mandate." In the words of the Treasury, "The OBR will put the UK at the forefront of international best practise, exceeding the IMF's recommendations on fiscal transparency. The UK will be one of the few advanced economies with an independent fiscal agency producing the official fiscal and economic forecasts on which budget decisions are made."

While the previous administration had attempted to enshrine fiscal credibility in the "golden rules," there is little doubt that the Chancellor's giving up of control of the growth and deficit projections goes further. Drawing on some of the lessons learned from independent monetary policy, the hope is that having an entity that is independent of the Treasury, the judgements of which are part of the budgetary process, and which is free to comment on the sustainability of fiscal policy, will act as a significant constraint on the current (and future) Chancellor's fiscal decisions. It remains to be seen whether that independence can be sustained given that the OBR will be heavily involved in the budgetary process itself. But the seriousness of the intent to put budgetary planning on a more credible basis is clear.

H.M. Treasury forecast errors

% of GDP, forecast minus actual borrowing

Year of Budget	One year ahead	Two years ahead
2000	1.4	-0.3
2001	-0.5	-2.1
2002	-1.3	-1.7
2003	-0.5	-1.3
2004	-0.6	-0.5
2005	-0.4	-0.1
2006	0.4	-0.2
2007	0	-4.6
2008	-3.7	-8.9
2009	0.8	-

What happens next?

The incoming government has announced that the £6 billion (0.4% of GDP) of non-front-line spending cuts planned by the Conservatives for this year will go ahead, and departmental detail of those spending reductions will be published on Monday, May 24. That spending reduction will be partly offset by a decision to cancel the planned rise in employers' national insurance contributions in April 2011. Beyond this, the coalition agreement between the Liberal Democrats and Conservatives reports the policy compromises that have been reached across many of the contentious areas, but their net fiscal impact is in many cases ambiguous and agreement on specific spending cuts is not documented.

The emergency budget is likely to contain many offsetting fiscal changes in terms of their overall budgetary impact, and it is tough to gauge how much additional net tightening it will implement at this stage. The view that the coalition will want to "front-load" the bad news is widespread, and as BoE Governor King has highlighted, the urgency of consolidation has been raised by the crisis in the Euro area. But the OBR itself is likely to recommend a middle path. In a televised interview back in March, Budd remarked that "if you go too quickly (reducing the deficit) then there is a risk that the recovery will be snuffed out and we will go back into a recession. I mean what the Americans say, 'Remember 1937'."

Our forecast pencils in an additional 1% of GDP tightening over the course of the next two fiscal years compared to the last government's plans, with the main new measure being a hike in the rate of VAT to 20% (which raises around 0.7% of GDP). The extent of spending restraint over 2013-2015 may also be raised, partly to offset slightly downgraded forecasts of GDP growth. With a spending review

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to follow in the autumn, it is unclear how much detail of spending restraint will be presented at this stage. This configuration of forecast changes would likely see the deficit forecast for the end of the Parliament reduced from 4.0% to around 2.5% of GDP.

The impact on growth

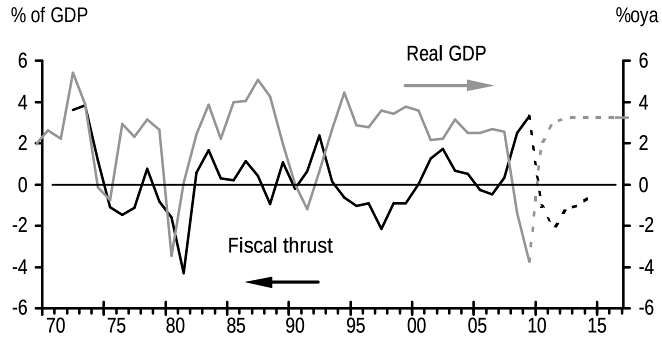
There is a lively debate about the impact a fiscal tightening has on growth. That reduced expenditure by the government or higher taxation will reduce demand and hence output directly may appear obvious. But the net impact on growth is ambiguous owing to offsetting changes in private sector behavior. Lower government borrowing may generate lower interest rates and greater confidence in the sustainability of the fiscal position, encouraging households and firms to spend. A substantial cross-country empirical literature argues for the existence of such "non-Keynesian" impacts of fiscal change. What does past UK experience tell us?

- **Macro models suggest a positive fiscal multiplier of around 0.3-0.8%-pt.** UK macro models have relatively high (positive) multipliers, meaning that a tightening would have a significant adverse effect on growth. In contrast, the multi-country variants of the macro models—which allow for the international transmission of shocks—have multipliers around half this size for the UK (first table).

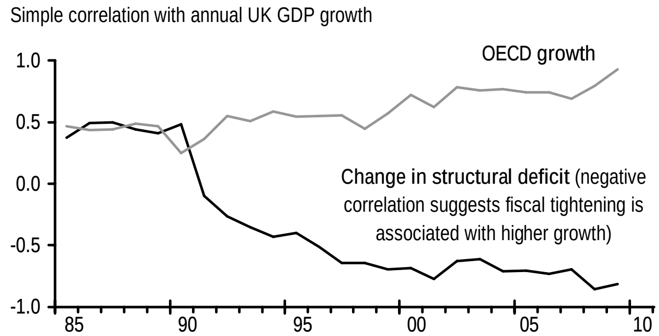
- **Some structural VAR models suggest the fiscal multiplier could actually be negative.** These models place less emphasis on theory and focus on identifying empirical relationships between macro variables—subject to imposed constraints. Perotti (2004) estimates that the UK fiscal multiplier is a small positive in his 1960-1979 sample, but significantly negative in the sample from 1980-2001.[1]

- **Case studies of UK history highlight the importance of global growth during fiscal tightening phases.** Fiscal policy was tightened significantly during 1979-1982 and 1994-2000. In each episode, the structural budget position improved by nearly 7% of GDP, a similar order of magnitude to current Budget plans. During the early 1980s, fiscal policy was tightened dramatically and quickly following the election of the Thatcher government. This coincided with a major recession in the UK and elsewhere (second table). In contrast, the budgetary consolidation of the mid-1990s was postponed until a recovery took hold. It was spread over a longer period, and coincided with a solid global upswing and an international asset price boom. UK growth was strong and tax-rich through this phase of consolidation, which delivered an unexpected improvement. While neither scenario serves as a reliable guide to growth prospects during the upcoming phase of fiscal tightening, both highlight the importance of the speed of implementation and the global context in which this occurs.

Change in cyclically adjusted public borrowing versus GDP growth



Rolling correlation with UK GDP growth in prior 10 years



How can we apply these findings in the current context? The standard macro models point to a small positive fiscal multiplier, which may be most appropriate in normal times. But in the current context of a very large budget deficit and concern about fiscal positions elsewhere, clear steps to reduce the deficit will move the UK away from a potentially sharp rise in risk premia. Moreover, the sharp rise in household and corporate saving rates since 2007 may partly reflect that they have already anticipated tighter fiscal times ahead. This may damp the negative effect of fiscal tightening to some degree. Working in the other direction is that the BoE has already reached the effective floor for policy rates, and there is a debate about the effectiveness of further easing via QE. Given that the sensitivity of household

1. See Roberto Perotti, "Estimating the effects of fiscal policy in OECD countries," ECB working paper No. 168, August 2002.

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and corporate cash flows in the UK is primarily to short-term rates, that may suggest that less of an offset to fiscal tightening can come from this source in the near term. As growth picks up, however, the BoE may have the option of reducing the monetary stimulus slowly to offset the ongoing drag from fiscal tightening.

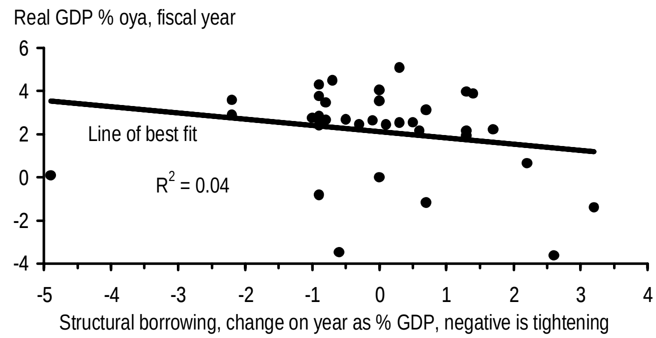
In constructing forecasts, our normal working assumption is to assume a fiscal multiplier that is an average of the estimates from the macro models mentioned above—0.5. Our bias is to think that the impact may prove smaller than this in the first instance as some of the coming tightening has already been anticipated by households and firms. Moreover, if (as we expect) fiscal tightening occurs in an environment of recovering world demand, this will encourage those whose employment and orders are directly impacted by lower government spending to anticipate that they will find other sources of demand for their skills and products. Assuming the structural deficit is tightened by a little more than 1% this year and close to 3% next year, a fiscal multiplier of 0.5 would imply the drag on growth will be around 0.5% of GDP this year and 1.5% next.

Can UK growth take the fiscal drag?

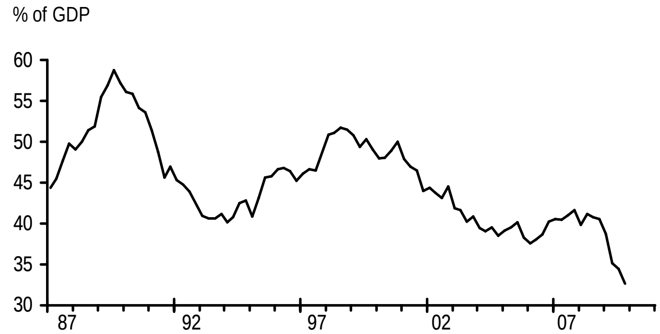
While there is no doubt that a very large multi-year fiscal tightening looms, it is a mistake to believe that fiscal changes dominate overall growth outturns. A simple scatter plot of the degree of structural tightening in each fiscal year versus growth in real GDP since the mid-1970s does not reveal a systematic bias toward years in which fiscal policy has been very tight (loose) being years in which growth is very weak (strong). The average of GDP growth in the three years that have seen the largest fiscal tightening (1981,1976, and 1997) is 2.2%. The average in the three easiest fiscal years (1992, 2002, and 2008) is 0.5%. The message we take from this is that, while fiscal policy can have an important impact on growth, it is the underlying swings in private sector behavior that dominate the business cycle.

Against the backdrop of the sharp fall in output recorded through mid-2009 and ongoing tightness of credit availability, there is understandable skepticism about the ability of the UK economy to withstand significant fiscal tightening while still generating a recovery in output. Our forecast for growth is somewhat more optimistic than the consensus, despite recognizing a significant drag from fiscal tightening. Some components of expenditure, notably investment spending by business and spending on durables and additions to the housing stock by households, have become extraordinarily depressed during the recession. As uncer-

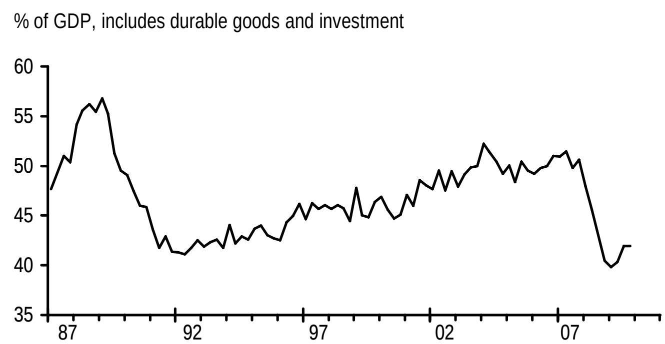
Change in structural public borrowing versus real GDP growth



Nominal business investment



Nominal household durable spending



tainty about the economic environment begins to abate, there is scope for these components of demand to grow rapidly. And even assuming only a small impact from the lower level of sterling, recovering global demand will encourage exports and manufacturing output to grow. Although UK growth has lagged our expectations to date, there are increasing signs that the cyclical recovery is building: household fears of unemployment have receded to pre-recession levels, and manufacturing output is growing strongly. Implicit in the forecast is the view, in the absence of fiscal tightening, that the UK would see growth at a near 4.5% pace during 2011.

Economic Research Note

SA's fiscal outlook constructive yet public wages a threat

- **Social spending, cyclical weakness, and one-offs caused 8.4% of GDP fiscal deterioration in two years**
- **Scope for fiscal outperformance near term as revenue could surprise on upside relative to Treasury forecast**
- **Restraint in wage growth essential to avoid higher corporate taxes in the medium term**
- **Debt ratio likely to peak below 50% of GDP while public enterprises add a further 20%-pts to debt**

South Africa's fiscal position deteriorated 8.4%-pts within a two-year period—a modest 1.7% of GDP surplus in FY2007/8 evolved into a 6.7% deficit by FY2009/10. This note takes a closer look at the cyclical, structural, and one-off factors which contributed to the changing fiscal picture, profiles the likely evolution of government debt, and highlights a key risk. We argue that fiscal performance could surprise consensus positively in the short term with a narrowing of the deficit to 3.8% in 2012. Yet beyond this, the deterioration in the structural component of the fiscal balance, which worsened by 4%-pts over the last two years, needs to be addressed. Nevertheless, the required improvement in the structural balance to stabilize the debt ratio is small by international comparisons and within comfortable reach. Based on our outlook for GDP growth and debt-servicing costs, we expect the government's debt-to-GDP ratio to peak at 48.5% of GDP in 2016.

Short-term outperformance likely even as longer-term trade-off looms

Overshoots in revenue collections in the first quarter of the year, a string of better-than-expected high-frequency activity indicators, and conservative revenue targets by Treasury offer scope for a faster narrowing in the fiscal deficit than forecast by Treasury. We expect GDP growth to pick up to 3%y/y and 3.5% in 2010 and 2011, respectively; high-frequency activity indicators point to a 4.5%q/q saar expansion in 1Q10. The narrowing of the output gap should lead to a reduction in the consolidated fiscal deficit to 3.8% and 3.5% in FY2012/13 and FY2013/14, respectively.

The medium-term outlook is, however, clouded by the recent widening in the structural deficit. Consolidated government expenditure ballooned from 28.5% of GDP in 2007 to 34% in 2009, and most of this rise was unrelated to the cyclical downturn. Spending on economic services rose

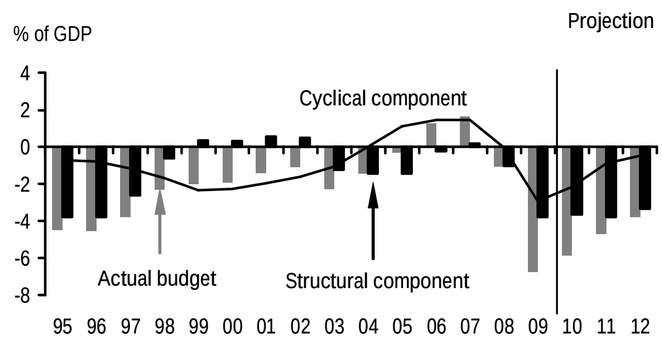
Structural and cyclical deficit

% of GDP unless otherwise stated

Fiscal year	2007	2008	2009	2010f	2011f	2012f
Consolidated budget deficit:						
Official forecasts	1.7	-1.0	-6.7	-6.2	-5.0	-4.1
J.P. Morgan				-5.7	-4.6	-3.8
Primary balance (J.P. Morgan)	4.2	1.3	-4.4	-3.2	-1.7	-0.7
Cyclically adjusted deficit						
Official forecasts	0.2	-1.8	-5.5	-4.7	-4.2	-3.4
J.P. Morgan	0.2	-1.0	-3.8	-3.5	-3.7	-3.3
Tax revenues (J.P. Morgan)	27.5	26.9	24.4	24.4	24.6	25.2
Gross debt (J.P. Morgan)	27.7	27.0	33.5	38.0	41.5	43.4
Public sector borrowing requirement	-0.3	4.0	11.3	10.7	8.4	6.7
Output gap (J.P. Morgan)	4.3	0.7	-3.0	-1.9	-1.2	-0.5

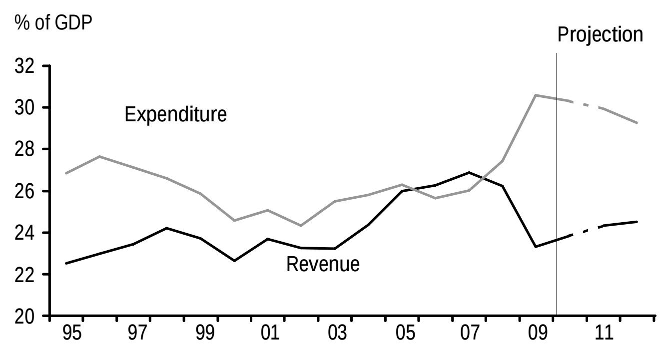
Source: National Treasury, J.P. Morgan

Structural and cyclical budget balances



Source: J.P. Morgan, National Treasury

Government revenue and expenditure (main budget)



Source: J.P. Morgan, National Treasury

by 2.2%-pts of GDP over the same period, which also reflected part of the government's R60 billion support to electricity producer Eskom. While this can be regarded as a one-off, certain recurring expenses also picked up significantly. Social spending rose from 15.7% of GDP in 2007 to 18.6% in 2009 and particularly benefited education (up 1%-pt of GDP), healthcare (up 0.7-%pt), and housing (up 0.7%-pt). Expansions in welfare spending, including the child care grant, added a further 0.6%-pt of GDP to expenditure. Consequently, only 3.2%-pts of the 8.4%-pt deterioration in the fiscal balance between 2007 and 2009 is attributable to cyclical factors, while one-off items widened the deficit by 1.2%-pts of GDP with the worsening in the

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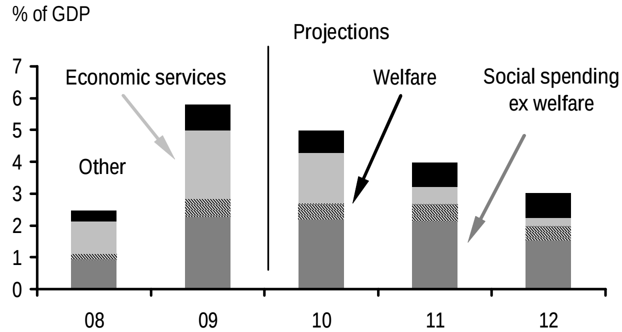
structural component of the deficit accounted for the remaining 4%-pts of GDP. Stripping out cyclical and one-off items, we estimate a structural deficit of 3.7% of GDP in FY2009/10, which compares favorably to the government estimate of 5.5%. The required structural adjustment to stabilize the debt-to-GDP ratio is small by international comparison at a mere 1.2% of GDP, resulting in a structural deficit and primary surplus of 2.5% and 1.4% of GDP, respectively, and remains within comfortable reach. Under our base case scenario, the debt ratio is projected to advance from 27% of GDP in 2008 to 42% next year before stabilizing at around 48.5% by 2016 (first chart). Debt of public sector enterprises is expected to pick up to 20% of GDP in 2014 and ease modestly thereafter.

A key risk to the benign outlook and avoidance of costly trade-offs is a significant moderation in the growth of the public sector wage bill. Last year, salary increases for government employees averaged 11.5% after successful bargaining by unions. This, together with the introduction of several occupation-specific dispensations and gains in employment, contributed to a 16% rise in the wage bill to 11.1% of GDP. However, the budget assumes a significant moderation in expenditure on total employee compensation to 7.1% per annum over the next three years. Recent strike actions targeted at public enterprises appear to set a relatively high benchmark for negotiations by other unions in coming months—despite falling inflation—and highlight the key risk to the outlook. Should the government fail to rein in growth in the wage bill, it may be forced to look at alternative ways to raise revenues, particularly against a backdrop of upside pressures on other expenditure items. We estimate that if wage settlements exceed the budgeted wage increase by 1%-pt per annum for three years, a 1.5%-pt rise in the company tax rate would be necessary to offset the additional pressure on the deficit in the absence of other savings measures.

Implications for government's borrowing requirement

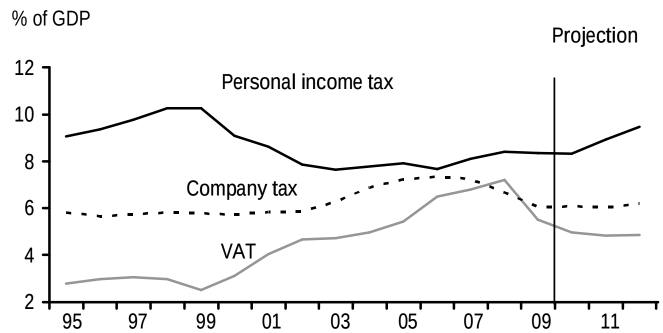
After a rapid widening in the government's borrowing requirement from R23 billion in 2008 to R161 billion in 2009 and a projected R162 billion in 2010, we expect a modest easing to R140 billion per annum in the medium term. Most of the funding need will continue to be met by debt issuance in the domestic market, and to that extent, South Africa is less dependent on international markets for its funding. We expect foreign borrowing of US$2-2.5 billion per annum in the medium term. Public sector enterprises are also expected to raise R50 billion per annum from domestic loans (including short-term loans) and US$1 billion a year from foreign loans, in addition to funding from multilateral institutions and export credit agency financing, to meet a public sector funding requirement of 8.4% of GDP in 2011 and 6.7% in 2012.

Increase in expenditure (relative to FY2007/08)



Source: J.P. Morgan, National Treasury

Taxes



Source: National Treasury

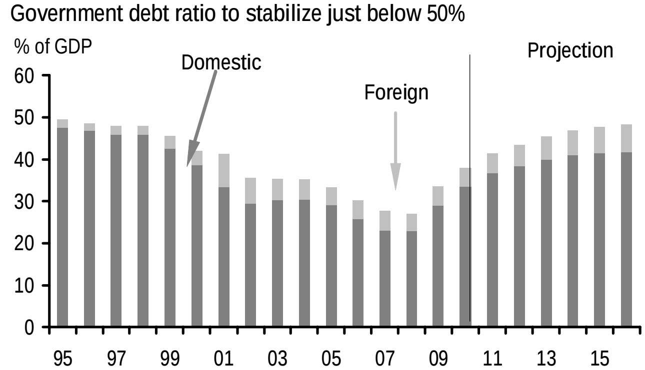
Company tax revenue

R bn

	2007	2008	2009	% of total
Financial services	41.3	48.1	33.7	24.9
Manufacturing	38.6	44.6	38.1	28.2
Mining	13.2	22.4	10.0	7.4
Wholesale, Retail	12.6	14.7	14.1	10.4
Business services	12.9	12.0	12.0	8.9
Other	23.0	25.4	27.4	20.3
Total	141.6	167.2	135.3	100.0

Source: National Treasury

Government debt ratio to stabilize just below 50%



Source: J.P.Morgan, National Treasury

United States

- **Economy looked set for 4% growth just two weeks ago; sharp drop in equity prices will test resiliency**
- **Core CPI has slowed to 0.9%oya; the 6-month run rate for the core CPI is down to only 0.3% saar**
- **Latest reports print on the weak side of expectations including jobless claims and mfg surveys**

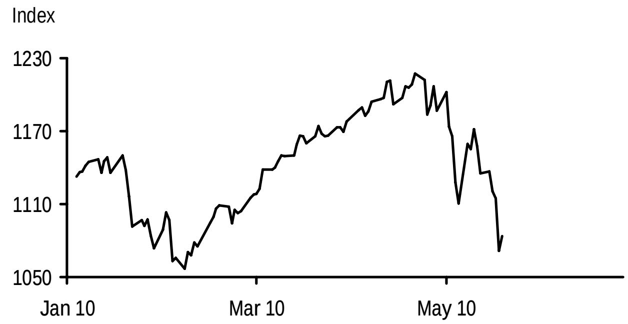
Just two weeks ago the incoming data fully supported the forecast of 4.0% growth through the middle two quarters of the year and core inflation well below 1%. Most important for growth prospects, the April labor market report confirmed steadily increasing private sector hiring, providing hard evidence that this would not be yet another jobless recovery.

The inflation part of the forecast certainly is still tracking. With the April CPI now in hand, the core CPI is running 0.9% oya and the 6-month run rate has receded to only 0.3% saar. Moreover, the two trends that had tended to apply upward price pressure to inflation, rising commodity prices and a weakening dollar, have quickly reversed. All of a sudden, risks look stacked on the low side of the longtime forecast that core inflation would be running slightly below 0.5%oya at year-end.

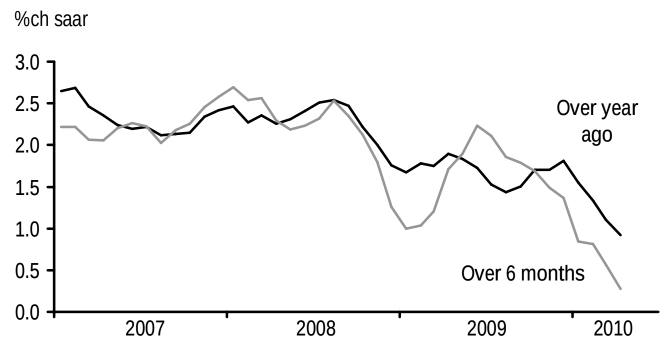
The pressing question is how resilient the economy will be in the face of the sharp decline in equity prices over the past month. To be sure, there is a partial offset in the form of lower oil prices and slightly lower mortgage rates. But the very visible risk is that the wealth destruction from the decline in equity prices, and the fear factor reflecting uncertainty about possible further declines, will significantly damp both consumer and business spending. For now, the forecast is unchanged. But revisions are possible in light of near-term financial market performance and incoming economic data.

As it turns out, the latest round of reports on growth were generally on the soft side of expectations (for the first time in several weeks), and seemingly too soon to reflect fallout from the Euro area fiscal problems and associated equity market declines. The latest weekly data show a recent collapse in mortgage purchase applications (associated with the expiration of the homebuyer tax credit), a very soft weak for chain store sales (blamed on a winter-like week of weather in May), and a seemingly inexplicable but sharp rise in initial jobless claims. Moreover, early May regional manufacturing surveys from the New York Fed and the Philadelphia Fed each posted declines in readings for new orders and for the derived composite.

S&P 500 index of equity prices



Core CPI



What would normally be viewed as important reports out next week on April home sales, durable goods orders, and consumer spending will likely be treated like historical documents from a less troubling time. Attention will focus on more timely information that can be used to gauge the fallout from the stock market decline. These include the May consumer confidence surveys, the regional business surveys, and the weekly report on initial jobless claims. In addition, automakers should be providing guidance as to how the equity market decline is affecting new car and light truck sales this month.

Core inflation gets small

The April CPI declined 0.1% and the core CPI increased only 0.047%. This report confirms that the recent sharp slowdown in core inflation was no fluke. Inflation as measured by the core CPI has run close to zero over the past six months as core services prices have continued to slow and the seemingly anomalous increases in goods prices that boosted inflation in the first half of last year came to an end (see US Focus page in this *GDW*.)

Those concerned about the chances of higher inflation have argued for some time that the slowdown in core inflation is largely an artifact of high vacancy rates in the rental market. The inflation rate for both OER and rents has been running close to zero, and these two components account for roughly 40% of the core CPI. To be sure, housing-related prices have certainly contributed to the subdued price readings. But the slowing trend is more general. The 6-month run rate for the core CPI, even excluding OER and tenants' rent, is now down to only 0.8% saar.

The tentative forecast for the April core PCE price index, the Fed's preferred measure of inflation, calls for a 0.1% increase as the PPIs for medical care were relatively firm. The core PCE price index puts a smaller weight on OER and rent than the core PCE and is running a little higher. If the April forecast is realized, core PCE prices will slow to 1.2%oya and 0.8% saar over the past six months. The core PCE includes imputed prices, such as the price of free financial services, that are viewed as unreliable by many. If the market-based core PCE price index (a variant that excludes imputed prices) were to rise 0.1% in April, this measure of core inflation would slow to 1.0%oya and only 0.6% saar over the past six months.

While the core CPI is running below 1%oya, the overall CPI was still up 2.2%oya in April due to an 18.5% annual increase in energy prices. Based on current energy futures prices, the headline CPI is now on track to drop below 1%oya by the fourth quarter.

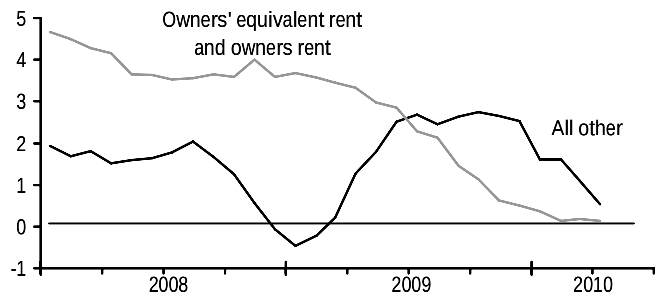
Housing activity is about to turn down

Housing starts steadily increased from severely depressed levels through the first four months of this year. The latest report on April starts shows a 5.8% rise in total starts and a 10.2% surge in single-family activity to a pace of 593,000. This leaves April starts some 21.4% (not annualized) above the 4Q09 average. The recent gains were almost surely boosted by the homebuyer tax credit.

Although the Homebuilders survey shows builders turning more optimistic in May, the more recent round of data sends a strong message that the expiration of the tax credit will send both housing starts and home sales lower for at least the next couple of months. While housing starts rose in April, housing permits declined 11.5% and single-family permits declined 10.7%. The huge drop is a sign that the tax-credit related burst of activity is over and that builders will reduce activity in the near term. Meanwhile, mortgage purchase applications have collapsed in the first two weeks of May, down a combined 34.1%, as the tax credit had front-loaded home sales.

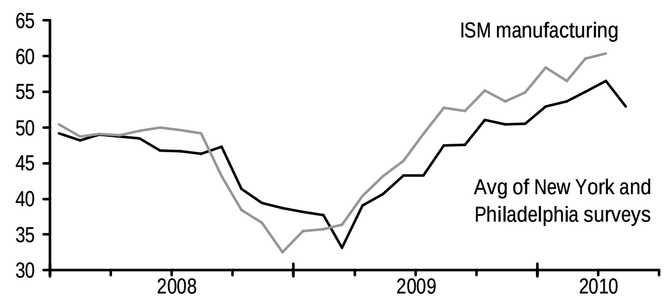
Core consumer prices

%ch saar, over 6 months



Average composite of regional manufacturing surveys and ISM mfg

Sa



Regional surveys slip in May

Manufacturing activity surged in March and April. Factory IP rose 1.0% in each of the two months. And the ISM manufacturing survey registered roughly 60 in both months, with new orders topping 65 in April. The early May regional manufacturing surveys in hand so far point to some moderation in growth this month. The headline reading of the Empire State survey declined from a lofty 31.9 reading in April to 19.1 in May. And key components including new orders (14.3) and shipments (11.3) declined even more. The May readings are consistent with solid growth, but not the kinds of manufacturing gains seen in prior months. The headline reading for the May Philadelphia Fed survey managed a small gain to 21.4, and production posted a good gain to 15.6. But the key leading indicator, new orders, slipped to 6.1, its lowest reading since January.

The derived composite for both surveys (calculated from components using ISM weights) declined in May and by an average of 3.6pts. This tentatively points to a decline in the ISM manufacturing survey for May and a noticeable moderation in monthly IP growth. Other regional surveys out next week from the Richmond Fed, Kansas City Fed, and Chicago PMI will help refine the near-term view on manufacturing.

Data releases and forecasts

Week of May 24 - 28

Mon
May 24
10:00am

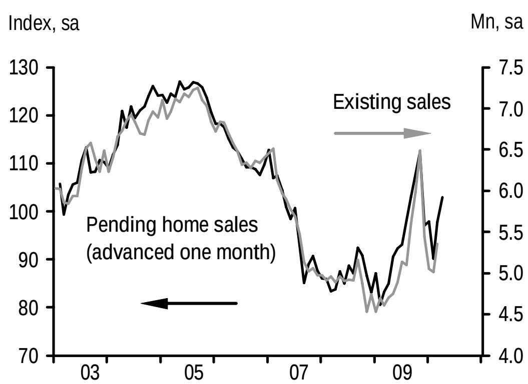
Existing home sales

	Jan	Feb	Mar	Apr
Total (mn saar)	5.05	5.01	5.35	5.65
%m/m	-7.2	-0.8	6.8	5.6
%oya nsa	7.0	7.1	19.6	20.2
Months' supply (nsa)	7.8	8.5	8.0	
Single-family	7.6	8.2	7.7	
Median price (%oya)	0.1	-2.1	0.4	

Increases in pending home sales the past couple of months point to more than a 5% increase in existing home sales in April following an even larger increase in March.

The recent readings reflect temporary effects of the second homebuyer tax credit, and recent signals point to a fall-off in sales as soon as the credit expires. For example, single-family housing starts increased 10.2% in April, presumably reflecting a boost from signed contracts for new homes. However, single-family permits declined 10.7% in April, presumably in response to concerns that sales will not hold at current levels. More dramatically, mortgage applications for home purchase have declined a combined 35% in the first two weeks of May.

Pending home sales, existing home sales



Tue
May 25

Home price indexes

%oya, unless noted

		Dec	Jan	Feb	Mar
9:00am	S&P/Case-Shiller				
	20-city composite	-3.1	-0.7	0.6	2.6
	%m/m sa	0.3	0.3	-0.1	-0.3
	10-city composite	-2.4	-0.1	1.4	
10:00am	FHFA purchase-only				
	%oya	-2.0	-3.3	-3.4	-2.6
	%m/m sa	-1.9	-0.6	-0.2	-0.2

The Case-Shiller 20-city house price measure is expected to decline 0.3% in March on a seasonally adjusted basis but accelerate to a 2.6% increase on an over-year-ago basis. The March figure is expected to be slightly weaker than the recent trend, partly reflecting the higher share of distressed sales in the market. Seasonal factors have not yet caught up to the fact that distressed sales are an unusually large share of the market in the winter (when other sales are seasonally low) and an unusually small share in the summer (when other sales are seasonally high). The Core Logic measure of house prices has already been released and was down 0.3%. Note that there is some upside risk to this forecast as the boost to sales from the temporary tax credit boosts sales demand.

The FHFA house price index is expected to decline 0.2% (samr) in March, leaving the index down 2.6%oya. Over the entire cycle, the FHFA price index did not seem to move in line with informed perceptions of the market, and it is not followed as closely as the Case-Shiller measure.

Tue
May 25
10:00am

Consumer confidence

Sa

	Feb	Mar	Apr	May
Conference Bd index	46.4	52.3	57.9	53.0
Present situation	21.7	25.2	28.6	
Jobs plentiful	4.0	4.0	4.8	
Jobs hard to get	47.3	46.3	45.0	
Plentiful less hard to get	-43.3	-42.3	-40.2	
Expectations	62.9	70.4	77.4	

Over the past six months consumer confidence has fluctuated in a relatively narrow range and has averaged 52.9. The forecast looks for a May reading very close to that average.

Influences on confidence in the past month have been mixed. The economic data have generally come in on the strong side of expectations, and the April labor market report shows a convincing improvement in net hiring. The decline in energy prices should also help boost confidence. And the latest weekly reading from the ABC News/Washington Post confidence survey improved toward the high end of its recent range.

But the sharp decline in equity prices in the past few weeks should have been attention-getting. The S&P 500 index has dropped roughly 8% in the month since the April survey, and the focus of the news has been more on Euro area problems than on the generally improving US data.

The job market differential (percent jobs plentiful less jobs hard to get) has not been a very reliable indicator of monthly changes in the unemployment rate lately, but any noticeable change in the differential will get attention.

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Wed
May 26
8:30am

Durable goods

%m/m sa

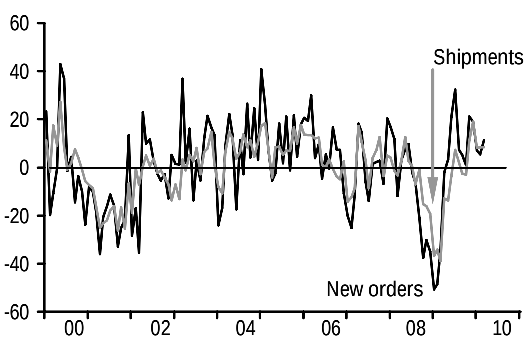
	Jan	Feb	Mar	Apr
New orders	4.9	0.5	-1.2	2.3
Ex transportation	-0.6	2.1	3.7	0.6
Nondef cap. gds ex air	-2.9	3.0	4.6	-1.0
Shipments	-0.1	-1.5	1.5	0.8
Nondef cap. gds ex air	-1.2	2.3	1.9	1.0
Inventories	0.0	0.7	0.4	

The March durables report had a weak headline but great details, as orders for nondefense capital goods excluding aircraft jumped 4.6%. For the April report, we're looking for the opposite situation, a strong headline number and capital equipment trends to take a breather. Boeing received orders for 34 high-value 777s during the month, though many of those occurred late in the month and so may not appear in the durables report. If they do, which we assume, it should give a pretty sizable boost to the headline orders number. Within transportation, that should be partly offset by a slight drop in motor vehicle production during the month.

Excluding transportation, the strength in March may have borrowed some from April. In addition, there is a seasonal tendency for April core capital goods orders to be weak. One factor tending to boost ex transportation orders is higher prices of manufactured goods, particularly semi-finished ones. The survey data on manufacturing in April were very strong, and so any pullback that may occur would likely be temporary. Of course, developments in Europe and in financial markets could invalidate some of that momentum. However, the durables report is probably not where we would first detect any real economy fallout from the financial stress.

Core capital goods orders and shipments

%ch over 3 months, saar



Wed
May 26
10:00am

New home sales

	Jan	Feb	Mar	Apr
Total (000s, saar)	338	324	411	430
%m/m	-4.2	-4.1	26.9	4.6
%oya nsa	-4.2	-13.8	22.6	24.6
Months' supply	8.2	8.6	6.7	
Median price (%oya)	3.5	5.7	4.3	

New home sales jumped 27% in March, one of the largest single-month percent gains in this series. However, in level terms the pace of new home sales is far from impressive. Every rebound must begin somewhere, but unfortunately the surge in new home sales looks like it may end shortly after having started. The homebuyer tax credit was likely the central reason behind the big jump in new home sales, and with that credit having expired at the end of April, indications are that housing demand is starting to slacken. In the data flow there is still one more month of tax credit-supported home sales. We expect another month with a solid increase in new home sales and look for this figure to rise almost 5% in April.

Thu
May 27
8:30am

Jobless claims

000s, sa

	New claims (wr.)		Continuing claims		Insured
	Wkly	4-wk avg	Wkly	4-wk avg	Jobless,%
Mar 13[1]	454	464	4668	4692	3.6
Mar 20	445	454	4681	4684	3.6
Mar 27	442	448	4562	4651	3.5
Apr 3	463	451	4686	4649	3.7
Apr 10	480	458	4663	4648	3.6
Apr 17[1]	459	461	4653	4641	3.6
Apr 24	451	463	4627	4657	3.6
May 1	446	459	4665	4652	3.6
May 8	446	451	4625	4643	3.6
May 15[1]	471	454			
May 22	455	455			

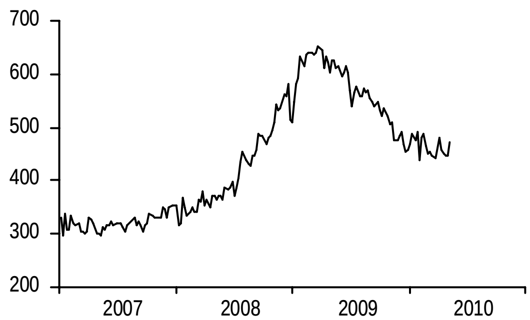
1. Payroll survey week

Jobless claims have been a riddle. Claims fell briskly in the second half of last year. In the first half of this year, in contrast, the improvement in claims has been excruciatingly slow, even as other data have been quite upbeat. The latest jump up in claims only adds to this mystery. While there have been spikes higher in the last few months, in most of those instances the Labor Department cautioned that special factors—reporting difficulties, moving holidays, etc.—were at fault. Last week, however, these officials said the disappointingly high 471,000 was a clean read. Its hard to blame the usual culprits: weather, automaker shutdowns, etc. Other possibilities include a drop-off in homebuilding activity coinciding with the end of the homebuyer tax credit or an increase in workers idled by the Gulf oil spill. To be sure, neither of these is wholly convincing.

For the week ending May 22, we look for jobless claims to partially retreat to 455,000. Use this forecast with caution; if you can't explain the past, it is hard to predict the future accurately.

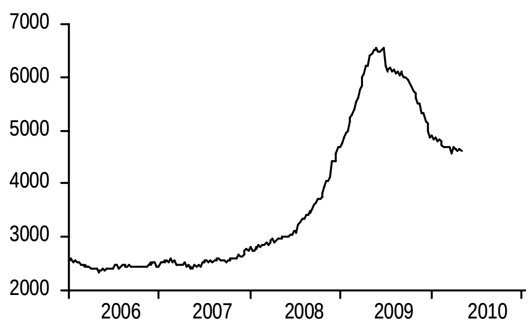
Initial jobless claims

000s, sa



Continuing jobless claims (first 26 weeks of UI)

000s, sa



Thu
May 27
8:30am

Gross domestic product

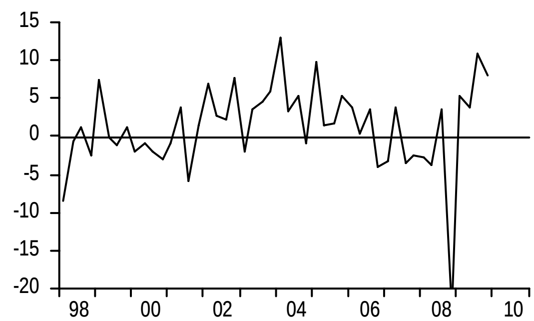
%ch, q/q saar, unless noted

	3Q09	4Q09	Adv 1Q10	Second 1Q10
Real GDP	2.2	5.6	3.2	3.4
Final sales	1.5	1.7	1.6	1.6
Domestic final sales	2.3	1.4	2.2	3.3
Consumption	2.8	1.6	3.6	4.0
Equip. and software	1.5	19.0	13.4	17.3
Nonres. structures	-18.4	-18.0	-14.0	-15.2
Residential investment	18.9	3.7	-10.9	-11.1
Government	2.7	-1.3	-1.8	-1.8
Net exports (%-pt contr.)	-0.8	0.3	-0.6	-1.7
Inventories (%-pt contr.)	0.7	3.8	1.6	1.8
Core PCE price index	1.2	1.8	0.6	
%oya	1.3	1.5	1.4	
GDP chain price index	0.4	0.5	0.9	
%oya	0.6	0.7	0.4	
Adj. corporate profits	10.8	8.0		5.0
%oya	-6.6	30.6		30.3

Real GDP growth in the first quarter should be revised 0.2%-pt higher to 3.4%, as incoming data point to higher than originally reported growth for consumption and capital equipment investment. This should be partly offset by weaker construction and net exports. This report will also provide the first estimate of first-quarter corporate profits. Employee compensation growth picked up last quarter, as firms finally started increasing the paid number of hours worked. This should put a little bit of pressure on margins—which have been expanding strikingly—and cause profit growth to slow further to a 5% increase in 1Q.

Corporate adjusted pre-tax profits

%q/q, not annualized



Fri
May 28
8:30am

Personal income

%m/m sa, unless noted

	Jan	Feb	Mar	Apr
Personal income	0.4	0.1	0.3	0.5
Wages & salaries	0.5	0.1	0.2	0.7
Consumption	0.3	0.5	0.6	0.1
Real consumption	0.1	0.5	0.5	0.0
PCE price index	0.2	0.0	0.1	0.1
Core	0.00	0.04	0.08	0.07
Mkt-based core	0.0	0.1	0.1	
Core (%oya)	1.5	1.3	1.3	1.1
Mkt-based core (%oya)	1.4	1.2	1.1	
Saving rate	3.5	3.0	2.7	3.2

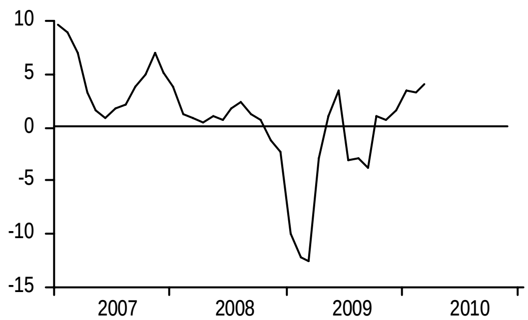
The very strong April payroll report points to a solid gain in personal income last month. Growth in transfer receipts is scheduled to slow, according to government data reported elsewhere. Income receipts on assets, which trended down in the first quarter, should turn flat going into the first month of the second quarter. Putting these together, we look for income growth of 0.5%. We do not expect a big move in personal current taxes and so expect a similar increase in disposable personal income.

Both auto sales and sales in the retail control category declined last month, and we look for nominal consumer spending on goods to slip 0.4%. Even with outlays on utilities slipping some last month, we look for services spending to be up 0.3% and total nominal consumer spending to round up to 0.1%. We look for real consumer spending to round up to a flat reading. Real consumer spending in February and March should be revised up, reflecting revisions to retail sales data for those months.

The headline and core PCE price measures are each expected to increase 0.1%. This is a little more than the increases in the CPI measure, in part because medical care services—which are derived from the PPI—appeared to have increased a relatively firm 0.4% last month. Even so, the core PCE price measure should be up only 1.1% over its year-ago level.

Nominal employee compensation

%ch over 3 months, saar



Fri
May 28
9:55am

Consumer sentiment

	Mar	Apr	Pre May	Fin May
Univ. of Mich. Index (nsa)	73.6	72.2	73.3	71.5
Current conditions	82.4	81.0	81.1	
Expectations	67.9	66.5	68.3	
Inflation expectations				
Short term	2.7	2.9	3.1	
Long term	2.7	2.7	2.9	
Home buying conditions	156.0	154.0	150.0	

The preliminary reading on the May University of Michigan measure of consumer sentiment increased to 73.3. But the sharp decline in equity prices since the preliminary survey is expected to prompt a lower reading in the final report. This confidence survey historically has been more sensitive to the equity market performance than the monthly Conference Board survey. Note that readings to date have shown a substantial improvement in the assessment of current conditions since late last year, but virtually no improvement in expectations.

Results should also show a decline in one-year inflation expectations from the 3.1% in the preliminary reading, in response to the decline in the price of crude oil. The assessment of other economic conditions has been mixed over the past several months. Respondents expect progressively smaller increases in unemployment, while expectations for income growth are still extremely modest.

Review of past week's data

Empire State survey (May 17)

Diffusion indices, sa

	Mar	Apr	May
General bus. conditions	22.9	31.9	~~30.0~~ *19.1*
New orders	25.4	29.5	*14.3*
Shipments	25.6	32.1	*11.3*
Unfilled orders	4.9	-3.8	*-7.9*
Prices paid	29.6	41.8	*44.7*
Prices received	8.6	6.3	*5.3*
Composite	57.1	59.6	*54.3*

The first regional manufacturing survey for May, from the NY Fed, slowed from very strong growth. The headline reading of the Empire State survey declined from 31.9 in April to 19.1 in May, a larger pullback than many had expected. Key activity measures also declined, with new orders declining from 29.5 in April to 14.3 in May and shipments declining from 32.1 to 11.3.

Some details were positive. Employment increased from 20.3 to 22.4, and the six-month outlook for capital spending increased from 31.7 to 38.2. But the derived composite, based on ISM weights, declined from 59.6 in April to 54.3 in May. The headline general business conditions question is essentially a confidence gauge, and it's certainly conceivable that the European crisis could be denting business confidence against what would otherwise appear to be a favorable domestic backdrop.

Homebuilders survey (May 17)

Sa

	Mar	Apr	May
Housing market	15	19	~~19~~ *22*
Present sales	15	20	*23*
Prospective buyer traffic	10	~~14~~ *13*	*16*

The Homebuilder survey for May increased 3pts to 22 and each of the three components also increased by 3pts. The index is still severely depressed in comparison to the history of the series, but it has bounced to its highest reading since August 2007.

The increase in the measure of current sales is not surprising, given that homebuyers were taking advantage of the homebuyer tax credit. It is more surprising that homebuilders are not expecting a drop-off in sales in the coming months. The homebuilder survey is generally sent out on the first business day of the month, and most responses come back shortly thereafter. It could be that homebuilders are extrapolating forward the recent incentive-fueled strength in home sales, but it seems more likely that the combination of an improving labor market and relatively low mortgage rates is giving enough help to the housing market to offset the fading of the tax incentives.

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Producer price index (May 18)

%m/m sa, unless noted

	Feb	Mar	Apr	
Finished goods	-0.6	0.7	~~0.0~~	*-0.1*
%oya (nsa)	4.4	6.0	*5.5*	
Core	0.1	0.1	~~0.1~~	*0.2*
%oya (nsa)	1.0	0.9	~~0.9~~	*1.0*
Energy	-2.9	0.7	~~0.4~~	*-0.8*
Cars	0.5	-1.1	~~0.3~~	*0.6*
Trucks	-0.1	-0.1	~~0.1~~	*-0.2*
Core intermed.	0.9	0.7	~~0.8~~	*1.1*
Core crude	-0.6	6.0		*4.0*

The PPI for April declined 0.1% as both food and energy prices fell in the month. The core PPI rose 0.2%, the average increase within a narrow band for the past two years. The core intermediate and core crude PPI showed continued strength, rising 1.1% and 4.0%, respectively. In the core finished goods PPI, passenger car prices rose 0.6% and capital goods prices were up 0.2%.

Housing starts (May 18)

Mn units, saar

	Feb		Mar		Apr	
Starts	~~0.62~~	*0.60*	~~0.63~~	*0.64*	~~0.65~~	*0.67*
Single-family starts	~~0.54~~	*0.53*	~~0.53~~	*0.54*	~~0.55~~	*0.59*
Multifamily starts	0.08		0.10		~~0.10~~	*0.08*
Permits	~~0.64~~	*0.65*	0.68		~~0.68~~	*0.61*

Single-family starts posted a stronger-than-expected gain in April but single-family permits were down, suggesting that the recent trend toward stronger readings on starts may be nearing an end. Housing starts rose 5.8% in April to an annual pace of 672,000 and were up in all regions except the West. The strength was concentrated in single-family starts, which were up 10.2% to 593,000, the fourth consecutive monthly increase. But housing permits, a key leading indicator, fell 11.5% to 606,000, with single-family permits down 10.7%. The very large divergence between starts and permits is likely associated with the ending homebuyer tax credit.

CPI (May 19)

%m/m sa, unless noted

	Feb	Mar	Apr	
Total	0.0	0.1	~~0.0~~	*-0.1*
%oya (nsa)	2.1	2.3	~~2.3~~	*2.2*
Core	0.05	0.04	*0.05*	
%oya (nsa)	1.3	1.1	~~1.0~~	*0.9*
Core services	0.1	0.1		*0.2*
Core goods	-0.1	-0.1		*-0.3*
Food	0.1	0.2	~~0.5~~	*0.2*
Energy	-0.5	0.0	~~1.7~~	*-1.4*
Housing	0.0	0.0		*-0.1*
Owners' eq. rent	-0.02	-0.11	~~0.10~~	*-0.03*
Rent	-0.03	0.06	~~0.05~~	*0.01*
Lodging away from home	0.1	0.3	~~0.0~~	*1.4*
Apparel	-0.7	-0.4	~~0.2~~	*-0.7*
New vehicles	0.1	0.1	~~0.1~~	*0.0*
Used vehicles	0.7	0.5	~~0.4~~	*0.2*
Airfares	-0.7	0.4	~~0.0~~	*2.2*
Communication	-0.1	0.0	*0.0*	
Medical care	0.5	0.3	~~0.3~~	*0.2*

The Consumer Price Index fell 0.1% in April and the ex-food and energy prices core CPI was unchanged. Over the past year, the core CPI is up only 0.9%, the slowest increase since 1961. After a year of green shoots, the unemployment rate is off only 0.2%-pt from its peak, and now with inflation falling, the real fed funds rate is moving higher. This combination is likely to keep the Fed on hold for a very long time.

Core service prices were tame again last month, as they have been for much of the last year, increasing 0.2%. This is a touch higher than the past few prints thanks in part to a 1.4% increase in the price of lodging away from home, the biggest since 2007. However, rents and owners' equivalent rent were each unchanged.

Core goods inflation, which declined again in April, had been running higher than core service inflation in 2009. It normally runs below core service inflation, so recent deflation is more of a normalization, particularly in vehicle prices which had been soaring. Vehicle prices were down 0.2%; except for the cash-for-clunkers-depressed August 2009 reading, this was the lowest print since December 2008. After rising much of last year, apparel prices were down for the fourth straight month, falling 0.7% in April.

Philadelphia Fed survey (May 20)

Diffusion indices, sa

	Mar	Apr	May	
General bus. conditions	18.9	20.2	~~21.0~~	*21.4*
New orders	9.3	13.9		*6.1*
Shipments	13.6	5.6		*15.8*
Inventories	-11.0	2.0		*-7.9*
Prices paid	38.6	42.7		*35.5*
Prices received	-0.4	1.0		*3.5*
Composite	52.8	53.4		*51.6*

The headline reading of the Philadelphia Fed regional manufacturing survey edged up as expected, from 20.2 in April to 21.4 in May. The headline reading is an assessment of overall economic conditions. The individual components, which reflect actual conditions for respondent firms and provide a more reliable read on economic activity, were mixed but generally lower in May than in April. New orders declined from 13.9 in April to 6.1 in May, and employment dipped from 7.3 to 3.2. Shipments, however, increased substantially, from 5.6 to 15.8. The composite index, calculated from components using ISM weights, declined from 53.4 in April to 51.6 in May. The composites of both May regional surveys available point to a likely dip in the May ISM manufacturing survey.

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US focus: core inflation approaching zero

- The core CPI rose 0.047% in April and has now slowed to 0.9%oya. This is a smaller annual increase than at the height of the deflation scare in the first half of the last decade and the lowest annual increase in core inflation since 1966.

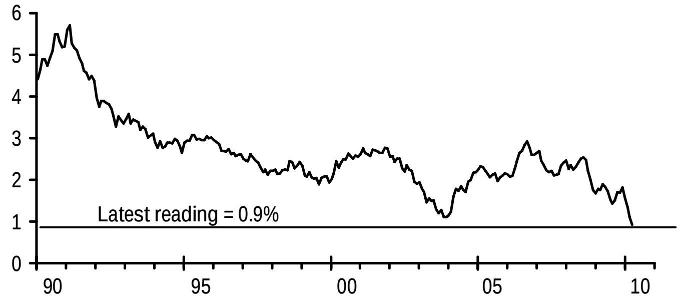
- The slowdown in the core CPI has been especially pronounced over the past several months. While the core CPI is running 0.9%oya, it has increased only 0.3% at an annual rate over the past six months.

- Core services prices have slowed fairly steadily over the past couple of years. The big shift in core inflation recently has been the reversal of what had appeared to be an anomalous acceleration in core goods prices during the first half of last year. That acceleration had been concentrated in motor vehicles and tobacco prices, the latter reflecting tax increases.

- Core goods prices have now declined for the past three months in a row. With the cigarette tax increases behind us, tobacco prices have slowed to 0.6% saar over the past three months. Apparel prices have been especially soft lately, declining 7.0% saar over the past three months.

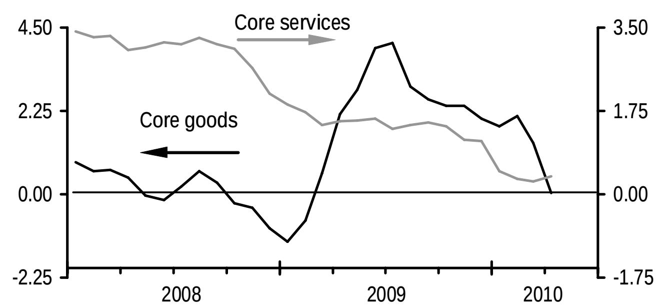
- The influences of rising energy prices and a weaker dollar that had tended to support prices have reversed lately. The recent decline in the price of crude oil should have at least a modest impact on core prices, most visibly in the price of air transportation. And the appreciation of the trade-weighted dollar should tend to hold down import prices.

Core CPI
%oya

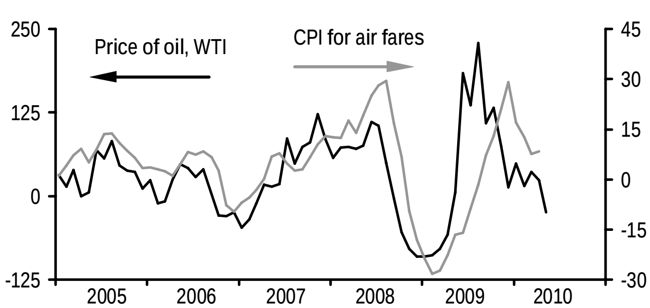


Core CPI
%ch saar

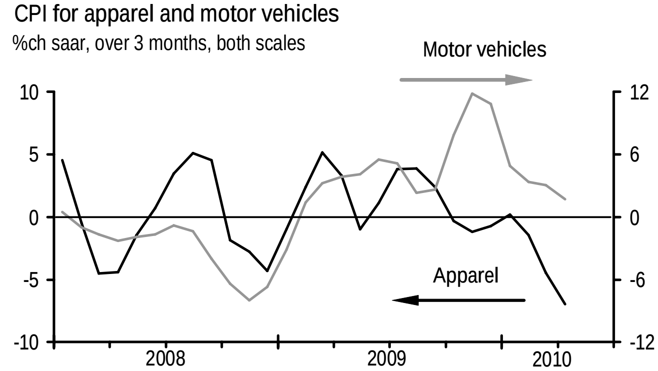
Core CPI, goods and services
%ch saar, over 6 months, both scales



Price of crude oil and CPI for air fares
%ch saar, over 6 months, both scales



CPI for apparel and motor vehicles
%ch saar, over 3 months, both scales



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Euro area

- **Euro business and consumer surveys suggest some negative spillover to the real economy**
- **But, surveys did not reveal any dramatic collapses and remained at elevated levels in May**
- **Euro area core inflation is still sliding**

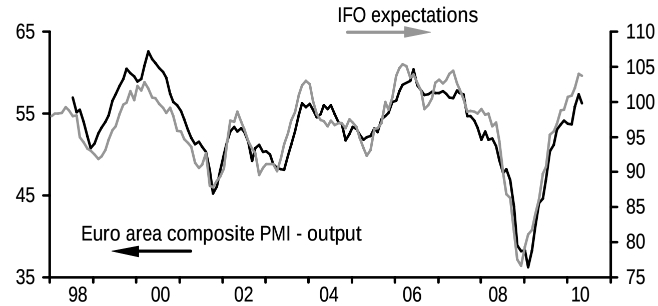
This week's consumer and business surveys suggested that the sovereign debt turmoil is having some negative spillover effects on the real economy. But, none of the surveys revealed any convincing breaks to the downside. Consumer confidence in May reversed the solid increase of the prior month, but this left it in the range it has been in since October last year. And the flash PMI fell by 1.1pts in May, but at 56.2 continued to signal very solid GDP growth momentum in the region of close to 3% annualized. Finally, the German IFO, which measures both activity and sentiment, remained broadly unchanged in May, with the expectations index still very elevated.

In the detail of the PMI, the composite new orders index fell by 1.5pts in May, but the employment index rose further to above the 50 level. This suggests that the flow of new orders slowed slightly from an above-trend pace, but that this did not deter corporates from further increasing their hiring. In our view, this suggests some resilience. However, the PMI new orders index tends to lead the employment index, and therefore it is important it does not fall much further. If the new orders index were to continue falling in the coming months, despite the stimulus to exports that should be coming from the weaker currency, it would undermine the positive spillover effects from industry to the wider economy that has been evident in the business surveys since March. In this context, the activity and outstanding business indices of the Euro area services PMI still increased slightly in May.

One particularly striking aspect of this week's surveys was the very sharp 8.2pt fall in the output index in the German manufacturing PMI. It is unclear whether this is simply a technical correction, given that this index had risen very sharply over the past three months to a very high level of 67. We note that the IFO expectations index in the German manufacturing sector did not decline in May and that the current conditions index increased solidly. Nevertheless, it is likely that manufacturers across the region made a small downward adjustment in May, given that the output index fell 2pts in France and likely decreased by a similar amount in the rest of the region as well. But, in services, the country breakdown was more encouraging. It fell by 1.5pts in

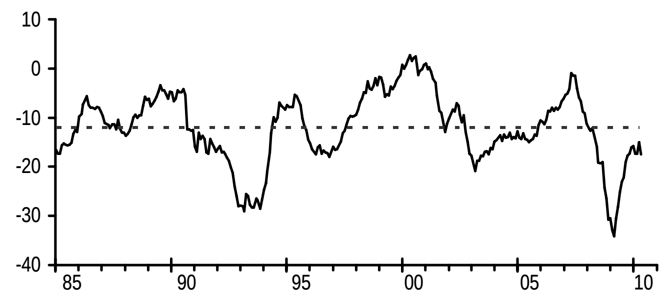
Euro area PMI and German IFO

DI, sa, both scales



Euro area consumer confidence

% balance, sa, dotted line shows average since 1985

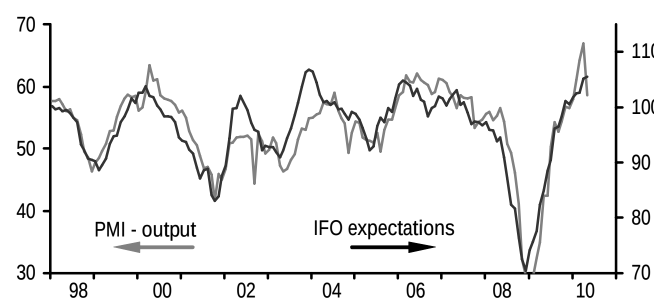


Euro area manufacturing PMI

DI, sa, both scales

German manufacturing surveys

DI, sa, both scales



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Germany, but rose by 2.8pts in France and by 0.5pt on average in the rest of the region.

Euro area core inflation still sliding

Euro area core inflation—excluding unprocessed food and energy—moderated in April to 0.7%oya, the lowest rate seen since EMU's launch. Moreover, of the 16 countries in EMU, two of them saw a lower price level in April than a year earlier (Ireland at -3.3% and Portugal at -0.5%).

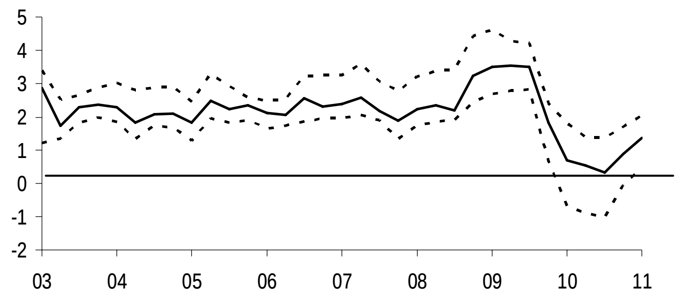
We now expect the ECB to be on hold through the end of 2011, partly due to the ongoing headwind from fiscal consolidation and partly due to a very low inflation rate. Given its commitment to price stability, the outlook for inflation will be very important to the central bank in setting the policy rate. The ECB has two key ways of shaping its medium-term view of inflation: first, a macro model provides a modal expectation of the inflation outlook, and second, a set of bivariate time series models creates a sense of the risks around the modal outlook (see "Understanding how the ECB forms its view of inflation risk," *GDW*, February 1, 2008). Although it has risen sharply since the trough last autumn, the level of capacity utilization is still very low, and the unemployment rate has broadly stabilized at a high level of 10%. This suggests that slack is likely to continue to bear down on core inflation, although the recent fall in the currency will act to mitigate the decline slightly.

The ECB employs bivariate models, which forecast inflation on an 18-month horizon using past information on inflation itself and one additional factor in each regression, to generate a sense of the risk distribution around the modal view. These bivariate time series models point to a subdued outlook for core inflation: indeed, all but one of the regressions predicts an inflation rate below the ECB's definition of price stability (close to but below 2%). The average of the 17 bivariate regressions points to a core inflation rate in the middle of 2011 of 0.7%oya, but with a sense of more upside risk around this average rather than downside risk. Ten of the regressions predict an inflation rate above the average, with the highest at 2.3%oya (labor compensation). Meanwhile, only seven of the regressions predict an inflation rate below the average, although two of them predict a significant amount of deflation (capacity utilization and GDP).

We have long argued that core inflation will continue to slide this year, and this remains our forecast. A slightly weaker overall growth forecast means that the output gap will close more slowly than previously thought. And in our Phillips Curve model, the output gap has a much bigger effect on inflation than the currency.

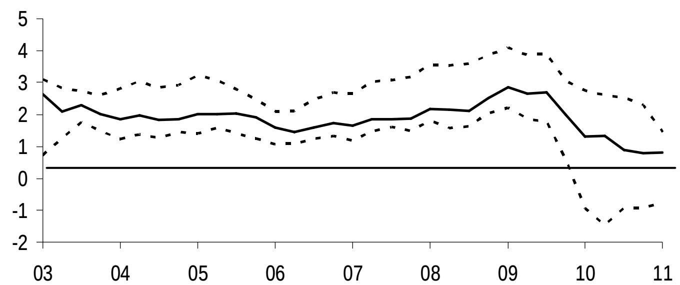
Forecast for the Euro area headline inflation

%oya, area shows min and max forecast from the bivariate time series models



Forecast for the Euro area core inflation

%oya, area shows min and max forecast from the bivariate time series models



Inflation forecasts for June 2011 and September 2011

%oya

	Headline			Core		
	Jun 11	Sep 11	Difference	Jun 11	Sep 11	Difference
Univariate	1.01	1.46	0.45	1.15	1.12	-0.03
M1	1.71	2.06	0.35	0.86	1.46	0.59
M2	0.96	1.46	0.50	1.08	1.10	0.02
M3	0.21	1.27	1.06	0.79	0.81	0.02
M3 corrected	0.09	1.22	1.13	0.71	0.73	0.02
Loans	0.69	1.03	0.33	0.29	0.25	-0.04
3-month Euribor	0.99	1.26	0.28	0.80	0.78	-0.02
10-years rate	0.90	1.59	0.69	1.11	1.32	0.21
Spread 3m-10y	0.89	1.37	0.48	0.90	0.86	-0.05
Capacity use	-0.05	0.48	0.52	-0.92	-0.75	0.17
Unemployment	0.66	1.16	0.50	0.39	0.20	-0.19
Compensation	1.09			1.22		
Unit labor cost	1.69			2.29		
GDP	-0.02			-0.50		
USD/EUR	0.59	1.65	1.06	1.13	1.12	-0.01
Import prices	1.47	1.58	0.11	0.49	0.52	0.03
WTI	1.21	1.42	0.21	0.64	0.84	0.20
Average	0.83	1.36	0.53	0.73	0.74	0.01

Figures indicate bivariate regression forecasts for headline and core inflation.

Predictions were made available on May 19, 2010.

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Data releases and forecasts

Week of May 24 - 28

Output and surveys

Manufacturing orders

Index, sa

		Dec	Jan	Feb	Mar
Tue	Euro area				
May 25	Values				
11:00am	New orders (%m/m sa)	0.6	-1.6	1.5	—
	New orders (%oya sa)	9.7	10.4	12.2	—

National business surveys

		Feb	Mar	Apr	May
Wed	France (INSEE survey—manufacturing)				
May 26	Index				
8:45am	Composite index	90	93	97	—
	Index of past production	1	5	22	—
	Expected output—personal	-1	5	4	—
	Expected output—general	1	-3	8	—
Thu	Italy (ISAE survey)				
May 27	2000=100, sa				
9:30am	Producer confidence	84.0	84.4	85.5	—
Wed	Belgium (BNB survey)				
May 26	% balance of responses, sa				
3:00pm	Overall	-7.0	-3.6	-2.4	—
	Manufacturing	-8.6	-6.5	-4.5	—
	Commerce	-4.9	-1.2	1.5	—
	Construction	-14.3	-9.3	-7.0	—

It is likely that the national business surveys remained close to their April levels in May. The weakness in the flash PMI was to a significant extent from the German manufacturing component, which saw a sharp fall. In the rest of the region, manufacturing output eased more modestly and services activity expanded somewhat, led by France. And the German IFO, which is more comparable to the INSEE, ISAE, and BNB surveys, was broadly unchanged in May, with only a small moderation of the expectations component. Overall, it appears that the business surveys have so far fallen only modestly given the sovereign debt turmoil.

Demand and labor markets

Domestic consumption

		Jan	Feb	Mar	Apr
Wed	France				
May 26	Consumption of manufactured products, real terms				
8:45am	%m/m sa	-2.5	-1.4	1.2	—
	%oya sa	1.5	1.3	2.5	—

Inflation

Consumer prices

		Feb	Mar	Apr	May
	Euro area				
	HICP (%oya nsa)	0.9	1.4	1.5	<u>1.6</u>
Thu	Germany (prelim)				
May 27	%m/m nsa	0.4	0.5	-0.1	<u>01</u>
8:00am	%oya	0.6	1.1	1.0	<u>1.2</u>
	HICP (%oya)	0.5	1.2	1.0	<u>1.2</u>
	Baden Wuerttemberg (%oya)	0.3	1.3	1.1	<u>1.3</u>
	Bavaria (%oya)	0.4	1.1	0.9	<u>11</u>
	Brandenburg (%oya)	0.3	0.8	0.7	<u>0.9</u>
	Hesse (%oya)	0.3	0.8	0.8	<u>1.0</u>
	North-Rhine West (%oya)	0.6	1.2	0.8	<u>1.0</u>
	Saxony (%oya)	0.5	1.3	1.1	<u>1.2</u>
Fri	Spain (flash)				
May 28	HICP (%oya nsa)	0.9	1.5	1.6	<u>16</u>
9:00am					
Fri	Belgium CPI				
May 28	%m/m nsa	0.4	0.4	0.3	<u>0.1</u>
11:15am	%oya nsa	0.7	1.7	1.8	<u>1.9</u>

German inflation is expected to increase slightly in May. We expect to see opposite movements from those in April: energy prices will likely be down and core inflation is expected to move up, although only partially reversing the big drop that took place in April. Food inflation is expected to have increased again in May.

Import prices

		Jan	Feb	Mar	Apr
Fri	Germany				
May 28	%m/m nsa	1.7	1.0	1.7	1.2
8:00am	%oya nsa	1.4	2.6	5.0	<u>7.1</u>

German import prices are expected to have risen even further in April, thanks to rising oil prices. Core import prices also are expected to have increased, influenced by the sharp exchange rate depreciation of the past months.

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Review of past week's data

Output and surveys

Real GDP

	3Q09		4Q09		1Q10	
Euro area						
%q/q sa	0.4		0.0		0.2	
%q/q saar	1.6		0.2		0.8	
%oya	-4.1		-2.2		0.5	
Germany (final)						
%q/q sa	0.7		0.2		*0.2*	
%q/q saar	2.9		0.7		*0.6*	
%oya	-4.8		-2.2		*1.5*	
GDP components (%q/q saar)						
Private consumption	~~-3.9~~	*-5.3*	~~-3.7~~	*-0.7*	__	*-3.2*
Government consumption	~~4.8~~	*3.0*	~~-2.2~~	*-0.8*	__	*4.4*
Mach, equip, other investment	~~4.5~~	*3.1*	~~-3.2~~	*-3.8*	__	*-6.3*
Construction investment	~~3.0~~	*2.3*	~~-2.0~~	*-3.8*	__	*-14.4*
Exports	~~14.1~~	*13.4*	~~12.6~~	*9.4*	__	*10.8*
Imports	~~22.4~~	*20.2*	~~-7.1~~	*-6.3*	__	*26.7*
Contributions to GDP growth (%q/q saar)						
Domestic final sales	~~-0.7~~	*3.1*	~~-3.1~~	*1.0*	__	*1.0*
Inventories	~~6.2~~	*7.0*	~~-4.7~~	*-4.8*	__	*8.4*
Net trade	~~-2.4~~	*-2.0*	~~9.0~~	*7.0*	__	*-5.5*
Spain (final)						
%q/q sa	-0.3		-0.1		*0.1*	
%q/q saar	-1.1		-0.6		~~0.4~~	*0.3*
%oya	-4.0		-3.1		*-1.3*	
GDP components (%q/q saar)						
Private consumption	-0.1		1.3		__	*1.8*
Government consumption	5.5		-6.6		__	*5.9*
Mach and equip investment	7.2		13.0		__	*-4.7*
Construction investment	-10.0		-8.5		__	*-13.1*
Exports	8.7		12.5		__	*8.1*
Imports	7.0		8.5		__	*4.6*

German GDP was confirmed to have increased 0.6%q/q saar in 1Q10 in the final release. As expected, there was a decline in consumer spending, reflecting a decline in disposable income (due to one of the volatile components). The household saving rate was broadly unchanged. Construction spending also fell, reflecting the severe winter at the beginning of the quarter, and subtracted 1.5%-pt from annualized GDP growth. This drag is set to reverse in the current quarter. In contrast, machinery investment rose in 1Q10, but this only reversed the decline seen in the prior quarter. Therefore, the domestic final sales have yet to expand convincingly in Germany, although the business surveys point to some improvement in the current quarter so far.

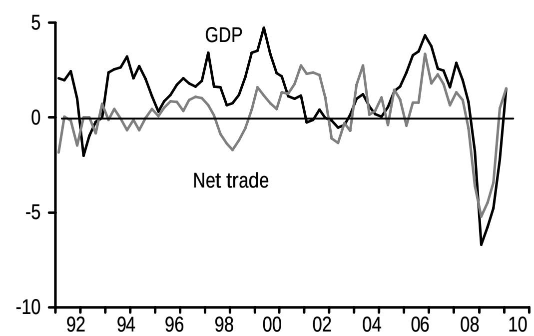
Exports rose impressively in 1Q10, even though there was a huge weather-related fall in January. This reflected a very strong monthly gain in March, which sets up a solid increase for the current quarter. Nevertheless, imports rose by even more so that net trade was a drag on GDP in 1Q10. Finally, it appears that much of the imports explain a large inventory build in 1Q10, which more than reversed the surprise destocking seen at the end of last year.

By sector, manufacturing output rose 11%q/q saar and output in services grew convincingly for the first time in this recovery. However, employment was still cut at the same pace as in 4Q09 in manufacturing, with most of the job creating in 1Q10 occurring in private services and the government sector. Finally, while overall employment was unchanged in 1Q10, hours worked per employee rose close to 2%q/q saar (close to the pace seen in 4Q09). Given the sharp decline in the workweek during the recession, it will be important that hours continue to recover gradually in the coming quarters, if a return to job cuts is to be avoided in Germany.

Spain's final 1Q GDP report, which includes expenditure detail, showed that the economy eked out a tiny 0.3% annualized gain in GDP last quarter. Consumer spending rose for the second quarter in a row, offset by a continued, steep decline in fixed investment, including home construction. The economy did exit the recession in 1Q10, but the domestic adjustment after the housing boom is continuing.

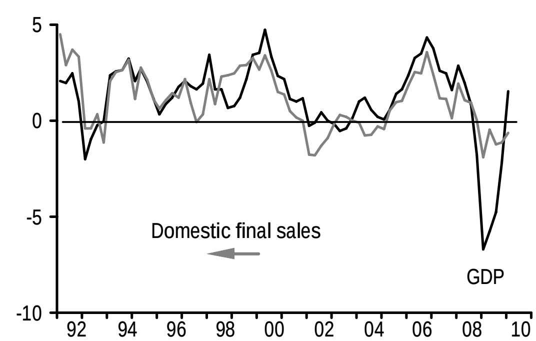
German GDP and the contribution from net trade

%oya and contribution to %oya GDP



German GDP and the contribution from domestic final sales

%oya and contribution to %oya GDP



Purchasing managers index flash (manufacturing)

Index, sa

	Mar	Apr	May	
Euro area				
Overall region	56.6	57.6	~~57.7~~	*55.9*
Germany	60.2	61.5	~~61.5~~	*58.3*
France	56.5	56.6	~~56.9~~	*56.2*

Purchasing managers index flash (services)

Index, sa

	Mar	Apr	May	
Euro area				
Overall region	54.1	55.6	*56.0*	
Germany	54.9	55.2	~~56.0~~	*53.7*
France	53.8	59.2	~~59.3~~	*61.9*

Purchasing managers index flash (composite)

Index, sa

	Mar	Apr	May	
Euro area				
Overall region	55.9	57.3	~~57.5~~	*56.2*
Germany	58.7	59.3	~~59.8~~	*55.5*
France	55.8	59.2	~~59.4~~	*60.5*

The flash output index of the Euro area composite PMI fell 1.1pt in May. But, at 56.2, it remained at a level that is normally consistent with GDP growing at almost a 3% annualized pace. The composite new orders index fell, reflecting weaker domestic orders, but the employment index rose to above 50. This implies only a partial shift to greater caution by corporates in May. At 55.0 on new orders and 50.4 on employment, these subindices are still signaling above-trend growth in orders and also some modest job creation. By sector, the output index fell 4.5pts in manufacturing, while the activity index rose in services by 0.4pt.

The greatest puzzle was in the country breakdown, with a sharp 8.2pt decline in the German manufacturing output index explaining much of the overall decline, despite a modest IFO result. Therefore, it is possible that the correction of the German manufacturing PMI, which should be benefiting from the weaker currency, is partly technical given the huge record of 66.9 it set last month. Nevertheless, the large shifts within the German PMI pulled down the new orders to inventory ratio of the Euro area manufacturing PMI.

Outside of Germany, the country breakdown was quite encouraging. Excluding Germany, the composite output index actually nudged up slightly. The services PMI fell 1.5pts in Germany, rose 2.8pts in France, and must have therefore increased by around 0.5pts in the rest of the region. In manufacturing, the declines of the output index were more broad-based. But, outside of Germany, the decline was 2pts on average and therefore nowhere near as dramatic as in Germany. Therefore, in manufacturing, the PMI is suggesting that firms have become a bit more cautious, although the decline seen in Germany is not easy to interpret.

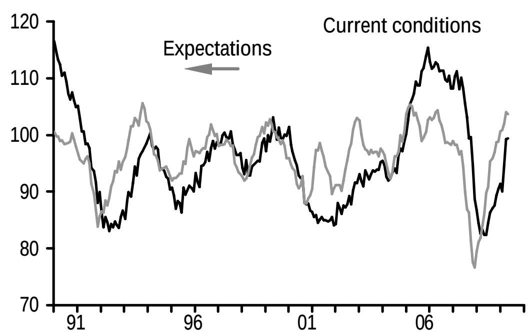
National business surveys

	Mar	Apr	May	
Germany (IFO survey)				
2000 = 100, sa				
Business climate	98.2	101.6	~~101.4~~	*101.5*
Business expectations	102.0	104.0	~~103.0~~	*103.7*
Current conditions	94.6	99.3	~~100.0~~	*99.4*

The German IFO was broadly unchanged in May, with only a small fall in the overall expectations index. Manufacturing expectations in the IFO nudged up and current conditions improved more significantly, despite the large decline seen in the German manufacturing PMI. Outside of manufacturing, the retail, wholesale, and construction indices moderated slightly. This appears more consistent with the German services PMI, which fell in the month. But, in terms of levels, the overall IFO is still pointing to solid growth momentum in Germany.

IFO current conditions and business expectations

Index, sa



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Demand and labor markets

Consumer confidence (prelim)

	Mar	Apr	May	
Euro area (European Commission survey)				
% balance of responses, sa				
Consumer confidence	-17	-15	__	*-18*

Euro area consumer confidence fell 2.5pts from -15.0 in April to -17.5 in May. The decline was sizable, but this move simply reversed the increase seen in April and therefore left confidence in the range it has been in since October last year. On its own, the decline in May was not too dramatic, although it will be important for a stabilization to be achieved in the coming months. No component or country details were published in the flash release.

External trade and payments

Foreign trade

	Jan		Feb		Mar	
Euro area						
€ bn sa						
Trade balance	~~1.9~~	*1.6*	~~3.3~~	*3.5*	__	*0.6*
Trade balance—year earlier	~~-3.0~~	*-3.2*	~~-1.9~~	*-2.2*	~~0.7~~	*1.7*
Exports	~~111.7~~	*112.3*	~~114.7~~	*116.1*	__	*124.8*
%m/m sa	~~-0.2~~	*0.1*	~~2.7~~	*3.4*	__	*7.5*
Imports	~~109.8~~	*110.7*	~~111.4~~	*112.6*	__	*124.2*
%m/m sa	1.1		~~1.5~~	*1.7*	__	*10.3*

Euro area nominal exports surged in March and were up 31%q/q saar in 1Q10. This was more than twice the pace seen in 4Q09 and came despite the severe weather restraining German exports in January. Nominal exports from the region have now recovered 64% of the peak-to-trough decline seen during the recession. And intra-Euro area trade flows, which are less likely to be affected by currency effects, increased by a solid 4.6%m/m in line with a strong German exports report. It appears that the recovery in trade is picking up strongly in the spring.

By country, the improvements were broad-based in March. Exports to outside of the EU27 rose 13.3%m/m in Germany, by around 3%m/m in France, Italy, and Spain, and by 13-14% in Portugal and Greece. While the March flows were firm, the improvement in Germany stood out. In addition, the trajectory in 1Q10 implies a 40% annualized increase in 2Q10 even if exports remain unchanged at the March level. With the currency weaker and the export orders/expectation indices in the PMIs and German IFO surveys at or close to record highs last month, the data are tracking a large trade boost to the region, with Germany leading the way.

Inflation

Consumer prices

	Feb	Mar	Apr	
Euro area (final)				
HICP (%m/m nsa)	0.3	0.9	~~0.4~~	*0.5*
HICP (%oya nsa)	0.9	1.4	*1.5*	
HICP (%oya core-X)[1]	0.8	0.9	~~0.8~~	*0.7*
HICP (%oya core-XX)[2]	0.9	1.0	*0.8*	
HICP (%m/m ex-tobacco)	0.3	0.9	*0.4*	

1. Excluding unprocessed food and energy.
2. Excluding food, alcohol, tobacco, and energy.

The rise in Euro area inflation in April was a result of two offsetting forces: the upward movement of energy and food inflation in sequential terms on the one hand, and the two-tenths fall of core inflation on the other. Some of the upward movement in the most volatile inflation components (food and energy) in the last few months was likely amplified by the sharp depreciation of the euro. However, the upward risk on headline inflation due to the ongoing weakness of the currency is likely to be offset by the larger-than-expected amount of slack in the system due to the fiscal consolidation effort.

The decline in core inflation excluding all food and energy was caused by service inflation related to package holidays and accommodation, contributing roughly 75% of the four-tenths decline in service inflation in April. The fall in services prices related to tourism is likely to reverse in May. The inflation rate in the rest of the service inflation basket also declined, albeit more slowly. Core goods inflation rose one tenth, pushed up by a rise in clothing inflation. Past the noise and the seasonal disturbances, it seems that core inflation is still slowly sliding in line with our forecast of core rate of 0.5%oya by year-end.

Energy inflation kept rising in April, thanks to widespread rises in gasoline prices and a tariff increase in natural gas prices in France. Fresh food inflation also rose significantly.

Producer prices

	Feb	Mar	Apr	
Germany				
%m/m nsa	0.0	0.7	~~0.3~~	*0.8*
%m/m sa	0.0	0.6	__	*0.7*
%oya nsa	-2.9	-1.5	~~0.1~~	*0.6*

German producer price inflation was particularly strong in April, thanks to a jump in producer prices for pig iron and steel. Prices in the chemical sector also rose significantly.

Japan

- **Real GDP increased 4.9% ar in 1Q as expected, but the details were not as positive**
- **Machinery orders on a rising trend; both corporate and consumer sentiment continue to improve**
- **BoJ announced the outline of the new measure, but its immediate impact appears limited**

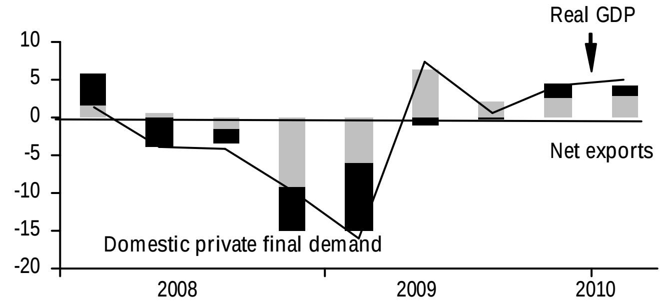
Japan's first-quarter real GDP rose 4.9%q/q saar, in line with expectations. With the upward revision of the previous three quarters' prints averaging 0.9%-pt, the level of real GDP was 4.2% higher than the level a year earlier and has recovered 46% of the 8.6% plunge from the peak in 1Q08 to the trough in 1Q09. For prices, deflation measured by the domestic demand deflator eased to 1.9% from 2.6% in 4Q09, and to 2.4% for all of 2009. These data suggest that a steady recovery is continuing and domestic deflation is easing, although the level of activity remains low.

However, the details of the report were not so upbeat. The main driver of GDP growth was again exports, but growth has not broadened to other sectors as we had expected. While private domestic final demand had picked up in 4Q09, the pace slowed in 1Q10. Private consumption continued to increase, but the contribution was concentrated in durable goods; services fell further. Moreover, the impressive gain in headline GDP was partly due to a rise in inventories; however, this likely implies slower future output growth. To be sure, strong gains in employees' compensation (labor income) in 1Q10 should feed through to higher consumption in the near future. In addition, machinery orders and the latest sentiment indicators support our view that growth is firm. Nevertheless, we now anticipate a slowdown from the impressive 5% 1Q growth, particularly with the deterioration in financial markets on the back of the European sovereign debt shock. Indeed, the Nikkei equity price index continued to fall, and the yen spiked against the US dollar this week.

The BoJ announced the preliminary framework for the measure to facilitate strengthening the foundation for economic growth, which was initially indicated at the policy meeting on April 30. The key feature of the measure is that the Bank will provide one-year loans—which can be rolled over at the existing policy rates—to private banks, which lend or invest the funds to firms that match the purpose of the measure. Further details—including the total amount—will be determined in the near future. This measure is not an additional easing measure of monetary policy, at least as we understand it, so market reaction was limited.

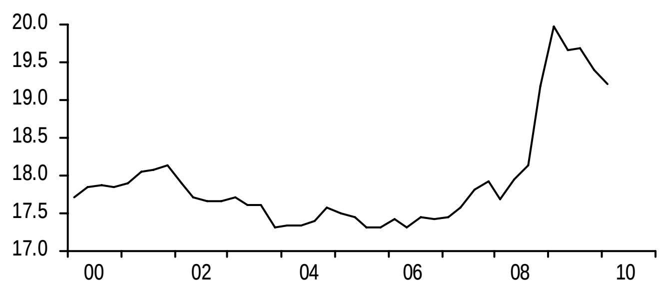
Real GDP

%q/q saar and %-pt contribution



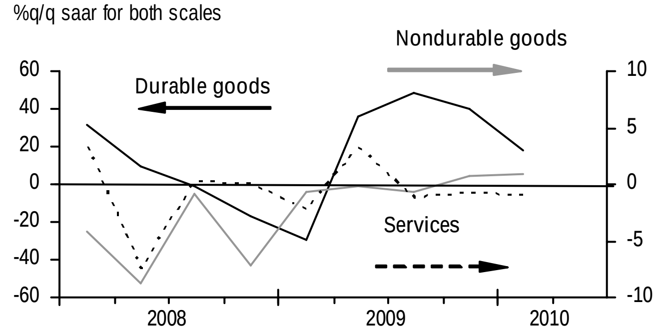
Real inventories to sales ratio

%, J.P. Morgan estimate



Real household consumption

%q/q saar for both scales



1Q GDP: upbeat headline with soft details

The main driver of 1Q real GDP growth was again exports, which rose 30.5%q/q ar after a 25.2% gain in 4Q09. The 9.6% rise in imports was somewhat higher than we had anticipated, but the growth in exports was a positive surprise. On the other hand, while private domestic final demand contributed to growth, the increase was less than that in the previous quarter and weaker than our forecast. Housing investment climbed for the first time since 4Q08, but was also less than we had expected. Another fall in service consumption by households was yet another disappointment, with the increase in total consumption below our estimate—just 1.3% for 1Q10 (we had originally forecast 3.5%), lower than the 2.7% in 4Q09.

A bigger surprise was the large, 0.7%-pt contribution from the change in inventories, which returned to positive territory after two quarters of decline. This unexpected growth may be revised down in the second estimate, due on June 10, as the inventory-to-sales ratio is still high, suggesting a likely fall in inventories, particularly in the nonmanufacturing sector. Public spending as a whole increased, with public consumption rising 2.0%, while investment fell 6.5%—which was a surprise as monthly data suggested an increase.

Looking ahead, the pace of growth is likely to slow to 2.5%-3.0% in coming quarters as the boom in exports is expected to moderate. While the weaker-than-projected gain in 1Q private consumption poses some downside risk, the impressive 6.7% increase in labor income should support overall consumption. Falling public investment is expected to continue, but an uptrend in housing and business investment seems likely as both have been relatively depressed.

Machinery orders increase

Core machinery orders recovered, rising 5.4%m/m sa in March, leaving the 1Q average 12% ar higher than in 4Q. This, the largest gain since 3Q07, further supports our view that business capital spending is now solidly on the path to recovery. The details of the report were also encouraging with orders from manufacturers posting a fourth consecutive m/m rise, and March's rise in orders from the nonmanufacturing sector recovering much of the loss of the previous two months. Moreover, the Cabinet Office's outlook for 2Q core orders looks for another 6.6%q/q saar rise, with nonmanufacturing orders expected to climb for the first time in four quarters. Although orders from manufacturing firms are forecast to fall substantially, we feel this may be too cautious given ongoing solid momentum in manufacturing indicators. Aside from core orders, foreign machinery orders rose 3.9%m/m sa in the month for a double-digit gain in 1Q10 even after the rapid rises witnessed in the previous two quarters (+13.4%q/q sa, after +26.7% in 4Q and +33.5% in 3Q).

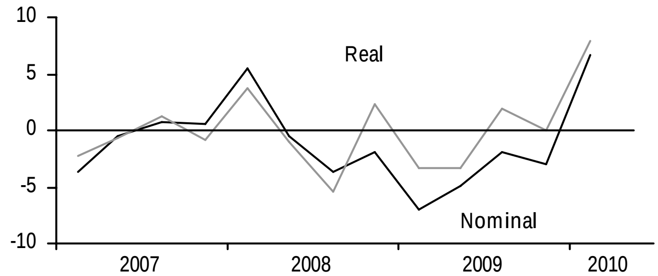
Sentiment continued to improve

For the first time since April 2008, the May Reuters Tankan large manufacturers' sentiment DI survey posted a reading above the neutral zero—at 4 (it was zero in April and -8 in March). This indicates that general business conditions have finally reached a level regarded as "good." The nonmanufacturing DI, where recovery had lagged that in manufacturing, was essentially unchanged between April and May, but materially higher than March (-15 after -14 in April and -22 in March). The result sends a message that the broad-based economic recovery continues. Note, however, that the majority of respondents replied to the survey prior to the recent turmoil in financial markets. Next week's Shoko Chukin small firm survey (Wednesday) will be the first sentiment indicator to reflect the recent escalation in concern over sovereign debt.

The ESRI's consumer sentiment index rose further in April, to 42.0 from March's 40.9, reaching a new high in the current cycle. This positive development was in line with upbeat messages from other consumption-related survey indicators, such as the Household and Employment DIs in the Economy Watchers survey, the unemployment rate, and the job offers-to-applicants ratio.

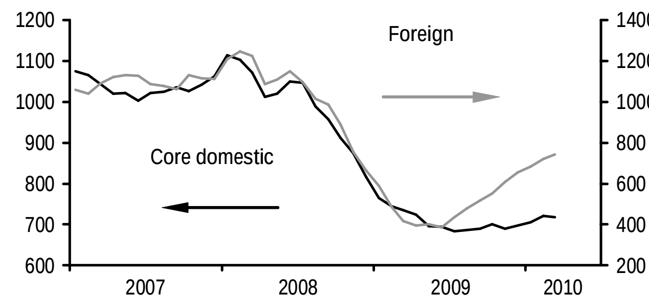
Compensation of employees

%q/q saar



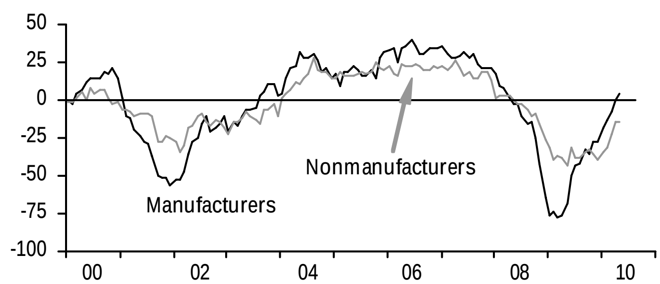
Machinery orders

Bn yen for both scales, 3mma



Reuters Tankan

DI



Data releases and forecasts

Week of May 24 - 28

Mon
May 24
1:30pm

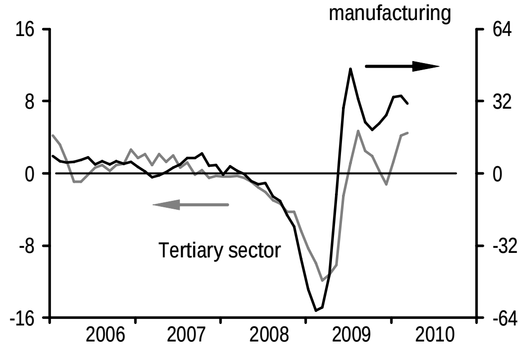
Index of all sector activity

%m/m sa

	Dec	Jan	Feb	Mar
All sector	-0.3	3.4	-2.3	-0.6
Tertiary sector	-0.7	2.9	-0.3	-3.0
Industrial production	2.6	4.3	-0.6	1.2
Construction	-0.4	0.7	4.5	___
Public sector	0.2	0.1	-1.2	___

METI all-sector activity indices

%3m/3m, saar



Wed
May 26
8:50am

Corporate service prices

%oya

	Jan	Feb	Mar	Apr
Overall	-1.2	-1.2	-1.1	-0.7
Ex international transport	-1.7	-1.6	-1.3	___

The CSPI should continue to fall amid still-low levels of wages and domestic demand. However, signs of moderation in deflation have emerged very recently.

Wed
May 26
2:00pm

Shoko Chukin small firm survey

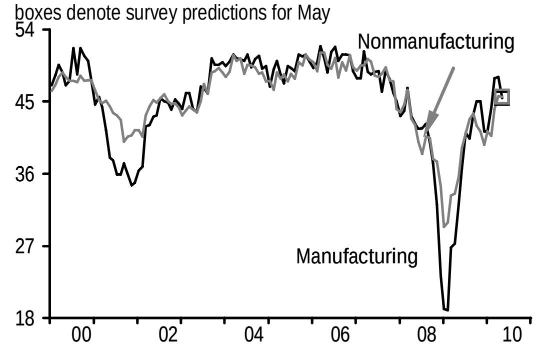
Diffusion index

	Feb	Mar	Apr	May
Sentiment index	42.3	45.8	46.8	45.5
Manufacturers	44.2	47.9	48.1	___
Nonmanufacturers	40.7	44.1	45.7	___
Sales (%oya)	1.4	3.4	5.1	___
Profit margins	-16.3	-10.3	-10.1	___
Financing conditions	-8.5	-5.1	-2.4	___
Inventory	-15.7	-13.2	-11.5	___
Capacity	-24.0	-20.8	-19.4	___
Employment	-13.2	-10.5	-11.5	___
Input prices	1.9	3.5	9.3	___
Output prices	-11.4	-9.8	-6.9	___

Small firms' predictions for the May headline index included in the previous report looking for a retreat after the rapid rise seen in April, led by the manufacturing sector. This appears to be broadly consistent with the survey predictions in the latest March IP report, where manufacturing output is projected to increase significantly in April and then show a modest negative payback in May.

Small firm sentiment by sector

DI, direction of conditions, boxes denote survey predictions for May



Thu
May 27
8:50am

Customs-cleared international trade

¥ bn sa, unless noted

	Jan	Feb	Mar	Apr
Balance	601	472	666	695
Exports (%m/m)	8.6	-1.8	0.0	5.0
Imports (%m/m)	9.4	0.5	-3.7	5.0
Balance (nsa)	61	647	952	690
BoJ real export index (%m/m)	0.3	1.1	2.8	___
BoJ real import index (%m/m)	1.5	1.8	-3.8	___

Based on the continued uptrend in foreign machinery orders, manufacturers' predictions for a strong rise in their April output, and the jump in the export order index in April's manufacturing PMI report, we expect solid growth for exports. Meanwhile, nominal imports were likely boosted by the surge in commodity prices during the month.

Fri
May 28
8:30am

Consumer prices

%oya

	Feb	Mar	Apr	May
Tokyo				
Overall	-1.8	-1.7	-1.5	-1.3
Core (ex fresh food)	-1.8	-1.8	-1.9	-1.6
Ex food and energy	-1.3	-1.2	-1.4	-1.3
Nationwide				
Overall	-1.1	-1.1	-1.3	
Core (ex fresh food)	-1.2	-1.2	-1.7	
Ex food and energy	-1.1	-1.1	-1.9	

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The elimination/reduction of high school tuition fees, as of last month, will have a measurable impact on overall consumer prices. The move subtracted 0.37%-pt from the oya change in the Tokyo core CPI, and will probably subtract 0.5%-pt from the oya change in the nationwide measure.

Overall, the reports are expected to reiterate that the underlying trend in CPI deflation is easing at a gradual pace, consistent with our view that the output gap (which is estimated to have been at its most negative in 1Q09) affects core core CPI with a four-quarter lag.

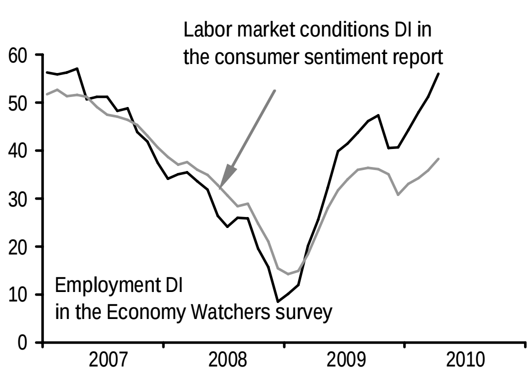
Fri
May 28
8:30am

Labor force survey

	Jan	Feb	Mar	Apr
Unemployment rate (% sa)	4.9	4.9	5.0	4.8
Labor force (%m/m sa)	0.7	-0.4	0.1	___
Total employment (%m/m sa)	0.9	-0.4	-0.1	___
Unemployed (%m/m sa)	-4.7	-2.1	3.1	___
Job offers ratio (sa)	0.46	0.47	0.49	0.51

The unemployment rate rose 0.1%-pt in the March report, from a rate 0.7%-pt lower than the cycle peak reached last July. However, the details of the report were more encouraging than the headline figure, as the number of people employed recovered almost all of the previous month's loss. Moreover, the labor market DI in both the Economy Watchers survey and the consumer sentiment report has become increasingly upbeat in recent months.

Labor market DIs



Fri
May 28
8:30am

Household survey of expenditures

%m/m sa, incl. agricultural worker households

	Jan	Feb	Mar	Apr
All households				
Real spending	-1.3	-1.6	5.9	-3.0
%oya	1.7	-0.5	4.4	2.5
Core	-1.9	-0.7	5.0	___
%oya	0.4	0.1	3.2	___
Worker households				
Real disposable income	3.4	-0.1	-1.1	___
Propensity to spend ratio (%)	73.5	72.2	78.1	___

Fri
May 28
8:50am

Commercial sales

%oya, unless noted

	Jan	Feb	Mar	Apr
Commercial sales	-3.9	-1.0	2.4	___
Wholesale sales	-6.1	-2.6	1.5	___
Total retail sales	2.3	4.2	4.7	3.4
%m/m sa	2.0	0.9	0.8	-1.0

Consumption-related survey indicators uniformly suggest that the underlying trend in consumer spending remains solid, despite the exclusion of several items from the extended "eco-point" system. However, bad weather and low temperatures during the month likely weighed on spending on seasonal items and, therefore, on overall consumer spending in April.

Review of past week's data

Corporate goods price index (May 17)

%oya

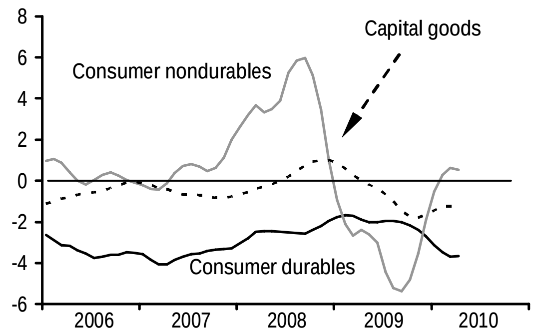
	Feb	Mar	Apr
Domestic CGPI	-1.6	-1.3	~~-0.3~~ *-0.2*
Export prices	1.3	-2.2	___ *-0.7*
Import prices	8.0	4.4	___ *10.1*

The headline index continued its m/m increase, rising 0.4% in April after +0.2% in March and +0.1% in the three months through February. The result reiterates the feeling that deflationary pressure among corporates has eased somewhat amid recovering corporate activity. We note that prices of consumer durables continued to fall at a much faster rate than the prices of capital goods.

The April CGPI report also showed further deterioration in the international terms of trade, calculated as the export price index divided by the import price index, and poses a risk to corporate profits. This is the result of higher import prices, boosted by the surge in commodity prices, such as energy and metals/metal products.

Breakdown of final goods domestic CGPI

%oya, 3mma



Machinery orders (May 17)

%m/m sa

	Jan	Feb	Mar
Domestic private sector, ex for ships and from utilities	~~-3.7~~ *-3.1*	~~-5.4~~ *-3.8*	~~5.0~~ *5.4*
Manufacturing	~~3.3~~ *3.6*	~~-0.3~~ *4.4*	___ *3.1*
Core nonmanufacturing	~~-12.9~~ *-11.7*	~~-4.0~~ *-3.7*	___ *12.6*
Foreign	~~-8.8~~ *2.3*	~~8.4~~ *3.0*	___ *3.9*

Core machinery orders recovered solidly in March, and finished the quarter up 2.9%q/q sa, compared with a 1.1%q/q rise in 4Q09. The result provides additional support to our view that business capital spending is now experiencing a solid recovery.

The prospect of recovery was reinforced by the March report, which showed orders from manufacturing firms posting a fourth consecutive m/m rise, and orders from the nonmanufacturing sector in March recovering most of the loss from the previous two months. Moreover, the CAO's outlook for 2Q core orders anticipates another 1.6%q/q rise, with nonmanufacturing orders expected to increase for the first time in four quarters. Although orders from manufacturing firms are predicted to fall substantially, we feel this is too cautious given ongoing solid momentum in manufacturing indicators.

Aside from core orders, March showed a fourth consecutive monthly rise in foreign machinery orders, up at a double-digit pace in 1Q on top of the sharp increases posted in each of the previous two quarters (+13.4%q/q sa in 1Q10 after +26.7% in 4Q09 and +33.5% in 3Q09). With Japan's exports appearing to be solid, we expect 2Q foreign machinery orders to come in ahead of the CAO outlook, which looks for a meaningful drop after the rapid rise and fast pace of growth in the previous three quarters.

Construction spending (May 17)

% change

	Jan	Feb	Mar
Public	24.0	19.6	___ *5.9*
%m/m sa, by J.P. Morgan	~~18.8~~ *18.7*	~~-3.0~~ *-2.3*	___ *-9.4*
Private	-9.8	-15.0	___ *-20.2*
Residential	-1.3	-9.5	___ *-17.1*
Nonresidential	-18.7	-20.6	___ *-23.0*
Building and structures	-21.4	-25.9	___ *-29.0*
Civil engineering	-14.8	-13.2	___ *-16.0*

The public component, which is used for estimating GDP public investment, jumped 62.4%q/q saar in 1Q10, a significant leap from the -3.9% in 4Q09. However, the figure was artificially boosted by a change in methodology (a revision of the assumed progress pattern of construction and also of seasonal factors in the winter months). Hence, the government made some adjustments, as this strength was not reflected in the 1Q GDP report.

Reuters Tankan survey (May 18)

DI, % saying "good" minus "bad"

	Mar	Apr	May
Manufacturing	-8	0	___ *4*
Nonmanufacturing	-22	-14	___ *-15*

For the first time since April 2008, the large manufacturers' sentiment DI in May rose above the neutral zero level. This indicates that business conditions overall are finally reaching a level regarded as "good." The nonmanufacturing DI, where recovery had lagged that in manufacturing, was essentially unchanged between April and May, after having risen materially in the previous months. The result suggests that the broad-based economic recovery continues.

As for manufacturing, the sentiment DIs of several sectors (food, precision instruments, chemicals, electric machinery) have been running above neutral levels, with upward momentum seen particularly in electric machinery firms, which cited better-than-assumed orders and a return to sales levels last seen prior to the collapse of Lehman Brothers. Although transport machinery producers are concerned about soft domestic demand, the outlook DI of the overall manufacturing sector, which represents firms' prospects for business conditions three months ahead, looks for a further solid improvement.

Within nonmanufacturing firms, transportation/electric utilities, where sentiment DI deteriorated substantially on rising oil prices in April, bounced back in May and is expected to recover over the next three months amid the upturn in manufacturing. The commercial sector, which this month assessed business conditions as "bad," is more optimistic about near-term prospects. That sector, as well as transportation/electric utilities, is likely to be a key driver of the expected rise in overall nonmanufacturing sentiment DI in the next three months.

Index of tertiary sector activity (May 18)

% change

	Jan	Feb	Mar
%m/m sa	~~2.5~~ *2.9*	~~-0.2~~ *-0.3*	~~-0.5~~ *-3.0*
%oya	~~-0.5~~ *-0.1*	~~0.4~~ *0.8*	~~4.0~~ *1.6*

The tertiary sector activity index fell much more than expected in March; however, 1Q10 ended up 4.5%q/q saar, posting the highest quarterly average level since 4Q08. The result, together with the continued uptrends in nonmanufacturing DI business surveys, increased our confidence that the nonmanufacturing sector is now joining the recovery.

The March decline was driven by wholesale trade, civil engineering and architectural services, and information services. However, the weakness in the first two categories appears to reflect payback for previous outsize increases. Indeed, the inherent volatility in the activity index for information services suggests that such a rapid decline will be followed by some rebound in coming months.

Meanwhile, the activity indexes for retail trade and transport and utilities, each of which showed upbeat momentum in today's Reuters large firm survey, extended their run of m/m increases. In addition to the solid performance of the retail trade sector, our measure of personal services remained on an accelerating trend, with the %3m/3m sequential change rising to 3.6% ar from +2.2% in February and +0.6% in January. The increase is consistent with our view that consumers have become more willing to spend, even outside of household durables.

Consumer sentiment (May 18)

Diffusion index, nsa

	Feb	Mar	Apr
Consumer sentiment	39.8	40.9	42.0
Standard of living	40.7	41.2	___ *42.4*
Income growth	38.8	39.5	___ *40.4*
Labor market conditions	34.2	35.9	___ *38.3*
Durable goods purchases[1]	45.4	46.8	___ *47.0*

1. The DI asks whether a respondent thinks that now is a good time to purchase durable goods.

The consumer sentiment index rose further in April, after the March reading topped the previous high of 40.5 reached in September/October 2009. This positive move was in line with upbeat feedback from other consumption-related survey indicators, such as the Household and the Employment DIs in the Economy Watchers survey, and the large retailers' sentiment DI in the monthly Reuters large firm survey. It is becoming increasingly clear, in our view, that underlying consumer spending remains solid, after having increased in 1Q due partly to the front-loading of purchases of household appliances ahead of the exclusion of several items from the extended "eco-point" system.

Looking at the details, all four of the component DIs extended their run of m/m rises since the start of this year. The labor market conditions DI has been rising more robustly than the other three, joining upbeat moves in the Employment DI in the Economy Watchers survey, the unemployment rate, and the job offers ratio.

Nationwide department store sales (May 18)

%oya, unless noted

	Feb	Mar	Apr
Overall	-7.1	-5.1	~~-6.0~~ *-5.8*
%m/m sa, by J.P. Morgan	0.2	-1.0	~~-0.8~~ *-0.6*
Same store	-5.4	-3.5	___ *-3.7*

Department store sales registered a weak start to 1Q10. By our seasonal adjustment, sales slipped m/m in April on top of a decline in March. However, the Japan Department Store Association considered the slow start to be the result of a temporary weather effect—bad weather and low temperatures during the month.

Industrial production—final (May 19)

%m/m sa

	Jan	Feb	Mar
Production	4.3	-0.6	~~0.3~~ *1.2*
Shipments	4.5	-0.2	~~1.6~~ *2.0*
Inventories	1.1	1.6	-1.6
Inventory/shipments ratio	-1.8	0.3	~~-5.2~~ *-5.5*
Operating ratio	7.1	0.0	___ *0.6*
Production capacity (%oya)	0.2	0.1	___ *0.7*

GDP—first preliminary estimates (May 20)

%q/q saar

	3Q09	4Q09	1Q10
Real GDP	~~-0.6~~ *0.5*	~~3.8~~ *4.2*	~~5.0~~ *4.9*
Private consumption	~~2.4~~ *2.5*	~~2.8~~ *2.7*	~~3.5~~ *1.3*
Residential investment	~~-27.7~~ *-26.1*	~~-12.5~~ *-10.3*	~~20.0~~ *1.1*
Business investment	~~-9.8~~ *-7.9*	~~3.8~~ *5.1*	~~8.0~~ *4.2*
Public consumption	~~0.3~~ *0.4*	~~2.5~~ *2.8*	~~0.5~~ *2.0*
Public investment	~~-5.8~~ *-3.9*	~~-5.0~~ *-4.7*	~~15.0~~ *-6.5*
Exports	~~37.8~~ *39.1*	~~21.7~~ *25.2*	~~16.0~~ *30.5*
Imports	~~23.3~~ *24.2*	~~5.1~~ 6.3	~~8.0~~ *9.6*
%-pt contribution to q/q saar GDP growth			
Net exports	~~2.1~~ *2.2*	~~2.2~~ *2.5*	~~1.3~~ *3.0*
Inventories	~~-0.8~~ *-0.4*	-0.6	~~-0.5~~ *0.4*
GDP deflator (%oya)	~~-0.6~~ *-0.7*	~~-2.8~~ *-2.7*	~~-3.1~~ *-3.0*

See main essay.

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Canada

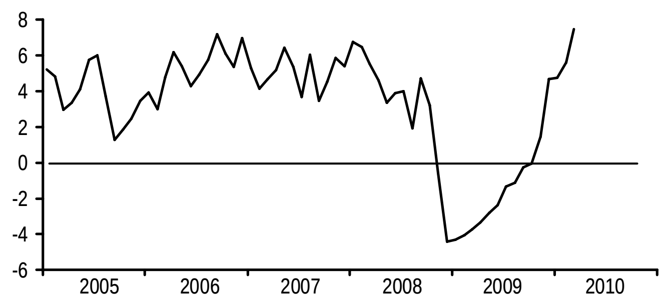
- **Strong March data point to 6%q/q ar 1Q GDP growth, up from our 5.8% expectation**
- **1Q retail sales post strongest increase in more than two years, pointing to strong consumption in 1Q GDP**
- **April CPI inflation higher than expected but remains below BoC's 2% target**

Data released this week point to extremely strong GDP growth in 1Q but further cooling in the housing market. Existing home sales fell 2.6% sa in April. They have fallen in three of the past four months and are down 6.8% from their December 2009 peak but still up 20%oya. Mortgage interest rates rising off of their 50-year lows have been one of the key factors behind the cooling of housing demand. And with the BoC expected to begin to raise its policy rate at the June 1 rate announcement, mortgage interest rates will likely rise further, thereby placing even more restraint on housing demand in the coming months.

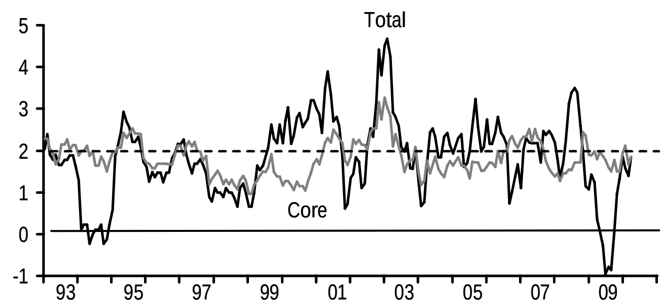
Key March source data behind monthly GDP were released this week. Both wholesale and retail sales rose considerably more than expected in March. Together with March manufacturing shipments released the previous week, they point to a 0.5%m/m increase in March GDP (to be released on May 31) yielding a 6.0%q/q ar increase in GDP for all of 1Q (also released on May 31), up from our previous estimate of 5.8%. The strength in first-quarter output had been presaged by strong readings on the index of leading indicators. April figures were released this week and though the pace of growth has stopped accelerating, the recent performance of the index points to strong GDP growth in 2Q. The April CPI release was a little stronger than expected but rather tame in comparison to the previous two months, which had been buffeted by one-off price increases at the Winter Olympics in February and their subsequent reversal in March. There were no odd factors influencing the April report as both the total and the core index posted modest monthly increases with the oya rates remaining below the BoC's 2% target.

Wholesale sales increased for the fourth time in five months, rising 1.4%m/m in March to effectively offset a 1.5% decline in February. Six of the seven major sectors posted gains in March. The major contributors to the increase were the machinery, equipment and supplies, and building materials and supplies subsectors. In volume terms, wholesale sales were up 2.2%m/m in March. Wholesale inventories edged down 0.2%m/m following a 0.3% increase in February. The inventory-to-sales ratio fell to

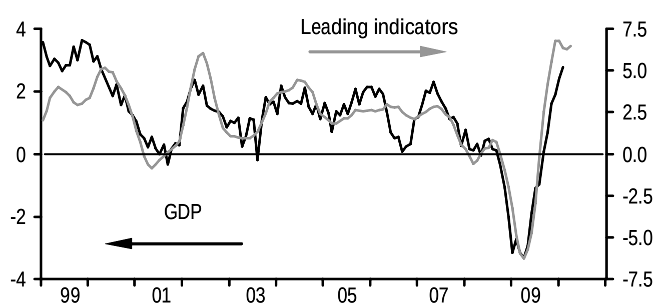
Real retail sales
%oya



Consumer prices
%oya



Monthly GDP and leading indicators
6-mo % ch, both scales



1.15 in March, below levels experienced prior to the recent recession and indicating that the inventory correction in the wholesale sector has generally run its course. For all of 1Q, real wholesale sales rose 5.3%q/q, up from a 3.9%q/q increase in 4Q, their fastest quarterly rate of increase in the brief history of the new series dating to 1Q04.

Retail sales increased for a fourth consecutive month in March, rising 2.1%m/m in current dollars. Higher sales at motor vehicle and parts dealers (+3.6%m/m) were the main contributor to the gain. Sales in volume terms increased 2.2%m/m in March. Sales increased in eight of the 11 retail subsectors. Warmer-than-usual weather in much of Canada in March likely influenced sales at some stores. Sales at building material and garden equipment and supplies dealers increased 6.6%m/m. Strong sales in those stores also benefited from the strength of the Canadian housing market. For all of 1Q, real retail sales were up 7.8%q/q ar, the highest quarterly pace of advance since 4Q07, pointing to another strong contribution from consumer spending to 1Q GDP.

The index of leading indicators rose a larger-than-expected 0.9%m/m in April, continuing a string of 11 straight increases averaging 1.0% a month. Eight of the 10 components advanced, led by housing and the equity market; one component was unchanged; and one fell. The rapid acceleration of the leading index has stabilized over the past couple of months but at a pace that points to robust GDP growth.

The Canadian total CPI rose a larger-than-expected 0.3%m/m nsa in April and edged up 0.1%m/m when seasonally adjusted. The monthly increase in the total CPI in April was due largely to a 0.6%m/m rise in the shelter component, reflecting higher prices for natural gas and homeowners' replacement costs. However, prices rose in seven of the eight major components. The over-year-ago inflation rate jumped to 1.8% from 1.4%oya in March due mostly to an unfavorable base effect (the total CPI fell in April 2009). The core index also rose 0.3%m/m not seasonally adjusted and 0.2%m/m when seasonally adjusted. The over-year-ago core rate increased to 1.9% from 1.7% in March. Both oya rates remained below the Bank of Canada's 2% target.

This week's strong reports clearly keep a BoC rate hike at the June 1 announcement on the front burner. However, we hasten to note that inflation remains contained and below target. And while the economy has rebounded strongly of late, a sizable negative output gap remains, which should contain demand-driven inflation pressures. Still, we look for a 25bp rate hike on June 1 not due to inflation concerns but rather because policy is currently at an emergency setting, which the economy no longer requires. In its last rate announcement and Monetary Policy Report, the Bank explicitly stated this: "With recent improvements in the economic outlook, the need for such extraordinary policy is now passing, and it is appropriate to begin to lessen the degree of monetary stimulus."

Data releases and forecasts

Fri
May 28
8:30am

Current account
C$ bn, saqr, unless noted

	2Q09	3Q09	4Q09	1Q10
Current account	-11.0	-13.8	-9.8	-7.3
% of GDP	-2.9	-3.6	-2.5	-1.8
Merchandise	-1.7	-4.1	0.6	2.3
Nonmerchandise	-9.3	-9.7	-10.3	-9.6

The current account deficit probably narrowed from 2.5% of GDP in 4Q09 to 1.8% in 1Q10 largely reflecting improving terms of trade in the first quarter.

Review of past week's data

Wholesale sales (May 19)
Sa

	Jan		Feb		Mar	
Total,%m/m	~~2.4~~	*2.5*	~~-1.2~~	*-1.5*	~~0.7~~	*1.4*
%oya	~~9.5~~	*9.6*	~~8.5~~	*8.4*	~~9.5~~	*10.3*

Leading indicators (May 20)
%m/m

	Feb		Mar		Apr	
Smoothed	~~0.9~~	*1.0*	~~1.0~~	*1.2*		*0.9*
Unsmoothed	~~1.5~~	*1.7*	~~0.5~~	*0.9*		*1.3*

Consumer price index (May 21)
%m/m nsa, unless noted

	Feb		Mar		Apr	
Total CPI	0.4		0.0		~~0.1~~	*0.3*
%oya	1.6		1.4		~~1.6~~	*1.8*
CPI Core	0.7		-0.2		~~0.1~~	*0.3*
%oya	2.1		1.7		~~1.7~~	*1.9*
Ex food & energy	0.7		-0.3		~~0.1~~	*0.4*
%oya	1.4		0.9		~~0.9~~	*1.2*
Ex food, energy, tax (%oya)	1.4		0.9			###

Retail sales (May 21)
%m/m sa, unless noted

	Jan		Feb		Mar	
Total	~~0.9~~	*1.2*	~~0.5~~	*0.8*	~~0.0~~	*2.1*
%oya	~~6.6~~	*6.9*	~~6.4~~	*7.0*	~~6.2~~	*9.1*
Ex autos	~~2.0~~	*2.2*	~~-0.1~~	*0.0*	~~0.3~~	*1.7*
%oya	~~6.2~~	*6.4*	~~4.8~~	*5.2*	~~5.5~~	*7.5*
Ex autos & gas	~~2.0~~	*2.2*	-0.2		~~0.3~~	*1.6*
%oya	~~4.5~~	*4.7*	~~3.2~~	*3.5*	~~3.6~~	*5.2*
Real retail sales	~~0.2~~	*0.4*	~~0.6~~	*0.9*	~~-0.5~~	*2.3*
%oya	~~4.9~~	*5.1*	~~5.5~~	*6.0*	~~4.4~~	*7.9*

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Mexico

- **Banxico left rates unchanged, as expected**
- **1Q10 GDP confirmed that Mexico's recovery has been driven by external demand ...**
- **... but signaled that domestic demand has stabilized**

Today Banco de México held its monthly monetary policy meeting. The board left the reference rate unchanged at 4.5%, as was widely expected. But more important in our view was the more dovish tone that we perceived from its post-meeting communiqué compared to last month's statement, particularly as it emphasized that the Euro area sovereign crisis is posing risks that were not seen previously. In fact, board members now foresee that central banks in developed economies could extend their accommodative stance even longer than market participants were expecting. However, Banxico also highlighted that adjustments in local markets to global uncertainties have happened in an orderly and liquid fashion. The board mentioned that: (1) global growth has continued expanding, but the Euro area sovereign crisis has posed some doubts about the pace of economic recovery; (2) Mexico's economic recovery has been mainly driven by external demand, while domestic demand remains weak, and fixed investment has not rebounded; (3) 12-month headline and core inflation decreased in April, showing that there have been no second-round effects from the CPI surge at the beginning of the year; the monetary authority thus expects inflation to follow its projected inflation rangess; (4) medium- and long-term inflation expectations remain well-anchored, although they continue to be above Banxico's long-term target; and (5) it will continue paying close attention to wage settlements, inflation expectations, and the pace at which the output gap narrows. All in all, this supports our low-for-long view (consensus: +25bp in January; IRS market: +25bp in November).

Economic recovery entering Phase II

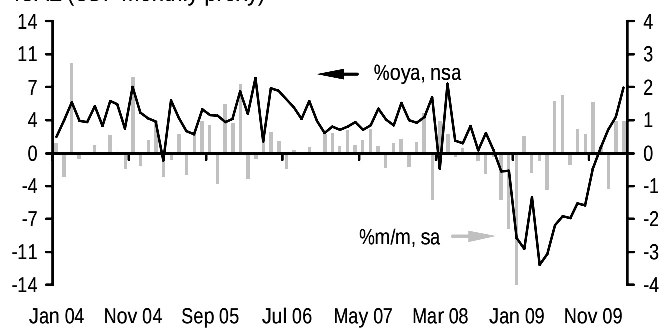
We classify Mexico's economic recovery in three phases. Back in 2008/2009, Mexico experienced a sharp decline in manufacturing activity—similar to that in the US. This led to a massive loss of jobs that eventually (two quarters later) hurt domestic demand. This was the "anatomy of the crisis." In this context, "the chronicle of recovery" has been a rebound of manufacturing activity (Phase I) that has strengthened the labor market, helping to stabilize domestic conditions (Phase II). Now we expect domestic demand to gain momentum, particularly in 2H10 (Phase III).

GDP
%oya

	1Q09	2Q09	3Q09	4Q09	2009	1Q10
GDP	-7.9	-10.0	-6.1	-2.3	-6.5	4.3
Agriculture	0.1	3.4	1.3	2.1	1.8	-1.5
Industrial	-9.6	-11.1	-6.3	-1.9	-7.3	5.4
Manufacturing	-13.5	-16.1	-9.4	-1.4	-10.2	9.9
Nonmanufacturing	-4.3	-4.2	-2.1	-2.7	-3.3	-0.1
Services	-7.3	-10.2	-6.2	-2.9	-6.6	3.8

Source: INEGI and J.P. Morgan

IGAE (GDP monthly proxy)



Source: INEGI

This week INEGI released 1Q10 GDP as well as March's IGAE (GDP monthly proxy). The Mexican economy grew 6.9%oya in March, boosting GDP by 4.3%oya during the first quarter of the year. These figures show that Mexico's recovery has been mainly driven by external demand. This is confirmed by manufacturing activity that grew 9.9%oya in 1Q10, after having averaged -10.2% in 2009, as manufacturing production is highly correlated with Mexican exports (table). Moreover, domestic demand has stabilized. The services sector—mostly reflecting domestic conditions—posted an over-year-ago gain of 3.8%, after having fallen 6.6% in 2009.

Also, we believe that the sequential decline in quarterly GDP does not impugn the country's economic recovery. On the one hand, even though in seasonally adjusted annualized terms GDP declined 1.4% with respect to the previous quarter, March's IGAE posted a monthly increase of 1% for the second month in a row, after an unchanged reading in January (chart). On the other hand, Mexico's GDP is considerably more volatile than developed economies'. Problems with seasonal adjustment partly account for this volatility. The seasonal adjustment process does not fully adjust for events that occur at slightly different times of the year, such as the effects of the Easter vacation period. In this context, for example, the "Holy Week" took place in April in 2009, while this year part of this vacation period fell in March (1Q10), and the other in April (2Q10).

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As a result, we believe that this quarterly decline does not necessarily mean that the Mexican economy contracted during the first quarter of the year, but rather reflected an earlier Easter. All in all, we continue to forecast that Mexico's GDP will grow 4.5% in 2010 (consensus: 4.2%), as we anticipate domestic demand will gain momentum in 2H10, when we expect better labor market conditions to translate into higher consumer spending.

Data releases and forecasts

Week of May 24 - 28

Mon May 24 9:00am

Consumer prices

	Mar 2H	Apr 1H	Apr 2H	May 1H
%2w/2w	0.16	-0.31	-0.18	-0.49
Core	0.19	-0.03	0.09	0.04
%oya	4.88	4.41	4.13	3.98
Core	4.35	4.13	4.10	4.00

Mon May 24 9:00am

Trade balance

	Jan	Feb	Mar	Apr
Balance (US$ mn)	-333	244	237	-150
ytd (US$ bn)	-0.3	-0.1	0.2	0.0
Exports (US$ bn)	19.3	21.1	25.9	24.2
%oya	26.7	31.2	39.0	38.8
%m/m sa	1.4	2.5	3.3	3.1
Imports (US$ bn)	19.6	20.9	25.7	24.3
%oya	16.9	25.7	38.6	41.5
%m/m sa	2.8	2.2	5.5	2.3

Tue May 25 9:00am

Labor market report

% of labor force

	Jan	Feb	Mar	Apr
Open unemployment rate	5.9	5.4	4.8	4.9
Sa	5.5	5.2	4.6	___

Tue May 25 9:00am

Central bank foreign reserves

US$ bn

	Apr 30	May 7	May 14	May 21
Gross international reserves	97.4	98.1	98.0	___

Tue May 25

Nominal GDP

	2Q09	3Q09	4Q09	1Q10
%oya	-7.0	-3.4	3.5	11.0
Deflator	3.3	2.9	5.9	___

Tue May 25 9:00am

Balance of payments

US$ bn

	2Q09	3Q09	4Q09	1Q10
Current account balance	0.4	-3.7	-0.7	0.1
Transfers	5.7	5.5	4.8	4.8
CA as % of GDP	0.2	-1.6	-0.3	0.0
Capital account balance	-3.0	6.5	13.8	6.3
FDI	5.1	1.6	0.7	4.3
Equity flows	0.2	2.1	0.6	-0.7
Local bond market flows	-0.1	2.2	1.8	2.6
Reserves, change	-4.7	1.9	14.7	4.8

Fri May 28 3:30pm

Public sector indicators

Mex$ bn

	Jan	Feb	Mar	Apr
Overall balance	6.4	16.5	-11.6	___
Ytd	6.4	22.9	11.3	___
Primary balance	30.5	22.2	-7.3	___

Review of past week's data

Consar report (May 17)

Mex$ bn

	Feb	Mar	Apr	
Assets under management	1,196	1,223	___	*1,239*
Government securities	796	791	___	*801*
Equity investment	156	172	___	*175*

Central bank foreign reserves (May 18)

US$ bn

	Apr 30	May 7	May 14	
Gross international reserves	97.4	98.1	___	*98.0*

Real GDP (May 20)

%oya, unless noted

	3Q09		4Q09		1Q10	
Total	-6.1		-2.3		~~4.9~~	*4.3*
%q/q saar	~~10.4~~	*10.1*	~~8.4~~	*7.9*	~~0.0~~	*-1.4*
Agriculture	1.3		2.1		~~-1.3~~	*-1.5*
Industry	-6.3		-1.9		*5.4*	
Services	-6.2		-2.9		~~2.7~~	*3.8*

Indicator of overall economic activity (IGAE) (May 20)

	Jan		Feb		Mar	
%oya	~~2.4~~	*2.5*	~~3.4~~	*3.8*	~~4.5~~	*6.9*
%m/m sa	~~-1.0~~	*-1.1*	~~0.5~~	*1.0*	~~0.6~~	*1.0*

Banamex CPI inflation expectations survey (May 20)

%oya, except policy rate: %p.a., median value

	Apr 19	May 5	May 20	
End-2010	5.22	5.10	___	*5.00*
Core	4.50	4.36	___	*4.34*
End-2011	3.83	3.87	___	*3.80*
One year forward	3.86	4.01	___	*4.04*
Banxico policy rate (YE10)	5.00	4.75	___	*4.50*

Retail sales (May 21)

	Jan	Feb	Mar	
Retail sales				
%oya	-1.8	2.3	~~1.8~~	*2.3*
%m/m sa	-0.6	1.4	~~1.2~~	*0.6*

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Brazil

- **Widespread price hikes put pressure on core inflation**
- **Despite a sequential decline, April Caged is still higher than the pre-crisis pace of job creation**
- **Cyclical recovery boosting federal tax revenues**

Despite solid fundamentals and very good economic performance, Brazilian financial assets have been hit by the Euro area sovereign crisis. The equity market is 13% lower month-to-date, and the Brazilian real is down almost 7% against the US dollar in the same period. On the policy side, the latest COPOM minutes introduced the Euro area crisis as a dovish risk factor and, accordingly, the local yield curve began to compress, despite the continued hawkish data flow of late (see below). We believe memories of 2008 could well prevent an acceleration in COPOM's tightening pace to 100bp (which was becoming increasingly likely due to the signals of overheating), but the bar for a slowdown in the current tightening pace of 75bp is much higher. Indeed, in the 2008 crisis, although the commodity price meltdown helped to disinflate the economy, the main driver of the monetary easing was a sudden seizing of credit markets amid a violent confidence crisis. Apparently, the current environment is not resulting in any disruption in trade credit lines or foreign currency financing, and Brazilian corporates are not subject to the currency mismatches that provoked the 2008 credit events. That said, liquidity and credit contagion are being closely monitored by the Brazilian authorities, and any signal of an abrupt reduction in liquidity will impact the ongoing policy normalization process.

Headline and core inflation on the rise

The IPCA-15 increased 0.63%m/m in May, up from 0.48% in April and above the market consensus forecast of 0.58% (J.P. Morgan: 0.59%). Upside surprises were widespread, with prices of food away from home, used cars, rents, and condominium along with electricity tariffs increasing more than we forecast, resulting also in an acceleration in core inflation to 0.58%m/m from 0.39% in April. With this week's release, the 12-month cumulative IPCA-15 accelerated to 5.26%, from 5.22%, and core inflation remained close to 5% (4.97% in May from 4.95% in April), reinforcing our long-standing view that above-trend growth is putting upward pressure on underlying inflation (first chart).

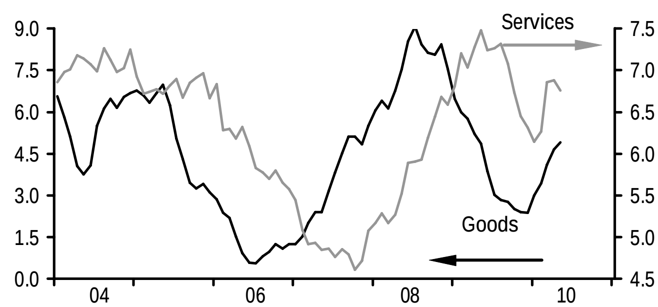
The deceleration in food prices (1.0% from 1.71%) was not enough to impede the increase in the IPCA-15 inflation because housing and transportation costs accelerated on the back of administered and market-driven price increases

IPCA-15: headline and core inflation above the 4.5% target

%oya

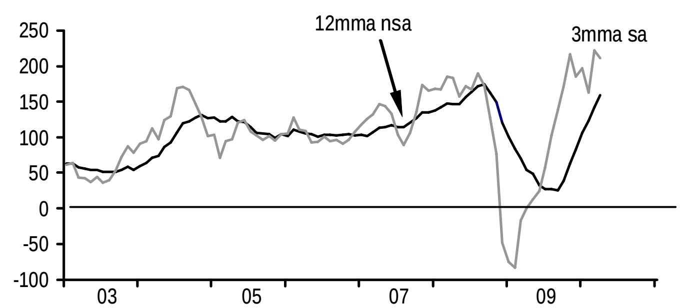
IPCA-15: both goods and services inflation on the rise

%oya, both scales



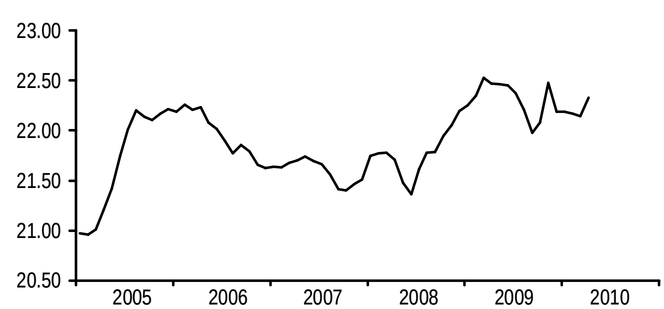
CAGED—net change in payrolls (establishment survey)

000s of net job creation, monthly average



Federal tax revenues

12-month trailing as % of GDP



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(electricity, fuel, services, and vehicle prices). In terms of goods prices, slower rises in food prices led to a stabilization of the rate of increase of the nondurables group, albeit at a rather rapid pace (6.1%oya), while durable goods prices continued to rebound after falling for more than a year on the back of the end of tax incentives amid strong credit-driven demand. Core services posted a small deceleration (6.76%oya from 6.88%), but we believe the tight the labor market will keep upward pressure on this group for the remainder of the year (second chart previous page).

April formal job creation slowing to a still strong pace

The April Caged survey of the formal labor market posted a net payroll increase of 305,068 nsa, up from 266,415 in March and 106,205 in April 2009. Last month's net job creation was the best April performance on record, according to the Labor Ministry. Despite the excellent result in not seasonally adjusted terms, seasonally adjusted net job creation declined in April to 200,000, from the relatively high 235,000 registered in March. Even so, the April seasonally adjusted increase is much better than the pace of job creation registered before the global crisis of 180,000 per month, and it seems strong enough to put downward pressures on unemployment rates (third chart previous page). Both gross job creation and job cuts posted sequential declines in April (on a seasonally adjusted basis), interrupting a strong sequence of acceleration in hiring and firing in the formal labor market. In terms of sectors, there were no specific drivers of the marginal decline in the overall net payrolls, but the manufacturing and services sectors appear to be normalizing the pace of hiring to a more sustainable level.

Tax revenues to help reach primary surplus target

The April federal tax revenue report showed strong revenue collections of R$70.9 billion (consensus: R$67.2 billion), or a 16.8%oya expansion in real terms (IPCA-deflated). In addition to the boost provided by the recent strong economic performance (captured by taxes on corporate profits), last month's tax collection was also influenced by a 93%oya increase in taxes on vehicle production, as a result of the end of fiscal incentives in March. The revenue collection data point to a strong April primary surplus, reversing part of the disappointment with 1Q10 fiscal performance. We expect a R$15.7 billion surplus for the public sector primary balance (due next week), which would be enough to meet the bimonthly budget target.

Data releases and forecasts

Week of May 24 - 28

Tue May 25 8:30am

Current account balance
US$ bn, net inflows

	Jan	Feb	Mar	Apr
Current account (CA)	-3.8	-3.3	-5.0	-4.2
Trade balance	-0.2	0.4	0.7	1.3
Services	-8.4	-4.0	-3.9	-5.8
Net transfers	0.3	0.2	0.3	0.3
CA, 12-month sum	-25.4	-28.0	-31.6	-35.8
CA, 12-month sum, %GDP	-1.6	-1.7	-1.8	-2.0
Foreign direct investment	0.8	2.8	2.0	2.8

Thu May 27 7:00am

National unemployment
% of labor force, new methodology

	Jan	Feb	Mar	Apr
Open rate, nsa (30 days)	7.2	7.4	7.6	7.6

Thu May 27 8:30am

Public sector borrowing requirement
Minus denotes surplus

	Jan	Feb	Mar	Apr
R$ bn				
Primary	16.2	0.9	-0.2	15.7
Primary, ytd	16.2	17.0	16.8	32.5
12-month sum, as % of GDP				
Primary	-2.3	-2.2	-1.9	-2.0
Interest payments	5.3	5.4	5.4	5.4
Nominal	3.0	3.2	3.5	3.4
Net debt, % of GDP	41.2	42.1	42.4	43.3

Fri May 28 6:00am

General prices (IGP-M)
%m/m nsa

	Feb	Mar	Apr	May
Overall	1.2	0.9	0.8	1.3
%oya	0.2	1.9	2.9	4.3
Wholesale prices	1.4	1.0	0.7	1.6
Consumer prices	0.9	0.8	0.7	0.5
Construction prices	0.4	0.5	1.2	1.2

Review of past week's data

Consumer prices (IPCA-15)
%m/m nsa, % weights in parentheses

	Mar	Apr	May	
Total	0.6	0.5	*0.6*	
Ex. volatile	0.4	0.4	~~0.5~~	*0.6*
Trimmed mean	0.4	0.5	~~0.5~~	*0.6*

Formal job creation (Caged)

	Feb	Mar	Apr
Monthly creation (000)	209.4	266.4	305.0
ytd, nsa	1478.5	1710.1	1908.9

Chile

- **Demand was booming while supply slumped in 1Q**
- **Upbeat business mood bodes well for supply-side rebound**
- **BCCh likely to initiate hikes despite market downturn**

Chile reported 1Q real GDP at only +1.0%oya, compared to market expectations of +1.2%oya. The 1Q performance implies a 1.5%q/q (not annualized) drop in output reflecting the severe impact of the late-February earthquake. Unsurprisingly, this is the worst economic performance since 4Q08 when the global crisis severely impacted the economy (first chart). However, the key observation from the 1Q report lies in the contrast between the resilience of the demand side of the economy and the temporary setback to the supply side. Private consumption was up 7.5%oya (versus 5.7%oya in 4Q) while investment in machinery and equipment jumped 20.3%oya (versus -17.1%oya in 4Q).

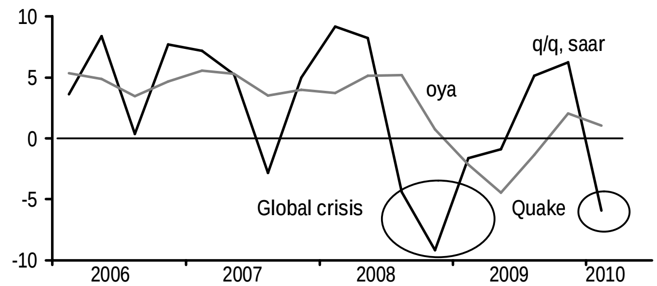
The economy should rebound as upbeat business sentiment indicators suggest a very strong reversal is in the pipeline (third chart) in sectors that were disproportionately affected by the earthquake early in the year, like industry (-6.0%oya in 1Q). While this suggests a double-digit expansion for industry in 2H10, business sentiment could well retrace somewhat ahead due to the concerns over deterioration in the Euro area. The immediate impact of market deterioration has been a weaker CLP.

On balance, we forecast that the economy will rebound by only 2.7%oya in 2Q as drags from some sectors will remain in place. However, the expansionary forces should gain momentum in 2H10 when we forecast an above-potential 8.1%oya expansion in real GDP. This should average a 5.0%oya growth rate for the economy in 2010—lower than our prior forecast of 5.5%.

Demand trends reinforce the perception—voiced repeatedly by the central bank (BCCh)—that the economy was recovering at a faster pace than expected by monetary authorities just prior to the earthquake. It also provides the justification for the initiation of the policy rate normalization cycle, which we forecast for the next meeting in June (+25bp followed by a steady rise of the policy rate from 0.5% to 2.25% by year-end). There is a risk that global risk aversion affecting financial markets (which is depressing copper prices and the peso) can affect the central bank's perception of the balance of risks. Certainly, if there is a belated beginning to fed funds normalization in the US (as J.P. Morgan forecasts), this could challenge BCCh's bias to tighten down the road.

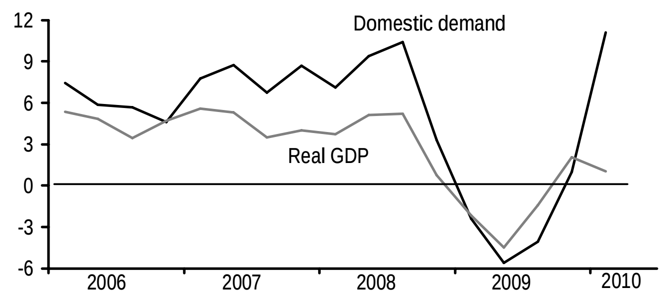
Chile: real GDP

%ch



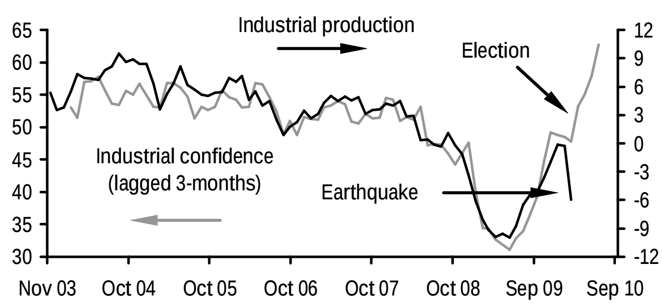
Chile: real GDP and domestic demand

%ch



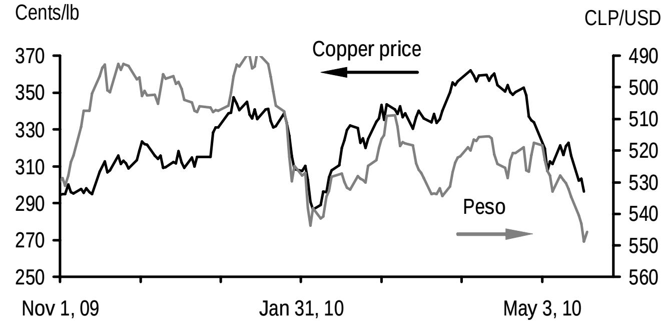
Chile: industrial confidence (Icare) and industrial production (INE)

Index, min=0; max=100 %oya, 3-mma



Chile: copper price and peso

Cents/lb CLP/USD



Yet, paradoxically, the negative impact on CLP from global market uncertainty offers an opportunity to initiate the tightening without an outcry from exporters.

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Argentina:

Data releases and forecasts

Week of May 24 - 28

Fri May 21 — Trade balance

	Jan	Feb	Mar	Apr
US$ bn	43.54	41.38	43.48	___

Fri May 21 — Industrial production

	Jan	Feb	Mar	Apr
%oya nsa	5.2	11.0	10.6	___

Fri May 21 — Economic activity

	Jan	Feb	Mar	Apr
%oya nsa	4.8	4.9	6.0	___

Week of May 24 - 28 — Budget balance

	Jan	Feb	Mar	Apr
ARS bn	1.04	1.21	1.22	___

Review of past week's data

Consumer confidence

	Mar	Apr	May
Index	41.38	43.48	___ *x.x*

Chile:

Data releases and forecasts

Week of May 24 - 28

Fri May 28 — Industrial production

	Jan	Feb	Mar	Apr
%oya nsa	-1.1	0.5	-17.4	___

Review of past week's data

Real GDP

	3Q09	4Q09	1Q10
%oya	-1.4	2.1	___ *1.0*

Current account balance

	3Q09	4Q09	1Q10
US$ bn	0.57	1.01	___ *1.52*

Colombia:

Data releases and forecasts

Week of May 24 - 28

Thu May 27 — BanRep monetary policy meeting
%p.a.

	Feb	Mar	Apr	May
Repo rate	3.5	3.5	3.0	3.0

Review of past week's data

Industrial production

	Jan	Feb	Mar
%oya nsa	1.54	3.07	~~8.0~~ *6.4*

Retail sales

	Jan	Feb	Mar
%oya nsa	8.65	4.00	~~8.20~~ *9.3*

Ecuador:

Data releases and forecasts

Week of May 24 - 28

No data releases expected.

Review of past week's data

No data released.

Peru:

Data releases and forecasts

Week of May 24 - 28

Fri May 28 — Real GDP

	2Q09	3Q09	4Q09	1Q10
%oya nsa	-0.8	-0.2	3.8	6.6
%q/q saar	-1.8	10.0	11.5	7.3

Review of past week's data

Real GDP

	Jan	Feb	Mar
%oya nsa	3.60	5.90	~~7.90~~ *8.8*

Venezuela:

Data releases and forecasts

Week of May 24 - 28

Week of May 24-28 — Real GDP

	2Q09	3Q09	4Q09	1Q10
%oya nsa	-2.6	-4.6	-5.9	-4.0
%q/q saar	0.1	-7.4	-4.6	-4.0

Review of past week's data

No data released.

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United Kingdom

- **Jump in core inflation suggests inflation will be slower to fall back below target**
- **Minutes reveal more divergence in views about the extent of disinflation that will come through**

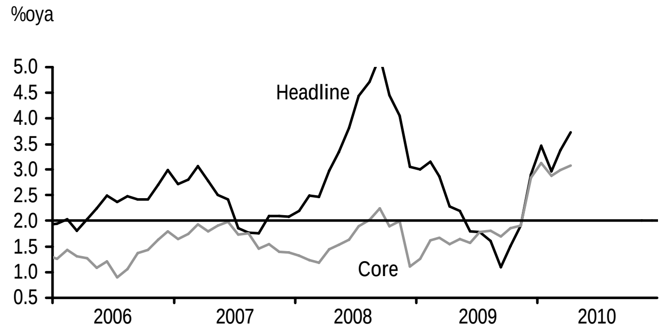
Gilt spreads and sterling continue to show little UK-specific impact from the sovereign stresses around Europe. This is noteworthy given the large fiscal deficit in the UK, and the surge in CPI inflation to 3.7% reported for April this week. Policymakers continue to emphasize that steps are being taken to address these issues. The new Chancellor, George Osborne, will detail plans for £6 billion of public spending cuts on Monday, followed up by an emergency Budget on June 22 (see the research note "UK fiscal policy: the coming tightening and its impact" in this *GDW*). Meanwhile, Bank of England Governor Mervyn King insists that a host of temporary factors are masking a powerful disinflationary trend that warrants leaving the BoE's highly accommodative policy stance unchanged. Here we take a look at what is going on in the inflation data, and what could cause the BoE to change its judgement about the outlook.

Inflation remains high and sticky

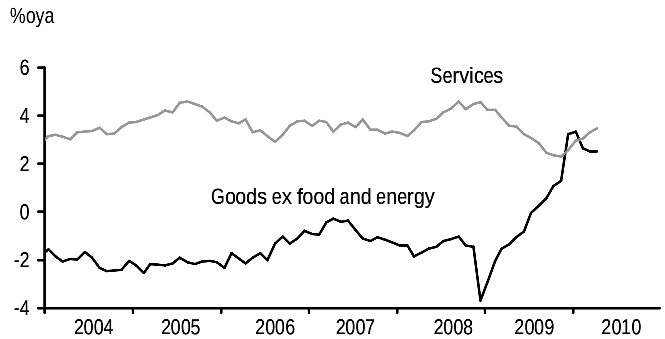
Contrary to expectations of a decline, core CPI inflation in April accelerated a tenth to 3.1%oya while the headline CPI made a new high for the year of 3.7%. The upside surprise in April was broad-based across nearly all sectors, and core inflation in particular. In sequential terms, we estimate both core goods and services made solid 0.3%m/m sa gains. This comes on top of a similar surprise in March. Our analysis has been pointing to outright price declines in core goods prices, and gains in services around half the pace reported of late. How unusual do recent outturns look compared to what our models say?

- **Recent services outturns have departed slightly from the disinflationary script, but this could easily be noise.** After hitting a peak of nearly 5% early last year, services inflation almost halved in the space of a year. This has been broadly consistent with the widening in slack, which has tended to lead inflation by about a year. Our estimate of slack suggests that inflation will continue to slow before reaching a trough around the end of the year. But in the last two releases, services inflation has accelerated slightly, even after stripping out an estimated impact from the hike in VAT. The rise in services inflation does not

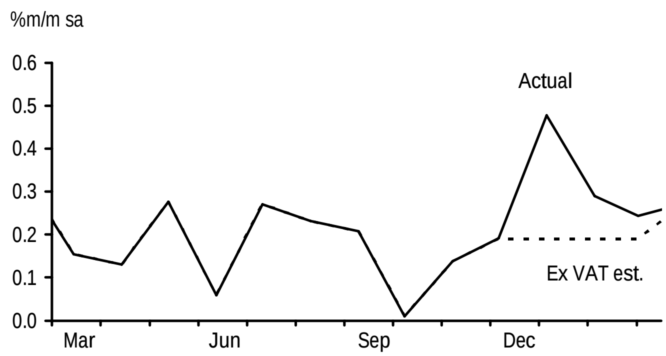
CPI inflation



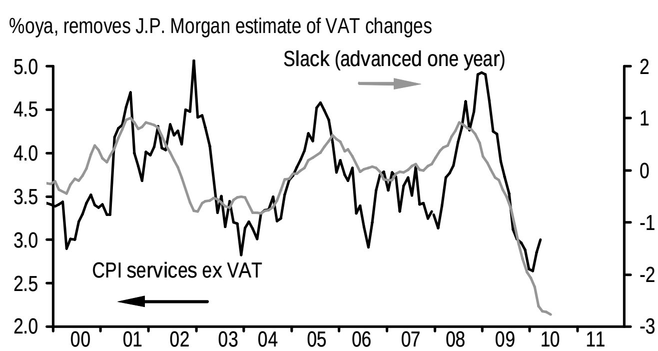
Core CPI inflation



Core services CPI (excludes transport services)



CPI service inflation versus composite slack indicator



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look particularly striking given that the mapping between the two series is relatively loose, but continued acceleration from here would be a surprise.

- **Core goods inflation is still within our model's boundaries, but an acceleration from here would be unusual.** Goods prices showed strong gains last year, a significant part of which is likely due to the weaker currency. Our model of goods pricing—which looks at unit labor costs, slack, and other cost pressures—has pointed clearly to a return to deflation this year. That appeared to be happening already around the turn of the year, after an attempt to remove VAT effects. But the last two releases have shown strong sequential gains in core goods prices. That leaves inflation within the sector running toward the upper end of a one standard deviation boundary around our model's central projection. This is not that unusual, but the steepness of the drop implied by the model later in the year suggests that core goods pricing should turn down soon.

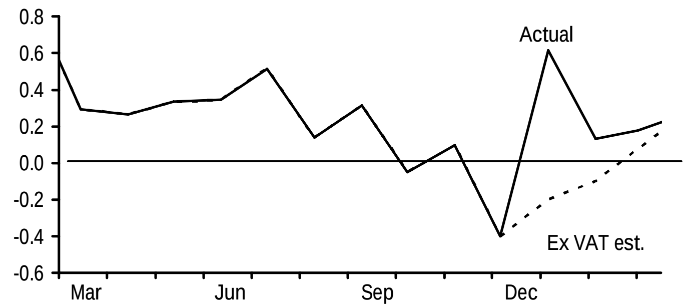
Considered individually, the upside surprises across sectors of the core inflation basket do not yet look odd relative to the usual range of error from the models. But the next couple of inflation releases take on renewed importance as a test of the view that core inflation is set to fall. At minimum, recent outturns do imply inflation is unlikely to fall back as quickly as we thought, even if the basic directionality remains down, and we have adjusted the forecast accordingly (box).

Good and bad news for the MPC

The minutes of the May MPC meeting, which did not have access to April CPI data, report some divergence of views among members on the speed and magnitude of the expected fall in inflation. Governor King's letter to the Chancellor, as prompted by the CPI release, restated the MPC's view that the recent increase in inflation was likely temporary, but communicated a little more uncertainty around the central view. In King's own words: "inflation has been somewhat higher than expected over the past year and the Committee is conscious that the pace and extent of the prospective fall in inflation are highly uncertain. It will monitor developments closely...the MPC is very conscious that there are risks to inflation in both directions. On the downside, there is a risk that inflation will turn out to be weaker, perhaps because the influence of spare capacity in the economy could be more significant than assumed. On the upside, there is a risk that inflation may be raised by further commodity price increases or other price level surprises.

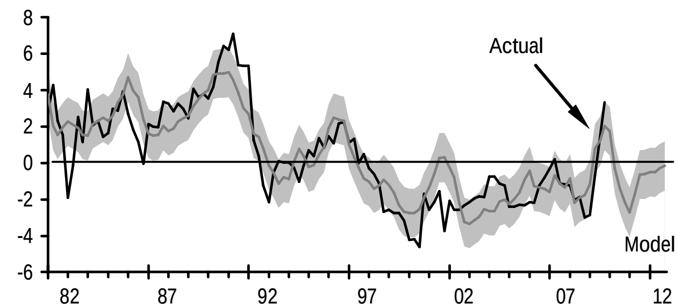
Core goods CPI

%m/m sa



Core goods model

%oya, excludes estimate of VAT effect



Changes to our inflation forecast

We have pushed back the timing of expected declines in core goods prices by three months, to August, and have penciled in higher gains in food and service sector prices for the next couple of releases. This leaves the CPI averaging 2.7% in 4Q (previously 2.1%). Half of this upward revision owes to the changes mentioned, while half is due to the assumption that the April surprise will not be unwound. The next few releases will be important in tracking this view. But these changes alone imply a trough in the CPI in 2Q/3Q next year of 1.7% (previously 1.5% in 2Q11). This forecast continues to assume another hike in VAT to 20% in January 2011.

And if the current period of above-target inflation causes inflation expectations to move up that may lead to some persistence in the current high level of inflation."

The good news for the MPC is that, taking the news on inflation and real activity together, there is increasing evidence that growth in nominal demand is recovering. As the minutes of the May MPC meeting recognize, sequential growth in nominal expenditure over 2H09 was not far from its long-run average. The same looks likely to have been

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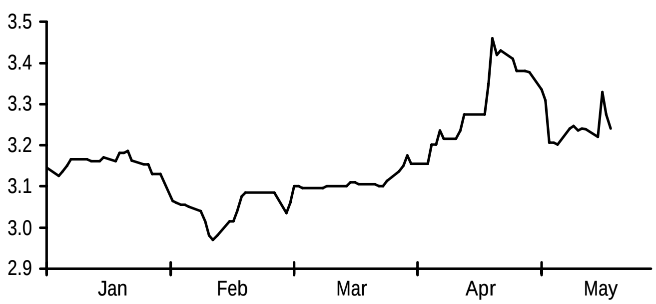
true for 1Q10, while 2Q is shaping up to reveal outright strength in nominal spending. Though the extent to which that can be attributed to policy change will be open to debate, the MPC will feel that low rates and QE are gaining some traction.

The bad news for the MPC is that upward surprises in nominal demand are tending to reflect higher inflation rather than volume growth, and inflation outturns are extending the period in which the MPC's inflation forecasts have been persistently overshot to the upside. We have written previously that the MPC's rhetoric had been too dismissive of above-target inflation outturns given the risk that they would persist. King's description of increases in VAT and commodity prices as "price level shocks" has also appeared misplaced given that it has been clear for a while that both would likely contribute to higher inflation at some point. The MPC has been comforted that measures of inflation expectations have remained stable despite persistently coming in above target since 2006. This week a measure of inflation expectations from markets (derived from 5-year swap contracts) rose from 3.22% to 3.33% following the April CPI, but fell back from this level towards the end of the week.

Given ongoing concerns that Euro area growth will be undermined by the sovereign debt crisis and the looming acceleration of fiscal tightening in the UK, we would not expect higher-than-expected inflation outturns to generate a near-term rethink of policy from the MPC. But its rhetoric around inflation will be forced to reflect more concern. We continue to believe, however, that the MPC's relatively tolerant view on inflation dynamics is very sensitive to its perceptions of downside risks to a solid central forecast for GDP growth. While low and falling rates of core inflation will encourage the Fed and ECB to be patient before beginning to tighten, that decline is likely to be slower and more muted in the UK, and will eventually encourage an earlier policy reversal.

Market UK inflation expectations

%, derived from the 5yr spot contract of inflation swaps



Data releases and forecasts

Week of May 24 - 28

During the week 8:00am

Nationwide house price index
Sa

	Feb	Mar	Apr	May
%m/m	-1.0	1.0	1.0	0.5
%oya	9.3	9.1	10.6	9.8
%3m/3m saar	6.9	6.3	4.4	6.8

Tue May 25 9:30am

Real GDP (2nd estimate)
Sa

	3Q09	4Q09	1Q10[1]	1Q10
Total GDP (%q/q)	-0.3	0.4	0.2	0.3
%oya	-5.3	-3.1	-0.3	-0.2
%q/q ar	-1.1	1.8	0.8	1.2
Breakdown (%q/q sa)				
Private consumption	0.1	0.4	__	0.2
Public consumption	0.4	1.2	__	0.6
Fixed investment	1.6	-3.1	__	0.5
Exports	0.1	3.7	__	-1.4
Imports	1.3	4.1	__	-0.2

1. Preliminary outcome

The surge in IP in March means production growth for the quarter is stronger than the ONS estimated in its preliminary release of 1Q GDP. This change alone points to a revision in GDP from 0.2% to 0.3%. The surge in 1Q business investment reported this week was concentrated in services (ex. distribution) and contruction. This may point to some upward revision in the output of these sectors as well, which could result in GDP printing at 0.4%q/q.

Consumption appears to have slowed in 1Q, mostly as a result of the snowstorms at the start of the year. The monthly trade report suggests that export volumes fell in 1Q while imports were broadly stable. The suggests that net trade will have been another drag on growth in 1Q, for the third consecutive quarter. Our forecast implies that this drag will be offset by another significant boost from inventories and support from a gradual recovery in domestic final demand.

Tue May 25 9:30am

Index of services
Sa

	Dec	Jan	Feb	Mar
%m/m	0.6	-0.8	0.6	0.2
%oya	-1.1	-1.2	0.1	0.5
%3m/3m saar	1.9	2.3	1.8	0.7

The preliminary release of 1Q GDP implies a two-tenths gain in March. This would leave services output running three-tenths higher than the quarterly average. Modest sequential growth in the current quarter would then set up 2Q for a gain of twice the strength seen in 1Q.

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Tue
May 25
9:30am

BBA lending

	Jan	Feb	Mar	Apr
Secured lending (ch £bn, sa)	2.5	2.7	2.4	2.5
Loan approvals (000s sa)[1]	35.4	33.4	34.9	34.0

1. For house purchase.

We had thought the stamp duty cut for first time buyers announced in the March Budget would boost approvals in April. But the BoE's lending panel data showed a drop in April and suggest otherwise.

Thu
May 27
11:00am

CBI survey of distributive trades
% balance

	Feb	Mar	Apr	May
Volume of retailer sales	23	13	13	13

Fri
May 28
12:01am

Gfk consumer confidence
Sa

	Feb	Mar	Apr	May
% balance	-14	-15	-16	-16

Review of past week's data

Rightmove house price index

	Mar	Apr	May
%m/m nsa	0.1	2.6	__ *0.7*

CBI industrial trends

% balance

	Mar	Apr	May
Total order book	-37	-36	~~-35~~ *-18*
Output expectations	5	14	~~16~~ *17*
Output prices	17	16	__ *14*

The CBI industry survey showed a notable improvement in May, particularly in the order readings. Notwithstanding these encouraging signs, we would treat the orders readings with some caution—as they have generally not provided a good window on higher frequency changes in manufacturing activity. We prefer the CBI's output expectations reading, which points towards manufacturing growth at 2% ar pace. However, the PMI has done a better job of tracking the official recently, and suggests that output is still expanding at a 5%q/q, saar pace.

Retail prices

%oya

	Feb	Mar	Apr
CPI	3.0	3.4	~~3.5~~ *3.7*
Core CPI[1]	2.9	3.0	~~2.8~~ *3.1*
RPI (1987=100)	219.2	220.7	~~221.7~~ *222.8*
RPI	3.7	4.4	~~4.8~~ *5.3*
RPIX	4.2	4.8	~~4.8~~ *5.4*

1. CPI ex food, energy, alcohol, and tobacco.

BoE's minutes of May MPC meeting

MPC voted 9-0 vote for unchanged policy. See main text.

Retail sales

Volumes, seasonally adjusted

	Feb	Mar	Apr
Including auto fuel (%m/m)	~~2.6~~ *2.4*	~~0.4~~ *0.5*	~~-0.2~~ *0.2*
Ex auto fuel (%m/m)	~~2.0~~ *1.8*	~~0.2~~ *0.4*	~~-0.5~~ *0.2*
Ex auto fuel (%oya)	~~5.1~~ *4.1*	~~4.0~~ *3.4*	~~2.6~~ *3.1*
Ex auto fuel (%3m/3m saar)	~~-0.2~~ *-1.6*	~~-2.4~~ *-4.0*	~~1.9~~ *1.8*

Ex fuel sales finished 1Q 0.8% higher than the quarterly average. This momentum, together with the resilience in April, points to a strong gain in 2Q retail sales of around 5% ar, following last quarter's decline.

This is no guarantee that overall consumption for the current quarter will show the same trend. But the April retail sales release adds to the sense that growth in general is set to accelerate in 2Q, after a setback at the start of the year that in part reflected the January snowstorms. Greater uncertainty remains about whether this momentum will be sustained later in the year.

Business investment prelim

2000=100, sa

	3Q09	4Q09	1Q10
%q/q	-0.8	-4.3	~~0.0~~ *6.0*
%oya	-21.4	-23.5	~~-16.7~~ *-11.0*

These numbers are preliminary and should be treated with some caution. But future revisions are unlikely to alter the impression that a decisive turn in business spending behavior took place at the start of the year. The bad news is that the level of business spending is still 22% below its pre-crisis peak.

Provisional estimates of M4 money and credit

Sa

	Feb	Mar	Apr
M4 (%m/m)	0.2	~~0.2~~ *0.1*	__ *0.0*
M4 (%oya)	~~3.9~~ *3.8*	~~3.6~~ *3.5*	__ *3.3*
M4 lending (%m/m)[1]	~~-0.1~~ *-0.2*	~~0.5~~ *0.3*	__ *-0.4*
M4 lending (%oya)[1]	3.7	~~3.3~~ *3.2*	__ *2.8*

1. Excludes the effect of securitization.

Public sector finances

£ bn, nsa

	Feb	Mar	Apr
PSNCR	~~8.0~~ *8.2*	~~25.8~~ *25.6*	__ *8.8*
PSNB	~~9.7~~ *8.7*	~~23.5~~ *18.0*	~~11.5~~ *10.0*
Balance on current budget	~~-4.0~~ *-3.0*	~~-14.8~~ *-8.3*	~~-10.5~~ *-9.3*
Net debt to GDP (%)	60.5	62.0	__ *62.1*

April is the first month of the fiscal year, making it hard to say much about how the year as a whole will turn out. But the monthly figures continue to point to a better outturn for FY10/11. For a start, downward revisions to borrowing have taken the FY09/10 outturn down from a previously estimated £163 billion, to £156 billion or 11.1% of GDP (excluding financial sector interventions). This is some way from the £178 billion projection made a year ago. We had been looking for a £10 billion drop in the deficit this year (£6 billion owing to the new government's plans and £4 billion improvement with the business cycle). This same assumption would imply a FY10/11 outturn of around £144 billion (9.8% of GDP).

Sweden and Norway

- **Swedish GDP likely bounced in 1Q... finally**
- **Riksbank July hike more likely than not if 1Q GDP proves strong and financial conditions don't worsen**
- **We are trimming our 2011 growth forecasts slightly**

Around the middle of last year, we forecast that the Swedish and Norwegian economies would bounce, with GDP growth to be particularly strong in Sweden and with Norwegian growth moving largely in line with developments in Western Europe. We thought that Sweden would outperform given its large export sector, which was set to benefit from a rebound in global trade. Norway, on the other hand, would not benefit as much from trade given the relatively small size of non-oil and gas exports as a share of mainland (non-oil and gas) GDP and given the quick appreciation of the krone after the financial crisis. We also thought that Norwegian mainland demand would suffer from weaker oil activity following the fall in oil prices from the high seen in mid-2008.

In recent quarters, growth has been weaker than we expected in each country, but the scale of the surprise relative to our forecast has been different. Norwegian growth has been modest (0.9% ar on average over the past year), but has largely tracked developments in Western Europe. Swedish growth, on the other hand, not only failed to outperform, but was weaker than elsewhere in Western Europe.

We think that developments in 1Q will lead to some realignment between the data and our view. This week's national accounts release showed Norwegian mainland GDP rising a modest 0.6% ar in 1Q. This pace of growth was weaker than our forecast, but not far from the performance of the Euro area in the same quarter. The Swedish 1Q GDP release next week, on the other hand, will likely show a sharp bounce in activity. We forecast GDP to have increased 4% ar, although monthly IP and service output indicators suggest that the rise could be even larger. On the expenditure side, retail sales were broadly flat in the quarter, but a sharp gain in car sales suggests that consumer spending moved up briskly. Meanwhile, exports look likely to have risen sharply, and the industrial stocks survey points to a boost from inventories.

Our Riksbank call could change next week

We have warned for some time that our call that the Riksbank will stay on hold until early 2011 is being challenged. This call has been grounded on the idea that core inflation would slide more quickly than the Bank thought this year, a view that we still hold. As time has passed, however, the Riksbank has become increasingly anxious about keeping the policy rate at 0.25% in an environment in which house prices were rising quickly. It therefore became clear that the Bank would tolerate some downside surprises in inflation in order to prevent imbalances from forming in asset markets. We haven't changed our call in recent weeks given the deterioration in global financial market conditions and increasing uncertainty about global growth. But the Riksbank's rhetoric does not seem to have shifted much in response to recent developments. As the July meeting draws closer, a hike looks increasingly likely. As a result, if GDP next week prints in line with our forecast or better, and if financial market conditions do not deteriorate further, we will probably change our Riksbank call and forecast some policy tightening this year.

J.P. Morgan GDP forecast at different points in time
%q/q, saar

	3Q09	4Q09	1Q10	2Q10	3Q10	4Q10	1Q-4Q11[1]
Euro area							
July 31, 2009	2.5	2.5	3.0	2.0	2.0	2.0	
Dec 11, 2009	1.5	2.5	3.0	3.0	3.0	2.5	
May 21, 2010	1.6	0.2	0.8	3.0	2.0	1.8	1.8
Sweden							
July 31, 2009	3.0	4.0	4.0	2.5	2.5	2.5	
Dec 11, 2009	0.7	2.5	4.0	4.0	3.5	3.0	
May 21, 2010	-1.0	-1.6	4.0	4.0	3.5	3.0	2.8
Norway							
July 31, 2009	2.5	3.0	3.0	2.5	2.5	2.5	
Dec 11, 2009	2.0	3.0	3.0	3.0	3.0	2.8	
May 21, 2010	1.3	1.6	0.6	2.5	3.0	3.0	2.5

1. Average quarterly changes in GDP, measured in %q/q, saar terms.

Trimming growth forecasts for next year

Unless global financial conditions worsen further, the global economy and, in turn, Sweden and Norway are likely to enjoy a solid cyclical upswing through the remainder of this year (with quarterly growth averaging 3.5%-4% ar in Sweden and 2.5%-3% ar in Norway). The outlook for next year, however, seems less benign. In particular, fiscal tightening is likely to be sizable in Western Europe, Scandinavia's main trading partner. Last week, we trimmed our Euro area growth forecast, and we feel we need to reflect this change in our forecast for Scandinavia. We are therefore trimming our average quarterly growth forecast for 2011 slightly, from 3% ar to 2.75% ar in Sweden and from 2.75% ar to 2.5% ar in Norway.

The next Sweden and Norway data watch will be published on June 4, 2010.

Sweden:

Data releases and forecasts

Weeks of May 24 - June 4

Tue May 25 9:30am — Unemployment: Labor Force Survey (Statistics Sweden)

	Jan	Feb	Mar	Apr
% of labor force, nsa	9.4	9.3	9.1	__

Wed May 26 9:30am — Trade balance
Skr bn nsa

	Jan	Feb	Mar	Apr
Exports	79.1	82.6	99.4	__
Imports	70.9	80.6	92.2	__
Trade balance	8.2	2.0	7.2	__

Thu May 27 9:30am — Producer prices
%oya

	Jan	Feb	Mar	Apr
PPI	0.3	0.8	-1.7	__
For domestic supply	2.1	2.3	-0.2	__

Fri May 28 9:30am — Real GDP

	2Q09	3Q09	4Q09	1Q10
GDP (%q/q sa)	0.0	-0.2	-0.4	1.0
GDP (%q/q saar)	0.2	-1.0	-1.6	4.0
GDP (%oya wda)	-6.1	-5.7	-1.7	0.6

Fri May 28 9:30am — Retail sales
Volumes

	Jan	Feb	Mar	Apr
%m/m (sa)	0.4	-1.1	0.7	__
%oya (wda)	3.3	2.0	4.1	__

Mon May 31 9:15am — NIER business and consumer surveys

	Feb	Mar	Apr	May
Mfg tendency Index, sa	3	2	-4	__
Consumer Index, nsa	13.0	15.5	19.5	__

Tue Jun 1 8:30am — Purchasing managers survey, manufacturing
% balance, sa

	Feb	Mar	Apr	May
Overall index	61.5	61.1	64.0	__

Review of past two weeks' data

Consumer prices

	Feb	Mar	Apr
CPI (%oya)	1.2	1.2	~~1.2~~ *1.0*
CPIF (%oya)	2.7	2.5	~~2.4~~ *2.2*

Unemployment: monthly labor market board

	Feb	Mar	Apr
% of labor force, nsa	5.6	5.2	__ *4.9*

Norway:

Data releases and forecasts

Weeks of May 24 - June 4

Fri May 28 10:00am — Labor Directorate
Nsa

	Feb	Mar	Apr	May
Unemployment rate (%)	3.2	3.1	3.0	__

Fri May 28 10:00am — Labor Force Survey
3mma,sa

	Dec	Jan	Feb	May
Unemployment rate (%)	3.4	3.4	3.5	__

Mon May 31 10:00am — Retail sales
Volumes

	Jan	Feb	Mar	Apr
%m/m sa	-0.5	0.3	-0.1	__
%oya sa	2.4	3.3	3.2	__

Mon May 31 10:00am — Credit indicator
%oya

	Jan	Feb	Mar	Apr
	4.2	4.2	3.9	__

Tue Jun 1 9:00am — Purchasing managers survey, manufacturing
% balance, sa

	Feb	Mar	Apr	May
Overall index	49.3	49.7	51.9	__

Tue Jun 1 11:00am — NEF/EEF house prices
All dwellings, NOK

	Feb	Mar	Apr	May
%m/m	0.2	1.0	1.3	__
%oya	10.2	10.7	9.8	__

Review of past two weeks' data

Consumer prices

	Feb	Mar	Apr
CPI (%oya)	3.0	3.4	3.3
CPI-ATE (%oya)	1.9	1.7	1.7

Trade balance
Nkr bn, excluding erratics, nsa

	Feb	Mar	Apr
Exports	~~64.2~~ *64.1*	70.5	__ *63.6*
Imports	~~31.8~~ *32.6*	~~41.5~~ *41.8*	__ *36.5*
Trade balance	~~32.4~~ *31.5*	~~29.0~~ *28.7*	__ *27.1*
Balance ex oil and gas	~~-6.3~~ *-7.2*	~~-11.1~~ *-11.5*	__ *-11.6*

Real GDP
Non-oil

	3Q09	4Q09	1Q10
Mainland GDP (%q/q sa)	0.3	~~0.3~~ *0.4*	~~0.4~~ *0.1*
Mainland GDP (%q/q saar)	~~1.4~~ *1.3*	~~1.3~~ *1.6*	~~1.6~~ *0.6*

Central Europe: Czech Republic, Hungary, Poland, Romania

- **Revising down our CE-4 rate calls**
- **Czech general election on May 28-29 is unlikely to bring a strong reform-oriented government**
- **Czech public finances will muddle through EMU debt crisis unless serious policy mistakes are made**

As a result of J.P. Morgan's recent revision to its ECB rate call (on hold through 2011 versus the previous forecast of 150bp in rate hikes), we have pushed back the start of rate-hiking cycles in Central Europe and also see less rate hiking than previously. Our end-2011 rate forecasts have been revised down 50bp in Poland and Hungary, 75bp in Romania, and 100bp in the Czech Republic. The first rate hikes are expected to come one quarter later than previously anticipated. Additionally, we have extended the 3Q10 trough of the rate-cutting cycle in Hungary to 4.50%, although we see the MPC pausing this month on the back of worsening risk appetite and smaller downside risks to inflation than previously anticipated.

While no Central European central bank fully synchronizes its rate-setting policy with the ECB's, such a change in the Euro area rate outlook will have an impact on CE-4 rates. First, the interest rate differential versus the euro is an important factor affecting exchange rates owing to the attractiveness of carry trades or FX hedging costs for local exporters. Second, the ECB policy stance reflects (or at least should reflect) the economic and inflation developments of the Euro area, the region's key trading partner.

We remain upbeat on Central Europe's growth prospects, yet central banks will not want interest rate differentials to widen too much. Although the downward revision in overall Euro area growth has been moderate, the redistribution of growth from the southern periphery to Germany is striking. German exports are expected to benefit from strong economic growth outside Europe and a weaker euro. As Central Europe's main trade links are with Germany, we have not cut our growth forecasts for Central Europe and still expect GDP growth to average 4% next year. Nonetheless, we believe CE-4 central banks will delay their hiking cycles to avoid fueling FX appreciation with too-wide interest rate differentials versus the ECB. As Central Europe moves to above-potential growth and inflationary pressures gradually emerge in 2011-12, central banks will be compelled to tighten monetary conditions. Yet, we expect a large part of this tightening to come from FX appreciation.

Central Europe: policy rate revisions
% p.a.

	Current	Jun 10	Dec 10	Jun 11	Dec 11
Czech, new	0.75	0.75	0.75	1.00	2.00
Czech, old		0.75	0.75	1.75	3.00
Hungary, new	5.25	5.00	4.50	4.50	5.00
Hungary, old		5.25	5.00	5.00	5.50
Poland, new	3.50	3.50	3.50	4.00	4.50
Poland, old		3.50	3.75	4.50	5.00
Romania, new	6.25	6.00	5.50	5.75	6.25
Romania, old		6.00	5.50	6.50	7.00
Euro area, new[1.]	1.00	1.00	1.00	1.00	1.00
Euro area, old		1.00	1.00	1.75	2.50

1. Forecast changed on May 14. This week's changes are in bold.

Czech elections: left-wing party expected to emerge victorious

On May 28-29, the Czechs will vote in general elections, and recent opinion polls indicate a victory of the left-wing Social Democrats with about 30% of votes versus 20% for their rival, right-wing Civic Democrats. We can expect lengthy and noisy negotiations following the elections, given that the gains by left-wing parties are likely to be very close to the gains by center and right-wing parties, similar to the three previous elections. On the scale of potential election outcomes, we consider a coalition of right-wing parties to be the most market-friendly (we assign 25% probability); a coalition of Social Democrats with a smaller right-wing party (35%) or even a grand coalition with Civic Democrats (5%) both to be neutral; and a Social Democrat majority government (10%), or minority government with the support of Communists, to be the least market-friendly (25%).

We doubt that any government will push through important public finance reforms, such as long overdue pension reform, or cut the structural budget gap significantly. However, unless a new government makes a series of serious policy mistakes, and if the European recovery continues, we believe the country's public finances will muddle through the current debt crisis in Europe. Remember that public debt was 35.4% of GDP last year, low in comparison with most European countries, and is financed mostly domestically. The highest risk of significantly irresponsible fiscal policy comes from a left-wing government with participation (even indirect) of the Communists. But, this is mitigated by growing public awareness of the fiscal risks, arising from frequent media coverage of fiscal problems across Europe.

The Central Europe data watch is published biweekly, next on June 4.

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Czech Republic:

Data releases and forecasts

Weeks of May 24 - June 4

No major data releases.

Review of past two weeks' data

Consumer prices

%oya

	Feb	Mar	Apr
%oya	0.6	0.7	*1.1*
%m/m nsa	0.0	0.3	*0.3*
Food	-2.5	-1.5	~~-0.5~~ *-0.6*
Housing	1.1	1.0	~~1.4~~ *1.5*
Transport	4.1	4.3	~~4.0~~ *4.1*

Inflation accelerated to 1.1%oya in April, but core inflation remained close to zero in annual terms. While demand-side inflationary pressures are generally nonexistent now, the price level is slowly creeping higher after bottoming in October 2009. The recovering Czech economy will bring demand-driven inflation. Indeed, recent data indicate that the recovery in export-oriented industries is slowly spilling over into domestic demand. Moreover, without a positive base effect, we foresee headline CPI fluctuating around 1%oya in the coming few months and rising to 3%oya by the end of the year.

Real GDP, preliminary

%

	3Q09	4Q09	1Q10
GDP (%oya)	-5.0	-2.8	~~1.7~~ *1.2*
%q/q saar	2.3	3.0	~~2.5~~ *0.7*

The economy returned to growth on an annual basis in the first quarter, rising 1.2%oya. GDP growth slowed to 0.2%q/q in 1Q10 from 0.7%q/q, which is a little disappointing. However, we do not want to draw strong conclusions from the preliminary data, given that they are often revised. Initial GDP releases tend to underestimate GDP growth in the recovery phase and overestimate it in the slowdown/recession phase of the cycle. High-frequency data indicate a continuing recovery in export-oriented industries, which is slowly spilling over into domestic demand. Moreover, Germany, the country's key trading partner, continues to recover well. We expect the Czech economy to expand about 2% this year. Importantly, the possible adverse impact of the fiscal crisis in peripheral EMU halting the recovery in core EMU countries is the key risk to our optimistic outlook and the reason why we have not upgraded our forecast. In forecasting Czech GDP this year, we will be more sensitive to developments abroad than to incoming domestic data.

Balance of payments

CZK bn

	Jan	Feb	Mar
Current account	15.6	10.3	~~-1.0~~ *-12.6*
Ytd	15.6	25.9	~~24.9~~ *13.3*
Ytd a year ago	1.0	21.4	25.0
Trade balance	15.6	17.8	~~17.0~~ *21.3*
Services	1.0	1.2	~~1.0~~ *-4.1*
Income	-6.9	-6.1	~~-18.0~~ *-26.9*
Current transfers	5.9	-2.6	~~-1.0~~ *-2.9*
Financial account	-0.9	2.1	__ *-14.9*
FDI	7.4	8.2	__ *-1.0*
Portfolio investment	3.3	2.2	__ *2.6*
Other investments	-7.1	-13.8	__ *-22.5*

The monthly current account (C/A) slipped into deficit due to a large dividend outflow. We forecast the C/A deficit to widen to 1.8% of GDP this year from 1.1% of GDP on the back of reviving imports and dividend outflow.

Hungary:

Data releases and forecasts

Weeks of May 24 - June 4

Tue
May 25
9:00am

Retail trade

%

	Dec	Jan	Feb	Mar
%oya wda	-7.4	-5.6	-4.3	-4.2
%m/m swda	-0.6	0.6	0.0	0.2

Mon
May 31

Monetary policy announcement

We expect the NBH to pause this month owing to recent market volatility, but see scope for rate cutting to resume once the risk appetite improves.

Mon
May 31
9:00am

Producer prices

%oya

	Jan	Feb	Mar	Apr
Producer prices	-0.6	-2.8	-3.5	-1.2
Domestic	1.6	0.0	1.2	__
Export	-1.4	-5.4	-7.9	__

Fri
Jun 4
9:00am

Industrial output

%oya

	Jan	Feb	Mar	Apr
Production, wda	5.7	8.1	2.8	8.5
Production, nsa	3.4	8.1	2.8	8.5
%m/m swda	8.9	-1.5	-0.4	-0.1

Industrial production likely moved sideways in m/m terms in April, but the oya rate will be boosted by a very low base (IP fell 5.1%m/m last April).

Review of past two weeks' data

External trade

EUR mn

	Jan	Feb	Mar
Trade balance	290	373	~~500~~ *653*
Ytd	290	664	~~1364~~ *1317*

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Ytd a year ago	-200	96	582
Exports, %oya	14.6	18.0	__ 17.8
Imports, %oya	2.7	17.4	__ 16.0

Consumer prices
%oya

	Feb	Mar	Apr
All items (KSH)	5.7	5.9	5.7
%m/m nsa	0.2	0.6	~~0.6~~ 0.8
Food	2.1	2.3	__ 2.4
Consumer durables	3.4	3.7	__ 2.1
Gasoline	22.3	25.5	__ 25.2
Services	6.0	5.9	__ 5.7
Core inflation	4.8	4.6	__ 4.2
%m/m sa	-0.1	0.1	__ 0.1
Regulated g&s (NBH)	6.5	6.7	__ 6.4
Market g&s (NBH)	3.6	3.6	__ 3.3

Disinflation in consumer durables and services prices was the main driver of the drop in CPI inflation in April. Core inflation decelerated and the 3m/3m annualized core CPI rate remained below the central bank's 3% target. We continue to look for a steady decline in headline CPI inflation through the summer, with a trough of around 3.0% in July-August, followed by a move back up to around 3.8%oya by year-end. The recent weakening of HUF is likely to have some impact, mainly on the fuel component. We do not share the NBH's view that inflation will significantly undershoot the 3% target next year. Our 2011 CPI forecast stands at 3.2%oya, or nearly 1%-pt above the NBH's forecast. While this is still close to target, we do not believe the inflation outlook alone calls for further significant monetary easing.

Real GDP, preliminary
%oya, unless otherwise stated

	3Q09	4Q09	1Q10
Real GDP	-7.1	-4.0	~~-1.0~~ 0.1
%q/q saar	-4.7	-1.7	~~1.5~~ 3.6

Preliminary 1Q data and revisions to 2009 showed that the Hungarian economy exited recession already in 4Q09—a quarter earlier than prior to the revisions. A return to growth late last year is more consistent with the pattern seen in the rest of the region. A detailed breakdown is not yet available, but the high-frequency data suggest that export-oriented industries led the expansion. Consumption probably continued to contract, but inventories should have provided a substantial boost. Strong industrial production and manufacturing orders data from Germany bode well for ongoing recovery in Hungary in coming quarters. We have raised our 2010 GDP growth forecast to 0.8%oya from 0.5% previously.

Average gross wages
%oya

	Jan	Feb	Mar
Gross wages, nominal	6.5	~~0.9~~ 0.8	~~1.5~~ 9.4
Private sector	5.2	4.0	__ 6.9
Public sector	8.9	-6.2	__ 16.2

Wage growth jumped largely on the back of bonus payments in the public sector. Private sector wage growth excluding bonuses, the measure watched most closely by the central bank, was broadly unchanged at 5.3%oya although the downtrend in place through late last year has come to a halt.

Poland:
Data releases and forecasts
Weeks of May 24 - June 4

Tue May 25 — Monetary policy announcement

The NBP will probably keep rates on hold and maintain a neutral policy stance.

Wed May 26 10:00am — Retail sales

%oya, unless otherwise stated

	Jan	Feb	Mar	Apr
Retail sales (nominal)	2.5	0.1	8.7	4.5
Real, CPI-adjusted	-1.0	-2.7	6.0	2.1
%m/m sa	-0.8	0.0	4.9	-4.0

Mon May 31 10:00am — Real GDP, preliminary

%oya, 2000 prices

	2Q09	3Q09	4Q09	1Q10
Real GDP	1.1	1.8	3.3	3.2
%q/q saar	2.8	2.8	5.3	3.0
Domestic demand	-2.1	-1.5	1.3	__
Private consumption	1.7	2.2	1.8	1.5
Fixed investment	-3.2	-1.6	1.5	3.5
%-pt contribution to oya real GDP growth				
Domestic final sales	0.5	0.9	1.6	1.9
Inventories	-2.6	-2.5	-0.2	2.1
Net trade	3.2	3.3	1.9	-0.8

GDP growth probably held close to the 4Q pace in over-year-ago terms as a large deterioration in the net trade contribution was offset by a jump in inventories. Domestic final sales probably strengthened only moderately as private consumption growth slowed a bit, but fixed investment growth should have accelerated.

Review of past two weeks' data

Consumer prices
%oya

	Feb	Mar	Apr
All items			
%oya	2.9	2.6	~~2.3~~ 2.4
%m/m	0.2	0.3	0.4
Food, %oya	2.8	1.4	__ 0.7
Fuel, %oya	14.5	15.6	__ 17.0

April CPI inflation eased a bit less than forecast. A high base in food prices and lower core inflation contributed roughly evenly to the decline in the oya CPI rate. The slight upside surprise compared to our forecast came from core. The outlook remains for a decline in the headline CPI to below 2%oya over the summer, followed by a move back up to around 2.8%oya by year-end. In 2011, we see inflation hovering in the upper half of the NBP's 1.5%-3.5%oya target range.

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Balance of payments

EUR mn

	Jan	Feb	Mar
Current account balance	-754	~~106~~ *155*	~~-885~~ *-559*
Ytd (bn)	-0.8	-0.6	~~-1.5~~ *-1.2*
Ytd a year ago (bn)	-0.8	0.0	-0.1
Trade balance	-205	~~-248~~ *-233*	__ *-514*
Exports, %oya	11.9	20.1	__ *24.1*
Imports, %oya	7.6	~~22.3~~ *22.1*	__ *27.0*
Service balance	259	~~109~~ *113*	__ *350*
Income balance	-841	~~-923~~ *-895*	__ *-1010*
Current transfers	33	~~1168~~ *1170*	__ *615*
Fin. + cap. account balance	7000	~~1847~~ *1961*	__ *2227*
FDI, net	1153	~~814~~ *840*	__ *1173*

Gross wages and employment

%oya

	Feb	Mar	Apr
Gross wages, nominal	2.9	4.8	~~5.0~~ *3.2*
Real (CPI-adj.)	0.0	2.2	~~2.7~~ *0.7*
Employment, 000s, nsa	5293	5294	~~5300~~ *5308*
Employment, %oya	-1.1	-0.6	~~-0.2~~ *0.0*

Producer prices

%oya

	Feb	Mar	Apr
Producer prices	-2.4	~~-2.4~~ *-2.6*	~~-1.0~~ *-0.5*
%m/m nsa	-0.1	~~0.0~~ *-0.2*	__ *1.2*

Industrial output

%oya

	Feb	Mar	Apr
Industry	9.2	~~12.3~~ *12.5*	~~11.2~~ *9.9*
%oya swda by GUS	10.1	~~9.6~~ *9.8*	~~11.2~~ *8.8*
%m/m swda by GUS	1.5	~~2.3~~ *2.5*	~~0.3~~ *-2.1*
Manufacturing	10.7	~~13.6~~ *13.9*	__ *11.3*
Construction	-24.7	~~-10.8~~ *-10.9*	__ *-6.1*

The recovery in IP took a breather in April, with output falling 2.1%m/m sa after an upwardly revised expansion of 2.5%m/m in March. The construction sector continued to recover from weather-depressed lows. After gaining momentum in the first quarter, the pace of IP slowed in April, but nonetheless remains solid. The 3m/3m annualized rate of growth declined to 10.9% in April from 14.3% in 1Q10, but this is still a very decent pace and is in line with the 4Q09 expansion. The loss of momentum, also conveyed by the April manufacturing PMI, could partly reflect the appreciation of the zloty in recent months. Yet, with zloty gains now being reversed and German manufacturing orders data sending encouraging signals, we expect the momentum in Polish IP growth to remain close to current levels in coming months.

Core inflation

%oya

	Feb	Mar	Apr
CPI—ex food and energy	2.2	2.0	*1.9*
CPI—ex administered prices	2.7	2.3	__ *2.1*
CPI—15% trimmed mean	2.8	2.6	__ *2.3*
Avg. of four NBP measures	2.7	2.4	__ *2.2*

Romania:

Data releases and forecasts

Weeks of May 24 - June 4

No major data releases.

Review of past two weeks' data

Consumer prices

%

	Feb	Mar	Apr
%oya	4.4	4.2	~~4.1~~ *4.3*
%m/m nsa	0.2	0.2	~~0.2~~ *0.4*

Romanian CPI inflation increased a tenth to 4.3%oya in April. We think that the current disinflation is close to the bottom, if not already there in March. Given that demand-side inflationary pressures have so far been limited due to depressed domestic demand, we expect CPI inflation to remain in the 4%-5%oya range for the rest of the year, driven by cost inflation and tax changes. The harvest and resulting impact on food prices is currently the key risk on the upside.

Real GDP, preliminary

%

	3Q09	4Q09	1Q10
%oya	-7.1	-6.6	~~-1.5~~ *-2.6*
%q/q saar	~~0.2~~ *0.4*	~~-6.0~~ *-5.9*	~~0.0~~ *1.2*

The contraction of GDP eased to 2.6%oya in the first quarter, as GDP rose 0.3%q/q. While the export-oriented industrial sector has continued to revive, domestic demand has remained depressed as the labor market is still deteriorating and credit growth has not revived yet. We continue to expect that Romania will emerge from recession this year, driven by the recovery in Western Europe (our base case). However, the disappointing 1Q figure and upcoming fiscal tightening—either via large-scale spending cuts as announced recently by President Basescu or a combination of spending cuts and tax hikes as we expect—has led us to downgrade our growth forecast to 1% this year from 1.5%.

Current account balance

EUR bn

	Jan	Feb	Mar
Current account	-0.1	-0.7	~~-0.4~~ *-0.7*
Ytd	-0.1	-0.8	~~-1.0~~ *-1.5*
Ytd a year ago	-0.5	-0.5	~~-0.7~~ *-0.9*

Incoming balance of payments data indicate that the significant shrinking of the current account gap is over and a slow rewidening has already started. As the recovery is likely to be tepid this year, we look for only minor widening of the deficit to 5.5% of GDP from 4.8% last year.

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South Africa

- **We expect GDP to have expanded 4.5%q/q in 1Q10 with risks to the upside**
- **Activity reports point to a strong rebound in tertiary sector activity, led by the trade sector**
- **CPI is likely to have remained sticky at 5.0%oya in April on the back of higher transport costs**

The focus of next week's data calendar is the 1Q10 economic activity report which could surprise consensus on the upside. In our view, the building blocks point to a first-quarter economic expansion of 4.5%q/q saar to take over-year-ago growth to 1.4%oya following a 1.6%oya contraction in the previous quarter. Based on our estimates, the main underpinning to growth shifted from manufacturing and government services to wholesale and retail trade in 1Q10, while we had anticipated that such a shift would take place only in the next quarter. We see moderate upside risks to our 4.5%q/q forecast.

The primary sector probably remained weak in 1Q10. While mining production should have expanded 17%q/q saar in 1Q10, food production likely contracted further, subtracting 0.1%-pt from growth. Meanwhile, support from the secondary sector waned sharply at the beginning of the year. Data for the first two months of the quarter tracked a lackluster 2.6%q/q saar recovery in manufacturing, but production picked up in March to 6.2%q/q, which suggests a 0.9%-pt contribution to growth in 1Q10. The main underpinning to growth likely shifted back to the tertiary sector in 1Q10: the recovery in the trade sector is gaining momentum at a surprisingly quick pace. Retail sales expanded 1.0%oya in March and are now up 14.9%q/q saar in the first quarter. We expect wholesale and retail trade to add 1.2%-pts to growth in the first quarter, after having subtracted 0.1%-pt in 4Q10. The recovery in the finance, real estate, and business sector—representing 21.4% of GDP—is also expected to have registered further gains. A positive surprise in the finance and real estate sector could push GDP above 4.5%q/q saar.

Inflation likely remained sticky in April on higher administered prices

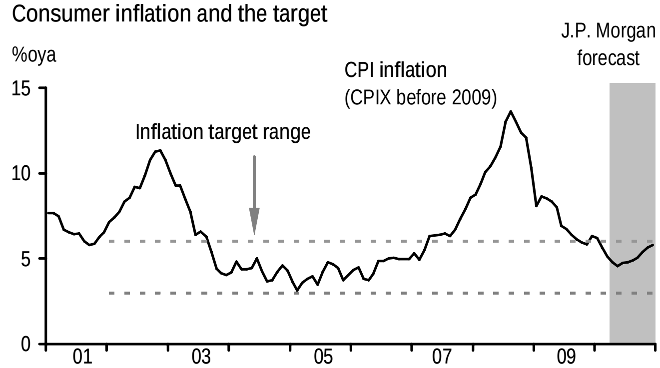
Next week's inflation report will probably show only a modest easing in inflation to 5.0%oya in April from 5.1% in the previous month. The CPI likely rose 0.4%m/m after a 48c/l increase in gasoline prices, partly due to a 25c/l hike in the fuel levy, pushed transport costs 1.2%m/m higher. We see CPI inflation moderating to 4.6%oya in May before picking up again to end the year at 6.0%oya. In our view, inflation will print between 5%oya and 6% throughout most of 2011, which suggests a moderate probability that the inflation band will be exceeded in some months. While we had expected the SARB to begin to normalize its policy rate with a 50bp hike in March 2011 on account of a closing output gap and pickup in inflationary pressures, the recent rise in risks to the global recovery and delay in the start of the hiking cycle in many developed markets caused us to push out the first hike to the second quarter in 2011.

Gross Domestic Product by activity
Contributions (%-pt q/q saar)

	2008		2009				2010
	3Q	4Q	1Q	2Q	3Q	4Q	1Qe
Agriculture and forestry	0.4	0.1	-0.1	-0.3	-0.2	-0.2	-0.1
Mining and quarrying	-0.5	0.0	-1.7	0.8	-0.3	0.2	0.8
Primary sector	-0.2	0.1	-1.8	0.5	-0.6	0.0	0.7
Manufacturing	-0.9	-2.9	-4.4	-1.6	1.1	1.5	0.9
Electricity, gas, and water	0.1	0.0	-0.2	0.0	0.1	0.0	0.0
Construction	0.2	0.2	0.3	0.3	0.2	0.1	0.1
Secondary sector	-0.6	-2.8	-4.3	-1.4	1.4	1.6	1.0
Wholesale and retail trade	-0.7	0.0	-0.3	-0.7	-0.1	-0.1	1.2
Transport, communication	0.3	0.1	-0.2	-0.1	0.1	0.2	0.2
Finance, real estate, bus.	1.7	1.6	-0.5	-0.8	-0.3	0.2	0.5
General government services	0.8	0.8	0.3	0.4	0.7	1.0	0.3
Personal services	0.2	0.1	0.2	0.2	0.2	0.2	0.2
Tertiary sector	2.3	2.4	-0.6	-1.2	0.5	1.5	2.4
Taxes and subsidies	-0.2	-0.4	-0.7	-0.7	-0.4	0.1	0.3
GDP at market prices	1.3	-0.7	-7.4	-2.8	0.9	3.2	4.5

Retail sales: recovery gaining momentum

Consumer inflation and the target



The South Africa data watch will be published next on June 4.

Data releases and forecasts

Weeks of May 24 - June 4

Tue
May 25
11:30am

Real GDP by output sector

%q/q saar, except as noted

	2Q09	3Q09	4Q09	1Q10
GDP (market prices)	-2.8	0.9	3.2	4.5
GDP (market prices, %oya)	-2.7	-2.2	-1.4	1.4

See text.

Wed
May 26
11:30am

Consumer prices

%oya, except as noted

	Jan	Feb	Mar	Apr
CPI	6.2	5.7	5.1	5.0
%m/m nsa	0.3	0.6	0.8	0.4
Core	5.7	5.3	5.0	4.8

See text.

Thu
May 27
11:30am

Producer prices

	Jan	Feb	Mar	Apr
Total (%oya)	2.7	3.5	3.7	4.6
%m/m nsa	1.3	0.4	0.3	0.6

Mon
May 31
8:00am

Monetary and credit aggregates

	Jan	Feb	Mar	Apr
M3 (%oya)	0.6	0.1	1.5	__
M0 (%oya)	6.3	4.8	12.4	__
Private sector credit (%oya)	-0.7	-0.6	-0.7	-0.5
%m/m nsa	0.0	0.6	0.2	__
Credit to households (%oya)	2.9	3.5	3.6	3.8
Total domestic credit (%oya)	0.9	-0.3	-0.1	__

Mon
May 31
2:00pm

Trade balance

R bn, except as noted

	Jan	Feb	Mar	Apr
Trade balance	-3.4	-5.5	0.5	__
Exports	36.6	40.4	51.5	__
%m/m	-19.4	10.5	27.5	__
Imports	40.0	45.9	51.1	__
%m/m	-4.1	15.0	11.2	__

Tue
Jun 1
11:00am

Kagiso BER PMI

	Feb	Mar	Apr	May
PMI (% weights)	60.4	55.6	55.2	57.0
Business activity (25)	65.2	59.9	54.3	__
New sales orders (30)	68.6	54.8	56.2	__
Suppliers' performance (15)	48.1	52.4	55.9	__
Inventories (10)	58.7	56.8	50.6	__
Employment (20)	52.1	53.2	56.3	__
Memo: prices paid	61.9	61.6	63.8	__
Business expectations	74.0	73.2	65.7	__
PMI nsa	55.5	53.4	50.6	__

Wed
Jun 2
11:00am

New vehicle sales

%oya, except as noted

	Feb	Mar	Apr	May
Passenger car sales	21.2	13.6	28.0	__
%m/m nsa	-7.4	9.9	-20.1	__
Light commercial vehicles	13.0	14.8	28.1	__
Heavy/medium comm. veh.	-14.1	27.5	4.9	__
Total vehicle sales	16.2	14.7	26.6	__
%m/m nsa	0.5	11.4	-20.2	__

Review of past two weeks' data

Manufacturing production

Volume output

	Jan	Feb	Mar
Manufacturing (%oya)	3.5	2.7	~~3.9~~ *6.3*
%m/m sa	-0.6	~~-1.5~~ *-1.4*	__ *2.6*

Manufacturing production rose 2.6%m/m, sa after a 1.4% contraction in February to take over-year-ago growth up to 6.3% from 2.7% in the previous month (consensus: 3.0%oya; J.P. Morgan: 3.9%). The upside surprise is largely due to strong output growth in consumer-orientated goods, which rose 3.3%m/m to be up 1.4%q/q saar. While production of electrical machinery rose 9.1%m/m and has grown 27.7% q/q saar in the first quarter, it only carries a weight of 2.5% in the manufacturing index while consumer-oriented goods make up a third of the index. Manufacturing of commodity-related goods was broadly flat m/m, but is up 13.9% q/q saar based on our estimates. The March reading implies a 6.2% annualized gain in manufacturing production in the first quarter, which should add 0.9%-pt to GDP growth.

MPC decision

The SARB kept rates on hold at 6.5% in line with expectations.

Retail sales

%oya

	Jan	Feb	Mar
Real	-1.5	-1.5	~~1.1~~ *1.0*
Nominal	4.8	4.0	__

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Australia and New Zealand

- **RBA policy "well placed," indicating near-term pause**
- **Aussie firms' capex plans to remain impressive**
- **Kiwi Budget incentivizes saving over consumption**

The data flow in Australia this week showed that monetary policy has reached a key touchstone for both RBA officials and consumers. The minutes from the May Board meeting describe policy as "well placed," while plummeting consumer confidence showed that higher market interest rates are beginning to hit home. In New Zealand, the 2010 Budget aimed to promote savings over consumption and property speculation; we had anticipated the impact of less advantageous taxing of housing for some time. The highlight in the week ahead is the Aussie 1Q capex survey, which should show a substantial increase in spending plans, although there is little else on the economic agenda.

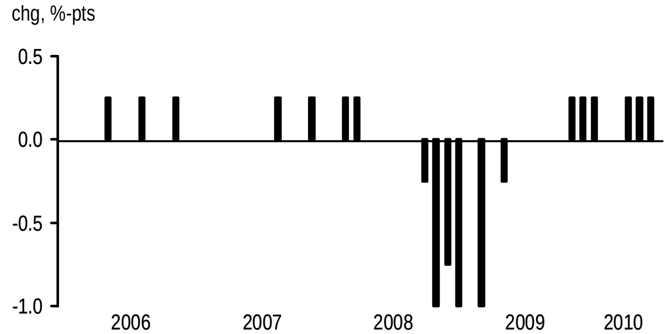
RBA officials believe policy "well placed"

This week's minutes from the RBA's Board meeting two weeks ago confirmed that the main reason the RBA hiked the cash rate a further 25bp was the soaring terms of trade, owing to the forthcoming stimulatory (and inflationary) effects of the resources boom. That said, Board members were wary of the uncertainty in the Euro area, which added to the case for a pause. Officials concluded at the May Board meeting, however, that another rise in the cash rate would leave monetary policy "well placed." Indeed, with the policy stance now closer to a "normal" setting, the first phase of the tightening cycle appears to be over.

The minutes this week again referred to market interest rates being back to "average" levels for most borrowers. Following six rate hikes in seven meetings, however, the RBA acknowledged that the policy tightening may have started to affect behavior. Recent economic data had shown subdued retail sales and a sharp drop in home loan approvals, for example. On the other hand, credit conditions for parts of the business sector had started to improve, and forward-looking indicators suggested solid growth in the labor market in the period ahead.

As flagged in the minutes, the "major news of the domestic economy has been the further strengthening in commodity markets." Contract prices for iron ore were estimated by the RBA to have risen and were up close to 100% in the June quarter, and coking coal prices had risen significantly, meaning the terms of trade would likely recover to the highs seen in 2008. The RBA believes that the huge wave of na-

Australia: RBA policy moves



Australia: real mining investment

tional income set to be triggered by the rising terms of trade, which officials forecast will grow by around 20% this year, will more than offset the scaling back of fiscal and monetary stimulus. The net effect suggests that domestic output will continue to strengthen.

That said, the surging terms of trade have given rise to further concerns about the inflation outlook, particularly given that many sectors of the economy appear to be operating with little spare capacity. The recent upward revision to the RBA's inflation forecasts means that inflation would "not be much below the top of the target range." We believe inflation will track above the RBA's 2%-3% comfort zone in the period ahead. There already is evidence, for example, of substantial wage gains in the hot mining regions. The riches on offer in mining towns to the west and north have triggered skill shortages even in non-mining sectors of the economy, as the mining industry drains the pool of workers elsewhere.

On global conditions, the RBA's commentary mentioned that global growth would be a little above trend. There remained significant divergence across regions, however. Growth in Asia remains robust, with the Chinese economy continuing to expand strongly, though in Europe it remained weak, with activity appearing relatively flat in the March quarter. On the latter, the RBA Board discussed in detail increasing sovereign debt concerns in the Euro area, and acknowledged that the situation could worsen further. Indeed, conditions have since deteriorated, meaning that the fiscal consolidation likely to occur in the Euro area will likely lead to a deeper economic contraction than RBA members foresaw two weeks ago.

Global factors likely will dominate the RBA's near-term decision making; as a result, we anticipate a policy pause at the next Board meeting in early June. The pause will be extended for longer if global conditions remain troubling. The tightening cycle is not over, however. With Australia's economy already growing at trend, with little spare capacity, policy eventually will head into restrictive territory, especially given growing official concerns surrounding the medium-term inflation outlook.

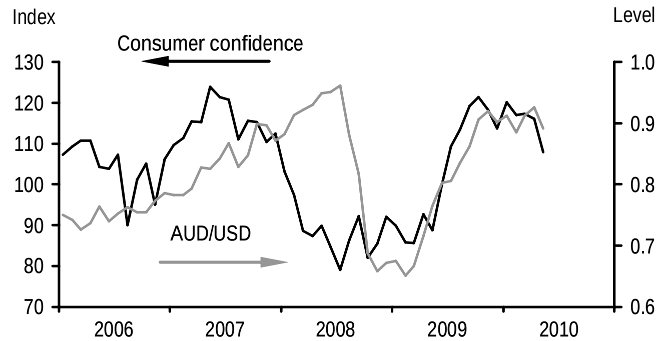
1Q capex survey next week's highlight

The 1Q investment survey in Australia next week likely will deliver on expectations for the further swelling of Australia's already bulging investment pipeline. It is important to note, though, that this survey preceded the announcement of the government's response to investment-sensitive portions of the Henry Review. The government earlier this month, for example, announced its intention to introduce a tax on "excess" mining company profits. The proposed 40% Resource Super Profits Tax (RSPT) kicks in after capital allowances, and an allowance for the risk-free rate. Australian mining companies since have announced that a host of investment projects may not go ahead if the RSPT is introduced.

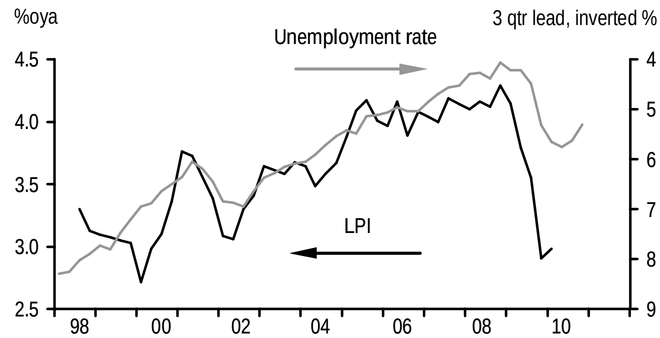
The 1Q capex survey, though, should paint a positive picture of the investment outlook; firms will likely have upgraded their future spending plans. For 2009-10, the sixth estimate of firms' spending plans should print at A$116 billion, compared to A$110.6 billion in the previous survey. After allowance for firms' usual estimation errors, this will imply that spending essentially is unchanged from the record-high levels reported for 2008-09. With respect to the outlook, firms' spending plans for the year ended June 2011, by our estimates, will imply a rise of 18% on current elevated levels, unchanged from the previous survey. New spending in mining should lead the way, thanks to soaring demand for bulk commodities in Asia.

Private investment as a share of Australia's GDP already is running at 24% of GDP, close to the record high reached toward the end of 2008. If the plans of managers in the 1Q survey are realized, this ratio will rise to new highs in the next fiscal year. On the RSPT, Ken Henry, Secretary to the Treasurer, focused much of his annual post-Budget speech

Australia: Westpac-Melbourne consumer sentiment index and AUD



Australia: labor price index and unemployment



this week on justifying the new resources tax. Henry argued that the proposal would reduce the tax burden on companies, thereby encouraging additional investment. He said that given that the RSPT is similar to an allowance for corporate capital, in that it taxes only economic rent, compared to royalties, which tax receipts, it does not distort production or investment. Further, because it taxes rent, it should have no impact on prices.

Rate hikes stinging the consumer

Australia's consumer confidence, as measured by the Westpac-Melbourne Institute (WMI), slumped 7%m/m in May, marking the largest fall since October 2008. We anticipated a smaller drop in confidence, although we suspected it would be driven mainly by a fall in sentiment toward family finances, owing to the RBA's policy tightening and the fact that the government delivered a "no frills" Budget that did little to woo voters in this election year. But, a large decline was recorded in sentiment toward the economic outlook, possibly owing to the mounting risks to global growth resulting from heightened sovereign concerns in Europe.

The WMI reiterated, though, that the deterioration in confidence owed mainly to higher mortgage rates. In the last rate hike cycle, after average mortgage rates rose to 7.3% in March 2005 from 7.05%, the WMI index dropped by

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15.5%, then fell 8.5% on average following each of the next seven rate hikes. The most recent rate hike in the current tightening cycle, delivered in early May, pushed the variable mortgage rate up to 7.4% from 7.15%; this prompted an 8.1%m/m drop in confidence among those respondents with a mortgage, compared to average falls of 2.3% following the five previous rate hikes in this cycle.

Aussie wage growth rose sharply in 1Q

Australia's labor price index (LPI) grew more than expected in 1Q, rising 0.9%q/q (J.P. Morgan and consensus: 0.8%), marking the fastest quarterly growth rate since the end of 2008. Both public and private wages accelerated, rising 1.2% and 0.8%, respectively.

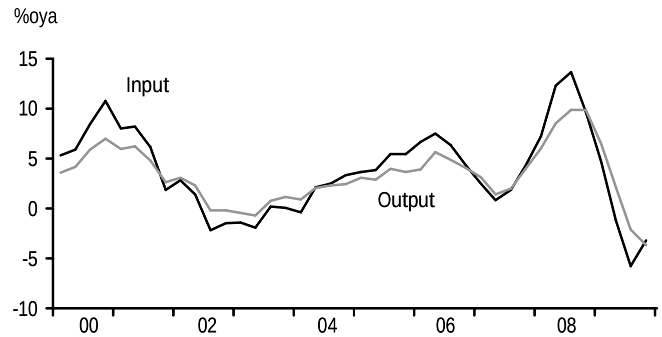
Given solid employment gains (the economy has added 110,000 jobs, mostly full time, this year) and signs of emerging skills shortages, pressure on wages will continue to build. Indeed, tightening labor market conditions will be a growing concern for RBA officials, particularly after the government announced last week that it expects the economy to approach full employment by mid-2012. With leading indicators of employment recently creeping higher, it appears that solid job gains will continue, meaning wages should rise further. This will be particularly obvious in sectors such as mining, where wage growth already has picked up sharply, rising to 1.9%q/q in 1Q from 1.1% in 4Q. The threat of steeply rising wages and broader inflation pressures reinforces our view that the RBA will tighten policy further this year, after a near-term pause.

NZ Budget to deteriorate further near term

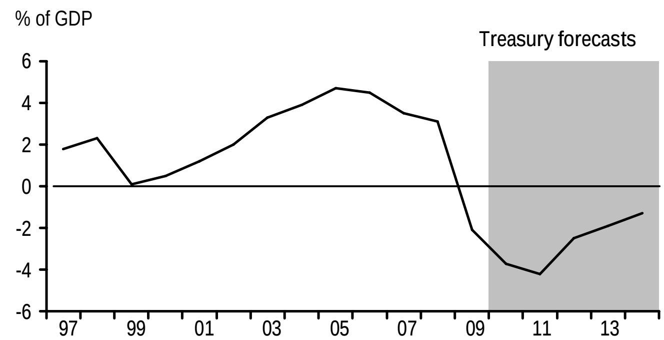
"Save and invest" was the key theme of the New Zealand Budget released this week. The budget focused on rebalancing the tax system toward savings and investment, and away from the borrowing and consumption that have historically dominated as the main drivers of economic growth. Finance Minister Bill English described Budget 2010 as "broadly fiscally neutral," but the jump in the projected operating deficit in the March 2011 year suggests otherwise, at least in the near term. The highlights were a reduction in personal income taxes, the confirmed hike in the goods and services tax (GST), and the changes to the way property is taxed. Of the (few) surprises, the tax package undoubtedly was the most impressive, particularly the personal tax cuts worth NZ$14.3 billion over four years.

The Budget included updated Treasury forecasts, which showed that the government believes New Zealand's economic growth outlook is better than that expected six months ago. Treasury now forecasts that the economy will

New Zealand: producer prices



New Zealand: operating balance excluding gains and losses (OBEGAL)



expand 3.2% in the March 2011 year, compared to 2.4% previously. We had expected a better fiscal position in the year ahead given the improved economic outlook, but this was not the case. Beyond the next year, however, the Treasury forecasts the fiscal position to improve significantly, with the operating balance returning to surplus in 2015-16.

NZ PPI spiked, but will not influence RBNZ

The PPI numbers released in New Zealand this week showed that producer prices picked up in the March quarter. The numbers, though, will have few implications for the RBNZ; the consumer price data were released weeks ago, and showed that headline inflation remained at the midpoint of the RBNZ's 1%-3% target range for the second straight quarter.

Input prices, or changes in the costs involved in production, were up 1.3%q/q (J.P. Morgan: 0.8%; consensus: 0.5%), rising for the second straight quarter. The main driver of the rise in input prices was electricity generation and supply, up 16.2%q/q. Prices received by producers spiked 1.8%q/q in 1Q (J.P. Morgan: 0%; consensus: 0.5%) following four straight quarters of decline. The increase owed mainly to the dairy product manufacturing index, which surged 29.6%q/q, marking the largest increase on record. With

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respect to monetary policy, although we believe the PPI numbers will have few implications for near-term policy decisions, we maintain our call for the first rate hike to be delivered in July. While we acknowledge the risk of a June move, growing uncertainties in the Euro area and weakness in some of the domestic indicators suggest that the RBNZ has scope to sit on the sidelines for a little while longer.

Australia:

Data releases and forecasts

Week of May 24 - 28

Mon
May 24
11:30am

Sales of new motor vehicles
Units, sa

	Jan	Feb	Mar	Apr
%m/m	-3.2	-1.9	-2.7	-3.5
%oya	15.5	17.3	19.2	11.8

Wed
May 26
10:30am

WMI leading index
Sa

	Dec	Jan	Feb	Mar
%m/m	0.7	0.4	0.5	__

Wed
May 26
11:30am

Construction work done
Sa

	2Q09	3Q09	4Q09	1Q10
%q/q	3.6	1.6	2.6	-1.0
%oya	10.1	5.4	3.9	6.9

A very high base from last quarter's spike in public building works (in particular in the education sector) will have depressed growth in construction work completed in 1Q.

Thu
May 27
11:30am

Private new capital expenditure
Sa

	2Q09	3Q09	4Q09	1Q10
%q/q	2.3	-5.2	5.5	5.0
%oya	8.2	-2.7	-2.3	7.4

Investment spending probably rose 5%q/q in real terms in the March quarter, reflecting improved conditions for mining, in particular.

Review of past week's data

WMI consumer confidence survey
100=neutral, seasonally adjusted

	Mar	Apr	May	
%m/m	0.3	-1.0	~~-3.0~~	*-7.0*

Labor price index
Sa

	3Q09	4Q09	1Q10	
(%q/q)	0.7	0.6	__	*0.9*
(%oya)	3.6	2.9	__	*3.0*

New Zealand:

Data releases and forecasts

Week of May 24 - 28

Thu
May 27
10:45am

Trade balance
Nsa

	Jan	Feb	Mar	Apr
Trade balance (NZ$ mn)	271	335	567	500

We expect another healthy surplus in April, with exports underpinned by strong demand from Australia and Asia. Both export and imports will be slightly lower over the month, however, with the sharper fall in exports leading to a narrowing of the surplus to NZ$500 million.

Fri
May 28
10:45am

Building consents
Sa

	Jan	Feb	Mar	Apr
%m/m	-2.9	5.8	-0.4	-2.0
%oya	35.0	29.8	32.9	15.8

Permits likely fell further in April, with the 2%m/m drop we forecast to mark the fourth fall in five months. The decline will provide further evidence that the property market is slowing, and reaffirm our view that residential investment will be flat over the first six months of the year.

Review of past week's data

Producer price index

	3Q09		4Q09		1Q10	
Inputs (%q/q nsa)	~~-1.1~~	*-1.4*	~~0.3~~	*-0.1*	~~0.8~~	*1.8*
Outputs (%q/q nsa)	~~-1.4~~	*-1.1*	~~-0.4~~	*0.4*	~~0.0~~	*1.3*

Visitor arrivals

	Feb		Mar		Apr	
Total (%m/m nsa)	~~-1.9~~	*-2.1*	~~1.1~~	*0.8*	__	*-1.8*

Net permanent immigration

	Feb		Mar		Apr	
Monthly (000s, nsa)	2.6		-0.3		__	*-0.6*
12-month sum (000s, nsa)	21.6		21.0		__	*20.0*

Credit card spending

	Feb		Mar		Apr	
%oya	~~1.2~~	*1.1*	~~6.3~~	*6.2*	~~1.5~~	*1.9*

Greater China

- **Hong Kong: CPI picked up modestly in April; no substantial jump expected in the near term**
- **Hong Kong: labor market remained steady; unemployment at lowest rate since 1Q08**
- **Taiwan: 1Q GDP stronger than expected, supported by strong domestic demand and trade flows**
- **Taiwan: March export orders eased modestly in April, showing some payback for previous gains**

Hong Kong: CPI picked up modestly

Hong Kong's April headline CPI rose 2.4%oya, from 2.0% in March. Netting out the effects of all government relief measures, the underlying inflation rate edged up to 1.3%oya in April, faster than the 0.8% increase recorded in March, due mainly to larger over-year-ago increases in the prices of clothing and footwear, fresh vegetables, and private housing rent. Food prices increased 1.9%oya, compared to a 1.3% gain in March, reflecting rising prices of meals away from home (2.6%oya in April compared to 1.7%oya in March). Meanwhile, clothing prices also posted a relatively large increase of 1.9%oya after a 1.2% decline in March.

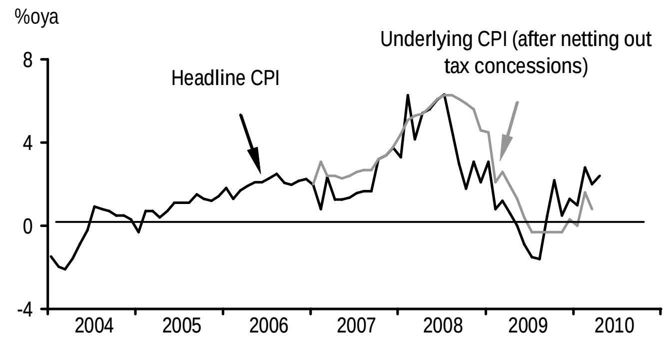
Hong Kong's underlying CPI inflation appears to be resuming a gradual uptrend. The improving and relatively stable labor market in recent months suggests that the modest recovery is also continuing. If the current economic momentum continues, inflation pressures could rise further, but we do not expect to see these increase substantially in the near term.

Unemployment rate fell further

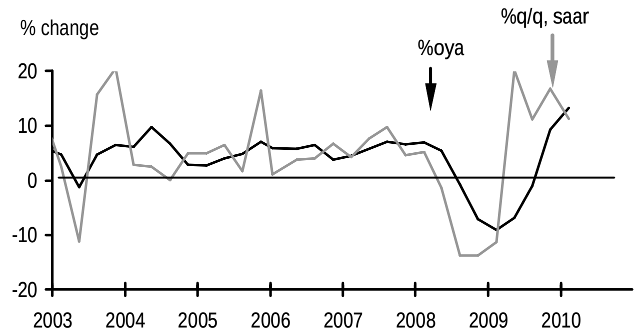
Hong Kong's unemployment rate for the February-April period posted an average of 4.4% sa (J.P. Morgan: 4.5% sa; consensus: 4.3% sa), remaining at the same level as in the three months ending in March. The number of unemployed decreased by an average of 1,826 persons seasonally adjusted in the February-April period. Meanwhile, seasonally adjusted total employment posted a slight increase of 3,652 in the three months ending in April, after a significant decline of 43,506 persons during the January-March period. The total labor force rose by 629 for the three-month average ending in April, compared to the sharp decline of 54,048 at the end of March.

Overall, April's data suggest that Hong Kong's labor market remains stable at present. The unemployment rate is the lowest since 1Q08. However, uncertainties in the external environment could affect household and business sentiment in the longer term. While Hong Kong's direct exposure to troubled European sovereigns appears to be limited, its financial markets are closely related to the external economies, so a sudden liquidity withdrawal could threaten its important banking sector and thereby the economy. It is hard to judge the impact of European developments on the rest of the world at this stage, particularly on trading partners of the core EU, such as mainland China. Therefore, it remains to be seen whether subsequent market developments will affect Hong Kong's financial and export sectors in the longer term.

Hong Kong: headline CPI and underlying CPI



Taiwan: real GDP



Taiwan: stronger-than-expected 1Q GDP

Taiwan's GDP continued to show strong growth in 1Q, rising 11.3q/q saar, although the speed of expansion moderated from the previous quarter (16.7q/q saar). Real GDP rose 13.3%oya (J.P. Morgan: 12.9%; consensus: 8.9%), compared to a 9.2%oya increase in the previous quarter. Official seasonally adjusted figures show real GDP increased 11.3%q/q saar in 4Q, following growth of 16.7% and 11.2% in 4Q09 and 3Q09, respectively. We expect Taiwan to continue to expand at a robust pace throughout 2010 and, based on the constructive outlook, particularly in Asian markets at present, we are revising our forecast for Taiwan's real GDP growth rate to 9.2% from 8.2% previously.

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Taiwan exporters continued to benefit from the recovery in the global manufacturing sector in 1Q, due to strong growth momentum particularly in mainland China as well as in other fast-recovering Asian economies. In 1Q, total exports of goods and services increased 28.6%q/q saar. Meanwhile, imports slowed slightly, rising 34.2%q/q saar, easing from 40.3%q/q saar in the previous quarter, reflecting still strong demand momentum.

Domestic demand rose significantly, up 11.9%q/q saar in 1Q, primarily driven by a steady upturn in gross capital formation, which increased a notable 122.4%q/q saar compared to growth of 68.6%q/q saar in 4Q. Taiwan manufacturers, especially tech producers, appeared to be very aggressive in boosting their capex plans in order to remain competitive. Private consumption contracted from the previous quarter, posting a 9.6%q/q saar decline in 1Q after a strong gain of 16.4%q/q saar in the previous quarter.

Going forward, as the expansion in emerging Asian countries broadens and the expected double-digit global capex expansion further supports the Taiwanese economy, we expect the labor market to experience a decent recovery. Thus consumer sentiment, which has been further boosted by the improving medium-term outlook of the economy on the back of intensifying cross-strait economic links, would support private consumption demand.

Export orders continue to ease

Taiwan's export orders eased further after having accelerated sharply in recent months, expanding 35.2%oya in April (J.P. Morgan: 35.7%; consensus: 36.1%), compared to 43.7%oya growth in March. Seasonally adjusted export orders fell 1.4%m/m sa in April, on top of a 1.2%m/m decline in March, with the sequential trend slowing notably to 29.6%3m/3m saar from 44.4%3m/3m saar in March. April's modest easing in export orders shows that the strong growth trend from the recovery period right after the recent financial crisis has started to show moderating momentum.

China:

Data releases and forecasts

Week of May 24 - 28

No data releases.

Review of past week's data

No data released.

Hong Kong:

Data releases and forecasts

Week of May 24 - 28

Thu
May 27
4:30pm

Merchandise trade
HK$ bn

	Jan	Feb	Mar	Apr
Balance	-29.5	-19.7	-38.9	27.8
Exports	222.3	182.5	231.8	248.0
%oya	18.4	28.5	32.1	24.6
Imports	251.8	202.1	270.6	275.8
%oya	39.5	22.4	39.8	28.1

Review of past week's data

Labor market survey (May 18)
sa, 3mma

	Feb	Mar	Apr
Unemployment rate			
% avg	4.6	4.4	~~4.5~~ 4.4
Employed			
Ch m/m, 000 persons	56.5	-43.6	~~5.3~~ 3.7

Consumer prices (May 20)
% change

	Feb	Mar	Apr
Oya	2.8	2.0	~~2.1~~ 2.4
M/m sa	2.3	-1.6	~~0.2~~ 0.3

Taiwan:

Data releases and forecasts

Week of May 24 - 28

Mon
May 24
4:00pm

Labor market survey
%

	Jan	Feb	Mar	Apr
Unemployment rate, sa	5.7	5.7	5.6	5.5
Unemployment rate, nsa	5.7	5.8	5.7	5.4

Mon
May 24
4:00pm

Industrial production
%

	Jan	Feb	Mar
Oya	35.2	39.2	33.7
M/m sa	2.6	0.6	1.2

Thu
May 27
4:00pm

Composite leading indicator
% change

	Jan	Feb	Mar	Apr
M/m sa	1.8	0.8	0.3	__

Review of past week's data

Export orders (May 20)
% change

	Feb	Mar	Apr
%oya	36.3	43.7	~~39.6~~ 35.1
%m/m sa	5.2	-1.2	~~0.5~~ -1.4

Real GDP (May 20)
% change

	3Q09	4Q09	1Q10
% oya	-1.0	9.2	~~12.9~~ 13.3
%q/q saar	11.2	16.7	~~5.7~~ 11.3

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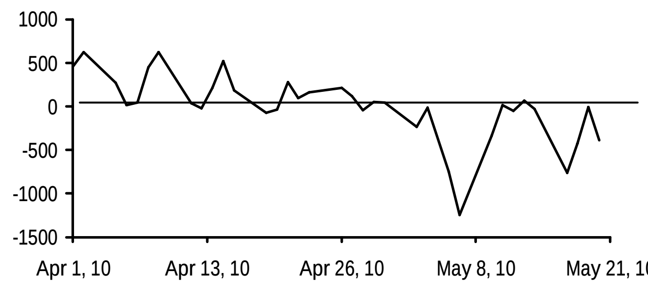
Korea

- **Global tensions hit Korea's financial markets**
- **Household income appears to have risen in 1Q**
- **Next week: April BoP and May consumer and business surveys**

There were few important data releases this week to influence our view that Korea's real GDP growth would moderate in the current quarter, to 4.0% from 7.5% in 1Q10. However, rising global risk aversion pressured local financial markets, pulling both the KOSPI and USD/KRW down more than 5% this week. Escalated tensions between North and South Korea also damped market sentiment after South Korea's Joint Civilian-Military Investigation Group (JIG), which includes 24 foreign experts, released a report containing the assertion that torpedo parts provided "conclusive" proof of North Korea's role in the sinking of a South Korean Navy ship on March 26, which left 46 sailors dead or missing. Reportedly, South Korea will now ask the United Nations Security Council to consider stricter economic sanctions against North Korea, although it remains to be seen whether China will agree to this. Rising concerns over geopolitical risks on the Korean peninsula could work against the country's financial asset prices amid a climate of global risk aversion, but should have less effect on local consumer sentiment unless the possibility of broad-based military confrontation materializes in any serious way.

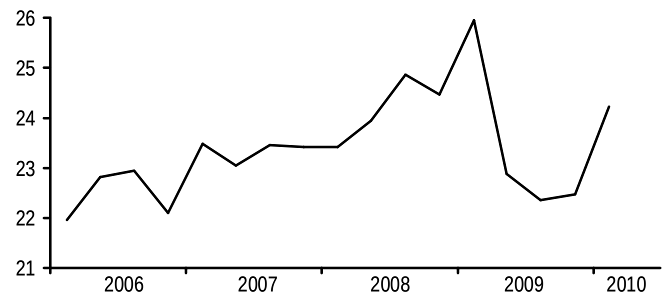
Foreigners' net purchases in KOSPI

KRW bn



Household sector's saving[1]

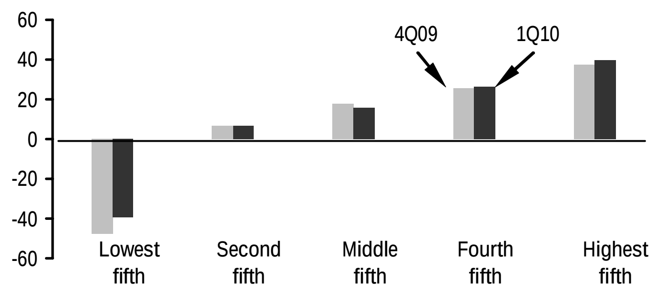
% of disposable income



1. Excluding single family households; household sector's saving is defined as the difference between disposable income and consumption expenditures. Thus, the NSO survey categorizes interest payments on borrowing as saving.

Household sector saving by income group

% of disposable income



Household income gained further in 1Q10

According to the quarterly survey of multi-family households by the National Statistics Office (NSO), household income rose 7.3%oya in 1Q10, implying a gain of 2.2%q/q sa, after a rise of 4.0% in 4Q09. Labor income, which comprises about 65% of household income, climbed 1.3% in 1Q10, following an increase of 3.5% in 4Q09. Meanwhile, consumption expenditures rose a solid 9.5%oya in 1Q10, but mainly as a result of base effects. On our calculations, consumption expenditures actually dropped 0.3%q/q saar in 1Q10 after rising for three straight quarters. Accordingly, the household sector's saving rate, which is defined as the difference between household income and consumption expenditures, moved up in 1Q although the low-20% income group's saving remained in negative territory.

Europe set to sway next week's surveys

Next week's releases of two surveys will likely show that both business and consumer sentiment retreated modestly, in May due mainly to rising concerns over European nations' debt problems. To be sure, Korea's direct exposure to peripheral Europe (Greece, Ireland, Italy, Portugal, and Spain) is limited, with those countries accounting for less than 2% of Korea's exports, while local Korean financial institutions' direct exposure is estimated to be only US$640 million. However, the second-order impact via financial markets and export demand from the overall Euro area will still matter. Separately, the Bank of Korea is scheduled to release the April balance of payments report, which is likely to show that current account surplus rose.

Data releases and forecasts

Week of May 24 - 28

Week of May 24

FKI business survey

100=neutral reading, nsa

	Feb	Mar	Apr	May
One-month-ahead outlook	116.2	111.2	113.4	105.0
Current conditions	98.7	113.1	108.9	108.0

Overall business sentiment is expected to have pulled back in May, with European sovereign debt concerns damping expectations. The one-month-ahead outlook index likely declined notably, aggravated by unfavorable seasonality, while the first-20-day trade numbers suggest that the current conditions index could have only edged down.

Wed May 26 6:00am

Consumer survey

100=neutral reading, nsa

	Feb	Mar	Apr	May
Index	111	110	110	107

The headline consumer survey index is anticipated to have moved lower this month, driven by the equity market correction and housing market weakness.

Thu May 27 8:00am

Current account

US$ bn nsa

	Jan	Feb	Mar	Apr
Balance	-0.4	0.2	1.7	2.7

See main story.

Review of past week's data

Bankruptcy filings (May 19)

	Feb	Mar	Apr	
Bankruptcy filings	111	144	~~130~~	*125*
Dishonored bill ratio	0.03	0.02	~~0.02~~	*0.03*

Bankruptcy filings remained in a tight range of 111 to 152 since last May, with government support and guarantees continuing to aid small and medium-sized companies.

Housing prices (May 20)

% change from previous week, apartment prices only

Week of May 3	May 10	May 17	
0.0	0.0	__	*0.0*

BoK Watch

- **Korea bond market stayed firm**

Although the market has advanced its rate hike expectations somewhat after the hawkish Monetary Policy Committee statement last week, Korea's bond market rebounded following the initial sell-off, as concerns intensified over European sovereign debt reinforcing the flight-to-quality theme. As a result, bond yields were almost unchanged since the MPC meeting, with 3-year KTB yields actually down 3bp, while interest rate swap rates were 5-8bp lower across the curve.

Interest rates

% p.a.

	Apr 29	May 6	May 13	May 20
Overnight call	2.00	2.01	2.01	2.02
Three-month CD fixing	2.45	2.45	2.45	2.45
One-year MSB	2.67	2.79	2.89	2.89
Three-year treasury bond	3.58	3.79	3.79	3.74
Three-year corporate bond	4.40	4.53	4.53	4.51

Deposit changes at deposit money banks

KRW tn

	Feb	Mar	Apr	May 1-17
Total deposits	16.0	-4.6	9.6	14.7
Demand	2.0	-3.7	1.0	1.1
Time and savings	14.0	-0.9	8.6	13.6

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ASEAN: Indonesia, Malaysia, Philippines, Singapore, Thailand, Vietnam

- **ASEAN data remains upbeat—levels still pointing solidly up**
- **External demand indicators remain strong—limited evidence of a pause as yet**
- **Domestic demand is less consistent, with some stops and starts**

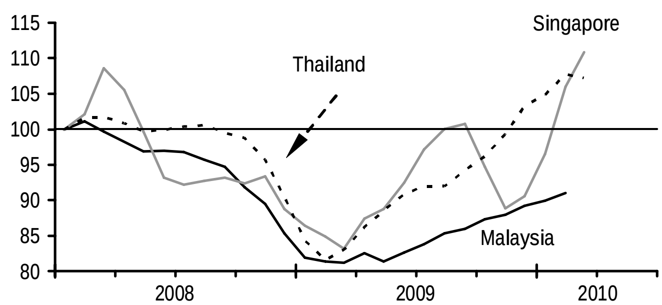
Most of the ASEAN countries have released data through 1Q10 and the underlying tone—for both domestic and external demand—continues to be strong. In level terms, most countries are seeing activity indicators close to, if not above, the peaks witnessed in 2008. In particular, production for external demand in many countries is well above levels seen in 2008, though there are some interesting variations across the region. Similarly, the domestic demand indicators also suggest a solid recovery into 1Q10, but there is less consistency in terms of the underlying trends across the region.

The upshot is that the underlying strength in activity continued into 1Q10 with almost uniform strength in external demand, but with somewhat more variability in domestic demand. Also, with the forward-looking indicators remaining positive, it is likely that 2Q10 external demand could likewise be robust. That said, there will likely be some payback, which, in the forecast, is expected to occur in late 2Q10 or into 3Q10 with growth anticipated to moderate to around or slightly below trend in 2H10. Part of this reflects payback for the strong 1H10 outcome, but also assumes that the investment cycle will not be particularly vigorous. This suggests that there is potentially some upside risk to 2H10 growth forecasts.

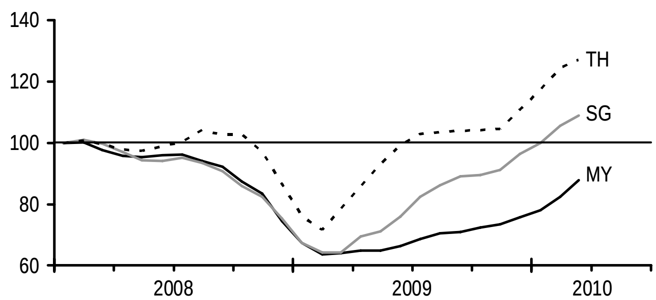
External demand firing strongly in 1Q10

Across the region, external demand indicators remain upbeat through 1Q10. Manufacturing activity in Singapore and Thailand has seen particular strength during the quarter, which effectively has lifted activity to levels solidly above the pre-crisis peaks in 1Q08 (first chart). In Singapore, the volatile biomedical sector has tended to swing the monthly data, but the uptrend is fairly clear. Although Malaysia's manufacturing sector is likewise moving higher, the recovery has not been as impressive as its neighbors. Similarly, production of electronics—a key export for the region—has been strong. In particular, production in Thailand has been a regional standout, reflecting exceptional strength in the hard drive sector (second chart). Similarly, the laggard in terms of electronics production is Malaysia.

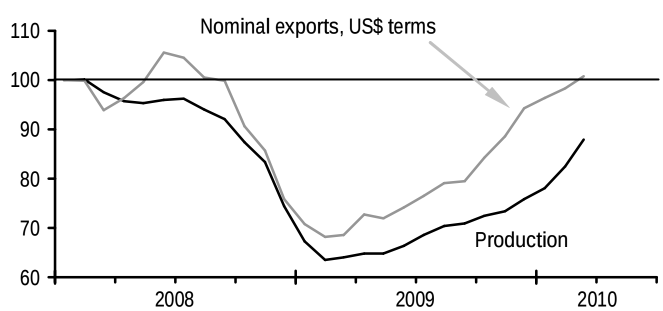
ASEAN-3: manufacturing production
Index, Jan08=100, 3mma, sa



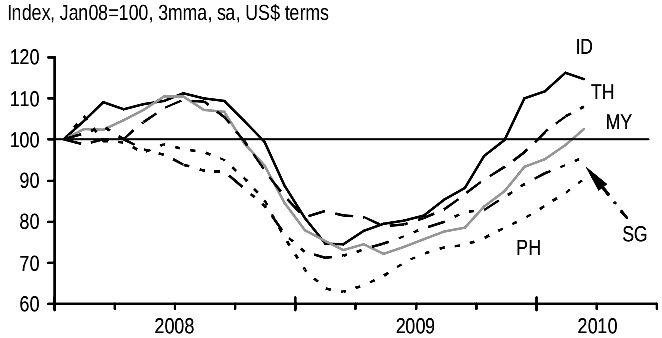
ASEAN-3: electronics production
Index, Jan08=100, 3mma, sa



Malaysia: electronics production and exports
Index, Jan08=100, 3mma, sa



ASEAN: exports
Index, Jan08=100, 3mma, sa, US$ terms



This relative weakness seems at odds with the export data, with exports of electronics recovering at a significantly faster pace than production (third chart). In this context, the differences between the two measures could owe to methodological issues between the data sets with the production data not fully capturing more recent developments in the manufacturing sector.

Nonetheless, exports have continued to recover strongly—most impressively in Indonesia, which has seen a surge in exports of resource-related products (fourth chart previous page). Similarly, in the case of Thailand, the combination of strong agricultural exports and a solid recovery in the electronics sector has boosted overall exports.

Indeed, electronics exports across the region have seen a solid recovery, led by Malaysia and Thailand, while Singapore and the Philippines, though impressive, have been less stellar (first chart). The variation in performance likely reflects the somewhat different product mixes between the countries.

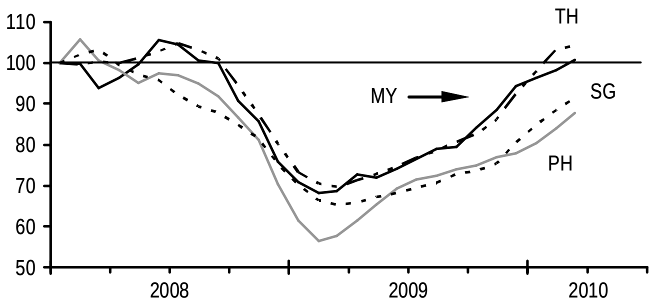
Domestic demand up at various speeds

In contrast to the almost uniform strength in external demand, domestic demand indicators around the region have been mixed. Motor vehicles sales are a useful proxy for private durable goods demand and reflects, among other things, the availability of financing and also of sentiment.

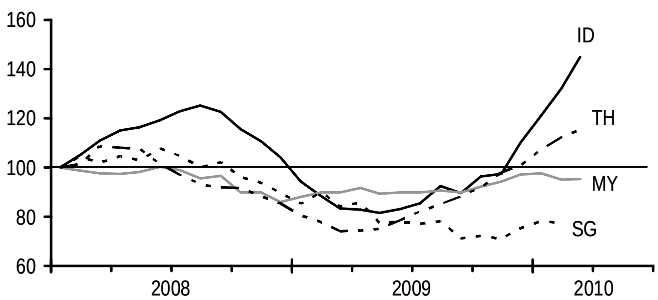
Within the region, the standout is Indonesia, where motor vehicle sales are now well above the peak of the pre-crisis period. Indeed, they are now printing at all-time historical highs (second chart). Thailand's motor vehicle sales have also been impressive and, like Indonesia, are now also above the peak of the pre-crisis period, though the recent political uncertainty could dent demand even as rates remain at historical lows. The two laggards are Malaysia and Singapore. In Malaysia, unlike Thailand, the dip during the crisis was not as deep, nor is the recovery as impressive. In Singapore, recent tweaks to guidelines that determine vehicle supply have led to fewer motor vehicles on the road. Thus, the lackluster performance reflects more administrative changes than weakness in demand. Indeed, real estate prices in Singapore continue to rise amid effervescent demand.

The ASEAN countries, with the exception of Thailand, do not have comprehensive high frequency data on private investment. Capital goods imports, a measure that includes machinery and transport equipment, provides a high frequency proxy. Moreover, judging by the correlation between the two series in Thailand, this suggests that they provide a useful indication of the underlying capex cycle (third chart). Of interest is the relative consistency of demand in Indonesia, which saw only a modest dip in 2Q09 before recovering.

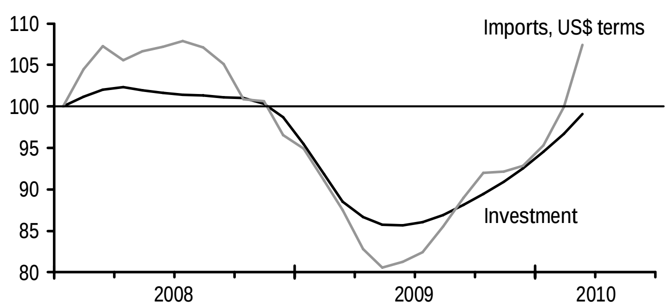
ASEAN: electronics exports
Index, Jan08=100, 3mma, sa, US$ terms



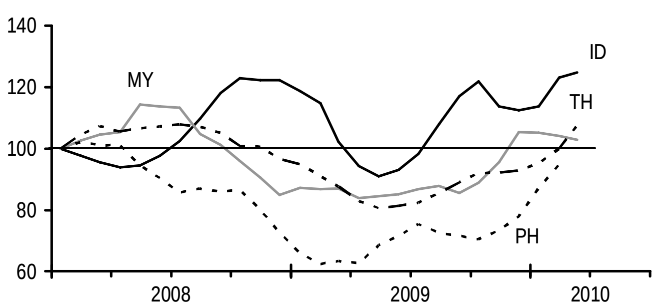
ASEAN: motor vehicle sales
Index, Jan08=100, 3mma, sa



Thailand: private investment and capital goods imports
Index, Jan08=100, 3mma, sa



ASEAN-4: capital goods imports
Index, Jan08=100, 3mma, sa except Indonesia, US$ terms



In Malaysia, the recovery seems to have slowed in 1Q10, while in Thailand and the Philippines, the recovery still appears to have some way to go (fourth chart).

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Indonesia:

Data releases and forecasts

Week of May 24 - 28

No data releases.

Review of past week's data

No data released.

Malaysia:

Data releases and forecasts

Week of May 24 - 28

No data releases.

Review of past week's data

Consumer prices (May 21)

% change

	Feb	Mar	Apr
Oya	1.2	1.3	~~1.9~~ *1.5*
M/m sa	~~0.7~~ *0.0*	~~-0.3~~ *0.3*	~~0.2~~ *0.1*

April inflation in Malaysia was effectively flat from March, with headline inflation up a lower-than-expected 1.5%oya and ahead a modest 0.1%m/m sa on the month. Core inflation, excluding food and transport costs, rose 1.3%oya and was flat on the month. While the underlying inflation trend has moderated over the course of 1Q10, food prices have been climbing. Of note, despite the recent stabilization in transport and utility costs—both relating to the recent moderation in energy prices in local currency terms as a result of the stronger MYR—food prices have been on a steady climb since 4Q09, and the trajectory seems to be headed somewhat higher, reaching 5.8%3m/3m saar in April against an average of 4.3%3m/3m saar between 2003 and 2008. The authorities will be presenting the recommendations on the plan for future subsidy cuts to parliament on March 26 with a public discussion on March 27. Developments here will be closely watched given their impact on both inflation and the fiscal position. The expectation is that there will be a phased withdrawal of the subsidies over the next three to five years. How this will be implemented will also be a function of the political economy in Malaysia—with such liberalization usually politically unpopular.

Philippines:

Data releases and forecasts

Week of May 24 - 28

Wed
May 26
9:00am

Merchandise trade

US$ bn nsa

	Dec	Jan	Feb	Mar
Imports	3.9	4.3	3.9	4.6
%oya	19.2	31.1	27.6	39.4

Strong GDP growth and remittance inflows should have supported further gains in imports.

Thu
May 27
9:30am

Real GDP

% change

	2Q09	3Q09	4Q09	1Q10
%oya	0.8	0.4	1.8	4.6
%q/q saar	6.0	3.1	3.5	6.0

Growth likely accelerated in 1Q after being sluggish in 2H09 compared to the rest of the region. In particular, exports and consumption likely led growth.

Review of past week's data

Government budget

Bn pesos

	Feb	Mar	Apr
Balance	-33.2	-63.9	2.6
Revenue	76.5	96.9	124.5
Expenditure	109.9	160.7	121.9

The government ran its first monthly budget surplus since April 2009. April revenues are always boosted from tax returns due that month and, as a result, revenues surged from March. At the same time, expenditures fell due to restrictions on spending ahead of elections. Despite the better April budget balance, the year-to-date deficit in the first four months of the year is roughly the same size of last year's deficit. Thus, we reiterate our forecast for a deficit of 3.5% of GDP this year versus 3.9% last year.

OFW worker remittances (May 17)

% change

	Jan	Feb	Mar
Oya	8.5	7.1	~~9.0~~ *5.6*
M/m sa	-0.3	1.8	~~0.5~~ *-5.5*

OFW remittances fell 5.5%m/m sa, leaving them up only 5.6%oya. In level terms, the seasonally adjusted level fell from February, leaving it at its smallest size since mid-2009. However, the non seasonally adjusted level was much stronger. Before seasonal adjustment, remittances grew about 10% on the month, posting the second highest monthly inflow on record at US$1.55 billion.

The large decline (sa) in March was a surprise. Nevertheless, it is worth noting that the magnitude of decline is not unprecedented and remittance flows tend to be choppy. Thus, large declines are usually followed by strong gains, and we would expect remittances to rebound in coming months. April may be very strong given inflows usually associated with the Easter holiday. Remittance inflows for 1Q were US$4.3 billion. First-quarter flows tend to be the weakest of the year and, if the quarterly profile this year closely follows those in recent years, then remittance flows should rise around 8% this year. We, however, remain more optimistic for inflows in 2010, as the positive turn in labor market conditions around the world should lead to more employment opportunities and higher wages for OFWs. Nevertheless, we did slightly lower our remittance forecast to 9.5% in 2010 from 10% previously on the lower-than-expected March inflow.

Strong remittance growth should continue to boost the local bid for RoPs. Indeed, strong remittance inflows, along with successful elections recently and positive technicals, should provide notable support for RoPs this year.

Singapore:

Data releases and forecast

Week of May 24 - 28

Mon
May 24
1:00pm

Consumer prices
% change

	Jan	Feb	Mar	Apr
Oya	0.2	1.0	1.6	3.3
M/m sa	0.7	0.5	0.5	0.4

Sequential inflation likely continued to rise in line with previous months, but the over-year-ago figure is anticipated to surge due to “base effects” from the previous April print.

Wed
May 26
1:00pm

Industrial production
% change

	Jan	Feb	Mar	Apr
Oya	39.2	17.9	43.0	16.0
M/m sa	11.0	5.2	-1.5	-2.3

The volatile pharmaceutical sector likely declined in April, holding back overall expansion in production.

Review of past week’s data

Merchandise trade (May 17)
US$ bn nsa

	Feb	Mar	Apr
Trade balance	1.5	3.5	2.9
Exports	23.4	29.3	29.0
Non-oil domestic (NODX)	8.5	10.7	10.0
%m/m sa, US$ terms	6.2	4.5	-0.4
%oya, US$ terms	33.3	37.9	33.4

April’s non-oil domestic exports (NODX) rose 5.0%m/m sa leaving them up 40.9%oya in US$ terms. Looking through the monthly volatility, NODX grew a strong 30.4%3m/3m saar, in line with the growth rate in March and well above its 10-year trend of around 10%. Surprisingly, electronics and pharmaceuticals were down on the month, despite the rise in overall NODX growth. Electronics fell 8.0% while pharmaceuticals were down 5.4%. However, exports outside of these sectors surged 17.2%, which may reflect an unusually large shipment, for example from the transport engineering sector. Most of the monthly declines in electronics and pharmaceuticals appear to be payback from strong gains in previous months rather than a worrisome sign. Electronics still expanded at a robust 32.9%3m/3m saar while pharmaceuticals were basically flat after several months of sequential trend contraction. Sequential trend NODX growth peaked in 1Q and is now moderating to more sustainable, albeit still strong, rates. With global growth expected to remain firm in 2H10, NODX growth should, too.

Real GDP (May 20)

	3Q09	4Q09	1Q10
%oya	0.6	4.0	~~13.6~~ *15.5*
%q/q saar	11.5	-2.8	~~32.1~~ *38.6*

Singapore’s economy expanded by a record 38.6%q/q saar, which is notably faster than the already robust 33% gain recorded in the Advance GDP release. Exports and investment drove growth, while private and government spending took a breather early this year. Following revisions, we have now raised our 2010 GDP forecast to 9.6% for 2010.

Thailand:

Data releases and forecasts

Week of May 24 - 28

Mon
May 24
9:30am

Real GDP
% change

	2Q09	3Q09	4Q09	1Q09
%oya	-4.9	-2.7	5.8	8.4
%q/q saar	8.8	6.9	15.3	2.8

Demand in general was likely strong in 1Q10 and should have seen a solid gain in overall growth. However, the recent political crisis will likely cast a pall over activity in 2Q10, and some moderation in domestic demand can be expected given its impact on sentiment.

Review of past week’s data

No data released.

Vietnam:

Data releases and forecasts

Week of May 24 - 28

During
the week

Consumer prices
%oya

	Feb	Mar	Apr	May
All items	8.5	9.5	9.2	10.0
%m/m sa	0.6	0.9	0.1	0.6

After slowing notably in April, inflation likely picked up again in May. The long-run monthly gain is around 0.9% sa, thus even a 0.6% rise is relatively soft.

During
the week

Merchandise trade
US$ bn nsa

	Feb	Mar	Apr	May
Trade balance	-1.3	-1.2	-1.3	-1.5
Exports, %oya	-25.6	5.2	33.2	26.4
Imports, %oya	21.1	33.8	27.4	25.2

The trade deficit likely widened in May as export growth slowed more than imports.

Review of past week’s data

No data released.

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Asia focus: export growth moderating, but still strong

Over the past year, exports from EM Asia have surged. As of March, exports from the region leapt 35.4%oya in USD terms and an even faster 44.8%oya if China is excluded. Indeed, export growth accelerated in many of the countries that reported April trade figures, suggesting that EM Asian export growth may have strengthened further this quarter.

Despite strengthening over the past year, export growth has already begun to moderate in sequential terms. Indeed, after peaking at 68.9%3m/3m saar in February, export growth slowed to 44.1% in March. Available April data suggest further moderation in 2Q10. This trend remains consistent even if China is excluded and generally reflects the underlying trajectory of electronics exports. However, with global growth likely to be firm, we expect export growth to remain above its 10-year average of 19%.

Emerging Asia exports

US$ value, %3m/3m saar

	4Q09	1Q10	Jan	Feb	Mar	Apr
China	69.3	37.1	72.7	82.9	37.1	19.2
Hong Kong	41.8	41.8	39.3	36.9	41.8	na
India	38.2	71.0	32.9	47.7	71.0	na
Indonesia	141.4	18.6	84.0	83.4	18.6	na
Korea	55.3	34.0	59.1	54.8	34.0	34.2
Malaysia	99.6	45.3	67.7	62.2	45.3	na
Philippines	39.2	56.6	48.6	50.5	56.6	na
Singapore	36.9	31.0	50.9	41.0	31.0	30.4
Taiwan	68.6	69.4	78.7	76.8	69.4	37.4
Thailand	56.2	54.5	62.7	64.0	54.5	na
Em. Asia	64.8	44.1	62.9	68.9	44.1	na
Em. Asia ex China	61.1	49.9	54.7	57.3	49.9	na

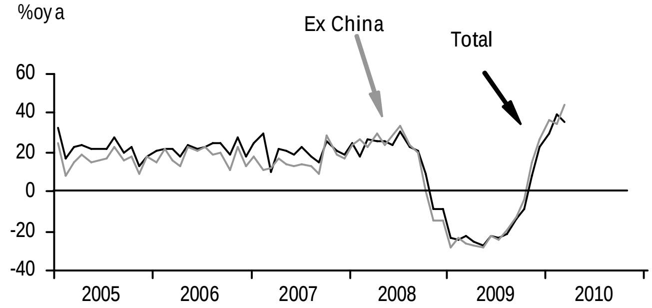
Emerging Asia exports

US $ value, %oya

	4Q09	1Q10	Jan	Feb	Mar	Apr
China	24.2	-13.7	45.6	24.2	30.4	na
Hong Kong	9.2	31.9	18.3	28.3	31.9	na
India	9.3	54.1	11.5	34.8	54.1	na
Indonesia	50.0	46.6	59.3	56.5	46.6	na
Korea	32.8	34.3	45.8	30.3	34.3	31.5
Malaysia	23.0	50.9	44.8	26.1	50.9	na
Philippines	23.8	43.7	42.5	42.5	43.7	na
Singapore	33.4	38.4	28.7	32.5	38.4	40.9
Taiwan	46.8	50.1	75.8	32.6	50.1	47.8
Thailand	26.2	41.0	31.4	23.5	41.0	na
Em. Asia	22.5	35.4	29.6	39.6	35.4	na
Em. Asia ex China	26.5	44.8	36.6	34.6	44.8	na

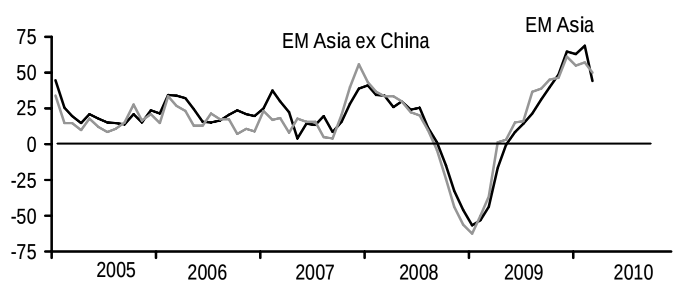
Emerging Asia: total exports

%oya



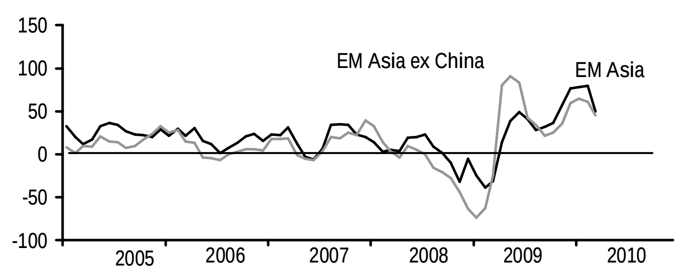
Emerging Asia: total exports

%3m/3m saar



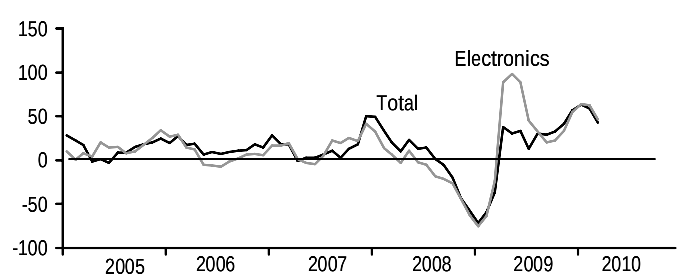
Emerging Asia: electronics exports

%3m/3m saar



Korea, Singapore, Taiwan: exports

%3m/3m saar



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US economic calendar

Monday	Tuesday	Wednesday	Thursday	Friday
24 May Existing home sales (10:00am) Apr 5.65 mn	25 May S&P/Case-Shiller HPI (9:00am) Mar 2.6% Consumer confidence (10:00am) May 53.0 FHFA HPI (10:00am) Mar -2.6% Richmond Fed survey (10:00am) May Auction 2-year note $42 bn St Louis Fed President Bullard speaks in London (11:15am) Fed Chairman Bernanke (8:30pm) and Philadelphia Fed President Plosser (10:00pm) speak at Bank of Japan Conference	26 May Durable goods (8:30am) Apr 2.3% Ex transportation 0.6% New home sales (10:00am) Apr 430,000 Auction 5-year note $40 bn Richmond Fed President Lacker speaks in Washington (4:15pm) Chicago Fed President Evans speaks at Bank of Japan Conference (8:00pm)	27 May Initial claims (8:30am) w/e prior Sat 455,000 Real GDP (8:30am) 1Q second 3.4% KC Fed survey (11:00am) May Auction 7-year note $31 bn St Louis Fed President Bullard speaks in Stockholm (2:40am)	28 May Personal income (8:30am) Apr 0.5% Real consumption 0.0% Core PCE deflator 0.1% (1.1%oya) Chicago PMI (9:45am) May Consumer sentiment (9:55am) May final 71.5
31 May Memorial Day Markets closed	1 Jun ISM manufacturing (10:00am) May Construction spending (10:00am) Apr Dallas Fed survey (10:30am) May	2 Jun ADP employment (8:15am) May Pending home sales (10:00am) Apr Light vehicle sales May	3 Jun Initial claims (8:30am) w/e prior Sat Productivity and costs (8:30am) 1Q revision ISM nonmanufacturing (10:00am) May Factory orders (10:00am) Apr Chain store sales May Announce 3-year note $36 bn Announce 10-year note (r) $20 bn Announce 30-year bond (r) $13 bn Atlanta Fed Pres Lockhart (7:30am), Boston Fed Pres Rosengren (12:15pm) and KC Fed Pres Hoenig (1:15pm) speak	4 Jun Employment (8:30am) May Atlanta Fed President Lockhart speaks (9:30am)
7 Jun Consumer credit (3:00pm) Apr San Francisco Fed President Yellen speaks (5:00pm)	8 Jun NFIB survey (7:30am) May JOLTS (10:00am) Apr Auction 3-year note $36 bn Fed Governor Duke speaks (8:00am) and Kansas City Fed President Hoenig speaks (7:00pm)	9 Jun Wholesale trade (10:00am) Apr Beige book (2:00pm) Auction 10-year note (r) $20 bn	10 Jun Initial claims (8:30am) w/e prior Sat International trade (8:30am) Apr Flow of funds (12:00pm) 1Q Federal budget (2:00pm) May Auction 30-year bond (r) $13 bn	11 Jun Retail sales (8:30am) May Consumer sentiment (9:55am) Jun preliminary Business inventories (10:00am) Apr Philadelphia Fed President Plosser speaks (8:20am)
14 Jun	15 Jun Import prices (8:30am) May Empire State survey (8:30am) Jun TIC data (9:00am) Apr NAHB survey (1:00pm) Jun	16 Jun PPI (8:30am) May Housing starts (8:30am) May Industrial production (9:15am) May	17 Jun Initial claims (8:30am) w/e prior Sat CPI (8:30am) May Current account (8:30am) 1Q Philly Fed survey (10:00am) Jun Leading indicators (10:00am) May Announce 2-year note Announce 5-year note Announce 7-year note	18 Jun

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Euro area economic calendar

Monday	Tuesday	Wednesday	Thursday	Friday
24 May	25 May Euro area: Industrial new orders (11:00am) Mar Italy: ISAE cons. conf. (9:30am) May Netherlands: CBS bus. conf. (9:30am) May	26 May Germany: GfK cons. conf. (8:00am) Jun France: INSEE bus. conf. (8:45am) May Consumption of mfg goods (8:45am) Apr Belgium: BNB bus. conf. (3:00pm) May ECB member José Manuel González-Páramo speaks in Frankfurt, Germany (9:40am)	27 May Germany: CPI 6 states and prelim (8:00am) May <u>1.2%oya</u> France: INSEE cons. conf. (8:45am) May Italy: ISAE bus. conf. (9:30am) May Contractual wages (10:00am) Apr ECB member José Manuel González-Páramo speaks in Barcelona, Spain (1:00pm)	28 May Germany: Import prices (8:00am) Apr <u>7.1%oya, nsa</u> Spain: HICP flash (9:00am) May <u>1.6%oya, nsa</u> Belgium: CPI (11:15am) May <u>1.9%oya, nsa</u> ECB member Lorenzo Bini Smaghi speaks in Eltville, Germany (3:30pm)
31 May Euro area: M3 (10:00am) Apr EC business conf. (11:00am) May EC cons. conf. final (11:00am) May HICP flash (11:00am) May Germany: Retail sales (8:00am) Apr Italy: PPI (10:00am) Apr CPI prelim (11:00am) May	1 Jun Euro area: PMI Mfg final (10:00am) May Unemployment rate(11:00am) Apr Germany: PMI Mfg final (9:55am) May Employment (9:55am) Apr Unemployment (9:55am) May France: PPI (8:45am) Apr Employment final (8:45am) 1Q PMI Mfg final (9:50am) May Italy: PMI Mfg (9:45am) May Spain: PMI Mfg (9:15am) May	2 Jun Euro area: PPI (11:00am) Apr	3 Jun Euro area: PMI services & composite final (10:00am) May Retail sales (11:00am) Apr Germany: PMI services & composite final (9:55am) May France: ILO unemployment (8:45am) 1Q PMI services & composite final (9:50am) May Italy: PMI services & composite (9:45am) May Spain: PMI services & composite (9:15am) May Netherlands: CPI (9:30am) May	4 Jun Euro area: GDP prelim (11:00am) 1Q
7 Jun Germany: Mfg orders (12:00am) Apr	8 Jun Germany: Foreign trade (8:00am) Apr Industrial production (12:00am) Apr France: Foreign trade (8:45am) Apr Monthly budget situation (8:45am) Apr	9 Jun Belgium: GDP final (3:00am) 1Q	10 Jun Euro area: ECB rate announcement (1:45pm) <u>No change expected</u> ECB press conf. (2:30pm) Germany: CPI final (8:00am) May France: Industrial production (8:45am) Apr Italy: Industrial production (10:00am) Apr GDP final (11:00am) 1Q	11 Jun France: CPI (8:45am) May Spain: CPI final (9:00am) May
14 Jun Euro area: Industrial production (11:00am) Apr Italy: Labor costs (10:00am) 1Q	15 Jun Euro area: Foreign trade (11:00am) Apr Employment (11:00am) 1Q Germany: ZEW bus. survey (11:00am) Jun Italy: Foreign trade (10:00am) Apr Netherlands: Industrial production (9:30am) Apr	16 Jun Euro area: Labor costs (11:00am) 1Q HICP final (11:00am) May Italy: CPI final (10:00am) May	17 Jun Euro area: ECB monthly bulletin (10:00am) Jun	18 Jun Germany: PPI (8:00am) May Italy: Industrial orders (10:00am) Apr Netherlands: CBS cons. conf. (9:30am) Jun

Highlighted data are scheduled for release on or after the date shown. Times shown are local.

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Japan economic calendar

Monday	Tuesday	Wednesday	Thursday	Friday
24 May All sector activity index (1:30 pm) Mar -0.6%m/m, sa BoJ monthly economic report (2:00 pm)	25 May	26 May Corporate service prices (8:50 am) Apr -0.7%oya Shoko Chukin small business sentiment (2:00 pm) May 45.5, DI Minutes of Apr 30 BoJ MPM (8:50 am) BoJ governor Shirakawa's opening address at the 2010 international conference held at BoJ (9:30am) Auction 3-month bill	27 May Trade balance (8:50 am) Apr 690billion yen, sa Auction 2-year note	28 May Nationwide core CPI (8:30 am) Apr -1.7%oya All household spending (8:30 am) Apr -3.0%m/m, sa Unemployment rate (8:30 am) Apr 4.8%, sa Job offers to applicants ratio (8:30 am) Apr 0.51, sa Total retail sales (8:50 am) Apr 3.4%oya
31 May PMI manufacturing (8:15 am) May IP preliminary (8:50 am) Apr Nominal wages (10:30 am) Apr Housing starts (2:00 pm) Apr Construction orders (2:00 pm) Apr BoJ governor Shirakawa's speech at the Japan National Press club (1:30pm)	1 Jun Auto registrations (2:00 pm) May Auction 10-year bond	2 Jun Monetary base (8:50 am) May Auction 3-month bill	3 Jun PMI services/ composite (8:15 am) May MoF corporate survey (8:50 am) 1Q BoJ board member Suda's address in Wakayama prefecture (11:00am)	4 Jun Auction 6-month bill
7 Jun	8 Jun M2 (8:50 am) May Current account (8:50 a m) Apr Economy watcher survey (2:00 pm) May Coincident CI (2:00 pm) Apr Auction 30-year bond	9 Jun Private machinery orders (8:50 am) Apr Auction 3-month bill	10 Jun GDP 2nd est. (08:50am) 1Q Corporate goods prices (8:50 am) May Consumer sentiment (2:00 pm) May Auction 5-year note	11 Jun
During the week: Cabinet Office private consumption index Apr				
14 Jun MoF business outlook survey (8:50 am) 2Q IP final (1:30 pm) Apr BoJ Monetary Policy Meeting Auction 1-year bill	15 Jun BoJ Monetary Policy Meeting and statement BoJ governor Shirakawa's press conference (3:30 pm)	16 Jun Tertiary sector activity index (8:50 am) Apr BoJ monthly economic report (2:00 pm) Auction 3-month bill Auction 20-year bond	17 Jun Reuters Tankan (8:30 am) Jun Flow of funds (8:50 am) 1Q Construction spending (2:00 pm) Apr	18 Jun Minutes of May 10 and May 20-21 BoJ MPM s (8:50 am)
During the week: Nationwide department store sales May				

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Canada economic calendar

Monday	Tuesday	Wednesday	Thursday	Friday
24 May Victoria Day Markets closed	25 May	26 May Payroll employment (8:30am) Mar	27 May	28 May Current account (8:30am) 1Q -$7.3 bn
31 May Quarterly GDP (8:30am) 1Q Monthly GDP (8:30am) Mar IPPI (8:30am) Apr	1 Jun BoC rate announcement (9:00am)	2 Jun	3 Jun	4 Jun Employment (7:00am) May Building permits (8:30am) Apr Ivey PMI (10:00am) May
7 Jun	8 Jun Housing starts (8:15am) May	9 Jun	10 Jun International trade (8:30am) Apr New house price index (8:30am) Apr	11 Jun Capacity utilization (8:30am) 1Q
14 Jun New vehicle sales (8:30am) Apr	15 Jun Manufacturing sales (8:30am) Apr Productivity and costs (8:30am) 1Q Existing home sales Apr	16 Jun	17 Jun Wholesale sales (8:30am) Apr	18 Jun Leading indicators (8:30am) May

Highlighted data are scheduled for release on or after the date shown.

Latin America economic calendar

Monday	Tuesday	Wednesday	Thursday	Friday
24 May Brazil: FGV CPI IPC-S May 23 0.46%m/m, nsa Mexico: CPI 1H May -0.49%2w/2w Core 1H May 0.04%2w/2w Trade balance Apr *Holiday: Argentina, Ecuador*	25 May Brazil: Fipe CPI May 23 0.35%m/m, nsa Current account balance Apr -US$4.2bn FDI Apr US$2.8bn Mexico: Nominal GDP 1Q10 11%oya Unemployment rate Apr 4.9% Current account balance 1Q10 Central bank reserves *Holiday: Argentina*	26 May	27 May Brazil: Unemployment rate Apr 7.6% Primary budget balance Apr BRL14.8 billion Net Debt % GDP Apr 43.4% Colombia: BanRep meeting May no change	28 May Brazil: IGP-M May 1.32%m/m, nsa Chile: IP Apr Mexico: Public sector balance Apr Peru: GDP 1Q 6.6%oya
During the week: Venezuela: GDP 1Q -4.0%oya				
31 May Argentina: Construction activity Apr Chile: BCCh minutes Unemployment rate Apr Colombia: Unemployment rate Apr	1 Jun Brazil: IP Apr Trade balance May Mexico: Central bank reserves Banxico survey May Family remittances Apr Peru: CPI May WPI May	2 Jun Brazil: Fipe CPI May 30 Capacity utilization Apr	3 Jun Mexico: Consumer confidence May IMEF survey May Manufacturing Nonmanufacturing *Holiday: Brazil*	4 Jun Colombia: PPI May Ecuador: CPI May
During the week: Argentina: Government tax revenue May Colombia (Sat Jun 5): CPI May				
7 Jun Brazil: Auto Report (Anfavea) May Chile: Economic activity Apr Trade balance May *Holiday: Colombia, Venezuela*	8 Jun Brazil: GDP 1Q Chile: CPI May Mexico: Central bank reserves	9 Jun Brazil: COPOM meeting Jun IPCA May Mexico: CPI May Core May	10 Jun Brazil: Fipe CPI Jun 7 Mexico: Auto report May Wage negotiations May Peru: BCRP meeting Jun Trade balance Apr	11 Jun Argentina: CPI May WPI May Colombia: BanRep minutes Mexico: IP Apr Fixed investment Mar
During the week: Venezuela: CPI May				
14 Jun Mexico: ANTAD same-store sales *Holiday: Colombia*	15 Jun Chile: BCCh meeting Jun Mexico: Central bank reserves Peru: GDP Apr	16 Jun Brazil: IGP-10 Jun FGV CPI IPC-S Jun 11 Retail Sales Apr Colombia: Trade balance Apr	17 Jun	18 Jun Argentina: IP May GDP 1Q Current account balance 1Q Brazil: IGP-M 2nd rel Jun Colombia: IP Apr Retail sales Apr Mexico: Retail sales Banxico meeting
During the week: Argentina: Budget balance May Brazil: CAGED Formal job creation May				

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UK/Scandinavia/Switzerland economic calendar

Monday	Tuesday	Wednesday	Thursday	Friday
24 May United Kingdom: Speech by BoE's Adam Posen in London (6:30pm)	25 May United Kingdom: GDP Prelim (2nd release) (9:30am) 1Q 1.2 %q/q, saar Index of services (9:30am) Mar 0.2 %m/m, sa BBA mortgage lending (9:30am) Apr 2.5 ch £bn, sa (secured) Loan approvals 37.0 K, sa Sweden: Labor force survey (9:30am) Apr Norway: Sector accounts (10:00am) 1Q Switzerland: UBS cons. Indicator (8:00am) Apr	26 May Sweden: Trade balance (9:30am) Apr	27 May United Kingdom: CBI distributive trades (11:00am) May 13 %bal, sa Sweden: PPI (9:30am) Apr Switzerland: Employment (9:15am) 1Q	28 May United Kingdom: Gfk cons. conf. (12:01am) May -16%bal, sa Sweden: GDP (9:30am) 1Q 4.0%q/q saar Retail sales (9:30am) Apr Norway: Labor directorate unemployment (9:00am) May Mfg wage index (10:00am) 1Q AKU unemployment (10:00am) Mar Switzerland: Trade balance (8:15am) Apr KOF leading indicator (11:30am) May 2.05 Index, sa
During the week : United Kingdom: Nationwide HPI (08:00am) May 0.5 %m/m, sa				
31 May Sweden: Business tendency (9:15am) May Consumer conf. (9:15am) May Wage stats (9:30am) Mar Norway: Retail sales (10:00am) Apr Credit indicator (10:00am) Apr	1 Jun United Kingdom: PMI mfg (9:30am) May Sweden: PMI (8:30am) May Financial Stability Report 2010:1 (9:30am) Norway: PMI mfg (9:00am) May NEF HPI (11:00am) May Switzerland: GDP (7:45am) 1Q 2.4%q/q, saar PMI (9:30am) May 65.5 %bal, sa	2 Jun United Kingdom: Net lending to individuals (9:30am) Apr M4 & M4 lending final (9:30am) Apr PMI construction (9:30am) May	3 Jun United Kingdom: PMI services (9:30am) May	4 Jun United Kingdom: New car regs. (9:00am) May Switzerland: SNB's Philipp Hildebrand speaks (9:40am)
During the week : United Kingdom: Halifax HPI May				
7 Jun Norway: IP Mfg (10:00am) Apr	8 Jun United Kingdom: BRC retail sales (12:01am) May Norway: Gallup cons. Conf. (7:00am) 2Q Norges Bank's Governor Svein Gjedrem speaks Switzerland: Unemployment (7:45am) May CPI (9:15am) May	9 Jun United Kingdom: N'wide cons. conf.(12:01am) May Markit jobs report (12:01am) May Trade balance (9:30am) Apr Quoted mortgage int. rates May Sweden: TNS prospers inflation expectation survey 2Q Industrial production and orders (9:30am) Apr Norway: Regional network 2/10 (10:00am)	10 Jun United Kingdom: MPC rate announcement and Asset purchase target (12:00pm) No change expected Sweden: CPI (9:30am) May AMV unemployment (10:00am) May Norway: CPI (10:00am) May PPI (10:00am) May	11 Jun United Kingdom: Industrial production (9:30am) Apr PPI (9:30am) Apr
14 Jun United Kingdom: BoE quarterly bulletin Q1 Switzerland: Producer and import prices (9:15am) May	15 Jun United Kingdom: RICS HPI (12:01am) May CPI (9:30am) May DCLG HPI (9:30am) Apr Norway: Trade balance (10:00am) May	16 Jun United Kingdom: Labor market report (9:30am) May	17 Jun United Kingdom: Retail sales (9:30am) May CBI industrial trends (11:00am) Jun BoE/Gfk NOP Inflation Attitudes Survey (10:20am) Sweden: Labor force survey (9:30am) May House prices (9:30am) May Switzerland: Industrial production (9:15am) 1Q SNB rate announcement (09:30am) No change expected Fin. Stab. Report 2010 (10:00am)	18 Jun United Kingdom: M4 an M4 lending prelim (9:30am) May Public sector finances (9:30am) May Construction output (9:30am) 1Q

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Emerging Europe/Middle East/Africa economic calendar

Monday	Tuesday	Wednesday	Thursday	Friday
24 May Israel: Monetary policy announcement <u>+25bp</u> Turkey: Capacity utilization (10:00am) May <u>72.7%</u> Russia: Retail sales Apr <u>4.0%</u> Unemployment Apr <u>8.1%</u> Capital investment Apr <u>1.5%</u>	25 May Hungary: Retail sales (9:00am) Mar <u>-4.2%oya</u> Poland: Monetary policy announcement <u>No change</u> South Africa: GDP (11:30am) 1Q <u>1.4%oya</u>	26 May Poland: Retail sales (10:00am) Mar <u>4.5%oya</u> South Africa: CPI (11:30am) Apr <u>5.0%oya</u>	27 May South Africa: PPI (11:30am) Apr <u>4.6%oya</u>	28 May Czech Rep: General elections on 28-29 May
During the week:				
31 May Hungary: PPI (9:00am) Apr <u>-1.2%oya</u> Monetary policy announcement <u>No change</u> Poland: GDP (10:00am) 1Q <u>3.2%oya</u> Turkey: Foreign trade (10:00am) Apr South Africa: Credit & money (8:00am) Apr Private sector credit <u>-0.5%oya</u> Trade balance (2:00pm) Apr	1 June Czech Rep: PMI (9:30am) Apr Hungary: PMI (9:00am) Apr Poland: PMI (9:00am) Apr Turkey: PMI (10:00am) Apr Russia: Manufacturing PMI Apr South Africa: Kagiso PMI (11:00am) May <u>57.0</u>	2 June South Africa: Vehicle sales (11:00am) May	3 June Romania: Retail sales (10:00am) Apr Turkey: CPI (10:00am) Apr PPI (10:00am) Apr	4 June Hungary: Industrial output (9:00am) Apr <u>9.2%oya, wda</u>
During the week:				
7 June Czech Rep: Trade balance (9:00am) Apr Industrial output (9:00am) Apr Retail sales (9:00am) Apr South Africa: Gross reserves (8:00am) May	8 June Czech Rep: Current account (10:00am) 1Q Hungary: Trade balance (9:00am) Apr Romania: Industrial output (10:00am) Apr Turkey: Industrial production (10:00am) Apr	9 June Czech Rep: CPI (9:00am) May GDP final (9:00am) 1Q Hungary: Central bank minutes GDP final (9:00am) 1Q Romania: Trade balance (10:00am) Apr	10 June Romania: CPI (10:00am) May	11 June Hungary: CPI (9:00am) Apr Turkey: Current account (10:00am) Apr
During the week:				
14 June Poland: Current account (2:00pm) Apr	15 June Czech Rep: PPI (9:00am) May Poland: CPI (2:00pm) May Turkey: Unemployment (10:00am) Mar Israel: CPI (6:00pm) May	16 June Czech Rep: Current account (10:00am) Apr Romania: Current account Apr Turkey: Consumer confidence (10:00am) May	17 June Poland: Average gross wages & employment (2:00pm) May Turkey: Monetary policy announcement	18 June Hungary: Average gross wages (9:00am) Apr Poland: PPI (2:00pm) May Industrial output (2:00pm) May
During the week:				

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Non-Japan Asia economic calendar

Monday	Tuesday	Wednesday	Thursday	Friday
24 May Australia: New motor vehicle sales (11: 30 am) Apr -3.5%m/m, sa Singapore: CPI (1:00 pm) Apr 3.3%oya Taiwan: Unemployment rate (4:00 pm) Apr 5.5%, sa IP (4:00 pm) Apr 33.7 %oya Thailand: GDP (9:30 am) 1Q 8.4%oya	25 May	26 May Australia: Westpac leading index (10: 30 am) Mar Construction work done (11:30 am) 1Q -1.0% q/q, sa Philippines: Imports (9.00 am) Mar 4.6US$ bn Singapore: IP (1:00 pm) Apr 16.0%oya	27 May Australia: Private capital expenditure (11:30 am) 1Q 5.0% q/q, sa Hong Kong: Trade balance (4:30 pm) Apr 27.8 HK$ bn Korea: Current account (8:00 am) Apr 2.7US$ bn Philippines: GDP (10:00am) 1Q 4.6%oya New Zealand: Trade balance (10:45 am) Apr 500NZ$ mn Taiwan: Leading index (4:00 pm) Apr *Holiday India*	28 May New Zealand: Building permits (10:45 am) Apr -2.0%m/m, sa *Holiday Indonesia, Malaysia, Singapore, Thailand*
During the week: Korea: FKI business survey May 105.0 Index, nsa Consumer survey May 107.0 Index, nsa Vietnam: CPI May 10.0%oya Trade balance May -1.5US$ bn				
31 May Australia: Pvt. Sector credit (11:30 am) Apr Current account balance (11:30 am) 1Q Company operating profits 1Q India: GDP 1Q Korea: IP (8:00 am) Apr Leading index (8:00 am) Apr Service sector activity (8:00 am) Apr Thailand: Trade balance (2:30 pm) Apr IP (2:30 pm) Apr PCI, PII(2:30 pm) Apr	1 Jun Australia: Building approvals (11:30 am) Apr Retail sales (11:30am) Apr RBA cash target (3:30 pm) Jun China: PMI manufacturing May Hong Kong: Retail sales (4:30 pm) Apr India: PMI May Trade balance Apr Korea: CPI (8:00 am) May Trade balance (10:00 am) May Indonesia: CPI (2:00 pm) May Trade balance (2:00 pm) Apr Thailand: CPI (2:00 pm) May	2 Jun Australia: GDP (11:30 am) 1Q New Zealand: ANZ commodity price (3:00 pm) May Singapore: PMI (9:30 pm) May Thailand: BoT monetary policy meeting (2:30 pm) Jun	3 Jun Australia: Trade balance (11:30 am) Apr Philippines: CPI (9:00 am) May BSP Monetary policy meeting (5:00 pm) Jun	4 Jun Indonesia: BI rate announcement (1:00 pm) Jun Korea: GDP (8:00 am) 1Q F Malaysia: Trade balance (6:00 pm) Apr Philippines: CPI (9:00 am) May
7 Jun Australia: ANZ job ads (11:30 am) May New Zealand: QVNZ house prices May Taiwan: CPI (4: 00 pm) May Trade balance (4:00 pm) Apr *Holiday New Zealand*	8 Jun Korea: PPI (12:00 pm) May New Zealand: Manufacturing activity (10: 30 am) 1Q	9 Jun Australia: Westpac consumer confidence (10: 30 am) Jun NAB bus. Confidence (11: 30 am) May Housing finance approvals (11:30 am) Apr Korea: Unemployment rate (9:00am) May Money supply (12:00 pm) May	10 Jun Australia: Unemployment rate (11: 30 am) May New Zealand: RBNZ official cash rate (9:00 am) Jun Business NZ PMI (10:30 pm) May Terms of trade (10:45 am) 1Q China: Trade balance (12:00 pm) May Korea: BoK monetary policy meeting (10:00 am) Jun Malaysia: IP (12:00 pm) Apr Philippines: Exports (9:00 am) Apr	11 Jun China: CPI 10:00 am) May PPI(10:00 am) May FAI (10:00am) May Retail sales (10:00 am) May IP (10:00 am) May India: IP Apr
During the week: China: Money supply May				
14 Jun India: WPI (12:00 pm) May Korea: Export price index, Import price index (12:00 pm) May New Zealand: Retail sales (10:45 am) Apr *Holiday Australia, China, Philippines*	15 Jun Singapore: Retail sales (1:00 pm) May *Holiday China*	16 Jun Australia: Westpac leading index (10: 30 am) Apr Dwelling starts (11:30 am) 1Q Malaysia: CPI (5:00 pm) May Philippines: OFW remittances Apr *Holiday China, Hong Kong, Taiwan*	17 Jun Hong Kong: Unemployment rate (4:30 pm) May Singapore: NODX (1:00 pm) May	18 Jun
During the week: China: FDI May Philippines: Budget balance May				

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Global Data Diary

Week / Weekend	Monday	Tuesday	Wednesday	Thursday	Friday
24 - 28 May	24 May	25 May	26 May	27 May	28 May
	Israel • BoI mtg: +25bp Japan • All sector act index (Mar) Russia • Retail sales (Apr) Thailand • GDP (1Q) United States • Existing home sales (Apr)	Euro area • Ind new orders (Mar) Italy • ISAE cons confl (May) Poland • NBP mtg: no change South Africa • GDP (1Q) United Kingdom • GDP prelim (1Q) United States • Case-Shiller HPI (Mar) • Consumer conf (May) • FHFA HPI (Mar) • Bernanke speech	France • INSEE bus conf (May) • Consumption of mfg goods (Apr) Japan • Shoko Chukin (May) • BoJ MPM minutes (Apr) • Shirakawa speech United States • Durable goods (Apr) • New home sales (Apr)	Colombia • BanRep mtg: no change France • INSEE cons conf (May) Italy • ISAE business conf (May) Japan • Trade balance (Apr) Philippines • GDP (1Q) United States • Real GDP 2nd rel (1Q)	Japan • Core CPI (Apr) • Household spending (Apr) • Retail sales (Apr) • Unemployment (Apr) Sweden • GDP (1Q) United States • Chicago PMI (May) • Consumer sentiment final (May) • Personal income (Apr)
31 May - 4 June	31 May	1 June	2 June	3 June	4 June
Germany • Retail sales (Apr)	Canada • GDP (1Q) Euro area • EC business conf (May) • HICP flash (May) Hungary • NBH mtg: no change India • GDP (1Q) Japan • IP prelim (Apr) • PMI mfg final (May) • Shirakawa speech Korea • IP (Apr) United States • Memorial Day: markets closed	Canada • BoC meeting: no change Euro area • PMI mfg final (May) United States • ISM mfg (May) PMI • Czech Republic, Hungary, Poland, Sweden, Switzerland, Turkey (May) PMI manufacturing • China, Norway, Russia, South Africa, UK (May)	Australia • GDP (1Q) Euro area • PPI (Apr) United States • Light vehicle sales (May) • Pending home sales (Apr) Thailand • BoT meeting: no change	Euro area • PMI services/comp (May) • Retail sales (Apr) Japan • PMI services/comp (May) • MoF corporate survey (May) Philippines • BSP meeting: +25bp United Kingdom • PMI services (May) United States • Factory orders (Apr) • ISM nonmfg (May) • Productivity and costs (1Q)	Euro area • GDP prelim (1Q) Indonesia • BI meeting: no change Switzerland • Hildebrand speech United States • Employment (May)