Global Economics
4 May 2007

Hong Kong • London • Mumbai • New York • Sydney • Tokyo

Global Weekly Economic Monitor

Bird Watching

Inflation concerns keep central banks in a hawkish mood.

LEHMAN BROTHERS
Where vision gets built. SM

REGULARS

Forecast Summary **2**
The Week Ahead........................ **3**
Economic Themes........................**4**
The Week At A Glance....... **16-17**
Energy Outlook.................. **79-80**
Equity Outlook................... **81-82**
The World At A Glance...... **84-85**
Global Economics Team........... **86**

DATA VIEW

United States...................... **18-26**
Canada **27-29**
Euro Area........................... **33-41**
United Kingdom................. **43-48**
Scandinavia & Switzerland. **49-51**
Japan **52-56**
Asia Ex-Japan **59-70**
Emerging Europe & Africa. **71-76**

GLOBAL

Global Letter
US flu vaccine **5**
If the US sneezes does the world catch a cold? Probably not this time.

Energy Overview
All hype: OPEC's disappointing capacity growth **77-78**
OPEC's 2007 average capacity looks set to grow only 300k b/d y-o-y.

UNITED STATES

Overview
Can the Fed declare victory and cut rates? **6-7**
Weak data have renewed the call for rate cuts but the Fed will likely stay on hold.

EUROPE

Overview
Papering over the cracks **8-9**
Sooner or later, the ECB should respond to questions about M3 money demand.

Focus
The French consumption lifeline **30-32**
A slowing housing market poses downside risks to French consumer spending.

Focus
UK: 25 or 50? **42**
While a 50bp rate hike is possible, we expect 25bp hikes in May and August.

JAPAN

Overview
Cloudy outlook **10-11**
The data point to solid growth in Q1, but the cyclical outlook is looking cloudier.

ASIA EX-JAPAN

Overview
The mixed blessing of capital inflows **12-13**
There is no "silver bullet" policy response. The danger is some economies overheat.

Focus
India: New challenges for the RBI **57-58**
Balancing the costs and benefits of FX intervention is a tightrope walk for the RBI.

EMERGING MARKETS

Overview
Turkey: A close shave **14-15**
A more diverse parliament may herald an improved political outlook.

FORECAST SUMMARY: KEY FEATURES OF OUR FORECASTS[1]

		3Q06	4Q06	1Q07	2Q07	3Q07	4Q07	2006	2007	2008
GDP growth										
Global [3]	Modal forecast	1.9	3.3	2.0	2.3	2.2 ↓	2.3 ↓	2.9	2.4	2.3
	Upper bound	1.9	3.3	2.5 ↓	3.9	3.8 ↓	3.9 ↓	2.9	2.9 ↓	3.8
	Lower bound	1.9	3.3	1.5 ↑	0.7	0.4 ↓	0.4	2.9	1.4 ↑	0.6
US	Modal forecast	2.0	2.5	1.3 ↓	2.7 ↑	2.2 ↓	2.4 ↓	3.3	2.1 ↓	2.5
	Upper bound	2.0	2.5	1.3 ↓	4.2 ↑	3.7 ↓	3.9 ↓	3.3	2.7 ↓	4.0
	Lower bound	2.0	2.5	1.3 ↑	1.2 ↑	0.7 ↓	0.9 ↓	3.3	1.5	1.0
Euro area	Modal forecast	2.4	3.6	2.4	2.2	2.1	2.1	2.8	2.6	2.0
	Upper bound	2.4	3.6	3.0	3.4	3.6	3.8	2.8	2.8	3.7
	Lower bound	2.4	3.6	1.8	1.0	0.6	0.4	2.8	1.1	0.0
UK	Modal forecast	2.7	2.7	2.8	2.8	1.8	1.7	2.8	2.6	2.2
	Upper bound	2.7	2.7	2.8	3.8	3.3	3.2	2.8	3.6	3.7
	Lower bound	2.7	2.7	2.8	1.8	0.3	0.2	2.8	1.6	0.7
Japan	Modal forecast	0.5	5.5	2.6 ↑	1.2 ↓	2.0 ↓	2.7	2.2	2.4 ↑	2.5
	Upper bound	0.5	5.5	3.6 ↑	3.5 ↓	4.0	4.0	2.2	3.2	3.4
	Lower bound	0.5	5.5	1.6 ↑	-1.0 ↓	-0.5	-0.5	2.2	1.6 ↑	0.5
Emerging Markets [2]										
	Emerging Europe & SA	-	-	-	-	-	-	5.6	5.2 ↑	5.2 ↑
	Asia ex-Japan	-	-	-	-	-	-	8.4	8.0	8.2
Inflation (% y-o-y)										
Global [3]		2.4	1.6	1.8	1.7	1.8	2.5	2.3	2.0	2.1
US		3.4	1.9	2.4	2.4	2.5	3.6	3.2	2.7	2.7
Euro area		2.1	1.8	1.9	1.7	1.8	2.2	2.2	1.9	2.1
UK		2.4	2.7	2.9	2.6	2.1	2.2	2.3	2.4	2.2
Japan		0.6	0.3	-0.1	-0.1 ↓	0.0 ↓	0.3	0.2	0.0 ↓	0.5
Brent oil price ($ per barrel) [4]		70.7	60.6	58.6	65.0	74.0	72.0	66.2	67.5	72.0
Official interest rates (%)										
US		5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	4.75
Euro area		3.00	3.50	3.75	4.00	4.25	4.25	3.50	4.25	4.25
UK		4.75	5.00	5.25	5.50	5.75	5.75	5.00	5.75	5.75
Japan		0.25	0.25	0.50	0.50	0.75	1.00	0.25	1.00	1.75
10-year bond yields (%)										
US (Treasury)		4.63	4.70	4.65	4.75	4.80	4.80	4.70	4.80	4.80
Euro area (Bund)		3.71	3.92	4.06	4.15	4.20	4.15	3.92	4.15	3.95
UK (Gilts)		4.52	4.74	4.97	5.06	5.12	5.09	4.74	5.09	4.89
Japan (JGB)		1.68	1.75	1.70	1.80	1.95	2.20	1.75	2.20	2.60
Exchange rates										
$/euro		1.27	1.32	1.32	1.38	1.35	1.31	1.32	1.31	1.25
yen/$		117	117	117	118	116	112	117	112	100
$/ £		1.87	1.96	1.95	2.03	1.96	1.87	1.96	1.87	1.71

1 *All forecasts are modal forecasts unless stated. The upper and lower bounds define an interval with a 5% chance of an outcome above the former and a 5% chance of an outcome below the latter. Annual GDP is % y-o-y, quarterly GDP growth figures are % q-o-q (saar). Inflation and oil forecasts are period averages. Official interest rates, 10yr yields and exchange rates are end of period. The ↑↓ arrows signify changes from last week.*

2 *Countries covered in the emerging markets are: Emerging Europe & South Africa:- Hungary, Poland, Russia, Turkey, South Africa; Asia ex-Japan:- China, India, Hong Kong, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan, Thailand.*

3 *Global GDP and inflation figures are proxied using data/forecasts for the United States, European Union, Japan and Canada.*

4 *From 17 November 2006, the oil price forecast (period averages) has been changed from an assumption based on the oil futures market to a forecast developed by our Chief Energy Economist Ed Morse (see "Crude oil prices: Launching our forecast", 17 November 2006, for more details).*

THE WEEK AHEAD

GLOBAL: BIRD WATCHING

Inflation concerns should prompt a mildly hawkish statement from the Fed, very hawkish rhetoric from the ECB and a rate hike from the Bank of England.

UNITED STATES: CLOSE CALL ON FOMC BIAS

The FOMC should keep rates on hold. They may modify, but are unlikely to drop, their anti-inflation bias. The trade balance and retail sales will provide clues about Q1 GDP revisions.

		Previous	Lehman	Consensus
Wednesday:	**FOMC meeting**			
Thursday:	**Trade balance** (Mar)	-$58.4bn	-61.5	-60.0
Friday:	**PPI** (Apr)	1.0% m-o-m	0.5	0.5
	Core PPI (Apr)	0.0% m-o-m	0.2	0.2
	Retail sales (Apr)	0.7% m-o-m	0.4	0.3
	Retail sales ex-autos (Apr)	0.8% m-o-m	0.5	0.4

EUROPE: CENTRAL BANKS IN THE LIMELIGHT

Central banks will take the limelight in Europe this week. We expect a firmly hawkish tone from the ECB press conference—reflecting solid growth momentum—and strong hints that a rate hike is likely to be implemented in June. In the UK, a 25bp rate hike is fully priced in by markets. So attention will focus on the accompanying statement for hints of the timing and extent of any further rate hikes.

		Previous	Lehman	Consensus
Monday:	**Germany manufacturing orders** (Mar)	3.9% m-o-m	-1.5	-0.5
Tuesday:	**Germany industrial production** (Mar)	0.9% m-o-m	0.0	0.0
Thursday:	**France industrial production** (Mar)	1.1% m-o-m	-0.2	0.3
	ECB governing council meeting (May)	3.75%	3.75	3.75
	UK manufacturing output (Mar)	-0.6% m-o-m	0.5	0.4
	UK MPC meeting (May)	5.25%	5.50	5.50

ASIA: STRONG CHINESE EXPORTS

China's export growth should rebound in April after falling sharply in March, which was a payback for the frontloading of shipments in February ahead of anticipated tax changes. On the monetary policy front, we expect the Bank of Korea to keep rates on hold, but Bank Indonesia is likely to cut rates by 25bp. In Japan, we expect bank lending growth to have slowed further in April, suggesting that corporations and households remain cautious about taking on debt.

		Previous	Lehman	Consensus
Sometime:	**China export** (Apr)	6.9% y-o-y	30.0	17.4
Tuesday:	**Indonesia central bank meeting** (May)	9.00%	8.75	8.75
Thursday:	**Japan bank lending, adjusted** (Apr)	2.1% y-o-y	1.6	n.a.
	South Korea central bank meeting (May)	4.50%	4.50	n.a.

ECONOMIC THEMES

GLOBAL

- We expect the global economy to weather the US-led slowdown and recent market distress.
- The main risk to global growth is worse-than-expected collateral damage from the US housing market slump.
- We see the Fed on hold, at least two more hikes from the ECB and a long, but slow, cycle of rate hikes from the BOJ.
- We expect the dollar to fall as global imbalances are worked out, with Asia playing a big part. But the timing is uncertain.
- With demand firm and supply tight, we forecast oil prices to continue to ratchet up in 2007, likely peaking in Q3.

UNITED STATES

- The Fed is likely on hold all year, although rate cuts are now more likely than rate increases.
- Despite below-trend GDP growth, inflation will likely remain above the Fed's implicit comfort zone throughout 2007.
- Subprime mortgage problems will likely extend the housing recession, but the pace of construction cuts should slow.
- We expect a mild slowdown in consumer spending, as healthy income growth offsets declining housing wealth.
- Tight labor and commodity markets, slowing productivity growth and rising import prices suggest upside inflation risks.

EUROPE

- Latest data suggest that the economy has maintained strong momentum at the start of 2007.
- We are more optimistic than the consensus on 2007 growth, looking for a rate of 2.6% but a slowdown to 2.0% in 2008.
- Base effects from energy price moves are likely to cause significant swings in headline inflation for the rest of this year.
- We expect the ECB to hike rates by 25bp in both June and September, and possibly in December too.
- UK CPI figures have been strong and we judge that inflation will remain at or above 2% for the rest of the year.
- We expect 25bp rate hikes from the BOE in May and in August, taking rates to their highest level since early 2001.

JAPAN

- The economy is emerging from a secular deflation but an aging cycle and policy tightening pose risks to the reflation.
- The key macro drivers of deflation – falling land prices and de-leveraging – appear to have reached a turning point.
- The corporate sector recovery has yet to feed through to wages and consumption, but should gradually start to do so.
- After years of deflation, a "mountain of cash" exists: a move into risk/real assets would move markets and buoy activity.
- The BOJ is set to hike rates gradually but will go faster if growth looks like accelerating or it sees signs of "overheating".

EMERGING MARKETS

- Poland: With inflation below the NBP's target, we believe that rates are likely to remain on hold at 4%.
- Hungary: We expect the government's fiscal package to have a positive effect in the medium term.
- Turkey: The EU story dominates. Economic imbalances are not being unwound at the pace that we had anticipated.
- Asia: With inflation low and public finances healthy, the region is well positioned to weather a global slowdown.
- China: The slow pace at which the government carries out economic reforms risks prolonging the unbalanced growth.
- India: There are some symptoms of overheating, but potential growth is rising and has scope to rise further.
- Korea: We detect incipient signs of an economic upswing, but we are cautious due to the many downside external risks.
- Brazil: The virtuous cycle of falling interest rates, growth and improved credit indicators should continue.

GLOBAL LETTER

US flu vaccine

Ethan Harris
212 526 5477
eharris@lehman.com

Zach Pandl
212 526 8010
zapandl@lehman.com

If the US sneezes does the world catch a cold? Probably not this time.

The US plays a special role in the global economy and markets. There appears to be a "CNN effect" where US news affects the world out of proportion to its share of GDP and market capitalizations. And yet today, with a visible weakening in US growth, the global economy and markets remain strong. Will the "American flu" spread?

A recent IMF study argues—correctly, in our view—that contagion effects are not as great as they appear on the surface ("Decoupling the Train?" WEO April 2007). It is true that foreign economies often go into recession at about the same time as the US (Figure 1). However, foreign growth appeared unaffected around two recent US slowdowns. Moreover, the synchronized recessions of the past have often been the result of common factors or shocks rather than US contagion effects. Oil shocks, inflation-fighting central banks and the popping of the IT bubble in 2000 were global, not US-specific, shocks.

In the current period there are a number of reasons to expect decoupling of US and global growth. First, the energy shock hurts consumers in the US (and other consuming nations) but it transfers spending power to oil producers who have been relatively quick to spend the windfall, boosting their economies and the economies of their trading partners. Second, the main shock to the US economy, a collapse in home demand, is almost purely a US problem—only a few other countries face serious housing risks and the US housing industry is a low-import sector. Third, the sources of strength overseas are also country specific. Euro-area reform at first weakened growth but now supports it, Japan is emerging from a unique deflation problem, China is determined keep the juggernaut going to move workers into the manufacturing sector, and many emerging market economies such as Brazil are reaping the rewards of more disciplined policy.

There are two caveats to this pretty picture. First, globalization has increased both financial and economic linkages. Second, there is a big difference between a housing-related slowdown and a full-blown US recession. If the housing recession spreads to the two remaining pillars of US growth—consumption and employment—and if the US stock market takes a tumble, the global economy will have a hard time ignoring the "US problem." As the figures show, the world does pay attention to US recessions and major stock market moves. Ah-choo!■

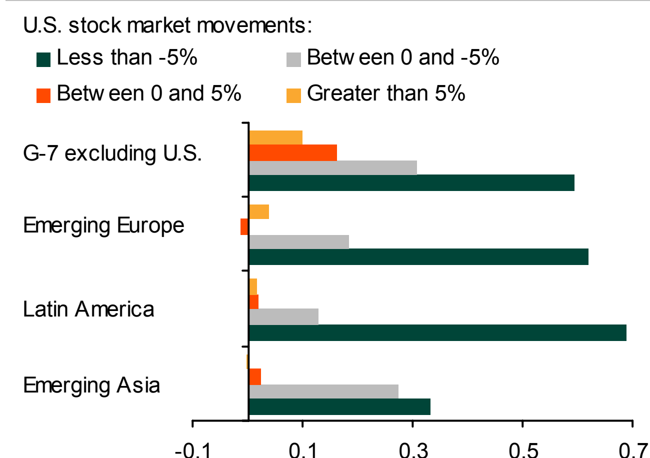
Figure 1. Global growth during US downturns

Change in GDP growth (median for region)

	All Recessions	Slowdowns 1986	Slowdowns 1995
United States	-3.8	-0.7	-1.5
Other industrial countries	-2.0	-0.1	-0.3
Latin America	-1.7	1.9	0.0
Middle East and North Africa	-0.6	-0.2	0.7
Emerging Asia	-1.3	0.9	0.3
Sub-Saharan Africa	0.2	-0.6	1.9
Emerging Europe and CIS	-3.6	--	3.8

Source: IMF World Economic Outlook, April 2007.

Figure 2. Correlation between US and global markets



Source: IMF World Economic Outlook, April 2007.

UNITED STATES: OVERVIEW

Can the Fed declare victory and cut rates?

Ethan Harris
+ 1 212 526 5477
eharris@lehman.com

Weak data have brought the perma-bears out of hibernation, renewing the call for multiple Fed rate cuts. The Fed will likely prove very reluctant to heed these calls.

Hope springs eternal

The market continues to price in rate cuts from the Fed…

Since the start of the recent tightening cycle in June 2004 the markets have consistently priced in a weaker-than-warranted path for the funds rate (Figure 1). Recent soft data—anemic 1.3% Q1 GDP growth and moderating 2.1% core PCE inflation—have revived the rate-cut story in the past week. Although rate cuts are possible, we are sticking to our baseline view: the Fed is on hold until Q3 2008. Indeed, at the coming FOMC meeting we expect the Fed to reiterate that the "predominant policy concern remains the risk that inflation will fail to moderate as expected."

What if the core falls below 2%?

… and weak growth and inflation data have encouraged this view

Among perma-bears there is a sense that the Fed is always just a couple of bad numbers away from a rate cut. A second quarter of sub-2% GDP, a couple of more months of sub-100,000 payrolls or a slide below 2% in the year-over-year core PCE deflator could be enough to get a rate cut. In reality the Fed outlook is more complicated.

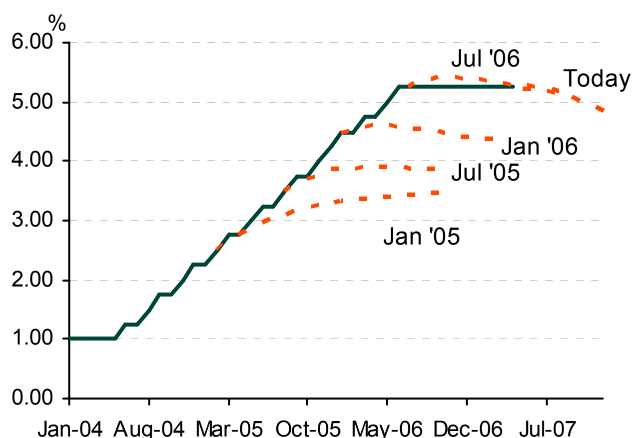
But the Fed is likely skeptical about Q1 GDP…

There is no magic rate-cut threshold for the Fed. Like most economists, Fed officials must be skeptical about the low Q1 GDP number. Defense spending fell 6.6% on the quarter, slicing 0.3pp from GDP growth. This is clearly a blip off its 2% trend growth rate. Trade sliced another 0.5pp off growth, but surely given the weak dollar and stronger growth overseas trade should be a neutral or positive contributor going forward. And inventory investment tumbled further to just $14bn, cutting 0.3pp from growth. We would expect inventory investment to roughly match final sales growth, suggesting a small positive contribution to growth in the coming quarters. Add it all up and "true" Q1 growth was 2½%.

… and is comfortable with some slowing in the labor market

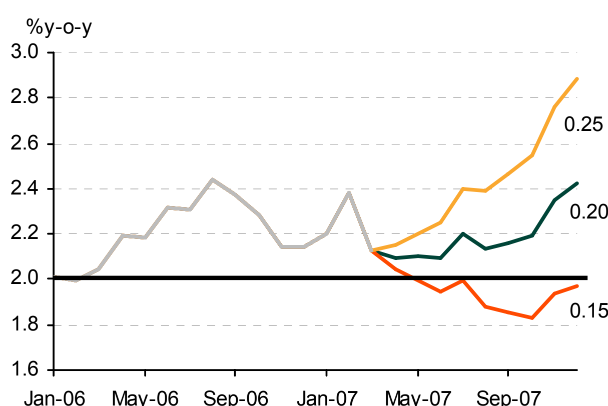
The Fed probably is also comfortable with the labor market. From the Fed's perspective, presumably some loosening of the labor market is acceptable as long as it is not accompanied by a broader weakening of the economy. A number of Fed officials have argued that the trend payroll employment has slowed to roughly 100,000. A moderately sub-100,000 number may be the price we have to pay to ease labor cost pressures.

Figure 1. Fed funds: expected and actual



Source: Fediscope.
Note: Market expectations for six months ahead, "Today" is as of 2 May.

Figure 2. Core PCE scenarios



Source: Commerce Department.

The Fed will be even more cautious in reacting to inflation…

The Fed will be even more cautious in reacting to inflation. The flat March core PCE number dropped year-over-year inflation from 2.38% to 2.12%. We think this was a fluke, reflecting unusual weakness in medical and apparel costs. Nonetheless, with a little luck and some friendly "base effects," year-over-year core PCE inflation could drop below 2% in the next several months. Last spring, there were four strong monthly readings in a row starting in March. In the 12-month growth calculation, if those 0.3% and 0.2% readings are replaced with 0.1% readings, the core should drop below 2% by the May release (the day after the Fed's June 27-28 FOMC meeting). Even with 0.15% readings core inflation should slip below 2% in June (Figure 2). Surely if GDP growth is still weak, this sub-2% inflation number will give the Fed grounds to cut rates?

… as it takes seriously the 1-2% core PCE range

Even in this environment a rate cut is far from a done deal. For most FOMC members 2% is not the ultimate target. Roughly half of the current FOMC has endorsed a 1% to 2% range, and several have underscored that 1.5% is the middle of that range. Virtually all members have made clear that they are not happy with 2%-plus core inflation. Since Philadelphia President Santomoro retired, no FOMC member has explicitly favored a higher range than Bernanke.

Secrets of the Temple

The FOMC discussed an inflation target under Greenspan, but did not make it public

This is not a radical position for the Fed. Back at the July 1996 FOMC meeting then-Governor Yellen spearheaded a discussion about the "price stability objective." Despite her current dovish reputation, in 1996 she made a detailed case for 2% as a sensible objective for CPI inflation. Allowing for measurement differences at the time, this was consistent with a 1.5% objective for the PCE deflator. At the end of that meeting Greenspan concluded "we have now agreed on 2 percent." The super-secretive chairman went on to warn his committee: "I will tell you that if the 2 percent inflation figure gets out of this room, it's going to create more problems for us than I think any of you might anticipate." In other words, the only thing new today is that Bernanke has opened up this messy discussion.

You've got to ask yourself one question: do I feel lucky?

We believe rate cuts are unlikely unless inflation fundamentals improve

Not only is the FOMC serious about getting the core below 2%, it does not want to declare victory on inflation prematurely. The last thing it wants to do is say "mission accomplished," and cut rates, only to see inflation pop back up again. This fear of flip-flopping explains why Fed policy tends to move slowly except during economic or financial meltdowns.

Can the Fed be confident that any drop in the core will be sustained? The core has flirted with the 2% "line" four times in the last three years only to bounce back up again. There are some reasons to expect inflation to fall—GDP growth is slow and housing vacancies may take some of the heat off rent. However, most inflation indicators point to upside risks:

- At 4.5% the unemployment rate remains below most measures of NAIRU.
- Most labor cost measures have picked up.
- The latest 73 reading for ISM prices paid confirms that commodity pressure is rapidly awakening from its winter nap.
- Productivity growth has slowed from a peak of 4% to below 2%, making it harder to offset labor and commodity costs.
- Import prices for consumer products are accelerating.
- Measures of inflation expectations have picked up slightly
- Inflation pressures are building on a global basis.

Perhaps all the inflationary bullets have been fired, or maybe not.■

EUROPE: OVERVIEW

Papering over the cracks

Michael Hume
+44 (0)20 7102 4191
mhume@lehman.com

Sooner or later, Christian Noyer's public questioning of the stability of euro-area M3 money demand will require a public answer from the governing council.

Following its April policy meeting the president of the ECB, Jean-Claude Trichet, indicated that he did not wish to say anything "that would be aiming at changing [market interest rate] expectations for the month of June". Since then, the news has been balanced with signs of increasing domestic strength but also growing concerns about the health of the US economy. Hand in hand with these developments, the euro-dollar exchange rate has continued to rise. But with the currency moves having been orderly and gradual, less pronounced in trade-weighted terms and, importantly, reflecting underlying fundamentals, we doubt the ECB will wish to make much of them. Instead, we expect the prepared statement of the governing council to reflect the upbeat mood of the domestic data and signal – using the code words "strong vigilance" – that markets are justified in expecting a 25bp interest rate increase in June.

Stable instability

Interpreting the impact of money has become harder…

This week's robust M3 money supply data would ordinarily be another good reason for thinking that the ECB will communicate a very hawkish tone. The single-month measure of M3 money supply growth increased in March to 10.9% y-o-y – up from 10.0% in April and way ahead of the expected of 9.7%. However, gauging how the governing council collectively views these data has become more complicated since the governor of the Banque de France, Christian Noyer, lent his voice to those questioning the stability of euro-area M3 money demand and setting out the possible causes of this instability.

…following continued questioning by Mr Noyer…

We noted seven weeks ago[1] the analysis contained in a Banque de France working paper[2] highlighting instability in euro-area M3 money demand and questioning the suitability of the current reference value of 4½%. We also pointed out that it had been referred to by Christian Noyer in a way that suggested that it had been taken to heart by senior officials. Since then, there have been two interesting developments. First, under questioning from the press, President Trichet prevaricated, falling back on the technicality that "it is not correct that the Banque de France has said that they would not be in agreement with this reference value". Second, Mr Noyer has subsequently reiterated his comments. In opening remarks to a joint Banque de France/Deutsche Bundesbank conference in Eltville, Germany, he repeated that M3 velocity had changed over time and added that "most remarkably, instead of delivering some erratic pattern, a new velocity trend seemed to emerge with liquidity expanding much more rapidly".[3] He went on to flesh this out by referring to some of the recent financial innovations that are the likely sources of this change in velocity (Figure 1).

…and his implicit criticism of the reference value

According to Mr Noyer, the money demand function, while affected by a structural shift, nonetheless remains a valid concept and should still be used in the conduct of monetary policy. Consequently, his campaign is not about tearing down the monetary pillar but, implicitly, it is about changing the reference value. Up to now, the ECB had shown no serious willingness to revise the value as illustrated by Mr Trichet's prompt intervention in March. However, it is worth quoting Mr Trichet exactly: "the reference value is not an intermediate target that we would change regularly *every year*" (our italics). There is of course a big difference between every year and every eight or ten years: the current value was decided in 1998. This discrepancy persuades us that the M3 reference value could be a subject ripe for discussion.

1 *"Growing divergence and growing division",* Global Weekly Economic Monitor*, 16 March 2007.*
2 *"Is there a structural break in equilibrium velocity in the euro area?" by Bordes, C., Clerc, L., and Marimoutou, V., Banque de France working paper no. 165, February 2007.*
3 *"Financial Innovation, Monetary Policy and Financial Stability", Noyer, C., 27/28 April 2007.*

ECB policy guide?

Perhaps the reference value should be 7½%…

So, will Mr Noyer convince his colleagues that the reference value needs to be revised? In December 1998, the governing council assumed that the velocity of money was declining by around ½% to 1% per annum. The resulting reference value for M3 was 4½% per annum.[4] Based on the estimates reported in the Banque de France working paper, since 2000, the decline in velocity seems to have been about 3½% per annum – i.e., considerably greater than the ½% to 1% assumption incorporated in the current reference value. All else equal, this new trend for velocity is consistent with a reference value for M3 money supply growth of 7% to 7½%.

…and perhaps, practically, it already is?

It has been suggested that the ECB has not been much concerned by excess liquidity until the beginning of the current rate hike cycle anyway. With the official reference value, this certainly seems to be the case – changes in the money gap are of little use in tracking changes in ECB rates because money growth has been consistently above the reference value over this period. Intriguingly, using a reference value of 7½% the experience since 2002 gives the impression that change in the money gap matter after all (Figure 2). This may shed new light on the weight placed on money given that when the ECB moved to tighten policy in 2005 it was against the advice of most outside observers.

Reference deference

So far, reactions have been quite muted…

So far, reactions to Mr Noyer's latest speech have been limited to a reminder by governing council member Klaus Liebscher of the importance of monetary analysis. But revising the reference value does not entail abandoning the monetary pillar. The ECB's governing council derived the reference value for M3 growth from structural parameters at the time it was first implemented. To the extent that the reference value remains a valid concept for monetary policy, this suggests that the ECB should assess those parameters regularly – every year would make little sense, but once a cycle does not seem unreasonable.

…but sooner or later an official response is needed

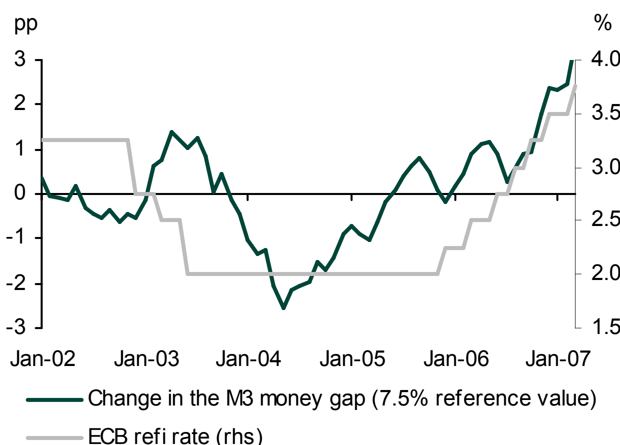
Reforming the M3 reference value within the governing council would be an important change to the practicalities of the ECB's monetary policy framework and is likely to come only after extensive research and debate. But in the light of Mr Noyer's analysis and that of his staff at the Banque de France, the governing council will likely come under increasing pressure to explain its position. Next week's press conference will probably not be used to do this. But, sooner or later, the ECB will need to either conduct a review or make a public defence of the current reference value.■

Figure 1. Sources of change in money velocity

1. Increased holdings of euro-denominated banknotes - the euro is now the largest banknote circulation in the world
2. Home bias in asset holdings has decreased further and the euro has increased demand for euro-denominated assets
3. Rapid expansion in "other financial institutions" including securitisations. OFI monetary assets now account for 10.5% of M3.
4. Increased ease with which banks can hedge credit risk and manage maturity and credit mismatches. This may have supported credit supply.
5. The interest elasticity of money demand may have been boosted by high yielding, highly liquid, deposits and the introduction of "retail derivatives".

Source: Noyer, C., (2007), Lehman Brothers.

Figure 2. A "new" M3 money gap and ECB policy



Source: ECB, Lehman Brothers.

[4] *The ECB referred to the quantity equation which equates money growth to real output growth, plus inflation, minus the annual rate of change in the velocity of money. See "The monetary policy of the ECB", ECB 2004.*

JAPAN: OVERVIEW

Cloudy outlook

Kenichi Kawasaki
+81 3 6440 1420
kekawasa@lehman.com

Hiroshi Shiraishi
+81 3 6440 1427
hshirais@lehman.com

The data point to solid GDP growth in Q1. But the cyclical outlook is starting to look cloudier, while the upward pressure on prices remains muted.

From a growth perspective, the economy seems to have gotten off to a decent start in 2007. But it still appears to lack autonomous momentum, while some cyclical indicators have recently started to weaken. In addition, consumer prices continue to surprise on the downside. A full-fledged reflation still looks some way off.

Solid Q1, but soft March data

We have revised up our GDP forecast for Q1 significantly

We have been pointing out over the past month or so that the risks around our forecast for Q1 – 0.2% q-o-q (1.0% saar), which we pencilled in at the end of last year – are clearly skewed to the upside. With an almost full set of monthly data now available for Q1, we have decided to revise our forecast: we now look for real GDP to have expanded a solid 0.7% q-o-q (2.6% saar) in Q1, following the 1.3% jump in Q4 last year (Figure 1).

Consumption appears to have rebounded solidly, thanks partly to the weather

Consumption appears to have been the main source of growth in Q1: we look for real consumption to have picked up by 0.8% q-o-q. In the latter half of last year, the unusual weather pattern appears to have affected consumption adversely. But in the first couple of months of this year, the unusually warm weather seems to have boosted spending on spring clothing and leisure.

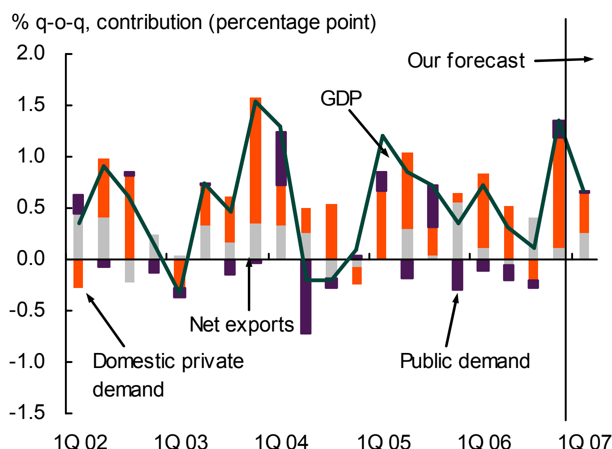
Exports continued to pick up, driven by shipments to Asia

In addition, exports picked up solidly in Q1. The Bank of Japan's real export index was up 3.0% q-o-q in Q1 after growing 1.0% in Q4 last year. On the one hand, exports to the US have been clearly slowing. Indeed, we estimate that export volume to the US declined by over 3% on the quarter in Q1. However, countering this has been robust exports to the rest of Asia (Figure 2). With imports remaining soft, net exports probably contributed about 0.3pp to real GDP growth.

But inventories in the tech sector remain elevated

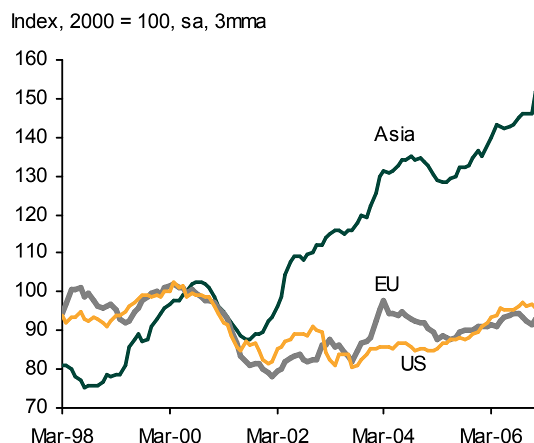
That said, the March data released at the end of last week were not bright. In particular, industrial production unexpectedly declined, falling 0.6% on the month. In Q1 as a whole, industrial production contracted 1.3% q-o-q after the 2.1% increase in Q4. The production plans survey suggested a rebound in output in the next couple of months (1.5% m-o-m in April and 1.4% in May). But inventories in the key high-tech component goods sector picked up further in March, pointing to the risk that manufacturing output, and therefore related capex, may stagnate in the coming quarters (Figure 3). Indeed, shipments of semiconductor-making equipment plunged in March.

Figure 1. Real GDP: contribution from components



Source: Cabinet Office and Lehman Brothers Global Economics.

Figure 2. Export volume: by region



Source: CEIC, Ministry of Finance, and Lehman Brothers Global Economics.

A sharp correction in manufacturing output could trigger a capex slowdown

At this point, based on the view that global growth should hold up despite the US slowdown, we do not expect manufacturers' capex to turn down in the near future. Meanwhile, surveys suggest that non-manufacturers' appetite for capex remains strong, underpinned by healthy balance sheets. Still, an unexpectedly sharp correction in manufacturing output could well trigger a cyclical downswing in the overall capex cycle, particularly given that this capex upturn has already lasted for four years.

Sustained robust consumption growth seems unlikely

Meanwhile, it is difficult to envisage a sustained robust expansion in consumption as wages remain stubbornly subdued. Total cash salaries fell 0.4% y-o-y in March, the fourth consecutive decline. While this represents an improvement from -1.0% y-o-y in February, the March figure was pushed up by a jump in special payments, which are quite volatile. The rate of decline in scheduled earnings, the core component, worsened to 0.9% y-o-y in March from 0.6% in February.

Employment is steadily growing, but there are also some initial signs of softness

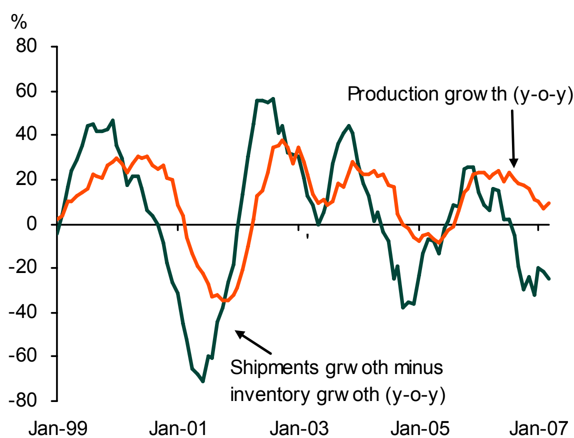
Granted, employment has been steadily growing. But there are some worrying signs on this front too: the job offers-to-applicants ratio has been trending down, albeit gradually, since last summer, with the number of new job offers falling. This is likely to be due partly to a technical factor: the regional labour departments, which compile these figures, are tightening the quality standard of job advertisement to eliminate "fake" job offers. And other surveys such as Tankan suggest that firms are increasingly judging the size of their labour force to be insufficient, particularly given that baby-boomers are starting to reach retirement age. That said, the average hours worked per employee are also starting to decline of late. Whether these signs of weakness translate into a slowdown in employment growth needs to be monitored closely (Figure 4).

The core CPI now looks likely to stay in negative territory for some time

The latest signs on consumer prices were also disappointing. The rate of decline in the nationwide core CPI worsened by more than expected in March, to 0.3% y-o-y from 0.1% in February. Tokyo core CPI was flat on the year in April, only a marginal improvement from the 0.1% decline in March. Excluding food and energy, the seasonally adjusted Tokyo CPI was flat on the month. April, being the first month of the new financial year, would have been a natural time for service providers to mark up their prices in order to secure profit margins amid rising costs. But the data suggest that such moves were quite limited. Given these results, it now appears likely that the year-on-year rate of change in the nationwide core CPI will not move back into positive territory until autumn this year even with the rebound in gasoline prices.

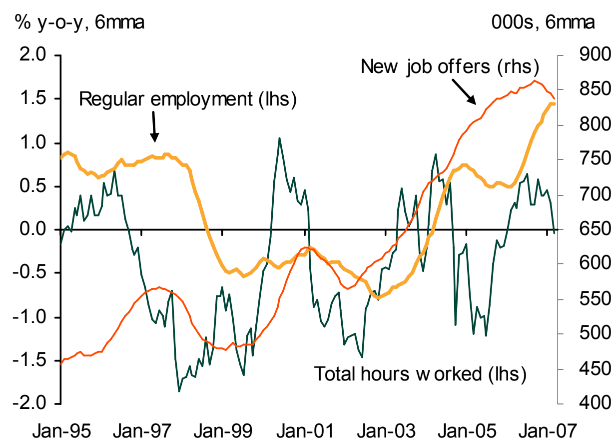
Bottom line: The Q1 GDP report is likely to print a solid reading, but the near-term cyclical outlook does not look compelling. The exit from deflation and full normalization of the economy may turn out to be an even more drawn-out process than we forecast at the start of the year.■

Figure 3. Electric parts and devices



Source: Ministry of Economy, Trade and Industry and Lehman Brothers Global Economics.

Figure 4. Employment, new job offers and hours worked



Source: Ministry of Health, Labour and Welfare and Lehman Brothers Global Economics.

ASIA EX-JAPAN: OVERVIEW

The mixed blessing of capital inflows

Rob Subbaraman
+85 2 2252 6249
rsuba@lehman.com

There is no "silver bullet" policy response. The danger is some economies overheat.

On top of a big current account surplus, Asia ex-Japan is attracting strong capital inflows, which is testimony to the region's robust economic growth and better fundamentals. Foreign capital is typically beneficial for developing economies, as it augments domestic savings, helping facilitate growth and development. However, sometimes (e.g., 1994-96 in Asia) capital inflows can become too large and of poor quality, causing excessive currency appreciation, overheating and, in the end, abrupt capital flight. Unfortunately, there is no "ideal" preventative policy response.

The decrease in net capital inflows masks surging inflows and outflows

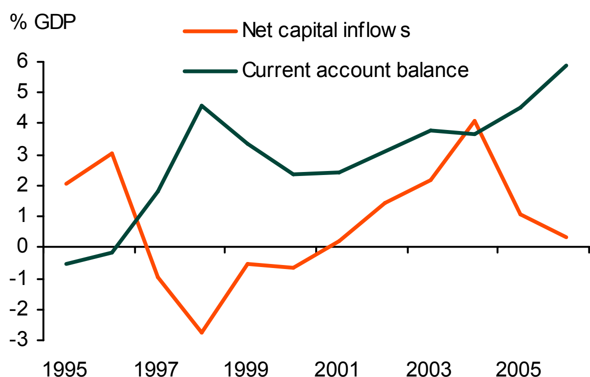
At the outset, the shortcomings in Asian capital flow data should be noted, including differences in data collection methodology across countries, incomplete coverage (e.g. large "errors and omissions" categories), and long lags. For example, China's semi-annual balance of payments data are only available to 1H 2006, and so the data for 2H are estimated, based on monthly FX reserves, FDI inflows, and the trade surplus. That said, aggregating the data the best we can yields the following results:

- Despite high oil prices, Asia ex-Japan's current account surplus increased to US$338bn, or nearly 6% of GDP, last year (Figure 1). We estimate that China's gigantic surplus comprised about 70% of the total.
- By constrast, net capital inflows to the region decreased last year to just 0.3% of GDP. However, the decrease in *net* capital inflows masks surging inflows and outflows (Figure 2). We estimate that capital inflows (FDI, portfolio and other investments) to Asia ex-Japan averaged 6.1% of GDP in 2005-06, similar to that in the two years before the Asian crisis. However, in contrast to 1995-96, the region's capital outflows have also swelled to average 4.8% of GDP over the past two years.
- In absolute size, China has attracted the largest capital inflows in recent years, but once scaled by GDP it becomes apparent that most Asian countries have been experiencing strong capital inflows and outflows (Figure 3).

The capital inflows appear to have intensified so far this year

The limited data available for this year point to intensifying capital inflows. Korea's capital inflows totalled US$24bn in Q1 versus US$60bn in 2006. FX reserves have surged in China (US$136bn in Q1 versus US$248bn in 2006) and India (US$22bn in Q1 versus US$39bn in 2006) and judging from China's and India's trade data these surges seem to have been largely driven by capital inflows.

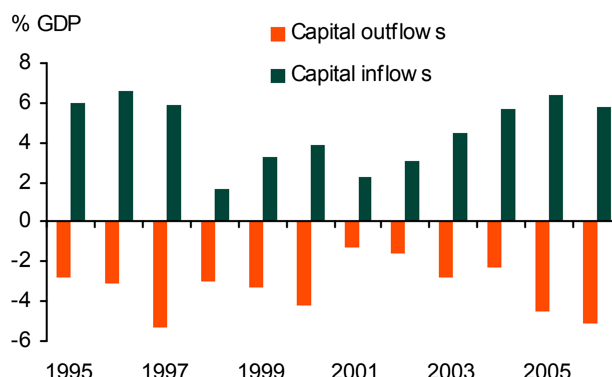
Figure 1. Asia ex-Japan's current account and net capital inflows*



* Includes China, India, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan and Thailand

Source: CEIC and Lehman Brothers.

Figure 2. Asia ex-Japan's total capital inflows and outflows*



* Includes China, India, Philippines, Singapore, South Korea, Taiwan and Thailand

Source: CEIC and Lehman Brothers.

There are many possible policy responses to large, persistent capital inflows, but each has different costs and benefits:

Currencies can appreciate too far, hurting exports

Allow currency appreciation. An appreciating and more flexible currency should at some point raise exchange rate uncertainty and reduce expectations of further appreciation, thereby helping to discourage short-term capital inflows. But the danger is the exchange rate overshoots, hurting exports. Asian currencies bar the HK$ have appreciated to varying degrees, most notably in Korea and Thailand, but none have been allowed to float freely.

Sterilised FX intervention can raise interest rates and incur quasi-fiscal costs

Sterilised FX intervention. All Asian monetary authorities have intervened in the foreign exchange (FX) market to manage the pace of currency appreciation, and it has been common practice to sterilise the expansive monetary effects of FX purchases by selling central bank bills or government securities. However, heavy sterilised FX intervention can have unwanted side effects. If the domestic assets that investors (typically banks) want to hold are not perfect substitutes for the sterilisation bonds, interest rates will tend to rise, attracting yet more capital inflows. It can also entail quasi-fiscal costs if the FX reserves earn less than the interest paid on the sterilisation bonds, which may soon be the case in India (see *Asia ex Japan Focus: "*India: New challenges for the RBI"). An alternative way to limit money and credit growth, which has become popular in China and India, is to raise the bank reserve requirement ratio (RRR). The RRR is not costly for the central bank, but it acts as a tax on the banking sector, and can promote disintermediation as non-bank financial institutions develop to bypass the RRR, which can be more difficult to regulate.

Too low interest rates limit monetary policy control

Keep interest rates low. This policy can help reduce capital inflows, but at the expense of losing some autonomy over monetary policy, which appears to be the case in China.

Capital controls tend to lose their effectiveness over time

Capital controls. They can vary from a one-year ban on the repatriation of all investments held by foreigners (Malaysia, 1998), to an implicit withholding tax on short-term capital inflows (Thailand, December 2006). The drawback is that they tend to become less effective over time as loopholes are found, and they can seriously hurt investor confidence.

Relaxed restrictions on capital outflows raise the risk of capital flight

Liberalise capital outflows. The data show that this policy is gaining popularity in Asia to counter the strong inflows. China, Taiwan, Korea, Malaysia, Thailand and India have all been easing restrictions on overseas institutional investments. There is also growing interest in setting up government-owned investment corporations that can help channel domestic savings overseas, along the lines of Singapore's Tamasek Holdings. The risk is the potential for larger capital flight in the event of a domestic crisis.

The biggest danger, in our view, is some economies overheating

Asian policymakers have taken an eclectic approach to managing strong capital inflows. However, with rising risks from sterilised FX intervention, we expect more emphasis on allowing currency appreciation, liberalising capital outflows, and keeping interest rates lower than otherwise. The biggest danger, in our view, is some economies overheating, fuelling asset price bubbles and/or inflation. On that note, the recent pickup in the region's aggregate money and credit growth is worth monitoring (Figure 4).■

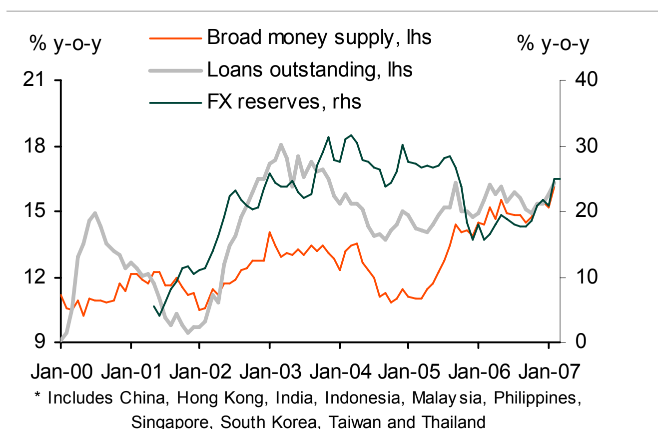
Figure 3. Balance of payments by country (2006 , % GDP)

	Current	Capital inflows		Capital outflows		Net capital	Balance of
	Account	FDI	Other	FDI	Other	inflows*	payments*
China	9.0	3.0	0.5	0.6	2.3	0.3	9.4
HK	10.7	22.6	33.5	22.9	43.5	-7.5	3.2
India	-1.0	1.9	2.5	1.1	-0.4	4.2	3.2
Indonesia	2.6	2.1	1.0	0.9	1.5	1.5	4.1
Malaysia	17.2	0.0	n.a.	4.1	n.a.	-12.5	4.6
Philippines	4.3	2.0	0.3	0.1	4.4	-1.1	3.2
Singapore	27.5	18.3	26.1	6.5	53.6	-14.9	12.5
S. Korea	0.7	0.4	6.4	0.8	3.5	1.8	2.5
Taiwan	7.2	1.4	9.3	2.2	14.7	-6.0	1.3
Thailand	-0.2	4.9	5.4	0.3	4.6	5.4	5.2

* Includes errors and omissions

Source: CEIC and Lehman Brothers.

Figure 4. Asia ex-Japan's FX reserves, money and loans*



* Includes China, Hong Kong, India, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan and Thailand

Source: CEIC and Lehman Brothers.

EMERGING MARKETS OVERVIEW

Turkey: A close shave

Tolga Ediz
+44 20 710 27467
tediz@lehman.com

Although recent events have damaged Turkey's democratic reputation, a more diverse parliament after the election may herald an improved medium-term political outlook.

Although we have been arguing that markets were underestimating political risks in Turkey, we did not anticipate how rocky things would get. But after a turbulent week, we see the light at the end of the tunnel and are encouraged about the medium-term political outlook. What is clear is that Turkey's politics may never be the same again.

The powers that be say "No"

There is little doubt that events this week may be regarded as a blemish on Turkey's democracy. But the constitutional court's decision to annul the presidential election was the cleanest way out of the political crisis triggered by the military's statement against the government on Friday. Early elections, likely to be held on 22 July, should allow the debate on whether there is a threat to Turkey's secularist political system to be shifted to a more democratic platform and reduce tensions overall. But there are lessons to be learnt from the recent episode:

First, the secular power system clearly has a strong defence mechanism: in a sense, the court ruling was a way of telling the AKP that there are limits to how much a 30% share of the vote, even if that means a lion's share of the parliamentary seats, can buy in terms of power. Indeed, the court's action has now essentially guaranteed that Turkey's presidents will be consensus candidates (since a quorum of two-thirds of the parliament is now required to take part in the first two rounds of the vote), and therefore have secularist credentials. And even if the constitution is changed such that the new president is elected by public vote, we doubt that the winner would be a staunch Islamist (see below).

Second, the recent events suggest that democracy is taking stronger roots. This may sound odd after the furore over the military's statement. But the bigger story was the public protest in response. Not only was the weekend protest one of the largest in Turkey's history, it was also peaceful, organised by civil organisations with notices circulated on the internet. And most important of all, the protests also gave a clear message that military intervention in Turkey's politics was not welcome. And it was these protests that eventually tipped the balance in our view, just as much as the noise from the military.

Third, Turkish markets and the economy proved very resilient to what was essentially an earthquake in the political system. There was no panic buying of dollars by the public or local corporates. The currency lost little more than 4% during the worst of the turbulence, with local bond yields rising by around 100bp. These small moves suggest that a much deeper FX options market (vols and risk reversals were high before the turbulence, suggesting investors had bought some protection already) can help to reduce market turbulence. We maintain our view that the Turkish economy is still one of the most vulnerable to external shocks. And although the favourable backdrop for carry trades was a big factor in helping to limit any sell-off, we think the resilience of the markets and the economy nonetheless looks positive for the future.

The implications

These events also have important implications for the AKP. Even though it is the most popular political party, it has obviously not regained the trust of a significant portion of the populace. The AKP has to move even further into centrist ground than it has done already and inspire confidence across a broader section of the public. This will be an important factor to watch in the general election.

All in all, we are a little more optimistic about the political outlook. It is true that the next election could bring about a more divided parliament, but that is as it should be: part of the reason for the current turbulence is the fact that it was not a true representation of actual voter intentions – almost half of the population was not represented in the current parliament because under the old rules parties needed at least 10% of the vote to gain representation. For political stability to be sustained in our view, the parliament should represent the broad political spectrum. We expect the centre-right parties to merge or fight under common lists. Indeed, there are now strong signs that the centre-left may do the same, probably under the CHP banner. Such a consolidation of the centre-left and centre-right votes, therefore reducing the number of parties in play, would mean major political realignment and restore in a more sustained way some proper checks and balances on the government.

In addition, we still think it likely that the AKP will win the general election, likely to be held in July even if more parties enter the parliament. The short time frame gives opposition parties little time to exploit synergies from their mergers. Furthermore, the opposition has not created much of an alternative to the AKP government. And it seems clear to us that Turkey's next president is likely to be a compromise candidate with strong secular credentials as discussed above. Our base case is that the general election will produce a small working majority for the AKP, followed by the election of a president with strong secular credentials. With stronger "checks and balances" in place, we would see no scope for the military to intervene again.

The curve ball: a constitutional change?

That said, having ignored all the warning signs up to now, investors are starting to become worried about the possibility that the AKP will succeed in changing Turkey's constitution such that the president is elected by a public vote rather than parliament. Those analysts/investors that welcomed the possibility of foreign minister Abdullah Gul becoming president now worry that the public could elect an Islamist president, thus creating another crisis between elected politicians and the military or that the constitutional change could bring about another power struggle between the Ankara establishment and the government.

We think these worries are too alarmist. Although we would not be surprised by a shift to direct election, we doubt that it would happen quickly, mainly because the president is likely to send such an amendment to a referendum. Furthermore, our view is that over two rounds, there is very little chance that the public would be ready for an Islamist president. And we would also discount the possibility that the controversial speaker of parliament can be the acting president – Article 102 of the constitution makes it clear that the incumbent carries on until a new one is elected.

Conclusion: Watch the polls, but the worst should be over for now

All this is not to say that there will be no more volatility in the months ahead. After all, attention will now start to focus on opinion polls and the risk of a coalition is clearly higher than it was a few months ago. But we think the worst is over for now. The debate on secularism should now shift to a more democratic platform and eventually, we see the greatest likelihood being a secular president. The worst case scenario would in fact be an election outcome that replicates the current parliamentary breakdown, in which case we would expect more stress between the government and the military. As things stand, our base case is for a more balanced parliament, but still with the AKP as the leading party.

As for markets, we expect the currency to grind higher once again as political noise dies down. Judging by the spike in volatility and risk reversals in options markets, technicals in FX markets are healthy. Indeed, we expect the spike in FX volatility to correct and expect markets to be driven by external factors more than domestic ones in the coming days. Although the bond market is trickier, we are now more optimistic about the direction of interest rates in the medium-term.■

WEEK AT A GLANCE

Economic events in the week ahead

TKY	LDN	NY	(Tokyo, London and New York time)		Period	Prev 2	Prev 1	Latest	Lehman	Consensus
Sometime in the week										
			China	Exports, % y-o-y	Apr	33.3	51.7	6.9	30	17.4
			China	Trade Balance, US$bn	Apr	15.9	23.8	6.9	21.6	11
16.00	8.00	3.00	UK	Halifax house prices, % m-o-m, sa	Apr	1.4	1.9	1.1	0.7	0.8
16.00	8.00	3.00	UK	Halifax house prices, % y-o-y, 3mma, nsa	Apr	9.8	9.9	10.8	10.5	10.6
Monday 7 May										
17.00	9.00	4.00	Taiwan	Trade balance, US$bn	Apr	1.8	2.2	2.2	2	n.a.
17.00	9.00	4.00	Taiwan	Exports, % y-o-y	Apr	17.5	-3.6	10.4	10	8
				Euro group and ECONFIN in Brussels						
19.00	11.00	6.00	Germany	Manufacturing orders (% m-o-m, sa)	Mar	0.6	-0.3	3.9	-1.5	-0.5
19.00	11.00	6.00	Germany	Manufacturing orders (% y-o-y, sa)	Mar	7.3	6.8	9.5	9.0	n.a.
			UK	Bank Holiday						
14.45	6.45	1.45	Switzerland	Unemployment rate, nsa	Apr	3.3	3.2	3.0	n.a.	2.9
14.45	6.45	1.45	Switzerland	Unemployment rate, sa	Apr	3.0	3.0	2.9	n.a.	2.8
	18.00	13.00	US	TSY 3-year auction, $bn				16	14	n.a.
	20.00	15.00	US	Consumer credit, change, $bn	Mar	6.0	6.6	3.0	4.0	5.0
21.30	13.30	8.30	Canada	Building permits, % m-o-m	Mar	-9.0	10.4	-22.4	4.0	n.a.
Tuesday 8 May										
			Indonesia	Central bank policy meeting, policy rate, %	May	9.50	9.25	9.00	8.75	8.75
10.30	2.30		Australia	Retail sales, % m-o-m sa	Mar	0.3	0.8	0.9	0.5	0.5
13.01	5.01		Malaysia	Exports, % y-o-y	Mar	6.2	11.3	-2.8	3.5	2
13.01	5.01		Malaysia	Industrial production, % y-o-y	Mar	7.0	2.4	-0.2	2.5	1
				Euro group and ECONFIN in Brussels						
19.00	11.00	6.00	Germany	Industrial production incl. constr. (% m-o-m, sa)	Mar	0.0	0.9	0.9	0.0	0.0
19.00	11.00	6.00	Germany	Industrial production incl. constr. (% y-o-y, sa)	Mar	6.9	7.2	7.6	8.4	n.a.
19.00	11.00	6.00	Germany	Industrial production excl. constr. (% m-o-m, sa)	Mar	0.0	0.7	0.9	0.0	n.a.
19.00	11.00	6.00	Germany	Industrial production excl. constr. (% y-o-y, sa)	Mar	6.7	6.5	6.9	7.2	n.a.
17.00	9.00	4.00	Norway	Industrial production, % y-o-y, nsa	Mar	-2.0	-2.4	-1.6	n.a.	n.a.
23.00	15.00	10.00	US	Wholesale inventories, %m-o-m	Mar	-0.3	0.6	0.5	0.2	0.4
	18.00	13.00	US	TSY 10-year auction, $bn				13	13	n.a.
	18.00	13.00	US	ISM semiannual report						
Wednesday 9 May										
14.00	6.00	1.00	Japan	Coincident diffusion index, %	Mar	63.6	30.0	30.0	22.2	22.2
14.00	6.00	1.00	Japan	Leading diffusion index, %	Mar	31.8	40.9	27.3	40.0	40.0
15.00	7.00	2.00	Germany	Trade balance (€ bn, sa)	Mar	14.7	15.8	13.8	15.0	15.0
15.00	7.00	2.00	Germany	Trade balance (€ bn, nsa)	Mar	11.1	16.2	14.2	18.1	n.a.
16.30	8.30	3.30	Netherlands	Manufacturing output (% m-o-m, sa)	Mar	1.2	0.3	1.3	0.8	n.a.
16.30	8.30	3.30	Netherlands	Manufacturing output (% y-o-y, sa)	Mar	4.1	5.0	5.9	6.5	n.a.
16.30	8.30	3.30	Netherlands	Industrial production (% m-o-m, sa)	Mar	2.2	-3.5	2.4	0.3	-0.3
16.30	8.30	3.30	Netherlands	Industrial production (% y-o-y, nsa)	Mar	0.4	-2.6	-1.3	-2.0	n.a.
8.01	0.01		UK	BRC Sales Monitor, like-for-like, % y-o-y, nsa	Apr	3.1	3.3	3.9	3.5	n.a.
16.30	8.30	3.30	Sweden	Industrial production, % m-o-m, sa	Mar	2.5	-2.3	1.3	n.a.	0.7
16.30	8.30	3.30	Sweden	Industrial production, % y-o-y, nsa	Mar	10.3	4.1	6.8	n.a.	6.9
20.00	12.00	7.00	US	MBA mortgage applications, %w-o-w	04-May	-2.5	3.6	0.6	n.a.	n.a.
	19.15	14.15	US	FOMC meeting, %				5.25	5.25	5.25
Thursday 10 May										
8:50			Japan	Bank lending, nsa, % y-o-y	Apr	1.8	1.4	1.1	0.6	n.a.
8:50			Japan	Bank lending, NPL-adjusted, nsa, % y-o-y	Apr	2.8	2.4	2.1	1.6	n.a.
8:50			Japan	Broad liquidity, nsa, % y-o-y	Apr	2.6	2.7	2.6	2.6	2.5
8:50			Japan	M2+CDs, nsa, % y-o-y	Apr	1.0	1.1	1.1	1.1	1.1
14.00	6.00	1.00	Japan	Speech by BOJ Governor Fukui						
16.00	8.00	3.00	Japan	Economy Watchers Survey: Current	Apr	47.2	49.2	50.8	n.a.	n.a.
16.00	8.00	3.00	Japan	Economy Watchers Survey: Outlook	Apr	50.9	52.1	51.3	n.a.	n.a.
10.00	2.00		S. Korea	Central bank policy meeting, overnight call rate, %	May	4.50	4.50	4.50	4.50	n.a.
10.30	2.30		Australia	Employment change, ('000) m-o-m	Mar	-5.3	23.2	10.5	20.0	12.5
13.30	5.30	0.30	S. Korea	Consumer confidence index	Apr	96.1	98.1	97.8	99.0	n.a.
15.45	7.45	2.45	France	Industrial production (% m-o-m, sa)	Mar	1.0	-0.2	1.1	-0.2	0.3
15.45	7.45	2.45	France	Industrial production (% y-o-y, sa)	Mar	0.6	-0.4	2.6	0.6	n.a.
15.45	7.45	2.45	France	Trade balance (€ bn, sa)	Mar	-2.4	-2.6	-2.7	-2.6	-2.6

Economic events in the week ahead continued

TKY	LDN	NY	(Tokyo, London and New York time)		Period	Prev 2	Prev 1	Latest	Lehman	Consensus
16.30	8.30	3.30	Netherlands	CPI (% m-o-m, nsa)	Apr	0.1	0.5	1.1	0.3	0.4
16.30	8.30	3.30	Netherlands	CPI (% y-o-y, nsa)	Apr	1.4	1.5	1.8	1.6	1.7
16.30	8.30	3.30	Netherlands	HICP (% m-o-m, nsa)	Apr	-0.2	0.7	1.3	0.3	n.a.
16.30	8.30	3.30	Netherlands	HICP (% y-o-y, nsa)	Apr	1.2	1.4	1.9	1.7	n.a.
17.00	9.00	4.00	Italy	Industrial production (% m-o-m, sa)	Mar	1.3	-1.7	-0.5	0.7	0.6
17.00	9.00	4.00	Italy	Industrial production (% y-o-y, sa)	Mar	3.8	1.6	0.5	1.3	n.a.
20.45	12.45	7.45	Euro area	ECB governing council meeting	%	3.50	3.50	3.75	3.75	3.75
21.30	13.30	8.30	Euro area	ECB press conference						
17.30	9.30	4.30	UK	Manufacturing output, % m-o-m, sa	Mar	0.1	-0.2	-0.6	0.5	0.5
17.30	9.30	4.30	UK	Manufacturing output, % y-o-y, sa	Mar	2.4	1.9	1.2	0.9	0.9
17.30	9.30	4.30	UK	Industrial production, % m-o-m, sa	Mar	-0.1	0.0	-0.2	0.4	0.4
17.30	9.30	4.30	UK	Industrial production, % y-o-y, sa	Mar	0.5	0.4	0.3	0.0	0.0
17.30	9.30	4.30	UK	Trade in goods, global balance, £ bn, sa	Mar	-6.9	-6.4	-6.8	-7.3	-6.7
17.30	9.30	4.30	UK	Trade in goods, EU balance, £ bn, sa	Mar	-2.6	-2.6	-2.7	-3.0	n.a.
17.30	9.30	4.30	UK	Trade in goods, non-EU balance, £ bn, sa	Mar	-4.3	-3.8	-4.1	-4.3	-4.1
17.30	9.30	4.30	UK	Import prices, % y-o-y, nsa	Mar	0.1	-1.6	-1.3	0.0	n.a.
17.30	9.30	4.30	UK	Import prices ex oil and erratics, % y-o-y, nsa	Mar	0.6	0.7	0.5	1.2	n.a.
20.00	12.00	7.00	UK	MPC meeting, repo rate, %	May	5.25	5.25	5.25	5.50	5.50
20.00	12.00	7.00	UK	MPC meeting, probability of 25bp rate hike	May				80	80
16.30	8.30	3.30	Sweden	CPI, % m-o-m, nsa	Apr	-0.5	0.5	0.7	n.a.	0.3
16.30	8.30	3.30	Sweden	CPI, % y-o-y, nsa	Apr	1.9	2.0	1.9	n.a.	1.8
16.30	8.30	3.30	Sweden	Targeted UND1X, % m-o-m, nsa	Apr	-0.9	0.4	0.5	n.a.	0.3
16.30	8.30	3.30	Sweden	Targeted UND1X, % y-o-y, nsa	Apr	1.2	1.3	1.2	n.a.	1.0
17.00	9.00	4.00	Norway	CPI, % m-o-m, nsa	Apr	-1.3	0.4	0.6	n.a.	0.5
17.00	9.00	4.00	Norway	CPI, % y-o-y, nsa	Apr	1.2	0.8	1.1	n.a.	0.7
17.00	9.00	4.00	Norway	Targeted CPI-ATE, % m-o-m, nsa	Apr	-0.8	0.6	0.7	n.a.	0.4
17.00	9.00	4.00	Norway	Targeted CPI-ATE, % y-o-y, nsa	Apr	1.0	1.1	1.5	n.a.	1.6
16.00	8.00	3.00	Czech rep	CPI (% y-o-y)	Apr	1.3	1.5	1.9	2.1	2.2
21.30	13.30	8.30	US	Initial jobless claims, m	05-May	341	326	305	310	n.a.
21.30	13.30	8.30	US	Continuing jobless claims, 000	28-Apr	2.529	2.588	2.495	2.500	n.a.
21.30	13.30	8.30	US	Trade balance, $bn	Mar	-61.5	-58.9	-58.4	-61.5	-60.0
21.30	13.30	8.30	US	Import prices, %m-o-m	Apr	-1.1	0.1	1.7	1.0	1.0
21.30	13.30	8.30	US	Non-petroleum import prices, %m-o-m	Apr	-0.1	0.1	0.3	1.0	n.a.
	16.00	11.00	US	Fed's Moskow at payments conference						
	16.15	11.15	US	Fed's Kroszner at payments conference						
	18.00	13.00	US	TSY 30-year auction, $bn				9	5	n.a.
	19.00	14.00	US	Budget balance, $bn	Apr	17.6	57.9	118.8	140.0	140.0
Friday 11 May										
16.00	8.00	3.00	India	Industrial production, % y-o-y	Mar	12.5	11.4	11.0	10.1	10.4
16.00	8.00	3.00	Spain	Final CPI (% m-o-m, nsa)	Apr	-0.7	0.1	0.8	1.4	1.4
16.00	8.00	3.00	Spain	Final CPI (% y-o-y, nsa)	Apr	2.4	2.4	2.5	2.5	2.5
16.00	8.00	3.00	Spain	Final CPI (core, % m-o-m, nsa)	Apr	-0.8	0.2	0.6	1.4	1.3
16.00	8.00	3.00	Spain	Final CPI (core, % y-o-y, nsa)	Apr	2.7	2.8	2.5	2.5	2.5
16.00	8.00	3.00	Spain	Final HICP (% m-o-m, nsa)	Apr	-0.7	0.1	0.8	1.4	1.4
16.00	8.00	3.00	Spain	Final HICP (% y-o-y, nsa)	Apr	2.4	2.5	2.5	2.5	2.5
16.00	8.00	3.00	Hungary	CPI (% y-o-y)	Apr	7.8	8.8	9.0	8.8	8.9
18.00	10.00	5.00	Iceland	CPI (% y-o-y)	May	7.41	5.87	5.29	n.a.	4.40
16.00	8.00	3.00	Slovakia	CPI (% y-o-y)	Apr	3.0	2.7	2.7	n.a.	2.6
21.30	13.30	8.30	US	PPI, %m-o-m	Apr	-0.6	1.3	1.0	0.5	0.5
21.30	13.30	8.30	US	PPI, %y-o-y	Apr	0.2	2.6	3.1	2.9	2.9
21.30	13.30	8.30	US	Core PPI, %m-o-m	Apr	0.2	0.4	0.0	0.2	0.2
21.30	13.30	8.30	US	Core PPI, %y-o-y	Apr	1.8	1.8	1.6	1.8	1.8
21.30	13.30	8.30	US	Retail sales, %m-o-m	Apr	0.0	0.5	0.7	0.4	0.3
21.30	13.30	8.30	US	Non-auto retail sales, %m-o-m	Apr	0.2	0.4	0.8	0.5	0.4
21.30	13.30	8.30	US	Non-auto, non-gas retail sales, %m-o-m	Apr	0.2	0.3	0.4	0.4	n.a.
21.30	13.30	8.30	US	Non-auto, gas, build. mat. retail sales, %m-o-m	Apr	0.2	0.3	0.3	0.6	n.a.
23.00	15.00	10.00	US	Business inventories, %m-o-m	Mar	0.1	0.2	0.3	0.0	0.2
20.00	12.00	7.00	Canada	Change in payrolls, '000	Apr	88.9	14.2	54.9	15.0	n.a.
20.00	12.00	7.00	Canada	Unemployment rate, %	Apr	6.2	6.1	6.1	6.2	n.a.

UNITED STATES: ECONOMIC OUTLOOK

Below trend, above target

John Shin
+1 212 526 9432
john.shin@lehman.com

Michelle Meyer
+1 212-526-7977
mimeyer@lehman.com

We expect growth to remain below trend while inflation remains stubbornly above target, leaving the Fed on the sidelines.

First quarter GDP rose an anemic 1.3%, below expectations. However, most of the unexpected weakness stemmed from weak export growth and a sharp decline in national defence spending. Consumption and business investment surprised on the upside. We look for growth to bounce back to 2.7% in Q2, bringing average GDP to 2% for the first half of the year. We expect some of the strength from the consumer to be transferred to the business sector with modest growth in business fixed investment and inventories. Consumption should weaken to the low 2% range in response to higher energy prices and the fading housing wealth effect. We expect residential investment to continue to depress growth, but for the drag to lessen through year-end.

The biggest risk to our growth forecast is a double dip in the housing market. In the near term, the risk is on the demand side as tighter lending standards have the potential to significantly curb sales. Over a longer horizon, the problems in the subprime mortgage market will likely cause an increase in foreclosures, adding to inventory. We think the fallout from the subprime mortgage market will extend the disequilibrium in housing in the medium term, restraining growth, but not leading to a recession. We expect growth to remain below trend, averaging 2.1% this year and 2.5% next year.

The March CPI report showed benign core inflation, mechanically lowering the path of inflation over the next few quarters. However, our outlook for inflation has not changed. Commodity prices are strong. The sub-NAIRU unemployment rate should put further pressure on wages, while lower productivity growth makes it harder for firms to offset these costs. This should keep core inflation above the Fed's implicit target zone for the next year. Faced with above-target core inflation and only moderately below-trend growth, we expect the Fed to remain on hold through year-end.

The below table does not reflect Friday's employment report

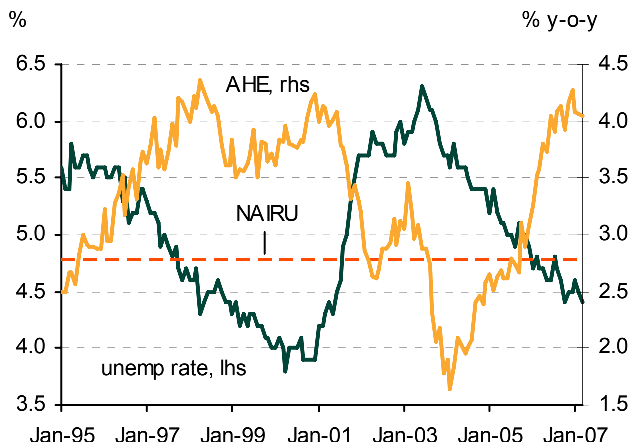
The outlook at a glance

%	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07 E	3Q07 E	4Q07 E	2006	2007 E	2008 E
Real GDP	5.6	2.6	2.0	2.5	1.3	2.7	2.2	2.4	3.3	2.1	2.5
Private consumption	4.8	2.6	2.8	4.2	3.8	2.3	2.2	2.1	3.2	3.1	2.1
Government expenditure	4.9	0.8	1.7	3.4	0.9	3.0	2.0	2.0	2.1	2.1	2.1
Non res fixed invest	13.7	4.4	10.0	-3.1	2.0	6.6	4.6	4.6	7.2	3.5	5.2
Residential fixed invest	-0.3	-11.1	-18.6	-19.8	-17.0	-10.0	-8.0	-4.0	-4.2	-14.4	-2.5
Exports	14.0	6.2	6.8	10.6	-1.2	6.5	7.0	7.0	8.9	5.4	7.0
Imports	9.1	1.4	5.6	-2.6	2.3	4.0	4.0	4.0	5.8	2.3	4.0
Contributions to GDP:											
Domestic final sales	5.4	1.6	2.0	1.9	2.0	2.2	2.0	2.2	3.1	2.1	2.2
Inventories	-0.1	0.4	0.1	-1.2	-0.3	0.3	0.1	0.1	0.2	-0.2	0.1
Net trade	0.0	0.4	-0.2	1.6	-0.5	0.1	0.1	0.1	0.0	0.2	0.1
Unemployment rate	4.7	4.6	4.7	4.5	4.5	4.6	4.7	4.7	4.6	4.6	4.8
Non-farm payrolls, 000	252	124	202	177	152	120	110	110	189	123	110
Consumer prices	3.7	4.0	3.4	1.9	2.4	2.4	2.5	3.6	3.2	2.7	2.7
Core CPI	2.1	2.4	2.8	2.7	2.6	2.4	2.3	2.4	2.5	2.4	2.4
Core PCE deflator	2.0	2.2	2.4	2.2	2.2	2.1	2.1	2.1	2.2	2.1	1.9
Federal deficit (fiscal yr, $bn)									-248	-175	-175
Current account deficit (% GDP)									-6.5	-6.5	-6.5
Fed funds	4.75	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	4.75
3-month USD LIBOR	5.00	5.48	5.37	5.36	5.35	5.40	5.40	5.40	5.36	5.40	4.80
TSY 2-year note	4.82	5.15	4.68	4.81	4.58	4.80	5.00	5.00	4.81	5.00	4.80
TSY 5-year note	4.82	5.09	4.58	4.69	4.54	4.75	4.80	4.80	4.69	4.80	4.80
TSY 10-year note	4.86	5.14	4.63	4.70	4.65	4.75	4.80	4.80	4.70	4.80	4.80

Notes: Real GDP and its contributions are seasonally adjusted annual rates. Unemployment is measured as a percentage of the labor force. Inflation measures are y-o-y percent changes. Interest rate forecasts are end of period. Payrolls are monthly average changes. Table last revised 04 May. All forecasts are modal forecasts (i.e., the single most likely outcome).

Source: BLS, Commerce & Census Departments, and Lehman Brothers.

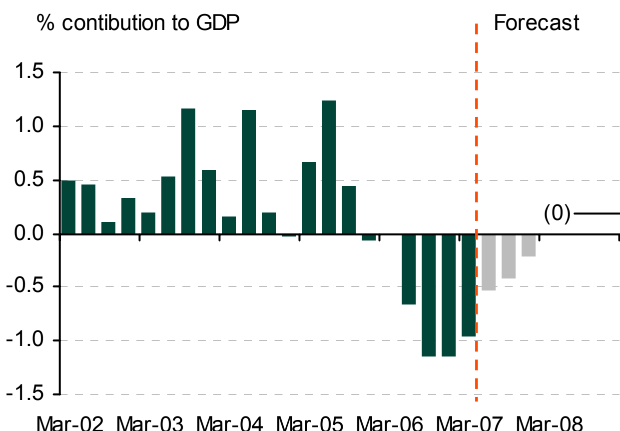
We expect modest gains in the labor market



Source: BLS, Lehman Brothers.

- The job market should remain healthy, with the unemployment rate staying around 4.7%, just below our estimate of NAIRU.
- Firms have remained fairly conservative in hiring relative to the past several years.
- With a moderately tight labor market and recent cost-of-living increases, we expect a continued acceleration in the growth of average hourly earnings.

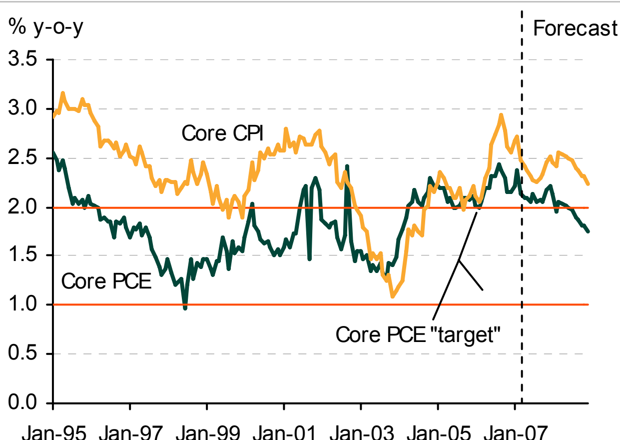
The drag from housing construction should diminish



Source: Commerce Department and Lehman Brothers.

- Residential investment sliced more than 1pp from GDP growth in the second half of 2006. We expect the drag from construction to lessen this year.
- Excess inventories and soft demand should keep homebuilders from increasing construction until after next year.
- On a regional level this year, we expect construction to remain depressed in the "bubble" markets but to enter a recovery stage in the "non-bubble" markets.

Core inflation should remain elevated



Source: Bureau of Labor Statistics, Commerce Department and Lehman Brothers.

- We look for the core PCE to remain above the Fed's implicit target for the fourth year in a row, falling back within the range by the end of next year.
- The recent pickup in energy prices should boost headline inflation, potentially feeding into core measures.
- The strength in the labor market points to upward, albeit more gradual, increases in labor cost pressures, which should continue feeding into trend inflation.

UNITED STATES: MARKET OUTLOOK

Cash back!

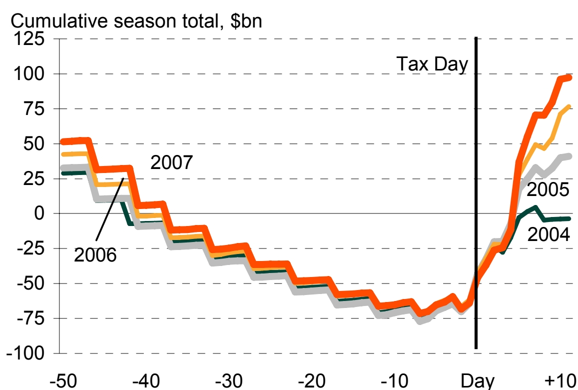
Drew Matus
+1 212 526 9878
dmatus@lehman.com

The growth rate of non-withheld tax receipts suggests a smaller budget deficit than we had forecast. We estimate the budget deficit will fall to just $175 billion in fiscal year 2007.

Given the growth in tax receipts following the mid-April tax deadline, recently we lowered our budget deficit forecast for fiscal year 2007 to just $175 billion. We look for a similar deficit in fiscal year 2008. Although the growth in individual income tax receipts tempted us to lower our deficit projections even more aggressively, a recent deceleration in corporate tax receipts has convinced us that caution is warranted in determining our new budget estimates.

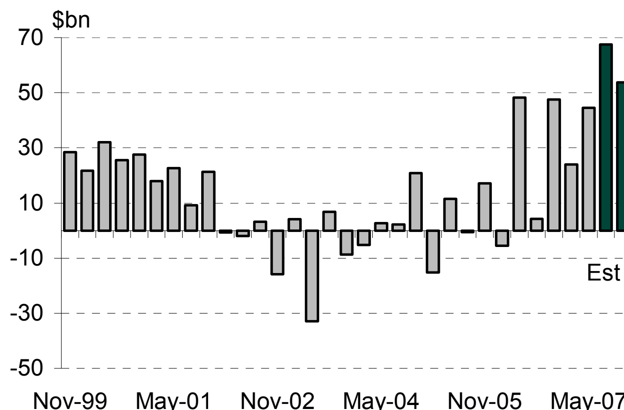
The Treasury announced the terms of its quarterly refunding and, as expected, also announced the elimination of the 3-year note from the auction cycle. Issuance sizes were smaller than expected with the 3-year note auction on Monday just $14bn and the reopening of the bond just $5bn. The size of the 10-year note was $13bn, as expected. Between the net issuance settling on 15 May and the quarterly interest payment by the Treasury, investors will receive close to $44.5 billion in cash from the Treasury. Although recently such cash flows are not without precedent, these flows are large by historical standards and, with the elimination of the 3-year note, will only get larger over the next few quarters.

Figure 1. Net tax receipts (non-withheld less refunds)



Source: LehmanLive.

Figure 2. Cash flows to investors



Source: US Treasury, Lehman Brothers Global Economics.

		In 1 mths' time		In 3 mths' time		In 12 mths' time	
%	Current rate	Market	Lehman	Market	Lehman	Market	Lehman
Fed funds rate	5.25	5.23	5.25	5.19	5.25	4.76	5.25
3-mth LIBOR rates	5.36	5.34	5.41	5.31	5.40	4.87	5.40
spread (bp)	11	11	16	12	15	11	15
10-yr bond yields	4.67	4.74	4.72	4.74	4.77	4.77	4.80
yen per dollar	120.3	119.8	117.8	118.9	117.0	115.1	103.7
dollars per euro	1.36	1.36	1.35	1.36	1.35	1.37	1.28

* *Lehman estimates are modal ('most likely outcome') forecasts. Table updated 4 May 07*

* *Market estimates for 10-yr yields assume a constant differential between benchmark yields and fitted par yields.*

UNITED STATES: CALENDAR

Economic releases in the week ahead

		Period	Prev 2	Prev 1	Latest	Lehman	Consensus
Monday 7 May							
13.00	TSY 3-year auction, $bn				16	14	n.a.
15.00	Consumer credit, change, $bn	Mar	6.0	6.6	3.0	4.0	5.0
Tuesday 8 May							
10.00	Wholesale inventories, %m-o-m	Mar	-0.3	0.6	0.5	0.2	0.4
13.00	TSY 10-year auction, $bn				13	13	n.a.
13.00	ISM semiannual report						
Wednesday 9 May							
7.00	MBA mortgage applications, %w-o-w	4-May	-2.5	3.6	0.6	n.a.	n.a.
14.15	FOMC meeting, %				5.25	5.25	5.25
Thursday 10 May							
8.30	Initial jobless claims, m	5-May	341	326	305	310	n.a.
	Continuing jobless claims, 000	28-Apr	2.529	2.588	2.495	2.500	n.a.
8.30	Trade balance, $bn	Mar	-61.5	-58.9	-58.4	-61.5	-60.0
8.30	Import prices, %m-o-m	Apr	-1.1	0.1	1.7	1.0	1.0
	Non-petroleum import prices, %m-o-m	Apr	-0.1	0.1	0.3	1.0	n.a.
11.00	Fed's Moskow at payments conference						
11.15	Fed's Kroszner at payments conference						
13.00	TSY 30-year auction, $bn				9	5	n.a.
14.00	Budget balance, $bn	Apr	17.6	57.9	118.8	140.0	140.0
Friday 11 May							
8.30	PPI, %m-o-m	Apr	-0.6	1.3	1.0	0.5	0.5
	PPI, %y-o-y	Apr	0.2	2.6	3.1	2.9	2.9
	Core PPI, %m-o-m	Apr	0.2	0.4	0.0	0.2	0.2
	Core PPI, %y-o-y	Apr	1.8	1.8	1.6	1.8	1.8
8.30	Retail sales, %m-o-m	Apr	0.0	0.5	0.7	0.4	0.3
	Non-auto retail sales, %m-o-m	Apr	0.2	0.4	0.8	0.5	0.4
	Non-auto, non-gas retail sales, %m-o-m	Apr	0.2	0.3	0.4	0.4	n.a.
	Non-auto, gas, build. mat. retail sales, %m-o-m	Apr	0.2	0.3	0.3	0.6	n.a.
10.00	Business inventories, %m-o-m	Mar	0.1	0.2	0.3	0.0	0.2

Economic releases in the weeks ahead

		Period	Prev 2	Prev 1	Latest	Lehman	Consensus
Week beginning 14 May							
14-May	Fed's Lockhart at Atlanta Fed conference						
15-May	Fed's Bernanke, Lockhart, Minehan, Mishkin, Geithner at financial markets conference						
	CPI, %m-o-m	Apr	0.2	0.4	0.6	0.3	n.a.
	CPI, %y-o-y	Apr	2.1	2.4	2.8	2.5	n.a.
	CPI, Index, NSA	Apr	202.4	203.5	205.4	206.5	n.a.
	Core CPI, %m-o-m	Apr	0.3	0.2	0.1	0.2	n.a.
	Core CPI, %y-o-y	Apr	2.7	2.7	2.5	2.4	n.a.
	Empire State survey	May	24.4	1.9	3.8	3.0	n.a.
	Total net international capital flows, $bn	Mar	-11.8	79.6	94.5	35.0	n.a.
	NAHB housing index	May	39	36	33	33	n.a.
16-May	Fed's Plosser and Kohn at financial markets conference						
	Housing starts, m, saar	Apr	1.399	1.506	1.518	1.490	n.a.
	Housing starts, %m-o-m	Apr	-14.3	7.6	0.8	-1.8	n.a.
	Building permits, m, saar	Apr	1.571	1.532	1.564	1.540	n.a.
	Building permits, %m-o-m	Apr	-2.6	-2.5	2.1	-1.5	n.a.
	Industrial production, %m-o-m	Apr	-0.4	0.8	-0.2	0.2	n.a.
	Capacity utilization, %	Apr	81.1	81.6	81.4	81.5	n.a.
17-May	Philadelphia Fed survey	May	0.6	0.2	0.2	2.5	n.a.
	Leading indicators, %m-o-m	Apr	-0.3	-0.6	0.1	0.1	n.a.
	Fed's Lacker on inflation						
	TSY Secretary Paulson at Dartmouth commencement						
18-May	Consumer sentiment, 1966=100	May-pre	88.4	85.3	87.1	87.0	n.a.
Week beginning 21 May							
24-May	Durable goods orders, %m-o-m	Apr	-8.8	2.3	3.7	-0.5	n.a.
	Durable goods orders ex-transport, %m-o-m	Apr	-3.3	-0.6	1.3	n.a.	n.a.
	Core capital goods orders, %m-o-m	Apr	-6.2	-2.4	4.8	1.0	n.a.
	Core capital goods shipments, %m-o-m	Apr	-3.1	-0.1	0.6	0.4	n.a.
	New home sales, m, saar	Apr	0.873	0.836	0.858	0.860	n.a.
	New home sales, %m-o-m	Apr	-14.4	-4.2	2.6	0.2	n.a.
	Median new home prices, %y-o-y	Apr	1.8	0.4	6.4	n.a.	n.a.
	TSY 2-year note announcement, $bn				16	18	n.a.
	TSY 5-year note announcement, $bn				13	13	n.a.
25-May	Existing home sales, m, saar	Apr	6.44	6.68	6.12	6.20	n.a.
	Existing home sales, %m-o-m	Apr	2.7	3.7	-8.4	1.3	n.a.
	Median existing home prices, %y-o-y	Apr	-3.0	-1.0	-0.3	n.a.	n.a.
Week beginning 28 May							
28-May	Memorial Day Holiday - Markets Closed						
29-May	Consumer confidence, (1985=100)	May	111.2	108.2	104.0	106.0	n.a.
	Case-Shiller home price index, %y-o-y	Mar	0.7	-0.1	-1.0	-1.7	n.a.
30-May	ADP national employment report, change, 000	May	65	98	64	n.a.	n.a.
	FOMC minutes	9-May					
31-May	GDP, %q-o-q saar	Q1-pre	2.0	2.5	1.3	1.3	n.a.
	Final sales, %q-o-q saar	Q1-pre	1.9	3.7	1.6	1.6	n.a.
	Price deflator, %q-o-q saar	Q1-pre	1.9	1.7	4.0	4.0	n.a.
	Construction spending, %m-o-m	Apr	-0.6	1.5	0.2	-0.1	n.a.
	Chicago NAPM	May	47.9	61.7	52.9	52.0	n.a.
1-Jun	Personal income, %m-o-m	Apr	1.1	0.7	0.7	0.4	n.a.
	Personal consumption expenditures, %m-o-m	Apr	0.6	0.7	0.3	0.5	n.a.
	Core PCE deflator, %m-o-m	Apr	0.22	0.33	0.05	0.18	n.a.
	Core PCE deflator, %y-o-y	Apr	2.2	2.4	2.1	2.1	n.a.
	Non-farm payrolls, change, 000	May					
	Unemployment rate, %	May					
	Average hourly earnings, %m-o-m	May					
	Average hourly earnings, %y-o-y	May					
	Non-farm workweek, hrs	May					
	Consumer sentiment, (1966=100)	May-fin	85.3	87.1	n.a.	n.a.	n.a.
	ISM purchasing managers index	May	52.3	50.9	54.7	54.0	n.a.
	ISM prices paid	May	59.0	65.5	73.0	70.0	n.a.
	OFHEO house price index, %q-o-q	Q1	1.3	1.0	1.1	0.5	n.a.
	Pending home sales, %m-o-m	Apr	-4.2	1.1	-4.9	1.0	n.a.
	Domestic vehicle sales, m, saar	May	12.8	12.3	12.5	n.a.	n.a.

UNITED STATES: PREVIEW

The week ahead

Drew Matus
+ 1 212 526 9878
dmatus@lehman.com

John Shin
+1 212 526 5194
john.shin@lehman.com

Michelle Meyer
+1 212-526-7977
mimeyer@lehman.com

Zach Pandl
+1 212 526 8010
zapandl@lehman.com

The FOMC should keep rates on hold. They may modify, but are unlikely to drop, their anti-inflation bias. The trade balance and retail sales will provide clues about Q1 GDP revisions.

TSY 3-year auction (Monday)

This afternoon the Treasury will auction $14 billion in 3-year notes in the final auction for this maturity. Falling deficit forecasts have reduced the Treasury's need to borrow. As a result the Treasury has discontinued this recent returnee to the Treasury line-up, helping maintain liquidity at other benchmark maturity points.

Consumer credit (Monday)

Consumer installment credit should increase $4bn in March, only slightly more than February's increase of $3bn. We look for credit card debt to continue to rise as consumers finance some of the increase in gasoline costs with credit cards. We expect little change in non-revolving credit, which is largely auto loans, given weak auto sales in March.

Wholesale inventories (Tuesday)

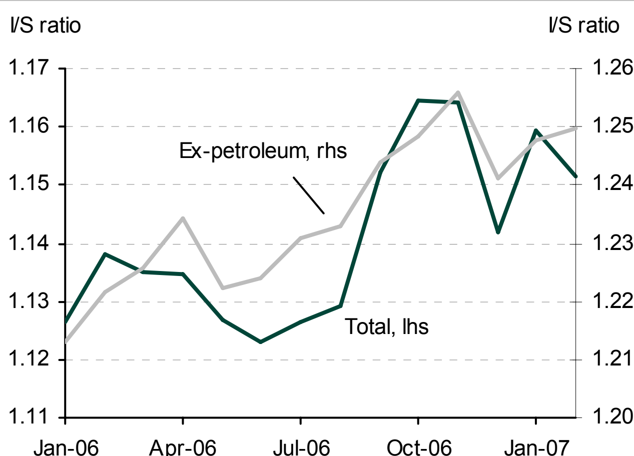
We look for wholesale inventories to rise 0.2% in March

We look for wholesale inventories to rise 0.2% in March, or 8.1% year-over-year. Wholesale inventories have grown more slowly in the past several months as firms have attempted to liquidate their excess stocks. While the inventory-to-sales (I/S) ratio – a measure of the excess supply of inventories – has recently moderated, a significant part of the improvement is due to a fall in petroleum stocks (Figure 1). Outside this volatile component, I/S ratios remain elevated in the wholesale sector, suggesting sluggish inventory growth is likely to continue for at least the next several months.

TSY 10-year auction (Tuesday)

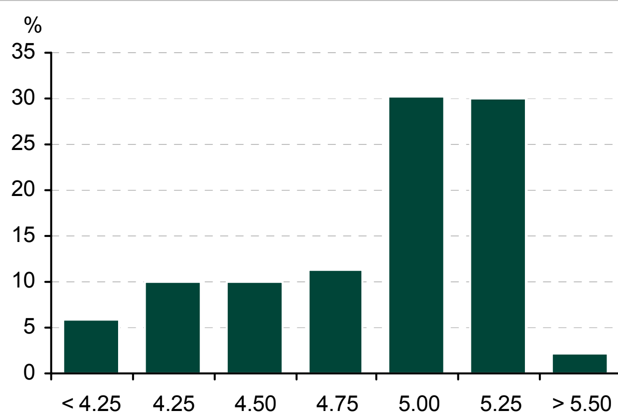
This afternoon the Treasury will auction $13 billion in 10-year notes, an unchanged amount from the previous refunding. The issue will be reopened in June. At that time we expect an additional $9 billion will be auctioned, resulting in a $22 billion total issue size.

Figure 1. Wholesale inventories



Source: Census Bureau.

Figure 2. December Fed funds distribution



Source: Fediscope – Lehman Brothers, as of 2 May.

FOMC meeting (Wednesday)

We expect the Fed to remain on hold and reiterate its anti-inflation bias

Despite some soft data we expect the Fed to remain firmly on hold and reiterate its anti-inflation bias. The old FOMC directive still rings true today so substantive changes are unlikely.

The FOMC should make little, if any, changes in its description of growth…

Since the last FOMC meeting, a very weak 1.3% Q1 report has highlighted the downside risks to growth. However, the Fed can see through this report—as we note in the *US Overview*, adjusting for unusual weakness in defense spending, trade and new orders, the underlying number was above 2%. Moreover, the broad flow of data still remains mixed and consistent with low 2% GDP growth. Hence we expect the FOMC to make little if any changes in its description of growth: "Recent indicators have been mixed and the adjustment in the housing sector is ongoing. Nevertheless, the economy seems likely to continue to expand at a moderate pace over coming quarters." Should they choose to alter the language, they would likely simply elaborate on the current state of two key risk areas—housing and capital spending—but leave their reasonably optimistic assessment of the outlook unchanged.

…but likely soften the statement that core inflation has remained elevated

A similar story applies on the inflation front. The core PCE was remarkably soft in March: flat for the month and up only 2.1% from a year ago. However, most forward-looking inflation indicators point to increased upside risks. The unemployment rate remains below most estimates of NAIRU. Productivity growth continues to slow. Commodity prices have picked up significantly. And measures of inflation expectations have risen modestly. Therefore we expect offsetting changes in the Fed's description of inflation. They will likely soften the statement that "recent readings on core inflation have been somewhat elevated," but they could add concerns about commodity pressures to their inflation forecast sentence: "Although inflation pressures seem likely to moderate over time, the high level of resource utilization has the potential to sustain those pressures." Finally, we believe it is much too early for the Fed to drop its anti-inflation bias. It is still the case that "the Committee's predominant concern remains the risk that inflation will fail to moderate as expected."

Trade balance (Thursday)

We look for the trade balance to widen to $61.5bn, largely due to higher energy prices

The March trade balance should widen out to $61.5bn, larger than February's $58.4bn (Figure 3). The increase in the trade deficit should come about largely as a result of higher energy prices. Petroleum imports dropped by nearly $4bn from January to February, and a 9% increase in petroleum import prices implies a reversal of that drop. Strong import demand should also come from continued consumption strength in the US, as nominal consumer imports have risen 15% y-o-y. However, solid foreign demand should provide some offsetting export strength, as it has over the past several months. We look for exports to rise around 2% in March, as good growth overseas has helped to move the trade deficit off its record highs. The trade deficit peaked in August 2006 at $68.9bn, and although a drag from growth in Q1, we expect trade balance to have a small positive contribution to GDP growth in 2007 for the first time since 1995.

Import prices (Thursday)

April import prices should rise 1% after jumping 1.7% in March

Import prices should rise another 1.0% in April after jumping 1.7% in March, but the story again will be in energy prices. Crude oil prices surged in the month, but even ex-petroleum we look for import prices to rise 1% as natural gas prices also jumped up. As usual, the main point of market interest will be the "core" consumer goods prices, which have been trickling up over the past year from -0.3% y-o-y in March 2006 to 1.8% y-o-y in March 2007. We expect another 0.2% m-o-m increase in April, which would take the y-o-y rate to 2.1%. Markets will probably pay more attention to import prices after the FOMC minutes from the 21 March announcement showed some concern, stating that "…recent increases in prices for energy and some non-energy imports likely would boost overall inflation in the near term and might put upward pressure on prices of some core

goods and services." The recent depreciation in the dollar may also boost inflation in the medium term, although the April data are likely much too soon to see any impact.

Initial jobless claims (Thursday)

We look for initial claims to inch up to 310,000, a level that is consistent with continued strong job growth.

TSY 30-year auction (Thursday)

The Treasury will auction $5bn in a re-opening of the 30-year bond

The Treasury will auction $5 billion this afternoon in a re-opening of the existing 30-year bond. This makes the total issue size for the first bond of the year just $14 billion and suggests total bond issuance of just $28 billion for the year. This is well below market expectations which, for the most part, exceeded $35 billion.

Budget balance (Thursday)

We look for the budget surplus to rise to $140bn

With non-withheld tax receipts outpacing our expectations for April by $11 billion it seems likely that overall receipts could be as high as $350 billion for the month. Even with an acceleration in the growth rate of outlays, this surge in receipts is large enough to drive the budget surplus for the month up to $140 billion. This would lower the year-to-date deficit to $118 billion, a $65 billion improvement relative to last year, a level consistent with our recently revised deficit estimate of just $175 billion.

PPI (Friday)

April PPI should rise 0.5%

The April producer price index (PPI) should rise 0.5%, reflecting a cooling of both energy and food prices, but a firming of core inflation pressure. The increase should reduce the year-over-year rate to 2.9% from 3.1%.

We look for energy and food PPI to rise 1.8% and 0.1%, respectively

Both gasoline and heating oil prices rose during April, while natural gas prices (which feed into the PPI with a one-month lag) declined the previous month. Assuming a trend-like increase in electricity prices, energy PPI inflation should decelerate, rising 1.8% m-o-m, or 1.9% y-o-y. Food prices, which have been driven higher by a surge in corn and livestock prices, should also cool, rising just 0.1%. Outside the volatile food and energy components, however, core inflation looks likely to rebound by 0.2%, after remaining unchanged in March. Much of the weakness in the March core reading was due to a drop in light vehicle prices. Payback from this component, combined with sustained pipeline inflation pressures, should translate into a solid core reading for April.

Core PPI should rise 0.2% or 1.8% y-o-y

With the core PPI accelerating, we are frequently asked what level of core PPI inflation is consistent with the Fed's "comfort zone" of 1-2% for the core PCE deflator. To answer this question, methodological differences between the two inflation measures become important. First, the PPI is only a measure of goods prices; it does not include the price of services. Second, the PPI measures only the price of domestic produced goods, whereas the CPI and PCE deflators measure the price of all goods consumed, regardless of where they are produced. Third, in addition to consumer products, the PPI includes the price of capital equipment. Accounting for these differences and the historical trends in the series, we judge that a rough "comfort zone" for the core PPI is 0.0% to 1.5% y-o-y (Figure 5). With the core likely to accelerate to 1.8% y-o-y in April, the PPI report is likely to be an unwelcome reminder of the upward pressure on core consumer goods prices.

Retail sales (Friday)

We look for retail sales to rise 0.5%, pushed up from rising gasoline prices

April retail sales should get off to a decent start, with a headline figure of 0.4%, and ex-autos up 0.5%. We expect auto sales to have a fairly neutral impact on the overall number this month, given that the relationship between domestic unit auto sales, which came in at 12.5 saar, and motor vehicle parts in the retail sales report has been very loose. The market will focus on the core retail sales components, which will likely have

several buffeting cross-currents. Gasoline prices should push the retail sales number up. Gasoline sales rose 3.1% in March, and 1.5% in February. From what we know of retail gas prices, we look for gasoline prices to rise another 1.1% in April, causing ex-autos and ex-gasoline retail sales to rise 0.4%.

"Control" retail sales should rise a solid 0.6%

But the "control" number for retail sales, which is ex-autos, gasoline, and building materials, should rise a solid 0.6% (Figure 6). We expect building materials to fall 1.0% in April, which depresses the "raw" ex-autos and ex-gas number. Building materials have behaved in puzzling fashion over the past few months, with a surprising 1.4% gain in March, and significant and sizable revisions to previous data in the past few reports. Building materials are counting as part of construction and do not count in the national income and product accounts as a part of consumer spending, even though these data come out with the retail sales report. Meanwhile, control retail sales should reflect continued decent consumer spending, as the robust state of the labor market helps to partially offset the negative impact of a declining housing wealth effect.

We do not expect major seasonal distortions from Easter

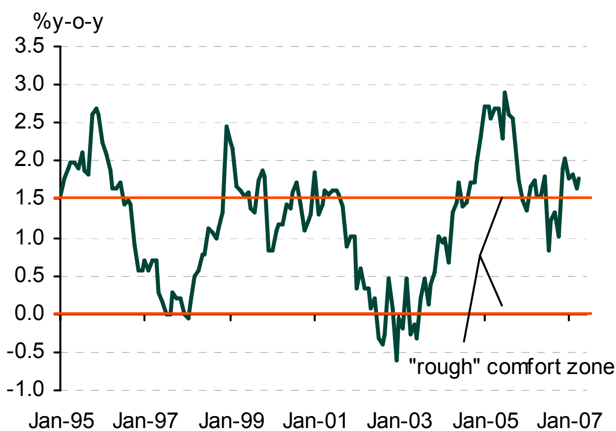
Seasonal impacts from Easter, which are always a problem with the retail sales number during the Spring, should be more modest in this report. Easter fell on April 7th this year, which is just a couple of days different than the average in the past two decades. Some impact may come from Easter falling on April 16th last year, offering a longer Easter shopping season in 2006, but overall we do not expect a major seasonal distortion problem from the data this time around.

Business inventories (Friday)

Business inventories likely remained unchanged in March

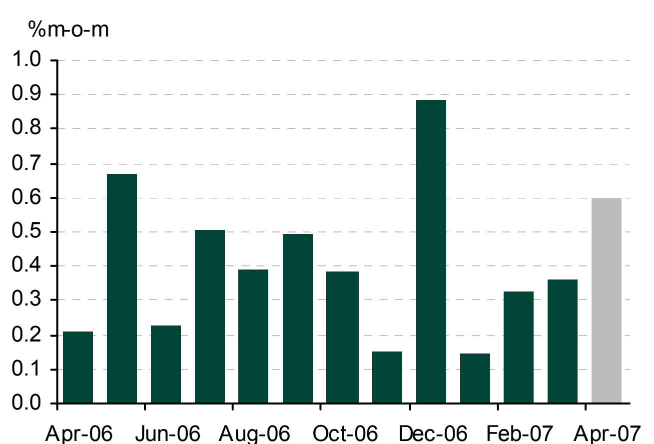
Business inventories likely remained unchanged in March, after increasing in each of the last 12 months. Manufacturing inventories, which were reported in last week's Factory Orders report, increased 0.2% during the month, and we look for an equivalent rise in the wholesale inventory component. Retail inventories, in contrast, should decline 0.3%, reflecting a 0.8% decline in motor vehicle dealer stocks. While retail motor vehicle inventories have now fallen in seven of the last eight months, we believe this trend is close to ending. In an effort to reduce an overhang of excess stocks, manufacturers aggressively cut production in the second half of 2006, and stocks have now returned to more sustainable levels. Despite the decline in the current month, therefore, we look for a pickup in auto production and gradual inventory growth for the remainder of this year.

Figure 5. Core PPI



Source: Bureau of Labor Statistics, Lehman Brothers.

Figure 6. "Control" retail sales



Source: Commerce Dept, Lehman Brothers.

CANADA: OUTLOOK

Holding pattern

John Shin
+1 212 526 9432
joshin@lehman.com

We expect the Bank of Canada to stay on the sidelines in 2007, although the growth picture has brightened of late and inflation has surprised on the upside.

Canada's growth outlook has brightened recently. The strong labor market has been a key factor underpinning robust consumer spending and general aggregate demand, with payrolls up by an average of 48,000/month since September 2006 and the unemployment rate down around 30-year lows.

Continued labor market strength has helped to alleviate market concerns about near-term downside growth risks. While Q4 GDP came in moderately soft at 1.4% on a quarterly annualized rate, several factors helped mitigate the softness of the headline. First, Q3 was revised up a few tenths to 2.0%. Second, the monthly real GDP data showed that the quarter ended on a strong note. Third, much of the Q4 weakness came from inventories, which points to some upside risks for Q1. Firms likely ran down their stocks in the face of unanticipated strong demand and will need to rebuild inventories in H1 2007 as consumer spending has remained solid.

Inflation has surprised to the upside lately, and core inflation has been above the 2% target for most of the past two quarters. On balance, we are still comfortable with our view that the Bank will remain on hold at 4.25% through 2007. But the recent surge in inflation readings, combined with strong payroll numbers, has increased the chances that the next Bank of Canada move could be a hike.

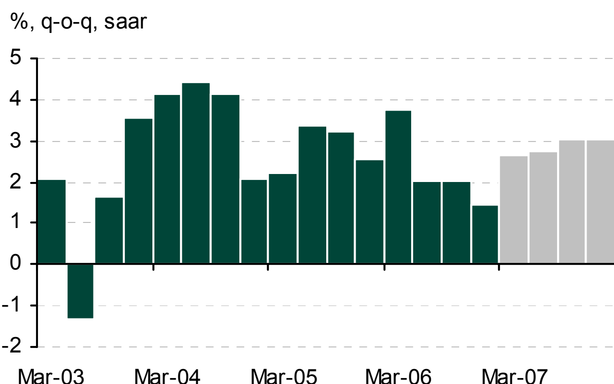
The outlook at a glance

%	1Q06	2Q06	3Q06	4Q06	1Q07E	2Q07E	3Q07E	4Q07E	2006	2007E	2008E
Real GDP	3.8	2.0	2.0	1.4	2.7	2.8	3.0	3.0	2.7	2.4	3.0
Consumption	5.4	3.7	5.1	3.1	2.7	2.0	2.0	2.0	4.1	2.9	2.0
Government	3.6	4.4	2.0	1.8	3.0	3.0	3.0	3.0	3.4	2.7	3.0
Investment	10.6	2.8	3.1	3.7	3.1	3.1	3.1	3.1	6.7	3.2	3.1
Exports	-4.8	-1.3	3.5	4.8	3.0	3.5	3.7	3.7	1.3	3.4	3.7
Imports	-1.9	9.0	5.1	-0.6	2.5	2.3	2.6	2.6	5.2	2.6	2.6
Contributions to GDP:											
Domestic final sales	6.2	3.6	4.0	3.0	2.9	2.5	2.5	2.5	4.5	2.9	2.5
Inventories	-1.2	2.4	-1.3	-3.8	-0.4	-0.2	0.2	0.2	-0.2	-0.8	0.1
Net trade	-1.2	-4.0	-0.7	2.2	0.2	0.4	0.4	0.4	-1.6	0.3	0.4
Unemployment rate	6.4	6.2	6.4	6.1	6.1	6.2	6.3	6.4	6.3	6.3	6.5
Average monthly payrolls	37	32	4	43	42	15	20	20	29	24	15
Consumer prices	2.4	2.6	1.7	1.3	1.8	1.8	2.3	3.1	2.0	2.3	2.1
Core "ex-eight" CPI	1.7	1.8	2.1	2.2	2.2	2.4	2.3	2.2	1.9	2.3	2.1
Gov't budget, % GDP									0.3	0.1	0.0
Current acc't, % GDP									2.0	2.1	2.0
Overnight Target Rate	3.75	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.00
10-year bond yields	4.23	4.63	3.98	4.05	4.10	4.20	4.30	4.30	4.05	4.30	4.30
30-year bond yields	4.23	4.67	4.07	4.10	4.20	4.30	4.40	4.40	4.10	4.40	4.40
CAD/USD	1.168	1.116	1.118	1.165	1.140	1.150	1.230	1.250	1.165	1.250	1.300

Notes: Real GDP and its contributions are seasonally adjusted annual rates.
Unemployment is as a percentage of the labour force. Prices are year-on-year. Financial rates are end-of-period.
"ex-eight" inflation measure is Bank of Canada's core rate. Table last revised 20 April 2007

Source: Lehman Brothers.

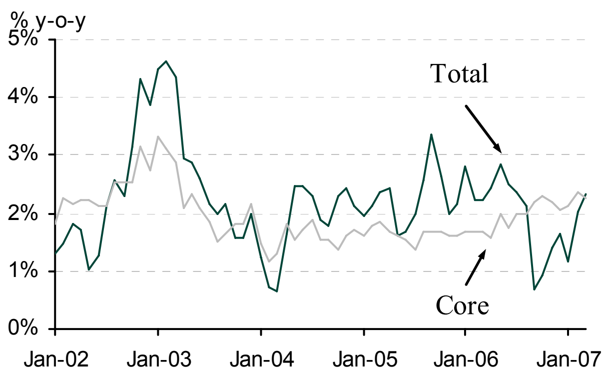
Canadian growth has been below potential for the past two quarters



Source: Statistics Canada and Lehman Brothers.

- GDP growth in Canada disappointed in Q4, coming in at 1.4%.
- The Bank of Canada considers potential growth to be around 2.8% on an annual basis, as productivity growth has been sluggish.
- In aggregate, Canada is now around its potential output limit, with the accompanying capacity constraints.

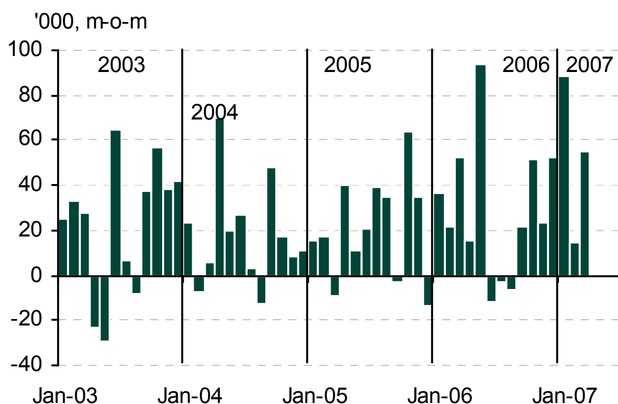
Headline inflation has fallen sharply



Source: Bank of Canada, Statistics Canada and Lehman Brothers.

- The February consumer price index data surprised significantly on the upside.
- Core inflation is currently running at 2.3% y-o-y, above the formal target.
- We expect both headline and core inflation to reach the 2% target by the end of 2008.

The labor market is robust



Source: Statistics Canada and Lehman Brothers.

- Payroll growth has recently sharply picked up in Canada, where the labor market is roughly a tenth the size of that of the US.
- The labor market has been streaky; it was strong for the first five months of the year, fell for the next three, but has since rebounded, including two very surprising gains in December and January.
- The unemployment rate, at 6.1%, is around its lowest level in more than a generation.

CANADA: PREVIEW

The week ahead

John Shin
+1 212 526 9432
joshin@lehman.com

The main event of the week will be on Friday with the release of the Labour Force Survey.

Building permits (Monday)

Building permits should bounce back modestly

Building permits should rise 4.0% in March, after two very volatile months in which they fell 22.4% in February after a 10.4% increase in January. The pickup in permits should reflect the gain in March housing starts.

Housing starts (Tuesday)

We look for housing starts to be little changed

We expect housing starts to be little changed at 210K in April, after they jumped to 210.9K in March. Housing starts had moved around sharply in the previous two months.

International merchandise trade balance (Thursday)

The trade balance should pick up modestly

The international merchandise trade balance should rise to C$6.0bn in March, after falling sharply to C$4.8bn in February. However, the previous month's decline was largely the result of a railway strike that reduced exports, and those effects likely reversed themselves during March.

Labour force survey (Friday)

The Labour Force Survey should show solid growth

The Labour Force Survey should show continued strength, with a gain of 15,000 jobs in April and an increase in the unemployment rate to 6.2% by a tenth. The survey has surprised sharply on the upside several times in the past few quarters, and has been very supportive of growth. The unemployment rate is currently at around a 30-year low for Canada.

Economic events in the weeks ahead

		Period	Prev 2	Prev 1	Latest	Lehman	Consensus
Monday 7-May							
8.30	Building permits, % m-o-m	Mar	-9.0	10.4	-22.4	4.0	n.a.
Tuesday 8-May							
8.15	Housing starts, '000	Apr	248.5	196.0	210.9	210.0	n.a.
Thursday 10-May							
8.30	International merchandise trade, C$bn	Mar	5.0	5.8	4.8	6.0	n.a.
Friday 11-May							
7.00	Change in payrolls, '000	Apr	88.9	14.2	54.9	15.0	n.a.
	Unemployment rate, %	Apr	6.2	6.1	6.1	6.2	n.a.
Week beginning 14-May							
15-May	New motor vehicle sales, % m-o-m	Mar	6.3	-4.0	-3.7	0.5	n.a.
	Manufacturing shipments, % m-o-m		1.8	-1.9	-0.2	0.5	n.a.
17-May	Consumer price index, % m-o-m (nsa)	Apr	0.1	0.7	0.8	0.5	n.a.
	Consumer price index, % y-o-y (nsa)		1.2	2.0	2.3	2.3	n.a.
	Core CPI, % m-o-m (nsa)		0.1	0.5	0.3	0.2	n.a.
	Core CPI, % y-o-y (nsa)		2.1	2.4	2.3	2.5	n.a.
18-May	Retail sales, % m-o-m	Mar	0.2	2.3	0.1	0.4	n.a.
	ex-motor vehicles, % m-o-m		-0.6	2.0	1.0	0.7	n.a.

EURO AREA: FOCUS

The French consumption lifeline

Gustavo Reis
+44 20 710 29085
gustavo.reis@lehman.com

A slowing housing market poses downside risks to French consumer spending. However, we expect financial wealth and income growth to adequately compensate.

Since mid-2003, the two largest economies in the euro area have embarked on lopsided recoveries. While German GDP growth has been buoyed by robust fixed investment and net trade, growth in France has depended on resilience in household consumption. The optimism that has accompanied the German upswing has been notably absent in France. This may partly reflect a growing awareness of the competitiveness challenges that now face the French manufacturing sector. This is symbolised most clearly by the country's declining export market share: between 1998 and 2005, according to ECB calculations, the market share of French exporters fell by 10-15%. This compares with a near-10% gain attained by German exporters. [1]

Weak competitiveness threatens the economy…

Consequently, despite recovering business morale in France, the economy is threatened by not only a combination of monetary policy tightening, the appreciation of the euro and slower global growth, but also a France-specific problem of weakened competitiveness. The importance of household consumption growth in driving the recovery forward is therefore clear. Luckily, the latest data – showing that household consumption of manufactured goods increased by 6.3% y-o-y in March – suggests that this is still occurring (Figure 1).

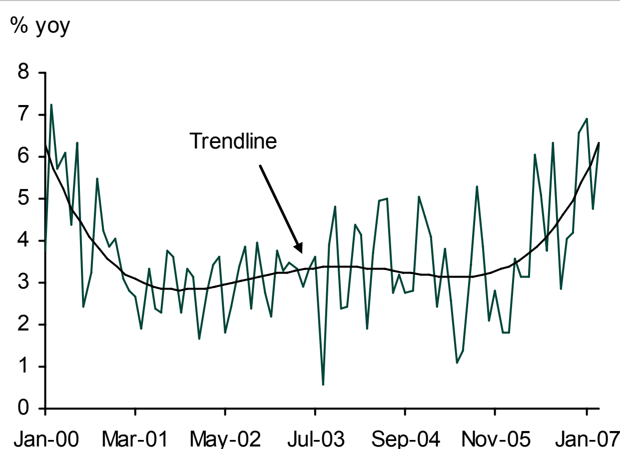
The no-nonsense consumer

…but has been offset by consumption in recent years...

An accounting exercise illustrates the important role of household consumption in driving French GDP growth: in 2005 and 2006, it contributed, on average, 1.3pp (saar) to average GDP growth of 1.7% q-o-q (saar). This compares with fixed investment (at 0.8pp), net trade (at -0.5pp) and inventories (at -0.2pp). Narrowing the window to 2006 alone gives a slightly different impression: consumption contributed, on average, 1.5pp to average GDP growth of 2.5% q-o-q (saar), compared with fixed investment (at 0.9pp), net trade (at 0.1pp) and inventories (at -0.5pp).

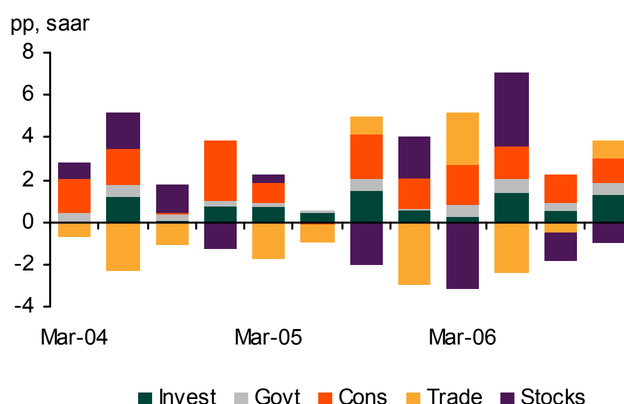
To assess whether this consumption "lifeline" is sustainable, we have first investigated the extent to which the relative strength of consumer spending has been warranted by fundamentals. Our hypothesis is that, if consumers have stretched their finances ahead of real income and wealth developments – the fundamentals – there is a greater risk of

Figure 1. French household consumption of goods



Sources: INSEE, Datastream and Lehman Brothers Global Economics.

Figure 2. Contributions to GDP growth



Sources: INSEE, Datastream and Lehman Brothers Global Economics.

prompt retrenchment, especially in the event of an adverse shock (such as from falling house prices).

…reflecting robust wealth and income fundamentals

To test this we have estimated a consumption function using quarterly data to the end of 2004 and evaluated its "out-of-sample" forecast errors for 2005 and 2006. Figure 3 shows that our (standard) consumption function has done a good job in predicting spending growth over the past two years – its mean-squared forecast error (or MSFE) averages only 0.29pp. This analysis suggests that the relative strength of household consumption in France can be explained, at least statistically, by gains to wealth and income.

The vanishing housing boost

But a slowing housing market poses downside risks…

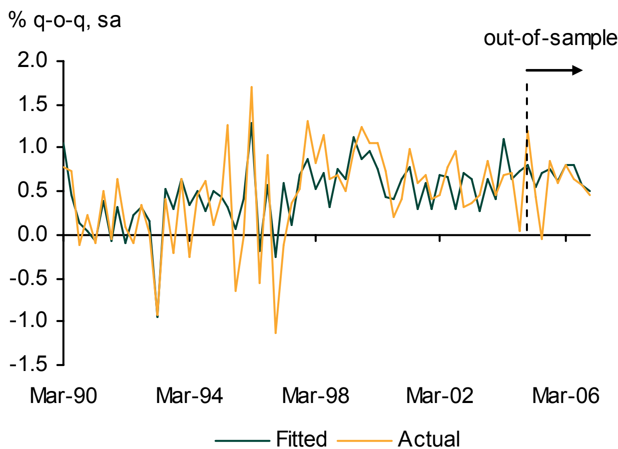
So much for the past. What about the impact of the slowing housing market? House price inflation, which peaked at 14.3% y-o-y in Q1 2006, eased to 9.3% y-o-y at the end of last year.[2] Following years of double-digit growth, rising interest rates appear to be inducing disinflation in house prices, and we expect further interest rate increases to reinforce that inducement. That stands to drain momentum from household consumption. The question is by how much?

The support provided by rising housing wealth to consumer spending in recent years suggests that the momentum drain has already been large. An econometric contributions exercise using our estimated consumption function shows that the positive contribution from rising housing wealth to spending – which peaked at more than 1pp in 2004 – had vanished by Q4 2006, but that this has been offset by a larger contribution from real income growth, which in Q4 2006 accounted for 1.2pp of the 2.5% y-o-y growth in consumption.[3]

…with consumption already adjusting to cooler housing

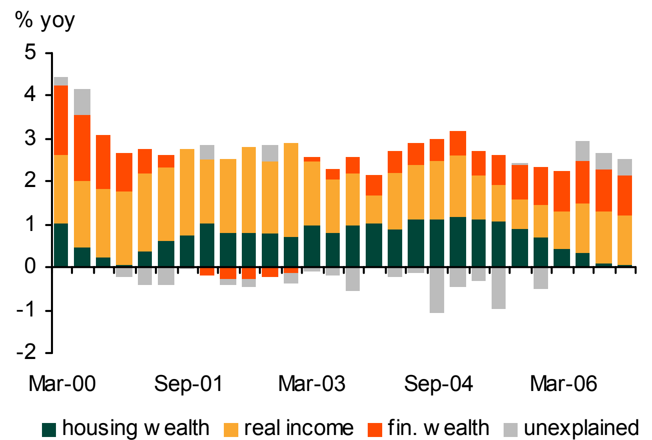
According to our estimates, financial wealth has also been playing a role in fuelling consumption, although there is a caveat here. When estimating consumption functions, equity prices or financial wealth variables usually "compete" in short-run explanatory power with consumer confidence and/or unemployment. In our case, where we have included a financial wealth variable but no consumer confidence or unemployment variable, there is a risk that confidence and cyclical effects not captured by variations in real income may end up being attributed to financial wealth. Therefore, we take the magnitude of this financial wealth effect with a pinch of salt. We have nonetheless found that, relative to the alternatives, financial wealth does improve the explanatory power of our consumption function.

Figure 3. Forecasting performance of consumption



Sources: Lehman Brothers Global Economics.

Figure 4. Econometric contributions to consumption



Sources: Lehman Brothers Global Economics.

Homeless, but alive and kicking

With house price inflation probably on course for a further slowdown, forecasters of French consumption must make a judgement on the sensitivity of consumption to housing wealth.

We estimate a housing wealth effect of 6 cents on the euro…

Simulations on our model suggest that the adjustment of spending to housing wealth shocks is important enough to affect forecasts. The elasticities and the dynamic adjustment within our consumption function suggests that spending rises by 6 cents for every euro increase in net housing wealth, with short-term impacts even larger (Figure 5). However, this being a single-equation simulation, second-round effects of housing wealth on income have not been considered, which would impact the saving ratio and wealth itself.

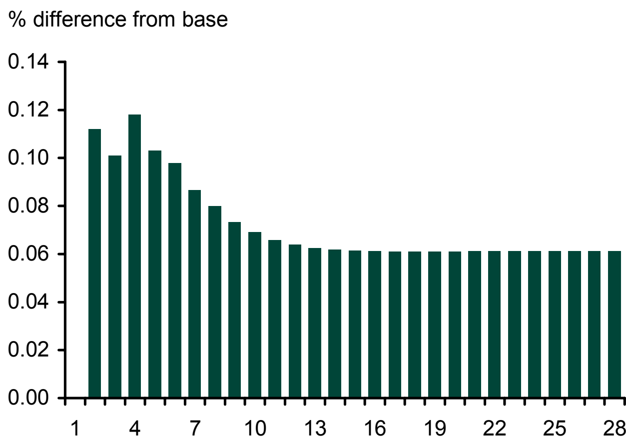
However, our model's estimates are not typical. An OECD paper suggests that, based on a consumption function estimated with data up to 2002, the propensity to consume out of housing wealth was not significantly different from zero.[4] The expansion of the mortgage market and a higher degree of mortgage equity withdrawal in recent years may go some way to explaining the difference.

…which is small enough to be offset by income and financial wealth gains

Looking ahead, even with a heightened sensitivity to housing, real income growth – rooted in healthy labour market conditions – and higher financial wealth seem set to support household consumption in the short run (Figure 6 highlights our forecasts for Q1 and Q2 2007). If we are right, the absence in France of a German-style support to the economy from net exports and investment stands to be compensated by the cushion provided by more confident consumers.■

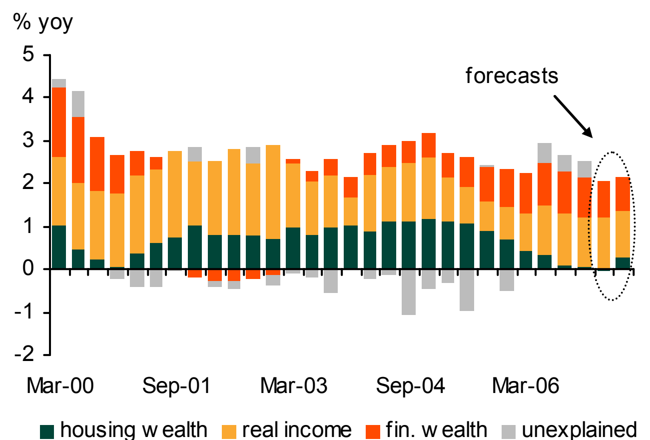
1 *Baumann and di Mauro(2007), "Globalisation and euro area trade – interactions and challenges", ECB occasional paper series no. 55, March 2007.*
2 *Indice trimestriel des prix des logements anciens – France metropolitaine.*
3 *OECD data on net housing wealth is not available for 2006, but we extended the series as per house prices.*
4 *Catte, Girouard, Price and Andre (2004), "Housing markets, wealth and the business cycle", Economics Department working papers no. 34, December 2004.*

Figure 5. Housing wealth effect on consumption



Sources: Lehman Brothers Global Economics.

Figure 6. French household consumption forecast



Sources: Lehman Brothers Global Economics.

EURO AREA: ECONOMIC OUTLOOK

Investment drive

Michael Hume
212-526-0978
mhume@lehman.com

Sandra Petcov
+44 20 710 21142
spetcov@lehman.com

Growth momentum in the euro area looks set to remain solid as a result of strength in investment. But households still do not seem well placed to boost spending by much.

During the past two years, output in the euro area has accelerated significantly, driven largely by domestic final sales and, within that, fixed investment growth, which is now running at a pace well above its long-run average and close to what was recorded in the 1999-2000 boom. Some of this reflects the recovery in the German construction sector, which has emerged from a decade of recession. This trend looks set to continue, although last year's rates of growth are unlikely to be maintained. More fundamentally, firms are now both able and willing to invest: capacity constraints are biting, balance sheets are in an extremely sound condition, access to external financing is readily available on favourable terms and business confidence is high. With this in mind, we expect investment growth this year to match last year's rate and look for still-solid – if a little softer – growth in 2008. These forecasts are above those contained in the latest ECB *Staff Projections*, particularly for this year.

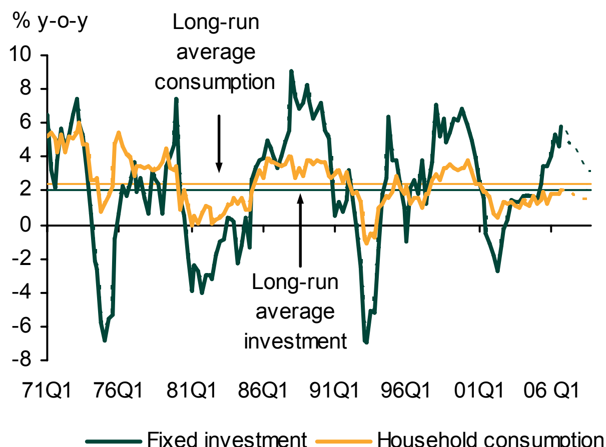
That said, we still see little sign that the pickup in growth is benefiting households to the usual extent. Although employment has accelerated at an unusually rapid rate relative to past recoveries, pushing down the unemployment rate to a 25-year low, this has not yet resulted in a pickup in wage growth and thereby household incomes. This, we suspect, reflects two factors: first, structural reforms have probably lowered the natural unemployment rate; and second, globalisation makes domestic labour market conditions less relevant, reducing employees' bargaining power. As a result, we remain of the view that consumer spending growth will stay modest – also relative to ECB expectations – hampering GDP growth in the medium term. Nevertheless, stronger domestic momentum could, by boosting firms' pricing power, result in a pickup in headline inflation to a little above 2% next year. Faced with this prospect, we expect not only an ECB rate hike of 25bp in June, but a further rate rise in September as well, to 4¼% – with the risk of another hike later in the year should wage growth surprise on the upside.

The outlook at a glance

%	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07	2006	2007	2008
Real GDP	3.4	4.0	2.4	3.6	2.4	2.2	2.1	2.1	2.8	2.6	2.0
Household consumption	2.2	1.5	2.8	1.6	1.6	1.9	1.6	1.6	1.8	1.8	1.5
Fixed investment	4.3	9.0	3.6	6.3	4.2	4.7	4.2	3.6	4.9	4.9	3.4
Government consumption	5.5	-0.2	2.7	1.5	1.8	1.8	1.9	1.9	2.2	1.8	1.9
Exports of goods and services	13.5	4.1	7.7	15.0	3.8	5.6	5.8	5.7	8.5	7.0	5.1
Imports of goods and services	10.1	3.9	9.2	7.1	5.5	6.5	6.2	6.1	7.9	6.5	5.8
Contributions to GDP:											
Domestic final sales	3.3	2.7	2.9	2.6	2.2	2.5	2.2	2.1	2.5	2.4	2.1
Inventories	-1.3	1.2	0.0	-2.2	0.8	0.0	0.0	0.1	-0.1	-0.1	0.1
Net trade	1.4	0.1	-0.5	3.2	-0.6	-0.2	-0.1	-0.1	0.3	0.3	-0.2
Unemployment rate	8.2	7.9	7.8	7.6	7.3	7.3	7.1	6.9	7.9	7.1	6.6
Compensation per employee	2.2	2.4	2.3	1.8	1.9	1.6	1.6	2.1	2.2	2.0	2.3
Labour productivity	1.2	1.4	1.2	1.8	1.7	1.3	1.2	0.9	1.4	1.3	0.8
Unit labour costs	1.0	1.1	1.1	0.0	0.3	0.3	0.8	1.4	0.8	0.7	1.5
Consumer prices	2.3	2.5	2.1	1.8	1.9	1.7	1.8	2.2	2.2	1.9	2.1
Core consumer prices	1.3	1.4	1.4	1.5	1.8	1.9	2.0	2.0	1.4	1.9	1.9
ECB main refi. rate	2.50	2.75	3.00	3.50	3.75	4.00	4.25	4.25	3.50	4.25	4.25
3-month rates	2.82	3.06	3.42	3.73	3.92	4.15	4.40	4.40	3.73	4.40	4.30
10-yr bund yields	3.76	4.07	3.71	3.92	4.06	4.15	4.20	4.15	3.92	4.15	3.95
$/euro	1.20	1.27	1.27	1.32	1.32	1.38	1.35	1.31	1.32	1.31	1.25

Notes: Quarterly national accounts figures are % q-o-q changes at a seasonally adjusted annualised rate. Annual figures are % y-o-y changes. Unemployment is % of labour force. Inflation, wages, productivity and unit labour costs are % y-o-y. Interest rates and currencies are end-of-period.
Source: Lehman Brothers Global Economics.

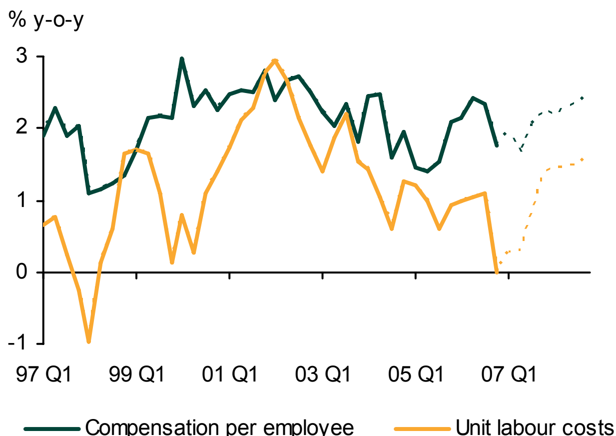
Growth momentum is still skewed towards the corporate sector



Source: Eurostat and Lehman Brothers Global Economics.

- Investment growth in the euro area is running at a rate that is firmly above its long-run average and comparable to the rates seen in the last boom.
- Household consumption growth, on the other hand, is still below its long-run average and far less buoyant than in the last upturn.
- With income growth accruing disproportionately to firms rather than households at the moment, we expect these trends to continue.

Wage growth ought to strengthen but remain moderate



Source: ECB and Lehman Brothers Global Economics.

- Despite the sharp fall in unemployment, the latest indications on wage growth and unit labour cost growth were very soft, at 1.8% y-o-y and 0.0%, respectively.
- Base effects should keep wage and unit labour cost growth in check for the rest of this year.
- Next year, however, the improvement in the labour market should lead to some pickup in wage growth.
- But structural reforms and globalisation should curtail the rise relative to previous cycles.

GDP growth looks likely to have eased a little in Q1

% q-o-q, sa	2006 Q3	2006 Q4	2007 Q1	2007 Q2
Germany	0.8	0.9	*0.2*	*0.6*
France	0.1	0.7	*0.7*	*0.5*
Italy	0.3	1.1	*0.2*	*0.2*
Spain	0.9	1.2	*0.8*	*0.7*
Netherlands	0.7	0.6	*0.8*	*0.7*
Euro area	0.6	0.9	*0.6*	*0.5*

* *Lehman Brothers forecasts in italics.*

Source: National statistics agencies and Lehman Brothers Global Economics.

- GDP expanded rapidly in Q4, with significant momentum across the major euro-area countries.
- Spain and Italy outperformed; German GDP was up at the same rate as the euro-area average, despite the pre-VAT-hike boost. France and the Netherlands lagged behind.
- Growth momentum looks set for a slowdown in Q1, particularly in Italy given weak industrial output, and in Germany, as a result of the VAT hike.
- This week, the Bank of Spain estimated euro-area GDP growth to have been in the middle of a range of 0.4-0.8%, with Spanish growth above our forecast at 1%.

EURO AREA: MARKET OUTLOOK

More ECB tightening likely

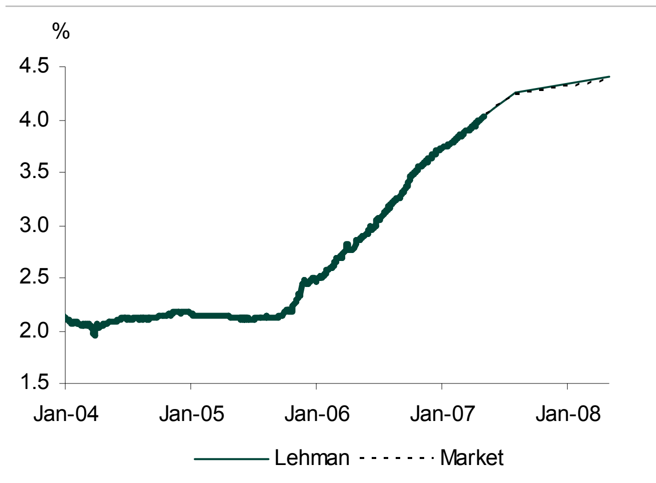
Sandra Petcov
+44 20 710 21142
spetcov@lehman.com

Strong growth momentum will probably be enough to offset the impact of a stronger euro in the ECB's thinking. If so, rates may rise in September as well as in June.

Heading into the ECB rate-setting meeting next week, there are no indications that the governing council is about to agree to a rate hike quite yet: neither we, nor any of the other 82 economists polled by Reuters this week, expect a move at this meeting. That said, the newsflow over the past week has remained strong, especially as far as business sentiment and the labour market are concerned. Hence, the ECB is likely to play down the weakness in retail sales as temporary and emphasise the still-buoyant growth outlook and resulting upside risks to price stability. We expect clear hints of an intended June move to be given, probably by use of the key phrase "strong vigilance".

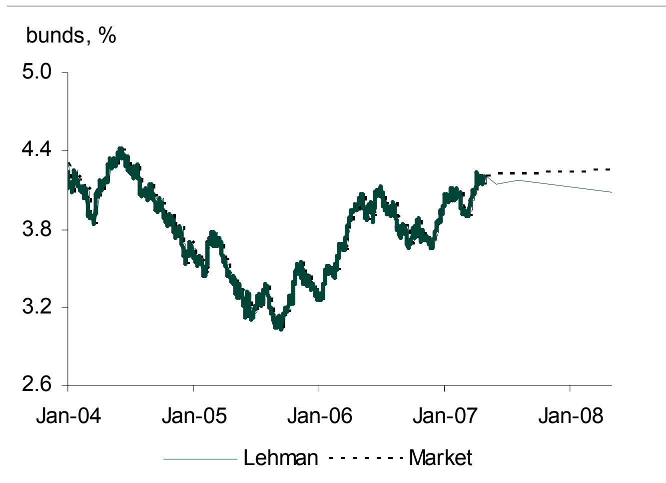
As far as the rate outlook beyond June is concerned, the picture appears less clear. A Market News "sources" story this week suggested that some within the ECB see the upward trend in the euro as likely to cap rates. This is possible, although we doubt that the current level of the exchange rate and its recent, gradual and orderly, appreciation will worry the governing council much as yet. Our own view is that US growth ought to recover a little heading into the second quarter, and that the single currency should peak soon. If so, this, along with any sign of a pickup in wage growth, would strengthen the case for rates being hiked in September as well, as we predict.

Figure 1. Three-month interest rates



Source: LehmanLive and Lehman Brothers Global Economics.

Figure 2. Ten-year bund yields



Source: LehmanLive and Lehman Brothers Global Economics.

The outlook at a glance

%	Current rate	In 1 mth's time Market	In 1 mth's time Lehman	In 3 mths' time Market	In 3 mths' time Lehman	In 12 mths' time Market	In 12 mths' time Lehman
Minimum bid rate	3.75	n.a.	3.75	n.a.	4.00	n.a.	4.25
3-mth rates	4.03	4.10	4.10	4.23	4.25	4.37	4.40
spread (bp)	28	n.a.	35	n.a.	25	n.a.	15
10-yr bond yields	4.21	4.21	4.15	4.22	4.17	4.25	4.08
spread vs US bonds (bp)	-52	-51	-71	-50	-69	-51	-78
yen per euro	163.5	162.8	163.3	161.9	162.8	157.7	133.7
dollars per euro	1.36	1.36	1.37	1.36	1.38	1.37	1.29

** Lehman estimates are modal ('most likely outcome') forecasts. Table updated 04 May 2007.*

EURO AREA: CALENDAR

Economic events in the week ahead

			Period	Prev 2	Prev 1	Latest	Lehman	Consensus
Monday 7 May								
		Euro group and ECONFIN in Brussels						
12.00	Germany	Manufacturing orders (% m-o-m, sa)	Mar	0.6	-0.3	3.9	-1.5	-0.5
12.00	Germany	Manufacturing orders (% y-o-y, sa)	Mar	7.3	6.8	9.5	9.0	n.a.
Tuesday 8 May								
		Euro group and ECONFIN in Brussels						
12.00	Germany	Industrial production incl. constr. (% m-o-m, sa)	Mar	0.0	0.9	0.9	0.0	0.0
12.00	Germany	Industrial production incl. constr. (% y-o-y, sa)	Mar	6.9	7.2	7.6	8.4	n.a.
12.00	Germany	Industrial production excl. constr. (% m-o-m, sa)	Mar	0.0	0.7	0.9	0.0	n.a.
12.00	Germany	Industrial production excl. constr. (% y-o-y, sa)	Mar	6.7	6.5	6.9	7.2	n.a.
Wednesday 9 May								
8.00	Germany	Trade balance (€ bn, sa)	Mar	14.7	15.8	13.8	15.0	15.0
8.00	Germany	Trade balance (€ bn, nsa)	Mar	11.1	16.2	14.2	18.1	n.a.
9.30	Netherlands	Manufacturing output (% m-o-m, sa)	Mar	1.2	0.3	1.3	0.8	n.a.
9.30	Netherlands	Manufacturing output (% y-o-y, sa)	Mar	4.1	5.0	5.9	6.5	n.a.
9.30	Netherlands	Industrial production (% m-o-m, sa)	Mar	2.2	-3.5	2.4	0.3	-0.3
9.30	Netherlands	Industrial production (% y-o-y, nsa)	Mar	0.4	-2.6	-1.3	-2.0	n.a.
Thursday 10 May								
8.45	France	Industrial production (% m-o-m, sa)	Mar	1.0	-0.2	1.1	-0.2	0.3
8.45	France	Industrial production (% y-o-y, sa)	Mar	0.6	-0.4	2.6	0.6	n.a.
8.45	France	Trade balance (€ bn, sa)	Mar	-2.4	-2.6	-2.7	-2.6	-2.6
9.30	Netherlands	CPI (% m-o-m, nsa)	Apr	0.1	0.5	1.1	0.3	0.4
9.30	Netherlands	CPI (% y-o-y, nsa)	Apr	1.4	1.5	1.8	1.6	1.7
9.30	Netherlands	HICP (% m-o-m, nsa)	Apr	-0.2	0.7	1.3	0.3	n.a.
9.30	Netherlands	HICP (% y-o-y, nsa)	Apr	1.2	1.4	1.9	1.7	n.a.
10.00	Italy	Industrial production (% m-o-m, sa)	Mar	1.3	-1.7	-0.5	0.7	0.6
10.00	Italy	Industrial production (% y-o-y, sa)	Mar	3.8	1.6	0.5	1.3	n.a.
13.45	Euro area	ECB governing council meeting	%	3.50	3.50	3.75	3.75	3.75
14.30	Euro area	ECB press conference						
Friday 11 May								
9.00	Spain	Final CPI (% m-o-m, nsa)	Apr	-0.7	0.1	0.8	1.4	1.4
9.00	Spain	Final CPI (% y-o-y, nsa)	Apr	2.4	2.4	2.5	2.5	2.5
9.00	Spain	Final CPI (core, % m-o-m, nsa)	Apr	-0.8	0.2	0.6	1.4	1.3
9.00	Spain	Final CPI (core, % y-o-y, nsa)	Apr	2.7	2.8	2.5	2.5	2.5
9.00	Spain	Final HICP (% m-o-m, nsa)	Apr	-0.7	0.1	0.8	1.4	1.4
9.00	Spain	Final HICP (% y-o-y, nsa)	Apr	2.4	2.5	2.5	2.5	2.5

Central European Time

Economic events in the weeks ahead

			Period	Prev 2	Prev 1	Latest	Lehman
Week beginning 14 May							
14 May	Spain	GDP (% q-o-q, sa, flash estimate)	Q1	0.9	0.9	1.2	0.8
	Spain	GDP (% y-o-y, sa, flash estimate)	Q1	3.8	3.8	4.0	3.7
	Euro area	Industrial production (% m-o-m, sa)	Mar	1.2	-0.2	0.7	-0.1
15 May	Germany	GDP (% q-o-q, sa, flash estimate)	Q1	1.2	0.8	0.9	0.2
	Germany	GDP (% y-o-y, sa, flash estimate)	Q1	2.8	3.1	3.7	3.0
	France	GDP (% q-o-q, sa, flash estimate)	Q1	1.1	0.1	0.7	0.6
	France	GDP (% y-o-y, sa, flash estimate)	Q1	2.6	2.0	2.5	2.6
	France	CPI (% y-o-y, nsa)	Apr	1.2	1.0	1.2	1.2
	France	HICP (% y-o-y, nsa)	Apr	1.4	1.2	1.2	1.3
	Netherlands	GDP (% q-o-q, sa)	Q1	1.2	0.7	0.6	0.8
	Netherlands	GDP (% y-o-y, sa)	Q1	3.0	3.0	2.9	3.4
	Netherlands	Unemployment rate (%, 3mth avg, sa)	Apr	5.0	5.0	5.0	5.2
	Italy	GDP (% q-o-q, sa, flash estimate)	Q1	0.6	0.3	1.1	0.2
	Italy	GDP (% y-o-y, sa, flash estimate)	Q1	1.7	1.6	2.8	2.3
	Euro area	GDP (% q-o-q, sa, flash estimate)	Q1	1.0	0.6	0.9	0.6
	Euro area	GDP (% y-o-y, sa, flash estimate)	Q1	2.8	2.8	3.3	3.1
16 May	Euro area	New car registrations (% y-o-y, nsa)	Apr	-0.9	-3.9	-2.5	6.4
	Germany	Final HICP (% y-o-y, nsa)	Apr	1.8	1.9	2.0	1.8
	Italy	Final HICP (% y-o-y, nsa)	Apr	1.9	2.1	2.1	2.0
	Euro area	HICP (% y-o-y, nsa)	Apr	1.8	1.8	1.9	1.8
	Euro area	HICP ex-energy, food, alcohol & tobacco (% y-o-y)	Apr	1.7	1.9	1.9	1.9
Week beginning 21 May							
	Germany	Preliminary HICP (% m-o-m, nsa)	May	0.5	0.2	0.4	0.2
22 May	Euro area	Trade balance (€ bn, sa)	Mar	2.0	1.3	0.6	0.7
	Germany	ZEW expectations (balance, nsa)	May	2.9	5.8	16.5	25.9
23 May	Spain	GDP (% q-o-q, sa, 1st full estimates)	Q1	0.9	0.9	1.2	0.8
	Spain	GDP (% y-o-y, sa, 1st full estimates)	Q1	3.8	3.8	4.0	3.7
24 May	Germany	GDP (% q-o-q, sa, 1st full estimates)	Q1	1.2	0.8	0.9	0.2
	Germany	GDP (% y-o-y, sa, 1st full estimates)	Q1	2.8	3.1	3.7	3.0
	France	Business confidence (index, sa)	May	108	109	111	111
	Italy	ISAE business survey (index, sa)	May	95.8	95.6	98.2	98.2
	Germany	ifo business climate index (sa)	May	107.0	107.7	108.6	108.7
	Germany	ifo index: current conditions (sa)	May	111.6	112.4	113.2	113.2
	Germany	ifo index: expectations (sa)	May	102.6	103.2	104.3	104.3
	Belgium	Industrial confidence (% balance, sa)	May	3.5	1.4	3.8	3.8
25 May	France	Household consumption (% m-o-m, sa)	Apr	1.0	-0.5	0.7	0.2
	France	Household consumption (% y-o-y, sa)	Apr	6.9	4.8	6.3	6.3
	France	Household consumption (ex autos) (% m-o-m, sa)	Apr	1.6	-0.8	1.0	0.4
	France	Household consumption (ex autos) (% y-o-y, sa)	Apr	9.7	6.8	8.7	9.1
	Italy	Hourly w ages (% y-o-y, nsa)	Apr	3.2	2.6	2.6	2.9
Week beginning 28 May							
	Germany	Preliminary CPI (% y-o-y, nsa)	May	1.6	1.9	1.9	1.9
	Germany	Preliminary HICP (% y-o-y, nsa)	May	1.9	2.0	2.0	2.0
29 May	Spain	Retail sales volumes (% y-o-y, nsa, w da)	Apr	4.1	3.6	5.5	4.8
	Euro area	Current account (€ bn, sa)	Mar	2.0	3.5	-5.2	0.6
30 May	Spain	HICP (% y-o-y, nsa, flash estimate)	May	2.5	2.5	2.5	2.4
	Euro area	M3 (% y-o-y)	Apr	9.9	10.0	9.7	9.4
31 May	Germany	ILO unemployment rate (% of labour force, sa)	Apr	7.4	6.9	6.8	6.7
	Germany	ILO employment change (1000s, sa)	Apr	42.0	40.0	40.0	45.0
	France	Unemployment (% of labour force, sa)	Apr	8.5	8.4	8.3	8.3
	France	Unemployment change (1000s)	Apr	-12.0	-25.0	-34.0	-15.0
	Euro area	HICP (% y-o-y, nsa, flash estimate)	May	1.8	1.9	1.8	1.6
	Euro area	Industrial confidence (% balance, sa)	May	5.4	6.0	6.6	6.6
	Italy	Preliminary CPI (% y-o-y, nsa)	May	1.8	1.7	1.6	1.5
	Italy	Preliminary HICP (% y-o-y, nsa)	May	2.1	2.1	2.0	1.9
1 June	Euro area	Manufacturing PMI (activity, index, sa)	May	55.6	55.4	55.4	55.4
	Euro area	GDP (% q-o-q, sa, 1st full release)	Q1	1.0	0.6	0.9	0.6
	Euro area	GDP (% y-o-y, sa, 1st full release)	Q1	2.8	2.8	3.3	3.1
	Euro area	Unemployment (% of labour force, sa)	Apr	7.4	7.3	7.3	7.3
	Euro area	Unemployment change (% m-o-m, sa)	Apr	-1.3	-1.2	-1.0	0.1

Central European Time

EURO AREA: PREVIEW

The week ahead

Sandra Petcov
+44 20 710 21142
spetcov@lehman.com

Gustavo Reis
+44 20 710 29085
gustavo.reis@lehman.com

Lavinia Santovetti
+44 20 710 26364
lsantove@lehman.com

The ECB meeting takes centre stage. We expect a firmly hawkish tone to the press conference with strong hints that a rate hike will likely be implemented in June.

Monday (Manufacturing orders)

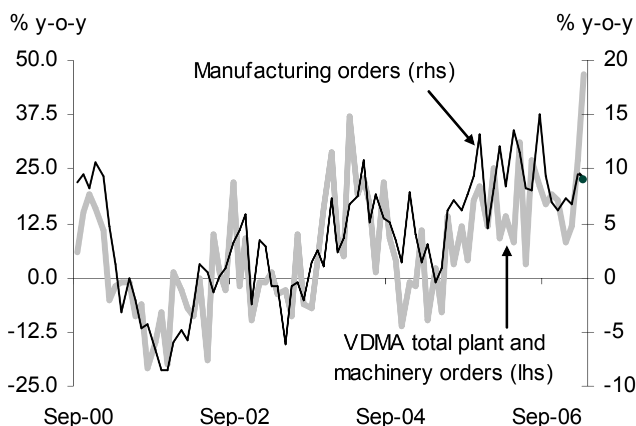
In contrast to both our own and the median forecast – which had been for a moderate rise – **German manufacturing orders** jumped by a full 3.9% m-o-m (sa) in non-annualised terms in February. This strength is hard to square with the decline – albeit to a still-high level – in the new orders component of the purchasing managers' index in both February and March. (We have found this survey to be helpful in predicting manufacturing orders in the past.) Consequently, we have factored in some payback in manufacturing orders in March, forecasting a drop of 1.5% m-o-m. That said, there may well be some upside risks: VDMA total plant and machinery orders surged by 47% y-o-y in real terms in March. The relationship between this measure and the headline manufacturing series is rather loose on a monthly basis, but this nevertheless sends a clear signal about the possible direction of the official series (Figure 1).

Tuesday (Industrial production)

A strong first quarter for German industrial output

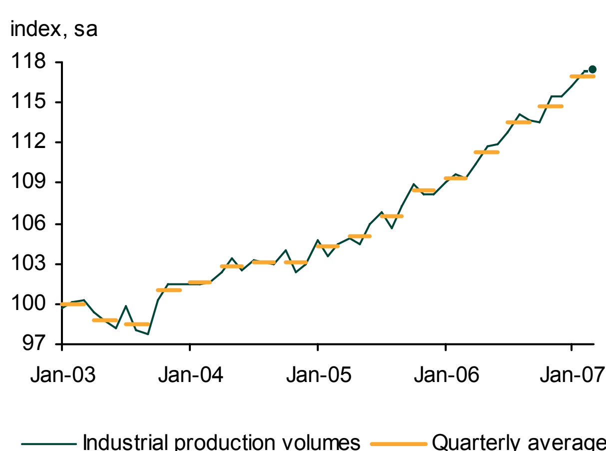
German industrial production looks to be on track for a strong first quarter, even with our forecast for no change in the level of production (on both the headline basis including construction and the ex-construction measure that feeds into the euro-area aggregate figures). Including construction, this should equate to a 2.1% q-o-q (sa) rise, whereas excluding it should lead to a reduced 1.9% q-o-q increase (Figure 2). Our bridging model suggests that, if so, industrial production could have added about a quarter of a percentage point and construction a further fifth of a percentage point to overall Q1 GDP growth. Whether this will prove sufficient to counteract the impact of what looks like a large hit from the VAT hike on retail spending growth and car sales is, as yet, unclear. Our bridging model suggests it may not be, but this may be missing the impact of what might well have been a sizeable inventory re-build; the German finance ministry certainly seems to think that growth has continued to be robust.

Figure 1. German manufacturing orders and VDMA orders



Source: FSO, VDMA, Datastream and Lehman Brothers Global Economics.

Figure 2. German industrial production (ex construction)



Source: FSO, Datastream and Lehman Brothers Global Economics.

Wednesday (External trade and industrial production)

German goods trade surplus likely up in March

In contrast to the rest of the euro area, where growth was entirely domestically driven last year, net trade made a sizeable positive contribution to 2006 real GDP growth in **Germany**, accounting for 1.2pp out of the total growth rate of 2.9% y-o-y. The growth contribution from net trade to German GDP was particularly pronounced in Q4, amounting to a whopping 2.2pp vis-à-vis overall growth of 0.9% q-o-q (Figure 3). This, however, looks to have been overstated, at least to a certain degree, by difficulties in allocating some exports between the third and the fourth quarter, which the statisticians resolved by counting all exports in doubt as having taken place in Q4. The **nominal goods trade data** published since suggest not only that there were no such special effects in Q1, but that there may have been some payback, with import growth outstripping that of exports. That said, the March goods trade surplus may have expanded a little again, from €13.8bn (sa) to €15.0bn, as there is likely to have been some unwind of the outsized jump in imports seen in February. Altogether, we expect net trade to have reduced Q1 GDP growth, perhaps by as much as 0.6pp.

Dutch industrial production probably up slightly

Following a smart 2.4% m-o-m (sa) rise in February, **Dutch industrial production** is likely to have softened in March. According to the manufacturing PMI, CBS and European Commission business surveys, confidence waned noticeably in March, and so we judge that Dutch IP probably increased by a mild 0.3% m-o-m (sa).

Thursday (Industrial production, trade, consumer prices and ECB meeting)

French industrial production likely fell

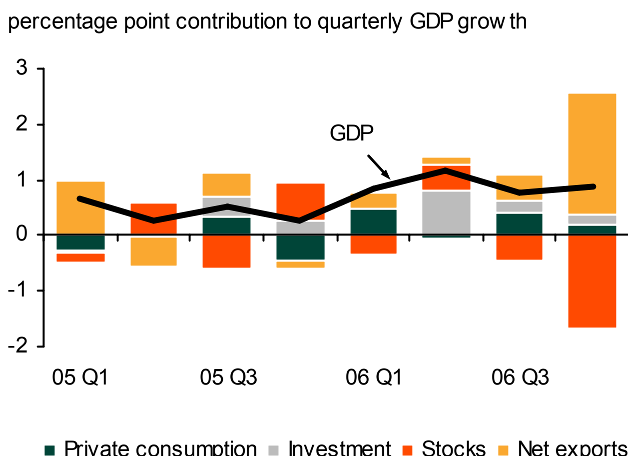
Since January, French industrialists have been reporting that output growth has been rising on a tide of surging orders. Underlying demand appears to have strengthened – mostly on the back of foreign orders – and the decline in inventory levels looks positive for future production. Following February's robust 1.1% m-o-m (sa) pickup in output, however, we deem that **French industrial production** is likely to have softened moderately in March (Figure 4). We look for a 0.2% m-o-m (sa) drop, leaving Q1 industrial production 1.0% above its Q4 average. If this is confirmed, industrial production is likely to have contributed between 0.3pp and 0.4pp to French GDP growth in Q1, following negative contributions in the second half of 2006.

After widening from €2.6bn to €2.7bn in February, we expect the **French external trade** deficit to narrow to €2.6bn in March, reflecting primarily a stronger export performance.

Dutch inflation to show payback in April

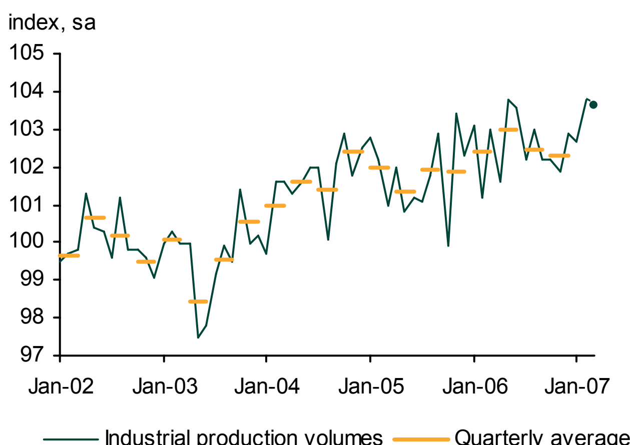
The **Dutch CPI** inflation rate spiked to 1.8% y-o-y in March due to an unexpected surge in core inflation to a 3½-year high of 1.5%, up from 1.2% in February. We judge that the increase in core inflation was largely due to seasonal factors: warm weather conditions probably led to an earlier-than-usual end to the winter sales season in the clothing sector and the earlier-than-usual Easter probably also contributed to higher holiday-related

Figure 3. German real GDP growth and its components



Source: FSO, Datastream and Lehman Brothers Global Economics.

Figure 4. French industrial production



Source: INSEE, Datastream and Lehman Brothers Global Economics.

prices in March. If this is the correct explanation for the rise, some payback is likely to have occurred in April, with clothing prices set to be broadly unchanged on the month (versus the usual seasonal rise) and holiday-related prices likely falling after the Easter period. On the other hand, preliminary information from other European countries points to a rebound in food prices, which, together with the rise in fuel prices, will most likely partially offset the above-mentioned disinflationary effects. All in all, we expect the Dutch CPI to have increased by 0.3% m-o-m (nsa) in April (implying a flat reading in seasonally adjusted terms), pushing the annual rate two tenths lower, to 1.6%. Core inflation probably eased back to 1.3% y-o-y (Figure 5). HICP-measured inflation probably also posted a similar-sized drop, to 1.7% y-o-y.

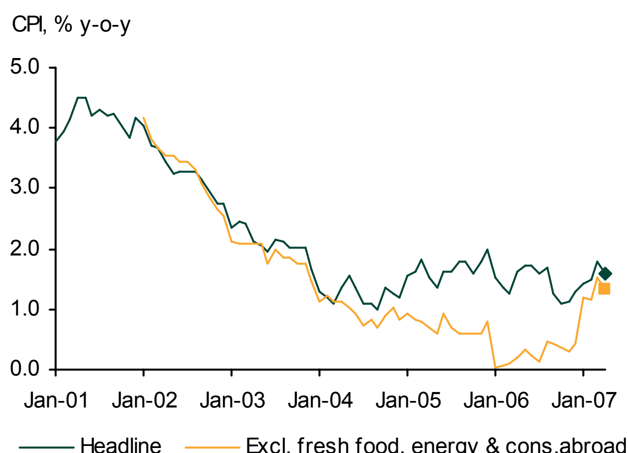
Italian industrial production likely rebounded in March

Having picked up strongly at the end of last year (by 1.4% q-o-q, sa), **Italian industrial production** has cooled in early 2007. The two consecutive drops (of 1.7% and 0.5% m-o-m, in January and February respectively) seem to have been a correction towards levels of production that are nonetheless still above the 2006 average. In March, business confidence remained stable at 0.9 standard deviations above its long-run average (Figure 6), and indications from the components suggest that the outlook for both production and orders seems to have improved slightly, having lost some ground in January. We are therefore looking for a 0.7% m-o-m (sa) rise, which would be consistent with a 0.9% q-o-q (sa) drop in Q1. March manufacturing figures will also be important to firm our forecast for Q1 GDP growth (the flash estimate will be published on 14 May), which for the moment we forecast to print at 0.2% q-o-q (sa).

We expect strong hints of a planned June ECB rate hike

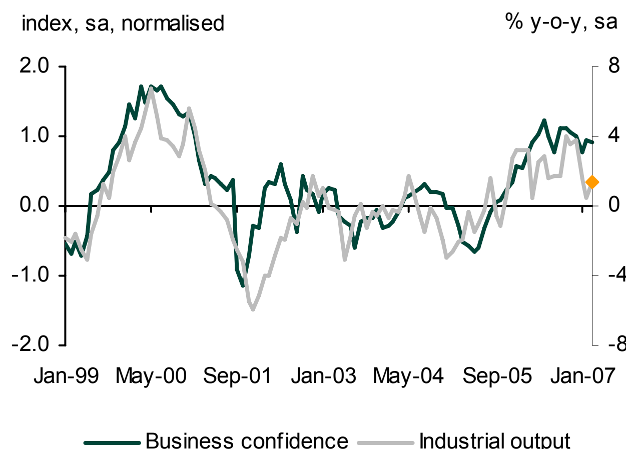
As has become the norm in recent months, attention in markets is likely to focus less on the actual **ECB rate decision** itself – the unanimous expectation of all 83 economists polled by Reuters between 1 and 3 May, ourselves included, is for rates to remain unchanged at 3¾% – than on the message conveyed by the prepared statement and the question and answer session. We expect strong hints to be given, most probably through the use of the key phrase "strong vigilance", that a rate hike is intended to be implemented in June. Moreover, we look for signs that the ECB feels even more assured about the growth outlook and, faced with a 25-year low in the unemployment rate, even more concerned that the rapid declines in unemployment may trigger an increase in wage inflation. Several further issues are likely to be raised during the discussion. One is centred on how the ECB interprets monetary data – an issue where what seem to have been internal debates until recently are increasingly spilling out into the open. (Bank of France governor Christian Noyer's speech last week was a case in point. For a detailed discussion, see the *Europe Overview* in this issue.) Another is what the ECB makes of the strengthening euro, which is now near the levels reached in late 2004 when measured in trade-weighted terms (Figure 7). We expect Mr Trichet to reiterate that abrupt moves in the currency would be unwelcome, but not to be drawn on any specific exchange rate

Figure 5. Dutch consumer prices



Source: CBS, Datastream and Lehman Brothers Global Economics.

Figure 6. Italian industrial production and confidence



Source: ISTAT, ISAE and Lehman Brothers Global Economics.

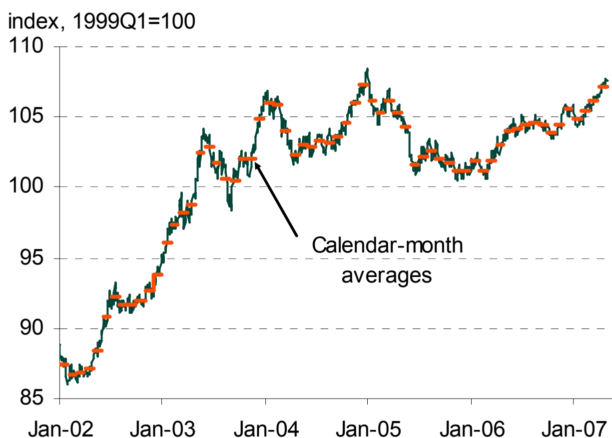
level that would cause discomfort at the ECB. Finally, we expect questions to be asked about the ECB's intentions for the path of interest rates beyond June, but with no firm indications likely to be given. Our view continues to be that there will be one additional rate hike beyond June, probably in September.

Friday (Industrial production, business confidence and retail sales)

Spanish inflation stable at 2.5% on rising food prices

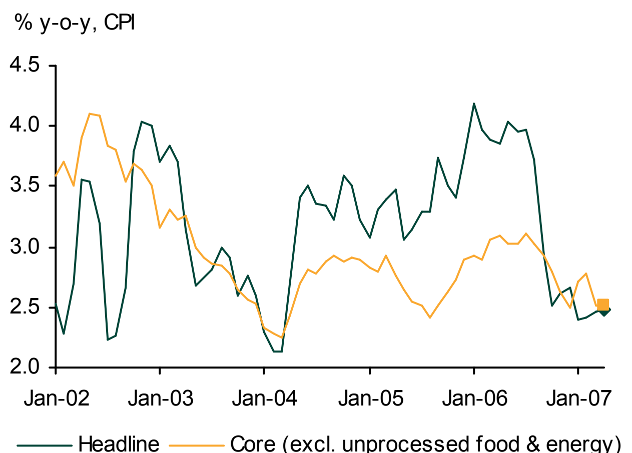
According to the advance estimate, **Spanish HICP** inflation moved sideways in April at 2.5% y-o-y, slightly above our original forecast of 2.4%. We expect the final report to confirm the preliminary figure and we suspect that a stronger-than-usual rebound in unprocessed food prices lay behind the upside surprise, in line with similar developments in other euro-area countries. CPI-measured inflation probably stayed unchanged at the same level of 2.5% y-o-y. On the month, CPI is likely to have increased by 1.4% (nsa) – equivalent to a 0.3% rise in seasonally adjusted terms. On top of rising food prices, energy prices probably posted a sizable increase in April, mirroring rising fuel prices and an increase in domestic gas tariffs. Yet, a favourable base effect probably caused the annual rate in the energy component to fall and shave about 0.1pp off the headline inflation rate. Excluding unprocessed food and energy, core CPI inflation was probably unchanged at 2.5% y-o-y (Figure 8).

Figure 7. The nominal effective exchange rate of the euro



Source: ECB and Lehman Brothers Global Economics.

Figure 8. Spanish consumer prices



Source: INE, Datastream and Lehman Brothers Global Economics.

UNITED KINGDOM: FOCUS

25 or 50?

Alan Castle
+44 20 710 27745
apcastle@lehman.com

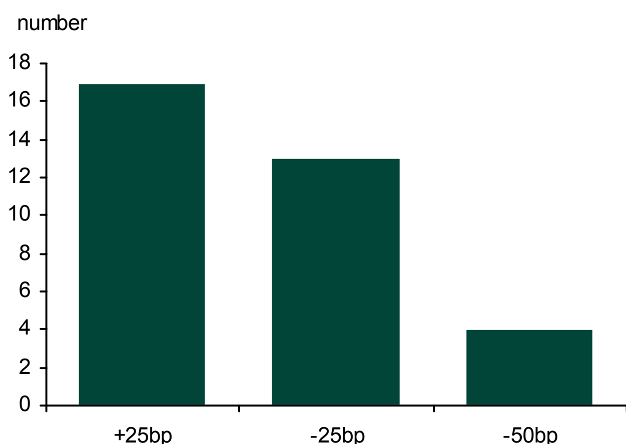
We would not rule out a 50bp rate hike next week. However, a more plausible scenario is that a hawkish Inflation Report *could lead to back-to-back rate hikes in May and June.*

All 61 analysts polled by Reuters (including ourselves) judge that the Monetary Policy Committee (MPC) will raise rates by 25bp next week. This unusual degree of unanimity has been engendered by March's 3.1% CPI print that triggered an explanatory letter from the governor to the chancellor. However, given the MPC's propensity to surprise of late, it is worth asking whether there is a chance of a different outcome – particularly as the May meeting coincides with the publication of the quarterly *Inflation Report*. Despite the dovish voting stance of external MPC member David Blanchflower, we see little case for no-change in rates: after all, the February *Inflation Report* suggested that another rate hike was needed to keep inflation on track to meet the 2% target in the medium term, and most data since then have been at least as strong as the MPC expected.

What then are the chances of a 50bp rate hike? At first glance, it would seem unlikely for a majority of members to support such a move. First, it has never happened before in the ten-year history of the MPC (Figure 1). Second, it would smack of panic after the March inflation figures and be at odds with the tone of Mervyn King's letter to the chancellor that expressed confidence in the view that the CPI would fall back to target in the near term. Third, it would take the markets by surprise and some MPC members seem to put more weight on this following January's unexpected rate increase.

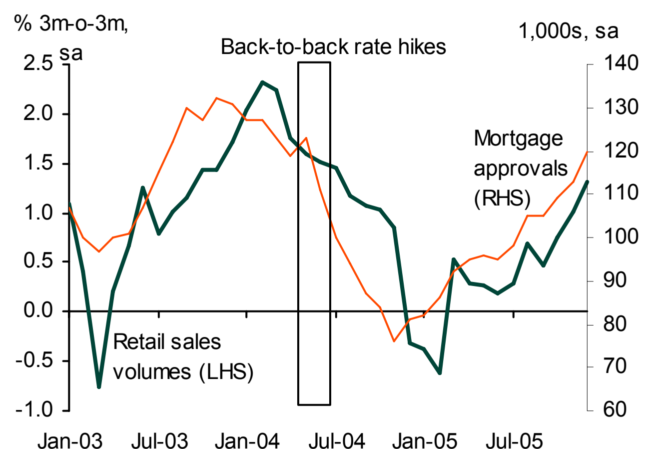
The counter-argument is that it is often difficult to second-guess the findings of Inflation Reports. So, with underlying growth and inflation pressures having, arguably, strengthened, there is a risk that the Bank's medium-term CPI projection is raised further above the 2% target. Moreover, the two most hawkish MPC members – Andrew Sentance and Tim Besley – who supported a hike in April and have recently hinted that a series of further hikes may be necessary could decide to vote for a more aggressive tightening. More realistically, as the MPC meets every month, the *Inflation Report* and May minutes could line up the market for a back-to-back move in June that would have more or less the same impact as a 50bp hike in May. When this happened in May/June 2004, it was widely seen as the trigger for the mini-slowdown in the UK consumer and housing sectors that followed over the next 18 months (Figure 2). At the moment though, our base case is that a 25bp rate hike in May is followed up by another move in August.■

Figure 1. Ten years of rate changes at MPC meetings



Source: Bank of England, Lehman Brothers Global Economics.

Figure 2. Similarities with 2004



Source: ONS, Datastream, Lehman Brothers Global Economics.

UNITED KINGDOM: ECONOMIC OUTLOOK

Turning the screws

Alan Castle
+44 20 710 27745
apcastle@lehman.com

Michael Hume
212-526-0978
mhume@lehman.com

Inflation concerns persist and the Bank of England looks set to remain hawkish.

After the recent run of robust data, we decided to make significant changes to our near-term macroeconomic forecasts. In terms of GDP growth, we now expect Q2 GDP growth to match the 0.7% q-o-q rate that was recorded in the first quarter – driven by greater-than-expected strength in housing and consumption. As a result, our full-year 2007 growth rate has risen from 2.4% to 2.6%. Further out, our GDP projections remain similar to those in the latest Lehman UK Forecast (LUKF) – see *UK: Turning the screws*, 17 November 2006 – and consistent with a loss of momentum in the second half of 2007. Our 2008 forecasts are consistent with a rebalancing of the economy away from the consumer sector and towards the external sector.

We have made bigger changes to our CPI and RPI projections, reflecting a number of factors including the upside surprise in March. In particular, food and energy prices are likely to put more upward pressure on near-term inflation than we had expected. As a result, the targeted CPI rate is set to fall back to 2.0% by August but then rise into year-end. Meanwhile, the headline RPI rate could remain above 4% for the rest of the year. Policymakers remain worried about a pickup in medium-term price pressures too, even if attention appears to have shifted away from concerns about the pass-through of higher spot inflation to pay settlements to signs that firms are minded to raise output prices.

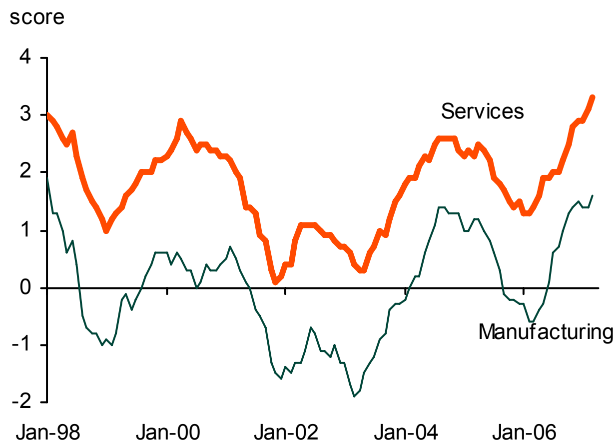
These forecast revisions have necessitated a rethink on our monetary policy call too. So, rather than looking for a peak in rates after the widely expected May rate hike, we now expect the MPC to raise rates to 5.75% by August. Moreover, we judge that there is a chance of a move up to 6% beyond then as well. In 2008, we no longer pencil a rate cut into our modal forecast. In terms of currency forecasts, we are minded to soften our call on the extent of sterling depreciation against the euro going forward.

The outlook at a glance

%	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07	2006	2007	2008
Real GDP	3.3	3.1	2.7	2.7	2.8	2.8	1.8	1.7	2.8	2.6	2.2
Private consumption	0.5	4.6	1.3	4.3	1.0	2.4	1.3	1.0	2.0	2.2	1.5
Fixed investment	9.0	4.8	8.6	10.6	1.5	5.4	4.0	1.9	6.5	5.3	2.2
Government consumption	1.7	2.6	2.5	2.8	2.0	2.0	2.0	1.6	2.4	2.2	1.9
Exports of goods and services	43.0	9.6	-37.6	-1.7	-2.8	4.0	6.1	6.9	11.6	-4.5	7.0
Imports of goods and services	44.0	15.0	-37.6	-0.9	0.2	3.4	6.0	4.7	11.8	-3.6	4.7
Contributions to GDP:											
Domestic final sales	2.2	4.3	2.8	5.2	1.3	2.9	2.0	1.3	2.9	2.8	1.7
Inventories	2.5	0.8	-1.8	-2.3	2.3	-0.1	0.0	0.0	0.3	0.0	0.0
Net trade	-1.4	-2.0	1.7	-0.2	-0.9	0.0	-0.2	0.4	-0.4	-0.2	0.5
Consumer prices (CPI)	1.9	2.2	2.4	2.7	2.9	2.6	2.1	2.2	2.3	2.4	2.2
RPI	2.4	2.9	3.4	4.0	4.5	4.5	4.2	4.3	3.2	4.4	3.3
RPIX	2.2	2.8	3.2	3.5	3.7	3.4	2.9	3.0	2.9	3.3	2.6
LFS unemployment rate	5.3	5.5	5.5	5.5	5.5	5.7	5.9	6.1	5.5	5.8	6.2
Average earnings	4.2	4.3	4.0	4.0	4.8	4.2	4.3	4.1	4.1	4.3	3.5
Output per worker	1.7	1.9	2.3	1.9	1.9	1.4	1.3	1.1	2.0	1.4	1.2
Unit wage costs	2.0	1.9	2.0	1.9	2.3	2.1	2.3	2.3	2.0	2.2	1.2
Official repo rate	4.50	4.50	4.75	5.00	5.25	5.50	5.75	5.75	5.00	5.75	5.75
10-year gilt-bund spread	0.66	0.69	0.85	0.84	0.97	0.97	0.98	1.00	0.84	1.00	1.00
£ per euro	0.70	0.69	0.68	0.67	0.68	0.68	0.69	0.70	0.67	0.70	0.73
$ per £	1.73	1.85	1.87	1.96	1.96	2.03	1.96	1.87	1.96	1.87	1.71

Notes: Quarterly national accounts figures are % q-o-q changes at a seasonally adjusted annualised rate. Annual figures are % y-o-y changes. Unemployment is % of labour force. Inflation, wages, productivity and unit labour costs are % y-o-y. Interest rates and currencies are end-of-period.
Source: Lehman Brothers Global Economics.

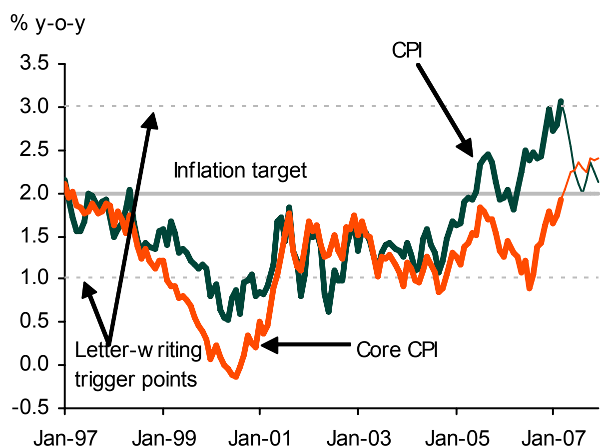
Investment intentions



Source: Bank of England, Lehman Brothers Global Economics.

- The corporate sector has started to spend again: business investment rose at its fastest pace since end-1998 in Q4 2006, driven by capex expansion in the service sector.
- Short-term indicators of investment intentions have tended to strengthen, notably the Regional Agents' scores released alongside the monthly MPC minutes.
- The medium-term outlook is supported by the relatively low cost of capital, the past momentum in GDP growth and equity markets, and the fall in energy prices.

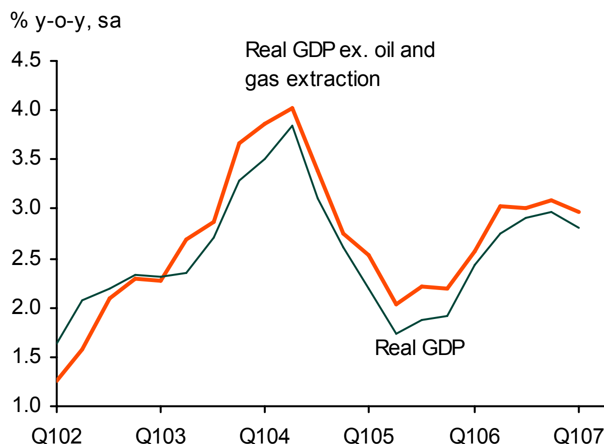
CPI and core CPI (excluding energy, food, alcohol and tobacco) forecasts



Source: ONS, Datastream, Lehman Brothers Global Economics.

- CPI inflation rose from 2.8% to 3.1% in March, triggering an explanatory letter from the governor of the Bank of the England to the chancellor.
- Our latest forecast envisages a fall in the targeted CPI rate back to target by late-summer, but a further rise in the exclusion-based core inflation measure.
- Other measures of core inflation – ie, our optimal-trimmed mean (OTM) and weighted-median indices – are pointing to a near-term softening of price pressures.

Real GDP excluding oil and gas



Source: ONS, Datastream, Lehman Brothers Global Economics.

- The first estimate of Q1 GDP growth was in line with our forecast and non-oil output continues to grow at a strong and steady pace.
- The ONS's March retail report was slightly stronger than we expected but consistent with a slowdown in consumption growth in the first quarter.
- Housing indicators have, if anything, strengthened of late. We are concerned that the MPC's past rate hikes have not impacted on consumer sentiment.

UNITED KINGDOM: MARKET OUTLOOK

Becoming more hawkish

Alan Castle
+44 20 710 27745
apcastle@lehman.com

Michael Hume
212-526-0978
mhume@lehman.com

As well as a rate hike at the May MPC meeting, we are now expecting a move at the August meeting. Further out, the risks are no longer tilted towards rate cuts.

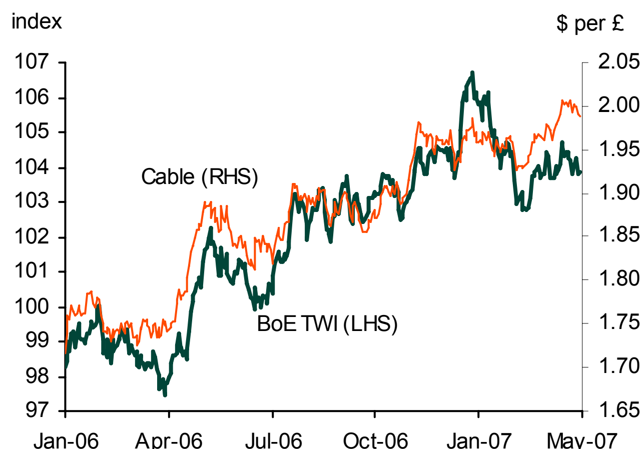
The recent strong dataflow persuaded us to raise our growth, inflation and interest rate forecasts. In particular, we now expect 25bp rate hikes at both the May and August *Inflation Report* meetings, and have taken out of our forecast a rate cut pencilled in for start-2008. Hence, our call on the short end is fairly close to market pricing (Figure 1). Sterling markets have been quiet again this week, although there continued to be upward pressure on rates across the yield curve – particularly at the short end. There are few data releases that are likely to change rate expectations ahead of the May MPC meeting. So attention will probably turn to the Bank's new *Inflation Report*, published on 16 May. Medium-term CPI projections similar to those published in February would be consistent with a further tightening of policy at or before the August meeting.

Despite recent data surprises, trade-weighted sterling – as well as its key component, the euro-sterling cross-rate – has remained relatively stable. However, attention has focused on the rise in the cable rate to multi-year highs (Figure 2). We are reviewing our medium-term call for sterling to depreciate against both the dollar and the euro. But, for the moment, we have raised our near-term projections for sterling on these cross-rates.

Figure 1. Three-month interest rates

Source: LehmanLive, Lehman Brothers Global Economics.

Figure 2. Trade-weighted sterling and cable



Source: Datastream, Lehman Brothers Global Economics.

The outlook at a glance

		In 1 mth's time		In 3 mths' time		In 12 mths' time	
%	**Current rate**	**Market**	**Lehman**	**Market**	**Lehman**	**Market**	**Lehman**
Base rates	5.25	n.a.	5.50	n.a.	5.75	n.a.	5.75
3-mth LIBOR	5.73	5.80	5.75	5.91	6.00	5.90	5.90
spread (bp)	48	n.a.	25	n.a.	25	n.a.	15
10-yr bond yields	5.10	5.09	5.06	5.07	5.07	4.98	5.02
spread vs bunds (bp)	96	94	97	92	97	79	100
dollars per £	1.99	1.99	2.02	1.99	2.02	1.98	1.81
£ per euro	0.68	0.68	0.68	0.69	0.68	0.69	0.71

** Lehman estimates are modal ('most likely outcome') forecasts. Table updated May 4 2007.*

UNITED KINGDOM: CALENDAR

Economic events in the weeks ahead

		Period	Prev 2	Prev 1	Latest	Lehman	Consensus
Sometime during the week							
8.00	Halifax house prices, % m-o-m, sa	Apr	1.4	1.9	1.1	0.7	0.8
	Halifax house prices, % y-o-y, 3mma, nsa	Apr	9.8	9.9	10.8	10.5	10.6
Monday 7 May							
	Bank Holiday						
Tuesday 8							
	No economic releases						
Wednesday 9							
0.01	BRC Sales Monitor, like-for-like, % y-o-y, nsa	Apr	3.1	3.3	3.9	3.5	n.a.
Thursday 10							
9.30	Manufacturing output, % m-o-m, sa	Mar	0.1	-0.2	-0.6	0.5	0.5
	Manufacturing output, % y-o-y, sa	Mar	2.4	1.9	1.2	0.9	0.9
	Industrial production, % m-o-m, sa	Mar	-0.1	0.0	-0.2	0.4	0.4
	Industrial production, % y-o-y, sa	Mar	0.5	0.4	0.3	0.0	0.0
9.30	Trade in goods, global balance, £ bn, sa	Mar	-6.9	-6.4	-6.8	-7.3	-6.7
	Trade in goods, EU balance, £ bn, sa	Mar	-2.6	-2.6	-2.7	-3.0	n.a.
	Trade in goods, non-EU balance, £ bn, sa	Mar	-4.3	-3.8	-4.1	-4.3	-4.1
	Import prices, % y-o-y, nsa	Mar	0.1	-1.6	-1.3	0.0	n.a.
	Import prices ex oil and erratics, % y-o-y, nsa	Mar	0.6	0.7	0.5	1.2	n.a.
12.00	MPC meeting, repo rate, %	May	5.25	5.25	5.25	5.50	5.50
	MPC meeting, probability of 25bp rate hike	May				80	80
Friday 11							
	No economic releases						
Week beginning 14 May							
14-May	Producer prices (Apr)						
	DCLG house prices (Mar)						
15-May	RICS housing survey (Apr)						
	Targeted CPI, % m-o-m, nsa	Apr	-0.8	0.4	0.5	0.4	n.a.
	Targeted CPI, % y-o-y, nsa	Apr	2.7	2.8	3.1	2.9	n.a.
	RPI (all items), % m-o-m, nsa	Apr	-0.5	0.7	0.6	0.6	n.a.
	RPI (all items), % y-o-y, nsa	Apr	4.2	4.6	4.8	4.7	n.a.
	RPIX (exc. mortgage costs), % m-o-m, nsa	Apr	-0.7	0.5	0.6	0.6	n.a.
	RPIX (exc. mortgage costs), % y-o-y, nsa	Apr	3.5	3.7	3.9	3.8	n.a.
	CPI ex-energy, food, alc. and tob., % y-o-y, nsa	Apr	1.6	1.7	1.9	2.0	n.a.
16-May	Labour market report (Feb/Mar)						
	Bank of England *Inflation Report* (May)						
18-Apr	Retail sales volumes, % m-o-m, sa	Apr	-1.5	1.6	0.3	0.2	n.a.
	Retail sales volumes, % 3m-o-3m, sa	Apr	0.9	1.1	0.4	1.2	n.a.
	Retail sales volumes, % y-o-y, sa	Apr	3.5	5.1	4.8	0.0	n.a.
Week beginning 21 May							
21-May	Rightmove house prices (May)						
	Public finances (Apr)						
	Broad money (Apr)						
23-May	MPC minutes (May)						
24-May	CBI Monthly Trends (May)						
	Second estimate of business investment (Q1)						
25-May	Second estimate of real GDP (Q1)						
	Index of services (Mar)						
Week beginning 28 May							
31-May	Lending to individuals (Apr)						
01-Jun	PMI manufacturing (May)						

UNITED KINGDOM: PREVIEW

The week ahead

Alan Castle
+44 20 710 27745
apcastle@lehman.com

Peter Newland
+44 20 710 24026
peter.newland@lehman.com

Thursday brings data on the manufacturing sector and, crucially, the MPC's rate decision. Assuming that there is a 25bp rate hike then the statement will be closely scrutinised.

Halifax house prices (Sometime during the week)

Almost all measures of house prices have shown no sign of cooling in recent months and the very strong rise in the Rightmove asking price series in April points to further momentum in measures of prices based on approvals such as the Nationwide and Halifax series. We have pencilled in a 0.7% m-o-m (sa) rise in the Halifax measure in April, consistent with an increase in the annual rate to 10.5% y-o-y (3mma). Looking further ahead, the continued strength of housing activity data – such as the RICS sales-to-stock ratio – points to further upward pressure on annual rates of house price inflation over the next six months.

BRC Sales Monitor (Wednesday)

Look for healthy retail sales growth

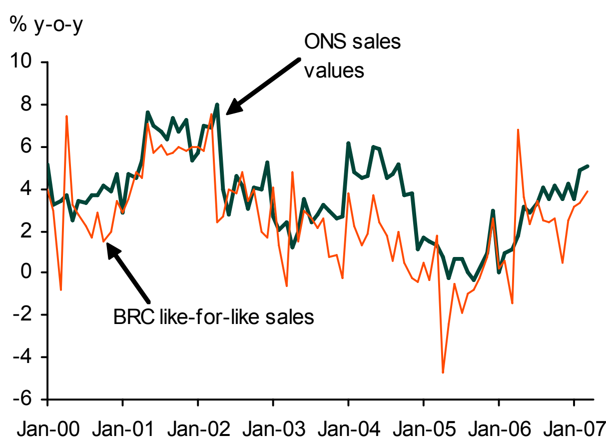
BRC like-for-like sales values growth rose from 3.3% y-o-y (nsa) to 3.9% in March (Figure 1). In April, the CBI retail survey reported a strong rise in sales volumes growth, although this survey has tended to paint a healthier picture than the BRC and the official numbers. And other short-term indicators, such as weekly John Lewis sales, have taken a softer tone. All in all, we have pencilled in a small drop in BRC like-for-like sales growth, to 3.5%, and judge that this would be consistent with monthly growth in the official volumes series of 0.2% (sa).

Industrial production (Thursday)

We expect a rebound in manufacturing output

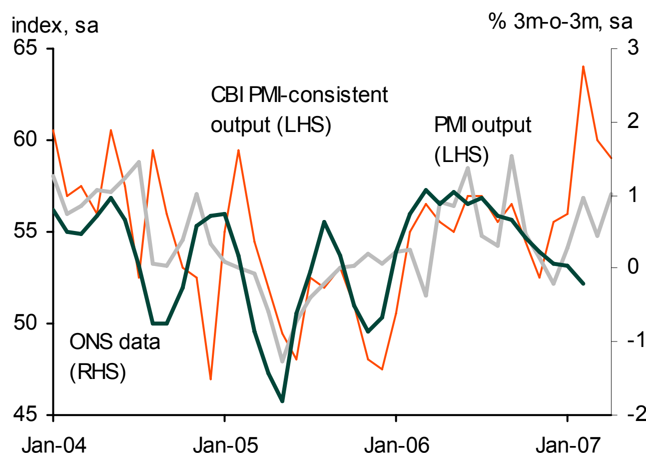
Last month's (February) manufacturing report was much weaker than expected, with the biggest monthly fall in output since October 2005. The ONS commentary noted some "temporary" weakness in the transport and aircraft sector, but more worrying signs with regard to the health of the food and drink sector. We have tended to play down the weakness of the official data, particularly as almost all surveys of manufacturing activity have continued to strike a stronger tone (Figure 2). Hence, our baseline forecast is that there has been a significant, 0.5% m-o-m (sa), rebound in output in March. Combined with softer production figures from the utilities and oil and gas sectors, we expect the broad industrial production series to rise by 0.4% m-o-m. These forecasts are consistent with the Q1 growth estimates published by the ONS in their first estimate of real GDP.

Figure 1. Retail sales values



Source: BRC, ONS, Datastream, Lehman Brothers Global Economics.

Figure 2. Manufacturing output



Source: CBI, CIPS, ONS, Datastream, Lehman Brothers Global Economics.

Further ahead, the strength of surveys suggests that the manufacturing sector will make a positive contribution to GDP growth in the second quarter.

External trade (Thursday)

We expect a deterioration in the net trade position

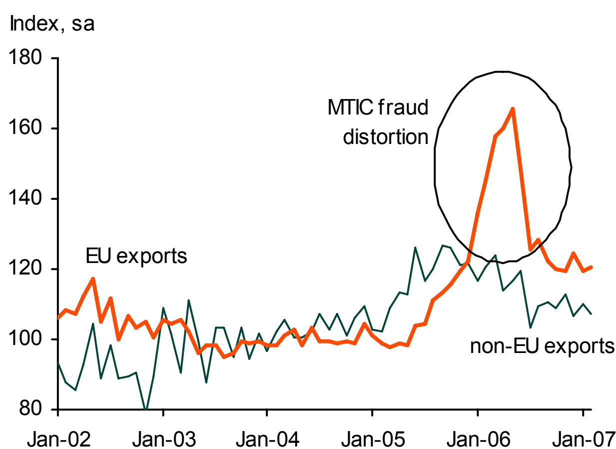
The global trade in goods deficit widened from £6.4bn (sa) to £6.8bn in February, driven largely by a deterioration in the net trade position with non-EU countries (Figure 3). This reflected a rebound in import volumes and a small deterioration in the terms of trade (ie, a larger rise in import prices than export prices) (Figure 4). In February, we expect a further widening of the global goods deficit, to £7.3bn, partly reflecting a further rise in import prices. Specifically, the rise in sterling oil prices and a stronger tone to the import components of the producer prices dataset point to a rise in both headline and core import price measures. We have pencilled in a rise in the latter from 0.5% y-o-y (nsa) to 1.2%.

MPC meeting (Thursday)

Rates are likely to rise by 25bp in May

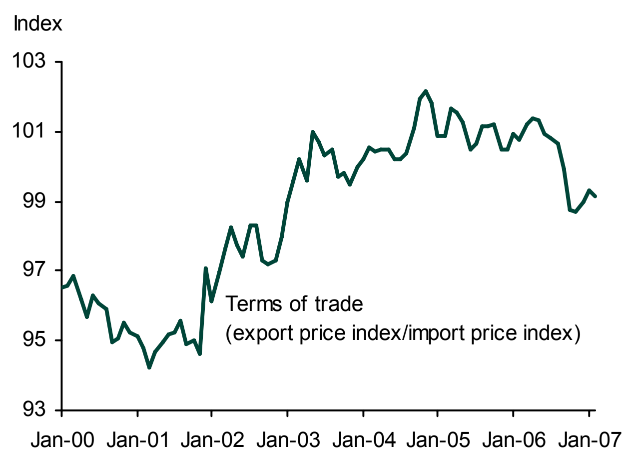
We attribute an 80% probability to a 25bp rate hike at the May MPC meeting coinciding with the Committee agreeing on its latest projections for GDP growth and CPI inflation in the context of the *Inflation Report* to be published on 16 May. The argument for another quarter-point rate hike is fairly well worn and dates back to the last *Inflation Report* in February. Since then, our judgement is that the majority of growth and inflation indicators have been at least as strong as the MPC had expected. Indeed, one reason why there were not more votes in favour of an immediate rate hike at the April meeting is that some members did not want to spring another surprise on financial markets. Since that meeting, the biggest news has been the 3.1% CPI print in March that required the governor to write an explanatory letter to the chancellor. But there have also been hawkish signals from producer price data, the majority of housing market indicators, and most data on consumer spending. We have decided to split the remaining 20% of our subjective probability distribution equally between a no-change decision and a 50bp rate hike, although the biggest risk to our baseline rates view – that there is a further rate hike in August – is that the MPC sanctions a back-to-back rate hike in June. (For more details see this week's *UK Focus*.)

Figure 3. Export volumes



Source: ONS, Datastream, Lehman Brothers Global Economics.

Figure 4. Terms of trade



Source: ONS, Datastream, Lehman Brothers Global Economics.

SCANDINAVIA AND SWITZERLAND: ECONOMIC OUTLOOK

Signs of growing inflation pressures

Peter Newland
+44 (0)20 7102 4026
peter.newland@lehman.com

Alan Castle
+44 20 710 27745
apcastle@lehman.com

Inflation remains weak, but there are signs that strong output and employment growth have started to push up wages and prices. We expect a little more monetary tightening in Sweden, Switzerland and Denmark this year, and quite a bit more in Norway.

The Riksbank left rates on hold in April but suggested that it will revise up the projected policy path, which previously had just one more 25bp hike this year in the central case. Inflation pressures are building from stronger-than-expected output growth, higher oil prices, a weaker currency and, in particular, signs of higher wage growth in the New Year pay round. Meanwhile, the Norges Bank retains a strong bias towards more rate hikes. We still expect another 75bp of hikes in Norway this year and 50bp in Sweden.

Swedish inflation has remained soft, but we expect it to rebound more sharply than the central bank projected in the February *Monetary Policy Report*. Our view is based on continued strong activity and employment growth, which has started to feed into higher wages. GDP grew 1.2% q-o-q in Q4 and at its fastest annual rate in more than ten years in 2006. We expect it to slow in 2007 with less of a boost from net trade.

Norwegian targeted (CPI-ATE) inflation remains low, but the Norges Bank has become increasingly concerned that capacity constraints and labour market tightness could translate into inflationary pressures later in the year. We expect targeted inflation to rise from 0.8% in 2006 to 1.7% in 2007 and to rise closer to the 2.5% target in 2008. The Norges Bank surprised markets by leaving rates unchanged in April, but the accompanying statement laid the groundwork for further tightening. We expect a 25bp hike at the May meeting.

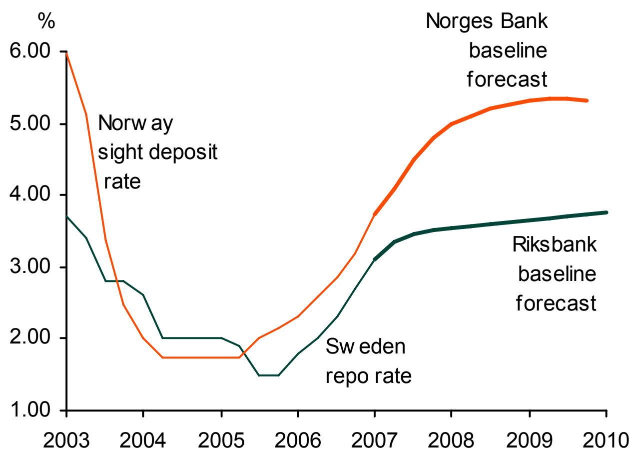
Swiss GDP was boosted by above-trend consumer spending growth and very strong export growth in 2006, we expect both to slow slightly in 2007 but we have revised our forecasts slightly higher for 2007 and 2008 in recent weeks, based on our more optimistic outlook for euro-area growth. At its March meeting the Swiss National Bank (SNB) hinted that a further normalisation of interest rates was likely. The rebound in CPI inflation in April and the continued weakness of the currency support this case. We expect two more rate hikes, at the June and September meetings, in line with our ECB call.

The outlook at a glance

%	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07	2006	2007	2008
Real GDP											
Switzerland	2.7	2.7	1.7	1.8	2.0	2.0	2.4	2.4	2.7	2.1	2.0
Sweden	5.9	5.2	3.7	5.0	4.1	2.8	2.8	2.8	4.7	3.8	2.8
Norway (mainland)	4.3	4.3	4.5	5.0	4.1	3.2	2.4	2.4	4.6	3.8	2.8
Denmark	4.3	5.0	2.5	0.6	3.2	2.8	2.8	2.8	3.2	2.6	2.5
Targeted inflation											
Switzerland (CPI)	1.2	1.3	1.2	0.5	0.1	0.7	1.1	1.4	1.1	0.8	1.6
Sweden (UND1X)	1.0	1.5	1.3	1.3	1.3	1.0	0.7	1.0	1.3	1.0	1.8
Norway (CPI-ATE)	0.9	0.8	0.5	0.8	1.2	1.6	1.9	2.0	0.8	1.7	2.1
Denmark (CPI)	2.1	2.0	1.8	1.7	1.9	1.7	1.7	1.7	1.9	1.7	1.6
Official rates											
Switzerland	1.25	1.50	1.75	2.00	2.25	2.50	2.75	2.75	2.00	2.75	2.75
Sweden	2.00	2.25	2.50	3.00	3.25	3.50	3.50	3.75	3.00	3.75	3.75
Norway	2.50	2.75	3.00	3.50	4.00	4.25	4.50	4.75	3.50	4.75	4.75
Denmark	2.75	2.85	3.25	3.75	4.00	4.25	4.50	4.50	3.75	4.50	4.50
Ten-year yield spread to bund											
Switzerland	-1.27	-1.24	-1.30	-1.44	-1.38	-1.30	-1.20	-1.20	-1.44	-1.20	-1.20
Sweden	-0.08	-0.04	-0.05	-0.14	-0.16	-0.10	0.00	0.10	-0.14	0.10	0.10
Norway	0.15	0.28	0.40	0.44	0.50	0.55	0.60	0.65	0.44	0.65	0.65
Denmark	0.09	0.05	0.02	0.00	-0.03	-0.03	-0.03	-0.03	0.00	-0.03	0.00
Exchange rate (currency per euro)											
Switzerland	1.57	1.56	1.58	1.60	1.61	1.63	1.60	1.55	1.60	1.55	1.55
Sweden	9.40	9.22	9.27	9.03	9.30	9.20	9.10	9.00	9.03	9.00	8.50
Norway	7.98	7.86	8.27	8.25	8.13	8.05	7.65	7.25	8.25	7.25	7.00
Denmark	7.46	7.46	7.46	7.45	7.45	7.45	7.45	7.45	7.45	7.45	7.45

Notes: Quarterly national accounts figures are % q-o-q changes at a seasonally adjusted annualised rate. Annual figures are % y-o-y changes. Inflation is % y-o-y. Interest rates and currencies are end-of-period.
Source: Lehman Brothers Global Economics.

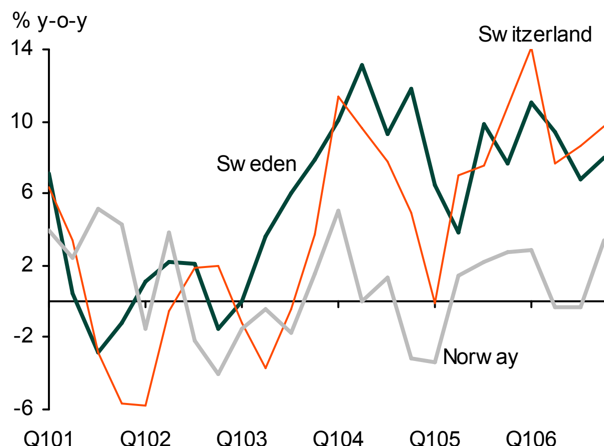
Central bank interest rate projections



Source: Riksbank, Norges Bank, Lehman Brothers Global Economics.

- The Riksbank published its own projections for interest rates for the first time in its February *Monetary Policy Report*.
- The baseline scenario had just two further hikes (one this year and another further out). But the statement from the April meeting suggested an upward revision.
- The Norges Bank retains a more hawkish view. The current baseline projection is for rates to reach 5.25% in 2009.

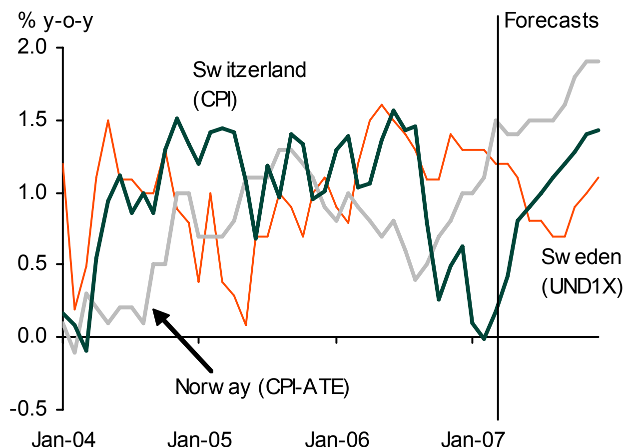
Export growth



Source: SFSO, SCB, SSB, Datastream, Lehman Brothers Global Economics.

- Net trade was a significant driver of growth in Switzerland and Sweden in 2006. Exports have risen consistently and import growth has been relatively weak.
- However, the story in Norway is slightly different, with very strong domestic final sales growth having been the key driver of growth in 2006.
- We expect a slight cooling of growth in the euro area and the UK to lead to less of a boost from net trade in 2007.

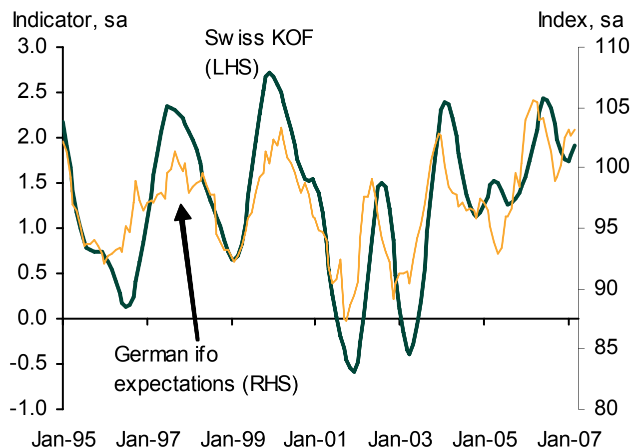
Targeted inflation



Source: SFSO, SCB, SSB, Datastream, Lehman Brothers Global Economics.

- Targeted inflation remained very weak in 2006, relative to central bank targets and comparable euro-area and UK data.
- With domestic wage and price pressures building in Norway, we expect quite a sharp pickup in inflation in the second half of 2007.
- Inflation should also edge higher, to a lesser degree, in Switzerland and Sweden.

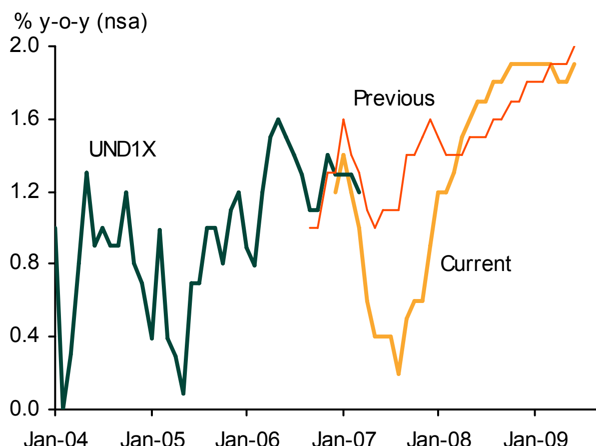
Switzerland: Leading indicator points to slightly softer growth in 2007



Source: SFSO, SCB, SSB, Datastream, Lehman Brothers Global Economics.

- The widely followed KOF leading indicator has edged lower from the 5½-year high of 2.44 (standardised index) registered in June 2006.
- This is consistent with our forecast of a softening of GDP growth to 2.0% y-o-y in 2007, from the 2.7% rate we expect to have been recorded in 2006.
- However, the KOF and forward-looking indicators in the euro area, such as the expectations component of the German ifo, have turned higher again recently.

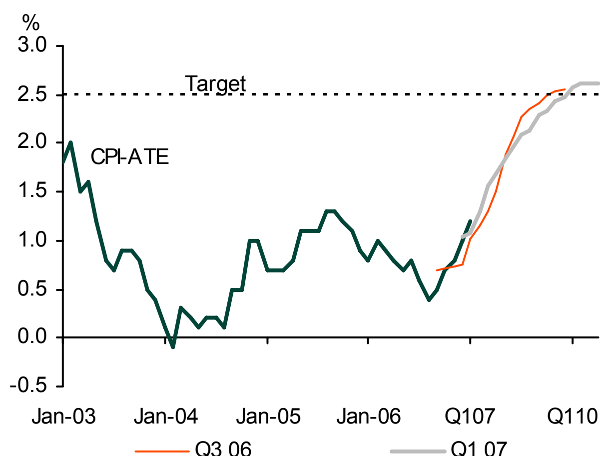
Sweden: Riksbank inflation forecasts



Source: Riksbank, SCB, Datastream, Lehman Brothers Global Economics.

- The Riksbank's February *Monetary Policy Report* revealed a significant downward revision to its forecast for targeted (UND1X) inflation this year.
- The effects of the strong currency, weaker oil prices and strong growth in labour supply were highlighted as contributing factors.
- However, hints of stronger-than-expected wage growth and a rebound in energy prices may lead to upward revisions in the future.

Norway: Norges Bank inflation forecasts



Source: Norges Bank, SSB, Datastream, Lehman Brothers Global Economics.

- The Norges Bank updated its inflation projections in March, judging there to be more underlying inflation pressure in the short term.
- The targeted CPI-ATE rate jumped to 1.5% in March, up from a low of 0.4% in August but still some way below the 2.5% target.
- We expect the CPI-ATE to average 1.7% in 2007 and to rise further towards target in 2008, keeping the Norges Bank on a tightening path.

JAPAN: ECONOMIC OUTLOOK

Forecast adjustments

Kenichi Kawasaki
kekawasa@lehman.com

Hiroshi Shiraishi
hshirais@lehman.com

We have bumped up our forecast for Q1 GDP but nudged down those for the next couple of quarters. We also pushed down our inflation forecast slightly further.

We have revised up our forecast for real GDP growth in Q1 to 2.6% q-o-q (saar) from 1.0% before, reflecting stronger consumption and exports. That said, the big picture remains largely the same. Japan's economy is in the process of emerging from secular deflation, but the pace remains slow. In fact, some cyclical indicators have started to show signs of weakness (see *Japan Overview* in this issue). Reflecting this, we have nudged down our forecast for the next couple of quarters. In addition, given the latest soft CPI report, we have revised down our forecast for the core CPI further: we now look for it to be flat on the year (+0.1% before) in 2007 on average.

Despite structural repairs, the transmission mechanisms are muted

Growth continues to be driven by the corporate sector; income transmission to the household sector remains muted, suggesting that sustained robust growth in consumption is unlikely. A decade of macro de-leveraging appears largely to have come to an end and land prices are turning around – that much is encouraging. But bank lending data indicate that full-fledged credit creation has yet to start. In the meantime, steady improvement in the jobs market should continue and household demand should gradually firm. With help from continued growth in the global economy, we expect economic growth to continue at a decent pace. However, the economy seems unlikely to start generating robust reflationary momentum during 2007.

Premature macro policy tightening is not helping

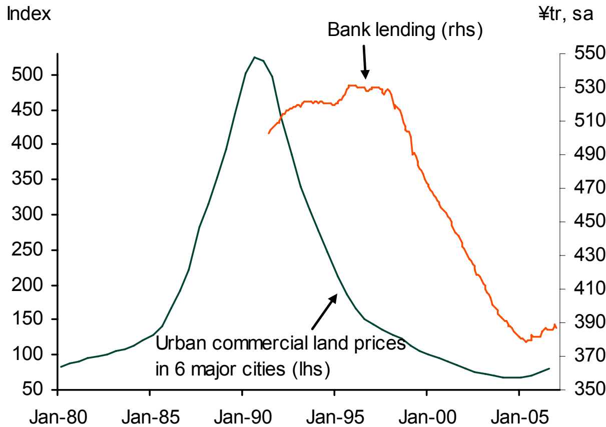
With deflation still in a twilight zone, macro policy, in our view, should focus on vanquishing deflation. But while the global slowdown is starting to merge with an aging domestic cycle, macro policy is being tightened (prematurely, in our view). Having presided over years of deflation, the BOJ appears vigilant against reflation and has signalled its intent to raise rates steadily. Modest fiscal tightening, in the form of the abolition of past income tax cuts and ongoing expenditure cuts, looks set to continue. However, a hike in the consumption tax seems unlikely before FY09.

The outlook at a glance

%	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07	2006	2007	2008
Real GDP	2.9	1.3	0.5	5.5	2.6	1.2	2.0	2.7	2.2	2.4	2.5
Consumption	0.2	2.2	-4.2	4.2	3.2	1.4	1.6	2.2	0.9	1.8	2.1
Business investment	15.2	13.3	4.5	13.2	1.6	4.1	4.5	5.1	7.7	5.8	4.6
Resdential investment	3.6	-8.0	-0.3	9.1	-3.9	2.4	2.4	2.4	1.0	1.0	2.4
Public demand	-2.1	-2.6	-1.5	3.1	0.4	0.2	-0.4	-0.3	-1.3	0.3	-0.2
Exports	9.5	2.5	9.9	2.4	8.7	4.5	4.9	6.1	9.6	5.8	5.8
Imports	8.1	5.6	-1.9	-1.0	2.0	4.1	4.1	3.6	4.6	1.9	5.2
Contribution to GDP:											
Domestic final sales	1.9	2.3	-2.0	5.4	2.0	1.6	1.6	2.1	1.4	2.0	2.0
Inventories	0.5	-0.8	0.9	-0.3	-0.4	-0.6	0.1	0.1	0.0	-0.2	0.2
Net trade	0.5	-0.2	1.6	0.5	1.0	0.2	0.3	0.5	0.8	0.6	0.3
Nominal GDP	1.8	0.7	-0.1	5.6	2.3	1.6	2.2	2.7	1.3	2.4	3.1
GDP deflator	-1.2	-1.2	-0.8	-0.5	-0.4	-0.1	0.1	0.1	-0.9	-0.1	0.7
Unemployment rate	4.2	4.1	4.1	4.0	4.0	3.9	3.8	3.7	4.1	3.9	3.6
Core consumer prices	0.0	0.0	0.2	0.1	-0.1	-0.1	0.0	0.3	0.1	0.0	0.5
Domestic CGPI	2.8	3.1	3.5	2.8	2.2	2.2	2.5	2.7	3.0	2.4	2.2
Bank lending	0.1	1.4	1.9	1.3	1.8	1.9	2.0	2.0	1.2	1.9	2.4
Industrial production	3.2	4.1	5.4	5.7	2.9	3.1	2.7	1.4	4.2	2.6	3.7
Unconditional call rate	0.00	0.00	0.25	0.25	0.50	0.50	0.75	1.00	0.25	1.00	1.75
3-month rates	0.11	0.35	0.42	0.60	0.70	0.75	0.95	1.20	0.60	1.20	1.95
10-year bond yield	1.78	1.90	1.68	1.75	1.70	1.80	1.95	2.20	1.75	2.20	2.60
Yen per $	117	110	118	115	117	117	115	112	115	112	100

Notes: Real GDP and its contributions are seasonally adjusted annual rates. Unemployment is measured as a percentage of the labour force. Bank lending, industrial production and prices are year-on-year percentage changes. Currency and interest rate forecasts are end-of-period. Table last revised 2 May 2007. All forecasts are modal forecasts (ie, the single most likely outcome). Source: Lehman Brothers Global Economics.

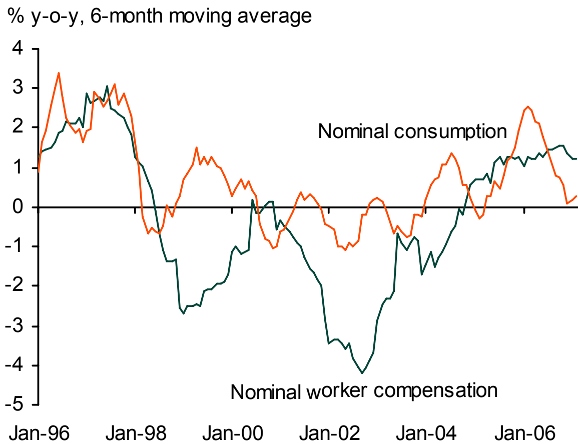
Credit creation transmission mechanism has yet to be fully ignited



Source: CEIC, Bank of Japan, Japan Real Estate Institute, and Lehman Brothers Global Economics.

- The economy was in a liquidity trap for the best part of a decade, with a relentless decline in bank lending stymieing the BOJ's monetary easing.
- Bank lending is starting to increase, indicating that post-bubble de-leveraging has come to an end.
- However, the trend of recent bank lending data suggests that the credit transmission mechanism has yet to be fully reignited.

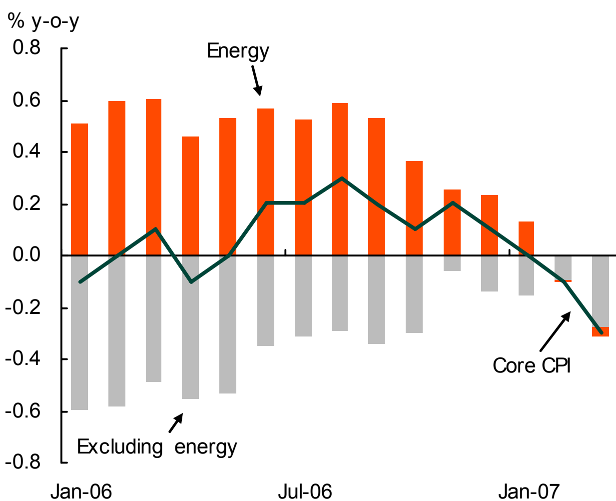
Stronger wage growth is needed for consumption to drive growth



Source: Cabinet Office, Ministry of Health, Labour and Welfare, and Lehman Brothers Global Economics.

- Employment has been growing steadily over the past year and corporate appetite for hiring still looks strong.
- But growth in worker compensation remains muted, as wage growth, at the macro level, has failed to pick up.
- For consumption to become a prime driver of growth, wage growth needs to pick up further, particularly given that mounting fiscal headwinds still pose risks.

Underlying upward pressure on prices should build, but gradually



Source: Ministry of Internal Affairs and Communications, and Lehman Brothers Global Economics.

- The year-on-year rate of the core CPI dipped into negative territory as the contribution from energy prices dissipated.
- Underlying upward pressure on consumer prices should build, albeit quite gradually, as the economy continues to grow.
- This, together with our forecast for a rebound in oil prices, points to a pickup in CPI inflation towards the year-end. But the recent data point to downside risks.

JAPAN: MARKET OUTLOOK

Eager to "normalize"

Kenichi Kawasaki
+81 3 6440 1420
kekawasa@lehman.com

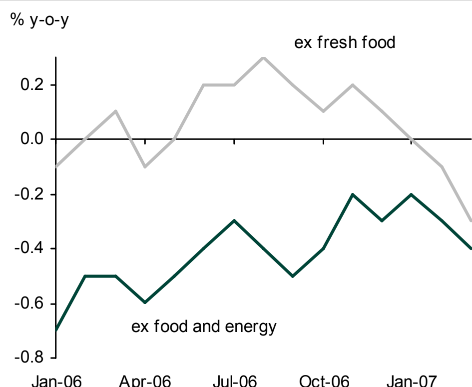
Hiroshi Shiraishi
+81 6440 1427
hshirais@lehman.com

The BOJ's Outlook Report indicated that the Bank remains eager to keep a "gradual" rate hike path.

The Bank of Japan last week reiterated its intention to hike interest rates "gradually" in its semi-annual report on the *Outlook for Economic Activity and Prices*. Indeed, at the press conference that followed the release of the report, Governor Toshihiko Fukui suggested that "even if prices are expected to fall on the year in the near term, as long as the mechanism of the economic expansion is well intact and price trends in the long term are expected to be firm", the Bank should not be keeping rates on hold for too long because that "may have an adverse impact on the allocation of resources and, in turn, result in a wide fluctuation in economic activity".

In the Outlook Report, reflecting the fact that actual inflation has clearly been undershooting thier expectations, board members revised down their inflation forecast for FY07 significantly: the median value of the board members' forecast fell to 0.1% y-o-y from 0.5% (Figure 1). However, based on the view that the economy will continue to grow at a pace slightly above its potential, the board members maintained their view that inflation will gradually pick up over the medium term: the median forecast for core CPI in FY08 was +0.5% (Figure 2). The BOJ acknowledged the risk that inflation may not pick up as much as it expects, particularly if "wage growth were to remain low". But it downplayed the risk of the economy falling into a deflationary spiral and, instead, emphasized the risk that the "simulative effect of monetary policy may be further amplified". If the growth outlook remains reasonably benign, the Bank seems unlikely to abandon its current policy stance, unless inflation figures deteriorate further from here.

Figure 1. Nationwide CPI



Source: Ministry of Internal Affairs and Communications, and Lehman Brothers Global Economics.

Figure 2. Forecasts of the majority of board members*

	Real GDP	Domestic corproate goods prices	Core CPI
FY07	+2.0~+2.1 (+2.1)	+0.7~+0.8 (+0.7)	+0.0~+0.2 (+0.1)
as of October 06	+1.9~+2.4 (+2.1)	+1.1~+1.5 (+1.2)	+0.4~+0.5 (+0.5)
FY08	+2.0~+2.3 (+2.1)	+0.8~+1.0 (+1.0)	+0.4~+0.6 (+0.5)

* The figures in the bracket is the median value of board members' forecast. The forecasts of the "majority" of Policy Board members exclude the highest and lowest figures.

Source: Bank of Japan and Lehman Brothers Global Economics.

The outlook at a glance

		In 1 mth's time		In 3 mths' time		In 12 mths' time	
%	**Current rate**	**Market**	**Lehman**	**Market**	**Lehman**	**Market**	**Lehman**
Call money rate	0.50	n.a.	0.50	n.a.	0.50	n.a.	1.25
3-mth rates	0.67	0.71	0.70	0.80	0.80	1.03	1.45
spread (bp)	17	n.a.	20	n.a.	30	n.a.	20
10-yr bond yields	1.63	1.63	1.75	1.66	1.85	1.80	2.35
spread v US bonds (bp)	-305	-273	-311	-279	-301	-310	-251
yen per dollar	119.5	119.0	117.8	118.1	118.0	114.4	103.7
yen per euro	163.1	162.7	160.3	161.8	162.8	157.7	133.7

** Lehman estimates are modal ("most likely outcome") forecasts. Last updated on 1 May 2007.*

JAPAN: CALENDAR

Economic events in the weeks ahead

		Period	Prev 2	Prev 1	Latest	Lehman	Consensus
Wednesday 9 May							
9-May	Coincident diffusion index, %	Mar	63.6	30.0	30.0	22.2	22.2
9-May	Leading diffusion index, %	Mar	31.8	40.9	27.3	40.0	40.0
Thursday 10 May							
8:50	Bank lending, nsa, % y-o-y	Apr	1.8	1.4	1.1	0.6	n.a.
8:50	Bank lending, NPL-adjusted, nsa, % y-o-y	Apr	2.8	2.4	2.1	1.6	n.a.
8:50	Broad liquidity, nsa, % y-o-y	Apr	2.6	2.7	2.6	2.6	2.5
8:50	M2+CDs, nsa, % y-o-y	Apr	1.0	1.1	1.1	1.1	1.1
14.00	Speech by BOJ Governor Fukui						
16.00	Economy Watchers Survey: Current	Apr	47.2	49.2	50.8	n.a.	n.a.
16.00	Economy Watchers Survey: Outlook	Apr	50.9	52.1	51.3	n.a.	n.a.
Saturday 12 May							
	Speech by BOJ Deputy Governor Muto						
Week beginning 14 of May							
14-May	Current account balance, nsa, ¥bn	Mar	1776.8	1194.4	2417.5	n.a.	n.a.
14-May	Current account balance, nsa, % y-o-y	Mar	-4.7	49.8	4.9	n.a.	n.a.
14-May	Domestic corporate goods prices, nsa, % m-o-m	Apr	-0.3	0.0	0.3	n.a.	n.a.
14-May	Domestic corporate goods prices, nsa, % y-o-y	Apr	2.1	1.7	2.0	n.a.	n.a.
14-May	Debt left by bankruptcies, nsa, ¥tr	Apr	4.0	5.5	-0.6	n.a.	n.a.
15-May	Core machinery orders, % m-o-m	Mar	-0.7	3.9	-5.2	n.a.	n.a.
15-May	Core machinery orders, % y-o-y	Mar	-3.8	2.6	-4.2	n.a.	n.a.
16-May	Capacity utilization, sa, index	Mar	108.2	105.9	106.3	n.a.	n.a.
16-May	Industrial production, sa, % m-o-m	Mar	0.9	-1.7	0.7	n.a.	n.a.
16-May	Industrial production, nsa, % y-o-y	Mar	4.8	4.0	3.1	n.a.	n.a.
16-May	Consumer confidence, monthly index nsa	Apr	48.4	48.6	47.2	n.a.	n.a.
16-May	BOJ Monetary Policy Meeting						
17-May	BOJ Monthly Report						
17-May	GDP Deflator, nsa, % y-o-y	Q1	-0.8	-0.7	-0.5	n.a.	-0.4
17-May	Real GDP % q-o-q	Q1	0.3	0.1	1.3	0.7	0.7
17-May	Real GDP Annualized	Q1	1.3	0.5	5.5	2.6	2.7
18-May	Tertiary Industry Index, m-o-m	Mar	-0.4	1.6	1.0	n.a.	n.a.
18-May	Coincident diffusion index, %	Mar	63.6	30.0	30.0	n.a.	n.a.
18-May	Leading diffusion index, %	Mar	25.0	40.9	27.3	n.a.	n.a.
Week beginning 21 of May							
23-May	All-industry output, sa, % m-o-m	Mar	-0.1	-0.2	0.9	n.a.	n.a.
24-May	Customs-cleared trade balance, nsa, ¥bn	Apr	-3.492	979.6	1633.5	n.a.	n.a.
24-May	Customs-cleared trade balance, nsa, % y-o-y	Apr	-99.1	7.4	73.9	n.a.	n.a.
25-May	Nationwide CPI, sa, % m-o-m	Apr	0.0	-0.3	-0.4	n.a.	n.a.
25-May	Nationwide CPI, nsa, % y-o-y	Apr	0.3	0.0	-0.2	n.a.	n.a.
25-May	Nationwide CPI, core, sa, % m-o-m	Apr	0.1	-0.2	-0.4	n.a.	n.a.
25-May	Nationwide CPI, core, nsa, % y-o-y	Apr	0.1	0.0	-0.1	n.a.	n.a.
25-May	Tokyo CPI, nsa, % y-o-y	May	0.1	0.0	0.0	n.a.	n.a.
25-May	Tokyo CPI, core, nsa, % y-o-y	May	0.2	0.0	-0.1	n.a.	n.a.
Week beginning 28 of May							
28-May	Corporate service price index, nsa, % y-o-y	Apr	0.6	0.4	0.6	n.a.	n.a.
29-May	Unemployment rate, sa, %	Apr	4.0	4.0	4.0	n.a.	n.a.
29-May	Job offers-to-applicants, sa, ratio	Apr	1.06	1.05	1.03	n.a.	n.a.
29-May	All-household spending, sa, % y-o-y	Apr	-1.9	0.6	1.3	n.a.	n.a.
29-May	Retail sales, sa, % m-o-m	Apr	2.3	-0.9	-1.3	n.a.	n.a.
29-May	Retail sales, nsa, % y-o-y	Apr	-0.8	-0.2	-0.7	n.a.	n.a.
29-May	Shoko Chukin survey, sa, index	May	48.8	50.4	49.6	n.a.	n.a.
30-May	Industrial production, sa, % m-o-m	Apr	-1.7	0.7	n.a.	n.a.	n.a.
30-May	Industrial production, nsa, % y-o-y	Apr	4.0	3.1	n.a.	n.a.	n.a.
31-May	Total cash salaries, nsa, % y-o-y	Apr	-1.4	-0.7	-0.4	n.a.	n.a.
31-May	Overtime hours, nsa, % y-o-y	Apr	-0.7	0.7	-0.4	n.a.	n.a.
31-May	Housing starts, nsa, % y-o-y	Apr	-0.7	-9.9	5.5	n.a.	n.a.
31-May	Construction orders, nsa, % y-o-y	Apr	33.9	7.0	-1.6	n.a.	n.a.

JAPAN: PREVIEW

The week ahead

Hiroshi Shiraishi
+81 3 6440 1427
hshirais@lehman.com

We expect bank lending growth to have slowed further in April, suggesting that corporates and households remain cautious about taking on debt.

Bank lending (Thursday)

Bank lending growth probably slowed in April

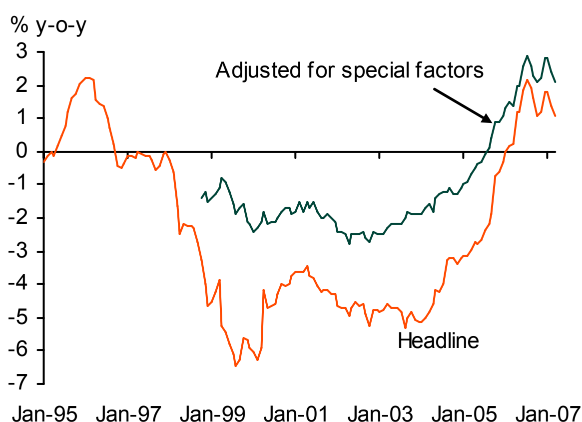
In the past, bank lending data often posted a large movement at the start of new financial year. In April last year, the rate of increase in bank lending jumped to 1.2% y-o-y from 0.2% in March. In seasonally adjusted terms, we estimate that the level of bank lending picked up 0.7% on the month last April. However, bank lending has not picked up much since then, with its trend softening in the past few months (Figure 1). Despite the turnaround in the real estate market, corporates and households still appear to be quite cautious about taking on debt. We expect bank lending to pick up modestly on the month in April this year. But given the large base effect, we expect its year-on-year rate of increase to slow to 0.6% from 1.1% in March. Adjusted for write-offs, securitisations, and exchange rate moves, we expect the rate of increase in bank lending to moderate to 1.6% y-o-y from 2.4% in March.

Money supply (Thursday)

We expect money supply growth to have been little changed in April

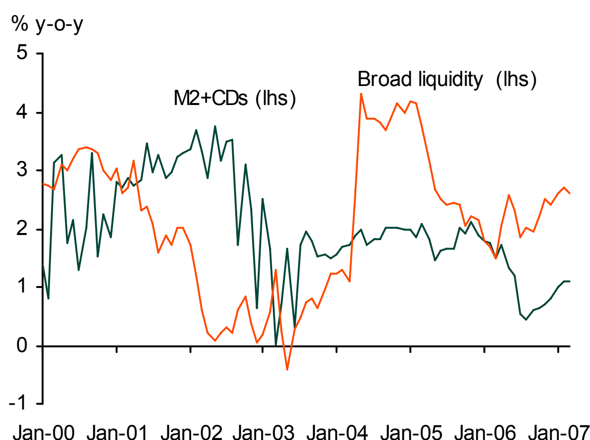
The rate of growth in M2+CDs has been picking up gradually since Q4 last year, albeit from a depressed level. Within M2+CDs, funds appear to be shifting from cash and demand deposits into time deposits, given the increase in interest rates in summer last year. And with another rate hike by the BOJ in February, this trend will likely continue in coming months. More broadly, however, funds appear to be gradually moving away from bank deposits and into other types of assets: growth in broad liquidity has been running higher than growth in M2+CDs over the past year. Within the broad liquidity measure, the rate of growth in investment trusts is continuing to pick up. That said, with credit growth remaining muted, money supply growth seems unlikely to pick up much further in the near term. We look for the rate of increase in both M2+CDs and broad liquidity to have remained unchanged at 1.1% y-o-y and 2.6% in April, respectively.

Figure 1. Bank lending: headline and adjusted



Source: CEIC, Bank of Japan, and Lehman Brothers Global Economics.

Figure 2. Money supply growth



Source: CEIC, Bank of Japan, and Lehman Brothers Global Economics.

ASIA EX-JAPAN: FOCUS

India: New challenges for the RBI

Sonal Varma
91-22-4037-4087
sonal.varma@lehman.com

Rob Subbaraman
+85 2 2252 6249
rsuba@lehman.com

Balancing the costs and benefits of FX intervention is a tightrope walk for the RBI.

Like most of its Asian counterparts, the Reserve Bank of India (RBI) has resisted rapid appreciation of the rupee through heavy foreign exchange (FX) intervention in a bid to maintain export competitiveness. However, lately there seems to have been some change in policy: the RBI has allowed the INR/USD to appreciate by 6.8%, in the past two months, to nearly a nine-year high (Figure 1). While taming inflation is part of the reason, we believe that it also reflects the rising risks and costs associated with heavy, sustained FX intervention.

RBI's FX intervention intensified early this year…

Buoyed by over 9% GDP growth and relatively high interest rates, India's *net* capital inflows have tripled over the past five years to US$37.3bn in 2006 and over the past two years have been the source of appreciation pressure on the rupee (Figure 2). In an effort to resist this appreciation, the RBI exchanged rupees for a net US$20.6bn-worth of foreign currencies in 2006, and in February this year it conducted its highest ever monthly FX intervention of US$11.9bn (Figure 3).

…requiring increased selling of MSS bills and hikes to the CRR ratio

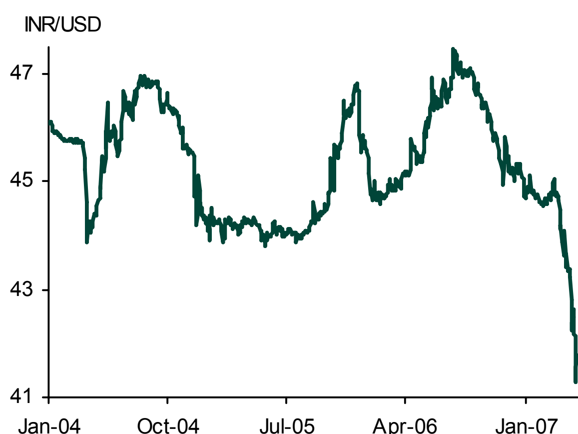
This intervention in the FX market has caused a surge in the net foreign assets on the RBI's balance sheet. In order to avoid a commensurate surge in reserve money, the RBI has had to sterilise, i.e. "mop up", the liquidity by reducing its holding of net domestic assets. In FY2003-04 (ending in March), its preferred sterilisation tool was the selling of government securities, but with the subsequent depletion of this stock, the RBI switched to market stabilisation scheme (MSS). Another tool that has been increasingly employed is raising the cash reserve requirement (CRR). This requires the commercial banks to set aside a larger share of their deposits at the RBI – earning zero interest – thereby reducing their willingness to step up their lending because of faster reserve money growth.

RBI's sterilisation efforts have been only partially successful

In FY2006-07, the RBI sterilised close to US$7.9bn by selling MSS bills. However, that was not sufficient to counter the surge in net foreign assets (Figure 4). As a result, reserve money growth picked up from 17.2% y-o-y in March 2006 to 23.7% in March 2007, the fastest pace in more than a decade. Also since November 2006, the RBI has hiked the CRR from 5.0% to 6.5%, but this seems to have been only modestly successful in discouraging banks from stepping up their lending: credit was still growing at a rapid clip of 28.2% y-o-y at the end of April.

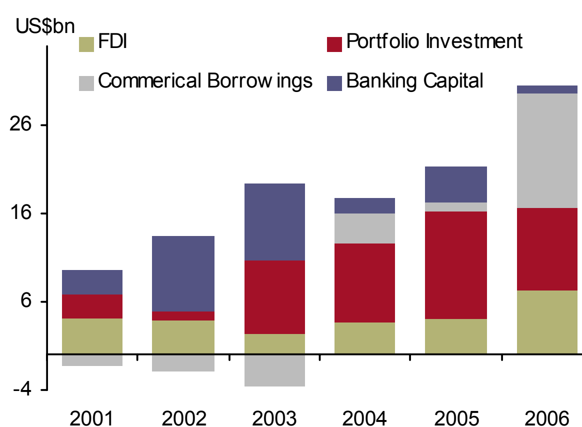
To more rigorously test the extent to which the RBI's FX intervention has been sterilised, we estimated the relationship between net domestic assets and net foreign

Figure 1. Recent movements in INR/USD



Source: CEIC and Lehman Brothers.

Figure 2. Main sources of net capital inflows



Source: RBI, CEIC and Lehman Brothers.

assets after controlling for seasonal effects using data from 1990 to 2007. The *sterilisation co-efficient,* which measures the response of a change in net domestic assets to a change in net foreign assets, is -0.79. That is, a US$100 increase in net foreign assets resulted in sterilisation operations that mopped up US$79 of the total increase from the system. The *sterilisation co-efficient* has risen further to -0.87 during 2003-2007 reflecting a step up in the RBI's sterilisation efforts in the face of rapidly rising capital inflows. Hence, the RBI's sterilisation policy appears to have been fairly successful.

Further heavy sterilized FX intervention could raise domestic interest rates…

While the RBI has managed liquidity reasonably well so far, the sterilisation required for heavy, persistent FX intervention involves rising risks and costs. Continued issuance of MSS bills can put upward pressure on domestic interest rates, thereby attracting more capital inflows and requiring further sterilisation. Moreover, using MSS to sterilise can involve a "quasi fiscal cost" when the interest paid on the MSS bills exceeds the interest earned on the RBI's FX reserves, which are mostly deployed in safe but low-yielding US securities and deposits. For instance, in FY2004-05 and FY2005-06 the RBI reported that it earned 3.2% and 4.1% respectively on its foreign currency assets and gold before depreciation, while it paid around 5.5% on its MSS bills. The average interest rate on MSS bills has risen further to about 7.0% in FY2006-07.

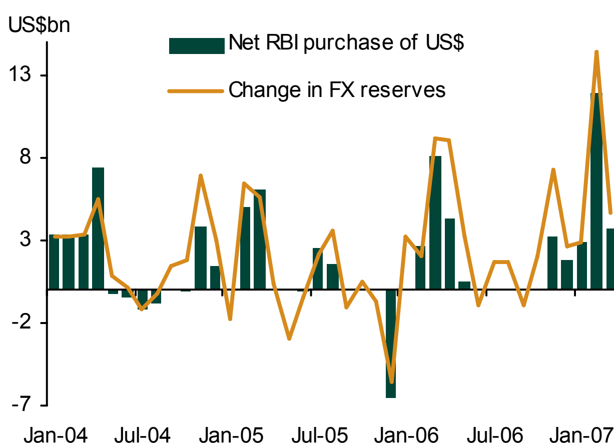
…and could lead to a quasi fiscal cost this financial year

We estimate that, if India's FX reserves continue growing at their current rate, the RBI runs the risk of incurring a quasi fiscal cost. On top of high inflation, this may explain why the RBI recently eased off its FX intervention, and why the CRR (on which the RBI pays no interest) has become an increasingly popular tool. The RBI's net foreign assets rose by US$44bn in FY2006-07. If we assume that they rise by the same amount in FY2007-08 and that MSS bills are used to sterilise liquidity to keep the reserve money-to-GDP ratio constant, then based on current interest rates on US Treasury and MSS bills we estimate that there should be no quasi fiscal cost. However, if India's FX reserves follow the pattern of China, and surge by, say, US$80bn in FY2007-08, then the quasi fiscal cost rises to US$0.7bn, or 0.1% of GDP, while a further surge in reserves by US$120bn in FY2008-09 escalates the quasi fiscal cost by another US$1.8bn.

We expect the RBI to follow an eclectic approach to managing capital inflows

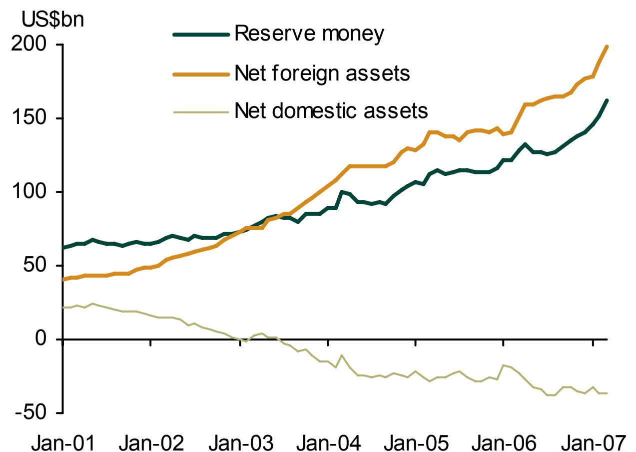
Bottom-line: With rising sterilisation costs, we expect the RBI to follow an eclectic approach to managing capital inflows: allowing some currency appreciation (we expect INR/USD to reach 40.5 by end 2007), lifting more restrictions on capital outflows, tightening restrictions on certain short-term speculative capital inflows, and resorting to greater usage of the CRR (we expect three more 50bp hikes by December) to control liquidity. The risk is that excessive rupee appreciation could worsen the current account deficit significantly; while resisting rupee appreciation can compromise monetary policy autonomy and raises the risk of excess liquidity fueling asset price bubbles.■

Figure 3. Intervention by the RBI and FX reserves



Source: RBI, CEIC and Lehman Brothers.

Figure 4. Net foreign and domestic assets of the RBI



Source: CEIC and Lehman Brothers.

ASIA EX-JAPAN: ECONOMIC OUTLOOK

Three possible surprises

Rob Subbaraman
+852 2252 6249
rsuba@lehman.com

Mingchun Sun
+852 2252 6248
minsun@lehman.com

Young Sun Kwon
+852 2252 1370
youngsun.kwon@lehman.com

Sonal Varma
+ 91 22 4037 4087
sonal.varma@lehman.com

Low inflation, a revival of investment and the Southeast Asian economies starting to shine.

In our opinion, the biggest risk is a downturn in exports, but there is ample room for policy responses. Government budgets are generally in good shape and, in most countries, public debt/GDP is below the OECD average. This leaves plenty of room to expand fiscal policy. Inflation is well under control, too. If some of the downside risks to growth were to materialise, nearly all Asian countries could cut rates. Against this backdrop, our outlook is cautious but positive, forecasting more than 8% growth this year and next.

The consensus could get it wrong in three areas. The first is inflation surprising on the low side. Asian inflation has remained benign in recent years, despite surging oil prices. We attribute this to prudent monetary policies, strong productivity growth after a decade of structural reforms and intense competitive pressures from China and India.

The second potential surprise is resurgent investment. In China, tighter policies cooled investment temporarily in 2006, but it has rebounded in early 2007. We do not expect much more cooling; there is huge demand for capital in less developed parts of China. In the rest of the region, investment has languished in most countries since the Asian crisis. Ten years on, there is a growing competitive need to upgrade the capital stock. Conditions seem ripe for a revival: economic fundamentals are much improved; interest rates are low; and public infrastructure spending looks set to soar, which should spur private investment.

The third possible surprise is stronger-than-expected growth in the Southeast Asian economies. Despite setbacks in Thailand, Southeast Asian politics have become more stable and macro policies more prudent. Indeed, in recent years, the Southeast Asian cubs have made more progress than the Northeast Asian tigers in improving their economic fundamentals. The climate in Southeast Asia seems ripe for a resurgence in investment, which has been badly lacking. This would set the stage for all of the economies to grow at their full potential in 2008 for the first time since the Asian crisis.

A major challenge for Asian central banks is coping with large net capital inflows on top of current account surpluses. Slowing the pace of currency appreciation has led to a massive build up of FX reserves and is helping keep exports competitive. However, it also risks undermining monetary autonomy, with the negative consequences of asset price bubbles and/or inflation. Our base case is that Asian currencies will appreciate and Asian policymakers will increasingly turn their focus to stimulating domestic demand.

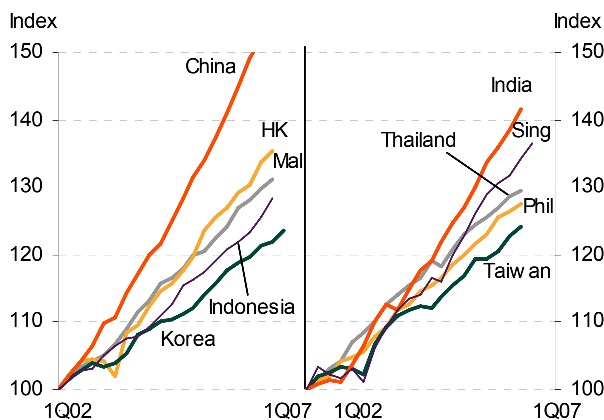
Forecast changes this week: None.

The outlook at a glance

	Real GDP (% growth y-o-y)				CPI (% y-o-y)			
	Latest*	2006	2007	2008	Latest#	2006	2007	2008
China	11.1	10.7	10.2	9.8	3.3	1.5	2.8	2.8
Hong Kong	7.0	6.8	5.5	6.5	2.4	2.0	2.5	3.5
India	8.6	9.1	9.6	9.9	5.8	4.8	5.9	5.7
Indonesia	6.1	5.5	5.7	6.5	6.3	13.1	6.5	5.0
Malaysia	5.7	5.9	5.0	6.0	1.5	3.6	2.2	3.0
Philippines	4.8	5.4	5.8	6.5	2.3	6.2	3.5	4.0
Singapore	6.0	7.9	5.5	6.0	0.7	1.0	1.6	2.1
South Korea	4.0	5.0	4.3	4.8	2.5	2.2	2.3	2.6
Taiwan	4.0	4.6	3.9	5.0	0.7	0.6	1.0	1.5
Thailand	4.2	5.0	3.5	5.5	1.8	4.6	2.8	3.5
Asia ex-Japan	8.3	8.4	8.0	8.2	3.4	3.0	3.3	3.4

** GDP data are for Q4, except for China, Singapore and South Korea (which is Q1).*
 # CPI data are for April, except for China, Hong Kong, Indonesia and Sinapore (which are for March).
 # CPI data for India are based on the wholesale price index for the week of 21 April 2007.
All forecasts are modal (ie, the most likely single outcome). Table last revised on 4 May 2007.
Source: CEIC and Lehman Brothers.

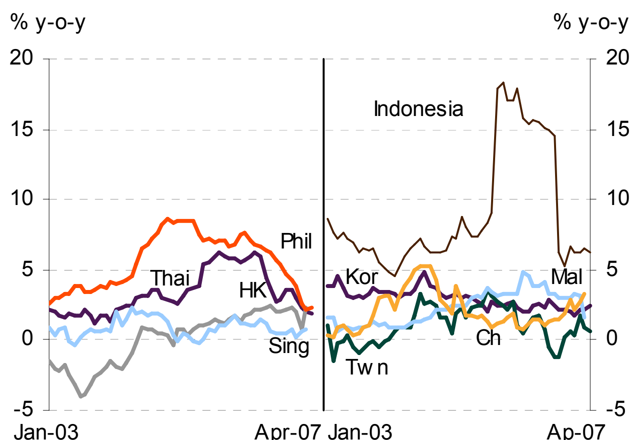
The region: The level of real GDP (seasonally adjusted, indexed 1Q2002 = 100)



Source: CEIC and Lehman Brothers.

- We expect an export slowdown this year, but the region has plenty of room to ease monetary and fiscal policies, rotating the mix of GDP towards domestic demand.
- Indexed to 100 in 2002, China's GDP (161) is off the chart, but its growth is too dependent on exports and investment. Southeast Asia is also starting to shine.
- The laggard economies have been Korea and Taiwan. Both have heavily indebted household sectors and are facing intense competitive pressures.

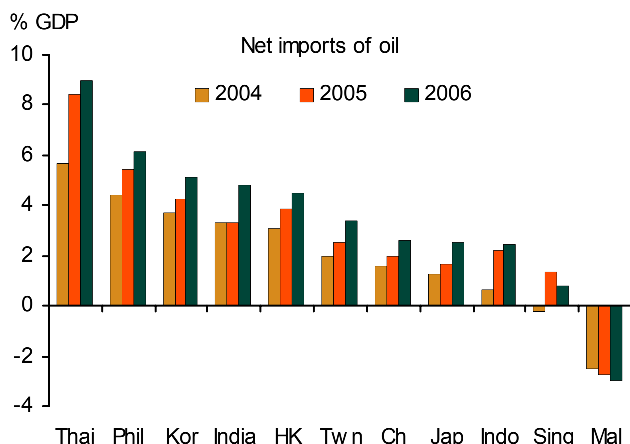
The region: Consumer price inflation (% y-o-y)



Source: CEIC and Lehman Brothers.

- After rising sharply on surging oil prices and cuts in government oil price subsidies, inflation has fallen sharply in Indonesia and remains benign elsewhere.
- We expect oil prices to rise again, to an average of US$68/bbl in 2007, but the impact on the year-on-year CPI inflation should be modest given a high base year of comparison.
- How low inflation goes could be the big surprise. High productivity growth, prudent monetary policies and intense competition are keeping inflation low.

The region: Very exposed to oil price shocks



Source: CEIC and Lehman Brothers.

- High oil prices hurt Asia ex-Japan's economies substantially more than those of most other regions, with Thailand, Philippines, Korea and India most exposed.
- Our Oil team expects oil prices to rise again, and our economic forecasts are based on this view. But if oil prices stay low, it will be a major plus for the region.
- If oil prices surprise us on the downside, it could result in larger current account surpluses, lower CPI inflation, more scope for rate cuts and stronger growth.

CHINA: ECONOMIC OUTLOOK

Set for another year of double-digit growth

Mingchun Sun
+852 2252 6248
minsun@lehman.com

We expect 2007 to mark the fifth consecutive year of double-digit growth.

China's real GDP growth rebounded strongly to 11.1% y-o-y in Q1 from 10.4% in 4Q 2006, driven by a 101% y-o-y increase in the trade surplus, a 23.7% gain in fixed-asset investment and 14.9% growth in retail sales. We have raised our 2007 growth forecast from 9.8% to 10.2%, making 2007 the fifth straight year of double-digit growth.

There are both welcome and unwelcome signs in the Q1 data. Welcome: retail sales grew 14.9% y-o-y versus 14.3% 4Q 2006, suggesting consumption has picked up. Consumption is low as a share of GDP and needs to pick up to rebalance growth away from investment and exports. Unwelcome: the gigantic and rapidly increasing trade surplus is making growth even more dependent on exports.

These data suggest that government policies to rebalance the economy have had mixed results at best. The government had promised a comprehensive set of policies and reforms to rebalance the economy, but has so far implemented only a few, with tweaks here and there. That these policies have failed to achieve their goals raises the risk that, if the government continues carrying out the promised reforms at its current slow pace, the unbalanced growth could be prolonged, making the longer-term outlook riskier.

We have raised our 2007 forecast of CPI inflation to 2.8% from 2.5% as a result of stronger-than-expected inflation in Q1. Since inflation will likely hover around 3.0% for most of this year, on our estimates, we judge that the central bank will hike rates once more in Q2 to keep the real deposit rate positive. In addition, we expect two additional 50bp hikes in the reserve requirement ratio this year as excess liquidity will likely continue to be generated through the trade surplus.

In addition to the monetary tightening measures, we expect the government to introduce other tightening measures soon, including more cuts to the VAT rebates for exporters and more administrative measures to cool investment and bank lending. Such measures usually work for a while and then lose their effectiveness over time. On the currency side, we expect continued heavy intervention by the central bank to limit renminbi appreciation to 7.50 CNY/USD by year-end, given that the government's top priority is to maintain employment and social stability. However, keeping the RMB on a tight leash makes it more difficult to rein in the trade surplus and reduces the scope to raise interest rates without attracting strong capital inflows. We are cautious about how effective these measures might be in rebalancing the economy; we expect China's supercharged growth to continue in 2007, but probably still in an unbalanced way.

The outlook at a glance

% y-o-y unless otherwise stated	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07	2006	2007	2008
Real GDP	10.4	11.5	10.6	10.4	11.1	10.2	9.8	9.5	10.7	10.2	9.8
Retail sales	12.8	13.9	13.8	14.3	14.9	14.7	14.7	15.0	13.7	14.8	14.7
Fixed-asset investment (ytd)	27.7	29.8	27.3	24.0	23.7	25.0	23.0	22.0	24.0	22.0	23.0
Industrial production	15.9	18.0	16.2	14.8	18.2	16.0	15.5	15.0	16.2	16.2	16.0
Exports	26.5	24.1	28.8	29.0	27.9	26.7	21.5	20.0	27.2	23.6	19.8
Imports	24.9	18.5	22.1	15.5	18.2	19.3	23.4	24.7	20.0	21.6	23.9
Trade surplus (US$bn)	23.1	38.0	48.7	67.8	46.5	62.3	55.2	71.4	178	235	243
Current account surplus (% of GDP)									8.8	9.6	8.7
Consumer prices	1.2	1.4	1.3	2.0	2.7	3.0	3.2	2.5	1.5	2.8	2.8
1-yr bank lending rate	5.58	5.85	6.12	6.12	6.39	6.66	6.66	6.66	6.12	6.66	6.93
1-yr bank deposit rate	2.25	2.25	2.52	2.52	2.79	3.06	3.06	3.06	2.52	3.06	3.33
Reserve requirement ratio	7.50	7.50	8.50	9.00	10.00	11.00	11.50	12.00	9.00	12.00	13.00
CNY/USD	8.02	8.00	7.91	7.81	7.73	7.64	7.57	7.50	7.81	7.50	7.10

Note: All forecasts are modal (ie, the most likely single outcome). Table last revised on 4 May, 2007.
Source: CEIC and Lehman Brothers.

INDIA: ECONOMIC OUTLOOK

Managing the transition to high growth

Rob Subbaraman
+852 2252 6249
rsuba@lehman.com

Sonal Varma
+91 22 4037 4087
sonal.varma@lehman.com

The growth spurt is largely structural in our view, but it is posing new policy challenges.

India is undergoing a remarkable transition: average GDP growth has surged from 5.7% in the 1990s to 8.8% over the past four years. This does not look like a flash in the pan. India's low-cost economy is reaping the rewards of market liberalisation; Indian companies (initially in services, but now also in manufacturing) are seizing the opportunities presented by new technologies and a more open economy. A middle class is fast emerging.

We judge that this growth spurt has more to do with structural factors than cyclical ones. Gross domestic investment as a share of GDP jumped from 28.0% in 2003-04 to 33.8% in 2005-06 and looks set to climb further. Robust government revenue is providing room for much-needed public infrastructure spending, FDI inflows are rising exponentially, and savings of the private corporate sector have surged from 4.7% in 2003-04 to 8.1% in 2005-06. High corporate savings is a sign of healthy profits, and this has occurred in spite of accelerating wages. This suggests to us that productivity is picking up, spurred by the diffusion of new technologies and rising competition.

However, the transition to this higher growth trajectory is creating new policy challenges. Wholesale price inflation rose to 6.5% y-o-y in March, and credit is growing at more than 28% y-o-y, albeit from a low base of 42% of GDP. These data suggest that part of the growth spurt could be cyclical, but exactly how much is hard to tell. For instance, the investment surge is affecting demand first – contributing to the surge in the prices of metals and cement – but should eventually help ease capacity constraints. The Reserve Bank of India (RBI) has hiked the repo rate to 7.75%, but this is fuelling large capital flows. The RBI has let the rupee appreciate recently, but too much appreciation could hurt exports, while heavy FX intervention could jeopardise monetary autonomy, raising the risk of the economy overheating. We expect the RBI to take a middle-road approach: managing the pace of rupee appreciation, while working hard to mop up liquidity by heavily utilizing the cash reserve ratio and open market operations.

Overheating cannot be ruled out, but far more important, in our view, is the scope for India's economy to sustain 9-10% growth in the medium term. Given that India's GDP per capita is just US$700, nearly three-fifths of its workforce is still in the countryside and half its population is under 25 years old, there is still much growth potential to be unlocked. The key is more supply-side reforms without politics getting in the way.

The outlook at a glance

% y-o-y growth unless otherwise stated	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07	2006	2007	2008
Real GDP	9.8	8.9	9.2	8.6	9.5	9.4	9.5	9.9	9.1	9.6	9.9
Agriculture	6.2	3.4	1.7	1.5	3.0	3.0	3.0	4.0	3.2	3.3	4.0
Industry	9.7	9.7	10.3	9.9	11.0	11.1	11.0	11.5	9.9	11.2	11.4
Services	11.1	10.5	10.8	11.3	11.0	10.8	10.5	11.5	10.9	11.0	11.1
Industrial output	8.7	10.5	11.8	10.9	10.8	10.7	11.0	12.0	10.5	11.1	11.8
M3 money supply	17.8	18.3	19.3	19.0	21.2	21.1	19.3	19.1	18.6	20.1	18.2
Non-food credit	34.6	32.9	32.4	30.1	30.5	29.1	27.0	28.5	32.4	28.7	26.6
Wholesale price index	4.0	4.6	5.1	5.6	6.4	5.9	5.9	5.5	4.8	5.9	5.7
Consumer price index (average)	5.0	6.2	6.5	7.5	8.1	6.9	6.7	5.7	6.3	6.8	5.4
Merchandise trade balance (% GDP)	-5.9	-5.9	-6.1	-6.9	-7.1	-7.0	-6.9	-6.7	-6.9	-6.7	-7.8
Current account balance (% GDP)	-1.3	-1.3	-1.5	-1.2	-2.0	-2.1	-2.2	-2.5	-1.2	-2.5	-3.4
Fiscal deficit (% GDP)	-4.5	-5.1	-4.3	-3.7	-3.7	-3.6	-3.4	-3.3	-3.7	-3.3	-3.0
Repo rate (%)	6.50	6.75	7.00	7.25	7.50	7.75	8.00	8.00	7.25	8.00	8.25
Reverse repo rate (%)	5.50	5.75	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Cash reserve ratio (%)	5.00	5.00	5.00	5.25	6.00	7.00	7.50	8.00	5.25	8.00	9.00
10-year bond yield (%)	7.53	8.13	7.68	7.61	7.98	8.20	8.50	8.50	7.61	8.50	8.75
Exchange rate (INR/USD)	44.6	46.1	46.0	44.2	43.6	40.8	40.6	40.5	44.2	40.5	38.5

Note: Consumer price index is a simple average of indices for industrial workers, non-manuel employees and agricultural labour. Fiscal deficit is for central government. All forecasts are modal (ie, the most likely single outcome). Table last revised on 4 May, 2007.

Source: CEIC and Lehman Brothers.

SOUTH KOREA: ECONOMIC OUTLOOK

Holding up

Young Sun Kwon
+852 2252 1370
youngsun.kwon@lehman.com

Despite recent strong data flow, we remain cautious whether a recovery in domestic demand can be sustained, given resurging oil prices and slowing global demand.

In response to recent strong data, we have revised our Q1 GDP forecast up to 4.0% y-o-y. Two factors lie behind our decision. First, export growth (measured in current prices) picked up to 15.0% y-o-y in Q1 from 13.8% in Q4 2006. Second, domestic demand seems to be holding up well (for now at least). Consumer goods sales growth jumped to 7.3% y-o-y in Jan-Feb from 4.5% in Q4 2006. Over the same period, equipment investment growth rose to 13.9% y-o-y from 5.1%.

However, we have trimmed our growth forecast for the next three quarters given increasing downside risks from a weakening US economy and resurging oil prices, thereby leaving our 2007 GDP forecast unchanged at 4.3%. For the same reason, we have trimmed our 2008 GDP growth forecast to 4.8% from 5.1% previously.

We are also trimming 0.2pp from CPI headline and core inflation in 2007, and 0.3pp from CPI in 2008. The reduction largely reflects our view that higher personal debt and delayed job creation will likely limit the recovery in consumption.

In terms of monetary policy, we retain our call that that the BOK will likely stay on hold for the rest of 2007. Low consumer price inflation, signs of easing house prices, and slowing mortgage loan growth should provide strong support for the Bank of Korea (BOK) not to hike rates. But we do not expect rate cuts either: (1) recent data flow suggests that the economy is neither too hot nor too cold; (2) although money supply growth has moderated recently, liquidity conditions are still sufficient to support the economy; (3) because policymakers now realize the negative effects of too low interest rates over 2001 to 2004, they are probably more conservative about cutting rates.

We also retain our view that the Korean won will likely appreciate less than other Asian currencies. In real trade-weighted terms, the Korean won has risen faster than other Asian currencies up to last year. The continued narrowing current account surplus should help depreciate the won, but the extent will be limited by general US$ weakness.

The outlook at a glance

% y-o-y growth unless otherwise stated	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07	2006	2007	2008
Real GDP	6.3	5.1	4.8	4.0	4.0	4.0	4.3	4.8	5.0	4.3	4.8
Private consumption	5.2	4.1	4.0	3.7	4.0	4.0	4.0	4.1	4.2	4.0	4.0
Business investment	7.0	7.2	11.1	5.3	8.0	5.0	5.6	6.0	7.6	5.8	6.0
Construction investment	0.2	-5.0	-0.1	3.2	2.0	2.4	2.0	1.4	-0.4	1.8	2.0
Exports	11.1	16.0	13.1	10.4	10.8	9.0	9.4	10.5	12.6	9.9	9.5
Imports	10.7	13.6	11.2	7.7	10.7	9.4	10.0	10.6	10.8	10.2	9.5
Contributions to GDP:											
Domestic final sales	4.0	2.4	3.4	4.1	2.2	2.7	1.8	1.0	3.5	1.8	3.6
Inventories	1.4	0.1	-0.2	-1.3	-1.1	-0.4	-0.1	1.0	-0.1	0.0	0.0
Net trade	0.9	2.6	1.6	1.2	3.0	1.7	2.6	2.7	1.6	2.5	1.2
Unemployment rate (sa, %)	3.5	3.5	3.5	3.4	3.2	3.3	3.4	3.5	3.5	3.4	3.5
Employment	1.5	1.2	1.2	1.2	1.2	1.2	1.3	1.3	1.3	1.2	1.3
Consumer prices	2.0	2.3	2.5	2.2	2.1	2.2	2.2	2.5	2.2	2.3	2.6
Core CPI	1.3	1.8	2.1	2.0	2.3	2.4	2.4	2.5	1.8	2.4	2.6
Current account (% of GDP)									0.7	0.0	-0.5
Bank loans	9.1	10.6	11.0	13.3	12.1	10.9	10.3	8.8	11.0	10.5	11.0
Residential property prices	0.9	2.3	1.2	4.5	0.2	0.5	0.8	1.0	6.2	5.9	5.0
BOK target call rate (%)	4.00	4.25	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50
3-year T-bond yield (%)	4.93	4.92	4.57	4.92	4.76	4.90	4.90	4.90	4.92	4.90	5.00
10-year T-bond yield (%)	5.42	5.25	4.73	5.06	4.93	5.00	5.00	5.00	5.06	5.00	5.10
Exchange rate (KRW/USD)	975.9	960.3	945.2	929.8	943.1	940	940	930	929.8	930	900

Note: Interest rates and currency are end of period, other measures are period averages. Residential property prices are quarterly average changes. Table last revised on 20 April, 2007. All forecasts are modal forecasts (i.e., the single most likely outcome).
Source: Bank of Korea, CEIC, and Lehman Brothers.

AUSTRALIA: ECONOMIC OUTLOOK

Growth pains

Stephen Roberts
+612 8259 4846
sroberts@grangesecurities.com.au

Overstretched capacity and accelerating economic growth spell higher inflation with an interest rate hike a possibility late in 2007.

Australian economic growth accelerated through 2H 2006 and the stronger growth spurt looks set to continue. Since the end of 2003, Australia has enjoyed a massive positive terms of trade shock, driving very strong growth in national income. Output fell behind income growth in recent years as increasing supply constraints limited the extent that GDP could grow. A substantial lift in business investment spending over the past two years, especially in the mining sector, has set the scene for big increases in production and exports in 2007.

Housing activity is also on the brink of a stronger turn with demand for new housing demand running well ahead of the much diminished supply of recent years, particularly in Australia's biggest state, New South Wales. Another factor that could add substantially to GDP growth from mid-2007 is the welcome change in the weather. Due to a severe drought, rural output in Q4 2006 fell at a 41% saar but, if wet conditions persist, as indicated in long-range weather forecasts, rural output could rebound by Q4 at a 40% saar pace.

After 16 years of continuous economic expansion the Australian economy is currently close to full capacity. The unemployment rate in March, at 4.5%, was at a 31-year low. Wages are growing at a 4% annual rate with the most capacity-constrained sectors, such as mining and construction, showing 7% annual wages growth. Briefly lower petrol prices may lower annual inflation readings through to mid-2007, but by year-end all measures are likely to show annual inflation rising through the Reserve Bank's 2-3% target band. We see the Reserve Bank lifting its cash interest rate by 25bp to 6.5% late in 2007 with another increase likely in the first half of 2008.

The Australian dollar recently pushed up to a seventeen-year high above USD0.83. Wide interest rate differential support plus strengthening exports and narrowing trade and current account deficit positions should support the Australian dollar and make the dips in periods of high risk aversion relatively shallow.

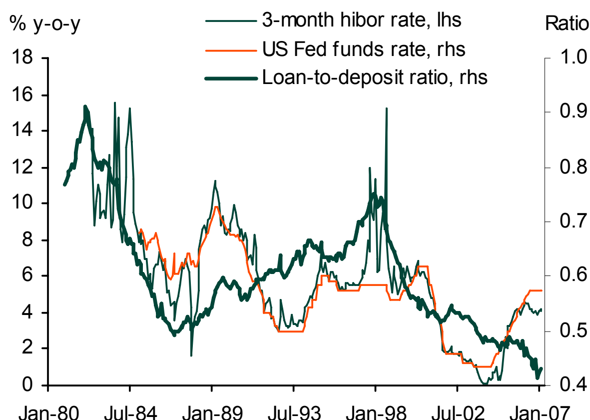
The outlook at a glance

% saar unless otherwise stated	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07	2006	2007	2008
Real GDP	3.5	2.0	1.3	4.2	2.8	3.3	3.8	4.0	2.7	3.6	4.0
Consumption	4.4	2.8	2.8	5.0	3.2	3.2	3.4	3.4	3.1	3.5	3.7
Government	2.2	8.0	5.1	5.5	2.8	2.8	3.0	3.0	4.9	4.0	3.0
Investment	3.9	6.4	-7.3	5.3	2.6	2.6	3.0	3.0	5.6	2.2	8.0
Exports	2.9	9.2	1.4	3.0	3.0	4.5	6.0	8.0	3.5	3.9	6.5
Imports	4.3	9.3	-2.3	27.9	2.0	2.8	3.0	3.0	7.6	6.9	4.5
Contributions to GDP:											
Domestic final sales	3.4	4.9	1.1	5.4	2.9	2.9	3.2	3.2	4.1	4.0	3.5
Inventories	0.5	-2.2	-0.6	4.0	-0.2	0.2	0.0	0.0	-0.4	0.0	0.0
Net trade	-0.4	-0.7	0.8	-5.2	0.1	0.2	0.6	0.8	-1.0	-0.5	0.5
Unemployment rate, (% labour force)	5.0	4.9	4.8	4.6	4.5	4.4	4.2	4.0	4.6	4.0	3.8
Average monthly employment, ('000)	19.0	34.0	28.0	19.0	10.0	15.0	20.0	20.0	25.0	18.0	22.0
Consumer prices, (% y-o-y)	3.0	4.0	3.9	3.3	2.4	1.6	1.4	2.4	3.6	2.0	3.2
RBA's trimmed mean, (% y-o-y)	2.6	2.8	2.9	2.9	2.7	2.5	2.5	2.8	2.8	2.6	3.2
Fiscal balance, (% of GDP)									1.60	1.10	0.90
Current Account balance, (% of GDP)									-5.9	-5.2	-4.4
Official Cash Rate (%)	5.50	5.75	6.00	6.25	6.25	6.25	6.25	6.50	6.25	6.50	6.75
3-year bond yield (%)	5.36	5.78	5.76	6.10	6.20	6.05	6.20	6.50	6.10	6.50	6.80
10-year bond yield (%)	5.41	5.79	5.51	5.89	5.90	6.00	6.30	6.60	5.89	6.60	6.90
AUD/USD	0.72	0.74	0.75	0.79	0.80	0.82	0.81	0.80	0.79	0.80	0.75

Notes: Quarterly national accounts figures are % q-o-q changes at a seasonally adjusted annualised rate. Annual figures are %y-o-y changes. Unemployment is % of labour force. Interest rates and currencies are end-of-period. Table last revised 29 March 2007.
Sources: Australian Bureau of Statistics, Reserve Bank of Australia and GrangeSecurities.

REST OF ASIA: ECONOMIC OUTLOOK

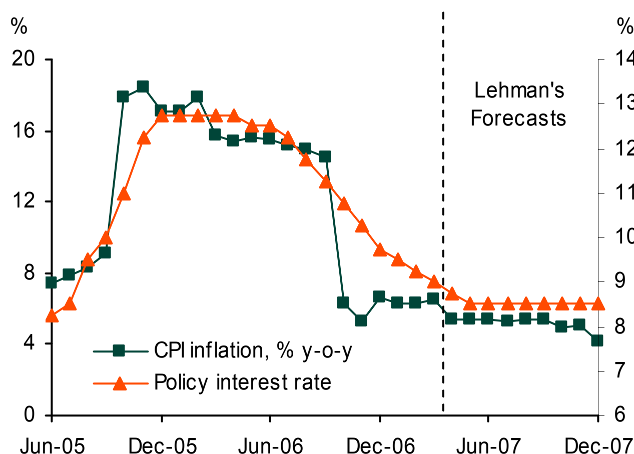
Hong Kong: The economy is humming along on liquidity



Source: CEIC and Lehman Brothers.

- China's booming economy is generating huge demand for Hong Kong's services and also appears to have a lot to do with Hong Kong's surfeit of liquidity.
- With Hong Kong's large financial and property sectors, ample liquidity can cause a reinforcing spiral, with asset prices and domestic demand feeding off each other.
- We expect GDP growth of 5.5% in 2007, but the number could be substantially higher or lower. Hong Kong is probably the most exposed to global conditions.

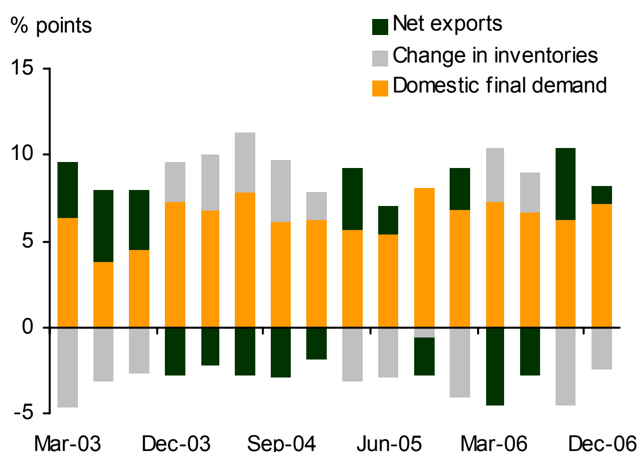
Indonesia: Investment revival could work wonders



Source: CEIC and Lehman Brothers.

- Inflation fell sharply in Q4 2006 and we expect it to remain low, averaging 6.5% in 2007, and to prompt further rate cuts to 8.50% by the end of 2007.
- External vulnerability indicators have improved, but the economy needs urgently to attract new investment to realise its full growth potential.
- We are forecasting 5.7% GDP growth in 2007 and 6.5% in 2008, but we could raise our forecast if reforms to improve the investment climate are implemented.

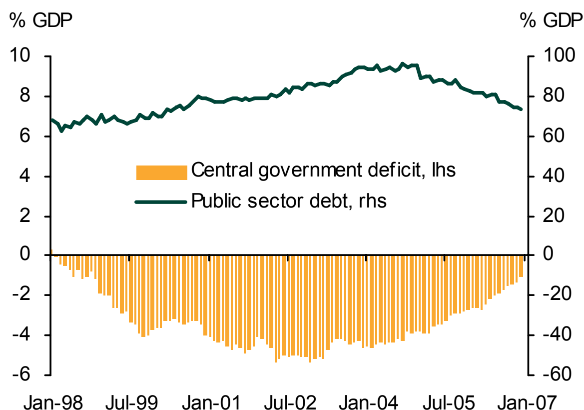
Malaysia: Powered by domestic demand



Source: IMF, World Economic Outlook, CEIC and Lehman Brothers.

- Malaysia's GDP growth has held up well, underpinned by robust consumption, which has been supported by low real interest rates and high household borrowing.
- Furthermore, fiscal policy is becoming more expansionary; the corporate tax rate has been cut, and the capital gains tax on property has been abolished.
- We expect GDP growth of 5.0% this year, with a mind to revise up. The main risk is Malaysia's high exposure to global conditions (exports comprise 122% of GDP).

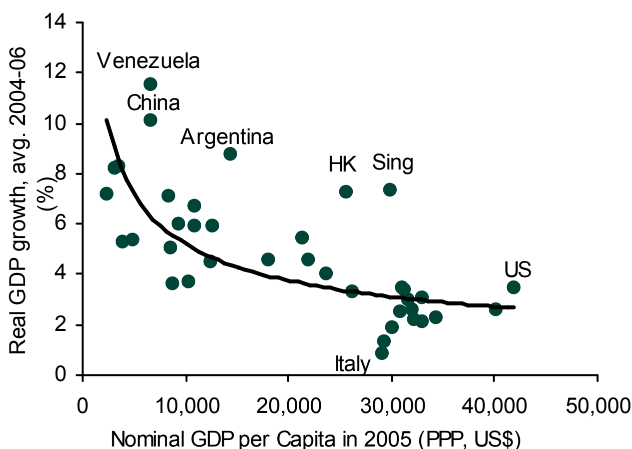
The Philippines: Improved fiscal position and strong overseas worker remittances support economy



Source: CEIC and Lehman Brothers.

- Philippine GDP grew by 5.4% in 2006 and there has been good progress on consolidating fiscal policy and reducing the non-performing loan ratio.
- The rolling 12-month sum fiscal deficit has fallen to 1.0% of GDP in December 2006, while public debt has fallen to 73.7%. The fundamentals are improving.
- With robust overseas worker remittances, a widening current account surplus, rising FDI and a recovery in bank lending, GDP should rise 5.8% in 2007.

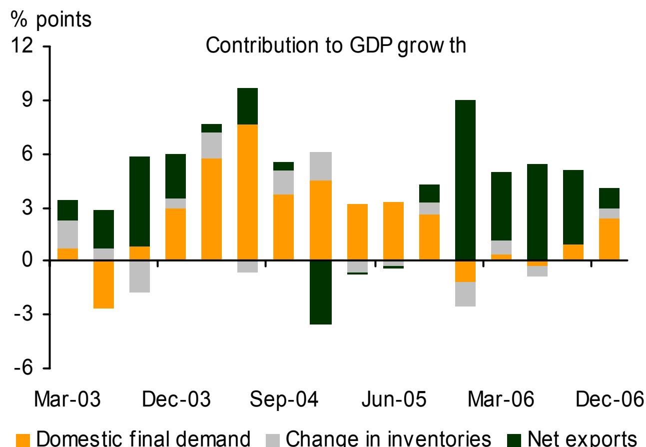
Singapore: Successfully re-inventing itself, but highly exposed to global economic cycle



Source: World Bank, CEIC and Lehman Brothers.

- Singapore has risen to the challenge of competition, moving into high-end electronics and new niches (biotech, offshore engineering, wealth management).
- These new niche industries are thriving. It is striking that Singapore, a developed country, averaged 7.8% growth in 2004-06 (see figure), with just 1.0% inflation.
- The main risk for Singapore's economy is that, being small and so open (exports make up 260% of GDP), it is very exposed to a global economic slowdown.

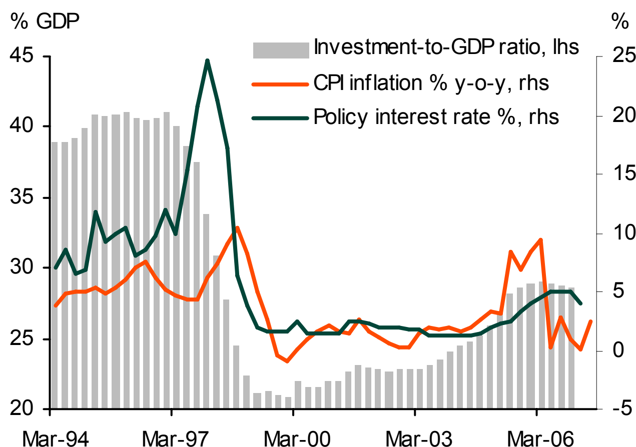
Taiwan: Political uncertainty is high and the economy is too reliant on net exports



Source: CEIC and Lehman Brothers.

- Taiwan's GDP growth was lopsided in 2006: it was driven mostly by exports; domestic demand was lacklustre, likely hurt by prolonged political uncertainty.
- The hollowing out of production to China also crimped investment, while the sharp rise in credit card debt, coupled with higher rates, has constrained consumption.
- Domestic demand recovered in Q4 but, given the cloudy political situation, this may not be a full-fledged recovery. We expect 2007 GDP growth to slow to 3.9%.

Thailand: Despite risks, investment may surprise



Source: Bank of Thailand and Lehman Brothers.

- Political uncertainty, bombings and abrupt policy changes have started to weigh on the economy. We have lowered our 2007 GDP growth forecast from 5.0% to 3.5%.
- That said, the fundamentals are still healthy: FX reserves are high, the fiscal budget is near balance, and debt levels are low. Also, with inflation easing, rates are being cut.
- We have a cautious near-term outlook, but if the political uncertainty lifts (elections are expected before yearend), we would expect a strong economic rebound in 2008.

ASIA EX-JAPAN: PREVIEW

The week ahead

Rob Subbaraman
+852 2252 6249
rsuba@lehman.com

Mingchun Sun
+852 2252 6248
minsun@lehman.com

Young Sun Kwon
+852 2252 1370
youngsun.kwon@lehman.com

Sonal Varma
+91 22 4037 4087
sonal.varma@lehman.com

Stephen Roberts
+612 8259 4846
sroberts@grangesecurities.com

China's export growth should rebound in April after falling sharply in March, which was payback for the frontloading of shipments in February ahead of anticipated tax changes. On the monetary policy front, we expect the Bank of Korea to keep rates on hold, but the Bank Indonesia is likely to cut rates by 25bp. India's industrial output growth should hold up well in March. Australia's fiscal budget should be expansionary, with tax cuts.

CHINA

External trade (Tuesday)

China's export growth should rebound strongly in April to 30.0% y-o-y from 6.9% in March (Figure 1). But the rebound should only be viewed as exports returning to their normal growth trend, because the surprisingly weak numbers in March were probably caused by exporters' frontloading their shipments in February ahead of the widely anticipated cuts in value-added tax rebates. Meanwhile, we expect import growth to continue rising, to 18.0% y-o-y in April from 14.5% in March, given strong domestic demand and the government's efforts to boost imports. As a result, the trade surplus should rebound to US$21.6bn in April from US$6.9bn in March.

Economic events in the week ahead

			Period	Prev 2	Prev 1	Latest	Lehman	Consensus
Sometime during the week								
	China	Exports, % y-o-y	Apr	33.3	51.7	6.9	30.0	17.4
	China	Trade Balance, US$bn	Apr	15.9	23.8	6.9	21.6	11.0
Monday 7 May								
16.00	Taiwan	Trade balance, US$bn	Apr	1.8	2.2	2.2	2.0	n.a.
16.00	Taiwan	Exports, % y-o-y	Apr	17.5	-3.6	10.4	10.0	8.0
Tuesday 8 May								
	Indonesia	Central bank policy meeting, policy rate, %	May	9.50	9.25	9.00	8.75	8.75
	Australia	Federal government budget for Year 2007 - 2008	07-08					
9.30	Australia	Home building approvals, % m-o-m	Mar	-1.6	-2.4	10.6	-6.8	-5.0
9.30	Australia	Retail sales, % m-o-m sa	Mar	0.3	0.8	0.9	0.5	0.5
12.01	Malaysia	Exports, % y-o-y	Mar	6.2	11.3	-2.8	3.5	2.0
12.01	Malaysia	Trade Balance, RMbn	Mar	11.6	7.6	7.6	9.0	9.3
12.01	Malaysia	Industrial production, % y-o-y	Mar	7.0	2.4	-0.2	2.5	1.0
Thursday 10 May								
9.00	S. Korea	Central bank policy meeting, overnight call rate, %	May	4.50	4.50	4.50	4.50	n.a.
9.00	The Philippines	Exports, % y-o-y	Mar	-3.6	21.8	7.8	5.0	4.7
9.30	Australia	Employment change, ('000) m-o-m	Mar	-5.3	23.2	10.5	20.0	12.5
12.30	S. Korea	Consumer confidence index	Apr	96.1	98.1	97.8	99.0	n.a.
Friday 11 May								
11.00	S. Korea	Export price, % y-o-y	Apr	-0.4	1.9	2.8	3.0	n.a.
11.00	S. Korea	Import price, % y-o-y	Apr	-2.3	1.5	4.4	4.0	n.a.
14.30	India	Wholesale price index, % y-o-y	28-Apr	6.1	6.1	5.8	5.7	n.a.
15.00	India	Industrial production, % y-o-y	Mar	12.5	11.4	11.0	10.1	10.4

Hong Kong Time

INDIA

Industrial production (Friday)

India's industrial output likely held up well in March

We expect India's industrial output to rise by 10.1% y-o-y in March, lower than the 11.0% in February due to slower growth in consumer durables and electricity output, the former reflecting the tighter monetary stance (Figure 2). Recent data support our forecast: the ABN Amro PMI index eased to 53.0 in March from 53.6 in February; motor vehicle production declined by 0.1% y-o-y in March after rising 8.6% in February; and export growth was quite sluggish at 8.8% in March. However, we expect the other components of the manufacturing sector to remain strong, particularly those related to infrastructure spending and private business investment.

SOUTH KOREA

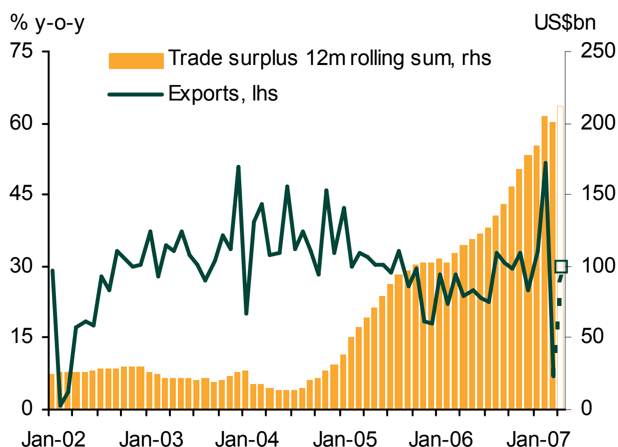
Monetary policy meeting (Thursday)

We expect the Bank of Korea to remain on hold in May

We expect the Bank of Korea (BOK) to keep its target interest rate unchanged at 4.50% for the following reasons. First, 4.0% y-o-y Q1 GDP growth was below the BOK's own forecast of 4.4% in the first half in 2007. Stronger-than-expected April export growth (17.8% y-o-y versus 13.6% in March) suggests that Q2 GDP growth could pick up, but it is too early to be sure. Second, the steep climb in residential property prices has noticeably lessened after the BOK hiked the reserve requirement ratio in November 2006 and the government tightened the regulations on mortgage loans in January (Figure 3). Third, CPI inflation, which picked up to 2.5% y-o-y in April from 2.2% in March, remained at 2.1% y-o-y in Jan-April, below the BOK's target band (CPI: 2.5-3.5%). Fourth, the BOK will likely regard the fallout from the US subprime mortgage, higher oil prices and possible policy tightening in China as increasing the downside risks to the economic outlook.

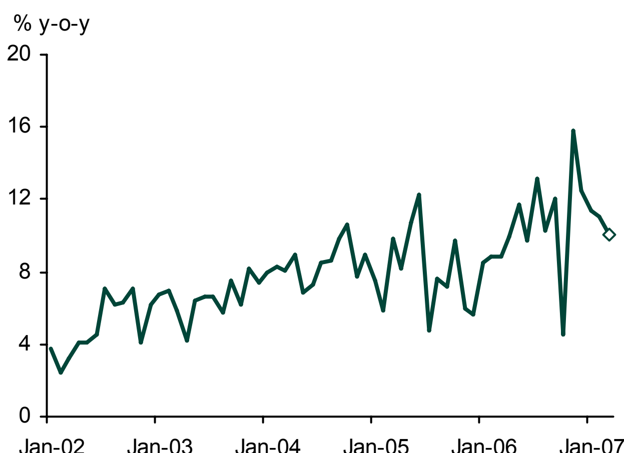
Since the consensus is also for the BOK to stay on hold, the focus will be on the BOK governor's comments after the meeting. We expect the comments to be neutral for future policy direction. Although there are significant signs of stabilisation in the housing market and moderation in mortgage growth recently, the governor will likely refrain from sounding dovish to show vigilance on house prices and excess liquidity. Again, the key variable for future monetary policy decisions should be economic growth rather than house prices and CPI inflation. Even though April export data suggest upside risks to our forecast of 4.3% GDP growth in 2007, we remain cautious on external risks as well as still high household debt. According to the BOK's *Financial Stability Report* released on 2 May, the ratio of household debt to income rose to over 140% in 2006, higher than that

Figure 1. China's exports and trade surplus



Source: CEIC and Lehman Brothers.

Figure 2. India's industrial output



Source: CEIC and Lehman Brothers.

of the US or of Japan. In the report, the BOK judged that households' debt-servicing capacity looks set to weaken as interest rates have risen and the growth rate of financial liabilities has exceeded that of assets. All in all, neither rate cuts nor hikes look feasible, so we retain our call that the BOK will stay on hold for the rest of 2007.

AUSTRALIA

2007-08 Budget (Tuesday)

Australia's Government Budget will likely deliver a mix of tax cuts…

Treasurer Costello's final budget before the government has to go to the polls later this year is likely to deliver a mix of tax cuts, aimed chiefly at low- and middle-income earners, and increased spending on public infrastructure. The tax and spending initiatives are likely to limit forecast budget surpluses to an annual average A$9bn through to 2010-11 from a no policy change average of around A$14bn. The budget is likely to add impetus to economic growth, but not to the point of provoking an early higher interest rate response from the Reserve Bank of Australia.

Employment (Thursday)

… while the labour market should remain tight in April

We expect that employment rose by 20,000 (sa) in April after a 10,500 increase in March. Job vacancy surveys have all been very strong and employment growth in April is likely to have been sourced from a slightly higher labour force participation rate. As a result, we forecast that the unemployment rate was unchanged at 4.5%, a 31-year low.

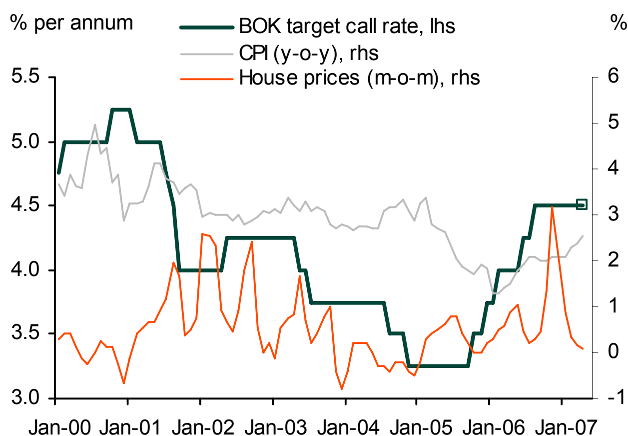
TAIWAN

Exports (Monday)

Taiwan's export growth likely slowed in April

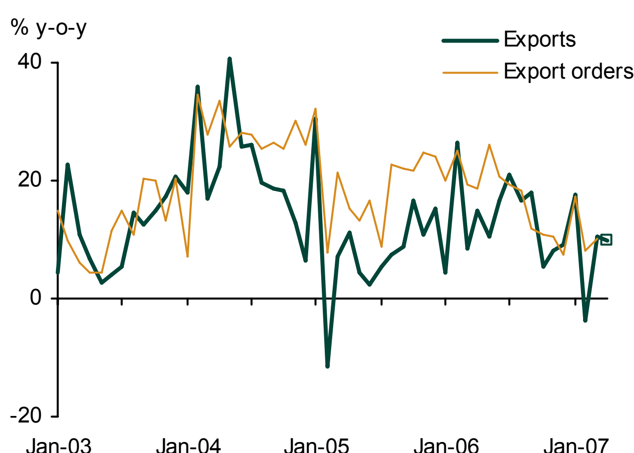
We expect Taiwan's export growth to slow to 8.5% y-o-y in April from 10.4% in March (Figure 4). This is mainly because of softening global electronics demand. The growth in electronic products, which comprise 32% of total exports, slowed sharply to 7.4% y-o-y in Jan-March from 24.4% in 2006. In terms of destination, Taiwan's exports to major markets are all slowing: Exports to China (39% share of total exports) slowed to 6.9% y-o-y in Jan-March versus 14.9% in 2006. Exports to the US (15% share) plunged to 0.8% y-o-y versus 11.2%, and exports to Japan (8% share) moderated to 5.8% y-o-y versus 7.8%. We expect this trend to continue until the global electronics cycle turns up (the market consensus for the turning point is the second half of this year).

Figure 3. South Korea's call rate, CPI and house prices



Source: CEIC and Lehman Brothers.

Figure 4. Taiwan's exports and export orders



Source: CEIC and Lehman Brothers.

TURKEY: OUTLOOK

Election year

Tolga Ediz
+44 20 710 27467
tediz@lehman.com

Turkey's economy remains vulnerable to external shocks and the currency is vulnerable to a global unwind of the carry trade. Parliamentary elections, likely in July, will be key.

The sharp shock in FX markets in May and June, when TRY lost about 30% against the dollar, showed how vulnerable the economy was to external shocks. Not much has changed since: the current account deficit is just as large despite the strength of FDI flows. That said, there are a couple of important differences that suggest that this time around a similar shock would have a smaller, albeit still sizeable, effect on the currency. First, investors seem to have learnt from last year and there is less leverage in the options market now. Second, the central bank has learnt its lessons too, and has stated repeatedly that it stands ready to tighten policy at an early stage of any volatility. Third, there has already been a large accumulation of hard currency deposits by local residents.

We are now more optimistic about the political outlook

Recent political events, which were nothing short of an earthquake to the political system, caused barely a ripple in the domestic economy. The episode taught us what we already knew: Turkish markets are far more dependent on what happens externally. But we are also encouraged by the lack of panic by local residents in response to a significant political event at home. This looks positive for the economy in the future. We think that the political outlook will improve and we do not view negatively the prospect of a more divided parliament after the elections (likely to be on 22 July - see *Emerging Markets Overview* "Turkey: A Close Shave"). We expect the ruling AKP to renew its mandate but with a smaller majority.

We now look for a 50bp rate cut in November

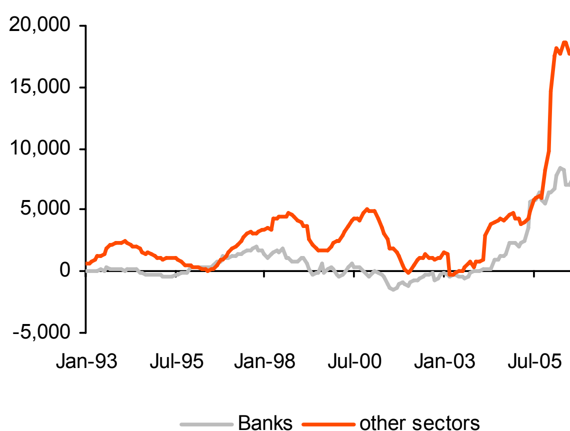
As for the economy, there are three key issues to consider this year. First, our view is that Turkey's external imbalances are a reflection of the domestic savings imbalance. Thus far, the adjustment has proven to be very slow, despite the sharp fall in consumer spending. The second factor to consider is the sharp rise in corporate borrowing in hard currency, especially whether the corporate sector is making productive use of the additional funds. Third, we remain sceptical that inflation will fall on a sustained basis unless service price inflation starts to head lower quickly. We look for inflation to fall gradually in the second half of the year but for progress on that front to be stalled again next year. That said, we expect the Central Bank of Turkey (TCMB) to be encouraged by the fall in inflation in late summer, especially if markets react well to the election result. We look for a 50bp rate cut in October.

The outlook at a glance
(% y-o-y, unless stated otherwise)

	2006	2007	2008
Real GDP, % y-o-y	5.5	5.0	6.5
Domestic demand	6.0	4.5	6.4
Stockbuilding	1.0	1.0	1.0
Net trade	-1.5	-0.5	-0.9
Consumer prices*, y-o-y	10.2	7.5	7.0
Producer prices*, yoy	11.5	7.0	8.0
Primary budget **	9.5	7.5	5.5
Current account**	-8.3	-7.5	-8.0
Repo rate*	17.5	17.0	16.5
12-month treasury bill yield*	21.0	20.0	19.0
$/TL rate*	1.47	1.48	1.60

** end of period ** % of GNP*
Source: Lehman Brothers.

Long-term borrowing by Turkey's private sector
$, mn 12m rolling



Source: Turkish Treasury, Lehman Brothers.

POLAND: OUTLOOK

Solid fundamentals offset political risk

Robert Beange
+44 20 710 22232
rbeange@lehman.com

Interest rates could be hiked modestly in 2007.But we see no immediate inflation risks.

ECONOMIC OUTLOOK

Domestic demand should drive growth from 2007

In 2007, the balance of growth is expected to become less favourable. For several years, domestic demand has tended to grow less quickly than GDP, a trend that has allowed the external deficit to fall very sharply. However, several factors suggest that this pattern will be reversed. First, certain groups of public sector workers have been granted large wage increases. This, together with rising levels of employment, should create the income growth to support higher consumption. Second, the long awaited pickup in investment is now firmly established. Third, inflows of funds from the EU should increase substantially in 2007. While we expect growth to slow modestly in 2007, domestic demand should expand more rapidly.

Naturally, this pattern implies that the external deficit will rise in 2007. However, rising inflows from the EU should mask some of the deterioration. Therefore, we expect the current account deficit to remain at a modest 2.5% of GDP. On inflation, we have the same view as the consensus through to next spring, at which point it is expected to be close to the mid-point of the 2.5% +/- 1pp target range. However, thereafter we expect inflation to quickly fall back below 2%.

The budget deficit target has been set at 3.7% of GDP for 2007 – the new *Convergence Programme* foresees a deficit of just 3.4% of GDP. And given our forecast for growth we consider that that an undershooting is likely. Oddly, the European Commission expects a deficit of 4% of GDP. But the outlook beyond 2007 is less bright.

MARKET OUTLOOK

Rate hikes, briefly

Our impression is that the Monetary Policy Council does not have sufficient faith in the NBP staff's inflation projection to hike while inflation is close to – or even outside – the lower edge of the target range. Next spring, inflation should temporarily be close to target, which would allow time for 50bp of tightening. The zloty appears to be fairly valued and we do not expect much movement during 2007.

The outlook at a glance
(% y-o-y, unless stated otherwise)

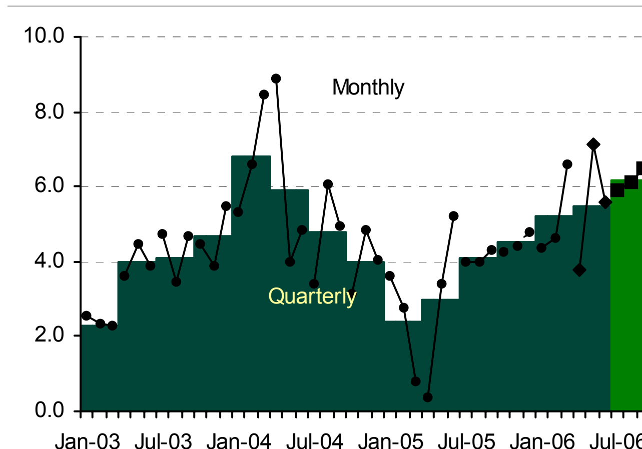
	2006	2007	2008
Real GDP	5.6	5.5	5.0
Current account, % of GDP	-2.0	-2.5	-2.5
Budget deficit (ESA 95), % of GDP**	-2.5	-2.5	-2.7
Unemployment rate*	15.2	14.0	13.5
Wages	5.5	6.0	6.5
Consumer prices*	1.8	2.0	2.5
Industrial output	12.5	12.0	10.0
Intervention rate*	4.00	4.50	5.00
PLN/Euro*	3.78	3.90	3.90
PLN/US$*	2.82	3.06	3.19

Table last revised 11 December 2006.

** End-of-period.** Excluding allowable pension reform deductions.*

Source: Lehman Brothers.

Monthly GDP growth



Source: Lehman Brothers.

HUNGARY: OUTLOOK

On the right track

Silja Sepping
+44 20 710 26837
ssepping@lehman.com

The implementation of the fiscal package seems well on track. We believe that inflation has peaked, paving the way for rate cuts as early as May.

ECONOMIC OUTLOOK

Ambitious fiscal plans should improve the medium-term outlook

We continue to believe that the long-awaited fiscal package that was launched in 2006 will put Hungary on the right track to solving its twin-deficit problem. The budget deficit is predicted to fall from 9.2% of GDP in 2006 to 6.6% in 2007 and 4.3% in 2008 (including the costs of pension reform). Revenue-raising measures were implemented in autumn 2006 and the 2007 budget shows conservative planning, so we believe that the government's targets can be met.

Growth should slow and the current account narrow

Increased taxation and higher inflation have started to reduce domestic demand, slowing growth to around 3% in 2007 from around 4% in 2006. The slowdown in import demand along with the buoyant export demand should bring the current account deficit down to around 5% in 2007 from 6% in 2006.

Inflation has peaked

The wide-scale regulated price adjustment and VAT hike pushed inflation well above the NBH's 3% inflation target early this year. We believe the 9% y-o-y rate recorded in March to have been the peak and expect inflation to drop sharply to around 5% by the end of 2007. The central bank's 3% target should be well within reach in 2008.

MARKET OUTLOOK

Easing cycle to start in May

We believe that the extent of fiscal consolidation in the pipeline, the 200bp of rate hikes that the National Bank of Hungary (NBH) has delivered and the recent strength of the forint should have allayed fears of any second-round inflationary effects. With inflation having peaked, we believe that the easing cycle can start as early as May when the NBH publishes its updated inflation projections. We expect the NBH to deliver 150bp of cuts to 6.5% this year, followed by another 100bp next year. The shift in the exchange rate band has been another hotly debated topic. We do not expect a change for now, as a stronger forint is unlikely to be in the government's interest and the current FX regime is consistent with the NBH's medium-term inflation objectives.

The outlook at a glance (% y-o-y, unless stated otherwise)

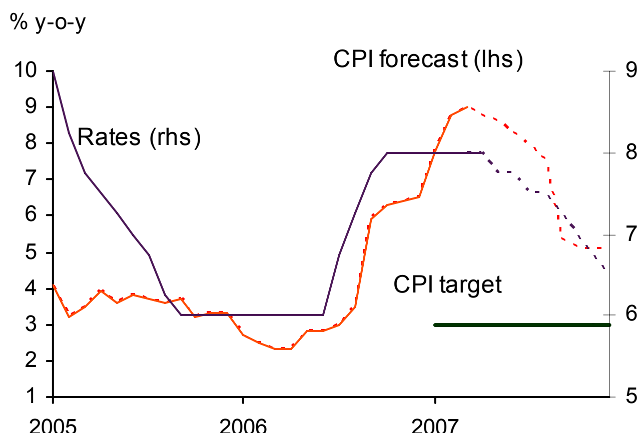
	2006	2007	2008
Real GDP	4.0	3.0	3.0
Current account, % GDP	-6.0	-5.0	-4.0
Fiscal deficit, ESA 95, % GDP**	-9.2	-6.6	-4.3
Unemployment rate	7.5	7.7	7.5
Real gross wages	3.7	1.0	4.0
Consumer prices*	6.3	5.0	3.0
Industrial output	10.0	7.0	8.0
Intervention rate*	8.00	6.50	5.50
HUF basket*	-9.7	-13.2	-13.2
HUF/Euro*	255	245	245
HUF/US$*	190	192	200

Table last revised 2 May 2007.

** End-of-period. ** Including pension reform costs.*

Source: Lehman Brothers.

CPI inflation, interest rate outlook



Source: KSH and Lehman Brothers.

SOUTH AFRICA: OUTLOOK

Imbalances growing

Robert Beange
+44 20 710 22232
rbeange@lehman.com

Rand appreciation should take the edge off inflation for now. But the real risk is the external imbalance, which is unlikely to diminish in the coming years.

ECONOMIC OUTLOOK

Growth has slowed but remains in excess of potential

The most pressing problem for South Africa is its current account deficit. And in our opinion this will not abate in the coming years. Our estimates suggest that the potential growth rate of South Africa is close to 3.0%, some 1.5pp below that assumed by the SARB and around one-half of the growth rate sought by the government. While growth has been in excess of this speed limit for some years without generating inflation, the current account deficit has been steadily increasing. Unless the authorities are prepared to tolerate a period of sub-3% growth – which seems not to be the case – the current account deficit should continue to increase. Further, a ramping up of infrastructure spending – not least that associated with the 2010 World Cup – should ensure that the public sector contribution to growth remains significant. Such a continued worsening of the external deficit could result in occasional bouts of rand weakness and increased inflation expectations. Indeed, we assume a 10% weakening of the rand during 2007.

For 2007, we expect the current account deficit to remain at close to the 5.5% of GDP gap expected for 2006. However, we do not consider that this marks the end of the worsening trend, but rather is the result of the 2006 deficit being biased upward by some temporary factors. Regarding inflation, our estimates suggest that CPIX, the target measure, will approach the upper-edge of the 3% to 6% target range next spring before falling back to about 5.5% at end-2007.

MARKET OUTLOOK

We expect the SARB to hike again in February

We believe that the rand will begin to weaken once again during 2007 after some stability in the early part of the year. The key reason for this would be a renewed widening of the external deficit. For the SARB, we expect at least one more rate hike – 50bp in August.

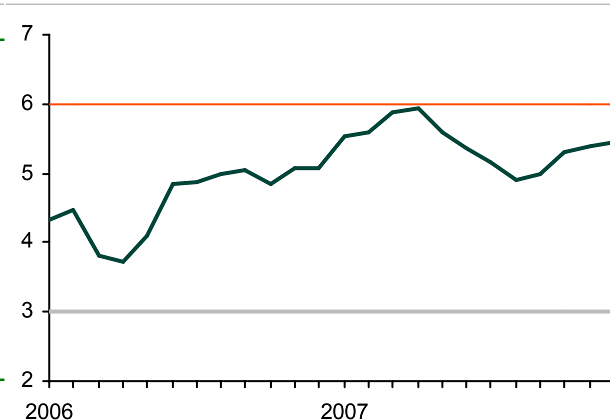
The outlook at a glance
(% y-o-y, unless stated otherwise)

	2006	2007	2008
Real GDP	4.4	4.0	4.0
Current account, % of GDP	-5.5	-5.5	-6.0
Budget balance, % of GDP	0.0	0.0	0.0
Foreign exchange reserves, gross, $b	25.5	26.5	26.5
CPIX*	5.1	5.5	5.0
Manufacturing output	3.8	4.0	4.0
Refinancing rate*	9.0	9.5	9.5
ZAR/Euro*	9.38	9.88	10.41
ZAR/US$*	7.00	7.75	8.50

Table last revised 11 December 2006.
** End-of-period.*

Source: Lehman Brothers.

CPIX
(% y-o-y)



Source: Lehman Brothers.

CZECH REPUBLIC: OUTLOOK

Inflation picture still benign

Silja Sepping
+44 20 710 26837
ssepping@lehman.com

Despite the strength of the real economy, the inflation picture is still benign in our view. The government's fiscal package is a welcome step, although implementation risks remain.

ECONOMIC OUTLOOK

Weak political backdrop…

Parliamentary elections in mid-2006 ended in deadlock; with both sides winning an equal number of seats. Seven months on, a centre-right government (comprising the ODS, Christian Democrats and Greens) was formed, but only with the support of two renegade Socialist deputies.

…is the key risk for policy implementation

The Czech Republic is already off-track to meet the fiscal consolidation targets in the Convergence Programme, and the government has given up the 2010 euro entry target, but has hinted at 2012 as a feasible date. The government proposed an ambitious fiscal package in April, with the main aim to reverse the generous social spending measures approved ahead of the last elections and bring the deficit close to 3% again next year. The lack of legislative majority is certainly the key implementation risk, but a fear of early elections that the ODS has promised if the package is not passed means that it is likely to pass the parliamentary debate in one form or another.

Still benign inflation outlook

Despite the weak political backdrop, the real economy has continued to grow rapidly but the composition has been gradually changing. With fiscal and monetary policies still accommodative, a shift towards rising domestic demand has been visible that has started to widen the external gap. That said, the inflation picture remains benign on the back of high productivity gains and competitive retail market, with no clear underlying inflation pressures visible yet. We expect inflation to stay at around 2% in the first half of the year, before rising closer to 3% by end-2007.

MARKET OUTLOOK

Only moderate hikes by the CNB

While inflation still seems at bay, the CNB seems increasingly concerned about the strength of the real economy and may aim to deliver a pre-emptive hike in response. So, we are assuming two 25bp hikes this year – in Q3 and Q4 respectively.

The outlook at a glance (% y-o-y, unless stated otherwise)

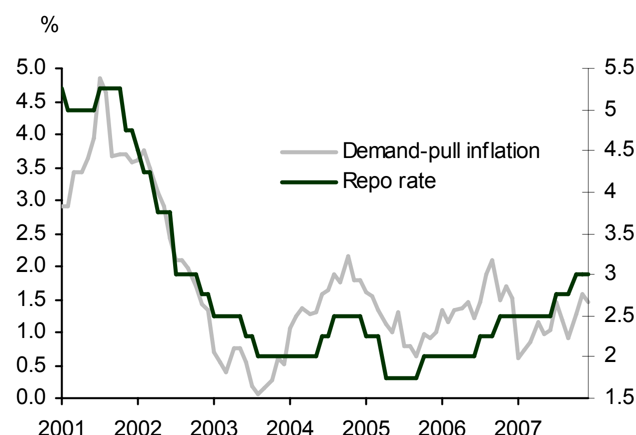
	2006	2007	2008
Real GDP	6.0	5.0	4.5
Current account, % GDP	-4.2	-4.5	-4.5
Fiscal deficit, ESA 95, % GDP	-2.9	-4.0	-3.0
Unemployment rate (ILO)	7.7	7.0	6.5
Real private sector wages, % y-o-y	4.0	4.5	4.5
Consumer prices*	1.7	3.0	3.5
Industrial output	10.0	7.0	7.0
Intervention rate*	2.5	3.00	3.25
CZK/Euro*	27.5	28.7	29.0
CZK/US$*	20.5	22.5	23.7

Table last revised 2 May 2007.

** End-of-period.*

Source: Lehman Brothers and CZSO.

CPI inflation



Source: Lehman Brothers and CNB.

EMERGING EUROPE: PREVIEW

The week ahead

Robert Beange
+44 20 710 22232
rbeange@lehman.com

Tolga Ediz
+44 20 710 27467
tediz@lehman.com

Silja Sepping
+44 20 710 26837
ssepping@lehman.com

CPI from Czech Republic, Hungary, Iceland, Romania and Slovakia will be in focus, along with a slew of trade balance data. Continuing events in Turkey and the Iceland general election will also be in the spotlight.

Hungary: CPI inflation (Friday)

CPI inflation for April will be released on Friday. We believe inflation to have peaked in March and expect a gradual decline from now on. For April, we project an 8.8% y-o-y rate vs 9% y-o-y in March. We maintain our view that inflation should fall to 5% y-o-y by the end of the year and the 3% target should be within reach next year.

Czech Republic: CPI inflation (Thursday)

We project April CPI inflation to have risen to 2.1% y-o-y vs 1.9% in March. We still believe that the inflation picture is benign and expect inflation to stay at around 2% for the majority of the year, before rising to 3% in the last quarter. The pickup in inflation is still primarily driven by administered price adjustments, with core inflation under 1% y-o-y.

Economic events in the week ahead

			Period	Prev 2	Prev 1	Latest	LBGE	Market
Some time during the week								
	Turkey	Current account (USD bn)	Mar	-2.1	-3.0	-3.3	-3.4	-3.1
Monday 7 May								
	Israel	Minutes of 22 April BoI meeting						
14.00	Poland	Forex reserves (EUR bn)	Apr	39.6	38.7	38.1	n.a.	n.a.
9.00	Romania	Industrial output (% y-o-y)	Mar	3.9	4.9	10.2	n.a.	n.a.
Tuesday 8 May								
9.00	Hungary	Industrial output (% m-o-m, preliminary, sa)	Mar	2.2	-0.2	0.4	0.5	n.a.
8.00	South Africa	Gross reserves (USD bn)	Apr	25.9	26.3	26.5	n.a.	n.a.
8.00	South Africa	Net reserves (USD bn)	Apr	23.3	23.7	24.0	n.a.	24.4
9.00	Turkey	Industrial production (% y-o-y)	Mar	3.0	14.9	7.1	6.0	3.5
Wednesday 9 May								
9.00	Czech Republic	Trade balance (CZK bn)	Mar	-2.85	10.96	13.60	10.00	11.30
Thursday 10 May								
9.00	Czech republic	CPI (% y-o-y)	Apr	1.3	1.5	1.9	2.1	2.2
9.00	Czech republic	Unemployment rate (%)	Apr	7.9	7.7	7.3	n.a.	6.8
9.00	Hungary	Trade balance (EUR mn)	Mar	-82.1	-193.4	-103.8	-70.0	-70.0
9.00	Romania	CPI (% y-o-y)	Apr	4.0	3.8	3.7	n.a.	n.a.
12.00	Romania	Trade balance (EUR bn)	Mar	-2.10	-1.06	-1.34	n.a.	n.a.
9.00	Slovakia	Real wage growth (% y-o-y)	Mar	4.2	8.6	9.1	n.a.	n.a.
13.00	South Africa	Manufacturing production (% y-o-y)	Mar	4.5	5.7	7.1	6.0	6.3
Friday 11 May								
9.00	Hungary	CPI (% y-o-y)	Apr	7.8	8.8	9.0	8.8	8.9
11.00	Iceland	CPI (% y-o-y)	May	7.41	5.87	5.29	n.a.	4.40
13.00	Iceland	Unemployment rate (%, Labour Inst method)	Apr	1.2	1.3	1.3	n.a.	1.3
9.00	Slovakia	Trade balance (SKK bn)	Mar	-12.63	4.88	-2.10	n.a.	0.90
9.00	Slovakia	CPI (% y-o-y)	Apr	3.0	2.7	2.7	n.a.	2.6
Saturday 12 May								
	Iceland	General elections to the AlÞingi						

CET Time

ENERGY: OVERVIEW

All hype: OPEC's disappointing capacity growth

Edward Morse
+1 212 526 3767
emorse@lehman.com

Adam Robinson
+1 212 526 0706
arobinson@lehman.com

Michael Waldron
+1 212 526 0706
michael.waldron@lehman.com

Ashutosh Agrawal
+44 20 710 29134
ashutosh.agrawal@lehman.com

Despite strong expansion by Saudi Arabia and Angola, OPEC's 2007 average capacity look set to grow only 300k b/d y-o-y. Above-ground issues should cause declines in Iran, Venezuela and Nigeria, resulting in OPEC spare capacity stagnating at 2.3m b/d.

OPEC should add relatively little to 2007 sources of crude. On average, its capacity should grow only 300k b/d (0.9%) y-o-y, less than its anticipated demand growth of 430k b/d (5.7%) and less than non-OPEC supply growth of 830k b/d. Although Saudi Arabia is aggressively augmenting its capacity through 2011 and Angola's production is rising fast, other members—Iran and Venezuela—should see production capabilities decline due to political issues impeding investment. Nigeria and Iraq are more erratic as production capacity swings with unpredictable security environments. Other Gulf Cooperation Council (GCC) members and North African members should see modest supply growth damped by demand increases. Even with OPEC production depressed from cuts, 2007 spare capacity should average only 2.3m b/d, with only 1.9m b/d available to the market during a tight Q4 when inventories should draw 1.3m b/d.

In its latest monthly *Oil Market Report,* the International Energy Agency (IEA) forecast OPEC crude capacity to expand 2.6m b/d through the end of 2008. It posits capacity at the end of 2006 of 33.9m b/d and anticipates 34.8m b/d by end of 2007 and 36.5m b/d by end of 2008. Although instructive, these numbers deceive somewhat in not identifying the average capacity available to OPEC at given times during the year, a crucial input for determining spare capacity. So, while the IEA's headline number may have OPEC's capacity increasing by 900k b/d from the beginning to the end of 2007, its average capacity should be less, owing to the fact that we see most capacity not coming online until the fourth quarter (Figure 1).

Yes, Saudi Arabia and Angola should be important capacity growers

Saudi Arabia should add at least 3m b/d to capacity by early next decade

Like the IEA, we see Saudi Arabia and Angola underpinning OPEC's expansion. We do not doubt that Saudi Arabia will add at least 3m b/d to current capacity by early next decade. We estimate the Kingdom's current capacity at 10.8m b/d, versus EIA's range of 10.5-11.0m b/d and Saudi Arabia's official range of 11-11.3m b/d. Higher estimates likely include very heavy oils which have limited marketability and do not accurately reflect spare production capacity that is refine-able in today's market. Saudi Arabia's 500k b/d expansion of Khursaniyah, expected at the beginning of Q3, represents the largest OPEC capacity addition this year. 2008 should see the addition of 250k b/d at Shaybah while 1.2m b/d from the Khoreis field should come online in 2009. On average, we see Saudi capacity growing from 10.7m b/d in 2006 to 11.1m b/d in 2007 and 11.4m b/d in 2008.

Offshore fields continue to drive Angola's growth

Angola's average capacity should grow by 250k b/d in 2007, in line with production increases. Beginning to end of year capacity should grow 270k b/d on the back of offshore projects Dalia, Rosa and Plutonio. Expansion should continue through 2008 as capacity will likely reach 2.0m b/d by mid-year and settle at 2.2m b/d by year-end.

The rest of the GCC and North Africa should contribute less

Together, Kuwait, UAE, Qatar, Algeria and Libya should add about 335k b/d from the beginning to the end of 2007. Yet, we see the group's average capacity gain at only 260k b/d, of which almost 80k b/d should go to satisfy internal demand growth. UAE, as the largest grower, increases on average by 120k b/d with additions from investment in Murban. Kuwait should contribute about 60k b/d, but it suffers from a political standoff between its Emir and parliament, preventing 15-year efforts to reopen its oil sector to

foreign investment to spur greater growth. While Libya and Algeria combined should contribute 60k b/d of average growth, their capacity potential has recently diminished with more uncertain investment climates and licensing terms.

While Iran, Venezuela and Nigeria should decline

Political climates contribute to Iran and Venezuela declines

Despite geological promise, above-ground politics in Iran and Venezuela make their environment for oil field maintenance and new projects prohibitive. In Iran an increased focus on gas by the government and a business climate which restricts foreign ownership and relies on unpopular buyback agreements for project development should result in average capacity declines of 120k b/d this year and year-end capacity of 3.65m b/d. With no new investment, decline rates could accelerate in future years. Venezuela should suffer a similar fate. Since President Hugo Chavez took office in 1999 the country has lost more than 30% of production capacity. Underinvestment resulting from the diversion of PDVSA funds for social spending should worsen with this week's nationalization of the Orinoco heavy oil belt. As a result, Venezuelan capacity should decline on average by 100k b/d this year and settle at 2.4m b/d by year-end.

Q4 return of Nigeria capacity possible, but security concerns still a major risk

While Nigeria's business climate remains open to foreign investment, its security environment bodes poorly for growth. With an estimated 600k b/d of capacity offline due to Niger Delta militancy, Nigeria's 2007 capacity could decline by an average of 380k b/d. Despite Shell assertions that Forcados (380k b/d) may return in June, our forecast allows for the return of much of the shut-in 600k b/d at the end of the year, with virtually all of the gains in 4Q07. However, given uncertainty after controversial presidential elections two weeks ago which continues to threaten oil – the 15k b/d Funiwa field was shut-in on Tuesday and ten oil workers were kidnapped on Thursday – it is very possible that much of the production will not come back before 2008, putting significant downside risk on our expected OPEC growth of 300k b/d.

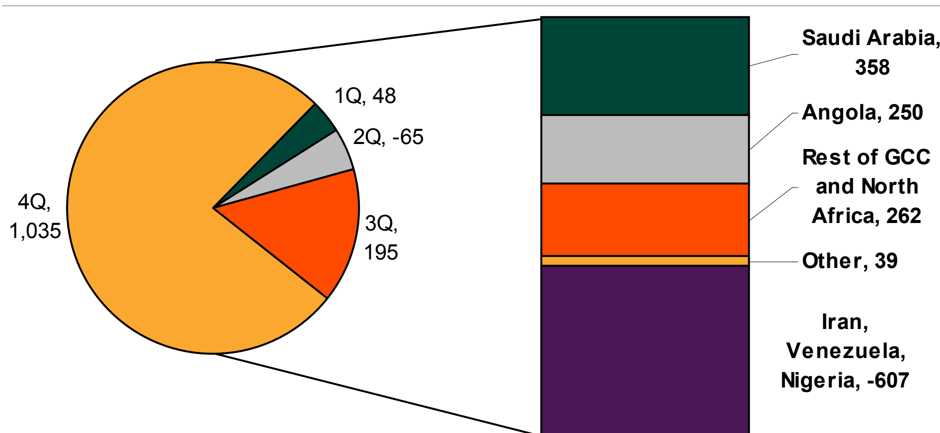
As a result, spare capacity should continue to languish

Spare capacity temporarily higher from production cuts, but should fall through year

Although we calculate current OPEC spare capacity (total capacity minus production) at about 2.8m b/d, this figure should decline through the year and average 2.3m b/d for 2007. 2007's spare capacity should best 2006's 1.7m b/d, but only because of OPEC production cuts which have reduced 1H07 OPEC production by 1.3m b/d y-o-y, reducing another cushion in the market, inventories. Since the cuts in 4Q06, inventories have drawn at an alarming rate of over 1.0m b/d. Plus, significant geopolitical downside risk exists in our growth forecast from Nigeria or a possible disruption in the Basra area of Iraq as a result of insurgent conflict and/or Iranian meddling due to US pressure on its nuclear program. Overall, with another year of low spare capacity and an increasing call on OPEC, the fundamentals continue to point to a high price environment in 2007.

Bulk of y-o-y capacity growth comes in Q4, but is contingent upon large Nigeria return

Figure 1. OPEC average y-o-y capacity growth by quarter and by country



All figures k b/d
Source: Lehman Brothers Estimates.

ENERGY: OUTLOOK

The upside potential in oil prices

Edward Morse
+1 212 526 3767
emorse@lehman.com

Adam Robinson
+1 212 526 0706
arobinson@lehman.com

Michael Waldron
+1 212 526 0706
michael.waldron@lehman.com

Ashutosh Agrawal
+44 20 710 29134
ashutosh.agrawal@lehman.com

In 2007, prices should average $66-$75, after averaging $66.11 in 2006.

June-07 WTI prices closed at $63.19 on Thursday, down $3.27 (4.9%) from last Friday's close. June-07 WTI was depressed this week versus both deferred WTI and June-07 Brent. The contango between June-07 and June-2011 WTI moved from -$2.85 last Friday to -$5.52 yesterday, while the prompt WTI/Brent spread went from a recent high of -$1.95 to -$2.86. This continues to indicate to us that prompt WTI is marching to its own beat and that global supply-demand fundamentals are tighter than prompt WTI prices might indicate. More reflective of global market tightness, Brent prices closed at $66.05 on Thursday, down $2.36 (3.4%) for the week.

Upside catalysts next week include continued geopolitical risk of production outage in Nigeria, where election protests were held this week, foreign hostages were taken, and Chevron shut in an additional 15k b/d of production. Downside risks include a distinct possibility of a bearish build in US gasoline stocks, which we believe hit their Q2 minimum this week. With a Belgian strike averted that would have bottled up at least 700k b/d of European refining capacity, one would expect increased European exports of gasoline to the United States. This occurred last year under similar conditions of pre-driving season gasoline tightness. And with the trans-Atlantic gasoline arbitrage once again wide open, it is possible US gasoline imports could tick upward going forward. The other item to watch next week will be US refinery runs, which should also increase seasonally, taking some physical pressure off the front of WTI and also increasing the likelihood of a gasoline build.

Light sweet crude quarterly oil price forecast ($, period averages)[1]

	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07E	3Q07E	4Q07E	2005	2006	2007E	2008E
Price ($ per barrel)	62.76	70.43	70.70	60.61	58.62	65.00	74.00	72.00	55.25	66.15	67.50	72.00

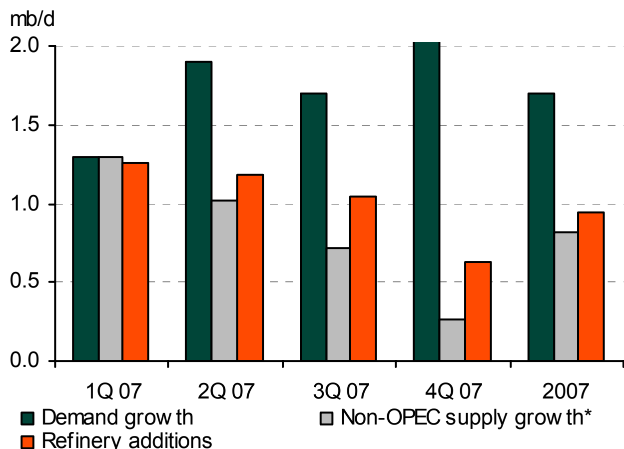
(1) Forecast for Brent prices. Actuals for Brent. Forecast WTI likely to trade $2 below Brent in 2007-08.
Source: Actuals – Bloomberg; Estimates - Lehman Brothers.

Supply-demand balance 2006-07 (m b/d)

	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07	2005	2006	2007	2008
Demand												
USA	20.4	20.5	20.8	20.7	21.0	20.7	20.9	21.1	20.8	20.6	20.9	21.3
Rest of OECD	29.6	27.4	27.9	28.9	28.8	27.5	27.9	29.6	28.8	28.5	28.5	28.8
China	6.8	7.0	6.8	7.2	7.1	7.4	7.4	7.8	6.6	6.9	7.4	8.0
Rest of World	28.2	28.3	28.4	28.5	29.1	29.2	29.1	29.4	27.5	28.4	29.2	30.0
Total Demand	**85.0**	**83.2**	**83.9**	**85.2**	**86.0**	**84.8**	**85.3**	**87.9**	**83.7**	**84.3**	**86.0**	**88.1**
Supply												
OECD	20.0	19.7	19.9	20.0	20.0	19.8	19.7	19.9	20.3	19.9	19.8	20.1
North America	14.0	14.0	14.3	14.3	14.3	14.2	14.2	14.2	14.1	14.1	14.2	14.7
Europe	5.5	5.2	5.0	5.1	5.2	5.0	4.9	5.0	5.6	5.2	5.0	4.8
Rest of Non-OPEC	26.9	27.2	27.4	27.8	28.1	28.1	28.1	28.2	26.6	27.3	28.1	28.5
FSU	11.8	12.1	12.2	12.4	12.6	12.6	12.7	12.7	11.6	12.1	12.7	13.0
Other (1)	2.1	2.1	2.1	2.1	2.2	2.2	2.2	2.3	2.0	2.1	2.2	2.3
Total Non-OPEC	**49.0**	**49.0**	**49.4**	**49.9**	**50.3**	**50.0**	**50.0**	**50.4**	**48.9**	**49.3**	**50.2**	**50.9**
OPEC Crude	31.3	31.1	31.3	30.3	29.6	30.1	31.4	31.8	31.1	31.0	30.7	32.7
OPEC NGLs	4.2	4.2	4.3	4.3	4.3	4.3	4.4	4.4	4.2	4.3	4.4	4.5
Total Supply	**84.6**	**84.3**	**85.1**	**84.5**	**84.2**	**84.4**	**85.8**	**86.6**	**84.2**	**84.7**	**85.3**	**88.1**
Inventory Change	-0.4	1.1	1.1	-0.7	-1.8	-0.3	0.5	-1.3	0.5	0.3	-0.7	0.0

Note: Supply balances carry Angola with OPEC; (1) Other includes global processing gains and biofuels outside US and Brazil
Source: Lehman Brothers estimates (including historical numbers).

We expect the market to continue to tighten in 2007 – both upstream and downstream



**Excludes Angola and OPEC NGLs*
Source: Lehman Brothers.

- Global oil demand growth (+1.7m b/d) should outpace non-OPEC supply growth (+0.8m b/d without Angola) and refinery capacity additions (+0.95m b/d) in 2007.
- China (+500k b/d), commodity producers (+500k b/d), and the US (+340k b/d) are likely to underpin demand.
- Non-OPEC supply growth underpinned by FSU (+540k b/d), Brazil (+280k b/d) and US (+150k b/d); Mexico (-260k b/d) and Norway (-220k b/d) are big decliners.
- Overcapacity since 1980 has led to underinvestment in refining for 25 years, continuing into 2007. However, current investment could bring a capacity glut by 2009.

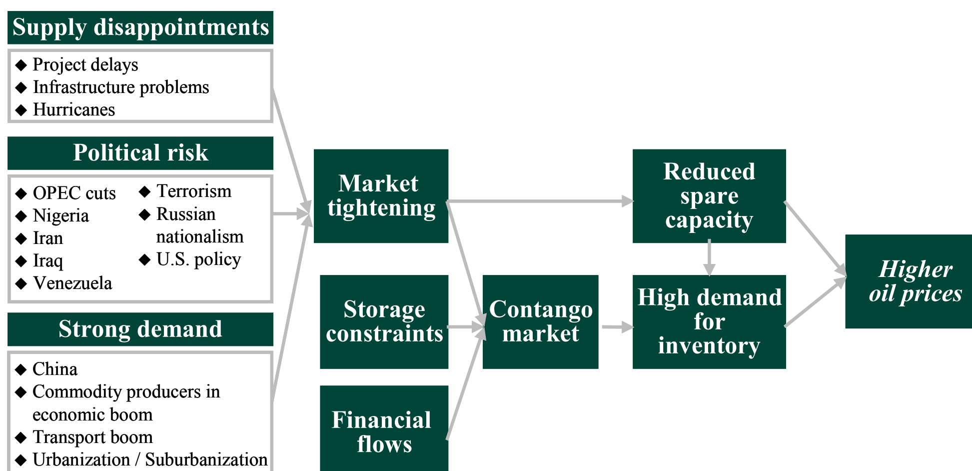
OPEC demand offsets OPEC capacity additions, keeping a lid on spare capacity growth

Yr-end capacity, mb/d	2005	2006	2007	y-o-y
Algeria	1.38	1.43	1.45	0.02
Angola	1.41	1.47	1.74	0.27
Indonesia	0.93	0.88	0.88	0.00
Iran	3.95	3.75	3.65	-0.10
Iraq	1.75	2.00	2.00	0.00
Kuwait	2.60	2.60	2.68	0.07
Libya	1.65	1.70	1.80	0.10
Nigeria	2.60	2.10	2.50	0.40
Qatar	0.80	0.85	0.85	0.00
Saudi Arabia	10.45	10.80	11.30	0.50
United Arab Emirates	2.50	2.60	2.75	0.15
Venezuela	2.50	2.45	2.40	-0.05
OPEC 10 + Angola	**30.77**	**30.63**	**31.99**	**1.36**
OPEC 12	**32.52**	**32.63**	**33.99**	**1.36**

Source: Lehman Brothers.

- Average capacity growth for 2007 should be 300k b/d, entirely offset by OPEC demand growth of 430k b/d. Year-end to year-end capacity should grow 1.36m b/d.
- Even with Angola, OPEC capacity growth should be limited by the precarious security situation in Nigeria, lack of investment and drilling in Iran and Venezuela and ongoing civil conflict in Iraq.
- Saudi capacity growth remains the exception, with additional 500k b/d expected by the end of 2Q 2007.
- OPEC accounts for 9.3% of global oil demand, up from 8.0% in 2002. Growth should be spurred by accelerating GDP and inefficient energy use.

A tightening market reduces spare capacity, triggering higher oil prices to slow demand growth as well as increased demand for inventory as a substitute cushion against disruption



Source: Lehman Brothers.

EQUITY MARKET: OUTLOOK

US quarterly earnings

Shanthi Nair, CFA
+44 (0)20 7102 4518
snair@lehman.com

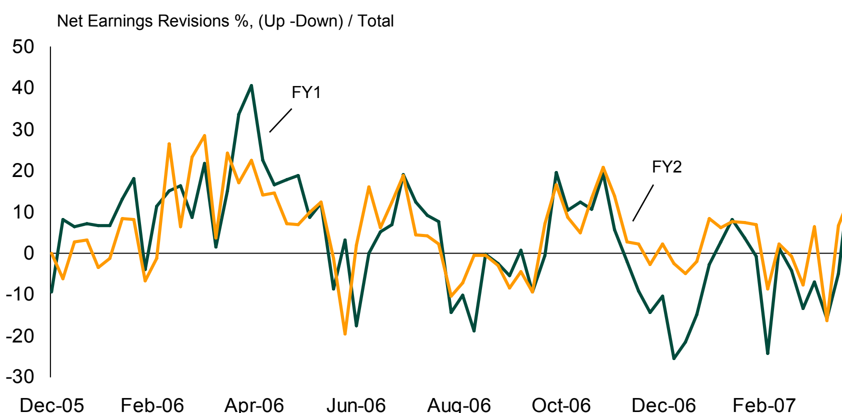
Ian Scott
+44 (0)20 7102 2959
iscott@lehman.com

Over half the companies in the S&P 500 have reported first-quarter numbers and results appear stronger than expected. While expectations have been low leading up to the season, thereby contributing to the strength of the surprise, underlying earnings are stable and do not show any signs of pressure at this stage. Moreover, companies (and analysts) appear confident of the outlook over the medium term. With results so far coming in stronger than expected, our forecast for earnings growth this year of 7% globally and 6% in the US might well turn out too low. However, given that we do not have complete data yet, we are not making any changes to our forecasts.

Worries about slowing corporate earnings have been reflected in downgrades to analyst estimates in the run-up to the earnings season. However, the sharp upgrade to estimates over the past week (Figure 1) implies that company guidance following the results has been stronger than expected. It is also worth noting that estimates for both the current year and the next have been marked up.

Estimates have been revised up strongly over the past week reflecting an improved outlook

Figure 1. US Weekly Earnings Revisions Balance



FY1 refers to the current unreported year and FY2 refers to the next unreported year.
Source: IBES, Factset, Lehman Brothers

The surprise ratio is 3.95:1 based on 52% of companies in the S&P 500 that have reported so far

Turning to outcomes versus expectations, the surprise ratio is strong at 3.95, although lower than levels of approx 4.5 for similar stages in the reporting season over the past two years. We define a positive surprise as an outcome that exceeds estimates by more than 3% and a negative surprise as one that falls below expectations by more than -3%.

Underlying earnings growth appears stable at 6.4% y-o-y for the market ex-financials

In terms of the underlying numbers, too, growth appears solid, based on data for approximately 55% of companies in the S&P 500. Top lines have expanded by 10% year on year. Excluding financials, this is still strong at 6.6% year on year. As in the last quarter, the largest contribution to market growth in income has been from the financials sector. For the market as a whole, operating income growth is 14.6%, while it is lower at 6.4% for the market ex-financials. However, growth in operating income remains positive for all sectors except the Consumer sector.

To summarise, the first quarter results appear to be holding up well, with underlying earnings growth in line with expectations. Given the pessimism coming into the earnings season, this is a favourable outcome and should prove supportive for the markets. Over the course of the year, we expect earnings growth to slow most in the US and the UK reflecting rising cost pressures, but to remain positive.

RECOMMENDED WEIGHTINGS

Recommended asset allocation

	Benchmark	Recommended Weighting	Recommendation
Equities	60	72	Overweight
Bonds	35	24	Underweight
Cash	5	4	Underweight

Source: Lehman Brothers research and FTSE World.

- We expect global equities to continue to outperform bonds over the next 12 months, although they could face some headwinds as earnings growth slows.
- Equity valuations look attractive, even after adjusting for the higher risk of equities relative to bonds.
- Net supply from the corporate sector is subdued and consistent with healthy forward returns

Recommended market allocation

	Benchmark	Recommended Weighting	Recommendation
North America	49	49	Neutral
Europe Ex-UK	22	22	Neutral
UK	10	7	Underweight
Japan	9	14	Overweight
Asia Ex-Japan	7	7	Neutral
Latin America / Other EMG	3	0	Underweight

Benchmark: FTSE World Index.
Source: Lehman Brothers research and FTSE World.

- Although the market has underperformed we remain bullish on the market. We expect that the recovery from deflation symbolised by improving land prices will continue and advocate an overweight position.
- We are underweight the UK market – domestically exposed sectors remain expensive and vulnerable to further expected tightening.
- We are neutral on the US and Continental Europe as the case for underweighting US versus Continental Europe is not as convincing as over the past few years.

Regional index forecasts

	Price Indices* Current**	Price Indices* End 2007	Dividend Yield	Price Return Local	Total return Local	Total return $ terms
US	1496	1570	0.9%	5%	6%	6%
Europe ex UK	457	460	1.5%	1%	2%	-2%
Japan	1704	1920	0.6%	13%	13%	21%
UK	6484	6600	1.8%	2%	4%	-2%
Asia ex Japan	373	370	1.9%	-1%	1%	2%
Global	**379**	394	1.2%	4%	5%	4%

*S&P500, FTSE W Europe ex UK, Topix, FTSE100, FTSE W Asia Pacific ex Japan, FTSE W World

** As of 02-May-2007

Source: Lehman Brothers

- Although the Japanese market has underperformed over this year we remain confident that the wider recovery in the Japanese economy will continue and that this could drive market outperformance. The recovery in land prices is the best indicator of the end to the prolonged deflation and we recommend overweighting sectors that would benefit from exposure to domestic reflation like domestic banks, brokers and REITs.
- We expect the UK market to underperform owing to the effects of tighter monetary policy on the domestically exposed interest-rate sensitive sectors.

THE WORLD AT A GLANCE

Period averages	Real GDP (% y-o-y)			Consumer Prices (% y-o-y)			Current Account (% of GDP)		
	2006	2007	2008	2006	2007	2008	2006	2007	2008
The Americas	3.4	2.3 ↓	2.6	3.4	3.0	3.1	-5.2	-5.3	-5.3
United States	3.3	2.1 ↓	2.5	3.2	2.7	2.7	-6.5	-6.5	-6.5
Canada	2.7	2.4	3.0	2.0	2.3	2.1	2.0	2.1	2.0
Latin America									
Brazil	2.9	4.0	3.6	3.1	4.2	3.8	1.4	0.9	0.6
Mexico	4.8	3.4	3.6	4.1	3.6	3.9	-0.2	-1.1	-1.0
Argentina	8.5	6.7	3.7	9.8	10.0	15.0	2.8	1.8	0.5
Asia	5.0	4.9 ↑	5.0 ↓	1.6	1.6	1.9	4.3	4.1	3.6
Japan	2.2	2.4 ↑	2.5	0.2	0.0 ↓	0.5	3.9	3.7	3.7
Australia	2.7	3.6	4.0	2.8	2.9	3.2	-5.9	-5.2	-4.4
Asia ex Japan, Aust.	8.4	8.0	8.2	3.0	3.3	3.4	5.9	5.6	4.4
China	10.7	10.2	9.8	1.5	2.8	2.8	8.8	9.6	8.2
Hong Kong	6.8	5.5	6.5	2.0	2.5	3.5	10.1	8.0	7.5
India*	9.1	9.6	9.9	4.8	5.9	5.7	-1.2	-2.5	-3.4
Indonesia	5.5	5.7	6.5	13.1	6.5	5.0	2.8	2.0	1.0
Malaysia	5.9	5.0	6.0	3.6	2.2	3.0	15.4	13.0	11.0
Philippines	5.4	5.8	6.5	6.2	3.5	4.0	5.7	2.0	0.5
Singapore	7.9	5.5	6.0	1.0	1.6	2.1	27.7	25.0	22.0
South Korea	5.0	4.3	4.8	2.2	2.3	2.6	0.7	0.0	-0.5
Taiwan	4.6	3.9	5.0	0.6	1.0	1.5	7.1	6.0	4.5
Thailand	5.0	3.5	5.5	4.6	2.8	3.5	1.5	0.5	0.0
Europe	3.1	2.9	2.3	2.5	2.3	2.4	0.3	0.1	0.2
European Union	2.9	2.7	2.1	2.2	2.0	2.1	-0.5	-0.6	-0.5
Euro area	2.8	2.6	2.0	2.2	1.9	2.1	-0.1	-0.1	0.2
Germany	2.9	2.3	2.1	1.8	2.1 ↑	1.7	5.1	4.8	5.1
France	2.1	2.4	1.9	1.9	1.5	1.9	-1.4	-1.9	-1.9
Italy	1.9	1.8	1.6	2.2	1.9 ↓	2.1	-2.3	-1.7	-1.6
Spain	3.9	3.4	2.4	3.6	2.7	2.9	-8.8	-10.5	-10.5
Netherlands	2.9	2.8	1.8	1.7	1.8	1.8	9.0	9.5	9.6
Belgium	3.0	2.2	1.4	2.3	1.8 ↑	1.7	2.5	2.7	3.1
Austria	3.4	2.5	1.5	1.7	1.5	1.6	3.0	3.2	3.5
Finland	5.5	3.7	2.7	1.3	1.4	1.2	6.0	6.3	6.7
Greece	4.5	5.1	2.5	3.3	3.3	3.8	-12.1	-11.5	-11.0
Portugal	1.3	1.2	1.0	3.0	2.4	2.8	-9.5	-9.3	-9.0
Ireland	6.3	7.0	3.7	2.7	2.4	2.3	-3.3	-3.0	-2.7
United Kingdom	2.8	2.6	2.2	2.3	2.4	2.2	-3.4	-3.5	-3.9
Sweden	4.7	3.8	2.8	1.3	1.0	1.8	6.4	5.4	4.9
Denmark	3.2	2.6	2.5	1.9	1.7	1.6	1.3	1.2	1.2
Poland	5.6	5.5	5.0	1.8	2.0	2.5	-2.0	-2.5	-2.5
Hungary	4.0	3.0 ↑	3.0	6.3	5.0	3.0	-6.0	-5.0	-4.0
Czech Republic	6.0	5.0	4.5	1.7	3.0 ↑	3.5	-4.2 ↑	-4.5 ↑	-4.5 ↑
Switzerland	2.7	2.1	2.0	1.1	0.8 ↓	1.6	14.9	14.5	14.0
Norway	4.6	3.8	2.8	0.8	1.7	2.1	11.5	8.4	7.7
Russia	6.3	6.0	5.5	9.6	9.0	8.0	10.3	7.0	6.0
Turkey**	5.5	5.0 ↑	6.5 ↑	10.2	7.5 ↓	7.0	-8.3 ↑	-7.5	-8.0 ↓
South Africa	4.4	4.0	4.0	5.1	5.5	5.0	-5.5	-5.5	-6.0
G7	2.9	2.3	2.4	2.3	2.0	2.1	-2.3	-2.4	-2.4
OECD	3.1	2.5	2.5	2.4	2.1	2.2	-2.0	-2.1	-2.0
Total of above countries	3.7	3.2	3.2	2.7	2.4	2.6	-0.9	-1.1	-1.2

Note: All figures relate to the modal forecast, ie, the "most likely" outcome.

** Inflation refers to Wholesale prices   ** CPI is end-of-period*

The ↑↓ arrows signify changes from last week.

Official Rates, %			10-year Yields, %			Currency per Dollar			*End of period*
2006	2007	2008	2006	2007	2008	2006	2007	2008	
5.25	5.25	4.75	4.70	4.80	4.80	1.00	1.00	1.00	United States
4.25	4.25	4.00	4.05	4.30	4.30	1.17	1.25	1.30	Canada
13.25	12.00	10.00	12.0	10.00	8.50	2.19	2.33	2.49	Brazil
7.00	6.25	5.50	8.00	7.30	7.00	10.82	11.25	11.65	Mexico
9.50	9.50	16.00	-	-	-	3.10	3.20	3.30	Argentina
0.25	1.00	1.75	1.75	2.20	2.60	117	112	100	Japan
6.25	6.50	6.75	5.88	6.60	6.90	0.79	0.80	0.75	** Australia
6.12	6.66	6.93	-	-	-	7.81	7.50	7.10	China
3.92	4.25	3.75	3.73	4.25	4.25	7.78	7.75	7.75	Hong Kong
7.25	8.00	8.25	7.61	8.50	8.75	44.2	40.5	38.5	India
9.75	8.50	8.25	-	-	-	8994	8900	8500	Indonesia
3.50	3.50	3.50	-	-	-	3.53	3.30	3.17	Malaysia
7.50	7.00	6.75	-	-	-	49.0	47.0	45.0	Philippines
3.44	3.40	3.00	-	-	-	1.53	1.44	1.35	Singapore
4.50	4.50	4.50	5.06	5.00	5.10	930	910	900	South Korea
2.75	3.00	3.00	-	-	-	32.6	31.8	30.5	Taiwan
5.00	3.50	3.50	-	-	-	35.5	35.0	33.5	Thailand
3.50	4.25	4.25	4.00	4.22	4.02	1.32	1.31	1.25	** Euro area
3.50	4.25	4.25	3.92	4.15	3.95	1.32	1.31	1.25	Germany
3.50	4.25	4.25	3.95	4.15	3.95	1.32	1.31	1.25	France
3.50	4.25	4.25	4.18	4.47	4.27	1.32	1.31	1.25	Italy
3.50	4.25	4.25	3.98	4.17	3.97	1.32	1.31	1.25	Spain
3.50	4.25	4.25	3.95	4.15	3.95	1.32	1.31	1.25	Netherlands
3.50	4.25	4.25	3.97	4.17	3.97	1.32	1.31	1.25	Belgium
3.50	4.25	4.25	3.96	4.18	3.98	1.32	1.31	1.25	Austria
3.50	4.25	4.25	3.92	4.11	3.91	1.32	1.31	1.25	Finland
3.50	4.25	4.25	4.19	4.47	4.27	1.32	1.31	1.25	Greece
3.50	4.25	4.25	4.09	4.30	4.08	1.32	1.31	1.25	Portugal
3.50	4.25	4.25	3.92	4.14	3.94	1.32	1.31	1.25	Ireland
5.00	5.75	5.75	4.74	5.09	4.89	1.96	1.87	1.71	** United Kingdom
3.00	3.75	3.75	3.78	4.25	4.05	6.84	6.87	6.80	Sweden
3.75	4.50	4.50	3.92	4.15	3.95	5.65	5.69	5.96	Denmark
4.00	4.50	5.00	-	-	-	2.89	2.98 ↓	3.12 ↓	Poland
8.00	6.50 ↓	5.50 ↓	-	-	-	190	192	200	Hungary
2.50	3.00 ↑	3.25 ↓	-	-	-	20.5	22.5	23.7	Czech Republic
2.00	2.75	2.75	2.48	2.95	2.75	1.21	1.18	1.24	Switzerland
3.50	4.75	4.75	4.36	4.80	4.60	6.18	5.53	5.60	Norway
-	-	-	-	-	-	26.3	26.0	25.7	Russia
17.50	17.00 ↓	16.50 ↓	-	-	-	1.47	1.48 ↓	1.60 ↓	***Turkey
9.00	9.50	9.50	-	-	-	7.04	7.75	8.50	South Africa

Note: all figures relate to the modal forecast, ie, the "most likely" outcome.

*** US$ per currency*

**** In redenominated lira*

CONTACTS

Global

Paul Sheard	Global Chief Economist	psheard@lehman.com	1-212-526-0067
Edward Morse	Chief Energy Economist	emorse@lehman.com	1-212-526-3767
Alastair Newton	Senior Political Analyst	anewton@lehman.com	44-20-7102-3940
Valerie Monchi	Managing Editor	vmonchi@lehman.com	1-212-526-3173
Allison Carlsen	Administrative Assistant	acarlsen@lehman.com	1-212-526-5471

North America

Ethan Harris	Chief US Economist	eharris@lehman.com	1-212-526-5477
Drew Matus		dmatus@lehman.com	1-212-526-9878
Michelle Meyer		mimeyer@lehman.com	1-212-526-7977
Zach Pandl		zapandl@lehman.com	1-212-526-8010
John Shin		joshin@lehman.com	1-212-526-5194
Teresa Sotelo	Administrative Assistant	tsotelo@lehman.com	1-212-526-6566

Europe

Michael Hume	Chief Economist Europe	mhume@lehman.com	1-212-526-0978
Alan Castle		apcastle@lehman.com	44-20-7102-7745
Giada Giani		ggiani@lehman.com	44-20-7102-1135
Peter Newland		peter.newland@lehman.com	44-20-7102-4026
Sandra Petcov		spetcov@lehman.com	44-20-7102-1142
Gustavo Reis		gustavo.reis@lehman.com	44-20-7102-9085
Linda Stock	Administrative Assistant	linda.stock@lehman.com	44-20-7102-2719

Japan

Kenichi Kawasaki	Chief Economist Japan	kekawasa@lehman.com	81-3-6440-1420
Hiroshi Shiraishi		hshirais@lehman.com	81-3-6440-1427
Megumi Kemmotsu	Administrative Assistant	mkemmotsu@lehman.com	81-3-6440-1495

Asia

Rob Subbaraman	Chief Economist Asia ex-Japan	rsuba@lehman.com	852-2252-6249
Stephen Roberts		sroberts@grangesecurities.com.au	61-2-8259-4846
Young Sun Kwon		youngsun.kwon@lehman.com	852-2252-1370
Mingchun Sun		minsun@lehman.com	852-2252-6248
Sonal Varma		sonal.varma@lehman.com	91-22-4037-4087
Madeleine Lee	Administrative Assistant	madlee@lehman.com	852-2252-6227

Latin America

Guillermo Mondino	Head of Emerging Markets Research	gmondino@lehman.com	1-212-526-7791
Gianfranco Bertozzi		gbertozz@lehman.com	1-212-526-3339
John H Welch		jwelch@lehman.com	1-212-526-5843

Emerging Europe

Robert Beange		rbeange@lehman.com	44-20-7102-2232
Tolga Ediz		tediz@lehman.com	44-20-7102-7467
Silja Sepping		ssepping@lehman.com	44-20-7102-6837

Foreign Exchange Research

Jim McCormick	Global Head of FX Research	jmmccorm@lehman.com	44-20-7103-1283
David Mozina		dmozina@lehman.com	1-212-526-6785
Phyllis Papadavid		ppapadav@lehman.com	44-20-7103-1297

Equity Strategy

Ian Scott	Global Equity Strategist	iscott@lehman.com	44-20-7102-2959

Visit our Global Economics website at https://live.lehman.com

Subscribers to the *Global Weekly Economic Monitor* whom we understand have access to our LehmanLive website have been given a URL which links them straight to the publication. Clicking on this URL not only gives access to the *Monitor*, but to the whole range of our research products, including updates in real time and archives.

WEBCAST: Ethan Harris and Michael Hume present the Global Letter and the Week Ahead. Also available on our site on LehmanLive at https://live.lehman.com

The electronic version of the Monitor is typically available by Friday noon New York time. If you would like to gain access to our client website, from which you will be able to download the electronic version of the Monitor and all other economics publications, please contact your Lehman Brothers' sales representative.

Analyst Certification

The views expressed in this report accurately reflect the personal views of Michael Hume; Ethan Harris; Kenichi Kawasaki; Drew Matus; Michelle Meyer; John Shin; Robert Beange; Alan Castle; Tolga Ediz; Sandra Petcov; Hiroshi Shiraishi; Mingchun Sun; Rob Subbaraman; Silja Sepping; Young Sun Kwon; Edward Morse; Adam Robinson; Ian Scott; Lavinia Santovetti; Gustavo Reis; Peter Newland; Zach Pandl; Sonal Varma; Michael Waldron; Stephen Roberts; and Ashutosh Agrawal; the primary analysts responsible for this report, about the subject securities or issuers referred to herein, and no part of such analyst's compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed herein.

Important Disclosures

Lehman Brothers Inc. and/or an affiliate thereof (the "firm") regularly trades, generally deals as principal and generally provides liquidity (as market maker or otherwise) in the debt securities that are the subject of this research report (and related derivatives thereof). The firm's proprietary trading accounts may have either a long and / or short position in such securities and / or derivative instruments, which may pose a conflict with the interests of investing customers.

Where permitted and subject to appropriate information barrier restrictions, the firm's fixed income research analysts regularly interact with its trading desk personnel to determine current prices of fixed income securities.

The firm's fixed income research analyst(s) receive compensation based on various factors including, but not limited to, the quality of their work, the overall performance of the firm (including the profitability of the investment banking department), the profitability and revenues of the Fixed Income Division and the outstanding principal amount and trading value of, the profitability of, and the potential interest of the firms investing clients in research with respect to, the asset class covered by the analyst.

Lehman Brothers generally does and seeks to do investment banking and other business with the companies discussed in its research reports. As a result, investors should be aware that the firm may have a conflict of interest.

To the extent that any historical pricing information was obtained from Lehman Brothers' trading desks, the firm makes no representation that it is accurate or complete. All levels, prices and spreads are historical and do not represent current market levels, prices or spreads, some or all of which may have changed since the publication of this document.

Lehman Brothers' global policy for managing conflicts of interest in connection with investment research is available at www.lehman.com/researchconflictspolicy.

To obtain copies of fixed income research reports published by Lehman Brothers please contact Valerie Monchi (vmonchi@lehman.com; 212-526-3173) or clients may go to https://live.lehman.com.

Legal Disclaimer

This material has been prepared and/or issued by Lehman Brothers Inc., member SIPC, and/or one of its affiliates ("Lehman Brothers"). Lehman Brothers Inc. accepts responsibility for the content of this material in connection with its distribution in the United States. This material has been approved by Lehman Brothers International (Europe), authorised and regulated by the Financial Services Authority, in connection with its distribution in the European Economic Area. This material is distributed in Japan by Lehman Brothers Japan Inc., and in Hong Kong by Lehman Brothers Asia Limited. This material is distributed in Australia by Lehman Brothers Australia Pty Limited, and in Singapore by Lehman Brothers Inc., Singapore Branch ("LBIS"). Where this material is distributed by LBIS, please note that it is intended for general circulation only and the recommendations contained herein do not take into account the specific investment objectives, financial situation or particular needs of any particular person. An investor should consult his Lehman Brothers' representative regarding the suitability of the product and take into account his specific investment objectives, financial situation or particular needs before he makes a commitment to purchase the investment product. This material is distributed in Korea by Lehman Brothers International (Europe) Seoul Branch. Any U.S. person who receives this material and places an order as result of information contained herein should do so only through Lehman Brothers Inc. This document is for information purposes only and it should not be regarded as an offer to sell or as a solicitation of an offer to buy the securities or other instruments mentioned in it. No part of this document may be reproduced in any manner without the written permission of Lehman Brothers. With exception of the disclosures relating to Lehman Brothers, this report is based on current public information that Lehman Brothers considers reliable, but we do not represent that this information, including any third party information, is accurate or complete and it should not be relied upon as such. It is provided with the understanding that Lehman Brothers is not acting in a fiduciary capacity. Opinions expressed herein reflect the opinion of Lehman Brothers' Fixed Income Research Department and are subject to change without notice. The products mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors. If an investor has any doubts about product suitability, he should consult his Lehman Brothers representative. The value of and the income produced by products may fluctuate, so that an investor may get back less than he invested. Value and income may be adversely affected by exchange rates, interest rates, or other factors. Past performance is not necessarily indicative of future results. If a product is income producing, part of the capital invested may be used to pay that income. Lehman Brothers may, from time to time, perform investment banking or other services for, or solicit investment banking or other business from any company mentioned in this document. No part of this document may be reproduced in any manner without the written permission of Lehman Brothers. © 2007 Lehman Brothers. All rights reserved. Additional information is available on request. Please contact a Lehman Brothers' entity in your home jurisdiction.

UK07-0243