Weekly Macroeconomic Report

08 March 2010

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Summary

- US: In February payrolls declined for the 25th month in the past 26, dropping by 36,000 (-26,000 prior), but the Unemployment rate was steady at 9.7%; 4Q Final Non-Farm Productivity rose 6.9% QoQ annualised (+7.8% Q3), while Unit Labour Costs declined 5.9% YoY (-7.6% Q3); the February ISM Manufacturing Index eased to 56.5 from 58.4 prior, while the ISM Non-Manufacturing rose to 53.0 from 50.5 prior;
- Europe: 4Q Euro-Zone GDP rose 0.1% QoQ (+0.4% Q3) and was 2.1% lower YoY in seasonally adjusted terms (-4.1% Q3), February Euro-Zone Unemployment was stable at 9.9%, February Final PMI Indexes were mixed (Manufacturing 54.2 vs. 52.4 prior, Non-Manufacturing 51.8 vs. 52.5 prior), January Euro-Zone Retail Sales fell 0.3% MoM (+0.5% prior) and 1.3% YoY (-0.5% prior);
- Japan: the January Jobless Rate declined to 4.9% from 5.2% prior, Labour Cash Earnings rose 0.1% YoY (-5.9% prior), while Household Spending was 1.7% higher YoY (+2.1% prior).

FOREX Market

The week on Forex markets saw the US dollar continuing overall to remain sustained, trading between 1.37 and 1.345 against the euro, rising from 1.52 to about 1.50 versus the pound sterling, while rising from 89 to about 90 versus the yen. It was stable around 6.83 against the Chinese yuan. The euro traded between 120 and about 122 versus the yen, and traded between 0.89 and 0.915 versus the pound sterling.

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1. Leader

Federal Reserve speakers went to great lengths during the week to indicate that, in their opinion, the central bank should maintain low interest rates until the economic recovery becomes fully entrenched.

Chicago Fed President Charles Evans told reporters in Chicago during the week that he needed to see signs of "highly sustainable" economic growth before being in a position to support steps towards tighter monetary policy, but at the same time reassured markets that he was being "mindful of any inflationary warning signs". At the same time, policy makers will need to decide whether to move towards more restrictive policies before the economy returns to "average, normal type of business conditions".

The recession appears to be over in a "narrow, technical sense", with the recovery, however, likely to be hampered going forward due to restrained bank lending and wary businesses and consumers, Evans also indicated. He said that he expects 3%-3.5% growth for 2010, but with unemployment declining "only modestly" and inflation remaining "relatively stable".

St. Louis Fed President James Bullard, for his part, stated after a speech in St. Cloud, Minnesota that, with the economy at an early stage of economic recovery, policy makers want to remain "very accommodative" for the time being.

Snowstorms in the Eastern US last month may have contributed to the decline in (February) payrolls, Bullard said. "Employment hasn't really turned around yet," he said in response to questions from reporters. "When you are just starting to recover, you are in the first six to nine months, or even the first year, you are susceptible to new shocks that could hit" the economy.

The district bank chiefs' views echo the Federal Open Market Committee often repeated pledge to keep interest rates near zero for an "extended period".

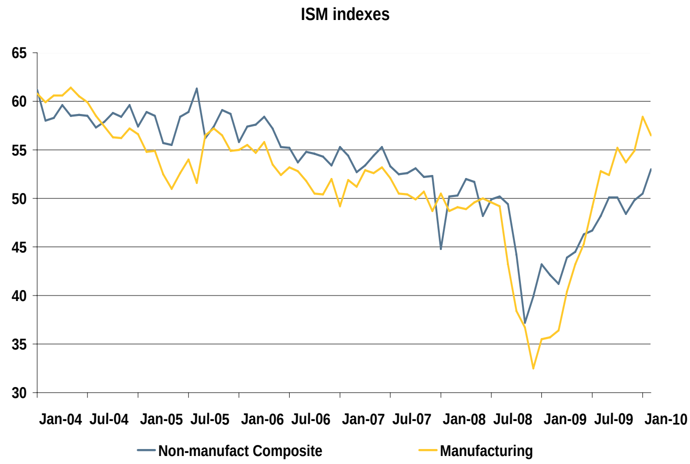
Federal Reserve Chairman Ben S. Bernanke had said the previous week that the US economy is in a "nascent" recovery that still requires low interest rates to help to spur demand by consumers and businesses once the federal fiscal stimulus begins to wane.

2. USA

ISM Manufacturing & Services Indexes

The February ISM Manufacturing Index declined to 56.5 (57.9 exp., 58.4 prior), falling from the highest level since August 2004 but still staying *above the 50 expansion threshold for the seventh consecutive month*. There were declines in production (58.4 vs. 66.2) and in new orders (59.5 vs. 65.9), partly offset by increases in inventories (47.3 vs. 46.5) and in employment (56.1 vs. 53.3). Prices Paid posted a small decline to 67.0 (70.0 prior), staying however at a level that indicates some pressures.
The February ISM Non-Manufacturing Index rose to 53.0 (51.0 exp., 50.5 prior), and stayed above the 50 expansion threshold for the second consecutive month and *reaching the highest level since October 2007*. There were improvements in the month in business activity (54.8 vs. 52.2), new orders (55.0 vs. 54.7), employment (48.6 vs. 44.6) and in backlog of orders (46.0 vs. 45.5).; the Prices Paid index eased to 60.4 from 61.2, but remained relatively sustained due to the increases in energy prices.

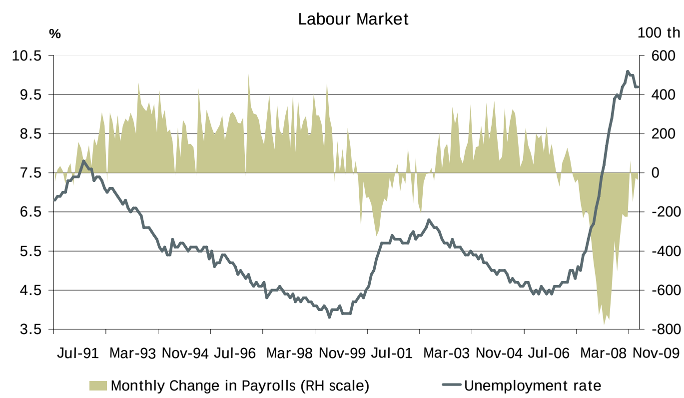
Fig: 2.1 USA ISM Indexes (source: ISM, last update 02/2010)



Non-farm Payrolls & Unemployment Rate

The February Unemployment Rate was stable at 9.7% (9.8% exp.), **and 36K Non-Farm Payrolls were lost** (-68K exp., -26K prior) as manufacturing payrolls rose by 1K (+20K prior), the construction sector lost 64K (-77K prior) but there was a 42K increase in services (+20K prior), mostly due to temporary jobs (+48K vs. +50K prior); Average Hourly Earnings were up 0.1% MoM (+0.2% prior) and 1.9% YoY (1.9% prior), indicating that wage increases are continuing to be very moderate at present. *The monthly numbers may have been distorted negatively by poor weather, but overall the labour market may be very close to starting to create jobs again, as rising demand is helping to stabilise the employment situation.*

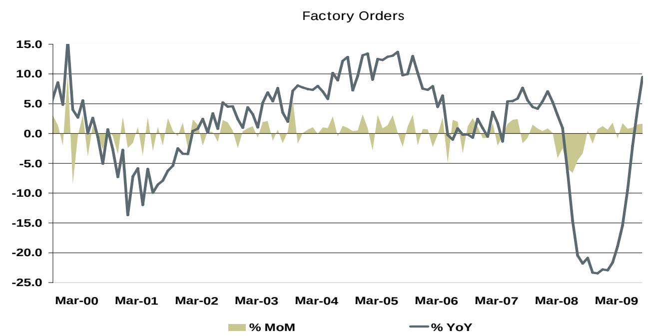
Fig: 2.2 USA Labour Market (source: Bureau of Labour Statistics, last update 02/2010)



Factory Orders

January Factory Orders increased 1.7% MoM (+1.8% exp., +1.5% prior) **and were 9.5% higher YoY**, with Ex-Transportation orders rising 0.1% MoM (+1.5% prior) and 8.9% YoY, thus *posting the fifth consecutive increase*, thanks to the need to replenish depleted stockpiles and to higher export orders; capital goods orders increased 5.1% MoM (+2.0% prior, +16.7% YoY) aided by an 18.7% MoM rise in defence orders (+0.6% prior, +35.8% YoY), and durable goods orders rose 2.6% MoM (+1.8% prior, +9.7% YoY) thanks to a 15.0% MoM increase in transportation orders (+1.6% prior, +14.7% YoY).

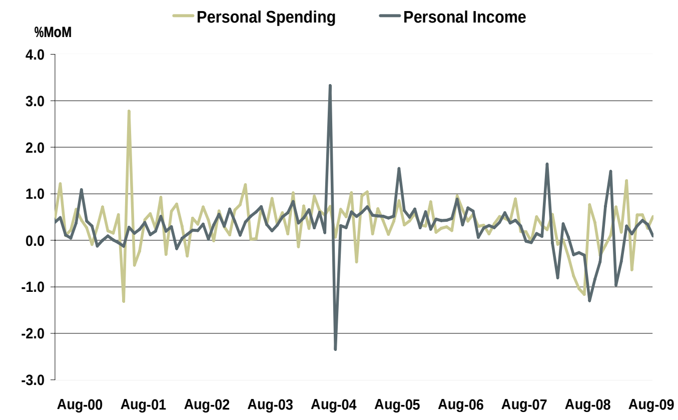
Fig: 2.3 USA Factory Orders (source: Census Bureau, last update 01/2010)



Personal Income & Spending

January Personal Income rose 0.1% MoM (+0.4% exp., +0.3% prior), managing a small increase in the month even as high unemployment and slow growth in wages continue to hamper income growth; the number was negatively impacted in the month by declines in dividend and interest income.
January Personal Spending rose 0.5% MoM (+0.4% exp., +0.3% prior), increasing in the month as consumers were more positive after a long period of extreme caution in spending patterns; looking ahead, consumer spending is likely to improve sustainably if employment prospects take a turn for the better. The savings rate fell to 3.3% from 4.2%, the lowest level since October 2008, but remained higher compared to previous years that had seen it persistently negative.

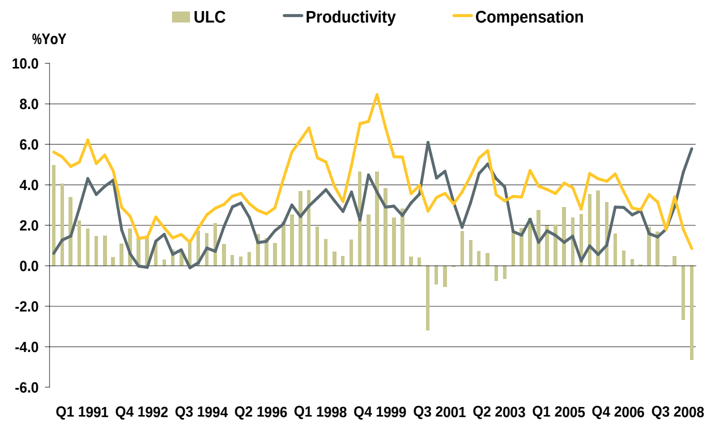
Fig: 2.4 USA Personal Income & Spending (source: Department of Commerce, last update 01/2010)



Productivity & Unit Labour Cost – final data

4Q Final Non-Farm Productivity rose 6.9% QoQ annualised (+6.3% exp., +7.8% Q3), revised up in line with headline GDP (+6.2% first estimate), and remaining at elevated levels due to the fact that the total output of the US economy posted a healthy rise in Q4, even as the total number of workers declined as the vast majority of companies strived very hard to slash costs in the period.
Unit Labour Costs were 5.9% lower (-4.5% exp., -7.6% Q3), also well ahead of the previous estimate (-4.4%), as companies not only reduced their workforce but also kept a very tight lid on individual compensation, aided in this by the limited number of job offers on the market that significantly reduced the competition for trained workers at present.

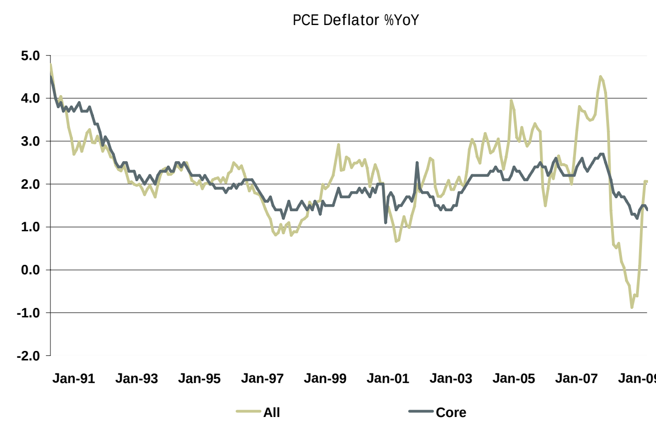
Fig: 2.5 USA Productivity & ULC (source: Bureau of Labour Statistics, last update 12/2009)



PCE Deflator

The January PCE Deflator rose 0.2% MoM (+0.1% prior) **and was 2.1% higher YoY** (+2.2% exp., +2.1% prior), rising moderately even as energy prices have more than doubled since the December 2008 lows, but most other prices remained muted due to the general economic situation. The Core PCE was flat MoM (0.0% exp., +0.1% prior) and 1.4% higher YoY, as expected (+1.5% prior), indicating a very moderate rate of growth in the overall level of prices at present.

Fig: 2.6 USA PCE Deflator (source: B.E.A., last update 01/2010)



US – Monetary Policy

Central Bank Monitor

The Federal Reserve (Fed) released its latest edition of the Beige Book during the week. It highlighted continued improvements in economic conditions, in part obscured by the severe snow storms that affected large parts of the country in February.
Consumer spending improved in most parts of the country, although snow "hampered" activity in early February. Some districts noted increased discretionary spending, but overall "sales were strongest for lower-pried items". Consistent with the week's data on auto sales, the report indicated some weakening in such sales, attributing part of this to the weather.
Manufacturing activity "increased further in most Districts". Increases were especially noteworthy in high-tech equipment, automobile and metal industries. Weather was again cited as a factor impeding production during parts of February. Commentary on residential real estate was better than implied by some of the national data, especially given the obvious relevance of weather to this sector. However, as to be expected, *"commercial real estate conditions remained weak,"* with tenants receiving rent concessions in some cases. Federal stimulus was cited as a plus in this sector, sporadically.
A couple of regional banks (Philadelphia and Richmond) received reports of increased loan inquiries, but overall "loan demand remained weak across the country", with most regional banks attributing this to low levels of overall activity. On the supply side, the comments stressed caution on the part of banks, while noting in some cases that lending standards had not tightened further in recent months.
The overall tone of the labour market reports was "soft", but with fewer layoffs and, in some cases, the initial signs of demand for workers. Pressures on prices and wages remained limited.

Our Outlook

United States economic growth is expected to remain moderate at best in the coming quarters as the unemployment rate remains elevated. Domestic and international demand remain modest, despite the continuing barrage of fiscal and financial measures, which are, however, expected to progressively help to stabilise the economy in the coming quarters. In total, the Fed reduced short-term rates by over 500 bps in over a year to sustain the economy and help heal financial markets, reducing rates down to the current 0% to 0.25% range in December 2008; **there is no scope for further cuts and further unconventional measures are unlikely to be announced at the next scheduled meeting on 16 March, with the Fed currently scaling down its liquidity provision measures (it has recently started to normalise the spread between the discount rate and the Fed Funds rate, by raising it from 0.25% to 0.50%, it was at 1% before the financial crisis began).** The market currently expects US interest rates to remain around 0.25% up to August 2010; rates are then expected to gradually increase as the year progresses, reaching about 1.0% by the spring of 2011.
Overall, expectation for rate hikes during the year have been declining in recent months as the Fed continues to repeat that rates will remain unusually low "for an extended period" (now officially indicated to mean "at least six months").

US – Data Due Out Next Week

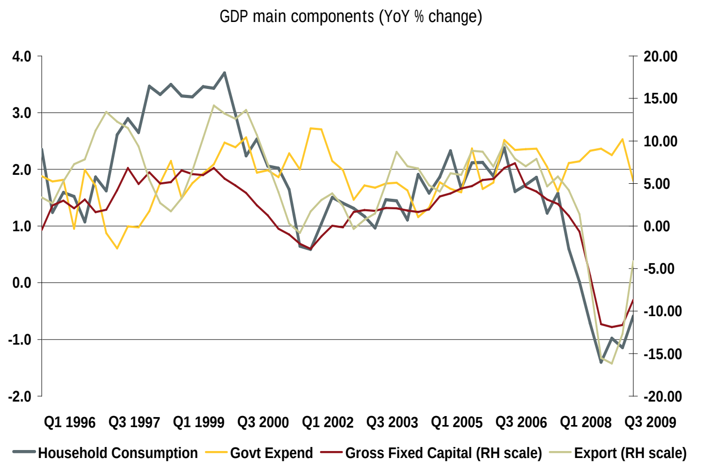
January Trade Balance, February Advance Retail Sales, March Preliminary University of Michigan Confidence.

3. EURO Area

Euro-Zone 2009-4Q GDP Growth Rate

4Q Euro-Zone GDP was rose 0.1% QoQ, as expected (+0.4% Q3) **and was 2.1% lower YoY seasonally adjusted terms, also as expected** (-4.1% Q3), hindered by weak private consumption (0.0% QoQ vs. -0.2% Q3), government spending (-0.1% QoQ vs. +0.8% Q3) and capital investments (-0.8% QoQ vs. -0.9% Q3), which offset the improvement coming from net exports, which added 0.3% to GDP growth in the quarter (imports +0.9% QoQ vs. +2.8% Q3, exports +1.7% QoQ vs. +2.9% Q3), and, once again, proved to be the main engine of growth for the Euro-Zone economy. The change in inventories had no impact on quarterly growth (+0.5% Q3).

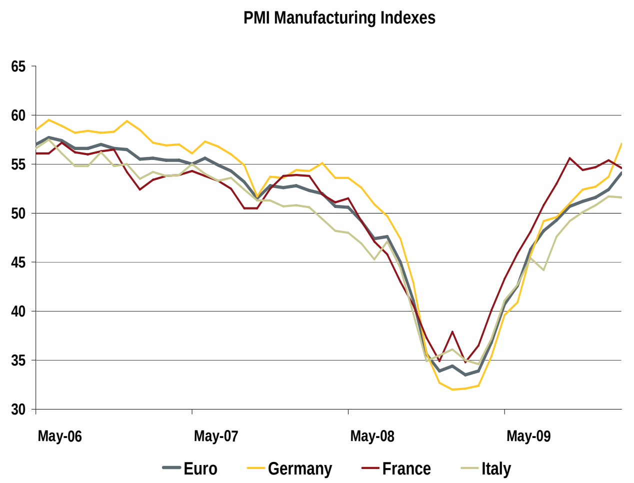
Fig: 3.1 EMU GDP Growth Rate (source: Eurostat, last update 12/2009)



Euro-zone Final PMI Indexes

The February Final Euro-Zone PMI Manufacturing Index rose to 54.2 (54.1 preliminary and exp., 52.4 prior month), continuing to recover from the record low set in February (33.5) as some signs of improvement in demand materialised. At individual country level, there was a significant improvement in Germany (57.2 vs. 53.7 prior), but a small setback in Italy (51.6 vs. 51.7 prior) and France (54.9 vs. 55.4 prior).
The February Final Euro-Zone PMI Services Index declined to 51.8 (52.0 preliminary, 52.5 prior month), but remained above the 50 expansion level for the sixth consecutive month and well above the record low (39.2 in February), a sign of stabilization even as unemployment continues to rise and consumer confidence remains relatively low. Record low interest rates and significant government stimulus plans are currently having a significant impact on the level of activity. At the individual country level there were declines in Italy (50.8 vs. 50.9), France (54.6 vs. 56.3) and Germany (51.9 vs. 52.2), all easing in the month, possibly negatively influenced by relatively inclement weather.

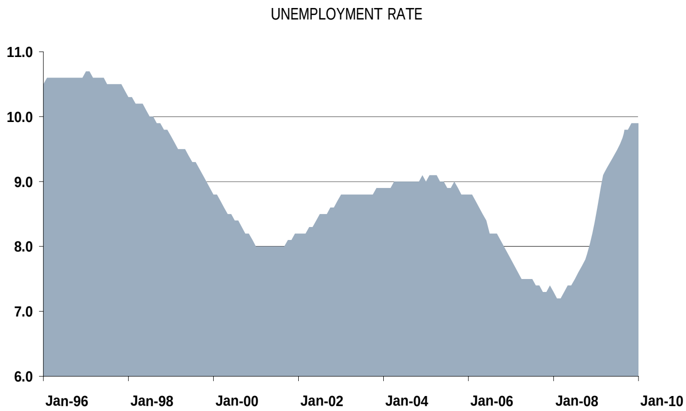
Fig: 3.2 EMU PMI Indexes (source: Markit, last update 02/2010)



Euro-Zone Unemployment Rate

The January Euro-Zone Unemployment Rate was stable at 9.9% (10.1% exp., prior originally reported as 10.0%), *staying at the highest level in more than ten years*, continuing to remain elevated as the slowdown in investments and exports in the last few quarters has forced companies to limit the number of workers in an effort to weather the slump. Despite signs that the worst of the slowdown may now be behind us, this negative trend (a lagging indicator) may continue for a while going forward. The highest rate of unemployment was once again registered in Spain (18.8% vs. 15.8% a year ago), particularly badly hit by the slowdown in the domestic Construction sector, with Ireland also suffering a large increase (13.8% vs. 9.4% a year ago).

Fig: 3.3 EMU Unemployment Rate (source: Eurostat, last update 01/2010)

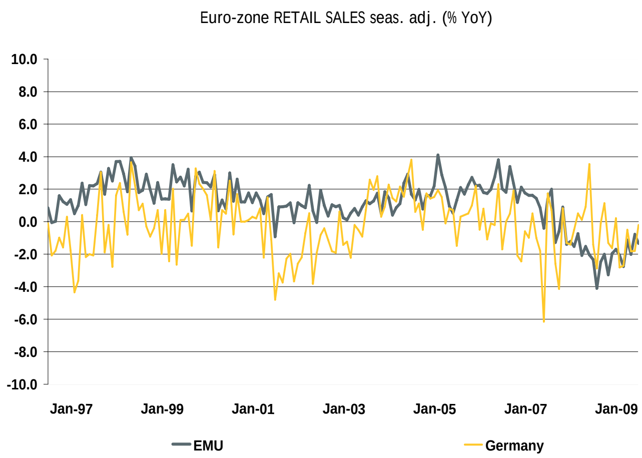


Euro-Zone & Germany Retail Sales

January Euro-Zone Retail Sales declined 0.3% MoM (-0.3% exp., +0.5% prior) **and were 1.3% lower YoY** (-1.6% exp., -0.5% prior), falling in the month as rising jobs losses continued to sap consumer demand, and now falling YoY for twenty consecutive months. Food sales fell 0.1% MoM (+0.4% prior, +0.2% YoY), while the sales of non-food products declined 0.6% MoM (+0.3% prior, -1.5% YoY) as consumers continued to pare back non-essential purchases due to the uncertainties of the employment market.

German Retail Sales were flat MoM (-0.6% exp., +0.9% prior) **and were 3.4% lower YoY** (-1.1% exp., -1.8% prior), stable in the month as higher sales of food were offset by lower spending on clothing & shoes, and on furniture & fittings.

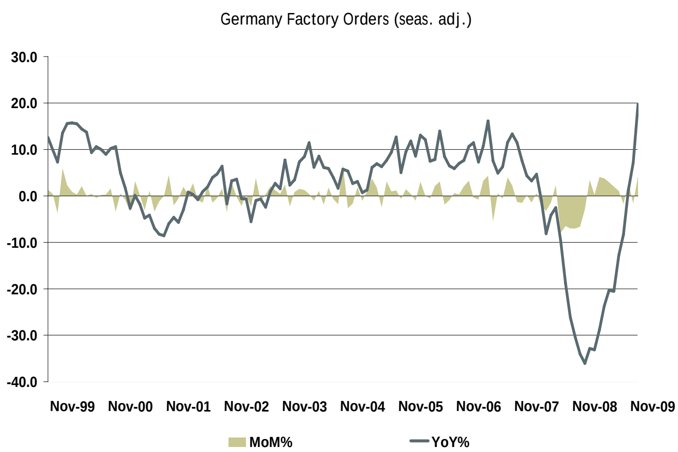
Fig: 3.4 EMU & GER Retail Sales (source: Eurostat & Bundesbank, last update 01/2010)



Germany Factory Orders

February Factory Orders rose 4.6% MoM (+1.3% exp., -1.6% prior) **and were 19.6% higher YoY** (+15.4% exp., +7.3% prior), boosted in particular by rising investment demand; orders for intermediate goods rose 6.0% MoM (-2.5% prior, +22.5% YoY), those for capital goods rose 3.7% MoM (-1.0% prior, +20.6% YoY) and those for consumer goods, which were probably negatively impacted by inclement weather, increased by 0.4% MoM (+0.1% prior, +2.5% YoY).

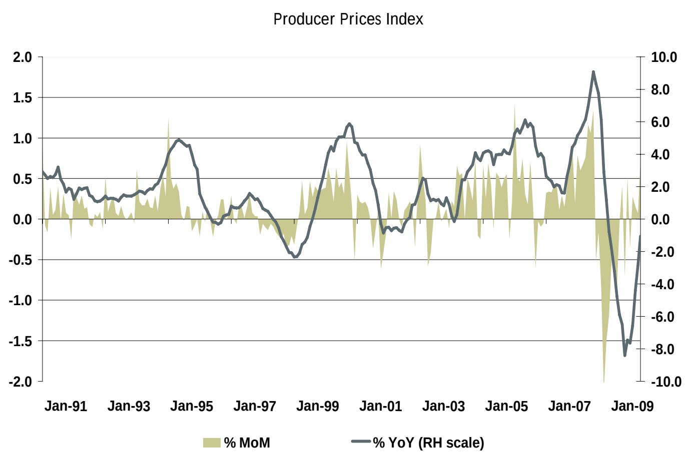
Fig: 3.5 GER Factory Orders (source: Bundesbank, last update 01/2010)



Euro-Zone PPI Indexes

January Euro-Zone PPI rose 0.7% MoM (+0.6% exp., +0.1% prior) **and was 1.0% lower YoY** (-1.1% exp., -2.9% prior), boosted in the month by higher costs for intermediate goods (+0.5% MoM vs. +0.1% prior, -1.5% YoY) and for energy (+2.0% MoM vs. +0.1% prior, -1.7% YoY), but still in negative territory YoY as the overall economic environment does not permit widespread price increases.

Fig: 3.6 EMU PPI Indexes (source: Eurostat, last update 01/2010)

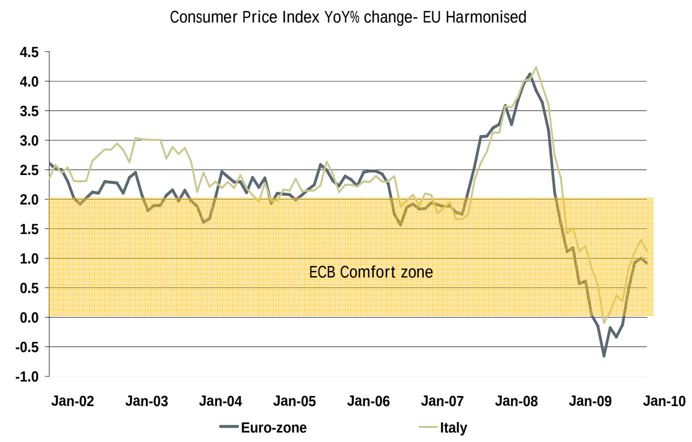


Euro-Zone & Italy CPI Indexes

The February Euro-Zone CPI Estimate was +0.9% YoY (+0.9% exp., +1.0% prior), indicating that the dip into deflation territory is over as YoY energy price comparisons are no longer deflationary, but at the same time highlighting that there are limited inflationary pressures in the euro-zone economy at the present time.

February Preliminary Italian EU-Harmonised CPI was unchanged MoM (+0.2% exp., -1.5% prior) **and was 1.1% higher YoY** (+1.3% exp. and prior), as higher utility bills offset a decline in transport costs in the month.

Fig: 3.7 EMU CPI Indexes (source: Eurostat & ISTAT, last update 02/2010)



EUR – Monetary Policy

Central Bank Monitor

The European Central Bank (ECB) left interest rates unchanged at 1.0% during the week, as widely expected. It did, however, make announcements regarding its liquidity provisions to the financial system, taking a further step in removing the emergency measures introduced in reaction to the financial slump.
With regards to weekly and one-month liquidity auctions they are set to remain at full allotment at a fixed rate, at least until the October 2010 meeting. *The three-month auction is, however, going to return to competitive bidding from the end of April 2010, and the total amount of the operation will not be pre-set*. The last six-month auction will be held at the end of March, it will have a full allotment but the rate will be indexed to the refinancing rate (likely, but not guaranteed, to remain at 1% in the coming months).
Speaking at the press conference after the meeting, **ECB President Jean-Claude Trichet** indicated that "the euro-system continues to provide liquidity support to the banking system of the euro area at very favourable conditions". He also commented on the situation in Greece, where he stated that "I don't trust that it would be appropriate to have the introduction of the IMF as a supplier of help".

Our Outlook

The messages being sent to financial markets from ECB sources are fully consistent with a neutral bias, given that the ECB is not worried about the risks of inflation in the coming months, has recognised the limited level of economic activity and has the expectation of a gradual pace of recovery in the coming quarters; overall, it has reduced official interest rates by 3.25% since October 2008, to the current 1.0% level, reached after the last 25 bps rate reduction that the ECB enacted at its meeting in early May 2009.
A variation of interest rates is not likely at the next meeting on 8 April and most economists continue to expect very low interest rates going forward, as economic growth is forecast to improve only gradually in the coming quarters and the low level of economic activity limits the potential for price increases at present.
The process of winding down the extraordinary measures to supply liquidity to financial markets has however started, so the ECB's overall monetary policy will progressively become less accommodative going forward, even if interest rate increases do not seem imminent just yet.

EUR – Data Due Out Next Week

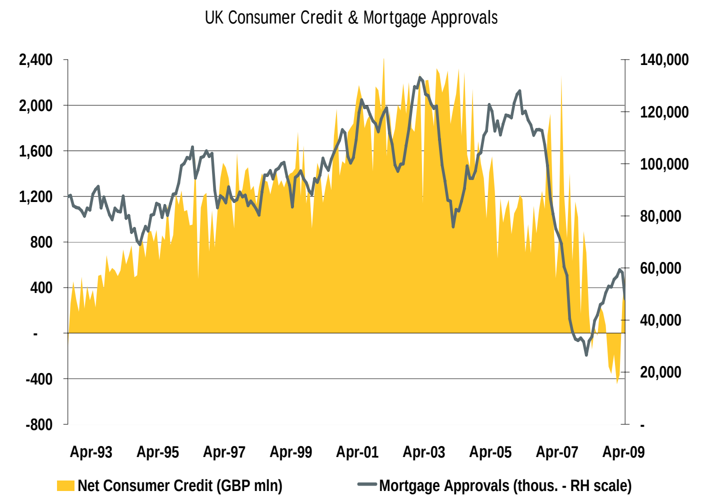
February Final German EU-Harmonized CPI, January French Industrial and Manufacturing Production, January Italian Industrial Production, 4Q Final Italian GDP, January Euro-Zone Industrial Production.

4. UK

Net Consumer Credit & Mortgage Approvals

January Net Consumer Credit rose by £0.5B (-£0.1B exp., +£0.3B prior) as credit card debt rose by £171M (+£201M prior), while other debt increased by £330M (+£64M prior), indicating that some consumers may be starting to find the confidence to take on new debt, even as banks have enacted strict lending standards and many consumers are wary or unable to take on more debt in the present circumstances. Although this is now the second consecutive monthly increase, the amount is small compared to the over £1B a month that was, on average, being added up to 2007.
Net Lending Secured on Dwellings (mortgages) increased by £1.5B (+£0.9B exp., +£1.2B prior), continuing to post small positive gains in the month; this is a positive sign for the overall level of activity in the UK housing market, which seems to be striving to stabilise at present.
Mortgage Approvals declined to 48.2K (50.0K exp., 58.2K prior), dropping to an eight-month low and interrupting the recovery from the lowest level in at least nine years set in November 2008 (27K), hampered by poor weather and continuing limited credit availability, even as low prices and financing rates attract some bargain hunters into the market.

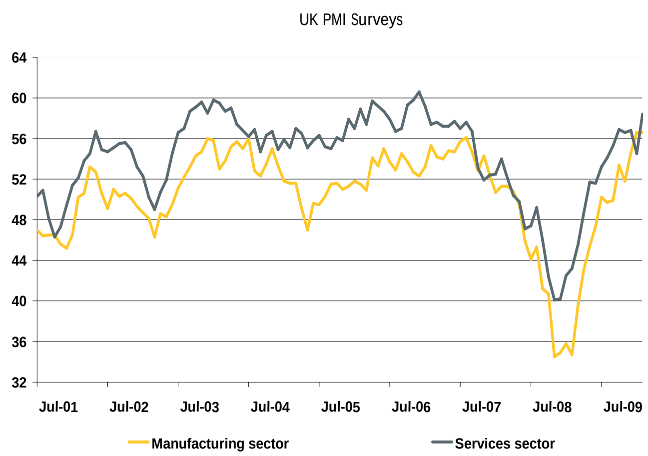
Fig: 4.1 Net Consumer Credit & Mortgage Approvals (source: BoE, last update 01/2010)



PMI Manufacturing & Services Indexes

The February PMI Manufacturing Index was stable at 56.6 (56.5 exp), and has now managed to remain above the 50 expansion threshold for five consecutive months, the support coming from record low interest rates, worldwide government stimulus and the devaluation of the pound sterling that seems to be helping UK manufacturing recover at present. However, growth appears to be moderate.
The February PMI Services Index rose to 58.4 from 54.5 (55.0 exp.), reaching its highest level in over three years, indicating an improvement in the prospects of the important Services sector, that ranges from shops and restaurants to the Banking sector. The Index has been in a gradual uptrend after touching a 40.1 low in October 2008 as the financial crises reached its apex, and has now been above the 50 expansion threshold for ten consecutive months.

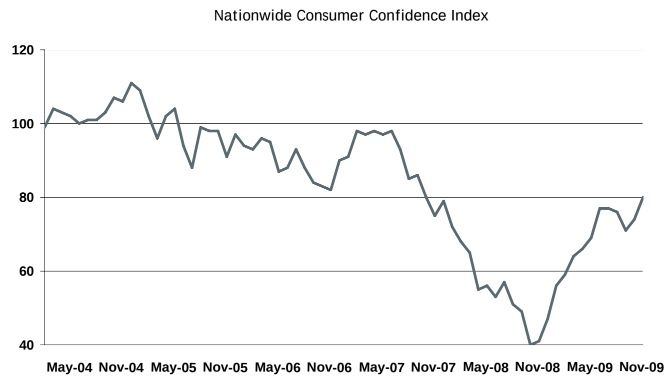
Fig: 4.2 UK PMI Indexes (source: Markit, last update 02/2010)



Nationwide Consumer Confidence Index

February Nationwide Consumer Confidence rose to 80 (73 exp., 74 prior), rising to the highest level since January 2008; the increase in the present situation component (27 vs. 23 prior) was supported by an improvement in expectations (115 vs. 109 prior) and partly offset by a decline in spending (93 vs. 97 prior); overall consumers seem to be recovering some of their confidence as the housing market and the economy in general appear to be in a process of bottoming, while ultra-low interest rates are easing the burden of debts.

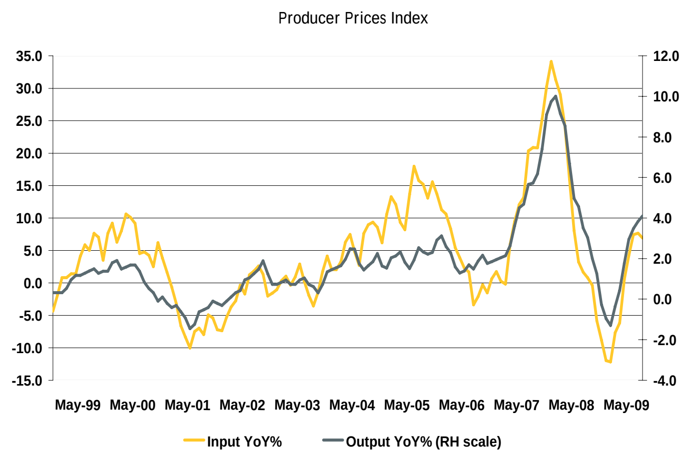
Fig: 4.3 UK Nationwide Consumer Confidence (source: Nationwide Building Society , last update: 02/2010)



PPI Input & Output Prices Indexes

February PPI Input Prices rose 0.1% MoM (+0.2% exp, +1.3% prior) **and were 6.9% higher YoY** (7.8% exp., 7.7% prior, originally reported as 8.4%), the fastest annual pace in nine months. The modest monthly increase was dominated by the higher prices of fuel (+0.3% MoM vs. +6.9% prior, -16% YoY). **PPI Output Prices rose 0.3% MoM** (+0.2% exp., +0.4% prior) **and were 4.1% higher YoY** (+4.0% exp., +3.8% prior), due to higher petroleum costs (+2.2% MoM vs. +1.1% prior, +8.3% YoY). **Core Output Prices rose 0.3% MoM** (+0.2% prior) **and were 2.9% higher YoY** (+2.6% prior), indicating an increase in price pressures as the YoY comparisons have become less favourable, a trend that is now, however, likely to ease going forward.

Fig: 4.4 UK PPI Indexes (source: O.N.S., last update 02/2010)



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UK – Monetary Policy

Central Bank Monitor

The Bank of England (BOE) left interest rates unchanged at 0.50% last week, as widely expected, and also left the total size of its asset purchase programme unchanged at £200B, also as expected. There were no official statements after the meeting, as usual when no decisions are taken. The minutes of the meeting will be published on 17 March.

Our Outlook

Since March 2009 the BOE has kept its official interest rate at a record low level to fight the economic and financial crisis. Albeit recent economic data has suggested that the UK economy has begun to grow again, it is likely that the central bank will not change this policy in the foreseeable future as it has warned several times that, according to its forecasts, recovery would be "slow and protracted".

The next Monetary Policy Meeting is scheduled for Thursday, 8 April and with interest rates already at a record low 0.50%, a further cut seems unlikely. The BOE now seems to prefer to continue to adopt a 'wait-and-see' attitude on the economy, inflation and interest rates, and its recently completed £200B bond purchase may be restarted if deemed appropriate and necessary. At the November 2009 meeting the BOE discussed the possibility of lowering the remuneration of the reserves banks deposit with the central bank in a bid to spur lending: no immediate action was taken, but this option is now a possibility going forward.

UK – Data Due Out Next Week

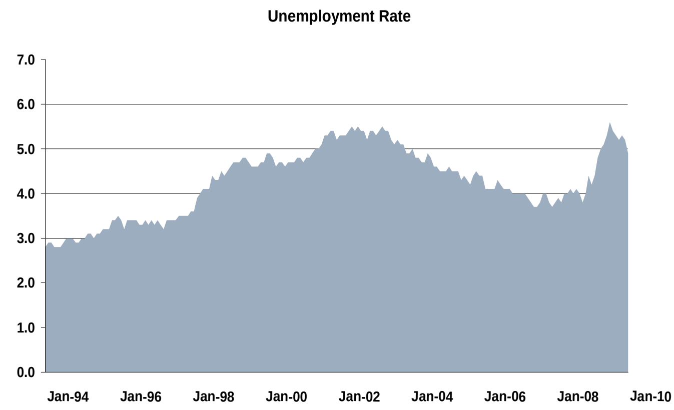
January Trade Balance, January Industrial Production and Manufacturing Production, February NIESR GDP Estimate.

5. JAPAN

Jobless Rate

The January Jobless Rate declined to 4.9% (5.1% exp., 5.2% prior), declining sharply in the month, to a ten-month low, after reaching a record high of 5.7% in July 2009, as higher exports and industrial production led to a better employment climate; **the Job-to-Applicant Ratio was stable at 0.46** (0.47 exp.), indicating that the number of job offerings is staying well below the level of people unemployed. The improvement in export demand and industrial production, if sustained in the coming months, should continue to help stabilise the unemployment rate going forward, but economists do not expect further significant declines in the unemployment rate in the coming months.

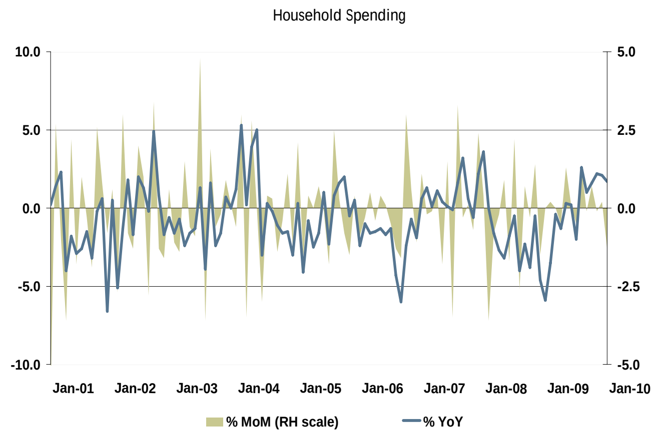
Fig: 5.1 JAP Jobless Rate (source: MIAC, last update 01/2010)



Household Spending

January Household Spending declined 1.3% MoM (+0.2% prior) **and was 1.7% higher YoY** (+2.5% exp., +2.1% prior), easing in the month but positive year-on-year for the sixth consecutive month, after more than a year spent mostly in negative territory. This is a sign that consumers may be feeling a bit more cheerful as the unemployment rate starts to decline and financial markets are less turbulent than in the past.

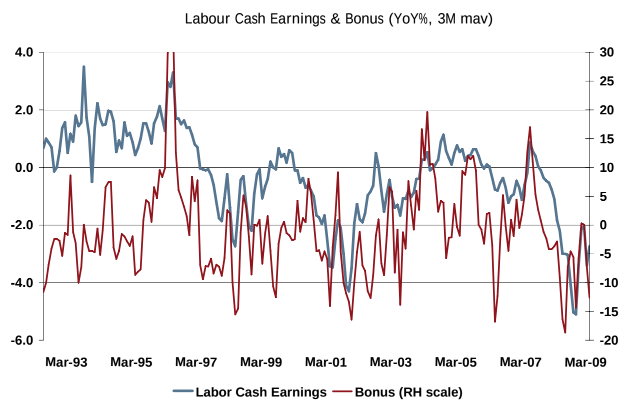
Fig: 5.2 JAP Household Spending (source: MIAC, last update 01/2010)



Labour Cash Earnings

January Labour Cash Earnings were 0.1% higher YoY (-1.2% exp., -5.9% prior), higher for the first time in nearly two years, thus ending the longest negative streak since 2003; regular wages were 0.5% lower YoY (-1.2% prior), overtime payments increased 2.2% YoY (-0.2% prior) and bonus payments were 10.3% higher YoY (+9.9% prior), benefiting from the increases in export demand and manufacturing production in recent quarters. The progressive improvement in earnings signals a less difficult, but still not easy, scenario for consumer spending going forward.

Fig: 5.3 JAP Labour Cash Earnings (source: MHLW, last update 01/2010)



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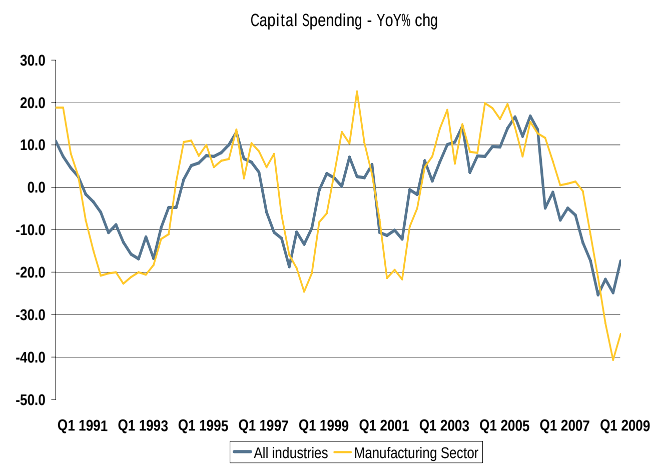
Capital Spending

In 2009-4Q capital spending slid 17.3% YoY (-24.8% prior), *declining for the 11th consecutive quarter*. **Capital spending, excluding software fell 18.5% YoY** (-25.7% prior). In detail, Manufacturers' spending contracted 34.5% YoY, a slight improvement from the prior record 40.7% collapse, auto manufacturers' spending fell 51.6% (-59.7% prior), spending among electronics producers was down 37% (-46.3% prior) and chemical manufacturers' capex fell 30% (-35% prior).
The quarterly survey also showed that profits surged 102.2% (-32.4% prior), climbing for the first time in 10 quarters. It was the second biggest advance since the survey began in 1955. "The higher profits were due to stronger performance among auto, semiconductor and other electronics manufacturers spurred by government purchase incentives for fuel-efficient cars and appliances in Japan and overseas", the ministry official said.

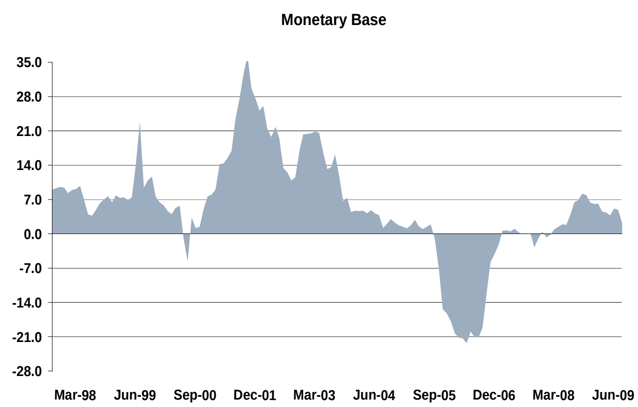
Fig: 5.4 JAP Capex (source: MOF, last update 12/2009)



Monetary Base

The February Monetary Base expanded by 2.2% YoY (+4.9% prior), with banknotes in circulation rising 0.1% YoY (-0.2% prior) and current account balances increasing by 15.3% YoY (+43.4% prior), indicating a less robust pace of creation of liquidity on the part of the Bank of Japan (BOJ). After some initial hesitation, the BOJ joined the other major central banks in aggressively pumping extra liquidity into the market in an effort to alleviate the financial turmoil and thus try to sustain the levels of economic activity, but now seems to be slowing the pace of monetary expansion as the economy shows some signs of stabilisation; some observers blame this slowdown in money creation as one of the main reasons for the yen's "excessive" strength on FX markets, and would welcome a faster pace of monetary creation from the BOJ.

Fig: 5.5 JAP Monetary Base (source: BoJ, last update 02/2010)



JAPAN – Monetary Policy

Central Bank Monitor

BOJ board member Tadao Noda made two important points during the week: 1) the Japanese government needs to significantly improve its finances 2) further monetary easing is not needed at the moment and would serve little. "Maintaining fiscal discipline, in other words showing a road map and implementing it decisively in a timely manner, is critical" to keep bond yields low, Noda said in a speech. He later also indicated to reporters that "the impact of further accommodative policies will be limited compared with before", given that the key interest rate is already at only 0.1%, and there is therefore very little space for further reductions.

Our Outlook

The BOJ unexpectedly reduced rates to 0.10% (from 0.30%) in December 2008 in a bid to help sustain economic growth, responding to negative inflation and to the weakness of the global economy, and has since left interest rates unchanged. The BOJ has indicated that it is aware of the risk of keeping interest rates too low for too long, but it is unlikely to be in a position to increase interest rates until the economy overcomes the current difficult phase and CPI returns to a positive rate of growth (National CPI has now been negative since February 2009, and is unlikely to return to positive territory soon). **The policy board's next interest rate setting meeting is on 17 March and no action on rates is expected**.

JAPAN – Data Due Out Next Week

January Current Account and Trade Balance, February Domestic CGPI, 4Q Final GDP, January Final Industrial Production and Capacity Utilization.

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