GLOBAL ECONOMIC OUTLOOK – NOVEMBER

2013

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External Economic Relations Division

CZECH NATIONAL BANK

Contents

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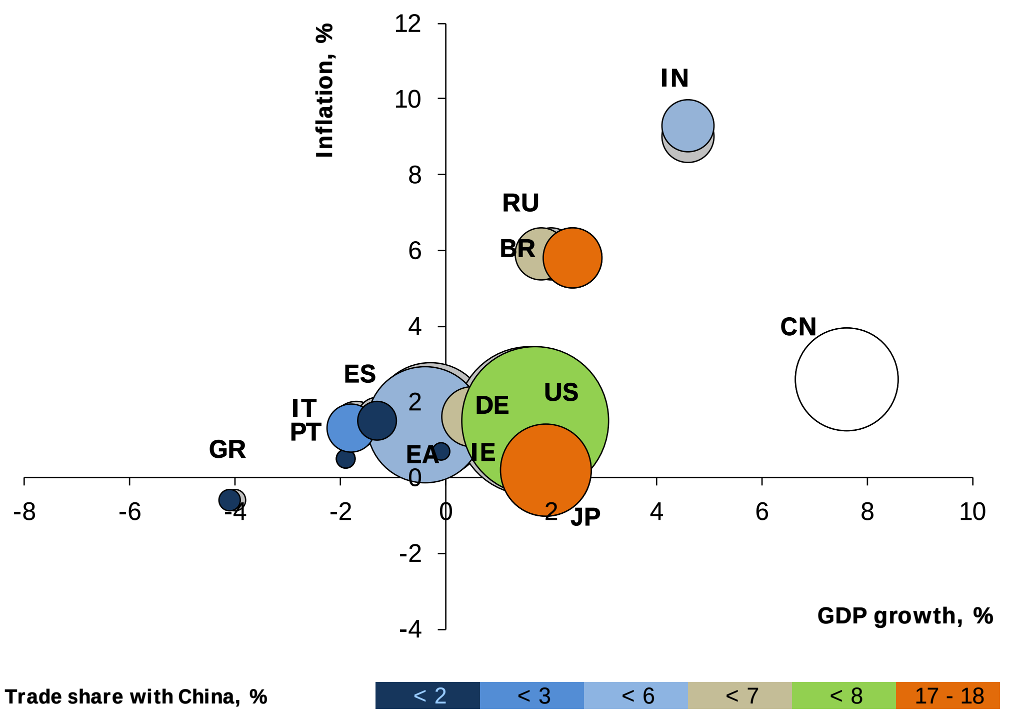
The November issue of Global Economic Outlook presents its regular overview of recent and expected developments in selected advanced and emerging economies, focusing on key economic variables such as GDP, inflation, leading indicators, interest rates, exchange rates and commodity prices. This issue also focuses on internationalisation of the Chinese currency (renminbi) in international transactions. Although the renminbi has been used more frequently in recent years, especially when carrying out regional transactions, its use as a global currency remains low.

The outlooks for the global economy for 2014 still confirm – compared to the expectations for this year – improved economic performance, which is also indicated by numerous leading indicators. The euro area economy is expected to extricate itself from the economic downturn thanks to a recovery in almost all its member countries. The outlooks for the US economy also remain optimistic at the one-year horizon, attacking the 3% level of growth. However, this expected increase in economic growth is accompanied by disinflationary trends both in the euro area as a whole and Germany; the outlooks for the US economy do not exceed 2% inflation. The economy in Japan shows different developments. An increase in inflation, not seen for a very long period of time, is expected amid a slightly lower economic growth rate.

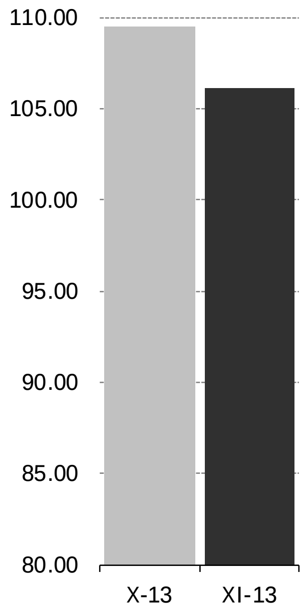
The economy in China, which is significantly involved in international trade (see the Chart), will slow slightly its performance at the end of next year amid somewhat elevated levels of consumer price inflation. Conversely, the other BRIC countries will reach higher economic growth in 2014 than their current performance, amid decreasing inflation outlooks.

The interest rate outlooks for the USA and the euro area point to a gradual rise in rates across maturities. This rise should be more pronounced in 2015. The US dollar is expected to appreciate against the euro and other reserve currencies, as well as against the Russian, Indian and Brazilian currencies, over the one-year horizon. On the other hand, it is expected to depreciate moderately against the Chinese currency over the same time scale. The outlooks for dollar prices of oil (despite their recent increase) and natural gas remain gradually declining until the end of 2015. The outlooks for food commodities are stable overall, but mixed across the individual components. Industrial metal prices are expected to rise gradually over the same time frame.

The importance of international trade with China in 2012 (selected economies)



Outlook for Brent crude oil prices in December 2013

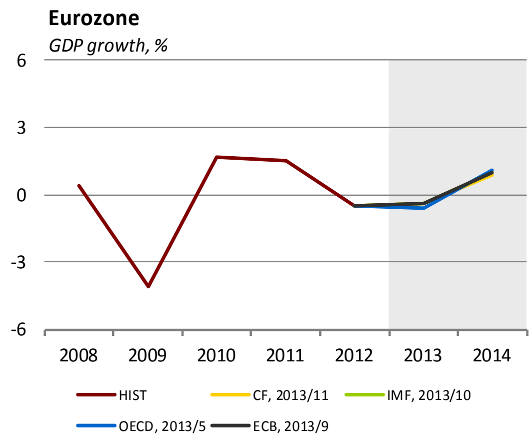


The size of each point represents the size of the country/region according to nominal GDP in US dollars in 2011. The colour of the points is assigned according to the ratio of trade with China to the country's or region's total trade in 2012, %. The grey colour is the CF forecast (GDP, inflation) or Bloomberg survey (oil price) for the previous month.
[Cut-off date for data: 15 November 2013]

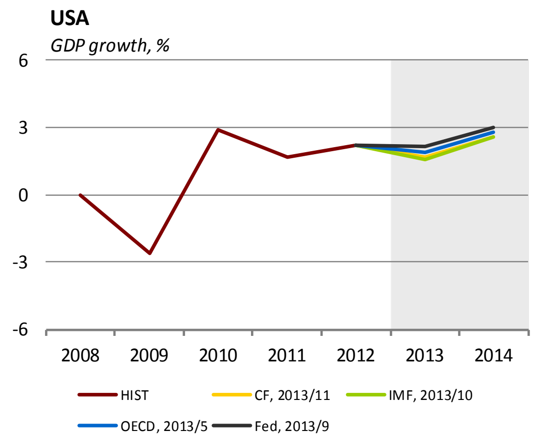
Source: Bloomberg, Comtrade, Consensus Economics, CNB calculations.

II.1 GDP outlook in advanced countries

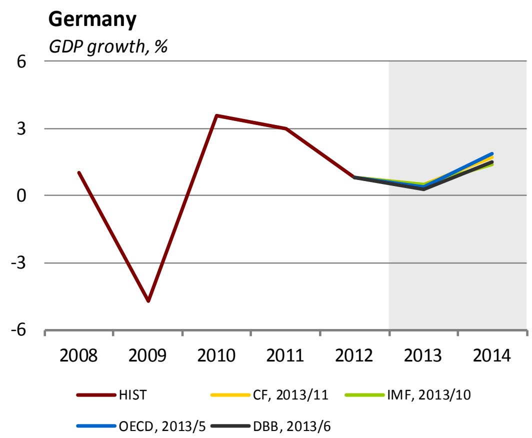
The new CF revised the outlook for the euro area this year to the September level of -0.4% (this is also in line with the Commission's new outlook, which is not included in those regularly monitored in GEO). Although the state budget deficit declined last year, the government debt in the euro area increased to 90.6% of GDP. Macroeconomic data from the euro area and Germany were mixed. The CF left the outlook for Germany at 1.5% in 2013 but this outlook does not take into account a decline in quarterly GDP growth to 0.3% in 2013 Q3 (preliminary estimate), which was published after the CF's cut-off date for data. Macroeconomic data were mostly favourable in the United States. Subsequently, the CF increased the estimate for GDP growth to 1.7%. Economic growth will intensify to 0.9%–2.6% in all the mentioned economies next year. A new BoJ outlook was published at the start of November. Unlike the CF, which expects economic growth of 1.9% next year, the BoJ assumes that GDP growth may amount to 2.7% (the median of the outlooks), provided that exports and industrial production edge up and private fixed investment also shows an increase. Economic growth in Japan will initially be fostered by growth in domestic demand. This will be dampened by an increase in excise duty, which will affect GDP in the fiscal year 2014 according to the BoJ's estimates (-0.7 b.p. compared to +0.3 b.p. this year). As a result of the rise in indirect taxes, the BoJ is lowering its outlook for GDP growth in the fiscal year 2014 to 1.5%, bringing it more into line with the CF outlook (1.6%) for the calendar year 2014.



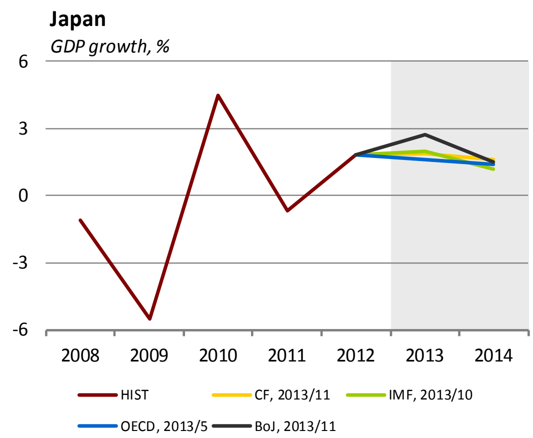
	CF		IMF	OECD	ECB
2013	-0.4		-0.4	-0.6	-0.4
2014	0.9	→	1.0	1.1	1.0



	CF		IMF	OECD	Fed
2013	1.7		1.6	1.9	2.2
2014	2.6	→	2.6	2.8	3.0



	CF		IMF	OECD	DBB
2013	0.5	→	0.5	0.4	0.3
2014	1.7	→	1.4	1.9	1.5



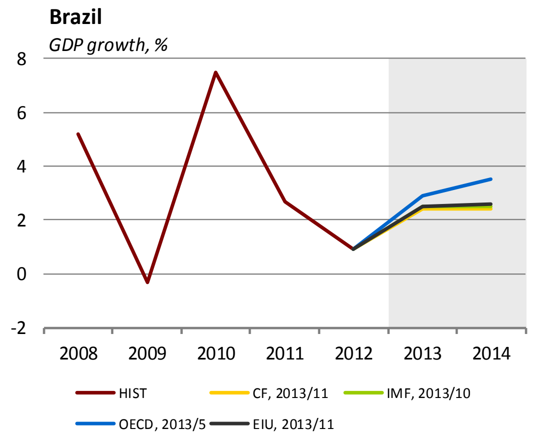
	CF		IMF		OECD	BoJ
2013	1.9	→	2.0	→	1.6	2.7
2014	1.6		1.2	→	1.4	1.5

Note: Legend shows latest forecast data in format “Source, year/month” of forecast publication. HIST: historical values. ECB and Fed: midpoint of range. Arrow indicates direction of revision of newly published forecast. If no arrow is shown, no new forecast was available in previous month or by cut-off date in current month. Asterisk indicates first published forecast for given year.
[Cut-off date for data: 15 November 2013)
Source: CF, IMF, OECD, ECB, Fed, DBB, BoJ, CNB calculations.

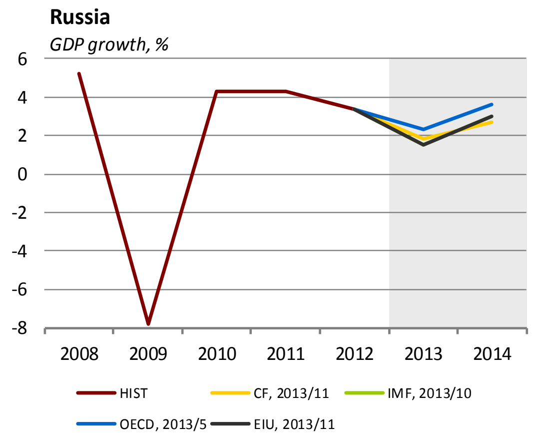
II.2 GDP outlook in BRIC countries

This month's new CF forecasts show mixed developments in the monitored emerging economies. China remains at the top of the ranking of the fastest growing economies. The estimate for its growth this year and the next edged up after the economy reported optimistic figures regarding industrial production and foreign trade. Faster expected growth will allow China to implement reforms which are currently being discussed at the Communist Party congress. These reforms are expected to include freer movements of market rates and the RMB exchange rate, while local governments should be controlled more by the central government. Conversely, the economy in Russia is experiencing problems, having grown at the lowest rate in Q2 since 2009 Q4. Russia's Ministry of Finance even believes that the average annual increase in GDP in Russia will be only 2.5% until 2030.

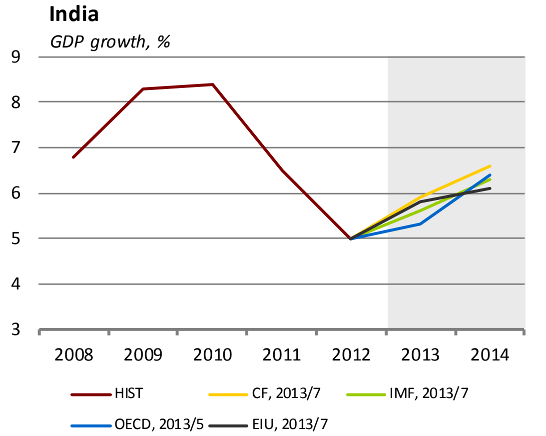
The situation in India and Brazil is unclear. Industrial production in Brazil is increasing, albeit more slowly than expected by markets. Moreover, the analysts fear a rating downgrade in response to the government's worse financial performance. Optimistic data regarding international trade were published in India but high inflation is pushing the interest rate upwards, thus preventing investment growth.



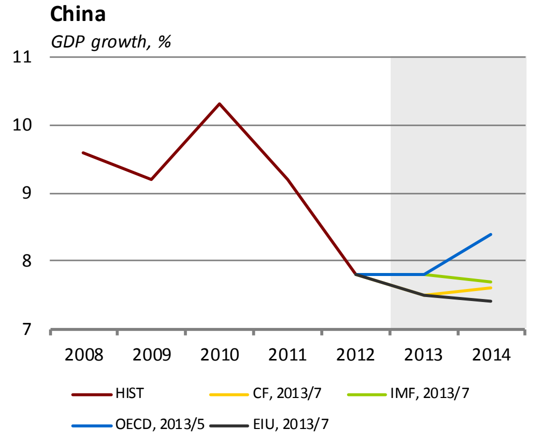
	CF	IMF	OECD	EIU
2013	2.4	2.5	2.9	2.5
2014	2.4	2.5	3.5	2.6



	CF	IMF	OECD	EIU
2013	1.8	1.5	2.3	1.5
2014	2.7	3.0	3.6	3.0



	CF	IMF	OECD	EIU
2013	5.9	5.6	5.3	5.8
2014	6.6	6.3	6.4	6.1

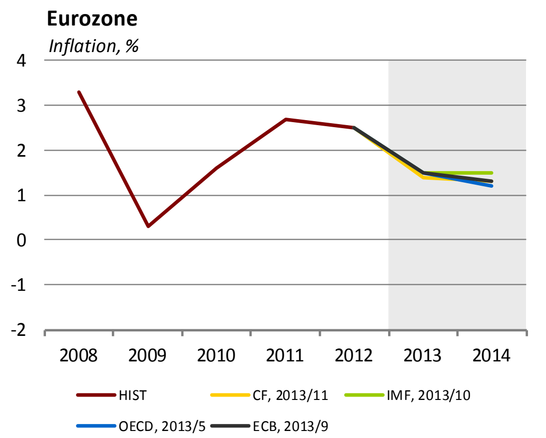


	CF	IMF	OECD	EIU
2013	7.5	7.8	7.8	7.5
2014	7.6	7.7	8.4	7.4

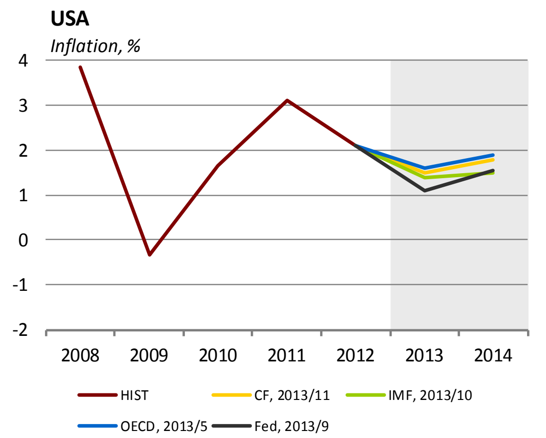
Note: Legend shows latest forecast data in format "Source, year/month" of forecast publication. HIST: historical values. Arrow indicates direction of revision of newly published forecast. If no arrow is shown, no new forecast was available in previous month or by cut-off date in current month. Asterisk indicates first published forecast for given year.
[Cut-off date for data: 15 November 2013)
Source: CF, IMF, OECD, EIU, CNB calculations.

II.3 Inflation outlook in advanced countries

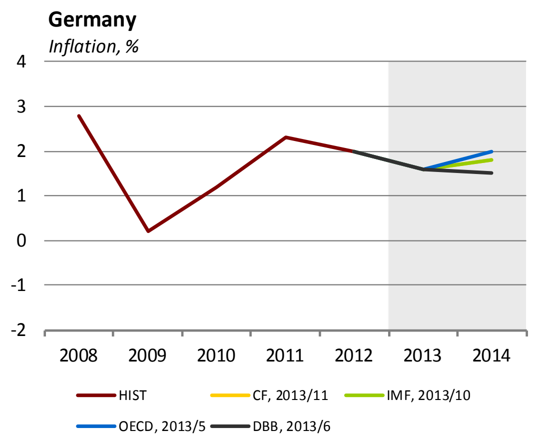
The latest macroeconomic data suggest a disinflationary trend both in the euro area as a whole and Germany. Prices in the euro area grew by 1.1% in September. The growth rate of consumer prices in Germany amounted to 1.2% in October. Headline and core inflation remain low. Slower growth in consumer prices can also be observed in the United States. The November CF outlook expects consumer price inflation to stand between 1.4% and 1.6% in these economies this year. The CF outlook for Japan for 2013 increased gradually from zero expected in July to 0.2% (the October and November outlooks). The new BoJ outlook expects prices in the economy (the median of the outlooks) to grow by 0.7% due to an improvement in the balance of aggregate domestic supply and demand. Inflation in Japan will pick up significantly in 2014 (2.3% according to the CF and 3.3% according to the BoJ). Price developments are likely to be affected by the two planned increases in excise duties. Provided that the tax increase will completely feed through into the prices of taxed goods, the BoJ estimates the total upward impact on inflation at 2.0 pp in 2014.



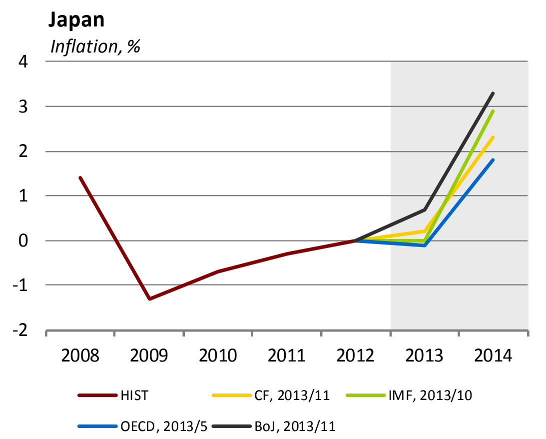
	CF	IMF	OECD	ECB
2013	1.4	1.5	1.5	1.5
2014	1.3	1.5 ➡	1.2	1.3



	CF	IMF	OECD	Fed
2013	1.5 ➡	1.4	1.6	1.1
2014	1.8 ➡	1.5	1.9	1.6



	CF	IMF	OECD	DBB
2013	1.6 ➡	1.6 ➡	1.6	1.6
2014	1.8	1.8	2.0	1.5



	CF	IMF	OECD	BoJ
2013	0.2 ➡	0.0	-0.1	0.7
2014	2.3 ➡	2.9	1.8	3.3

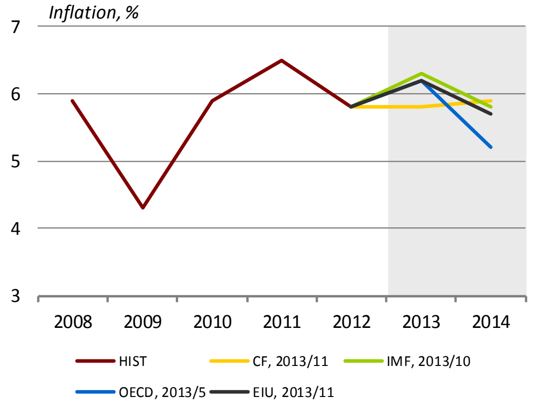
Note: Legend shows latest forecast data in format "Source, year/month" of forecast publication. HIST: historical values. ECB and Fed: midpoint of range. Arrow indicates direction of revision of newly published forecast. If no arrow is shown, no new forecast was available in previous month or by cut-off date in current month. Asterisk indicates first published forecast for given year.
[Cut-off date for data: 15 November 2013)
Source: CF, IMF, OECD, ECB, Fed, DBB, BoJ, CNB calculations.

II.4 Inflation outlook in BRIC countries

As in the case of GDP, current inflation and its forecast are very mixed across the BRIC countries. Despite a very slight increase, the inflation outlook in China remains well below the government's target although inflation in October was the highest since February 2013. Inflation also accelerated in Russia, for the first time in five months. Nevertheless, its outlook for this year and the next remained broadly unchanged. Despite this, analysts believe that Russia's central bank cannot boost the slowly growing economy by lowering rates due to the threat of high inflation. Inflation is also a major issue in Brazil where it stands just below the upper boundary of the tolerance band and is driven mainly by food prices. However, analysts note that inflation in Brazil cannot be halted by higher interest rates only but structural reforms on the supply side will be necessary. The highest inflation of the emerging countries under review is recorded in India. Owing to the weak rupee and food and fuel prices, it surged to its eight-month high (10.1%) in October. High interest rates, which must therefore be maintained by India's central bank, hamper investment activity in the country and thus slow the economy.

Brazil

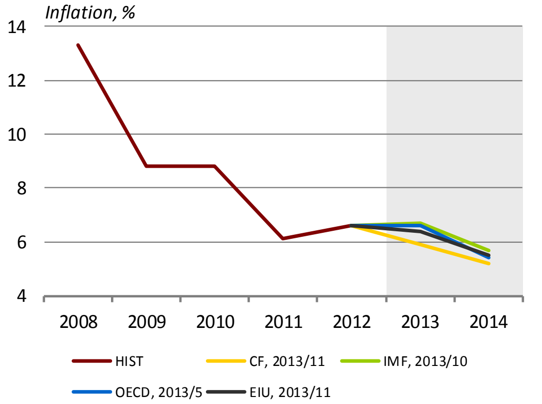
Inflation, %



	CF		IMF	OECD	EIU	
2013	5.8	→	6.3	6.2	6.2	→
2014	5.9	↗	5.8	5.2	5.7	→

Russia

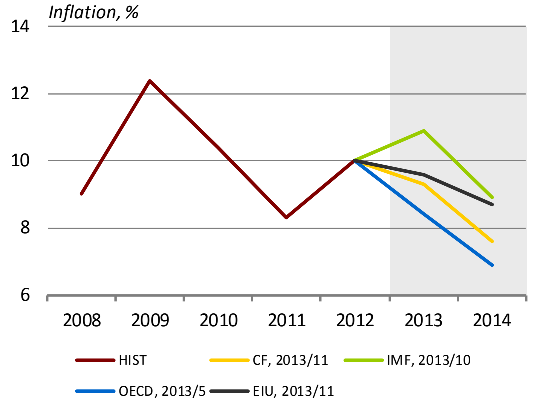
Inflation, %



	CF		IMF	OECD	EIU	
2013	5.9	→	6.7	6.6	6.4	→
2014	5.2	↘	5.7	5.4	5.5	→

India

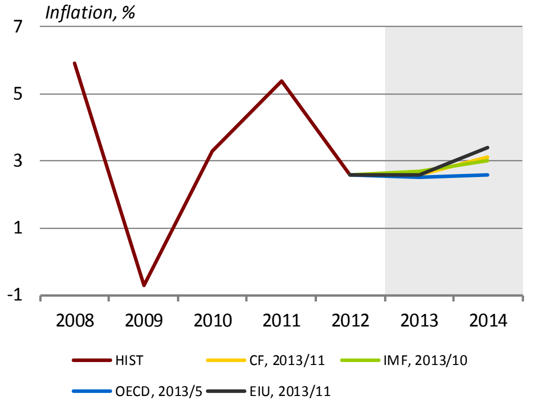
Inflation, %



	CF		IMF	OECD	EIU	
2013	9.3	↗	10.9	8.4	9.6	→
2014	7.6	→	8.9	6.9	8.7	→

China

Inflation, %

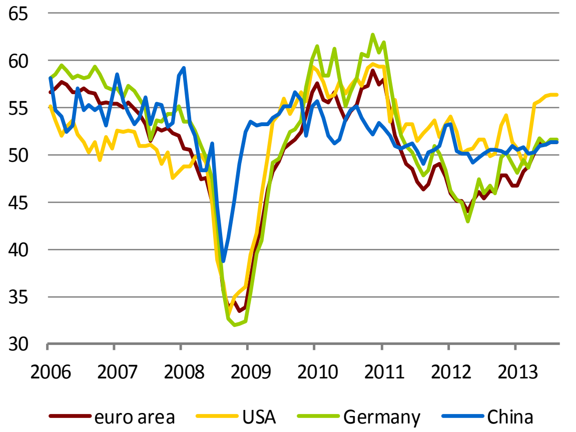


	CF		IMF	OECD	EIU	
2013	2.6	→	2.7	2.5	2.6	→
2014	3.1	→	3.0	2.6	3.4	→

Note: Legend shows latest forecast data in format "Source, year/month" of forecast publication. HIST: historical values. Arrow indicates direction of revision of newly published forecast. If no arrow is shown, no new forecast was available in previous month or by cut-off date in current month. Asterisk indicates first published forecast for given year.
[Cut-off date for data: 15 November 2013)
Source: CF, IMF, OECD, EIU, CNB calculations.

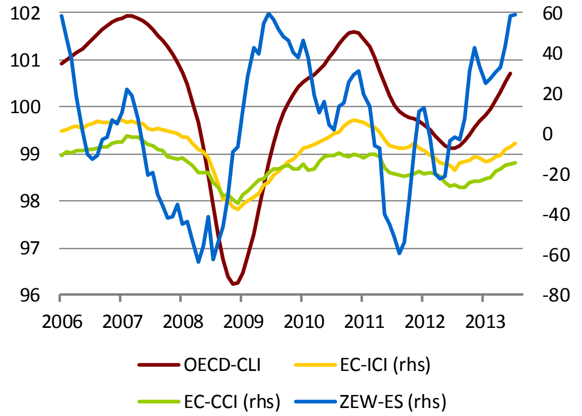
Based on the monitored leading indicators in October (very small changes in both directions with a slightly more significant decline in consumer confidence), the current relatively fast economic growth (compared to Europe) accompanied by a slight slowdown in consumer demand growth can be expected to continue in the United States. All the monitored leading indicators edged up in the euro area, which suggests a continuation of the current insignificant economic growth which may accelerate somewhat. Leading indicators in Germany were flat or edged up. Their developments suggest continued fairly strong GDP growth (compared to other euro area countries). In China, the PMI (Purchasing Managers' Index) in industry increased for the fourth time in a row, signalling a slight acceleration of the current economic growth rate.

PMI in manufacturing



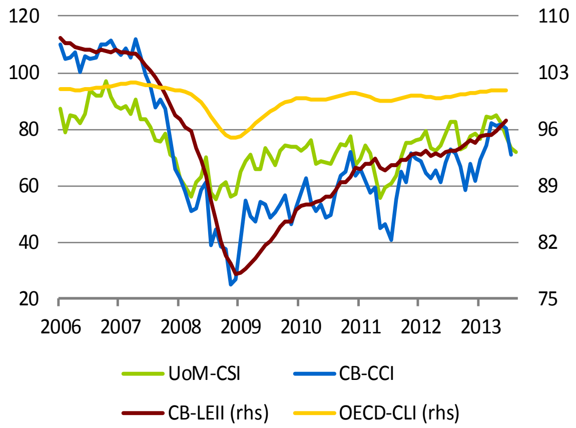
	EA	US	DE	CN
8/13	51.4	55.7	51.8	51.0
9/13	51.1	56.2	51.1	51.1
10/13	51.3	56.4	51.7	51.4

Euro area



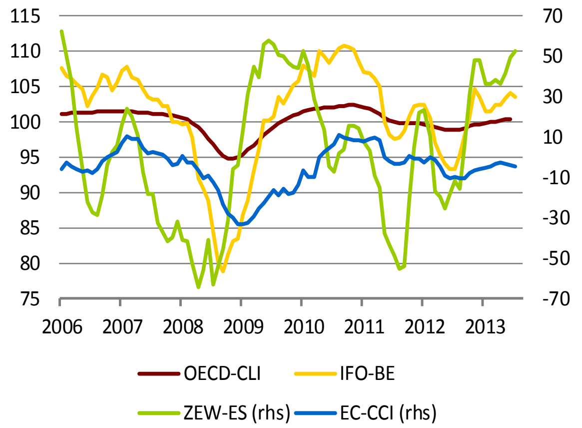
	OECD-CLI	EC-ICI	EC-CCI	ZEW-ES
8/13	100.5	-7.8	-15.6	44
9/13	100.7	-6.6	-14.9	58.60
10/13		-4.8	-14.5	59.10

USA



	CB-LEII	OECD-CLI	UoM-CSI	CB-CCI
8/13	96.4	100.8	82.1	81.8
9/13	97.1	100.7	77.5	80.2
10/13			73.2	71.2

Germany



	OECD-CLI	IFO-BE	ZEW-ES	EC-CCI
8/13	100.4	103.3	42.0	-3.4
9/13	100.5	104.2	49.6	-4.0
10/13		103.6	52.8	-4.2

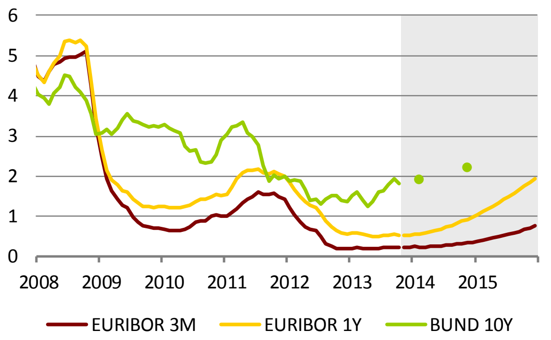
Note: **PMI** = Purchasing Manager Index (50); **OECD-CLI** = OECD Composite Leading Indicator (100); **EC-ICI** = European Commission Industrial Confidence Indicator (0); **EC-CCI** = European Commission Consumer Confidence Indicator (0); **ZEW-ES** = ZEW Economic Sentiment (0); **CB-LEII** = Conference Board Leading Economic Indicator Index (2004 = 100); **UoM-CSI** = University of Michigan Consumer Sentiment Index (Dec 1966 = 100); **CB-CCI** = Conference Board Consumer Confidence Index (1985 = 100); **IFO-BE** = IFO Business Expectations (2005 = 100). Values in parentheses indicate the index threshold between expected economic expansion and decline or the period as of which the index was normalised. [Cut-off date for data: 13 November 2013)
Source: OECD, EC, IFO, Conference Board, University of Michigan, CNB calculations.

IV.1 Interest rate outlook in the euro area and the USA

Short-term euro rates were flat in October and the 1Y EURIBOR showed even a slight increase at the end of the month. Market rates could already reflect a further decrease in excess liquidity, which dropped to the lowest level since September 2011 (EUR 186 billion). In early November, however, the ECB lowered its key rate by 25 bp to 0.25% and decided on further three-month longer-term refinancing operations until mid-2015. As a result, the one-year rate fell to 0.5% while the shift in the 3M rate was negligible. The outlook based on implied rates also shifted lower and the central bank did not rule out the possibility of a further lowering in the key rate and the use of other instruments.

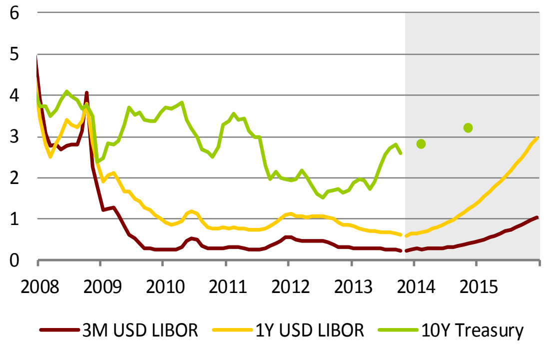
The decline in LIBOR dollar rates continued at both maturities into October but halted at the start of November. The new forecast remained broadly unchanged for the 1Y LIBOR, being only slightly lower for the 3M rate. CF11 did not change the outlooks for 10Y US Treasury yields, while reducing the outlook for the 10Y German bond by 0.1 pp at the three-month horizon and increasing the outlook for the rates by 0.3 pp at the one-year horizon.

EURO AREA



	10/13	11/13	06/14	12/14	06/15	12/15
3M EURIBOR	0.23	0.22	0.27	0.36	0.52	0.76
1Y EURIBOR	0.54	0.53	0.69	0.99	1.41	1.94
	10/13	11/13	02/14	11/14		
10Y Bund	1.81		1.9	2.2		

USA



	10/13	11/13	06/14	12/14	06/15	12/15
3M USD LIBOR	0.24	0.24	0.30	0.43	0.69	1.05
1Y USD LIBOR	0.62	0.60	0.86	1.34	2.04	2.97
	10/13	11/13	02/14	11/14		
10Y Treasury	2.60		2.8	3.2		

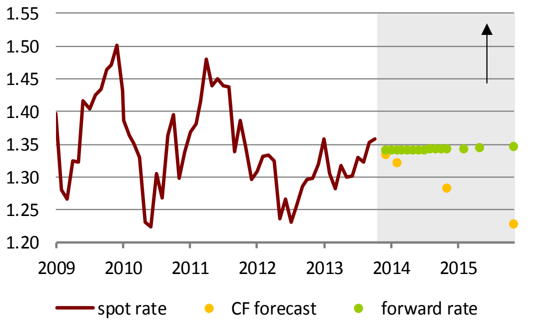
Note: Forecasts for EURIBOR and LIBOR rates are based on implied rates from interbank market yield curve (FRA rates are used from 4M to 15M and adjusted IRS rates for longer horizons). Forecasts for German and US government bond yields (10Y Bund and 10Y Treasury) are taken from CF. [Cut-off date for data: 11 November 2013]
Source: Thomson Reuters (Datastream), Bloomberg, Consensus Forecasts, CNB calculations.

IV.2 Outlook for selected exchange rates

The dollar depreciated against the euro in September and October but the trend reversed in November. The probability of monetary policy tightening in the United States increased when employment indicators improved further and growth also edged up in Q3. Conversely, the surprising decrease in inflation and new unemployment data in the euro area suggest that the recovery is not that strong, to which the central bank responded by lowering its key rate. Subsequently, the euro depreciated against the dollar to USD 1.33 against the euro and according to CF11, it is expected to depreciate by more than 4% at the one-year horizon. The exchange rate of the dollar against the yen showed no clear trend in October. Despite a partial success of previous actions, market surveys show that the willingness of companies to invest and expand is relatively small. Conversely, consumer confidence decreased in light of the expected tax increase. The exchange rate of the pound against the dollar also stabilised after the speed of recovery of the UK economy was above expectations. The exchange rate of the euro against the Swiss franc saw no major changes in October.

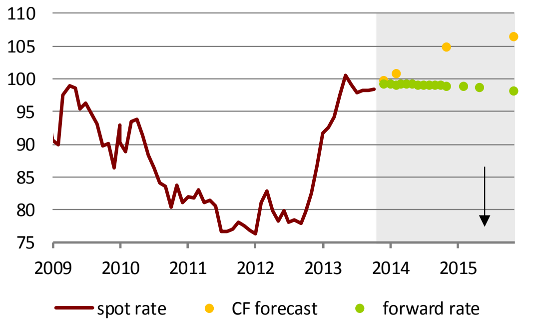
The exchange rates of the BRIC countries' currencies (except China) against the dollar saw no clear trend in October, while depreciating in November. Concerns re-emerged that these countries will have to face capital outflows in connection with the Fed's actions. However, the developments have so far been moderate compared to 2013 Q2. A depreciation of the Indian currency was fostered by the central bank's decision to reduce the supply of dollars to refineries. Speculation whether the central bank would terminate currency swaps contributed to a depreciation of the Brazilian real. The Chinese renminbi appreciated significantly against the dollar, as the central bank shifted the central parity. Nevertheless, further actions towards full convertibility as well as internationalisation of the currency, which are being addressed in Focus, can be expected only after the Communist Party of China congress. Russia's central bank wants to improve internationalisation of the currency by means of a new symbol for the Russian rouble.

US$ per Euro



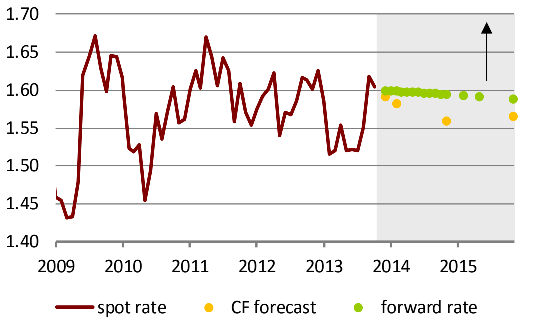
	11/11/13	12/13	02/14	11/14	11/15
spot rate	1.341				
CF forecast		1.334	1.321	1.282	1.227
forward rate		1.341	1.341	1.342	1.346

Yen per US$



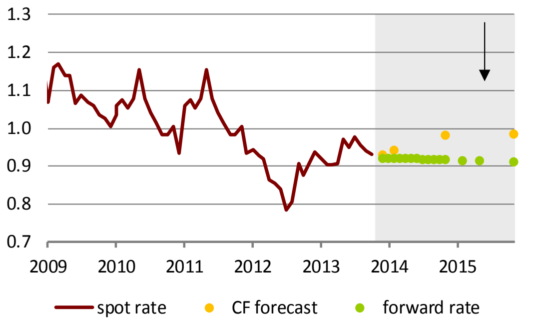
	11/11/13	12/13	02/14	11/14	11/15
spot rate	99.16				
CF forecast		99.61	100.70	104.70	106.30
forward rate		99.15	98.99	98.86	98.02

US$ per UK£



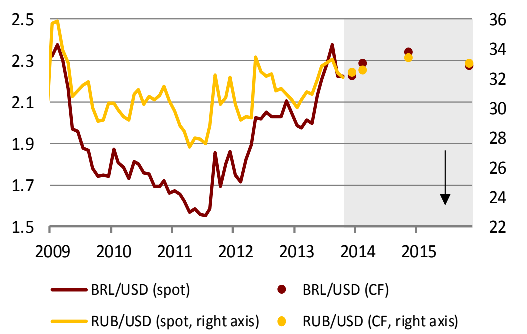
	11/11/13	12/13	02/14	11/14	11/15
spot rate	1.599				
CF forecast		1.590	1.582	1.558	1.565
forward rate		1.599	1.598	1.594	1.587

Swfr per US$



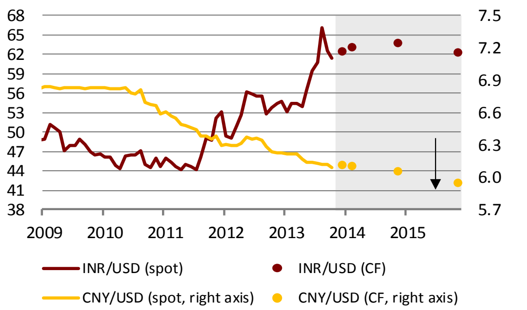
	11/11/13	12/13	02/14	11/14	11/15
spot rate	0.919				
CF forecast		0.927	0.940	0.980	0.983
forward rate		0.919	0.919	0.916	0.909

BRAZILIAN REAL, RUSSIAN ROUBLE



	11/11/13	12/13	02/14	11/14	11/15
BRL/USD (spot)	2.33				
BRL/USD (CF)		2.23	2.29	2.34	2.28
RUB/USD (spot)	32.76				
RUB/USD (CF)		32.42	32.58	33.38	33.01

INDIAN RUPEE, CHINESE RENMINBI



	11/11/13	12/13	02/14	11/14	11/15
INR/USD (spot)	63.27				
INR/USD (CF)		62.37	62.99	63.71	62.28
CNY/USD (spot)	6.12				
CNY/USD (CF)		6.11	6.10	6.05	5.95

Note: Arrow indicates currency appreciation against US dollar. Exchange rates as of last day of month. Forward rate does not represent outlook; it is based on covered interest parity, i.e. currency of country with higher interest rate is depreciating. Forward rate represents current (as of cut-off date) possibility of hedging future exchange rate. [Cut-off date for data: 14 November 2013)
Source: Thomson Reuters (Datastream), Bloomberg, Consensus Forecasts, CNB calculations.

V.I Oil and natural gas

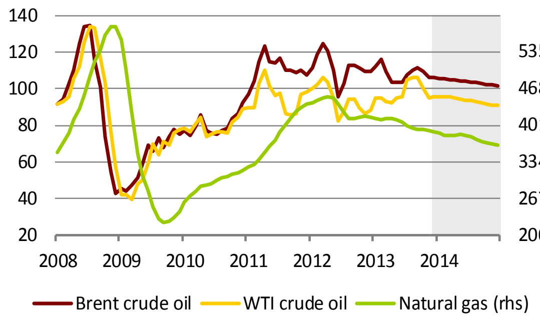
The price of Brent crude oil saw no major movements in October, averaging USD 109/b. It fell below USD 107/b at the start of November and fluctuated around this level (which is similar to the oil price a year ago) until mid-November. The price of WTI crude oil showed an even larger decline and the spread between the two benchmarks widened further, to an almost 6-month maximum. The price decline was due mainly to sufficient oil supplies and oil processing businesses' lower demand for seasonal reasons; on the other hand, Brent crude oil was supported by better data from China and still considerable geopolitical tensions. Futures prices also fell slightly from the previous month, despite the Fed's unchanged monetary policy.

OPEC revised slightly upwards the outlook for global demand for 2013, due mainly to higher than expected actual demand from OECD countries and some African countries. Demand is expected to increase by 0.9 million and 1.04 million barrels a day this year and the next respectively. Similarly, the IEA expected a slightly higher increase in demand – about 1 mb/d and 1.1 mb/d in 2013 and 2014 respectively as the situation in the global economy improves.

According to OPEC, the volume of oil supplies from non-OPEC countries should rise by 1.2 mb/d, which is slightly more than in the previous report. According to the IEA, a fall in extraction was recorded for the third consecutive month, especially in Saudi Arabia. According to preliminary data, although commercial oil inventories in OECD countries rose by 7.5 million barrels, their level is below the five-year average.

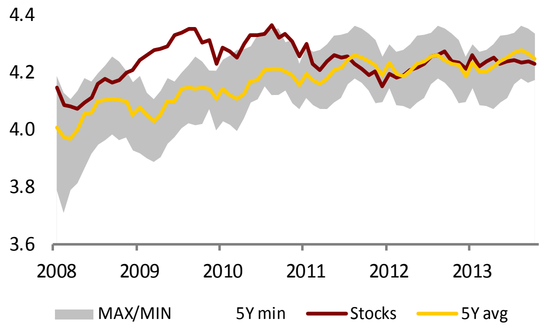
The outlook for Brent prices based on futures is decreasing and the prices should be just below USD 100/b at the one-year horizon. The EIA does not expect the price of oil to show major changes until the end of 2013; it should be at USD 107/b on average in Q4. The average price should drop further to USD 102/b in 2014. The November CF expects the price to stand at USD 106.4/b at the end of November 2014.

OUTLOOK FOR PRICES OF OIL AND NATURAL GAS

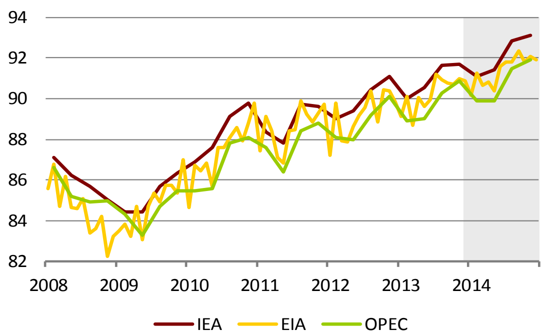


	Brent	WTI	Natural gas
2013	-3.11	3.88	-6.71
2014	-4.06	-4.46	-6.20

TOTAL STOCKS OF OIL AND OIL PRODUCTS IN OECD

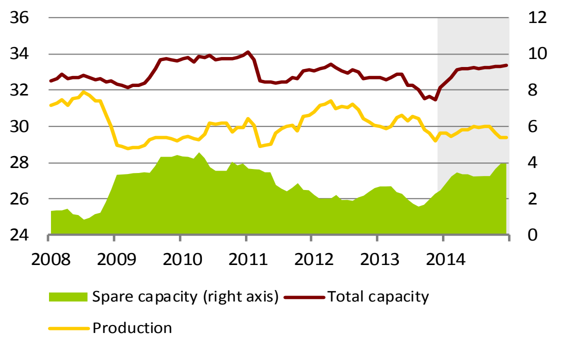


GLOBAL CONSUMPTION OF OIL AND OIL PRODUCTS



	IEA	EIA	OPEC
2013	1.10	1.21	1.04
2014	1.23	1.26	1.14

PRODUCTION, TOTAL AND SPARE CAPACITY IN OPEC COUNTRIES



	Production	Total capacity	Spare capacity
2013	-2.74	-2.33	3.60
2014	-1.07	2.72	54.35

Note: Oil price in USD/barrel, price of Russian natural gas at German border in USD/1,000 m3 (IMF data, smoothed by the HP filter). Future oil prices (grey area) are derived from futures and future gas prices are derived from oil prices using model. Tables show annual percentage changes. Total oil stocks (commercial and strategic) in OECD countries including average, maximum and minimum in past five years in billions of barrels. Global consumption of oil and oil products in millions of barrels a day. Production and extraction capacity of OPEC in million barrels a day (EIA estimate). [Cut-off date for data: 14 November 2013)
Source: Bloomberg, IEA, EIA, OPEC, CNB calculations

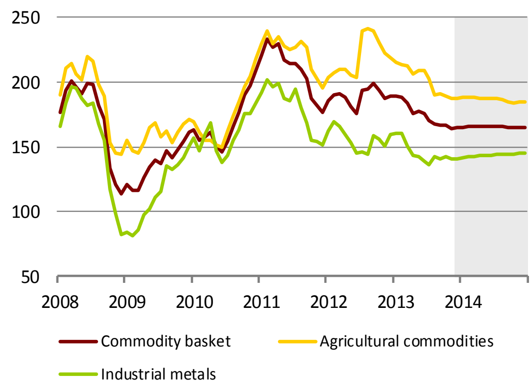
V.2 Other commodities

The overall non-energy commodity price index was flat in October as a slight decline in prices of food commodities was offset by a slight increase in industrial metal prices. No dramatic fluctuations are expected for the overall non-energy commodity price index over the outlook horizon.

Industrial metals have been affected by relatively positive economic data from advanced economies and China in recent months and a similar effect is expected in their outlook. Concerns regarding changes in monetary policy settings by the Fed are having an opposite effect on prices. Overall, an economic recovery should be accompanied by only a slight rise in metal prices. Prices of aluminium, nickel and zinc recorded the largest increases in this category in October.

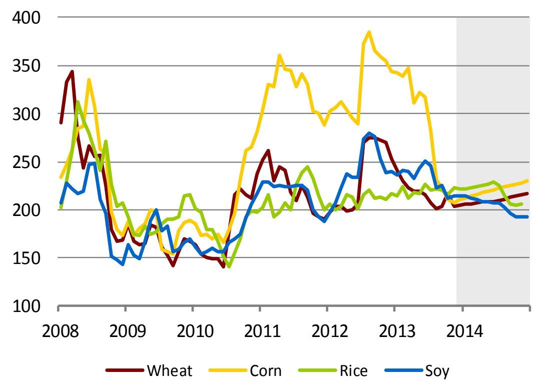
As regards food commodities, the largest decreases were recorded by soy beans and maize, while prices of wheat and sugar increased. Prices of wheat, maize and coffee are expected to increase over the outlook horizon, while the price of soy beans is expected to drop. The price of rubber declined again slightly after three months and cotton also showed a slight decline. The prices of these two commodities are slightly increasing over the outlook horizon.

PRICES OF NON-ENERGY COMMODITIES



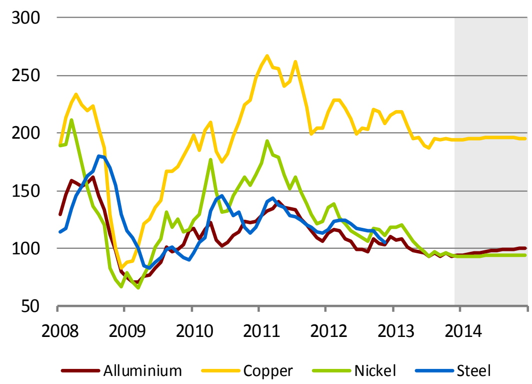
	Overall	Agricultural	Industrial
2013	-7.9	-8.2	-6.9
2014	-5.0	-7.3	-1.0

FOOD COMMODITIES



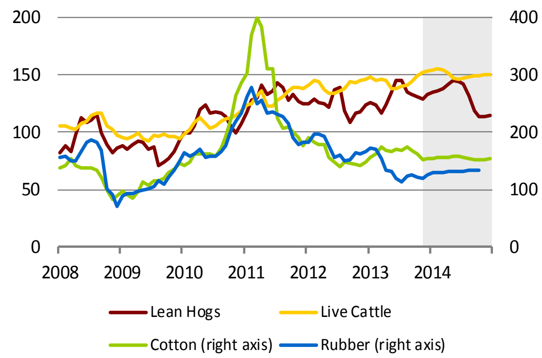
	Wheat	Corn	Rice	Soy
2013	-8.5	-16.2	4.2	-4.0
2014	-2.4	-20.6	-0.5	-12.0

METALS



	Aluminium	Copper	Nickel
2013	-8.4	-7.6	-14.4
2014	0.1	-1.5	-8.0

MEAT, NON-FOOD AGRICULTURAL COMMODITIES



	Lean hogs	Live Cattle	Cotton	Rubber
2013	6.0	3.2	3.9	-21.6
2014	-0.1	3.6	-6.1	

Note: Structure of non-energy commodity price indices corresponds to composition of The Economist commodity indices. All prices are given as indices, 2005 = 100 (charts) and percentage changes (tables). [Cut-off date for data: 14 November 2013)
Source: Bloomberg, CNB calculations.

The internationalisation of the renminbi[1]

One of the processes that may change the global currency market over the coming decades is China's efforts to promote the use of its currency (the renminbi) in international transactions, i.e. to internationalise the renminbi. In the short period since reforms were launched in 2009, the renminbi has gained ground in regional transactions, as the Chinese way is based on developing offshore centres and on taking gradual steps in the regulation of financial flows. However, the use of the Chinese currency on the global scale remains low because of China's specific exchange rate regime, lack of openness to capital flows and underdeveloped financial market.

Introduction

The development of the Chinese economy over the last decade has largely reflected a pro-growth state policy focused on foreign trade. However, recent years have seen growing efforts to make the economy more market-oriented. Under one reform, the Chinese currency, the renminbi (RMB),[2] will be made freely tradable: the exchange rate against the dollar will be market determined and capital flows will be significantly liberalised. Given China's large share in international trade (see the next section), this raises the question of whether such steps will also lead to greater internationalisation of the renminbi, i.e. use of the currency in international transactions, particularly between non-residents (Kenen, 2011).

But is China's significance in international trade a sufficient parameter for evaluating its degree of currency internationalisation? In reality, an international currency performs more than one task. First there is the aforementioned significance of the country of origin in <u>international trade</u>. Another aspect is the use of the currency in <u>international financial transactions</u>. Besides free movement of capital and a developed financial sector, it is crucial to have a <u>sufficient stock of domestic debt instruments</u>. The last factor is whether the currency is used as a reserve one. This is a moot point, as the <u>status of reserve currency</u> is rather specific, but the currency's share in central banks' reserves clearly indicates the significance such institutions attach to it. The following three sections try to assess to what extent the renminbi performs these tasks.

Currency internationalisation offers major advantages to domestic exporters, who benefit from the transfer of exchange rate risk to their counterparties in trade and financial transactions (Eichengreen, 2013). Similarly, domestic financial institutions can enter the global financial system without facing exchange rate risk. Governments can benefit from issuing abroad in the domestic currency, but the change in the country's international status is also significant. On the other hand, the disadvantages include the impossibility of maintaining a fixed exchange rate regime and regulating capital mobility, the sensitivity of the exchange rate to sentiment on foreign currency markets, and the greater demands placed on the stability of the domestic financial system.

1. Exchange rate regime and two renminbi markets

The main prerequisite for wide use of a currency in international transactions is full convertibility and a free exchange rate regime, i.e. the ability to trade in the currency without limitations. The RMB regime since 2005 can be characterised as a managed float, with a clear appreciation trend against the US dollar. The long-term process of reforming the exchange rate system hinges on capital flow liberalisation and has

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[2] The renminbi is the name generally used for the Chinese currency, while the yuan is the currency unit.

necessitated several extraordinary measures. One example is the establishment of the following two independent markets for the renminbi (and thus partial convertibility):

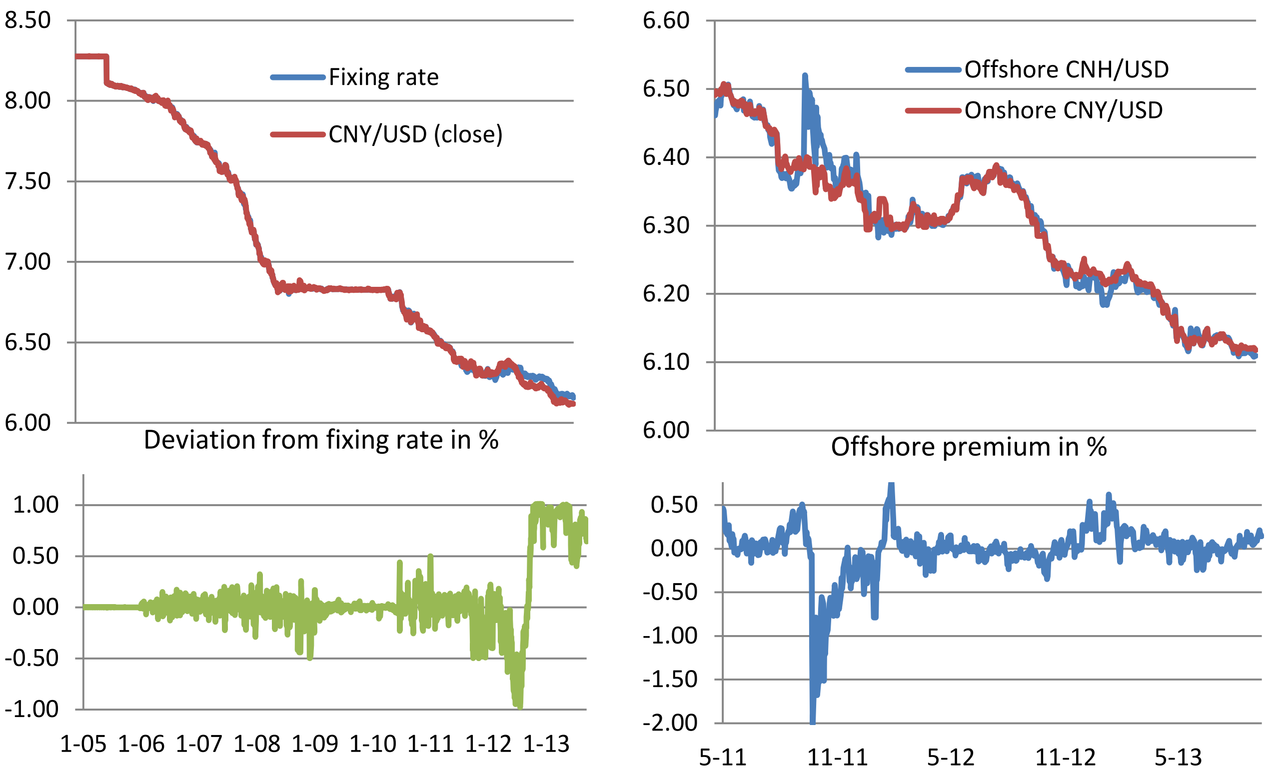
The onshore market (CNY exchange rate)

- This market is based in Mainland China and is fully regulated, since 2005 as a managed float. The China Foreign Exchange Trade System (CFETS), authorised by the People's Bank of China (PBC), sets the central parity rate (or "fixing rate") for the renminbi against the US dollar on a daily basis. The exchange rate is allowed to fluctuate within a band of ±0.5% around the central parity (or even ±1% between April 2012 and August 2013; it is by widening the band that China wants achieve greater exchange rate flexibility). The left-hand side of Figure VI-1 shows the deviation from the fixing rate. A large deviation from the fixing rate at the end of the day indicates appreciation/depreciation pressure.
- The central parity is subject to adjustment and since mid-2005 the renminbi has appreciated by 38% against the US dollar. Besides the dollar, eight other currencies may be traded against RMB (Ballantyne, Garner and Wright, 2013) in several segments (spots, forwards, swaps, cross-currency swaps and currency options). Most trading, including that in derivatives, is in the CNY/USD pair. According to CFETS data, the average monthly spot market turnover in January–August 2013 was USD 327 billion, with CNY/USD accounting for 92%.

<u>Figure VI-1: RMB exchange rate on the onshore and offshore markets</u>

a) Onshore market and deviation from fixing rate

b) Onshore market vs. offshore market



Source: Datastream, CNB calculations.

The offshore market (CNH exchange rate)

- This market, within which the renminbi is fully convertible, was established in 2011 and is concentrated in four RMB centres (Hong Kong, Macau, Singapore and Taiwan). Each centre has a designated bank for clearing with the onshore market in order to keep the two exchange rates close to each other. Foreign financial flows affect the offshore exchange rate and give rise to a premium (see the right-hand side of Figure VI-1). A number of other financial centres (e.g. London and Paris) are linked to the offshore market and are allowed to trade in RMB deposits.

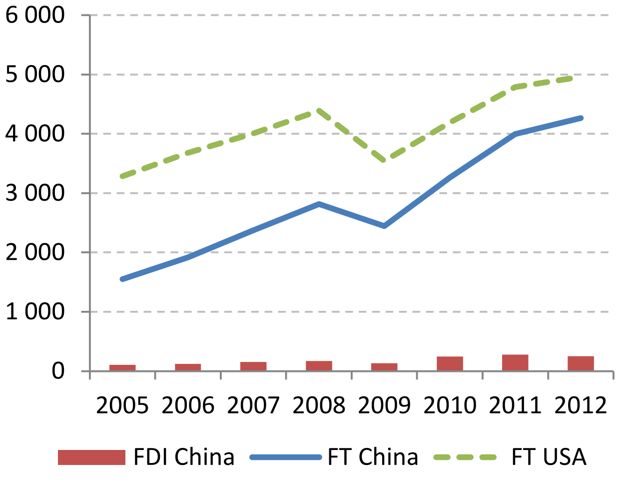
The growth of the offshore market is reflected in the renminbi's global status. According to the latest BIS study (April 2013), the Chinese currency is now the ninth most traded currency in the world. With daily trades of USD 120 billion it has overtaken the Swedish krona and the NZ dollar and accounts for 2.2% of daily turnover on global currency markets. Other sources confirm the growing role of the renminbi. According to SWIFT data, the Chinese currency ranked 11th among the currencies used for international payments, with a share of 0.87%. The year-on-year increase in payments in this currency was 5.5%. France and the UK were the most important partners in Europe.

2. The significance of China and its currency in international trade

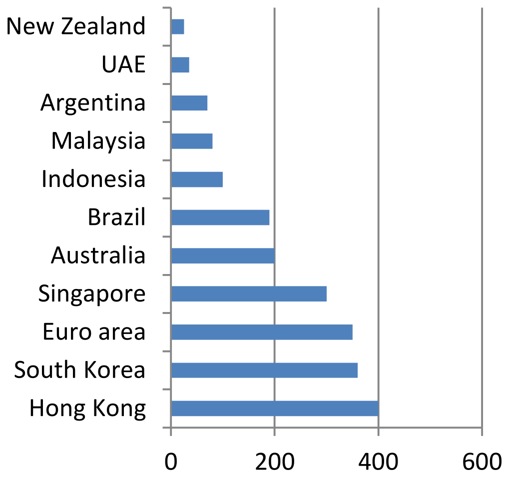
In 2010, China overtook Japan to become the second largest economy in the world, with a share of almost 10% of global GDP. Compared to China's economic significance, however, the renminbi's role in international trades is small. For this reason, the Chinese central bank launched a pilot scheme for RMB trade settlement in 2009. In 2012, RMB transactions with Hong Kong exceeded USD 413 billion, i.e. 90% of total trades settled in RMB.[3] This is still a very low proportion compared with overall trade in goods and services (see Figure VI-2).

Figure VI-2: China's involvement in international trade and RMB promotion

a) Foreign trade (FT) and foreign direct investment (FDI) (USD billions)



b) Selected bilateral currency swaps (CNY billions)



Note: UAE – United Arab Emirates

Source: IMF IFS, central banks, CNB calculations.

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[3] http://www.hkma.gov.hk/media/eng/doc/key-functions/monetary-stability/rmb-business-in-hong-kong/hkma-rmb-booklet.pdf

To increase RMB liquidity and enhance offshore trading, the central bank has signed a number of bilateral currency swap agreements (see the right-hand side of Figure VI-1). These agreements may also be used to settle RMB transactions, as announced for example by the South Korean central bank. The three largest facilities (Hong Kong, South Korea, Singapore) have all been used to some extent. The newly introduced direct trading in selected currencies (see the previous section) should also support direct trading in RMB.

The fact that the USA is China's largest trading partner and that the dollar is still the preferred currency for US firms is also important for the future development of the renminbi's use in trade transactions. On the other hand, Western Union statistics suggest a tendency towards the Chinese currency. US firms' RMB transactions rose by 90% year on year in the first half of 2013. These payments accounted for 12% of all US payments to China (compared to 8.5% last year).

3. Liberalisation of capital flows and development of the financial system

China's capital openness is relatively low by international comparison. Its capital flows are incomparable with its trade flows (see Figure VI-2) and consist essentially only of foreign direct investment. Portfolio and other investment is minimal. However, capital flow liberalisation is an important goal for the reforming China (as declared in its 12th five-year plan). This goal is being implemented gradually, often with the use of pilot programmes in offshore centres (hubs). The projects are expanding and RMB financial flows are increasing as confidence in the programmes grows.

Hong Kong, which currently represents the biggest pool of RMB funds outside Mainland China, is playing a key role in testing the liberalisation of capital flows and the development of the financial system. The development of RMB trade settlement has resulted in a sharp increase in RMB deposits on the offshore market. RMB deposits in Hong Kong grew more than 52 times between 2005 and 2013 and now account for more than 20% of all deposits in that country (see the left-hand side of Figure VI-3). The stock of certificates of deposit has also grown sharply. Together with deposits they amounted to USD 137 billion at the end of April. RMB loans and RMB bonds totalled almost half of this amount in the same period. Further development of financial products will also be supported by a recently introduced CNH interbank rate (CNH HIBOR).

Access to onshore markets and trading in Chinese assets in the domestic currency is much more complicated. Hong Kong is again the exception, as institutions based there can invest in a limited range of onshore assets subject to a quota (currently USD 15 billion). This has created a direct link between the onshore and offshore financial markets in the form of portfolio investment. Direct interbank integration is still in the pilot phase. Interbank loans are subject to caps (short-term) or approval (long-term).

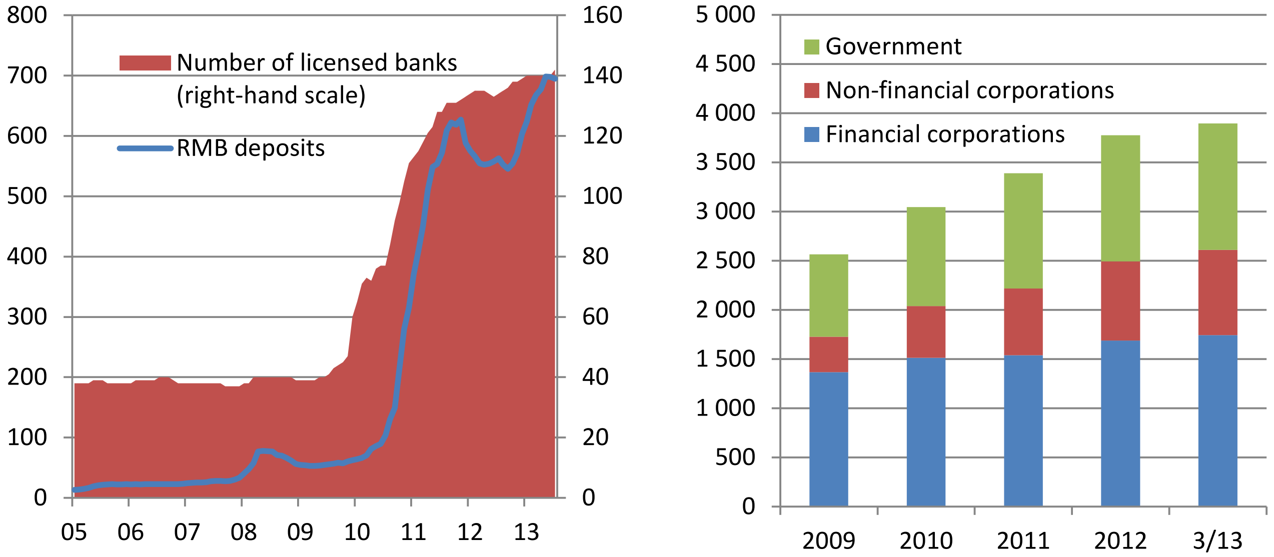
Foreign investors can invest directly in China under the Qualified Foreign Institutional Investor (QFII) programme. A 3-month minimum holding and a cap of USD 150 billion on total holdings apply. In December 2012, the restrictions were lifted for central banks, sovereign wealth funds and investment companies. Similarly, only foreign central banks are allowed to freely enter the interbank bond market in addition to the QFII scheme.

The small volume of portfolio flows also reflects China's underdeveloped debt markets. Domestic lending is ensured by an extensive banking system, with debt instruments providing far less financing (see the right-hand side of Figure VI-3). For comparison, the USA's domestic debt exceeded USD 25 trillion in 2010.

The development of the bond market is also important from the perspective of central banks considering depositing part of their foreign exchange reserves in renminbi. Central banks have much easier access to such assets than private investors, but insufficient convertibility makes it impossible to regard RMB investments as proper reserves. One important motive for holding reserves is liquidity. Consequently, the renminbi has not benefited as much as the Australian dollar and the Canadian dollar from the current reserve portfolio diversification trend.

Figure VI-3: Selected RMB financial assets

a) Deposits in Hong Kong (RMB billions) b) Domestic debt by issuer (USD billions)



Source: Datastream, Bank for International Settlements, CNB calculations.

To sum up, the renminbi does not yet meet all the conditions for an "international currency". It is not widely used in trade and financial transactions and does not have reserve currency status. Nonetheless, a substantial change has been visible since 2009, when the internationalisation process was launched, and the renminbi is starting to gain ground. The specific Chinese way is based on pilot programme testing, exchange rate reforms and the development of an offshore RMB market, with an effort to avoid the mistake of opening up to capital flows too quickly. Further progress with liberalisation will require not only a successful offshore market, but also development of the domestic bond market and reform of the banking sector (including solving the problem of shadow banking), as well as further appreciation of the renminbi against the dollar.

China's interest in promoting this status and speeding up reforms in recent years are of key importance going forward, but the road ahead will be difficult. China faced a tricky situation in June 2013, when the USA announced its exit from the monetary stimulus. The subsequent capital outflow affected domestic liquidity (among other factors), forcing the central bank to intervene and narrow the exchange rate fluctuation band. The outcome is also uncertain, as the case of Japan shows. In the 1980s, the Japanese government set itself the objective of achieving greater internationalisation of the yen. Although the Japanese currency became a "safe haven", only 40% of Japanese exports and 20% of imports are currently settled in the yen.

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ANNEXES

A1. Change in GDP predictions for 2013

	CF		IMF		OECD		CB / EIU	
EA	-0.1	2013/11 2013/10	0.2	2013/10 2013/7	-0.5	2013/5 2012/11	0.2	2013/9 2013/6
US	0.1	2013/11 2013/10	-0.1	2013/10 2013/7	-0.1	2013/5 2012/11	-0.3	2013/9 2013/6
DE	0.0	2013/11 2013/10	0.2	2013/10 2013/7	-0.2	2013/5 2012/11	-0.1	2013/6 2012/12
JP	0.0	2013/11 2013/10	0.0	2013/10 2013/7	0.9	2013/5 2012/11	0.0	2013/11 2013/7
BR	0.0	2013/11 2013/10	0.0	2013/10 2013/7	-1.1	2013/5 2012/11	0.0	2013/11 2013/10
RU	-0.2	2013/11 2013/10	-1.0	2013/10 2013/7	-1.5	2013/5 2012/11	-0.3	2013/11 2013/10
IN	0.0	2013/11 2013/10	-1.8	2013/10 2013/7	-1.2	2013/5 2012/11	0.0	2013/11 2013/10
CN	0.0	2013/11 2013/10	-0.2	2013/10 2013/7	-0.7	2013/5 2012/11	0.2	2013/11 2013/10

A2. Change in inflation predictions for 2013

	CF		IMF		OECD		CB/EIU	
EA	-0.1	2013/11 2013/10	-0.2	2013/10 2013/4	-0.1	2013/5 2012/11	0.1	2013/9 2013/6
US	0.0	2013/11 2013/10	-0.4	2013/10 2013/4	-0.2	2013/5 2012/11	0.1	2013/9 2013/6
DE	0.0	2013/11 2013/10	0.0	2013/10 2013/4	-0.3	2013/5 2012/11	0.1	2013/6 2012/12
JP	0.0	2013/11 2013/10	-0.1	2013/10 2013/4	0.4	2013/5 2012/11	0.0	2013/11 2013/7
BR	0.0	2013/11 2013/10	0.2	2013/10 2013/4	0.9	2013/5 2012/11	0.0	2013/11 2013/10
RU	0.0	2013/11 2013/10	-0.2	2013/10 2013/4	0.2	2013/5 2012/11	0.0	2013/11 2013/10
IN	0.3	2013/11 2013/10	0.1	2013/10 2013/4	0.7	2013/5 2012/11	0.0	2013/11 2013/10
CN	0.0	2013/11 2013/10	-0.3	2013/10 2013/4	1.0	2013/5 2012/11	0.0	2013/11 2013/10

A3. List of abbreviations

BoJ	Bank of Japan
BR	Brazil
BRIC	Brazil, Russia, India and China
CB-CCI	Conference Board Consumer Confidence Index
CB-LEII	Conference Board Leading Economic Indicator Index
CBOT	Chicago Board of Trade
CF	Consensus Forecasts
CN	China
CNB	Czech National Bank
DBB	Deutsche Bundesbank
DE	Germany
EA	euro area
EC	European Commission
ECB	European Central Bank
EC-CCI	European Commission Consumer Confidence Indicator
EC-ICI	European Commission Industrial Confidence Indicator

EIU	The Economist Intelligence Unit database
EEA	European Economic Area
ES	Spain
EU	European Union
EMI	European Monetary Institute
EURIBOR	Euro Interbank Offered Rate
Fed	Federal Reserve System (the US central bank)
FRA	forward rate agreement
GBP	pound sterling
GDP	gross domestic product
GR	Greece
CHF	Swiss franc
ICE	Intercontinental Exchange
IE	Ireland
IFO	Institute for Economic Research
IFO-BE	IFO Business Expectations
IMF	International Monetary Fund
IN	India
IRS	interest rate swap
IT	Italy
JP	Japan
JPY	Japanese yen
LIBOR	London Interbank Offered Rate
N/A	not available
OECD	Organisation for Economic Co-operation and Development
OECD-CLI	OECD Composite Leading Indicator
PMI	Purchasing Managers' Index
PT	Portugal
RU	Russia
UoM	University of Michigan
UoM-CSI	University of Michigan Consumer Sentiment Index
US	United States
USD	US dollar
ZEW-ES	ZEW Economic Sentiment

A4. List of thematic articles published in GEO

2013

	Issue
The internationalisation of the renminbi (Soňa Benecká)	2013-11
Unemployment during the crisis (Oxana Babecká a Luboš Komárek)	2013-10
Drought and its impact on food prices and headline inflation (Viktor Zeisel)	2013-9
The effect of globalisation on deviations between GDP and GNP in selected countries over the last two decades (Vladimír Žďárský)	2013-8
Competitiveness and determinants of travel and tourism (Oxana Babecká)	2013-7
Annual assessment of the forecasts included in GEO (Filip Novotný)	2013-6
Apartment price trends in selected CESEE countries and cities (Michal Hlaváček and Luboš Komárek)	2013-5
Selected leading indicators for the euro area, Germany and the United States (Filip Novotný)	2013-4
Financial stress in advanced economies (Tomáš Adam and Soňa Benecká)	2013-3
Natural gas market developments (Jan Hošek)	2013-2
Economic potential of the BRIC countries (Luboš Komárek and Viktor Zeisel)	2013-1

2012

	Issue
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