

GLOBAL ECONOMIC OUTLOOK – SEPTEMBER

Monetary and Statistics Department
External Economic Relations Division

2011

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Authors:	Oxana Babecká	II.
	Milan Klíma	III.
	Jan Hošek	VI.
	Soňa Benecká	V.
	Jan Hošek	IV.
	Luboš Komárek	Summary
	Oxana Babecká	Focus
	Soňa Benecká	Current topic
Editors:	Oxana Babecká	
	Martin Motl	
Editor-in-Chief:	Luboš Komárek	

The September issue of the Global Economic Outlook presents recent and expected developments in selected countries from the point of view of standard indicators such as GDP, inflation, leading indicators, interest rates, exchange rates and commodity prices. The regular detailed analysis (section VII *Focus*) provides a description of the *Monetary policy of the central bank of the Russian Federation*. Given the fairly turbulent situation, this issue also features a section VIII *Current topic* entitled *Where to look for a safe haven currency*.

The global economy is not in the best of shape. According to most current outlooks, its three strongest components, i.e. the economies of the USA, the euro area and China, can expect a slowdown in economic growth. This situation is being exacerbated by growing financial market tensions reflecting the still disappointing solutions to the internal problems of the USA and in particular the euro area. A relatively sharp fall in output is also projected for Germany, the previous driver of the euro area economy. A look at the monitored leading indicators, which all deteriorated compared to August, does not yield any more optimism. The inflation outlook is broadly unchanged for the advanced economies, but remains elevated for China, which could lead to faster appreciation of the renminbi.

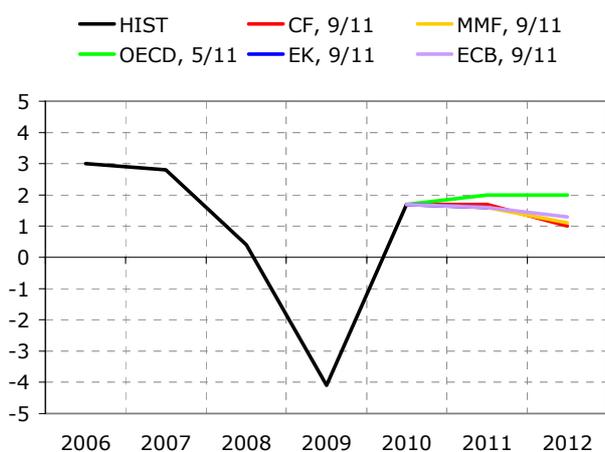
The interest rate outlooks are still being revised downwards; yields on the long-term government bonds of the least risky countries (Germany and the USA) have fallen particularly significantly, as has their outlook for the one-year horizon. In the euro area, the outlook for three-month and one-year interbank rates has also declined owing to the planned provision of liquidity. These rates should even start to decrease from their current levels. By contrast, the outlook for the USD/EUR exchange rate is unchanged owing to risks in both the euro area and the USA.

Commodity markets still reflect concerns regarding the expected decline in global demand. This is reflected in falling outlooks for prices of oil and industrial metals. The outlooks for food commodity prices remain elevated.

II.1 GDP

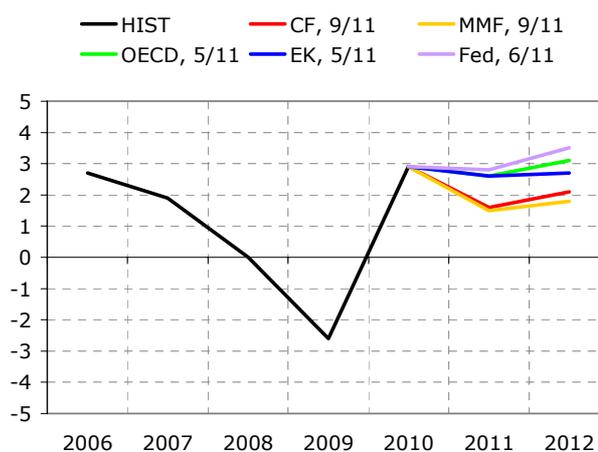
The new forecasts of CF, the Commission, the ECB and the IMF reveal a deteriorating outlook for economic activity in most of the countries and regions monitored in the GEO. This is due on the one hand to a slowdown of the global economy and on the other hand to adverse internal factors (disappointing recent macroeconomic data from advanced economies, growing financial market tensions, and problems and ambiguities relating to public finances in the euro area and the USA). The forecasts published in September expect GDP to grow by 1.6–1.7% in 2011 and to slow to 1.0–1.3% in 2012. Germany will grow by 2.7–2.9% this year but slow to 1.3% next year. The US economy will grow by 1.5–1.6% this year and 1.8–2.1% the next. Economic growth in China is expected to be 9.1–9.5% in 2011 and 8.6–9.0% in 2012.

EURO AREA



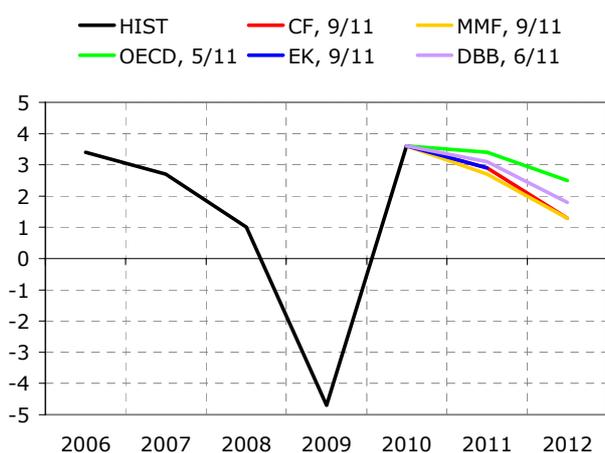
	HIST	CF	MMF	OECD	EK	ECB
2010	1.7					
2011		1.7	1.6	2.0	1.6	1.6
2012		1.0	1.1	2.0		1.3

USA



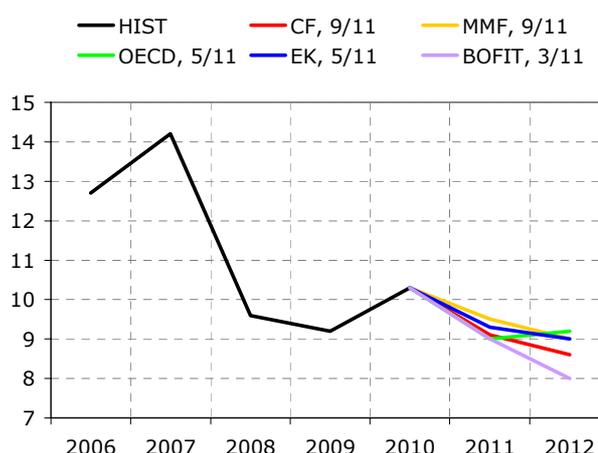
	HIST	CF	IMF	OECD	EC	Fed
2010	2.9					
2011		1.6	1.5	2.6	2.6	2.8
2012		2.1	1.8	3.1	2.7	3.5

GERMANY



	HIST	CF	MMF	OECD	EK	DBB
2010	3.6					
2011		2.9	2.7	3.4	2.9	3.1
2012		1.3	1.3	2.5		1.8

CHINA



	HIST	CF	MMF	OECD	EK	BOFIT
2010	10.3					
2011		9.1	9.5	9.0	9.3	9.0
2012		8.6	9.0	9.2	9.0	8.0

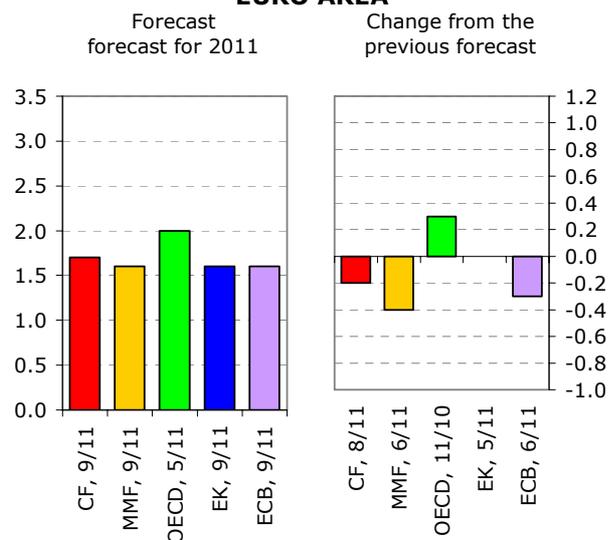
Note: Legend shows latest forecast data in format "Source, month/year of forecast publication". HIST: historical value. ECB and Fed: midpoint of range. [Cut-off date for data: 20 September 2011]

Source: CNB calculation using Eurostat, CF, IMF, OECD, EC, ECB, Fed, DBB and BOFIT databases.

II.2 Current GDP forecast and change from the previous forecast

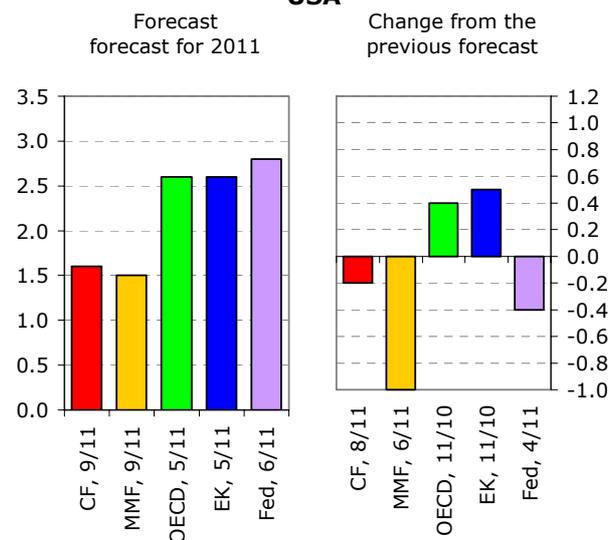
The September CF, ECB and Commission forecasts reduced the outlook for economic growth this year by 0.1–0.5 p.p. for all monitored countries and regions except for the Commission’s forecast for Germany, which was increased by 0.3 p.p. According to the Commission, Germany’s current annual GDP growth has so far been driven “mechanically” by a fast recovery of the economy at the start of the year. The Commission expects weaker economic growth in H2 compared to the May forecast. The IMF’s forecast was lowered by 0.4 p.p. for the euro area, by 0.5 p.p. for Germany, by 1.0% for the United States and by 0.1 p.p. for China.

EURO AREA



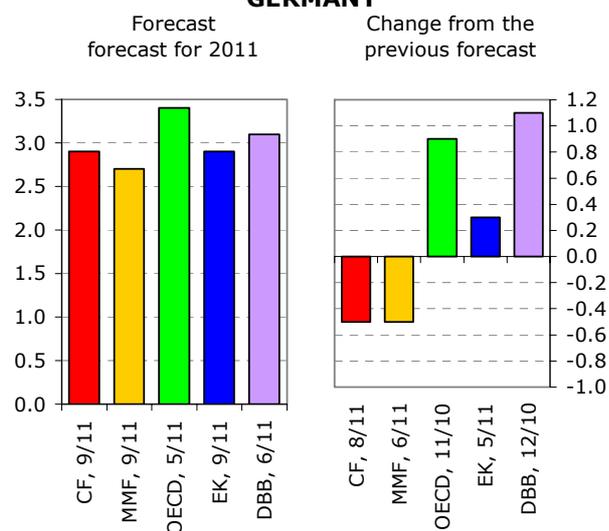
	2010	CF	MMF	OECD	EK	ECB
Forecast	1.7	1.7	1.6	2.0	1.6	1.6
Change		-0.2	-0.4	0.3	0.0	-0.3

USA



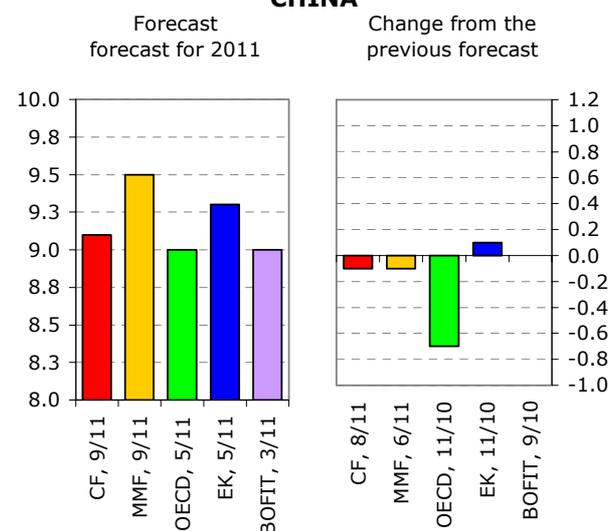
	2010	CF	MMF	OECD	EK	Fed
Forecast	2.9	1.6	1.5	2.6	2.6	2.8
Change		-0.2	-1.0	0.4	0.5	-0.4

GERMANY



	2010	CF	MMF	OECD	EK	DBB
Forecast	3.6	2.9	2.7	3.4	2.9	3.1
Change		-0.5	-0.5	0.9	0.3	1.1

CHINA



	2010	CF	MMF	OECD	EK	BOFIT
Forecast	10.3	9.1	9.5	9.0	9.3	9.0
Change		-0.1	-0.1	-0.7	0.1	0.0

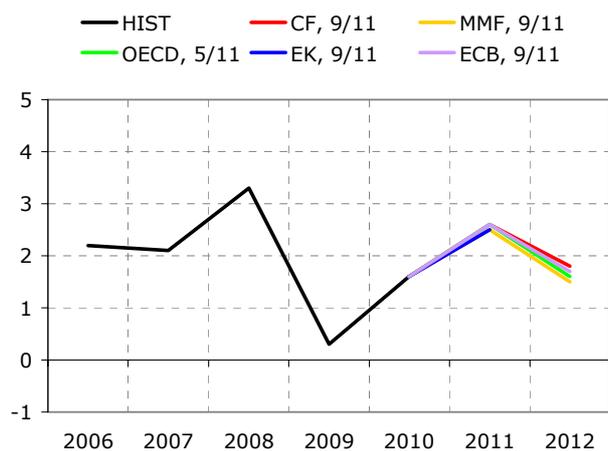
Note: Horizontal axis of left-hand (right-hand) chart shows latest (previous) forecast data in format “Source, month/year of forecast publication”. HIST: historical value. ECB and Fed: midpoint of range. [Cut-off date for data: 20 September 2011]

Source: CNB calculation using Eurostat, CF, IMF, OECD, EC, ECB, Fed, DBB and BOFIT databases.

II.3 Inflation

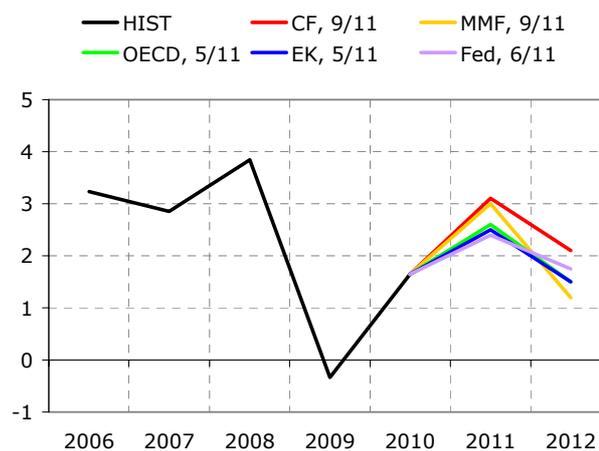
The inflation pressures caused by the commodity price growth in 2011 Q1 are gradually abating. According to the latest forecasts (CF, ECB, Commission, IMF), inflation in the euro area and Germany will reach 2.2–2.6% this year but should not exceed 1.3–1.9% in 2012. According to CF and the IMF, consumer prices in the USA will rise by 3.0–3.1%; a pronounced slowdown (to 1.2–2.1%) is expected next year. Inflation in China will be around 5.3–5.5% this year and is expected to decline to 3.3–3.9% in 2012 (CF, IMF).

EURO AREA



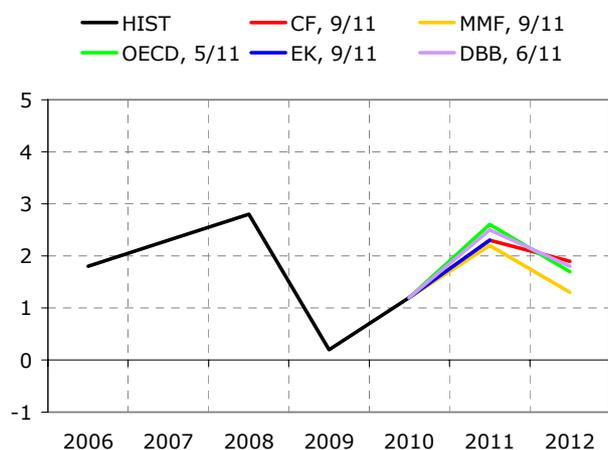
	HIST	CF	MMF	OECD	EK	ECB
2010	1.6					
2011		2.6	2.5	2.6	2.5	2.6
2012		1.8	1.5	1.6		1.7

USA



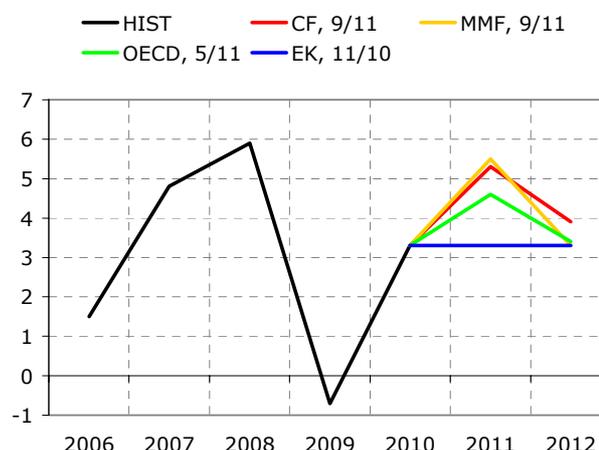
	HIST	CF	MMF	OECD	EK	Fed
2010	1.6					
2011		3.1	3.0	2.6	2.5	2.4
2012		2.1	1.2	1.5	1.5	1.8

GERMANY



	HIST	CF	MMF	OECD	EK	DBB
2010	1.2					
2011		2.3	2.2	2.6	2.3	2.5
2012		1.9	1.3	1.7		1.8

CHINA



	HIST	CF	MMF	OECD	EK
2010	3.3				
2011		5.3	5.5	4.6	3.3
2012		3.9	3.3	3.4	3.3

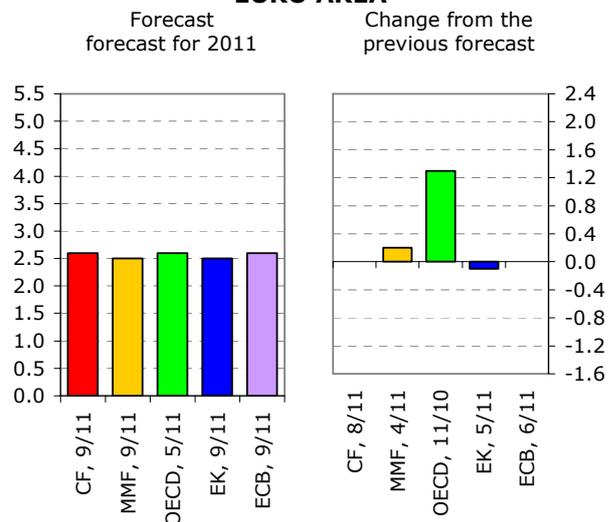
Note: Legend shows latest forecast data in format "Source, month/year of forecast publication". HIST: historical value. ECB and Fed: midpoint of range. [Cut-off date for data: 20 September 2011]

Source: CNB calculation using Eurostat, CF, IMF, OECD, EC, ECB, Fed, DBB and BOFIT databases.

II.4 Inflation forecast and change from the previous forecast

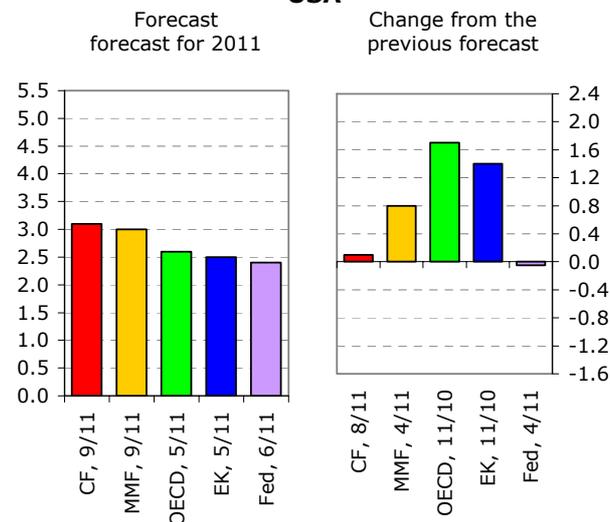
The changes to the outlooks for inflation in the euro area and Germany show no clear trend this year: the Commission revised its outlook downwards, while the IMF expects higher inflation in the euro area and the CF and ECB forecasts were left unchanged. CF and the IMF revised inflation in the United States upwards. According to CF, inflation in China next year will remain at the level of the August outlook. The IMF increased its outlook for 2011.

EURO AREA



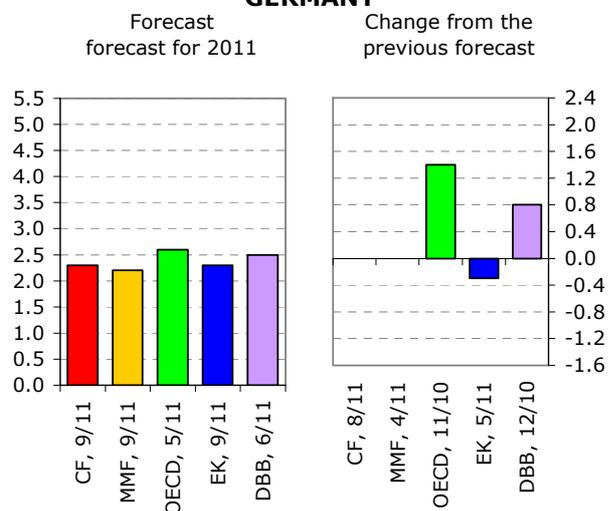
	2010	CF	MMF	OECD	EK	ECB
Forecast	1.6	2.6	2.5	2.6	2.5	2.6
Change		0.0	0.2	1.3	-0.1	0.0

USA



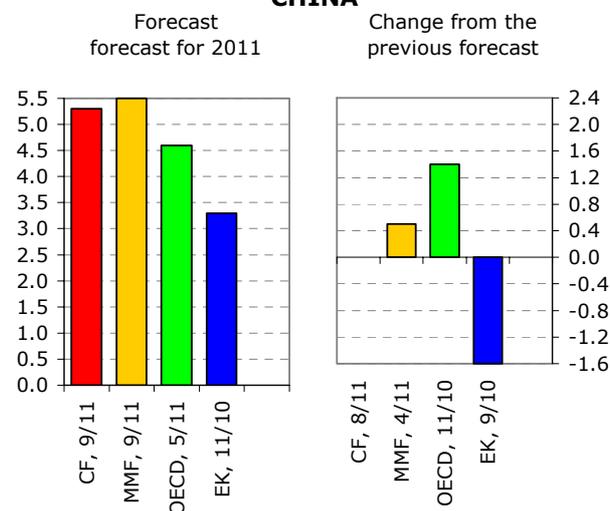
	2010	CF	MMF	OECD	EK	Fed
Forecast	1.6	3.1	3.0	2.6	2.5	2.4
Change		0.1	0.8	1.7	1.4	-0.1

GERMANY



	2010	CF	MMF	OECD	EK	DBB
Forecast	1.2	2.3	2.2	2.6	2.3	2.5
Change		0.0	0.0	1.4	-0.3	0.8

CHINA



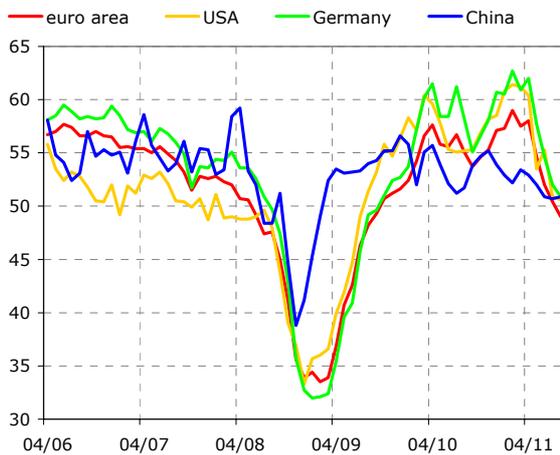
	2010	CF	MMF	OECD	EK
Forecast	3.3	5.3	5.5	4.6	3.3
Change		0.0	0.5	1.4	-1.6

Note: Horizontal axis of left-hand (right-hand) chart shows latest (previous) forecast data in format "Source, month/year of forecast publication". HIST: historical value. ECB and Fed: midpoint of range. [Cut-off date for data: 20 September 2011]

Source: CNB calculation using Eurostat, CF, IMF, OECD, EC, ECB, Fed, DBB and BOFIT databases.

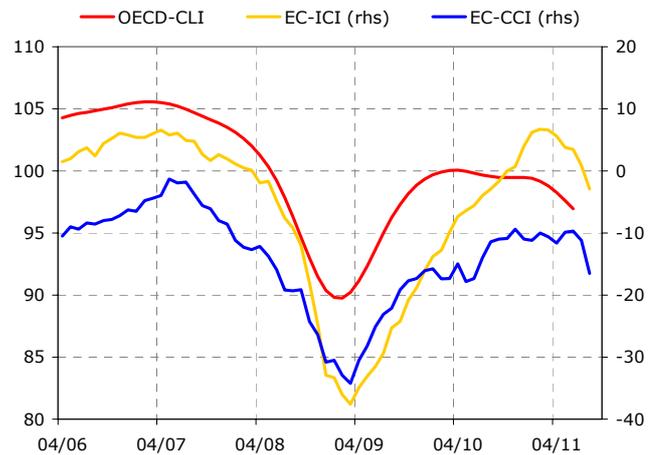
The estimates for the evolution of the global economy in 2011 H2 deteriorated further in September. The PMI (Purchasing Managers' Index) in industry fell below its August level in all the countries under review and even below 50 points (the level dividing future growth from decline) to 49 points in the euro area. The exception is China, where the index edged up, returning to its July level of 50.9 points. Other leading indicators also declined in the USA, the euro area and Germany, with the fall in the consumer confidence indicators being particularly pronounced. This is confirmed by the September CF, which signals a downturn in consumption in these economies.

PMI IN MANUFACTURING



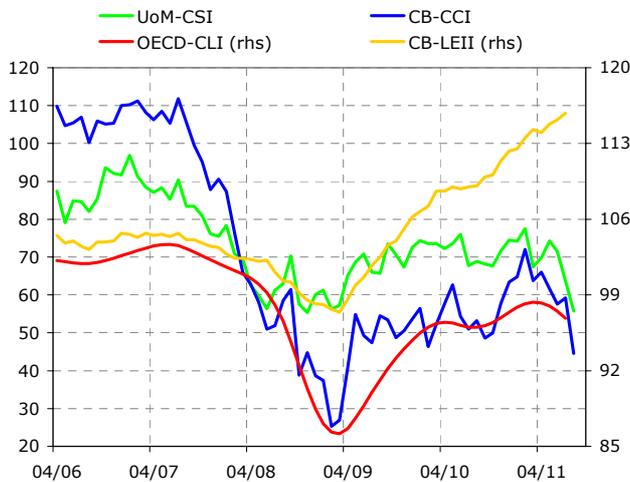
	EA	US	DE	CN
6/11	52.0	55.3	54.6	50.9
7/11	50.4	50.9	52.0	50.7
8/11	49.0	50.6	50.9	50.9

EURO AREA



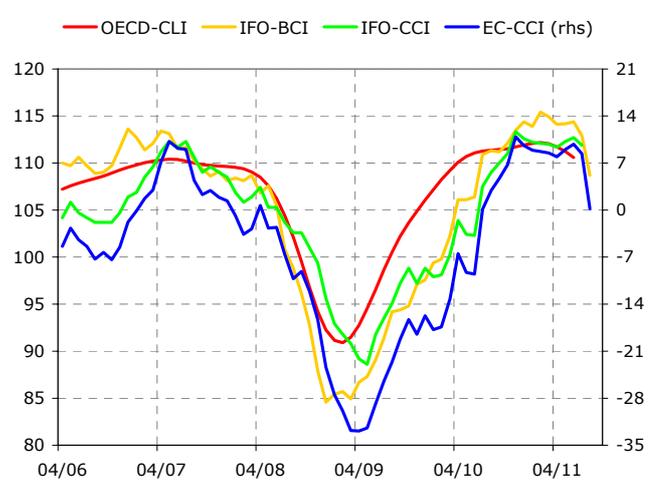
	OECD-CLI	EC-ICI	EC-CCI
6/11	96.9	3.5	-9.7
7/11		0.9	-11.2
8/11		-2.9	-16.5

USA



	OECD-CLI	CB-LEII	UoM-CSI	CB-CCI
6/11	97.5	115.2	71.5	57.6
7/11	96.8	115.8	63.7	59.2
8/11			55.7	44.5

GERMANY



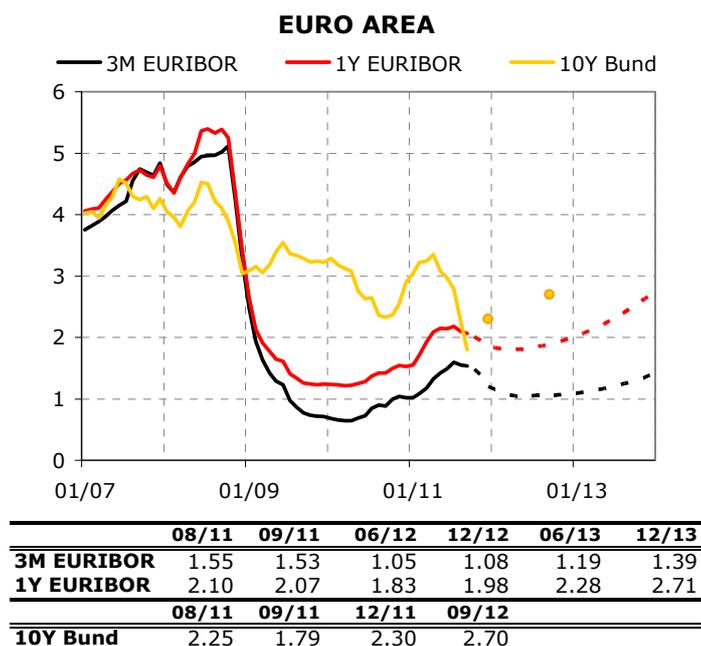
	OECD-CLI	IFO-BCI	IFO-CCI	EC-CCI
6/11	110.6	114.4	112.7	9.8
7/11		112.9	111.9	8.4
8/11		108.7	0.0	0.2

Note: OECD-CLI stands for OECD Composite Leading Indicator, EC-ICI (right-hand scale) for European Commission Industrial Confidence Indicator, EC-CCI (right-hand scale) for EC Consumer Confidence Indicator, CB-LEII for Conference Board Leading Economic Indicator, CB-CCI for CB Consumer Confidence Index, UoM-CSI for University of Michigan Consumer Sentiment Index, IFO-BCI for Institute for Economic Research – Business Climate Index, and IFO-CCI for IFO Consumer Confidence Index. [Cut-off date for data: 16 September 2011]

Source: CNB calculation using OECD, EC, IFO and UoM databases.

IV.1 Outlook for short-term and long-term interest rates: Euro area

At its September meeting the ECB left its key refinancing rate at 1.5%. In a subsequent communication it changed its assessment of the inflation and growth risks, confirming the market's opinion that rates would not be raised in the near future. The 3M and 1Y EURIBOR rates thus remained broadly flat at their late-August levels in the first half of September. However, the outlook based on market contracts shifted back to lower levels over the entire forecast horizon, fairly significantly so for the 1Y maturity. The 3M EURIBOR should therefore fall until 2012 Q2 (below 1.1%) and then increase only gradually. The 1Y rate is expected to fall to just above 1.8% and later increase more sharply. The 10Y German government bond yield responded to the ECB's worse forecast and the increased uncertainty in financial markets with a further fast decline to 1.7% in early September. Although CF09 significantly reduced its future outlook, it still expects growth of 2.3% at the 3M horizon and 2.7% at the 1Y horizon.

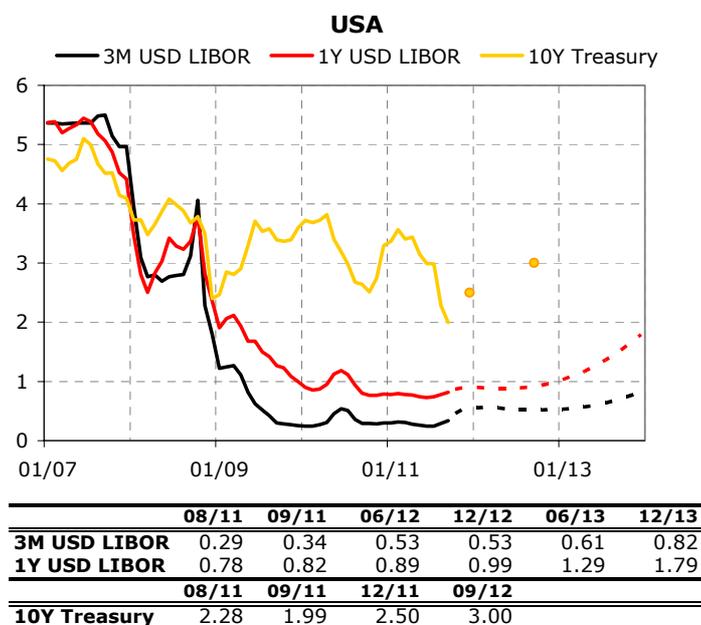


Note: Forecast for EURIBOR rates is based on rates implied by interbank market yield curve (FRA rates are used from 4M to 15M and adjusted IRS rates for longer horizon). Forecast for German government bond yield (10Y Bund) is derived from CF forecast. Dashed lines and points represent outlook. [Cut-off date for data: 12 September 2011]

Sources: Thomson Reuters (Datastream), Bloomberg, CNB calculations.

IV.2 Outlook for short-term and long-term interest rates: USA

Rates in the USA showed a similar pattern as those in the euro area. The worse outlooks for the US economy are fuelling market expectations that the Fed will continue its low-rate policy for a very long time to come, and a third wave of quantitative easing is not ruled out either. The 3M LIBOR dollar rate rose by about 10 b.p. between early August and mid-September after a long stagnation and is expected to rise further until the end of the year, but it should be flat throughout 2012 before resuming a moderate rise. The same goes for the 1Y LIBOR rate, though it should grow more steeply in 2013. Despite the downgrading of the USA's rating, the 10Y government bond yield continued to drop sharply owing to the increased uncertainty in financial markets; the CF09 forecast also shifted downwards but remains rising.

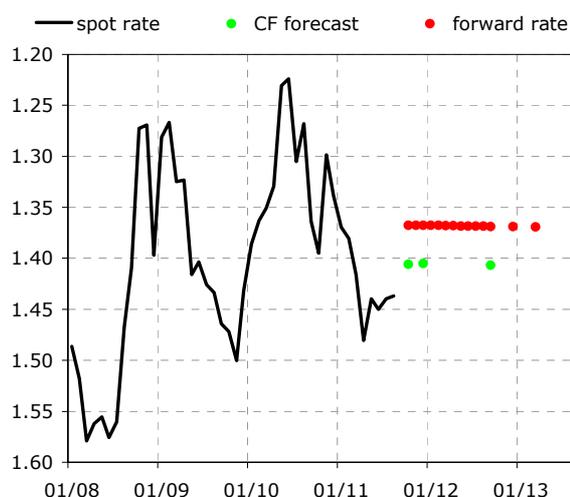


Note: Forecast for 3M and 1Y USD LIBOR rates is based on rates implied by London interbank market yield curve (USD LIBOR rates are used up to 3M, 3M FRA rates up to 15M, and adjusted IRS rates for longer horizon). Forecast for US government bond yield (10Y Treasury) is derived from CF forecast. Dashed lines and points represent outlook. [Cut-off date for data: 12 September 2011]

Sources: Thomson Reuters (Datastream), Bloomberg, CNB calculations.

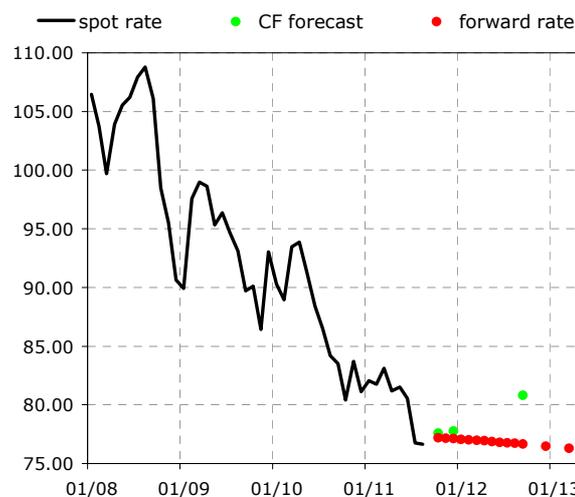
The dollar's appreciation in early September due to the increased financial market uncertainty and the euro area debt crisis affected the euro-dollar exchange rate forecast. The September CF expects the rate to be flat at USD 1.4/EUR until the end of 2011. Further appreciation of the dollar is being prevented by weak US economic growth and the lack of a credible debt reduction plan. As a safe haven currency, the Swiss franc has benefited from the financial market situation (see section VIII *Current topic*). In response to its appreciation, the Swiss central bank has fixed a ceiling of CHF 1.2/EUR on the rate and, according to the new CF, the rate will remain at this level for at least the next three months. The yen is also traditionally perceived by investors as a safe investment. Although the Japanese central bank took no major exchange rate measures, the yen is expected to weaken against the dollar in the months ahead. Depreciation of the pound against the dollar worsened the economic outlook for the UK economy, and the new CF forecast is also less optimistic.

US\$ per Euro



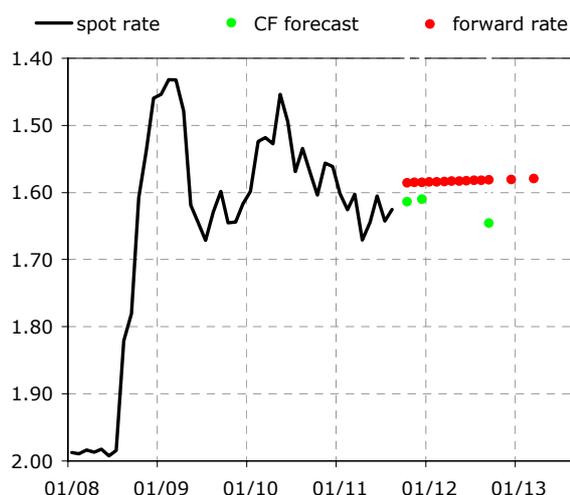
	12/9/11	10/11	12/11	09/12	09/13
spot rate	1.368				
CF forecast		1.406	1.405	1.407	1.354
forward rate		1.368	1.368	1.369	1.368

Yen per US\$



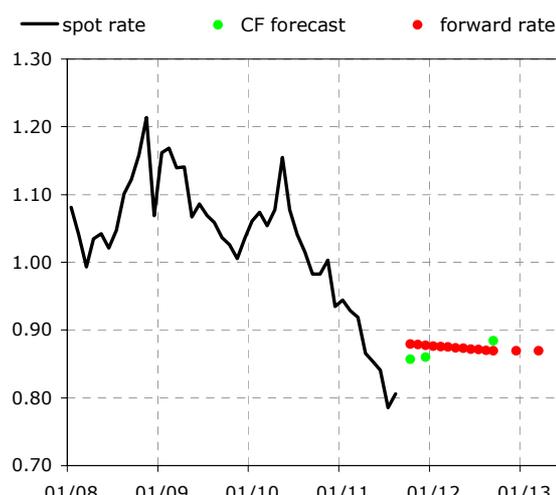
	12/9/11	10/11	12/11	09/12	09/13
spot rate	77.21				
CF forecast		77.57	77.77	80.80	85.67
forward rate		77.18	77.10	76.64	75.85

US\$ per UK£



	12/9/11	10/11	12/11	09/12	09/13
spot rate	1.586				
CF forecast		1.614	1.610	1.646	1.627
forward rate		1.586	1.585	1.582	1.576

Swfr per US\$



	12/9/11	10/11	12/11	09/12	09/13
spot rate	0.880				
CF forecast		0.857	0.860	0.884	0.967
forward rate		0.879	0.877	0.869	0.862

Note: Increase in currency pair represents appreciation of US dollar; data as of the last day of the 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) possibilities for securing future exchange rate. [Cut-off date for data: 15 September 2011] Source: CNB calculation using Bloomberg and Consensus Forecasts databases.

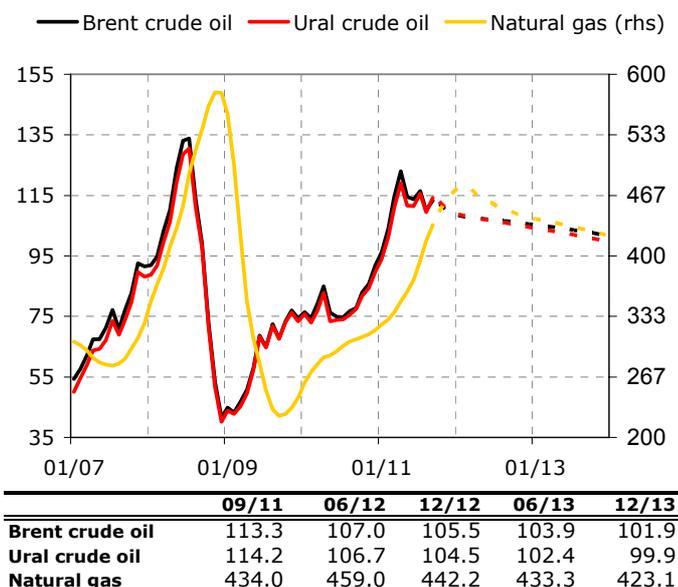
VI.1 Oil and natural gas

After falling sharply in early August, the oil market calmed and the price of Brent oil rose steadily from USD 103.5 to USD 116 a barrel. In mid-September it stabilised at USD 112 a barrel (probably only temporarily). The start of the current forecast is thus about USD 8.5 a barrel higher than the previous one, but the future price curve changed from horizontal to downward-sloping, hence the price expected at the end of 2013 is the same as in the previous forecast (about USD 102 a barrel). A downward-sloping curve of prices of futures contracts on the oil market is normal from the long-term perspective. A steeper slope might signal a temporary supply shortfall. The current decline in international stocks of oil and oil products would be consistent with this. However, this shortfall should subside as Libya's oil gradually returns to the market as expected.

Note: Oil prices in USD/barrel are taken from listings on London-based ICE Futures Europe international exchange. Prices of Russian natural gas at border with Germany in USD/1000 cubic m are calculated using IMF data. Future oil prices are derived from oil futures. Dashed line represents outlook. [Cut-off date for data: 12 September 2011].

Source: Bloomberg, IMF, CNB calculations.

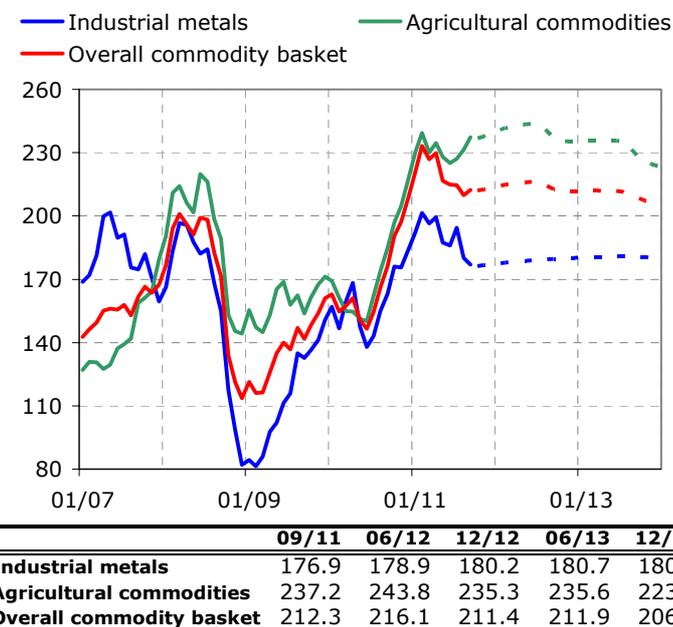
OUTLOOK FOR PRICES OF OIL AND NATURAL GAS



VI.2 Other commodities

Having fallen sharply in early August, prices of metals and agricultural commodities (cotton and rubber) fluctuated only moderately with no visible trend and their outlook was virtually unchanged from the previous month. Food commodities had more dramatic development. Wheat prices rose in the remainder of August but fell back to their early-August level in the first half of September. However, the outlook remains strongly rising. The decline in the price of maize in September was much smaller than the rise in August and the price is thus still near its historical high. A further rise until mid-2012 is expected, but a switch to a sharp fall is expected with the new harvest. Similar price developments can be observed for soy. The price of rice has been rising since early August and the forecast is also rising. The price of sugar is still high but should drop markedly according to the forecast. The price of coffee also remains close to its all-time high, but no major decline is expected. The price of pork dropped sharply in mid-August, but this is nothing unusual for this commodity. By contrast, the price of beef is almost at a historical high and its outlook is rising.

OUTLOOK FOR OTHER COMMODITY PRICES



Note: Chart shows indices, year 2005 = 100. Dashed line represents outlook. [Cut-off date for data: 12 September 2011].

Source: Bloomberg, outlooks based on futures.

MONETARY POLICY OF THE CENTRAL BANK OF THE RUSSIAN FEDERATION¹

Over the last 20 years, Russia has been through a period of transformation, with the emergence and development of a market economy and its institutions. But it has also experienced crises (in 1998 and 2008) that have directly affected monetary policy. Over time, the accuracy of its monetary policy objectives has increased and new instruments have been applied. Monetary policy has both influenced and adapted to the changing economic and financial landscape. The Russian central bank is currently moving towards gradually increasing exchange rate flexibility, strengthening the role of interest rates and switching to full-fledged inflation targeting. This article traces the history of its monetary objectives (part 1) and exchange rate policy (part 2) over the past 20 years and briefly summarises their outcomes and outlook.²

Introduction

The Bank of Russia (BoR) assumed the functions of the central bank of the Russian Federation following the collapse of the Soviet Union and the dissolution of the State Bank of the USSR at the end of December 1991.³ According to Article 1 of the Federal Law on the Central Bank of the Russian Federation and the Constitution of the Russian Federation the central bank performs its functions independently of the state, but the central bank law also requires the BoR to elaborate and pursue monetary policy in collaboration with the government (Article 4). The BoR publishes its monetary policy objectives and tasks every year in a document called "Guidelines for the Single State Monetary Policy". Starting 2009, the monetary policy guidelines are specified for a three-year period. The guidelines for the next year are submitted to the State Duma of the Federal Assembly of the Russian Federation for approval by 1 December.

The Duma appoints the chairman and members of the Board of Directors of the BoR at the proposal of the Russian Federation president and the BoR chairman respectively. It is also entitled to have representatives in the National Banking Board in a set quota. The Board is a collegiate body of the BoR and has 12 members (a chairman and 11 others), of whom two are delegated by the Federation Council, three by the Duma, three by the president and three by the government. Among other things, it considers the draft and final versions of the monetary policy guidelines for the next year and discusses their implementation. The close links with the government limit the room for independent and effective monetary policy. Moreover, monetary policy has been strongly affected (and partly constrained) by economic instability, especially during the 1990s.

¹ The author of this article is Oxana Babecká Kucharčuková (Oxana.Babecka-Kucharcukova@cnb.cz). The views expressed herein are those of the author and do not reflect the official position of the Czech National Bank.

² An empirical analysis of the effectiveness of the BoR's monetary policy is planned for the November issue of GEO.

³ The Russian central bank was founded in 1860, when, at the decree of Alexander II, the State Commercial Bank was converted into the State Bank of the Russian Empire. With the onset of the Communist regime in October 1917 and the nationalisation of commercial banks, the central bank underwent a series of major changes. During the first decade of Soviet rule, its role and functions in the economy shifted from a simple treasury carrying out settlement and other treasury operations in the War Communism period (1918–1921) to a central bank using market instruments in the New Economic Policy period (1921–c.1927), but they were eventually adapted to the needs of the planned economy. Between January 1923 and June 1991, the State Bank of the USSR was the Soviet Union's only central bank. Shortly after the signing of the Declaration of State Sovereignty of the RSFSR (Russian Soviet Federative Socialist Republic), the State Bank of the RSFSR, later renamed the Bank of Russia, started to operate alongside the State Bank of the USSR. On 13 July 1990, the Bank of Russia, accountable to the Supreme Soviet of the RSFSR, was created on the basis of the Russian Republic Bank of the State Bank of the USSR.

1. Monetary policy objectives and priorities

According to the central bank law (Article 3), the BoR's primary objective is to ensure the stability of the national currency. Fulfilment of this objective implies supporting the stability of domestic prices. Curbing inflation was therefore one of the monetary policy priorities of the BoR and the government of the Russian Federation right from the start. However, in 1992–1995 this process was greatly complicated by economic turbulence accompanied by hyperinflation and by the remnants of planned economy (direct lending to the government motivated by federal budget deficit financing and the existence of centralised special-purpose loans to certain sectors).

In the 1990s, the single monetary policy guidelines did not define the primary objective precisely. At that time, the BoR's hierarchy of objectives and priorities was not transparent and the objectives and priorities themselves were hard to distinguish from the monetary policy tasks. The monetary policy priorities were adjusted as the economic environment changed. The 1997 priorities included financial stabilisation, reduction of interest rates, and non-inflationary economic growth; those for 1999 included GDP, the balance of payments and unemployment. Curbing inflation regularly ranked among the priorities. Generally, the 1990s monetary policy priorities were focused on stabilising the economic situation and supporting economic growth. In 1999 and 2000, reducing inflation (along with halting the economic decline and returning to a growth path) was defined by the BoR as the "ultimate objective" of monetary policy. Since 2001, reducing inflation has been the primary monetary policy objective of the Russian Federation.⁴

Although full-fledged inflation targeting is not applied in Russia, the BoR and the government specify a target band for inflation every year; since 2003 the inflation target has been defined for three years, and since 2009 the entire monetary policy has been set for a three-year period. The BoR has focused every year on gradually reducing inflation. In 2011, the three-year inflation target was set in terms of a horizontal band (5–7%) for the first time.⁵ The BoR defines the inflation target on the basis of alternative scenarios for the domestic and world economy and in line with the social and economic development forecast drawn up by the government.⁶ Since 2003 the BoR has published a core inflation target in addition to the headline inflation target.

Besides publishing an inflation target, the BoR forecasts quantitative indicators of monetary policy. In the 1990s, the guidelines for the single state monetary policy contained forecasts for the monetary base and M2. The number of quantitative indicators rose over time, eventually evolving into a "monetary programme" covering net domestic assets, net credit to banks and net international reserves. The monetary base and M2 remain central quantitative indicators. The quantitative indicators are not monetary policy targets (except for M2 in 1995–2002; see footnote 4). By publishing the monetary indicators, the BoR in effect reveals the monetary indicator values that would enable the inflation target to be hit assuming that one of the economic scenarios

⁴ Besides the primary objective, the BoR has also set secondary objectives/priorities. In 1995–2002, the secondary objectives/priorities included M2 and a rouble devaluation ceiling. The monetary policy priorities have been adjusted at times of crisis. For example, support for, and provision of sufficient liquidity to, the banking sector were among the priorities during the escalating financial crisis after the collapse of Lehman Brothers.

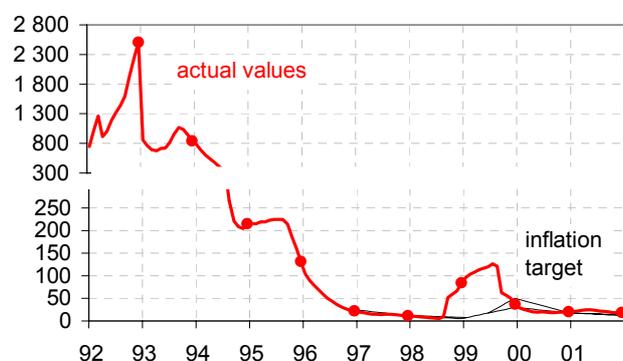
⁵ The inflation target is calculated as the percentage "December-on-December" change.

⁶ In 1997 the BoR used the inflation forecast of the Ministry of the Economy. The BoR gradually started to prepare its own forecasts. At the same time it takes into account the government's forecasts. Information on the model used by the BoR to create the forecast is very limited. No description of the model could be found on the BoR official website or in its publications available via the internet. To the best of our knowledge, the only reference that exists is Borodin et al. (2008). The authors provide a brief description of the first (preliminary) version of the QPM model. The BoR started work on this model in 2007. No information is available on the further development of modelling, especially on the application and level of development of the DSGE model.

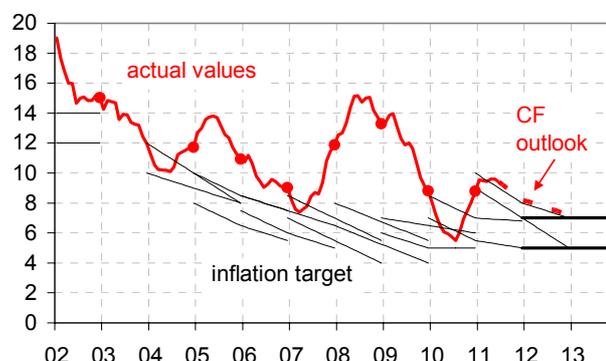
drawn up by the BoR or the government materialises. The quantitative indicators are therefore informative and the BoR reserves the right to revise them during the year if the actual economic conditions deviate significantly from the forecast.

Figure VII-1: Basic monetary policy indicators and GDP growth

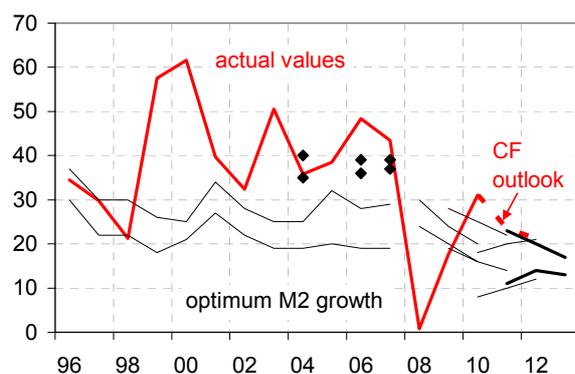
a) Inflation 1992 - 2001



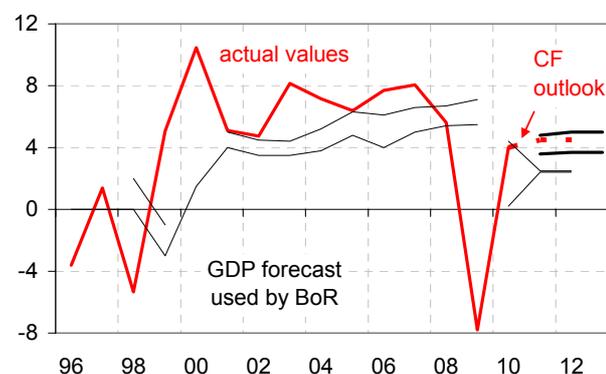
b) Inflation 2002 - 2013



c) M2 growth



d) GDP growth



Note: Data on the inflation target (December-on-December), optimum M2 growth and the GDP growth outlook start in 1996. Points in the upper charts refer to inflation in December. Data are not available for previous periods. Optimum M2 growth was revised upwards in 2004, 2006 and 2007 (see the points in the lower-left chart).

Source: CNB calculation using Datastream IFS, Consensus Forecasts, Rosstat and BoR: Guidelines for the Single State Monetary Policy, *Bulletin of the Bank of Russia*, publications from 1996 to 2010.

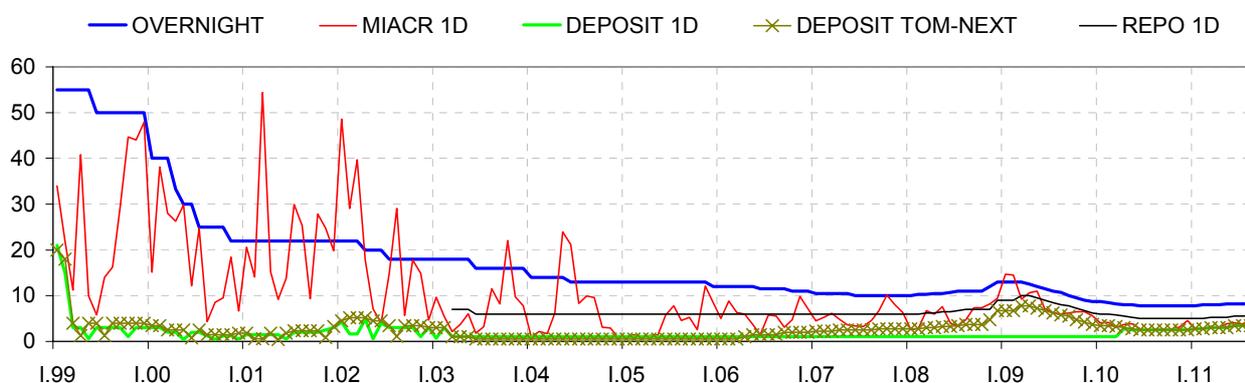
Figure VII-1 depicts the actual values of inflation and M2 versus the targets, as well as GDP growth and the GDP forecasts used by the BoR to set the inflation target. From the end of 1996 to the first half of 1998, actual inflation was within the target band or even lower than expected by the BoR. In August 1998, the financial crisis reversed this trend. Over the past decade, actual inflation has been mostly above the target. Administered prices, which are difficult to forecast, world commodity market developments and the crisis have significantly contributed to the overshooting of the inflation target. For example, inflation was rising before the collapse of Lehman Brothers. Other emerging and advanced economies also recorded a moderate inflation surge in this period.

In recent years, the BoR has regularly mentioned the introduction of full-fledged inflation targeting. The preparations are currently scheduled to be completed at the end of 2013. In the meantime, the bank will steer towards a more flexible exchange rate and a stronger regulatory function of interest rates. This function is still very limited,⁷ owing, among other things, to the relatively wide interest rate band (see Figure VII-2). Although the spread between the central bank's lending and deposit rates has narrowed

⁷ The BoR's other standard monetary policy instruments are reserve requirements, open market operations and foreign exchange operations.

considerably in recent years, reaching 4.75% in August 2011, it is still much wider than in advanced economies.

Figure VII-2: Interest rates in 1999–2011



Note: The ceiling for market rate fluctuations is the overnight lending rate (OVERNIGHT); the floor is defined by the deposit rate, mostly the one-day TOM-NEXT (DEPOSIT TOM-NEXT) rate, which has the largest transaction volumes. DEPOSIT 1D and REPO 1D are the central bank's one-day deposit and repo rates respectively. MIACR 1D is the one-day interbank market rate. Monthly data. The August 2011 data cover only the first week of the month.

Source: BoR and Datastream.

2. Exchange rate policy

Exchange rate policy, which, in accordance with the central bank law and the constitution of the Russian Federation, is focused on ensuring the stability of the Russian rouble, is an important element of BoR policy. The BoR tries to keep the rouble from appreciating and depreciating significantly and to prevent strong volatility of the rouble against the main world currencies, i.e. USD and, since 2005, USD and EUR. The BoR publishes the expected pace of appreciation of the rouble in the guidelines for the single state monetary policy almost every year (2011 being the exception).

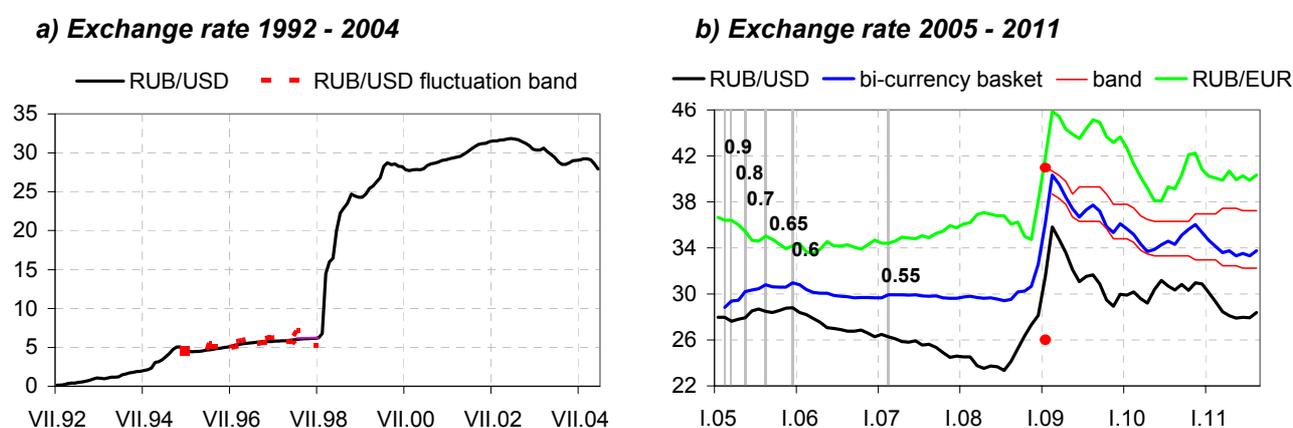
The separation of the Russian Federation's currency from those of the former Soviet Union republics was completed in 1993.⁸ The rouble was floated and its rate was determined by supply and demand on the Moscow Interbank Currency Exchange (MICEX). Since the second half of the 1990s the exchange rate has been declared daily by the BoR (except in the post-crisis period between 1998 H2 and 1999 H1, when the rate was set by the MICEX). In 1995 the BoR introduced a fluctuation band for the rouble-dollar exchange rate (see the left-hand side of Figure VII-3). Until 1997 the band was relatively narrow, but it was later widened by the BoR. In mid-August 1998 a further deterioration of the economic and financial situation culminated in Russia defaulting on GKO's (short-term government bonds). Demand for roubles slumped and prices surged. In ten days, the rouble fell to around half its original value in dollar terms, and at the year-end it was three times weaker than just before the default. The BoR had to abolish the fluctuation band and float the rouble again.

In February 2005, the exchange rate policy was overhauled and a managed float against a bi-currency (EUR-USD) basket was introduced. The dollar's share in the basket was

⁸ Internal convertibility of the rouble was introduced by Decree of the RSFSR President of 15 November 1991 "On Liberalisation of External Economic Activity in the RSFSR". Following the Russian Federation's assumption of the obligations defined in Article VIII of the IMF Statute, the rouble became partially externally convertible. The introduction of full external convertibility was prevented by capital movement restrictions, which stayed in place for another ten years and were lifted by the BoR only in July 2006. A few days later the Government of the Russian Federation amended the section of the Act on Foreign Exchange Regulation and Foreign Exchange Control relating to forex market liberalisation and declared the rouble convertible. However, convertibility of the rouble has often been debated in the Russian media and there is no consensus among analysts on whether the rouble became *de facto* convertible in 2006 or whether this happened later on.

gradually reduced from 90% in early 2005 to 55% in February 2007, where it remains (see the right-hand side of Figure VII-3). The worsening economic and financial situation between August 2008 and February 2009 forced a change to the fluctuation band against the USD-EUR basket. The adjustment was completed at the end of January 2009 with the setting of a horizontal fixed fluctuation band for the rouble against the bi-currency basket. This band of RUB 26–41 was in place for almost 10 months, but its regulatory function ceased to exist de facto in February 2009 when a floating band was introduced. The margins of the floating band have changed automatically by RUB 0.05 whenever the accumulated interventions by the BoR have equalled USD 0.7 billion. Regular interventions are the main exchange-rate policy instrument. Since May 2008, some of the interventions have been target purchases/sales⁹, i.e. the intervention amounts are calculated by the BoR on the basis of data on the Russian trade balance, the state budget and world commodity prices. Interventions in excess of the target (or plan) amounts are focused on mitigating exchange rate fluctuations not induced by fundamental factors.¹⁰ Euro interventions are substantially smaller than dollar ones.

Figure VII-3: Exchange rate policy



Note: Monthly data. The vertical columns in the right-hand chart illustrate the gradual decrease in the share of dollars (figures next to columns) in the bi-currency basket. Points in the right-hand chart show the fixed band against the bi-currency basket.

Source: CNB calculations, Datastream and BoR: Guidelines for the Single State Monetary Policy, *Bulletin of the Bank of Russia*.

The favourable commodity market situation has enabled the central bank to accumulate foreign exchange reserves rapidly, i.e. it has given it greater scope to intervene during crises. In the 1990s, low oil prices and economic turbulence in Russia kept the stock of reserves close to or even below the critical level. Coverage of imports by foreign exchange reserves was last below the 3-month threshold in 2001. Between then and 2008 H2 the reserves accumulated quickly (see Figure VII-4). Since 2007, Russia has been the third-largest holder of reserves in the world.¹¹ The share of the euro in Russia's international reserves has risen gradually and stood at 42.5% at the end of 2010, just 3.4% less than the dollar share. Russia's foreign exchange reserves peaked in August 2008 at USD 596.6 billion. The reserves contracted sharply during the 2008 financial crisis and the accumulation of new international reserves slowed significantly as oil prices fell. The reserves began to expand again in June 2009.

⁹ In March 2010, "target" interventions were replaced by "plan" interventions.

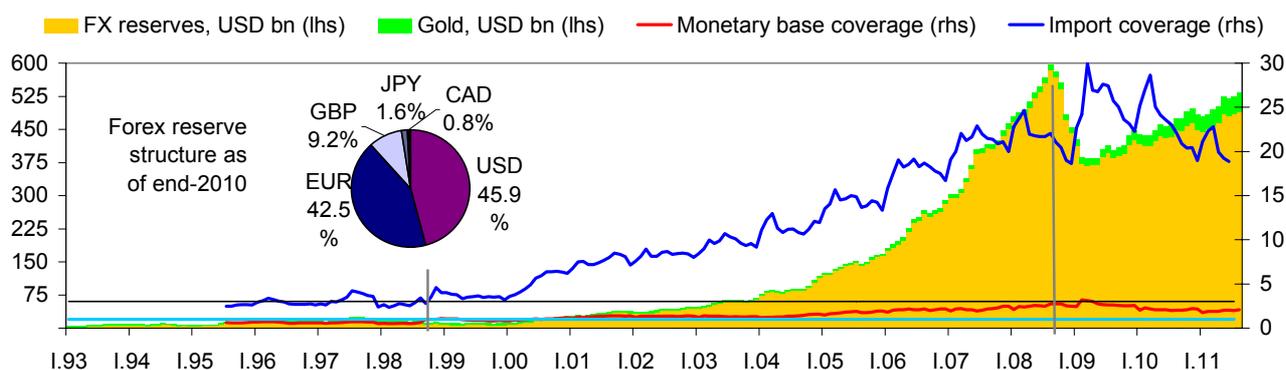
¹⁰ Data on daily interventions are not available. The BoR has published the (net) monthly intervention amounts since May 2008.

¹¹ In 2011, about 30% of international reserves are held by China and 11% by Japan. Russia has a 4.6% share, closely followed by Saudi Arabia with 4.5%. The euro area has 3.3%. (CNB calculations using IMF-IFS database)

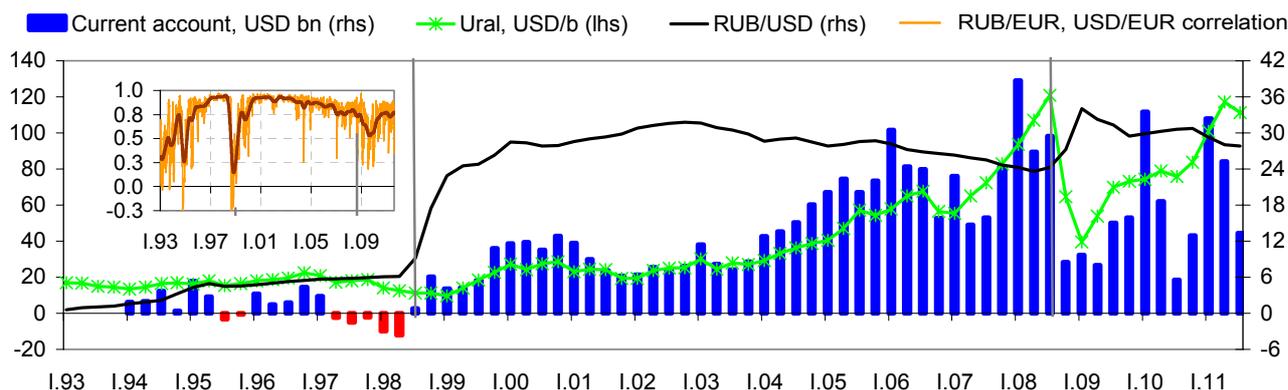
After the rouble stabilised, exchange rate policy started to focus on greater flexibility of the rouble's exchange rate against the bi-currency (EUR-USD) basket under the plan to introduce inflation targeting in the future. The margins of the floating band were widened from two roubles (in February 2009) to five roubles (in March 2011) and the accumulated interventions shifting the rouble's floating fluctuation band were reduced to USD 0.6 billion (also in March 2011).

Figure VII-4: External environment and reserves

a) International reserves and their structure



b) Balance of payments and exchange rate



Note: Cut-off date for data: 1 August 2011. Monetary base coverage is calculated as the ratio of reserves to the monthly base in the given month. If this ratio is less than 1 (the horizontal blue line), the country has insufficient reserves. Import coverage (in months) is calculated as the ratio of reserves to average imports in the last three months. The horizontal black line shows the optimal level of reserves, equalling three months of imports. CAD is the Canadian dollar. For other currency abbreviations see p. 22. The correlation is calculated using the bivariate GARCH model on daily data. The vertical lines indicate the default on 17 August 1998 and the collapse of Lehman Brothers on 15 September 2008. The brown line in the correlation chart is smoothed using the HP filter.

Source: CNB calculations using BoR statistics and the IFS database.

Monetary policy outcomes and outlook in the Russian Federation

The Russian economy has shown several times that it can return quickly to a growth path after a major crisis, despite being a weaker performer than other emerging economies.¹² Russia's prosperity depends above all on commodity prices. Thanks to the favourable global commodity market situation Russia has one of the largest stocks of foreign exchange reserves in the world and the rouble has been appreciating in recent years. Inflation has fallen from four-digit (in the first half of the 1990s) to single-digit values. The effectiveness of the BoR's policy is, however, limited by its links with the Russian government and by Russia's monopolistic and oligarchic structure. Despite the

¹² For example the BRICK countries (Brazil, Russia, India, China and South Korea).

difficult economic and political conditions over the last 20 years, the BoR has made significant progress in improving the formulation and communication of its objectives; in addition, it now has a model-based forecasting system. Despite this growing transparency, however, ambiguities remain in its monetary policy.

This brief account of the legislation and of the stylised facts about the BoR's monetary and exchange rate policies raises a rather surprising question: what is the Russian central bank's primary objective? According to the central bank law, the BoR's objective is to ensure stability of the rouble, but according to the guidelines for the single state monetary policy the primary monetary policy objective is to maintain inflation within the band set by the central bank and the government. The guidelines mention an exchange rate policy aimed at keeping the Russian rouble within an "acceptable" range of fluctuations and at restraining "excessively sharp" appreciation of the rouble. However, they do not mention whether stability of the rouble is considered a second or secondary monetary policy objective (if we regard maintaining price stability as the primary objective). According to BoR Chairman Sergey Ignatiev, reducing inflation is the first objective and preventing rapid appreciation is the second.¹³ Obviously, this could result in a conflict between the inflation and exchange rate objectives. Therefore, according to Ignatiev, the BoR is trying to strike a balance in achieving these two objectives.

In reality, however, inflation has mostly exceeded the target values. By contrast, the BoR has kept the rouble's exchange rate against the USD-EUR basket within the set band. The BoR has achieved its primary exchange rate policy objective (rouble stability) mostly through regular interventions. As these interventions are sterilised only partially, exchange rate policy is de facto fuelling money supply growth and inflation. Another inflationary factor (and exchange rate volatility risk) is the specific nature of the Russian economy. Russia is the world's biggest commodity exporter, so it is dependent on world commodity markets and the exchange rate of the dollar (in which most commodity prices are quoted). Russia mainly imports manufactured goods and machinery. The high oil prices and asymmetric foreign trade structure are a positive terms-of-trade shock. Beck and Barnard (2009) show that in this situation the rouble's real appreciation is due to a positive inflation differential vis-à-vis the average of Russia's trading partners instead of nominal appreciation. This makes it more difficult for the BoR to keep inflation at low levels. Inflation is also being fuelled by the policy of mitigating the rouble's appreciation by accumulating dollar reserves and increasing the money supply.

The introduction of full-fledged inflation targeting requires the implementation of a floating exchange rate regime with interest rates as the main monetary policy instrument. The BoR has so far relaxed the exchange rate slightly by widening the rouble's fluctuation band against the dollar-euro basket and is planning to scale down its interventions. It is simultaneously moving towards strengthening the role of interest rates in the management of the economy, and in particular towards narrowing the interest rate band. Effective management requires a minimal spread between deposit and lending rates (a narrow spread is also an indicator of financial stability).¹⁴

¹³ Ignatiev (2003).

¹⁴ The interest rate policy is often criticised in the literature as being ineffective. According to Andryushin and Kuznecova (2010) the interest rate policy merely fulfils the function of liquidity regulation for the purpose of short-term refinancing of commercial banks and sterilisation of excess liquidity. Moiseev (2009) also points to the need to develop money market segments with longer maturities and recommends making the interest rate system simpler and more transparent.

Currently there is no date for the accomplishment of preparations to the introduction of full-fledged inflation targeting.¹⁵ Successful introduction of full-fledged inflation targeting hinges on the BoR's ability to resolve the "exchange rate vs. inflation" dilemma and to avoid an "Impossible Trinity" situation.¹⁶

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¹⁵ See the *Guidelines for the Single State Monetary Policy in 2011 and for 2012 and 2013*. Under the previous year's guidelines, however, the plan was to complete the preparations by the end of 2012.

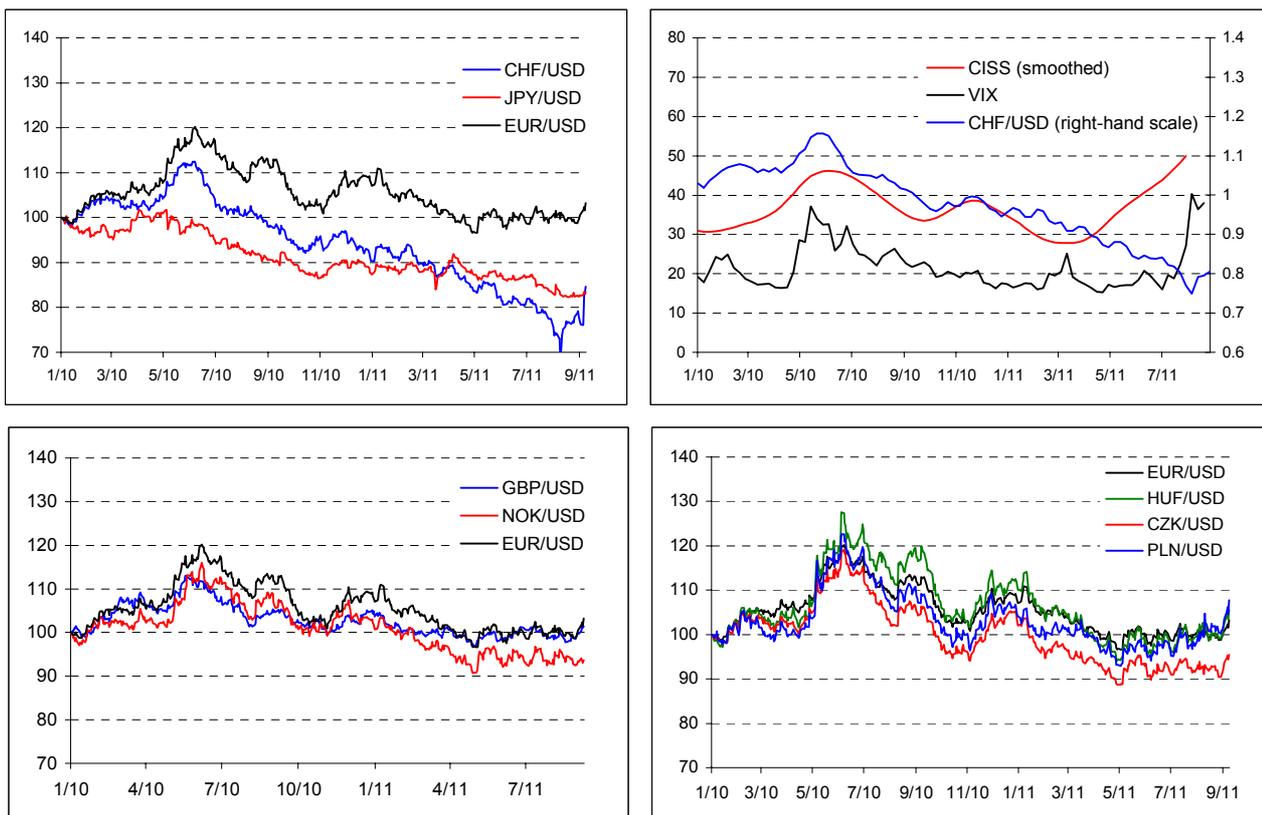
¹⁶ The theory of the Impossible Trinity was developed by Robert Mundell and states that only two out of three objectives can be achieved in the regulation of an economy: free capital movement, a fixed exchange rate and an independent monetary policy. The combination of free capital flows and keeping fluctuations of the rouble within a narrow band precludes the effective use of interest rates and effective control of inflation.

WHERE TO LOOK FOR A SAFE HAVEN CURRENCY¹

The growing financial market turmoil last month resulted in a sharp appreciation of the Swiss franc, which is viewed as a safe haven for investors. Between early May 2010 and early September 2011 the franc appreciated by 28% against the dollar and by 33% against the euro. In response, the Swiss central bank fixed the ceiling on the franc-euro exchange rate at CHF 1.2/EUR. The export-oriented Swiss economy recorded subdued growth last year despite near-zero rates, and further appreciation was no longer acceptable to the central bank. The Japanese yen, which has the same status among investors, has shown a similar trend since mid-2010 (see the left-hand side of Figure VIII-1). The question therefore arises whether there are any alternatives to the current safe haven currencies. Safe currencies tend to appreciate at times of increased uncertainty, and the Swiss franc has strengthened significantly in the last few months.

Possible alternative safe havens include the British pound, the Norwegian krone and the Australian dollar, as well as the Hungarian forint, the Czech koruna and the Polish zloty among the Central European currencies. Yet none of them has shown any appreciation amid the increased financial uncertainty in recent months (see Figure VIII-1 below). The forint and the zloty have in fact depreciated against the dollar and the euro.

Figure VIII-1: Dollar exchange rate against selected world currencies and financial stress²



Note: Daily data index for exchange rates (data as of 4 January 2010=100); weekly data for financial stress indicators; CISS is composite systemic risk indicator and VIX measures implied volatility of S&P index options

Source: CNB calculations using Datastream data

¹ Author: Soňa Benecká (Sona.Benecka@cnb.cz). The views expressed in this article are those of the author and do not necessarily reflect the official position of the Czech National Bank.

² The topic of financial stress measurement was addressed in the previous issue of Global Economic Outlook http://www.cnb.cz/miranda2/export/sites/www.cnb.cz/en/monetary_policy/geo/gev_2011_08_en.pdf

In recent years, several papers have covered the issue of how to identify safe haven currencies. For example, Ranaldo and Soderlind (2009) found that, besides the Swiss franc and the Japanese yen, the euro and the British pound may be safe havens in the event of financial market turmoil. Their conclusions were partly questioned by a study by Kohler (2010), which showed that these currencies do not necessarily behave in the standard manner during crises. Habib and Stracca (2011) analysed the macroeconomic features of the countries whose currencies are safe havens. They broke down the factors into categories: exchange rate policy, country risk, size of the economy and its financial markets, and financial openness. They found several significant factors for advanced countries, although the results should be interpreted with some caution.

From the point of view of this paper we can look at the macroeconomic and financial characteristics of the countries that are considered as safe havens and compare them with the alternatives (see Table VIII-1). The common features of safe haven countries are high country ratings (credibility) and small current account deficits/surpluses, sufficiently developed capital and foreign exchange markets, and low transaction costs. Liquidity plays a key role in the decisions of international investors. The ideal currency is highly credible and isolated from financial turmoil and usually offers a low yield. Central European currencies are in a worse position in this respect, so no major change can be expected in their position in the global financial market.

Figure VIII-1: Selected country characteristics (2010 data)

	Country risk and external vulnerability				Size and liquidity of financial markets		
	Net external assets (2009)	Public debt/GDP	Current account/GDP	Rating	Market capitalisation/GDP	Bid-ask spread	Size of forex market
USA	0.6	92.7	-3	AAA	118	0.027	84.9
Japan	10.0	225.0	3	AA	75	0.036	19
Switzerland	29.6	39.5	8	AAA	235	0.063	6.4
United Kingdom	-2.9	76.7	-2	AAA	138	0.027	12.9
Norway	79.0	48.9	13	AAA	61	0.115	1.3
Australia	-25.6	21.9	-5	AA+	136	0.040	7.6
Hungary	3.8	78.4	-1	BBB-	21	0.352	0.4
Czech Republic	27.0	40.1	-1	A+	22	0.272	0.2
Poland	5.7	55.2	-2	A-	41	0.233	0.8

Note: Data are in per cent except for ratings and bid-ask spreads. Grey-shaded variables are statistically significant determinants of Habib and Stracca (2011) model. Net external assets for 2009 and size of exchange rate market are calculated as shares in total turnover by currencies from BIS study; ratings are Fitch long-term credit ratings.

Source: CNB calculations using data from IMF, Datastream and World Bank, BIS, Fitch

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BOFIT	Bank of Finland Institute for Economies in Transition
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
EU	European Union
EUR	euro
EURIBOR	Euro Interbank Offered Rate
Fed	Federal Reserve System (the US central bank)
FRA	forward rate agreement
GBP	pound sterling
GDP	gross domestic product
CHF	Swiss franc
IFO	Institute for Economic Research
IFO-BCI	IFO – Business Climate Index
IFO-CCI	IFO – Consumer Confidence Index
IMF	International Monetary Fund
IRS	Interest rate swap
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
UoM	University of Michigan
UoM-CSI	University of Michigan Consumer Sentiment Index
US	United States
USD	US dollar

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