GLOBAL ECONOMIC OUTLOOK - SEPTEMBER

2015

Monetary Department
External Economic Relations Division

CZECH NATIONAL BANK

Cut-off date for data
18 September 2015

CF survey date
7 September 2015

GEO publication date
25 September 2015

Notes to charts

ECB and Fed: midpoint of the range of forecasts.
The arrows in the GDP and inflation outlooks indicate the direction of revisions compared to the last GEO. If no arrow is shown, no new forecast is available. Asterisks indicate first published forecasts for given year.
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.

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The September issue of Global Economic Outlook presents its regular overview of recent and expected developments in selected territories, focusing on key economic variables: inflation, GDP growth, leading indicators, interest rates, exchange rates and commodity prices. In this issue, we also present the major economic reforms planned and implemented by Indian Prime Minister Narendra Modi, whose ambition is to liberalise and streamline the Indian economy and to ensure that its rapid growth does not fizzle out.

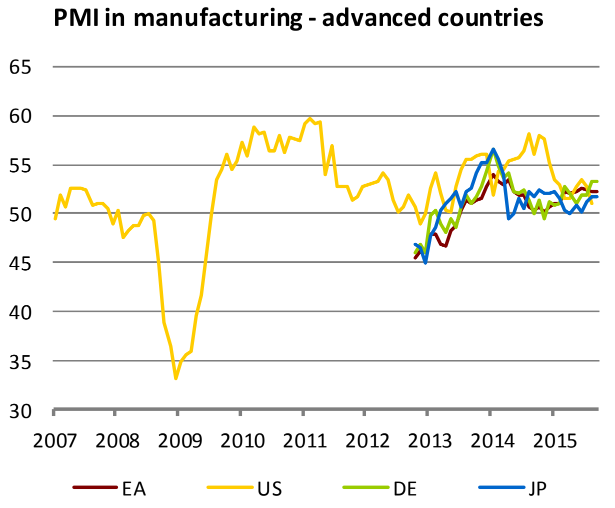
The growth outlooks for the main world economies in both 2015 and 2016 were revised downwards in September. The only exception was the USA, whose outlook for this year was increased compared to the previous month. The rate of growth of the US economy should accelerate gradually, staying about 1 pp above the current outlooks for the euro area. As the strongest European economy, Germany remains the engine of European growth, although its growth is weakening. However, Ireland is the fastest growing euro area economy. The growth rate of the Japanese economy is expected to rise visibly next year and converge towards that of the euro area. New figures on inflation in the main world economies reveal that consumer price inflation will be well below 1% this year. It is expected to go up next year, albeit at different rates across the economies under review, and approach the 2% level generally regarded as price stability.

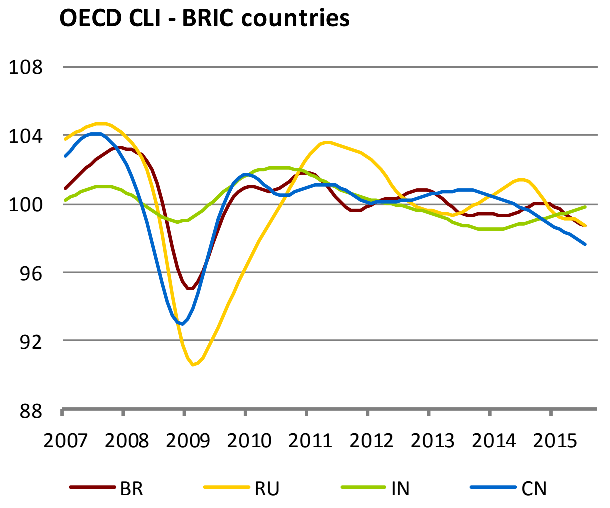
The outlooks for emerging BRIC countries for 2016 remain mixed. The Indian economy remains the leader of this group. Its growth outlooks for this period declined slightly but are still more than 1 pp above the projected performance of the Chinese economy. China's slowdown is one of the main risks to the world economy (see also the leading indicators below). Consumer price inflation in India will also be higher, slightly exceeding 5% at the end of 2016. The two other BRIC countries will be considerably worse off. Updated outlooks still indicate that neither the Russian nor the Brazilian economy will avoid recession this year. Moreover, the two countries will this year face high inflation, which is expected to reach double figures. The outlooks for both countries for 2016 bring some optimism, as the opposite tendencies are expected, i.e. economic growth should rebound and inflation should drop visibly.

The euro area interest rate outlook remains at zero at the one-year horizon, mainly because of the ECB's quantitative easing and hints of a possible extension of asset purchases. The Fed can be expected to raise interest rates earlier, but the September meeting did not indicate whether it will take this step this year. According to CF, the dollar will appreciate slightly against the euro at the one-year horizon and is also expected to appreciate slightly against all the other monitored currencies except the Russian rouble; the dollar is expected to be broadly stable against the Indian rupee.

The oil price outlook remains very slightly rising and oil prices should not exceed USD 60 a barrel at the end of 2016. Natural gas prices based on long-term contracts normally lag behind oil prices by 6 to 9 months and are therefore expected to continue falling in the next few months to levels visibly below USD 200 per 1000 m^3 and to start rising gradually again in the second half of 2016. The non-energy commodity price index will edge up at the one-year horizon owing to modest growth in both its sub-indices, i.e. food commodities and industrial metals.

Leading indicators for countries monitored in the GEO





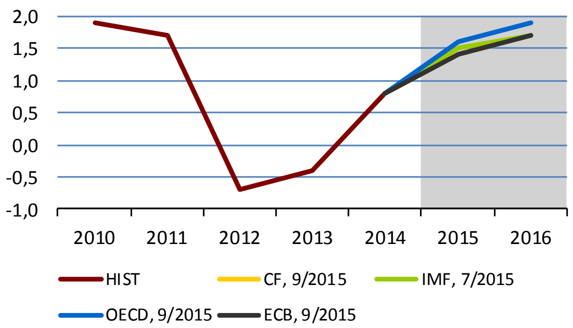
Zdroj: Bloomberg, Datastream

II.1 Eurozone

Euro area GDP is expected to grow by around 1.5% this year. CF and the ECB revised their outlooks down slightly. In 2016, economic growth is expected to accelerate slightly (by tenths of a percentage point). However, uncertainty regarding future developments is rising as a result of information about a slowdown of the Chinese economy and the external environment in general, whereas domestic demand is expected to be more favourable. Quarterly GDP growth slowed by 0.1 pp to 0.4% in 2015 Q2, while annual GDP growth was 1.9%. According to the current whole-year outlook, a slight slowdown in growth can be expected in the rest of this year. Household consumption was the biggest contributor to the quarterly growth in Q2 (1.3 pp). Except for change in inventories, the contributions of the other GDP components were also positive. Industrial production growth picked up pace in month-on-month terms in July and the average annual growth rate of industrial production since the start of the year was 1.3%. The PMI in manufacturing was flat just above 52 between March and August, suggesting an improving situation in manufacturing. In Q2, annual retail sales growth maintained the pace recorded in Q1 (2.1%) and accelerated further in July. Together with a drop in unemployment in July, this signals continued growth in household consumption.

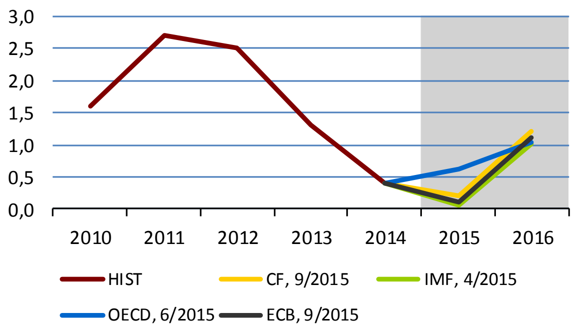
Consumer price inflation is expected to be only slightly positive this year, not exceeding 1% until 2016. Inflation edged down to 0.1% in August. The modest annual rise in the price level was due to higher prices of food and services, whereas energy prices fell substantially. This is consistent with inflation excluding energy and food prices of 0.9% in August. The ECB kept its key interest rates unchanged in September. Statements made by Mario Draghi revealed its determination to further increase or extend the current asset purchase programme if warranted by a worsening of the economic situation. As a result, the 3M Euribor fell to slightly more negative levels and its outlook is close to zero.

GDP growth, %



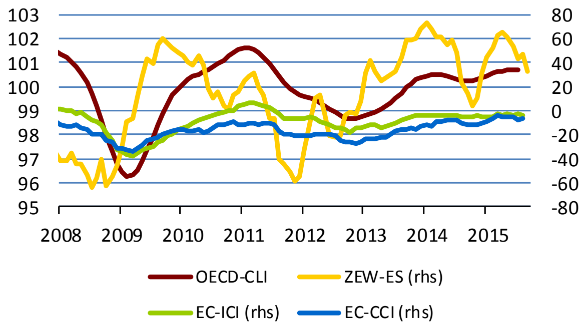
	CF	IMF	OECD	ECB
2015	1,4	1,5	1,6	1,4
2016	1,7	1,7	1,9	1,7

Inflation, %



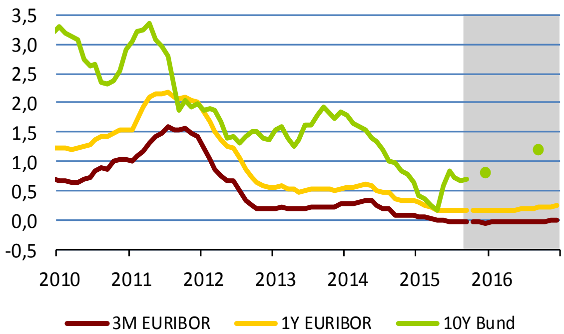
	CF	IMF	OECD	ECB
2015	0,2	0,1	0,6	0,1
2016	1,2	1,0	1,0	1,1

Leading indicators



	OECD-CLI	EC-ICI	EC-CCI	ZEW-ES
6/15	100,7	-3,4	-5,6	53,7
7/15	100,7	-2,9	-7,2	42,7
8/15		-3,7	-6,9	47,6

Interest Rates



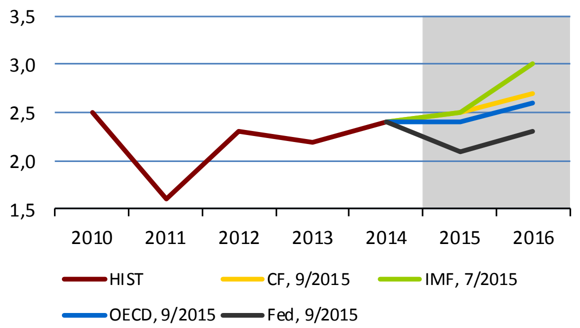
	08/15	09/15	12/15	09/16
3M EURIBOR	-0,03	-0,03	-0,04	-0,02
1Y EURIBOR	0,16	0,16	0,16	0,21
10Y Bund	0,67	0,69	0,80	1,20

II.2 United States

According to revised data, the US economy grew faster in Q2 than the first estimate had suggested (2.3%). Annualised quarterly GDP growth was 3.7%. The largest revision was recorded by growth in corporate investment, especially in construction and research and development. Household consumption rose by 3.1% (in annualised quarterly terms). The solid domestic demand is being supported by the labour and housing markets. The number of new jobs in the non-agricultural sector rose by 173,000 in August (seasonally adjusted), fewer than the market had expected. New jobs were created above all in the public sector (education), while the growth in construction and retail moderated. However, substantial revisions of the jobs data for June and July, coupled with a decrease in unemployment to 5.1%, the lowest level since April 2008, still suggest an improving labour market situation. The average hourly wage increased by 0.3% month on month (compared to expectations of 0.2%). Leading indicators are mixed. The PMI in manufacturing fell slightly in July and August, while consumer confidence rose somewhat.

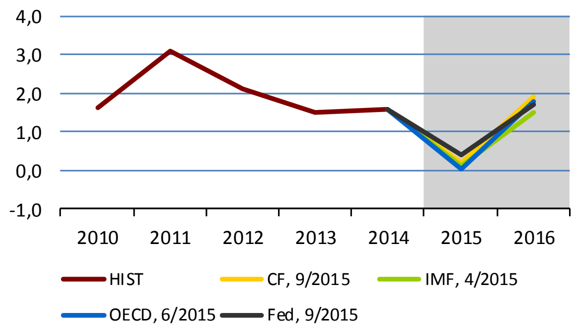
Annual consumer price inflation was unchanged from the previous two months at 0.2% in August. The annual change in industrial producer prices remained negative (-2.9%). In addition to low oil prices, the low US inflation is still due to a strong dollar and contained wage pressures. According to the Fed, anti-inflationary pressures may rise further in the short term owing to recent developments abroad, in particular China. The Board of Governors therefore decided at its September meeting to maintain the current monetary policy settings. At the same time, it did not indicate whether the first rate hike would come before the end of this year. This suggests the Fed will need more time to analyse the impacts of the financial market turbulence as well as the expected slowdown in emerging economies. Members of the Board of Governors remain concerned that the US economic recovery is still too fragile. The US dollar has recently weakened against the euro but is still 13% stronger in year-on-year comparison.

GDP growth, %



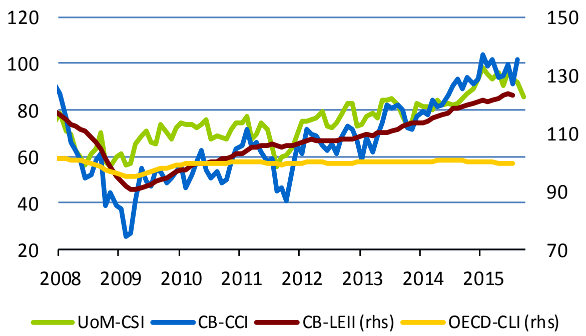
	CF	IMF	OECD	Fed
2015	2,5	2,5	2,4	2,1
2016	2,7	3,0	2,6	2,3

Inflation, %



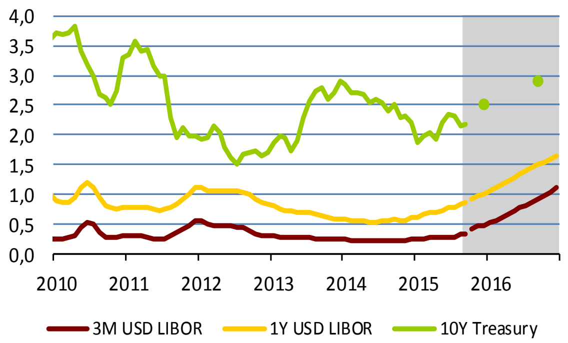
	CF	IMF	OECD	Fed
2015	0,2	0,1	0,0	0,4
2016	1,9	1,5	1,8	1,7

Leading indicators



	CB-LEII	OECD-CLI	UoM-CSI	CB-CCI
6/15	123,6	99,6	96,1	99,8
7/15	123,3	99,5	93,1	91,0
8/15			91,9	101,5

Interest Rates

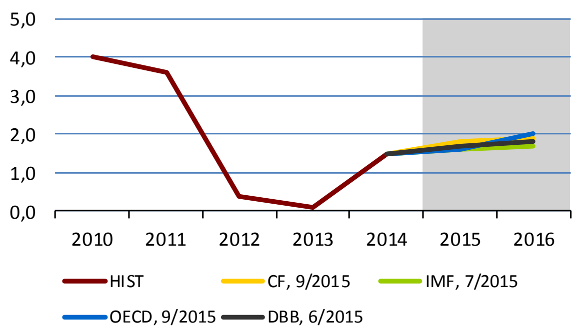


	08/15	09/15	12/15	09/16
USD LIBOR 3M	0,32	0,33	0,48	0,93
USD LIBOR 1R	0,84	0,84	1,01	1,49
Treasury 10R	2,16	2,19	2,50	2,90

II.3 Germany

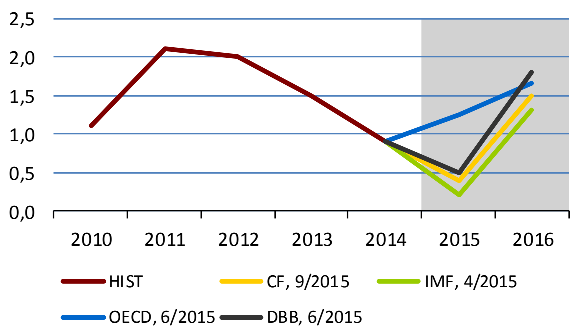
The performance of the German economy increased in 2015 Q2 owing to accelerating exports and slowing imports. By contrast, household consumption growth and its contribution to economic growth weakened somewhat. Overall, the quarterly GDP growth rate rose by 0.1 pp to 0.4% and the annual growth rate from 1.0% to 1.6%. However, the leading indicators in July and August are not suggesting any further acceleration of the economy. Short-term developments point to signs of a slowdown: industrial production growth slowed to 0.4% in July and factory orders declined. The September CF lowered Germany's expected economic growth to 1.8% in 2015 as a whole and to 1.9% next year. Despite rising prices of food and services, German inflation remained very low at 0.2% in August on account of a drop in energy prices of almost 8%. CF lowered its estimate of inflation for 2015 as a whole to 0.4%.

GDP growth, %



	CF	IMF	OECD	DBB
2015	1,8	1,6	1,6	1,7
2016	1,9	1,7	2,0	1,8

Inflation, %

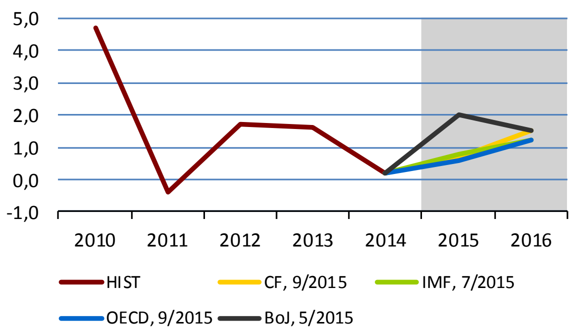


	CF	IMF	OECD	DBB
2015	0,4	0,2	1,2	0,5
2016	1,5	1,3	1,7	1,8

II.4 Japan

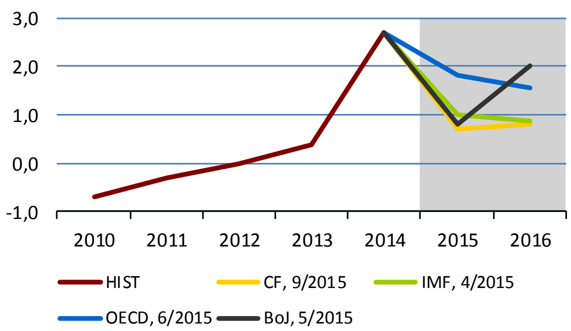
In line with expectations, the Japanese economy contracted in Q2 by 0.3% quarter on quarter according to revised data. The revision resulted in a smaller economic decline, due mainly to higher inventories. Private consumption fell by 0.7% and the contribution of foreign trade was also negative. The Japanese economy is being affected by the economic slowdown in China and other Asian countries, as well as weaker exports to the USA. Inflation did not improve either, as annual headline inflation stood at 0.6% in July. The Ministry of Finance is therefore considering an additional fiscal stimulus of JPY 2 trillion before the end of this year. Prime Minister Abe even mentioned the possibility of lowering corporate taxes. The stock market decline in China in August and a rise in risk aversion pushed down the Japanese Nikkei 225 stock market index, while the Japanese yen appreciated against the dollar. In line with the new data, the September CF lowered its outlooks for growth and inflation in both years.

GDP growth, %



	CF	IMF	OECD	BoJ
2015	0,7	0,8	0,6	2,0
2016	1,5	1,2	1,2	1,5

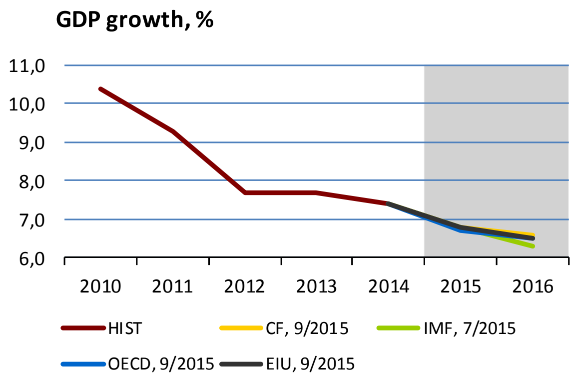
Inflation, %

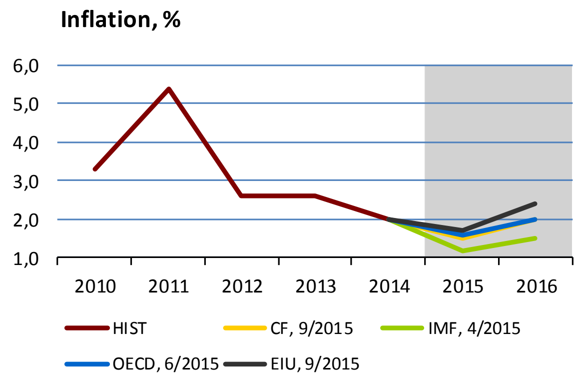


	CF	IMF	OECD	BoJ
2015	0,7	1,0	1,8	0,8
2016	0,8	0,9	1,6	2,0

III.1 China

Industrial production growth edged up in August (to 6.1%), but was weaker than originally expected. Investment growth also fell short of expectations. The PMI in manufacturing remained below 50 for the sixth consecutive month. The revised GDP figure for 2014 was more bad news. GDP grew by just 7.3% last year, not 7.4% as originally published. Chinese exports and imports continued to fall in August (by 5.5% and 13.8% respectively). According to CF and the EIU, GDP can be expected to rise by 6.8% this year and 6.5%–6.6% the next. The worsening macroeconomic data from China are feeding concerns about the negative impacts of the slowdown of the world's second-largest economy on growth in other countries. China's central bank further eased monetary policy by cutting interest rates by 0.25 pp to stabilise the renminbi, which started to depreciate in August following an unexpected easing of the exchange rate regime. As a result, foreign exchange reserves recorded their largest-ever decline in August (2.6%).



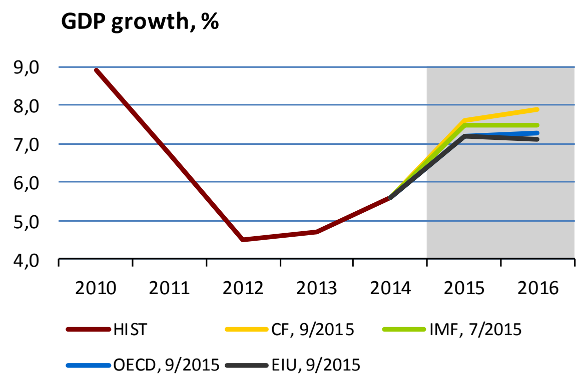


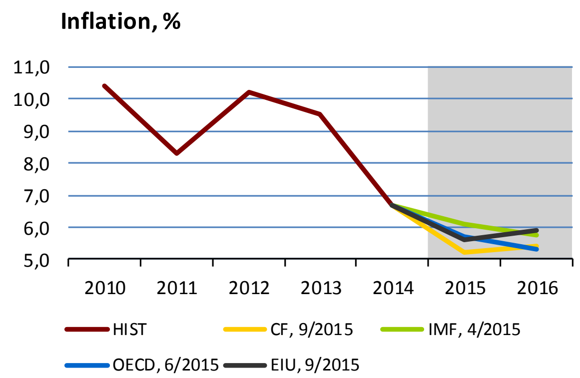
	CF	IMF	OECD	EIU
2015	6,8	6,8	6,7	6,8
2016	6,6	6,3	6,5	6,5

	CF	IMF	OECD	EIU
2015	1,5	1,2	1,6	1,7
2016	2,0	1,5	2,0	2,4

III.2 India

Despite moderating slightly, optimism still prevails regarding India's GDP growth. The CF and the OECD forecasts for 2015 and 2016 were lowered by 0.1 pp. The EIU's prediction fell rather more sharply – by 0.3 pp this year and 0.6 pp the next. Inflation was 3.7% in August. Its decline of 0.1 pp was due mainly to lower oil prices and sluggish growth in prices of food, especially sugar and vegetables. Both the CF and the EIU lowered their inflation outlooks for both years by 0.1–0.3 pp. Both institutions thus expect the inflation target to be hit in 2016. The Indian central bank kept its key interest rate unchanged. However, it is expected to lower it at the next meeting in response to developments abroad and government pressure. Industrial production rose by 0.4% in July. By contrast, the PMI in manufacturing fell slightly compared to the previous month. This was due to strengthening monsoon rains, which, however, are still below average.





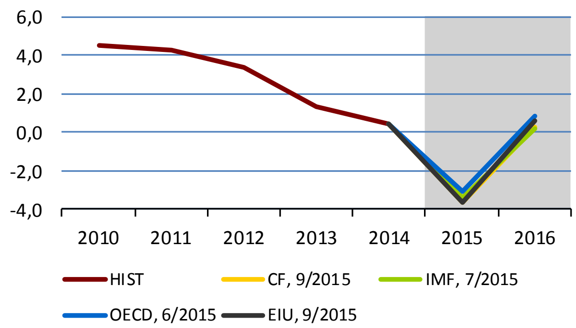
	CF	IMF	OECD	EIU
2015	7,6	7,5	7,2	7,2
2016	7,9	7,5	7,3	7,1

	CF	IMF	OECD	EIU
2015	5,2	6,1	5,7	5,6
2016	5,4	5,7	5,3	5,9

III.3 Russia

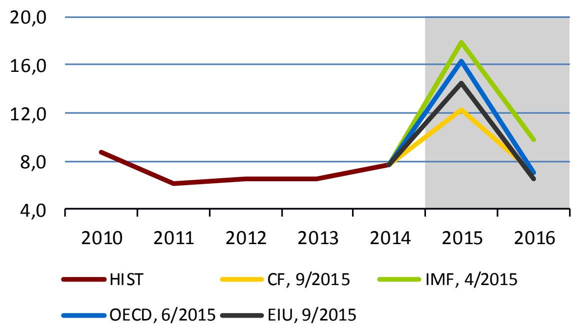
The dynamics of Russia's short-term macro-indicators remain negative. Industrial production declined by 4.3% in August, and retail sales and real wage growth dropped by more than 9% in July. By contrast, inflation went up in August compared to July, reaching 15.8% for consumer prices. Trade recorded the worst developments in August. Russia's exports and imports at current prices fell by more than 40% owing to a significant deterioration in turnover with China (a decline of 32.8%) and unfavourable oil price and exchange rate developments. The rouble weakened to RUB 65 to the dollar in mid-September, showing a strong negative correlation with oil prices. The new MER forecast expects oil prices to reach about USD 52 a barrel this year. The price of Ural crude oil fell to around USD 46 a barrel in mid-September. The net capital outflow was USD 52.5 billion in 2015 H1 and is expected to reach USD 93 billion in 2015 as a whole. The September CF and the EIU lowered the GDP outlook compared to the previous month and now expect the economy to contract by 3.6% in 2015 and grow by 0.3%–0.6% in 2016. Inflation should reach 12.3%–14.5% this year and fall to 6.5%–7.1% next year.

GDP growth, %



	CF	IMF	OECD	EIU
2015	-3,6	-3,4	-3,1	-3,6
2016	0,3	0,2	0,8	0,6

Inflation, %

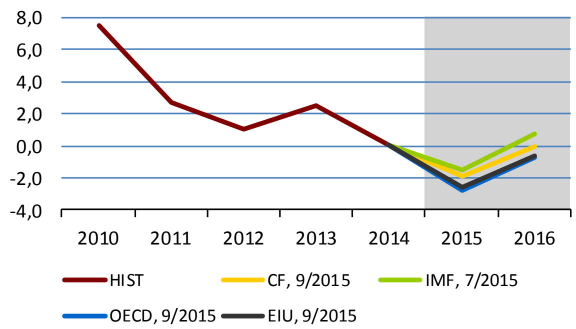


	CF	IMF	OECD	EIU
2015	12,3	17,9	16,3	14,5
2016	7,1	9,8	7,0	6,5

III.4 Brazil

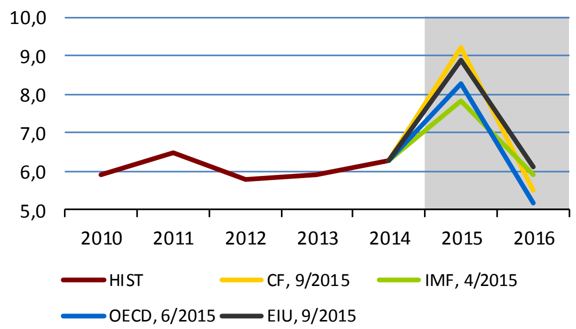
The Brazilian economy remains in decline and industrial production growth is continuing to fall. The PMI in manufacturing also dropped slightly compared to July. The deterioration in the Brazilian economy, and above all in public finances, resulted in Standard & Poor's downgrading Brazil's rating by one notch to the speculative grade. Moreover, the rating outlook remains negative. The CF, the EIU and the OECD worsened their outlooks for the economic contraction this year. The EIU and the OECD expect the economy to contract next year as well. Inflation decreased in August for the first time since December 2014, albeit only slightly to 9.5%. The CF and the EIU forecasts for this year as a whole deteriorated to 9.2% and 8.9% respectively. Next year these institutions expect inflation to return to the required band. The Brazilian central bank left its policy rate unchanged, as previous restrictions had failed to lower inflation significantly and exacerbated the economic crisis.

GDP growth, %



	CF	IMF	OECD	EIU
2015	-1,9	-1,5	-2,8	-2,6
2016	0,0	0,7	-0,7	-0,6

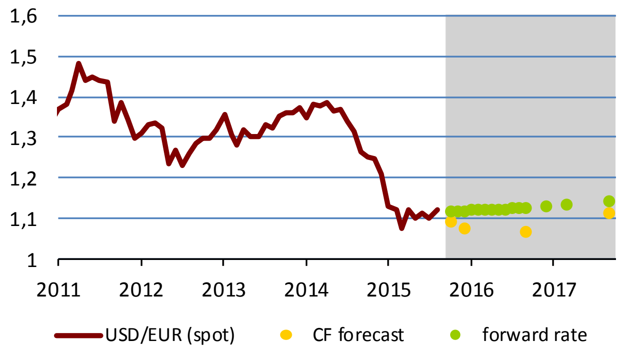
Inflation, %



	CF	IMF	OECD	EIU
2015	9,2	7,8	8,3	8,9
2016	5,5	5,9	5,2	6,1

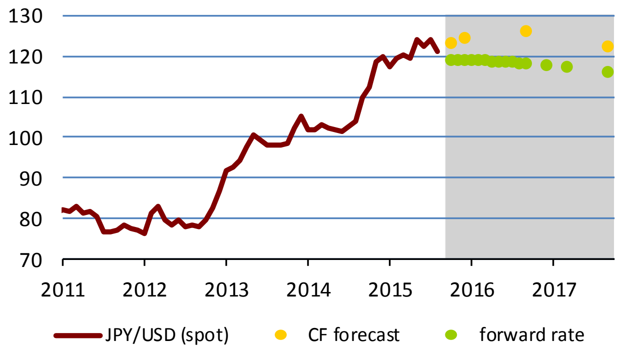
IV. Outlook of exchange rates vis-à-vis the US dollar

The euro



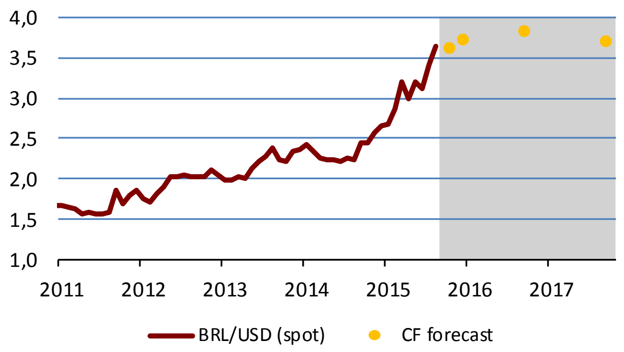
	7/9/15	10/15	12/15	09/16	09/17
spot rate	1,117				
CF forecast		1,093	1,077	1,066	1,111
forward rate		1,118	1,119	1,126	1,143

The Japanese yen



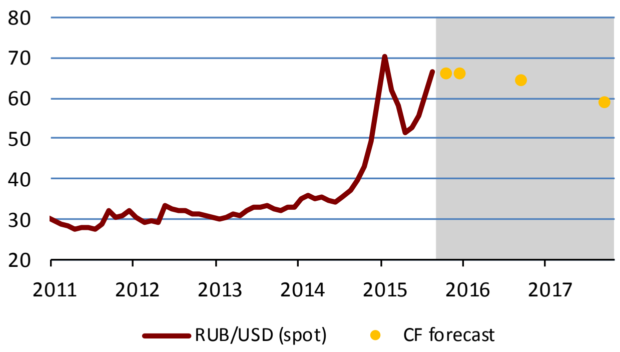
	7/9/15	10/15	12/15	09/16	09/17
spot rate	119,3				
CF forecast		123,2	124,4	126,1	122,3
forward rate		119,2	119,1	118,2	116,1

The Brazilian real



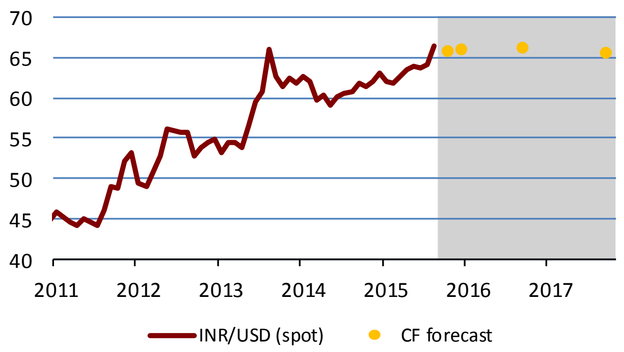
	7/9/15	10/15	12/15	09/16	09/17
spot rate	3,846				
CF forecast		3,623	3,714	3,827	3,699

The Russian rouble



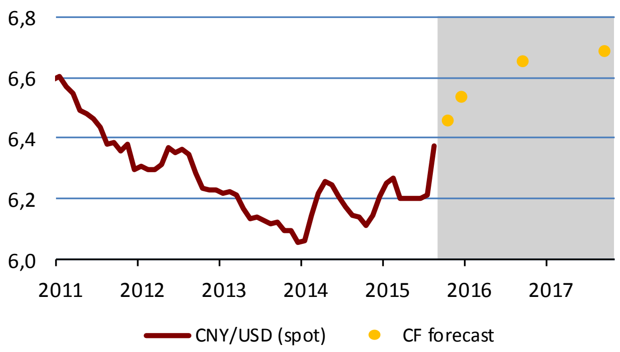
	7/9/15	10/15	12/15	09/16	09/17
spot rate	68,78				
CF forecast		66,03	66,11	64,27	59,02

The Indian rupie



	7/9/15	10/15	12/15	09/16	09/17
spot rate	66,84				
CF forecast		65,78	65,97	66,17	65,63

The Chinese renminbi



	7/9/15	10/15	12/15	09/16	09/17
spot rate	6,366				
CF forecast		6,458	6,536	6,653	6,687

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
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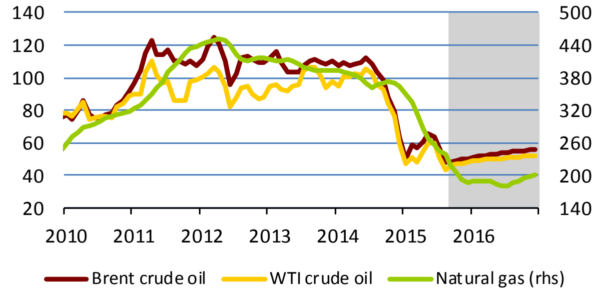
V.1 Oil and natural gas

In the first half of August, the Brent crude oil price temporarily calmed just below USD 50 a barrel (bbl). In the second half of the month, however, unusually large swings occurred, with oil prices first plunging to their lowest level in more than six years (USD 42.7/bbl) and then rising by more than 25% in three days as a result of the closing of short positions. In the first half of September, the oil price trended downwards again owing to a persisting fundamental excess of oil in the market. Of the three large oil agencies, the IEA drew the most attention with its forecast. It further raised its estimate for oil demand growth this year to a five-year high of 1.7 million barrels a day (mb/d) and continues to expect above-average growth of 1.4 mb/d next year. By contrast, it expects supply to drop by 0.5 mb/d, implying growth to 31.3 mb/d in demand for OPEC oil in 2016. In 2016 H2, therefore, demand for OPEC oil could exceed current OPEC extraction and global stocks should start falling.

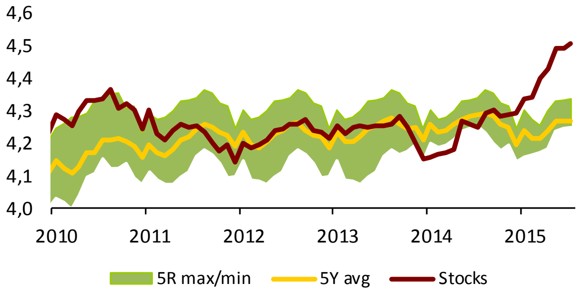
The market forecast based on the futures curve of 7 September again shifted slightly downwards. It implies an average Brent price of USD 54.8/bbl this year and a further drop to USD 53.7/bbl next year on account of only slow growth in prices from their current low levels. The EIA did not revise its forecast, which is in line with the market prediction for this year. For next year, however, it continues to expect prices to rise to USD 59/bbl on average. WTI prices should be USD 5/bbl lower. The September CF forecast also expects the price of Brent oil to rise to USD 59/bbl at the one-year horizon. However, these forecasts are subject to many uncertainties, such as how rapidly Iranian extraction will expand, how consumption in large emerging economies will develop, how supply and demand in OECD countries will respond to persisting low oil prices and whether OPEC will maintain its current policy.

Outlook for prices of oil and natural gas (USD/1000m3)

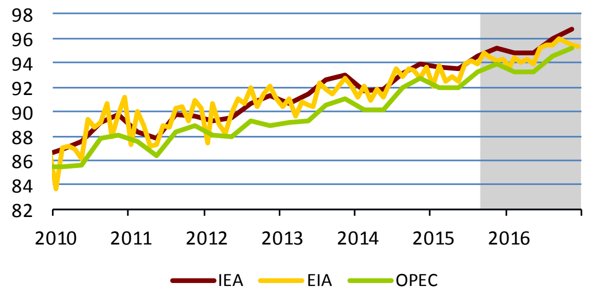


	Brent	WTI	Natural gas
2015	54,82	50,17	257,76
2016	53,74	50,62	189,49

Total stocks of oil and oil products in OECD (bil. barrel)

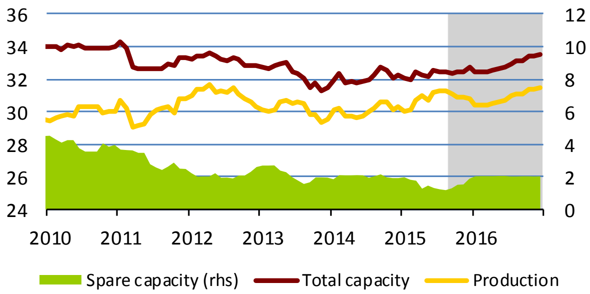


Global consumption of oil and oil products (mil. barrel / day)



	IEA	EIA	OPEC
2015	94,22	93,62	92,78
2016	95,59	94,93	

Production, total and spare capacity in OPEC countries (mil. barrel / day)



	Production	Total capacity	Spare capacity
2015	30,83	32,35	1,52
2016	30,86	32,89	2,03

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. 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).
Source: Bloomberg, IEA, EIA, OPEC, CNB calculation

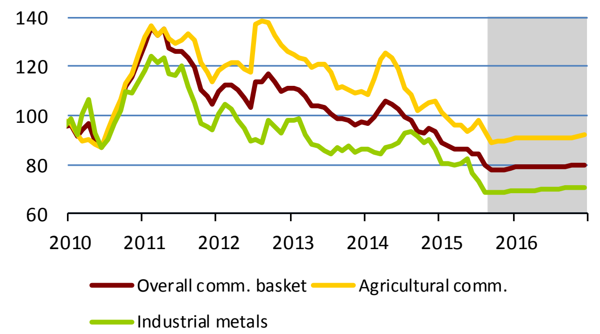
V.2 Other commodities

The average monthly non-energy commodity price index plunged in August and continued to fall in the first half of September. The food commodity sub-index showed a similar pattern. The basic metals sub-index also fell in August, but the decline halted in the first half of September. Speculative net long positions also dropped for non-energy commodities (as they did for oil), but the market outlook for both sub-indices, and hence also the overall index, is rising gently.

Prices of virtually all basic metal items were pushed down by a further drop in the Chinese PMI from 47.8 in July to 47.3 in August. This is causing concerns about a decline in Chinese industry and thus a slowdown in demand for industrial commodities. The situation was exacerbated by repeated devaluation of the Chinese currency, which made commodities more expensive for Chinese customers. Last but not least, a sharp decrease in the US PMI is signalling weaker industrial demand in the USA. At the end of August, however, the drop in world prices of most basic metals (except nickel) halted and prices edged up. Following a decrease in early July, iron ore prices are rising moderately. However, the outlook is falling amid still subdued demand, as Chinese steel production fell by 4.6% year on year in August.

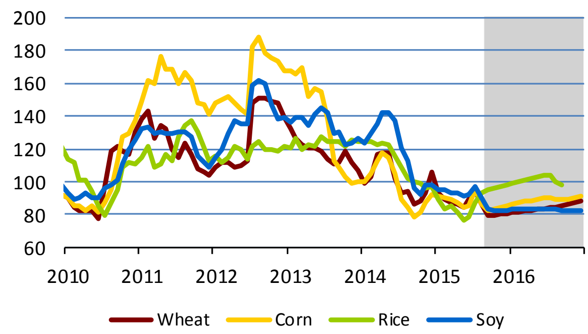
Agricultural commodity prices fell for both cereals and oil crops. The USDA raised its estimates of global stocks of wheat and corn after the 2015 harvest and left its estimate for soy near all-time highs despite a slight decline. Soy prices dropped partly due to the devaluation of the renminbi, as China's exports account for over 60% of global soy trade. Sugar prices plunged due to a sharp depreciation of Brazil's currency. Meat prices also declined. Natural rubber prices fell further owing to low oil prices and rising stocks in China.

Non-energy commodities price indicies



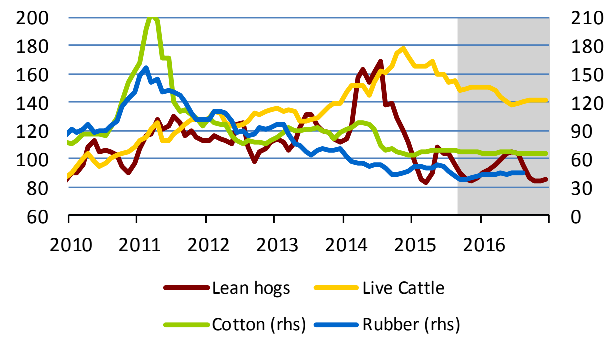
	Overall	Agricultural	Industrial
2015	83,0	94,3	74,9
2016	79,4	91,2	70,0

Food commodities



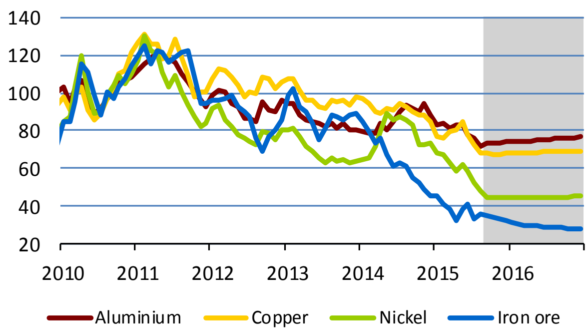
	Wheat	Corn	Rice	Soy
2015	85,9	87,0	88,4	89,9
2016	84,3	89,2	101,4	83,0

Meat, non-food agricultural commodities



	Lean hogs	Live Cattle	Cotton	Rubber
2015	92,9	157,8	67,7	46,7
2016	94,1	143,2	66,3	

Basic metals and iron ore



	Aluminium	Copper	Nickel	Iron ore
2015	77,8	73,7	54,7	36,5
2016	75,3	68,4	44,8	29,0

Note: Structure of non-energy commodity price indices corresponds to composition of The Economist commodity indices. All prices are given as indices, 2010 = 100 (charts) and percentage changes (tables).
Source: Bloomberg, CNB calculations.

The economic reforms of Indian Prime Minister Narendra Modi[1]

India, the fastest growing major world economy,[2] is the current star of the notional BRIC group. As well as having recorded strong economic results for quite some time now, its outlooks are fairly optimistic thanks to a recently launched process of extensive reforms.[3] The current Indian Prime Minister Narendra Modi, who took the helm of the world's most populous democracy after a crushing electoral victory in May 2014, is the symbol of these reforms. This article presents the major planned and implemented reforms, which are aimed at liberalising and streamlining the Indian economy and ensuring that its rapid growth does not fizzle out.

1 The economic situation and Modi's rise to power

India is a federal parliamentary republic headed by an indirectly elected president. However, the prime minister holds most of the executive power. The latest elections to the lower house of parliament, held in May 2014, were won by the Bharatiya Janata Party (BJP) led by Narendra Modi, the long-time chief minister of the federal state of Gujarat. Multi-party coalitions are the norm in India, but Modi managed to win a majority for his party (the first time this has happened in India since 1984). His party therefore now rules alone and can focus fully on its programme.

The previous government of Prime Minister Manmohan Singh[4] was not too successful from the economic perspective.[5] Annual GDP growth started to slow sharply in 2010, from 13.1% in 2010 Q1 to 2.3% in 2012 Q1. Other economic problems also emerged – a sustained high current account deficit, weak industrial production growth, high inflation (regularly reaching double figures in 2012 and 2013) and a high level of corruption, which sparked major protests in 2011.

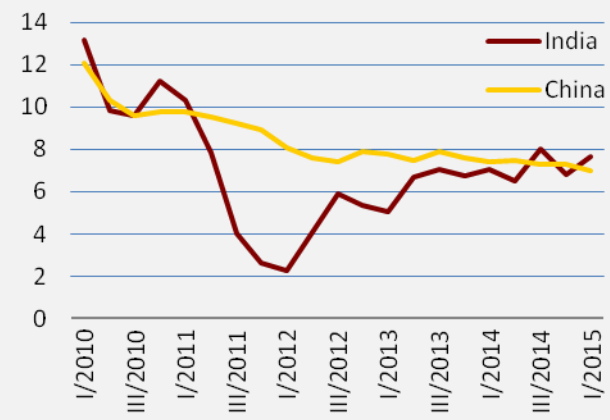


Chart 1 GDP growth (in % yoy) and comparison with China

Source: EIU

Chart 2 Consumer price inflation (in % yoy)

Source: EIU

Economic issues were thus the centrepiece of the BJP's election campaign. Besides reducing high inflation, the party's manifesto emphasised the need for economic recovery and sustainable economic growth. It also promised to maintain fiscal discipline, reform the banking system, make the economy globally competitive,

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[1] Written by Pavla Břízová (pavla.brizova@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. Cut-off date for information and data presented here is 7 August 2015.

[2] India overtook China in terms of annual GDP growth in 2014 Q3. It fell behind again the following quarter but reclaimed the lead in 2015 Q1. Moreover, current developments in China are indicating a further slowdown. However, the China's economy is far bigger than India's. The annual nominal increases in GDP are therefore much larger in China. Chinese GDP totalled USD 10.4 trillion in 2014 (the second highest in the world), while Indian GDP was USD 2 trillion (ninth in the world).

[3] Another reason for optimism is the expected demographic trend. India is the second most populous country in the world (behind China), and more than half of its population is under 25.

[4] Singh served two terms of office: 2004–2009 and 2009–2014.

[5] This was of course due also to external effects – the global financial crisis and its second-round effects, especially the Fed's first mention of tapering its quantitative easing programme in May 2013, which led to a sharp depreciation of the rupee and an outflow of capital.

attract foreign capital into the country and invest in infrastructure projects. Modi stated that he would lead India to full use of its economic potential and make it a global economic driver. This was to be achieved by creating new jobs, building infrastructure and focusing on new industrial sectors. In the political area, he pledged to speed up government decision-making procedures and remove bureaucratic barriers hindering the country's economic development.

Since taking office Modi has introduced a raft of reforms and initiatives, from an overhaul of the tax system, through projects to improve social welfare and quality of life, to extensive liberalisation of FDI inflows. More than a year on from the elections, although some observers rate his progress with reforms as slow (compared to what had been expected after such an impressive victory), these are clearly the most radical changes in India's economic policy since the economic liberalisation of 1991.

Some achievements do seem apparent. The Indian economy grew by 7.3% in FY[6] 2014/2015, compared to just 4.5% in FY 2012/2013. The question remains, however, how much of this economic recovery can be attributed to Prime Minister Modi's actions and how much to the fall in global oil prices, as the country imports almost two-thirds of the oil it consumes.

Another factor dampening optimism about the current growth of the Indian economy is the fact that the Indian statistics authority changed its GDP calculation method quite significantly this January. As well as updating the reference year and switching to market prices, it changed the way the structure of the Indian economy and the output of firms are estimated. The difference between the FY 2013/2014 growth figures calculated using the previous and new methodology is 2.2 pp. According to the IMF, however, the methodological change has improved the calculation of economic activity, and it has adjusted its estimates of future economic growth in India accordingly.

The improved economic situation in India is confirmed by data on industrial production. It has been rising by about 4% year on year every month since November last year. Previously, it had been lurching between growth of around 3% and decline of 2%.

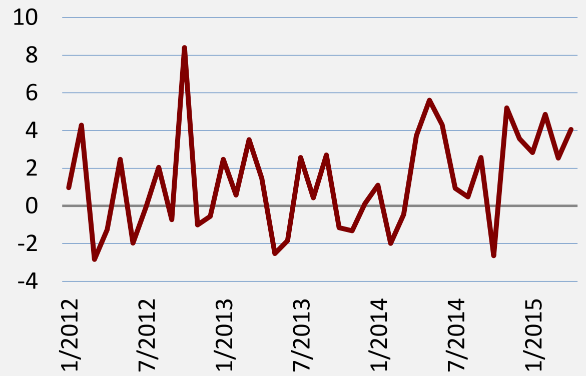

Chart 3 Industrial production index

Source: EIU

Note: Index – FY 2004/2005 = 100, in % yoy

2 Doing business in India and foreign investment

After becoming prime minister, Narendra Modi set about tackling the main problems of India's economy – inefficiency (especially in the government sector), excessive regulation and the vast red tape hindering business and trade. He set a political target of moving India up from 142th to 50th place on the World Bank's ease of doing business ranking.[7] He started cutting the bureaucratic burden on firms and modernising the inefficient civil service. However, firms are now complaining that authorities, in fear of making bad decisions, are referring issues to higher tiers of government, often right up to the Prime Minister's office, so that doing business remains as difficult as ever.

Expropriation rules

The prime minister's efforts to reform the Land Acquisition Bill have triggered the most disputes so far. Modi would like to speed up India's transformation from a still mostly agricultural economy to an industrial one. However, the debate about how to fairly and efficiently sell off the agricultural land owned by small farmers to large companies building industrial factories and necessary infrastructure is stirring up strong emotions in a country where 49% of the population[8] still lives on agriculture.

The law has its origins in the British colonial era and enables the state to expropriate private land in the public interest if the owner receives fair compensation. In 1984, the applicability of this law was extended to cases where the state acquires land on behalf of a private company. Two years ago, the previous government replaced the original law with a new one much more accommodating of the rights of small farmers. The consent of more than 70% of the farmers affected was necessary for most sales of land. As a result, however, investment projects totalling around USD 392 billion were halted or significantly delayed, especially in areas such as the construction of power stations, large industrial concerns and new mines. The future economic growth of the country is heavily dependent on the completion of these projects.

[6] Instead of a calendar year, India uses a fiscal year running from April until the end of the following March in its statistics.

[7] The Czech Republic currently ranks 44th out of 189 countries.

[8] 2012 estimate.

In December last year, therefore, the new prime minister issued a temporary decree under which investment in defence, rural development, affordable housing and industrial corridors is exempted from the duty to obtain the consent of local farmers. During the approval process, however, the decree met with sharp opposition in the opposition-controlled upper house of parliament. After more than six months of political fighting, Prime Minister Modi's government eventually abandoned its efforts to change the law at the central level. However, it suggested that federal states should incorporate the proposed changes into their local legislation and so unblock the halted projects in their territories.

Make in India

Prime Minister Modi's most important initiative is Make in India, which he introduced in September 2014. It aims to convince foreign companies to relocate their production to India. The prime minister believes he might even make India the centre of global industrial production. Through this heavily promoted initiative, he would like to boost his country's production capacity and foster job creation using foreign capital and technology. Almost half of India's population still works in agriculture, but the sector generates only 17% of GDP.[9] The transfer of part of this labour force to industry could significantly increase labour productivity.

This is a fundamental ideological change in the orientation of the entire economy. Modi is bringing in a new manufacturing-based export growth model, but to make this plan work, extensive changes must be made across all government departments. A key condition for success is significantly simplified access of foreign capital to the country. The first steps taken by the prime minister in this respect include reducing red tape (unifying and simplifying forms, extending licence expiry dates, etc.) and putting the bulk of administration online.

Foreign financing

Reducing the regulation of foreign investment in India is an issue all of its own. Until 1991, India isolated itself from global trade with the idea of protecting its economy and achieving self-sufficiency. Imports were subject to heavy duties, exports to taxes and quotas, and foreign direct investment (FDI) projects to strict limits on ownership, various restrictions (technology transfer restrictions, export obligations and so on) and government consent. Although these barriers have gradually been lifted since the 1990s, many remain in force. The system is lacking in transparency and is opening up only bit by bit. For instance, the level of foreign ownership permitted in the insurance sector has recently been raised from 26% to 49%. However, there are still limits of 20% in state banking[10] and 74% in private banking. The situation is similar in other business areas.

The relaxation of foreign capital inflow conditions has intensified further since Modi took office. The prime minister announced that FDI would be allowed in all sectors where necessary for the creation of new jobs, infrastructure development or the acquisition of missing technology and know-how.[11] During his first year, he visited the 16 countries with the greatest potential for bilateral ties in order to support trade and capital inflows. His efforts are starting to bear fruit. During his first year in office (June 2014 to May 2015) the inflow of FDI into India was more than USD 36 billion, up 50% on the previous 12 months.

India is also benefiting from the fact that neighbouring China is being forced to abandon its previous growth model based on manufacturing with low value added due to the rising price of labour of its population and other costs. FDI of this type is thus seeking new destinations and India is a natural candidate.

3 Fiscal policy reforms

Another important area Narendra Modi decided to overhaul immediately after taking office is the tax system in India. His primary objective is to complete and implement a single Goods and Services Tax (GST) as soon as possible. India currently has a non-transparent dual system of indirect taxation where various taxes are determined and collected by both the federal states and central government. Double taxation is common and the whole system seriously hampers the movement of goods between Indian states. Moreover, until recently turnover was subject to a cascade tax. Now the value added tax system is used instead.

Efforts to reform indirect taxes date back to 2000, when the first discussions about the need to unify the tax system and make it more transparent started. However, the preparations for the reform progressed at snail's pace. Rapid completion of the reform is one of Prime Minister Modi's primary objectives. His finance minister Arun Jaitley submitted a specific reform bill to the lower house of parliament in December 2014.

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[9] Figure for FY 2014/2015. Industry currently produces 30% of GDP and services the remaining 53%.

[10] Public sector banks, i.e. banks managed and majority-owned by the government, accounted for 90% of the Indian banking sector in 1991, before liberalisation. Now they account for around 80%.

[11] With the exception of multi-brand retail trade. India prides itself on the fact that small traders account for 95% and organised retail trade (e.g. hypermarkets and chain stores) for only 5% of local retail trade. While the entry of individual foreign brands into the Indian market has been gradually allowed and is no longer subject to limits on ownership, multi-brand retail trade is still prohibited due to concerns that Western-style chain stores might crowd out typical Indian retailers.

A comprehensive indirect tax on the production, sale and consumption of goods and services is planned to take effect in April 2016, replacing all the existing indirect taxes at central and local level. Exports will be subject to a zero rate, while imports will be taxed at the same rate as domestic products and services in line with the destination principle. However, the bill is not sure to be approved. It has been lying in the upper house of parliament since May and a tough political battle is being waged over its final shape. The tax rate has not been decided yet.

The implications of the tax reform for the Indian economy are huge. The finance minister has said that it is the largest tax reform since independence in 1947 and he believes that this step will finally turn the 29 Indian states into a single market. The main benefits of the reform include increased competitiveness of Indian products on both the domestic and international market and simplified tax collection, which should have a positive effect on economic growth.

Better budget administration

Prime Minister Modi's main objective on the budget expenditure side is to invest heavily in the country's neglected and inadequate infrastructure. This is key to his plan to develop industry and attract foreign capital and technology. Specifically, the government wants to invest in upgrading and extending the road and railway transport network. Investment from the public budget currently plays a vital role in India, as private investment is very limited. Capital costs are high and banks are unwilling to provide investment loans as they have too many bad loans on their books.

The overall state of public finances improved slightly during the new government's first year compared to previous years. The budget recorded a deficit of 4.0% of GDP in FY 2015/2015, 0.4 pp lower than a year earlier. This was the Indian state's best budget result since 2007.

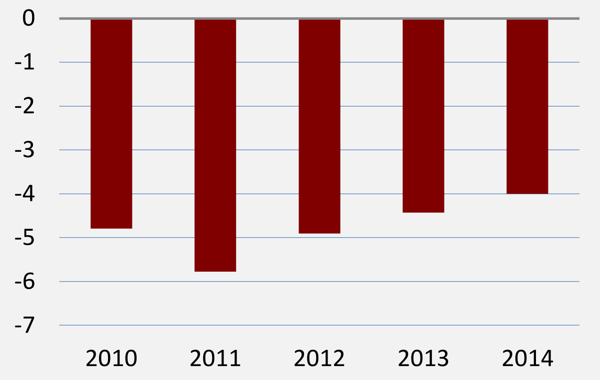

Chart 4 Central government budget deficit

Source: EIU

Note: In % of GDP, data for FY starting in April of given year

One of the causes of the improvement in public finances was the abolition of some costly energy and agricultural subsidies. More money was saved by holding transparent electronic auctions for coal-mining licences and mobile network frequencies. Despite this, Modi is facing criticism for allowing the economy, which is growing at a pace of more than 7% a year, to generate such high budget deficits. One of his government's failures so far is the zero progress it has made with the privatisation of inefficient and indebted state companies (such as Air India and Indian Railways). Only the sale of loss-making state-owned hotel groups is planned for this year.

4 Modernisation of monetary policy

Monetary policy has also undergone some major changes. The Reserve Bank of India (RBI) officially switched to inflation targeting in March this year, continuing its drive to become an independent and credible central bank.[12] However, it embarked on this course before Prime Minister Modi took office. The main driver of this process is the current RBI Governor, former IMF chief economist Raghuram Rajan, who was appointed in September 2013.[13]

The first inflation target was set at 8% as of January 2015 even before the new monetary regime was formally adopted, and was comfortably fulfilled. The reference value for January 2016 was set at 6% based on the method of gradual lowering the point inflation target. An inflation target of 4% with a tolerance band of ±2 pp will apply from FY 2016/2017. Monetary policy seems to be successful thus far. Inflation was running at 8% in July 2014 and was only 5.4% a year later (June 2015). However, the fall in global oil prices played a major role in this decline.

India's international reserves have been increasing since Raghuram Rajan was appointed governor. At the time he joined the central bank, the reserves totalled around USD 275 billion, whereas today they amount to more than USD 353 billion. They are being built up in preparation for a rise in interest rates around the world (especially in the USA). The RBI is creating a buffer it can draw on in the event of excessive volatility of the rupee's exchange rate.

Another step towards bringing Indian monetary policy into line with advanced norms will be the creation of a monetary policy committee as the RBI's future decision-making body. Until now, the governor has had

[12] The CNB's quarterly Central Bank Monitoring covered this topic in detail in June 2015.

[13] For the second year in a row, Global Finance awarded Raghuram Rajan with the top "A" grade in its Central Banker Report Cards. CNB Governor Miroslav Singer earned the same grade this year.

exclusive powers in this area. However, the Indian government and central bank have yet to agree on the specific legislation for the planned change. The disputes relate mainly to which of the institutions will nominate more committee members and whether the governor will have the right of veto.

5 Modi's food policy

The central bank is not alone in striving to reduce inflation. Active measures are also being taken by the government. Since about half of India's consumer basket consists of food, Prime Minister Modi has focused mainly on reducing food prices. In his first year in office, he introduced several changes with short-term effects – he made part of the national wheat reserves available for sale in the open market, forced the Indian states to allow farmers to sell fruit and vegetables directly to customers and set a ceiling on guaranteed grain price growth.

From the longer-term perspective, he decided to combine the reduction in food price inflation with the development of manufacturing industry. One-third of Indian fruit and vegetable production currently goes off before it can be consumed or processed, putting upward pressure on prices. This is due, for example, to a lack of cold storage warehouses and to unsuitable infrastructure hindering transport from producers to consumers. Farmers thus usually sell their goods as fast as possible to the nearest middleman, even at disadvantageous prices. Moreover, only about 2% of domestically produced fruit and vegetables are processed in the food industry (as compared to 80% in Malaysia and 30% in Thailand). Modi has therefore said that he will increase the total amount of industrially processed food from 10% today to 25% in 2015.

Back in 2008, Modi's predecessor Manmohan Singh came up with the idea of building government "food megaparks" concentrating warehouses, cold stores, ripening rooms and other equipment in one place in close proximity to agricultural areas. Modi has enthusiastically set about implementing this project. Forty-two parks were planned. Four are now up and running, 21 are under construction, and specific locations have been chosen for the remaining 17. In this way, the prime minister will perhaps achieve two objectives at once – reducing inflation and boosting economic growth.

6 Enhancing quality of life

Besides the economic reforms described above, Modi is planning many other ambitious measures. These include cleaning up India's streets (the Clean India initiative), protecting the sacred Ganges from pollution, providing toilets for the half of the population who still have none, and building 100 "smart cities", where hundreds millions of villagers will move in the next decade as a result of urbanisation, and countless numbers of "smart villages" with internet access, clean water and low-carbon energy.

Modi has also launched a Digital India programme aimed at making all government services available electronically, extending high-speed internet access to rural areas and enhancing computer literacy among the poor. The Housing for All initiative, which Modi introduced in June this year, is aimed at fully eliminating Indian slums by 2022 by building 20 million affordable houses for the poor.

7 Conclusion

It is uncertain what Prime Minister Modi will really succeed in implementing during his time in office and whether it will provide India with sustainable growth. However, he does seem to be moving his country towards greater prosperity. India can only benefit from better conditions for doing business, the development of industry, access to foreign capital, efficient tax collection and independent monetary policy. However, his success will depend on the willingness of India's federal states to participate in the solutions he is proposing, as the prime minister's powers are limited by the high degree of independence of those states. Many of the planned projects will be difficult to implement without their support.

A1. Change in GDP predictions for 2015

	CF		IMF		OECD		CB / EIU	
EA	-0,1	2015/9 2015/8	+0,0	2015/7 2015/4	+0,2	2015/9 2015/6	-0,1	2015/9 2015/6
US	+0,2	2015/9 2015/8	-0,6	2015/7 2015/4	+0,4	2015/9 2015/6	+0,2	2015/9 2015/6
DE	-0,1	2015/9 2015/8	-0,0	2015/7 2015/4	+0,0	2015/9 2015/6	+0,7	2015/6 2014/12
JP	-0,1	2015/9 2015/8	-0,2	2015/7 2015/4	-0,1	2015/9 2015/6	-0,1	2015/5 2015/1
BR	-0,3	2015/9 2015/8	-0,5	2015/7 2015/4	-2,0	2015/9 2015/6	-1,1	2015/9 2015/8
RU	-0,1	2015/9 2015/8	+0,4	2015/7 2015/4	-3,1	2015/6 2014/11	0	2015/9 2015/8
IN	-0,1	2015/9 2015/8	+0,0	2015/7 2015/4	-0,1	2015/9 2015/6	-0,3	2015/9 2015/8
CN	-0,1	2015/9 2015/8	+0,0	2015/7 2015/4	-0,1	2015/9 2015/6	-0,1	2015/9 2015/8

A2. Change in inflation predictions for 2015

	CF		IMF		OECD		CB/EIU	
EA	0	2015/9 2015/8	-0,9	2015/4 2014/10	+0,0	2015/6 2014/11	-0,2	2015/9 2015/6
US	-0,1	2015/9 2015/8	-2,0	2015/4 2014/10	-1,4	2015/6 2014/11	-0,3	2015/9 2015/6
DE	-0,1	2015/9 2015/8	-1,0	2015/4 2014/10	+0,0	2015/6 2014/11	-0,6	2015/6 2014/12
JP	-0,1	2015/9 2015/8	-1,0	2015/4 2014/10	+0,0	2015/6 2014/11	-0,2	2015/5 2015/1
BR	+0,3	2015/9 2015/8	+2,0	2015/4 2014/10	+2,9	2015/6 2014/11	+0,1	2015/9 2015/8
RU	+0,3	2015/9 2015/8	+10,6	2015/4 2014/10	+8,6	2015/6 2014/11	0	2015/9 2015/8
IN	-0,2	2015/9 2015/8	-1,4	2015/4 2014/10	-0,7	2015/6 2014/11	-0,3	2015/9 2015/8
CN	+0,1	2015/9 2015/8	-1,3	2015/4 2014/10	-1,0	2015/6 2014/11	+0,1	2015/9 2015/8

A3. List of abbreviations

ABS	asset-backed securities
BoJ	Bank of Japan
BR	Brazil
BRIC	countries of Brazil, Russia, India and China
BRL	brazilian real
CB-CCI	Conference Board Consumer Confidence Index
CB-LEII	Conference Board Leading Economic Indicator Index
CBOT	Chicago Board of Trade
CBR	Central Bank of Russia
CF	Consensus Forecasts
CN	China
CNB	Czech National Bank
CNY	Chinese renminbi
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
EIA	Energy Information Administration
EIU	Economist Intelligence Unit
EIU	The Economist Intelligence Unit database
EU	European Union
EUR	the 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
HICP	harmonised index of consumer prices
CHF	Swiss franc
ICE	Intercontinental Exchange
IFO	Institute for Economic Research
IFO-BE	IFO Business Expectations
IMF	International Monetary Fund
IN	India
INR	Indian rupee
IRS	Interest Rate swap
JP	Japan
JPY	Japanese yen
LI	leading indicators
LIBOR	London Interbank Offered Rate
MER	Ministry of Economic Development (of Russia)
OECD	Organisation for Economic Co-operation and Development
OECD-CLI	OECD Composite Leading Indicator
PMI	Purchasing Managers' Index
PPI	producer price index
RU	Russia
RUB	Russian rouble
TLTRO	targeted longer-term refinancing operations
UoM	University of Michigan
UoM-CSI	University of Michigan Consumer Sentiment Index
US	United States
USD	US dollar
USDA	United States Department of Agriculture
WEO	World Economic Outlook
WTI	West Texas Intermediate (crude oil used as a benchmark in oil pricing)
ZEW-ES	ZEW Economic Sentiment

A4. List of thematic articles published in the GEO

2015

	Issue
The economic reforms of Indian Prime Minister Narendra Modi (Pavla Břízová)	2015-9
The Chinese renminbi in the SDR basket: A realistic prospect? (Soňa Benecká)	2015-8
Annual assessment of the forecasts included in GEO (Filip Novoný)	2015-7
Seasonal price movements in the commodity markets (Martin Motl)	2015-6
Assessment of the effects of quantitative easing in the USA (Filip Novoný)	2015-5
How consensus has evolved in Consensus Forecasts (Tomáš Adam and Jan Hošek)	2015-4
The US dollar's position in the global financial system	2015-3
The crisis and post-crisis experience with Swiss franc loans outside Switzerland (Alexis Derviz)	2015-2
The effect of oil prices on inflation from a GVAR model perspective (Soňa Benecká and Jan Hošek)	2015-1

2014

	Issue
Applicability of Okun's law to OECD countries and other economies (Oxana Babecká Kucharčuková and Luboš Komárek)	2014-12
Monetary policy normalisation in the USA (Soňa Benecká)	2014-11
Changes in FDI inflows and FDI returns in the Czech Republic and Central European countries (Vladimír Žďárský)	2014-10
Competitiveness and export growth in selected Central European countries (Oxana Babecká Kucharčuková)	2014-9
Developments and the structure of part-time employment by European comparison (Eva Hromádková)	2014-8
The future of natural gas (Jan Hošek)	2014-7
Annual assessment of the forecasts included in GEO (Filip Novoný)	2014-6
How far the V4 countries are from Austria: A detailed look using CPLs (Václav Žďárek)	2014-5
Heterogeneity of financial conditions in euro area countries (Tomáš Adam)	2014-4
The impacts of the financial crisis on price levels in Visegrad Group countries (Václav Žďárek)	2014-3
Is the threat of deflation real? (Soňa Benecká and Luboš Komárek)	2014-2
Forward guidance – another central bank instrument? (Milan Klíma and Luboš Komárek)	2014-1

2013

	Issue
Financialisation of commodities and the structure of participants on commodity futures markets (Martin Motl)	2013-12
The internationalisation of the renminbi (Soňa Benecká)	2013-11
Unemployment during the crisis (Oxana Babecká and 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

	Issue
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
Global trends in the services balance 2005–2011 (Ladislav Prokop)	2012-12
A look back at the 2012 IIF annual membership meeting (Luboš Komárek)	2012-11
The relationship between the oil price and key macroeconomic variables (Jan Hošek, Luboš Komárek and Martin Motl)	2012-10
US holdings of foreign securities versus foreign holdings of securities in the US: What is the trend? (Narcisa Kadlčáková)	2012-9
Changes in the Czech Republic's balance of payments caused by the global financial crisis (Vladimír Žďárský)	2012-8
Annual assessment of the forecasts included in the GEO (Filip Novotný)	2012-7
A look back at the IIF spring membership meeting (Filip Novotný)	2012-6
An overview of the world's most frequently used commodity indices (Jan Hošek)	2012-5
Property price misalignment around the world (Michal Hlaváček and Luboš Komárek)	2012-4
A macrofinancial view of asset price misalignment (Luboš Komárek)	2012-3
The euro area bond market during the debt crisis (Tomáš Adam and Soňa Benecká)	2012-2
Liquidity risk in the euro area money market and ECB operations (Soňa Benecká)	2012-1

2011

	Issue
An empirical analysis of monetary policy transmission in the Russian Federation (Oxana Babecká)	2011-12
The widening spread between prices of North Sea Brent crude oil and US WTI crude oil (Jan Hošek and Filip Novotný)	2011-11
A look back at the IIF annual membership meeting (Luboš Komárek)	2011-10
Where to look for a safe haven currency (Soňa Benecká)	2011-9
Monetary policy of the central bank of the Russian Federation (Oxana Babecká)	2011-9
Increased uncertainty in euro area financial markets (Tomáš Adam and Soňa Benecká)	2011-8
Eurodollar markets (Narcisa Kadlčáková)	2011-8
Assessment of the forecasts monitored in the GEO (Filip Novotný)	2011-7

	Issue
How have global imbalances changed during the crisis? (Vladimír Žďárský)	2011-6
Winners and losers of the economic crisis in the eyes of European investors (Alexis Derviz)	2011-5
Monetary policy of the People's Bank of China (Soňa Benecká)	2011-4
A look back at the IIF spring membership meeting (Jan Hošek)	2011-3
The link between the Brent crude oil price and the US dollar exchange rate (Filip Novotný)	2011-2
International integration of the Chinese stock market (Jan Babecký, Luboš Komárek and Zlatuše Komárková)	2011-1