Short term factors and long term convergence to push inflation higher in CEE

- Inflation growing worldwide mainly on higher food and oil prices. Supply to work for easing of prices unless droughts repeat next year
- Long-term price convergence to affect inflation, particularly when it comes to new EU member states
- Tightened monetary conditions based on currency appreciation and interest rate differentials, pro-vide premium yields to investors investing in CEE currencies

After a couple of years of a successful disinflation process in CEE (1), inflation is suddenly in an upward trend. This is not only a regional issue - inflation is growing worldwide. It is mainly higher food and oil prices that are blamed for the higher inflation and their contributions to inflation in CEE are much bigger than in Western of Europe.

Higher commodity prices, particularly of crude oil, wheat and milk powder have been crucial factors which elevated inflation in recent months. While growing global demand for wheat and milk powder can continue to put pressure on their prices, supply side should work for easing of prices unless droughts repeat next year. “We expect that central banks will not fully respond on these factors as they are exogenous and very likely to only have temporary or one-off effects on inflation. However, some reaction by the CEE central banks is still likely, and we expect them to respond to higher headline inflation with modest rate hikes or at least by making hawkish comments to support further their disinflationary efforts”, states Juraj Kotian, co-head of CEE Macro & Fixed Income Research at Erste Group.

Apart from short-term factors, long-term price convergence also affects inflation, particularly, when it comes to new EU member states. With goods and services still cheaper than in the more advanced EU countries overall, new EU member states are gradually approaching price levels common for the EU-15. “The price convergence in CEE should be perceived as a natural effect of income convergence. Furthermore, the tightened monetary conditions based on currency appreciation and interest rate differentials, provide premium yields to investors investing in CEE currencies”, says Kotian.

A consistent part of the convergence has been achieved via exchange rate appreciation, which increased returns on investments in CEE fixed income instruments. The rest of the convergence has been delivered via higher inflation, accompanied by higher interest rate differentials. As CEE economies are to continue their price convergence process, investments in CEE countries with flexible exchange rates should continue to deliver premium yields distributed differently among exchange rate appreciation and interest rate differentials. Demand for CEE currencies providing a yield premium should help central banks in their disinflation effort and skew the distribution of this premium more towards exchange rate appreciation than to interest rate differentials.

More important for further price development and profitability of investments into CEE currencies is convergence story related to growth of incomes and price level. Price convergence in CEE will be achieved via combination of exchange rate appreciation and inflation differential – both are supportive for investments into CEE currencies. Inflation differential translates into higher interest rate differential while exchange rate appreciation increases return from currency investments directly. Further price convergence and tightened monetary conditions in CEE (via exchange rate appreciation or/and higher interest rates) should generate a yield premium on investments into CEE currencies about 2-6% p.a. over next two years. The exception is Slovakia, where monetary policy will not have chance to react on price convergence because of Euro adoption.

The Erste Group Analyst state: “As long as countries converge in terms of income and price levels, we expect this premium to stay a positive in countries with a flexible exchange rate regime and inflation targeting. According to our forecasts:

- the largest yield premium, about 6% p.a. including currency effect, might be achieved via investments into Romanian Leu, followed by
- a yield premium of 3.6% p.a. for Polish Zloty over years 2008-2009.
- An investment into Czech currency is to produce a yield premium about 2.5 p.a. in average during 2008-2009.
- About 2% p.a. a yield premium is expected for Hungary, where slipped economic growth provides only modest impetus for price convergence and rationale for over tightening of monetary policy.
- We expect a yield premium for investments into Slovak koruna close to zero in average over 2008-2009 as exchange rate will be fixed and rates aligned to eurozone soon due to euro adoption.”

(1) In analysis only CEE countries with flexible exchange rates, particularly the Czech Republic, Slovakia, Hungary, Poland and Romania.