December 11, 2007

Special Report

Soaring inflation

- Inflation jumped on higher food and fuel prices
- Hawkish comments and modest rate hikes are expected in coming months
- Income convergence process puts a permanent upward pressure on prices
- Price convergence accompanied by tightened monetary policy provides a reasonable premium to investors
- A yield premium of about 2-6% p.a. expected from investments in CEE currencies over the next two years

Soaring inflation - what does it mean for CEE[1)] region?

After a couple of years of a successful disinflation process in CEE, 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. That is why we decided in the first part of this report to look under the surface of the short-term factors that have elevated inflation in CEE in recent months. However, it is questionable whether central banks should react to one-off inflation factors, which are likely to have only a temporary effect on inflation; their origin is somewhere other than the local economy.

In the second part of the report, we focus on price convergence associated with income convergence, which puts pressure on price growth in the long run. A decent 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. Over 2000-07, investments in money market instruments of CEE countries with flexible exchange rates generated 3-8% p.a. additional return above euro money market investments.

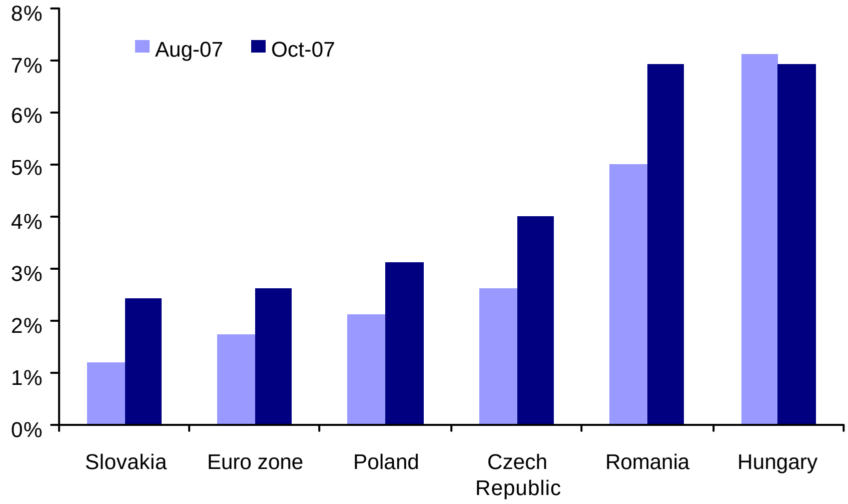
As CEE economies are to continue their price convergence process, investments in CEE countries with flexible exchange rates should continue to deliver premium yields distributed differently among exchange rate appreciation and interest rate differentials. Demand for CEE currencies providing a yield premium 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.

Short-term factors currently dominate in inflation

Inflation jumped up by one percentage point

In the last couple of months, the inflation development surprised on the upside almost everywhere in Europe. Average inflation in the Eurozone suddenly jumped to 2.6% y/y in October from just 1.7% y/y reported two months ago (in August). A similar development was observed in CEE economies, where inflation has increased about one percentage point or more[2)]. This in not the whole story, as it is very likely that inflation in the Eurozone will climb further and approach 3% y/y in the coming months.

Inflation development



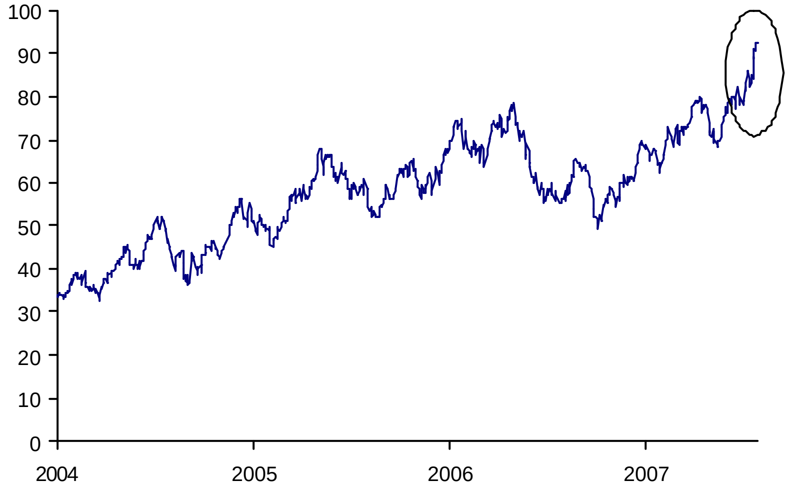
Source: Eurostat, Erste Group Research

[1)] We analyzed only CEE countries with flexible exchange rates, particularly the Czech Republic, Slovakia, Hungary, Poland and Romania.
[2)] Inflation in Hungary has not jumped because of a strong base effect from a year ago related to the change of VAT. However, the m/m inflation of about 0.7-0.8% reported in September and October reveals the same pattern in growth of consumer prices.

One third of increase can be ascribed to oil prices

It is not difficult to find common determinants of the higher inflation in Europe. The first is higher oil prices, which have been elevated from an average value of 60 USD/bbl in 1H07 to above 80 USD/bbl in October and further above 90 USD/bbl in November this year. While in the first half of this year, oil prices denominated in EUR were even about 10% lower than a year ago, oil prices increased tremendously - by 28% y/y and 40% y/y in October and November, respectively. Higher oil prices immediately fed into fuel prices and increased inflation of transport costs by about three percentage points, on average, as of October. Given the roughly 10-15% weight of transport costs in consumer baskets, higher oil prices explain about 0.3-0.4% of the recent upswing in inflation.

Crude oil prices in USD/bbl



Source: Reuters, Erste Group Research

Food prices contributed much more to higher inflation

Food prices have been the second factor behind the high inflation. Food prices in CEE economies went up 6-12% y/y in October, while in the Eurozone, it was "only" 3.9% y/y, on average. Given the weight of food prices in the consumer basket in the range of 17-20% for CEE and 36% for Romania, excessive food price growth (growth above inflation) contributed three percentage points to the recent inflation upswing in Romania and 0.6-0.8% for the rest of the CEE countries. In the table below, we can see that it is mainly prices of bread and cereals, milk products and vegetables that have increased remarkably. The price movement has been triggered by a killer combination - surging demand and squeezed supply caused by droughts (except for vegetable prices, where drought probably played the only role).

Food inflation y/y by product categories

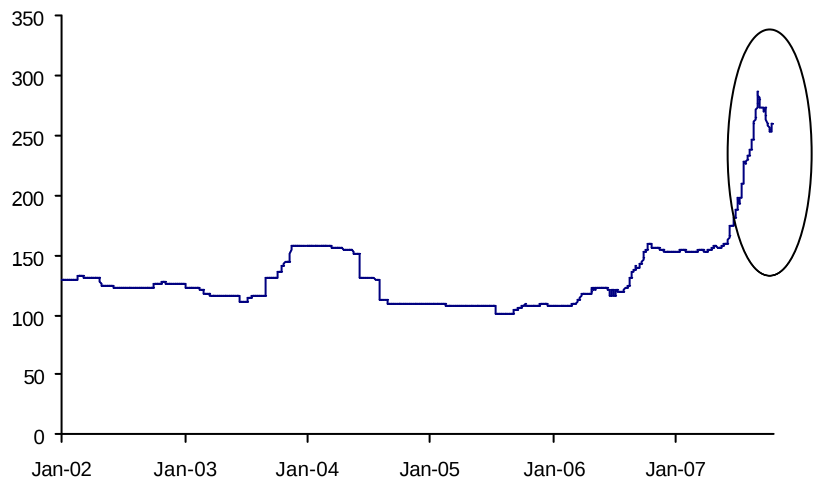
	Euro area 12	Czech Republic	Hungary	Poland	Romania	Slovakia
Overall inflation	2.5	4.0	6.9	3.1	6.9	2.4
Food prices y/y	**3.9**	**6.7**	**13.5**	**6.0**	**10.3**	**6.6**
which of:						
Bread and cereals	5.4	6.9	22.5	10.8	11.8	15.9
Meat	2.6	1.9	2.7	5.7	1.1	1.9
Fish and seafood	2.2	1.0	5.0	1.7	1.7	1.9
Milk, cheese and eggs	7.5	13.7	11.8	10.8	8.2	7.8
Oils and fats	1.1	8.8	8.0	11.4	26.2	2.8
Fruit	5.1	18.7	31.4	27.1	17.3	12.9
Vegetables	3.3	3.5	30.0	-13.1	30.9	7.5
Sugar and sweets	1.5	1.2	-1.6	-3.0	0.0	-1.3
Food products n.e.c.	0.7	2.7	6.3	3.5	2.8	4.7

Source: Eurostat, Erste Group Research

Wheat prices doubled, due to drought and increased demand

Wheat prices almost doubled during the year to 240 EUR/ton because of summer drought and the shrinking surplus of wheat in the European market. Well-subsidized European producers used to struggle for many years with a surplus of production and "low prices". However, this has now been "resolved", thanks to increased demand from the bio-fuel industry, which is supported by generous tax incentives and subsidized inputs.

Wheat prices in EUR/ton



Source: Reuters, Erste Group Research

Shortage of milk powder put pressure on milk products

Higher prices of milk products reflect rising demand for milk products and milk powder, especially from the Asian market, where the growing affluent population is changing its dairy consumption habits. Higher prices were also caused by supply factors. Drought in Australia, a big supplier of milk powder, contributed to a shortage of milk powder on the global market in the middle of year. Finally, higher wheat and corn prices increased the price of feed, which pushed up production costs of milk. We should perhaps expect higher meat prices due to this effect soon.

Seasonal and one-off effects should not have big influence on rates

We believe that the supply, negatively affected by drought this year, will improve next year, or in the worst case stay at the current level. In both cases, the supply side should work for disinflation next year. Because of the typical volatility of food and oil prices, central banks focus more on core inflation or inflation adjusted for fuel and food prices. As shocks in food and fuel prices have been either exogenous and one-off or seasonal, central banks do not automatically need to tighten monetary policy due to higher headline inflation. The same is valid for administrative measures like a hike of the VAT rate (as in Hungary in 2006 and the Czech Republic next year), which have sizable - but temporary - effects on inflation. On the other hand, if central banks do not form expectations firmly via some formal tightening, the credibility of inflation targeting may suffer and expectations of higher inflation can spill over into wages.

Rationale behind further price convergence

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. In order to achieve convergence, the price growth is generally higher among the new member states than in 'old Europe' (the alternative channel of price convergence is exchange rate appreciation).

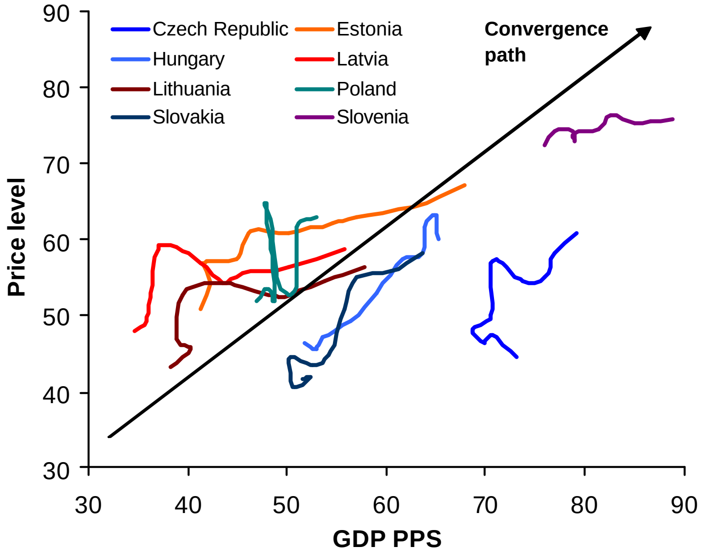
Where does price convergence come from?

Balassa-Samuelson effect

Price convergence comes alongside real convergence. This relationship is often explained by the Balassa-Samuelson effect. The quicker economic growth in new EU member states (which are closing their productivity gaps against old EU countries, particularly in the internationally competitive sector of tradable goods) translates into higher growth of wages, since companies distribute some of their gains in employee earnings[3]. The wage growth in the tradable sector (spurred by the productivity gains) transfers into salaries of workers in the area of services. Given that the service sector is not as open to cross-border competition, higher salaries can be achieved via higher prices of services and not only by productivity gains like in the more competitive tradable sector[4].

[3] *Increased demand for labor by new companies attracted by rising productivity also supports wage growth.*
[4] *Higher salaries also mean increased purchasing power and higher demand for goods and services.*

GDP in PPS vs. price level convergence paths



Source: Eurostat, Erste Group Research

Quality improvements

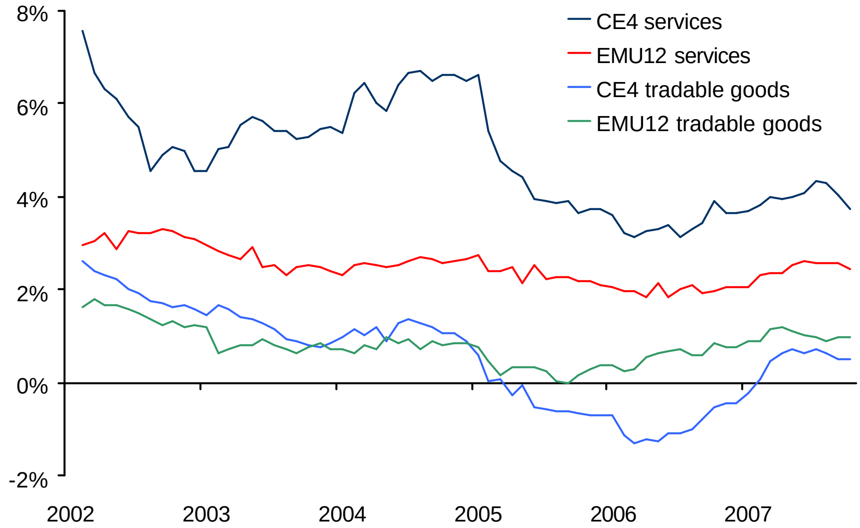
Unfortunately, recent papers do not provide much evidence to explain price convergence through the B-S effect. The B-S effect has been reckoned between 1-2% p.a. for CEE countries[5], only a fraction of the price convergence observed in new member states during the last 10 years. Another aspect to be taken into consideration is the quality enhancements of goods and services in transition economies. Having previously had lower purchasing power, producers in new EU members often focused on offering low prices, sometimes at the expense of quality. As the income of households in transition countries has grown, a higher share of producers started to offer branded products at a higher price, but also with better quality. Hence, even though quality improvements support the statistical inflation rate, we believe this process should not be viewed as harmful.

Convergence is more advanced in tradable goods than in services

Cross-country differences are much more profound for services than for goods. The reason is that the cross-border trade is much easier in the case of tradable goods. For example, if the price of the same TV set was significantly different in two neighboring countries, it would be relatively easy for retailers to import cheaper products in order to sell either at lower prices or with a higher margin. As a consequence, demand for cheaper TV sets would grow at the expense of costly ones and their prices would gradually approach each other[6]. However, little such pressure exists in the case of services, as it is quite uncommon that people would go watch a movie in a neighboring country, even if the ticket price was much cheaper there[7].

[5] *See Egert B.: "Real Convergence, Price Level Convergence and Inflation Differential in Europe", WP138 - OeNB (2007)*
[6] *The prices do not necessarily have to be equal, since one has to count with transport costs when determining whether an import is more profitable than a domestic purchase. At the same time, a company in a cheaper country might have lower expenses, due to different input prices (such as wages, rent, taxes, etc.), allowing for some difference in prices even with a market equilibrium.*
[7] *There are exceptions in both groups. For example, prices of services offered online might be very competitive in many cases. At the same time, it might be difficult or too expensive to transport goods, which have short durability (such as bakery products), even if the prices were significantly different.*

Growth of prices of tradable goods vs. services

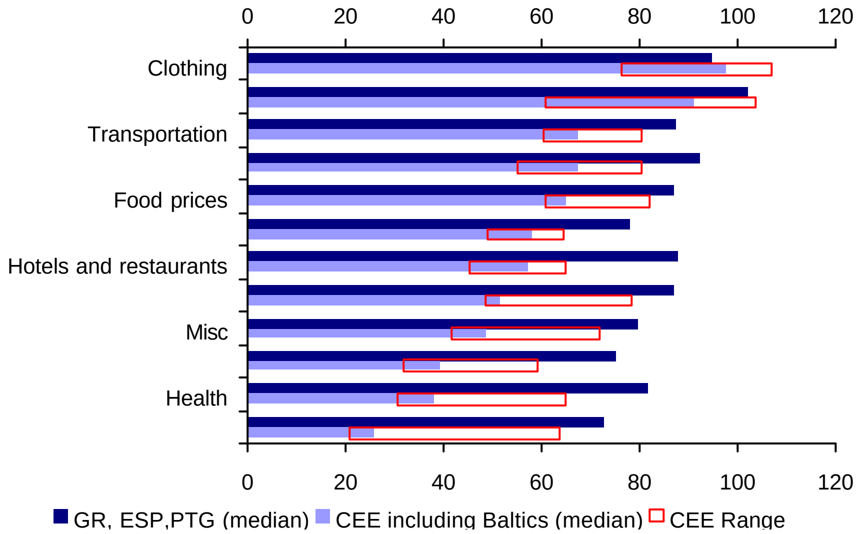


The figure for CE4 is simple unweighted average of price growth rates in Czech Republic, Hungary, Poland and Slovakia. Source: Eurostat, Erste Group Research

Largest price gaps persist in education, housing and healthcare

In 2005, the price level in the new EU member states varied between 42% and 89% of the EU average. In the case of services, the range was as wide as 25-81% of the EU average, while in the case of goods, the differences were shallower and the price levels were 57-92% of the EU average (in all mentioned categories, Bulgaria was the cheapest new EU member country, while Cyprus was the most expensive). Comparing 'old' and 'new' Europe, prices were particularly close in the cases of clothing and communication, while the biggest existing price gaps are areas under partial state control, such as education, housing (this category includes energy prices) and healthcare.

Price levels by categories



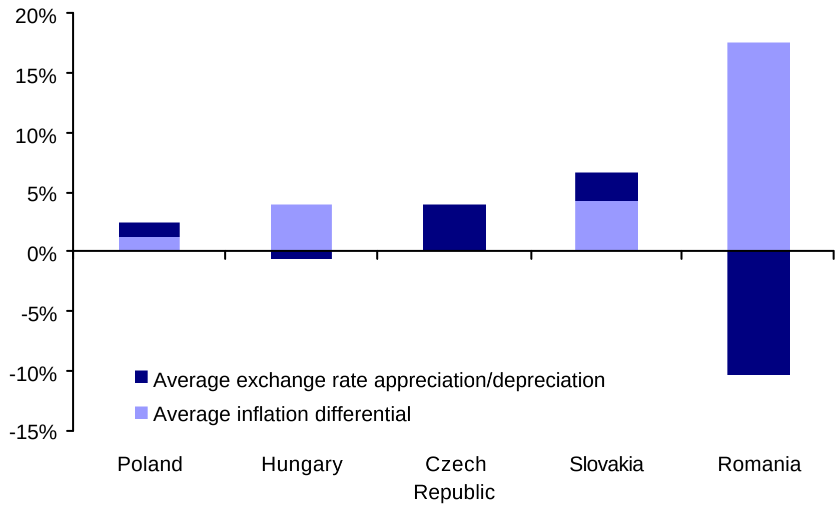
Source: Eurostat, Erste Group Research

As a consequence, price growth is quicker in the case of services than in the case of almost-converged tradable goods. This should also hold in the future, when higher inflation in emerging countries should be driven especially by prices of services. The situation is somewhat different in the case of those services still under state influence, as regulators are able to put artificial brakes on price growth. Price convergence will come sooner or later in these sectors as well, but its pace will depend on governments relaxing their regulatory grip.

Exchange rate matters

Price convergence does not automatically mean higher inflation. In countries with flexible exchange rate regimes, it is achieved by a mix of a positive inflation differential and currency appreciation. The more significantly the exchange rate strengthens, the lower (even negative) the inflation differential is between the transition country and the Eurozone. Currency appreciation significantly helped some CEE countries to compress inflation and progress in price convergence.

Average contribution of exchange rate appreciation and inflation differential to price convergence (p.a.)



Source: Eurostat, Erste Group Research

Inflation differential about 1-2% after joining Eurozone

For a euro-adopting converging country, once the exchange rate is fixed, the disinflationary impact of exchange rate appreciation wanes and inflation is the only channel for price convergence[8]. As a consequence for euro hopefuls with a floating exchange rate regime, inflation rates should accelerate after Eurozone entry - especially in those states where the gap in the price level is deeper. New EU members could also see precedents for higher inflation in some EU-15 countries, such as Portugal, Greece and Spain. These three cheapest EU members among 'old Europe' countries all saw higher inflation than the rest of the EU-15 countries. Compared to EU-15 average inflation at 2.0% y/y in 1999-2006, price growth in all mentioned countries exceeded 3% in the same period. A unique case is Ireland, which is no longer an economic laggard in the EU-15, as it was in the 1980s. However, Ireland's strong economic growth, which continuously exceeded other EU-15 countries in the last couple of years, also brought higher inflation (at 3.5% y/y on average during 1999-2006). Given the much lower price level in CEE, the inflation differential of CEE after fixing currencies might be higher than in Ireland, approaching 2% or even higher, on average.

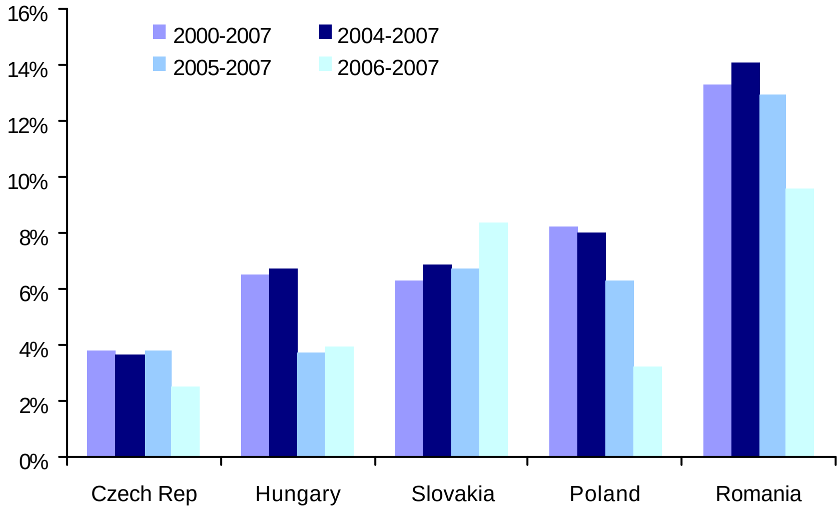
[8] *The euro exchange rate could still fluctuate against the currencies of the country's trading partners outside the Eurozone, in turn influencing imported inflation.*

Investments in CEE currencies benefit from price convergence

Price convergence is accompanied by monetary tightening…

To combat higher inflation, the new EU member states will have to tighten monetary conditions. This should particularly concern euro adepts ahead of evaluation of their preparedness to adopt the euro, as the Maastricht criteria do not take long term convergence much into account. Hence, even more tightening is necessary to compress inflation to below the required limit. Tightening might take the form of an appreciating currency or via central bank rate hikes. We see the currency route as the more efficient with regards to inflation, especially as new EU members generally belong to the most open economies within the EU[9] and the exchange rate has a more significant impact on inflation than in some bigger 'old Europe' economies. What is more, if one believes that the domestic currency will not depreciate[10], high domestic interest rates might be circumvented by borrowing in a foreign currency.

An average yield premium (p.a.)



Source: Reuters, Erste Group Research

…which provides generous yield premiums to currency investors

As a result of tightening via exchange rate appreciation or increased interest rate differential, investors with funding in euro receive a premium yield for investments in CEE currencies. The yield might be volatile, but in general it provides a reasonable premium. Over 2000-07, investments in money market instruments in CEE countries with flexible exchange rates generated 3-12% p.a. additional return above euro money market investments.

As long as countries converge in terms of income and price levels, we expect this premium to stay positive in countries with a flexible exchange rate regime and inflation targeting. According to our forecasts, the highest yield premium over 2008-09, about 6% p.a. including interest rate carry, could be achieved via investments in the Romanian leu, followed by a yield premium of 3.6% p.a. for the Polish zloty. Investments in the Czech koruna should produce a yield premium of about 2.5% p.a. on average during 2008-09. About a 2% p.a. yield premium is expected for Hungary, where slow economic growth provides only modest impetus for price convergence and rationale for tight monetary policy. We expect a yield premium for investments in the Slovak koruna of close to zero on average over 2008-09, as the exchange rate will be fixed and rates aligned with the Eurozone soon, due to euro adoption.

[9] *Larger countries such as Romania and Poland are exceptions, being around the EU average.*
[10] *This is not an unreasonable assumption in new EU member states with a floating regime, due to higher productivity growth.*

Expected inflation and average yield premium p.a. for 2008-09

	Inflation 2007	2008	2009	Interest rate differential	Currency appreciation p.a.	Yield premium p.a.
CZECH REPUBLIC	4.0	5.1	3.2	-0.3	2.8	**2.5**
SLOVAKIA	3.3	3.5	3.5	0.0	0.0	**0.0**
HUNGARY	6.9	3.9	2.3	2.1	0.0	**2.1**
POLAND	3.4	3.0	2.7	1.2	2.4	**3.6**
ROMANIA	6.1	4.8	4.2	3.4	2.9	**6.2**

Source: Erste Group Research

Conclusion

Higher commodity prices, particularly of crude oil, wheat and milk powder, have been crucial factors that have elevated inflation in recent months. While growing global demand for wheat and milk powder could continue to put pressure on prices, the supply side should work in the opposite direction, unless droughts occur again next year. We expect that central banks will not fully respond to 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 further their disinflationary efforts.

However, for future price development and profitability of investments in CEE currencies, the convergence story related to growth of incomes and price levels is more important. CEE countries continue to grow in income and their price levels are also rising because of more expensive services and price growth related to quality improvements. Price convergence in CEE is achieved via a combination of exchange rate appreciation and inflation differentials, which are both supportive for investments in CEE currencies. The inflation differential translates into a higher interest rate differential, while exchange rate appreciation increases the return on 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 in CEE currencies of about 2-6% p.a. over the next two years. The exception is Slovakia, where monetary policy will not have an opportunity to react to price convergence because of the expected euro adoption.

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Comments to inflation outlook and exchange rate/interest rate development

Czech Republic – David Navratil (macro analyst at Ceska sporitelna): Inflation will accelerate to 6% due to supply-side factors: foodstuff, oil prices and regulated prices plus change in taxes, while the demand inflation is still compressed deep below the inflation target. CZK is currently the strong, however, the trend reversal should come in 1H as koruna will come back to EUR/CZK 27-27.3. Inflation structure and CZK will limit speed of rate hikes, therefore we expect another hike in April and at the end-2008 to 3.75-4%.

Hungary - Orsolya Nyeste (macro analyst at EB Hungary): While in the regional countries free floating systems operate which allow nominal currency appreciation, in Hungary the central bank is not totally independent in its tools fighting against inflation, as in the range 240-245 HUF/EUR it should rather concentrate on defending the exchange rate band than inflation fighting. Such a system keeps inflation and interest rates nominally higher - compared to the Czech Rep. Slovakia and Poland. However, given subdued economic growth in Hungary and supposing anchored inflationary expectations, no significant second-round inflation effects and improvement in the global market environment, the central bank could cut the base rate to 7% by June 2008 and to 6.50% by the end of next year.

Slovakia – Michal Musak (macro analyst at Slovenska sporitelna): In Slovakia, the planned 2009 Emu entry means that the koruna will be replaced by the euro and interest rates will be the same as in the remaining EMU countries. While continued price convergence will likely lead to higher inflation compared to the Eurozone, the monetary policy will be shared with the Eurozone. In case of the less likely scenario of euro delay, the first response would likely be significant currency depreciation. Still, from the medium-term perspective, convergence would lead to renewed currency strengthening after this initial weakening period.

Poland – Martin Lobotka (macro analyst at Ceska sporitelna): Inflation is on the rise as elsewhere in the CEE region, the main factors driving it are food and fuel. The situation in Poland is more complicated than in other countries in terms of translation of the higher headline inflation into expectations. While the Slovak Republic enjoys healthy and high growth with real wages still far from growth of real productivity, Hungary is disinflationary in terms of the real economy (if not inflationary expectations buildup). The Czech Republic is in a similar situation as Poland, but lower GDP growth next year due to reforms, moderate unions' demands and lower consumption makes the threat of inflationary expectations buildup more remote than in an economy such as the Polish where aggregate real wages grow at double-digit rates and nothing is in sight to slow the economy. Therefore, the MPC will need to deliver at least two hikes next year to contain this threat.

Romania – Dumitru Dulgheru (macro analyst at BCR): The central bank is set to tighten monetary policy in 2008, particularly in the first half of the year, when the key rate could be raised by 50 bp to 8%. This is to ensure an improved outlook of inflation in the medium term, while mandatory reserves which are the highest in the EU are likely to remain at this level. In the medium term, RON is expected to appreciate, amidst higher volatility during some periods generated by international and local developments. An attractive interest differential as compared to peer countries along with fairly good economic performance of the country in the years ahead, including limitation of the external imbalance, and a more stable international context should restore confidence towards the region and in the Romanian market in particular with favourable effects on the FX rate.

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