29 July 2024 | 7 pages

Poland Economics View

Real FX strength calling for nominal weakness

OUR TAKE

CEE currencies have seen in recent years very significant real appreciation, driven mainly by elevated inflation. The move probably reflects FX overshoot, rather than actual improvement in equilibrium exchange rates. Correcting for the overshoot will take some time and it can potentially happen through relative deflation, nominal depreciation or a mix of both. Given our inflation forecasts we think a risk of (medium term) nominal depreciation is relatively higher in Poland.

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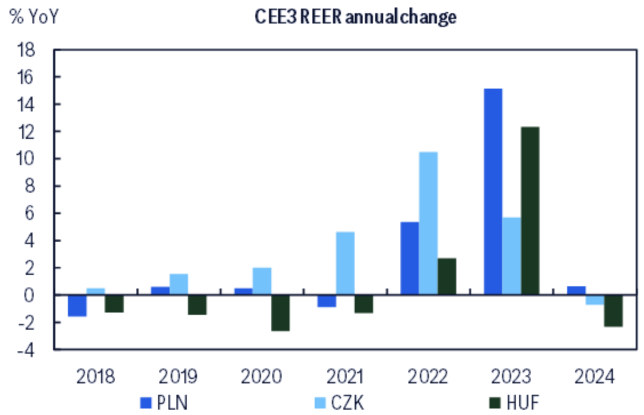
Over last two and a half year CEE currencies experienced significant appreciation in real (i.e. inflation-adjusted) terms, ranging from 12.7% for HUF to 22.1% for PLN. From analytical point of view those changes in real effective exchange rates (REER) can be decomposed into a nominal FX move and an inflation component. The former is simply a reflection of what is happening to market exchange rates and the latter reflects the inflation differential between the CEE and their main trading partners. In other words, changes in REER show how the competitive position of Central European exporters changes as a result of fluctuation in FX rates or rising prices/production costs.

We find that a significant portion of the recent real appreciation was caused by higher inflation than among main trading partners. Since the beginning of 2022 the inflation has contributed between 10.8% (CZK) and 16.8% (HUF) to REER move, with the biggest impact in 2022 and much smaller one in 2023 (Figures 2-4). The situation changed in 2024.

Moderating inflation limits the REER outperformance

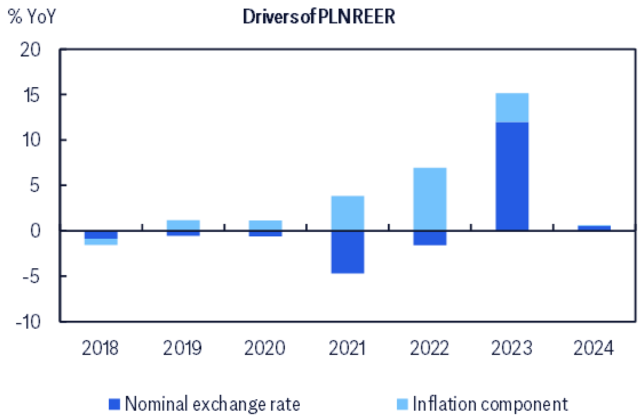
So far in 2024, CEE currencies have either depreciated slightly in real terms (CZK and HUF) or gained only modestly (PLN). We note that recent REER performance has been affected mostly by the nominal FX movements, as the inflation moderated significantly and is now running close to respective targets of central banks. Our inflation forecasts suggest that inflation in the Czech Republic and Hungary will remain low or moderate in the coming months, which means that the real FX rate is unlikely to get a boost from this side. The situation is a bit different in Poland where we expect inflation to rise more substantially as a result of energy price increases, but even in that case the boost to REER should be smaller than in previous years.

Figure 1. Following significant appreciation in 2022-2023, this year the REER performance has been more muted



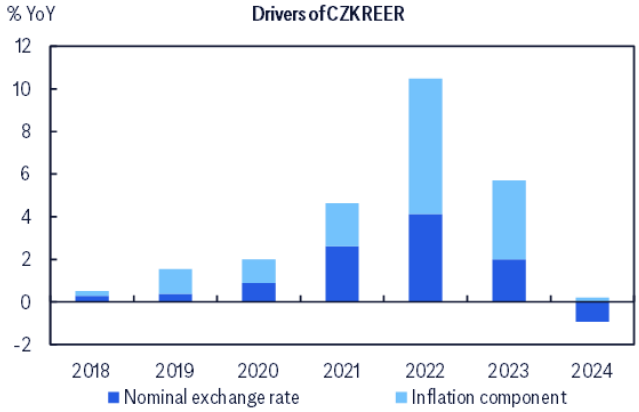
Source: Citi Handlowy

Figure 2. Zloty REER improved after 3Q23 thanks to nominal appreciation, likely driven by expectations of larger EU flows in 2024



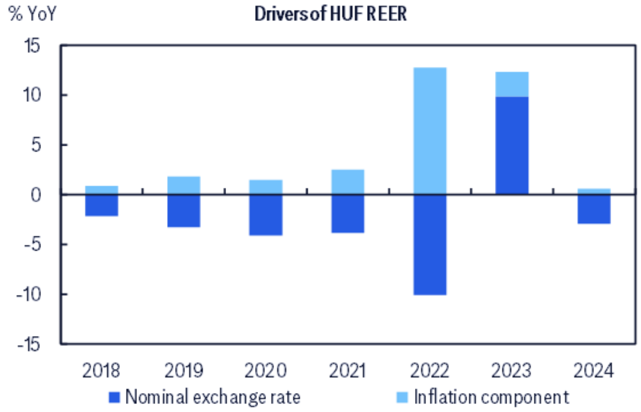
Source: Citi Handlowy Estimates

Figure 3. Impact of inflation on Koruna REER decreased significantly this year



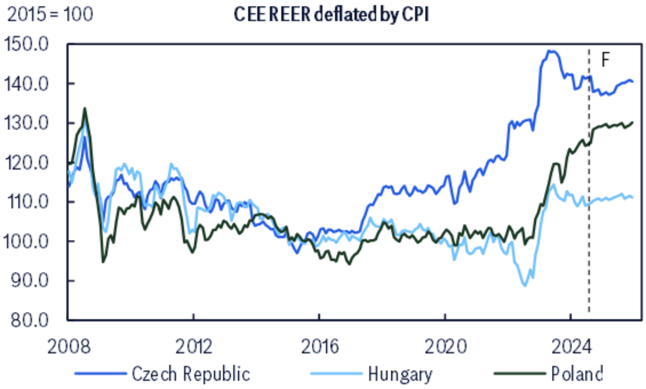
Source: Citi Handlowy Estimates

Figure 4. Nominal strengthening of the Forint was an outlier last year, as the currency is back in the deprecation trend



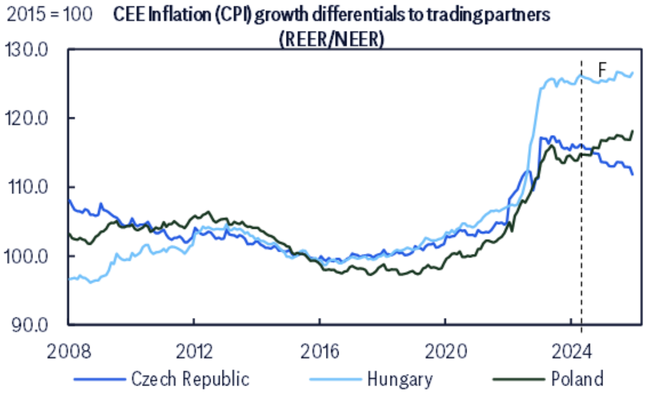
Source: Citi Handlowy Estimates

Figure 5. While our forecast envisages the PLN to strengthen in real terms, the move is likely to be driven by Poland's higher inflation differential



Source: Citi Handlowy Forecasts

Figure 6. In HUF case the inflation differential has been offset by nominal depreciation, while Czech relative deflation should help avoid a larger currency appreciation

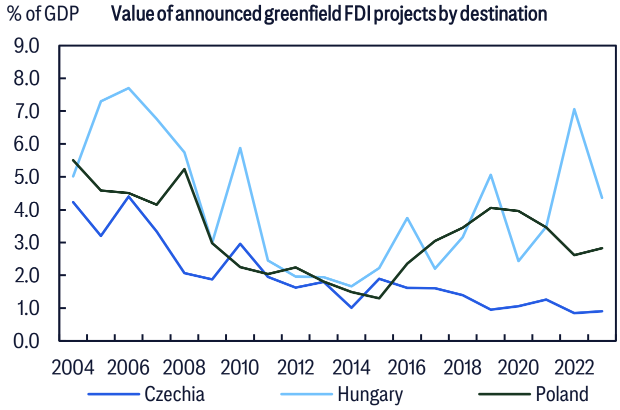


Source: Citi Handlowy Forecasts

Significant strengthening of the currency could be an obstacle for exporters as it decreases the profitability of their foreign sales and is lowering competitiveness of the production. Nevertheless, so far we have not seen any significant decline in the share of CEE exports in global market even despite the large extent of real appreciation (Figure 9). One potential explanation for relative resilience of CEE exports is related to foreign direct investments, which in the last couple of years were contributing positively to economic growth in the region. Central European countries benefited from nearshoring trends and the fact that even despite significant wage increases in recent years, labour costs in the region remained significantly lower than in the euro area. Based on the most recent data for 2023, the announced greenfield investments (Figure 7) ranged from close to 1% of GDP in Czechia to 4.4% of GDP in Hungary. The actual flow of net inward FDIs (Figure 8) is quite robust at 3%-4% of GDP, though the inward FDIs into equity shows less robust picture with steady but easing inflow reported only in Poland (around 1.3% of GDP in Q1), less steady, but still solid in Hungary (1.9%), while almost zero in the Czech Republic, where the FDI inflow has been driven by reinvested earnings.

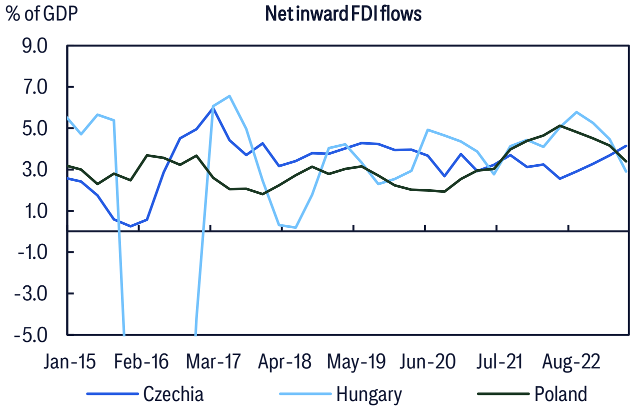
Although the share of CEE exports in global trade is holding relatively well, CEE exporters face serious challenges. First, the weak growth in the euro area means orders for CEE production may remain subdued in the coming months. Second, car industry in the region is undergoing transformation that was triggered by rising market share of EV models. Furthermore, while the industry activity is yet to rebound, the ongoing improvement in private consumption can lead to stronger imports. If this is accompanied by a rise in (usually import-intensive) investment activity, this could lead to potential deterioration in current account.

Figure 7. Greenfield projects announcements could lead to even larger FDI inflows to CEE countries…



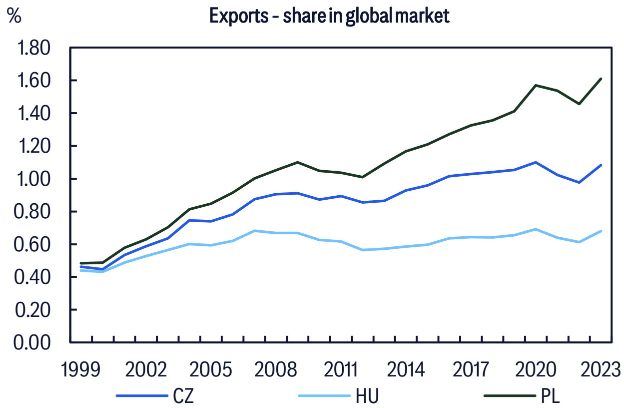
Source: Citi Handlowy, UNCTAD

Figure 8. Inward FDI inflows in the Czech Republic were supported by reinvested earnings, while only Poland has maintained steady, though easing, FDI inflow into equity



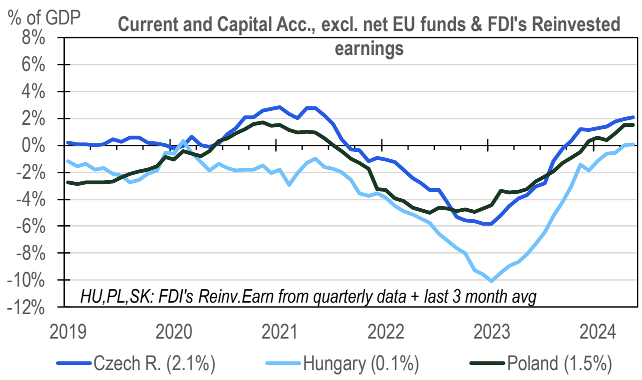
Source: Citi Handlowy, OECD

Figure 9. Despite significant strengthening of currencies in real terms, the CEE countries managed to keep their share in global exports…



Source: Citi Handlowy, Haver Analytics

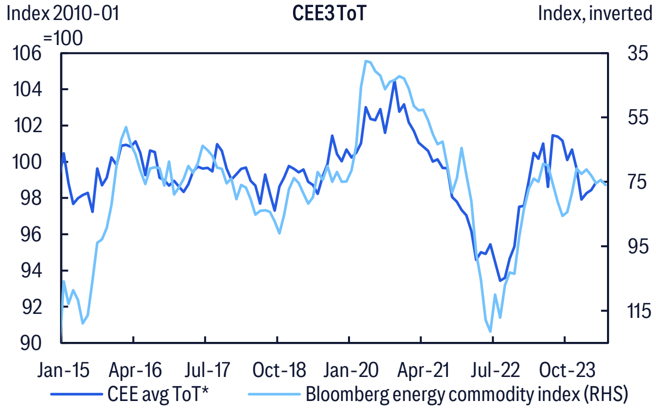
Figure 10. …however the mix of strong consumption and weakish exports may put on hold further improvement in current account balances in Central Europe



Source: Citi Handlowy, Haver Analytics

As recent years showed, C/A balances tend to be also affected by terms of trade (i.e. the ratio of exports-to-imports prices). Since CEE countries are importers of oil and gas, the spike in energy prices in 2022 as a result of Russia aggression against Ukraine had a significant impact on their terms-of-trade. Since then, the situation improved considerably, but commodities prices remain an important factor to watch. Brent oil moved over 10% higher since the beginning of June while gas prices increased by about 45% from this year's low, though they are significantly lower than in previous two years. Further rise in prices of energy commodities could have an adverse impact on external balances, but also on FX. We note that CEE3 currencies (in nominal terms) have proved sensitive to oil prices swings (Figure 13). The correlation analysis suggests that the Hungarian forint remains the most vulnerable one (Figure 14) while the CZK is most resilient to commodity price shocks. In that context, the geopolitical developments remain of significant importance for CEE FX.

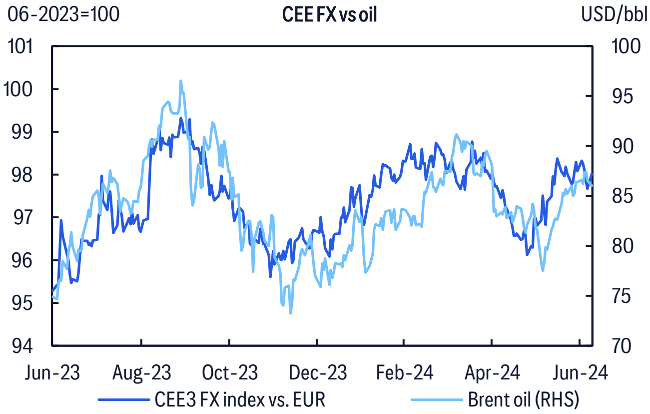
Figure 11. Terms-of-trade in CEE3 improved as the energy price shock eased since the 2022 spike



*Up to Dec-2023 the index is average of Czech Republic, Hungary and Poland. Since Jan-2024 Poland is excluded from calculations due to outliers in trade data from national accounts in the country.

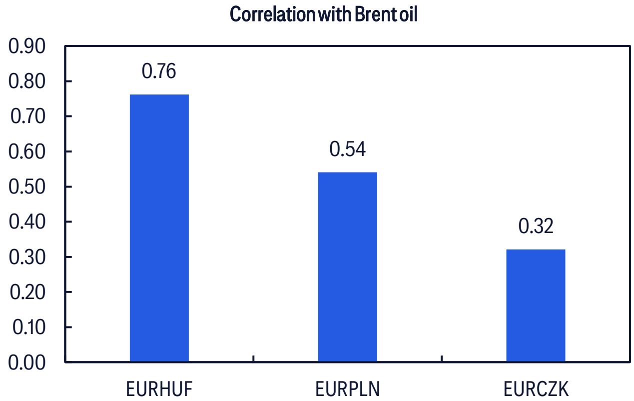
Source: Citi Handlowy, Refinitiv

Figure 12. CEE3 currencies tend to react to changes in oil prices...



Source: Citi Handlowy, Refinitiv

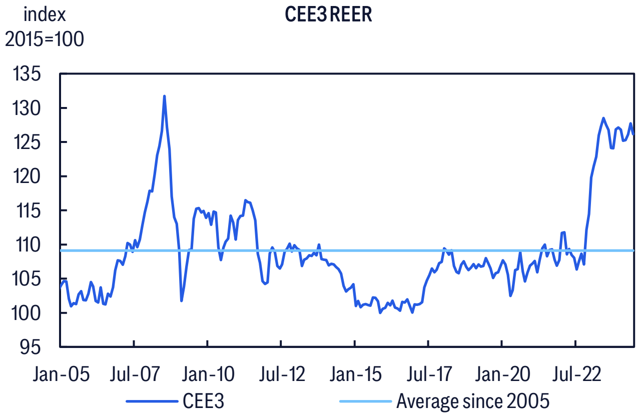
Figure 13. ... and Hungarian forint appears the most sensitive to oil prices swings



Correlation of monthly changes in the last 12 months

Source: Citi Handlowy Estimates, Refinitiv

Figure 14. If REER rates are mean-reverting, this can imply gradual weakening of real exchange rates in the region

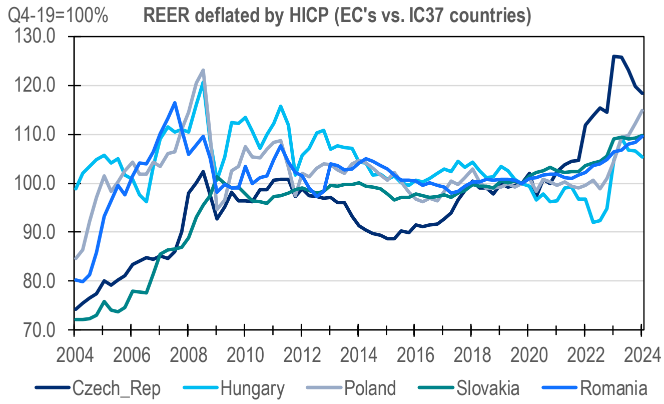


Source: Citi Handlowy, Haver Analytics

Given the scale of real FX appreciation in the region, an important question is to what extent current levels of REER reflect a new equilibrium and to what extent they are result of temporarily high inflation. We do not have a full answer here, but our intuition would be that REERs overshot their equilibrium levels. First, economic developments from last two years (war in Ukraine, changing security risks, rising energy transition costs) are an argument for weakening, rather than strengthening of equilibrium exchange rates. Second, experience from the past suggests that REER exchange rates may be at least to some extent mean-reverting (Figure 14). This would suggest that current strength of CEE REER is a transitory phenomenon and over time real exchange rates in the region may gradually weaken.

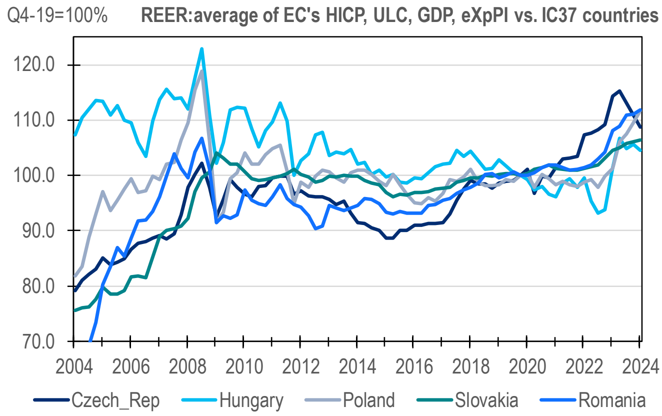
Weakening of REER can happen either through weakening of the nominal exchange rate or through lower inflation. In the Czech Republic the REER already peaked in 2023 and gradual real depreciation is under way, happening both via both higher EUR/CZK and significant improvement in inflation outlook, of which the later should become even more apparent in 2025. The most interesting case in the region seems to be in Poland, where PLN continued to appreciate in real terms also in recent months and where we expect inflation to rise in the coming months. This increases a risk that the REER adjustment in Poland will happen via nominal depreciation rather than via disinflation. Therefore, although in the near term hawkish NBP can continue to support the PLN, we see a risk that over the medium term (by which we mean next 1-2 years) the zloty come under depreciation pressure in order to correct the misalignment vs equilibrium rate.

Figure 15. While the CZK has kept strong outperformance relative to peers in real terms if CPI is used as deflator ...



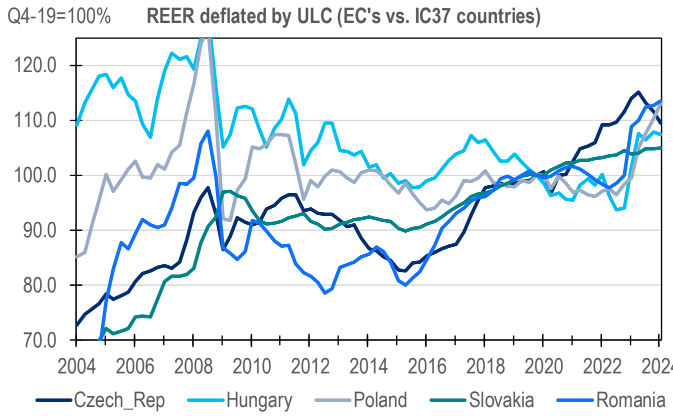
Source: European Commission, Citi Handlowy

Figure 16. ... it has become actually weaker compared to RON and PLN currencies when alternative price deflators are considered ...



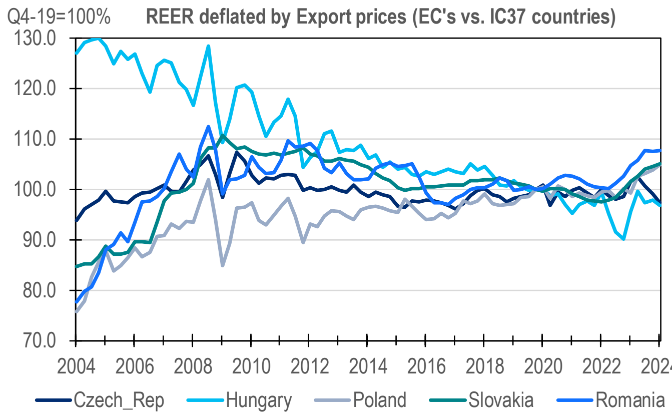
Source: European Commission, Citi Handlowy

Figure 17. ... reflecting relatively stronger increase in ULC ...



Source: European Commission, Citi Handlowy

Figure 18. ... and export prices in these countries



Source: European Commission, Citi Handlowy

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