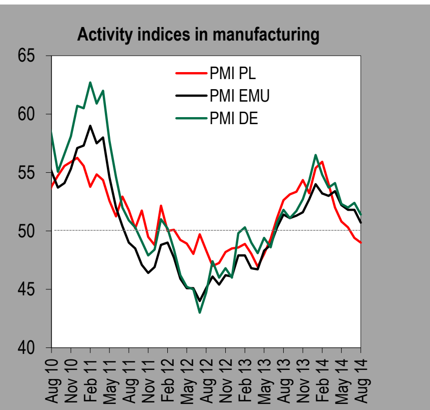
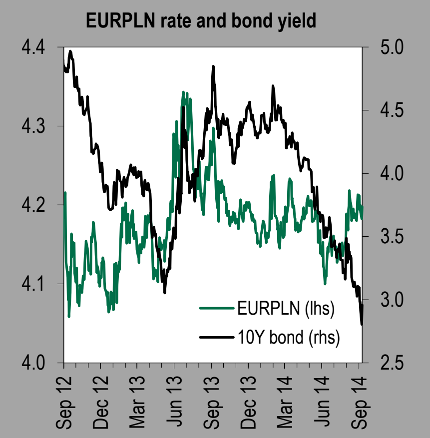
MACROscope

Polish Economy and Financial Markets

September 2014

Ch-ch-ch-ch-changes





■ **Unlike David Bowie, it looks as if Polish Prime Minister Donald Tusk knew what he was waiting for and decided to "turn and face the strain".** His departure, to head the European Council, has major consequences for Polish politics as he has been prime minister for seven years and will also resign his leadership of the ruling party, Civic Platform, ahead of local government elections (November this year), presidential elections (mid-2015) and general elections (autumn 2015). This augurs an interesting period ahead in Polish politics, although it is too early to affirm that political risk has increased from a market point of view.

■ **This is not the only change we discuss this month. The change in Poland's economic outlook has more immediate consequences.** In our last MACROscope in July, we said we thought that worries about a slowdown were exaggerated. In fact, the soft patch in 2Q14 was of little significance and GDP growth surprised positively. However, other factors are at play. First, the flow of monthly economic data from Poland and the EU has been disappointing, suggesting slower growth in Poland's main Western trading partners in 2014-15. Second, the escalation of the conflict between Ukraine and Russia, with its economic consequences and additional sanctions, has also changed the economic scenario for Poland. We currently predict GDP growth of 3.1% in 2014E and in 2015E (versus our previous forecasts 3.5% and 3.7%, respectively) and expect to see figures of below 3% in a few of the coming quarters. We think the CPI could remain below zero until the end of this year and will increase towards only 1.5% by the end of 2015E.

■ **Although changes in macroeconomic scenario have been going on for several weeks (please see our *Rates and FX Outlook* at the beginning of this month), the Polish Monetary Policy Council (MPC) decided to keep rates on hold in September.** Nevertheless, like the children in Bowie's song, it seems the MPC members are "quite aware of what they're going through", as they suggested that monetary easing will start in October. The same applies to market players, as, after the MPC meeting, calls for monetary easing have intensified.

■ **The main changes in the economic scenario also affect the outlook for the Polish currency.** The additional geopolitical risks decrease the likelihood of a significant strengthening of the zloty in the final quarter of this year. Although an inflow of capital to the bond market may be a compensating factor, we see EURPLN at c4.15 in December. As regards next year, we now forecast a slower strengthening of the zloty than in our previous assumptions.

In this issue:

Financial market on 9 September 2014:

NBP deposit rate	1.00	WIBOR 3M	2.51	EURPLN	4.1978
NBP reference rate	2.50	Yield on 2-year T-bond	2.02	USDPLN	3.2605
NBP lombard rate	4.00	Yield on 5-year T-bond	2.42	CHFPLN	3.4813

This report is based on information available until 9.09.2014.

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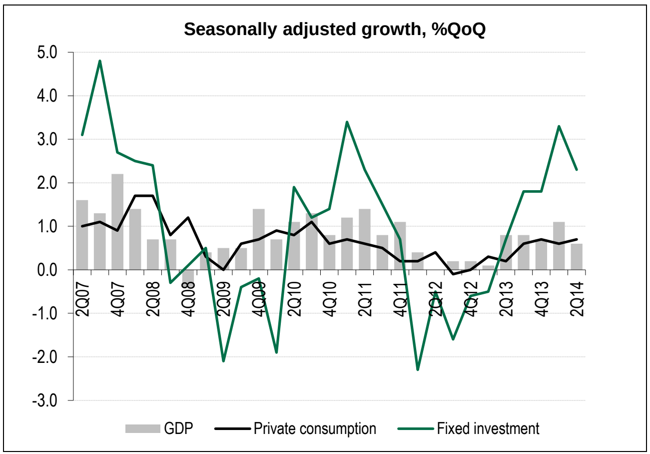
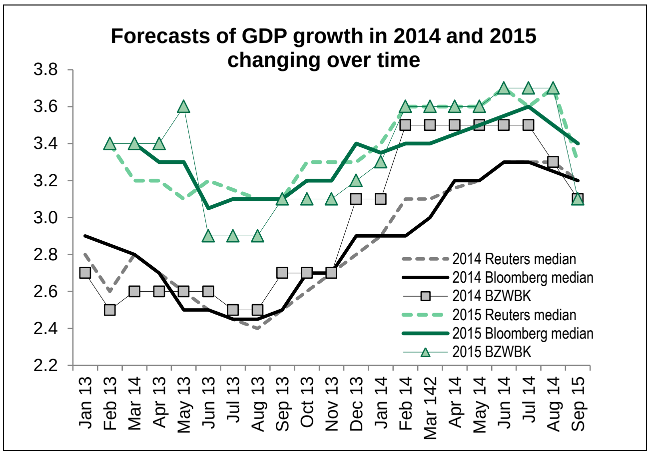
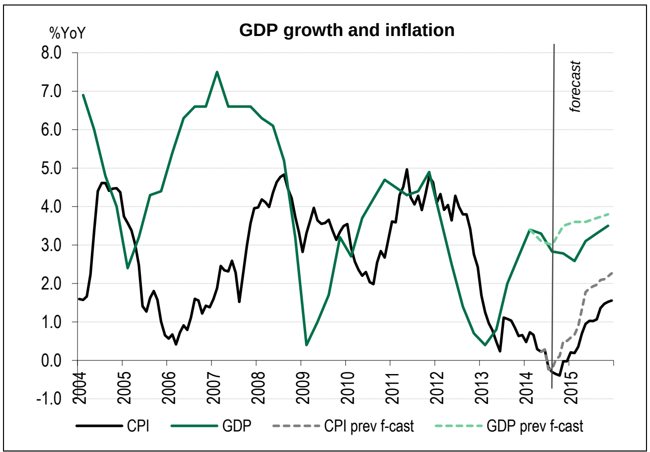
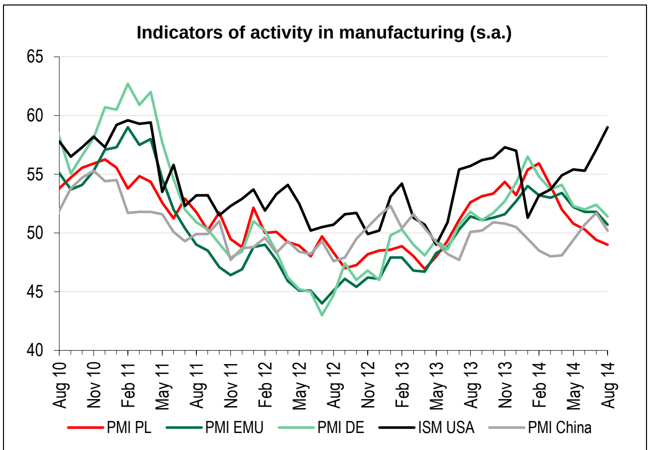
Economic update









Source: CSO, Reuters, Bloomberg, Markit, BZ WBK

GDP growth in 2Q14 was pretty good . . .

▪ GDP growth slowed only slightly in 2Q14, to 3.3% YoY from 3.4% in 1Q. Interestingly, domestic demand growth accelerated sharply to 5.1%YoY (the highest in almost four years). While, to some extent, this was the result of the anticipated strong contribution of inventories (effect of very low base in 2Q13), the big positive surprise was the solid investment growth (8.4% YoY or 2.3% QoQ after seasonal adjustment). Although we had assumed that much of the surge in investment spending at the beginning of the year was due to one-off effects (very good weather boosting construction works, temporary tax allowances boosting car purchases), it is now clear that the underlying trend remained strong in the second quarter. Private consumption growth was also quite decent at 2.8% YoY.

. . . but the economic outlook deteriorated

▪ However, recent weaker data from Poland, the disappointing performance of the Euro zone economy, plus the possible negative impact of further-reaching sanctions against Russia (and Russian sanctions against the EU), suggest coming quarters will see a further deceleration of economic growth and slower CPI growth (see chart). We expect GDP growth to slow to below 3% in 2H14E, with a possible dip to around 2.5% in 1Q15E. Other analysts are also cutting their forecasts.

▪ The labour market is still quite positive, so real household income growth should remain supportive for private consumption in the coming quarters (we are expecting it to rise by c3% YoY). As regards investment, private sector firms may become more cautious in 2H14E, cutting investment plans in response to rising global uncertainty. On the other hand, the public sector is likely to boost investment spending during the election cycle (2014-15), using the new EU cohesion funds. The draft 2015 budget suggests fiscal consolidation may be slightly slower than previously planned. Consequently, domestic demand may serve to stabilise economic growth in Poland to some extent, while the outlook for exports is becoming more challenging.

Exports and industry likely to stay weak

▪ Exports rose 7.3% YoY in June overall, but detailed data showed a rather pessimistic picture as trade with most major partners decelerated markedly.

▪ Industrial output was also weak in June and July, expanding by a mere 1.8% YoY and 2.3% YoY, respectively. The deceleration was also visible in export-oriented sectors, which also suggests a weaker performance by exports in July.

▪ The Polish manufacturing PMI dropped to 49.0 pts in August from 49.4 pts the previous month. As a result, after six consecutive months of falls (since February when it stood at 55.9 pts), the index is now at its lowest since May 2013. New orders dropped in August for the third consecutive month and at the fastest pace since April 2013 Export orders contracted for the fourth month in a row. The output index dropped below 50 pts for the first time in 14 months. Other leading indicators, like the Central Statistical Office's business climate survey, are also deteriorating. Moreover, economic activity gauges for Germany and the Euro zone showed a further drop.

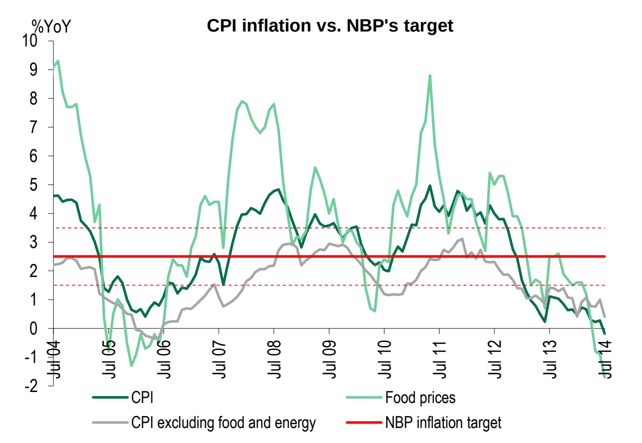
▪ The weak performance of leading indicators suggests that the outlook for industry and exports is weak.

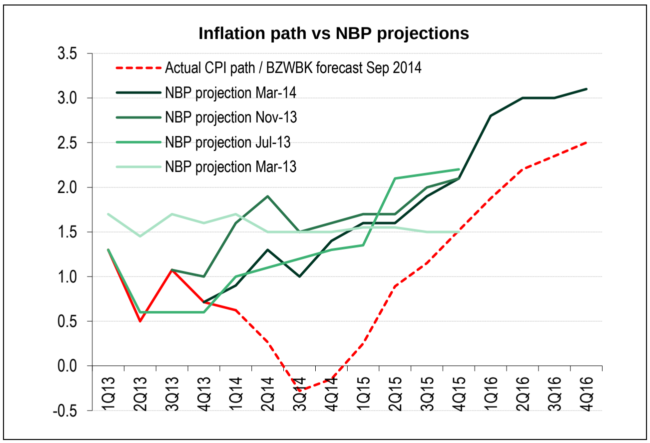
Construction and retail sales may improve

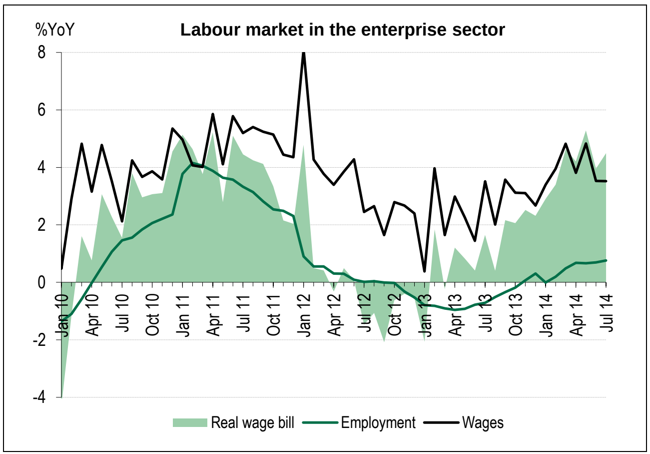
▪ Data on construction were very disappointing (1.1% YoY, vs. an average of more than 12% in first five months of the year). However, planned infrastructure investments and elections lead us to expect some rebound in this sector.

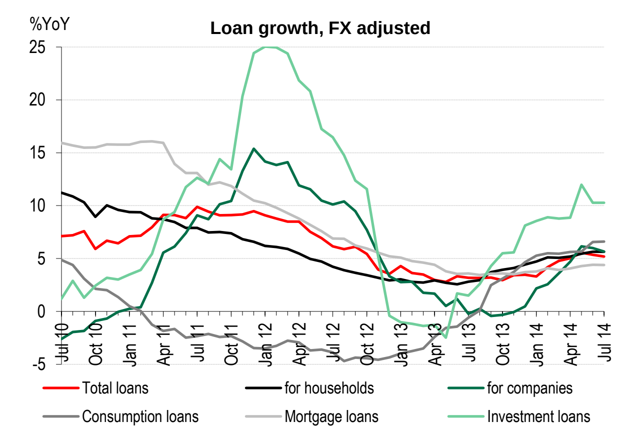
▪ Retail sales growth accelerated to 2.1%YoY in July. We are expecting a slight acceleration in the coming months thanks to the strong labour market.

Economic update









Source: CSO, NBP, BZ WBK.

Inflation is on a downward path

- July's annual CPI inflation rate was negative for the first time on record (-0.2% YoY) thanks to positive supply shocks (food and fuel prices fell by 1%-2% YoY). The decline in food prices was in line with the historical average, but it may be more pronounced in August and could continue in the coming months.
- The only surprise in the other goods and services categories was om communication, where we noticed an increase for the second time in a row (1.2% MoM),caused by new tariffs in the mobile phone market, where the price war has evidently ended.
- There was a noticeable drop in housing costs YoY, despite stable prices MoM. This was a result of the base effect caused by the introduction of the waste management act in July 2013 (and a sharp increase in prices in this segment). This led to a significant decline in core inflation. Inflation excluding food and energy fell to 0.4% in July from 1.0% in June.
- PPI inflation dropped to -2% YoY in July and there has been no sign of price pressure on Polish producers for some time. The only upward signal comes from the PMI survey, where the input and output sub-indices rose.
- Slower economic growth means it will take longer to close the negative output gap, so we see no substantial increase in inflationary pressure in the near term. Additionally, the oversupply of food on the Polish and European markets is likely to persist in the coming months, dragging prices lower, due to the Russian ban on food imports. This means inflation is likely to be significantly lower than we earlier assumed, with the CPI staying below zero until the end of 2014E and rising gradually towards 1.5% by the end of 2015E, significantly below the central bank's 2.5% target. In our view, the target will not be reached until end of 2016E.

Labour market is still strong

- The labour market is still in quite good shape and we are expecting this to continue in the coming quarters, which would support growth in consumption.
- Average employment in the corporate sector grew 0.8% YoY in July. Despite signs of an economic slowdown in Poland and abroad, Polish companies are still gradually increasing demand for new employees.
- Wage growth reached 3.5% YoY in July. Low inflation supports growth of real purchasing power. The wage bill increased by 4.5% YoY in real terms in July – the same as the average for March-June.
- The registered unemployment rate fell to 11.9% in July, with a quite impressive decline in the number of unemployed (-34k versus -16k in July 2013). The seasonally-adjusted unemployment rate, according to Labour Force Survey (LFS), also declined, to 9.0%, the lowest level since 2009.Labour Ministry estimates put the August registered unemployment rate at 11.7%. If confirmed, this would suggest that positive trends in the labour market are building up again.

Loans expand moderately, but a slowdown is likely

- The loan market is still showing good growth but the improvement stalled somewhat recently. The slowdown in economic growth and rise in uncertainty may weigh on loan growth in the upcoming quarters.
- Growth in corporate loans has stabilised at around 5% YoY, with investment loans rising by over 10% YoY and current loans expanding by c4% YoY in July. Household loans are rising at a similar pace (c5.5% YoY), with a positive performance in all sectors: consumer lending is up rising by c6.5% YoY and housing loans by c4.5% YoY.
- The results of a survey of credit officers showed that banks are expecting an easing of lending criteria and stronger demand for loans in 3Q. However, as the level of risk implied by the economic outlook is one of the main drivers of credit criteria, these forecasts may no longer be valid.

Monetary policy watch

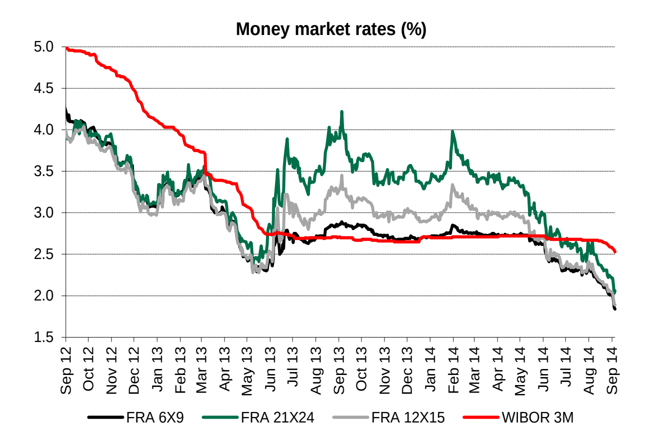
Excerpts from the MPC's communiqué after its September meeting

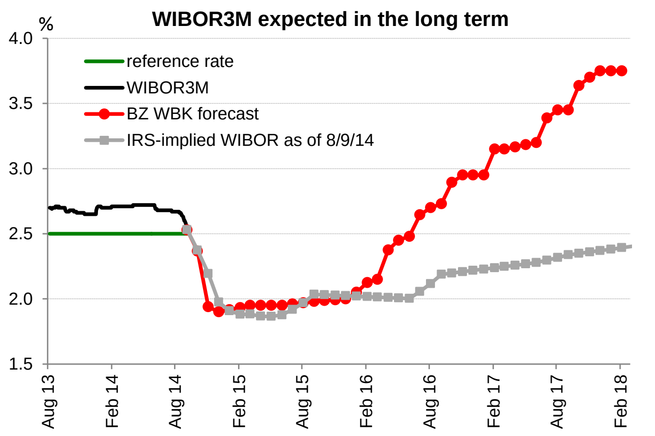
(…) economic growth in the euro area came to a halt in quarterly terms, as GDP in Germany and Italy decreased and France remained in stagnation. Economic activity indicators for the euro area may be pointing to some improvement in economic activity in 3Q, though a deterioration in industrial sentiment has been recorded of late. In the largest emerging market economies, economic activity growth remains weak relative to their previous performance. Prices of many agricultural and energy commodities have decreased in recent months. Along with moderate global economic growth, this contributes to low inflation in many countries.

In Poland, incoming data point to a slowing momentum of economic growth. (…) According to data for July, the annual growth in industrial production and retail sales remained low, while construction and assembly output growth plunged.

In July, the annual CPI inflation declined and was negative (…). The decline in inflation was driven by the decline of food prices and lower core inflation, which indicates a lack of demand pressure. Also, a decline in producer prices confirms a lack of cost pressures. It is accompanied by very low inflation expectations among businesses and households.

In the opinion of the Council, uncertainty about the outlook for economic activity in Poland has recently increased, which translates into higher uncertainty about the prospects of inflation returning to target. The Council decided to keep NBP interest rates unchanged. **If the incoming data confirm a weakening of economic activity and an increase in the risk of inflation remaining below the target in the medium term, the Council will start to adjust monetary policy.**





Sources: NBP, Reuters, BZ WBK.

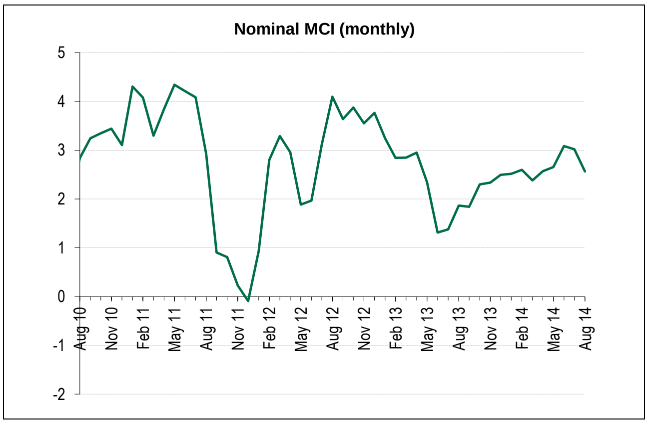
All is not lost that is delayed

- The Monetary Policy Council left interest rates unchanged, in line with our forecast and with market consensus. We think the shift in the balance of risk to slower economic growth and very low inflation seen in recent last weeks justified an interest rate cut (even by 50bp) as early as this month. However, it seems that such voices in the MPC are still in minority, and other members wanted to see more data to confirm that the economic scenario has changed.
- This was reflected in the statement. The most important sentence reads: "*If the incoming data confirm a weakening of economic activity and an increase in the risk of inflation remaining below the target in the medium term, the Council will start an adjustment of monetary policy*". The Council also noted that recently uncertainty has increased surrounding economic growth in Poland, and, by extension, about the chance of inflation returning to target.
- As regards the inflation outlook, the MPC clearly pointed out that we are currently facing: (1) sub-zero inflation, i.e. way below target; (2) a lack of demand-side pressure; (3) a lack of cost pressure; (4) very low inflationary expectations by households and companies. At the same time the council wrote that "incoming data point to a slowing momentum of economic growth". Therefore, we have little doubt that monetary easing is about to start.
- In answer to a question about what would have to happen to prevent rate cuts, the NBP governor said that, among other things, the council would want to see an outstanding performance from manufacturing. Our forecast for industrial output in August assumes negative year-on-year growth; but even a reading slightly above zero would hardly be "outstanding". Put more simply, we think the macro data will allow the MPC to cut rates in October.
- At the press conference, Marek Belka said that the MPC does not have to wait for the NBP's November projection. The last sentence of its statement says the council will "start an adjustment" of monetary policy, rather than "adjust policy". This means that the cycle of rate cuts may begin in October.

A short easing cycle ahead – 75bp in 4Q

- Why hasn't the MPC cut interest rates already? We suspect that such a move was discussed but lacked a majority (the NBP president said the Council was not unanimous). One of arguments was high uncertainty regarding situation in the east (the conflict in Ukraine). Secondly, during the conference Belka mentioned forward guidance, which the MPC formally abandoned in July. We think the MPC is still unofficially committed to it (or at least some members are) and, therefore, did not want to change interest rates before the end of third quarter.
- Given the lack of urgency the MPC showed at the September meeting, we see a risk that the 75bp cut we expect will be spread over three months rather than just October-November.
- As the Monetary Policy Council opened the door to interest rate cuts, we can say that an informal easing bias was introduced. We would have to see a significant positive surprise in economic data to prevent the council from cutting rates, in our view. We think that, given the recent change in the macroeconomic scenario, the council will cut rates by 75bp and will probably do it in gradual steps of 25bp every month in 4Q.
- Currently, the market is pricing-in an almost 75bp rate cut in three months and a very small chance of a rate hike in the next two to three years (see chart).

Restrictiveness of the Monetary Policy (Council)



MCI likely to fall further in the upcoming months

- In August the MCI nominal monetary restrictiveness index fell markedly on the back of the PLN depreciation and declining money market rates.
- Our index of monetary conditions rose between mid-2013 and mid-2014, supported by more or less stable rates and a strengthening currency. Recent developments are the beginning of a reversal of this trend, in our view, as interest rate cuts are likely to push the index lower. However, a de-escalation of the conflict in Ukraine could result in an appreciation of the domestic currency, so any monetary policy easing should be limited

Rzońca (1.44)

Winiecki (1.45)

Kaźmierczak (1.41)

Glapiński (1.38)

Hausner (1.03)

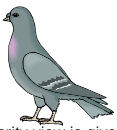
Bratkowski (0.58)

Belka (0.96)

Zielińska-Głębocka (0.81)

Chojna-Duch (0.73)

Osiatyński



The index runs from 0 to 2. A vote for the majority view is given a score of 1. A vote for a more hawkish (less dovish) decision than the majority view has a score of 2 and a vote for a less hawkish (more dovish) decision than the majority view has a score of 0. Value of the index for a given MPC member is a weighted average of points for all votes. Recent votes have higher weights, more distant – lower.

Numbers directly by the name are values of the index for period since the beginning of current term of office of the current MPC and NBP governor.

Direction of the restrictiveness axis reflects our expectations regarding direction of interest rate changes in the nearest 12 months.

As there was no vote on the rate change for a long time, the positioning of MPC members on the axis is based mainly on our assessment, as we took into account comments of MPC members in recent period.

There is likely to be a majority in favour of cutting rates in October

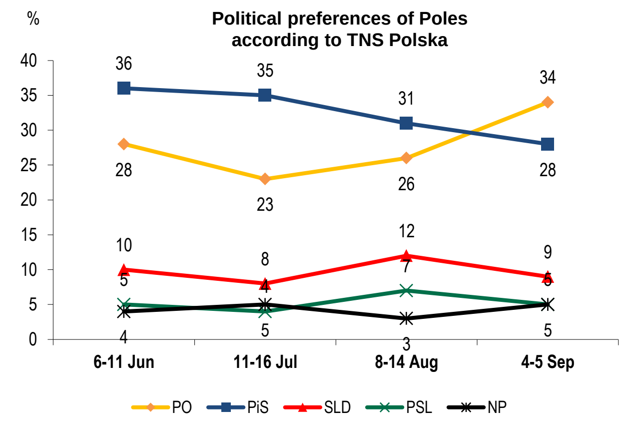
As shown on the previous page, the MPC statement and Belka's comments at the press conference suggested not only that a cut in October is very likely, but also that it will be the start of a cycle. Reports of MPC members' comments, which appeared in the media in the last two months, indicate that a majority of council members would support a rate cut motion in October. The two most dovish members (see the restrictiveness index on the left) continue to call for monetary easing. Elżbieta Chojna-Duch said a 50bp cut should take place next month. Jerzy Osiatyński said before the September meeting that there was no macroeconomic reason for the current very high interest rates in Poland. Additionally, Andrzej Bratkowski said that if the next monthly data are weak, the Council should consider a rate cut in October. In his opinion, rates could be trimmed by 50-100bp in total during a short easing cycle. We perceive Bratkowski as the most forward-looking member of the Council and with quite a flexible approach toward monetary policy. He stressed that one should be certain that the economic situation has changed significantly before cutting rates and more data are required to make such a judgment. After this comment it was clear that there would not be a majority in September. Only two other members were possibilities to support easing – Anna Zielińska-Głębocka and Marek Belka. The former said after the September meeting that cuts of 25bp in both October and November are the best solution and later the MPC might think about more. As regards the NBP governor Belka, the voting results will show whether he decided to vote in favour of a rate reduction, even in a minority. In any case, the above-mentioned five council members are enough to start monetary policy easing next month, especially as Bloomberg reported on September 5 that three anonymous MPC members said most members declared their support in September for rate cuts and the MPC is likely to cut rates by 25bp in October and November.

What are the arguments against easing?

It is difficult for us to understand why the MPC – after agreeing that easing is necessary and justified – did not cut rates immediately and on a larger scale, but again chose a strategy of small steps. While such a decision might negatively affect the zloty, this would support the economy, without fuelling concern about an excessive rise in inflation. Belka noted recently that the weakness of the Polish currency does not worry the MPC. It seems, however, that for some members currency stabilisation is an important argument. For example, in the middle of August Andrzej Kaźmierczak told the Polish Press Agency that the priority was "not to destabilise markets, not to destabilise exchange rate, to maintain stability of the entire financial system". We think that this sort of argument could have cropped up in September, with the added context of the crisis in Ukraine. It is interesting that the more hawkish council members have not been speaking to the media recently. Maybe the list of arguments against cuts is not that long after all and the MPC will be close to unanimous when taking decisions in October.

Source: NBP, Reuters, BZ WBK.

Fiscal policy watch



Macroeconomic assumptions to 2015 budget

	2014E	2015E	2016E	2017E	2018E
GDP (PLNbn)	1,693.6	1,771.2	1,876.3	1,988.6	2,119.0
GDP growth (%)	3.3	3.4	3.7	3.9	4.0
Inflation rate (%, avg)	0.1	1.2	2.3	2.1	2.5
LFS unemployment rate (%, avg)	9.7	9.1	8.6	7.9	7.3
LFS employment (%YoY, avg)	1.5	0.8	0.7	0.7	0.6
EURPLN (avg)	4.15	3.98	3.76	3.56	3.54
USDPLN (avg)	3.07	2.92	2.77	2.62	2.60
NBP reference rate (%, avg)	2.4	2.0	2.4	3.1	3.6

Main parameters of 2015 budget draft (PLNbn)

	2014 plan (1)	2014 E (2)	2015 plan (3)	change (3) / (2)
Total revenue	**277,782**	**286,200**	**297,253**	***3,9%***
Tax revenue	247,980	257,963	269,820	*4,6%*
VAT	115,700	126,000	134,630	*6,8%*
CIT	23,250	23,250	24,530	*5,5%*
PIT	43,700	43,000	44,390	*3,2%*
Non-tax revenue	28,148	26,583	25,885	*-2,6%*
Total spending	**325,287**	**320,187**	**343,332**	***7,2%***
Budget balance	**-47,505**	**-34,000**	**-46,080**	***35,5%***

	Spread vs. Bunds (10Y) in bp			CDS (5Y USD)		
	10.07	change since 11.06.14	change since 31.12.13	10.07	change since 11.06.13	change since 31.12.13
Poland	217	5	-20	58	-1	-21
Czech	30	2	-28	45	-7	-15
Hungary	318	5	-59	167	-23	-89
Greece	506	70	-155	103	5	67
Spain	161	38	-60	71	-6	-154
Ireland	114	9	-39	50	-9	-70
Portugal	275	71	-135	175	6	-171
Italy	173	38	-42	94	-11	-75
France	33	0	-16	40	-3	-14
Germany				22	0	-5

Source: Ministry of Finance, TNS Polska, Reuters, BZ WBK.

Government reshuffle ahead

- Donald Tusk will assume his new position as president of the European Council on December 1, quitting the job of prime minister and PO party leader. That means a change of government ahead of local elections (November 16, 2014), presidential elections (mid-2015) and general elections (autumn 2015). The reshuffle will not only include a new prime minister, but probably also several other ministers, including Elzbieta Bieńkowska, Minister of Infrastructure and Development and responsible for spending EU funds. The new appointments (requiring 50% plus one vote and the presence of at least half the members of parliament) should not be an issue for the ruling PO-PSL coalition.

- It is too early to say how the changes will affect the Polish political scene. The most recent opinion poll showed a rise in support for the ruling PO party after the news of Tusk's nomination for the top EU job. It will definitely be an interesting time in Polish politics. We do not see a significant rise in political risk, nor do we expect a major change in economic policy. However, there are already signs of fiscal policy becoming more accommodative before the elections.

Slower fiscal consolidation?

- The 2015 budget draft approved by the government assumes a budget deficit of PLN46.1bn, or 2.6% of GDP, higher than the cPLN34bn (2% of GDP) expected at the end of 2014. The finance minister claims that the general government deficit will be cut to below 3% of GDP in 2015, which should allow Poland to exit the Excessive Deficit Procedure in 2016. This would require a significant consolidation outside the central budget. This is not impossible, but may be an ambitious task, especially in an election year. In general, we have the feeling that the path of fiscal consolidation may be slowing down compared to plans outlined in the last convergence programme. However, this should not necessarily be perceived as a negative factor (as long as the general government deficit is kept below 3% of GDP), as it will help the economy to weather a more challenging external environment.

- The government's macro assumptions for 2015 budget are not very conservative (as opposed to the past few years), especially in the light of the risks to growth in Europe and an uncertain geopolitical outlook. Our GDP and CPI forecasts for 2014-15 are lower.

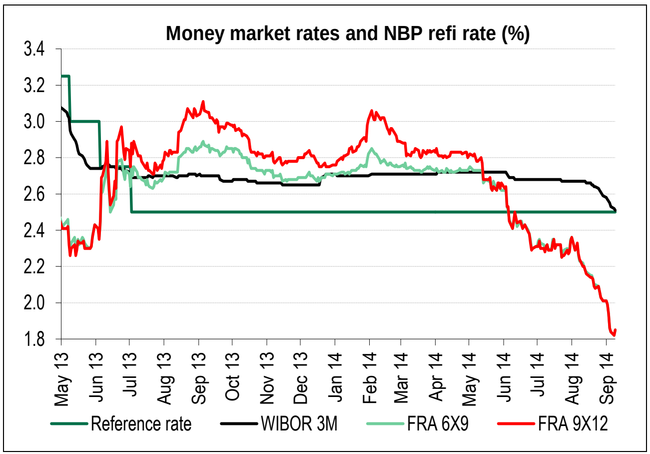
- The government decided to tweak the pension indexation system and adjust tax deductions for families with children, which will effectively boost social benefits next year (by c0.5%, according to our estimates) and increase households' disposable income. The changes would cost Poland some PLN2.8bn, i.e. less than 0.2% of GDP. This amount would probably add directly to domestic demand in 2015 as the changes mainly affect lower-earning families with a propensity to spend.

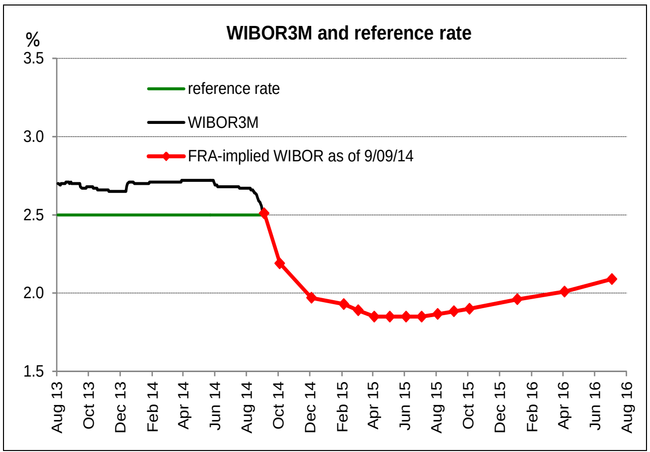
New record lows for rates due to ECB

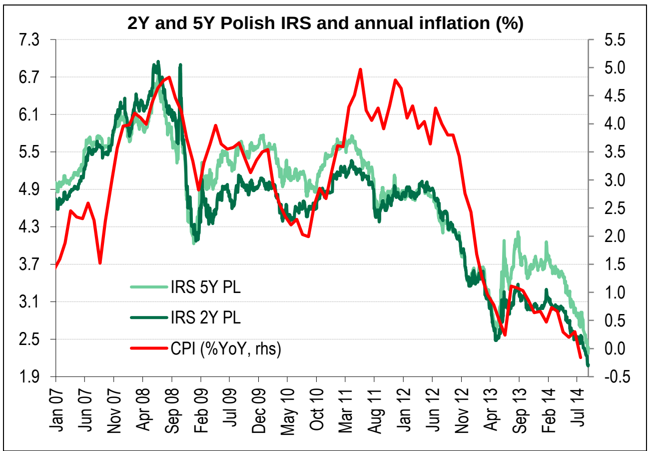
- Over the past two months a combination of disappointing growth, ongoing deflation concerns and geopolitical risks have pushed the yields of both core and peripheral EU debt to new all-time lows. What is more, we noted a significant improvement in credit risk measures across CEE and peripheral markets, with declines in credit default swaps and narrowing spreads vs. bunds.

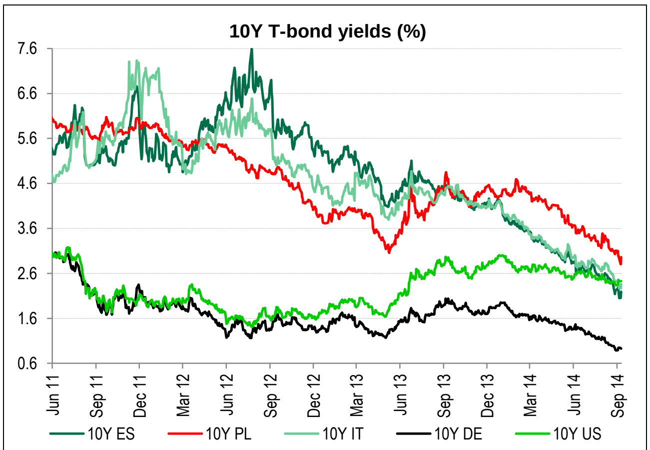
- Early September brought another wave of strengthening as the ECB surprised markets by cutting its policy rates by 10bp and announcing a purchase programme for ABS and covered bonds from October. The ECB's policy package should shift the front end of curves down, while the long ends may be more sensitive to macro data releases and the Fed's exit strategy. Therefore, the FOMC meeting in mid-September will be the key. More hawkish rhetoric and an upward revision in forecasts for the US economy should result in a fresh steepening of curves (rising long-term yields).

Interest rate market









Source: Reuters, BZ WBK.

Rate cuts on the agenda

▪ Money market rates have edged lower over the last two months on growing expectations of rate cuts by the MPC after weak macro data and evidence of deflation. WIBOR rates have declined by 5-22bp and the curve has flattened as 12M rates dropped the most. At the same time, FRA rates fell sharply across the curve (by 19-52bp as compared with the end of June), confirming the strong belief in a rate cut after the summer.

▪ As expected, the MPC left official rates unchanged at its September meeting. However, the council clearly suggests a cycle of cuts before it publishes CPI and GDP projections in November. This resulted in a sharp decline in money market rates, in particular for the longest tenors. It is worth noticing that WIBOR 12M fell to below the level of WIBOR 3M. The last time this occurred was during the cycle of monetary easing that ended in July 2013. The FRA market is pricing-in a rate cut of nearly 75bp in three months' time.

▪ We have significantly lowered our forecasts for money market rates due to changing macro and monetary policy scenarios for upcoming quarters (see our *Rates and FX Outlook* report). Now we expect WIBOR 3M to decline to 1.90% at the end of this year. Please find updated quarterly forecasts on page 12.

Strong rally for internal and external reasons

▪ Poland's T-bonds and IRS strengthened considerably in July and August. Yields and IRS rates reached new record low levels (the 10Y T-bond yield dipped below 3%) as the domestic debt market was still being supported by expectations of rate cuts in Poland, more monetary policy easing in the Euro zone and a further strengthening of German bunds (the 10Y yield fell below 1%). However, at the end of August Polish T-bonds and IRS were hurt by emerging market weakness as investors worried about more negative news from Ukraine. However, the correction on both market was short-lived.

▪ The beginning of September brought fresh falls. IRS rates declined to their new all-time lows (dropping 6-12bp across the curve on a daily basis after the MPC decision). Contrary to our expectations, the market reacted positively to news there was no rate cut this month, along with the very dovish rhetoric and the suggestion that the council will start a cycle of easing at its next meeting. Market sentiment has also improved due to the substantial monetary policy easing announced by the ECB, significantly weaker-than-expected US labour market data and the ceasefire agreement reached between the Ukraine and pro-Russian separatists. The 10Y benchmark yield easily broke support at 3% and fell towards 2.85%.

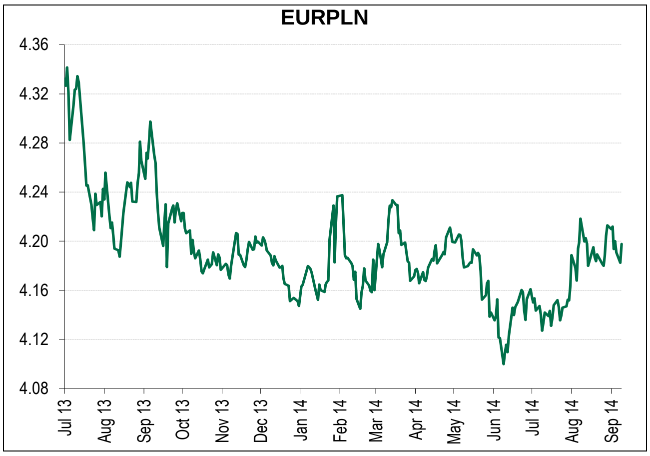
The decline in yields and rates could continue

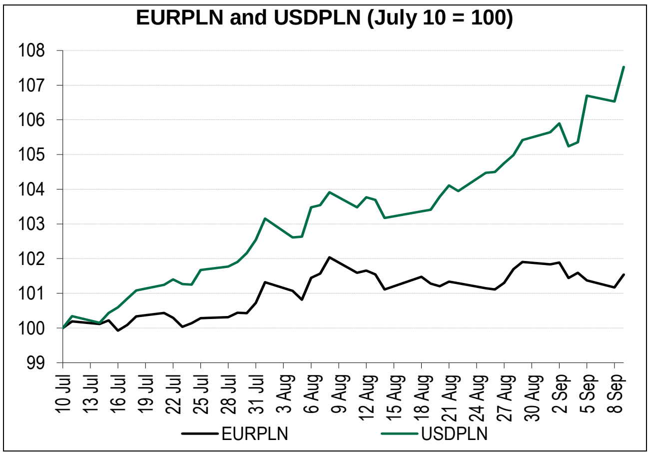
▪ European monetary policy conditions became more relaxed in recent days and had a substantial impact on the interest rate market. We think Polish rates will continue to benefit from expectations of interest rate cuts at home and the anticipated inflow of fresh liquidity from the ECB into the European markets. Additionally, market sentiment towards Central and Eastern Europe has improved in recent days and this may also attract investors to the Polish market. We think the front end of the yield curve may fall below 2% when the MPC delivers its first cut, while 10Y T-bond yields may even drop to c2.7% in the coming weeks.

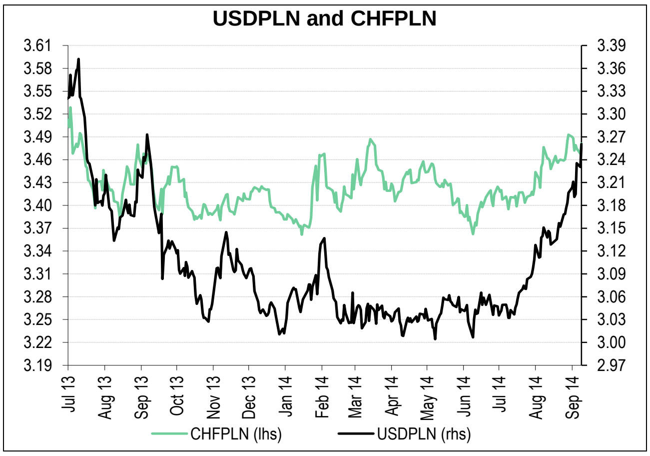
▪ Political changes in Poland may temporarily add volatility (especially if these changes include, for example, the finance minister), but we think that, on balance, this should be neutral for the market.

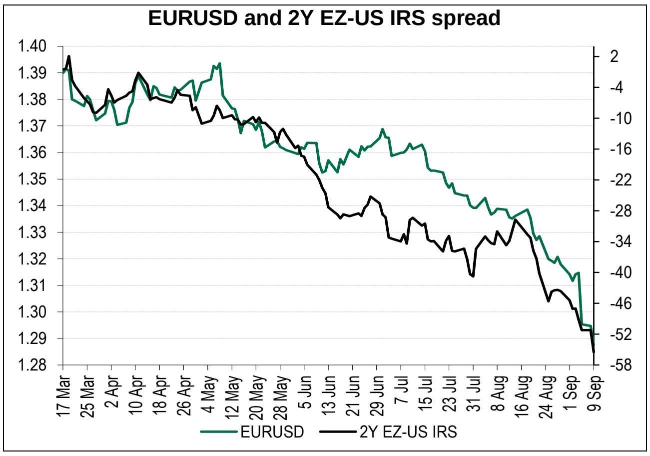
▪ On a medium to long-term horizon we still expect domestic yields/IRS rates to edge higher, following trends in core markets, as economic prospects should improve and the US Fed may start hiking rates in the second half of 2015. This would increase the steepness of Polish curves.

Foreign exchange market









Sources: CSO, Reuters, BZ WBK

Slower zloty appreciation ahead

▪ In July we suggested that the summer could be quite hot in the Polish FX market. Indeed, the exchange rate faced noticeable changes in July-August and early September. The sudden increase in global market volatility seen in late July had a significant impact on the zloty. Expectations of faster rate hikes in the US and worries about an escalation of the Ukraine-Russia conflict pushed the EURPLN above 4.17. In August, the exchange rate tested 4.23 twice (its highest since March) but by mid-September was below 4.20, thanks to the unexpected ECB easing and disappointing US non-farm payrolls data.

▪ The economic outlook for Poland has deteriorated in the course of the past two months, in our view. We have cut our GDP growth forecasts to 3.1% on average in 2014E and 2015E (with a possible dip below 3% in the next few quarters). Inflation is also likely to be lower than previously expected, due in part to Russian sanctions on Polish food exports. We have also revised the expected monetary policy scenario and envisage the main interest rate declining by 75bp over the next three months. This, in our view, points to a slower appreciation of the zloty than we predicted earlier.

▪ However, it should be noted that both interest rates and GDP growth in Poland will most likely remain among the highest in Europe. That is why we still assume the Polish currency should appreciate gradually in the final months of 2014 and in 2015. In the short run, the inflow of foreign capital to the Polish debt market – given the speculation about rate cuts – may support the currency, while persisting geopolitical risks should prevent any significant appreciation. We now expect the EURPLN to be close to 4.15 at year-end vs 4.0 previously, and c4.10 on average in 2015 (vs 3.95 forecasted previously).

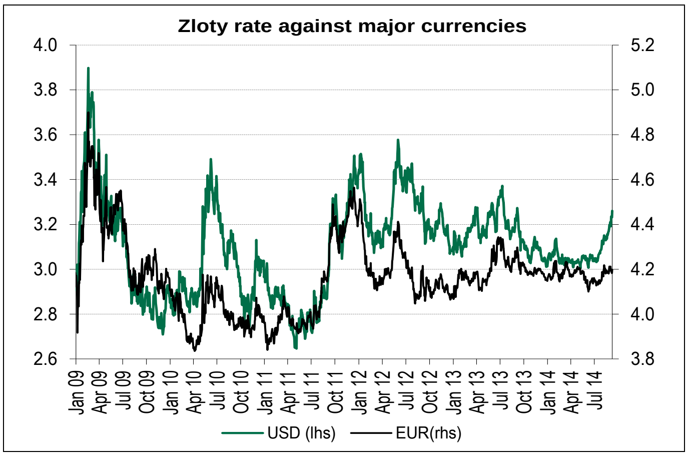
▪ We noted a divergence between the EUR/PLN and USD/PLN. The former increased by 1.5% and the latter by more than 7% since mid-July when the current wave of zloty depreciation vs the dollar started. This is the biggest mismatch in their upward moves since March 2012 (6% vs. 15%) when concern about QE3 and the Euro zone periphery intensified (elections in Greece, France). Back then, the EUR/PLN's pull-back helped the zloty to recover vs. the dollar despite a further decline of the EURUSD. At the start of September, the EUR/PLN retreated from its recent peak of 4.23, making the current situation somewhat similar to developments in March 2012.

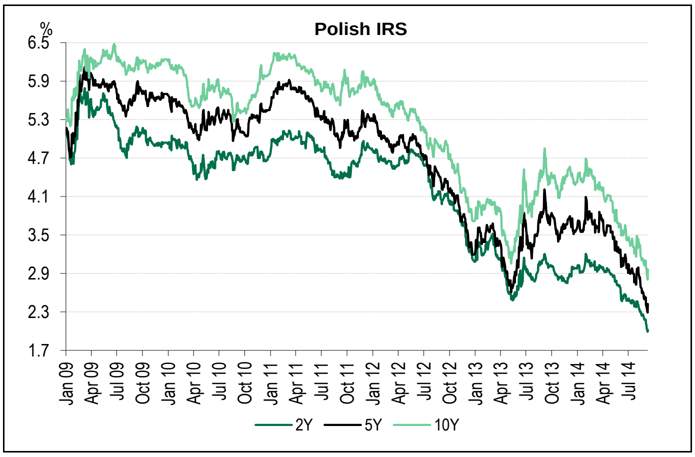
Euro under pressure

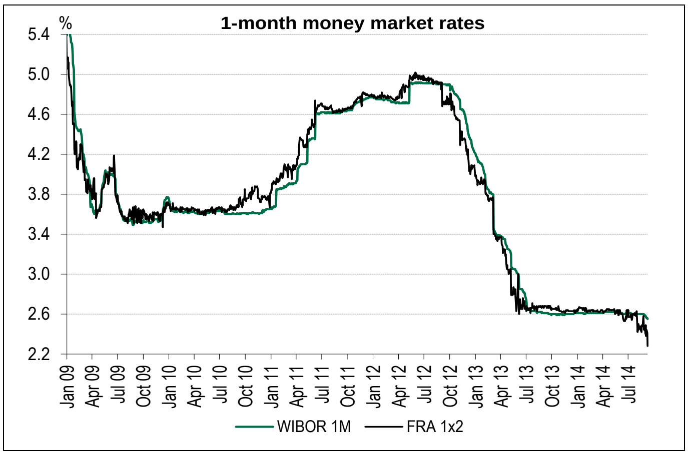
▪ The EURUSD continued its downward trend over the summer months as Euro zone data continued to disappoint and US numbers surprised on the upside. The fall clearly accelerated after the ECB announced its unexpected rate cut and ABS/covered bonds purchase program in September. Consequently, the EURUSD dropped to c1.29, its lowest since July 2013. Considering the period from early May until now, the euro has had the third weakest performance vs the dollar of its G10 peers (after the Swedish and Norwegian currencies), losing c6.5%. None of the G10 currencies gained vs the dollar during this period. The best performer, the Australian dollar, lost 0.3%.

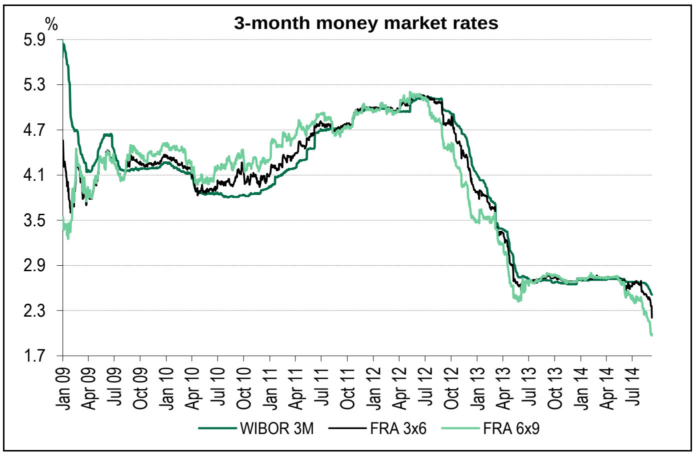
▪ We have also revised our forecasts for the EURUSD. Given the poor Euro zone macro data released in recent months, the substantial scale of monetary policy easing announced by the ECB and the strong performance of the US economy we expect the EURUSD to be at or below 1.31 at the end of the year (vs the 1.37 we expected in July). On average, the exchange rate should be close to 1.33 in 2015 (vs our 1.44 previous forecast).

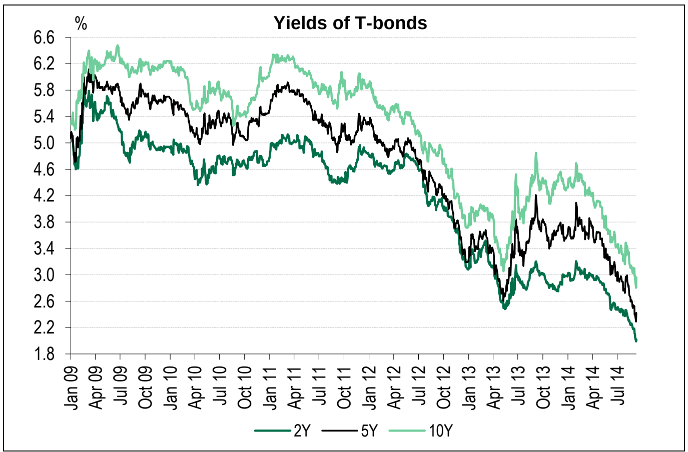
Market monitor

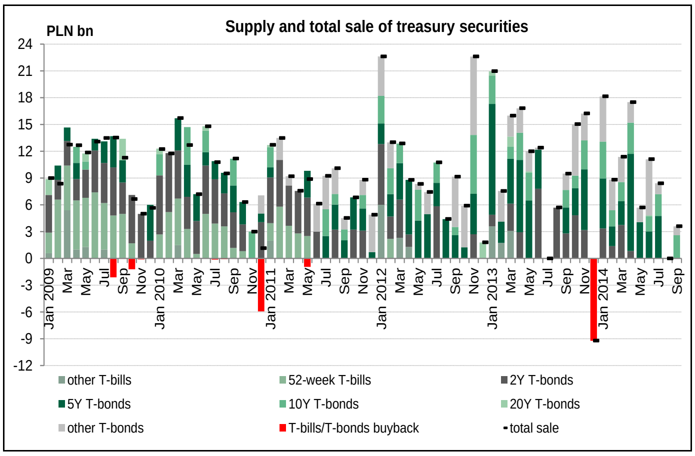












Treasury bond auctions in 2013/2014 (PLN mn)

month	First auction				Second auction				Switch auction		
	date	T-bonds	offer		date	T-bonds	offer		date	T-bonds	offer
September'13	5.09	OK0112/PS0718	5000-7000	5706.8					25.09	DS1013/OK0114	WZ0119/DS1023
October	3.10	PS0718	2500-4500	3008.0	22.10	OK0116/IZ0823/DS1023	6000-12000	12019.9	16.10	EUR20140203**	445.0
November	7.11	OK0116/PS0718	4000-7000	7964.2	13.11	USD20140115**	100	132.2	20.11	OK0114/PS0414	DS1023/WS/WZ/IZ
December									5.12	OK0114/PS0414	PS0416/WZ0119
January '14	9.01	PS0718/WZ0124	3000-5000	6013.0	23.01	OK/PS/WZ/DS	6000-10000	12129.7			
February	6.02	OK0716/WZ0119	2000-4000	4810.0	13.02	PS0718/DS1013	3000-5000	4011.0			
March	6.03	OK0716/WZ0119	2500-5500	6573.0					20.03	PS0414/OK0714	PS0718/DS1023
April	3.04	DS1023/WZ0119	3000-5000	5781.0	23.04	OK0716/PS1016/PS0718	5000-10000	11722.3			
May	8.05	PS0719/WZ0119	3000-5000	5694.2	22.05	IDS1024	1000-2000	1270.0			
June	5.06	DS/WS/WZ	3000-5000	4989.7					18.06	OK0714/WZ0115	WZ0119/PS0719
July	3.07	DS0725/WS0428	1000-3000	2419.0	23.07	WZ0119/PS0719	2000-6000	5999.0			
August	-	-	-	-	-	-	-	-	-	-	-
September	4.09	DS0725/WS0124	2000-3000	3595.0	25.08	USD20150716**	Up to 400		18.09	WZ0115/PS0415	to be chosen

** with supplementary auction, ** buy-back auction, *** demand/sale.*

Source: MoF, Reuters, BZ WBK.

Economic calendar

MONDAY	TUESDAY	WEDNESDAY	THURSDAY	FRIDAY
8 September DE: Exports (Jul) CZ: Industrial output (Jul)	**9** CZ: CPI (Jul)	**10**	**11** HU: CPI (Jul)	**12** ***PL: Money supply (Aug)*** EZ: Industrial output (Jul) US: Retail sales (Aug) US: Flash Michigan (Sep)
15 ***PL: Balance of payments (Jul)*** ***PL: CPI (Aug)*** US: Industrial output (Aug)	**16** ***PL: Core inflation (Aug)*** ***PL: Wages and employment (Aug)*** DE: ZEW index (Sep)	**17** ***PL: Industrial output (Aug)*** ***PL: PPI (Aug)*** EZ: HICP (Aug) US: CPI (Aug) US: FOMC decision	**18** ***PL: MPC minutes*** US: House starts (Aug) US: Building permits (Aug) US: Philly Fed index (Sep)	**19**
22 US: Home sales (Aug)	**23** ***PL: Retail sales (Aug)*** ***PL: Unemployment rate (Aug)*** CN: Flash PMI – manufacturing (Sep) DE: Flash PMI – manufacturing (Sep) EZ: Flash PMI – manufacturing (Sep) HU: Central bank decision	**24** DE: Ifo index (Sep) US: New home sales (Aug)	**25** CZ: Central bank decision US: Durable goods orders (Aug)	**26** US: Final GDP (Q2) US: Michigan index (Sep)
29 US: Personal income (Aug) US: Consumer spending (Aug) US: Pending home sales (Aug)	**30** ***PL: Balance of payments (Q2)*** ***PL: Inflation expectations (Sep)*** EZ: Flash HICP (Sep) CZ: GDP (Q2) US: Consumer confidence index (Sep)	**1 October** ***PL: PMI – manufacturing (Sep)*** CN: PMI – manufacturing (Sep) DE: PMI – manufacturing (Sep) EZ: PMI – manufacturing (Sep) US: ISM – manufacturing (Sep) US: ADP report (Sep)	**2** EZ: ECB decision US: Industrial orders (Aug)	**3** EZ: PMI – services (Sep) DE: PMI – services (Sep) US: ISM – services (Sep) US: Non-farm payrolls (Sep) US: Unemployment rate (Sep) US: ISM – services (Sep)
6 DE: Industrial orders (Aug)	**7** DE: Industrial output (Aug) CZ: Industrial output (Aug)	**8** ***PL: MPC decision*** US: FOMC minutes	**9** DE: Exports (Aug) CZ: CPI (Sep)	**10** HU: CPI (Sep)
13	**14** ***PL: Balance of payments (Aug)*** ***PL: Money supply (Sep)*** DE: ZEW index (Aug) EZ: Industrial output (Aug)	**15** ***PL: CPI (Sep)*** ***PL: Core inflation (Sep)*** US: Retail sales (Sep) US: Fed Beige Book	**16** ***PL: Wages and employment (Sep)*** EZ: HICP (Sep) US: Industrial output (Sep) US: Philly Fed index (Oct)	**17** ***PL: Industrial output (Sep)*** ***PL: PPI (Sep)*** US: House starts (Sep) US: Building permits (Sep) US: Flash Michigan (Oct)

Calendar of MPC meetings and data releases for 2014

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
ECB meeting	8	6	6	3	8	5	3	7	4	2	6	4
MPC meeting	7-8	4-5	4-5	8-9	6-7	2-3	1-2	19	2-3	7-8	4-5	2-3
MPC minutes	23	20	20	17	22	20	-	21	18	23	20	18
Flash GDP*	-	14	-	-	15	-	-	14	-	-	14	-
GDP*	-	28	-	-	30	-	-	29	-	-	28	-
CPI	15	14[a]	14[b]	15	14	13	15	13	15	15	13	15
Core inflation	16	-	14	16	15	16	16	14	16	15	17	16
PPI	21	19	19	17	20	18	17	20	17	17	20	17
Industrial output	21	19	19	17	20	18	17	20	17	17	20	17
Retail sales	24	24	25	24	26	26	23	26	23	-	-	-
Gross wages,employment	20	18	18	16	19	17	16	19	16	16	19	16
Foreign trade	about 50 working days after reported period											
Balance of payments*	2		31			30			30			
Balance of payments	17	12	17	11	15	13	14	13	15	14	13	
Money supply	14	14	14	14	14	13	14	14	12	14	14	
Business climate indices	23	21	21	23	22	23	22	22	22	22	21	19

* quarterly data. [a] preliminary data for January. [b] January and February.
Source: CSO, NBP, Ministry of Finance, Reuters, Bloomberg.

Economic data and forecasts for Poland

Monthly economic indicators

		Aug 13	Sep 13	Oct 13	Nov 13	Dec 13	Jan 14	Feb 14	Mar 14	Apr 14	May 14	Jun 14	Jul 14	Aug 14E	Sep14E
PMI	pts	52.6	53.1	53.4	54.4	53.2	55.4	55.9	54.0	52.0	50.8	50.3	49.4	49.0	49.2
Industrial production	% YoY	2.2	6.3	4.6	2.9	6.7	4.2	5.3	5.5	5.5	4.4	1.8	2.3	-0.8	7.6
Construction production	% YoY	-11.1	-4.8	-3.2	-2.9	5.8	-3.9	14.4	17.4	12.2	10.0	8.0	1.1	0.3	7.3
Retail sales [a]	% YoY	3.4	3.9	3.2	3.8	5.8	4.8	7.0	3.1	8.4	3.8	1.2	2.1	1.8	4.2
Unemployment rate	%	13.0	13.0	13.0	13.2	13.4	14.0	13.9	13.5	13.0	12.5	12.0	11.9	11.7	11.7
Gross wages in corporate sector	% YoY	2.0	3.6	3.1	3.1	2.7	3.4	4.0	4.8	3.8	4.8	3.5	3.5	4.0	3.4
Employment in corporate sector	% YoY	-0.5	-0.3	-0.2	0.1	0.3	0.0	0.2	0.5	0.7	0.7	0.7	0.8	0.8	0.8
Exports (€)	% YoY	2.8	9.0	3.8	2.3	10.1	10.5	5.8	10.9	6.7	11.5	7.3	6.3	2.2	10.5
Imports (€)	% YoY	-0.3	4.2	4.6	0.6	0.0	6.6	7.3	3.1	6.2	11.6	9.6	5.7	1.5	16.8
Trade balance	EUR mn	299	660	259	-25	-85	406	268	484	733	-14	333	229	391	-113
Current account balance	EUR mn	-618	-907	-6	-911	-497	-873	-508	615	941	124	-391	-356	-509	-1,368
Current account balance	% GDP	-1.9	-1.9	-1.8	-1.7	-1.4	-1.2	-1.2	-1.0	-0.9	-0.8	-0.9	-0.8	-0.8	-0.9
Budget deficit (cumulative)	PLN bn	-26.8	-29.6	-39.5	-38.5	-42.2	-2.6	-11.7	-17.5	-21.3	-22.5	-25.4	-26.4	-25.0	-25.2
Budget deficit (cumulative)	% of FY plan	51.9	57.4	76.5	74.7	81.8	5.6	24.7	36.8	44.8	47.3	53.4	55.5	52.6	53.0
CPI	% YoY	1.1	1.0	0.8	0.6	0.7	0.5	0.7	0.7	0.3	0.2	0.3	-0.2	-0.3	-0.4
CPI excluding food and energy	% YoY	1.4	1.3	1.4	1.1	1.0	0.4	0.9	1.1	0.8	0.8	1.0	0.4	0.4	0.7
PPI	% YoY	-1.1	-1.4	-1.4	-1.5	-1.0	-1.0	-1.4	-1.3	-0.7	-1.0	-1.8	-2.0	-1.4	-1.2
Broad money (M3)	% YoY	6.1	6.1	5.9	5.7	6.2	5.4	5.2	5.2	5.4	5.2	5.2	6.2	6.3	6.9
Deposits	%YoY	5.8	6.0	5.9	5.2	6.0	4.9	4.7	4.7	5.4	5.5	5.5	6.8	6.7	6.7
Loans	%YoY	3.3	3.7	2.9	3.8	4.0	4.2	4.7	5.3	6.1	5.4	4.9	5.4	5.8	5.4
EUR/PLN	PLN	4.23	4.24	4.19	4.19	4.18	4.18	4.18	4.20	4.18	4.18	4.14	4.14	4.19	4.20
USD/PLN	PLN	3.18	3.17	3.07	3.10	3.05	3.07	3.06	3.04	3.03	3.04	3.04	3.06	3.15	3.20
CHF/PLN	PLN	3.43	3.43	3.40	3.40	3.41	3.39	3.42	3.45	3.43	3.42	3.39	3.41	3.46	3.48
Reference rate [b]	%	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50
3M WIBOR	%	2.70	2.69	2.67	2.65	2.67	2.70	2.71	2.71	2.72	2.72	2.69	2.68	2.65	2.54
Yield on 2-year T-bonds	%	2.98	3.07	2.90	2.80	2.94	2.99	3.06	2.99	2.94	2.79	2.54	2.45	2.30	2.10
Yield on 5-year T-bonds	%	3.67	3.86	3.62	3.64	3.65	3.67	3.79	3.68	3.60	3.36	3.10	2.89	2.73	2.50
Yield on 10-year T-bonds	%	4.31	4.50	4.28	4.38	4.41	4.42	4.47	4.26	4.10	3.80	3.54	3.34	3.23	3.00

Note: [a] in nominal terms, [b] at the end of the period.
Source: CSO, NBP, Finance Ministry, BZ WBK own estimates.

Quarterly and annual economic indicators

		2012	2013	2014E	2015E	1Q14	2Q14	3Q14E	4Q14E	1Q15E	2Q15E	3Q15E	4Q15E
GDP	PLN bn	1,596.4	1,635.7	1,692.8	1,765.9	397.4	413.5	415.6	466.3	409.0	430.6	435.1	491.1
GDP	% YoY	2.0	1.6	3.1	3.1	3.4	3.3	2.8	2.8	2.6	3.1	3.3	3.5
Domestic demand	% YoY	-0.1	0.0	3.9	4.0	3.0	5.1	3.9	3.6	3.5	3.9	4.2	4.3
Private consumption	% YoY	1.3	0.8	2.8	2.8	2.6	2.8	2.9	2.9	2.8	2.7	2.8	2.9
Fixed investments	% YoY	-1.6	-0.2	7.5	5.4	10.7	8.4	7.0	6.0	5.0	5.0	5.0	6.0
Industrial production	% YoY	1.0	2.3	4.1	4.3	4.9	3.7	3.2	4.3	4.0	4.8	4.3	4.2
Construction production	% YoY	-1.0	-10.3	6.5	7.2	9.8	9.9	3.0	5.6	6.0	5.7	8.5	7.8
Retail sales [a]	% YoY	6.0	2.6	4.0	6.2	5.1	4.6	2.8	3.6	4.3	5.1	7.2	8.0
Unemployment rate [b]	%	13.4	13.4	12.2	11.7	13.5	12.0	11.7	12.2	12.4	11.2	11.1	11.7
Gross wages in the national economy [a]	% YoY	3.7	3.4	3.5	4.0	4.2	3.5	3.2	3.2	3.6	3.6	4.6	4.6
Employment in the national economy	% YoY	0.0	-1.1	0.2	0.4	-0.3	0.1	0.4	0.4	0.4	0.4	0.3	0.3
Exports (€)	% YoY	5.9	5.0	7.6	8.3	9.1	8.4	6.5	6.5	7.5	8.0	8.5	9.0
Imports (€)	% YoY	2.3	0.0	7.8	9.9	5.6	9.1	8.2	8.2	9.0	10.0	10.0	10.5
Trade balance	EUR mn	-5,175	2,309	2,193	-327	1,159	1,052	508	-525	652	326	-77	-1,228
Current account balance	EUR mn	-14,191	-5,328	-5,223	-8,437	-766	674	-2,135	-2,996	-1,450	-318	-2,956	-3,713
Current account balance	% GDP	-3.7	-1.4	-1.3	-2.0	-1.0	-0.9	-0.9	-1.3	-1.4	-1.7	-1.8	-2.0
General government balance	% GDP	-3.9	-4.3	5.7	-2.9	-	-	-	-	-	-	-	-
CPI	% YoY	3.7	0.9	0.1	0.9	0.6	0.3	-0.3	-0.1	0.2	0.9	1.1	1.5
CPI [b]	% YoY	2.4	0.7	0.0	1.6	0.7	0.3	-0.4	0.0	0.3	1.0	1.4	1.6
CPI excluding food and energy	% YoY	2.2	1.2	0.7	1.3	0.8	0.8	0.5	0.8	1.1	1.3	1.4	1.5
PPI	% YoY	3.4	-1.3	-1.0	1.1	-1.2	-1.2	-1.5	-0.2	0.4	1.3	1.4	1.2
Broad money (M3) [b]	% oY	4.5	6.2	5.5	6.0	5.2	5.2	6.9	5.5	5.6	5.8	5.9	6.0
Deposits [b]	%YoY	20.6	9.8	9.1	11.7	4.7	5.5	6.7	5.8	6.1	6.3	6.5	6.8
Loans [b]	%YoY	36.6	8.7	8.8	13.7	5.3	4.9	5.4	5.1	5.1	5.2	5.2	5.2
EUR/PLN	PLN	4.19	4.20	4.17	4.09	4.19	4.17	4.18	4.16	4.13	4.10	4.07	4.05
USD/PLN	PLN	3.26	3.16	3.10	3.08	3.06	3.04	3.13	3.18	3.16	3.13	3.05	2.99
CHF/PLN	PLN	3.47	3.41	3.42	3.10	3.42	3.42	3.45	3.40	3.28	3.18	3.02	2.94
Reference rate [b]	%	4.25	2.50	1.75	1.75	2.50	2.50	2.50	1.75	1.75	1.75	1.75	1.75
3M WIBOR	%	4.91	3.02	2.53	1.96	2.71	2.71	2.62	2.08	1.92	1.95	1.97	1.99
Yield on 2-year T-bonds	%	4.30	2.98	2.51	2.18	3.01	2.76	2.28	2.00	2.03	2.12	2.22	2.35
Yield on 5-year T-bonds	%	4.53	3.46	3.01	2.55	3.71	3.35	2.71	2.28	2.37	2.47	2.60	2.78
Yield on 10-year T-bonds	%	5.02	4.04	3.54	2.95	4.38	3.82	3.19	2.75	2.75	2.82	3.02	3.20

Note: [a] in nominal terms, [b] at the end of period. Source: CSO, NBP, Finance Ministry, BZ WBK own estimates.

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