

Weekly economic update

6 –12 October 2008

Surprising decision of the House of Representatives to reject the Paulson's rescue plan for the US financial sector last Monday triggered a surge in risk aversion, which resulted in a collapse in stock markets, strengthening in bond markets, strong rise in money market rates and weakening in currencies in the region. Uncertainty was additionally fuelled by information about financial problems of European banks. Work on the rescue package have been resumed in the US Congress though, and on Wednesday the Senate approved amended plan, including among others higher protection for depositors and higher tax rebates. On Friday, the plan was accepted by the House of Representatives.

Green light for the US government's takeover of "toxic assets" improved investors' sentiment only for a while, and this week began with increased risk aversion among other due to information about problems of next financial institutions in Europe. One should take into account that uncertainty and risk aversion will remain at elevated levels for some time. Financial market players are increasingly concerned that effects of the plan may be insufficient to prevent the US economy from recession and financial market from further distress. The key issue in the near term will be to restore market liquidity and "defreezing" money markets that stalled in recent days. While the main effect of the Paulson's plan was supposed to be restoration of confidence in the markets, the wave of criticism it has suffered recently and problems with its approval in the Congress may reduce its positive impact on market moods.

In the local market, an important event will be auction of 10Y bonds. Demand for the government securities should be quite high, as financial institutions are seeking relatively safe investments. Possibly, the problem of financial market crisis will be tackled by politicians. On Friday the president Lech Kaczyński said he may call a meeting of the Cabinet Council (a panel of all members of the government and the president) to debate risks for the Polish economy.

Economic calendar

Time GMT	COUNTRY	INDICATOR	PERIOD		FORECAST		LAST VALUE
					MARKET	BZWBK	
TUESDAY (7 October)							
18:00	US	FOMC minutes	Sep	-	-	-	-
WEDNESDAY (8 October)							
	JP	Bank of Japan decision	-	%	0.5	-	0.5
09:00	PL	Auction of 10Y bonds	-	-	-	-	-
09:00	EZ	Revised GDP	Q2	%YoY	1.4	-	2.1
12:00	US	Pending home sales	Aug	%MoM	-2.0	-	-3.2
THURSDAY (9 October)							
09:00	GB	Bank of England – decision	-	%	5.0	-	5.0
10:30	US	Jobless claims	w/e	k	475	-	497
12:00	US	Wholesale inventories	Aug	%MoM	0.5	-	1.4
FRIDAY (10 October)							
10:30	US	Import prices	Sep	%MoM	-2.5	-	-3.7
10:30	US	Trade balance	Aug	\$ bn	-59.0	-	-62.2

Source: BZ WBK, Reuters

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What's hot this week – Few events, high emotions

Main features of the US bailout package approved by the Congress

Main assumption:

Purchase of toxic assets, related mainly to housing market, from financial institutions for \$700bn

Additional amendments added by the Senate:

- Tax allowances for households and enterprises - \$150bn (including financing of \$40bn thanks to lowering of spending or increase in some taxes),
- Temporary increase in value of deposits covered by insurance of Federal Deposit Insurance Corporation from \$100.000 to \$250.000 – without additional costs of the banks – FDIC may borrow from the US Treasury to cover potential losses related to higher insurance limit,
- Possibility to suspend marked-to-market valuation required by the Securities and Exchange Commission.

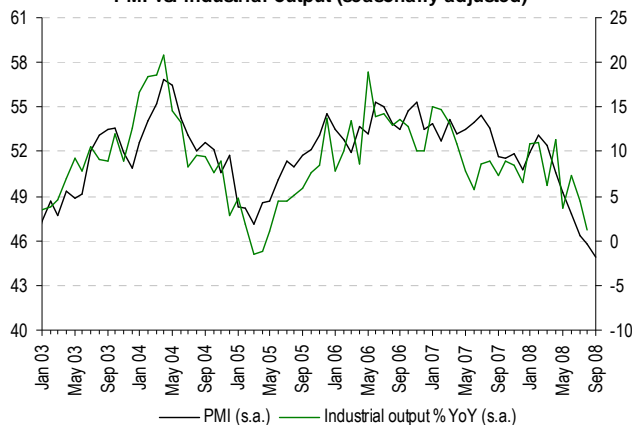
■ In the nearest week, there are no important data releases scheduled in Poland, and a list of publications abroad is also very short. However, this is not going to be a quiet and peaceful week for the financial sector.

■ Despite approval of rescue package for the financial sector by the House of Representatives, market sentiment has not improved, among others to troubles of European banks. Uncertainty and elevated risk aversion will not disappear easily. In the long run, investors' moods may be spoiled by fears of recession in the US and in the euro zone, magnified by a set of very weak recent data releases.

■ Amid lack of domestic events, local market will eye changes in sentiment abroad, among others under influence of FOMC minutes, speeches of Fed and ECB presidents, and scarce data releases in the US and euro zone.

Economy last week – Weaker and weaker data, deteriorating moods

PMI vs. industrial output (seasonally adjusted)

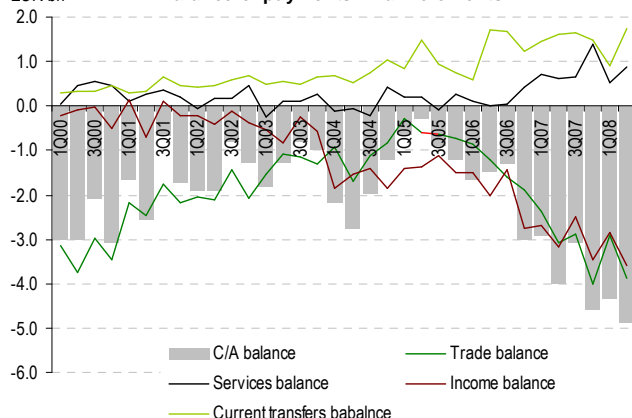


■ PMI index for Polish manufacturing sector fell in September to 44.9 from 45.8 in August. Index of new orders fell clearly to 43, while employment index fell to 45.2. Data suggested that economic slowdown is gaining momentum.

■ Data about manufacturing activity in the euro zone (PMI) and in the US (ISM) were also very grim, showing deep collapse in September, and signalling growing risk of recession in the world's biggest economies.

■ *Monetary policy guidelines for 2009* were not much different from the version for 2008. The MPC said that monetary policy strategy will be adjusted after "binding" decision about euro zone entry. Then, the policy will be subordinated to permanent fulfilment of convergence criteria, which according to MPC members will require more restrictive monetary policy.

Balance of payments - main elements



■ According to the Ministry of Finance, inflation rate in September fell to 4.4%YoY amid 0.3%MoM price increase. Our forecast shows CPI growth by 4.5%YoY and 0.3%MoM.

■ Quarterly balance of payments data showed lower current account deficit in Q2 (€4.9bn). Meanwhile, deficits in previous quarters have been revised up, so after the H1 the 12-month C/A gap reached 5% of GDP, versus 4.5% according to previously available data.

■ ECB left main interest rates unchanged. However, a tone of the bank president's statement has been clearly softened. In our view, interest rate cuts in the euro zone may start already in November, and till the middle of 2009 the main interest rate may fall to 3.0-3.5%.

Quote of the week – Fast rate cuts in the euro zone may affect MPC decisions

Jan Czekaj, MPC member, Reuters, 2 October

I believe that the situation is such that a rate hike is not needed immediately. I even wonder whether another hike will be needed at all. We will see what happens with inflation.

Jean Claude Trichet, ECB president, press conf., 2 October

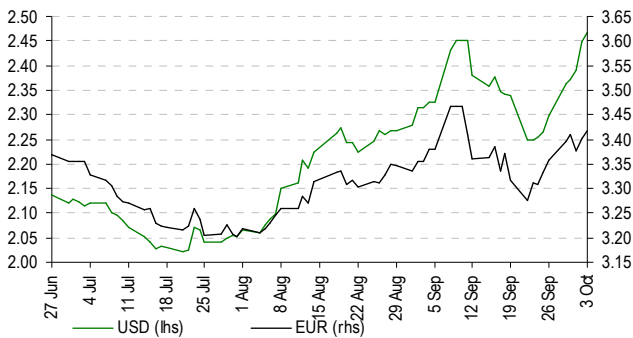
With the weakening of demand, upside risks to price stability have diminished somewhat, but they have not disappeared..

We examined two options: first, leaving interest rates unchanged; second, decreasing interest rates.

In our view, the MPC may decide to hike interest rates once again, most likely in October. This month the government is expected to present a schedule of euro adoption. If it is considered by the Council as a "binding decision", the MPC may be willing to tighten monetary policy. Nevertheless, while prospect of Poland's fast euro zone entry increases likelihood of more restrictive monetary policy, a change in the prospects of ECB policy to more relaxed may neutralise the former factor and deter the MPC from next hikes. Thus, the result of the last ECB meeting lowered a likelihood of interest rate hikes in Poland.

Market monitor

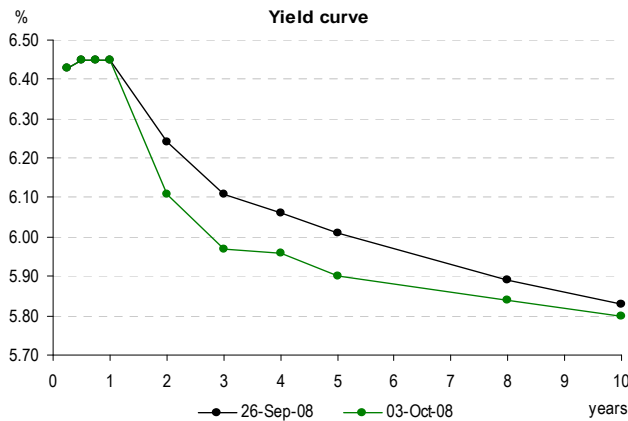
Zloty exchange rate



Risk aversion weakens the zloty

- Throughout the whole past week the zloty was weakening in reaction to rising risk aversion, which resulted from problems of financial institutions, lack of support for the US bailout plan and uncertainty over the world economy. The significant dollar appreciation also contributed to the zloty gains. The USDPLN rate rose in the course of the week by ca. 17 groszy, i.e. over 7%.
- Due to lack of permanent improvement in moods after approval of the bailout package by the US Congress, one may expect the climate in the local FX market will rather stay nervous, and the currencies will be sensitive to large fluctuations. We forecast the EURPLN rate trading range at 3.38-3.48 and 2.45-2.55 for the USDPLN rate.

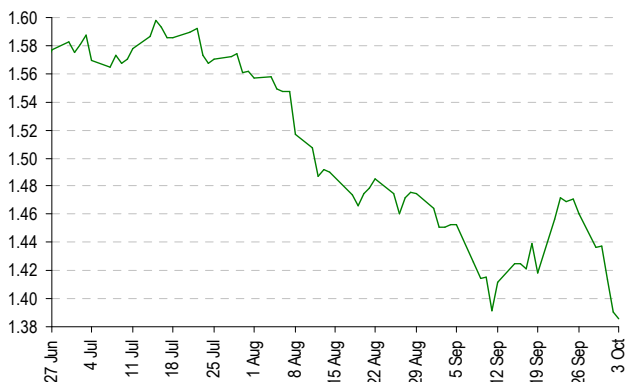
Yield curve



Domestic yields lower after ECB meeting

- For the better part of last week yields of local bonds were broadly stable, as effect of strengthening in the core debt markets was offset by increased risk aversion lowering demand for Polish debt. Significant fall in yields took place after the ECB meeting and suggestion that rate cuts in the euro zone are possible soon, which affected expectations regarding monetary policy in Poland as well. Yield of 2Y bond fell below 6% for the first time since the start of this year.
- The auction of 10Y bonds scheduled on Wednesday should be successful. We expect large demand from domestic investors.

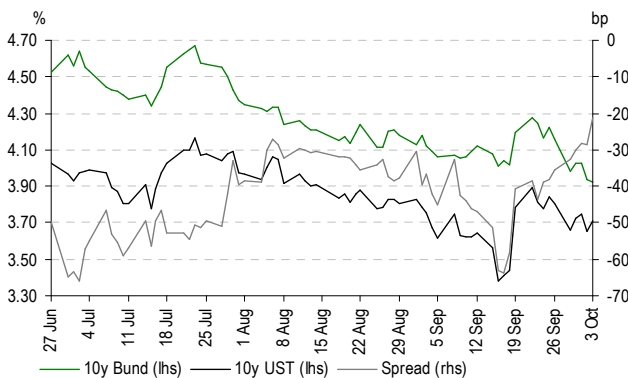
EURUSD rate



Strong dollar due to uncertainty, ECB statement

- Dollar clearly strengthened versus euro due to increasing risk aversion and problems of European banks, while at the end of the week this move was also reinforced by higher expectations for monetary easing in the euro zone.
- This week a list of planned events that may be significant for the market, is quite short. The minutes of the September FOMC meeting and the August trade report are likely to dominate a relatively dull agenda. However, key issue for the exchange rates will be market expectations regarding consequences of the Paulson's plan implementation. Investors' attention will also focus on speeches of Ben Bernanke and Jean Claude Trichet.

10y Bunds & Treasuries and spread



Higher risk aversion strengthens bonds

- Capital flee to safe assets led to significant fall in yields in the core debt markets last week. The fall in yields was deeper in the European debt markets as there was increase in expectations that the ECB will cut rates already this year.
- Yields in the core debt markets this week will probably remain low, as risk aversion remains high and stock markets keep falling, which leads to higher demand for safe assets. However, any signs of rising optimism on the markets may trigger a correction in bonds and increase in yields.

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