

Weekly economic update

3 – 9 November 2008

Rise in global risk appetite led to rebound in global stock markets and strong recovery of the emerging market currencies. The CEE region was positively affected by news about support from the IMF, the EU and the World Bank for Hungary. Besides, the Fed lowered interest rates again (by 50bp to 1%) and suggested further rate cuts due to downside risk to economic growth. Several central banks in Asia also cut interest rates and the Fed provided a few emerging markets' central banks with FX swaps in US dollars. Rebound of the zloty took place at the same fast pace as its weakening the previous week. Significant strengthening, although with limited liquidity, was observed also in the local debt market. However, at the end of the week, both the zloty and domestic bonds weakened. Performance of currencies in the region was related to EURUSD, which lowered towards the end of the week after earlier surge.

Situation in the international markets and high volatility will be still dominating factors for the Polish financial markets. The NBP will launch operations providing the market with liquidity for up to 3 months, which should lead to fall in rates in money market. Last week the finance ministry said that given difficult market conditions the debt issuance policy in November will be flexible. Thus, the auction of 5Y bonds scheduled earlier for this week has been cancelled, while tender of treasury bills will be held instead. With no domestic data releases, the key focus of attention will be CPI inflation forecast for October of the Ministry of Finance as well as international events. The ECB and the Bank of England are expected to cut rates by 50bps. The key data release will be the US non-farm payrolls report. Besides, we will get economic activity indicators for manufacturing and services both from the euro zone the US. The markets may be also influenced by outcome of the presidential elections in the US. Some impact on the CEE region markets may be also expected with respect to the Czech central bank decision with speculation about a rate cut.

Economic calendar

Time GMT	COUNTRY	INDICATOR	PERIOD		FORECAST		LAST VALUE
					MARKET	BZWBK	
MONDAY (3 November)							
10:00	PL	Auction of PLN200-500m of 13-week and PLN0.5-1.5bn of 52-week Treasury bills					
9:00	EZ	Manufacturing PMI	Oct	pts	41.3	-	45.0
15:00	US	Manufacturing ISM	Oct	pts	41.8	-	43.5
TUESDAY (4 November)							
10:00	EZ	PPI	Sep	%YoY	8.0	-	8.5
15:00	US	Factory orders	Sep	%MoM	-1.0	-	-4.0
	US	Presidential election day					
WEDNESDAY (5 November)							
9:00	EZ	Services PMI	Oct	pts	46.9	-	48.4
13:15	US	ADP report	Oct	'000	-95	-	-8.0
15:00	US	Non-manufacturing ISM	Oct	pts	47.3	-	50.2
THURSDAY (6 November)							
12:45	EZ	ECB meeting – decision		%	3.25	3.25	3.75
12:00	GB	BoE meeting – decision		%	4.00	4.00	4.50
13:30	US	Unit labour costs	Q3	%	2.9	-	-0.5
13:30	US	Labour productivity	Q3	%	1.0	-	4.3
FRIDAY (7 November)							
15:00	US	Non-farm payrolls	Oct	'000	-185	-	-159
15:00	US	Rate of unemployment	Oct	%	6.3	-	6.1

Source: BZ WBK, Parkiet Reuters;

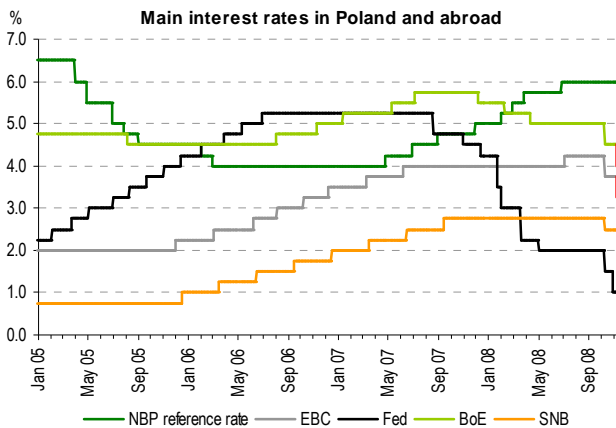
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What's hot this week – FinMin's inflation forecast, ECB decision

- Amid difficult market conditions, the Ministry of Finance announced that debt issuance policy will be flexible in November. This week's auction of 5Y bonds was cancelled, while auction of T-bills will take place.
- As usually at the start of the month, the Ministry of Finance will release inflation forecast for September. We expect a drop in CPI growth to 3.9-4.0%YoY amid monthly increase of 0.1%. Market consensus predicts 4.2%YoY rise.
- An important event also from the point of view of domestic monetary policy will be ECB decision on Thursday. Market consensus suggests a rate cut by 50 bp. Also, the Bank of England will announce the decision and is expected to cut rates by 50 bp.
- This week the NBP should start delivering liquidity in 3-month operations, which should start improving situation in the money market

Economy last week – Neutral MPC bias, the road map to euro approved**Projections in subsequent Inflation Reports**

PKB	Feb 08	Jun 08	Oct 08*	Oct 08**
2008	4.4-5.8	4.3-5.5	5.0-5.3	4.9-5.2
2009	3.5-6.1	3.4-6.2	1.9-3.7	1.7-3.5
2010	3.6-6.9	3.8-6.8	2.7-4.5	2.4-4.3
CPI	Feb 08	Jun 08	Oct 08*	Oct 08**
2008	3.6-4.7	3.8-4.7	4.2-4.4	4.2-4.4
2009	2.6-4.9	2.5-5.8	3.9-5.7	3.1-5.3
2010	2.1-4.8	0.1-5.7	1.9-4.5	1.5-4.3

* version of the projection with cut off date as of September 26; ** version of the projection with cut off date as of October 16;

Note: According to the NBP projection, GDP growth and CPI inflation will be in the indicated ranges with probability of 50%

- Monetary Policy Council kept main interest rates on hold and changed informal policy bias from restrictive to neutral, mainly under influence of deteriorating prospect of GDP growth.
- New NBP projection shows GDP growth below 3% in 2009 and below 4% in 2010. Although at the same time inflation projection is still high (above 4% in 2009 and above the target on average in 2010), the risk is asymmetric on the downside.
- It seems to us that in nearest months the Council changes the bias from „neutral” to „easing”.
- A scale of rate cuts will depend on pace of economic slowdown and disinflation, prospects of euro zone entry and situation in financial markets. We may see the first rate cut amid inflation fall below 3.5% at the start of 2009. A total scale of cuts next year may reach 100 bp.

„Road map to euro”

Date	Event
Nov-Dec '08	Analytic works of working groups
Q1 '09	Start of procedure of Constitution change
H1 '09	Zloty enters the ERM2 mechanism
Dec '10 – Jan '11	Applying to EC and ECB for preparation of convergence reports beyond regular date of their release
May '11	Convergence reports of EC and ECB
May – Jun '11	Procedure of Poland's assessment by EU institutions
mid '11	Decision of ECOFIN Council on central parity
Jan '12	Poland joins euro zone

- The government approved agenda for euro zone entry. Credibility of plan to adopt euro in 2012 depends largely on passing changes in the constitution, for which a support of PiS is required. The latter is conditioned on the result of the referendum. It should take place before the ERM2 entry and according to PO declarations it may take place in the spring.
- Tone of recent comments of President Lech Kaczyński was slightly less supportive for fast euro zone entry than his earlier statements just after the Cabinet Council meeting. NBP president Sławomir Skrzypek said that it cannot be ruled out that not all dates indicated in the government's schedule of the euro zone entry will be fulfilled. However, one should remember that in the official statement the MPC clearly declared a support for adopting the euro as soon as possible.

Quote of the week – Direction of interest rate movements is predetermined**Andrzej Sławiński, MPC member, TVN CNBC, 30 October**

(...) sooner or later [interest rate path] will be adjusted to weakening business climate. In such situation as we see abroad, a direction is predetermined. (...) Economic growth perspectives abroad are still being trimmed. (...) Scale of recession in world economy will be much higher than recently predicted.

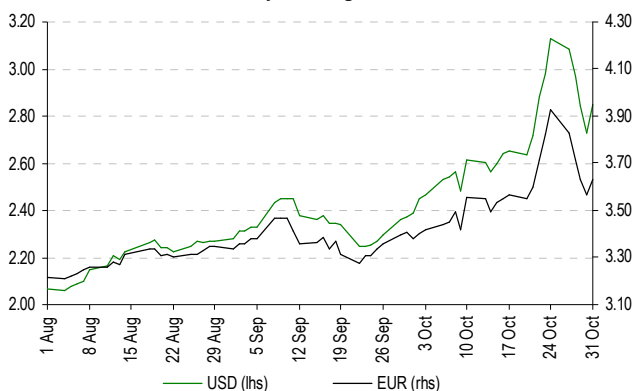
Marian Noga, MPC member, Dziennik, 30 October

Interest rates should remain unchanged for quite long, at least until end of Q1 2009. If we want to enter the euro zone as soon as possible, it will be required to decrease interest rate disparity between Poland and euro zone. This is a huge difference, so there will be a need to cut rates. However it does not imply it should be done quickly.

Events in international financial markets and their impact on significant lowering of forecasts of economic growth, including worse perspectives for Polish economy, influenced opinions of the MPC members. A softening of tone of MPC members' comments was seen in October and was reflected in the MPC's communiqué. After the MPC meeting a scenario of rate cuts was confirmed by comments of moderate central banker Andrzej Sławiński and "hawkish" Marian Noga. According to Sławiński, uncertainty concerning future economic situation is high, which makes predicting changes in interest rate path extremely difficult. However, he has no doubts that interest rates may go only in one direction. It suggests that bias of some of MPC members is already "easing". A need to reduce interest rate disparity versus euro zone was also mentioned by Marian Noga, however in his opinion there should be no hurry with rate cuts.

Market monitor

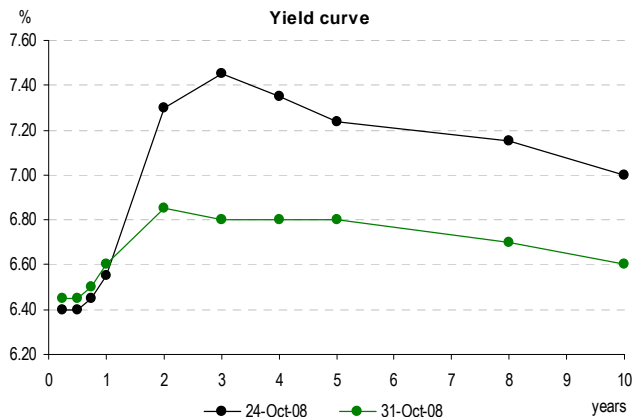
Zloty exchange rate



Large zloty swings

- A drop of zloty implied volatility from elevated level in the option market was accompanied by strong rebound of currencies in the region after a weakening at the similar scale in the previous week. During the week the zloty reached 3.44 against the euro and 2.62 versus the dollar on the wave of risk appetite and EURUSD rate upward correction. At the end of the week another weakening was recorded amid dollar and yen recovery in the international markets.
- In our opinion the zloty appreciation experienced recently does not rule out further weakening trend of the zloty in the nearest time, though the coordinated IMF, EU and World Bank activities for emerging markets (especially in the region) and interest rate cuts by major central banks should contribute to lowering zloty volatility.

Yield curve



Yields decline, still lack of liquidity

- Along with investors' sentiment improvement in the world markets and falling risk aversion, weakening of core debt markets and price increases in stock markets the prices of Polish bonds also rose. The lack of liquidity maintained large bid-ask spread. The result of the MPC meeting had smaller influence on the debt market situation. Bond yields decline were followed by drop in FRA and IRS rates.
- This week the moods in the foreign markets will still determine the domestic debt market behaviour and most probably the liquidity will not be restored in the nearest time until the situation in the international markets starts to stabilise. Relatively good macroeconomic parameters, prospects for euro zone entry should support the domestic assets and result in fall of risk premium.

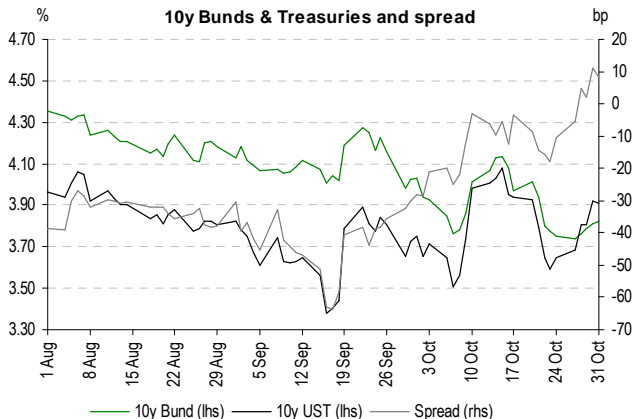
EURUSD rate



Upward correction in EURUSD market

- After strong demand for US dollar observed in the last couple of weeks, which was connected with higher risk aversion, recent days brought the correction of the EURUSD rate. This was supported by market expectations for rate cut by Fed. After the level of 1.32 was broken, the dollar started to gain again, especially as risk appetite has diminished towards the end of the week. Also, closing positions at the end of the month could have had an effect.
- It seems that appetite for US dollars will remain at elevated level until liquidity problems on global market disappear and the situation normalises in this regard,. However, the pace of dollar appreciation should be rather moderate and in this trend we may see upward corrections of EURUSD rate.

10y Bunds & Treasuries and spread



Core bond markets down as equities recovered

- Lower risk aversion in global markets, which was clear at the beginning of last week led to a recovery in equity markets and prices of bond fell as a result. At the end of the week, moods deteriorated again despite rate cut in the US and in some Asia countries, IMF support and Fed's swap lines improving liquidity in dollars. Higher risk aversion led to another gains in the bond market and yields of Treasuries and Bunds fell. Nevertheless, during the week yields of ten-year papers rose by ca. 20 bp in both cases.
- Global moods will remain the key for core bond markets. Also, euro zone's assets will be under influence of the ECB decision of rate and the scale of very likely reduction. Also any hint of further cuts and comments after press conference will be important. Additionally a few economic activity indicators will release (PMI, ISM) and US non-farm payrolls.

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