Bank Zachodni WBK

Weekly economic update

2 – 8 August 2010

Financial markets positively reacted to stress test results for European banks, which together with publication of good economic data for the euro zone and the US, led to higher risk appetite last week. Improvement in market sentiment was visible in European debt markets, which was reflected in positive results of government debt auctions in the countries of higher fiscal risk (Portugal, Italy, Hungary). During the week the euro strengthened against the dollar. The Polish currency also appreciated and the trend was stopped at the psychological barrier of 4.0 against the euro. This was the last support level we mentioned in the previous weekly report. Polish data on consumer and business sentiment confirmed positive tendencies in the Polish economy.

The presented assumption of government's financial plan for the next few years were not positive for the markets. Higher than previously announced budget deficit (PLN45bn), later than previously assumed reduction of fiscal deficit below 3% of GDP (2013), as well as hawkish comments by MPC members in reaction to planned VAT hikes, led to a correction of the Polish bond market. This week the focus of investors will be still on government's fiscal plan, though on Monday PMI for July will be released and the Ministry of Finance will publish CPI inflation forecast. As regards sentiment abroad, this will be driven by data on economic activity and the ECB meeting.

Economic calendar

Time CET	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (2 August)					
11:00	**PL**	**Repurchase tender of 52-week T-bills worth PLN7.36bn**					
9:00	**PL**	**PMI**	**Jul**	**pts**	**53.9**	**53.9**	**53.3**
9:58	EZ	PMI – industry	Jun	pts	56.5	-	56.5
16:00	US	ISM – industry	Jul	pts	54.0	-	56.2
		TUESDAY (3 August)					
11:00	EZ	PPI	Jun	% YoY	3.1	-	3.1
14:30	US	Core PCE	Jun	%MoM	0.1	-	0.2
14:30	US	Personal income	Jun	%MoM	0.1	-	0.4
14:30	US	Personal spending	Jun	%MoM	0.1	-	0.3
16:00	US	Factory orders	Jun	%MoM	-0.3	-	-1.4
16:00	US	Pending home sales	Jun	k	78.1	-	77.6
		WEDNESDAY (4 August)					
11:00	**PL**	**2Y bond auction OK1012 and PS0415 worth PLN3.0-6.0bn**					
9:58	EZ	PMI - services	Jul	pts	56.0	-	56.0
11:00	EZ	Retail sales	Jun	%YoY	0.1	-	0.3
14:15	US	ADP report	Jul	k	35.0	-	13.0
16:00	US	ISM - services	Jul	pts	53.0	-	53.8
		THURSDAY (5 August)					
12:00	DE	Factory orders	Jun	%MoM	1.5	-	-0.5
13:45	EZ	ECB Decision		%	1.0	-	1.0
14:30	US	Unemployment claims	week	k	454.0	-	457.0
		FRIDAY (6 August)					
12:00	DE	Industrial production	Jun	%MoM	0.7	-	2.6
14:30	US	Non-farm payrolls	Jul	k	-75.0	-	-125.0
14:30	US	Unemployment rate	Jul	%	9.6	-	9.5

Source: BZ WBK, Reuters; Dow Jones

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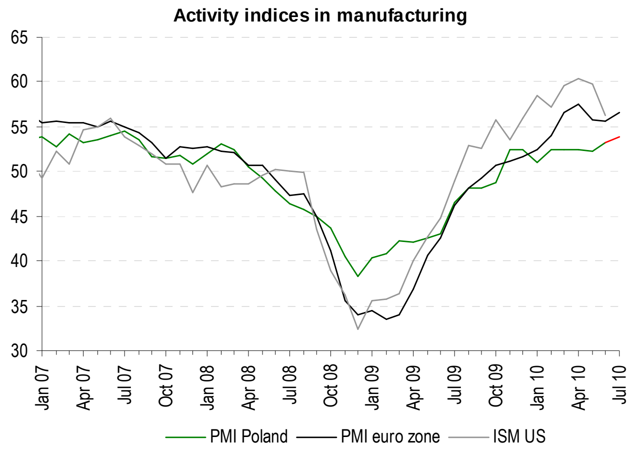
What's hot this week – New month, new data

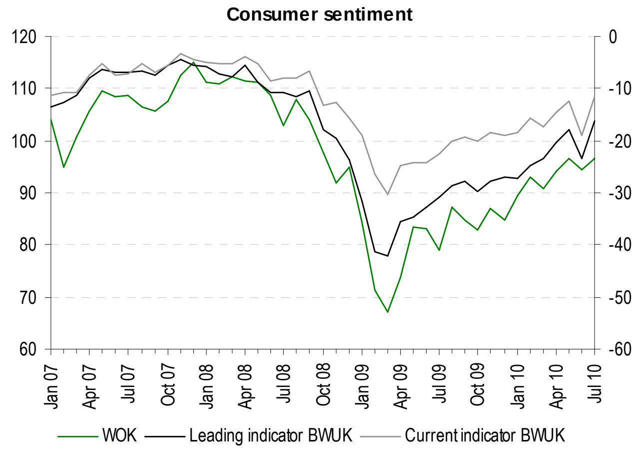


▪ At the beginning of the new month the PMI index of industrial activity and inflation forecasts of the Ministry of Finance are to be released. In our opinion business activity continued an upward trend reaching the three-years high in July, which is linked with the further improvement of economic situation in the eurozone, particularly in Germany.

▪ Our forecast indicates a decline in inflation to 2.0%YoY (the effect of high base in prices of tobacco and fuels). The most difficult to predict are food prices, affected by this year's weak supply (we predict a fall by ca. 1%MoM).

▪ Abroad, apart from several important data releases (PMI and ISM indices of activity, retail sales and, above all, employment in the US), the most important for investors will be press conference after the ECB meeting and the next set of financial results of companies for the Q2.

Economy last week – Better moods of consumers and entrepreneurs



▪ Polish consumer sentiment clearly improved in July after a temporary decline in the previous month. Measures of consumer climate calculated by the stats office and Ipsos institute index of consumer optimism (WOK) rebounded upward reaching pre-crisis levels.

▪ The NBP economic survey shows that in Q2 situation of enterprises improved, but Q3 forecast are not as optimistic as in the previous months, however expectations continue to suggest improvement. The greatest recovery recorded companies in the industry, and the lowest in services. Companies expect a slower inflow of orders in Q3, both in commerce and industry. Declining optimism related to export growth prospects, despite improving its price competitiveness in Q2. Forecasts of employment are improving, but there was no record of increase in planned investments of companies.

Assumptions to Multi-Year Financial Plan

	2010	2011	2012	2013
Budget revenues (PLN bn)	249.0	268.2	290.7	304.2
Budget spending (PLN bn)	301.2	313.2	330.7	334.4
Budget deficit (PLN bn)	52.2	45.0	40.0	30.0
General govt deficit (PLN bn)	80.0	75.8	47.8	23.4
Public debt (% GDP)	5.7	5.1	3.0	1.4
Public debt (% GDP)	54.7	54.4	54.6	53.7
GDP growth (% YoY)	3.0	3.5	4.8	4.1
Avg inflation (%YoY)	2.0	2.3	2.5	2.5
Unemployment rate (%)	12.3	9.9	8.6	7.3
Real wage growth (%YoY)	2.3	1.4	3.8	3.9

Source: Reuters

▪ The government discussed the Multi-Year Financial Plan, but the final version will be adopted on Tuesday (see main assumptions of the document in the table).

▪ There are no plans to increase income taxes (PIT, CIT), or pension contributions. The government plans to introduce a three-year temporary hike in base VAT rate by 1 pct. point (up to 23%) and some changes in the preferential VAT rates (reduction from 7% to 6% tax on processed food and increase from 3% to 6% tax on unprocessed food). According to MinFin estimates, tax changes will boost budget revenues by PLN5-6bon per year.

▪ The plan also envisages the introduction of a rule which would enforce an automatic increase of VAT by a further 1 point in the event during the year, public debt has exceeded the threshold of 55% of GDP.

Quote of the week – Will tax hike hasten MPC decisions?

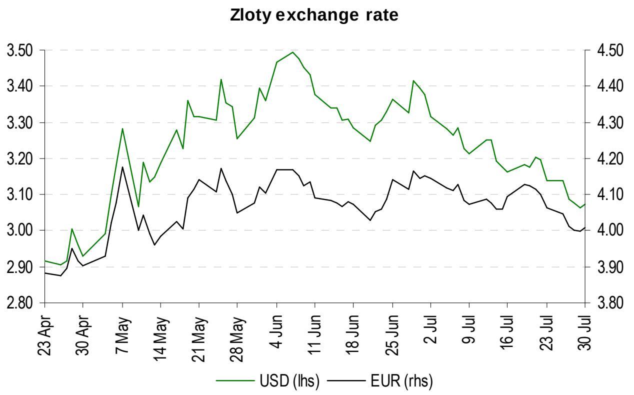
Adam Glapiński, MPC member, PAP, 30 Jul
From the perspective of MPC member, the government's manipulation in the VAT means an increase in prices, and thus the need for higher interest rates (...). It all together leads to a slowdown in economic growth. (...) A comprehensive reform of public finances is needed, rather than short term measures.

Andrzej Kaźmierczak, MPC member, PAP, 30 Jul
The increase in the VAT rate means the price increase. So surely this will have consequences for the discussion of the MPC decisions on interest rates, there is no doubt. (...) As regards the impact of pricing, it will be larger than 1 percentage point.

Anna Zielińska-Głębocka, MPC member, PAP, 27 Jul
The optimal solution would be to reduce spending (...). While the pension contribution has previously been reduced and you can go back to previous solutions, VAT would increase the negative effect. This could cause a price increase and the MPC would have to deal with the potential effect of such changes.

The increase in VAT rates will have negative effect on inflation next year. The price impulse may be higher than 1pp especially if apart from a hike in the basic rate there would be announced changes in reduced rates (VAT on processed food down from 7% to 6%, tax on unprocessed food up from 3% to 6% – the share of the latter in the CPI is 2x higher!). The Monetary Policy Council, which has already sharpened the tone in June, will undoubtedly take into account the deteriorating inflation outlook, as demonstrated by recent statements by "presidential" members, not regarded as the hawks. The hike may be easier for MPC also due to an increase in the path of inflation this year, affected by higher food prices (although that is not an argument for tightening per se). We still expect the first rate hike in a cycle (by 25 bp) in Q4.

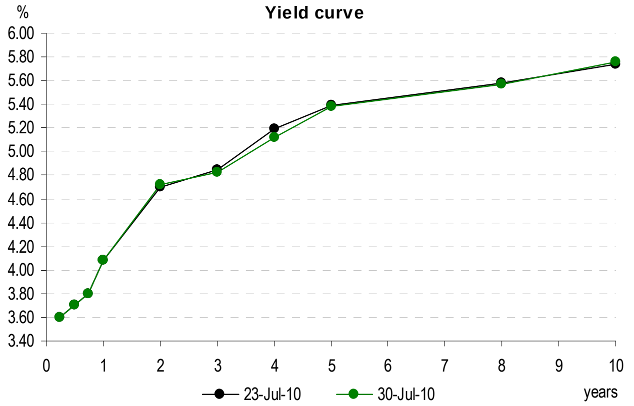
Market monitor



Surge of risk appetite supported the zloty

▪ The EURPLN plunged last week on optimistic reaction of the stress-tests results and positive data from the euro zone and the US. The exchange rate stopped at 4.0 – the last of levels of support mentioned last week. Then the stabilization occurred, even after the temporarily declines below 4.0 the zloty did not manage to regain the momentum. After the lower-than-expected data on US GDP in Q2 the EURPLN advanced to ca. 4.02.

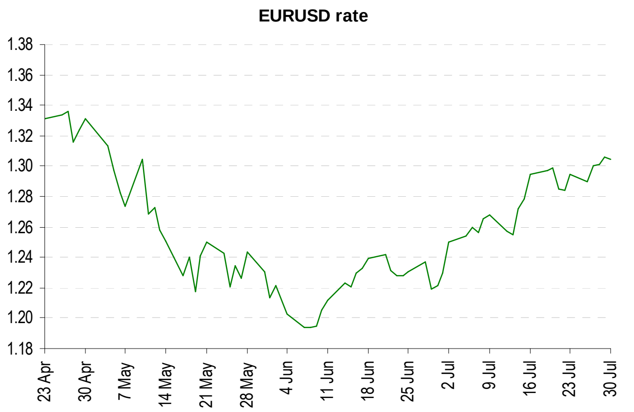
▪ The psychological level of supported at 4.0 still may play a vital role. We assume, that only a strong external impulse may pull the EURPLN out of the horizontal trend observed in the past week. Regarding the character of the impulse, the level of support at 3.94, the level of resistance at 4.05.



Yields prone to market sentiment and domestic issues

▪ During the first part of the week the yields declined on upbeat on the global market and higher risk appetite from abroad. Later on, the correctional move occurred and yields pared loses. After Friday's information of the long-term budget plan that sees PLN45bn deficit in 2011 (versus just below PLN40bn anticipated by the market) and following hawkish comments by the MPC members the declined further.

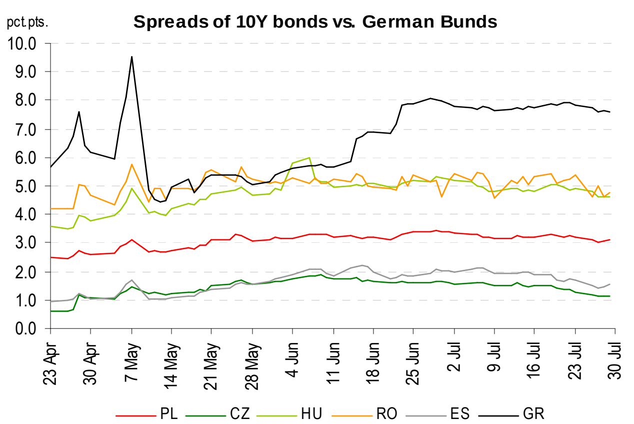
▪ This week we expect the stabilization with some slight tendency for yields' increase. The upward pressure will be the result of the "hawkish" comments by the MPC members and the Wednesday's bond auction. The case of the auction is that bonds of close tenors will be issued at the same time and that may be hard to digest.



Good data back the euro

▪ The overall positive opinion on the stress-tests results did not trigger euro's appreciation. However, optimistic data from the European debt market (Italy, Spain, Hungary, Portugal managed to sell their bonds on pretty good conditions) supported the common currency. The EURUSD stayed above 1.29 and was testing several times the resistance at 1.30.

▪ The EURUSD hovers somewhere around the level of support at 1.30 and the upward trend-line. The upward trend lost momentum during the past week. In the first part of the week we expect some stabilization. Later in the week some further euro's appreciation towards 1.32 is possible.



Good news from the European debt market

▪ The difficult situation in Hungary was dominated last week by positive results of bonds' auction conducted by some European countries (perceived by the market as peripheral). As the worries about their ability to manage short-term financial needs abated, the spreads versus 10Y Bunds declined and the CDS rates also showed some relief.

▪ Despite positive results of stress-tests the fiscal risk (especially for euro zone's peripheral countries) still remains the key risk for the markets. This would especially the case if they decided to cumulate financing of high borrowing needs in the short period to profit form positive markets moods.

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