Bank Zachodni WBK

Weekly economic update

18 – 24 October 2010

The zloty appreciated in the previous week, supported by positive sentiment in global markets and domestic CPI data, which boosted expectations of faster rate hikes in Poland. This week, we do not expect a permanent rise of EURPLN above 3.92, and the zloty should rather appreciate gradually towards 3.86.

This week's agenda is very busy in terms of information of vital importance for financial markets. Abroad, there are many important macroeconomic data releases, next Q3 financial reports of US companies, and the numerous speeches of US central bankers. Since Thursday, investors' attention will be also focused on the meeting of G20 finance ministers and central bankers, at which one of the main topics of discussion will be exchange rate policy and the issue of the Chinese currency undervaluation. In Poland, there will be publication of numerous economic indicators crucial for the future MPC decisions. We expect that on balance they will be fairly hawkish, although it is hard to say whether it will be enough to tip the balance of arguments in favour of a rate hike in October.

Economic calendar

Time CET	COUNTRY	INDICATOR	PERIOD		FORECAST		LAST VALUE
					MARKET	BZWBK	
		MONDAY (18 October)					
11:00	**PL**	**Tender of 52-week T-Bills worth PLN500-600m**					
14:00	**PL**	**Wages in enterprises sector**	**Sep**	**%YoY**	**4.0**	**4.2**	**4.2**
14:00	**PL**	**Employment in enterprises sector**	**Sep**	**%YoY**	**1.7**	**1.7**	**1.6**
15:15	US	Capacity utilization rate	Sep	%	74.8	-	74.7
15:15	US	Industrial production	Sep	%MoM	0.2	-	0.2
		TUESDAY (19 October)					
10:00	EZ	Current account balance	Aug	€ bn		-	-3.8
11:00	DE	ZEW index	Oct	pts.	-8.0	-	-4.3
14:00	**PL**	**PPI**	**Sep**	**%YoY**	**4.4**	**4.3**	**4.1**
14:00	**PL**	**Industrial production**	**Sep**	**%YoY**	**10.9**	**11.2**	**13.5**
14:30	US	Building permits	Sep	m	0.58	-	0.571
14:30	US	Housing starts	Sep	m	0.58	-	0.598
		WEDNESDAY (20 October)					
14:00	**PL**	**Core inflation**	**Sep**	**%YoY**	**1.2**	**1.2**	**1.2**
20:00	US	Fed's Beige Book					
		THURSDAY (21 October)					
9:58	EZ	Flash PMI – manufacturing	Oct	pts.	53.2	-	53.7
9:58	EZ	Flash PMI – services	Oct	pts.	53.7	-	54.1
11:00	**PL**	**Bond switching auction**	**-**	**-**	**-**	**-**	**-**
14:00	**PL**	**MPC minutes**	**-**	**-**	**-**	**-**	**-**
14:30	US	New jobless claims	w/e	k	455.0	-	462.0
16:00	EZ	Consumer sentiment	Oct	pts.		-	-11.2
16:00	US	Leading indicators	Sep	pts.	0.2	-	0.3
16:00	US	Philadelphia Fed index	Oct	pts.	1.0	-	-0.7
		FRIDAY (22 October)					
10:00	DE	Ifo index	Oct	pts.	106.5	-	106.8
14:00	**PL**	**CSO business climate**	**Oct**	**pts.**	**-**	**-**	**-**

Source: BZ WBK, Reuters, Parkiet

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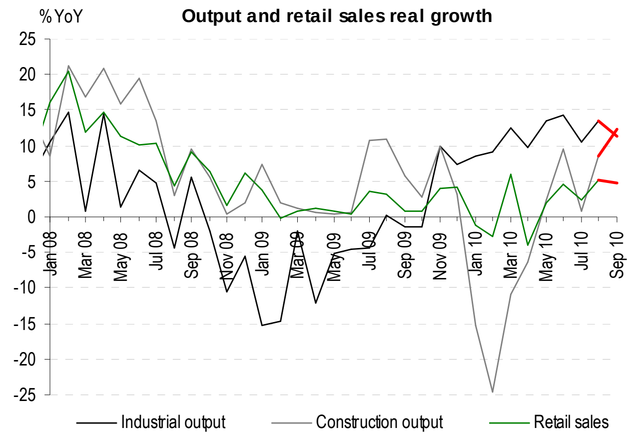
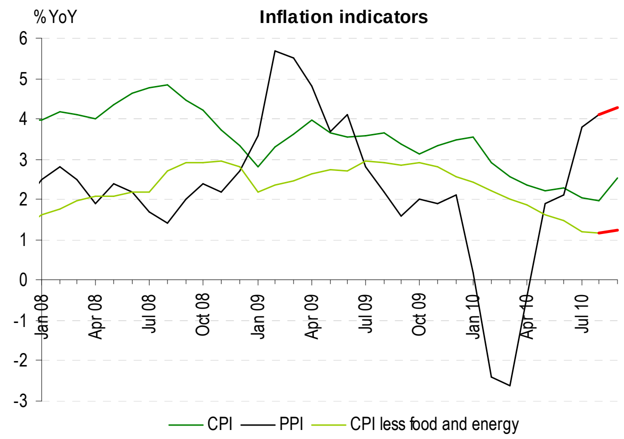
What's hot this week – Data, earnings reports, comments from Fed and G20

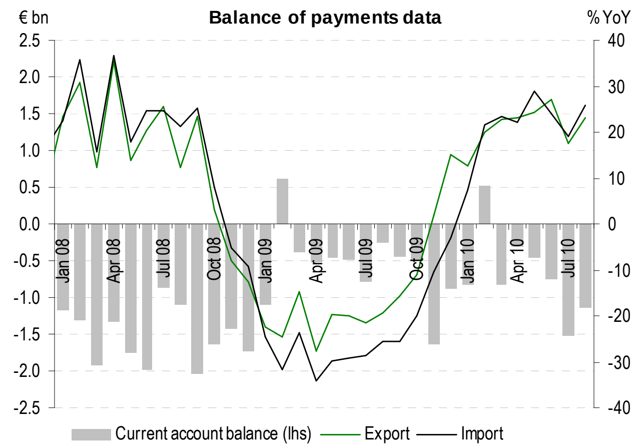


- This week will be full of important data locally and abroad. Domestic macro figures will be crucial for recently volatile market expectations regarding the timing of the first rate hike by the MPC. Our forecasts for key local data due this week (wages, industrial and construction output, PPI) are above consensus in come cases and below in other cases, but their overall tone should be hawkish, confirming continuation of economic expansion.
- As to events abroad there will be plenty of major macro figures (including the euro zone's flash PMIs for October and data from the US housing market), earnings reports, and numerous events at which Fed members are going to speak. Besides, markets will wait for meeting of G20 finance ministers and central bankers on October 21-23. This may be particularly important in the context of a pressure on China to revalue the yuan.

Economy last week – CPI inflation started upward trend



- Annual CPI inflation rose stronger than expected in September – to 2.5% from 2.0% in July and August. Our forecast, market consensus and FinMin's estimate were at 2.3% and the highest market forecast was 2.4%.
- The main reason for surprisingly strong rise in CPI inflation was much larger than we assumed increase in foodstuff prices (almost 2%MoM), probably as a delayed effect of unfavourable local weather conditions earlier this year and strong upward trend in food prices abroad.
- Based on actual CPI data we currently estimate that the core CPI excl. prices of food and energy reached 1.2%YoY in September, against our earlier forecast 1.1%.
- The start of upward trend in inflation is not a surprise (only the scale of the rise is) and we maintain view that CPI will keep mounting in the next months (up to ca. 3% at the end of 2010 and above 3% in early 2011).



- C/A gap in August was broadly in line with expectations reaching €1.1bn amid improvement in export growth to just over 23%YoY and import growth to nearly 26%YoY. Cumulative 12-month C/A gap after August widened to 2.8% of GDP from 2.5% after n July and 2.1% at the start of the year. The gap is still covered in much more than 100% by inflow of long-term capital (FDIs and EU funds).
- Rapid growth in trade volume reflects still important role of foreign trade in economic revival in Poland, but we predict that in the next quarters the net exports' contribution to GDP growth will be increasingly negative due to slower economic growth abroad and simultaneous revival in domestic demand.
- Monetary statistics for September showed slowdown in annual growth of M3 money supply and credit, but this was largely due to the FX effect (stronger zloty).

Quote of the week – Swift rate hike necessary or premature?

Andrzej Bratkowski, MPC member, Reuters, 13 Oct

This is a transitory factor, but it fuels inflation expectations. This strengthens my opinion about a need of a swift rate hike.

Elżbieta Chojna-Duch, MPC member, PAP, 13 Oct

The data [CPI for September] are an argument for a hike, but it is possible that it will not take place until the end of this year.

Andrzej Kaźmierczak, MPC member, Reuters, 13 Oct

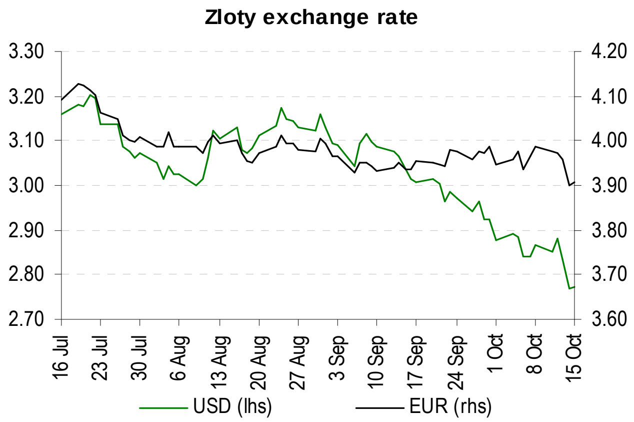
I would be cautious to draw a conclusions regarding significant monetary tightening, because it could be premature and it could be inadequate cure.

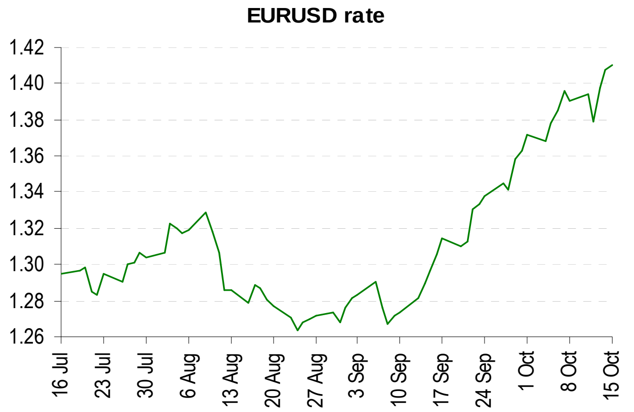
Anna Zielińska-Głębocka, MPC member, Reuters, 13 Oct

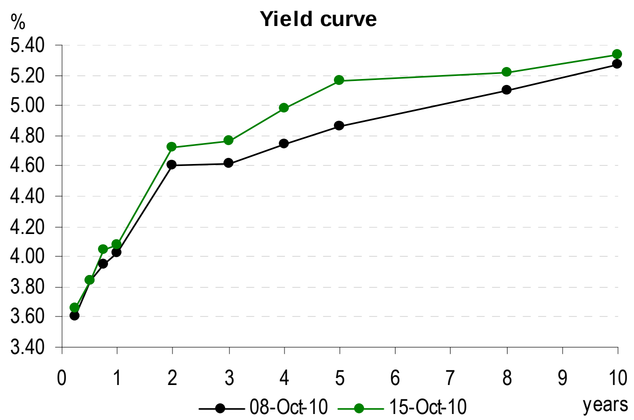
We are wondering what will be next, we wait for inflation projection. This [CPI rise in September] is a bit worrisome.

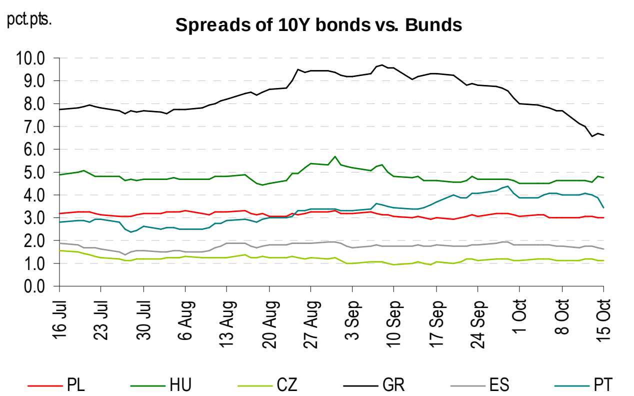
Surprisingly strong rise in CPI has not changed views in the MPC. Some rate-setters still see a necessity to hike rate swiftly. The others remain in wait-and-see approach. In our view, currently there is good moment for a pre-emptive rate hike (although rather not by 50bps). Clear rise in CPI inflation and continued economic recovery support such decision, despite uncertainty regarding global economy. However, the last MPC statement was dovish and suggested that a rate hike should be expected rather later than sooner. One has to wait for next macro figures for September to see whether they will tip the scale in favour of hawkish faction in the Council. We stick to our opinion that a rate hike in October would be possible in case of very strong macro data and clearly hawkish conclusions of the new projection (assuming that the Council would agree with it).

Market monitor









Clear strengthening of the zloty

- Already on Monday the EURPLN was testing the level 3.98, and just as we expected the try was unsuccessful. The zloty strengthened, and by the middle of the week the rate fluctuated in the range 3.95-3.97. CPI data released on Wednesday triggered a strong downward trend in EURPLN. The rise in market expectations for rate hike in Poland (and consequent widening of the interest rate disparity with the US and the euro zone) contributed to the increase in demand for the zloty. The EURPLN broke through important technical support of 3.92 and temporarily reached 3.89. At the end of the week there was some slight rebound of the earlier sharp drop. This week, we do not expect a permanent rise above 3.92, and the zloty should appreciate gradually towards 3.86, supported by quite hawkish domestic economic data.
- Beginning of last week was marked by a clear appreciation of the dollar, the EURUSD fell from 1.40 to 1.378. The following days have shown, however, that expectations related to Fed's further monetary expansion remain crucial factor for the EURUSD movements. Even before the publication of Fed minutes, the euro erased losses from the start of the week, and because the minutes suggested, in market assessment, soon continuation of quantitative monetary easing, the EURUSD reached the highest level since January. An additional, though less important support for the euro was better than expected industrial production in the euro area and successful auctions in Greece and Italy. Reaction to Bernanke's speech on Friday was limited. We think that dollar may gain in expectation for details of Fed actions. Key levels for this week are the support at 1.365 and resistance at 1.42.

Domestic yields up due to higher inflation

- The start of the last week on the Polish debt market was quiet as investors awaited Wednesday's inflation data and the auction of 5-year bonds. Demand for government securities at the auction was relatively weak, which resulted in higher yields in the middle and long end of the curve. After the surprisingly high data on CPI, yields surged mostly at the short and of the curve, while at the long end the reaction was limited. The biggest part of the upward move in yields that occurred last week, took place on Wednesday, while in remaining days the dominant trend was stabilization.
- In the past week, yields in the core debt markets have increased significantly. This time, expectation for the Fed's return on the debt market did not cause an increase in demand for safe assets. On the contrary, a clear improvement in global market sentiment caused higher risk appetite and investors preferred to buy stocks or higher yielding bonds of the euro area peripheral countries. Such situation was reflected in reduced demand for German and US bonds at auctions last week.
- In the bond markets of peripheral euro area countries the biggest gain over the past week took place in case of Greek securities. Their spread versus German Bunds fell by almost 100pb. The largest weakening hit bonds in Hungary, where the government, aiming to cut budget deficit to 3% of GDP in 2011, proposed to introduce new taxes in sectors such as energy, telecommunications, which according to investors can stifle economic growth.

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