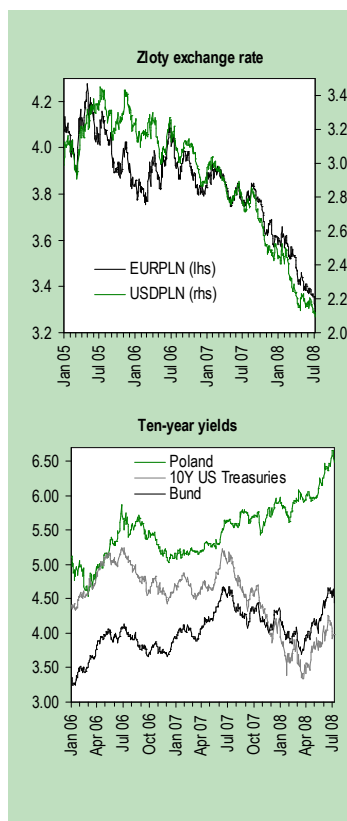


# MACROscope

## Polish Economy and Financial Markets

July 2008



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## Hot start off for July

▪ **Though Poland has enjoyed summer weather already since mid-June, the foreign exchange market witnessed real heat in the first days of July.** In five business days, starting from 3 July, PLN strengthened against EUR by almost PLN 0.10, i.e. by ca. 3%. The scale of appreciation against USD was similar. In spite of the fact that last month we wrote that the market may want to drive the EURPLN rate down to lowest level ever, the scale and pace of zloty appreciation was beyond our expectations. We still see some potential for the FX market correction and even though our EURPLN rate projection for July was overstated, at the end of the year it may not have to be far away from the expected by us level of 3.30. The rapid PLN strengthening at the beginning of July was accompanied by lower yields, as this was interpreted by some market participants as a factor potentially limiting the interest rate hikes. A question arises: will the core markets fear of global inflation again?

▪ **After a two-month break in the monetary policy tightening, in June the Monetary Policy Council increased the interest rates by 25 bp and in our opinion there is a risk of subsequent hikes.** Interestingly, the Council's statement missed the sentence referring to an informal restrictive bias in monetary policy. We have the impression that the communication wording deliberately leaves some room either for subsequent increases (if necessary) or for the termination of the hikes cycle with the June hike. In other words, the Council does not want to give today any indication of its approach but remains vigilant and ready to act. Nevertheless, we believe that the risk of further increases in the reference rate up to 6.25-6.50% is still in place. It may happen in September (publication on inflation data for August – it will be at ca. 5%) or/and October (another inflation projection).

▪ **Cooling down of the business climate seems to be gradual and quite soft.** Nevertheless, the recent macroeconomic data, primarily in business climate indices, indicate that the upward trend is weakening steadily which confirms our projections on reduced GDP growth dynamics in the next months of the year. However, if the growth slows down slightly below 5%, it should not prevent the Council from taking a decision on another hike as the inflation rate will remain at a higher level over some time.

▪ **Recently, growing inflation has become one of the key problems seen by the global economy, fuelled by substantially higher food prices.** The global increase in prices driven, primarily, by higher prices of agriculture products had even gained itself a special name – *agflation*. This month we are taking a closer look at the issue, analysing the reasons behind the global increase in food prices and presenting a couple of analyses and hypothesis on related prospects.

Financial market on 30 June 2008:					
NBP deposit rate	4.50	WIBOR 3M	6.48	USDPLN	2.1824
NBP reference rate	6.00	Yield on 2-year T-bonds	6.47	EURPLN	3.3788
NBP lombard rate	7.50	Yield on 5-year T-bonds	6.38	EURUSD	1.5482

This report is based on information available until 09.07.2008

## Special focus

### Agflation – is the worst over, or rather still to come?

Over the past few months, growing inflation became the biggest issue of the worldwide economy. Goods and service prices soared both in emerging and developed markets, with inflation rates growing much above the levels considered acceptable by central banks. This was driven by a record-high growth in the prices of fuel and energy as well as food and agriculture product prices. A new definition was coined to describe this phenomenon: **agflation** (*agriculture + inflation*).

Growing food prices are a sensitive subject because this problem affects virtually everyone. In some of the developing countries, the food price surge caused violent protests and riots. Elsewhere, it “only” hit the headlines, became a source of higher inflation pressure and a significant factor affecting restrictiveness of monetary policy. The scale of its impact placed agflation in the focus of attention of governments, central banks and economists.

This month, we are going to analyse the root causes of agflation and present some comments on the current situation as well as possible development trends.

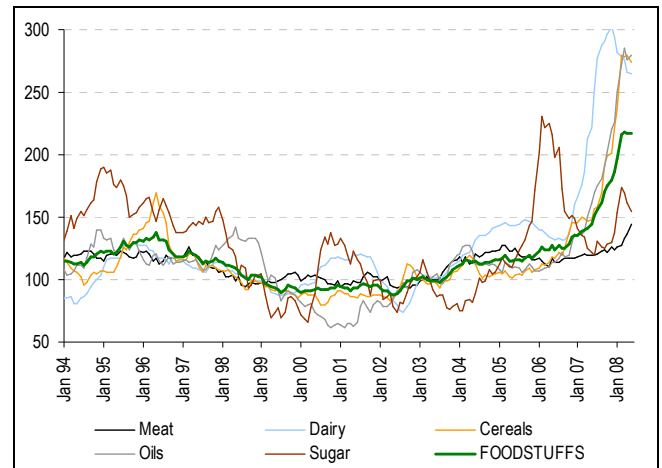
#### Agflation – a global phenomenon

Large price movements are nothing unusual on the agricultural market. However, the current situation does differ from the previous periods in several aspects. Firstly, price growth periods are usually shorter than the decline periods. Meanwhile, currently we have seen food prices grow for the second season in a row. Secondly, the present rate of growth is much higher than anytime over the past couple of decades. Thirdly, the all-time-high growth of prices is not limited to selected markets and products – rather, it affects virtually all basic products on all agricultural markets worldwide.<sup>1</sup>

The prices of agricultural commodities soared in the years 2006-2007. As this growth trend continued into early 2008, food prices reached the highest level in almost 50 years. The index of global average food prices calculated by the *Food and Agriculture Organization of the United Nations* (FAO) was more than 50% higher in May 2008 compared to the same period last year. The highest growth was observed in cereals and oil products, where the index soared by 90-

100%YoY. A similar growth was observed a little bit earlier with respect to dairy products, but after the correction over the past few months the growth rate reached “only” 20%YoY. Meat prices increased more slowly for a long time, but lately the growth rate has exceeded 20%YoY.

#### Main agricultural commodities – USD prices on the global market (1998-2000=100)

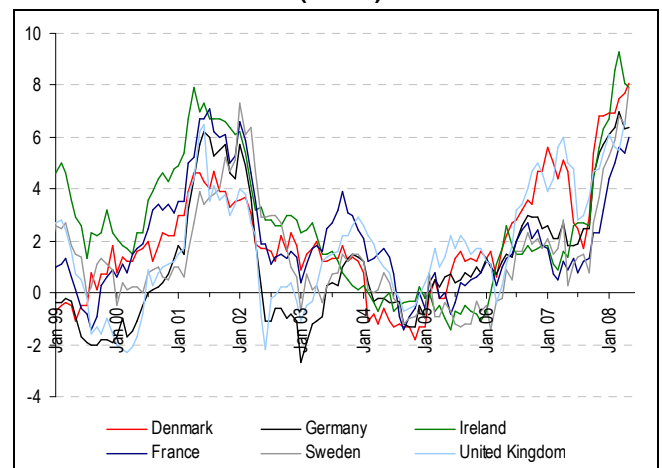


Source: FAO

Please note that FAO indices refer to food prices denominated in USD and therefore are slightly overstated due to the very strong depreciation of this currency on worldwide markets. Of course, those countries whose currency grew stronger against USD have been less affected by changing food prices.

However, the food price growth has become an urgent problem in nearly all countries. Developing countries with low per capita income were the most heavily affected, particularly those that are net food importers. Nevertheless, even in the developed EU countries with a strong currency, rapid food price growth became one of the major inflation drivers (although with a smaller impact than in poorer states).

#### Food and non-alcoholic beverage prices in selected EU countries (%YoY)



Source: Eurostat

<sup>1</sup> FAO, *Soaring Food Prices: Facts, Perspectives, Impacts and Actions Required*, June 2008

## Why is food getting more expensive?

The sustainable growth trend observed over the past few years is quite easy to explain if we analyse the figures with respect to changes in demand and supply on agricultural markets. It might be more difficult to answer a question why the growth was so rapid in the past two years and to predict how sustainable this trend is.

We have many reasons to believe that this unprecedented surge in food prices worldwide has been driven by accumulation of several factors which boosted the growth of demand and at the same time contributed to the limitation of supply and increase in costs of production and transport. Effects of those developments were additionally reinforced by some special factors and unexpected shocks. Here are the most important developments which have led to the present situation.

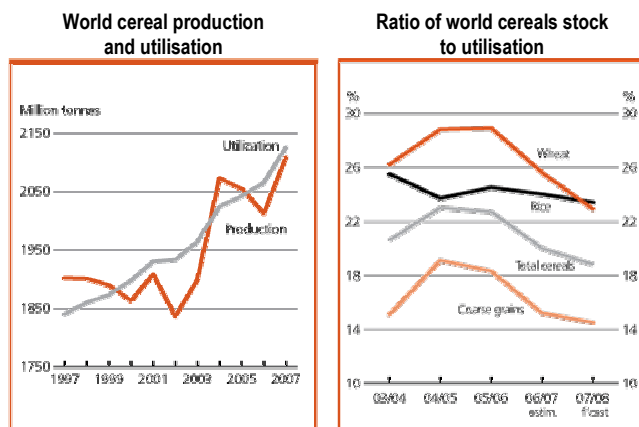
### Weather-related production losses

One of the major causes of the soaring food prices was a considerable decline in production of cereals in the years 2005-2006. Following a very good year of 2004, the harvest in the two major global grain exporters (Australia and Canada) declined by ca. one-fifth in two subsequent years due to unfavorable weather conditions. The global production picked up in 2007, but not enough to meet the growing demand (among other things, due to other weather anomalies).

### Decline in food reserves

The other key driver was a drop in the world level of food stock (primarily the cereals) to record-lows. This was attributable, among others, to government actions resulting from international agreements which factored in the development of the international trade and progress in the exchange of information and transport technology. On the other hand, it was strengthened by the fact that food production was lagging behind the growing demand.

## Global production, consumption and stock of cereals



Source: FAO

With a number of food exporters affected by the negative supply shock, the reduced volume of global food reserves contributed to sharper price movements in response to production problems.

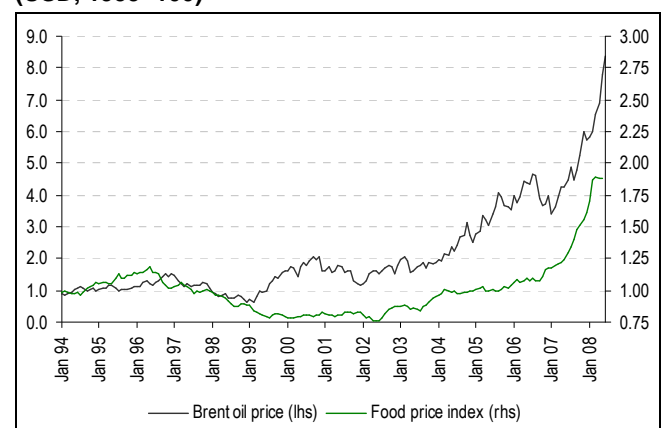
### Protectionism, trade barriers

Protectionist initiatives undertaken by governments in response to the food price growth were yet another important factor which influenced the global market. "Precautionary" export bans or taxes imposed by some important food producers in order to protect domestic consumers have led to further instability in the market. As a result, even the markets which did not experience a major slump in production (e.g. the rice market) have been affected. Some analysts call it the "snowball effect": rising prices of certain agricultural products have led some of the food producers to limit their own exports. As a result, the major food importers quickly increased food purchase volumes as protection against further price increase and food deficit. This in turn has caused a further growth of prices and affected other markets one by one.

### Growth of fuel and energy prices and transport costs

There is no doubt that the unprecedented growth of fuel and energy prices worldwide has had a very strong impact on food prices. Expensive oil and natural gas translate directly into the higher cost of production, fertilization and transport of agricultural products. For instance, some fertilizers cost 2.5-times more in early 2008 than in early 2007. Freight charges increased more than twice over the year.

## Movements in food prices and crude oil prices (USD, 1999=100)



Source: FAO, Reuters, BZ WBK

Apart from the direct effect, all-time-high oil prices had also an indirect, yet significant influence on the food market. Namely, expensive oil makes the biofuel business more profitable (see below).

### Biofuel production

Over the past few years, the global agricultural market has been much influenced by the development of the biofuel market. This sector indicates a very high growth rate – the global ethanol production volume tripled and the bio-diesel production increased more than 10 times in the period from 2000 to 2007 (starting from a very low level, though). Production of “green” fuels has triggered a very strong growth in the demand for agricultural commodities. According to the available figures, more than 50% of the increased global demand for cereals and vegetable oils in 2005-2007 was driven by the growth of production and use of biofuels. Without doubt, this factor played an important role in the sharp growth of cereals and vegetable product prices over the past few seasons.

Additionally, subsidised biofuel production “crowds out” the edible plants from the market as their production becomes relatively less profitable. The area earmarked for growing edible plants is thus reduced and the supply declines. In turn, high demand for commodities for biofuel production increases the consumption and prices of fertilizers, which in turn boosts the food production costs in general.

### Higher consumption and changing diets

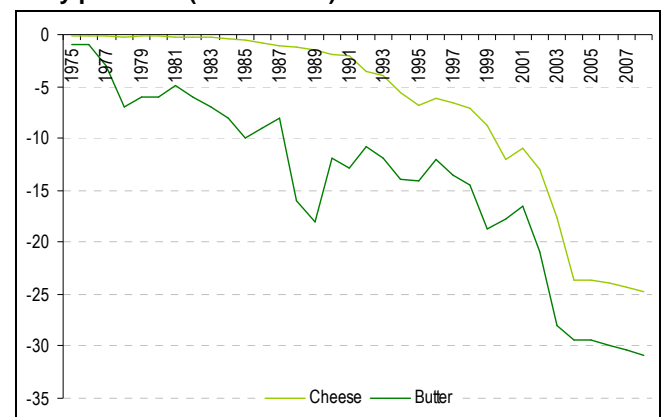
The rising consumption, often named as an important cause of price growth worldwide, results from the global population growth and a strong increase of income per capita, especially in the developing countries. It should be noted, however, that increasing food consumption resulting from the population growth is not a new phenomenon – it has been observed over the centuries but has not caused any significant (or sustainable) food price spikes until now. To the contrary, relative prices of food were on the decline for a long time, one of the reasons being that the food production kept ahead of the growing demand thanks to rising productivity.

But the past few years saw much more vital changes in food consumption than the volume growth only. In the developing countries, rapid improvement of living standards and rising incomes (in the period of economic boom) have led not only to increase in food consumption but also to significant changes in diets. This process was largely driven by socio-economic changes taking place in countries such as China and India, leading to pronounced changes in the eating habits and a growing demand for better-quality food (i.e. more diversified and rich in animal proteins, as well as dairy products.) More sophisticated diet results in the increased demand for crops (ca. 16 kg. of plant fodder

is required to produce 1 kg of meat) and stronger interdependencies between the prices of various agricultural commodities.

However, experts have different opinions on how this process has contributed to the rise of food prices on the global market. Firstly, this factor operates in the medium-term perspective and on a gradual basis. It is rather unlikely that it caused the sharp upward spike in prices over the past two years. Moreover, China has been self-sufficient in terms of the production of basic agricultural products so far. But as much as the meat consumption growth could have been counterbalanced by an adequate boost of domestic production, their dairy product supplies had to come primarily from imports.

### **China: foreign trade balance for selected dairy products (in '000 tons)**



Source: OECD

### Speculative demand

The last driving factor to be mentioned here is the noticeable increase of the role of agricultural commodities as a speculative instrument on financial markets. In the recent period, investors have become much interested in financial products quoted on the agricultural market. With the stock market very unstable, investment funds have been looking for alternative opportunities to grow capital and diversify risk – hence the growing popularity of derivatives based on food prices. The debate as to whether this is one of the underlying causes for recent food price surges does remain open (for instance, the IMF research<sup>2</sup> suggests quite the opposite relation in terms of cause and effect, i.e. the rising food prices have triggered the inflow of speculative capital into forward markets, rather than vice versa.) It seems likely, though, that this has been one of the vital factors to increase the price volatility and amplify the impact of the fundamental imbalance between the demand and supply on movements in market prices.

<sup>2</sup> IMF, *World Economic Outlook 2006*, Chapter 5: "The boom in commodity prices: Can it last?"

The table below shows the factors which have impact on global food prices, divided by their nature (however, in some cases a distinction whether the factor is of short- or rather long-term nature was very difficult).

#### Food price drivers

	Short term	Long-term
<b>Demand</b>	speculative transactions	strong growth of demand for commodities needed for biofuel production (cereals, oilseeds, vegetable oils) and increased demand for fertilizers  strong growth of population and income per capita  change in diets triggered by per-capita income growth in developing countries
<b>Supply</b>	weather anomalies experienced by the leading global producers of food  protectionist actions undertaken by certain countries (tariffs, export bans)	oil and electricity prices, which have impact on food production and transport costs
<b>Other</b>	a sharp reduction of food reserves worldwide  depreciation of the US dollar	low food reserves worldwide  concentration of the food export market (there are only a few leading exporters)

#### What comes next? ...

Whether (and how long) the food prices will continue to grow is vital for governments, central banks and ordinary citizens who see their portfolios shrinking with each increase. In order to answer this question, we must assess the demand and supply trends in a longer term as well as determine which of the above-identified factors will continue to shape the agricultural market (for how long and to what extent.)

#### The supply will increase, but so will the demand

Current projections of the agricultural product supply in this season are fairly optimistic<sup>3</sup>. The global production of cereals is expected to increase, in particular as regards wheat. Oilseeds harvests were rather poor in the past season, but a considerable improvement in the year to come is expected. A further increase in plant production is expected thereafter, based on the increase of areas earmarked for growing crops (high prices being the incentive) and improved productivity. Projections also provide for the growth in the global meat and dairy

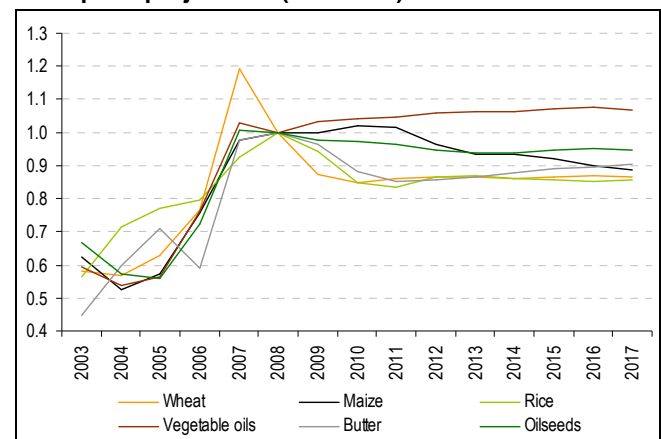
production, even though high prices of fodder will curb the supply.

However, this optimistic picture is tainted by the expected, continued strong growth of the cumulative demand for most of food products. The cereals and oilseeds market will probably be shaped by the increase in production and use of biofuels (although it is possible that the leading biofuel producers will adopt a different approach and reduce the subsidies, which might cause the demand to fall on this account) Animal production, on the other hand, will be driven by the growing consumption in developing countries. The experts are thus of the opinion that there is only a slight chance to have the record-low food reserves replenished in the short-term perspective. This process will take at least a couple of years, during which the market will remain sensitive to demand and supply shocks. Low level of food reserves will also prevent a slump in food prices for most of the products.

#### Projections assume that the prices will stabilise

The annual OECD and FAO report on the agricultural market development prospects<sup>4</sup> (published in June) states that after the spike observed in early 2008, food prices should remain stable in the upcoming years at a level close to the current record-highs, much above the average from the previous years. This is with exception of some products (wheat, dairy products), where the prices are expected to fall by ca. 20% in the subsequent periods, and to remain stable thereafter.

#### Food price projections (2008=100)



Source: OECD, FAO

On the one hand, this means that consumers should accept relative food price changes and high grocery bills as something normal because there is very little chance to go back where we were (pricewise) a couple of years ago. This, coupled with high prices of fuels, can be one of the factors to curb the consumer demand in many

<sup>3</sup> FAO, *Food Outlook*, June 2008; *Crop Prospects and Food Situation*, April 2008

<sup>4</sup> OECD-FAO *Agricultural Outlook 2008-2017*, June 2008

developing countries (at least in the short-term perspective). In developed countries, where the food price growth is not so rapid (among other things, due to a relatively high share of highly-processed food in the overall consumption structure) this effect will be much weaker. On the other hand, stabilisation of prices means that the annual growth rate should slow down considerably, so that the impact of food prices on the global inflation will also weaken.

#### ... and so did the previous forecasts

Long-term OECD and FAO projections confirm what one would suspect – the record-high spike of food prices will not go on forever. After all, some of the factors responsible for the accumulation of recent disturbances on the food market were temporary and ultimately should disappear. In the long-term perspective, we have reasons to believe that the development of technology and progress in animal farming and crops growing methods (especially in the developing countries) will lead to a rapid improvement of productivity so as to meet the ever-growing demand for food and agricultural products (even though the new land for growing crops becomes less available). Nevertheless, financial markets and central banks are also very keen to know the short-term development prospects, i.e. how quickly the prices will stabilise. It should be highlighted that the last-year report by OECD and FAO projected a similar scenario for price stabilisation – the difference was, the process was expected to start earlier and at a much lower level. Instead, prices have soared to all-time highs.

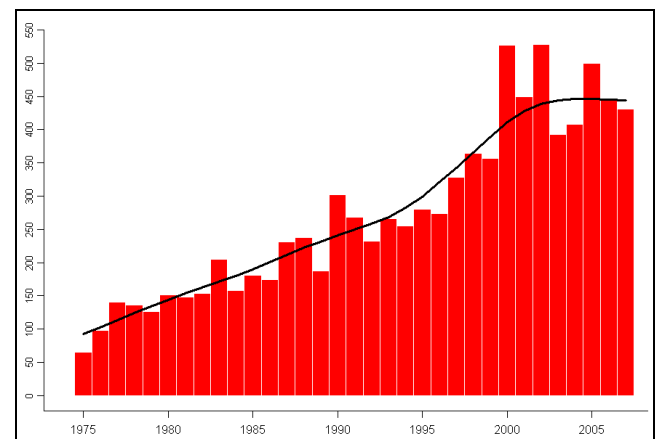
#### Weather, oil and USD as the main risk factors

Unfortunately, we cannot rule out that this happens again, so that we might see further instability before the market “calms down”. One of the signs is the situation on the oil market (the key risk factor for the projections, according to the OECD-FAO report) where the prices surged to more than \$140 per barrel over the past few weeks, against the projected growth from \$90 in 2008 to \$104 in 2017. USD exchange rate movements are also vital because the dollar’s depreciation triggers the rise of food prices on the global market (same as the oil). The OECD report assumes the USD exchange versus other currencies more than 10% stronger than currently.

Another instability factor is weather and its impact on harvests. The OECD report does not take account of any weather anomalies whatsoever, nor does it factor in any related supply shocks over the entire projection timeline. However, this approach ignores what weather reports

say, i.e. that natural catastrophes are on the rise.<sup>5</sup> Weather anomalies have been occurring more often than before and are more pronounced, whereby the risk of considerable losses in production has actually become a regular feature in the agricultural market landscape. The same scenario takes place virtually in each season: favorable harvest projections from early months of the year must be adjusted downwards owing to unexpected weather anomalies. This year, we witnessed several catastrophes (including frost and earthquakes in China, a cyclone in Myanmar, floods in the U.S.) as well. Even though the current projections still indicate the growth in the global production of crops year-on-year, some countries (e.g. Poland) have already adjusted their harvest projections much downwards. In the upcoming months we will see what the future has in store for consumers.

#### **The number of recorded natural disasters**



Source: OFDA/CRED International Disaster Database

As much as the global food price growth is very likely to slow down in the mid-term perspective, it is very hard to pinpoint the date when we can expect this to happen. We could see it the second half of the year, but it might as well take another season (or two) of continued growth.

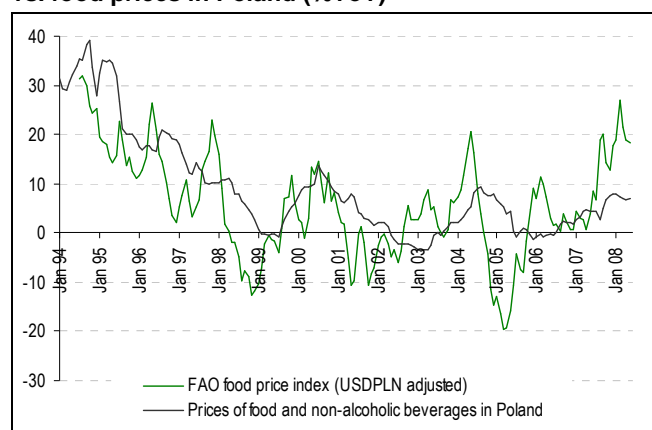
In the long-term perspective, the change dynamics on the food market will also depend on a number of other factors whose impact we cannot predict at this moment. Will the global warming effect continue, as many experts say, or are we going to enter into a period of colder weather, as shown by some recent surveys? How will it influence the agricultural output? Will the energy prices continue to soar? Whether and how will governmental policies be amended with respect to biofuel or GMO production? All these questions can have a decisive impact on the food price growth in the coming years.

<sup>5</sup> CRED, *Annual Disaster Statistical Review. The Numbers and Trends 2007*, May 2008

## Agflation and Poland

Poland is relatively vulnerable to the food price driven inflation because grocery bills represent a large portion of household expenses – much more than in most of the developed countries (over 25% against the EU average of ca.15%). Domestic food prices largely depend on the condition of the global market, but if we analyse the domestic prices against the global prices (with the PLN exchange rate movements taken into account), it seems that this relationship has weakened recently. This is partly attributable to the increase of highly-processed food in the consumption structure, which makes domestic food prices dependent more on indirect costs of production (energy, labor), storage and transport, rather than on the price of agricultural commodities. Another reason might be relatively high crop harvest in 2007, contrary to the global output. The second conclusion from the graph is relative protection of food prices in Poland against falls in world prices.

### Global prices of agricultural products vs. food prices in Poland (%YoY)

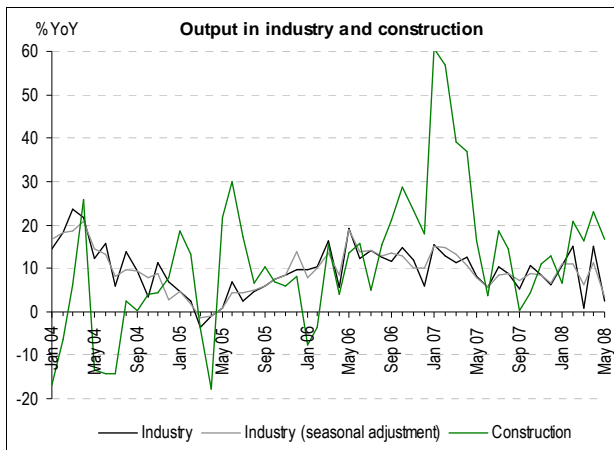


Source: FAO, BZ WBK

Domestic harvest projections for this year indicate a sustainable downward trend because much of the country is affected by draught. The most recent estimates show a drop in production by ca.19-26% against the previous year. At the same time, meat production has been on the decline as the farmers reduce the number of animals due to the rising prices of fodder. The experts assume that these changes will have a limited impact on the prices for the time being, because the grain can be imported from other European countries with favorable harvest projections. But if the price-stabilisation scenarios do not come into effect (note the strong growth in forward contracts for cereals throughout June), the limited domestic supply might translate even stronger into food prices.

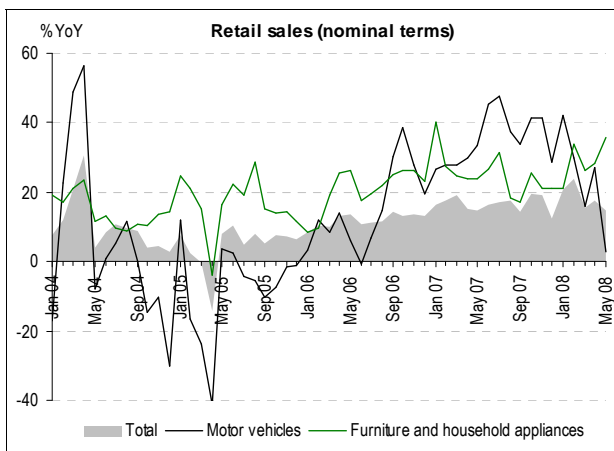
In this context, a question arises how much can growth in food prices slow down this year and in 2009. The NBP inflation projection assumes that in 2009 food prices will rise by only 1.6%, while our forecast predicts ca. twice as fast increase, which is still a considerable slowdown from 6-7% growth in food prices experienced this year. Nevertheless, there are other elements (e.g. zloty exchange rate) that make us more optimistic than the NBP in assessment of inflation prospects in the next year.

## Economic update



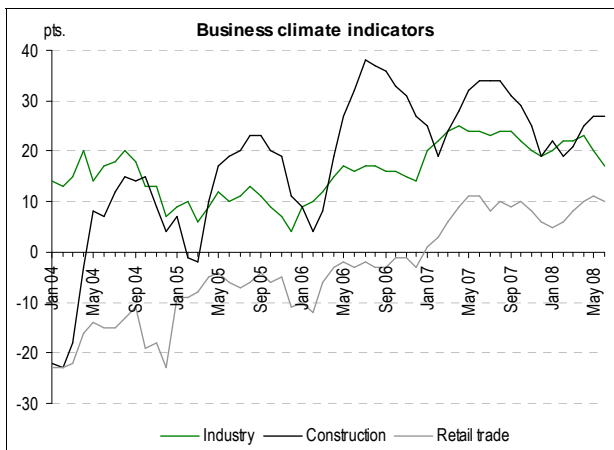
### Industrial output below forecasts

- Industrial output growth in May reached 2.3%YoY, much below market expectations. This resulted to a large extent from the number of hours worked, so one should not treat it as an indication of rapid economic slowdown. Differences in the number of working days will occur until October.
- In seasonally adjusted terms, industrial output rose 3.4%YoY, which is the lowest result in 3 years, however it was very volatile in the last several months. Still, there is clear weakening of the upward tendency, which confirms our predictions of slower GDP growth in the remainder of this year.
- Construction output growth in May reached 16.6%YoY (in seasonally adjusted terms 15.2%YoY) and despite the lower number of working days showed that so far investment activity has been strong.



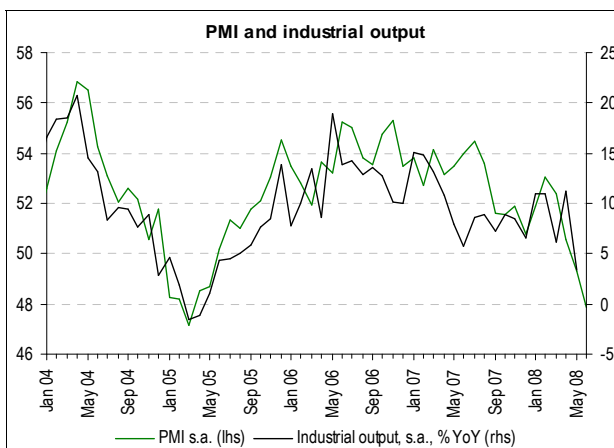
### Solid rise in retail sales continued

- Nominal growth in sales was 14.9%YoY. The result means a deceleration as compared to previous months, but one should remember that growth rate of sales in May this year was negatively affected by two long weekends (one long weekend a year ago) and the new law which forces shops to be closed during holidays (4 such days in May this year). Strong, double-digit nominal rise in retail sales was noticed in all categories except for motor vehicles.
- Real growth in sales was 11.2%YoY, which means that sales deflator (an indicator of inflationary pressure in retail trade) reached 3.7%YoY against 3.6%YoY in April.
- All in all, the retail sales data for May suggest that consumption demand remains strong and its source is improvement in labour market and reduction in fiscal burden.



### Business climate indicators down again

- Although business climate indicators for manufacturing, construction and retail trade calculated by the stats office remained in the positive territory in June (indicating optimistic assessment of the business climate), this was the first time since early 2002 that indicators for all the three analysed sectors fell in annual terms at the same time in one month.
- In June, there was also strengthening of earlier observed tendency of deterioration in consumer confidence. There was a significant fall in both the current situation and expectations indices. Both of them were the lowest since April 2007. In case of the expectations indicator, a fall in the annual terms (eliminating influence of seasonal factors) started already in May, but it was deepened in June. The current situation indicator fell in annual terms for the first time in the history of monthly data of the consumer confidence survey conducted by the CSO.

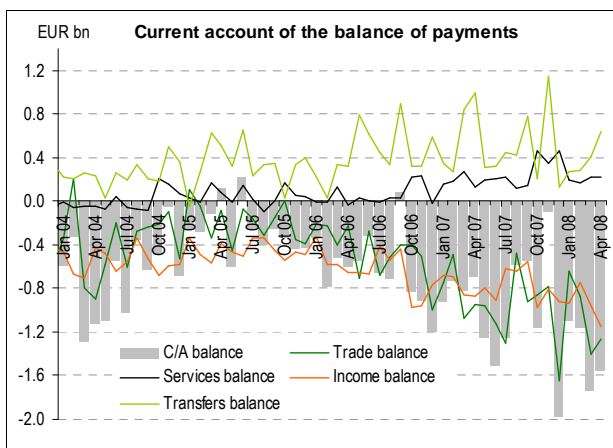
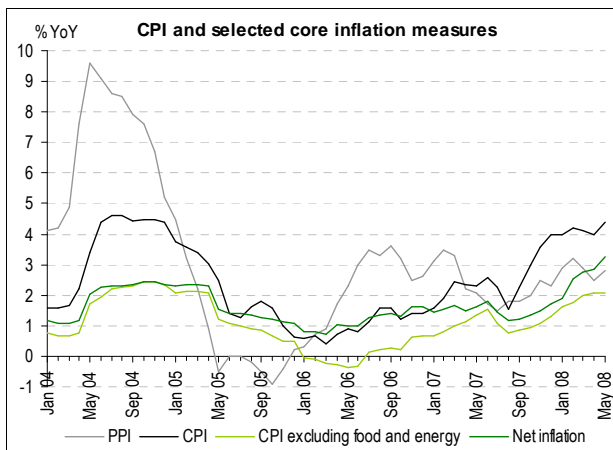
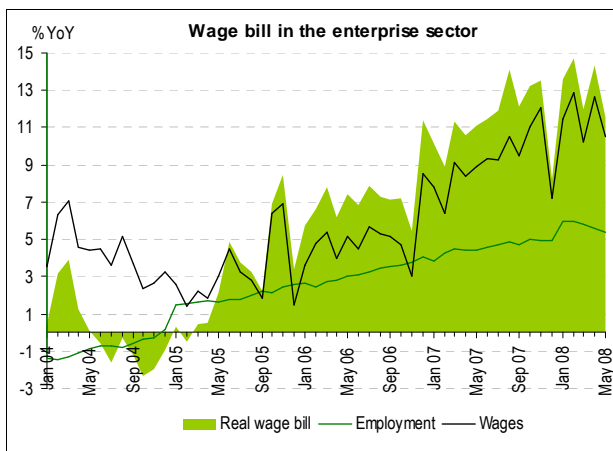
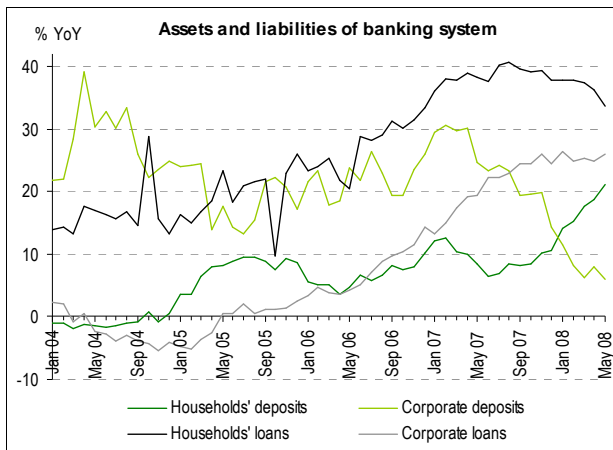


- There was deterioration in all sub-indicators calculated by the stats office except for expected changes in unemployment. The most significant worsening was observed in assessment of households' financial situation and the country's overall economic situation. What is important, there was also deterioration in assessment of households' ability to make major purchases, although it was at high level in the past months.
- Another negative signal as regards economic activity in Poland in months to come is PMI manufacturing for June. It dropped to 47.9pts from 49.3pts in May, for the second straight month remaining below the level of 50pts, which indicates contraction in economic activity. The fall in overall PMI was influenced to a large extent by deteriorated assessment of situation in exports. PMI index of exports orders dropped to 43.2pts in June from 46.9pts in May, the strongest in almost 7 years.

Source: CSO, own calculations



## Economic update



Source: CSO, NBP, own calculations

### Adjustment in households' assets boosts money growth

- Money supply increased 15%YoY in May. Annual rise in deposits accelerated to 17.4% from 16.4% in April, mostly due to strong rise in households deposits (21.2%). The downward tendency in money supply and deposits growth rates seen in 2007 has been reversed this year due to a portfolio adjustment, i.e. a change in the structure of households financial assets (increase in share of bank deposits at expense of more risky assets).
- Annual growth rate of total loans decelerated to 27.5% from 28.4% in April, although this has not applied to corporate borrowing which increased 26%YoY (one of the highest growth rate in 9 years), which suggests that investment activity remains strong. Increase in households borrowing lowered again, to 33.8%YoY, the lowest level in 18 months.

### Weaker improvement in labour market conditions

- Wages and employment in enterprises sector were lower than expected in May, increasing 10.5%YoY and 5.4%YoY, correspondingly. Wage bill in the sector increased 16.4%YoY in nominal terms and 11.5% in real terms, which was the slowest increase since December 2007.
- At the end of May the registered unemployment rate reached 10% and according to tentative estimated of the labour ministry it reached 9.6% at the end of June. This means annual reduction of 2.9pp and 2.7pp, respectively. Although pace of the unemployment reduction has been gradually decelerating, it is still fast, positively influencing households' situation.
- Our predictions of further slowdown in pace of unemployment reduction suggest that labour market tensions should weaken, which would be positive for the inflation outlook.

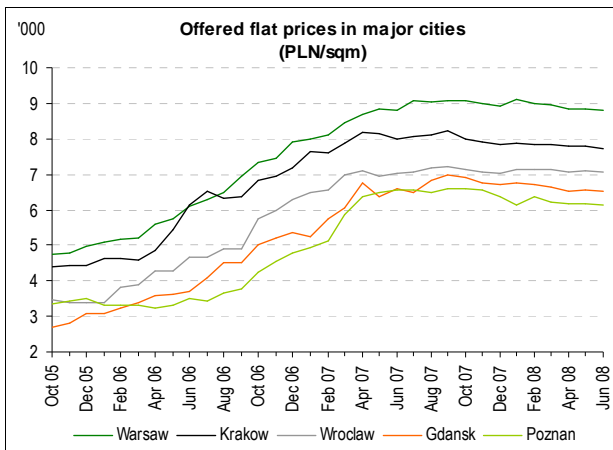
### Almost all inflation indicators up

- May saw increase in almost all inflation indicators. CPI inflation accelerated to 4.4%YoY from 4%YoY in April with increase in food and fuel prices of 7%YoY.
- Net inflation increased to 3.2%YoY from 2.8% in April. There was also increase in other measures of core inflation except for the new one calculated by the NBP, i.e. CPI excluding food and energy prices (with fuel prices as an element of energy prices), which remained at 2.06%YoY.
- PPI inflation accelerated to 2.8%YoY in May, mainly due to hikes in energy and natural gas prices. If the energy prices rise further, this may feed through into other goods and services, although so far producers have not indicated willingness of large price increases (producer prices in manufacturing grew a mere 1.6%YoY in May).

### Gradual widening of external imbalance continues

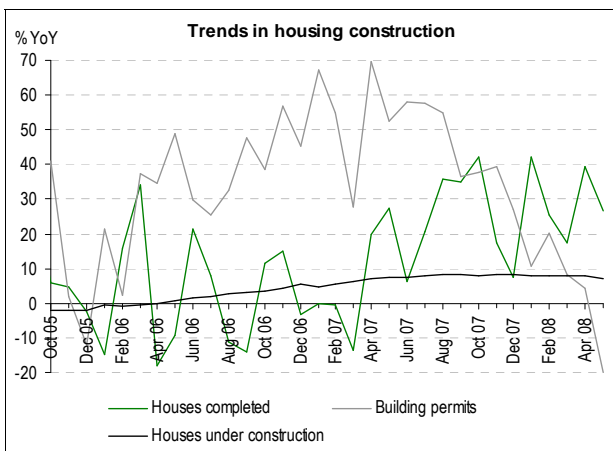
- The balance of payments data for April showed wider than expected current account deficit (over €1.5bn) and its cumulated value for the last 12 months rose to 4.7% GDP from 4.3% after March.
- Nevertheless, taking into account large inflow of foreign direct investments and EU funds on investments, widening current account gap is still safely financed and does not pose a significant threat to external stability of the Polish economy.
- The exports and imports growth rates remained at high level, reaching 31.1%YoY and 31.3%YoY, respectively. Although this shows that so far exports have been able to cope with the zloty's appreciation and economic slowdown abroad, we maintain of forecasts assuming weakening of Poland's exports growth in the second half of this year.

## Housing market update



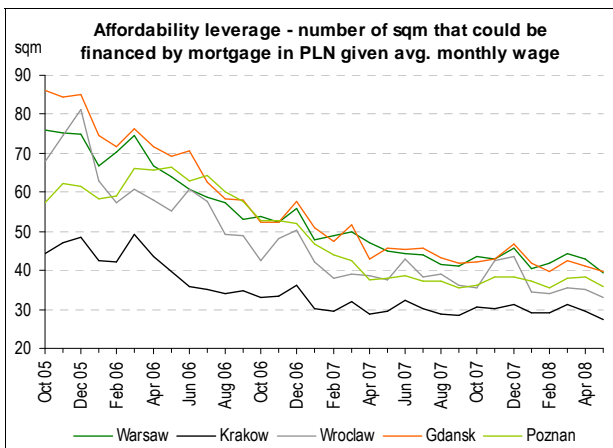
### Prices of houses and land slowly going down

- Second quarter saw a slight decline in house prices in Poland's biggest cities. According to report by szybko.pl and Expander, average prices went down by 1-2% in this period. At the same time, in some locations (primarily, smaller cities), prices went up in the same period.
- Average prices of building plots declined in Q2, even though in the past there was usually a seasonal spike in demand and prices of land in the spring.
- There is increasing number of signals about weakening households' demand and growing developers' problems with selling new investments. On the other hand, Q2 saw a shortening of response to internet advertisements at szybko.pl which suggested a revival in demand. We maintain opinion that the demand side structurally still dominates the supply.



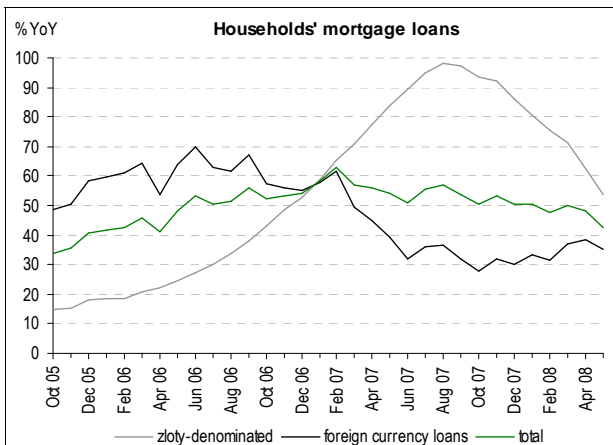
### Supply of new flats still rising

- In May, almost 11,000 new houses have been completed and in the last 12 months the number soared to 147,000. It is likely that this year house completions will clearly exceed 150,000, reaching the highest level since 1992.
- The number of building permits and house starts remained at high levels, although lower than last year when a boom in construction has just started.
- A ratio of houses for sale or for renting is constantly growing. In May they represented 45% of houses completed, which suggests that large part of this amount may soon enter the secondary market. In the short run, amid suppressed demand, it would continue pushing prices of houses and flats downwards.



### Loan costs growing faster than wages

- For a number of months, flats affordability, defined as the relation of average wages to average house prices, has been rising. In 12 months time, the number of square meters that could be purchased for average annual pay, has increased by 9% in Warsaw, 15% in Kraków and 17% in Poznań.
- At the same time, a rise in interest rates is quick enough to result in reduction of loan-leveraged flats affordability (in case of loans in PLN). In May, it was ca. 13%YoY down in Warsaw, Gdańsk and Wrocław, 7% lower in Kraków and 5% in Poznań.
- The so-called "S" regulation of banking supervision implies that a rise in PLN interest rates is automatically causing a reduction in affordability of foreign currency loans, even though costs of the latter have remained hardly changed recently.



### Foreign currency loans gaining importance

- Mortgage loans resume a fairly rapid rate of growth (in May 41.5%YoY), although signs of deceleration are visible.
- Significant rise in local interest rates and related costs of debt servicing, as well as clear trend of zloty appreciation encourage more and more clients to seek loans in foreign currencies, primarily in Swiss franc. In May, difference in interest rates between PLN and CHF denominated mortgage loans exceeded 3 bp.
- Increase in foreign currency households' debt reported in May almost tripled a corresponding rise in zloty-denominated loans (and if we take into account impact of zloty appreciation on lowering PLN value of foreign currency loans, the disproportion was even bigger).

Source: CSO, NBP, szybko.pl, own calculations

## Central bank watch

### Inflation projections (%)

	Apr '07	Jul '07	Oct '07	Jul '08	Jun '08
2008	1.6-3.8	2.1-3.8	2.2-3.5	3.6-4.7	3.8-4.7
2009	2.1-4.6	2.1-4.3	2.5-4.6	2.6-4.9	2.5-5.8
2010	-	-	-	2.1-4.8	0.1-5.7

### GDP growth projections (%)

	Apr '07	Jul '07	Oct '07	Jul '08	Jun '08
2008	4.0-6.3	4.3-6.7	4.4-6.2	4.4-5.8	4.3-5.5
2009	4.0-7.0	4.0-7.2	3.8-6.7	3.5-6.1	3.4-6.2
2010	-	-	-	3.6-6.9	3.8-6.8

Note: there is a 50% probability that the annual growth of GDP and inflation will be within the indicated ranges.

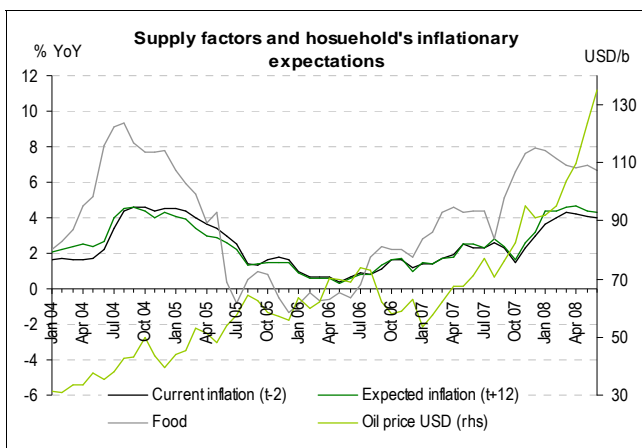
### Important fragments of the MPC statement in June (indication of changes as compared to May statement)

The Polish economy is still in the period of strong growth encompassing all its sectors. However, data released recently indicate that economic growth has continued at a high level, though it may slow down somewhat in the next quarters – **gradually slowing down, which is consistent with previous expectations.**

The latest information on the US economy ~~confirms earlier signals of a substantial economic slowdown in this country~~ **signal that the slowdown of activity in this economy may be less deep than previously expected, though it may last longer.** Uncertainty also persists as to the scale of the deceleration of euro-area economic growth and of its impact on the Polish economy. **At the same time, many countries have recorded a rise in both the current and the forecast inflation.**

In the Council's assessment it is quite probable that the wage pressure and, consequently, inflationary pressure will persist **despite the expected slowdown in the economic growth.** Increased inflation in the months to come will, to a large extent, result from the growth of administered prices and also from the food and fuel price growth observed in the world economy and affecting the Polish market **Persistently increased inflation** This creates a risk of inflation expectations remaining at an elevated level and, consequently, feeds the risk of the so-called second-round effects. Moreover, the rise in prices of energy and food may be gradually passing through to other prices, particularly to prices of some services.

In the medium term inflationary pressure may be curbed by still good financial results of enterprises and **continuously** high investment growth conducive to productivity growth. Inflationary pressure may also be constrained by the slowdown in the global economy and, consequently, also in the Polish economy. The inflationary pressure may additionally be eased by globalisation, **though its overall impact will probably be weaker than before.** The previous increases of the NBP's interest rates and the zloty appreciation observed over the past few quarters **will** also be conducive to lowering inflation.



Źródło: NBP, Reuters

### Is this the end? Rather not

- After two-months break in tightening cycle, the MPC decided to hike rates again by 25 bp in June. Probably, the new inflation projection was helpful in taking such a decision – despite three hikes delivered this year and zloty appreciation, CPI inflation in 2009 is expected to be higher as compared to the February's projection (lower for 2010). Will there be more hikes and when they should be expected?

- The question is so important, as the MPC dropped the sentence in the communiqué, which indicated informal restrictive bias in monetary policy. In our opinion, the risk of further hikes to 6.25-6.50% is still relatively high. We think that likely months for next rate hikes are September (following CPI inflation peak at ca. 5% in August and GDP data release for Q2) or/and October (when the next inflation projection is published).

### A lot of changes in the MPC communiqué

- In the last two months, with no rate hikes, new elements appeared in the MPC statements. In April, a phrase on the zloty appreciation and global economic slowdown with possible impact on the Polish economy was included. In May, the MPC wrote about possible risk of a pass through of high food and energy prices into other prices, especially prices of some services. This time around the statement is constructed in a different way than earlier.

- The most striking change in the June statement is dropping an informal restrictive bias, which had been included in the official statements for many months. It is hard to tell whether this change was intentional or accidental, as MPC members present at the press conference did not refer clearly to that when asked about it. If the MPC actually wanted to change the informal restrictive bias to neutral one, it would be good to communicate it clearly to the market and general public. We have an impression that the document is written in a way so that it could be consistent with possible further hikes (if they prove necessary) or with an end in the tightening cycle at 6%. In other words, the Council does not want to indicate a bias, but is vigilant and ready to act.

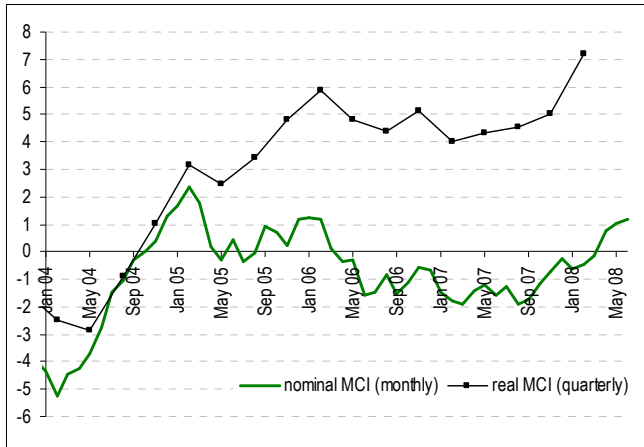
- Comments of MPC members (see the next page for details) Confirmed such interpretation. In the previous months it seemed possible that the MPC might end the tightening cycle with the reference rate at the level of 6%, though we have been mentioning the asymmetric upside risk to this scenario. Despite the fact that phrase indicating the informal restrictive bias was dropped from the statement, we think that the MPC may deliver more tightening in order to limit inflationary expectations. Intensifying inflation risks globally and changes in expectations on main central bank's policy may support this view.

### Inflation expectations at high level

- Inflation expected by households within next 12 months fell in June to 4.3% from 4.4% in May. This was mainly driven by the decrease in current inflation indicator (CPI lagged by two months), which is used by the NBP, as a base to calculate expectations measure. The answers breakdown for May was not so optimistic.

- The percentage of people expecting faster than currently increase in price have fallen (to 28% from above 32% in January-April period). However, above 50% of polled households expect that prices within a year will rise as fast as currently. The sum of answers to the two questions is close to 80%. Though this proportion of the people is slightly lower than in the pre-accession period, it is very high. This is probably the result of fast rise in prices of food, fuel and energy.

## Restrictiveness of the Monetary Policy (Council)



### Real MCI sharply up due to appreciation in the REER

- According to our calculations, Q1 saw significant rise in the real MCI index, indicating considerable increase in monetary policy restrictiveness at that time.
- What is interesting, this happened despite Q1 saw a fall in short-term market interest rates in real terms. The difference between actual level of short-term real market rates in Q1 and their long-term trend estimated by us did not change, so their impact on the real MCI was neutral.
- According to the Eurostat, there was noticeable appreciation of the real effective exchange rate (REER) of the zloty in Q1. Deviation between average REER in Q1 and its long-term trend substantially widened, leading to rise in the real MCI.
- Besides, in June there was another increase in nominal MCI, driven both by higher rates and lower EURPLN.

7.0%



Filar 1.50 (1.61)

Noga 1.50 (1.52)

Wasilewska-Trenkner 1.50 (1.48)

Wojtyna 1.31 (0.91)

6.5%

Sławiński 1.06 (0.91)

Czekaj 1.00 (0.86)

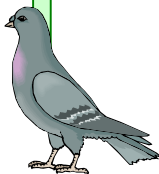
Skrzypek 0.81 (N/A)

Owsiak 0.81 (0.91)

Nieckarz 0.81 (0.83)

6.0%

Pietrewicz 0.75 (0.74)



Index is between 0 and 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. Average of points for all votes is the value of the index for a given MPC member.

Numbers directly by the name are values of the index for period since the beginning of Sławomir Skrzypek's term as NBP governor and numbers in parentheses are values of the index for 2004-2006.

Direction of the arrow reflects our expectations regarding direction of interest rate changes within the nearest 12 months. Values in percent indicate our subjective assumption as regards a preferred level of the reference rate in 12 months by a particular MPC member.

### In Q1 hawks proposed hikes by 50 bp each month

The voting results of the Monetary Policy Council, which were published in the *Inflation Report* in June, showed that during the meetings in January-March period, each month a motion to hike interest rates by 50 bp was proposed. As one could have expected, they were supported by three members of the Council, ranked in our restrictiveness ranking as the most hawkish. In this period the majority of the Council accepted three hikes by 25 bp.

### ... but they have recently started expressing a bit different opinions

What is interesting the group of hawkish members within the Council was not so unanimous presenting view on monetary policy prospects in recent interviews. The most hawkish MPC member Dariusz Filar thinks that further interest rate hikes are still possible this and next year. What is more, he was not convinced that any break in tightening cycle will take place (or how long this may be). In Marian Noga's opinion, one cannot hike rates suddenly and the next hike may take place in October if inflation does not start falling after August peak. However, NBP president, considered as a dove, said that rate hike before October cannot be ruled out if it's necessary. All in all, recent comments from MPC members do not change our view on monetary policy prospects. We still think that at the end of this year the reference rate may reach 6.25-6.5%. Likely months for further rate hikes will be September (after Q2 GDP data and August inflation at ca. 5%) and/or October (next inflation projection).

### Czekaj suggested holiday break in tightening

The view that the next interest rate hike is not likely to take place within the next months was confirmed by Jan Czekaj during the press conference after the MPC meeting. He said that prospects of monetary policy will depend on the scale of economic slowdown in Poland as well as on decisions of major central banks, with a significant change regarding their policy actions, which have taken recently. However, it is worth to notice that expectations regarding official rate in the euro zone have changed again after the ECB meeting, which was accompanied by dovish comments of the President.

### More dovish members did not exclude possibility of hikes

A possible continuation of tightening cycle, depending on upcoming data releases and situation in the foreign exchange market, is visible in comments of virtually all members of the Council. The NBP President, considered by the market as a dove, said that rate hike before October cannot be ruled out if it is necessary. Even Mirosław Pietrewicz, the most radical dove taking into account our ranking of restrictiveness, did not exclude a possibility of hike.

### Conflict between NBP and MF or between MPC and MF?

In recent weeks we saw a serious exchange of opinions between the central bank and the Ministry of Finance (see next page for more details). MPC members did not take a position on this issue, excluding Halina Wasilewska-Trenkner, who mentioned possible negative consequences if the debate becomes political issue.

## Government and politics

### Comments by NBP and finance minister on inflation

**Jacek Rostowski, finance minister:** NBP President, Sławomir Skrzypek, unfortunately played an important role in voting leading to delaying rate hikes. (...) He voted 9 times against a rate hikes, in which four times his vote was decisive. (...) Then he hiked rates to the higher level than it would be necessary in the case of earlier reaction. Higher inflation and the level of interest rates are the costs of the delay. (...) In Poland the effect of inflation increase not connected with higher energy and food prices, is much bigger than in the UE. This is the result of central bank's policy.

**NBP statement:** This comment [of finance minister] is an attempt to divert attention from a complete lack of government's activity as regards public finance reform, which was announced many times. No government's activity in terms of structural reforms threaten Poland's position within the European Union.

**Sławomir Skrzypek, NBP President:** As the President of the central bank I appeal to the government to cooperate. (...) Combating inflation requires cooperation of both institutions in policy mix i.e. harmonisation of monetary and fiscal policy – one cannot shift the responsibility to another. As MPC Chairman I have step against unfair and unreliable attacks on the NBP. (...) Polish economy does not need conflicts, but institutional cooperation of NBP and government

### Finance minister's comment on euro zone entry prospects

**Reuters, 8 July:** Today we have the situation, in which Slovakia ... is joining the euro zone after a significant currency appreciation so we can suspect that a well-prepared country like Poland may be subject to strong speculation towards appreciation on the currency market. This may create problems, so we will analyse this case (Slovakia), ponder what is the best way to prevent this.

**PAP, 18 June:** According to constitutional lawyers, we will most likely need a change in the Constitution before the euro zone entry. Everybody knows what are political conditions today, as this is simple arithmetic. Such a change would have to be accepted by at least part of the main opposition party. As for today I assume that change in the Constitution is required. If this is the case, this would not be a good idea to join the ERM2 before these legal changes. The order should be as followed: to reach the consensus as regards the euro adoption, change in the Constitution, decision to join the ERM2. In my opinion, we should join the euro zone as soon as possible, given that we are credible regarding meeting all necessary criteria. Therefore, we have start the discussion concerning necessary legal changes.

### Conflict between NBP and finance ministry

- During the debate on motion of confidence against finance minister, he presented arguments in his defence. While the opposition accused him of high prices, he replied that this was the fault of the central bank, as interest rate hikes were delayed.
- In reaction to these comments, the NBP blamed the government for the lack of structural and public finance reforms.
- The conflict between chiefs of two institutions placed in Warsaw across the Świętokrzyska street, is certainly not conducive to built the reputations of both institutions. Especially, as mutual accusations are not necessarily justified. NBP has no influence on global inflation pressure connected with high food and energy prices, while core inflation measure excluding this factors is below the target. On the other hand, government may say that the President of the country may veto pro-reform bills.

### Finance minister about the path to euro zone

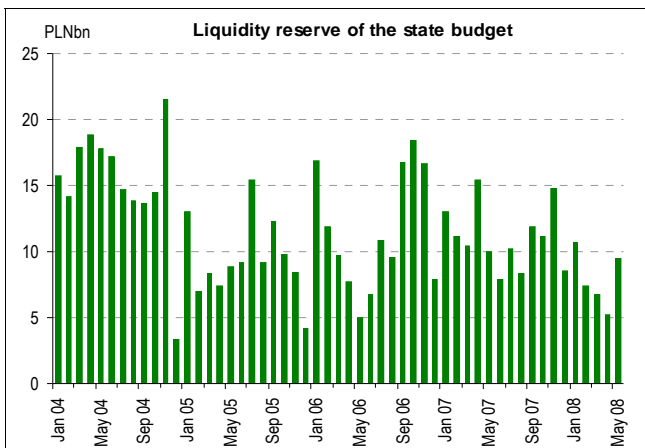
- At the beginning of July the final approval of Slovakia entry to the euro zone was announced and the conversion rate was set at the same level as the last parity in the ERM2. This was the occasion for Polish finance minister to say that Polish zloty may face appreciation pressure within ERM2 as well.
- His comments showed also that entry to the ERM2 mechanism should take place if all necessary legal changes in the Polish Constitution are accepted. Otherwise, there would be high risk of being in the ERM2 too long, if no political consensus is built. In our opinion, such an interpretation would lower probability of entering to ERM2 until the end of this parliament's tenure (2011).
- On the other hand, if changes in the Constitution were accepted, appreciation pressure on the zloty could reinforce.

### Central budget performance still good

- Information regarding current situation in the central budget are still quite optimistic. Although the ministry of finance indicates sometimes lower than planned realisation of excise tax revenues, but other revenues are roughly in line with the plan (VAT) or better than assumed (PIT, CIT).
- After May budget deficit amounted to PLN1.85bn against PLN12bn showed in the preliminary plan of realisation. According to ministry's estimates the deficit rose to PLN3.5bn in June, although it could have been even lower if not a part of revenues worth PLN2bn, which was delayed.
- After a several months of decrease, the liquidity reserve of the state budget rose quite substantially in May. This increases flexibility of the ministry in offering treasury papers in the environment of high yields.

### Assumptions for budget 2009 approved

- On 10<sup>th</sup> June the government accepted budgetary assumption for the next year, which are consistent with the convergence programme approved earlier. We maintain our opinion about this document (see May's edition of MACROscope). It seems that GDP growth of 5% may be too optimistic forecast and it was recently confirmed by finance minister, who said that risk is asymmetric to the downside. On the other hand, the forecasted average CPI inflation (2.9%) is too low and higher result will positively affect budgetary revenues.
- On 11<sup>th</sup> July ECOFIN confirmed lifting the excessive deficit procedure against Poland. However, at the same time the Commission called Poland to reform public finance sector and lower budget deficit even more given high economic growth. Commission sees also risk for budget in 2009 and following years.

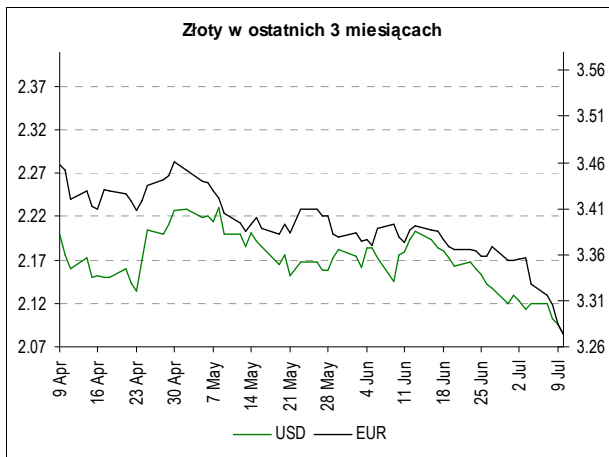


### Central budget revenues, spending and deficit (PLNbn)

	2008	2009	YoY change
Overall revenues of central budget	281.89	310.52	10.2%
Tax and non-tax revenues (i.e. excluding revenues connected with EU transfers)	246.61	268.90	9.0%
Overall spending of central budget	308.98	328.7	6.4%
Central budget result	-27.1	-18.2	-

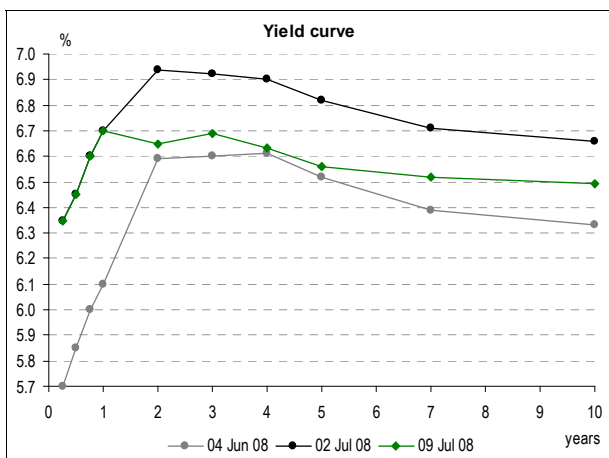
Source: Ministry of Finance, PAP, Reuters, own calculations

## Market monitor



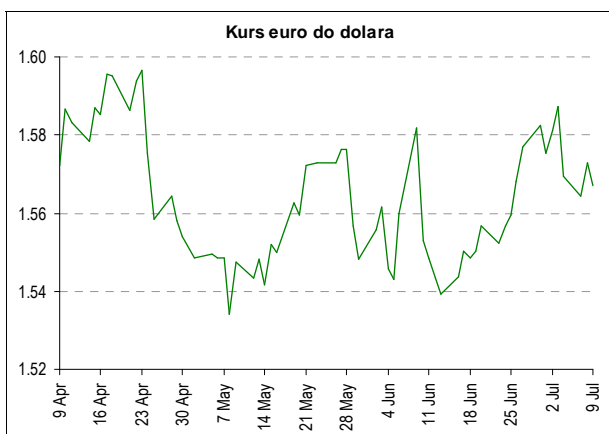
### Sharp zloty appreciation, EURPLN below 3,30

- In June the zloty exchange rate was quite stable within narrow trading range of 3.35-3.40. Though last month we wrote that the zloty might test record-high (ca. 3.34), the scale of strengthening was for majority of market participants. The scale of appreciation against the euro and the dollar was similar – USDPLN below 2.08, EURPLN below 3.27. What is interesting, the beginning of the quarter again shows higher demand for the Polish currency. Will the next wave of appreciation come in October? Well, this will be probably supported by another rate hike.
- We still see a possibility of correction on the foreign exchange market and though our EURPLN forecast for July proved to be too high, the year-end will not necessarily show the rate much lower than our prediction of 3.30.



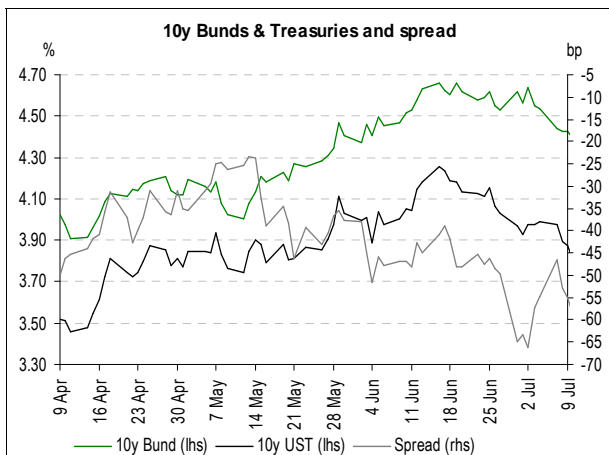
### High volatility on the Polish bond market

- In the previous report we wrote about negative moods in the fixed income market and indeed the most of the last month was rather bearish for bonds. However, in line with expectations rise in yields was limited and treated as an opportunity to buy Polish papers. This was the case in reaction to data from the Polish labour market and low industrial production in Germany. While the reaction to the MPC meeting, or rather to comments by MPC members, was slightly bullish, the ECB meeting influenced the market even more. While expecting rate hike by the ECB, high yields globally drove the Polish curve, but the dovish comment after the meeting stopped the negative sentiment.
- Fall in yields at the start of July accompanied zloty strengthening, as this might have been interpreted as the factor limiting scope for interest rate hikes. However, the remaining question is whether the core bond market will not play global inflation risk again.



### EURUSD – volatile market but within narrow range

- Last month we expected the dollar to weaken towards 1.57 against the euro and this scenario materialized just within a couple of days. In the remainder of June, the greenback recovered (even to below 1.54), among others due to comments of Fed representatives and referendum results in Ireland. Another wave of rising trend for EURUSD came after the publication of economic data and the tendency even strengthened in reaction to relatively dovish statement released by Fed and due to expectations for ECB meeting (rate at ca. 1.59).
- First days of July brought another fall in EURUSD rate as a result of dovish comment of the ECB President after the rate hike and better-than-expected data from the US labour market. We expect ERUUSD to maintain in the above-mentioned trading range with a tendency to fall to 1.55 towards the year-end.

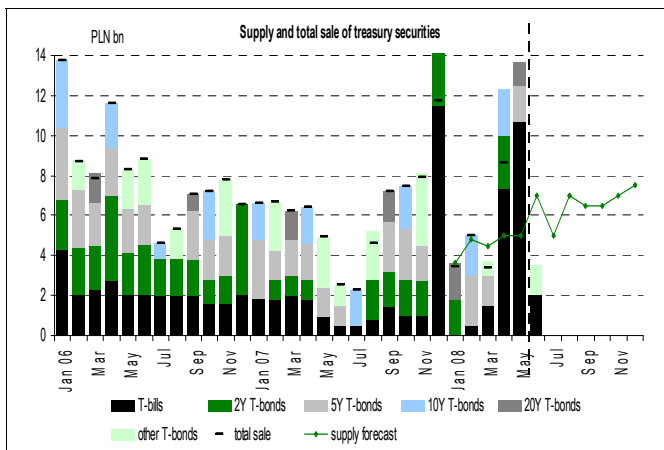
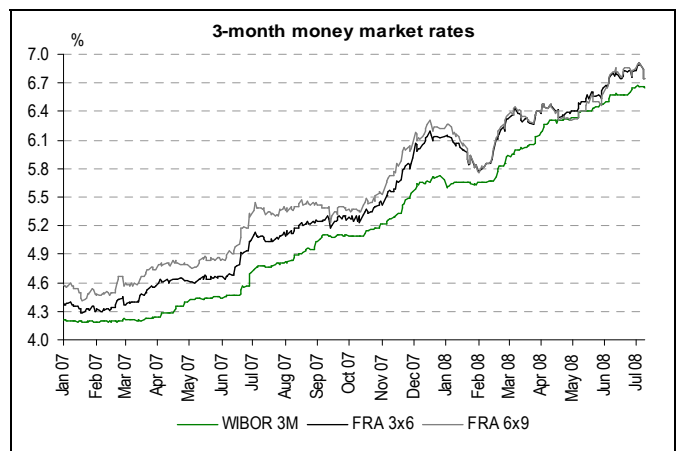
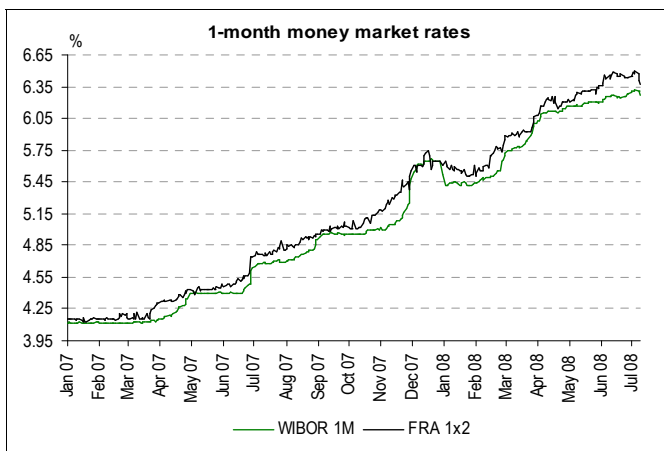
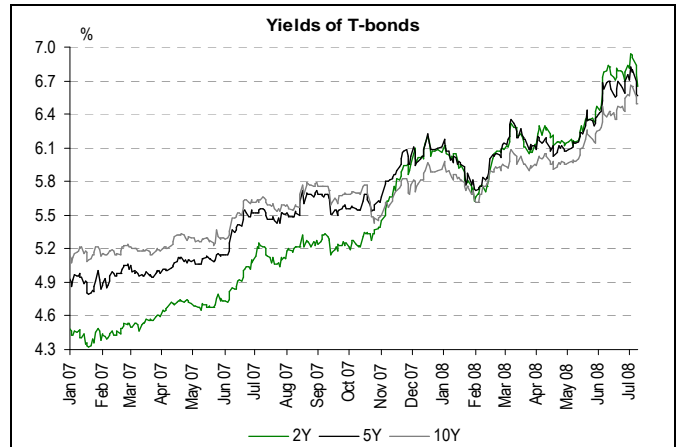


### Yields still high in core markets

- Last week quite substantial movements in core bond markets were observed, depending on economic data releases and central bankers' comments. Overall, yields of ten-year Treasuries and Bunds at the moment of preparing this report were roughly the same as a month ago – at the level of 3.90% and 4.40, respectively.
- Comments of ECB President confirmed that rate hike in July was rather a one-off signal. What is more, with the economy likely to have weakened considerably over the course of 2008, we could well see the ECB cut interest rates in 2009, provided inflationary pressures abate. Though the market still sees a possibility of hike by Fed, our scenario assumes flat official rates in the US this year. While in the near term bond markets may be under influence of global inflationary pressure, we expect fall in yields until year-end.

Source: Reuters, BZ WBK

# Market monitor



**Treasury bill auctions (PLN m)**

Date of auction	(OFFER)*/SALE					
	52W	26W	13W	5W	3W	2D
14.01.2008	2000	-	-	-	-	-
11.02.2008	500	-	-	-	-	-
10.03.2008	1417	-	-	737	-	-
10.04.2008	-	-	-	-	-	2837
14.04.2008	3134	1005	573	-	-	-
05.05.2008	2787	-	-	-	2007	-
26.05.2008	3000/3275	1500/964	1500/1167	-	-	-
02.06.2008	1500/1496	-	500/810	-	-	-
09.06.2008	1400/1320	-	1400/1577	-	-	-
16.06.2008	1400/1443	-	1400/1449	-	-	-
07.07.2008	1200/965	-	500/709	-	-	-
14.07.2008	-	-	-	-	-	-
21.07.2008	-	-	-	-	-	-

\* based on data of the Ministry of Finance

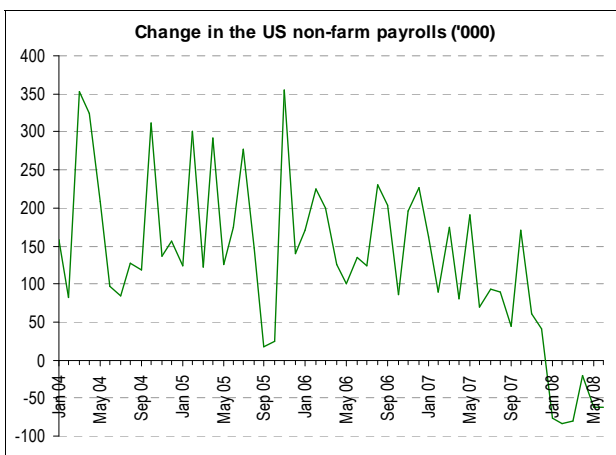
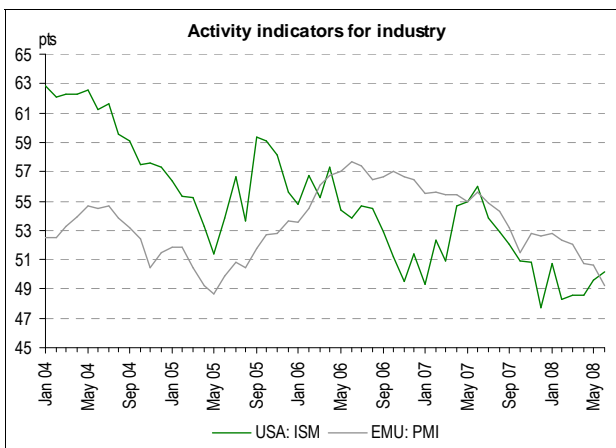
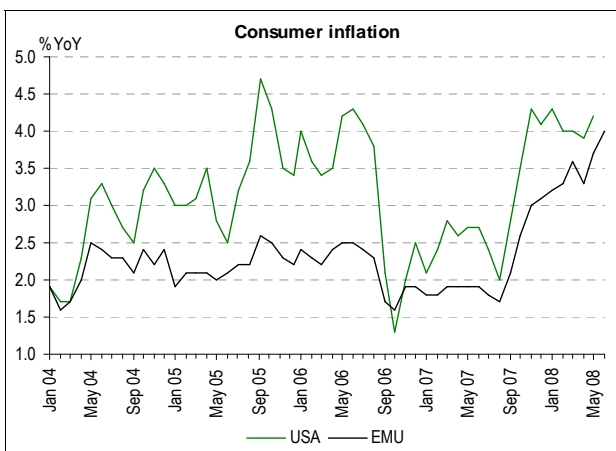
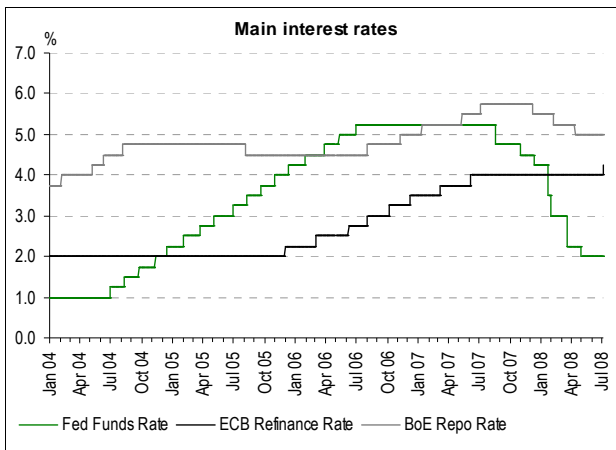
**Treasury bond auctions in 2008 (PLN m)**

month	First auction			Second auction			Switch auction				
	date	T-bonds	offer	sale	date	T-bonds	offer	sale	date	T-bonds	sale
January	02.01	OK0710	1 800	1 655	09.01	WS0922	1 800	1 800	16.01	PS0413 / IZ0816 / WS0922	524 / 766 / 431
February	06.02	PS0413	2 500	2 500	13.02	DS1017	2 000	2 000	20.02	WZ0816 / WZ1118	855 / 914
March	05.03	PS0413	1 500	1 500	12.03	WS0437	700	700	19.03	PS0413/WZ0118/WS0922	1632/ 340 /369
April	02.04	OK0710	2 700	2 700	09.04	DS1017	2 300	1 208	16.04	PS0413/DS1017	3399/2804
May	07.05	PS0413	1 800	1 800	14.05	WS0922	1 200	714	21.26	OK0710/PS0413/DS1017	0/0/0
June	04.06	IZ0816/WZ0118	500/1000	505/719	-	-	-	-	11.06	no switch auction organised	-
July	02.07	OK0710	1000	1000	09.07	DS1017	700	705	-	-	-
August	06.08	2Y	-	-	13.08	12Y CPI   10L float	-	-	-	-	-
September	03.09	5Y	-	-	10.09	20Y	-	-	-	-	-
October	01.10	5Y	-	-	08.10	10Y	-	-	-	-	-
November	05.11	5Y	-	-	12.11	12Y CPI   10Y float	-	-	-	-	-
December	03.12	2Y	-	-	-	-	-	-	-	-	-

\* with supplementary auction

Source: Ministry of Finance, Reuters, BZ WBK

## International review



Source: Reuters, ECB, Federal Reserve

### Main central banks suggest no further changes in rates

▪ In line with expectations the FOMC left interest rates unchanged at 2% at its meeting at the end of June. However, against expectations of some market players, Fed did not include suggestions on possible rate hike in the future. The statement said that "upside risks" to prices have picked up while growth risks "diminished somewhat", which suggested flat rates for some time. In our view, rates will be stable at least till year-end, as US central bank will not be willing to hike rates in the environment of rising unemployment and slower growth.

▪ Though the European Central Bank decided to increase main interest rate by 25 bp to 2.25%, the comments of the ECB chief during the press conference did not suggest that this was a beginning of longer cycle of tightening. He said that inflation in the euro zone may remain elevated for longer than previously predicted, however the central bank action made so far will help in reaching price stability.

### ... despite strong inflationary pressure

▪ The ECB's decision to hike rates for the first time for more than a year was a response to another increase in inflation in the euro zone, above expectations again. According to flash estimate the annual HICP index rose in June to 4% from the revised upward 3.7% in May. The annual PPI also accelerated in the euro zone – to 7.1% in May from 6.2% in April, while the market expected 6.7%.

▪ US inflation indicators also turned out higher than expected. They showed that 12-month CPI index increased by 4.2% in May against market consensus pointing to a stabilisation at the level of 3.9%. The hawkish signal of CPI data was somewhat softened by core CPI index, which was in line with forecasts (0.2%MoM and 2.3%YoY), and core PCE index, which rose by 0.1% (market expected 0.2%).

### ... as risk for economic growth is rising

▪ The room for antiinflationary actions by central banks is limited by pessimistic signals as regards the economic conditions of the US and euro zone economy.

▪ Though data on US retail sales proved to be better than expected (rise by 1%MoM in May against forecast of 0.5% and at the same time data for April were revised upward to 0.4% from -0.2%), consumer spending is likely to weaken again in the autumn as the impact of tax rebates from the fiscal stimulus package fades. As a result, also the increase in ISM manufacturing index (to 50.2 pct in June from 49.6 in May, while market expected a fall to 48.6) may prove temporary. US ISM for services sector fell in June to 48.2 from 51.7 in May, which was below market consensus forecast of 51.

▪ Euro zone manufacturing index PMI also fell in June (to 49.2 from 50.6, much below the peak of 57.8 in June 2007), which was roughly in line with expectations. What is more PMI for services sector fell to 49.1 from 50.6, which was the lowest level within four years, well below the previous year's peak at 58.3. Overall PMI index decreased to 49.3 from 51.1 in May. Also, business climate index published by the European Commission fell sharply in June to 94.9 from 97.6 in the previous month (peak at 111.6 in May 2007). Overall, indicators of activity in the euro zone points to stagnation and their further fall could signal a possibility of recession.

### US labour market not as pessimistic as feared

▪ Though the American unemployment rate in June was unchanged at the level of 5.5% (market expected decrease to 5.4%) and the employment fell slightly more than the average of expectations (by 62'000), it is worth to notice that some market players feared that the data may be even worse.



## Economic calendar

Monday	Tuesday	Wednesday	Thursday	Friday
<b>7 July</b> <i>PL: Auction of Treasury Bills</i>	<b>8</b> US: Pending home sales (May) US: Wholesale inventories (May)	<b>9</b> <i>PL: Auction of 10Y bonds</i> <i>EZ: Revised GDP</i>	<b>10</b> GB: BoE meeting – decision	<b>11</b> US: Import prices (Jun) US: Trade balance (May) US: Preliminary Michigan (Jul)
<b>14</b> <i>PL: Auction of Treasury Bills</i> <i>PL: Money supply (Jun)</i> EZ: Industrial production (May)	<b>15</b> <i>PL: CPI (Jun)</i> <i>PL: Wages and employment (Jun)</i> <i>PL: Balance of payments (May)</i> DE: ZEW index (Jul) US: NY Fed index (Jul) US: PPI (Jun) US: Retail sales (Jun)	<b>16</b> EZ: Final HICP (Jun) US: CPI (Jun) US: Capital flows (May) US: Capacity utilisation (Jun) US: Industrial output (Jun)	<b>17</b> US: Build permits (VI) US: House starts (VI) US: Philadelphia Fed index (Jul)	<b>18</b> <i>PL: Industrial output (Jun)</i> <i>PL: PPI (Jun)</i>
<b>21</b> <i>PL: Auction of Treasury Bills</i> JP: Market holiday	<b>22</b> <i>PL: Net inflation (Jun)</i>	<b>23</b> <i>PL: Switch auction</i> <i>PL: Business climate (Jul)</i>	<b>24</b> <i>PL: MPC minutes (Jun)</i> DE: Ifo index (Jul) US: Home sales (Jun)	<b>25</b> <i>PL: Retail sales (Jun)</i> <i>PL: Unemployment (Jun)</i> EZ: M3 money supply (Jun) US: Durable goods (Jun) US: Final Michigan (Jul) US: New home sales (Jun)
<b>28</b> <i>PL: Auction of Treasury Bills</i>	<b>29</b> <i>PL: MPC meeting</i> US: Case/Shiller index (May)	<b>30</b> <i>PL: MPC meeting – decision</i> US: ADP report (Jul)	<b>31</b> EZ: Flash HICP (Jul) EZ: Economic sentiment (Jul) US: Preliminary GDP (Q2) US: GDP deflator (Q2) US: Core PCE (Q2) US: Chicago PMI (Jul)	<b>1 August</b> EZ: Manufacturing PMI (Jul) US: Non-farm payrolls (Jul) US: Unemployment (Jul) US: Manufacturing ISM (Jul)
<b>4</b> EZ: PPI (Jun) US: Core PCE (Jun) US: Factory orders (Jun)	<b>5</b> EZ: Services PMI (Jul) EZ: Retail sales (Jun) US: Non-manufacturing ISM (Jul) US: Fed meeting- decision	<b>6</b> <i>PL: Auction of 2Y bonds</i>	<b>7</b> GB: BoE meeting – decision EZ: ECB meeting – decision US: Pending home sales (Jun)	<b>8</b> US: Labour productivity (Q2) US: Unit labour costs (Q2) US: Wholesale inventories (Jun)
<b>11</b> <i>PL: Auction of Treasury Bills</i>	<b>12</b> <i>PL: Balance of payments (Jun)</i> US: Trade balance (Jun)	<b>13</b> <i>PL: CPI (Jul)</i> EZ: Industrial output (Jun) US: Import prices (Jul) US: Retail sales (Jul)	<b>14</b> <i>PL: Money supply (Jul)</i> EZ: Preliminary GDP (Q2) EZ: Flash HICP (Jul) US: CPI (Jul)	<b>15</b> US: NY Fed index (Aug) US: Capital flows (Jun) US: Capacity utilisation (Jul) US: Industrial output (Jul) US: Preliminary Michigan (Jul)

Source: CSO, NBP, Finance Ministry, Reuters

## MPC meetings and data release calendar for 2008

	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
MPC meeting	29-30	26-27	25-26	29-30	27-28	24-25	29-30	26-27	23-24	28-29	25-26	22-23
MPC minutes	24	21	20	24	23	19	24	21	18	23	20	18
GDP*	-	29	-	-	30	-	-	29	-	-	28	-
CPI	15	15 <sup>a</sup>	13 <sup>b</sup>	15	14	13	15	13	15	14	13	15
Core inflation	22	-	21 <sup>b</sup>	22	21	20	22	21	22	21	20	22
PPI	18	19	19	18	21	18	18	20	18	17	20	18
Industrial output	18	19	19	18	21	18	18	20	18	17	20	18
Retail sales	24	25	26	22	28	24	-	-	-	-	-	-
Gross wages, employment	16	15	17	15	19	16	15	18	15	15	18	15
Unemployment	24	25	26	22	28	24	-	-	-	-	-	-
Foreign trade	about 50 working days after reported period											
Balance of payments*	2	-	31	-	-	30	-	-	30	-	-	-
Balance of payments	18 <sup>c</sup>	12	13	15	15	17	15	12	12	-	-	-
Money supply	14	14	14	14	14	13	14	14	12	-	-	-
NBP balance sheet	7	7	7	7	7	6	7	7	5			
Business climate indices	23	22	21	23	23	23	23	22	23	23	21	22

\* quarterly data, <sup>a</sup> preliminary data for January, <sup>b</sup> January and February, <sup>c</sup> November 2007

Source: CSO, NBP

## Economic data and forecasts

### Monthly economic indicators

		Jun 07	Jul 07	Aug 07	Sep 07	Oct 07	Nov 07	Dec 07	Jan 08	Feb 08	Mar 08	Apr 08	May 08	Jun 07	Jul 08
Industrial production	%YoY	5.6	10.4	8.9	5.4	10.8	8.5	6.4	10.7	15.0	1.0	15.1	2.3	7.9	8.9
Retail sales <sup>c</sup>	%YoY	16.2	17.1	17.4	14.2	19.4	19.2	12.4	20.9	23.8	15.7	17.6	14.9	16.5	17.5
Unemployment rate	%	12.3	12.1	11.9	11.6	11.3	11.2	11.4	11.7	11.5	11.1	10.5	10.0	9.6	9.5
Gross wages <sup>b,c</sup>	%YoY	9.3	9.3	10.5	9.5	11.0	12.0	7.2	11.5	12.8	10.2	12.6	10.5	10.8	10.9
Employment <sup>b</sup>	%YoY	4.6	4.7	4.8	4.7	5.0	5.0	4.9	5.9	5.9	5.8	5.6	5.4	5.0	4.9
Export (€) <sup>d</sup>	%YoY	10.7	17.0	14.9	8.2	13.5	13.1	8.7	23.2	30.2	12.0	31.1	12.6	15.1	16.1
Import (€) <sup>d</sup>	%YoY	20.8	23.3	13.4	13.7	17.7	15.4	15.4	18.7	32.5	13.9	31.3	17.7	18.3	17.0
Trade balance <sup>d</sup>	EURm	-1123	-1299	-472	-917	-859	-783	-1645	-535	-840	-1402	-1260	-1568	-1600	-1600
Current account balance <sup>d</sup>	EURm	-1506	-1252	-576	-546	-1183	-67	-2061	-962	-1347	-1738	-1550	-1768	-1900	-1550
Current account balance <sup>d</sup>	% GDP	-3.5	-3.7	-3.6	-3.8	-3.8	-3.5	-3.7	-3.9	-4.0	-4.3	-4.7	-4.8	-4.8	-5.1
Budget deficit (cumulative)	PLNbn	-3.7	0.6	0.3	0.2	-4.4	-6.0	-16.9	4.4	0.0	1.9	0.6	-1.9	-3.5	-6.8
Budget deficit (cumulative) <sup>e</sup>	% of FY plan	21.7	-3.6	-1.6	-1.2	26.2	35.5	100.0	-16.4	-0.1	-6.9	-2.2	6.8	12.9	25.2
CPI	%YoY	2.6	2.3	1.5	2.3	3.0	3.6	4.0	4.0	4.2	4.1	4.0	4.4	4.6	4.5
PPI	%YoY	1.7	1.5	1.8	1.8	2.0	2.5	2.3	2.9	3.2	2.9	2.5	2.8	2.8	2.6
Broad money (M3)	%YoY	14.7	15.6	16.1	14.4	13.8	13.6	13.4	12.9	13.5	13.6	15.0	15.0	16.1	15.8
Deposits	%YoY	15.2	15.9	16.3	15.4	15.2	15.1	14.5	14.3	14.7	15.3	16.7	17.4	17.8	17.8
Loans	%YoY	29.2	31.4	31.1	31.0	30.6	30.1	30.0	30.3	29.5	29.7	28.4	27.5	26.0	24.6
USD/PLN	PLN	2.84	2.75	2.80	2.73	2.61	2.49	2.47	2.46	2.43	2.28	2.19	2.19	2.17	2.11
EUR/PLN	PLN	3.81	3.77	3.81	3.79	3.71	3.66	3.60	3.61	3.58	3.54	3.45	3.40	3.37	3.31
Reference rate <sup>a</sup>	%	4.50	4.50	4.75	4.75	4.75	5.00	5.00	5.25	5.50	5.75	5.75	5.75	6.00	6.25
Lombard rate <sup>a</sup>	%	6.00	6.00	6.25	6.25	6.25	6.50	6.50	6.75	7.00	7.25	7.25	7.25	7.50	7.75
WIBOR 3M	%	4.52	4.78	4.80	5.09	5.13	5.36	5.67	5.64	5.74	6.03	6.29	6.41	6.58	6.34
Yield on 52-week T-bills	%	4.42	4.70	4.80	5.01	5.04	5.30	5.78	5.75	5.66	6.09	6.10	6.10	6.63	6.70
Yield on 2-year T-bonds	%	4.93	5.14	5.23	5.25	5.30	5.77	6.06	5.92	5.90	6.17	6.20	6.27	6.73	6.80
Yield on 5-year T-bonds	%	5.40	5.50	5.61	5.60	5.59	5.90	6.07	5.94	5.93	6.20	6.12	6.25	6.62	6.60
Yield on 10-year T-bonds	%	5.52	5.60	5.68	5.69	5.64	5.70	5.85	5.81	5.82	5.98	5.98	6.10	6.41	6.50

Source: CSO, NBP, Finance Ministry, BZ WBK own estimates

<sup>a</sup> at the end of period <sup>b</sup> in corporate sector <sup>c</sup> in nominal terms <sup>d</sup> balance of payments data on transaction basis <sup>e</sup> 2006 - % of Dec, 2007 - % of plan

## Quarterly and annual economic indicators

		2006	2007	2008	2009	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	3Q08	4Q08
GDP	PLNbn	1 060.0	1 167.8	1 282.2	1 387.9	267.7	281.5	288.5	330.1	294.1	310.0	317.1	361.0
GDP	%YoY	6.2	6.6	5.3	4.5	7.3	6.5	6.5	6.4	6.1	5.6	4.9	4.9
Domestic demand	%YoY	7.3	8.3	6.6	6.3	9.3	9.2	8.4	6.5	6.3	6.5	6.6	6.8
Private consumption	%YoY	5.0	5.0	5.7	5.5	6.8	4.9	4.8	3.6	5.6	5.7	5.7	5.7
Fixed investments	%YoY	14.9	17.6	12.8	11.4	23.8	19.0	16.7	15.2	15.7	14.0	13.0	11.0
Industrial production	%YoY	12.5	9.7	7.4	5.4	13.0	8.5	8.1	9.6	8.5	8.4	6.7	6.1
Retail sales (real terms)	%YoY	11.9	14.0	13.6	12.3	17.4	14.1	12.8	12.2	16.0	12.5	12.6	13.0
Unemployment rate <sup>a</sup>	%	14.8	11.4	9.3	8.0	14.3	12.3	11.6	11.4	11.1	9.6	9.1	9.3
Gross wages (real terms) <sup>c</sup>	%YoY	4.2	6.7	6.2	4.8	5.9	6.5	8.1	6.5	7.2	6.7	6.1	4.9
Employment <sup>c</sup>	%YoY	3.2	4.6	5.1	2.8	4.2	4.5	4.8	5.0	5.9	5.3	4.8	4.2
Export (€) <sup>b</sup>	%YoY	20.4	12.8	13.8	6.0	13.4	12.7	13.1	12.0	21.3	19.4	10.0	6.0
Import (€) <sup>b</sup>	%YoY	24.0	17.9	17.9	11.0	19.5	19.7	16.6	16.2	21.1	22.3	16.0	13.0
Trade balance <sup>b</sup>	EURm	-5 539	-11 311	-17 613	-25 567	-2 322	-3 029	-2 684	-3 276	-2 769	-4 428	-4 707	-5 709
Current account balance <sup>b</sup>	EURm	-7 283	-11 577	-19 487	-27 841	-2 468	-3 434	-2 376	-3 299	-4 038	-5 218	-4 399	-5 832
Current account balance <sup>b</sup>	% GDP	-2.7	-3.8	-5.2	-6.6	-2.9	-3.5	-3.8	-3.7	-4.1	-4.4	-4.7	-5.2
Budget deficit (cumulative) <sup>a</sup>	PLNbn	-25.1	-16.9	-20.1	-18.2	-4.8	-3.7	0.2	-16.9	1.9	-3.5	-7.2	-20.1
Budget deficit (cumulative) <sup>a</sup>	% GDP	-2.4	-1.4	-1.6	-1.3	-	-	-	-	-	-	-	-
CPI	%YoY	1.0	2.5	4.4	3.6	2.0	2.4	2.0	3.5	4.1	4.3	4.8	4.2
CPI <sup>a</sup>	%YoY	1.4	4.0	4.1	3.5	2.5	2.6	2.3	4.0	4.1	4.6	4.8	4.1
PPI	%YoY	2.5	2.3	2.9	3.4	3.3	2.0	1.7	2.3	3.0	2.7	2.5	3.4
Broad money (M3) <sup>a</sup>	%YoY	16.0	13.4	13.0	11.0	18.0	14.7	14.4	13.4	13.6	16.1	15.4	13.0
Deposits <sup>a</sup>	%YoY	15.2	14.5	13.2	11.4	17.7	15.2	15.4	14.5	15.3	17.8	16.6	13.2
Loans <sup>a</sup>	%YoY	23.4	30.0	19.0	15.8	26.8	29.2	31.0	30.0	29.7	26.0	22.6	19.0
USD/PLN	PLN	3.10	2.77	2.21	2.15	2.97	2.82	2.76	2.52	2.39	2.18	2.14	2.13
EUR/PLN	PLN	3.90	3.78	3.40	3.29	3.89	3.80	3.79	3.65	3.58	3.41	3.33	3.31
Reference rate <sup>a</sup>	%	4.00	5.00	6.50	6.50	4.00	4.50	4.75	5.00	5.75	6.00	6.50	6.50
Lombard rate <sup>a</sup>	%	5.50	6.50	8.00	8.00	5.50	6.00	6.25	6.50	7.25	7.50	8.00	8.00
WIBOR 3M	%	4.21	4.73	6.42	6.70	4.20	4.42	4.89	5.39	5.80	6.43	6.59	6.85
Yield on 52-week T-bills	%	4.18	4.69	6.33	6.50	4.14	4.40	4.84	5.37	5.84	6.28	6.60	6.60
Yield on 2-year T-bonds	%	4.57	5.23	6.42	6.30	4.47	4.78	5.21	5.71	5.99	6.40	6.70	6.60
Yield on 5-year T-bonds	%	5.03	5.52	6.36	6.25	4.95	5.19	5.57	5.85	6.02	6.33	6.60	6.50
Yield on 10-year T-bonds	%	5.22	5.56	6.16	6.03	5.17	5.36	5.66	5.73	5.87	6.16	6.40	6.20

Source: CSO, NBP, Finance Ministry, BZ WBK own estimates

<sup>a</sup> at the end of period; <sup>b</sup> balance of payments data on transaction basis <sup>c</sup> in corporate sector

This analysis is based on information available until 09.07.2008 has been prepared by:

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