

MACROscope

Polish Economy and Financial Markets

October 2008

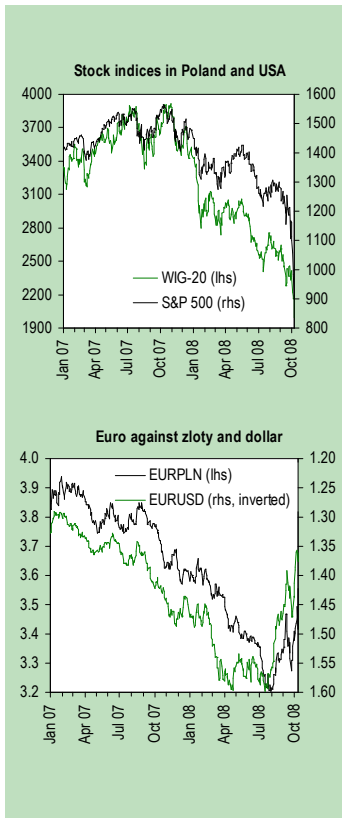
Great Uncertainty

Over the last month the crisis in the global financial system intensified. Serious problems of next of the largest financial institutions in the world led to substantial rise in risk aversion. Approval of the rescue package for the financial sector in the US has not improved market moods for long. After several liquidity injections, the world's major central banks decided for more decisive move and there was coordinated rate cut of 50bps. The question is whether additional actions taken by many governments - aimed at recapitalisation of the banks, increasing confidence in the banking system and restoration of the normal money markets' functioning - will prove effective.

There is undoubtedly growing risk of significant economic slowdown in environment of the Polish economy, among others due to freezing of the credit markets. This could additionally constrain demand for Polish exports and worsen the global investment climate, leading to decrease in FDIs inflow to Poland. Thus, we decided to lower GDP growth forecast for the next year (to below 4%), mainly due to lower increase in fixed investment (weaker inflow of FDIs and weaker credit activity). However, investment activity in Poland will be supported by rising inflow of EU funds and additional stabiliser of economic growth in Poland will be solid growth in consumption demand thanks to reduction in PIT, indexation of social benefits and still strong consumer confidence. However, increase in private consumption next year will be lower than this year due to slower rise in average wage and employment (stabilisation of the unemployment rate amid return of a part of emigrants).

An important new element for the domestic market is declaration of the Prime Minister about swift euro adoption in Poland. Consistent realisation of this project should support the zloty, and at the same time increase inclination of Polish central bankers to conduct relatively more restrictive monetary policy than in scenario of later euro adoption. However, while before intensification of the global crisis and coordinated rate cuts abroad this meant higher probability of interest rate hike at the next MPC meeting, now relatively more restrictive monetary policy may mean stable rates.

The two above mentioned factors - global financial crisis and prospects for swift euro adoption - substantially increase uncertainty of the zloty exchange rate forecasts for the next year. Economic slowdown could weaken the zloty, especially in case of abandoning the plan of ERM2 entry next year and swift euro adoption. On the other hand, entry to the ERM2 next year, resolution of the credit crisis and fall in risk aversion could lead to increase in capital inflow to the Polish market. As for now, we keep our exchange rate forecasts for the next year and possible correction could take place after publication by the government of the official schedule of Poland's entry to the euro zone.



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Financial market on 30 September 2008:

| | | | | | |
|--------------------|------|-------------------------|------|--------|--------|
| NBP deposit rate | 4.50 | WIBOR 3M | 6.63 | USDPLN | 2.3708 |
| NBP reference rate | 6.00 | Yield on 2-year T-bonds | 6.19 | EURPLN | 3.4083 |
| NBP lombard rate | 7.50 | Yield on 5-year T-bonds | 5.99 | EURUSD | 1.4376 |

This report is based on information available until 10.10.2008

Special focus

On the trail of the NBP rates*

For quite some time, the Monetary Policy Council has been facing a dilemma of how to restrain strong inflation pressure without decelerating the GDP growth. The additional factor to be reckoned with in this dilemma is the crisis in financial markets on the one hand and the Polish Prime Minister's declarations about the possibly soonest euro convergence on the other. This situation makes forecasting monetary policy decisions in Poland very difficult. If we believe in the scenario of gradual calming down of the situation in global markets and its only moderate impact on the Polish economy, as well as in the fast euro adoption process, then the rates in Poland should have been higher as compared to the second scenario. The latter assumes prolonged global recession and no necessity to lower Polish inflation to the level necessary to meet the Maastricht criterion. Additionally, the situation in the foreign exchange market complicates the situation even more. If the government shows no determination in euro adoption process and recent declarations are withdrawn and at the same time fundamentals of the Polish economy deteriorate amid global slowdown, the disinflation process would become more difficult.

We decided to develop a model for the MPC's interest rates policy, which may serve the purpose of defining the function of the MPC's reaction function and estimating its parameters. The dependencies indicated by the model may prove very useful both when interpreting the decisions already taken by the MPC and when predicting its future decisions. However, in today's circumstances the problem is that the above-mentioned factors not included in the model (i.e. euro adoption process and global crisis) may affect the MPC's decisions. Namely, it is hard to imagine that after the co-ordinated rate cuts by the major global central banks the MPC decides to do the opposite. This is despite the fact that our model predicts such a scenario, as after the adoption of the most likely assumptions as to the materialisation of factors which will determine the MPC's decisions, the rate hike in October looked very probable. Well, it does not mean it will take place.

Taylor rule in modelling interest rates

The theoretical concept most frequently applied by economists when modelling the interest rate policy is

the so-called Taylor's rule¹. In its original form devised for analysing the interest rates policy of the American Federal Reserve, the Taylor's rule is as follows:

$$i_t = \bar{r} + \pi_t + \beta_1(\pi_t - \pi^*) + \beta_2 y_t$$

where:

i_t – nominal rate of federal funds

\bar{r} – real natural interest rate

π_t – annual inflation rate (measured as GDP deflator)

π^* – desired inflation rate

y_t – percentage divergence of the real GDP from the potential GDP

In the interest of simplicity, Taylor proposed the following estimates:

$$i_t = 2 + \pi_t + 0,5(\pi_t - 2) + 0,5y_t = 4 + 1,5(\pi_t - 2) + 0,5y_t$$

This rule means that when the current inflation is at the desired level equal to, e.g. 2%, while the output is at the potential level, the rate of federal funds should be 4%:

$$i_t = 2\% + \pi_t, \text{ where } \pi_t = \pi^* = 2\%.$$

Each divergence of the current output from its potential level and each divergence of the current inflation from its desired level by 1 pp (up or down) should result in increasing or decreasing the nominal rate of federal funds by 1.5 pp and 0.5 pp, respectively.

In view of its evident simplicity, Taylor's rule is frequently used in practice for analysing the interest rates policy. Yet, not to omit the variables, vital for the monetary policy management, in the modelling process, the starting point for building the monetary policy model is usually adopted as the function of reaction which contains a relatively wide scope of variables. Trial estimates and statistical tests carried out next, enable final selection of the most vital set of variables which impacts the policy pursued by a given central bank. Again, it is worth to emphasise that in the environment of crisis on global financial markets, interest rates path in the US depends also on some one-off factors, which are not necessarily included in the model.

How to do it in Poland?

Pursuant to the Act on the National Bank of Poland, the key objective of the NBP's activity is maintaining a

* The research prepared with contribution of Łukasz Postek during his internship at Bank Zachodni WBK's Treasury Division

¹ Taylor, John B. *Discretion versus policy rules in practice*; Carnegie-Rochester Conference Series on Public Policy, Vol. 39 (1993), pp. 195-214.

stable level of prices while supporting the government's economic policy unless the latter collides with the primary objective. The target set out by the act is delivered by the MPC under the strategy of direct inflation targeting, while using a wide range of information when taking decisions on rates, i.e. inflation data, economic activity ratios and all other information which help assess the inflation outlook. Consequently, the function of the MPC's reaction can be put down as follows (details in the technical annex):

$r = f$ (interest rates to date, inflation data, economic activity ratios, other data)

Therefore, for the purpose of the MPC policy model we accept that the level of interest rates in Poland is determined by their values in the past and the scope of information on economy available to the MPC members at the moment of taking their decisions. From among the information on economy, we avail of a group of inflation-related ratios (CPI, PPI, core inflation indicators, inflation expectations, publication of inflation reports), economic activity ratios (GDP growth pace, dynamics of industrial and construction-assembly production, dynamics of retail sales, PMI index) and other potentially vital variables in monetary policy management (EURPLN rate, USDPLN rate, oil prices, wage and productivity dynamics).

When modelling the function of the central bank's response, it is possible to adopt the so called backward-looking approach based only on data which available to the Monetary Policy Council (MPC) at the time of taking a decision are used. Alternatively, also a forward-looking approach is applied which enables to use future data (unknown to the central bank at the decision taking time). Given that the latter triggers some methodological doubts, we follow the backward-looking approach.

In addition, when modelling the interest rates policy in Poland, we decided to adopt the approach which consists in examining the function of the entire Monetary Policy Council's response rather than examining separately the function of response by each member of the 10-member Council. An interest rate hike passed by the ratio of 10:0 votes is in that case treated precisely the same way as the ratio of 6:4 which may actually have a meaning in the context of projecting the Council's decisions going forward. Nevertheless, separate modelling for each and every member of the Monetary Policy Council is burdened by a material flaw related to the limited in time availability of data on the voting mode by individual members of the Council. That information is available in its full scope with a significant delay in Inflation Reports published three times a year

(the last Inflation Report was published in June, while the next one will be available in October).

What is most significant for the MPC?

The carried out econometric analysis indicates that the following factors, out of the initial set of variables, are most important for decisions taken by the MPC: past value of the interest rate, CPI inflation, the fact of publishing an inflation report in a given month, GDP dynamics as well as the dynamics of wages, PMI and oil prices. Overall, those elements together explain, in statistical terms, more than 99% of the variability of the NBP reference rate. More importantly, the estimations for all parameters behind those variables are consistent with the theory of economy and diagnostic tests qualify the model as a correct one in econometric terms.

The outcome does not mean that other data are not important for the MPC when taking a decision. Their impact may simply not be strong or regular enough to be detected by the model and recognised as a material one. In addition, some dependencies are not linear and are more qualitative than quantitative in nature, thus sometimes it is impossible to factor them in the qualitative analysis.

MPC's response to inflation data

Firstly, preliminary estimations prepared by us indicate that the "turning point" for the MPC in its monetary policy may be not the inflation target of 2.5% but a slightly lower inflation level of ca. 2.25%. The assumption that the Council increases interest rates only when inflation exceeds 2.5% results in some deterioration of the model's predictive power. This is in line with an intuitive approach because the MPC's actions should be preventative and anticipative.

In addition, the MPC's activity with regard to the inflation of 2.25% are not fully symmetric. The Council responds more promptly and decisively when the CPI inflation exceeds 2.25% than when it is below that level. In case of a low inflation, the Council prefers to wait a little longer and make sure of a given signal's durability. Interest rate reductions are then not as significant as in the case is for interest rate hikes. Nevertheless, in the longer term, an average response is similar in terms of its strength for both cases which evidences that the CPI inflation hitting 2.25% can be actually referred to as the "turning point" in te MPC's policy.

The carried out analysis allows to conclude that the publication of Inflation Report is much more significant for the MPC's decisions if a higher inflation emerges and a more restrictive monetary policy is pursued. In

such a situation, projections have a higher weighting. Therefore it can be concluded that the Council tries to be prudent when imposing interest rate hikes on the economy and refrains from that if the prospects for inflation and the economy are not confirmed in the projection with an indication of the need to tighten the monetary policy.

What is more, produced estimations indicate that from the MPC's point of view the average natural interest rate required to maintain inflation at around 2.25% is ca. 5%. This means that when inflation stabilises at 2.25% (no pressure on higher or lower inflation), in the MPC's opinion, the reference rate should be maintained at 5%. When comparing that level with the existing reference rate, we may define the relative restrictiveness of the monetary policy.

MPC's response to economic activity indicators

Information on the GDP growth is a significant factor shaping the monetary policy. It is believed that there is a certain level of GDP growth, referred to as a potential one, which is safe from the inflation perspective. Only once it is exceeded, the inflationary pressure grows and there is a need to increase the interest rates. Interestingly, our model indicates that changes in GDP dynamics, i.e. quarterly changes in the annual GDP growth pace are more important than the GDP dynamics itself (and even the gap vs. the potential growth rate which is set at 5%). It is also worth noticing that the Council is more sensitive to a lower GDP growth dynamics than to a higher one. In the first case, the average scale of interest rate cuts is higher than the scale of interest rate hikes in the second case.

As indicated by our analysis, also the annual dynamics of PMI index is important from the perspective of running the monetary policy, however, its positive impact on the interest rates becomes evident only after ca. one quarter on average.

MPC's response to other information

In spite of expectations, it turned out that neither the nominal nor the real EURPLN and USDPLN exchange rate (or its dynamics) represents a statistically significant determinant of the reference rate. This is probably driven by a relatively high volatility of the foreign exchange rate which causes that not all its fluctuations are recognised by the model as fundamentally important. With a view to modelling precisely the impact of the FX market on the MPC's decisions, the rate should be defined differently as a variable. Perhaps, the variance of the current exchange rate against the so called FEER - Fundamental

Equilibrium Exchange Rate (The MPC refers to that rate in its statements) - would be of better use but in this very case it would be difficult for us to define the track of FEER as perceived by the MPC.

A clear though directly not very strong impact of oil prices on the monetary policy comes as no surprise. That influence is reflected mostly (indirectly) in the share in CPI. As it might have been expected, that impact occurs with some delay (of more than a quarter) due to the protracted transmission of oil market prices to inflation ratios.

According to our analysis, NBP rates are also determined to a significant extent by the wage dynamics, however, it impacts the MPC's decisions with a five-month delay. It should be noted, though, that the wage indicator defined as the annual growth turned out to be statistically insignificant. Therefore, we decided to include the dummy variable against the growth rate of 6.5%YoY. This means that if the annual earnings dynamics exceeds 6.5%, the Council views it as a signal of an inflationary pressure which needs to be reflected in the monetary policy. The level of 6.5% growth was mentioned several times by MPC members as consistent with the inflation target of 2.5%, as it exceeds the target only by the average growth rate of labour productivity.

We introduced to the model also the second dummy variable with the value of one for March and April of 2005 because those observations turned out to be the so-called untypical observations. Those were the only months for which the seasonally adjusted output dynamics was negative. What is more, those months saw also a negative dynamics of retail sales which undoubtedly raised serious concerns about the condition of the Polish economy and may have had a serious impact on the MPC's decisions. Given that such a situation occurred only twice (in two subsequent months), it was impossible to identify precisely the variables that were the exact reason for reducing the reference rate and the extent to which they impacted the MPC's decision. On the other hand, the fact cannot be ignored as it has an adverse impact on the assessment of the model adjustments to data. As shown by estimations for that definition of the variable, in given months the NBP rate varied from the rule implied by the model on average by above 30 basis points downwards.

Where are the rates moving?

Assuming that the developed model of MPC's response function allowed us to identify ratios of the highest statistical significance for running the monetary policy,

helping in predicting the MPC's decisions may be its useful feature. The generated estimations enabled defining the relative power and delay of response to each of the indicators which may be of high importance as it allows not only to interpret decisions already taken up by the MPC but also provides the technical capacity to predict future decisions of the Council. Analysis of fitted values to actual time series of NBP interest rates and analysis of residuals show that the equation points at the trend of official rates pretty well, but has some problem with anticipating exact moments of decisions. In particular, it is significantly wrong in two cases, every time forecasting lower rate than observed. It may be a result of the above mentioned methodological flaw in the approach, as the key rate is treated as continuous variable and MPC as a monolith.

Of course the forecast depends on the assumptions regarding future readings of economic indicators, which

influence the MPC's decisions. However, taking into account strong impact of the past and lagged values, the model indicates that rate hike in October would take place no matter what scenario is assumed for the next data releases. The model also indicated that in the following months a change in the direction of monetary policy was possible, as for most of assumed scenarios it predicted the reference rate to go back to 6% at the turn of the year and then no change until the first quarter of 2009. However, as we noticed at the very beginning of this text, it seems that factors not included in the model will have large influence on further MPC decisions. Rate hike in October looks unlikely given the intensification of the global crisis and the response of main central banks in the form of coordinated rate cuts. In the following months, another new element will be prospects of the euro zone entry and government's binding decision with this regard.

Technical appendix

The result of our estimates indicate that the reaction function of the MPC may be approximated as below:

$$r_t = c + \alpha_1 r_{t-1} + \phi_1^1 (cpi - 2.25)_{t-1}^1 + \phi_1^0 (cpi - 2.25)_{t-1}^0 + \phi_2^0 (cpi - 2.25)_{t-2}^0 + \phi_2^1 raport_0 (cpi - 2.25)_{t-1}^1 + \gamma_1^1 d.pkb_{t-1}^1 + \gamma_1^0 d.pkb_{t-1}^0 + \gamma_3^1 pmi_{t-3}^1 + \theta_1^1 oil_{t-4}^1 + \theta_2^1 place_{t-5}^1 + \theta_3^1 instr_t$$

where:

$(cpi - 2.25)_{t-1}^0$ - CPI - 2.25, if disparity is negative; otherwise: 0

$(cpi - 2.25)_{t-1}^1$ - CPI - 2.25, if disparity is positive; otherwise: 0

$raport_0$ - dummy variable which equals 1 if inflation report is published in current month; otherwise: 0

$d.pkb_{t-1}^0$ - disparity between two recent and available to MPC (when the decision meeting is held) levels of GDP growth, if the disparity is negative; otherwise: 0

$d.pkb_{t-1}^1$ - disparity between two recent and available to MPC (when the decision meeting is held) levels of GDP growth if the disparity is positive; otherwise: 0

pmi_{t-3} - annual growth rate of PMI (lagged by 3 months)

$instr_t$ - dummy instrumental variable which equals 1 for March and April 2005; otherwise: 0

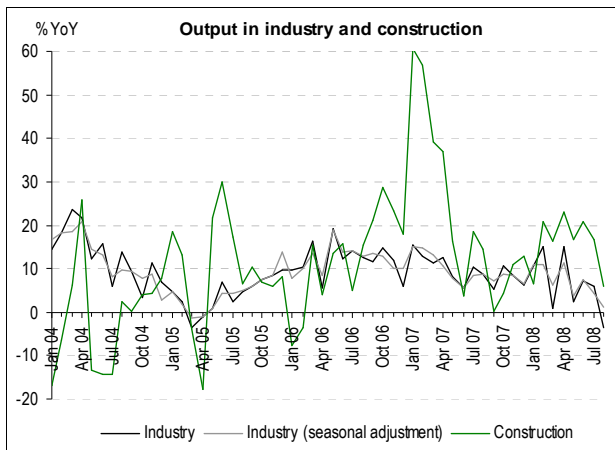
oil_{t-4} - monthly growth rate of oil price (lagged by 4 months) quoted as West Texas Intermediate from www.eia.doe.gov

$place_{t-5}$ - dummy variable which equals 1, if annual growth of average wage in enterprises breaks the level of 6.5%; otherwise: 0. The variable is lagged by 5 months.

OLS estimates and diagnosis statistics for the model defined are presented below:

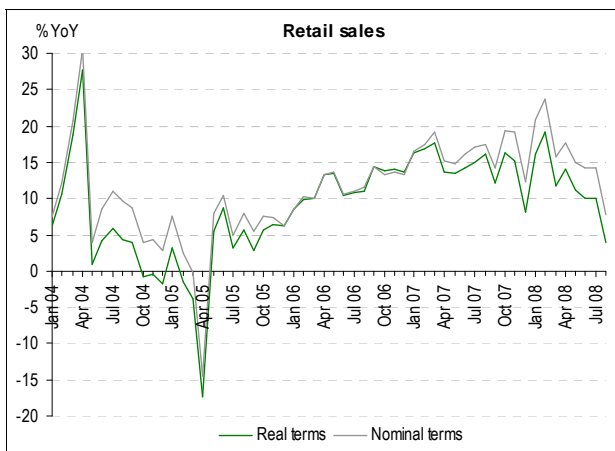
| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|--------------------------------------|-------------|-----------------------|-------------|--------|
| c | 0.643730 | 0.139965 | 4.599210 | 0.0000 |
| r(-1) | 0.865738 | 0.028698 | 30.16701 | 0.0000 |
| (cpi - 2.25) ⁰ (-1) | 0.075635 | 0.040402 | 1.872045 | 0.0679 |
| (cpi - 2.25) ¹ (-1) | 0.094044 | 0.023406 | 4.017985 | 0.0002 |
| (cpi - 2.25) ⁰ (-2) | 0.097578 | 0.045570 | 2.141256 | 0.0378 |
| raport(cpi - 2.25) ¹ (-1) | 0.079281 | 0.019745 | 4.015349 | 0.0002 |
| instr | -0.301560 | 0.063069 | -4.781436 | 0.0000 |
| pmi(-3) | 0.011905 | 0.001480 | 8.043526 | 0.0000 |
| oil(-4) | 0.006778 | 0.002699 | 2.511238 | 0.0158 |
| pkb ¹ (-1) | 0.077933 | 0.028371 | 2.746955 | 0.0087 |
| pkb ⁰ (-1) | 0.085936 | 0.033679 | 2.551601 | 0.0143 |
| place(-5) | 0.050760 | 0.027827 | 1.824121 | 0.0749 |
| R2 | 0.994259 | Mean dependent var | | 5.0268 |
| Adjusted R2 | 0.992824 | S.D. dependent var | | 0.8812 |
| S.E. of regression | 0.074650 | Akaike info criterion | | -2.165 |
| Sum squared resid | 0.245195 | Schwarz criterion | | -1.731 |
| Log likelihood | 72.60889 | F-statistic | | 692.74 |
| Durbin-Watson stat | 2.257110 | Prob(F-statistic) | | 0 |

Economic update



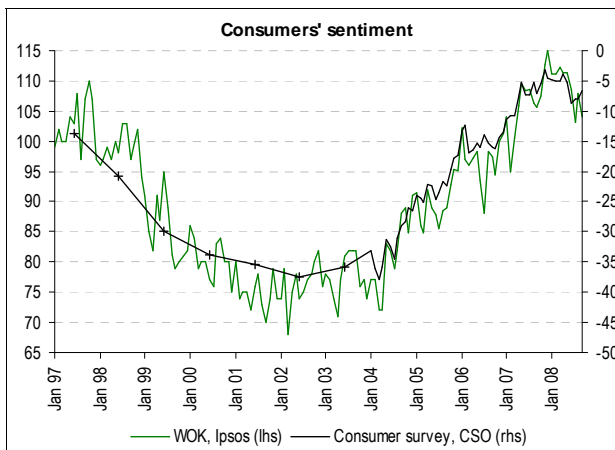
Fall in industrial output in August

- Industrial output in August fell 3.7%YoY after 5.9%YoY rise in July and 8.6% rise on average in 1H08.
- An important reason for drop in annual output growth in August was negative effect of lower number of working days (2 fewer than in August 2007). However, seasonally adjusted output growth reached merely 1.2%YoY against 4.4%YoY in July and 8.4%YoY average rise in 1H08, which indicates that we saw not only statistical effect of lower number of working days, but also weakening of the underlying output growth trend.
- Weakening of output growth was seen not only in industry, but also in construction: to 5.9%YoY from 16.8%YoY in July and 17.3%YoY on average in 1H08. All in all, output data for August are one of elements, which led to revision of our GDP growth forecast for Q3 and Q4 to 4.5% from 4.8%.



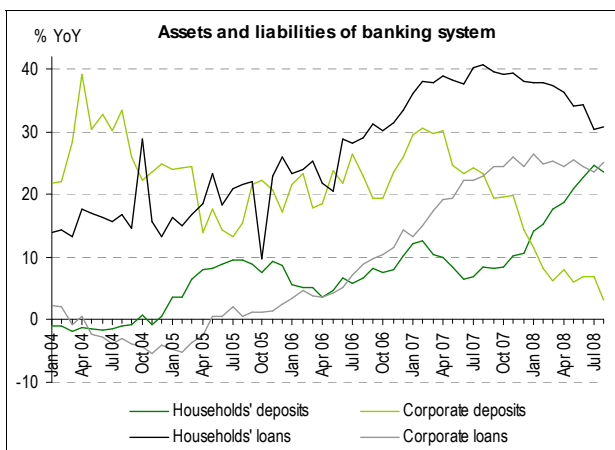
Retail sales not as bad as at first sight

- Nominal growth in retail sales in August decelerated to 7.7%YoY, the lowest level in ca. 3 years. Real growth was 3.9%YoY versus 10.1%YoY in July.
- The main reason responsible for the weak result was collapse in motor vehicles sales (-17.8%YoY after -5.6%YoY in July). However, the data do not cover private import of new and used cars. Fall in sales was also seen in food, beverages and tobacco products (-1.6%YoY).
- Other categories of retail sales experienced continuation of solid, two-digit growth. In particular, sales of furniture and households appliances grew 28.1%YoY, stronger than a month earlier, and sales of clothing and footwear rose 30.3%YoY (in real terms nearly 40%YoY, above average for the first seven months of this year).



Mixed signals from business climate indicators

- The stats office's business climate indicators for September fell on the month for all three analysed sectors. Fall in the index for manufacturing was stronger than suggested by seasonal pattern (annual drop deepened), confirming that this sector faces serious problems. This was also reflected in fall in the PMI manufacturing to 44.9 in September from 45.8 in August.
- On the other hand, September saw improvement in the stats office's consumer confidence survey. There was improvement in assessment of the country's economic situation, possibility of major purchases and savings, and weakening of concerns about unemployment rise. The Ipsos's consumer confidence survey for September also showed better assessment of economic situation. Continued relatively strong optimism of households suggests that consumption demand growth should remain solid.

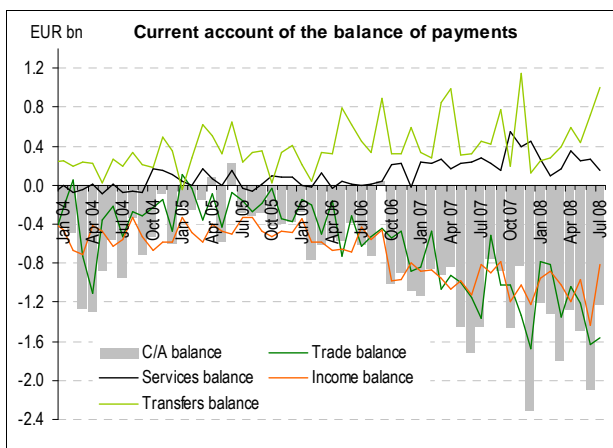
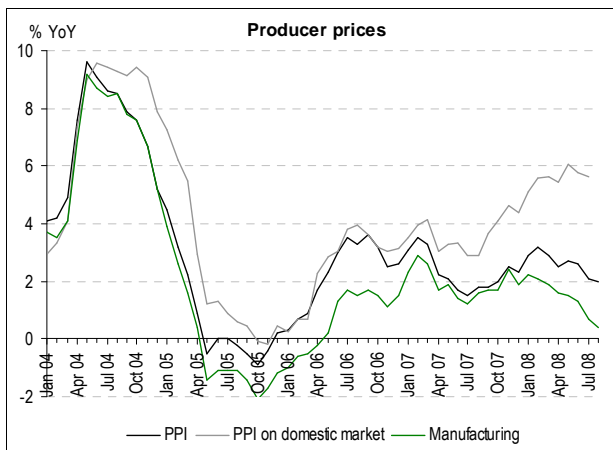
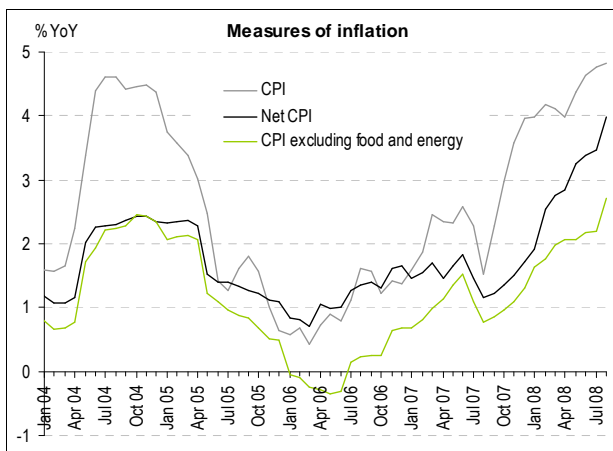
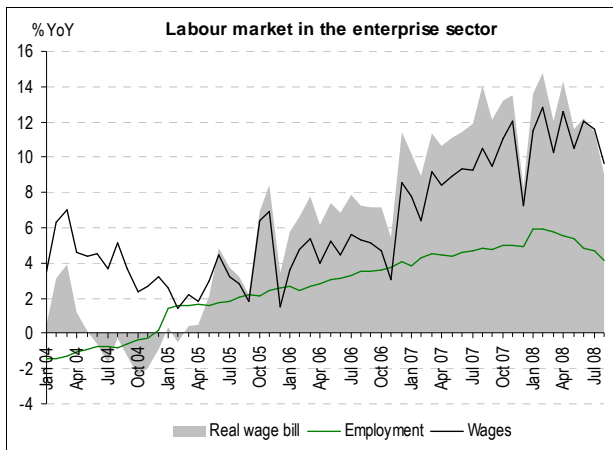


Robust growth in loans

- As for now, monetary statistics does not point at significant economic slowdown. Growth in money supply M3 slowed down to 16.6%YoY in August from 16.8%YoY in July, but it was considerably above the expectations at around 16%.
- Annual growth rate of loans accelerated by 1pp to 26.3%YoY, due to stronger rise in corporate borrowing (up to 25.2%YoY from 23.5%YoY in July), while households borrowing remained at high level of slightly above 30%YoY.
- There is also continuation of strong increase in households deposits (23.5%YoY), but at the same time corporate deposits growth continue to decelerate (3.1%YoY versus 7%YoY in July).
- Although so far the loans growth has been strong, fostering economic growth, the expected tightening of credit policy is likely to negatively affect pace of economic growth.

Source: CSO, own calculations

Economic update



Source: CSO, NBP, own calculations

Gradual softening in labour market conditions

- Annual growth rates of average wage and employment in the enterprise sector reached “a mere” 9.7% and 4.2%, below expectations. As a result, increase in wage bill in the enterprise sector lowered to 14.3%YoY in nominal terms and 9%YoY in real terms. Although this was the weakest growth since December, it still means substantial rise in households income.
- Moreover, average wage growth in August was negatively affected by lower number of hours worked (2 working days fewer than a year ago). Thus, we expect rebound in average wage growth in September.
- In longer term, wage pressure may gradually decrease, which is indicated by continued tendency of job losses in manufacturing began in May (-0.1%MoM in August).

CPI inflation peak below 5%, new core inflation above target

- The headline inflation rate in August remained at 4.8%YoY posted in July, after price drop of 0.4% on the month, while the market consensus was 5%YoY. The biggest surprise was food price performance, i.e. a decrease of as much as 1.6%MoM. It seems that either negative effect of bad weather conditions on this year's harvest was weaker than earlier estimated or food imports offset the effect.
- We forecast that over the next months the CPI inflation will gradually fall, but at least until the end of the next year will not fall for good below the upper end of the allowed fluctuation margin around the target.
- At the same time we predict the most closely watched measures of core inflation will also remain above the target for longer, following clear rise in August: the net inflation to 4%YoY from 3.5%YoY and CPI excluding food and energy prices to 2.7%YoY from 2.2%YoY.

Still strong price pressure at producers' level

- Producer prices increased 0.2%MoM and 2%YoY in August. Price growth in manufacturing slowed down to 0.4%YoY from 0.7%YoY in July. At the first sight such data indicate weak price pressure at the producers' level, but one should remember that price growth in manufacturing is lowered by fall in export prices in zloty terms due to annual pace of the zloty appreciation (its scale was 13.7% in August, slightly more than in July). A better measure of inflationary pressure at producers' level is PPI inflation on the domestic market, which reached 5.6%YoY in July, slightly down from 5.8%YoY in June (data on PPI on the domestic market are released with longer lag than data on total PPI).

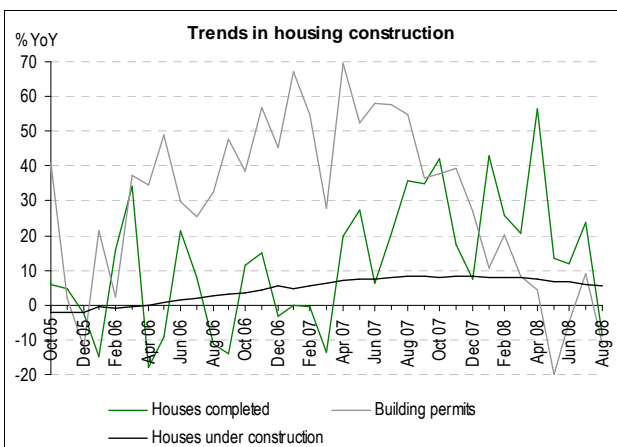
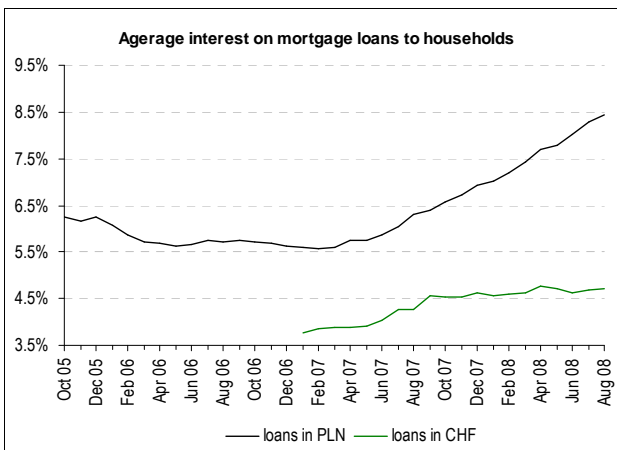
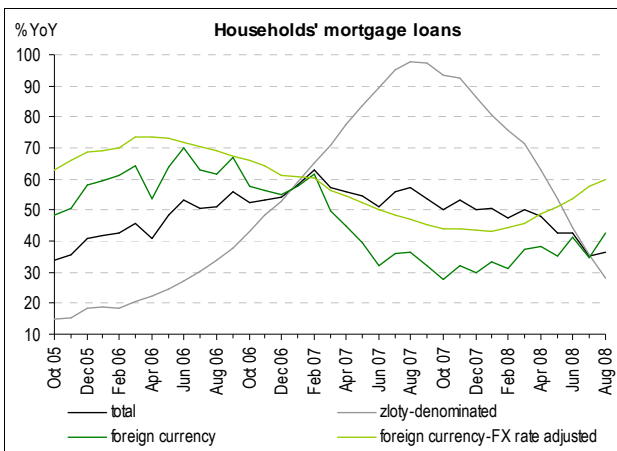
C/A deficit narrowed in July

- C/A gap narrowed in July thanks to improvement in income and transfers accounts as well as due to significant acceleration in exports growth. However, one should expect a slowdown in exports growth in the next months, as the lagged effects of the strong zloty and weaker external demand will start to kick in. Nevertheless, this should not be dramatic collapse in exports and negative contribution of net exports to GDP growth in Q3 might have been smaller than we had predicted earlier.
- The 12M cumulated C/A gap fell to 4.8% of GDP after July from upwardly revised 5% in June (upward revision for 2007 and downward for 2Q08). We forecast that at the end of this year the C/A gap will reach 5% and will exceed 6% in 2009. However, although extent to which it is financed through long-term capital gradually decrease, it still stands at nearly 100%.

Housing market update

Average offered house prices at secondary market in August

| City | Price (PLN/sqm) | Change 1M (%) | Change 12M (%) |
|-----------|-----------------|---------------|----------------|
| Białystok | 4847 | 0.4 | n/a |
| Bydgoszcz | 4349 | 0.4 | n/a |
| Gdańsk | 6791 | -2.5 | -3.0 |
| Gdynia | 7034 | -5.4 | n/a |
| Katowice | 4335 | 0.0 | n/a |
| Kraków | 7753 | -0.3 | -9.5 |
| Lublin | 5215 | -0.6 | n/a |
| Łódź | 4423 | -1.3 | -9.8 |
| Poznań | 5895 | -0.3 | -12.3 |
| Rzeszów | 5037 | 4.7 | n/a |
| Sopot | 10955 | -4.1 | n/a |
| Szczecin | 5344 | 1.8 | n/a |
| Warszawa | 9599 | 0.9 | -2.0 |
| Wrocław | 7151 | 2.1 | -2.2 |



Source: CSO, NBP, Oferty.net, own calculations

Housing stagnation continues

- According to Oferty.net website, in August prices were falling in most of Polish cities as compared to July, however there were also some gains (for example in Warsaw and some smaller cities). During last twelve months, in most of large cities prices went down significantly (the most in Kraków, Łódź and Poznań). One should remember that available data show offered prices. In times of stagnant demand, there may be higher tendency to lower transaction prices.
- While it is easier to find a bargain when buying flat, in the house rental market demand seems to be clearly dominating supply. According to Oferty.net, average rental fee for studio in Warsaw increased by over 13% during last year and amounted to PLN1756 per month in August.

High demand for housing loans

- Despite of signs of abating demand for flats, growth in mortgage loans remains high. According to NBP data, in August households' mortgage debt increased by ca. PLN8.6bn since end-July. Part of this increase corresponded to depreciation of Polish zloty, however according to our estimate, after adjustment reflecting FX fluctuations, demand for housing loans remained high and in August grew 47.3%YoY (versus 36.6% without adjustment).
- Almost entire increase in mortgage credit in August was in foreign currency loans. Their growth rate accelerated to 60%YoY (after FX adjustment), while demand for zloty-denominated loans has been weakening for a number of months (annual growth down to 28%YoY in August).

... but the financial crisis will trim credit availability

- August was the second straight month of clear increase in average margins in the banking sector (average margin for zloty-denominated loan 1.9 pp versus 1.5 pp in June).
- Deepening of financial crisis and severe liquidity squeeze, which triggered a surge in LIBOR money market rates, will force banks to keep rising margins and will constrain availability of loans. Apart from higher costs, customers will face tightening of lending procedures and standards, particularly for FX loans.
- Thus, it is possible that demand for flats may weaken further in the nearest months. In the short run, this may result in a decline in house prices. However, in a few years horizon, demand will certainly revive while there may be supply-side constraints.

House supply may start falling

- Worsening of credit availability will probably hurt not only households interested in buying real estate but also enterprises in the construction sector.
- Due to credit crunch, deterioration in business climate and decline in demand forecasts, it seems likely that construction enterprises will start cutting investment plans in the nearest quarters.
- While in the months ahead, the number of house completions will remain high due to realisation of projects started earlier, in one or two years perspective there may be a clear drop in new flats supply. As the structural demand in Poland is still high, it may imply another wave of house price growth in approximately two years time.

Central bank watch

Key fragments of the MPC statement as compared to August

The Polish economy is still in the period of growth encompassing most of its sectors. However, data released recently confirm earlier signals suggesting that the economic growth is gradually slowing down. **Data released recently suggest that - despite better than expected data on GDP in 2008 Q2 - economic growth may markedly decline in the coming quarters.** At the same time, information on labour market developments points to a sustained high growth of wages and a continuously unfavourable relation between wage and labour productivity growth.

Both the national accounts data and other information concerning economic activity in the euro area indicates stronger than expected a **continuing marked decline in GDP growth** in that region. In the United States, despite favourable data for 2008 Q2, subsequent quarters are still expected to see **further slowdown** a decline in economic activity. **Additionally, intensified turmoil in the financial markets observed recently is likely to deepen the economic slowdown in the external environment of the Polish economy.** At the same time, many countries continue to record increased, yet falling, inflation. Recently, oil prices in the world markets have **continued to decrease** ~~decreased markedly, albeit remaining at a relatively high level.~~

In the Council's assessment, in the coming quarters the pressure on wage increases will probably persist, although the gradually declining economic growth, **probably below potential output growth**, weakening labour demand and deteriorating financial results of enterprises should be easing the wage pressure and, consequently, also the inflationary pressure.

In view of the persisting uncertainty as to the scale of the slowdown in the Polish economy, the Council assessed that a more comprehensive assessment of the inflation outlook would be possible after analysing the data released in the near future and the **October projection of inflation and GDP.**

The Council has adopted a resolution on the Monetary Policy Guidelines for 2009 which took account of the results of the Monetary Policy Council meeting with the Prime Minister and the Government representatives held on 16 September 2008 devoted to the possibility of Poland joining the euro area.

Key fragments of the Monetary policy guidelines for 2009

The basic objective of the monetary policy conducted in 2009 will be – as in the previous years – to maintain inflation at the level of 2.5% in the medium term. At the same time, monetary policy will continue to be conducted in such a way as to support sustainable economic growth.

If a binding decision is taken on the scheduled date of Poland joining the euro area, the Council will pursue monetary policy that will make it possible to meet the convergence criteria, and thus allow Poland's adoption of the euro at a scheduled date.

In Poland 2009 is expected to bring a decline in economic growth. The structure of GDP growth is unlikely to change significantly, with rising domestic demand continuing to play the key role (although, as compared with 2008 it will be to a larger extent related to consumption growth, and to a lesser extent to investment growth) and the contribution of net exports to GDP growth remaining negative. Slowdown in economic growth should ease the inflationary pressure and be conducive to stabilizing the current account deficit.

Lower rates abroad will affect MPC decisions

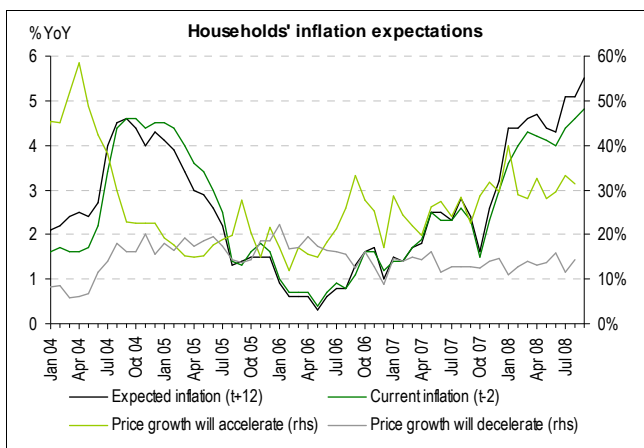
- The Monetary Policy Council has left main interest rates on hold in September. The tone of the official communiqué was close to the previous month's version, although slightly more dovish.
- One should notice that there was more significant emphasis on the risk of severe economic slowdown in the next quarters, both in Poland and abroad. The Council stated for the first time that economic growth rate in Poland may be below potential.
- Despite higher concern about scale of economic slowdown, the MPC maintained an informal restrictive policy bias and did not rule out further rate hikes.
- The MPC met at a special meeting in October, just after the main central banks' coordinated rate cut. Local rates were kept on hold and the Council said in a statement that effect of world central banks' action will be taken into account when analysing inflation and GDP growth prospects at the end of month.
- Does it mean a looming rate cut? Rather not, as in our opinion prospects of economic growth and stability of Polish financial sector are far better than abroad, while inflation rate is clearly above the inflation target. However, probability of more interest rate hikes has clearly decreased. It cannot be ruled out that at the next meeting the MPC will signal a change in policy bias to neutral.
- Important for the MPC decision will be the results of the new inflation projection that will show to what extent economic slowdown will affect inflation outlook. As regards prospects of euro zone entry, the Council agreed that it will wait for "binding decision" on this issue (see below).

MPC will wait for binding decision about euro

- *Monetary policy guidelines for 2009* are not very much different from 2008 version. Target of monetary policy and tools for its realisation remained unchanged.
- The MPC said that only after making a "binding decision about euro zone entry there will be adjustment in monetary policy strategy and in foreign exchange policy to conditions resulting from a necessity to meet convergence criteria".
- Monetary policy will be then subordinated to a goal of permanent fulfilment of all convergence criteria, which according to MPC members may require more restrictive policy.
- It is not certain whether in the MPC's view a "binding decision" will be the government's road map to the euro zone. Anyway, the agenda may be released at the end of October instead in the middle of month, possibly after MPC meeting.

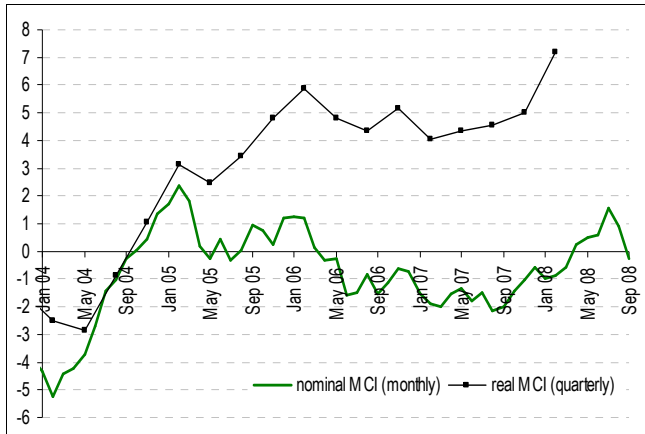
Inflation expectations still rising

- In September, index of households' inflationary expectations increased once again, reaching 5.5%, the highest level for seven years.
- To large extent, this resulted from an increase in currently observed inflation, on which the index level is based.
- Nevertheless, a ratio of people saying that prices will be growing at the same pace as now or faster (ca. 78%) was only slightly lower than in July (80%).
- At the same time, ratio of those who believed that prices will be growing at slower pace in the next twelve months has increased slightly (from 11.5% to 14.2%).



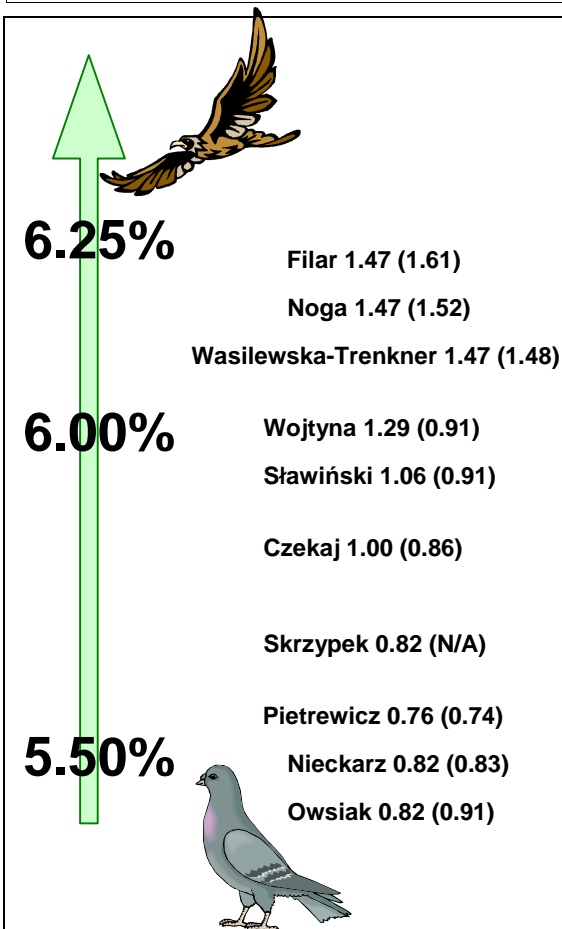
Źródło: NBP, Reuters

Restrictiveness of the Monetary Policy (Council)



MCI in September down the second straight month

- September brought clear fall in nominal MCI. This resulted mainly from increase in EURPLN, which narrowed difference to the appreciation side between the market zloty rate and our estimate of its long term-trend that proxies equilibrium rate.
- The scale of the difference was rapidly rising from April to July this year and particularly towards the end of the period some MPC members were expressing opinion that the pace of the zloty market exchange rate appreciation exceeds pace of the equilibrium exchange rate appreciation. This was an argument against rate hikes. The zloty weakening in the two last months blunts this argument.
- Taking into account recent developments in the local FX market, one may expect MCI to fall further in October despite rise in WIBOR rate.



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.

No change in restrictiveness index, target rates down again

Over the last month, our knowledge about outcome of votes at MPC meetings was not enriched. Already before publication of our previous report we had known results of the vote to hike rates by 25bps in June. Results of possible other votes, which did not end with change in rates, will be revealed only in the new *Inflation Report*.

Hawks still want to hike

Hawkish faction of the MPC continued calls for rate hikes. Of course, the calls were stronger before the coordinated rate cut by world's major central banks. For instance, Marian Noga said on October 2 in an interview with Reuters that in order to bring inflation back to target of 2.5% in the medium term, there is a need for one more hike and it should take place as soon as possible. At the same time, he suggested that if inflation prospects would be improving, the MPC bias could be changed to neutral from restrictive the next year. However, first rate cuts could be delivered not earlier than in 2010, in his opinion. Comments from other hawks, D. Filar and H. Wasilewska-Trenkner were similar. In Noga's view, the new inflation projection will be of high importance. He also said that the NBP reference rate should converge to the ECB refinancing rate and in the light of this the recent rate cut by the ECB of 50bp may discourage prof. Noga and other hawks to insist on next rate hikes.

Śławiński stresses importance of the planned euro zone entry

Until recently, the hawkish action within the MPC could have count on moderate rate-setter Andrzej Śławiński. For instance, after declaration of Prime Minister Donald Tusk that Poland will target at euro adoption in 2012, prof. Śławiński said in an interview with TVN CNBC that "project of Poland entry to the ERM2 and then to the euro zone means that our monetary policy will probably be relatively more restrictive than in the other situation". It seems, however, that while before the coordinated rate cut of 50bp by the world's major banks the "relatively more restrictive policy" probably meant a rate hike for prof. Śławiński, now it probably means stable rates for a longer time.

Czekaj put a question mark over a need for the next hike

MPC member Jan Czekaj, who he has been the only MPC member voting always in line with majority since the beginning of 2007, yet in late September said in an interview with TVN CNBC that after data for September and publication of the new inflation projection "one cannot exclude one rate hike", although already at that time he expected that GDP growth in 4Q08 and 1Q09 might slow down below 4%. A few days later, on October 2, prof. Czekaj put a question mark over a need for the next rate hike. "I believe that the situation is such that a rate hike is not needed immediately. I even wonder whether another hike will be needed at all". Now, he is likely to have even more doubts.

Can NBP governor support a hike?

An answer to this question seemed to be positive before the coordinated rate cut by the world's major central bank, as Mr. Skrzypek had stressed the importance of prospects for swift euro adoption in Poland. However, currently his inclination to hikes probably decreased or even changed to inclination to cuts.

Government and politics

Statement after Prime Minister's meeting with the MPC

On 16 September 2008, Prime Minister Donald Tusk and government representatives met with members of the Monetary Policy Council and its head, Governor of the National Bank of Poland, Sławomir Skrzypek. The following issues were agreed upon during the meeting:

- 2011 should be the year of fulfilling the criteria and positive decision of the European Commission concerning Poland's accession to the euro zone,
- the government, the Monetary Policy Council and the National Bank of Poland are ready to cooperate closely in order to achieve this goal,
- detailed schedule will be prepared in October following political consultations,
- working groups of the Ministry of Finance and the National Bank of Poland will soon start work preparing the accession path to the Exchange Rate Mechanism (ERM II).

Government's comments about euro zone entry

Donald Tusk, Prime Minister, Reuters, 7 October

I received information that the opposition wants to see a detailed agenda tomorrow in the Sejm. (...) Tomorrow the detailed agenda will not be ready for sure, however we assume that until the end of October the road map will be prepared and we will present it in public.

Jacek Rostowski, finance minister, PAP, 9 October

I confirm that ambitious yet realistic goal of the government is Poland's admission to the euro zone in 2011. According to the plan, the first half of next year is the best moment to join the ERM2 system. In the middle of 2011 we will ask the European Commission to confirm Poland's eligibility to enter the euro zone and calculation of the zloty exchange rate to euro. I believe that on January 1, 2012 Poland will formally join the euro zone.

Katarzyna Zajdel-Kurowska, deputy finance minister, Reuters, 8 October

Poland is in long-term appreciation trend. The more we wait (with ERM2 entry), the less favourable will be the zloty exchange rate.

Shorter road to the euro zone?

In September, there was an important change in the government's stance regarding Poland's entry to the euro zone. While until recently the officials avoided indicating any target date of adopting the euro, now the government declared that 2011 should be a year when convergence criteria are fulfilled and the European Commission issues a positive decision concerning Poland's euro zone accession. It suggests that switching the zloty to euro could take place in January 2012.

Realisation of the declared scenario will not be easy. A main problem that the government must face is lack of sufficient support in the parliament to change the constitution that is required before the euro zone entry. Without certainty that changes will be made, it is very risky to decide about entry to ERM-2, where the zloty must stay for at least two years without significant tensions to comply with exchange rate stability criterion. In order to enter the euro zone in 2012, entry to ERM-2 should take place no later than until the middle of 2009.

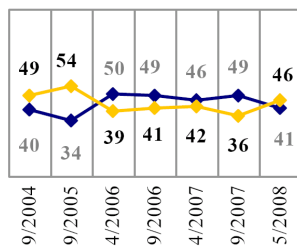
According to PM Tusk, if the opposition PiS does not agree to change constitution, a referendum is possible in the spring 2009. The problem is that either the result and the turnover in the referendum are highly uncertain (which is highlighted by recent OBOP opinion poll, see below).

In effect, despite strong government's declaration, entry to the euro zone in 2012 is under big question mark. Still, announcement of target date and start of preparations should be a factor stabilising the FX market is times of confidence crisis in world financial markets.

After the government presents the road map to the euro zone at the end of October, we will release more detailed report on this issue in the next MACROscope.

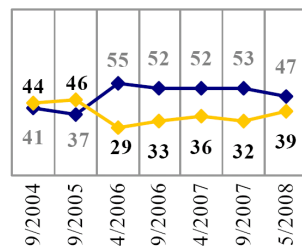
Are you personally happy or not that the euro could replace the zloty?

- very and rather happy
- very and rather unhappy



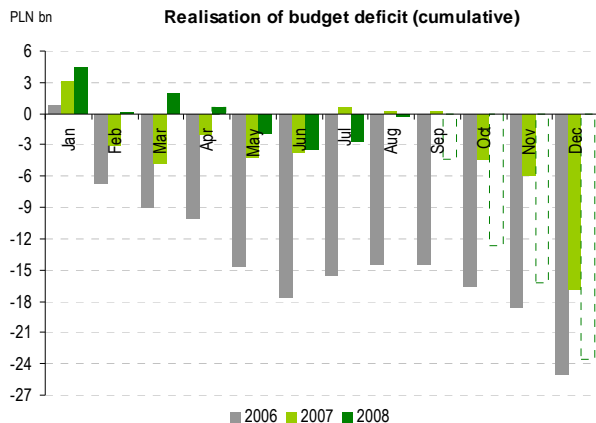
Do you think the introduction of the euro would have positive or negative consequences for Poland?

- very and rather positive
- very and rather negative



Flash Eurobarometer, The Gallup Organization

Realisation of budget deficit (cumulative)



... while most Poles are sceptical about euro adoption

OBOP opinion survey in the middle of September showed that 55% of Poles were sceptical about fast euro zone entry.

Negative trend was also confirmed by Eurobarometer, European Commission's cyclical survey, according to which there was a clear decline in support for euro adoption in Poland since September 2007 until May 2008 and the number of opponents (46%) exceeded the number of enthusiasts (41%) for the first time since 2005. There was also worsening in opinions about expected impact of euro adoption on the economy and households' own situation.

According to EC report, trends in Poland in the latest survey were the most negative among all new Member States.

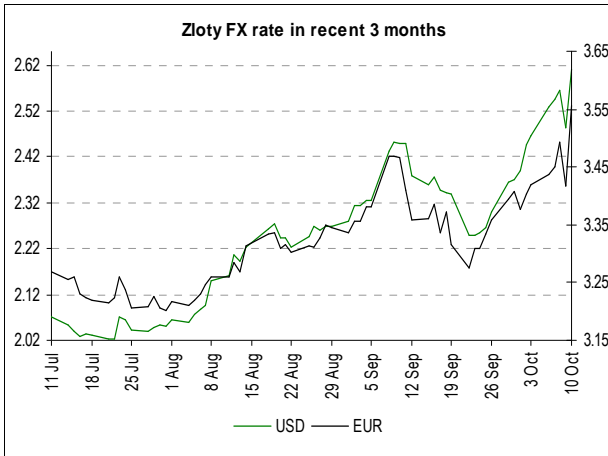
Spending growth kicked off in September?

After eight months of the year the state budget recorded a deficit of merely PLN325m, which implies a PLN2.3bn surplus in August.

While growth rate of indirect tax inflows decreased in August, PIT and CIT revenues were rising fast (12.3% and 11.4% correspondingly) reflecting solid increase in incomes of households and enterprises.

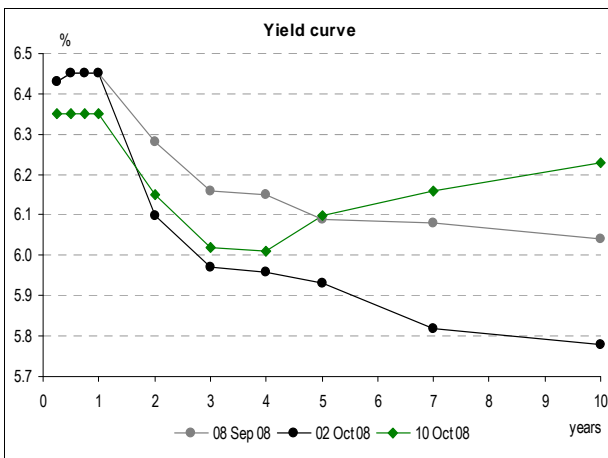
Realisation of spending after eight months was still much below plan. According to deputy finance minister Elżbieta Suchocka-Roguska, there was an acceleration in spending growth in September, and the deficit increased to ca. PLN4.5bn (over 16% of the annual plan). In the entire year, deficit will be probably close to PLN24bn.

Market monitor



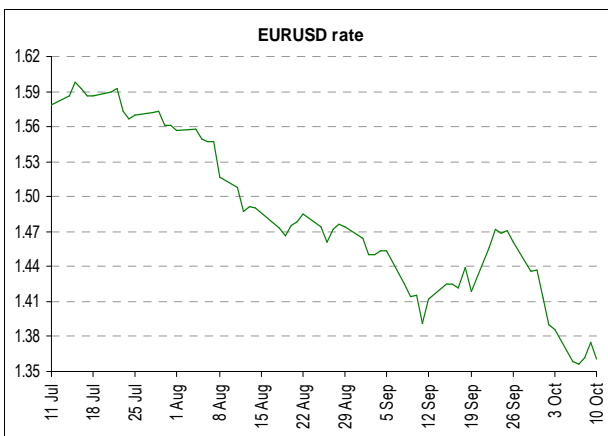
Another zloty sell-off

- After the zloty approached 3.50 against the euro at the start of September it strongly recovered, which went in line with a slight rebound in the equity markets. The government declaration on willingness to enter the euro zone in 2012 positively affected the zloty. A sudden rise in risk aversion was a result of a series of negative events in the international financial markets, the dollar strengthening and negative news from Hungary. This led to further depreciation and EURPLN temporarily exceeded 3.60.
- In our view the zloty may be still biased by the negative moods in the world markets. It may also be affected by lowered domestic economic activity forecasts. However the slowdown in Poland should be smaller than in the euro zone and the US, which together with euro adoption prospects, still good situation in external relations and expected upward EURUSD correction should support the zloty.



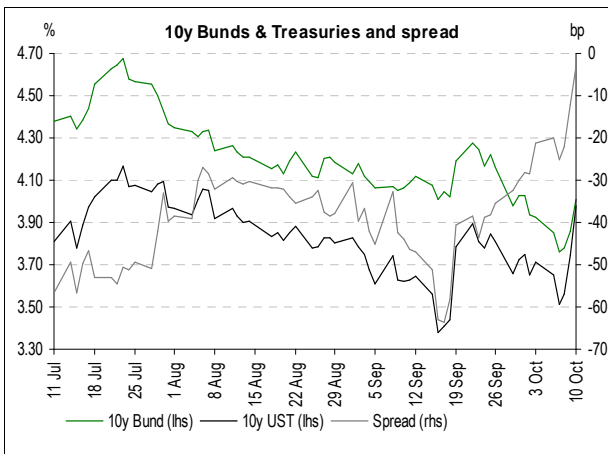
Debt market strengthens, IRS rates drops more

- During the last weeks there was a strengthening in the domestic debt market, though after negative news from Hungary yields suddenly jumped and debt market liquidity collapsed. Initially the strengthening was supported by the domestic data. The comments on euro adoption plans by Poland stabilised the shorter end of the yield curve, while the longer end strengthened on EMU convergence play (temporary drop of 5x5 spread to 10 pts). The financial markets turmoil contributed to softening of some MPC members' opinions, There was also a large increase in asset swap spread on deep IRS fall.
- After interest rate cuts by the major central banks, including the ECB and current situation in the financial markets the MPC will not decide to raise rates in October. However, the prospects of euro zone entry delay in time possibility of rate cuts.



The dollar continues to strengthen

- In September and at the start of October the dollar appreciation, which started in mid-July was continued. After weaker and negative news from the US financial sector (e.g. Lehman Brothers bankruptcy, nationalisation of AIG) the EURUSD rate bounced back above 1.47. Afterwards there was a series of negative news from the European banking sector and in US a rescue plan for financial sector was approved by the US Congress. Moreover the ECB communiqué clearly softened. The frozen credit markets and increased demand for the dollar increased the purchases of the US currency in the FX markets.
- In our view recent dollar appreciation may be perceived as excessive. We think that in short-term the euro may recover amid moods improvement in the world markets. Later on, the dollar appreciation should continue though at much slower pace.

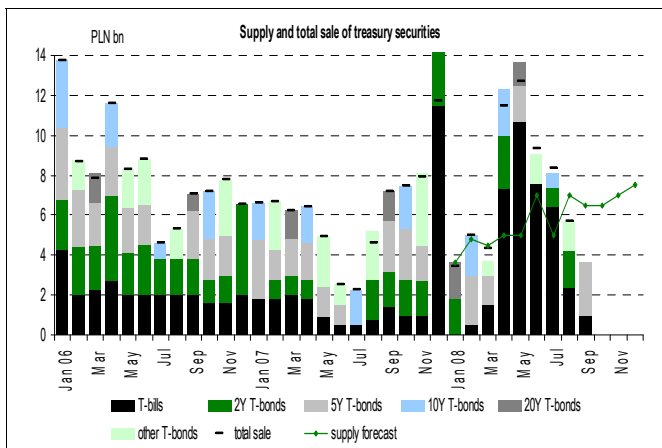
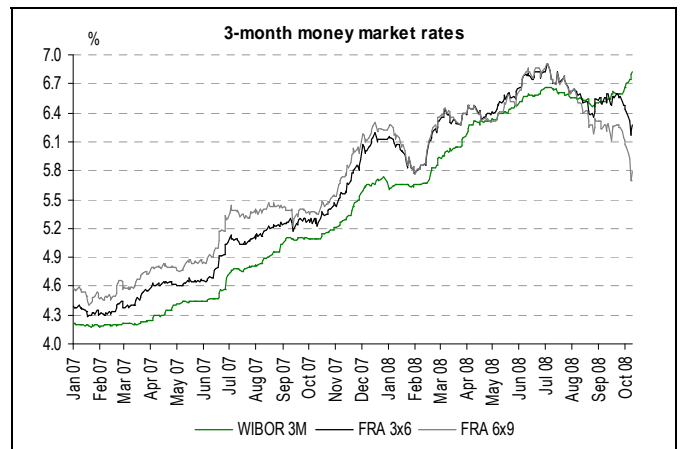
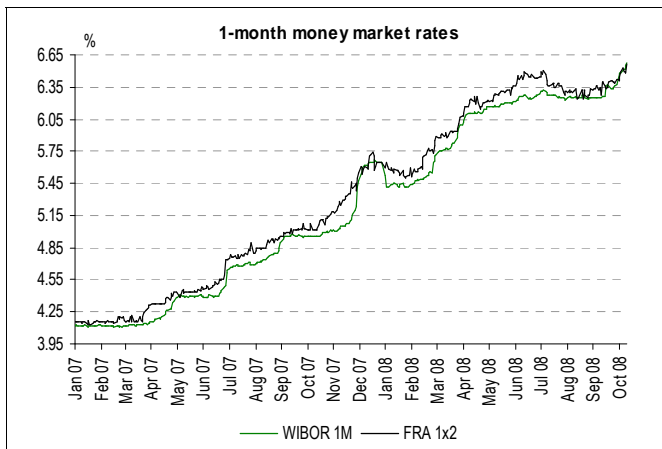
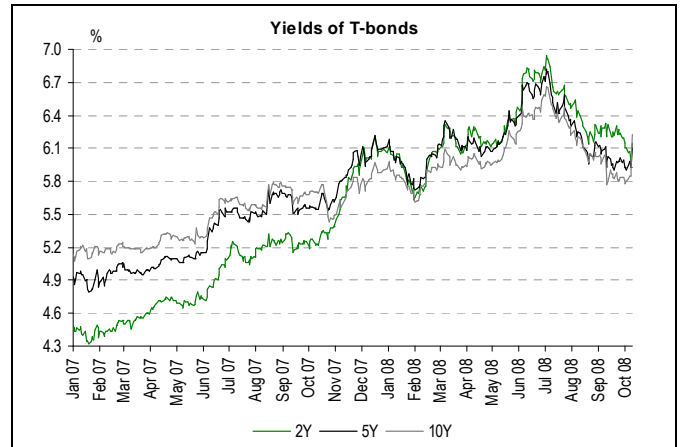
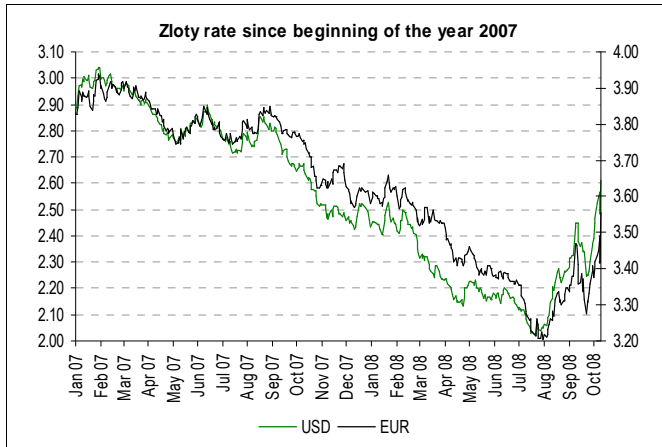


Bunds vs. Treasuries close to zero

- Amid negative news from the US financial sector and prospects of large Bond supply in order to purchase bad assets of financial institutions there was a significant weakening of the US government bonds. Later on there was a significant increase of risk aversion and of interest in safe haven assets, which strengthened core debt markets. The "dovish" comments of ECB were important for the euro zone market. However in mid-October there was another sell-off on investor's preference of holding cash. Yields of 10Y Treasuries rose over a month by 25 and Bunds fell by 4 bp.
- We expect the ECB to cut rates again yet this year and is going to continue monetary policy easing next year cutting rates by 25 bp each quarter down to 3.0%. We also expect the Fed will decrease rates by 25 bp till year end and will pursue with one more in Q109 to 1% for Fed Funds rate. The rates will be cut on deteriorating prospects of economic growth amid falling inflation.

Source: Reuters, BZ WBK

Market monitor



| Date of auction | (OFFER)*/SALE | | | | | |
|-----------------|---------------|-----------|---------|----|----|----|
| | 52W | 26W | 13W | 5W | 3W | 2D |
| 14.07.2008 | 1200/1298 | - | 500/629 | - | - | - |
| 21.07.2008 | - | 1000/1000 | 500/500 | - | - | - |
| 28.07.2008 | - | 1000/1023 | 500/526 | - | - | - |
| 04.08.2008 | 1200/1200 | 1200/1200 | - | - | - | - |
| 11.08.2008 | 700/700 | 700/700 | - | - | - | - |
| 18.08.2008 | 500/500 | 500/500 | - | - | - | - |
| 01.09.2008 | 500/500 | 500/502 | - | - | - | - |
| 08.09.2008 | 500/500 | 500/500 | - | - | - | - |
| 15.09.2008 | 800/800 | 800/800 | - | - | - | - |
| 06.10.2008 | 1500/1500 | - | - | - | - | - |
| 13.10.2008 | 800 | - | 800 | - | - | - |
| 20.10.2008 | 0-1500 | - | - | - | - | - |
| 27.10.2008 | 0-1500 | - | - | - | - | - |

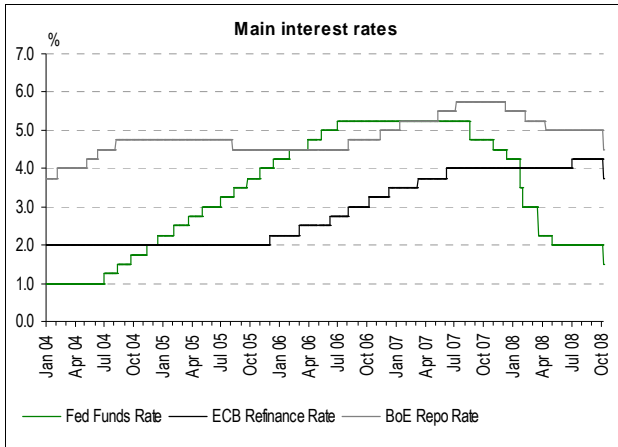
* based on data of the Ministry of Finance

| 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 | 23.07 | PS0413 | 1558 |
| August | 06.08 | OK0710 | 1 800 | 1 830 | 13.08 | WZ0118 IZ0823 | 1 000 500 | 1 000 451 | 22.08 | DS1017 | 1244 |
| September | 03.09 | PS0413 | 2 640 | 2 640 | 10.09 | WS0429 | 1 000 | 1 000 | 17.09 | DS1017/WS0429 | 3113/590 |
| October | 01.10 | PS0414 | 2 160 | 2 160 | 08.10 | DS1019 | 3 000 | 3 000 | - | - | - |
| November | 05.11 | 5Y | - | - | 12.11 | 12YCP 10Yfloat | - | - | - | - | - |
| December | 03.12 | 2Y | - | - | - | - | - | - | - | - | - |

* with supplementary auction

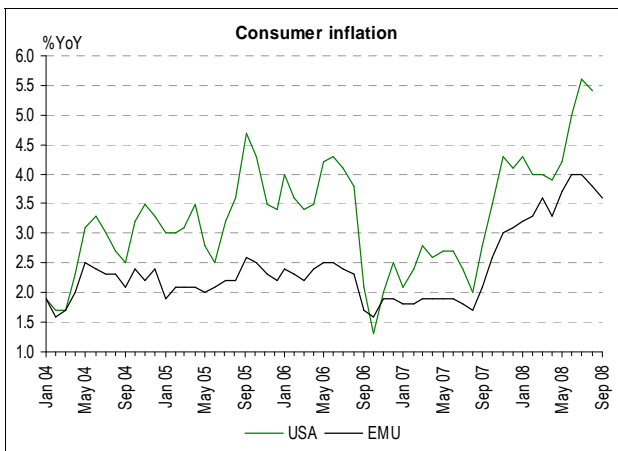
Source: Ministry of Finance, Reuters, BZ WBK

International review



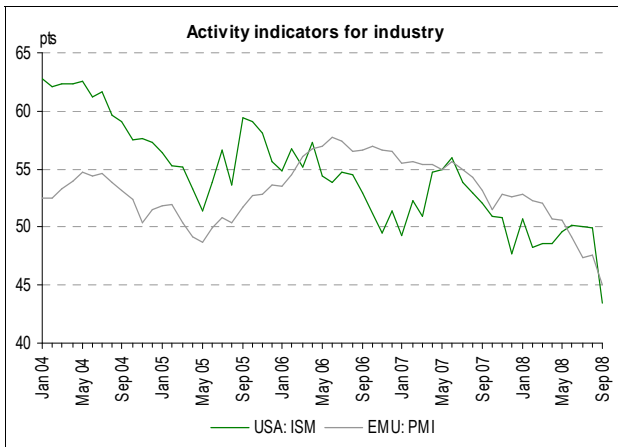
Major central banks cuts interest rates

- In September Fed left interest rates unchanged. According to the Fed minutes members of the Federal Reserve Board stated the inflation risk in the economy is smaller. At the same time it was underlined that interest rate cut may be needed, if the financial markets negatively affects economic growth.
- ECB left rates unchanged at the official meeting in October. However the tone of the ECB communiqué was softer than before. According to Trichet risks to economic growth are rising and inflation risks diminished, though they were not eliminated.
- Amid mounting pressure and uncertainty in the financial markets the speculation was growing for interest rate cuts by the major central banks. These expectations fulfilled a few days after the ECB decision. Fed, ECB, Bank of England, Bank of Canada and Swedish Riksbank cut interest rates by 50 bp, Bank of China by 27 bp and Swiss central bank by 25 bp in order to bring back trust in the credit markets.



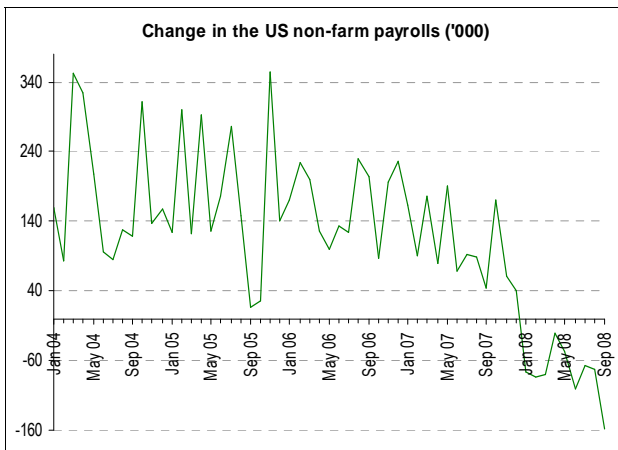
Lower inflation

- According to official and final data in the euro zone the inflation fell in August to 3.8%YoY from 4.0%YoY in July. On the other hand according to preliminary estimates for September inflation fell again to 3.6%.
- The US consumer prices fell in August by 0.1% as expected, and core inflation was at 0.2%MoM. The annual inflation was at 5.4% against forecasted 5.5%. The core CPI rose by 2.5% against expected 2.6%. PPI recorded a deeper decline (-0.9%MoM, 9.6%YoY) than expected (-0.5%). The core PPI index increased by 0.2% (3.6%YoY).
- The drops of commodities prices (on expected global economic slowdown) and food (amid quite good crops) may support the inflation prospects.



Poor data from the US, similar in the euro zone

- The PMI index in the manufacturing sector fell in September to the lowest level in 7 years, ie. 45 pts. PMI index for the services sector in the euro zone was below the market forecast and was at 48.4 pts. This is still a level close to the lowest in 5 years. The prices index fell to the lowest level since 2006 and expectations index in business was the lowest in 10 years. German Ifo disappointed in September and fell to 92.9 pts from 94.8.
- The ISM index for the US manufacturing sector fell in September to 43.5 pts against expected decline to 49.5 pts. ISM index for services fell to 50.2 pts from 50.6 pts in August, against expected decline to 50 pts, and this is still a poor result showing a marginal increase in activity in this sector. Drops were recorded by the employment and prices indices, while the new orders index increased. US retail sales fell in September by 0.3% against expected increase by 0.2%MoM.



- The housing market in the US is still limping looking its bottom. The home sales in the secondary market fell in August to 4.91m from 5m in July, and in the primary market to 460k from 520k.
- On the other hand the Philly Fed activity indices, Chicago PMI, consumer sentiment Michigan were better than expected.
- The US Q2 GDP growth was downwardly revised to 2.8% from earlier estimates of 3.3% due to downward revision of individual consumption and net exports.

Next poor data from the US labour market

- The rate of unemployment in the US remained at 6.1% in September. However, the non-farm payrolls dropped by 159k (expectations -105k) after a decline by 73k in August. Data for August and July were revised by 4k to the upside.

Source: Reuters, ECB, Federal Reserve

Economic calendar

| Monday | Tuesday | Wednesday | Thursday | Friday |
|---|--|--|---|--|
| 13 October <i>PL: Auction of Treasury Bills</i> <i>PL: Balance of payments (Sep)</i> | 14 <i>PL: CPI (Sep)</i> <i>PL: Money supply (Sep)</i> DE: ZEW index (Oct) EZ: Industrial production (Aug) | 15 <i>PL: Wages and employment (Sep)</i> EZ: Final HICP (Sep) US: PPI (Sep) US: NY Fed index (Oct) US: Retail sales (Sep) | 16 US: CPI (Sep) US: Capacity utilisation (Sep) US: Industrial production (Sep) US: Capital flows report (Aug) US: Philadelphia Fed index (Oct) | 17 <i>PL: Industrial production (Sep)</i> <i>PL: PPI (Sep)</i> US: House starts (Sep) US: Build permits (Sep) US: Preliminary Michigan (Oct) |
| 20 <i>PL: Auction of Treasury Bills</i> US: Leading indicators (Sep) | 21 <i>PL: Core inflation (Sep)</i> | 22 <i>PL: Switch auction</i> | 23 <i>PL: MPC minutes (Aug)</i> <i>PL: Business climate (Oct)</i> <i>PL: Retail sales (Sep)</i> <i>PL: Unemployment (Sep)</i> | 24 EZ: Flash PMI – manufacturing sector (Oct) EZ: Flash PMI – services sector (Oct) US: Home sales (Sep) |
| 27 <i>PL: Auction of Treasury Bills</i> DE: Ifo index (Oct) EZ: M3 money supply (Sep) US: New home sales (Sep) | 28 <i>PL: MPC meeting</i> DE: Gfk index (Nov) US: Case/Shiller house price index | 29 <i>PL: MPC meeting – decision</i> US: Durable goods orders (Sep) US: Fed meeting - decision | 30 EZ: Sentiment index (Oct) US: Flash GDP (Q3) US: Core PCE (Q3) US: GDP deflator (Q3) | 31 EZ: Flash HICP (Oct) US: Core PCE (Aug) US: Chicago PMI (Oct) US: Final Michigan (Oct) |
| 3 November EZ: PMI – manufacturing sector (Oct) US: ISM – manufacturing sector (Oct) | 4 EZ: PPI (Sep) US: Factory orders (Sep) | 5 <i>PL: Auction of 5Y bonds</i> EZ: PMI – services sector (Oct) EZ: Retail sales (Oct) US: ADP report (Oct) US: ISM – services sector (Oct) | 6 EZ: ECB decision GB: BoE decision US: Unit labour costs & productivity (Q3) | 7 US: Non-farm payrolls (Oct) US: Unemployment (Oct) |
| 10 | 11 <i>PL: Independence Day – market holiday</i> US: Market holiday DE: ZEW index (Nov) | 12 <i>PL: Auction of 12YCPI linked and 10Y floating rate bonds</i> EZ: Industrial production (Sep) | 13 US: Trade balance (Sep) | 14 <i>PL: Money supply (Oct)</i> EZ: Preliminary GDP (Q3) EZ: Final HICP (Oct0) US: Import prices (Oct) US: Retail sales (Oct) US: Preliminary Michigan (Nov) |

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 ^a | 13 ^b | 15 | 14 | 13 | 15 | 13 | 15 | 14 | 13 | 15 |
| Core inflation | 22 | - | 21 ^b | 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 | 25 | 26 | 26 | 23 | - | - |
| Gross wages, employment | 16 | 15 | 17 | 15 | 19 | 16 | 15 | 18 | 15 | 15 | 18 | 15 |
| Unemployment | 24 | 25 | 26 | 22 | 28 | 24 | 25 | 26 | 26 | 23 | - | - |
| Foreign trade | about 50 working days after reported period | | | | | | | | | | | |
| Balance of payments* | 2 | - | 31 | - | - | 30 | - | - | 30 | - | - | 30 |
| Balance of payments | 18 ^c | 12 | 13 | 15 | 15 | 17 | 15 | 12 | 12 | 13 | 12 | 12 |
| Money supply | 14 | 14 | 14 | 14 | 14 | 13 | 14 | 14 | 12 | 14 | 14 | 12 |
| NBP balance sheet | 7 | 7 | 7 | 7 | 7 | 6 | 7 | 7 | 5 | 7 | 7 | 5 |
| Business climate indices | 23 | 22 | 21 | 23 | 23 | 23 | 23 | 22 | 23 | 23 | 21 | 22 |

* quarterly data, ^a preliminary data for January, ^b January and February, ^c November 2007

Source: CSO, NBP

Economic data and forecasts

Monthly economic indicators

| | | Sep 07 | Oct 07 | Nov 07 | Dec 07 | Jan 08 | Feb 08 | Mar 08 | Apr 08 | May 08 | Jun 07 | Jul 08 | Aug 08 | Sep 08 | Oct |
|--|--------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|-------|
| Industrial production | %YoY | 5.4 | 10.8 | 8.5 | 6.4 | 10.7 | 15.0 | 1.0 | 15.1 | 2.4 | 7.3 | 5.9 | -3.7 | 6.0 | 0.4 |
| Retail sales ^c | %YoY | 14.2 | 19.4 | 19.2 | 12.4 | 20.9 | 23.8 | 15.7 | 17.6 | 14.9 | 14.2 | 14.3 | 7.7 | 13.5 | 10.6 |
| Unemployment rate | % | 11.6 | 11.3 | 11.2 | 11.4 | 11.7 | 11.5 | 11.1 | 10.5 | 10.0 | 9.6 | 9.4 | 9.3 | 9.2 | 9.1 |
| Gross wages ^{b,c} | %YoY | 9.5 | 11.0 | 12.0 | 7.2 | 11.5 | 12.8 | 10.2 | 12.6 | 10.5 | 12.0 | 11.6 | 9.7 | 11.4 | 9.3 |
| Employment ^b | %YoY | 4.7 | 5.0 | 5.0 | 4.9 | 5.9 | 5.9 | 5.8 | 5.6 | 5.4 | 4.8 | 4.7 | 4.2 | 4.0 | 3.7 |
| Export (€) ^d | %YoY | 9.0 | 15.6 | 11.3 | 8.0 | 22.6 | 29.1 | 10.6 | 34.1 | 12.5 | 16.6 | 21.7 | 6.7 | 24.8 | 7.7 |
| Import (€) ^d | %YoY | 15.1 | 19.7 | 19.8 | 16.6 | 19.8 | 31.4 | 12.2 | 31.8 | 13.5 | 19.7 | 20.8 | 16.9 | 25.4 | 11.6 |
| Trade balance ^d | EURm | -1024 | -1019 | -1333 | -1673 | -780 | -808 | -1345 | -1032 | -1213 | -1639 | -1563 | -1481 | -1341 | -1551 |
| Current account balance ^d | EURm | -881 | -1459 | -824 | -2314 | -1211 | -1322 | -1807 | -1282 | -1495 | -2098 | -1222 | -1481 | -1216 | -1851 |
| Current account balance ^d | % GDP | -4.4 | -4.5 | -4.4 | -4.7 | -4.7 | -4.8 | -5.0 | -5.0 | -5.0 | -5.0 | -4.8 | -4.9 | -4.9 | -5.0 |
| Budget deficit (cumulative) | PLNbn | 0.2 | -4.4 | -6.0 | -16.9 | 4.4 | 0.0 | 1.9 | 0.6 | -1.9 | -3.5 | -2.7 | -0.3 | -4.4 | -12.6 |
| Budget deficit (cumulative) ^e | % of FY plan | -1.2 | 26.2 | 35.5 | 100.0 | -16.4 | -0.1 | -6.9 | -2.2 | 6.8 | 12.8 | 9.9 | 1.2 | 16.3 | 46.6 |
| CPI | %YoY | 2.3 | 3.0 | 3.6 | 4.0 | 4.0 | 4.2 | 4.1 | 4.0 | 4.4 | 4.6 | 4.8 | 4.8 | 4.5 | 4.1 |
| PPI | %YoY | 1.8 | 2.0 | 2.5 | 2.3 | 2.9 | 3.2 | 2.9 | 2.5 | 2.7 | 2.6 | 2.1 | 2.0 | 2.1 | 2.5 |
| Broad money (M3) | %YoY | 14.4 | 13.8 | 13.6 | 13.4 | 12.9 | 13.5 | 13.6 | 15.0 | 15.1 | 16.3 | 16.8 | 16.6 | 16.7 | 16.1 |
| Deposits | %YoY | 15.4 | 15.2 | 15.1 | 14.5 | 14.3 | 14.7 | 15.3 | 16.7 | 17.4 | 18.5 | 19.4 | 18.8 | 18.7 | 17.7 |
| Loans | %YoY | 31.0 | 30.6 | 30.1 | 29.9 | 30.3 | 29.5 | 29.7 | 28.3 | 27.6 | 27.7 | 25.3 | 26.3 | 24.9 | 24.1 |
| USD/PLN | PLN | 2.73 | 2.61 | 2.49 | 2.47 | 2.46 | 2.43 | 2.28 | 2.19 | 2.19 | 2.17 | 2.07 | 2.19 | 2.34 | 2.52 |
| EUR/PLN | PLN | 3.79 | 3.71 | 3.66 | 3.60 | 3.61 | 3.58 | 3.54 | 3.45 | 3.40 | 3.37 | 3.26 | 3.29 | 3.37 | 3.48 |
| Reference rate ^a | % | 4.75 | 4.75 | 5.00 | 5.00 | 5.25 | 5.50 | 5.75 | 5.75 | 5.75 | 6.00 | 6.00 | 6.00 | 6.00 | 6.00 |
| Lombard rate ^a | % | 6.25 | 6.25 | 6.50 | 6.50 | 6.75 | 7.00 | 7.25 | 7.25 | 7.25 | 7.50 | 7.50 | 7.50 | 7.50 | 7.50 |
| WIBOR 3M | % | 5.09 | 5.13 | 5.36 | 5.67 | 5.64 | 5.74 | 6.03 | 6.29 | 6.41 | 6.58 | 6.62 | 6.52 | 6.56 | 6.50 |
| Yield on 52-week T-bills | % | 5.01 | 5.04 | 5.30 | 5.78 | 5.75 | 5.66 | 6.09 | 6.10 | 6.10 | 6.63 | 6.70 | 6.60 | 6.46 | 6.40 |
| Yield on 2-year T-bonds | % | 5.25 | 5.30 | 5.77 | 6.06 | 5.92 | 5.90 | 6.17 | 6.20 | 6.27 | 6.73 | 6.66 | 6.32 | 6.25 | 6.10 |
| Yield on 5-year T-bonds | % | 5.60 | 5.59 | 5.90 | 6.07 | 5.94 | 5.93 | 6.20 | 6.12 | 6.25 | 6.62 | 6.53 | 6.15 | 6.01 | 5.95 |
| Yield on 10-year T-bonds | % | 5.69 | 5.64 | 5.70 | 5.85 | 5.81 | 5.82 | 5.98 | 5.98 | 6.10 | 6.41 | 6.43 | 6.10 | 5.89 | 5.90 |

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

^a at the end of period ^b in corporate sector ^c in nominal terms ^d balance of payments data on transaction basis ^e 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 | 1 276.7 | 1 370.1 | 267.7 | 281.5 | 288.5 | 330.1 | 294.1 | 308.5 | 315.7 | 358.5 |
| GDP | %YoY | 6.2 | 6.6 | 5.2 | 3.9 | 7.3 | 6.5 | 6.5 | 6.4 | 6.1 | 5.8 | 4.5 | 4.5 |
| Domestic demand | %YoY | 7.3 | 8.3 | 6.3 | 5.6 | 9.3 | 9.2 | 8.4 | 6.5 | 6.3 | 6.2 | 6.2 | 6.4 |
| Private consumption | %YoY | 5.0 | 5.0 | 5.3 | 5.1 | 6.8 | 4.9 | 4.8 | 3.6 | 5.6 | 5.6 | 5.1 | 5.1 |
| Fixed investments | %YoY | 14.9 | 17.6 | 13.2 | 9.2 | 23.8 | 19.0 | 16.7 | 15.2 | 15.7 | 15.2 | 13.5 | 11.0 |
| Industrial production | %YoY | 12.5 | 9.7 | 5.7 | 4.5 | 13.0 | 8.5 | 8.1 | 9.6 | 8.5 | 8.5 | 2.7 | 3.2 |
| Retail sales (real terms) | %YoY | 11.9 | 14.0 | 10.7 | 8.4 | 17.4 | 14.1 | 12.8 | 12.2 | 16.0 | 11.1 | 7.8 | 7.9 |
| Unemployment rate ^a | % | 14.8 | 11.4 | 9.5 | 9.6 | 14.3 | 12.3 | 11.6 | 11.4 | 11.1 | 9.6 | 9.2 | 9.5 |
| Gross wages (real terms) ^c | %YoY | 4.2 | 6.7 | 6.2 | 3.4 | 5.9 | 6.5 | 8.1 | 6.5 | 7.2 | 7.7 | 5.9 | 4.5 |
| Employment ^c | %YoY | 3.2 | 4.6 | 4.7 | 1.3 | 4.2 | 4.5 | 4.8 | 5.0 | 5.9 | 5.2 | 4.3 | 3.5 |
| Export (€) ^b | %YoY | 20.4 | 13.4 | 16.5 | 6.0 | 14.3 | 13.5 | 13.8 | 12.0 | 20.3 | 20.9 | 17.9 | 8.0 |
| Import (€) ^b | %YoY | 24.0 | 19.5 | 18.0 | 11.0 | 20.6 | 20.7 | 18.2 | 18.9 | 20.5 | 21.5 | 21.2 | 10.0 |
| Trade balance ^b | EURm | -5 539 | -12 369 | -16 164 | -24 148 | -2 385 | -3 073 | -2 894 | -4 017 | -2 927 | -3 877 | -4 384 | -4 975 |
| Current account balance ^b | EURm | -7 445 | -14 586 | -18 843 | -27 227 | -2 905 | -4 010 | -3 084 | -4 587 | -4 333 | -4 866 | -3 918 | -5 725 |
| Current account balance ^b | % GDP | -2.7 | -4.7 | -5.1 | -6.7 | -3.1 | -3.9 | -4.4 | -4.7 | -5.0 | -5.0 | -4.9 | -5.1 |
| Budget deficit (cumulative) ^a | PLNbn | -25.1 | -16.9 | -23.6 | -18.2 | -4.8 | -3.7 | 0.2 | -16.9 | 1.9 | -3.5 | -4.4 | -23.6 |
| Budget deficit (cumulative) ^a | % GDP | -2.4 | -1.4 | -1.8 | -1.3 | - | - | - | - | - | - | - | - |
| CPI | %YoY | 1.0 | 2.5 | 4.2 | 3.3 | 2.0 | 2.4 | 2.0 | 3.5 | 4.1 | 4.3 | 4.7 | 3.9 |
| CPI ^a | %YoY | 1.4 | 4.0 | 3.7 | 3.2 | 2.5 | 2.6 | 2.3 | 4.0 | 4.1 | 4.6 | 4.5 | 3.7 |
| PPI | %YoY | 2.5 | 2.3 | 2.7 | 3.2 | 3.3 | 2.0 | 1.7 | 2.3 | 3.0 | 2.6 | 2.1 | 3.0 |
| Broad money (M3) ^a | %YoY | 16.0 | 13.4 | 13.9 | 10.5 | 18.0 | 14.7 | 14.4 | 13.4 | 13.6 | 16.3 | 16.7 | 13.9 |
| Deposits ^a | %YoY | 15.2 | 14.5 | 15.0 | 10.0 | 17.7 | 15.2 | 15.4 | 14.5 | 15.3 | 18.5 | 18.7 | 15.0 |
| Loans ^a | %YoY | 23.4 | 29.9 | 21.1 | 12.0 | 26.8 | 29.2 | 31.0 | 29.9 | 29.7 | 27.7 | 24.9 | 21.1 |
| USD/PLN | PLN | 3.10 | 2.77 | 2.32 | 2.51 | 2.97 | 2.82 | 2.76 | 2.52 | 2.39 | 2.18 | 2.20 | 2.51 |
| EUR/PLN | PLN | 3.90 | 3.78 | 3.43 | 3.36 | 3.89 | 3.80 | 3.79 | 3.65 | 3.58 | 3.41 | 3.31 | 3.44 |
| Reference rate ^a | % | 4.00 | 5.00 | 6.00 | 6.00 | 4.00 | 4.50 | 4.75 | 5.00 | 5.75 | 6.00 | 6.00 | 6.00 |
| Lombard rate ^a | % | 5.50 | 6.50 | 7.50 | 7.50 | 5.50 | 6.00 | 6.25 | 6.50 | 7.25 | 7.50 | 7.50 | 7.50 |
| WIBOR 3M | % | 4.21 | 4.73 | 6.32 | 6.27 | 4.20 | 4.42 | 4.89 | 5.39 | 5.80 | 6.43 | 6.57 | 6.50 |
| Yield on 52-week T-bills | % | 4.18 | 4.69 | 6.28 | 6.11 | 4.14 | 4.40 | 4.84 | 5.37 | 5.84 | 6.28 | 6.59 | 6.40 |
| Yield on 2-year T-bonds | % | 4.57 | 5.23 | 6.23 | 5.88 | 4.47 | 4.78 | 5.21 | 5.71 | 5.99 | 6.40 | 6.41 | 6.10 |
| Yield on 5-year T-bonds | % | 5.03 | 5.52 | 6.14 | 5.81 | 4.95 | 5.19 | 5.57 | 5.85 | 6.02 | 6.33 | 6.23 | 6.00 |
| Yield on 10-year T-bonds | % | 5.22 | 5.56 | 6.03 | 5.74 | 5.17 | 5.36 | 5.66 | 5.73 | 5.87 | 6.16 | 6.14 | 5.95 |

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

^a at the end of period; ^b balance of payments data on transaction basis ^c in corporate sector

This analysis is based on information available until 10.10.2008 has been prepared by:

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