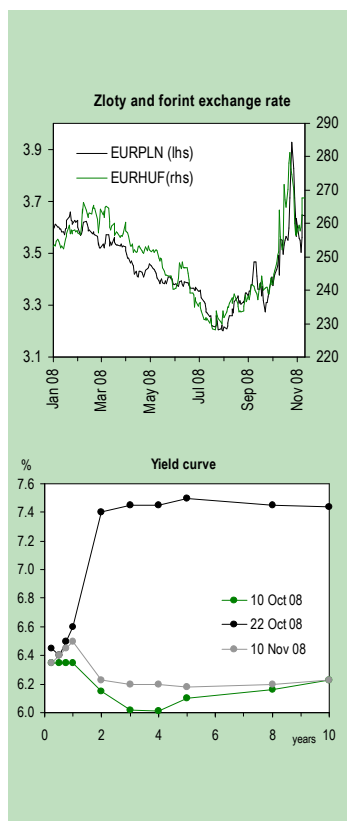


MACROscope

Polish Economy and Financial Markets

November 2008



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When in fear, euro is dear

▪ Last month we wrote that prospects for the zloty in the next months will depend on two factors acting in opposite direction – plans of euro adoption and consequences of the global crisis. After initial declaration that the government’s schedule of euro adoption will be revealed in mid-October, it was eventually published only towards the end of last month. Meanwhile, the zloty rapidly weakened amid significant deterioration in sentiment towards our region connected to a large extent with problems of Hungary. Although in the first *Special focus* we point out how much fundamentals of the Polish economy differ from that of Hungary, but in the short-term markets are driven more by emotions and contagion effect than rational assessment of differences in actual fundamental situation of different countries in the CEE region.

▪ The publication of the government’s schedule of the euro zone entry was positive factor for the Polish market, but more important was some rebound in risk appetite globally. However, one should not count on return of EURPLN towards 3.40 or lower. Until the end of this year we expect high volatility of the zloty and EURPLN should be in a wide range of 3.50-3.80, given continuously increased risk aversion in the global markets and strong tendency to hoard cash in US dollars. The zloty movements later in the year will depend on fate of the government’s plan of swift euro adoption. The road map approved by the cabinet indicates the ERM2 entry in the first half of 2009, but under condition that all necessary changes to the constitution will be made earlier. Meanwhile, the opposition Law and Justice make their support dependent on an outcome of binding (turnout above 50%) referendum with the most recent public opinion polls showing the referendum would be a close call. Until the referendum the zloty should be in similar range as until the end of 2008. If the outcome of the referendum opens way to ERM2 entry, the zloty should notably gain. Otherwise, the domestic currency may substantially weaken. We analyse the prospects for Poland’s euro adoption in the second *Special focus* section, including our subjective assessment of probability for different scenarios.

▪ In face of the intensification of the global crisis, Poland’s fundamentals are gradually weakening. Significant deterioration in prospects for the global economy and more and more indications of tightening in credit policy brought about another revision in our GDP growth forecast for Poland for 2009 (to 3.3% from 3.9% the previous month) and continuous downward revisions to forecasts of economic growth abroad means the risk to our forecast for Poland is still on the downside. At the same time, weaker economic growth and rapid decline in commodities prices lowered CPI inflation for the next year, although not much due to weaker zloty as compared to our previous scenario. Given worse growth prospects, better inflation outlook and significant scale of rate cuts abroad, we revised our expectations regarding domestic monetary policy. We think the overall scale of rate cuts by the MPC the next year may reach 100bp, although this will depend on the realisation of the euro adoption plan and pace of disinflation.

Financial market on 31 October 2008:					
NBP deposit rate	4.50	WIBOR 3M	6.85	USDPLN	2.8472
NBP reference rate	6.00	Yield on 2-year T-bonds	6.85	EURPLN	3.6330
NBP lombard rate	7.50	Yield on 5-year T-bonds	6.80	EURUSD	1.2760

This report is based on information available until 10.11.2008

Special focus

Hungarian contagion

In Polish and Hungarian languages, there is a saying, reflecting close ties of the two nations over past centuries. Does the saying should be also applied to similarity of the current economic situation and financial stability of these two countries? In the table below we present the selected parameters describing Poland's macroeconomic situation and financial stability against the background of Hungary, which are seen as one of the most vulnerable countries in the region, and the Czech Republic, which is seen as the region's safe-haven.

As compared to Hungary the economic growth in Poland has been much higher over the past few years. Importantly, this was coupled with much lower scale of internal imbalance, i.e. lower inflation as well as lower fiscal deficit and public debt, which gives Poland more manoeuvre in monetary and fiscal policies in response to the threats for economic growth, without detriment to assessment of the country's long-term price stability and public finance sustainability. In these elements Poland is much closer to the Czech Republic. Moreover, it is noteworthy that threats to economic growth in the Czech Republic and Hungary are more serious than in case of Poland due to higher relation of exports and total credit to GDP in these countries.

The balance of payments position in Poland is better than in Hungary (slightly narrower C/A gap and more favourable structure of its financing), although much worse than that of the Czech Republic. The possible financing gaps (measured as imports and short-term external debt in relation to FX reserves) seem the largest

in case of Hungary, while situation of Poland and the Czech Republic looks similar. Much different assessment of the situation in this regard was presented in the JP Morgan report where the zloty was indicated as the most vulnerable to capital outflow among currencies in the region, due to insufficient level of FX reserves and availability of external financing (the debt roll-over and possible size of support from the IMF). However, conclusions from the report seem doubtful given that data on FX reserves, C/A gap and short-term external debt of the country were not correct. Moreover, it was not taken into account that in case of Poland possible external borrowers should be more willing to provide financing as Polish macroeconomic policy over the past few years was more prudent. For instance, Poland could probably qualify for the newly established lending facility of the IMF for emerging markets that were running prudential macroeconomic policy over the last years (while Hungary had to meet several requirement within the framework of standard lending from the IMF).

As regards relation of loans to deposits and relation of private sector FX borrowing in the domestic banking sector to GDP, Poland's situation is much better than that of Hungary, although not that comfortable as in the Czech Republic. However, it is noteworthy that many research houses (e.g. Goldman Sachs) believe that even in case of Hungary the situation with respect to high FX borrowing is manageable. In case of Poland, it is worth to point out very low relation of average monthly mortgage payments to total monthly households income. According to the finance ministry's estimates, the relation stands at a mere 1.8%, which means that even very significant weakness of the zloty would not have a major impact on the financial stance of households sector as whole.

Indicator	Czech Republic	Poland	Hungary
GDP growth (IMF data and projections from World Economic Outlook, October 2008)	6.0% on average in 2004-07, 4.0% in 2008, 3.4% in 2009	5.5% on average in 2004-07, 5.2% in 2008, 3.8% in 2009	3.5% on average in 2004-07, 1.9% in 2008, 2.3% in 2009
Exports to GDP	77%	41%	81%
Total credit to GDP	66%	44%	73%
Fiscal deficit and public debt to GDP	1.0% and 28.9%	2.0% and 44.9%	5.0% and 65.8%
Average CPI inflation in 2008 (IMF projection)	6.7%	4.0%	6.3%
C/A deficit to GDP for 2008 (IMF projection)	2.2%	4.7%	5.5%
Share of FDIs in financing current account deficit	63% (additional 61% by EU funds)	ca. 60% (additional 33% by EU funds)	ca. 20% (additional 27% by EU funds)
Coverage of imports by FX reserves	3.6 months	5 months	3 months
Relation of short-term debt to GDP and FX reserves	15.7% and 87%	15.9% and 108%	18% and 107%
Loans to deposits ratio	73	109	140
Private sector FX borrowing in the domestic banking sector to GDP	4%	10%	28%

Bumpy road to euro

In September, there was a radical and quite unexpected change in the position of the Polish government on the issue of entering the euro zone. Until quite recently, Poland was consistently avoiding announcement of the target date of euro adoption. Neither was there any official government strategy in this respect.¹ Over the first months in the office, the current government was much alike the previous ones. Unofficially, there was some hope to accelerate the accession to the euro zone especially that in the past the Minister of Finance, Jacek Rostowski, strongly supported introduction of a common currency to Poland. However, official comments did not provide any guideline. For some time, Minister Rostowski even seemed to cool the hope for taking prompt decisions in this respect and often emphasised that Poland needed to be “prepared very well” for the introduction of euro and the macroeconomic criteria of convergence should be met even before introducing PLN to ERM II system. As a result, the market was quite sceptical towards setting the potential date for entering the euro zone (according to the Reuter’s survey carried out among the bank economists in August, years 2013-2014 were most likely).

The turning point in the government’s thinking about the euro zone was the speech of the Prime Minister, Donald Tusk, at the Economic Forum in Krynica. After the Forum the nature of discussions on accession changed and the official position of the Polish authorities was detailed. The outcome of the process is the *Road map of entering the euro zone by Poland* approved by the government and announced at the end of October.

The Government wants to accelerate the march towards euro

According to the official position specified in the *Road Map*, “the intention of the government of the Republic of Poland is that Poland meets the nominal convergence criteria in 2011. This will allow – once the European Commission issues a positive opinion on entering the euro zone by Poland and after waiving the derogation by the ECOFIN – to adopt a common European currency by our country on 1 January 2012 and crown thus the integration process with the Economic and Monetary Union”.

The Road Map includes, among others, the terms and conditions, required decisions and actions that should

be taken (along with the date) to enable the delivery of the government’s target, i.e. the introduction of euro in 2012. Below we present the elements of the government’s schedule that are in our view crucial from the financial market’s perspective.

Road Map of entering the euro zone – key elements

November 2008	appoint a Government Representative for coordinating preparations for euro introduction
December 2008	publish the NBP report on Poland’s full membership in the Economic and Monetary Union
Q1 2009	develop a National Plan of Euro Introduction (based on analyses in working groups) and establish a National Euro Coordination Committee.
Q1 2009	commence works on changing Polish constitution
H1 2009	introduce PLN to ERM II system
H2 2010	prepare drafts of legal acts on euro implementation (incl. the so-called framework act – umbrella law)
December 2010 / January 2011	file a request with the European Commission and ECB to prepare convergence reports outside the regular date of its publication
May 2011	convergence reports prepared by the European Commission and ECB
May-June 2011	Procedures of Poland’s assessment in various EU institutions
mid- 2011	ECOFIN’s decision on waiving the derogation towards Poland
mid- 2011	ECOFIN’s decision to set the irrevocable PLN/EUR conversion rate
immediately after setting EUR/PLN interest rate	commence the period of obligatory dual display of prices and monitor the pricing practices in the retail, bank sectors, etc.
1 January 2012	Poland’s accession to euro zone

Source: Ministry of Finance

... yet the road can be bumpy and steep

From the formal and technical perspective, the government plan to enter the euro zone in 2012 is feasible. However, the plan is ambitious, and the schedule for taking certain decisions is tight, in particular, if we consider the political aspects, events in financial markets and their potential impact on the macroeconomic environment and the position of Polish and global economies.

We will discuss the issues in more detail below to answer whether the government’s scenario is likely to be successfully delivered.

Will there be a political consensus on euro?

Before we start worrying whether Poland will be able to meet the economic convergence criteria in the upcoming years, i.e. the so-called Maastricht criteria (including, among others, level of fiscal deficit, inflation, exchange rate stability), the political factors will play a crucial role in the process of taking decisions on entering the euro zone.

¹ In 2005, in the Ministry of Finance, under the management of Mirosław Gronicki developed the document: *Poland’s integration with the euro zone and the strategy of process management*. However, it was not an official strategy of the government. Also, the document did not specify any target date.

At a very early stage, in fact before introducing PLN to ERM II system, it will be necessary to reach a wide political consensus on the pace of integration with the euro zone. There is consent among the decision taking authorities, which we completely agree with, that before a decision about ERM II is taken it is necessary to carry out legislative changes required before entering the euro zone, including the constitution change. According to the *Road Map* "change in the Polish constitution at this stage is not a formal condition of accessing the ERM II yet it is necessary to minimize the risk of failure to meet the exchange rate stability condition".²

It should be noted however that the political consensus on the date of introducing euro to Poland is important not only to ensure support for changes in the constitution. Strong political division as regards the issue of entering the euro zone is one of the factors taken into consideration by the European institutions (ECB, European Commission) in the course of negotiation with a country seeking full membership in the Economic and Monetary Union.³ For example, that is one of the reasons why Bulgaria, which has been trying to introduce its currency to ERM II, has not obtained the EU's consent yet.

As domestic currency needs to be covered with ERM II system for at least two years, changes in the constitution should take place in the few upcoming months so that the discussions about entering the euro zone in 2012 had any sense. According to the *Road Map* we should enter the ERM II at least in mid-2009.

To change the constitution, the majority of more than 2/3 votes is required in the Sejm so a significant part of opposition has to support the idea. The position of the Law and Justice (PiS) is of crucial importance as the party has the number of votes which would allow blocking changes to the constitution. Their superiority is small as the party has 157 members, i.e. only 4 more than the number of votes required to block changes to the constitution. However, the chances of winning a few Parliament members to vote against the party's position are minor as the party is very disciplined and the issue is very important. Moreover, it is not certain that it would be sufficient, i.e. whether all other opposition members will support the government's propositions for constitutional changes to enable prompt introduction of

euro. In general, the left-wing parties support prompt integration with the euro zone yet the votes cast by independent Parliament members can be diversified.

Current break down of votes in the Parliament

Parliamentary clubs and groups	No. of members
Parliamentary Club of the Civic Platform	209
Parliamentary Club of the Law and Justice	157
Deputies' Club of the Left	42
Deputies' Club of the Polish People's Party	31
Deputies' Group of the SDPL - Nowa Lewica	8
Deputies' Group Poland XXI	5
Democratic Deputies' Group	3
Independent members	5

Source: Parliament of the Republic of Poland

It seemed for some time that the current crisis in financial markets could be the factor facilitating the political agreement on euro regardless of the existing split and emphasising thus the importance of actions aimed at improving the Polish financial system security in the times of global turbulence. However, the talks of Donald Tusk with the representatives of opposition at the turn of October crumbled the hope and did not bring any significant agreement on the euro issue. The talks regarding the strategy of euro introduction to Poland are to continue in November and December. It was agreed at the last meeting that by the end of November each parliamentary club would prepare a report on the best euro accession date (according to a given party), and the debate in the Parliament attended by the Prime Minister and the Ministry of Finance is to be held before Christmas.

As for now, the Law and Justice remains sceptical to the issue of euro introduction (according to its head Jarosław Kaczyński it should take place not earlier than in 10 years time). The fact that the upcoming three years will be a period of continuous election campaign in Poland does not facilitate any changes in the party's position (2009 – elections to the European Parliament; 2010 – presidential elections; 2011- parliamentary elections). The attitude towards euro might be an important point of dispute between the Civic Platform and the Law and Justice throughout the campaigns.

According to the politicians, the only way to ensure the support of Law and Justice for constitutional changes is to conduct a referendum.

Referendum likely in the spring

In our view, a scenario assuming referendum before entry to the ERM II is currently very likely. There is a question about its possible timing. The government has

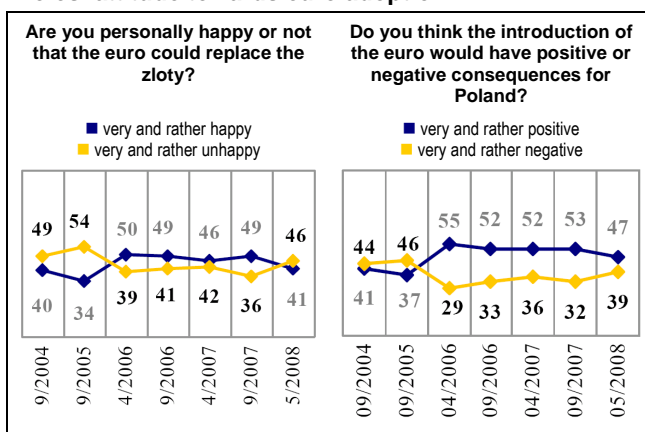
² If after accession to ERM II it turned out that there was no consent in the Parliament to change the constitution it could stir tension and turbulence in the fx market and generate the risk of unnecessary prolongation of the ERM II period, even if all the economic convergence criteria were met.

³ There are some fears that if the government changed, the commenced integration with the euro zone could be stopped or reversed.

not adopted an official stance in this regard. Some time ago, the PM Tusk did not rule out that if there is no way to convince the opposition, the referendum will probably take place in the spring. Nevertheless, his latest comments were much less clear, as he suggested recently that if a referendum is concerned, it must be preceded with a change in constitution. Comments of other prominent PO members (Schetyna, Chlebowski, Gowin) suggested that a referendum about euro zone entry date may be connected with the European Parliament election (7 June). This idea is quite appealing as joint election gives chances for increasing turnout of the referendum (though it is still highly uncertain whether it will be possible to reach turnout above 50% required for the referendum to be valid). Taking into account that according to the government's Road Map, entry to the ERM II should take place by the mid-2009, such schedule of referendum is quite tight, however it does not imply that government's plans may not be accomplished. Obviously if Poles decide to support fast integration with the euro zone.

The outcome of the referendum is not certain at this stage. OBOP opinion survey in the middle of September showed that 55% of Poles were sceptical about fast euro zone entry. Negative trends were also confirmed by Eurobarometer, the cyclical survey made for the European Commission by Gallup Organization, 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.

Poles' attitude towards euro adoption



Source: Flash Eurobarometr 237, The Gallup Organization

Although opinion polls from the recent months are not particularly optimistic, it seems that amid professional

and effective information campaign, there is a chance to increase social support for the fast euro zone entry. Important factor in this regard may be first experiences of Slovak Republic after introduction of the common currency in January 2009 and comparison of impact of global market turmoil on economies and financial systems in this country and in Poland. Nevertheless, result of the referendum is still highly uncertain.

Another uncertain issue is question that citizens will have to answer in the referendum. In president Lech Kaczyński's view, which is shared by PiS, the question should refer directly to planned date of euro adoption. For example "do you agree (to introduce euro) already in 2012?". In our opinion, the question should be more general, and could ask for example about support for changes in the constitution that are necessary before entering the euro zone.

There is also one more question: if the referendum is valid, and the result is consistent with the government's proposal, will the opposition be forced to back crucial changes in the constitution? From the formal point of view, the answer is NO. Nevertheless, it may be assumed that it will be extremely difficult to ignore public opinion in such situation.

ERM II in the middle of 2009?

As we wrote before, accession to the ERM II should take place until mid-2009, in order to have time – after conclusion of two-years period of participation in exchange rate mechanism (mid-2011) – for assessment of Poland's readiness for euro adoption by the EU institutions, for decisions of all relevant bodies, and the final stage of preparations for euro introduction.⁴

Nevertheless, apart from positive outcome of the referendum and political goodwill, a factor that seems to be essential before ERM II entry is stabilisation of situation in the world financial markets. On one hand, one could argue that a period of lower pressure on zloty appreciation may be favourable for pegging the currency to euro in ERM II, as it gives opportunity to set the central parity against euro at the level that would ensure higher international competitiveness of Polish exports, and probably which is closer to the equilibrium exchange rate level than the rate observed several months ago. Nevertheless, one should be conscious about a risk that is connected with pegging the currency

⁴ The *Road Map* assumes that the government will apply to the EC and ECB even before the end of the required two-year period for preparation of reports assessing Poland's readiness to adopt euro. Nevertheless, one should assume that the relevant reports will not be prepared before conclusion of the required minimum 2-year period of ERM II participation.

to euro at times of market turbulences and in perspective of significant economic downturn. In the period of market instability, there is higher risk of facing another wave of sudden capital outflow and significant weakening of the currency.⁵ In the case of such events after joining the ERM II it may be a threat for keeping the zloty in the agreed fluctuations band around the central parity, and at least result in costly FX interventions. While from the EU point of view strengthening of local currency versus euro during stay in the ERM II is not a significant problem and does not breach exchange rate stability criterion (example of Slovakia showed that it is possible to revalue central parity even several times), according to EU interpretation a devaluation of parity versus euro is unacceptable and inconsistent with FX stability condition. In practice, even if the zloty weakening will not go beyond allowed 15% band due to appropriate size of FX interventions, it may not be ruled out that the European Commission and the ECB will perceive such episode as a "significant tension" in the FX market, which is inconsistent with exchange rate stability. Until recently, there were also opinions about clear asymmetry in the EU's tolerance for currency depreciation (much lower than officially allowed 15%).

At this stage, it is still very hard to say whether until mid-2009 world financial markets will stabilise to the extent that would allow making a decision about ERM II entry without unnecessary risk.

On the other hand, it cannot be excluded that the government will be ready to take a risk of ERM II entry even before the market situation will stabilise entirely. Problems that have recently hit financial systems in the emerging markets, highlighted a need to seek solutions that would provide a shield against confidence crises. One of the ways to get protection against such events is possibly quick integration of domestic economy and the financial system with safe and credible economic area, as the euro zone. It is not without reason that after recent turmoil in the emerging markets, proposals of fast integration with the euro zone appeared not only in Hungary but even in Iceland, that until recently preferred to stay completely outside the European Union's structures.

⁵ While it may be expected that the fact of joining the ERM II itself may be a factor increasing confidence for the Polish currency, favoring its appreciation and decreasing vulnerability to swings in market sentiment, yet on the other hand, partial fixing of the zloty in conditions of high market volatility and uncertain macroeconomic environment, may increase the currency's exposure to speculative attacks.

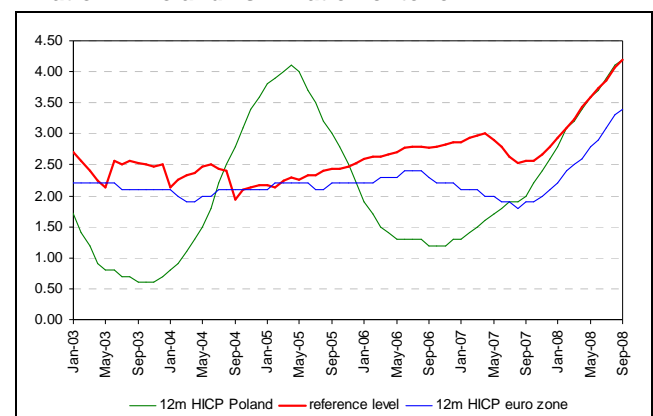
Is it possible to meet the criteria?

If the issue of constitution change is resolved and the decision about ERM II entry is made, the market attention will focus on analysis of chances for fulfilling Maastricht criteria in the required timeframe, i.e. until mid-2011. Unfortunately, at times of economic downturn, challenges that domestic macroeconomic policy will have to face in order to fulfil all convergence criteria simultaneously are much stronger than at normal times. Sharp economic slowdown that is likely to hit the world economy, and in particular euro zone, in the near future, may thus be a significant obstacle on the way to meeting necessary criteria before the euro zone entry.

The Maastricht Treaty requires that "a Member State has an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best-performing Member States in terms of price stability". In practice, in this calculation three EU countries with the lowest, yet not negative inflation are taken into account.

Since the start of this year, the reference value of inflation defined in accordance with Maastricht treaty has been increasing rapidly, reaching 4.2% in September. Simultaneously, average 12-month inflation in Poland was growing exactly at the same pace (see chart below). In situation of strong deceleration of economic growth in the EU next year, one should expect a sharp decline in the inflation reference level in the near future. It implies that meeting price stability criterion in 2011 may require bringing inflation in Poland close to 1.5%. While it seems likely that domestic inflation will be falling anyway over the next months and quarters, a pace of this reduction will be probably lower than in EU countries that will suffer the most from the effects of financial market crisis. Thus, realisation of inflation criterion may require relatively restrictive monetary policy in Poland.

Inflation in Poland vs. inflation criterion



Source: Eurostat, own estimates

At the same time, efforts to bring inflation down to reference levels in relatively short time may create serious difficulties in realisation of other criteria, in particular those concerning fiscal convergence.

Even before it was known that the crisis in the world financial markets will be so serious and economic slowdown so severe, our assessment of chances for realisation of fiscal consolidation plan outlined by the government was quite sceptical. Already in May edition of MACROscope we wrote about a risk of overshooting the deficit planned in the last convergence programme already in the next year, and the latest changes in economic outlook have even increased risk for the Polish budget. In November the government will present an update to the convergence programme, which should take into account impact of changes in economic situation on pace of fiscal deficit reduction. A positive news is that a path of fiscal consolidation planned in the previous report assumed meeting fiscal convergence criteria with a quite wide safety margin (general government balance at 1.5% of GDP in 2010 versus required below 3%). Nevertheless, one should remember that Polish public finances are still highly vulnerable to cyclical fluctuations⁶ and in situation of strong economic slowdown a scale of deficit growth may be strong enough to obstruct the country's way to the euro zone. Especially if the period of economic stagnation proves to be longer than currently predicted and lasts until 2010.

Fulfilment of long-term interest rate criterion will be largely conditioned on credibility of plans concerning realisation of inflation criterion and fiscal criteria. If market participants will be convinced that strategy of euro zone entry in 2012 is feasible, there should be no significant problems with interest rate criterion.

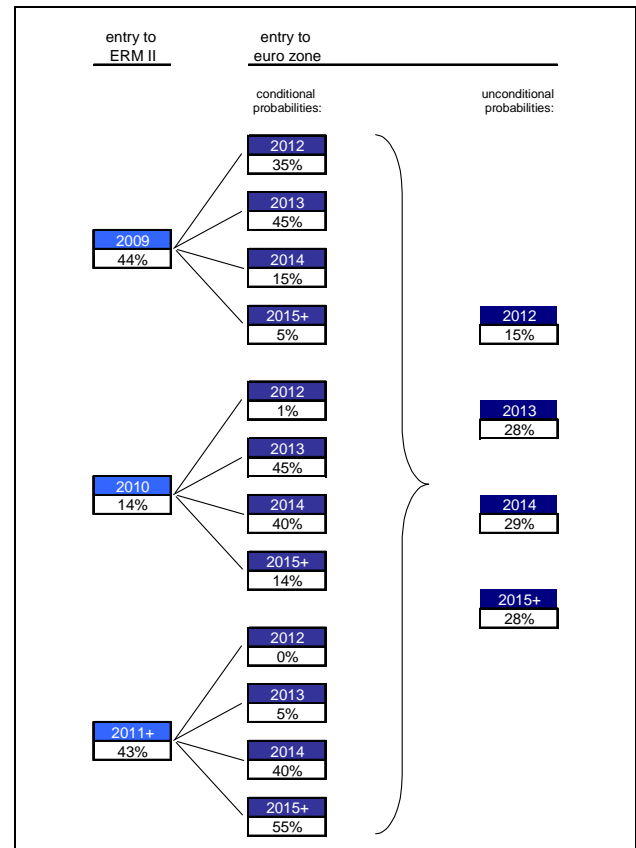
Euro 2012 yet under question mark

As can be seen, realisation of government's scenario assuming Poland's entry to the euro zone in 2012 is conditioned on many circumstances and each condition is burdened with quite significant uncertainty, particularly in current political and economic environment. Full implementation of the plan will be possible only if all questionable elements will be realised without problems and major delays.

Assessment of chances of fast euro introduction in Poland requires referring to analysis of conditional probability and detailed examination of particular risk

factors connected with subsequent stages on the road to the euro zone. We tried to follow this track and – taking into account all circumstances and issues related to integration with the EMU (among other, political consensus, possible referendum outcome, situation in the financial markets, potential problems with realisation of convergence criteria) – we prepared a probability chart summarising our subjective view on the agenda of euro adoption in Poland.

Probability chart of different scenarios of Poland's road to the euro zone



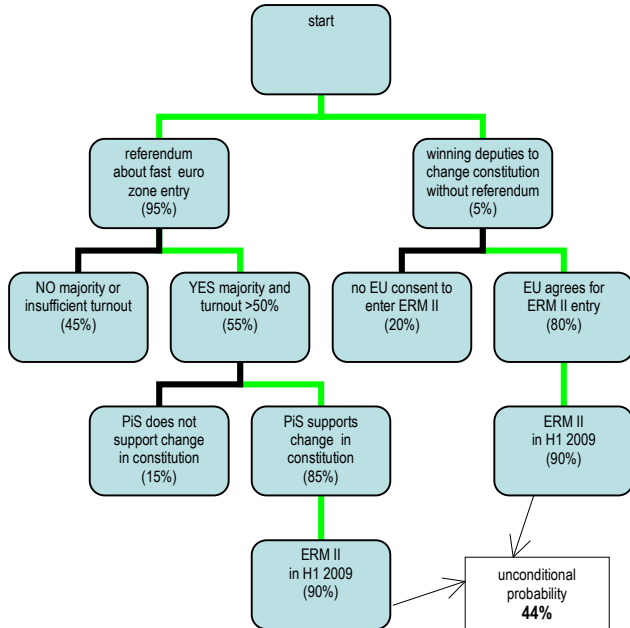
Source: own estimates

The results of the analysis are not particularly optimistic as they suggest that – in our view – 2012 is not a very likely date of euro introduction in Poland.

The next chart shows in more details the analysis of probability of the first stage of integration with the EMU – entry to the ERM II. In our opinion, one of the biggest question marks on the road to euro is the referendum that may take place in the spring. The main risk factor is negative or insignificant (turnout below 50%) result of the referendum, that may delay entry to the euro zone by several years. We believe that chances for positive outcome of the referendum are higher than 50%, however it is worth to note that this does not imply that likelihood of entering ERM II in 2009 is equally high (among others, due to risk of prolonged turmoil in the exchange rate market). In sum, chances for ERM II entry in the next two years are in our view almost 60%.

⁶ Mainly because of still very high share of fixed (non-discretionary) expenditures, which in situation of significant revenue slowdown triggers a rapid surge in budget deficit.

Chances of entry to the ERM II in H1 2009



Note: numbers in parentheses represent subjective conditional probability of a given event.

Perspectives of FX market in context of EMU integration

Date of ERM II entry will have significant implications for behaviour of the zloty. Huge uncertainty whether it will be possible to accomplish government’s plan implies that currently risk for exchange rates forecasts is even bigger than ever. Realisation of scenario more or less consistent with the *Road Map* will imply completely different path of zloty exchange rate next year (clearly stronger currency) than in scenario of a significant delay in entry to the exchange rate mechanism and the euro zone.

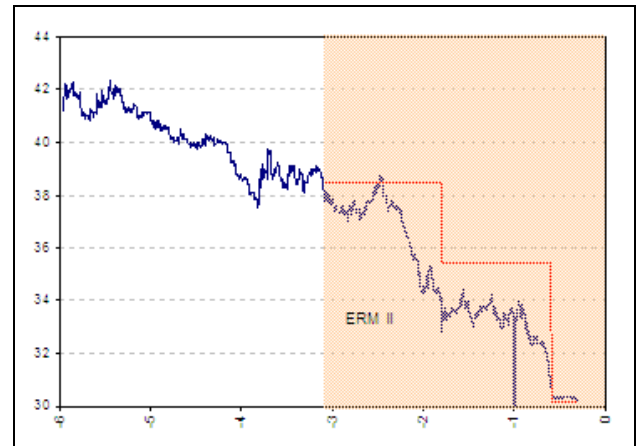
Forecasts are largely dependent on the main risk factor mentioned above – outcome of the referendum, or broadly speaking political support for changes in the constitution. As we assume that Poles should be in favour of joining the euro zone quickly, and thus 2009 is in our view the most likely date of ERM II entry, we believe than after a relatively weak first part of the next year, the second year-half should see a clear rebound in the zloty.

One should remember that a change from a free float to a managed exchange rate regime will require setting a central parity of the zloty against the euro, and a width of allowed fluctuations around it. As regards the parity, its level will be a subject of multilateral negotiations between Poland, the European Central Bank, and all the euro area Member States. The experience of Slovenia and Slovak Republic (that were entering the exchange rate mechanism in 2004 and 2005, correspondingly) shows that in each case the parity was set at the level of current market exchange of the local currency from the

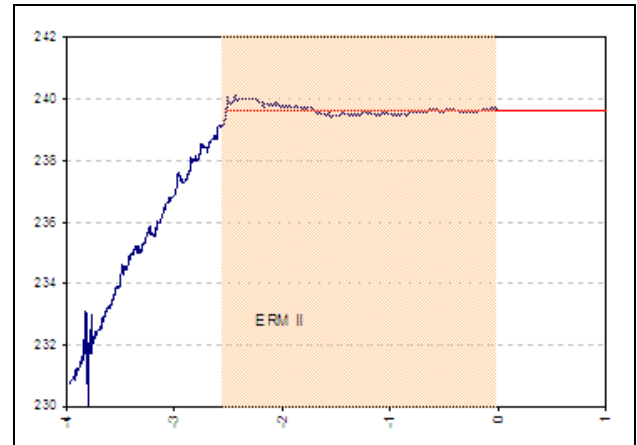
day preceding the accession. Such approach is possible also in case of Poland, however one cannot rule out that the EU would insist on stronger parity of the zloty versus euro, especially if financial markets do not stabilise fully until the moment of ERM II entry.

As regards the bands, the maximum width is $\pm 15\%$ around the parity. Even though every country has the right to propose a narrower range of allowed fluctuations, it is highly unlikely that Poland would opt for such limitation (in fact, except for Denmark, no other country in the ERM II has ever adopted narrower bands than the standard $\pm 15\%$).

EURSKK exchange rate on the road to euro



EURSIT exchange rate on the road to euro

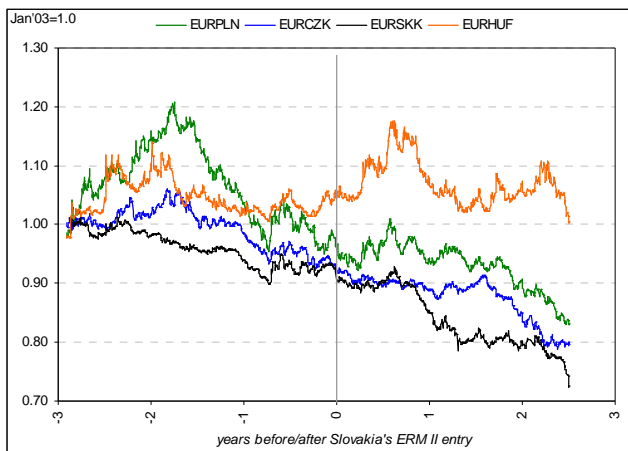


The experience of countries mentioned above shows that the level of parity adopted in the ERM II may be (as in the case of Slovenia), but does not have to be, consistent with the irrevocable conversion rate against euro determined at the time of entering the euro zone. In particular, in a situation of “justified” appreciation pressures on the local FX market during the country’s stay in the ERM II, reflecting a change in equilibrium exchange rate versus euro, it is possible that the central parity may be revalued, after consultation with the ECB and all the euro zone Member States (there were two such revaluations in Slovakia, by ca. 8% and 15% respectively). In contrast, an opposite move of the

central parity under ERM II regime is highly unacceptable, to avoid a risk of competitive devaluation before the euro zone entry. Thus, picking the right level of the parity at the time of entering the ERM II system is of the utmost importance, as one can be sure that a final irrevocable conversion rate against euro will not be higher than determined at this occasion, with all the consequences for the economy's competitiveness in the single currency area.

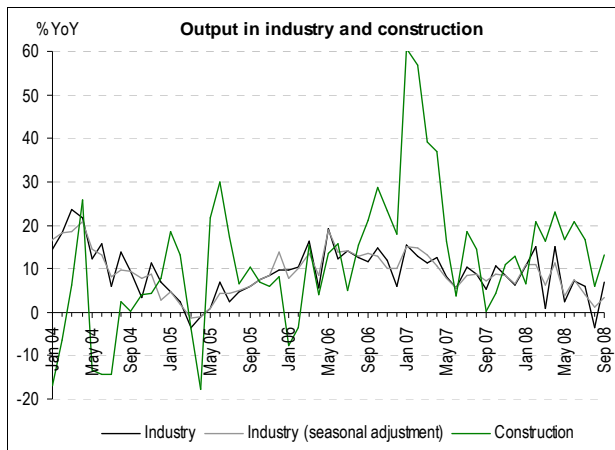
The example of the Slovak crown suggests that after entering the ERM II, the local currency may be a subject to increased appreciation pressure against euro. While in the two years period preceding the ERM II the EURSKK rate strengthened by 7.7%, in the two years just after the accession the appreciation reached 12%. Meanwhile, in the other countries in the region (staying outside the ERM II) a scale of currency appreciation was weaker in the second period than in the first. However, it is hard to determine to what extent such pattern of currency behaviour was an effect of joining the exchange rate mechanism, and to what extent it resulted from accelerating reforms and fundamental changes taking place in the Slovak economy.

CEE currencies against euro



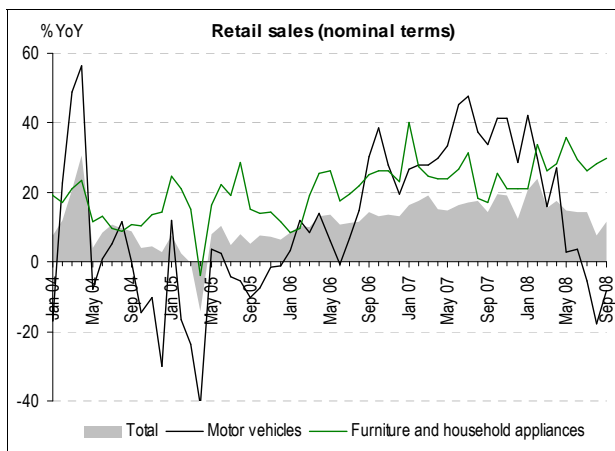
In our view, in case of Poland, after announcement of decision about ERM II entry, and possibly even already after clearing out uncertainties about political consensus and strengthening market belief that the decision will be made, the sentiment for the zloty should improve and – likewise in Slovakia – the currency should start outperforming other currencies in the region. Obviously, behaviour of the zloty will also depend on the situation in international financial markets. However, in our most likely scenario, assuming gradual stabilisation of moods abroad, one should expect to see a significant rebound in the domestic FX market since the middle of 2009 (average EURPLN at 3.45 in H2 versus 3.65 in H1). This does not change the fact that during stay in ERM II a scale of zloty fluctuations may be substantial, as the example of Slovakia proved that FX volatility actually increased after joining the exchange rate mechanism.

Economic update



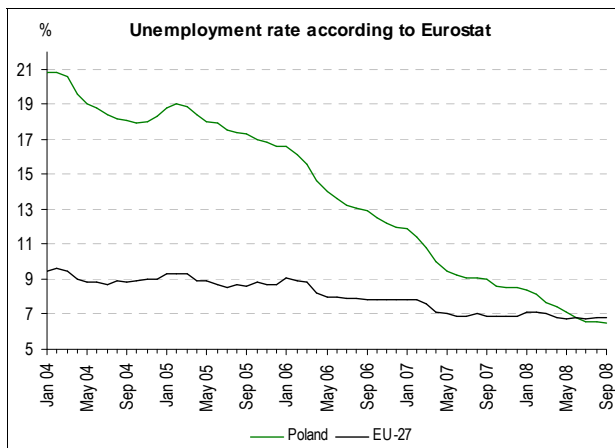
Headline output figure above expectations, but trend down

- Industrial output grew 7.0%YoY in September after 3.7%YoY drop in August. Rebound in output growth rate was the strongest in manufacturing, to 7.7%YoY from -3.8%YoY in August. Seasonally adjusted growth in production reached 3.5%YoY in September versus 7%YoY on average in January-August. Rise in construction output accelerated to 13.2%YoY in September from 5.9%YoY in the previous month, however it was lower than 15.8%YoY rise on average in January-August period.
- All in all, the data confirmed that deep deterioration in production figures in August was to a large extent a result of lower number of working days. However, the figures also showed a weakening in output growth trend after taking into account seasonal adjustment and this was observed already before intensification of the global financial crisis.



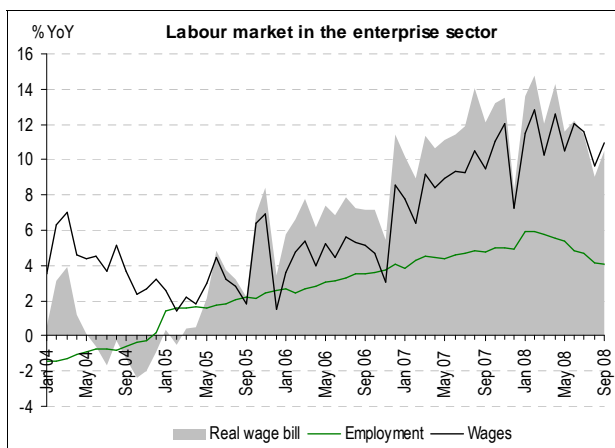
Continued solid rise in retail sales

- The nominal rise in retail sales was 11.6%YoY (8.3%YoY in real terms) in September after weaker growth of 7.7%YoY in August. The overall sales figure was biased down again by auto sales, which fell 8.2%YoY (effect of private auto import not registered by the stats office), while sales growth in other categories of retail trade were quite optimistic. The annual sales growth of such goods as clothing and footwear, pharmaceuticals and cosmetics, or furniture and household appliances held at very high level of 20-30%YoY, which means it is difficult to say the consumption demand is weak.
- We still predict that private consumption will be a stabilising factor for GDP growth in Poland the next year, though certainly some consumption growth deceleration will not be avoided due to some weakening in the labour market conditions.



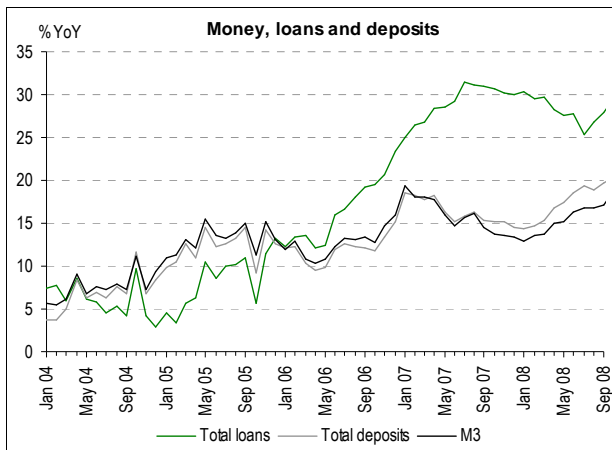
Further indication of softening in labour market conditions

- The registered unemployment rate fell to 8.9% in September and according to the Eurostat data based on Labour Force Survey the unemployment rate in Poland fell to 6.5% at the end of September versus the EU-27 average of 6.8%.
- Average wage growth in corporate sector rose to 10.9%YoY in September from 9.7%YoY in August while employment growth dropped to 4.1%YoY from 4.2%YoY the previous month.
- As wage growth in September was lower than average for January-August (11.4%YoY), the data indicate that the wage growth is gradually slowing down, though not as rapidly as data for August suggested, when the wage growth was influenced by one-off factors (lower number of hours worked in the month).
- Also in case of employment the data confirmed deceleration of growth rate (average for January-August was 5.3%YoY). In the whole corporate sector the employment rose by 0.1% against August, the detailed data showed that there were job losses in manufacturing for the fifth straight month and annual growth rate fell to 1.5% from a robust 4.6% at the beginning of the year.
- We forecast that wage and employment growth will continue to decelerate gradually together with GDP growth slowdown in the next quarters. The unemployment reduction will slowdown and in the second half of 2009 the unemployment rate will start to rise in annual terms.
- However, from the point of the view of the consumer demand in the next quarters, the currently observed wage bill growth still bodes well for consumption growth, especially with high current level of households' savings and expected reduction in PIT rates as well as high indexation of social security benefits. In September, wage bill in the corporate sector increased by 15.5%YoY in nominal terms and 10.5%YoY in real terms.



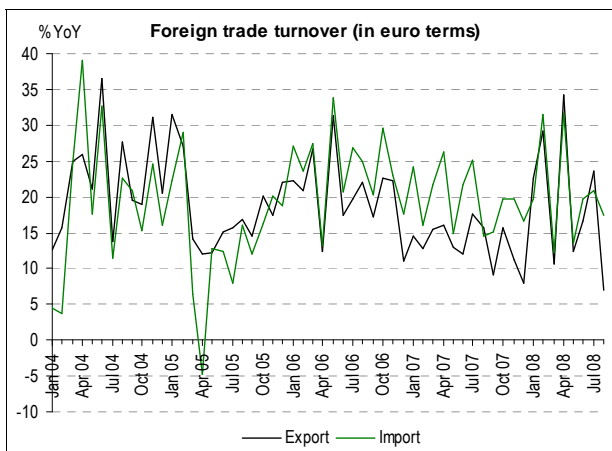
Source: CSO, own calculations

Economic update



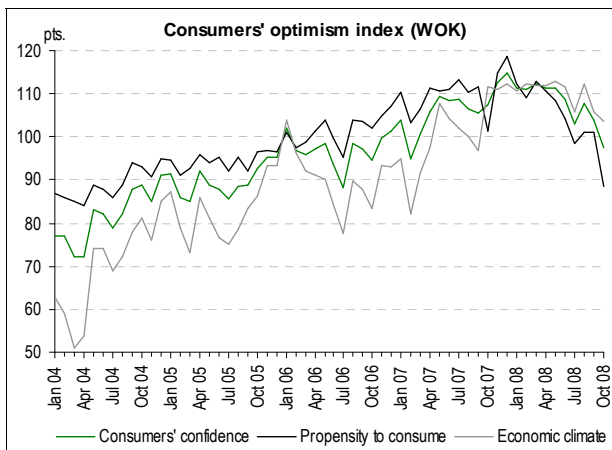
Tightening of credit policy by banks

- The M3 money supply growth accelerated to 17.1%YoY in September from 16.8%YoY in August. Households' deposits growth remained at nearly 24%YoY and corporate deposits growth rose to 6.7%YoY from 3.1%YoY. Faster rise in money supply and deposits in recent months is a result of change in savings structure and FX changes (higher value of FX deposits).
- Total loans growth accelerated to 27.8%YoY, mainly due to fast rise in households borrowing (33.4%YoY, which was related to FX changes) with continuation of strong rise in corporate borrowing of ca. 25%YoY. The expected tightening of credit policy by banks both towards corporations and households, as indicated by the latest survey by the NBP mainly due to uncertainty regarding future economic situation, will negatively affect the process of money creation and economic activity.



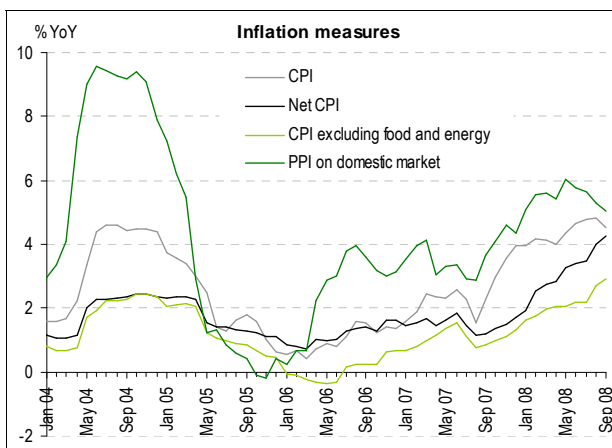
Clear slowdown in exports growth

- The balance of payments for August showed much lower growth rate in exports than in imports, indicating that the zloty appreciation observed until late July and the weakening of the external demand is negatively affecting Poland's foreign trade results. Apart from widening of the trade gap, August also saw lower surplus in services, larger deficit in income and narrower surplus in transfers.
- The 12M cumulated current account deficit in relation to GDP grew to 4.9% after August from 4.7% after July and according to our predictions it will reach 5.3% at year-end. As we forecast significant weakening in exports growth next year, the C/A gap is set to widen further in the course of 2009 (with gradually falling share of long-term financing in the deficit financing), which will be one of negatives factors for the zloty.



Global crisis spoils moods of enterprises and consumers

- October results of surveys of enterprises and consumer moods brought clear deterioration.
- Seasonally adjusted PMI fell to the lowest level in history (below very low levels in late 1998 and at the turn of 2001 and 2002), heralding weakening in export, output and labour market conditions in the next months.
- The CSO's business climate indicators for manufacturing, construction and retail trade lowered (monthly drop and deepening of annual decline).
- There was significant fall in the CSO's consumer confidence index and in Consumer Optimism Indicator by Ipsos, in both cases the most considerable was drop in expectations indices. In the Ipsos survey, there was also substantial deterioration in consumers propensity to consume.

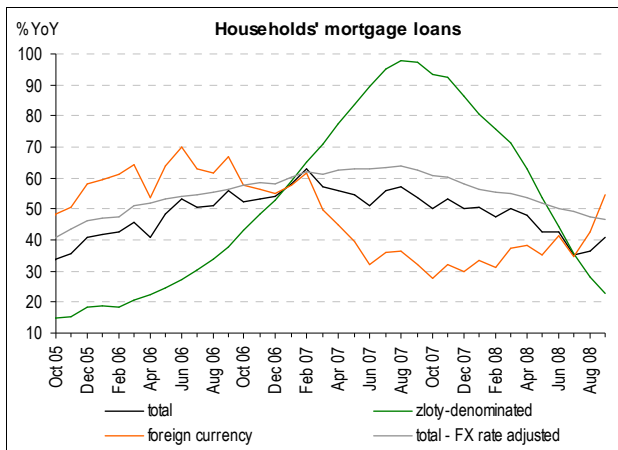


Weaker concerns about inflation, despite core inflation up

- CPI inflation slowed down to 4.5% in September. The major factors responsible for inflation decrease from 4.8% in August were prices of foodstuff (annual growth down to 5.1% from 6.9%) and fuel (to 3.7% from 6.8%).
- Prices of other consumer goods and services rose slightly more than we had expected. As a result, net inflation rose to 4.3%YoY from 4.0%YoY in August. CPI excluding prices of food and energy accelerated to 2.9%YoY from 2.7%YoY in August. All in all, core inflation measures show that despite the economic weakening, the underlying inflation pressure has not waned so far, though this should take place in the coming quarters amid weaker demand and softer labour market.
- Total PPI inflation rose to 2.1% from 2% in August while the PPI inflation on the domestic market fell to 5.1% from 5.3%.

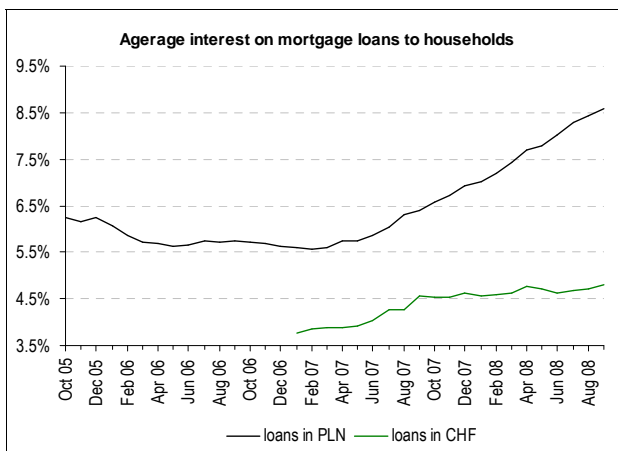
Source: CSO, Ipsos, NBP, own calculations

Housing market update



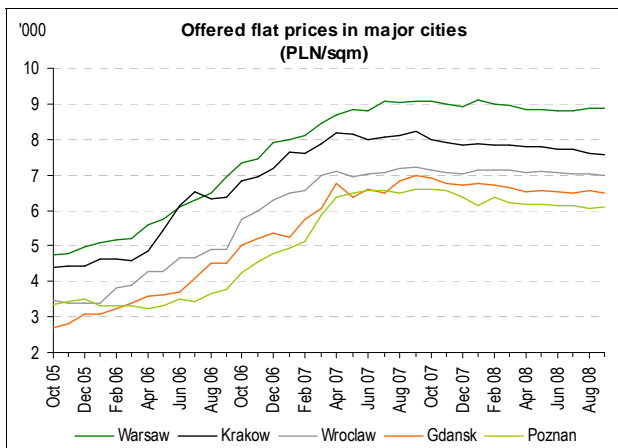
Mortgage loan growth was still strong in September

- Households' mortgage debt increased in September by nearly PLN8bn. However, likewise in August, large part of this growth was due to zloty depreciation versus Swiss franc (over 4%), which boosted value of FX loans expressed in PLN.
- According to our estimate, after taking into account changes in exchange rates, housing loans increased in September by ca. PLN5bn, and their annual (adjusted) growth slowed down to 46.7%YoY.
- Since January, demand for zloty-denominated mortgage loans was practically lifeless and almost entire growth in housing debt in the last four months referred to foreign currency loans. Due to significant changes in banks' credit policies, next months are going to see a dramatic change in situation in this regard.



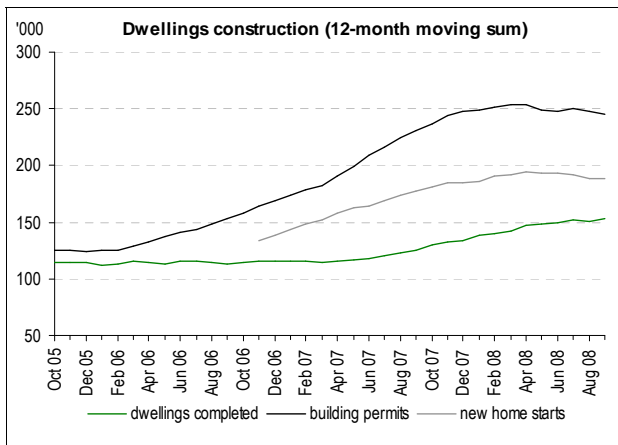
... but is likely to slow down sharply in subsequent months

- In October, better part of major commercial banks introduced important changes in credit policies, raising margins and tightening conditions of granting loans and borrowers' assessment (including a reduction in LTV ratio). Changes referred mostly to loans in foreign currencies.
- Due to a sudden weakening of the zloty and rise in money market rates, costs of debt servicing increased substantially (in case of FX loans by more than 10%). Zloty denominated loans are also more expensive due to rise in WIBOR rates and higher margins for new loan agreements.
- Lower loans availability and higher borrowing costs will weaken demand in the housing market, which we predicted already last month.



Prices still stagnation, what will be next?

- Behaviour of house prices in August and September was similar to situation in previous months. There was a clear stagnation, and in some cases slight declines in house prices.
- Deepening crisis in financial and credit markets and possible deterioration in labour market situation show a risk of deeper correction of prices in the near term.
- Housing market brokers recorded a clear drop in the number of transactions and rise in the number of flats offered for sale in the aftermath of financial market turmoil.
- On the other hand, there are also some signals about reviving demand for flats in some market segments, as in some investors' assessment real estate investment is a good choice for uncertain times and yield on houses for rental may be higher and more certain than on bank deposits.



Developers halting new investments

- Recently, developers started announcing abandoning or suspension of housing investments planned earlier due to difficult market situation and problems with financing. This confirms our last months' prediction that one should expect a clear decrease in supply of new houses in several quarters horizon.
- However, in the near term the number of house completions will remain high, which is suggested, among others, by data about new home starts. In the last 12 months there were 245,000 new building permits in Poland, while 188,000 new home starts. Even if part of those investments will not be finished, the number of house completions is likely to reach almost 170,000 by the end of this year, versus 134,000 in 2007.

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

Central bank watch

Key fragments of the MPC statement as compared to September

Data that have been released recently indicate that ~~despite better than expected data on GDP in 2008 Q2 – economic growth may markedly decline in Poland will decrease~~ in the coming quarters. **Stronger than previously expected economic slowdown will be driven by a significant decline in economic growth abroad, increased uncertainty as to the economic outlook as well as limited credit availability and its increased costs resulting from higher risk premium incorporated in market interest rates.** 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.

The Council maintains its assessment that in the coming months inflation will continue above the upper limit for deviations from the inflation target, which will to a large extent, be the result of high, **albeit declining**, annual growth of food prices as well as high growth of administered prices, including energy prices.

The Council assessed the probability of inflation ~~overshooting the inflation target in the medium term to be higher than the probability of inflation running above or below the target in the medium term to be roughly equal~~. Therefore, the Council does not rule out that bringing inflation down to the target in the medium term will require monetary policy tightening. 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's decisions in the coming months will depend on the incoming information on the outlook for economic growth and inflation in Poland and abroad.**

The Council will analyse the impact of developments in the domestic interbank market on the monetary policy transmission mechanism in Poland. The Council maintains its view that Poland should join the euro area at the earliest possible date, after achieving the necessary political support for amendments in the Constitution of the Republic of Poland and other legal acts necessary for the euro adoption in Poland.

GDP projections in subsequent Inflation Reports

	Feb 08	Jun 08	Oct 08*	Oct 08**
2008	4.4-5.8	4.3-5.5	5.0-5.3	4.9-5.2
2009	3.5-6.1	3.4-6.2	1.9-3.7	1.7-3.5
2010	3.6-6.9	3.8-6.8	2.7-4.5	2.4-4.3

CPI projections in subsequent Inflation Reports

	Feb 08	Jun 08	Oct 08*	Oct 08**
2008	3.6-4.7	3.8-4.7	4.2-4.4	4.2-4.4
2009	2.6-4.9	2.5-5.8	3.9-5.7	3.1-5.3
2010	2.1-4.8	0.1-5.7	1.9-4.5	1.5-4.3

* version of the projection with cut off date as of September 26; ** version of the projection with cut off date as of October 16; Note: According to the NBP projection, GDP growth and CPI inflation will be in the indicated ranges with probability of 50%

Elements of the NBP's "Confidence package"

Providing liquidity in PLN to banks, initially with 7 day and 14 day maturities, since November liquidity providing operations with 3M maturity.

Providing liquidity in foreign currencies in a form of FX swaps in EUR and USD (effectively, transactions were not settled thus far due to high cost proposed by the central bank); FX swaps in CHF were not available until now due to lack of agreement with the SNB (the agreement was reached at the start of November, and since 17 November the NBP will take part in weekly FX swap operations of the SNB and the Eurosystem).

Widening of list of instruments accepted by the central bank as a collaterals in liquidity providing operations.

Option of premature repurchase of long-term bonds issued by the NBP and purchased by banks with funds released after the reduction of reserve requirement several years ago.

No more rate hikes! What about cuts?

- The Monetary Policy Council has kept main interest rates unchanged in October and changed informal monetary policy bias from restrictive to neutral.

- The official communiqué was modified quite substantially as compared to previous month and its tone became much more dovish. Significant impact on the MPC assessment had strengthening of turmoil on the financial and housing markets that in the Council's opinion triggered a "significant deterioration of perspectives of economic growth in external environment of Polish economy" and drop of inflationary pressure in many countries.

- Taking into account a tone of the MPC statement it seems to us that the Council will decide to make one step further in the nearest months in terms of the bias and will change it from "neutral" to "easing". The question is how soon it might happen and when we may expect a start of monetary easing.

- A scale and a pace of interest rate reduction in Poland will depend on pace of economic slowdown and disinflation, perspectives of euro zone entry, and situation in the financial markets. One should take into account that due to significant zloty depreciation in the recent period, there was a substantial decrease in monetary restrictiveness even despite the main central banks' interest rates remained unchanged (see the next page). On the other hand, decisive interest rate cuts made by other central banks in Europe made Polish monetary policy more restrictive relative to monetary policies abroad.

- In our view, the first rate cut may take place after inflation rate falls below 3.5% at the start of 2009. A total scale of rate cuts next year may amount to as much as 100 bp.

NBP projection sees GDP slowdown and high inflation

- New NBP projection shows significant decrease in predicted economic growth rate in 2009-10 – GDP growth below 3% in 2009 and below 4% in 2010.

- Interestingly, despite significantly worse outlook for economic growth, inflation path predicted in the model remains quite high (above 4% in 2009 and above the target on average in 2010). Only since the middle of 2009 predicted path of core inflation is lower than in June version of the projection.

- In our view, assumption that world prices of commodities will be higher than predicted in June, is quite controversial.

- Nevertheless, according to authors of the projection, the risk for predicted inflation is strongly asymmetric on the downside. We fully agree with this view.

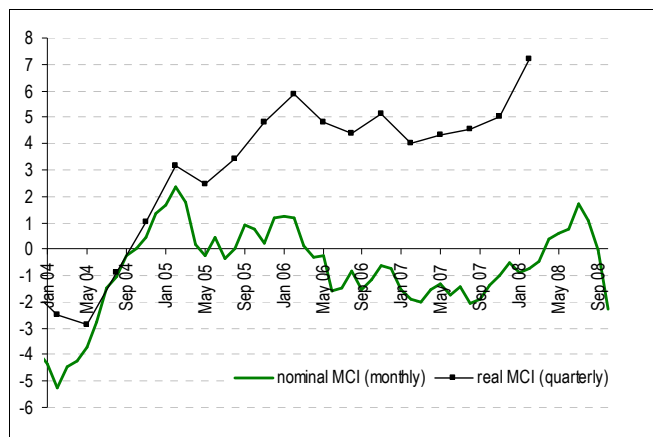
NBP's confidence package not too effective thus far

- In the middle of October, the NBP announced the so-called confidence package for banks that was aimed at "allowing banks acquisition of zloty funds for periods longer than one day, allowing banks acquisition of foreign currency funds and increasing possibilities of receiving liquidity in zloty via enhancing collaterals accepted by the NBP".

- Thus far, impact of bringing the package into life on situation in the money market was small, and spread between NBP main rate and WIBOR rates remained at very high level.

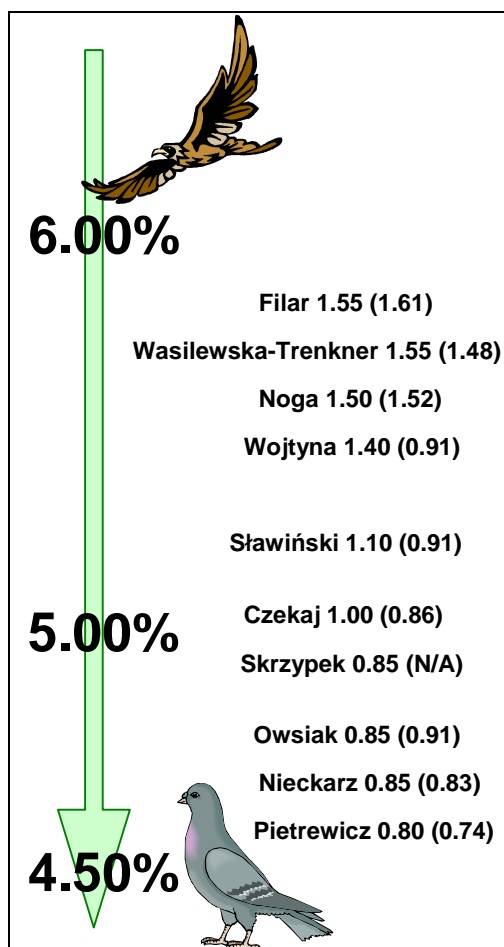
- In our view, a central bank's response should be continuation of operation in the framework of confidence package, which should restore normal market functioning in a relatively short term.

Restrictiveness of the Monetary Policy (Council)



MCI down for the third straight month

- In line with our expectations presented in the previous report, October brought further decline in nominal MCI. This resulted from substantial depreciation of the zloty against the euro.
- The scale of the zloty weakening was so significant that it more than offset the effect of considerable increase in WIBOR3M rate observed due to liquidity problems in Polish the inter-bank market.
- The fall in nominal MCI observed for the past few months means effective easing in monetary conditions, despite stabilisation of the official NBP interest rates after rate hike in June. However, one should remember that the MCI does not take into account all the factors that affect the effective level of monetary policy restrictiveness, e.g. availability of loans and overall tightening of credit policy by banks.



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 restrictiveness axis 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.

Change in expected direction of interest rate changes

The new *Inflation Report* included results of MPC votes at meetings in May, July and August when motions to raise rates by 25bps were voted in vain each time. The results has not changed significantly assessment of the balance of strengths within the Council. The motion for a rate hike was in each of the discussed cases supported by Dariusz Filar, Halina Wasilewska-Trenkner and Andrzej Wojtyna. In some of the cases they were joined by Marian Noga (in May and August) and Andrzej Sławiński (in August). At the same time, Jan Czekaj and NBP governor Sławomir Skrzypek remain the two MPC members voting in line with majority decisions every time this year. This means that their comments should be the most closely watched by the market. The most recent comments from them, but also from some of other rate-setters who are placed higher at our restrictiveness axis, indicate that rate cuts are only a matter of time. Thus, we revised our expectations regarding direction of rate changes.

NBP governor and prof. Czekaj point to a need of rate cuts

NBP governor Sławomir Skrzypek said on November 7 that rate cuts should be considered but the MPC as "it is a matter of not only the inflation criterion, but also financial stability as well as economic growth". In his opinion there are many argument to start easing cycle. His willingness to trim rates is suggested also by his recent comments suggesting he is quite sceptical about government's plans of swift euro adoption. The other of key rate-setters, prof. Jan Czekaj, said that "probability or even a need of rate cuts is getting more and more obvious". In his opinion, the MPC has to observe the situation and try to implement such policy that would be reasonably consistent with actions of other central banks. With our expectations that the ECB will follow the 100bp cut in rates made so far with further cuts of 100bp, we think that prof. Czekaj will soon see much room for rate cuts in Poland.

Prof. Sławiński says cuts are only a matter of time

According to prof. Sławiński, who usually votes in line with hawkish faction, "sooner or later [interest rate path] will be adjusted to weakening business climate" and "in such situation as we see abroad, a direction [of interest rates] is predetermined". His comments do not leave doubts that rate cuts in Poland are just a matter of time.

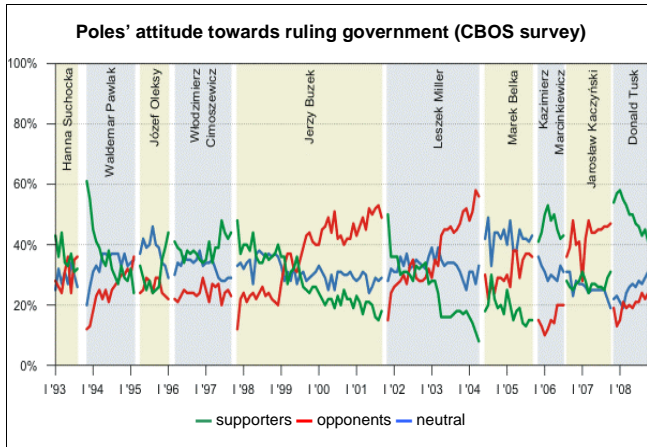
The only question is when hikes will begin

With conviction of majority of rate-setters that rate cuts are needed, the question arises when the easing cycle will begin. We think this will not take place before the year-end. This is suggested by the fact that even one of the radical doves on the rate-setting panel, Stanisław Nieckarz, did not presented a view that such sudden reaction is necessary. In his view, "conditions for start of monetary easing cycle and reduction in interest rate disparity will show up at the start of 2009".

Hawks do not think of hikes anymore, try to delay cuts

Hawkish MPC members are not convinced about a need to cut interest rates. According to H. Wasilewska-Trenkner there is no sense in making such decisions as long as situation in financial markets abroad does not settle down. In D. Filar's opinion, change in monetary policy parameters should wait until new inflation projection in February and revision in CPI basket in March, taking into account that a fall in inflation in Poland will be slower than in countries threatened by recession.

Government and politics



European Commission's economic forecasts

POLAND	2008	2009	2010
GDP growth (%YoY)	5.4	3.8	4.2
Employment (%YoY)	2.7	0.5	0.1
Unemployment rate (%)	7.3	7.3	7.8
HICP inflation (%YoY)	4.3	3.5	2.6
Current account balance (% GDP)	-5.2	-6.1	-6.2
General government balance (% GDP)	-2.3	-2.5	-2.4
General government debt (% GDP)	43.9	43.6	43.1
EURO ZONE	2008	2009	2010
GDP growth (%YoY)	1.1	0.1	0.9
HICP inflation (%YoY)	3.5	2.2	2.1

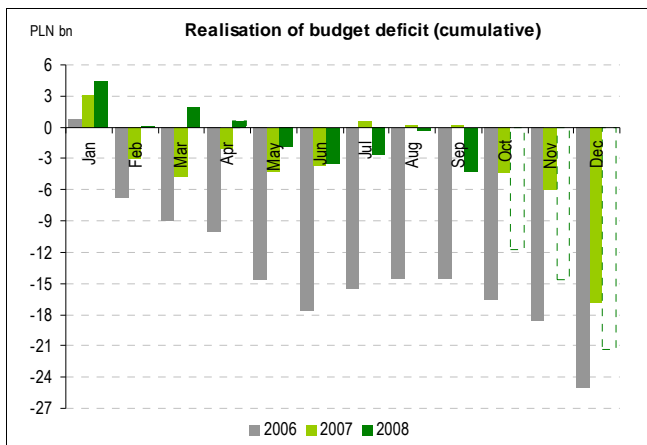
Planned government's action

Guarantees for banks' loans in the central bank (up to 50% of loan value) and guarantees for loans and credit lines granted by banks to each other due to meeting liquidity requirements

Lending treasury securities, sale of treasury securities with postponed payment of payment in instalments

Possible takeover / recapitalization of banks in difficult situation

Lifting threshold of guarantees for deposits in banks to equivalent of €50,000, in compliance with the decision about level of minimal guarantees made at the EU summit



PO leads in polls, although government's popularity lower

- Assessment of the government's activity by Poles becomes gradually more critical. However, the number of the cabinet's supporters is still clearly higher than its opponents.
- In case of the President's and parliament's activity the direction of changes is similar, although critical opinions dominate over positive ones.
- Despite the deepening disappointment with effects of the government's activity, the PO is still clearly leading in public opinion polls. If the opinion polls properly reflect reality, a possible early elections would give the ruling party even more votes in parliament than currently.
- Nevertheless, it seems that the PO will rather not want to risk early elections in situation of the impasse as regards the euro adoption issue, which was suggested by some comments.

EC forecasts for Poland quite optimistic

- The European Commission predicts that GDP growth in Poland will slow down to a lesser extent than in developed countries and reach 3.8% in 2009. The main driver of GDP growth in Poland will remain domestic demand, although both investment and consumption growth rates will decrease.
- Exports growth will also drop, mainly due to recession in the euro zone, but in the EC's opinion the Polish exports' structure and price competitiveness will partly offset the negative demand shock. Meanwhile, rising transfers from the EU will be lower Poland's current account deficit – in 2010 by 3.75% of GDP.
- According to the EC, the Polish banking sector was resistant to crisis in the financial market, but some small and average banks are vulnerable to turmoil in global markets due to large dependence on financing in foreign currencies.

Government guarantees for banks to come

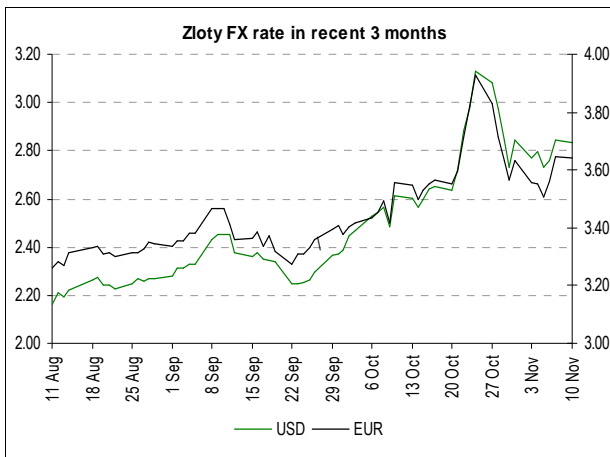
- The government passed a bill draft, which aims at supporting the liquidity situation in the domestic interbank market and unblocking credit market (the most important action proposals in the table on the left). The guarantees would be priced at commercial basis.
- According to the draft the finance minister would take particular actions in response to motion of financial institution after taking advice from KNF (Financial Supervision Committee) and the NBP president.
- The finance minister said that the government support will be granted to only „safe and strong in capital banks”, though later the deputy minister straightened out that this refers to banks with solvency ratio above 8%, i.e. in practice to all banks operating in Poland.

The budget spending started rising

- After three quarters the budget deficit was at PLN4.2bn, i.e. 15.5% of the level scheduled for this year in the budget bill.
- After a few months of holding back with spending, in September there was a clear acceleration, while the revenues growth rate slightly slowed down. The growth of indirect taxes clearly decelerated, which reflects most probably a weakening economic activity, though on the other hand the PIT taxes growth accelerated in September quite significantly.
- According to the FinMin estimates after the October the deficit widened to ca. PLN11.6-11.8bn. In the whole year it will be probably by over PLN5bn lower than it was initially planned. The realisation of 2009 budget will be much more challenging due to heavy economic slowdown.

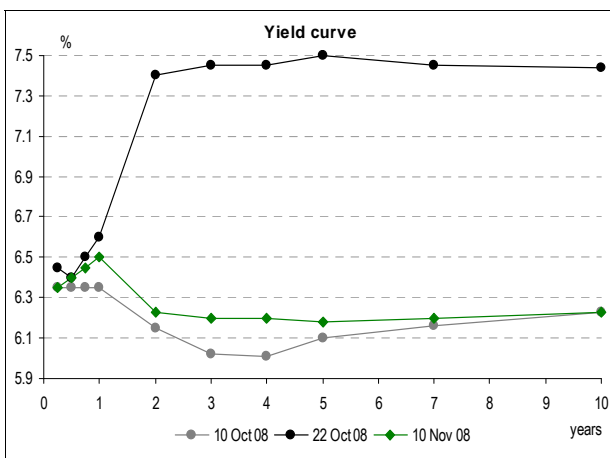
Source: Ministry of Finance, European Commission, CBOS, own calculations

Market monitor



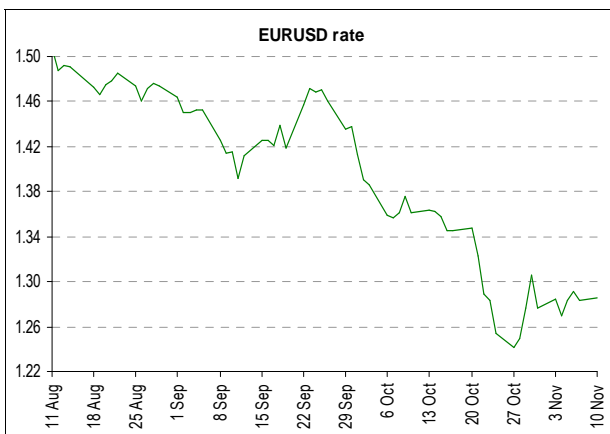
A jump in zloty volatility

- In October the zloty was hurt by risk aversion and especially negative sentiment toward the Eastern Europe (in region mainly Hungary – lowered rating by S&P, Fitch, Moody's), among others due to concerns over financing in the foreign currencies. In the result the EURPLN jumped to the highest levels since 2 years (ca. 4.00) and the market volatility significantly increased. Amid interest rate cuts by major central banks and rescue packages of international institutions (mainly IMF) for emerging countries the risk appetite improved and the zloty recovered.
- In our view the zloty may stay weaker in the nearest time. Similar as other emerging market currencies the zloty is under influence of risk appetite and deteriorating economic growth prospects. The interest rate cuts expectations as well as rising current account deficit will also be negative factors for the zloty.



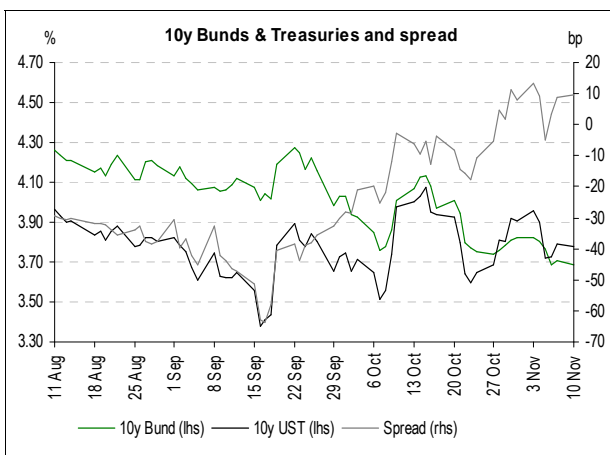
Gradual recovery after severe sell-off

- In the last weeks the market was mainly under influence of situation abroad and negative sentiment toward region contributed to significant and sudden sell-off (yields of some bonds were 8%). Despite softening of MPC members' opinions and majority of macroeconomic data below expectations the IRS rates (and FRA) temporarily and to smaller extent followed the bond yields. Amid improved risk appetite and zloty strengthening the market rates declined, while the bond market remained illiquid.
- Amid expected interest rate cuts in the first months of 2009 and realisation of key figures (CPI, production, wages) below market expectations in our view there is still some room of the interest rate market to strengthen. A gradual stabilisation of situation abroad should also gradually add to decline of risk premium.



Increased demand for the dollar

- In October there was an increased appetite for the dollar amid difficult conditions in the credit markets and high demand for safe-haven assets. Expectations for further interest rates reductions in the euro zone negatively affected the euro. The single currency recovered amid improvement of global moods and coordinated actions of governments aiming at reviving the confidence in the markets (deposit guarantees, banks recapitalisation, etc.). A rate cut by the ECB by only 50 bp (which was disappointing for some investors as compared to moves of other central banks) and return of fears over prospects of world economy contributed to dollar strengthening again.
- In our view the strengthening of the US currency should be moderate to ca. 1.23 in Q1 next year. The dollar appreciation trend should be interrupted by EURUSD rate corrections.

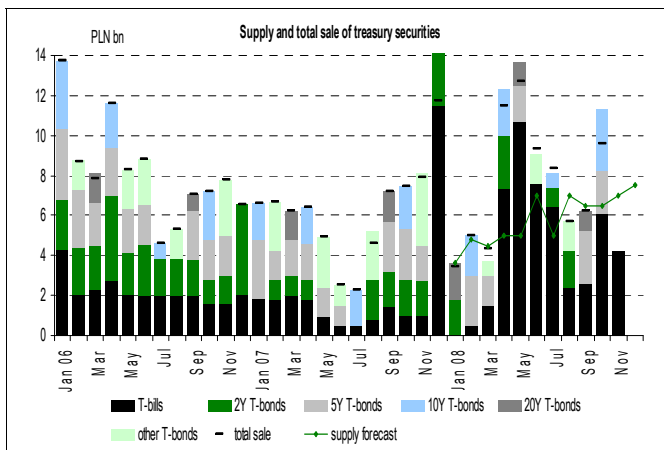
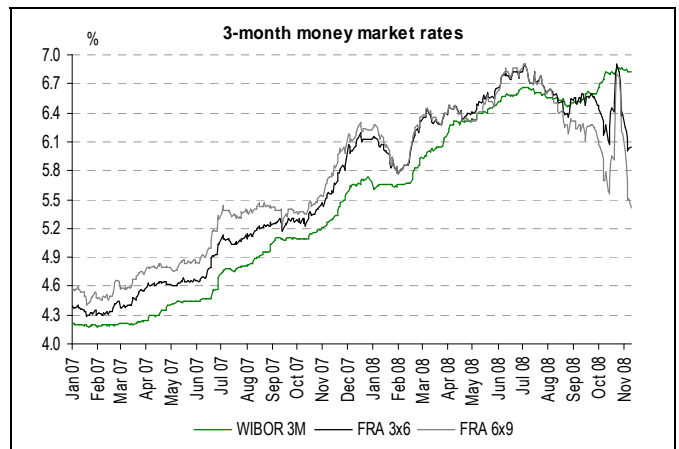
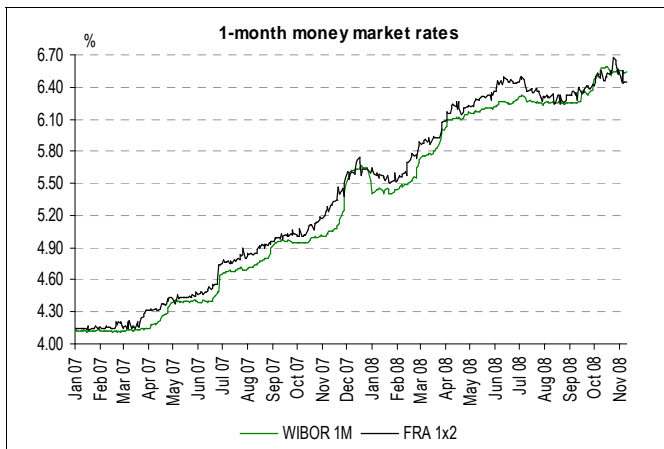
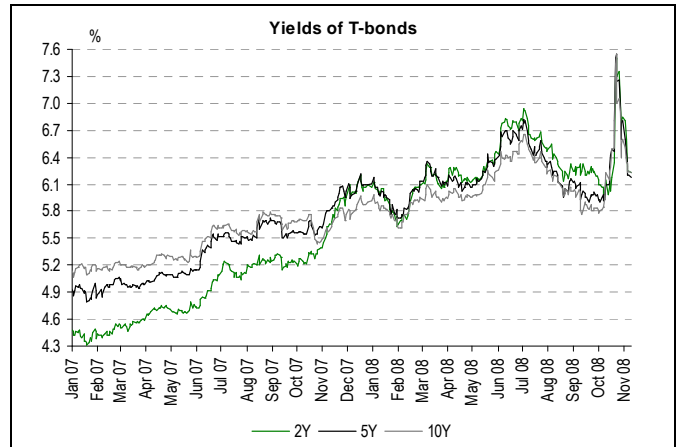
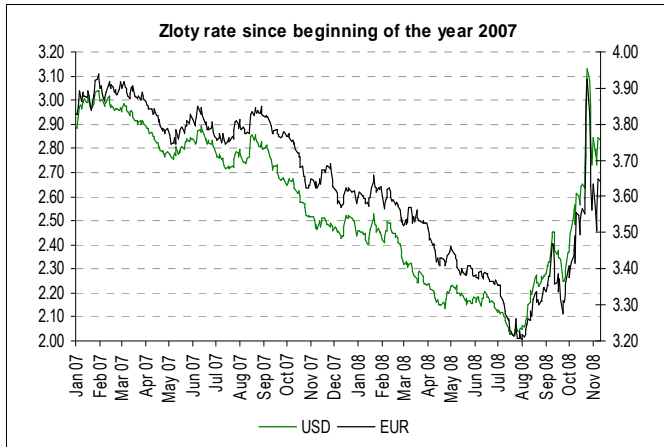


Strengthening in the core debt markets

- In the core debt markets there was a substantial fall of yields amid large increase of risk aversion and on expectations of more interest rate cuts. At the end of October yields of 10Y Bunds decreased below 10Y Treasuries levels. Later there was a downward correction of prices on higher risk appetite amid falling interest rates in the money markets. However, in November the core markets strengthened again amid releases of more poor data both from the US and the euro zone. Yields of 10Y Treasuries and Bunds declined since the release of previous report by 20 bp and 32 bp.
- In the core debt markets there may be further gradual strengthening due to mounting expectations for deeper interest rate cuts. In our view next year the interest rates the official rates of ECB and BoE will fall in both cases at least to 2% and Fed rates will lowered by 25 bp already this year.

Source: Reuters, BZ WBK

Market monitor



Treasury bill auctions (PLN m)

Date of auction	(OFFER)*SALE			
	52W	39W	26W	13W
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	800/812	-	-	800/803
20.10.2008	1000/495	-	-	1000/288
27.10.2008	-	-	-	1000/703
03.11.2008	500-1500/815	-	-	200-500/475
07.11.2008	-	200-700/896	-	500-1500/1299
17.11.2008	-	-	1000-2500	-
24.11.2008	-	-	1000-2500	-
08.12.2008	-	-	-	-

* based on data of the Ministry of Finance

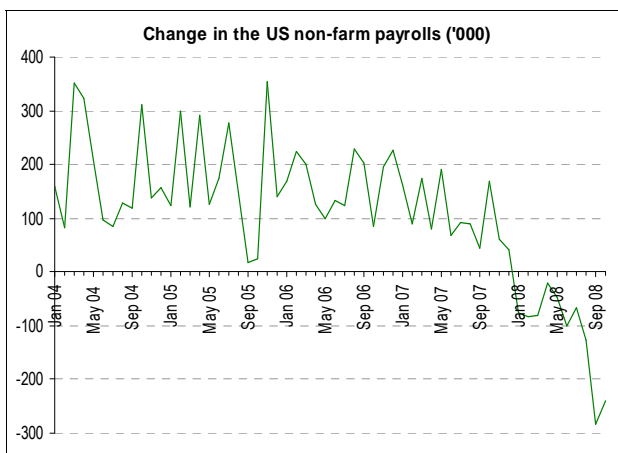
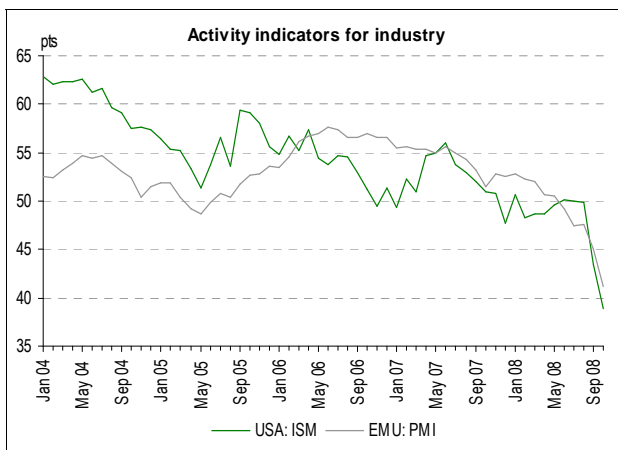
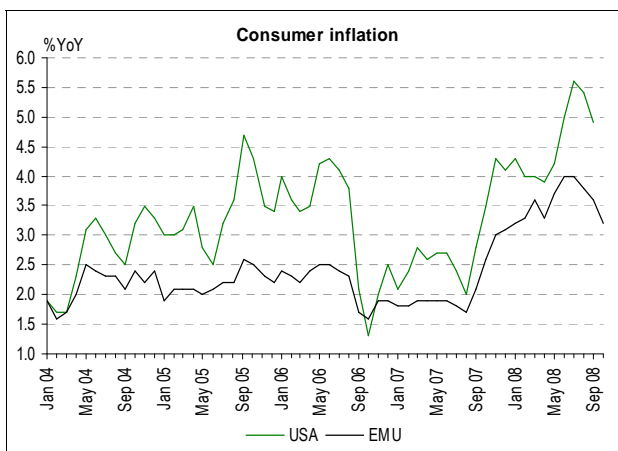
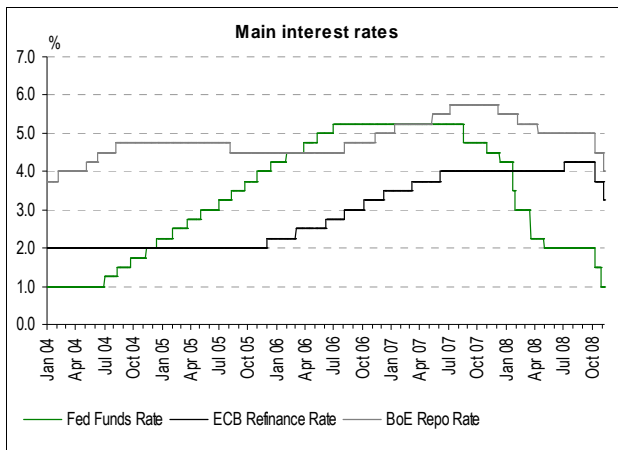
Treasury bond auctions in 2008 (PLN m)

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	23.07	PS0413	1558
August	06.08	OK0710	1 800	1 830	13.08	WZ0118 Z0823	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	24.10	IZ0816 / WZ0118	620 / 655
November	-	-	-	-	-	-	-	-	12.11	OK0710 / PS0414	874 / 314
December	03.12	2Y	-	-	-	-	-	-	-	-	-

* with supplementary auction

Source: Ministry of Finance, Reuters, BZ WBK

International review



Source: Reuters, ECB, Federal Reserve

Further monetary policy easing

▪ After coordinated interest rate cuts by the major central banks at the start of October at the end of the past month at the official meeting Fed cut interest rates by another 50 pb. The main rate declined to 1%. In Fed's view the risk for economic growth is still asymmetrical to the downside due to intensification of the crisis and moreover one may expect inflation fall.

▪ As expected the ECB lowered interest rates by 50 bp to 3.25%. J.C. Trichet said at the conference after the meeting that in the current environment he expects diminishing price pressure and he did not rule out further interest rate cuts.

▪ A series of central banks in Europe surprised with its interest rate decisions. The Czech central bank lowered interest rates by 75 bp against expected 25 bp. The market was also surprised by the scale of rates reduction of the Bank of England of 150 bp (the main rate fell to 3.0%), while the median of market forecasts pointed to a move of 50 bp. At a special meeting the interest rates were cut by 50 bp also in Switzerland, which resulted from expected influence of slowdown in the global economy on activity in this country.

Inflation falls

▪ According to official data of the Eurostat for September inflation in the euro zone declined to 3.6%YoY in line with preliminary expectations. What is more the preliminary statistic point to further inflation decline to 3.2% in October.

▪ US inflation remained unchanged In September in monthly terms (4.9%YoY), and core inflation rose by 0.1% (2.5%YoY) against expectations of 0.1%MoM and 0.2%, respectively.

▪ Lowered commodities prices and deteriorating economic growth prospects contribute to improving inflation perspectives.

Poor activity data

▪ PMI for manufacturing in the euro zone fell in October to 41.1 pts slightly below market forecasts. The services index fell more than expected to 45.8 pts, the lowest level in the surveys history (since 1998), against expected 46.9 pts. In Germany the activity decline was the largest in 5 years. At the same time the price pressure declined. The Ifo index fell in October to 90.2 the lowest level since May 2003 against expectations at 92.9.

▪ The ISM for manufacturing in the US lowered in October to 38.9 pts, the lowest level since 1982 and much below forecasts. The non-manufacturing ISM index fell also more than expected to 44.4 pts from 50.2 pts in September against expected 47 pts. The index reached the lowest level in 10 years, while the employment index recorded a decline to the record low level, i.e. 41.5 pts. US industrial production declined In September by 2.8%MoM against expectations of -0.8%. Meanwhile Philly Fed for October fell to -37,5 pts from 3.8 pts in September against expectations of -10 pts.

▪ US Q3 GDP fell by 0.3% against expected 0.5% decline. Data showed first private consumption fall since 1991 and its largest decline since 1980. The private consumption declined by 3.1% (+1.2% In Q2), exports rose by 5.9% (12.9% in Q2), imports fell by 1.9% (-7.3%), business investments declined by 1% (2.5%).

US payrolls keep on falling

▪ The non-farm payrolls fell in October by 240k, while the market expected a decline by 200k. Data for September were revised to -284k from -159k. The rate of unemployment rose to 6.5% from 6.1% in September against expectations of 6.3%.

Economic calendar

Monday	Tuesday	Wednesday	Thursday	Friday
10 November <i>PL: Auction of Treasury Bills</i>	11 <i>PL: Independence Day</i> US: Market holiday DE: ZEW index (Nov)	12 <i>PL: Switch auction</i> <i>PL: Balance of payments (Sep)</i> EZ: Industrial production (Sep)	13 <i>PL: CPI (Oct)</i> US: Balance of payments (Sep)	14 <i>PL: Money supply (Oct)</i> EZ: Flash GDP (Q3) EZ: Final HICP (Oct) US: Import prices (Oct) US: Retail sales (Oct) US: Preliminary Michigan (Nov)
17 <i>PL: Auction of Treasury Bills</i> US: NY Fed index (Nov) US: Capacity utilisation (Oct) US: Industrial production (Oct)	18 <i>PL: Wage and employment (Oct)</i> US: PPI (Oct) US: Capital flows report (Sep)	19 US: CPI (Oct) US: House starts (Oct) US: Building permits (Oct) US: FOMC minutes	20 <i>PL: Core inflation (Oct)</i> <i>PL: Industrial production (Oct)</i> <i>PL: PPI (Oct)</i> <i>PL: MPC minutes (Oct)</i> US: Wholesale inventories (Sep) US: Philadelphia Fed index (Nov)	21 <i>PL: Business climate (Nov)</i> EZ: Flash manufacturing PMI (Nov) EZ: Flash services PMI (Nov)
24 <i>PL: Auction of Treasury Bills</i> JP: Market holiday DE: Ifo index (Nov) US: Home sales (Oct)	25 <i>PL: MPC meeting</i> US: Preliminary GDP (Q3) US: Core PCE (Q3) US: GDP deflator (Q3)	26 <i>PL: Retail sales (Oct)</i> <i>PL: Unemployment rate (Oct)</i> <i>PL: MPC decision</i> US: Case/Shiller house price index US: Consumer confidence (Nov) US: Core PCE (Oct) US: Durable goods orders (Oct) US: Chicago PMI (Nov) US: Final Michigan (Nov) US: Home sales (Oct)	27 US: Market holiday EZ: M3 money supply (Oct) EZ: Economic sentiment (Nov)	28 <i>PL: GDP (Q3)</i> EZ: Preliminary HICP (Nov)
1 December <i>PL: PMI (Nov)</i> EZ: Manufacturing PMI (Nov) US: Manufacturing ISM (Nov)	2 EZ: PPI (Oct)	3 <i>PL: Auction of 2Y bonds</i> EZ: Services PMI (Nov) EZ: Retail sales (Oct) US: ADP report (Nov) US: Non-manufacturing ISM - (Nov)	4 EZ: Revised GDP (Q3) EZ: ECB decision GB: BoE decision US: Factory orders (Oct)	5 US: Non-farm payrolls (Nov) US: Rate of unemployment (Nov)
8 <i>PL: Auction of Treasury Bills</i>	9 DE: ZEW index (Dec) US: Pending home sales (Oct)	10 US: Wholesale inventories (Oct)	11 CH: SNB decision US: Trade balance (Oct) US: Import prices (Nov)	12 <i>PL: Balance of payments (Oct)</i> <i>PL: Money supply (Nov)</i> EZ: Industrial production (Oct) US: PPI (Nov) US: Retail sales (Nov) 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	26	-
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	26	-
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

		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 08	Nov 08
Industrial production	%YoY	10.8	8.5	6.4	10.7	15.0	1.0	15.1	2.4	7.3	5.9	-3.7	7.0	-0.4	1.6
Retail sales ^c	%YoY	19.4	19.2	12.4	20.9	23.8	15.7	17.6	14.9	14.2	14.3	7.7	11.6	9.1	7.6
Unemployment rate	%	11.3	11.2	11.4	11.7	11.5	11.1	10.5	10.0	9.6	9.4	9.3	8.9	8.9	9.1
Gross wages ^{b,c}	%YoY	11.0	12.0	7.2	11.5	12.8	10.2	12.6	10.5	12.0	11.6	9.7	10.9	8.8	6.7
Employment ^b	%YoY	5.0	5.0	4.9	5.9	5.9	5.8	5.6	5.4	4.8	4.7	4.2	4.1	3.7	3.5
Export (€) ^d	%YoY	15.6	11.3	8.0	22.6	29.1	10.6	34.1	12.5	16.6	23.7	7.1	24.0	7.7	6.7
Import (€) ^d	%YoY	19.7	19.8	16.6	19.8	31.4	12.2	31.8	13.5	19.7	20.9	17.4	25.3	11.6	6.4
Trade balance ^d	EURm	-1019	-1333	-1673	-780	-808	-1345	-1032	-1213	-1639	-1404	-1503	-1400	-1551	-1397
Current account balance ^d	EURm	-1459	-824	-2314	-1211	-1322	-1807	-1282	-1495	-2098	-1057	-1736	-2025	-1801	-1247
Current account balance ^d	% GDP	-4.4	-4.4	-4.7	-4.6	-4.7	-4.9	-5.0	-4.9	-5.0	-4.7	-4.9	-5.2	-5.2	-5.3
Budget deficit (cumulative)	PLNbn	-4.4	-6.0	-16.9	4.4	0.0	1.9	0.6	-1.9	-3.5	-2.7	-0.3	-4.2	-11.7	-14.6
Budget deficit (cumulative) ^e	% of FY plan	26.2	35.5	100.0	-16.4	-0.1	-6.9	-2.2	6.8	12.8	9.9	1.2	15.5	43.3	53.9
CPI	%YoY	3.0	3.6	4.0	4.0	4.2	4.1	4.0	4.4	4.6	4.8	4.8	4.5	3.9	3.6
PPI	%YoY	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	2.8
Broad money (M3)	%YoY	13.8	13.6	13.4	12.9	13.5	13.6	15.0	15.1	16.3	16.8	16.8	17.1	18.7	17.1
Deposits	%YoY	15.2	15.1	14.5	14.3	14.7	15.3	16.7	17.4	18.5	19.4	18.9	19.6	20.4	18.3
Loans	%YoY	30.6	30.1	29.9	30.3	29.5	29.7	28.3	27.6	27.7	25.3	26.7	27.8	29.5	27.4
USD/PLN	PLN	2.61	2.49	2.47	2.46	2.43	2.28	2.19	2.19	2.17	2.07	2.19	2.34	2.69	2.92
EUR/PLN	PLN	3.71	3.66	3.60	3.61	3.58	3.54	3.45	3.40	3.37	3.26	3.29	3.37	3.57	3.65
Reference rate ^a	%	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	6.00
Lombard rate ^a	%	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	7.50
WIBOR 3M	%	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	6.60
Yield on 52-week T-bills	%	5.04	5.30	5.78	5.75	5.66	6.09	6.10	6.10	6.63	6.70	6.60	6.46	6.45	6.35
Yield on 2-year T-bonds	%	5.30	5.77	6.06	5.92	5.90	6.17	6.20	6.27	6.73	6.66	6.32	6.25	6.46	6.25
Yield on 5-year T-bonds	%	5.59	5.90	6.07	5.94	5.93	6.20	6.12	6.25	6.62	6.53	6.15	6.01	6.48	6.22
Yield on 10-year T-bonds	%	5.64	5.70	5.85	5.81	5.82	5.98	5.98	6.10	6.41	6.43	6.10	5.89	6.39	6.28

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	1Q08	2Q08	3Q08	4Q08	1Q09	2Q09	3Q09	4Q09
GDP	PLNbn	1 060.0	1 175.3	1 282.7	1 365.7	295.3	309.9	318.0	359.5	315.8	329.6	336.8	383.4
GDP	%YoY	6.2	6.7	5.1	3.3	6.0	5.8	4.5	4.3	3.4	3.3	3.1	3.6
Domestic demand	%YoY	7.3	8.6	5.9	4.1	6.2	6.0	5.6	5.7	4.4	4.3	3.9	3.7
Private consumption	%YoY	5.0	5.0	5.1	4.5	5.6	5.5	4.8	4.5	4.5	4.5	4.5	4.5
Fixed investments	%YoY	14.9	17.6	12.3	5.6	15.7	15.2	11.5	10.0	9.0	7.0	5.0	4.0
Industrial production	%YoY	12.5	9.7	5.8	4.5	8.5	8.5	3.4	2.9	2.7	3.9	5.9	5.6
Retail sales (real terms)	%YoY	11.9	14.0	10.5	6.2	16.0	11.1	8.0	6.9	3.7	7.0	8.3	5.9
Unemployment rate ^a	%	14.8	11.4	9.2	9.8	11.1	9.6	8.9	9.2	10.5	9.2	9.1	9.8
Gross wages (real terms) ^c	%YoY	4.2	6.7	6.0	3.3	7.2	7.7	5.6	4.2	3.7	3.1	3.3	3.0
Employment ^c	%YoY	3.2	4.6	4.7	1.4	5.9	5.2	4.3	3.5	1.8	1.5	1.2	0.9
Export (€) ^b	%YoY	20.4	13.4	16.5	4.2	20.3	20.9	18.4	7.3	6.0	4.0	3.0	4.0
Import (€) ^b	%YoY	24.0	19.5	17.6	5.5	20.5	21.5	21.4	8.2	8.0	6.0	4.0	4.0
Trade balance ^b	EURm	-5 539	-12 369	-15 698	-18 059	-2 927	-3 877	-4 307	-4 588	-3 760	-4 735	-4 793	-4 771
Current account balance ^b	EURm	-7 445	-14 586	-19 354	-22 115	-4 333	-4 866	-4 818	-5 338	-5 266	-5 824	-5 404	-5 621
Current account balance ^b	% GDP	-2.7	-4.7	-5.2	-5.8	-4.9	-4.9	-5.2	-5.2	-5.5	-5.7	-5.8	-5.7
Budget deficit (cumulative) ^a	PLNbn	-25.1	-16.9	-21.3	-18.2	1.9	-3.5	-4.2	-21.3	-6.5	-12.8	-15.5	-18.2
Budget deficit (cumulative) ^a	% GDP	-2.4	-1.4	-1.7	-1.3	-	-	-	-	-	-	-	-
CPI	%YoY	1.0	2.5	4.2	3.0	4.1	4.3	4.7	3.7	3.4	3.0	2.8	2.9
CPI ^a	%YoY	1.4	4.0	3.6	2.8	4.1	4.6	4.5	3.6	3.3	2.8	2.9	2.8
PPI	%YoY	2.5	2.3	2.7	3.1	3.0	2.6	2.1	3.0	2.7	3.0	3.5	3.3
Broad money (M3) ^a	%YoY	16.0	13.4	15.7	8.8	13.6	16.3	17.1	15.7	13.4	11.3	9.7	8.8
Deposits ^a	%YoY	15.2	14.5	16.5	8.6	15.3	18.5	19.6	16.5	13.8	11.0	8.7	8.6
Loans ^a	%YoY	23.4	29.9	24.7	9.5	29.7	27.7	27.8	24.7	17.7	13.2	9.0	9.5
USD/PLN	PLN	3.10	2.77	2.40	2.86	2.39	2.18	2.20	2.84	3.02	2.89	2.78	2.75
EUR/PLN	PLN	3.90	3.78	3.48	3.55	3.58	3.41	3.31	3.62	3.71	3.59	3.47	3.44
Reference rate ^a	%	4.00	5.00	6.00	5.00	5.75	6.00	6.00	6.00	5.75	5.00	5.00	5.00
Lombard rate ^a	%	5.50	6.50	7.50	6.50	7.25	7.50	7.50	7.50	7.25	6.50	6.50	6.50
WIBOR 3M	%	4.21	4.73	6.33	5.55	5.80	6.43	6.57	6.53	6.20	5.61	5.20	5.20
Yield on 52-week T-bills	%	4.18	4.69	6.26	5.54	5.84	6.28	6.59	6.33	6.00	5.50	5.40	5.25
Yield on 2-year T-bonds	%	4.57	5.23	6.27	5.34	5.99	6.40	6.41	6.27	5.75	5.30	5.20	5.10
Yield on 5-year T-bonds	%	5.03	5.52	6.20	5.25	6.02	6.33	6.23	6.23	5.60	5.25	5.15	5.00
Yield on 10-year T-bonds	%	5.22	5.56	6.09	5.20	5.87	6.16	6.14	6.19	5.50	5.20	5.10	5.00

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 10.11.2008 has been prepared by:

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