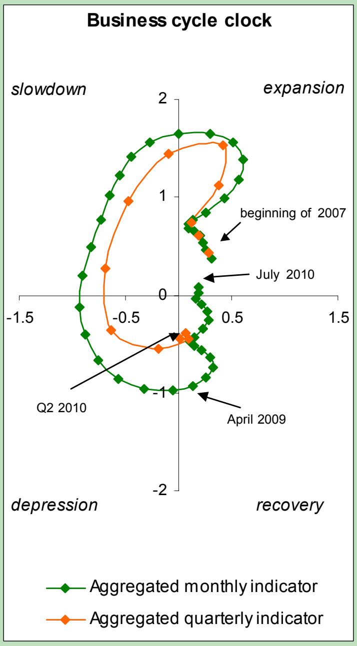
Bank Zachodni WBK

MACROscope

Polish Economy and Financial Markets

September 2010



Note: construction of business cycle clock, including concepts and methodology used for its creation was presented in November's MACROscope
http://english.bzwbk.pl/_items/english/doc/m_eng_2009_11.pdf

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It is time for brave decisions

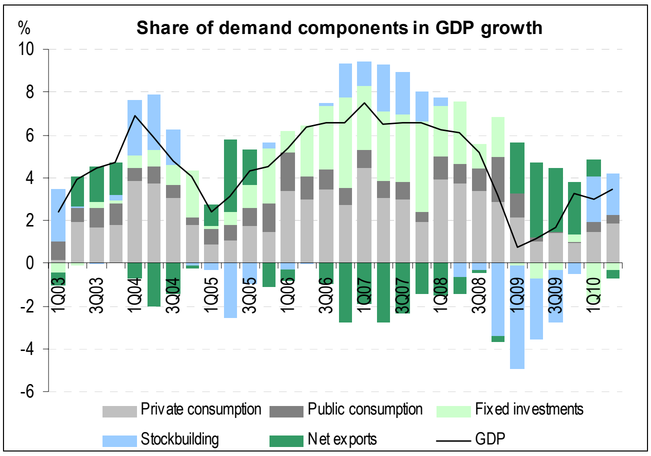
- **The growth of the Polish economy has gain momentum. We expect that the subsequent quarters will see a sustained economic growth of ca. 3.5-4.0% (whole year forecast up to 3.5% from 3.2%).** The published PMI for August confirmed our optimistic projection for a clear rebound in the manufacturing sector. We also expect that the other monthly economic indicators will evidence an improvement on July data. Despite the fact that in the reminder of the year we envisage a slower rise in the growth of export orders and production, the construction industry should witness an upturn and additionally improvement of the situation on the labour market should support private consumption. Yet, we remain cautious as regards the forecast for the next year and we sustain our GDP projection of 3.5%, mostly, due to the global risks.
- **Given the economic upturn, improvement on the labour market and expected clear rise in inflation fuelled by inflationary expectations, the Monetary Policy Council will soon need to take a brave decision on interest rates.** Actually, it faces the dilemma already right now. According to one of the MPC members, the interest rate hike was voted on at the Council's meeting in August. Of course, from the MPC's perspective, high uncertainty around further economic developments globally represents a risk factor. In our view, however, the local factors will prevail and the interest rates will be increased at one of the next MPC's meetings. It is also worth noticing that the MPC in its statement supported the banking supervision in the brave and justified attempt to finally limit FX lending for households.
- **It seems that the government has deferred brave reforms and decided to "buy itself some time" with the VAT increase, effective as of the next year.** The Multi-Year Financial Plan is disappointing, in terms of the proposed scale of the budget deficit reduction, not only for us but also for most of economic analysts. On the other hand, we should not be surprised by a moderate market response, in particular, given the relatively low level of planned borrowing needs. We will wait and see the actual delivery of the plan and we also need to remember that there is a high risk of exceeding the public debt/GDP ratio of 55%.
- **The holiday season on financial markets witnessed the stabilisation of EUR/PLN rate around 4.0, despite the re-emerging global risk aversion resulting from the publication of disappointing economic data, mostly in the US.** In addition, the strengthening of the global bonds markets fuelled by greater concerns about the global slowdown (or recession in the US) triggered a decrease in the bond yields on the Polish market and flattening of the yield curve. In our opinion, the inevitable interest rate rise and a series of new economic data which will bring an improvement in many indices (industrial production, construction output, labour market, higher CPI inflation, high PPI) should translate into rise in yields on the bond market. As regards the PLN rate, we sustain our earlier projections which indicate its strengthening (3.92 at September-end).

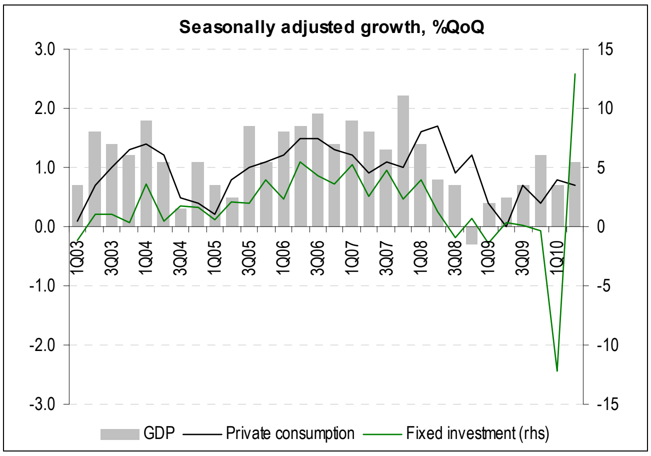
Financial market on 31 August 2010:

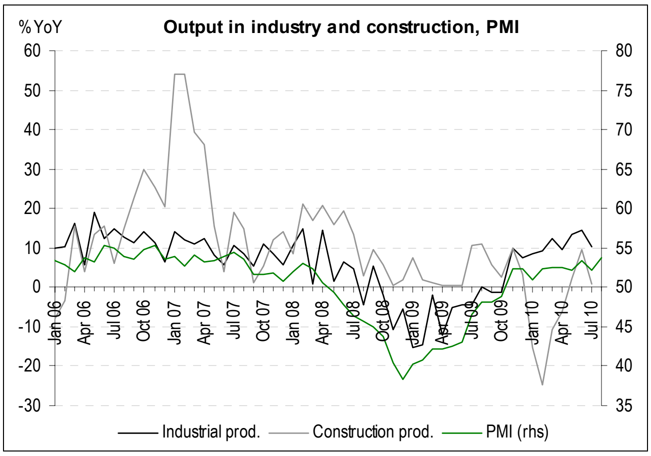
NBP deposit rate	2.00	WIBOR 3M	3,81	USDPLN	3.1583
NBP reference rate	3.50	Yield on 2-year T-bonds	4.67	EURPLN	4.0038
NBP lombard rate	5.00	Yield on 5-year T-bonds	5.15	EURUSD	1.2677

This report is based on information available until 01.09.2010

Economic update







Source: CSO, NBP, Reuters, own calculations

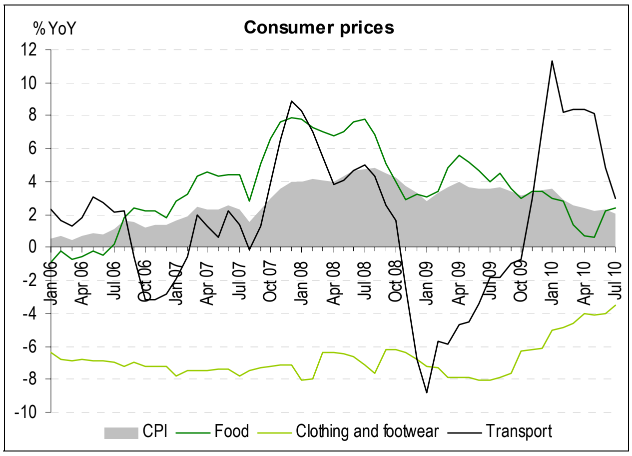
Improvement in the Polish economy continues

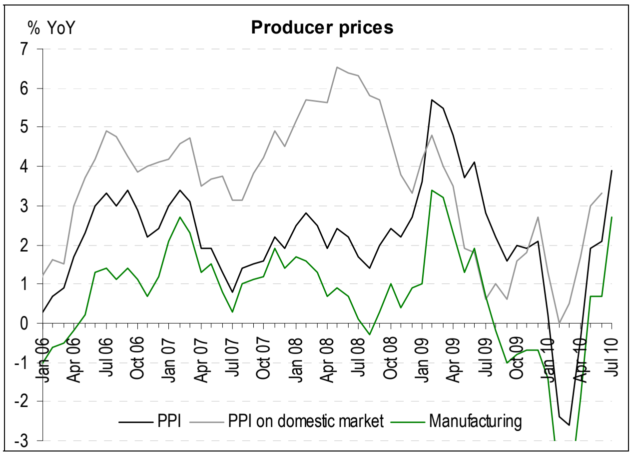
- Poland's GDP growth in Q2 reached 3.5%YoY, beating market expectations. The most important surprise in breakdown of the growth was a clear acceleration in private consumption. We had expected that Q4 2009 was the weakest in this case (a mere 1.7%YoY rise) and next quarters should see gradual improvement. However, our forecast pointed to stabilisation of the private consumption growth in Q2 at the level of slightly above 2%YoY. The data showed a rise of 3%YoY.
- On the other hand, one may be disappointed by figures on fixed investments, which showed second straight quarter of annual drop. However, it was not far from expectations pointing to small increase and it has to be stressed that after a slump of 12.4%YoY in Q1, in the next quarter there was a fall only by 1.7%YoY. As to positive contribution of change in inventories and negative contribution of net exports, the data were broadly in line with our predictions. As positive surprise in consumption was much larger than negative surprise in fixed investments, rise in total domestic demand exceeded our forecast of 3.7%YoY and reached 3.9%YoY. This was the highest growth rate since Q3 2008.
- Assuming an investment growth by a few percent in the H2 and persisting growth of individual consumption at ca. 3.0% (which shall be supported by the improvement on the labour market) and even with the prospect of the higher negative contribution of the net exports and lack of equally strong improvement of inventories, we expect that the Polish economy will expand in the similar pace as in the Q2 (or even faster). As a result we increase our forecast for GDP growth in 2010 from 3.2% (above consensus) to 3.5% Still, we remain cautious regarding the next year and keep our forecast at 3.5%, mainly due to global risks.

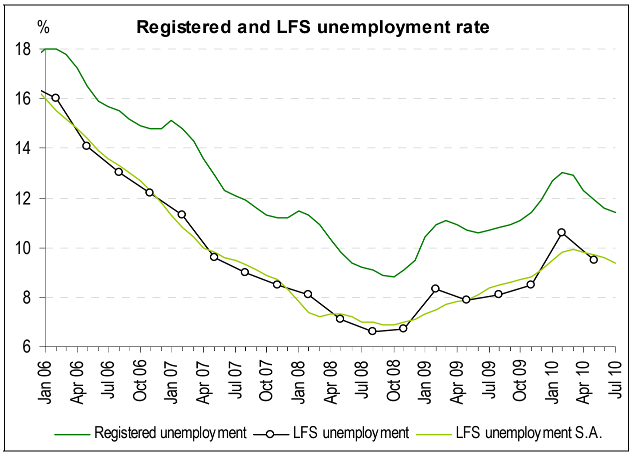
Solid production growth in July, worse in construction

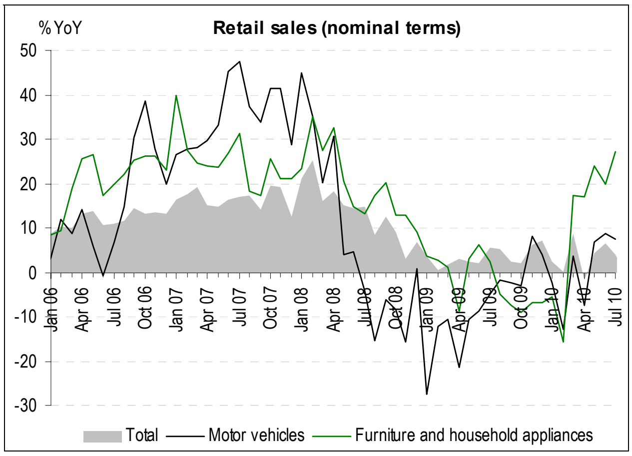
- Industrial production rose in July by 10.3%YoY (14.3%YoY in June), which was close to our forecast of 10.8%YoY (revised down from 12%YoY after a weak PMI index). The market consensus was slightly above 12%YoY.
- Although the figure was below market expectations, in our opinion this was definitely not the worrying signal as regards the situation in the Polish manufacturing sector. It is worth to recalling that in July there was one working day less as compared to July 2009. Therefore, statistics adjusted by seasonal factors show a more meaningful picture - increase in production by 11.3%YoY, which was similar to the previous month and higher than the average for the first half of the year. It is clear that the manufacturing take advantage of economic recovery in major trading partners. Data for the following months should bring a continuation of observed trends and the double-digit production rate of growth in the Q3 (clear rebound in August suggested by PMI index and the opposite effect of working days as compared to July), after which we forecast some slowdown at the turn of 2010 and 2011, as export orders will probably show some slowdown.
- The data on construction and assembly production were disappointing, as the growth was below 1%YoY, while the market consensus was 7.9% and our forecast was 5.5%. This represented a significant slowdown as compared to the increase in June, which reached almost 10%. However, we must remember that production in this sector has represented high volatility in recent months and August (as well as following months) should bring a clear rebound, which is presented in our forecasts.

Economic update









Source: CSO, NBP, Eurostat, own calculations

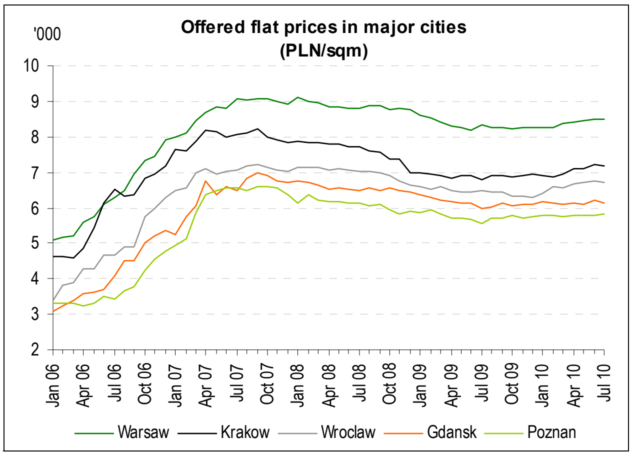
CPI inflation reached the bottom, very high PPI

- CPI inflation in July matched our forecast of 2.0%YoY, which was the lowest in the market, below the FinMin's estimate of 2.1% and market consensus of 2.2%. Prices changes in most of CPI categories were in line with our forecasts. Food prices dropped slightly more than 1%MoM while fuel prices slightly increased (0.2%MoM). Clear drop in prices was seen in clothing and footwear (1.3%MoM) while quite strong rise in prices took place in recreation and culture (0.5%MoM). For majority of other categories prices were broadly stable and core inflation dropped to 1.2%YoY from 1.5%.
- The next months will bring, according to our forecasts, acceleration in CPI inflation to above the central bank's inflation target at the turn of Q3 and Q4 of this year. Then, CPI inflation should continue upward trend in late 2010 and in early 2011. To some extent this will be due to accelerating food prices (their annual growth at the end of 2010 may be by ca. 1pp higher than 2.6%YoY in July). This will be related to a lagged effect of floods and the recently observed upward trend in agricultural commodities in the global markets. The expected zloty strengthening will partly offset these factors. However, we also predict some rise in core inflation later in the year.
- PPI inflation was a big surprise as it surged to 3.9%YoY in July. On a monthly basis producer prices rose 0.3%, despite significant zloty appreciation in the same period, which lowered export prices expressed in zloty. Clear rise in prices was seen in sectors related to commodities, but not only.
- Data on wages in enterprise sector had the opposite effect to PPI, as salaries increased by only 2.1%YoY, which led to slowdown in wage bill. However, we expect that the next month's figure will show growth of above 4%.

Improvement in the labour market supports sales

- Except disappointing wage growth, data for the labour market are rather optimistic. Employment is still rising quite fast and it seems that this is a permanent phenomenon, observed mostly in manufacturing and construction sectors. As a result, the unemployment rate is declining – in July to 11.4% in registered terms and to 9.4% according to seasonally adjusted Eurostat data; and to 9.5% in 2Q10 according to LFS. The number of declared layoffs went down a bit, mainly in the private sector, but remained at quite a high level of nearly 45k.
- Results of CSO consumer climate survey showed further improvement in evaluation of purchases by households and the expected opportunities to save money, but also worsened outlook of economic situation, future income and unemployment.
- The growth of retail sales decelerated in July to 3.9%YoY from 6.4%YoY in June. The real growth reached 2.4%YoY. Analysing the individual categories of the retail sales, many of them showed a typical seasonal trajectory. The high base from the previous year had a considerable impact on the lower annual growth (the unexpectedly high growth in July 2009 was in our opinion caused by the fact that during the peak of the economic and financial crisis fewer Poles decided to spent their holidays abroad). The biggest negative impact on the sales growth was put by the food, clothing and footwear. On the other hand, one should notice a considerable increase in sales of furniture and households appliances, i.e. durable goods, which accelerated to 27.2%YoY, the highest gain since April 2008. In our opinion, that indicates that the consumers' demand is pretty strong and after the vanishing of the base effect in coming months we shall see improvement of the sales.

Housing market update

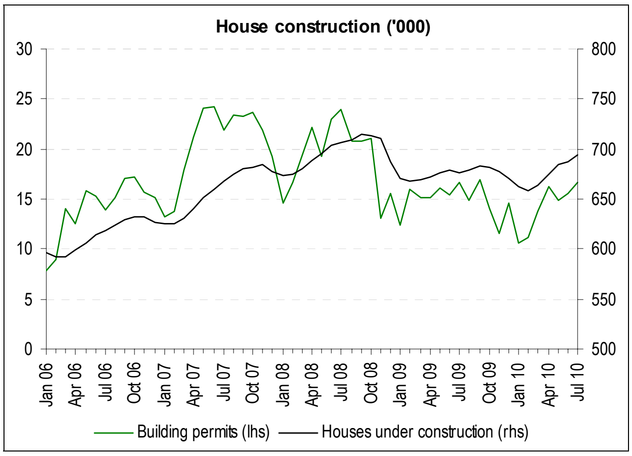


No major changes in the housing market

▪ There was no major changes in the domestic residential housing market in recent months. Households' demand for housing remains subdued, despite the gradual improvement in the labour market and easing the credit policy by banks. Buyers' activity was additionally reduced during the holiday period in line with a typical seasonality.

▪ Offered housing prices in most of Polish cities have been relatively stable since mid-2009. Relationship between costs of house purchase and the average household income has also stabilised in the horizontal trend in the last few months.

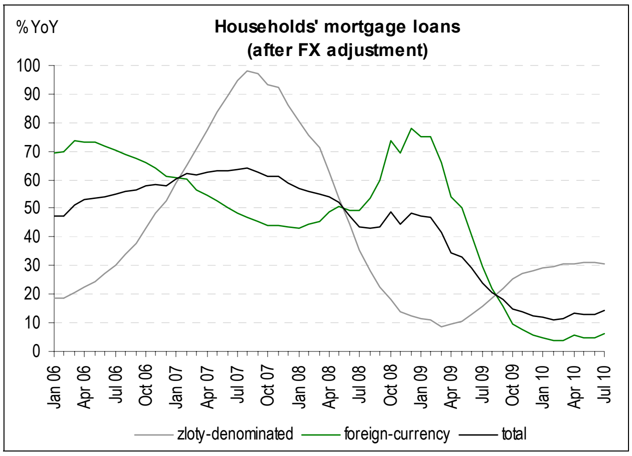
▪ During the past year average rent prices clearly decreased in major cities, to the greatest extent in the case of bed-sits (according to oferty.net website by about 12%YoY in Warsaw).



Developers' activity on the rise

▪ CSO statistics confirmed recovery on the supply side, that we signalled earlier. In Q2 developers clearly began increasing the number of construction starts. The number of issued building permits rose as well. According to the REAS report signals flowing from the developers indicate that they plan to continue starting new investments at a similar pace as before.

▪ The number of housing units put into use has been gradually declining since the peak that was reached at the end of 2009 (in July there was a 1/3 decline in house completions comparing to the last year), however, developers still have many available flats in their offer. It is worth noting that, despite the stagnation of demand, this does not cause a fall in prices. According to REAS, slight excess of demand over supply is maintained only in the segment of the cheapest, smallest flats.

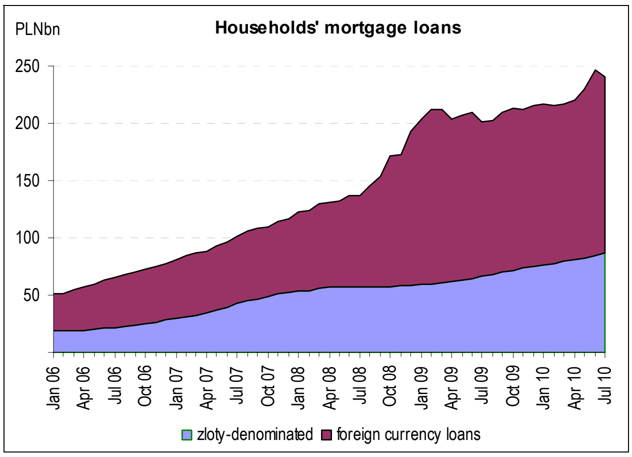


Softer credit policy of banks ...

▪ In recent months banks have continued a gradual easing of the criteria for granting housing loans, including reduction in their mark-ups and the requirements related to lender's own contribution. In July, according to Expander service, the average mark-up for loans in PLN reached its lowest level since August 2008. A decrease in the costs of credit is also a result of gradually declining WIBOR rate (3-month rates in August at the all-time low).

▪ In the case of foreign currency loans, conditions deteriorated slightly (increase in the mark-ups and market rates).

▪ Most banks in the recent NBP survey declared a tightening of credit policy in the housing segment in the third quarter, which may be related to the new regulations of Polish Financial Supervision Authority.



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

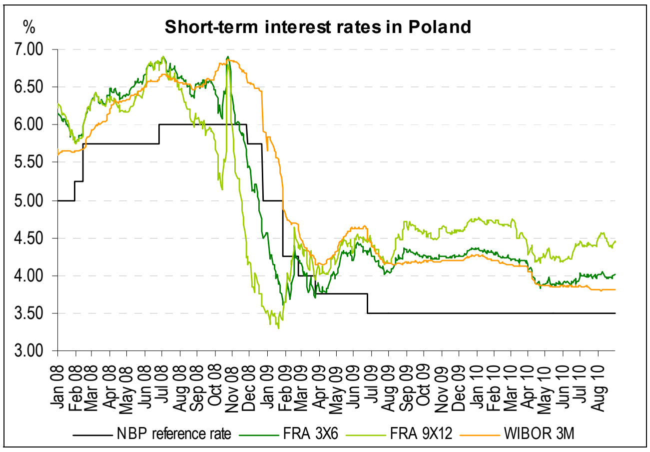
... but regulator's proposals will finally limit FX loans

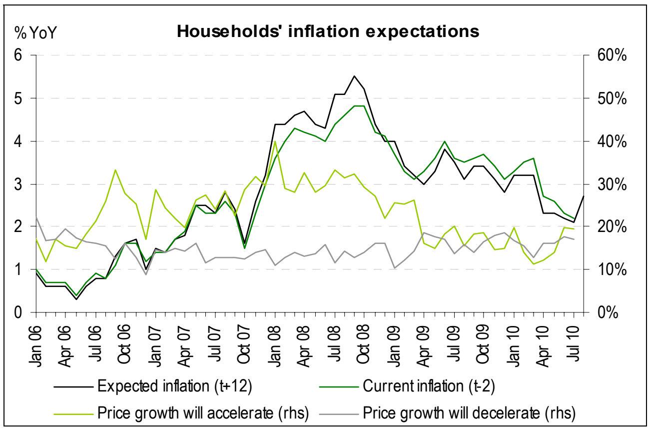
▪ Some elements of T recommendation has been put into effect in August. As a result, banks must not grant foreign currency loans at 100% LTV and must have at least 20% mortgage collateral. In December, next records will come into force, saying that banks will not be allowed to grant loans to persons whose total financial commitments are above 50% of revenue (or 65% for those earning more than the national average).

▪ The effect of T recommendation on the housing loans market should not be very large (according to the PFSA estimate, it will reduce lending by no more than 5%). The upgrade of the S recommendation, on which the regulators are currently working, may have a much greater impart. Due to risk for the economy, the proposal seeks to impose a limit on the share of FX loans in the banks' portfolios at no more than 50%.

Central bank watch

Selected fragments of the MPC statement in June
Released data, including the data on GDP for 2010 Q2, point to weakening economic growth in some of the largest economies, in particular in the United States. By contrast, in 2010 Q2 the economic growth accelerated significantly in Germany and to a lesser extent in the euro area as a whole. However, the risk of weakened external demand sustains the uncertainty as to the euro area economic growth in subsequent quarters. The adjustments in the balance sheets of households, enterprises and financial institutions continue in the developed economies.
In the recent period the price of some agricultural commodities have increased markedly in the global markets. At the same time, the observed alleviation of tensions in the financial markets have favoured the inflow of capital to emerging economies and the appreciation of those countries' currencies, including the strengthening of the zloty.
The data on the Polish economy indicate a stabilisation of the rate of economic growth. Fast growth in industrial output and a slow growth in construction continued. Growing employment in the enterprise sector and decline of the unemployment rate (also in seasonally adjusted terms) both point to a gradual improvement in the labour market situation, which, however, has not been accompanied by growing wage pressure so far. In 2010 Q2 growth of wages in the economy continued to fall gradually despite some acceleration in enterprise sector wages. Lending to enterprises remains limited, mainly due to reasons related to the demand for credit.
In subsequent months, inflation may be gradually increased by food and energy price growth. In the first months of 2011 the level of prices may be raised by the announced change of VAT rates. The impact of this change on inflation should nevertheless be minor.
In the opinion of the Council, introducing measures aimed at preventing fast growth in foreign currency lending to households is important for macroeconomic stability.
The Council maintains its view that Poland should join the ERM II and the euro area at the earliest possible date, after meeting the necessary legal, economic and organisational conditions.





Source: NBP, PAP, Reuters

No major changes after holidays…

▪ After a two-month vacation break, the Monetary Policy Council returned back to work. The decision was in line with broad expectations – main NBP interest rates remained unchanged with the reference rate at 3.5%.

▪ The tone of the MPC communiqué was similar as in June and the key sentence, which indicates a direction of MPC interest, was upheld. Though there were some changes in the communiqué, which indicated risk factors for future inflation taken in to account by the MPC, overall the balance of risks presented by the MPC did not change much.

▪ The Council remains in the wait-and-see mode and will watch the next macro data from the domestic and global economy in order to properly assess inflation risks. An important hint for the Council will be the new inflation projection, which will be revealed in October (after the MPC meeting). Earlier, in September, the MPC is due to adopt Monetary Policy Guidelines for 2011, which may shed more light on how the new MPC headed by new NBP Governor will conduct monetary policy. In particular, it will be interesting to see how the new Council would approach inflation rise due to exogenous factors, amid rising prices of food and higher VAT, which may fuel inflation towards the upper end of tolerance band around the target. It would mean a zero real interest rate (taking into account current inflation) in an environment of gradual economic recovery and improvement in the labour market, amid simultaneous risk factors concerning global economic growth.

… but MPC members' comments much more hawkish…

▪ Recent comments of the MPC members were much more hawkish than the official statement, especially after the publication of GDP data for the second quarter. We present more details on the next page. They clearly suggest that the moment of rate hike approaches inevitably.

▪ Probably the same members who voted in favour of rate hike already in August will propose the same motion in September. Especially, as according to our forecast, they will be supported by the new series of macroeconomic data for August (and already published PMI index and 2Q10 GDP figures).

▪ We think, however, that majority of the Council will prefer to wait till October for new inflation projection and budget for 2011. that's why we keep forecast of hike in October.

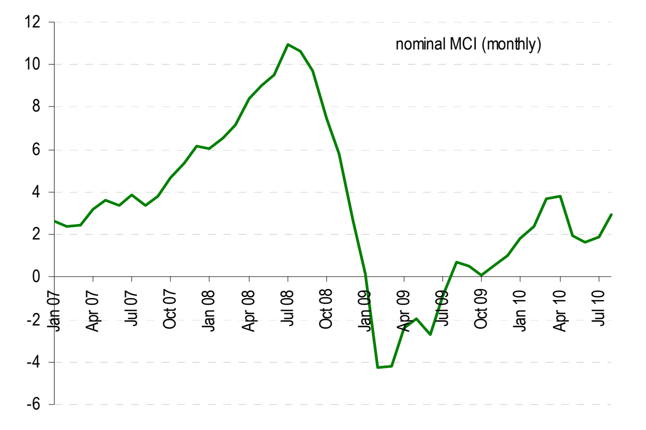
... what is justified by increasing inflation expectations

▪ From the perspective of monetary policy, households' inflationary expectations come to the forefront as global economy is recovering and there is improvement in the labour markets and a rise in the expected rate of inflation

▪ NBP data for August did not bring positive information in that regard. After several months of stabilisation at a low level (2.1% in July), the expected inflation rate rose to 2.7%. This was not associated with an increase in current inflation, which rose in June by only 0.1 pp.

▪ According to a study on consumer confidence by Ipsos, higher inflation expectations result from announced increase in VAT. The percentage of people expecting that prices will grow faster than currently maintained at a high level of nearly 20%.

Restrictiveness of the Monetary Policy (Council)



MCI shows more restrictiveness after holidays

- In July and August, nominal Monetary Condition Index rose after falling in May-June, mainly because of appreciation of the zloty during the summer. The average EURPLN in July decreased by 0.5% in July and in August went down by as much as 2.3%. Though the average three-month WIBOR rates decreased during this period, it was very moderate and therefore deviation of market rates from the long-term trend practically has not changed, which was almost neutral to MCI changes.
- In September, we expect further strengthening the zloty and an increase in rates on the money market. This will lead towards further increase in the MCI index.

Our index of MPC restrictiveness will return after the publication of voting results

Most recent statements by the MPC members were hawkish. However, many of the Council members were completely silent and did not express their view on inflation and rates and did not speak on topics related to monetary policy (although some of them are still very active as commentators in other fields). Also, there was no publication of the results of voting on changes in monetary policy parameters. Therefore, it is difficult to position the new Council's members in our restrictiveness index. It is difficult to create such an index even on a purely subjective basis. So we decided to wait for more information, as voting on rise in interest rate has already begun.

More and more hawkish, motion to hike rates already in August

After the publication of GDP for the second quarter two MPC members expressed hawkish opinions, which together with the information that there was motion to hike interest rates already in August, confirm the scenario of upcoming monetary tightening. During the meeting organised by the Polish Press Agency (PAP), Anna Zielińska-Głębocka, a member of the MPC presented her views on the economy, which, in our opinion, will justify an interest rate hike during one of the next MPC meetings. She said that she expects: maintaining the positive trends in the Polish economy in the following quarters (both in terms of exports, investments and consumption), an increase in inflation above the target (but not more than 3.5%, which is the upper end of the tolerance band around the target), the stabilisation of the zloty (rather than appreciation, which could act against inflation) and a loose fiscal policy. She stressed that she was disappointed by Multi-Year Financial Plan submitted by the government and concerned by the high growth in producer price index (PPI). Although she acknowledged that keeping rates stable may be a positive aspect, and that one can imagine a non-inflationary economic growth, even at 5%, in our opinion the balance of risks she presented speaks for the rise in interest rates soon. Moreover, the pressure for interest rate hike is increasing inside the Council, as Zielińska-Głębocka said that already at the August meeting the motion to hike rates was under voting.

In the interview for PAP and TVN CNBC, the MPC member Andrzej Bratkowski also presented the hawkish view, which was concluded with the statement ***"it is unlikely that we will not raise interest rates this year"***. He added: "Now the priority should be to not be late to give the markets a signal that the Council is determined to keep inflation at the level of the target; the economic growth should cope with it." According to Bartkowski, GDP figure for Q2 reduced the likelihood that Poland will suffer from the economic slowdown in the coming quarters, adding that any acceleration of GDP growth creates inflationary pressure in the end. He said that GDP data moved us closer to interest rate hikes as far, that it reduced the risk of short-lived recovery, and that "the reaction should be quick enough". Similarly to Zielińska-Głębocka, he drew attention to the rapidly rising producer prices. More importantly, he emphasised the importance of rising inflation expectations, stating that "all this may be the result of too long period of low interest rates."

Still, we do not know if these two MPC members actually voted in August in favour of the rate hike (we guess that rather not, and that means that the number of advocates of monetary tightening has been increasing), but it is obvious that the perception of the latest comments is far more hawkish. Other member of the Council, Andrzej Glapiński maintained (or rather strengthened) his earlier opinion that the Council should react to expected inflation rise in a decisive way with the first hike larger than 25bps (although later on there could be long pause until the next move). He said that ***"the MPC should act significantly, decisively, pre-emptively, not at the moment when something already happens"***. While overall hawkish opinion of Glapiński was similar to views presented by Bratkowski and Zielińska-Głębocka, we do not think there will be majority in the Council to hike rates by 50bp in one move. In the nearest minutes of the August MPC meeting, whether there was a motion to hike by 25 bp or 50bp.

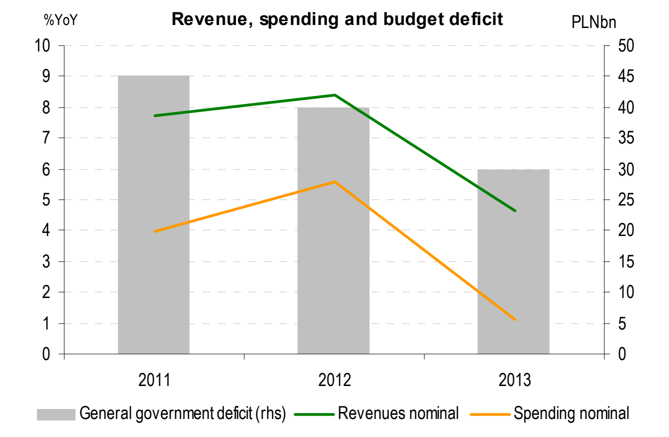
As the expectations for the interest rate hike in the nearest future are strengthened and the coming set of economic data that in our opinion will be quite hawkish (recovery of the industrial output, wages, retail sales and the CPI) may trigger rise in yields in the Polish fixed income market. However, the realisation of that scenario depends to some extent on the global market sentiment. It has to be added that both Zielińska-Głębocka and Bratkowski stressed the risks connected with the global economic situation and the possibility of the double-dip scenario in the US. Still, in our opinion, the local factors mentioned by the MPC members – listed above – would be more important regarding assessing the inflationary risks in the medium term. Zielińska-Głębocka claimed also that the MPC discussed lately inter alia whether it shall not surprise the financial markets. Does it mean interest rate hike coming in September?

Source: CSO, Eurostat, NBP, own calculations

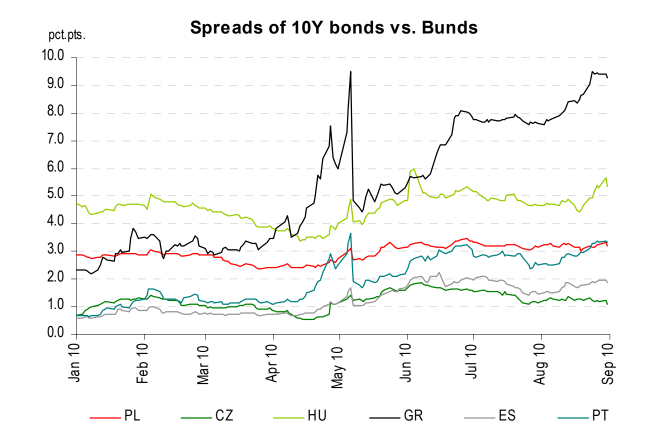
Government and politics

Assumptions of the Multi-Year Financial Plan

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



	Spread vs Bunds (10Y) in bps			CDS (5Y)		
	01.09	change since 31.06	change since 31.12.09	01.09	change since 31.06	change since 31.12.09
Poland	321	-16	34	153	-2	19
Czech Republic	111	-51	49	98	-4	4
Hungary	533	6	48	371	21	127
Greece	928	130	686	958	23	676
Spain	185	-15	125	247	-17	134
Portugal	332	17	263	343	25	253
Italy	155	3	79	229	35	121
Germany	-	-	-	44	1	17



Source: Ministry of Finance, Reuters, own calculations

Multi-Year Plan with no major reforms

▪ At the start of August, the government adopted a Multi-Year Financial Plan, which outlines the path of fiscal deficit reduction in Poland and ways of fiscal consolidation.

▪ The main element of the plan is the introduction of hike in the standard VAT rate by 1 pp. (up to 23%) and changes in the preferential VAT rates (reduction from 7% to 5% on processed food and increasing from 3% to 5% rate on unprocessed food). According to the MinFin estimates, tax changes will boost budget revenues by PLN5-6bn per year. The increase in indirect taxes instead of expenditure adjustment is a disappointment concerning the current government's reform plans. Specifically, it is not clear how the government wants to trim the public finance deficit by nearly PLN30bn in 2012 and nearly PLN25bn in 2013, amid a much smaller scale of reduction in central budget deficit.

▪ Moreover, the plan assumes that acceleration of privatization is bound to bring over PLN55bn in 2010-2013 period. In 2011, sale of additional packages of PKO BP and PZU will take place. Continuation of an ambitious privatization program is to reduce borrowing needs and limit an increase in public debt.

▪ However, looking at the assumptions of the plan regarding public debt to GDP ratio, it can be concluded that the government admits that we will balance on the edge of the 55% threshold. Probably that is why the plan presupposes the automatic introduction of two consecutive VAT hikes for 3 years by 1 pp each, if the ratio of debt to GDP exceeds 55%.

▪ Comments of PM Donald Tusk and Michał Boni show directly that by increasing VAT rates, the government wants to "buy some time" until the next parliamentary election, after which harsher financial reforms would be implemented.

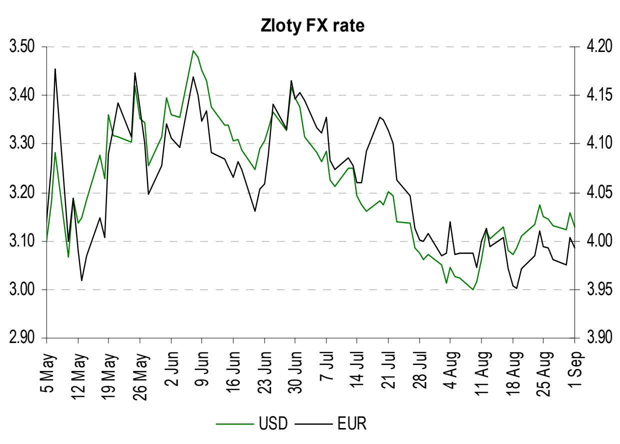
Valuation of fiscal risk remains high

▪ During the past two months, national debt problems have receded into the background for some time. It was reflected by a decline in CDS rates and the narrowing of spreads on 10-year bonds against Bunds observed nearly since mid-August. This was connected, among others, with publication of the results of stress-testing of European banks.

▪ Since the second half of September, fiscal risk evaluation began to increase again. This was the result of weak macro data publications from the major economies. This grew some concern about the second wave of global economic slowdown and the related increase in debt problems. The wave of concerns about occurrence of the double dip in the global business cycle caused a strong decrease in yields on the core markets, including Bunds. Yields of the countries, whose fiscal position was seen as relatively good, followed the Bunds. This was the case for the Polish government bonds whose yield declined even more than their German counterparts. In the case of countries with the most difficult fiscal situation, bond yields remained high (for some countries fell slightly – i.e. Hungary; in others as in Greece they increased), which led to widening of spreads vs. Bunds. Hence, in early September, both spreads vs. Bunds and CDS rates were for some countries higher than at the end of June.

▪ In the case of Poland and Czech Republic, holiday months have brought a decrease in evaluated fiscal risk. For the Czech Republic the spread vs. Bunds declined much more than for Poland. However, this result is not due to the better assessment of the fiscal position of the Czech Republic but to the reverse direction of changes in expectations regarding monetary policy in both countries.

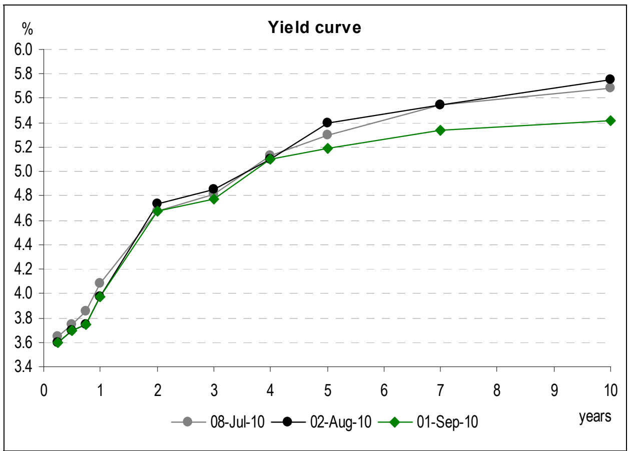
Market monitor



Stronger zloty despite high risk aversion

▪ Just as we expected, the EURPLN declined significantly during the past two months. From ca. 4.10 at the moment of previous report release (first week of July) the zloty firmed to below 4.0 at the beginning of September. As we pointed in the previous report, the two-month maximum did not reach the level of resistance at 4.16 (4.14 was the highest level, established after Hungary broke the negotiations with the IMF/EU). The positive sentiment on the global market and huge demand for the Polish bonds during the surge of risk aversion supported the zloty.

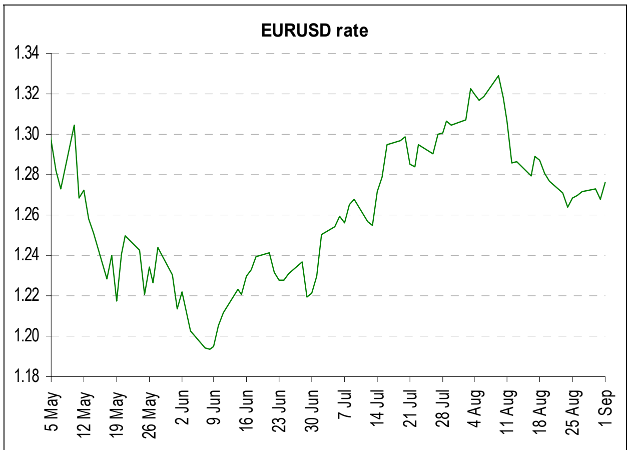
▪ We expect, that the zloty will appreciate further in September. The level at 4.05 shall be a strong resistance and we think the potential for the zloty's depreciation is limited, as the Polish currency was stable even in the period of higher risk aversion. We expect that the EURPLN will reach ca. 3.92 at the end of September.



Time for yields rise after considerable strengthening

▪ The yields on the domestic fixed income market increased during the first few weeks of July, which was connected with better than expected data on industrial output and retail sales. Later in the month, the yields plunged, as foreign investors rushed for Polish bonds. The record low yields of 10Y Bunds pushed the investors towards alternative allocations for their capital. As Poland positively distinguishes among the other countries in our region, our bonds give the potential for higher profit, with relatively lower risk.

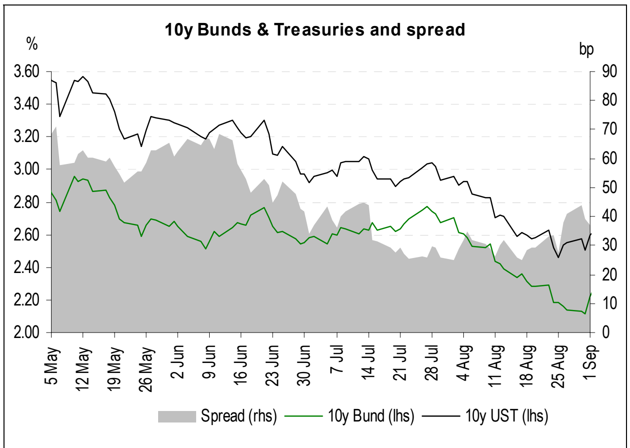
▪ At the end of August the hawkish comments of the MPC members triggered the upward trend of the yields. We expect, that this tendency may be continued during the coming month, as the pressure of soon interest rate hikes shall be strengthened due to better than expected macro data publications.



The euro backed by the demand for debt and weak US data

▪ The upward trend on the EURUSD market, which started in the first week of June, continued until the beginning of August, when the euro appreciated to ca. 1.33. Since that moment, the EURUSD started to decline, the dollar firmed to 1.26, slightly above the level we forecasted. The euro was supported by the better than expected data from the euro zone and the demand for bonds issued by the euro zone's peripheral countries. Worse than expected US data and insufficient – from investors' point of view – assurance of the Fed regarding its help to stimulate the US economy triggered the surge of risk aversion and the dollar's appreciation.

▪ In our opinion, the euro will appreciate in September. We still perceive 1.26 as the strong level of support, that shall not be broken. We anticipate, that the EURUSD will end the coming month in the range of 1.30-1.32.



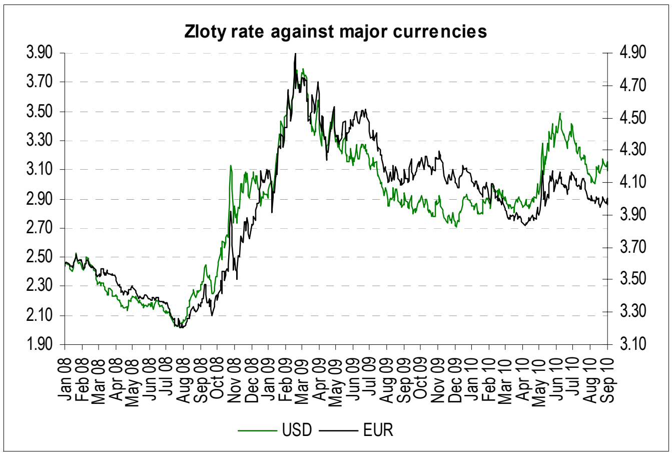
Record low yields of ten-year Bunds

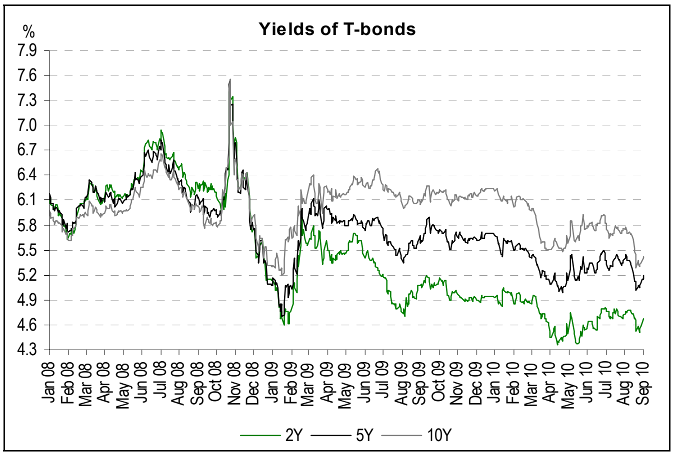
▪ The improvement of moods on the global market mood that emerged in July constrained the downward trend of the yields on the core fixed income markets. There was even some yields increase regarding the US bonds. The obvious deterioration of the outlook for the economic growth triggered the strong downward trend of the Bunds' and Treasuries' yields. The former many times established record low levels, while the latter declined to the levels last seen two years ago.

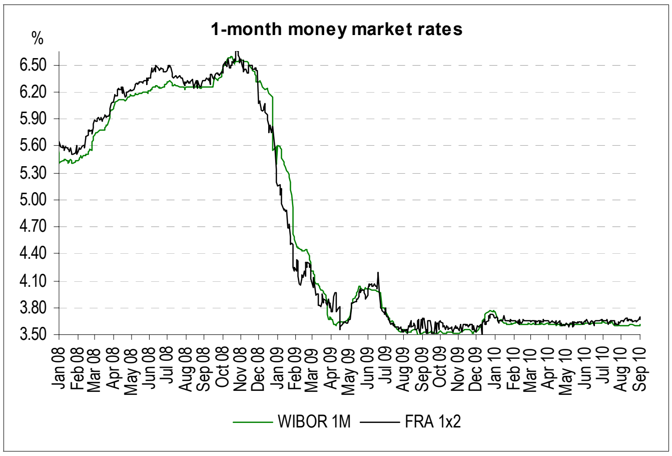
▪ As none of the data published in the euro zone and the US indicates the rising inflationary pressure, thus the are no chances for the interest rates' hikes in the foreseeable future. We expect, that it would be market sentiment that shall point the direction on the fixed income markets. And concerning the market mood, we anticipate, that it shall be gradually improving.

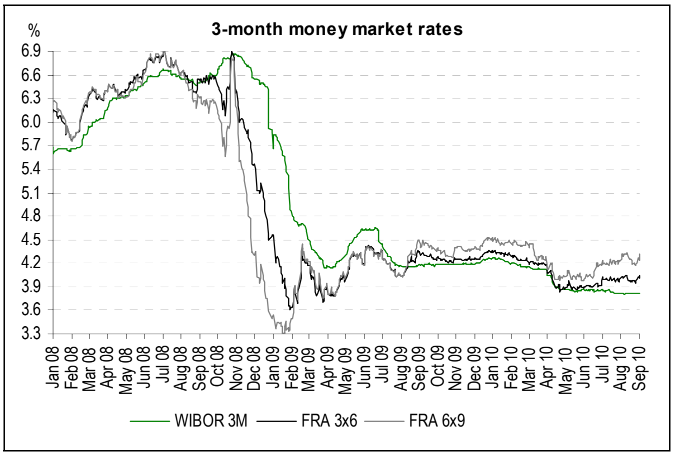
Source: Reuters, BZ WBK

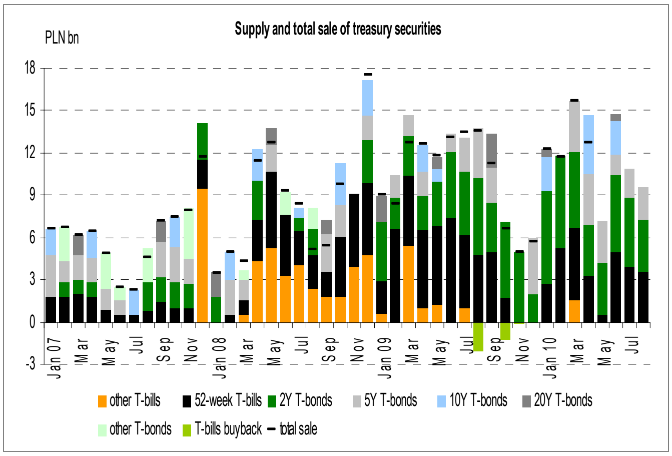
Market monitor











Treasury bills auctions (PLN m)

Auction date	OFFER	DEMAND/SALE
12.07.2010	52-week: 700-1000	4117/1000
26.07.2010	52-week: 1300-1800	5831/1800
9.08.2010	52-week: 1000-1500	3349/1313
16.08.2010	52-week: 700-1000	2108/917
23.08.2010	52-week: 500-800	2680/800
30.08.2010	52-week: 500-700	2592/551
6.09.2010		-
13.09.2010		-
20.09.2010		-
27.09.2010		-
4.10.2010		-
11.10.2010		-
18.10.2010		-

* *based on data of the Ministry of Finance*

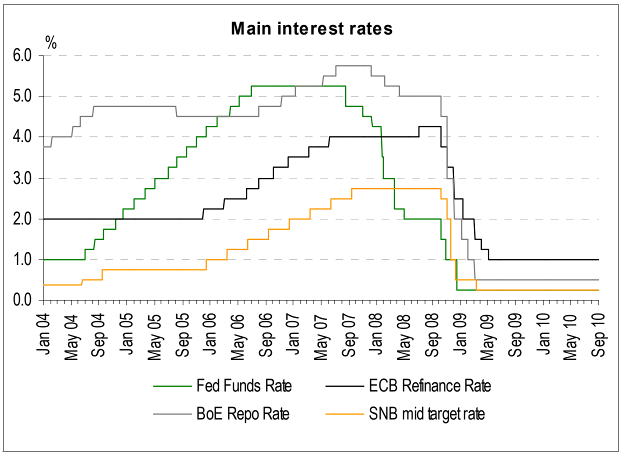
Treasury bond auctions in 2009/2010 (PLNm)

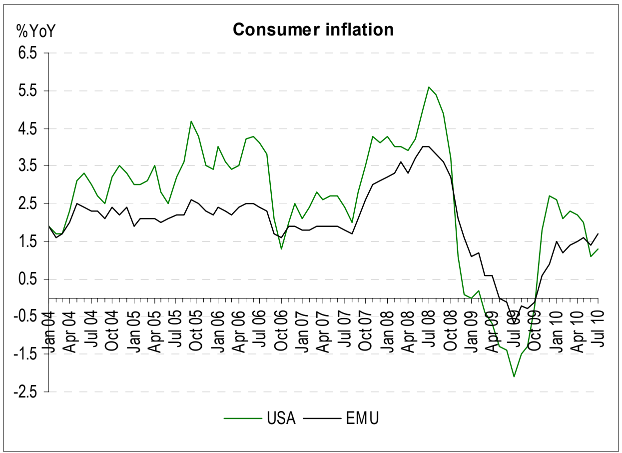
month	First auction				Second auction				Switch auction		
	date	T-bonds	offer	sale	date	T-bonds	Offer	sale	date	T-bonds	sale
October	7.10*	OK0112	3000-5400	5400	-	-	-	-	29.10	PS0413/PS0414/DS1019	1573/1753/1290
November	10.11	OK0712	3500-5000	5000	-	-	-	-	26.11	OK0712/P0414	1121/2243
December	2.12	OK0712/PS0415	3000-6000	5651	-	-	-	-	16.12	-	-
January	13.01*	OK0712	6600	6600	20.01*	DS1019/WS0429	2400/600	2409/591	6.01	PS0415/WZ0118	2494/2383
February	10.02*	OK/PS	6600	6600	17.02	DS/WS/WZ/IZ	-	-	3.02		-
March	10.03	OK0712	3500-5400	5448	17.03	WZ0121	2000-3600	3600	3.03	PS0415/DS1019/WS0429	1784/2662/315
April	7.04	OK0712	2500-3600	3219	14.04	DS1020	2000-4200	3600	21.04**	PS0415	3600/3000***
May	5.05	OK0712	2500-4500	3700	12.05	PS0415	1500-3000	2989	27.05	WZ0121	422
June	2.06	OK0712	3000-5400	5400	16.06	DS/WS/WZ/IZ	1500-3000	2430	23.06	PS0415/WS0429	1549/54
July	7.07	OK1012	3000-5000	4971	14.06	PS0415	-	-	21.07	-	-
August	4.08	OK1012/PS0415	3000-6000	6000	11.08	-	-	-	18.08	-	-
September	1.09	OK1012	2500-4000	4000	8.09	PS0415	-	-	15.09**	DS1020	-

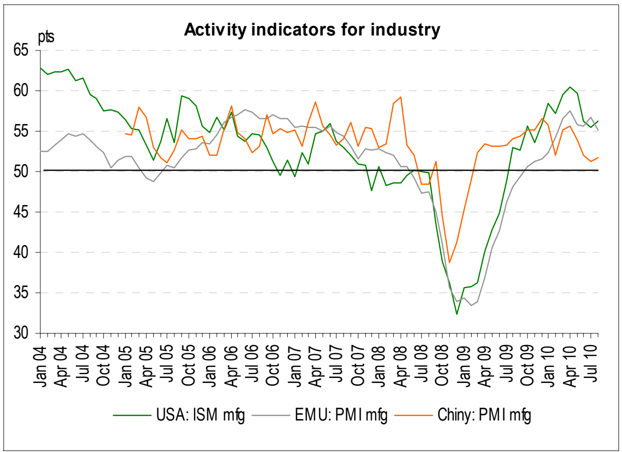
* with supplementary auction, ** primary auction, *** demand/sale

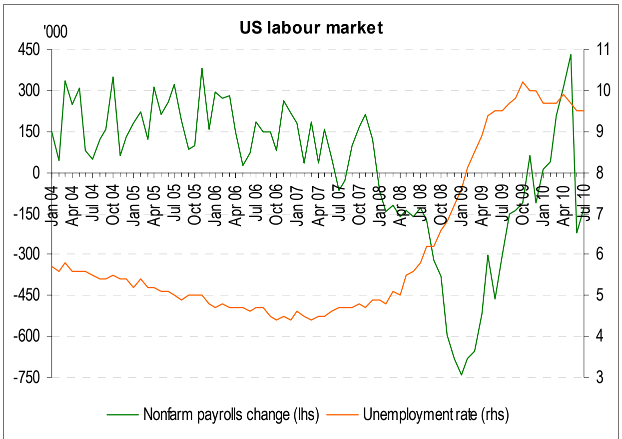
Source: Ministry of Finance, Reuters, BZ WBK

International review









Source: Reuters, ECB, Federal Reserve

Stress tests results as the main event on the market

- Main event of the July on the market financial market were the stress tests, conducted by the European banks. The final results revealed that 7 out of 91 banks failed to pass the tests, which was pretty in line with the analysts expectations. Despite common doubts concerning the not severe enough adverse scenario conditions, the reaction to the published results was quite positive (slight increase of the prices on the stock markets and yields on the core fixed income markets). The positive reaction was mainly due to high level of detailed information published together with the final results and market participants could carry their own simulations.
- Just as it was expected after the Fed's meeting the interest rates remained unchanged. In the communiqué issued after the meeting it was stressed that the pace of recovery of the US economy will be weaker than it has been previously anticipated, the inflation will be subdued, that all together gives to room for the keeping the interest rates at the exceptionally low level for an extended period of time. All in all, the comment was in line with the market expectations, though some disappointment arose as in the previous communiqué there had been no statements pointing to weaker growth. The declaration than triggered sudden decline of the Bunds and Treasuries was the intention to reinvest the funds collected from maturing debt in the long-term US bonds.
- The US CPI reached in July 1.2%YoY, versus market consensus at 0.5% and a 0.5% decline in June.
- The HICP inflation advanced in July by 1.7%YoY, while the flash estimates show a decline to 1.6%YoY in August.

Stabilisation of activity indices after sharp decline

- After the slight decline of the indices measuring the activity in the industry sector in the euro zone and considerable drop in the US and China the past two months showed some stabilization. The PMI's indices still hover above the level of 50 pts, that indicates that the improvement is in progress.
- According to the final data on the euro zone's manufacturing PMI in August the index reached 55.1pts versus 56.7pts in July (in June it reached 55.6pts). There was also a decline of the German PMI to 58.2pts in August versus 61.2pts in July and 58.4pts in June. These data obviously point to the slower pace of recovery in the euro zone. The PMI for the euro zone is at the lowest level since February 2010 and the downward trend of that index is observed since April 2010.
- The ISM index for the US manufacturing sector increased in August to 56.3pts from 55.5pts in July and 56.2pts in June. That was the first increase after the three months of drops.
- The Chinese PMI for the manufacturing sector declined in July to 51.2pts (the lowest level for 17 months) from 52.1pts in June. The lower reading caused some increase of the risk aversion on the global markets.
- The retail sales increased in the euro zone in June by 0.4%MoM versus market expectations at 0.1%.
- After the preliminary data on the US GDP growth at 2.4%QoQ in the Q2, the first revision showed an increase only by 1.6%.
- In July there were 131k less of the workplaces in the US the non-farm sector versus a decline by 221.0k in June (after the revision). The unemployment rate remained unchanged in July at 9.5% versus 9.7% in May. That is still close to the maximum reached during present recession at 10.1%, the level last seen in the eighties of the twentieth century.

Economic calendar

Monday	**Tuesday**	**Wednesday**	**Thursday**	**Friday**
6 ***PL: Auction of Treasury bills*** US: Market holiday	**7** DE: Factory orders(Jul)	**8** ***PL: bond auction*** DE: Trade balance (Jul) US: Beige book	**9** DE: CPI (Aug) US: Trade balance (Jul)	**10** ***PL: Balance of payments (Jul)*** US: Wholesale inventories (Jul)
13 ***PL: Auction of Treasury bills*** EZ: Industrial output (Jul)	**14** ***PL: CPI (Aug)*** ***PL: Money supply (Aug)*** DE: ZEW (Sep) US: Retail sales (Aug)	**15** ***PL: 10Y bond auction*** EZ: HICP (Aug) US: Import prices (Aug) US: NY Fed (Sep) US: Capacity utilization (Aug) US: Industrial output (Aug)	**16** ***PL: Wages and employment (Aug)*** US: PPI (Aug) US: Current account (Jul) US: Philly Fed (Sep)	**17** ***PL: PPI (Aug)*** ***PL: Industrial output (Aug)*** DE: PPI (Aug) EZ: Current account (Jul) US: CPI (Aug) US: Michigan (Sep)
20 ***PL: Auction of Treasury bills***	**21** ***PL: Core inflation (Aug)*** US: Building permits (Aug) US: House starts (Aug) US: Fed decision	**22** ***PL: Bond switching auction*** ***PL: Business climate (Sep)*** EZ: Industrial orders (Jul) EZ: Consumer confidence (Sep) US: Home prices (Jul)	**23** EZ: Flash PMI – industry (Sep) EZ: Flash PMI – services (Sep) US: Home sales (Aug) US: Leading indicators (Aug)	**23** ***Pl: Retail sales (Aug)*** DE: Ifo (Sep) US: Preliminary durable goods orders (Aug) US: New home sales (Aug)
27 ***PL: Auction of Treasury bills*** EZ: Money supply (Aug) US: Building permits (Aug)	**28** ***PL: Balance of payment (Q2)*** ***PL: Consumer confidence (Aug)*** DE: GfK (Oct) US: Consumer confidence (Sep) US: S&P/Case-Shiller home price index (Jul)	**29** ***PL: MPC decision*** EZ: Business climate (Sep)	**30** ***PL: Unemployment rate (Aug)*** EZ: Flash HICP (Sep) US: Core PCE (Q2) US: GDP (Q2) US: ISM NY (Sep) US: Chicago PMI (Sep)	**1 October** EZ: PMI – industry (Sep) EZ: Unemployment rate (Aug) US: Consumer spending (Aug) US: Personal income (Aug) US: Core PCE (Aug) US: Michigan (Sep) US: ISM – industry (Sep)
4 ***PL: Auction of Treasury bills*** EZ: PPI (Aug) US: Pending home sales (Aug) US: Industry orders (Aug) US: Final durable goods orders (Aug)	**5** EZ: Retail sales (Aug) EZ: PMI – services (Sep) US: ISM – services (Sep)	**6** ***PL: 2Y bond auction*** EZ: GDP (Q2) US: ADP report (Sep)	**7** DE: Industrial output (Aug) EZ: ECB decision	**8** US: Non-farm payrolls (Sep) US: Unemployment rate (Sep) US: Wholesale inventories (Aug)

Source: CSO, NBP, Ministry of Finance, Reuters.

MPC meetings and data release calendar for 2010

	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
MPC meeting	25-26	23-24	30-31	27-28	24-25	29-30	6	23-24	28-29	26-27	23-24	21-22
MPC minutes	21	19	18	22	20	22	20	20	21	20	22	21
GDP*	-	-	2	-	31	-	-	30	-	-	30	-
CPI	14	15[a]	15[b]	15	14	15	13	13	14	13	15	14
Core inflation	21	-	22	22	21	22	20	20	21	20	22	21
PPI	21	18	17	20	20	18	19	18	17	19	19	17
Industrial output	21	18	17	20	20	18	19	18	17	19	19	17
Retail sales	28	23	24	23	26	24	-	-	-	-	-	-
Gross wages, employment	19	16	16	19	19	17	16	17	16	18	18	16
Foreign trade	about 50 working days after reported period											
Balance of payments*	-	-	31	-	-	29	-	-	28	-	-	-
Balance of payments	15	12	12	13	17	16	13	11	10	12	10	-
Money supply	14	12	12	14	14	14	14	13	14	14	12	-
Business climate indices	22	22	22	22	21	22	22	20	22	22	22	22

* quarterly data, [a] preliminary data for January, [b] January and February

Source: CSO, NBP

Economic data and forecasts

Monthly economic indicators

		Aug 09	Sep 09	Oct 09	Nov 09	Dec 09	Jan 10	Feb 10	Mar 10	Apr 10	May 10	Jun 10	Jul 10	Aug 10	Sep 10
PMI	pts	48.2	48.2	48.8	52.4	52.4	51.0	52.4	52.5	52.5	52.2	53.3	52.1	53.8	53.4
Industrial production	%YoY	0.1	-1.3	-1.3	9.9	7.4	8.5	9.2	12.5	9.7	13.5	14.3	10.3	15.8	10.7
Construction production	%YoY	11.0	5.7	2.7	9.9	3.2	-15.3	-24.7	-10.9	-6.3	2.3	9.6	0.8	7.7	12.7
Retail sales [a]	%YoY	5.2	2.5	2.1	6.3	7.2	2.5	0.1	8.7	-1.6	4.3	6.4	3.9	5.7	7.0
Unemployment rate	%	10.8	10.9	11.1	11.4	11.9	12.7	13.0	12.9	12.3	11.9	11.6	11.4	11.2	11.0
Gross wages in enterprises sector [a]	%YoY	3.0	3.3	2.0	2.3	6.5	0.5	2.9	4.8	3.2	4.8	3.5	2.1	4.5	4.8
Employment in enterprises sector	%YoY	-2.2	-2.4	-2.4	-2.2	-1.8	-1.4	-1.1	-0.6	0.0	0.5	1.1	1.5	1.8	2.0
Export (€)	%YoY	-20.6	-17.0	-10.9	1.0	12.6	14.0	20.5	21.5	22.9	24.7	28.6	27.6	33.6	27.7
Import (€)	%YoY	-27.0	-26.8	-20.8	-11.0	-3.3	8.3	21.7	24.6	23.0	29.9	27.8	24.4	31.0	30.3
Trade balance	EURm	-420	59	-200	-291	-627	-104	-177	-526	-262	-450	-287	-280	-350	-174
Current account balance	EURm	-116	-250	-330	-1 376	-1 070	-672	67	-458	-336	-889	-1 004	-630	-450	-674
Current account balance	% GDP	-2.8	-2.3	-1.9	-1.8	-1.6	-1.6	-1.8	-1.9	-1.9	-2.1	-2.3	-2.3	-2.4	-2.5
Budget deficit (cumulative)	PLNbn	-15.6	-21.5	-24.0	-24.4	-23.8	-4.8	-16.7	-22.7	-27.0	-32.1	-36.8	-34.9	-36.6	-42.9
Budget deficit (cumulative)	% of FY plan	65.8	90.3	101.1	102.6	100.0	9.3	32.1	43.5	51.8	61.6	70.5	66.9	70.1	82.2
CPI	%YoY	3.7	3.4	3.1	3.3	3.5	3.5	2.9	2.6	2.4	2.2	2.3	2.0	2.2	2.5
CPI excluding prices of food and energy	%YoY	2.9	2.9	2.9	2.8	2.6	2.4	2.2	2.0	1.9	1.6	1.5	1.2	1.2	1.2
PPI	%YoY	2.2	1.6	2.0	1.9	2.1	0.2	-2.4	-2.6	-0.4	1.9	2.1	3.9	3.6	3.2
Broad money (M3)	%YoY	9.0	9.6	11.9	8.0	8.1	6.3	5.1	5.5	6.1	7.7	7.1	7.8	8.6	8.0
Deposits	%YoY	10.7	10.9	13.5	10.3	9.8	7.5	6.8	6.2	7.0	8.5	8.1	8.5	9.5	8.7
Loans	%YoY	19.8	18.6	14.9	13.4	8.6	5.4	3.0	2.2	3.8	5.1	8.0	8.6	8.4	7.7
USD/PLN	PLN	2.90	2.86	2.85	2.79	2.83	2.85	2.93	2.87	2.89	3.24	3.36	3.20	3.09	3.08
EUR/PLN	PLN	4.13	4.16	4.21	4.17	4.14	4.07	4.01	3.89	3.87	4.06	4.10	4.08	3.99	3.95
Reference rate [b]	%	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50
Lombard rate [b]	%	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00
WIBOR 3M	%	4.16	4.18	4.18	4.19	4.23	4.24	4.17	4.13	3.92	3.85	3.86	3.84	3.81	3.85
Yield on 52-week T-bills	%	4.23	4.33	4.35	4.26	4.25	4.01	3.90	3.92	3.84	3.71	3.93	4.08	3.97	4.00
Yield on 2-year T-bonds	%	4.92	5.10	5.03	4.92	4.92	4.95	4.90	4.76	4.47	4.52	4.66	4.73	4.68	4.75
Yield on 5-year T-bonds	%	5.53	5.74	5.65	5.64	5.67	5.58	5.51	5.27	5.10	5.26	5.35	5.35	5.23	5.25
Yield on 10-year T-bonds	%	6.08	6.18	6.15	6.14	6.21	6.12	6.09	5.71	5.56	5.74	5.83	5.73	5.54	5.50

Source: CSO, NBP, Finance Ministry, BZ WBK own estimates; [a] in nominal terms, [b] at the end of period

Quarterly and annual economic indicators

		2008	2009	2010	2011	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	3Q11	4Q11
GDP	PLNbn	1 272.8	1 342.6	1 421.3	1 512.1	327.4	345.1	352.6	396.1	349.2	366.1	373.7	423.1
GDP	%YoY	5.1	1.8	3.5	3.5	3.0	3.5	3.8	3.8	3.8	3.2	3.2	3.7
Domestic demand	%YoY	5.6	-1.0	3.8	4.4	2.2	3.9	4.1	4.9	4.9	4.5	3.9	4.2
Private consumption	%YoY	5.7	2.3	2.8	3.0	2.2	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Fixed investments	%YoY	9.6	-0.8	1.4	10.1	-12.4	-1.7	6.0	6.5	16.5	12.5	8.0	8.0
Industrial production	%YoY	3.6	-3.5	10.7	6.6	9.5	11.7	12.2	8.2	7.0	6.9	7.1	5.4
Construction production	%YoY	10.0	4.6	3.4	7.5	-16.7	2.5	7.2	11.0	24.2	3.8	2.9	7.4
Retail sales [a]	%YoY	13.1	3.5	5.4	7.8	4.0	3.1	5.6	8.4	5.2	7.4	8.2	9.8
Unemployment rate [b]	%	9.5	11.9	11.4	9.9	12.9	11.6	11.0	11.4	12.1	10.6	9.8	9.9
Gross wages in enterprise sector [a]	%YoY	10.3	4.4	3.8	4.7	2.8	3.8	3.4	4.7	3.9	4.3	4.7	5.0
Employment in enterprise sector	%YoY	4.8	-1.2	0.8	2.4	-1.3	0.4	1.8	2.3	2.5	2.4	2.3	2.2
Export (€)	%YoY	14.2	-17.1	23.3	11.5	18.3	25.4	29.4	19.9	17.0	12.0	10.0	8.0
Import (€)	%YoY	17.2	-25.4	24.3	14.9	18.0	26.8	28.5	23.6	21.0	16.0	14.0	9.8
Trade balance	EURm	-17 724	-3 183	-4 956	-9 859	-796	-999	-804	-2 358	-2 077	-2 375	-2 237	-3 170
Current account balance	EURm	-18 302	-5 039	-7 654	-9 459	-1 064	-2 229	-1 754	-2 608	-2 027	-2 175	-2 337	-2 920
Current account balance	% GDP	-5.1	-1.6	-2.1	-2.4	-1.9	-2.1	-2.3	-2.1	-2.3	-2.3	-2.4	-2.4
General government balance	% GDP	-3.7	-7.1	-6.5	-5.9	-	-	-	-	-	-	-	-
CPI	%YoY	4.2	3.5	2.6	3.1	3.0	2.3	2.2	2.7	3.2	3.2	3.0	3.0
CPI [b]	%YoY	3.3	3.5	2.9	3.0	2.6	2.3	2.5	2.9	3.3	3.1	2.9	3.0
CPI excluding food and energy prices	%YoY	2.3	2.7	1.6	2.3	2.2	1.7	1.2	1.4	2.1	2.3	2.4	2.5
PPI	%YoY	2.2	3.3	1.4	2.7	-1.6	1.2	3.6	2.5	2.9	2.2	2.2	3.6
Broad money (M3) [b]	%YoY	18.6	8.1	7.2	7.3	5.5	7.1	8.0	7.2	7.4	6.3	7.4	7.3
Deposits [b]	%YoY	20.6	9.8	7.6	7.1	6.2	8.1	8.7	7.6	7.7	6.4	7.4	7.1
Loans [b]	%YoY	36.0	8.6	9.8	10.0	2.2	8.0	7.7	9.8	13.4	10.1	12.4	10.0
USD/PLN	PLN	2.41	3.12	3.00	2.91	2.88	3.15	3.12	2.87	2.86	3.00	2.92	2.86
EUR/PLN	PLN	3.52	4.33	3.96	3.81	3.99	4.01	4.01	3.83	3.82	3.92	3.80	3.72
Reference rate [b]	%	5.00	3.50	3.75	4.50	3.50	3.50	3.50	3.75	4.00	4.50	4.50	4.50
Lombard rate [b]	%	6.50	5.00	5.25	6.00	5.00	5.00	5.00	5.25	5.50	6.00	6.00	6.00
WIBOR 3M	%	6.36	4.42	3.98	4.61	4.18	3.88	3.83	4.03	4.20	4.54	4.85	4.85
Yield on 52-week T-bills	%	6.26	4.54	3.98	4.61	3.94	3.83	4.02	4.15	4.30	4.55	4.80	4.80
Yield on 2-year T-bonds	%	6.22	5.17	4.76	5.10	4.87	4.55	4.72	4.88	4.95	5.10	5.15	5.20
Yield on 5-year T-bonds	%	6.15	5.65	5.33	5.60	5.46	5.24	5.28	5.35	5.45	5.60	5.65	5.70
Yield on 10-year T-bonds	%	6.06	6.11	5.74	5.96	5.97	5.71	5.59	5.70	5.80	5.95	6.00	6.10

Source: CSO, NBP, Finance Ministry, BZ WBK own estimates; [a] in nominal terms, [b] at the end of period

Bank Zachodni WBK

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