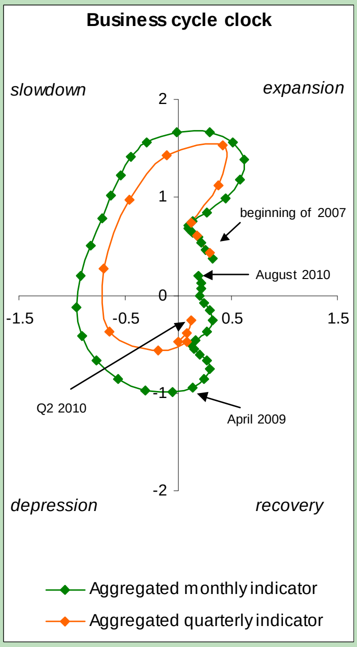
Bank Zachodni WBK

MACROscope

Polish Economy and Financial Markets

October 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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Expansion continues

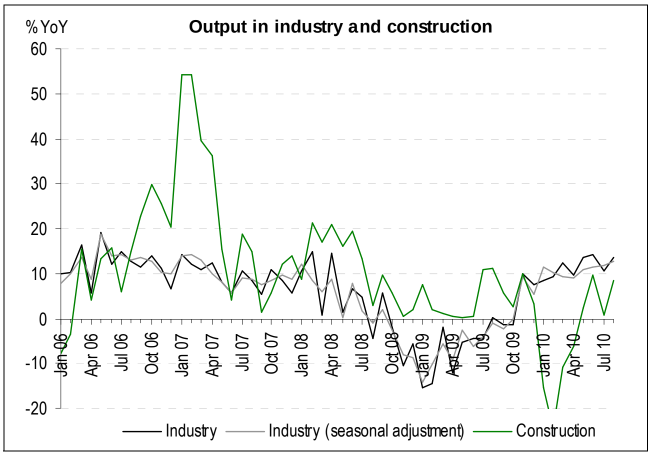
- **When we were preparing the last monthly report ("Time for bold decisions"), we were not deluding ourselves that there would be some serious changes in the fiscal policy, yet we were tentatively hoping for approaching monetary policy tightening.** Next year's budget presented in the Parliament was no surprise – we may see some improvement in fiscal imbalance, but no deeper reforms. Unfortunately, this year the public finance deficit might be higher than planned, and higher than last year (while the economic growth rate doubles). Poland would then stand out among other countries where the scale of fiscal expansion is smaller. This is no cause of concern for rating agencies at the moment, because analysts expect serious reforms to kick off after the parliamentary elections. The same applies to financial market players who focus on the fiscal risk in other countries (such as Ireland, Portugal – which has impact on the global risk, and therefore on movements of the zloty exchange rate) – and realise that Poland has already secured a large part of this year's borrowing requirements, and additionally the revenue from privatization should be high.
- **The Monetary Policy Council has not changed interest rates. Moreover, the Council's most recent statement was fairly dovish and implied that a similar decision might be made at the October meeting.** It seems that opinions are divided and some of the Council Members opt for an immediate increase of interest rates (a motion of 50bp rate hike was voted in August and probably also in September). However, the majority of the Council Members is still not ripe for such decision. One can only hope they will not be considering this option too long, so that the Monetary Council's final response does not lag behind the economic trend (and the monetary policy remains expansive for too long), despite the general awareness that it should be maintained on the forward-looking basis. In this dispute, we would rather have the monetary policy tighten already at this stage (although not necessarily by 50 bp). Additional argument in favour of such decision in case of new MPC is the issue of credibility, as indicated in the opinion poll among the banking experts, done by *Parkiet*.
- **Information about the 50bp rate hike motion in August had negative impact on the short-term interest rate market and this effect was further boosted by consecutive macroeconomic data; however, the Council's dovish statement in September has reversed these trends.** In our opinion, we might see a similar scenario materialize in the weeks to come. New macroeconomic data will be hawkish (our business cycle clock indicates that Polish economy is in the expansion stage) but the Council might again keep rates on hold. An interest rate hike in October would be likely only in case of exceptionally hawkish data and the same conclusions from new NBP projections (also, the Council would have to agree with these conclusions, as this is only one of many factors considered). In the foreign exchange market, we expect a fall of the EURPLN rate to 3.90.

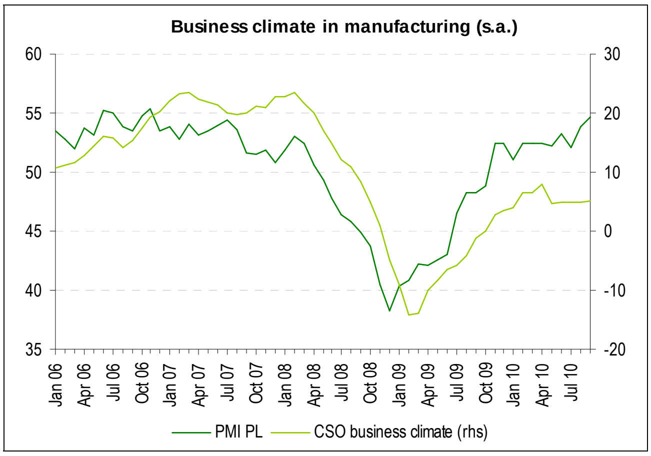
Financial market on 30 September 2010:

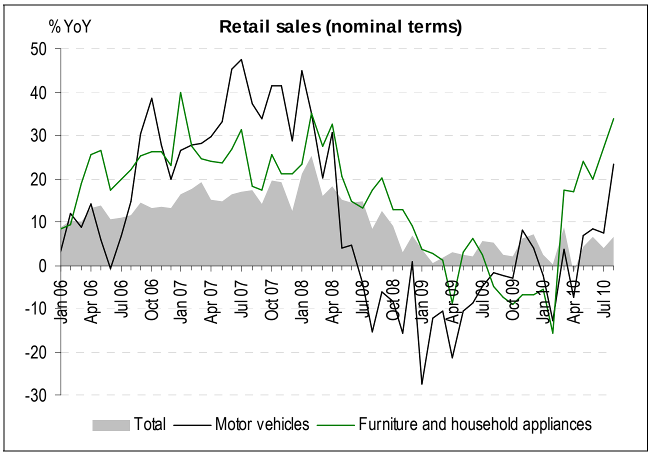
NBP deposit rate	2.00	WIBOR 3M	3,84	USDPLN	2.9250
NBP reference rate	3.50	Yield on 2-year T-bonds	4.70	EURPLN	3.9870
NBP lombard rate	5.00	Yield on 5-year T-bonds	5.06	EURUSD	1.3631

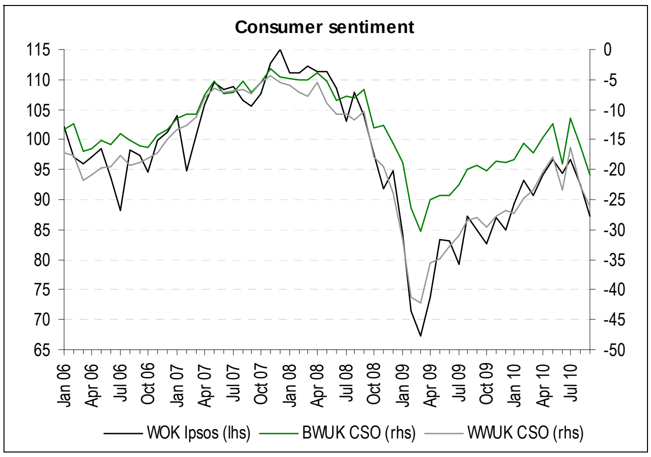
This report is based on information available until 08.10.2010

Economic update









Source: CSO, Ipsos, Reuters, own calculations

Polish industry keeps growing

▪ The industrial output growth in August reached 13.5%YoY and after seasonal adjustment it reached 12.7%YoY (the highest level for over three years). The data confirmed the positive trends in the industrial sector, probably still fuelled mainly by the foreign demand (which is confirmed by PMI survey). Nevertheless, the importance of the external factor will be probably diminishing in time due to anticipated slowdown of the economic growth in the Western Europe in the coming quarters. For the time being, the double-digit growth of the industrial production and the rising capacity utilization (according to the NBP survey it has been already above the long-term average in the second quarter) support expectations for the gradual rebound in the investment demand in the coming quarters, just as the companies start to build up their production potential.

▪ The construction output increased in August by 8.5%YoY, or 4.1%YoY after the seasonal adjustment. The data confirmed our assumptions, that the July's slowdown was only temporarily, probably caused by bad weather conditions and floods. We expect even faster growth in the construction sector in the coming months.

▪ Poland's manufacturing PMI for September rose to the highest level since November 2006 (instead of the widely expected drop). There was a clear improvement in new orders (sub-index highest since March 2007), including export orders, in employment (thanks to investment in new capacity and higher orders), and in production. Overall, the data suggest that in late Q3 there was still solid rise in activity of Polish manufacturing, which allows to be quite optimistic as regards forecasts of industrial production growth in the coming months.

Retail sales growth gaining momentum

▪ The retail sales growth in August reached 6.6%YoY. The biggest rebound occurred in sales of motor vehicles, where the annual growth improved to 23.2%YoY in August from 7.4%YoY a month earlier (the data from Samar car market watchdog show that September saw even bigger rebound in this market). The improvement was noticed also in the other areas. It is worth noticing that the sales of the furniture and household appliance surged again, to 33.7%YoY (the highest since February 2008). The strong demand for the durable goods suggests that consumer demand is well established, probably mainly due to pick-up in households' income and lower unemployment fears.

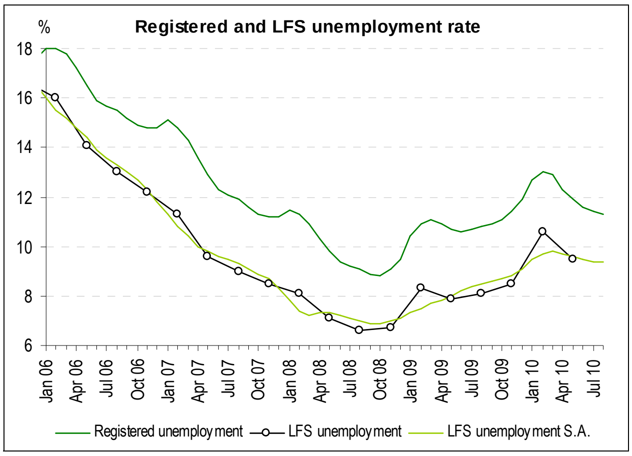
... but watch out for consumer sentiment

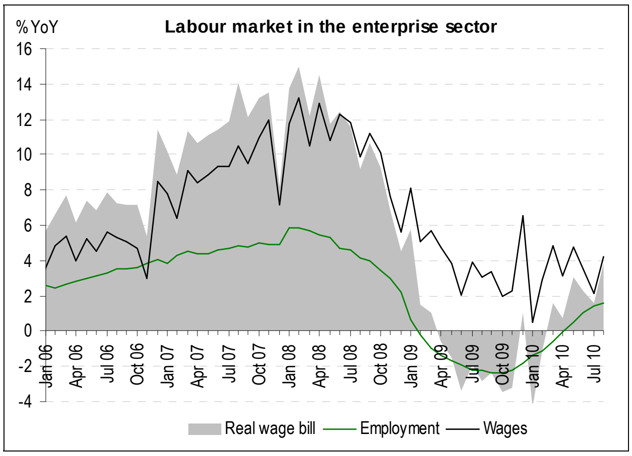
▪ The surveys on consumer sentiment showed somewhat less optimistic picture. The CSO current consumer sentiment index declined in September to -20.9, the lowest level since July 2009, and the leading index reached -26.1, the lowest since the start of the year. The Ipsos' WOK index of consumer confidence was also at this year's low in September.

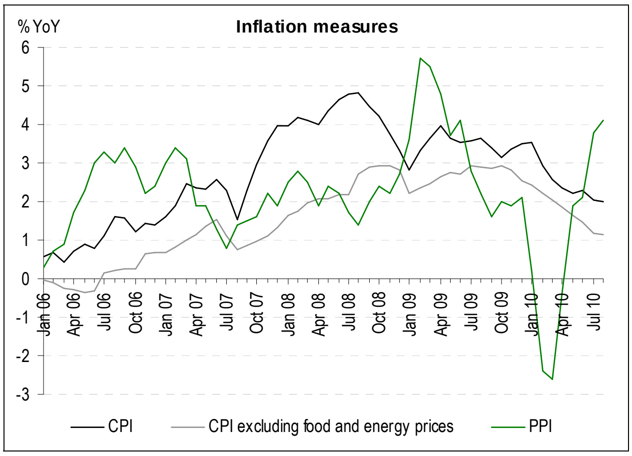
▪ The deterioration of the situation was observed in all factors influencing the consumer confidence, mainly in the assessment of domestic economic situation and the possibility of making some bigger shopping (yet according to Ipsos, a fall in propensity to consume was smaller). The outlook for the present and future financial situation and expectations regarding the unemployment worsened only slightly.

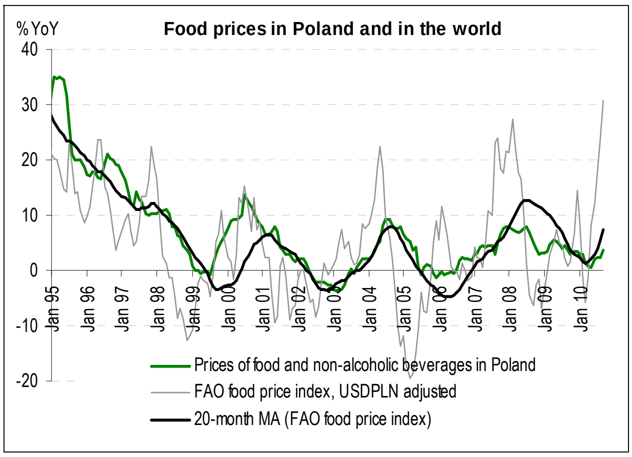
▪ If the downward trend in the consumer confidence continues, this could have negative impact on the moderate growth of the consumption in the coming quarters. Still, the improvement in the labour market (which is heralded by business climate surveys) should prevent a realization of this scenario.

Economic update









Source: CSO, NBP, Eurostat, FAO, own calculations

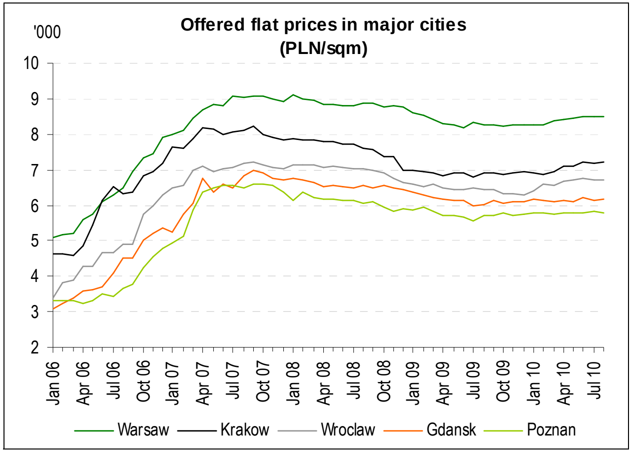
Further gradual improvement in the labour market

- The registered unemployment rate fell in August to 11.3%, in line with expectations. The number of registered unemployed stood at 1.8 million and was about 111k higher than last year. It is worth noting, however, that this was not the result of decrease in the number of jobs, as the number of employed increased during this period by almost 200k. Rise in unemployment in the last two years was therefore mainly the result of the influx of new people into the labour market (graduates and those returning from abroad, etc.).
- Eurostat's LFS-based unemployment rate (after seasonal adjustment) was stable in August at 9.4%.
- The average employment in the corporate sector in August was 1.6% higher than a year ago. The data was slightly below forecasts, however, it was still the tenth consecutive month of the upward trend in annual employment growth, and the number of jobs in the corporate sector returned to the level last seen in the end of 2008 (the latter comparison could be misleading due to annual change of sample of surveyed companies by the CSO, however LFS data about the number of employed show similar conclusion). The number of declared layoffs remains high, but business climate surveys are clearly heralding a rise in demand for labour in companies.
- The annual wage growth in the corporate sector accelerated clearly in August to 4.2%YoY from 2.1%YoY in July. The total wage bill in the corporate sector rose in August by 5.9%YoY in nominal terms and by 3.8%YoY in real terms. It was the strongest increase since January 2009. Continuing improvement in the labour market expected by us and rising labour income of households will support the growth of consumer demand in the coming months and quarters. This will also accelerate growth in unit labour costs in companies.

CPI still at the bottom, PPI sharply up

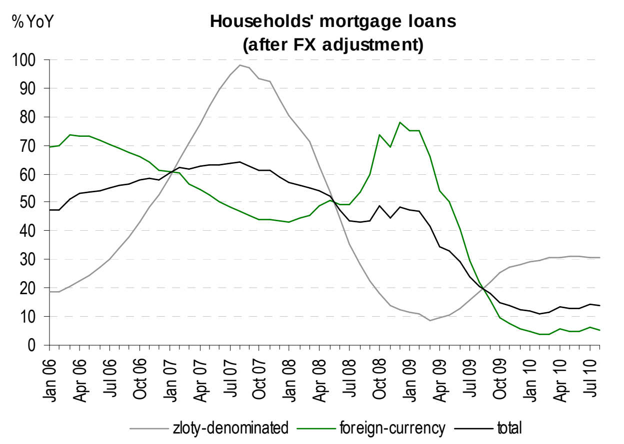
- Inflation rate remained flat in August at 2.0%YoY recorded in July and was lower than expected. The key factor that caused the difference was mainly food prices, which dropped considerably by 1.4%MoM versus the 1.1% decline in July. The lower prices were due to seasonal discounts of vegetables and fruits. In August there was no sign of the impact of growth in worldwide food prices, while the domestic factors such as the floods and weather anomalies also had limited effect. It seems however, that these factors shall put the upward pressure on the food prices in the coming months (in September, the dollar-based FAO index of food prices rose again by over 6%MoM). The moment of the CPI's recovery from the bottom has been postponed, but the scale of the expected increase of the inflation in general remains unchanged – it should be anticipated, that the CPI shall rise gradually in the coming quarters, breaching the NBP's target of 2.5% in the Q4 2010 and going above 3% at the beginning of 2011.
- There were little changes in core inflation measures in August (CPI excluding prices of food and energy remained at 1.2%YoY). We expect to see two more months of stabilisation or even slight decline, and then a gradual increase in core inflation to the level of NBP's inflation target in 2011.
- The PPI growth accelerated in August to 4.1%YoY. That was mainly due to the low base effect of the last year when the prices declined by 0.4%MoM (a 0.2%MoM decline this time). Prices in the manufacturing sector dropped by 0.3%MoM (the first decline since March), which was caused mainly by the stronger zloty that lowered the export prices. The highest growth in prices was recorded in mining industry, and in production of food, pharmaceuticals and tobacco.

Housing market update



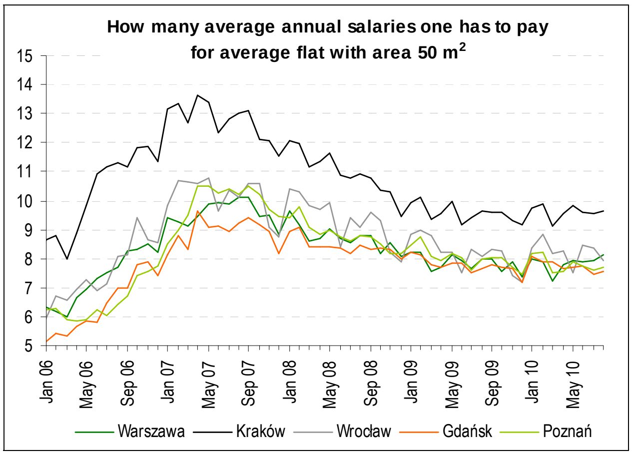
Summer stagnation in housing market

- Usually, activity in the real estate market in summer months is declining. Seasonal slowdown was also observed this year. This affected both the number of transactions and the property prices, which remained little changed in August.
- In all large cities, the average house prices are slightly higher than last year (by ca. 3-4%), although still well below the peak of the housing boom of the second half of 2007 (depending on the city, ca. 6-12 % lower).
- The first signals about the situation on the real estate market in September indicate a post-holiday revival of activity (which is supported by preannounced VAT tax hikes in 2011 and the government plans to trim the family housing incentive scheme), amid a slight drop in average prices in major cities.



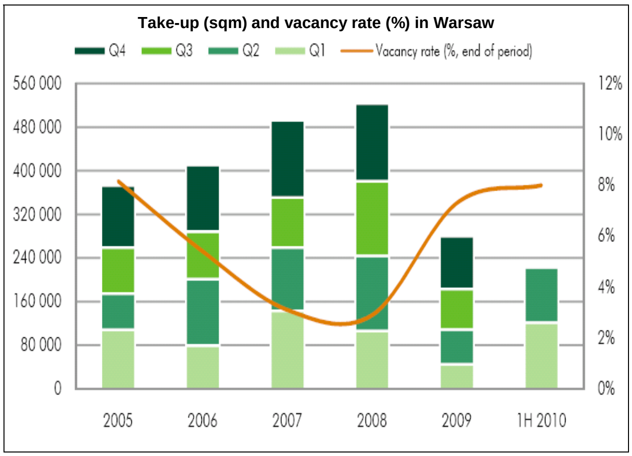
Small changes in the credit market

- In August, there were no significant changes in the banks' housing market product range.
- Customer demand for loans has stabilized in the last few months. Although the value of banks' mortgage loans portfolio increased in August by nearly PLN10bn, but it was mainly the result of increase in the CHFPLN rate. According to our estimates, after adjustment for exchange rate fluctuations, the growth rate of housing loans has stabilised in the last two quarters in a range of 13-14%YoY.
- Some provisions of banking supervision's Recommendation T, which entered into force in late August, did not cause a serious slowdown in lending. This is because banks are introducing more and more attractive offer of zloty-denominated mortgage loans.



Housing affordability largely unchanged

- Indices of housing affordability estimated by us, taking into account the property prices and the average level of wages in a given area, were fluctuating in a fairly limited extent in the last several months. In August, the average affordability in Warsaw was almost 2% lower than last year, while in Wroclaw and Gdansk it has increased on a similar scale. The biggest index rise took place in Poznan (ca. 4%YoY), while in Krakow it remained almost unchanged year-on-year.
- A much bigger improvement took place in case of availability of housing financed by zloty-denominated mortgage loan. According to our calculations, in all the five cities it has increased (by 8-15%YoY). Still, the indices were far below the values before the housing boom.



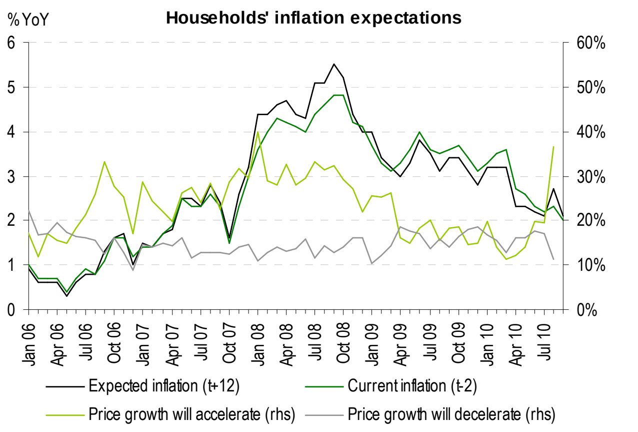
Gradual recovery in the commercial market

- Gradual recovery is seen in the commercial property market. According to the CB Richard Ellis report, in the first half of 2010 the demand for office space in Warsaw was ca. 30% higher than in the second half of 2009 (and total take-up reached 233,000 sqm).
- At the same time, the supply of new office space is limited, among others due to the difficult access to financing (restrictive policy of banks). Vacancy rate of office space in Warsaw was in the first half of 2010 still high at ca. 8%. The highest percentage of vacant office space is in Lodz (20%).
- In the warehouse space market, after stagnation in the previous year, in the first half of 2010 the number of leases has increased by over 60%YoY.

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

Central bank watch

Selected fragments of the MPC statement in September
Modest recovery in the global economy has continued and its pace in the second half of 2010 is likely to be lower than in the first half of the year. In the developed countries adjustments in the balance sheets of households, enterprises and financial institutions together with persistently unfavourable situation in the labour market, are conducive to weakening economic growth in the subsequent quarters. The effects of high fiscal imbalance and its anticipated reduction, as well as of monetary expansion, including non-conventional measures undertaken by central banks constitute an important risk factor for economic growth in those countries. At the same time, continuing high economic growth in major emerging economies supports global economic activity.
The data on the Polish economy in the 2010 Q3 indicate a gradual stabilisation of economic growth. Industrial output continues to grow rapidly; growth, yet irregular, has also been registered in the construction and retail sales. Capacity utilization in enterprises continues to grow gradually. Yet, certain deterioration has been seen in the enterprises' and households' assessment of the future economic situation. The situation in the labour market has been improving gradually which is reflected in the continuing rise of employment in enterprises and falling unemployment rate. Lending to enterprises remains limited, mainly due to reasons related to the demand for credit. Growth in household mortgage lending continues to rise gradually.
(…) In subsequent months, rising good and energy prices may contribute to a gradual rise in CPI inflation; in 2011 the level of prices may also be slightly increased by the announced change of VAT rates.
In the Council's assessment, moderate economic growth and the accompanying limited wage and inflationary pressures, along with the risk of weakening global economic growth in the subsequent quarters justify keeping the NBP interest rates unchanged.
At the same time, the Council will analyse the signs of a possible rise in inflationary pressure, and will follow the developments in inflation expectations.



Fragments of *Monetary policy guidelines for 2011*
Monetary policy is unequivocally focused on maintaining inflation as close as possible to the target of 2.5% and not just within the tolerance band. This is to facilitate the anchoring of inflation expectations and thus to allow the central bank to change monetary policy parameters less frequently in response to potential shocks affecting current inflation. It may also lead to lower volatility of long-term interest rates.
The occurrence of shocks in the economy is inevitable. (…) In the case of shocks which, in the Council's opinion, may lead to a relatively permanent increase in inflation expectations and, as a result, to the rise in inflation due to the emergence of the so-called second-round effects, the central bank will adjust its monetary policy parameters accordingly.
In assessing the risk of turmoil in the financial system and the inflation outlook in the longer run, it is useful to analyse monetary and credit aggregates.

Source: NBP

The MPC is not ripe for a rate hike

- At its meeting in September the MPC decided to keep interest rates on hold. The decision was announced extraordinarily late, which suggests that there was again a motion to hike rates, similar as in August. However, the reason for longer than usual meeting could also be debate on *Monetary Policy Guidelines for 2011* (more on this document below).
- In the post-meeting statement the Council explicitly said why borrowing costs remained unchanged. This was due to moderate GDP growth, limited wage pressure and inflationary pressure as well as possible weakening of global economy.
- At the same time, the Council added that it would analyse signs of a possible rise in inflationary pressure and performance of inflation expectations.
- It seems that as regards arguments taken into account by the MPC, when making decision in September there will be no big changes in October (as to inflation expectations, a dovish argument appeared just one day after the MPC meeting in September – see detail below) and we may see continuation of the wait-and-see approach.
- The new NBP projection for inflation and GDP will be a new element in October, but it is hard to assess whether it will tip the scales in favour of a hike. Taking into account fresh comments from some of MPC members (detail on the next page) the NBP projections may be of relatively low importance for the current MPC.
- All in all, we keep our view that interest rate hikes will begin in the final quarter of this year (the first rate hike will be probably on the scale of 25bps), but not necessarily already in October.

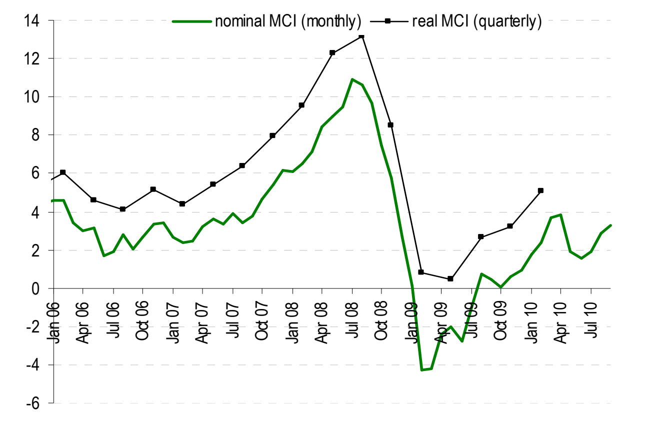
Clear drop in inflation expectations in September

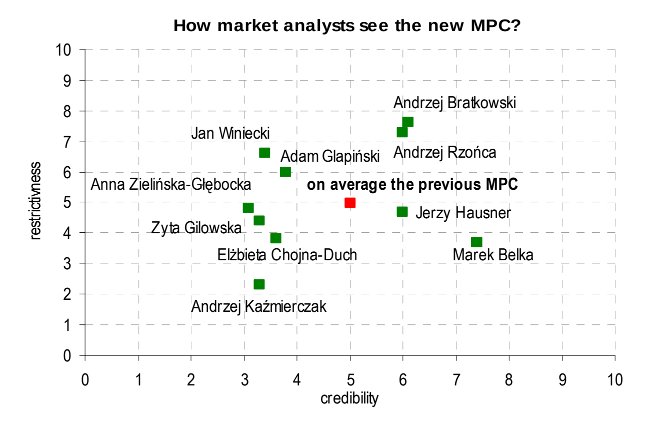
- Just one day after the MPC meeting in September, at which it was stressed that inflation expectations developments will be important for future MPC actions, the NBP released data on inflation expectations of households for September. The numbers showed drop to 2.1%YoY from 2.7%YoY in August, which means full reversal of earlier clear rise from 2.1%YoY in July.
- Drop in inflation expectations in September may be quite important argument at hands of MPC's doves as the current inflation known to surveyed households (CPI for July) lowered on a lower scale than the measure of expectations, to 2.0% from 2.3% in June. The considerable fall in inflation expectations in September was not related only to the 'adaptive factor'.

Little new in new Monetary Policy Guidelines for 2011

- *Monetary policy guidelines for 2011*, adopted by the MPC after long discussions, does not include any major changes as compared to previous years. Above all, the new MPC has not modified the inflation target – monetary policy will be still focused on maintaining inflation as close as possible to the target of 2.5% and not just within the tolerance band.
- Given lessons from the crisis, the MPC stressed stronger than in previous years that monetary aggregates and credit developments should be taken into account in monetary policy. The Council also pointed to importance of regulatory and supervisory policy, which has impact on pace of credit growth and its structure.
- As to instruments, the MPC abandoned bill discount credit.

Restrictiveness of the Monetary Policy (Council)





Appreciation of the zloty help the MPC out

▪ September brought increase in monetary policy restrictiveness measured by our nominal MCI. The monetary policy tightening despite no hike in NBP interest rates took place mostly due to appreciation of the zloty (drop in EURPLN and increase in its deviation downwards from the trend). Smaller contribution to rise in MCI was due to a slight increase in market interest rates (increase in WIBOR 3M and decrease of its deviation from the long-term trend).

▪ As regards assessment of overall restrictiveness of monetary policy one should remember about factors not included in the MCI calculations. From this point of view, it is important to note that credit policy of banks has been gradually eased since the start of 2010, acting towards effective easing of monetary policy.

Still waiting for first results of MPC votes

▪ We officially know that in August the MPC voted on interest rate hike of 50bps and increase in reserve requirements ratio by 50bps. Possibly, in September there was also motion to hike rates, but results of the votes have not been revealed yet and we cannot calculate our index of MPC members restrictiveness.

▪ Instead of that we present results of *Parkiet* survey among market economists and analysts on perceived restrictiveness and credibility of new MPC members. The benchmark was average levels for the previous MPC (value 5 in the scale from 0 to 10; higher value means higher restrictiveness and credibility). Results of the survey suggest that the key MPC members for the market is Jerzy Hausner – relatively high credibility and in the middle of the scale of restrictiveness. It is a pity that prof. Hausner does not appear in the media often.

A part of MPC insist on a pre-emptive interest rate hike

After the MPC meeting in September there was a meeting with MPC member Andrzej Bratkowski in the cycle Thomson Reuters Economic Spot. Similarly as NBP governor Marek Belka (see below for details regarding his comments), Bratkowski does have much confidence in results of the NBP projection. However, in other aspects their views are different. Above all, although Bratkowski is aware how uncertain are further developments in the world's economy, he has quite clear view on prospects for economic growth globally and in Poland. According to him, probability of double-dip scenario in the global economy is low and one may expect acceleration of economic growth in Poland to 3.5-4%, which will be close to current potential level of GDP growth in Poland. Thus, Bratkowski thinks one should not delay monetary tightening. Swift rate hike (probably larger than 25bps in a single move) would enable to contain inflation expectations (he believes that drop in NBP measure of households inflation expectations in September was transitory) and would prevent us from larger hikes in future. Comments of Andrzej Bratkowski, in particular the argument about a necessity to effectively manage inflation expectations and about a need to pre-emptively react to threat for the inflation target in the medium-term, are consistent with views, which have been expressed for a few months by other MPC member, Adam Glapiński.

…while other suggest that rates may remain unchanged until the end of 2010

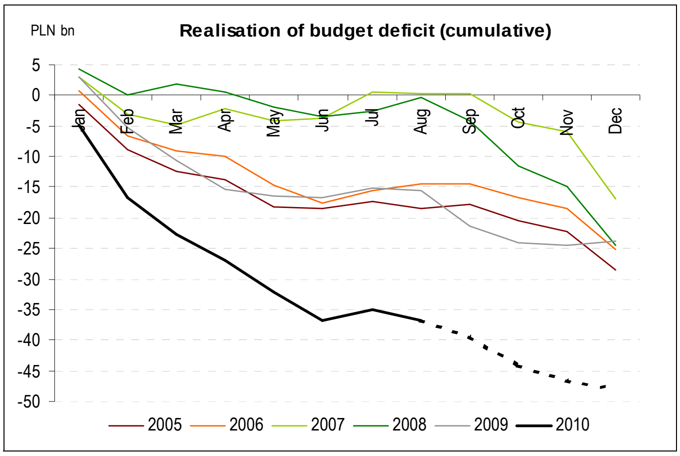
Elżbieta Chojna-Duch said on October 7 in an interview with PAP agency that 'due to situation in the external markets it is also not excluded that interest rates will remain unchanged until the end of this year'. Drawing conclusions from her comments one should remember that Chojna-Duch is not necessarily representative for the whole Council as she belongs rather to the dovish faction within the MPC. This is consistent with both our subjective feeling and with results of the *Parkiet* survey among market analysts, which is described above.

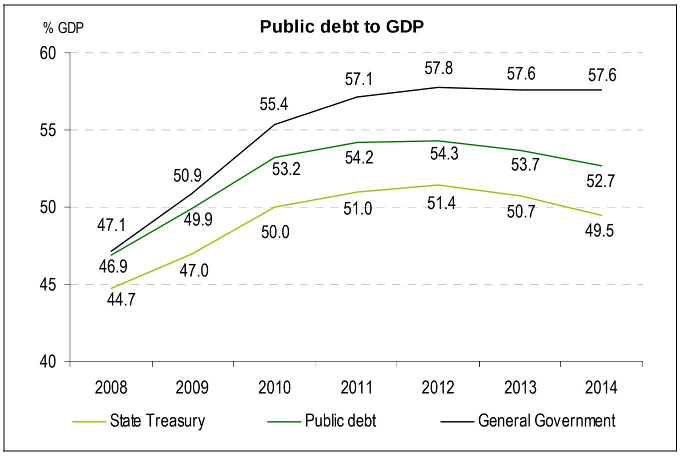
NBP governor feels comfortably

At a meeting with analysts organised by PAP agency, the NBP governor Marek Belka stressed that the current situation is highly uncertain (mainly as to situation abroad) and thus it is hard to predict developments in the Polish economy in the next quarters. On the other hand, none of the uncertainties is of a "dramatic nature" and situation of the MPC is quite comfortable. In particular, NBP governor said that situation in the labour market is favourable for the MPC, because there is no significant wage pressure, despite rising employment. Belka stressed that if there is something worrying as regards inflation prospects, the Council will react, but overall tone of his comments suggested that he does not see significant inflation threats. All in all, one could have an impression that NBP governor will support the first rate hike only after hard data will show clear rise in inflation, rebound in investment, etc. Especially that Belka has reservations as concerns results of the NBP projections.

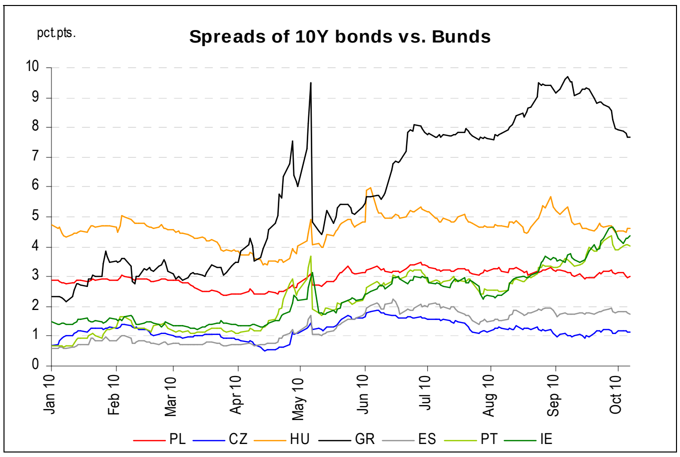
Source: CSO, Eurostat, NBP, own calculations

Government and politics





	Spread vs Bunds (10Y) in bps			CDS (5Y)		
	08.10	change since 01.09	change since 31.12.09	08.10	change since 01.09	change since 31.12.09
Poland	300	-21	13	129	-24	-6
Czech Rep.	114	3	52	90	-8	-4
Hungary	461	-71	-24	284	-87	40
Greece	768	-160	526	769	-189	486
Spain	173	-13	112	227	-20	114
Ireland	427	66	274	310	52	198
Portugal	403	70	334	343	58	311
Italy	144	-11	68	192	-37	84
Germany	-	-	-	38	-6	11



Source: Ministry of Finance, Reuters, own calculations

Performance of 2010 budget better than planned

- Performance of 2010 budget is better than planned. After August budget gap was PLN36.9bn or 70.7% of the full-year plan. There was an improvement of the income from indirect taxes and CIT what suggests that the economy is doing pretty good and gives hopes that the 2010 deficit may be lower by a few billion zlotys than PLN52.2bn initially planned. Still, the public sector deficit will be clearly higher than PLN100bn. According to the anonymous government sources it will widen to 7.9% of GDP from 7.1% in 2009.
- The realization of the privatization plan may be better than estimated. After selling the package of PGE, the IPO of WSE and sale of energy companies Energa and Enea may push this year's privatization inflows above the ambitious target of PLN25bn and thus limit the borrowing needs.

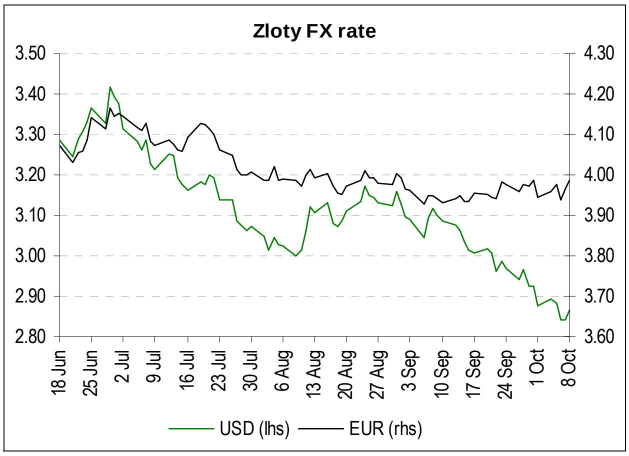
Government adopted 2011 budget and debt strategy

- The government approved and passed to the parliament the 2011 budget without any major changes versus the initial draft presented in the early September. As we have already mentioned, the coming year does not bring any crucial reforms and the fiscal deficit will be reduced only slightly. The minister of finance announced that the general government deficit will reach 6.5% of GDP in 2011 than drop to 4.5% in 2012 and to 2.9% in 2013. Still, there is no information on how this is going to be achieved.
- *The Public Debt Management Strategy for 2011-2014* indicates that in 2011-12 there will be a serious risk of breaking the second safety threshold for the public debt at 55% of GDP. As regards details of debt management, the *Strategy…* does not bring any vital changes.

Lower fiscal risk, except for Ireland and Portugal

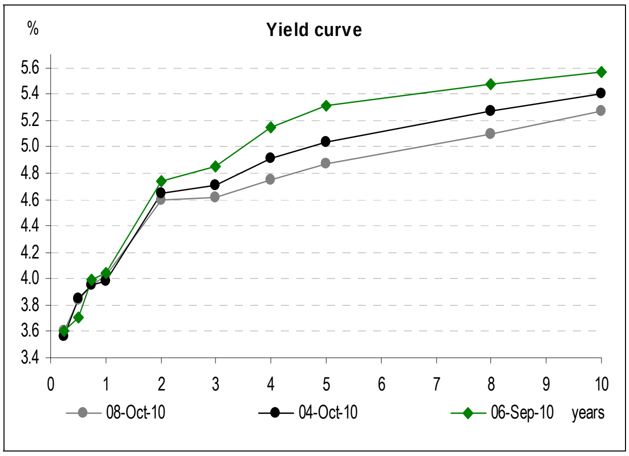
- September and the beginning of October brought the overall improvement of the fiscal risk assessment in Europe, what was clearly reflected in narrowing spreads versus Bunds and decline in CDS rates for most of the euro zone's countries. Still, the overall picture was disturbed by the case of Ireland and Portugal, for which worries over solvency increased. As to Ireland, the undermined confidence was due to rising costs of rescuing banks, which according to some estimates may enlarge the 2010 fiscal deficit to over 30% of GDP. Portugal suffered lack of trust as there is growing uncertainty whether the minority government will be able to implement the regulations aiming at improving the condition of public finances.
- Leaving these two countries aside, we observed the decline of fiscal risk. The CDS rates and spread versus Bunds declined even in case of Spain, which credit rating was downgraded by Moody's in late September. That shows that the worries over debt problems are abating and at the same time the valuation of the credit risk is becoming more selective. Even considerable surge of uncertainty regarding fiscal situation in one or a few countries does not necessarily translated into stronger concern about the whole Europe.
- In the countries of CEE region the risk of solvency declined due to improving economic situation and the quite ambitious plans of fiscal consolidation (Hungary said it will aim at reduction of the fiscal deficit below 3% of GDP in 2011), though Poland is lagging in the latter case. Still, the rating agencies seem not to bother. The Moody's rating agency suggested that the Polish and Czech's debt ratings are under the upward pressure.

Market monitor



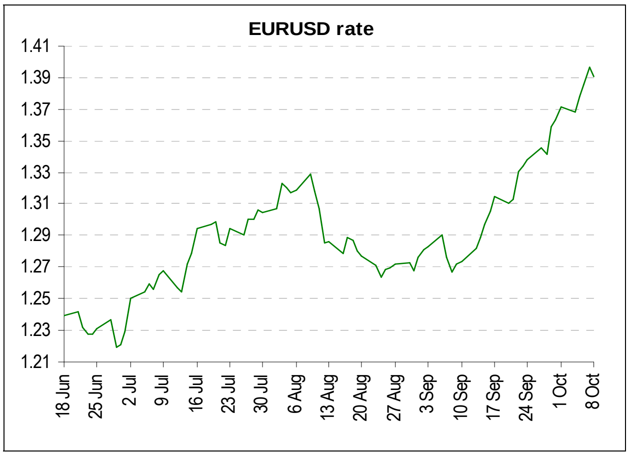
Slight correction of the EURPLN's downward trend

- Just as we expected, the EURPLN declined at the beginning of the month and reached 3.92 in the mid-September. Next few days brought visible zloty's depreciation even to 3.99 per euro (maximum level established on September 30). That was mainly due to Ireland's problems and lower than expected flash PMI estimates for the euro zone and Germany. The better than expected Chinese PMI, the upward revision of the US GDP growth in Q2, and higher probability of the monetary stimulus conducted by the Fed improved the market sentiment and the EURPLN declined to ca. 3.94 in the late September and first days of October.
- We expect, that in October the downward trend of the EURPLN will gain steam and somewhere in the mid-October the zloty will appreciate below 3.92 and may establish the monthly low at ca. 3.85-3.86. At the end of the month the EURPLN may reach 3.89.



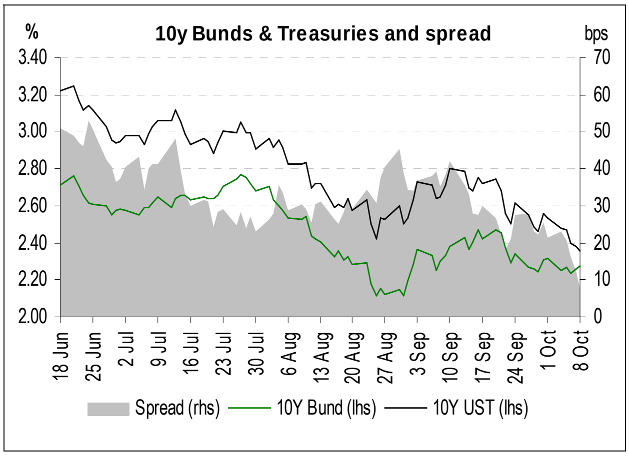
The dovish statement more important than the rate hike vote

- The upward trend in yields started at the end of August was continued only in the first week of September. The higher risk aversion in mid-September amid outstanding among the CEE countries fundamentals of Polish economy supported the demand for domestic bonds and lowered the yields. The lower than expected CPI reduced expectations for interest rates hikes and pushed the yields further down. The market reaction to the new that there was a voting on the 50bps interest rate hike in August was only temporarily, because the communiqué after the latest MPC meeting was dovish.
- We expect that in October the yields at the short end of the curve will initially go up as the new hawkish macro data emerge, but after the MPC meeting there may be another correction. At the long end we see a limited potential for the yields increase due to demand from abroad and limited supply.



The EURUSD at the highest level since February 2010

- The euro was under the severe pressure at the beginning of September due to suggestions published in *The Wall Street Journal* about the European banks (possible undervaluation of the risk connected with bonds of the PIIGS countries while conducting the stress-tests). After the publication of the Fed communiqué, which was interpreted as pointing to higher chances of the next round of the quantitative easing, the EURUSD surged, temporarily even above 1.40. The better than expected data from the euro zone and China (PMI and German Ifo index) and negative readings from the US (ISM and flash Michigan index) supported the euro, and the perspective for higher money supply in the US depreciated the dollar.
- We expect that the EURUSD will not manage to stay above 1.38-1.39 and in October there will be a correction of the latest clear euro appreciation.

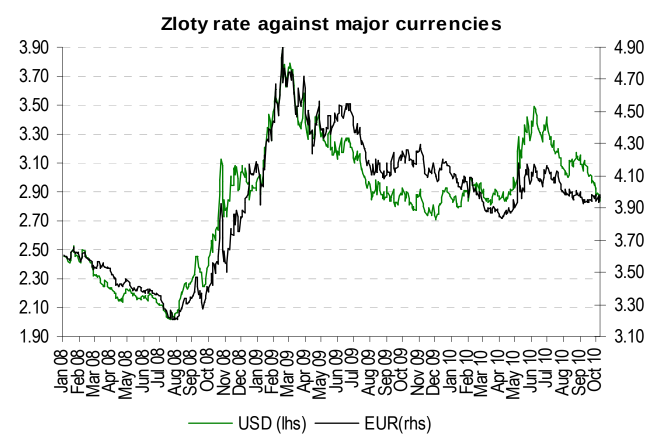


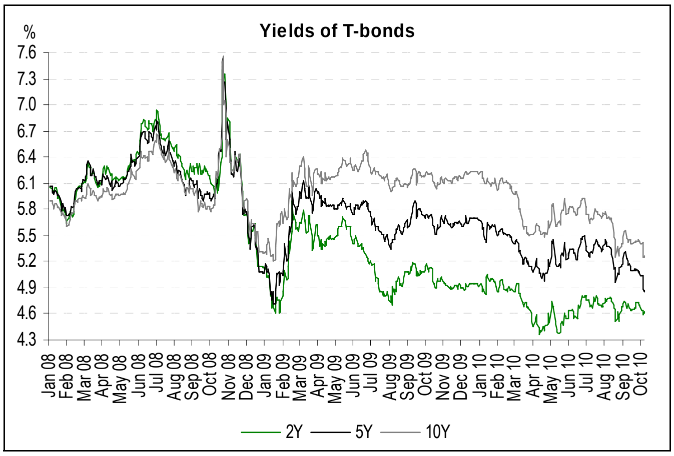
Expectations for the Fed's intervention lower the yields

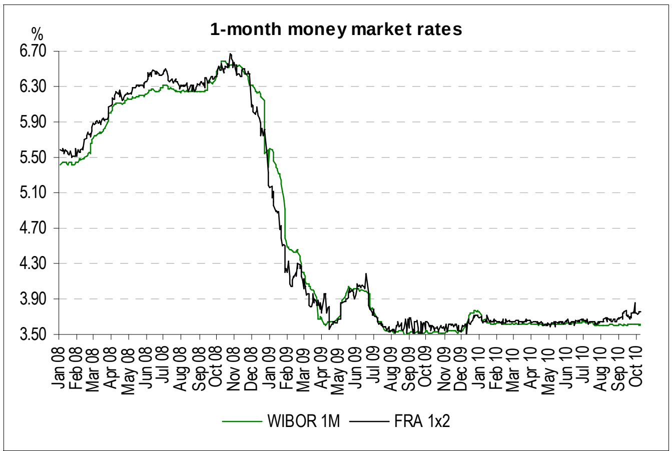
- The yields in the core fixed income markets recovered from the latest lows, as the expected by us improvement of the market sentiment took place. However, in the last decade of September there was higher demand for safe-heaven assets, this time not triggered by the risk aversion, but the reaction to the higher probability of the next round of the quantitative easing in the US (the Fed's purchase of US bonds). In the first days of October, the yields in the core fixed income markets hovered around the levels seen in the first half of September.
- The issue of the monetary policy tightening will not be in the agenda of ECB and Fed anytime soon (the Fed says that the inflation in the US is even too low). We expect that in October the yields of the 10Y Bunds and Treasuries will be traded in the horizontal trend constrained by the latest lows and highs (Bunds: 2.10-2.50%, Treasuries: 2.45-2.80%).

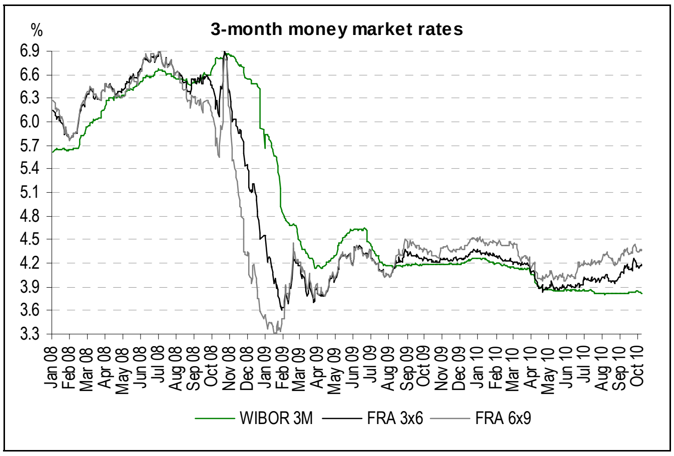
Source: Reuters, BZ WBK

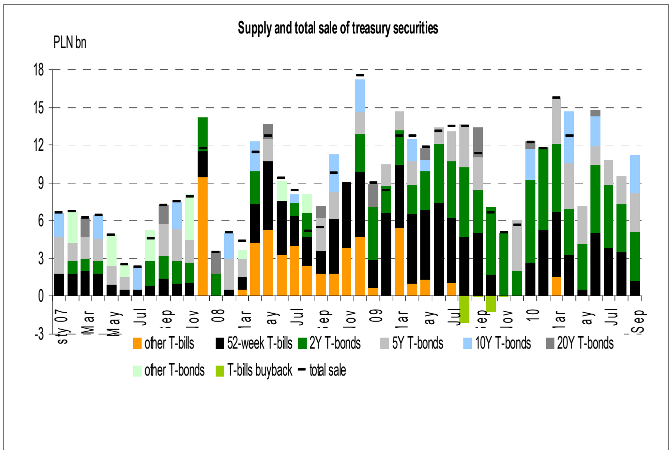
Market monitor











Treasury bills auctions (PLN m)

Auction date	OFFER	DEMAND/SALE
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	Cancelled	-
13.09.2010	Cancelled	-
20.09.2010	52 week.: 500-600	3438/600
27.09.2010	52 week.: 500-600	1150/580
4.10.2010	Cancelled	-
11.10.2010	Cancelled	-
18.10.2010	-	-
25.10.2010	-	-
22.11.2010	*Depending on the budget situation*	-
20.12.2010	*Depending on the budget situation*	-

** based on data of the Ministry of Finance*

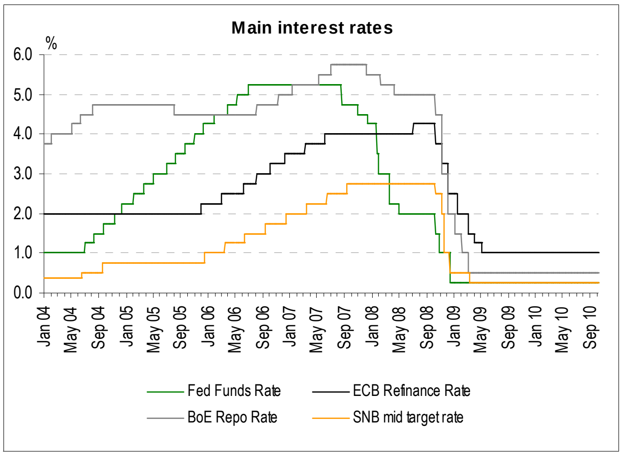
Treasury bond auctions in 2009/2010 (PLNm)

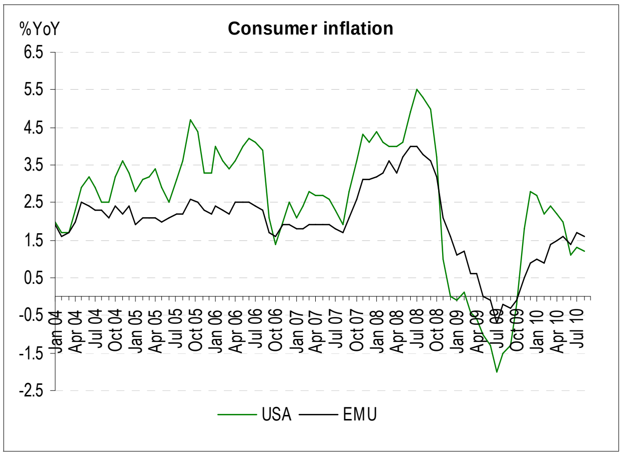
month	First auction				Second auction				Switch auction		
	date	T-bonds	offer	sale	date	T-bonds	Offer	sale	date	T-bonds	sale
November	10.11	OK0712	3500-5000	5000	-	-	-	-	26.11	OK0712/P0414	1121/2243
December	2.12	OK0712/PS0415	3000-6000	5651	-	-	-	-	16.12	-	-
January	13.01*	OK0712	6600	6600	20.01*	DS1019/WS0429	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	DS1110	DS1020
August	4.08	OK1012/PS0415	3000-6000	6000	11.08	-	-	-	25.08	DS1110	PS0415/DS1020
September	1.09	OK1012	2500-4000	4000	8.09	PS0415	1500-3000	3000	15.09**	DS1020	3000/3000***
October	6.10	OK0113	2000-3000	3000	13.10	PS0416	-	-	21.10	-	-

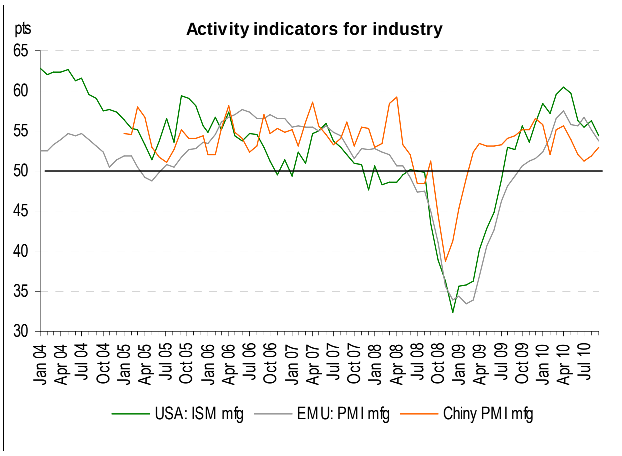
* with supplementary auction, ** primary auction, *** demand/sale

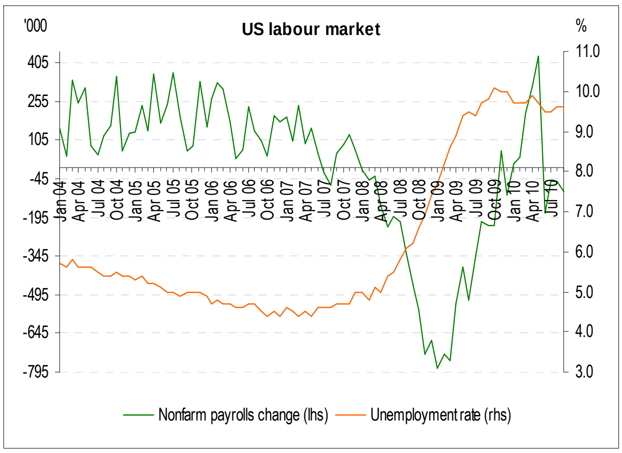
Source: Ministry of Finance, Reuters, BZ WBK

International review









Source: Reuters, ECB, Federal Reserve

Higher chances for the next round of the quantitative easing

▪ Just at it was expected, at the latest meeting the Federal Reserve left the interest rate unchanged. There was no declaration of new actions taken to stimulate the US economy, but there was a suggestion that the Fed is ready to take certain steps if there was such need. Additionally, what has not been mentioned in the previous statements, the Fed pointed to the too low inflation, which was interpreted as the next reason to resume the monetary stimulation of the US economy. The market priced-in the higher probability of the next round of the quantitative easing and pushed down the yields on the core fixed income market.

▪ In line with the market consensus, at the latest meeting the ECB left the main interest rate at 1.0%. According to the bank, the latest data from Europe support the expectations for the moderate economic growth in the second half of the year. Still, such factors as rising prices of oil and other commodities and the protectionist tendencies were outlined as threats to maintaining the positive momentum in the euro zone's economy. The ECB stressed that the inflationary pressure is subdued and the inflationary expectations are anchored at the proper level. Both factors support the outlook for no interest rates hikes in the foreseeable future.

▪ The US CPI reached 1.2%YoY in August and is well below the Fed's comfort zone at 1.7-2.0%.

▪ HICP inflation in the euro zone in August reached 1.6%YoY, while the flash estimates for September show a rise to 1.8%YoY, that is below the ECB target at 2.0% and does not increase the chances for the interest rate hikes.

China gains steam, the euro zone and US lagging behind

▪ In September only the Chinese manufacturing PMI index increased, while the indices for the euro zone and the US declined. That seems to confirm that the Chinese economy is strong and the recovery in the euro zone and US is unstable.

▪ The PMI-manufacturing index for the euro zone declined in September to 53.7 versus 55.1 in August and reached the lowest level since January 2010. The downward trend is becoming more visible, what does not give much hopes for the improvement in coming months. Perhaps the latest poor performance reflects the entrepreneurs' preparation for the expected slowdown in the H1 2011 due to implementation of the fiscal savings plans in Europe.

▪ The ISM index for the US manufacturing sector declined in September to 54.4 from 56.3 in August, reaching the lowest level since November 2009. The decline was partly due to lower inventories sub-index, while this was the factor that had been supporting the recovery in the Q1 and Q2.

▪ The Chinese PMI-manufacturing index climbed in September to 52.9 from 51.9 in August and that was the fourth consecutive month of the upward trend. The latest data particularly point to strong domestic demand and the industrial output growth is higher than the long term average.

▪ The final data on the US GDP growth in the Q2 showed an increase by 1.7%QoQ versus first revision at 1.6%. The data point that the upward revision was mainly due to higher private consumption and investments (visible revision of the growth in inventories). On the other hand, the negative contribution of the net exports was higher than previously estimated, mainly due to higher imports of goods.

▪ In September there were 95k less jobs in the US the non-farm sector versus a decline by 57.0k in August (after the revision). The unemployment rate remained unchanged at 9.6%.

Economic calendar

Monday	Tuesday	Wednesday	Thursday	Friday
11 October US: Market Holiday	**12** ***PL: Balance of payments (Aug)*** DE: CPI (Sep) US: Fed minutes	**13** ***PL: 5Y bond tender*** ***PL: CPI (Sep)*** EZ: Industrial output (Aug) US: Import prices (Sep)	**14** ***PL: Money supply (Sep)*** US: Trade balance (Aug) US: PPI (Sep)	**15** EZ: Trade balance (Aug) EZ: HICP (Sep) US: CPI (Sep) US: NY Fed index (Oct) US: Retail sales (Sep) US: Flash Michigan index (Oct)
18 ***PL: Auction of Treasury bills*** ***PL: Wages and employment (Sep)*** US: Capacity utilization rate (Sep) US: Industrial output (Sep)	**19** ***PL: PPI (Sep)*** ***PL: Industrial output (Sep)*** EZ: Current account (Aug) DE: ZEW index (Oct) US: Building permits (Sep) US: House starts (Sep)	**20** ***PL: Core CPI (Sep)*** US: Fed Beige book	**21** ***PL: Bond switching auction*** ***PL: MPC minutes*** EZ: Flash PMI – manufacturing (Oct) EZ: flash PMI – services (Oct) EZ: Consumer confidence (Oct) US: Leading indicators (Sep) US: Philly Fed (Oct)	**22** ***PL: Business climate (Oct)*** DE: Ifo index (Oct)
25 ***PL: Auction of Treasury bills*** EZ: Industrial orders (Aug) US: Home sales (Sep)	**26** ***PL: Retail sales (Sep)*** ***PL: Unemployment rate (Sep)*** DE: GfK index (Nov) US: S&p/Case-Shiller home price index (Aug) US: Consumer confidence (Oct)	**27** ***PL: MPC decision*** EZ: Money supply (Sep) US: Durable goods orders (Sep) US: New home sales (Sep)	**28** EZ: Economic sentiment (Oct)	**29** EZ: Flash HICP (Oct) EZ: Unemployment rate (Sep) US: Core PCE (Q3) US: Advance GDP (Q3) US: ISM NY index (Oct) US: Chicago PMI index (Oct) US: Michigan index (Oct)
1 November ***PL: All Saints Day*** US: Consumption (Sep) US: Personal income (Sep) US: Core PCE (Sep) US: ISM – manufacturing (Oct)	**2** ***PL: PMI – manufacturing (Oct)*** EZ:PMI – manufacturing (Oct) DE: Retail sales (Sep)	**3** US: ADP report (Oct) US: Industrial orders (Sep) US: ISM – services (Oct) US: Fed decision	**4** EZ: PMI – services (Oct) EZ: PPI (Sep) EZ: ECB Decision US: Flash productivity (Q3)	**5** EZ: Retail sales (Sep) US: Non-farm payrolls (Oct) US: Pending home sales (Sep)
8 DE: Industrial output (Sep)	**9** US: Wholesale inventories (Sep)	**10** ***PL: Bond switching auction*** ***PL: Balance of payments (Sep)*** US: Import prices (Oct) US: Trade balance (Sep)	**11** ***PL: The Independence Day*** US: Market holiday	**12** ***PL: Money supply (Oct)*** EZ: Flash GDP (Q3) EZ: Industrial output (Sep) US: Flash Michigan (Nov)

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	24	15	-	23	21	18	16
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	23	24	24	26	-	-
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	-	-	30
Balance of payments	15	12	12	13	17	16	13	11	10	12	10	13
Money supply	14	12	12	14	14	14	14	13	14	14	12	14
Business climate indices	22	23	22	23	21	22	23	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

		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	Oct 10
PMI	pts	48.2	48.8	52.4	52.4	51.0	52.4	52.5	52.5	52.2	53.3	52.1	53.8	54.7	53.5
Industrial production	%YoY	-1.3	-1.3	9.9	7.4	8.5	9.2	12.5	9.7	13.5	14.3	10.5	13.5	11.2	6.0
Construction production	%YoY	5.7	2.7	9.9	3.2	-15.3	-24.7	-10.9	-6.3	2.3	9.6	0.8	8.5	12.3	6.5
Retail sales [a]	%YoY	2.5	2.1	6.3	7.2	2.5	0.1	8.7	-1.6	4.3	6.4	3.9	6.6	7.2	7.3
Unemployment rate	%	10.9	11.1	11.4	11.9	12.7	13.0	12.9	12.3	11.9	11.6	11.4	11.3	11.4	11.4
Gross wages in enterprises sector [a]	%YoY	3.3	2.0	2.3	6.5	0.5	2.9	4.8	3.2	4.8	3.5	2.1	4.2	4.2	4.4
Employment in enterprises sector	%YoY	-2.4	-2.4	-2.2	-1.8	-1.4	-1.1	-0.6	0.0	0.5	1.1	1.5	1.6	1.7	1.9
Export (€)	%YoY	-17.0	-10.9	1.0	12.6	14.0	20.5	21.5	22.9	24.7	28.6	16.0	25.4	20.5	19.6
Import (€)	%YoY	-26.8	-20.8	-11.0	-3.3	8.3	21.7	24.6	23.0	29.9	27.8	20.0	27.0	25.5	20.4
Trade balance	EURm	59	-200	-291	-627	-104	-177	-526	-262	-450	-287	-865	-657	-393	-314
Current account balance	EURm	-250	-330	-1 376	-1 070	-672	67	-458	-336	-889	-1 004	-1 539	-1107	-993	-564
Current account balance	% GDP	-2.3	-1.9	-1.8	-1.6	-1.6	-1.8	-1.9	-1.9	-2.1	-2.3	-2.6	-2.9	-3.1	-3.2
Budget deficit (cumulative)	PLNbn	-21.5	-24.0	-24.4	-23.8	-4.8	-16.7	-22.7	-27.0	-32.1	-36.8	-34.9	-36.9	-39.5	-44.1
Budget deficit (cumulative)	% of FY plan	90.3	101.1	102.6	100.0	9.3	32.1	43.5	51.8	61.6	70.5	66.9	70.7	75.7	84.5
CPI	%YoY	3.4	3.1	3.3	3.5	3.5	2.9	2.6	2.4	2.2	2.3	2.0	2.0	2.3	2.5
CPI excluding prices of food and energy	%YoY	2.9	2.9	2.8	2.6	2.4	2.2	2.0	1.9	1.6	1.5	1.2	1.2	1.1	1.1
PPI	%YoY	1.6	2.0	1.9	2.1	0.2	-2.4	-2.6	-0.4	1.9	2.1	3.8	4.1	4.3	3.5
Broad money (M3)	%YoY	9.6	11.9	8.0	8.1	6.3	5.1	5.5	6.1	7.7	7.1	7.8	9.3	8.5	6.0
Deposits	%YoY	10.9	13.5	10.3	9.8	7.5	6.8	6.2	7.0	8.5	8.1	8.5	9.9	8.9	7.0
Loans	%YoY	18.6	14.9	13.4	8.6	5.4	3.0	2.2	3.8	5.1	8.0	8.6	10.0	9.3	8.4
USD/PLN	PLN	2.86	2.85	2.79	2.83	2.85	2.93	2.87	2.89	3.24	3.36	3.20	3.09	3.03	2.89
EUR/PLN	PLN	4.16	4.21	4.17	4.14	4.07	4.01	3.89	3.87	4.06	4.10	4.08	3.99	3.96	3.90
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	%	4.18	4.18	4.19	4.23	4.24	4.17	4.13	3.92	3.85	3.86	3.84	3.81	3.82	3.85
Yield on 52-week T-bills	%	4.33	4.35	4.26	4.25	4.01	3.90	3.92	3.84	3.71	3.93	4.08	3.97	4.02	4.00
Yield on 2-year T-bonds	%	5.10	5.03	4.92	4.92	4.95	4.90	4.76	4.47	4.52	4.66	4.73	4.68	4.69	4.65
Yield on 5-year T-bonds	%	5.74	5.65	5.64	5.67	5.58	5.51	5.27	5.10	5.26	5.35	5.35	5.23	5.15	4.90
Yield on 10-year T-bonds	%	6.18	6.15	6.14	6.21	6.12	6.09	5.71	5.56	5.74	5.83	5.73	5.54	5.45	5.30

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	1 418.7	1 508.8	327.4	345.1	349.5	396.6	349.1	366.9	369.1	423.6
GDP	%YoY	5.1	1.8	3.5	3.5	3.0	3.5	3.7	3.8	3.8	3.5	3.3	3.5
Domestic demand	%YoY	5.6	-1.0	3.9	4.4	2.2	3.9	4.3	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	10.8	7.1	9.5	11.7	11.7	8.7	7.5	7.4	8.0	5.4
Construction production	%YoY	10.0	4.6	3.3	7.2	-16.7	2.5	7.3	10.7	23.8	3.5	2.5	7.4
Retail sales [a]	%YoY	13.1	3.5	5.6	7.9	4.0	3.1	6.0	8.8	5.5	7.7	8.1	9.8
Unemployment rate [b]	%	9.5	11.9	11.5	10.1	12.9	11.6	11.4	11.5	12.3	10.8	10.2	10.1
Gross wages in enterprise sector [a]	%YoY	10.3	4.4	3.7	5.6	2.8	3.8	3.1	4.8	4.8	5.2	5.9	5.9
Employment in enterprise sector	%YoY	4.8	-1.2	0.7	2.1	-1.3	0.4	1.6	2.0	2.2	2.1	2.1	2.2
Export (€)	%YoY	14.2	-15.8	20.3	11.6	18.0	24.9	18.7	19.6	17.0	12.0	10.0	8.0
Import (€)	%YoY	17.2	-24.3	21.7	15.0	17.2	24.9	22.2	22.5	21.0	16.0	14.0	9.8
Trade balance	EURm	-17 724	-3 102	-5 270	-10 164	-676	-653	-1 915	-2 026	-1 954	-1 988	-3 413	-2 809
Current account balance	EURm	-17 384	-6 749	-9 333	-9 764	-1 134	-1 534	-3 639	-3 026	-1 904	-1 788	-3 513	-2 559
Current account balance	% GDP	-4.8	-2.2	-2.6	-2.5	-2.2	-2.1	-2.7	-2.6	-2.7	-2.8	-2.7	-2.5
General government balance	% GDP	-3.7	-7.1	-7.9	-6.5	-	-	-	-	-	-	-	-
CPI	%YoY	4.2	3.5	2.5	3.0	3.0	2.3	2.1	2.5	3.1	3.0	3.0	3.0
CPI [b]	%YoY	3.3	3.5	2.7	2.9	2.6	2.3	2.3	2.7	3.1	2.9	3.0	2.9
CPI excluding food and energy prices	%YoY	2.3	2.7	1.6	2.3	2.2	1.7	1.1	1.3	2.0	2.2	2.4	2.5
PPI	%YoY	2.2	3.3	1.8	3.5	-1.6	1.2	4.1	3.6	4.0	3.3	2.9	3.7
Broad money (M3) [b]	%YoY	18.6	8.1	7.2	7.1	5.5	7.1	8.5	7.2	7.4	6.3	6.9	7.1
Deposits [b]	%YoY	20.6	9.8	7.7	6.9	6.2	8.1	8.9	7.7	7.7	6.4	7.3	6.9
Loans [b]	%YoY	36.0	8.6	9.8	10.0	2.2	8.0	9.3	9.8	13.4	10.1	10.7	10.0
USD/PLN	PLN	2.41	3.12	3.00	2.89	2.88	3.15	3.10	2.89	2.89	2.97	2.88	2.82
EUR/PLN	PLN	3.52	4.33	3.97	3.81	3.99	4.01	4.01	3.86	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	3.96	4.61	4.18	3.88	3.82	3.95	4.20	4.54	4.85	4.85
Yield on 52-week T-bills	%	6.26	4.54	3.96	4.61	3.94	3.83	4.02	4.05	4.30	4.55	4.80	4.80
Yield on 2-year T-bonds	%	6.22	5.17	4.72	5.10	4.87	4.55	4.70	4.75	4.95	5.10	5.15	5.20
Yield on 5-year T-bonds	%	6.15	5.65	5.26	5.60	5.46	5.24	5.24	5.10	5.45	5.60	5.65	5.70
Yield on 10-year T-bonds	%	6.06	6.11	5.69	5.96	5.97	5.71	5.57	5.50	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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