

# Weekly economic update

4 – 10 October 2010

The zloty was quite volatile in recent days, starting and ending the week near 3.94, with a temporary weakening to 3.99. This was caused mainly by fluctuations of sentiment in global financial markets. After a rise in concerns about the European financial system and the peripheral euro area countries, there has been a revival of risk appetite globally under the influence of better-than-expected macroeconomic data at the end of the week, which have restored faith in the continued economic recovery.

While the MPC decision to leave interest rates unchanged in September was no surprise at all, the tone of communiqué and comments of the NBP President at the press conference was clearly more dovish than we expected. It seems that within the next month the Council's evaluation of the factors that justified leaving interest rates unchanged in September will not change significantly. While the macroeconomic data for the next month will probably confirm further improvement of economic activity (PMI rose in September to the four year-high, heralding continued strong expansion in the industry, with booming new orders, demand for labour and production costs), they may not be enough to tip the scales in favour of starting monetary tightening cycle in October. Still, we expect the MPC to deliver a 25pb-rate hike before the year-end.

This week, the investors' attention will be focused on the next important data releases in the euro zone and the US, as well as the first earning reports of American companies for the third quarter. Domestic factors will recede into the background in the absence of significant local events in the agenda.

## Economic calendar

Time CET	COUNTRY	INDICATOR	PERIOD		FORECAST		LAST VALUE
					MARKET	BZWBK	
<b>MONDAY (4 October)</b>							
11:00	EZ	PPI	Aug	%YoY	3.6	-	4.0
16:00	US	Pending home sales	Aug	%MoM	3.0	-	5.2
16:00	US	Industrial orders	Aug	%MoM	-0.4	-	0.1
<b>TUESDAY (5 October)</b>							
9:58	EZ	PMI – services	Sep	pts	53.6	-	55.9
11:00	EZ	Retail sales	Aug	%YoY	1.4	-	1.1
16:00	US	ISM – services	Sep	pts	52.0	-	51.5
<b>WEDNESDAY (6 October)</b>							
<b>11:00</b>	<b>PL</b>	<b>Tender of 2Y bonds OK1113</b>					
11:00	EZ	Final GDP	Q2	%QoQ	1.0	-	1.0
12:00	DE	Industrial orders	Aug	%MoM	0.8	-	-2.2
14:15	US	ADP report	Sep	k	23.0	-	-10.0
<b>THURSDAY (7 October)</b>							
12:00	DE	Industrial output	Aug	%MoM	0.5	-	0.1
13:45	EZ	ECB decision		%	1.0	-	1.0
14:15	US	Initial jobless claims	week	k	451.0	-	453.0
<b>FRIDAY (8 October)</b>							
14:30	US	Non-farm payrolls	Sep	k	0.0	-	-54.0
14:30	US	Unemployment rate	Sep	%	9.7	-	9.6
16:00	US	Wholesale inventories	Aug	%MoM	0.5	-	1.3

Source: BZ WBK, Reuters

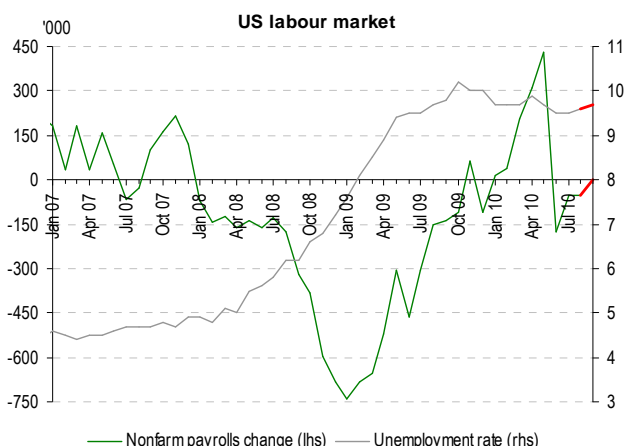
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**What's hot this week – US non-farm payrolls and start of earnings season for Q3**

- This week the calendar of domestic events is almost empty (there is only tender of 2Y bonds). Thus, the local financial market is likely to be even more dependent on global developments than usually.
- The key factor for the global markets this week will be Friday's release of the US non-farm payrolls report. However, earlier in the week we will get important hint on conditions in the US labour market, i.e. the ADP report and initial jobless claims. Much attention will be also paid to the euro zone's PMI and the US ISM for services due on Tuesday.
- Besides, global markets are waiting for the start of the Q3 earnings season. It will begin unofficially, when Alcoa releases its report (on Thursday, October 7). This time market expectations regarding financial results of major companies are less optimistic than a quarter earlier.

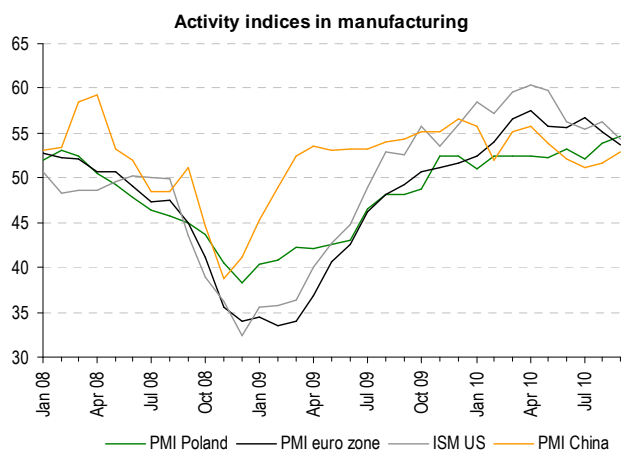
**Economy last week – Rates unchanged, PMI sharply up****Selected fragments from the September MPC statement (marked significant changes to the August statement)**

In August 2010 the annual CPI inflation amounted to 2.0%, thus remained below the NBP inflation target set at 2.5%. Core inflation continued at a low level. Yet, the majority of measures of inflation expectation exceed the current CPI inflation. High growth has been recorded in producer prices. In subsequent months, inflation may be gradually increased by food and energy price growth rising good and energy prices may contribute to a gradual rise in CPI inflation; in the first months of 2011 the level of prices may also be slightly raised increased by the announced change of VAT rates. The impact of this change on inflation should nevertheless be minor.

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.

The Council has discussed factors that may fuel inflationary pressures in the medium term. 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.

- MPC decision to keep rates on hold was announced extraordinarily late, which suggests there was again a motion to hike rates. In the post-meeting statement the Council justified why borrowing costs remained unchanged – moderate GDP growth, limited wage pressure and inflationary pressure, 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 inflation expectations. It seems that as regards arguments taken into account by the MPC, there will not be much changes over the next month (although fresh data may speak for a hike) and we may see continuation of the wait-and-see approach. The new NBP projection for inflation and GDP will be the only new element, but it is hard to assess whether it will tip the scales in favour of a hike. We keep our view that rates will be hiked by 25bps in Q4, but not necessarily in October.



- Poland's manufacturing PMI for September proved much higher than expected, rising to the highest level since November 2006 while market consensus pointed to a drop to 53.0 from 53.8. What is important, there was improvement in new orders, including export ones, and in employment. All in all, the data suggest that in late Q3 there was still solid rise in activity of Polish manufacturing.
- PMI indices in the industry for the euro area and Germany fell in September, but slightly less than that reported in flash estimates. Strong PMI rise in China signals that fears about slowdown in this economy may have been exaggerated.
- The FinMin's estimate of CPI inflation in September matched our forecast and market consensus, reaching 2.3%YoY. Increase in CPI inflation in September was probably a result of rebound in food prices (FinMin did not give details of its forecast).

**Quote of the week – Insufficient European Commission's proposals****Jacek Rostowski, finance minister, PAP, Reuters, 30 Sep**

*I think that this [the EC's proposal on how to take into account costs of pension system reforms in calculation of fiscal deficit and debt] is insufficient and unsatisfactory. This is step in the right direction, but only a small one. The proposal gives us a relief of maximum 1% of GDP, but our pension reform now creates costs of about 2.4% of GDP. We add so much every year to our deficit and debt. Impact of such reforms [of pension system] on public finance increases along with time. Meanwhile, it [costs] will be deducted [from debt] only for 5 years and in a digressive way.*

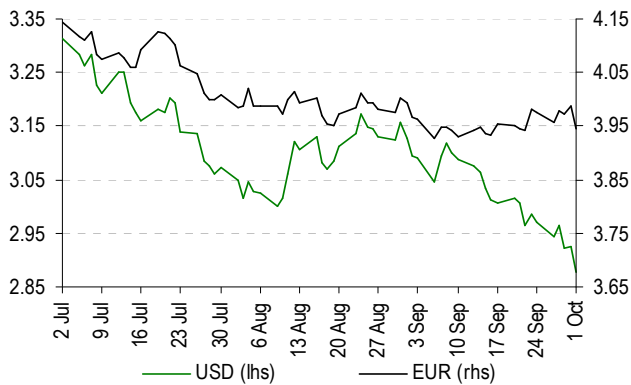
**Marek Belka, NBP governor, Reuters, 30 Sep**

*The Commission's proposals are inadequate. They may help Poland to adopt the euro only to a little extent.*

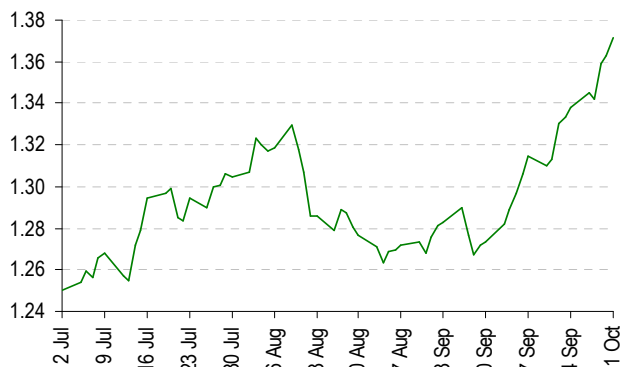
The European Commission's proposals revealed on Wednesday as to how take into account costs of pension system reforms fiscal accounts disappointed Poland's finance minister and NBP governor. First of all, Rostowski stressed that 1% leeway in case of fiscal deficit (limit up from 3% to 4% of GDP) is not enough. Second, he said the temporary leeway for public debt, i.e. 5-year period for diminishing deduction of costs of pension system reform from the debt (100% in the first year, 80% in the second year, etc.) is insufficient. We agree with Rostowski's argumentation that as pension system reforms give effect for decades (with costs felt for quite a long time) the relief should be larger and not for such a short period. The EC's approach is not encouraging for carrying out necessary, but costly reforms.

Market monitor

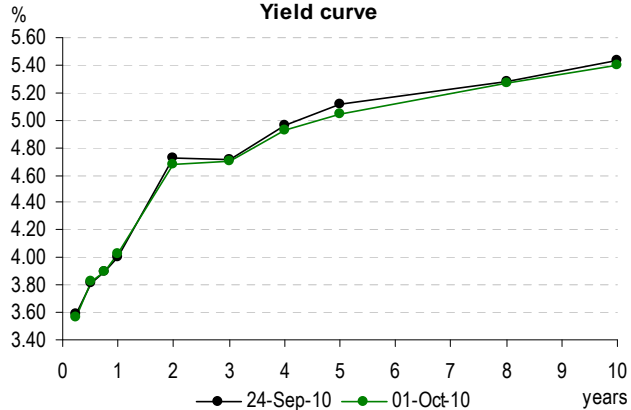
Zloty exchange rate



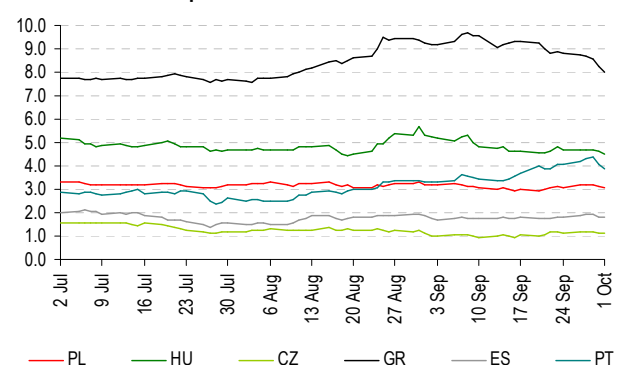
EURUSD rate



Yield curve



Spreads of 10Y bonds vs. Bunds



Zloty recovers after weak beginning of the week

At the beginning of the week the EURPLN declined, just as we expected. The zloty firmed to nearly 3.94, but the next few days brought the upward trend of the EURPLN. The surge of the risk aversion that occurred in the first part of the week was triggered by the worries over the stability of the European banking sector (Moody's rating agency cut the debt rating of the Anglo Irish Bank) and the cut of the Spanish debt. Only the Thursday's data from the US and Friday's Polish PMI dragged the EURPLN down, the zloty appreciated from 3.99 to 3.94 at the end of the week. The technical outlook is optimistic for the zloty. We expect that the zloty will appreciate to ca. 3.92 in the coming days.

The greenback gained versus the euro only at the beginning of the week, that was mainly due to worries over the European banks and Spanish debt cut. The rumours, that the Fed may change its stimulus policy (from buying large amounts of US bonds during the fixed period of time to more elastic interventions only when they are needed and not injecting than much dollars into the system) increased the possibility of actually taking such actions. Consequently, the EURUSD surged. The lower than expected demand for cash claimed by the banks before the Friday's payback of the loan to the ECB, Thursday's good data from the US (GDP and the labour market) and Friday's better than expected final data on the euro zone's PMI index for the industry pushed the EURUSD further to the north. The area of support at 1.35-1.36 was broken and the EURUSD climbed above 1.37. We expect that during the first few days of the week the EURUSD may be testing the resistance level at 1.38 and than some correctional decline to ca. 1.35-1.36 is possible.

Rebound in debt market after dovish MPC statement

Until Wednesday the yields in the domestic debt market were stable, as investors were awaiting the MPC statement. The communiqué appeared to be dovish, which triggered a significant correction of recent increase in yields, that took place under impact of minutes of the MPC August meeting, at which the Council voted on the rise in interest rates by 50 bp and the reserve requirement by 50 bp. Reversal of the upward trend also took place in the FRA market. This week, in the absence of domestic data releases, we expect the short end of the yield curve to remain stable. Meanwhile, there is some potential for a slight increase in yields at the long end.

Fall in yields in the core debt markets, that we have seen at the start of the week, was primarily due to the growth in risk aversion, and also due to pricing-in greater chance of stimulating the economy by the Fed. Only the last two days have brought a clear improvement in global market sentiment, so that the yields of Bunds and Treasuries have risen strongly.

During the last week the spreads of 10-year bonds versus 10-year German Bunds fell in most cases, while in the case of Polish 10-year bonds they remained roughly unchanged. Polish long-term bonds were relatively stable last week, while yields for peripheral euro zone countries have fluctuated markedly. In particular yields of Spain and Portugal initially grew strongly, and then after a sharp fall in risk aversion dropped below last Friday's levels.

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