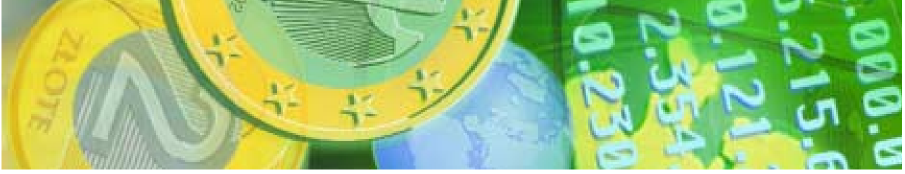


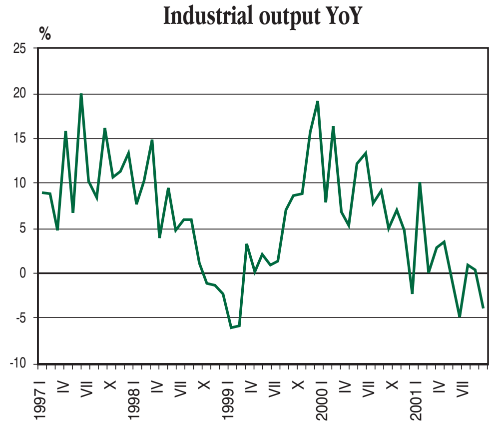
Poland's Economy – Financial Markets

November 2001 Nº 28

Main economic trends

- Economic data and the results of the economic research released in October suggest a further slowdown in the economic activity. On an annual basis, the decrease in employment accelerated from ca. 3% on average at the beginning of the year, to 4% in September; industrial output decreased by 3.8% y/y, exports and imports went down, the unemployment rate rose and the value of business loan volumes shrank in the first two decades of October. Moreover, the examination of the economic situation indicates further fall in both import and export orders, further cuts in employment and reduction in companies' investments. It seems that we will need to wait some more time for the revival expected in the fourth quarter.
- The slowdown in the economic growth and favourable supply factors allowed the inflation to fall to 4.3% in September. Further decrease to 3.8%-3.9% is expected in October. The core inflation indicators and inflationary expectations went down. Growth in salaries slowed down. This enabled the reduction in the central bank interest rates by 150 basis points. It seems that if the government presents a reliable budget draft, then the MPC, taking into account further deterioration of the economic situation and the possibility of recession in Poland, will cut interest rates in November by 100-150 basis points. Such reduction would allow to weaken the zloty and maybe to avoid the scenario of total exports collapse in the nearest quarters.
- In November, the Parliament will decide on the amendment to the tax act and on the level of the MPC members' remuneration. In the course of a Seym debate, significant differences were noted among particular parties, even within the government coalition, regarding the changes to PIT. It seems that the continuation of the concept to tax capital gains may reduce the scale of interest rate reductions or postpone these decisions, which was indicated by the MPC members in their commentaries. However, the inevitable decision to reduce salaries in the MPC and NBP may lead to the zloty weakening and sale-off of long-term bonds if this is related to the resignation of a few members of the MPC, or direct limitation of the central bank's independence.
- Financial markets will await the budget draft for 2002, which will probably be presented at the end of November. It would be crucial to limit the expenditures to PLN 183bn and the deficit to below PLN 40bn as well as to abandon creative budgeting and stitching the deficit into the budget-related funds. It seems also the concept to introduce the import tax may emerge again, maybe as an M.P.'s motion. The attack on the central bank and the import tax may hinder the negotiations with the European Union.

Industrial output YoY



Source: CSO

In this issue

Highlights

The most up-to-date economic data imply that the economic revival expected in the fourth quarter will not take place. The construction sector is already in deep recession and the sold industrial output after a deep fall in September may drop even deeper in October. Retail sales, after some enlivening in August, again showed ca. 3% of the real adverse growth in September. Even exports, which were the driver of the Polish economy this year, switched to a rear gear in September and a sudden decrease of export inflows was recorded on an annual and monthly basis. Anyway, the export outlooks are very bad, the companies inform about the fall in the number of export orders, the zloty remains strong against the Euro, the economic situation of our main trading counterparties is deteriorating at a frightening rate and the consumer and producer sentiment indicators record their all-time lows. The question about recession in the USA and maybe also in the Euroland is not a question ‘if’ but ‘how long and how deep’. The current market consensus implies the expectation for an economic revival in the second half of next year, pointing to very low interest rates, low crude oil prices and loosening of the fiscal policy. However, it is worth remembering that the current recession is most of all the crises of confidence, and if the customers’ and investors’ confidence will not be restored in the next two or three quarters, then the recession can be longer and deeper than it can seem today.

The Polish economy is completely unprepared for the possibility of recession. The automatic stabilizer in the form of increased budget deficit is unavailable, moreover, in order to avoid the public finance crises, this deficit should be limited. The economy is inflexible, with a number of sectors, which are not subject to competitive forces of a free market and with a fossilised job market, which hinders companies’ flexible reaction to the decreased demand. In the situation, when new generations of the demographic boom are fast approaching the job market, the registered unemployment rate will soon exceed 18%, and the one measured based on the BAEL methodology - 20% in the first quarter next year at latest. Due to wrong policy-mix, the zloty remains strong as foreign investors buy Polish securities, in the expectation of further interest rate cuts.

It seems that only the co-operation of the government and the central bank can break this vicious circle of the loose fiscal policy, high rates and the strong zloty. If the finance minister presents a credible budget draft for the next year, without creative budgeting and ‘sweeping rubbish under the carpet’ as well as the public finance rehabilitation plan for a medium term, then the MPC will probably reduce interest rates even in November, and latest in December, by further 100-150 basis points. The zloty will lose, which will let the exporters to take a breath and, at the same time, should not translate into the inflation growth, in the situation of 20% unemployment and the threat of recession. Unfortunately, it is very difficult to take the decision on the interest rate cut in the conditions of political blackmail. Although the current debate on the MPC salaries is, in a way, initiated by the Council, the financial markets, and probably also the European Commission, will watch very carefully whether the independence of the central bank is not limited at the same time.

Tab. 1. Inflation indicators

	05 2001	06 2001	07 2001	08 2001	09 2001	*10 2001 P*
Consumer Price Index (m/m, %)	1.1	-0.1	-0.3	-0.3	0.3	*0.4*
Consumer Price Index (y/y, %)	6.9	6.2	5.2	5.1	4.3	*3.9*
Producer Price Index (m/m, %)	0.0	-0.4	0.3	0.8*	0.4	*0.4*
Producer Price Index (y/y, %)	2.3	0.9	0.6	1.0*	0.6	*0.4*

Tab. 2. Activity indicators

	04 2001	05 2001	06 2001	07 2001	08 2001	09 2001
Retail Sales Index (m/m, %)	4.0	1.7	-1.3	0.5	2.9	-2.4
Retail Sales Index (y/y, %)	1.9	4.3	0.2	1.5	3.0	1.3
Household loans (y/y, %)	25.1	22.1	-1.3	20.3	20.4*	18.9
Industrial Output (m/m, %)	-7.7	3.1	-2.8	-1.4	5.6*	0.6
Industrial Output (y/y, %)	3.6	-0.9	-4.8	0.9	0.4*	-3.8
Exports, current prices (in payment terms, y/y, %)	25.9	2.7	3.3	3.3	15.3*	-6.0
Imports, current prices (in payment terms, y/y, %)	5.2	9.9	-1.7	-3.8	1.2*	-5.1
Foreign Trade Balance (NBP, USD m)	-710	-1 166	-902	-825	-1 019*	-946
State Budget Balance (PLN m)	-18.4	-20.4	-18.7	-19.4	-21.0	-21.8

Tab. 3. Poland’s Economy

	1997	1998	1999	2000	*2001 F*
Gross Domestic Product (fixed prices, y/y, %)	6.8	4.8	4.1	4.0	*1.3*
Individual Consumption (y/y, %)	6.9	4.9	5.4	2.4	*2.0*
Gross expenses on fixed assets (y/y, %)	21.7	14.5	6.5	3.1	*-4.0*
Exports, constant prices (y/y, %)	13.7	9.4	-2.6	16.0	*8.5*
Imports, constant prices (y/y, %)	22.0	14.6	1.0	7.6	*2.5*
Inflation (average annual, %)	14.9	11.8	7.3	10.1	*5.6*
Inflation (year end, y/y, %)	13.2	8.6	9.8	8.5	*4.3*
Unemployment Rate (year end, %)	10.3	10.4	13.1	15.0	*17.8*
Current Account Balance/ /GDP (%)	-3.2	-4.2	-7.5	-6.2	*-4.8*
Public debt / GDP (%)	47.2	43.2	43.0	42.3	*44.5*

y/y – year on year; m/m – month to month; F - forecast
* corrected data

Source: CSO, NBP, own forecasts and estimations

Tab. 4. Poland – medium-term forecast (average in period unless otherwise stated)

Category	2000	I kw. 2001	II kw. 2001	III kw. 2001	IV kw. 2001	2001	2002	2003	2004	2005
Interest rates										
1M	18.50	19.03	17.44	15.61	14.50	16.65	10.6	8.8	7.3	5.9
3M	18.78	18.53	17.09	15.37	13.80	16.20	10.4	8.6	7.2	5.8
6M	18.92	18.02	16.50	15.03	13.00	15.65	10.2	8.4	7.0	5.6
12M	19.01	17.61	16.07	14.82	12.30	15.20	9.8	8.0	6.7	5.4
Lombard rate	21.90	22.62	20.95	19.08	17.05	19.93	14.2	12.4	11.0	9.6
(end of period)	23.00	22.00	19.50	18.50	16.00	16.00	13.0	11.5	10.0	9.0
Intervention rate	17.90	18.62	16.95	15.08	13.05	15.93	10.2	8.4	7.0	5.6
(end of period)	19.00	18.00	15.50	14.50	12.00	12.00	9.0	7.5	6.0	5.0
Treasury bonds yields										
2L (bid)	17.37	15.59	14.91	14.37	11.20	14.00	8.8	7.7	6.5	6.2
3L (bid)	16.20	14.54	14.36	14.20	11.00	13.50	8.6	7.6	6.4	6.1
5L (bid)	14.00	13.12	13.38	13.43	10.30	12.60	8.0	7.2	6.2	5.9
10L (bid)	11.79	10.46	11.22	11.81	9.50	10.75	7.5	6.8	5.9	5.6
T-bills yields										
13-week	16.96	17.20	16.26	14.44	12.10	15.00	10.5	8.6	7.2	5.7
52-week	17.77	17.02	15.70	14.67	11.60	14.75	10.4	8.4	7.1	5.6
Exchange rates										
USD/PLN	4.3465	4.0876	3.9895	4.2168	4.12	4.10	4.31	4.55	4.72	4.78
EUR/PLN	4.0110	3.7765	3.4884	3.7545	3.73	3.69	3.92	4.05	4.25	4.40
EUR/USD	0.9172	0.9240	0.8744	0.89	0.905	0.898	0.91	0.89	0.90	0.92
USD/PLN (end of period)	4.1432	4.1000	3.9871	4.2367	4.18	4.18	4.40	4.70	4.75	4.80
EUR/PLN (end of period)	3.8544	3.6170	3.3783	3.8810	3.80	3.80	3.95	4.15	4.32	4.46
EUR/USD (end of period)	0.9303	0.8822	0.8473	0.9160	0.91	0.91	0.90	0.88	0.91	0.93
Macroeconomic indicators										
Real GDP (y/y, %)	4.0	2.3	0.9	0.8	1.2	1.3	2.0	3.5	4.7	5.0
Industrial output (y/y, %)	7.1	4.4	-0.7	-0.7	0.6	0.8	2.4	3.4	5.0	6.0
Inflation (y/y, %) (end of period)	8.5	6.2	6.2	4.3	4.3	4.3	4.8	4.2	4.0	3.6
Inflation (y/y, %)	10.1	6.7	6.6	4.9	4.1	5.6	4.4	4.5	4.2	3.7
Unemployment rate (%) (end of period)	15.0	15.9	15.8	16.3	17.8	17.8	18.8	18.5	17.5	16.0
Current account/GDP (%) (end of period)	-6.2	-5.3	-5.4	-4.5	-4.8	-4.8	-5.5	-6.0	-6.0	-6.5
Economic deficit/GDP (%)	-2.0	-	-	-	-	-4.3	-4.4	-3.9	-3.6	-2.8
Public debt/GDP (%)	42.3	-	-	-	-	44.5	50.0	52.0	50.0	49.0

Forecast date: 8 November 2001

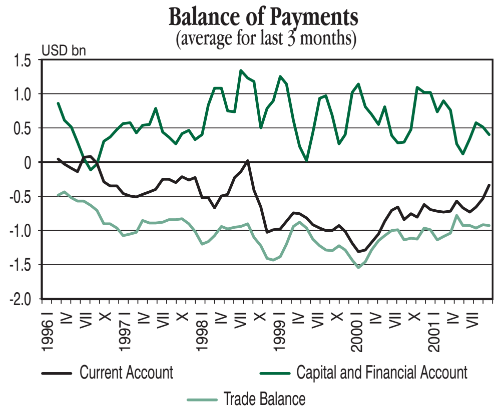
Notice: Forecasts based on information currently available. WBK Treasury and International Division cannot guarantee that the indicators will follow the patterns as shown above.

Low current account deficit confirms weakness of economy

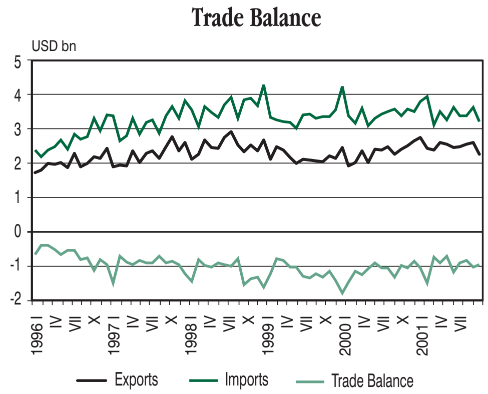
September current account deficit reached US$360m, well below US$600m consensus forecast. Twelve-month rolling deficit fell from 4.5% in August to 4.3% of GDP. Registered trade deficit fell from US$1,042m in August and US$974m in September 2000 to US$946m. Unclassified flows, which reflect Polish cross-border trade registered a surplus of US$439m. While in July-September period unclassified flows data usually exhibit seasonal increase, this time it appears that strong border trade performance is a result of economic revival in Russia and Ukraine, and therefore may signal a beginning of a new upward trend in unregistered exports.

While at the first glance the data appeared supportive for the zloty, a closer look at the current account components leads to the opposite conclusion. Exports have been rising vigorously in the first eight months of this year, partly because of a very low last year's base. However in September both export and imports recorded above 5%YoY declines, much deeper fall than can be attributed to one working day less in September 2001 comparing with September 2000. Especially a dramatic fall in exports draws attention. September payments' based data reflect trade activity in July-August, therefore it has nothing to do with recent rapid decline in economic activity and in business sentiment in Germany, nor has anything to do with the terrorist attacks of September 11. As shown in figure to the right Ifo index – reflecting sentiment among German businessmen – appears to be the leading indicator of Polish exports, and rightly so as Germany receives 35% of Polish exports. Therefore the recent deep decline in the German Ifo is yet to be reflected in further deterioration in Polish exports. In such case, combined with a much more demanding base last year exports could record a double digit YoY decline in 4Q01. This would probably harm investors' sentiment more than the positive impact of low annual C/A deficit figure. One word of caution should be mentioned here. Large firms, especially those foreign owned net out their foreign trade flows and often report to the central bank on net basis. If this activity increased in September, for example because of uncertainty created by terrorist attacks, then both exports and imports will be underreported.

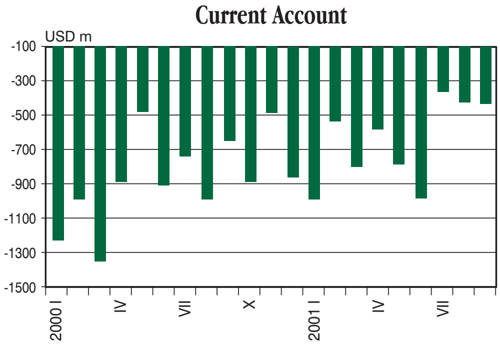
It is now clear that exports will no longer drive economic growth, and with poor prospects for domestic demand recovery economic growth will remain sluggish towards the fourth quarter. With 3Q growth around 1%YoY, and very slow recovery in the 4Q the full year figure will probably be around 1.5%, in the upper range of 1.2-1.5% forecast presented by finance minister Marek Belka.



Source: NBP, own calculations



Source: NBP



Source: NBP

Source: NBP, Reuters, own calculations

Inflation fell to 4.3% YoY

September inflation data confirmed weakening economic performance. CPI fell to 4.3% from 5.1% in August, well below 4.6% market consensus that was at level of 4.6%. While investors will perceive sharp CPI fall as very positive for the long-end of the yield curve, and they will be right in the short-run, we would remain cautious in the medium run. Consumer inflation fell amid very low food prices (2.9%YoY) and sharp deflation of fuel prices (-11.4%YoY). These positive supply factors will probably not last long; hence one should expect moderate upward inflation trend in coming quarters after a fall in inflation in October. Therefore strong positive sentiment across the yield curve should be used to shorten the duration of held treasuries.

What are further inflation prospects? Taking into account very weak economic activity in October, slight increase in food prices (0.4% MoM only) and the fall in fuel prices, we think that monthly inflation indicator will amount to about 0.3%, which will lead to the fall in annual inflation to the level of 3.8-3.9%. Finance ministry expects 4% inflation in October and 4.2% inflation in December.

Core inflation continues to fall

Inflation with controlled prices excluded fell from 4.8%YoY in August to 4.1% in September, net inflation (CPI excluding prices of fuels and food) declined from 6.5% to 5.8%, while 15%-trimmed mean dropped from 5% to 4.6%. All core inflation measures declined in September less than consumer inflation. We point out that net inflation remains as much as 1.5% above CPI, which confirms our view that rapid inflation declines were possible because of favourable supply factors, namely low food and fuel prices, which are likely to contribute to even deeper fall in inflation in October.

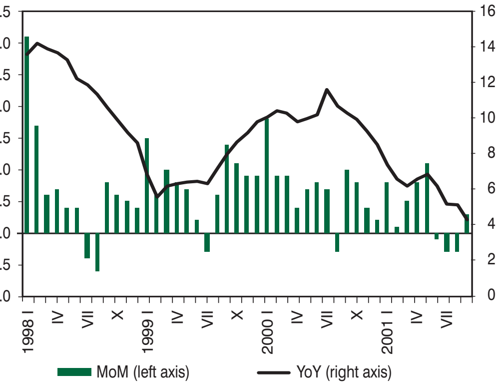
September industrial output below expectations

Industrial output in September seasonally rose by 0.6%MoM but it fell by 3.8%YoY, well below market consensus of –1.1%. This September has one working day less, but even in working-day adjusted terms industrial output fell some 1.5%YoY. Only nine out of 29 industrial branches recorded annual growth, biggest rise was recorded in water and gas supply (up 11.7%) and RTV equipment manufacturing (up 9.8%). The biggest fall took place in automotive industry (other means of transportation down 41%YoY, vehicles down 18%YoY). This confirms anecdotal evidence that many small firms co-operating with automotive giants may be out of business soon.

Construction output continues to record sharp falls, following 13.9%YoY decline in August it contracted 11%YoY in September.

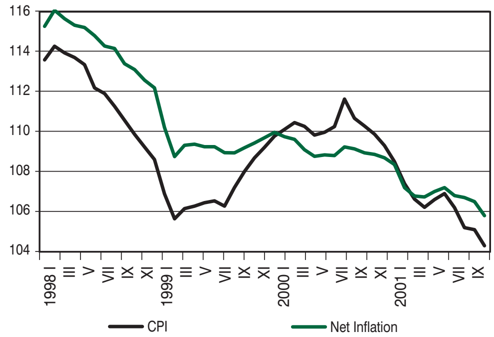
Sold industrial output prices rose by 0.4%MoM in September – in line with market expectations and recorded 0.6% annual growth, comparing with 1.0% in August.

Inflation (%)



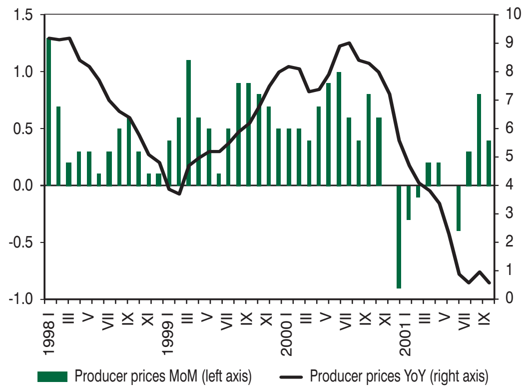
Source: CSO

CPI and Net Inflation
with food and fuel prices excluded



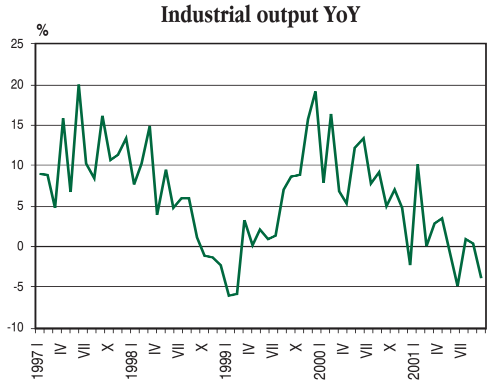
Source: CSO, NBP

Producer prices (%)



Source: CSO

Industrial output YoY



Source: CSO

Zloty strengthened by 4%, however risk of depreciation rises

In October, the zloty remained in the upward trend. The deviation from the old parity was slightly above 6% at the beginning of October, and in the last days of the previous month, it exceeded 10%. The average dollar/z?oty rate was 4.1365 in October against 4.2213 in September, and the average euro/zloty rate was 3.7486 against 3.8451 a month earlier. In the analysed month, the zloty was weakest on 2 October, and strongest on 26 October. The main reasons for the zloty firming up in October are as follows:

broad interest of foreign investors in the Polish treasury securities due to high interest rates and the outlook of their early reduction by the MPC (macroeconomic data still points to the low level of economic activity)

the market welcomed the public finance rehabilitation plan, presented by the new finance minister, Marek Belka.

The expectations of further interest rate cuts, can still favour the zloty strengthening in the near future, although it seems that the downward trend in the treasury papers' yield in the 5Y segment ended, and the market already priced the inflation fall below 4% in October and discounted the interest rate reduction by 150 bp in November. Therefore, in our opinion, the profits from long zloty positions are already very limited, and on the other hand, the risk of the zloty weakening is growing significantly. One should mention the possibility of recession in the Polish industry, the fall in exports figures and the political risk: attack on the central bank and fragile political support for the existing government.

Argentina will remain one of the more important risk factors, to which we draw our attention. The situation in this country triggered off a lot of confusion on the emerging markets as early as at the end of October. Although the Argentinean government presented the plan of debt conversion, the Fitch and S&P agencies assessed it as 'equivalent to insolvent'. For the time being, the zloty ignores the Argentinean factor, however, it can become substantial in the situation when other risks materialise.

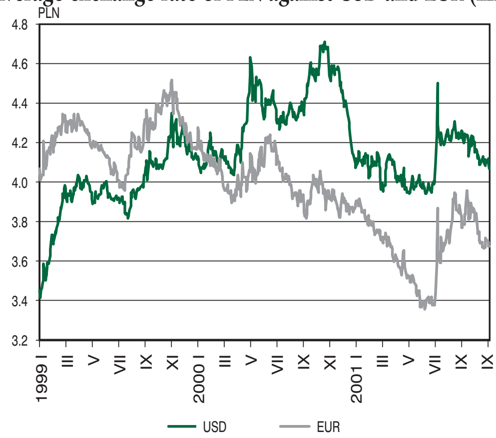
Dollar strengthens against euro

Despite the poor macroeconomic data from the USA, implying the recession, the dollar behaves unusually stable. The terrorist attacks of 11 September were followed by the dollar losing against the euro only in the short run. It remained in a slight upward trend already in October. Successively released poor data on the USA only raised expectations for further rate cuts by the Fed. Towards the end of September, the euro cost USD 0.92, and a month later slightly above USD 0.89.

The Euro did not manage to stop this unfavourable for itself trend as also the European economies did not manage to protect themselves against the slowdown. In addition, the decisions of the European Central Bank – most often contradictory to market expectations – weakened the euro, and the ECB policy is perceived as 'not catching up with the changes'.

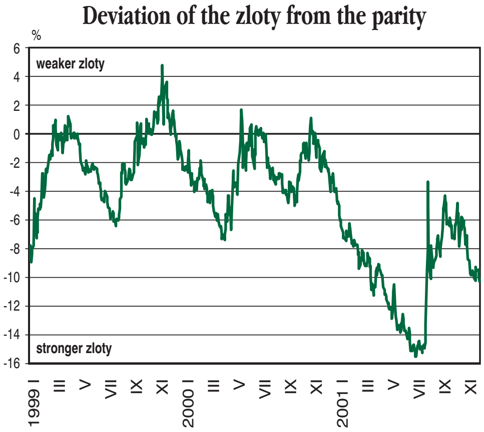
Greater confidence in dollar follows from the fact that investors believe in positive effects of the monetary and fiscal policies, and count on the American economy to overcome recession as the first one already in the first half of 2002.

Average exchange rate of PLN against USD and EUR (fixi



Source: NBP, Reuters

Deviation of the zloty from the parity



Source: NBP, own calculations

USD/EUR

Source: Reuters

Interest rates

In October, there was a considerable fall in WIBOR rates in longer terms (1M and longer). Interest rates of the money market gradually reduced as the MPC meeting was getting closer (24-25October), at which the decision on the NBP rates reduction was expected. After the MPC taking the decision in line with the expectations, there was a certain stabilisation of market rates at the level lower by 70 to 145 bp. than the one at the end September. Lower fall was recorded in shorter terms as short rates decreased strongly already in September, discounting an interest rate cut then, on which the Council, however, did not decide. In addition, deeper fall in longer term results from rising hopes for significant reduction in the NBP main interest rates in two –three quarters's time.

Short WIBOR rates (one day and SW) continued in October at a relatively high level. For the greater part of the month, O/N and T/N rates were around 16%, which is considerably higher than the NBP operation level. Low liquidity in the banking sector was due to determination of banks to place as much funds as possible in NBP bills, still at higher rates, when their reduction was practically determined. Moreover, at the end of the month, in the period of obligatory reserve settlement, short WIBOR rates rose above 21%.

Treasury bills

In October, the supply of treasury bills at five auctions was PLN 5.0bn against PLN 3.8bn at four September auctions. The supply of 8- and 13-week bills was nearly flat on September, however, the supply of 52-week papers substantially increased to PLN 4.6bn from PLN 3.2bn. With falling interest rates, average weighted yields, earned at auctions, fell for the fourth time in a row. The yields of 8- and 13-week bills decreased by ca. 70 bp to 12.78% and 13.09% respectively, however, the yield of 52-week was lower by as much as 137 bp and amounted to 12.52%. In the situation of an almost certain cut of NBP rates, the supply at auctions was high. The ratio of bill demand to supply was relatively high, reaching 3.46, although slightly lower than in September (3.86), when the supply was, however, much lower.

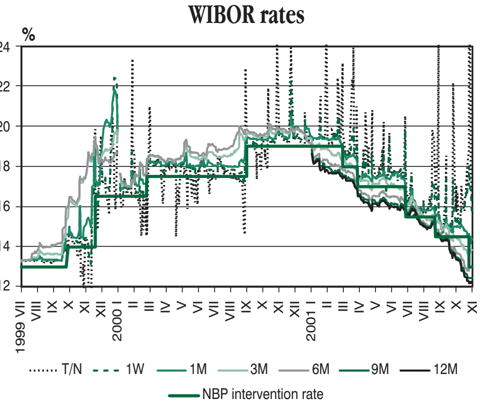
On the secondary market, for the greater part of the month, bill yields were dropping in expectation of the MPC meeting. After the decision of the Council, there was another fall by 20-30 bp, and yields levelled off later on. At the end of October, the yields were lower by 70-125 bp against September.

Treasury bonds

At t-bonds auction on 3 October, there was a strong fall in average yields. The yields on 2Y papers (OK 0803) amounted to 12.74% against 13.99% on 5 September, however, on 5Y papers (PS 0506), it was at the level of 12.6% against 13.02% a month earlier. The supply of bonds was minimally increased to PLN 2.0bn for 2Y papers and to PLN 600bn for 5Y papers. There was a broad interest in both types of bonds on the part of investors forecasting the NBP interest rate cuts, including foreign investors in particular. The ratio of bond demand to supply was 2.9 and 5.1 respectively. At the auction of 10 October, PLN 400m worth of variable 10Y bonds (DZ 0811) was offered. With a relatively high for these bonds demand (PLN 915m), the average price was as much as PLN 1005.96 for 1000.

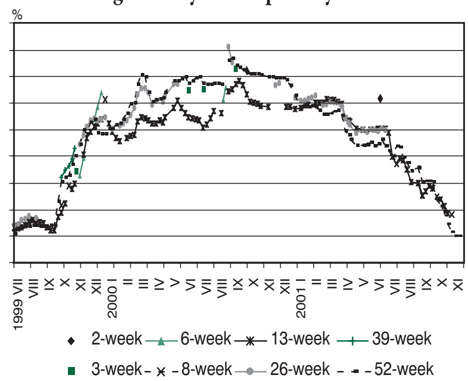
In October, on the secondary market, the yield curve in the bond sector flattened slightly even further due to decreasing spreads. At the shorter end, the yields dropped by 170-180 bp, however, in longer terms by 140 bp.

WIBOR rates



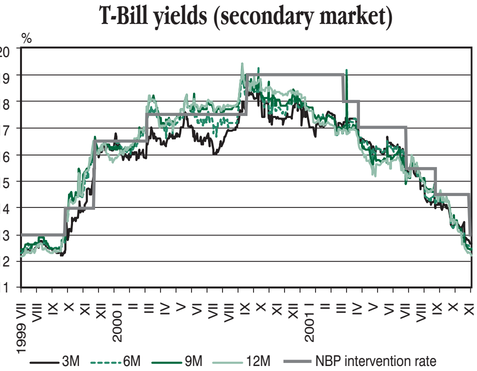
BZ WBK S.A. Treasury and International Division

Average T-Bill yields at primary auctions



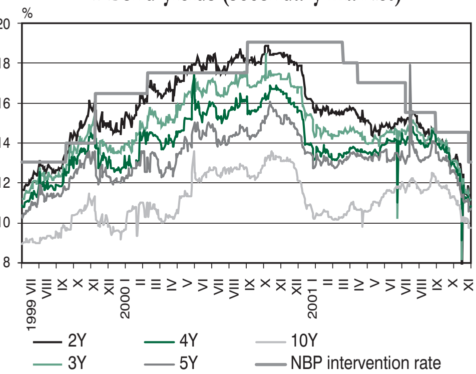
Source: BZ WBK S.A. Treasury and International Division

T-Bill yields (secondary market)



Source: BZ WBK S.A. Treasury and International Division

T-Bond yields (secondary market)



Source: BZ WBK S.A. Treasury and International Division

Deep amendment to 2002 state budget necessary

Finance Minister Marek Belka announced that the self-amendment to the 2002 budget draft, which will be presented by the new government will be so deep that, in fact, it will be a new draft. Minister Belka very critically referred to the 2002 budget submitted to the Parliament by the PM Jerzy Buzek's government. In his assessment, it includes an overvalued revenue plan and insufficient expenditure cuts. Belka announced bigger spending cuts and set a limit of total central budget spending at PLN 183bn compared with PLN 173bn planned for 2001. Budget draft is to be released by 20 November.

New government stopped PLN 8.5bn in this year's spending

The new government cut this year's spending by PLN 8.5bn, equivalent to 1.2% of GDP. Out of this amount, PLN2.1bn will represent cuts in budget reserves and PLN6.4bn cuts in central administration. Two biggest items are

Social Security Fund (FUS) will receive PLN2.15bn less

National defence ministry will face cuts worth PLN0.95bn.

Various forms of social assistance PLN0.55bn

Higher education and science PLN0.53bn

Finance minister estimated that total budget revenue shortfall will amount to PLN11bn, which is more than assumed in July budget revision. Therefore either the ministry will have to come up with additional PLN2.5bn spending cuts later this year or the deficit will be shifted to next year, as was the case in 2000/2001. Moreover, the biggest ticket among spending cuts is subsidy to FUS. This will either result from lower transfers to private pension funds or from higher borrowing of the state pension system in the banking sector. In both cases the total likely increase of the economic deficit of the public finances will be similar, and equal to PLN4.55bn (2.15+2.5) or 0.6% of GDP. On top of that one would have to add the likely increase of state liabilities next year resulting from this year cuts of the order of PLN2bn (0.25%). This information confirms our yesterday estimate that government spending cuts decisions will lead to around 0.5-0.6% of GDP deficit reduction.

Budget deficit rose to PLN21.8bn

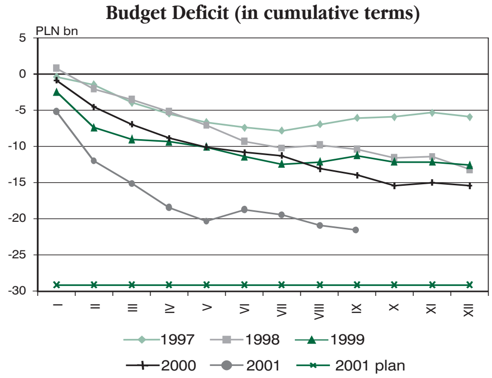
In September central budget deficit rose to PLN 21.8bn from PLN 20.9bn in August. After nine months it accounted for 74.9% of the annual target (amended). One has to keep in mind, however, that in September government pocketed PLN 1bn from UMTS licence fees, which will not happen again this year. According to finance ministry estimates January-October budget deficit reached PLN24.6bn or 84.4% of the revised plan. In November deficit is expected to rise to 96.8% of the plan, and in December another budget revision may take place.

Tax increase bill

The government proposed its tax bill. Its main features are: freezing tax thresholds for two years, imposing 20% withholding tax on interest income on all financial assets except pension savings and abolishing some tax deductions. The whole package is expected to raise PLN4.3bn for the central budget next year. Government has to rush, because the bills will have to be signed into law and published by 30 November. The bill will face numerous hurdles, as all parliamentary opposition parties and Solidarity trade union are against it and many amendments were proposed by coalition PSL (introducing new 50% tax threshold for the rich) and UP (taxing capital gains from stock exchange). Also the bill can be delayed during the parliamentary commission proceedings. Two years ago, when then ruling AWS-UW coalition tried to pass PIT cutting legislation it was effectively blocked by Maciej Manicki, SLD deputy, who submitted tons of amendments such as "replace a coma with a semicolon". Now the opposition can use the same trick, and ruling SLD-UP-PSL has even less time than AWS-UW had two years ago. Of course this time around ruling coalition has a friendly president and finance minister is a former President's aide.

We think that there is a non-zero probability that Belka tax package may not get through. What are the alternative scenarios? If opposition succeeds and holds the bill in the lower house such that 30 November deadline is missed, then finance minister may still hike VAT base rate from 22 to 24% or impose 2% import tax with the same fiscal effect. Economic empirical research suggests that among "choices in Belka tax menu" higher VAT rate would be least harmful for the long-term growth prospects of the Polish economy.

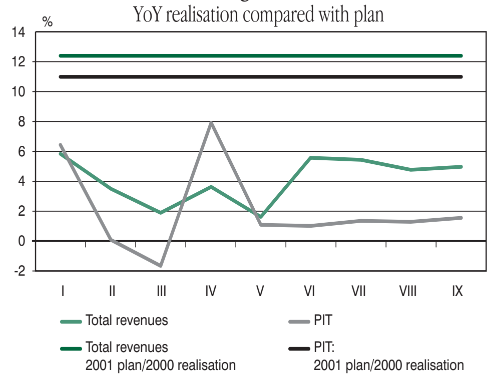
Budget Deficit (in cumulative terms)



Source: Finance Ministry

2001Budget Revenues

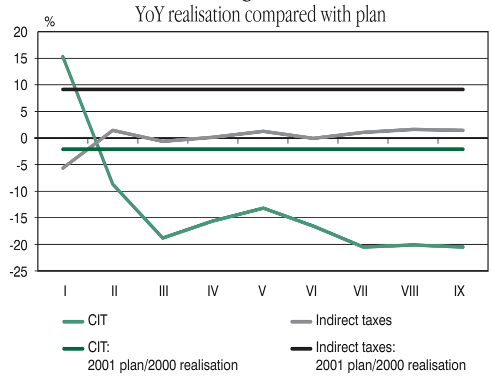
YoY realisation compared with plan



Source: Finance Ministry, own calculations

2001 Budget Revenues

YoY realisation compared with plan



Source: Finance Ministry, own calculations

MPC cut all rates by 150 bps

On 25 October MPC decided to reduce all interest rates by 150 bps. Intervention rate (28-day open market operation rate) fell to 13.0%, rediscount rate to 15.5% and lombard rate to 17%. MPC also maintained neutral bias, which in theory means that it is equally likely that next rate move will be up or down. However given that MPC have already cut interest rates this year five times maintaining neutral bias after each decision, we think that in practice MPC bias tells the markets that next rate cut is around the corner.

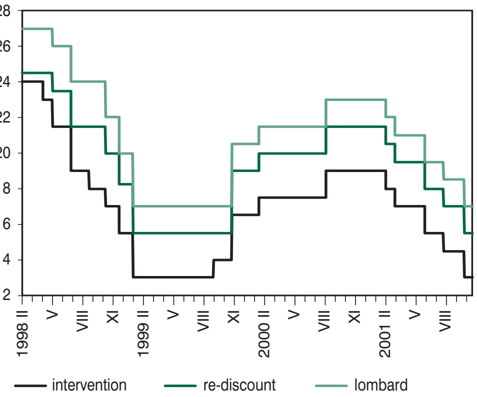
Markets would probably wonder why the move was 150 bps? We think that as in some cases in the past market consensus – equal to 150 bps - had some influence on the MPC decision. Because of strong exogenous shock – terrorist attacks, war, outbreak of "Anthrax anxiety" no economic or econometric model can tell what should be the appropriate interest rate response. Therefore the decision was probably based much more on "guts feeling" and economic theory than on precise estimates. And in such case it is simply much safer for the MPC not to deviate much from the market consensus. If they prove wrong by maintaining rates too high, then they would always be able to defend their position by saying that everybody was wrong (they have actually used such argument in the past).

Where do we go from here? MPC statement basically tells that there are no risks to disinflation process coming from the demand side, and that also supply side factors (oil prices) appear supportive for the disinflation process. MPC even "forgot" to mention food prices, their favourite supply side risk. There is no threat to inflation coming from the monetary aggregates. The only comment with a "hawkish flavour" is a note the PPI inflation accelerated in recent months. MPC also states that "core inflation measures suggest that recent decline in inflation was not caused only by transitory factors". MPC also cites falling inflation expectations. One might immediately ask, if inflation picture is so rosy why only 150? We think that the answer is as follows. MPC is less worried about inflation now but it remains concerned about a possible decline in propensity to save resulting from the planned introduction of tax on interest income. Therefore, if government backs off on this issue, and if it keeps the promise to limit next year spending to PLN183bn and deficit to PLN40bn, without creative budgeting, then the next rate cut, by 100-150bps will take place this year, possibly in November.

Recession risk suggests interest rate cut in November

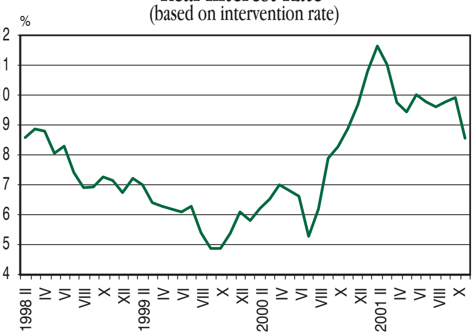
As we expected the CSO business sentiment survey confirmed results of earlier surveys by IRG institute and pointed to further economic slowdown. October business climate index in industry fell to –18, with 13% of polled industrial enterprises expecting an improvement and 31% indicating further deterioration.

NBP Interest Rates (%)



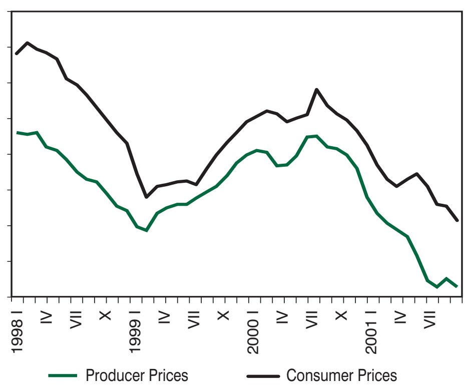
Source: NBP

Real Interest Rate
(based on intervention rate)



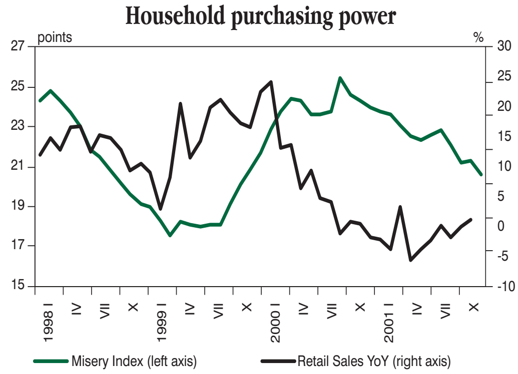
Source: NBP, CSO, own calculations

Inflation (%)



Source: CSO

Household purchasing power



Source: CSO, own calculations

October index was at the lowest level recorded in October in the past seven years. Firms reported that in response to falling demand they continued to reduce current production and expected that in the future demand would continue to shrink and these expectations are more pessimistic than in September. Unfortunately CSO did not give any information about export orders, but we think that reported contraction in demand also reflects declining external demand.

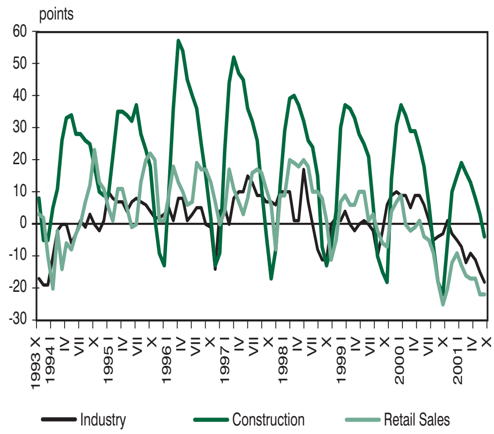
In construction situation continued to deteriorate, and the business climate index fell to –4, level unseen in October in the past eight years. In retail trade index remained flat at –22 but still deep in negative territory.

Firms in all three sectors reported plans to continue labour shedding, expect further deterioration of their financial situation and in many cases expect slower rise or even a fall in their prices.

Both business climate surveys published this week painted a recession picture. Construction has already been in recession, and now industrial sector appears to experience one too. We reiterate that despite three working days more in October both survey reported falling industrial output on monthly basis, which indicates that after 3.8%YoY fall in September, sold industrial output will decline some 6%YoY in October.

Before the last MPC meeting we called for a deeper rate cut. We are convinced now that our call was right and that there is a need to reduce interest rates in November by another 150 bps, even if the shape of the next year budget is not known.

Business Climate Indicators

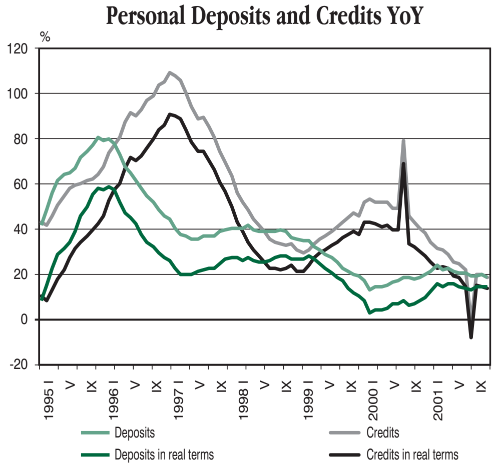


Source: CSO

Money supply rose 10%YoY in real terms

September money supply rose 0.9%MoM and 14.5%YoY against 1.3%MoM and 14.6%YoY in August. This represents almost 10% annual increase in real terms. In January-September period money supply rose some 9.2% in comparison with 6.8% a year earlier. Consumer credit decelerated from to 18.9%YoY from 20.4%YoY in August while household deposits also decelerated moderately from 19.9% to 19.3%YoY. Fast growth in money supply is the only argument for cautious interest rate cuts, since it can be dangerous for inflation in case when for some reasons demand for money will shrink. But in situation of low inflation and high unemployment we do not foresee such possibility. Especially that in October money supply slowed down.

Personal Deposits and Credits YoY



Source: NBP, own calculations

After 20 days of October: money supply slows, corporate credit continues to shrink

Money supply figures continue to support our view that 4Q economic activity will not exhibit any significant rebound. In first twenty days of October corporate credit continued to shrink. One may argue that companies lowered their gearing ahead of expected deep rate cut on 25 October, and indeed we have to wait until the full-month data is available to test this hypothesis. We also note that household deposits remain very volatile and this category should be watched very closely, as it seems to be the main MPC concern these days. As we expected following a rapid increase in government net credit in 1-10 October, it fell by PLN8bn in 10-20 October, helped by PLN3.7bn revenues from TP S.A. sale.

Employment losses accelerate, wages moderate

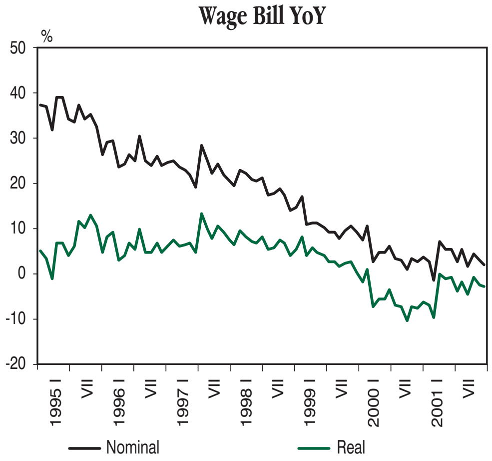
In September average corporate wage seasonally rose 1.1%MoM but in annual terms decelerated to 6.2% from 6.8% in August. Inflation is expected to fall to 4.6% in September which indicates that real September wage was 1.6% higher than a year ago. However at the same time corporate employment continued to fall at even accelerating rate from 3%YoY on average in 1-3Q2001 to 4%YoY in September. Therefore the growth of wage bill in real terms remains negative despite sharply falling inflation which does not support economic revival. We remain very concerned about accelerated job losses, which may indicate that economic recovery may still take some time to appear.

Figure at the right illustrates this point. In 1995-1999 period annual growth of real wage bill was positive which supported domestic demand. In 2000 continued job losses combined with inflation surprise led to sharp erosion of the wage bill, which undoubtedly was one of the key factors behind recent economic slowdown. However in 2001, despite rapid inflation decline real wage bill remained negative, mostly because of continued and even accelerated pace of job destruction. This process is likely to continue for some time, anecdotal evidence suggests that medium and small companies co-operating with giants in automotive and construction industry may be forced out of business next year. Therefore there seems to be little pressure on inflation coming from the corporate wages. One should keep in mind, however, that at the same time purchasing power of pensioners improved significantly and real pensions are expected to rise almost 5%YoY in 2001. This group is believed to have very high propensity to spend therefore one should expect private consumption some 8.5m pensioners to rise to partly offset contracting effects of lower corporate wage bill.

Labour market will not threaten disinflation process next year

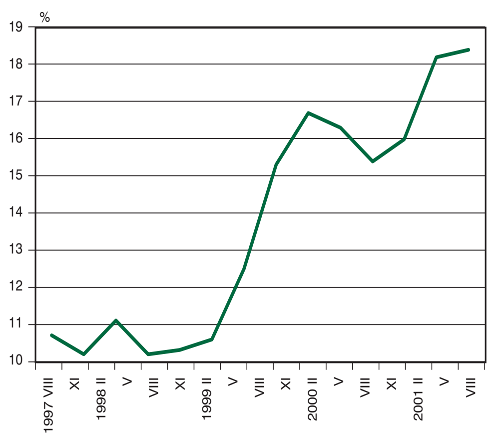
It seems now, that recent decline in nominal growth of wages combined with increase in unemployment and shrinking number of jobs and the lowest inflation in transformation period will have the following result. A great number of wage contracts signed in this year for 2002 will include low or even zero increase next year. Given expected further decline in corporate employment, the wage bill will hardly rose in nominal terms and certainly fall in real terms. Disposable income will fall even more due to hike in PIT and inroduction of tax on interests. Therefore, consumption demand will remain slight, even some demand will appear from household credit. In such a situation even if negative external factors appear (increase in fuel prices) or the zloty weakens, it will be next to impossible, that it will lead to increase in inflation expectations and result in significant increase in core inflation indicators.

Wage Bill YoY



Source: CSO, own calculations

Unemployment Rate (LFS definition)



Source: CSO, own calculations

The terrorist attacks on the USA and their impact on the economy are the most important developments of the last few weeks. As a result of these tragic events, there can appear some weakening in the American economy.

Further development of the economic situation in the USA will, to much extent, depend on how consumers will behave, as 2/3 of the American GDP depends on consumer demand. In analysts' opinion, the last events can significantly undermine trust of American consumers and entrepreneurs. Then, the American economy, which grew only by 0.3% in the second quarter, will not be able to avoid recession.

The American economy can also be jeopardised by the fact that the tragedy occurred at the moment when it was hoped that the American economy would start to recover.

More and more economists point to the possibility of recession in the USA. London Centre for Economics and Business Research forecasts that the GDP will drop by 2.9% in the third quarter and by 1.6% in the next.

The American tragedy generated huge losses of airline and insurance companies and mass reductions in employment. This will certainly have impact on sectors related to those, which suffered most.

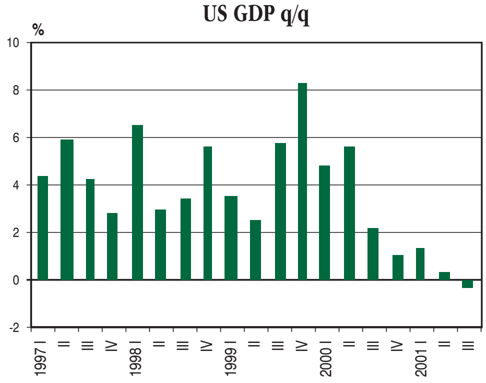
Starting from 17 September, central banks started a wave of interest rate reductions. The American Fed took the decision as the first one – even before the resumption of stock exchange trading after a four-day break – in order to prevent a sudden sale of shares and improve investors' sentiments. The Fed was followed by e.g. The European Central Bank, the Bank of Canada, the Bank of Switzerland, the Bank of England and the Bank of Japan. However, world stock exchanges are still concerned that interest rate cuts are insufficient to protect the global economy against recession.

Pessimistic scenarios for the USA for the months to come and further negative information on situation in the American economy made the Fed reduce interest rates by 50bp also on 2 October, being the ninth interest rate cut since the beginning of the year. From 3 October, the main USA interest rate has been 2.50% and is the cheapest since 1962. Two rate reductions by 50bp in such a short time prove that the American central bank is afraid of the effects of forecasted recession in the USA.

In the assessment of the International Monetary Fund, it is difficult to say at present what will happen to the USA economy. Events of 11 September will have impact on economic activity in the short run and will increase the risk of a lower growth rate not only in the USA but also in other countries. According to the International Monetary Fund, the world economy, even before the attacks on the USA, was on the verge of recession and now its developmental outlook deteriorated even more.

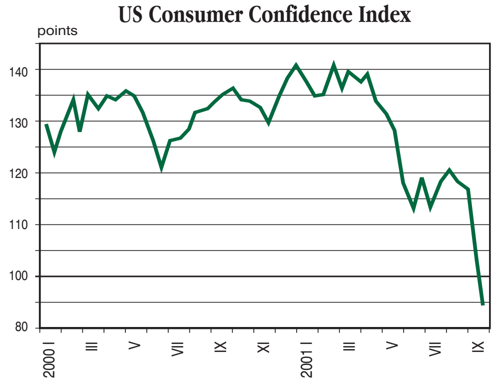
Problems will probably not omit the European economies, either. In particular, Germany seems threatened with recession due to strong trading relationships with the USA. The GDP forecasts for the whole euro zone were revised down to ca. 1.4% in 2001 (from earlier 1.8%) and to 1.1% in 2002 (from 2.2% before 11 September).

US GDP q/q



Source: Reuters

US Consumer Confidence Index

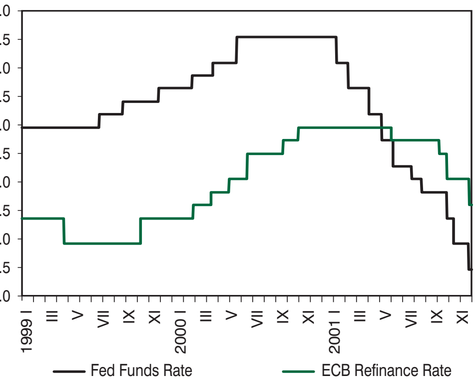


Source: Reuters

PMI for EMU

Source: Reuters

Interest Rates in the USA and the euro zone (%)



Source: Fed, ECB

Economic Release Calendar October / November 2001

Monday	Tuesday	Wednesday	Thursday	Friday
5 November POL: Food prices (2nd half of Oct) *EUR: Inflation preliminary (Oct)*	**6** *GER: Unemployment (Oct)* *EUR: Unemployment (Sep)* *EUR: Producer prices (Sep)* *EUR: Business climate indicators (Oct)* *USA: Fed meeting*	**7** POL: Balance of NBP (Oct) POL: Official reserve assets (Oct) *GER: Industrial orders (Sep)* *EUR: Retail sales (Aug)*	**8** *GER: Industrial output (Sep)* *EUR: GDP (2Q)* *EUR: ECB meeting*	**9** *USA: Producer prices (Oct)*
12	**13** *GER: Current account (Sep)* *GER: Trade balance (Sep)* *FRA: Inflation preliminary (Oct)*	**14** POL: Money supply (Oct) *USA: Retail sales (Oct)*	**15** POL: Inflation (Oct) POL: State budget (Oct) *FRA: Industrial output (Sep)* *ITA: Industrial output (Sep)* *ITA: GDP (3Q)*	**16** POL: Employment and wages in corporate sector (Oct) *ITA: Inflation (Oct)* *EUR: Inflation (Oct)* *USA: Inflation (Oct)* *USA: Industrial output (Oct)*
19 POL: Industrial output (Oct) POL: Producer prices (Oct) *EUR: Industrial output (Sep)*	**20** POL: Unemployment (Oct) *USA: Foreign trade (Sep)*	**21** *GER: Business climate IFO (Oct)*	**22** *FRA: Inflation (Oct)* *EUR: ECB meeting*	**23** POL: Food prices (1st half of Nov) *FRA: GDP (3Q)*
26	**27** POL: MPC meeting *GER: GDP (3Q)*	**28** POL: MPC meeting (decision) *EUR: Foreign trade (Sep)* *EUR: Money supply (Oct)*	**29** *ITA: Inflation preliminary (Nov)* *USA: Durable goods orders (Oct)*	**30** POL: Balance of payments (Oct) POL: Foreign trade on a cash basis (Oct) *FRA: Unemployment (Oct)* *FRA: Producer prices (Oct)* *ITA: Producer prices (Oct)* *EUR: GDP (3Q)*
3 December	**4** POL: Food prices (2nd half of Nov) *EUR: Business climate indicators (Nov)* *EUR: Unemployment (Oct)* *EUR: Producer prices (Oct)* *EUR: Retail sales (Sep)*	**5** POL: Business climate in industry, construction and retail trade (Nov) *GER: Unemployment (Nov)*	**6** *GER: Industrial orders (Oct)* *EUR: ECB meeting*	**7** POL: Balance of NBP (Nov) POL: Official reserve assets (Nov) *GER: Industrial output (Oct)* *USA: Unemployment (Nov)*

A glance at the economy

Category	unit	October	November	December	January	February	March	April	May	June	July	August	September
PRICES													
Consumer price index (y/y)	%	9.3	8.5	7.4	6.6	6.2	6.6	6.9	6.2	5.2	5.1	4.3	-
Consumer price index (m/m)	%	0.4	0.2	0.8	0.1	0.5	0.8	1.1	-0.1	-0.3	-0.3	0.3	-
Production price index (y/y)	%	7.2	5.6	4.7	4.1	3.8	3.4	2.3	0.9	0.6	1.0*	0.6	-
Production price index (m/m)	%	0.0	-0.9	-0.3	-0.1	0.2	0.2	0.0	-0.4	0.3	0.8*	0.4	-
Price index of assembly and construction production (y/y)	%	7.6	6.9	6.8	6.5	5.7	5.0	4.5	3.8	3.6	3.4*	3.2	-
Price index of assembly and construction production (m/m)	%	0.4	0.2	0.4	0.4	0.1	0.3	0.3	0.1	0.2	0.2*	0.1	-
Exchange rate USD/PLN (y/y)	%	7.2	3.5	0.2	-1.0	-0.7	-5.1	-11.5	-9.7	-3.2	-2.6	-6.0	-10.9
Exchange rate USD/PLN (m/m)	%	-1.6	-5.4	-4.7	-0.4	-0.8	-1.0	-0.9	-0.3	5.4	1.4	-0.6	-2.0
Exchange rate EUR/PLN (y/y)	%	-11.2	-8.1	-7.1	-7.7	-6.5	-10.3	-14.5	-18.8	-11.5	-3.2	-1.8	-5.7
Exchange rate EUR/PLN (m/m)	%	-1.7	-0.6	-0.4	-2.5	-2.0	-2.8	-2.9	-2.8	6.2	6.2	0.6	-2.7
Real gross wages in enterprise sector (y/y)	%	0.8	-1.9	2.4	1.1	1.6	-1.3	1.8	-1.3	2.7	1.7	1.8	-
ACTIVITY INDICATORS													
Gross domestic product (y/y)	%	-	2.4	-	-	2.3	-	-	0.9	-	-	-	-
Industrial output (y/y)	%	4.7	-2.2	10.1	0.1	2.9	3.6	-0.9	-4.8	0.9	0.4	-3.8	-
Industrial output (m/m)	%	-3.1	-1.4	-8.9	-2.5	14.7	-7.8	3.1	-2.8	-1.4	5.6	0.6	-
Construction and assembly production (y/y)	%	-1.1	-6.9	-9.7	-9.1	-8.2	-10.8	-11.7	-10.0	-10.3	-13.9	-11.0	-
Construction and assembly production (m/m)	%	-17.6	40.3	-59.3	7.4	18.6	-2.9	15.5	13.8	-4.9	2.8	10.7	-
Retail sales of goods [a] (y/y)	%	5.8	3.2	10.9	-0.2	0.1	1.9	4.3	0.2	1.5	3.0	1.3	-
Retail sales of goods [a] (m/m)	%	-3.4	20.8	-27.6	-1.7	17.5	4.0	1.7	-1.3	0.5	2.9	-2.4	-
Exports on a customs basis (y/y)	%	24.0	18.6	29.9	13.5*	17.9	9.4	6.2*	-2.1*	-1.4*	5.5	-	-
Exports on a customs basis (m/m)	%	-3.6	-8.5	1.1	-0.5	9.6	-13.5	1.1*	-3.0*	1.4*	3.7	-	-
Imports on a customs basis (y/y)	%	3.7	3.7	14.5	-3.1	2.8	0.9	-12.0*	-10.1*	-2.7*	-0.7	-	-
Imports on a customs basis (m/m)	%	-7.0	-2.9	-11.0	-4.2	16.1	-9.8	1.6	-4.2*	7.1*	-4.2	-	-
LABOUR MARKET													
Number of unemployed	thous.	2 613	2703	2 836	2 877	2899	2 878	2 841	2 849	2 872	2 893	2 920	-
Unemployment rate	%	14.5	15.1	15.7	15.9	16.1	16.0	15.9	15.9	16.0	16.2	16.3	-
Average employment in corporate sector	thous.	5 247	5 199	5 184	5 189	5 170	5 156	5 135	5 121	5 097	5 074	5 060	-
Average monthly gross wages in corporate sector	PLN	2 160	2 350	2 069	2 075	2 149	2 176	2 163	2 148	2 199	2 192	2 218	-
Nominal increase in wages (y/y)	%	10.2	6.4	9.9	7.7	7.9	5.2	8.8	4.9	8.0	6.9	6.2	-
STATE BUDGET													
Budget revenues	PLN bn	123.0	135.7	11.6	21.0	31.6	42.4	52.6	67.8	78.9	90.3	102.8	-
Budget expenditures	PLN bn	137.9	151.1	16.7	32.9	46.7	60.8	73.0	86.5	98.3	111.3	124.6	-
State budget deficit	PLN bn	-14.9	-15.4	-5.1	-12.0	-15.1	-18.4	-20.4	-18.7	-19.4	-21.0	-21.8	-
Domestic government debt	PLN bn	-	146.0	-	-	155.0	-	-	160.3	-	-	-	-
Foreign government debt	PLN bn	-	120.8	-	-	118.2	-	-	111.2	-	-	-	-

A glance at the economy

Category	unit	October	November	December	January	February	March	April	May	June	July	August	September
BALANCE OF PAYMENTS													
Current account	USD m	-420	-816	-956	-463	-751	-520	-737	-948	-285	-355*	-360	-
Trade balance	USD m	-861	-1 038	-1 516	-724	-908	-710	-1 166	-902	-825	-1 019*	-946	-
Exports	USD m	2 652	2 759	2 430	2 392	2 614	2 559	2 472	2 477	2 557	2 617*	2 276	-
Imports	USD m	3 513	3 797	3 946	3 116	3 522	3 269	3 638	3 379	3 382	3 636*	3 222	-
Services: net	USD m	-105	-155	-118	-86	-83	-62	-68	-64	-95	-60*	-24	-
Unclassified transactions: net	USD m	295	340	248	243	239	385	315	274	451	478	439	-
Capital and financial account	USD m	528	351	1 359	964	-33	-143	525	636	574	318*	314	-
Direct investments	USD m	537	570	486	383	343	535	321	604	447	358*	518	-
Portfolio investments	USD m	504	135	788	699	891	-177	-471	-304	70	142*	242	-
MONEY SUPPLY													
Money supply	PLN bn	291	294	293	296	301	303	305	308	315	319*	321	-
Money supply (y/y)	%	14.4	11.8	14.6	14.6	14.9	14.0	13.5	8.0	13.5	14.6	14.5	-
Money supply (m/m)	%	1.3	1.1	-0.6	1.0	1.9	0.6	0.7	0.8	2.3	1.3*	0.9	-
Total deposits (y/y)	%	17.0	15.5	17.5	17.1	16.8	16.1	15.5	9.1	15.4	16.3	15.8	-
Total deposits (m/m)	%	1.7	1.1	0.1	0.9	1.7	0.4	1.0	0.5	2.5	1.3	0.6	-
Household loans (y/y)	%	34.8	31.7	31.3	29.4	25.7	25.1	22.1	-1.3	20.3	20.4*	18.9	-
Household loans (m/m)	%	1.2	2.1	0.2	-0.3	0.4	1.1	1.3	1.2	3.6	2.5	1.7	-
Corporate loans (y/y)	%	14.0	13.5	12.2	12.0	11.7	9.5	8.4	7.1	9.2	9.2*	8.5	-
Corporate loans (m/m)	%	0.4	-1.9	1.2	0.9	0.6	0.0	-0.4	0.9	2.1	1.4*	1.7	-
FINANCIAL INDICATORS													
Average deviation from the central parity	%	-2.4	-5.0	-7.4	-8.8	-10.1	-11.8	-13.7	-15.0	-9.9	-6.6	-6.5	-8.6
Average exchange rate USD	PLN	4.5606	4.3143	4.1108	4.0925	4.0599	4.0175	3.9807	3.9705	4.1859	4.2459	4.2185	4.1332
Average exchange rate EUR	PLN	3.9035	3.8802	3.8648	3.7689	3.6952	3.5904	3.4856	3.3894	3.5998	3.8218	3.8450	3.7425
Average exchange rate DEM	PLN	1.9958	1.9839	1.9761	1.9270	1.8893	1.8357	1.7822	1.7330	1.8405	1.9541	1.9659	1.9135
Average WIBOR T/N	%	20.07	19.50	19.73	19.82	19.33	18.56	17.91	17.78	15.99	17.19	15.96	17.65
WIBOR 1M	%	19.65	19.83	19.44	19.33	18.36	17.45	17.50	17.38	16.11	15.73	14.99	14.81
WIBOR 3M	%	19.75	19.67	18.97	18.61	18.01	17.17	17.22	16.88	16.01	15.35	14.74	14.01
Average 3M T-bill yield	%	17.44	17.60	17.12	17.29	17.20	16.44	16.24	16.12	15.26	14.23	13.81	13.06
Average 6M T-bill yield	%	17.78	17.84	17.43	17.09	17.16	16.36	16.21	16.03	15.29	14.38	13.93	12.89
Average 9M T-bill yield	%	17.97	17.91	17.40	17.15	17.01	16.11	15.84	15.81	15.32	14.65	14.02	12.83
Average 12M T-bill yield	%	18.31	18.01	17.23	16.97	16.85	15.80	15.67	15.61	15.38	14.61	14.01	12.67
Average 2Y T-bond yield	%	18.23	17.20	15.68	15.48	15.60	14.59	14.92	15.22	15.13	14.40	13.57	11.36
Average 5Y T-bond yield	%	15.10	13.93	13.08	12.92	13.33	13.47	13.38	13.29	13.85	13.50	12.92	11.37
Average 10Y T-bond yield	%	13.06	11.50	10.44	10.23	10.68	10.61	11.30	11.74	11.87	11.97	11.57	10.35
MONETARY POLICY INSTRUMENTS													
Intervention rate	%	19.0	19.0	19.0	19.0	17.0	17.0	17.0	15.5	15.5	14.5	14.5	13.0
Rediscount rate	%	21.5	21.5	21.5	21.5	19.5	19.5	19.5	18.0	18.0	17.0	17.0	15.5
Lombard rate	%	23.0	23.0	23.0	23.0	21.0	21.0	21.0	19.5	19.5	18.5	18.5	17.0

** data officialy corrected, ª in current prices*

Sources: CSO, NBP, Finance Ministry, Reuters, own estimations

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