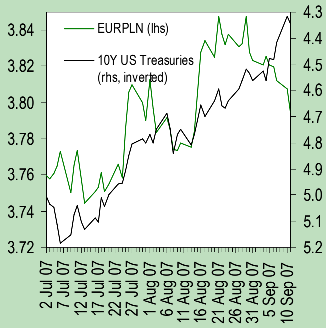
Bank Zachodni WBK

MACROscope

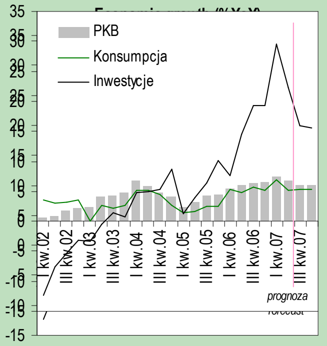
Polish Economy and Financial Markets

September 2007

EURPLN rate and 10Y US Treasuries



Wzrost gospodarczy (% r/r)



End of zloty correction?

- **New information on problems of more financial institutions investing in the subprime mortgage markets contributed to strong rise of nervousness in the international financial markets, higher volatility, rising money market rates, which resulted in a 50 bp discount rate cut by the Fed.** In the statement released on this occasion Fed changed the tone of its comments as compared to the communiqué released after the August meeting and emphasized that risks for growth increased and that it was going to act if needed to mitigate the adverse effects on the economy from disruptions in the financial markets. Such move strengthened expectations for interest rate cuts in the United States and contributed to postponing the interest rate hike decision in the euro zone.

- **Rising risk aversion in the global markets resulted in zloty weakening, however along our view it was rather temporary and we keep our forecast of zloty appreciation in September as compared to average rates recorded in August (and further strengthening in Q4).** A rise of yields was to some extent connected with the same factor, which affected the FX market, though the domestic factor (risk of higher inflation and expectations of next interest rate hikes) may still weaken the debt market in the longer run. In the short term there may be a small strengthening in the debt market on a temporary decline of inflation, interest rate cut by Fed and as a result of calming down moods in the foreign markets.

- **The Monetary Policy Council raised interest rates by 25 bp at the August meeting justifying its decision with tight conditions in the labour market and easing of the fiscal policy.** The statement did not explicitly suggest, when next decision to raise rates may be made. It seems to us that there is going to be no majority in the Council so as to pass the rate hike motion month after another, and moreover a few other factor may postpone it till November. In August and September inflation is going to be near 2%, which may make it difficult for the Council explaining another decision of raising rates to the public. Next quarterly data from the labour market are going to be available not until November. The situation in the global markets and moves of other central banks will also play some part in the decision making process. Early elections and awaiting the new government will also be of some importance.

- **GDP data significantly surprised the analysts and the market to the upside pointing to an increase by 6.7%YoY against expectations of 6%.** Data were not as hawkish as they might have been seemed at the first glance due to its positive structure, i.e. lower than expected private consumption growth and significant investments growth. Comments of central bankers suggested that released data confirm that past decisions.

In this issue:

Financial market on 31 August 2007:

NBP deposit rate	3.25	WIBOR 3M	5.03	USDPLN	2.7990
NBP reference rate	4.75	Yield on 2-year T-bonds	5.24	EURPLN	3.8230
NBP lombard rate	6.25	Yield on 5-year T-bonds	5.69	EURUSD	1.3658

This report is based on information available until 11.09.2007

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Special focus

What MCI tells about MPC?

Starting from this edition of the MACROscope we launch regular publication of monetary conditions index (MCI) for Poland. From the next month we will publish it in the Central Bank Watch section, together with subjective index of restrictiveness of MPC members.

What is MCI?

MCI is a synthetic index representing the impact of interest rates and exchange rate on the business activity and/or inflation. It allows to assess the degree to which monetary policy is restrictive and, hence, can be useful in envisaging future decisions to be taken by central banks and, consequently, changes in financial assets' prices. Apart from assessing the restrictiveness of the monetary policy in a given country, MCI is also used for assessing the openness of an economy (the smaller the relative impact of the exchange rate, the more closed the economy). It is also used as the indicator of convergence of a given economy to other economies.

The first reference to MCI was made in the literature dedicated to ways of quantifying the restrictiveness of the monetary policy in the second half of the 1980s. The popularity of MCI with the central banks increased along with the propagation of the direct inflation targeting. Central banks which pursue this strategy do not have indirect targets, therefore MCI, along with the inflation target, represented for them a vital point of reference for the current monetary policy. Some central banks, e.g. Bank of Canada which was a pioneer in the MCI application, used it as an indirect target of the monetary policy. Currently, the index is used by many central banks as well as international financial institutions (e.g. in the International Monetary Fund) and research institutions. New techniques are being developed for constructing MCI and the latest results of studies on the mechanism of the monetary policy transmission are applied. This very often leads to expanding the traditional MCI formula to include other changes than interest rates and exchange rate, mainly property and stock prices whose role in the process of monetary policy transmission is related to the so-called wealth effect. Thus expanded MCIs of the monetary policy are referred to as FCI (financial conditions index). Monetary condition indices also take sometimes into account monetary statistics and the yield curve slope (the less steep the curve or the more reversed the curve, the higher the degree of restrictiveness).

Where is the formula?

The general construction of the MCI is as follows:

$$MCI_t = \Sigma\, \omega_i\, (V_{i\,t} - V_{i\,0})$$

where:

V_{it} – the values of monetary policy variables identified from the transmission mechanism at time t

V_{i0} – the values of monetary policy variables identified from the transmission mechanism in a base period,

ω_i – elasticity of aggregate demand with respect to each of these variables.

The basic empirical problem in the process of constructing MCI is setting ω, i.e. establishing a relevant strength of impact of selected variables on the aggregate demand and inflation. Given the differences in the structures of different countries' economies, the values of weightings defined for them vary. Depending on whether in a given case the focal point is the impact of the monetary policy on prices and/or economic activity, MCI weightings should reflect the relevant strength of impact exerted by selected variables on inflation and/or aggregate demand.

As regards econometric issues, three main ways of establishing MCI weightings, i.e. estimating ω, are distinguished:

1. with use of large general equilibrium models,
2. with use of small partial equilibrium models or VAR analysis.
3. on the basis of demand gap analysis and inflation gap analysis (i.e. using estimates of IS curve and Philips curve).

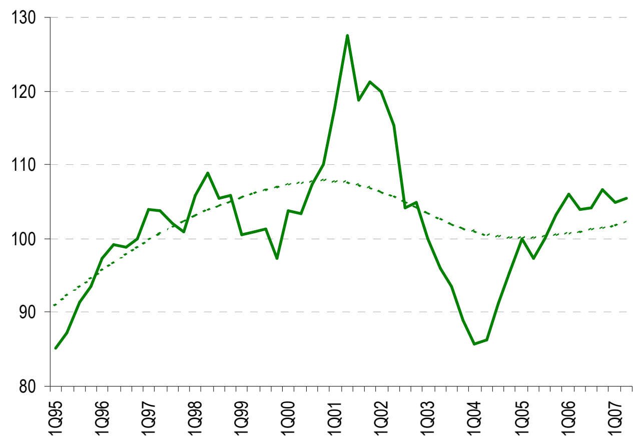
Another, highly simplified way of setting MCI weightings is a method which assumes that the weighting at the exchange rate should match the proportion between foreign trade turnover of the analyzed country and its GDP.

MCI in Poland

Studies on MCI have also been carried out in Poland. A few years ago, this index, in a few forms, was regularly published by the National Bank of Poland in *Inflation reports*. As the openness of the Polish economy grows, the management of the monetary policy by way of changing the interest rate becomes increasingly complex due to the concurrent, relatively stronger and stronger impact of the zloty exchange rate on economic activity and inflation. Thus, the assessment of the monetary policy restrictiveness, based exclusively on changes in interest rates or a separate analysis of interest rate and exchange rate changes, becomes more complex. Therefore, it seems to us, that such a synthetic measurement of the monetary policy restrictiveness as MCI is useful. At the same time, however, we acknowledge that the impact of the so-called wealth effect is yet too weak in the Polish economy to include in the construction of the aggregate measurement of the monetary policy restrictiveness for Poland such variables as financial assets' or property prices. In the definition of the MCI structured by ourselves for Poland, we only take into account the interest rate and exchange rate, which reflects the belief that in the Polish economy the most important and fastest channels along which the monetary policy exerts its influence on inflation are the interest rate channel and the exchange rate channel.

Moreover, in the case of the Polish economy, similarly to other quickly developing economies, where the so-called Harrod-Balassa-Samuelson effect operates, definition of the MCI is hampered by a long term appreciation trend of the real effective exchange rate.

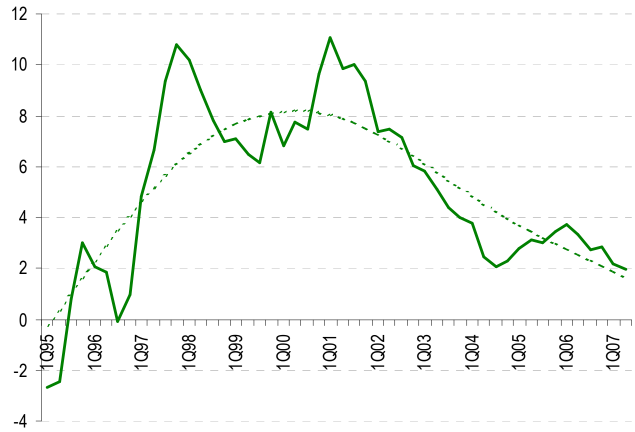
Real effective exchange rate in Poland



Source: Eurostat
Note: Index 1999=100. An increase in the index means strengthening of the real effective exchange rate. Dashed line indicates trend of the series calculated with Hodrick-Prescott filter

Given the high-paced growth in the productivity and a high inflow of foreign direct investments, the appreciation trend of the real effective exchange rate of the domestic currency should be considered natural as it is matched by appropriate adjustment of the equilibrium exchange rate. Hence, when setting MCI weightings, only deviations of the current real effective exchange rate from the equilibrium level (proxied by a long-term trend calculated by with use of the Hodrick-Precott filter) should be taken into account. A similar reservation concerns the real interest rate. As the Polish economy went through the phase of disinflation, we witnessed a long period of decline in the nominal and real interest rate (see the chart).

Real interest rate in Poland



Source: Eurostat, CSO, own calculations
Note: The real interest rates is WIBOR3M deflated with current CPI inflation. Dashed line indicates trend of the series calculated with Hodrick-Prescott filter.

For that reason, when setting MCI weightings, also in the case of the real interest rate its variances against the long-term trend should be taken into account. Given these reservations, in our calculations we use the following MCI formula:

$$MCI_t = \omega\,((r_t - r_t^*) - (r_0 - r_0^*)) +$$
$$+ (1 - \omega)\,((e_t - e_t^*) - (e_0 - e_0^*))$$

where:

$r_t - r_t^*$ – deviations of the real interest rate against the long-term trend in time period t,

$r_0 - r_0^*$ – deviations of the real interest rate against the long-term trend in the base time period,

$e_t - e_t^*$ – deviations of the real effective exchange rate against the long-term trend in time period t,

$e_0 - e_0^*$ – deviations of the real effective exchange rate against the long-term trend in base time period,

ω – weighting for the real interest rate,

$(1 - \omega)$ – weighting for the real effective exchange rate.

The quotient of parameters ω and $(1 - \omega)$ is the so-called MCI ratio. Its value represents the percentage change in the real exchange rate which matches the change in the real interest rate by 100 basis points relative to the impact on the economic activity and inflation.

Apart from MCI expressed in real terms, we also calculate nominal MCI. Its formula is similar to the one above, yet, instead of the real interest rate and real effective exchange rate, we use appropriately a nominal interest rate and nominal exchange rate of the zloty against the euro. A detailed description of the variables we use and the estimates of MCI weightings' can be found in the technical appendix.

MCI – advantages and disadvantages

Nominal MCI has a certain advantage over the real index. This is because that given the accessibility of data, the nominal MCI is an index of monetary policy restrictiveness which can be calculated with the smallest delay.

Comparison of nominal and real MCI

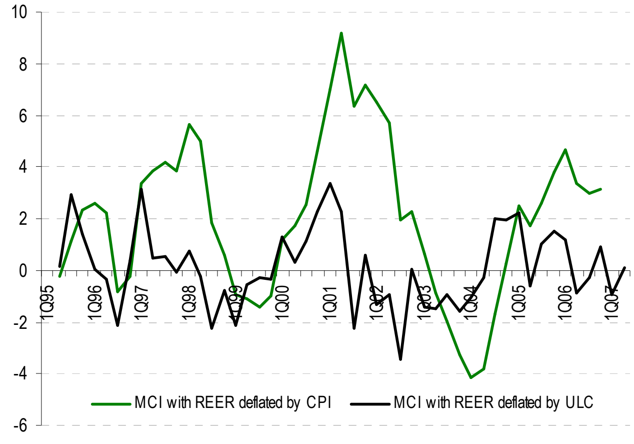
	Nominal MCI	Real MCI
Advantages	Can be calculated without delay, even on a daily basis, so it provides the most timely indication of changes in monetary policy stance	Uses real variables, so provides the most accurate picture of the current monetary policy stance
Limitations	Looks at nominal values which may be misleading, especially in periods of high inflation	Calculated with a lag needed to obtain real values of interest rates and real effective values of the exchange rate
Summary	Short-term monitoring of changes in monetary conditions	Accurate assessment of the current restrictiveness of monetary policy

Both the nominal and real MCI have significant limitations. First of all, they do not allow to differentiate between different types of exchange rate shocks. In the past, it led to grave errors in the monetary policy pursued by some central banks. The most spectacular example of the error made by the central bank due to the application of MCI is the reaction of New Zealand's monetary authorities to the break out of the Asian crisis in 1997. A striking depreciation of the New Zealand dollar in the aftermath of a drop in demand for export goods from this country translated into a drop in MCI. The central bank reacted to it by increasing interest rates thus causing a recession and deflation in the following years. This case shows that MCI index should not be used without an in-depth analysis of the exchange rate change drivers. Consequently, none of the central banks apply MCI as an operational target but merely as one of many information indicators referring to economic situation and inflation processes. When using MCI, one should be mindful of its weaknesses.

What does MCI tells about the MPC's policy?

Real MCIs structured by us, in two ways taking into account different indices of the real effective exchange rate, are represented in the chart below.

Real MCI



Source: Eurostat, CSO, own estimates
Note: Increase in the index indicate increase in monetary policy restrictiveness

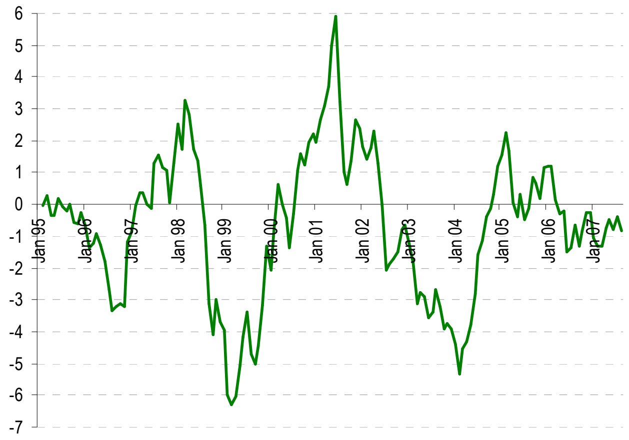
In our opinion, out of the two real MCIs calculated by us, the more consistent one with the perception of the monetary policy restrictiveness over the past years is the index with use of real effective exchange rate (REER) deflated by unit labour costs. This stems from the fact that using labour costs instead of CPI as a deflator enables to receive the REER index which better reflects changes in the economy's competitiveness. Besides, the REER index with unit labour costs as the deflator is available with shorter delay. Therefore, in calculating real MCI in future we will use the REER index deflated by unit labour costs. In turn, thanks to the application of variables' deviations from the trends rather than variables' deviations against the level in the base period, the resulting MCI indicates better the degree of monetary policy restrictiveness relative to the neutral level which is proxied by the trends of the real interest rate and REER.

As can be seen in the chart above, the MPC's policy, taking into account changes in the real effective exchange rate, has recently stricter in 2Q07 as compared to 1Q07. However, since the start of the year, the monetary policy in Poland has become less restrictive, as two rate hikes, in April and June, and appreciation of the REER in 2Q07 did not offset significant depreciation of the REER (relative to long-term trend) in the first months of the year.

Allowing for the delays in the mechanism of monetary policy transmission (real interest rates and exchange rate), the increase in monetary policy restrictiveness in 2Q07 should result in some weakening of inflationary pressure in 6-7 quarters. This stems from the analysis of the inflation reaction to the changes in deviations of real interest rates and real effective exchange rate against the long-term trend (see the technical appendix). Given strong fall in the MCI in 1Q07, it seems to us that scale of monetary tightening in 2Q07 has not been assessed by majority of MPC members as sufficient to counteract inflationary pressures fuelled among others by tightening in labour market conditions. This suggests that one should expect next rate cuts by the MPC, which is consistent with our scenario, assuming that the Council will raise borrowing costs one more time this year and then two times in 2008.

The real MCI we calculated, based on quarterly Eurostat data (the last available observation applies to Q2 this year) does not allow to assess the restrictiveness of the monetary policy over the past two months. In this case, the nominal MCI, shown on the chart below, proves useful.

Nominal MCI



Source: Eurostat, CSO, own estimates
Note: Increase in the index indicate increase in monetary policy restrictiveness

As evidenced by the chart above, the restrictiveness of the monetary policy in Poland has hardly changed over the two last months, despite a rate hike in August. Increase in short-term interest rates (both in absolute terms and relative to the trend) was offset by weakening of the zloty. All in all, the nominal MCI, taking into account the very recent changes in domestic monetary conditions, suggests, similar to the real MCI, that monetary tightening in Poland has not ended and one should expect further rate hikes, given risk factors to inflation, stressed by the MPC.

Technical appendix

The most popular method of defining MCI weightings is one based on the IS curve and Philips curve, i.e. equations of the demand gap and inflation gap. This method was used by the National Bank of Poland.

Less common is an approach using large macroeconomic weightings (general equilibrium models) applied by major research centers. The advantage of these models is that they take into account many different relations in the economy and thus allow to get to know channels of monetary policy impulses better. This method, however, is disadvantaged by the fact that general equilibrium models usually contain the monetary policy rule, i.e. the function of monetary authorities' reaction to the course of processes in the economy. Thus, it is difficult to establish the impact of individual variables on inflation and GDP as they are neutralized by a relevant monetary policy.

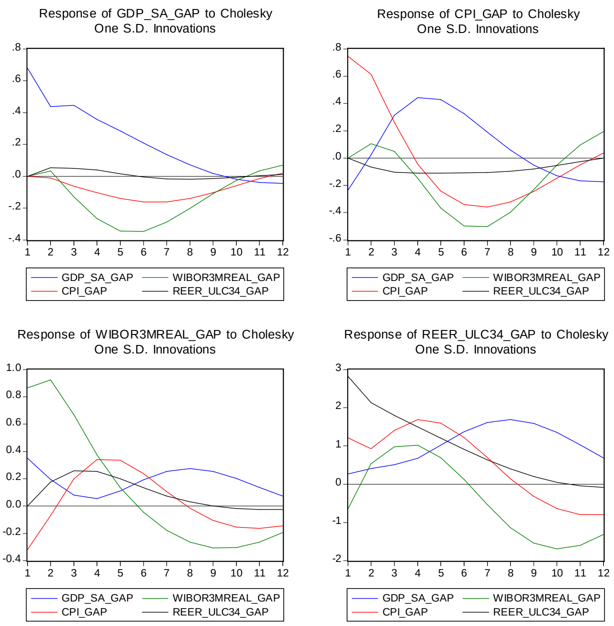
An advantage of another approach to setting MCI weightings, i.e. method based on small structural models, is a low degree of complexity, hence easy to analyse network of relations between variables, which allows to understand better how they influence inflation processes and economic activity. The same applies to VARs, however in their case the problem of structural relations is avoided. In our study, we use, in view of the efficiency of calculations, the method based on VAR, i.e. we set MCI weightings through the analysis of the reaction to the impulse-response functions. A good example of using this method is Charles Goodhart and Boris Hofmann's article titled Asset Prices, Financial Conditions and the Transmission of Monetary Policy, prepared for the conference titled Asset Prices, Exchange Rates and Monetary Policy at the Stanford University in 2002.

All the variables used for setting MCI weightings and index calculations have the form of a deviation of the logarithm of a given variable against the trend of this variable's logarithm. Such a form of variables allows to avoid the problem of non-stationarity of time series. Thanks to applying the deviation of variables against trends both in the process of setting MCI weightings and the very calculation of MCIs the obtained picture of the monetary policy restrictiveness is not distorted by the trend.

The long-term trend of variables is determined by means of Hodrick-Prescott filter (HP). This method leads to a change in the past values of MCI while expanding the index by new variable observations yet these changes are so insignificant that they do not distort the picture of the monetary policy restrictiveness. Notwithstanding the entire criticism around the HP filter, this method has a big advantage – the calculations are quick and easy.

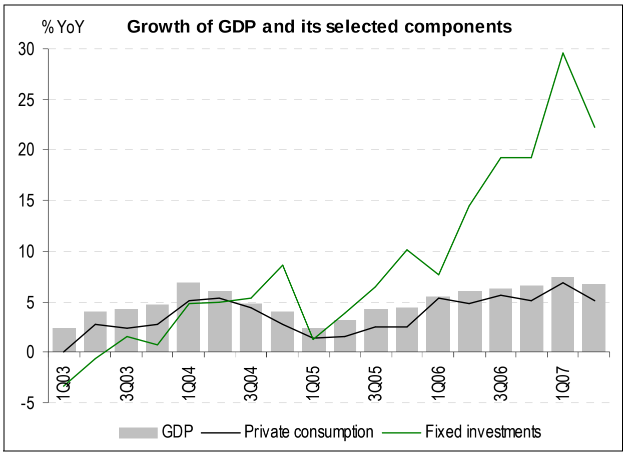
VAR was estimated based on quarterly data for the period from Q1 1995 to Q2 2007. For GDP, a seasonally adjusted time series from the Eurostat data base was used. For inflation, the CSO data on 12-month CPI inflation were applied. For the exchange rate, the real effective exchange rate index from the Eurostat data base (for 34 trade partners deflated by unit labor costs) was used. For the interest rate WIBOR3M was adopted. This selection is driven by both the accessibility of data and the importance of WIBOR in the credit market. Nominal interest rate have been deflated by the current CPI which warrants the accessibility of the data and the adaptability of inflation expectations in Poland.

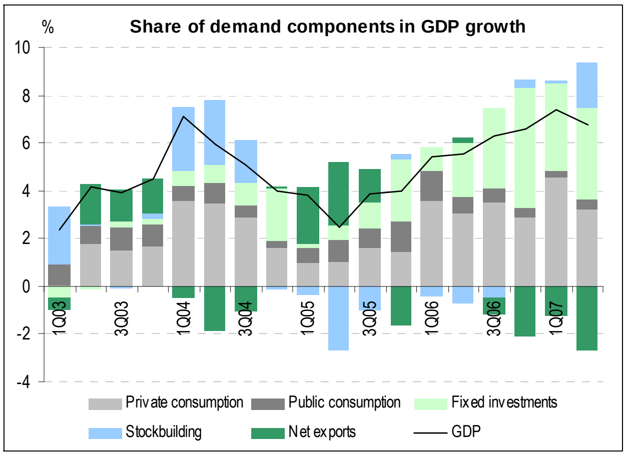
To determine MCI weightings, we estimate VAR with four endogenous variables, in the following ordering: GDP, inflation, real interest rate and real effective exchange rate. The variable ordering is standard in the light of the respective empirical literature. We also employ a few exogenous variables. These are dummy variables, mainly for the Asian and Russian crises. Delays in VAR are selected based on the AIC criterion and are set at 2. Below we present impulse-response functions from the estimated VAR.

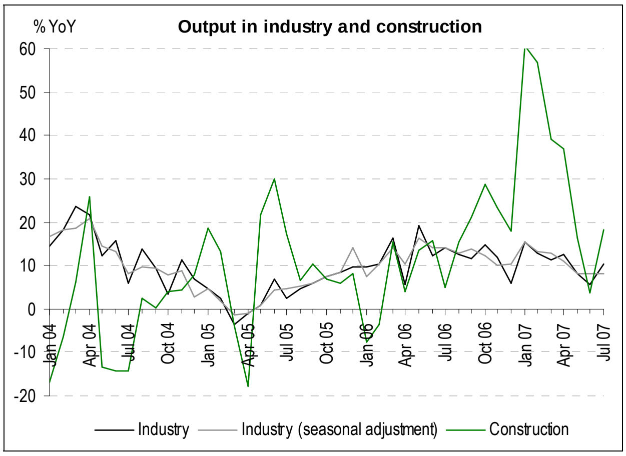


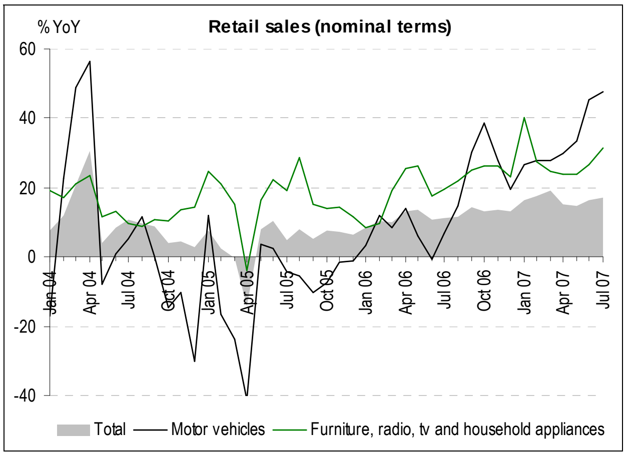
To determine MCI weightings, we calculate a relative strength of impact exerted by the real interest rate and real effective exchange rate on inflation over 12 quarters (an approach consistent with the aforementioned Goodhart and Hofmann's study). They are respectively 0.64 for the real interest rate and 0.36 for the real effective exchange rate. Thus, MCI ratio according to our calculations is 1.78. These results are similar to other weighting estimates for MCI in Poland, e.g. to NBP calculations.

Economic update









Source: CSO, own calculations

Surprising GDP figures for 2Q07

▪ GDP growth decelerated to 6.7%YoY in Q2 from 7.4% in Q1 against market expectations of around 6%. GDP breakdown was also quite surprising.

▪ Gross accumulation (including fixed investments and inventories change) increased by 33.4% with fixed investments rising by 22.3% (stronger than expected). The second engine of domestic demand i.e. consumption turned out to be weaker than expected. Overall consumption rose by 4.4% with private consumption growth at 5.1% (market consensus and our forecast was at ca. 6%). As a result, domestic demand increased by 9.3%YoY, while our estimate indicated growth of around 8%. Net export contribution to GDP amounted to -2.6 pp in Q2, and was more negative than expected. GDP deflator exceeded 3%.

▪ While stronger than predicted growth of overall GDP and domestic demand was perceived by the market as a hawkish argument, from the point of view of inflation prospects the breakdown of GDP growth in Q2 seems to be more favourable than expected. Investments increased faster than predicted, adding to economic potential in the long run, while consumption growth, exerting direct pressure on consumer prices, was weaker than expected. Besides, higher than expected GDP growth means that labour productivity gains in 2Q07 were stronger than earlier estimated.

▪ In the coming quarters we expect a continuation of a slowdown in economic activity, but its scale may be weaker than we had previously expected. Nevertheless, monthly economic indicators for the first month of the third quarter were not overly impressive (see below), suggesting that achieving GDP growth of much above 6% in Q3 may be difficult. However, after the second quarter data it seems quite certain that GDP growth in 2007 as a whole will surely exceed the level of 6%.

Weaker than forecasted output growth

▪ Sold industrial output declined by 0.2%MoM and increased 10.4%YoY in July. The result was slightly below market expectations at 11.1% and our forecast at 12.1%YoY. Seasonally adjusted growth in industrial output reached 8.3%YoY, i.e. was similar to the two previous months, but weaker than on average in the two first quarters of this year.

▪ Construction sector was in better shape than industry, posting 1.4%MoM and 18.4%YoY increase in July, which means a clear rebound after worrying slowdown to 3.7%YoY in June.

▪ All in all, the output figures for July for suggested that the start of third quarter in the economy was not a revelation, although pace of economic expansion remained robust. According to our predictions, GDP growth in Q3 will reach 6.1%.

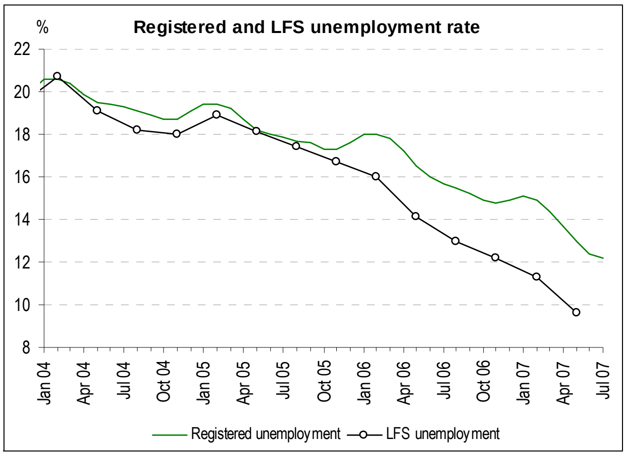
Acceleration in retail sales growth

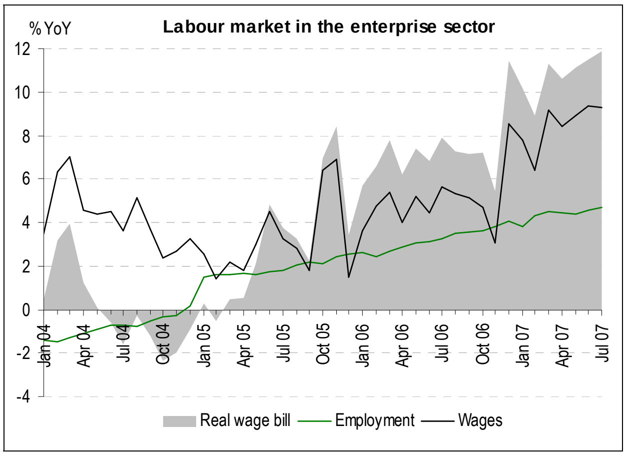
▪ The nominal retail sales increased 17.1%YoY in July, faster than in the previous three months. The real growth amounted to 15%YoY. The difference between the nominal and real sales growth rate is gradually picking up, which points to acceleration of price growth in trade, though it still remains relatively low.

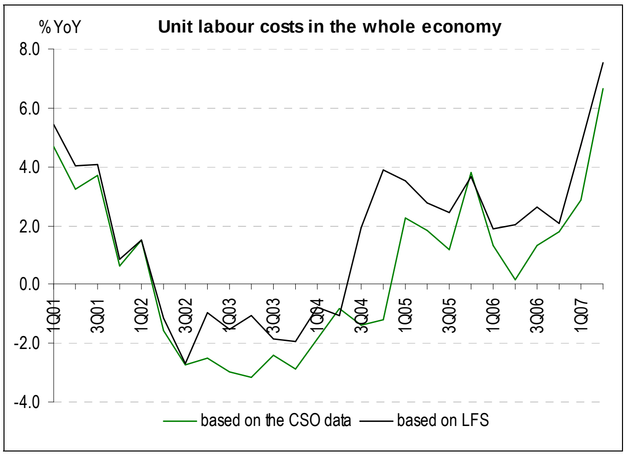
▪ The strong growth of sales maintained in all categories of retail sales, which shows that consumption demand is broad based. The highest acceleration of annual growth rate was observed in sales of durable goods, e.g. motor vehicles (47.6%YoY).

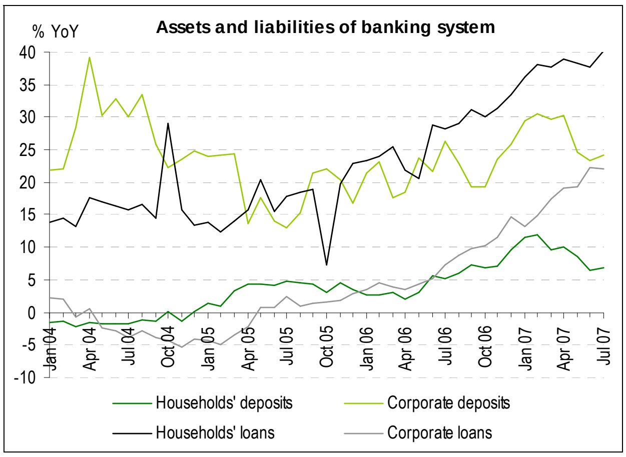
▪ All in all, the data confirmed that the improving situation in the labour market lead to the acceleration in consumer spending, and consequently one may expect keeping the private consumption rate at high level in the second half of the year (according to our forecast at 5.4%YoY both in 3Q07 and 4Q07).

Economic update









Source: CSO, NBP, own calculations

Unemployment below 10% for the first time in 10 years

- Data on registered unemployment did not bring any surprises – in line with earlier estimates of the labour ministry the registered unemployment rate fell to 12.2% at the end of July, i.e. to the lowest level since 1999. The number of unemployed dropped by nearly 590,000 i.e. by almost 25% in one year time.
- The CSO also released results of Labour Force Survey for Q2. They showed the LFS unemployment rate (consistent with EU statistics) fell to 9.6% in Q2 from 11.3% in Q1. This means that for the first time in ten year LFS unemployment in Poland was at one-digit level. According to LFS, the number of unemployed declined by almost 33%YoY, and the number of working population increased by 4.8%YoY. There was slight increase in participation rate and employment rate, to 53.5% and 48.4%, respectively.

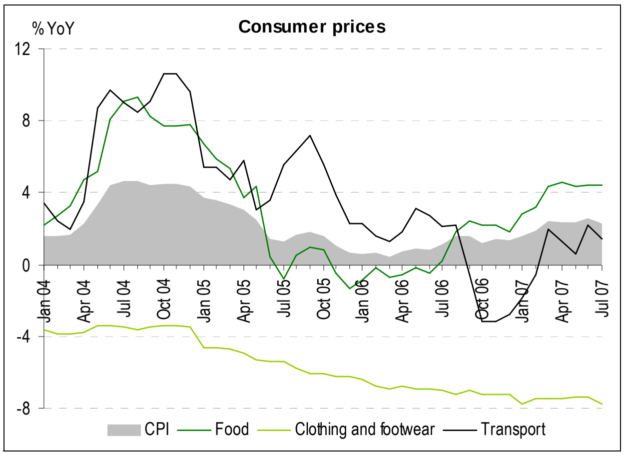
Rise in employment, wages and unit labour costs

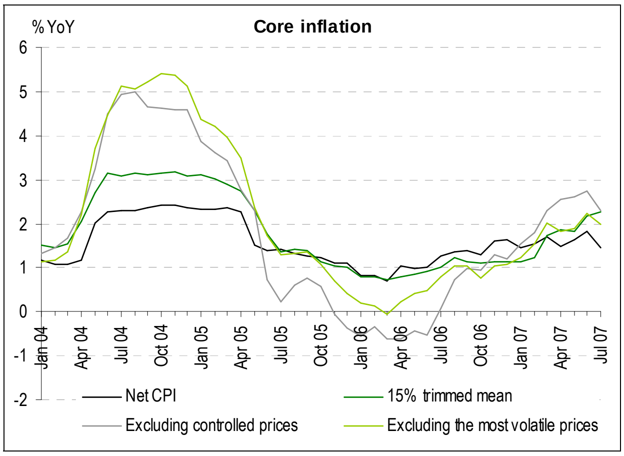
- Average wage in the corporate sector rose by 9.3%YoY in July. At the same time average employment grew by 4.7%YoY beating expectations and setting new record in the history of the Polish market economy. All in all, the data confirmed that high labour demand persists, which – amid simultaneous limitations on the supply side (labour migration, low participation rate) – keeps the wage growth at high level.
- July was the first month, when the lower (by 3 p.p.) disability pension contribution was in force. It is hard to estimate on the basis of data for a single month whether this reduction had important impact on the wage negotiations in companies. One may not rule out that without this factor the wage growth would have been even higher, though the full conclusions may be drawn only after several months.
- As for now the inflow of households' income from labour accelerated again. Wage bill growth in the corporate sector reached 14.4%YoY in nominal terms and 11.8%YoY in real terms. This is for sure a factor that fuels consumption demand.
- LFS results for 2Q07 point to significant acceleration of unit labour costs, at larger scale than it was suggested by the registered employment data. According to our estimates based on the LFS results and data on value added in Q2, productivity growth decelerated to 1.3%YoY in Q2 from 2.2% in Q1, and growth of unit labour costs accelerated to 7.6%YoY from 4.7%YoY in Q1. Although one should remember that central bankers have emphasized that the estimates based on the LFS results may lead to overstating the labour costs, there is clearly an upwards trend in unit labour costs growth and this is perceived by the MPC as a major risk factor for the medium-term inflation prospects.

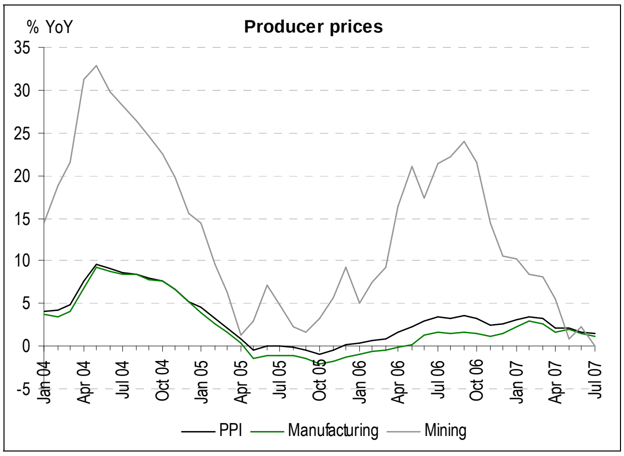
Unchanged trends in monetary statistics

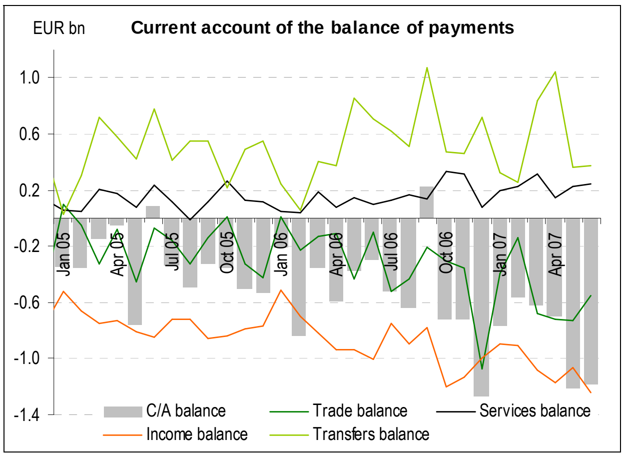
- Methodological changes in monetary statistics introduced by the National Bank of Poland did not lead to significant changes in earlier observed trends.
- Money supply M3 increased 15.6%YoY, with total deposits rising 15.9%YoY. In both cases, there was acceleration as compared to July, but deceleration against average growth rates in the first two quarters of the year. The same applies to household deposits growth (6.9%YoY in July) and corporate deposits growth (24.3%YoY).
- Total loans surged 31.4%YoY in July, the fastest since June 2000, mainly due to acceleration in growth of household borrowing to as much as 40.2%YoY, the highest level in almost 10 years. Corporate borrowing growth remained at solid level of 22.2%YoY.

Economic update









Source: CSO, NBP, own calculations

CPI and core inflation below the target

▪ In line with our forecast, the headline inflation rate fell to 2.3%YoY in July from 2.6% in June. It was below median of market forecasts and the Ministry of Finance's estimate at 2.4%.

▪ What is important, inflation drop did not result entirely from supply-side factors, as net inflation (CPI excluding food and fuel prices) fell to 1.5%YoY from 1.8%YoY in June. Although one should remember that the decline stems to large extent from the high base effect (rise in internet access prices in July 2006), even taking into consideration this fact one may state that net inflation stays at low level, which means that the underlying inflationary pressure is subdued.

▪ This is also indicated by low level of the remaining core inflation measures (CPI excluding the state controlled prices dropped by 0.4 pp to 2.3%YoY, CPI excluding the highest volatility prices by 0.3 pp to 2.0%YoY and CPI excluding the highest volatility and fuel prices to 1.9%YoY). Only the core inflation measured as a 15% trimmed mean increased by 0.1 pp to 2.3%YoY.

▪ All in all, current inflation indicators are not an argument for monetary tightening. Especially that in August-September period inflation will drop even further. Our forecast assumes that in August it reached 1.8%YoY while the median of market forecasts and FinMin's estimate point to 1.9%YoY. Anyway, clear fall in the headline inflation rate to below the central bank's target will make it more difficult to hike rates.

▪ However, one should remember that the Council is focused on more on figures signalising future prices processes, such as labour market data, and not on current inflation indicators. The current inflation indicators are low, below the inflation target, only confirms the decisions to leave rate unchanged a few quarters ago were right.

Transitory fall in PPI inflation

▪ Prices of sold industrial production rose by 0.4%MoM and 1.5%YoY in July. The slowdown of annual PPI growth was deeper than expected. In the manufacturing, producer prices rose by 0.4%MoM and 1.2%YoY against 1.4%YoY in June.

▪ Although another increase of prices in monthly terms may be a reason for concern, it resulted mainly from price hikes in case of tobacco products (by 5%MoM, which is effect of excise tax rise) and in case of refined petroleum products (by 2.8%MoM). Prices of other goods rose at lower rate or declined.

▪ On the other hand, one should remember, that decline of the annual PPI growth rate is to large extent a result of high statistical base. We predict that in the coming months, after high base effect fades away, PPI inflation will accelerate to above 3%YoY in December.

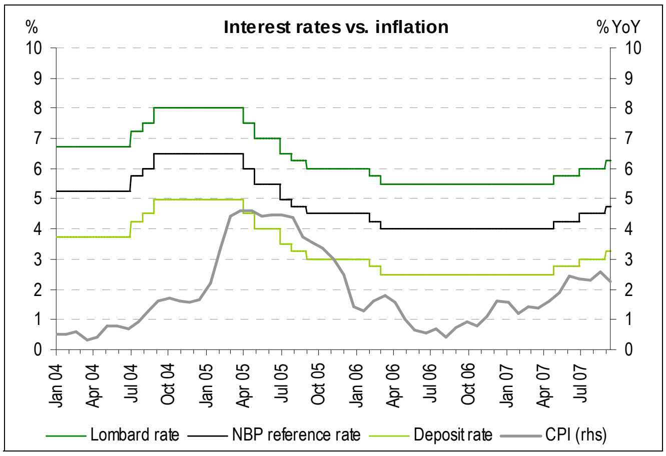
Moderate increase in external imbalance

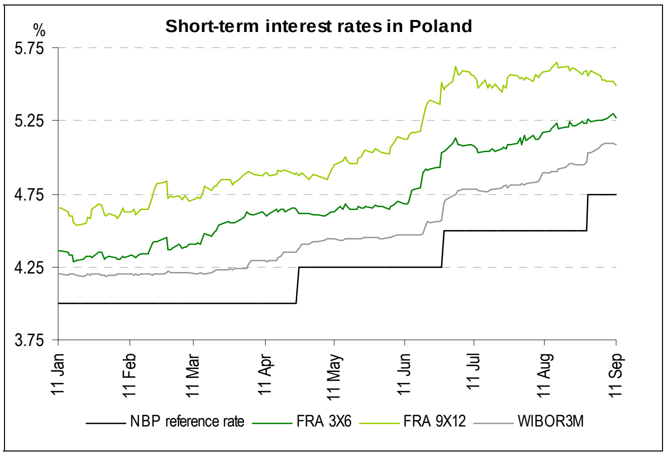
▪ Current account deficit reached €1.182bn in June against €1.214bn in May. The trade balance reached €557m against €732m in May. Relatively narrow trade gap was a result of robust exports performance and continuation of its double-digit growth (almost 13%YoY). Import growth accelerated to over 18%YoY, being stimulated by strong internal demand.

▪ June was the second straight month with clearly weaker inflow of funds from the EU. In effect, current transfers balance recorded only €373m surplus after €359m in May, well below levels seen a year earlier. However, one could assume that this is only a temporary phenomenon.

▪ Cumulative 12-months current account deficit after June increased to 3.1% of GDP from 2.5% at the end of 1Q07 and 2% one year ago, but this is still moderate level.

Central bank watch





Selected fragment of August MPC statement

The latest information on labour market developments points to a continuation of high wage growth and a deeper than previously estimated deterioration in the relation between wage and labour productivity growth. A further build-up in wage pressure and, consequently, inflationary pressure is possible. The recently made decisions leading to a decrease in revenues and an increase in expenditures of the public finance sector may lead to a deterioration of the public finance balance, which in the medium run may result in additional inflationary pressure. In the medium term inflation growth may be curbed by the continuing very good financial results of enterprises and a high investment growth conducive to productivity growth. Increase in inflation in medium-term may also be constrained by low growth of external prices, related to the monetary policy pursued by major central banks as well as the globalisation process and the ensuing rise in competition in the market of internationally traded goods and services. However, in the Council's assessment, the impact of those factors would be insufficient to keep inflation at the target level over the monetary policy transmission horizon.

MPC voting results in 2007 (motions to hike rates by 25bp)

	February	March	April	May	June
Skrzypek	-	-	-	-	-
Czekaj	–	–	+	-	+
Filar	+	+	+	+	+
Nieckarz	–	–	–	–	–
Noga	+	+	+	+	+
Owsiak	–	–	–	–	–
Pietrewicz	–	–	–	–	–
Sławiński	–	+	+	–	+
Wasilewska-Trenkner	+	+	+	+	+
Wojtyna	–	+	+	+	+

Source: NBP, Reuters

Third rate hike. When the next one?

▪ In August the Monetary Policy Council raised main interest rates by 25bp, for the third time this year. The reference rate was raised to 4.75%. In the face of economic data published before the meeting, especially from the labour market, such a decision was widely expected and did not cause significant reaction of the financial market.

▪ However, a question arises about next monetary policy actions, particularly that the next two months should bring fall in the headline inflation rate and recently we have experienced a turmoil in global financial markets. The latter factor already affected the monetary policy conducted by world's major central banks (no change in ECB rate, expected cut by Fed).

▪ Further interest rate hikes will depend on incoming economic data. So far there has been no majority in the Council to make such decisions month after another, and in September it is going to be more difficult as we would already be after three interest rate hikes. Thus, a remaining choice is October or November.

▪ We still expect fast rise in wages, but also some slowdown in job creation amid still fast economic growth. On the other hand, inflation in August and September will be close to 2% (core inflation below 2%), which may make it difficult to explain (next) hike to the general public. Also, the next quarterly labour market data will be available only in November.

▪ Situation on global markets as well as decision of other central banks may have some importance. Also, premature elections and expectations for the formation of new government could be relevant for the decision. In sum, we attach slightly higher probability to the rate hike in November and we maintain expectations for two more hikes in 1H 2008.

A few new elements in the MPC communiqué

▪ As one might have expected, the statement after the meeting and the press conference did not give clear answer to the question about next steps of the MPC.

▪ The MPC maintained a restrictive bias in monetary policy, justifying the decision with acceleration in unit labour costs growth on a scale that was higher than previously expected.

▪ The MPC emphasised to a larger extent a possible influence of the fiscal policy on future inflation. The Council referred to the situation in global markets, stating that further development of situation is going to be one of the factors, which are going to be taken into consideration on occasion of further decisions. The MPC Council wrote that the risk of more significant slowdown than previously expected of economic activity in the US and also in the euro zone increased.

Motion to hike rates in July

▪ We already know the voting results of the MPC decision to raise interest rates in June and they are in line with our expectations.

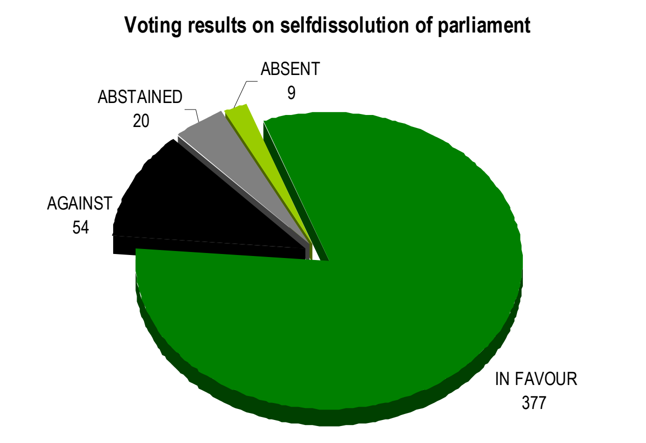
▪ The result could have been the same in August meaning that the NBP chief was in minority again. Though comments of some MPC members, who used to vote against tightening in the past (see details on the next page), may suggest that this time there were more members supporting the decision.

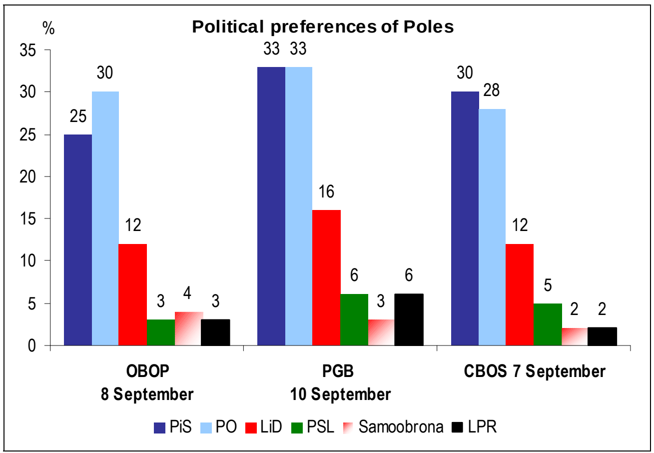
▪ On the other hand, result of the MPC's voting in July may be interesting, as we think that more members of the Council might have opposed a hike (as compared to the voting in April and June, when such motions were accepted). We think that more members were against a hike in July given the fact that they favoured such a decision already in the previous month.

Central bank watch

Comments of the central bank representatives	Our remarks
Sławomir Skrzypek, NBP President and MPC chairman **TVN CNBC, 6 September** We talk about inflation, which is in the target, within the tolerance band around the target. All NBP's models show that inflation will stay within the target. We still have strong productivity increase, but indeed growth rate of wages started to exceed productivity gains. This is connected with one more problem – according to the latest NBP analysis, we have some doubts whether these measures are accurate. Namely, looking at unit labour costs statistics one takes into account LFS data on employment, but they do not include the effect of migrations and that is why unit labour costs figures may be overestimated as this affects productivity growth. This does not mean that the relationship should be disregarded. I shared the view of the MPC members, who did not support interest rate hikes, as I had a different opinion as regards frequency and timing of rate hikes. Especially, the MPC decision in June was incomprehensible for the market, as it is enough to look how FRA contracts reacted to this decision and how the market reacted – there was a confusion and this affected expectations. From my point of view, I can only say that I will strive for such legal changes, which will make possible the announcement of full information after the MPC meeting, all the aspects, which were taken into account, together with the voting results. The eaerliets possible date of euro adoption in Poland is 2012.	At the beginning of September, the NBP governor gave first TV interviews, but they did not bring much new as compared to his previous comments as compared to his previous statements. Talking about inflation maintaining close to the target, he probably meant that CPI inflation will stay within the tolerance band around the target, as the target is not a range but the point of 2.5%. The forecasting models in the central bank show quite substantial risk that the target will be exceeded, but at the same time they indicate inflation will probably stay below 3.5%, which is the upper end of the range. Thus, the statement of NBP President indicates that he has a symmetric approach to the target, which is contrary to approach of some other members of the Council. As regards LFS data on employment, this is indeed the case that they may show overstated data and this was already noticed by the authors of NBP inflation projection. Nevertheless, this does not change that fact that situation in the labour market tightened in the second quarter as compared to the first quarter and as compared to expectations. Even if we take into account the CSO data on employment in the whole economy, the unit labour costs showed substantial increase in Q2 (though slightly lower than based on LFS) and created some risk for future inflation. What is interesting, NBP governor admitted he voted against rate hike in June because of the timing. Does it mean he would support a hike in July? If there was actually a chance for wide consensus in the Council for a rate hike in July, it is a pity they hurried and raised rate already in June. We positively perceive declarations of the NBP governor as regards faster publication of voting results. As regards the timing of publication of *minutes,* faster publication in their current form will not significantly improve transparency of monetary policy.
Stanisław Owsiak, MPC member **Thomson Financial, 30 August** Second-quarter data point towards a possibility of growth in inflation pressure and confirm that this year's decisions to raise rates were right. The MPC should pay special attention to food and oil prices, which may become a source of inflationary pressures. **Mirosław Pietrewicz, MPC member** **Reuters, 30 August** The last interest rate hikes should be a factor slowing down inflation growth next year. I expect CPI inflation to be slightly above the target at the end of the year, but it should not exceed 3%. The recent MPC decisions to raise rates are in harmony with second-quarter economic growth data.	In comments concerning economic growth data for the second quarter, the MPC members, who used to oppose decisions to raise rates, said the figures confirmed the MPC policy was accurate. This means they support the previous decisions of majority of the Council, admitting they were wrong when opposing rate hikes in April and June. In the opinion of the „doves", the moves, which were made in the monetary policy should decelerate inflation next year. It is interesting, however, whether they were also against the latest increase in rates, which took place in August or maybe they changed the view. The members being in minority in April and June were Stanisław Owsiak and Mirosław Pietrewicz, as well as NBP President Sławomir Skrzypek and Stanisław Nieckarz.
Marian Noga, MPC member **Reuters, 30 August** In my opinion the rate level, which will ensure stabilisation of inflation close to the target is 5.50%. This means three rate hikes are necessary until mid-2008. **Halina Wasilewska-Trenkner, MPC member** **PAP, 31 August** If currently observed processes, which increase inflationary pressure, are reinforced, 1-2 interest rate hikes may be needed within the next 12 months. But also, the economic picture may radically change.	On the other hand, it is clear the „hawkish" Council members opt for more rate hikes. The comments of Marian Noga are in line with what is priced by the interest rate market. Although, one may conclude from Halina Wasilewska-Trenkner's remarks that she considers smaller scale of monetary tightening, it is worth to watch closely her comment that the economic picture may radically change. It was actually the case in the past, as before the monetary tightening cycle started the same members of the Council had hoped the one or two interest rate hikes might be sufficient to keep inflation within the target.
Dariusz Filar, MPC member **PAP, 3 September** If we were convinced that interest rates hikes already applied eliminated risks for inflation, we would signal this. GDP growth in the second quarter, which was higher than expected, allow us to assess that actual GDP growth will equal the potential growth rate at the end of 2008, which will make possible to conduct neutral monetary policy. We are data-dependant. It will be very interesting how the inflation model will react to the new LFS data from the labour market and new GDP data, and what will be the outcome of the October's inflation projection as a result. (…) The July's projection indicated a need to increase interest rates, but the majority of the Council preferred to wait for the verification in the economic data released in August. I do not exclude that similar scenario may take place in October-November.	Professor Filar used to present rather hawkish view on monetary policy, but his comment on GDP data release was a bit more dovish that the mentioned-above statements of other members. However, in our opinion, much more interesting were Filar's comments as regards importance of upcoming data and new inflation projection for the future MPC's decisions. He did not exclude a possibility that next interest rate hike will take place in November and such scenario would be consistent with our forecast. Also, they were interesting comments on possible consequences of the crisis in global markets for the Polish economy. Filar's opinion was similar to the one presented by professor Andrzej Sławiński during the press conference after the MPC meeting. Namely, there are no circumstances suggesting that the crisis may affect directly conditions of Polish enterprises and the influence on the Polish economy may be indirect, small, if any.

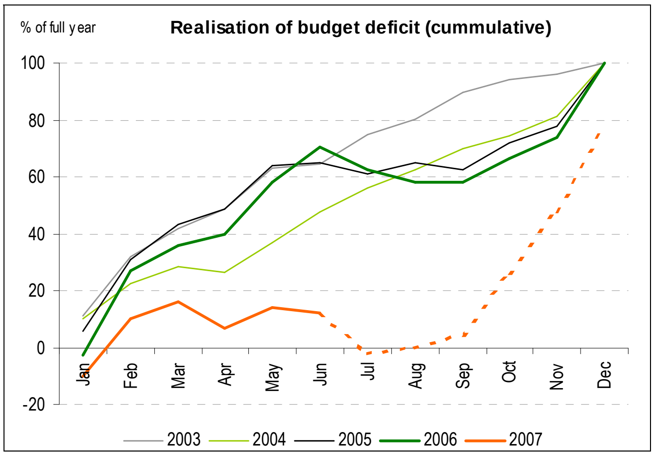
Government and politics





Macroeconomic assumptions of 2008 budget

	NEW	OLD
Deficit (PLNbn)	28.1	30.0
Expenditures (PLNbn)	275.1	271.6
Revenues (PLNbn)	247.0	241.6
GDP growth (%)	5.5	5.7
Domestic demand (%)	7.2	6.8
Gross accumulation (%)	13.9	13.4
CPI (average, %)	2.3	2.3
Average gross wage (%)	5.9	6.0
Average employment (%)	2.0	2.3
USDPLN (average)	2.77	2.77
EURPLN (average)	3.74	3.74
Current account deficit (% PKB)	above 5	4.7
NBP reference rate (average, %)	5.2	4.7



Source: BZWBK, Ministry of Finance, Sejm, opinion polls

Parliament dissolved. Who knows what will be next?

- Although the Polish political scene is usually full of surprises, in line with expectations the parliament decided to dissolve itself and against the motion were only parties, which cannot be sure they will get sufficient public support to be re-elected.
- Early elections are scheduled for October 21, opinion polls show many different scenarios for the shape of the Polish political scene after election.
- Still the same two parties are leading the polls – Civic Platform (PO) and Law and Justice (PiS) and such situation will most likely maintain until elections. However, it is impossible to predict who will win.
- After elections, a few scenarios are possible as regards majority coalition. Firstly, the two parties may form the government based on their own deputies only, assuming they have more than 50% of votes in Sejm. Secondly, both parties may form a coalition together or with the Peasant Party PSL. They can also split after elections and the majority in the parliament may be based on one of factions from PO or PiS, or POs may form a coalition government with left-wing LiD. As parliamentary elections in 2005 showed, scenario which seems very likely before the voting, may become very difficult to realise after elections and thus we are not trying to predict probability for different scenarios nor their possible consequences for financial markets.
- Nevertheless, it seems that investors on the market treat early elections and another turmoil on the Polish political scene with calm. Foreign exchange and bond market are reacting more to news from the global market amid housing market and credit market crisis, than to political events. According to Fitch Ratings, elections do not change rating prospects for Poland.

Pre-election spree of cabinet and deputies

- While early elections may bring some positive solutions as regards future macroeconomic policy, the risk factor is connected with significant spending increase before elections.
- Aside from controversial decisions on significant increase in minimum wage and extending possibility for early retirement, we saw a proposal on tax relief for families, which was put to the vote by the opposition parties and reduces revenues.
- Despite the fact that the Ministry of Finance decided to lower GDP growth forecast for the next year, they decided to increase the forecast of revenues. This was probably connected with higher-than-expected incomes in 2007. The expected spending rose as well, though to lower extent and deficit was lowered by PLN2bn. However, one should remember that not all parliament's proposals were included.

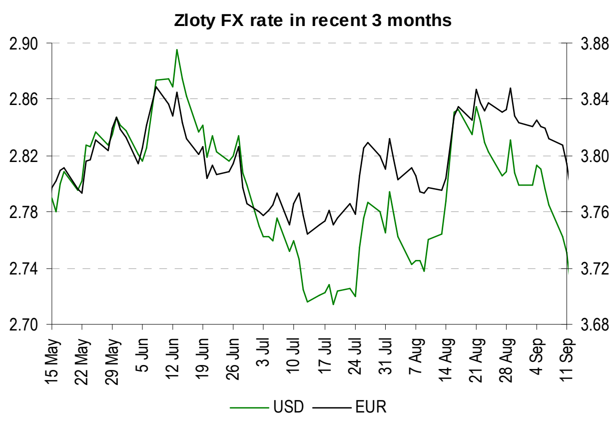
Budget surplus possible after August

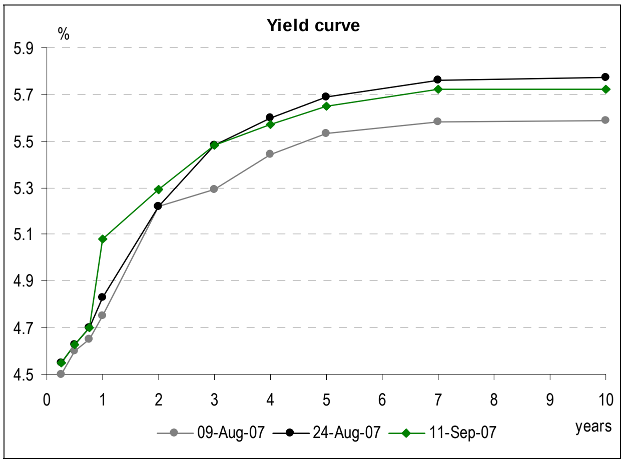
- In line with previous announcements, in July the central budget showed a surplus second month in a row and this time it was as high as PLN4.3bn. As a result, the cumulative budget result after seven months of the year was also positive at PLN600m.
- This was driven by strong increase in revenues (28%YoY in July and 25%YoY in Jan-Jul period), while spending increased by slightly less than 10%YoY in the seven months of the year.
- As compared to the expected path of revenues and spending, which was published by the Ministry of Finance at the beginning of the year, in the January-July period revenues were higher by PLN7bn and expenditures were lower by PLN8.5bn. As a result, budget deficit saw a surplus and not above 50% deficit as it was planned. One should remember, however, that spending will accelerate in the remainder of the year.

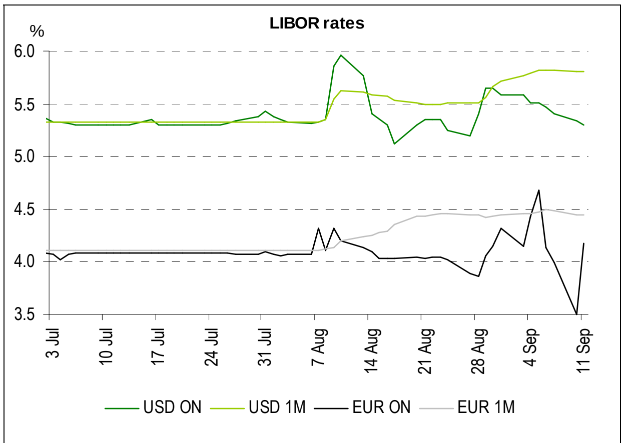
Government and politics

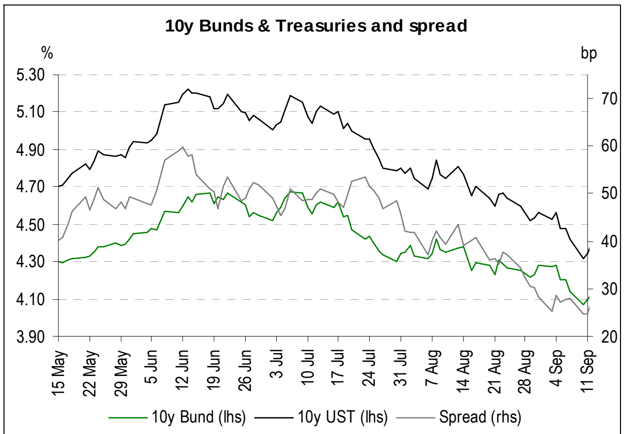
Comments of government representatives and politicians	Our remarks
Jarosław Kaczyński, Prime Minister **PAP, 4 September** Spending increase in the next year budget amounts to PLN27bn and despite this the requirement from the Convergence Programme, to lower budget deficit below 3% of GDP by 2009, will be met.	The comment of the Prime Minister does not seem consistent with the budgetary assumptions presented by the Ministry of Finance. If revenues were to rise by PLN27bn and the level for the next year amounts to PLN247bn, then this year's revenues would have to reach only PLN220bn, which would be less than assumed in this year's budget. And this year's realisation is expected to be above the plan.
Zyta Gilowska, deputy PM and finance minister **TVN CBNC, PAP, 5 September** The MPC activity to hike interest rate three times this year, including the reference rate, is calming down the economy a bit. I have an impression that if someone creates inflation expectations in Poland, this is also the MPC. (…) During the last two years when I worked as finance minister, I did not criticise the Monetary Policy Council, but now I think that they exaggerate. One cannot take enthusiasm away from people and scare them. The reduction in disability pension was antiinflationary and if we did not do it the wage pressure would be unlimited. In my personal opinion, not as a finance minister, but as an economist, economic growth may reach 6% next year. But I cannot include such assumption in the budget. **PAP, 29 August** Indeed I did not expect such decision of the MPC. I hoped the Council to prefer waiting. All core inflation measures for August are better than in July, and for July they were better than for June. We saw a decrease in both consumer and core inflation and we know they can fall further in the following months. (…) This means we have to start changing macroeconomic assumption in the next year's budget. From the vantage point we look at the Polish economy there are no new dangers on the horizon. A dangerous exceeding of productivity growth by wage growth did not take place yet.	It was very quiet in relations between the National Bank of Poland and the Ministry of Finance for quite a long time. It was probably connected with fact that interest rates were stable at relatively low level, but it seems that third rate hike was too much for the finance minister. The statement that the MPC creates inflationary expectations should be treated as an exaggeration (at least). What is interesting, Zyta Gilowska does not see any inflationary pressure, while at the same time her deputy, Katarzyna Zajdel Kurowska, said that "it is probable that we could see significant pressure on price growth in the near future". It would be positive if the ministry was able to reach one house view on inflation prospects, as this was not the first time when the two ladies sent contradictory statements in Polish media. Professor Gilowska added even more, saying that wage growth did not exceed yet dangerously the productivity growth. Well, we do not know what scale of growth in unit labour costs would be dangerous from the point of view of the Ministry of Finance, but as we presented in the *Economic Update* section of this report, acceleration in ULC, which was observed in the second quarter was really substantial. Finance minister said that another rate hike by the MPC was one of the reasons to change macroeconomic assumptions in the next years' budget. Indeed, the expected average reference rate was raised by 50 bp to the level of 5.20%, which is consistent with our expectations and market consensus. It is positive that the ministry lowered GDP growth forecast, but the main reason was rather the situation in global economy, as despite higher rates the ministry assumes higher domestic demand increase.
Zyta Gilowska, deputy PM and finance minister **PAP, 22 August** In 2007 we declared fiscal deficit at 3.4% of GDP and its reduction to 3.1% in 2008 and we maintain such targets. There are no signs that we will not be able to meet them. In 2009 the fiscal deficit should reach 2.9% of GDP. **Katarzyna Zajdel-Kurowska, deputy finance minister** **PAP, 27 August** The result assumed in the convergence programme is not endangered. On the contrary, it is possible that fiscal deficit this year will be lower than predicted 3.4% of GDP. Exact estimates will be presented later during the year, together with sending the 2008 budget draft to the parliament and sending the fiscal notification to the EU in autumn.	It actually seems that declarations of the finance ministry, included in the latest convergence programme, as regards this year's fiscal deficit will be fulfilled. This will be mainly a result of faster GDP growth which is forecasted by the European Commission to reach 6.5%. As a result, budget deficit this year should reach around PLN23bn and will be much lower than the planned PLN30bn. However, there are still many question marks about fiscal targets for the next years. Although it is predict fiscal policy in next year, not knowing who will conduct it, but last decision of the Sejm pose a risk to the fiscal targets. Besides, the Ministry of Finance assumes quite conservative assumptions regarding the pace of GDP growth in next two years (5.2% and 5% respectively) and estimates of fiscal deficit for next years were taking into account saving resulting from public finance consolidation which was not implemented.
Joanna Kluzik-Rostkowska, labour minister **Radio PiN, 7 September** This is very costly idea, because earlier the programme of supporting families was estimated to reach PLN28bn until 2014, while introduction of the new tax relief for families will cost PLN36bn in the same period and it deals with only some issues and is addressed to only some group of people. (…) This is an effect of pre-election madness. In August the unemployment may be lower by 0.1-0.2pp. In Autumn the situation may worsen a bit due to seasonal factors, so I would be very happy if the registered unemployment rate was at 10% [at the year-end], but if there is 11.5% it would not be bad result.	Additional element, which raises a question mark over the forecasts of budget deficit in the coming years are pre-election decisions of the Sejm. Labour minister, the same as finance minister, hopes that the Senate will change the Sejm's proposals, but it is not sure whether a Sejm's session will be held before the election to consider the Senate's amendments. According to the labour ministry, the registered unemployment rate at the end of August fell to 12% from 12.2% which means lowering of the estimate by 0.1pp. The fall will be a result of lower inflow of new unemployed, which is connected with lower number of unemployed graduates of high schools and universities. According to the estimates, the number of unemployed reached 1.8 million.
Wojciech Jasiński, treasury minister **PAP, 10 September** Next year I count on privatisation revenues of around PLN2.5bn. If we manage to privatise PGE [large producer of energy], privatisation inflows could reach even around PLN5bn.	The Ministry of Treasury estimates that privatisation revenues in 2008 will bring PLN2.5bn with a change for twice as much in case of privatising PGE. Assuming that not the whole privatisation revenues will be spend on financing the budget deficit, and borrowing needs will reach as much as PLN45bn, the actual performance of privatisation processes will be of relatively little importance for predicting supply of treasury papers.

Market monitor









Source: Reuters, BZ WBK

Possible end of zloty correction

▪ The average zloty rate was higher in August than in July, which was in line with our expectations. The EURPLN rate fluctuated in range of 3.80-3.86. Such situation in the domestic FX market resulted from higher risk aversion and retreat from emerging market currencies. Taking this into consideration, the weakening of the zloty was relatively limited. Political situation did not have much influence in the financial market.

▪ In our view zloty is going to be stronger in September than in August. This will occur as moods in the international financial markets calm down, among others on interest rate cut by Fed. Moreover, additional positive economic data should be a strong support for the zloty as well as expectations or more monetary policy tightening. In the early elections influence should be limited, though a positive reaction may not be ruled out.

Rising spreads against the core markets

▪ In August the domestic fixed income market experienced a significant weakening, and its main reason was the retreat from the risky assets, which affected the long term of the yield curve. Later the yields rose in the shorter end of the curve with regards to the growing expectations of interest rate hikes, the MPC's move and poor results of 2Y bonds. The yield rise was parallel to falling rates in the core debt markets, and higher spread reflected higher risk aversion.

▪ The comments of some central bankers point that, a rate hike may come in November, though the market may price-in such move already in October and in case of lack of rate change the expectations will be postponed. Amid lower uncertainty in the foreign markets yields may slightly fall in the Polish market, though rate hikes expectations will keep them high at the shorter end of the curve.

Temporary dollar's strengthening

▪ Since the release of our last report we noticed a flight to quality and significant dollar appreciation to 1.34 vs. euro. Later the EURUSD rate started gradually recovering and it rocketed to 1.38 in reaction to very weak data from the US labour market.

▪ With reference to the problems of institutions investing in the subprime mortgage markets a strong rise of rates was experienced in the money market, which resulted in lower liquidity and many central bank interventions (including ECB and Fed), which supported the market with repo transactions.

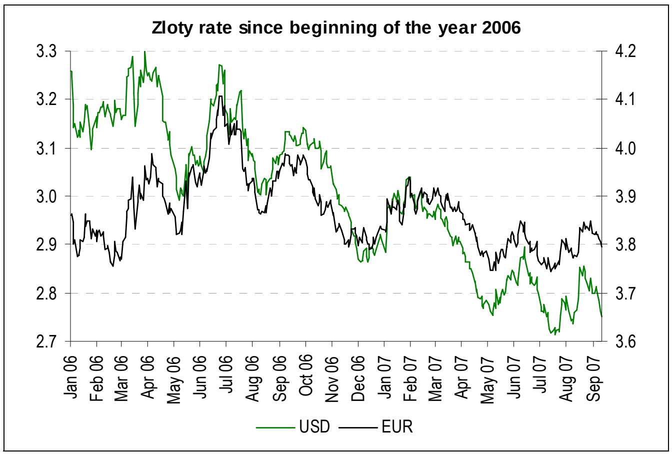
▪ Amid weaker data from the labour market in the United States, the high uncertainty in the markets and possible slowdown in the United States, Fed is most probably going to cut interest rates, which will contribute to dollar weakening. The EURUSD rate may record further increases till the year's end.

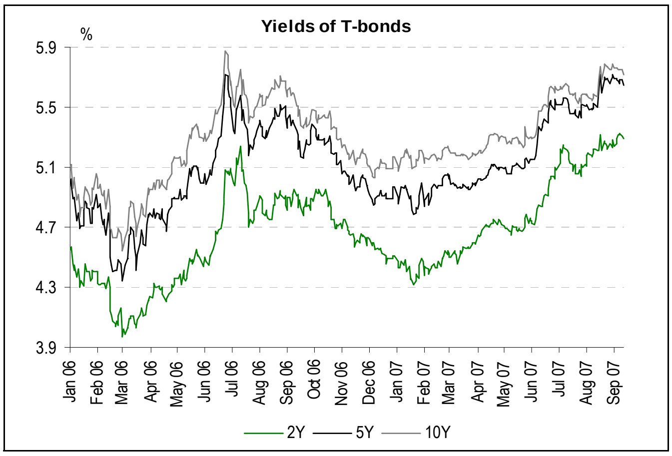
Flight to quality continued

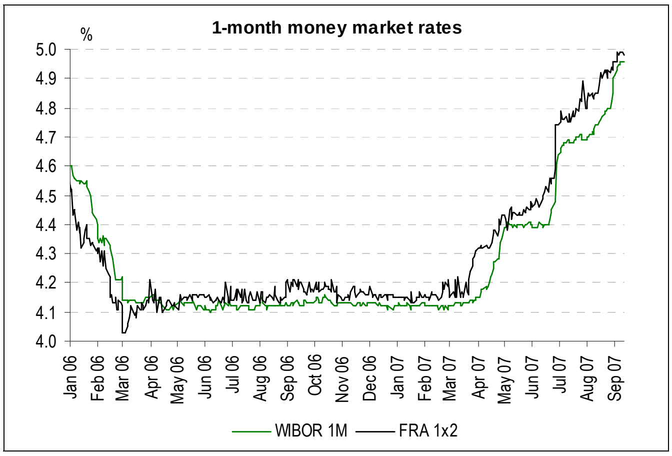
▪ New information in the problems of more financial institutions in the high risk mortgage credit markets in the US resulted in falling risk appetite and strong purchases of safe haven government securities (also US T-bills). After some stabilisation there was another wave of strengthening in reaction to data from the US labour market. Yields of 10Y Treasuries fell since mid-August from 4.76% to 4.31%. Yield of 10Y Bunds fell by 25 bp 4.11% on expectations of more hikes by the ECB.

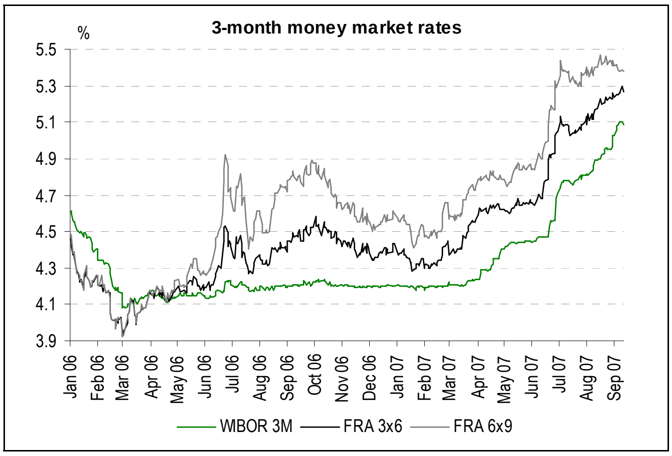
▪ We expect a cut in interest rate by the Fed at the September meeting, another one in Q4 and one more in Q1 2008, which may keep yields at low levels. Strong fundamentals in the euro zone are going to contribute to one more hike this year. However, it seems that there may be a slight correction in the markets in the short term.

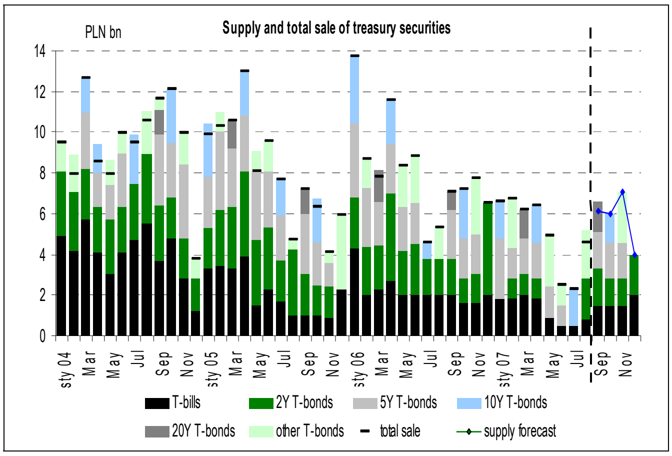
Market monitor











Treasury bill auctions (PLN m)

Date of auction	OFFER / SALE 52-week	Total
09.07.2007	500 / 500	500 / 500
23.07.2007	-	-
Total July	**500 / 500**	**500 / 500**
06.08.2007	800 / 800	800 / 800
20.08.2007	-	-
Total August	**800 / 800**	**800 / 800**
03.08.2007	900 / 900	900 / 900
17.08.2007	500- 1500	500- 1500
Total September*	**1 400 - 2400**	**1 400 - 2400**

* estimations based on Ministry of Finance preliminary information

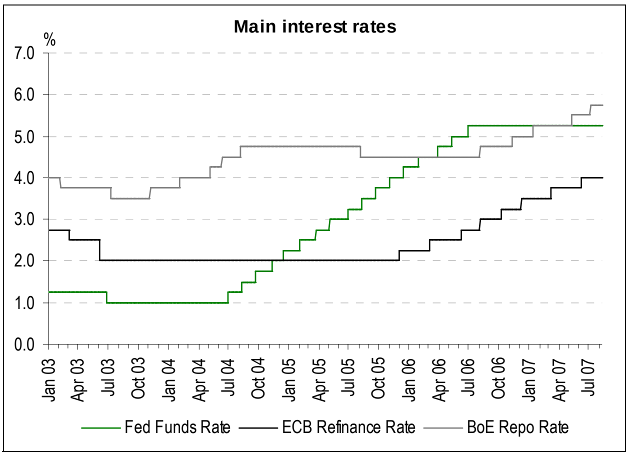
Treasury bond auctions in 2007 (PLN m)

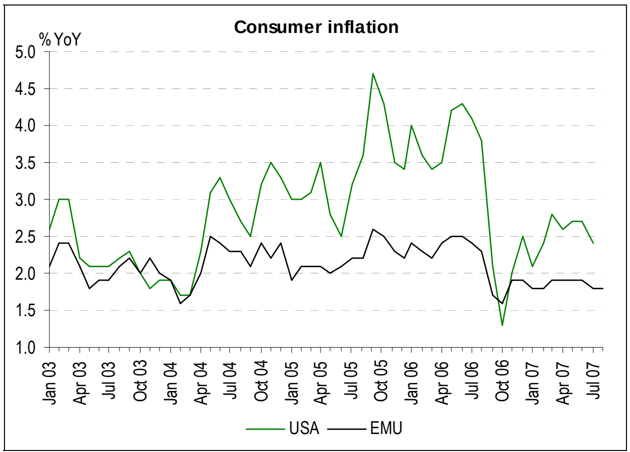
month	First auction				Second auction				Third auction			
	date	T-bonds	offer	sale	date	T-bonds	offer	sale	date	T-bonds	offer	sale
January	-	-	-	-	10.01	DS1017	1 800	1 800	17.01	PS0412	3 000	3 000
February	07.02	OK0709	1 000	1 000	14.02	WZ0118 | IZ0816	2400 | 0	2400 | 0	21.02	PS0412	1 500	1 500
March	07.03	OK0709	1 000	1 000	14.03	WS0922	1 400	1 400	21.03	PS0412	1 800	1 800
April	04.04	OK0709	1 000	1 000	11.04	DS1017	1 800	1 800	18.04	PS0412	1 800	1 800
May	-	-	-	-	09.05	WZ0118 | IZ0816	2000 | 500	2000 | 498	16.05	PS0412	1 500	1 500
June	06.06	-	-	-	13.06	WS0437	1 000	1 000	20.06	PS0412	1 000	1 002
July	04.07	-	-	-	11.07	DS1017	1 800	1 800	-	-	-	-
August	01.08	OK0709	2 000	1 400	08.08	WZ0118 | IZ0816	2 400 | 0	2 400 | 0	-	-	-	-
September	05.09	OK0709	1 800	1 800	12.09	WS0922	1 500	-	19.09	5Y	-	-
October	03.10	2Y	-	-	10.10	10Y	-	-	17.10	5Y	-	-
November	07.11	2Y	-	-	14.11	10Y WIBOR | 12Y CPI	-	-	21.11	5Y	-	-
December	05.12	2Y	-	-	-	-	-	-	-	-	-	-

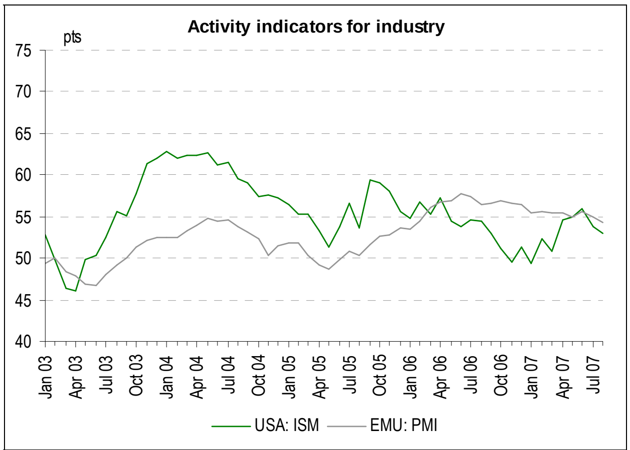
* with supplementary auction

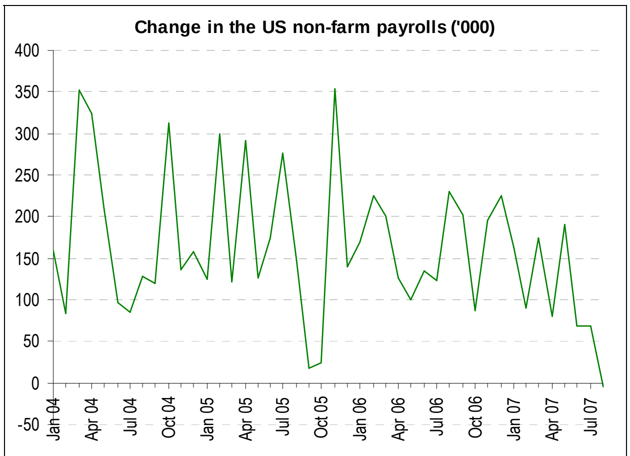
Source: Ministry of Finance, Reuters, BZ WBK

International review









Source: Reuters, ECB, Federal Reserve

ECB paused tightening, Fed may go for rate cuts

▪ Despite the fact Fed reiterated in its August communiqué the importance of the risk for inflation and that the economic growth is going to be moderate, amid increased nervousness in the financial markets and rising money market rates it cut the discount rate by 50 bp and supported market liquidity. In its communiqué Fed stated that risk for growth increased and that is going to act if needed to mitigate the adverse effects on the economy from disruptions in the financial markets.

▪ In contrary to previous expectations on an interest rate hike in the euro zone the turmoil in the financial markets contributed to postponing this decision, which was preceded by respective ECB Governor's comments. At the press briefing after the meeting Jean Claude Trichet said that monetary policy is still on accommodative side, and further moves may be pursued after stabilisation of the situation in the financial markets.

Inflation still outside Fed comfort zone

▪ The core PCE index, which is preferred by the Fed rose in July by 0.1%MoM, slightly below market expectations at 0.2%. CPI rose by 0.1%MoM (2.4%YoY), against a forecast of 0.2%. Core inflation amounted to 0.2%MoM and 2.2%YoY. PPI increased by 0.6%MoM, versus a forecast of 0.2%. The core PPI increased by 0.1%MoM, while expectations pointed to 0.2% increase. In the EMU the HICP index rose in line with forecasts in July by 1.8%. According to preliminary data this level stayed in August.

▪ The US core inflation stays outside the Fed's comfort zone, i.e. 1-2%, which till now was an argument against rate cuts. Moreover high food, fuel and loans prices growth affect American consumer sentiment (mainly the poorer ones), which is reflected in falling Michigan index. In the euro zone inflation stays near the target of the EBC, though the bank forecasts its increase.

Activity decelerates in the US and EMU

▪ ISM index for the manufacturing sector in the US fell in August to 52.9 pts. (amid higher employment index), while the services sector in the United States remained unchanged at 55.8 pts. Against forecasted decline to 54.8 pts (while employment index dropped to the lowest level in five years). Activity indices still point to economic expansion in the US.

▪ PMI index for manufacturing sector in the euro zone declined to 54.3 pts. Against 54.9 pts. in July. On the other hand, the PMI index for the services sector declined in August to 58.0 pts from 58.3 pts in July. These data show some sign of slight deceleration of economic growth in the euro zone, which is connected with higher interest rates, strong euro and high fuel prices.

▪ GDP data for Q2 in the US were revised from 3.4% to 4.0%. The revision regarded the increase of investments, net exports and inventories change, which to large extent contributed to good results in Q2. The consumer demand was also slightly upwardly revised. The core PCE index was downwardly revised from 1.4% to 1.3%YoY. The expectations point to lower GDP growth in the US in the coming quarters.

▪ Q2 GDP data in the euro zone, which showed a 2.5%YoY growth were revised as compared to the preliminary estimates.

Employment falls for the first time in 4 years

▪ The non-farm payrolls in the US declined for the first time since 2003, by 4k, while market analysts expected employment increase by 110k. Moreover the data for July and June were downwardly revised (from 92k to 68k in July and from 126k to 69k in June). What is interesting, the rate of unemployment remained unchanged at 4.6%. The tightening labour market conditions was one of the factors, which made Fed uncomfortable with rate cuts prospects. Poor data allow for such move, especially amid problems in the credit markets.

Economic calendar

Monday	Tuesday	Wednesday	Thursday	Friday
10 September	**11**	**12** ***POL: Auction of 20Y bonds*** ***POL: Balance of payments (Jul)***	**13** ***POL: CPI (Aug)*** CH: CNB meeting – decision US: New jobless claims US: Fed budget (Aug)	**14** ***POL: Money supply (Aug)*** EMU: Final HICP (Aug) US: Foreign trade prices (Aug) US: Retail sales (Aug) US: Capacity utilization (Aug) US: Industrial output (Aug) US: Preliminary Michigan (Sep)
17 ***POL: Treasury bills auction*** ***POL: Wages and Employment (Aug)*** US: NY Fed index (Sep)	**18** GER: ZEW Index (Sep) US: PPI (Aug) US: Net capital flows (Jul) US: Fed meeting – decision	**19** ***POL: Auction of 5Y bonds*** ***POL: PPI (Aug)*** ***POL: Industrial Output (Aug)*** JP: BOJ meeting – report after decision US: CPI (Aug) US: House starts (Aug)	**20** ***POL: MPC minutes (Aug)*** US: Philadelphia Fed index (Sep)	**21**
24 ***POL: Core inflation (Aug)*** ***POL: Business climate (Sep)*** JP: Market holiday	**25** ***POL: MPC meeting*** ***POL: Retail sales (Aug)*** ***POL: Unemployment (Aug)*** GER: Ifo Index (Sep) US: Consumer confidence (Sep) US: Home sales (Aug)	**26** ***POL: MPC meeting – decision*** US: Durable goods orders (Aug)	**27** ***POL: Switch auction*** EMU: M3 money supply (Aug) US: Final GDP (Q2) US: Core PCE (Q2) US: GDP deflator (Q2) US: New homes sales (Aug)	**28** ***POL: Balance of payments (Q3)*** EMU: Business climate (Sep) EMU: Preliminary HICP (Sep) US: Core PCE (Aug) US: Chicago PMI (Aug) US: Final Michigan (Sep)
1 October EMU: Manufacturing ISM (Sep) US: Manufacturing ISM (Sep)	**2** EMU: PPI (Aug)	**3** ***POL: Auction of 2Y bonds*** GER: Market holiday EMU: Non-manufacturing PMI (Sep) EMU: Retail Sales (Aug) US: ADP report (Sep) US: Non-manufacturing ISM (Sep)	**4** GB: BoE meeting – decision EMU: ECB meeting - decision US Factory orders (Aug)	**5** US: Non-farm payrolls (Sep) US: Unemployment (Sep)

Source: CSO, NBP, Finance Ministry, Reuters

MPC meetings and data release calendar for 2007

	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
MPC meeting	30-31	27-28	27-28	24-25	29-30	26-27	24-25	28-29	25-26	30-31	27-28	18-19
MPC minutes	-	-	-	-	24	21	19	23	20	25	22	13
GDP*	-	-	2	-	31	-	-	30	-	-	30	-
CPI	15	15[a]	14[b]	13	15	13	13	14	13	15	14	13
Core inflation	22		23[b]	23	23	22	23	23	24	22	23	21
PPI	19	19	19	20	21	20	19	20	19	18	20	19
Industrial output	19	19	19	20	21	20	19	20	19	18	20	19
Retail sales	29	23	23	25	25	26	24	24	25	-	-	-
Gross wages, employment	16	15	15	17	17	19	16	16	17	15	16	17
Unemployment	29	23	23	25	25	26	24	24	25	-	-	-
Foreign trade	about 50 working days after reported period											
Balance of payments*	2	-	30	-	-	29	-	-	28	-	-	-
Balance of payments	16[c]	12	14	13	18	15	13	13	12	15	13	-
Money supply	12	14	14	13	14	14	13	14	14	12	14	-
NBP balance sheet	5	7	7	6	7	6	6	7	7	5	7	-
Business climate indices	23	22	22	23	23	22	23	23	24	23	23	21

* quarterly data, [a] preliminary data, January, [b] January and February, [c] November 2006, [d] January, [e] February

Source: CSO, NBP

Economic data and forecasts

Monthly economic indicators

		Aug 06	Sep 06	Oct 06	Nov 06	Dec 06	Jan 07	Feb 07	Mar 07	Apr 07	May 07	Jun 07	Jul 07	Aug 07	Sep 07
Industrial production	%YoY	12.6	11.6	14.8	12.0	5.9	15.4	13.0	11.3	12.6	8.1	5.6	10.4	11.5	5.5
Retail sales [c]	%YoY	11.5	14.5	13.3	13.6	13.3	16.5	17.5	19.2	15.1	14.8	16.2	17.1	17.0	14.5
Unemployment rate	%	15.5	15.2	14.9	14.8	14.9	15.1	14.9	14.4	13.7	13.0	12.4	12.2	12.0	11.8
Gross wages [b c]	%YoY	5.3	5.1	4.7	3.1	8.5	7.8	6.4	9.1	8.4	8.9	9.3	9.3	9.4	9.5
Employment [b]	%YoY	3.5	3.5	3.6	3.8	4.1	3.8	4.3	4.5	4.4	4.4	4.6	4.7	4.7	4.6
Export (€) [d]	%YoY	22.3	18.6	23.0	21.8	8.3	16.2	13.8	14.6	16.5	11.3	12.8	15.7	17.3	9.6
Import (€) [d]	%YoY	22.9	19.2	27.3	21.3	16.9	22.2	12.1	21.2	24.9	14.2	18.3	16.6	19.7	14.1
Trade balance [d]	EURm	-434	-212	-311	-352	-1075	-400	-143	-683	-723	-732	-557	-668	-701	-630
Current account balance [d]	EURm	-646	222	-718	-716	-1271	-772	-566	-622	-700	-1214	-1182	-1038	-741	-400
Current account balance [d]	% GDP	-2.1	-1.9	-2.0	-2.1	-2.3	-2.5	-2.4	-2.5	-2.5	-2.8	-3.0	-3.2	-3.2	-3.4
Budget deficit (cumulative)	PLNbn	-14.5	-14.5	-16.6	-18.5	-25.1	3.1	-3.0	-4.8	-2.1	-4.3	-3.7	0.6	0.1	-1.4
Budget deficit (cumulative) [e]	% of FY plan	57.9	57.8	66.3	73.9	100.0	-10.3	10.1	16.1	6.9	14.2	12.3	-2.1	-0.4	4.6
CPI	%YoY	1.6	1.6	1.2	1.4	1.4	1.6	1.9	2.5	2.3	2.3	2.6	2.3	1.8	2.0
PPI	%YoY	3.3	3.6	3.2	2.5	2.6	3.1	3.5	3.3	2.2	2.1	1.7	1.5	1.9	2.1
Broad money (M3)	%YoY	13.0	13.4	12.8	14.6	16.0	19.3	18.0	18.0	17.8	16.0	14.7	15.6	15.1	14.6
Deposits	%YoY	12.2	12.1	11.8	13.4	15.2	18.5	18.3	17.7	18.2	16.4	15.2	15.9	15.0	14.7
Loans	%YoY	18.0	19.2	19.5	20.7	23.4	25.0	26.5	26.8	28.4	28.6	29.2	31.4	30.8	30.3
USD/PLN	PLN	3.05	3.12	3.09	2.97	2.88	2.98	2.98	2.94	2.83	2.80	2.84	2.75	2.80	2.79
EUR/PLN	PLN	3.90	3.97	3.90	3.82	3.81	3.88	3.90	3.89	3.82	3.78	3.81	3.77	3.81	3.80
Reference rate [a]	%	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.25	4.25	4.50	4.50	4.75	4.75
Lombard rate [a]	%	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.75	5.75	6.00	6.00	6.25	6.25
WIBOR 3M	%	4.19	4.21	4.22	4.20	4.20	4.20	4.20	4.22	4.32	4.44	4.52	4.78	4.80	4.95
Yield on 52-week T-bills	%	4.35	4.44	4.35	4.29	4.20	4.14	4.07	4.23	4.36	4.43	4.42	4.70	4.80	4.90
Yield on 2-year T-bonds	%	4.85	4.87	4.84	4.65	4.54	4.41	4.46	4.55	4.71	4.70	4.93	5.14	5.23	5.25
Yield on 5-year T-bonds	%	5.41	5.31	5.24	5.01	4.91	4.90	4.97	4.98	5.07	5.11	5.40	5.50	5.61	5.65
Yield on 10-year T-bonds	%	5.61	5.48	5.39	5.18	5.10	5.16	5.18	5.18	5.27	5.28	5.52	5.60	5.68	5.75

Source: CSO, NBP, Finance Ministry, BZ WBK own estimates

[a] at the end of period [b] in corporate sector [c] in nominal terms [d] balance of payments data on transaction basis [e] 2006 - % of Dec, 2007 - % of plan

Quarterly and annual economic indicators

		2005	2006	2007	2008	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07
GDP	PLNbn	983.3	1 057.9	1 155.8	1 253.2	242.4	253.9	261.4	300.1	267.1	279.6	282.9	326.3
GDP	%YoY	3.6	6.1	6.5	5.5	5.5	6.0	6.3	6.6	7.4	6.7	6.1	6.1
Domestic demand	%YoY	2.4	6.6	8.0	6.7	5.3	5.4	6.9	8.6	8.6	9.3	7.1	7.2
Private consumption	%YoY	2.0	5.2	5.7	5.6	5.4	4.8	5.6	5.1	6.9	5.1	5.4	5.4
Fixed investments	%YoY	6.5	16.5	19.0	13.5	7.6	14.5	19.3	19.3	29.6	22.3	16.0	15.5
Industrial production	%YoY	4.0	12.5	10.0	10.0	12.4	12.1	12.3	10.8	13.0	8.5	9.1	9.4
Retail sales (real terms)	%YoY	1.5	11.9	15.1	11.0	9.0	11.8	13.8	12.6	17.4	14.1	14.2	14.5
Unemployment rate [a]	%	17.6	14.9	11.5	10.0	17.8	16.0	15.2	14.9	14.4	12.4	11.8	11.5
Gross wages (real terms) [c]	%YoY	1.2	4.2	6.4	5.5	4.3	3.9	4.1	4.5	5.9	6.5	7.2	6.2
Employment [c]	%YoY	1.9	3.2	4.4	4.3	2.6	3.0	3.4	3.8	4.2	4.5	4.7	4.4
Export (€) [b]	%YoY	17.8	20.2	13.9	15.0	23.3	19.5	20.7	18.0	14.8	13.4	14.0	13.6
Import (€) [b]	%YoY	13.4	21.8	17.4	17.0	23.3	19.0	22.8	21.9	18.5	18.9	16.7	15.9
Trade balance [b]	EURm	-2 242	-3 896	-7 808	-11 260	-352	-646	-1 165	-1 733	-1 226	-2 012	-1 999	-2 571
Current account balance [b]	EURm	-4 130	-6 312	-9 756	-9 960	-1 396	-1 266	-949	-2 701	-1 950	-3 096	-2 179	-2 531
Current account balance [b]	% GDP	-1.7	-2.3	-3.2	-2.9	-1.9	-2.0	-1.9	-2.3	-2.5	-3.0	-3.4	-3.2
Budget deficit (cumulative) [a]	PLNbn	-28.6	-25.1	-23.4	-30.0	-9.0	-17.7	-14.5	-25.1	-4.8	-3.7	-1.4	-23.4
Budget deficit (cumulative) [a]	% GDP	-2.9	-2.4	-2.0	-2.4	-	-	-	-	-	-	-	-
CPI	%YoY	2.1	1.0	2.2	2.8	0.6	0.8	1.4	1.3	2.0	2.4	2.0	2.5
CPI [a]	%YoY	0.7	1.4	2.7	2.8	0.4	0.8	1.6	1.4	2.5	2.6	2.0	2.7
PPI	%YoY	0.7	2.5	2.5	3.0	0.9	3.0	3.6	2.6	3.3	2.0	1.8	3.0
Broad money (M3) [a]	%YoY	14.4	16.0	11.7	13.2	10.9	12.2	13.4	16.0	18.0	14.7	14.6	11.7
Deposits [a]	%YoY	13.4	15.2	10.5	14.9	10.3	11.9	12.1	15.2	17.7	15.2	14.7	10.5
Loans [a]	%YoY	11.8	23.4	29.6	18.0	13.6	16.0	19.2	23.4	26.8	29.2	30.3	29.6
USD/PLN	PLN	3.23	3.10	2.83	2.74	3.19	3.14	3.10	2.98	2.97	2.82	2.78	2.74
EUR/PLN	PLN	4.02	3.90	3.81	3.68	3.83	3.95	3.96	3.85	3.89	3.80	3.79	3.74
Reference rate [a]	%	4.50	4.00	5.00	5.50	4.00	4.00	4.00	4.00	4.00	4.50	4.75	5.00
Lombard rate [a]	%	6.00	5.50	6.50	7.00	5.50	5.50	5.50	5.50	5.50	6.00	6.25	6.50
WIBOR 3M	%	5.29	4.21	4.65	5.50	4.29	4.15	4.20	4.20	4.20	4.42	4.84	5.12
Yield on 52-week T-bills	%	4.92	4.18	4.60	5.40	4.02	4.06	4.37	4.28	4.14	4.40	4.80	5.03
Yield on 2-year T-bonds	%	5.04	4.57	4.98	5.40	4.23	4.49	4.89	4.67	4.47	4.78	5.21	5.45
Yield on 5-year T-bonds	%	5.25	5.03	5.37	5.70	4.67	5.04	5.36	5.05	4.95	5.19	5.58	5.75
Yield on 10-year T-bonds	%	5.24	5.22	5.50	5.90	4.83	5.27	5.55	5.22	5.17	5.36	5.68	5.80

Source: CSO, NBP, Finance Ministry, BZ WBK own estimates

[a] at the end of period; [b] balance of payments data on transaction basis [c] in corporate sector

This analysis is based on information available until 11.09.2007 has been prepared by:

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