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## MONTHLY MACROECONOMIC REVIEW

**June 2008, No 83 (6)**

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- Data on GDP growth in the first quarter clearly indicate that growth in private consumption has become a key factor helping to maintain the relatively high economic growth and partially compensate for the slower growth in investment and the negative contribution of net exports. The strong acceleration in the growth of household deposits, connected mainly with assets being moved from mutual funds to banks, creates favourable conditions for the continuation of the fast growth in private consumption. After the end of the current phase of adjustments in the structure of household portfolios, and in the face of the decreasing growth of corporate deposits, banks may start feeling more strongly the effects of the increasingly difficult access to financing sources, which may in turn lead to increased loan costs and reduced loan dynamics.
- The new NBP inflation projection will have a significant impact on further decisions concerning interest rates. This projection is to include both the favourable for inflation effects of zloty appreciation and higher interest rates, and the negative consequences of increases in regulated prices and the higher than expected by the NBP experts growth of unit labour costs. Our analysis of the likely results of all these changes suggests that their collective effect may be an upward shift of the inflation path at the start of period covered by the NBP projection and some lowering of inflation at the end of that period. The confirmation of the results of our analyses by the new inflation projection may induce many market participants to assume that the interest rate increase expected for June will be the last one in the current cycle. Because of the strength of inflationary pressures and the forecasted growth in the net inflation, to name but a few reasons, we regard this conclusion to be premature.
- The preliminary version of the assumptions for the budget draft for 2009 is based on the relatively realistic macroeconomic forecast, although the predicted inflation is clearly too low while the assumed investment and GDP growth seems to be on the high side. The proposed state budget deficit, amounting to PLN 18.2 billion would be considerably lower than that planned for this year, but still higher than the one achieved in 2007. Such a deficit level does not offer a full guarantee of following the path of fiscal deficit reduction set forth in the Convergence Programme, as it would require adopting quite optimistic assumptions regarding the level of surpluses in other parts of the general government sector. The high revenue growth envisaged in the preliminary version of the assumptions also gives rise to some considerable doubts.
- The implementation of this year's budget continues to proceed smoothly, which is primarily attributable to the significant delays in the execution of expenditure plans. This mostly concerns investment outlays, transfers to social security funds and spending connected with the utilization of EU funds. Somewhat worrying is the considerably lower than forecast by the Ministry of Finance growth in the indirect tax revenue. The continuation of the current trend in revenue from this source may result in a failure to reach the total level of revenues assumed in this year's budget.

June 2008

## KEY MACROECONOMIC INDICATORS

	Oct 07	Nov 07	Dec 07	Jan 08	Feb 08	Mar 08	Apr 08	May 08
<b>GDP and Output</b>								
GDP			6.1%					
Domestic demand			6.2%					
Private consumption			3.8%					
Investment in fixed assets, gross			18.5%					
Value added			6.2%					
in industry			7.9%					
in the construction sector			8.8%					
in the market services sector			6.9%					
Industrial production growth YoY	10.6%	8.3%	6.2%	10.6%	14.9%	0.9%	14.9%	2.3%
Industrial production growth MoM	9.6%	-4.7%	-8.7%	3.0%	1.6%	0.7%	4.0%	-8.5%
Retail sales YoY	19.4%	19.2%	12.4%	20.9%	23.8%	15.7%	17.6%	14.9%
Retail sales MoM	7.9%	-4.5%	15.7%	-18.7%	0.3%	11.8%	2.9%	-1.9%
<b>Labour Market</b>								
Average wage in the enterprise sector (PLN)	2951.67	3092.01	3244.22	2969.65	3032.70	3144.41	3137.74	3069.43
Wage growth in the enterprise sector YoY	11.0%	12.0%	7.2%	11.5%	12.8%	10.2%	12.6%	10.5%
Wage growth in the enterprise sector MoM	3.2%	4.8%	5.0%	-8.5%	2.1%	3.7%	-0.2%	-2.2%
Employment in the enterprise sector YoY	5.0%	5.0%	4.9%	5.9%	5.9%	5.8%	5.6%	5.4%
Employment in the enterprise sector MoM	0.5%	0.3%	0.2%	2.0%	0.4%	0.2%	0.1%	0.0%
Unemployment rate	11.2%	11.2%	11.4%	11.7%	11.5%	11.1%	10.5%	10.0%
<b>Foreign trade</b>								
Current account (EUR)	-1 289	-120	-1 944	-1 105	-1 324	-1 605	-1550	
Trade balance, transaction-based (EUR)	-604	-562	-1 294	-644	-933	-1 480	-1260	
Exports, transaction-based YoY (EUR)	15.8%	12.3%	20.0%	21.9%	28.7%	19.1%	31.1%	
Imports, transaction-based YoY (EUR)	17.2%	14.1%	21.2%	18.8%	32.3%	21.1%	31.3%	
Current account (% GDP)	-4.0%	-3.7%	-3.8%	-3.7%	-3.8%	-4.0%	-4.2%	
<b>Prices</b>								
CPI MoM	0.6%	0.7%	0.3%	0.7%	0.2%	0.4%	0.4%	0.8%
CPI YoY	3.0%	3.6%	4.0%	4.0%	4.2%	4.1%	4.0%	4.4%
Net inflation YoY	1.4%	1.5%	1.7%	1.9%	2.5%	2.7%	2.8%	3.2%
PPI MoM	-0.3%	-0.1%	-0.7%	1.2%	0.9%	0.6%	0.1%	0.8%
PPI YoY	2.0%	2.5%	2.3%	2.9%	3.2%	2.9%	2.5%	2.8%
<b>Money aggregates</b>								
Money supply M3 (PLN B)	541.0	547.7	560.3	568.6	579.0	581.0	593.9	599.6
Money supply YoY	13.8%	13.6%	13.4%	12.9%	13.5%	13.6%	14.9%	15.0%
Household loans YoY	39.6%	39.2%	37.9%	37.9%	37.8%	37.3%	36.2%	33.8%
Corporate loans YoY	24.7%	25.9%	24.4%	26.2%	24.8%	25.2%	24.9%	26.0%
Household deposits YoY	8.4%	10.2%	10.7%	14.2%	15.3%	17.5%	19.0%	21.2%
Corporate deposits YoY	19.6%	19.7%	14.3%	11.7%	8.2%	6.1%	7.8%	6.1%
<b>Exchange rates</b>								
EUR/PLN rate (end of month)	3.63	3.63	3.59	3.61	3.52	3.53	3.46	3.38
USD/PLN rate (end of month)	2.52	2.46	2.45	2.42	2.32	2.23	2.23	2.18
<b>Interest rates</b>								
NBP reference rate	4.75%	5.00%	5.00%	5.25%	5.50%	5.75%	5.75%	5.75%
Lombard rate	6.25%	6.50%	6.50%	6.75%	7.00%	7.25%	7.25%	7.25%
Deposit rate	3.25%	3.50%	3.50%	3.75%	4.00%	4.25%	4.25%	4.25%
WIBOR 3M	5.19%	5.56%	5.68%	5.68%	5.94%	6.15%	6.34%	6.48%
2Y bond yield	5.60%	6.04%	6.15%	5.71%	6.18%	6.29%	6.21%	6.48%
5Y bond yield	5.60%	6.04%	6.12%	5.75%	6.17%	6.12%	6.08%	6.38%
10Y bond yield	5.47%	5.78%	5.92%	5.66%	5.97%	5.96%	5.97%	6.27%
<b>Global economy</b>								
Eurozone inflation (YoYr)	2.6%	3.0%	3.1%	3.1%	3.5%	3.6%	3.3%	3.6%
Eurozone GDP (YoY)			2.4%			2.2%		
ECB basic rate	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%
US inflation (YoY)	3.5%	4.3%	4.1%	4.3%	4.0%	4.0%	3.9%	4.2%
US GDP (QoQ ann.)			0.6%					
Fed Funds target rate	4.50%	4.25%	4.25%	3.00%	3.00%	2.25%	2.00%	2.00%

Source: GUS, NBP, Eurostat, Reuters, ECB, Rezerwa Federalna, BRE Bank S.A. *Forecasts are marked in italics.*

## POLISH ECONOMY

### Changes in the structure of money supply growth – implications for the real economy

The latest GDP data (growth by 6.1% YoY in the first quarter of 2008) indicate that the Polish economy has already entered a very mature phase of the current business cycle. Growth in investment in the first quarter (15.7% YoY), although still high, is clearly lower than that reported in the record breaking first quarter of the previous year. On the other hand, an acceleration in private consumption could be observed, particularly when compared with the previous quarter (3.6% YoY in 4th quarter of 2007 and 5.6% YoY in the first quarter of 2008, respectively). Taking into account that due to the methodology of compiling the national accounts, the CSO data on the growth in the private consumption may not fully reflect its actual scale (as a result of, *inter alia*, the non-market services being included in the category, where estimates of growth in value added cannot be very precise), we may claim that private consumption is becoming the main driving force of the economy. This situation is clearly different from that observed last year, when such a role was played by investment.

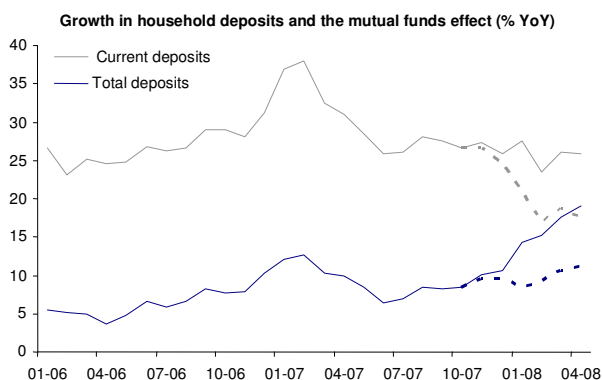
In the previous issue of our monthly we analyzed the prospects for economic growth in the context of business tendency indicators. In this case, we would like to make an attempt at answering the question regarding the conclusions that can be drawn for the Polish economy based on the analysis of monetary aggregates. Moreover, we would like not only to consider the implications for the real economy, but also to show them from the banking sector perspective, indicating existing linkages and the relevant risks.

Although money supply, as measured by M3, has been growing for some time at the stable annual rate of 13-16%, quite significant changes have been observed in its structure. As recently as in the middle of 2007 corporate deposits were growing by 23-24% while household deposits by 7-8% (these two categories together with cash in circulation account for approximately 85% of the total money supply M3). On the one hand, this situation was the result of the very high growth in revenues of enterprises, accompanied by a slower growth in costs, thanks to which enterprises enjoyed excellent financial results and could accumulate considerable surpluses of temporarily free funds. The relatively low growth in household deposits was, on the other hand, connected with the peak phase of the bull market on the Warsaw stock exchange, due to which most of the growth in savings was absorbed by the capital market (in particular mutual funds). The tendencies began to reverse in

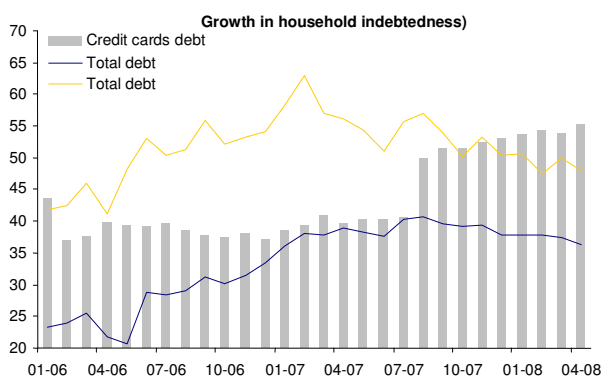
August 2007. The first wave of stock market correction, a result of the US subprime crisis, limited the inflow of funds to the capital market and led the more foresighted investors to shorten their equity positions, which in turn resulted in a higher growth in household deposits.

This growth was considerably boosted at the beginning of this year by redemptions of mutual fund shares following the culmination of the bad sentiment at the Warsaw stock exchange. In January only the balance of flows to investment funds amounted to minus 11.3 bn zlotys (in that period the WIG index dropped by over 14%). Since November 2007 the balance continues to be negative. Over the last 6 months the net amount withdrawn from mutual funds reached about 20 bn zlotys. The NBP data imply that the funds moved to banks were almost equally distributed between current and term deposits. In April 2008 the growth in household deposits reached the level of 19% YoY, although in MoM terms the growth was very small and did not even match the redemptions of mutual funds shares (which to some extent could have been connected with the deadline for the PIT settlement, falling at the end of April). The annual growth in current deposits amounted to 26% YoY in April, and in term deposits to 11% YoY. It is quite symptomatic, since the growth in term deposits was still negative by the end of 2007 and if it was not the inflow of money withdrawn from investment funds and additional incentives offered by banks for longer-term deposits, the situation would have remained unchanged (see the chart on the following page).

It may be assumed that, without shifts from mutual funds to bank deposits, the total annual growth in household deposits would have amounted to no more than 10.3% YoY in April. Admittedly, such a level would still be slightly higher than the actual growth achieved in November 2007 (8.5% YoY), but it would be too low to finance the continuously rapid credit growth. An increase in the "base" growth in household deposits, estimated in such a way, probably reflects the acceleration in wage growth reported in the first quarter of 2008. Notably, the impulse connected with the redemption of investment fund shares will not last for ever, which means that as the flows into and out of the mutual funds are balanced, the growth in the household deposits should gradually decrease.



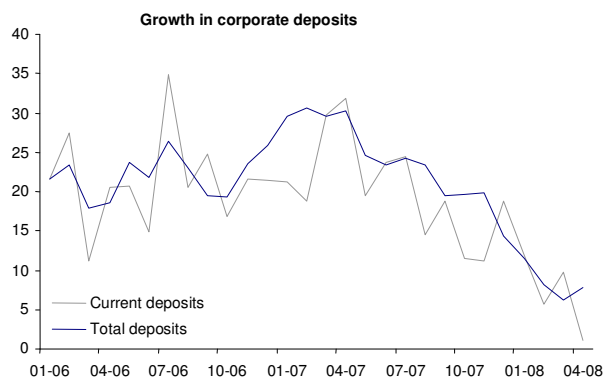
Dotted line indicates the growth of deposits without the effects of the inflow of monies withdrawn from mutual funds.



The fast growth of funds deposited on household accounts may be treated as a factor positively affecting private consumption prospects. The growth in deposits and the fact that most of the funds have been placed on current accounts indicate that they may be used to finance both current consumption and purchases of durable goods. This is indirectly confirmed by the data on household indebtedness. Although the growth in loans for this category of bank customers gradually decreases, (from over 40% YoY in mid-2007 to 36% YoY in April and below 34% in May 2008), it results primarily from the slower growth in the housing loans (57% YoY in September 2007 vs. 48% YoY in April 2008), related to the situation in the real estate market. Growth in consumer loans (reported in the NBP statistics as “other” and accounting for approximately 1/3 of all household loans) increased quite significantly – from 30% YoY in April 2007 to 37% YoY a year later. Even more dynamic was the growth in credit card debt (by 55% YoY over the last 12 months). Due to a very low share of this item in total household liabilities (just under 4%), the very fast growth in the credit cards usage should not yet be regarded as particularly worrying, but it clearly indicates the strength of consumer demand. The changing preferences of Poles regarding the financing of their short-term liabilities are reflected in the relatively low growth in overdraft loans. Their value increased over the 12 months through April by less

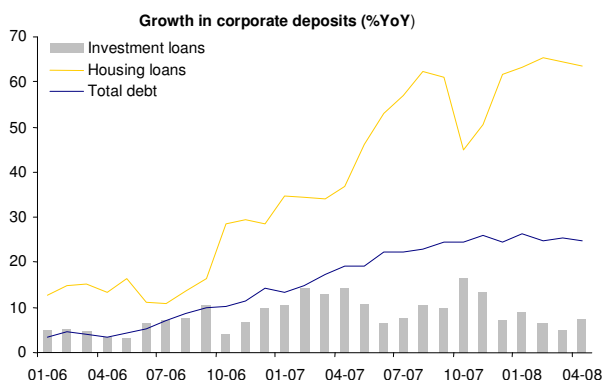
than 17%, although one has to admit that this is still much more than in the previous 12 month period (by 7 percentage points).

Growth in consumption is underpinned by the very dynamic wage and employment growth but it is also correlated with the high demand for loans. It probably reflects the growing consumption-related aspirations of households that have hardly been affected so far by the series of interest rates hikes implemented since April 2007. The question how to finance the further growth in bank loans becomes even more important in this situation, particularly if one takes into account the declining growth in corporate deposits..



The total value of corporate deposits declined in absolute terms in the first quarter of this year. As a result, their annual growth rate fell in March to 6.1% YoY. We believe that it had been caused, among others, by rising costs (including wage costs), which result in weaker financial standing of enterprises. In addition, because of the final settlement of the CIT for 2007 falling due at the end of the first quarter, many enterprises that benefited from last year’s very favourable market conditions were obliged to make sizable payments to the tax offices). Growth in corporate deposits increased somewhat in April (to 8.0% YoY), which we attribute to exceptionally good results of industrial production (growth by 14.9% YoY), but fell again in May and may slow down even further in the second half of 2008. The deteriorating financial prospects of enterprises are reflected by the changes in their demand deposits, which fell in April 2008 fell by almost 10 bn zlotys. The term deposits grew in the same month by almost 13 bn zlotys, (mostly those with up to one month maturity), which most likely was motivated by the need to create reserves for the payment of dividends planned for the next few months. It is also possible that rising interest rates encourage companies to manage their assets more efficiently and transfer some funds from current to term deposits.

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Regardless of the reasons for the lower level of corporate demand deposits, this situation does not bode well for investment dynamics over the coming months because of more limited financing possibilities. Data on corporate loans seem to confirm such a conclusion. Although growth in the total corporate loans has been quite stable and for several months remained at the level of approximately 25% YoY, the structure of this growth does not carry any positive information with regard to investment. Investment loans grew in April by as little as 7.5% YoY, whereas in October 2007 this figure was still by over 9 percentage points higher. This observation is consistent with the results of the latest NBP survey on the business tendency in the enterprise sector, which show that a lower percentage of firms are interested in this form of financing capital expenditure. Although loans for financing real estate transactions (in NBP statistics this category is presented separately, while it may also be treated as a form of financing capital expenditure) have been exhibiting an impressive annual growth of over 60%, this reflects, to a large extent, statistical base effects and can be assumed to gradually decline over the coming months. Moreover, this data suggests that a large part of the recent investment activity can be attributed to developers and other firms operating in the real estate market, which is not good news given the deteriorating conditions in this market.

The expected drop in enterprises' demand for loans will, however, mitigate tensions resulting from the changes in the funding ratio of the banking sector. If this does not materialize, banks will have to increase the scope of their external financing (which became much more expensive and difficult to obtain after the recent perturbations in the financial markets) or try to

get funds from the debt market by issuing their own securities (which is a more expensive form of financing than the interbank market or the deposit base). This could result in raising the cost of credit costs offered to bank customers, which, in turn, would reduce households consumption expenditures. Due to the strength of competitive pressures in the banking sector we do not expect any rapid increase in credit margins, the risk this factor poses for the growth in consumption and the whole of the GDP should not be disregarded.

We emphasise the risk related to more limited possibilities of financing bank lending because of the increasing importance of consumption for the continuation of economic growth. The data on monetary aggregates seem to confirm both the weakening investment activity (and we don't see any signs that this trend could be reversed in the near term), and a strong base for the further consumption growth. Large funds accumulated on household accounts may act as a buffer in a situation when market interest rates are rising and access to credit becomes more limited. Strong growth in private consumption will partly compensate for the falling investment growth allowing the GDP growth to stay at a relatively high level. This factor, however, will not be sufficient to prevent a gradual decline in the economic growth over the next several quarters.

Finally, it should be noted that under the conditions of a consumption-driven growth supported by the fast rising household incomes, producers will have little difficulty passing through the higher labour and energy costs to prices. At the same time, due to the buffer provided by funds gathered in bank accounts of households, the anti-inflation activities of the MPC may bring limited results. This means that the high output growth may be accompanied by high price dynamics for a period longer than currently assumed by most forecasts.

## MONETARY POLICY

### No hikes in May – the decision consistent with statements made by the MPC members

The May meeting of MPC ended in maintaining interest rates at the same level. The decision had been discounted earlier by financial markets (comments made by MPC members quite explicitly indicated that the next hike would be moved to June) and had only marginal influence on the valuation of financial instruments. The very communiqué of the Council, similar to that issued in April, was almost universally understood as a pre-announcement of further monetary tightening. The Council emphasised the mechanism of generating second round effects by higher prices of energy and food. The final paragraphs of the communiqué that usually serve as an instrument for communicating with the market and shaping the expectations regarding further decisions of the MPC, remained basically the same as in the previous statement (except for a newly added reference to the June inflation projection). The MPC has maintained its view that the risk of higher inflation still prevails and its lowering may require further monetary tightening. The Council also decided that a more complete assessment of inflation perspectives would be possible after new data and the new inflation projection are available.

### The key role of the June inflation projection

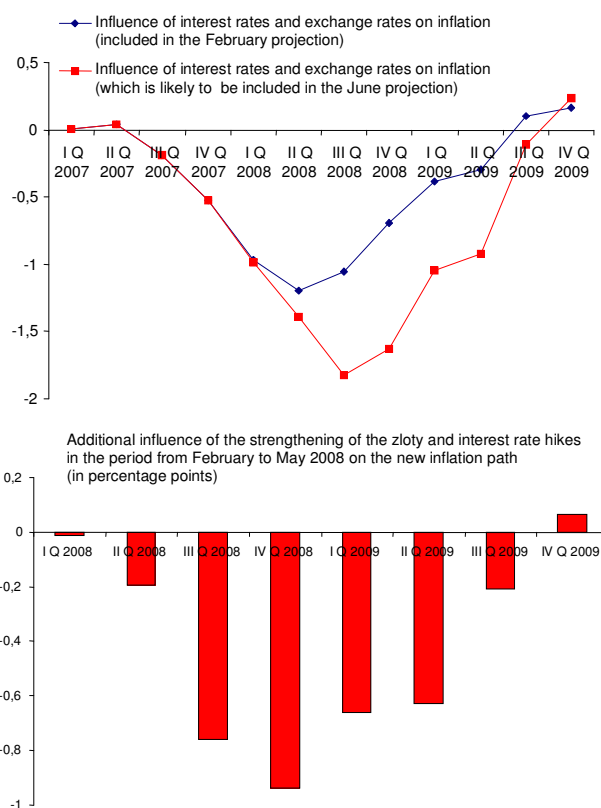
The increasing importance of the June inflation projection for the prospects of monetary policy and thus for various scenarios drawn by market participants persuaded us to try to assess the possible impact of factors not included in the previous projection on the shape of the inflation path. These factors include primarily the further strengthening of the zloty, stronger growth of unit labour costs and hikes in electricity and natural gas tariffs. The impact of these factors has been quantified based on the estimated equations of the ECMOD model (the official NBP forecasting model) and on simulation results (impulse response functions) documented in publications of the NBP.

### Stronger zloty, higher interest rates

Since the last projection (February 2008) a further strengthening of the zloty exchange rate has been recorded (see table below). Such a strengthening should contribute to a lowering of future inflation provided that it has a permanent character (which is an assumption usually made by the NBP in its forecasts). In order to quantify the influence of the further strengthening of the zloty on the June inflation projection, we calculated the difference between the influ-

ence of the zloty strengthening noted until today and the influence of the zloty strengthening already included in the February projection (see the charts below). We proceeded in a similar manner to assess the impact of interest rate hikes made in the period between February and May 2008 (NBP prepares its projections with the assumption of unchanged interest rates in the future). The appreciation of the zloty and the interest rate hikes introduced in the period between February and May 2008 could result in a downward shift of the projected inflation path in a 1-year horizon by almost 1 percentage point (see the chart below).

Changes in the PLN exchange rate (basket) in the given quarter (%)		
	February projection	June projection
I Q 2007	0.7	0.7
II Q 2007	-2.6	-2.6
III Q 2007	-0.7	-0.7
IV Q 2007	-4.3	-4.3
I Q 2008	<b>-1.5</b>	<b>-2.6</b>
II Q 2008	-	<b>-5.3</b>



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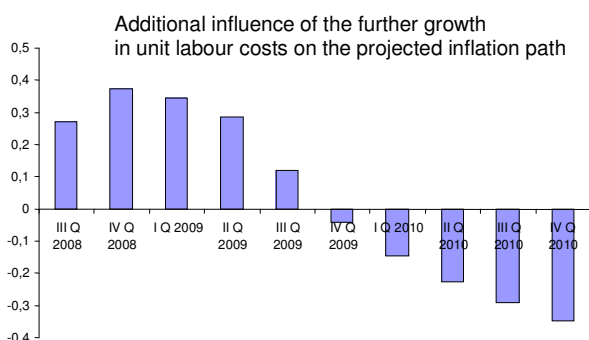
### Increases in electricity and gas tariffs

The February inflation projection of NBP also did not take into account the impact of increases in electricity and gas prices that took effect in April and May (these hikes were not yet formally approved before the release of the NBP projection). It can be conservatively assumed that these increases will move the path of projected inflation (as well as its starting point) by 0.2-0.4 percentage points over the next 12 months.

### Further growth in unit labour costs

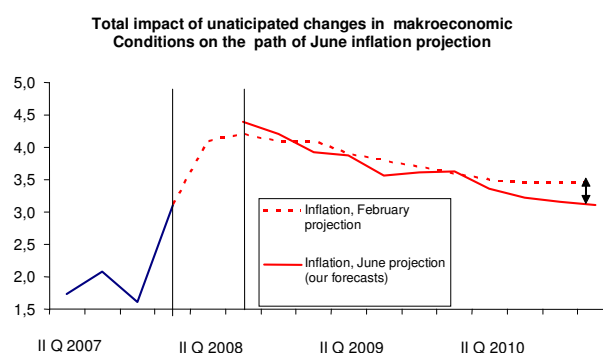
Similarly as in the autumn of 2007, we estimate that the growth in unit labour costs (i.e. one of the most important inflation determinants according to the ECMOD model) was much higher than that forecasted earlier. The February projection was based on the assumption that the growth in unit labour costs would decline quite considerably to the level below 7% YoY in the first quarter 2008, and to approximately 4% YoY in the third quarter 2008. Meanwhile, the data for the first quarter show that the ULC growth stayed above 8% YoY (i.e. close to the level observed in the last quarter of 2007). We calculated the impact of the continued strong growth in unit labour costs (not included in the previous projection) on inflation using the net inflation equation from the ECMOD model (the recursive form of the equation presented in our report of October 2007).

The influence of the further growth in unit labour costs on net inflation is illustrated by the chart below. Notably, the strong growth in the ULC results in an acceleration of inflation growth over the next 4 quarters. However, rising labour costs negatively affect the competitiveness of the economy and in a longer perspective lead to a slower GDP growth and lower demand pressures on prices (we assessed this effect on the basis of shifts in the historical projection paths as it cannot be estimated using a single equation of the model).



### The "predicted" new inflation path

We estimate that the joint effect of the changes in macroeconomic conditions discussed above may be a higher starting point of the projection and higher forecasted inflation compared to the previous projection over the next several quarters. However, it is possible that the central path of the projection will be somewhat lower than that projected in February in 2009 and 2010. We estimate that the inflation projected for 2010 will be close to the level of 3.0% YoY. We need to explain that the irregular shape of our inflation path results from the method used in its estimation (combination of individual effects). We expect the final NBP projection path to be much smoother, typical for a simulation based on a multi-equation model.



### Market scenario

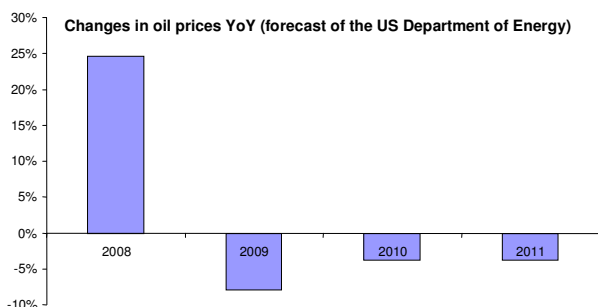
Publication of the projection, or more specifically the shape of the projected inflation path, may have significant implications for the interest rate market. A considerable drop in the forecasted inflation may temporarily generate expectations of faster and more aggressive cuts of interest rates (falling at the beginning of 2009). The probability of such a scenario may be increased by the commonly expected interest rate hike to be decided at the June MPC meeting. If the new projection indeed indicates a somewhat lower inflation in the years 2009-2010, the June hike may be regarded by many market participants as the last one in the current cycle.

### Risk factors

Changes in the macroeconomic environment as well as the planned re-estimation of the ECMOD model may significantly influence the shape of the projected inflation path and consequently the realisation of the scenario assumed by us for the monetary policy and the interest rate market. Other risk factors, not included in the analysis above, may involve expert corrections connected with food and oil prices. The latter may significantly affect the projection in the next 4 quarters. The probable effect of the oil price increases observed in the recent period may be an

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upward shift of the projected inflation path. However, the forecasts of the US Department of Energy (on which the NBP experts usually base their own forecasts) indicate a decrease in oil prices in the coming years (see the chart below), which may suggest a lowering of the price path in the NBP projection in the subsequent years.



In our calculations we did not take into account the impact of changes in the external environment. However, these changes (the expected lower growth of

the global economy in 2009) seem likely to contribute to the lowering of the forecasted inflation path.

We would like to emphasise that the inflation path resulting from our attempts to “predict” the new NBP projection is not identical with our inflation forecast. We adhere to our base mid-term scenario, according to which growth in inflation in Poland will prove to be “persistent” and will also occur in 2009 (to which the expected deregulation of the energy market may also contribute). This will mean that the period over which the MPC will be forced to maintain interest rates at a high level will be more extended. Hence, the scenario suggested above, according to which market participants may decide that the cycle of the monetary tightening has drawn to an end and will go on to expect fast rate cuts, may influence the market situation only for a rather short time. Even if the new inflation projection were to give a more positive signal, the considerable growth in net inflation, as forecasted by us, may prove an important factor limiting investors’ inclination to price in fast interest rate cuts.

## FISCAL POLICY

### **Preliminary assumptions to the budget for 2009: fairly realistic macroeconomic forecast, optimistic growth of revenues, threats to the implementation of the fiscal deficit reduction plans**

The preliminary version of assumptions for the draft budget for 2009 envisages total revenues amounting to PLN 310.5 bn and the deficit of PLN 18.2 bn. This means that after excluding the flows related to the use of EU funds, and taking into account the average annual inflation estimated at 2.9%, the real growth in revenues in relation to the amount included in this year's budget is to reach about 6%, while expenditure should grow by as little as 2%. Apart from inflation, assumed (probably intentionally) at an excessively low level, the remaining macroeconomic assumptions seem fairly reasonable, although it would be more prudent to assume a slightly lower growth of investments and the whole GDP. Moreover, the assumptions that the NBP reference rate will not exceed the level of 6% and that the zloty will strengthen quite considerably against the euro seem rather optimistic. The government's intention to lower the deficit to PLN 18.2 bn was well received by the market, which compared this amount to the deficit for this year, planned at PLN 27.1 bn. One has to keep in mind, however, that if spending does not suddenly accelerates at the end of this year, the actual deficit may prove quite significantly lower than planned. In case it reaches about PLN 20 bn (which we consider plausible if the revenue growth does not deteriorate further), it would mean that 2009 could be the second year in a row in which no noteworthy progress in reducing the state budget deficit has been achieved in spite of the relatively high GDP growth. It is worth reminding that the revised Ministry of Finance (MinFin) data show that the 2007 deficit amounted to slightly less than PLN 16 bn..

The question of the deficit level is a good illustration of the scale of difficulties which the MinFin encounters when starting to construct the next year's budget. Even if the deficit were to be finally set at approximately PLN 18 bn (which some commentators have already declared to be a very ambitious target), this would not guarantee, in our view, that the target set forth in the Convergence Programme with regard to the reduction of the deficit of the general government sector to 2% of the GDP in 2009 will be achieved. After adding the transfers to open pension funds, the real deficit of the state budget will exceed 2.5% of GDP, which means that the remaining parts of the public finance sector would have to achieve quite considerable surpluses. In 2007 the situation was saved by the surplus of the social insurance funds, estimated at 1% of the GDP, but a surplus of

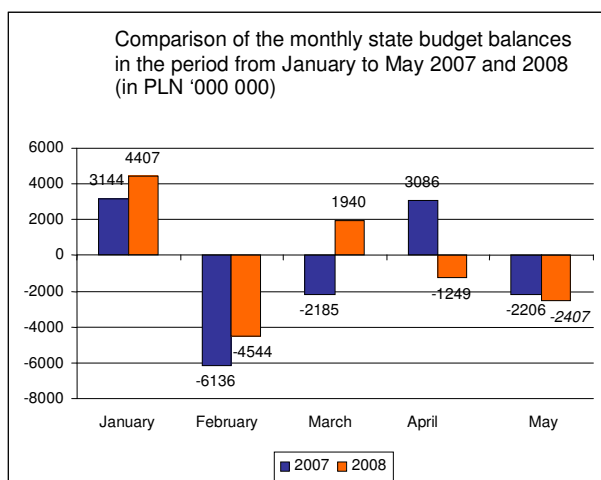
this size can hardly be assumed also for 2009. In order to set the deficit at the PLN 18 bn level, the MinFin had to plan both a fairly high growth in revenue and a much lower level than in previous years growth in expenditure. It is hard for us to assess the feasibility of the assumed expenditure growth is, as it will largely depend on the determination of the government and its ability to resist various types of pressure on spending increases (including the demands for high wage hikes in the public sector). However, the revenue growth proposed in the preliminary version of budget assumptions seems to us quite optimistic, particularly when taking into account the weakening economic growth and the consequences of the planned reductions in the PIT rates as well as of other decisions lowering the level of revenues. Another factor to be considered (as we indicate below) are the possible difficulties in collecting all the revenues planned for this year, which would mean that the nominal revenue growth assumed for the next year (10.2% overall and 9% after exclusion of the revenues from the EU) would have to be even higher when compared to the final results of this year's budget.

### **Implementation of the 2008 budget: delays in expenditure reduce the deficit, growth in indirect tax revenue lower than forecast**

The state budget deficit after the first five months of 2008 has been estimated by the Ministry of Finance at PLN 1.85 billion, i.e. by almost 2.5 bn less than in the same period of last year. However, this result also shows that in May alone the excess of expenditures over revenues amounted to over PLN 2.4 bn and was somewhat higher than in May 2007. If June does not bring an unexpected increase in the growth of revenues, the fiscal result of the whole second quarter may prove considerably worse than that of last year. Obviously, this does not mean that there are any significant threats to the implementation of the 2008 budget, as the main question remains by how much the deficit at the end of the year may be lower than planned. It is still very difficult to forecast this final deficit, as its level will largely depend on quite arbitrary decisions of the Ministry of Finance and other administrative units regarding the scale of actual spending, on the efficiency in absorbing the EU funds, and on indirect tax dynamics.

Preliminary data on the implementation of the budget in the period from January to May 2008 indicate that the lower than expected deficit was exclusively the result of considerable delays in releasing the planned expenditure. Compared to the schedule published by the Ministry of Finance, the total spending in this

period was by about PLN 11 bn lower. If spending was advancing at the same pace as in the first five months of 2007, the level of expenditure (and of the deficit) would already be higher by more than PLN 11 bn. According to the 2008 budget bill expenditure should increase this year by 22.5%, while its growth so far amounted to little over 8%. The largest delays occur in capital expenditure (no more than 7.8% of the planned spending has been implemented in the first four months of this year), in subsidies to the Social Insurance Fund and in expenditure on projects involving the use of EU funds. In our view the greatest probability that some of the delays will turn into real savings can be attributed to transfers to the Social Insurance Funds. This would be the effect of the strong in current contributions and of “advance payments” made at the end of last year. Thanks to the strong zloty and low interest rates, some savings may also occur in spending on foreign debt service, but they may be partly consumed by higher costs of servicing domestic debt (due to higher PLN interest rates and larger than planned issues of short-term Treasury bills). Expenditure related to the use of the EU funds may also prove lower than planned, but it will not directly translate into a lower deficit, as its should be assumed that the value of the EU funds registered as revenues will also be much lower.



The most worrying aspect of the implementation of this year’s budget is the unsatisfactory growth in indirect tax revenue. The growth in excise duty collection is particularly low (3.8%), but it is not drastically different from that, which has been implicitly assumed in the budget (6.5% in relation to the 2007 result) and may partly stem from usual delays, with which the consequences of hikes in excise duties on cigarettes become apparent. The weak excise duty collection so far this year indicates quite clearly, however, that the postulated reduction in excise duty on engine fuels would most probably result in a failure in

reaching the level of excise tax revenue assumed in this year’s budget. VAT revenue accounts for almost half of all tax revenues planned for 2008. VAT revenues had been forecasted to increase this year by almost 16% (compared to the 2007 result) but their actual growth thus far amounted to no more than 11.1%. Should this growth remain at the same level until the end of the year, the VAT revenues could be than by almost PLN 5 bn lower than planned. This gap could be partly filled by the higher CIT payments, but only in part, as due to deteriorating financial results of enterprises the growth in CIT revenue can be expected to decline later this year. Taking also into account the very strong probability that the budget will not receive all the planned funds from the EU, this means that there is a serious risk that the total revenue level assumed in the 2009 budget bill will not be achieved. The reasons for the relatively weak indirect tax revenue performance despite the quite strong growth in retail sales (real growth by 14% in the period from January to May), fast rising imports and much higher than assumed inflation, are rather puzzling and should be analysed in detail by the units responsible for budget implementation. One of such reasons could be the fact that inflation growth resulted, to a large extent, from increases in prices of food products that are subject to a reduced VAT rate, but it certainly cannot explain the whole problem of the relatively low VAT revenue dynamics. It should be noted that in 2007 VAT revenue increased by 14.1%, which helped to exceed the annual target by more than 4%.

**State budget results January-May 2008**

	PLN mn	% of plan	Growth (YoY)
<b>Revenue. of which:</b>	<b>108792.2</b>	<b>38.6%</b>	<b>11.0%</b>
Indirect taxes	65469.3	39.7%	8,8%
VAT	45569.3	39.1%	11.1%
Excise duty	19900.0	38.1%	3.8%
CIT	13301.5	49.0%	25.1%
PIT	15688.8	43.4%	7.1%
<b>Expenditure</b>	<b>110602.3</b>	<b>35.8%</b>	<b>8.1%</b>
Domestic debt service	7427.8	33.9%	- 8.5%
Foreign debt service	3647.7	61.6%	1.8%
Social Insurance Fund subsidy	8954.9	26.9%	35.5%
Local government subvention	20555.8	50.5%	11.2%
<b>Deficit/Surplus</b>	<b>1853.1</b>	<b>6.8%</b>	<b>- - -</b>

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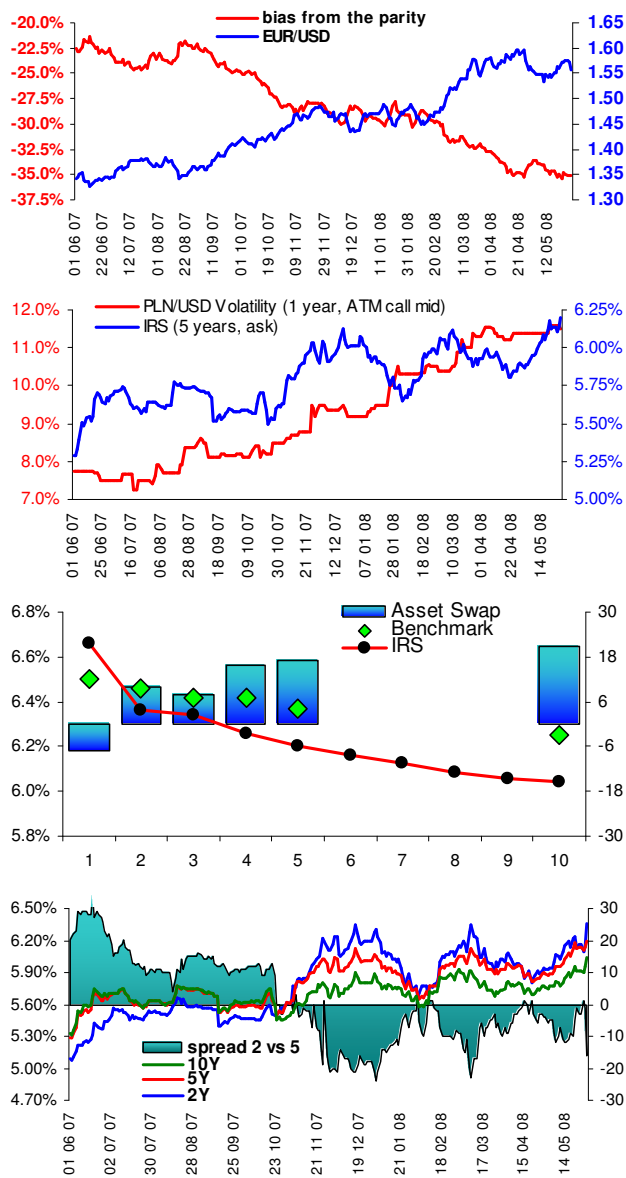
The Polish zloty strengthened against the major currencies. In the first half of the previous month the exchange rate exceeded the levels of PLN 3.40 to the euro and PLN 2.20 to the dollar. The weakness of the US dollar helped strengthen the Polish currency, as the dollar exchange rate, after a temporary strengthening against the euro, depreciated and reached the level of USD 1.58 against the euro. The end of May saw a reversal in the tendencies and return of the EUR/USD rate to the level of 1.56 (the publication of a number of macro data from the USA could have been an impulse, although their clear interpretation still remains an open issue). For the zloty, it meant a temporary weakening, particularly as Thursday, 22 May was a public holiday, which usually fosters drops in the zloty exchange rate.

The May decision of the MPC confirmed the scenario of a “break” in interest rate hikes, which strengthened the expectations regarding the next hike on the June MPC meeting. Consequently, the zloty strengthened and the exchange rate appreciated in late June to 3.36 against the euro and 2.16 against the dollar.

Fixed Income

The interest rate market saw a further flattening and a simultaneous upward shift of the yield curve. At its short end, the T-bond yields were consolidated at the levels of 6.65-6.75%. Treasury bills showed less resistance to the growth in yields, which increased to 6.80%. The 10Y bond yield exceeded 6% for the first time since mid-2006 and remains 40-50 base points above this level. The 6% threshold was also exceeded by the 10Y IRS rates. Due to the asset swaps widening with the maturity, the IRS curve is flatter than the T-bond yield curve.

Influenced by the recent macro data, the market clearly revised its position and started pricing yet another (after the one expected for June) interest rate hike this year. Expectations regarding the first rate cuts shifted over time, which is indicated by the relatively strong increase of yields in the 3-5Y tenor.



June 2008

**ECONOMIC AGENDA**

	June 2008	July 2008	August 2008	September 2008	October 2008	November 2008
CPI	13	15	13	15	14	13
Industrial production and PPI	18	18	20	18	17	20
Wages and employment in the enterprise sector	16	15	18	15	15	18
GDP estimates	-	-	29	-	-	28
Business tendency survey (GSO)	23	23	22	23	23	21
Money supply M3	13	14	14			
Balance of payments	17	15	12			
Core inflation	20	22	21	22	21	20
Official reserve assets	6	7	7			
MPC meetings	24-25	29-30	26-27	23-24	28-29	25-26
ECB meetings	5	3	7	4	2	2
FED meetings	24-25	-	5	16	29	29

Source: GUS, NBP, ECB, Federal Reserve

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