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- Prime Minister Tusk's statement setting the target date for euro adoption was a big surprise for market participants and most people concerned by this issue. We welcome the government's intention to intensify efforts aimed at joining the Eurozone, but we also see the need to make the government's plans in this area more precise. Implementation of measures that would ensure a sustained reduction of inflation down to a level compatible with the relevant Maastricht criterion will be one of the key prerequisites for these plans to succeed.
- GDP growth in Q2 (5.8% YoY) was slightly higher than expected, which can be attributed, to a large extent, to the still relatively high rate of investment growth. Also, the impact of the negative trade balance turned out to be less disadvantageous. Factors that supported investment growth rate include, among others, the quite strong activity in the construction sector and the expanding scale of investment in infrastructure. Nevertheless, we still believe that, owing to the deteriorating financial performance of enterprises, growing wage and credit costs as well as diminishing demand (and foreign demand in particular), there is a risk of a marked decline in investment growth, which, in turn, may lead to slower GDP growth.
- The high level of CPI and the expected increase in core inflation as well as the fast wage growth and the related risk of second round effects are the reasons that still make most analysts to expect some further tightening of monetary policy. However, a majority of MPC members' votes needs to be secured in order to take a decision on a rate hike. One may have quite serious doubts whether it will be possible to form such a majority given the growing risk of an economic slowdown and the expected gradual decline in the CPI-measured inflation. This suggests that the current cycle of monetary tightening is nearing its end, and that it even cannot be ruled out that it has already been completed.
- The new draft Public Finance Act contains numerous solutions first proposed by the previous government (including, in particular, the rather far-reaching changes in the organizational structure of the public finance sector), but it also presents a number of new proposals. The most important of them is, in our view, the intention to institutionalize long-term budget planning at both central and local government levels. The draft Act also postulates some further tightening of prudential rules applicable to the level of public debt. In our opinion, the greatest drawback of the new draft Act is that its authors have failed to introduce a clear rule that would limit the growth in public spending.

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KEY MACROECONOMIC INDICATORS

	Jan 08	Feb 08	Mar 08	Apr 08	May08	Jun 08	Jul 08	Aug 08
GDP and Output								
GDP			6.1%			5.8%		
Domestic demand			6.3%			6.2%		
Private consumption			5.6%			5.6%		
Investment in fixed assets, gross			15.7%			15.2%		
Value added			5.5%			6.1%		
in industry			6.9%			6.9%		
in the construction sector			16.7%			17.8%		
in the market services sector			6.7%			5.5%		
Industrial production growth YoY	10.6%	14.9%	0.9%	14.9%	2.3%	7.2%	5.6%	-3.7%
Industrial production growth MoM	3.0%	1.6%	0.7%	4.0%	-8.5%	5.0%	-3.4%	-8.1%
Retail sales YoY	20.9%	23.8%	15.7%	17.6%	14.9%	14.2%	14.3%	7.7%
Retail sales MoM	-18.7%	0.3%	11.8%	2.9%	-1.9%	2.4%	1.8%	-3.9%
Labour Market								
Average wage in the enterprise sector (PLN)	2969.65	3032.70	3144.41	3137.74	3.069.43	3.215.32	3228.98	3165.14
Wage growth in the enterprise sector YoY	11.5%	12.8%	10.2%	12.6%	10.5%	12.0%	11.6%	9.7%
Wage growth in the enterprise sector MoM	-8.5%	2.1%	3.7%	-0.2%	-2.2%	4.8%	0.4%	-2.0%
Employment in the enterprise sector YoY	5.9%	5.9%	5.8%	5.6%	5.4%	4.8%	4.7%	4.2%
Employment in the enterprise sector MoM	2.0%	0.4%	0.2%	0.1%	0.0%	0.0%	0.2%	0.0%
Unemployment rate	11.7%	11.5%	11.1%	10.5%	10.0%	9.6%	9.4%	9.3%
Foreign trade								
Current account (EUR)	-1 105	-1 324	-1 605	-1550	-1.602	-2292	-1222	
Trade balance, transaction-based (EUR)	-644	-933	-1 480	-1260	-1.240	-1706	-1563	
Exports, transaction-based YoY (EUR)	21.9%	28.7%	19.1%	31.1%	12.2%	16.1%	22.7%	
Imports, transaction-based YoY (EUR)	18.8%	32.3%	21.1%	31.3%	14.0%	20.2%	22.4%	
Current account (% GDP)	-3.7%	-3.8%	-4.1%	-4.2%	-4.3%	-4.4%	-4.3%	
Prices								
CPI MoM	0.7%	0.2%	0.4%	0.4%	0.8%	0.2%	0.0%	-0.4%
CPI YoY	4.0%	4.2%	4.1%	4.0%	4.4%	4.6%	4.8%	4.8%
Net inflation YoY	1.9%	2.5%	2.7%	2.8%	3.2%	3.4%	3.5%	4.0%
PPI MoM	1.2%	0.9%	0.6%	-0.1%	0.7%	0.3%	0.0%	0.2%
PPI YoY	2.9%	3.2%	2.9%	2.5%	2.7%	2.7%	2.3%	2.0%
Money aggregates								
Money supply M3 (PLN B)	568.6	579.0	581.0	593.9	599.6	605.7	616.1	627.5
Money supply YoY	12.9%	13.5%	13.6%	14.9%	15.0%	16.2%	16.8%	16.6%
Household loans YoY	37.9%	37.8%	37.3%	36.2%	33.8%	34.2%	30.5%	30.8%
Corporate loans YoY	26.2%	24.8%	25.2%	24.9%	26.0%	24.6%	23.5%	25.3%
Household deposits YoY	14.2%	15.3%	17.5%	19.0%	21.2%	22.6%	24.7%	23.5%
Corporate deposits YoY	11.7%	8.2%	6.1%	7.8%	6.1%	6.8%	7.0%	3.1%
Forex rates								
EUR/PLN rate (end of month)	3.61	3.52	3.53	3.46	3.38	3.35	3.20	3.35
USD/PLN rate (end of month)	2.42	2.32	2.23	2.23	2.18	2.12	2.05	2.27
Interest rates								
NBP reference rate	5.25%	5.50%	5.75%	5.75%	5.75%	6.00%	6.00%	6.00%
Lombard rate	6.75%	7.00%	7.25%	7.25%	7.25%	7.50%	7.50%	7.50%
Deposit rate	3.75%	4.00%	4.25%	4.25%	4.25%	4.50%	4.50%	4.50%
WIBOR 3M	5.68%	5.94%	6.15%	6.34%	6.48%	6.65%	6.56%	6.50%
2Y bond yield	5.71%	6.18%	6.29%	6.21%	6.48%	6.89%	6.53%	6.35%
5Y bond yield	5.75%	6.17%	6.12%	6.08%	6.38%	6.78%	6.31%	6.17%
10Y bond yield	5.66%	5.97%	5.96%	5.97%	6.27%	6.61%	6.25%	6.05%
Global economy								
Eurozone inflation (YoY)	3.1%	3.5%	3.6%	3.3%	3.6%	4.0%	4.1%	3.8%
Eurozone GDP (YoY)			2.2%			1.4%		
ECB basic rate	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%	4.25%	4.25%
US inflation (YoY)	4.3%	4.0%	4.0%	3.9%	4.2%	5.0%	5.6%	5.4%
US GDP (QoQ ann.)			0.9%			1.9%		
Fed Funds target rate	3.00%	3.00%	2.25%	2.00%	2.00%	2.00%	2.00%	2.00%

Source: CSO, NBP, Eurostat, Reuters, ECB, Federal Reserve, BRE Bank S.A. *Forecasts are marked in italics.*

POLISH ECONOMY

Surprising announcement of the target date for euro adoption

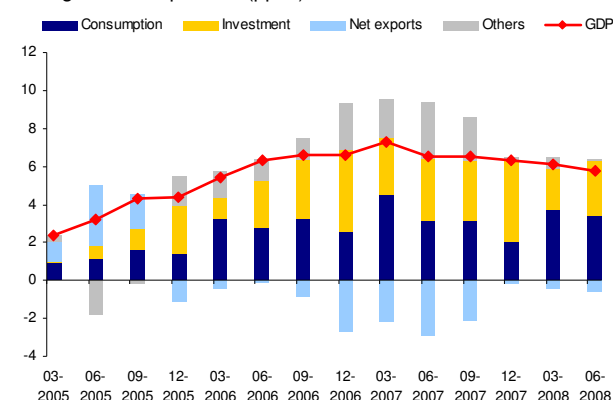
During the session of the Economic Forum in Krynica Prime Minister Donald Tusk unexpectedly announced that Poland should join the Eurozone already in 2011. This announcement was very surprising in itself, but also in the light of the earlier statements made by representatives of the Ministry of Finance which suggested that the entry of the zloty into the ERM2 mechanism may be considered only after the financial markets stabilize and once the issue whether Constitutional amendments are necessary is resolved. The date indicated by the Prime Minister's for adopting the euro (2011) was also confusing because taken literally it would mean that the zloty should join the ERM2 almost immediately. If this were the case, it would have been more appropriate to join this mechanism before publicly announcing the target date for the Eurozone entry, since the large strengthening of the zloty in response to the PM's statement indicates the consequences of announcing such steps in the reverse order. However, it has been later clarified that the government intends to fulfil all the conditions for adopting the euro by 2011, which means that the actual switch to euro would happen at the start of 2012. Nonetheless, also this date gives rise to some major doubts, since if the political agenda remains as it is, then final decisions concerning this matter would have to be made during an electoral campaign and just before the change of the government. We certainly welcome the government's intention to intensify efforts leading towards Poland's entry into the Eurozone. One of the key factors ensuring success in this endeavor lies in setting a realistic deadline and finding a proper way of communicating with financial markets and the whole society. An announcement of a fast entry into the Eurozone also implies the necessity of intensifying efforts aimed at a permanent reduction of inflation down to the level compatible with the relevant Maastricht criterion.

Sound GDP Data for Q2, yet the Outlook is Less Favorable

The data reflecting GDP growth in the second quarter were a positive surprise altogether. While the market consensus on Q2 growth had been moving down towards about 5.5% YoY following the weakening data on output growth, the figures published by the Central Statistical Office (CSO) revealed a growth of 5.8% YoY, i.e. not much lower than the 6.1% recorded in Q1. This relatively high GDP growth rate was due to both the continued strength of private

consumption (5.6% YoY), which was in line with the market consensus, and to a somewhat higher than the expected investment dynamics (15.2% YoY). Like in Q1, public consumption (-1.2% YoY) has adversely impacted the GDP growth, which must be attributed to the slow progress in releasing the budgeted expenditure (only 42.4% of spending planned for this year were made by the end of June). The biggest surprise was the scale of the negative contribution of net exports (-0.6 ppts.), which has been much lower than it might have been anticipated based on the data on the balance of payments available beforehand. One of the factors explaining this better outcome were differences in export and import deflators, which resulted in an improvement of the balance expressed at constant prices.

GDP growth composition (ppts.)

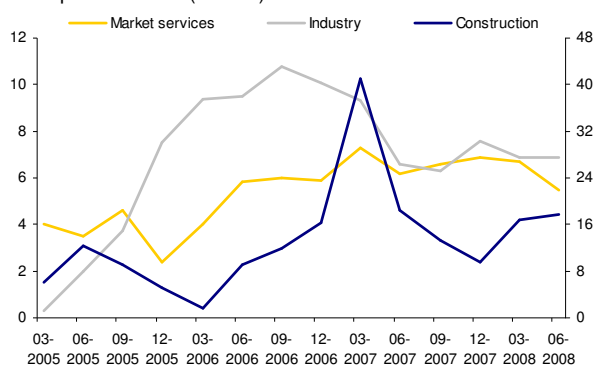


Of particular importance to the economic growth outlook are the trends in investments. As compared to the previous quarter, the growth rate in expenditure on fixed assets fell by 0.5 ppts only. The growth rate of the entire capital formation reported a more substantial drop (from 17.3% YoY in Q1 to 14.7% YoY), which indicates a significantly slower growth in inventories. Given these circumstances, there arises a question where does this still rapid investment growth come from and how long can it last? It appears that it was quite strongly impacted by the strong activity in the construction sector, which in Q2 reported a 17.8% growth in the value added, i.e. by 1.1 ppts. more than in the previous period. At the same time, the growth rate of value added in the remaining sectors of the economy has either remained unchanged (in industry it grew by 6.9% YoY) or tended downwards (e.g. in market services, growth by 5.5% YoY versus 6.7% YoY in the previous quarter). It means that the value added in both industry and market services increased at a pace which is slower than wage growth. Hence, rise

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in the profits of companies in these sectors was relatively slower, which should reduce their willingness to invest and in a longer perspective induce them to seek savings. According to data published by the CSO, the rate of profit growth reported by companies in the non-financial sector declined from more than 32% YoY in the H1 2007 down to 3.6% in the H1 2008, whilst the manufacturing sector has even reported a drop in its profits. At the same time the average cost index grew by 0.5 ppts. (mainly due to the fast growth in wages and costs of outsourced services) and the key profitability ratios deteriorated by the same degree.

Growth of the value added in market services, industry and consumption sectors (% YoY)



The confirmation of strong activity in the construction sector can be found in the CSO data on investment expenditure of enterprises during the H1 2007. However, it must be emphasized that these figures do not cover all the companies, but only companies with at least 50 employees. Hence, these data are not fully comparable with national account statistics, yet may serve as a useful tool for inter-sectoral comparisons. The construction sector reported growth in investment outlays (at current prices) by 32.0% YoY, and was outperformed only by the “production and supply of electric energy, gas and water” sector, which the corresponding expenditure grew by 37.4% YoY. For the sake of comparison, in the manufacturing sector investment expenditure in Q1 2008 grew by only 18.0% YoY. In all the sectors of the economy (apart from agriculture) the total outlays increased during this period by 18.6% YoY, whereas construction expenditure on buildings and construction works grew faster (20.6% YoY) than spending on equipment (machines, equipment, tools and devices, vehicles, other movables, etc. – 17.6% YoY). All these factors also seem to confirm the important role of the construction sector in sustaining investment growth.

CSO data also reflect some other significant changes in the structure of total investment. The share of investment undertaken by foreign-owned enterprises declined substantially (from 44% a year ago to 38%

in the H1 2008). This corresponds quite well with the more than 20% drop in FDI inflow as reported in the balance of payments’ statistics. The growing role of infrastructural investments is exemplified by the significant increase in the share of spending by public sector enterprises. Also, the investment spending of large corporations (above 250 employees) grew at a pace almost twice of that reported by companies with lower employment levels.

One of the possible explanations for the still relatively high investment growth could be the continuation of projects started in the earlier periods. In fact, neither the financial standing of companies nor the prospects of the Polish economy have deteriorated to such an extent so as to abandon the completion of these projects. Such thesis is indirectly supported by the results of NBP business tendency surveys indicating a high level of continued investment but less interest in expanding the earlier prepared investment projects. It may suggest that the coming quarters may bring a significant drop in the investment dynamics. However, CSO data which indicate the growth in the quantity (by more than 43%) as well as in value (by almost 26%) of newly launched investment fail to confirm such a claim. Nevertheless, these figures may be slightly misleading, since almost 2/3 of new projects are small electricity or gas supply connections. On the one hand this can be linked with rising outlays on production and supply of electric energy, while on the other it might confirm the thesis that many construction projects are now near to being completed. Growth in the estimated value of new projects may, in turn, be associated with the growing share of more capital-consuming infrastructural projects.

Some information concerning the overall investment activity and the situation in the construction sector can also be derived from data on monetary aggregates. The higher growth in investment loans (approx. 17% YoY now versus 7% at the end of 2007) suggests that due to the diminishing level of own funds (drop in the value of bank deposits and worse operating results of companies, the implementation of investment plans becomes more and more dependent upon access to bank financing. Growth rate of real estate loans for corporations has gone down from 60% YoY in Q1 to approx. 45% YoY in the recent months, which may signal some deterioration in the outlook for the construction sector. At the same time, the growth rate of housing loans for households declined from about 50% YoY to about 35% YoY. Although household expenditures are not included in fixed asset expenditure (though they are included in fixed capital formation), they are linked with some investments in technical infrastructure (such as the above-mentioned power

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connections) or the construction of ancillary commercial properties. Thus, the inflection point in the housing construction will most probably come at such a time, when the construction sector ceases to be the driver of total investments and GDP growth.

However, the question whether a deep dive in the real estate loans may be considered a forewarning of a radical change of the situation in the real estate market remains an open issue. In the case of housing loans, July witnessed their drop in absolute terms for the first time since February 2005. Analysis of this phenomenon must take into account that almost 57% of all housing loans are foreign-denominated (mostly in Swiss franc) and that the Polish zloty reached in July the peak of its strength. Excluding the zloty appreciation effect, the growth of foreign-currency loans could still be estimated at 5% per month. It would give an entirely different picture of the conditions prevailing at the real estate market, if not for the growing volume of refinancing loans. Strong zloty coupled with a substantial drop of margins over the last few years favored expansion of the refinancing loan market, which due to the bid and ask spread of exchange rates boosted the value of debt in the foreign currency. However, the refinancing loans alone do not have any effect of strengthening the demand for real property. The importance of FX valuation effects was visible in August, when about one half of the record high increase in housing loans (by more than PLN 8.5 bn) could be attributed to the strong depreciation of the zloty against the Swiss frank.

Irregardless of these doubts, it must be emphasized that the construction sector alone will not be able to push economic growth due to its limited share in total expenditure of enterprises. According to CSO data, in the group of companies with more than 50 employees, this share in the first half of 2008 amounted to only 2.5%. Due to the specificity of the construction business, smaller companies are an important constituent of this entire sector, which somewhat increases its share in the national economy. However, this share is still not large enough to uphold the claim that this sector might provide enough support to sustain strong GDP growth in the coming quarters.

The recent data on industrial output clearly point to the risk of a significant slowdown in economic activity. The annual growth rate in sold production fell in the negative territory for the first time since 2005 and reached -3.7%. This, and many other indicators, suggest that the GDP growth in the third quarter will decline quite substantially. In our opinion, this is most probably the time of the inflection point for the current business cycle, which also coincides with the shift of the center of the global slowdown to the Eurozone. Therefore, when assessing the prospects of our economy, we would place a much greater focus on the increasingly weak current data than on the still sound figures from the second quarter (which today have a historical value only). We anticipate that in the last quarter of this year the rate of GDP growth will slow down to approx. 4% YoY, which suggests that the growth rate for the whole 2008 may only slightly exceed 5%.

MONETARY POLICY

Will the NBP interest rates go up again?

Views on the further decisions of the MPC have recently become much more polarized. While most analysts still stick to the view the MPC will hike the rates at least one more time (most probably in October), there is also a strong (and growing) group of persons who are of the opinion that the current monetary policy tightening cycle, commenced in April 2007, has come to an end. We feel more inclined to adhere to the latter position although our belief that interest rates will not rise any further was somewhat weakened by the unexpected announcement regarding the target date for Poland's entry into the euro area. Several MPC members indicated that this may have an impact on the further conduct of monetary policy. A similar conditional statement was later included in the official document presenting the monetary policy assumptions for 2009. There is also still some uncertainty regarding the actual condition of the Polish economy and scale of the expected economic slowdown. The GDP data for the the second quarter of this year were somewhat stronger than expected, but the recent production and retail sales data are providing a rather worrying picture. When trying to predict the MPC decisions it is necessary to consider both the so-called fundamental factors that define the scale of threats to price stability and the possible reaction of individual Council members to changes in such factors. Taking into account only statistical data and current macroeconomic forecasts, one may keep claiming (as „hawkish” members of the Council do) that another rise in interest rates would help reduce inflation and would not significantly impact the outlook for economic growth. A rate hike is supported, first and foremost, by projections pointing to the risk of a considerable rise in core inflation (from the present 2.7% up to about 4.0% in mid-2009) as well as by rising inflationary expectations and the still high wage growth. It is worth pointing out that, although the new core inflation index (ex. all food and energy prices) still stays at a relatively low level (2.7% in August), since the beginning of this year it has grown significantly more than the CPI index, which means that the “blame” for rising headline inflation no longer can be put on the fast increases in prices of food and energy. Money supply growth continues to be high (16,6% in August) and so is the loan momentum (although it has been gradually declining). One can also claim that the GDP data published by the Central Statistical Office (CSO) suggest that higher interest rates have not yet negatively affected the rate of economic growth. All these factors put together suggest that there is still

space for at least one more hike in NBP reference rate.

However, whether any further hike in interest rates will actually happen depends on the distribution of votes in the very divided MPC. In the setting where the groups of self-declared or perceived “hawks” and “doves” comprise four Council members each, the positions to be taken by professors Sławiński and Czekaj will be of particular significance. The former is known for attaching great importance to the level of exchange rate and it is probably concerns about the detrimental effects of an excessive appreciation of the zloty that have recently brought the him closer to the “dovish” group. However, the large depreciation of the zloty since the beginning of August (by about 15% against the dollar and about 6% against the euro) should appease these concerns and therefore it cannot be ruled out that professor Sławiński could get convinced to vote in favor of one more rates hike. Until quite recently, the strong zloty was one of the MPC's main allies in its struggle against inflation, thus one may even venture to speculate that the intention to prevent an excessive weakening of the Polish currency was one of the factors that led to maintaining a de facto tightening bias in the recent MPC statements.

The position to be taken by professor Czekaj is quite hard to predict. On numerous occasions his vote was decisive for the results of the MPC voting. It cannot be excluded that professor Czekaj will oppose further tightening of monetary policy. He seems to put the risk of a further growth in prices at par with the risk of economic slowdown, and recent signals from the economy may suggest that the latter threat is getting more acute. Data on quite a decent GDP growth rate in Q2 refer to the past, while we have no doubts that this rate will decline considerably in the forthcoming quarters. Industrial output growth was negative in August, the decline in the unemployment rate eased and first drops in employment levels were reported in some branches of industry. Prospects for the Polish economy are turning for the worse as evidenced by the majority of business tendency indicators, including the PMI index that has hit its lowest level since 2002. In view of the adverse effects of the earlier appreciation of the zloty, growing unit labor costs and much higher-than-expected slowdown of economic activity in the euro zone, outlook for Polish exports is becoming less favorable. None of these signals can be ignored either by professor Czekaj, or by the remaining members of the MPC, although, undoubtedly, their impact on the vote of each MPC member will be different. The situation gets even more complicated because, owing to drops in prices

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of crude oil and various agricultural products, and despite expectations of a quite a substantial rise in core inflation, the CPI index will soon commence to fall (most likely to below 4.5% already in September). In its choices, the MPC cannot also completely disregard decisions taken by other central banks (such as, for example, the increasingly evident change in the policy stance of the ECB, or the earlier rates cut in the Czech Republic).

The complexity and ambiguity of signals from the Polish economy and its external environment, coupled with the clear risk of further growth in core inflation, faces the MPC members with the daunting

task of defining an adequate policy response. However, just as difficult is the task of analysts who are trying to anticipate the MPC decisions. In addition to finding an appropriate interpretation of signals coming from the economy, they also have to try to define a possible reaction function for the MPC and its individual members. A quite common reaction in a highly uncertain setting is waiting for additional information and this is the factor that may induce the MPC to refrain from increasing interest rates. Later on, as the signs of the looming economic slowdown intensify, it may prove be too late for hiking the rates any further.

FISCAL POLICY

Partly new, partly old draft Public Finance Act.

The new draft Public Finance Act, submitted by the Ministry of Finance (MinFin), is to a large extent based on ideas already presented during the term of Minister Zyta Gilowska, but introduces also several new proposals, with the most important being the intended institutionalization of long-term budget planning. The four-year Long-Term Financial Plan of the State (LTFPS), submitted by the Council of Ministers and approved by the Sejm, would be the instrument to serve this objective. However, the LTFPS is meant to have the form of a Sejm resolution instead of a binding legal act. Such a plan will have its counterparts at the local government level in the form of long-term financial projections (LTFP) covering also at least a 4-year horizon. It is of paramount significance that the level of deficit stipulated in the LTFPS should be (in principle, without any adjustments) taken into consideration when drafting annual budget bills. A strive to lengthen the time-horizon of fiscal policy deserves to be fully supported as it should bring about increased effectiveness and predictability of this policy. Two major doubts that may be raised with regard to the MinFin proposals concern the decision to refrain from adopting a transparent rule that would curb growth in public expenditure and the quite unclear hierarchy and diverging time-spans of various documents presenting the government's fiscal policy plans. Experience of many other countries, as well as recommendations of the IMF and other international organizations suggest that the adoption of an expenditure rule may be one of the most effective ways to consolidate public finance. The proposed LTFPS does not explicitly envisage introducing such a rule, as it is the level of deficit that is to be the most binding, which, in turn, brings the risk of giving fiscal policy a pro-cyclical bias. Our second doubt refers to the fact that the LTFPS, adopted as a resolution of the Sejm, would not be legally binding and that its links with other key documents, including first and foremost the Budget Bill and the Convergence Program, do not seem fully clear. The latter gained on importance due to a recommendation that it should be taken into account (on par with LTFPS provisions?) when drafting the budget bill (Article 122 of the MinFin's draft), but it still would remain subject to approval only by the Council of Ministers. Each of the three documents is to be prepared and presented at a different time and is to cover dissimilar periods (four years in case of the LTFPS, three years in case of the Convergence Program and one plus two years in case of the justification to the Budget Bill). Moreover, some important for the financial policy provisions are also to be contained in the medium-

term National Development Strategy and the Public Debt Management Strategy.

Instead of introducing a rule curbing the growth in expenditure, the MinFin opted for a modification of prudential rules that refer to the level of public debt. According to the new proposal, once the debt exceeds the threshold of 47% of the GDP, the state budget deficit could not be set at a higher level than in the preceding year, while in case of debt within the range of 52-55% of the GDP, the level of deficit would have to ensure a drop in this ratio. Exceeding the threshold of 55% of the GDP would activate several additional measures, such as freezing wages paid out of the state budget, reducing indexation of old-age and disability pensions, ban on new public investment and prohibition to grant new loans financed with state budget resources. An important change comparing to current rules is that the government's efforts aimed at restoring the health of public finance would get obligatory support of local governments only after the debt has surpassed the constitutionally determined ceiling of 60% of the GDP. In such a situation, the budgets of local government units could no longer provide for a deficit. Pursuant to the stipulations of the current Public Finance Law, prudential norms rules start to be binding for local government units once the public debt exceeds 50% of the GDP. Local government institutions have for long postulated that the rules for incurring liabilities should be made more flexible, but if introduced, the presently proposed solutions would mean that until the debt to GDP ratio reaches 60% the entire burden of corrective actions would rest with the state budget. Obviously, the modification of prudential norms, as proposed by the MinFin, might contribute to enhancing fiscal discipline, but we are not convinced whether, in order to reach this objective, it was necessary to multiply the number of quite arbitrarily determined thresholds, and whether the newly proposed rules for local governments would provide for the tightening of currently applicable norms. When submitting its new proposals, the MinFin failed to resist the temptation of pointing to savings that the implementation of the new rules should produce („PLN 500 million annually, or more”), although with the current debt to GDP ratio, such savings are of a purely hypothetical nature. On the other hand, the present MinFin leaders can be praised for not claiming that changes in the organizational structure of the public finance sector, first proposed by professor Gilowska (and to a large extent upheld in the current version of the draft law), will bring about savings earlier assessed at approx. PLN 10 bn. These far-reaching changes are to consist, among others, in winding-up of all auxiliary

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units, some budgetary establishments and special purpose funds, as well as in the introduction of „executive agencies“. Also, the scope of the public finance sector is to be adapted to the principles set forth in EU regulations (ESA95). However, it does not follow from the provisions of the proposed act that pursuant to EU rules, transfers to open pension funds will be considered as state budget expenditure. The current approach, i.e. putting these transfers „below the line“, distorts the actual level of deficit and requires adjustments when fiscal notifications are

sent to the EU. Other major changes include a yet another modification of the method of presenting settlements with the EU (in the form of a separate „European funds budget“) and further steps towards the introduction of task-based budgeting. All in all, the new draft Public Finance Act can be considered a step in the right direction, although not all of the proposed solutions seem appropriately substantiated or most urgent, while some solutions that, in our opinion, are needed, are missing in the draft.

MARKETS

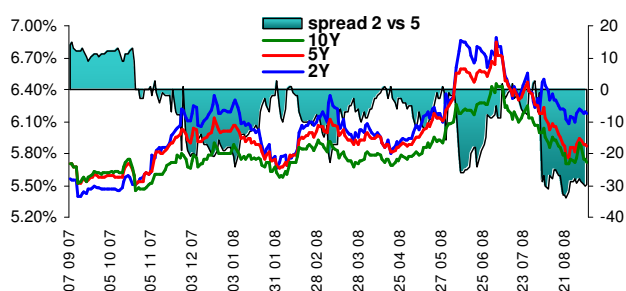
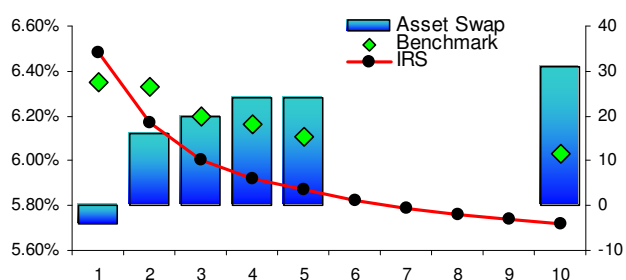
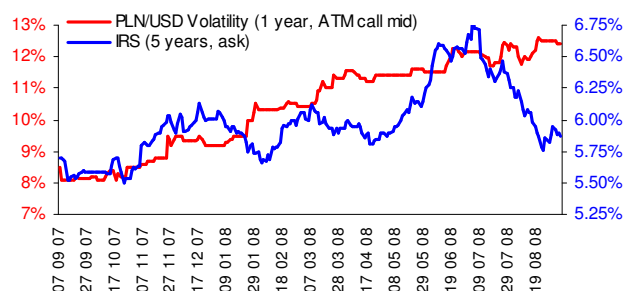
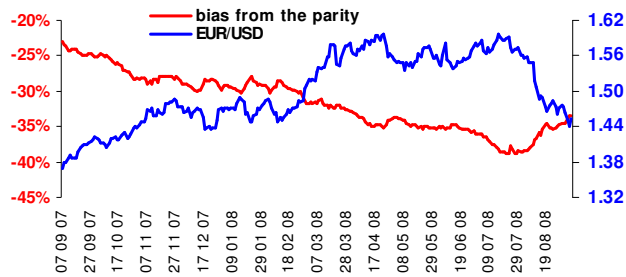
F/X

August saw a substantial depreciation of the zloty and other CEE currencies against core currencies that predominantly resulted from the appreciation of the dollar against the euro. The EUR/USD exchange rate, standing at approx.1.55 at the beginning of August, slumped down to 1.40-1.42 by the middle of September. Appreciation of the US currency could be attributed to a strong correction on the commodity markets (especially large declines in crude oil prices) and the mounting evidence that the slowdown in the euro area will be much stronger than expected. However, the recent intensification of crisis in the US financial sector stopped the strengthening of the dollar

Fading expectations of rate hikes in Poland were another factor that contributed to the weakening of the zloty. The exchange rate of the zloty against the euro shifted from 3.21-3.22 at the beginning of August to 3.47 by the end of the first week of September. Depreciation against the dollar was even more pronounced as the USD/PLN rate moved from close to 2.05 at the end of July to 2.46 on September 8, wiping out all zloty gains since the beginning of this year. The trend towards zloty weakening was temporarily reversed by Prime Minister Tusk's unexpected announcement of the target date for Poland's entry into the euro area.

Fixed Income

Reduced expectations of further monetary tightening combined with the renewed start of the "convergence play" translated into a drop in yields all along the yield curve. IRS rates declined slightly more considerably (particularly in the middle and end sections of the curve), bringing about further growth in asset swaps up to approx. 30 bp. 10Y treasury bond yields went down to below 6% for the first time since the beginning of May. Similarly, 2Y securities yields reached 6.20%, i.e. the level reported four months ago. However, as a result of deteriorating sentiment for our region, yields on Polish treasuries picked up slightly at the beginning of September. These trends were balanced by the prospects of Poland entry into the euro area, which brought about further fall in IRS rates by 10-15 bp (below 5.0% 10Y) and bond yields by 15-20 bp.



ECONOMIC AGENDA

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

Source: CSO, NBP, ECB, Federal Reserve

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