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MONTHLY MACROECONOMIC REVIEW

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TABLE OF CONTENTS

WIESLAW SZCZUKA
Chief Economist
tel. (22) 829 15 39
wieslaw.szczuka@brebank.pl

ERNEST PYTLARCZYK
Chief Analyst
tel. (22) 829 01 66
ernest.pytlarczyk@brebank.pl

RADOSŁAW CHOLEWIŃSKI
Analyst
tel. (22) 829 12 07
radoslaw.cholewinski@brebank.pl

MARCIN MAZUREK
Analyst
tel. (22) 829 01 83
marcin.mazurek@brebank.pl

- Claims that the Polish economy and financial system will avoid negative effects of the global turmoil have already been replaced by questions about the possible extent of such effects. However, there are still grounds to assume that the decline in economic activity in Poland will be reasonably moderate and that the Polish banking system remains in a relatively good condition. Measures taken by the government and the NBP in order to better protect bank customers, restore liquidity in the interbank market and provide access to foreign exchange, are aiming in the right direction, but it is still difficult to forejudge whether they will be sufficient to rebuild confidence.

- The statements of the MPC members indicate that the Council has, *de facto,* changed its stance from restrictive to neutral. Growing concerns about the negative impact of the global financial crisis and the tentative signs of declining inflationary pressure were among the factors that contributed to this change. The improving inflation outlook has largely been confirmed by the new NBP projection which somewhat surprisingly shows that inflation will stay elevated in 2009 but by the end of 2010 should already come close to the 2.5% target. However, the rising core inflation indicators, the continued high wage growth rate and the weakening of the zloty could be seen as factors which can delay the easing of monetary policy.

- The changing economic situation put in question the 4.8% GDP growth rate assumed in the draft budget for 2009 This, in turn, brings serious doubts as to the feasibility of the revenue forecast, and in particular to the very high growth in corporate income tax payments. The inflation forecast of 2.9% in 2009 has now become somewhat more realistic, but this implies that the government can hardly expect that higher than assumed inflation will bring additional fiscal revenue.

- Prime Minister Tusk's declaration on the timing of the euro adoption encouraged us to return to the regular monitoring of progress in meeting the Maastricht criteria. Even if Poland currently meets for sure only two of the five key conditions for accession to the Eurozone (regarding the fiscal situation and the level of long-term interest rates), it still appears to have the greatest chances to become the next country after Slovakia to join the common currency area. The biggest formal (and political) obstacle to a rapid adoption of the euro is currently the question of how to introduce the necessary changes to the Polish Constitution. Ensuring price stability will most likely be the most difficult economic criterion to fulfil, but the risk that the weakening of economic growth will cause a significant worsening of the fiscal situation should also not be ignored.

- Housing and other types of real property were among the few asset classes that managed to avoid large price declines over the past year, although a more precise assessment of price developments in the real estate market is hampered by the lack of reliable data. Even after the recent general stabilisation of real estate prices, and modest declines in some regions of Poland, there are still grounds to claim that the current level of housing prices is still higher than the levels implied by affordability indexes (price to income ratio, debt to income ratio), market rents or margins of property developers.

KEY MACROECONOMIC INDICATORS

	Jan 08	Feb 09	Mar 08	Apr 08	May 08	Jun 08	Jul 08	Aug 08	Sep 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%	7,0%
Industrial production growth MoM	3.0%	1.6%	0.7%	4.0%	-8.5%	5.0%	-3.4%	-8.1%	17,4%
Retail sales YoY	*20.9%*	23.8%	15.7%	17.6%	14.9%	14.2%	14.3%	7.7%	11,6%
Retail sales MoM	*-18.7%*	0.3%	11.8%	2.9%	-1.9%	2.4%	1.8%	-3.9%	1,8%
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	3171,65
Wage growth in the enterprise sector YoY	11.5%	12.8%	10.2%	12.6%	10.5%	12.0%	11.6%	9.7%	10,9%
Wage growth in the enterprise sector MoM	-8.5%	2.1%	3.7%	-0.2%	-2.2%	4.8%	0.4%	-2.0%	0,2%
Employment in the enterprise sector YoY	5.9%	5.9%	5.8%	5.6%	5.4%	4.8%	4.7%	4.2%	4,1%
Employment in the enterprise sector MoM	2.0%	0.4%	0.2%	0.1%	0.0%	0.0%	0.2%	0.0%	0,1%
Unemployment rate	11.7%	11.5%	11.1%	10.5%	10.0%	9.6%	9.4%	9.3%	8,9%
Foreign trade									
Current account (EUR)	-1 105	-1 324	-1 605	-1550	-1.602	-2292	-1222	-1736	
Trade balance, transaction-based (EUR)	-644	-933	-1 480	-1260	-1.240	-1706	-1563	-1503	
Exports, transaction-based YoY (EUR)	21.9%	28.7%	19.1%	31.1%	12.2%	16.1%	22.7%	7.1%	
Imports, transaction-based YoY (EUR)	18.8%	32.3%	21.1%	31.3%	14.0%	20.2%	22.4%	17.4%	
Current account (% GDP)	-4.7%	-4.8%	-5.0%	-5.0%	-5.0%	-5.0%	-4.8%	-5.0%	
Prices									
CPI MoM	0.7%	0.2%	0.4%	0.4%	0.8%	0.2%	0.0%	-0.4%	0,3%
CPI YoY	4.0%	4.2%	4.1%	4.0%	4.4%	4.6%	4.8%	4.8%	4,5%
Net inflation YoY	1.9%	2.5%	2.7%	2.8%	3.2%	3.4%	3.5%	4.0%	2,9%
PPI MoM	1.2%	0.9%	0.6%	-0.1%	0.7%	0.3%	0.0%	0.2%	0,2%
PPI YoY	2.9%	3.2%	2.9%	2.5%	2.7%	2.7%	2.3%	2.0%	2,1%
Money aggregates									
Money supply M3 (PLN B)	568.6	579.0	581.0	593.9	599.6	605.7	615.0	627.5	628,1
Money supply YoY	12.9%	13.5%	13.6%	14.9%	15.0%	16.2%	16.5%	16.6%	17,1%
Household loans YoY	37.9%	37.8%	37.3%	36.2%	33.8%	34.2%	30.3%	30.8%	33,4%
Corporate loans YoY	26.2%	24.8%	25.2%	24.9%	26.0%	24.6%	23.5%	25.3%	24,4%
Household deposits YoY	14.2%	15.3%	17.5%	19.0%	21.2%	22.6%	24.6%	23.5%	23,9%
Corporate deposits YoY	11.7%	8.2%	6.1%	7.8%	6.1%	6.8%	7.0%	3.1%	6,7%
Forex Rates									
EUR/PLN rate (end of month)	3.61	3.52	3.53	3.46	3.38	3.35	3.20	3.35	3,41
USD/PLN rate (end of month)	2.42	2.32	2.23	2.23	2.18	2.12	2.05	2.27	2,37
Interest rates									
NBP reference rate	5.25%	5.50%	5.75%	5.75%	5.75%	6.00%	6.00%	6.00%	6,00%
Lombard rate	6.75%	7.00%	7.25%	7.25%	7.25%	7.50%	7.50%	7.50%	7,50%
Deposit rate	3.75%	4.00%	4.25%	4.25%	4.25%	4.50%	4.50%	4.50%	4,50%
WIBOR 3M	5.68%	5.94%	6.15%	6.34%	6.48%	6.65%	6.56%	6.50%	6,63%
2Y bond yield	5.71%	6.18%	6.29%	6.21%	6.48%	6.89%	6.53%	6.35%	6,23%
5Y bond yield	5.75%	6.17%	6.12%	6.08%	6.38%	6.78%	6.31%	6.17%	5,99%
10Y bond yield	5.66%	5.97%	5.96%	5.97%	6.27%	6.61%	6.25%	6.05%	5,82%
Global Economy									
Eurozone inflation (YoY)	3.1%	3.5%	3.6%	3.3%	3.6%	4.0%	4.1%	3.8%	3,6%
Eurozone GDP (YoY)			2.2%			1.4%			
ECB base rate	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%	4.25%	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%	2,00%

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

POLISH ECONOMY

Poland in the light of the global crisis

The view that until recently seemed to prevail in statements of government representatives and most experts was that Poland would not be materially affected by the consequences of the global financial turmoil that started in August 2007 because of its strong macroeconomic fundamentals, good condition of the financial sector and virtual absence of any direct exposure to the so-called toxic assets.,.

Even if the tone of official statements has not yet changed very much, questions about the possible consequences of the crisis have recently ended up not only on the front pages of newspapers, but have also become the subject of discussions in most Polish homes. The two main reasons for this much increased concern and uncertainty are the recent sharp intensification of the crisis in the global financial markets and the increasingly clear signs that the "spectre" of this crisis is coming close to Poland's borders. The main sign of the deepening of the global crisis is the gradual transformation of the problems with liquidity and confidence in the financial markets into an economic downturn accompanied by a growing number of insolvencies of major financial institutions. According to the latest IMF forecasts, the global economic growth is expected to drop to 3% in 2009 while growth in the US and the euro area is expected to decline to just 0.1 - 0.2%. This means that the probability of a recession in the two largest economic areas is very high, whereas the main source of global growth will be the emerging and developing countries. While the IMF estimate of total potential losses for the financial sector set earlier this year at USD 945 billion had been considered excessively pessimistic, it has now been increased to about USD 1,400 billion (of which more than USD 560 billion are losses that have already been incurred).

In response to the intensification of threats to economic growth and stability of the financial systems, the governments and central banks of many countries are reaching for a whole arsenal of measures available to them to restore confidence, increase liquidity and strengthen the capital base of financial institutions. According to some estimates, the total value of funds which the Treasury Department and the Federal Reserve are prepared to put at the disposal of US financial institutions is already in excess of USD 3,000 billion (including USD 700 billion within the framework of the so-called Paulson plan), while the UK and other European countries have already declared support with a total value of at least EUR 2 billion. The US example shows that the official support has to be offered to a growing number of segments of the financial sector. Apart from the protection of deposits, banks and the interbank market, the mortgage loan market with its key institutions (Fannie Mae and Freddie Mac), and some insurance institutions (AIG), special support schemes have recently been created also for money market funds and the commercial papers market. Measures introduced in Europe were initially targeted at ensuring access to liquidity for banks (following the recent ECB decisions, this access has become practically unlimited), as well as broadening the protection of bank deposits (the joint EU decision to increase the minimum level of guaranteed deposits to EUR 50 k, with some countries opting to provide a much higher level or even full guaranties for bank deposits). Within the comprehensive plan announced by the British government, a strong emphasis has been put on providing additional capital to banks (which in practice will lead to their partial nationalisation) and creating a mechanism for guaranteeing interbank liabilities. Similar programmes were later introduced in Germany, France, Sweden and a number of other European countries. The US administration has also recently redirected its attention from buying the "toxic" assets to recapitalizing banks and providing guarantees for bank liabilities.

An important supplement to the direct actions taken with respect to the financial sector was the coordinated rate cut introduced by six major central banks (USA, the Eurozone, Great Britain, Canada, Switzerland and Sweden). This unprecedented event had the main objective of strengthening confidence and reducing the cost of capital. These rate cuts also indicate that in the view of the key central banks the threats to economic growth have become far stronger than the threats to price stability.

The formal actions taken by the Polish government and the NBP to deal with the consequences of the global turmoil have initially been limited to joining the EU understanding on the increase of the minimum deposit guarantee level to EUR 50 k (the Parliament has already adopted the necessary changes to the law on the Bank Guarantee Fund) and introducing the "confidence package" to enhance liquidity of the interbank market. The key elements of this package are the FX swaps to be offered by the NBP (which so far have been limited to USD and EUR), repo transactions for a period of up to 3 months, as well as some simplification of access to the NBP lombard facility. These activities can help increase availability of short-term funds and reduce difficulties in access to foreign currencies (although the NBP has yet to offer

CHF swaps), but are not likely to fully resolve the key problem of the lack of confidence. Therefore, the government has recently decided to follow the example of many other countries and presented a draft low introducing new guarantees for bank liabilities and offering the financial institutions some other forms of official support. The situation in the Polish banking sector was also the subject of several meetings of the Financial Stability Committee and two extraordinary meetings of the Monetary Policy Council. The government and NBP representatives are also resorting to various verbal interventions in order to calm the markets and restore confidence, but these actions do not always appear properly targeted and/or coordinated. There are also indications that the representatives of the Polish Financial Supervision Authority and the NBP have intensified their working contacts with financial institutions. The scope of the actions taken to date by the Polish authorities appears to reflect the official assessment of the scale of the current threats that are still perceived as moderate, and stemming mainly from the lack of confidence and the adverse impact of external factors.

Apart from the intensification of the global disturbances, the second key reason for the increased concern in Poland can be seen in the increasingly frequent signals that the consequences of the crisis will not bypass the Polish economy or the economies of other countries in this region. This is confirmed by the developments in Hungary and the Ukraine, where the governments already had to apply for external support to stabilise the situation in their financial markets and secure access to foreign exchange. These events and the deep crisis in Iceland, as well as the general increase in risk aversion have also contributed to a significant weakening of the zloty and sharp declines in Polish stock prices. One of the potential channels for transferring the consequences of external disturbances onto the Polish economy is the ownership structure of the banking sectors with most commercial banks being controlled by foreign financial institutions. In the so-called good times, this was considered a source of strength and stability of the Polish financial system, but, in the situation in which the some of the parent institutions themselves are experiencing serious problems (as was the case with AIG and Fortis Bank), this can incite concerns about the future of their branches and subsidiaries in Poland. Such concerns are understandable, but their extent should be limited, because in view of the good financial standing of the Polish the main threat appears to be the risk of an ultimate change in the ownership structure.

Based on publicly available information, it can be stated that the Polish banks do not have in their portfolios any assets which could be considered "toxic". This means that there is hardly any risk of losses resulting from the valuation of such assets. Nevertheless, the Polish interbank market has also been quite strongly affected by the loss of confidence among financial institutions. Market liquidity has been significantly reduced, access to funds became more expensive (increase in WIBOR 3M rates to approx. 80 bps above the reference rate) and the maturity of interbank deals has been much shortened. The situation of some the parent institutions (concerns about their solvency), as well as their policies for setting limits on interbank transactions, certainly contributed to these developments. It seems to be a valid question, why the Polish branches of foreign banks should be lending to each other, if their parent firms restrict the deals between themselves. Therefore, it is very important to try to ensure that the decisions on limits are being made independently by the management boards of Polish banks and take into account, as much as possible, the actual condition of the Polish banking sector. In order to strengthen confidence on the Polish market, it is also very important to ensure that those banks which have been receiving liquidity from their foreign owners, will continue to be able to count on this type of support.

However, apart from external reasons, there are also a number of internal factors that made the Polish banks more exposed to the consequences of the current disturbances. In some sense, the banks have become the "victims" of their own success, because in result of the rapid increase in lending the ratio of deposits to loans has recently dropped to below 100%, while the average capital adequacy ratio declined from 14.7% in Q1, 2006 to 10.9% in the middle of 2008. Although these indicators are still quite good both in absolute terms, as well as in comparison with many other countries, the direction of their change means that banks need to more actively try to secure sources of stable funding and strengthen their capital base. This can already be seen in the increased competition for deposits on the domestic market and the continued very fast increase in foreign liabilities. The latter have increased by more than 57% over the past twelve months from August 2007 to August 2008, whereas bank deposits increased by 17% in this period. The main reason for such a fast increase in foreign liabilities of Polish banks is the need to obtain funds allowing securing the FX risk resulting from mortgage loans in foreign currencies. Because of the almost complete closure of access to market financing, the main sources of FX loans and/or main counterparties in FX swaps have recently become the parent banks. The assurance of constant access to these funds or the establishment of an alternative source of such FX funds is therefore one of the important conditions for maintaining liquidity and confidence in the Polish banking system. Therefore, the possibility to obtain access to foreign currencies through swap transactions offered by the NBP should be very much welcomed. There are also views, that the quality of outstanding loans, and in particular of mortgage loans, could become a source of some difficulties for the Polish banking sector. It cannot be excluded that the looming economic slow-down will contribute to some increase in the non-performing loan ratio, but according to the Polish Financial Supervision Authority data this ratio continued to decrease at least until the middle of this year (from 6.3% in mid-2007 to 4.8% at the end of June 2008). This ratio is much lower in case of claims on households (3.8%) and very low in the case of mortgage loans (especially FX loans). The consequences of a possible worsening of the quality of the loan portfolios can in no way be compared with the losses caused by the so-called toxic assets because both the extent of threats and the speed at which such losses may appear are completely different (gradual process of establishing provisions as the NPL ratio rises compared with the necessity to immediately book losses caused by the drop in the market value of “toxic" assets).

Summing up the above comments, it can be stated that the scale of internal threats to the Polish banking system is moderate and can be further reduced through effective actions aimed at redistributing PLN liquidity (which is still more than sufficient at the level of the whole banking sector) and assuring access to foreign currencies. It is also necessary to make further efforts to strengthen confidence, including through the attempts to isolate the Polish banks, to the extent possible, from the consequences of the lack of confidence between their parent institutions. However, in order to strengthen their capital adequacy ratios and appropriately reflect the increased level of risk and higher cost of their own funding, banks will also be forced to somewhat tighten the lending conditions. This expected and already observed tightening of access to bank loans for enterprises and households, combined with the significantly increased difficulties in obtaining financing from other sources (stock exchange, corporate bonds, foreign markets), is one of the important factors contributing to the ongoing reductions in forecast investment and consumption growth. Combined with the negative consequences of the collapsing demand in the Eurozone and other export markets, this causes that nobody is questioning now that the Polish economy will be affected by the global disturbances, although the question of the possible extent of the decline in economic activity in Poland is still open. According to our estimates, the rate of GDP growth could decline in 2009 to a level close to 3% and start to rise again in the years 2010 - 2011. The materialization of such a scenario would still mean that thanks to its relatively strong economic fundamentals and the relatively good condition of the financial sector Poland would be only moderately affected by the consequences of the current global crisis of an almost unprecedented scale.

MONETARY POLICY

NBP rates on hold…

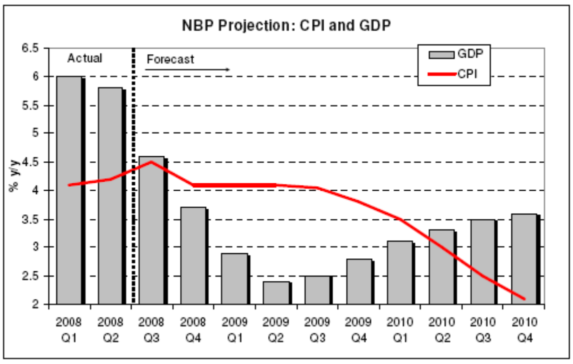
Polish MPC decided at its October meeting to leave interest rates unchanged. The NBP reference rate has remained at the level of 6% since the end of June 2008. This decision, although it may be regarded as a continuation of the wait-and-see strategy, does not appear obvious in light of the intensification of the financial markets turmoil. In the recent period, several major central banks decided to cut their interest rates in response to the fast deteriorating outlook for growth and in order to help overcome the liquidity problems. The very much increased aversion to risk resulted in a large pressure on emerging market currencies and stock exchange prices and brought a big increase in market volatility. Hungary and Iceland have been most seriously affected so far (along with Ukraine) and had to resort to massive rate hikes (by 300 and 600 bps respectively) in order to stop capital outflows and defend their currencies. These developments must have influenced the October MPC decision, which in this context may be considered as trying to avoid and risky changes rather than a simple continuation of the "wait-and-see" approach.

In fact, both the zloty depreciation and the recently adopted NBP "confidence package" provided some sort of a substitute for an interest rate cut by a de facto easing of monetary conditions. The repo transactions introduced by the NBP contributed to a large decline in overnight interest rates. It seems that the highly volatile market conditions had more impact on the MPC decision than the recent macroeconomic data clearly indicating a deteriorating outlook for the Polish economy. The latter could call for a rate cut, as the inflation rate starts declining, working-days adjusted industrial output, retail sales and wage growth follow a declining trend and employment in the enterprise sector ceased to increase. Moreover, sentiment indexes record new lows, indicating deteriorating prospects for both consumption and investment spending. Thus, with commodity prices trending downwards, inflation risks may soon not be the biggest concern for the MPC. That is why we expect the MPC to cut interest rates not later than in very first months of 2009, with a rising possibility that the first cut will happen still this year. The room for monetary easing will certainly increase as the ECB and other European banks will continue to reduce their official interest rates following the recent cut in the US. That is of particular importance, as the risk premium would thus remain intact or could even increase if the pace of rate cuts in Poland were to remain moderate.

…and a surprising inflation projection

Unlike the last MPC decision, which was in line with market consensus, the new inflation projection came as a surprise. According to the projection, the CPI inflation rate is to remain at elevated levels over the whole of 2009 (4.2%) and approach the NBP target only in 2010 (2.9%). At the same time, the GDP growth will slow down substantially, reaching merely 2.6% in 2009 and 3.4% in 2010. Although we share the view that the economy will slow quite considerably, we have very serious doubts as to the feasibility of the inflation outlook presented by the latest NBP projection. The reason why the NBP projection diverges so much from other forecasts and inflation trends observed in other countries might be assumptions made by NBP experts with respect to commodity prices (they expect them to rise whilst they are currently trending downwards, as we already mentioned) and clearly overstated (as well as probably out-dated) "consensus" forecast for inflation in the US and Eurozone.

Moreover, it is worth noting that in the NBP projection the official interest rates are presumed to remain unchanged. Therefore the monetary policy would have to be pretty restrictive when one considers that GDP growth is to slow down much below the potential output growth. That should strongly impact the inflation rate, while we do not see this being reflected in the recent NBP projection. Thus, we would not attach too much importance to its results, at least as far as the inflation outlook is concerned. We believe that the next MPC moves will be more influenced by the new macroeconomic data, further developments in the financial markets and the behavior of other central banks, in particular ECB. On the other hand, prospects of economic slowdown, rightly pointed out in the projection, might be an additional argument for the MPC to start easing its policy in the very near time.



FISCAL POLICY

Budget of optimistic assumptions

After the first plenary reading in the Sejm the draft 2009 Budget Act is now being analyzed by parliamentary commissions. In line with earlier announcements, next year's state budget deficit is to be reduced to PLN 18.2 billion (about 1.4% of GDP), while this year's deficit has been preliminarily estimated at PLN 22.8 billion. The decline in the deficit planned by the government has to come from a somewhat faster growth in fiscal revenue (from 8.3% this year to 8.9% in 2009, see table) and the simultaneous reduction in the spending growth (from 8.5% to 5.2%, or to 4.1% after taking into account the spending on projects co-financed by the EU). However, these quite ambitious plans are based on some rather optimistic assumptions. This means that the implementation of next year's budget can prove much more difficult than in 2008.

On the revenue side, the government is assuming the continuation of the very high growth in CIT collection (16.2%) and only a slight decline in the growth rate of VAT revenue (to 9.8%). PIT revenue is to increase by only 2.7%, which reflects the effects of the new, lower tax rates (18% and 32%) that will be in introduced from 1 January 2009.

The first of these assumptions appears to be particularly risky because it means that the increase in company profits would need to remain at a level similar to that observed in 2008. With a clear decline in GDP growth in 2009 (to 4.8% according to the Ministry of Finance, while we believe that the actual outcome may be closer to 3%), we do not consider it a likely scenario. The GDP growth rate assumed by the government was quite strongly criticised by representatives of the opposition parties and by many economists. The government is still reluctant to alter its macroeconomic forecast, but such an option has not been excluded by the Finance Minister Jan Vincent-Rostowski.

The government justified its relatively high forecast of GDP growth by the continuation of high growth in individual consumption, estimated at 5.1% (compared with 5.6% expected this year), and only a moderate drop in investment growth (from 14.5% to 10%). The forecast of high revenue from VAT is based on these assumptions. The question remains open, whether with slowing economy, declining wage pressure, stabilisation of employment and increasing burden of servicing household debt, such assumptions will not prove excessively optimistic. However, even after taking into account the effects of tax rate changes, the forecast PIT revenue appears quite realistic (the government is relying here on a forecast of wages increasing by almost 7%, which appears to be a reasonable assumption).

After the publication of the preliminary version of the assumptions to the budget for 2009, the Ministry of Finance was quite strongly criticised for its forecast of annual average inflation rate of 2.9%. The expectation of such a rapid decline in price growth was considered as an expression of excessive optimism. At the same time, suppositions appeared that the authors of the draft budget wanted to create a "reserve" that would make the implementation of next year's budget easier if the actual inflation proved higher than planned. We still believe that average inflation next year will be slightly higher than expected by the Ministry of Finance (we currently see it at about 3.2%). However, from today's perspective, the probability that higher than expected inflation will bring additional fiscal revenue is already much lower than at the time the budget assumptions were first released.

On the expenditure side, the government is expecting a significant decline in spending on benefits to natural persons (by 9.2%, which is largely due to a shift of pre-retirement benefit payments to the Labour Fund) and a significant reduction of transfers and subventions growth (including to the social insurance fund, to 3.8%). Current expenditure is to increase faster than the general spending (7.6%), as will capital expenditure (8.9%), while the highest rate of growth is expected in the costs of public debt service (17.9%). It can be expected that base interest rates (domestic and foreign) will be slightly lower than assumed by the Ministry, although it is difficult to assess the extent to which such cost reduction will be consumed by higher spreads and the weakening of the zloty exchange rate.

The government's assumptions regarding the reduced growth in fiscal spending are largely based on optimistic forecasts regarding the developments in the labour market. Essentially, with a rate of unemployment at 8.5% (Ministry of Finance forecast for 2009), it would be reasonable to expect a decline in spending on transfers or the financing of social insurance for the unemployed. However, we do not share the government's optimism that the decline in unemployment will be so large next year, especially in view of the expected economic slowdown. We are also sceptical in assessing the impact of the government's labour activation packages (about which we wrote in the August publication of the MMR). Changes in the pension system proposed by the government would be advantageous for the budget, however the related savings will probably not be as large as expected, since the group of people entitled to bridging pensions has already been increased by more than 100 thousand people compared with the earlier estimates. Additionally, there is still a major question mark, whether the proposed changes will come into force from the beginning of next year, as President Kaczyński has already proposed delaying their introduction.

In summary, we believe that the draft budget for 2009 is based on excessively optimistic macroeconomic assumptions. The increasingly clear signals of the ensuing economic slowdown mean that the conditions for implementing next year's budget could prove far more difficult than expected. In any case, it would be difficult to expect the appearance of any positive "surprises" which would lead to the inflow of additional revenue. Some help with achieving next year's budget targets could come from the by now almost routine operation of transferring additional funds to the Social Insurance Fund, although this year the scale of such a transfer (if it takes place at all) will almost certainly be lower than at the end of 2007. In the area of financing, the deficit the greatest doubts arise regarding the feasibility of obtaining the planned revenue from privatisation (a total of PLN 12 billion, of which almost PLN 6.8 billion would be transferred to the state budget).

	Estimated 2008	*Plan* 2009	*Change (%)* 2008/2007	2009/2008
Revenue, of which:*	247.8	269.9	8.3	8.9
Taxes, including:	230.4	252	11.6	9.4
VAT	108.9	119.6	13.0	9.8
PIT	39.2	40.3	10.9	2.7
CIT	28.5	33.1	16.1	16.2

**excluding EU funding*

	Estimated 2008	*Plan* 2009	*Change (%)* 2008/2007	2009/2008
Expenditure, including:*	263.7	277.5	8.5	5.2
Grants and subventions (including social insurance funds)	132.8	137.8	16.8	3.8
Social transfers	22.2	20.2	-3.5	-9.2
Current expenditure	51.8	55.8	35.8	7.6
Capital expenditure	16.9	18.4	27.1	8.9
Public debt service	27.8	32.8	1.1	17.9
Contribution to the EU budget	12.1	12.6	14.2	4.1

** excluding projects co-financed with EU funds*

EUROMONITOR

Our Euromonitor is coming back. Poland is getting closer to the euro area.

Euromonitor, the graphical presentation of the progress in meeting the Maastricht criteria, supplemented with brief descriptions, was a permanent feature of our monthly for a long time. We suspended its presentation when the prospects of Poland adopting the euro appeared excessively distant, but after Prime Minister Tusk's unexpected statement regarding the target date for adopting the euro, we decided to return to monitoring progress in meeting the convergence criteria. Our regular presentation will only cover three countries (Poland, the Czech Republic and Hungary), although in our comments below we also provide a very brief assessment of the situation in the Baltic countries, Bulgaria and Romania. We do not need to deal any more Slovakia because the consistent implementation of its plans and the remarkable progress in implementing economic reforms mean that this country will become the 16th member of the Eurozone on 1 January 2009.

The government has recently approved a "road map" that should lead to joining the euro area at the start of 2012. The government's intention is to fulfil all formal convergence criteria by the middle of 2011. This would require that Poland joins the ERM2 mechanism not later than by mid-2009. At the meeting between Prime Minister Tusk and the Monetary Policy Council on 16 September, it was agreed that the government, the MPC and the NBP would work together to achieve the targeted date for euro adoption. The most significant formal obstacle to the implementation of the government plans appears to be way and timing of introducing the necessary changes to the Polish Constitution. Since the largest opposition party (PiS) is rather strongly opposed to the proposed timing of the euro adoption, there is almost no chance that it will agree on a speedy process of revising the relevant provisions of the Constitution. However, both the minister of finance and the president of the NBP stated that Poland should not enter the ERM2 system before making such legal changes. Without a "miracle" by way of an understanding with the opposition, the only way of changing the Constitution before the end of the second half of 2009 appears to be to hold the referendum proposed by PiS or to announce early elections. Each of these solutions is subject to quite a high risk and, therefore, there is little surprising that the government is yet to declare how it intends to secure an agreement on changing the Constitution. Ultimately, it would be necessary to establish whether or not the political risk related to the result of the referendum or elections is larger than the economic risk related to the entry into ERM2 before making the necessary changes to the legal regulations. The lack of will to quickly resolve this dilemma will mean the need to postpone the timing of Poland's accession to the Eurozone. Another new element which could have a negative impact on the acceptance of the euro is the sharp intensification of disturbances in the global financial system, which has been observed since the middle of September. These disturbances have already led to a weakening of the zloty and are increasingly affecting the situation in the Polish banking system. In the opinion of the president of the NBP, the zloty should not enter into the ERM2 exchange rate system until the market situation stabilises. The situation on the markets is also being used by the president of the NBP as an excuse for distancing himself from the euro adoption target set by the government by indicating that this date should be rethought. This is probably not the most fortunate position given that the indication of a specific date of accession became an important factor enhancing confidence in the zloty and the Polish financial markets.

Our assessment of the progress in meeting the Maastricht criteria shows that Poland currently fulfils without any doubts only two of the five conditions for accession to the Eurozone. Poland has been observing the fiscal criterion since 8 July 2008, namely from the time of the decision made by the Council of the EU to abrogate the excessive deficit procedure that was started in 2004. For almost three year now Poland has also been observing the long-term interest rate criterion (namely since the end of 2005). The inflation level in Poland has remained very close to the limit specified by the respective Maastricht criterion for the last several months, although, according to the assessment of the European Commission presented in its last Convergence report, this was not sufficient to accept that Poland satisfies this criterion on a sustainable basis. For obvious reasons (lack of ERM2 membership), Poland does not fulfil the criterion of exchange rate stability and, because of the abovementioned need to make changes to the Constitution and other legal acts, Poland also does not satisfy the requirements regarding the compliance with EU regulations. Apart from the issues concerning the legal adjustments, the most important challenge at present appears to be the permanent reduction of inflation to a level which assures that the criterion of price stability is observed on in a sustainable manner. However, it cannot be ruled out that, in the case of a significant economic slowdown, problems with meeting the fiscal criterion could also return. Without neglecting these difficulties and risks, we believe that, from the point of view of the economic conditions, it is still possible for Poland to enter into the euro area at the beginning of 2012. However the achievement of this objective would require a great deal of determination on the part of the government and the ability to overcome the current political and legal obstacles.

Plans of the remaining new member states

Of the new member states, Slovenia (2007), as well as Cyprus and Malta (2008), have already adopted the euro. Slovakia will join them on 1 January 2009 and until that time it will remain in the ERM2 system. At present, the three Baltic countries are also participating in the ERM2l. Of the group of "old" member states, Denmark, which, like Great Britain, is not obliged to adopt the euro, is also in this mechanism.

Estonia and Latvia entered the ERM2 mechanism as early as in June 2004 (little more than a month after the accession of these countries to the EU), while Lithuania entered a year later, in May 2005. These countries applied the regime of a pegged (or fixed, in the case of Latvia) exchange rate and therefore the decision on the entry into the ERM2 were quite easy and did not even involve a change in exchange rate parities. According to the ERM2 rules, the exchange rates of these countries could deviate from the central parity by up to +/-15%, although Estonia and Lithuania decided that their currencies would be permanently fixed against the euro, whereas, in the case of the Latvian lat, the previously used 1% band of fluctuations remained.

Despite the quite long participation of these countries in the ERM2 system and their policy of fixing the exchange rates, the prospects of euro adoption by these countries do not currently appear close because of serious problems with inflation. Lithuania was planning accession to the Eurozone in 2007 but the European Commission did not grant support for its application because Lithuania minimally exceeded the reference value of the inflation criterion. At present, the Lithuanian government is declaring the will to accept the euro in 2010 - 2011, although this target is in no way binding and is sceptically assessed by the European Commission. Similarly, Estonia intended to accept the euro in 2007, although this deadline was initially postponed to 2008 and then to 2010 because of the excessively high inflation. The current, non-binding target being announced by the Estonian government is 2011. In turn, Latvia aimed to introduce the euro from 2008, although problems with inflation resulted in a postponement of this deadline into the undefined future. The Latvian government is indicating that accession to the Eurozone will be possible no earlier than in 2012.

Just like Poland, the Czech Republic and Hungary are also outside ERM2. Neither of these countries has a clearly specified target date for adopting the euro, although the reasons for this state of affairs are not identical. Hungary does not currently satisfy any of the Maastricht convergence criteria, although it took major steps recently to reduce the fiscal deficit. Hungary is still subject to the excessive deficit procedure (EDP) and therefore does not satisfy the fiscal criterion. Inflation and long-term interest rates are also at excessively high levels. The average yields of long-term treasuries exceeded the level required for the Maastricht criterion to be satisfied by approximately 120 bps over the past 12 months.

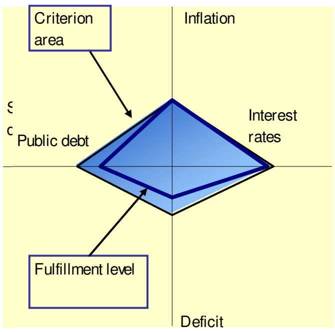
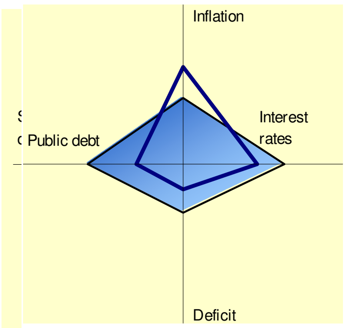
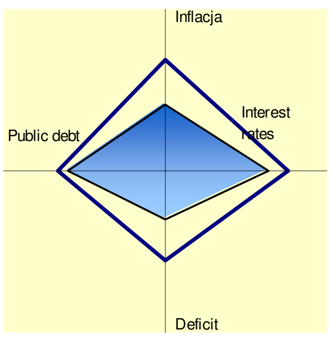
The Czech Republic was excluded from the rigours of the EDP in June 2008 and has been meeting the fiscal criterion since that moment. In the situation in which short-term interest rates in the Czech Republic are lower than in the Eurozone, this country will not have the least difficulty in satisfying the interest rate criterion. However, the inflation criterion is not satisfied, since average HICP inflation has exceeded the admissible value over the past 12 months by approximately 2 percentage points. However, with a fast drop in inflation (a trend being observed throughout the whole region), this issue could soon cease to be a problem. However the lack of political will to adopt the common European currency in the near future – strongest probably among the new member states – is noticeable. The representatives of the Czech central bank and the government have several times expressed their conviction that the euro adoption by a small economy, which is susceptible to external shocks and which has not yet achieved the appropriate progress in real convergence with the "old" EU states, is not the best strategy. Therefore, the Czech Republic's accession to the Eurozone will most probably take place when the process of real convergence (which is noticeable in the strong appreciation trend of the Czech koruna) is in its final phase.

The prospects for the two countries that joined the European Union in 2007 are also differentiated. Bulgaria, just like the Baltic States, despite not yet being in ERM2, adopted a regime of a pegged exchange rate as early as in the 1990s. The Bulgarian authorities would like to maintain the currency board, which has been used since 1997, throughout the whole period of ERM2 membership, up to the accession to the euro zone, which the Bulgarian government believes to take place in 2012. However, a very high C/A deficit (more than 20% of GDP) could give rise to doubts, whether the leva exchange rate against the euro has been set at the correct level. Just as in other countries of the region, Bulgaria's problem is also an excessively high inflation rate. A very low level of public debt and a budget surplus mean that Bulgaria easily satisfies the fiscal criterion. Long-term interest rates have also recently remained at a level which allows meeting the relevant Maastricht criterion.

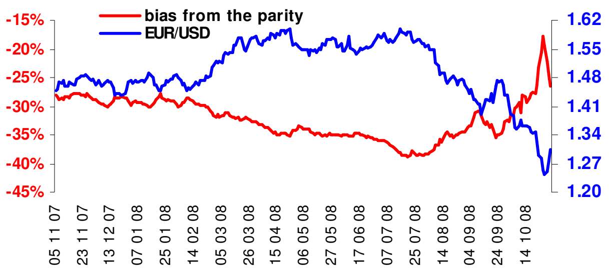
The prospects of introducing the euro are reasonably distant in the case of Romania. Its government representatives have indicated 2014 as a possible date, although this is not considered a binding target. The possible timing for ERM2 entry is given as 2012. Romania has only been observing the fiscal criterion as it is not subject to the EDP procedure. The level of the public debt (13% of GDP in 2007) is very low, but the gradually increasing fiscal deficit is creating a threat that also the fiscal criterion will cease to be fulfilled. Just as in the case of Bulgaria and the Baltic States, a serious cause of concern is the high level of the C/A deficit.

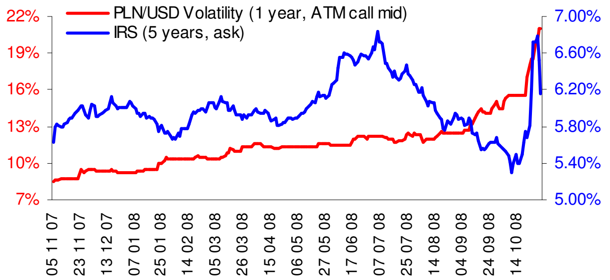
Therefore, if Poland makes consistent efforts towards meeting the nominal convergence criteria, it may become the next (and fifth after Slovenia, Cyprus, Malta and Slovakia) new member state to adopt the euro.

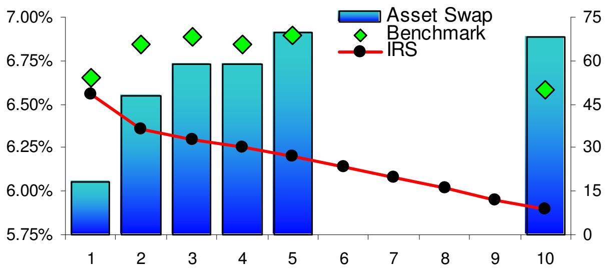
EUROMONITOR

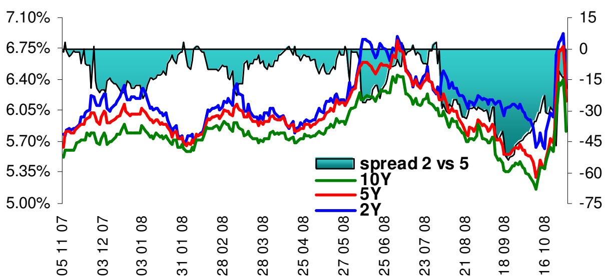
<table>
<tr><th></th><th>Convergence criteria*</th><th>• HICP inflation (12-month average): 4.2% (September 2008)
• Long-term interest rates (12-month average): 6.35% (August 2008)
• Budget deficit <3.0% of GDP
• Public debt:< 60.0% of GDP
• Membership of ERM2: 2 years</th><th>Exchange rate and the 2.5% and 15% fluctuation bands around the central ERM2 parity over the last 2 years (in the case of states outside the ERM2 – around the rate from the start of the observation period)</th></tr>
<tr><td>Poland</td><td>
</td><td>• HICP inflation (12-month average): 4.2% (September 2008)
• Long-term interest rates 5.97% (August 2008)
• Budget deficit 2.0% of GDP (2007)
• State debt: 45.2% of GDP (2007)
• Membership of ERM2: no</td><td></td></tr>
<tr><td>Czech Republic</td><td>
</td><td>• HICP inflation (12-month average): 6.4% (September 2008)
• Long-term interest rates (12-month average): 4.68% (August 2008)
• Budget deficit 1.6% of GDP (2007)
• State debt: 28.7% of GDP (2007)
• Membership of ERM2: no</td><td></td></tr>
<tr><td>Hungary</td><td>
</td><td>• HICP inflation (12-month average): 6.8% (September 2008)
• Long-term interest rates (12-month average): 7.54% (August 2008)
• Budget deficit 5.5% of GDP (2007)
• State debt: 66.0% of GDP (2007)
• Membership of ERM2: no</td><td></td></tr>
<tr><td colspan="4">*The convergence criteria with the Eurozone were set in the Treaty of Maastricht in 1992 and encompass five areas: price stability (HICP inflation in the 12 months before the qualification period cannot exceed the average of the three best performing member states by more than 1.5 percentage points), long-term interest rates (the yield on 10-year fixed-rate treasury bonds cannot exceed the average for the three EU states with the lowest inflation rates), public finance stability (lack of excessive deficit procedure, which requires the maintenance of the general government deficit below 3% of GDP and public debt below 60% of GDP), exchange rate stability (at least two years in the ERM2 system without any serious tension, namely within the +/-15% fluctuation band) and legislation compliance (legal adjustment to the EU requirements). In our summary, we are constantly (as data is released by Eurostat) monitoring the extent to which the first four criteria are satisfied by Poland, the Czech Republic and Hungary. The European Central Bank and the European Commission prepare convergence reports at least once every two years, assessing the extent to which the convergence criteria, which constitute the grounds for the decision of the EU Council expressing consent to the given state's accession to the Eurozone, are satisfied.</td></tr>
</table>

MARKETS









F/X

The turbulence on the global financial markets affected the FX market resulting in a strong increase in volatility. Rumours about liquidity problems of the major Hungarian bank, OTP, resulted in weakening of confidence to emerging markets, posing a huge selling pressure on their currencies. As a result, the zloty weakened against the main currencies. In the end of October, EUR/PLN temporarily rose to near 4.00 (last seen in September 2006), while USD/PLN broke through 3.00. Zloty's weakening partially arose from the appreciation of the US Dollar against the Euro - EUR/USD dropped to 1.25 in the third week of October. The last time the Dollar was so strong was two years ago.

Until the liquidity crisis passes, a period of intense volatility should be expected, which will appear in successive waves of strengthening and weakening of the zloty. We are of the opinion that the depreciation of the Zloty against the Euro is not of a permanent nature, whereas the correction of the exchange rate against the Dollar could prove longer-lasting (because of the progressive strengthening of the Dollar against the Euro). Last days seeing a partial correction of the previous zloty's weakening seem to confirm such a scenario.

Fixed Income

The rising aversion to the emerging markets resulted in decreasing bond prices, which was not justified by rate hike expectations. Yields temporarily went up much above 7%, first time since the mid 2004, when interest rates were hiked massively just after the EU accession. The yield curve is now rising up to 5 years and then decreases by some 30 bps. Also the IRS quotes have been inflating, though a bit more moderately, staying at 6.20-6.30% in the mid-part of the yield curve and falling below 6.00% at the long end, so the IRS curve stayed decreasing. Consequently, asset swaps kept rising, especially for longer maturities, up to 50-70 bps.

We see the current yield levels as fairly high with respect to prospects of economic slowdown and rate cuts in 2009. Nevertheless unless the aversion to emerging markets ceases, or at least moderates, yields may remain at elevated levels.

ECONOMIC AGENDA

	October 2008	November 2008	December 2008	January 2009
CPI	14	13	15	
Industrial production and PPI	17	20	18	
Wages and employment in the enterprise sector	15	18	15	
GDP estimates	-	28	-	-
Business tendency survey (CSO)	23	21	22	
M3 money supply	14	14	12	14
Balance of payments	13	12	12	16
Core inflation	21	20	22	
Official reserve money	7	7	5	7
MPC meetings	28-29	25-26	22-23	
ECB meetings	2	6	4	15
FED Meetings	28-29	-	16	27-28

Source: CSO, NBP, ECB, Federal Reserve

SPECIAL SECTION

Will housing prices drop?

Housing, or more widely – real estate, is among the few asset classes, which prices have resisted drops over the past year. Although the data cited by the NBP in the *Inflation Report* indicated a slight drop in offer prices towards the end of 2007, a return to their increase was recorded at the beginning of 2008. The behaviour of transaction prices is an unknown – the lack of reliable data sources obstructs the objective assessment of the situation on this market.

Information noise

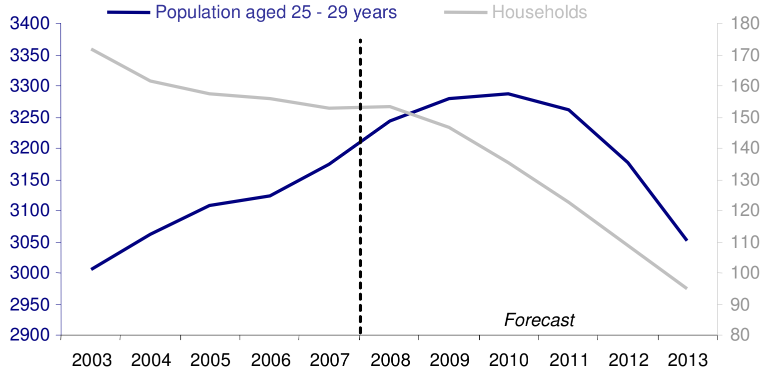
Property prices are not included in public statistics in Poland. Although the Central Statistical Office (CSO) announces the price per sq. m. of usable space in completed residential buildings, this index takes account just of the expense made by investors (namely the construction costs). After all, it is the CSO which suggests this, distancing itself from the charges of a mismatch between this measure and actual property prices. The NBP tries to partially fill this gap by presenting information in the *Inflation Report* on housing prices throughout the whole country and in the largest cities. Unfortunately, the data encompasses a very short period which makes analysis very difficult. Furthermore, the data quoted by the NBP is not taken from public statistics (such as, for instance, the data on the balance of payments or the money supply), but is provided by an external supplier and applies only to offer prices. Actual transaction prices are still unknown – meanwhile, a divergence between these two categories most frequently foreshadows the change in the market trend.

Interestingly, the number of private enterprises, mostly real estate intermediaries, which release their own estimates of housing price changes, has been recently increasing. However, they cannot be treated as representative for the whole country –they apply mainly to the largest cities. Furthermore, this data is limited to transactions conducted by the estate agents (in the case of transaction prices) or advertisements in offer tables (offer prices). No accusation can be made on a company publishing its own index, who, after all, is not obliged to fulfil tasks in the public statistics area. However, the problem arises when the publication is not accompanied by information on the methodology of the study, which, unfortunately, is a frequent situation, or even information which type of price (offer or transaction) is considered. However, such studies are fodder for the media, which, supported by the authority of an "analyst", depending on the title and the release, announce sudden drops or sharp increases in housing prices.

A question about fundamentals

At this point, it seems reasonable to ask about the fundamental rationale for housing price changes. Just as on every market, the price of this asset class is determined by the relationship between demand and supply. On the demand side, there is still a large group of people with unsatisfied housing needs. Unsatisfied needs obviously still do not generate demand (the textbook difference between potential demand and effective demand). Therefore, the argument that housing prices are still rising because a large number of people are still interested in purchasing, is incorrect. Essentially, many people may intend to buy a flat, but despite this, withhold from purchasing precisely because of the excessively high price.

Population aged 25 - 29 ('000)
and change in the household number ('000)



The truth is that in recent years we have seen a sharp increase in the number of people aged 25 - 29 (this is precisely the effect of the baby boom), who constitute the group of potential purchasers. However, this group is fading (just like the baby boom faded appropriately earlier) and, according to the latest CSO forecasts, a decline in the population of this group will be noticeable over the coming 5 years (see chart). Taking into account the fading increase in the total number of households, this trend will become even clearer.

The consequence of the long-term demographic processes will not only be lower demand for housing, but also their greater supply on the secondary market. In the short term, the supply of housing on the primary market will depend on the number of completed dwellings (this is at all-time high levels, although it has declined somewhat in recent months) and the likeliness of property developers to fulfil subsequent projects (this is secondary to the size of the current demand). However, at present, we are not seeing any strong institutional premises (changes in construction law and tax regulations) which could affect housing supply in the future.

Valuations problem

We have come to the matter of the adequacy of the current market prices. Various measures can be used here. The most frequently used are the so-called affordability indexes which compare property prices to the purchasing power of consumers. An example of this index is the ratio of the typical flat price on a given market to the annual disposable income of the representative household (price/income ratio, P/I). Another index is the ratio of the loan instalment required to purchase a typical flat (under certain assumptions regarding the down-payment and the term of the loan) to the monthly household income (debt/income ratio).

The first of these is used, *inter alia*, by NBP, in assessing the housing market situation in the *Inflation Report.* According to the central bank's calculations, in 2007, this index was at a level of between 6 and 10 in Poland's largest cities. This means that the price of a typical flat was on average as much as 10 times (in the case of Kraków and Wrocław) more than the annual disposable income of the representative household. Meanwhile, international institutions, such as e. g., the UN, OECD or IMF consider 3 - 4 to be a safe index level. When taking into account local conditions, the World Bank admits a slightly higher range of this index to a maximum of 5.

In view of the low demand elasticity on the Polish market, which arises from such reasons as the complicated and inefficient system of regulations, it can be assumed that the price/income ratio should be closer to 5 rather than 6 - 10. Assuming that the middle of this range is the average index for Poland in 2007 and adjusting it with growth in disposable income (approx 10 - 15% throughout in 2008), it can be estimated that housing prices (compared with income) are currently approximately 30% over-valued. Naturally, the increase in income will reduce this difference, thereby increasing the affordability of housing.

However, this type of assessment of the housing market situation ignores such factors as the interest rate level or the mortgage loan market development. These factors are taken into account by the second of the abovementioned indexes, namely the relationship of the mortgage loan to income. In Q1, 2008, the purchase of a flat of an average floor space (69 sq. m., according to CSO data) was related to spending of PLN 424 k (the average price per sq. m. throughout the country, according to the NBP, was almost PLN 7,600). Assuming a down-payment of 20% and a 30-year loan period, with an average (weighted) interest rate on zloty- and FX-denominated loans at a level of 5.9% per year, the monthly instalment on such a loan would be approx. PLN 2,400.

For the "typical" household, which consists of two people generating income which is equal to the average monthly salary in the national economy (approx. PLN 2,100 net per person), this gives a loan charge of more than 57%. Meanwhile, the level accepted by domestic banks as the admissible upper threshold is most frequently 50%. In countries with a developed banking system, exceeding a threshold of 40% already qualifies the loan as of increased risk. Provided the ratio of the loan instalment to the disposable income of our typical household dropped below 50%, housing prices would need to drop (*ceteris paribus*) by at least 12%. Obviously, a substitute for this change could be a drop in interest rates (in this case by at least 130 bp) and, in consequence, a drop in loan repayments.

From the buyer's point of view

These calculations indicate that housing prices are currently too high when compared to the purchasing power of the representative household. It obviously does not imply they have to drop, since the typical household does not need to be equivalent to the typical purchaser on the real estate market. Therefore, let us take a look at the market from the purchaser's point of view, ignoring income and creditworthiness. In equilibrium, the purchaser should not pay more for a flat (in the form of a loan instalment) than rental would cost him. However, if he or she treats the purchase of a flat as an investment, he or she should not pay more than he or she expects to obtain from rental. Under both approaches, we obviously need to take into account the time value of money. In the same manner (discounted cash flow method, DCF), all other assets, in particular, financial instruments, are valued.

If we were to ignore for a moment the difference between the interest rates on loans and deposits, these two approaches should yield similar results. In the *Inflation Report*, the NBP monitors the relationship between the market prices of flats and their valuations using the second above-mentioned approach. In the case of cities such as Kraków or Poznań, market prices varied from their "fundamental" counterparts by as much as 15%. However, these estimates are based on an even larger number of assumptions than the previously presented calculations. In particular, an assumption needs to be made about the level of rents on the housing rental market. A difference between the flat prices and their "intrinsic" value does not need to imply their reduction, but may induce the rental prices to rise.

Property developers...

More equivocal conclusions arise from the housing market analysis conducted from the property developers' perspective. In 2007, a property developer's profit in Warsaw (latest available data cited by the NBP) constituted as much as 45% of the price per sq. m. of flat sold. It is difficult to expect, with an average sales profitability for the whole enterprise sector at 6%, that these companies are able to maintain such margins for a longer time (keep in in mind their clearly cyclical nature and the increasing demand barrier). Even assuming that the margins generated by property developers are higher than the inter-sector average (these companies claim they are interested in at least 10-15% margin) and costs do not rise much faster than inflation, there is still room for a price correction by more than 30%.

Just like the estimates -provided afore, this figure should be taken with caution. Firstly, we are making a large number of assumptions (albeit necessary) at this point. Secondly, we are relying on partial, historical data (only this is available), which frequently applies only to a certain market segment. Thirdly, the fact that there is room for a downward price correction does not mean that nominal prices will fall. For understandable reasons, companies would prefer to avoid reducing list prices, using various promotions instead (discounts, finishing and additional equipment elements inclusive in the price, etc.). The actual prices will then decline. Furthermore, even if the nominal prices remain unchanged, real prices will decline (taking into account the inflation), as will relative prices (taking account the income growth).

Estimated overvaluation of housing prices - various approaches			
Price/income ratio	*Debt/income ratio*	DCF	Sales profitability
28%	12%	5-15%	30%
The above estimates should not be treated as forecasts of housing price changes.			

... and economic growth

Probable stagnation of housing prices and the demand barrier will result in the contraction of the construction sector activity. The latter, instead of running new projects, will need to concentrate on the sale of completed flats. This in turn means that, within a few quarters, the contribution of construction industry to the GDP growth could become negative. This phenomenon is typical for the business cycle phase, the Polish economy is facing right now. After all, both slow-down pressure in construction industry, as well as a probable stagnation of housing prices, are of a clearly cyclical nature.

CONTACT:
Financial Markets Department

ul. Senatorska 18
00-950 Warsaw
fax: (22) 829 02 05

Customer Relations Department Manager

Bogusław Goleń +48 22 829 02 11 bogdan.golen@brebank.com.pl

Financial Customers Department Manager

Inga Gaszkowska-Gębska +48 22 829 12 05 inga.gaszkowska-gebska@brebank.com.pl

FX Transactions Department Manager

Marcin Turkiewicz +48 22 829 01 84 marcin.turkiewicz@brebank.com.pl

Interest Rate Transactions Department Manager

Łukasz Barwicki +48 22 829 01 93 lukasz.barwicki@brebank.com.pl

Structured Instruments Department Manager

Jarosław Stolarczyk +48 22 829 01 67 jaroslaw.stolarczyk@brebank.com.pl