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MONTHLY MACROECONOMIC REVIEW

November/December 2008, No 88/89 (11/12)

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- The presentation of the new Stability and Development Plan shows that in the face of a growing risk of a steep decline in economic activity the government has found it necessary to take measures to stabilise the economy and support investment and consumer demand. The government's plan is a kind of experiment aimed to demonstrate whether such goals can be achieved without expanding the fiscal deficit. The success of this "experiment" will largely depend on the government's effectiveness and flexibility in implementing the different elements of the Plan, and especially on a more efficient absorption of EU funds.

- Owing to a rather limited usefulness of econometric models in determining the turning points in business cycles, it is necessary to also rely on other instruments, including, in particular, the leading economic indicators. In the past, the PMI has shown good predictive properties, and therefore the rapid drop of this index to the lowest level in the history of such surveys in Poland is found to be very disturbing. The negative tendencies in the Polish economy are also confirmed by the very strong decline in investment growth recorded in the third quarter and by the large drop in industrial output recorded in November.

- The cautious approach adopted so far by the Monetary Policy Council suggest that the Council members are still very worried about the inflation outlook and that they still fail to see the need to implement more decisive measures to support economic activity. Such approach is in line with the MPC mandate, but we believe that due to a growing probability of a relatively fast decline in inflation there is considerable scope for further easing of monetary policy.

- Despite a fairly low deficit after 11 months (about PLN 15 billion), the performance of this year's state budget has been much worse than in the same period of last year. Indirect tax collections are much lower than planned, which is particularly disturbing, as this can be considered both a symptom of a weakening economy and a harbinger of difficulties with reaching the 2009 revenue targets. Owing to large delays in the utilisation of EU funds, the total shortfall of budget revenue this year will be the highest since 2001.

- The changes introduced to the 2009 budget are, in our view, by far insufficient. The GDP growth rate forecast of 3.7% is an expression of an excessive optimism on part of the government, but even with such a rate of economic growth the planned budget revenue would be hard to come by. The government's approach may be justified by a large scale of uncertainty and concerns about negative consequences of any relaxation of fiscal policy. We are afraid, however, that it will be very difficult to stick to the proposed deficit level without imposing very tight control over expenditures and/or amending the budget in the course of the next year.

KEY MACROECONOMIC INDICATORS

	Apr 08	May 08	Jun 08	Jul 08	Aug 08	Sep 08	Oct 08	Nov 08
GDP and Output								
GDP			5.8%			4.8%		
Domestic demand			6.2%			4.3%		
Private consumption			5.5%			5.1%		
Investment in fixed assets, gross			15.2%			3.5%		
Value added			6.1%			4.7%		
in industry			6.9%			3.1%		
in the construction sector			17.8%			11.0%		
in the market services sector			5.5%			5.4%		
Industrial production growth YoY	14.9%	2.3%	7.2%	5.6%	-3.7%	6.8%	0.2%	*-8.9%*
Industrial production growth MoM	4.0%	-8.5%	5.0%	-3.4%	-8.1%	17.2%	2.9%	-13.1%
Retail sales YoY	17.6%	14.9%	14.2%	14.3%	7.7%	11.6%	7.9%	*5.1%*
Retail sales MoM	2.9%	-1.9%	2.4%	1.8%	-3.9%	1.8%	0.1%	*-6.5%*
Labour Market								
Average wage in the enterprise sector (PLN)	3137.74	3,069.43	3,215.32	3228.98	3165.14	3171.65	3241.81	3320.94
Wage growth in the enterprise sector YoY	12.6%	10.5%	12.0%	11.6%	9.7%	10.9%	9.8%	7.4%
Wage growth in the enterprise sector MoM	-0.2%	-2.2%	4.8%	0.4%	-2.0%	0.2%	2.2%	2.4%
Employment in the enterprise sector YoY	5.6%	5.4%	4.8%	4.7%	4.2%	4.1%	3.6%	3.1%
Employment in the enterprise sector MoM	0.1%	0.0%	0.0%	0.2%	0.0%	0.1%	0.1%	-0.2%
Unemployment rate	10.5%	10.0%	9.6%	9.4%	9.3%	8.9%	*8.8%*	*9.0%*
Foreign trade								
Current account (EUR)	-1 282	-1 495	-2 098	-1 057	-1 306	-1 967	*-2 330*	
Trade balance, transaction-based (EUR)	-1 032	-1 213	-1 639	-1 404	-1 503	-1 124	*-1 590*	
Exports, transaction-based YoY (EUR)	34.1%	12.5%	16.6%	23.7%	9.7%	22.5%	*7.5%*	
Imports, transaction-based YoY (EUR)	31.8%	13.5%	19.7%	20.9%	17.3%	21.2%	*11.8%*	
Current account (% GDP)	-5.0%	-5.0%	-5.0%	-4.8%	-4.8%	-5.1%	*-5.3%*	
Prices								
CPI MoM	0.4%	0.8%	0.2%	0.0%	-0.4%	0.3%	0.4%	0.2%
CPI YoY	4.0%	4.4%	4.6%	4.8%	4.8%	4.5%	4.2%	3.7%
Net inflation YoY	2.8%	3.2%	3.4%	3.5%	4.0%	4.3%	4.5%	*4.7%*
PPI MoM	-0.1%	0.7%	0.3%	0.0%	0.2%	0.2%	-0.3%	-0.5%
PPI YoY	2.5%	2.7%	2.7%	2.3%	2.0%	2.1%	2.4%	2.2%
Money aggregates								
Money supply M3 (PLN B)	593.9	599.6	605.7	616.1	628.6	630.5	637.4	647.9
Money supply YoY	14.9%	15.0%	16.2%	16.8%	16.8%	17.3%	17.6%	18.0%
Household loans YoY	36.3%	34.0%	34.4%	30.5%	31.5%	33.5%	40.4%	37.9%
Corporate loans YoY	24.9%	26.0%	24.6%	23.5%	25.2%	24.5%	26.9%	26.5%
Household deposits YoY	18.8%	21.0%	22.7%	24.7%	23.8%	24.1%	24.4%	24.9%
Corporate deposits YoY	8.0%	6.1%	6.9%	7.0%	3.1%	7.1%	4.3%	2.2%
Forex Rates								
EUR/PLN rate (end of month)	3.46	3.38	3.35	3.20	3.35	3.41	3.63	3.76
USD/PLN rate (end of month)	2.23	2.18	2.12	2.05	2.27	2.37	2.85	2.92
Interest Rates								
NBP reference rate	5.75%	5.75%	6.00%	6.00%	6.00%	6.00%	6.00%	5.75%
Lombard rate	7.25%	7.25%	7.50%	7.50%	7.50%	7.50%	7.50%	7.25%
Deposit rate	4.25%	4.25%	4.50%	4.50%	4.50%	4.50%	4.50%	4.25%
WIBOR 3M	6.34%	6.48%	6.65%	6.56%	6.50%	6.63%	6.85%	6.56%
2Y bond yield	6.21%	6.48%	6.89%	6.53%	6.35%	6.23%	6.86%	5.87%
5Y bond yield	6.08%	6.38%	6.78%	6.31%	6.17%	5.99%	6.82%	5.75%
10Y bond yield	5.97%	6.27%	6.61%	6.25%	6.05%	5.82%	6.60%	5.89%
Global Economy								
Eurozone inflation (YoY)	3.3%	3.6%	4.0%	4.1%	3.8%	3.6%	3.2%	2.1%
Eurozone GDP (YoY)			1.4%			0.7%		
ECB basic rate	4.00%	4.00%	4.00%	4.25%	4.25%	4.25%	3.75%	3.25%
US inflation (YoY)	3.9%	4.2%	5.0%	5.6%	5.4%	4.9%	3.7%	
US GDP (QoQ ann.)			2.8%			-0.3%		
Fed Funds target rate	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	1.00%	1.00%

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

POLISH ECONOMY

How deep can the slowdown be?

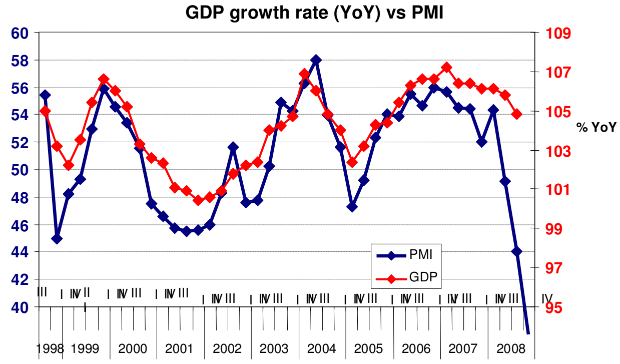
The fact that the global slowdown will negatively affect the growth of the Polish economy is now an obvious matter. Yet the determination of the scale of economic slowdown in Poland goes much beyond standard analysis based on econometric models, all the more so as the symptoms of the slowdown are not yet fully visible in the current data.

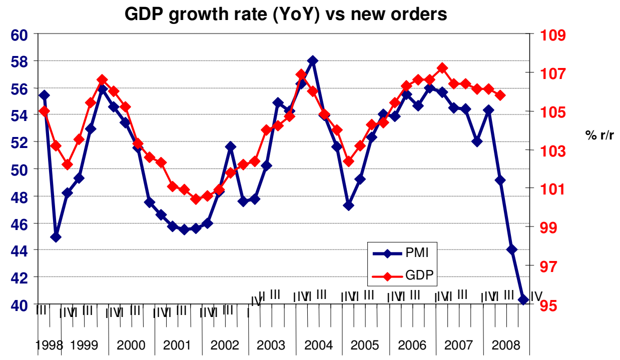
Econometric models and foretelling recession

To start with, let us briefly digress on econometric models. There can be no doubt that they are very useful tools of economic analysis. In a stable macroeconomic environment, the models should also do fine as forecasting tools. However, the weakness of econometric models (especially multiple-equation models) in predicting recessions is widely known, whereas they do much better in forecasting an economic recovery. One of the possible causes may be seen in a different pattern of changes in these two phases of the business cycle. Recessions are usually more rapid and of a shorter duration, while a typical model tries to present a picture of averaged changes in the economy over the entire cycle. Another issue is a widespread use of over-fitted time series models, which generate a high inertia of explained variables (in the model reality, however, elasticities of variables turn out to be limited relative to exogenous variables, including structural changes). We believe that also the NBP forecasting model – the multiple-equation NECMOD model – is not free from such problems. As we will show below, the GDP growth slowdown to 2.4% YoY in Q2 2009 (from 5.9% in Q2 2008) forecast by that model may therefore prove to be a too optimistic scenario!

Leading indicators and the risk of rapid decline in GDP growth

Leading economic indicators (that usually include also stock exchange indexes) ca play a useful role in determining turning points in business cycles. In our previous analyses, we have often referred to the purchasing managers index (PMI). Based on the historical correlation between this index and the GDP, we come to the conclusion that there is an asymmetric risk of very low GDP growth rates occurring in the quarters to come, which is also quite clearly visible on the enclosed graphs. When relying solely on changes in value of the aggregated PMI and its individual components, one could even claim that the Polish economy is at risk of entering a recession.

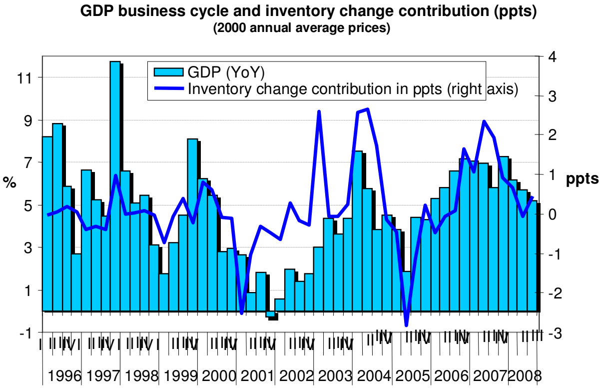




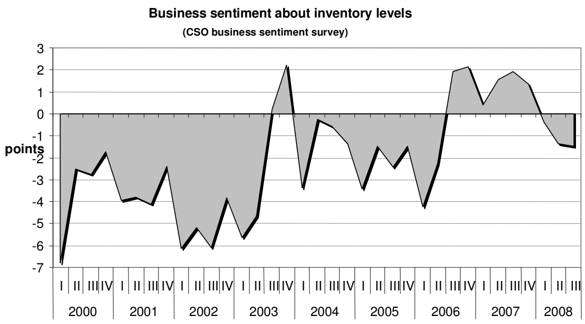
Changes in inventories and the upcoming slowdown

We have also tried to evaluate the risk of a rapid economic slowdown by looking at the inventory cycle to look for considerations pointing to. The chart below shows cyclical changes in the GDP against changes in inventories. Please note that inventory investments (or actually changes in their levels), which are part of private accumulation, are strongly pro-cyclical in Poland. This allows such changes to be used as yet another indicator providing a fuller picture of changes in the business cycle.

In the current phase of the business cycle, the contribution of inventory changes is gradually moving towards a negative value, which can be considered as a signal of an upcoming slowdown. While a strong and rather unexpected increase in the contribution of inventories in Q3 does not confirm this view, it cannot be ruled out that it was only a transient deviation from a previously observed trend.



This is also suggested by the CSO business sentiment surveys presenting the inventory balance, which entrepreneurs can describe by one of the following three terms: “too large”, “too small” or “sufficient”. The resulting ”sentiment mirror” reflects business sentiment in relation to the current inventory balance. A negative value of this index points to an unfavourable situation as it indicates an excessive inventory level, which is usually associated with insufficient demand.



Based on an analysis of those indexes, we come to the conclusion that contribution of inventory changes to the GDP growth will turn negative in the coming quarters. The current level of inventories is described by business operators as being excessive, while in the period of dynamic growth in 2006-2007 it was always considered insufficient. This means that at present we are witnessing symptoms of overproduction, which, when the inventory cycle is compared to the sentiment cycle, shows how mature the present stage of the business cycle is. The relatively high inventory accumulation is attributable to a declining demand (both domestic and foreign – as shown by the record-low export orders). However, due to the fact that demand will decline at a somewhat lower pace than the supply side of the economy (because of the fast-growing wage bill, and the still relatively high credit growth), inventories will also probably be reduced, while decreasing production will prevent their further accumulation. This does not stand in contradiction to the fact that business operators will still consider their current inventory level to be too high as the process of finding a new balance between output and demand has to be spread over time.

Yet in the present situation (being probably a turning point in the cycle), it is the statistical effect that is of key importance. Inventories will be reduced from a relatively high level to that closer to a state of equilibrium in a period of lower economic activity. This will lead to a highly negative contribution of inventory changes in the months to come, thus supporting the argument of a rapid economic slowdown (based only on past experience, the negative contribution of inventory changes may fall within the range from -1 to -3 ppts).

A rapid decline in the GDP growth rate (in Q4 2008 and Q1 2009) may give rise to a question about the possible reaction of the financial markets. We are still unable to determine which of the factors will dominate – those placing Poland among the emerging markets (increased investment risk, reduced return on investment and the need for a higher risk premium, as well as the issues related to credit risk, possible revision of the budget and financing the fiscal deficit), or those relating to the prospect of Poland’s accession to the Eurozone (then a cyclical slowdown would only involve lower interest rates, and markets would respond positively to a reduced risk of foreign debt rollover in connection with FX-swap lines offered by the NBP). Hence the most probable scenario for the months to come is characterised by high volatility of financial markets, reflecting alternating valuation of optimistic and pessimistic scenarios. However, the prospects of a lower economic growth, higher C/A deficit and lower FDI are expected to lead to a further weakening of the zloty.

The government tries to support the economy

The greatest value of the government's action plan for the strengthening of the economy lies in the very fact that such a document has been drafted. This means that the government is no longer wasting time assuring that Poland is an "island of stability", and has noticed the need to deal with the effects of a global crisis. A correct diagnosis of the patient's condition is always the key to effective therapy. However, one can still doubt if the government has made such an in-depth and thorough assessment of the current condition and prospects of the Polish economy, as the 2009 GDP forecast of 3.7% still seems to reflect excessive optimism. The investment growth downturn in the third quarter of this year (with an increase of a mere 3.5%) as well as the drop of the PMI index for manufacturing to the lowest level in more than ten years and the large decline in industrial production in November (- 8.9%), clearly point to rapidly deteriorating prospects of the Polish economy. In our opinion, the GDP growth rate next year may be about 2 percentage points lower than the revised Ministry of Finance forecast, which suggests that the decline in budget revenue may also be much greater. The government comes forward with rational arguments for adhering to the earlier announced reduction of state budget deficit to PLN 18.2 billion. However, combined with the announced increase of excise duty on cars and alcohol, this amounts to a further tightening of fiscal policy, i.e. a measure that may be considered pro-cyclical under the current conditions. Hence it is reasonable to ask if such an approach could be maintained if it turned out to be necessary to make further deep cuts in expenditure to offset a larger-than-planned revenue gap (estimated by some experts at up to twenty billion zlotys).

The total face value of the measures under the new plan unveiled by the government, i.e. PLN 91.3 billion (more than 7% of the GDP) may command respect, but a closer look at this plan shows that most of the funds have already been provided for in the draft budget, and/or their disbursement is subject to meeting a multitude of various conditions. Hence the new plan may be viewed as an experiment aimed to show if it is possible to support economic growth without increasing budget expenditure (and even with some spending cuts). After deducting the funds previously included in the draft budget (state guarantee ceiling of PLN 15 billion, expenditure related to the utilisation of EU funds of PLN 9.5 billion, PIT rate reduction and VAT changes of PLN 8 billion) the balance remaining for the new measures is just under PLN 56.8 billion, of which PLN 45 billion is a potential increase in lending to banks and enterprises resulting from the activation of state guarantees, and PLN 10 billion represents a potential increase in expenditure financed with EU funds. Certainly enough, the very fact that the Budget Act now provides for a higher ceiling for state guarantees and sureties does not guarantee that there will enough demand for using such guarantees and that banks will find sufficient funds to finance loans that would benefit from such enhancements. For example, in 2007, of the overall limit set at PLN 17 billion only PLN 3.1 billion was actually used, with only three guarantees (all for the state owned BGK bank) and two sureties granted. A substantial increase in the use of state guarantees and sureties would require not only greater interest from prospective beneficiaries, but also the establishment of an efficient mechanism of providing access to guarantees. Fees and other charges would also need to be set at an attractive level. The plan to "create" an additional PLN 20 billion in SME loans is, at this stage, of a similarly hypothetical nature. The success of this plan will also depend on demand for such financing and on the terms and conditions of its provision. Of course, BGK alone will be unable to provide such a large number of loans, and therefore the process would have to involve commercial banks. Within the new plan, the largest amount of real funds is involved in the proposal to accelerate the implementation of projects co-financed by EU funds. However, doubts may arise as to whether legislative changes recently implemented with regard to public procurement and environmental protection will be sufficient to bring the long-anticipated breakthrough in the pace and scale of utilising EU funds and whether such effect can be achieved without a dramatic simplification of all administrative procedures.

The action plan presented by the government doesn't contain many new elements that would help to solve the key problems of restoring confidence in the banking sector and securing access to funds needed to finance the further expansion in bank lending. The government plan just lists the measures that have been announced earlier and are at various stages of implementation. This includes the increased cover for individual bank deposits and a "confidence package" being introduced by the NBP, as well as the draft Act on support to financial institutions currently debated by the Sejm. No details have been released so far on another new law being prepared by the government that would provide a basis for the recapitalisation of financial institutions. Restoring normal operation of the interbank market and providing businesses and households with access to bank credit is a condition *sine qua non* for the success of any measures aimed at stabilising the economy. It is worth noting that to provide banks with access to guarantees for loans granted to other banks (as provided in the draft Act on support to financial institutions) is not enough, as this source of liquidity would be insufficient to cover the large gap resulting from the highly diverse growth

rates of bank deposits and loans. Without access to financing from other domestic and foreign sources, banks will be forced to adjust their lending growth rate to the growth of deposits placed by their customers.
The plan announced by the government is mainly targeted at supporting investment demand. This is to be achieved by providing additional state guarantees, loans to the SME sector, and by more efficiently using the EU funds. Given that the greatest risk to economic growth comes from collapsing investment demand, this is certainly the right priority. It is also good that the government is trying to focus investing activities on projects in the IT sector, R&D, and renewable energy, as such "intelligent" investment is conducive to furthering the goals set forth in the Lisbon Strategy. The announced investment-promoting measures include temporarily increased tax relief for new businesses, but the government did not specify its possible costs to the budget. It cannot be ruled out that in order to increase the effectiveness of the relief it will be necessary to extend it so as to cover additional enterprise groups.

The government plan does not provide for any new measures in support of consumer demand. It only reminds about the expected benefits of the already adopted reduction in PIT rates and of the earlier cuts in pension contributions. The effects of those changes had previously been accounted for in the draft budget, hence the inclusion of the information about the planned tax changes into the Stability and Development Plan does not by itself generate any additional growth-promoting stimulus. The fact that the plan devotes so little attention to the need to stimulate consumption can be considered as one of the weak points of the new package announced by the government. The decline in the wage growth envisaged for the next year (which is also needed in order to boost competitiveness and reduce inflationary pressure) and the expected increase in unemployment will probably lead to a decrease in incomes exceeding benefits from the PIT rate reductions, and will thus result in a lower consumption growth. The government's plan also lacks measures directly aimed to support exporters (e.g. by increasing the access to instruments offered by the Export Credit Insurance Corporation), while this group of enterprises is the most exposed to the effects of recession in the economies of our main trading partners. Despite the rising risk of a renewed increase in unemployment, no new measures have been proposed to support the labour market, and funds earmarked for the planned social solidarity reserve may prove far too modest if the economic slowdown were to turn out much deeper than assumed by the government.

Owing to a lack of detailed information on the method of implementing the measures announced by the government, it is hard at this stage to come up with even a preliminary assessment of benefits they may produce. It is certainly positive that the Stability and Development Plan has been announced, whereas the extent to which it will contribute to limiting the unavoidable decline in economic activity in Poland will mainly depend on the government's effectiveness in implementing the measures proposed in the plan. We believe that one of prerequisites for the success of the measures announced by the government is adequate flexibility in implementing government plans. It is very probable that some of the measures proposed will not produce the expected effects and/or that they will have to be complemented with new initiatives. This is indirectly confirmed by the case of the so-called Paulson plan, where soon after its approval by the Congress it turned out that the funds under the plan could be put to a better use for measures completely different from those originally intended.

MONETARY POLICY

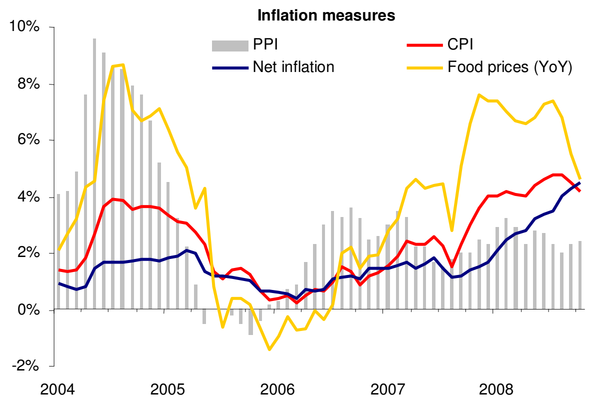
Cautious moves of the MPC

The decisions taken by the MPC at its last two meetings clearly show that the Council has not found it necessary as yet to take more decisive measures in support of economic growth. At the same time, when assessing the risks to price stability, the MPC became much more concerned about the effects of the ongoing depreciation of the zloty. The latter factor, combined with the somewhat confusing conclusions resulting from the new inflation projection (a steep decline in the GDP growth rate combined with a pick up in inflation in 2009, and with the CPI reaching the NBP target by the end of 2010) seems to have significantly influenced the October decision to keep interest rates unchanged. While such a decision was fully in line with market expectations, what may be surprising is the fact that no proposal to cut the rates was tabled at the October meeting. This may suggest that the Council strongly prefers to move in small steps and that even its dovish fraction found it sufficient at that time to signal a *de facto* change in the policy stance from restrictive to neutral. Our claim that the MPC prefers to play it safe and is rather risk-averse is not necessarily contradicted by the decision taken at the end of November to reduce interest rates by 25 basis points. While this decision, which we had anticipated, came as a surprise to most analysts (even though it had been signalled by prices of financial instruments), the very small scale of the cut in reference rate as well as the lack of changes to the width of the NBP rate "corridor" and to the rate of minimum reserve rate seem to confirm the Council's cautious approach. The result of the MPC meeting scheduled for 22-23 December will become a real test whether the Council is prepared to change its approach. We expect that this time the MPC will break with its unwritten tradition not to change the rates in December and will cut the reference rate, but only a reduction by at least 50 basis points would confirm that concerns about prospects of economic growth have prevailed over concerns about price stability.

The key factor in favour of further easing of monetary policy is the significantly increased probability of a relatively rapid decline in inflation to close to the NBP target. According to our estimates, this may take place as early as at the end of the next year, and not only at the end of 2010, as provided for by the NBP projection. In our view, the MPC should not be guided by the results of this projection, as it was based on assumptions that have largely become outdated. This concerns mainly oil prices (the projection provides that they will stabilise in 2010 at USD 106 per barrel), but also the scale of the global economic slowdown and the development of interest rates (it was assumed that in the euro area they will remain relatively stable until 2010). In a situation when concerns about the risk of deflation start to prevail in many countries, it is really hard to believe that, as suggested by the NBP projection, the average CPI level in Poland could increase next year to 4.7%. Headline inflation has been following a downward trend already for some time, benefiting from falling commodity prices and a lower growth of food prices. Next year this trend will gain strength owing also to base effects. A negative demand gap which will emerge as a result of a decline in the GDP growth to a level significantly below the potential of the Polish economy will become an important factor leading to a decreased inflationary pressure. The MPC is right to emphasise the threats arising from the still excessive wage growth, but as admitted in the most recent Council statement, lower demand for labour and deteriorating financial performance of companies will contribute to the weakening of the wage pressure. What may be one of the reasons why the MPC exercises caution in easing monetary policy is the further increase of the "net" core inflation index and the fact that the new core inflation measure (excluding food and all energy prices) has yet to decline from its current level of 2.9% (which is above the NBP target for CPI). It must be born in mind, however, that what has substantially contributed to the increase in "net" inflation is a recent series of increases in regulated electricity and gas prices, which should be a much lesser threat in the future in the face of falling energy prices and the recent announcements by the regulatory bodies. Slower growing costs and weakening consumer demand are also expected to result in the reduction of growth in prices of services and hence in diminishing their upward impact on core inflation. In a situation where most factors point to the prospect of a decreasing inflationary pressure, concerns about excessive depreciation of the zloty having potentially adverse effects (inflation-wise) are one the few arguments that the MPC can still resort to in order to justify its cautious approach to interest rate reduction. Yet these concerns appear to be exaggerated, as the experience of other countries which have recently reduced their interest rates seems to confirm the view (also expressed by some of the MPC members) that changes in interest rate disparity have in the current environment a rather limited impact on exchange rate movements. There are also reasons to believe that under conditions of weakening domestic demand (and deflationary tendencies in the external environment), the risk that the zloty depreciation will contribute to a large "import" of inflation is decreasing.

The intention to quickly proceed with the adoption of the euro, as announced by the government, has in the recent months become an additional important element in the MPC decision-making process. The majority of the Council members are in favour of the view that benefits of adopting the euro are larger than costs and therefore they feel obliged to pursue policy that would ensure meeting the Maastricht inflation criterion in a sustainable way. While being fully supportive of the rationale of this approach, we believe that in the face of the still considerable uncertainty as to the feasibility of the timeline set by the government (mainly due to resistance from the main opposition party) and given substantial risks to economic growth, the Council should not set a more ambitious goal for itself at the moment than the reduction of inflation to a level close to the NBP target. We are aware that with a fast-falling inflation in most of the EU member states this may not be enough to meet the requirements set in Maastricht, but as the actual test period will start at the earliest in spring of 2010, there would be still time to introduce some additional adjustment measures.

As we are convinced that inflation will be falling much faster than envisaged by the NBP projection, we believe that the MPC still has plenty of "ammunition" it could use to reduce the scale of decline in economic activity. The situation in the external environment is becoming increasingly negative as indicated both by the forecasts pointing to a GDP decline in most of the OECD member states in 2009, and by growing desperation of the monetary and fiscal authorities. In addition to negative external impacts, the scale of threats facing Poland's economic growth is already shown not only by the fast-deteriorating indicators of business and consumer sentiment (including especially an unprecedented decline of the PMI), but also by "hard" data pointing to a contraction in industrial production, decreasing employment in manufacturing and a rapid decline in investment growth. There are also increasingly strong signs that due to such factors as weakening consumer confidence, deteriorating situation in the labour market, rising debt service costs, and more difficult access to new credit, private consumption may prove to be much less helpful in mitigating the pace and scope of the decline in GDP growth. No wonder then that under such conditions the growth forecasts for the Polish economy are being continuously reduced. In our view, the GDP growth will be close to 2% next year, but any forecasts under the present situation carries a very high risk (which is indirectly confirmed by the fact that they range between 0.4% and 3.8%).
In almost all of the highly developed countries, quick interest rate cuts have been the response to deteriorating growth prospects. At the same time, there more and more assurances that even after the rates are brought to zero, monetary policy does not have to become ineffective. In the case of countries classified as emerging markets, the responses of monetary authorities have been more diversified, as in the face of a crisis not all of them can afford the "luxury" of easing monetary policy. As shown by the examples of Hungary, Russia and Iceland, the risk of a large capital outflow may force the central banks to hike the rats (at least temporarily). These examples suggest that contrary to quite often presented arguments, keeping interest rates in Poland at a relatively high level must by no means be viewed as a proof that sound fundamentals of the economy enable the MPC to focus on its main task of curbing inflation. It can also be seen as an expression of concerns about the negative impact of interest rate cuts on the development of the zloty exchange rate and the behaviour of foreign investors. In the case of the Czech Republic, even the relatively high current inflation has not prevented the central bank from cutting its reference rate in two steps by 75 and 50 basis points (to 2.25%). These cuts have not resulted in a very significant weakening of the Czech currency. The European Commission has given its new European economic recovery plan a motto "the time to act is now". We believe that there are many reasons to claim that the Monetary Policy Council should also guided by such a principle.



Fiscal Policy

Low expenditure saves the budget as revenue slumps.

State budget deficit after 11 months of this year has been estimated at PLN 14.8 billion. This figure suggests there is no risk the deficit level set for 2008 (PLN 27.1 billion) will be exceeded. As has been the case over the past few years, the final level of the deficit will largely depend on decisions taken at the very close of the year by the Ministry of Finance. It is, however likely, that the difference between the planned and actual deficit levels will not reach the amount of PLN 4.3 billion provided for by the MoF. The greatest unknown is what the MoF intends to do with the Social Insurance Fund (SIF) subsidy, as the amount held in social insurance funds bank accounts (almost PLN 17 billion at the end of November) suggests they are in good financial condition.

While there is no risk the deficit will be exceeded, the performance of this year's budget has been clearly worse than in 2007. After 11 months of the last year, the deficit reached only 20% of the amount set for the whole year, and this year it has already reached almost 55%. What makes an important difference is also that last year the low deficit was attributable both to higher-than-planned revenue and to lower expenditure, while this year the entire burden of maintaining fiscal discipline rests on the expenditure side, as revenue is much lower than expected. In line with the MoF estimates laid down in the explanatory statement to the draft Budget Act, the total revenue at the end of this year is to be about PLN 19 billion lower than planned, mainly owing to the very low absorption of EU funds. In our view, this estimate is overly optimistic, as it assumes that tax collections will be more than PLN 2 billion higher than those assumed in the budget. Based on the tax revenue performance so far, one can expect that at the end of the year it will be more than PLN 4 billion lower than planned, as PIT and CIT collections, while higher (by just over PLN 3 billion in total), will be unable to cover the indirect tax revenue shortfall, which we estimate at around PLN 8 billion. A weakening growth rate of indirect tax collections can be considered as one of the symptoms of declining economic activity. As the growth rate in wages and other earnings remains high, PIT collections still exceed the planned levels. The risk is, however, that at the end of the year the surplus may shrink, as some of the taxpayers may try to shift part of their incomes to the beginning of the next year in order to take advantage of the reduced rates of that tax. If our estimates prove correct, the revenue shortfall at the end of the year could reach about PLN 24-25 billion, i.e. nearly 9% of the amount provided for in the budget. To stress how exceptional this situation is, it is worth recalling that such a large shortfall in budget revenue was last witnessed in 2001, and that in the last four years fiscal revenue has always been higher than planned. Fortunately, this time the main cause of the shortfall is different as it reflects the difficulty in precise planning of EU funds inflows that since 2007 have been treated as budget revenue. The proposed separation of the EU funds budget, as envisaged by the new draft Public Finance Act, will not entirely solve this problem, but will, at least, increase budget transparency.

Expenditure performance is almost a mirror reflection of the situation on the revenue side. After eleven months of this year, expenditure reached only about 81% of the amount planned for the entire year, and it was almost PLN 28 billion below the level envisaged in the MoF schedule. Only 40.2% of funds earmarked for EU co-financed projects were actually disbursed in that period. Other expenditure has been made at a rate close to last year's, although relatively less funds have been appropriated for social insurance fund subsidies and for public debt service. Delays in the transfer of funds to social insurance funds are expected to be more than made up at the end of the year, while debt service expenditure may see real savings in excess of PLN 1 billion. Almost no improvement has been recorded in terms of better distribution of capital expenditure. During the first ten months of 2008, only 41% of the funds earmarked for the purpose was disbursed, which suggests that, as in the previous years, almost a half of those expenses will be made in the last month of the year.

State budget performance in January – November 2008

	PLN m	% of plan	YoY growth rate Jan-Nov 2008/ Jan-Nov 2007	YoY growth rate 2008 plan/ 2007 actual
Revenue, of which:	**235124.1**	**83.4%**	**109.0%**	**119.3%**
Indirect taxes	144439.4	87.6%	106.7%	112.6%
Excise duty	45560.4	87.3%	103.3%	106.5%
CIT	24227.9	89.2%	114.1%	110.6%
PIT	34740.4	96.1%	109.4%	102.2%
Expenditure	**249953.0**	**80.9%**	**112.7%**	**122.5%**
Domestic debt service	19160.1	87.5%	92.7%	96.7%
Foreign debt service	4758.2	81.7%	99.3%	117.6%
Social Insurance Fund subsidy	29656.6	89.2%	145.8%	139.1%
Local government subvention	39885.3	98.0%	110.5%	110.7%
Deficit/Surplus	**-14828.9**	**54.7%**	**246.6%**	**170.4%**

Source: Ministry of Finance

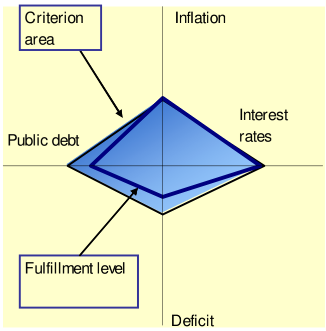
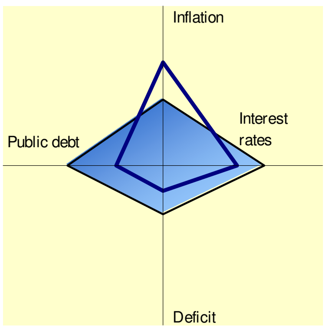
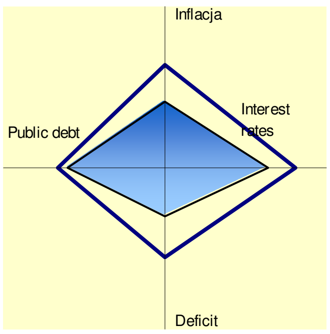
A cosmetic correction of the 2009 budget

In view of the economic downturn, the government has decided to reduce the GDP growth rate adopted in the macroeconomic assumptions underlying the 2009 draft budget from 4.8% to 3.7%. In our view, the fact that the correction scale is so small shows the government is still excessively optimistic about the possible economic development. It would be much safer to set the next year's growth rate close to the NBP and OECD forecasts (2.6-2.8% and 3%, respectively), whereas according to our own estimates the rate is likely to be slightly below 2%. So far, the Ministry of Finance has not provided any details of its new macroeconomic forecast, and therefore the source of the optimism emanating from the forecast is hard to identify. Indirectly, however, it can be suggested by a very small correction of budget revenue, which was reduced by a mere PLN 1.7 billion, and this only with regard to VAT revenue. The small scale of the reduction was based on the belief that private consumption would continue to grow fairly fast. Before the correction, the growth was expected to reach 5.1% in 2009, and this ratio does not seem to have changed significantly. A lack of information on a change in planned PIT and CIT collections may suggest that optimistic assumptions have been maintained concerning the wage bill growth rate, a further decline in unemployment and high corporate earnings. To offset the loss of revenue estimated at PLN 1.7 billion, the same correction was made on the expenditure side, which allowed the planned deficit to be maintained at an unchanged level (PLN 18.2 billion). Various types of specific provisions have been reduced by nearly PLN 1 billion, including mainly the provisions for EU co-financed projects and for health premiums financed from the state budget. Reductions have also affected, among other things, appropriations for the defence sector, for social security, and for EU budget contributions. According to the provisions of the Stability and Development Pact, the government has proposed to establish the Social Solidarity Reserve of PLN 1.14 billion as part of the budget. Funds for the purpose are to be raised by increasing the excise duty on alcohol and passenger cars. The limit for State Treasury sureties and guarantees has gone up from PLN 15 billion to 40 billion, and the intergovernmental lending limit has been increased from PLN 700 million to PLN 2 billion (probably with a view to enabling the government to grant Iceland the promised loan). The draft budget amendment has also included the amount of PLN 540 million, which the Enterprise Restructuring Fund intends to spend on severance pay to shipbuilding industry workers. While the disbursement of those funds (based on privatisation proceeds) will not increase the state budget deficit, it will add to the overall general government deficit.

We believe that the changes to the 2009 budget proposed by the government and already approved by the Sejm are by far insufficient. Real tax collections may be lower in 2009 not by PLN 1.7 billion, but by well over PLN 10 billion. This results both from a high probability of a much deeper decline in the GDP growth rate and from a base consisting of this year's tax revenue being lower than assumed by the government. According to our estimates, VAT collections may be about PLN 7 - 8 billion lower than originally planned by the MoF, and the planned excise duty revenue will also be hard to come by. In the face of an unexpected decline of corporate earnings there is no reason to hope for what appears to be an “astronomic” increase (of more than 16%) in CIT collections as provided in budget, and it would be safer to assume they will, at best, stay at the existing level. It is worth noting that in the “crisis” year of 2001 CIT revenue proved about 20% lower than planned and than the amount reached in the previous year. The wage bill growth rate is significantly lower than planned by the MoF, and lower proceeds from capital gains tax (attributable, among other factors, to the deduction of losses incurred this year) will probably also have an adverse effect on the amount of PIT revenue.

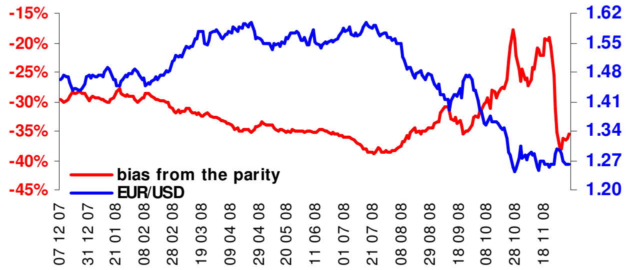
The adoption of a more conservative forecast of tax collections would force the government to make a corresponding deep reduction of expenditure and/or to increase the deficit level. The government is apparently rejecting both those options. In the first case, this probably results not only from objective difficulties in making such cuts in the final stage of work on the budget, but also from concerns about their potentially adverse impact on economic activity. Resolve to adhere to a previously proposed deficit level probably reflects the belief that increasing the deficit would not only be a high-risk decision (owing to a possible negative response from financial markets), but it would also be unreasonable in the context of the euro adoption plans and long-term benefits arising from discipline in public finance. We may suppose that based on such considerations the government intends to defend the deficit level as long as possible by limiting expenditure, and only when this proves to be no longer possible a proposal for a deeper correction of the budget will be put forward. Perhaps such approach is not most transparent, but it does have its internal logic and can partly be justified by the fact that uncertainty about further economic development in Poland is still very high. In any case, this suggests that good times are coming to an end also for those being responsible for the implementation of the budget, as it will take much greater effort than in the previous years to achieve the goals set in the 2009 draft Budget Act, if possible at all.

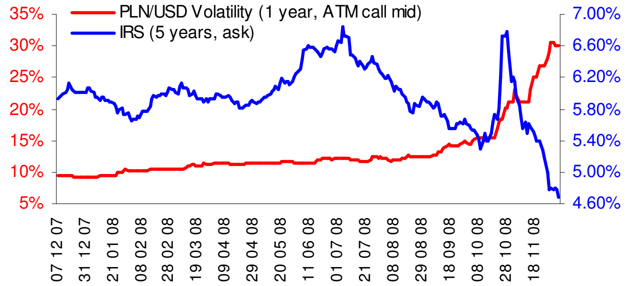
EUROMONITOR

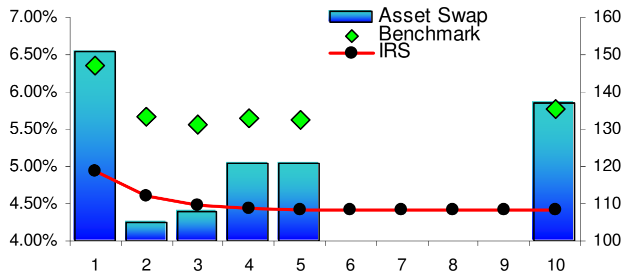
	Convergence criteria *	• HICP inflation (12-month average): **4.1%** (November 2008) • Long-term interest rates (12-month average): **6.31%** (November 2008) • Budget deficit: <**3.0% of GDP** • Public debt:< **60.0% of GDP** • ERM2 membership: **2 years**	Exchange rate and the 2.5% and 15% fluctuation bands around the ERM2 central parity over the last 2 years (in the case of states outside the ERM2 – around the rate as of the beginning of the observation period)
Poland		• HICP inflation (12-month average): 4.3% (November 2008) • Long-term interest rates (12-month average): **6.09%** (November 2008) • Budget deficit: **2.0% of GDP** (2007) • Public debt: **45.2% of GDP** (2007) • ERM2 membership: **no**	
Czech Republic		• HICP inflation (12-month average): 6.5% (November 2008) • Long-term interest rates (12-month average): **4.67%** (November 2008) • Budget deficit: **1.6% of GDP** (2007) • Public debt: **28.7% of GDP** (2007) • ERM2 membership: **no**	
Hungary		• HICP inflation (12-month average): 6.4% (November 2008) • Long-term interest rates (12-month average): **8.12%** (November 2008) • Budget deficit: **5.5% PKB** (2007) • State debt: **66.0% PKB** (2007) • ERM2 membership: **no**	

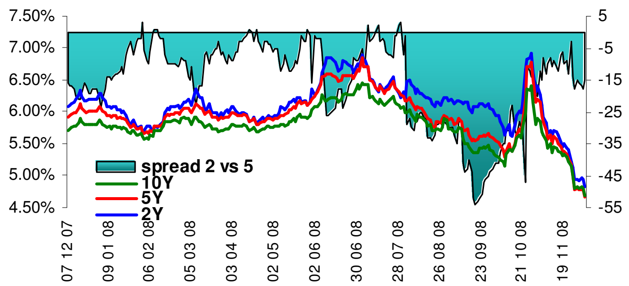
****The convergence criteria*** were set in the Treaty of Maastricht of 1992 and encompass five areas: price stability (HICP inflation in the 12 months before the qualification period cannot exceed the average of the three best-performing EU member states by more than 1.5 percentage points), long-term interest rates (the yield on 10-year fixed-rate treasury bonds cannot exceed the average for the three EU states with the lowest positive inflation rates), public finance stability (no excessive deficit procedure, which requires the general government deficit to be maintained 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, i.e. within the +/-15% fluctuation band) and legislation compliance (legal adjustment to the EU requirements). ***In our summary***, we are monitoring, on an ongoing basis (as data is released by Eurostat), 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 grounds for the EU Council decision giving consent to a state's accession to the Eurozone, are satisfied.*

MARKETS









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The zloty's downward trend against main currencies, persisting since early August, has gained strength over the last weeks. In the first weeks of December, the rate came close to the October peaks, breaking the levels of PLN 4.10 per euro and PLN 3.00 per dollar (with some correction later on). The scale of the zloty weakening against the US currency was smaller owing to an increase in the EUR/USD rate beyond 1.40 from the November lows of 1.23-1.24.

Contrary to previous concerns, the interest rate cut decided by the MPC in November, heralding a new easing cycle, has not become an additional zloty depreciation trigger (a similar situation was witnessed with the forint). As with the currencies of the other emergency markets, the continued risk aversion regime is crucial in this case. Given the fact that the number of potential risk factors is increasing (budget deficit, economic growth revisions, external debt), the depreciation trend of the zloty can hardly be expected to soon reverse.

Fixed Income

The commencement of a cycle of interest rate cuts by the MPC has contributed to a considerable drop in IRS rates along the entire yield curve. Poor macroeconomic data (especially a significant decline in investment growth rate) and revisions of forecasts for the next year justify expectations that the monetary policy will be significantly relaxed. The expectations have become even stronger after the recent rate cuts in the euro area, which expand the MPC's operating space (with rate disparity already reaching 325 bps).

Bond yields tend to be less susceptible to downward trends (with curve steepening visible), leading to soaring asset swaps up to 100 bps. Such a high spread results from an outflow of portfolio capital from the emerging markets, reflecting an increased risk premium. Nevertheless, the present yield levels (from 5.40% for 2-year bonds to 5.50% for 10-year paper) still seem high given the scale of the upcoming slowdown and the possible easing of the monetary policy.

ECONOMIC AGENDA

	December 2008	January 2009	February 2009
CPI	15	14	
Industrial production and PPI	18		
Wages and employment in the enterprise sector	15	19	
GDP	–	–	
Business tendency survey (CSO)	22		
Money supply M3	12	14	13
Balance of payments	12	16	12
Core inflation	22		
Official reserve assets	5	7	6
MPC meetings	22-23	29-30	26-27
ECB meetings	4	15	5
Fed meetings	16	27-28	–

Source: CSO, NBP, ECB, Federal Reserve

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