BRE BANK SA

THE BEST FINANCIAL INSTITUTION FOR DEMANDING CUSTOMERS

MONTHLY MACROECONOMIC REVIEW

April 2009,
No. 92/93 (3/4)

CONTENTS

WIESŁAW 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

- Concerns about financing of the current account deficit and rolling over a sufficiently large part of maturing foreign debt of banks, enterprises and the government have contributed to the weakness of the zloty persisting for more than half a year now. Such concerns are often justified by a steep decline in the inflow of foreign direct investment (FDI), the risk of portfolio capital outflow, and a substantial worsening of access to other sources of foreign funding. Our estimates show that a further decline in FDI by around 1/3 and changes in other components of the balance of payments may necessitate the reduction of the current account deficit to about 3% of the GDP. Such a change seems attainable (especially given the extent to which the zloty has weakened), which suggests that fears about secure financing of the deficit may prove overdone. However, a somewhat separate is ensuring the full refinancing of bank and corporate debt. Solving this problem will require cooperation and support from foreign owners and shareholders of the indebted units. The access to FCL should also help to reduce some concerns.
- Interest rate cuts in the recent months have been mainly justified by deteriorating prospects of the Polish economy, while the key factor reducing the speed and scale of these cuts have been the concerns about their impact on the zloty exchange rate. This means that the MPC has been treading along a rather narrow path between the need to stimulate the economy and the need to stabilise the zloty, while the question of inflation seems to have receded somewhat to the background. The Council continues to aim at achieving the inflation target, but in doing so it pays much more attention to the consequences of exchange rate changes.
- In our view, the MPC is still far from having exhausted the possibilities to support the economy with monetary policy instruments. While the effectiveness of the NBP interest rate cuts is often being questioned, we believe there is still room for this process to continue. The new measures announced by the NBP as part of the ‘Confidence Package’ are aimed in the right direction, but they still fail to solve all problems, including especially the access to Swiss franks on a longer term basis. The asymmetric deposit rate cut being considered by the NBP will not ensure a strong pickup in bank lending, as this requires sustainable access to financing, an increase in bank equity and a reduction of the level of risk (e.g. by activating the State Treasury guarantees).
- The state budget performance in Q1 2009 shows that the fiscal situation has clearly deteriorated. According to preliminary information, the state budget balance was by more than PLN 12 billion worse at the end of March than a year ago. Particularly disturbing are the low growth in tax revenue (especially VAT) and the rather fast growth in expenditure. According to our estimates, if the present tendencies continue, the total state budget revenue (including EU funds) may be more than PLN 30 billion lower than planned.
- The government’s policy to defend the deficit level set by the budget bill can be considered rational and justifiable both by the somewhat better situation of the Polish economy and by the limited access to financing. However, what makes the policy rather difficult to pursue is that the budget was based on not very realistic assumptions, which, in the face of declining revenue, necessitates ‘emergency’ cuts in expenditure and leaves no room for automatic stabilisers to operate. The revised fiscal data for 2008 (deficit of 3.9% of GDP) reinforce the concerns about the strength of Poland’s fiscal position.

KEY MACROECONOMIC INDICATORS

	Jul 08	Aug 08	Sep 08	Oct 08	Nov 08	Dec 08	Jan 09	Feb 09	Mar 09
GDP and Output									
GDP			4.8%			2.9%			
Domestic demand			4.3%			3.6%			
Private consumption			5.1%			5.5%			
Gross fixed capital formation			3.5%			3.5%			
Value added			4.7%			3.4%			
in industry			3.1%			-1.1%			
in the construction sector			11.0%			5.3%			
in the market services sector			5.4%			5.0%			
Industrial production growth YoY	5.6%	-3.7%	6.8%	0.2%	-8.9%	-4.4%	-15.3%	-14.3%	*-2.0%*
Industrial production growth MoM	-3.4%	-8.1%	17.2%	2.9%	-13.1%	-3.7%	-5.8%	2.7%	*15,5%*
Retail sales YoY	14.3%	7.7%	11.6%	7.9%	2.7%	2.5%	1.3%	-1.6%	*-3.0%*
Retail sales MoM	1.8%	-3.9%	1.8%	0.1%	-9.0%	11.2%	-22.9%	*-7.9%*	*9.4%*
Labour Market									
Average wage in the enterprise sector (PLN)	3228.98	3165.14	3171.65	3241.81	3320.94	3419.82	3215.75	3195.56	3332.65
Wage growth in the enterprise sector YoY	11.6%	9.7%	10.9%	9.8%	7.4%	5.4%	8.1%	5.1%	5.7%
Wage growth in the enterprise sector MoM	0.4%	-2.0%	0.2%	2.2%	2.4%	3.0%	-6.2%	-0.6%	4.5%
Employment in the enterprise sector YoY	4.7%	4.2%	4.1%	3.6%	3.1%	2.3%	0.7%	-0.2%	-0.9%
Employment in the enterprise sector MoM	0.2%	0.0%	0.1%	0.1%	-0.2%	-0.6%	0.4%	-0.4%	-0.5%
Unemployment rate	9.4%	9.3%	8.9%	*8.8%*	9.1%	9.5%	10.5%	10.9%	*11.2%*
Foreign trade									
Current account (EUR)	-879	-1 300	-1 881	-2 012	-1 637	-1 920	-1 078	525	
Trade balance, transaction-based (EUR)	-1 635	-1 329	-1 249	-1 526	-1 519	-1 688	-441	-142	
Exports, transaction-based YoY (EUR)	22.8%	9.4%	20.9%	0.5%	-11.3%	-16.4%	-25.2%	-28.2%	
Imports, transaction-based YoY (EUR)	22.5%	17.8%	21.0%	4.8%	-8.3%	-13.5%	-26.6%	-33.0%	
Current account (% GDP)	-4.9%	-5.0%	-5.2%	-5.3%	-5.5%	-5.5%	-5.4%	-5.0%	
Prices									
CPI MoM	0.0%	-0.4%	0.3%	0.4%	0.2%	-0.1%	0.5%	0.9%	0.6%
CPI YoY	4.8%	4.8%	4.5%	4.2%	3.7%	3.3%	2.8%	3.3%	3.6%
Net inflation YoY	2.2%	2.7%	2.9%	2.9%	2.9%	2.8%	2.2%	2.4%	2.5%
PPI MoM	0.0%	0.2%	0.2%	-0.3%	-0.5%	-0.5%	2.3%	2.3%	0.1%
PPI YoY	2.3%	2.0%	2.1%	2.4%	2.2%	2.6%	3.0%	5.7%	5.6%
Money aggregates									
Money supply M3 (PLN B)	616.1	628.6	630.5	637.4	648.3	666.3	668.9	678.4	684.2%
Money supply YoY	16.8%	16.8%	17.3%	17.6%	18.1%	18.6%	17.6%	17.4%	17.6%
Household loans YoY	30.5%	31.5%	33.5%	40.4%	37.9%	44.6%	45.4%	47.0%	43.7%
Corporate loans YoY	23.5%	25.2%	24.5%	26.8%	26.9%	28.9%	27.9%	28.5%	285.3%
Household deposits YoY	24.7%	23.8%	24.1%	24.4%	25.0%	26.4%	24.3%	24.4%	25.3%
Corporate deposits YoY	7.0%	3.1%	7.1%	4.3%	2.6%	4.0%	4.2%	4.0%	6.9%
Forex Rates									
EUR/PLN rate (end of month)	3.20	3.35	3.41	3.63	3.76	4.17	4.44	4.66	4.70
USD/PLN rate (end of month)	2.05	2.27	2.37	2.85	2.92	2.97	3.46	3.68	3.54
Interest Rates									
NBP reference rate	6.00%	6.00%	6.00%	6.00%	5.75%	5.00%	4.25%	4.00%	3.75%
Lombard rate	7.50%	7.50%	7.50%	7.50%	7.25%	6.50%	5.75%	5.50%	5.25%
Deposit rate	4.50%	4.50%	4.50%	4.50%	4.25%	3.50%	2.75%	2.50%	2.25%
WIBOR 3M	6.56%	6.50%	6.63%	6.85%	6.56%	5.88%	4.86%	4.51%	4.17%
2Y bond yield	6.53%	6.35%	6.23%	6.86%	5.87%	5.23%	4.81%	5.71%	5.61%
5Y bond yield	6.31%	6.17%	5.99%	6.82%	5.75%	5.25%	5.08%	5.90%	6.00%
10Y bond yield	6.25%	6.05%	5.82%	6.60%	5.89%	5.37%	5.49%	6.18%	6.27%
Global Economy									
Eurozone inflation (YoY)	4.1%	3.8%	3.6%	3.2%	2.1%	1.6%	1.1%	1.2%	0.6%
Eurozone GDP (YoY)			0.8%			-1.2%			
ECB basic rate	4.25%	4.25%	4.25%	3.75%	3.25%	2.50%	2.00%	2.00%	2.00%
US inflation (YoY)	5.6%	5.4%	4.9%	3.7%	1.1%	0.1%	0.0%	0.2%	-0,4%
US GDP (QoQ ann.)			-0.3%			-3.8%			
Fed Funds target rate	2.00%	2.00%	2.00%	1.00%	1.00%	0.00-0.25%	0.00-0.25%	0.00-0.25%	0.00-0.25%

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

POLISH ECONOMY

How to finance the current account deficit?

The reasons for the weakness of the zloty persisting for more than half a year include increased concerns about the financing the current account (C/A) deficit and the ability to ensure the rollover of a sufficiently large part of foreign liabilities of banks, enterprises and the government maturing this year. A lot of confusion has arisen around a study published last autumn by the bank J.P. Morgan, suggesting that with an assumed rollover rate of 50%, Poland may have a relatively low surplus of funds to maintain external liquidity. Even though the methodology applied in the study may give rise to some doubt, it shows how foreign investors may assess the risk involved in investing capital in Poland. Similar threats are pointed out by the authors of analyses presented by Goldman Sachs. According to their estimates, in order to offset the effect of what they consider a 'moderate' outflow of capital (a drop in new direct investment by 2/3 and a reduction of the stock of portfolio investment by 10% and non-resident deposits by 1/4), the C/A balance in Poland would have to change by as much as 6.8% of the GDP. The potentially large scale of the necessary C/A adjustment and doubts regarding the ability to refinance maturing debt seem to have contributed to the rather pessimistic views on the further development of the zloty exchange rate presented by analysts from various banks.

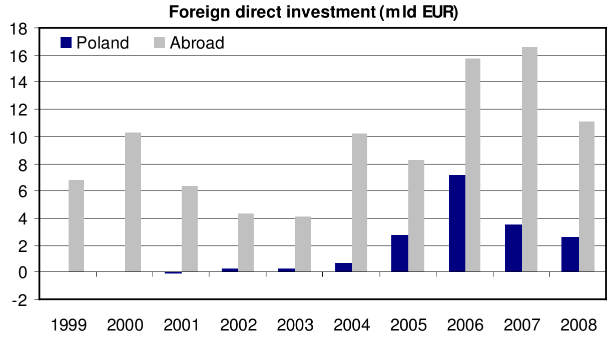
In our analysis, we will focus mainly on the question of financing the C/A deficit. Of course, this is not to say we do not appreciate the importance of the refinancing the debt maturing this year, but this subject needs a separate study. In 2008, current deficit reached 5.5% of the GDP (EUR 19.6 billion), which in 'normal' times could still be considered a fairly moderate level. Yet some anxiety may arise both from the rather fast growth rate of the deficit (from less than 1.5% of the GDP in 2005), and the unfavourable changes in the structure of its financing. While in 2004-2007 the inflow of foreign direct investment (FDI) more than offset the value of the C/A deficit, in 2008 this ratio dropped to a mere 56% (or 43% after taking into account the Polish FDI outflow). The resulting gap was filled mainly by a very large increase in foreign liabilities and a by a reduction in foreign assets of monetary financial institutions (by EUR 16.0 and 5.2 billion, respectively). Net debt of other economic operators also increased by nearly EUR 7 billion. Owing to significant deterioration of the conditions of access to all forms of external financing, it seems fully justified to ask whether such a financing structure will be possible to maintain this year, or rather it will prove necessary to reduce the level of the C/A deficit.

When analysing the options for financing the C/A deficit, it is worth to note some factors that may facilitate this task. One of them is the surplus on the capital account (not to be confused with the financial account), which amounted to nearly EUR 4 billion (1.1% of the GDP) last year. The main source of this surplus is the inflow of funds from the EU budget, most of which is classified as capital account transactions and only the rest as current transfers. As the differentiation between various categories of EU funds is somewhat arbitrary, it may even be reasonable to consider the balances of the current and capital accounts jointly. This is what e.g. the NBP does in its *Inflation Report*, when it forecasts the sum of these balances in 2009 at -3.5% GDP. The capital account surplus may be considered to be a stable and secure source of financing, as its level depends mainly on the efficiency in using the EU funds and does not fluctuate under the impact of changes in market conditions. If the government's announcements regarding an increased absorption of EU funds materialise, the positive balance of the capital account can be expected to reduce the demand for other funds necessary to finance the C/A deficit by not less than 1.2% of the GDP.

A new development that may contribute to some reduction of the C/A deficit in 2009 is a marked pickup in border trade caused by a strong depreciation of the zloty. That concerns not only increased trade activity near the Polish-German border, but also in the regions bordering Lithuania, Slovakia, and, to a slightly lesser extent, the Czech Republic. There are also reports indicating a substantially increased interest in private import of cars from Poland. However, most of the available information may only be considered as anecdotal evidence, as there are no complete and reliable data sources on the actual extent of border trade. Our attempt to estimate the magnitude of this trade on the basis of growth in selected retail sales components suggests that if the zloty remains weak, the additional revenue from sales in the border zones could reach even as much as 0.3% to 0.5% of the GDP.

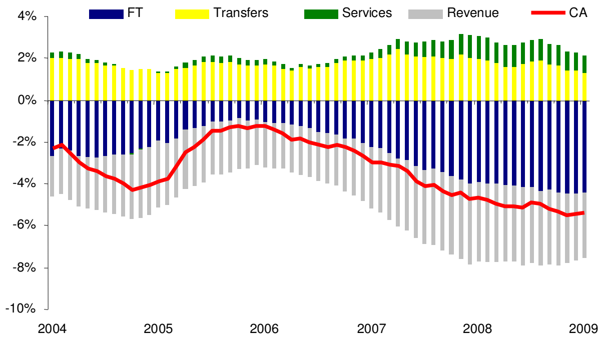
What can also be seen as factors mitigating the problem of financing the C/A deficit is the relatively large share of intra-corporate sales in the foreign trade turnover as well as the fairly close linkage between the negative income balance and the FDI inflow. The first of these factors means that any deficit in transactions between a Polish subsidiary and other foreign units of multinational corporation is almost automatically financed by a loan granted by the parent entity. With regard to FDI, it can be assumed that some part of their expected decline will result from a reduction of the value of re-invested profits. This was already the case in 2008, when re-invested profits dropped from EUR 6.6 billion in the previous year to slightly over EUR 4.4 billion. However, in such a situation the value of foreign investors' income recorded in the current account also decreases automatically, which means that such a decline in FDI does not complicate the task of financing the C/A deficit. However, the intention to waive dividend payments declared by most of the banks is likely to prevent a marked drop in re-invested profits this year. This does not alter the fact that owing to a rather rapid deterioration of financial results of enterprises operating in Poland one can expect profits of companies controlled by foreign capital to also drop quite steeply this year, and hence the scale of their repatriation will be smaller. Even a rather conservative assumption that foreign direct investors' income, which totalled about EUR 12 billion in 2008, will decrease by only 25%, means that on that account alone, the C/A deficit may decrease this year by almost 0.9% of the GDP. Such a rate of decrease in that income is quite probable, as already in 2008 net profits of non-financial enterprises decreased by 27% (and by as much as 44% in manufacturing).

Deducting from the 2008 C/A deficit (5.5% of the GDP) the expected surplus on the capital account and taking into account the probable decrease in the C/A deficit resulting from the growth in border trade and declining income of foreign investors still leaves an amount of about EUR 10 billion (2.9% of the GDP), which needs to be financed. This amount does not seem particularly high compared with the average volume of FDI inflows in 2006-2008, but in the face of the deepening economic downturn one should expect a considerable decline in the value of FDI. Last year, when the Polish economy was still growing relatively fast (4.9%), FDI was already seen to decline by more than 1/3 (from EUR 16.7 billion in 2007 to EUR 11 billion). Taking into account the recession in the countries from where most investments originate and a considerable deterioration of investors' sentiment towards countries of our region, it can be assumed that the decline in the FDI inflow this year will not be smaller than in 2008. This means that even with such an optimistic assumption the value of investment in Poland may drop to not much more than EUR 7 billion. The possibility of such a rapid decline in the FDI value is also indicated by the experience of the years 2001-2002, which saw a decrease in FDI by 38% and 31%, respectively, despite a much better situation in the external environment.



In assessing the possible extent of financing the C/A deficit by the FDI inflow, assumptions must also be made about the volume of Polish direct investment abroad, which negatively impacts the balance of the financial account. It reached its highest level in 2006 (EUR 7.1 billion), but this was mainly attributable to a single large transaction made by PKN Orlen. In 2008, the value of outward FDI was estimated at PLN 2.3 billion, i.e. over 2/3 less than in 2006. Unfortunately, when forecasting the value of new Polish investment abroad, one cannot rely on a comparison with the previous 2001-2002 slowdown due to some restrictions on capital flows which were still in force at the time. Yet given a deteriorating economic situation in Poland and the related strong decline in investment outlays as well as the considerably increased investment risk of countries to which the Polish capital is usually exported, it seems reasonable to assume that Polish FDI will drop this year by 30-40% and reach around EUR 1.5 billion. This decline could be even larger, if not for the already announced intention to complete the PKN Orlen investment in Lithuania. Taking into account our estimates of the outflow of productive capital from Poland means that in net terms FDI can finance not more than EUR 5.5 billion this year. If our other estimates are correct, it means that if no additional sources of financing are found, the 2009 C/A deficit should be by an additional EUR 4.5 billion (1.3% of the GDP) lower than last year. Reduction of trade deficit would have to be the main method of reaching such an improvement in the current account position. It is worth reminding that it was mainly the rising foreign trade imbalance what caused the increase in the current account deficit in 2007-2008 (the negative trade balance increased from 2% of the GDP in 2006 to 4.6% of the GDP last year). To achieve the desirable reduction in foreign trade deficit, import growth rate would have to be about 2-3 ppts lower than export growth rate. Taking into account the extent to which the zloty has weakened (by more than 1/3 against the euro since July 2008) and the expected decline in investment spending, it seems quite possible (but by no means obvious) that such a result could be achieved. According to the NBP data, the decline in imports in February was already by almost 5 ppts greater than the decline in exports (- 33.0% and – 28.2% YoY, respectively), while the CSO data show a difference of about 3 ppts in the January-February period. Whether these tendencies will continue until the end of this year will mainly depend on such factors as the further development of the zloty exchange rate, the scale of decline in investment and consumption in Poland, and the extent to which demand for Polish exports will weaken. It should be stressed that owing to a high risk of a decline in domestic demand without a positive contribution of 'net exports', even a small GDP increase could hardly be hoped for this year (the NBP forecasts provide that net exports will contribute some 0.7 ppts to the GDP growth rate of 1.1%).

C/A deficit and its structure (ppts)



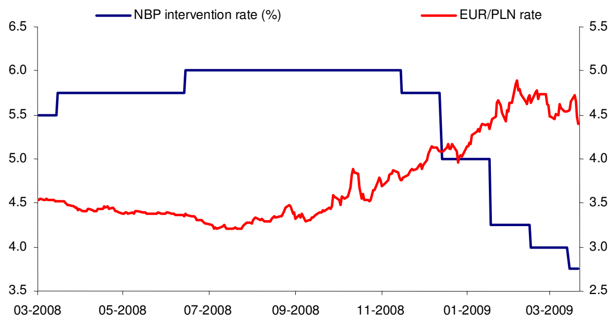
Our analysis shows that with the assumed FDI decrease by about 1/3 (against the 2008 level) and in the absence of other deficit-funding sources it may prove necessary this year to reduce the current account deficit to about 3% of the GDP. What may help to achieve such an adjustment is the expected improvement in the balances of income and (to a lesser extent) transfers accounts, but it is the reduction of trade imbalance that would have to play a central role. Reduction of the C/A deficit by about 2.5 ppts within one year seems possible to attain (which may be inferred from the example of 2005, when the deficit decreased by just as much). This, in turn, suggests that fears about the financing of this year's current account imbalance may prove somewhat excessive. It should be borne in mind, however, that if the decline in FDI inflow is higher than we have assumed, it will be necessary to increase the scale of trade balance adjustment and/or find additional funding sources.

Of course, solving the issue of C/A deficit financing is not tantamount to a full resolution of the problem of limited access to external funds. What must be kept in mind, among other things, is the risk of a further outflow of portfolio capital. In 2008 it reached more than EUR 3.5 billion, and the first two months of this year another outflow of about EUR 870 has already been registered. In 2008, the shortfall of funds available for C/A deficit financing and the outflow of resources within the financial account were mainly offset by a very high increase in the foreign liabilities of the banking sector and a decrease in its assets, but this year the access to this source of funding is likely to be much more limited. This year one can also expect a considerable decrease in new liabilities incurred abroad by Polish enterprises, but this may be offset to some extent by a higher inflow of funds to the general government sector resulting from the planned increase in the scale of utilisation of loans from EIB and other international financial institutions. As mentioned at the beginning, this analysis is not intended to elaborate on the question of refinancing all foreign liabilities maturing this year, but it is worth pointing out that the scale of this problem is indicated by the value of short-term foreign debt estimated at EUR 46 billion at the end of 2008. While there is not the slightest reason to be concerned about the ability to refinance (or repay) the State Treasury's foreign-currency debt maturing this year (estimated by the Ministry of Finance at slightly over EUR 3 billion, most of which has already been repaid), in the case of the liabilities of banks and enterprises it will be necessary to secure the full cooperation on part of the foreign owners and shareholders of these debtors, as a very large part of these liabilities are attributable to them. However, the recent decision of the Polish government to secure recourse to the IMF's Flexible Credit Line to the tune of USD 20.5 billion should go a long way towards removing any lingering concerns regarding access to external financing.

MONETARY POLICY

MPC treading a narrow path

The March meeting of the Monetary Policy Council ended with a decision to further ease the monetary policy. Following the reduction of NBP interest rates by another 25 bps, the key reference rate dropped to a historical low of 3.75%. As in February, the decision taken by the MPC was in line with the expectations of most market participants, which suggests that the predictability of the Council's actions has increased again. The small scale of the last two cuts has contributed to the emergence of views that the MPC has returned to its preferred method of moving in small steps. In our view, this change may be not so much a reflection of preferences of the majority of the Council's members but rather the effect of a narrowing room for manoeuvre in implementing monetary policy. While the recent interest rate cut was formally justified, as usual, by an assessment of inflation prospects (the probability of the CPI dropping below the NBP target), the deteriorating economic situation in Poland can be seen as the main factor underlying the decision. This was confirmed almost directly by Prof. Jan Czekaj, who stated in one of his interviews that 'among the real sphere data there is no single piece of information that would justify the Council's inactivity'. Statements made by the majority of the MPC's members quite clearly indicate that the main factor limiting the pace and scale of interest rate reductions are the concerns about an excessive weakening of the zloty. Hence the MPC has been recently moving on a rather narrow path between the need to stimulate the economy and the need to stabilise the zloty exchange rate. The question of inflation seems to have receded slightly into the background, which may be confirmed by the fact that a rather high increase in the CPI and core inflation as well as a surprisingly sharp increase in producer prices did not prevent the MPC from cutting interest rates. This approach is most likely based on a belief (which we also share) that the recent increase in inflation has only temporary character and that the declining inflationary pressure will soon allow bringing it down to close to the NBP target. The minutes from the February meeting of the MPC quite clearly indicate that the most important topic discussed by the Council members were the fluctuations of the zloty exchange rate. Owing to such a substantially increased role of the exchange rate in the MPC's decision-making process, some of the analysts have even come to formulate a sort of the Council's new reaction function interest rate changes with movements in the zloty exchange rate. This has been encouraged by statements of some of the Council members suggesting that the strengthening of the zloty (e.g. to around 4 zlotys per euro) would give the MPC much freedom to act. Because of the MPC's fairly evident concern about the appropriate level and stability of the zloty exchange rate one can even have the impression that apart from the inflation target, the Council has also started to pursue something akin to a very loosely defined exchange rate target. Obviously, no official confirmation of such a hypothesis can be hoped for, but if it proved true even in part, this would mean that we have already found ourselves in something like an imperfect ERM 2 mechanism, in which we cannot, unfortunately, count on any support from the European Central Bank.

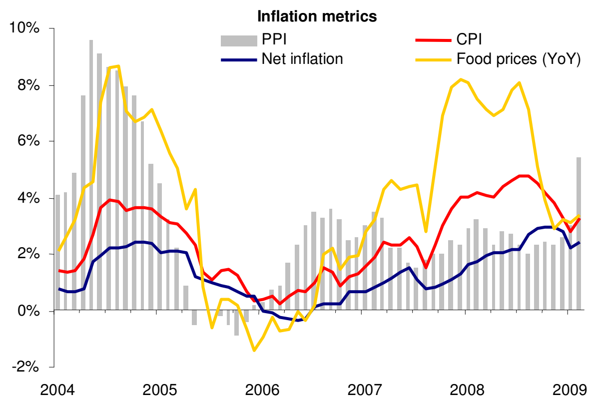


At its March meeting, the MPC again did not decide to reduce the minimum reserve requirements or to proceed with an asymmetric reduction of the NBP deposit rate that has been under consideration for quite some time already. The Council clearly does not yet see an urgent need to provide banks with additional funds by reducing the required reserves, as it believes that the banking system still remains over-liquid. This is thought to be confirmed, among other things, by the very high demand at the NBP money-market bill auctions (recently reaching more than PLN 40 billion) and the high level of deposits placed with the central bank. The MPC members also seem to be disappointed by the fact that funds used for the early redemption of NBP bonds have not contributed to increasing banks' lending activity because most of them have been placed on accounts at the central bank. An asymmetric reduction of the NBP deposit rate has been proposed some time ago as one of the measures that could encourage banks to increase their credit activity but it is not clear why the MPC has not yet decided to make such a move. It seems unlikely that this was caused mainly by concerns about banks' financial results, and this delay can rather be explained by some obstacles of a technical nature and perhaps also be doubts as to the effectiveness of such a step. Such doubts are certainly justified, as it is not the level of the deposit rate that makes banks place their surplus funds with the NBP, but rather the need to maintain adequate liquidity as well as the lack of other sufficiently attractive and safe alternatives.

Difficulties in convincing banks to increase their lending activity are by no means specific to Poland, as a similar situation, in which funds from liquidity-providing operations are being re-directed back to the central bank accounts can be observed also in the euro area, the US, and in many other countries. The problem that it is hard to push on a string has been known for long and described at length in various economic texts. Nevertheless, this has not discourage most monetary authorities from continuing to supply additional liquidity, even though the ECB has at some point slightly tightened its very liberal collateral rules and increased again (to 200 bps) the width of the corridor between its deposit and lending rates. At the same time, the Fed and some other central banks keep expanding the list of measures that aim to achieve so-called quantitative easing. Some of these measures are designed to bypass the banking system and directly reach entities seeking financing.

In Poland, we are still quite far from using this type of measures, and because of the very limited supply of marketable debt instruments other than Treasury securities there would also be technical obstacles for their wider application. The three key elements that seem to be indispensable in our present situation to stimulate lending activity include: providing banks with sustainable access to financing on appropriate terms (price, maturity and currency composition), strengthening the capital base and reducing the risk involved in lending (e.g. through an adequately priced and sufficiently broad access to State Treasury guarantees). Meeting those three conditions would require close cooperation between the government, the NBP, the Polish Financial Supervision Authority, and owners of financial institutions.
In spite of the quite frequent claims that the effectiveness of the NBP actions is limited and impaired, among other things, by the opposite directions of changes in the reference rate and credit spread levels both theory and the measures implemented by other central banks show that the NBP is still far from having exhausted the entire arsenal of instruments available to monetary authorities. In addition to the earlier mentioned reduction of the required reserve rate, the NBP has also been urged to introduce some forms of a 'qualitative easing', e.g. by relaxing the highly restrictive rules regarding the collateral accepted in transactions with the central bank. The good news is that the NBP decided to move in this direction, as according to its recent announcement starting from May, the list of collateral eligible for repo transactions will be expanded, and a netting mechanism to facilitate repeated use of the pledged collateral will be introduced. Another step in the right direction will be the extension of repo maturities to 6 months and of USD and EUR currency swaps to 1 month. However, it is to be regretted that it took so long to implement these, and that it will still not be possible to obtain access to the CHF for more than 1 week.

The MPC is also still very far from having exhausted the possibility of using the basic tool of the monetary policy, i.e. the interest rates. We do not fully share the view that this instrument is not very effective, as the WIBOR rates largely follow changes in the reference rate, and this means that positive effects of the NBP rates reductions are being felt both by borrowers already using variable-rate credit and by new bank customers, for whom this offsets the increase in spreads. The benefits of further interest rate cuts also seem to be recognised by the majority of the MPC members, as the Council is signalling its intention to continue the monetary policy easing cycle. This means that further interest rate reductions are very likely in the next few months, even if in the opinion of some of the MPC members (such as Prof. Filar and Prof. Noga) a short break could be useful to gather more information about the prospects of the Polish economy and to analyse the results of the cuts already made. The recent pick-up in inflation (to 3,6% in March, mainly on account of rising food prices) and any new concerns about the prospects for the zloty could also make the Council refrain from a rate cut in April.



FISCAL POLICY

Deteriorating fiscal position

The preliminary fiscal results for the first quarter show that the fiscal situation has clearly deteriorated. Deficit has already reached PLN 10.6 billion (58% of the amount planned for the whole year), while in the same period of 2008 a surplus of about PLN 1.8 billion was recorded. The one-off factors, which improved the budget in January (including extraordinarily high proceeds from excise duty and a shift of some PIT payments), did not occur in February, which pushed the deficit in that month up to PLN 8.2 billion, more than twice the amount reported in February 2008. The deficit registered in March 2009 (PLN -5.3 billion) also compares very poorly with the surplus of about PLN 1.9 billion achieved in March 2008. The 2009 budget provides that revenue will be increasing distinctly faster than expenditure (by 19.3% and 15.3%, respectively, comparing to actual results of 2008), while in the January-March period quite opposite and very unfavourable relation between these growth rates has been reported: budgetary revenue increased by only 2.6%, while expenditure rose by as much as 22.4%. Even though the deficit after the first quarter was slightly lower than envisaged in the official budget implementation schedule, representatives of the Ministry of Finance have already indicated that after April it may be as high as earlier planned, meaning that it may reach almost 90% of the amount set for the whole year. The state budget deficit is then expected to stabilize at that level for two more months, temporarily decrease in the August-September period, and climb again later to reach PLN 18,2 billion at the end of the year. While the schedule presented by the MoF may be considered more or less realistic with regard to the first half of this year (though the strong increase in revenue expected for May and June may give rise to considerable doubt), the probability of its fulfilment in the latter part of the year seems minimal. For instance, it is unclear what could make the revenue in Q4 to be by as much as 28% higher than in Q4 2008, and expenditure 2% lower. The publication of such a schedule by the MoF may be seen as an indirect confirmation that it is not possible to implement the state budget as planned and that its amendment will be unavoidable.

What is particularly worrying about the preliminary budget results presented by the MoF for the first quarter of 2009 is the development of tax revenue, which was in this period by about 1% lower than a year before, and in March alone it was by almost 10% lower than in the same month of the previous year. The situation regarding the collection of CIT and VAT revenue is by far the worst. The budget provides that CIT revenue will be as much as 22% higher than obtained last year, whereas after March, in spite of the very large payments related to the final settlement of the 2008 accounts, it was still by some 2% lower. The adoption of a rather optimistic assumption that despite the deteriorating financial position of enterprises the 2009 CIT revenue will prove close to the level recorded last year, would mean that the fiscal revenue from that source would be PLN 6 billion lower than planned. An even greater gap may be seen in VAT revenue. Its growth rate (against the 2008 performance) was set in the budget at a completely unreasonable level of almost 16%, while in the first quarter the VAT revenue was by about 9% lower than in the same period of 2008. The weakness of VAT revenue is the result, among others, of the strong decrease in retail sales growth (to -1.6% in February) and the rapid decline in imports (by about 1/3 in March). There is a risk that those adverse trends will persist or even aggravate later this year. If VAT revenue were to stay at last year's level, this would mean a shortfall of PLN 16.5 billion of revenue from that source in the state budget. We believe that even with some pickup in VAT revenue (which is rather hard to expect) there is not much chance of the shortfall being smaller than PLN 12 billion. The growth rate in excise duty revenue in the January-March period was close to that provided for in the budget, and the PIT revenue growth rate proved even slightly higher than expected, but in both cases the ratios were distorted by one-off factors. This means that the risk still exists that revenue from those taxes may prove several (2-4?) billion zlotys lower than planned, with a relatively greater risk regarding PIT revenue, which may decrease owing to a fast-deteriorating situation in the labour market and related steep decline in the wage bill growth rate. According to our very rough estimate, which is still highly uncertain at this stage, the overall shortfall of tax proceeds may reach PLN 20 to 26 billion this year. Given the fact that our GDP growth forecast (around 0%) is considerably lower than the one envisaged in the pessimistic scenario of the Ministry of Finance (1.7%), our calculations seems compatible with official estimates pointing to the risk of a revenue shortfall on the order of PLN 17 billion. It can also be expected that despite all efforts towards better utilisation of EU funds all of the revenue planned under this heading will be achieved. Even with a highly optimistic assumption that the EU funds utilisation ratio will increase from a mere 43% in 2008 to 70-75% this year, the shortfall in budget revenue from that source would range between PLN 8 and 10 billion. In all, this means that this year's budget proceeds may turn out to be by more than PLN 30 billion lower than planned, and this estimate may still be considered rather conservative.

With regard to budget expenditure, the most worrying development is its high growth rate (22.4%YoY after March), which is not only greater than planned (15.3%), but also considerably exceeds the growth rate of revenue. Public debt service expenditure increased by about PLN 2,7 billion (compared with the January-March 2008 period), but its growth was not much higher than that provided for in the budget. A rather high increase was also reported in the EU budget contribution (by about PLN 1 billion), which was attributable, to some extent, to the weakening of the zloty. The value of funds transferred to the Social Insurance Fund increased by about 80% compared to the first quarter of 2008. This large increase was not prevented by the fact that by the end March the social insurance institutions still had over PLN 15 billion deposited on bank accounts.

Estimated state budget performance in January-February 2009

	PLN m	% of plan	YoY growth rate
Revenue, of which:	**66326.3**	**21.9%**	**2,6%**
Indirect taxes	40394.7	22.7%	-1.7%
Excise duty	15189.6	26.1%	14.4%
CIT	8405.0	25.4%	-1.8%
PIT	7517.0	18.7%	3.5%
EU funds	5822.4	17.3%	53.9%
Expenditure	**76933.3**	**24.0%**	**22.4%**
Domestic debt service	4456.2	16.8%	105.7%
Foreign debt service	2860.5	46.3%	18.9%
Social Insurance Fund subsidy	6849.1	22.1%	80.9%
Local government subvention	15610.2	34.4%	10.1%
Deficit/Surplus	**-10607.0**	**58.35**	**---**

Source: Ministry of Finance

Government striving to maintain the deficit level

Already in January, soon after the adoption of the 2009 budget bill, the government started to look for savings in public expenditure set at PLN 17 billion. This action was prompted by concerns that the looming economic slowdown will lead to the emergence of a major gap in the state budget revenue. The government's efforts were only partly successful, as the savings declared by all ministries, local administration and the Social Insurance Fund reached only about PLN 10 billion, while an additional amount of PLN 9.7 billion was generated by changing the method of financing some part of the planned spending on infrastructural projects. Transferring this expenditure to the National Road Fund is a measure that may give rise to some doubt, as it does not lead to the reduction of the deficit of the entire general government sector, whereas it may entail an increase in the cost of financing. In case of problems with raising the needed funds, it may also become necessary to cancel or postpone some of the investment projects. The deteriorating GDP growth outlook and the related risk of an even deeper than currently assumed revenue shortfall contributed to the intensification of public discussions about the need to amend this year's budget and increase the deficit level. The government still officially maintains the position that the deficit set by the budget bill (PLN 18.2 billion) should not be changed. However, statements have also been made by some government representatives that this level must not be taken dogmatically and that a decision on a possible amendment of the state budget will be taken only in a few months time, after gathering more information on the prospects of the economy and the development of the fiscal situation. While Mrs. E. Suchocka-Roguska, Vice-Minister of Finance in charge of the budget, has recently denied any plans of revising the budget bill, she had also earlier admitted that the possibilities for reducing the planned expenditure have already been almost fully exhausted. At the same time, the government assures that it does not intend to increase tax burdens, which increases the probability that if adverse tendencies in revenue collection continue, raising the deficit level will become the only available option.

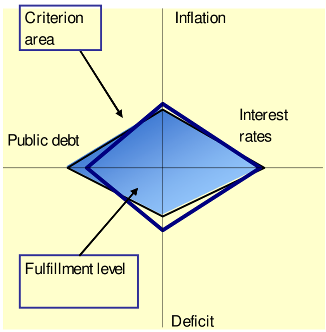
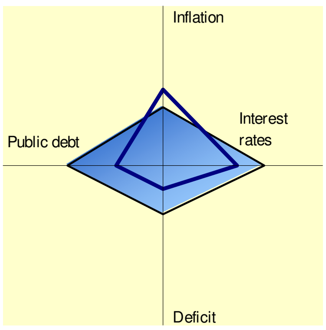
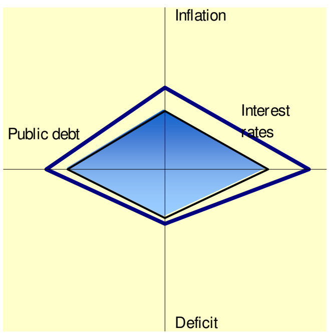
According to the recommendations of the International Monetary Fund, the fiscal stimulus necessary to deal with the consequences of the deepest decline in economic activity in decades should reach, on average, about 2% of the GDP. The IMF reiterates, however, that the scale of fiscal support in each country should depend, among other things, on its starting position (including the size of the output gap, the level of public deficit and debt, and the scope for the work of 'automatic fiscal stabilisers') and access to financing, whereas the measures taken should be reversible, form part of the government's medium-term strategy, and be combined with the implementation of growth-promoting structural reforms. According to the IMF estimates, the G-20 countries have already announced fiscal measures for 2009 with a value of about 1.8% of the GDP, which should contribute to an increase in their GDP growth by 0.8 to 3.2 ppts (depending on the assumed value of the fiscal multiplier). Analysts of one of the largest private financial institutions are much more radical in their recommendations for providing fiscal stimuli. They believe that the euro area countries should implement fiscal measures worth some 5% of the GDP both this and next year. These measures should mainly take the form of increased transfers to low-income households and tax relief to the middle class, while no preference should be given to public investment, as it produces results only with a considerable delay.

The fiscal policy pursued so far by the Polish government differs quite considerably from those recommendations and from measures being implemented by a number of other countries (though this does not apply to many countries in our region). According to the government, the best response to a decline in economic activity under the current circumstances is to maintain fiscal discipline, as only this will allow Poland to maintain high credit rating, avoid large outflow of capital and secure access to financing on relatively favourable terms. A low level of fiscal deficit will also create conditions conducive to easing the monetary policy and it will allow the government to proceed with its euro adoption plans. The government's position may be considered coherent and justifiable both by the relative 'strength' of the Polish economy (better starting position, lower forecast output gap), and by its relative 'weakness' manifested by a limited access to financing. By opting for a self-imposed strict discipline in fiscal policy, Poland is placed between countries that can afford a temporary large increase in fiscal imbalance (or are convinced of the need to reach for fiscal support measures irrespective of their long-term consequences) and the group of countries that are forced to tighten fiscal policy owing to a loss of equilibrium and the need to meet the requirements imposed by the IMF and/or other institutions providing financial support.

Unfortunately, even after accepting that the government's approach to conducting fiscal policy may be considered rational, one can also claim that the implementation of this policy has been burdened by some kind of an 'original sin' in the form of a budget based on very unrealistic macroeconomic assumptions. This has already been manifested by the poor revenue performance and the need to introduce additional, 'pro-cyclical' expenditure cuts. In the 2009 budget there is hardly any room for absorbing the effects of 'automatic stabilisers', which is usually considered as a necessary response of the fiscal policy to a decline in economic activity. Of course, ultimately it will not be possible to avoid fiscal consequences of lower growth and a deteriorating situation in the labour market (like the lower growth in social security contributions and an increase in the number of people entitled to unemployment benefits). While not all those negative effects will directly affect the state budget, the entire general government deficit will certainly increase and is very likely to exceed this year the important threshold of 3% of the GDP. Such a result (3.6% of the GDP) has been forecast by the European Commission already in January, while in the recently released fiscal notification the Polish authorities forecast that it could even reach 4.6% of GDP. However, even the fulfilment of those predictions would not have to undermine plans for a fast adoption of the euro, as it is the fiscal deficit recorded in 2010 that would be of key significance in this respect. This means that from the point of view of meeting the Maastricht criteria, the government has a bit more room for fiscal activism this year than next year. Nevertheless, the doubts regarding the possibility of securing funding of any additional fiscal measures, their effectiveness, and the scale of the 'crowding out' effect still remain valid. However, questions are also being asked whether, in a situation when an increase of fiscal deficit is probably unavoidable, it wouldn't be better if this process were less spontaneous and more controlled by the government. Such an approach could probably ensure better safeguarding of the government's main priorities and reduce the need to make 'emergency', across-the-board cuts in expenditure.

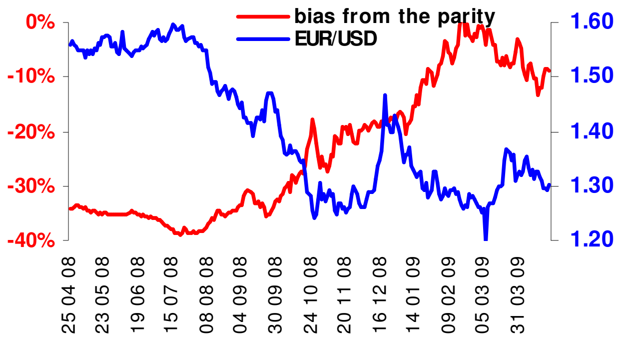
Concerns about the health of Poland's public finances have been reinforced by the newly released information that the 2008 general government deficit reached 3.9% of GDP, much exceeding the earlier official estimates of 2.7%. This reduces the prospects of an early euro adoption and significantly strengthens our doubts about the feasibility of not exceeding this year's deficit target of PLN 18.2 billion.

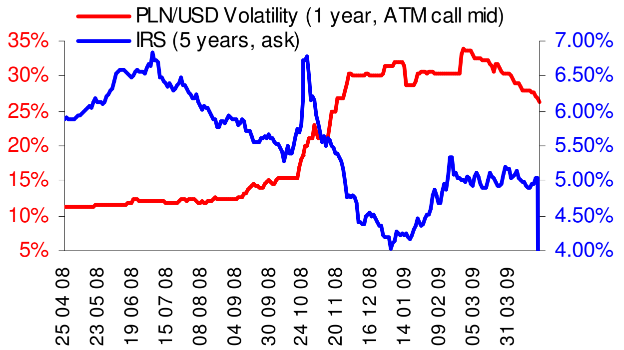
EUROMONITOR

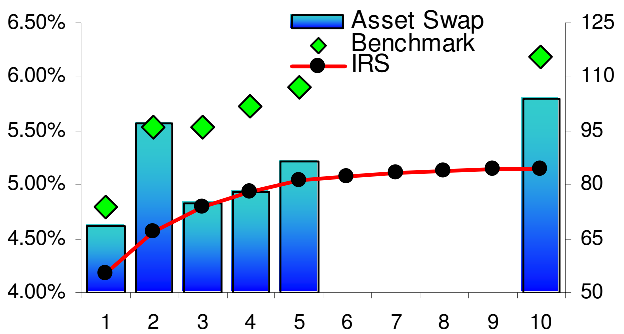
	Convergence criteria *	• HICP inflation (12-month average): 3.6% (March 2009) • Long-term interest rates (12-month average): **6.16%** (March 2009) • Budget deficit: **<3.0% of GDP** • Public debt:< **60.0% of GDP** • ERM2 membership: **2 years**	Exchange rate and the 2.5% and 15% fluctuation bands around 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): **4.0%** (March 2009) • Long-term interest rates (12-month average): **6.06%** (March 2009) • Budget deficit: **3.9% of GDP** (2008) • Public debt: **47.1% of GDP** (2008) • ERM2 membership: **no**	
Czech Republic	 	• HICP inflation (12-month average): **4.7%** (March 2009) • Long-term interest rates (12-month average): **4.67%** (March 2009) • Budget deficit: **1.5% of GDP** (2008) • Public debt: **29.8% of GDP** (2008) • ERM2 membership: **no**	
Hungary	 	• HICP inflation (12-month average): **5.0%** (March 2009) • Long-term interest rates (12-month average): **8.90%** (March 2009) • Budget deficit: **3.4% of GDP** (2008) • Public debt: **73.0% of GDP** (2008) • ERM2 membership: **no**	

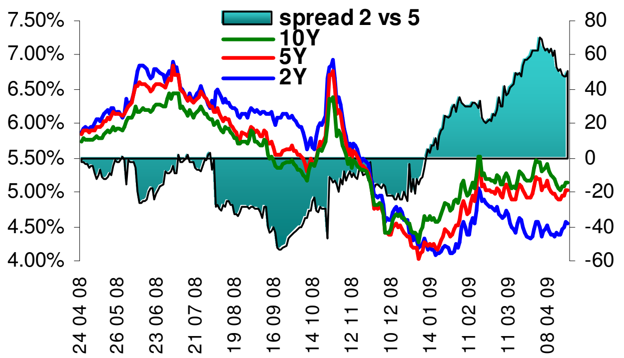
****The convergence criteria*** were set in the Treaty of Maastricht of 1992 and encompass five areas: price stability (HICP inflation in the 12 months before the qualification period cannot exceed the average of the three best-performing EU member states by more than 1.5 percentage points), long-term interest rates (the yield on 10-year fixed-rate treasury bonds cannot exceed the average for the three EU states with the lowest 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 euro area, are satisfied.*

MARKETS









F/X

After apprecing by more than 8% against the euro in the first half of April, the zloty started loosing ground again in the last two weeks. The EUR/PLN rate rose to 4.50, while the USD/PLN rate to about 3.40. The zloty was negatively affected by the strengthening dollar (the EUR/USD rate decreased to close to 1.30 from the peak of 1.37 a month ago), profit-taking after the rally on stock markets and bad news on the fiscal position of Poland and other CEE countries. The recent data showing that the 2009 budget deficit in Poland reached 3.9% of the GDP (vs. expected 2.7%), make the prospects of a rapid ERM-2 entry increasingly unlikely, which is another factor contributing to the zloty weakening. However, the recent PLN changes can still be as a temporary correction rather than a continuation of the downward trend. In our view, a medium-term the zloty still has some potential to appreciate.

Fixed Income

The decrease in bond yields in core markets has not translated as yet into major movements in the domestic debt market, though the results of recent Treasury bond auctions indicate rising demand for Polish securities. That suggests that the sentiment in the debt market may improve over the coming months. So far, some decline in yields has been witnessed only in the case of short IRS rates (up to about 4.50% for the two year tenor). Yields on Treasury bonds still remain on an elevated level, which might be attributed, *inter alia*, to some valid concerns about the fiscal developments (now being reinforced by the recent release of government debt and deficit data). The 10y/2y spread on treasuries has remained at former levels of 60-70 pb., with the yield on 10-year bonds topping 6.20%.

Economic Agenda

	April 2009	May 2009	June 2009	July 2009
CPI	15	14	15	14
Industrial production and PPI	20	20	19	17
Wages and employment in the enterprise sector	17	19	18	16
GDP estimates	–	29	–	–
Business tendency survey (CSO)	22	22	22	22
Money supply M3	14	14	12	14
Balance of payments	14	15	17	14
Core inflation	22	21	22	22
Official reserve assets	7	7	5	7
MPC meetings	28-29	26-27	23-24	28-29
ECB meetings	2	7	4	2
FED meetings	28-29	–	24	–

Source: CSO, NBP, ECB, Federal Reserve

SPECIAL SECTION

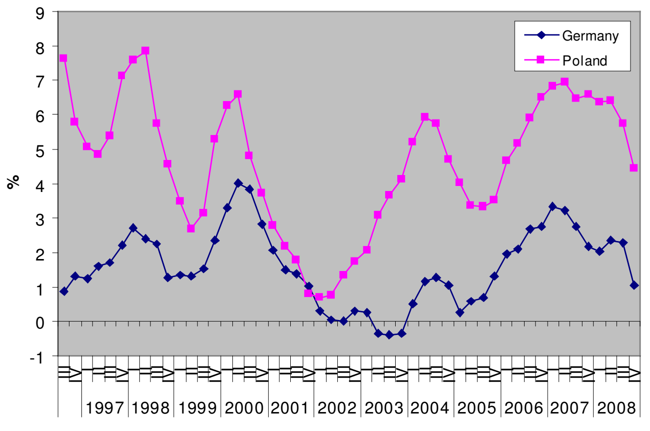
Looking for the bottom of the recession

The recent improvements in some business sentiment indicators (including the PMI) suggest that the pace of monthly declines in economic activity in Poland may have stabilised. To put it more clearly – the economic momentum is not getting increasingly negative (which does not rule out a further deterioration of indicators in annual terms). In our baseline scenario we assume that the first signals of economic upturn will appear in the second half of 2009. However, this scenario, based on an analysis of business sentiment indicators for the German economy, and the historical length of the Polish business cycle (including export response to stimulation by a weaker zloty) requires constant monitoring and has to be confirmed by other factors. This includes obtaining signals of recovery/stabilisation from a broader set of business sentiment indicators for the Polish and the German economies, as well as progress in the stabilisation of the situation in financial markets and in the banking sector. Yet even for purely arithmetic reasons, a trend reversal for indicators of the supply side of the economy does not necessarily have to translate into a GDP growth rate for 2009 in excess of 0% YoY.

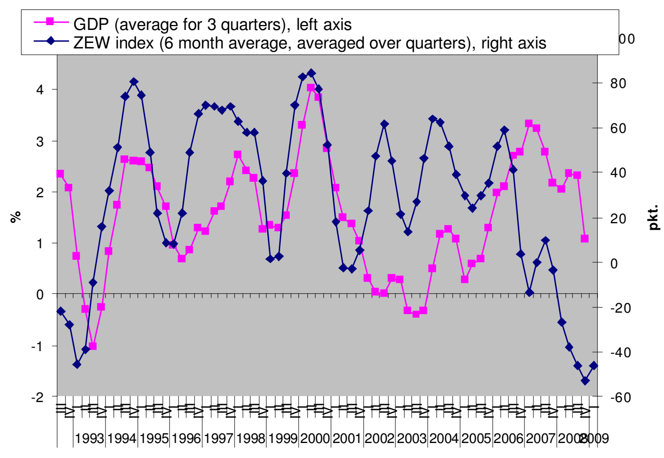
Synchronisation of the business cycle for Poland and Germany

The business cycle in the Polish economy is highly correlated with the cycle in the German economy, while the turning points usually occur with a small delay of just 1-2 quarters. The strong linkage of the business cycles results from the importance of trade links with Germany. While the share of imports from Poland in Germany's total imports is marginal (1-2%), for Poland it accounts for about 25% of the total export volume (2008 figures). 80% of the changes in German imports witnessed over the past 12 years (quarterly data) were identical in terms of direction to the changes in imports from Poland.

GDP YoY, average for 3 quarters

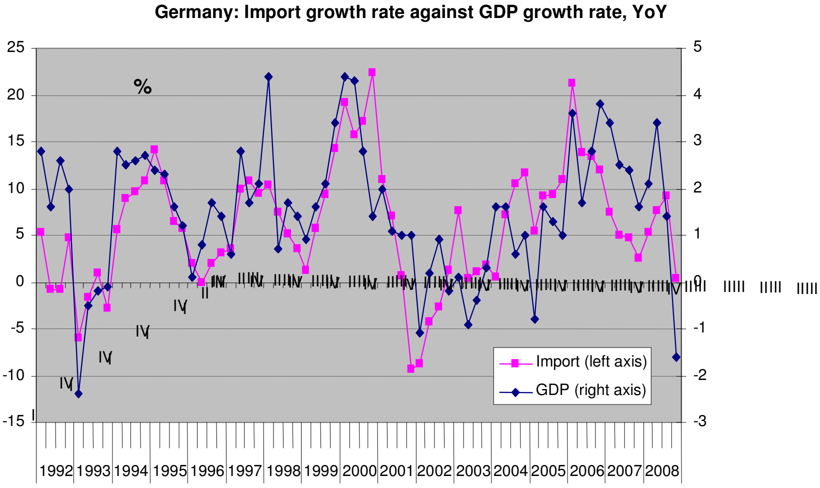


ZEW vs GDP of Germany (YoY)



In a situation where real data are indicative of a continuous slowdown of the German economy, symptoms of recovery may be sought only in leading sentiment indicators. Confrontation of a 6-month (more stable) average ZEW index with the average growth rate of the German GDP (see the chart) provides information on the pattern of the German business cycle. We are mainly interested in the forecasting properties of the ZEW index in the lower turning points of the business cycle, which conventionally indicate the moment when the economy starts to feel the first symptoms of a recovery. We can clearly see that historically the ZEW index marked the lower turning points with a lead time of about two quarters. If the historical relationship between the GDP and the ZEW index were to continue, a reversal of the declining GDP trend should take place in the latter part of 2009 (keeping in mind that we look at the growth rates, hence a reversal of the declining trend should result in a lower pace of decreases).

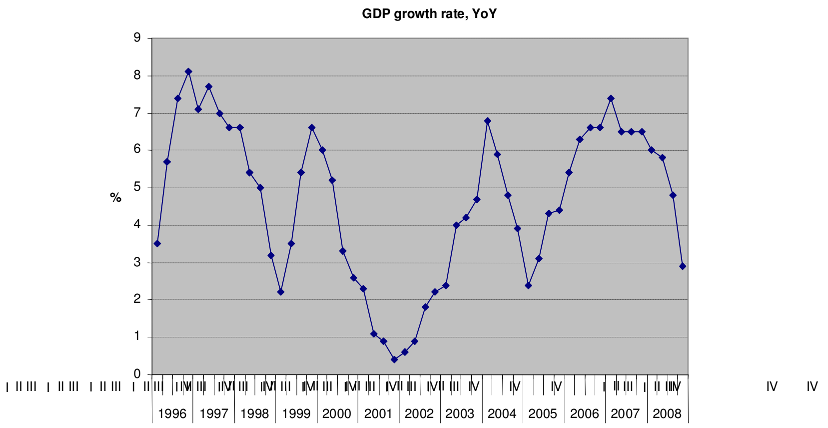
As an improvement in the German GDP growth is expected to have a very strong impact on the growth in imports, this, in turn, implies a rapid reversal of the declining tendency in Polish exports (this again relates to growth rates and not levels).

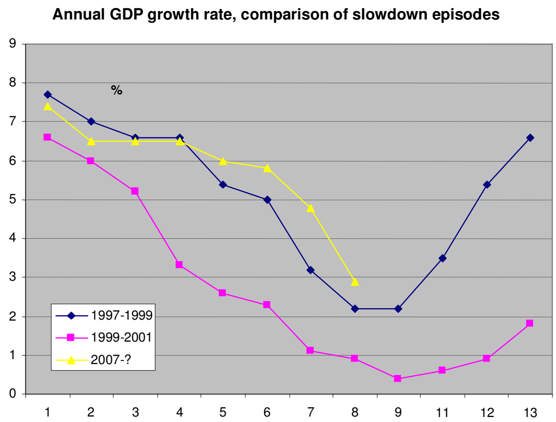


At this point, let us make two reservations. Firstly, the whole analysis is based on an implicit assumption that the restructuring of the German economy will not result in a significant change in direction and structure of trade flows. Because of a large of price competitiveness of Polish exports (mainly resulting from the considerable depreciation of the real exchange rate), no adverse changes (like a reduction Poland's share in the total German imports) should be expected. As a matter of fact, the signals so far seem quite positive, an example of this being the increased car purchases in Poland by Germans, or the significant increase in border trade. One could even claim that Germany's external demand will move closer to those CEE economies, which have experienced a high depreciation of the exchange rate (including Poland). Secondly, we assume that the strong declines in the German GDP growth, which are expected for the first half of this year, will only temporarily depress the Polish exports (but this still means that monthly export decreases on the order of some 20-30% YoY are to be expected in the months to come).

Polish business cycle: some observations

Some similar relationships can also be identified based on the data for the Polish economy. However, a comparison of the popular PMI index with the GDP growth rate does not point (yet) to any particularly good forecasting properties of this index (even if its de-correlation with the actual production growth in the recent months may suggest that the index is increasingly reflecting the real prospects of the sector). Therefore we focus on the examination of historic data showing the length of slowdown periods in the Polish economy. Since 1996, the Polish economy has experienced four such episodes (see the chart on the left). For the sake of better presentation, we have put together the slowdown episodes for the Polish economy, where Quarter 1 corresponds to the cycle peak (see the chart on the right).





Apart from the 2004-2005 slowdown that was mainly triggered by the strong EU accession shock and reflected, in part, the resulting base effects, the behaviour of the Polish economy between the peak and the bottom of the business cycles was quite similar in the other cases:

i) 1997-1999 (10 quarters from peak to bottom, counting from the so-called 'initiating downturn'),
ii) 1999-2001 (9 quarters from peak to bottom),
iii) (2007-***2009?***) (decline in the GDP growth rate has already continued for 7 quarters)

Based on past experience, the current decline in the GDP growth should thus continue for another 2-3 quarters and the lowest GDP growth rate (on annual basis) should be achieved in Q2 or Q3. Given the strength of the negative tendencies in the economy, which has already been reflected in the significant declines of the GDP growth rate on a quarter to quarter basis (with a likely negative Q on Q growth in the first quarter of this year), we believe that the third quarter of 2009 can be seen as the most probable trough in the current business cycle with the weakest annual GDP growth rate. Such a conclusion seems also consistent with the results of the analysis based on sentiment indexes and the outlook for growth in Germany.

What signals should we look for?

Analyses based on historical data may certainly carry serious errors; with the passage of time, changes occur both in the structure of the economy and the set of 'shocks' that lead to a deviation of macroeconomic variables from the equilibrium. Listed below are what we consider the key signals which, when confirmed, should lend probability to the scenario drawn up in our analysis.
1) Gradual reduction of problems with access to credit for investment and current purposes. Indicators that should be monitored in this respect include, among others, the credit spreads, the index describing the 'ability to meet financial obligations on a current basis' published by the CSO as part of its business tendency survey, and data on credit and deposit growth for enterprises and households, adjusted for the impact of exchange rate changes.
2) Signs of a return of 'risk appetite' on a global scale, and a stop (or reversal) in capital outflow from the region. An important symptom of improvement in prospects for the Polish economy should be the stabilisation, and then the strengthening of the zloty.
3) Change of the momentum of a range of sentiment indicators and elimination of 'false signals'. It was a coherent change in the trend of a number of sentiment indicators in Q1 2008 that allowed us to isolate the domestic component of the business cycle and correctly foresee a downturn in the later part of the year.
4) Bottom of the inventory cycle. A significant decline in inventories will provide an incentive to expand current production levels. While its quality is still insufficient, some information can be inferred from the CSO inventory sentiment data and a relevant component of the PMI index.
5) State budget performance. Possible decisions to cut or freeze public investment spending should be carefully monitored, as their effects could be material for economic developments in the second half of the year. Deep cuts in capital expenditure and difficulties in absorbing UE funds may delay the rebound of the Polish economy.
6) Dynamics of changes in the labour market. Cost adjustments in enterprises seem to be proceeding somewhat faster than during previous recessions. This process should facilitate faster restructuring of enterprises and an improvement of their competitiveness. We must bear in mind that in the past a recovery of the Polish economy usually has been determined by an improvement on the supply side (industry, infrastructural investment). The end of the employment reduction process, while being a lagging indicator with respect to the business cycle itself, will probably be a major prerequisite for a recovery in consumer demand (albeit owing to a considerable inertia of labour market developments, we expect such signals to appear only at a later stage).

CONTACT:
Financial Markets Department
ul. Senatorska 18
00-950 Warszawa
fax: (22) 829 02 05

Head of Corporate Sales

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

Head of Financial Institutions Sales

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

Head of FX

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

Head of Interest Rate Transactions

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

Head of Structured Instruments

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