

## Poland

- the economy is slowing fast!

Team Emerging Markets – 12.10.2001

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The central bank has lowered its leading interest rate from 19% to 14.5% this year (on 28/2, 28/3, 27/6 and 22/8 by 1, 1, 1.5 and 1 percentage points, respectively).

### We expect:

- another 2 percentage-point cut in Q4, 2001
- the EUR/PLN to be at 385.00 three months from now; currently it is 374.00

### Focus in Q4 2001 on:

- Presentation of the budget for 2002 by the new left-wing coalition government consisting of SLD and PSL (reformed communists and the agricultural party).

### We recommend:

- buy Polish bonds if the value of the zloty dips - at present the currency is fundamentally too expensive.
- take profit for the short term on Polish equity holdings.

### Politics:

The parliamentary election on 23 September returned the expected result: a turn to the left. However, SLD (the reformed Communist party) did not gain the majority. They formed a coalition government with PSL (the agricultural party). The new prime minister is Mr Leszek Miller, and the finance minister will be Mr Marek Belka.

PSL is redder than SLD, and anti-EU on several fronts, and the party will now be a significant factor in the process of restructuring Poland's agricultural sector to EU conditions, which may be a difficult task.

For the longer term Poland's goal is firm - membership of the EU. But in view of the problems encountered by the EU in their extension efforts towards the east, it is not unlikely that Poland joins later than 1 January 2004.

### Economy:

The restrictive monetary policy pursued in 2000 with successive interest-rate increases and the strong appreciation of PLN are having their effect on the economic activity in 2001. We therefore downgraded our estimate of GDP growth yet again, this time from +2.8% in 2001 to +2.2%. Similarly, our estimate for 2002 has been lowered from +4.0% to 3.2%. Unemployment is

now more than 16%. The inflation rate is falling, as shown in the table below, which sets out the average inflation rate. The central bank's target for 2002 has just been changed from 6%-8% to 5% +/-1%.

	2000	2001	2002
GDP growth, %	+4.0	+2.2	+3.2
Inflation, %	+10.1	+6.0	+5.6
Curr.acc., % of GDP	-6.3	-5.0	-4.8
Budget, % of GDP	-2.7	-3.7	-5.0

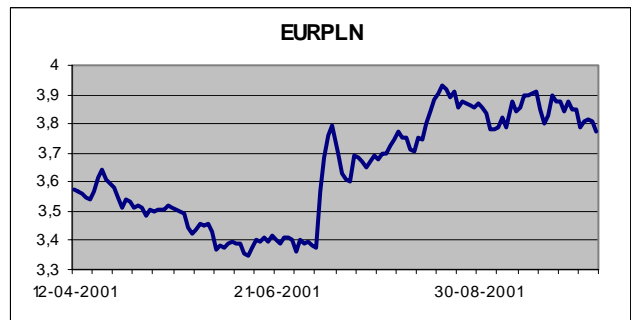
The budget for 2002 is being prepared by the new government. Mr Belka has announced that the government's goal is a deficit of PLN 40bn, or 5% of GDP. But they have not yet succeeded in convincing us how revenue of PLN 143bn can be generated by an economy which is slowing down fast. And there is a new problem, namely the government contra the central bank. The government wants a heavy reduction in interest rates, whereas the central bank is hesitant.

We expect the central bank will react to the falling inflation rate by lowering interest rates by 2 percentage points before the turn of the year. We expect a cut of 1 percentage point at the meeting on 24-25 October and 1 percentage point in November or December. There will be more interest-rate cuts in 2001 - depending on the budget.

Polish press reports released today intimate that the government coalition has agreed amongst themselves that, unless the central bank lowers interest rates by 6 percentage points before the end of March 2002, the bank's charter may be extended with a passage about maintaining economic growth and employment in addition to the inflation target. The central bank's independence is thus at risk.

### Foreign exchange:

The EUR/PLN rate for the past six months is shown in the chart below:

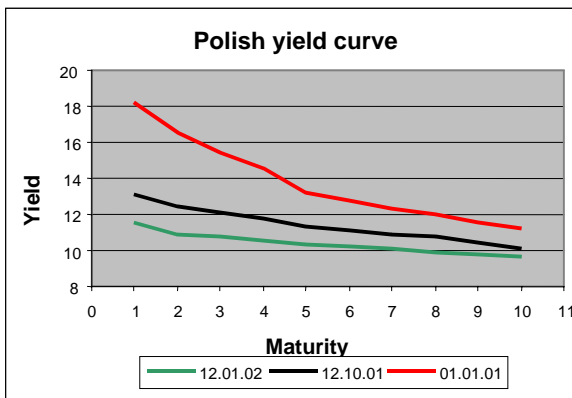


PLN has been through a turbulent period since early July, having weakened from 340.00 to 390.00 against EUR in less than three months! Because of uncertainty about the election and the budget, market participants were clearly closing their PLN positions. The technical picture shows that the EUR/PLN rate (currently 374.00) should trade in the range of 365.00 - 390.00, which we expect will apply also to the coming period. Downward breach of 365.00 will strengthen PLN further from the present level. However, that is not a likely development. We rather believe that the EUR/PLN rate will again test the range of 385.00 - 390.00, and we recommend investors to buy PLN for test of 365.00.

**The Polish yield curve:**

In our update on Poland of 28 August we predicted a strong fall in yields until August 2002. Actually, developments have caught up with our prediction, and the scenario we predicted a year ahead has already come true. Now we anticipate only moderate falls in market rates.

The chart below shows the yield curve since the turn of the year and a projection of how we expect the curve to proceed over the next three months. We anticipate a steepening yield curve at three months' term, and we anticipate 2-year yields to fall by 1.50 percentage points, 5-year yields by 1 percentage point, and 10-year yields by 0.50 percentage point.



The inflation rate and the economic slowdown will in our opinion prompt interest-rate cuts, since the real interest rate is too high.

**Potential return:**

On the basis of interest and exchange rates as forecast by us, we have prepared the below matrix of expected returns:

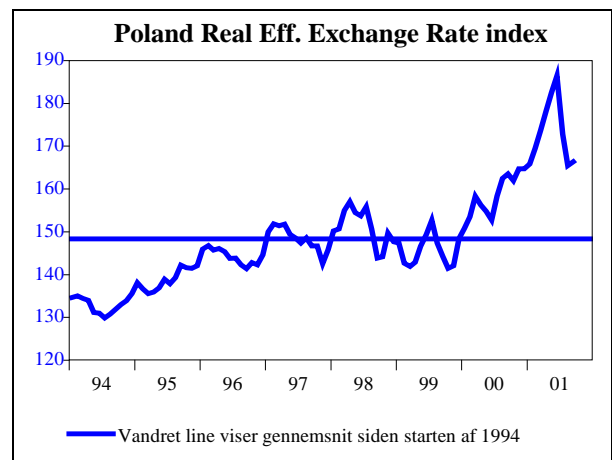
	+ 3m	EURPLN now	EURPLN +3m	Net
2yr	6,75%	375	385	3,98%
5yr	6,09%	375	385	3,33%
10yr	5,47%	375	385	2,73%

We used the following bonds in our calculations:

Code:	Coupon:	Paper:	Maturity:	Price:	Yield to maturity:
B88310	12.00%	POLGB	12.10.03	100.00	11.99%
B88311	8.50%	POLGB	12.05.06	90.45	11.25%
B88328	6.00%	POLGB	24.11.10	76.35	10.09%

Evidently, Polish bonds still hold potential at the present yield level - the decisive factors are the timing and the exchange rate.

**We recommend investors to buy Polish bonds at dips in the value of the zloty. PLN is fundamentally too expensive at present, as shown in the chart below.**



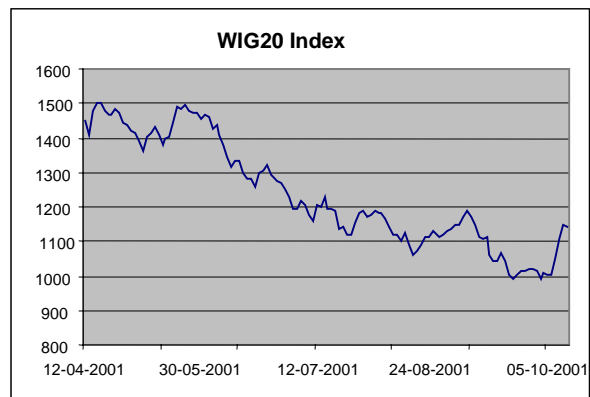
The horizontal line shows the average since early 1994

An interesting buy alternative to the above bonds would be:

Code:	Coupon:	Paper:	Maturity:	Price:	Yield to maturity:
B88138	13.50%	IKEA	12.05.06	105.90	11.74%

**Polish equities:**

Polish equity prices rose last week by 15%, as shown in the chart below. The buyers were mainly domestic pension funds. It is merely a week since the index traded at its lowest level since 1998.



If the short-term rally continues, Polish equities will outperform other East European markets, since Poland's beta value is higher. However, Poland is in a state of political unrest, which may put a damper on market activity. We are convinced that the rally seen recently is slowing down - so we recommend investors to take profit on their equity positions for the short term.

**Coming events:**

<b><u>Date:</u></b>	<b><u>Indicator:</u></b>	<b><u>Exp.</u></b>
15.10	CPI September	4.6%
15.10-19.10	Budget data for September	
18.10-23.10	Unemployment	16.1%
31.10	Current account, September (USD)	