Bank Zachodni WBK

Eyeopener – daily update

Hawkish statements, hawkish data

14 February 2005

Last week, the Polish financial market was vulnerable to political news (Lower House speaker statement about possible shortening of parliament's term of office in May and deputy PM Hausner quitting the SLD), but as the most important factor one should perceive an interview with MPC member Andrzej Wojtyna on monetary policy prospects, published by Reuters late on Friday. In general, he suggested that possible adoption of neutral policy bias in the nearest time should not be treated by the market as a sign for swift rate cuts. Even though inflation outlook has improved recently, among others on the back of zloty strengthening, Wojtyna is not going to support monetary easing as long as there is political risk, which may lead to zloty depreciation. For the same reason, one should not expect him to back FX interventions aimed at zloty weakening. We expect Wojtyna's comments should cool down market expectations regarding rate cuts, similarly as it happened in case of MPC's Wasilewska-Trenkner's comments in mid-January. Before Wojtyna's statements, the market had been pricing in 75bps cuts until year end (too aggressive in our opinion).

This week, there will be many data releases, which may affect the market view on future monetary policy. The most important will be CPI figures and labour market statistics on Tuesday as well as output data and PPI numbers on Thursday. Today, the NBP will publish monetary statistics for January.

What's hot this week

Many data releases are due for this week

The most important will be CPI figures

Last week the Polish financial market remained vulnerable to political news (Lower House speaker statement about possible shortening of parliament's term of office in May and deputy PM Hausner quitting the SLD). Upcoming days will bring publications of very important macroeconomic data for January, which will influence the zloty and treasuries' yields. Crucial data will be released on Tuesday and Thursday. Data on inflation and corporate wages will show how strong price pressure was at the beginning of 2005, while output data will suggest whether December's slowdown was a good reason to change GDP growth forecast for 2005 as a whole. We expect annual CPI inflation to reach as much as 4.7%YoY while market consensus points to 4.6%. However, the range of market forecasts is very wide (from 4.4% to 4.8%). This might be connected with the fact that since January 2005 the CSO stopped publishing preliminary food prices data (which made inflation forecasting more difficult) and additionally the effect of administrative prices hikes (e.g. energy and gas prices, many excises taxes increases) is very uncertain. Inflation increase may limit market expectations (in our opinion too excessive) for rate cuts this year, as even one of the most dovish MPC members, Mirosław Pietrewicz, said last week that no cuts are possible when inflation is rising.

Also on Tuesday the CSO will publish labour market statistics - employment and wages in enterprise sector. Corporate wages are closely watched by financial market participants as they seem to be important for monetary policy perspective. Although, in our opinion the data on wages growth in the whole economy are much more important. Quite interestingly, the figures for the

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...and labour market statistics from the enterprise sector to be published on Tuesday

4Q04 was published by the CSO last week had no influence on the market (actually, it was not even noticed). Wage growth amounted to 5.6%YoY in the final quarter of last year showing an acceleration from 5.1% in 3Q04. It exceeded inflation rate by above one percentage point, sending contrasting signal as compared to monthly figures from the enterprise sector. In January we expect corporate wages to rise by 4.8%YoY, which is above market consensus of 4.1%. We see employment in this sector to rise in annual terms for the second consecutive month (by 0.2%).

5Y bond auction may also be an important driver for the market sentiment

On Wednesday the second auction for new 5y benchmark will take place. Owing to the upside risk of inflation data ahead of the auction the ministry will probably show (on Monday) the offer in the middle of announced range of PLN2.5-3.5bn. The market seems to price in benign inflation increase in 1Q05, so distinct jump might diminish an interest for those bonds below 6%.

Output figures and PPI numbers on Thursday

On Thursday we will see a continuation of inflation data with PPI figure, which should show further decrease in annual terms. The scale of reduction will depend on usual January's administrative prices rise affecting this index. We see PPI inflation down from 5.6% in December 2004 to 5.2% (market expects 5.0%). However, data on industrial output will be much more important that day, especially in the context of December's sharp deceleration (to 6.4%). In 1Q05 the growth will be even lower amid high statistical base effect. But if January's production surprises on downside again this may lead to GDP growth forecast revision. We expect 5.6% annual growth. On the other hand, we expect a continuation of positive trend in construction output (two-digit growth in January) - statistical base effect as well as weather condition were very favourable.

Data ob budget performance also due for this week

During the week, the Ministry of Finance will present data on budget performance after January. Earlier estimations given by the ministry strongly influenced market expectations and data should not be important for the market.

At the end of the week, EcoFin may publish its (negative) opinion on Poland's convergence program

It is also possible that at the end of the week, the EcoFin Council will publish its opinion on the Polish Convergence Programme. In line with recent Commission's assessment, this will most likely include critical remarks as regards Poland's plan to bring deficit down to below 3% of GDP in 2007. The criticism shows that fiscal problems are not connected with Polish pension funds (OFE) only (although unfavourable EU decision will increase deficit by about 1.5% of GDP), but primarily with no necessary reforms during the period and too optimistic growth assumption for 2007. On Wednesday the Ministry of Finance will present plan B needed in case of unfavourable EU ruling on OFE.

***Bottom line**: If the data turn out to be in line with our forecasts (higher than market consensus), one can expect higher yields (and possibly weaker zloty). EcoFin Council opinion is likely to follow Commission's assessment, criticising Polish fiscal plans to being deficit down below 3% of GDP.*

What's hot today

MPC's Wojtyna does not see room for monetary easing

Very important hints on monetary policy prospects from MPC's Wojtyna

On Friday, MPC member Andrzej Wojtyna, regarded as one of those rate-setters whose votes settle the Council's decisions, gave an extensive interview with Reuters agency. The interview shed more light on monetary policy prospects for this year. We think his comments clearly suggest he does not see room for monetary easing as long as there is risk of zloty deprecation due to substantial uncertainty regarding chances for continuation of fiscal consolidation after parliamentary elections. Of course, Wojtyna realizes that inflation outlook has been improving, which justifies a change in policy bias to neutral from tightening, but it should not be treated as a sign of a pending monetary easing. Please find Friday's statements from Wojtyna together with our comments in the table below.

Wojtyna's statements	Our comments
These price shocks are fading away and wage growth remains in check, making it possible for inflation to return close to the bank's 2.5% target at the end of this year.	Wojtyna thinks that exogenous inflationary shocks are weakening and demand pressure is still benign, which improves the inflation outlook. We also think CPI should be close to the target at the end of this year.
I believe rates should be changed only while holding an easing or tightening bias and not a neutral stance. the neutral bias is the most comfortable situation for the central bank, because it shows balanced risks and stable macroeconomic situation. In such case no rate changes should be made in normal conditions, i.e. when there is no risk of exchange rate risk and no very strong shocks. Currently we have normal conditions.	If the inflation projection and balance of risk perceived by the rate-setters were favourable enough for a bias change to neutral, one should not treat it as a sign of a swift rate cuts. This would rather mean no need for rate hike or rate cut. Markets should not take easing for granted after adopting neutral bias. Rate cuts should be expected only after adopting easing bias.
The balance of risks goes in such direction that it creates a room for changing the bias to neutral. But if political risk and uncertainty grow before the election, the possibility of keeping a neutral stance for a longer period will be limited. If the risk for inflation rose, return to a tightening bias would be necessary. In terms of macroeconomic factors, the balance of inflation risks is favourable. A bigger risk could appear if the zloty's strengthening trend reversed. Nothing indicates this for the moment, but the upcoming elections are the unknown. If we artificially separate economic and political factors, reasoning that there is a possibility of a faster bias change or rate cuts is quite convincing. But only as long as we ignore politics and I believe we cannot put it aside.	Although inflation outlook improves currently, pointing to a possibility of policy bias change to neutral, Wojtyna shares opinion of MPC's Balcerowicz and Filar (as well as our view) that zloty is vulnerable to political uncertainty and the growing political risk ahead of elections may lead to zloty depreciation and thus to deterioration of inflation outlook. Wojtyna thinks one should not underestimate political factors and he is afraid of potential zloty weakening on the back of potential political turmoil. Therefore, he does not see justification for monetary easing now. On the contrary, he does not exclude the MPC could again adopt tightening bias if negative market scenario materialises. Such view on monetary policy prospects may be shocking for those market players, who still think that swift rate cuts may take place after the Council adopts neutral bias in monetary policy.
Lack of discussion [on economic program between future coalition partners] upsets me, especially if election were to take place in June. There is a risk of zloty weakening, if main market players started to perceive that there are problems with constructing a credible economic program. This means, above all, continuation of fiscal consolidation, on which our euro zone membership depends.	Lack of consistent economic program of prospective coalition partners suggests there may be problems with implementation of necessary reforms after elections. That is why elections are connected with a risk of weakening on the Polish financial market. Given contradictory views of PO and PiS on the priorities of the domestic economic policy, one may expect the Poland's road to the euro zone may be really bumpy.
As for the exchange rate, the time has not come for such actions. They are not necessary, because FX interventions have sense, if there is high probability that they will be effective and will reverse the trend permanently. Changing the current exchange rate policy regime without a high degree of certainty that the exchange rate does not return to a trend is risky and very disputable. If we tried to influence [the zloty] and offset every change in exchange rate with interest rate change, we would have to raise rate again, when political factors would cause depreciation of the zloty in two-three months. This would lead to a rise in uncertainty for enterprises and households, because high volatility of interest rates concerns everyone, not mainly exporters [as in case of exchange rate].	Rising worries that a zloty's strength could hurt growth triggered speculation whether the central bank could intervene on the FX market, abandoning its hands-off policy towards the free-floating zloty. Wojtyna's comments show he should not be numbered among advocates of FX interventions. He believes they could be efficient only when it is certain the trend is reversing (this is consistent with view of other MPC member Andrzej Sławiński). What is more important, Wojtyna also think that the central bank should not try to influence the exchange rate through rate changes. He believes this would imply unnecessary high volatility in interest rates and boosted uncertainty in the economy. At the same time it would probably be unsuccessful in steering the zloty.
Appreciation creates some room for rate cuts if we assume it is permanent. (…) There is no use lifting rates again after three months, if zloty begins to depreciate [after cutting them now]. (…) We will be able to talk that appreciation is permanent only when there is lower significance of political factors, when we know appreciation stems mainly from economic and fundamental factors.	Monetary easing is possible only after the MPC perceives the zloty's appreciation trend as lasting and this will not happen before the impact of political factors wanes and the zloty rate is determined mainly by fundamentals. Wojtyna warned, similarly as NBP governor Leszek Balcerowicz and MPC member Dariusz Filar did earlier, that it could turn into weakness due to political uncertainty and doubts whether budget reforms will be continued after the elections.

We think Wojtyna's comments should cool market expectations for rate cuts significantly

All in all, Wojtyna's statements should affect market expectations regarding future monetary policy, based on recent zloty strengthening. Let us recall that similar effect came from comments of MPC member Halina Wasilewska-Trenkner, who said in mid-January that rate cuts did not seem probable in 2005. After notable rise in market interest rates following her comments, the market again began to price in rate cuts very aggressively (too aggressively in our opinion). For instance, FRA prices show that market players are expecting a first rate cut within the nearest three months. Last week, Reuters agency published results of its latest poll among market economists, which showed the MPC will change its policy bias to neutral in February (this is expected by 13 out of 16 surveyed analysts while 3 of them predict a neutral bias will be adopted in April) and trim rates by a total of 50-75 bps by the end of 2005 (this is predicted by 11 out of 16 analysts; 5 economists forecast rates will remain steady this year). While we think that change in policy bias seems to be justified, in our opinion there are no reasons at the moment to assume the monetary policy will be relaxed soon. Wojtyna's comments confirm our view and they should lead to increase in market interest rates.

Bottom line: ***Wojtyna's statements show that possible adoption of neutral policy bias in the nearest time should not be treated by the market as a sign for swift rate cuts. Even though inflation outlook has improved recently, among others on the back of zloty strengthening, he is not going to support monetary easing as long as there is political risk, which may lead to zloty depreciation. For the same reason, one should not expect him to back FX interventions aimed at zloty weakening. Positive for the zloty, negative for the yield curve.***

The zloty trading ranges (11.02.2005)

	Min	Max	Fixing
USD	3.1060	3.1400	3.1362
EUR	4.0025	4.0400	4.0352

F/X rates (today's opening)

EURUSD	1.2939	CADPLN	2.5134
USDPLN	3.1001	DKKPLN	0.5388
EURPLN	4.0108	NOKPLN	0.4752
CHFPLN	2.5804	SEKPLN	0.4409
JPYPLN*	2.9564	CZKPLN	0.1332
GBPPLN	5.8184	HUFPLN*	1.6410

*per 100 units

Treasury yield curve (11.02.2005)

T-bills	Yield	Change (bp)
3M	6.20	0
6M	6.15	0
9M	6.06	0
12M	6.05	0
Bonds		
2Y	6.00	0
3Y	5.95	2
4Y	5.97	3
5Y	5.95	5
8Y	5.86	4
10Y	5.80	3

WIBOR rates (11.02.2005)

Term	Rates	Change (pb)
O/N	6.59	23
T/N	6.59	4
SW	6.60	0
2W	6.60	0
1M	6.60	0
3M	6.60	-1
6M	6.50	-2
9M	6.36	-1
1Y	6.30	-1

Market monitor

The zloty came under pressure in the morning on Friday, as some foreign players decided to reduce their exposure in Polish currency, when political risk regarding possibility of earlier election mounted. The unit lost 0.6% to the euro and 0.8% to the dollar reaching in absolute terms 4.03 and 3.1350 respectively. Afternoon's part of the session brought Friday's trend reversal and the zloty closed respectively below 4.01 and 3.11. Due to surprisingly good Japanese current account data the dollar fell broadly reaching 1.2940.

Bonds were affected by both zloty deterioration and Bunds' pullback following unsuccessful 10y bond auction in US. DS0509 hit 5.94% in the shallow market, typical on Friday. Till the end of the day 5y benchmark lost even 1bp more.

Ministry of Finance on Monday will offer PLN900m of 1y bills.

Barring the influence of political factors that by their nature are unpredictable in the short term, the market behaves typically as in the period that is rather eventless. Next week will probably pull out the market from stagnation due to meaningful portion of data both domestic and international. For bonds Monday will bring release of supply for 5y bond tender that in our opinion should amount to max. PLN3bn, as the ministry of finance won't be willing to assume the risk of higher inflation data on Tuesday following announcement of the offer close to the top of the range PLN2.5-3.5bn. Friday's hawkish comments from MPC member Wojtyna, as it was released at closing, will affect fixed income markets only today in the morning.

On the zloty, apart from the inflation and production data an impact will have, throughout the change of EURUSD performance, Tuesday's US capital inflow data and Wednesday's Fed chief's testimony to Senate Committee. Subsequent political surprises cannot be excluded, so investors will open long positions in Polish currency cautiously.

***Bottom line**: Politics elevate volatility in the FX market. Interest rate market has been relatively resilient so far. Friday's MPC member comments should be reflected in debt prices, leading to weakening of the interest rate market.*

International update

No major data abroad are due for today.

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