Bank Zachodni WBK

# Eyeopener – daily update

## Very important EcoFin decision

7 March 2005

**The most important event in the coming days will be meeting of EU member states' finance ministers scheduled for March 8. One of the subjects under discussion will be reform of Stability and Growth Pact determining e.g. whether (and how) costs of pension system reform would impact excessive deficit procedure. This decision would be crucial for Poland, as it might impact ability of the country to lower budget deficit to the level allowing the euro zone entry. Finance minister Mirosław Gronicki announced recently that he prepared a plan (details will be presented after EcoFin meeting), which would allow Poland for deeper deficit reduction and accession to the euro zone in schedule even amid unfavourable EU decision on pension reform costs.**

**One should remember, however, that probability of early election (in June) rose substantially last week. In such case, current finance minister would be able to prepare only tentative assumptions for 2006 budget, and the decisions on fiscal policy shape would be up to the next government. Although, it is worth noticing that president Aleksander Kwaśniewski said on Friday that if the Sejm had not decided on its dissolution on May 5, election would take place in September (this suggested that possible PMs' resignation might not be accepted).**

## What's hot this week

*EcoFin Council meeting will be very important for the market*

Crucial event of the coming week will be meeting of finance ministers from the EU member states, scheduled on 8 March. One of the subjects under discussion during the summit will be reform of Growth and Stability Pact including, among others, debate on whether (and how) costs of pension system reforms in EU member states should impact procedure of excessive deficit. Decision on this issue will be crucial for Poland, as it will resolve on whether or not Poland could run deficits higher than 3% of GDP by the amount of private pension system balance (ca. 1.8% of GDP) without a risk that it would prevent closure of excessive deficit procedure until 2007. This could in turn impact the country's eligibility for euro zone entry within the planned horizon, i.e. by 2007. EcoFin's ruling on this matter would be then recommended to the EU Council that would make a final decision at the end of March. However, it is very likely that the ultimate EU verdict would be consistent with recommendation given by the finance ministers' committee on Tuesday.

*… as it is still uncertain whether (and how) costs of pension system reform would impact excessive deficit procedure*

*Ministry of Finance prepared a contingency plan, which is expected to allow euro zone entry in 2007 even in case of unfavourable EU decision*

Finance minister Mirosław Gronicki announced recently that the Ministry of Finance had prepared a special plan of actions ("plan B") that would allow Poland for deeper reduction of fiscal deficits than devised previously and thus would allow for accession to the euro zone in schedule even despite unfavourable EU ruling on costs of pension reform. It is likely that details of this plan would be revealed by the minister later this week, after EcoFin meeting, especially if the decision proves to be unfavourable for Poland. To some extent, this could counterbalance potential negative impact of bad news about the EU ruling on Polish financial market. According to hints given earlier by minister Gronicki, actions envisaged in "plan B" would yield

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*Additional savings of ca. 0.5% of GDP in 2006 and above 1% in 2007*

reduction in budget deficit by ca. 0.5% of GDP in 2006 and over 1% of GDP in 2007, so that Poland should end up 2007 with fiscal deficit at ca. 2.8% of GDP even without taking away balance of open pension funds sector.

*On Friday CSO will release 4Q04 GDP data*

On Friday at 10:00 the CSO will hold press conference to present data on GDP growth in the final quarter of 2004. Earlier, the stats office released tentative GDP figures for the entire 2004 so the publication would verify analysts' estimates made based on figures for the whole year. We predict GDP grew 4.2% in 4Q04, amid 1.8% rise in private consumption and 7.0% in fixed investment. Market consensus is quite close, as it points to 4.1% GDP, 1.8% consumption and 7.3% investment growth. The data on economic growth are not likely to reduce market expectations for soon rate cuts, especially that much more important for investors in this regard would be CPI release due at the beginning of the next week.

*On Saturday the SLD will discuss election timing*

*Will President accept PM resignation in case parliament would not dissolve itself*

On Saturday, 12 March, the SLD will reconsider the best timing of parliamentary election. Party leader Józef Oleksy said on Friday they could support early election (even earlier than in June), as the SLD was losing control over the government. On Friday, president Aleksander Kwaśniewski met left-wing parties' politicians as well as Prime Minister Marek Belka and lower House speaker Włodzimierz Cimoszewicz. After the meeting, the president said that parliamentary election is unlikely earlier than June 19 or 26. He said also that if the Sejm had not decided on its dissolution on May 5, election would take place in September (this suggested that a possible PMs' resignation would not be accepted). Also, Lower House speaker did not exclude a possibility that parliamentary election, presidential election and referendum on EU constitution could take place at the same time (in autumn).

***Bottom line**: EcoFin's recommendation on pension funds treatment in the context of excessive deficit procedure would be crucial for Poland's ability to meet euro entry criteria, and thus would be critical for the Polish market this week. GDP data for 4Q04 should have smaller importance, showing similar picture as emerged after full-year data.*

# What's hot today

*Nieckarz sees CPI inflation at 2.5% in the middle of the year*

### MPC's Nieckarz says he will not cut automatically

*… but we think this might be below 2% in June*

MPC member Stanisław Nieckarz said in an interview with PAP agency on Friday that inflation in 1Q05 would be lower than in 4Q04 and if the zloty remained strong for a longer time, CPI might fall to the inflation target of 2.5% towards the end of the first half of the year. Such prediction seems conservative. In our opinion, and according to market consensus, CPI may fall below 2% in June. Nieckarz also thinks that strong zloty can negatively affect export and thus reduce the pace of economic growth to 4.5% this year from 5.5% last year. MPC member added that if investment growth does not reach at least 14-15%, lower contribution of net export may cause that GDP growth will fall to only 4%. In general, he thinks that reduction in inflation rate to the inflation target before the year end will be harmful for the economy.

*He reiterated that rate cuts would not be automatic after easing bias introduction*

Nieckarz's comments on inflation outlook and economy's prospects suggest he is going to support monetary easing. Although MPC member said an easing bias means higher probability of rate cuts than probability of hikes or stabilisation in interest rate, he reiterated that a bias change to easing does not mean that rate cut will take place automatically in the nearest time. In his opinion, the first rate cut is equally probable to take place "at the nearest meeting, at the second meeting or at the fourth meeting". According to him, much will depend on exchange rate as well as food and oil prices. Asked about possible scale and frequency of rate cuts this year, Nieckarz said this was uncertain and would be dependant on the effects of indirect tax hikes in first months of the year (they have not been visible entirely so far in Nieckarz's opinion) and on chances for stronger than earlier expected decrease in food prices growth. Despite all doubts and reservations expressed by Nieckarz, he did not seem to be concerned about possible inflationary pressure in future. He emphasised that despite gradual reduction, the unemployment is still high enough to constrain wage pressure and possible second-round effects of recently high inflation. Nieckarz also believes that political situation will have minor impact on the inflation outlook and may only cause temporary fluctuations of the zloty exchange rate and bond yields.

***<u>Bottom line:</u> One of the two most dove-ish MPC members leaves little doubts whether he will support rate reduction this year. However, whether they will actually take place as well as its scale and timing will depend on other, more moderate rate-setters. Therefore, Nieckarz's statements are of little importance for formulation of market expectations regarding monetary policy scenario for this year. After the unexpected change in bias policy to easing, it would be interesting what other central bankers have to say.***

## Market monitor

Polish currency continued a correction that started in Thursday afternoon on uncertainly regarding upcoming election. The dollar climbed to 3.0140 and the euro to 3.9530 against the zloty. As the unit hit those levels as a result of Tuesday's comments from PM, the market bounced back mainly versus the euro reaching 3.9150. In relation to the dollar it recorded a lesser rebound to 2.98. Ahead of US employment data the zloty stabilised in the vicinity of 3.9250 and 2.99. A sharp rise in the cross rate, as a consequence US labour market data, triggered above 1% surge of the zloty to the dollar, which fell, in absolute terms, to 2.9550. EURPLN rate advanced to 3.90.

Bonds declined at the opening on sliding zloty, but their movement proved to be only a minor one. PS0310 achieved 5.54%. As pressure from f/x market faded it eased down to 5.52%. Dramatic upward Bunds movement, following payrolls publication, entailed Polish long dated papers and 5y benchmark closed at 5.46%.

Ministry of finance, likewise a week ago, will offer PLN800m worth of 1y bills at Monday's auction.

Preponderance of short positions in euro rate against the dollar and bonds in core markets was so huge, that even higher-than-expected data failed to prevent its sudden covering. Because employment components in majority of indicators published ahead of last Friday hinted pronounced improvement in labour market conditions, actual market consensus were significantly above the final reading. Polish market reacted through the channel of strong

**The zloty trading ranges (0403.2005)**

| | Min | Max | Fixing |
|---|---|---|---|
| USD | 3.8960 | 3.9530 | 3.9278 |
| EUR | 2.9460 | 3.0140 | 2.9944 |

**F/X rates (today's opening)**

| | | | |
|---|---|---|---|
| EURUSD | 1.3228 | CADPLN | 2.3952 |
| USDPLN | 2.9515 | DKKPLN | 0.5246 |
| EURPLN | 3.9044 | NOKPLN | 0.4737 |
| CHFPLN | 2.5218 | SEKPLN | 0.4318 |
| JPYPLN* | 2.8143 | CZKPLN | 0.1321 |
| GBPPLN | 5.6717 | HUFPLN* | 1.6132 |

*per 100 units

**Treasury yield curve (04.03.2005)**

| T-bills | Yield | Change (bp) |
|---|---|---|
| 3M | 6.05 | -5 |
| 6M | 5.95 | -5 |
| 9M | 5.85 | -2 |
| 12M | 5.60 | -5 |
| **Bonds** | **Yield** | **Change (bp)** |
| 2Y | 5.43 | -5 |
| 3Y | 5.43 | -4 |
| 4Y | 5.44 | -2 |
| 5Y | 5.46 | -3 |
| 8Y | 5.50 | -3 |
| 10Y | 5.50 | -3 |

**WIBOR rates (04.03.2005)**

| Term | Rates | Change (pb) |
|---|---|---|
| O/N | 6.59 | 22 |
| T/N | 6.59 | 18 |
| SW | 6.56 | 11 |
| 2W | 6.56 | 11 |
| 1M | 6.52 | 5 |
| 3M | 6.35 | 2 |
| 6M | 6.10 | 1 |
| 9M | 5.93 | 3 |
| 1Y | 5.83 | 3 |

correlation between the zloty and euro, especially when the latter rises. The experience teaches that such an impulse at the end of Friday's session has an impact on market performance in the coming week, the more so because not so many releases are scheduled. Amid strong EURUSD the zloty has a chance to set new record highs to the dollar. In a slightly different situation are bonds which after Friday's overreaction should stabilise, as employment growth has been substantial yet, what confirms expansion in the US economy.

***<u>Bottom line</u>: US employment did not surprise. This time market reaction took by surprise. The zloty and bonds finally advanced on the back of core markets. Current week will start with positive sentiment in the markets, but it seems that the zloty will benefit more than treasury papers.***

# International update

Retail sales in the euro zone rose by 0.3% in January on monthly basis, but were 0.6% below the level seen in January 2004, confirming the fragile state of consumer confidence. Eurostat also said unemployment across euro zone remained steady at 8.8% in January from December.

US employers created 262,000 jobs last month, the biggest gain in four months, as car sector workers returned from temporary layoffs and construction activity bounced back from a cold January. The unemployment rate, however, rose to 5.4% from January's 5.2%, but the gain partly reflected an increase in workers entering the labour force. Overall, the report showed a welcome pick-up in job creation, which had been somewhat sluggish in the prior three months. The release, initially, caused indecisive fluctuations in both directions, but afterwards EURUSD and bond prices grew sharply.

US factory orders unexpectedly rose 0.2% in January, as gauge of business spending posted solid gains. US consumer sentiment fell in February. The University of Michigan's final index for February was 94.1, down from January's final reading of 95.5. Analysts on average had forecasted the final February figure would dip slightly to 94.5.



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