Bank Zachodni WBK

Eyeopener – daily update

Waiting for a cut

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All economic data for May has been already released and now everyone waits for the MPC verdict on interest rates. The decision will be announced on Wednesday and this will be the focus of attention for the Polish financial this week. The market prices in continuation of monetary easing bond yields hit historically low levels on Friday. Positive moods on foreign markets also played an important role in determining sentiment in the domestic market. Friday's comments from Krzysztof Rybiński, a deputy governor of the NBP, suggested that recent data substantially worsened the central bank's assessment of economic prospects and improved the inflation outlook perceived by the NBP. What will be the MPC's response to such situation? MPC member Mirosław Pietrewicz, seen as one of radical doves, said "there is no use in waiting" with adjustment in both policy bias and interest rate level. Market analysts take into account four scenarios. The most hawkish one assumes 25 bps rate cut without change in policy bias, while the most dovish envisages 50 bps cut and simultaneous shift to easing bias. While the former does not seem to be very likely, taking into account recent comments of MPC members, the latter seems too aggressive considering how much medium-term economic forecasts could change under influence of only single economic data (on GDP in 1Q05). We believe that there are two most likely scenarios – a 25 bps rate cut with the change of policy bias to easing, suggesting chance for additional 25-50 bps cut before the election, or 50 bps cut with no change in neutral bias, showing that the scale of policy adjustment is adequate to the change in assessment of economic situation after latest data releases. We bet the MPC will pass the first of these options, although we realise that working out a common stance by the 10-members panel with different (sometimes extremely different) views could be exceptionally difficult this time.

What's hot this week

The feature of this week will be the MPC decision on rates

All economic data releases for May has been already announced, thus both financial market and the Monetary Policy Council can now adjust to the new situation. Bond yields fell substantially during the last couple of days hitting historically low levels and positive moods on foreign markets had undoubtedly high importance in determining sentiment in Poland. What will be the MPC's response to such situation? MPC members stressed in their public speeches that the situation requires "adjustment in monetary policy" and thus it is almost sure that the MPC will deliver a monetary easing already this week. It is difficult, however, to draw a conclusion from their statements on a scale of the adjustment and it is not easy to guess the outcome of the nearest MPC meeting. Especially that the Council will have to settle whether it is proper to trim rates with a neutral bias adopted in April. A decision on policy bias will be equally (or even more) important than a scale of rate cut. Market analysts take into account four scenarios. The most hawkish one assumes 25 bps rate cut without change in policy bias, while the most dovish envisages 50 bps cut and simultaneous shift to easing bias. While the former does not seem to be very likely, taking into account recent, quite dovish comments of MPC members, the latter seems too aggressive considering how much medium-term economic forecasts could change under influence of

The question is how much rate will be trimmed and whether the policy bias will be changed

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single economic data (on Q1 GDP). The scenario of a rate cut of 50 bps with a bias change to easing seems to be priced in by the market, but it seems too aggressive to us, given that expectations for the next 12-18 months has not changed so dramatically. We believe that two other scenarios are more likely – a 25 bps rate cut with change of policy bias to easing, suggesting chance for additional 25-50 bps cut before the election, or 50 bps cut with no change in neutral bias, showing that the scale of policy adjustment is adequate to change in assessment of economic situation after latest data releases. We bet the MPC will pass the first of these two options, although we would choose the second. We realise that working out a common stance by the 10-members panel with different (sometimes extremely different) views could be exceptionally difficult this time. It is worth to notice that rate cut by 25bps with change of policy bias should be more positive for the market than cut by 50 bps wit bias unchanged.

We think the MPC will cut rates by 25bps and change bias to easing, which is also the market consensus

Apart from the MPC decision, data on balance of payments for April will be released this week. However their impact on the market should be limited. We see small current account deficit of €59m, while the market consensus points to a slight surplus of €16m. We forecast export to grow by 7.4%YoY in euro terms, while imports should show a decrease in annual terms, as it rose substantially in April 2004 amid pre-accession spree.

Balance of payments statistics are due to be published on Thursday

This week the key driver for major markets will be the Thursday's FOMC decision on interest rates. A rate hike of 25bp is commonly expected and then another one in August. Moreover, the main international FX and debt markets will be affected by data on the real economy that are expected to shed more light on the strength of the European and US economy.

Abroad, the focus of attention will be the FOMC meeting

<u>Bottom line:</u> We see 25bp rate cut accompanied by a bias change as the most likely outcome of the MPC meeting. This would be more positive for the market than a cut by 50 and keeping neutral bias, although it is worth to notice that 50bp cut and change of bias to easing is already discounted by the fixed income market.

What's hot today

Central bank getting more pessimistic about economic perspectives

On Friday, MPC member Mirosław Pietrewicz expressed his concerns regarding Poland's economic perspectives. He said it was very likely that GDP growth this year would be below current government expectations and would be closer to 3% than 4%. He also expected no significant pickup in growth rate in the second quarter (2.5%), after surprisingly weak results of the first one (2.1%). Thus, according to Pietrewicz, the MPC should adjust downwards its predictions regarding future investment and consumption growth, which were overly optimistic in the past. In his opinion, there is a room for some adjustment in monetary policy, and this refers to both the policy bias and the level of interest rates. "There is no use in waiting" stated Pietrewicz, adding that delaying decision until the next GDP data appear would be a waste of time.

MPC's dove thinks "there is no use in waiting" with adjustment in both policy bias and rate level

Pietrewicz's opinion was not a surprise, as he is one of the most dove-ish members of the rate-setting panel. However, there was also one more important statement on Friday, suggesting that the entire central bank's view on economic prospects could change substantially in the near future. Deputy governor of the NBP Krzysztof Rybiński, who took part in the seminar on economic perspectives, said on Friday that GDP growth this year "could be lower, or significantly lower than 4%". Rybiński ascertained that balance of risks has moved recently towards lower GDP and lower inflation, however it was still hard to measure by how much. In his opinion, if it turns out that slowdown in economic growth and investment growth is persistent, and moderate growth in employment does not translate into consumption rise, then inflation in 2006 could be very low. He said that one of extreme, yet possible scenarios for 2006 could even be a deflation. Such statements suggest significant change in economic forecasts of the central bank. Let us remind that in the *Inflation report* released in May, the NBP staff presented updated inflation and GDP projections that had envisaged inflation picking up to the 2.5% target and GDP growth staying firm above 5% in the medium run. Rybiński's comments implied that the view of the central bank has considerably changed after the release of recent economic data. If this is true, the MPC members will have even more arguments to cut interest rates at their nearest meetings. Having this in mind please note that it is quite strange that economic predictions of the NBP has changed so dramatically after adding only one observation to the model (1Q05). Thus, one cannot in fact rule out another equally dramatic change in forecasts, back to optimistic scenario, when for example data for 2Q05 or 3Q05 show better than expected results.

NBP deputy governor suggests the central bank's assessment of economic situation has worsened

…while inflation outlook perceived by the NBP has improved

Central bank's projections are very volatile under influence of current data

***Bottom line**: The central bank's outlook for economic growth and inflation has substantially changed after recent data releases, which gives even more chances for decisive monetary easing. However, the NBP predictions seem so volatile that one cannot exclude they will turn very optimistic again after some positive figures appear in the coming months.*

Thoughts on ERM2 and euro zone entry

PO leader reiterates fast euro adoption is a good idea of Poland

Leader of the opposition Civic Platform (PO) Jan Rokita said on Friday that Poland should be ready to join the euro zone in 2009, as envisaged by the current government, assuming that policy of fiscal adjustment would be continued. In his opinion, fast adoption of the single currency would be a panacea for excessively strong appreciation of the zloty that could arise after implementation of economic reforms that would stimulate the Polish economy. He also said the PO would try to convince their potential ally PiS about benefits of this solution after the government is formed.

…although NBP deputy chief doubts whether 2009 is still a plausible entry date

Meanwhile, NBP deputy chief Krzysztof Rybiński suggested on Friday that entering the euro zone in 2009 could be impossible, because Poland could be unable to meet fiscal convergence criterion until 2007. Fiscal deficit in 2007 could be at ca. 4%, if the convergence programme would be executed in its current shape – the NBP vice-president warned. On the other hand, if Poland wants to adopt the euro since 1 January 2009, then it must enter the ERM2 not later than in April 2006, Rybiński said. He added that entering the

ERM2 could mitigate somehow a risk of excessive zloty appreciation, as the currency should be more stable in this framework.

***Bottom line*: PO still holds the priority of fast euro zone entry, positive for the financial market. However, meeting the goal of euro zone entry in 2009 would require bold decisions regarding fiscal reform at the very beginning of next government's term of office.**

Market monitor

The zloty trading ranges (24.06.2005)

	Min	Max	Fixing
USD	3.3240	3.3490	3.3396
EUR	4.0115	4.0420	4.0265

F/X rates (today's opening)

EURUSD	1.2167	CADPLN	2.6937
USDPLN	3.3157	DKKPLN	0.5416
EURPLN	4.0326	NOKPLN	0.5080
CHFPLN	2.6159	SEKPLN	0.4300
JPYPLN*	3.0343	CZKPLN	0.1349
GBPPLN	6.0558	HUFPLN*	1.6313

*per 100 units

Treasury yield curve (24.06.2005)

T-bills	Yield	Change (bp)
3M	4.80	0
6M	4.69	-1
9M	4.69	4
12M	4.55	-5
Bonds	**Yield**	**Change (bp)**
2Y	4.65	-3
3Y	4.68	-6
4Y	4.70	-10
5Y	4.74	-6
8Y	4.75	-3
10Y	4.76	-5

WIBOR rates (24.06.2005)

Term	Rates	Change (pb)
O/N	5.62	+37
T/N	5.66	+14
SW	5.44	-1
2W	5.34	-2
1M	5.30	0
3M	5.17	0
6M	4.98	-2
9M	4.90	-2
1Y	4.82	-3

On Friday, the zloty weakened in the first part of the session, but gained later during the day. The range of rate changes was not very large. In the morning EURPLN was 4.03 and USDPLN 3.3392. At close, the zloty was traded at 4.02 against the euro and at 3.3280 to the dollar. All in all, the zloty rate against a basket of both major currencies was slightly stronger at the end of the week than on Thursday's close. At the beginning of this week the zloty should fluctuate within quite a narrow range, as market participants are awaiting the MPC decision due on Wednesday.

The fixed income market continued strengthening during the last day of the previous week. While the market had not reacted negatively on the relatively strong retail sales data published on Thursday, it was positively affected by dove-ish comments of MPC member Mirosław Pietrewicz and NBP deputy governor Krzysztof Rybiński on Friday. The domestic market was also still supported by good moods on the German debt market. As a result, bond yields on the Polish market seen a record low levels across the whole yield curve. At Friday's close 2Y bonds were traded at 4.65% and yield of 5Y bonds fell to 4.74%.

At today's tender of T-bills, the Ministry of Finance will offer PLN400m worth of 52-week papers and PLN100m worth of 13-week bills. Given recent strengthening on the fixed income market, one may count on considerable fall in bill yields in comparison with the previous tender.

***Bottom line:* The Polish bond market continue strengthening on the expectations for monetary easing, with additional support from the core markets. The zloty also slightly strengthened and such tendency may continued this week.**

International update

The US Commerce Department said on Friday that new orders for durable goods leaped by a larger-than-expected 5.5% on a large gain in civilian aircraft orders. Excluding the volatile transportation category, orders for durable goods slipped unexpectedly by 0.2%. Analysts were expecting all durable goods orders to rise 1% and for orders excluding transportation to gain 0.5%.

Today, the major market will focus on publication of Ifo index for June. Economists surveyed by Reuters expect a modest rise to 93.3 from 92.9 in the previous month.

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