

Eyeopener – daily update

Market in weak sentiment, awaits CPI

14 October 2005

In an official statement published yesterday, the MPC confirmed earlier criticism regarding the next year's budget draft. This adds to uncertainties related to future fiscal policy that negatively influences the market. The bank's concerns about the 2006 budget may make some central bankers cautious about further rate cuts.

Balance of payments statistics published yesterday by the NBP showed higher than expected C/A gap in August, but the economy remains well-balanced as regards external relations. 12-month cumulative C/A deficit remained at 1.9% of GDP seen a month earlier. Stronger than predicted foreign trade turnover (both exports and imports growth slightly above 15%YoY) points to continuously well performance of export sector despite the strength of the zloty and some revival in domestic demand.

Today, the key focus of attention on the Polish financial market will be CPI inflation figures for September. September's inflation is widely expected to rise, but our forecast (1.7%YoY) is lower than market consensus (1.8%YoY) and MinFin's estimate (1.9%YoY). In our opinion, even if the data are slightly higher than expected, they will not change substantially balance of risks for future inflation.

What's hot today

CPI figures and money supply statistics due today

Today at 16:00 local time, the CSO will publish CPI data for September. We forecast inflation accelerated to 1.7%YoY (market consensus is 1.8%, while Ministry of Finance foresees even 1.9%) amid high prices of fuel and food. However, the increase is likely to be reversed already in the very next month, after the effects of excise tax cut on fuels start working in October. Moreover, we do not expect to see signals of building demand-side pressure on prices in the CPI data, and thus a moderate rise in inflation should not significantly worsen medium-term inflation outlook.

Also today the NBP will release monetary statistics for September. Money supply figures (released also on Friday) are likely to show continuing acceleration in M3 growth to 11.6%YoY in September amid improving growth in loans – mostly for households – and deposits, reflecting expanding economic activity in the second year-half. It will be important to see whether the data show any signs of improvement in demand for loans from enterprises.

Bottom line: *CPI inflation in September is widely expected to rise, but our forecast is lower than market consensus and MinFin's estimate. In our opinion the data will not change substantially balance of risks for future inflation.*

We estimate inflation rose to 1.7%YoY in September, market consensus points to 1.8%YoY

Monetary statistics to show accelerating money supply growth

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MPC criticises the 2006 budget draft

...for overly optimistic revenue targets

...and unfavourable structure and too fast rise in spending

Criticism re new debt management strategy was also repeated

Will the new cabinet be able to improve fiscal plans for 2006?

MPC sceptically on the 2006 budget

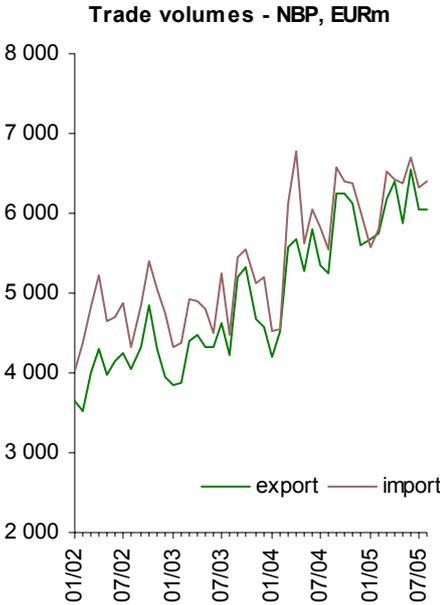
In an opinion on the 2006 budget draft, the MPC said that targets regarding the state budget deficit, public finance deficit and general government deficit according to ESA95 would be tough to achieve due to overly optimistic revenue targets, especially as regards VAT revenues (a rise in assumed tax collection ratio was negatively assessed), and underestimated spending. Even though the assumed budget expenditures seem to be underestimated, the Council thinks their growth is too high from the perspective of needed adjustment in public finance, partly as a result of costly bills adopted by the outgoing parliament earlier this year. The MPC also expressed concerns about unfavourable structure of public spending – too high share of fixed spending. Thus, the MPC called for deep fiscal reforms on the spending side (because tax burden is already much too high) so that underpin economic growth, prevent public debt from further growth and firm the country's road to the euro zone. The rate-setting panel sees basic macroeconomic assumptions to the 2006 budget draft (GDP growth at 4.3% and annual average inflation at 1.5%) as realistic. However, the Council expressed doubts regarding possible inflationary effects of the planned hike in excise tax on fuels since January 2006. As regards public debt, the Council repeated criticism expressed earlier by central bank's officials with respect to the new debt management strategy of the finance ministry (see our yesterday's report).

Generally negative opinion of the MPC about the 2006 budget draft prepared by the outgoing government casts serious doubt on the plans of the new ruling coalition assuming lowering of the next year's budget deficit, especially that there is no time for serious legislation changes this year. We think the promises seem particularly incredible given PiS ideas assuming additional spending and possibly some lowering of revenues.

Bottom line: The MPC's opinion confirmed earlier criticism regarding the next year's budget draft. This adds to uncertainties related to future fiscal policy that negatively influences the market. The bank's concerns about the 2006 budget may make some central bankers cautious about rate cuts.

Robust growth in exports and imports

According to the NBP data released yesterday, Poland's current account deficit narrowed to €380m in August from a revised €438m gap in July, but was well above market forecasts, not to mention our prediction of a surplus. However, trade data showed the economy is still well-balanced. After August, 12-month cumulative C/A deficit remained at 1.9% of GDP seen after July. The trade deficit stood at €368m in August after a revised €286m deficit in July, with both exports and imports rising by around 15%YoY. Both exports and imports growth was higher than our forecasts that pointed to 12.5%YoY and 10.4%YoY, respectively. Stronger than expected imports rise suggests that domestic demand is accelerating while still impressive exports' growth indicates that Polish firms are managing pretty well despite the local currency is appreciating. Situation of other elements of the current account in August was similar as in previous months. Income account recorded a high deficit of €664m, while services and current transfers saw surpluses of €199m and €453m, respectively. As the current account balance was worse than



expected, the figures are a bit negative for the zloty, but strong exports supports the local currency. At the same time, given strong performance of imports, suggesting recovery in domestic demand, the data are rather and argument for the MPC to hold back from another rate cuts, which is negative for the interest rate market. However, the market is more focused on today's inflation data.

Bottom line: Higher than expected C/A gap in August, but the economy remains well-balanced as regards external relations. Stronger than predicted foreign trade turnover points to some revival in domestic demand and continuously well performance of export sector despite the strength of the zloty.

Market monitor

Zloty was heavily depreciating against main currencies throughout whole Thursday as investors turned back from emerging markets, as well currencies as stocks and bonds. Yesterday investors decided to take advantage of historically strong zloty to take profits, which resulted in zloty correction. It lost 1% against euro and EURPLN soared from 3.88 opening to 3.92, to finally fluctuate above 3.91. On today's opening zloty stayed around 3.92. Yesterday zloty depreciated significantly against dollar as USDPLN increased from 3.24 to below 3.29, which was supported by deep EURUSD slump. Today's opening is lower at 3.26, as euro recovered all its Thursday losses against dollar in the overnight trade. Deep falls on the equity market also contributed to zloty weakening. Polish currency slightly depreciated also on the back of current account deficit data, which showed higher than expected deficit. Dollar appreciated against common currency and EURUSD bottomed at 1.1915, on Fed's Mark Olson statement on higher inflation risk and on the fact that US import prices increase was highest for the last 15 years, mainly as a result of higher fuel prices. These strengthened expectations of further interest rates hikes. Dollar was positively affected also by slightly better than expected US trade deficit data. Later on euro recovered and on today's opening EURUSD is at 1.202.

Fixed income market was under influence of falls in foreign debt markets, as 10Y Bund hit 2 month high and results of auction in Hungary were poor. Apart from that investors were closing positions before tomorrow's data on CPI in Poland and USA. Yields rise of 14-19bp. could be affected by stronger expectations on U.S. rates increases as investors prefer attractive Treasuries yields from more risky emerging markets bonds. Investors await today figures especially CPI to predict the level of rates raise.

Bottom line: Emerging markets currency depreciation and bonds weakening. Markets await CPI data.

International update

Yesterday data on export and import prices as well as trade balance in U.S. were published. U.S. trade deficit widened to USD59.05bn in August from revised USD57.96bn in July, which was slightly lower than market forecast at USD59.50bn and caused EURUSD drop to 1.9. Exports rose at 1.7%MoM in

The zloty trading ranges (13.10.2005)

| | Min | Max | Fixing |
|-----|--------|--------|--------|
| EUR | 3.8795 | 3.9265 | 3.9020 |
| USD | 3.2475 | 3.2870 | 3.2563 |

F/X rates (today's opening)

| | | | |
|---------|--------|---------|--------|
| EURUSD | 1.2017 | CADPLN | 2.7688 |
| USDPLN | 3.2598 | DKKPLN | 0.5222 |
| EURPLN | 3.9220 | NOKPLN | 0.4981 |
| CHFPLN | 2.5181 | SEKPLN | 0.4174 |
| JPYPLN* | 2.8425 | CZKPLN | 0.1321 |
| GBPPLN | 5.6747 | HUFPLN* | 1.5600 |

*per 100 units

Treasury yield curve (13.10.2005)

| T-bills | Yield | Change (bp) |
|---------|-------|-------------|
| 3M | 4.20 | 0 |
| 6M | 4.18 | 0 |
| 9M | 4.15 | 0 |
| 12M | 4.15 | 0 |
| Bonds | | |
| 2Y | 4.51 | 19 |
| 3Y | 4.55 | 18 |
| 4Y | 4.74 | 16 |
| 5Y | 4.89 | 17 |
| 8Y | 4.93 | 17 |
| 10Y | 4.90 | 14 |

WIBOR rates (13.10.2005)

| Term | Rates | Change (pb) |
|------|-------|-------------|
| O/N | 4.59 | -2 |
| T/N | 4.60 | -2 |
| SW | 4.60 | -1 |
| 2W | 4.60 | -1 |
| 1M | 4.60 | 0 |
| 3M | 4.53 | -1 |
| 6M | 4.45 | 0 |
| 9M | 4.42 | 0 |
| 1Y | 4.41 | -1 |

August as compared to 0.5%MoM in July and 12.1%YoY and imports respectively 1.8%MoM in August against –0.6%MoM in July and 10.9%YoY. S&P 500 and U.S. stock futures dropped as trade deficit report was released. Deficit increased to third highest level with record imports from China, which may strengthen interest rate rise expectations. Export prices in U.S. rose to 0.9%MoM in August from –0.1%MoM in July and 3.8%YoY, whereas import prices respectively to 2.3%MoM from 1.2%MoM and 9.9%YoY. Imports prices rise, which is the largest increase in almost 15 years and more than twice as expected, was mainly a result of rise in fuel prices. Number of jobless claims in USA dropped by 2000 to 389 000 in comparison to previous week.

Federal Reserve board Governor Mark Olson in his statement said that high energy costs increased higher inflation pressure, which might have strengthened dollar, as Olson was the only Fed policymaker, who voted against rates increase in September.

Yields in Hungary rose over 10bp. on two bond tenders in Hungary and forint significantly depreciated. Central bank of Slovakia intervened on the currency market to defend SKK, as investor were leaving emerging markets and crown heavily depreciated.

On Friday important data will be released such as CPI, retail sales, capacity utilization, industrial output and preliminary Michigan sentiment index as far as U.S. economy is concerned. Markets await US inflation figures to forecast further Fed moves.

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