Eyeopener – daily update

Deeper fiscal adjustment required

2 March 2006

Today at 10:00 local time GDP data for 4Q05 will be released. They should confirm estimates based on earlier, preliminary figures for the full year. However, one cannot rule out some surprises resulting from possible revisions of data for previous quarters. Meanwhile, the NBP said yesterday that from March on it will release data two hours earlier than previously, bringing forward regular publication of core inflation, balance of payments statistics and other figures to 14:00 local time from 16:00 local time. The change follows the earlier, analogous decision by the stats office.

As expected, the European Commission has criticised Poland's Convergence Programme, calling for faster and more decisive fiscal adjustment. However, imposing serious sanctions on Poland does not seem likely for some time.

Inflation forecasts are being systematically revised down. Finance Ministry hinted yesterday they predict CPI to reach 0.9%YoY in February and stay below 1% until November. On the other hand, there are signals the market may be too optimistic counting on downward revision in inflation data for January.

What's hot today

GDP data at 10:00 local time

GDP growth in 4Q05 predicted at close to 4%

Today at 10:00 local time, the Central Statistical Office will release GDP data for 4Q05. We think the figures should not differ much from estimates for the final quarter of last year that were based on preliminary GDP data for entire 2005. Therefore, we predict total GDP growth in 4Q05 amounted to 3.9% (market consensus is 4.1%), private consumption grew 3.3% (market expects 3.2% rise) and fixed investment jumped 9.8% (median of market forecasts stands at 9.9%). If actual data are broadly in line with the consensus, which is fully priced-in by the market, they should not affect the zloty or domestic bonds. However, one cannot exclude the CSO will revise data for previous quarters and thus the picture of economic growth in 4Q05 will change somewhat as compared to estimates based on preliminary figures for 2005 as a whole.

Revision of previous quarters' figures possible

Bottom line: ***GDP data for 4Q05 should confirm estimates based on earlier, preliminary figures for the full year. However, one cannot rule out some surprises resulting from possible revisions of data for previous quarters.***

Cold shower from Brussels

As expected, European Commission criticised Poland's fiscal adjustment plans

Yesterday, the European Commission called on Poland to strengthen budgetary adjustment in 2006, improve the long-term sustainability of public finances and strengthen the expenditure controls, because the updated version of the Convergence Programme prepared by the new government does not present a strategy that would enable the country to correct excessive deficit in 2007, as required by the Council, or even in 2008. Among

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others, the official statement from the EC blamed the political situation in Poland for the country's inability to introduce measures aiming at the reduction of general government deficit. Anyway, the report said Poland's policy of freezing the nominal budget deficit at PLN30bn looked insufficient to rein in public finances. As a result, the Commission said it plans further discipline steps against Poland. The Commission will send the report to EU finance ministers (Ecofin), who are to approve a final opinion on Poland's public finances and then decisions on disciplinary steps will be made. The question is what kind of sanctions may be applied. For instance, the EU may impose deficit-cutting targets. However, the Commission gave no details on the decision, even on its timing. EU Commissioner on monetary affair Joaquin Almunia said the Commission would have to issue a new policy recommendation for Poland under the excessive deficit procedure. But he hinted the Commission might recommend giving Poland more time than until the end of 2007 to lower its deficit. "It is early to anticipate if we will give a new deadline in 2008 or 2009, we will see," he said.

EC will recommend further disciplinary steps for Poland

... but may also give Poland more time to meet deficit target

Besides criticism on Poland's efforts in the field of deficit reduction, Alumunia suggested that Poland should finally set its euro zone entry deadline once a new deadline for deficit reduction is agreed. "I will ask the Polish authorities... if once they agree with the new adjustment path, they can be in a position to clearly establish a target for joining the euro zone," he said.

Poland's hopes on changing OFE classification seem futile

Moreover, while the government continuously insist on the EU side to change ruling on the classification of Polish open pension funds in order to take into account costs of the pension system reform, the Commission said that planned privileges for coalminers threatened the reform. "What amounts to a very comprehensive pension reform is being undermined by the granting of special treatment to certain groups and there is parliamentary support for expenditure initiatives that seem incompatible with the planned reduction of the deficit," the Commission said. Almunia appeared to dismiss suggestions by Polish government that Eurostat could still change the way it counts pension reform costs. "The rules are the same for everybody," he said.

***Bottom line:* As expected, updated version of Poland's Convergence Programme has been criticised by the European Commission. However, imposing serious sanctions on Poland does not seem likely for some time.**

How low is Poland's inflation?

FinMin predicts inflation below 1% until November

According to the Ministry of Finance, the headline inflation rate should hold below 1.0% until November this year (we predict it will not exceed that level in this period) before inching up to 1.5% in December (we think the year may end with inflation at 1.7%YoY). Jacek Krzyślak, director of the ministry's research department, said yesterday inflation should stand at 0.9% in February and March, up from 0.7% in January. "We believe that the lack of pressure from the wage side will help lead to low inflation," he told Reuters. He added the ministry also assumed that there would be no supply-side shocks from food and fuel prices and the strong zloty would keep constraining inflation. Krzyślak also said that a revision in consumer basket might affect inflation estimates. The market seems to expect that due to the basket's revision January's inflation will be revised downwards, which could lower a path of expected inflation within the nearest months. Meanwhile, Eurostat's data on HICP in Poland for January do not support such belief. The EU stats agency said yesterday that HICP in Poland increased to 0.9%YoY in the first month of this year from 0.8%YoY in December. Given that last year Eurostat's data were quite a good hint on a direction and scale of data revision (according to the Eurostat, HICP in Poland in January 2005 dropped to 3.7%YoY which was followed by a revision in CSO data from preliminary reading of 4.0%YoY to 3.8%YoY), one may conclude that there are little chances for downward revision of inflation in January this year. On the contrary, the Eurostat's data point to a possibility of upward revision and this would be a negative surprise for the interest rate market.

Bottom line: ***Inflation forecasts are systematically revised down, but there are signals the market may be too optimistic counting on downward revision in inflation data for January.***

Market monitor

Yesterday zloty recovered some of the Tuesday losses against the main currencies. Polish currency appreciated from 3.786 to 3.769 against the euro and from 3.171 to 3.16 versus the dollar. This came in with rise of indices on the stock exchange and higher demand for Polish bonds. Zloty was also supported by the Slovakian crown, which appreciated to the record high level against the euro. The dollar continued to fall against the single currency amid Tuesday's softer than expected data from U.S and yesterday's data on quite positive growth in manufacturing sector in the euro zone reflected by the PMI index. Thus the EURUSD rate rose from 1.193 to 1.196, though eased at the end to 1.19 after stronger than expected manufacturing ISM figure in U.S.

Polish fixed income market strengthened in reaction to MPC's decision and statement released late on Tuesday. Investors may speculate on further rate cuts as the Council's communiqué gave some hints that further monetary policy easing is not excluded. Initially bonds strengthened before the auction, which results were positive, and in effect yields fell to the lowest levels in history. Near the end of the session bonds slightly corrected in reaction to the situation on core bonds markets. U.S Treasuries trimmed early losses and marginally strengthened in reaction to fall of annual core PCE figure, which along poor yesterday data weakened expectations on faster rate hikes. However ISM figure appeared to be stronger than market forecasted which effected in the rise of U.S. 10Y yields from 4.56% to 4.58%. This affected German bonds as well and yields of 10Y Bunds rose from 3.49% to 3.51%.

At yesterday's auction Ministry of Finance sold PLN1.8bn of 2Y OK0408 bonds at record low average yields of 3.975% as compared to 4.343% at the previous tender, while demand amounted to PLN5.72bn. At the supplementary tender Poland placed additional PLN360m of 2Y bonds and the demand amounted to PLN786m.

Today the market will focus on the Q4 GDP data, which if in line with forecasts, should be neutral for expectations regarding future rate cuts. Also, the ECB's decision on interest rates (25bps rate hike expected) could be important for market sentiment.

The zloty trading ranges (1.03.2006)

	Min	Max	Fixing
EUR	3.7680	3.7850	3.7756
USD	3.1530	3.1730	3.1627

F/X rates (today's opening)

EURUSD	1.1931	**CADPLN**	2.7390
USDPLN	3.1612	**DKKPLN**	0.5043
EURPLN	3.7720	**NOKPLN**	0.4627
CHFPLN	2.4163	**SEKPLN**	0.4041
JPYPLN*	2.6874	**CZKPLN**	0.1317
GBPPLN	5.4818	**HUFPLN***	1.4962

*per 100 units

WIBOR rates (1.03.2006)

Term	Rates	Change (bp)
O/N	4.15	-14
T/N	4.15	-15
SW	4.14	-13
2W	4.14	-11
1M	4.14	-8
3M	4.08	-8
6M	4.06	-5
9M	4.05	-5
1Y	4.04	-6

Forward Rate Agreements (1.03.2006)

Term	Mid	Change (bp)
1x2	4.01	-9
3x6	3.91	-2
6x9	3.90	-2
9x12	3.91	-2
3x9	3.91	-3
6x12	3.92	-2

T-bond auction (01.03.2006)

	Offer	Bid	Sale	Average
		PLN m		Yield
2Y*	2 160	6 508	2 160	3.975

*** with a supplementary auction**

Polish Treasuries (1.03.2006)

Term	Yield	Change (bp)
2Y	3.97	-3
3Y	4.15	-2
4Y	4.28	-1
5Y	4.34	-2
8Y	4.5	-5
10Y	4.54	-4

***Bottom line*: Zloty recovered Tuesday's losses against the euro, while bonds continued to strengthen after the MPC's statement and slightly dovish communiqué as well as amid positive auction results.**

International update

In February PMI manufacturing index rose in to 54.5 pts the highest level for 19 months and was stronger than analysts' forecast of 54 pts, which shows improved outlook of manufacturing sector in the EMU. However the employment index still remained below 50 pts and amounted to at 49.7 pts as compared with 49.6 pts, which means jobs were cut for the 57th month in a row excluding December 2005. According to Eurostat, February HICP inflation in the euro zone fell from 2.4%YoY in January to 2.3%YoY. In January unemployment rate in the euro zone amounted to 8.3%, which was in line with market consensus and was unchanged from the revised December level.

In U.S. core PCE price index rose in January as expected by 0.2%MoM as compared to 0.1%MoM in the previous month and dropped in annual terms from 1.9% to 1.8%. ISM manufacturing index reflecting national factory activity soared from 54.8 pts in January to 56.7 pts, whereas analysts expected much lower figure at 55.6 pts. The prices paid component fell from 65.0 pts in January to 62.5 pts, while new orders index soared from 58.0 to 61.9 pts. Employment component rose from 51.3 pts to 55.0 pts.

At today's meeting the European Central Bank will make a decision on the level of interest rates in the euro zone. Market expects the main interest rate will rise by 25 bps to 2.5%.

TIME GMT	REGION	INDICATOR	PERIOD		MARKET	LAST VALUE
10:00	EMU	Revised GDP	Q4	%	1.7	-
12:45	EMU	ECB meeting – decision	Mar	%	2.5	2.25

Source: Reuters

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