

Eyeopener – daily update

Data positive for bonds

17 July 2006

Friday's data on CPI delivered support for the Polish debt market. The headline inflation rate in June was lower than expected, falling to 0.8%YoY from 0.9%YoY in May. This confirmed opinion of MPC's Andrzej Wojtyna that talking about rate hikes in Poland is premature. At the same time, the economy is still strongly expanding, which was confirmed by better than predicted budget performance in 1H06 and further revival in credit market visible in monetary statistics for June.

This week will be full of macroeconomic data releases in Poland and abroad that could have significant impact on expectations regarding future decisions of the central banks. As regards domestic data, in our view they should go in line with Friday's CPI figure, showing growth rates slightly below market consensus, which will be supportive for domestic bonds. At the same time, they will be still consistent with predicted continuation of strong economic growth in the remaining part of the year. Top of the busy agenda abroad will be Bernanke's semi annual testimony to the Senate Banking Committee and release of minutes of Fed June meeting. Also, inflation measures and news from housing market will be key for investors' expectations. We expect to see signals that would confirm predictions that interest rate hikes in the US will be paused.

New finance minister Stanisław Kluza said in an interview with *Rzeczpospolita* daily that he is not going to modify anything in proposals of former finance minister Zyta Gilowska and continue her work on changes in tax system. Kluza said he would present his own ideas when the parliament would finally make a decision on changes proposed by Gilowska. Besides, he reiterated his view the finance ministry should not be active on the FX market at all.

This week will be very busy in terms of data releases and other events important for the markets

Data on average wage and employment due today

Output and PPI figures on Wednesday

What's hot this week

This week, both in Poland and abroad, will be full of economic data releases and other events that could have significant impact on expectations regarding future decisions of the central banks. As regards domestic data, in our view they should go in line with Friday's CPI figure, showing growth rates slightly below market consensus, which will be supportive for domestic bonds. At the same time, they will be still consistent with predicted continuation of strong economic growth in the remaining part of the year.

Labour market data due today at 14:00 local time, which are important for the MPC, are likely to show continuously strong rise in employment (we forecast 3.0%YoY rise against market consensus pointing to 3.1%YoY growth) and not so bad growth in wages (we predict 4.5%YoY increase which is consistent with median of market forecasts), which would support expectations for further rise in consumption, but not evoke fears of swift rate hike.

On Wednesday, the CSO will release output and PPI figures. According to our forecast (8.2%YoY rise), June's growth in industrial output was weaker than in May (19.1%YoY) due to lower number of working days. Our forecast suggests it was also below market consensus (10.3%YoY), so the release could be supportive for the bond market. PPI data (we expect 2.2%YoY increase in producer prices while market consensus is 2.3%) will probably

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The key focus of attention abroad will be speeches by Ben Bernanke and a release of minutes of Fed meeting in June

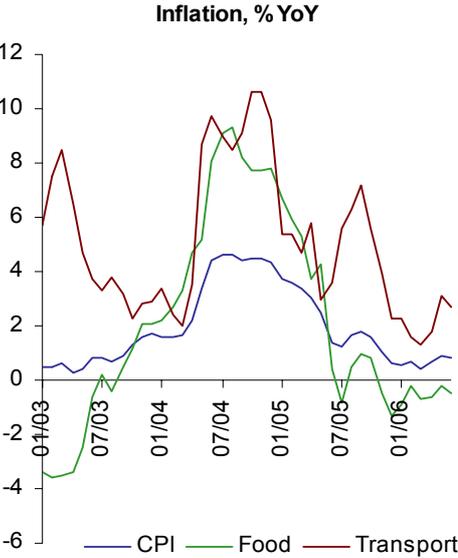
have less importance for the market, as the data are expected to confirm there is no demand-side pressure on prices.

Top of the busy agenda abroad will be speeches by Ben Bernanke and the release of minutes of FOMC June meeting. On Wednesday, Bernanke delivers his semi annual testimony to the Senate Banking Committee and the minutes will be published on Thursday. Also, inflation measures and news from housing market will be key for investors' expectations. We expect to see signals that would confirm predictions that interest rate hikes in the US will be paused. It will be relatively quite week in the euro zone, but the German ZEW (due on Tuesday) will provide the first look at sentiment in the bloc's largest economy in July.

***Bottom line:* This is an important week for the Polish market with a few crucial data releases. This is also key week for US interest rate markets and the EURUSD rate with a number of top tier data and Fed events scheduled abroad.**

What's hot today

CPI inflation still very low



CPI inflation figure was positive for the Polish fixed income market, as it was below forecasts. While the most optimistic was the estimation of the Ministry of Finance (0.9%YoY), which was below market consensus of 1.0%, the price growth was even lower and amounted to only 0.8%YoY after a monthly drop in prices by 0.3%MoM. As usual in summer months, food prices contributed to this fall as they were lower by 1.1% than in May. Also, fuel prices saw a decrease by 0.3%MoM. At the same time, other elements of consumer basket did not show price growth and according to our estimation net inflation (CPI excluding food and fuel prices) remained stable at the very low level of 1%YoY. This shows that underlying price pressure in the economy remains benign. Therefore, in our opinion, Friday's CPI data confirmed the view presented recently by MPC's Wojtyna that talking about interest rate hikes in Poland is premature. MPC members from the so-called dove-ish faction also took the floor last week, saying roughly the same thing. Jan Czekaj said on Friday there are no risk that CPI inflation exceeds the target (of 2.5%) in the horizon of monetary policy transmission and the target should be achieved only at the end of 2007. Stanisław Nieckarz saw no reason to change interest rates until the end of 2007.

We expect CPI inflation to remain below 1% in the next couple of months, while at the very end of the year it may rise to ca. 1.5%. At the same time we expect net inflation to remain stable at ca. 1% and in such circumstances it is indeed difficult to imagine interest rate hike in Poland. What is more, even if we assume the risk-case scenario, in which food prices rise much faster (monthly average by 1% in September-December after very moderate falls in July-August by 0.5%) and fuel prices continue sharp increase (although lower USDPLN rate should be a stabilising factor), CPI inflation would be only moderately above 2% and let's remind that the NBP target is 2.5%.

Bottom line: Yesterday’s CPI data, which showed no demand-side pressure on prices, confirmed the view presented recently by MPC’s Wojtyna that talking about interest rate hikes in Poland is premature.

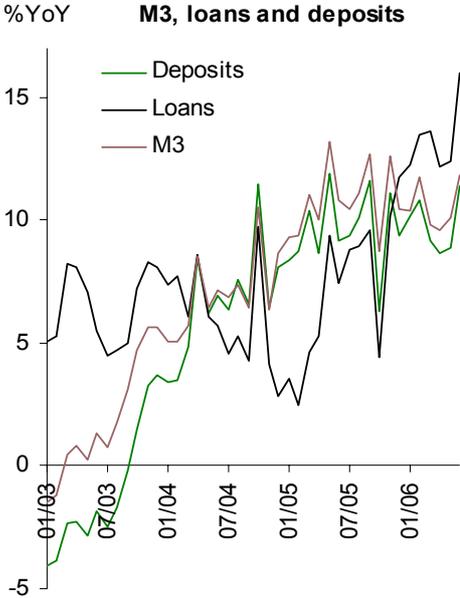
Upbeat budget data

According to official data from the Ministry of Finance, budget deficit amounted to 57.8% of the full-year plan after the first half of the year. The result is slightly better than tentative estimates at 59-60%. Revenues reached 47.3% and spending 48.7% of the full-year plan. NBP profit for 2005 (an amount of above PLN1bn) will be transferred to the budget only in July and thus low budget gap was not a result of one-off payment. Excluding this effect (as NBP profit of above PLN4bn was transferred last year), the annual rise in total revenues amounted to 12.2%YoY in the first half of the year and 11% in June alone as compared to the planned 8.6% growth in the whole 2006. As regards indirect taxes inflow, which is the most important contributor of revenues, the annual growth amounted to 9.8%YoY in H1 as a whole and 7.6% in June alone, which was below the plan of 10.6%. However, other items offset this, namely personal income tax (16.8% increase in H1 against planned 6.9% growth), higher dividends, and higher revenue of budgetary units. As regards spending side, according to deputy finance minister Elżbieta Suchocka-Roguska some delay in expenditures was recorded and we should expect them to be higher in following months.

Budget gap lower than expected again

No threats to execution of this year’s budget

Bottom line: Lower than planned budget deficit in the first half of this year. No impact on the market, as the focus of attention now is the 2007 budget and medium-term fiscal perspectives.



Higher credit activity, acceleration in money growth

Broad money M3 rose by 11.8%YoY in June, which was slightly above our forecast of 11.7%, not to mention market consensus of 11.3%. Credit market rose by as much as 16%YoY (12.4% in May) driven mostly by higher households’ credits expansion (28.8%YoY growth as compared to 20.5% rise in the previous month). Actually, households’ credit market has been rising by PLN5bn each month since March 2006, which to a large extent was connected with high mortgages’ growth. In recent months, activity on this market was reinforced by the new central bank regulation introducing restrictions as regards access to FX mortgages. The new law was expected to come into effect since the beginning of July and many people applied for credits in 1H06. Businesses’ credits also accelerated in June to 5.1%YoY from 4.3% in the previous month and we think this gradual process will be continued. Also, deposit market increased quite substantially in June for both firms and households by close to PLN5bn (5.6%YoY) and by almost PLN1bn (21.7%YoY), respectively.

Bottom line: Data confirm high economic activity, although credits acceleration was probably driven to a large extent by households’ mortgages.

Market monitor

The zloty gained on Friday versus both the euro and the dollar. The EURPLN rate fell from 4.048 at the opening to 4.027 at the session's close. The USDPLN fell from 3.198 to 3.187. Polish currency was supported by the slightly improved sentiment towards the emerging.

Despite the weaker than expected US economic data released on Friday the dollar slightly appreciated against the single currency from 1.266 in the morning to 1.263 at the closing of the Polish session. The greenback's strengthening was partly a result of conflicts in the Middle East and Japan – North Korean tensions as US currency is still considered as a safe haven asset.

CPI figure that was below market consensus strengthened Polish fixed income market and bonds' yields fell by 8-10 bp as compared to Thursday's closing. The market was also supported by the MPC member comments Stanisław Nieckarz that there was no reason for a rate change at least till the end of next year. Core markets strengthening on softer than expected US retail sales and Michigan index contributed to improved sentiment toward the emerging markets due to falling expectations of further monetary policy tightening in US and to the drop of yields on the Polish market as well. 10Y Treasuries yields marginally declined from 5.08% at Thursday closing, to 5.07% (and to 5.05% today in the morning), while yields of 10Y bunds decreased from 4.02% to 3.98%. Bunds were also supported by the ECB's Jose Manuel Gonzalez-Paramo comments that raised doubts on the August rate hike.

Bottom line: Zloty appreciated against the main currencies. Bond's yields fell by several basis points on lower than expected CPI inflation, dovish comments from the MPC and core markets strengthening on the US data release. Today investors will focus on labour market data and quite significant data abroad.

International update

US retail sales in June fell by 0.1%MoM, which was much below market expectations of 0.4%MoM rise as compared to 0.1%MoM rise in the previous month.

Michigan consumer sentiment index fell in July to 83 from 84.9 in June. The current conditions index declined to 100.8 from 105.0, while the consumer expectations number decreased to 71.6 from 72.0.

Today several important data are going to be released abroad.

| TIME GMT | REGION | INDICATOR | PERIOD | | MARKET | LAST VALUE |
|----------|--------|---------------------------|--------|------|--------|------------|
| 9:00 | EMU | Final HICP (H) | May | %YoY | 2.5 | 2.5 |
| 13:15 | US | Capacity utilisation (H) | Jun | % | 81.9 | 81.7 |
| 13:15 | US | Industrial production (H) | Jun | %MoM | 0.4 | -0.1 |

Source: Reuters

The zloty trading ranges (14.07.2006)

| | Min | Max | Open* | Close** | Fixing |
|-----|--------|--------|--------|---------|--------|
| EUR | 4.0240 | 4.0481 | 4.0481 | 4.0270 | 4.0390 |
| USD | 3.1802 | 3.2000 | 3.1980 | 3.1870 | 3.1861 |

* 6:30 GMT. ** 15:00 GMT

The EUR/USD trading range (14.07.2006)

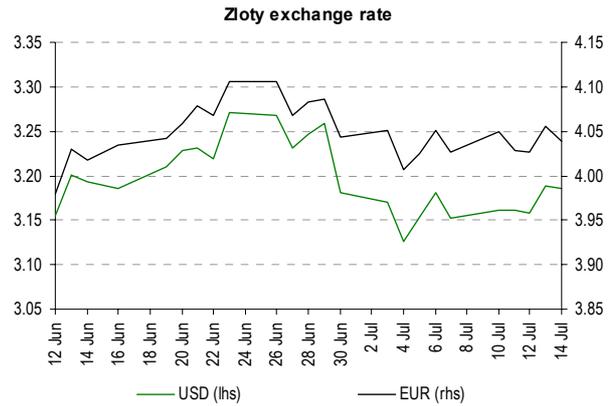
| | Min | Max | Open* | Close** |
|---------|--------|--------|--------|---------|
| EUR/USD | 1.1632 | 1.1685 | 1.2656 | 1.2632 |

* 6:30 GMT. ** 15:00 GMT

F/X rates (today's opening)

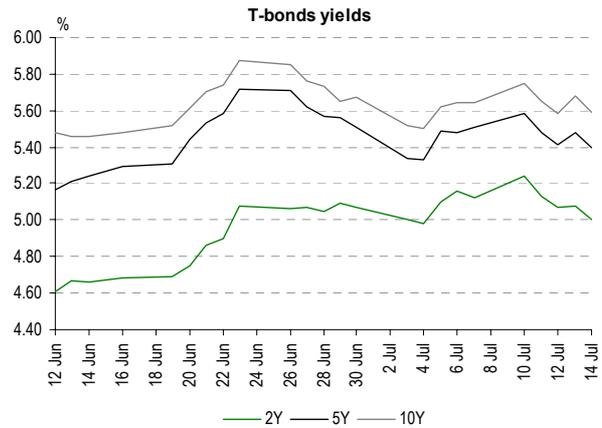
| | | | |
|---------|--------|--------|--------|
| EURUSD | 1.2632 | CADPLN | 2.8320 |
| USDPLN | 3.1962 | DKKPLN | 0.5414 |
| EURPLN | 4.0370 | NOKPLN | 0.5114 |
| CHFPLN | 2.5899 | SEKPLN | 0.4380 |
| JPYPLN* | 2.7465 | CZKPLN | 0.1418 |
| GBPPLN | 1.2632 | CADPLN | 2.8320 |

*per 100 units



Fixed income markets (14.07.2006)

| Term | PL | | US | | DE | |
|------|-------|-------------|-------|-------------|-------|-------------|
| | Yield | Change (bp) | Yield | Change (bp) | Yield | Change (bp) |
| 2Y | 5.00 | -8 | 5.10 | -2 | 3.52 | -4 |
| 3Y | 5.18 | -10 | 5.06 | -1 | 3.65 | -5 |
| 4Y | 5.33 | -9 | | | 3.69 | -6 |
| 5Y | 5.40 | -8 | 5.03 | 0 | 3.74 | -7 |
| 8Y | 5.48 | -8 | | | 3.91 | -7 |
| 10Y | 5.59 | -9 | 5.07 | 0 | 3.98 | -6 |



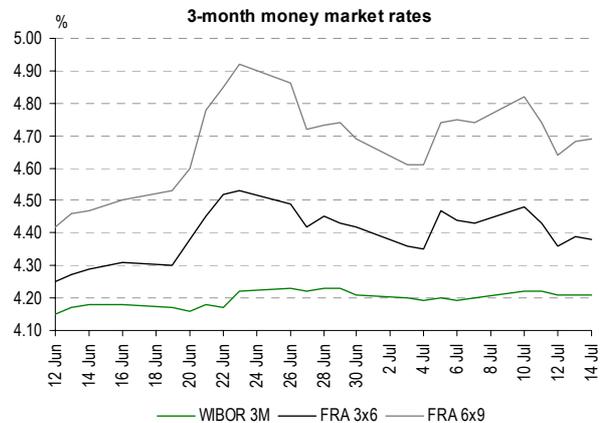
T-bond auction

| Date | Offer | Bid | Sale | Avg. Yield | Prev. Avg. Yield | Change | |
|-------|-------|-------|-------|------------|------------------|--------|----|
| | | PLN m | | % | % | bp | |
| 06.07 | 2Y | 1 800 | 4 089 | 1 800 | 5.025 | 4.517 | 51 |
| 21.06 | 5Y | 2 000 | 3 530 | 2 000 | 5.525 | 5.031 | 49 |
| 12.07 | 10Y | 800 | 4 905 | 800 | 5.595 | 4.978 | 62 |

* with a supplementary auction

WIBOR rates (14.07.2006)

| Term | Rates | Change (bp) |
|------|-------|-------------|
| O/N | 4.10 | 4 |
| T/N | 4.10 | 0 |
| SW | 4.11 | 1 |
| 2W | 4.11 | 0 |
| 1M | 4.12 | 0 |
| 3M | 4.21 | 0 |
| 6M | 4.35 | 0 |
| 9M | 4.51 | 1 |
| 1Y | 4.65 | 0 |



Forward Rate Agreements (14.07.2006)

| Term | Mid | Change (bp) |
|------|------|-------------|
| 1x2 | 4.16 | 4 |
| 3x6 | 4.35 | -1 |
| 6x9 | 4.66 | 1 |
| 9x12 | 4.95 | -1 |
| 3x9 | 4.53 | 0 |
| 6x12 | 4.84 | 0 |

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