

# Weekly economic update

18 July – 24 July 2005

Publication of CPI inflation for June was the most important event in the previous week. Thanks to very deep monthly fall in food prices (1.2% which resulted in a reduction in annual growth rate of food prices to 0.4% from 4.3% in May) the annual inflation rate fell to 1.4% from 2.5%. Low inflation gave some hope for the market that recent weakening of the zloty may be stopped amid capital inflow on the fixed income market. This is particularly important ahead of Wednesday's five-year bonds auction, after unsuccessful tender of ten-year papers last week. In the upcoming week data on core inflation will be published. According to our estimation, net inflation (CPI excluding food and fuel prices), inched down to 1.4% from 1.5% in May, but lower CPI inflation rate will be probably one of arguments for MPC members to cut rates again. Especially, as for the first time since October 2003 the inflation rate fell below the tolerance band of inflation target (2.5% +/- 1pp). However, as the central bankers admitted, the decision will depend more on data about economic activity rather than on current inflation figure (which was in line with average forecast). Data from the labour market released on Friday showed continuation of improvement with wage bill rising by 4.8%YoY in real terms. This week the most important will be the publication of industrial production figure. It seems that only very strong output growth could stop the MPC from cutting interest rates (possibly by 50bps) in July.

## Economic calendar

Time GMT	COUNTRY	INDICATOR (importance level*)	PERIOD	FORECAST		LAST VALUE	
				MARKET	BZWBK		
<b>MONDAY (18 July)</b>							
09:00	POL	Auction for 52-weeks and 13-weeks treasury bills – PLN400m and PLN100m (M)					
09:00	EMU	Final HICP (H)	Jun	%YoY	2.1	-	1.9
13:00	USA	Net capital flow (H)	May	\$bn	-	-	47.4
<b>TUESDAY (19 July)</b>							
09:00	GER	ZEW index (H)	Jun	-	22.0	-	19.5
09:00	EMU	Industrial production (M)	May	%MoM	-0.3	-	0.6
14:00	POL	Industrial production (H)	Jun	%YoY	4.8	7.8	0.9
14:00	POL	PPI (H)	Jun	%YoY	-0.1	-0.1	-0.5
<b>WEDNESDAY (20 July)</b>							
09:00	POL	Auction for 5y bonds (PS0310) – PLN2-3bn (H)					
09:00	EMU	Trade balance (M)	May	\$bn	-	-	1.3
15:00	USA	Greenspan testifies to Congress (H)					
<b>THURSDAY (21 July)</b>							
08:00	EMU	C/A (M)	May	\$bn	-	-	-11.6
14:00	USA	Leading indicators (M)	Jun	-	0.3	-	-0.5
18:00	USA	FOMC Minutes (H)					
<b>FRIDAY (22 July)</b>							
09:00	EMU	Industrial orders (M)	May	%MoM	-	-	1.5
14:00	POL	Business climate (M)	Jul	-	-	-	-
14:00	POL	Core inflation (H)	Jun	%YoY	1.4	1.4	1.5

\* Importance level: (H)igh, (M)oderate; Source: Reuters, BZ WBK, Parkiet

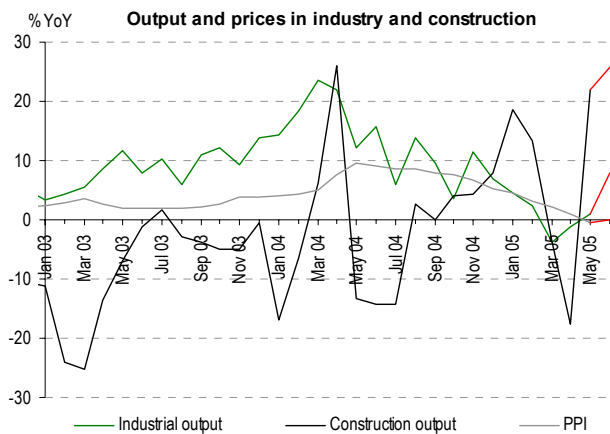
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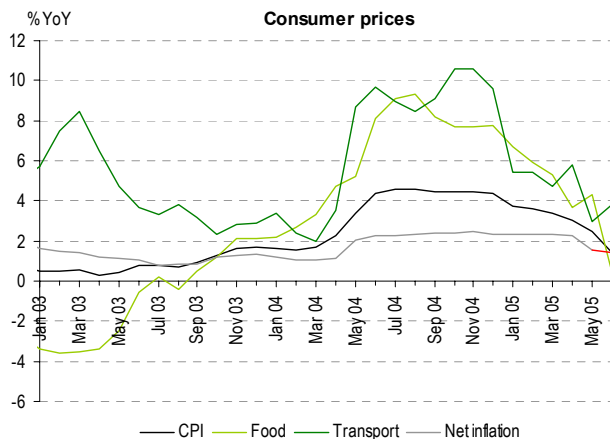
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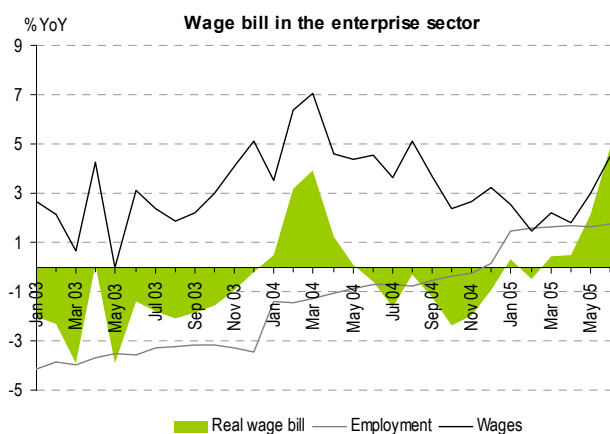
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**What's hot this week** – What was the economic situation at the end of 2Q05?

- June's data on industrial production will be one of the most important from the point of view of monetary policy and thus will be crucial for the financial market.
- After disappointing figure for May, some revival is commonly expected, but its scale will be the key.
- While market consensus points to growth of around 5%, we believe output might grow faster, which was partly influenced by higher number of working days.
- Growth of ca. 8% would show that the Polish economy got out of slowdown relatively quickly. On the other hand, another disappointment would leave no doubt that the MPC would deliver interest rates cut already this month.
- We also expect that construction output growth reached above 20% growth in June for the second consecutive month. Also, CSO business climate data should be quite positive.

**Economy last week** – Inflation is falling, labour market conditions are improving

- Deep fall in food prices lowered consumer price index. Fuel prices showed a moderate growth of 0.8%. Prices of other goods and services included displayed very stable prices, showing no signs of demand pressure in economy.
- The deeper was the fall in food prices, the bigger might be also deflation in July. Thus, another significant drop in CPI, possibly even to (below) 1%YoY, is well possible.
- In the second half of the year inflation rate should fluctuate around this level. This creates quite favourable conditions to deliver more easing in monetary policy.
- MPC's Sławiński said recently that one should not concentrate on CPI inflation, but on net inflation.
- June's data on core inflation (and PPI) will be released in the coming week. Net inflation fell only slightly as large adjustment (from 2.3% to 1.5%) took place in May. 12M PPI inflation should remain below zero despite rising fuel prices.



- Labour market data from the enterprise sector showed a considerable improvement.
- Corporate wages rose by 4.5%YoY, which was much higher than forecasts (market 2.8%, BZ WBK 3.3%) and the highest since one year. It is not known whether this was a one-off.
- At the same time employment continued to rise (0.3% MoM and 1.7% YoY). In the first half of the year enterprises created 90 thousands of new jobs (in 2004 almost no new jobs were created).
- As a result of falling inflation, wage bill in real terms rose by as much as 4.8%YoY, the fastest growth for years.
- Budget realisation after June (52.9% of plan) was worse than expected, but not as bad as it seems at first glance, especially if we take into account revenues from indirect taxes, which did show signs of lower economic activity.

**Quote of the week** – MPC ready to cut rate by 50 bps this month

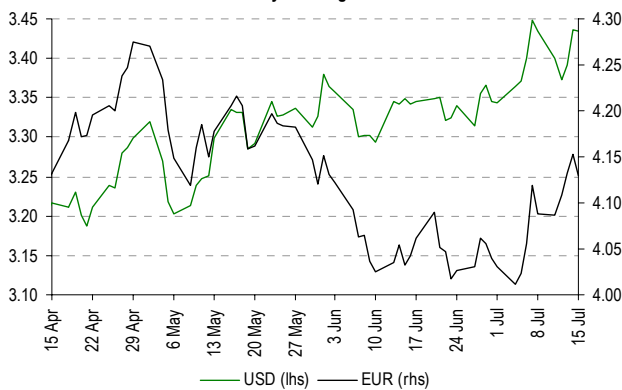
**Marian Noga, MPC member; PAP, 13 July**

*The room left for further interest rate cuts is 75 basis points. It seems that nothing will stop the MPC from cutting rates of this scale until the year-end. If industrial output growth in June reached 3-5%, the MPC should cut rates by 50 bps in July. It is better for the MPC to be pre-emptive rather than to be late with decisions.*

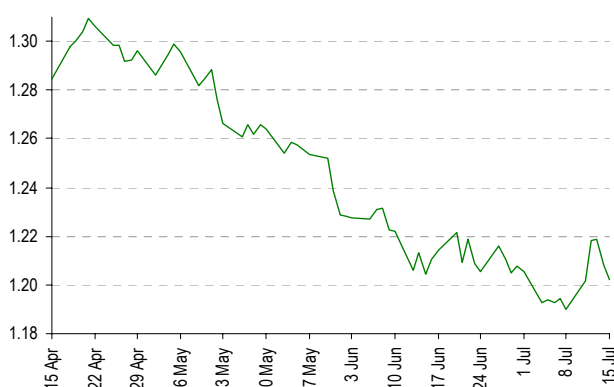
Among numerous MPC members' statements we have chosen the one, which present a link between production data and rate decision in the most direct way. Unfortunately prof. Noga did not suggest whether an output growth in 7-9% range would be enough to postpone cut at all, or should it justify smaller 25 bps adjustment. In the Reuters interview he added that rate cut of additional 25 bps would be possible after election and that this would not be the end of cycle.

## Market monitor

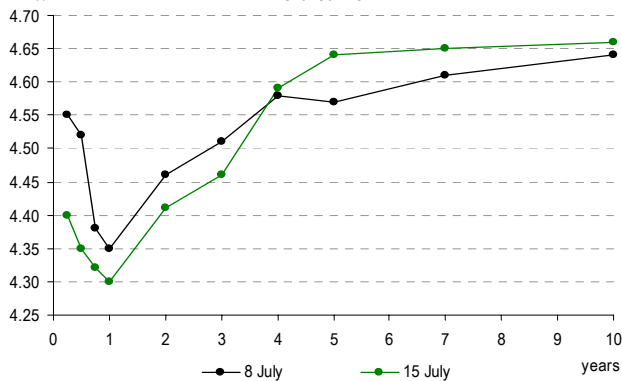
Zloty exchange rate



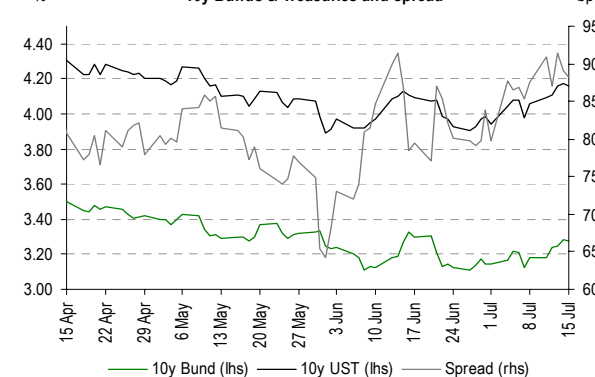
EURUSD rate



Yield curve



10y Bunds &amp; Treasuries and spread



## What will mean the production to the zloty?

▪ Last week the zloty recorded a decline due to high C/A deficit and low demand at bond auction. Good inflation number, through positive impact on debt papers market, managed to stop a downward tendency of the Polish currency. Owing to the euro gains to the dollar, the zloty weakened during a week mainly against the euro (1.2%), retaining its value to the dollar.

▪ Next week the zloty performance will depend on production data, which will determine also the outcome of 5y papers auction. If the data proves to be in line with our forecasts may bring about a further deterioration in the Polish market, however its scale should not be a major one. We expect the zloty to fluctuate within a range of 4.1-4.2 to the euro and 3.36-3.46 against the dollar.

## US central bank: testimony and report

▪ The euro last week experienced an increase as a result of weaker than expected data from US labour market. Trade deficit lower than market consensus and favourable budget projections in US supported the dollar. But following the release of stable inflation in US the euro gained again. A week ended above 1.2. During a week the euro advanced by 1%

▪ Next week may turn out to be very volatile in the EURUSD market. First net capital flow will show if even lower US trade deficit gets financing abroad. In the second part of the week Alan Greenspan's testimony and a report from the latest FOMC meeting will give hints regarding monetary policy. Nevertheless despite high volatility we do not expect breaching outside the range of 1.20-1.22.

## The market eyes production numbers

▪ At the outset of the week bonds declined owing to weakening zloty and yield rise in core markets. Later the driving force in the market became results of unsuccessful auction, which pushed 5y benchmark to 4.75%. Low CPI inflation reversed a situation and PS0310 gained to 4.6%. FRA curve also moved downwards pricing in cumulative reduction by 100 bp till the year-end.

▪ Next week will be crucial for the Polish interest rate market owing to industrial output data, which if they do not reach a level, forecasted by us, may bring about a fall in yields in the 5y sector below the level of 4.5%. It seems that likewise previous auctions Ministry of Finance will offer relatively low supply number.

## Yields abroad are likely to retain current levels

▪ Bonds in the core markets recorded a fall due to hawkish comments from ECB representatives, diminishing hopes for rates cuts in the euro zone and decline in oil prices, affecting positively economic growth in US. 10y papers in US and Germany hit respectively 4.18% and 3.29%. 5/5y spread between the euro and the Polish curve was reduced to 53 bp in reaction to the Polish inflation data in June.

▪ After a series of economic data in US recently it seems that yields reached their equilibrium level, that however may be tested by the Fed report. In the euro zone in turn where German index ZEW and EMU inflation will be published, may bring about a further yield rise.

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