Bank Zachodni WBK

Weekly economic update

5 September – 11 September 2005

The MPC cut the reference rate by 25 bp to 4.5% and maintained easing bias in monetary policy at its meeting last week. One of the reasons for such decision was the new projection of GDP and inflation prepared by NBP staff. As we expected, as compared to previous NBP estimates, GDP projection was much lower for 2005-07 and CPI projection was roughly the same for 2007, but lower for 2005-06. Despite the fact that the statement mentioned two important risks for inflation (fiscal policy, oil prices), the view of the Council was that "the probability of inflation running below the inflation target is higher than presented in the August inflation projection". This represents quite doveish view, leaving room for further rates reductions. The assessment of the economic situation presented in the new *Inflation report* confirmed the view reflected in recent MPC decisions. The report showed also voting results of the MPC in 2Q05. Quite unexpectedly, Stanisław Nieckarz, perceived by the market as an ultra-dove joined the hawkish camp in May in rejecting motion to change bias into easing (after it was changed to neutral in April). Then, the MPC decision in June (easing bias together with 50 bp rate cut) was large surprise for the market. All in all, we maintain our opinion that NBP official rate may fall by further 50 bp in six-months period. Although we do not expect cuts in the election period (September-October) and possibly August's reduction will be the last move this year, this will depend on upcoming economic data, election results and situation on the foreign exchange market after election. So far, the zloty performs much better than predicted. Contrary to our expectations, political uncertainty ahead of elections was offset by factors positive for the domestic currency (such as inflow of capital on the fixed income market after doveish message from the MPC, inflow of funds on the equity market and results of public opinion polls that were favourable from financial market's point of view). As a result, the zloty exchange rate broke the lower end of the ranges indicated by us as barriers for its fluctuations last week.

Economic calendar

Time GMT	COUNTRY	INDICATOR (importance level*)	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (5 September)					
09:00	**POL**	**Auction of T-bills 52-week of PLN400m and 13-week of PLN200m (M)**					
	US	Labor Day Holiday					
09:00	EMU	Retail sales	Aug	%MoM	-0.3	-	0.4
		TUESDAY (6 September)					
14:00	US	ISM non-manufacturing	Jul	%MoM	59.5	-	60.5
		WEDNESDAY (7 September)					
09:00	**POL**	**Auction of 2-year bonds PLN 2.0-2.5bn (H)**					
12:30	US	Unit labour costs	II kw.	%	1.3	-	1.3
18:00	US	Fed issues Beige Book					
		THURSDAY (8 September)					
-	UK	BoE meeting – decision on interest rates (H)		%	4.5	4.5	4.5
14:00	US	Wholesale inventories (H)	Jul	%	0.5	-	0.7

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

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What's hot this week – No data releases, final stage of work on the 2006 budget starts

Main budgetary parameters

	2005 P	**2006 F**
Revenues (PLNbn)	176.25	184-189
Expenditures (PLNbn)	209.7	216-222
Budget deficit (PLNbn)	33.45	28-34*
Budget deficit (% of GDP)	3.4	2.8-3.4

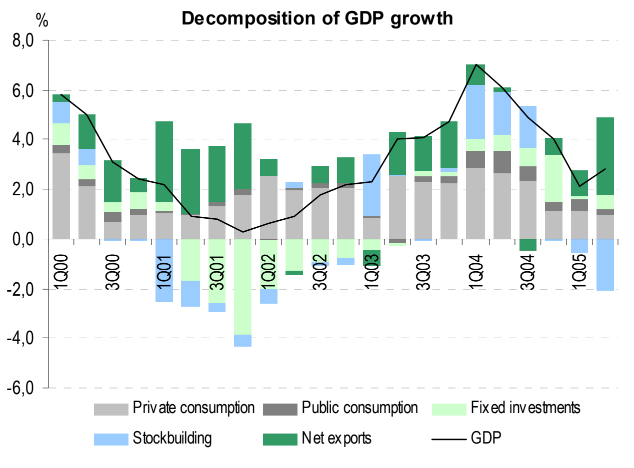
Note: P – planned, F – forecast; * according to news that appeared in the media finance minister Mirosław Gronicki narrowed the range of planned budget deficit for 2006 to PLN30-33bn from PLN28-34bn and spending limit was set at PLN221bn.

- During the nearest week, as usual at the beginning of a month, there will be no publication of important macroeconomic data.
- However, it is possible that we will see more detailed information on the next year's budget. Some time ago finance minister Mirosław Gronicki announced that the 2006 budget draft will be presented in details on September 10. Well, this date does not seem to be valid anymore.
- Meanwhile, it is known that the 2006 budget draft will be discussed this week (on Tuesday) at the government's meeting. Then, it will be sent for consultations with social partners.
- Apart from possible news about the final shape of the next year's budget, an important event for the fixed income market, and possibly also indirectly for the FX market, will be Wednesday's auction of 2Y bonds.

Economy last week – Doveish message from the MPC

Crucial fragments of the MPC statement from 31 August 2005
According to the August inflation projection, the price growth should be lower than expected in the May Report. Assuming unchanged interest rates, there is a 50-percent probability that inflation will stay within the range of 0.9%-1.5% in 2005 Q4 (compared with 1.1%-2.2% in the May Report), 1.0%-3.1% in 2006 Q4 (compared with 1.2%-3.8%) and 1.2%-4.1% in 2007 Q4 (compared with 0.7%-4.3%).
Still, it has to be emphasised that the inflation projection presented in the Report does not account for all sources of uncertainty, such as the unknown economic policy of the government in the coming years and the effects of worsened outlook for public finance in connection to the bills. passed by the Parliament largely impeding the necessary reduction of the public finance deficit and of the pace of public debt growth in the subsequent years. Moreover, the projection does not allow for the latest information which might have a significant bearing on the forecasted price growth (oil prices).
In the Council's assessment, in the monetary policy transmission horizon the probability of inflation running below the inflation target is higher than presented in the August inflation projection, among others, due to possible acceleration in the structural changes ongoing in the Polish economy.

- MPC decision to cut interest rates by another 25bp and maintain easing bias in monetary policy were in line with our expectations and market consensus.
- The fragments of the MPC statement after the meeting, presented in the table, show that the majority of MPC members perceive the medium-term inflation positively even though there are rate-setters who point out factors of serious inflationary risk.
- Given the dominant views within the Council, we maintain our view that official interest rates may be lowered by another 50bp in six-months period.
- One of the reason for that are worse prospects for economic growth. The new GDP projection was significantly lowered in comparison with the previous one. In this context, it seems that GDP data for 3Q05 will be crucial for next moves in monetary policy parameters.



- One of arguments for rate cut in August were probably GDP figures for 2Q05. Although GDP growth in that period reached 2.8% and was in line with our expectations and slightly above market consensus, the breakdown of the growth was less favourable than expected.
- While consumption growth exactly matched our estimates (it reached 1.5%YoY) and acceleration in fixed investment growth did not differ considerably from our forecasts (reaching 3.8% versus 5% predicted by us), domestic demand contracted by 0.3%YoY (against 1.1%YoY in 1Q05), as stock building was much lower year ago, lowering GDP growth rate by as much as 2.1pp in 2Q05.
- Luckily, net export positively contributed to GDP growth to an even larger than expected degree. Its positive contribution to GDP growth in 2Q05 amounted to as much as 3.1pp.

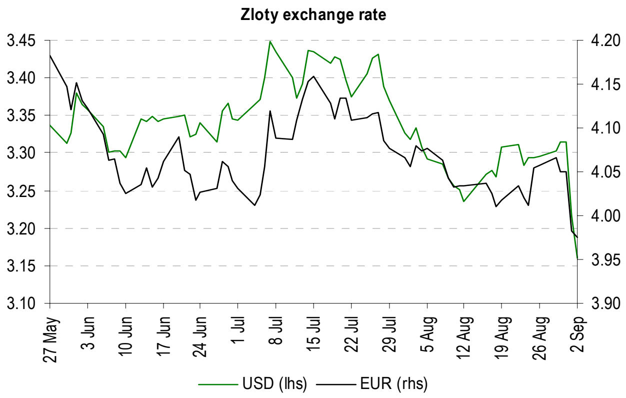
Quote of the week – Are NBP governor comments in line with the view of majority of MPC?

Leszek Balcerowicz, NBP governor, MPC chairman; PAP, 2 September

The central bank's monetary policy, based on its constitutional duties, should be such as not to jeopardise price stability, not only in the short-run but also in the long-term. Good monetary policy is not about reacting to current data or politicians' comments, nor those from analysts or commentators. We should show likewise that we can resist the pressure from current data.

After August MPC meeting, the media cited only few comments from NBP governor. Meanwhile, voting records of the MPC in 2Q05 showed that view of supporters of more restrictive policy (including NBP governor) is not the key for MPC decisions. Market participants should pay more attention to comments of rate-setters from the mainstream or to some of doves, as the latter used to change their mind suddenly and tip the balance in the MPC.

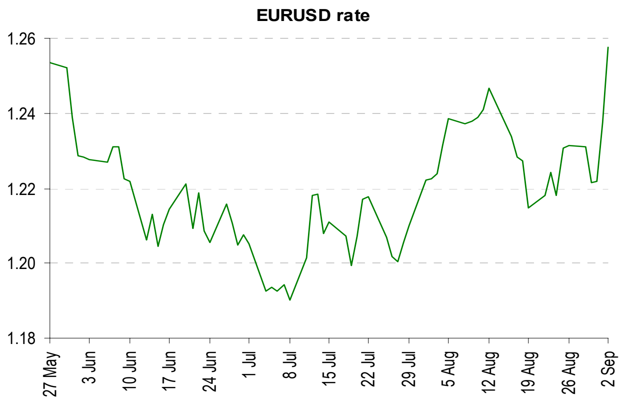
Market monitor



Unexpected zloty strengthening

▪ After very calm beginning of the week (the market did not react to rejection of presidential veto to the VAT bill allowing for rebate on construction materials), the substantial zloty appreciation started on Wednesday.

▪ It was driven by several factors. Fixed income and equity markets saw substantial flows of foreign capital. At the same time, a significant appreciation of the euro against the dollar took place and a result the zloty strengthened much more against the dollar (above 4%) than against the euro (above 2%). The zloty rate broke the lower end of the ranges we indicated last week. We predict that this week the EURPLN will range between 3.90 and 4.00, and USDPLN will be in 3.10-3.20 range.

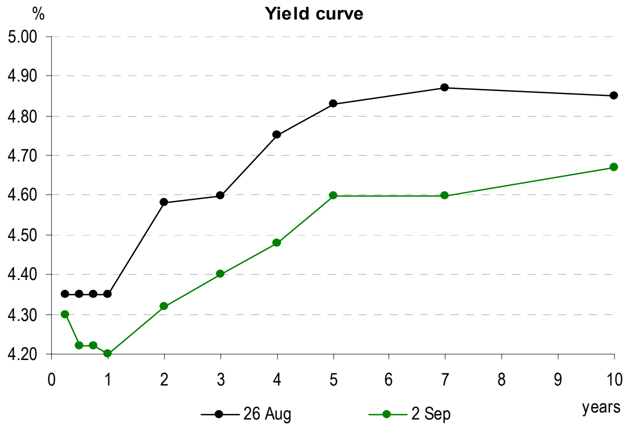


… and US dollar weakened against the euro

▪ Last week the EURUSD rate continued rising trend, which has been reinforced by economic data, which were quite disappointing showing worse than expected shape of the American economy.

▪ After Wednesday's release of lower-than-expected Chicago PMI, also ISM manufacturing was below expectations. Although Friday's non-farm payroll data were not so negative, they did not bring EURUSD back below 1.25, which was broken for the first time since late May.

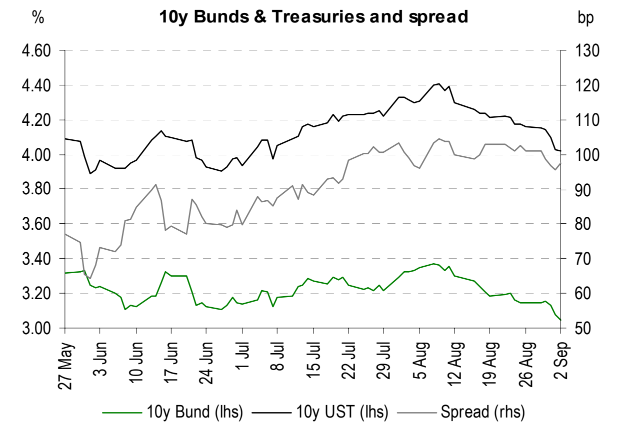
▪ Last but not least, important factors behind negative mood for the dollar were effects of hurricane Katrina and high oil prices.



Big optimism on Polish debt market

▪ In line with our predictions, Polish market reacted positively on MPC decision and statement. Steeping of the yield curve that we had anticipated was not very significant though (difference between 2y and 10y bond yield rose by 8 bp), because fall in yields at the long end of the curve was not stopped by worse fiscal perspectives after Sejm's vote.

▪ Yields of 2y and 5y bonds wend down by almost 30 bp last week while yield of 10y bond fell almost 20 bp. On FRA market, 6x9 and 9x12 contracts fell by 25 bp. In the 3 months horizon, one 25 bp interest rate cut is being priced in, and another one of the same scale within the next quarter.



... likewise on the core markets

▪ Similar factors that were behind dollar weakening (weak macro data, effects of hurricane and high oil prices) resulted in strengthening of Treasuries. Yield of 10y US bond fell by almost 10 bps. Positive sentiment was seen also on Bund market – yield of 10y papers recorded the lowest level in history, falling below 3.05%. Spread between the two bonds maintained below 100 bp for the better part of the week.

▪ While the long end of Polish yield curve saw significant move downwards, following good sentiment abroad, the spread 5x5 between yield curve in Poland and in the euro zone dropped slightly by ca. 10 bps to 75 bp.

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