

Weekly economic update

24 October – 30 October 2005

This is going to be a very hot end of the month. After Lech Kaczyński has been elected for president, the focus of attention of financial market players will turn on the process of government formation. Negotiations on crucial points of economic programme between teams of experts from PO and PiS should kick off today, and signature of coalition agreement is possible on Friday (of course assuming negotiations are successful). Market will closely eye every news regarding possible compromise solutions, as they could hint on the government's economic strategy for the coming years. The key question is whether victory of PiS candidate in the presidential race would not decrease PO's readiness for entering the coalition, as some of the party's official have already raised doubts if a reasonable compromise on economic programme would be possible. The talks will be very difficult. It appears that two opposite scenarios start emerging: either PO enters the government (assuming it gets some significant concessions from PiS), which will be a positive signal for the market, or coalition talks end up with a failure and PiS government would be forced to seek support in Samoobrona and PSL – in such a case one should not expect the government to come up with pro-market economic reforms in the coming years.

Apart from political events, there will be a number of economic news this week. Already today the NBP will publish core inflation statistics, while on Tuesday the CSO will inform about retail sales growth and unemployment rate. Those publications should not alter significantly the assessment of economic situation. They also should have no crucial meaning for the MPC that starts its two-day meeting on Tuesday. We still expect the MPC will keep interest rates on hold this time, awaiting publication of 3Q05 GDP data (several Council members reiterated this fact recently) and clarification of political situation.

Economic calendar

Time GMT	COUNTRY	INDICATOR (importance level*)	PERIOD		FORECAST		LAST VALUE
					MARKET	BZWBK	
MONDAY (24 October)							
14:00	POL	Net inflation (W)	Sep	%YoY	1.3	1.2	1.3
TUESDAY (25 October)							
8:00	GER	IFO index (H)	Oct		96.4	-	96.0
14:00	USA	Consumer confidence (H)	Oct		90.0	-	86.6
14:00	POL	Retail sales (H)	Aug	%YoY	7.0	9.6	7.9
14:00	POL	Unemployment (M)	Aug	%	17.7	17.6	17.8
14:00	POL	MPC meeting – first day					
WEDNESDAY (26 October)							
14:00	POL	MPC meeting – decision (H)	Oct	%YoY	4.50	4.50	4.50
THURSDAY (27 October)							
9:00	USA	Durables orders (H)	Sep	EUR bn	-1.0	-	3.4
FRIDAY (28 October)							
8:00	EMU	Money supply M3 (H)	Sep	%	8.2	-	8.1
9:00	EMU	Preliminary HICP (H)	Oct	%YoY	2.3	-	2.2
12:30	USA	Final GDP (H)	3Q	%	3.5	-	3.3
13:45	USA	Michigan index (H)	Sep		77	-	76.9

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

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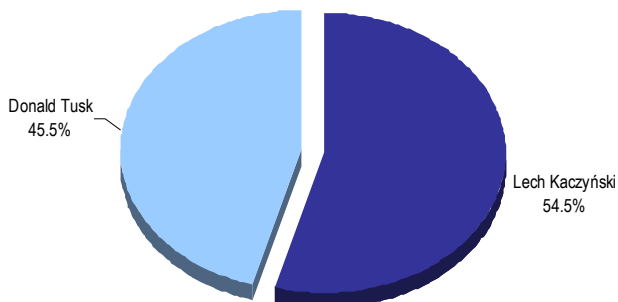
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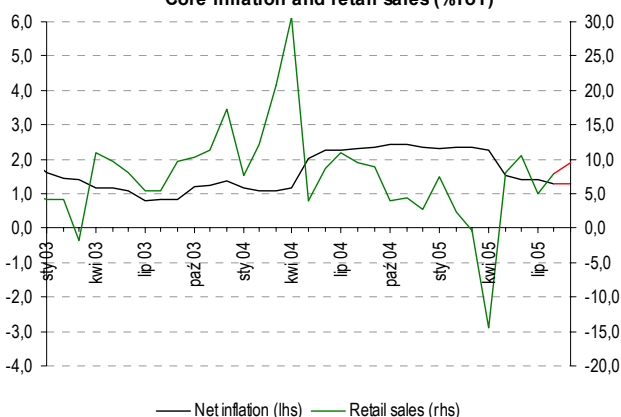
What's hot this week – Hot period in politics and economy

Run-off of presidential election



- Contrary to earlier polls, PiS candidate Lech Kaczyński won presidential election in the second round with a support of 54.5% of voters against 45.5% backing for Donald Tusk (according to data from 91% of polling wards).
- For the financial market, the most important now will be talks between PiS and PO on government formation. If the negotiations go ahead quickly, it will be a stabilising factor for investors' moods. Then, a shape of coalition agreement will become important (should be known by Friday).
- Nevertheless, first negative signals can already be seen – PM designate Marcinkiewicz declared meeting of Maastricht criteria in 2009 rather than earlier mentioned 2007 and no hurry in fiscal adjustment is needed in his opinion. Such stance could impede establishment of coalition with the PO, which would be a negative scenario for the market.

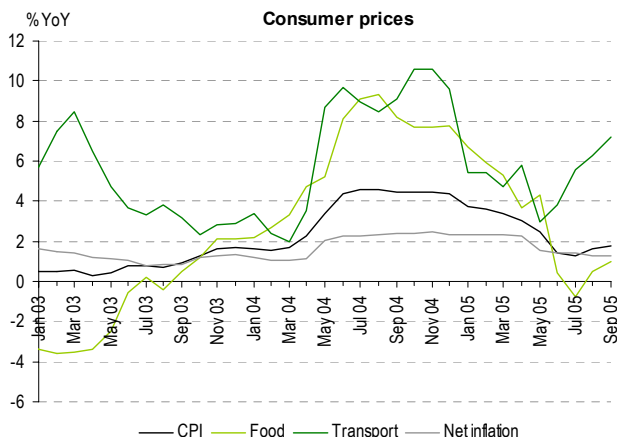
Core inflation and retail sales (%YoY)



- We estimate that net inflation fell to 1.2%YoY in September, the lowest level in 17 months. Other core inflation measures should remain low, confirming that underlying inflationary pressure is still subdued.
- Retail sales data should indicate strong increase of 9.6%YoY, confirming that growth of consumption demand accelerated in 3Q05, although this still does not seem to pose serious threat to the inflation target.
- The unemployment rate in September again slightly declined along with rising labour demand in enterprises.
- The MPC will rather refrain from cutting rates again at this week's meeting. Rate-setters have been stressing recently they would like to wait for GDP numbers for 3Q05 (due for release in late November). An argument for the pause in any changes in monetary policy parameters is also political uncertainty.

Economy last week – Economy on the rise, no inflationary pressure

Consumer prices



- Industrial output increased by 5.5%YoY in September with seasonally adjusted growth at 5.1%YoY. Faster output growth suggests some improvement in the pace of GDP growth in 3Q05, but this could be still driven to a large extent by exports and not domestic demand.
- However, further expansion of construction output (it rose 10.5%YoY in September) is a positive indication as regards investment activity.
- PPI inflation decelerated to -0.2%YoY, which shows that it is hard to talk about direct effects of high fuel prices on other prices, not to mention the risk of second-round effects.
- Wage growth of 1.8%YoY in September was much weaker than expected, which weakens concerns about second-round effects. Fortunately, employment growth accelerates, which supports expectations of consumption revival in 3Q05.

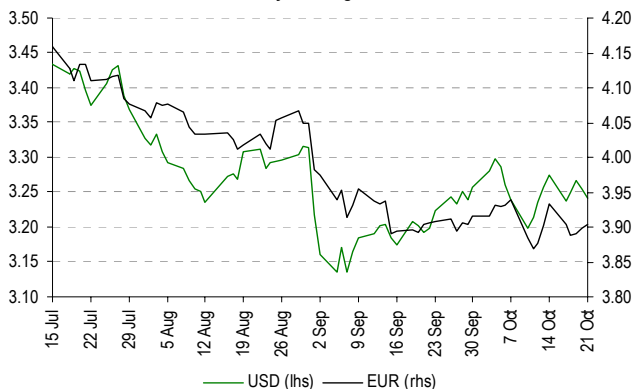
Quote of the week – Pension funds the only PiS' idea on deficit reduction?

Cezary Mech, candidate for finance minister; PAP, 18 October
I am not sure that we can say in those talks that we can give 2007 as ERM-2 entry, I believe that this is not possible. The key element will be treatment of open pension funds (OFEs) by the Eurostat. If its stance is not changed, where one could find additional PLN15bn? Due to OFEs we have to tighten our belt, so there is a question how this would affect economic activity. I don't have this vision how to reduce public spending by PLN15bn.

The question when Poland will join the euro zone is actually the question about the prospects for public finance sector. It seems that the main point of PiS economic programme as regards public finance is assumption that OFEs will be treated as a part of the public finance sector. It is interesting what arguments the new government will provide for a change to decision of EU side. Would it be resistance to undertake major changes in the public finance?

Market monitor

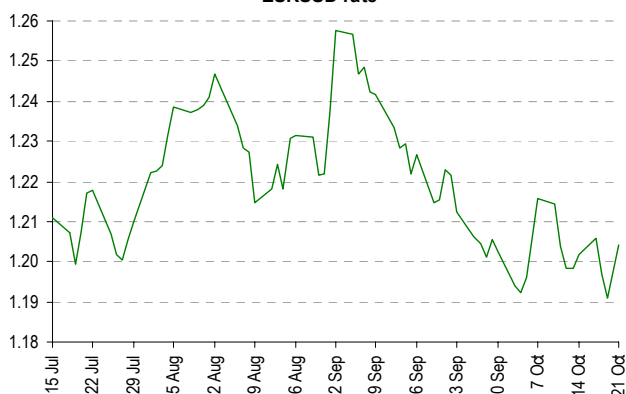
Zloty exchange rate



Zloty with hopes for new government

- In the first part of the previous week zloty strengthened on partial return of foreign investors on the emerging markets after lower than expected inflation in USA and lower expectations on rates hikes in the previous week. Later on zloty weakened against dollar on high PPI in USA and EURUSD drop. Data on high industrial production in euro zone effected in expectations increase on rates hikes in EMU, EURPLN rose and USDPLN dropped. The end of the week was stable for zloty, Polish currency gained around 1% against dollar and 0.7% against euro.
- In this week, the key factors for zloty will be the course of coalition talks on government between PO and PiS. We forecast EURPLN to oscillate in range 3.85-4.00, and USDPLN 3.24-3.36.

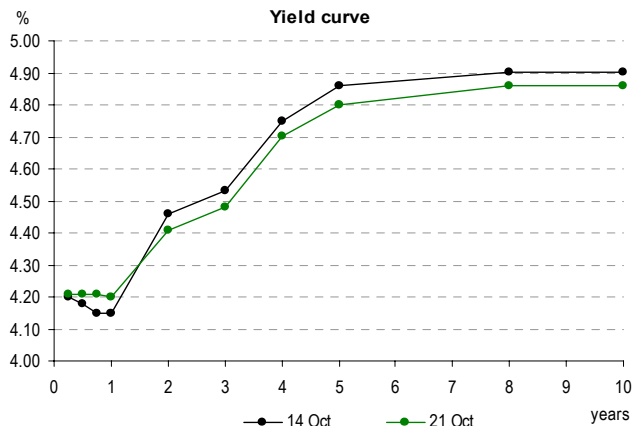
EURUSD rate



Volatile EURUSD

- Dollar recovered part of its losses against euro, which followed on U.S. low CPI data. The greenback strengthened on higher than expected PPI and net capital flows data and the EURUSD hit 3 month low of 1.1876. Higher than expected inflation figure for euro zone resulted in EURUSD increase. Next dollar strengthening followed dovish statement of ECB Executive Board member Gonzalez-Paramo and perspective of spread between rates in U.S. and EMU widening.
- Interest rate spread will support dollar, though this may be limited by

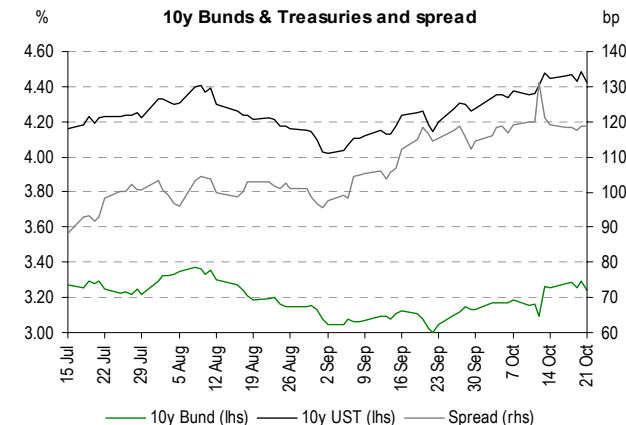
Yield curve



Fixed income market stable, waiting for new cabinet

- Bonds strengthened slightly as compared to previous week and yield curve flattened. Initially market strengthening was connected with partial comeback of foreign investors on emerging markets on U.S. from the week before. Despite later yields rise, which was a result of higher than expected U.S. PPI figure, bonds strengthened on dovish comments of ECB and yields drop on the core markets.
- Cooperation of two coalition parties as well as economic and public finance reforms plans may have significant influence on the process of new government construction. Macroeconomic data on net basis inflation and retail sales will be also essential.

10y Bunds & Treasuries and spread



Yields and spread stabilization

- Yields of U.S. Treasuries stabilized at high level, tough similarly to 10Y Bunds strengthened slightly, despite the hawkish comments of Fed and ECB throughout the week on higher than forecasted inflation PPI in U.S. and HICP inflation and industrial production in euro zone.
- GDP, durable goods, consumer confidence and Michigan index in U.S. as well as German IFO index, and preliminary inflation HICP index for euro zone data may influence on central banks representatives statements and yields levels.

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