

Weekly economic update

7 November – 13 November 2005

Last week the National Council of the Civic Platform (PO) decided (with overwhelming majority) to be an opposition party to PiS minority government. Although the resolution did not rule out a possibility of forming coalition government in future (if PiS breaks informal coalition with Samoobrona, but PiS officials are against it), PO's deputies will be against the vote of confidence in the cabinet, planned for Thursday. SLD will be also against, while other parties (LPR, PSL, Samoobrona) are still waiting with making a final decision. Therefore, Marcinkiewicz's cabinet has a chance to be formed only if populist parties support it. It is hardly good news for the market. If the cabinet reaches absolute majority (50% + 1 vote with the presence of at least 50% deputies) this would mean that uncertainty period is almost over and thus one could expect some stabilisation on the market. However, one should remember that the cabinet may reach majority in the Sejm *only if* populist parties (Samoobrona, LPR, PSL) support it. This means rather gloomy prospects for fiscal reforms. On the other hand, if the government is not accepted by the parliament a risk of early elections increases. In such case, even short-term market reaction may be negative, although it has to be noticed that such scenario could mean higher chances for return to negotiation table by PiS and PO. Anyway, this is hard to be optimistic about sentiment on the Polish financial market taking into account the fact that political risk increased quite substantially in recent weeks, and this may be reflected in economic policy. Recent statements of new finance minister were very good example. She said there was no room for spending cut in the budget and she would like to increase budget deficit to above PLN30bn anchor presented by Prime Minister. Additionally, in the weekend edition of Financial Times she gave an interview stressing a need to boost social spending in Poland and saying that foreign supermarket branches like Tesco are unwelcome in Poland, as they do not contribute to economic development.

Economic calendar

Time GMT	COUNTRY	INDICATOR (importance level*)	PERIOD	FORECAST		LAST VALUE	
				MARKET	BZWBK		
MONDAY (7 November)							
9:00	POL	Auction of 52-week T-bills PLN400m					
10:00	EMU	Retail sales (H)	Sep	%YoY	1.3	-	2.0
WEDNESDAY (9 November)							
11:00	POL	Auction of 12-year inflation indexed bonds IZ0816 PLN0.5bn (H)					
15:00	USA	Wholesale inventories (H)	Sep	%	0.3	-	0.5
THURSDAY (10 November)							
13:30	USA	International trade	Sep	USD bn	-61.0	-	59.03
13:30	USA	Import prices	Oct	%	0.0	-	2.3
14:45	USA	Preliminary Michigan index	Nov		93.3	-	91.2
19:00	USA	Fed budget	Oct	USD bn	-55	-	-69.55
FRIDAY (11 November)							
	POL	Independence Day – Holiday					

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

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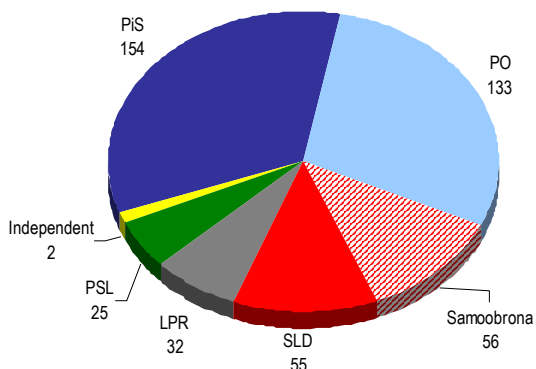
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What's hot this week – Who will support minority government?

Distribution of seats in Sejm



- This week the vote of confidence in new cabinet will be crucial for financial markets.
- The cabinet may reach the absolute majority only if Samoobrona supports it together with LPR or PSL.
- ... or with support of both LRP and PSL if Samoobrona's deputies leave the proceedings.
- These three parliamentary caucuses will make a decision just before the vote, after they meet PM. If the cabinet does not reach majority, we will see the beginning of the second step in the three-steps constitutional procedure. Then Sejm will propose PM, who will have to reach absolute majority. Possibly, in such scenario there would be a chance for talks between PiS and PO again, but the uncertainty period will extend. There are no positive scenarios from financial market's point of view.

Economy last week – Focus on politics in Poland, focus on economy abroad

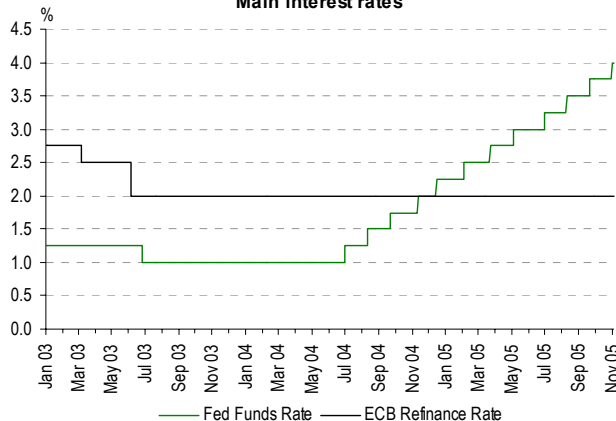
Profiles of ministers in charge of economic issues

Teresa Lubinska Finance Minister	Head of the finance department at the University of Szczecin in northwestern Poland and Marcinkiewicz's former economics professor. She has published research on public finances and last year was appointed member of a council advising the outgoing finance minister. Lubinska favours a gradual approach to reducing the budget deficit.
Piotr Woźniak Economy Minister	Geologist and economic expert of the conservative Law and Justice party. Served as a diplomat in Canada in 1992-1996. Advised a previous right-wing cabinet on infrastructure issues and was a deputy chief of gas group PGNiG.
Andrzej Mikosz Treasury Minister, in charge of privatisation	Lawyer specialising in capital market issues and former member of the Securities Commission. He fought for minority shareholders' rights in several high profile cases.

Source: Reuters

- Minority cabinet of PiS was sworn in. Ministers responsible for economic affairs were not widely known for financial markets, but there is a question what will be their influence on economic policy.
- Economic programme of the new cabinet raises doubts as regard changes planned for 2006, as the government will have to solve the problem of how to achieve lower deficit with higher spending and lower revenues at the same time. Revenues may be lower as the government planned to resign from the increase of excise tax on fuels. Higher expenditures were promised in electoral campaign.
- Additionally, economic programme of the cabinet leaves a lot of doubts as regards medium-term perspective. It is based on hope that the Eurostat will change definition of Polish pension fund, classifying them as part of public sector. Budget for 2007 will be a real test for the cabinet.

Main interest rates



- As expected, Fed continued its course of raising interest rates and increased main rate by 25bp to 4%. The statement was roughly unchanged suggesting that the Fed would continue hiking at a measured pace. The European Central Bank left the main interest rate unchanged at 2.0% and the chairman's comments were rather dovish.
- In practice, all economic indicators (PMI, ISM), for both United states and the euro zone, were above market expectations.
- In October non-farm payrolls rose by 56,000 as compared to revised -8,000 in September and forecast at 100,000. Weaker data did not change view on fast interest rate raises as according to Department of Labor's report there were signs of wages increase and this appeared to have stronger impact. The jobless rate amounted to 5%.

Quote of the week – Finance minister wants higher deficit

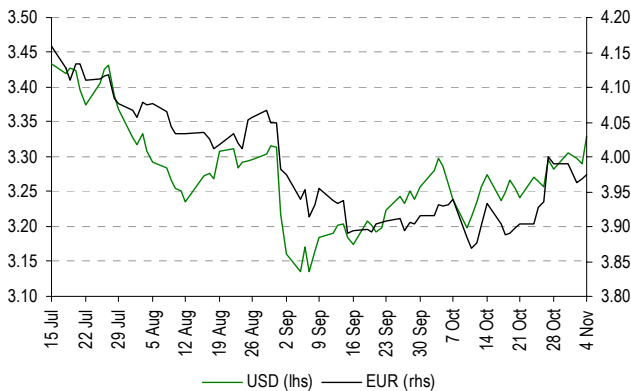
Teresa Lubinska, finance minister; Reuters, 3 November

This is my personal request that we raise the deficit slightly (by PLN1-2bn), but Marcinkiewicz wants it to remain at PLN30bn. I want to raise spending on education and high technology. (...) It seems there is small room for manoeuvre as regards a change in public debt management strategy. I will know the details in December. We should be careful with this regard.

It is exceptionally surprising that a finance minister wants higher budget deficit than Prime Minister. She should try to avoid similar statement, as this may be very costly for taxpayers (and her credibility as a finance minister). This is enough to note that her comments led to a rise in bond yields. Comments on public debt strategy were in contrast with recent statements of PiS economic expert Cezary Mech, (he announced U-turn in strategy).

Market monitor

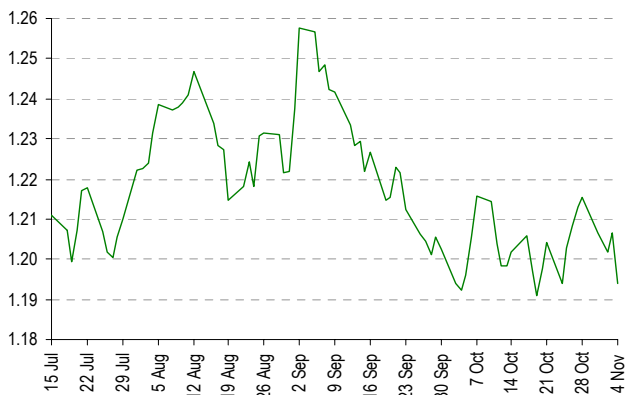
Zloty exchange rate



Calm before a storm on FX market

- The beginning of the week was quite calm due to holiday and low activity of investors. Zloty strengthened on appointment of Marcinkiewicz's cabinet and improved sentiment of investors to emerging markets. USDPLN oscillated 3.29-3.31 as a result of EURUSD moves. On controversial statements of finance minister and European Commission critique on plans to increase budget deficit and delay euro zone entry date zloty depreciated to 4.005 against euro and 3.38 to dollar. Within a week zloty lost 1.4% to the greenback and gained 0.4% against euro.
- Political situation stays uncertain until voting on confidence motion. We forecast EURPLN trading in range 3.97-4.10, whereas USDPLN between 3.33-3.47.

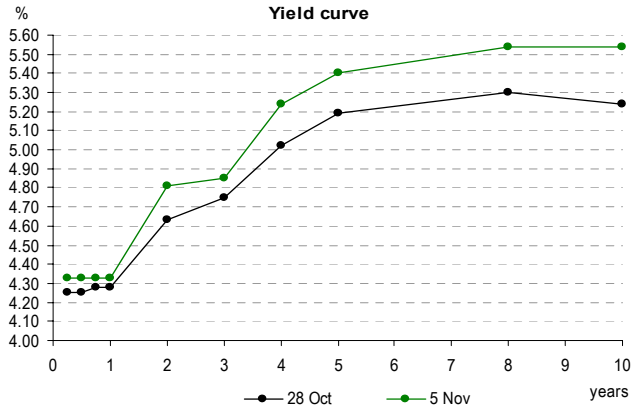
EURUSD rate



Dollar strengthens in Fed rates raise perspective

- On previous Monday EURUSD dropped from 1.209 to 1.1975 in Fed Funds rates raise perspective. On Fed's decision and more hawkish comments of EBC members euro recovered to 1.206. ECB left rates in euro zone unchanged and on more dovish than expected Trichet statement and very good data from U.S. EURUSD slumped to 1.194. Thursday Alan Greenspan's statement of uncertainty towards inflation pressure strengthened rates hikes expectations and target rate at 5%.
- This week EURUSD should be stable though it is worth to pay attention to economic data - Michigan index and trade balance in U.S.

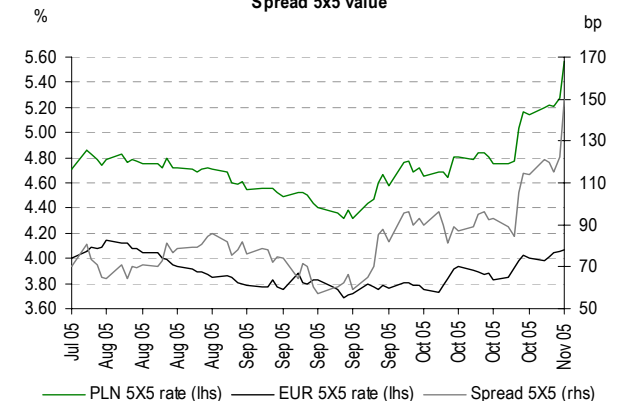
Yield curve



Costly MinFin statements

- Similar to FX activity on bond market was low at the beginning of the week due to All Saint's Day and local investors leave. Bonds slightly weakened, though new cabinet appointment brought little yields drop. Later on yields curve steepened and debt was cheaper on finance minister statement of desire to widen budget deficit. Significant increase of yields occurred on European Commission critique toward plans and statements of the Polish government.
- Uncertain political situation lasts and Marcinkiewicz cabinet will have to count on populist parties in confidence voting, which does not support investors' moods. Yields are additionally boosted by core bond markets weakening.

Spread 5x5 value



Yields higher as rates hikes expected; spread rockets

- Higher than ISM figures, further Fed's rate raise and Greenspan hawkish statement contributed to 10Y Treasuries yields raise over 4.65%, which was the highest level for over a year. Bunds' yields rose on hawkish comments of EBC members negative data from German economy. Surprising dovish comments of EBC's chairman that current monetary policy is adequate contributed to debt market strengthening and weakening of expectations of faster rates rise.
- Recent political events such as coalition crisis, minority government, unfortunate statements of finance minister and EC critique negatively affected Polish markets. In the result spread 5x5 showing euro zone entry date perspective rose within two last weeks from 93bp. to 150bp., which is the highest level since October 2004.

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