

Weekly economic update

3 – 9 July 2006

The key event of last week was FOMC meeting concluded with the 17th straight hike by 25 bp. The decision was in line with expectations, but a tone of statement released after the meeting was less hawkish than expected and was interpreted by the market as a signal that Fed may pause monetary tightening. This caused significant weakening of the US dollar and strengthened bonds, equities and commodities. However, one should remember that Fed did not exclude further rate hikes and next decisions will depend on forthcoming economic data. Large dose of important data in the US will be delivered in the nearest week and participants of the Polish market may pay them much attention in face of no domestic events scheduled.

The MPC meeting, overshadowed by FOMC meeting, concluded with no change in interest rates, as expected. In line with our predictions, the Council said that better assessment of medium-term inflation prospects will only be possible in July when the new inflation projection will be published. The tone of the official statement released after the meeting indicates that stronger than expected economic revival provided food for thought for the MPC and it will be a reason of increased central bank's vigilance in the months ahead, although possible monetary policy tightening is still rather distant. Thus, we maintain our view that the reference rate will remain on hold at 4% until the end of this year.

After the MPC meeting two hawkish rate-setter took floor in the media. While Halina Wasilewska-Trenkner expects worsening of NBP inflation projections, Dariusz Filar make a need for rate hikes conditional on a threat to stabilisation of inflation at 2.5%. Possibly, in the nearest week we will get to know opinion of other MPC members, which will give a better picture of dominating view within the Council.

Economic calendar

Time GMT	COUNTRY	INDICATOR (importance level*)	PERIOD		FORECAST		LAST VALUE
					MARKET	BZWBK	
MONDAY (3 July)							
8:00	EMU	Manufacturing PMI (H)	Jun	pkt	57.4	-	57.0
14:00	USA	Manufacturing ISM (H)	Jun	pkt	55.0	-	54.4
TUESDAY (4 July)							
9:00	EMU	PPI (M)	May	% r/r	0.3	-	0.8
	USA	Independence Day – Public holiday					
WEDNESDAY (5 July)							
9:00	POL	Auction of PLN1.8-2.3bn 2Y OK0808 bonds (H)					
8:00	EMU	Non-manufacturing PMI (H)	Jun	pts	59.0	-	58.7
9:00	EMU	Retail sales (M)	May	%YoY	2.0	-	2.8
14:00	USA	Factory orders (H)	May	%	0.2	-	-1.8
THURSDAY (6 July)							
11:00	GB	BoE meeting – decision (M)	Jul	%	4.5	-	4.5
11:45	EMU	ECB meeting – decision (H)	Jul	%	2.75	-	2.75
12:30	USA	ISM services (H)	Jun	pts	59.0	-	60.1
FRIDAY (7 July)							
12:30	USA	Non-farm payrolls (H)	Jun	'000	150.0	-	75.0
12:30	USA	Unemployment (H)	Jun	%	4.6	-	4.6

* - poziom ważności: (W)ysoki, (U)miarkowany; Źródło: Parkiet, Reuters, BZ WBK

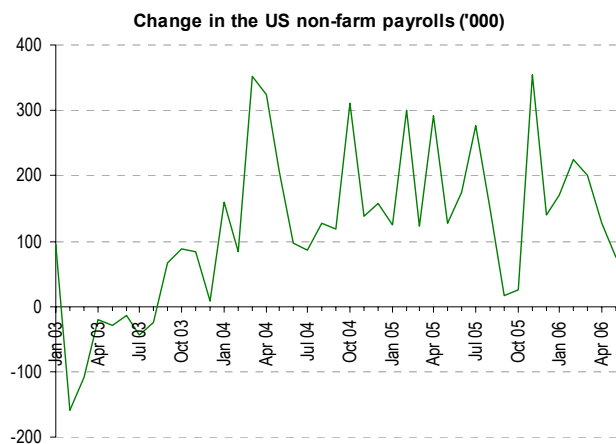
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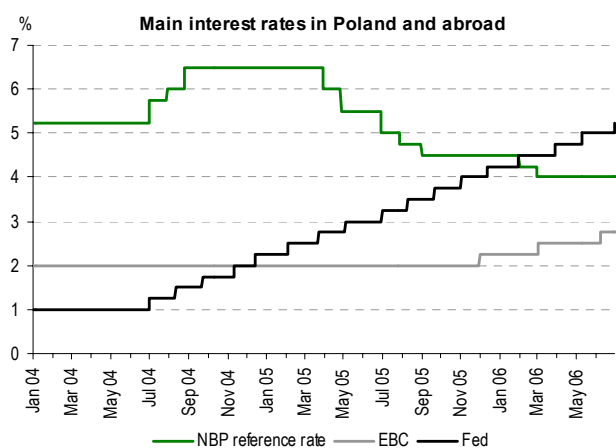
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What's hot this week – No domestic events, important news from abroad

- In the nearest week there will be no releases of relevant macro data. There should be also no important news from political scene, as we are entering a silly season and the markets has already forgotten about the dismissal of finance minister Zyta Gilowska.
- Therefore, participants of the Polish financial market are likely to focus on ECB meeting and publication of several important data in the US.
- The statement released after last week's FOMC meeting gave market a hope that monetary tightening in the US will be paused. Whether this hope will be maintained will depend on the forthcoming economic data.
- As usual, very much attention will be paid to data on non-farm payrolls, as they are regarded as important gauge of prospects for interest rates in the US.

Economy last week – Higher inflation risk, but rate hikes not so swift

- MPC meeting last week, concluded with no change in interest rates, was overshadowed by FOMC meeting. However, decision and comments of the Polish central bank were also important for the domestic financial market, even if prospects for interest rates in the US have dominant impact in the short-term.
- FOMC statement proved less hawkish than market had expected, suggesting a possibility of a pause in monetary tightening. However, further decisions of US central bank will depend on forthcoming economic data, so one cannot exclude that monetary tightening in the world's largest economy will be continued.
- Contrary to FOMC statement, the tone of MPC communiqué was slightly more hawkish than one could have expected.

Selected fragments of Monetary Policy Council's statement (28 June)

The May data on output, retail sales and employment in the enterprise sector in Poland proved better than expected and indicated that the high rate of economic growth recorded in Q1 will be also continued in 2006 Q2.

Further signals have arisen pointing to building wage pressure in some parts of the public sector. All this may lead to further increases in wage pressure.

Low level of all core inflation indices suggests that inflationary pressure continues to be low.

In the Council's assessment, the balance of risks for future inflation may point to an increased probability of inflation running, in monetary policy transmission horizon, at a higher level than it was accounted for in the April projection and at the May meeting of the Monetary Policy Council. A broader assessment of the inflation outlook will be possible in July 2006 after the publication of the inflation projection.

- In line with expectations the MPC pointed out that all economic activity indicators and labour market statistics released last month were better than expected and continuation of the strong upward tendencies could become a source of inflationary pressure.
- The Council repeated the warning against possible increase in wage pressure in the public sector which can spill over on the whole economy.
- On the other hand, the MPC stressed that despite ongoing economic expansion, core inflation measures, showing underlying inflationary pressure, remain low.
- However, in the final assessment of balance of risks for future inflation the Council clearly stated that it worsened. Now the key question is what will be shown in the new inflation projection of the NBP, which will be published in July.

Quote of the week – Inflation should not be running much above target

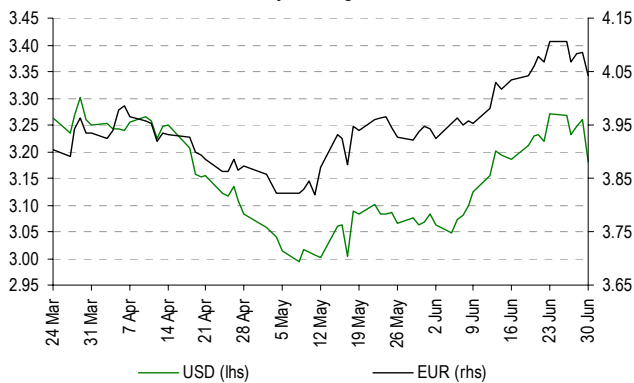
Dariusz Filar, MPC member; PAP, 30 June

Current level of NBP reference rate seems close to a neutral level and one may expect that possible increase of inflation above the target will not be significant. (...) Future inflation path does not have to increase in whole time horizon of the projection. There may be only a change in shape of the path, and we will know this in July. (...) We would like so that inflation after return to the target would stabilise as close to this level as possible, i.e. at 2.4-2.6%, not more.

Dariusz Filar a need for rate hikes conditional on a threat to stabilisation of inflation at a very close level to the target of 2.5%. In his opinion it should be 2.4-2.6%, not more. This would mean low tolerance for inflation running above the target but below the upper end of the allowed fluctuation band (1.5-3.5%). However, it remains to be seen whether Filar's view is shared by majority of the Council. Moreover, even Filar himself does think that such threat is significant. This suggests that even opinion of hawks do not justify rate hikes on the scale that is priced in by the market.

Market monitor

Zloty exchange rate

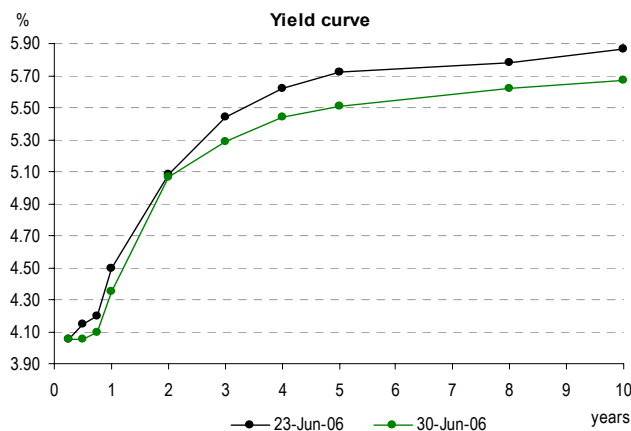


Correction of the zloty

▪ After fall which resulted after Zyta Gilowska dismissal zloty rate stabilised at slightly stronger levels supported by appreciation of other emerging market currencies which effected after Turkish and Slovakian central banks intervened to defend the lira and the crown. Fed's communiqué also decreased pressure on the currencies of developing economies. During the week zloty gained by ca. 0.5 % to euro and 2.6% vs. the dollar.

▪ With no data in the domestic market the zloty rate will remain under influence of foreign figures, especially from U.S., after Fed correlated its further moves with coming data. We assume that the EURPLN rate may stay in range of 4.02-4.12, while the USDPLN rate between 3.13 and 3.23. If emerging currencies fall further central bank interventions may be some support in the short term.

Yield curve

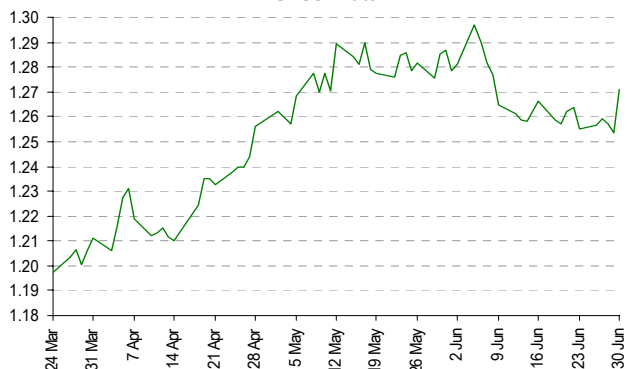


.. as well as in the debt market

▪ In line with our view the observed yields levels last week were overshoot and in the past week there was a strong correction (yields fell by 11-22 bp) in the debt market, while the yield curve flattened. As expected the MPC did not change the interest rates, while the communiqué resulted in FRA rates rise (during the week they fell by 10-20 bp) and fall of longer-term yields. The short term of the curve was affected by the hawkish comments of the MPC member.

▪ In our opinion there are still no reasons to raise the interest rates till the end of this year. Next week Polish debt may be under influence of the core markets and data released abroad as well as sentiment toward the emerging markets. Any MPC members' comments may be essential as well.

EURUSD rate

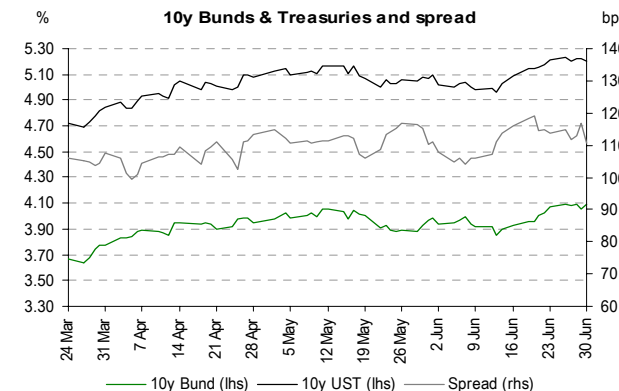


Dollar weaker after Fed's communiqué less hawkish

▪ The dollar was gaining against the euro throughout the most part of the previous week ahead of Fed meeting, while hawkish statements of ECB members on positive growth perspective, low rates level and need of limiting inflation pressure did not give support to the euro. It was the Fed's less hawkish communiqué that contributed to significant weakening of the U.S. currency. The EURUSD rose since last Friday by 1.9%.

▪ In our view, amid soon end of rate hikes in U.S. and expected slowdown of U.S. economy, as well as further rate hikes in the euro zone the dollar may be under pressure. Next week the ECB's decision, activity indices and U.S. labour market data will be crucial for the EURUSD rate.

10y Bunds & Treasuries and spread



Fed's communiqué strengthens Treasuries

▪ 10Y yields of U.S. bonds fluctuated in range of 5.20-5.25% as market expected a hawkish Fed's statement. The communiqué was less hawkish than forecasted and resulted in Treasuries' strengthening (to 5.18%). Yields of 10Y Bunds stayed at 4.09% in reaction to strong Ifo index, ECB comments and U.S. market behaviour.

▪ Fed cooled down the market expectations on the size and pace of further monetary policy tightening. However the core markets may still feature quite high volatility as when next data are released investors may still speculate on rate hikes. We assume the main Fed Funds rate stays at 5.25% level. The ECB communiqué may include some hints on faster pace of rate hikes in the EMU, which may be crucial for the EMU.

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