

Weekly economic update

31 July – 6 August 2006

Monetary policy (not only in Poland) has recently had key influence on financial markets. Last week rate hike in Hungary led to appreciation of region's currencies and next week similar ECB decision should be expected. Still, the most important for the market are expectations as regards next steps by Fed, which will be influenced by another portion of data (especially from the labour market). As regards Polish MPC, nothing has changed except some worsening in communication with markets. The MPC did not refer to new inflation projection, which may suggest that it was not entirely accepted (which is not surprising taking into account some of assumptions). We share the opinion of MPC's Filar that monetary policy tightening should not be expected until core inflation rises significantly. This means certainly not this year.

In the following weeks financial market may be also driven by fiscal policy prospects. After finance minister Stanisław Kluza said that budget revenues in 2007 may reach PLN209bn i.e. some PLN4bn less than previously planned, the issue of budget 2007 will be closely watched again. Lowering revenues confirms our view that they were overestimated, but even if PiS' politicians assured again that budget anchor as regards deficit (PLN30bn) should be maintained, they did not indicate how this will be achieved (lower spending, higher spending outside central budget or higher indirect taxes). As we wrote many times in the past, budget 2007 will be a real test for the government and markets should carefully watch not only central budget deficit figure, but especially general government deficit.

Economic calendar

Time GMT	COUNTRY	INDICATOR (importance level*)	PERIOD	FORECAST		LAST VALUE	
				MARKET	BZWBK		
MONDAY (31 July)							
9:00	EMU	Preliminary HICP (H)	Jul	%YoY	2.5	-	2.5
9:00	EMU	Economic sentiment (H)	Jul		107.0	-	107.2
14:00	US	Chicago PMI (H)	Jul		56.0	-	56.5
TUESDAY (1 August)							
8:00	EMU	Manufacturing PMI (H)	Jul		57.4	-	57.7
9:00	EMU	Unemployment (M)	Jun	%	7.9	-	7.9
12:30	USA	Core PCE (H)	Jun	%	0.2	-	0.2
14:00	USA	Manufacturing ISM (H)	Jul		53.9	-	53.8
WEDNESDAY (2 August)							
9:00	POL	Auction of 2Y bonds (H)					
9:00	EMU	PPI (M)	Jun	%YoY	0.7	-	6.0
THURSDAY (3 August)							
11:00	GB	BoE meeting – decision (M)	Aug	%	4.5	-	4.5
11:45	EMU	ECB meeting – decision (H)	Aug	%	3.0	-	2.75
8:00	EMU	Non-manufacturing PMI (H)	Jul		60.0	-	60.7
9:00	EMU	Retail sales (M)	Jun	%YoY	1.5	-	0.8
14:00	USA	Factory orders (H)	Jun	%	0.9	-	0.7
14:00	USA	Non-manufacturing ISM (H)	Jul		57.0	-	57.0
FRIDAY (4 August)							
12:30	USA	Non-farm payrolls (H)	Jul	'000	150	-	121
12:30	USA	Unemployment (H)	Jul	%	4.6	-	4.6

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

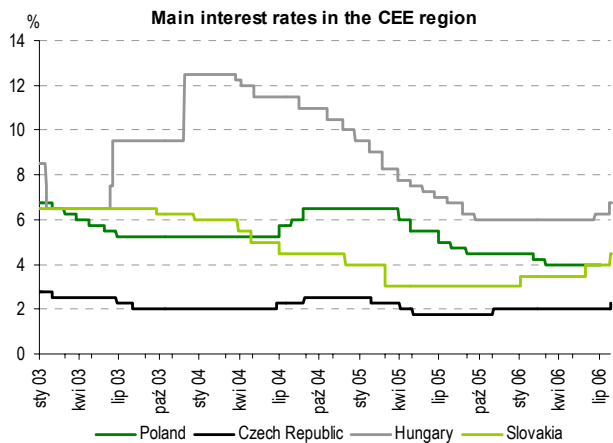
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What's hot this week – Rate hikes, but not in Poland as for now

- The MPC did not change monetary policy parameters, but last week interest rates were raised by central banks in Czech Republic, Hungary and Slovakia. The European Central Bank will probably join them next week.
- Only rate hike in Hungary influenced positively currencies in the region, as it was more significant than expected. While given the absence of data releases in Poland, the ECB decision will be very important for financial markets, the influence may be limited by the fact that 25 bp hike is widely expected.
- Financial markets are focused much more on prospects on US economic data, which should be helpful in assessment of chances for the next interest rate hike (or rather a pause in tightening) by Fed. This week the most important will be US labour market report.

Economy last week – It seems the MPC did not accept the new projection**Important elements of Monetary Policy Council's statements (26 July)**

The low level of all core inflation indices indicates that inflationary pressure remains contained.

The inflation and GDP projections, which are presented in Inflation Reports, are **one of the inputs** to the monetary policy decisions.

Having considered the latest data and the July inflation projection, the Council confirms the view expressed at its meeting in June that the probability of inflation running, in the monetary policy transmission horizon, above the level assessed in the **April projection** has increased.

It should be emphasised that, in the opinion of the authors of the projection, the inflation projection presented in the Report does not account for all sources of uncertainty. This primarily applies to the scale of the future impact of globalisation on inflation, the impact of global imbalances on the world economic growth, the growth of workforce, the effect of drought in Poland on food prices, the shape of economic policy in the coming years, in particular, the effect of increased wage pressure on public finance in Poland and the exchange rate developments.

Inflation projections NBP (% YoY)

	January 2006	April 2006	July 2006
Q4 2006	0.5-2.3	0.5-2.0	1.0-1.9
Q4 2007	1.1-3.6	1.3-3.4	1.5-3.5
Q4 2008	0.8-3.9	1.2-3.9	1.7-4.3

GDP growth projections (%)

	January 2006	April 2006	July 2006
2006	3.8-5.1	3.9-5.0	4.7-5.3
2007	3.4-5.2	3.4-5.8	3.6-5.9
2008	3.6-5.5	3.5-6.2	4.0-6.6

Source: NBP, Inflation Report - July 2006

Note: Projection shows that there is a 50-percent probability that inflation and GDP growth will stay within the ranges indicated in the table.

- As the outcome of MPC decision was obvious, market was concentrated on the communiqué after the meeting. Unfortunately, NBP gave another example of poor communication.
- The key paragraph of the communiqué, including rate-setters' judgment on inflation prospects, seems...out-of-date, as the MPC referred to April's not July' projection.
- The MPC maintained the opinion that inflation path may be higher than presented in April projection, this may refer only to figures for 2007, and not to 2008 when the projection increase is the most visible.
- This would mean that majority of MPC believes that inflation will reach the target earlier than predicted before, but would not necessarily exceed the target in the medium-term. Such scenario would not require monetary tightening.

▪ The new projection indicates that over the whole horizon of the projection, the rise of consumer prices will be more significant than expected in the April report.

▪ However, some of the assumptions adopted by authors of the projection e.g. as regards shape of fiscal policy and strong wage increase (6.5-7.0% in 2008) represent rather a risk-case scenario for inflation rather than the most likely one. It seems majority of MPC see medium-term inflation prospects in more bright colours and that is why the Council did not refer to the projection in the communiqué after the meeting.

▪ In the Report the MPC mentioned also a couple of arguments for lower inflation (increase in labour market flexibility, factors supporting stronger zloty, lower prices of some imported products), but clearly they were not entirely included in the projection.

Quote of the week – Core inflation is the key

Jan Czekaj, MPC member; PAP, 27 July

Current level of interest rates should ensure that in the horizon of monetary policy transmission inflation would not increase further after reaching the target. (...) Even in the case that CPI temporarily exceeds the target amid supply-side shocks, no monetary tightening would be necessarily required.

Dariusz Filar, MPC member; Reuters, 27 July

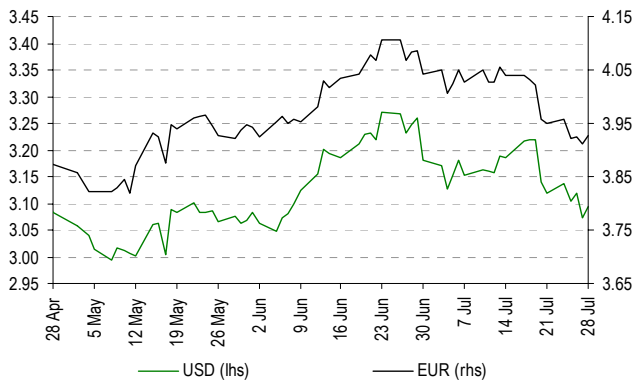
Core inflation in the nearest four-six months will be key for the future decisions in monetary policy. If it will grow in this period, which is very probable, the council will consider rate tightening.

Dariusz Filar is perceived as a hawk by the market, but reaction of market rates to his comment was negative. In our opinion, this statement was not as hawkish as it seems, because if serious talks about monetary tightening are to start only if core inflation increases, one should not expect a hike in the following months. We expect net inflation to remain at very low level until the end of this year (only slightly above 1%) and below the target of 2.5% next year.

On the other hand, statements of Jan Czekaj seem to represent the view of majority of the Council.

Market monitor

Zloty exchange rate

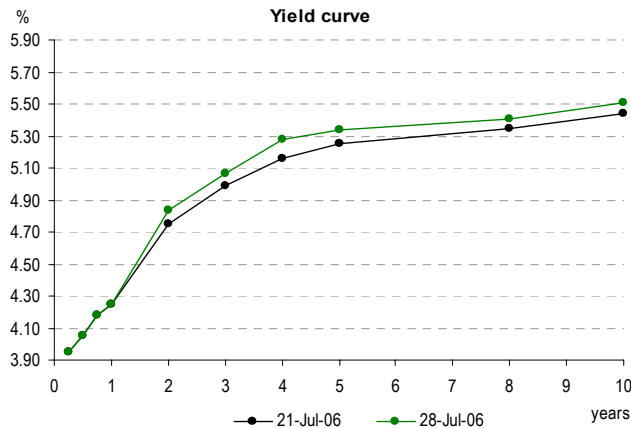


Central banks in the region gave support to the zloty

▪ In the previous week central banks in the region raised the main interest rates, which supported their currencies and effected in zloty appreciation. These move went along falling expectations of rate hikes in US, which also positively affected the assets of emerging economies. Zloty strengthened since last Friday by 0.5% against the euro and 1% vs. the dollar.

▪ The 3.9-3.92 levels appeared strong resistance for the zloty and this may be an issue also in the coming week. After a few sessions of consolidation there may be a slight correction. It seems that zloty might have broken the 3.9 level amid much weaker US data and the next resistance would be 3.88 level. However, next week the EURPLN rate may fluctuate in range of 3.9-4.0, while the USDPLN between 3.04 and 3.14.

Yield curve

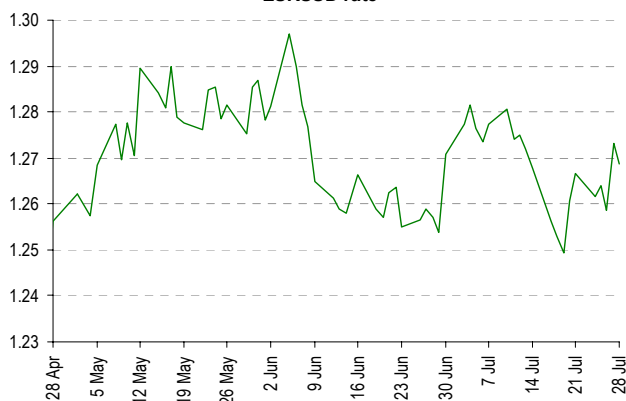


Yields in the slight rising trend

▪ In the previous week the debt market was rather stable and was under significant influence of the core markets. After early increase in bonds prices, bonds yields gradually rose later on, among other with regards to lowered revenues in 2007 budget, comments of A. Lepper of need of higher spending and comment of MPC member. The Council did not change the rates, while the communiqué and inflation report had little impact.

▪ There are no key data scheduled for next week in Poland, thus the debt is going to be mainly under influence of international markets and statistics released abroad (mainly ECB's decision and communiqué and labour market figures in US). In the domestic market the activity of investors may be moderate due to holiday period.

EURUSD rate

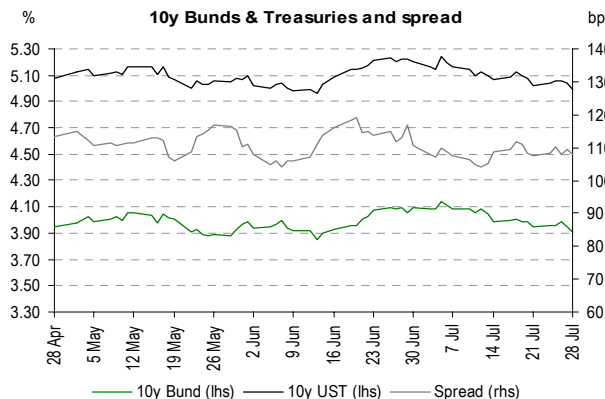


Quite high EURUSD volatility, lower growth in US

▪ The dollar continued to fall against the single currency since the start of the week, among others in reaction to information on possible diversification of currency reserves of China. The fall of EURUSD rate was observed after better than forecasted consumer confidence and home sales data in US. Next wave of dollar's weakening resulted after slightly dovish US Beige Book and softer Q2 GDP. The dollar lost ca. 0.4% during the week.

▪ The ECB decision and the communiqué is going to be a key factor for the relation of the euro to the greenback. Indices measuring activity level in the euro zone and the US (PMI, ISM) will be important as well. The non-farm payrolls data released at the end of the week will be essential for the dollar.

10y Bunds & Treasuries and spread



Stable in the core markets

▪ After prior week's Fed's chief statements the expectations for further rate hikes in US fell significantly. After a slight correction yields of 19Y Treasuries fluctuated in a tight range at low levels (5.02-5.07%) strengthening to 5.02% (observed in the previous Friday) among others after Beige book and US Q2 GDP. Bunds yields fell from 3,95% to 3,93%

▪ The market expects the ECB will raise the main rate in the euro zone by 25 pb to 3%. The most important for the euro zone's debt will be the communiqué and earlier released sentiment, activity and HICP inflation indices for the euro zone. In US the ISM activity indices as well as labour market data, which may reassure the market on a pause in monetary policy tightening series will be also essential.

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