Bank Zachodni WBK

# Weekly economic update

25 September – 1 October 2006

**The last week brought turning point on the domestic political scene, which provoked a weakening on the financial market. The next week will also probably be influenced by politics. There are two basic scenarios for the further development of the situation. In the first one, PiS sets up a new coalition with LPR, PSL and a part of Self-defense. In the second scenario, if the setting up of a new coalition fails, PiS will probably decide for early elections. Taking into account that from the economic policy point of view each one of those scenarios seems to be better than actual political situation, the departure of Andrzej Lepper from the cabinet can have a positive impact on the domestic financial market in longer time horizon. A new coalition or the result of possible early elections (in accordance to the latest opinion polls) should be, from the foreign investors point of view, seen better than a government with the participation of a radical populist. Nonetheless, the lack of fast solution can keep on weakening the market, especially that the situation in the region won't be helping.**

**Apart from the political events, the coming week will bring another portion of domestic data (we think they will confirm condition of the economy) and MPC meeting. We think MPC's communiqué won't give clear clues concerning further monetary policy actions. The Council is to adopt *Monetary Policy Guidelines for 2007*, although it is not certain whether the document will be released this week. In our view it shouldn't include major changes compared to the previous version.**

## Economic calendar

| Time GMT | COUNTRY | INDICATOR (importance level*) | PERIOD | UNIT | FORECAST MARKET | FORECAST BZWBK | LAST VALUE |
|---|---|---|---|---|---|---|---|
| | | **MONDAY (25 September)** | | | | | |
| **08:00** | **POL** | **Retail sales** | **Aug** | **%YoY** | **10.9** | **10.2** | **10.0** |
| **08:00** | **POL** | **Unemployment rate** | **Aug** | **%YoY** | **15.6** | **15.6** | **15.7** |
| 16:00 | USA | Home sales | Aug | m | 6.25 | - | 6.33 |
| | | **TUESDAY (26 September)** | | | | | |
| 08:00 | GER | IFO index | Sep | pts | 104.2 | - | 105.0 |
| 14:00 | USA | Consumer confidence | Sep | pts | 102.0 | - | 99.6 |
| | | **WEDNESDAY (27 September)** | | | | | |
| **-** | **POL** | **MPC meeting – decision** | - | **%** | **4.0** | **4.0** | **4.0** |
| 08:00 | EMU | M3 money supply | Aug | %YoY | 7.5 | - | 7.8 |
| 14:00 | US | New home sales | Aug | m | 1.05 | - | 1.072 |
| 12:30 | US | Durable goods orders | Aug | % | 0.8 | - | -2.5 |
| | | **THURSDAY (28 September)** | | | | | |
| 12:30 | USA | Core CPE | Q2 | % | 2.9 | - | 2.8 |
| 12:30 | USA | Final GDP | Q2 | % | 2.9 | - | 2.9 |
| | | **FRIDAY (29 September)** | | | | | |
| 09:00 | EMU | Economic sentiment | Sep | pts | 106.2 | - | 106.7 |
| 09:00 | EMU | Flash HICP | Sep | %YoY | 1.9 | - | 2.3 |
| 12:30 | USA | Core PCE | Aug | %MoM | 0.2 | - | 0.1 |
| 13:45 | USA | Final Michigan | Sep | pts | 84.6 | - | 82.0 |
| 14:00 | USA | Chicago PMI | Sep | pts | 57.0 | - | 57.1 |

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

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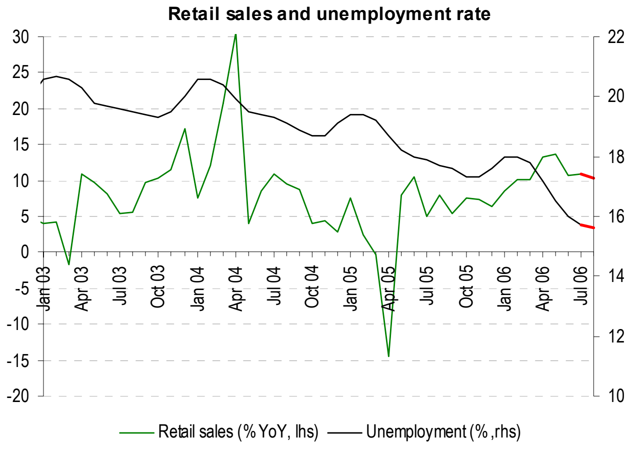
## **What's hot this week –** A few data releases, MPC meeting, and most of all politics

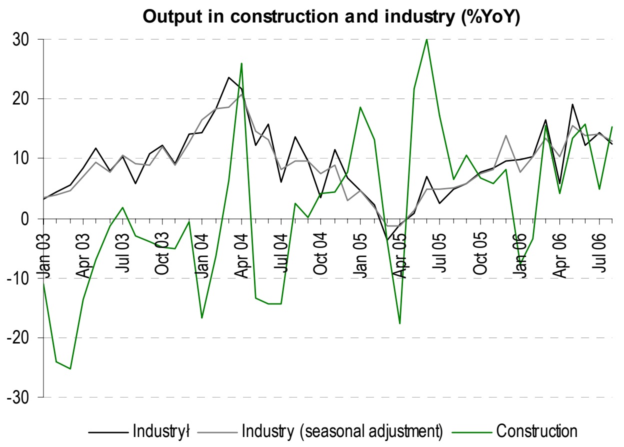



▪ The coming week will see a lot of important events: data releases on Monday, MPC decision and communiqué on Wednesday, and during the week negotiations concerning the setting up of a new coalition will be carried out.

▪ There will be also major data releases abroad. After a surprisingly low Philadelphia Fed index for September, information about the condition of the US economy will be watched very carefully.

▪ Domestic data releases due for Monday should, in our view, confirm the good shape of the Polish economy and strong consumption demand. MPC's meeting this week won't be thrilling, it is hard to expect the council's communiqué will be different than usually and will contain much more than a simple data description. October's meeting will be more important, as then we will get to know the new inflation projection.

## **Economy last week –** Output rises, inflation still under control

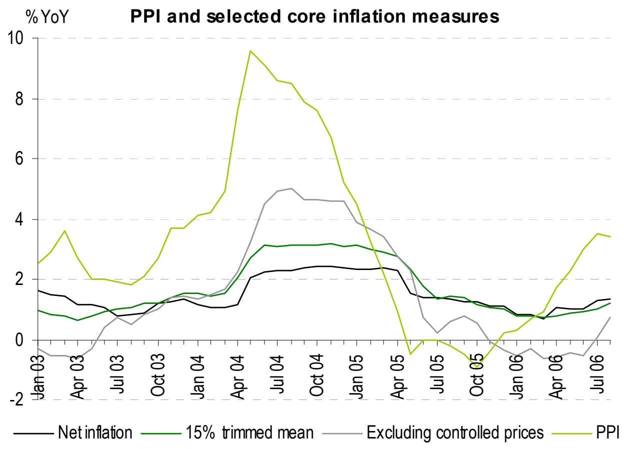



▪ Industrial output growth amounted to 12.5%YoY in August, beating market expectations at 14.8%YoY and our forecast at 17.8%YoY. Seasonally adjusted growth amounted to 12.9%YoY.

▪ Nevertheless, taking into account the fact that output growth in August was exactly the same as the average for January-July, strong growth trend remains in place, confirming our forecast assuming that GDP growth in 3Q06 amounted to around 5%.

▪ High construction output growth in August (15.3%YoY) also bodes well for estimates of high GDP growth in 3Q06, suggesting that investment activity keeps reviving.

▪ Export results are also likely to remain good, which is suggested by the fact that in export-orientated branches output growth remained very high.




▪ PPI in August turned out to be lower than expectations, growing by 3.4%YoY against market consensus at 3.6%YoY. Producers prices rise is still linked mostly to high oil and commodities prices (in mining price rise was 22.3%YoY against average 14%YoY rise in January-July), but price rise in manufacturing sector slowed down to 1.6%YoY from 1.7% in July. It is then hard to talk about uncontrolled rise in pressure on prices at producers level.

▪ All core inflation measures have recorded a rise in August. Net inflation was at 1.35%YoY against market consensus at 1.3%YoY. Rise of the majority of the measures was lower than that of the headline inflation rate, which confirmed that recent inflation impulse was mainly of exogenous shock character, while the underlying inflation remains under control, clearly below MPC's target of 2.5%.

## **Quote of the week –** Divergent views within the MPC

**Andrzej Sławiński, MPC member;** PAP, 18 September

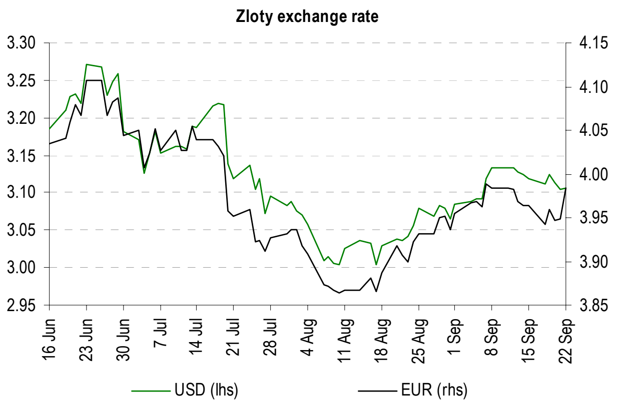
*Price shock on the food market caused by drought could permanently affect inflation only in case of second-round effects, but we know on the basis of experience from 2004 that the risk of the effects is lower than we assumed reacting to accession shock.*

**Dariusz Filar, MPC member;** PAP, 19 September

*There may be occur a threat of second-round effect following increased inflation expectations. This threat is much stronger than in 2004 when job creation was considerably weaker than today, the unemployment rate was a few percentage points higher and emigration to the EU countries has been only starting.*

MPC's hawk Dariusz Filar said last week that a 25bp rate hike should take place as soon as in October and further ones of the same size could be delivered after release of further inflation projections. However, it doesn't seem that Filar's view is shared by the majority of the MPC members which is showed by the contrasting statement from Andrzej Sławiński. In our view, most of MPC members think in a similar way to Sławiński and judge the inflation rise as temporary. Thus, we still believe that there will be no rate hikes in the predictable future.

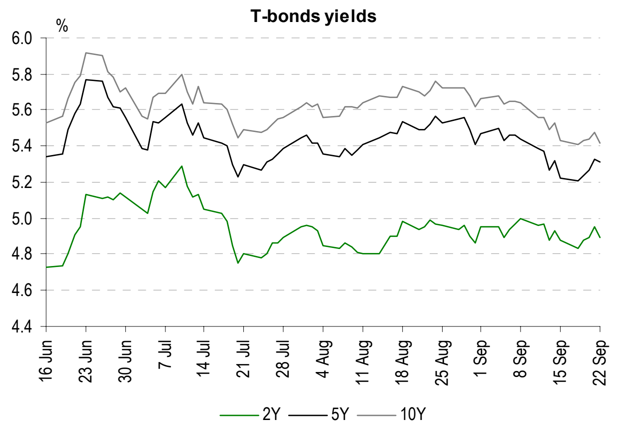
## Market monitor




### EURPLN below 3.93, now we are waiting for 4.0

▪ A week ago we have written that the breaking of the 3.95 level by the EURPLN rate will open the way to 3.90. And indeed, on Monday zloty kept its appreciation trend breaking the 3.93 level. However, in the next days there was a sell-off of the zloty, first as a consequence of riots in Hungary and then due to the crisis in the Polish government and the EURPLN rate got close to 4.0.

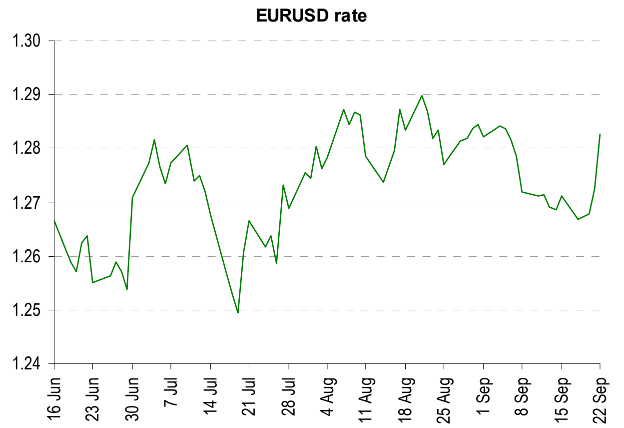
▪ Political tensions should last for a while, and the situation on the emerging markets is not favourable so the breaking of the 4.0 level is still a risk to consider. However, higher levels are perceived as opportunity to buy zloty. This is why we expect the EURPLN rate to range next week between 3.95 and 4.05, and the USDPLN between 3.06-4.06.




### Despite correction, bonds still quite expensive

▪ The situation on the fixed income market was similar. On Monday, positive mood was kept despite rising yields on the core markets. Then, especially due to politics and to hawkish comment by MPC member Filar a correction took place and it widened in the next part of the week after additional inflow of political information.

▪ It is worth reminding that even if tensions on the political scene will remain, the information coming from this area are not necessarily negative for the market, and the ejection of Andrzej Lepper is a better information than fulfilling his wishes concerning budget spending and deficit. Meanwhile, despite the recent correction, we think that Polish bond yields are still quite low – on Friday large part of recent losses was regained.

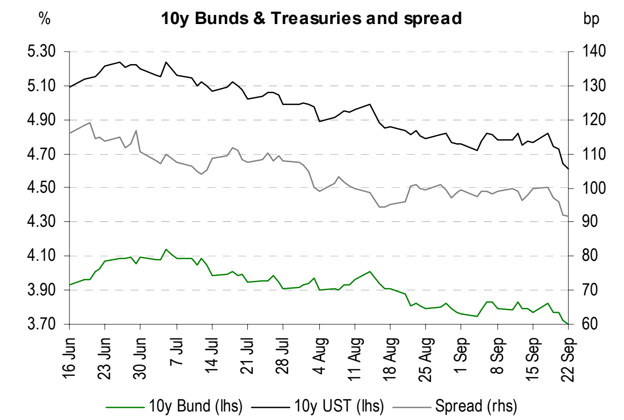



### Major weakening of the dollar after worse figures

▪ During the better part of the week, the dollar was traded around the 1.27 level – lower after lower ZEW index, higher after figures from the American housing market and with almost no reaction to Fed's decision.

▪ The dollar has consequently weakened (above 1.28) after further data releases suggesting weakening of economic activity in the US. The Philadelphia Fed index strengthened market's conviction concerning the end of rate hikes in the US, and has even bolstered the view of some economists that the Fed could start cutting rates next year.

▪ Further developments on the global FX markets will depend on whether the American economy will experience a "soft landing". Many figures, which are due for release the next week, can help in that assessment.




### Will the next Fed move be a rate cut?

▪ At the beginning of the week yields of Bunds and Treasuries rose a little after hawkish statement from ECB's representatives and a report release about low net capital flow to the US. Fed's decision increased market volatility, but did not provoke considerable changes on core fixed income markets.

▪ Treasuries' yields have noted a considerable loss after the release of the Philadelphia Fed index, and gave yields on the short end of the Treasury curve their biggest shove down in more than a year. We assume that the next move of Fed will be a cut already for a while. During the week, a fall of 10Y yields has occurred by more than 15bp (to ca. 4.60%) for Treasuries and 7bps (to ca. 3.70%) for Bunds.

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