

Weekly economic update

16 - 22 October 2006

The last week did not bring any clarification of the political situation, but everything tends to show there will be a solution at the beginning of the next week. After the postponement of the parliament session, voted in order to continue discussion about coalition of PiS and Samoobrona it seems we will come to a restoration of the old PiS-LPR-Samoobrona coalition. In the medium-term, this solution is not good from a perspective of economic policy as the participation of the populist Samoobrona to the coalition can appear to be expensive for the public finance, but in the short run, stabilization on the political scene can have a good impact on moods on the Polish finance market. Parliament session and voting on dissolving the parliament has been rescheduled for Tuesday and until that time, everything should be clear.

Macroeconomic data and NBP's report about economic situation in Q4 published during the last week confirmed the picture of current and expected economic situation. There is still high economic activity, a clear firming of the labour market conditions is taking place and price growth gradually accelerates. However, concerning inflation processes, CPI figures showed that they are still under control. Inflation in September was lower than expected and stabilized at 1.6%YoY just as in August. Although net inflation has, according to our forecasts, probably slightly rose, it still remains at a very low level (considerably below inflation target) and we do not expect it to reach the inflation target at least until the end of 2007. MPC members' declarations concerning medium-term inflation prospects were quite differentiated. However, it is hard to consider, based on these comments, that a majority in favour of swift rate hike exists in the Council. Some major domestic data published next week will be helpful to assess medium-term inflation prospects and as a consequence they will be a clue on further moves in monetary policy.

Economic calendar

| Time GMT | COUNTRY | INDICATOR (importance level*) | PERIOD | UNIT | FORECAST | | LAST VALUE |
|-------------------------------|---------|--|--------|-------|----------|-------|------------|
| | | | | | MARKET | BZWBK | |
| MONDAY (16 October) | | | | | | | |
| 12:00 | POL | Wages (H) | Aug | %YoY | 5.7 | 6.3 | 5.3 |
| 12:00 | POL | Employment (H) | Aug | %YoY | 3.5 | 3.5 | 3.5 |
| TUESDAY (17 October) | | | | | | | |
| 09:00 | GER | ZEW index (H) | Oct | | -20.0 | - | -22.2 |
| 09:00 | EMU | Final HICP (H) | Sep | % YoY | -0.3 | - | -0.4 |
| 12:30 | USA | PPI (H) | Aug | %MoM | 37.5 | - | 32.9 |
| 13:00 | USA | Net capital flow (H) | Aug | Bn | 82.3 | - | 82.4 |
| 13:15 | USA | Capacity Use (H) | Sep | % | 0.0 | - | -0.1 |
| 13:15 | USA | Industrial production (H) | Sep | % MoM | 0.0 | - | -0.1 |
| WEDNESDAY (18 October) | | | | | | | |
| 9:00 | POL | Auction of PLN1.5-2.5bn of 5Y PS0511 (H) | | | | | |
| 12:00 | POL | Industrial production (H) | Sep | %YoY | 10.9 | 6.3 | 12.5 |
| 12:00 | POL | PPI (H) | Sep | %YoY | 3.6 | 3.6 | 3.4 |
| 12:30 | USA | CPI (H) | Sep | % YoY | -0.2 | - | 0.2 |
| 12:30 | USA | House starts (H) | Sep | m | 1.633 | - | 1.665 |
| THURSDAY (19 October) | | | | | | | |
| 16:00 | USA | Philadelphia Fed index (H) | Oct | | 7.1 | - | -0.4 |

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

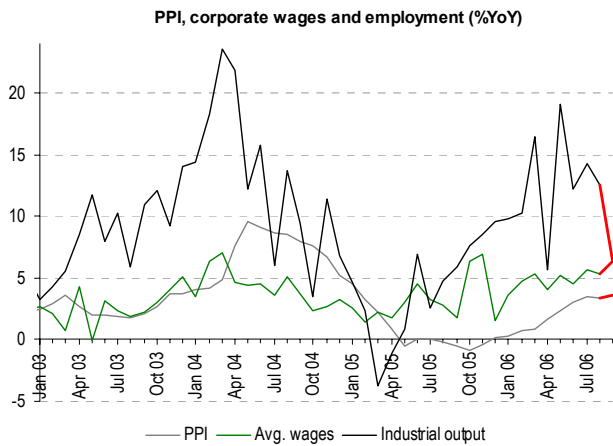
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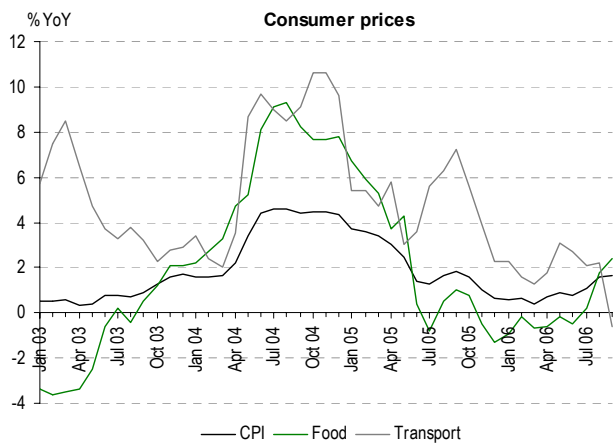
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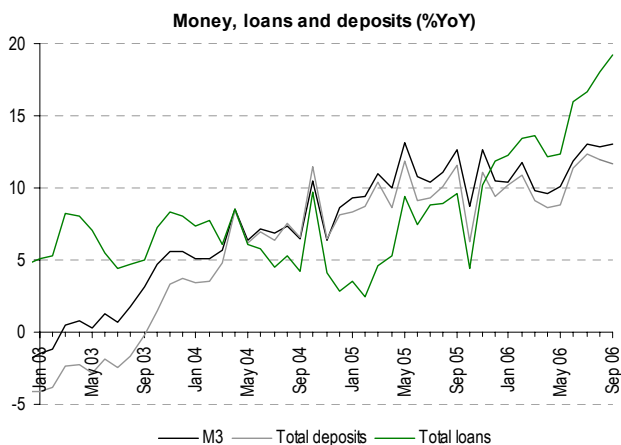
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What's hot this week – New coalition and a few major data releases

- Apart from settlements on the political scene, the next week will bring another portion of important domestic data, which will be clues concerning the strength of economic activity and inflationary pressures.
- According to our forecasts, wage rise in companies has accelerated again, but it was partly be due to low base effect and the wage growth rate in the next few months can be moderated. Nevertheless, firmer labour market conditions suggest the upkeep of fast consumption demand rise and will keep central bank's vigilance concerning threats to inflation from the labour market.
- September saw a sharp slowdown in industrial output growth in our opinion, but due to statistical effects (less working days) rather than to economic activity weakening. Sharp fall in fuel prices shown in CPI data suggests that PPI inflation may be lower than expected in September.

Economy last week – Picture of economic situation confirmed

- Consumer prices rose by 0.2%MoM and 1.6%YoY in September. Inflation stabilization, instead of slight rise predicted by the market, is due to lower than expected food prices rise and fuel prices fall.
- In other categories of good and services, price trends were quite stabile, though net inflation, according to our forecasts, probably slightly grew due to price rise acceleration in such categories as "housing and energy", "hotels and restaurants" and "other products and services". However, net inflation remains very low and will reach only 1.5% at the end of 2006 and 2.2% at the end of 2007.
- All in all, the data do not change medium-term inflation prospects and our expectations concerning MPC decision on interest rates.



- Current account deficit amounted to €610m which is much more than we assumed. Import growth remained higher than exports rise and trade deficit reached €453m. Moreover, surplus on current transfer bill appeared lower than expected. Cumulated C/A deficit in relation to GDP rose to 2.1% compared to 2% after July, but the level is still low considering high pace of domestic demand growth.
- Monetary statistics for September indicated economic activity remains strong. Money supply growth of 13%YoY and total credits growth of 19.2%YoY show that upward tendencies in the economy are maintained. What is important, revival of loans growth for companies remains in place (rise by 9.9%YoY, fastest in the past 5 years), which is a good sign for investment estimates.

Quote of the week – Discrepancies within the hawkish camp

Marian Noga; MPC member, PAP, 12 Oct

Until the end of the year, interest rates should remain at the same level and it seems that only January will be the first month in which we can consider a possible interest rate hike. (...) One cannot exclude such a situation, in which interest rates will remain unchanged in 2007.

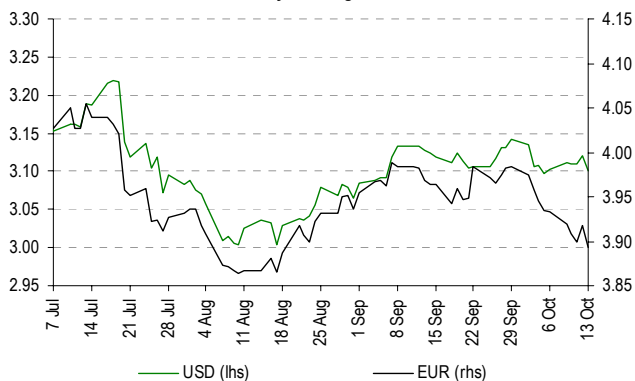
Halina Wasilewska-Trenkner, MPC; Reuters, 13 Oct

The October projection will be key. If it shows significant changes to the previous projection (published in July) then I think rates should be raised this year and most rate-setters on the Council will share this view.

Comments of hawkish MPC members show that there is no conviction within the Council about the need of fast rate raises. Although in Wasilewska-Trenkner's opinion the new inflation projection can convince the majority of the Council to vote for a rate hike already this year, even the "hawkish" MPC's Noga does not exclude that rates will remain unchanged not only this year but also during the whole next year. We keep the opinion that the likelihood of a raise this year is very small and that the Council will keep analysing the situation.

Market monitor

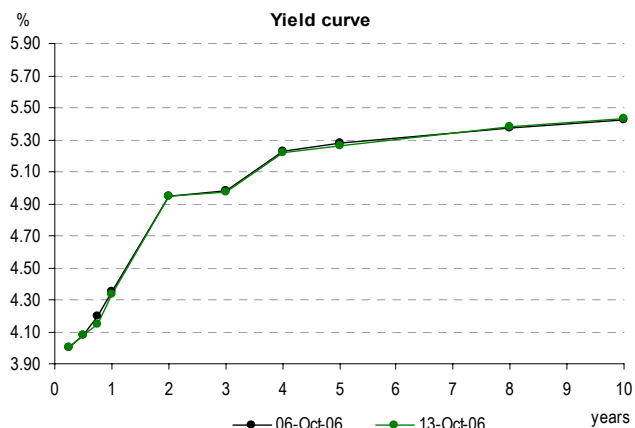
Zloty exchange rate



Zloty gains on improved sentiment in the region

- The zloty strengthening was continued also in the previous week. Polish currency was supported by the improvement of foreign investors' sentiment to the region (record high Slovak crown against the euro, forint appreciation) and inflow of the capital into the Polish bourse. Events in North Korea did not influence the emerging markets. The EURPLN rate broke 3,9 and fell during the week by 0,9%, and USDPLN by 0,3%.
- Polish currency will be under influence of foreign investors to the region, especially in the context of US inflation data releases. Postponed Sejm meeting should not significantly influence the zloty, while the vote on its selfdissolving may add some uncertainty. In our view EURPLN rate will fluctuate in range of 3.84-3.94, and USDPLN in 3.05-3.15.

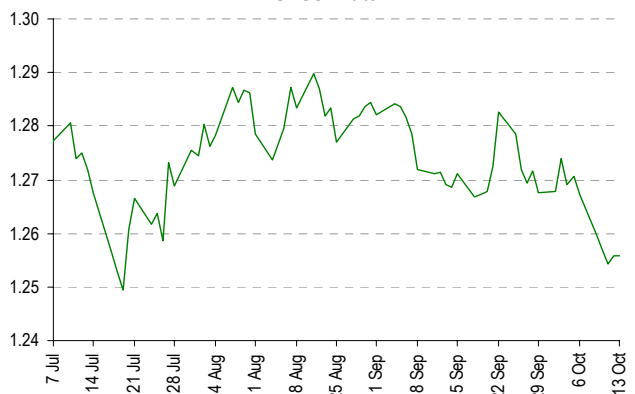
Yield curve



Bond prices stable

- Prices in the bond market did not change significantly and the market reacted mainly on the tendencies in the core markets. The debt weakened slightly after the 10Y bonds auction amid higher than expected inflation in Hungary. At the end of the week there was some strengthening among others after inflation data.
- The statements of the MPC members are as often divided and hardly allow to explicitly assess the monetary policy moves. We still assume the government bond prices are high amid rising inflation risk and very good economic data. Next week labour market statistics are going to be key factors influencing the expectations of potential rate hikes. Production data and situation in the core markets is going to be important as well amid many essential releases.

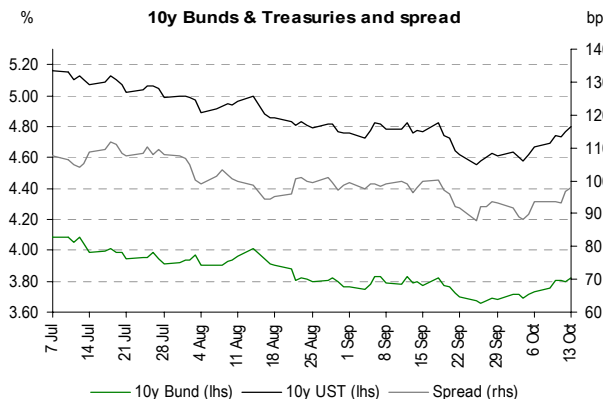
EURUSD rate



Strong dollar, low volatility of the EURUSD

- The dollar fluctuated in a narrow range against the euro during the last week and remained at a high level against the single currency slightly above 1.25. It happened, among other things, after the release of the FOMC minutes after the last Fed's meeting (concern about inflation), Beige Book (lack of signs of serious slowdown), and Fed members comments about growth and inflation as well as after the retail sales figure.
- In the nearest days US inflation figures and the housing data (expected falls) will be key for the dollar. Philadelphia index will also be of a certain interest as it had an impact on the market last month. In the euro zone, one should focus on the ZEW index and the HICP inflation, which lately started to fall.

10y Bunds & Treasuries and spread



Yields rise on core markets

- During the last few days a consequent weakening took place on the core markets in further reaction to good figures from the labour market published in the last week and after the FOMC minutes release, in which Fed's members expressed their concern about risks for inflation. This report and the Beige Book and retail sales data diminished expectations concerning a substantial slowdown of the US economy and rate cuts expectations.
- The next week abounds with international figures release, from which the most important will be CPI, PPI in the US, just as output data and Philadelphia index. Falling inflation can be a support for Treasuries. In the euro zone, ZEW index, HICP inflation and output data will be key.

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