

# Weekly economic update

30 July – 5 August 2007

In the last two weekly economic reports we wrote about a possibility of correction in the Polish foreign exchange market and finally it happened. Though one could have noticed some influence of domestic factors (no interest rate increase, continuation of political uncertainty), there is no doubt that, in line what we envisaged, the key factor leading to zloty depreciation was rising risk aversion on the global market and flight to quality. The EURPLN rate reached (or even temporarily exceeded) the level of 3.82, which we indicated last week as the upper end of the predicted trading range, but we think that the short-term zloty depreciation trend is not over yet. Therefore, we increase the range for EURPLN rate to 3.77-3.87 and at the same time we maintain the forecasted average rate for August at 3.82. We continue to expect medium-term appreciation (ca. 3.70 at the end of the year)

In the nearest future the risk aversion will be also the main subject in the fixed income market, which showed higher domestic yields despite the fact that yields in core markets recorded falls. Additionally, though statement released after the MPC meeting was not overly hawkish, we still think that next interest rate hike is well possible in August, which was confirmed by MPC members in their interviews. One should remember that May's communiqué did not suggest a rate hike either (while it actually took place in June) and that the MPC's decision will be data-dependent (while we predict clear rebound in output and sales growth and still strong wage growth, also for the whole economy in the second quarter).

## Economic calendar

Time GMT	COUNTRY	INDICATOR	PERIOD		FORECAST		LAST VALUE
					MARKET	BZWBK	
<b>TUESDAY (31 July)</b>							
9:00	EMU	Economic sentiment	Jul	pts	111.2	-	111.7
9:00	EMU	Flash HICP	Jul	%YoY	1.9	-	1.9
12:30	US	Core PCE	Jun	%MoM	0.2	-	0.1
13:45	US	Chicago PMI	Jun	pts	58.0	-	60.2
14:00	US	Consumer confidence index	Jul	pts	105.0	-	103.9
<b>WEDNESDAY (1 August)</b>							
<b>9:00</b>	<b>PL</b>	<b>Auction of 2Y bonds</b>					
8:00	EMU	Manufacturing PMI	Jul	pts	54.8	-	55.6
12:15	US	ADP report	Jul	'000	115	-	150
14:00	US	Manufacturing ISM	Jul	pts	55.5	-	56.0
<b>THURSDAY (2 August)</b>							
12:00	GB	BoE meeting – decision		%	5.75	-	5.75
11:45	EMU	ECB meeting – decision		%	4.00	-	4.00
12:30	US	New jobless claims		'000	310	-	301
14:00	US	Factory orders	Jun	%	0.9	-	-0.5
<b>FRIDAY (3 August)</b>							
8:00	EMU	Services PMI	Jun	pts	58.1	-	58.3
9:00	EMU	Retail sales	Jun	%YoY	0.7	-	-0.5
12:30	US	Non-farm payrolls	Jul	'000	130	-	132
12:30	US	Unemployment rate	Jul	%	4.5	-	4.5
14:00	US	Non-manufacturing ISM	Jul	pts	59.5	-	60.7

Source: Reuters

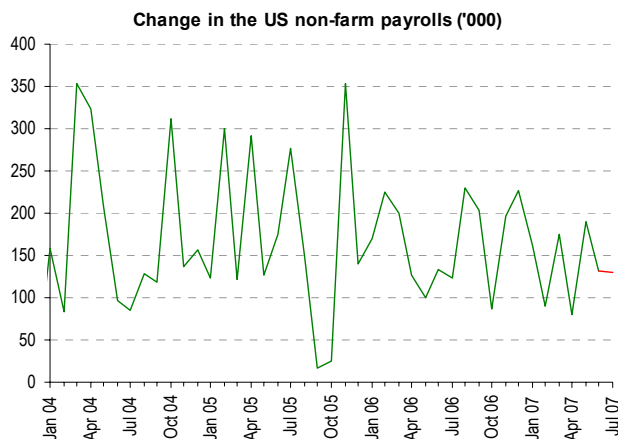
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**What's hot this week** – Nothing locally, interesting global markets

- The Polish financial market remains under significant influence of events in global markets and the key factor is the risk appetite. This is why the fact that no important economic events are scheduled for the upcoming week should not mean lower activity and lower volatility, as regards both the foreign exchange and fixed income markets. Additionally, high market uncertainty as regards future moves may be reinforced by political events.

- Next comments of MPC members will be important only after data releases. The announcement of inflation forecast of the FinMin for July will be important (we estimate 2.3%).

- In the international markets, US labour market figures will be the key. Also, many economic indicators (also for the euro zone) will be published and they will show to what extent problems in the housing market spill over in to other sectors of the US economy.

**Economy last week** – Summer recess**Element of July MPC statement (changes in different font)**

In the Council's assessment, in the next quarters economic growth will most probably continue to exceed the growth of potential GDP. The latest information on labour market developments points to a continuation of high wage growth and a deterioration in the relation between wage and labour productivity growth. A further build-up of wage pressure and, consequently, inflationary pressure is possible. **Nevertheless**, the Council assessed that in the medium term inflation growth may be curbed by **increase in productivity** ~~a continuation of high productivity growth~~, and very good financial standing of enterprises. **Inflation growth may be also constrained by** low growth of external prices, related to the monetary policy pursued by major central banks as well as the globalisation process and the ensuing **intensified rise** in competition in the market of internationally traded goods and services. ~~However, in the Council's assessment, the impact of those factors would be insufficient to keep inflation at the target level over the monetary policy transmission horizon. Therefore, the Council assessed the probability of inflation running above the inflation target in the medium term to be higher than the probability of inflation running below the target and decided to increase the NBP interest rates.~~

- The MPC decided to leave rates unchanged (reference rate at 4.50%). It was commonly expected by the market participants and did not result in a significant reaction.

- The statement released after the meeting did not determine the next rate hike will take place in August, so there is a chance that July's break will prolong into the next month. Interest rate market reacted in some weakening of expectations of a rate hike in August.

- However, one should remember that the Council does not exclude next hikes, as informal restrictive bias in monetary policy remains intact and probability as regards the timing of next moves may be assessed after next data publications.

- We continue to expect that the Council will deliver next 25 bp hike in August (and another one in 4Q07). We expect official rates to peak at 5.50% in 2008.

**Inflation projections (% YoY)**

	Jul 06	Oct 06	Jan 07	Apr 07	Jul 07
4Q 2007	1.5-3.5	1.9-3.8	2.1-3.8	1.3-2.6	2.3-3.3
4Q 2008	1.7-4.3	2.2-4.6	2.2-4.5	1.6-3.8	2.1-4.1
4Q 2009	-	-	2.4-5.2	2.1-4.6	2.1-4.5

**GDP growth projections (%)**

	Jul 06	Oct 06	Jan 07	Apr 07	Jul 07
2007	3.6-5.9	4.1-6.2	4.9-6.7	6.0-7.0	6.2-6.8
2008	4.0-6.6	4.5-7.0	3.6-6.4	4.0-6.3	4.3-6.7
2009	-	-	3.5-6.5	4.0-7.0	4.0-7.2

Source: NBP, Inflation Report – July 2007

Note: there is a 50% probability that the annual growth of GDP and inflation will be within the indicated ranges

- The level of inflation at the end of 2009 did not change as compared to the April projection, but path of CPI approaching to this level was increased. This is connected with higher food prices growth (trends in global food market, new assessment of crops, VAT increase in 2Q08, which probably will not take place) and stronger labour market recovery, which, according to authors of the projection, may not be balanced by the anti-inflationary influence of the reduction of disability pension contribution.

- The projection results and conclusions from the *Report* did not change monetary policy prospects. It is uncertain whether the MPC's members agree with the view that the effect of reduction of the disability pension contribution is anti-inflationary (it was one of the arguments in favour of the rate hike already in June), they may be sceptical also against other elements of the projection (e.g. weaker zloty in nominal terms)

**Quote of the week** – MPC data-dependant

**Sławomir Skrzypek, NBP governor; press conference, 25 July**  
*August is a very interesting month as far as data inflow is concerned.*

**Jan Czekaj, MPC member; PAP, 27 July**

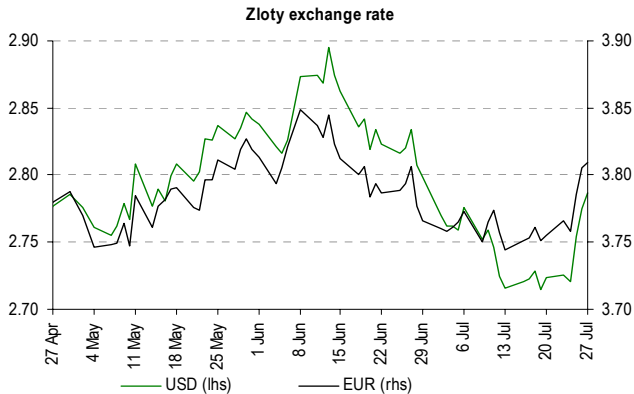
*If June's situation repeats in July [further wage growth and low growth in output maintained], the probability of interest rate hike in August would increase.*

**Halina Wasilewska-Trenkner, MPC member; PAP, 26 July**

*We still face uncertainty. If we were certain the hike would take place in July. There is no certainty and we will know more after data set, to be released in August.*

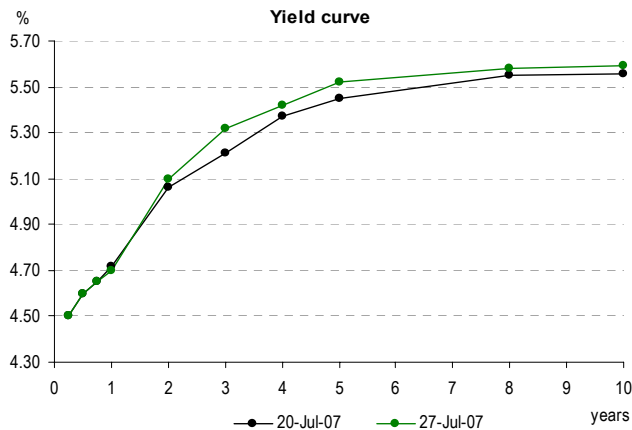
After the MPC meeting several interviews with MPC members were released. All of them have agreed that future decisions are going to be highly dependant on incoming data - Dariusz Filar emphasized the importance of the wages and net inflation data, Mirosław Pietrewicz pointed to data about industrial production, retail sales and unemployment, while Jan Czekaj emphasised the relation of wages and productivity and GDP data. It is worth noticing that almost all of them (including Mirosław Pietrewicz who is considered as one of the "doves") admitted that further interest rate hikes may be needed. Such comments support our base scenario presuming interest rate hike next month.

## Market monitor



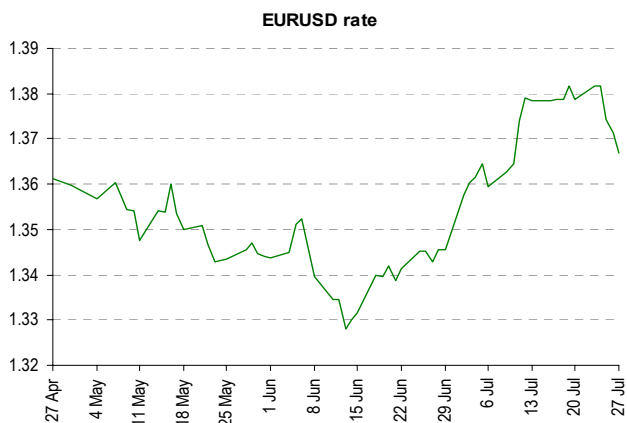
## Correction in the FX market ...

- There was a significant correction in the FX market in line with the view presented in our last report. Its main reason was rising risk aversion in the international markets. Zloty also did not find support in the MPC decision, which did not decide to raise interest rates in July. The EURPLN rate temporarily broke the upper band of forecasted range, i.e. 3.82 and afterwards it declined below this level. At the end of the week the USDPLN rate was traded near 2.78.
- We see potential for further weakening in the FX market amid holding situation of low appetite for risk, though it may be preceded by a short-term strengthening. We decided to increase the forecasted FX ranges to 3.77-3.87 for the EURPLN rate, and to 2.74-2.84 for the USDPLN rate.



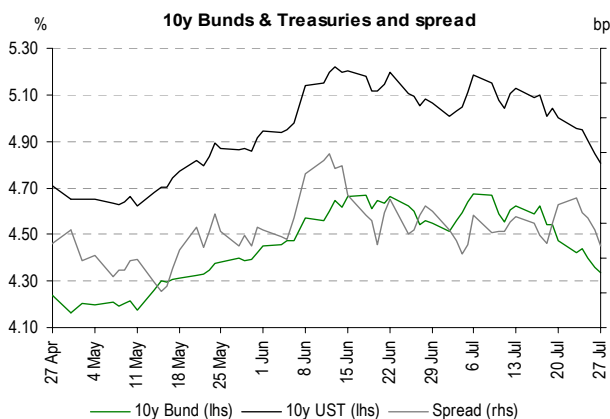
## ... and fixed income market on risk aversion

- An increase of risk aversion affected also the domestic bonds. Initially the debt market was quite stable and it even slightly strengthened after the release of the MPC communiqué, which did not determine the interest rate hike in August. However, at the end of the week the sell-off of the risky assets in the international markets contributed to higher yields and spread over the core debt markets.
- Despite the MPC communiqué, which was not too hawkish, we keep our baseline scenario presuming another interest rate hike next month, which may be supported by the comments of some of the MPC members and our forecasts assuming better data from the economy. The market is going to be under influence of the sentiment in the international markets. Thus bond yields may stay at relatively higher levels.



## Dollar recovery

- After a period of significant dollar weakening, which reached record-low level against the single currency, there was a sudden recovery of the US currency with regards to technical correction and limiting short positions in the dollar, which were connected with negative news from the US housing market. The EURUSD rate declined by 1.3% from ca. 1.383 to 1.365.
- The market expectations indicate that this week the Bank of England and the ECB are going to leave interest rates unchanged. The ECB's communiqué is going to be important and it may confirm expectations of rate hike in September. The dollar is going to be influenced by the data from the labour market, as well as activity indices, which may be also essential for the euro.



## Substantial strengthening in the core debt markets

- The fears over negative influence of the weakening in the US housing market to other sectors of the US economy led to return of expectations of interest rate cuts in the United States and higher risk aversion, which additionally strengthened core debt markets. Yields of 10Y Treasuries and Bunds fell to 4.77% and 4.31% against 5.00% and 4.50% in the previous Friday.
- After such significant collapse of yields the data from the US labour market may have some opposite negative influence. On the other hand, the ISM and PMI indices may show a slight decline. The communiqué of the European Central Bank is going to be the most important for the euro zone market.

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