Bank Zachodni WBK

Weekly economic update

4 – 10 August 2008

Although last week the zloty reached new high against the euro, EURPLN did not managed to break 3.20. There were a few corrections, but not on a large scale and maximum level of EURPLN during the week was 3.23. At the end of the week the zloty was at similar level versus the euro as a week earlier. At the same time, the domestic currency weakened to the dollar amid the greenback's strengthening in the international markets. We still think that potential for the zloty strengthening is running low and we expect more significant correction. An impulse for that may be a rate hike in the Czech Republic suggested in recent comment from Czech central bankers. Such a decision could weaken the zloty. Tone of MPC statement after its meeting last week and fresh comments from Polish central bankers showed that prospects for domestic monetary policy abroad are different than in Poland's southern neighbours. The MPC again included informal restrictive bias in the official statement. However, one should note that also a few new dovish elements appeared in the document, which lowers risk of more radical steps than in our scenario of rise in the reference rate to 6.25-6.5% in September and/or October. Arguments for further tightening will be increase in inflation and inflation expectations, which pose a threat of the second-round effects. Therefore, we think that fall in domestic yield curve continued last week may soon be reversed at least to some extent.

This week Polish bonds may be negatively affected by comments from the ECB, which in our view remains in hawkish mood. After a series of quite strong data from the US, the FOMC is also unlikely to be dovish. This may lead to increase in yields on the core markets and thus harm the domestic debt market.

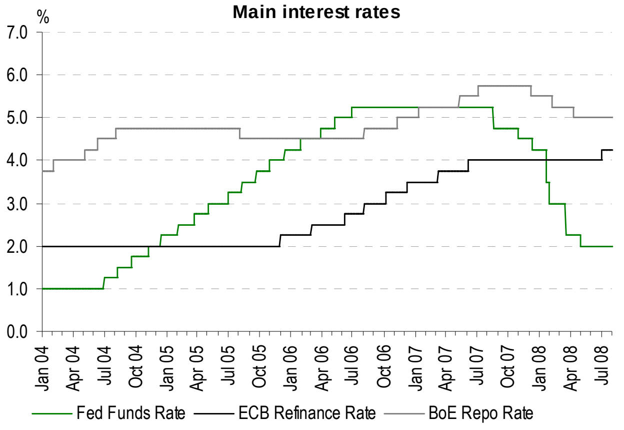
Economic calendar

Time GMT	COUNTRY	INDICATOR	PERIOD		FORECAST		LAST VALUE
					MARKET	BZWBK	
		MONDAY (4 August)					
9:00	**PL**	**T-bill auction: 26-week worth of PLN1.2bn and 25-week worth of PLN1.2bn**					
9:00	EZ	PPI	Jun	%YoY	7.9	-	7.1
12:30	US	Core PCE	Jun	%MoM	0.2	-	0.1
14:00	US	Factory orders	Jun	%MoM	0.7	-	0.6
		TUESDAY (5 August)					
8:00	EZ	Services PMI	Jul	pts	48.3	-	49.1
9:00	EZ	Retail sales	Jun	%YoY	-1.2	-	0.2
14:00	US	Non-manufacturing ISM	Jul	pts	48.5	-	48.2
18:15	US	Fed meeting – decision	-	%	2.0	-	2.0
		WEDNESDAY (6 August)					
	PL	**Auction of 2Y bonds worth PLN 1 - 2.5 bn**					
		THURSDAY (7 August)					
11:00	GB	BoE meeting - decision	-	%	5.0	-	5.0
11:45	EZ	ECB meeting - decision	-	%	4.25	-	4.25
12:30	US	New jobless claim	w/e	'000	420.0	-	448.0
14:00	US	Pending home sales	Jun	%MoM	-1.0	-	-4.7
		FRIDAY (8 August)					
12:30	US	Labour productivity	Q2	%	2.6	-	2.6
12:30	US	Unit labour costs	Q2	%	1.4	-	2.2
14:00	US	Wholesale inventories	Jun	%MoM	0.6	-	0.8

Source: BZ WBK, Reuters

Maciej Reluga Chief economist (+48 22) 586 8363
Piotr Bielski (+48 22) 586 8333
Piotr Bujak (+48 22) 586 8341
Cezary Chrapek (+48 22) 586 8342
e-mail: ekonomia@bzwbk.pl

What's hot this week – Decisions of central banks abroad

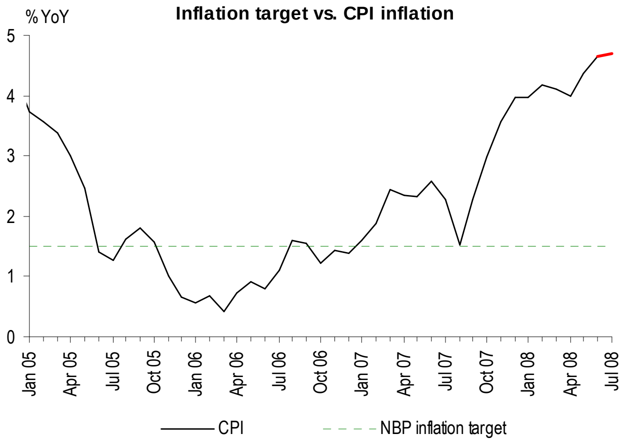


- As no local events apart from auction of bills and bonds are expected this week, attention will be focused on foreign markets, which will be mostly influenced by decisions of central banks.
- Recent signals from the ECB suggested that rate hike by 25 basis points made in July should be enough to bring inflation back to the target level. We think rates in the euro zone will remain unchanged until year-end, although the ECB will maintain hawkish rhetoric. US central bankers, as those from the ECB, have dilemma of simultaneous inflation rise and economic slowdown, which in our opinion will result in Fed rates kept on hold until year-end. As regards the Bank of England, we also expect rates to be kept on hold until the end of this year.
- The key for the Polish market may prove decision of the Czech central bank due on Thursday.

Economy last week – MPC not that hawkish as at first sight

Selected fragments of the MPC statement after July meeting
The Council assessed the probability of inflation overshooting the inflation target in the medium term to be higher than the probability of inflation running below the target. Therefore, the Council does not rule out that bringing inflation down to the target in the medium term would require further monetary policy tightening. At the same time, due to the persistence of shocks observed in food and commodity markets, bringing inflation down to the target level may take somewhat longer time.
In the Council's assessment, in the coming quarters the pressure on wage increases will probably persist, though the gradually slowing economic growth should be easing the wage pressure and, consequently, also the inflationary pressure.
This pressure may also be constrained by the slowdown in the global economy and, consequently, also in the Polish economy. The inflationary pressure may still be eased by the import of goods from countries with low production costs. The previous increases of NBP's interest rates will also have the same effect, as well as the rapid zloty appreciation observed over the past quarters, which in the recent period has most probably outpaced the appreciation of the equilibrium exchange rate.

- The MPC kept interest rates unchanged at its meeting last week. The post meeting statement of the Council was interpreted by the market as a hawkish one. This was connected with the fact that in the statement the MPC included again the phrase about the informal restrictive bias.
- However, it is worth to notice that a few new dovish arguments appeared as well in the document – influence of economic slowdown on easing wage and inflationary pressure, possibility that bringing inflation back to target will take longer time, strong zloty appreciation on the pace faster than appreciation of the equilibrium exchange rate.
- Although radical steps by the MPC become less likely, we do not change our view that after summer break the reference rate will increase to 6.25% or 6.50%, depending also on the development of economic situation abroad.



- In our opinion, the key factor which will persuade the MPC to continue monetary policy tightening will be further inflation acceleration and concerns about its possible effect on inflation expectations (according to the NBP, in July inflation expected by households in 12 months increased to 5.1%YoY from 4.3%YoY in June) and risk of the second-round effects.
- CPI forecast published on Friday by the Ministry of Finance pointed at rise to 4.8%YoY, which is in line with a median of market forecasts in *Parkiet* daily survey. FinMin assumes a drop in food price of 1%MoM and fuel price rise of 1%MoM (in our opinion –1.2%MoM and 0.1%MoM respectively). Our forecast for July's CPI is at 4.7%YoY, which results in stabilization of net inflation (CPI excluding food and fuel price) at 3.4%. In August, we expect CPI at 5.2% and its reduction afterwards.

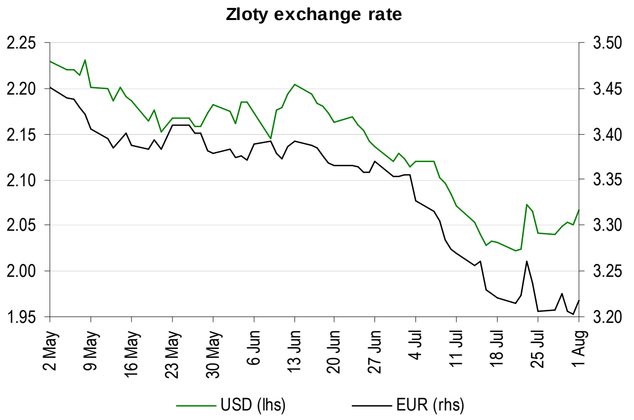
Quote of the week – We have never said that rate hikes cycle is over

Jan Czekaj, MPC member, Rzeczpospolita daily, 31 July

If wage pressure is decreasing, rate hikes will not be necessary. But we have never said that rate hikes cycle is over. Some of the Council members would like to wait and see what will happen in the Polish economy. So far we do not know, how deep the economic slowdown will be. (…) In Poland first symptoms of slowdown in industrial production, retail sales and pace of employment growth have been already observed. (…) It will be important at what level inflation will be in August when its peak is expected. But it will be important as well, if and to what degree inflation will go down in September. In my opinion, at this moment one should not predict when and what decisions will be made.

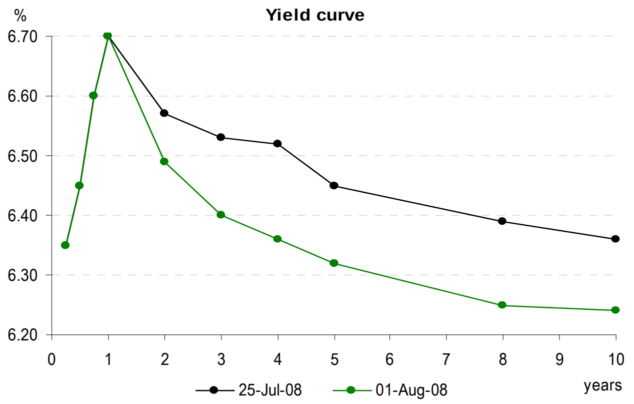
Statement by Prof. Czekaj, who always voted in line with MPC decision in recent years, indicates that as for now he is not sure what decision in monetary policy should be made, and he waits for progress of events. He stressed, however, that one cannot state that rate hikes cycle has ended. For him the key focus of attention in next months will be scale of economic slowdown and the level at which CPI inflation will peak in August. In our opinion inflation increase above 5% will persuade prof. Czekaj to opt for one or two rate hikes, in line with our forecast.

Market monitor



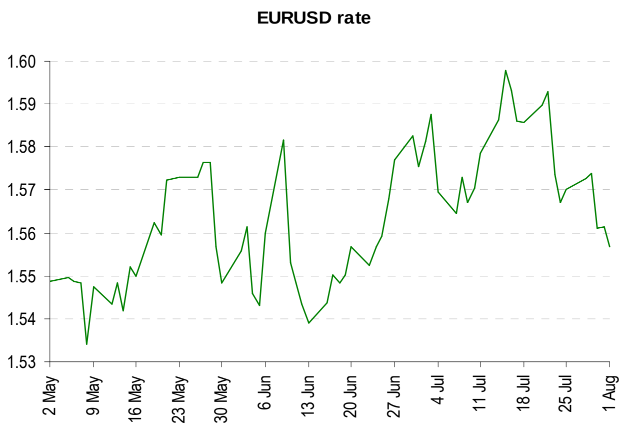
Zloty failed to break the level of 3.2 to the euro, again

- Last week was the second one in a row, when the zloty did not strengthen. During the week EURPLN reached new record at 3.2022, but in line with our view the level of 3.20 was not broken. Unsuccessful attempts to break it led to a few corrections, but their range was limited. In comparison with the end of the previous week, the zloty did not changed much against the euro and weakened to dollar due to fall in EURUSD.
- This week, local foreign exchange market will be watching events abroad, while the key focus of attention will be the Czech central bank's decision. If rates are really cut what the majority of the bank's Council members announced, currencies in the region may weaken, and the zloty as well. We maintain the expected trading range for EURPLN at 3.20-3.30 and for USDPLN at 2.00-2.10.



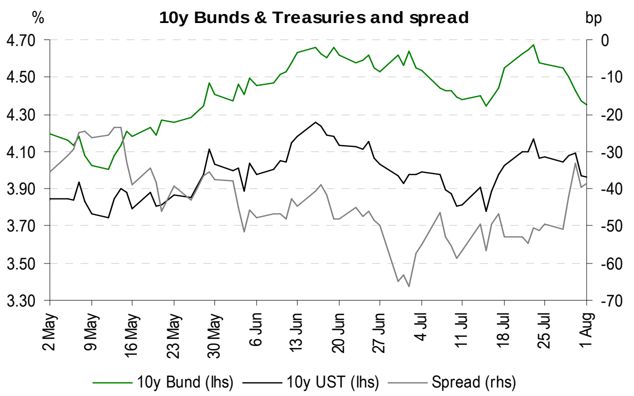
Further strengthening in local debt market

- July was very positive for the Polish bonds and the turn of July and August either. Lowering of the domestic yield curve was driven by local factors, i.e. decrease in rate hikes expectations influenced by stronger zloty and next indications of economic slowdown, and foreign factors like 'dovish' signals from the Czech central bank and significant strengthening in core debt markets. MPC official statement (interpreted by the market as 'hawkish') only resulted in a temporary correction.
- This week, local debt market will be affected by core debt markets driven by tone of the Fed and ECB statements and outcome of the Czech central bank meeting. It may affect the market's perception of the monetary policy in the whole region, including Poland.



Dollar stronger against the euro

- Last week brought continuation of the dollar's appreciation observed the previous week. Poor data on the euro zone's economy (PMI and EC economic sentient index) negatively affected the euro, while the rise in HICP to 4.1% was in line with expectations and neutral for EURUSD. The dollar was positively affected by better than expected data on employment, although some of the US labour market statistics were negative. The dollar appreciation was coupled with oil price drop. At the end of the week EURUSD was below the level of 1.56.
- At the beginning of this week, the dollar exchange rate against the single currency may be unstable while waiting for the FOMC meeting on Tuesday and ECB meeting on Thursday. However, if data from the euro zone and the US due for release on Monday surprise, they may move EURUSD rate as well.



Sharp decline in yields in core debt markets

- Core debt markets saw very significant strengthening last week. Yield of 10Y Treasuries and Bunds dropped by 10 and 22 bps, respectively. It happened despite increase in risk appetite and rising interest in stocks as fall in oil prices weakened concerns about inflation outlook. At the end of the week, 10Y Treasuries and Bunds were at 3.97% and 4.35%, respectively.
- This week, core debt markets will still be influenced by changes in oil prices and in risk appetite, but conclusions drawn from the Fed and the ECB statements and comments from the banks' officials will be the key factors. In our opinion the ECB will be 'hawkish' in rhetoric, which should negatively affect Bunds.

Additional information is available on request. Please contact Bank Zachodni WBK S.A. Treasury Division, Economic Analysis Unit, ul. Marszałkowska 142, 00-061 Warsaw, Poland, phone (+48 22) 586 83 63, email ekonomia@bzwbk.pl, http://www.bzwbk.pl