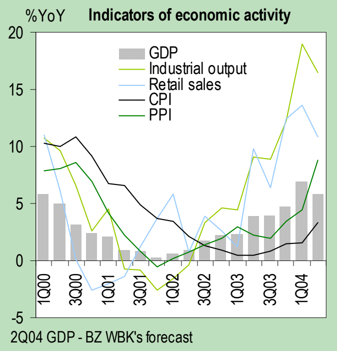
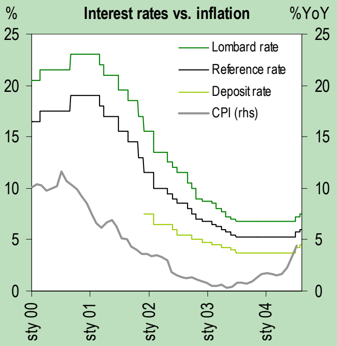
MACROscope

Polish Economy and Financial Markets

August 2004





The expected change

- **Last month we warned that July is an extraordinary month in Poland, during which changes on the finance ministry's post takes place unusually often**. And indeed, it turned out that it actually became a rule - finance minister Andrzej Raczko was replaced by Mirosław Gronicki. This time, however, a change in ministry's position was quite smooth, without any disturbances on the Polish financial market, as Gronicki's candidature was positively assessed by investors. We share such an opinion, although one should remember that finance minister will have to convince the cabinet and the deputies to his ideas of lowering budget deficit. And next year we will have parliamentary and presidential elections.

- **One of the tasks of the new finance minister, besides preparing budget for 2005, will be an increase in the transparency of fiscal policy**. Although, it is worth noticing that is hard to believe in his medium-term plans, given that we will see a government's change already next year. While in July's monthly report we focused on the issue of monetary policy transparency, in this month's *Special Focus* we analyse the transparency of fiscal and budgetary policies, as this problem is at least equally important as monetary transparency in Poland (or perhaps even more). Especially, that - as we have been repeating for a number of months - it is public finance sector area that creates the most significant risk for the stability of economic developments in Poland at the moment. Thus, it is worth considering to what extent the degree of fiscal transparency allows correct appraisal of this risk and for forecasting future developments.

- **The recently published statistical data confirmed that this year's economic growth will be high and inflation rate would be higher than expected earlier** CPI inflation jumped outside the tolerance band of the inflation target already in June, and it seems that inflation have risen even further in July. The data for output in construction and industry, as well as retail sales growth confirmed that though the GDP growth decelerated in 2Q04 as compared to 6.9% recorded in 1Q04, it is still very likely to remain robust at around 6%. The figures added to the list of arguments speaking for another interest rate hike, unlike the data from the labour market, which showed little more than a typical seasonal improvement. Also the growth in money and credit supply does not seem to signal any significant reinforcement of the inflationary pressure on the part of domestic demand related factors.

- **The Monetary Policy Council surprised financial markets again**. This time, by raising main interest rates, while majority of market analysts had expected the rates to be kept on hold. While we did expect a rate hike already in July, we were thinking that the scale of this move would be rather the same as in June (50 bps). We expect another decision of rates increase already in August.

Financial market on 30 July 2004:

NBP deposit rate	4.50	WIBOR 3M	6.41	PLN/USD	3.6299
NBP reference rate	6.00	Yield on 52-week T-bills	7.18	PLN/EUR	4.3759
NBP lombard rate	7.50	Yield on 5-year T-bonds	7.81	EUR/USD	1.2055

This report is based on information available until 11.08.2004

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Hazy landscape

Transparency? Yes, please.

Last month we focused on the issue of monetary transparency. We have tried to assess the transparency level of the monetary policy in Poland and to point out the improvements required in this regard. However, the economists' interest in transparency of economic policies does not boil down only to monetary policy area (although undoubtedly this is an area with the largest bulk of the writing and the practice to date). In the last couple of years, one could observe a significant rise in interest in transparency of fiscal and budgetary policies. Rapidly growing literature on this subject describes potential benefits arising from implementing transparent procedures and frameworks as regards planning and realisation of the budget, and points out to the solutions improving the transparency of fiscal activities. It seems that the problem of fiscal transparency in Poland is at least equally important as monetary transparency (or perhaps even more). Especially, that – as we have been repeating for a number of months – it is public finance area that creates the most significant risk for the stability of economic developments in Poland at the moment. Thus, it is worth considering to what extent the degree of fiscal transparency in Poland allows for correct appraisal of these risks and for forecasting future developments in this regard.

Is it really necessary?

Transparency of fiscal policy could be defined similarly as in case of monetary transparency discussed last month. It is a situation when the citizens and other economic entities receive clear, comprehensive, understandable information about the government's fiscal activities. Obviously it requires openness as regards decisions in public finance. Fiscal policy could be regarded as transparent if its rules, instruments, areas of competences, are clearly specified, if it guarantees that the participants and the observers of economic life get timely access to information and reliable data, that allow for receiving complete and understandable picture of the public finance sector.

Available economic research shows that improvement in transparency of fiscal policy could, similarly as in the case of monetary policy, bring about significant advantages. It could, among others, notably facilitate achievement of government's fiscal objectives, improve the control over public finances, reduce the cost of public debt servicing (e.g. by reduction of risk premium and correct communication of government's intentions to the financial market). Nevertheless, at the same it is worth remembering that introduction of transparent rules and principles is not a universal panacea for all problems accumulated in the public finance sector. Maintaining sustainable public finance requires – apart from ensuring readable and reasonable rules of communication with the economic environment – responsible decisions from the fiscal authorities, a determination and will for implementing necessary reforms, sometimes deep systemic changes, avoiding temptation to resort to short-sighted decisions for the sake of (often unpopular) solutions, profitable for long-term economic development. Although obviously, the fact of existence of transparent rules, allowing for monitoring government performance by the general public should reduce politicians' leaning towards such short-sighted actions.

Good standards, best practices

The interest in the issue of transparency in public finances has started to strengthen in the second half of the nineties. The first countries that decided to incorporate the frameworks emphasising fiscal transparency into their legal systems (in 1997-1998) were: Great Britain, Australia and New Zealand (interestingly, the same countries are also famous for the best transparency practices in monetary policy). Until now, the legal frameworks that they have established, can serve as benchmarks for other countries in this regard. Their experience has motivated continued economic research on this subject and provided a staring point for work on special codes of good practices in fiscal transparency. The best known codes have been drawn up and published by the International Monetary Fund (*Code of Good Practices on Fiscal Transparency*, IMF 1998, revised 2001) and the Organisation for Economic Co-operation and Development (*OECD Best Practices for Budget Transparency*, OECD 2001). Those two documents will serve as a frame of reference for our appraisal of fiscal transparency in Poland.

The table on the next page presents a breakdown of selected criteria of fiscal transparency (according to the IMF's code) for the countries that have just joined or are applying for the membership in the European Union.

... versus Polish reality

Obviously, our appraisal of transparency in Polish fiscal policy is by no means a pioneering work on this subject. Since 2001 the IMF presents periodical reports on the country's progress in implementing rules of fiscal transparency (so-called ROSC, i.e. *Report on Observance of Standards and Codes*, recently updated in June 2004). The issue is also discussed in annual OECD reports on Poland, and in numerous comments, articles and analysis

Observations on fiscal transparency

	Realistic annual budget	Budget documents include forward year estimates	Medium-term macroeconomic framework guides annual budget process	Budget documents include medium-term objectives	New and ongoing policy costs are distinguished in the budget	Analysis of fiscal sustainability / long term risks	Budget coverage: inclusion of extrabudgetary funds
Bulgaria	*	Yes – 3 years	No	Yes [3]	*	[5]	No [6]
Czech Republic	Yes	No [1]	Yes	Yes	Yes	[4]	No [7]
Estonia	Yes	Yes – 3 years	Yes	Yes	Yes	[4]	Yes [6]
Hungary	Yes	Yes – 3 years	Yes	Yes	Yes	[1]	Yes [6]
Latvia	Yes	No [1]	No	No [1]	No	[6]	Yes
Lithuania	Yes	Yes – 3 years [2]	Yes	No	No	[4]	No
Poland	**No**	**Yes – 2 years [2]**	**No**	**Yes [3]**	**No**	**[4]**	**No**
Romania	No	Yes – 3 years	Yes	Yes	No	[1]	Yes
Slovak Republic	Yes	Yes – 2 years [2]	*	Yes	No	[4]	Yes
Slovenia	Yes	Yes – 2 years	Yes	Yes	No [1]	[4]	No [6]
Turkey	No [1]	No	No	No	No	[6]	No [6]

* No observation
[1] Improvements are in progress
[2] Aggregate projections only (Lithuania and Slovak Republic aggregate projections are not in the budget document, but are sent to parliament with the draft budget)
[3] Objectives are stated in general terms only
[4] Analysis of long-term risks is done on an ad-hoc basis. In the case of Poland, some improvement was recorded in June 2003 update.
[5] Inadequate considerateion of fiscal risks in general
[6] Improvements reported since initial ROSC
[7] Extrabudgetary funds, hovewer, are approved by parliament and discussed at the same time as the budget

Source: William Allan, Taryn Parry *Fiscal Transparency in EU Accession Countries: Progress and Future Challenges*, IMF Working Paper No. 03/163, August 2003

made by domestic economists and institutes (e.g. IBnGR). From all the research completed so far, the following consensus seems to emerge: although in the last couple of years Poland has managed to make a significant progress in implementing and enhancing the rules of fiscal transparency, there is still a lot of headroom for improvement in many important areas while some of the existing solutions – putting it mildly – leave a lot to wish for.

A few positive elements

Let's start with more positive picture of the Polish public finance sector's transparency, looking at areas, where the level of transparency may be assessed as correct and matching international standards.

Legal environment binding for the public finance sector in Poland seems to quite solid. Although regulations concerning the transparency are not consolidated within one single act (as it is the case in the United Kingdom), and are very fragmented, being a part of many different acts, this is also the case in the majority of other countries. The Polish constitution and the Public Finance Act (as well as a few other acts and decrees being based on the two) drive the shape and functioning of public finance system. The Public Finance Act, accepted by the parliament in 1998, defines very clearly the limits of the public sector and sharing out of competences and responsibilities inside the sector. Unfortunately – as it was rightly stated in one of the reports of Gdańsk institute for Market Economics – the accurate definition of the public sector (included in the Public Finance Act), is in practice much less important, as it is not reflected in budgetary reporting, which does not take into account many funds and agencies being outside the central budget (more details below).

Fortunately, some improvement has been witnessed over the couple of recent years as regards the consolidation of public sector – a few government's agencies and funds were eliminated, and their tasks were taken over by ministries or other entities (in accordance with recommendations of international institutions). The plan of fiscal reform assumes further decrease in a number of outside-central-budget entities and their consolidation with the central budget. These activities are extremely important from the point of view of fiscal policy transparency, as they may contribute to higher government's control over expenditures of total public finance sector and to increased knowledge about the economic situation in the sector. However, despite some efforts, which have been already made, the area of public finance sector outside the control of the Ministry of Finance is still quite substantial.

It is worth noticing an improvement as regards transparency of tax system in Poland. A significant simplification of the system was observed during the last couple of years – a number of tax deductions and special allowances were eliminated in the personal income tax and corporate income tax, a harmonisation of VAT took place, VAT exemptions for enterprises employing disabled were replaced by direct subsidies, etc. To improve efficiency of tax administration, special office responsible for servicing large taxpayers were created, as well as service centres in majority of regional offices. The government made also efforts to ensure uniform procedures and interpretation of tax regulations in inland revenue offices (although further improvement in this regard is necessary).

There is a visible improvement in terms of availability of data and information concerning public finance sector, although it is still a subject of many reservations (see below). Data and documents are to larger extent available in electronic form in the internet (mostly on the Ministry of Finance's website). Unfortunately, again, this concerns mainly central budget statistics, which represents a fraction of total public finance sector. Also, availability is not usually going hand in hand with the clarity of information – we will talk about this problem also below.

Statistics of budget realisation are published on regular basis and their credibility is fine, to a large extent they are compatible with international standards. With assistance from the International Monetary Fund, the Ministry of Finance is working on the publication of public sector data on accrual basis, consistent with GFSM 2001 format (*Government Finance Statistics Manual*), and consistent with the EU methodology.

… but many shortcomings are still left

Unfortunately, there are also elements in the Polish system, which seriously darken the picture of public finances. One of the most significant problem is a lack of one, comprehensive and clearly defined measure of public finance stance. This causes that receiving timely, coherent and reliable information on the situation in the whole public sector is a serious problem. The most closely watched indicator, which attracts attention of the government, media and public opinion, is the state budget deficit. Meanwhile, it covers only a part of the whole public finance sector – particularly after the reform of local governments' finances increased the share of local governments in tax revenues, contributing to a desirable decentralisation of public finance. Besides, there are also other indicators of the fiscal stance being published (with different lag), including: the deficit of the public finance sector (for some time "the economic deficit of public finance" was used, but it was gave up recently), annual GFS account (calculated using IMF's *Government Finance Statistics* methodology), and public finance result, calculated in the national accounts system. The multitude of ideas surely does not make it easier to be at home in the actual condition of Poland's public finance, particularly that the measures yield different results (see table below), and none of the measures is consistent with the standards and good practices. What is more, there were changes in the way of calculations a few times recently, which significantly complicate, for instance, inter-temporal comparisons.

Various measures of stance of fiscal policy in Poland

(% of GDP)	1999	2000	2001	2002	2003
State budget	-2.0	-2.2	-4.3	-5.1	-4.8
General government (GFS basis)	-0.8	0.1	-4.5	-5.8	–
Economic balance	-2.9	-1.9	-4.5	-4.9	-5.2
SNA93 (including revenues of OFE)	-2.0	-2.5	-3.5	-3.6	-4.1
SNA93 (excluding revenues of OFE)	-2.4	-3.9	-5.0	-5.5	-5.7

Source: OECD Economic Surveys 2004 - Poland

In recent years, the government treated definitions of fiscal deficits quite freely, considerably changing the scope of information published in the official reporting. For example, the government transfers to open pension funds were excluded from budget spending, while contributions to the Social Security Fund maintained in budget revenues. Such solution (regardless of its rationale) distorted not only comparisons with previous years, but also distorted consistency between the deficit level and borrowing needs of the public sector presented in official documents. As a result, an analysis of fiscal policy required its observers to calculate adequate, comparable indicators of deficits on their own. Surely, this is a situation, which substantially constrains clarity of the government's fiscal policy. Meanwhile, both the IMF and the OECD recommended in their documents that any change in methodology or rules in budget accounting should not only be precisely justified and explained, but also revised indicators for previous years (in time series format) should be published to enable comparability and reliable analysis of budgets in different years.

Establishing an official, comprehensive headline measure of the fiscal deficit in Poland that could serve as a policy target and could be monitored and published regularly with a short time lag, has been a major recommendation advised to the government for a number of years by both mentioned organisations (IMF and OECD). Regrettably, little has been done so far to complete this task. However, the obligations enforced on Poland by the accession to the European Union might prove to be helpful in this regard. First of all, as a EU member state, staying outside the euro zone, we are committed to submit annual convergence reports (and bi-annual fiscal notifications) to the European Commission. Such report should consist of: a medium-term objective for the budgetary position of close to balance or in surplus, the adjustment path and the expected path for the general government debt ratio; the main assumptions about expected economic developments; a description of budgetary and other economic policy measures being taken and/or proposed to achieve the objectives of the programme; an analysis of how changes in the main economic assumptions would affect the budgetary and debt position.[1] This information must cover, as well as the current and preceding year, at least the following three years. Preparing a convergence report would require regular estimation of the level of fiscal deficit and public debt in line with the standard employed in the European Union, i.e. ESA95. This norm matches in practice all the requirements of fiscal transparency defined in the codes of good practices by the IMF and the OECD. Moreover, the new minister of finance Mirosław Gronicki declared recently that he would try to present a motion to change a Polish legislation in a way that the ESA95 standard would be binding also in the domestic budget reporting even since 2005.

Still, a large number of Polish institutions, agencies and funds, which are a part of public finance sector, is outside the area of budgetary reporting – despite some improvement, mentioned above, consisting in a gradual consolidation of these structure within the central budget. At the same time, these institutions administer a quite significant part of money – only Social Security Office (ZUS) and the rural pensions system (KRUS) receive in total some PLN50bn of subsidies from the central budget, and finance minister has a limited control of this amount. Additionally, Polish authorities quite often take quasi-fiscal decisions, which are not reflected in budgetary statistics, but have a significant impact of the stance of public finances. The example of such activities is public help in financing (or recapitalisation) state-owned enterprises via transfers of shares of listed companies or government treasuries. Also, recently accepted amendments to the law on public highways, which introduced a special fuel surcharge paid directly to the National Road Fund, managed by the BGK bank, seems to be inconsistent with the best practices of transparency.

As mentioned above, the discussion on fiscal policy in Poland is concentrated on the central budget, and not on the overall sector of public finances. What is more, the binding legal system obliges the government to execute central budget only and responsibilities for the deficit of the total public sector is not clear (limits of public debt to GDP ratio are a kind of limitation). This situation increases an incentive for fiscal authorities to push out some spending and deficit outside the central budget to other entities (funds, agencies) in a case of any risk of breaching the Budget Act. For example, it is a common practice that the Social Security Fund or healthcare funds increase their debt in the banking sector, as subsidies from the central budget are usually underestimated. Obviously, this does not increase fiscal policy transparency. OECD recommended that rigid rules concerning central budget should be replaced by a rule implying some restrictions on total spending of public sector. In the opinion of the organisation's analysts, such a solution would increase transparency and eliminate pro-cyclical element in the Polish budget at the same time.

As regards the state budget, it is worth to point to one more element, which raises serious doubts from the point of view of fiscal policy transparency. A budget draft for a given year is prepared on the basis of earlier accepted macroeconomic assumptions for the that year. The problem is that these assumptions seem to be questionable. Unfortunately, one can have an impression that they are modified depending on a current needs of the budget's authors, aiming, for instance, at creating some safety margin in the revenues level or imposing tighter limit on spending. The low accuracy of the finance ministry's forecasts is confirmed by ranking of predictions prepared since a few years by former speaker of the Lower House Marek Borowski.

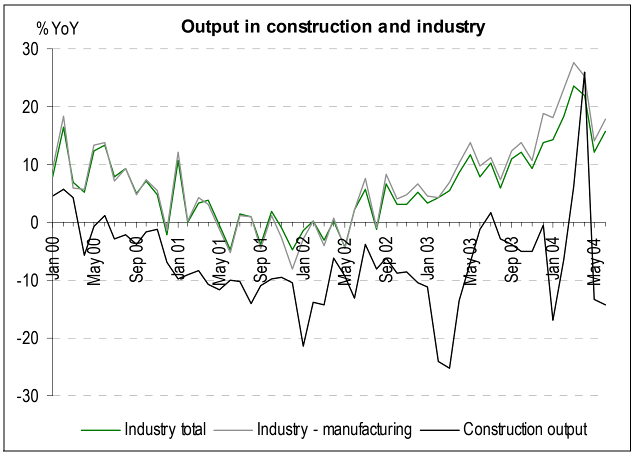
Amongst positive elements of the Polish fiscal policy, which increase its transparency, we have mentioned above the increasing availability to data and publication via websites of different ministries. However, one should also notice that the quality and intelligibility of information are far from ideal. The best example in this regard may be the plan of public finances reform prepared by the deputy Prime Minister, Jerzy Hausner. Documents included in the programme were commonly available (a special internet site was created), but the way financial effects of the plan were presented was totally blurred and caused confusion among local analysts and external observers. Well, it was even unclear for authors of the programme themselves. Let's remind that financial market participants were surprised a few times by deputy PM Jerzy Hausner, as he was quoted several times by giving different amounts of fiscal savings resulting from the reform programme.

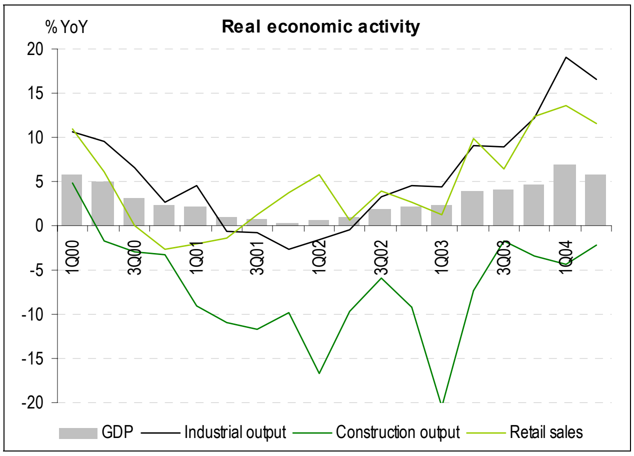
[1] European Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, Official Journal L 209 , 02/08/1997 p. 0001 - 0005

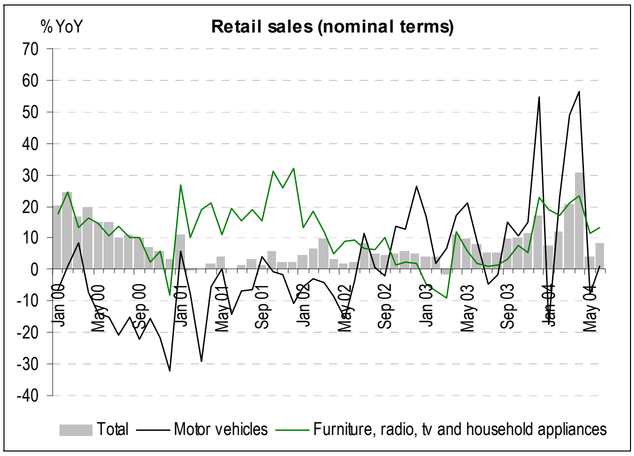
Landscape still hazy, although clearer and clearer

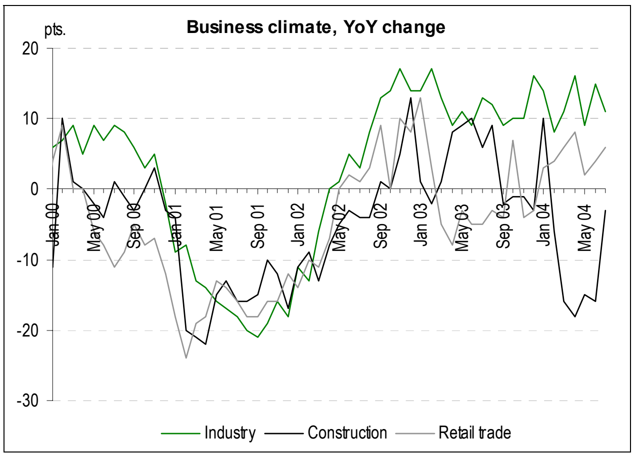
To summarise, despite a significant improvement observed in the last couple of years as regards an increase in fiscal policy transparency, we still we have many reservations regarding clarity of total picture of the Polish public finance sector. The list of negative aspects is long enough to assess the overall picture unenthusiastically. This problem is important, as we have written many times in the past that the situation in fiscal policy is the most significant risk factor for long-term development of the Polish economy. That is why, a correct diagnosis of the situation in this area is the key for both policy makers and financial markets participants. The EU accession creates some hopes for improvement standards and practices as regards fiscal policy transparency. Reporting standards imposed by the European Commission will force the Polish government to introduce rules of reporting consistent with the international standards, and will force higher publications' reliability.

Economic update









Source: CSO, BZWBK own estimates

Output growth back on fast track

▪ After distortions related to the EU entry, rate of growth of industrial output has returned to the previously observed upward trend.

▪ Sold industrial output grew by 15.7%YoY in June after a revised 12.2%YoY growth in May. Seasonally adjusted growth rate of industrial output was 13.6%YoY in June.

▪ The figures confirmed that despite post-accession deceleration in output growth rate (following extraordinary boom before the EU entry), strong rebound in Polish industry was continued.

▪ Likewise in previous months, the growth was driven mainly by export, but expansion was widespread in industry, which was reflected in the fact that a growth in output was recorded in as much as 25 out of 29 branches of industry.

▪ Meanwhile, indicators for industry remained poor. Output in this sector was 4.2% lower than in the analogous period of last year, against 3.3% annual drop in May.

▪ This suggests that improvement in investment activity is not rapid and remains rather moderate. However, taking into account that average rate of growth in the construction sector has been systematically improving for many quarters and in 2Q04 was the best since 1Q00, one can count on further gradual improvement in the subsequent quarters.

▪ The average growth rate of industrial output in 2Q04 amounted to 16.6%YoY after 18.7%YoY rise in 1Q04, and construction output in 2Q04 was on average 0.5% lower than a year ago, following 5.7% annual fall in January-March period.

▪ Such results of the economy, although not free from serious flaws (disappointing pace of recovery in construction) confirmed our forecast of economic growth for 2Q04 – we still predict that it reached nearly 6%YoY.

... and the same phenomenon observed in retail sales

▪ Retail sales grew 8.6%YoY in June, stronger than a mere 4.0%YoY rise in May. Although the results for these two months were not impressive compared to excellent February-April period, they confirmed that the upward trend in retail sales remained solid.

▪ Deceleration in growth rate in comparison with the pre-accession period was related to a large extent to a slump in new car sales. In other components, a healthy, two-digit growth rates were recorded. Excluding autos, retail sales rose nearly 10%YoY.

▪ Average growth in retail sales in 2Q04 was 14.4%YoY against 13.5%YoY rise in 1Q04. Although inflation in this period also considerably accelerated (to 3.3%YoY on average in 2Q04 vs. 1.6% YoY in 1Q04), which lowered retail sales growth in real terms, the pace of retail sales growth in recent months was another confirmation of high GDP growth in 2Q04.

Business climate survey bodes well for future

▪ The CSO's business climate indicators for July were optimistic for all sectors included in the survey.

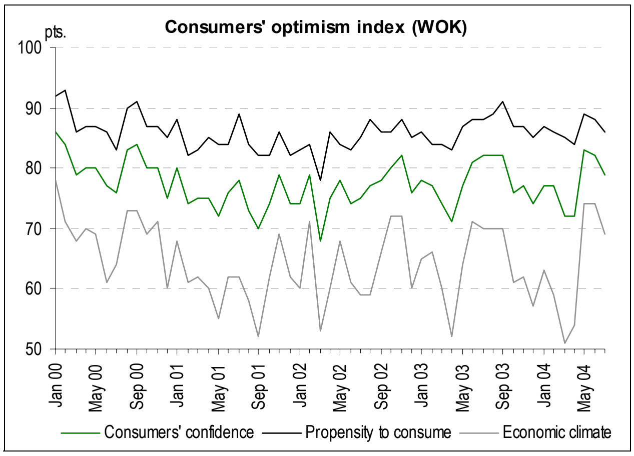
▪ The most distinctive improvement was in industry, but evaluation of business climate in July was in all sectors better than in the first half of the year. This applies to both levels and annual changes in indicators.

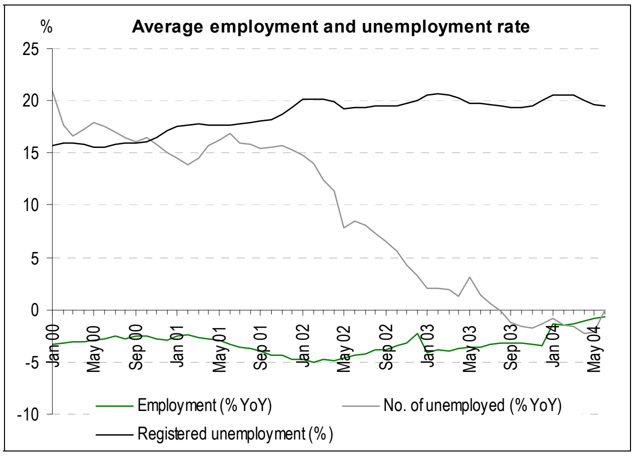
▪ Among impediments for economic activity, there was a rise in the role of uncertain economic situation, which suggested that enterprises might still be not willing to start new investments.

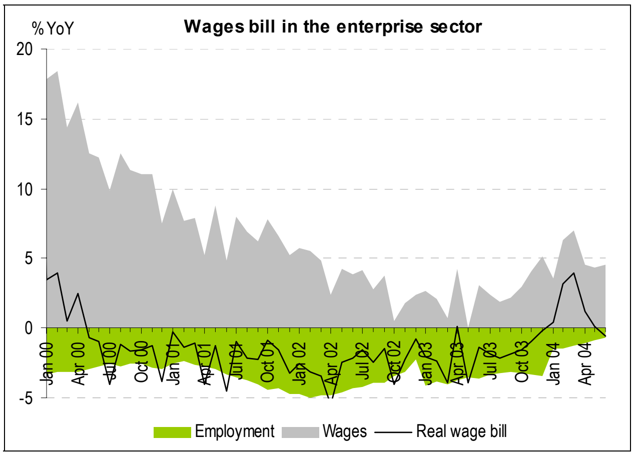
▪ However, there was an improvement in expectations regarding employment.

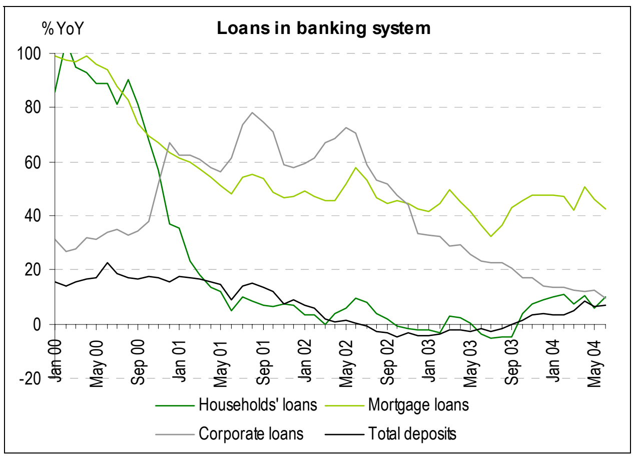
▪ Industrial enterprises predicted slower price increases than previously, but retailers still expected robust price growth.

Economic update









Source: CSO, NBP, BZWBK own estimates

... but consumer confidence is less encouraging

▪ Consumer confidence survey for July performed by Ipsos institute showed that households got over pre-accession boom.

▪ All three indicators calculated by the institute (overall optimism, propensity to consume, economic situation) lowered both on a monthly basis and in annual terms.

▪ This was the second consecutive month of a monthly drop in indices after the significant improvement observed in May.

▪ What is important, July saw a reduction in households' inflation expectations (on a larger scale than the size of growth in inflation expectations in the beginning of this year was observed).

▪ The central bank's measure of inflation expectations for July showed an increase. The divergence is related to the methodology used by the NBP.

Slight improvement in labour market conditions

▪ The registered unemployment rate fell to 19.5% in June from 19.6% in May. Although monthly drop was of seasonal nature, it is worth noticing that, like in the previous month, the unemployment rate was also 0.2pp lower than in the analogous period of the previous year.

▪ According to the Ministry of Social Policy, the registered unemployment rate in July declined to 19.3% in. The ministry expects the downward tendency to be continued in future.

▪ Our predictions indicate that after drop in the unemployment rate below 19% in September-October, it will again start to rise due to seasonal effect in the two last months of the year.

▪ We expect that at the end of the year it will reach 19.2% and will further ease to 18% at the end of 2005. In the subsequent years, a continuation of gradual decline should is expected.

▪ Average wage in the enterprise sector rose 2.2%MoM and 4.5%YoY in June, while average employment inched up 0.2%MoM, but was still 0.7% lower than a year ago.

▪ June was the third consecutive month of a monthly rise in employment. This happened for the first time since early 1998 and one can hope the positive trend will be continued in the nearest future.

▪ Meanwhile, wage increase turn out to be quite moderate, particularly taking into account simultaneous, strong rebound in inflation rate. This shows that persistently high unemployment still constrains wage claims, which helps to keep wage-price spiral under control.

▪ Wage bill in the enterprise sector rose 3.8%YoY in nominal terms. However, quickly accelerating inflation caused that wage bill in real terms was 0.6% lower than a year ago (for the first time this year).

Nothing new in monetary statistics

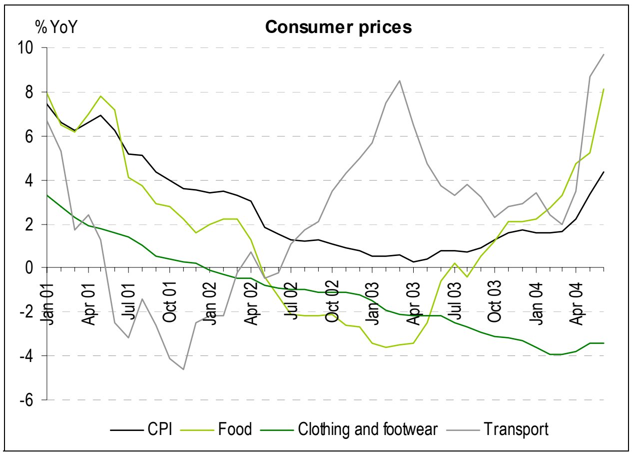
▪ In June, broad money supply M3 rose 1.1%MoM and 6.6%YoY against 6.4%YoY increase in May, which was exactly in line with our forecast.

▪ There were no surprising changes in the figures, tendencies observed in previous months were maintained.

▪ All in all, monetary statistics did not show any signs of possible inflationary pressure. Stagnation in corporate borrowing and a continuation of huge increase in their deposits suggest that enterprises are still reluctant to spend money on new fixed investment.

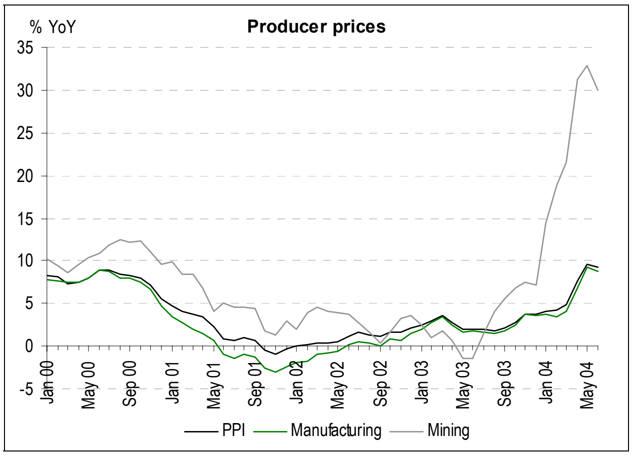
▪ At the same time, there are also no signs of consumption boom, as growth in households' borrowing results almost entirely from huge increase in mortgages.

Economic update



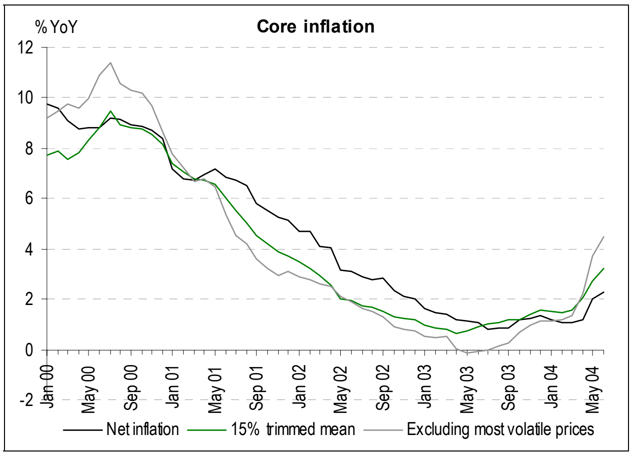
CPI glides up in the air

- June saw another significant acceleration in consumer inflation to 4.4%YoY from 3.4%YoY in May. The acceleration was again strongly related to effect of Poland's entry to the EU.
- This time the main inflationary impulse were food prices, which grew due to high demand for Polish foodstuffs from other member countries after elimination of trade barriers since May 1.
- Fuel prices, although 0.6% lower than in May, also remained one of factors pushing annual inflation up, as their monthly rise in June 2003 was much deeper than this year.
- We forecast the CPI will again increase in July and August, but in the next months it should gradually ease, mainly due to a fall in food prices (agriculture output is estimated to be much better than a year ago). However, annual inflation at the year-end should still be close to 4% (above the MPC target of 2.5% +/-1pp).



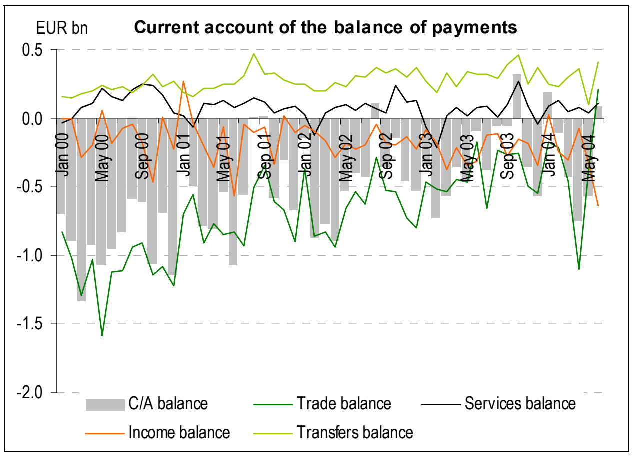
... but upward trend in PPI stopped (at least for a moment)

- Producer prices fell 0.2%MoM in June and were 9.2% higher than a year ago. Thus, the annual PPI slightly decelerated from 9.6% in May.
- Monthly fall in prices was seen in case of oil products (-5.6%), tobacco products (-1.3%) and mining (2.1%). On the other hand, June saw a significant rise in food and beverages prices (2.4%), which was probably related to increased demand for Polish food after the EU entry. Other categories of prices were roughly stable.
- The figures confirmed that pressure on prices, which strengthened recently, stemmed mainly from exogenous factors such as supply shocks and one-off rise in foreign demand after EU accession. However, oil prices reaches another highs in August, which suggests producer prices growth may remain at high level for a longer period of time.



Core inflation up, but the main measures still low

- In June, all measures of core inflation followed CPI and recorded increases. The two most important indices - net inflation and 15% trimmed mean - were in line with our expectations and grew to 2.3%YoY and 3.2%YoY, respectively.
- The remaining three measures were much higher. CPI excluding controlled prices rose to 4.5%YoY, CPI excluding the most volatile and fuel prices grew to 3.8%YoY and CPI excluding the most volatile prices jumped to 4.5%YoY.
- All in all, the data on core inflation (particularly net inflation, which was still below the central bank's inflation target of 2.5%) confirmed that recently observed significant acceleration of inflation is caused by high food and fuel prices, while underlying inflationary pressure is not necessarily very strong.

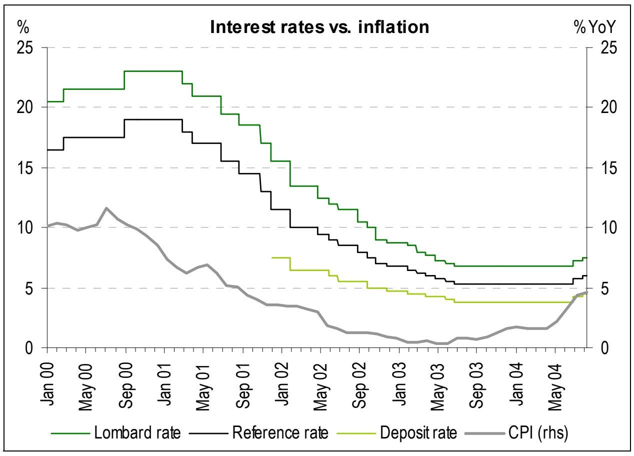


Delusive balance of payments figures

- Balance of payments figures for June showed trade surplus (€203m) and C/A surplus (€83m), but they are likely to be considerably revised in future amid problems with data collection after EU accession.
- Significant revision was made in case of May's data. While a month ago the central bank estimated that there was €234m C/A deficit and €38m trade gap in May, new estimates showed the deficits were above €300m wider and amounted to €568m and €379m, respectively.
- Due to the scale of revisions and unreliability of tentative data, one has to analyse recent balance of payments figures very carefully. However, one conclusion seems to be valid: external position of the Polish economy is still very favourable.

Source: CSO, NBP, BZWBK own estimates

Central bank watch



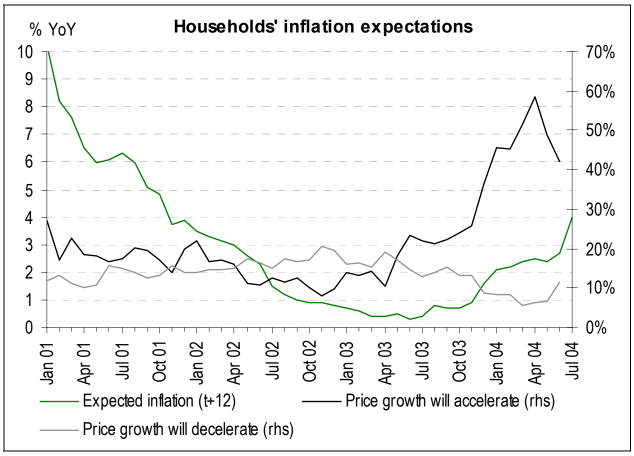
The MPC likes shocking – in July another surprise

- The MPC surprised financial markets again. This time, by raising main interest rates, while majority of market analysts had expected the rates to be kept on hold.
- While we did expect a rate hike already in July, we were rather thinking that the scale of this move would be the same as in June.
- According to the MPC, increase in rates was necessary in order to ensure that observed inflation upturn was temporary and that the rate of inflation returns to the MPC target (2.5%).
- We expect interest rates hikes to be continued and we forecast 50-75 bps until year-end. We predict the peak in official rates next year at 7.0-7.5%.
- The next move already in August. Its scale will depend on the next set of macroeconomic indicators (especially wages).

Important elements of the MPC statement from 28 July 2004
The acceleration of inflation was foremost a result of the increase in the price of fuel and foodstuffs, an increase in tax rates for indirect taxation and other factors connected with Poland's EU entry, including an increase in the demand for Polish foodstuffs. An increase in all the inflation measurements in the last few months is accompanied by a significant increase in household inflationary expectations, of entrepreneurs and traders.
The data on economic activity in June confirms a high economic growth rate.
A significant growth in inflation expectations together with an increasing likelihood of maintaining high economic growth increases the risk of persistent higher inflation. The salaries growth rate in the economy will be a significant factor in the formation of future inflation.
Endeavouring that the increased inflation above the upper limit of permissible deviations from the inflationary target has a transitory character and that, after the expiry of transitory factors, inflation should return to a level that is in conformity with the inflationary target of the MPC (2.5%), the Council has decided to raise the NBP rates by 0.25 pp.
Monetary policy is conducted with a lax fiscal policy and a lack of clear perspectives as to the scale of reforms, which could lead to the recovery of public finances.
Within the last two months, a significant zloty strengthening too place, which – if maintained – will be a factor supporting low inflation.

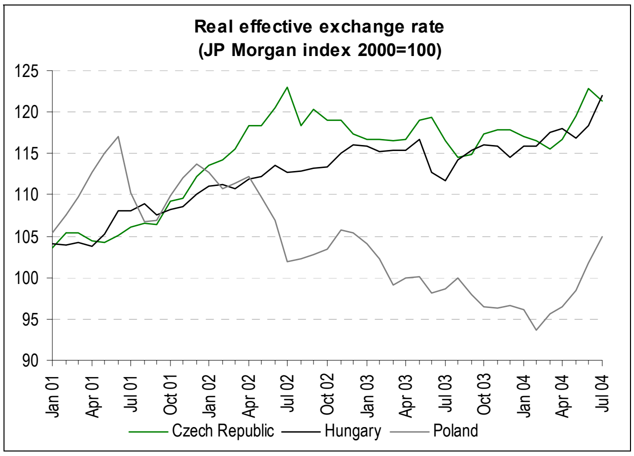
The same justification of the decision. So why lower scale?

- The NBP president's statement (details on the next page) that the decision was an outcome of the voting procedure typical for collective bodies, suggested that, likewise many times in the past, the scale of interest rate rise was a result of a compromise between opposing factions in the polarised Council.
- The lower scale of central bank's reaction in July might have also resulted from the high degree of uncertainty, which the NBP is facing in current economic situation, but a return to more decisive moves cannot be ruled out.
- The MPC is highly worried that temporary and exogenous shocks affecting inflation could be reinforced by domestic factors, so any strong revival in the pace of wage growth, would make the return to 50bps rate hikes more likely.



Inflation expectations – rising or improving?

- As usual, after taking decision on interest rates, the central bank published inflation expectations data for July (a sharp increase to 4% from 2.7% in June), and detailed structure of households' expectations for June.
- Interesting fact is that the measure of inflation expectations increased in June despite the structure of answers was actually improving. The same situation took also place already in May.
- The ratio of people expecting prices to rise faster over the next 12 months fell to 42.3% in June from 48.7% in May (58.5% in April). At the same time the ratio of those who predicted slower growth in prices rose to 11.6% in June from 6.7% in May and (6.1% in April).
- Such structure of answers could mean that second-round effects of price growth did not appear yet.



Source: CSO, NBP, BZWBK own estimates

Not only higher rates affects monetary policy restrictiveness

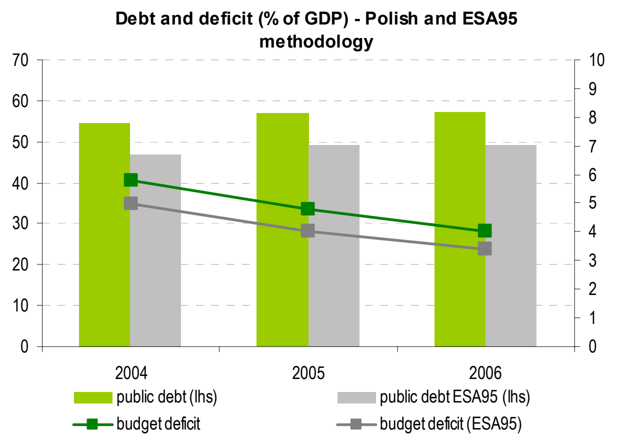
- For the first time since the couple of months, the MPC mentioned exchange rates as a factor supporting low inflation.
- And indeed, the overall restrictiveness of monetary policy rose not only because of increasing interest rates, but it was also influenced by sharp zloty appreciation.
- Real effective exchange rate strengthened by 6.6% in June-July period (since January by close to 10%), which was much more than in the case of Hungarian forint and Czech crown.
- This appreciation may be perceived as a recovery after last year's sharp drops in the value of the Polish currency (by 8.4%).
- In the medium-term perspective, we continue to be optimistic about zloty prospects, but at the same time we maintain our view on temporary zloty weakening in autumn this year amid political and fiscal worries.

Central bank watch

Comments of the central bank representatives	Remarks
Leszek Balcerowicz, prezes NBP; press conference after MPC meeting, 28 July The central bank is not sure enough that CPI will be at its local maximum in July. Factors being responsible for inflation increase are temporary, but it is important to avoid their long-term influence. [Q: why the hike of 25 bps only?] The MPC is a collective body and the decision in an outcome of the procedures, which are binding. [Q: What was the outcome of the MPC meeting with government representatives?] Very good meeting in terms of atmosphere. The government agreed that the MPC has to bring inflation down to the inflation target. Strengthening of the zloty is a factor supporting low inflation. But the zloty is still weaker than the level, which could negatively affect exports.	The direction of the MPC's move, as well as its justification were consistent with our prediction. NBP president Leszek Balcerowicz was questioned about this during the press conference after the meeting. His answer, shown in the left-hand column, suggested that, likewise many times in the past, the scale of interest rate rise was a result of a specific votes decomposition within the MPC. Also, MPC members answered very interestingly to the question concerning the outcome of the MPC meeting with government's representatives. While NBP chief said that the government concentrated on inflation and said that both sides agreed that NBP inflation target's realisation is very important, the other MPC member presented completely different priorities.
Krzysztof Rybiński, deputy NBP governor; Radio PiN, 2 August In the inflation projection that was presented in May we clearly said that it is very likely, with over 50% probability, that inflation in 2005 may go beyond the upper limit of acceptable deviations from the inflation target, that it may be above 3.5%. And since that time the structure of pro-and anti-inflationary factors favoured a higher inflation. Nevertheless, please remember that we are talking not about a forecast but about a projection. The NBP prepares inflation scenario providing unchanged level of interest rates. However, the MPC, being aware of inflation threats, can influence the economy and inflation with interest rates, so that the inflation did not deviate from the target so much but it returned to it within a certain period.	Deputy NBP governor confirmed the central bank would publish inflation projection for the first time in late August. Undoubtedly, this will be another argument for the hawkish faction within MPC, as the inflation projection was increased in comparison with the previous forecast (not published, but described in May's inflation report). Possibly, with the arguments of worsening inflation prospects and higher inflation expectations (their central bank measure will rise for sure, as it will be based on June's CPI figure), it will be easier to convince members supporting 25 bps hike (or no hikes at all) that rates increase should be more significant. Additionally, the NBP published quarterly report on business climate (the MPC knew it already in July), which indicated ongoing economic recovery with some job creation, high utilisation capacity and increasing inflation expectations. What is interesting, report showed that rising prices are the most important impediment for enterprises' activity.
Dariusz Filar, MPC member; Rzeczpospolita, 2 August Central banks' experiences from the past years show that this period [of increasing rates] could well last ca. three years, resulting in interest rate rise by 5 pct. points in 7 steps (Switzerland, 1989-1991), or no more than one year with 7 steps totalling 2.25 pct. points (euro zone, 1999-2000). It all depends on the local entry conditions and how they develop. PAP, 4 August If such projection [as presented by Rybiński] is likely it can be a more serious challenge for the MPC. 25-bps rate hike at recent meeting resulted from certain distribution of forces within the MPC. Bigger amounts of raises or a sharp hike cannot be ruled out. Taking into account that neutral real interest rate is at ca. 4% we can imagine at which level the nominal rate should be.	At the beginning of August, Dariusz Filar was present twice in the media – he published the article in Rzeczpospolita daily and gave an interview for Polish Press Agency. In both ways, he suggested a possible scale of monetary tightening in Poland. Firstly, he presented the recent experience of other central banks, which showed the cumulative rate hikes in the tightening cycle amounted from 2.25pp to 5.0pp. According to Filar, this was one of monetary policy characteristics, which should be closely watched to envisage a possible timing and scale of interest rate hikes. Secondly, the MPC member showed an estimation of neutral real interest rate (4%), which was also supposed to give a hint on possible scale of an increase in nominal rates. Taking into account that Dariusz Filar is one of the hawkish MPC members, we think that his statements confirm our expectations as regards the scenario of NBP reference rate in the following quarters – an increase to 7.0-7.5% in 2005 (cumulative hike since the beginning of the cycle of some 2pp), with a possibility of a return to 50bps moves (possibly already in August).
Marian Noga, MPC member; press conference after MPC meeting, 28 July [Q: What was the outcome of the MPC meeting with government representatives?] The leitmotif of the meeting was a determination to maintain high GDP growth rate in the two following years.	According to Marian Noga, the leitmotif of the meeting between MPC members and the government was not a will to maintain low inflation. To astonishment of press conference's participants (at least some of them), he said that the most important for both NBP and the cabinet was to maintain high GDP growth rate in the two following years.
Stanisław Owsiak, MPC member; PAP, Reuters, 16 July Sometimes it is better to wait two or three months and then react decisively. Sometimes an increase of 25 basis points may not have any impact at all on inflation and inflation expectations.	Before July's meeting Stanisław Owsiak suggested it would be better to wait a bit before raising rates, and also that hikes should be significant enough to cap rising price pressure. Well, it turned out that the MPC did not wait with a hike and, what is more, the MPC did not decide to act decisively. Results of July's voting may be very interesting.
Andrzej Sławiński, Andrzej Wojtyna, MPC members; joint article in Gazeta Wyborcza , 21 July The pace of inflation depends in large part on currency exchange rates. Meanwhile, there are many signs showing that the trend of the zloty exchange rate has just reversed. There is no simple answer to how to conduct monetary policy when inflation is driven largely from fuel and food price increases.	In the MPC statement after July's meeting, the Council, for the first time within couple of months, mentioned exchange rate as a factor potentially supporting low inflation in the future. This element was also visible earlier, in the article of two MPC members, in which Sławiński and Wojtyna recognised that exchange rate trend had reversed. They also emphasised high uncertainty in conducting monetary policy when inflation increase is connected mainly with supply shocks.

Government and politics

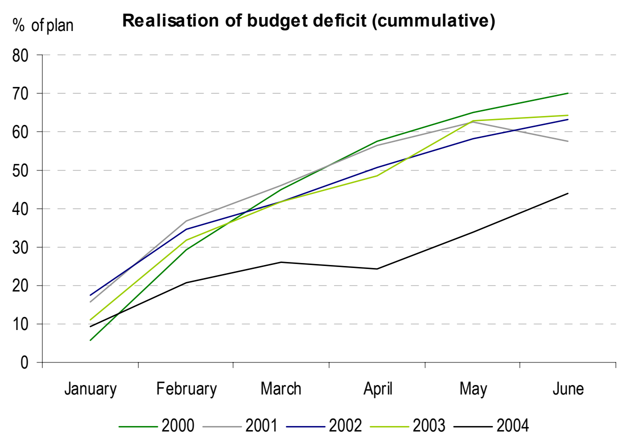
New faces in the Ministry of Finance	
Name	**Description**
Mirosław Gronicki, Finance Minister; PhD in economics, former unofficial advisor of Economy Minister Jerzy Hausner, expert of independent research institute, chief economist of Millennium Bank	An advocate of public finance reform and lowering budget deficit and public debt ratios to GDP. However, he judges an excessive reduction in deficit as unnecessary from the point of view of future economic growth. Gronicki's statements from the couple of last weeks may be found on the next page.
Stanisław Stec, Secretary of State in the Ministry of Finance, replaced Wiesław Ciesielski, SLD deputy, vice-chief of public finance committee, a candidate for the Monetary Policy Council member in January 2004.	According to *Rzeczpospolita* daily, Stec was an author of idea to increase the tax-free amount for the poorest and he was a supporter of the introduction of clear-cut interpretation of tax law in Poland. Asked about his plans in the Ministry of Finance, he said he would like to improve the collection of taxes.



Financial effects of the new pension bill

	Change in indexation mechanism	Elimination of "old portfolio"	Total
2005	-4.5	+0.5	-4.0
2006	-2.2	+1.0	-1.2
2007	-5.2	+1.5	-3.7
2008	-3.5	+2.1	-1.4
2009	-7.2	+2.8	-4.4
2010	-5.5	+3.6	-1.9
2005-2010	-28.1	+11.5	-16.6

Note: "+" denotes costs, "-" denotes savings



Source: Ministry of Finance, Ministry of Social Policy

We told you so - new finance minister in July!

- Last month we warned that July is an extraordinary month in Poland, during which changes on the finance ministry's post takes place unusually often.
- It turned out that it actually became a rule - finance minister Andrzej Raczko (headed for IMF job) was replaced with Mirosław Gronicki.
- The nomination was neutral for the market. Though Gronicki is an advocate of decisive public finance reform, Prime Minister Marek Belka plays the main economic role in the cabinet.
- The main aim of the new finance minister is preparing next year's budget. We think he will do his duty quite well, but one should remember that the final shape of fiscal policy in 2005 (election year) will depend to a large extent on politicians.

… and he will change public debt definition

- New finance minister would soon seek a change in budget accounting rules in Poland to ESA-95 standards.
- This change would be aimed at mitigating a risk of breaching the maximum, constitutionally binding, level 60% of GDP by Polish public debt and thus to lower the risk of excessively strong fiscal adjustment in the coming years.
- The chart compares tow methodology, based on government's documents, with an assumption of positive Eurostat's decision, as regards treatment of Polish pension funds.
- We have predicted such an initiative from the cabinet long time ago We do not think that this move must be necessarily a bad news for the market, assuming that at the same time the government and the parliament do not abandon essential fiscal reforms aimed at systematic reduction of public spending.

What about the Hausner plan?

- The Sejm accepted that indexation of pension benefits will take place only when the cumulative inflation exceeds 5%, but at least every two years.
- The bill also imply costs, which are a consequence of elimination of the so-called "old portfolio". But according to the government's estimation savings in 2005-07 did not change.
- … and this was achieved by overstating inflation forecast for 2005 and underestimating the CPI for 2006.
- SdPl demands were met and government made amendments to a few bills (verification of disability pensions, equal age of pensioners), which decreased the amount of total savings.
- Parliament rejected the proposal to increase healthcare contribution. We will see whether deputies will come back from holidays with new "interesting" ideas.

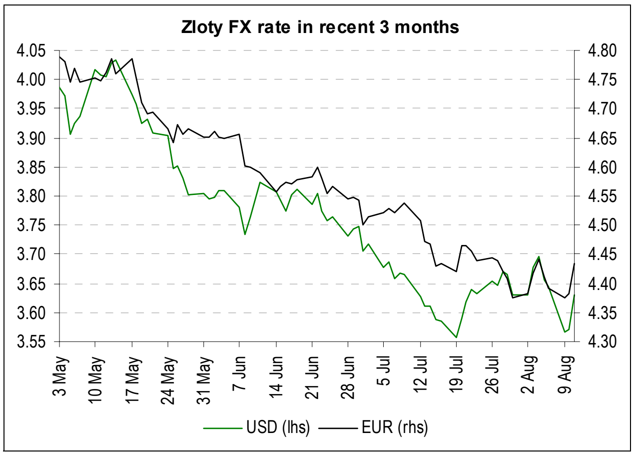
Budget realisation on track

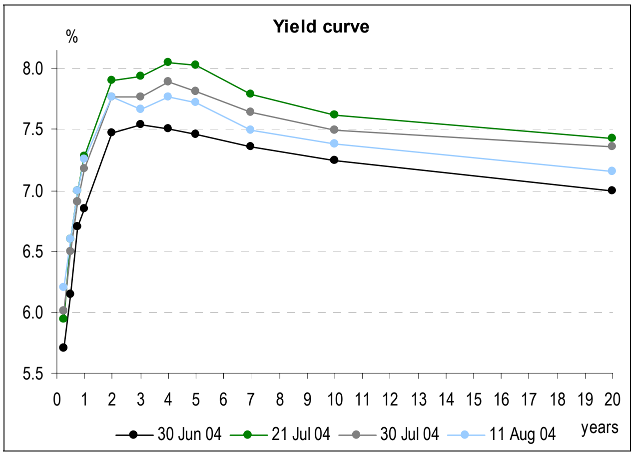
- Budget deficit after June reached PLN19.88bn or 43.9% of the annual plan (after May the deficit was 33.8% of the plan).
- Revenue side of the budget did not perform well, as slump (possibly temporary) in VAT revenue after EU entry took place. Inflows from indirect taxes, fell 25.8%YoY in June alone.
- The second largest component of budget revenue, inflows from PIT, fell by 12.8%YoY in June and by 15%YoY in 1H04.
- CIT revenues were negative in June. Current CIT revenues are still high, but inland revenue offices returned excess tax payments.
- Total revenues of the budget dropped significantly in June (by 16.7%YoY), but this resulted largely from one-off factors and they are likely to rebound in the remainder of the year, following continuation of the economic recovery.

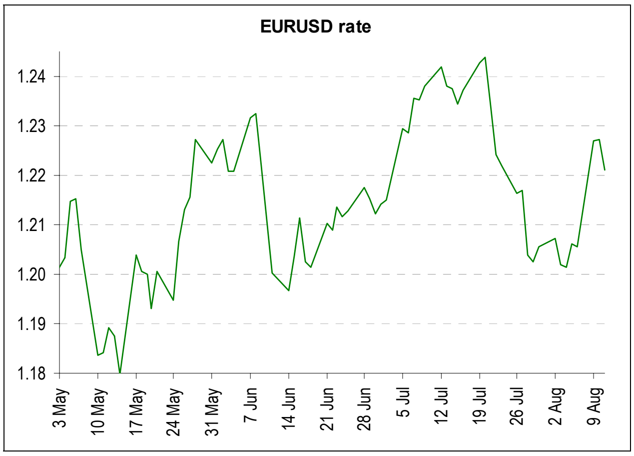
Government and politics

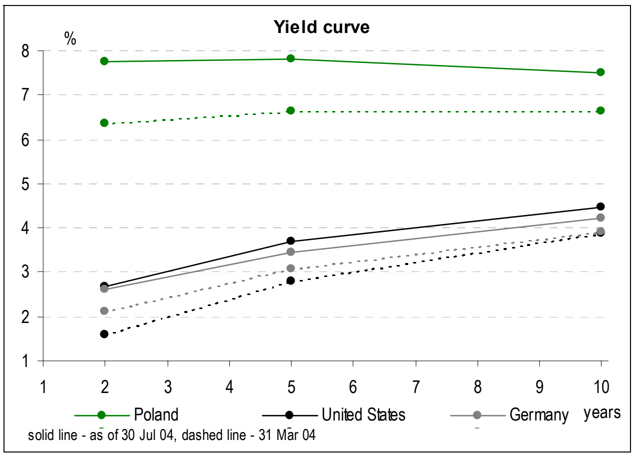
Comments of government representatives and politicians	Remarks
Jerzy Hausner, deputy PM, economy and labour minister PAP, 27 July [About meeting between the government's officials and the MPC] This is was very good working meeting. Both sides get along fine with each other that both, actions aimed at keeping low inflation and very important actions aimed at reform of public finance, are necessary for sustainable, long-term growth of the economy. In the longer horizon, our goals are the same, Poland should have high and sustainable growth, with safe macroeconomic balance.	In the *Central bank watch* section above, we draw your attention to MPC members' conclusions from the meeting with the government representatives (Leszek Balcerowicz concentrated on inflation, while Marian Noga was talking only about GDP growth). However, the day before their comments, the deputy Prime Minister reconciled them, as he said that there is a common target of high GDP growth with low inflation. What is important, he emphasised that the achievement of high GDP growth in the longer run is possible only if public finance reform is undertaken. Well, what deputies think about it?
PAP, Reuters, 20 July The government's proposal is for zero real growth in wages in the public sector. As such we are talking only about keeping (them) in line with inflation. The problem is that at the moment...the outlook on prices is uncertain.	We can wonder why the inflation forecast of the government's members (also this presented below by the finance minister) is below majority of market forecasts. An explanation of this fact may be the planned zero percent real growth in public sector wages and forthcoming negotiations in the Three-Party Committee i.e. lower expected inflation means lower budget spending on public wages.
Mirosław Gronicki, finance minister Reuters, 3 August Inflation will be above MPC's target, just below 4% in the first quarter of 2005. But later, in April through July inflation will be falling, if only due to the base effect, and possibly steeper depending on the pass-through effect from the exchange rate. If it was to turn out that inflation expectations next month stabilise or start falling then interest rate moves will be less needed. The assumption of our forecast is that the central bank will do something about inflation expectations.	The Ministry of Finance's inflation forecast assumes a fall to 2.5%YoY next year, assuming the reversal of negative supply shocks and maintaining of restrictive monetary policy. At the first glance, the ministry's forecast seem to be divergent with the central bank's projection presented by the deputy NBP governor. One has to remember that the central bank talks about the inflation *projection* (with the assumption of flat official rates), while the ministry of finance's inflation *forecast* assumes a continuation of restrictive monetary policy (possibly it means further rate hikes) that would lead to lower inflation expectations.
PAP, 28 July If inflation and inflationary expectations are growing, it is the central bank's job to combat the two. At the moment, it is a fully justified decision. I will not comment whether it is too much or loo little. Restrictive macroeconomic policy will lead to slowdown in domestic demand. If additionally, economic recovery in the EU is slower than expected, we can face lower GDP growth. If not, exports will drive the Polish economy at least in 1H05 and we have a chance to achieve 5% GDP growth.	New finance minister praised the MPC for raising interest rates again. This was not a common phenomenon in the past. Quite contrary, finance ministers usually wanted the central bank to keep rates as low as possible during as long as possible period of time, to achieve higher GDP growth (i.e. higher budgetary revenues). Let's hope that this time we are witnessing a real improvement in cooperation between the two institutions, although some development in this area was already observed when Andrzej Raczko replaced Grzegorz Kołodko at the finance minister's post. Perfect situation would be achieved if an exchange of courtesies translates into better policy mix (more restrictive fiscal policy allowing monetary policy to be less restrictive).
Rzeczpospolita, 23 July PLN35bn deficit is for me a top limit. If we make PLN29bn I'll be happy, also if we'll have PLN33bn. PAP, Reuters, 22 July What we have in our medium-term strategy is the maximum level of the deficit [PLN38.8bn] and I have said that my goal is to get below that. I will force all initiatives aimed at lowering budget deficit and financing needs of public sector. We have an inflation surprise. This can hurt consumer demand and translate into worse budget revenues in 2005. We do see such a risk. The inflation surprise may cause problems in the Polish economy next year. The MPC must fight with inflation	Mirosław Gronicki declared to lower next year's budget deficit. Such statement could have been widely expected, but one should be aware of political limitation new minister is facing. It seems that Gronicki is well conscious of this risk, as he admitted there was no place for a revolution, but he would try to do things that may be done. Gronicki mentioned also lowering the deficit would be difficult due to a more rapid than predicted inflation increase, which limits consumption demand and thus budgetary revenues. This may suggest that next year's budget deficit may be indeed lower than the assumed PLN38.8bn, but rather not significantly. Although in the interview for Rzeczpospolita Gronicki mentioned much lower levels of the deficits, we think one should assume the level of PLN35bn, mentioned recently by deputy PM Jerzy Hausner, as realistic.
Krzysztof Martens, senior SLD official Polish Radio PR3, 28 August [Q: Is it possible that SLD will vote against Belka's cabinet in October?] This is a strategic decision. (...) Our strong precondition is **NO** nomination of Ananicz. If he is appointed, we will withdraw our ministries from the government. (...) Today the relationship between the SLD and Marek Belka's government for the next couple of months (or 10 months) will be determined.	One of the SLD's senior officials Krzysztof Martens repeated recently several times that the Prime Minister is very close to come into open conflict with the SLD, as PM stuck to his proposal of nominating Andrzej Ananicz for a chief of the Intelligence Agency. Similar reactions were visible after PM proposed Anna Radziwiłł for deputy education minister post. While it is hard to imagine that the SLD will withdraw all ministers immediately, the fact is that higher political risk may influence the process of accepting budget for 2005 or may be an important element in a political game before the second vote of confidence for Belka's government in October.
Tomasz Nałęcz, senior Labour Union official Reuters, 25 July If there are such nominations and actions of public prosecutor's office, I have to say that I do not have big chances that the SdPl will support PM Belka in another confidence vote in autumn.	While SLD got very angry about Belka's personal decisions, as proposed candidates for public posts were not connected with the party, deputies of SdPl criticised Prime Minister for nominating SLD politicians. Indeed, quite surprisingly, Marek Belka appointed Lech Nikolski, linked with former cabinet of Leszek Miller, for deputy minister in the Ministry of Economy responsible for the National Development Programme. In this case, SdPl's Nałęcz warned that the party's support for the cabinet in the confidence vote was getting less likely. Well, then who will support the cabinet in October?

Market monitor









Source: Reuters, BZ WBK

More expensive zloty and cheaper and cheaper bonds

- Since early May moods on the Polish market have been to larger and larger extent influenced by expectations of interest rate hikes. In July, this factor came to the fore. The situation on the political scene was of much less importance than in the first half of this year. Due to holiday time turnover was often moderate but price volatility was large.
- In first two decades of July, market situation was reflecting very strong expectations of the fast rate hikes, which were intensified by comments from NBP representatives and deputy PM Jerzy Hausner. As a result, the zloty reached the strongest level since February 2003 and the yield curve moved upward to the level from mid-2002.
- Starting from around 19 July the trends became shaky. Statistical data softened views for soon rate increases, and comments from politicians and central bankers reminded of fiscal problems. Therefore, yields remained in a horizontal trend and the zloty depreciated. After smaller than expected rate hike, both markets strengthened.
- At the end of July, the zloty was stronger than on the last day of June by nearly 2.5% against a dollar-euro basket. The yield curve moved upwards by 20-35bps last month, while on 21 July it was even 40-60bps higher than at the end of June. From the duration of 4 years up, the negative slope of the curve is maintaining.
- In early August FX market remained volatile, while fixed income market was more stable. After much worse than forecasted data from the US labour market were released, very rapid strengthening appeared following international markets.
- Given expectations of another NBP's rate hikes we expect further rise in yields of treasuries. Appreciation trend of the zloty is likely to reverse temporary in September-October, when a debate over budget draft for 2005 will begin.

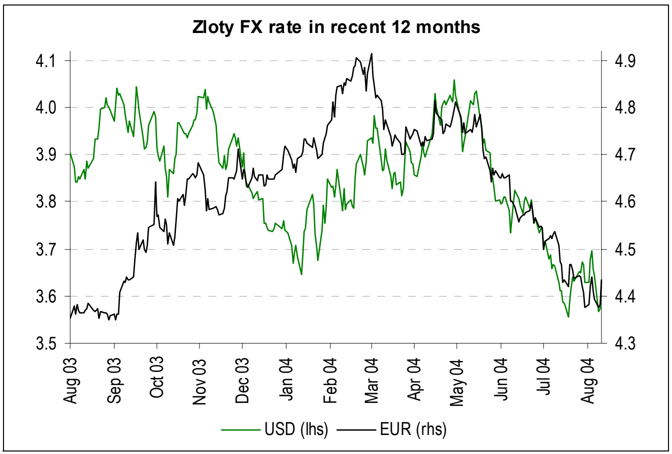
Still lack of stabilisation on the FX market

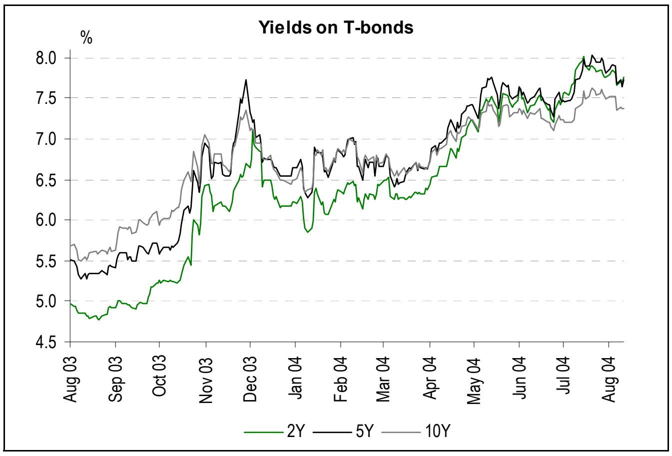
- FX markets still remain volatile. In the first half of July the dollar was depreciating quite clearly following a series of data that weakened expectations of rate hikes in the US. The EURUSD rate approached 1.245, the highest level for four months.
- Depreciation trend reversed rather rapidly after Alan Greenspan's speech at Senate that was supportive for market expectations of rate hikes. Afterwards the dollar appreciated further after data on consumer sentiment. As a result the EURUSD rate fell to ca. 1.20 and did not weaken considerably after weak data on the GDP. Only poor data from labour market resulted in very rapid dollar depreciation to the level of above 1.22 per the euro.
- Prospects for the dollar in the coming months remain uncertain. We expect more sustainable appreciation after presidential elections, as the Fed may decide to hike rates more aggressively.

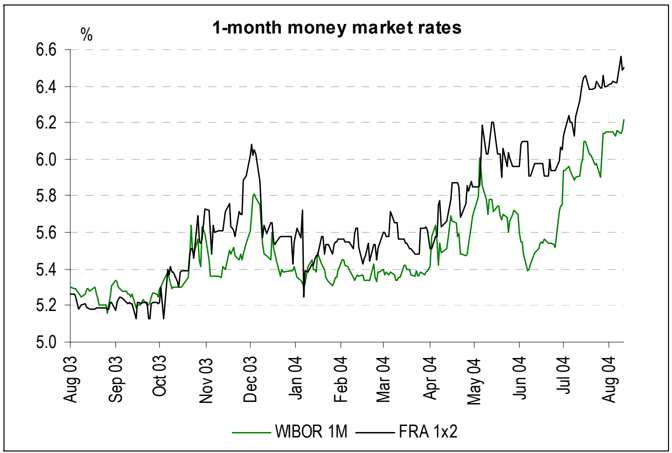
Correction on the fixed income market continues

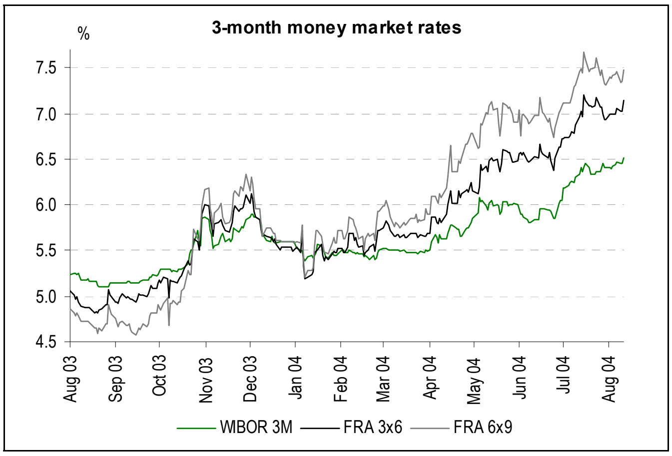
- On rising yields, in July the risk premium for Polish bonds, measured with a difference between expected 5-year interest rate in Poland and in the Eurozone in five years time, was relatively stable and at month-end was close to the level from June. It suggests that medium-term perception of Poland's outlook remains unchanged despite deterioration of current situation.
- In July, horizontal trend was shaped on the American fixed income market with large daily volatility. Only in early August, bigger move appeared when the curve fell by 20-25bps after release of data on employment
- Despite recent falls we expect a continuation of upward trend of yields following another interest rate hikes by the Fed. As it was until now, it may be accompanied by a significant volatility due to relevant uncertainty factors.

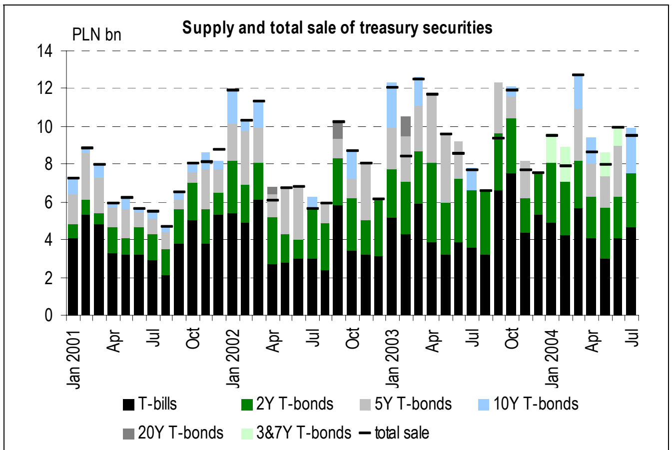
Market monitor











Treasury bill auctions (PLN m)

	OFFER / SALE		
Date of auction	13-week	52-week	Total
5.07.2004	100 / 100	1,100 / 1,100	1,200 / 1,200
12.07.2004	100 / 100	1,100 / 1,100	1,200 / 1,200
19.07.2004	100 / 100	1,100 / 1,100	1,200 / 1,200
26.07.2004	-	1,100 / 1,100	1,100 / 1,100
July total	**300 / 300**	**4,400 / 4,400**	**4,700 / 4,700**
2.08.2004	-	1,000	1,000
9.08.2004	-	900	900
14.08.2004	-	1,100	1,100
21.08.2004	-	1,400	1,400
28.08.2004	-	1,100	1,100
August total	**-**	**5,500**	**5,500**
September*		**3,200 - 4,900**	

* own estimations based on preliminary information for 3Q04

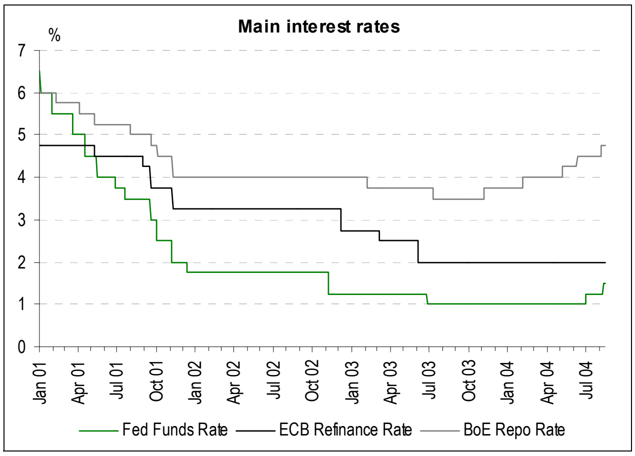
Treasury bond auctions in 2004(PLN m)

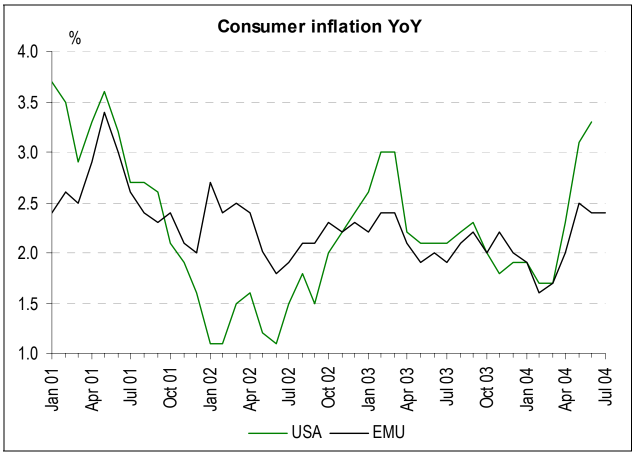
month	First auction				Second auction				Third auction			
	date	T-bonds	offer	sale	date	T-bonds	offer	sale	date	T-bonds	offer	sale
January	07.01*	OK0406	3,200.0	3,200.0	14.01	WZ0307/0911	1,500.0	1,407.0	-	-	-	-
February	04.02*	OK0406	2,900.0	2,600.0	11.02	WZ0307/0911	1,800.0	1,110.8	-	-	-	-
March	03.03	OK0406	2,500.0	2,500.0	10.03	DS1013	1,700.0	1,700.0	17.03*	DS0509	2,760.0	2,760.0
April	07.04	OK0406	2,200.0	2,200.0	14.04	DS1013	1,400.0	577.0	21.04	DS0509	1,700.0	1,700.0
May	05.05	OK0806	2,700.0	2,039.5	12.05*	WZ0307/0911	1,200.0	1,181.0	19.05	DS0509	1,700.0	1,695.0
June	02.06	OK0806	2,200.0	2,200.0	9.06	WZ0307/0911	1,000.0	1,000.0	16.06*	DS0509	2,640.0	2,640.0
July	07.07*	OK0806	2,800.0	2,800.0	14.07*	DS1013	2,400.0	2,001.0	-	-	-	-
August	04.08*	OK0806	3,480.0	3,086.0	11.08*	WZ0307/0911	1,550.0	1,470.0	-	-	-	-
September	01.09	OK0806	2,200-3,000	-	8.09	WS0922	500-1,500	-	15.09	5Y	2,000-3,000	-
October	06.10	OK1206	-	-	13.10	10Y	-	-	20.10	5Y	-	-
November	03.11	OK1206	-	-	10.11	WZ0307/0911	-	-	17.11	5Y	-	-
December	01.12	OK1206	-	-	-	-	-	-	-	-	-	-

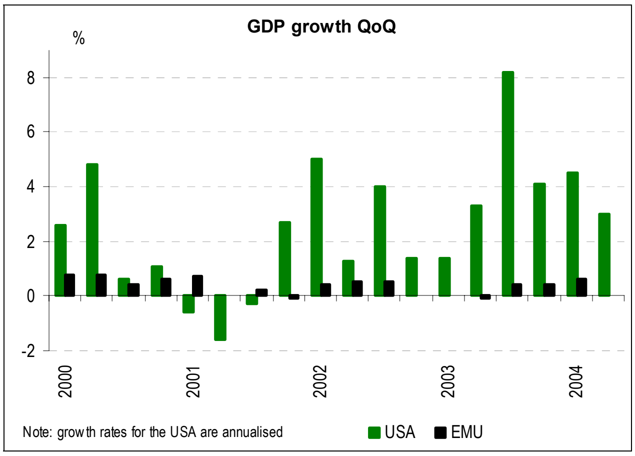
* with supplementary auction

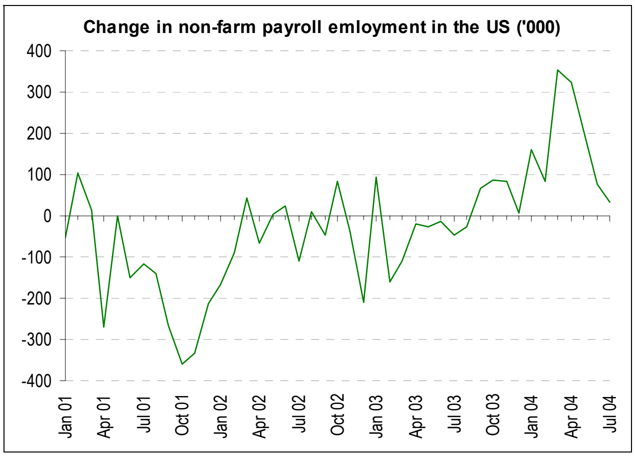
Source: Ministry of Finance, Reuters, BZ WBK

International review









Source: Reuters, ECB, Federal Reserve

Interest rate hike cycle goes on

- As forecasted, on 10 August the Fed decided to raise interest rates by 25bps again. Federal funds rate rose to 1.5%. In the statement it was written that recent slowdown in economic growth and in improvement on the labour market were temporary and result from high energy prices. According to the Fed, economy is ready to return to a path of high growth. Another rate hikes at each of the three meetings before the end of this year are likely.
- On 5 August the ECB kept the refinance rate at 2%. First interest rate hike in the Eurozone is expected only next year.
- On the same day, the Bank of England decided to raise interest rates by 25bps in order to cool down the economy, limit consumers' borrowing and prevent further increase in house prices. It was the fifth quarter-point interest rate hike since November last year. The repo rate stands at 4.75%.

Higher inflation maintains

- In the Eurozone, preliminary estimations of inflation in June were confirmed in a final release and data exactly matched market consensus forecast. Consumer prices did not change on monthly basis and, as a result, the annual inflation rate decreased to 2.4% from 2.5% in May. According to preliminary estimations for July, inflation remained at 2.4%YoY, while market forecast pointed to return to 2.5%. Since May, price growth is above the upper end of the ECB's inflation ceiling target of 2.0%.
- In the United States, data on inflation roughly matched market forecast. In June, the prices increased by 0.3%MoM, while a rise of 0.2% was forecasted by analysts. This figure resulted in the increase in annual inflation rate to 3.3% from 3.1% recorded in May. At the same time, annual core inflation rate increased to 1.9% from 1.7% in May.

The growth in the US below expectations

- According to advanced information, GDP growth in the USA totalled 3.0% in 2Q04, compared to 4.5% growth in 1Q04. It was considerably below expectations at 3.6%. A slowdown was deeper than forecasted due to slower increase in consumption – by 1%, i.e. the slowest since the beginning of 2001.
- In mid-July, in line with forecast, data on Eurozone's economic growth in 1Q04 were confirmed. Eurozone's GDP recorded a rise of 0.6%QoQ and 1.3%YoY in this period.
- Moreover, the European Commission reiterated growth forecasts for 2Q04 and revised downward the forecast for 3Q04. Now, both of them are at the level of 0.3-0.7%QoQ. In mid-August, a flash estimate of the GDP for 2Q04 will be released (market expectations are at 0.6%QoQ and 2.0%YoY) and the Commission will publish the latest forecast for 3Q04 and 4Q04.

Disappointment with the data from American labour market

- In July data from American labour market turned out to be much worse than forecasted. As the matter of fact, the unemployment rate declined to 5.5% from 5.6% in June, however non-farm pay-roll employment rose by a mere 32,000, which was significantly below economists' expectations at 240,000. What is more, June's figure was revised downward to 78,000 from 112,000 released initially. This meant a considerable deterioration against March-May period when the level of 200,000 was clearly exceeded.
- The Germany's leading business climate indicator IFO rose to 95.6pts in July from 94.6pts in June, beating the consensus for an increase to 95.0pts. IFO institute said in the statement that both the assessments of the current business situation as well as business expectations for the coming six months had improved.

What's hot this month

Monday	Tuesday	Wednesday	Thursday	Friday
2 August POL: T-bill auction *EMU: PMI (Jul)* *USA: ISM (Jul)*	**3** *EMU: Producer prices (Jun)* *EMU: Unemployment (Jun)*	**4** POL: T-bond auction OK0806 *GER: Unemployment (Jul)* *EMU: Retail sales (Jun)* *USA: Factory orders (Jun)*	**5** *EMU: ECB meeting*	**6** *USA: Unemployment (Jul)*
9 POL: T-bill auction *ITA: Industrial output (Jun)* *ITA: GDP (2Q)*	**10** *FRA: Industrial output (Jun)* *USA: Fed meeting*	**11** POL: Balance of payments (Jun) POL: T-bond auction WZ0307 & WZ0911	**12** *ITA: Inflation final (Jul)* *FRA: GDP (2Q)* *GER: GDP (2Q)* *USA: Retail sales (Jul)*	**13** POL: Money supply (Jul) POL: Wages & employment (Jul) *FRA: Inflation preliminary (Jul)* *EMU: GDP (2Q)* *USA: Producer prices (Jul)* *USA: Foreign trade (Jun)*
16 POL: Inflation (Jul) POL: T-bill auction	**17** *EMU: Industrial output (Jun)* *USA: Inflation (Jul)* *USA: Industrial output (Jul)*	**18** POL: Industrial output (Jul) POL: Producer prices (Jul) *EMU: Inflation final (Jul)* *EMU: Foreign trade (Jun)*	**19**	**20** POL: Retail sales (Jul) POL: Unemployment (Jul) POL: Business climate (Aug) *FRA: GDP (2Q)*
23 POL: T-bill auction	**24** POL: Core inflation (Jul) POL: MPC meeting (1st day) *FRA: Inflation final (Jul)* *GER: GDP (2Q)*	**25** POL: MPC meeting (decision) POL: Food prices (1H Aug)	**26** *GER: IFO (Aug)* *EMU: Money supply (Jul)*	**27** *USA: GDP (2Q)*
30 POL: T-bill auction	**31** *ITA: Inflation preliminary (Aug)* *EMU: Inflation preliminary (Aug)*	**1 September** POL: T-bond auction OK0806 *EMU: PMI (Aug)* *EMU: Unemployment (Jul)* *USA: ISM (Aug)*	**2** *GER: Unemployment (Aug)* *EMU: ECB meeting* *EMU: Producer prices (Jul)* *USA: Factory orders (Jul)*	**3** *EMU: Retail sales (Jul)* *USA: Unemployment (Aug)*
6 POL: T-bill auction	**7**	**8** POL: T-bond auction WS0922	**9** *EMU: GDP (2Q)*	**10** POL: Balance of payments (Jul) *USA: Producer prices (Aug)* *USA: Foreign trade (Jul)*

Source: CSO, NBP, Finance Ministry, Reuters

Data release calendar for 2004

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
MPC meeting	20-21	24-25	30-31	26-27	25-26	29-30	27-28	24-25	-	-	-	-
GDP*	-	20	-	-	-	9	-	-	-	-	-	-
CPI	15	16[a]	15[b]	14	14	14	14	16	14	14	15	14
Core inflation	23	-	23[b]	23	24	22	23	24	22	22	23	22
PPI	20	18	17	20	20	18	19	18	17	19	19	17
Industrial output	20	18	17	20	20	18	19	18	17	19	19	17
Retail sales	23	20	19	22	21	23	23	20	21	21	24	21
Gross wages, employment	16	13	12	15	17	16	14	13	14	14	17	14
Unemployment	23	20	19	22	21	23	23	20	21	21	24	21
Foreign trade	about 50 working days after reported period											
Balance of payments*	2	-	31	-	-	30	-	-	30	-	-	-
Balance of payments	30	-	12[c]	13	14	16	13	11	10	12	12	-
Money supply	14	13	12	14	14	14	14	13	14	14	12	-
NBP balance sheet	7	6	5	7	7	7	7	6	7	7	5	-
Business climate indices	22	20	19	22	21	22	21	20	21	21	22	21
Food prices, 1-15	-	9[c], 25[d]	25	23	25	25	23	25	24	25	25	23

* quarterly data,
[a] preliminary data, January, [b] January and February, [c] January, [d] February
Source: CSO, NBP

Economic data and forecasts

Monthly economic indicators

		Jul 03	Aug 03	Sep 03	Oct 03	Nov 03	Dec 03	Jan 04	Feb 04	Mar 04	Apr 04	May 04	Jun 04	Jul 04	Aug 04
Industrial production	%YoY	10.3	5.9	10.9	12.1	9.2	13.9	14.4	18.3	23.5	21.8	12.2	15.7	9.0	20.7
Retail sales [c]	%YoY	5.4	5.5	9.7	10.3	11.4	17.3	7.6	12.1	20.7	30.6	4.0	8.6	9.9	9.5
Unemployment rate	%	19.6	19.5	19.4	19.3	19.5	20.0	20.6	20.6	20.5	20.0	19.6	19.5	19.3	19.1
Gross wages [b c]	%YoY	2.4	1.9	2.2	3.0	4.1	5.1	3.5	6.3	7.0	4.6	4.4	4.5	4.5	5.4
Employment [b]	%YoY	-3.2	-3.2	-3.1	-3.2	-3.3	-3.5	-1.4	-1.5	-1.3	-1.1	-0.9	-0.7	-0.6	-0.5
Export [d]	%YoY	8.9	4.4	20.1	11.4	8.2	14.0	19.6	10.9	29.9	25.0	23.6	30.5	17.9	22.1
Import [d]	%YoY	8.3	3.0	12.5	4.9	2.5	6.2	10.6	2.7	25.0	36.3	19.3	20.8	9.9	21.4
Trade balance [d]	EURm	-657	-232	-266	-254	-503	-545	-173	-218	-461	-1 106	-379	203	-350	-250
Current account balance [d]	EURm	-375	-55	-57	314	-356	-566	191	-101	-428	-748	-568	83	-250	-200
Current account balance [d]	% GDP	-2.3	-2.4	-2.2	-2.0	-1.9	-2.0	-1.7	-1.4	-1.3	-1.5	-1.6	-1.5	-1.4	-1.5
Budget deficit (cumulative)	PLNbn	-27.7	-29.6	-33.1	-34.8	-35.5	-37.0	-4.2	-9.4	-11.8	-11.0	-15.3	-19.9	-23.7	-27.2
Budget deficit (cumulative)	% realisation	63.8	70.6	84.4	93.3	98.9	100.0	9.3	20.7	26.1	24.3	33.8	43.9	52.3	60.0
CPI	%YoY	0.8	0.7	0.9	1.3	1.6	1.7	1.6	1.6	1.7	2.2	3.4	4.4	4.6	4.7
PPI	%YoY	1.9	1.8	2.1	2.7	3.7	3.7	4.1	4.2	4.9	7.6	9.6	9.2	8.7	8.7
Broad money (M3)	%YoY	0.7	1.7	3.1	4.7	5.6	5.6	5.1	5.1	5.7	8.5	6.4	6.6	6.9	6.7
Deposits	%YoY	-2.5	-1.7	-0.2	1.5	3.3	3.7	3.4	3.5	4.8	8.4	6.2	6.9	7.5	7.6
Credits	%YoY	4.9	5.2	5.4	7.5	8.5	8.1	7.4	7.7	6.1	8.5	6.1	5.5	11.6	12.1
USD/PLN	PLN	3.90	3.92	3.98	3.92	3.94	3.79	3.74	3.84	3.89	3.97	3.93	3.78	3.64	3.64
EUR/PLN	PLN	4.44	4.37	4.46	4.59	4.62	4.66	4.71	4.85	4.77	4.76	4.72	4.59	4.47	4.40
Reference rate [a]	%	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	6.00	6.25
WIBOR 3M	%	5.26	5.16	5.17	5.42	5.68	5.69	5.46	5.46	5.49	5.69	5.99	5.91	6.34	6.50
Lombard rate [a]	%	6.75	6.75	6.75	6.75	6.75	6.75	6.75	6.75	6.75	6.75	6.75	6.75	7.50	7.75
Yield on 52-week T-bills	%	4.85	4.82	4.91	5.30	5.95	6.02	5.59	5.78	5.87	6.20	6.65	6.79	7.15	7.30
Yield on 2-year T-bonds	%	4.89	4.86	5.02	5.53	6.31	6.49	6.17	6.34	6.34	6.83	7.41	7.44	7.80	7.85
Yield on 5-year T-bonds	%	5.17	5.38	5.60	6.04	6.86	6.82	6.65	6.76	6.60	7.13	7.57	7.50	7.79	7.85
Yield on 10-year T-bonds	%	5.37	5.60	5.93	6.36	6.92	6.75	6.65	6.81	6.65	7.02	7.32	7.27	7.44	7.45

Source: CSO, NBP, Finance Ministry, BZ WBK own estimates

[a] at the end of period [b] in corporate sector [c] in nominal terms [d] balance of payments data on transaction basis

Quarterly and annual economic indicators

		2002	2003	2004	1Q03	2Q03	3Q03	4Q03	1Q04	2Q04	3Q04	4Q04
GDP	PLNbn	781.1	814.7	882.2	187.1	200.2	201.3	226.0	203.7	216.1	216.9	245.4
GDP	%YoY	1.4	3.8	5.9	2.3	3.9	4.0	4.7	6.9	5.8	5.1	5.9
Total consumption	%YoY	2.8	2.5	3.6	1.1	2.8	2.9	3.3	3.3	3.3	3.6	4.0
- Private consumption	%YoY	3.3	3.1	4.4	1.4	3.8	3.5	3.9	4.0	4.2	4.5	5.0
Fixed investments	%YoY	-5.8	-0.9	7.6	-3.6	-1.7	0.4	0.1	3.5	6.0	8.0	10.0
Industrial production	%YoY	1.1	8.7	16.7	4.4	9.1	8.9	12.2	19.0	16.5	15.6	15.8
Retail sales (real terms)	%YoY	1.9	7.9	9.6	1.2	9.8	6.4	12.4	13.6	10.8	6.1	8.0
Unemployment rate [a]	%	20.0	20.0	19.2	20.6	19.7	19.4	20.0	20.5	19.5	19.0	19.2
Gross wages (real terms)	%YoY	1.5	2.0	1.6	1.4	1.7	1.7	3.2	3.8	1.1	0.4	0.9
Export [b]	%YoY	6.0	9.1	14.0	8.4	5.4	11.4	11.1	19.3	26.4	7.0	5.0
Import [b]	%YoY	3.5	3.3	13.6	3.1	-2.5	8.2	4.5	12.6	25.7	9.0	8.0
Trade balance [b]	EURm	-7 701	-5 345	-5 576	-1 600	-1 118	-1 325	-1 302	-909	-1 282	-1 540	-1 845
Current account balance [b]	EURm	-5 404	-3 550	-3 283	-1 584	-895	-463	-608	-696	-1 233	-616	-738
Current account balance [b]	% GDP	-2.7	-1.9	-1.7	-2.6	-2.2	-2.1	-1.9	-1.5	-1.6	-1.7	-1.7
Budget deficit (cumulative) [a]	PLNbn	-39.4	-37.0	-40.7	-15.5	-23.8	-33.1	-37.0	-11.8	-19.9	-30.7	-40.7
Budget deficit (cumulative) [a]	% GDP	-5.0	-4.5	-4.6	-8.3	-4.2	-4.6	-1.7	-5.8	-3.7	-5.0	-4.1
CPI	%YoY	1.9	0.8	3.4	0.5	0.5	0.8	1.5	1.6	3.3	4.6	4.2
CPI [a]	%YoY	0.8	1.7	4.3	0.6	0.8	0.9	1.7	1.7	4.4	4.4	4.3
PPI	%YoY	1.0	2.6	7.4	3.0	2.2	1.9	3.4	4.4	8.8	8.5	7.8
Broad money (M3) [a]	%YoY	-2.0	5.6	6.3	0.5	1.3	3.1	5.6	5.7	6.6	7.4	6.3
Deposits [a]	%YoY	-4.1	3.7	6.4	-2.3	-1.9	-0.2	3.7	4.8	6.9	8.3	6.4
Credits [a]	%YoY	5.2	8.1	12.6	8.7	6.1	5.4	8.1	6.1	5.5	11.6	12.6
USD/PLN	PLN	4.08	3.89	3.79	3.90	3.83	3.93	3.89	3.82	3.89	3.68	3.76
EUR/PLN	PLN	3.85	4.40	4.61	4.19	4.36	4.42	4.62	4.78	4.69	4.46	4.52
Reference rate [a]	%	6.75	5.25	6.75	6.00	5.25	5.25	5.25	5.25	5.25	6.50	6.75
WIBOR 3M	%	9.09	5.69	6.21	6.37	5.60	5.20	5.60	5.47	5.87	6.57	6.95
Lombard rate [a]	%	8.75	6.75	8.25	7.75	6.75	6.75	6.75	6.75	6.75	8.00	8.25
Yield on 52-week T-bills	%	8.18	5.33	6.77	5.75	4.94	4.86	5.76	5.75	6.24	7.32	7.77
Yield on 2-year T-bonds	%	7.94	5.38	7.33	5.58	4.91	4.92	6.11	6.28	6.86	7.88	8.30
Yield on 5-year T-bonds	%	7.86	5.61	7.47	5.50	4.98	5.38	6.57	6.67	7.10	7.88	8.23
Yield on 10-year T-bonds	%	7.34	5.77	7.22	5.60	5.19	5.63	6.68	6.70	7.00	7.46	7.70

Source: CSO, NBP, Finance Ministry, BZ WBK own estimates

[a] at the end of period [b] balance of payments data on transaction basis

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