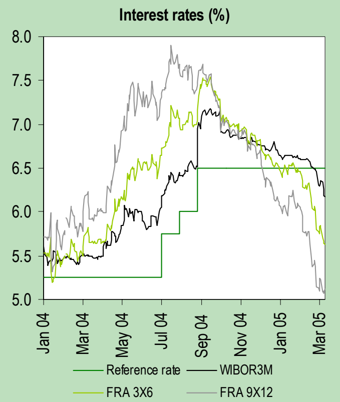
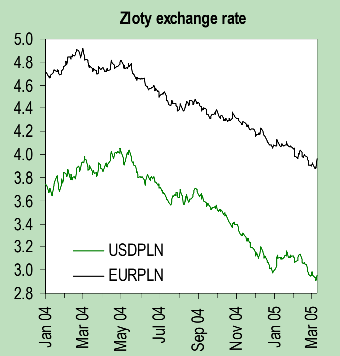
Bank Zachodni WBK

MACROscope

Polish Economy and Financial Markets

March 2005





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Take it easy

- **In February the Monetary Policy Council made unexpected decision to change monetary policy bias form restrictive to EASING, passing over a neutral approach.** As it was stated by one of MPC members, Halina Wasilewska-Trenkner, the decision was burdened with a large risk, which was connected with uncertain financial markets reaction. After the MPC showed that it was more dovish than financial market was expected, the only possible reaction was sharp strengthening on the interest rates market and pricing-in even more cuts than previously. Foreign capital inflow, encouraged by the prospects of relatively swift interest rate cuts, kept the zloty strong (it is hard to agree, but market is not perceiving political risk as large), which in turn may force the MPC to cut rates amid improving balance of risks for future inflation. Statements of MPC members that adoption of easing bias does not mean automatically swift rate cuts were ignored by the market. It is not surprising given that the February decision was shocking for the market and was against previous signals sent by MPC members before the meeting and in previous official statements.

- **One of the most important arguments for the Council to change bias to easing was the new inflation projection of the NBP staff, which showed a significant improvement in inflation outlook as compared to November Inflation Report.** Though conclusions of the Report justified introduction of neutral rather than easing bias (likelihood of inflation below target close to the likelihood of inflation above). in MPC's own view the balance of risks was more favourable than presented by NBP analysts. The MPC expects lower food prices and stronger zloty (NBP models imply depreciation) and additionally the projection's starting point assumed CPI inflation at 4.5% in 1Q05, while after January data release it seems it may be close to 4%.

- **According to the NBP rates reduction of 150bps could be dangerous from the point of view of inflation target realisation.** However, the MPC is not necessarily of the same opinion. Therefore, what will be the scale of interest rates reduction this year? This will depend on inflation path, economic growth perspectives (especially investments) and zloty exchange rate. Taking into account our forecasts as regards development of the above-mentioned variables, we foresee a total rate cut of 100bps until end-2005. However, much more difficult is to predict a sequence of reductions, especially if we remind how unpredictable MPC decisions were in June-August 2004 period and we take into account surprising February decision. In the third base case scenario we expect 50bps in the second quarter and 50bps in the third quarter. Nevertheless, similarly to the market, which started to price in that rate cuts will take place sooner than previously expected, we think borrowing costs may be reduced even earlier in the case of another inflation surprise and stronger zloty.

Financial market on 28 February 2005:

NBP deposit rate	5.00	WIBOR 3M	6.31	PLN/USD	2.9501
NBP reference rate	6.50	Yield on 52-week T-bills	5.50	PLN/EUR	3.9119
NBP lombard rate	8.00	Yield on 5-year T-bonds	5.34	EUR/USD	1.3260

This report is based on information available until 10.03.2005

Special focus

Prospects for loans after EU entry

In the previous edition of MACROscope we presented an analysis of changing size and pattern of credit activity in Poland. We outlined trends observed over the recent periods which consisted in upsetting the relation between the economic activity, including investments, and the size of credit activity in the banking sector. The attempt to explain this phenomenon was an introduction to a more thorough analysis of the changing pattern of credit activity and drafting a likely scenario of the lending market growth in Poland.

As part of the preliminary analysis of the changing credit activity trends in Poland we would also like to outline the background for the related processes in Poland by presenting the corresponding experience of similar economies. We would like to show the impact of catching up with economic growth and process of integration with European structures (the EU accession and aspiring to become a member of the euro zone).

A starting point

In the previous MACROscope edition we stressed that the lending market in Poland is underdeveloped even as compared to countries with relatively low GDP per capita. This is illustrated by the table below which shows the size of domestic credit in relation to GDP in selected EU member states (both old and new ones).

Loans to GDP ratio in Poland and selected EU members

Country	Loans to GDP ratio at year-end	
	2000	2003
Lithuania	11.4%	20.6%
Poland	**29.3%**	**32.4%**
Czech Republic	32.1%	34.8%
Hungary	41.7%	44.7%
Greece	49.3%	66.2%
Germany	111.6%	112.6%
Spain	107.9%	114.0%
Ireland	116.8%	127.3%
Portugal	128.6%	135.7%
Great Britain	133.7%	150.2%

Source: central banks and statistical offices of the analysed countries, own calculations

The table shows that the degree of development of the lending market in Poland is a few times lower than in Western Europe and also lower than in other countries from our region i.e. the Czech Republic and Hungary. This situation stems from lower level of economic development in Poland.

Empirical research indicates a strong positive correlation between GDP *per capita* and the role money plays in economy. In more developed countries, volume of credit activity considerably exceeds the nominal GDP. In Hungary, which is at similar still a bit higher stage of economic development than Poland, the relation of the total credit activity to the GDP is nearly 50%. In Poland, since the early days of transformation the loans to GDP ratio was dynamically growing (primarily in view of the very low starting value – after 1989, the modern banking system in Poland was built from scratch, dominance of planning and delivery of tangible tasks was abandoned for the benefit of dominance of money processes), but it is still very low at ca 30%.

Apart from the GDP level, high inflation and the resultant need to keep high nominal and real interest rates were also key drivers of credit activity in Poland. As a result, credit was expensive. Coupled with low household income and low financial strength of businesses, with conservative credit policy of banks, loan accessibility was very limited.

In the recent years, however, nominal and real interest rates dropped substantially (thanks to curbed inflation) which contributed to considerable increase in credit accessibility. For the time being, the effects are evident for one lending segment i.e. housing loans. To some extent, this situation might be driven by the effects we described in the *Special focus* section in the previous edition.

Relative to other countries, the growth in credit activity in Poland has been apparently hindered by quite stringent credit grading and provisioning rules. According to some estimates, while applying the Polish grading criteria, the share of loans which should be provided would be much higher than it is in other countries because of less restrictive standards. Such a situation translates into relatively higher costs of credit in Poland (from banks' point of view), expressed as the relation between the provisions and average loan balance, which means relatively lower appetite for credit among Polish banks which limits the growth of their loan books.

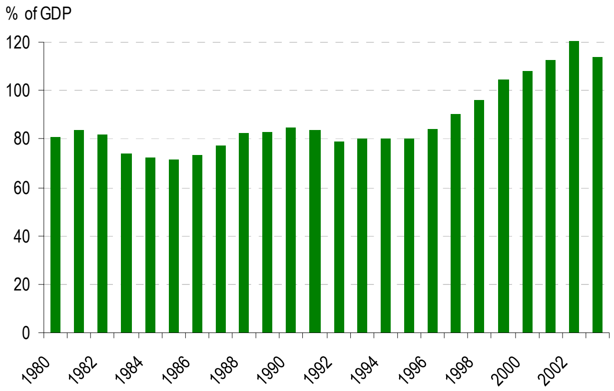
The credit grading and provisioning standards were changed in late 2003 and this should lead to the drop in the NPL ratio and provision cover which will be reflected in a drop in costs of credit from the banks' point of view. This in turn should encourage banks to loosen the loan sanctioning criteria i.e. to enhance loan accessibility. The changes in the credit grading and provisioning rules were associated, among other things, with Poland's accession to the EU and opening the Polish market to direct and unlimited competition from foreign banks[1].

More loans in the European Union?

Change in the grading rules is just one of the examples showing the impact of EU accession on the growth in the lending market. Can the EU accession become a watershed in the process of increasing the role of money in the Polish economy and fuel credit activity growth? While trying to answer this question it is worth referring to experience of other countries. One of the old EU member states that Poland can be compared to, and often is (in view of its demographic potential and relatively similar stage of economic development at the moment of acceding to the EU) is Spain.

Spain acceded to the EU (known as European Community at that time) in 1986. And this is when this country started to record a growth in loans to GDP ratio. While in four consecutive years prior to Spain's EU accession, total loans grew at a slower pace than nominal GDP, since its EU entry the credit growth rate exceeded the nominal GDP growth. This had not changed until 2003. The only exception were the years 1991-1992, i.e. the period of material slowdown in GDP growth in Europe and the currency crisis which affected countries in the ERM. The changes in the relation between the credit activity and GDP in the analysed period in Spain is illustrated in the graph below.

Loans to GDP in Spain in 1980-2003



Source: Bank of Spain, own calculations

The graph shows that the relation of credit activity to GDP increased in Spain over several years after the EU accession by over a half. Can this be repeated in Poland? The factor which undoubtedly supports this view is lower staring point in Poland which means a higher credit growth potential. Can the drivers be similar to those in Spain after its EU accession? Not necessarily as the date when Spain joined European Community does matter. In 1986, scope of liberalisation of financial services and degree of the financial market development in Spain was lower than in 2004 in Poland. In Spain, a major role in the development of the lending market after the EU accession was played by thorough changes in the banking sector i.e. liberalisation of the rules of providing financial services by banks, privatisation of banks, increased competition in the sector and opening the market to a higher number of foreign entities. In Poland similar changes took place much earlier which means that today they do not generate the potential for the lending market growth. This is why, Spain (and other countries who joined the EU in the 80's of the last century even at a similar stage of economic development) does not seem to be the best country to be compared to Poland.

The lack of possibility to translate the experience of older EU members states into the likely scenario for Poland does not mean that the EU accession will not promote the acceleration of the lending market development in Poland. There are a few arguments supporting that. Firstly, the increased competition on the banking market following the EU accession and dismantling barriers for operations of foreign banks in the country can promote stronger credit growth. Secondly, after the EU accession (you can assume that to a great extent this was the major reason) the household sentiment considerably increased. This must have been related to the growth in income expected in the future which also means increased interest in loans for financing current expenses. And this is what we could see in the 2004 money statistics.

After the EU accession and the resultant optimism as regards the outlook for economy, we should also see growing interest in credit from businesses. In addition, this will be promoted by the need to provide current funding for implementation of projects to be refinanced with EU grants.

The impact of European integration on the development of the domestic financial market, including the lending market, does not boil down to issues related to the EU accession itself. In view of the money nature of the changes in the economy, the prospects of Poland's accession to the euro zone will be of a higher importance.

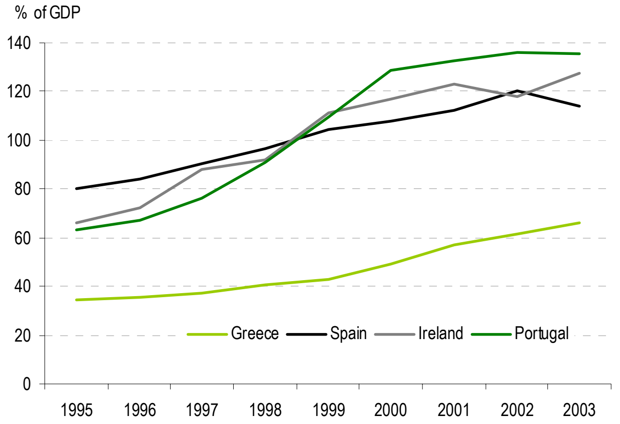
[1] Change in credit grading will trigger a statistical decrease in the share of problem receivables with the credit risk that the banks are exposed to remaining unchanged. The new regulations will change the way of presenting the credit portfolio quality to be more similar to the standards applicable to other EU members states and will enhance the comparability of individual banking sectors.

Credit boom on the way to euro?

Experience of old EU members states shows that the process of joining the EMU might trigger the credit boom. This phenomenon was primarily observed in countries at a lower stage of economic development i.e. apart from the already mentioned Spain, it happened in Greece, Portugal, and Ireland. These countries had underdeveloped lending market which meant huge growth potential which was released by the process of interest rate convergence to the level in the euro zone (drop in costs of credit). Nominal interest rates were on the wane a few years prior to joining the euro zone and were equal to the level prevailing in the monetary union at the moment when national currencies were replaced with the euro. Real interest rates were on the wane still after the accession to the monetary union in view of the growth in inflation driven, among other things, by the Harrod-Ballasa-Samuelson Effect and by the increase in the domestic demand fuelled by, among other things, the growth in credit activity[2]. Growth in credit accessibility possible thanks to the decrease in real costs weakened the interim liquidity limitations of households and allowed to reduce the net level of savings as well as to grow the current consumption. Obviously, the effect would not matter if it had not been for the fact that while awaiting the improvement in the economic conditions after the accession to the EMU the income of households increased. The reduction in the liquidity limitations in the analysed group of countries was also promoted by the continuation of the development of the financial services sector and the competition in the banking sector after those countries acceded to the EU. As a result, in those countries the relation between the dynamic credit growth and GDP increased. This is illustrated by the chart below. It shows the credit boom on the way to the euro zone started in the analysed group of countries as early as 3-4 years prior to the euro convergence (then the level of interest rates was adjusted) and reached its peak in the year of acceding the euro zone. Annual nominal interest rates on loans (accompanied by low inflation in view of the need to meet the nominal convergence criteria) were 16%-30% at that time (see the graph below).

[2] It should be noted that in a monetary union i.e. in a situation when there are no national currencies, a dynamic growth in credit activity in one of the economies triggers further growth in credit activity in this economy through the increase in the inflationary pressure meaning the drop in the real costs of credit (nominal interest rates stem from credit policy pursued by the EU).

Loans to GDP in Greece, Ireland, Portugal and Spain in 1995-2003



Note: Greece entered the euro zone in 2001, other countries in 1999
Source: central banks and statistical offices of the analysed countries, own calculations

Similarly to Spain after its EU accession, a question emerges whether the lending performance in other countries on their way to the euro zone can be repeated in Poland? The key factor which should be taken into account while trying to answer this questions is the scale of the expected adjustment of the domestic interest rates to the interest rates in the EMU. The data presented in the table below indicates that the existing level of interest rates in Poland is lower relative to the analysed countries a few years prior to their accession to the monetary union.

Current short-term interest rate in Poland in comparison with Greece, Ireland, Portugal and Spain four years ahead of their entry to the EU (% p.a.)

Country and year	3-month interest rate (average in December of a given year)
Poland 2004	6.21
Greece 1996	12.99
Spain 1994	8.22
Ireland 1994	6.22
Portugal 1994	10.47

Note: Greece entered the euro zone in 2001, other countries in 1999; Poland plans to enter the euro zone in 2009
Source: Reuters, Eurostat

The comparison of the absolute interest rate level is not the only tool which indicates that Poland's potential to adjust the interest rates on its way to the euro zone is lower relative to other analysed countries. The same is suggested by the difference between the existing level of short-term interest rates in Poland and the expected rate in the euro zone at the moment of the assumed euro zone entry against the relevant difference in interest rates for the analysed countries a few years prior to their accession to the monetary union. To this end we assume that the nominal interest rate in the euro zone will grow by 2009 i.e. the time when the zloty is to be replaced by Euro, up to 4%-4.5% from the existing 2%[3]. This level would be higher than the 3% in January 1999, when Spain, Ireland and Portugal joined the euro zone and similar to the one in early 2001 when Greece acceded the monetary union.

The structure of credit growth was very similar in the analysed countries. The highest percentage growth was recorded for home mortgages, however, in view of their low opening position, the nominal growth in loans was the highest on the business side. This was the case in Greece, Spain and Portugal and for some time also in Ireland. In all these countries, the structure of loans was gradually changing towards the dominance of home loans at the cost of business loans. This phenomenon in Spain is illustrated in the table below.

Structure of loans in Spain in 1992-2003 (% of total loans)

Date	Corporate	Household		Other
		Housing	Consumer durables	
1992	68.0	18.4	5.3	8.3
1993	64.3	22.3	4.9	8.5
1994	61.5	25.6	4.8	8.0
1995	60.2	27.0	4.7	8.1
1996	58.8	28.4	4.5	8.3
1997	57.5	30.2	4.6	7.7
1998	56.3	30.5	5.1	8.1
1999	55.2	31.1	5.0	8.7
2000	55.1	32.2	4.9	7.8
2001	53.8	33.5	5.4	7.4
2002	53.3	34.0	5.0	7.6
2003	52.4	35.1	4.5	8.1

Source: Bank of Spain

In view of the fact that the value of home mortgages in Poland is exceptionally low relative to other EU members states and the euro zone (it is below 10% of the total loans and account for less than 5% of the GDP against the average 40% of the GDP in the EU), we can expect trends similar to Spain's i.e. the home mortgage market should grow at the fastest rate. This trend was evident in the recent years.

The accession of the individual countries to the euro zone was accompanied by thorough liberalisation of the financial services market (leading among others to the enhanced accessibility of loans in foreign currencies). In Poland, the process was gradual over the last several years and now is practically over, which means that it will not have a major contribution to the acceleration of the growth in the lending market in Poland. It will be more important that unlike in the analysed countries the process of Poland's acceding the monetary union will overlap the first years of EU membership and the resultant possibility of a rapid increase in the Polish market penetration by foreign banks.

On the other hand, the scale of the lending market development on Poland's way to euro zone measured by the growth in the relation between banking loans and the GDP will be limited by the development of financial instruments other than banking loans. The growing popularity of instruments like leasing or factoring will contribute to the decrease in demand for business loans.

The credit activity data may also fail to reflect the scale of the lending market development because of phenomena such as securitisation of banking assets i.e. sale of part of the banks' credit portfolios to other financial institutions (it was very popular in the case of home mortgages in Portugal). That means that in spite of a rapid growth in new loans, the net growth in credit activity shown in money statistics of the central bank will be much lower. In this context, also other factors described in the previous MAKROscope may come to play an important role (F/X movements, repayment of old debts).

Conclusion: chance for high growth

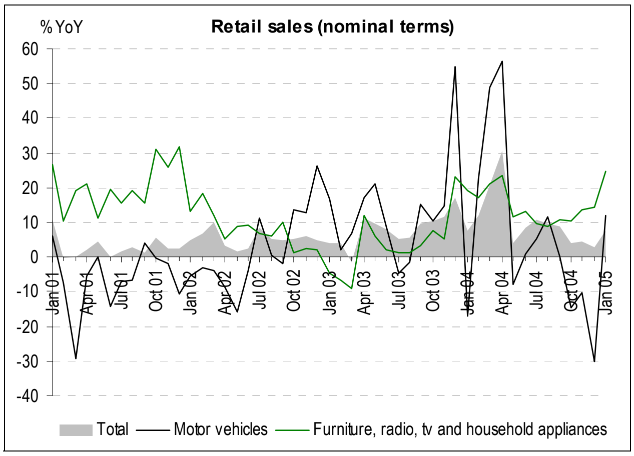
In conclusion, the banking system in Poland, including the lending market are underdeveloped which creates a huge potential for dynamic growth in the future. This growth rate will be determined by the GDP growth in Poland. The faster the GDP will grow (income of households and financial capacity of business), the stronger the demand for credit. The role of money in the Polish economy under the influence of the attempt to catch up with the economic development level after the EU accession as well as on the way to and immediately after joining the euro zone will surely be growing. Yet, the growth in the role of money does not have to be reflected in the pro rata growth in the relation between credit and GDP. It is the case as after the deep liberalisation of financial services in Europe and the dynamic development of the financial market in the recent years, a banking loan is no longer a monopoly to finance transactions in the economy. Therefore, the relation between credit and GDP in Poland will most likely move towards the levels observed in more developed European countries (following the growth in GDP), still this growth will not be so dynamic as in the case of other "catching up" countries in the past as other segments of the financial markets, which did not exist in the past, will grow at a faster rate.

[3] If the inflation in the euro zone is around the inflation target of the ECB (inflation not higher than 2%), the real interest rate in the euro zone would grow by at least 2%, which may be considered the equilibrium level for the euro zone.

In addition, in spite of the fact that the continuation of convergence of short term interest rates, both nominal and real, to the level in the euro zone may contribute to the credit growth in Poland, the room for adjusting the level of interest rates in Poland is now much smaller than it was in the analysed countries prior to their accession to the monetary union (4-5 years). Therefore, the credit growth potential in Poland driven by the decrease in interest rates seems lower than in the analysed countries. Particularly so because interest rates in the euro zone are very low at present and their growth is expected.

It should be noted that the growth potential of some types of loans can be higher than the growth potential of loans in general. Based on the experience of old EU member states and the trends recently observed in Poland, we can expect the continuation of the home mortgage boom which has already started.

Economic update



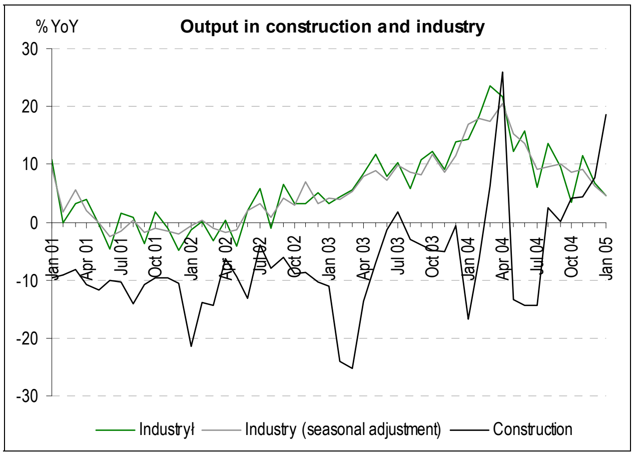
Good start of the year in retail trade

▪ In January retail sales rose 7.5%YoY (3.1%YoY in real terms), which was consistent with our forecast of 7.4%YoY, but higher than market consensus of 4.4%YoY.

▪ Result was much better than average outcome of 4Q04, i.e. 3.7%YoY, which partly stemmed from positive base effect in car sales that rose 11.9%YoY (average 20%YoY drop in 4Q04).

▪ However, apart from car sector, also other branches in retail sales recorded two-digit rates of growth – the best results in sales of pharmaceuticals and cosmetics (25.9%YoY) and household appliances (24.5%YoY).

▪ Even though following months could see a deterioration in annual growth amid adverse base effect, we maintain view that private consumption growth in 1Q05 could reach almost 3%YoY.



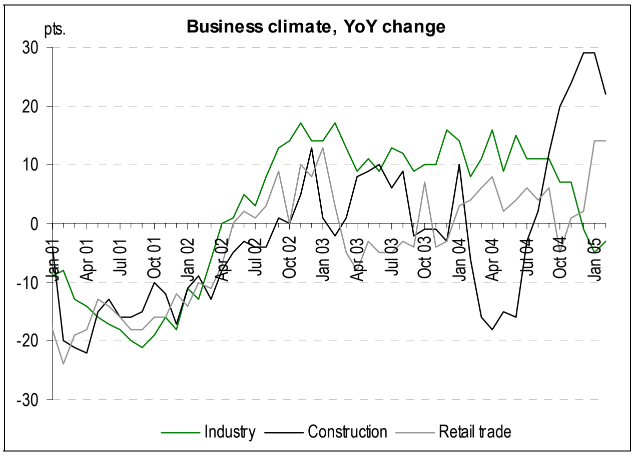
... and in construction; industry depressed by base effect

▪ January saw a continuation of improvement of production in construction and assembly, which surged 18.6%YoY after 7.8%YoY rise in December.

▪ Even though part of the rise resulted from low base effect and good weather conditions in January, improvement was strong enough to claim it reflected also strengthening investment activity.

▪ Industrial output increased 4.7%YoY in January after revised up 6.8%YoY rise in December. Seasonally adjusted growth reached 4.6%YoY.

▪ Slowdown in industrial production growth in 1H05 was inevitable because of very high base effect. However, January data showed that in critical branches (manufacturing) situation is still relatively good.

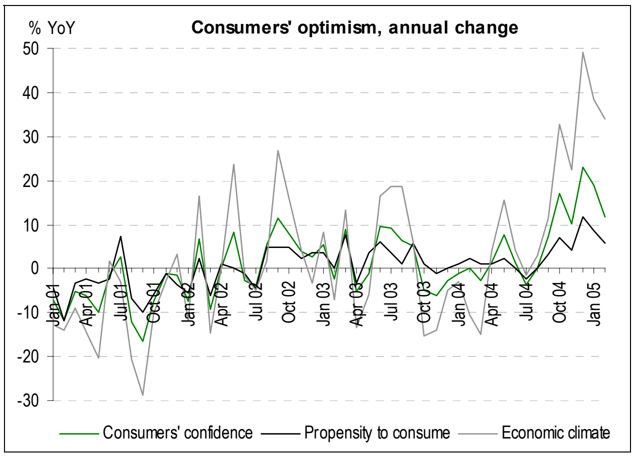


Business climate surveys confirm positive trends

▪ Business climate indices from the CSO confirmed similar picture as in February – moods in construction and retail trade have been improving sharply on annual basis (though climate indices are still below zero), while industry keeps on expanding (positive index), however slower than last year (index decreased third month in a row).

▪ Worse assessment in industry resulted, among others, from drop in current demand and production, there was a bit faster drop in domestic orders. However, expectations for future months remained very optimistic. Slight improvement seen in employment forecasts.

▪ Construction saw sixth consecutive month of double-digit growth in climate index (YoY). Seasonally weaker current assessment was coupled with strong improvement in expectations. Climate in retail trade has been improving at the best rate in six years.



Source: CSO, Ipsos, BZWBK own estimates

Consumers getting more optimistic

▪ Consumers' sentiment surveyed by Ipsos institute worsened in February amid seasonal effect.

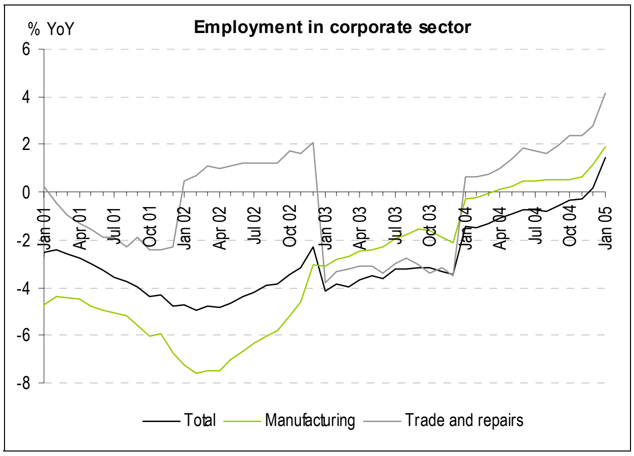
▪ In annual terms, it was the fifth consecutive month of double-digit improvement in optimism (11.7%YoY).

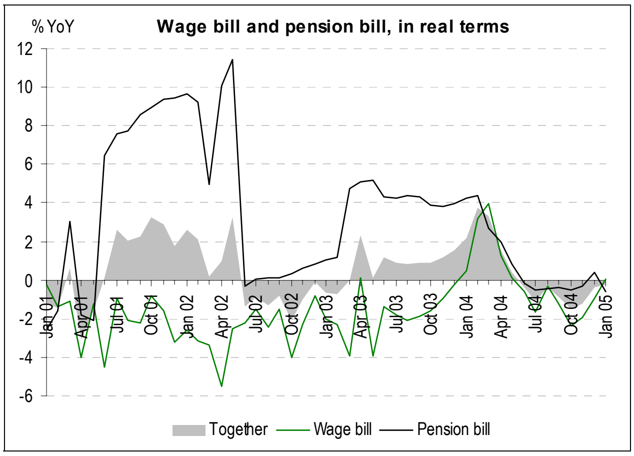
▪ There was also clear improvement in assessment of economic situation and in propensity to spend.

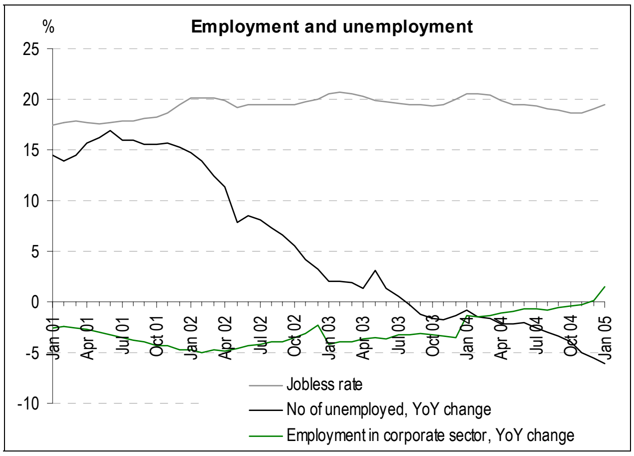
▪ Positive trends were confirmed by consumer climate survey made by CSO, which showed improvement in consumers' current confidence by nearly 12 pp. YoY and rise in leading indicator of consumers' confidence by 14 pp. YoY.

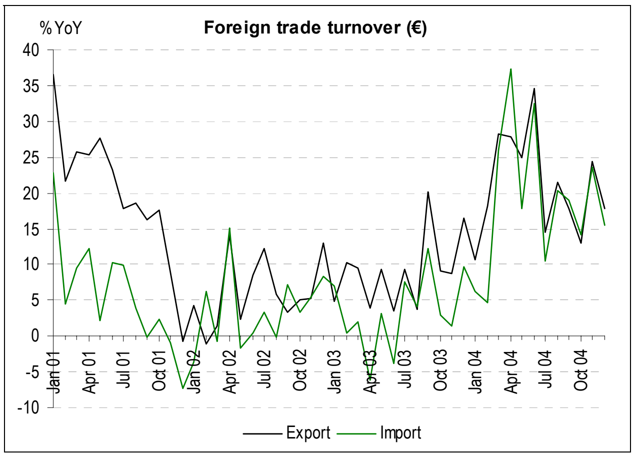
▪ Improvement in consumers' optimism and business climate indices in retail trade seem to be heralding upcoming acceleration in consumption growth. High unemployment seems to be the most important obstacle in this regard.

Economic update









Source: CSO, NBP, BZWBK own estimates

Labour market improving, though no break-through yet

- Employment in corporate sector rose much stronger than expected in January, by 1.4%YoY against average market forecast 0.2%YoY. The biggest improvement was recorded in manufacturing (1.9%YoY) and trade and repairs (4.2%YoY).
- This information should be interpreted with caution, because upturn in employment numbers could have resulted from a yearly change in statistical sample of firms surveyed by the stats office (higher number of firms employing over 9 persons).
- However, it could also reflect the fact that stronger rise in investment activity observed at the turn of the year at last persuaded companies to hire new staff. If this is the fact, one could predict a gradual acceleration in pay rise in the coming months, as a natural product of rising labour demand.
- Meanwhile, rise in salaries surprised on the downside and reached merely 2.6%YoY in January. Earlier concerns of pay growth acceleration in a period of wage negotiations and relatively high inflation failed to materialise.
- Consequently, real wage bill in corporate sector in January was almost the same as one year before (0.1%YoY rise). Thus far, there seems to be no impulse from households' revenues that could trigger faster growth in private consumption. Similarly in the case of social transfers – real pension bill in January was 0.6% lower than last year.
- However, one should bear in mind that wage growth in entire economy is clearly higher than in corporate sector alone. In 4Q04 average salaries in national economy rose 5.6%YoY, while corporate sector saw merely 2.7%YoY increase.

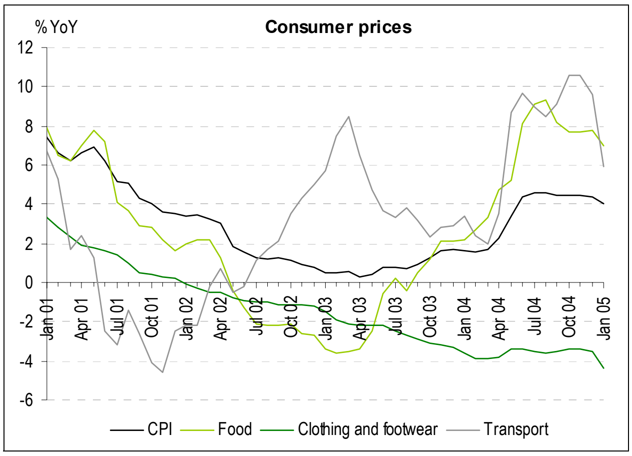
Unemployment inched up seasonally, but trend positive

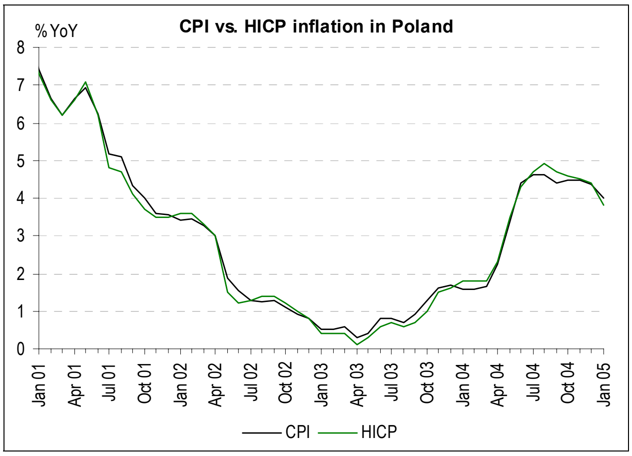
- Unemployment rate recorded a seasonal hike in January to 19.5%. However, it implied significant and accelerating drop of unemployment in annual terms (from 20.6% in January 2004), confirming gradual improvement on the labour market.
- Number of unemployed dropped by 6%YoY. The number of newly registered jobless has been falling for a couple of months (year on year).
- We expect a continuation of those positive trends for the rest of this year and we predict that registered unemployment rate should drop to below 18% at the end of this year.
- According to preliminary estimates from the Ministry of Economy, unemployment rate remained at 19.5% in February, and it should start descending since March.

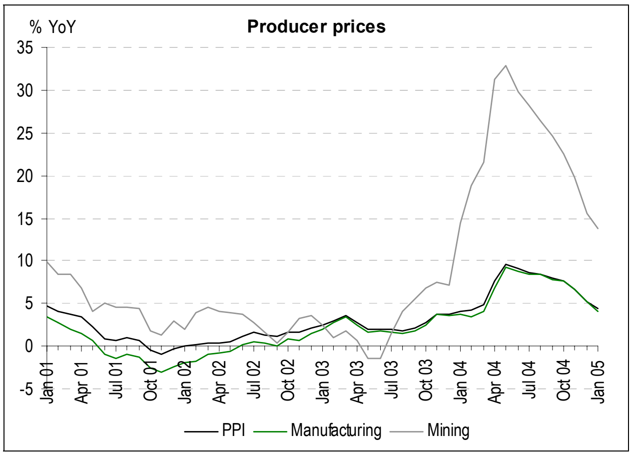
Export still strong, low deficit in current account

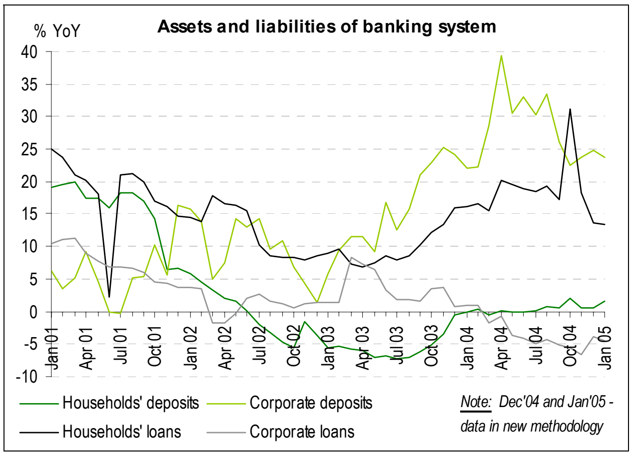
- Current account deficit reached €275m in December (against revised €67m surplus in November), which was much below market consensus forecast of €470m and our prediction €570m.
- In the whole 2004 current account deficit reached €3.14bn (against €4.11bn in 2003), which represented ca. 1.5% of GDP (after November it was ca. 1.8% of GDP).
- Low external imbalance of Polish economy is one of fundamental factors, supporting zloty appreciation. Especially that it results mainly from continuing fast rise in exports.
- In December exports rose 17.8%YoY, and imports 15.4%YoY. It shows that despite ongoing zloty appreciation, external demand for Polish goods remains strong; simultaneously, strong domestic demand was also reflected in those figures.

Economic update









Source: CSO, NBP, Eurostat, BZWBK own estimates

Shocking low inflation in January

▪ Inflation rate in January fell from 4.4%YoY to 4.0%YoY. It was a shocking result for the market, as consensus forecast amounted to 4.6%YoY, and even the biggest optimists did not suspect the figure could drop below 4.4%.

▪ The biggest surprise came from food market, where prices fell 0.3%MoM. Usually, the first month of the year is a period of substantial rise in food prices.

▪ This time the CSO did not show data on fuel prices, however prices in transportation (broader category) dropped 1.6%YoY, so one could suppose fuels got cheaper by over 2%. It surely stemmed from strong zloty appreciation at the end of 2004, and even rise in excise tax for fuels (3.4%) and LPG gas (10%) introduced in January did not manage to offset downward trend.

▪ Prices of clothing and footwear also dropped substantially (by 1.8%MoM, i.e. twice stronger than usually in January), which could have also resulted from zloty appreciation (cheaper import).

▪ Effects of some administrative hikes and indirect tax rises did not appear in January. They might impact CPI with a delay.

... could prove to be even lower

▪ As usually, together with CPI data for February the CSO will publish revised inflation for January, according to new weights system.

▪ Eurostat's data showed that Poland's HICP inflation in January reached 3.8%, i.e. 0.2 pp. lower than CPI. It could suggest that after revision of weights, CPI could be lower than tentative estimate suggested.

▪ In 1Q05 inflation rate should be close to 4%, and in subsequent months we expect it should drop sharply to ca. 2% in June. Second half of the year should see stabilisation of inflation at slightly below 2%.

Producer prices growth sharply decelerating

▪ Producer prices growth was also lower than expected in January, and dropped to 4.4%YoY from revised down 5.2%YoY in December.

▪ Similarly as in the case of CPI, the most important factors dragging producer prices down were falling prices of fuels, metals and other natural resources, coupled with zloty appreciation.

▪ Falling PPI growth will help in reduction of consumers' inflation in subsequent months. Annual PPI growth could drop to close to zero in the middle of the year.

▪ High uncertainty regarding future oil prices still maintains. In the second half of 2005 producer prices growth could accelerate again above CPI growth on back of very low base effect.

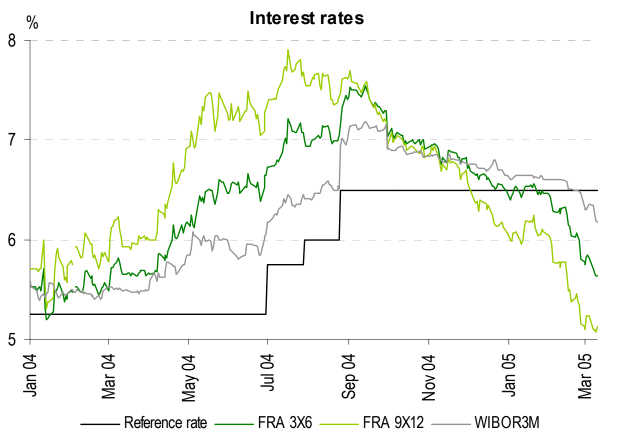
Disruption in money supply time series again

▪ Since January 2005 the NBP changed methodology of monetary statistics (because of data harmonisation with ESCB). Definition of Monetary Financial Institutions has been extended with cooperative savings and credit unions (SKOK).

▪ The change disrupted monetary time series' consistency. NBP showed estimates of monetary aggregates in comparable terms, but only for last 13 months, which allows to compute only two observations of annual growth rates.

▪ According to the data, January saw acceleration in M3 growth to 9.4%YoY from 8.8% in December. There is still no break-through seen on the credit market – loans for households have been growing quite rapidly (13.3%YoY), but debt of corporations keeps shrinking at growing pace (-4.5%YoY in January against -3.9% in December).

Central bank watch



Crucial fragments of the MPC statement from 25 February
No significant changes were observed in the external environment of the Polish economy.
Strong zloty appreciation reduces inflation. However, the appreciation tendency may, at the same time, contribute to the weakening in the economic growth.
The GDP growth rate in 2005 is expected to reach 4.0%-4.5%, and thus to be slightly lower than forecast in the November *Report*, mainly as a result of the currently expected lower contribution of net exports to GDP growth.
According to the February inflation projection the price growth rate should be lower than that expected in the November Report. Assuming unchanged interest rates inflation will with a 50% probability stay in the range of 1.2%-4.0% in 2005 Q4 (2.5%-5.2% in the previous projection), 0.4%-4.2% in 2006 Q4 (1.3%-4.8% in the previous projection) and 0.5%-4.6% in 2007 Q4.
In the Council's assessment for the past several months there has been a change in the balance of risks for future inflation, which resulted in a situation that the current balance may be more favourable than that presented in the February projection. This is because, the hitherto scale of zloty appreciation was larger than what was accounted for in the projection and the dynamics of food prices may be declining faster than assumed. Still, the Council acknowledges the uncertainty related to *inter alia* the developments in oil prices and the zloty exchange rate.

NBP inflation projections (% YoY)

	May 2004	Aug 2004	Nov 2004	Feb 2005
4Q 2005	2.1-5.4	2.8-5.5	2.5-5.2	1.2-4.0
4Q 2006	1.1-4.4	1.6-5.1	1.3-4.8	0.4-4.2
4Q 2007	-	-	-	0.5-4.6

Probability of CPI falling in a given range in 4Q 2006

CPI	Aug04 projection	Nov04 projection	Feb'05 projection
< 1.5%	23%	27%	39%
1.5-2.5%	13%	14%	14%
2.5-3.5%	15%	16%	13%
> 3.5%	49%	43%	34%

Important fragments of the *Inflation Report February 2005*
In the months December 2004-January 2005, the Council maintained its tightening bias in monetary policy, because in its assessment the probability of inflation running above the target (of 2.5%) in the monetary policy transmission horizon was still higher than the probability of inflation falling below 2.5%, however the balance of risks gradually changed towards lower inflationary pressure.
In 2004 Q4 and in January 2005 no signals appeared that would testify to an emergence of wage pressure resulting from increased inflation expectations (second-round effects). (...) Available data and NBP survey results indicate that pay rises planned in 2005 are moderate.
After a period of decline in unit labour costs in the economy, since 2004 Q3 they have been on a slight increase. Consequently, the disinflationary influence of this factor has gradually been weakening.
Due to the predominantly adaptive character of inflation expectations, the Council expects that, together with the swift decrease in inflation, in the second half of 2005 the expectations will fall to the level close to the target of 2.5%.
Starting from the 2005 Q2 a decline in the 12-month price rate of growth can be expected, which in the second half of 2005 should be close to the level of 2.5%.

Source: NBP, Reuters, own estimates

MPC decision: dovish, surprising, risky

- It seems MPC decisions are predictable only when there are no changes in monetary policy parameters.
- MPC decision to change bias to easing directly from tightening, passing over a neutral, was a big surprise for the market.
- It is hard to perceive the MPC statement as overly dovish – it underlined positive business climate, improvement on the labour market and the fact that inflation fall was driven only by food and fuel prices decrease.
- In our opinion, even if the Council believed that probability of rate cut was higher than probability of rate hike, a better idea was to change bias to neutral in the first step. The MPC decision seemed to underestimate a possible market reaction to very dovish signal.
- The market reacted with sharp fall in market interest rates (see chart) and capital inflow strengthened the zloty (despite rising political risk). In turn, the zloty appreciation may force the MPC to cut rates amid improving balance of risk for inflation.
- Justifying its decision, the Council said that the balance of risks for future inflation had been improving for a few recent months. If so, the question is the MPC did not change a bias to neutral in recent months? Instead, the MPC said in the statements after the meetings in January and December that balance of risks had not changed significantly.
- February decision led to revisions of expectations as regards in interest rates cut this year - now we foresee a total rate cut of 100bps until end-2005: 50bps in Q2 and 50bps in Q3. Nevertheless, similarly to the market, which started to price in that rate cuts will take place sooner than previously expected, we think borrowing costs may be reduced even earlier.

Significant change in inflation projection

- It seems that one of the most important arguments for the Council to change bias to easing, except strong zloty, was the new inflation projection of the NBP staff, which showed a significant improvement in inflation outlook.
- According to NBP there should be no problems with achieving 2.5% in the next three years horizon (assuming no rate changes).
- Conclusions of the *Report* justified introduction of neutral rather than easing bias (likelihood of inflation below target close to the likelihood of inflation above). However, in MPC's own view the balance of risks was more favourable than presented by the NBP.
- The MPC expects lower food prices and stronger zloty (NBP models imply depreciation). What is more, the projection assumed CPI inflation at 4.5% in 1Q05, while after January data release it seems it may be close to 4%.

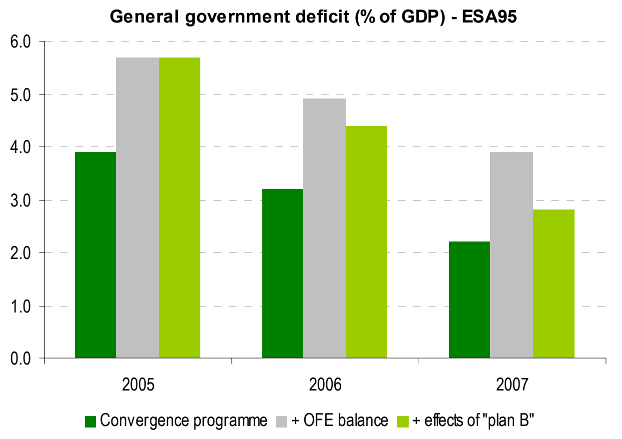
Labour market might stop to lower inflation

- In the chapter of *Inflation Report*, which included a description of monetary policy in December 2004-February 2005 (fragments on the left), the MPC did not explain convincingly why a restrictive bias had been maintained in this period.
- Balance of risks gradually changed towards lower inflationary pressure. However, if probability of exceeding inflation target was only moderately above 50% in November, it is quite surprising that balance of risks did not change to an extent suggesting equal probabilities of CPI inflation below and above the target.
- The MPC paid attention to no second-round effects and to forecasts of lowering inflation expectations to 2.5%
- On the other hand, in the economy growth rate of wages was recently higher than productivity dynamics - the disinflationary influence of this factor has been gradually weakening.

Central bank watch

Comments of the central bank representatives	Remarks
Leszek Balcerowicz, NBP governor, MPC chairman MPC press conference, 25 February According to those who adopt the easing bias (and not “according to the Council”), there is higher probability of cuts than hikes in rates.	It seems the MPC was far from unanimous when taking February decision. In our opinion, this was suggested by statements of NBP president during the press conference. For example, he said that the decision reflected a balance of power within the Council at the meeting.
Krzysztof Rybiński, NBP deputy governor PAP, Reuters, 28 February We expect that over the next three years the realisation of the bank's target of 2.5% is very probable. The scale of interest rates reduction expected by the market, which is 150bps or more over the next 12 months would cause that inflation projection would show inflation significantly above the target. (…) In the light of projection the expectations are inconsistent with realisation of the target.	The statement of deputy NBP governor Krzysztof Rybiński brought a correction on the interest arte market, but it was quite short-lived. As compared to rates levels observed before the MPC meeting, the market is actually expecting deeper (and faster) reduction in official rates. While according to the NBP rates reduction of 150bps could be dangerous form the point of view of inflation target realisation, the MPC is not necessarily of the same opinion. Recent statements and decisions of the MPC indicated that it rather expects lower inflation as compared to the projection of NBP staff. In one of interviews, MPC’s Stanisław Nieckarz disagreed with deputy NBP chief.
Dariusz Filar, MPC member MPC press conference, 25 February Easing bias does not mean immediate rate cuts. The change in bias to easing means only that there is a greater probability of cuts than other moves, but in no way are MPC decisions automatic. This does not mean that we will cut rates directly after change in bias, this will depend on an assessment of the situation. **Stanisław Nieckarz, MPC member** MPC press conference, 25 February Easing bias does not mean immediate rate cuts. In theory, it (the easing bias) may last for a longer time, even half a year.	During press conference after MPC meeting, members of the Council, including Stanisław Nieckarz who is regarded as ultra dovish, stressed that adoption of easing bias does not mean automatically swift rate cuts. However, such statements were ignored by the market. February’s decision was rather a message to carry traders that it is necessary to hurry up in profiting from interest rates differential before cuts start for good. Even if in March the Council confirms statements that cuts are not automatic (and rates will be kept on hold), the market will probably just price-in cuts at the following meeting. Especially as inflation will soon start to fall and we will see weaker economic figures amid statistical base effect.
Stanisław Nieckarz, MPC member PAP, 6 March If the zloty remained strong for a longer period of time achieving CPI inflation target of 2.5% may take place towards the end of the first half of the year. We have to pay attention to the fact that despite gradual reduction, the unemployment is still high enough to constrain wage pressure and possible second-round effects of recently high inflation.	Inflation forecast of MPC member seems quite conservative. In our opinion, CPI may fall below 2% in June. Market consensus seems to perceive inflation perspective in the following months similarly (at least) to our forecasts and that is why it prices in relatively fast rate reductions. One of the two most dovish MPC members leaves little doubts whether he will support rate reduction this year. However, its scale and timing will depend on other, more moderate rate-setters. Therefore, to formulate expectations regarding monetary policy scenario for this year it would be interesting what other central bankers have to say.
Marian Noga, MPC member Reuters, 18 February I think the bias will change in February, to neutral. We should change to easing only when inflation falls below the target, which is possible in the summer. **Mirosław Pietrewicz, MPC member** Rzeczpospolita, 10 February We are waiting for final GDP growth and investment figures for 4Q04. If investment figures are only slightly better than in the third quarter and GDP growth falls, I think it will be a reason to ease our policy bias.	It is hard to expect that market participants will believe MPC members’ statements that rates cut are not automatic after easing bias was introduced . In recent weeks a few members of the MPC (two quotes on the left but Jan Czekaj, Dariusz Filar, Stanisław Nieckarz and Andrzej Wojtyna were speaking in a similar way) were assuring that neutral bias should be adopted soon, while adoption of easing bias seemed more distant. Therefore, it is not surprising that MPC decision brought large volatility to the financial market if a bias change was against previous signals sent by MPC members. It is worth noticing that a couple of those statements were given after surprisingly low CPI inflation in January and after new inflation projection was preliminarily presented to the Council.
Mirosław Pietrewicz, MPC member Reuters, 7 March After evaluating February data, the first rate reduction could be ordered as soon as in March, but this is not certain (…) Currently it seems that over 2005 rate cuts will total more than the 50-75 basis points expected at the end of last year.	Besides the first explicit suggestion from the MPC on a possible scale of rate cuts, Mirosław Pietrewicz said also that the key factors for rates reduction will be: exchange rate of the zloty, inflation processes and investments. While investments are likely to accelerate, inflation may fall to the target fasters than it was assumed in the NBP inflation projection and the zloty may remain quite strong (not without an influence of the February MPC decision).
Halina Wasilewska-Trenkner, MPC member TVN24, 25 February MPC members judged that such a solution will satisfy the market. We meant to demonstrate that the monetary policy could be loosened in the near time. It was a decision burdened with a large risk. The risk is connected with the fact that we do not know how financial markets will react, and the zloty exchange rate and long-term interest rates depend on them.	As we mentioned above, February decision seemed to underestimate a possible market reaction. From this perspective, it is worth to mention what one of MPC members (Halina Wasilewska-Trenkner) told private television TVN 24. This statement shows that a discussion on this problem took place during the meeting, but the majority in the Council (we will know the voting in some time) decided to take a “large risk”. Well, the MPC showed that it was more dovish than financial market was expected and the only possible reaction was sharp strengthening on the interest rates market and pricing-in even more cuts than previously.

Government and politics



Communiqué concerning works on the Strategy for Public Finance Management in 2005-2008

The Ministry of Finance informs that works on the Strategy for Public Finance Management in 2005-2008 are being conducted. The aim is to point to an optimal strategy and measures, which will lead Poland into the euro zone still in this decade. The proposed measures can be divided in 5 areas:

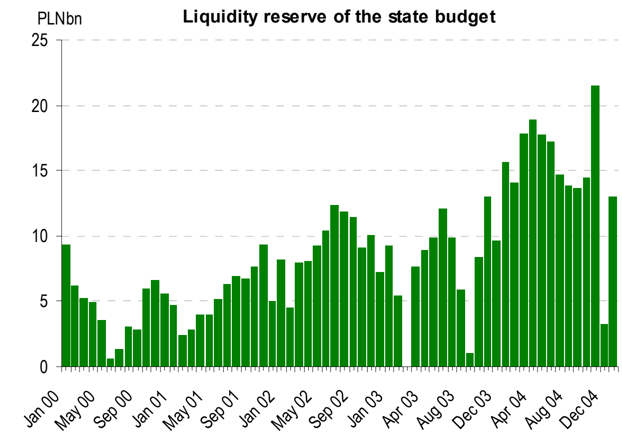
1. Actions aimed at rationalisation of public spending,
2. Regulatory actions lying in the hands of the Minister of Finance,
3. Actions aimed at making structure of budget spending more flexible,
4. Strategy of tax system,
5. Instruments of management, improvement in effectiveness and computerization public finance (computerization of state budget execution, integration of public purchases platform).

The strategy provides for a deeper reduction of the general government deficit than that provided for in the Convergence Programme. Currently, Poland is a subject to excessive deficit procedure (according of Article 104 of the EU Treaty). The ECOFIN Council, in the opinion on update of the Convergence Programme, recommended that Poland should undertake additional measures aimed at reduction in general government sector to below 3% of GDP until 2007.

Support for main political parties according to PBS

Party	Support (%)			Estimated number of seats in the Sejm
	Jan	Feb	Mar	
PO	25	27	22	130
Samoobrona	14	16	17	90
LPR	12	10	15	83
PiS	14	14	14	72
SLD	11	8	7	35
PD	-	-	6	30
PSL	6	6	5	20

Note: PBS poll was carried out on 5-6 March among 1054 Poles.



Source: Ministry of Finance, PBS, own estimates

EcoFin has not reached an agreement yet

- The EcoFin Council, or finance ministers of EU member states, has not reached an agreement on the shape of considered reform of the Stability and Growth Pact at their regular meeting on 7-8 March. The next meeting is due for 20 March in order to reach an agreement before the EU summit on 22-23 March.
- Among a list of factors, which could justify breaching of the budget deficit limit, the key one for Poland is how costs of pension reforms (reflected in OFE balance in Polish case) will be treated.
- Anonymous hints from EU diplomats and media information suggest that the EcoFin will propose a compromise solution, which will enable a country that breaches the budget deficit limit due to costs of pension system reform to avoid sanctions.
- According to information published by *Rzeczpospolita* daily, excessive deficit procedure could be closed in case of those countries, which carried out a pension reform system, if their deficit only slightly exceeds 3% of GDP and is planned to fall below 3% in the next year.
- In case of Poland, this would probably mean that general government deficit would not have to be reduced below 3% already in 2007 (as has been required by the European Commission so far), but only in 2008.
- It is still uncertain whether avoidance of excessive deficit procedure will be equal to recognition that a country fulfils the fiscal Maastricht criteria.
- In the nearest time, the Ministry of Finance is expected to present "the plan B", or the plan of deeper reduction in budget deficit than has been planned so far. It is a shame that the ministry has realised such necessity so late and still delay presenting the plan. For the moment, one has to be satisfied with the general communiqué published by the ministry.

Closer to elections, watch public opinion polls!

- After declarations of Prime Minister, increasing probability that elections will take place in spring, rather than in autumn (we write more about this issue below in the section concerning politicians' statements), results of public opinion polls became the focus of attention.
- The first poll after PM's declarations and formation of the Democratic Party (PD) was carried out by the PBS (see table for results).
- It seems that the PO and PiS may have problems with creating a majority coalition. An additional partner for them could be the newly-created Democratic Party, but PO and PiS leaders may be reluctant to co-operation with such members of the new party as deputy PM Jerzy Hausner (member of the SLD until very recently).
- Even of the PO and PiS gets a majority of seats, it is still uncertain whether they will reach an agreement on an economic program.

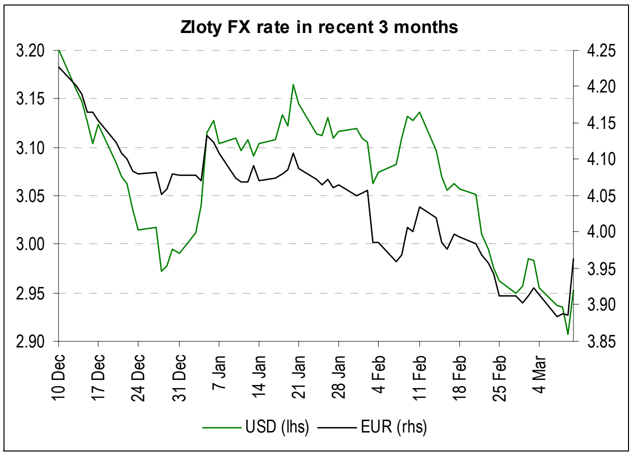
Good start of the year for the state budget

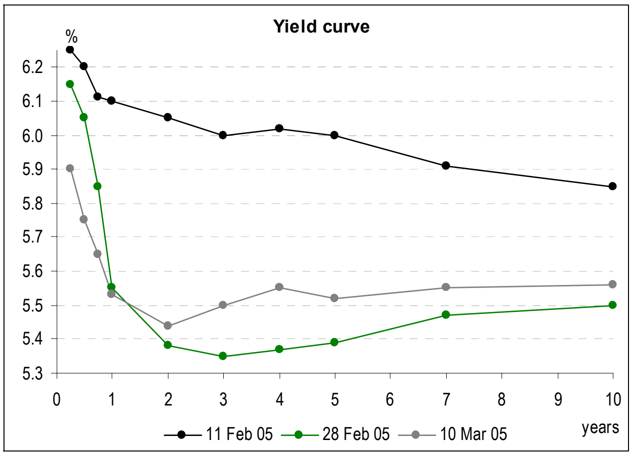
- Deficit of the sate budget after January reached a mere 4.5% of the full-year plan. Thus, it was even lower than optimistic assumptions of the Ministry of Finance (see February's MACROscope for details) and much lower than average deficit execution after January in 2000-2004, standing at 11.9%.
- Relatively low deficit could have been achieved despite increased contribution to the EU budget – mainly due to rising inflows from indirect taxes (almost 55% YoY). In spite of fall in income tax inflows, total budget revenues grew almost 40%YoY.
- Although results of the first month of the year may not be a good indication for the remainder of the year, they are supportive for the sentiment on the domestic debt market. Particularly that liquidity of the budget increased to PLN13bn in January after a drop to just PLN3.3bn at the end of 2004.

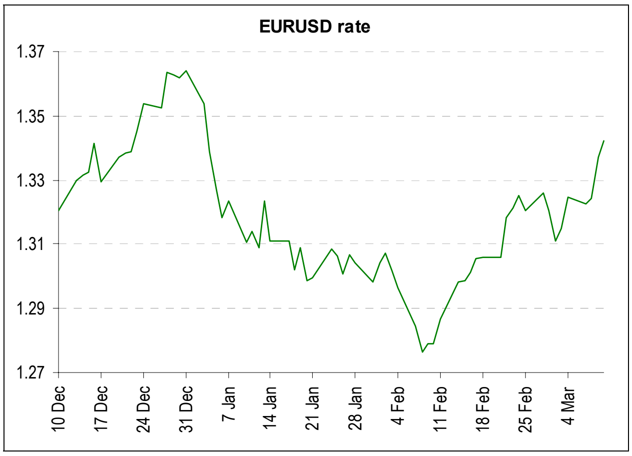
Government and politics

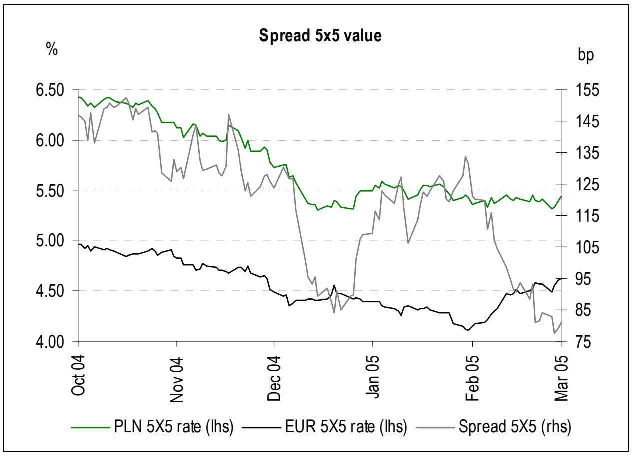
Comments of government representatives and politicians	Remarks
Aleksander Kwaśniewski, President PAP, 7 March If the parliament's term was not shortened, the first turn of presidential elections, parliamentary elections and the referendum of EU Constitution would take place together on 25 September. This is tough declaration of the Sejm's speaker Cimoszewicz. We have agreed with the Prime Minister that on 5 May the election campaign will start. [With that moment] Everyone makes individual decision on what he or she will do in future. **Włodzimierz Cimoszewicz, Lower House speaker** PAP, 4 March I treat my declarations very seriously and on 5 May I will put the motion aimed at shortening of parliament's term to the vote. I cannot imagine anything that could speed up this process in accordance with the constitution. I do not know exactly plans of the Prime Minister. I admit that a scenario assuming resignation of the Prime Minister and dismissal of the entire cabinet does not make sense at the moment, because decision of the length of Sejm's term and election date should be made in Sejm. Resignation of the Prime Minister and the whole government for achievement of such goal would increase chaos in the country. (…) Resignation of Prime Minister in May does not make any sense, because it will finish with elections in September. **Marek Belka, Prime Minister** PAP, 3 March I will do everything so that on May 5 parliament will decide to dissolve itself. In such situation, polls should take place on June 19. (…)I have already made a decision on my political future, but I will announce it on 5 May. Regardless of what Sejm decides on May 5, the election campaign will start then. I will feel then as free of any constraints that the Prime Minister is subject to.	Prime Minister Marek Belka pledged he would do everything so that the parliament would decide to dissolve itself on May 5. He also announced that regardless of what happens on May 5, if the parliament decides one way or another, he would regard the mission of his government to have ended. Such statements suggest that one cannot rule out that Belka would step down from the post if the parliament does not pass dissolution motion, however the PM refused to confirm it explicitly. Anyway, PM rejected opposition's call for his immediate resignation, saying the government still has work to do (e.g. a healthcare reform). In his speech, Belka reaffirmed his support for the newly-created Democratic Party, signalling he might join it after May 5. Such intention was confirmed by leader of the new political force Władysław Frasyniuk who had said Belka told him he would join the party on May 5. In our view, it looks like Belka could try to induce the Sejm to pass motion on self-dissolution by signalling he is just about to join the opposition shortly before the voting. In such a case, it would be discrediting for the SLD to stick to the government any more. Alternatively – in the event of no success – Belka could also resign after the voting. However, the latter solution would be less favourable, as it means uncertainty regarding election date (assuming the President accepts the resignation). In a negative scenario (related to constitutional procedure), it could take place in the middle of summer holidays, which is highly undesirable solution for most of political parties (high absence of voters and uncertain election results). Meanwhile, Belka strongly insist on the SLD to drop their resistance to early elections. SLD leader Józef Oleksy said the party would consider the date issue again at the meeting on March 12. For the time being, Oleksy changes his mind very often and almost every day present different view on possible election date. One thing is sure, significant political uncertainty is here to stay with us and this may worsen sentiment on the market and cause increased volatility on both the FX and debt market until situation clears up.
Jerzy Hausner, deputy PM, economy and labour minister Reuters, 9 March I talked with Prime Minister Belka yesterday and submitted my resignation. The Prime Minister said he accepted my resignation. (…) I expect the Prime Minister to make the decision on acceptance of my resignation at the earliest in two weeks. (…) As for Prime Minister Belka, we are joined by a friendship and soon we will be creating a new party.	The immediate reaction of the Polish financial market to Hausner's decision was quite nervous (the zloty lost almost 1% in a few minutes), but it was short-lived, as market players soon realised that Hausner's dismissal is of little importance in current circumstances – it will have no impact on the government's economic policy, particularly that in the pre-election period one should not expect any, even the most cautious, attempts aimed at reforming public finance.
Jan Rokita, PO leader PAP, 1 March My experts are very seriously considering this type of project as a project which fights against excessive zloty appreciation in a situation where fiscal reforms are causing further currency strengthening and the central bank chooses not to intervene. (…) This trend [of zloty strengthening] is slowly starting to become excessive, it is not yet there but is becoming so. There are two ways to prevent this occurring: one in the hands of government and the other in ... the central bank's. The central bank has interest rates and market interventions. Its [the bank's] position is against [using monetary policy tools to weaken the zloty] and it is not showing excessive fears about zloty appreciation. I will not comment on this for now. I will also not ask or demand of Leszek Balcerowicz this or that action. (…) So the government has one other tool -- a delicate instrument which requires very courageous decisions that in certain conditions could be possible. This plan envisages trying to stabilise the exchange rate through some sort of fixed zloty rate - here everyone suggests unilateral euroisation. This would be done after initial fiscal reforms are carried out and public finances strengthened. I do not want to determine this at the moments, as it would be premature. If it turns out that the NBP does not want to meet expectations of the government, we would not call the bank to act different way, but I would prefer to use instruments that are at the government and finance ministry's disposal.	Rokita called his idea of fixing the zloty an "euroisation", but we think he rather meant some kind of narrow exchange rate band regime (or currency board). Real euroisation (meaning unilateral adoption of the euro) seems to be a rather impossible option, as the ECB and the European Commission may oppose such idea, not to mention stance on this issue presented by the Law and Justice (PiS), a potential coalition partner of the PO in the next cabinet. So far, PiS declared Poland should not abandon its currency and euro zone entry should be delayed far beyond 2010. It seems more likely that PiS could accept introduction of the band regime (to save the economy from further appreciation of the zloty), but not aimed at fast euro entry. We think such solution would be unacceptable for the National Bank of Poland. The Polish central bank has repeated clearly that Poland should adopt the euro as soon as possible and until the euro zone entry, the zloty exchange rate regime should be as flexible as possible and Poland's stay in the ERM2 (with quite wide band of +/-15%) should be as short as possible. Rokita suggested that a change of the exchange rate regime could be decided by the government alone (if the central bank does not try to weaken the zloty voluntarily through interest rate changes or FX interventions). Does it mean the PO is going to change the NBP act? All in all, given all the problems with a change of the exchange rate regime in Poland, Rokita's idea seems to be very provisional (actually, it was admitted by PO leader). However, it is likely to be discussed further in future and a possibility of a change in the exchange rate regime (with a parity rate possibly far from current levels) becomes an additional risk factor for the domestic FX market.

Market monitor









Source: Reuters, BZ WBK

Politics generates minor correction

▪ Last month zloty continued its upward tendency gaining 5.85% to the dollar and 1.78% to the euro. It was triggered mainly by huge foreign capital inflow, encouraged by the prospects of relatively swift interest rate cuts following surprisingly low January inflation release and a change of bias in monetary policy to easing one.

▪ Strong correlation with euro rate returned, which was gaining to the dollar. Zloty's decline owing to political confusion became an opportunity for players to add to positions in zloty.

▪ Though it is hard to agree with that looking at opinion polls, foreign capital deems election risk as relatively low. Capital inflow into interest rate market may still support the zloty what in turn might be an argument for interest rate cut, especially if February inflation proves to be lower-than-expected.

February inflation will point to rates reduction path

▪ The bond yields fell by 29-61 bp. The curve changed its shape into positive both in 2/5y and 5/10y sectors. Behind such significant yield movement laid the same reasons which made the zloty buoyant.

▪ The whole FRA curve shifted down, while so far mainly rate of 6x9 and 9x12 had declined. Presently FRA 1x2 prices in 40 bp cut in March. Yield backup induced by politics was used to long positions increase by market players. Corrections triggered by the tenders had only technical nature.

▪ February inflation data will be crucial for the curve performance. A sequence of rate cuts depends on them and magnitude of market interest rates movements, as a consequence. Regardless of the timing of NBP decision bonds will be supported by strong zloty. While shifting downwards the curve may become more positively sloped.

The dollar rather down

▪ Initial advancement of the euro against the dollar was a result of technical factors impact. Then demand for the euro was triggered by Fed speakers' comments (including Greenspan) pointing to "measured" pace of tightening and statements from Asian central banks on possibility of reserve diversification. Eventually US labour market data, though high ones, weakened the dollar due to short positions preponderance in EURUSD. Last few day deepened dollar's losses to 1.34 ahead of trade data.

▪ Next month US international trade report will act against the dollar, though other data will probably support it. However the product of these forces may negatively influence the American currency, though the market may suffer a correction after recent dramatic gains. The Fed hiking rates by another 25 pb will probably meet market consensus.

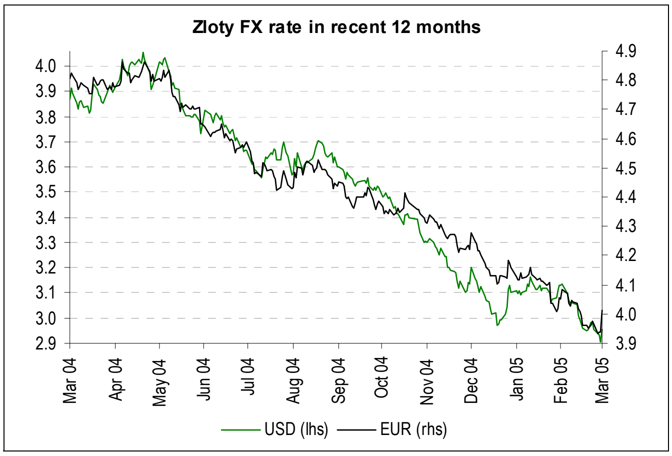
Papers less profitable

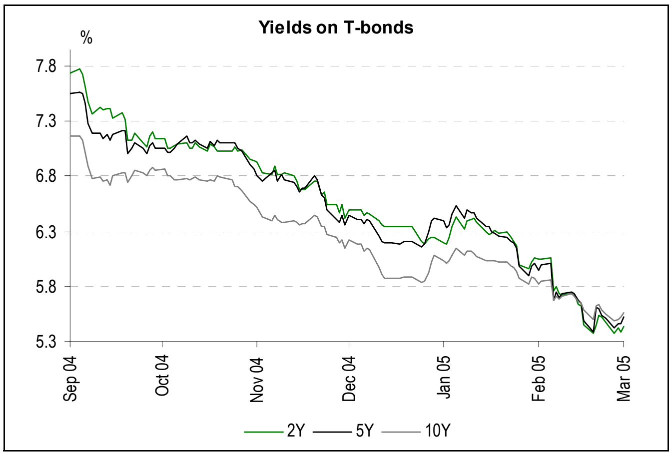
▪ Spread 5/5y between Polish and euro curve substantially narrowed from 120 to 80 bp. It occurred on the back of strong zloty, inviting to invest in Polish assets and declines in the Bunds' market.

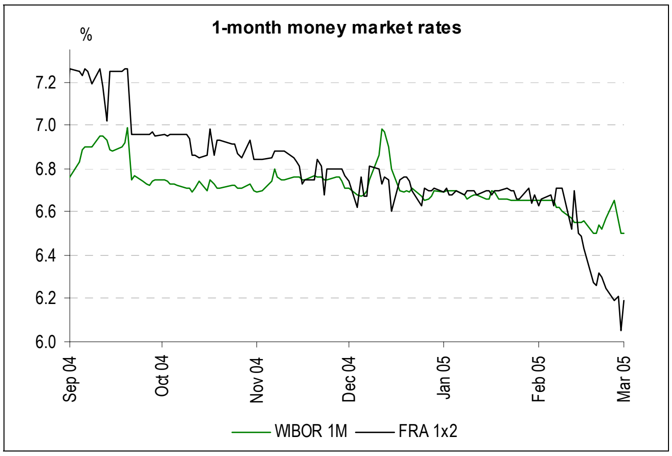
▪ Slumps in German 10y bonds (3.78%) were triggered mainly by technical factors though certain impact had the data from euro zone. In turn, US papers (4.53%) deteriorated mostly due to fundamental reasons, as macro data showed positive prospects for expansion in US. Spread between them has already widened to 75 bp.

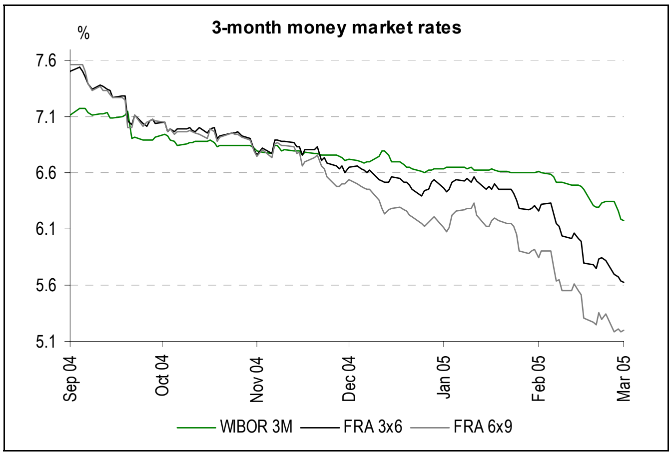
▪ High reading of employment data confirms that labour market starts to catch up with the rest of the economy. Consecutive US rate hikes will make position in American papers less profitable that may cause 10y bond yield to rise, though preceding correction after recent price falls may be seen.

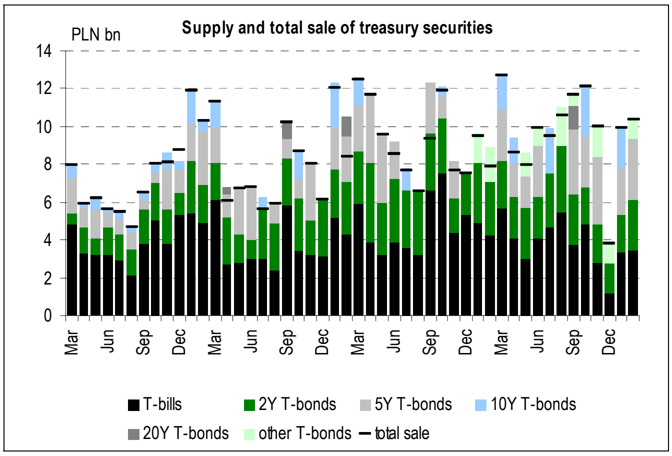
Market monitor











Treasury bill auctions (PLN m)

	OFFER / SALE		
Date of auction	13-week	52-week	Total
07.02.2005	-	900 / 900	900 / 900
14.02.2005	-	900 / 900	900 / 900
21.02.2005	-	800 / 800	800 / 800
28.02.2005	-	800 / 800	800 / 800
Total February*	**-**	**3 400 / 3 400**	**3 400 / 3 400**
07.03.2005	-	800 / 800	800 / 800
14.03.2005	-	600 – 1 000	600 – 1 000
21.03.2005	-	600 – 1 000	600 – 1 000
24.03.2005	100	700 – 1 100	800 – 1 200
Total March*	**100**	**2 700/-3 900/ 800**	**2 800-4 000/ 800**

* estimations based on Ministry of Finance preliminary information

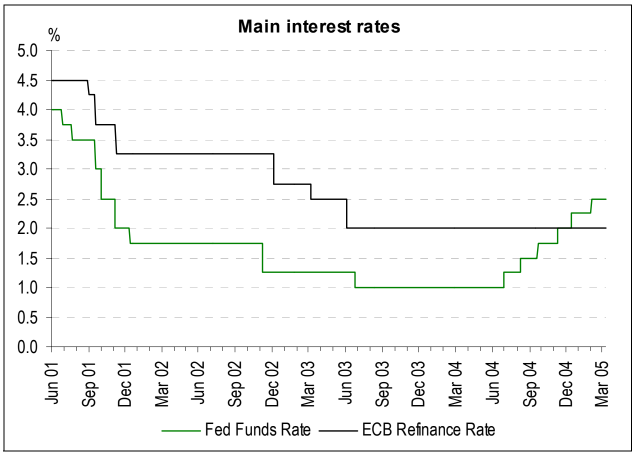
Treasury bond auctions in 2005(PLN m)

month	First auction				Second auction				Third auction			
	date	T-bonds	offer	sale	date	T-bonds	offer	sale	date	T-bonds	offer	sale
January	05.01	OK0407	2 000	2 000	12.01	DS1015	2 600	2 130	19.01	PS0310	2 500	2 500
February	02.02*	OK0407	2 760	2 760	09.02*	IZ0816	960	960	16.02*	PS0310	3 840	3 200
March	02.03*	OK0407	3 000	3 000	09.03	WS0922	1 400		16.03	PS0310	2 500-3 500	-
April	06.04	2Y	-	-	13.04	10Y	-	-	20.04	5Y	-	-
May	04.05	2Y	-	-	11.05	12Y CPI	-	-	18.05	5Y	-	-
June	01.06	2Y	-	-	08.06	3&7Y Float	-	-	15.06	5Y	-	-
July	06.07	2Y	-	-	13.07	10Y	-	-	20.07	5Y	-	-
August	03.08	2Y	-	-	10.08	12Y CPI	-	-	-	-	-	-
September	07.09	2Y	-	-	14.09	20Y	-	-	21.09	5Y	-	-
October	05.10	2Y	-	-	12.10	10Y	-	-	19.10	5Y	-	-
November	02.11	2Y	-	-	09.11	12Y CPI	-	-	16.11	5Y	-	-
December	07.12	3&7Y Float	-	-	-	-	-	-	-	-	-	-

* with supplementary auction

Source: Ministry of Finance, Reuters, BZ WBK

International review

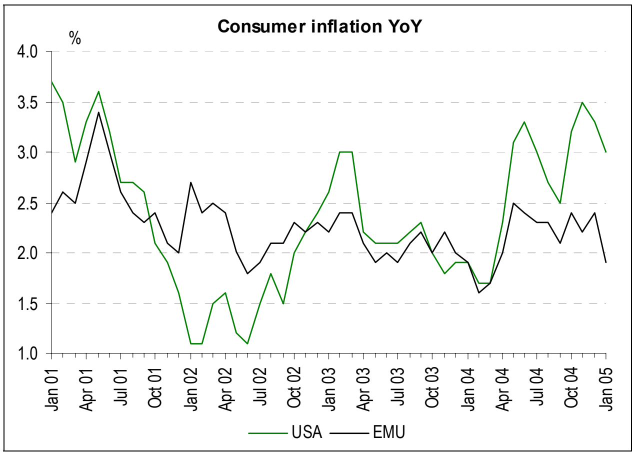


Rates still „fairly low"

▪ Last month the Fed did not make any decisions on rates, but minutes from February meeting was published and two Fed chairman's testimonies to the Congress took place.

▪ In both Greenspan's testimony to Senate and the minutes from February FOMC meeting it was stressed that real rates in US are still "fairly low" what means they would be hiked further in order to curb inflation. FOMC expressed its concern about current account deficit which would probably stay wide. Generally the market did not receive any signals on possibility of pause in rate hikes cycle.

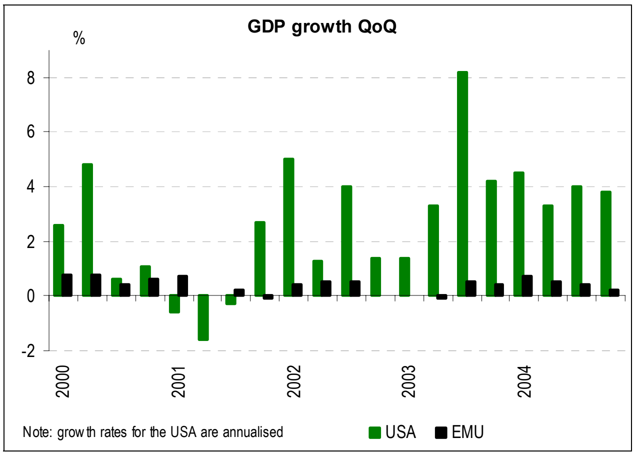
▪ ECB left rates unchanged at 2.0%. ECB governor during press conference announced that forecasts of GDP growth for euro zone in 2005 had been reduced from 1.9% to 1.6%. But despite that, overtone of Trichet's comments were perceived as moderately hawkish.



Inflation in Europe declines below the target

▪ Consumer prices in US grew in January by mere 0.1%, as energy prices fell substantially the second consecutive month. Excluding food and energy prices, core inflation recorded in January an increase by 0.2%. In annual terms CPI advanced by 3.0%, and net inflation by 2.3%. Thus concerns about high indicator levels did not realise following producer prices release. Due to systematically climbing oil prices in February, next month inflation may not yet be so favourable.

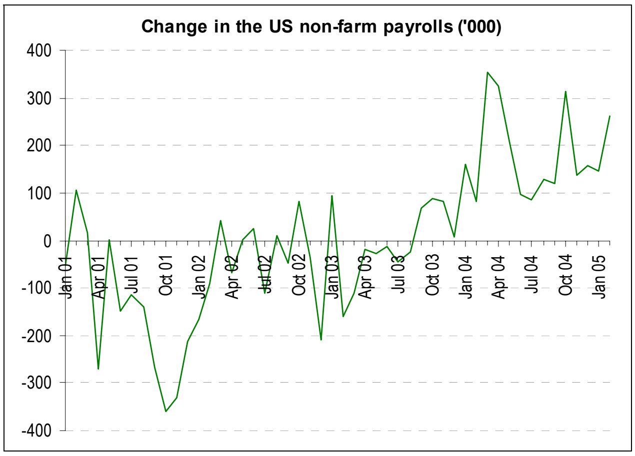
▪ In January in euro zone record inflation decline was recorded to 1.9% from initially reported 2.1%. Reduction of inflation rate was possible due to exceptionally huge price decline in France. Thereby headline indicator of price growth dynamics in euro zone fell below ECB target of 2.0%. It does not change that we still expect hikes in the final quarter of the year.



Strong growth revision in US

▪ Economic growth in euro zone slowed to 0.2%QoQ in 4Q04. Eurostat reported in initial estimates that euro zone GDP grew by 1.6%YoY against expectations of expansion at 0.4%QoQ and 1.8YoY. In the whole 2004 national output in euro zone increased at a pace of 2.0%. Moreover EC lowered GDP forecast for 1Q and 2Q05 to 0.2-0.6%. Germany's weak data negatively affected the whole EMU, in spite of decent reading from France and Spain, where domestic demand boosted growth.

▪ US economic expansion at the end of 2004 was meaningfully stronger than initially reported, as 4Q04 US GDP was upwardly revised owing to better results in retail trade and investments. GDP grew finally by 3.8% in 4Q04 instead of 3.1% according to flash estimates. Despite data revision for the final quarter GDP reached 4.4%YoY in 2004, significantly more than recorded a year earlier.



Source: Reuters, ECB, Federal Reserve

US labour market in a good shape

▪ Change in US non-farm payrolls in February amounted to 262 000 of new jobs, mostly due to higher number in auto and construction sectors. Unemployment rate yet increased to 5.4% from 5.2% in January, but it partly reflects higher number of workers entering labour force. Overall, report showed welcome improvement in job creation process, that lagged during last few months.

▪ Investors confidence indicator ZEW in Germany increased in February to 35.9 from 26.9 in January, more than expected, as economy prospects became brighter. Despite optimistic signs incorporated in ZEW index IFO sentiment indicator unexpectedly fell in February to 95.5 from 96.4 in January, because economic prospects in manufacturing and retail trade worsened. According to IFO's chief increase in domestic demand is still sluggish.

What's hot this month

Monday	Tuesday	Wednesday	Thursday	Friday
28 February ***POL: T-Bills auction*** ***POL: C/A (XII)*** EMU: CPI (I) EMU: Business climate (II) USA: Chicago PMI (II)	**1 March** GER: Unemployment (II) EMU: PMI (II) EMU: Unemployment (I) USA: ISM manufacturing (II)	**2** ***POL: 2y bonds auction (OK0407)*** EMU: PPI (I) EMU: GDP (4Q)	**3** EMU: ECB decision USA: Productivity (IV kw.) USA: ISM non-manufacturing (II)	**4** EMU: Retail sales (I) USA: Non-farm payrolls (II) USA: Final Michigan (II) USA: Factory orders (I)
7 ***POL: Treasury bills auction*** ***POL: Reserve assets (II)***	**8** EU: EcoFin meeting	**9** ***POL: 20y bond auction*** USA: Beige Book (II)	**10** GER: Trade balance (I) GB: BoE meeting – decision USA: Wholesale inventories (I) USA: Monthly budget statement (II)	**11** ***POL: GDP (4Q)*** USA: International trade (I)
14 ***POL: Treasury bills auction*** ***POL: CPI (II)*** ***POL: Money supply (II)***	**15** ***POL: Gross wages (II)*** ***POL: Employment (II)*** GER: ZEW index (III) USA: Business inventories (I) USA: Retail sales (II) USA: Net capital flow (I)	**16** ***POL5y bond auction*** EMU: Final HICP (II) USA: Industrial production (II) USA: Capacity utilisation (II)	**17** ***POL: PPI (II)*** ***POL: Industrial production (II)*** EMU: Industrial production (I) USA: Leading indicators (II)	**18** USA: Import prices (II) USA: Preliminary Michigan index (III)
21 ***POL Treasury bills auction***	**22** ***POL: Core inflation (II)*** ***POL: Business climate (II)*** USA: PPI (II) USA: FOMC decision	**23** ***POL: Switching auction*** ***POL: Retail sales (II)*** ***POL: Unemployment (II)*** EMU: Balance of payment ECB(I) GER: IFO index (III) EMU: Trade balance Eurostat (I) USA: CPI (II)	**24** USA: Durable goods orders (II)	**25**
28 Easter Monday	**29** USA: Consumer confidence (III)	**30** ***POL: MPC meeting - decision*** EMU: Money supply (II) USA: Final GDP (4Q)	**31** ***POL: Balance of payment (II)*** EMU: Business climate (III) USA: Factory orders (III) USA: Chicago PMI (II)	**1 April** USA: Payrolls (III) USA: Final Michigan index (III) USA: ISM manufacturing (III)

Source: CSO, NBP, Finance Ministry, Reuters

MPC meetings and data release calendar for 2005

	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
MPC meeting	25-26	24-25	29-30	26-27	24-25	28-29	26-27	30-31	27-28	25-26	29-30	20-21
GDP*	-	-	21	-	-	21	-	-	21	-	-	21
CPI	17	15[a]	14[b]	14	16	14	14	16	14	14	14	14
Core inflation	25	-	22[b]	22	24	22	22	24	22	24	22	22
PPI	20	17	17	19	20	17	19	18	19	19	18	19
Industrial output	20	17	17	19	20	17	19	18	19	19	18	19
Retail sales	21	23	23	21	23	21	21	22	21	21	23	21
Gross wages, employment	17	15	15	15	18	15	15	16	15	17	17	15
Unemployment	21	23	23	21	23	21	21	22	21	21	23	21
Foreign trade	about 50 working days after reported period											
Balance of payments*	-	-	31	-	-	30	-	-	-	-	-	-
Balance of payments	31[c]	28	31	29	31	30	-	-	-	-	-	-
Money supply	14	14	14	14	13	14	-	-	-	-	-	-
NBP balance sheet	7	7	7	7	6	7	-	-	-	-	-	-
Business climate indices	21	21	22	22	20	22	22	19	22	21	22	22

* quarterly data, [a] preliminary data, January, [b] January and February, [c] November 2004, [d] January [e] February , *Source: CSO, NBP*

Economic data and forecasts

Monthly economic indicators

		Feb 04	Mar 04	Apr 04	May 04	Jun 04	Jul 04	Aug 04	Sep 04	Oct 04	Nov 04	Dec 04	Jan 05	Feb 05	Mar 05
Industrial production	%YoY	18.3	23.5	21.8	12.2	15.8	6.0	13.7	9.5	3.5	11.4	6.8	4.7	3.6	0.9
Retail sales [c]	%YoY	12.1	20.7	30.6	4.0	8.6	10.9	9.6	8.8	4.0	4.4	2.8	7.5	4.9	-4.8
Unemployment rate	%	20.6	20.4	19.9	19.5	19.4	19.3	19.1	18.9	18.7	18.7	19.1	19.5	19.5	19.3
Gross wages [b c]	%YoY	6.3	7.0	4.6	4.4	4.5	3.6	5.1	3.7	2.4	2.7	3.2	2.6	0.8	2.7
Employment [b]	%YoY	-1.5	-1.3	-1.1	-0.9	-0.7	-0.7	-0.8	-0.6	-0.4	-0.3	0.2	1.4	1.6	1.7
Export [d]	%YoY	18.3	28.2	27.9	24.9	34.5	14.6	21.5	17.7	13.0	24.3	17.8	16.3	14.8	4.1
Import [d]	%YoY	4.6	25.8	37.4	17.8	32.4	10.5	20.2	19.0	14.2	23.5	15.4	17.9	20.0	4.8
Trade balance [d]	EURm	-9	-535	-1 021	-232	-172	-509	-312	-326	-320	-480	-652	-500	-250	-600
Current account balance [d]	EURm	-14	-447	-541	-416	-379	-532	97	-334	-66	67	-275	-300	-150	-600
Current account balance [d]	% GDP	-1.7	-1.7	-1.7	-1.7	-1.8	-1.8	-1.7	-1.8	-2.0	-1.8	-1.5	-1.6	-1.6	-1.6
Budget deficit (cumulative)	PLNbn	-9.4	-11.8	-11.0	-15.3	-19.9	-23.2	-25.9	-29.0	-30.8	-33.8	-41.5	-1.6	-9.0	-13.4
Budget deficit (cumulative)	% realisation	20.7	26.1	24.3	33.8	43.9	51.3	57.1	63.9	67.9	74.6	91.6	4.5	25.6	38.3
CPI	%YoY	1.6	1.7	2.2	3.4	4.4	4.6	4.6	4.4	4.5	4.5	4.4	4.0	4.1	3.9
PPI	%YoY	4.2	4.9	7.6	9.6	9.1	8.6	8.5	7.9	7.6	6.7	5.2	4.4	4.1	3.0
Broad money (M3)*	%YoY	5.1	5.7	8.5	6.4	7.2	6.8	7.4	6.5	10.5	6.4	8.7	9.4	-	-
Deposits*	%YoY	3.5	4.8	8.4	6.2	6.9	6.4	7.6	6.6	11.5	6.5	8.1	8.4	-	-
Credits*	%YoY	7.7	6.1	8.5	6.1	5.7	4.6	5.2	4.2	9.5	4.0	2.9	3.3	-	-
USD/PLN	PLN	3.84	3.89	3.97	3.93	3.78	3.64	3.64	3.58	3.46	3.28	3.09	3.11	3.06	2.98
EUR/PLN	PLN	4.85	4.77	4.76	4.72	4.59	4.47	4.43	4.37	4.32	4.26	4.14	4.08	3.99	3.90
Reference rate [a]	%	5.25	5.25	5.25	5.25	5.25	6.00	6.50	6.50	6.50	6.50	6.50	6.50	6.50	6.50
WIBOR 3M	%	5.46	5.49	5.69	5.99	5.91	6.34	6.58	7.12	6.89	6.81	6.72	6.44	6.54	6.30
Lombard rate [a]	%	6.75	6.75	6.75	6.75	6.75	7.50	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00
Yield on 52-week T-bills	%	5.78	5.87	6.20	6.65	6.79	7.15	7.24	7.38	7.00	6.81	6.44	6.28	5.95	5.50
Yield on 2-year T-bonds	%	6.34	6.34	6.83	7.41	7.44	7.80	7.66	7.51	7.04	6.81	6.39	6.24	5.82	5.50
Yield on 5-year T-bonds	%	6.76	6.60	7.13	7.57	7.50	7.79	7.65	7.33	7.03	6.78	6.29	6.31	5.80	5.50
Yield on 10-year T-bonds	%	6.81	6.65	7.02	7.32	7.27	7.44	7.36	6.96	6.75	6.43	6.02	5.98	5.72	5.50

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

* Since January 2005 the NBP changed methodology of monetary statistics (definition of Monetary Financial Institutions has been extended with cooperative savings and credit unions (SKOK)). As the NBP showed estimates of monetary aggregates in comparable terms for last 13 months only, forecasting the data for 2005 is burdened with large risk.

Quarterly and annual economic indicators

		2002	2003	2004	2005	1Q04	2Q04	3Q04	4Q04	1Q05	2Q05	3Q05	4Q05
GDP	PLNbn	781.1	814.7	884.2	949.2	203.8	216.1	218.8	245.7	220.2	231.6	233.8	263.1
GDP	%YoY	1.4	3.8	5.4	4.7	6.9	6.1	4.8	4.2	3.9	4.4	5.0	5.3
Domestic demand	%YoY	0.9	2.5	4.9	4.7	5.5	5.1	4.6	4.3	3.9	4.4	5.0	5.3
Total consumption	%YoY	2.8	2.5	2.8	3.1	3.3	3.5	2.9	1.8	2.5	2.9	3.4	3.5
- Private consumption	%YoY	3.3	3.1	3.2	3.5	3.9	3.8	3.5	1.8	2.8	3.3	3.9	4.1
Fixed investments	%YoY	-5.8	-0.9	5.0	10.7	3.5	3.6	4.1	7.0	12.0	11.0	12.0	9.2
Industrial production	%YoY	1.1	8.4	12.3	7.2	19.0	16.4	9.2	6.1	3.0	6.6	9.3	9.8
Retail sales (real terms)	%YoY	1.9	3.6	7.9	1.9	13.6	11.3	4.0	-1.0	-2.2	-2.6	6.0	6.5
Unemployment rate [a]	%	20.0	20.0	19.1	17.7	20.4	19.4	18.9	19.1	19.3	18.2	17.7	17.7
Gross wages (real terms)	%YoY	1.5	2.0	0.8	2.4	3.8	1.6	-0.5	-1.5	-1.9	0.4	1.4	1.8
Export [b]	%YoY	6.0	9.1	21.0	11.0	19.3	29.1	17.6	18.2	11.0	11.0	10.0	10.0
Import [b]	%YoY	3.5	3.3	18.9	13.0	12.6	29.3	16.3	17.6	13.2	10.0	12.0	12.0
Trade balance [b]	EURm	-7 701	-5 077	-4 947	-6 349	-909	-1 438	-1 148	-1 452	-1350	-1413	-1616	-1 970
Current account balance [b]	EURm	-5 404	-4 109	-2 971	-4 127	-592	-1 338	-767	-274	-1050	-989	-1212	-1 478
Current account balance [b]	% GDP	-2.7	-2.2	-1.5	-1.7	-1.7	-1.8	-1.8	-1.5	-1.6	-1.4	-1.5	-2.0
Budget deficit (cumulative) [a]	PLNbn	-39.4	-37.0	-41.5	-35.0	-11.8	-19.9	-29.0	-41.5	14.0	22.8	29.8	35.0
Budget deficit (cumulative) [a]	% GDP	-5.0	-4.5	-4.7	-3.7	-5.8	-3.7	-4.1	-5.1	6.4	3.8	3.0	2.0
CPI	%YoY	1.9	0.8	3.5	2.5	1.6	3.3	4.5	4.4	4.0	2.7	1.8	1.7
CPI [a]	%YoY	0.8	1.7	4.4	1.8	1.7	4.4	4.4	4.4	3.9	1.9	1.8	1.8
PPI	%YoY	1.0	2.6	7.0	1.9	4.4	8.8	8.3	6.5	3.8	0.6	0.9	2.2
Broad money (M3) [a]	%YoY	-2.0	5.6	8.7	-	5.7	7.2	6.5	8.7	-	-	-	-
Deposits [a]	%YoY	-4.1	3.7	8.1	-	4.8	6.9	6.6	8.1	-	-	-	-
Credits [a]	%YoY	5.2	8.1	2.9	-	6.1	5.7	4.2	2.9	-	-	-	-
USD/PLN	PLN	4.08	3.89	3.65	2.97	3.82	3.89	3.62	3.27	3.05	2.93	2.95	2.96
EUR/PLN	PLN	3.85	4.40	4.53	3.94	4.78	4.69	4.43	4.24	3.99	3.90	3.95	3.93
Reference rate [a]	%	6.75	5.25	6.50	5.50	5.25	5.25	6.50	6.50	6.50	6.00	5.50	5.50
WIBOR 3M	%	9.09	5.69	6.21	5.98	5.47	5.87	6.68	6.81	6.43	6.20	5.60	5.70
Lombard rate [a]	%	8.75	6.75	8.00	7.00	6.75	6.75	8.00	8.00	8.00	7.50	7.00	7.00
Yield on 52-week T-bills	%	8.18	5.33	6.50	5.50	5.75	6.24	7.26	6.75	5.91	5.40	5.40	5.30
Yield on 2-year T-bonds	%	7.94	5.38	6.89	5.44	6.28	6.86	7.66	6.75	5.85	5.30	5.30	5.30
Yield on 5-year T-bonds	%	7.86	5.61	7.02	5.54	6.67	7.10	7.59	6.70	5.87	5.40	5.50	5.40
Yield on 10-year T-bonds	%	7.34	5.77	6.84	5.58	6.70	7.00	7.25	6.40	5.74	5.50	5.60	5.50

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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