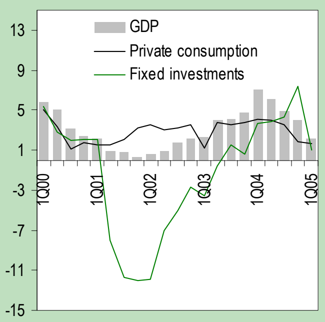
Bank Zachodni WBK

MACROscope

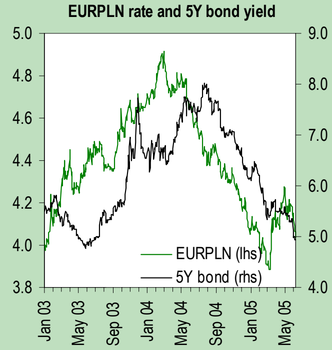
Polish Economy and Financial Markets

June 2005

Economic growth (%YoY)



EURPLN rate and 5Y bond yield



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G(rowth) D(ecline) P(uzzle)

- **The topic of this month's MAKROscope edition is the analysis of the strength and intensity displayed by inflation persistence in Poland vs the euro zone**. Our estimates show that the degree of inflation persistence in Poland is much higher than in the euro zone which means that the impact of various types of shocks on Poland's inflation lasts much longer than in the euro zone (inflation in Poland recovers its equilibrium much slower). For the domestic monetary policy, given the necessity to fulfil the inflation criterion to enter the euro zone, this represents both a threat (should negative shocks prevail), and an opportunity (should positive shocks prevail).

- **As for the foreseeable future, inflation prospects look good which has been reflected in the new NBP inflation projections.** In the longer time perspective, the projection indicates inflation stabilization around the inflation target. Along with the absence of a significant change to the balance of risks for future inflation, this was probably one of the factors which made the MPC to keep the interest rates unchanged at the meeting in May. At that time, the MPC did not know yet the poor GDP results recorded in Q1. Relevant comments made by the vice-governor of NBP, Krzysztof Rybiński and MPC members – Dariusz Filar and Halina Wasilewska-Trenkner imply that the central bank does not know reasons for the rapid slow down in investments growth at the beginning of the year. The market expects, that after poor results in Q1, the MPC will decide on a 50bp cut already in June. In our opinion, though poor results can induce the Council to cut the rates already in June, without the knowledge if the downturn is temporary or permanent, central bankers' bravest decision will be 25pb.

- **Poor GDP results for Q1 this year compelled us to review projections for the following quarters of the year.** Our current forecast is that the GDP for the whole year will be 3.8% with the growth in investments by ca. 8% and consumption growth of 2.5% (earlier, we forecast 4.3%, 11% and 2.9% respectively). This will be an effect of more modest than the previous expectations re. the economic results in the first two quarters of the year. We still envisage, however, that H2 will see another acceleration of growth in investments and higher paced GDP growth.

- **Distinctly lower GDP growth in Q1 this year, and, above all, downturn in investments growth over this period, had an impact on the domestic interest rate market.** Greater expectations to see another reduction of interest rates by the MPC, resulted, in a drop in bonds yield to the levels close to historical minimums recorded a few years ago already in June. This was additionally fuelled by a drop in the yield of bonds on international markets as a result of speculations about arresting interest rate hikes in the United States and a reduction of interest rates in the euro zone. In line with our expectations, the PLN exchange rate started to strengthen again and we still believe that EUR/PLN drop to 4.0 is possible in June and July. A possible step-down of the finance minister constitutes a risk factor.

Financial market on 31 May 2005:

NBP deposit rate	4,00	WIBOR 3M	5,44	USDPLN	3,3265
NBP reference rate	5,50	Yield on 52-week T-bills	5,00	EURPLN	4,1212
NBP lombard rate	7,00	Yield on 5-year T-bonds	5,13	EURUSD	1,2389

This report is based on information available until 08.06.2005

Special focus

Stubborn like inflation

Problems with criteria

The year of 2009 is the earliest possible date of Poland's entry into the euro zone assumed so far by the Polish authorities. This means a necessity to fulfill euro zone membership criteria by 2007. The debate held to date on the possibilities to replace the zloty with the single currency before the end of the current decade has been focused, nearly exclusively, on fiscal criteria. Reduction of the budget deficit to below 3% of GDP and maintenance of the public debt below 60% of GDP represent a huge challenge faced by the domestic macroeconomic policy. Still, the prospects of the Polish fiscal policy in the years to come will depend on the new government. Therefore, a more in-depth analysis of Poland's chance to meet fiscal criteria will be feasible as late as autumn when we know the outcome of parliamentary elections and the shape of the new ruling coalition as well as the details of its economic program. Assuming that fiscal plans of the new government will be credible for participants of the financial market, there should be no problems with meeting the criterion regarding long-term interest rates.

Meanwhile, it is worth emphasizing that it will be difficult to fulfill other euro zone membership criteria. A big challenge will be represented by leading the zloty through the corridor of acceptable fluctuations within ERM2, i.e. meeting the exchange rate stability criterion. Zloty's presence in ERM2 will mean a loss of independence for the Polish central bank as regards the interest rates policy (necessity to preserve control over the exchange rate will supercede other objectives of the monetary policy). In such circumstances, doubts arise as to the ability to meet the inflation criterion. One of the MPC members, Stanisław Nieckarz, has stated recently that inflation in Poland will be lower in H2 2005 than the average in the EU. One can agree with the Council member's view as regards prospects of inflation later on this year, but low inflation is not to be enjoyed for ever and without the possibility to adjust interest rates freely, it might prove very difficult to meet the inflation criteria in the future.

Chances of meeting the inflation criteria are bound to be analyzed increasingly frequent as we are entering into a period when current decisions in monetary policy bear influence on the macroeconomic situation in 2007. For example, according to the ECMOD model, used by the NBP for preparation inflation projections, the strongest impact of interest rates changes on inflation can be evident only after a few years. Hence, we decided to take a closer look at the features of inflation processes in Poland or rather of inflation persistence.

Inflation persistence and the issue of euro adoption

Our objective is to compare the degree of inflation persistence in Poland with the strength of this phenomenon in the euro zone. Such a comparison allows for more adequate assessment of the degree of difficulty Poland might have fulfilling the inflation criterion to enter the euro zone. Knowledge of differences between the inflation persistence in Poland and the euro zone, allows to define how risky the occurrence of inflation shocks might be for the possibility to fulfill the inflation criterion. Given the increasing extent of economic integration, Poland and the euro zone are affected by the same shocks, but with different characteristics of inflation processes, the influence of these shocks on inflation may be much different in Poland and in the euro zone. For example, assuming a higher degree of persistence in Poland than in the euro zone, occurrence of an inflation shock will result in much longer inflation effects domestically than in the euro zone. Comparison of inflation persistence in Poland and the euro zone allows to define how determined, relatively to the EBC's actions, should the MPC's reactions to the same shocks be, in order to ensure fulfillment of inflation criterion[1].

What is inflation persistence?

The key issue in the analysis of inflation persistence is the right definition and fashion of measuring the inflation persistence. According to the popular definition,

[1] We base our analysis on the simplifying assumption that the reference value for the assessment of meeting the inflation criterion will depend on inflation in the euro zone, while actually it will depend on inflation in three countries with the most stable prices, and not only among euro zone members, but among all EU member countries. However, we assume that it is most likely that these three countries will be current euro zone members, as the ECB will exclude countries where inflation is transitory very low.

"persistence" is the continuance of an effect after the cause is removed. One of the elements of this definition is thus a cause, most often described in the terminology of economists as a shock. By the same token, inflation persistence would define how long inflation reacts to a shock.

According to the definition, inflation persistence is the pace rate at which inflation returns to the equilibrium level (average level) over a long period of time. Such a definition indicates that in the inflation persistence estimates, as part of the time series analysis, the key role is played by assumptions re. the inflation equilibrium level. The majority of analyses to date, have focused on adopting inflation equilibrium level constant in time, or on taking into account few structural breaks. In the empirical literature of the past few years, e.g. studies published within Inflation Persistence Network (which is a special group established by EBC in 2003 with a view of analyzing in depth the phenomenon of inflation persistence in the euro zone), necessity is emphasized to apply time-varying mean of inflation. This is the actual approach we apply in our analysis.

Causes of inflation persistence

Drivers of the high degree of inflation persistence can be multifold. They are related, for example, to the specialization of a given economy, market structure or the manner in which expectations are formulated. For example, in the case of an exchange rate shock, inflation effects can be very different in different economies depending on the share of imported goods in consumption. In Poland, a source of high inflation persistence can also be the fact that the share of food in consumer basket is relatively high. Hence, a shock affecting food market produces inflation effects which are stronger than in other countries (thus, it is the structure of economy that matters or rather structure of consumption in this case).

As regards the degree of inflation persistence, an important role is played by credibility and transparency of monetary policy. Since credible and transparent monetary policy oriented to price stability can stabilise inflation expectations, such shocks to inflation as, for example, growth in the crude oil prices, should not result in persistent inflation hike, as the public and particularly those who are involved in the mechanism of shaping wages, are convinced that the central bank will act consistently and effectively to limit inflation. On the other hand, if the monetary policy is not credible or loses its credibility then the inflation persistence will most likely grow, complicating monetary policy even more.

What central banks think about that?

For monetary policy, inflation persistence degree is vital information as it provides knowledge of the impact of changes in monetary policy parameters on the future inflation track. High degree of inflation persistence makes monetary policy management difficult as in such a situation a lot of time is needed to achieve the desired scale of impact exerted by changes in parameters of monetary policy on inflation. What is more, the longer the delay in the mechanism of transmission of monetary policy impulses, the higher the probability that an additional shock will take place during its period, which will make the change in monetary policy parameters ineffective or even inadequate.

The empirical studies show that if there is uncertainty as to the degree of inflation persistence in a given country, because, for example, it is not certain what will be the prevailing mechanism of formulating prices and salaries, it seems that the best solution, from the central bank's point of view, to assume, when taking a decision, that inflation persistence is quite high[2].

The way to measure it

Inflation persistence can be measured both based on structural models and pure time-series analysis. In terms of structural models, the key issue is the definition of the equilibrium from which the economy starts and to which it tends to return after a shock. The equilibrium path of inflation is determined by the structure of the model. This may be given, for example, by a credible inflation target set by a central bank.

While applying the time series approach, the inflation process is specified as a univariate stochastic process. Unlike structural models where the reaction over time can be tracked separately for individual shock types (e.g. changes in oil prices or exchange rates), with the use of simple tools of the time series analyses the shocks cannot be given a particular economic interpretation. In

[2] see Coenen (2003), Angeloni, Coenen and Smets (2003).

this approach they are viewed as a sum of all the various factors which have an impact on inflation in a specific period.

While considering the simplest case of an AR(1) model, the implied long-term inflation level is the function of the constant variable and autoregressive factor. The latter is treated as the measurement of the degree of inflation persistence: if the autoregressive factor is low, there is a strong trend of the inflation returning to the long-term average. If the factor is close to 1 it takes inflation a longer time to return to the equilibrium level.

As the idea behind our research is primarily to compare the inflation reaction to various shock types profile in Poland to the euro zone rather than to define the inflation reaction profile to specific shocks, we are applying the time series analysis. Nonetheless, in order to enhance the robustness of the estimates, apart from the parametric approach based on the AR class models, we are also applying non-parametric approach proposed in one of papers published within the Inflation Persistence Network established by the EBC (see the technical annex for details).

Results of estimates and conclusions

The produced estimates of the inflation persistence confirm the intuitive presumption that the degree of this phenomenon in Poland is stronger than in the euro zone. In theory, estimates of high inflation persistence in Poland can be driven by the fact we do not take sufficient account of the changes in the long-term inflation equilibrium level. In the first part of the analysed period, the inflation reduction process was continued in Poland which was reflected in clear cut changes in inflation targets for the subsequent years. In the countries with disinflation, changes in the equilibrium level can be very significant. Nevertheless, with the use of one of the measures, we estimated the inflation persistence with a break-down into two subperiods – the first one to 2001 (inclusive) when the inflation increased substantially and the other one staring in 2002 when inflation, fluctuating a lot, was low – it turned out that after the end of the disinflation process (when the long-term inflation equilibrium level should not change a lot), the degree of the inflation persistence in Poland did not decline. Just the opposite, the inflation persistence increased while it decreased in the euro zone at the same time.

In addition, we are interested in the strength of the phenomenon in Poland relative to the euro zone rather than the absolute degree of inflation persistence in Poland. In this context, we can assume that even if we had used the inflation equilibrium measure more variable over time and this would have reduced the estimates of the inflation persistence both in Poland and the euro zone, the relation between the degree of this phenomenon in Poland and the euro zone would be similar to the presented estimates.

The inflation persistence is usually measured based on aggregated data, however, in the analysis of the sources of inflation persistence, the aggregated data analysis, i.e. estimating the inflation persistence in terms of individual inflation components, can also prove useful. This is why apart from making the estimates of inflation persistence against the overall price index, we also compared the inflation persistence in Poland to the persistence in the euro zone for food prices. In the specialised literature, it is highlighted that the highest degree of inflation persistence is most often related to the inflation components which have the highest weighting in the consumer basket[3]. Although weight of food and non-alcoholic beverages in the euro zone (standing at almost 16%) is smaller than in Poland (nearly 27%), it is also the highest in the whole consumer basket.

In the case of food price inflation in Poland against the overall inflation, our outcomes vary depending on the measure used. The food prices inflation persistence was lower than the total price inflation persistence when calculated based on one measure and higher when calculated based on the other. Nonetheless, in each case the degree of food prices inflation persistence in Poland is high. It turns out, however, that the food prices inflation persistence in the euro zone is almost as high as in Poland. Does that mean that from the point of view of meeting the inflation criterion, the Polish Central Bank does not have to be afraid of shocks on the food market? Unfortunately this is not the case as food prices in Poland have a much higher share in the consumer basket than in the euro zone. This is why even if we assume that the food prices inflation persistence in Poland is as high as in the euro zone, the Polish central bank must focus on shocks on the food market much more that the ECB. At the same time, it is worth noticing that with symmetric consequences of inflation persistence (it takes longer for inflation to return to equilibrium level both in case of positive and negative shocks) it may be very supportive for the Polish MPC, if a favourable inflation shock occurs, as its effects will be more persistent than in the euro zone.

In conclusion, the outcome of our research implies that inflation in Poland is very stubborn. That means that if one wants to be sure that the Maastricht inflation criterion is met, i.e. that Poland will accede to the euro zone as

[3] see Clark (2003)

planned, the Polish central bank must also be very stubborn in keeping inflation at a low level. If unfavourable inflation shocks arise, keeping the inflation in Poland below a relevant reference level, i.e. the inflation criterion, will require the Polish central bank to take very firm actions. That obviously means that the high degree of inflation persistence, if its is necessary to reduce the price growth rate, is commensurate with the need to incur proportionally higher costs in the real economy. On the other hand, if favourable inflation shocks occur, the relatively high degree of inflation persistence in Poland will be an ally of the monetary authorities. It will facilitate stabilisation of inflation at a low level for a long time without a necessity of taking costly actions.

The results of the estimates, based only on two measures of inflation persistence and only on one way of estimating the inflation equilibrium level does not give certainty around the degree of inflation persistence in Poland relative to the euro zone. Even ECB encounters problems with credible estimation of the inflation persistence in the euro zone. The outcome of the work done by a special research group will be presented still this year. It is to become the benchmark for the Polish central bank. The information about the degree of inflation persistence and its changes over time will be useful from the point of view of the domestic monetary policy, which will be autonomously pursued before the zloty has been converted into euro, but it can also be a guidance for the domestic economic policy (fiscal, payroll, structural policies) in relation to the scope of the required reforms aimed at changing the nature of inflation processes in the country, which is potentially unfavourable for the economy growth prospects through increasing the costs of inflation stabilisation at a low level.

If we assume that our estimates are correct and the degree of inflation persistence in Poland is in fact very high, and what is more, much higher relative to the euro zone, the question how to change this should be posed.

Structural reforms should be the primary method of reducing the inflation persistence as they allow to reduce the rigidity related to adjusting prices downwards. Structural reforms contribute to the reduction in the rigidity on the goods and labour markets and as a result the economy has more shock adjustment capacity, which means that the degree of inflation persistence is reduced. In view of the above, we should not be surprised to see the stubbornness demonstrated by some central bankers who keep repeating that one of the factors favourable for inflation stabilisation at a low level are structural reforms in the economy. Nonetheless, in view of the fact that the planned deadline by which Poland must meet the inflation criterion is rather close, the structural reforms may not produce the desirable results from the point of view of inflation persistence over that short period of time.

An alternative way of avoiding negative implications of the high degree of inflation persistence may be the central bank's care about its credibility and transparency of its policy. This would allow to improve functioning of inflation expectations channel of monetary policy transmission mechanism and thus enable a more effective elimination of undesirable effects of possible shocks on Poland's way to the euro zone.

References:

Angeloni, I., Coenen, G., Smets, F., *Persistence, the Transmission Mechanism and Robust Monetary Policy*, ECB Working Paper No 250, August 2003; Published in: Scottish Journal of Political Economy 50, pp. 527-549.

Clark, T.E., *Disaggregate Evidence on the Persistence of Consumer Price Inflation*, Research Working Paper 03-11, Federal Reserve Bank of Kansas, December 2003.

Coenen, G., *Inflation Persistence and Robust Monetary Policy Design*, ECB Working Paper No 290, November 2003.

Robalo Marques, C., *Inflation Persistence: Facts of Artefacts?*, ECB Working Paper No 371, June 2004.

Technical Annex

In order to assure the best-possible comparability of our estimates of inflation persistence between Poland and the euro zone, we adopt a unified approach in both cases. We do not wish to engage in discussion about the pros and cons of different measures of inflation persistence. A detailed discussion on the issue may be found in Robalo Marques (2004). On the basis of this paper we decided to employ two measures. The first of them is the sum of autoregressive coefficients resulting from univariate estimations. As auxiliary inflation persistence indicator we use a non-parametric measure based on the concept of mean reversion. The use of two measures is aimed at increasing robustness of our results, especially that we base of relatively small sample.

The data covers the period from January 1999 to April 2005. We use the official data published by the Eurostat and CSO. For each variable we estimate the following equation:

$$y_t = \alpha + \sum_{j=1}^{p} \beta_j y_{t-j} + \varepsilon_t$$

$$\rho = \sum_{j=1}^{p} \beta_j$$

where y_t refers to the deviations of inflation in period t from the mean for that period, and ρ is the sum of autoregressive coefficients, or the analysed measure of inflation persistence. The lag length j is individually determined for each series.

The additional measure, based on the concept of mean reversion is defined as the following:

$$\gamma = 1 - \frac{n}{T}$$

where n to is the number of times the inflation crosses the mean during a time interval with $T+1$ observations.

The values of γ close to 0.5 signal the absence of any significant persistence (white noise behaviour) while values close to 0 or 1 signal strong positive or negative autocorrelation, respectively.

In case of both measures we focus on deviations of a series from a mean. Thus, one has to remember that both the parametric measure and the non-parametric indicator are burdened with the uncertainty regarding measurement of a mean (inflation equilibrium level).

When measuring inflation equilibrium level, the most naïve approach is to assume that the level is constant in the whole period under analysis. Such approach may be seen as reasonable only for short-term, during which the structure of the economy is fairly stable. However, for longer time horizon or for economies undergoing significant structural changes, the assumption of a constant inflation mean is unreasonable.

We emphasise that because many empirical research as well as the intuition, suggests that the strength of inflation persistence depends very strongly on the assumed inflation equilibrium level. There is strong negative relationship between the flexibility of the assumed long run level of inflation and inflation persistence. Thus, the assumption of a constant mean of inflation, as often done in researches, leads to very high estimates of inflation persistence. This is likely to be the case in countries like Poland where relatively fast disinflation process takes place.

Measurement of the long run level of inflation could be based on a theoretical model, but this would drive us away from the unified, univariate approach we applied. Thus, in order to stay within the univariate approach, we must rely on pure statistical model to extract the mean of inflation. Basing on the above mentioned article by Robalo Marques, the Hodrick-Prescott appears as the most obvious candidate. Alternatively, one could also think of core inflation or survey inflation expectations as of mean inflation measures. Besides, for countries in which a credible inflation-targeting monetary policy has been followed, one could also use the exogenously announced inflation target. However, as the record of DIT regime in Poland is not very successful, we do not apply such approach. All in all, we decide to extract the mean of inflation with the use of Hodrick-Prescott filter.

The use of γ serves three purposes. First, the methodology is independent of the possible disadvantages of common assumptions underlying parametric estimation methods. Second, it is very intuitive and allows us to obtain results even for very short time series. Third, it provides a robustness check for the parametric estimates.

Moreover, an interesting property of the non-parametric measure is that with its use persistence for the whole period is approximately a weighted sum of the persistence for the two non-overlapping consecutive subperiods. This can be written as follows:

$$\gamma \approx w\gamma_1 + (1-w)\gamma_2$$

where w means the share of observations in the subperiod for which γ_1 is calculated in the whole period.

We take advantage of this property to explore whether degree of inflation persistence in Poland changed after inflation had stabilised at low level, comparable with inflation level in the euro zone. In order to do so, we divide the whole sample into two subsamples. The first sample covers the period from January 1999 to December 2001 and the second sample covers the period from January 2002 to April 2005. Of course, we could estimate the degree of inflation persistence for subsamples also with a use of the parametric measure, but given its vulnerability to low number of observations, the results could be of little robustness.

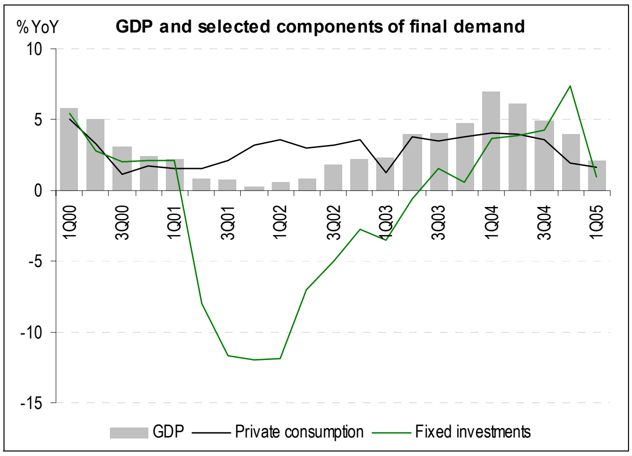
Table 1: Estimates of ρ

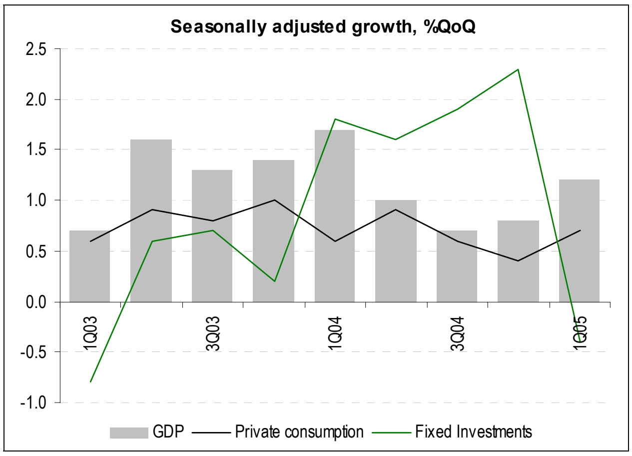
	Euro zone		**Poland**	
	Overall inflation AR(7)	Food prices AR(8)	Overall inflation AR(3)	Food prices AR(3)
Jan1999-Apr2005	0.3257	0.8272	0.9188	0.7901

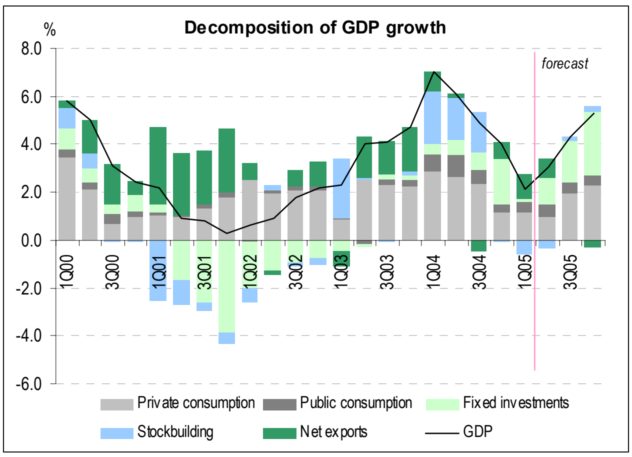
Table 2: Estimates of γ

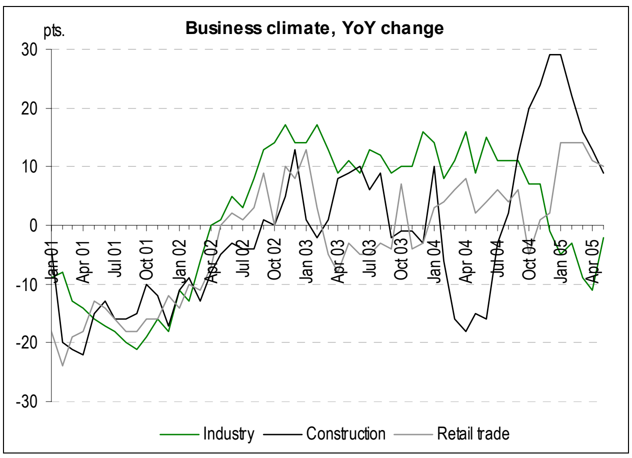
	Euro zone		**Poland**	
	Overall inflation	Food prices	Overall inflation	Food prices
Jan1999-Apr2005	0.7200	0.9200	0.9200	0.9467
Jan1999-Dec2001	0.7429	0.9429	0.8857	0.9429
Jan2002-Apr2005	0.6923	0.8974	0.9487	0.9487

Economic update









Source: CSO, own calculations

Deep investment slowdown weighed down on GDP growth

- Slowdown in economic growth was widely anticipated, however its scale exceeded expectations. GDP growth in 1Q05 reached a mere 2.1%YoY against average forecast 3%.
- The biggest disappointment concerned investment growth, which dropped to 1% from 7.4% in 4Q04. It was very difficult to find plausible explanation for this downturn.
- Private consumption was also quite weak, rising 1.7%YoY after 1.9% growth in 4Q04.
- Total domestic demand rose 1.1%YoY, which was the weakest result since 3Q03, where the economy was still in a stage of severe economic slowdown.
- Contribution of net exports was positive and reached ca. 1 pp.
- In seasonally adjusted terms, GDP in 1Q05 increased 1.2%QoQ, which was the highest rise since 1Q04 (1.7%) and showed that it is difficult to talk about breakdown in economic expansion trend.
- However, investment outlays dropped (by 0.4%QoQ) even after eliminating seasonal fluctuations, after seven quarters of stable and quite rapid growth.
- Interestingly, drop in real investment growth in the first quarter resulted from strong rise in deflator – to over 5%YoY from 3.2%YoY in 4Q04. Nominal investment rose by ca. 6%YoY.
- Despite slowdown in investment growth, growth in value added in construction sector accelerated from 1.6% to 5.3%YoY. Value added in industry rose only 0.9%YoY in 1Q05, against more than 5% in 4Q04, and in market services value added increased 2.5% (after 3.7% in 4Q04).
- According to our estimates, agriculture recorded significant rise in value added in 1Q05, of some 7%YoY, after a record strong rise of 21%YoY in 4Q04.

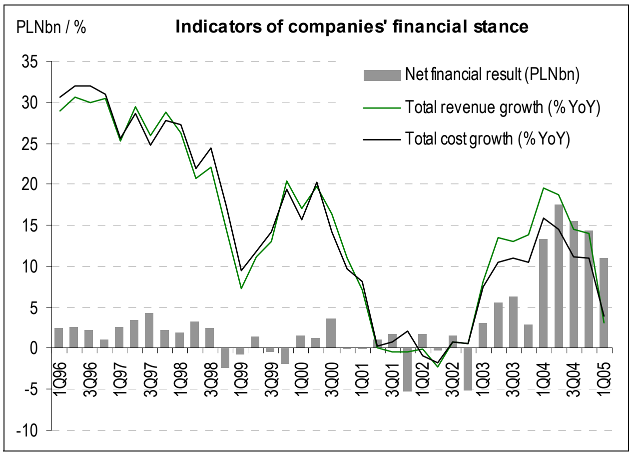
GDP growth in 2005 unlikely to exceed 4%

- GDP growth rate should be improving in the remainder of the year, however it would be extremely difficult to achieve average growth rate above 4% in 2005 with such weak starting point.
- For GDP growth forecasts for subsequent quarters, the key is the assessment to what extent a slowdown in investment growth was persistent. In our opinion, sharp contraction in 1Q05 was a temporary phenomenon. Signals from various areas of economy (e.g. economic climate surveys, bank and money statistics – see below) suggest that investment demand has been on the rise.
- We forecast that GDP growth rate will be steadily growing in the subsequent quarters of this year. It would be assisted by accelerating investment growth (in double digits at the end of the year) and picking up consumption thanks to drop in inflation, which will raise real worth of households' earnings.

Economic climate surveys show the economy is expanding

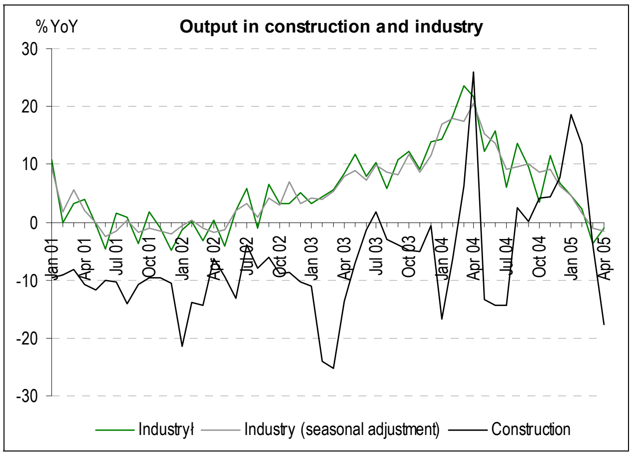
- Weak GDP figures in 1Q05 were even more surprising, given that business climate polls suggest that Polish economy is on the expansionary path.
- Business climate in trade and construction has been improving very fast in annual terms; moods in industry are slightly worse than last year, but still positive. Firms report rise in new orders, mostly thanks to domestic orders, which shows that there is no stagnation in domestic demand.
- Although in May sharp rise in consumers' optimism decelerated somehow and indices of households' confidence were lower than in April, they were still above levels from corresponding period of last year – general index of consumers' optimism rose 7.2%YoY, and index of propensity to consume increased 5.6%YoY.

Economic update



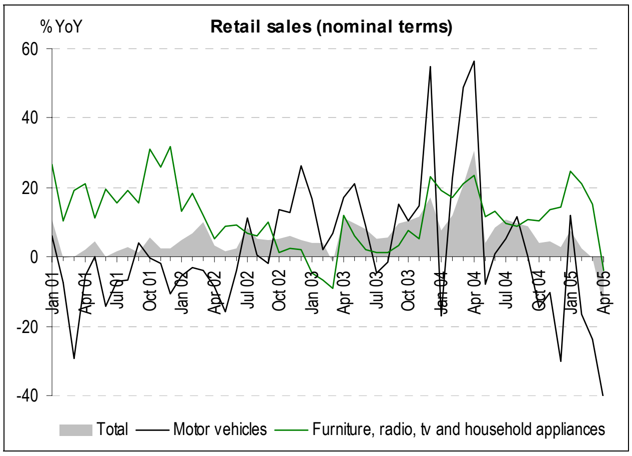
Polish companies' profits still very high

- In 1Q05 Polish non-financial enterprises recorded worse financial results than in four preceding quarters.
- However, if we exclude outstanding 2004, the results were the best ever recorded since the beginning of economic transition in Poland, which confirms that firms' situation is still reasonably good.
- Despite very high statistical base, total companies' revenues recorded an increase in relation to 1Q04 (3.1%YoY). One should note that for the first time since mid-2002 companies' costs rose faster than their revenues.
- Financial situation of exporters – even though deteriorated in the first quarter – was still much better than average in the whole sample of enterprises in almost all aspects, except for financial liquidity.



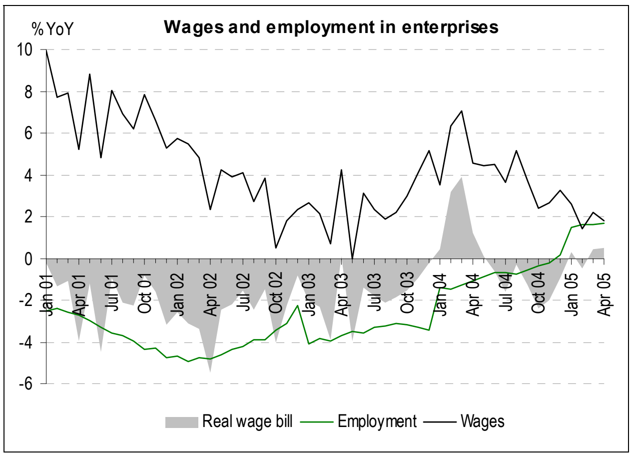
Output decline softer than expected

- In April, sold industrial output dropped 1%YoY, and production in construction fell 17.7%YoY.
- As a matter of fact, those were quite good results, clearly better than market consensus forecast – average forecast of industrial output was at –5%YoY.
- Slump in annual rate of growth in industry and construction was inevitable amid very high base caused by pre-accession economic revival in 2004. The scale of drop signals that construction and industry are still in expansion.
- Already in May, after base effect fades away, output growth should start improving. In construction, sharp upturn to double-digit growth levels is very likely, while in industry the recovery should be more gradual.



... but retail sales surprised on the downside

- In contrast to production figures, retail sales results were weaker then expected. Worth of sales dropped in April 14.4%YoY in nominal terms and 17.4%YoY in real terms.
- Downturn in sales growth was caused to large extent by high statistical base in April 2004. In line with expectations, the deepest slump took place in the market of motor vehicles (-41.2%YoY). This sector was influenced the most by turbulences in demand caused by the EU accession.
- Additionally, April figures were under negative influence of earlier Easter (March in 2005, April in 2005) and could have been biased down by smaller sales in the mourning after Pope's death.
- After one-off factors wane, retail sales growth should sharply rebound in May.

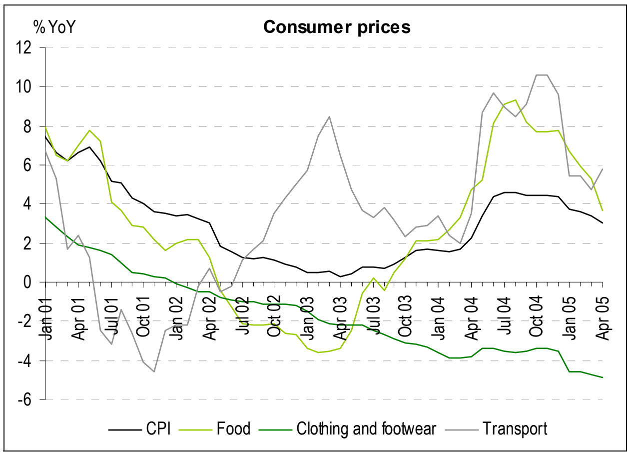


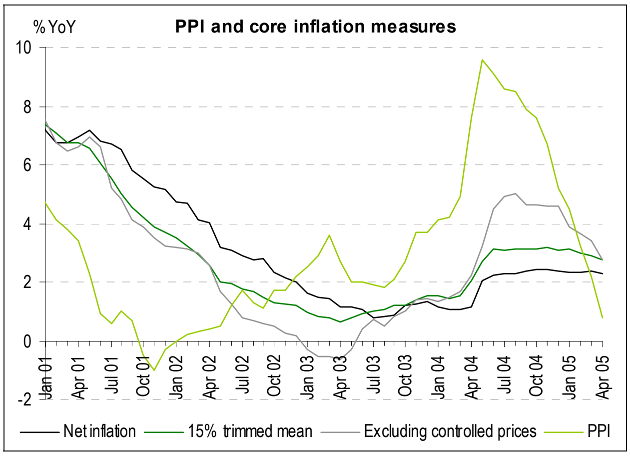
Source: CSO, own calculations

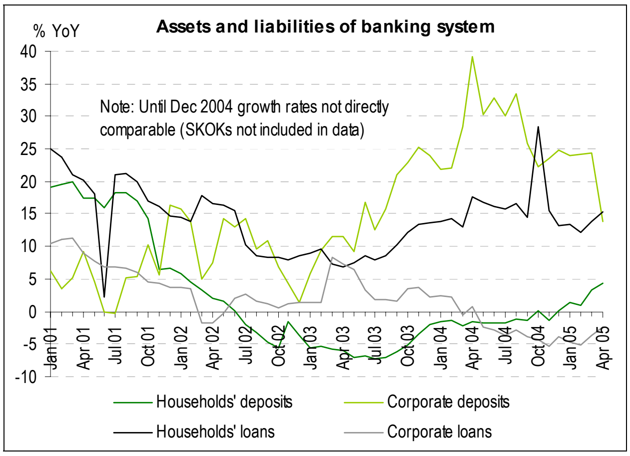
Employment improvement amid disciplined wages

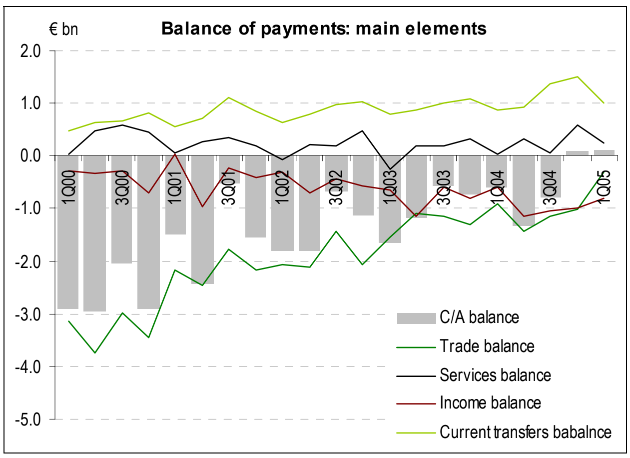
- Data from corporate sector showed that despite gradual improvement in demand for labour, wage discipline maintains.
- Average wage in enterprises rose 1.8%YoY in April, lower than in March (2.2%). Average employment increased 1.7%YoY, which was the fastest growth since mid-1998. In effect, total wage bill in corporate sector rose 3.5%YoY, and its real growth reached 0.5%YoY – the same as in March.
- Little propensity to lift salaries in firms is positive for inflation perspectives, however it could harm private consumption growth if persists longer.
- We foresee acceleration in wages and employment growth in the second year-half, which – coupled with significant drop in CPI – will be supportive for growth in private consumption demand.

Economic update









Source: CSO, NBP, own calculations

Inflation in downward trend, impact of EU accession wanes

- Inflation rate fell to 3%YoY in April from 3.4% in March, which was exactly in line with our forecast.
- In relation to March, quite significant rise was recorded in the case of prices of fuels (4.5%MoM, amid weak zloty and high prices of crude oil) as well as food and tobacco (both 0.5%MoM).
- This is still not the end of downward inflation trend, which results mainly from the effect of high statistical base – price growth in mid-2004 was under impact of EU entry – and good situation on the food market.
- Those factors will continue affecting CPI also in the coming months, therefore we foresee inflation decline to 2.4%YoY in May and 1.7%YoY in June. In the second year-half inflation rate should fluctuate in 1.5%-1.6% band.
- In line with expectations, all measures of core inflation fell in April, following headline CPI figure.
- Net inflation dropped by 0.1 pp, to 2.3%YoY, while other measures fell a bit deeper, from 0.14 pp to 0.64 pp.
- Big stability of net inflation – excluding prices of food and fuels from the CPI – observed since mid-2004 confirms that significant rise in inflation last year stemmed from factors caused by EU accession and its recent turnaround results from reversal of trend in the food market.
- On the other hand, decline in other measures of core inflation shows lack of major demand-side pressure on inflation.
- Very high statistical base has been pushing annual PPI growth sharply – in April it fell to 0.6%YoY, and in May it will most likely drop below zero. Nevertheless, in the second year-half PPI growth will rebound and will start rising.

Money grows quite rapidly

- Broad money M3 rose 10.3%YoY in April, after (revised) 11%YoY growth in March
- Growth in households' deposits has been becoming more and more clear – in April it reached 4.4%YoY after 3.3%YoY in March. In turn, companies' deposits slowed down a bit, mostly amid very high base in April 2004.
- Gradual revival is taking place on the credit market as well – total loans rose almost 5%YoY. It partly resulted from one-off surge in households' debt for purchase of shares in Polmos Białystok IPO (ca. PLN1bn of loans); however even if we eliminate this effect, April's rise in households' borrowing seems decent. Loans for companies, even though still lower than last year, have also shown some signs of revival.

Positive trends in foreign trade maintained

- In March, current account deficit saw €67m surplus, while trade account recorded deficit of €334m.
- Growth in exports and imports (in euro) decelerated sharply because of very high base effect, to 10.1%YoY and 5.3%YoY, correspondingly. However, level of monthly turnover in both exports and imports was one of the highest recorded so far, which shows that situation in foreign trade is still good.
- In the entire 1Q05 current account surplus reached €118m, while in the previous year there was €654m deficit. In effect, moving cumulative current account deficit declined after the first quarter to 1.1% of GDP, from 1.5% in 4Q04. In the second quarter, the deficit will be probably also much lower than last year, thus contributing positively to GDP growth. The situation is likely to change in the second half of 2005.

Central bank watch

Crucial fragments of the MPC statement from 25 May 2005
Since the last meeting of the Monetary Policy Council no significant changes in the external environment of the Polish economy have been observed that could affect the outlook for economic growth and inflation in Poland.
Available data signal a gradual improvement in the labour market. (…) This gradual improvement in the labour market is accompanied by a low wage growth.
The zloty exchange rate developments in May 2005 have been broadly consistent with the path accounted for in the May *Inflation Report*. The exchange rate developments may be affected by the situation in the international financial markets and the uncertainty related to the pre-election period.
Numerous legislative proposals put forward in the recent months may cause a widening of the public finance deficit and, in consequence, postpone the compliance with of the euro-area membership criteria. The uncertainty about the prospects for public finance reforms and the extent of implementation of other necessary structural reforms is a significant inflation risk factor.
In the Council's assessment, the May inflation projection and the currently available data indicate that the balance of risks for future inflation has not changed enough to warrant a change of the monetary policy parameters.

Balance of risks has changed, but not "enough"

- After April's change of monetary policy bias into neutral, May's decision of keeping rates on hold was not surprising.
- The MPC's assessment of inflation outlook was quite balanced, though it is hard to call it "dove-ish".
- The MPC said that the balance of risks for future inflation has changed, but did not say in which direction.
- If recent rates cuts are taken into account, one may suppose that balance of risks has changed favourably for inflation, though whole statement included a few hawkish arguments.
- One may expect that for some MPC members balance of risks changed favourably "enough" for inflation after GDP data for 1Q, which will probably mean higher propensity to decrease interest rates already this month.

NBP inflation projection (YoY)

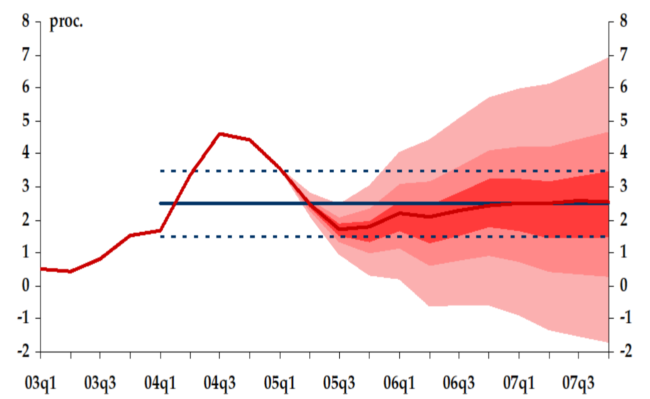
	Q4 2005	Q42006	Q4. 2007
V 2004	2.1-5.4%	1.1-4.4%	-
VIII 2004	2.8-5.5%	1.6-5.1%	-
IX 2004	2.5-5.2%	1.3-4.8%	-
II 2005	1.2-4.0%	0.4-4.2%	0.5-4.6%
V 2005	1.2-2.0%	1.2-3.8%	0.7-4.3%

Note: Projection shows that assuming unchanged interest rates, there is a 50-percent probability that inflation will stay within the ranges indicated in the table.

Inflation projection did not change much

- The MPC statement after the meeting referred also to the new *Inflation report* of the central bank.
- Pace of price growth is expected to be lower than showed in the previous projection, however this is not a significant change (see table on the left).
- As compared to February's projection, today the NBP expects deeper inflation reduction this year (CPI below inflation target), inflation path in the following quarters is similar, while at the end of projection period (end of 2007) inflation is again slightly lower as compared to February's NBP expectations.
- Asymmetry of the new inflation projection is negative.
- Since May 2005 NBP projections are based on new econometric model and include not only inflation, but also GDP growth.

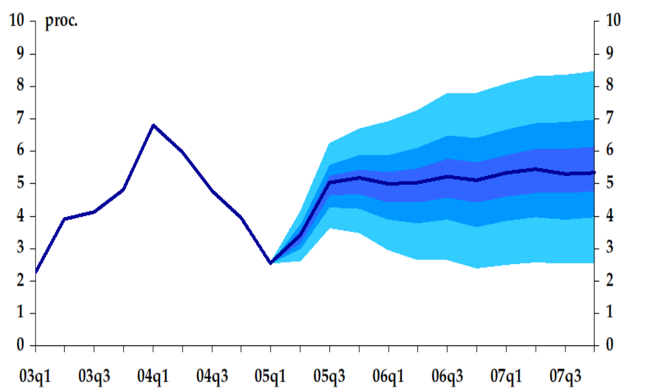
Inflation projection in NBP's May *Inflation report*



Forward-looking monetary policy. That's right!

- According to the projection, the likelihood of inflation running above the inflation target in the monetary policy transmission horizon is considerably lower until mid-2006, and afterwards close to the probability of inflation staying below the target of 2.5%.
- This suggests that the MPC attached more weight to the medium- and long-term horizon than to short-run inflation expectations, as in the other case probability distribution would justify a continuation of decisive monetary easing.
- Such approach is well justified given a necessity to keep low inflation until 2007 to meet Maastricht criterion (if Poland is to join the euro zone as soon as possible) and we emphasised this factor many times in the past.

GDP growth projection in NBP's May *Inflation report*



Source: NBP

In 2007 high GDP growth and inflation in the target

- Forecast of GDP growth in 2005 was revised down in comparison with the February projection and now stands at 4%, but is predicted to accelerate to 5-5.5% in 2006-2007, unless unexpected deterioration in domestic conditions for business or negative shocks in the global economy occurs.
- GDP data for Q1 creates a risk for the economic growth forecast this year as a whole. Although it is worth to notice that the central bank has also problems with this data interpretation.
- It is not certain whether the central bank will change its forecasts for the following years. As for now, medium-term predictions show not much room for interest rates reduction.
- After GDP data for Q1 financial market prices-in 50 bp rate cut already in June (and considers a return to easing bias). We expect fine-tuning in rates of 25 bp.

Central bank watch

Comments of the central bank representatives	Remarks
Leszek Balcerowicz, NBP governor, MPC chairman MPC press conference, 25 May [Q] What does it mean "balance of risks for future inflation has not changed enough"? [A] It is not a coincidence that we used such formula. This is important that the Council did not distance itself from this projection. I would not be surprised if the rate of GDP growth was better in 2005. But it is more important what will happen in longer term, though such forecasts are biased with higher uncertainty.	The answer of NBP president to the question on expression "did not change enough", which we mentioned above, might suggest that rates reduction was discussed during May's meeting. NBP president mentioned that the MPC view on future GDP growth was consistent with the projection prepared by central bank's analysts, though he added that he would not be surprised if GDP growth was higher than 4% this year. It would be interesting to see whether after the release of GDP data for Q1 the MPC will still agree with the projection and whether the forecast of the president will change.
Krzysztof Rybiński, deputy NBP governor Press conference presenting *Inflation report*, 25 May Current unemployment rate is considerably above NAWRU [non-accelerating wage rate of unemployment] , in the horizon of projection it is not certain whether NAWRU gap will close. (…) Estimations regarding NAWRU are biased with high uncertainty. Assuming that interest rates were changed in a scale priced-in by the market on 22 April (cut-off date for inflation projection) we have a small difference in deviation from inflation projection path. In both scenarios inflation path is similar.	While the central bank refers directly to NAWRU in the model used in forecasting inflation, the deputy NBP president refused to answer what is the level of NAWRU estimated by the NBP. But the answer to this question is crucial from the monetary policy perspective to assess whether unemployment reduction may lead to intensification of wage pressure. As the scale of interest rates reduction priced-in by the market on 22 April (FRA 9X12 was quoted only slightly above 5%) would not change inflation path considerably , it means that there is some room for rates reduction from today's 5.5% without creating a substantial risk for future inflation.
Dariusz Filar, MPC member MPC press conference, 25 May It is worth to notice that the Council emphasised in the communiqué that there are two points of reference: inflation projection and currently available data.	Professor Filar suggested that for the Council important for assessment of inflation perspective not only of the projection (which changes once a quarter), but also of current economic data. This could mean that the balance of power of different views in the Council might change depending on upcoming information. We cannot exclude that rate cut was voted in May, but Filar was certainly against such motion.
Stanisław Nieckarz, MPC member MPC press conference, 25 May In the second half of this year Polish inflation will be lower than average inflation in the European Union.	During the press conference we had an impression that NBP president was trying to limit expectations for further cuts, Stanisław Nieckarz reminded that there is also different option within the MPC. However, we do not know what is the conclusion for monetary policy in Poland from the fact that inflation will be lower in the EU for a few months.
Marian Noga, MPC member Słowo Polskie Gazeta Wrocławska, 28 May Of course we are aware of the fact that inflation is falling. But it will rise starting from this autumn. And the MPC is making decisions, of which effects will be visible only after above one year. Then inflation will be around 2.5%. This is one of the most important conditions to enter the euro zone. By keeping interest rates at current level we will keep inflation in the target next year. (…) Surely, we should not do anything with rates at the moment. If data on inflation will be confirmed, then possibly some rate cut before year-end might be appropriate. Two years before adopting the euro we will stop to monitor interest rates. We will eye on foreign exchange rate of our currency, which will have to be constant.	As result of MPC voting in the first quarter (see below). Marian Noga was in the group supporting more hawkish monetary policy, concentrated around the president of the central bank. In this context, his comments form end-May should not be surprising, as they emphasise a necessity of being cautious when conducting monetary policy. However, he did not exclude a possibility of some interest rate cut (similarly to Dariusz Filar) in case of favourable inflation perspective. As we expect a significant reduction in inflation rate in summer, we expect lowering interest rates in the following months. It is difficult to assess what professor Noga meant in the second half of the comment presented on the left. Possibly, he allow a possibility of introduction of currency board system, in which the exchange rate is stable and unchanged and rates fall automatically to the UE level.

MPC voting results in Q1 2005

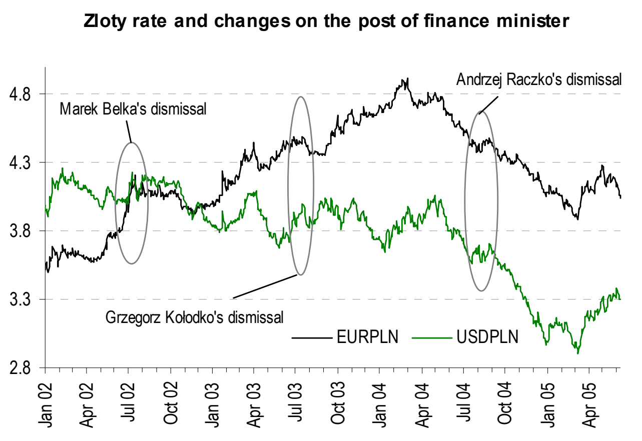
	January	February		March
	neutral	neutral	easing	- 50 bp
L. Balcerowicz	–	+	–	+
J. Czekaj	+	–	+	+
D. Filar	–	+	–	–
S. Nieckarz	+	–	+	+
M. Noga	–	+	–	+
S. Owsiak	–	–	+	+
M. Pietrewicz	+	–	+	+
A. Sławiński	+	–	+	+
A. Wojtyna	+	–	+	+
H. Wasilewska-Trenkner	–	+	–	+

Source: Inflation report May 2005

Remarks

In the *Inflation report* we read" "The MPC was acting on the conviction that there persisted uncertainty concerning the outlook for inflation and that its decisions should not be conducive to any significant fluctuations in market expectations as to the future interest rate path. That is why the adjustment of interest rates to the appropriate level considering future inflation should be gradual." Well, for sure the shift in policy bias directly from tightening to easing was not a gradual change. An explanation of unpredictability of some of MPC decisions is given by detailed results of MPC voting pattern in 1Q05. The report showed that at January's meeting the MPC voted over a change in policy bias from tightening to neutral. The motion was rejected by five votes with a casting vote of NBP president. Surprisingly enough, just one month later, professor Owsiak changed his mind and voted against a shift in policy bias to neutral and supported a direct shift to easing bias from tightening one, against the view of NBP president, who voted in favour of neutral bias. Analysing the MPC decisions ex post (which is always easier) it seems the better option was to change monetary policy approach from tightening into neutral in January and from neutral to easing in February. Voting results show it was not easy for the Council to agree to such a compromise.

Government and politics



Finance minister change again in early summer?

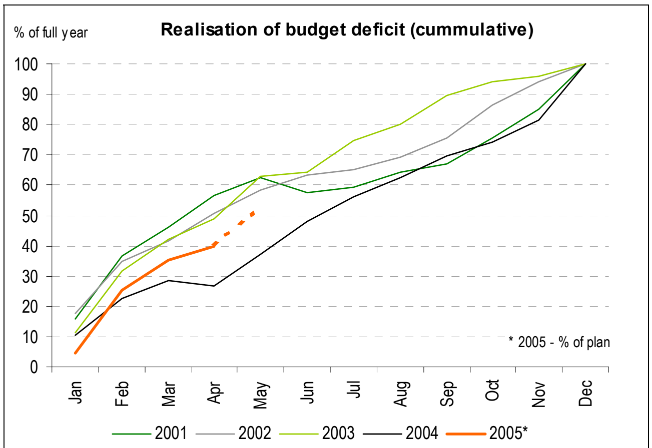
- The opposition parties called a motion of no confidence in Mirosław Gronicki if he did not back off from a hike of excise tax on heating oil.
- Opposition against finance minister's decree is very strong indeed and does not include only opposition parties.
- The question is, however, whether the finance minister would wait until deputies decide on his future and would not resign before.
- PM Marek Belka decided to postpone the introduction of higher excise tax (from June 15 to August 1) and additionally the parliamentary committee prepared a bill to cancel this tax hike. This would lower the pressure on finance minister to an extent.

Planned changes in excise tax in 2005	Rise (in %)
increase in the excise tax on fuels and diesel oil	3.4
increase in the excise tax on gas for vehicles	10
increase in the excise tax rate on spirits	3.4
average annual growth of the excise tax rate on tobacco goods, it was considered to introduce a minimal rate of excise tax	14.7

Source: Justification to Budget Act for 2005

Higher excise aimed to combat grey zone

- Under the banner of fighting grey zone in the economy, finance minister proposed to rise excise tax on heating oil.
- However, it is difficult not to have an impression that fiscal issues were very important for finance minister as well. the increase is expected to bring additional budgetary revenues of PLN1.3bn this year's.
- Minister Gronicki said: "we assumed these revenues in this year's budget". However, this assumption seems to be quite new, as it was not mentioned in the Budget Act. Is a grey zone in the oil sector a new phenomenon?
- Higher inflows from indirect taxes (as well as higher than expected dividends) are expected to fill revenues gap connected with lower VAT revenues (see below).



(Small) gap in indirect taxes revenues

- After April budget deficit amounted to PLN13.9bn or close to 40% of the annual plan.
- In our opinion, the most important element to watch was figure concerning indirect taxes revenues, as their performance disappointed in March and one could have expected further difficulties amid slightly slower economic growth.
- At the first glance those revenues were quite poor again (drop of above 4%YoY), one should remember that annual growth rate was affected by high statistical base effect (high revenues amid higher economic activity ahead of EU accession).
- In nominal terms, indirect tax revenues amounted to PLN9.4bn, which cannot be perceived as a bad result. Although a gap in VAT revenues will take place. Total revenues fell by

Support for political parties

	PBS poll		GFK Polonia poll	
	support (in %)	number of seats	support (in %)	number of seats
PiS	19	110	22	137
PO	18	101	20	126
Samoobrona	16	97	15	61
LPR	11	71	10	93
SLD	8	53	7	43
SdPl	5	28	4	-

Note: PBS poll prepared for Gazeta Wyborcza daily on May 21-22; GFK Polonia poll prepared for Rzeczpospolita daily on June 2-5

Will Po-PiS have a majority after election?

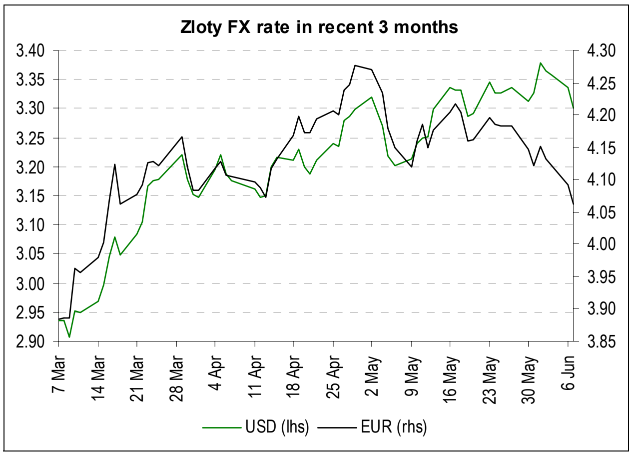
- Opinion polls do not bring clear-cut results as regards a possibility of majority coalition of Civic Platform and Law and Justice.
- According to PBS poll, joint result of two parties (37%) is one of the lowest in the last two years and would mean only 211 seats in the parliament, 20 short of majority.
- On the other hand, GFP Polonia poll is the first since a couple of months showing a majority for PO-PiS. This is partly thanks to the fact that smaller number of parties would be in parliament.
- In both polls PiS is leading, which could mean higher influence of this party on new cabinet's economic program. PiS does not want to enter the euro zone as soon as possible.
- Still a few months until election and everything may change.

Source: Ministry of Finance, Gazeta Wyborcza, Rzeczpospolita

Government and politics

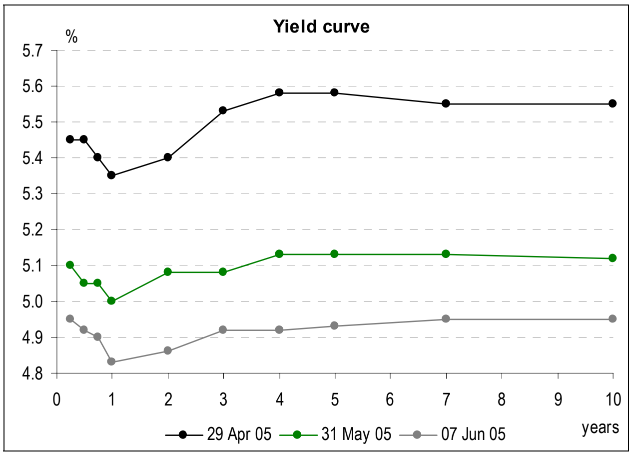
Comments of government representatives and politicians	Remarks
Marek Belka, Prime Minister PAP, Reuters, 24 May Undoubtedly, a rejection of the constitutional treaty by France would weaken France's position in the EU, but I do not believe it would have any negative impact on our plans to adopt the euro. (…) I think that gloomy scenarios of abrupt market reaction are not realistic. PAP, Reuters, 30 May We can speculate whether the euro will start to weaken against the dollar (…) but nobody is wise enough to predict short-term movements. We do not know effects of this event. (…) We think that Poland should continue the ratification process. We should give the decision-making power to the people of Poland. **Mirosław Gronicki, finance minister** PAP, Reuters, 30 May I don't think it (the French referendum) should have an impact on the zloty. The French "No" would not affect Poland's euro adoption. These are separate processes. The French "No" was a political matter while Poland's euro entry is a financial issue regulated by other laws. (…) The French vote could influence the euro and then possibly the zloty indirectly. But I don't expect any larger zloty moves in the near term.	In line with our expectations, as well Prime Minister's the Polish financial market did not react nervously to result of the French referendum. Also, the indirect influence of changes in cross exchange rate EURUSD on the Polish currency was not visible. While euro fell against the dollar, the zloty was quite stable against the basket of two main currencies, though it lost slightly against the greenback. However, already at the beginning of June an appreciation trend of the Polish currency was visible. So gloomy perspective of currency crisis in new member states did not materialise. We agree with the Polish government representative, who said that the French rejection of the EU constitution would not affect the prospects of Poland adopting the euro. This will depend on domestic macroeconomic policy and meeting Maastricht criteria rather than on the French „non". However, a determination of new cabinet to reform public finances will be known only after election. Statements of Law and Justice (PiS) politicians - a possible winner in election – suggest that bringing deficit below 3% of GDP does not necessarily mean a will to adopt the euro (see below). What can be other effect of rejection of the constitution treaty? Well, there is a possibility of additional difficulty in reaching agreement as regard EU budget for 2007-13. There is also a risk that France will harden its stance regarding services directive.
Mirosław Gronicki, finance minister PAP, 30 May If it goes fine, it is possible that inflation fall below 1% in July. This would be the lowest level in 2005. The annual average inflation in 2005 can reach the level of 1.9%, but it may be even lower.	Finance minister Gronicki presented quite optimistic scenario of inflation this year. Our forecasts assume inflation at 1.5% in July and slightly above 2% on average this year. It seems the finance minister still hopes that the next year's budget would not be affected by costs of indexation of pensions, which will take place only if the cumulative inflation in 2004-05 exceeds 5%. In such case budget deficit could be lower by PLN4.5bn in 2006. Of course, this would be only temporary relief, as next finance minister will have to spend money on this anyway.
Mirosław Gronicki, finance minister Reuters, 14 May The repayment of the (Paris club) debt is only one condition for a ratings upgrade. Poland's economic fundamentals are good. If the political risks are eliminated after elections, Poland has a big chance to see its rating go up.	It is hard to disagree with the statement that if political risk disappears and new cabinet continues public finance reform, there is a chance for higher rating for Poland. According to S&P reforms introduced by 10 countries, which joined the EU last year, will structurally improve the stance of their public finances. In the meantime, however, S&P downgraded Hungarian local currency debt amid worsening fiscal perspective.
Jacek Socha, treasury minister Reuters, 19 May This PLN5.7bn [privatisation target for this year] is an ambitious amount for an election year but together with dividends coming from the treasury, it could be that we reach this target. The government expects to receive about PLN2bn in dividends from state-owned companies this year, which is about four times the planned amount.	This year privatisation revenues target may be difficult to reach given the delay in the IPO of PGNiG until September. If political calendar is take into account, it is possible that the privatisation of this company would not happen in 2005 at all. Then finance minister would have to fid other sources of financing budget deficit. However, this does not necessarily mean higher supply of treasury papers on the domestic market, as possibility (higher demand) of issues of eurobonds on the international market were not fully used.
Lech Kaczyński, PiS candidate for President Reuters, 8 June I am supporting the idea that in politics citizens of free country have right to truth. And the truth is, undoubtedly, that own currency is a very important attribute of sovereignty. I do not exclude a possibility of euro introduction in Poland, I ma not saying "no" unambiguously. (…) Taking into account that we have the year of 2005 today, it is not likely in this decade. Although, I repeat once again, I am not saying "no". **Kazimierz Marcinkiewicz, PiS** PAP, 7 June We would like to meet Maastricht criteria within four years. As regards joining the euro zone, we are working on meeting necessary criteria, but we would like to join when it will be the most profitable. We would like to show what real criteria should be met to make euro zone entry beneficial. This is not the case that fast euro adoption is favourable. We would like to achieve budget deficit below 3% of GDP with low inflation (…) At the moment we can maintain current level of public debt, but lower it in the longer perspective.	On different occasions politicians of Law and Justice (PiS) expressed their doubts as regards euro zone entry. What is interesting, a reluctance of PiS to hurry with replacement of the Polish currency by the common currency is not a result of dislike to meet necessary criteria. Statement of Kazimierz Marcinkiewicz suggested that PiS understands very well that low budget deficit and low inflation are beneficial form the point of view of long-term GDP growth. What is more, PiS would like to achieve budget deficit below 3% of GDP during the term of office of next parliament and to lower public debt in the longer horizon, although they would like to avoid social spending cuts and would like to concentrate on administrative costs reduction and lowering taxation. Meeting Maastricht criteria in 2008 would allow to enter the euro zone in 2010. but the PiS candidate for the president of Poland, Lech Kaczyński, stated that this won't happen in this decade, which results fro more fundamental factors. Namely he named own currency a "attribute of sovereignty". According to opinion poll conducted at the end of last year, the Polish society is also sceptical in terms of replacement of the zloty by the euro. Well, maybe this is the factor, which also influences the attitude of PiS. It will be interesting whether it will be easy to convince them to change the view after election. Benefits and costs of euro adoption were well presented in the central bank's report published in February last year.

Market monitor



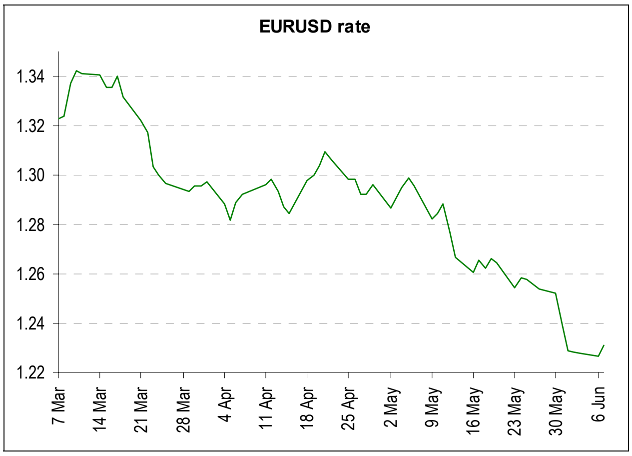
Strong zloty with minister at the background

- Last month the zloty was under pressure of external factors, however domestic events had mixed impact on it. The zloty was losing against the main currencies, when EURUSD rate was breaching significant technical support lines, what was boosted by at the end of May by failure of referenda in Europe. The data from the Polish real economy affected the zloty contradictorily. Poor data on GDP caused a flow into the Polish fixed income market that finally bring the zloty rate against the euro down to 4.1 at the beginning of June, posting monthly gain against that currency by 1.64%. Against the dollar the zloty fell by almost 3%.
- We believe that in June and July a decline in EURPLN rate to 4.0 is possible, in line with our predictions. Political stabilisation will probably be conducive to such move. However risk factor came up in the form of possibility of finance minister dismissal.



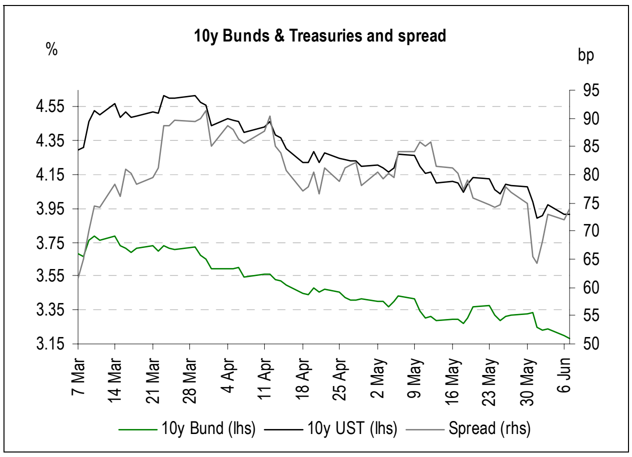
Stabilisation following gains

- In the middle of May bond prices were correlated with the zloty performance that resulted in increases of their yields. Negative impact of expectations for voting in Europe was compensated by systematic bond prices growth abroad. Only GDP data induced meaningful downward movement on the Polish curve, which found an equilibrium level at 5%. FRA contracts deepened a range of market expectation for interest rate cuts to 75 bp in half a year horizon, as FRA 6x9 fell to the level of 4.70%
- Because of the fact that the Polish bond yields movement has already taken place in May after poor data on fixed investment, one should expect, in our opinion, a stabilisation of the Polish papers performance next month ahead of MPC meeting. However amid still strong core markets one cannot rule out yield decline to historical low at 4.8%



Bigger chances for gains that further fall

- Throughout the first part of the month decline of EURUSD rate was determined by the dollar's strength, which broke significant technical level of 1.276 after data on narrower US trade gap. At the turn of May and June the dollar strengthening was related to expectations for French and Dutch referenda and aftermaths of their negative outcome. A streak of weak US data (ISM indices and payrolls numbers) managed only to restrain the euro from further losses from the range of 1.22-1.23. During the whole month the dollar gained against the single currency by 4.5%.
- Throughout the next month the picture of the EURUSD market will be shaped by condition of the euro. We deem that the sentiment for the common currency will be improving gradually that should enable it to revert to its recent technical levels 1.245-1.25, where renewed consolidation is expected.

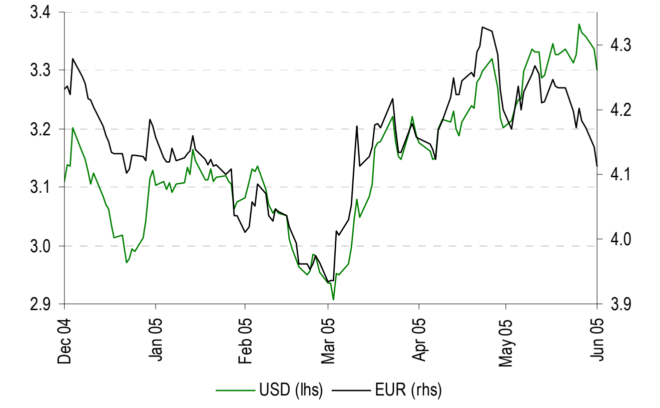


Tight trading range till the Fed

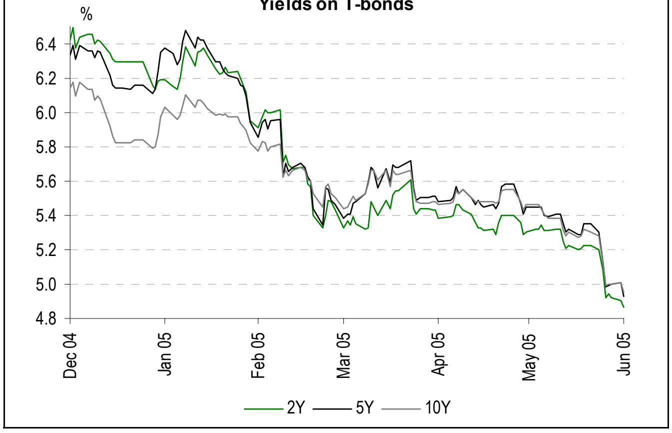
- Last month US bond yields declined by close 40 bp (to ca. 3.9%) owing to the absence of fears in the market about inflation increase and a signal from the Fed official on potential end of rate hikes cycle. Papers' yields in Europe fell (10y Bund – 3.20%) because of poor macroeconomic data and systematical lowering in forecasts of growth in the quarters to come by ECB. On the back of dramatic yield decline in Poland spread 5/5y between the Polish and euro curve reduced to 80 bp form 100 pb a month earlier.
- Yields of longer dated bonds in US will probably fluctuate in the coming month (till Fed meeting on 30th June) between the low reached in the reaction of data on US labour market and currently strong resistance at 4%. However consistent stance from the Fed and continuation of hikes cycle may induce an upward breakout.

Source: Reuters, BZ WBK

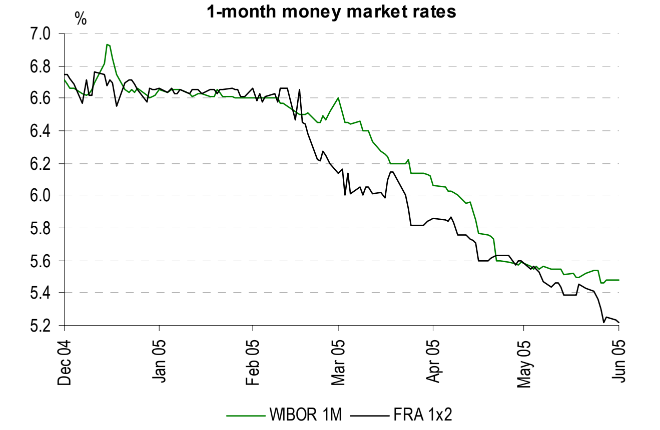
Market monitor



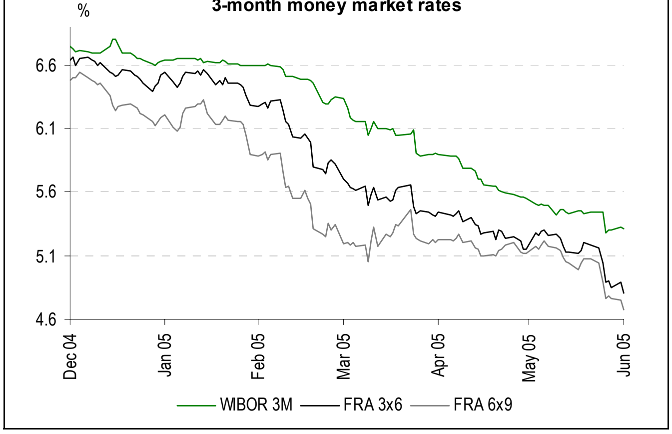
Zloty FX rate in recent 6 months



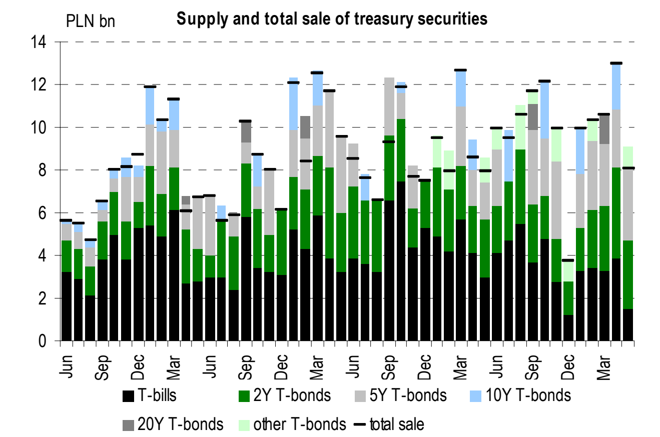
Yields on T-bonds



1-month money market rates



3-month money market rates



Supply and total sale of treasury securities

Treasury bill auctions (PLN m)

	OFFER / SALE		
Date of auction	**13-week**	**52-week**	**Total**
16.05.2005		600/600	600/600
23.05.2005		400/400	400/400
30.05.2005		500/500	500/500
Total May		**1 500 / 1 500**	**1 500 / 1 500**
06.06.2005		600/600	600/600
13.06.2005		600 – 900	600 – 900
20.06.2005		600 – 900	600 – 900
27.06.2005	100	600 – 900	700 – 1 000
Total June*	**100**	**2 400 - 3 300 / 600**	**2 500 - 3 400 / 600**

* estimations based on Ministry of Finance preliminary information

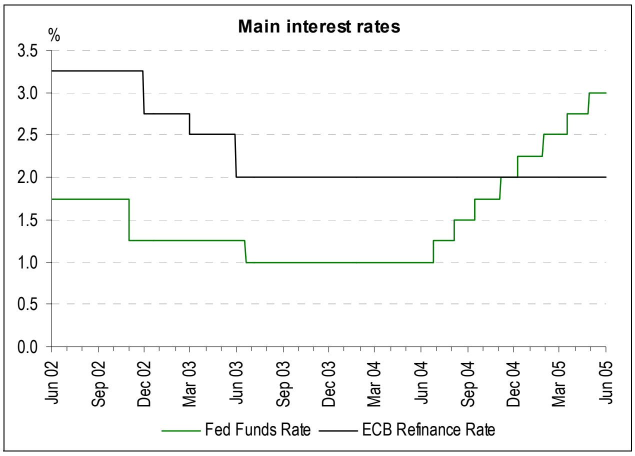
Treasury bond auctions in 2005(PLN m)

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	1 400	16.03	PS0310	2 900	2 900
April	06.04	OK0407	3 500	3 500	13.04	DS1015	2 200	2 130	20.04*	PS0310	2 750	2 750
May	04.05*	OK0807	3 120	3 120	11.05	IZ0816	1 000	0	18.05*	PS0310	3 360	3 360
June	01.06*	OK0807	3 000	3 000	08.06	WZ0911	1 200	-	15.06	PS0310	2500 - 3000	-
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

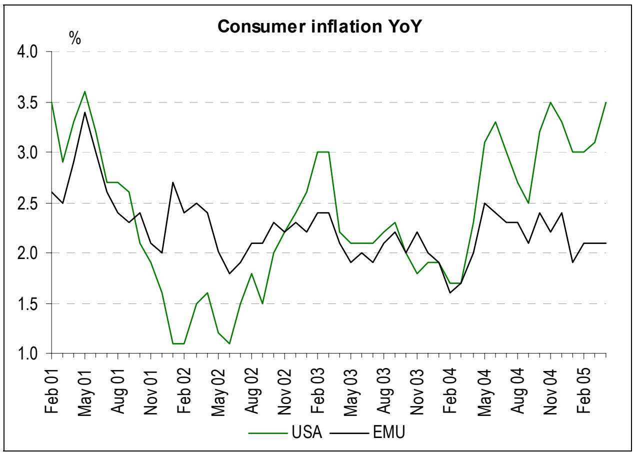
International review



Central banks emphasize low level of rates

▪ ECB, as expected, left rates unchanged at 2.0% at the meeting on 2nd July. ECB chief Trichet reiterated its conviction that interest rates in euro zone are at the right level and emphasized the necessity of staying vigilant regarding inflation. It declined to comment, if interest rate cut was being discussed during a meeting.

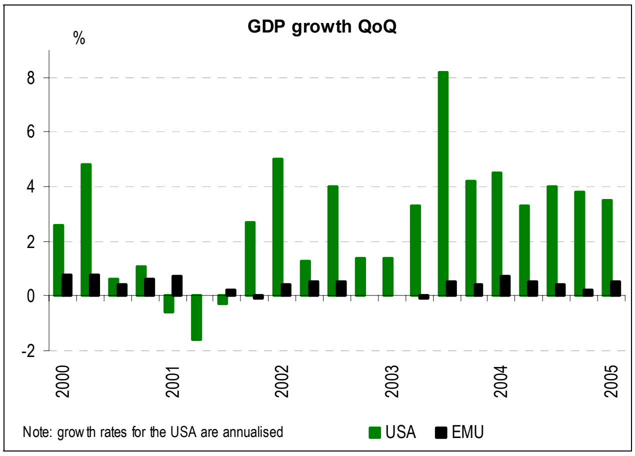
▪ The Fed showed in minutes it recorded "a discernible up-creep" in inflation measures recently, raising concerns that risks from accelerating prices were mounting. The minutes acknowledged some signals of economic slowdown but was convinced they would be "transitory" and central bank should not respond weak figures since expansion seemed to have solid foundation. The minutes left no doubt that the Fed intends to keep raising rates, as their level is still too low.



US core inflation surprises again

▪ Annual price growth in euro zone slowed to 2.0% in May, from 2.1% in April, according to the first estimate of May inflation.High oil prices pushed up consumer prices in euro zone to 2.1%YoY in April. Euro zone inflation rose an expected 0.4%MoM last month. The annual inflation rate was stable from March and February and in line with the initial estimate for April.

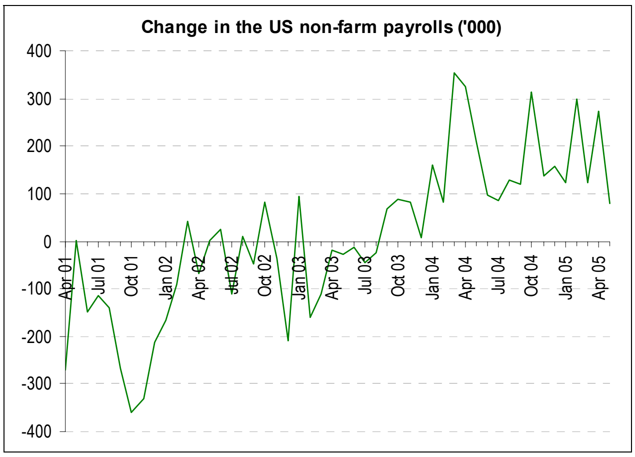
▪ Rising food and energy prices pushed US CPI up by 0.5% in April, but core index remained unchanged. The rise in CPI was a bit above expectations for a 0.4% gain, but analysts had expected prices excluding food and energy to rise 0.2 %. On annual basis consumer prices have grown by 3.5%. Core CPI were up by 2.2% over the past twelve months.



Revision strongly up in US, in Europe slightly down

▪ GDP growth in euro zone was lower than expected in 1Q05 as the Eurostat revised down its estimate to a 1.3% annual rise in GDP. Eurostat had previously estimated 1Q growth of 1.4%YoY. In the last quarter of 2004 GDP expanded at the pace of 1.6%. Quarterly growth was unrevised at 0.5%. Separately, the European Commission cut its growth forecast for 2Q for the second time by 0.1% to 0.1-0.5% in the April-June period but retained a 0.2-0.6% estimate for 3Q.

▪ Upward revision of economic growth in US for 1Q was slightly worse than expected (3.6%) and amounted to 3.5%QoQ against initial estimates of 3.1%. The majority of the revision reflected a lower trade gap. GDP deflator was revised a shade lower to 3.2%, but preferred by the Fed PCE deflator stayed unchanged at 2.2%.



Source: Reuters, ECB, Federal Reserve

Labour market this time below expectations

▪ US employers created only 78,000 jobs last month, far fewer than expected. It was the weakest monthly non-farm job growth since August 2003, and well below expectations of analysts for 185,000 new jobs. Unemployment rate moved down to 5.1% from April's 5.2% to its lowest level since September 2001. Payrolls data for April remained unrevised, but March figures were decreased by 24,000 to 122,000 of new jobs.

▪ The IFO institute's gauge of German business confidence unexpectedly fell to its lowest level in almost two years in May, as a drop in expectations outweighed an improvement in the assessment of current conditions. IFO business climate index declined for a fourth straight month to 92.9 from 93.3 in April. Index ZEW, released prior to IFO, fell to its lowest level in six months in May to 13.9.

What's hot this month

Monday	Tuesday	Wednesday	Thursday	Friday
30 ***POL: Treasury bills auction***	**31** ***POL: C/A (III)*** EMU: Money supply (IV) EMU: Business climate (V) EMU: Preliminary HICP (V)	**1 June** ***POL: 2y bond auction*** USA: ISM Manufacturing (V)	**2** EMU: PPI (IV) EMU: ECB meeting - decision USA: Durable goods orders (IV) USA: Factory orders (IV)	**3** USA: Payrolls (V) USA: USA: ISM non-manufacturing (V)
6 ***POL: Treasury bills auction***	**7**	**8** ***POL: FRN's auction*** USA: Wholesale inventories (IV)	**9** GB: BoE meeting - decision	**10** USA: USA: Import prices (V) USA: International trade (IV) USA: Monthly budget statement (V)
13 ***POL: Treasury bills auction***	**14** ***POL: CPI (V)*** ***POL: Money supply (V)*** USA: PPI (V) USA: Retail sales (V)	**15** ***POL: 5y bond auction*** ***POL: Gross wages (V)*** ***POL: Employment (V)*** USA: Business inventories (IV) USA: CPI (V) USA: Net capital flow (IV) USA: Industrial production(V) USA: Beige book	**16**	**17** ***POL: PPI (V)*** ***POL: Industrial production (V)*** EMU: Industrial production (IV) USA: C/A (1Q) USA: Preliminary Michigan index (VI)
20 ***POL: Treasury bills auction*** USA: Leading indicators (V)	**21** ***POL: Retail sales (V)*** ***POL: Unemployment (V)*** GER: ZEW index (VI)	**22** ***POL: Business climate (VI)*** ***POL: Core inflation (V)*** EMU: Trade balance (IV) EMU: Industrial orders (IV)	**23**	**24** USA: Durable goods orders (V)
27 ***POL: Treasury bills auction*** GER: IFO index (VI) EMU: C/A (IV)	**28** EMU: Money supply (V) USA: Consumer confidence (VI)	**29** ***POL: MPC meeting - decision*** USA: Net PCE (1Q) USA: Final GDP (1Q)	**30** ***POL: C/A (IV)*** EMU: Business climate (VI) USA: FOMC meeting - decision	**1 July** USA: ISM manufacturing (VI)
4 ***POL: Treasury bills auction*** EMU: PPI (V)	**5** EMU: Retail sales (V) USA: Factory orders (V)	**6** USA: ISM non-manufacturing (VI)	**7** GB: BoE meeting - decision EMU: ECB meeting - decision	**8** USA: Payrolls (VI) USA: Wholesale inventories (V)

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*	-	-	11	-	-	9	-	-	8	-	-	9
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	25	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	25	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	12	11	12	-	-	-
Money supply	14	14	14	14	13	14	14	12	14	-	-	-
NBP balance sheet	7	7	7	7	6	7	7	5	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

		May 04	Jun 04	Jul 04	Aug 04	Sep 04	Oct 04	Nov 04	Dec 04	Jan 05	Feb 05	Mar 05	Apr 05	May 05	Jun 05
Industrial production	%YoY	12.2	15.8	6.0	13.7	9.5	3.5	11.4	6.8	4.6	2.3	-3.7	-1.0	1.7	10.8
Retail sales [c]	%YoY	4.0	8.6	10.9	9.6	8.8	4.0	4.4	2.8	7.5	2.4	-0.3	-14.4	9.0	6.5
Unemployment rate	%	19.5	19.4	19.3	19.1	18.9	18.7	18.7	19.1	19.5	19.4	19.3	18.8	18.3	18.2
Gross wages [b c]	%YoY	4.4	4.5	3.6	5.1	3.7	2.4	2.7	3.2	2.6	1.4	2.2	1.8	2.7	3.0
Employment [b]	%YoY	-0.9	-0.7	-0.7	-0.8	-0.6	-0.4	-0.3	0.2	1.5	1.6	1.6	1.7	1.9	2.0
Export [d]	%YoY	23.8	35.0	13.8	22.1	18.0	15.5	29.7	20.5	32.5	23.2	10.1	7.4	13.2	6.8
Import [d]	%YoY	16.8	33.7	9.1	22.0	18.9	15.3	23.6	15.7	20.3	25.4	5.3	-4.3	17.5	14.5
Trade balance [d]	EURm	-248	-192	-486	-314	-345	-265	-255	-501	126	-110	-334	-269	-521	-668
Current account balance [d]	EURm	-627	-336	-734	253	-383	75	176	-163	81	-30	67	-59	-431	-498
Current account balance [d]	% GDP	-1.8	-1.9	-2.0	-1.8	-2.0	-2.1	-1.8	-1.5	-1.4	-1.4	-1.1	-0.8	-0.7	-0.8
Budget deficit (cumulative)	PLNbn	-15.3	-19.9	-23.2	-25.9	-29.0	-30.8	-33.8	-41.5	-1.6	-8.8	-12.3	-13.9	-18.6	-22.0
Budget deficit (cumulative)	% realisation	36.9	47.9	55.9	62.3	69.8	74.1	81.4	100.0	4.5	25.2	35.2	39.6	53.0	62.8
CPI	%YoY	3.4	4.4	4.6	4.6	4.4	4.5	4.5	4.4	3.7	3.6	3.4	3.0	2.4	1.7
PPI	%YoY	9.6	9.1	8.6	8.5	7.9	7.6	6.7	5.2	4.5	3.2	2.2	0.8	-0.2	0.3
Broad money (M3)*	%YoY	6.4	7.2	6.8	7.4	6.5	10.5	6.4	8.7	9.3	9.4	11.0	10.0	11.5	10.8
Deposits*	%YoY	6.2	6.9	6.4	7.6	6.6	11.5	6.5	8.1	8.4	8.7	10.4	8.7	10.2	10.1
Credits*	%YoY	6.1	5.7	4.6	5.2	4.2	9.5	4.0	2.9	3.7	2.2	4.4	4.9	6.7	7.3
USD/PLN	PLN	3.93	3.78	3.64	3.64	3.58	3.46	3.28	3.09	3.11	3.06	3.04	3.21	3.29	3.32
EUR/PLN	PLN	4.72	4.59	4.47	4.43	4.37	4.32	4.26	4.14	4.08	3.99	4.02	4.16	4.18	4.08
Reference rate [a]	%	5.25	5.25	6.00	6.50	6.50	6.50	6.50	6.50	6.50	6.50	6.00	5.50	5.50	5.25
WIBOR 3M	%	5.99	5.91	6.34	6.58	7.12	6.89	6.81	6.72	6.63	6.54	6.15	5.78	5.48	5.30
Lombard rate [a]	%	6.75	6.75	7.50	8.00	8.00	8.00	8.00	8.00	8.00	8.00	7.50	7.00	7.00	6.75
Yield on 52-week T-bills	%	6.65	6.79	7.15	7.24	7.38	7.00	6.81	6.44	6.28	5.95	5.51	5.36	5.19	4.90
Yield on 2-year T-bonds	%	7.41	7.44	7.80	7.66	7.51	7.04	6.81	6.39	6.24	5.82	5.43	5.39	5.27	4.90
Yield on 5-year T-bonds	%	7.57	7.50	7.79	7.65	7.33	7.03	6.78	6.29	6.31	5.80	5.56	5.50	5.38	5.00
Yield on 10-year T-bonds	%	7.32	7.27	7.44	7.36	6.96	6.75	6.43	6.02	5.98	5.72	5.57	5.49	5.36	5.00

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)). Before January 2005 the table presents growth rates in old methodology, not fully comparable with recent data.

Quarterly and annual economic indicators

		2002	2003	2004	2005	1Q04	2Q04	3Q04	4Q04	1Q05	2Q05	3Q05	4Q05
GDP	PLNbn	781.1	814.7	885.3	939.6	204.1	216.3	219.2	245.7	218.5	228.1	232.3	262.7
GDP	%YoY	1.4	3.8	5.4	3.8	7.0	6.1	4.9	4.0	2.1	3.0	4.3	5.3
Domestic demand	%YoY	0.9	2.6	5.0	3.4	6.0	5.8	5.2	3.3	1.1	2.2	4.2	5.5
Private consumption	%YoY	3.3	3.1	3.4	2.5	4.1	4.0	3.6	1.9	1.7	1.5	3.0	4.0
Fixed investments	%YoY	-5.8	-0.9	5.3	7.9	3.7	3.9	4.3	7.4	1.0	7.0	10.0	10.0
Industrial production	%YoY	1.1	8.4	12.3	5.1	19.0	16.4	9.2	6.2	0.7	3.7	7.1	9.0
Retail sales (real terms)	%YoY	1.9	3.6	7.1	2.1	13.6	11.3	4.0	1.1	-0.4	-2.7	4.0	7.3
Unemployment rate [a]	%	20.0	20.0	19.1	17.7	20.4	19.4	18.9	19.1	19.3	18.2	17.6	17.7
Gross wages (real terms)	%YoY	1.5	2.0	0.8	0.9	3.8	1.6	-0.5	-1.5	-1.3	0.2	2.1	2.7
Export [b]	%YoY	6.0	9.1	21.9	12.1	19.3	29.1	17.6	21.8	20.8	9.1	10.0	10.0
Import [b]	%YoY	3.5	3.3	19.1	11.9	12.6	29.3	16.3	18.2	15.7	8.5	12.0	12.0
Trade balance [b]	EURm	-7 701	-5 077	-4 510	-4 884	-909	-1 438	-1 148	-1 015	-318	-1 459	-1 616	-1 491
Current account balance [b]	EURm	-5 404	-4 109	-2 959	-3 201	-654	-1 530	-868	93	118	-989	-1 212	-1 118
Current account balance [b]	% GDP	-2.7	-2.2	-1.5	-1.4	-1.7	-1.9	-2.0	-1.5	-1.1	-0.8	-0.9	-1.4
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	2.3	1.6	3.3	4.5	4.4	3.6	2.3	1.6	1.6
CPI [a]	%YoY	0.8	1.7	4.4	1.6	1.7	4.4	4.4	4.4	3.4	1.7	1.6	1.6
PPI	%YoY	1.0	2.6	7.0	1.4	4.4	8.8	8.3	6.5	3.3	0.3	0.5	1.6
Broad money (M3)* [a]	%YoY	-2.0	5.6	8.7	10.0	5.7	7.2	6.5	8.7	11.0	10.8	12.3	10.0
Deposits* [a]	%YoY	-4.1	3.7	8.1	9.3	4.8	6.9	6.6	8.1	10.4	10.1	11.6	9.3
Credits* [a]	%YoY	5.2	8.1	2.9	10.0	6.1	5.7	4.2	2.9	4.4	7.3	9.4	10.0
USD/PLN	PLN	4.08	3.89	3.65	3.20	3.82	3.89	3.62	3.27	3.07	3.27	3.30	3.14
EUR/PLN	PLN	3.85	4.40	4.53	4.08	4.78	4.69	4.43	4.24	4.03	4.14	4.12	4.03
Reference rate [a]	%	6.75	5.25	6.50	5.25	5.25	5.25	6.50	6.50	6.00	5.25	5.25	5.25
WIBOR 3M	%	9.09	5.69	6.21	5.62	5.47	5.87	6.68	6.81	6.44	5.52	5.25	5.25
Lombard rate [a]	%	8.75	6.75	8.00	6.75	6.75	6.75	8.00	8.00	7.50	6.75	6.75	6.75
Yield on 52-week T-bills	%	8.18	5.33	6.50	5.24	5.75	6.24	7.26	6.75	5.91	5.15	5.00	4.90
Yield on 2-year T-bonds	%	7.94	5.38	6.89	5.28	6.28	6.86	7.66	6.75	5.83	5.19	5.10	5.00
Yield on 5-year T-bonds	%	7.86	5.61	7.02	5.42	6.67	7.10	7.59	6.70	5.89	5.29	5.20	5.30
Yield on 10-year T-bonds	%	7.34	5.77	6.84	5.41	6.70	7.00	7.25	6.40	5.76	5.29	5.20	5.40

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

[a] at the end of period; [b] balance of payments data on transaction basis
* Since January 2005 the NBP changed methodology of monetary statistics. Before January 2005 the table presents growth rates in old methodology, not fully comparable with recent data.

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