

Weekly economic update

14 February - 20 February 2005

The Polish financial market remained vulnerable to political news recently (Lower House speaker statement about possible shortening of parliament's term of office in May and deputy PM Hausner quitting the SLD). Upcoming days will bring publications of very important macroeconomic data for January, which will influence the zloty and treasuries' yields. Data on inflation and corporate wages will show how strong price pressure was at the beginning of 2005, while output data will suggest whether December's slowdown was a good reason to change GDP growth forecast for 2005 as a whole. If the data turn out to be in line with our forecasts (higher than market consensus), one can expect higher yields (and possibly weaker zloty). Certainly, the data will bring high volatility amid very wide range of market forecasts. It is also possible that at the end of the week, the EcoFin Council will publish its opinion on the Polish Convergence Programme. In line with recent Commission's assessment, this will most likely include critical remarks as regards budgetary assumptions until 2007. The criticism shows that fiscal problems are not connected with Polish pension funds (OFE) only. On 16th Feb MinFin will present plan B needed in case of unfavourable EU ruling on OFE.

Economic calendar

TIME GMT	COUNTRY	INDICATOR (importance level*)	PERIOD	FORECASTS		LAST VALUE	
				MARKET	BZWBK		
MONDAY (14 February)							
10:00	POL	Auction for 52-weeks Treasury Bills – PLN900m (M)					
15:00	POL	Money supply (M)	I	%YoY	8.6	7.8	8.0
TUESDAY (15 February)							
15:00	POL	CPI (H)	I	%YoY	4.6	4.7	4.4
15:00	POL	Corporate wages (H)	I	%YoY	4.1	4.8	3.2
15:00	POL	Corporate employment (M)	I	%YoY	0.2	0.2	0.2
10:00	EMU	GDP (H)	4Q	%	0.4	-	0.3
10:00	GER	ZEW Index (H)	II	-	32.5	-	26.90
14:00	US	Net capital inflows (H)	XII	\$bn	-	-	81.00
WEDNESDAY (16 February)							
10:00	POL	Auction for 5y bonds (PS0310) – PLN2.5-3.5bn (H)					
14:15	US	Industrial production (H)	I	%MoM	0.3	-	0.8
14:15	US	Capacity utilisation (H)	I	%	79.40	-	79.20
16:00	US	Alan Greenspan Testimony to Senate Banking Committee					
THURSDAY (17 February)							
15:00	POL	Industrial production (H)	I	%YoY	4.2	5.6	6.4
15:00	POL	PPI (M)	I	%YoY	5.0	5.2	5.6
13:30	US	Import prices (M)	I	%	0.7	-	-1.3
FRIDAY (18 February)							
13:30	US	PPI (M)	I	%MoM	0.3	-	-0.7
14:45	US	Preliminary Michigan index (M)	II	-	95.50	-	95.50
DURING A WEEK							
	POL	Budget performance (M)	I	PLNbn	-2.3	-2.2	-

* Importance level: (H)igh, (M)oderate; Source: Reuters, BZ WBK, Gazeta Bankowa

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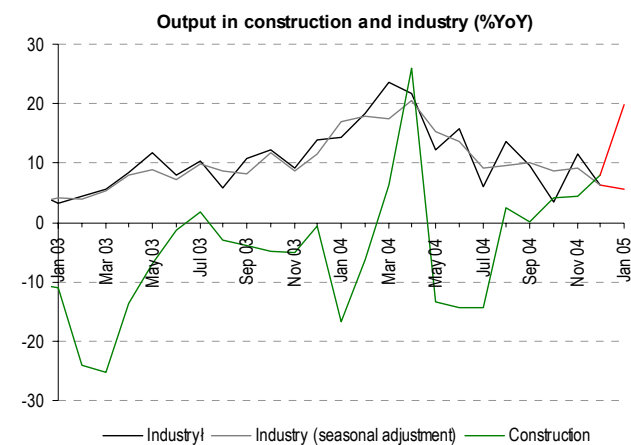
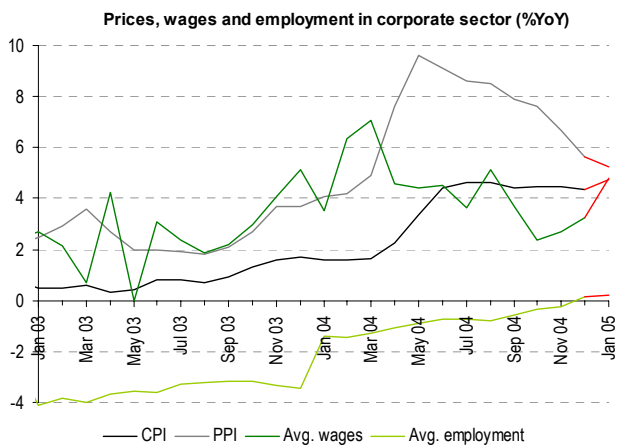
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What's hot this week – A lot of important economic data



- Inflation increase may limit market expectations (in our opinion too excessive) for rate cuts this year. Even one of the most dovish MPC members, Miroslaw Pietrewicz, said recently that no cuts are possible when inflation is rising.
- Since January 2005 the CSO stopped publishing preliminary food prices data, which made inflation forecasting more difficult. This implied, together with uncertain effect of administrative prices hikes, quite wide range of market forecasts (4.4-4.8%), which may reinforce market reaction.
- CSO will publish labour market statistics - employment and wages in enterprise sector. Corporate wages will be important from monetary policy point of view. Though, figure for wages in the whole economy is the key and the CSO showed that in 4Q04 they rose faster than inflation (by 5.6%YoY).
- Employment is expected to rise in annual terms for the second consecutive month.

- On Thursday we will see a continuation of inflation data with PPI figure, which should show further decrease in annual terms. The scale of reduction will depend on usual January's administrative prices rise affecting this index.
- However, data on industrial output will be much more important, especially in the context of December's sharp deceleration (to 6.4%). In 1Q05 the growth will be even lower amid high statistical base effect. But if production surprises on downside again this may lead to GDP growth forecast revision.
- On the other hand, we expect a continuation of positive trend in construction output (two-digit growth in January) – statistical base effect as well as weather condition were very favourable.
- During the week, the Ministry of Finance will present data on budget performance after January. Earlier estimations given by the ministry strongly influenced market expectations and data should not be important for the market.

Economy last week – Much cry and little wool

Fragments of the statement after MPC meeting with cabinet members

In order to meet these criteria [Maastricht], it is necessary to fully implement the Convergence Programme, the update of which was passed by the Government on 24 November 2004. Attaining this objective should be supported by proper fiscal-monetary policy mix.

A key element in the implementation of the Convergence Programme is to bring fiscal deficit below 3% of GDP and to keep it at this level. (...) A high and sustainable economic growth rate reconcilable with the inflation target would facilitate the implementation of the Convergence Programme. While assessing the compliance with the convergence criteria it would also be desirable to correctly account for the short-term costs following from the introduction of retirement pension reform, which will limit the level of public debt in the long run.

The period of Poland's participation in ERM II before its entry to the euro area should not be longer than the required minimum. Thus, the decision to join the mechanism should be taken when it is possible to conclude with a high degree of probability that the reforms being implemented as well as the macroeconomic situation would ensure the compliance with the remaining criteria within this period.

The Government and the MPC also agree that it would be most desirable if the institutions of the European Union interpreted the exchange rate criterion in a way that would eliminate unnecessary macroeconomic risk.

- Conclusions from the meeting could have been disappointing for market participants speculating on whether some actions could be taken to weaken the zloty.
- However, statements included in the joint communiqué (see table on the left) had to be very general.
- Even if any measures are planned in the case of further zloty appreciation (MinFin buying foreign currency on the market or NBP intervening on the market), discussion on such subjects should be confidential to be effective.
- As regards longer perspective, it is difficult to expect that any decisions can be taken by current government. Reduction of the fiscal deficit will be the task for new cabinet after election. That is why the market will probably disregard the communiqué.
- Possibly, the criticism expressed by the European Commission and EcoFin Council will force new cabinet to undertake fiscal reforms.

Quote of the week – Strong zloty now does not mean strong zloty in a few months

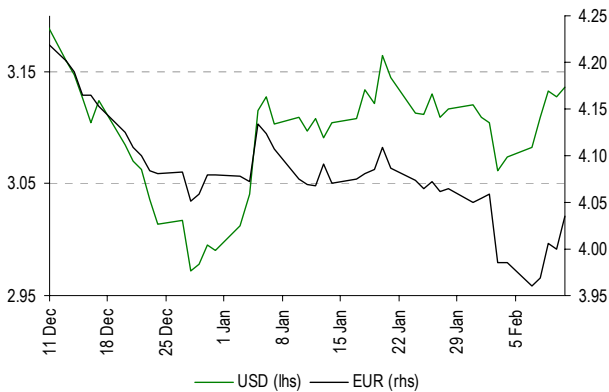
Dariusz Filar, MPC member
(TOK FM Radio, 8 Feb)

The fact that the zloty is strong today is not a guarantee that it will be strong in a few months time. (...) Looking back at history in Poland, all political climaxes strongly influenced the zloty to weaken. We do not know how investors see the risk which will accompany the election period. (...) If future inflation path is favourable from the point of view of MPC, change in bias from tightening to neutral cannot be excluded.

Professor Filar's statements suggest that instead of cutting rates in reaction to the zloty's strength, the central bank will remain cautious in conducting monetary policy, as the zloty's strengthening driven to a large extent by inflow of short-term capital ("reason for the zloty appreciation lies to a large extent abroad") may lead to a rapid depreciation in future. Also, Filar pointed out that recent rate cut in Czech Republic did not weaken the koruna.

Market monitor

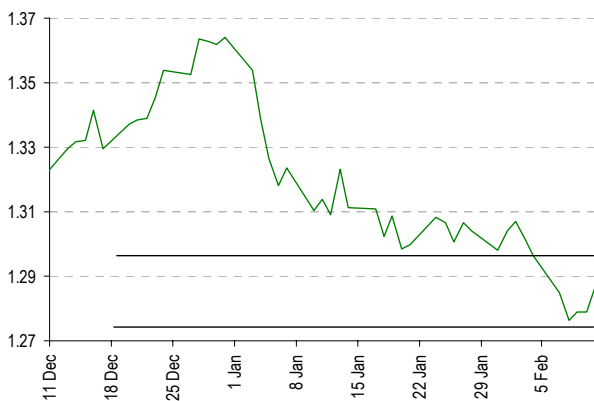
Zloty exchange rate



Politics signals its presence

- Last week the zloty gave back the gains from February's beginning. It weakened by 2.03% to the dollar and 1.26% to the euro.
- Deputy PM Hausner's quit from SLD party, in our opinion neutral, was used by investors as an opportune timing for profit taking. Additionally, in the second part of the week the zloty got cheaper due to confusion related to election date.
- Breaking the ranges, which we indicated last week were caused by political reasons, but it's worth noting that they were short-term ones.
- Next week, we expect the zloty to fluctuate in a range 3.98-4.07 to euro and 3.08-3.15 to dollar. Wider bracket for euro stems from assumption of similar volatility of both rates.

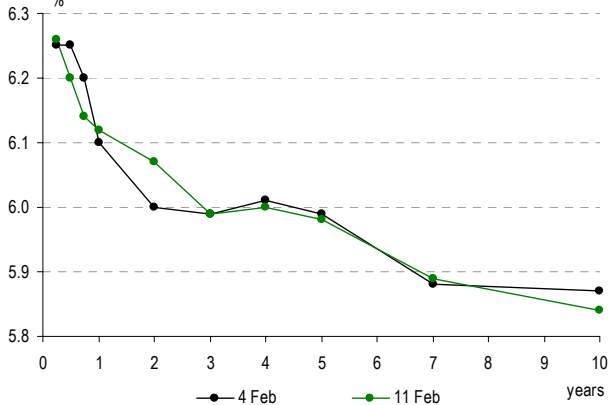
EURUSD rate



Is US still able to attract capital?

- Beginning of last week brought further decline of the euro in the aftermath of Greenspan's comments (next week he will deliver a speech on Wednesday) and hints on reduction of budget shortfall. Despite good US trade data, though expected, the euro regained majority of losses. Ultimately during the whole week cross lost 0.75% to the dollar.
- Strong rebound from 1.2730 which constitutes significant technical barrier indicates that it will be hard to break that level. On Tuesday, subsequent report on capital inflow to US will be released, that will show if trade shortfall is covered by foreign investment. We think that the euro may reach recent technical limit 1.2940, but it depends largely on data.

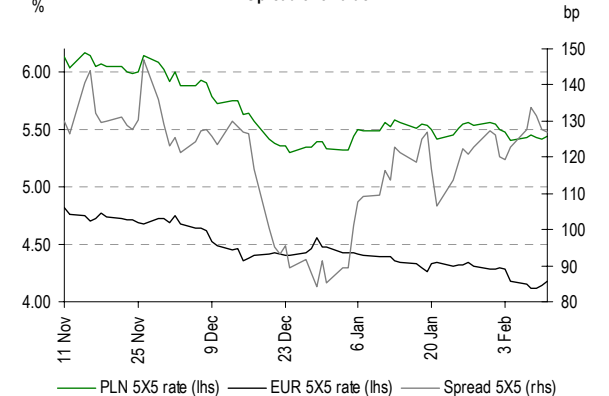
Yield curve



Inflation and auction key for the market

- Yield curve shifted last week only slightly with high turnover sanctioning lower levels of rates. FRA contracts 6x9 stabilised at the level discounting 75 bp rate cut.
- Auction for inflation-linked bonds took place only, which for the sake of its specificity and size of the tender did not constitute the trend setting factor.
- The second auction for new 5y benchmark will take place on Wednesday. Owing to the upside risk of inflation data ahead of the auction the ministry probably will show the offer of max. PLN3bn. The market seems to price in benign inflation increase in 1Q05, so distinct jump might diminish an interest for those bonds below 6%.

Spread 5X5 value



A bit wider spreads

- Last week spread 5/5 between Poland and euro zone widened from 123 to 130 bp. It was caused by domestic political factors and euro curve flattening. We expect the spread to retain above 120 bp. While, in our opinion, value of 130 bp already reflects a series of risks, before the election it may rise even to 150 bp.
- Spread between 10y bonds in Germany and US rose slightly to 62 bp, but it took place amid certain volatility triggered by unsuccessful 10y US Treasuries auction. Next week we do not perceive any factors that may suddenly change positive mood in core markets. Next week data will exert an influence mainly to EURUSD rate.

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