

Weekly economic update

21 February - 27 February 2005

Surprisingly low inflation strengthened the Polish fixed income market (though it was quite strong, anyway), which is now pricing-in over 100bps cut in official rates this year. Moreover, FRA 3x6 is anticipating over 50bps rate cut. In order to have this scenario materialised, the MPC would have to adopt neutral approach in monetary policy in February, easing approach in March, and then cut rates (by 50bps) in April. It seems quite unlikely at the moment. Data on output in industry and construction did not signal that Polish economy was entering a slowdown period deeper than resulting from a high statistical base effect. This week retail sales figures will be released, and should confirm this conclusion in our view. However, some of the MPC members are apparently getting more and more concerned about economic deceleration, which suggests that the next economic data releases might put them under pressure for interest rate reductions. Nevertheless, after inflation data release only dove-ish MPC members presented their views in media (comments of the others were more hawkish, but were expressed before CPI release). Therefore it would be crucial to see statement of the whole Council after the meeting on 24-25 February. We expect that policy bias will be changed to neutral, but the MPC will want to underscore significance of three monetary policy biases, rendering market assessment of short-term rate cuts perspectives as too aggressive. More hints on monetary policy perspectives should be delivered on 28 February when new inflation projection will be published. Meanwhile, the perspective of Poland's accession to the euro zone seems to be moving away in time.

Economic calendar

Time GMT	COUNTRY	INDICATOR (importance level*)	PERIOD	FORECAST			LAST VALUE
				MARKET	BZWBK		
MONDAY (21 February)							
10:00	POL	Auction for 52-weeks T-bills – PLN800m (M)					
15:00	POL	Business climate (M)	II	-			
TUESDAY (22 February)							
07:00	GER	GDP (M)	4Q	%QoQ	-	-	0.1
09:00	EMU	C/A ECB (M)	XII	€bn	2.3	-	3.2
15:00	USA	Consumer confidence (H)	II	-	103.0	-	103.4
WEDNESDAY (23 February)							
09:00	POL	Retail sales in nominal terms (H)	I	%YoY	4.4	7.4	2.8
09:00	POL	Unemployment (M)	I	%	19.4	19.6	19.1
09:00	GER	IFO index (H)	II	-	96.75	-	96.40
13:30	USA	CPI (H)	I	%MoM	0.2	-	-0.1
	USA	Fed Minutes (H)	2 II 2005	-	-	-	-
THURSDAY (24 February)							
10:00	POL	Switching auction (H)					
13:30	USA	Durable goods orders (H)	I	%	0.4	-	1.1
FRIDAY (25 February)							
	POL	MPC meeting – decision (H)	-	%	6.5	6.5	6.5
09:00	EMU	Money supply (M)	I	%YoY	6.5	-	6.4
15:00	USA	Home sales (M)	I	M	6.75	-	6.69

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

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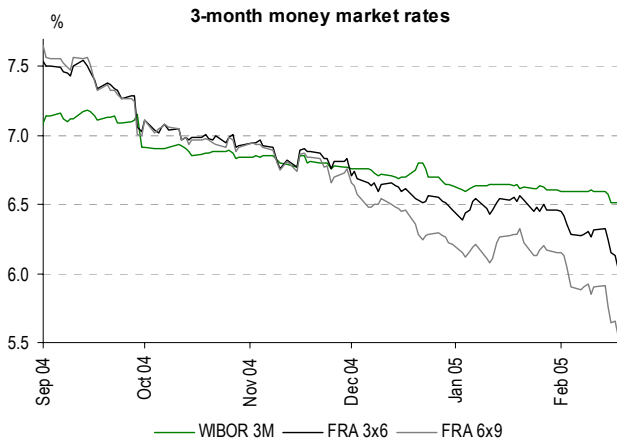
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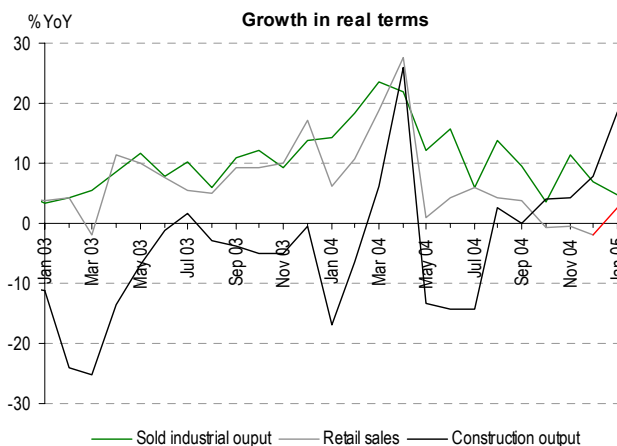
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What's hot this week – Neutral bias and a few data releases

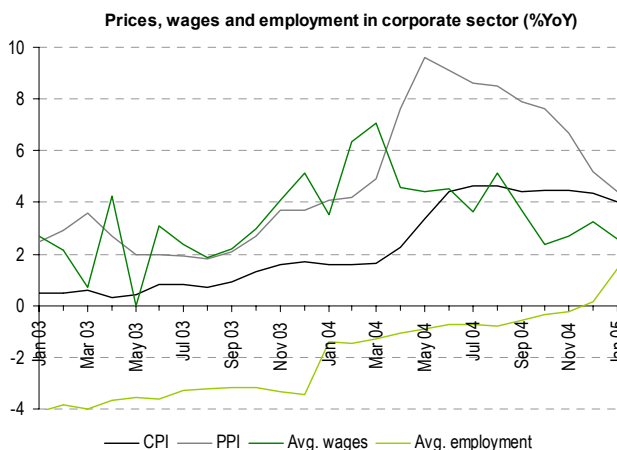


- Market expectations for interest rate cuts have reinforced sharply after data on inflation (see chart). Adoption of neutral policy bias in February is widely anticipated.
- In our opinion, decision on bias change would have been made regardless of inflation level in January, amid improvement in general medium-term balance of risks for inflation.
- Recent comments of the MPC members were rather heterogeneous. Does it mean a split up in the Council again? Or perhaps, the timing of comments was crucial (before or after CPI data release)?
- For this reason, market would carefully eye MPC official statement and comments after the meeting. They could curb market expectations regarding scale of rate cuts in future (it is hard to expect bigger scale than priced-in currently).
- The MPC would refer on Friday to new inflation projection, which publication is scheduled for February 28.



- Before the MPC meeting, the CSO press conference will be held, during which data on retail sales and registered unemployment will be revealed.
- We expect retail sales growth (in nominal terms) above the market consensus. In real terms, we may see the first increase for several months (see chart).
- Retail sales figures will confirm, in our opinion, that slowdown in economic growth to below 4% in 1Q05 would result only from low base effect, which is going to act even stronger in months to come.
- This also concerns industrial output. We see its January's growth of 4.7%YoY as quite solid, taking into account that manufacturing alone (mostly export-oriented) saw 5.6%YoY rise, while the slowdown was recorded in mining.
- ...and construction output surged by almost 20%YoY.
- The unemployment rate will seasonally increase to 19.5%.

Economy last week – Shocking January data change 2005 inflation path



- Annual inflation rate fell to 4.0% in January from 4.4% in December. This was a shock for the market, as no one had expected CPI drop, and the median forecast was 4.6%YoY (our forecast stood at 4.7%YoY).
- The data affected forecasted inflation path. 1Q05 will see annual inflation of around 4%, while 2Q05 will experience inflation decline to below 2% and stabilise there until year-end.
- One should remember, however, that inflation reduction was caused by falling food and fuel prices. Meanwhile, according to our estimates, net inflation inched up by 0.1pp to 2.4%YoY. Therefore, January's data do not change the medium-term inflation outlook. Should they change monetary policy stance?
- January did not see the effects of administrative price hikes, which means they may be seen in February.
- January PPI and wages also low, but there was employment rise of 1.4%YoY and labour demand may grow faster in future.

Quote of the week – Euro zone entry more distant

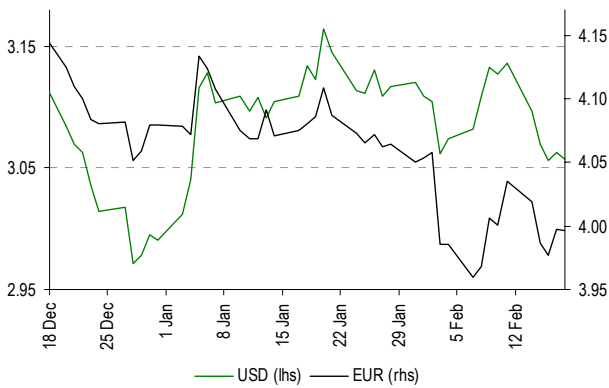
Mirosław Gronicki, finance minister
(PAP, 17 Feb)

2009 is the first year when euro zone entry is possible, but higher probability is for 2010. The highest probability is for 2011. (...) Theoretically, there may be necessity of further spending cuts in 2007 to lower deficit by 0.7pp and bring to below 3% of GDP. (...) There is no official target [date of the entry]. The target will be announced only when it will be agreed with the NBP. This may be 2009, but this may be 2010 as well.

There is a growing risk of delay in Poland's entry to the euro zone beyond 2009. This was even suggested by the finance minister, who used to be very optimistic on the entry date. Critical opinion of the EU side on the Poland's convergence program is not only related to the ruling on Polish pension system. The European Commission criticised Polish fiscal plans for too optimistic GDP growth forecast for 2007, no adoption of fiscal measures included in the Hausner plan and thus too slow reduction of deficit.

Market monitor

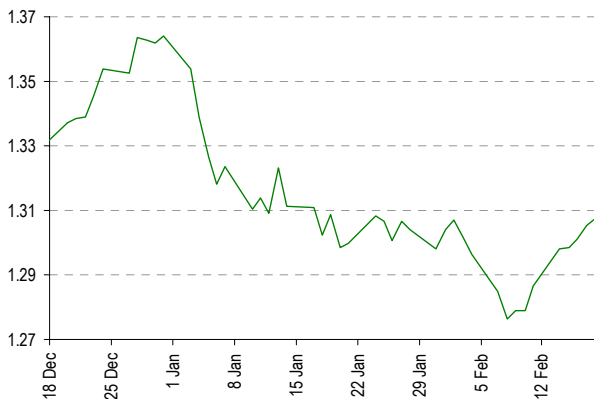
Zloty exchange rate



The zloty ignores the politics

- The zloty strengthened to the euro by 0.97%. It gained above 2.5% to the dollar which was losing throughout the whole week to majority of currencies.
- Initially, the Polish currency followed rising euro, boosted additionally by capital inflow into bond auction. When it turned out that demand was only 1.73 times higher than supply, the zloty suffered a correction.
- As impact of politics eased slightly last week, zloty rate broke outside the brackets indicated by us - to the dollar lastingly, to the euro temporarily, stabilising just above lower band of fluctuations.
- We think, next week zloty fluctuations will be in the range 3.96-4.05 to the euro and 3.03-3.11 to the dollar because of maintenance of EURUSD in the vicinity of 1.30.

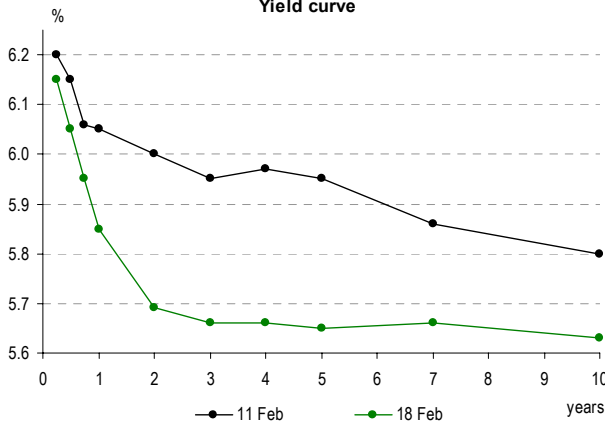
EURUSD rate



What was the reasoning behind last Fed's decision?

- EURUSD rate gained last week above 2% owing to concerns of the markets about the ability of covering still wide trade deficit in US (above \$56bn). Lower than previously, but still favourable data on capital inflow into US failed however to reverse the dollar's decline. EURUSD rate again fell into January's trading range 1.2960-1.31, boosting its technical significance.
- Next week we do not expect any breaking from that bracket unless the markets are surprised by Minutes from last Fed meeting. However one should anticipate that it will not differ substantially from the content of Fed chief's testimony delivered last week.

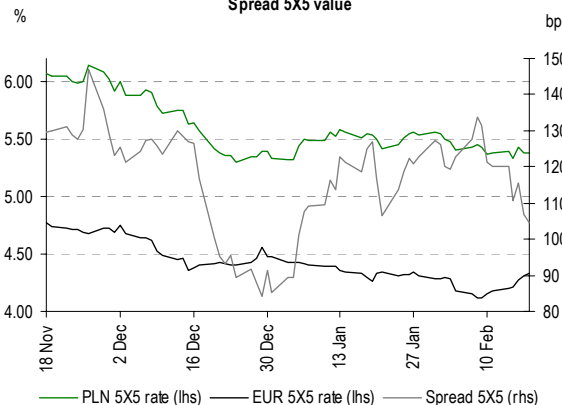
Yield curve



Nervousness till Friday cannot be excluded

- Due to surprisingly low inflation yields strongly declined reaching levels 5.64% and 5.70% for 5 and 2 years (both slumped by ca. 30 bp). Actually, the curve in the sector 5/10y flattened completely owing to a necessity of preserving 5/5y spread to euro curve. In FRA contracts NBP interest rate cuts by above 100 bp are included and FRA 6x9 takes into account above 50 bp. Successful auction amid large supply confirmed lower yields.
- The market usually freezes in the week, in which Council's meeting takes place. But this time decision will be announced on Friday, and data release and switching auction will be seen prior to it. Again, the MPC statement will be of key importance, especially after low inflation "shock". The market will be affected by core curves that may retain the volatility at elevated levels.

Spread 5X5 value



Greenspan in the leading role

- Due to strong yield decline in Poland and their rise in Europe 5/5y spread narrowed to 105 bp from 130 bp. Risks from politics and possible delay of Poland's euro zone entry do not justify that event. We expect that in the foreseeable future spread may widen to above 120 bp.
- Owing to the fact that Fed chief did not signal any changes to the pace of rate hikes, spread between 10y bonds in US and Germany stayed at ca. 60 bp.
- Quote from Fed chairman that "real rates are fairly low" backed up yields in US and Europe by 15-17 bp (to 4.20% and 3.60%, respectively). On Wednesday, when US CPI, IFO index and Fed Minutes from last meeting is scheduled, the market will take a hint if bonds weaken further.

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