

Weekly economic update

28 February - 6 March 2005

We wrote last week that it was hard to expect that the Monetary Policy Council decision or its justification could reinforce market expectations for rate cuts. However, the MPC proved it was possible. The change in monetary policy approach directly from tightening to easing, omitting neutral one, will most likely assure market players that they were right to aggressively price in rate cuts this year. Statements of MPC members that the change in bias to easing does not mean automatically equal to swift rate cuts will probably be ignored by the market, which is set to price in even larger scale of rate cuts than earlier. Capital inflow coupled with that fact may lead to further strengthening of the zloty and this in turn will be one of arguments for rate cuts. It seems the MPC accepted the invitation from financial market for a quite risky game. On Monday, the central bank will publish the new inflation projection (included in the Inflation report for 4Q04). It is based on the assumption of no change in official interest rates, but the most important will be central bankers' answer a question: „will the inflation target be endangered in case rate cuts on a scale being priced in by the market?”

Economic calendar

Time GMT	COUNTRY	INDICATOR (importance level*)	PERIOD	FORECAST			LAST VALUE
				MARKET	BZWBK		
MODNAY (28 February)							
08:00	POL	Inflation Report (H)	4Q				
10:00	POL	Auction for 52-weeks T-bills – PLN800m (M)					
16:00	POL	C/A (M)	XII	€bn	-469	-570	31
10:00	EMU	HICP (H)	I	% YoY	-	-	2.4
15:00	USA	Chicago PMI (H)	II	-	61.00	-	62.40
TUESDAY (1 March)							
09:00	EMU	PMI (H)	II	-	-	-	51.9
15:00	USA	ISM manufacturing (H)	II	-	56.5	-	56.4
WEDNESDAY (2 March)							
09:00	POL	Auction for 2y bonds OK0407 – PLN1.5-2.5bn (H)					
10:00	EMU	PPI (M)	I	% YoY	-	-	3.6
10:00	EMU	GDP (M)	4Q	% QoQ	-	-	0.3
	USA	Alan Greenspan's Testimony to Budget Committee					
THURSDAY (3 March)							
12:45	EMU	ECB Decision (H)		%	2.0	-	2.0
13:30	USA	Productivity (H)	4Q	%	1.3	-	0.8
15:00	USA	ISM non-manufacturing (M)	II	-	60.0	-	59.2
FRIDAY (4 March)							
10:00	EMU	Retail sales (M)	I	% YoY	-	-	0.5
13:30	USA	Change in non-farm payrolls (H)	II	k	200	-	146
14:45	USA	Final Michigan (H)	II	-	94.70	-	95.50
15:00	USA	Factory orders (H)	I	%	0.3	-	0.3

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

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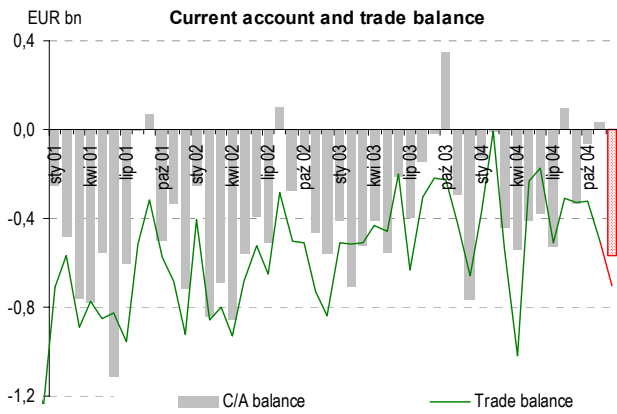
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What's hot this week – Focus on inflation projection and core markets



- The feature of this week on the Polish market will be publication of the new inflation projection – publication of balance of payments data for December will be in the shade.
- We expect that the last month of 2004 saw continuation on robust rise in both exports and imports (close to 20% r/r). According to our forecasts, a seasonal widening of trade gap and deterioration of the C/A balance took place, but 12-month cumulative C/A deficit slightly narrowed to 1.7% of GDP from 1.8% of GDP after November.
- Low scale of external imbalance of the economy is one of fundamentals factors supporting the zloty.
- Participants of the Polish market will wait for additional conclusions from the new inflation projection and watch core markets (the most important data releases abroad will be the US manufacturing ISM (on Tuesday) and non-farm payrolls (on Friday).

Economy last week – Very surprising decision of the MPC

Fragments of the MPC statement from 26 February 2005

In the assessment of the Council change of balance of risks for future inflation has been seen for several months, which enabled that currently this balance may be more favourable than was presented in February's projection. Recent zloty's appreciation scale was as higher that was taken into account in projection, and food prices dynamics may diminish faster than was assumed. The council notices however uncertainty regarding among others developments of oil prices and zloty's exchange rate.

According to February's inflation projection pace of prices growth will be lower than expected in November's Report. Under assumption of unchanged interest rates with probability of 50% inflation will retain in the bracket 1.2-4.0% in 4Q05 (2.5-5.2% in previous projection), 0.4-4.2% in 4Q06 (1.3-4.8% in previous projection) and 0.5-4.6% in 4Q07.

It is expected in 2005 that GDP growth will amount to 4.0-4.5% and will be slightly lower than expected in November's Report, mainly owing to presently predicted lower contribution of net exports to GDP growth.

Strong zloty's appreciation lowers inflation. However appreciation tendency may simultaneously contribute to economic growth weakening.

- MPC decision to change bias to easing directly from tightening was surprising for all market participants.
- After adoption of easing bias, the only question is a scale of interest rates cuts this year. Details of the new inflation projection may help to answer the question.
- Justifying its decision, the Council said that the balance of risks for future inflation had been improving for a few recent months. If so, why the MPC said in January and December that balance of risks had not changed significantly.
- Such inconsistency in MPC statements shows that tightening bias was probably maintained too long.
- Of course, the balance of risks significantly improved during the last month. The MPC pointed out mainly the zloty strengthening. The Council said strong zloty may not only lower inflation, but also weaken the economic growth.



- Retails sales grew 7.5%YoY in nominal terms (our forecast was 7.4%, market consensus stood at 4.4%) and 3.1%YoY in real terms. Although the result was positively affected by one-off acceleration in new car sales' growth rate, it suggests that slowdown in retails sales in 1H05 could be attributed to high base effect and consumption may rebound in 2H05.
- Such view is supported by steady improvement of the labour market conditions. The unemployment rate seasonally increased to 19.5%, but its annual fall deepened to 1.1pp.
- Employment growth gains momentum, which may translate into higher wage growth. Wage growth in the whole economy is higher than CPI and much stronger than in the enterprise sector (see chart).
- This is reflected in consumer confidence, which seasonally weakened in February, but again considerably improved in annual terms.

Quote of the week – Easing bias does not mean easing policy?

Stanisław Nieckarz, MPC member

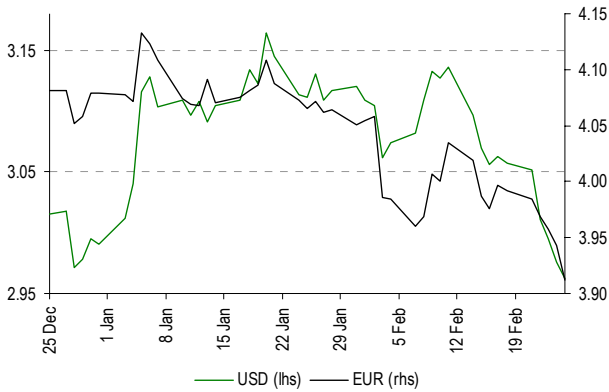
(Reuters, 25 Feb)

Easing bias does not mean immediate rate cuts. In theory, it (the easing bias without rate cuts) may last for a longer time, even half a year.

MPC members, including Stanisław Nieckarz who is regarded as ultra dove-ish, stressed at the press conference that adoption of easing bias does not mean automatically swift rate cuts. Such statements will most likely be ignored by the market, which is set to price in rate cuts throughout this year even more aggressively than earlier.

Market monitor

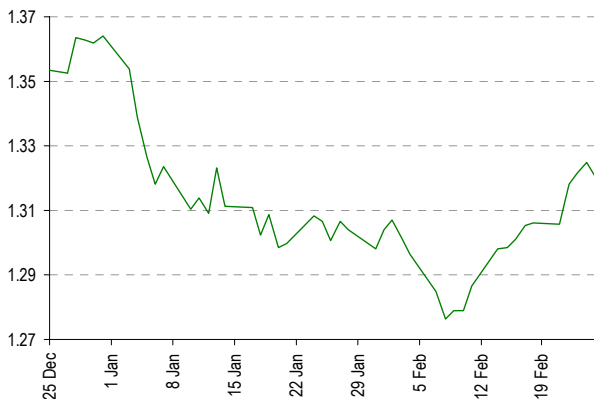
Zloty exchange rate



Capital flows into Poland

- Last week the zloty recovered substantial gain respectively by 3.08% to the dollar and 2.01% to the euro.
- The advancement occurred due to strong capital inflow into our region countries. Plans of budget deficit reduction in 2006/2007 created additional impulse. Change in bias to easing one did not caused major zloty's rate changes, but it may contribute to further play on zloty strengthening until cut are materialised.
- Strong correlation between the zloty and euro has returned, so next week EURUSD fluctuations will be crucial for our currency, especially amid light domestic economic calendar.
- Next week we expect the zloty to fluctuate in the ranges: 3.87-3.97 to euro and 2.92-3.00 to dollar.

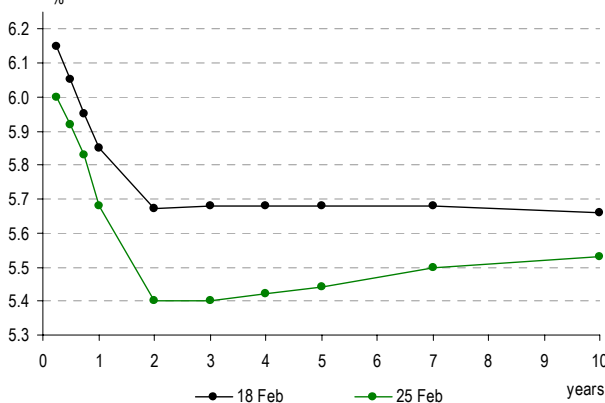
EURUSD rate



Mention on reserves diversification

- Last week the euro gained to the dollar almost 2%. The direct reason of breakout above 1.31 was a statement from the central bank of Korea, though denied afterwards, on potential reserves diversification. Overtone of FOMC Minutes from last Fed meeting was also negative to the dollar that enabled the rate to retain 1.32 mark.
- Economic sentiment indicators that are to be published next week ought not to affect strongly EURUSD rate. Only Fed chairman testimony, ECB decision and Friday's labour market report have an opportunity to set a tendency un the market (weekly initial jobless claims data point to decent result). Until that time the euro will stay rangebound within 1.31-1.33.

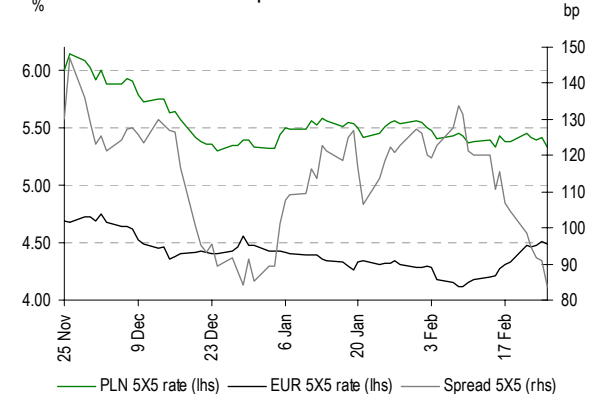
Yield curve



The market taken by surprise

- Due to change in bias to easing yields fell along the curve 7-17 bp. The biggest drop was recorded in 2y sector that reached 5.40% at the end of the week. The curve changed its slope in 5/10y sectors into positive. FRA contracts price in above 125 bp in the whole year.
- 2y bond auction amid rate cuts expectations will probably attract meaningful demand, but one cannot exclude profit taking prior to the tender following substantial market movement. Moreover Polish interest rate market will be affected by core markets. ECB decision and US non-farm payrolls data will be the most closely watched. In case of strong data one cannot exclude negative impact on long end of the curve.

Spread 5X5 value



Return of convergence play?

- Further yield rise in Germany and their substantial drop in Poland made the 5/5y spread to narrow to 84 bp. As long as the zloty strengthens, investors will ignore drop in relative attractiveness of Polish curve.
- 10y Bunds fell more profoundly than 10y bond in US, as they were affected stronger by technical factors (Bunds broke strong upward trend, US Treasuries stay within a range). Spread fell from 60 bp to 52 bp.
- Interest rate markets await portion of sentiment indicators (ISM, PMI), ECB decision and another Fed chairman testimony. The week will be finished with US payrolls data. We still believe that spread between the markets in Europe and USA may widen due to signals confirming economic expansion in US.

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