

Weekly economic update

14 March – 20 March 2005

This week inflation indicators, especially today's CPI data release, will be crucial for financial markets. If inflation surprises on the downside, it will reinforce market expectations for rate cuts. While low corporate wages growth and decreasing PPI inflation, as well as lower-than-expected GDP growth data for 4Q04, should also improve sentiment on the Polish interest rate market, one cannot forget of core markets, on which the sentiment remains bearish.

The Ministry of Finance prepared (but did not publish yet) the *Strategy for Public Finance Management in 2005-2008*. Estimations regarding additional fiscal tightening of 0.45% in 2006 and 1.12% of GDP in 2007 are difficult to verify without knowing details of the document. That is why a credibility of the programme is limited (for both markets and the European Commission) as for now. Although current opposition already declared the *Strategy...* would be thrown out, we positively perceive the fact that minister of finance started a discussion on three-year fiscal planning, including tax strategy.

Economic calendar

Time GMT	COUNTRY	INDICATOR (importance level*)	PERIOD	FORECAST		LAST VALUE
				MARKET	BZWBK	
MODNAY (14 March)						
10:00	POL	Auction for 52-weeks T-bills – PLN800m (M)				
14:00	EMU	Trichet testifies before European Parliament	-	-	-	-
15:00	POL	CPI (H)	Feb	%YoY	4.0	4.0
15:00	POL	Money supply (M)	Feb	%YoY	9.4	9.5
TUESDAY (15 March)						
10:00	GER	ZEW index (H)	Mar	-	-	35.90
13:30	USA	Retail sales (M)	Feb	%MoM	0.5	-0.3
14:00	USA	Net capital inflow (H)	Jan	\$bn	-	61.30
15:00	POL	Corporate wages (H)	Feb	%YoY	2.5	1.3
15:00	POL	Corporate employment (H)	Feb	%YoY	1.4	1.6
15:00	USA	Factory orders (M)	Jan	%	0.6	0.2
-	USA	Greenspan's testimony	-	-	-	-
WEDNESDAY (16 March)						
10:00	POL	Auction for 5y bonds PS0310 PLN2.5-3.5bn (H)				
10:00	EMU	Final HICP (H)	Feb	%MoM	-	-0.6
14:15	USA	Industrial production (H)	Feb	%MoM	0.3	0.0
14:15	USA	Capacity utilisation (H)	Feb	%	79.20	79.00
THURSDAY (17 March)						
10:00	EMU	Industrial production (M)	Jan	%MoM	-	0.5
15:00	POL	PPI (H)	Feb	%YoY	3.7	4.4
15:00	POL	Industrial production (H)	Feb	%YoY	2.8	4.7
FRIDAY (18 March)						
13:30	USA	Import prices (H)	Feb	%MoM	0.6	0.9
14:45	USA	Preliminary Michigan index (H)	Mar	-	-	94.10

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

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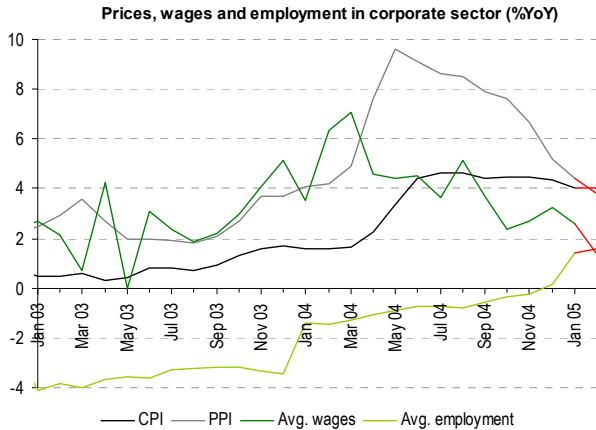
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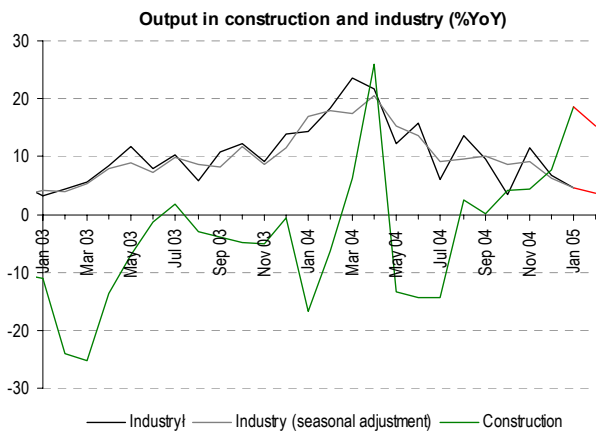
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What's hot this week – Another (January and February) inflation surprise?

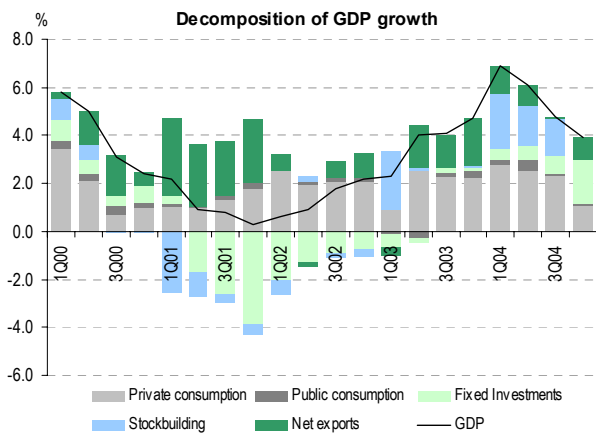


- Today's CPI inflation release will be the most important event for the market this week.
- Together with February's data, revised inflation for January according to new weights system will be also published.
- It is worth noticing that Eurostat's data showed that Poland's HICP inflation in January reached 3.8%, i.e. 0.2 pp. lower than CPI. It could suggest that after revision of weights, CPI could be lower than tentative estimate.
- If the revision from 4% to 3.9% takes place, the level of 4% might not be broken in February even if inflation rose last month. If revision is deeper (or if food prices surprise on the downside), February's inflation might be below 4%.
- This would be very positive signal for interest rate market. Especially as data on PPI inflation should show it fell again and corporate wages grew very moderately.



- The CSO will also publish a couple of other figures.
- We expect a deceleration in industrial production, and annual increases in March and April (if any) will be even lower. Production in construction sector should continue two-digit growth.
- We also expect a continuation of positive signals in the statistics concerning employment.
- Budgetary data should be in line with hints given recently by officials, while money supply data are under influence of changed methodology and forecasts are burdened with risk.
- While economic data this week should be supporting for sentiment on the Polish interest rate market, one cannot forget international bond markets, on which the sentiment remains bearish.
- ... and there is heavy calendar abroad this week.

Economy last week – Investments and net exports positive, consumption and inventories quite weak



- GDP growth for 2004 was revised down to 5.3% from a tentative release of 5.4%. Growth in 4Q04 was also slightly weaker than we estimated earlier - 3.9% against 4.1%.
- Private consumption in 4Q04 grew 1.8%. We believe such low rate of growth will not be a permanent phenomenon.
- Fixed investment growth of 7.2% confirmed strong recovery. We expect two-digit growth in 2005.
- Despite strong zloty net export had again strong positive impact (close to 1 percentage point) on economic growth.
- 4Q04 saw no effect of rise in inventories, which was experienced in the three previous quarters of last year (when its contribution ranged between 1.6 and 2.3 pp).
- Data for 4Q04 lead to slightly lower optimism as regards GDP growth in 2005 and we see there is a risk on the downside to our forecast of 4.7% for the entire year.

Quote of the week – New (better?) fiscal strategy

Mirosław Gronicki, finance minister

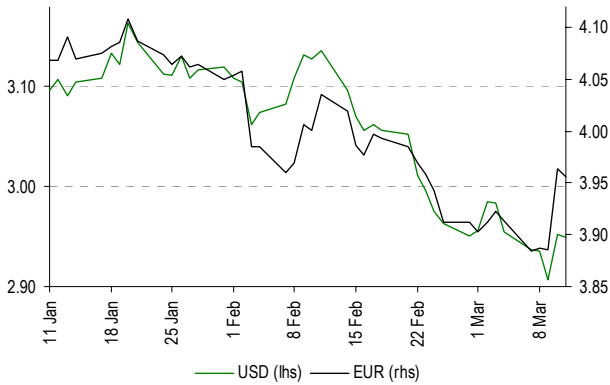
(Rzeczpospolita, 12-13 March)

Public finance reform does not consist only in accepting a package of new bills. This cannot be reduced to expenditure reduction or tax changes. This is also a question of cash management in public finance sector. (...) This is necessary to introduce clearing accounts in public finance sector, which will be based on tasks and to introduce spending planning not for one year only, but for three years.

Fiscal policy strategy includes plans to bring deficit to below 3% of GDP in 2007, tax strategy as well as some changes in fiscal policy management. Additional fiscal tightening of 0.45% in 2006 and 1.12% of GDP in 2007 is in line with the European Commission's recommendation. However, we still do not know details. Tax strategy assumed a gradual reduction of taxes with flat tax rate of 18% as a target in 2008 (with 50% corporate investment tax relief). These assumptions will be probably changed by new cabinet.

Market monitor

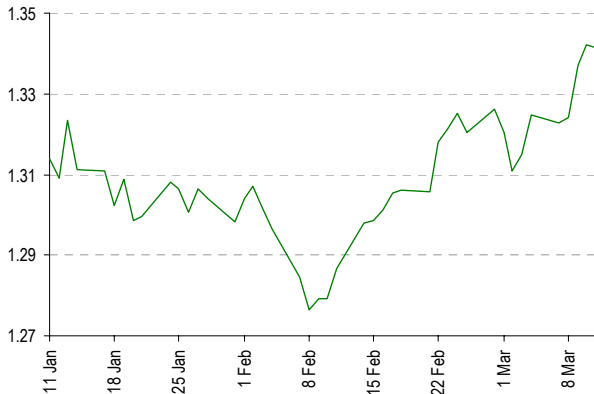
Zloty exchange rate



Sell-off in the whole region

- Last week the zloty rate actually did not change to the dollar, however it lost 1.07% to the euro. The market was very volatile and exchange rate fluctuations reached 2%.
- US data and clarification around PM Belka's statements gave the zloty positive impulse that lasted till Wednesday, when minister Hausner had resigned. In the remaining part of the week due to sentiment deterioration in the whole region, currency suddenly lost despite euro strengthening.
- If inflation and real economy data support expectations for deep cuts, the zloty has a chance to gain this week. Otherwise it will be "doomed" to influence of EURUSD rate and politics. We expect the zloty to fluctuate within the ranges 3.9-4.0 to the euro and 2.9-2.98 to the dollar.

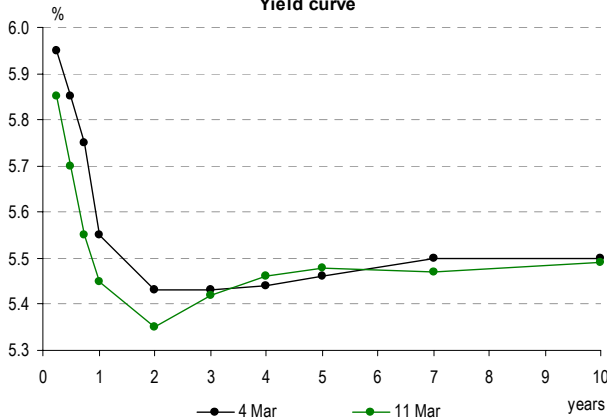
EURUSD rate



Dollar under fire from all angles

- The euro gained 1.25% to the dollar last week. It was triggered by Japanese PM comments on diversification of reserves and ECB Council member on possibility of inflation increase within euro zone. Those news appeared at technically important levels, that compounded rate movement. Euro gains were boosted by expectations and publication of large US trade deficit.
- This week (on Tuesday) the market will become convinced, how US copes with financing trade gap. If capital inflow data disappoint the market, the dollar will be under renewed pressure. Otherwise magnitude of rate decline is limited to 1.3250-1.33.

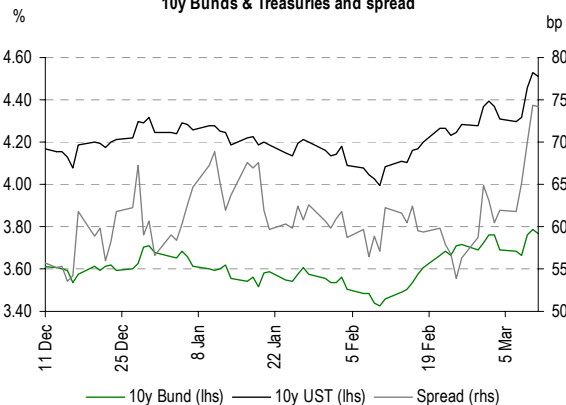
Yield curve



What will be inflation path?

- Yield curve, amid elevated volatility, moved only on the short end last week. 5y sector was the biggest mover (5.34-5.56%), which experienced the most Thursday's sell-off owing to liquidity and incoming tender. 2y sector and FRA contracts strengthened ahead of inflation data respectively by 8 bp and 15 bp. (9x12 prices in already above 150 bp of rate cut).
- Current sentiment in bond market is not conducive to large offers, so papers supply on the auction should not exceed PLN3bn. CPI will show what will be inflation path this year and thus what will be the yield levels on the short end of the curve. Core markets, on which sentiment remains negative, will remain under influence of data releases.

10y Bunds & Treasuries and spread



Core curves diverge

- Last week 10y yields in US and Germany rose to 4.53% and 3.77%. Prices of the former fell due to high oil prices against the background of economic expansion, the latter – on the back of concerns about inflation growth. The spread widened to 76 bp from 62 bp due to deeper slump in US. Spread 5/5i between euro and Polish curve ceased to narrow owing to political risk rise.
- Because we expect gradual yield rise of US papers, such dramatic move may induce a correction due to psychological level of 4.50%. Net capital inflow (Tuesday) should not spoil the market performance, though production and sales may have an impact on prices. Bunds will depend on ZEW index, but their moves will rather be similar to Treasuries.

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