

Weekly economic update

25 July – 31 July 2005

Last week, the most important event for the Polish financial market was the release of output figures. As growth in industrial production proved much stronger than market expectations (6.8%YoY increase was only slightly below our forecast), a significant correction took place on the interest rate market and market players began to price in only 25bp cut this month instead of previous strong expectations for 50bp cut. At the same time, the market did not react to data from inflation front that were broadly in line with expectations. Growth rate of producer prices was slightly higher than expected, but similarly to falling core inflation measures, low PPI confirmed that there were virtually no threats to inflation at the moment. The exception are high fuel prices, but one of MPC members pointed out that this was not only a risk factor for inflation, but also a threat for economic growth. With very favourable inflation outlook for upcoming months, the outcome of the nearest MPC meeting and central bank's moves in the remainder of the year will depend on how the Council assesses potential inflationary impact of expected revival of the Polish economy. An important indication regarding condition of the real economy, to be published already before the MPC meeting, will be today's data on retail sales in June. A growth close to our forecast (5.7%YoY) and to market consensus (6.2-6.4%YoY) would confirm up-to-date picture of developments in economic activity and would be consistent with expectations for 25bp reduction in rates this week. As expectations concerning further moves of the MPC (overall scale of rate cuts this year) are diversified (there is only no doubts that easing bias will be maintained for some time) it will be crucial what the central bankers say after the meeting.

Economic calendar

Time GMT	COUNTRY	INDICATOR (importance level*)	PERIOD	FORECAST		LAST VALUE	
				MARKET	BZWBK		
MONDAY (25 July)							
08:00	POL	Retail sales (H)	Jun	%YoY	6.4	5.7	8.0
08:00	POL	Unemployment (M)	Jun	%	18.1	18.2	18.3
TUESDAY (26 July)							
08:00	GER	IFO index (H)	Jul	-	94.0	-	93.3
14:00	USA	Consumer confidence (H)	Jul	-	105.4	-	105.8
WEDNESDAY (27 July)							
-	POL	MPC meeting - decision (H)	-	%	4.75	4.75	5.00
12:30	USA	Durable goods orders (H)	Jun	%MoM	-0.1	-	5.5
THURSDAY (28 July)							
08:00	EMU	Money supply (H)	Jun	%YoY	7.1	-	7.3
09:00	POL	Switching auction (H)					
FRIDAY (29 July)							
09:00	EMU	Business climate (M)	Jul	-	-	-	-0.29
09:00	EMU	Preliminary HICP (H)	Jul	%YoY	2.2	-	2.1
12:30	USA	Preliminary GDP (H)	2Q	%QoQ	-	-	3.8
13:45	USA	Chicago PMI (H)	Jul	-	-	-	96.0
14:00	USA	Final Michigan index (H)	Jul	-	55.0	-	53.6

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

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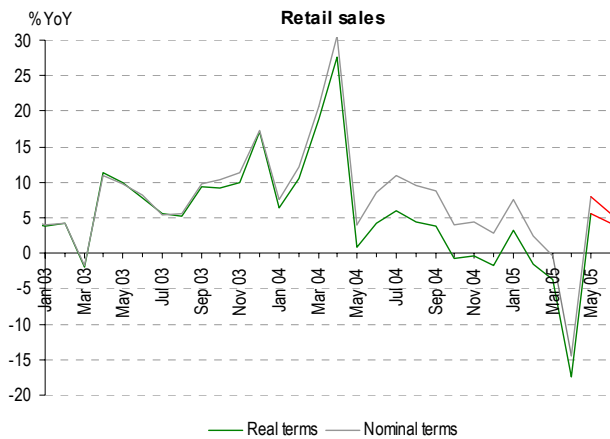
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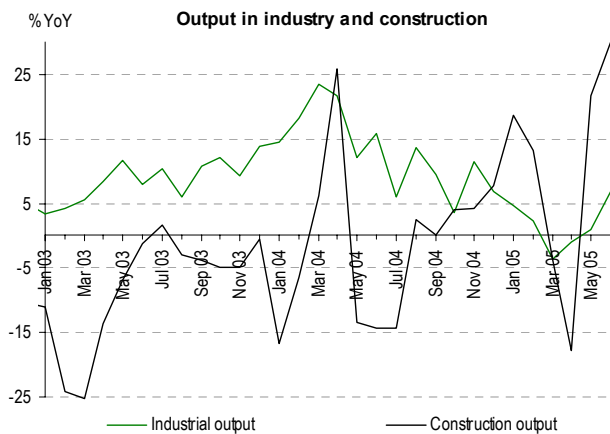
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What's hot this week – Another rate cut expected

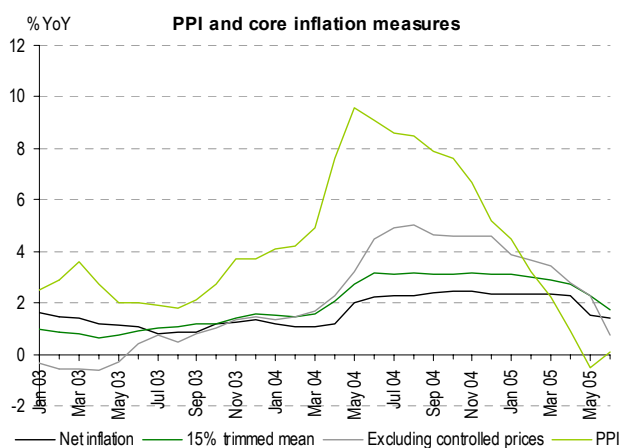


- The highlight of this week in the Polish financial market will be the MPC meeting with decision's announcement scheduled for Wednesday.
- Financial market prices in a rate cut of 25bp. Other decision would cause adequate adjustment in the interest rate market.
- Most of market analysts also expect 25bp drop in official rates (according to PAP poll, such decision is predicted by 10 out of 16 surveyed banks, including us). 4 analysts expect 50bp reduction and 2 economists believe rates will be kept on hold.
- Before the MPC decision we will see retail sales and unemployment figures. In our opinion the data will confirm the Polish economy is on the right track to faster growth.
- Besides, the week will be busy in terms of data abroad.

Economy last week – Upbeat output figures



- Industrial output growth in June was 8.8%MoM and 6.8%YoY, i.e. slightly below our forecast, but much stronger than market expectations.
- Acceleration in industrial output growth resulted mainly from an improvement in manufacturing, which bodes well for persistence of the overall revival in industry.
- There was surge in construction output (29.9%YoY jump). Even though a part of that stemmed from low base and – similar to industry – from higher number of working days, the data strongly supported expectations of revival in economic growth in the remainder of the year (this was also supported by continuously, moderately optimistic results o business climate survey for July).
- All in all, output figures brought about a reduction in expected scale of rate cut at the nearest MPC meeting.



- Better-than-expected output figures for June have not changed the inflation outlook perceived by MPC members (see *Quote of the week* section).
- Data on core inflation and producer prices indicated that inflationary pressures in the nearest time will remain well-contained.
- The exception are fuel prices, which caused a rebound in PPI inflation to 0.1%YoY, while a slight decline or no change in producer prices was expected.
- Net inflation in June amounted to 1.4%YoY, down from 1.5%YoY in May, which shows that demand pressure on prices in the Polish economy is subdued. One should notice, however, that a scale of core inflation drop was much smaller than that of CPI fall, which means that reduction in headline inflation rate is mainly a result of reversal in trend of food prices.

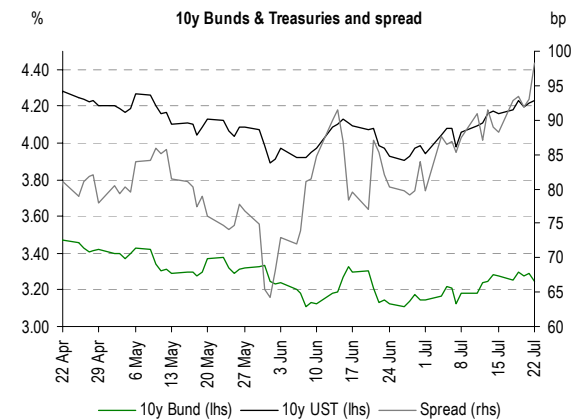
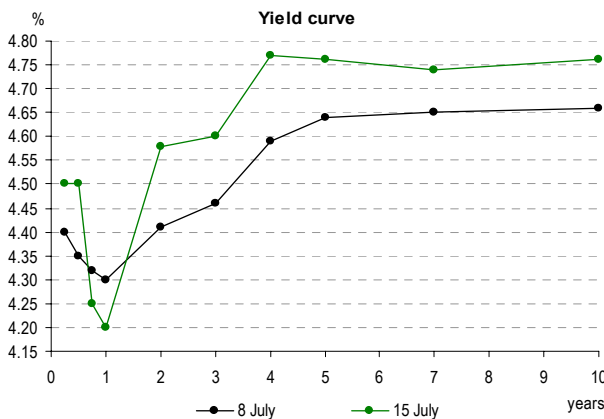
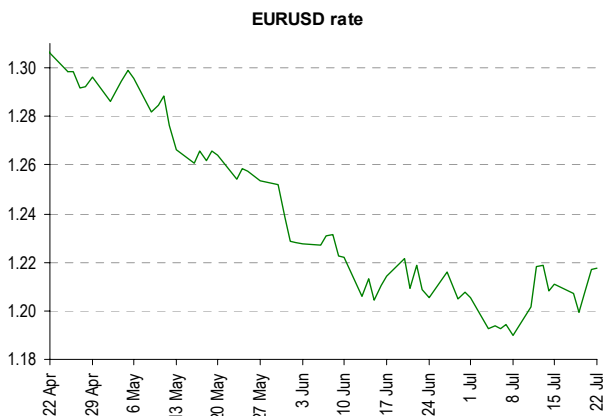
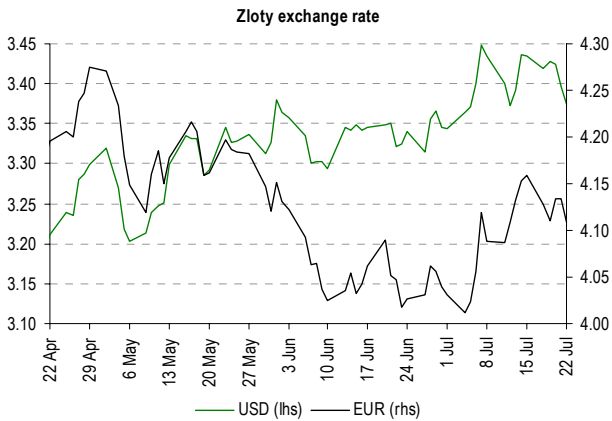
Quote of the week – No threats to inflation

Andrzej Sławiński, MPC member; PAP, 21 July

Easing bias in monetary policy adequately reflects economic situation and inflation outlook. (...) There are no direct threats to inflation. If they appear, it will happen rather in a distant future. (...) If a pilot made decisions on a basis of only one indicator [output figures] out of all he has in a cockpit, he would probably not carry out right manoeuvres.

Comments from Prof. Sławiński show that in his opinion there is still no certainty as regards return of economic growth to its potential level in a foreseeable time while inflation outlook remains upbeat. The tone of comments from a few other MPC members was similar, which suggests that there are still many advocates of further rate cuts in the Council. However, some improvement in economy's results will decrease rate-setters' penchant for aggressive moves.

Market monitor



Everything hinges on the Council

- Through the initial part of the next week the zloty was weakening under influence of sell-off in the bond market after production data and renewed fall of the euro to 1.2 level. The second part of the week saw an upward tendency of the Polish currency, as real data improved an outlook for the economy and due to a rise of the euro abroad following Greenspan's testimony. Yuan revaluation only to the limited extent affected the Polish market.
- Till Wed the domestic market will be affected mainly by EURUSD rate movements. Later however MPC decision will "take on the baton". It seems that the decision on keeping rates on hold would be greater surprise for the market than deeper cut what could result in advancement of the zloty. We forecast the zloty to trade in the range of 4.08-4.18 to the euro and 3.34-3.44 to the dollar.

Waiting for make-up of the basket

- Till Greenspan's testimony to Congress EURUSD rate was affected by negative mood from previous week. As his comments and Thursday's FOMC report from the last meeting did not provide any additional impulse for the dollar, the euro gained to 1.22. Yuan revaluation due to the lack of detailed information brought about a substantial volatility in the market that ultimately caused the dollar to advance to 1,205.
- In fact only Friday's data on 2Q05 GDP data in US may meaningfully alter EURUSD performance, but one cannot rule out that some new information about make-up of the basket of reference currencies for the yuan comes up. In case of further improvement of IFO index the euro may gain in the short term.

The market prices in 25 bp

- Last week yields on the Polish curve rose significantly mainly due to high production data, that allayed expectation for rate cuts. In spite of initial caution yet investors reverted to buying of papers after 5y bond tender. Gains in prices were however limited by weaker performance in the core markets. During a week yields on the curve above 1y rose by 10-18 bp.
- Likewise FX market, at the outset of that week the bond market should stay calm, as the Polish papers discount reduction by 25 bp. A decision different from market consensus may result in volatility in the market, which may exert a substantial influence on the course of switching auction. As usual the market will be vulnerable to bond fluctuations in the core markets.

Markets eye US GDP data

- Initially foreign papers were weakening owing to comments from Alan Greenspan on further interest rate hikes, but next attack in London and later w Egypt boosted demand for safe papers (Bunds reached 3.22%, and US Treasuries 4.22%) The spread between the foregoing markets reached 100 bp in 10y sector. In turn 5/5y spread between the Polish and euro curve increased to almost 70 bp owing to a fall in prices in Poland.
- The German bonds will probably await IFO index release regarding which there are upbeat predictions. In turn US papers market will await 2Q05 preliminary US GDP data slated for Friday. Owing to the lack of other important data the market is unlikely to show elevated volatility.

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