Bank Zachodni WBK

Weekly economic update

3 October – 9 October 2005

The turmoil around talks between potential coalition partners PiS and PO will probably ease this week, after efforts to start negotiations in front of TV cameras had completely failed last week. It seems that continuation of fight would not help in public support for candidates of both caucuses applying for president's chair, and thus we foresee some moderation of the conflict. We maintain our view presented last week that the process of government formation and agreement on programme of the new coalition would probably last for at least few weeks, so before the conclusion of presidential election we will get to know little new about the government and its policy. Financial market should survive this period in tranquillity, similarly like in recent days, being aware that lack of cooperation between PO and PiS is a matter of ongoing presidential campaign. This week there will be also no publications of domestic economic data, and thus Polish financial market will mostly follow trends observed abroad. Meanwhile, there will be a number of data releases on the core international markets. The most important will be labour market report in the US. After optimistic data about the number of new jobless claims released last week it seems likely that this report will beat expectations, being supportive for the dollar.

In line with our expectations, the Monetary Policy Council left interest rates unchanged and maintained easing bias in monetary policy. We still believe that official rates could be reduced by 50 bps in the course of next six months with the next decision (25 bps) in November. The *Monetary policy guidelines for 2006* just released by the MPC showed that since 2006 the Council abandons using bias in monetary policy as a tool for communication with the financial market. Inflation target, means of its realisation and other instruments of monetary policy remained unchanged.

Economic calendar

Time GMT	COUNTRY	INDICATOR (importance level*)	PERIOD		FORECAST		LAST VALUE
					MARKET	BZWBK	
		MONDAY (3 October)					
09:00	**POL**	**Auction of T-bills 52-week of PLN400m and 13-week of PLN100m (M)**					
08:00	EMU	PMI manufacturing	Sep	pts.	-	-	50.4
14:00	US	ISM manufacturing	Sep	pts.	52.0	-	53.6
		TUESDAY (4 October)					
09:00	EMU	PPI	Aug	%YoY	-	-	4.0
14:00	US	Factory orders	Aug	%	0.6	-	-1.9
		WEDNESDAY (5 October)					
09:00	**POL**	**Auction of 2-year bonds (H)**					
08:00	EMU	PMI non-manufacturing	Sep	%	-	-	53.3
09:00	EMU	Retail sales	Aug	%	-	-	0.0
14:00	US	ISM non-manufacturing	Sep	pts.	59.5	-	65.0
		THURSDAY (6 October)					
11:00	UK	BoE meeting – decision	-	%	-	-	4.5
11:45	EMU	ECB meeting – decision	-	%	2.0	-	2.0
		FRIDAY (7 October)					
12:30	US	Non-farm payrolls	Sep	'000	-125.0	-	169.0
14:00	US	Wholesale inventories	Sep	%	0.3	-	-0.1

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

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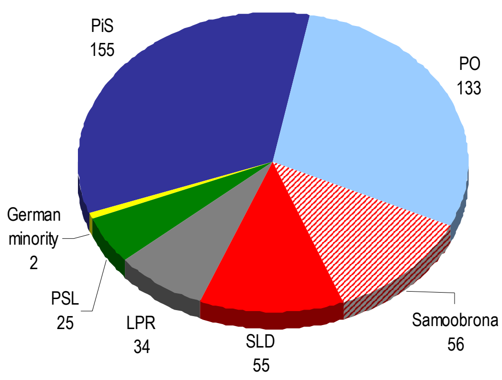
What's hot this week – PiS-PO government only after few weeks

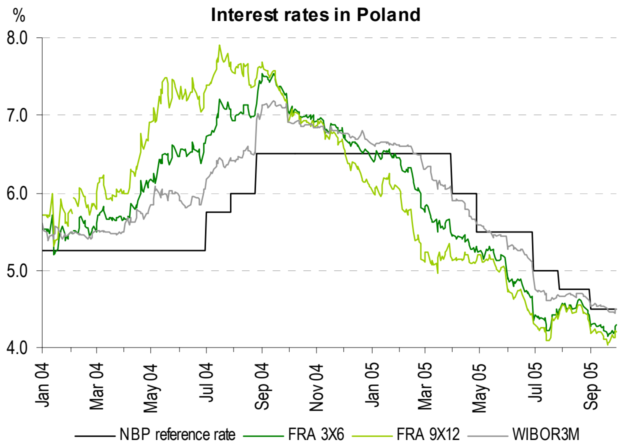
Distribution of seats in the Sejm after election



- This week there will be no important data releases in Poland, while talks between PiS and PO about future coalition are likely to settle down for a while (as further conflict could be harmful for both parties' presidential candidates). Domestic events will therefore have limited impact on the financial market in Poland.
- A number of economic data will be released abroad. In the US and the euro zone there will be i.e. indices of economic activity in manufacturing and services sectors, showing hints on the pace of economic growth in those economies at the start of 4Q05.
- For the FX market, key will be the report from the US labour market – after optimistic data about initial jobless claims, it is likely that non-farm payroll number will fall above market forecasts, supporting the dollar.
- The EBC is unlikely to change interest rates this week.

Economy last week – Interest rates unchanged this time

Interest rates in Poland



- In line with expectations, the MPC maintained reference rate at 4.5% and easing bias in monetary policy.
- Easing bias means that the MPC still sees probability of inflation falling below the target (2.5%) substantially higher than a likelihood that it will be above the target, and thus implying higher chances that the next interest rate move will be a cut than a hike.
- We do not change our view that interest rates could be reduced by 50 bps in the course of the next 6 months. The next decision is possible already in November if GDP data for 3Q05 show slightly lower rise in consumption and investment than predicted by the MPC.
- In our opinion, the MPC communiqué gave very limited (if any) indications as regards future monetary policy decisions and we perceive statement as a deterioration in communication with the market.

Crucial fragments of *Monetary policy guidelines for 2006*

The MPC will be thoroughly analyse situation for the risk of appearance of second round effects resulting from both up-to-date and possible future hikes in oil prices. If probability of those effects is high, the Council will make immediate moves counteracting rise in inflation expectations. One should notice that a risk of appearance of second-round effects could be contained by still high level of unemployment and its slow decline.

In particular, such factors like rise in labour market elasticity, companies' restructuring and international competition could act towards weakening of inflationary pressure.

MPC will also take into account development in balance of risks having impact on probabilities of future inflation being above or below the target. The Council will also take into account deviations of actual inflation from previously forecasted. Such deviations imply that future events in the economy could be different from earlier predicted.

- Monetary policy guidelines for 2006 showed that since new year the MPC abandons using policy bias as a tool for communication with the financial market. Communication will be realised by the use of inflation reports, official statements and press conferences (and the MPC promised to improve their clarity and quality).
- Inflation target, means of its realisation and other instruments of monetary policy remained unchanged.
- Lots of attention has been devoted to a reaction of monetary policy to high oil prices and their potential effects. However, the MPC admitted that still difficult situation on the labour market makes risk of second-round effect quite low.
- The MPC still believes that Poland should join the euro zone as fast as possible.

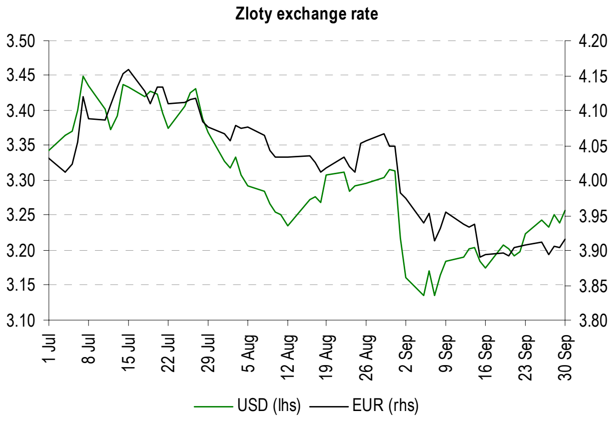
Quote of the week – Second-round effects could have been dangerous… if they appeared

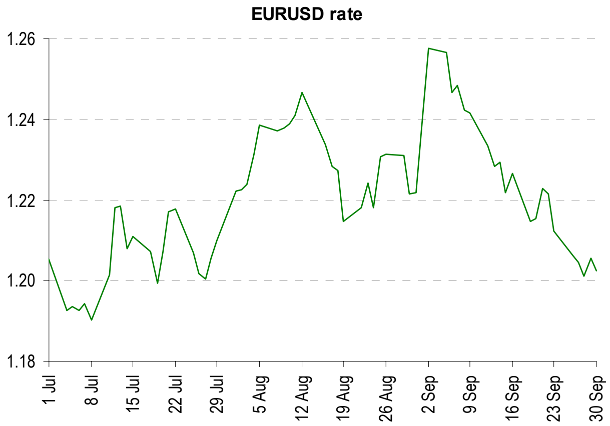
Andrzej Wojtyna, MPC member; PAP, Reuters 28 Sep

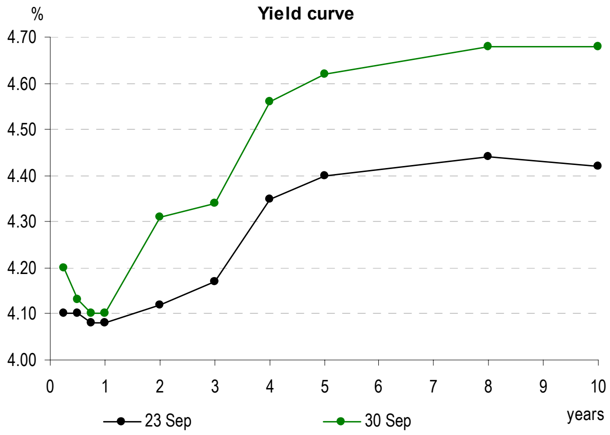
Signals that there could be second-round effects are crucial for us... Higher oil prices could translate into rising inflation expectations, and it could be followed by higher wages and wage negotiations. In such a case the council, just like last year when it raised interest rates three times, will be prepared for appropriate action.

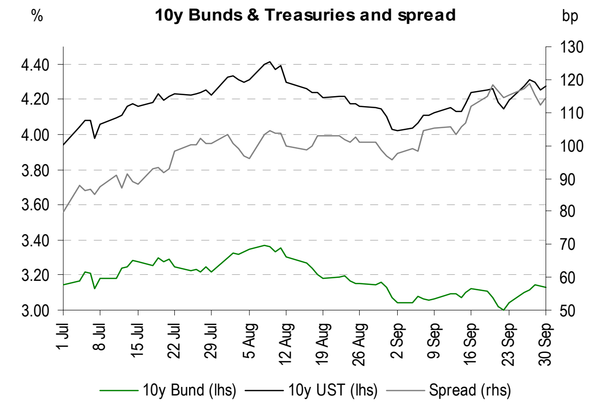
Wojtyna mentioned rate cuts as a theoretical possibility. It is not a situation expected by the MPC though. It is obvious that if second round effects appear, tightening of monetary policy would be necessary. But MPC's last statement and August inflation report showed that this was not very likely, amid low wages growth, high productivity growth, microeconomic changes in enterprises, which together with high international competition limits the impact of high oil prices on inflation.

Market monitor









The zloty calmly welcomed the election result

▪ Surprising election's results brought about weakening of the zloty on Monday (stronger to the dollar as it gained versus the euro), but it was transitory. Yet at the same day, the zloty offset some of the losses. In the further part of the week the zloty was stable despite persisting political uncertainty, as it was supported by FinMin's hint that it would sell a part of receipts from an offer of dollar-denominated bonds. Only on Friday, the zloty started to weaken moderately – possibly due to political situation.

▪ Political uncertainty is set to negatively affect the zloty in the nearest time. On the other hand, the domestic currency will be supported by announced FinMin's transactions on the market. All in all, we predict, the zloty rate will be traded at 3.88-3.98 versus euro and 3.22-3.32 to the dollar.

Dollar in good shape thanks to strong data

▪ At the very beginning of last week, the dollar strengthened versus the euro when it turned out that hurricane Rita was weaker than expected. The dollar tried to break 1.20 and succeeded a few times, mainly thanks to better than expected data on durable goods.

▪ Although a few indicators during the week were weaker than predicted, but Chicago PMI that, released as the last one in the week, was much better than forecasted and supported the greenback, being a good indication for ISM surveys due for publication in the nearest week. After better than expected data on initial jobless claims, the dollar is also supported by relatively good expectations regarding non-farm payrolls numbers to be published on Friday.

Unclear signals from the MPC weakened debt market

▪ Last week brought two waves of weakening on the debt market. The first one took place due to PiS win in the election which triggered concerns about reforms. The second, bigger wave of sell-off was caused by hawkish statement of the MPC and comments from press conference after the Council's meeting. Some role was also played by deterioration of moods in Hungary which somewhat discouraged investors towards the whole region, particularly given political jitters in Poland.

▪ After publication of hawkish statement and comments from prof. Wojtyna, later comments from other MPC members renewed market's faith in further rate cuts and strengthened the interest rate market. This week, with no data in Poland scheduled and stalled coalition talks, much will depend on situation on the core markets.

Yields abroad go up

▪ Last week on the core debt markets saw rise in yields. It was stronger in the euro zone than in the US, as Ifo index was much stronger and expected and ECB data showed money supply expanded at faster pace than predicted. US Treasuries lost on much stronger than forecasted data on initial jobless claims and good economic activity indicators.

▪ This week, there will a be a plenty of important macroeconomic data abroad, both in the euro zone and in the US. Besides, an ECB meeting on rate is scheduled, but it should bring no change in rates. Meanwhile, the BoE may cut rates again, which would be crucial for the sterling. Expectations among economists as regarding outcome of the BoE meeting are split.

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