Bank Zachodni WBK

Weekly economic update

23 - 29 January 2006

The situation on the Polish political scene is still very dynamic. While in the beginning it turned out that President Lech Kaczyński may dissolve the parliament as early as in the first days of February if the budget is not accepted, then there appeared a chance that early election will not take place in spring. PiS leader proposed a "stabilisation plan" for 6 months, which assumed that opposition parties will support 11 most important bills and not try to dismiss ministers by vote of non-confidence, and after this period the government coalition could be formed. Three parties (LPR, PSL, Samoobrona) preliminarily supported the proposal, but they would like to add a few bills to the plan which would increase social spending and lower independence of the central bank. In the meantime, there is still (very?) small chance of creating PO-PiS coalition. Well, political uncertainty will continue for some time (vote on budget 2006 on Tuesday) and may be important factor influencing markets. However, expectations as regards Monetary Policy Council's decision will be vital for the financial market. Economic data published last week showed that acceleration of economic growth is continued, but with no threat for inflation target in the medium-term, especially as inflation data were below expectations again (and much below the tolerance band around the target). Risk factors for inflation include political uncertainty, which may lead to sharp zloty depreciation in the extreme scenario, as well as recently observed rise in oil prices. These two arguments may be important for some members of the Monetary Policy Council, but we think that arguments in favour of low inflation should prevail and we expect rate cut of 25 bp at the end of this month. Additional problem with forecasting MPC decision is connected with the date of publication of the new Inflation Report (only after decision, though the Council will discuss it next week), as the new inflation projection will be important benchmark for the Council's point of view.

Economic calendar

TIME GMT	REGION	INDICATOR (importance level*)	PERIOD		FORECAST		LAST VALUE
					MARKET	BZWBK	
		MONDAY (23 January)					
15:00	**POL**	**Business climate (M)**	**Jan**	**pts**			
		TUESDAY (24 January)					
15:00	**POL**	**Unemployment (M)**	**Dec**	**%YoY**	**17.6**	**17.6**	**17.3**
15:00	**POL**	**Retail sales (H)**	**Dec**	**%YoY**	**8.6**	**8.1**	**7.3**
15:00	**POL**	**Net inflation (H)**	**Dec**	**%YoY**	**1.1**	**1.1**	**1.1**
	POL	**MPC meeting (M)**	**Dec**				
9:00	EMU	Current account (M)	Nov	EUR bn	-	-	-
		WEDNESDAY (25 January)					
9:00	GER	Ifo index (H)	Jan	pts	99.8	-	99.6
15:00	USA	Home sales (M)	Dec	m	6.9	-	-
		THURSDAY (26 January)					
13:30	USA	Durable goods orders (H)	Dec	%	1.0	-	4.4
		FRIDAY (27 January)					
9:00	EMU	Money supply M3 (H)	.Dec	%	7.5	-	7.6
13:30	USA	GDP advance (H)	Q4	%	3.1	-	4.1
15:00	USA	New homes (M)	Dec	m	1.24	-	-

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

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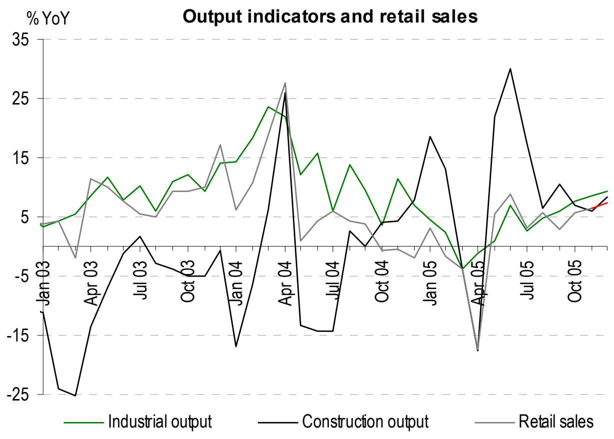
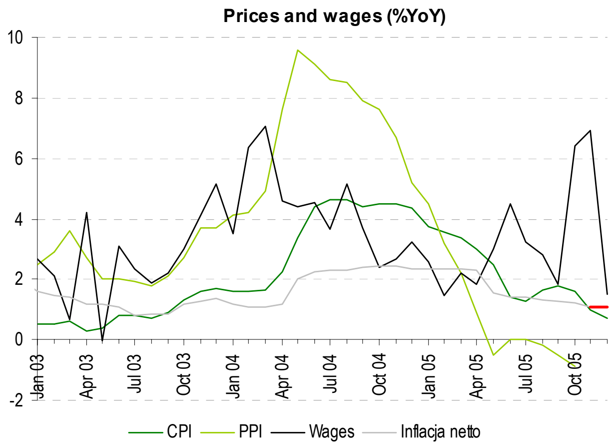
What's hot this week – Still the same: fast growth, low inflation



▪ Next week we will see another portion of data on economic activity – retail sales for December and business climate for January.

▪ They should not change the economic picture considerably given that data on production in industry (growth of 9.2%YoY) and construction (8.3%YoY) confirmed higher rate of GDP growth in Q4. Seasonally adjusted data were even stronger – growth in industry 13.3%YoY, which was the highest annual growth rate since mid-2004, when economic activity was additionally boosted by EU accession.

▪ According to our estimates, GDP growth in the final quarter of 2005 was at 4.5% or even higher, but this will depend on retail sales data, which we expect to rise by 8.1%YoY (market consensus slightly higher). GDP growth for 2005 as a whole should amount to some 3.5%.



▪ Similarly as in previous months, better data on economic growth were accompanied by no inflation pressure – data on CPI and PPI well below expectations, and wage growth sharply decelerated.

▪ On Tuesday, the NBP will publish core inflation data for December. Although CPI inflation was lowered mainly by the same factors as in previous months (food and fuel prices), price changes in other categories of goods and services do not point to any sings of inflationary pressure.

▪ According to our estimates, net inflation (CPI excluding food and fuel prices) remained in December at 1.1%YoY and it is likely to stay below 1.5% i.e. below the lower end of allowed fluctuation band around the inflation target until the end of this year.

▪ Other measures of core inflation will probably also maintain at very low levels.

Economy last week – Poland will not lower excessive deficit

Selected assumptions of *Convergence programme*

	2005	2006	2007	2008
General government balance* (% GDP)				
January 2006 version	-2.9	-2.6	-2.2	-1.9
November 2004 version	-3.9	-3.2	-2.2	-
GDP growth (% YoY)				
January 2006 version	3.3	4.3	4.6	5.0
November 2004 version	5.0	4.8	5.6	-
Average inflation (% YoY)				
January 2006 version	2.2	1.5	2.2	2.5
November 2004 version	3.0	2.7	2.5	-

* OFE included in public finance sector

▪ The new Convergence Programme does not include news which could be warmly welcomed by the European Commission, rating agencies and the financial market.

▪ The government continues quite risky game with the European Commission, as it said Poland will not reduce excessive fiscal deficit until 2007, if the EU institutions will not change their stance on classification of Polish open pension funds.

▪ Additionally, deficit level of 2.2% of GDP in 2007 (which implies above 3% if pension funds are taken into account) was maintained despite lowering forecasts of economic growth (from 5.6% to 4.6%), which may raise doubts as regards consistency of the programme. What is interesting, the Ministry of Finance assumed stable official interest rates at 4.5% until 2008.

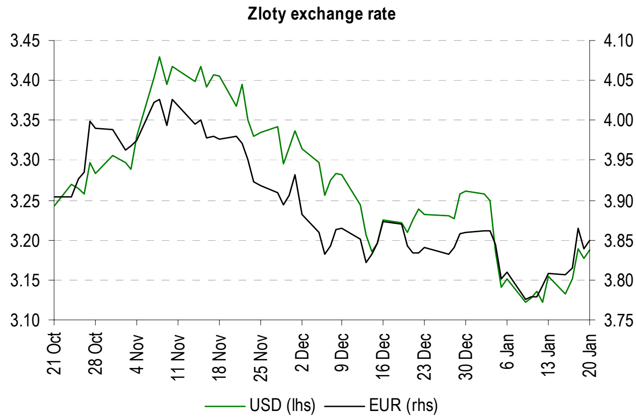
Quote of the week – Will political situation make rate cut impossible?

Andrzej Wojtyna, MPC member; PAP, 19 January

From purely macroeconomic point of view I would be willing to agree that some possibility of monetary policy easing exist, and surely it is worth to discuss it and to find the best solution. However, we have the situation as in the period of still favourable macroeconomic conditions from the point of view of possible rate cut, we wee a significant rise in political risk. Such event like a perspective of early election should be taken in to account by the Council.

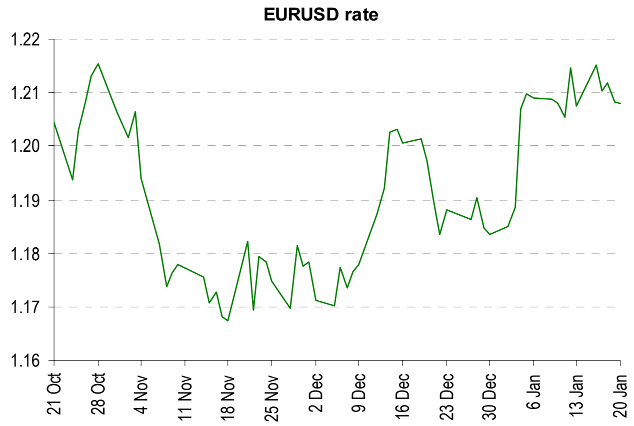
Indeed, political risk creates a problem for the MPC. However, in our opinion, even if the zloty depreciates sharply (let's say to 4 against euro) as a result of political situation, this would not create a considerable threat for the inflation target, which is very distant at the moment, as economic factors (mentioned by Wojtyna) make inflation outlook favourable and justify interest rate cut by 25 bp.

Market monitor



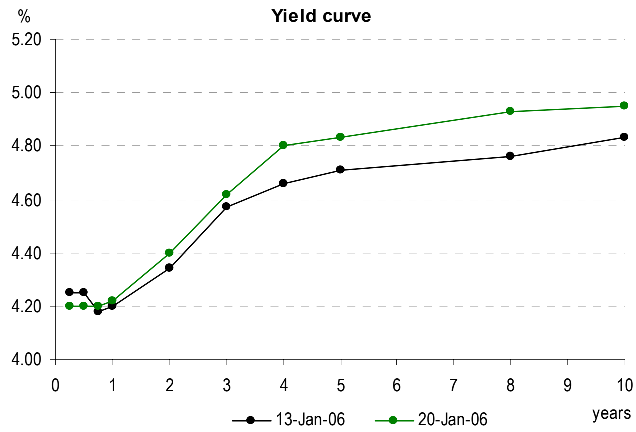
Zloty weakened by politics

- Zloty weakened in the past week from record high levels despite positive macroeconomic data as FX market was negatively influenced by political situation, perspective of early elections, possible entering of populist parties into government coalition, suggestions of introducing changes to Polish central bank NBP bill. EURPLN and USDPLN rates rose by ca. 1%.
- The situation on the political stage may gradually stabilise, however we believe Polish currency will not return to appreciation trend soon as scenario of support for government in exchange for costly bills may affect the market. We forecast that the EURPLN rate will stay at the earlier given range 3.79-3.89. with resistance level at 3.83-3.84, while we expect range of 3.13-3.23 for USDPLN.



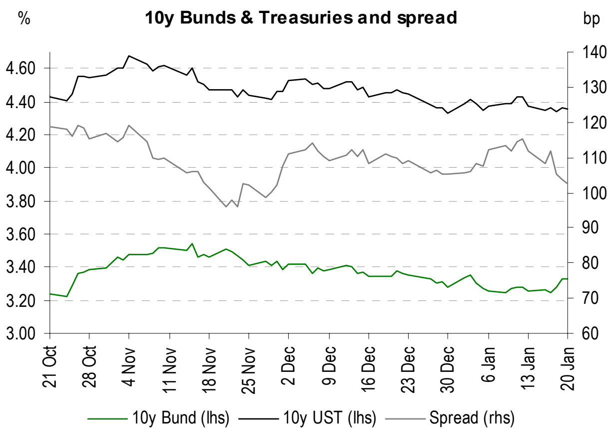
Dollar slightly stronger

- EURUSD rate fluctuated heavily within last week and the dollar strengthened against the single currency by ca. 0.7% as compared to Monday's opening. At the beginning of the week the greenback gained versus the euro amid lower liquidity in market holiday in U.S. Positive industrial production data. net capital flows and labour market situation, as well as Fed comments strengthened the U.S. currency. Low CPI and Philadelphia Fed index brought some corrections.
- In the incoming week Ifo index may confirm acceleration in the largest economy of EU. Money supply M3 figure will be essential due to the weight put to this figure by ECB. Quite important will be durable goods orders and home sales data. which may support the view of a slowdown on the market.



Expectations on rate cut vs. politics

- Longer end of the Polish Treasury bond yield curve rose in the past week by 5-17 bps in comparison to previous Friday closing. Initially good consumer prices inflation as well as wages data supported debt market. however rising probability of early elections as well as high supply of bonds at tender effected in a correction. Auction results appeared to be very positive. Thus yields fell as well as after low PPI figure, which showed lower inflation pressure.
- Next week one of the last macroeconomic data are going to be released before MPC meeting, which in our opinion will not significantly affect the decision of the Council. Polish debt may be still under pressure of uncertain political situation, although speculation on interest rate cut should prevail and yields should stay on relatively strong levels.



Bunds weaken and spread drops

- Yields of 10Y Treasuries were slightly lower at 4.35%. and Bunds weakened from 3.25% to 3.32%, which was mainly an effect of hawkish ECB comments on vigilant monitoring of inflation and too low rates in the euro zone. Strong industrial production, Fed members statements and labour market data contributed to low level of U.S. bond prices and temporary yield drop resulted after low CPI. High oil prices also added to core bond markets volatility.
- Amid comments of ECB members weakening of German government bonds may result after stronger money supply (M3) in the euro zone as well as Ifo index. In the U.S. the most important will be GDP Q4 advance figure as well as situation on home sales market and durable goods orders. U.S. yields may rise before Fed meeting.

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