Bank Zachodni WBK

Weekly economic update

3 – 9 April 2006

Last week passed under the sign of monetary policy decisions. While fifteenth consecutive rate hike in the US, even though expected, managed to shake sentiment towards emerging markets quite seriously, equally anticipated Polish Monetary Policy Council's decision to keep rates on hold met with hardly any market reaction. However, both decision and its justification, as well as later comments of MPC's members confirmed our opinion that Polish interest rates are bound to stay unchanged for the rest of the year.

The first week of a new month will be as usually a period of no major data releases in Poland. However, on Tuesday, the Sejm session starts with a debate on self-dissolution in the agenda. Vote over the motion seem to be determined, as most of parties oppose the idea of premature election. In such situation market participants will wonder what will be further developments on the Polish political scene. Possibility of PiS coalition with populists may somewhat worsen investors' moods. However, stronger influence on the domestic market should be expected from tendencies on global markets. From this point of view, the nearest week will bring many important news. A number of activity indices for the euro zone and US will be released this week, while on Friday key data on non-farm payrolls in the US are due. The figures could hint on further possible moves by Fed and ECB. The nearest ECB meeting on Thursday should not bring another interest rate hike.

Economic calendar

TIME GMT	REGION	INDICATOR (importance level*)	PERIOD		FORECAST MAREKT	FORECAST BZWBK	LAST VALUE
		MONDAY (3 April)					
9:00	**POL**	**Auction of PLN0.7bn of 26-week and PLN1.0bn of 52-weekT-bills (M)**					
8:00	EMU	Manufacturing PMI (H)	Mar	pts	55.0	-	54.5
14:00	USA	Manufacturing ISM (H)	Mar	pts	57.9	-	56.7
		TUESDAY (4 April)					
	POL	**Start of four-day parliamentary meetings**					
9:00	EMU	PPI (M)	Feb	%YoY	5.4	-	5.3
9:00	EMU	Unemployment (M)	Feb	%	8.3	-	8.3
		WEDNESDAY (5 April)					
9:00	**POL**	**Auction of EUR3.6bn of 2Y OK0408 bonds (H)**					
8:00	EMU	Non-manufacturing PMI (H)	Mar	pts	58.3	-	58.2
9:00	EMU	Retail sales (H)	Jan	%YoY	1.2	-	0.9
14:00	USA	Non-manufacturing ISM (H)	Mar	pts	59.0	-	60.1
		THURSDAY (6 April)					
10:00	GB	BoE meeting – decision (M)	Apr	%	4.5	-	4.5
11:45	EMU	ECB meeting – decision (H)	Apr	%	2.5	-	2.5
		FRIDAY (7 April)					
12:30	USA	Non-farm payrolls (H)	Mar	'000	190.0	-	243.0
12:30	USA	Unemployment (H)	Mar	%	4.8	-	4.8
14:00	USA	Wholesale inventories (H)	Feb	%	0.5	-	0.1

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

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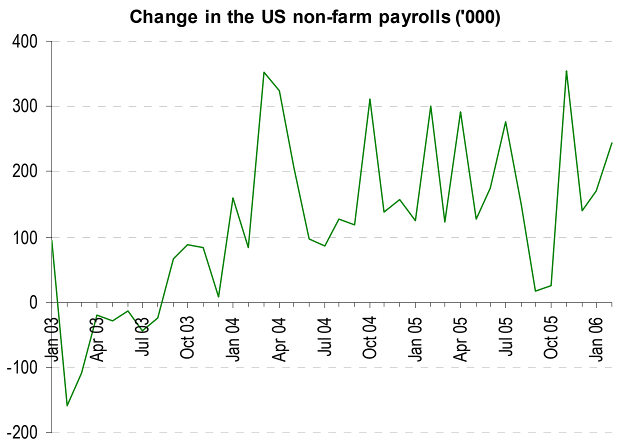
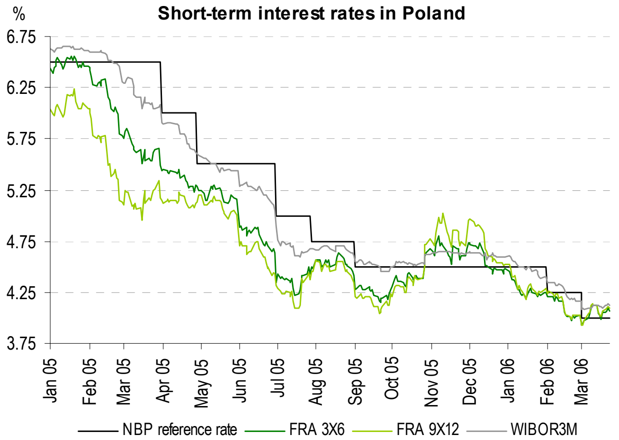
What's hot this week – Is stabilisation in domestic politics possible, what about rates abroad?



- Start of the month, as usual, will be a period of no data releases in Poland. However, investors will not suffer from monotony thanks to political events.
- On Tuesday the Sejm session starts with a debate on self-dissolution motion by PiS and possibly a change in electoral law. Snap election in May still seem unlikely, as PO does not plan to back the motion. In such situation, a key question is what next – will PiS go for a coalition with Samoobrona and PSL or LPR? Will Samoobrona leader become a deputy PM? Will it have impact on government's policy? Or perhaps on the change of finance minister? All those issues could have potentially negative impact on the Polish financial market.
- There will be a number of activity indices released in the US and euro zone, and on Friday key data on US non-farm payrolls that could hint on future moves by Fed and ECB.

Economy last week – Interest rates unchanged, tax rates as well



- Monetary Policy Council left main interest rates unchanged in March, in line with expectations, which had no impact on the financial market.
- Decision has been justified by a rise in domestic demand and unit labour costs that could gradually push inflation towards inflation target in the medium run, even though in the nearest quarters CPI will remain very low.
- Although official statements of the MPC have often been biased towards hawkish view, most recent comments from doves and moderate central bankers suggest that this month's communiqué quite properly reflects state of minds on the rate-setting panel. This was confirmed by Reuters' interview with Jan Czekaj on Thursday (see below).
- We stick to our opinion that interest rates will remain unchanged until the end of this year.

Planned measures aimed at reduction of tax wedge
A cut in mandatory disability pension contributions to 9% from 13% and reduction in health insurance contribution to 1.8% from the current 2.45%; these changes are due to come into force on Jan 1, 2007.
A promise to cut PIT rates to 18 and 32% from 2009 on. The ministry also promises to adjust for inflation tax brackets (possibly already in 2006) frozen by previous administrations in 2002 and a gradual phasing in of tax breaks for families with children.
Several measures simplifying VAT regulations and more favourable rules on amortisation.
…and ways of financing these changes
PLN3.6bn thanks to a rise in excise tax on heating oil to bring it level with diesel, a return to a level of excise tax on fuel before reduction in September 2005, adjustment in excise taxes on other products in line with EU guidelines.
PLN1.5bn rise in revenues due to changes in business taxation.
PLN4.1bn brought by the phasing out of a tax break on housing construction and repairs, and better VAT collection.

- The planned tax reform may bring some positive effect on the labour market, but relatively modest scale of reduction in tax wedge and the fact that it is going to be financed mainly by an increase in other taxes (indirect taxes also form a total tax wedge, as indirect taxes are also between total labour cost paid by employers and effective consumption of employees) does not give much hope for acceleration in long-term GDP growth.
- We think Poland needs reduction in taxes' relation to GDP, while the planned reform will not allow for that.
- On the other hand, modest scale of the planned reform is comforting from a budget perspective. More ambitious reform on the revenue side of the budget could lead to increase in fiscal imbalance, given politicians' inability to constrain spending side. Having said this, there are still concerns about implementation of the reform in what may prove to be a hostile political environment.

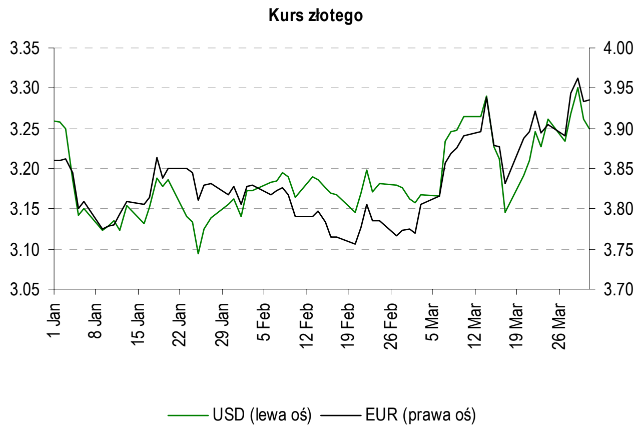
Quote of the week – No need to make any move

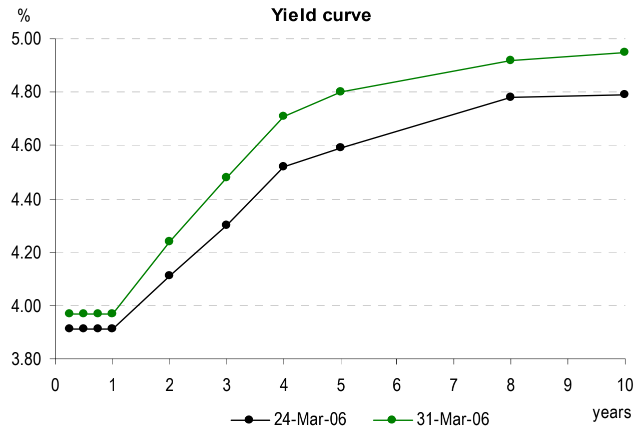
Jan Czekaj, MPC member; Reuters, 30 March

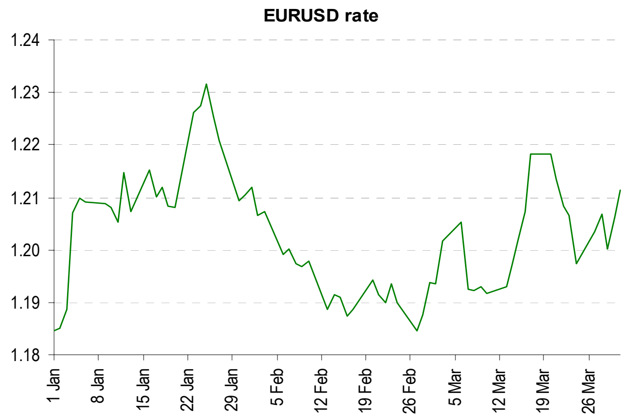
Real interest rates at around 2.5-3.0 percent could be considered appropriate for the Polish economy. We are in a good position. For now there is no need to make any move in any direction. (...) It's too early to talk about a depreciation trend. However, it must be remembered that the exchange rate affects inflation fast - faster than rates.

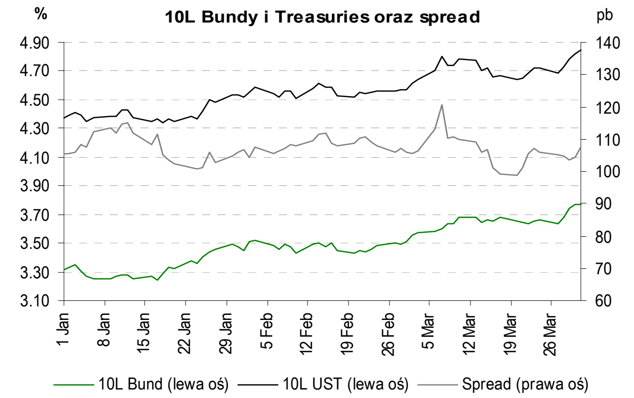
Czekaj's comments confirm our view that interest rates in Poland will remain unchanged in a foreseeable future, unless significant changes take place in picture of future economic situation and inflation prospects. We think April's inflation projection will not bring as significant improvement in future inflation path so that convince majority of rate-setters to lower borrowing costs again.

Market monitor









Further capital outflow from the region

- Zloty and other currencies in the region weakened in the past week mainly in reaction to more hawkish Fed's communiqué and the situation on the core bond markets, which was in line with our scenario from the last report. The weakening on the U.S. market and the euro zone contributed to a further outflow of capital from the emerging markets with investors seeking higher yields with lower risk. Last week zloty lost ca. 1% against the euro and ca. 0.2% vs. the dollar.
- Amid rising yields of government bonds in U.S. the zloty weakening is an effect of structural flows change. Uncertain situation in politics may also weigh on the zloty rate this week. We expect that the EURPLN rate will fluctuate in range 3.9-4.0, while USDPLN should stay between 3.21 and 3.31.

Core bond markets weaken Polish market again

- After a slight strengthening at the beginning of the week Polish debt weakened in reaction to rise of yields of German Bunds and U.S. government bonds. In line with our expectations the decision to leave the interest rates unchanged as well as the communiqué of the MPC were quite neutral for the market. Since the previous Friday bond yields increased by ca. 13-21 bp, and the yield curve slightly steepened.
- Bonds yields may rise further with regards to assumed weakening on the core bond markets, which may cause capital outflow and zloty depreciation. In this situation and still negative impact of politics even the slightly better inflation projection might not be a sufficient for further rate cuts by the MPC. Demand for 2Y bonds will show the sentiment of investors towards Poland.

Dollar weakening

- Since last Friday the dollar weakened against the euro by ca. 0.3%. Initially U.S. currency slightly strengthened amid Fed meeting. The highest in last 15 years Ifo index, ECB's president statement and rumours on currency reserves diversification by some central banks caused euro appreciation. Fed's communiqué was quite hawkish and U.S. data was positive, which increased expectations for further rate hikes in U.S. and resulted in dollar slight recovery.
- In the coming week the euro may strengthen against the dollar. Activity indices may show further expansion of euro zone and U.S. economies. Moreover the key factor for the EURUSD rate will be the EBC's communiqué, which amid the recent comments of Trichet, may be hawkish. Non-farm payrolls will also have crucial influence on the dollar.

Ifo, Trichet and Fed contribute to yields rise

- U.S. Treasuries weakened at the beginning of the week before the Fed's meeting and after the FOMC's communiqué was released and expectations for further monetary policy tightening increased. Thus 10Y Treasuries yields increased from 4.69% to 4.83%. Ifo index and hawkish comments of Trichet contributed to Bunds weakening with 10Y yields up from 3.67% to 3.75%.
- We expect that the ECB will leave the main rates unchanged in the euro zone and in its communiqué the ECB may reassure the market that the next rate hike will come in May and may suggest further steps, while core bond yields may still rise. Activity indices may affect the foreign debt as well as well as the labour market data from the United States.

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