Bank Zachodni WBK

Weekly economic update

7 August – 13 August 2006

The beginning of August is under the sign of decisions of world's key central banks. Last Thursday the rate hike by 25 bp has been applied by the European Central Bank and – quite surprisingly – the Bank of England. Hawkish tone of the ECB statement and surprise from the BoE weakened European debt markets, however not for long, as the move has been erased after Friday's report from American labour market. This week all eyes will be on the Fed given that there is still some uncertainty surrounding the next move in US interest rates. Given the evidence of a slowing in economic activity and the recent rise in the unemployment rate we feel that, on balance, rates will remain on hold at 5.25%. It could have positive impact on investors' sentiment towards currencies in our region, although the scale of reaction should be moderate – the market has largely discounted the move last week, after the data from US supported hopes for no hike. On the other hand, it could prove to be a close call, with recent comments from Fed members suggesting that it could go either way. At the end of the week the Bank of Japan also meets but no change in interest rates is expected.

As regards domestic data releases, we will get to know only balance of payments results for June. We expect to see solid growth in exports and imports (20% YoY) and low current account deficit, which should be positive for the zloty.

Last week the media informed that the reform of Poland's public finances that was expected to bring fiscal savings of about PLN8-9bn in 2-3 years will be slowed down. The government maintains a pledge to keep budget deficit anchor at PLN30bn, however falling determination to curb spending and recurring calls of Samoobrona to push costly measures ahead of local election remain a source of uncertainty for the market.

Economic calendar

Time GMT	COUNTRY	INDICATOR (importance level*)	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (7 August)					
9:00	**POL**	**Auction of PLN1.0bn 52-week T-bills (M)**					
		TUESDAY (8 August)					
12:30	US	Labour productivity (H)	Q2	%	1.8	-	7.7
12:30	US	Unit labour costs (H)	Q2	%	3.5	-	1.6
18:15	US	Fed meeting – decision (H)	Aug	%		-	5.25
		WEDNESDAY (9 August)					
9:00	**POL**	**Auction of PLN1.5-3.0bn of 7Y FRN WZ0911 and PLN0-0.5bn of 12Y CPI linked bonds IZ0816 (M)**					
14:00	US	Wholesale inventories (H)	Jun	%	0.7	-	0.8
		THURSDAY (10 August)					
12:30	US	Trade balance (H)	Jun	bn $	-64.0	-	
18:00	US	Fed's budget (M)	Jul	bn $	-46.0	-	-53.37
		FRIDAY (11 August)					
12:00	**POL**	**Current account (M)**	**Jun**	**m €**	**-179**	**-200**	**-209**
12:00	**POL**	**Trade balance (M)**	**Jun**	**m €**	**-127**	**-100**	**-483**
6:00	JP	BoJ meeting – decision (M)	Aug	%			
12:30	US	Foreign trade prices (H)	Jul	%	0.9	-	0.1
12:30	US	Retail sales (H)	Jul	%	0.6	-	-0.1

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

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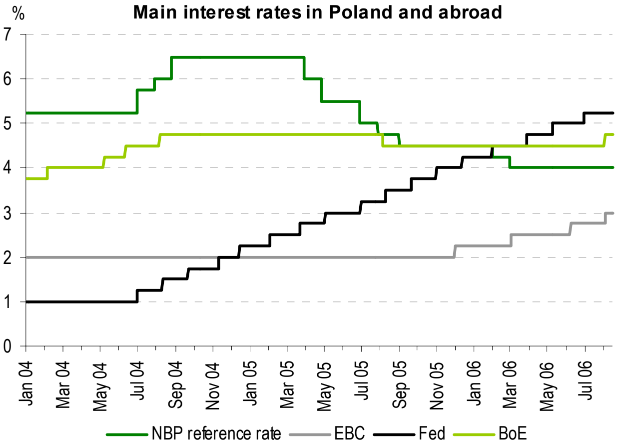
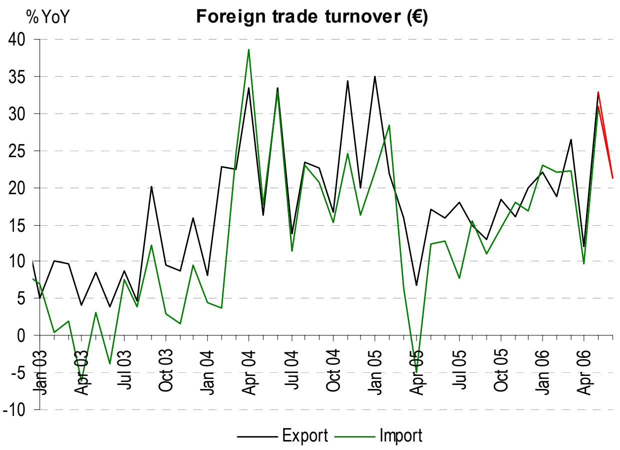
What's hot this week – Focus on the Fed

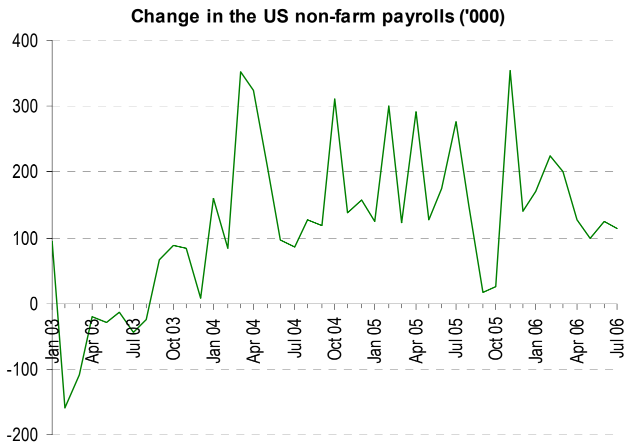


- All eyes will be on the Fed this week and its decision will be very important for changes in the sentiment on the emerging markets.
- If – according to our view – there will be a pause in rate interest hikes at 5.25%, one could hope for strengthening of currencies in our region, although in a limited scale. It seems that bond market has already priced-in such scenario.
- In turn, if US interest rates go up for the eighteenth time, to 5.50%, market's negative reaction could be quite strong, and global risk aversion would re-emerge. A potential moderating factor could be a possible suggestion from Fed that a risk of further rate hikes is rather limited.



- On Friday, the NBP will publish balance of payments data for June. We expect that both exports and imports maintain strong growth rates of above 20%, which is slightly above market median forecast (and slower than in May). Current account deficit should stay low at ca. €200m (our forecast is consistent with market consensus), which implies that cumulative 12-month gap will be maintained at very low level 1.5% of GDP.
- There are several data releases abroad during the week, that could affect Polish market amid lack of domestic events. US trade data for June could be negative for the dollar, with the deficit expected to widen modestly, which would underpin concerns about external imbalances. Meanwhile, retail sales on Friday will also be closely watched for the latest trends in terms of consumer spending.

Economy last week – European interest rates up



- In line with expectations, the European Central Bank has raised main interest rate to 3.0% on August 3rd. Tone of the press conference after the meeting was hawkish enough to convince the market that end of policy tightening will not take place soon. Bank of England took the market by surprise, lifting its main rate by 25 bp, which effected in weakening on European markets.
- Data from the American labour market were weaker than expected, showing 113,000 rise in non-farm payrolls and increase in unemployment rate to 4.8%. This implies significant slowdown in job creation in the US over the last few months. Thus, the data strengthened market's view that Fed may pause rate hikes at the nearest meeting. However, uncertainty surrounding the decision is still quite high.

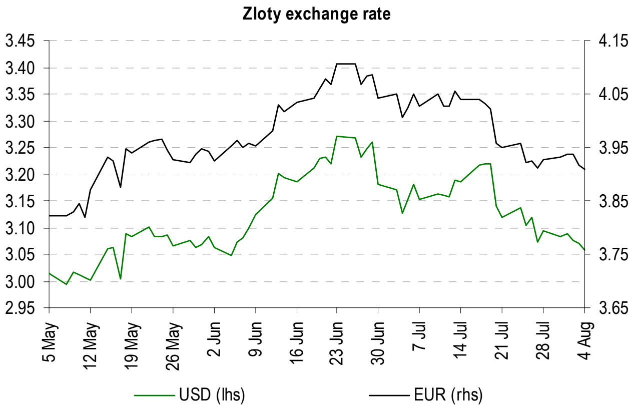
Quote of the week – Summer drought will not harm this year's inflation

Jacek Krzyślak, head of MinFin research; PAP, 1 August

Inflation in July 2006 reached 0.7-0.8%YoY (drop by 0.3-0.4%MoM). We believe that inflation fall in July was caused by frop in food prices by 2.1%. In our view the impact of summer drought should not weigh on inflation path this year, because intervention import from the EU is possible. Food prices are not a threat for inflation. There could be slight problem with fruits and vegetables but basing on CSO information, decline in harvest will be of several percent magnitude. In August, a drop in inflation to 0.6% is possible, and inflation should remain below 1% until October. At the end of year it should reach 1.5%.

Ministry of Finance's forecasts for the coming months are optimistic and consistent with our view. In the ministry's opinion the summer drought should have no large effect on this year's inflation path. Our forecasts suggest that CPI will fall to 0.6% in September-October (MinFin thinks this level is possible even in August), and then we predict a gradual rise to ca. 1.5% in December. This path is positive for the fixed income market, weakening fears of interest rate hike in Poland in the near time.

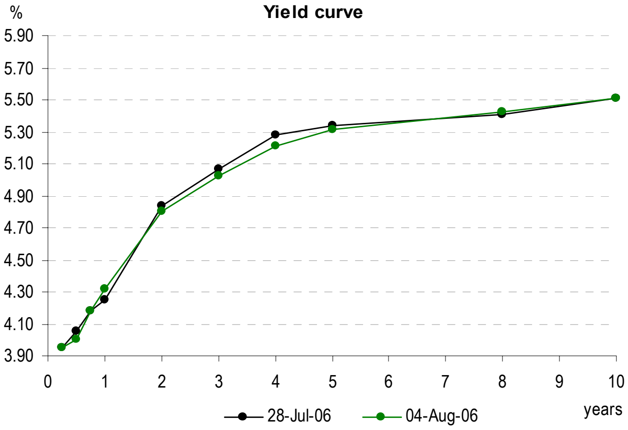
Market monitor



Zloty below 3.90 after US data

▪ In the last week the activity in the Polish market was rather moderate. The zloty's exchange rate traded in quite narrow ranges, and at the end of the week slightly strengthened against the main currencies (below 3.9 vs. euro after US. payrolls). Since last Friday the zloty gained ca. 1,2% against the euro and 2,1% vs. the dollar.

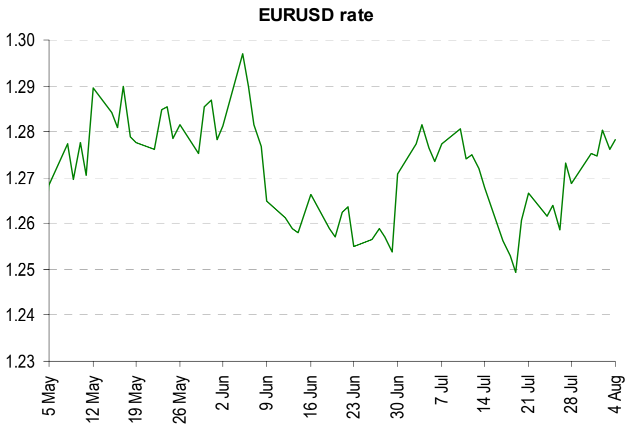
▪ The Tuesday's Fed's decision is going to be the key factor for the zloty and other emerging markets. We assume the FOMC will pause with monetary policy tightening in US, which may give some boost the emerging currencies. The EURPLN rate may trade near below 3.9, while 3.86-3.88 and 3.84 are going to be next resistance levels. In our opinion the EURPLN may trade in range of 3.86-3.96, while the USDPLN between 2.97 and 3.07.



Bonds strengthen after US labour market data

▪ In the most part of the week the situation in the debt market was quite calm similar to the FX market, and the bond prices moves were not significant, while investors were in holiday moods. Yields rose throughout the first days of the week though a significant correction appeared on Friday after non-farm payrolls data in US. During the week yields fell by ca. 1-7 bp.

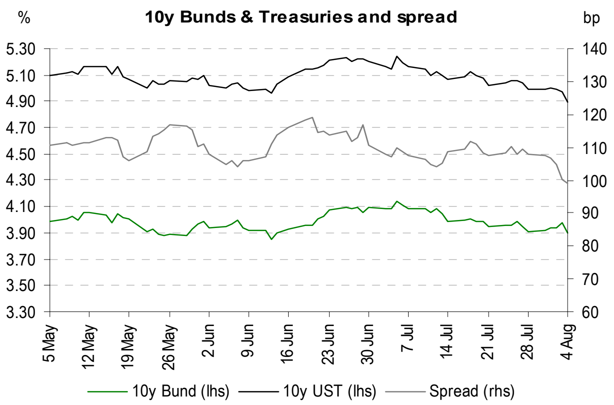
▪ In the coming days the FOMC decision is going to be the most important factor influencing the emerging markets. After Fed leaves the rates unchanged, bonds should slightly strengthen, though the reaction of the market may be much more limited, than if the rates are raised further. In case of tightening the rise of yields in the core markets may be significant, which would have an effect also on the Polish market.



The dollar weakened ahead of Fed and after payrolls

▪ In the beginning of the past week the EURUSD rate was rather stable, however later on in technical trading it rose above 1.28. After a correction the dollar weakened again after quite hawkish statements of the ECB. At the end of the week the greenback started to recover again, however after the US jobs data the EURUSD rate rocketed to 1.29. Since last Friday the greenback lost ca.1% versus the euro.

▪ In our view the dollar may weaken further as the Fed after 17th consecutive rate hike pauses with monetary policy tightening. Labour market statistics and trade balance data may be slightly less important. We stay with our view that the EURUSD rate may reach 1.30 at the end of the year.



Treasuries strengthen ahead of Fed's decision

▪ The US bond market considerably strengthened since last Friday, which resulted from increased expectations of a pause in rate hikes series in US. The German government papers initially weakened among others after ECB's communiqué, though soft labour market data in US effected in substantial strengthening. 10Y yields of Treasuries fell from 5.02% to 4.88%, while Bunds from 3.93% to 3.91%.

▪ Amid lack of rate hike from Fed the strengthening in the core markets may be not significant, as such a move is to large extent discounted in the prices of financial instruments. If a hike occurs the weakening may be substantial. The euro zone's bonds are going to be under strong influence of US market.

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