

Weekly economic update

4 – 10 September 2006

Data published on Wednesday that in line with our expectations GDP growth in 2Q06 reached 5.5%, slightly exceeding average market forecast at 5.4%. The breakdown of the growth was a (positive) surprise for all market analysts, showing much stronger than predicted rise in fixed investment and positive contribution of net exports. At the same time, 2Q06 saw continuation of solid private consumption growth. All in all, the data confirmed that the economy remains on the path of healthy growth with no threats to macroeconomic balance, as inflation and current account deficit are still contained. According to our estimates, labour productivity in the whole economy grew stronger than wages and unit labour costs declined in 2Q06. Therefore, we think that the GDP figures have not significantly changed central bankers' assessment of medium-term inflation prospects. It seems to be reflected in the tone of the statement released after MPC meeting concluded on Wednesday. Although the Council said that "the analysis of the latest data indicates that the path of future inflation will be similar to that presented in the July projection", the sentence that inflation will be "similar" to the July projection is not too precise, so it is possible that in the Council's view true inflation path will be somewhere between paths presented in July projection and its April version. Such scenario would not necessary require swift interest rate hikes. Thus, we maintain our view that interest rates will remain on hold for the nearest 12 months.

In the nearest week there will be no publication of domestic data releases. However, one may expect there will be another news regarding a draft of the 2007 budget which has to be sent by the government to the parliament until the end of September. Possible information about continued pressure on increase in budget spending could negatively affect the market, but repeated declarations of Prime Minister Jarosław Kaczyński about commitment to budget anchor should calm down market participants.

Economic calendar

| Time GMT | COUNTRY | INDICATOR (importance level*) | PERIOD | FORECAST | | LAST VALUE | |
|--------------------------------|---------|---|--------|----------|-------|------------|------|
| | | | | MARKET | BZWBK | | |
| MONDAY (4 September) | | | | | | | |
| 9:00 | POL | Auction of PLN1.0bn 52-week T-bills auction (M) | | | | | |
| 9:00 | EMU | PPI (M) | Jul | %YoY | 5.8 | - | 5.8 |
| | US | Market holiday | | | | | |
| TUESDAY (5 September) | | | | | | | |
| 8:00 | EMU | Non-manufacturing PMI (H) | Aug | | 57.6 | - | 57.9 |
| 9:00 | EMU | Retail sales (M) | Jul | | 1.3 | - | 1.5 |
| WEDNESDAY (6 September) | | | | | | | |
| 9:00 | POL | Auction of PLN1.8-2.3bn of OK1208 2Y bonds (H) | | | | | |
| 12:30 | US | Labour productivity – revised (H) | Q2 | % | 1.5 | - | 1.1 |
| 12:30 | US | Unit labour costs – revised (H) | Q2 | % | 3.8 | - | 4.2 |
| 14:00 | US | Non-manufacturing - ISM (H) | Aug | | 55.0 | - | 54.8 |
| THURSDAY (7 September) | | | | | | | |
| 11:00 | GB | BoE meeting – rate decision (M) | Sep | % | | - | 4.75 |
| 12:30 | US | Jobless claims (H) | | k | | - | 316 |
| 14:00 | US | Wholesale inventories (H) | Jun | | 0.7 | - | 0.8 |
| FRIDAY (8 September) | | | | | | | |
| 6:00 | JP | BOJ meeting – report after decision (M) | Sep | | | | |

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

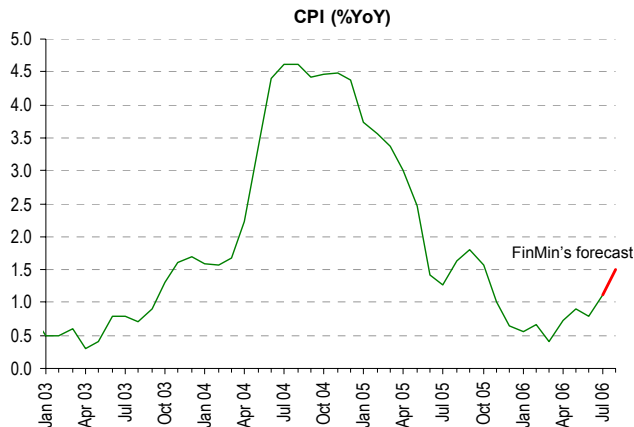
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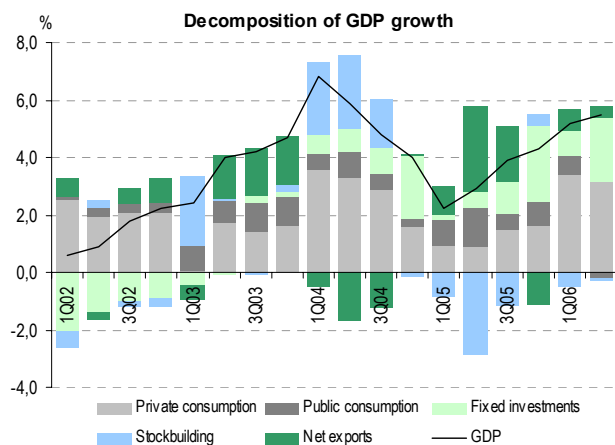
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What's hot this week – No domestic data releases

- The nearest week will not bring any releases of domestic data. The most important event for the debt market will be Wednesday's auction of 2-year bonds. This may not be particularly successful given market weakening following presentation of FinMin's forecast of August CPI inflation (see chart and *Quote of the week* section).
- As we entered September that is a month during which the government finishes work on the budget draft, one may expect continuation of inflow of information regarding planned changes in revenues and spending as compared to initially presented assumptions.
- Waiting for domestic data due for release in next weeks, participants of the Polish financial market will closely watch major data releases and tendencies on international markets.

Economy last week – High GDP growth, stable interest rates

- GDP growth in 2Q06 matched our expectations and reached 5.5%YoY, after 5.2% rise in 1Q06. The growth was fuelled by 5.1% rise in domestic demand while net exports added additional 0.4 pp.
- Private consumption growth was very close to our expectations, reaching 4.9%YoY (slight deceleration from 5.2% in Q1), while big positive surprise came from fixed investment growth that accelerated to 14.4%YoY, the highest pace of growth for eight years, nearly doubling 7.4% growth seen in Q1.
- The scale of improvement in investment activity bodes-well for long-term economic growth, and at the same time should slow down a pace at which output gap closes, which is likely to weaken inflationary pressure connected with accelerating GDP growth.
- The data confirmed the whole year growth will top

Important elements of Monetary Policy Council's statements (30 August)

The growth of real GDP in 2006 Q2 reached 5.5% y/y (compared with 5.2% in Q1) and was higher than assumed in the July inflation projection.

The contribution of net exports to GDP growth and the growth of gross fixed capital formation were higher than forecast in the July projection.

The rise in the annual growth of prices in relation to June 2006 was mainly the result of the acceleration in the annual growth in the prices of food and internet services. The growth of food prices accelerated in connection to the unfavourable weather conditions in July. In turn, the rise in the prices of internet services mainly followed from the expiry of special price reductions offered by one of the providers.

All measures of core inflation have increased. August did not bring any changes to inflation expectations of households (0.8% y/y). According to the GUS business tendency surveys, the expected prices in retail sales, prices of industrial production and construction and assembly output have been gradually increasing since the beginning of 2006.

In the opinion of the Council the analysis of the latest data indicates that the path of future inflation will be similar to that presented in the July projection.

- The MPC did not surprise the market, keeping main interest rates on hold for the sixth straight month. As we expected, this time the MPC communiqué referred to the latest inflation projection released in July (rather than to its April's version).
- However, the statement that the path of future inflation will be "similar" to that presented in the July projection is so general that it is hard to tell whether assessment of inflation prospects changed as compared to the one presented a month ago. Especially that the remaining part of the official statement after the meeting included few elements of judgement on future inflationary pressures. There was a dominance of simple data description.
- It seems that the Council adopted wait-and-see approach and we do not change our expectations

Quote of the week – CPI inflation at 1.5%YoY in August

FinMin communiqué; www.mf.gov.pl, 1 September

The Ministry of Finance estimates that CPI grew 0.2%MoM in July, which would drive annual inflation rate up to 101.5%.

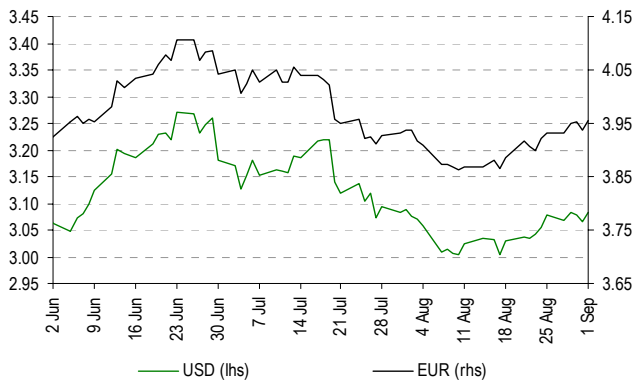
Piotr Soroczyński, deputy finance minister; 1 September

We are worried by the jump in August but this does not have to be a lasting effect. (...) At the end of the year inflation will be at around 2%. It might rise to 2.2-2.3 percent in the first months of next year but may even fall in the second half of 2007.

Forecast of inflation in August presented by the Ministry of Finance is much less optimistic than our predictions to date, assuming inflation stabilisation at 1.1%YoY posted in July. However, as shown by July data, FinMin's estimates of inflation are not always as accurate as in the first months of this year. Besides, the ministry said that inflation acceleration stems from hikes in food prices which has a nature of supply shock and thus it does not have to affect medium-term inflation prospects.

Market monitor

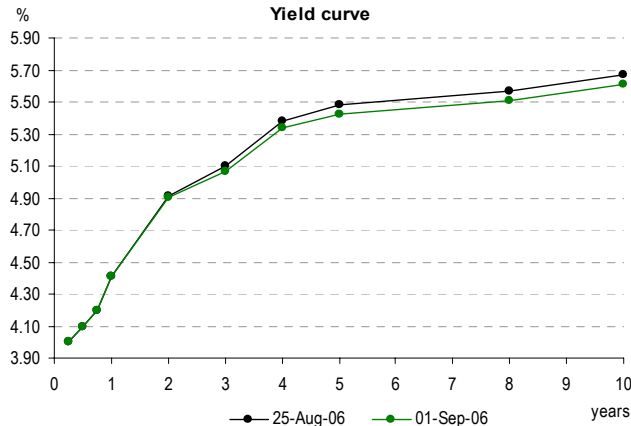
Zloty exchange rate



Zloty weakens further

- Last week the weakening trend of the Polish currency was continued. After a few days zloty fluctuated in a narrow range and the market activity was limited. The wave of weakening came at the end of the week and it was connected with deterioration of investors' sentiment to the emerging markets and the negative influence of inflation forecasts of Ministry of Finance. Zloty lost ca. 0.8% vs. the euro and 0.9% against the dollar.
- In our view there is still potential for zloty weakening in the short term. The EURPLN rate may soon test the 4.0 level. The results of the 2 year bonds auction may show the foreign investors' sentiment to the Polish market, though the situation in the international markets may be of higher importance. Zloty may fluctuate in range of 3.92-4.02 against the euro and 3.05-3.15 versus the dollar.

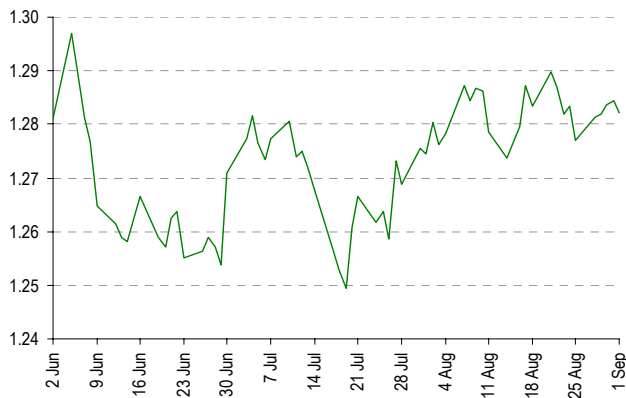
Yield curve



MF's inflation forecast spoils the moods

- In the first days of the previous week the debt market was very calm and bond prices remained almost unchanged. More significant strengthening came in after the release of the MPC's communiqué, which in spite of the very good economic data and higher July CPI appeared rather neutral for the rate hikes perspective. However the Friday release of the inflation forecast of the Ministry of Finance contributed to some weakening.
- Next week the situation in the bonds market may be quite stable with lack of important publications in the domestic and the international market. The bonds tender in Poland and activity indices in the foreign markets may have some influence. The Council members' comments may appear crucial, while the market will await the inflation data amid the finance ministry inflation forecast.

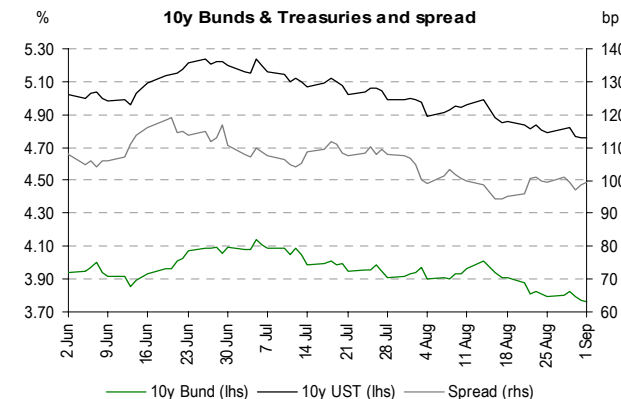
EURUSD rate



The EURUSD still volatile

- Initially the dollar stayed below 1.28 against the euro, however after the release of the Fed minutes from the August rate meeting, which confirmed it did not include signals on the need of further rate hikes in the US to curb the inflation. The ECB communiqué contributed to further dollar weakening though before and after the non-farm payrolls the greenback recovered. Since previous Friday the dollar weakened vs. the euro by 0.3%.
- During the week situation in the core markets should stabilize taking into consideration small number of data releases. At the beginning of the week the activity may be limited with regards to the market holiday in US. Later on the relation of the euro to the dollar will be influenced mainly by the activity indices from the services sector and labour market data from US for the second quarter.

10y Bunds & Treasuries and spread



Falling yields trend continued

- The falling yields trend is present in the core markets for some time and this was featured last week, among others after less hawkish Fed minutes, Q2 GDP data and other data showing moderating inflation pressure, as well as the Fed's statement on rising productivity helping to curb the prices pressures. A slight correction effected after the US jobs data.
- In the next several days amid lack of essential releases the market will focus on the non-manufacturing PMI and ISM activity statistics in US as well as on the labour market data and wholesale inventories in United States. The tone of the ECB's chairman's statement strengthened expectations on the continuation of rate hikes in the EU12.

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