

# Weekly economic update

11 – 17 September 2006

Inflation release for August will be the key event on the Polish market next week. If the forecast of the Ministry of Finance, which assumes food prices increase (untypical in this period even in difficult years in agriculture sector), materialises, market expectations as regards soon monetary tightening may be reinforced. In this context it is worth to notice comments of central banks' representatives, which indicated a scenario of no reaction to inflation increase caused by supply side shocks. Our CPI forecast shows increase in annual inflation above the NBP's target in 1Q07 (higher food prices and excise taxes rise), but at the end of the next year it should fall to below 2.5% again. At the same time, net inflation should not considerably exceed the level of 2%, which means, in our opinion, that interest rate hike would not be necessary. Unless such situation will be used as an opportunity to build credibility of the new NBP governor (to be appointed at the beginning of 2007) by let's say two fine-tuning 25 bps rate hikes. However, this is not our base-case scenario.

MPC decisions will be data dependant and labour market situation seems (one of) the most important. This week statistics on wages and employment in August will be published. While we do expect relatively strong growth in both indicators, this does not seem to be excessive if one takes into account rise in productivity. According to our estimates, pressure from unit labour costs side lowered somehow in the second quarter.

Political factors, especially related to discussion on the next year budget, may still affect the markets. Comment of MPC's Wasilewska-Trenkner on possible rate hike in the case of budget deficit increase above PLN30bn led to market weakening despite of the fact that such scenario does not seem to be likely. Such a reaction shows that not necessarily very strong negative impulse is needed to break the level of 4.0 in EURPLN rate.

## Economic calendar

Time GMT	COUNTRY	INDICATOR (importance level*)	PERIOD	FORECAST		LAST VALUE	
				MARKET	BZWBK		
<b>TUESDAY (12 September)</b>							
12:00	POL	Trade balance (M)	Jul	mIn €	-170	-400	61
12:00	POL	Current account (M)	Jul	mIn €	-204	-400	160
12:30	USA	Trade balance (H)	Jul	mld \$	-65.5	-	-64.8
<b>WEDNESDAY (13 September)</b>							
9:00	POL	Auction of PLN0-2.0bn WS0922 20Y bonds (H)					
<b>THURSDAY (14 September)</b>							
12:00	POL	CPI (H)	Aug	% YoY	1.4	1.3	1.1
12:00	POL	Money supply (M)	Aug	% YoY	12.4	12.5	13.1
12:30	US	Retail sales (H)	Aug	% MoM	0.4	-	1.4
<b>FRIDAY (15 September)</b>							
12:00	POL	Wages (H)	Aug	% YoY	5.2	6.0	5.6
12:00	POL	Employment (H)	Aug	% YoY	3.3	3.4	3.3
9:00	EMU	Final HICP (H)	Aug	% YoY	2.3	-	2.4
12:30	USA	CPI (H)	Aug	% MoM	0.2	-	0.3
13:15	USA	Capacity use (H)	Aug	%	0.3	-	0.4
13:15	USA	Industrial production (H)	Aug	% MoM	82.5	-	82.4
13:45	USA	Preliminary Michigan (H)	Sep		80.0	-	

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

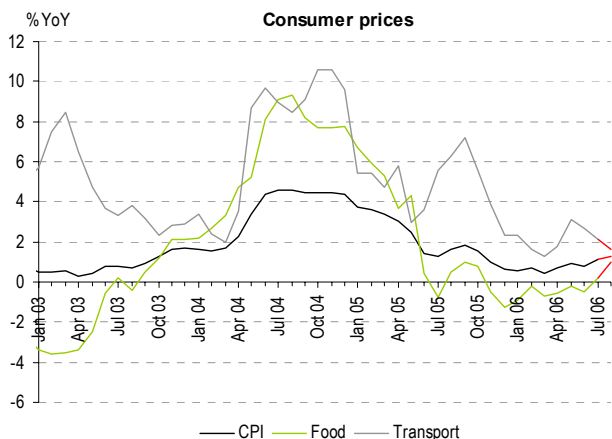
**Maciej Reluga** Chief economist (+48 22) 586 8363

**Piotr Bielski** (+48 22) 586 8333

**Piotr Bujak** (+48 22) 586 8341

**Cezary Chrapek** (+48 22) 586 8342

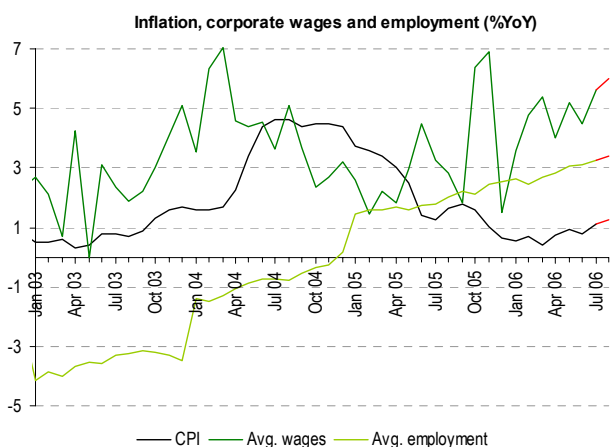
e-mail: ekonomia@bzwbk.pl

**What's hot this week – Inflation the most important out of many data**

Financial market players impatiently await CPI inflation figure for August. After the Ministry of Finance's forecast (increase to 1.5%) brought the yields higher, lower figure may give some positive impulse for the market, although positive sentiment on the fixed income market appeared already at the end of the week.

Of course, it is extremely difficult to forecast the influence of drought on food prices, but in our opinion the risk is on the downside as compared to the ministry's forecast. With moderate food price increase (which has not taken place for many years, even with drought or flood), our forecast of 12M CPI change is 1.3%. This is below average market forecast of 1.4%.

The same day NBP will publish monetary statistics showing acceleration in money supply and credits, also in the enterprises sector.



When expecting data on inflation market participants will get information on balance of payments. Current account balance and trade balance were very volatile in recent months (high deficits in May, surpluses in June) and we expect this was continued in July (deficits of ca. 400 mln euro). We forecast strong growth in exports and imports (17.8% and 22%YoY) to be maintained.

After inflation release, at the end of the week, data from the labour market will be published. They are very important for monetary policy perspective, but will be overshadowed by CPI figure. If inflation sends a hawkish signal to the market, high growth in employment and wages may even reinforce bearish mood on the bond market. However, we expect neutral influence of labour market figures after relatively low inflation reading.

**Economy last week – Government preliminarily approved budget****Budget parameters and macroeconomic assumptions**

	2006 E	2007 F
Revenues (PLNbn)	196.5	212.2
Expenditures (PLNbn)	225.8	242.2
Deficit (PLNbn)	29.3	30.0
Financing needs (PLNbn)	41.0	44.0
GDP (%YoY)	5.2	4.6
Domestic demand (%YoY)	5.1	5.1
Investment (%YoY)	10.0	10.0
Unemployment rate (% end-year)	15.3	14.1
Inflation (% annual average)	1.1	1.9
NBP ref. rate (% annual average)	4.0	4.3
EURPLN	3.91	3.90
USDPLN	3.11	3.04

E – estimates, F – forecast; Source: Ministry of Finance

The main macroeconomic assumptions for 2007 concerning GDP growth and inflation are unchanged.

The planned increase in revenues of almost 9% seems quite ambitious goal, but it is possible to be realised as GDP growth may be even higher than projected.

It is hard to call the budget draft, with spending increase more significant than nominal GDP growth, a step towards public finance reform and the cabinet is not making efforts to curb Poland's fiscal imbalance during the period of economic prosperity. The best example is the planned increase in financing needs.

Government plans excise tax increases for tobacco, beer and fuel, which may lead to another one-off increase in CPI inflation in 1Q07. Taking into account forecasted increase in food prices, CPI will be probably above 2.5%.

**Quote of the week – Higher food prices do not mean higher rates**

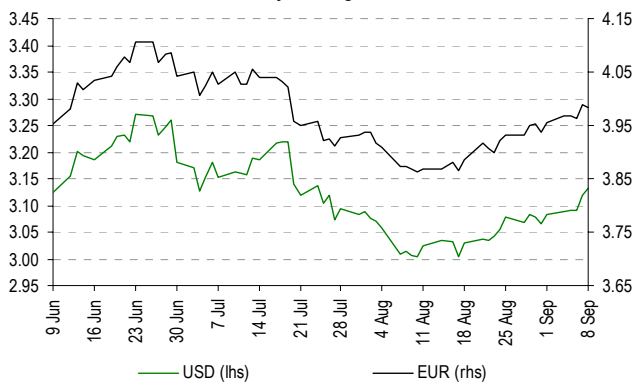
**Halina Wasilewska-Trenkner, MPC member;** Radio PiN 7 September  
*[Rate hike] depends on what factors will drive inflation upwards. If the source of inflationary pressure is only high food prices as a result of dry summer weather, than it is obvious this effect will be only transitory, until new agricultural year.*

**Krzysztof Rybiński, deputy NBP governor;** PAP 6 September  
*NBP should react to supply side shocks only if they influence inflation processes and inflation expectations. As for now it is impossible to assess drought impact on inflation, it will be possible only in a few months time.*

One of MPC members and NBP deputy governor suggested that interest rate hike is not necessary if inflation increase is caused by food prices rise. Such approach is in line with MPC's *Monetary policy guidelines* for this year (and consistent with logic of monetary policy conducting). Thus, even taking into account recent comments of other central bankers (Leszek Balcerowicz, Marian Noga), we do not change our view that it is still not the timing to think seriously about monetary tightening in Poland.

## Market monitor

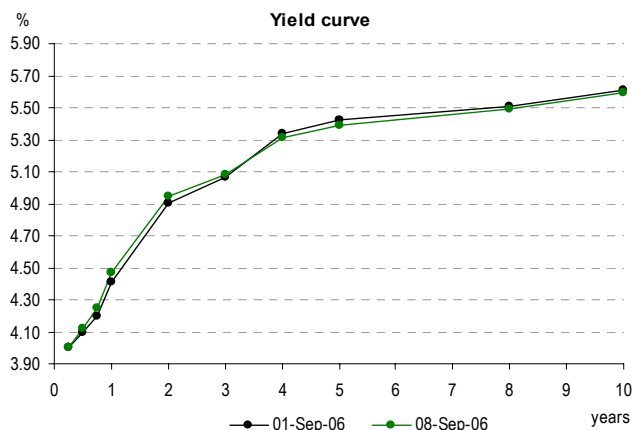
Zloty exchange rate



## Zloty weakens further

- Last week zloty weakened close to 4.0 level against the euro. Its depreciation was triggered among others by the news on the budget draft for 2007. A temporary improvement of moods in the emerging markets helped the zloty, though after the US labour market data there was another wave of depreciation of the developing economies' currencies.
- Next week inflation data will be the most crucial for bonds, but it may influence the FX market through the bonds market moves. Inflation data from US are going to be important for the emerging markets and if they are positive, this may appear positive for the zloty. In our view the EURPLN rate will fluctuate in range of 3.93-4.03 while the USDPLN rate in range of 3.07-3.17.

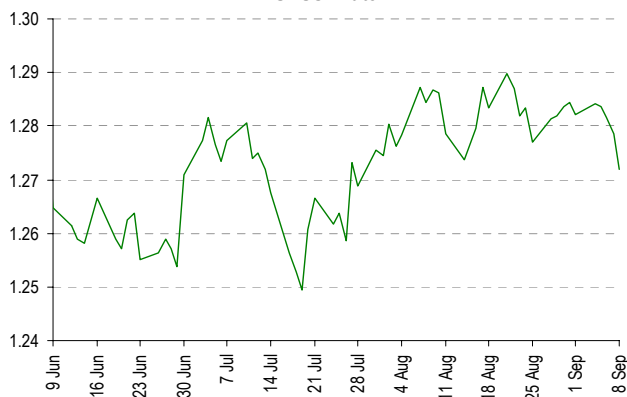
Yield curve



## Debt almost unchanged, awaiting inflation

- After a significant rise of yields in the previous Friday after the inflation forecasts of the Ministry of Finance, the start of last week was rather calm. Better moods in the region supported the rising bonds prices. However, after the comments of the NBP president on inflation, MPC member comments and increase of yields in the core markets there was some correction. At the end of the week the increased foreign investors' demand helped Polish papers to recover.
- If the inflation forecasts of the MF realise there may be a slight correction of bonds. However even then we believe that the monetary policy perspective does not change significantly. In our opinion, the CPI will be lower, which may support the debt. Labour market data and reaction of core markets to the US (CPI) data will be also essential.

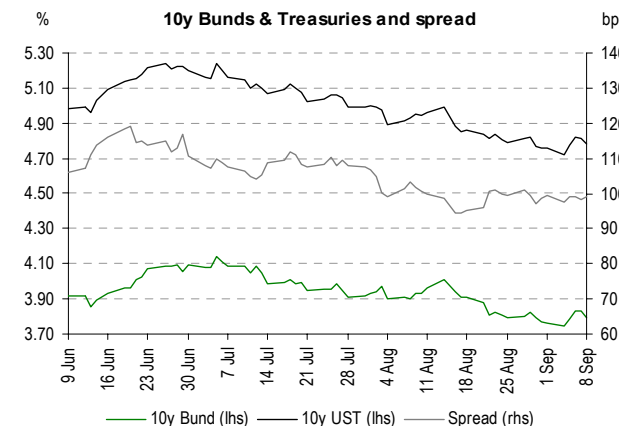
EURUSD rate



## Volatile EURUSD, dollar recovers

- After a period of lower activity of the US investors connected with Labour Day in United States the dollar regained strength versus the single currency in reaction to the OECD report suggesting further hikes in US and unit labour costs for Q2, which hit the market expectations on the ending of the rate tightening by the Federal Reserve. During the week dollar gained ca. 1%.
- Data describing the economic growth in US (industrial production and retail sales) as well as CPI inflation data will be crucial for the relation of euro to the greenback. If they are above forecasts the expectations for raising rates by Fed may be revived. The US foreign trade statistics may of slightly less importance. The market may focus also on the HICP inflation in the EU-12 countries.

10y Bunds &amp; Treasuries and spread



## Core bond yields slightly higher

- Another figures from the labour market has caused a considerable Treasuries weakening, as much as the quoted OECD report and the Fed representative, Janet Yellen, statement about restrictive Fed's bias. The German market was following the situation in US and, moreover, the ECB's statement about readiness to further rate hikes had a negative impact on the bonds.
- In spite of market's apprehension about inflation in the USA, we keep the view the Fed will leave the rates unchanged until the end of the year, maybe longer, and in Q2 of 2007 a cut by 50 may be expected and another later next year due to the US economic slowdown. The risk of rate hike in euro zone is in the upward direction to 3.50% by the end of the year and to 3.75% in Q1 2007.

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Additional information is available on request. Please contact Bank Zachodni WBK S.A. Treasury Division, Economic Analysis Unit, ul. Marszałkowska 142, 00-061 Warsaw, Poland, phone (+48 22) 586 83 63, email [ekonomia@bzwbk.pl](mailto:ekonomia@bzwbk.pl), <http://www.bzwbk.pl>



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