

Weekly economic update

2 - 8 October 2006

Political turmoil continues. Talks between PiS and PSL have been postponed, which increases the probability of earlier elections. However all the options are still possible and we will not necessarily know the denouement the next week. If PSL does not join the coalition, the voting concerning the Parliament dissolution will take place only during the meeting scheduled for October 10-13. Thus, politics will “hang over” the market for a while.

Monetary policy concerns are of a greater interest to us. Although it can be very difficult to predict the further decisions in the next few months, at least there are only two possible options – rates higher or on hold. During the last week we saw MPC’s decision and *Monetary policy guidelines for 2007*, which did not give clear answer to interrogations concerning interest rates prospects. Admittedly, some Council members are alarming a hike is possible already in October, however it does not seem the majority of the members shares such a view. The communiqué after the meeting was slightly hawkish, as the Council stated that inflation in 2006-07 will be higher than predicted in the July projection. Inflation projections beyond 2007 were missing, and this period is essential from the monetary policy point of view. However, views concerning inflation projections presented in the *Guidelines* were quite balanced. Hawkish arguments found their opposite in factors neutralising them (e.g. influence of factors linked to globalisation, productivity growth amid higher investments, possibility of higher imports and not necessarily inflation). One can have the feeling the document has been written on the principle of “something nice for everyone”. This is why we keep our view that the Council will wait for further economic indicators (labour market ones, LFS data only in December), in order to evaluate the risk of second-round effects on inflation in case it temporarily exceeds the target (probably in Q1 2007).

Economic calendar

Time GMT	COUNTRY	INDICATOR (importance level*)	PERIOD	UNIT	FORECAST		LAST VALUE
					MARKET	BZWBK	
MONDAY (2 October)							
8:00	EMU	Manufacturing PMI (H)	Sep		56.5	-	56.5
14:00	USA	Manufacturing ISM (H)	Sep		53.5	-	54.5
TUESDAY (3 October)							
9:00	EMU	PPI (M)	Aug	% YoY	5.7	-	5.9
9:00	EMU	Unemployment (M)	Aug	% YoY	7.8	-	7.8
WEDNESDAY (4 October)							
9:00	POL	Auction of PLN1.0-1.5bn of 2Y OK1208 bonds (H)					
8:00	EMU	Non-manufacturing PMI (H)	Sep		57.0	-	57.1
9:00	EMU	Retail sales (M)	Aug	% YoY	2.0	-	2.5
14:00	US	Factory orders (H)	Aug	% MoM	0.5	-	-0.6
14:00	US	Non-manufacturing ISM (H)	Sep				
THURSDAY (5 October)							
11:00	UK	BoE meeting – decision (M)	Oct	%	4.75	-	4.75
11:45	EMU	ECB meeting – decision (H)	Oct	%	3.25	-	3.0
FRIDAY (6 October)							
12:30	US	Non-farm payrolls (H)	Sep	'000	123	-	128
12:30	US	Unemployment (H)	Sep	%	4.7	-	4.7

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

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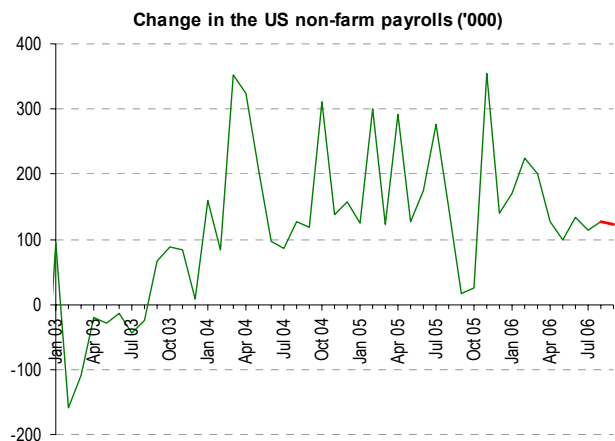
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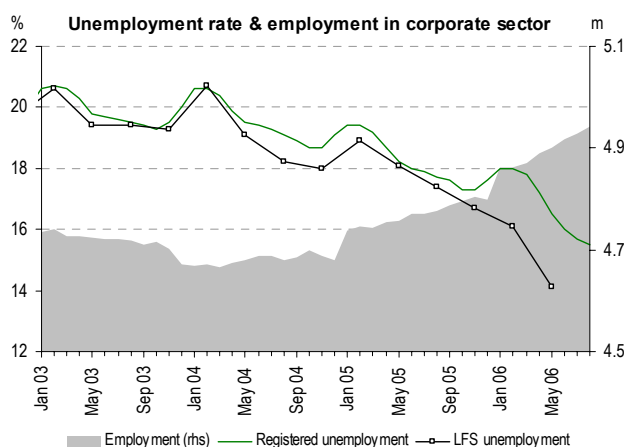
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What's hot this week – Data releases only abroad

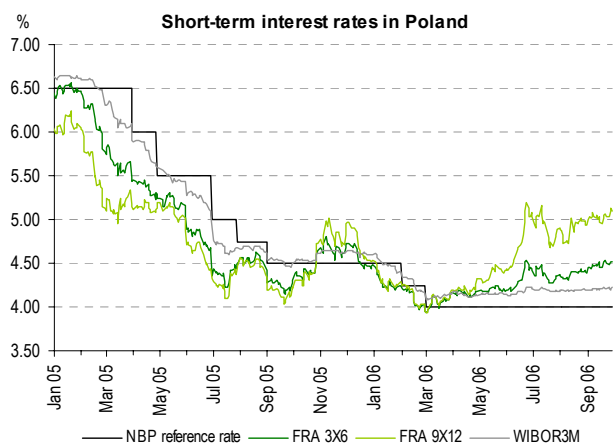


- There are no important events scheduled for this week in Poland.
- Opposition parties have not succeeded in rescheduling the Parliament's meeting, so the only information may be PSL's decision concerning its joining the ruling coalition.
- We can hope there will be some new MPC members declarations. Hawkish arguments have been already presented and possible interviews with mainstream members, who decide about the monetary policy shape could give clues whether interest rates prospects have changes after the publication of labour market data.
- International figures (employment figures are the most important) will be an indicator of slowdown in the American economy. ECB's decision with very likely rate increase, as well as communiqué will be key in Europe.

Economy last week – Hawkish data from the labour market



- Quarterly results of the LFS data showed the biggest unemployment fall in the study history – in Q2 2006 to 14.1% (from 16.1% in Q1 and 18.1% in Q2 2005).
- Total number of unemployed dropped 23%YoY, which may raise some concerns whether the scale of firming in labour market conditions will not exert a pressure on prices in the economy.
- Especially that indicator of labour activity increased a mere 0.1pp on a quarterly basis and fell 0.9pp in annual terms which means the higher demand for labour is not offset by an increase in labour supply.
- Strong unemployment reduction translates into higher disposable income of households, thus confirms forecasts for high consumption demand in the second part of the year (of ca. 5%).



- LFS data were clearly one of the arguments for a slightly more hawkish communiqué of the MPC.
- The tone of the MPC statement suggested that central bankers' perception of future inflation path gradually worsens, but not to an extent requiring rate hike in the near future.
- In the next month figures, we do not expect bigger changes in the evaluation of the economic situation, and the next LFS report will be released by the end of the year. Thus, it is not likely, the Council decides for a pre-emptive move this year, which was suggested by one of the Council's member.
- Approval of the budget for 2007 was neutral for the market, although budget deficit is high taking into account fast economic expansion.

Quote of the week – Does “slightly” make a big difference?

MPC's press conference after the meeting of September 27th.

Question of Gazeta Wyborcza's journalist:

You said inflation will be **slightly** above the level showed in July's projection...

Leszek Balcerowicz, MPC's chairman:

I didn't say *slightly*.

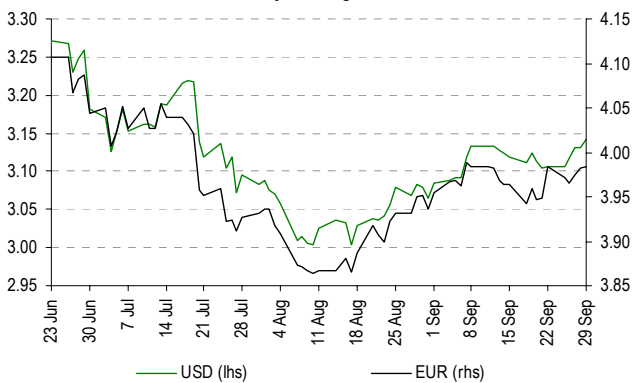
Stanisław Niekarcz, MPC's member:

Slightly, slightly...

There is no doubt, the period of view convergence in the MPC is over. Council's members even argue if inflation will be above the target in 2007, or only **slightly** above. First, taking into account the influence of summer drought, it is clear that average inflation in 2007 will be higher than forecasted. Second, if only this factor will increase inflation, it is not important because a rate rise is not necessary. Third, obviously, divergences about evaluation of 2008 are much bigger as the Council have not even mentioned them in the statement.

Market monitor

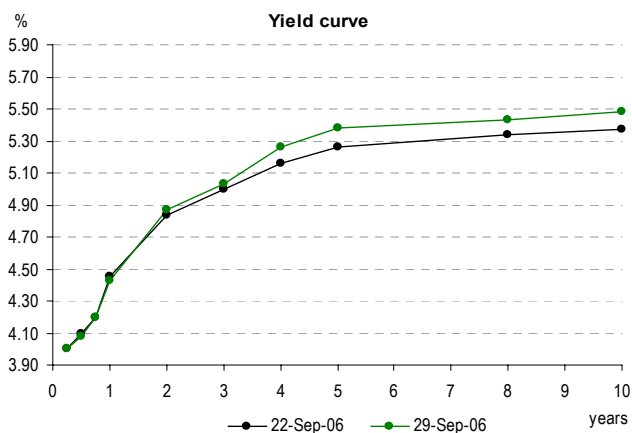
Zloty exchange rate



There is still some potential for zloty weakening

- With regards to the continuation of political turmoil on the Polish political stage and unstable situation in the emerging markets zloty stayed at weaker levels as compared to the previous week. Polish currency fluctuated in a tight range against the main currencies, its value did not change against the euro and fell by ca. 1.1% versus the dollar.
- In our view the present situation are not as important as to have higher influence on the zloty or other assets strength, and their negative influence is offset by the positive macroeconomic data. Global capital flow will have higher impact on the Polish market. We assume there is still some potential for zloty weakening. We expect the EURPLN rate to fluctuate next week in range of 3.93-4.03, while the USDPLN rate in 3.09-3.19.

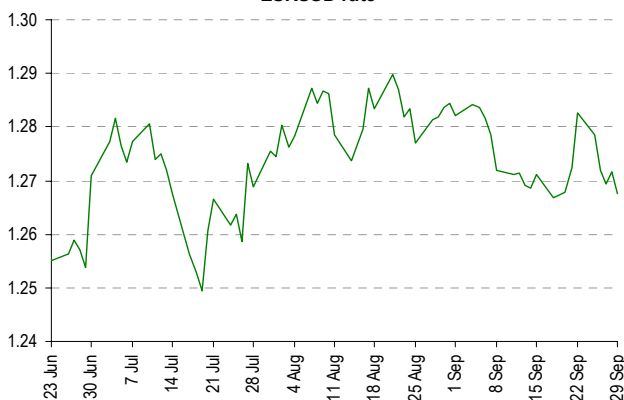
Yield curve



Rising yields and yield curve steepening

- Last week Polish debt weakened in a further reaction to unstable political situation in Poland and region. Moreover rising yields in the core markets contributed to the fall of bonds prices. Slightly more hawkish tone of the MPC communiqué as well as comments of some MPC members also did not help Polish bonds.
- Political situation diminishes the chances of establishing a majority coalition in the parliament. However in our view the possible scenarios should not mean deterioration in situation in politics and should not significantly affect the market. Macroeconomic data, especially the labour market figures, as well as the change on the post of the NBP's president will be the most important for the possibility of a rate hike at the start of next year.

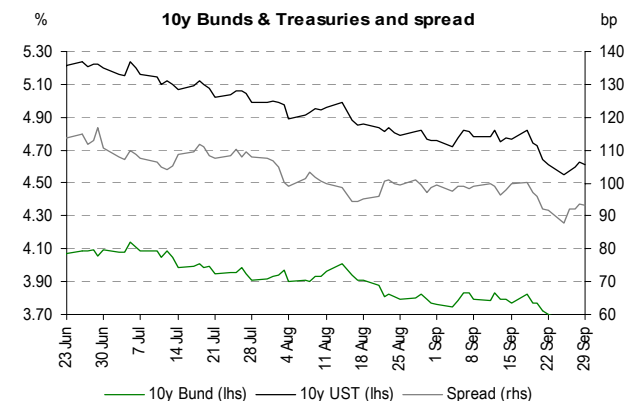
EURUSD rate



Dollar moderate recovery

- Dollar appreciation was favoured by better than expected US housing market figures, consumer confidence indicator and the low level of the expectations component of the IFO index, which had a negative influence on the euro. The dollar stayed on a slightly stronger level (0.8%) against the single currency compared to the last week despite decrease of GDP estimate for Q2 in the US.
- Next week, key event for the EURUSD rate will be the ECB's meeting, and most of all the communiqué, which can contain clues concerning pace of further rate hikes in the euro zone. Economic activity indicators and the figures from the labour market in the US will be also essential. The euro can keep on gaining but potential of strengthening can decrease.

10y Bunds & Treasuries and spread



A slight correction after a period of strengthening

- At the beginning of the week yields on the US market continued a decreasing trend. Bunds have been supported by the Ifo index. Later, despite a weaker US GDP data, there was some profit taking. Compared to previous Friday yields of 10Y Bunds and Treasuries have practically not changed.
- The ECB's communiqué is going to be a key factor for expectations concerning final level of the official interest rate in the euro zone and the pace at which it will be reached. Especially in the context of weakening expectations concerning economic situation in Germany (Ifo) and falling inflation in the euro zone. Despite some market participants started thinking about the end of rate hikes this year, we hold our view it should occur only at the beginning of next year.

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