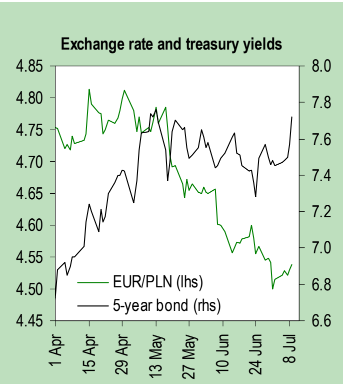
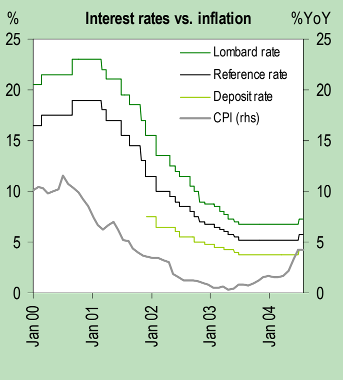
Bank Zachodni WBK

MACROscope

Polish Economy and Financial Markets

July 2004





In this issue:

Maciej Reluga
Chief Economist
(+48 22) 586 8363

Piotr Bielski
(+48 22) 586 8333
Piotr Bujak
(+48 22) 586 8341
Aleksander Krzyżaniak
(+48 22) 586 8342

Email: firstname.secondname@bzwbk.pl

The calm before the storm?

- **The summer holidays have just started and we are entering the silly season, during which we should witness fewer than the usual number of important news and events.** However, perhaps it is worth recalling that, although the summer holidays in the three preceding years had shown equally good promise, it turned out that July was a month of violent fluctuations on the Polish financial market in those years. In July 2002 and July 2003 the turmoil was caused by the unexpected resignations of finance ministers (Marek Belka and Grzegorz Kołodko, correspondingly), while in July 2001 the panic on the market was originated by irresponsible politicians' comments regarding an economic crisis. At this moment, nothing – except for recent rumours about the deputy PM's possible dismissal – seems to be indicating that such a negative scenario could materialise again. However, it is worth noting that in the three past years there were also no early signals of the upcoming trouble.

- **In June, the situation on the political scene contributed rather to calming down and improving market moods.** The cabinet of Marek Belka won the vote of confidence in the Sejm, which postponed the early elections scenario. However, within the next couple of months we expect a deterioration in investors' moods due to problems with implementation of the public finance reform, amid a watering down of the Hausner plan. So, even if our updated currency outlook assumes a slightly stronger zloty than previously forecasted, we still expect a returning wave of depreciation in the autumn amid continuing fiscal problems and political risk. This should be accompanied by rising yields in treasuries, which should be driven by a tightening of monetary policy, and this not only in Poland.

- **Recent zloty strengthening was also triggered by the MPC, as they hiked interest rates more than was expected by the market.** The decision was the reaction to higher than expected inflation indicators, as the MPC acted in order to prevent a possible pass-through of CPI increase into inflationary expectations of households. As CPI inflation will remain above the central bank's inflation target for the next couple of months, we think that another 50bps is quite possible relatively soon.

- **In recent years the tendency to improve the transparency of monetary policy has been observed all over the world**. In countries which follow a DIT strategy, a particularly strong emphasis is put on communicating to the public monetary authorities' intentions and the manner in which the authorities are going to deliver their objectives along with rationale behind the decisions taken. Therefore, in this month's *Special focus* section, we try to assess the transparency level of the monetary policy in Poland and point to the changes required in this regard.

Financial market on 30 June 2004:					
NBP deposit rate	3.75	WIBOR 3M	6.05	PLN/USD	3.7470
NBP reference rate	5.25	Yield on 52-week T-bills	6.85	PLN/EUR	4.5422
NBP lombard rate	6.75	Yield on 5-year T-bonds	7.46	EUR/USD	1.2122

This report is based on information available until 09.07.2004

Still far from OK

DIT strategy – communication first and foremost

In recent years the tendency to improve the transparency of monetary policy has been observed all over the world. A particularly strong emphasis on communicating to the public monetary authorities' intentions and the manner in which the authorities are going to deliver their objectives along with rationale behind the decisions taken is put in the countries which follow the Direct Inflation Targeting (DIT) strategy. This strategy, also adopted by the National Bank of Poland, is often considered not so much as a way of conducting monetary policy, but rather as a way of communicating how monetary policy is conducted. Hence, the transparency of monetary policy is deemed a special feature of the DIT strategy. In this text, we try to assess the transparency level of the monetary policy in Poland and point to the changes required in this regard.

Transparency – what is it and what is it for?

First of all, it is worth defining the term „transparency of monetary policy". In the most general terms, it can be said that the transparency of monetary policy means the provision of clear information by the central bank to the public as broadly understood (households, enterprises, financial markets, government, parliament) and compliance with the principle of openness in monetary policy.

What benefits will the transparency of the monetary policy bring? First of all, it ensures the public's better understanding of the rationale for the central bank's decisions. It also enhances the monetary authorities' accountability before public opinion for the achievement of the targets set. These two elements provide a nominal anchor for the economy in the form of a clearly defined, reliable inflation target (this is the key role of the DIT strategy which determines its importance).

Moreover, ensuring high transparency of monetary policy improves the effectiveness of the inflation expectations channel, which is a particular point of interest for those central banks (e.g. NBP), which cannot count on an effective credit channel or interest rate channel. The channel of expectations is particularly important in the DIT strategy, hence the conclusion that transparency is a necessary feature of the effective DIT strategy. The higher the degree to which the central bank can shape expectations, the more effective monetary policy is. Expectations, on the other hand, can be shaped better when the actions taken by the central bank are transparent, hence also credible.

By submitting its own line of reasoning and arguing to external assessment, the central bank imposes on itself a strong external discipline. This encourages improvement in the quality of analyses and research undertaken by the central bank. With facilitated monitoring of monetary policy by the public, the predictability of monetary authorities' reaction function grows, which brings about tangible macroeconomic benefits. This is achieved by enhancing the stability of the yield curve. Thanks to the perfect transparency of monetary policy, the central bank's reaction function would be fully predictable, and the inflation target fully credible. In such a situation, the yield curve would change only in response to the publication of macro data rather than to changes in the monetary policy parameters. Thus, the economy would not have to bear costs of monetary policy surprises.

What is very important is the fact that the monetary policy transparency is instrumental in enhancing the central bank's credibility. According to the research done based on the IFO Institute's survey filled in by bank economists, the transparency of monetary policy is one of the key three factors which contribute to building the central bank's credibility (see the detailed results in the table below).

Determinants of the central bank's credibility

Factor	Importance
High level of independence	1.80
History of doing what it says it will do	2.93
Transparency and openness	3.13
History of fighting inflation	3.70
Decisions constrained by a rule	4.85
Small deficit and low debt ratio	5.26
Incentives (personal loss) for rate-setters	6.38

Note: 1 – the highest importance, 7 – the lowest importance
Source: Jakob de Haan, Sandra Waller, "Credibility and Transparency of Central Banks: New Results Based on Ifo's World Economic Survey", CESifo Working Paper No. 1199, May 2004

In the long run, maintaining the transparency of monetary policy, while ensuring the central bank's credibility, gives the monetary authorities more flexibility in adjusting the policy to the changing economic conditions (e.g. the central bank can afford an inflation increase above the inflation target because people believe the bank's claims that this is going to be temporary). Still, in the short run, taking actions aimed at enhancing transparency often contradicts monetary policy flexibility. In order to keep monetary policy transparent, the central bank must refrain from taking frequent, discretional decisions, as they are often barely comprehensible to public opinion. The interchangeability of the transparency and flexibility of the monetary policy over a short period of time can be more or less distinct depending on how the DIT strategy has been designed in a given country. For example, the transparency of the monetary policy within the DIT strategy improves when the CPI is used as the inflation target, whereas the central bank's flexibility benefits when one of the core inflation measures, indifferent to the impact exerted on the general level of prices by one-off supply shocks, is used as the inflation target. *Nota bene*, in this point, the Polish central bank has voiced its strong support for transparency.

Summarizing, despite the fact that the transparency of monetary policy can sometimes make the central bank's life difficult, it seems, that the potential benefits surpass costs by far and it is certainly worth investing in transparency. The majority of central banks all over the world are aware of that, and we have witnessed a strong tendency to increase the transparency level of monetary policy.

World's Best Examples

The transparency of central bank operations, just like the transparency of fiscal policy, is regarded as important to such an extent that respective special best practice codes are formulated. In 1999, the International Monetary Fund developed and published a special Code of Good Practices on Transparency in Monetary and Financial Policies.

American Fed is the most often indicated as a model to follow (while this would have been unthinkable 10 years ago), while the European Central Bank does not receive a good press in this regard. Among countries who apply the DIT strategy, the Bank of England and the Reserve Bank of New Zealand are the most highly rated banks.

The Bank of England is known primarily for the excellent quality of its inflation reports and its manner of presenting inflation forecasts. New Zealand almost runs abreast with the Brits, besides the former country can be considered an innovator in terms of transparency in monetary policy (New Zealand also pioneered the use of DIT strategy). For example, the Reserve Bank of New Zealand has been publishing short-term interest rate forecasts since not long ago. It would be rather difficult to demand more from the central bank in terms of transparency. However, role models do not need to be sought in faraway, overseas territories. As regards the institutional aspects of transparency in monetary policy, such as inflation reports and forecasts, the practices of the nearby Czech National Bank would serve as a good pattern to follow.

We are getting better and better

In line with the assumptions of the DIT strategy adopted in Poland in 1998, our central bank has also been pursuing intensive actions aimed at enhancing transparency of the monetary policy. Our situation in this field appears much better than before 1998. A gradual improvement of transparency in the actions of the Polish central bank can be observed since that time. The MPC modified the form of inflation reports that the NBP has been publishing since 1995 and improved their quality as well as increased the frequency of their publication. One should also view very positively the publication of documents containing the bank's strategy in the short-term (policy assumptions for a given year) and in the medium-term (the medium term strategy for the years 1998-2003, as wells as the monetary policy strategy beyond 2003). Publishing reports on monetary policy implementation outlining the performance of the monetary policy, which like inflation reports contain the assessment of target performance, is also of great importance.

The decision of the MPC about increasing the frequency of its meetings and holding them on a regular basis every month also contributed to the transparency of the monetary policy. A good practice is also the Council's immediate communication of its decisions (the decision is announced on the same day it is made), which is not a rule by any means as, for example, the central bank of Slovenia does not do it. The NBP deserves praise for publishing attributed voting records on motions submitted during the meetings of the Council. This practice is pursued among a relatively small number of countries. For instance, the National Bank of Hungary does not publish the voting records at all and the Czech central bank discloses only non-attributed voting records. It also needs to be appreciated that the MPC explains their decisions both through formal press releases and during press conferences several hours after a decision announcement. Some of the central banks, for example the Hungarian do not explain their decisions directly after taking them.

The fact that the MPC communicates the so-called bias in the monetary policy (quite a rare approach among other central banks) can also be regarded as a useful tool for enhancing transparency. Admittedly, there was a lot of commotion caused by the previous Council that systematically cut interest rates with a neutral bias, but the new Council has recently sorted out that issue (not without some problems given confusion caused by this in the financial market).

Last, but not least, the consistent struggle by the MPC towards making the zloty rate fully float has greatly contributed to improving the transparency of our monetary policy. The example of the Hungarians who changed the interest rates in a surprising manner to maintain the forint within the exchange rate band, clearly shows how important for the transparency of monetary policy conducted as a part of the DIT strategy is the absence of any obligations of the central bank in relation to exchange rate. In this respect, the Polish central bank can be cast as a role model, especially among the countries in our region which adhere to the DIT strategy.

... but still far from the ideal

Despite a systematic and visible improvement in transparency in the functioning of the Polish central bank, there is still room for improvement so that the monetary policy could be yet more transparent for the public. Obviously, the issue of inflation forecasts comes first. The table below proves that the NBP is the only central bank among countries following the DIT strategy which does not publish such forecasts in any form.

Inflation forecasts in DIT countries

	Shown?	Is the body responsible for decisions an "owner" of the forecast?
Australia	Yes	No
Brazil	Yes	No
Canada	Yes	Yes
Chile	Yes	No
Czech Republic	Yes	No
Hungary	Yes	No
Iceland	Yes	No
Israel	Yes	No
Mexico	Yes	No
New Zealand	Yes	Yes
Norway	Yes	No
Peru	Yes	No
Philippines	Yes	No
Poland	**No**	**-**
South Africa	Yes	Yes
South Korea	Yes	No
Sweden	Yes	Yes
Switzerland	Yes	Yes
Thailand	Yes	Yes
UK	Yes	Yes

Source: A. Fracasso, H. Genberg, C. Wyplosz, „How Do Central Banks Write? An Evaluation of Inflation Targeting Central Banks", Geneva Reports on the World Economy Special Report 2, May 2003

It has been announced for quite a time that the Polish central bank would start publishing inflation projections. The new MPC have promised that it will happen shortly. It is not known though whether the Council will subscribe to such projections or whether it will only be a projection of the NBP staff. It seems that only in the former case there would be a chance to enhance the transparency of policy pursued by the MPC. As regards projections whose 'owners' would be NBP staff and assuming that these might be sometimes ignored by the Council, in some respects such projections might mislead the public thus contributing to uncertainty. As shown in the table, a body responsible for monetary policy decisions is the owner of inflation forecasts in the minority of central banks publishing them (7 out of 19). However, it is worth noticing that this is the case in the banks, which are regarded as the most credible.

Economic literature argues sometimes that a formalised inflation forecast is not an indispensable element of DIT strategy – perhaps it would be possible to dispense with it. However, a commonly accepted view is that the central bank actions and policies must be forward-looking. Unfortunately, the inflation reports of the central bank dwell much more on discussing current developments in the Polish economy rather than on explaining the effects of the internal anti-inflation policy and at least a verbal assessment of inflation outlook.

Apart from inflation forecasts, publishing the minutes of the Council meetings would also be very useful in predicting central bank decisions. A controversial issue is still what time slippage there would be before publishing such minutes and whether it would be a literal transcript with the names of speakers indicated or a general file note outlining arguments raised without ascribing them to particular members of the Council. At any rate, the publication of some form of minutes of the MPC meetings would be worth considering. This might give some more information about the decision-making mechanisms of a body with as many members as the Polish MPC (the largest number among countries with a DIT strategy). It might, at least to some extent, compensate for the recently visible withdrawal of the Council members from the public eye.

A factor which obscures the transparency of Polish monetary policy is an issue of change in inflation targets. The previous MPC modified the inflation targets twice – in 1999 and 2002 (in both cases the change did not help and the Council failed to meet the modified targets). When changing the targets, the MPC explained that such action was necessary to maintain transparency of the monetary policy in significantly changed economic conditions. In view of the fact that the rules of changing the target had neither been determined nor publicly announced before, that modification led to obscuring transparency of the monetary policy and undermining its credibility. The absence of rules specified for changing the inflation target and the fact that targets were changed in the past can make people expect it in the future, and such expectations may in turn question the credibility of the target initially set (without actual change) and its consistent pursuit.

The issue of changing inflation targets is also related to determining the conditions under which missing the inflation targets is acceptable (known as the escape clause). The MPC very often, and rightly, stresses that the Polish economy is strongly liable to exogenous shock (e.g. supply shocks on the fuel and food markets). Trying to remedy the direct effects of such developments by means of the instruments of the monetary policy is impossible and any attempts in this respect may appear very costly. As we know, the inflation targets in Poland have been regularly exceeded (both in terms of undershooting and overshooting), largely because of the reasons mentioned above, as they lie outside the scope of monetary policy. Because they still have a major influence on inflation in Poland and setting a range of deviations from the inflation targets did not prove effective, it seems that the adoption of an escape clause would be a justified solution.

The shortcomings of transparency in Polish monetary policy are unfortunately noticeable in such basic issues as the procedures for data publication. One of the key factors considered by the MPC when making decisions are inflation expectations. In statements after recent MPC meetings this factor was at the top of the list of risk factors contributing to higher inflation. Meanwhile, data on inflation expectations compiled by the NBP on the basis of the Ipsos institute's survey are usually revealed only in statements after the Council meeting. Obviously enough, this does not facilitate predicting monetary policy decisions.

Also, financial market participants find the lack of a schedule of sessions of the Council several months ahead a great disadvantage as this type of information is of great importance to investors in the market of future interest rate. Most of the central banks realise the importance of a precise schedule of rate-setters' meetings for the market. For example, the web site of the Fed contains a schedule of FOMC meetings until January 2006 inclusive. Perhaps the Polish MPC might follow foreign experiences also in another matter and always announce monetary policy decisions at the same time. This might contribute to increased effectiveness in the financial market on the day of the Council meeting. Undoubtedly, the timing of announcing such decisions affects the activity of market players. Without relevant information publicised by the MPC, a period of lower market activity right before a decision announcement may be unnecessarily lengthened or unexpectedly shortened.

Confused targets

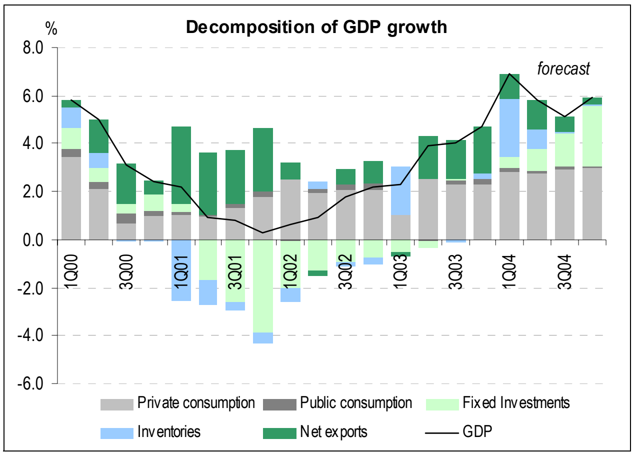
In the end, we would like to touch on the issue which is crucial to the DIT strategy, i.e. the clarity of inflation targets. In its *2002 Monetary Policy Assumptions,* the MPC changed the form of the inflation target. The Council replaced the target applied earlier in the form of a specific range (e.g. 6-8% as at the end of 2001) with defining a point target with a permissible deviation range (e.g. 3% +/- 1 pp as at the end of 2003). While presenting the rationale behind the change, the MPC stated that the change was driven by their conviction that paralleled to the reduction in the price growth rate the inflation target should be set more clearly. However, they set the permissible deviation range in view of the obvious uncertainty as to the conditions required for the achievement of the inflation target which are independent of monetary policy (i.e. supply shocks, foreign exchange movements etc.).

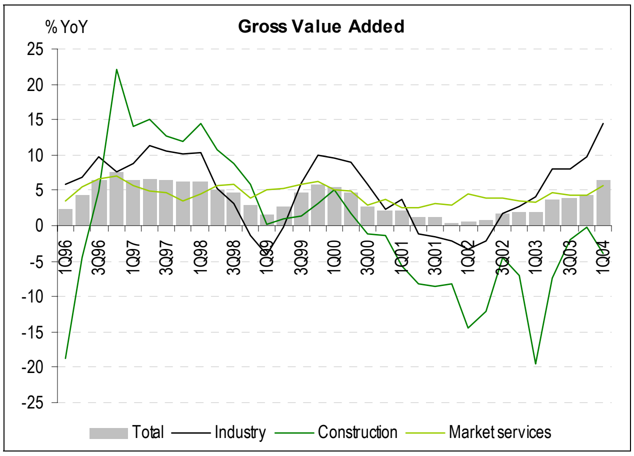
The new form of the inflation target was also applied to setting the continuous inflation target after 2003 - it is to be 2.5% +/- 1 pp. Not that long ago, the importance of the formula adopted a few years ago was stressed by MPC member Dariusz Filar. In his interview with Reuters, dated 18 May, he said: "It must be borne in mind that the 1 pp margins around the inflation target of 2.5% are only a kind of a safety valve while the inflation target figure, that is the 2.5%, is the centre of our attention." Similar view was presented by NBP governor Leszek Balcerowicz on July 8. On the other hand, in the MPC statement dated 27 April this year, one could read that it was feasible that the "upper end of the inflation target would be exceeded." Similar statements were also made by some other central bankers. Making statements like that, the central bank is kind of undermining its own efforts to focus the attention of the monetary policy audience on the central point of the inflation target. This evidently blurs the transparency of the monetary policy. Focus on the central point of the inflation target was a clear guideline about what level of inflation (upwards or downwards) will trigger the relevant response of the MPC. It also was a clear message for all who formulate inflation expectations (households, financial market participants). A concern may be raised whether, in the Polish environment (which often triggers substantial fluctuations in the inflation rate), setting the inflation target in the form of a point with a margin around the target will not cause instability in the policy instrument or excessive interest rate movements in a situation where the central bank will respond to each deviation from the central point of the inflation target. The answer to this could be the return to the formula based on the inflation range. However, this might be treated as a weakening in the determination to curb inflation rather than an indication of the central bank's intention of improving the mechanisms of monetary policy.

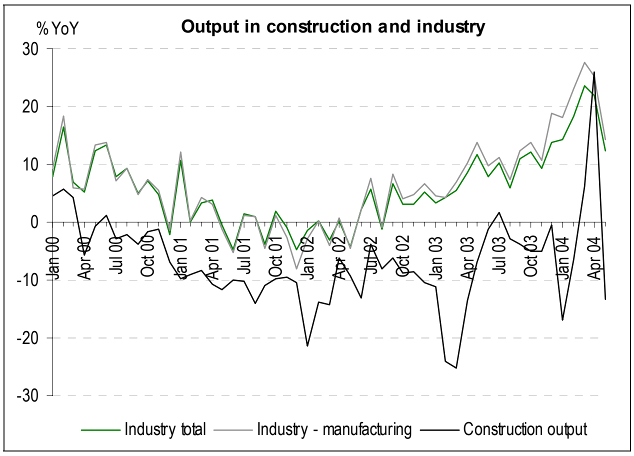
Either way, in their statements and official documents central bankers tend to point to the importance of the upper end of the margin around of the inflation target (at the cost of losing focus on the central point of the inflation target) and suggest that one may expect a reaction on the part of the MPC only after the upper limit has been exceeded. This shows that the target defined as a point with margins is actually becoming a target in the form of a range. What makes it worse, in this case is that the band can be named a *band-of-indifference*. We can talk about such a phenomenon when the monetary policy audience is of the opinion that as long as the inflation fluctuate within the defined range (between 1.5-3.5% in the Polish scenario) no response from the central bank is expected. Monetary authorities are expected to step into action only after the upper (or lower) end of the inflation target range has been exceeded. This phenomenon increases the risk that the upper end of the inflation target will really be exceeded and there will be long-term deviations from the inflation target. This is why it seems to us that the MPC should avoid statements that might suggest that the upper end of the inflation target was the key factor in their decision-making. This is important as inflation expectations are of key importance for the MPC. It may turn out that as a result of stressing the importance of the upper end to the inflation target the upper end itself may become the focus of inflation expectations, instead of the central point of the inflation target (a phenomenon called *range bias*).

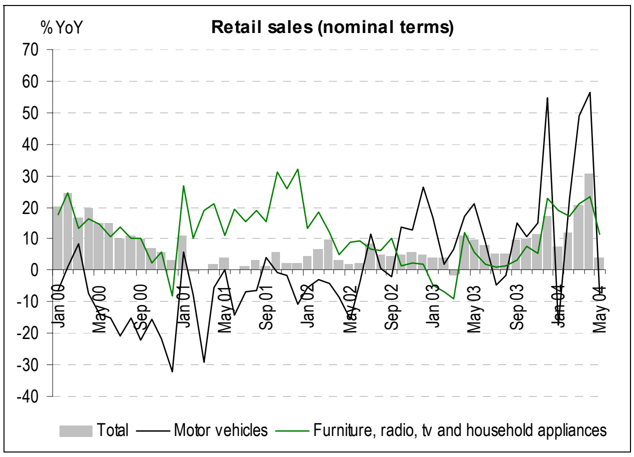
Summing up, the Polish central bank has been on a long journey to reach a viable level of transparency in monetary policy. In some areas, we lag behind other countries whereas in others we outperform them. In general, however, we are still far from OK and there is a lot to be done to arrive at optimal transparency in monetary policy. Fortunately, in many cases it does not necessary to resolve some very serious dilemmas (as in the case of publishing inflation forecasts) but merely requires listening intently to the needs of policy recipients and a little bit of good will on the part of central bankers.

Economic update









Source: CSO, BZWBK own estimates

GDP growth in 1Q04 at nearly 7%!

- In 1Q04 Polish economy was expanding at the fastest rate since 1997. GDP growth strongly exceeded expectations, reaching 6.9% against 4.7% in 4Q03.
- Rapid surge in economic growth rate was largely contributed by stock changes (as much as PLN5bn). It added ca. 2.5 pct. points to the GDP growth rate (see graph on the left).
- ... this could have resulted from the economic developments that took place just before the EU accession (e.g. higher imports), and does not confirm a persistent recovery in domestic demand.
- Rise in private consumption remained almost unchanged at 4%. It is robust growth, however it does not represent a strong revival in consumption demand.
- The long-awaited rebound in investment outlays took place, albeit only moderately. Investments in 1Q04 barely rose by 3.5%YoY (against a very low reference base) compared to growth of 0.1%YoY for 4Q03.
- Net exports' contribution to GDP growth went down to 1 pct. point from nearly 2 pts in 4Q03 (perhaps due to import-stimulating stocking up before the EU accession).
- According to the deputy CSO president Janusz Witkowski the GDP growth in 2Q04 was still high, yet lower than the 6.9% reached in 1Q04. However, it should be coupled with accelerating investment growth. Deputy PM Jerzy Hausner believes the GDP grew 6% in the second quarter, while we forecast 5.8%.
- It seems more and more likely that GDP growth for the whole of 2004 will reach 6%. This will be possible if the recovery in the investment process gains more strength in the coming quarters.

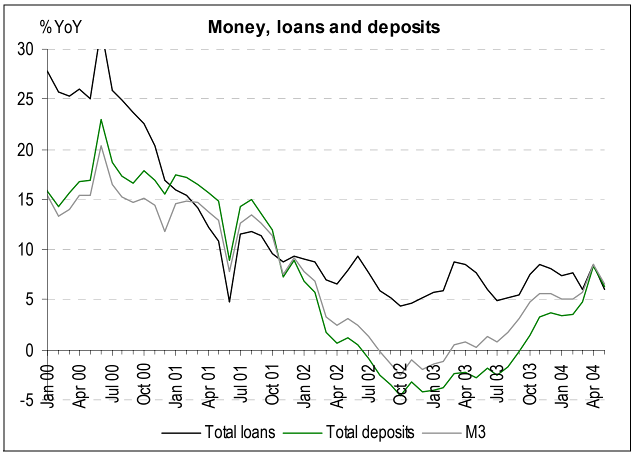
Post-accession slowdown in output growth

- After extraordinarily strong upsurge in indicators of real economic activity recorded just before the EU accession, May saw significant downturn in the variables. Industrial output growth reached 12.3%YoY after 22-23% rise in March-April.
- In spite of this slowdown, the growth in production should still be regarded as relatively strong and consistent with the continuing trend of recovery in Polish industry. Production growth after seasonal adjustment reached 15.3%YoY, which is still one of the highest results recorded so far.
- Upturn in construction output in April by almost 26%YoY proved to be a one-off event, also caused by expectations related to EU entry. In May output in construction sector plummeted 13.4%YoY, and the seasonally adjusted fall amounted to 6.8%YoY.

... as well as in retail sales growth

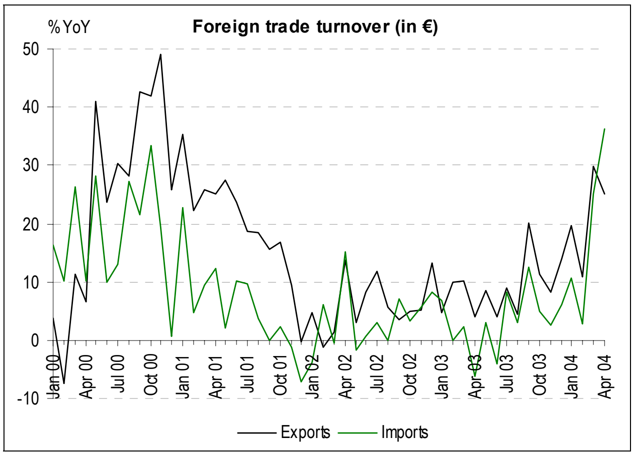
- Retail sales in May were more than 20% lower than in April, while its annual growth dropped to merely 4% from 30.6%YoY in the previous month.
- The slowdown in growth resulted mostly from a downturn in car sales (-40.1%MoM and –7.8%YoY, against a gigantic growth of 56.3%YoY in April).
- Still, the average retail sales growth in April-May period reached 17.3%, which is a very good result.
- It is still too early to fully assess the impact of EU accession on the medium-term growth of retail sales and other economic indices (even the data for June does not give the complete answer). However, we believe that fairly stable growth in private consumption will remain in the second half of 2004.

Economic update



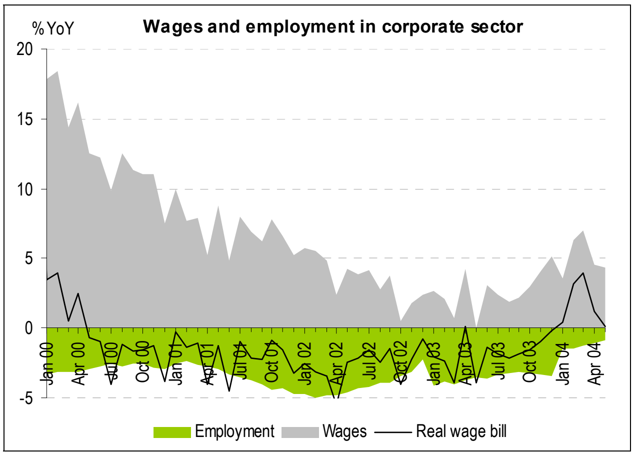
Money supply also influenced by the EU accession

- After one-off surge in April to 8.5%YoY (resulting partly from companies' activity before EU accession), money supply growth slowed down in May to 6.5%YoY. An almost identical drop in growth was recorded for total deposits and total loans.
- Households' deposits still lower than last year (-1.8%). In turn deposits accumulated by non-financial firms – despite a slight drop – remain over 30% higher than in the corresponding period for 2003.
- Vigorous growth on the households' credit market continues (16.5%YoY), being fuelled mostly by the boom in mortgage loans. Credits for companies plummeted sharply (by PLN3.6bn since end-April) and were 2.3% lower than in May 2003 (in April they grew 0.5%YoY).



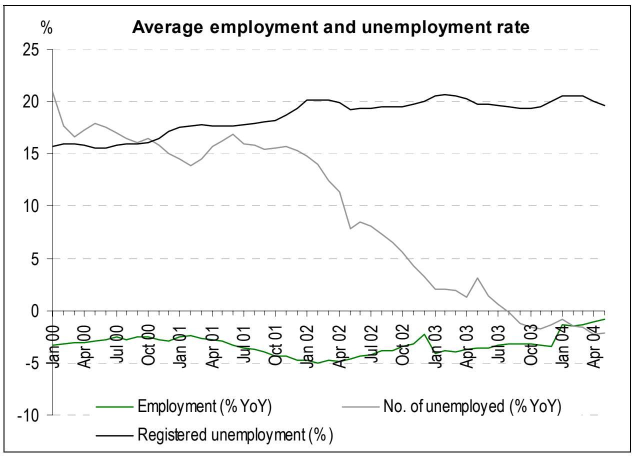
... as well as balance of payments figures for April

- As with other economic variables, balance of payments data were strongly affected by the atypical consumers' and entrepreneurs' behaviour in April, just before the EU accession.
- Current account deficit reached €611m in April against €482m in March and €353m in April 2003. Trade deficit jumped to €1.1bn from €461m in March and €443m a year ago.
- Imports grew strongly by 8.1%MoM and 36.3%YoY. At the same time, exports decreased 2.5%MoM and rose 25%YoY.
- One should not draw too strong conclusions from this data. The fears connected with the EU accession resulted in an extraordinary shopping spree in April, which biased the statistical figures (a similar effect took place in output and sales). This effect should cease in the second half of the year.



Bitter-sweet data from the labour market

- Wage rises in the corporate sector reached 4.4%YoY in May, much below expectations. High unemployment is clearly constraining wage pressure in the economy.
- Average employment in enterprises still lower than last year (-0.9%YoY against –1.1% in April), however it inched up by 0.1% since April. A second consecutive monthly rise in employment gives some hope for improvement on the labour market in the coming months. However, the progress should be rather moderate and slow.
- The wage bill in the corporate sector rose 3.5%YoY in May. However, mounting inflation rate "eats up" its real purchasing power – the real wage bill inched up by just 0.1%YoY. The data suggest that there should be no pressure on prices arising from the labour market in the coming months.

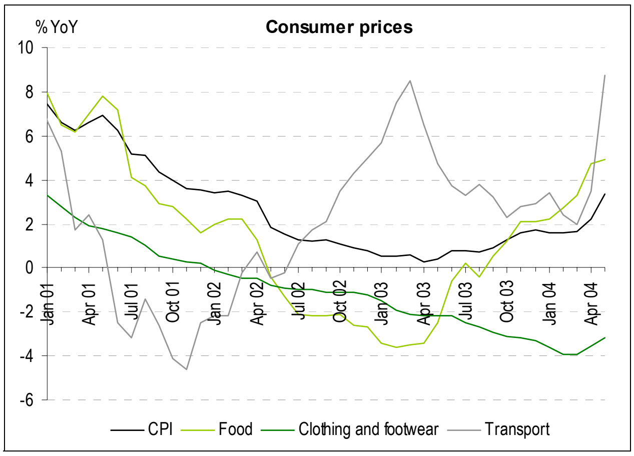


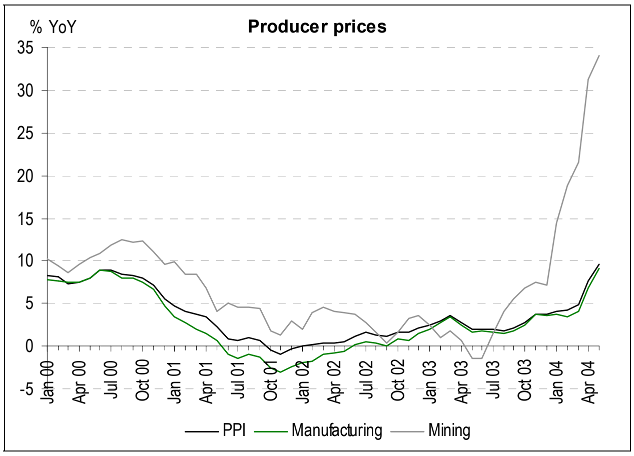
Source: CSO, NBP, BZWBK own estimates

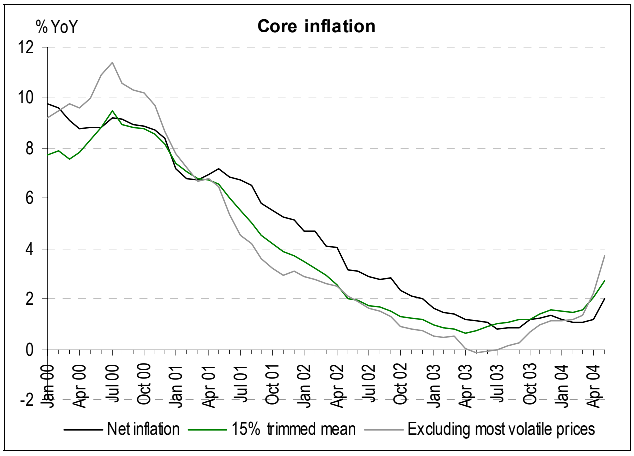
Unemployment lower mostly due to seasonal effect

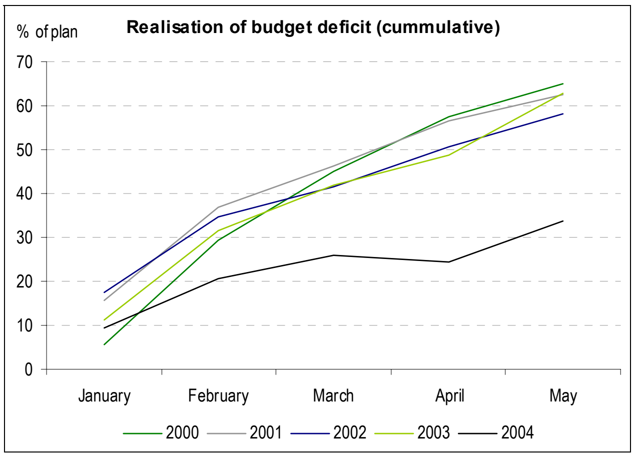
- Registered unemployment rate fell to 19.6% in May from 20% in April, while the number of unemployed dropped by 81,300.
- Unfortunately, the fall resulted almost exclusively from the seasonal effect. In relation to May 2003 the unemployment rate was only 0.2 pct. points lower, which suggests that the demand for labour remains indifferent to stronger and stronger signs of economic recovery. It is also reflected by the number of new job offers, which was lower than last year and in April.
- Even though a slight improvement, reflected in a minor rise in employment, has already begun, this process is still clearly lagging behind most of the macroeconomic data describing the level of activity in Polish economy.

Economic update









Source: CSO, NBP, Ministry of Finance, BZWBK own estimates

Strong inflation rebound after the EU accession

▪ Unexpectedly strong CPI growth in May – after the accession to the EU, prices rose 1%MoM and the annual inflation rate jumped to 3.4% from 2.2%YoY in April.

▪ Main sources of rapid inflation surge were: fuel prices (growing 5.6%MoM), housing and energy costs (1.9%MoM), and household's maintenance (1.1%MoM). Prices of food, clothing and footwear were also pro-inflationary, however much weaker.

▪ Faster growth in retail prices was thus largely connected with Poland's accession to the EU. According to the NBP's estimates the direct effect of EU entry was responsible for almost half of monthly price increases in May.

▪ This is not the end of price rises after the EU accession. In June, the inflation rate could reach 4.3%YoY, mostly because of sharp rises in food prices. In the first half of June, these prices went up by 2.4%MoM, which resulted to a large extent from strong demand for Polish meat and dairy products from Western EU countries.

▪ Thus, inflation rate is very likely to breach the upper end of the inflation target as early as June. At the end of summer and in the autumn, one could expect inflation to fall gradually, amid collapsing food prices. Nevertheless, it is likely to stay above the target until the middle of 2005.

▪ The rise in producer prices was also much stronger than expected, reaching 1.2%MoM and 9.6%YoY. It was the highest growth since December 1997.

▪ As in the previous month, the surge in PPI resulted mostly from a sharp rise in the sectors producing and processing natural resources and metals. Also, some growth (although much weaker) was observed in the production of food, clothes, tools and machinery – to a large extent it could have resulted from a one-off rise in VAT taxes after 1 May.

Core inflation also rising, although weaker

▪ Core inflation rose in May, following the headline inflation rate.

▪ Two most important indices increased much weaker than the CPI. Net inflation rose to 2%YoY from 1.2%YoY in April, while the 15%-trimmed mean rose to 2.7%YoY from 2.1% a month before.

▪ Growth in the remaining three measures was stronger. CPI excluding controlled prices increased to 3.2%YoY from 2.3%YoY a month ago, CPI excluding the most volatile prices and fuel prices went up to 3.2%YoY from 2.1%YoY in April and CPI excluding the most volatile prices jumped to 3.7%YoY from 2.2%YoY in the previous month.

▪ The figures showed that although inflation is set to accelerate in the immediate future, there is no significant threat to the inflation target from the underlying inflationary pressure in the medium-term.

Central budget results still positive

▪ Central budget deficit reached PLN15.bn at the end of May, i.e. 33.8% of the plan for 2004. Total budget revenues grew robustly by 9.1%YoY and after five months of this year reached PLN61.8bn, i.e. 68% of the annual plan.

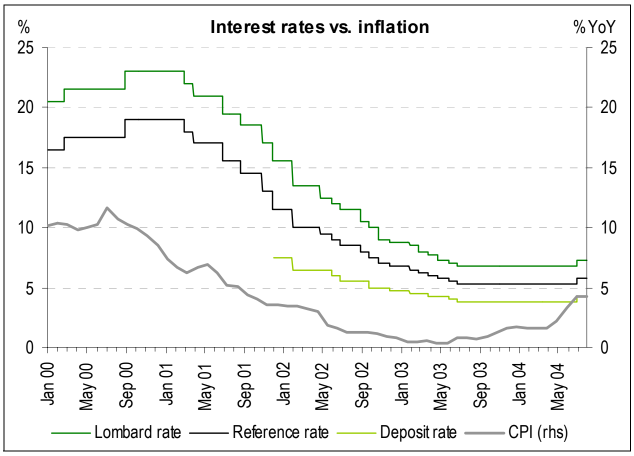
▪ There was no downturn in VAT revenues in May.

▪ There is a high probability that budget deficit in the entire year will be lower than planned in the Budget Act (PLN45.3bn), although officials from the Ministry of Finance remain sceptical.

▪ The liquidity surplus remains at very high level, which should increase the flexibility of the Finance Ministry at the auctions of treasuries in the remaining part of the year.

▪ In June the NBP transferred its 2003 profit to the budget. The realisation of budget deficit reached ca. 45% of the annual plan.

Central bank watch



Rate hike already in June. And what a rise!

▪ At the beginning of June we expected a rate hike in July only, but after surprisingly high inflation data (3.4% in May), an interest rates increase in June seemed inevitable.

▪ Nevertheless, the MPC surprised the financial market with the scale of the increase – 50 bps against expectations of 25 bps.

▪ It seems the market now expects another 50bps in three-months time. This is close to our view, as we think that another 50bps is highly possible relatively soon, as consumer inflation is likely to stay above the central bank target (of 2.5% +/- 1pp) for a couple of months.

▪ In our opinion, June's decision did not change the outlook for official rates up to the end of 2005. We still expect something like a 100bps increase within the next 12 months.

Important elements of the MPC statement from 30 June 2004
Observed acceleration of inflation is to a large extent a result of the growth in the prices of fuels and food, an increase in indirect tax rates and other factors connected with Poland's EU accession. This type of price increases does not have to lead to a permanently increased inflation if it does not strengthen inflationary expectations and in effect does not lead to further increase in salaries and prices.
Risk of inflation growth, which is connected with increasing inflationary expectations, is increased by a significant growth in domestic demand. Conducted analyses indicate that the slowing down of the growth rate of the PPI and of retail sales, noted in May 2004, resulted chiefly from the compensatory acceleration effect during the period of March-April, connected with Poland's EU accession. This means maintenance of the strong growth trend of these measurements which has been observed for many months.
Endeavouring that the increased inflation has a transitory character and that, after the expiry of extraordinary factors, it returns to a level in line with the MPC's inflationary target (2.5%), the Council has resolved to raise the NBP rates by 0.5 point percentage.
Monetary policy is conducted with a lax fiscal policy and a lack of clear perspectives as to the scale of reforms, which could lead to the recovery of public finances.
Supply factors may lead to a further increase in inflationary pressure. Oil prices continue at a high level and the forecast prices were very insignificantly decreased.

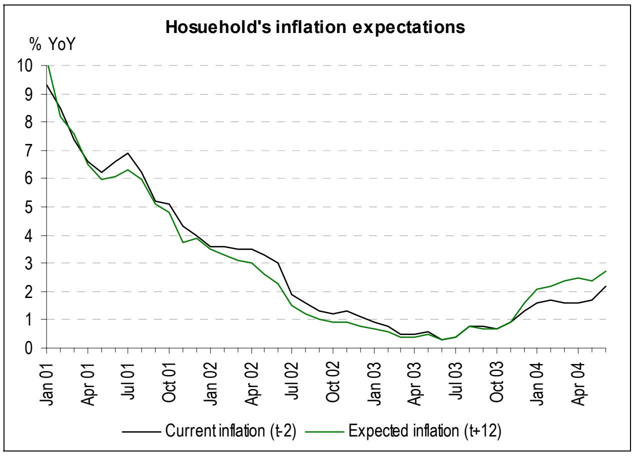
MPC counteracts an increase in inflation expectations

▪ Arguments supporting low inflation in the future included: low business credit, high productivity in industry, high unemployment rate limiting wage pressure (low wages were mentioned for the first time for a couple of months).

▪ The increase in households' expectations of future inflation (up to 2.7% in June from 2.4%) was one of the most important arguments (in first position in the statement) behind the rate hike.

▪ As regards current inflation performance, the MPC stressed the recent growth was caused by high food and fuel prices, as well as a one-off effect connected with EU accession.

▪ The Council also emphasized that increase in CPI inflation does not necessarily have to lead to higher expectations of inflation and the hike was aimed at keeping CPI inflation within the target, after the above-mentioned one-off shocks cease.



… but it boils down to reacting to current inflation

▪ It is quite interesting that data on June's inflation expectations was published after the MPC decision, during press conference.

▪ According to the Ipsos opinion poll, households' expectations of inflation "fell again significantly in June".

▪ Inflation expectations calculated by the central bank strongly depend on the current inflation rate, and June's poll was conducted after the release of April's inflation rate.

▪ Therefore, one should expect that the next data on households' inflation expectations will again indicate a sharp increase, as CPI inflation went up in May to 3.4% and to above 4% in June.

▪ Even if the central bank could state that it is trying to counteract the secondary effects of rising inflation expectations, in practice it is just reacting to the current inflation rate.

Structure of prices dynamics

Factor	Feb	Mar	Apr	May
Demand	-0.01	0.08	0.11	0.21
Supply	0.07	0.20	0.36	0.37
UE	0.04	0.03	0.30	0.46
Inflation	0.10	0.32	0.77	1.03

Share of specific factors in monthly CPI growth (in %)

Factor	Feb	Mar	Apr	May
Demand	-8.1	26.3	14.0	20.0
Supply	70.2	63.8	46.7	35.4
UE	37.9	9.9	39.3	44.6
Inflation	100.0	100.0	100.0	100.0

Source: CSO, NBP

NBP on prices after EU accession

▪ The NBP summarised the results of the monitoring of price movements after Poland's entry to the EU.

▪ The highest rise in prices after joining the EU took place in food prices (prices of rice up by 27,7%, beef 21,7%, bananas 18%, many others more than 5%).

▪ In the case of many products the expected drop in prices have not yet appeared, but the central bank expects them to do so in the coming months.

▪ The NBP maintained its estimate of the direct effect of EU entry on prices (annual average inflation in 2004 higher by 0.9pp), but it was surprised by the indirect effect of the accession, such as the substantially increased external demand for Polish foodstuffs.

▪ Share of demand-side factors influencing inflation is stable and relatively low as compared to other factors.

Central bank watch

Comments of the central bank representatives	Remarks
Leszek Balcerowicz, prezes NBP; PAP, TVN24, press conference after MPC meeting, 30 June The MPC decided to raise all interest rates by 50bps. The decision reflects the importance which the MPC attach to maintaining low inflation in Poland. We have carefully analysed cases in which central banks, which had achieved low inflation level, faced a risk of inflation acceleration. There was no example of a reaction which would be limited to only one move. Interest rates hikes were usually higher than previous reductions.	Most comments of MPC members after the interest rate hike indicated that this was not a single move and one should expect a continuation of monetary tightening in the future. NBP president said the central bank's staff had analysed other central banks' experiences in lowering inflation or rather in preventing inflation from rising after successfully bringing it down. The conclusion was that success was never achieved by limiting interest rate hikes to only one move. Additionally, the NBP chief said in a television interview that in these cases "interest rates hikes were usually higher than previous reductions". So, more hikes will come soon and these are likely to be 50bps movements.
Jerzy Pruski, deputy NBP governor; PAP, 15 June A joint commission of Ministry of Finance and the NBP has discussed the FX rate. At this stage a consensus boiled down to the opinion that the future rate of the zloty against the euro should reflect the latest broadly understood market tendencies and the fundamental needs of the Polish economy, so that it is convergent with Poland's long-term interest. The FX rate cannot be too strong as it will be no good for the competitiveness of the economy and should not be too weak because it will have a pro-inflationary impact.	At the end of last year, NBP representatives were saying that there was a chance of starting ERM-2 negotiations in 2003. Well, the economic situation has complicated amid no political will to implement the necessary changes in the Polish public finance sector, which has delayed the process of accession to the euro zone. As Poland would like to enter the ERM-2 mechanism for the shortest possible period (of two years), negotiations in this regard were postponed. That is why, current meetings of a joint commission of the Ministry of Finance and the NBP boil down to very general conclusions and statements. Nevertheless, in the meantime, other countries which recently joined the EU (Estonia. Lithuania, Slovenia) have already joined the ERM-2 mechanism and it is quite possible they will join the euro zone in 2007.
Jan Czekaj, MPC member; Reuters, 23 June The Council has changed its policy bias to tightening and I do not rule out a decision in the near future to raise rates. I don't know if it will be 25 or 50 or 75 or 100 basis points. Nevertheless, undoubtedly today the likelihood of interest rate hikes is much higher than that of rate cuts, or even keeping rates unchanged. Compared to what we knew last month, the most significant change is the actual inflation rate and inflation expectations which one can expect will rise too. Other factors roughly matched the expectations. […] Monetary policy is now at very difficult moment. Actual inflation amounted to 3.4% in May and we are very close to the upper end of the inflation target. Obviously this must cause specific worries to the MPC.	There have been quite a few comments from the MPC members after higher than expected inflation data for May. However, they seemed to unambiguously indicate the inevitability of a more restrictive monetary policy in the near future. The statement of Jan Czekaj, shown in the left-hand column, confirmed market expectations about a very likely interest hike in June. However, it is worth remembering his comment dated 15th June, just after the publication of inflation data, when he was much more reserved, saying "today, we cannot say clearly whether it is caused by the supply or demand shocks […] June should clarify the situation". It is evident that CPI figure for May was so very shocking that the Council did not decide to wait for the next months data to be published. The phrase "compared to what we knew last month, the most significant change is the actual inflation rate" clearly suggests that the current CPI inflation rate will be the most important economic indicator, which will inform us about the prospects of interest rates in future.
Dariusz Filar, MPC member; Reuters, MPC press conference, 30 June Impulse from the food prices will recede soon. Monetary policy impulses act with a time-lag. We are making the decision now so that inflation would be expected to be lower next year. The process of interest rate hikes is currently going on all over the world, it is discussed by the Fed. All the economic journals in the world are wondering how long this process will last and what the scale of hikes will be, not whether there will be any hikes.	Increase in CPI inflation rate in recent months was driven by factors independent of monetary policy and this is also likely to be the case in the near future. Dariusz Filar emphasised that current high inflation rate was connected with high food prices and this impulse should recede soon. This is also our view that CPI inflation will lower when one-off factors disappear. And this will take place already next year, and most likely will not even depend on whether or not the MPC raise interest rates. But really, it is not worth analysing whether next rate hikes will take place in Poland or not. It is only a question of timing and scale.
Mirosław Pietrewicz, MPC member; Reuters, 14 June Inflation in May was higher than expected. This was the result of anxiety over our membership in the EU and price adjustments. At our June meeting, the Monetary Policy Council will have to very seriously consider the problem of price pressure.	Even Mirosław Pietrewicz, who can hardly be perceived as a supporter of restrictive monetary policy, stated the MPC had to seriously think about higher inflationary pressure, despite the fact that inflation increase in June was driven purely by one-off factors. This was also the signal that a rate hike was coming. However, it is interesting whether Mirosław Pietrewicz voted in favour of a hike as high as 50 bps.
Halina Wasilewska-Trenkner, MPC member; PAP, Reuters, 1 July I like to have 1% inflation, but I would rather have increasingly higher income even at the cost of slightly higher inflation if it is not faster than the increase in my income. […] Therefore economic growth is a value which in my opinion should be prized above all other variables, such as inflation. MPC press conference, 30 June We want to reassure households that we will not look on idly at rising inflation, but we will aim, at all costs, at maintaining a low level of inflation. The decisions will be made that will keep a tight rein on inflation.	The MPC strongly stressed they were ready to do everything so that inflation stayed at low level, but the message was not entirely consistent. During the press conference after the meeting, MPC member Halina Wasilewska-Trenkner said that inflation was an absolute priority and the central bank would aim at all costs at keeping price growth at low level. Such a decisive message, sent by the whole MPC, was intended to enable constraining any rise in inflation expectations. However, one day later Wasilewska-Trenkner stated that inflation is not of the utmost importance. According to her, the priority is economic growth. Does it mean that not all MPC members feel like raising interest rates aggressively?

Government and politics

Budget macroeconomic assumptions for 2005

	2004 budget	2005 assumptions
Revenues (PLNm)	154 553	168 400
Expenditures (PLNm)	199 852	207 200
Budget deficit (PLNm)	45 300	38 800
Budget deficit (% of GDP)	5.3	4.1
GDP (%YoY)	5.7	5.0
Domestic demand (%YoY)	4.6	4.8
Individual consumption (%YoY)	3.8	3.4
Fixed investments (%YoY)	8.3	10.8
Unemployment rate (%)	19.0	17.9
Inflation (%, annual average)	2.5	2.8
NBP ref. rate (%, annual average)	5.3	6.2

Macroeconomic budget assumptions accepted

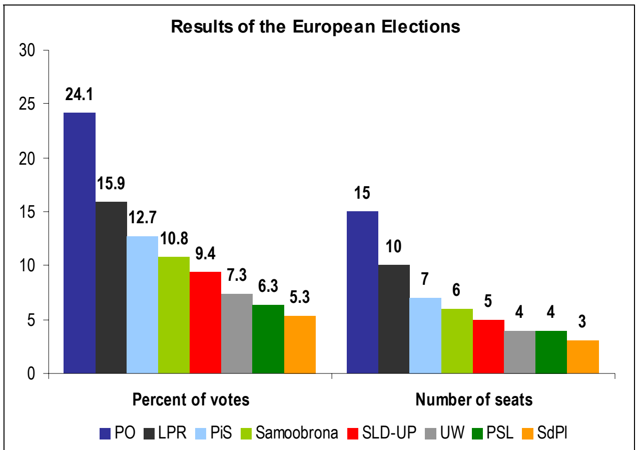
- Budget deficit in 2005 would be PLN38.8bn, but the Ministry of Finance added it was possible to lower it by PLN3.2-3.7bn, assuming that the full version of the Hausner plan was accepted.
- However, the Ministry of Finance wrote that the "forecasted level of public spending is the result, amongst other things, of the financial effects of the fiscal consolidation plan".
- This mean that during further work on next year's budget, the planned deficit may go up rather than down, as change in pension indexation scheme and change in the rural pensions system (KRUS) are not certain.
- Macroeconomic assumptions for the budget for 2005 are quite cautious, which is positive, as it is possible that budgetary revenues will be higher than assumed, as we believe will also be the case this year.

Vote of confidence for Marek Belka's cabinet

	FOR	AGAINST	Abstained	Absent
SLD	156			1
UP	15			
FKP	15			2
SdPl	33			
Unaffiliated	16	2		1
PO		55		
PiS		43		
PSL		36	1	1
LPR		24		1
Samoobrona		31		
Minor caucuses	1	24		1
SUM	**236**	**215**	**1**	**7**

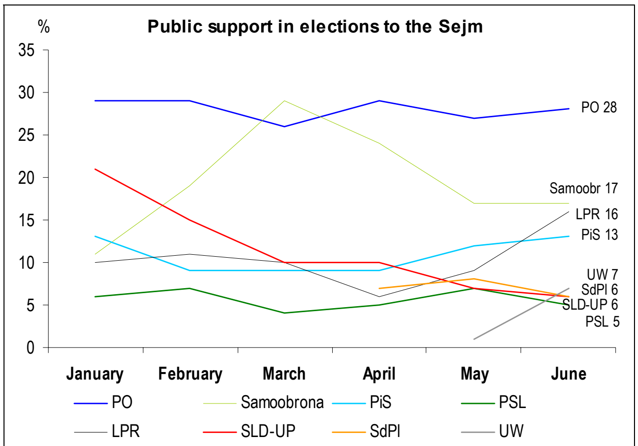
Belka wins! Will the optimism stay for long?

- Marek Belka won the second parliamentary vote of confidence. Deputies voted 236 to 215 (with one abstention) in favour of Belka.
- The vote ended several months of political instability, but not for long, as Belka vowed to call another vote of confidence in October.
- This was one of the conditions demanded by the SdPl. Other conditions mean watering down the government's plan for public finance reform.
- Therefore, if the cabinet wants to win the vote of confidence in the autumn, the scale of possible fiscal savings is limited.
- Belka's victory means improved sentiment on the market in the short-run, but in future investors should recall problems with the implementation of public finance reform.



Civic Platform won, very low turnout

- The clear winner of the European elections in Poland was the Civic Platform (PO). In spite of pre-election opinion polls, the League of Polish Families (LPR) took second place and Law and Justice (PiS) took third place.
- Self-Defence (Samoobrona) gained much lower support than suggested in pre-election opinion polls.
- The support for the SLD-UP was higher than for the PSL and the SdPl, which probably had its significance during the vote of confidence for Marek Belka's cabinet.
- It is extremely difficult (if not impossible) to draw any conclusions from the results of parliamentary elections as regards elections to the domestic parliament, as the turnout was extremely low and only marginally exceeded 20%.



European elections helped some parties

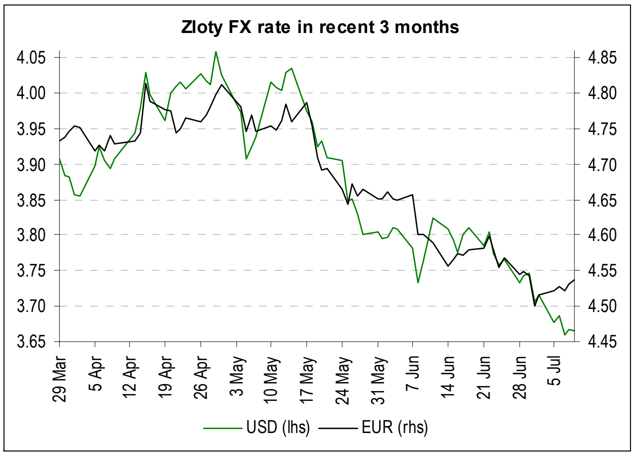
- According to CBOS opinion poll, in elections to the domestic parliament the highest number of people would vote for PO, then Samoobrona and LPR almost ex aequo in second place.
- PiS and Freedom Union (UW) come after the first three parties.
- Joint support for PO, PiS and UW amounted in June to 48%.
- European elections helped the Freedom Union and the Social democracy (SdPl) as they maintain support of above 5%.
- People polled were also asked about expected trend in support for political parties – a gloomy perspective for Samoobrona and SLD-UP, while a positive outlook for PO and PiS.
- The declared turnout in the domestic elections was at only 49% (down from 54% in May), which could have been connected with low turnout in the elections to the European Parliament.

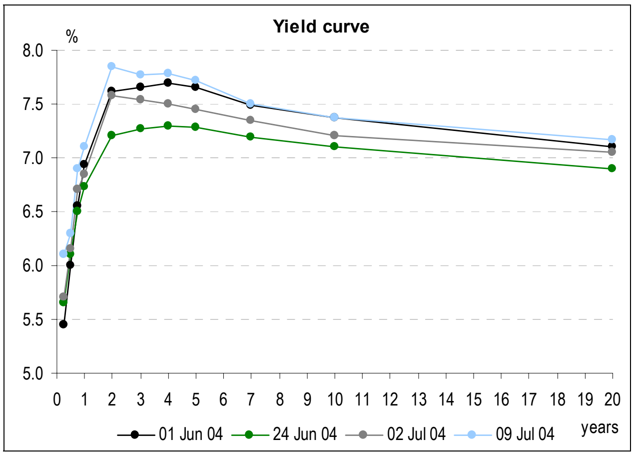
Source: CBOS, Ministry of Finance, National Electoral Committee, Sejm

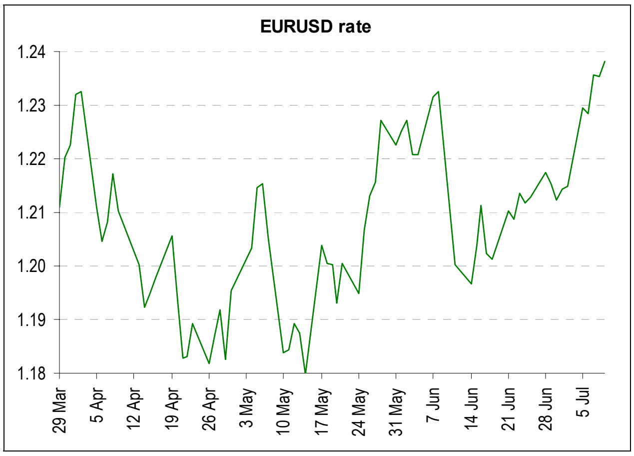
Government and politics

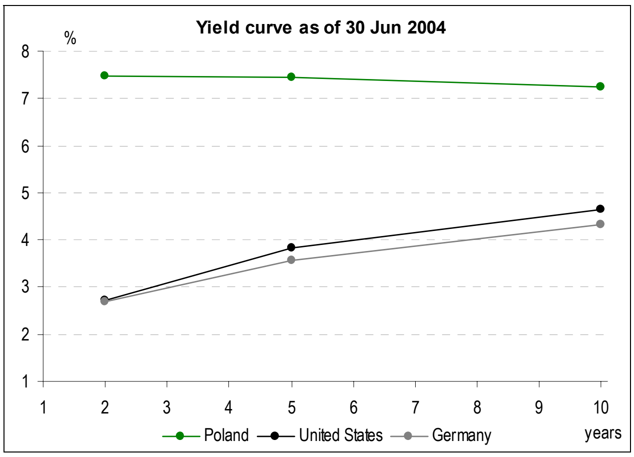
Comments of government representatives and politicians	Remarks
Jerzy Hausner, deputy PM, economy and labour minister PAP, 6 July At the moment, the opinions reaching me point to a 6% GDP growth in 2Q04. We have two months of data - a very high rise in output in April and a relatively high rise in May, we know something about consumer demand and we know that investments are making a slow start. Talking about 6% is safe.	Deputy Prime Minister Jerzy Hausner forecasts GDP growth at 6% in the second quarter of 2004. It is worth bearing this estimation in mind as his predictions as regards economic growth were quite accurate in recent quarters (at least they did not overestimate the final results). Well, the economic recovery is a fact and it does not seem that it is likely to weaken significantly in the upcoming quarters. Even if, after EU accession, annual growth of some economic indicators were much lower.
Reuters, 9 July I expect that it is possible the MPC may hike rates again [in July]. Reuters, 5 July I think the Council in a way gave itself some space deciding on an interest rates hike, and one can expect there to be no further decision in July or over the summer holidays. Reuters, 1 July There is no mistake in the MPC's decision. The MPC's decision is good for the budget as it means the strengthening of the zloty and the strengthening of the zloty increases the chances of executing our plan, i.e. of making the debt to GDP ratio below 55%. My problem is that this decision may hamper investments.	Unbelievable! Jerzy Hausner praised the MPC for raising interest rates. What is more, he added that this was positive for the budget (amid zloty strengthening which took place after the decision). The minister did not expect the MPC to deliver another rate hike soon. As early as on 5 July he did not expect this to take place over summer holidays. However, a few days later, he did not exclude the possibility of another interest rate hike during the next meeting of the Monetary Policy Council. Financial market participants are likely to ask themselves whether the change in deputy PM's opinion resulted from a frank discussion with the NBP president Leszek Balcerowicz. The answer to this rhetorical question is likely to be reflected in a rise in short-term market rates.
Reuters, 29 June I understand now that what the PM said in his exposé does not mean he intends to withdraw from plans to reform the pension system. […] Changes in individual bills will not have a significant financial effect. […] This is the cost of compromise, the cost of winning the vote of confidence. Someone will have to return to this issue, but not me and not this government. Reuters, 28 June It is important to me whether the actions started will lead to our goal, i.e. to the restoration of public finance. It does not matter how many billions we save, but whether we will hold back public debt growth. This is my priority: public debt cannot exceed 55% of GDP in 2004 and 60% next year. One has to do everything to avoid it. Reuters, 25 June As far as I know, the rumours about my resignation are at the very least premature.	At the end of June, the Życie Warszawy daily suggested that the deputy PM had already made decision about his resignation and was expected to announce it shortly . Although the news had been denied by the Prime Minister Marek Belka and minister Jerzy Hausner himself, the denials did not seem to be very convincing, as both officials said that the rumours were "premature" (not "unfounded"!). In turn, in the interview published in Gazeta Wyborcza daily, Marek Belka said that if the most crucial bills from the Hausner plan were dismantled, not only Hausner but the whole government would quit. However, in his opinion, to resile from a few minor solutions demanded by the SdPl was not a reason for too much concern. However, the change in the government's stance on some issues (the withdrawal from motions aimed at alleviating entrepreneurs' life) is said to be the reason why the deputy economy minister Małgorzata Okońska-Zaremba is considering resignation. This could suggest that Jerzy Hausner is no more the person with a predominant voice in the government as regards economic issues. If so, then Okońska-Zaremba's resignation might be not the last one in the economy ministry.
Krzysztof Pater, social policy minister PAP, Reuters, 8 July I am pleased with talks with Eurostat. Our aim is to finish the talks before the next fiscal consolidation. Also, we see a will to find a solution, which would enable us to classify Polish pension funds [OFE] as a part of public finance sector. Some legal changes [in the OFE Act] may be necessary. An amendment of this act should be ready before year-end.	Krzysztof Pater said Poland might amend the pension law in order to secure the European Union's approval to treat the compulsory open pension funds (OFE) as a part of the public sector. This would allow a reduction in the official ratios of public debt and fiscal deficit, making it easier to meet fiscal convergence criteria. The amendment Pater referred would probably be aimed at introducing some kind of additional guarantees for pensions, so that their real value would be guaranteed by law. It should not have any impact on the condition of public finances or the economy.
Elżbieta Suchocka-Roguska, deputy finance minister Reuters, 7 July After receiving the central bank's profit, in June the budget deficit will be between 43% and 45% of the annual plan. After July it will definitely exceed 50%, we estimate it will be at 50-55%. Reuters, 24 June NBP will probably not transfer part of its last year's profit in June, because a decision of the cabinet is needed to do so, and it has not been taken as yet. Reuters, 18 June Today, there are no foundations to say that budget revenues this year will be higher than planned in the Budget Act. We will be very happy, if we receives revenues close to the amount assumed in the Budget Act. Reuters, 15 June The budget deficit after June will be a little over 40%. There is a chance that the deficit for the end of the year will be at least several hundred million zlotys lower than the PLN45.3bn in the Budget Act.	During the last couple of weeks, deputy finance minister Elżbieta Suchocka-Roguska has been quite intensively informing financial markets participants about state budget results. Unfortunately, sometimes her statements were not entirely coherent. As regards budget deficit realisation after June, minister used to change her mind a few times in just a couple of days. It was to some extent understandable given uncertainty connected with the transfer of the central bank's profit to the budget (the cabinet approved the NBP report only on 29 June). Finally, it turned out that NBP profit was transferred and budget realisation was below 45% of the annual plan in June. Much more interesting were the comments of Mrs Suchocka-Roguska as regards the possible lowering of the budget deficit in 2004 to below the level assumed in the Budget Act. Initially, she claimed that there is a chance that the deficit for the end of the year would be at least several hundred million zlotys lower than planned. However, this view was completely contradictory to the official stance of her boss, the minister of finance, Andrzej Raczko. Therefore, after just three days, Mrs Suchocka-Roguska was trying to assure us that "there are no foundations" for expecting in 2004 a budget deficit lower than planned.

Market monitor









Source: Reuters, BZ WBK

Vote of confidence and higher rates supported the zloty

- In June, the situation on the political scene contributed rather to calming down and improving market moods. However, a slightly higher price volatility resulted from expectations of an interest rate hike that were formed by ambiguous data.
- First half of June was quite calm due to a lack of important events and data releases. In the 2nd half of the month zloty appreciation trend continued, since the chances of the Sejm's support for Belka's government increased and, what is more, expectations of an interest rate hike were strengthening. The fixed income market was strengthening initially, as well. However after food price data investors recognised ultimately that the rate hike is certain and the yield curve moved upwards substantially.
- At June-end the zloty was stronger than in May by some 2% against a dollar-euro basket. The longer end of the yield curve moved upwards by 5-10bps and the shorter one was unchanged.
- In early July, after a rate hike higher than forecasted, the zloty appreciated and inversion of the yield curve widened to a whole segment above 2Y, as a result of the weakening of shorter end, while before the curve was inversed from 4Y tenor up. MPC decision convinced us to revise our currency forecast for 3Q2004 towards a stronger zloty in July-August period.
- MinFin released a plan for financing borrowing needs in 3Q04 (details in tables on page 15). Nevertheless, it seems that 4Q04 will be the most difficult as far as the plans are concerned. Our estimations point to the fact that financing needs will total nearly PLN42bn, assuming this year's deficit is lower by PLN2bn than planned. Providing the plan of privatisation revenues is put into action (PLN5-6bn worth of PKO BP) and part of liquidity cushion is used (more than PLN15bn) it will be possible to cover them without significant rise in the supply of treasuries.

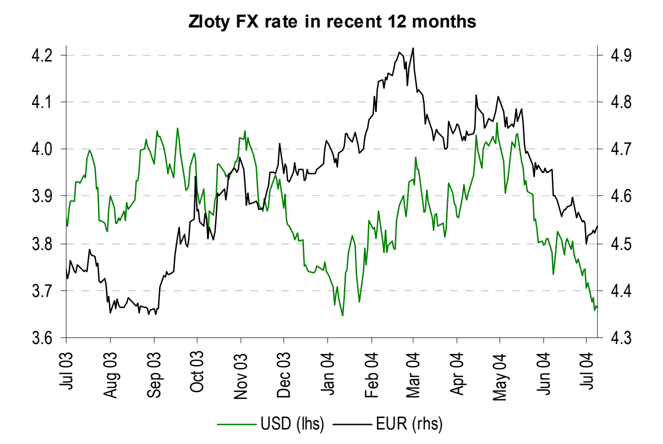
Uncertain outlook of FX markets

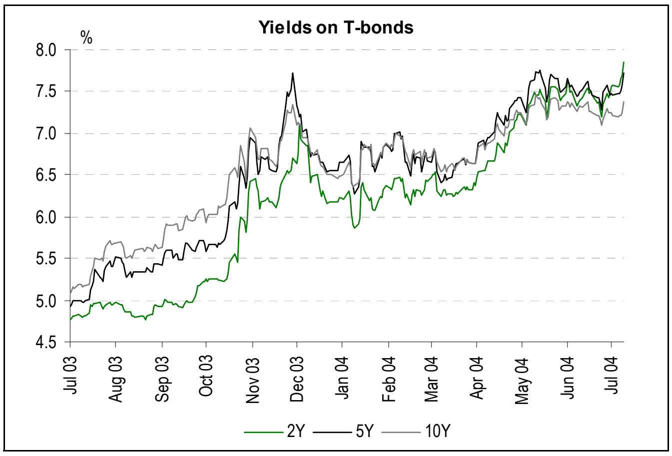
- Since early May, substantial fluctuations in FX rates on the main markets are observed again. At the beginning of June, the dollar was weak (EURUSD rate above 1.23) given difficult situation in Iraq and high crude oil prices. In mid-month, comments from Fed representatives on restrictive monetary policy strengthened the dollar rapidly but temporarily to below 1.20. In turn, afterwards the EURUSD was rising gradually to 1.215 since market expectations turned to rate hike by no more than 25bps.
- After Fed's decision, which matched expectations, FX rates remained unchanged. However, after weaker than forecasted data from US labour market, the EURUSD returned to above 1.23.
- Prospects for the dollar in the coming months remain uncertain. Given forecasts of rate hikes and, on the other hand, geopolitical tensions we believe that there will still be no clear trend.

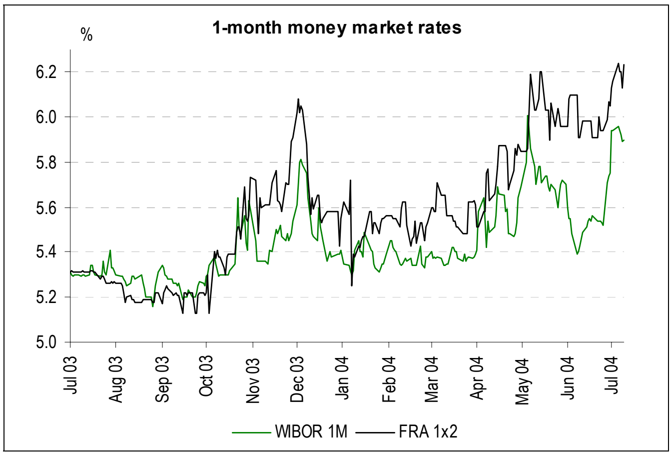
Correction on the fixed income market after Fed decision

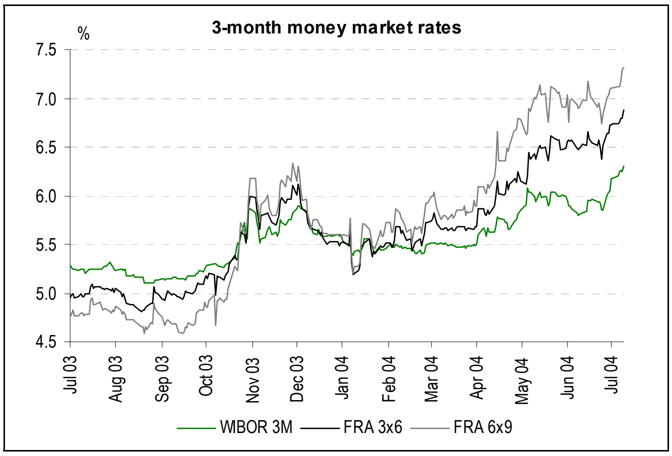
- On relatively stable yields, in June the risk premium for Polish bonds measured with a difference between expected 5-year interest rate in Poland and in the Eurozone in five years time declined by a further 15bps to 155bps. A second consecutive month of such a trend may be a confirmation of a better perception of Poland's outlook after accession to the EU.
- In June, yields on bonds on the American market were rising initially, especially at the shorter end of the curve. On the other hand, in the second half of the month, the prices stabilised. After the Fed decision the yields declined by some 30bps.
- Up to the end of the year, we foresee a further increase in yields, following further interest rate hikes in the United States, but this may be accompanied by significant volatility due to relevant uncertainty factors.

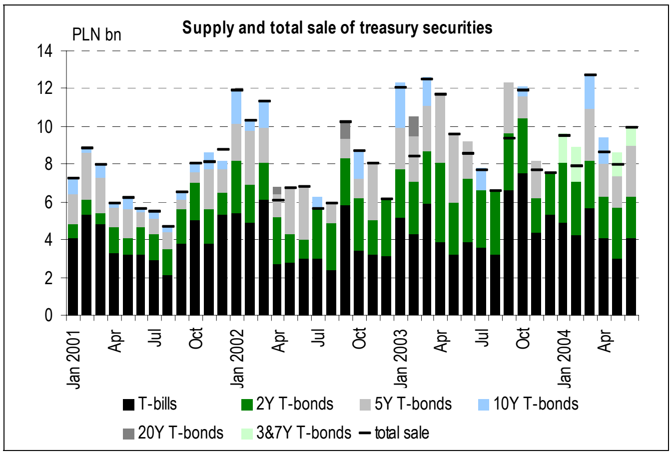
Market monitor











Treasury bill auctions (PLN m)

Date of auction	OFFER / SALE 13-week	52-week	Total
7.06.2004	-	1,000 / 1,000	1,000 / 1,000
14.06.2004	-	1,000 / 1,000	1,000 / 1,000
21.06.2004	-	1,000 / 1,000	1,000 / 1,000
28.06.2004	100 / 100	1,000 / 1,000	1,100 / 1,100
June total	100 / 100	4,000 / 4,000	4,100 / 4,100
5.07.2004	100	1,100	1,200
12.07.2004	100	1,100	1,200
19.07.2004	100	1,100	1,200
26.07.2004	-	1,100	1,100
July total	300	4,400	4,700
August & September*		9,100 - 10,400	

* BZ WBK own estimates based on preliminary information for 3Q04

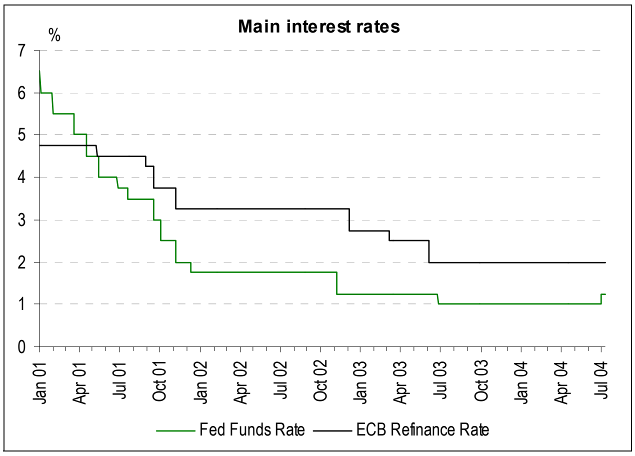
Treasury bond auctions in 2004(PLN m)

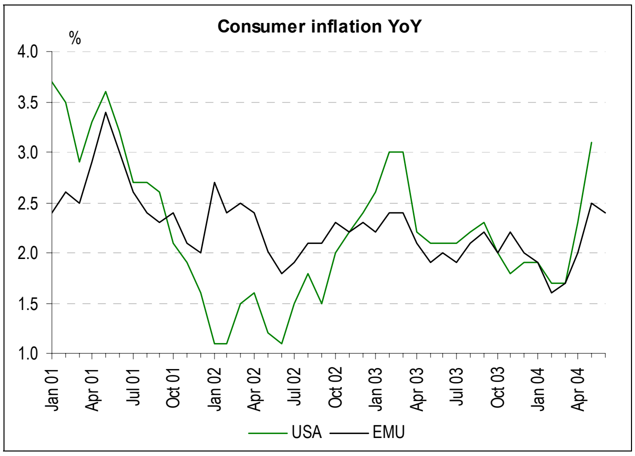
month	First auction date	T-bonds	offer	sale	Second auction date	T-bonds	offer	sale	Third auction date	T-bonds	offer	sale
January	07.01*	OK0406	3,200.0	3,200.0	14.01	WZ0307/0911	1,500.0	1,407.0	-	-	-	-
February	04.02*	OK0406	2,900.0	2,600.0	11.02	WZ0307/0911	1,800.0	1,110.8	-	-	-	-
March	03.03	OK0406	2,500.0	2,500.0	10.03	DS1013	1,700.0	1,700.0	17.03*	DS0509	2,760.0	2,760.0
April	07.04	OK0406	2,200.0	2,200.0	14.04	DS1013	1,400.0	577.0	21.04	DS0509	1,700.0	1,700.0
May	05.05	OK0806	2,700.0	2,039.5	12.05*	WZ0307/0911	1,200.0	1,181.0	19.05	DS0509	1,700.0	1,695.0
June	02.06	OK0806	2,200.0	2,200.0	9.06	WZ0307/0911	1,000.0	1,000.0	16.06*	DS0509	2,640.0	2,640.0
July	07.07*	OK0806	2,800.0	2,800.0	14.07	DS1013	1,500-2,500	-	-	-	-	-
August	04.08	OK0806	2,200-3,000	-	11.08	WZ0307/0911	1,000-2,000	-	-	-	-	-
September	01.09	OK0806	2,200-3,000	-	8.09	WS0922	500-1,500	-	15.09	5Y	2,000-3,000	-
October	06.10	OK1206	-	-	13.10	10Y	-	-	20.10	5Y	-	-
November	03.11	OK1206	-	-	10.11	WZ0307/0911	-	-	17.11	5Y	-	-
December	01.12	OK1206	-	-	-	-	-	-	-	-	-	-

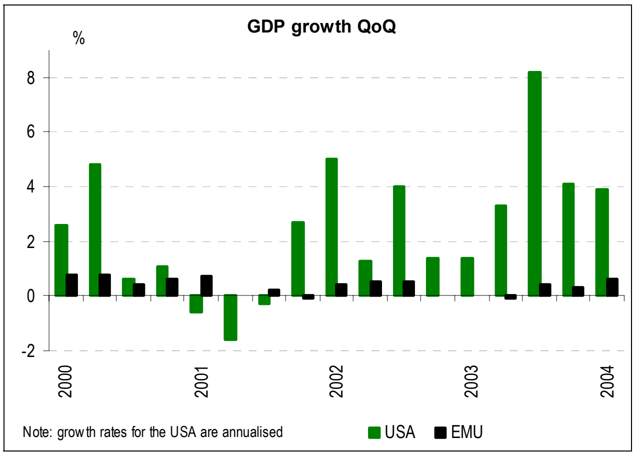
* with supplementary auction

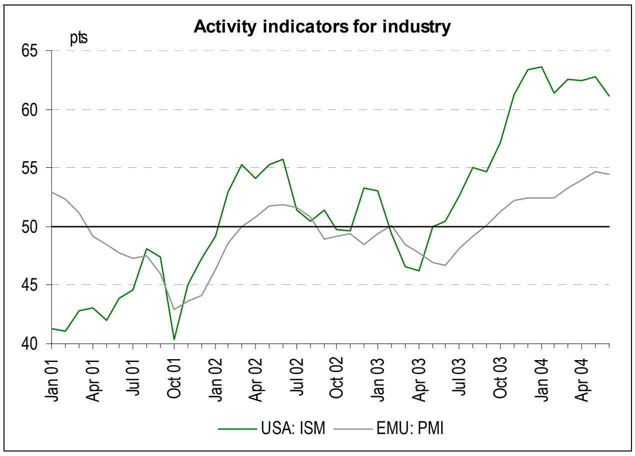
Source: Ministry of Finance, Reuters, BZ WBK own estimates

International review









Source: Reuters, ECB, Federal Reserve

Interest rates are already higher in the US

- As forecast, on 30 June the Fed decided to raise interest rates by 25bps for the first time in four years. Federal funds rate is at 1.25% now. In the statement from the meeting it was reiterated that rate hikes would come at "measured" pace, which means further 25bp hikes rather than larger ones. Assurance was given that Fed would respond to changing economic prospects. We expect the rates will have risen by further 100bps by the year-end.
- On 1 July, in line with expectations, the ECB's Council kept the refinance rate at 2% for the thirteenth month in a row. The ECB president judged that, despite the fact that stronger inflationary pressure would continue in the short-term, there was no threat to medium term inflation outlook. At the same time, economic recovery is not strong enough, yet. First interest rate hike in the Eurozone is likely only next year.

Surge in inflation after increase in energy prices

- In the Eurozone, preliminary estimations of inflation in May were confirmed in a final release and data exactly matched market consensus forecast. Consumer prices increased by 0.3%MoM and the annual inflation rate accelerated to as much as 2.5% from 2.0% in April. According to preliminary estimations for June, inflation decreased to 2.4%YoY. Analysts believe that, in the absence of any further shocks, the drop in inflation may signal that the Eurozone's inflation peaked in May. At present, it is above the upper end of the ECB's inflation ceiling target of 2.0%.
- In the US, data on inflation was worse than forecast. In May, the prices increased by 0.6%MoM, which was the highest increase since January 2001 and resulted mainly from a 4.6% rise in energy prices. The figure resulted in a surge in inflation to 3.1% YoY from 2.3%. Core inflation rate declined from 1.8% to 1.7%.

High growth in the US, but lower than estimated earlier

- At June-end, final data on economic growth was released in the United States. In the first quarter of this year, US GDP increased by 3.9%QoQ compared to 4.1% recorded in the fourth quarter 2003. The figure for 1Q04 meant an unexpected, deep, downward revision of preliminary estimations at 4.4% released a month ago while analysts' forecasts pointed to their confirmation. The revision resulted mainly from increasing the estimations of imports. What is more, the report confirmed what was signalled a month ago, that a clear increase in inflationary pressure was recorded at the beginning of this year.
- In mid-July, a second release of Eurozone's GDP data for the first quarter 2004 is planned (the previous estimate from 1 June was at 0.6%QoQ and 1.3%YoY) and the European Commission will publish the latest forecast for 2Q04 and 3Q04.

Business climate indicators down, deviating from expectations

- Contrary to expectations, in June economic activity in the Eurozone's industry was rising at a slower pace than in May. Reuters PMI index fell to 54.4pts in June from 54.7pts recorded in May, while a rise to 55.0pts was expected. Similarly, in the United States a growth in activity in industry recorded a deceleration in June, but it exactly matched the forecasts. The ISM index decreased to 61.1pts in June against 62.8pts in May. The figure above the level of 50pts means improvement in the activity.
- Also contrary to expectations, German index IFO declined to 94.6pts in June (the lowest level for nine months) from 96.0pts in May (revised from 96.1pts). Both the assessment of the present economic situation and expectations for the future are worse than a month ago. The IFO institute assessed that a decline in the index in July would be an argument for an interest rate cut.

What's hot this month

Monday	Tuesday	Wednesday	Thursday	Friday
5 July POL: T-bill auction	**6** *GER: Unemployment (Jun)* *EMU: Retail sales (May)*	**7** POL: T-bond auction OK0806	**8**	**7**
12 POL: T-bill auction *ITA: Industrial output (May)* *FRA: Industrial output (May)*	**13** POL: Balance of payments (May) *FRA: Inflation preliminary (Jun)* *USA: Foreign trade (May)*	**14** POL: Inflation (Jun) POL: Money supply (Jun) POL: Wages & employment (Jun) POL: T-bond auction DS1013 *ITA: Inflation final (Jun)* *USA: Retail sales (Jun)*	**15** *EMU: GDP (1Q)* *USA: Industrial output (Jun)* *USA: Producer prices (Jun)*	**16** *EMU: Inflation final (Jun)* *USA: Inflation (Jun)*
19 POL: Industrial output (Jun) POL: Producer prices (Jun) POL: T-bill auction *EMU: Industrial output (May)* *EMU: Foreign trade (May)*	**20**	**21** POL: Retail sales (Jun) POL: Unemployment (Jun) POL: Business climate (Jul)	**22**	**23** POL: Food prices (1H Jul) POL: Core inflation (Jun) *FRA: Inflation final (Jun)*
26 POL: T-bill auction *EMU: Balance of payments (May)*	**27** POL: MPC meeting (1st day) *GER: IFO (Jul)*	**28** POL: MPC meeting (decision) *EMU: Money supply (Jun)*	**29**	**30** *ITA: Inflation preliminary (Jul)* *EMU: Inflation preliminary (Jul)* *EMU: Economic sentiment; Business climate (Jul)* *USA: GDP (2Q)*
2 August POL: T-bill auction *EMU: PMI (Jul)* *USA: ISM (Jul)*	**3** *EMU: Producer prices (Jun)* *EMU: Unemployment (Jun)*	**4** POL: T-bond auction OK0806 *GER: Unemployment (Jul)* *EMU: Retail sales (Jun)* *USA: Factory orders (Jun)*	**5** *EMU: ECB meeting*	**6** *USA: Unemployment (Jul)*
9 POL: T-bill auction *ITA: Industrial output (Jun)*	**10** *FRA: Industrial output (Jun)* *USA: Fed meeting*	**11** POL: T-bond auction WZ0307 & WZ0911	**12** *ITA: Inflation final (Jul)* *USA: Retail sales (Jul)*	**13** *FRA: Inflation preliminary (Jul)* *EMU: GDP (2Q)* *USA: Producer prices (Jul)* *USA: Foreign trade (Jun)*

Source: CSO, NBP, Finance Ministry, Reuters

Data release calendar for 2004

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
MPC meeting	20-21	24-25	30-31	26-27	25-26	29-30	27-28	-	-	-	-	-
GDP*	-	20	-	-	-	9	-	-	-	-	-	-
CPI	15	16[a]	15[b]	14	14	14	14	16	14	14	15	14
Core inflation	23	-	23[b]	23	24	22	23	24	22	22	23	22
PPI	20	18	17	20	20	18	19	18	17	19	19	17
Industrial output	20	18	17	20	20	18	19	18	17	19	19	17
Retail sales	23	20	19	22	21	23	21	20	21	21	24	21
Gross wages, employment	16	13	12	15	17	16	14	13	14	14	17	14
Unemployment	23	20	19	22	21	23	21	20	21	21	24	21
Foreign trade	about 50 working days after reported period											
Balance of payments*	2	-	31	-	-	30	-	-	30	-	-	-
Balance of payments	30	-	12[c]	13	14	16	13	11	10	12	-	-
Money supply	14	13	12	14	14	14	14	13	14	14	-	-
NBP balance sheet	7	6	5	7	7	7	7	6	7	7	-	-
Business climate indices	22	20	19	22	21	22	21	20	21	21	22	21
Food prices, 1-15	-	9[c], 25[d]	25	23	25	25	23	25	24	25	25	23

* quarterly data,
[a] preliminary data, January, [b] January and February, [c] January, [d] February
Source: CSO, NBP

Economic data and forecasts

Monthly economic indicators

		Jun 03	Jul 03	Aug 03	Sep 03	Oct 03	Nov 03	Dec 03	Jan 04	Feb 04	Mar 04	Apr 04	May 04	Jun 04	Jul 04
Industrial production	%YoY	7.9	10.3	5.9	10.9	12.1	9.2	13.9	14.4	18.3	23.5	21.8	12.3	19.4	8.0
Retail sales [c]	%YoY	8.1	5.4	5.5	9.7	10.3	11.4	17.3	7.6	12.1	20.7	30.6	4.0	6.2	7.4
Unemployment rate	%	19.7	19.6	19.5	19.4	19.3	19.5	20.0	20.6	20.6	20.5	20.0	19.6	19.5	19.3
Gross wages [b c]	%YoY	3.1	2.4	1.9	2.2	3.0	4.1	5.1	3.5	6.3	7.0	4.6	4.4	4.8	4.3
Employment [b]	%YoY	-3.6	-3.2	-3.2	-3.1	-3.2	-3.3	-3.5	-1.4	-1.5	-1.3	-1.1	-0.9	-0.8	-0.8
Export [d]	%YoY	4.0	8.9	4.4	20.1	11.4	8.2	14.0	19.6	10.9	29.9	25.0	15.8	8.6	6.0
Import [d]	%YoY	-4.0	8.3	3.0	12.5	4.9	2.5	6.2	10.6	2.7	25.0	36.3	19.5	10.9	4.2
Trade balance [d]	EURm	-179	-657	-232	-266	-254	-503	-545	-173	-218	-461	-1 106	-725	-300	-600
Current account balance [d]	EURm	-97	-375	-55	-57	314	-356	-566	191	-101	-428	-611	-525	-136	-300
Current account balance [d]	% GDP	-2.3	-2.3	-2.4	-2.2	-2.0	-1.9	-2.0	-1.7	-1.4	-1.3	-1.4	-1.5	-1.5	-1.4
Budget deficit (cumulative)	PLNbn	-23.8	-27.7	-29.6	-33.1	-34.8	-35.5	-37.0	-4.2	-9.4	-11.8	-11.0	-15.3	-20.0	-23.5
Budget deficit (cumulative)	% realisation	52.2	63.8	70.6	84.4	93.3	98.9	100.0	9.3	20.7	26.1	24.3	33.8	44.1	51.8
CPI	%YoY	0.8	0.8	0.7	0.9	1.3	1.6	1.7	1.6	1.6	1.7	2.2	3.4	4.3	4.3
PPI	%YoY	2.0	1.9	1.8	2.1	2.7	3.7	3.7	4.1	4.2	4.9	7.6	9.6	9.7	9.2
Broad money (M3)	%YoY	1.3	0.7	1.7	3.1	4.7	5.6	5.6	5.1	5.1	5.7	8.5	6.5	6.6	6.6
Deposits	%YoY	-1.9	-2.5	-1.7	-0.2	1.5	3.3	3.7	3.4	3.5	4.8	8.4	6.4	6.9	7.2
Credits	%YoY	6.1	4.9	5.2	5.4	7.5	8.5	8.1	7.4	7.7	6.1	8.5	6.0	10.9	11.6
USD/PLN	PLN	3.80	3.90	3.92	3.98	3.92	3.94	3.79	3.74	3.84	3.89	3.97	3.93	3.78	3.67
EUR/PLN	PLN	4.44	4.44	4.37	4.46	4.59	4.62	4.66	4.71	4.85	4.77	4.76	4.72	4.59	4.52
Reference rate [a]	%	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.75
WIBOR 3M	%	5.38	5.26	5.16	5.17	5.42	5.68	5.69	5.46	5.46	5.49	5.69	5.99	5.91	5.90
Lombard rate [a]	%	6.75	6.75	6.75	6.75	6.75	6.75	6.75	6.75	6.75	6.75	6.75	6.75	6.75	7.25
Yield on 52-week T-bills	%	4.66	4.85	4.82	4.91	5.30	5.95	6.02	5.59	5.78	5.87	6.20	6.65	6.79	7.10
Yield on 2-year T-bonds	%	4.79	4.89	4.86	5.02	5.53	6.31	6.49	6.17	6.34	6.34	6.83	7.41	7.44	7.70
Yield on 5-year T-bonds	%	4.90	5.17	5.38	5.60	6.04	6.86	6.82	6.65	6.76	6.60	7.13	7.57	7.50	7.60
Yield on 10-year T-bonds	%	5.03	5.37	5.60	5.93	6.36	6.92	6.75	6.65	6.81	6.65	7.02	7.32	7.27	7.35

Source: CSO, NBP, Finance Ministry, BZ WBK own estimates

[a] at the end of period [b] in corporate sector [c] in nominal terms [d] balance of payments data on transaction basis

Quarterly and annual economic indicators

		2002	2003	2004	1Q03	2Q03	3Q03	4Q03	1Q04	2Q04	3Q04	4Q04
GDP	PLNbn	781.1	814.7	882.2	187.1	200.2	201.3	226.0	203.7	216.1	216.9	245.4
GDP	%YoY	1.4	3.8	5.9	2.3	3.9	4.0	4.7	6.9	5.8	5.1	5.9
Total consumption	%YoY	2.8	2.5	3.6	1.1	2.8	2.9	3.3	3.3	3.3	3.6	4.0
- Private consumption	%YoY	3.3	3.1	4.4	1.4	3.8	3.5	3.9	4.0	4.2	4.5	5.0
Fixed investments	%YoY	-5.8	-0.9	7.6	-3.6	-1.7	0.4	0.1	3.5	6.0	8.0	10.0
Industrial production	%YoY	1.1	8.7	16.5	4.4	9.1	8.9	12.2	19.0	17.8	14.5	14.8
Retail sales (real terms)	%YoY	1.9	7.9	9.1	1.2	9.8	6.4	12.4	13.6	10.7	6.0	6.0
Unemployment rate [a]	%	20.0	20.0	19.2	20.6	19.7	19.4	20.0	20.5	19.5	19.0	19.2
Gross wages (real terms)	%YoY	1.5	2.0	1.7	1.4	1.7	1.7	3.2	3.8	1.3	0.6	1.1
Export [b]	%YoY	6.0	9.1	11.6	8.4	5.4	11.4	11.1	19.3	16.6	7.0	5.0
Import [b]	%YoY	3.5	3.3	12.9	3.1	-2.5	8.2	4.5	12.6	22.6	9.0	8.0
Trade balance [b]	EURm	-7 701	-5 345	-6 425	-1 600	-1 118	-1 325	-1 302	-909	-2 131	-1 540	-1 845
Current account balance [b]	EURm	-5 404	-3 550	-3 322	-1 584	-895	-463	-608	-696	-1 272	-616	-738
Current account balance [b]	% GDP	-2.7	-1.9	-1.8	-2.6	-2.2	-2.1	-1.9	-1.5	-1.7	-1.7	-1.8
Budget deficit (cumulative) [a]	PLNbn	-39.4	-37.0	-40.5	-15.5	-23.8	-33.1	-37.0	-11.8	-20.0	-30.5	-40.5
Budget deficit (cumulative) [a]	% GDP	-5.0	-4.5	-4.6	-8.3	-4.2	-4.6	-1.7	-5.8	-3.8	-4.8	-4.1
CPI	%YoY	1.9	0.8	3.2	0.5	0.5	0.8	1.5	1.6	3.3	4.2	3.9
CPI [a]	%YoY	0.8	1.7	3.9	0.6	0.8	0.9	1.7	1.7	4.3	4.1	3.9
PPI	%YoY	1.0	2.6	7.6	3.0	2.2	1.9	3.4	4.4	9.0	9.0	8.1
Broad money (M3) [a]	%YoY	-2.0	5.6	10.2	0.5	1.3	3.1	5.6	5.7	6.6	7.1	6.0
Deposits [a]	%YoY	-4.1	3.7	9.2	-2.3	-1.9	-0.2	3.7	4.8	6.9	8.0	6.1
Credits [a]	%YoY	5.2	8.1	11.9	8.7	6.1	5.4	8.1	6.1	10.9	11.6	12.6
USD/PLN	PLN	4.08	3.89	3.86	3.90	3.83	3.93	3.89	3.82	3.89	3.82	3.90
EUR/PLN	PLN	3.85	4.40	4.69	4.19	4.36	4.42	4.62	4.78	4.69	4.62	4.68
Reference rate [a]	%	6.75	5.25	6.25	6.00	5.25	5.25	5.25	5.25	5.25	6.25	6.25
WIBOR 3M	%	9.09	5.69	6.01	6.37	5.60	5.20	5.60	5.47	5.87	6.23	6.47
Lombard rate [a]	%	8.75	6.75	7.75	7.75	6.75	6.75	6.75	6.75	6.75	7.75	7.75
Yield on 52-week T-bills	%	8.18	5.33	6.65	5.75	4.94	4.86	5.76	5.75	6.24	7.30	7.30
Yield on 2-year T-bonds	%	7.94	5.38	7.24	5.58	4.91	4.92	6.11	6.28	6.86	7.83	8.00
Yield on 5-year T-bonds	%	7.86	5.61	7.39	5.50	4.98	5.38	6.57	6.67	7.10	7.77	8.00
Yield on 10-year T-bonds	%	7.34	5.77	7.15	5.60	5.19	5.63	6.68	6.70	7.00	7.42	7.50

Source: CSO, NBP, Finance Ministry, BZ WBK own estimates

[a] at the end of period [b] balance of payments data on transaction basis

Bank Zachodni WBK S.A.

TREASURY DIVISION

plac Gen. Władysława Andersa 5, 61-894 Poznań
secretary tel. (+48 61) 856 58 35, fax (+48 61) 856 55 65

This analysis is based on information available until 09.07.2004 has been prepared by:

ECONOMIC ANALYSIS UNIT

ul. Marszałkowska 142, 00-061 Warszawa, fax (+48 22) 586 83 40

Email: ekonomia@bzwbk.pl Web site (incl. Economic Service page): http://www.bzwbk.pl

Maciej Reluga – Chief Economist
Phone (+48 22) 586 83 63, Email: maciej.reluga@bzwbk.pl

Piotr Bielski	(+48 22) 586 83 33
Piotr Bujak	(+48 22) 586 83 41
Aleksander Krzyżaniak	(+48 22) 586 83 42

TREASURY SERVICES DEPARTMENT

Kraków
Rynek Główny 30/8
31-010 Kraków
tel. (+48 12) 424 95 01, 424 95 02
fax (+48 12) 424 21 41

Poznań
pl. Gen. W. Andersa 5
61-894 Poznań
tel. (+48 61) 856 58 14, 856 58 25
fax (+48 61) 856 55 65

Warszawa
ul. Marszałkowska 142
00-061 Warszawa
tel. (+48 22) 586 83 20
fax (+48 22) 586 83 40

Wrocław
ul. Rynek 9/11
50-950 Wrocław
tel. (+48 71) 370 25 87
fax (+48 71) 370 26 22