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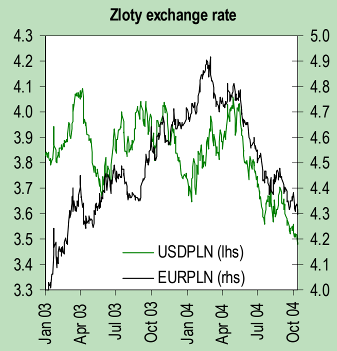
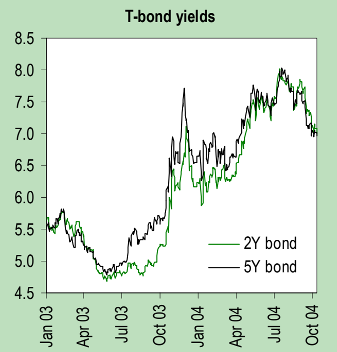
MACROscope

Polish Economy and Financial Markets

October 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

Policy-mix plans for 2005

- **Unlike in the last several years, this September witnessed a substantial zloty appreciation and a lowering in treasuries' yields.** Undoubtedly, the Finance Minister's policy contributed to this trend reversal and it wasn't as much a fiscal policy as an information policy. Despite the fact that the next year budget is not a breakthrough in the Polish public finance and only takes some of the issues into the next year, market players did like the way in which the minister "solicited" the budget. The budget thrives on an economic growth thanks to which the budget deficit shrinks and the proposed change of the public debt definition (the debt will grow again in 2005) postpones excesses of subsequent safety thresholds into an unspecified future. It is good to remember though that expenditure cuts in certain areas (social spending) are of temporary nature and the problem will return twice as painful in 2006. So, financial markets will again expect a budget debate with trepidation next year, especially that political instability creates additional uncertainty as to further developments after the election and the composition of the future government coalition which will face a very difficult task of drawing up and performing the 2006 budget. This will also be accompanied by a high supply of treasuries next year. Our assessment of the budget draft is published in the first special focus of the month titled All that glitters is not gold.

- **The second special focus of the month is about monetary policy – specifically signals sent by the Monetary Policy Council in the context of their decisions.** The Monetary Policy Council have been surprising the financial market with decisions since their members were appointed to the office. When analysing gaps between decisions of the monetary regulators and market expectations, we might ponder whether the MPC appears controversial or perhaps forecasts of those market players are simply inadequate? To crack this issue we need to analyse signals coming from the Council after subsequent meetings (because they create a basis for expectations towards a future policy) and to compare them with measures adopted during the following meetings. Not well justified changes between smaller and larger interest rate movements over the last several months and a lack of any movement in this respect during the last MPC meeting imply that decisions are not made in line with a clear strategy, are haphazard and may depend on quickly changing consensus within the Council. Particular decisions show that irrespective of the MPC's real intentions, transparency and predictability of future decisions are very small. The analysis will also try to answer a question to what extent The Monetary Policy Guidelines for 2005 adopted by the MPC in September are helpful in setting assumptions and expectations regarding the directions and objectives of the monetary policy for the next year.

Financial market on 30 September 2004:					
NBP deposit rate	5.00	WIBOR 3M	6.91	PLN/USD	3.5569
NBP reference rate	6.50	Yield on 52-week T-bills	7.07	PLN/EUR	4.3832
NBP lombard rate	8.00	Yield on 5-year T-bonds	7.00	EUR/USD	1.2323

This report is based on information available until 12.10.2004

Special focus

At the first glance, the draft of the next year's budget looks quite good. Comparing to the previous assumptions made by finance minister Andrzej Raczko, the budget deficit has been reduced by a few billion zlotys which has met with a positive reaction of the financial markets (appreciation of the zloty and fall in bond yields). At the same time, macroeconomic assumptions raise no concerns which could put the delivery of the deficit assumed under the question mark. Can, however, the 2005 budget be considered a breakthrough budget, a reformist one which brings Poland closer to fulfilling the fiscal Maastricht criteria (budget deficit below 3% of the GDP and public debt below 60% of the GDP)? It is not the case in our opinion, and the budget for next year can instead be defined as a passive approach to fiscal policy. Such a strive for survival was in fact quite easy in the environment of economic expansion – the better part of the fiscal tightening applied to high budget revenues. Budget takes advantage of the quick economic growth, without preparing the public finance sector for the economic slowdown which can take place in the years to come. And it is important to the extent that the reduction of the expenditure in some areas (revaluation of social benefits) is temporary in nature and the problem will come back doubled in 2006. Thus, next year, financial markets will be apprehensive again about the budget debate, especially that an additional source of uncertainty is the political stage after the elections, and the shape of actual governmental coalition, which will have to face a very difficult task of designing and delivering the 2006 budget. Additionally, the financial market will be influenced next year by high supply of treasuries which, due to a number of factors "under the line", is not reduced in a scale, which might be suggested by the budget deficit reduction.

Some sort of excuse for the government and the finance minister is the current political situation in which it is difficult to imagine reformist majority in the parliament right before the elections. It seems that this political risk and the history of the past years when budget planning was accompanied by a lot of commotion (both political and on the financial markets), set the scene for the positive reception of the budget by the financial markets and "no bad news was a good news".

Macro-assumptions – justified optimism

Macroeconomic assumptions for next year's budget can be described as conservative since a 5% economic growth is assumed along with the reduction of average annual inflation. It is expected that as the private consumption slowly decelerates, investments will speed up as a result of which domestic demand will go up to 5% from 4.7% planned for this year. In our opinion, one can be even more optimistic when it comes to the pace of the economic growth next year (we anticipate a GDP growth above 5.5%). While we project a similar growth in domestic demand (though we expect a quicker consumption growth and slower investment growth), we believe there is also a chance net exports will have a positive impact on the GDP growth. The Finance Ministry attributes a decrease in the pace of private consumption growth to the slower growth in pension benefits (due to the lack of revaluation, there will be a growth of 2.2% comparing to 4.5% in 2004) and to the expected increasingly common propensity to save (due to higher interest rates). However, growth in the wage bill in the national economy is expected to accelerate from 4.2% in 2004 to 6.1% in 2005. Investment growth next year is rather uncertain, especially, when we consider the GDP figures for the first half of this year, but still, its pace assumed in the budget for the next year, though optimistic, does not differ significantly from the average market expectations in this regard.

In comparison to the previous budget-related assumptions, the finance minister changed projections for the zloty exchange rate and interest rates of the

Macroeconomic assumptions for 2004-05

	2004 Budget Act	2004 P	2005 Draft
GDP, nominal in PLNbn	861.5	884.0	952.6
GDP, % YoY	5.0	5.7	5.0
Total consumption % YoY	3.3	3.4	3.2
Private consumption, % YoY	3.8	3.8	3.7
Fixed investments % YoY	12.2	7.4	12.9
Exports, %YoY	8.7	14.2	12.0
Imports, % YoY	8.5	11.0	12.0
Average inflation, %YoY	2.0	3.4	3.0
Average wages PLN	2 290	2 306	2 423
Average employment '000	8 733	8 488	8 577
Unemployment rate, %	17.8	19.3	18.2
Average intervention rate %	3.7	5.8	7.4
Current account deficit, USDbn	-8.4	-3.0	-4.4
Foreign direct investments, USDbn	5.15	3.4	3.5

Note: P – planned realisation
Source: Ministry of Finance

central bank. Increase in the interest rates assumed by the central bank was as much as 1 p.p. – the ministry anticipates an increase in the reference rate up to 7% at the end of this year and up to 7.5% next year. It stems, among others, from higher than previously expected inflation, although, in our opinion, the average annual inflation can prove higher next year than the assumed 3%. New assumptions as regards zloty exchange rate reflect more or less our expectations, though considering the latest developments in the currency market, there is a chance that the average annual PLN rate will be ca. 4.3 against the Euro and 3.5 against the US dollar (the government assumes 4.42 and 3.68 respectively).

High income = lower deficit

It might be concluded that since macroeconomic budget-related assumptions (GDP growth, inflation) are conservative there should be no difficulty with achieving the planned budget income figures or that higher-than-planned budget income and a lower deficit are likely (similarly to this year). This impression is dispelled, however, upon a more in-depth analysis of tax inflows (details below) which grow next year at quite a high pace. The government sustained the previous assumption of a 5% economic growth despite the suggestion of deputy Prime Minister Jerzy Hausner that "growth in 2005 will certainly be above 5%". Maintaining the economic growth forecast can be perceived as positive as its increase would constitute a temptation to further increase budget income in order to increase the expenditure limit. The finance minister adopted a strategy according to which conservative macroeconomic assumptions are accompanied by aggressive income growth. This means that if economic growth and inflation prove higher than the values provided for in the budget, additional income in this regard can provide a kind of "buffer" in case any of the assumptions behind the income growth does not materialize, e.g. better collection of taxes, elimination of grey economy zone.

Budget deficit (PLNbn)

	2004 Budget Act	2004 P	2005 Draft
Budget expenditures	199.85	199.85	208.74
Budget revenues	154.55	156.15	173.74
Budget deficit	45.30	43.70	35.00
Budget deficit (% GDP)	5.3	4.9	3.7

Source: Ministry of Finance

The budget deficit decreases when a very high growth in income is recorded. Next year's budget deficit is to be PLN35bn with the income of PLN173.7bn and expenditure of PLN 208.7bn. This means that comparing to the previous budget draft, the deficit has dwindled by PLN 3.7bn.

In the economic sense, similarly to last year, the budget deficit planned at PLN 35bn should be increased by the elements which have got "under line" – transfers to OFE (Open Pension Funds) (PLN 11.3bn), expenditure related to the EU accession (PLN 4.6bn), credit for KUKE S.A. for the payment of damages guaranteed by the State Treasury arising from the insurance of exports contracts (PLN1.0bn) and repayment of healthcare funds' debts (PLN2.2bn). Total expenditure related to these items will total PLN19.1bn, which means increase in the deficit up to PLN54.1bn, i.e. 5.7% of GDP. This year's deficit, in a similar methodology would be ca. PLN60bn, so the actual deficit reduction will not be nearly PLN9bn as the table above presents but only PLN6bn.

Since the budget planned for 2005 contains more elements under the line (this year, apart from transfers to OFE and expenditure related to the EU accession, there was also a loan for restructuring of the coal sector which came up to PLN16.3bn in total), the actual growth in budget expenditure is 1pp. higher and totals 5.4%. We should remember, however, that the budget expenditure will be strongly affected next year by expenses related to the EU accession which will nearly double and will amount to PLN10.2bn (5% of all the expenses).

As it was mentioned at the outset, the budget expenditure level is strongly driven by the absence of pension benefits revaluation. It must be remembered, however, when analyzing the next year's budget that this is only a temporary improvement, and that inflation projections for the foreseeable future are that indexation will take place in 2006 which will contribute to increasing budget expenditure by a few billion zloty. Bearing this in mind, drop in the share of determined expenditure from 62.2% this year to 58.8% in 2005, is not an exceptionally significant achievement.

Subsidies and subventions represent 45.9% of all the central budget expenditure (this year: 49.7%), a substantial part of which (over 1/3) is represented by subsidies to specific funds, i.e. almost 100% to Social Security Office (FUS) and to farmers' pension system (KRUS). Aside from the fact that subsidies to these two funds seem to be underestimated, it has to be mentioned that budget draft includes financial effects of two bills, which were not yet (when this report went to printing) accepted by the parliament. The first one concerns a growth in social contribution paid by some employees, which is planned to increase FUS revenues by PLN1.6bn. What is interesting, the criticism regarding this proposal expressed by Polish entrepreneurs was, at lest partly, shared by the finance minister. Mirosław Gronicki said that additional revenues are negligible from the point of view of the situation in total public sector, as the deficit in the fund of social transfers amounts to PLN50bn. Well, it seems that this amount of money of PLN1.6bn was a significant argument for the social policy minister and other cabinet's members. And the deputies will most likely share this view. The second bill, which is still discussed and which is aimed to bring revenues of close to PLN1bn, concerns a change in social contribution payments by Polish farmers.

Let's take a look, however, at budget income which displays very high dynamics next year.

Budget revenues (PLNbn)

	2004 P	2005	Real growth
Budget revenues	156.12	173.74	8.0%
Tax revenues	136.83	154.42	9.6%
VAT revenues	63.52	73.06	11.7%
Excise tax revenues	37.26	42.29	10.3%
PIT revenues	22.13	23.49	3.0%
CIT revenues	13.16	14.69	8.4%

Source: Ministry of Finance

Budget income grows mainly as a consequence of significant growth in tax income, and in particular, indirect taxes. According to the Ministry of Finance this is driven by the fact that in 2005 there will be no more one-off implications of EU accession causing reduction in budget income from VAT and excise tax. However, it should be noticed, and this is also mentioned in *The Justification for the Budget Act*, that bigger consumer demand prior to Poland's EU accession boosted income from VAT (and CIT, due to higher profit generated by companies). This effect will not repeat next year either so one-off factors will not be favorable to budget income only.

Growth in income from indirect tax is driven also by system changes. This applies, among others, to the carried forward effects of implementing the new VAT Act (higher rates will apply for 12 months, and not only for 8 like this year). As it is well known, the element "pushing up" the income side of the budget was usually better tax collection. We have not been disappointed this time either as *The Justification…* reads: "positive assumptions as regards the process of collecting income by the state budget arise partly from the expected improvement in the operations of treasury services". Interestingly enough, we read on the next page that lower than expected income from VAT in 2004 was driven by "failure to fully deliver assumptions as to the envisaged additional income arising from more effective collection". How then can we give credit to the notion that results in this respect will improve next year when plans for this year have not been met?

Growth stemming from excise tax should not surprise anyone given the increase in rates which will take place next year: increase in the excise tax on fuels and diesel oil (by 3.4%), on gas for vehicles (by 10%), increase in the rate on spirits (by 3.4%), and average annual growth of the rate on tobacco goods (14.7%).

High growth rate is, however, displayed also by income from direct taxes, in particular, in comparison with current year. In the case of CIT, the Ministry of Finance envisages this year a 6.8% drop in the nominal terms while next year a growth of 8.4% is expected. When it comes to PIT, following a decrease in income from this tax by 13.8%, it is to increase next year by 6.1%. Undoubtedly, another freeze of tax thresholds and the effect of eliminating tax allowances (increasing burdens) are helpful to some extent, however, apart from giving a standard argumentation as regards fast economic growth (though, smaller than this year) *The Justification…* does not give a precise explanation of why these estimates are so high. Perhaps, we are dealing again with better tax collection. It is a pity the Ministry has not published information on the size of progress made in this regard this year.

As for non-tax income the budget will receive next year a bigger contribution from NBP's profit (PLN570m up on last year) and more funds arising from the budget compensation from the EU (PLN450m up on last year). On the other hand, less income from customs is envisaged (PLN655m down on last year).

Public debt keeps growing

At the end of 2003, the relation of the public debt enlarged by risk-weighted contingent liabilities arising out of state guarantees and sureties amounted to 51.6%. This meant an excess of the first safety threshold (50%), which, in line with the Public Finance Act, imposed on the Finance Minister an obligation to plan the relation between the deficit and income in the 2005 budget of not more than 29.3%.

As the table below shows, the public finance sector deficit is to reduce next year by 1.8pp. Concurrently, the sector's primary result (excluding capital expenditure), which determines a change in the public debt, decreases by 1.7pp and totals 1.4% of the GDP. The planned deficit of the public finance sector, according to the EU methodology, decreases next year by a similar degree and is now 3.9% of the GDP. If, however, we took into account the Eurostat's negative decision re. classification of Polish pension funds (details in the frame), the deficit should be increased by 1.9pp and would then total 5.8% of the GDP – we are still far from fulfilling the Maastricht criterion of 3% of the GDP.

Is Eurostat's decision equivalent to delaying introduction of the euro in Poland?

At the end of September, Eurostat published the second fiscal notification this year. This is information on the size of deficit and public debt in the EU states. It contained additional news as regards treating private pension funds as part of the public sector. After bilateral discussions with representatives of the EU member states, Eurostat decided to introduce a transition period to adhere to the decision of March, according to which Polish Open Pension Funds cannot be treated as part of the public finance. The transition period will last until March 2007, which means that in the first fiscal notification for 2007, all the EU member states will have to take non-guaranteed pension funds to the governmental sector (re. mainly Poland and Sweden). As a result, deficit and public debt would grow significantly in statistical terms (in the very year when we want to meet the Maastricht criteria).

Eurostat flatly declined Polish proposals of changes to definitions, and as the head of this institution Michel Vanden Abeele said "negotiations on this issue have been definitely closed". Still, however, the Polish party maintains that they have every intention to try to persuade Eurostat to change their mind. The thing is, however, that at present, mere intentions do not seem sufficient, and Eurostat's decision is final. Still, certain alternative solutions are at hand and they can enable avoiding a sudden growth in deficit and public debt in 2007. In fact, negotiations with EU finance ministers (EcoFin) are still possible to change the definition of ESA95, or (which is more likely) to change the clauses in the Growth and Stability Pact, so that the countries introducing reforms in the pension schemes are not punished for that by deferring their introduction into the euro zone, or by blocking EU funds. Because if this actually happened, the countries with a high hidden public debt in the form of future pension liabilities (France, Germany) would be discouraged to reform their own pension schemes.

Statistics related to the public debt best reflect the fact that the budget for next year is no breakthrough in public finance. Using the currently applicable methodology of calculating the public debt, its relation to the GDP grows by 2.5 pp and exceeds in 2005 the second caution threshold (55% of the GDP) specified in the Public Finance Act. According to the EU method (ESA95), which the finance minister wants to introduce at the beginning of 2005, in order to avoid consequences of exceeding subsequent security levels, public debt grows by 1.6 pp a year.

Public finance sector in 2004-05 (% of GDP)

	2004	2005
Deficit of public finance sector (Polish methodology)	6.3	4.5
Primary deficit of public finance sector (Polish methodology)	3.1	1.4
Deficit of public finance sector (ESA 95)	5.7	3.9
State Treasury debt	48.4	50.8
State Treasury debt plus risk-weighted contingent liabilities arising out of state guarantees and sureties	49.7	52.3
Public debt plus risk-weighted contingent liabilities arising out of state guarantees and sureties	53.6	56.1
Debt of *general government* sector (ESA 95)	46.6	48.2

Source: Ministry of Finance

Borrowing needs still very high

The key parameter of the next year budget for market participants are borrowing needs of the state's budget. The ministry has informed that they would total ca. PLN 46.5bn against PLN 52.4bn envisaged for this year. This means quite a significant reduction, but as we mentioned earlier, its scale will be smaller than the scale on which the budget deficit will decline due to the big volume of the expenditures "under the line" – transfers to the Open Pension Fund, prefinancing of EU projects, reduction of healthcare funds' debt, borrowing for KUKE S.A. (Exports Contracts Insurance Corporation) for the payment of damages guaranteed by the State Treasury arising from the insurance of exports contracts. Not much help will be brought by the repayment of the loan by the National Health Fund of ca. PLN 320m.

Scale of financing needs in 2004 and 2005 (PLNbn)

	2004	2005
Budget deficit (Budget Act)	45.5	35.0
Transfers to pension funds	11.4	11.3
EU accession related spending	3.6	4.6
Compensation for the lack of wage indexation in the past	1.5	-
Restructuring of healthcare institutions	-	2.2
Repayment of credit of National Healthcare Fund	-	-0.3
Credits for repayments of compensations connected with for government's guarantees as regards special insurance of export contracts	-	1.0
Privatisation	-7.0	-4.4
Total	**55.0**	**49.4**

Source: BZ WBK, Ministry of Finance

It is planned to allocate to the budget PLN4.5bn from privatization (total receipts arising from this next year will amount to PLN5.3bn). Undoubtedly, the general atmosphere in the parliament is not conducive to accelerating the privatization process and, as the finance minister noted, what will happen next year will depend on the determination of the incumbent government and the one to come. The minister said that the borrowing needs in the country would depend on privatization ("a billion or much more can flow in") and possibility to finance abroad ("if the zloty appreciates we will not give the green light to such issues"). Thus, there is a risk that in the domestic market, the government will want to sell even more comparing to the values planned. The Ministry of Finance assumed that net foreign financing will be almost flat (PLN3.58bn against PLN3.22bn in 2004). Issue of bonds in the international market is planned to total US$1.4bn and €1.25bn.

Net domestic treasuries issuance (in PLNm)

	Plan 2004	*Budget 2005*	*2005/2004*
Domestic financing	47 608.9	42 914.8	-9.9
Treasuries	44 521.1	45 891.0	3.1
1. Market treasuries	43 358.7	43 853.6	1.1
1.1. T-bills	3 245.5	0.0	-
1.2. T-bonds	40 113.2	43 853.6	9.3
1.2.1. variable interest rate	7 489.8	5 593.9	-25.3
1.2.2. fixed interest rate	30 811.3	36 422.7	18.2
1.2.3. bonds with indexation	1 812.1	1 836.9	1.4
2. Savings bonds	2 895.8	2 940.0	1.5
3. Non-market bonds	-1 733.3	-902.6	-47.9
Given loans	-228.3	-2 904.9	1272.4
Net amount from the previous year	3 316.0	-71.3	-

Source: Ministry of Finance

Financing borrowing needs of nearly PLN50bn will be reflected in the size of net issue of securities on the domestic market planned next year. The most significant growth (nearly 20%) will be recorded in the case of fixed rate bonds (details in the table), which can be perceived as a negative factor for the long end of the yield curve. The Ministry is trying to account for that with the change in the market conditions which make the issue of fixed rate bonds more favorable for the budget, but the fact is that our net issue of market treasuries and treasuries overall will be higher than last year despite the reduction in borrowing requirements. As the table below shows, the ministry has planned that the net issue of treasury bills in 2005 will be zero. Apart from the fact that the expected market conditions in 2005 will make the issue of T-bills less beneficial than the issue of securities with long maturities, the ministry has probably concluded that the gross issue next year (similarly to 2004, this will be slightly above PLN 50bn) will reach the maximum level that the market can absorb at reasonable prices. The planned volume of bonds supply in auctions in 2005 is PLN66.2bn in the case of fixed rate bonds and PLN7.8bn in the case of floating rate bonds. For a comparison, respective amounts for 2004 are PLN68.5bn and PLN10.2bn.

As for the structure of investors in the financial market who, according to the Finance Ministry, will finance the fiscal deficit, the most significant change, comparing to this year, is noticeable in the case of growth in the share of banking sector and non-banking institutions of the Polish finance market and a drop in the share of foreign investors. Moreover, "balance of funds carried forward to next year" declines overall which is in line with the earlier statements of the finance minister on the intended full utilization of the so-called liquidity deposit with a view to avoiding an excess of the public debt/GDP relation at 55% of the GDP (the old Polish method of calculating public debt applies this year).

Strategy for the new government

Along with the draft budget, the government adopted also *The strategy of public debt management*. The document, just like other medium-term plans, should not have an impact on the market because it is highly likely that it will be modified by the new government following the elections. Although, it has to be noticed that new finance minister will have no other choice and the policy will have to be aimed at lowering (or at least a stabilization) of the relation of public debt to GDP.

According to the information contained in this document, public debt/GDP relation, according to ESA95 methodology, is to increase until 2006, and it is to stabilize thanks to the reduction of budget deficit down to PLN30bn in 2007 (PLN32bn in 2006).

Financing budget deficit (in PLNm)

	Projected performance *2004*	Structure *(%) 2004*	Budget Draft *2005*	Structure *(%) 2005*
Total	50 827.8	100.0	46 494.9	100.0
Banking sector	7 292.8	14.3	8 214.1	17.7
Non-banking sector	22 000.0	43.3	22 472.0	48.3
Foreign investors	15 000.0	29.5	12 300.0	26.5
Net amount from previous year	3 316.0	6.5	-71.1	-0.2
Foreign financing	3 218.9	6.3	3 579.9	7.7

Source: Ministry of Finance

The state treasury debt will continue its upward trend continuously until 2007. It is also planned that local government units will record the deficit of 0.3% of GDP in 2005-06, they will balance their budgets in 2007. The government expects that net privatization revenues (receipts transferred to the budget) will amount to PLN4.5bn each year in 2005-07 period.

Public finance sector in 2004-05 (% of GDP)

	2005	2006	2007
Budget deficit	3.7	3.1	2.7
Balance of local government units	-0.3	-0.3	0.0
State Treasury Debt	50.8	51.9	52.3
Public debt	54.6	55.3	55.0
Public debt plus risk-weighted contingent liabilities arising out of state guarantees and sureties	56.1	56.8	56.5
Debt of *general government* sector (ESA 95)	48.2	48.3	47.7

Source: Ministry of Finance

Other objectives of *The strategy…* include extension of average maturity of the market debt (from 2.12 years in 2003 to 2.6-2.9 years) and growth in the share of non-banking sector and foreign investors in financing the total Polish debt.

Macroeconomic assumption of *The Strategy…*

	2005	2006	2007
GDP growth (%)	5.0	4.8	5.6
CPI inflation (average. %)	3.0	2.7	2.5
NBP reference rate (end period. %)	7.40	7.40	7.00
NBP reference rate (average. %)	7.50	7.25	6.75
EUR/PLN (end period)	4.39	4.25	4.24
EUR/PLN (average)	4.42	4.29	4.24
USD/PLN (end period)	3.72	3.73	3.85
USD/PLN (average)	3.68	3.70	3.79

Source: Ministry of Finance

The MPC's view of the budget

At the end of September, the MPC adopted and published an opinion on the draft *Budget Act for 2005*. The MPC's statement seems highly balanced. The macroeconomic assumptions of the budget have been assessed as positive though some income items were described as very ambitious and, perhaps, overly optimistic. In general, criticism was not too harsh. The Council admitted that the budget is a step in the right direction as it limits the size of fiscal deficit and takes into account introduction of part of savings proposed in Hausner's plan. On the other hand, the MPC stated that simplification of the taxation system was necessary as well as further fiscal reforms aimed at confining the structural deficit by way of capping public spend.

The Monetary Policy Council presented the central bank's estimates as regards various measures of public finance imbalance. They imply that the size of fiscal deficit adjusted by cyclical fluctuations is smaller than in 2004, but much bigger than in 2003, which indicates that the scale of desired tightening of the fiscal policy should be much larger. The MPC stressed that to prevent further accumulation of public debt, it is necessary to conduct further reforms in the subsequent years, and the necessary condition for reversing the debt growth trend is achieving the primary surplus in the budget as soon as possible.

Measures of fiscal imbalance (% GDP)

	2003	2004	2005
Cyclically adjusted public finance sector result	-3.8	-5.7	-4.3
Cyclically adjusted public finance sector primary result	-0.7	-2.6	-1.2

Source: NBP

Special focus

What about the MPC?

The Monetary Policy Council have been surprising the financial market with decisions since their members were appointed to the office. This relates both to adopting a change in monetary policy bias in April and to four decisions on interest rates made June through September. After three interest rate increases, which extent differed from what the majority of market players predicted, the September MPC meeting left the interest rate unchanged and preserved its restrictive approach to the monetary policy whilst most of the market players expected an upsurge by 25 or 50 basis points. Sometimes the monetary authorities baffle financial markets with their course of action aiming at a specific objective (it might have been so in June when the MPC wanted to build credibility in their anti-inflationary intentions). However, it is difficult to imagine that the MPC would continue to pursue the same goal through several meetings in a row. When analysing gaps between decisions of the monetary authorities and market expectations, we might ponder whether the Council appears controversial or perhaps forecasts of those market players are simply inadequate? To crack this issue we need to analyse signals coming from the Council after subsequent meetings (because they create a basis for expectations towards a future policy) and to compare them with decisions made at the following meetings. Substantial volatility of financial markets in the wake the Council's decisions should not be underestimated either, especially if any adverse developments might have been avoided with a more transparent monetary policy in place. Expectations with regard to directions and objectives of the monetary policy next year will take a clearer course in the light of inflation projection that NBP published for the first time in August and *The Monetary Policy Guidelines for 2005* adopted by the MPC in September.

The MPC likes to surprise the audience

While the months of June through September did not surprise our financial markets with the accumulated result of interest rate increases (up by 125 basis points), particular decisions were hard to predict. It is also interesting that each decision when treated individually can be rationalised with numerous economic arguments valid and relevant at the time of making those decisions. The problem is though that the decisions cannot be viewed in separation from the previous ones or from official statements of the MPC and the NBP inflation projection. The table below illustrates in our opinion the most important excerpts, which were in bold letters in the MPC official statements. Market expectations broken down by subsequent months are illustrated on page 16.

Let's recap what the monetary policy has been like over the past few months. Following the first interest rate rise by 50 basis points in June which proved an anti-inflation attitude of the new MPC, emotions cooled down and the next interest rate increase in July was reduced to 25 basis points. Then we might have assumed that there was the Council's strategy behind - a strong message at the onset to prove their reliability followed by a gradually firming grip as the macroeconomic situation unfolded. Information released after the July meeting indicated that the key driver of subsequent interest rate increases would be wage pressure in the economy. As we did not anticipate a dynamic growth in salaries in the economy, it seemed at that time that subsequent jumps by 25 basis points would be more likely. Although, reality proved much more complex, despite the fact that salary figures published in August indicated the lowest growth since the beginning of the year (by 3.6%YoY). It appeared that some of the Council members resorted

Short history of monetary policy decisions

Month	Decision	Justification
June	+ 50 basis points	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.
July	+ 25 basis points	A significant growth in inflation expectations together with an increasing likelihood of maintaining high economic growth increases the risk of persistent higher inflation. The salaries growth rate in the economy will be a significant factor in the formation of future inflation.
August	+ 50 basis points	Factors decisive as to the scale of the increase resulted from the August inflation projection and the risk of appearance of wage pressure stemming from inflation expectations. Endeavouring that the increased inflation has a transitory effect, the Council does not change its position that the tightening of monetary policy should take place gradually.
September	0 basis points	If the appreciation of the zloty visible in Q3 persists, it will be more probable that inflation in the mid-term perspective will be slightly lower than it was presented in the Inflation Report.

Source: NBP, BZ WBK

to a new argument, i.e. inflation projection prepared by NBP analysts.

A higher-than-expected interest rate rise in August (by 50 basis points) was affected by the inflation projection highlighted on the top of the statement (we need to remember that the market learnt about the projection only after the MPC made a decision on the interest rates, so this move could not have been predicted at any rate). Another argument was a possibility of higher wage claims, which might materialise during the talks of the Three-party Committee. A restrictiveness of the monetary policy manifested itself not only in the size of interest rate hike, but also in the official statement released after the meeting. Noticeably, the August meeting yielded another approach to the monetary policy differing from the one adopted after the July meeting. According to the inflation projection, the central bank interest rates should continue to grow if the MPC wants to achieve the inflation target in mid-term. If the MPC gave credence to the inflation forecast and decided to take a more aggressive stance in August, then we might have expected another rise in September. However, who could know that the belief of the MPC would be so short-lasting. In its August statement, the MPC stated that they did not change the position that the tightening of monetary policy should take place gradually. Interestingly enough, the MPC sustained the view which had not been publicised and secondly it was difficult to figure out what they meant by "consistent and gradual manner". An answer was provided during the press conference when NBP governor Leszek Balcerowicz stated that it might be both 25 and 50 basis points. At that stage, he probably did not suppose himself that "consistent and gradual manner" as understood by the whole Council might also translate into no rate hike as early as in September.

As we now know September witnessed another change in strategy and no interest rate hike as a result of appreciating zloty. It appeared that exchange rates play a major part in decisions of the central bank while the previous announcement did not even suggest it and, what is more, exchange rate was mentioned in the context of likely depreciation if no fiscal reforms were launched thus stimulating inflation pressure. The July announcement mentioned appreciating zloty as a factor contributing to low inflation – a significant zloty strengthening – if maintained – will be a factor supporting low inflation. Two Council's members (Andrzej Sławiński and Andrzej Wojtyna) wrote in an article published by *Gazeta Wyborcza* on 21 July, i.e. several weeks into zloty appreciation, that "there appear many signs proving that the currency movement has just been reverted". Apparently these signs were not of key importance when it came to making decisions on interest rate increases in July and August. Only in September when zloty appreciated by another 2%, it was factored in as a key decision contributor highlighted in the announcement. So, the Council mentioned exchange rates in July, remained silent about it in August only to elevate it to the top ranking issue in September. The September announcement though is not unequivocal by any means as it also says that the assessment of how the current zloty appreciation impacts future inflation has a big dose of uncertainty. Interestingly enough, the announcement also says that there have been worrisome signs of growing wage claims since the last Council's meeting. Let us remind that the risk of wide scale salary rises was the main argument in favour of increasing interest rates through June, July and August. Why then MPC did not raise interest rates in September if the risk continued to be strong or even grew yet stronger? Apparently, the MPC viewed the zloty appreciation by several percents as a more important argument, which positively affects inflation in a short-run but becomes uncertain in a longer term. It is a pity that the MPC failed to recognise the importance of exchange rates earlier. What is the message from the September announcement which could help us to predict the course of monetary policy? If the zloty appreciates and a demand for salary rises ceases to grow stronger, there will not be further interest rate hikes. We need to remember though that the history of MPC decisions over the past several months shows that giving forecasts as to the course of the monetary policy on the basis of MPC announcements may appear disappointing.

Inflation projection – helpful or confusing?

Monetary policy decision within last two months were under the strong influence of very important information i.e. the central bank started to publish inflation projections. A body responsible for monetary policy decisions is the "owner" of inflation forecasts in the minority of central banks publishing them. However, already in the July edition of MACROscope we indicated that if such a solution is adopted in Poland, it may bring some negative consequences. We wrote then "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". Unfortunately, this actually happened in September, as the MPC, after taking a decisive decision on rates hike of 50bps based on inflation projection's conclusions, withdrew from this in the following month.

Let's remind that at the time of presenting the inflation projection, the NBP deputy governor Krzysztof Rybiński said that a return of inflation to the target level of 2.5% would require further decisive rate hikes, and that the scale of increases should be even higher than discounted at that time by the market. This does not seem to be consistent with the MPC's way of thinking, given September's decision on keeping rates on hold. In this context, the MPC decision may be interpreted as a kind of motion of no confidence in the NBP's inflation projection, which used to be on the top of the list of arguments supporting stronger than expected rise in main interest rates in August. During the couple of weeks ahead of the MPC meeting several Council's members distanced themselves from the projection's conclusions, and so one could have an impression that no rate hike during the September meeting was a kind of compensation for (perhaps) exaggerated reaction to the overly pessimistic inflation outlook presented in August. This situation introduced another source of uncertainty into prediction of future monetary policy decisions, as it reveals growing divergence of opinions between the MPC and the NBP research team.

What is interesting, in the official statement the MPC did not question the NBP's inflation projection openly. Quite contrary, the information released after the meeting reads that the developments in majority of areas of the Polish and of the world economy pointed to the continuation of the tendencies observed since the beginning of the year and corresponding to the expectations presented in the August *Inflation Report*. Thus, the official statement offered no real help in guessing the MPC's true motivations of stopping the cycle of rate hikes and whether this stop was a definitive one or only temporary. Possibly, the statement was not written by MPC members, who voted against rate hike.

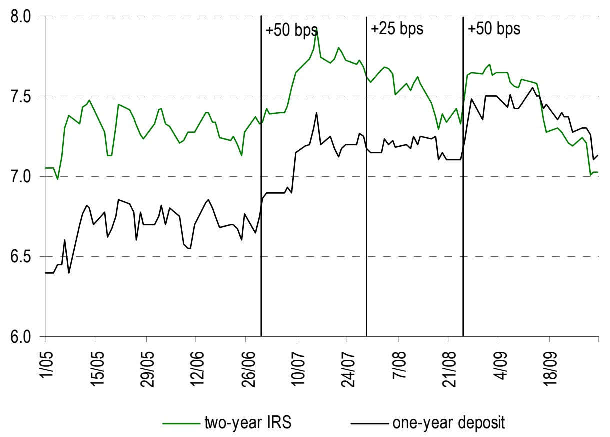
One should also remember that the NBP staff will present new inflation projection in November, which, in our opinion, will maintain the most important conclusions of medium-term threats for inflation target, even if some of important assumptions became outdated. We still hope the inflation projection will be helpful in following monetary policy in Poland and in predicting future changes in interest rates. Possibly, the participation of the MPC members in preparing the projection (for example when main assumptions are formulated) would be solution to increase the importance of the projection and to achieve higher level of consistency between information presented by MPC members and NBP research representatives. This way, the projection would be important information for financial markets, as there would be higher chance that its conclusions would not be ignored by the Council when the decision on interest rates is taken.

Predictability very limited

As mentioned above, the erratic pattern of interest rate moves observed in last couple of months does not make it easy to predict future directions in monetary policy. Surely, the fact that the opponents of any rate hikes prevailed this time, even though the general assessment of the economic situation has not changed much, suggests that one should be quite cautious with expectations of further monetary tightening. Let's remind that two-three months ago we had expected that in this cycle of interest rates hikes the reference rate would reach a peak at 7.0-7.5%. We have leant towards the upper end of this range after the MPC's hawkish decision in August, its strong statement and pessimistic inflation projection suggesting the threats perceived by the MPC are high and it is determined to fight them. Nevertheless, September's decision proved that the signals sent by the MPC after the last meeting were misleading (wasn't it the case also in July?) and that the former prediction of less decisive tightening may be more appropriate.

Please note that if the strategy suggested after the July meeting was continued, and rates were hiked by 25 bps in both August and September, the reference rate would be today at the level as it is (6.5%) and the confusion could have been avoided. The path of interest rates changes, presented above, casts a serious doubt on whether there is any consistent plan or strategy that the MPC follows on its task of achieving the inflation target. To the contrary, rapid swings back and forth between smaller and higher rate hikes in three previous months, and no rate hike in September, suggested the decisions were made at purely ad-hoc basis and were results of quickly changing consensus within the Council. This shows that – regardless of the MPC members' true intentions – the transparency of the monetary policy and the predictability of future interest rate decisions is extremely low. Of course, this may bring some costs for the economy. As we wrote in July edition of MACROscope "thanks to the perfect transparency of monetary policy, the central bank's reaction function is fully predictable, and the inflation target is credible and 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". When the monetary policy from the last couple of months is analysed, it turn out that the Polish economy may indeed bear some costs of monetary policy surprises. The chart below shows that the Polish financial market not only nervously reacted to MPC decisions, but also that some changes in trends of prices of financial instruments (especially at the short end of the yield curve) were observed as a result of complete changes in MPC justifications and "strategies".

Unpredictability of the MPC and market volatility



Source: NBP, BZ WBK

Monetary policy AD 2005

In September, the Monetary Policy Council published *The monetary policy guidelines for 2005* (though the English version of this document was not yet available at the central bank website two weeks after the meeting). In this document, in line with expectations, the MPC specified how the Council interprets the continuous inflation target of 2.5% with its tolerance band of +/-1% and its realisation. As this was the first such document of the new MPC, it is worth to analyse it more carefully. Explanation as regards target interpretation and its realisation was presented in 10 bullet points (see the box).

In the context of the ten monetary policy principles, it is worth to take a look at how the MPC is presenting conditions for conducting monetary policy at present and how it justifies the decisions made recently. Well, the monetary policy in 2004 was aimed at preventing price growth in future, which could take place as a result of inflation expectations growth and higher wage claims. However, the MPC was also taking into account the supply shocks' influence on the domestic demand. The balance of risk presented by the MPC suggests, in our opinion, that rising oil prices create higher risk for economic growth rather than for inflation. The MPC presented a number of dilemmas it is facing, when conducting the monetary policy, however it did not reveal how these dilemmas affected the changes in the scale of the central bank's reaction in recent months.

Decalogue of the MPC

1. Continuous target means that it will not be verified in December, but in the course of each subsequent years. The target will be binding until ERM2 entry or until the end of the MPC's term of office.
2. CPI inflation YoY in each separate month will be the key measure for target interpretation, although it is justified to use also quarterly and annual measures.
3. The monetary policy is definitely aimed at maintaining inflation rate as close as possible to the 2.5% target, not just at keeping inflation within the band of tolerance.
4. The fluctuations within the +/-1% band should be treated as a natural consequence of small shocks and cyclical factors, which should cancel out each other in the long term, usually without need of monetary policy reaction. However, stronger shocks pushing inflation outside the band, might require the central bank's response.
5. The scale of reaction mentioned in point 4 will depend on the strength of shocks and the degree of inflation expectations' inertia. Reaction to demand-side shocks is less controversial, while the biggest problem for the MPC is a reaction to supply shocks, which affect inflation and output in opposite directions.
6. The monetary policy goal in case of supply shocks occurrence would be to counteract so-called second round effects, i.e. a rise in wage claims and inflation expectations. Core inflation measures will be useful when analysing supply-side shocks.
7. The lag of transmission mechanism of monetary policy on inflation and output depends, to a large extent, on structural and institutional changes occurring in the economy. Central banks can only roughly assess the period after which its decisions influence the economy.
8. The decisions on keeping rates on hold during a couple of months or quarters are also the decisions with important consequences for the economy when it implies closing or opening of the output gap.
9. Because of high uncertainty surrounding monetary policy, the decisions should be based on the total available information, not only on the inflation projection. It is impossible to establish a simple rule of monetary policy known for market participants.
10. The restrictiveness of monetary policy should be assessed not only by the level of real interest rates, but also by the real exchange rate of the zloty.

The major goal of monetary policy in 2005 would be to bring inflation back, first to the tolerance band of inflation fluctuations, and then "close to the 2.5% target". It seems the MPC will perceive the target symmetrically, which means it will treat equally deviations above and below the target. The MPC underlined that the process of lowering inflation should be realised in a way, to avoid excessive fluctuations in output, interest rates and inflation.

The Council said that the nature of monetary policy transmission in Poland suggested that effects of majority of shocks on inflation may be neutralized within 1-3 years, so the MPC would "continue the policy aimed at relatively fast curbing inflation down to 2.5% within 5-7 quarters". The MPC listed the factors which will be favourable and unfavourable for the inflation target realisation. However, what is interesting, according to the MPC there are as much as three positive tendencies (export-driven growth, substantial increase in productivity, weak positions of Polish firms as regards transferring high production costs into consumer prices), which will be conductive to faster return of the inflation to the target. On the other hand, there was only one element (strong supply shocks e.g. high oil prices), which could extend the period, during which the CPI inflation would go back to the target. If one takes into account that the MPC perceive this element as a risk factor for economic growth, one could come to a conclusion that the MPC perceives inflation perspectives in Poland quite positively.

According to the guidelines, the monetary policy decisions should be mostly forward-looking. However, because the supply shocks highly increased the uncertainty regarding future inflation, the MPC will put much more attention not only to the inflation projection presented in the *Inflation report*, but also on other forecasts of inflation prepared in the NBP and other institutions. Still, the inflation projection is expected to be very important point of reference for the MPC decisions (well, it was not the case in September). Also, amid supply shocks occurrence the MPC will analyse core inflation measures "to a larger extent". It was not specified whether "larger extent" means to a larger extent than currently, to a larger extent as compared to other inflation measures or possibly to larger extent than the previous MPC did. The Monetary Policy Council stated that "forward-looking policy will be accompanied by the MPC's aspiration to improve communication". We can only hope this will happen in the near future as the quality of communication with financial markets is, to put it mildly, quite low. The MPC will continue signaling directions in monetary policy decisions by the use of approach (bias) in monetary policy (see the table below).

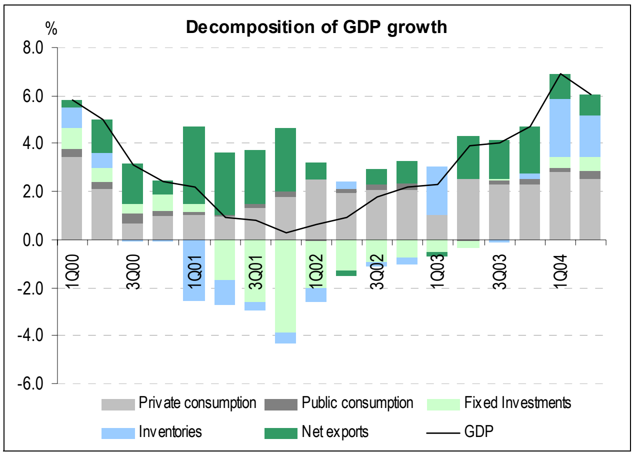
Bias in monetary policy

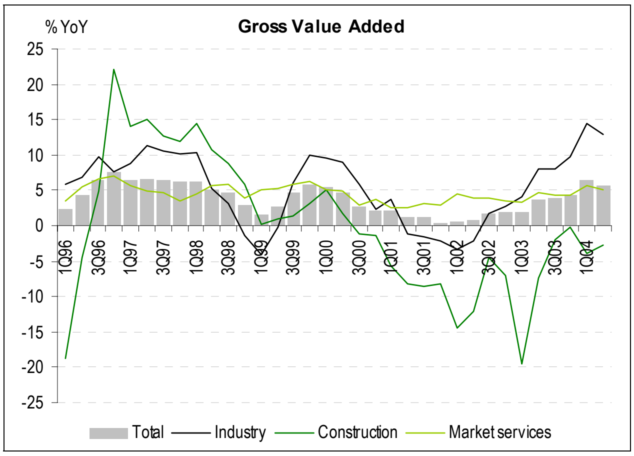
Bias	Means that:	Applied when:
Tightening	A rise in interest rates is more likely than a cut in interest rates.	Probability of inflation rising above 2.5% would be **substantially higher** than that it will fall below this level.
Easing	A cut in interest rates is more likely than a rise in interest rates	Probability of inflation falling below 2.5% would be **substantially higher** than that it will rise above this level.
Neutral	Probabilities of a rise and a cut in interest rates are similar	Probability of inflation rising above 2.5% would be **similar** as probability below this level.

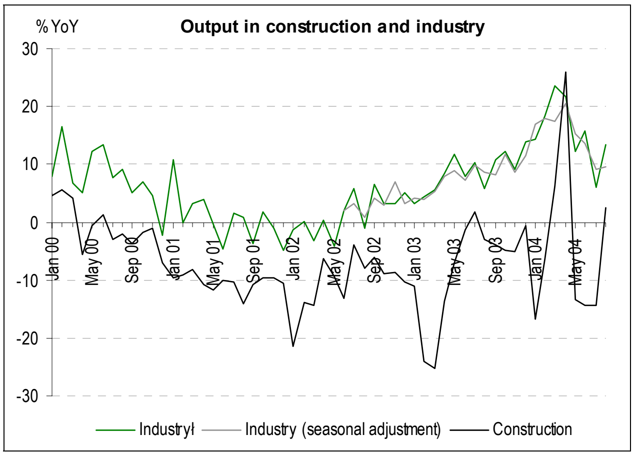
Source: Monetary policy guidelines for 2005

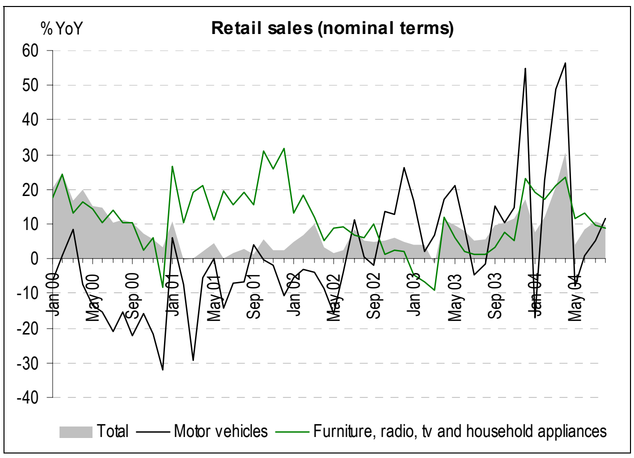
The instruments of monetary policy in 2005 would be almost identical to those used currently. The important exception would be shortening of NBP bills' maturity from 14 to 7 days, so the basic open market operations would be in a form of regular weekly tenders with a supply of 7-days securities. There was one more interesting fact in the guidelines. Next year the reference rate called POLONIA (*Polish Overnight Index Average*) will be introduced. This will be the average O/N rate weighted with the amounts of transactions on the inter-bank deposit market.

Economic update









Source: CSO, BZWBK own estimates

GDP in line with forecasts, investments disappointed

- In line with our forecast, GDP growth in 2Q04 reached 6.1% after 6.9% growth recorded in the first quarter.
- Domestic demand rose 5.1%YoY, from which one could derive that net exports remained an important driver of economic activity in Poland. Its contribution to GDP growth reached almost 1 percentage point, similarly as in 1Q04.
- Total consumption increased 3.4%YoY and private consumption rose 3.8%YoY. On the one hand, the growth in consumption was supported by pre-accession buying spree, however, on the other hand, a surge in inflation was hampering real consumption growth (average 12-month CPI growth rose to 3.3%YoY in 2Q04 from 1.6% in 1Q04). It would affect real consumption spending also in the following quarters.
- Gross accumulation was 13.8% higher than last year, which was close to our prediction. However, the composition of this growth was quite different from expectations. The biggest surprise came from gross investments, which rose merely 3.3%YoY (against 3.5% in 1Q04). It was compensated by higher than expected rise in inventories – its contribution to GDP was very high in the second consecutive quarter, reaching almost 2 percentage points.
- Gross value added rose 5.6%YoY. The structure of this growth was consistent with expectations and similar as in preceding quarters. Value added in industry rose 12.8%, in construction 2.8%, and in market services the rise amounted to 5.1%YoY.
- In 3Q04 GDP growth is likely to decelerate to 5.1%YoY. However, we still expect it would be based on more significant rebound in investments. GDP growth for the entire 2004 should be slightly below 6%.

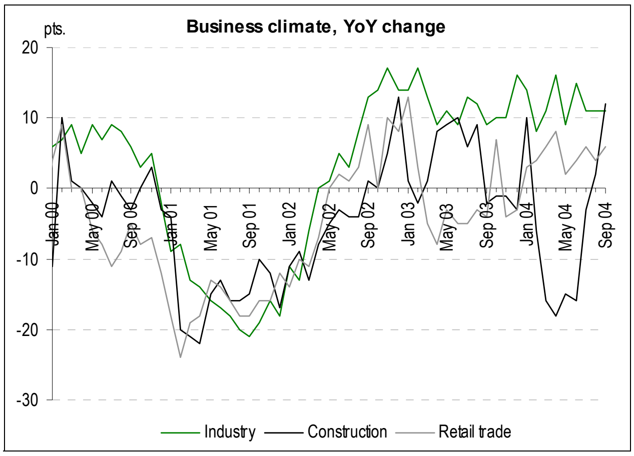
Industrial output below expectations

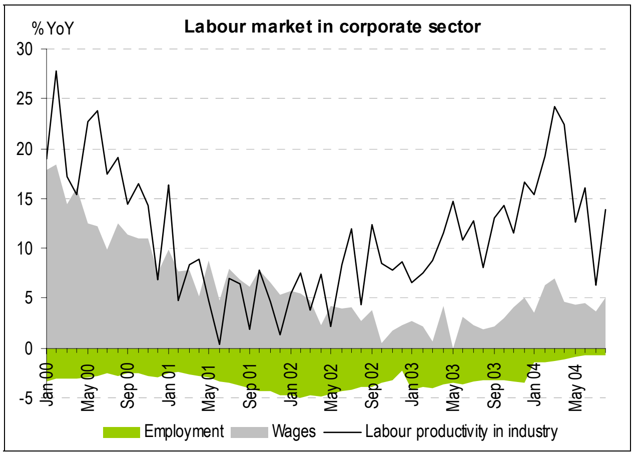
- Forecasts of weaker GDP growth in 3Q04 have been confirmed by the industrial output figures, which were lower than expected again in August. Annual growth in production reached 13.5% against forecasted ca. 16%.
- August results were influenced by the number of working days, 2 higher than last year – contrary to July, when there was 1 working day less than in 2003. After adjustment for seasonal and one-off factors, industrial output growth reached 9.5%YoY in August against 9.5%YoY in July.
- Construction output rose in August by 2.6%YoY, however it resulted mainly from positive difference in the number of working days. After adjustment, the growth in production in construction and assembly was still in red, reaching –6.2%YoY.

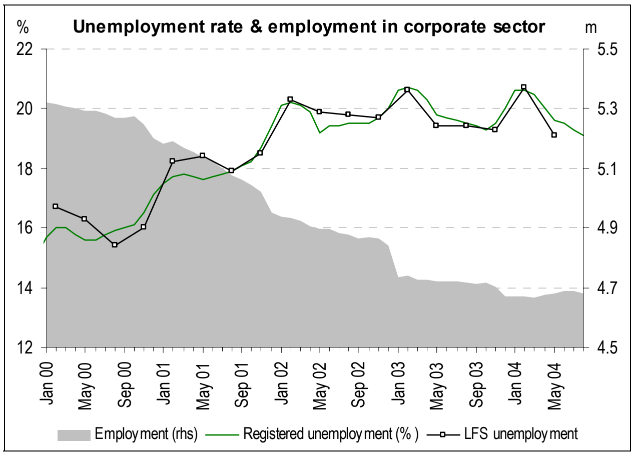
... as well as retail sales

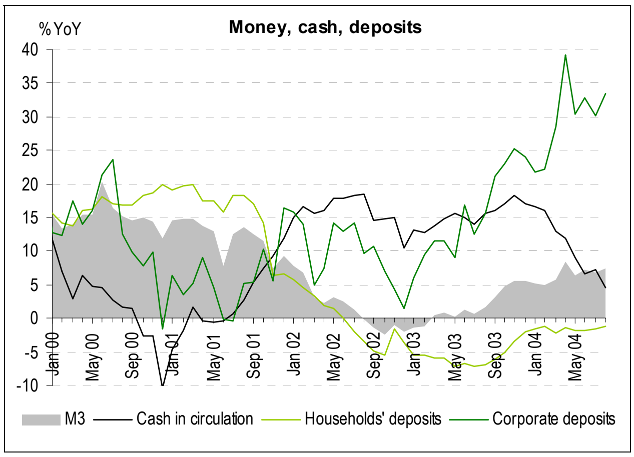
- Retail sales were also below expectations in August, growing 9.5%YoY in nominal terms against 10.9%YoY in July.
- However, this should be regarded as a quite good result. The growth in sales of ca. 10%YoY was recorded in nearly all sections, which suggested that consumption demand is uniformly rising at reasonably high pace.
- The car sales – that were booming just before the EU entry – are recovering after sharp collapse experienced just after May 1st. According to our estimates, retail sales excluding car sales rose 9.4% in August against 11.5% in July.
- On the other hand, there are hardly any signs of buoyant consumption boom, which decreases concerns about resurgence of strong demand-side pressure on inflation.

Economic update









Source: CSO, NBP, BZWBK own estimates

Upbeat business climate and consumers' sentiment

▪ Despite weaker macroeconomic figures, the results of recent business climate surveys are getting more and more optimistic. In September the climate improved in industry, trade and – for the first time in long time – in construction sector.

▪ Entrepreneurs keep reporting rise in portfolio of new orders, stronger in case of domestic than foreign orders, which signals gradual rise in the importance of domestic demand in the creation of economic growth.

▪ September saw also another significant improvement in consumers' sentiment. Index of optimism (WOK) reached the highest level in last five years. It could be the beginning of strong trend in sentiment improvement. Nevertheless, consumption boom would be constrained in the near term by substantial uncertainty resulting from high unemployment and inflation.

Wages keep growing, unemployment keeps disappointing

▪ Unfortunately, rapid change on the labour market is quite unlikely. Wages are growing rather moderately (taking into account mounting inflation), while employment does not show any significant improvement. In August average salaries in corporate sector rose 5.1%YoY, while average employment was 0.8% lower than last year.

▪ Acceleration of wage growth came after one-off slowdown to 3.6% in July, so average for the two months was little changed as compared to average growth in 2Q04, which stood at 4.5%YoY.

▪ This is not a situation that creates a risk of building demand pressure, especially that rising prices notably damaged real purchasing power of the households' earnings. In August, nominal wage bill in corporate sector was 4.3% higher than last year against 2.9%YoY in July. However, in real terms wage bill was still negative, at –0.3%YoY (against –1.6% in July and –0.6% in June).

▪ Meanwhile, we still do not experience a significant recovery of labour demand in Polish enterprises, most likely due to strong rise in labour productivity, which allowed firms to boost their effectiveness strongly.

▪ Registered unemployment rate reached 19% in August against 19.3% in July and 19.5% a year ago. The number of unemployed decreased by 3%YoY. Also the indices for September should post further improvement – according to the deputy PM Jerzy Hausner the unemployment rate dropped to 18.9-19% in September, and the number of unemployed fell below 3 million for the first time in 3 years. The situation seems to be gradually improving, however the pace of this improvement is not impressing. Unemployment rate still remains very high and considering present pace of its reduction, it would remain high for a prolonged time.

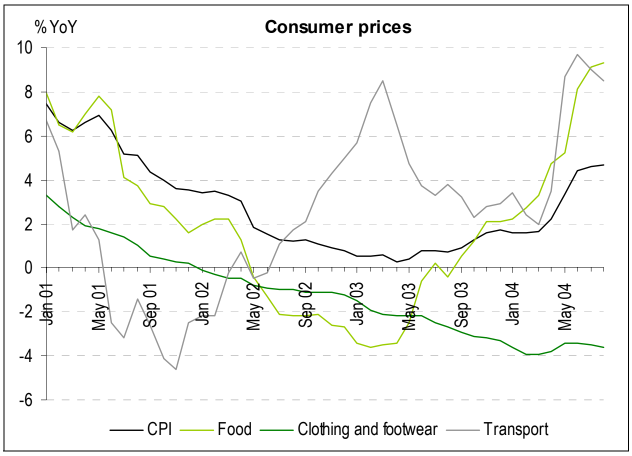
Money growth under control

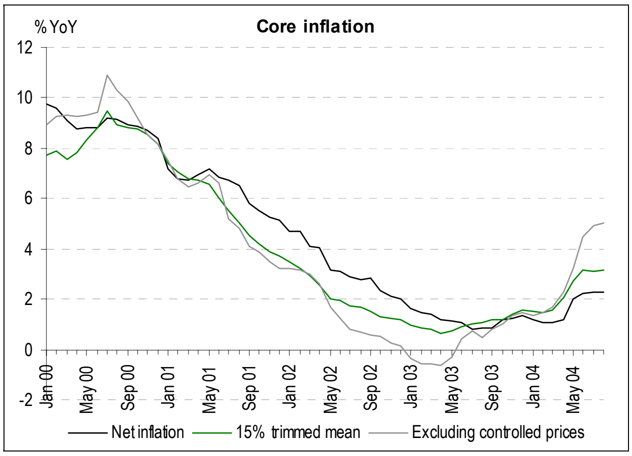
▪ Broad money M3 rose 7.3%YoY in August after a revised growth of 6.8%YoY in July.

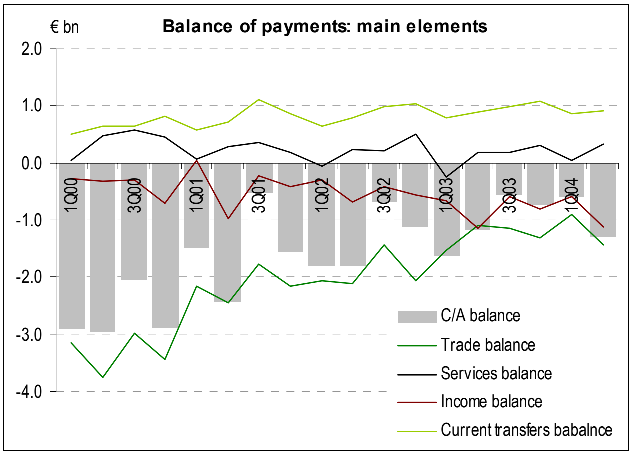
▪ Main trends from previous month were maintained – slowdown in cash in circulation growth (4.6%YoY against 12.2%YoY average in 1H04), drop in households' deposits, although at somewhat smaller scale than previously (-1.2%YoY after –1.7% in July and on average in 1H04), and still strong rise in corporate deposits (33.3%YoY against ca. 30% growth in July and on average in 1Q04).

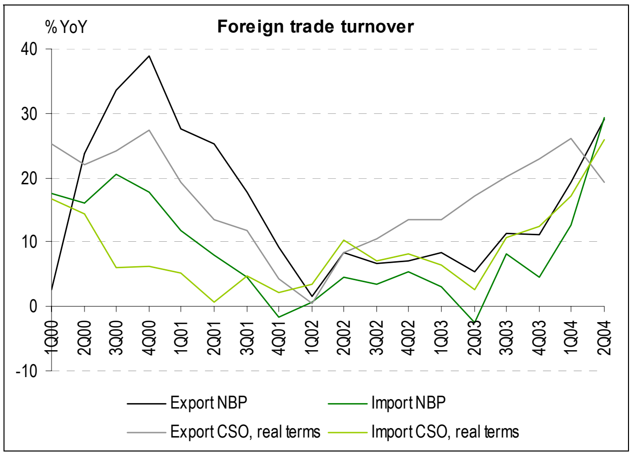
▪ As regards sources of money creation, some acceleration of loans for households was observed (to 16.7%YoY from 15.7% in July), while credit for companies remains in stagnation, falling 2.9%YoY in August, against –3.6%YoY last month.

Economic update









Source: CSO, NBP, BZWBK own estimates

Inflation stopped rising

- In August the rate of inflation remained at July's level of 4.6%. Deceleration of upward trend was possible due to deeper than expected fall in food prices (-1.6%MoM) and clothing and footwear (-0.9%MoM). Fuel prices rose 0.9%MoM in August, but it did not push up the headline inflation rate, as the growth was weaker than recorded lat year (2%MoM).
- It seems that inflation rate has already reached its peak this year, and should be gradually descending in the following months, to 4.2-4.3%YoY at the end of year.
- If would result mostly from reversal of upward trend on the food market, amid very good harvest this year. It seems to be confirmed by 0.1%MoM decline in food prices in 1H September.
- Nevertheless, CPI growth is very likely to remain much above the NBP inflation target for at least a couple of months, more or less until mid-2005.
- Growth in producer prices slightly accelerated in August, reaching 8.7%YoY. It was closely related to high prices of oil and other energy resources. Persistently high level of producer prices is still an important source of inflation risk in future, although so far their pass through into the growth of consumer prices seems to be rather limited.
- Core inflation is also stabilising. Measures of core inflation lost pace in August, following the CPI. Three of the measures remained unchanged since July, while two of them rose slightly by 0.1%MoM.
- Two most important measures – net inflation and 15% trimmed mean – remained low. Net inflation is still below the inflation target, and amounts to 2.3%, while 15% trimmed mean (3.2%) still stays within the ±1pp. fluctuations band. However, three remaining indices are much higher, two of them are above 5%.

Current account still low, foreign trade turnover rising fast

- Current account deficit in 2Q04 reached €1.3bn, i.e. similar level as in previous year (€1.2bn) and over twice as much as in 1Q04 (€0.6bn).
- In relation to GDP the deficit remained at 1.7%, like in 1Q04 (against 2.4% of GDP in 2Q03). It was the lowest quarterly deficit since mid-nineties.
- Foreign trade turnover saw very rapid expansion. Both exports and imports (measured in euro) rose more than 29%YoY in 2Q04, after 19.3%YoY (exports) and (12.6%YoY) in 1Q04.
- The data confirmed that export activity remains a significant driving force of economic expansion in Poland. However, quickly narrowing gap between export and import growth suggests that at the same time we are facing revival in domestic demand. It would lead to reduction of net export contribution in GDP creation.
- Since the accession to the EU the balance of payments statistics are being affected by the financial flows between Poland and the EU. According to the information from the NBP the majority of flows from structural funds and cohesion fund are treated as capital flows, whereas Poland's contribution to the EU budget is entirely added to current transfers. Thus on balance, the flows between Poland and the EU may have negative impact on Polish current account balance.
- Since May 2004 monthly balance of payments statistics coming from the NBP have been biased substantially because of problems with data collection system. For this reason, the central bank decided to change the timing of data publication, delaying it by 2 weeks – until 2005 the data will be released 8 (rather than 6) weeks after reporting period. This change is supposed to result in substantial improvement in data quality.

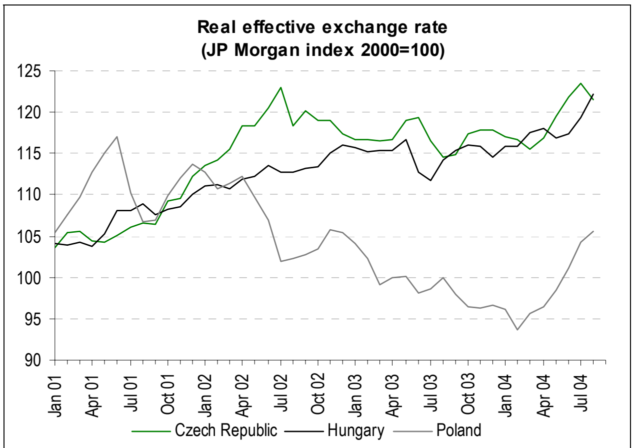
Central bank watch

Expectations of banks' analysts and MPC decisions in June-September period

Month	June	July	August	September
MPC decision	**+50 bps**	**+25 bps**	**+50 bps**	**0 bps**
Number of analysts expecting no rate hike	2	12	6	**2**
Number of analysts expecting 25bps hike	15	**2**	11	7
Number of analysts expecting 50 bps hike	**0**	3	**0**	7
Number of analysts surveyed	17	17	17	16

Own compilation on the basis of *Gazeta Bankowa* surveys

Important elements of the MPC statement from 29 September 2004
Should the currently observed appreciation of the zloty turn out permanent, the probability of lower inflation as compared to the central projection presented in August will increase. However, in view of the diversity of factors influencing the zloty exchange rate and its resultant high volatility, the assessment of the current appreciation's impact on future inflation is subject to a considerable uncertainty.
The abating of some of the factors which have contributed to inflation growth in the past few months is also signalled by a deceleration in the growth rate of inflation expectations of individuals in September 2004 (4.6% in the 12-month horizon). Nevertheless, they remain high, which lifts the risk of wage pressure. In the period since the last MPC meeting there have appeared disconcerting signals indicating to wage demand escalation.
Considering a very high level of production capacity utilisation in manufacturing, high inflation expectations and recovery in domestic demand, the risk of cost effects pushing the inflation up remains considerable.
The moderate level of wage growth at the moment, together with the still relatively high growth of labour productivity as well as a delay (according to GUS data) in investment recovery in relation to what was expected in August, will have some, though limited, influence on the faster than expected rate of inflation drop in the projection horizon.



Important fragments of *The Monetary policy guidelines for 2005*
The horizon of the current inflation target is either Poland's entry to the ERM2 or the end of term of office of the current MPC.
The monetary policy is definitely aimed at maintaining inflation rate as close as possible to the 2.5% target, not just at keeping inflation within the band of tolerance.
The reaction of monetary policy to unexpected shocks will depend on their strength and character as well as on the extent of inertia in inflation expectations.
The decisions on keeping rates on hold during a couple of months or quarters are also the decisions with important consequences for the economy when it implies closing or opening of the output gap.
The restrictiveness of monetary policy should be assessed not only by the level of real interest rates, but also by the real exchange rate of the zloty.
The Council will continue actions aimed at relatively fast reduction of inflation to the level of 2.5% within 5-7 quarters.
Faster return to the target could be possible if: a) inertial influence of the EU entry on inflation will turn out to be weaker than expected; b) unexpected, favourable supply shocks appeared in the nearest months; c) shortening of lags in monetary policy transmission mechanism have taken place recently due to structural and institutional changes in the economy.

Source: CSO, NBP, BZWBK own estimates

MPC chooses the most unexpected options

▪ The MPC keeps surprising. While almost all market participants expected rates to go up by 25 or 50 basis points, the Council decided to keep the rates on hold.

▪ Looking at the sequence of MPC decisions since June, it is hard to see consistent tactics of monetary authorities. It seems that the decisions depend on quickly changing balance of strength within the MPC rather than on stable reaction function.

▪ The only rule, which one may detect in recent MPC decisions is that the Council always chose that option among the possible ones, which was the least expected by the market.

▪ No rate hike in September could have been a form of doves' "revenge" for rate increase of "as much as" 50bps in August, which was caused by an overly pessimistic (in doves' opinion) inflation projection.

We have something for each of you

▪ In the official statement published after the MPC meeting, no explicit critique of the inflation projection was expressed, but it was said that inflation will decelerate faster than it had been assumed in the projection.

▪ Among factors favourable for inflation outlook, the MPC listed mainly the zloty appreciation, and apart from that moderate wage growth and lag in investment rebound was indicated.

▪ On the other hand, the MPC stressed uncertainty related to influence of FX rate on inflation, maintained earlier forecast of fast economic growth and pointed out signals of strengthening wage claims.

▪ In general, the statement did not bring clear hints on future monetary policy. The striking fact is the lack of phrase pointing to necessity of further, gradual monetary tightening.

Does zloty appreciation mean no further rate hikes?

▪ Both in the statement after the MPC meeting and in *The Monetary Policy Guidelines for 2005*, the MPC stressed much stronger than earlier the meaning of FX rate changes for evaluation of monetary policy restrictiveness. Does recent appreciation of the zloty mean the end of interest rate hikes?

▪ Not necessarily, because even considering recent appreciation of the zloty, the new inflation projection (to be published in November) will confirm threats to medium-term inflation outlook.

▪ However, it will be difficult to find a majority in the Council for more aggressive rate hikes in the nearest months.

▪ In such situation we return to the lower end of the range of maximum level of interest rate in current tightening cycle indicated by us a few months ago (7-7.5%). We think the reference rate will reach 7% by mid-2005.

The Monetary Policy Guidelines for 2005

▪ The MPC said that monetary policy will be focused on achieving target level of 2.5% rather than maintaining it within the allowed margin of deviations (+/-1%).

▪ The most serious problem for the MPC is a reaction to supply shocks, which affect inflation and economic growth in opposite directions. Not every shock will require reaction of monetary policy.

▪ According to the MPC, due to high uncertainty monetary policy decisions should be based on all available information, not only on the inflation projection. However, the projection will be the most important point of reference for MPC decisions.

▪ Set of monetary policy instrument will be almost unchanged in 2005. The important change will be shortening of NBP bills' maturity from 14 to 7 days.

Central bank watch

Comments of the central bank representatives	Remarks
Krzysztof Rybiński, deputy NBP governor PAP, Reuters, 20 September For the MPC and the NBP a fragment of the projection from 3Q05 to the end of 2006 is much more important than the next two quarters. This is the period when monetary policy can influence inflation and the risk in this period is more relevant. It doesn't matter if inflation will be by a half of percentage point higher or lower in the first quarter 2005, since it will be still above the target. However it is relevant if it will be much above the target in 2006. The fast economic growth is closing the output gap, and this may keep inflation high for a longer period than financial markets expect at the moment.	After a series of MPC members' comments weakening hopes for further rate hikes (see below), the hawks stroke back. Deputy governor of the bank Krzysztof Rybiński was trying to quell speculations that an improving food price outlook could force a cut in the NBP inflation projection. Rybiński stressed that even if inflation in the nearest two or three quarters was lower than forecasted, the more important for the MPC is the medium-term inflation outlook, i.e. in the period when current monetary policy affects inflation. Particularly that even if inflation was lower than expected in the nearest time, it would remain much above the central bank's inflation target.
Dariusz Filar, MPC member Bloomberg, 6 October It [rising zloty] has a certain impact on the inflation level in the future and in the moment it stops to work, we will have to tell ourselves that the exchange rate factor stopped to positively influence the inflation prospects. Then, it would demand relatively stronger action with other monetary policy instruments. I don't rule out that an inflation peak may appear in the first quarter of 2005. It could be lower than it was assumed earlier, but it doesn't mean that it will not appear. I would be very careful then in saying that the peak of inflation was in July and August and now it only will slow down. Even if the assumed parameters were high at the beginning, it doesn't mean that at the end of 2005 and the beginning of 2006 the inflation path given in the projection must be fundamentally different from the August projection.	The conclusion of the interview with Filar indicate not only that he was supporting a rate hike in September, but it clearly suggested that hawks did not lay down their arms. Filar's statement showed that the new inflation projection will be very important weapon in hawks' hands again, as it will show that the inflation path is only slightly lower than in the August projection and it does not have to be a fundamental difference. Therefore, another monetary tightening is well possible in November. Another set of argument will show up in 1Q04, as one should be very careful, following Filar's way of thinking, saying that that the peak of inflation was in July-August. We expect inflation increase in 1Q05 and even if the CPI inflation is likely to be slightly lower than currently, it may trigger the MPC reaction. Also, while foreign exchange is influencing the monetary policy restrictiveness, according to Filar no further strengthening of the zloty (and not necessarily zloty weakening) is sufficient argument for rates increase.
Andrzej Sławiński, MPC member Rzeczpospolita, 18-19 September The central bank should counteract such price increases [which may translate into stronger inflation expectations], so that interest rate would not have to be raised strongly in future, which could increase the unemployment rate. However, when the unemployment is already high – as is the case in Poland – the risk that inflation expectations will translate into inflation is relatively lower. Wage pressure becomes relatively weaker. Situation of many households becomes relatively more difficult. Increase in food prices causes relative fall in demand for non-foodstuffs. All these conditions causes that along with high unemployment, the risk of "overdosing" monetary tightening rises.	Until August's decision of the MPC, participants of the Polish financial market could have observed quite interesting regularity, according to which one could have noticed in the public media only those comments of the MPC members, which presented the views of the more "hawkish" faction, suggesting more decisive rate hikes. Thus, the comments from the central bank that we have seen within a few weeks before MPC meeting in September were quite surprising, as three MPC members signaled that one should be very cautious as regards further tightening of monetary policy. Andrzej Sławiński pointed to possibility of "overdosing" monetary tightening in a reaction to inflationary supply shocks amid high unemployment rate. Halina Wasilewska-Trenkner and Andrzej Wojtyna hinted they were not especially convinced towards the NBP's pessimistic inflation projection, which assumed a constant rise in the rate of inflation in the nearest months. Well, it seems strange why a few weeks earlier the MPC had unexpectedly raised interest rate by "as much as" 50bps, saying that the main reason for that was the publication of the inflation projection, which means the Council agreed with the conclusions from the projection. Such rapid change in opinions, because it is perceived that way by the market, significantly reduced predictability of monetary policy. Despite Wojtyna suggested that the degree of the MPC's identification with the projection will be rising over time, the way the MPC treated the projection in August and September causes that the projection did not become a factor increasing transparency of monetary policy and did not make predicting interest rate changes easier. It is also worth to take note of Wojtyna's comment on the pace, at which the MPC will try to reduce inflation to the inflation target of 2.5%. He stressed (similarly as it was made in *The Monetary Policy Guidelines for 2005* that the Council will try to reduce output volatility. It would be very difficult to find similar phrases in comments of members of the previous MPC, while indeed the goal function of the central bank usually includes such element. Comments of MPC members before September's meeting signaled that quite rapidly they started to perceive threats to inflation as weaker than just a few weeks earlier, when in a reaction to publication of pessimistic inflation projection, the MPC raised interest rate by 50bps. No rate hike in September was a big surprise and a proof of lack of consistency in the MPC's perception of risks to the inflation target and the decisions adequate to that.
Halina Wasilewska-Trenkner, MPC member Reuters, 16 September Many things indicate inflation has already reached its maximum, and should be falling now, which will be supported by a fall in food prices in the next few months due to the good harvest. […] It seems inflation shock resulting from EU accession is going past. Also, wage growth appears to be limited and is not generating serious inflationary pressure. The sum of signals from the economy is positive, in this light the threat of inflation is weakening.	
Andrzej Wojtyna, MPC member PAP, 13 September I disagree with an opinion that we do identify ourselves with the inflation projection. We did not attend a press conference whereby we wanted to give a signal that the projection is being prepared by NBP economists and presented to the MPC. (…) Due to more frequent working meetings of the Council with NBP analysts the identification degree will be growing in the long run in the future. We do not want to bring inflation down to 2.5% as fast as possible as what is the fastest is not always the best. (…)The point is to find such a path that would allow to return to the target relatively fast but at the same time would allow to reduce output volatility. After 25bps rate hike, a return to 50bps increase was to play a role of signal and show that the Council is determined so that not to allow for occurrence of the second-round effects, so that higher inflation expectations did not translate into stronger wage claims because this would lead to inflation acceleration. Despite it was stressed in the communiqué, it was overlooked.	

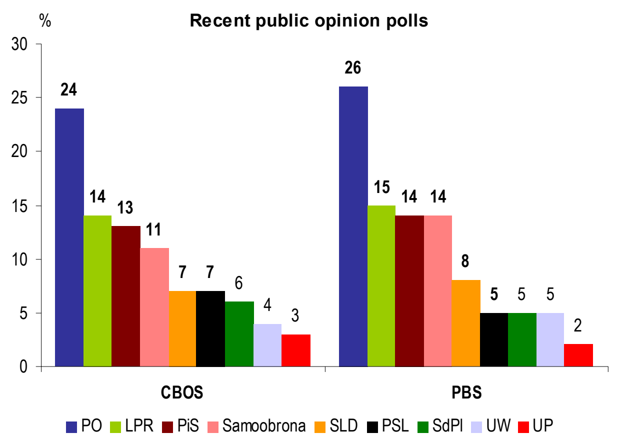
Government and politics

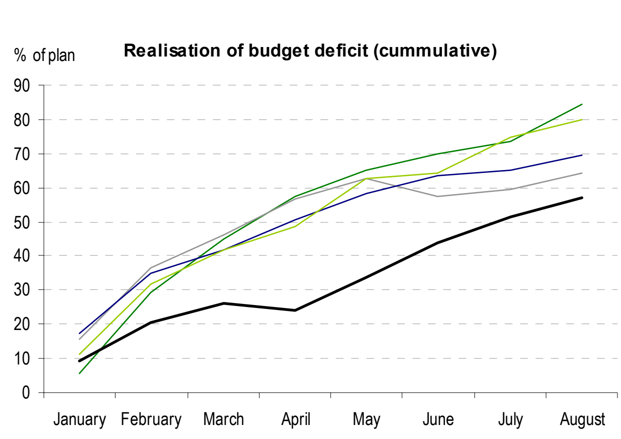
Confidence vote for Belka

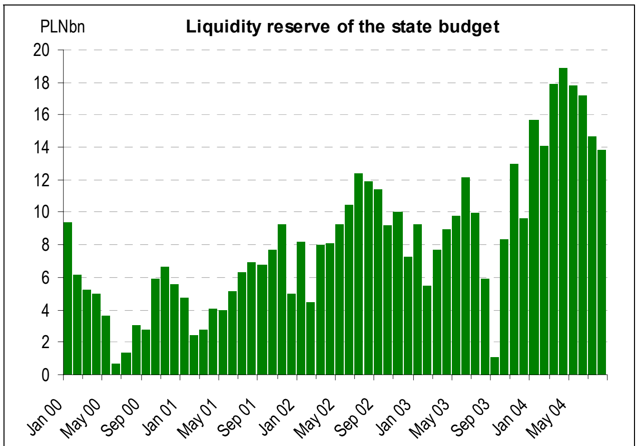
Likely distribution of votes in the confidence vote for Belka's cabinet.

DEFINITELY FOR	DEFINITELY AGAINST
SLD (158), UP (15), SdPl (33), PLD (11)	PO (56), PiS (44), LPR (25)
POSSIBLY FOR	**POSSIBLY AGAINST**
Unaffiliated deputies (23)	PSL (40), Samoobrona (31), SKL, PBL, RKN, PP, ROP (24)
TOTAL FOR max. 240 votes	**TOTAL AGAINST** ca. 220 votes
COULD ABSTAIN: part of unaffiliated deputies	

Simple majority of votes is sufficient to win the vote of confidence.







Source: Ministry of Finance, Ministry of Social Policy, CBOS, PBS

Déjà vu!

▪ On the October 15, the vote of confidence in the Belka's government will take place, in line with the PM's pledge that he would ask for the vote after submitting the 2005 budget draft to the parliament.

▪ Part of the SLD rebelled against Belka, but the mutiny was headed off and all SLD will fall in line behind PM Belka.

▪ The SdPl (formally an opposition party) decided to back the cabinet. Similar decision was also made by the junior coalition partner UP and PLD headed by Roman Jagieliński. Most of independent deputies are also likely to support the government.

▪ Such balance of strengths suggests that we will see repeat of the result of the vote of confidence for Belka's cabinet in June. Such scenario has been priced in by the market, so its materialisation should not trigger significant reaction of investors.

Recent results of public opinion polls

▪ The latest results of public opinion polls showed that the Civic Platform (PO) keeps leading. However, its result is lower than in the first half of the year when it was close to 30%.

▪ The odds are that the level of support for the PO will not be high enough to allow them for ruling the country without forming a coalition.

▪ Meanwhile, the formation of a stable coalition may be difficult. Suggested coalition of the PO and the PiS (Law and Justice) has only 37-40% support.

▪ Even if the PO and the PiS manage to achieve majority of seats in the parliament, they may have problems with preparation of consistent economic programme.

▪ Many propositions of the PiS (e.g. elimination of the MPC and modification to goal of the NBP) cannot be accepted by the PO.

This year's budget still in good shape

▪ After August the budget deficit reached 57.1% of the full-year plan. The result is better than the results recorded in a corresponding period of a few past year.

▪ Relatively low level of deficit is a consequence of higher-than-planned tax revenues, mostly inflows from CIT and excise tax. These inflows offset lower than assumed VAT revenues.

▪ At the same time, despite substantial annual rise in August, budget spending remains under control.

▪ All in al, there is growing chance that actual budget deficit at the end of the year will turn out to be lower than PLN45.3 planned in the budget act. In the 2005 budget draft, the Ministry of Finance assumed that this year's budget deficit will be lower than planned by PLN1.6bn. According to deputy finance minister Elżbieta Suchocka-Roguska the deficit may be reduced by as much as PLN2bn.

▪ However, the scale of reduction in this year's budget deficit may be by a few dozen million zlotys lower than estimated by the ministry due to rise in Poland's contribution to the EU budget. This has been caused by higher than expected use of the EU structural funds.

▪ This is good news for Poland – additional cost for the budget is low, while contrary to earlier worries the country managed to make use of the EU aid funds. Net balance of financial flows between Poland and the EU will probably turn out to be more beneficial for Poland than it was expected earlier.

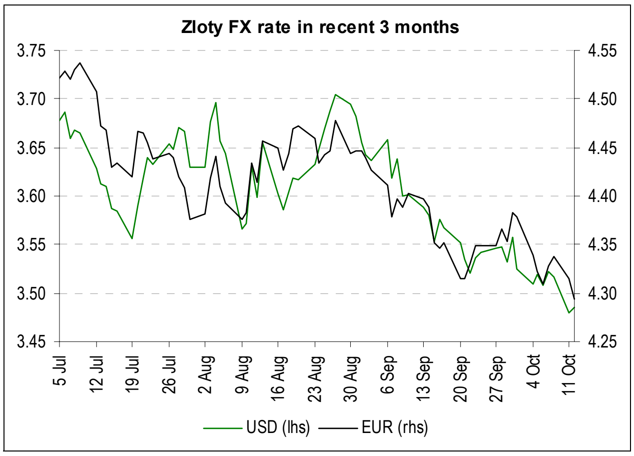
▪ Liquidity of the budget remains high, but has been gradually reduced for a few months – at the same time the finance ministry lowered the supply of treasury papers.

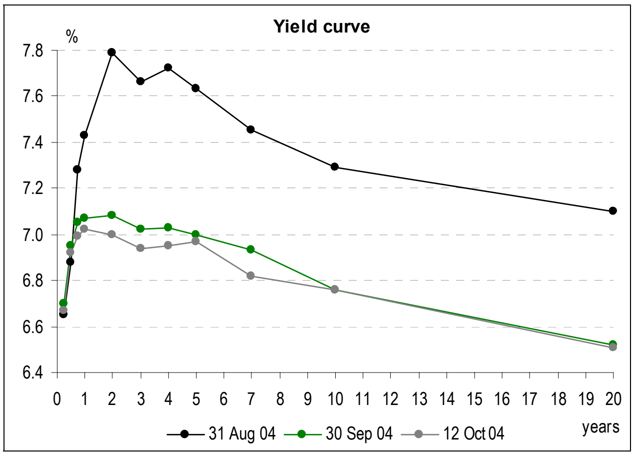
▪ Further reduction in budget liquidity will be caused by the direct payments to Polish farmers, which will be pre-finance from the state budget starting from October 18.

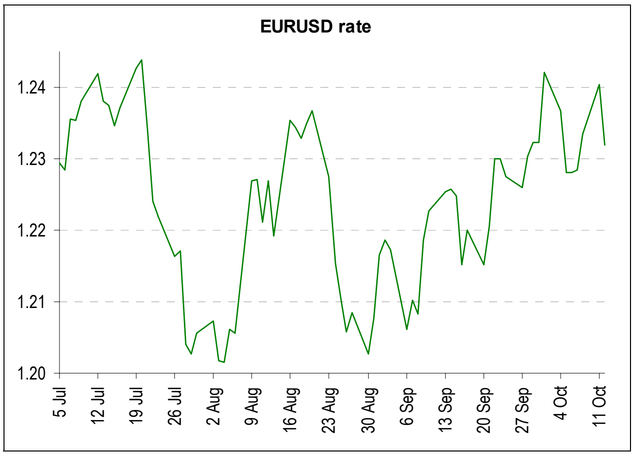
Government and politics

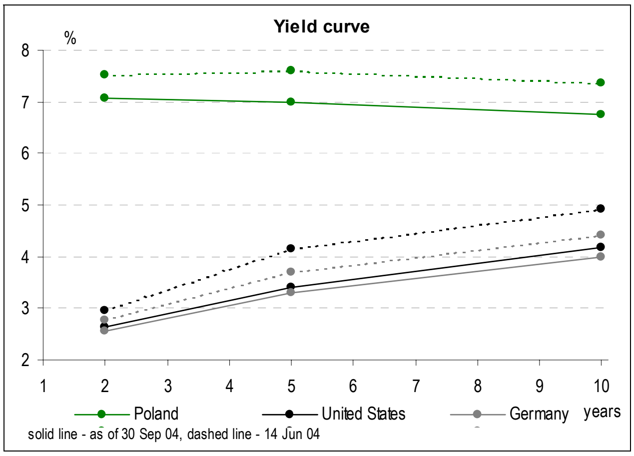
Comments of government representatives and politicians	Remarks
Marek Belka, Prime Minister; Radio PiN, 1 October I remember when in May this year all the analysts claimed that the public debt to GDP ratio at the year-end will be 57.6-57.8%, that is above the constitutional safety threshold at 55%. It turns out today that it is 52.2% or 52.5%, or even less. […] It will depend on executing budgets of local governments. There was a PLN6bn surplus in them after the first half of the year. At the year-end we foresee, very cautiously again, a deficit of PLN6bn. […] I am convinced very deeply that the safety threshold at 55% will not be breached next year and in the years to come after it providing our plans of public finance reform will be executed.	Belka's comment on this year's level of public debt is not new information, as recent estimates had showed earlier the risk of breaching 55% threshold of the public debt-to-GDP ratio this year is getting much smaller. Deceleration in public debt increase was possible to a large extent thanks to significant zloty appreciation in recent months, which lowered zloty value of foreign currency denominated part of the Poland's public debt. Belka believes that there are chances that 55% threshold will not be exceeded also in 2005. However, this issue is not as important as this year's level of public debt, as next year Poland is expected to switch to the ESA95 norms, which gives a figure lower by several percentage points. The Ministry of Finance assumes that according to the ESA95 methodology, public debt will stabilise at just above 48% in 2005-2006 after hitting 46.6% this year.
Jerzy Hausner, deputy PM, economy and labour minister; PAP, Reuters, 22 September We want to maintain September's level by the end of the year. In October the unemployment rate will fall. There is a question mark over November. Every November was a month of rising unemployment. This November does not have to mean a deterioration. December is the most inconvenient. There are no seasonal jobs that month. […] We want to maintain this state so that at the end of 2004 the unemployment rate will be below 19%. I foresee that in 2005 the number of unemployed will fall to some 2.5m persons and unemployment rate will fall to below 17%. Falling below 2m is possible in 2006 and in 2008 we will meet EU standards.	Deputy PM Hausner expects the number of unemployed to fall by over 1 million within slightly above two years. This would mean the reduction by one third of the current level. Well, such significant scale of unemployment reduction requires much more decisive reforms than designed and introduced so far by the government. Relatively low level of the zloty exchange rate, which is perceived by Hausner as a condition for maintaining fast pace of the economic growth, will not be enough to solve the problem of very high unemployment. The fast pace of unemployment reduction in the coming years assumed by the deputy PM seems more like a wishful thinking than a credible forecast, especially that it will be others than Hausner that would guide social and economic policies at that times.
Mirosław Gronicki, finance minister; Reuters, 17 September Excessive strengthening of the zloty could slow economic growth but I do not see a threat of this over the next year, possibly in 2006. I agree with the NBP view that 4.20 zlotys per euro is neutral to exports, but if it fell below the level, it could lower exports' profitability. [Asked whether it is possible that the zloty will strengthen to 4.2 against the euro by the year-end] It will be difficult but all is possible. We are doomed to success - if the political situation is calm, if there are no excessive problems with the budget.	Finance minister's comments show that although government's officials are pleased with recent strengthening of the domestic currency, which helped to curb public debt increase, at the same time they are worried that further gains of the zloty could hamper the economic growth. At the beginning of October, the zloty exchange rate reached the highest level since many months, on growing expectations that the Belka's government will win planned confidence vote. One may expect that when the positive scenario materialises, some correction will take place, but later on the zloty remain strong due to fast economic growth and high foreign currency inflows.
PAP, 7 October This year, budget deficit will be significantly lower than we have planned. It is highly probable that next year's budget deficit will below PLN35bn. As far as I know one should not expect proposals of tax changes from SLD. That's what I know so far. SLD has consented to the point that there will be no social tax relieves. This is no good way. The money must be found for aid programs for the poorer. It has been just accepted by the SLD caucus.	Finance minister said that budget deficit for 2005 is very likely to be lower than planned PLN35bn. In our opinion, while conservative macroeconomic assumption supports such a view, too optimistic assumptions regarding rise in tax revenues may make reduction of the next year's deficit problematic. What is more, the timing of minister's comment about a possibility of lowering budget deficit (higher revenues) in 2005 was not fortunate, as the SLD announced its new project on increasing social benefits. So far, the party did not present the source of financing extra spending. Gronicki's statements may allow the SLD for saying that one does not need additional sources of financing because, as the deficit is expected to lower.
Jarosław Neneman, deputy finance minister; PAP, 8 October The budget is very tight both on the revenue and spending side. Currently, we do not see possibility to increase revenues. It is not enough to say that there will be higher efficiency in tax collection. (…) There are no sums in [the next year's] budget to be spent. They would have to be gathered somehow, i.e. taken them away from somebody. **Krzysztof Janik, SLD chairman;** PAP, 8 October [SLD wants so that pensioners, whose gross monthly income does not exceed PLN800, receive some financial support in cash] We estimate that it would cost PLN1.3bn next year. We have one idea [how to finance the proposal]. We see some possibilities in the budget, but we will present them during work on the next year's budget.	The SLD announced a new project on increasing social benefits. According to the motion, the beneficiaries of old-age and disability pension systems with the lowest income (below PLN800 per month) would receive cash subsidies from the budget of up to PLN900 per month. The bill would increase 2005 budget spending by ca. PLN1.3bn. The SLD's motion added to the set of other parties' proposals that will be debated during the budget debate in the parliament in the nearest time. They are potentially dangerous for budget consistency, however one should remember that according to the Polish law, the parliament cannot increase the size of budget deficit planned for the next year. To some extent, this mitigates the risk that the parliament would accept irresponsible solutions with no sources of financing. According to the ministry, the budget is based on very tight revenues plan and there is no possibility to find additional financing without cuts on the spending side.

Market monitor









Source: Reuters, BZ WBK

Better short-term outlook – the zloty and bonds get stronger

- Despite approaching vote of confidence in the government, there are no signs of nervousness on the Polish financial market so far, since cabinet's victory in the Sejm is almost certain. In September interest in Polish market from foreign investors increased considerably. It was mainly demand from them that was influencing quotations of the zloty and Treasury bonds.
- In the second week of September the market began to appreciate given information that S&P agency may consider improvement in the outlook for Poland's debt rating. Afterwards, positive moods prevailed till the month-end. The zloty was appreciating given expectations of rate hikes. Strengthening on the bond market was supported by inflation and output data, which reduced the expected scale of rate hikes. Small depreciation of the Polish currency resulted from legally not-binding Sejm's resolution on PKO BP privatisation (exclusion of foreign investors from privatisation). The surprising MPC's decision resulted in significant but short-lived weakening of the zloty and further downward move of the yield curve.
- At September-end the zloty was stronger than on the last day of August by more than 2% against the dollar-euro basket. The appreciation exceeded even 3% around 20 September. The yield curve moved downwards by 50-70bps last month, with more significant move at the shorter end.
- In early October the S&P agency realised its announcement and upgraded the outlook for the rating, which allowed for further strengthening on the Polish financial market. The rate of the zloty against the dollar fell to the lowest level since early 1999, and it was the strongest against the dollar-euro basket since early 2003.
- We expect that present, strong levels will maintain on both FX and fixed income markets in the fourth quarter. Monetary policy is likely to be a main factor of uncertainty.

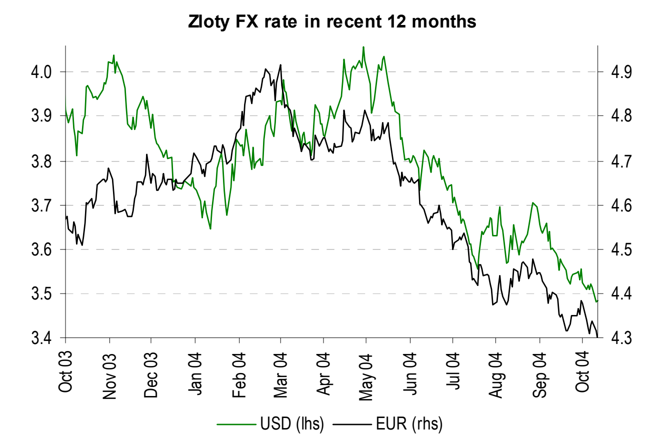
The US dollar remains weak

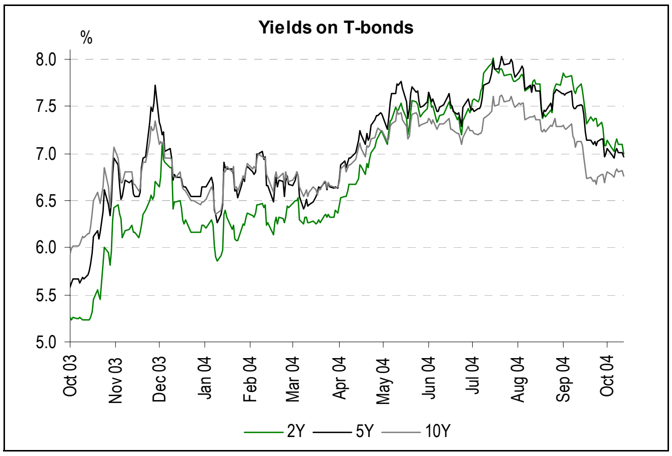
- In September market saw significant depreciation of the dollar against the euro. Within the month the EURUSD increased from some 1.205 to 1.24 and it remained at this level in early October.
- Despite continuing the cycle of interest rate hikes in the US, market participants are still worrying about sustainability of revival in the American economy. Geopolitical tensions are conductive to it. What is more, huge nervousness and high prices on the crude oil market have negative influence on dollar quotations.
- On 2 November presidential election will be held in the United States. This is another factor of uncertainty. Therefore we expect certain volatility, but the EURUSD rate should not leave a range from recent months. In the post-election period we foresee the EURUSD rate in a range of 1.24-1.29.

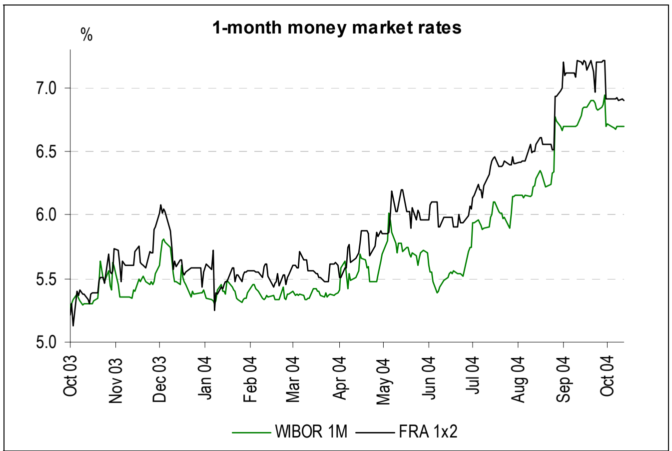
Uncertain outlook for bond markets

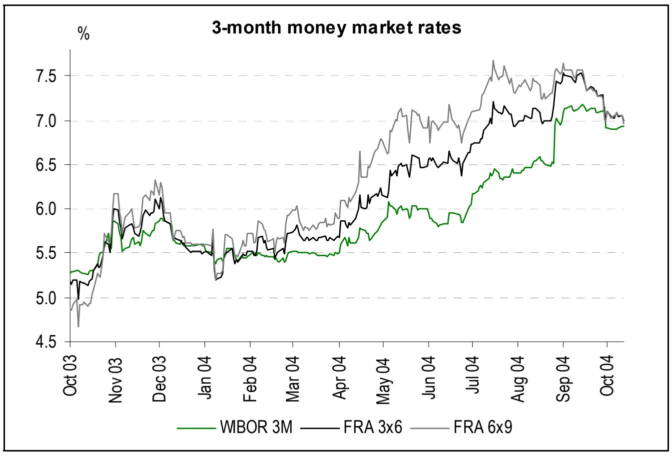
- At a significant fall in yields, in September the risk premium for Polish bonds recorded a fall of 15 basis points to some 145bps. Since Poland's accession to the European Union the premium declined by 35bps. It points to significant improvement in perception of Poland's medium-term outlook.
- At the beginning of September, yield curve on the US fixed income market moved upwards after good report from the labour market. Afterwards, the yields returned to a downward trend that continues since mid-June, despite rate hikes. It proves that uncertainty regarding sustainability of the growth is maintaining. Especially as another data from the labour market disappointed.
- The outlook for fixed income market is highly uncertain. Nevertheless, we expect moderate increase in yields in 4Q04 in the base-case scenario.

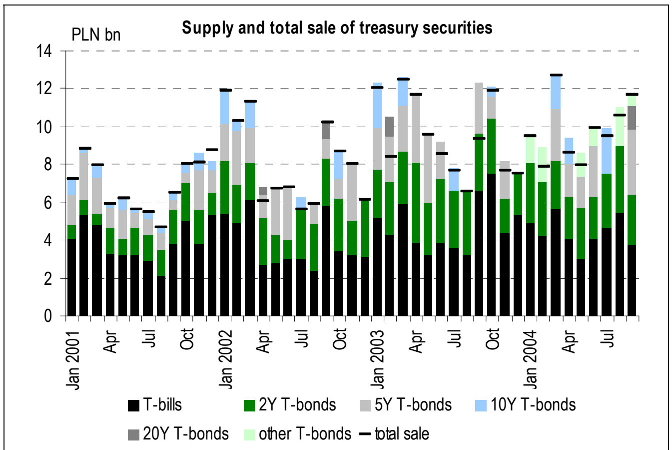
Market monitor











Treasury bill auctions (PLN m)

Date of auction	13-week	OFFER / SALE 52-week	Total
6.09.2004	-	1,000 / 1,000	1,000 / 1,000
13.09.2004	-	1,000 / 1,000	1,000 / 1,000
20.09.2004	-	500 / 500	500 / 500
27.09.2004	100 / 100	1,100 / 1,100	1,200 / 1,200
September total	**100 / 100**	**3,600 / 3,600**	**3,700 / 3,700**
4.10.2004	100	900	1,000
11.10.2004	100	800	900
18.10.2004	100	800	900
25.10.2004	-	1,000	1,000
29.10.2004	-	1,000	1,000
October total	**300**	**4,500**	**4,800**
November & December*		**6,100 - 7,800**	

* estimations based on preliminary information for 4Q04

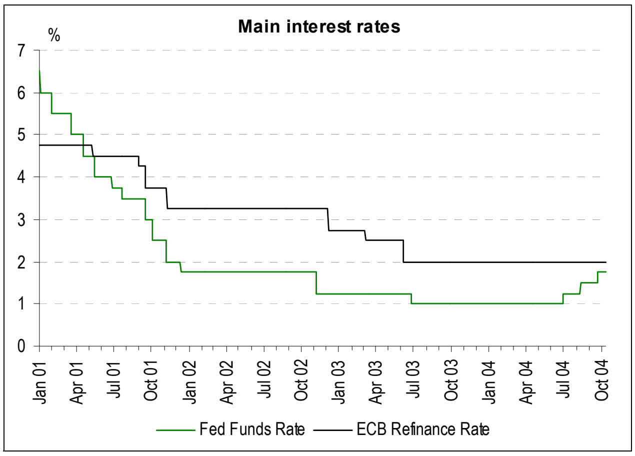
Treasury bond auctions in 2004(PLN m)

month	First auction				Second auction				Third auction			
	date	T-bonds	offer	sale	date	T-bonds	offer	sale	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	2,400.0	2,001.0	-	-	-	-
August	04.08*	OK0806	3,480.0	3,086.0	11.08*	WZ0307/0911	1,550.0	1,470.0	-	-	-	-
September	01.09	OK1206	2,700.0	2,700.0	8.09*	WS0922	1,200.0	1,200.0	15.09*	DS0509	3,480.0	3,480.0
October	06.10	OK1206	2,000.0	2,000.0	13.10	DS1015	2,600.0	-	20.10	DS0509	2,000-3,000	-
November	03.11	OK1206	2,000-3,000	-	10.11	WZ0307/0911	1,000-2,000	-	17.11	DS0509	2,000-3,000	-
December	01.12	OK1206	2,000-3,000	-	-	-	-	-	-	-	-	-

* with supplementary auction

Source: Ministry of Finance, Reuters, BZ WBK

International review

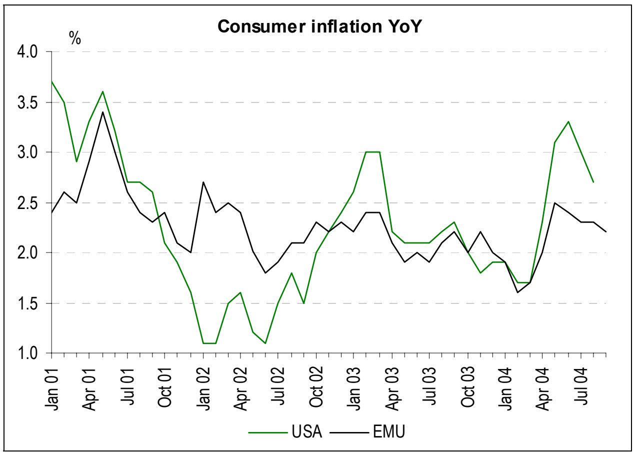


Fed continues the hikes, ECB's rates still unchanged

▪ In line with expectations, on 21 September the Fed decided to raise interest rates. It was the third quarter-point rate hike this year. The federal funds rate stands at 1.75%.

▪ The rhetoric of the American central bank has not changed. In the statement the Fed said that: the risks to growth and price stability were roughly equal and policy accommodation could be removed at a measured pace; output growth appeared to have regained some traction and labour market conditions had improved modestly; despite the rise in energy prices, inflation and inflation expectations had eased in recent months. In our opinion, the rates will be raised by 25 basis points during one of two Fed meetings planned by the end of the year.

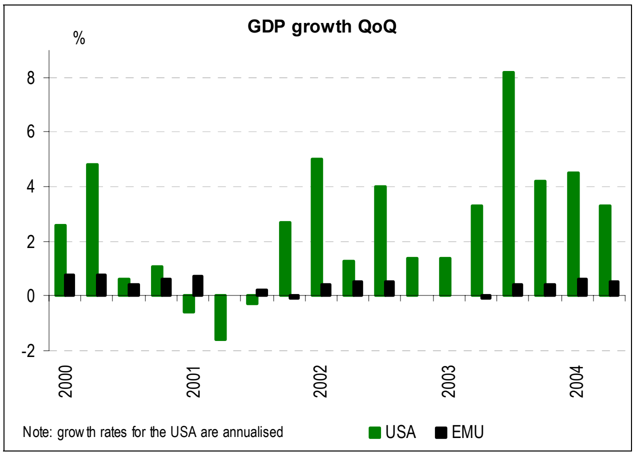
▪ On 7 October the ECB kept the refinance rate at 2%. First interest rate hike in the Eurozone is likely only next year.



Inflation pressure is still weakening

▪ In the Eurozone, preliminary estimations of inflation in August were confirmed in the final release, which exactly matched market forecast. The prices increased by 0.2%MoM and annual inflation rate stabilised at 2.3%, unchanged from July. According to preliminary estimations, in September inflation fell to 2.2%YoY, in line with forecasts again. For five consecutive months inflation has exceeded the upper end of the ECB's inflation ceiling target at 2.0%. On the other hand, the figure was the lowest since May.

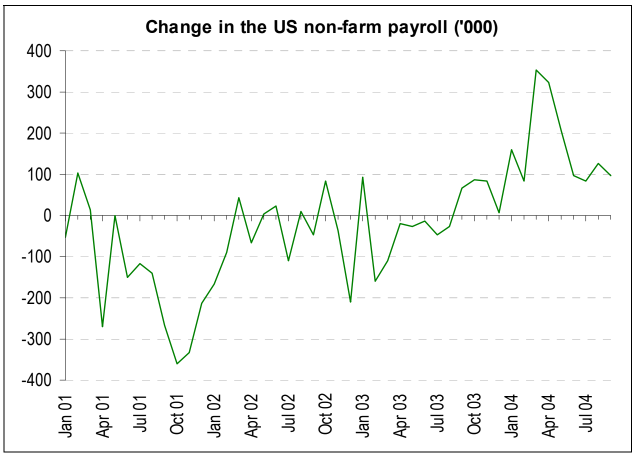
▪ Also in the US data on inflation matched expectations. In August the prices increased by 0.1%MoM. This figure resulted in a decrease in annual inflation rate to 2.7% from 3.0% in July. At the same time, annual core inflation rate declined to 1.7% from 1.8% in July. The figures suggested that the Fed didn't have to hurry with rate hikes and it could continue at a measured pace.



Growth in the US higher than estimated earlier

▪ According to final data on economic growth in the United States, in the second quarter 2004, the American GDP increased by 3.3%QoQ compared to 4.5% recorded in the first quarter this year. Despite deterioration from previous quarter, such a figure meant a higher than expected upward revision of preliminary estimations at 2.8% released a month ago. It resulted mainly from changes in foreign trade figures. Meanwhile analysts' forecasts pointed to the revision to 3.0%.

▪ In mid-October, a second and last revision of data on economic growth in the Eurozone for the second quarter 2004 is planned. Previous estimate from 7 September was at 0.5%QoQ and 2.0% YoY. At he same time, the European Commission will publish the latest forecast for 3Q04 and 4Q04. at present both of them are at the level of 0.3-0.7%QoQ.



Source: Reuters, ECB, Federal Reserve

Weak figures from American labour market

▪ Data from the US labour market disappointed not for the first time this year, though to lower degree than in June and July. In September non-farm payroll employment increased by 96,000, i.e. clearly below economists' expectations at 155,000. Figure for August was revised downwards to 128,000 from 144,000 released previously. In line with expectations, in September the unemployment rate amounted to 5.4%, unchanged from August.

▪ Index of German entrepreneurs' sentiment IFO declined to 95.2 pts in September from 95.3pts in August, while market forecast pointed to slightly deeper fall to 95.1pts. Deterioration in the index was rather small given worries that rising oil prices may weaken the growth. The assessment of present situation improved and expectations are worse than a month ago. Head of the IFO institute assessed that the results confirmed continuation of revival..

What's hot this month

Monday	Tuesday	Wednesday	Thursday	Friday
4 October POL: T-bill auction *EMU: Producer prices (Aug)* *EMU: Retail sales (Aug)* *USA: Factory orders (Aug)*	**5** *GER: Unemployment (Sep)* *EMU: Unemployment (Aug)*	**6** POL: T-bond auction OK1206	**7** *EMU: ECB meeting*	**8** *GER: Industrial output (Aug)* *USA: Employment (Sep)*
11 POL: T-bill auction	**12** *FRA: Industrial output (Aug)*	**13** POL: T-bond auction DS1015 *FRA: Inflation preliminary (Sep)* *ITA: Industrial output (Aug)*	**14** POL: Inflation (Sep) POL: Money supply (Sep) POL: Wages & employment (Sep) *ITA: Inflation final (Sep)* *EMU: GDP (2Q)* *USA: Foreign trade (Aug)*	**15** *USA: Retail sales (Sep)* *USA: Producer prices (Sep)* *USA: Industrial output (Sep)*
18 POL: T-bill auction *EMU: Inflation final (Sep)*	**19** POL: Industrial output (Sep) POL: Producer prices (Sep) *EMU: Industrial output (Aug)* *USA: Inflation (Sep)*	**20** POL: T-bond auction DS0509	**21** POL: Business climate (Oct) *EMU: Foreign trade (Aug)*	**22** POL: Retail sales (Sep) POL: Unemployment (Sep) POL: Core inflation (Sep) *FRA: Inflation final (Sep)*
25 POL: Food prices (1H Oct) POL: T-bill auction *GER: IFO (Oct)*	**26** POL: MPC meeting (1st day) *EMU: Balance of payments (Aug)*	**27** POL: MPC meeting (decision)	**28** *EMU: Money supply (Sep)*	**29** POL: Balance of payments (Aug) POL: T-bill auction *ITA: Inflation preliminary (Oct)* *EMU: Economic sentiment; Business climate (Oct)* *EMU: Inflation preliminary (Oct)* *USA: GDP (3Q)*
1 November **All Saints' Day** *EMU: PMI (Oct)* *USA: ISM (Oct)*	**2** *USA: Election Day*	**3** POL: T-bond auction OK1206 *GER: Unemployment (Oct)* *USA: Factory orders (Sep)*	**4** *EMU: Producer prices (Sep)* *EMU: Unemployment (Sep)* *EMU: ECB meeting*	**5** *GER: Industrial output (Sep)* *EMU: Retail sales (Sep)* *USA: Employment (Oct)*
8 POL: T-bill auction	**9**	**10** POL: Money supply (Oct) POL: T-bond auction WZ0307 & WZ0911 *USA: Fed meeting*	**11** **Independence Day**	**12** *EMU: GDP (3Q)*

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	24-25	28-29	26-27	-	-
GDP*	-	20	-	-	-	9	-	-	8	-	-	-
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	23	23	23	22	24	21
Gross wages, employment	16	13	12	15	17	16	14	13	14	14	17	14
Unemployment	23	20	19	22	21	23	23	23	23	22	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	29	30	30
Money supply	14	13	12	14	14	14	14	13	14	14	10	14
NBP balance sheet	7	6	5	7	7	7	7	6	7	7	5	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

		Sep 03	Oct 03	Nov 03	Dec 03	Jan 04	Feb 04	Mar 04	Apr 04	May 04	Jun 04	Jul 04	Aug 04	Sep 04	Oct 04
Industrial production	%YoY	10.9	12.1	9.2	13.9	14.4	18.3	23.5	21.8	12.2	15.8	6.0	13.5	10.3	4.6
Retail sales [c]	%YoY	9.7	10.3	11.4	17.3	7.6	12.1	20.7	30.6	4.0	8.6	10.9	9.6	8.1	8.7
Unemployment rate	%	19.4	19.3	19.5	20.0	20.6	20.6	20.5	20.0	19.6	19.5	19.3	19.1	19.0	18.9
Gross wages [b c]	%YoY	2.2	3.0	4.1	5.1	3.5	6.3	7.0	4.6	4.4	4.5	3.6	5.1	4.7	5.4
Employment [b]	%YoY	-3.1	-3.2	-3.3	-3.5	-1.4	-1.5	-1.3	-1.1	-0.9	-0.7	-0.7	-0.8	-0.6	-0.5
Export [d]	%YoY	20.1	11.4	8.2	14.0	19.6	10.9	29.9	25.0	23.6	39.0	27.0	25.2	11.5	14.7
Import [d]	%YoY	12.5	4.9	2.5	6.2	10.6	2.7	25.0	36.3	19.3	35.5	13.7	21.4	9.7	15.2
Trade balance [d]	EURm	-266	-254	-503	-545	-173	-218	-461	-1 106	-379	-89	-131	-119	-200	-320
Current account balance [d]	EURm	-57	314	-356	-566	191	-101	-428	-748	-568	-404	-154	-119	-350	-320
Current account balance [d]	% GDP	-2.2	-2.0	-1.9	-2.0	-1.7	-1.4	-1.3	-1.5	-1.6	-1.7	-1.6	-1.6	-1.8	-2.1
Budget deficit (cumulative)	PLNbn	-33.1	-34.8	-35.5	-37.0	-4.2	-9.4	-11.8	-11.0	-15.3	-19.9	-23.2	-25.9	-29.1	-33.6
Budget deficit (cumulative)	% realisation	84.4	93.3	98.9	100.0	9.3	20.7	26.1	24.3	33.8	43.9	51.3	57.1	64.2	74.1
CPI	%YoY	0.9	1.3	1.6	1.7	1.6	1.6	1.7	2.2	3.4	4.4	4.6	4.6	4.4	4.2
PPI	%YoY	2.1	2.7	3.7	3.7	4.1	4.2	4.9	7.6	9.6	9.1	8.6	8.7	8.4	7.8
Broad money (M3)	%YoY	3.1	4.7	5.6	5.6	5.1	5.1	5.7	8.5	6.4	7.2	6.8	7.3	7.5	10.3
Deposits	%YoY	-0.2	1.5	3.3	3.7	3.4	3.5	4.8	8.4	6.2	6.9	6.4	7.5	7.4	11.3
Credits	%YoY	5.4	7.5	8.5	8.1	7.4	7.7	6.1	8.5	6.1	5.7	4.6	5.2	5.9	11.7
USD/PLN	PLN	3.98	3.92	3.94	3.79	3.74	3.84	3.89	3.97	3.93	3.78	3.64	3.64	3.58	3.50
EUR/PLN	PLN	4.46	4.59	4.62	4.66	4.71	4.85	4.77	4.76	4.72	4.59	4.47	4.43	4.37	4.30
Reference rate [a]	%	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	6.00	6.50	6.50	6.50
WIBOR 3M	%	5.17	5.42	5.68	5.69	5.46	5.46	5.49	5.69	5.99	5.91	6.34	6.58	7.12	7.10
Lombard rate [a]	%	6.75	6.75	6.75	6.75	6.75	6.75	6.75	6.75	6.75	6.75	7.50	8.00	8.00	8.00
Yield on 52-week T-bills	%	4.91	5.30	5.95	6.02	5.59	5.78	5.87	6.20	6.65	6.79	7.15	7.24	7.38	7.05
Yield on 2-year T-bonds	%	5.02	5.53	6.31	6.49	6.17	6.34	6.34	6.83	7.41	7.44	7.80	7.66	7.51	7.08
Yield on 5-year T-bonds	%	5.60	6.04	6.86	6.82	6.65	6.76	6.60	7.13	7.57	7.50	7.79	7.65	7.33	7.00
Yield on 10-year T-bonds	%	5.93	6.36	6.92	6.75	6.65	6.81	6.65	7.02	7.32	7.27	7.44	7.36	6.96	6.80

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	890.3	187.1	200.2	201.3	226.0	203.7	216.2	221.3	249.0
GDP	%YoY	1.4	3.8	5.9	2.3	3.9	4.0	4.7	6.9	6.1	5.1	5.7
Total consumption	%YoY	2.8	2.5	3.4	1.1	2.8	2.9	3.3	3.3	3.4	3.4	3.5
- Private consumption	%YoY	3.3	3.1	4.1	1.4	3.8	3.5	3.9	4.0	3.8	4.2	4.3
Fixed investments	%YoY	-5.8	-0.9	7.0	-3.6	-1.7	0.4	0.1	3.5	3.3	8.0	10.0
Industrial production	%YoY	1.1	8.7	13.5	4.4	9.1	8.9	12.2	19.0	16.4	9.9	8.8
Retail sales (real terms)	%YoY	1.9	7.9	9.2	1.2	9.8	6.4	12.4	13.6	11.3	4.5	7.2
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	1.6	-0.1	1.4
Export [b]	%YoY	6.0	9.1	21.5	8.4	5.4	11.4	11.1	19.3	29.1	20.6	17.5
Import [b]	%YoY	3.5	3.3	18.1	3.1	-2.5	8.2	4.5	12.6	29.3	14.4	16.5
Trade balance [b]	EURm	-7 701	-5 077	-4 167	-1 529	-1 089	-1 155	-1 304	-909	-1 438	-450	-1 370
Current account balance [b]	EURm	-5 404	-4 109	-3 537	-1 641	-1 176	-568	-724	-592	-1 302	-623	-1 020
Current account balance [b]	% GDP	-2.7	-2.2	-1.8	-2.7	-2.4	-2.4	-2.2	-1.7	-1.7	-1.7	-1.8
Budget deficit (cumulative) [a]	PLNbn	-39.4	-37.0	-43.5	-15.5	-23.8	-33.1	-37.0	-11.8	-19.9	-29.1	-43.5
Budget deficit (cumulative) [a]	% GDP	-5.0	-4.5	-4.9	-8.3	-4.2	-4.6	-1.7	-5.8	-3.7	-4.2	-5.8
CPI	%YoY	1.9	0.8	3.4	0.5	0.5	0.8	1.5	1.6	3.3	4.6	4.2
CPI [a]	%YoY	0.8	1.7	4.2	0.6	0.8	0.9	1.7	1.7	4.4	4.4	4.2
PPI	%YoY	1.0	2.6	7.4	3.0	2.2	1.9	3.4	4.4	8.8	8.6	7.8
Broad money (M3) [a]	%YoY	-2.0	5.6	8.8	0.5	1.3	3.1	5.6	5.7	7.2	7.5	8.8
Deposits [a]	%YoY	-4.1	3.7	8.3	-2.3	-1.9	-0.2	3.7	4.8	6.9	7.4	8.3
Credits [a]	%YoY	5.2	8.1	9.6	8.7	6.1	5.4	8.1	6.1	5.7	5.9	9.6
USD/PLN	PLN	4.08	3.89	3.70	3.90	3.83	3.93	3.89	3.82	3.89	3.62	3.49
EUR/PLN	PLN	3.85	4.40	4.56	4.19	4.36	4.42	4.62	4.78	4.69	4.43	4.33
Reference rate [a]	%	6.75	5.25	6.75	6.00	5.25	5.25	5.25	5.25	5.25	6.50	6.75
WIBOR 3M	%	9.09	5.69	6.30	6.37	5.60	5.20	5.60	5.47	5.87	6.68	7.19
Lombard rate [a]	%	8.75	6.75	8.25	7.75	6.75	6.75	6.75	6.75	6.75	8.00	8.25
Yield on 52-week T-bills	%	8.18	5.33	6.58	5.75	4.94	4.86	5.76	5.75	6.24	7.26	7.08
Yield on 2-year T-bonds	%	7.94	5.38	6.99	5.58	4.91	4.92	6.11	6.28	6.86	7.66	7.14
Yield on 5-year T-bonds	%	7.86	5.61	7.12	5.50	4.98	5.38	6.57	6.67	7.10	7.59	7.10
Yield on 10-year T-bonds	%	7.34	5.77	6.98	5.60	5.19	5.63	6.68	6.70	7.00	7.25	6.97

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 12.10.2004 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

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