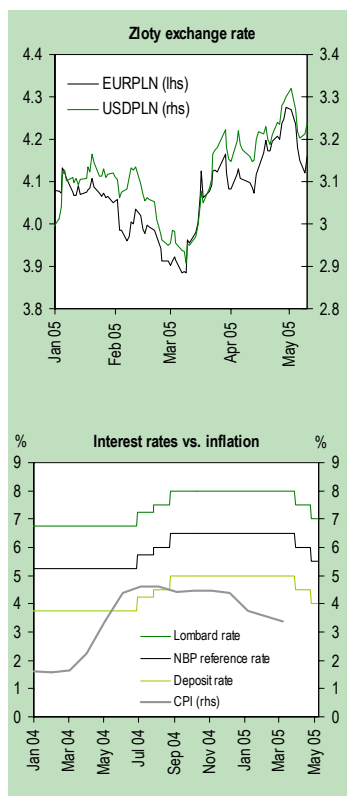


# MACROscope

## Polish Economy and Financial Markets

May 2005



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## Time to relax

▪ **After several weeks of turbulent developments of Polish political scene, which had negative impact on the financial market, the situation has stabilised for some time.** After failed voting on Sejm's self-dissolution in May, it looks like the government will remain in the office until autumn election. The most important event until then will be work over budget draft for 2006, which should be quite positively appraised by the market (with ca. PLN30bn deficit). As the president and the Sejm's speaker vowed to block legislation disrupting public finances, such political perspectives should improve sentiment on the Polish market at least until political uncertainty rises again in the proximity of election date. Thus, we foresee strengthening of the zloty in June-July period.

▪ **Political uncertainty was one of the most important arguments behind introduction of neutral bias in monetary policy in April by the MPC; it suggests the Council will hold back with further rate cuts for some time.** Simultaneously, the MPC reduced interest rates in April by as much as 50 bps amid quite optimistic inflation perspectives (inflation rate below inflation target for some time). Because economic situation is rather favourable from the point of view of inflation perspectives, it could mean that after risk factors die out (apart from politics, high prices of natural resources), the MPC could return to easing bias in policy and to interest rate reductions. Nevertheless, political uncertainty regarding economic programme of the next government (especially regarding path of fiscal deficit reduction, and perspectives of joining ERM-2 and the euro zone) did not diminish, and thus one should not expect fast return to easing cycle in monetary policy. Although MPC member Halina Wasilewska-Trenkner said that "cycle of interest reductions is now over", we believe that low inflation figures in the next months and risk of lower than earlier expected economic growth would sway the MPC to apply minor fine-tuning reduction in borrowing costs (25 bps) in the summer period (July).

▪ **This month we resume analysis of developments on credit market in Poland, that has been initiated several months ago, by presenting results of estimated econometric model.** Despite significant changes in the economy over the last few years, statistical data confirmed existence of long-term relationship between real loans, GDP, interest rate and inflation. The results seem to confirm conclusions, that arose in the preliminary stages of our analysis – in the coming years we should face significant acceleration in credit growth in Poland, which would be stimulated by maintaining relatively fast economic growth, fall in interest rates ahead of euro zone entry, and cementation of low level of inflation.

### Financial market on 29 April 2005:

NBP deposit rate	4,00	WIBOR 3M	5,59	USDPLN	3,2988
NBP reference rate	5,50	Yield on 52-week T-bills	5,35	EURPLN	4,2756
NBP lombard rate	7,00	Yield on 5-year T-bonds	5,58	EURUSD	1,2961

This report is based on information available until 10.05.2005

## Special focus

### Credit VARiation

A few months ago we drew your attention to the trends arising in the credit market in Poland. In two consecutive MAKROscope editions, in February and March, we presented an analysis of the phenomena witnessed over the past quarters and tried to draw conclusions as to how the process of making up for the delay in the economic development as well as deepening integration with the EU institutions (EU accession and drive to enter the euro zone) can impact further development of the credit market. We promised back then to present a more formal analysis of events in the credit market, based on statistical and econometric inference. This month we are fulfilling the promise and presenting the outcome of our estimates.

To examine the dependencies in the Polish credit market we used multivariate model of vector autoregression (VAR) with the error correction mechanism, which explains relationship between the value of loans, economic activity and the costs of funds (more details on the model, statistical data used, as well as the estimation results can be found in the *Technical Annex* on page 5). This model allows to analyze long-term dependencies between the economic variables, at the same time taking into account short-term dynamics of variables and temporary departures from the equilibrium state. However, before we present the outcome of estimation, it is worth mentioning a few vital reservations as regards the adopted methodology, data used and estimates made.

- A significant factor, which continues to hinder econometric analysis of the processes happening in the Polish economy is statistical data accessibility. In the analysis we base on quarterly data for the period 1995q1-2004q4. This is a relatively short sample, especially when we want to estimate relations of the long-term equilibrium in the economy.

- Issues with data are related also to their quality; frequent changes to methods and definitions distort the continuity and comparability of time series and can have an adverse impact on the outcome of calculations.

- In the analyzed period a few significant changes were recorded in the economy which could have contributed to the change of behaviour in economic variables and mutual correlations between them. For example, the period included both a finishing stage of the accelerated economic transformation period and the first serious slowdown in the GDP growth; it was also the final stage

of disinflation and shift to inflation stabilization on a relatively low level; economy was also highly influenced by the EU accession.

- Given the limited accessibility and comparability of statistical data as well as the small size of the sample, we had to narrow down to a very simple specification of the econometric model; simple construction might not intercept all the dependencies actually existing in the economy.

- As a standard, this type of analyses entails a problem with identifying to what extent the changes in the value of loans are driven by changes in the demand for loans, and to what extent by changes in the supply. Our simplified model describes solely the demand side, and hence there is a risk that the specification will not take into account significant factors (supply ones) which could impact the credit volume in the analyzed period. This could distort the outcome.

As a result of all the said problems, the estimation of the theoretically and statistically accurate, stable long-term relationship that describes changes in the credit volume in the Polish economy has proven extremely difficult. In the majority of cases, our analyses, which took into account many alternative specifications of credit demand functions availing of various definitions of variables and various levels of data disaggregation, ended as a fiasco making it impossible to empirically confirm existence of stable and economically reasonable equilibrium relation throughout the whole analyzed period. In fact, only in the case of data with the highest degree of aggregation, the outcome can be considered satisfactory in terms of the statistical features of the model, as well as the economic interpretation. We present the outcome below.

The model in question describes relations between the total loans, GDP, short-term interest rate and inflation (see *Technical Annex*). Available statistical data confirmed there was a relation of long-term equilibrium between the said variables. The estimated long-term relation is as follows:

$$k_t = 4.437 \cdot y_t - 0.996 \cdot r_t - 2.073 \cdot cpi_t - 0.282 \cdot trend_t$$

In line with intuition and theoretical principles, the real value of loans ( $k_t$ ) has proven positively correlated with the level of economic activity ( $y_t$ ), while the coefficient sign at  $r_t$  and  $cpi_t$  is negative reflecting the adverse impact of costs related to the obtainment of loans.

It is worth noting a relatively high value of the coefficient next to  $y_t$ . It is much higher than values worked out in similar empirical analyses for other European economies (usually between 1 and 2) and suggests high income

elasticity of the credit demand function in Poland. It is worth remembering, however, that at the initial stage of transformation (and still now) economy was characterized by a very low relation of loans to GDP comparing to other developed market economies, hence, such a high coefficient at  $y_t$  most likely reflects, among others, the process of catching up in this regard, i.e. deepening of the credit market.

Sensitivity of the loan to the costs of its obtainment proved much smaller, however significant. One should be aware of the fact that what really matters in economy is not the level of the nominal but the real interest rate. If we assume that inflation expectations are formed in an adaptative way, the said long-term equilibrium relation, having been transformed, can be presented in a slightly different form:

$$k_t = 4.437 \cdot y_t - 0.996 \cdot rr_t - 3.069 \cdot cpi_t - 0.282 \cdot trend_t$$

where  $rr_t = (r_t - cpi_t)$  is a real interest rate.

Long term semi-elasticity of the loan against the interest rate is close to 1 (in absolute value), which indicates that the monetary policy has quite a big impact on processes in the monetary area of the Polish economy. This outcome might be found surprising in view of the problems with conveying signals of monetary policy into the credit market that the central bank has complained about recently and which are driven by high overliquidity of the banking system witnessed in Poland throughout the better part of the last decade. It also seems to suggest that further convergence of real interest rates in Poland in the period preceding the euro zone entry can prove a significant factor generating an animated growth in loans in the banking system.

An even more crucial positive impulse stimulating the credit market development can be consolidation of the low inflation level as the estimated long-term equation suggests a strong negative impact of CPI on interest in loans in Poland. It can be interpreted in such a way, for example, that the high inflation gives rise to the sense of uncertainty among potential borrowers, however, such a high parameter at  $cpi_t$  is – undoubtedly – a big surprise. In particular, the fact that the value of this coefficient is ca. three times higher than the value of semi-elasticity of the loan against the interest rate suggests quite serious conclusions for the monetary policy. Such a result namely suggests that a permanently low level of growth in prices can prove a strong driver of the growth in loans and economic activity even if it was at the expense of higher real interest rates. It seems, however, that such conclusion might be too farfetched and a distinctly negative value of the coefficient in question in the model

can result – just as in the case of high income elasticity – from the transformation processes in the Polish economy which the simple model specification does not take formally into account. The fact that in the analyzed period we concurrently dealt with a high-paced disinflation and dynamic development of the credit market could, and most likely did, result not so much from their mutual cause-result dependencies but rather from the fact that the transforming economy was coming from a certain starting point to the equilibrium and it was happening concurrently on many separate levels. Prudence in the interpretation of a distinctly negative semi-elasticity of loans against  $cpi_t$  in the cointegration equation is also suggested by the fact that this semi-elasticity also implies a reversely proportional dependence in the opposite direction – the model envisages that growth of loans in economy is a vital anti-inflation factor in the long term.

It is worth noting that in the equations of short-term dynamics estimated in the VEC model (see page 5) dependencies between the change in loans and the change in inflation have a slightly different character – closer to what intuition would prompt. In the equation which explains a change in the loan:

$$\Delta k_t = \beta_0 \cdot ECM_{t-1} + \beta_1 \cdot \Delta k_{t-1} + \beta_2 \cdot \Delta y_{t-1} + \beta_3 \cdot \Delta r_{t-1} + \beta_4 \cdot \Delta cpi_{t-1} + \beta_5 + \varepsilon_t$$

$\beta_3$  coefficient is negative (-0.69), while  $\beta_4$  is positive (0.76). Let's notice that absolute values of both parameters are similar. What is more, the Wald test does not allow to reject the restriction which says that both coefficients are equal in terms of the module ( $\beta_3 = -\beta_4$ ), which means that the equation above can be written down as:

$$\Delta k_t = \beta_0 \cdot ECM_{t-1} + \beta_1 \cdot \Delta k_{t-1} + \beta_2 \cdot \Delta y_{t-1} + \beta_3 \cdot (\Delta r_{t-1} - \Delta cpi_{t-1}) + \beta_5 + \varepsilon_t$$

Thus, over a short period of time, a change in the real value of loans is distinctly (negatively) reliant on changes in the level of the real interest rate ( $\beta_3 \approx -0.7$ ), but not on the fluctuations in the inflation itself. Sensitivity to the cost of the loan (cost of funds) comes out onto the first burner in terms of its impact over the short period of time while pushing back into the back burner reliance on income factors ( $\beta_2 = 0.42$ ).

Taking all this into account it seems even more justified to suspect that the evident reverse dependence between the inflation rate and real value of loans in a long period of time estimated in the model can be more an accident or a result of the influence of mechanisms not taken account of in the model rather than the actual long-term relationship existing in the economy.

Apart from assessing the overall direction and strength of the mutual interaction between the variables represented by the values of the estimated parameters, the vector autoregression model allows to analyze the dynamic structure of delays in their mutual interactions – at what pace disturbances/changes in individual variables translate into changes in time of other values and variables in the model. The purpose of analysis is served by the so-called impulse responses analysis to unit shocks in the model. It is possible to analyze, for example, how disturbances of individual variables in the model stimulate changes in the values of other variables as well as how quickly, after such accidental disturbance happen the economy (model) returns to the state of long-term equilibrium. Estimated profiles of responses to the shocks in the credit market, interest rates, in the GDP level or inflation, based on our VEC model, are presented in the form of charts in the *Technical Annex* on page 5.

Functions of responses for individual variables indicate that a one-off disturbance equal to one standard deviation in any of the variables has a permanent impact on other variables in the model (which is typical of the VAR models with cointegration). The real value of loans reacts most quickly to GDP changes, i.e. as soon as one quarter after the shock. Nearly as quick is response to the shock fluctuation in inflation which manifests itself the strongest after two quarters to be followed by recovery and stabilization. This means that unexpected changes in economy such as recession or a rapid inflation hike (e.g. resulting from the growth in oil prices) should limit the value of loans very quickly, i.e. already after 1-2 quarters. Interestingly enough, reaction in the opposite direction takes a bit longer as the model implies that full effects of the unexpected disturbance in the credit market (e.g. driven by an introduction of act regulating the level of interest rates) should affect economy (GDP, inflation) only after ca. 3-4 quarters. Full response of loans to a change in the interest rates level spreads over a longer period of time and takes ca. 5-6 quarters, which confirms that the central bank's policy should be forward-looking and effected adequately in advance.

It is also quite time-consuming for all the variables in the model to come back to the state of mutual equilibrium (described in the cointegration equation) after either of them goes through some disturbances. The estimated functions of impulse responses indicate that it takes ca. 4-6 quarters. The slowest process is the return to equilibrium after a shock change in the value of loans while the most rapid recovery seems to be witnessed in the case of GDP disturbances.

Despite doubts as to the accuracy of model specification, the outcome seems to confirm the conclusions initially drawn at the early stages of the Polish credit market analysis and presented in the previous months. They suggest that in the upcoming years we might see in Poland a significant acceleration in the growth of loans in the banking sector, which will additionally be fuelled by the envisaged maintenance of a relatively strong GDP growth, drop in interest rates in view of the euro zone entrance, and stabilization of the inflation rate at quite a low level. While, over a long period of time, the most crucial factor conducive to the development of the credit market should be GDP growth and reduction of distance that separates Poland and other European economies in terms of loan saturation (loans to GDP ratio), in a shorter perspective – a few quarters – it is the changes in the real interest rates that should impact the dynamics of loans in the banking system. It can be hoped for, in this context, that within a short period of time the credit market will show an impact of quite a distinct slump in the real interest rate on loans that has been witnessed since mid-2004 as a consequence of evident inflation acceleration after Poland's accession to the EU.

## Technical Annex

For the purpose of analysis of credit development in Polish economy, we have built a vector error correction model (VEC), based on approaches used in similar empirical surveys made recently for various European economies<sup>1</sup>. Variables used in the model have been defined in the following way:

- $k_t$  real stock of loans (in log terms); total credit in monetary financial institutions in constant prices (deflator: CPI index);
- $y_t$  scale variable (in log terms); level of GDP in constant prices, seasonally adjusted;
- $r_t$  nominal interest rate; WIBOR 3M;
- $cpi_t$  inflation rate; annual growth rate of the CPI.

We have used quarterly data for the period 1995q1:2004q4.

Performed statistical tests allowed to consider all above-mentioned variables to be integrated of order I(1) (test results are not listed here because of limited space).

The number of lags in the VEC model has been chosen to be 2, as a compromise between the number of degrees of freedom and a good fit of the model. Selected model specification included (restricted) time trend and (unrestricted) intercept term in the cointegration vector. Cointegration test based on Johansen's procedure confirmed existence of one cointegrating vector for above listed variables in the analysed sample. Estimated coefficients of the cointegration vector in VEC(2) model are presented below:

	$k$	$y$	$r$	$cpi$	Trend
	-1.0000	4.4372	-0.99620	-2.0725	-0.028177
		(1.3241)	(.95377)	(.66409)	(.014801)

Note: Standard errors in parenthesis

Next table presents values of estimated coefficients in short-term dynamic equations:

	$\Delta k$	$\Delta y$	$\Delta r$	$\Delta cpi$
$ECM_{t-1}$	-.053508 [.259]	-.078710 [.024]	.013827 [.564]	.10448 [.000]
$\Delta k_{t-1}$	.32417 [.060]	.038325 [.750]	.11434 [.188]	-.035785 [.554]
$\Delta y_{t-1}$	.42118 [.089]	-.22275 [.204]	-.054376 [.660]	-.24096 [.009]
$\Delta r_{t-1}$	-.69378 [.048]	.17532 [.472]	.46574 [.011]	.29751 [.020]
$\Delta cpi_{t-1}$	.75922 [.061]	.14579 [.605]	.18665 [.356]	.039906 [.778]
Const	2.2204 [.255]	3.2580 [.024]	-.57374 [.562]	-4.3086 [.000]
R-Squared	.19812	.29536	.36452	.67694
DW-statistic	1.6627	1.9607	2.1359	1.6901

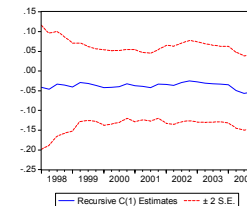
Note: p-values in brackets;

$$ECM = -1.0000*k + 4.4372*y - 0.99620*r - 2.0725*cpi - 0.028177*Trend$$

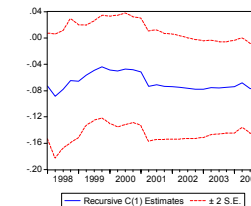
On the ground of standard diagnostic tests and statistics one could concur that estimated model has relatively good statistical properties. Null hypotheses about normality of residuals, and lack of heteroscedascity cannot be rejected; only in the case of one equation autocorrelation of residuals has been confirmed.

Simulations made showed some variability of estimated coefficients in short-term equations in time, before 2001, followed by their stabilisation. Interestingly, the equation there  $\Delta k$  was a dependent variable was characterised by the highest stability of coefficients. Charts below present evolution in time (recursive rolling estimates) of coefficients next to error correction term  $ECM_{t-1}$  in short-term dynamic equations.

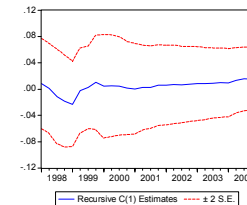
Equation for  $\Delta k$ :



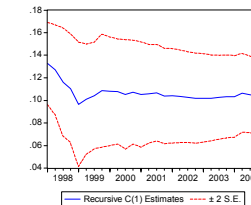
Equation for  $\Delta y$ :



Equation for  $\Delta r$ :



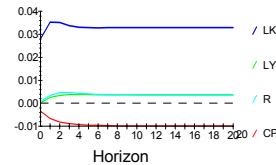
Equation for  $\Delta cpi$ :



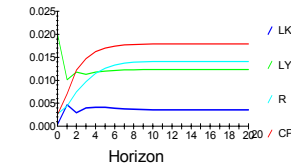
Above results and analysis of development of economic variables in time made us try to estimate entire model separately on two sub-samples: 1995q1:2000q4 and 2001q1:2004q4. Achieved results for the first sub-sample were quite close to those for the full sample, however in the case of the second period it was impossible to confirm existence of one stable long-term relationship between variables. It could suggest a break in function of credit development in this period, however it could well be a result of very low number of observations in both sub-samples, which dramatically lowers number of degrees of freedom, and does not allow for reliable statistical inference (especially in the case of VAR model).

Charts below present impulse responses of individual variables and estimated cointegrating vector (CV) to unit shocks in endogenous variables in the model.

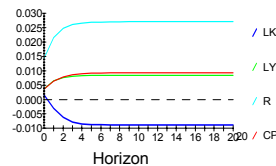
Generalized Impulse Response(s) to one S.E. shock in the equation for LK



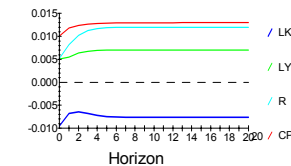
Generalized Impulse Response(s) to one S.E. shock in the equation for LY



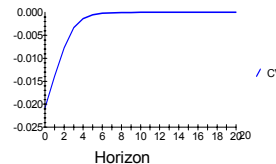
Generalized Impulse Response(s) to one S.E. shock in the equation for R



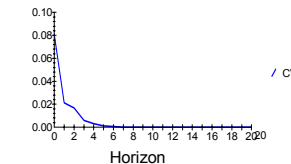
Generalized Impulse Response(s) to one S.E. shock in the equation for CPI



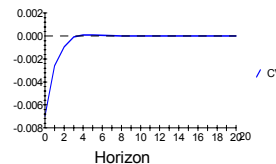
Generalized Impulse Response(s) to one S.E. shock in the equation for LK



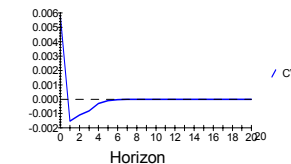
Generalized Impulse Response(s) to one S.E. shock in the equation for LY



Generalized Impulse Response(s) to one S.E. shock in the equation for R

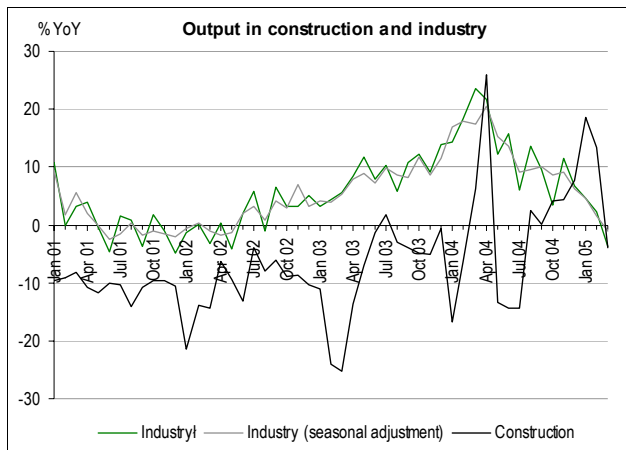


Generalized Impulse Response(s) to one S.E. shock in the equation for CPI



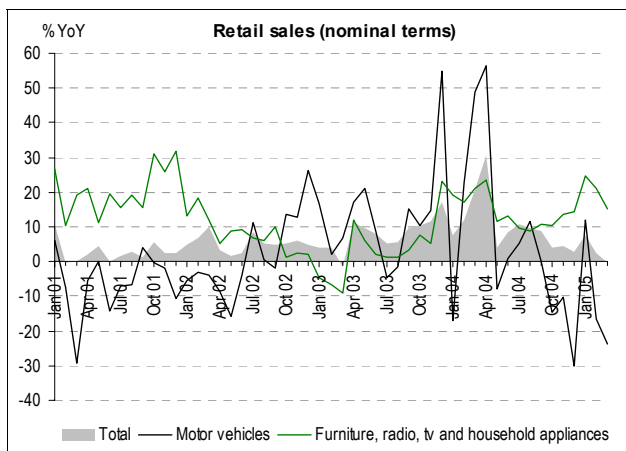
<sup>1</sup> See: Brzoza-Brzezina M. (2004), *Lending booms in Europe's periphery: South-Western lessons for Central-Eastern members*, NBP; Calza A., Manrique M., Sousa J. (2003), *Aggregate loans to the euro area private sector*, ECB Working Paper No. 202; Hofmann B. (2001) *The determinants of private sector credit in industrialized countries: do property prices matter?*, BIS Working Paper No. 108.

## Economic update



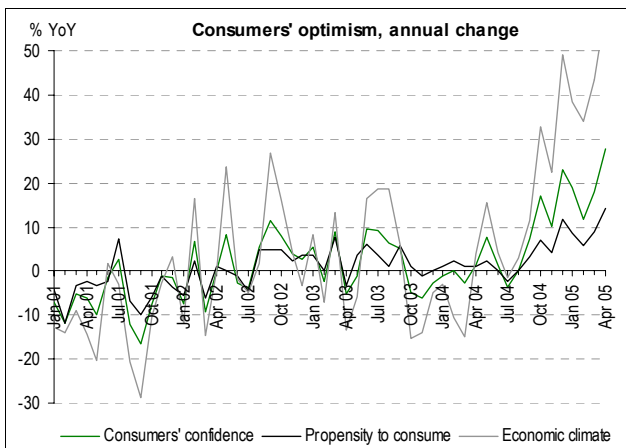
### Deeper than expected fall in output

- Due to high base effect and lower number of working days, it was expected that industrial output in March will record the first annual fall since mid-2002, but its actual scale was much deeper than predicted 0.5%YoY and amounted to 3.7%YoY.
- Construction output dropped 3.8%YoY after 13.3% jump in February. This resulted from lower number of working days and high base (the same factors as in case of industry) and additionally from rather unfavourable weather conditions.
- March output figures limited our optimism regarding pace of this year's GDP growth. We still think that the second half of the year will be much better than the first one, but before it happens, weak result in industry will translate into deceleration in GDP growth in 1Q05 to a mere 3%. We see growing risk for our GDP growth forecast for the whole year at close to 4.5%.



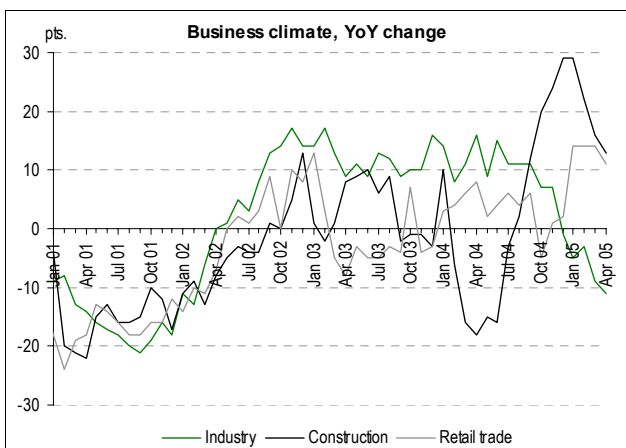
### ...but retail sales better than forecasts

- Contrary to output figures, retail sales growth in March was a nice surprise. Retail sales declined a mere 0.3%YoY, while we predicted 7%YoY decrease.
- If not slump in motor vehicles, retail sales would probably record a healthy rise. Despite high base (pre-accession surge in sales), retail sales in such categories like pharmaceuticals and medicines as well as furniture, radio, tv and household appliances grew 29%YoY and 15%YoY, respectively.
- Even if March sales were positively affected by the date of Easter, their level shows that deceleration in consumption in 4Q04, continued to some extent in 1Q05, was rather transitory and one may expect rebound in consumption demand in 2H05. Especially taking into account rapidly warming up moods of consumers (see below for more details).



### Surge in consumers' confidence

- April saw record strong rise in indices of consumer optimism, although they have not reached record high levels yet.
- There was significant decrease in households' fear of unemployment.
- The authors of the consumer confidence survey suggested that robust growth in consumer optimism indices was a one-off phenomenon related to events in Poland after the Pope's death, but in our opinion the results confirm the earlier established tendency in consumer moods.
- We maintain our view that the 2H05 should see clear acceleration in consumption demand growth. Along with stronger and stronger investment activity (thanks to firms' optimism), higher consumption should allow GDP growth to return to above 5% in the final quarter of this year.

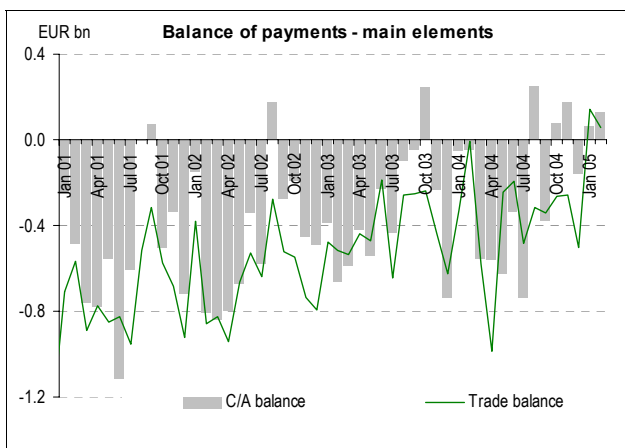
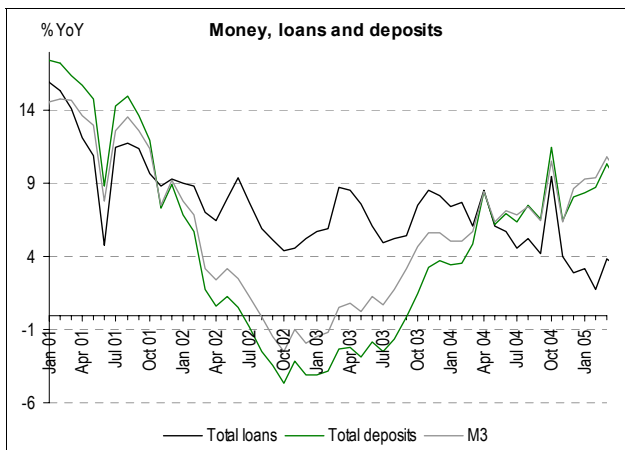
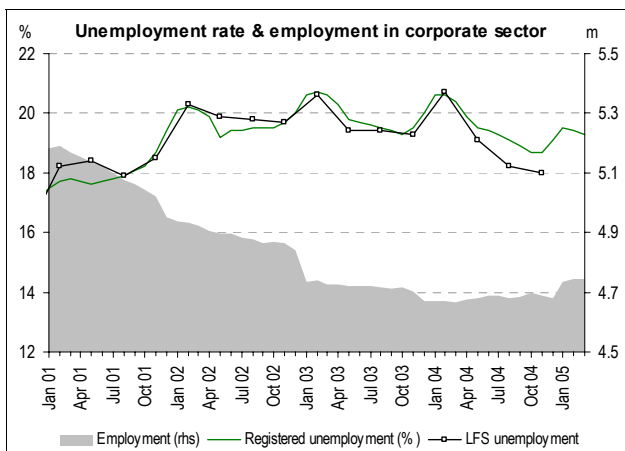
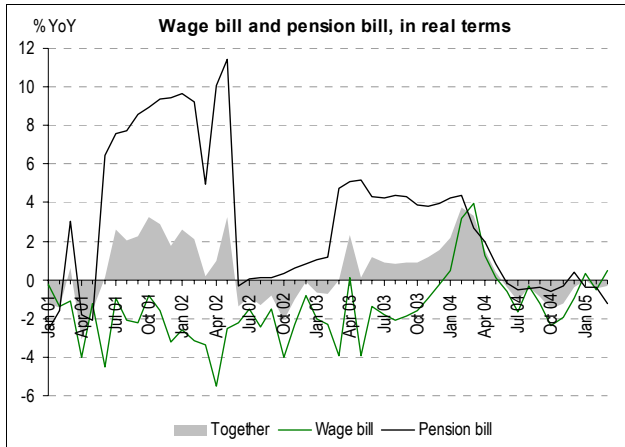


### Enterprises quite upbeat on the future

- Results of the April business climate survey were similar as last month.
- Business climate in retail trade and construction again notably warmed up in comparison with the analogous period of last year.
- Industry saw some deterioration in annual terms, but excepting results from the year ago, boosted by pre-accession heat in the economy, index for industry was at one of the highest levels in the history of CSO business climate survey.
- In all the sectors surveyed, upbeat expectations for future were maintained: firms predict rise in production and sales. A significant improvement in domestic orders was noted, which confirms our predictions concerning strengthening of domestic demand this year.

Source: CSO, Ipsos, own calculations

# Economic update



Source: CSO, NBP, own calculations

## Labour market conditions continue to improve

- Average employment in the enterprise sector decreased 0.1% from February, but rose 1.6%YoY (slightly below market consensus and our forecast of 1.7%YoY), confirming continuation of positive trend in labour demand, which started a few months ago.
- Average wage grew 2.9%MoM and 2.2%YoY in March after a mere 1.4%YoY increase a month earlier. The result was better than the market consensus at 1.5%YoY and our forecast of 1.8%YoY, but of course one could hardly recognized it as a serious sign of wage pressure intensification. However, we expect gradual acceleration in wage growth in the following months of this year up to above 5% towards the end of the year.
- Along with a healthy rise in employment and reduction in inflation rate, average wage increase of 2.2%YoY translated into wage bill growth of 3.8%YoY in nominal terms and 0.5%YoY in real terms. This is some improvement as compared to a few previous months, when wage bill in the enterprise sector was declining in annual terms (except for January).
- We predict that wage bill will start rising much faster in next months, on a scale that has not been observed in the Polish economy for several years (except for short period between February and April 2004). At the moment, situation on the labour market seems very favourable for inflation outlook, but one cannot exclude that labour market will become a source of some inflationary pressure soon.
- However, the pressure should not be strong, as in spite of steady reduction, the unemployment is still very high. In March, the registered unemployment rate was 19.3% versus 20.4% a year earlier. It is still high enough to claim that current unemployment level strongly acts disinflationary, even assuming that natural unemployment rate in Poland is very high.

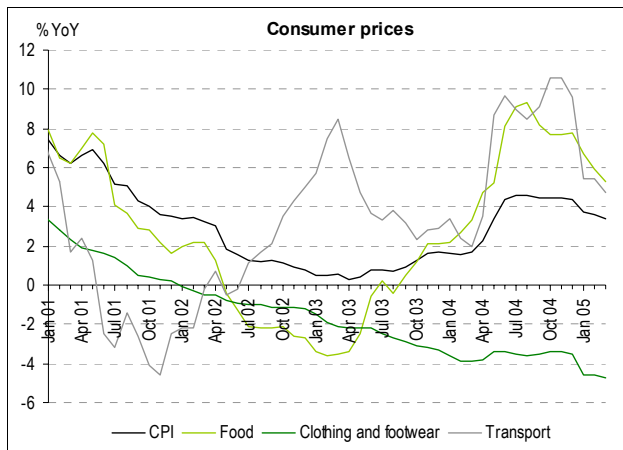
## Two-digit growth in money supply

- Broad money supply M3 grew 10.8%YoY in March against 9.4%YoY rise in the previous month.
- Total deposits increased 10.3%YoY with a solid improvement in households' deposits growth rate and maintained high pace of corporate deposits growth.
- Increase in total loans slightly accelerated in March, but it was still sluggish (3.8%YoY against 1.7% in February). Growth in households borrowing rebounded to 13.7%YoY and corporate loans growth also slightly improved (to -3.6%YoY from -5%YoY a month earlier). One has to remember zloty-value of loans is negatively affected by zloty appreciation.
- Money supply statistics reflects that the Polish economy sees high (although temporarily weakened) economic growth.

## Very good current account and trade position

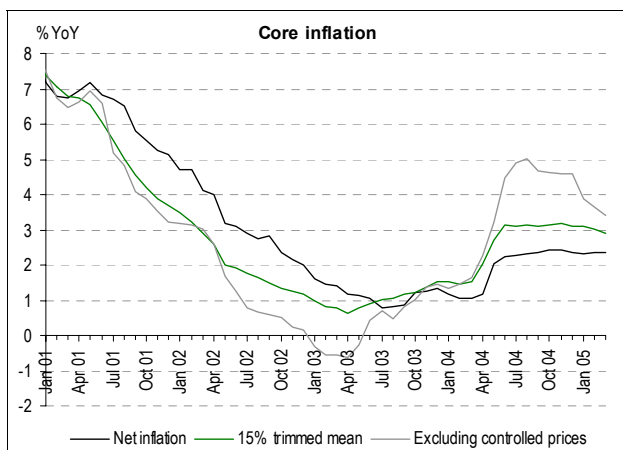
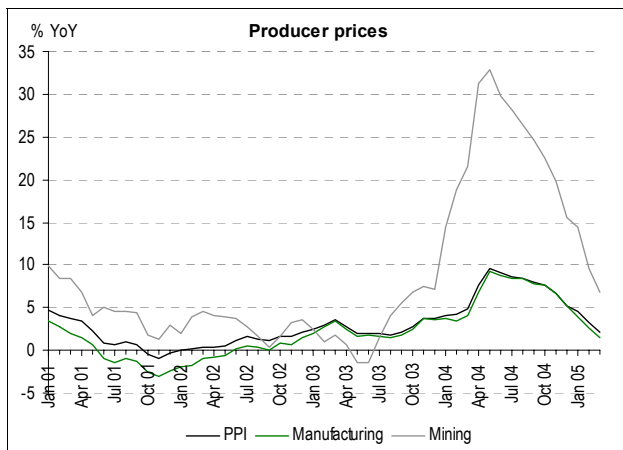
- February saw surpluses on both current account and trade account (€132m and €57m, respectively).
- Additionally, January figures were revised and they showed a C/A surplus of €63m instead of earlier reported deficit.
- 12-month cumulated C/A deficit lowered to 1.3% of GDP after February.
- Both exports and imports recorded robust growth of 22.6%YoY and 21.1%YoY, respectively, in euro terms. However, due to strong appreciation of the zloty in the course of last 12 months (by close to 18%), growth rates of exports and imports in zloty terms are close to zero. Nonetheless, exports grows faster than imports anyway. Thus, net export contribution to GDP growth was most likely positive in 1Q05, offsetting to some extent low growth in individual consumption.

## Economic update



### Change in our CPI forecast after the CSO revealed index of monthly price changes in 2004 using wage system for 2005

Month of 2005	Old forecast (%YoY)	New forecast (%YoY)
April	3.3	3.0
May	2.4	2.3
June	1.6	1.6
July	1.6	1.5
August	1.6	1.5
September	1.5	1.6
October	1.4	1.5
November	1.4	1.4
December	1.6	1.6
Annual average	2.3	2.2



Source: CSO, NBP, own calculations

### CPI surprised on the downside again

- In March, consumer prices rose 0.1%MoM, exactly matching our forecast. However, annual CPI growth proved lower than we predicted and decelerated to 3.4% from 3.6% in February.
- Discrepancy in accuracy of forecasts of monthly and annual price changes resulted from the fact that until the data release the CSO had not revealed monthly price changes in 2004 recalculated using weight system used in 2005.
- Therefore, accurate forecasts of monthly price changes in first months of this year did not yield accurate forecasts of annual price changes in that period.
- Anyway, CPI inflation in March surprised on the downside again – market consensus was 3.5% - bringing about some improvement in inflation forecasts for the remainder of the year.
- The main reason for inflation fall in March was deceleration in annual growth of food and fuel prices, as monthly price changes in these categories were lower than in the analogous period of last year. Food prices grew 0.2%MoM and 5.3%YoY against 5.9%YoY increase a month earlier. Fuel prices grew 0.9%MoM and 9.1%YoY after 10.2% jump in the previous month. Price changes in other categories of consumer goods and services were less relevant for overall price change.
- All in all, March CPI data confirmed that inflation will be falling in the nearest months (mainly due to reversal of negative shocks on the food market). We forecast that CPI inflation will drop to around 1.5% in mid-year and will stay at that territory until the end of the year.
- The above mentioned effects on our forecasts from changes in weight system and recalculation of monthly price changes in 2004 are shown in the table.

### Rapid deceleration in PPI inflation

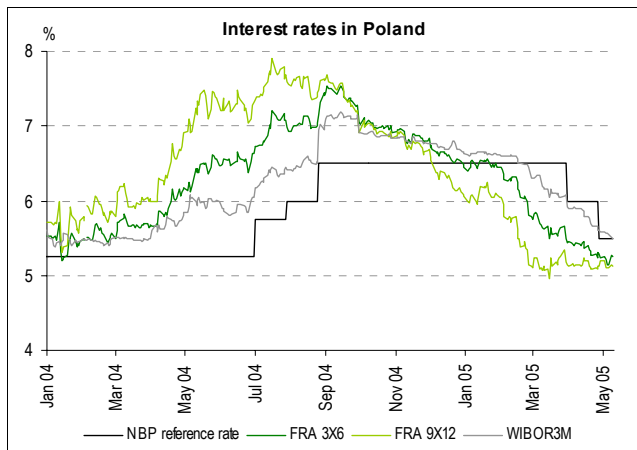
- PPI grew 0.5%MoM and 2.2%YoY in March.
- The monthly price growth was much higher than expected, but annual price change was very close to our forecast and market consensus (both at 2.1%), because February data were revised down.
- The data showed that the strongest price growth took place in case of refinery products (almost 7%MoM) and tobacco products (1.1%MoM). Robust price growth in these categories of goods at the corporate level may translate into higher CPI growth in the following months.
- However, PPI trend seems very favourable for CPI inflation outlook, as PPI growth is expected to decelerate sharply in the nearest months (due to effect of very high base) – in May and June PPI growth should turn into red.

### Core inflation almost stable

- Four out of five core inflation measures calculated by the NBP declined by 0.1-0.2pp in March as compared to February.
- Only the net inflation slightly increased to 2.4%YoY from 2.3%YoY in the previous month (in fact it was almost stable, as the change concerned the second decimal place).
- Stabilization of net inflation in the range of 2.2-2.4%, observed for almost a year, confirms that jump in CPI inflation seen in the second half of 2004 was caused almost solely by surge in food and fuel prices, which are excluded from the net inflation.
- Now, when effects of shocks on these two markets loses momentum (oil shock weakened and shock on the food market even reversed) one may expect that CPI growth will fall for some time below the net inflation.



## Central bank watch



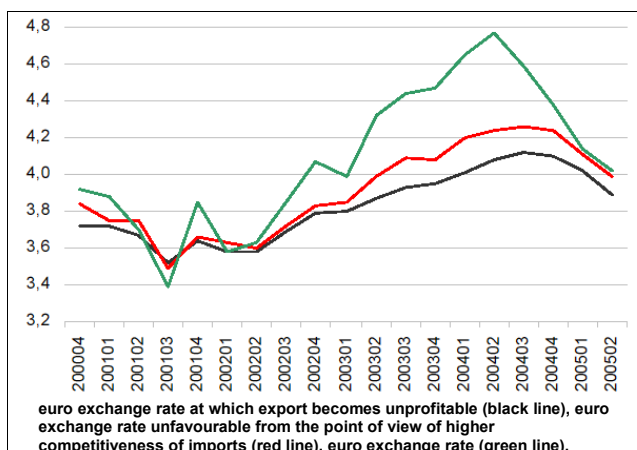
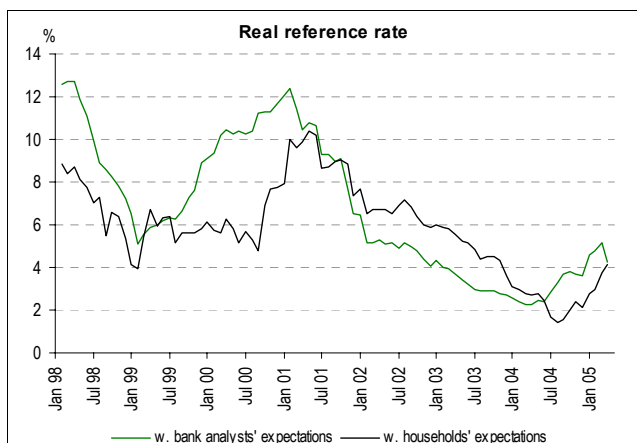
### Crucial fragments of the MPC statement from 27 April 2005

International forecasting agencies revised upwards oil price forecasts for the coming years. According to their current forecasts, the years 2006 and 2007 will see these prices decrease on a smaller scale than previously expected.

The fall in the current inflation as well as the shrinking gap between inflation measured with the price index of consumer goods and services and core net inflation both confirm the disappearance of transitory factors which contributed to inflation increase in 2004. The data on inflation in 1Q05 and the latest food price forecasts suggest the likelihood of inflation rate running lower in the years 2005-2006 than presented in the February Inflation Report.

The exchange rate developments in April 2005 have been broadly consistent with the path accounted for in the February Report. The developments of the exchange rate may be affected by the situation in the international financial markets and the uncertainty related to the pre-election period.

The Council is concerned about numerous legislative proposals put forward in the recent months which may result in an increase in the general government deficit and, in consequence, a postponement of the fulfilment of the euro area membership criteria. The uncertainty concerning the prospects for public finance reforms and the extent of the implementation of other necessary structural reforms is a significant risk factor for inflation.



Source: NBP, Reuters, own estimates

### Hawkish interest rate cut

- The Monetary Policy Council cut main interest rates by 50bp, while majority of market participants expected a reduction of 25bp. However, in practice the decision was more hawkish than it seems at the first glance.
- Rates reduction was accompanied by a change in monetary policy bias from *easing* to *neutral*. As a result, market reaction to decision was in line with expectations for a scenario of 25bp cut and maintaining easing bias.
- While we had expected the Council to cut borrowing costs by 50bp in total, but in two cautious moves of 25bp in April and May (which was expected by us to be followed by change in bias into neutral), the April's decision proved to be bolder and delivered entire expected change in monetary policy during just one MPC meeting.

### Statement rather dovish, politics as the main risk factor

- MPC statement showed that a reason for more aggressive cut was the fact that the MPC assesses inflation outlook quite optimistically - in the Council's assessment, the balance of risks for future inflation is more favourable than presented in the February inflation projection and starting from 3Q05 inflation may stay below the inflation target for a few quarters.
- The reason for shifting bias was uncertainty regarding political situation and economic programme of the new cabinet after election (see table on the left and *Central bank watch* section).
- Besides political factors, the MPC recognised high commodity prices as the only risk element for future inflation. MPC assessment may be adjusted in case of another change in oil price forecast. However, at the same time the MPC mentioned a potentially negative impact of this factor on economic growth.

### Is there a room for further cuts?

- By the adoption of neutral bias the central bankers suggested that 100bp reduction in official rates within the last two months was sufficient, at least for a while.
- This confirmed that expectations of some market participants for 200-300bp cumulative cuts in 2005 were exaggerated.
- If inflation is low in the following months, in line with our expectations, and risks for GDP growth perceived by the Council maintain, some fine-tuning move in interest rates (by 25bp) is possible in the second half of the year.
- In the base-case scenario we expect that before election one reduction of such scale will take place (in July). One has to remember that political risks, mentioned by the MPC, will not disappear until election (well, they may stay with us even longer).

### Zloty roller-coaster without consequences

- According to the NBP business climate report, despite a considerable zloty appreciation, the EURPLN rate still remains above the level declared as the profitability breaking-point for exporters and unfavourable from the point of view of higher competitiveness of imported goods (see chart on the left).
- As regards the USDPLN rate, there is still a range of zloty value, for which exporters are competitive, while imported goods are already cheaper as compared to their domestic substitutes.
- One has to remember that responses of entrepreneurs are formulated to a large extent based on current rate, and April's depreciation of the zloty was favourable for exporters.
- Short-term strengthening of the zloty, which we expect in June-July should not have a significant impact on MPC's policy, as a weakening is expected in the autumn (around elections).

## Central bank watch

### Comments of the central bank representatives

### Remarks

#### Leszek Balcerowicz, NBP governor, MPC chairman

MPC press conference, 27 April

In the past years deflation was caused by seasonal factors. It cannot be ruled out also this year, however one should not draw long-term conclusions [for monetary policy] from this fact.

We also do not agree with an opinion that the problem with inflation gave way in Poland to the problem with deflation. Although in a scenario of very low food prices in the summer period one cannot fully exclude that CPI inflation will come down below zero. In the case of PPI it is next to certain that it will be in the red for next several months.

#### Marian Noga, MPC member

MPC press conference, PAP, 27 April

Inflation will fall this year to ca. 2.5% and will remain below 2.5% until end-2007. One should distinguish two steps: bringing inflation down to the range of fluctuations 1.5-3.5%, and the second – to 2.5%. At present, the Council is on good way towards 2.5%.

Once again MPC members repeated expectations that CPI will drop below the target in the coming months. It suggests that such scenario has been already taken into account in the decisions regarding interest rate level and was not an obstacle for return to the neutral bias. Short-term inflation forecasts are very optimistic, however it is medium-term outlook (2007) that should be the most important for the MPC.

#### Andrzej Sławiński, MPC member

Radio PiN, 28 April

Net inflation is very likely to fall below 2% quite rapidly.

[Neutral bias] is reflecting, hopefully, transitory accumulation of some risks and uncertainties. It is not only about what could happen on the oil market, but we also mean that Polish economy needs possibly fast entry to the ERM-2, and then to the euro zone. In order to make it possible, we need certainty that Maastricht criteria will be fulfilled. Now we are entering such a period when we will not have such certainty for some time whether this criteria will be met soon enough.

Please note that we had created quite significant comfort for the market in the last couple of months, i.e. initially we had changed bias, and then there were interest rate decisions. We cannot rule out that it will be that way that if there will be rate changes, they will be preceded with change in bias, however one cannot exclude (although it is less likely) that there will be changes in interest rates under present bias.

Expectations regarding net inflation are consistent with our view, but the MPC member presented such opinion for the first time. It implies that the Council has already discounted in its decisions not only significant fall in CPI, but also drop in net inflation.

Professor Sławiński hoped that rise in political risk, mentioned in the MPC's statement, is transitory. Because the situation is rather favourable in terms of inflation outlook, it could imply that after risk factors die out, the Council could return to easing bias and rate reductions. The problem is that after the Sejm's voting at the beginning of May we already know that the period of uncertainty will last for almost half a year. And it is also uncertain whether the MPC will reach certainty regarding Poland's road to the euro zone just after the election, taking into account differences in views on this issue of potential of the ruling coalition.

Sławiński's comment suggests that potential further rate cuts are more likely after another change in policy bias, back to easing, than with neutral bias. However, we expect that there might be one fine-tuning rate cut in July without a change in bias.

#### Andrzej Wojtyna, MPC member

MPC press conference, PAP, 27 April

Under neutral bias, probability of [interest rate] decision is symmetrically distributed. It would be better to have reductions made under easing bias, and rate hikes under tightening bias, however one has to take into account the situation when temporarily a role of uncertainty increases, also because of political factors. There are possible options where such decisions could be made under neutral bias.

A rate cut under neutral policy bias cannot be ruled out completely, of course. In our opinion the next rate cut already in May is very unlikely (reduction in June also does not seem probable). One should remember, however, that there is another uncertainty related to May MPC meeting, because this month the Council will receive new inflation projection. We do not believe that it would significantly change the MPC's knowledge about inflation outlook in the medium term (which is confirmed by Wasilewska-Trenkner's comments). Neutral bias was probably introduced after having look at preliminary results of the projection.

PAP, 28 April

Weak consumption growth, if prolonged (and signals coming from the market do not suggest strong improvement in 1Q05), will put persistence of present economic revival under question mark. Optimistic commentators say that investment took over the weight of sustaining revival amid slow consumption growth, limited possibilities of maintaining export growth and need for reduction in budget deficit, maintaining average GDP growth above 4% would require at least doubling inflation growth in relation to the one observed in 2004.

Companies could be refraining from increasing investment outlays if it turns out that rise in consumption demand did not accelerate in 1Q05. Political risk could be hampering investment and demand growth.

As the date of parliamentary and presidential election approaches, the significance of political risk will be rising, which may lead to zloty depreciation and its negative impact on inflation. Financial market participants will recognise this risk increasingly through the opinions of potential coalition members on continuation of fiscal reforms and, which is closely related, on the perspectives of euro adoption.

Therefore, it is crucial that the main parties publicized their economic programmes as soon as possible. It is worrying that we still cannot get to know these programmes, and recent comments of one of the leading politicians regarding possible Poland's road to the Economic and Monetary Union unfortunately suggested that their [programmes] construction is still at quite early stage.

A factor that could trigger more decisive relaxation of monetary policy is a slowdown in economic growth on a bigger than predicted scale. This risk was addressed by professor Wojtyna in his commentary to INE PAN's economic report. However, we still predict GDP growth rate of above 4% this year, because slowdown in private consumption growth should be temporary (in 2H05 real growth in consumption would be prompted by a drop in inflation) and we still expect double-digit growth in investment and only slightly negative contribution of net exports to overall economic growth. It seems the central bank also did not change its economic forecasts so far, as in one of the interviews Andrzej Sławiński said that GDP growth would reach 4.0-4.5% on average this year and 5% at the end of the year. In the statement, the MPC noted that there is a downside risk for this forecast.

Professor Wojtyna also underscored increase of significance of political risk in the near term. It seems that in MPC's opinion this risk is offsetting factors potentially positive for future inflation and was the most important reason for the MPC to signal, by adoption of neutral bias, that likelihood of reducing interest rates today is lower than probability of keeping rates on hold. Political risk encompasses such elements like date of parliamentary election (today it is known only approximately), uncertainty regarding economic programmes of political parties, that could form the new government, and a strategy of the new government re entry to the ERM-2 and euro zone. Interestingly, despite such strong pressure on shortening the parliament's term of office from the opposition parties, they still did not manage to present (or maybe even prepare) their economic programmes.

## Government and politics

### Results of voting over parliament's self-dissolution

	for	against	abstained	not present
SLD	2	140	-	8
PO	56	-	-	-
PiS	46	-	-	-
PSL	38	-	-	2
Samoobrona	31	-	-	-
SdPI	27	1	1	2
UP	-	11	1	-
LPR	25	-	-	-
others	30	20	9	10
<b>TOTAL</b>	<b>255</b>	<b>172</b>	<b>11</b>	<b>22</b>

### Support for political parties in May's PBS opinion poll

	Support in %	Number of mandates
PiS	22 (17)	124
PO	22 (24)	122
Samoobrona	15 (17)	81
LPR	11 (12)	61
SLD	7 (6)	36
PSL	6 (4)	36
PD	4 (5)	-
SdPI	4 (3)	-

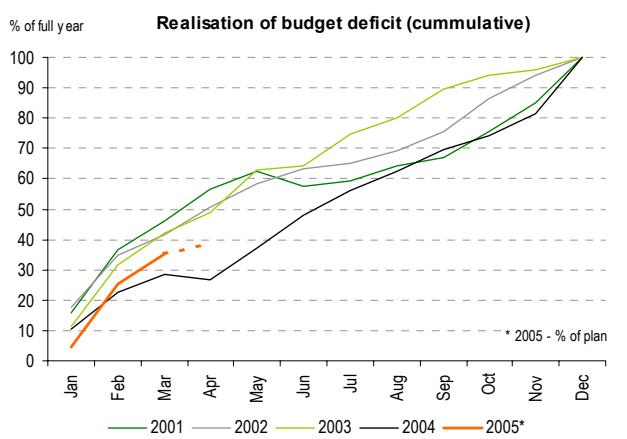
Note: April results in parentheses

### Parliamentary election in autumn

- In line with expectations, the opposition did not manage to find two-thirds majority and shorten its term of office – more than 50 votes were missing.
- PM Marek Belka submitted his resignation after the voting, but the president Aleksander Kwaśniewski refused to accept it. In practice it rules out a possibility of early election.
- We do not think that a constructive non-confidence vote against Marek Belka may be successful. Such an idea appeared among some SLD politicians.
- Though PSL and Samoobrona may support this idea, it will be difficult to find a common candidate.
- There is some risk of pre-election spending spree, although it is not high, in our opinion (see next page for details).

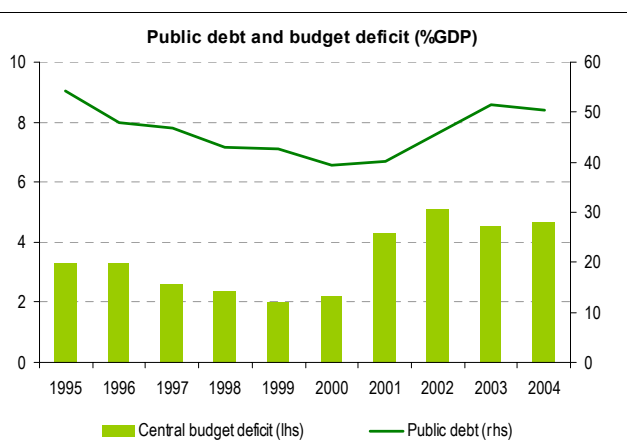
### Law and Justice (PiS) takes the lead in opinion polls

- As parliamentary election will take place in autumn (between September 25 and October 16), pre-election opinion polls may be still a subject of substantial changes.
- For the moment, Law and Justice (PiS) took the lead in some of April's opinion polls (first May results in the table on the left), just ahead of Civic Platform (PO). Joint support for the two parties does not guarantee majority coalition.
- Additional risk factor is connected with a possibility of a change in the electoral law. Political parties reaching very low popularity in opinion polls today (close to parliamentary threshold of 5%), but having majority in parliament they plan to change electoral law in a way to get more seats at the expense of political parties, which lead the polls.



### Lower growth a risk factor for indirect taxes inflow

- After three months of the year, the budget deficit reached 35.2% of the full-year plan and totalled PLN12.3bn.
- Although performance of revenues was very good in the whole quarter (very good January amid transfer of revenues from 2004), March alone was less impressive, especially as regards indirect taxes inflow.
- Budget deficit amounted to 38-39% of the plan after April.
- The Ministry of Finance estimated GDP growth in 1Q05 at 2.5% (we expect 3%), though it underlined that a slowdown reflects statistical base effect only, while seasonally adjusted growth on quarterly basis accelerated.
- Lower economic growth (and lower inflation) is a risk factor for realisation of revenue targets this year.



### Public debt above 50% in 2004

- Public debt plus the expected amount of payments under guarantees and endorsements given by entities of the public finance sector amounted to PLN444.1bn or 50.3% GDP in 2004. This was above the first safety threshold.
- Debt of *general government* in ESA95 standards amounted to PLN386.2bn or 43.7% GDP. The Ministry of Finance expect it to rise to 45.1% GDP in 2005.
- Breaking the first safety threshold implies the launch of some prudence procedures when planning budget for 2006 – the relation of the state budget deficit to the state budget revenues cannot exceed the corresponding relation from the current year.
- This relation is the upper limit for the budget of each local government.

Source: Ministry of Finance, PBS, Sejm

## Government and politics

### Comments of government representatives and politicians Remarks

#### Aleksander Kwaśniewski, president

Reuters, 6 May

I have decided to reject the resignation of the Cabinet submitted by Prime Minister Marek Belka. (...) I call on parliament not to pass laws that are bad for the Polish economy (and) aimed only at having an electoral effect. I see no reasons to sign any laws that I believe are harmful or linked to the election campaign

#### Włodzimierz Cimoszewicz, Lower House speaker

Polityka, 2 May

As the Lower House speaker I have such power that I can ensure that bills aimed at increasing budgetary spending, deteriorating country's finances and aimed at political campaign only won't be on the agenda.

#### Marek Belka, Prime Minister

PAP, Reuters, 6 May

I invite the opposition to cooperate. Finance Minister Mirosław Gronicki is open to their opinions. I have concerns that the opposition would not like to take responsibility for the budget (...) it is easier to criticise. This I not our intention to prepare budget for election, but the budget which will be favourable for the Polish economy for years. Our duties include (...) continuation of privatisation and preparing the budget for 2006.

#### Marek Dyduch, SLD general secretary

PAP, 6 May

The government has a plan of its activity until autumn and we agreed with SDPI and UP which bills we would like to pass through the parliament, especially social bills. At the beginning SLD made budgetary cuts, now is the time for bills for the poorest.

#### Krzysztof Janik, parliamentary caucus chief of SLD

PAP, 6 May

Unfortunately, at the beginning of this Sejm's term of office SLD had to cut spending, but today when budgetary situation is good we can compensate for costs borne by the poorest. There is money for this in the budget. This will cost the budget PLN1.3bn.

#### Kazimierz Marcinkiewicz, Law and Justice (PiS)

PAP, 25 April

Poland should adopt the euro when it will pay to us. According to our analysts, it should not be 2009, because we will not be ready for that yet and it could lead to significant price growth. Precise analysis regarding a date of our entry will be possible when we are closer to Maastricht criteria, which we should meet in 4-6 years. Reduction in budget deficit to close to 3% of GDP is a very important element.

The 2006 budget will most likely be prepared by the current government, but there is a possibility of self-amendment after election. There is no reason for which the 2006 budget would have to be passed until the end of 2005. One may delay its final approval by a few months, but of course there are no chances to change everything. Only the 2007 budget will be the one in which tax changes and other solutions will be taken into account. (...) Budget spending are too high, but we would like to start with reduction in administrative spending. According to our plan, one may save PLN6bn in this field through the elimination of state agencies, funds and unnecessary offices, through consolidation of the budget. Financial resources which we spend on social welfare are not that much, but they are directed incorrectly and thus they are ineffective. One cannot save on social spending.

We want to eliminate the MPC, because it is useless institution. The central bank has the governor and board, and even if one should adopt other way of appointing the board, it is the institution, which together with the governor should be responsible for monetary policy. The independence of the central bank is important and therefore we agree with its constitutional guarantees, but the NBP decisions should take into account current situation, and it was not always the case.

After unsuccessful (for the opposition) voting on self-dissolution of the parliament, there is a question about a possibility of pre-election spending spree. According to Rzeczpospolita daily, deputies from both coalition and opposition parties (excluding the Civic Platform) proposed bills (connected mostly with social spending), which may increase next year's budget deficit by some PLN10bn. However, the same case was observed before election four years ago, but most of the bills were not accepted (or were rejected by presidential veto) at the end of the day. Statements of the two persons, holding the most important positions in the country are very important in this regard - the president expressed his readiness to vote irresponsible bills, while declaration of the Lower House speaker suggested there may be no need for action of president, as these bills might not be even discussed in the parliament. We can only hope that the commitments will be met.

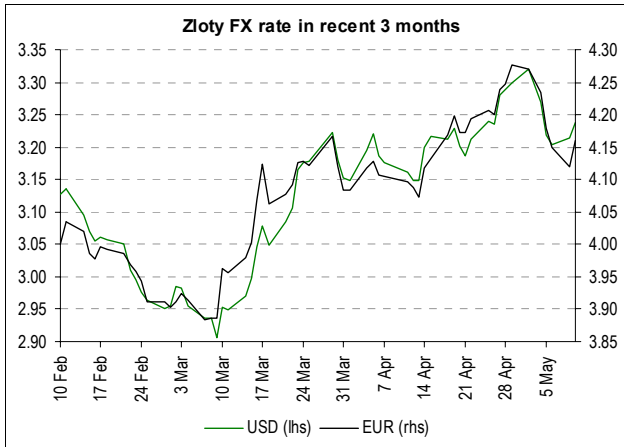
We still expect the finance minister to present budget deficit of some PLN30bn for 2006, which may be perceived positively by the market given high political risk ahead of parliamentary and presidential election. It is worth to notice that deputies of the current parliament won't have a possibility to do a harm to this budget. It has to be sent to the parliament by the end of September and even if election takes place on the latest possible date (October 16), deputies might not have a chance to start discussion.

One of possibilities to influence negatively the next year's budget is an approval of a couple of "socially sensitive" bills before parliamentary election. Statements of the president and the Lower House speaker presented above suggest this is rather unlikely. However, even if the SLD managed somehow to pass these bills through the parliament, there is nothing standing in the way to change/reject such bills after election, when deputies will start to discuss the budget. In any case, in new parliament SLD will not be strong enough (actually, it is possible SLD won't be present) to block such initiatives.

By the way, when analysing budgets for the last couple of years, we did not notice any drastic cuts in social spending, which the current majority in the parliament would have to undo. Lowering of budget deficit took place rather thanks to higher revenues.

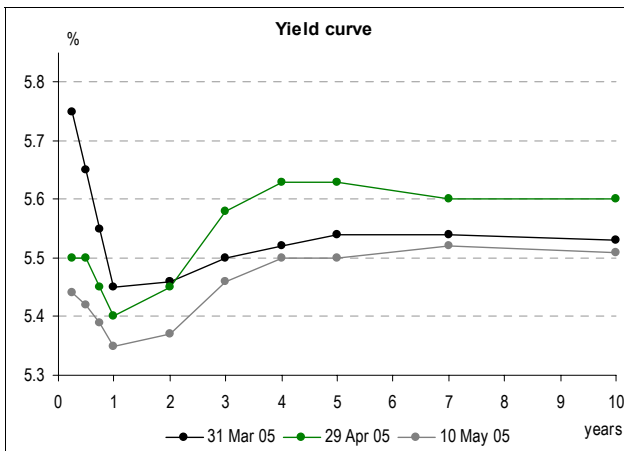
As we wrote on the previous page, April results of public opinion polls confirmed changes in Poles' political preferences. According to some surveys, the first place in elections, if they were held this month, would be taken by the Law and Justice (PiS). Moreover, one of PiS leaders Lech Kaczyński leads in the opinion polls for presidential elections. Although it is not clear whether changes in Poles' political preferences are persistent, the leading position of PiS in opinion polls strengthens concerns about the economic policy of the next government, especially in such key issues like euro adoption of fiscal adjustment. One of PiS leaders (and co-authors of the party's economic program) Kazimierz Marcinkiewicz declared last month that the budget deficit in Poland might be reduced to 3% of GDP in four years, but the euro zone entry should take place "only when it pays" to Poland. He also declared a reduction in tax burden by the next cabinet - lowering in labour costs through savings in Social Security Fund and Social Security Office, reduction in normal VAT rate to 18%, maintaining of CIT rate at 19% and introduction of two PIT rates (possibly at 18% and 28%). Additionally, PiS would like to improve tax stability through implementation of the rule of at least one-year *vacatio legis* in case of tax changes. Possibly, there is a chance for an agreement between PO and PiS on the issue of reducing and simplifying taxes. The problem is that PO would like to reduce budget deficit as soon as possible, while PiS does not see a possibility of savings in social spending. According to Marcinkiewicz, one should focus on cuts in administrative spending. Probably due to that fact he does not see a possibility of budget deficit reduction to below 3% earlier than in 4-6 years. Possibly the one of forms of spending cuts in public offices is an idea of the MPC elimination. Anyway, it is good that PiS ceased to call for constraining the central bank independence.

# Market monitor



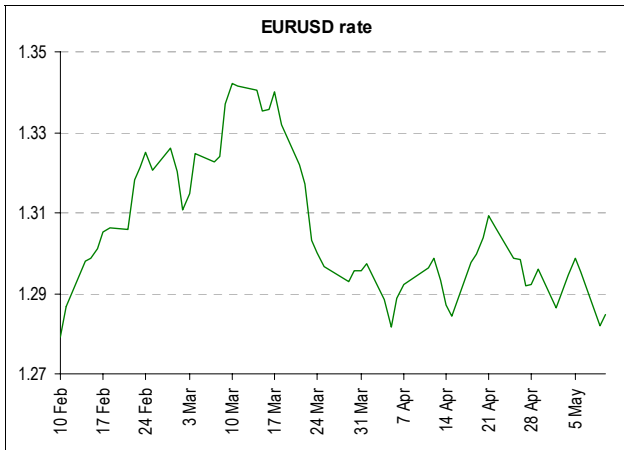
## Relative political stabilisation

- During the first part of the month the zloty fluctuated within a range of 4.08-4.14 to the euro and 3.16-3.23 against the dollar. Due to advancement of EURUSD rate and a rise in political risk the zloty breached 4.2 to the euro, where it found a support in the short term. In the last week of April accumulation of zloty decline took place ahead of voting in the Sejm, when it reached the level of 4.3. Prime Minister's declaration on possibility of staying in the office, supported by external factors, triggered dramatic capital inflow into the Polish market bringing the zloty to 4.12 to the euro.
- Next month, amid meaningfully limited political risk the zloty may not only retain current levels, but also strengthen even more. We expect the Polish currency to fluctuate around 4.1 to the euro and level of 4.08 (technically significant) may be broken only in the short term.



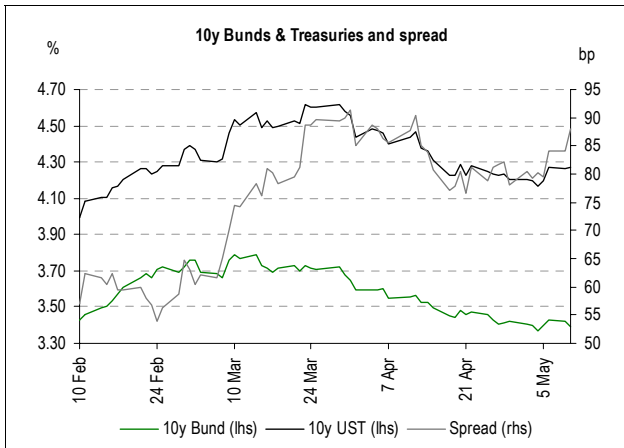
## The slope is likely to rise

- Bonds throughout the majority of last month maintained low yield levels with only two periods of market deterioration after quite unsuccessful 10y bond auction and as a result of weak zloty performance ahead of voting in parliament. In the latter situation yield rise was boosted by unexpected change in bias by MPC after cut of 50 bp. As compared with previous month, yields on the long end virtually did not change, however at the short end fell slightly owing to deeper than expected rate reduction.
- Next month we expect the long end of the Polish yield curve to be relatively stable despite a rise in yields on the core curves, as market expectations for deeper rate cuts decrease. The short end will however be falling because of weak macroeconomic data and fast diminishing inflation.



## Dollar's sensitivity to the data... but not only

- The dollar stayed under pressure of conflicting signals on the one hand pointing to rising inflation and on the other hand to weaker economic growth. Fed meeting as usual boosted the dollar, but its dovish statement in conjunction with hawkish comments from ECB strongly weakened the dollar. Strong data from US labour market that gave a boost to the dollar, clarified the picture of EURUSD market, as investors again got more concerned about inflation than growth slowdown.
- After surprisingly high US employment data the markets again may price in larger scale of interest rate hikes in US. Every release that will not correspond to such a scenario will probably act negatively to the dollar's performance. Moreover, possibility of a change in Chinese foreign exchange policy will start again to weigh upon the international markets.

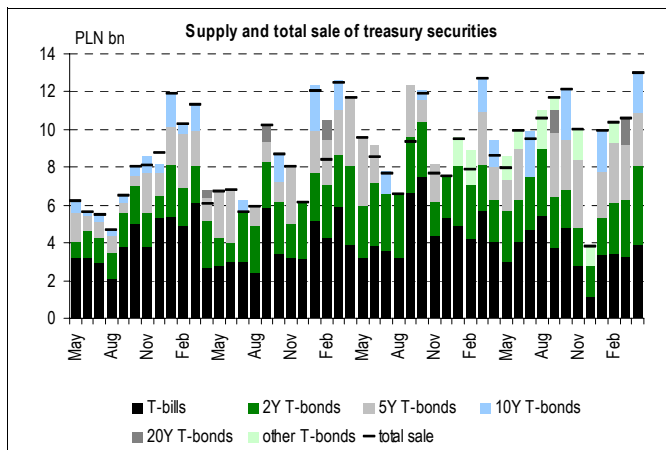
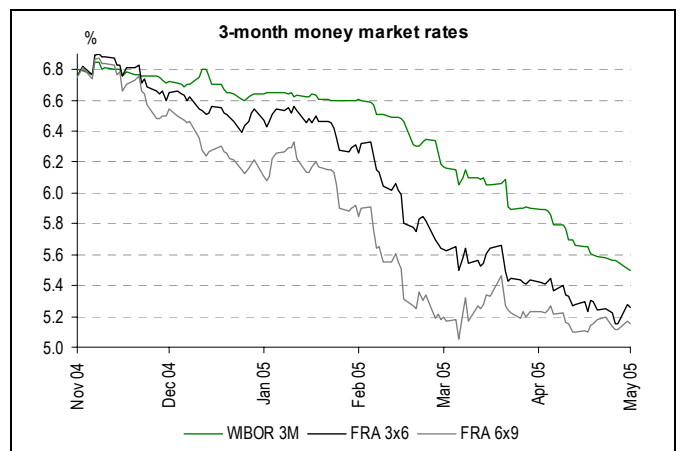
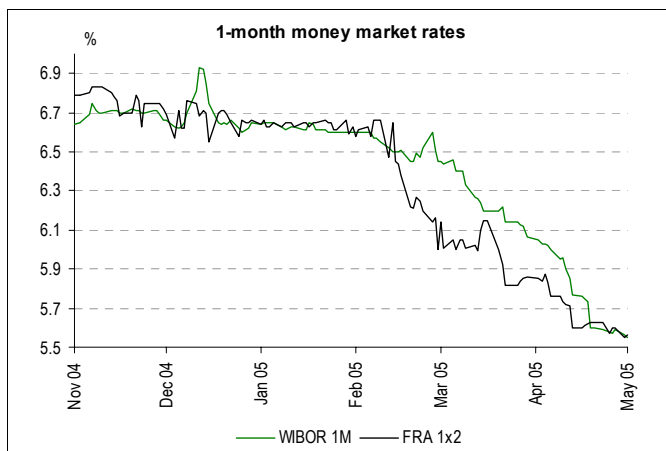
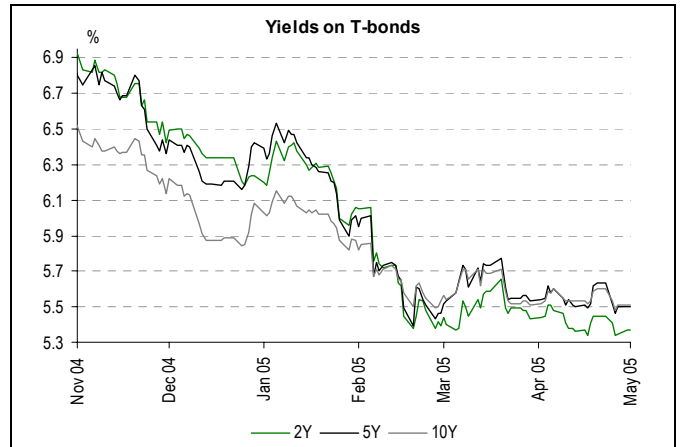
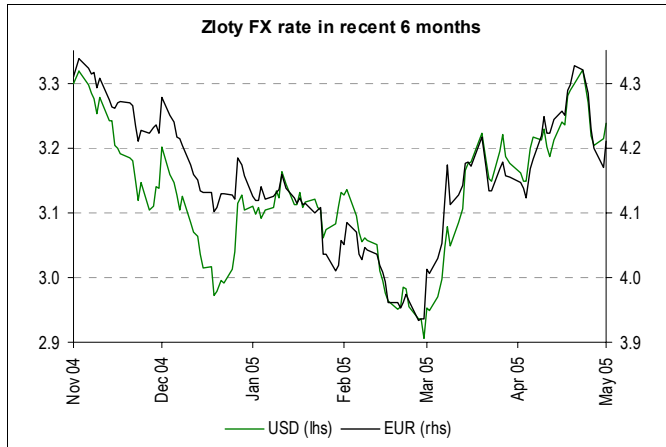


## Yields are likely to go up, but gradually

- Spread 5/5y between the Polish and euro curves widened to slightly above 100 bp in the periods of higher yields on Polish curves. For most of the time, however, it remained between 90 and 95 bp. Reduction of political risk will may lower that spread to even 80 bp.
- Owing to investors' fears of sustainability of US economic growth bond yields in core markets fell to the levels below 4.2% for 10y US Treasury and below 3.4% in case of 10y German Bund. Only strong employment data in US triggered a rise in yields.
- Foreign bond yields will probably increase, but it would happen gradually, as new publications pointing to growing inflation and better performance of US real economy reveal.

Source: Reuters, BZ WBK

# Market monitor



### Treasury bill auctions (PLN m)

Date of auction	13-week	OFFER / SALE	
		52-week	Total
04.04.2005	100/100	1 000/1 000	1 100/1 100
11.04.2005	100/100	1 000/1 000	1 100/1 100
18.04.2005	100/100	800/800	900/900
25.04.2005		800/800	800/800
<b>Total April*</b>	<b>300/300</b>	<b>3 600 / 3 600</b>	<b>3 900 / 3 900</b>
16.05.2005		800 - 1 000	800 - 1 000
23.05.2005		800 - 1 000	800 - 1 000
30.05.2005		800 - 1 100	800 - 1 000
<b>Total May*</b>	<b>300/100</b>	<b>2 400 - 3 000</b>	<b>2 400 - 3 000</b>

\* estimations based on Ministry of Finance preliminary information

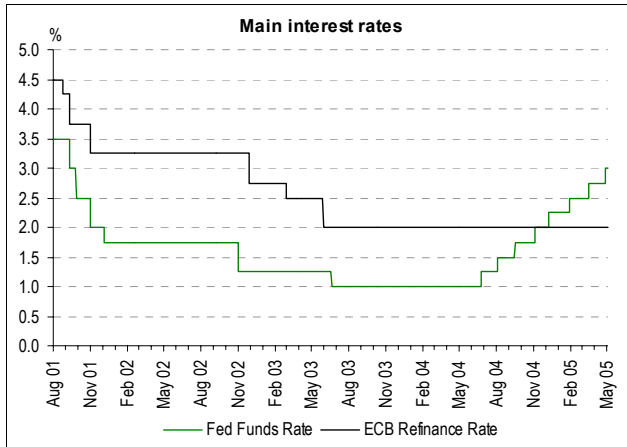
### Treasury bond auctions in 2005(PLN m)

month	First auction			Second auction			Third auction					
	date	T-bonds	offer	sale	date	T-bonds	offer	sale	date	T-bonds	offer	sale
January	05.01	OK0407	2 000	2 000	12.01	DS1015	2 600	2 130	19.01	PS0310	2 500	2 500
February	02.02*	OK0407	2 760	2 760	09.02*	IZ0816	960	960	16.02*	PS0310	3 840	3 200
March	02.03*	OK0407	3 000	3 000	09.03	WS0922	1 400	1 400	16.03	PS0310	2 900	2 900
April	06.04	OK0407	3 500	3 500	13.04	DS1015	2 200	2 130	20.04*	PS0310	2 750	2 750
May	04.05*	OK0807	3 120	3 120	11.05	IZ0816	1 000	-	18.05	PS0310	2 500 - 3 000	-
June	01.06	2Y	-	-	08.06	3&7Y Float	-	-	15.06	5Y	-	-
July	06.07	2Y	-	-	13.07	10Y	-	-	20.07	5Y	-	-
August	03.08	2Y	-	-	10.08	12Y CPI	-	-	-	-	-	-
September	07.09	2Y	-	-	14.09	20Y	-	-	21.09	5Y	-	-
October	05.10	2Y	-	-	12.10	10Y	-	-	19.10	5Y	-	-
November	02.11	2Y	-	-	09.11	12Y CPI	-	-	16.11	5Y	-	-
December	07.12	3&7Y Float	-	-	-	-	-	-	-	-	-	-

\* with supplementary auction

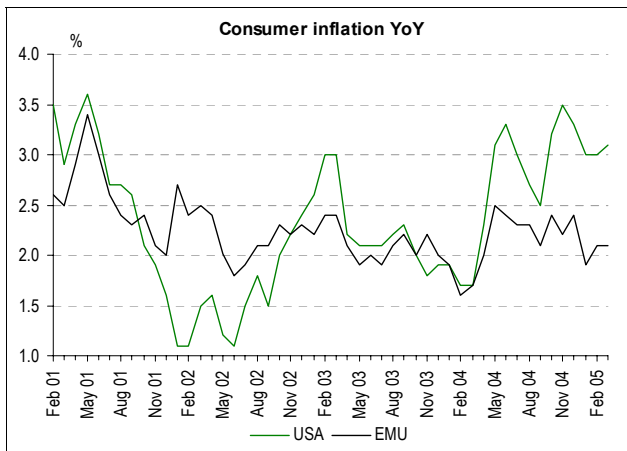
Source: Ministry of Finance, Reuters, BZ WBK

# International review



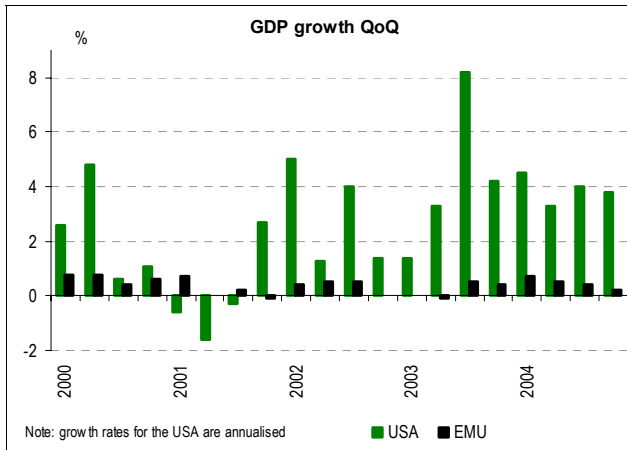
## Dovish Fed, hawkish ECB

- The Fed at the meeting on May 3<sup>rd</sup> hiked interest rate by 25 bp to 3%. It admitted that recent data showed some spending slowdown, but it is still concerned about inflation pace and producers' pricing power in the economy. Under such circumstances "measured" pace of future rate moves was retained. Markets perceived that statement as a signal that rate hikes cycle gradually comes to an end.
- ECB left rates unchanged at the level of 2%. At press conference ECB chief ruled out a possibility of rate cuts arguing that present level of official rates is exceptionally low given a set of economic conditions. It contradicts statements from Trichet presented at the meeting on April 10<sup>th</sup> when a wording took place on concerns about economic growth in euro zone.



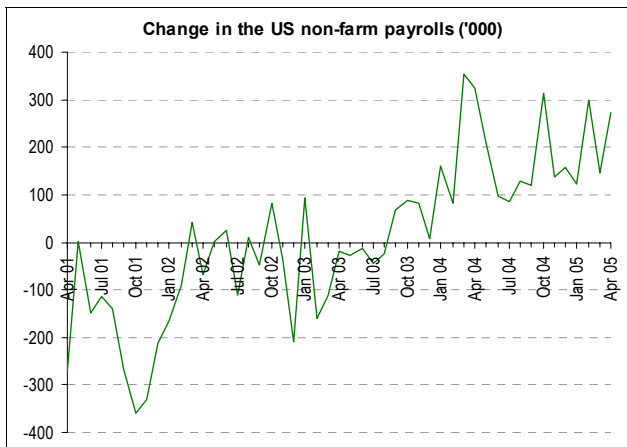
## US core inflation sharply up

- Consumer prices in euro zone rose by 0.7% on monthly basis in March solely due to higher oil prices. It translated into annual inflation rate of 2.1%, equal to preliminary data. Core measure of inflation in euro zone grew to 1.6%YoY from 1.4%YoY recorded a month ago. Thus HICP which is preferable indicator by ECB still maintains above inflation target.
- US CPI rose by 0.6% in March, the biggest monthly growth since October 2004, after a rise of 0.4% in February. Net measure that excludes volatile energy and food prices accelerated to 0.4% from 0.3% previously. It was the highest monthly rise in core inflation since August 2002, which showed higher pace of growth in many categories of products. In annual terms headline inflation rose by 3,1% and core one by 2.3%.



## Oil acts as a brake to US growth

- Economic growth in euro zone remained unchanged at 0.2% on quarterly basis and 1.6%YoY in 4Q04 according to the final data. EC forecasts that quarterly economic growth in euro zone should speed up to 0.3-0.7% in 2Q05 from 0.2-0.6% in 1Q05.
- American economy grew at its slowest pace for two years in 1Q05 decelerating to 3.1%YoY, as consumers and producers restrained spending due to rising prices. The main reasons of weaker results were lower final sales which growth decreased to 1,9% from 3.4% a month ago and negative contribution of net exports at 1.5 pp. Economists expected that GDP would grow in 1Q05 at faster pace of 3.6%YoY.



## US employment rises, German IFO declines

- Number of new jobs in US rose by surprising 274,000 in April. For two preceding months data were revised upwards by a total of 93,000. April change in non-farm payrolls significantly exceeded economists' expectations of 170,000. Unemployment rate stayed unchanged at 5.2%. Those data alleviated a bit market concerns about a slowdown in US amid decent rise of inflation.
- Investors' confidence in Germany indicator ZEW declined to 20.1 in April due to fears that slower economic growth in US may harm the recovery in Germany. IFO index fell in April to 93.3 from 94.0 in March, as moods in manufacturing and wholesale trade were still worsening. The third subsequent decline of that index is perceived as a signal of deceleration in German economy.

Source: Reuters, ECB, Federal Reserve

## What's hot this month

Monday	Tuesday	Wednesday	Thursday	Friday
<b>2 May</b> USA: ISM manufacturing (IV)	<b>3 Constitution Day</b> USA: Factory orders (III) USA: FOMC meeting - decision	<b>4</b> <b>POL: 2y bond auction</b> USA: ISM non-manufacturing (IV) EMU: Retail sales (III) EMU: ECB meeting - decision	<b>5</b> <b>POL: Voting in Sejm's self-dissolution</b> USA: Productivity (1Q)	<b>6</b> <b>POL: Reserve assets (IV)</b> USA: Payrolls (IV)
<b>9</b> GB: BoE meeting - decision USA: Wholesale inventories (III)	<b>10</b>	<b>11</b> <b>POL: 12y CPI bond auction</b> USA: International trade (III) USA: Monthly budget statement (IV)	<b>12,</b> USA: Retail sales (IV)	<b>13</b> <b>POL: Money supply (IV)</b> USA: Business inventories (III) USA: Import prices (IV) USA: Preliminary Michigan index (V)
<b>16</b> <b>POL: Treasury bills auction</b> <b>POL: CPI (IV)</b> USA: New York Fed index (V) USA: Net capital flows (III)	<b>17</b> USA: Housing starts (IV) USA: PPI (IV) USA: Capacity utilisation (IV) USA: Industrial production (IV)	<b>18</b> <b>POL: 5y bond auction</b> <b>POL: Gross wages (IV)</b> <b>POL: Employment (IV)</b> USA: CPI (IV)	<b>19</b> EMU: Final HICP (IV) EMU: Industrial production (III) USA: Leading indicators (IV) USA: Philly Fed Index (V)	<b>20</b> <b>POL: PPI (IV)</b> <b>POL: Industrial production (IV)</b> <b>POL: Business climate (V)</b>
<b>23</b> <b>POL: Treasury bills auction</b> <b>POL: Retail sales (IV)</b> <b>POL: Unemployment rate (IV)</b>	<b>24</b> <b>POL: Net inflation (IV)</b> GER: ZEW index (V) EMU: Trade balance - Eurostat (III) EMU: Factory orders (III)	<b>25</b> <b>POL: MPC meeting - decision</b> GER: IFO Index (V) USA: Durable goods orders (IV)	<b>26</b> USA: Preliminary GDP (1Q)	<b>27</b> EMU: Balance of payments EBC (III) USA: Core PCE (IV)
<b>30</b> <b>POL: Treasury bills auction</b>	<b>31</b> <b>POL: C/A (III)</b> EMU: Money supply (IV) EMU: Business climate (V) EMU: Preliminary HICP (V)	<b>1 June</b>	<b>2</b> EMU: PPI (IV) EMU: Retail sales (IV) EMU: ECB meeting - decision USA: Durable goods orders (IV) USA: Factory orders (IV)	<b>3</b> USA: Payrolls (V)
<b>6</b>	<b>7</b>	<b>8</b> USA: Wholesale inventories (IV)	<b>9</b> GB: BoE meeting - decision	<b>10</b> USA: USA: Import prices (V) USA: International trade (IV) USA: Monthly budget statement (V)

Source: CSO, NBP, Finance Ministry, Reuters

## MPC meetings and data release calendar for 2005

	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
MPC meeting	25-26	24-25	29-30	26-27	24-25	28-29	26-27	30-31	27-28	25-26	29-30	20-21
GDP*	-	-	11	-	-	9	-	-	8	-	-	9
CPI	17	15 <sup>a</sup>	14 <sup>b</sup>	14	16	14	14	16	14	14	14	14
Core inflation	25	-	22 <sup>b</sup>	22	24	22	22	24	22	24	22	22
PPI	20	17	17	19	20	17	19	18	19	19	18	19
Industrial output	20	17	17	19	20	17	19	18	19	19	18	19
Retail sales	21	23	23	25	23	21	21	22	21	21	23	21
Gross wages, employment	17	15	15	15	18	15	15	16	15	17	17	15
Unemployment	21	23	23	25	23	21	21	22	21	21	23	21
Foreign trade	about 50 working days after reported period											
Balance of payments*	-	-	31	-	-	30	-	-	-	-	-	-
Balance of payments	31 <sup>c</sup>	28	31	29	31	30	12	11	-	-	-	-
Money supply	14	14	14	14	13	14	14	12	-	-	-	-
NBP balance sheet	7	7	7	7	6	7	7	5	-	-	-	-
Business climate indices	21	21	22	22	20	22	22	19	22	21	22	22

\* quarterly data, <sup>a</sup> preliminary data, January, <sup>b</sup> January and February, <sup>c</sup> November 2004, <sup>d</sup> January <sup>e</sup> February, Source: CSO, NBP



## Economic data and forecasts

### Monthly economic indicators

		Apr 04	May 04	Jun 04	Jul 04	Aug 04	Sep 04	Oct 04	Nov 04	Dec 04	Jan 05	Feb 05	Mar 05	Apr 05	May 05
Industrial production	%YoY	21.8	12.2	15.8	6.0	13.7	9.5	3.5	11.4	6.8	4.6	2.3	-3.7	-3.9	0.5
Retail sales <sup>c</sup>	%YoY	30.6	4.0	8.6	10.9	9.6	8.8	4.0	4.4	2.8	7.5	2.4	-0.3	-9.3	15.4
Unemployment rate	%	19.9	19.5	19.4	19.3	19.1	18.9	18.7	18.7	19.1	19.5	19.4	19.3	18.8	18.4
Gross wages <sup>b c</sup>	%YoY	4.6	4.4	4.5	3.6	5.1	3.7	2.4	2.7	3.2	2.6	1.4	2.2	2.6	3.5
Employment <sup>b</sup>	%YoY	-1.1	-0.9	-0.7	-0.7	-0.8	-0.6	-0.4	-0.3	0.2	1.5	1.6	1.6	1.7	1.9
Export <sup>d</sup>	%YoY	28.6	23.8	35.0	13.8	22.1	18.0	15.5	29.7	20.5	31.6	22.6	14.2	11.4	17.3
Import <sup>d</sup>	%YoY	37.2	16.8	33.7	9.1	22.0	18.9	15.3	23.6	15.7	19.1	21.1	7.0	-2.7	19.4
Trade balance <sup>d</sup>	EURm	-987	-248	-192	-486	-314	-345	-265	-255	-501	142	57	-213	-147	-406
Current account balance <sup>d</sup>	EURm	-562	-627	-336	-734	253	-383	75	176	-163	63	132	-158	63	-316
Current account balance <sup>d</sup>	% GDP	-1.8	-1.8	-1.9	-2.0	-1.8	-2.0	-2.1	-1.8	-1.5	-1.4	-1.3	-1.1	-0.8	-0.6
Budget deficit (cumulative)	PLNbn	-11.0	-15.3	-19.9	-23.2	-25.9	-29.0	-30.8	-33.8	-41.5	-1.6	-8.8	-12.3	-13.5	-17.5
Budget deficit (cumulative)	% realisation	26.5	36.9	47.9	55.9	62.3	69.8	74.1	81.4	100.0	4.5	25.2	35.2	38.5	50.0
CPI	%YoY	2.2	3.4	4.4	4.6	4.6	4.4	4.5	4.5	4.4	3.7	3.6	3.4	3.0	2.3
PPI	%YoY	7.6	9.6	9.1	8.6	8.5	7.9	7.6	6.7	5.2	4.5	3.2	2.2	0.4	-0.6
Broad money (M3)*	%YoY	8.5	6.4	7.2	6.8	7.4	6.5	10.5	6.4	8.7	9.3	9.4	10.8	9.8	11.6
Deposits*	%YoY	8.4	6.2	6.9	6.4	7.6	6.6	11.5	6.5	8.1	8.4	8.7	10.3	9.1	10.9
Credits*	%YoY	8.5	6.1	5.7	4.6	5.2	4.2	9.5	4.0	2.9	3.1	1.7	3.8	3.4	5.8
USD/PLN	PLN	3.97	3.93	3.78	3.64	3.64	3.58	3.46	3.28	3.09	3.11	3.06	3.04	3.21	3.22
EUR/PLN	PLN	4.76	4.72	4.59	4.47	4.43	4.37	4.32	4.26	4.14	4.08	3.99	4.02	4.16	4.15
Reference rate <sup>a</sup>	%	5.25	5.25	5.25	6.00	6.50	6.50	6.50	6.50	6.50	6.50	6.50	6.00	5.50	5.50
WIBOR 3M	%	5.69	5.99	5.91	6.34	6.58	7.12	6.89	6.81	6.72	6.63	6.54	6.15	5.80	5.55
Lombard rate <sup>a</sup>	%	6.75	6.75	6.75	7.50	8.00	8.00	8.00	8.00	8.00	8.00	8.00	7.50	7.00	7.00
Yield on 52-week T-bills	%	6.20	6.65	6.79	7.15	7.24	7.38	7.00	6.81	6.44	6.28	5.95	5.51	5.36	5.30
Yield on 2-year T-bonds	%	6.83	7.41	7.44	7.80	7.66	7.51	7.04	6.81	6.39	6.24	5.82	5.43	5.39	5.30
Yield on 5-year T-bonds	%	7.13	7.57	7.50	7.79	7.65	7.33	7.03	6.78	6.29	6.31	5.80	5.56	5.50	5.50
Yield on 10-year T-bonds	%	7.02	7.32	7.27	7.44	7.36	6.96	6.75	6.43	6.02	5.98	5.72	5.57	5.49	5.50

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

<sup>a</sup> at the end of period <sup>b</sup> in corporate sector <sup>c</sup> in nominal terms <sup>d</sup> balance of payments data on transaction basis

\* Since January 2005 the NBP changed methodology of monetary statistics (definition of Monetary Financial Institutions has been extended with cooperative savings and credit unions (SKOK)). As the NBP showed estimates of monetary aggregates in comparable terms only for last several months, forecasting the data for 2005 is burdened with large risk

## Quarterly and annual economic indicators

		2002	2003	2004	2005	1Q04	2Q04	3Q04	4Q04	1Q05	2Q05	3Q05	4Q05
GDP	PLNbn	781.1	814.7	883.7	942.0	203.8	216.1	218.8	245.0	217.4	228.9	233.1	262.0
GDP	%YoY	1.4	3.8	5.3	4.3	6.9	6.1	4.8	3.9	3.0	3.5	4.9	5.4
Domestic demand	%YoY	0.9	2.5	4.5	4.2	5.5	5.1	4.6	2.9	2.8	3.2	4.9	5.6
Total consumption	%YoY	2.8	2.5	2.8	2.9	3.3	3.5	2.9	1.5	2.2	2.7	3.4	3.5
- Private consumption	%YoY	3.3	3.1	3.2	3.4	3.9	3.8	3.5	1.8	2.5	3.2	3.9	4.0
Fixed investments	%YoY	-5.8	-0.9	5.1	11.0	3.5	3.6	4.1	7.2	11.0	10.0	12.0	11.0
Industrial production	%YoY	1.1	8.4	12.3	6.1	19.0	16.4	9.2	6.2	1.0	2.5	9.1	11.7
Retail sales (real terms)	%YoY	1.9	3.6	7.1	5.4	13.6	11.3	4.0	1.1	-0.8	3.3	8.7	10.3
Unemployment rate <sup>a</sup>	%	20.0	20.0	19.1	17.7	20.4	19.4	18.9	19.1	19.3	18.2	17.6	17.7
Gross wages (real terms)	%YoY	1.5	2.0	0.8	1.5	3.8	1.6	-0.5	-1.5	-1.4	1.0	3.0	3.6
Export <sup>b</sup>	%YoY	6.0	9.1	21.9	13.4	19.3	29.1	17.6	21.8	21.9	13.1	10.0	10.0
Import <sup>b</sup>	%YoY	3.5	3.3	19.1	12.2	12.6	29.3	16.3	18.2	14.8	10.2	12.0	12.0
Trade balance <sup>b</sup>	EURm	-7 701	-5 077	-4 510	-4 226	-909	-1 438	-1 148	-1 015	-14	-1 105	-1 616	-1 491
Current account balance <sup>b</sup>	EURm	-5 404	-4 109	-2 959	-2 929	-654	-1 530	-868	93	37	-635	-1 212	-1 118
Current account balance <sup>b</sup>	% GDP	-2.7	-2.2	-1.5	-1.3	-1.7	-1.9	-2.0	-1.5	-1.1	-0.6	-0.8	-1.3
Budget deficit (cumulative) <sup>a</sup>	PLNbn	-39.4	-37.0	-41.5	-35.0	-11.8	-19.9	-29.0	-41.5	14.0	22.8	29.8	35.0
Budget deficit (cumulative) <sup>a</sup>	% GDP	-5.0	-4.5	-4.7	-3.7	-5.8	-3.7	-4.1	-5.1	6.4	3.8	3.0	2.0
CPI	%YoY	1.9	0.8	3.5	2.2	1.6	3.3	4.5	4.4	3.6	2.3	1.5	1.5
CPI <sup>a</sup>	%YoY	0.8	1.7	4.4	1.6	1.7	4.4	4.4	4.4	3.4	1.6	1.6	1.6
PPI	%YoY	1.0	2.6	7.0	1.2	4.4	8.8	8.3	6.5	3.3	-0.1	0.1	1.4
Broad money (M3) <sup>a</sup>	%YoY	-2.0	5.6	8.7	-	5.7	7.2	6.5	8.7	10.8	-	-	-
Deposits <sup>a</sup>	%YoY	-4.1	3.7	8.1	-	4.8	6.9	6.6	8.1	10.3	-	-	-
Credits <sup>a</sup>	%YoY	5.2	8.1	2.9	-	6.1	5.7	4.2	2.9	3.8	-	-	-
USD/PLN	PLN	4.08	3.89	3.65	3.05	3.82	3.89	3.62	3.27	3.07	3.17	3.03	2.97
EUR/PLN	PLN	3.85	4.40	4.53	4.03	4.78	4.69	4.43	4.24	4.03	4.12	4.04	3.97
Reference rate <sup>a</sup>	%	6.75	5.25	6.50	5.25	5.25	5.25	6.50	6.50	6.00	5.50	5.25	5.25
WIBOR 3M	%	9.09	5.69	6.21	5.64	5.47	5.87	6.68	6.81	6.44	5.62	5.25	5.25
Lombard rate <sup>a</sup>	%	8.75	6.75	8.00	6.75	6.75	6.75	8.00	8.00	7.50	7.00	6.75	6.75
Yield on 52-week T-bills	%	8.18	5.33	6.50	5.50	5.75	6.24	7.26	6.75	5.91	5.40	5.40	5.30
Yield on 2-year T-bonds	%	7.94	5.38	6.89	5.43	6.28	6.86	7.66	6.75	5.83	5.30	5.30	5.30
Yield on 5-year T-bonds	%	7.86	5.61	7.02	5.55	6.67	7.10	7.59	6.70	5.89	5.40	5.50	5.40
Yield on 10-year T-bonds	%	7.34	5.77	6.84	5.59	6.70	7.00	7.25	6.40	5.76	5.50	5.60	5.50

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

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

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