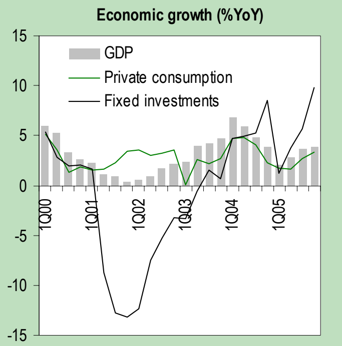
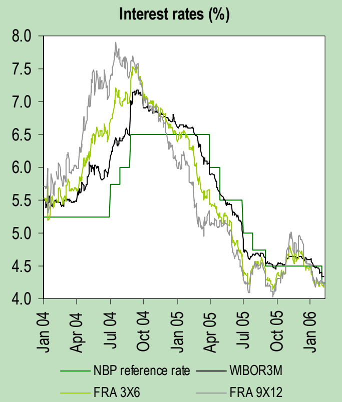
Bank Zachodni WBK

MACROscope

Polish Economy and Financial Markets

February 2006





In this issue:

Stabilisation on paper

- **The parliamentary crisis ended up in signing the so-called stabilisation pact between Law and Justice (PiS), Self-defence, and League of Polish Families (LPR), which means that President Lech Kaczyński is not likely to make a decision about early election in spite of the fact that the Budget Act will not be passed on time.** This does not mean, however, that the political risk that may affect financial markets has been substantially reduced. There is still a lot of uncertainty around the economic policy to be pursued by the new parliamentary majority and some risk of passing popular, yet costly, acts (fortunately, the most costly ones were not added to the major package), let alone the possible amendment of the NBP Act, which in our opinion, is one of key risks for the market. As a result, the question is whether the stabilisation on the political scene is sustainable and how its continuation or discontinuation may impact financial markets is still open. Other risk factors include possible negative opinion from the European Commission as regards the Polish *Convergence Programme* and a possible outflow of capital from emerging markets in the face of growing official interest rates and growing yields in the United States and the euro zone.

- **Economic situation gives more reasons for optimism than the political scene.** The revival sustainable for a number of months is still underway and growing in strength. While the preliminary 2005 GDP data was worse than expected, it showed further growth acceleration in Q4. What is more, the structure of the GDP growth indicated much strengthened domestic demand primarily fuelled by acceleration of investment growth. Exports are still growing fast, however imports are beginning to outstrip them. The improvement on the labour market continues and so does the growth in consumer optimism, which should stimulate growth in consumptions demand in subsequent quarters. In spite of this, inflation outlook is still positive as confirmed by the new *Inflation Report*. The inflation path for the upcoming years as projected by the NBP experts has descended against the previous forecast which was reflected in the decision to cut interest rates by 25bp again. If the short-term macroeconomic data will show that there are still no factors, which may pose a threat to inflation, another interest rate cut cannot be ruled out in the following months.

- **In the *Special focus* section we forecast the supply of treasuries throughout the year.** Gross borrowing needs amount to PLN122.8bn, and Ministry of Finance may additionally repurchase at the switch auctions ca. PLN6bn of Polish papers maturing after 2006. Borrowing needs will be covered with net foreign financing (PLN20.5bn) as well as domestic treasuries issues (PLN108.3bn). According to our estimates the ministry will offer ca. PLN93bn at primary auctions and another PLN15bn may fall on switch auctions.

Financial market on 31 January 2006:					
NBP deposit rate	3.00	WIBOR 3M	4.40	USDPLN	3.1630
NBP reference rate	4.50	Yield on 52-week T-bills	4.14	EURPLN	3.8285
NBP lombard rate	6.00	Yield on 5-year T-bonds	4.86	EURUSD	1.2104

This report is based on information available until 08.02.2006

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Special focus

What supply of Treasuries in 2006?

Our main goal in this article is to estimate the supply of treasuries offered at auctions this year as well the time structure of the new issues. T-bills' and T-bonds' issues aim to finance borrowing needs of the state and they are adjusted with appropriate instruments so as to level off the supply and spread the distribution evenly across the year in order to fulfil the main goal of the debt management strategy for years 2006-2008 approved by the former government, i.e. to minimize public debt management costs. Although according to earlier declarations of the present government, the strategy may change, no binding decisions have been made. Thus in our base scenario, we analyze the situation and information as outlined in the binding September-2005 document.

Main determinants of treasuries supply

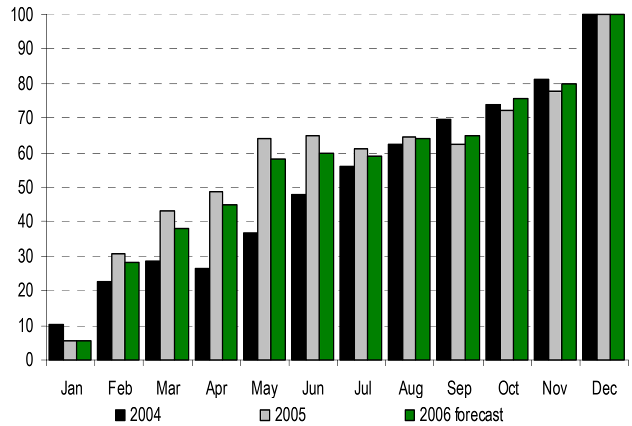
The starting point in assessing the supply of the treasuries is the budget deficit and the so-called spending "below the line" (large part is represented by transfers to pension funds (OFE)), which together with the deficit represent the net borrowing needs. This amount is covered mainly with income from domestic issues of treasuries as well as foreign debt financing. After setting the size of foreign issue as well as the value of maturing treasuries in 2006, the size of borrowing needs on the domestic market and thus size of treasuries issue may be estimated. It may happen that the overall treasuries supply in a given year will be higher than the borrowing needs for this year, when the Ministry of Finance decides to buy back papers maturing in the following years. The amount of offered T-bills and T-bonds in particular months may be adjusted and levelled off according to MF's plans by means of switch auctions as well as the so-called "liquidity cushion", that is funds accumulated in the budget accounts.

First of all – the budget deficit

According to the first amendment to the budget bill for 2006, the budget deficit was reduced by PLN2.03bn as compared to the draft from September 2005 - from PLN32.57bn to **PLN30.55bn**. Actually, we do not see serious threats for the budget in the shape presented by the government.

Estimating the realization of the budget deficit for this year as well as the size of the resultant borrowing needs, we take into consideration average performance of the deficit in the previous years. We use most of all 2004-2005 data, as the trends from previous years do not fully apply due to our current membership in the European Union. The Ministry of Finance announced that according to new estimates the budget deficit in January 2006 will be between 5%-6%, much lower than previously given range of 9%-10%. Low deficit realization may partly result from carting forward some of the last year's income to 2006. According to historical data one can see the acceleration in the budget deficit realization as of February, while by the end of April the realization often exceeds 50% of the annual plan. This year the budget burden will rise additionally starting from March due to indexation of both old age and disability pensions. However, we think that in view of quicker pace of the GDP growth this year, the budget inflows will be respectively higher and the pace of the deficit realisation will be slightly slower in the first few months as compared to the same period in 2005. The performance against the budget in June is usually one of the lowest as the NBP transfers its profits to the budget accounts. In 2005 the profit of PLN1.23bn was significantly lower than PLN4.2bn transferred in the previous year. As a result, we forecast that the borrowing needs connected with budget deficit will follow the pattern outlined below.

Realization of the budget deficit (%)



Source: Ministry of Finance, BZ WBK

Inflows and outflows "below the line"

The actual borrowing needs, not directly connected with the functioning of the state budget, are higher by such elements as the net privatization proceeds and expenditures (mainly transfers to Open Pension Funds - OFE), funds for pre-financing EU projects, funds from structural funds as well as loans granted.

According to the budget draft for 2006 net privatization proceeds and expenditures were assumed at PLN-8.61bn. This comprises mainly transfers to the Open Pension Funds amounting to ca. PLN12.76bn as well as their main financing source i.e. privatization proceeds of PLN5.5bn. Taking into consideration problems with getting the whole planned amount from the privatization process in previous years, we assumed its percentage realization similar to the previous years (70%), which lowered the analyzed net value to PLN-10.27bn. Most of the proceeds from privatization should fall for the second half of the year. We think that the calendar of privatization proceeds and transfers to OFE may correspond to that in 2004-2005, thus we assumed realization of net privatization proceeds and expenditures in line with the average figures from last two years.

Spending on pre-financing tasks supported with EU contributions as well as expenditures from structural funds are forecasted by the Ministry of Finance at ca. PLN1.96bn and 1.25bn, respectively. In view of Poland's short period of membership in the EU, we assume these figures at the level close to that in 2004-2005.

Another position which increases the borrowing needs is the net value of loans granted, which according to the 2006 budget is planned at PLN-1.41bn. Higher borrowing needs result from loans granted to the Compensation Fund (PLN1.0bn), Export Credits Insurance Corporation PLC (PLN500m), public health care units (PLN300m) as well as municipal units (PLN30m). We assumed that the related expenses will be similar to those in the last two years.

As a result, having taken account of the "below the line" spending (**PLN14.89bn**), the net borrowing needs of the budget should amount ca. **PLN45.44bn**.

Heavy foreign financing

Net borrowing needs are mainly covered with domestic issues of treasuries in the country as well as foreign financing. In order to estimate the supply of T-bills and T-bonds on the domestic market, we need to decrease the borrowing needs by the value of foreign financing.

According to the assumptions of the new public debt management strategy and its main target, i.e. minimization of debt service expenses, the Ministry of Finance started to finance the budget deficit through international issues to much higher extent than before (mainly in euro). One of the factors triggering such behaviour was the relatively low increase in the risk connected to the foreign debt growth and its marginal impact on the zloty rate assumed by the FM in the face of approaching entry to the euro zone and the resultant elimination of the FX risk. Thanks to this approach, the MF was able to raise earlier funds at a lower cost thanks due to lower interest rates in the euro zone. However, in view of the fact that that euro zone membership delays, the basic assumption of the strategy is not met and doubts emerge as to the rationale behind applying the strategy in its current shape. We assume that the MF's strategy will not change and net foreign financing of the deficit will total PLN20.5bn as planned in first budget amendment, while the realization of this amount will be evenly distributed across individual quarters.

Thus the funds that have to be raised by way of net treasuries issue on the domestic market amount to **PLN24.94bn**.

Buyback of maturing treasuries

Funds raised through new T-bills and T-bonds issue on the domestic market will have to cover part of the net borrowing needs (PLN24.94bn) as well as outflows from buying back of maturing both market as well as other papers issued in the past years. According to the Ministry of Finance data as at 31 December 2005, the value of treasury bills maturing in 2006 amounted to PLN24.4bn and of treasury bonds to PLN51.01bn, which gives a total of **PLN75.41bn**. In line with the first budget amendment from November 2005, the spending on the buybacks of T-bills and T-bonds was planned at PLN22.73bn and PLN49.11bn, respectively which adds up to PLN71.84bn. The difference may stem from lower than previously assumed amount of bonds bought back at switch auctions organized until the end of the last year.

Market T-bills and T-bonds maturing in 2006 (PLN bn)

	bills	bonds	Market treasuries	
			monthly	quarterly
January	2.70	0.00	2.70	
February	3.20	2.89	6.09	*12.99*
March	4.20	0.00	4.20	
April	3.60	9.87	13.47	
May	1.50	5.16	6.66	*22.33*
June	2.20	0.00	2.20	
July	1.40	0.94	2.34	
August	1.00	10.13	11.13	*14.26*
September	0.80	0.00	0.80	
October	0.80	0.31	1.11	
November	0.90	13.41	14.31	*25.83*
December	2.10	8.30	10.40	
Sum	**24.40**	**51.01**	**75.41**	**75.41**

Source: Ministry of Finance, BZ WBK

Moreover the first budget amendment includes negative balance of saving bonds (**PLN-1.87bn**) and non-market bond issues (**PLN-0.09bn**). We assume that the balances will be realised pro rata to amounts maturing in particular months.

Thus the amount necessary to be raised on the domestic market to cover part of the borrowing needs, i.e. the supply of treasuries on the domestic market may total ca. **PLN102.31bn**. In the first budget amendment, the planned proceeds from market treasuries issue amount to PLN97.35bn – the difference is related to lower expenses on the repurchase of maturing treasuries mentioned above and the assumed lower privatization proceeds. The table below shows quarterly estimates of market treasuries supply on the domestic market resulting from borrowing needs.

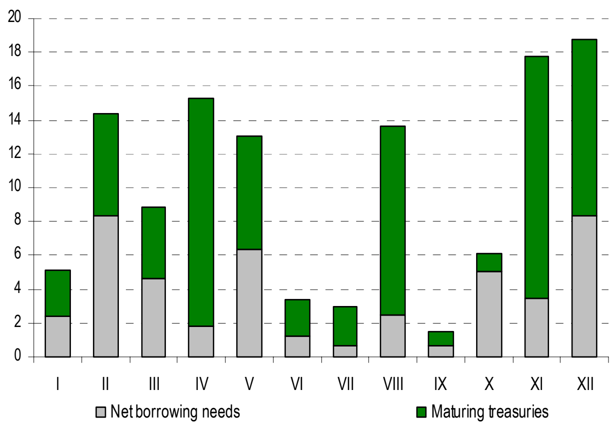
Borrowing needs (BN) on the domestic market in 2006 (PLN bn)

	BN	Foreign financing	Domestic financing including treasuries		
			other	market	
	net	net	net	net	net
Q1	-15.41	5.12	-0.57	-12.99	**23.85**
Q2	-9.37	5.12	-0.36	-22.33	**26.93**
Q3	-3.82	5.12	-0.54	-14.26	**13.50**
Q4	-16.83	5.12	-0.50	-25.83	**38.03**
Sum	**-45.44**	**20.50**	**-1.96**	**-75.41**	**102.31**

Source: Ministry of Finance, BZ WBK

The graph below presents gross borrowing needs. It is worth noting that the highest burden falls for the months of February, April, May, August, November and December. The months of February, May, December and to a large extent March will see high borrowing needs driven by the budget deficit. In the months of April, May, August, November and December, the maturing treasuries (April OK0406 PLN9.10bn, May PS0506 PLN5.16bn, August OK0806 PLN10.13bn, November PS1106 PLN13.41bn, December OK1206 PLN8.30bn) will be the key driver behind MF funding needs.

Gross borrowing needs in 2006 (PLN bn)



Source: Ministry of Finance, BZ WBK

Switch auctions and levelling off of the treasuries supply

According to our estimates the ministry may buy back ca. PLN15.52bn bonds at the switch auctions, 62% (PLN9.57bn) of which will be represented by bonds maturing in 2006. In effect, the supply of treasuries issued at ordinary as well as switch auctions may grow to ca. **PLN108.26bn** - by additional ca. PLN5.95bn, i.e. the value of bonds with maturity dates in subsequent years and bought back in 2006.

The mentioned amount of PLN9.57bn will serve to level off the treasuries supply across the year as planned by the Ministry of Finance. What is more, the MF may use funds accumulated in the budget accounts and in term deposits in order to adjust the issue size to the borrowing needs and market situation each month.

Thus the actual size of treasuries supply offered at ordinary auctions cmay amount to ca. **PLN92.74bn**, while the balance of PLN15.52bn may be offered at switch auctions.

Conclusion

According to our estimates, in January the borrowing needs are low. Nonetheless the Ministry of Finance decided to offer much higher amount so as to use the raised funds for financing the borrowing needs in the next few months. What is more, the MF counted on the possibility of raising higher funds from the treasuries issue due to high demand of investors for Polish bonds triggered by expectations on rate cuts by the MPC, despite high political risk in our opinion. Similar situation may occur in February and March. If the macroeconomic data turn to be “dovish” and the situation on the political scene stabilises, then the demand for Polish papers on the part of investors will stay high in the advent of further monetary policy easing, while the Ministry of Finance may issue more treasuries in the first quarter than indicated by initial estimates.

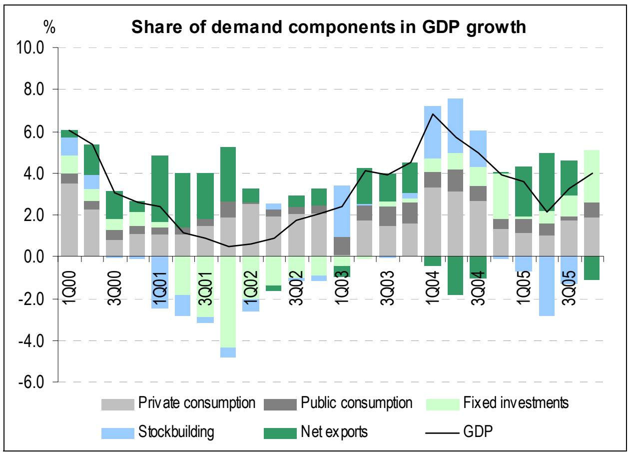
We tried to forecast the size of the treasuries that the Ministry of Finance would be willing to offer. We assumed thus the most desirable by the MF scenario of the treasuries buybacks at switch auctions. The table below outlines the results of our analysis with the break down into particular quarters. The actual issue size may differ from the estimates, if the Ministry of Finance decides to change its debt management strategy and the borrowing needs are covered with net foreign issues to a lower extent. Then the treasuries issue size on the domestic market would substantially increase. The actual privatisation processes will also be important.

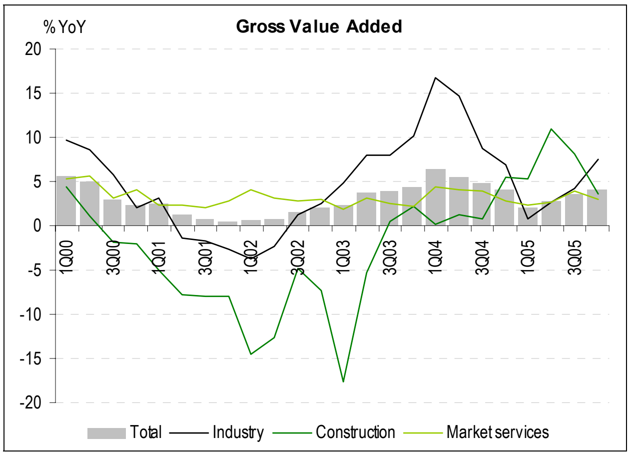
Forecast of treasuries supply in 2006 (PLN bn)

	MF’s offer		ordinary auctions	switch auctions	sum
	min	max			
Q1	22.5	32.3	30.6	4.3	34.8
Q2	20.0	30.0	22.5	3.6	26.1
Q3	11.0	17.0	15.6	4.3	19.7
Q4	23.0	35.0	24.0	3.3	27.3
Sum	**76.5**	**114.3**	**92.6**	**15.5**	**108.3**

Source: BZ WBK

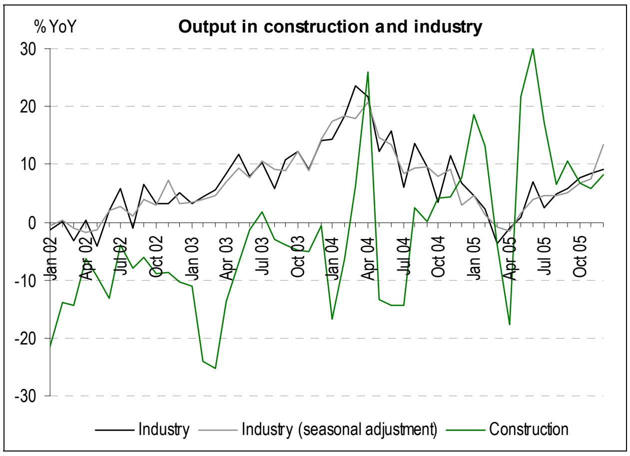
Economic update





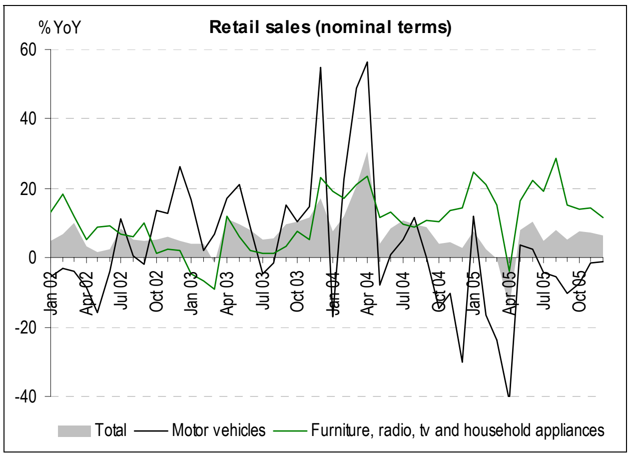
Domestic demand again on the foreground

- According to preliminary data, in 2005 Polish GDP rose 3.2%. While total growth was weaker than expected, it was achieved amid much stronger than predicted domestic demand, especially investment that soared 6.2%. Private consumption increased 3.2%, in line with expectations.
- Results of 4Q05 (derived from data for entire year and three first quarters) show this situation with even greater clarity. However, one should keep in mind that those estimated figures are appropriate only if the CSO does not revise data for three previous quarters of 2005 (which cannot be ruled out).
- GDP growth in 4Q05 reached ca. 4% against expected 4.5%, while domestic demand growth accelerated to ca. 5% YoY. Such strong revival was possible mainly due to upsurge in investment outlays by almost 10%YoY (the highest growth since 1998). Private consumption growth accelerated moderately to 3.3%, in line with our prediction. Rising domestic demand should help in maintaining expansionary trends in Polish economy.
- For the first time for over a year, net exports' contribution to GDP growth was negative and reached ca. -1 pct. point. What is important, available foreign trade statistics show this situation has not resulted from downturn in Polish export growth, but from a pickup in imports (natural consequence of reviving domestic demand).
- On the supply side, there was a significant acceleration in growth of value added in industry (ca. 7.5%YoY in Q4), however – interestingly – value added growth decelerated in construction (to 3.6%) and market services (to ca. 3%), which seems not entirely consistent with monthly data about construction output and retail sales.



Industry and construction on the rise

- Data on production in industry and construction in December confirmed rapid rise in economic activity at the end of 2005. Industrial output rose 9.2%YoY, and after removing seasonal fluctuations even 13,3%YoY, which was the best result since mid-2004 (pre-accession boom).
- Production rise was recorded in 20 out of 29 industrial branches (mostly in manufacturing), the biggest one in those with large share of output for export, which confirms that external demand remains an important driver of companies' activity.
- On the other hand, solid rise in construction output (8.3%YoY and 10.3%YoY after removing seasonality) confirms that domestic demand has also strengthened. It found confirmation also in strong investment rise in Q4 2005. The question is what will be effect of severe winter at the beginning of 2006.

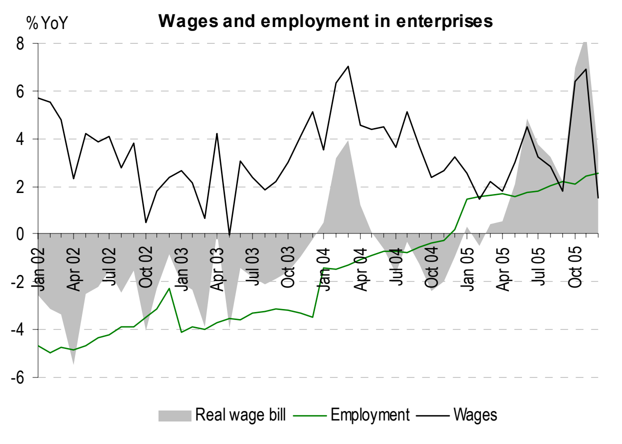


Source: CSO, own calculations

Retail sales also up, yet more slowly

- Nominal worth of retail sales in December was 6.3% higher than in the previous year, which was result below forecasts and worse than in November (7.3%YoY). However, growth in real terms was only slightly weaker and reached 6.2%, which represented a decent expansion.
- In total, real growth of retail sales in Q4 2005 was 5.4%YoY, up from 4.1% in Q3. It is clear that after weak first half of the year, last months brought about moderate improvement in households' shopping activity.
- Slight difference between nominal and real growth in retail sales shows that increase in prices in retail trade is hardly noticeable despite recovering domestic demand, which is a good information for inflation prospects.

Economic update

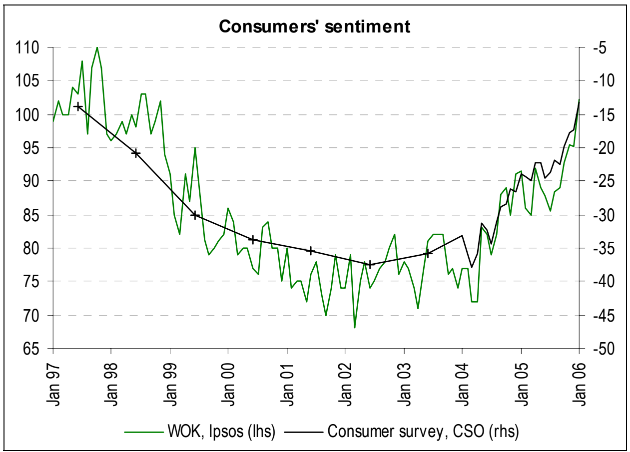


Labour market warming up

- After two months of extraordinary increases, average wages in enterprises slowed down to 1.5%YoY in December, confirming that record-high growth rates in October and November resulted from shifts in bonus payments.
- Average pay rise in September-December (all months affected by bonus shift effect) reached 4.1%YoY, and thus was faster than 2-3% increase in the first part of the year. It shows that wages have been picking up, yet gradually.
- Employment growth in enterprises has been advancing as well – in December it increased 2.6%YoY. In effect, wage bill in corporate sector has been growing and in Q4 2005 it rose on average 6.2%YoY, which was the highest rate of improvement for a number of years (at least since 2000, i.e. since comparable time series are available).

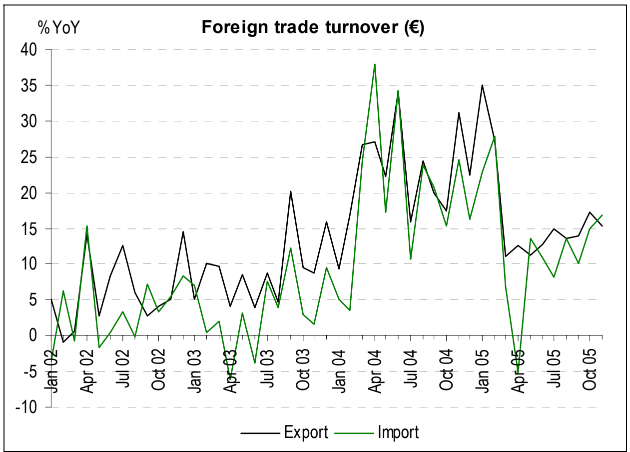
Wage rise not necessarily dangerous for inflation

- Certainly, improvement in wage bill, and thus faster rise in households' disposable income, bodes well for perspectives of consumption demand in subsequent quarters.
- At the same time, rising wage growth is still not excessively dangerous for inflation prospects, because labour productivity growth does not lag behind.
- Despite growing number of jobs, labour productivity in Polish industry has increased by more than 7%YoY in Q4 2005, which was much above average pay rise in this period (4.6%). In effect, unit labour costs in industry have descended by 3.5%YoY.
- The question is whether this trend will be persistent if demand for labour continues and acceleration in wage growth keeps going in subsequent quarters.



Consumers' optimism at highest levels for years

- All available surveys clearly show strong improvement in consumers' sentiment in recent months, with particular strengthening of this process in January 2006.
- Index of consumers' optimism (WOK) by Ipsos institute topped 100 pts. in January for the first time since 1998, which shows higher number of optimists than pessimists. Indices of consumer climate by IRG SGH are also at highest levels since 1998, and measures of consumer confidence by CSO in January were the best ever recorded. It resulted from both better assessment of consumers' own financial situation and clear improvement of assessment of overall economic situation.
- Above-mentioned results, coupled with noticeable revival on the labour market, support expectations for further recovery in consumption demand in the next quarters.

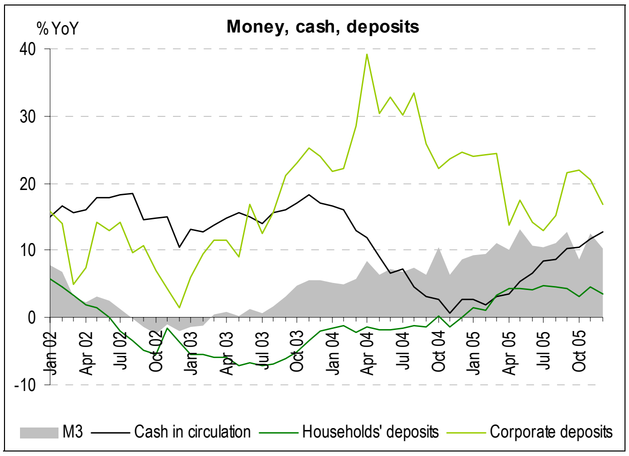


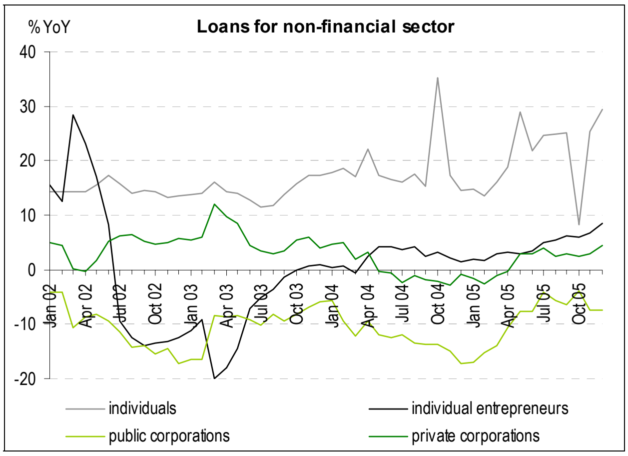
Source: CSO, NBP, Ipsos, own calculations

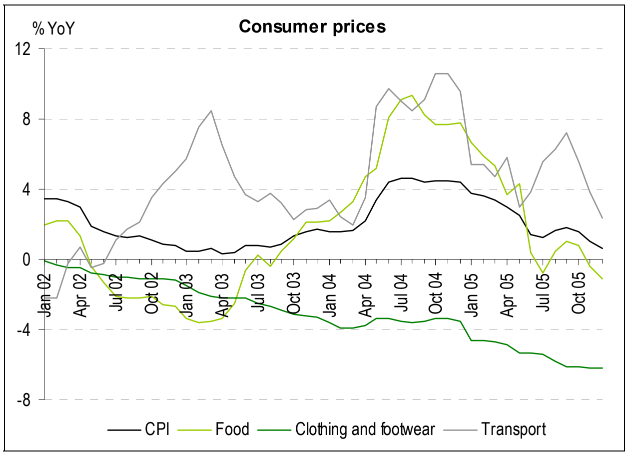
Export growing fast... import even faster

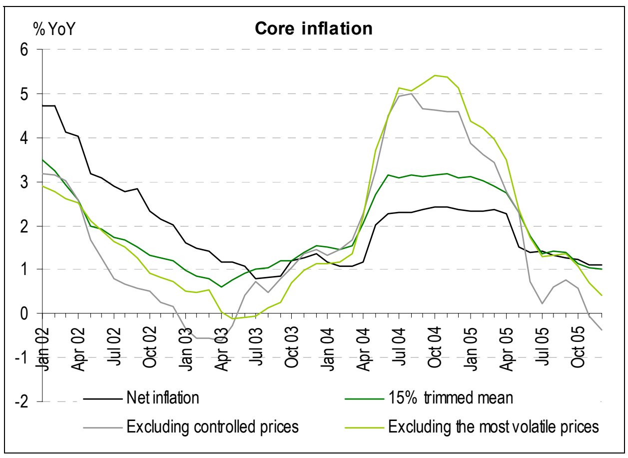
- Revival in domestic demand is reflected in increasingly strong demand for imports, which is observed in foreign trade data.
- In November import of goods increased 16.8%YoY, outpacing still high growth rate of export (15.3%YoY). Growth rate on export and import of services also remained high, at 17.8% and 17.6%YoY correspondingly, confirming continuation of expansion in both external and domestic demand.
- Current account deficit in November was higher than forecasted, reaching €539m. Cumulated C/A deficit in relation to GDP remained low (ca. 1.6% of GDP), however it is hard to expect that downward trend will be maintained. If so, then it will be difficult to maintain positive contribution of net export to GDP growth in 2006.

Economic update









Source: CSO, NBP, own calculations

More and more money and loans

- Money supply in December rose 10.3%YoY, in line with expectations. High rate of M3 increase corresponds to fast expansion in economic activity at the end of 2005.
- Total deposits increased 9.3%YoY, out of which households' deposits rose 3.5%YoY, and companies' deposits by 16.8%YoY.
- Sluggish increase of money on households' bank accounts results, among others, from quickly growing interest in alternative investments. E.g. in December 2005 Polish mutual funds recorded a record-high net inflow of money of over PLN3bn.
- Very fast advance in firms' deposits results from still high profits achieved by Polish companies. Worth mentioning is also accelerating rise in cash in circulation.
- Total credit growth accelerated to 11.8%YoY in December, mostly thanks to surge in households' loans (almost 23%YoY). The biggest rise takes place in mortgages (over 40%YoY) and cash loans (almost 25%), the latter used probably for financing consumption expenditures.
- Companies are still reluctant to extend their debt in banks, although there is some moderate improvement also in this area. Companies' loans increased 2.8%YoY in December, which was the fastest rise since November 2003. While loans for private companies were growing, loans for public-owned firms are in the downtrend.
- NBP data show rising demand for investment credit (up more than 10%YoY), in particular zloty-denominated (21%YoY). Foreign-currency investment loans in Polish banks were reimbursed and/or supplemented by foreign debt, not reflected in domestic money supply statistics. According to NBP, firms' foreign debt has been growing quickly for some time and now represents ca. half of total companies' debt.

Inflation very low, no signs of demand-side pressure

- Once again inflation proved to be lower than forecasted and fell to 0.7%YoY in December, the lowest level since August 2003.
- Reasons for inflation decline were exactly the same as in previous months: low prices of food and fuels.
- A set of supply-side circumstances favourable for inflation could be transitory, as it is connected with accidental (and probably reversible) effects, like Russian restrictions on sale of Polish food and reduction in excise tax for fuel. Nevertheless, price changes in other categories of goods and services did not show any existing inflationary pressure.
- We forecast that in January CPI growth could pick up only slightly, and in Q1 it should be on average at ca. 1%YoY.
- In March, like every year, the CSO will update a basket of goods and services, used for computing CPI inflation. At this occasion an important change could take place – in 2006 for the first time ever mobile phone services will enter the basket, as they were not taken into account by CSO before. Because of permanent reductions in prices of mobile services, it could bring inflation rate down) after basket update, the CSO will publish revised inflation rate for January. Taking into account that according to telecom market regulator URTiP average price of mobile connections decreased in 2005 by a dozen or so percent, and total telecommunication services represented ca. 4-5% of consumption basket, impact of this change on CPI growth rate could reach 0.2-0.3 pct. points.
- In December, all measures of core inflation (in annual terms) declined a little. Two most closely observed measures, i.e. net inflation and 15% trimmed mean stayed close to 1%. According to our estimates, net inflation should stay below 1.5% at least until the end of this year.

Central bank watch

Inflation projections (% YoY)

	February 2005	May 2005	August 2005	January 2006
Q4 2006	0.4-4.2	1.2-3.8	1.0-3.1	0.5-2.3
Q4 2007	0.5-4.6	0.7-4.3	1.2-4.1	1.1-3.6
Q4 2008	-	-	-	0.8-3.9

GDP growth projections (%)

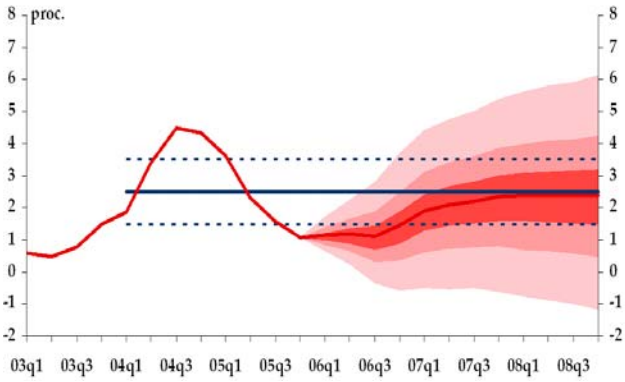
	August 2005	January 2006
2006	3.9-5.3	3.8-5.1
2007	3.8-5.6	3.4-5.2
2008	-	3.6-5.5

Note: Projection shows that there is a 50-percent probability that inflation and GDP growth will stay within the ranges indicated in the table.

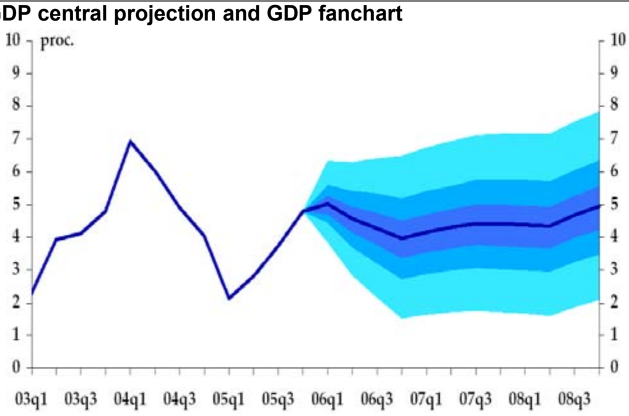
Probability of inflation (%):

	below 1.5%	below 2.5%	below 3.5%
Q3 2006	67.2	91.8	98.8
Q4 2006	53.5	79.8	93.7
Q1 2007	40.8	66.8	86.1
Q2 2007	36.5	60.7	81.2
Q3 2007	34.5	57.7	77.8
Q4 2007	33.1	54.3	73.7
Q1 2008	33.5	53.5	72.3
Q2 2008	33.6	52.8	71.0
Q3 2008	34.4	53.1	70.5
Q4 2008	35.5	52.9	69.5

Inflation central projection, fanchart and MPC's target



GDP central projection and GDP fanchart



Source: NBP

Lower predicted inflation = lower interest rates

- In line with broad market consensus, the Monetary Policy Council reduced interest rates by 25bp in January, bringing the reference rate down to 4.25%. Such decision was well justified by economic picture, which still shows that inflation prospects are positive despite acceleration in economic growth.
- The new *Inflation Report* and projections included therein were probably important arguments behind monetary easing, as the foreseen inflation path proved to be more optimistic than previous one presented in August, showing CPI inflation converging towards the MPC's target of 2.5% quite slowly.
- As shown in the tables on the left, inflation perspective improved, while GDP growth projections were moderately lowered. According to inflation projection the probability of CPI inflation being below the target is higher than probability of inflation being above 2.5% until the end of 2008.
- Official statement after January's meeting did not gave clear hints on future monetary policy decisions and central bankers' judgement on inflation outlook. While the MPC was expected to show a new way of communication this year, after dropping monetary policy bias, we did not notice it, unfortunately. This does not make predicting monetary policy prospects easier and worsens its transparency.
- MPC decision and quite optimistic inflation scenario presented in the *Inflation Report* seem to suggest that another cautious interest rate cut cannot be ruled out in the coming months, possibly even in February. Of course it will depend on coming economic data (especially on inflation and labour market figures) and situation on the financial markets. However, in our opinion the room for monetary easing does not seem to be much larger than another 25bp.

A lot of uncertainty factors

- The Council presented many uncertainty factors, which can influence the new inflation projection. The problem is that these factors are twofold, and some of them could improve inflation outlook (globalisation, zloty appreciation), while others could act in the opposite direction (scale of future employment growth, shape of government's economic policy).
- The *Report* puts high emphasis on possibility of permanent improvement in the labour market, which could imply higher inflation pressure as compared to the base-case scenario presented in the projection. Although it was admitted that this factor could be mitigated to some extent by a rise in labour supply that would limit pressure on price growth.
- As regards globalisation effects, import of cheap consumption goods from countries with low production costs tamed domestic inflation, and this effect could persist or even strengthen if such kind of import intensifies.
- Inflation projection assumes slight zloty depreciation in the short run, so if the zloty stabilises or even strengthens, this should positively affect predicted inflation path, as compared to scenario presented in the *Report*.
- Similarly as in the previous projection, the growth rate of potential output is expected to accelerate from 4% in 2006 to 4.3% in 2008. Real GDP throughout the projection horizon remains below the potential product and the output gap remains negative, though slightly narrower than in the August projection.
- GDP (and inflation) projection was lowered because of lower forecast growth rate of investment outlays. Change in assumptions as regards the utilisation of EU funds after 2006 has been an important factor in the assessment of the future investment path.

Central bank watch

Comments of the central bank representatives	Our remarks
Leszek Balcerowicz, NBP president, MPC chairman **PAP, 31 January** The moment in which the inflation converges to the target is roughly similar to what was expected in August report i.e. mid-2007. Labour market data on wages and employment are crucial for the interpretation of inflation projection. If the tendency of employment growth is maintained inflation may be higher. CPI inflation was brought down by temporary factors such as food prices and fuel prices. (…) Much more data indicate that investment revival is permanent phenomenon rather than temporary. The MPC is not sure of GDP data and expects a confirmation of preliminary data. **PAP, TVN24, 2-3 February** [Question: What do you think about Prime Minister's opinion that the MPC should cut rates given very low inflation rate?] Answer: I do not want to comment on this, although I can say that such behaviour of Prime Minister is not present in other countries. Not so long ago we presented NBP experts' research, which showed than in many countries there was a period similar to what is observed in Poland at the moment i.e. inflation rate was very low. Some of central banks under the pressure of such situation, and also under some external pressure, decided to lower interest rates, but then suddenly it appeared that inflation started to rise and rates had to be increased. I am not saying this has to be like this. I am saying that the responsibility and the fact we have constitutional aim to carry out this important function should persuade to judiciousness.	During official MPC press conference the NBP highlighted potential risk factors for inflation (as usually), and emphasised revival in economic growth and employment, not mentioning potential effects positive for inflation outlook listed in the MPC communiqué. Therefore, given the MPC took decision about rate cut, these comments were probably not fully representative for the view of the entire Council. This would not be the first time when the so-called hawkish faction within the Council was outvoted, as the scenario took place when the NBP decided to cut rates in July and August 2005. Additionally, NBP President together with Dariusz Filar, Marian Noga and Halina Wasilewska-Trenkner were in minority three times (July, August and November 2005) when they put a motion to change monetary policy bias to neutral from easing. Economic reality, as well new NBP inflation projection showed that the majority was right. The four hawks were able to convince Stanisław Owsiak and Mirosław Pietrewicz to vote in favour of resignation from monetary policy bias, which was quite unfortunate as the MPC has a problem with replacement of this communication tool. NBP President said during the press conference that inflation's return to the target is similar to what was assumed in August projection (mid-2007), but the fact is the new projection shows this will happen at the beginning of 2008. The Council declared that in 2006 monetary policy would be conducted so as to achieve the target in the horizon of 5 to 7 quarters. Is the fact that beginning 2008 represents the eighth quarter suggest something as regards interest rates? Not necessarily as inflation was lowered to some extent by temporary factors.
Jan Czekaj, MPC member **PAP, 31 January** In the projection inflation is approaching the target, but not exceed it until the end of 2008. Data on economic revival concern only a few latest months and they may be treated as really average in the context of the full year. Despite economic revival, an output gap in Poland will remain negative until 2008, and inflation rate in this period would be gradually approaching the target.	Czekaj's statements confirmed that the inflation projection was important argument in favour of interest rate cut, which is not surprising given that inflation is expected to return to the target in two years time. On the other hand, however, referring to the second part of Czekaj's statement, we think that data on economic revival in recent months should be more important for the MPC than the data for 2005 as a whole (affected by weak H1), as positive economic situation should be maintained in the following quarters. Of course, still there is question how this will affect inflation processes.
Marian Noga, MPC member **Bloomberg, 25 January** Inflation has remained below the lower limit of the central bank's target for two months, which is against our policy and cannot be tolerated. The only thing that could stop us is concern over public finances. The economic situation leaves no doubt a rate cut is required, but the political situation and uncertainty over the final shape of the 2006 budget law binds our hands. Inflation rate should rise back to the middle of the targeted range in H2 2007. The new projection to be published next week will judge whether it may happen sooner.	Noga's comments before the MPC meeting showed quite strongly that interest rate cut in January was very likely. It is remarkable that such reasoning and statements on necessity to cut rates and no tolerance for too low inflation appeared in the interview with central banker, who usually was voting together with the so-called "hawkish" faction in the MPC. It could signal a change in balance of views in the rate-setting panel and could mean there are some chances that January's rate cut could be not the last one this year. However, this will depend heavily on macroeconomic data releases, especially as regards inflation and labour market.
Halina Wasilewska-Trenkner, MPC member **PAP, 6 February** There is a question what policy appropriate, keeping rates on current low level or further cuts, which would be unnoticeable for investors and borrowers and would create a threat for inflation increase. We will see what happens, whether there is a room for a move. We have the next inflation projection in May. Rate hike would be necessary if all risk factors we mentioned [oil prices, exchange rate, food prices, labour market, budget] coincided and increase inflationary pressure. Productivity growth will determine how fast inflation will return to the target.	If Halina Wasilewska-Trenkner assumes that another cut would not affect investment and consumption decisions, the only way a rate cut could increase inflation is zloty depreciation due to lower interest rate differential between Poland and major economies. However, in the new inflation projection of the NBP, which was an argument for rate cut in January, the zloty exchange rate was assumed at weaker level than the current one. Thus, some depreciation of the zloty should not fundamentally change conclusions from the projection. While some caution of the central bank is understandable, we believe that majority of MPC members think of inflation prospects much more in terms of the most likely scenario, not the most pessimistic one.
Andrzej Wojtyna, MPC member **PAP, 19 January** From purely macroeconomic point of view I would be willing to agree that some possibility of monetary policy easing exist, and surely it is worth to discuss it and to find the best solution. However, we have the situation as in the period of still favourable macroeconomic conditions from the point of view of possible rate cut, we see a significant rise in political risk. Such event like a perspective of early election should be taken in to account by the Council.	Although the risk of early election is gone (at least for some time), this is the fact that political risk creates a problem for the MPC. This is connected with uncertain shape of economic policy of the government (and new parliamentary majority) and a risk of accepting popular, yet costly, acts, not to mention a possibility of changing the NBP Act. However, in our opinion, even if the zloty depreciates sharply (let's say to 4 against euro) as a result of political situation, this would not create a considerable threat for the inflation target, which is very distant at the moment, as economic factors (mentioned by Wojtyna) make inflation outlook favourable and it justified interest rate cut in January.

Government and politics

Selected elements of the so-called stabilisation pact

Proposals	Notes
Amendment to the NBP charter	Making the NBP responsible for economic growth
Changes in tax system	No details
Amendment to the Act on Old-age and Disability Pensions	Every-year indexation taking into account not only inflation, but also wage growth
Return of excise tax on fuels for farmers	In line with the government's proposal that is allowed by the EU regulation
Changes in Act on Freedom of Business Activity	No details
Act on Financial Supervision	Supervision to be concentrated in one office

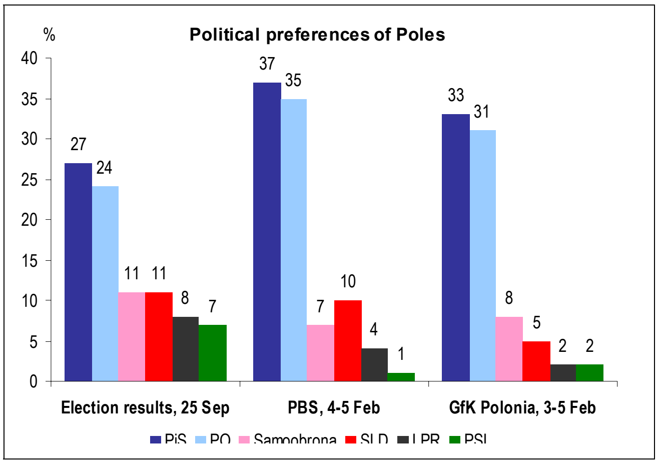
PiS reached an agreement with populists

▪ Populist parties accepted the PiS proposition to sign a stabilisation pact. The pact was signed on February 2 and is intended to bind for at least 12 months.

▪ Under the reached agreement, over 140 bills are expected to be passed, but only a minor part of them concerns the economic policy. The bills which could be very costly for public finance were excluded from the core part of the pact and will be considered only if it is possible given condition of the state budget.

▪ Although costly bills hang over prospects for fiscal deficit reduction, the highest risk from the financial market's point of view is related to the planned changes to NBP charter.

▪ The pact also assumes several potentially positive changes, but there is lack of details on the proposals.



Will opinion polls stabilise the stabilisation pact?

▪ According to the latest public opinion polls, the Law and Justice (PiS) is still the leader of popularity, but with support only 2 pp higher than that for the Civic Platform (PO).

▪ The joint number of seats of the two parties would represent the constitutional majority of above two-thirds.

▪ What is interesting, if the parliamentary election took place on 5 February, i.e. after the so-called stabilisation pact was signed, there would be only four parties in Sejm – apart the two leaders mentioned above, this would be SLD and Self-Defence. In the case PO and PiS could not reach an agreement again, according to GfK poll PiS would be able to form a coalition government with the Self-Defence (current coalition partner in the parliament), while according to PBS poll PO could form majority coalition with SLD.

Selected assumptions of the *Convergence Programme*

General government balance* (% of GDP)

	2005	2006	2007	2008
Updated version	-2.9	-2.6	-2.2	-1.9
November 2004 version	-3.9	-3.2	-2.2	-

* OFE included in public finance sector

Macroeconomic assumptions

	2005	2006	2007	2008
GDP growth (%)	3.3 (5.0)	4.3 (4.8)	4.6 (5.6)	5.0
Average inflation (%)	2.2 (3.0)	1.5 (2.7)	2.2 (2.5)	2.5
The reference rate (%)	5.3	4.5	4.5	4.5

Note: in brackets assumptions from the previous Convergence Programme

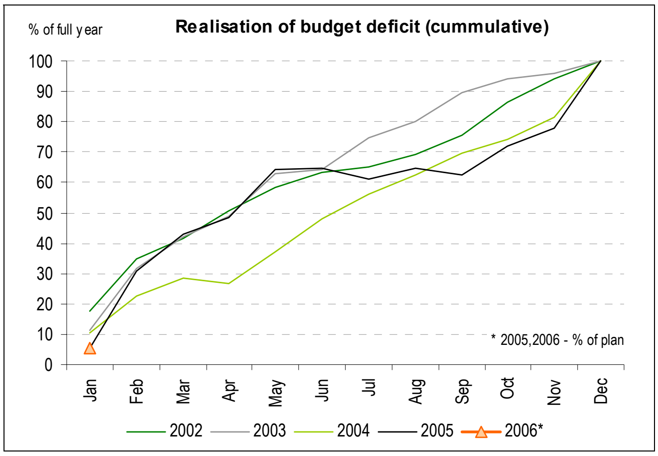
Convergence Programme revealed at last

▪ In line with earlier unofficial information, the updated version of Poland's Convergence Programme, which was finally published after a significant delay, did not include anything that could be warmly welcomed by the European Commission, rating agencies or the financial market.

▪ The government said that Poland will not reduce excessive fiscal deficit until 2007, if the EU institutions will not change their ruling on classification of Polish open pension funds.

▪ Additionally, deficit level of 2.2% of GDP in 2007 was maintained despite lowering forecasts of economic growth (from 5.6% to 4.6%), which may raise doubts as regards consistency and credibility of the programme.

▪ What is interesting, the Ministry of Finance assumed stable official interest rates at 4.5% until 2008.



Good budget performance in 2005 will help 2006 budget

▪ According to final data from the FinMin, budget deficit in 2005 amounted to PLN28.6bn, or 81.6% of the full-year plan. Budget revenues were higher than planned by more than PLN5bn (or almost 3%), despite macroeconomic indicators were worse than assumed: GDP growth reached 3.5% versus predicted 5%, and inflation was 2.1% versus forecasted 3%.

▪ What is interesting, indirect tax revenues were lower than planned. This is an effect of December alone, as revenues from indirect taxes were PLN2bn lower than average for the previous months of 2005.

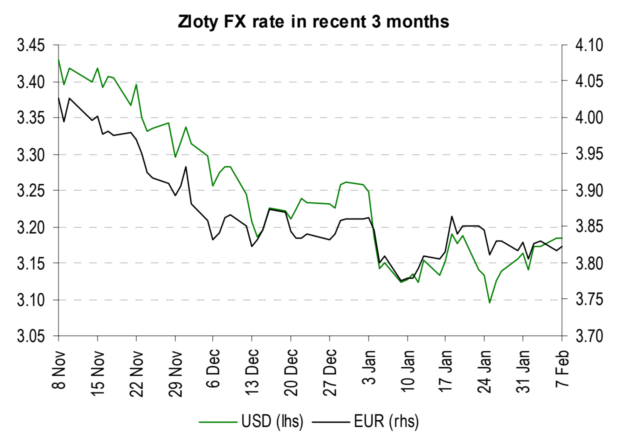
▪ It seems that a part of revenues were transferred from December 2005 to January 2006 (the same trick was applied a year earlier). This worsens transparency of fiscal policy, but will help to meet very ambitious revenue targets for 2006.

Source: Ministry of Finance, PAP, Reuters, opinion polls

Government and politics

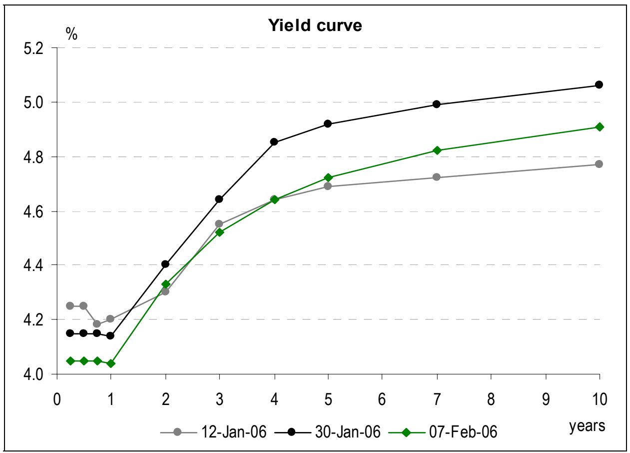
Comments of government representatives and politicians	Our remarks
Kazimierz Marcinkiewicz, Prime Minister **PAP, 26 January** [Q: Do you expect a rate cut?] For sure. I cannot imagine that it would be otherwise given a fall in inflation to below 1%. I would even dare to cut rates by 50bps. There are analysts who say that interest rates should stand at 3.5%.	In reaction to PM's suggestions about a possibility of rate reduction, NBP governor said that "in other EU countries Prime Ministers do not behave such way". While Prime Ministers actually do not speak often about interest rates, comments from ministers are quite a common practice. The fact that such practice does not facilitate co-ordination of macroeconomic policy does not mean that it does not happen. The another matter is that reduction of 50bps at once seems impossible.
Zyta Gilowska, deputy PM, finance minister **PAP, 31 January** Without the euro zone we are defenceless against exchange rate fluctuations and intensive actions of speculative capital. We have to do everything so that prepare Poland for euro adoption. (…) I think that talking about a date [of euro zone entry] is like putting a spell on. A presumption that we will be ready in 2009 is doubtful. Joining the ERM2 in 2007 is impossible because we have not reached a sufficient degree of financial system stabilisation.	Entry to the euro zone in 2009 seems not only doubtful, but almost impossible. Especially that this would mean a necessity of joining the ERM2 in 2007, which was excluded by finance minister. It is a shame that Poland, as the only new member state of the EU, did not set a target date for euro adoption. EU Commissioner on economic and monetary affairs Joaquin Almunia took note of that fact and said that cost of it is "increased uncertainty in European institutions and in the financial markets". It will be interesting how the European Commission will react to the new Convergence Programme.
Cezary Mech, deputy finance minister **PAP, 27 January** We have proposed the European Commission so that countries which has public debt below 60% of GDP even excluding open pension funds from the public finance sector could treat the funds as a part of public finance sector. One should hope that in the course of discussion on pension reform classification of pension funds will be an element of broader analysis. Adoption of the euro may bring some benefits, such as elimination of FX risk and reduction in transaction costs, but the process involves the risk connected with no possibility of running autonomous FX and monetary policies.	Although details of the deputy finance minister's proposal and its justification are not known, one should not expect that the EU will accept the proposal in a foreseeable future. Especially that delay in euro adoption is seen also in other countries of the region while the EU (the same as the current Polish government) is not in hurry push Poland into the block. Still, it is interesting whether Mr Mech had an opportunity to acquaint himself with the NBP report on benefits and costs of euro adoption, which showed the former significantly predominate the latter. Let us hope that independent monetary policy means for deputy finance minister a policy that is independent not only from the ECB, but also from the domestic government.
Artur Zawisza, PiS, head of Sejm's economy committee **Gazeta Wyborcza daily, 23 January** PiS supports elimination of the MPC, but this has only indirect connection with economic issues. In fact, the postulate of MPC elimination is a part of the "Cheap State" programme, which assumed elimination of these institutions which are not necessary. In our opinion it is the NBP board that should be in charge of monetary policy decisions. [Q: Will you wait for elimination of the MPC until a change to the constitution or you are going to change the NBP charter and just to lower the number of MPC members and change them?] Such action [lowering the number of MPC members] is probably not appropriate in this case. However, I put an emphasis on "probably". In fact, there is a question about a tactics of our actions. While there was a justification for fast action in case of the National Broadcasting Council, such swift moves in case of the MPC would not bring significant effect, as the rule of MPC functioning would not change. Even if there were not 10 members, yet 3 or 5 rate-setters, the inconsistency or illegibility of monetary policy decisions would not disappear. [Q: Will the draft of the NBP charter prepared by the Self-defence will be discussed by the Sejm?] There is no reason to defer this draft. This is a draft like any other. Changes in the NBP charter are needed, although we do not want to undermine the central bank's independence and we will vote against changes going in that direction. We intend to extend responsibility of the NBP [to make the central bank responsible for economic growth]. **Przemysław Gosiewski, head of PiS parliamentary caucus** **PAP, Reuters, 2 February** The number of MPC members is still an open question. For now we simply have wanted to make the central bank responsible for growth, along the same lines as the U.S. Fed. **Kazimierz Zdunowski, Self-defence's expert, author of planned changes to the NBP charter** **Gazeta Wyborcza daily, 7 January** Our draft bill is not against the Polish constitution and EU regulations. (…) So what that they will say so? Will they sent troops? You may say that I am ugly. And what? Each of us will stick to own opinion.	An issue of central bank independence is becoming more and more often discussed in the context of possible changes to the NBP charter. The idea of changing the NBP charter appeared as one of elements (for some deputies probably as one of the most important elements) of the so-called stabilisation pact signed by PiS with Self-defence and LPR for the nearest 12 months. According to the pact, the NBP charter should "make the central bank responsible for economic growth". Only this and as much as this. "As much as this" because the proposal raises significant reservations of lawyers about its conformity with the Accession Treaty which holds that a central bank of any EU member state should aim primarily at price stability. "Only this" because there is an draft of NBP charter prepared by the Self-defence, which assumes many other controversial changes. In particular, it allows for dismissing the NBP governor, if the Sejm does not accepts a report on monetary policy implementation. According to the ECB, the changes to NBP charter proposed by Self-defence are against the EU law. Therefore, it is not sure whether the Self-defence's proposal will be discussed in the parliament at all. Kazimierz Zdunowski's comments suggest that Self-defence is not concerned about lawyers' opinions. However, there is open question whether the ruling party, the government and individual ministers (e.g. finance minister) will want to support such ideas. Nevertheless, the stabilisation pact will be gradually executed, so we will not avoid hot discussion (attractive for media) about the central bank responsibility for the economic growth. Comments from PiS officials show there is not one consistent version of the draft. On the one hand, we hear a postulate of MPC elimination, which is impossible without changing the constitution, and PiS with its supporters have not sufficient majority to change the constitution. On the other hand, an issue of lowering the number if MPC members continuously appears and such move could mean in practice replacement of all MPC members, which would probably mean a change in monetary policy. In our opinion an attack on the central bank's independence is one of crucial risk factors for the financial market. While making the NBP responsible for the economic growth would not necessarily cause nervous reaction (the MPC will be able to say that it support economic growth through maintaining price stability), an attack on the bank's independence and a proposition of personal changes could undermine investors' confidence in Poland's economic policy.

Market monitor



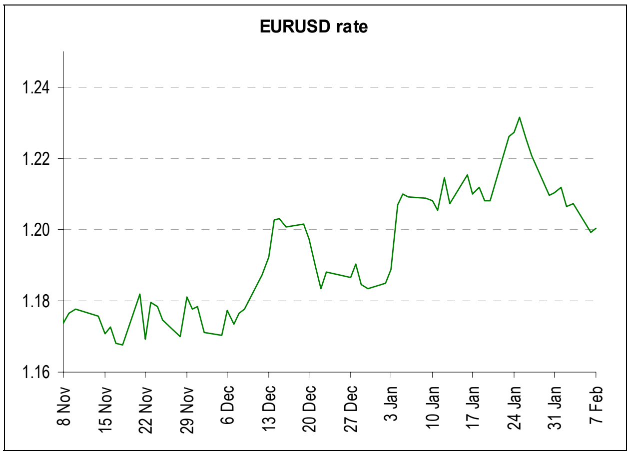
Zloty still strong, though above 3.80 against the euro

- When we sent the January report the zloty traded at the strongest levels since June 2002 (below 3.80 against the euro) after Zyta Gilowska was nominated for the post of finance minister and deputy PM, and indices on the stock exchange set new records. We considered this appreciation as temporary and in fact zloty rate went back above 3,80 against euro.
- One have to admit that taking into consideration the current political risk (this time new shape of economic policy is going to be a key focus point instead of the early elections case) the correction was relatively small, and when EURPLN rate traded above 3.85 investors decided to take long zloty positions.
- Substantial capital flows to the emerging markets work in favour of zloty, which if remains it will not allow a more significant correction to pursue.



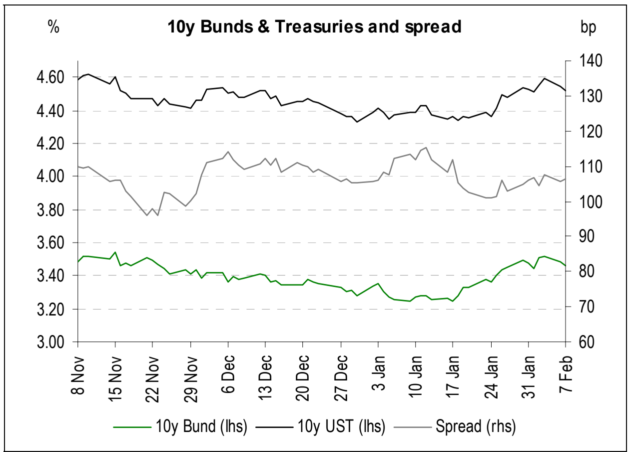
Bonds are strong as well, risk factors important

- Bond market remains at strong levels though yields are slightly higher than in the middle of January. As far as the weakening on the core bond markets increased Polish yields the rate cut accompanied by “dovish” tone of inflation projection worked in the opposite direction. If the January inflation appears to be low and labour market data shows no substantial rise in wages and employment the market will price in next rate cut in February.
- Risk factors for the market in the next few months comprise economic policy of new parliamentary coalition (especially plans to change the NBP bill), negative opinion of European Commission with regards to the Convergence Programme as well as possible capital outflows from the emerging markets amid perspective of rising official interest rates and yields in the United States as well as in the euro zone.



EURUSD around 1.20, will go rather higher

- After EURUSD returned above 1.20 (and even 1.22) at the beginning of this year, the dollar strengthened again at the start of February below 1.20, due to increased expectations for next interest rate hikes. Fed’s policy will be less supportive for the dollar, while an important risk factor is a situation on the U.S. housing market (possible slump).
- The same dose of monetary policy tightening is expected in the euro zone (starting from March), reflecting improvement of economic activity indicators describing situation in the euro zone. Moreover the dollar may be again negatively affected by problem of twin deficits in United States.
- We stand by our forecast, that EURUSD rate will fluctuate between 1.20-1.25 for the most part of the year.

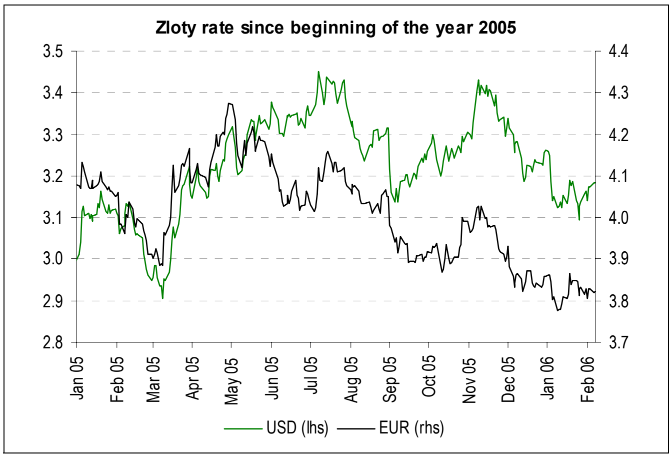


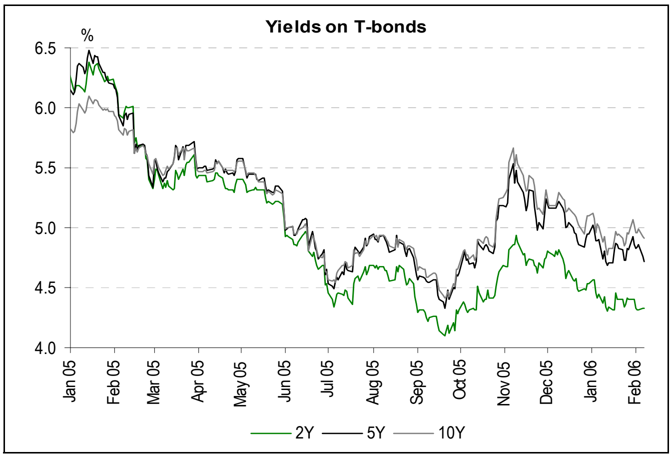
Source: Reuters, BZ WBK

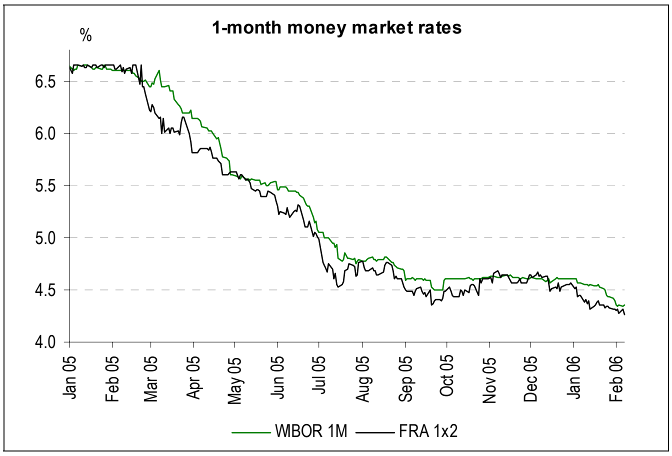
Yields rise abroad. To be continued.

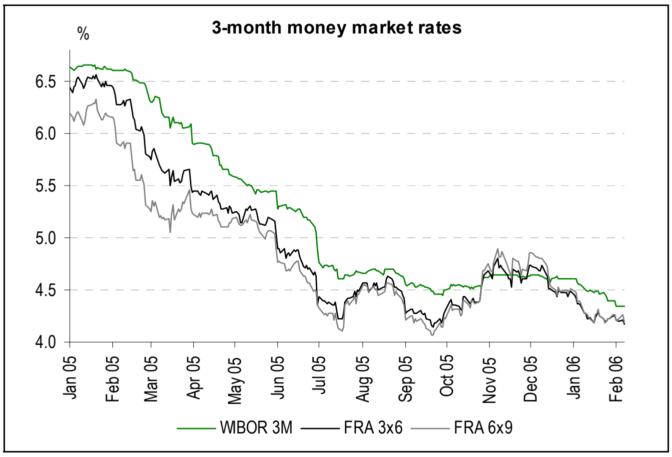
- The second part of the January and the beginning of February was a period of significant yields increase of U.S. Treasuries as well as German Bunds, which resulted from supported views on continuation of rate hikes, publication of macroeconomic data, which confirmed the improvement of economic situation, as well as information about high supply of bonds at auctions in U.S.
- We support the forecast of further yields rise in the next few months, which may negatively influence Polish interest rate market (and the zloty). Fed will probably end rate hike series near 4.75-5.00%, and the ECB at 2.75%, though 3% level can not be ruled out. This will be dependant on the level of economic recovery as well as inflation pressure in the euro zone. When it comes to yields on the core markets, they may be by a few dozen bps higher in the middle of the year.

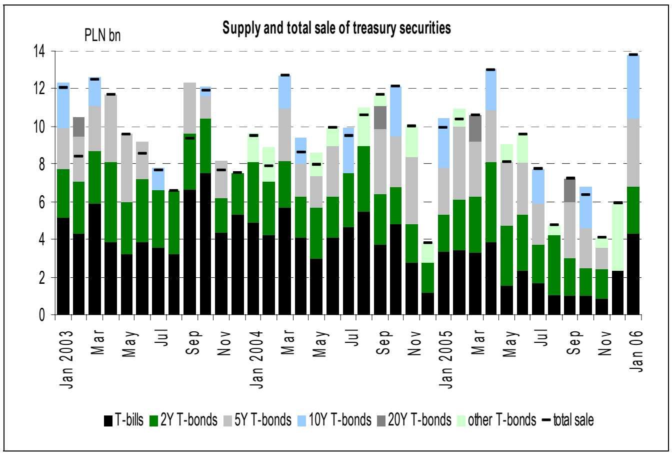
Market monitor











Treasury bill auctions (PLN m)

Date of auction	OFFER / SALE 3-week	13-week	52-week	Total
05.12.2005	-	100 / 100	1 200 / 1 200	1 300 / 1 300
19.12.2005	-	100 / 100	900 / 900	1 000 / 1 000
Total December	**-**	**200 / 200**	**2 100 / 2 100**	**2 300 / 2 300**
02.01.2006	2 000 / 2 000	100 / 100	1 100 / 1 100	3 200 / 3 200
16.01.2006	-	100 / 100	1 000 / 1 000	1 100 - 1 100
Total January	**2 000 / 2 000**	**200 / 200**	**2 100 / 2 100**	**4 300 / 4 300**
06.02.2006	-	-	1 000 / 1 000	1 000 / 1 000
20.02.2006	-	-	1 000 – 1 300	1 000 – 1 300
Total February*	**-**	**-**	**2 000 - 2 300**	**2 000 - 2 300**

* estimations based on Ministry of Finance preliminary information

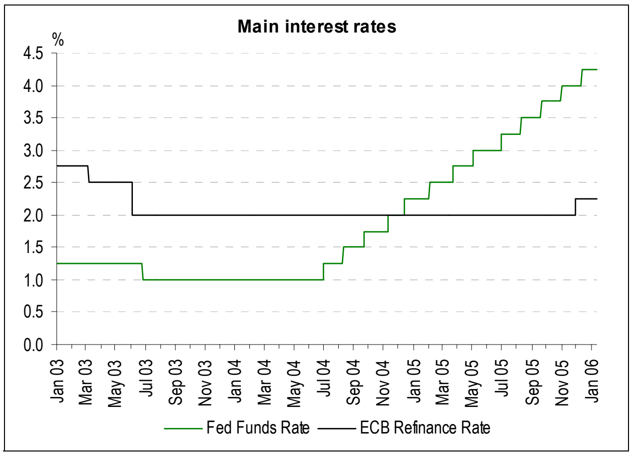
Treasury bond auctions in 2006 (PLN m)

month	First auction date	T-bonds	offer	sale	Second auction date	T-bonds	offer	sale	Third auction date	T-bonds	offer	sale
January	04.01	OK0408	2 500	2 500	11.01*	DS1015	3 360	3 360	18.01*	DS1110	3 600	3 600
February	01.02*	2Y	2 400	2 300	08.02	7Y WIBOR | 12Y CPI	1 000 | 500	1 000 | 493	15.02	5Y	1 800 - 2 800	-
March	01.03	2Y	-	-	08.03	20Y	-	-	15.03	5Y	-	-
April	05.04	2Y	-	-	12.04	10Y	-	-	19.04	5Y	-	-
May	04.05	2Y	-	-	10.05	7Y WIBOR | 12Y CPI	-	-	17.05	5Y	-	-
June	07.06	2Y	-	-	14.06	20Y	-	-	21.06	5Y	-	-
July	05.07	2Y	-	-	12.07	10Y	-	-	-	-	-	-
August	02.08	2Y	-	-	09.08	7Y WIBOR | 12Y CPI	-	-	-	-	-	-
September	06.09	2Y	-	-	13.09	20Y	-	-	20.09	5Y	-	-
October	04.10	2Y	-	-	11.10	10Y	-	-	18.10	5Y	-	-
November	02.11	2Y	-	-	08.11	7Y WIBOR | 12Y CPI	-	-	15.11	5Y	-	-
December	06.12	2Y	-	-	-	-	-	-	-	-	-	-

* with supplementary auction

Source: Ministry of Finance, Reuters, BZ WBK

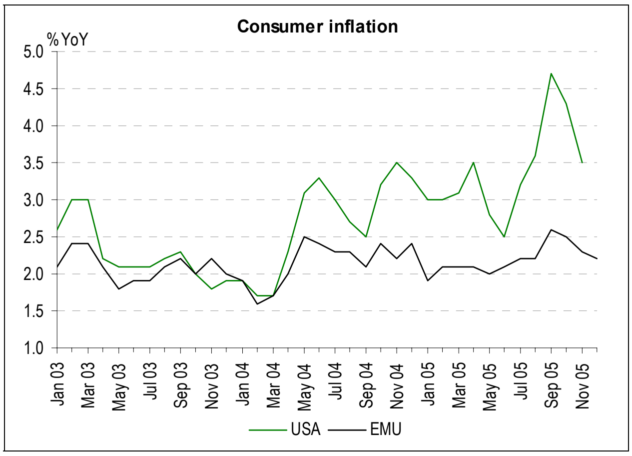
International review



Fed raises interest rates, tough and of rate hikes closer

▪ During the meeting on the last day of January Fed raised main interest rate in the 14th consecutive month from 4.25% to 4.5%. In the wording of communiqué released after the meeting some changes were introduced, which suggested, that the tightening in monetary policy in U.S. will continue tough it draws to an end. After January meeting a new president of American central bank was appointed. Ben S. Bernanke is going to chair next Fed's meeting scheduled for March 28.

▪ European Central Bank left the main interest rate level unchanged at 2.25%, however a rate hike was considered. According to the EBC's president Jean Claude Trichet's statement on keeping vigilance towards the inflation, monetary policy tightening is getting closer and is expected to come already in March.

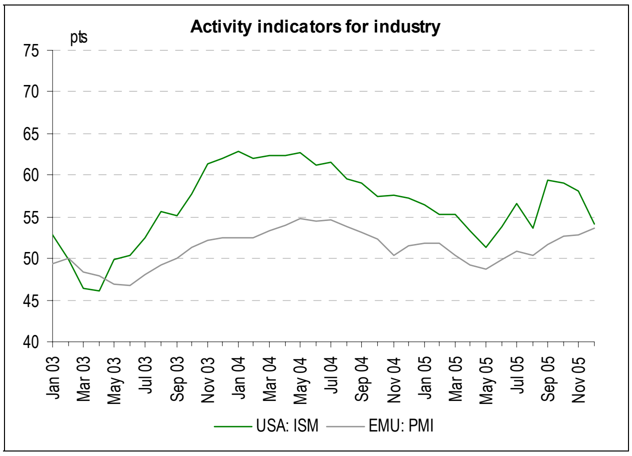


Inflation lower in U.S., higher in the euro zone

▪ Consumer price index CPI in United States fell in December by 0.1%MoM. Market expectations were less optimistic as Wall Street analysts forecasted the consumer prices rose at average by 0.2%MoM. In the result annual inflation figure fell to 3.4% from 3.5% in November.

▪ Core inflation rise in United States amounted to 0.2%MoM which was the same as the November reading. Annual core inflation in U.S. slightly rose in December to 2.2% as compared to 2.1% in the previous month.

▪ According to the Eurostat, inflation figure in the euro zone increased in January to 2.4%YoY from 2.2%YoY in December. The result was in line with market consensus.

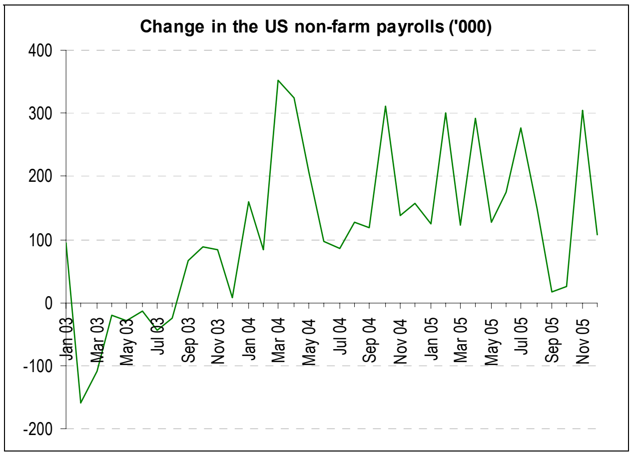


Economic activity keeps on solid level

▪ According to preliminary data Q4 U.S. GDP growth amounted to 1.1%, which was much weaker than expected 2.8%. However, economic activity indices show, that GDP growth slowdown was temporary, mainly due to the effects of the hurricanes.

▪ ISM index for the manufacturing sector in U.S. fell in January to 54.8 pts from 55.6 pts in December, although the figure was higher than expectations at 55.4 pts. ISM index for the services sector declined to 56.8 pts from 61.0 pts in December, which was much below the market consensus at 59.5 pts.

▪ PMI index for the services sector in the euro zone increased in January to 57 pts from 56.8 pts in December and reached the highest level for 2 years. Manufacturing PMI index fell to 53.5 pts from 53.6 pts in December(16-month high) and was below market forecasts at 54.1 pts.



Source: Reuters, ECB, Federal Reserve

Positive data from U.S. labour market

▪ Non-farm payrolls rose in January by 193,000, which was much weaker than expectations as the market consensus amounted to 240,000.

▪ However the some upward revisions of the previous months readings were made: from 108,000 to 140,000 in December and from 305,000 to 354,000 in November. In effect, the overall meaning of the data was positive for the labour market.

▪ Moreover the unemployment rate unexpectedly dropped to 4.7% from 4.9%, reaching the lowest level since July 2001. Analysts expected that the rate will stay unchanged.

▪ In the Q4 the labour productivity fell by 0.6%, while the unit labour costs jumped by 3.5%, whereas the market expected much more positive values.

Economic calendar

Monday	Tuesday	Wednesday	Thursday	Friday
6 February ***POL: Treasury bills auction***	**7**	**8** ***POL: Auction of bonds: 7Y floating rate and 12Y CPI linked bonds***	**9** USA: Wholesale inventories (Dec)	**10** USA: Budget deficit (Jan) USA: Foreign trade (Dec)
13 ***POL: Balance of payments (Dec)***	**14** ***POL: Money supply (Jan)*** GER: ZEW index (Feb) EMU: Preliminary GDP (Q4) USA: Retail sales (Jan)	**15** ***POL: Auction of 5Y bonds*** ***POL: Preliminary CPI (Jan)*** ***POL: Wages (Jan)*** ***POL: Employment (Jan)*** USA: Net capital flows (Dec) USA: Capacity use (Jan) USA: Industrial output (Jan)	**16** USA: Build permits (Jan) USA: House starts (Jan) USA: Foreign trade prices (Jan)	**17** ***POL: PPI (Jan)*** ***POL: Output in industry and construction (Jan)*** EMU: Industrial output (Dec) USA: PPI (Jan) USA: Preliminary Michigan (Feb)
20 ***POL: Treasury bills auction***	**21** ***POL: MPC meeting*** EMU: Eurostat trade (Dec) USA: FOMC minutes (Jan)	**22** ***POL: MPC meeting – decision*** EMU: Current account (Dec) USA: CPI (Jan)	**23** ***POL: Business climate (Jan)*** ***POL: Switch auction*** GER: IFO index (Feb)	**24** USA: Durable goods (Jan)
27 EMU: Money supply M3 (Jan) USA: New homes sales (Jan)	**28** EMU: Consumer sentiment (Feb) EMU: Final HCPI (Jan) USA: Core PCE (Q4) USA: Preliminary GDP (Q4) USA: Chicago PMI (Feb) USA: Consumer confidence (Feb) USA: Home sales (Jan)	**1 March** ***POL: Auction of 2Y bonds*** ***POL: GDP (Q4)*** EMU: PMI manufacturing (Feb) EMU: Unemployment (Jan) USA: Core PCE (Jan) USA: Personal income (Jan) USA: ISM manufacturing (Feb)	**2** EMU: GDP revised (Q4) EMU: PPI (Jan) EU: ECB rate (Mar)	**3** EMU: PMI non-manufacturing (Feb) EMU: Retail sales (Jan) USA: Michigan index (Feb) USA: ISM non-manufacturing (Feb)
6 USA: Factory orders (Jan)	**7** USA: Unit labour cost (Q4) USA: Labour productivity (Q4)	**8** ***POL: Auction of 20Y bonds***	**9** USA: Foreign trade (Jan)	**10** USA: Non-farm payrolls (Feb) USA: Unemployment (Feb) USA: Wholesale inventories (Jan) USA: Fed budget (Feb)
13	**14** ***POL: Money supply (Feb)*** ***POL: Balance of payments (Jan)*** GER: ZEW index (Mar) USA: Retail sales (Feb)	**15** ***POL: Auction of 5Y bonds*** ***POL: Wages (Jan)*** ***POL: Employment (Jan)*** ***POL: CPI (Jan & Feb)*** USA: Foreign trade prices (Feb) USA: Net capital flows (Jan)	**16** EMU: Final HCPI (Feb) USA: Build permits (Feb) USA: CPI (Feb) USA: House starts (Feb)	**17** ***POL: PPI (Feb)*** ***POL: Output in industry and construction (Feb)*** EMU: Industrial output (Jan) USA: Capacity use (Feb) USA: Industrial production (Feb)

Source: CSO, NBP, Finance Ministry, Reuters

MPC meetings and data release calendar for 2006

	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
MPC meeting	30-31	21-22	28-29	25-26	30-31	27-28	25-26	29-30	26-27	24-25	28-29	19-20
GDP*	-	-	1	-	30	-	-	29	-	-	29	-
CPI	16	15[a]	15[b]	14	15	14	14	14	14	16	15	14
Core inflation	24		23[b]	24	23	23	24	23	22	24	23	22
PPI	19	17	17	20	19	20	19	18	19	18	20	19
Industrial output	19	17	17	20	19	20	19	18	19	18	20	19
Retail sales	24	-	-	-	-	-	-	-	-	-	-	-
Gross wages, employment	16	15	15	18	17	16	17	16	15	16	16	15
Unemployment	24	-	-	-	-	-	-	-	-	-	-	-
Foreign trade	about 50 working days after reported period											
Balance of payments*	-	-	31	-	-	-	-	-	-	-	-	-
Balance of payments	13[c]	13	14	-	-	-	-	-	-	-	-	-
Money supply	13	14	14	-	-	-	-	-	-	-	-	-
NBP balance sheet	6	7	7	-	-	-	-	-	-	-	-	-
Business climate indices	23	23	23	24	23	23	24	23	25	23	23	22

* quarterly data, [a] preliminary data, January, [b] January and February, [c] November 2005, [d] January, [e] February

Source: CSO, NBP

Economic data and forecasts

Monthly economic indicators

		Jan 05	Feb 05	Mar 05	Apr 05	May 05	Jun 05	Jul 05	Aug 05	Sep 05	Oct 05	Nov 05	Dec 05	Jan 06	Feb 06
Industrial production	%YoY	4.6	2.3	-3.7	-1.1	0.9	6.9	2.6	4.8	5.9	7.6	8.5	9.2	10.3	7.8
Retail sales [c]	%YoY	7.5	2.4	-0.3	-14.4	8.0	10.5	5.0	7.9	5.4	7.5	7.3	6.3	7.6	8.0
Unemployment rate	%	19.5	19.4	19.3	18.8	18.3	18.0	17.9	17.8	17.6	17.3	17.3	17.6	18.1	18.0
Gross wages [b c]	%YoY	2.6	1.4	2.2	1.8	3.0	4.5	3.2	2.8	1.8	6.4	6.9	1.5	3.4	3.8
Employment [b]	%YoY	1.5	1.6	1.6	1.7	1.6	1.7	1.8	2.0	2.2	2.1	2.5	2.6	1.8	1.8
Export (€) [d]	%YoY	35.0	27.3	11.0	12.6	11.3	12.9	15.0	13.5	14.0	17.2	15.3	16.2	12.1	10.5
Import (€) [d]	%YoY	22.7	27.9	6.8	-5.2	13.5	10.8	8.1	13.5	10.0	14.9	16.8	17.6	14.9	12.2
Trade balance [d]	EURm	100	-60	-359	-19	-495	-172	-143	-341	-127	-35	-368	-600	-40	-168
Current account balance [d]	EURm	-408	-317	-275	114	-685	53	-308	-376	-245	-392	-539	-700	-290	-398
Current account balance [d]	% GDP	-4.0	-3.8	-3.4	-2.7	-2.5	-2.1	-1.8	-1.8	-1.5	-1.5	-1.6	-1.7	-1.6	-1.7
Budget deficit (cumulative)	PLNbn	-1.6	-8.8	-12.3	-13.9	-18.3	-18.5	-17.5	-18.5	-17.8	-20.6	-22.2	-28.6	-1.7	-8.6
Budget deficit (cumulative) [e]	% realisation	5.5	30.9	43.2	48.6	64.0	64.8	61.1	64.7	62.3	72.1	77.7	100.0	5.5	28.0
CPI	%YoY	3.7	3.6	3.4	3.0	2.5	1.4	1.3	1.6	1.8	1.6	1.0	0.7	0.9	1.1
PPI	%YoY	4.5	3.2	2.2	0.9	-0.5	0.0	0.0	-0.2	-0.5	-0.9	-0.4	0.5	0.5	1.0
Broad money (M3)	%YoY	9.3	9.4	11.0	10.0	13.2	10.8	10.4	11.1	12.7	8.7	12.6	10.3	10.4	10.3
Deposits	%YoY	8.4	8.7	10.4	8.7	11.9	9.2	9.4	10.1	11.6	6.3	11.1	9.3	9.4	9.3
Loans	%YoY	3.5	2.4	4.6	5.3	9.4	7.4	8.8	9.0	9.6	4.4	10.2	11.8	12.6	13.3
USD/PLN	PLN	3.11	3.06	3.04	3.21	3.29	3.34	3.40	3.29	3.20	3.26	3.37	3.25	3.16	3.17
EUR/PLN	PLN	4.08	3.99	4.02	4.16	4.18	4.06	4.10	4.05	3.92	3.92	3.97	3.85	3.82	3.83
Reference rate [a]	%	6.50	6.50	6.00	5.50	5.50	5.00	4.75	4.75	4.50	4.50	4.50	4.50	4.50	4.00
Lombard rate [a]	%	8.00	8.00	7.50	7.00	7.00	6.50	6.25	6.25	6.00	6.00	6.00	6.00	6.00	5.50
WIBOR 3M	%	6.63	6.54	6.15	5.78	5.48	5.22	4.66	4.67	4.57	4.50	4.64	4.62	4.49	4.25
Yield on 52-week T-bills	%	6.28	5.95	5.51	5.36	5.19	5.09	4.30	4.33	4.15	4.19	4.35	4.38	4.22	4.10
Yield on 2-year T-bonds	%	6.24	5.82	5.43	5.39	5.27	5.14	4.50	4.60	4.22	4.42	4.75	4.64	4.40	4.30
Yield on 5-year T-bonds	%	6.31	5.80	5.56	5.50	5.38	5.25	4.70	4.84	4.51	4.85	5.23	5.04	4.82	4.85
Yield on 10-year T-bonds	%	5.98	5.72	5.57	5.49	5.36	5.24	4.72	4.87	4.57	4.90	5.36	5.14	4.94	4.95

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 [e] 2005 - % of Dec, 2006 - % of plan

Quarterly and annual economic indicators

		2003	2004	2005	2006	1Q05	2Q05	3Q05	4Q05	1Q06	2Q06	3Q06	4Q06
GDP	PLNbn	842.1	922.2	967.7	1 022.6	226.2	235.7	237.2	268.5	238.2	248.5	250.3	285.7
GDP	%YoY	3.8	5.3	3.2	4.4	2.1	2.8	3.7	3.9	4.1	4.3	4.3	4.9
Domestic demand	%YoY	2.7	5.9	1.9	4.2	1.1	-0.5	1.6	5.1	3.9	4.2	4.1	4.6
Private consumption	%YoY	1.9	4.0	2.3	3.6	1.7	1.6	2.7	3.3	3.5	4.0	3.5	3.5
Fixed investments	%YoY	-0.1	6.3	6.2	8.2	1.2	3.8	5.7	9.8	9.0	8.0	8.0	8.0
Industrial production	%YoY	8.4	12.3	4.0	5.9	0.7	2.3	4.5	8.3	9.8	3.8	4.9	5.1
Retail sales (real terms)	%YoY	3.6	7.1	1.5	7.5	-0.4	-3.2	4.1	5.4	4.6	7.0	8.6	9.7
Unemployment rate [a]	%	20.0	19.1	17.6	16.6	19.3	18.0	17.6	17.6	17.9	16.8	16.3	16.6
Gross wages (real terms) [c]	%YoY	2.0	0.8	1.2	2.7	-1.3	0.8	1.1	3.8	2.4	2.4	4.2	1.7
Employment [c]	%YoY	-3.5	-0.8	1.9	2.3	1.5	1.7	2.0	2.4	1.9	2.2	2.6	2.6
Export (€) [b]	%YoY	9.1	22.3	16.1	8.7	23.1	12.2	14.1	16.2	10.9	9.8	8.4	6.1
Import (€) [b]	%YoY	3.3	19.5	12.3	9.7	17.8	5.7	10.4	16.3	12.2	9.0	9.8	8.1
Trade balance [b]	EURm	-5 077	-4 552	-2 621	-3 627	-316	-690	-612	-1 003	-577	-600	-950	-1 500
Current account balance [b]	EURm	-4 108	-8 401	-4 087	-4 537	-1 001	-529	-926	-1 631	-1 077	-710	-1 080	-1 670
Current account balance [b]	% GDP	-2.1	-4.1	-1.7	-1.7	-3.3	-2.1	-1.5	-1.7	-1.7	-1.7	-1.8	-1.7
Budget deficit (cumulative) [a]	PLNbn	-37.0	-41.5	-28.6	-30.5	-12.3	-18.5	-17.8	-28.6	-12.2	-18.3	-24.4	-30.5
Budget deficit (cumulative) [a]	% GDP	-4.4	-4.5	-3.0	-3.0	-	-	-	-	-	-	-	-
CPI	%YoY	0.8	3.5	2.1	1.1	3.6	2.3	1.6	1.1	1.0	1.0	1.1	1.3
CPI [a]	%YoY	1.7	4.4	0.7	1.8	3.4	1.4	1.8	0.7	1.2	1.2	1.0	1.8
PPI	%YoY	2.6	7.0	0.7	1.0	3.3	0.1	-0.2	-0.3	0.8	0.5	1.0	1.7
Broad money (M3) [a]	%YoY	5.6	8.7	10.3	11.2	11.0	10.8	12.7	10.3	10.1	10.3	9.0	11.2
Deposits [a]	%YoY	3.7	8.1	9.3	10.8	10.4	9.2	11.6	9.3	9.0	10.8	8.9	10.8
Loans [a]	%YoY	8.1	2.9	11.8	15.0	4.6	7.4	9.6	11.8	13.4	15.1	17.3	15.0
USD/PLN	PLN	3.89	3.65	3.23	3.19	3.07	3.28	3.30	3.29	3.16	3.18	3.24	3.18
EUR/PLN	PLN	4.40	4.53	4.02	3.93	4.03	4.13	4.02	3.91	3.83	3.91	4.01	3.98
Reference rate [a]	%	5.25	6.50	4.50	4.00	6.00	5.00	4.50	4.50	4.00	4.00	4.00	4.00
Lombard rate [a]	%	6.75	8.00	6.00	5.50	7.50	6.50	6.00	6.00	5.50	5.50	5.50	5.50
WIBOR 3M	%	5.69	6.21	5.29	4.23	6.44	5.49	4.63	4.59	4.31	4.20	4.20	4.20
Yield on 52-week T-bills	%	5.33	6.50	4.92	4.23	5.91	5.21	4.26	4.31	4.14	4.20	4.30	4.30
Yield on 2-year T-bonds	%	5.38	6.89	5.04	4.38	5.83	5.27	4.44	4.60	4.30	4.30	4.40	4.50
Yield on 5-year T-bonds	%	5.61	7.02	5.25	5.01	5.89	5.38	4.68	5.04	4.82	4.95	5.10	5.15
Yield on 10-year T-bonds	%	5.77	6.84	5.24	5.09	5.76	5.37	4.72	5.13	4.95	5.05	5.15	5.20

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

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

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