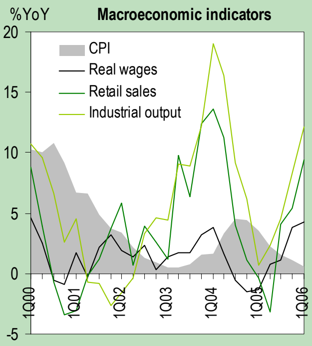
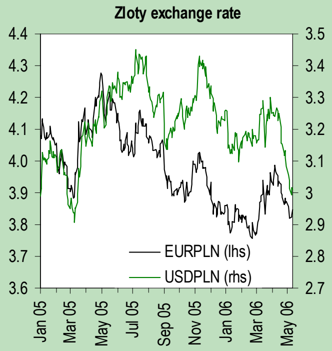
Bank Zachodni WBK

MACROscope

Polish Economy and Financial Markets

May 2006





In this issue:

Maciej Reluga
Chief economist
+48 22 586 8363

Piotr Bielski
+48 22 586 8333

Piotr Bujak
+48 22 586 8341

Cezary Chrapek
+48 22 586 8342

Email: ekonomia@bzwbk.pl

May revival

- **At the beginning of May a coalition deal of Law and Justice (PiS) with Self-defence (Samoobrona) and League of Polish Families (LPR) was concluded, which gave the government support of over 50% of votes in the Sejm, the lower house of the parliament.** Two junior parties received five nominations for ministerial posts, including deputy prime ministers. Changes in the cabinet were rather neutral for the financial market, because it seems, that so far influence of new coalition members on the key issues in the government's policy is limited, and what is more at the moment of entry to the government the populists eased their radical postulates in the economic matters. Nevertheless, it does not change the fact that the perspectives of government's economic policy remain under big question, which may be partly answered, when we know the budget for the next year. The presence of Zyta Gilowska in the government may be the indicator showing in which direction the government policy goes and until she stays on her post, investor's moods should stay relatively stable. We keep our exchange rate forecasts assuming zloty depreciation in the second part of this year and EURPLN rate up to ca. 4,00, which could be supported by capital outflow from emerging markets.

- **Most of the figures referring to economic activity were a positive surprise in March.** Output in industry and construction, retail sales, wages and employment in the corporate sector data appeared to be explicitly higher than expected, showing that economic growth at the start of this year is accelerating faster than one could expect. It is happening thanks to invariably good export performance as well as firm strengthening of domestic demand, including consumption. It allows to expect a GDP growth of 5.3% in the Q1 this year and maybe above 5% in the whole 2006.

- **Accelerating economic growth calls a question whether in this conditions we will face a rise of inflation.** We dedicated more attention to this issue in the *Special focus* recalling to the examples of other countries at the similar level of economic development. The conclusions from this analysis indicate that midterm inflation perspective in Poland seem still favourable. Although one should expect gradual rise of inflation to 2.5% level, amid changes occurring with regards to the structure of Polish economy and the way of its connection to the world economy, it seems to us that the risk of uncontrollable inflation rebound, which could hurt the realization of inflation goal in the midterm or cause destabilization of Polish economy is quite low.

- **In April the MPC left the interest rates unchanged once again.** Last comments of the Council members and its official statement indicate that the current level of interest rates is appropriate in their opinion and adequate to the economic situation, which is in line with our view, that the reference rate is going to stay at 4% for a longer time if further data do not bring breaking surprises with regards to inflation level and growth rate.

Financial market on 28 April 2006:

NBP deposit rate	2.50	WIBOR 3M	4.13	USDPLN	3.0841
NBP reference rate	4.00	Yield on 52-week T-bills	4.00	EURPLN	3.8740
NBP lombard rate	5.50	Yield on 5-year T-bonds	4.89	EURUSD	1.2561

This report is based on information available until 10.05.2006

Special focus

What about this inflation?

In March, the growth in prices of consumer goods and services was 0.4% yoy. Excepting the period of April/ May 2003, this was the record low in the history of Poland's market economy. The low inflation in 2003 proved temporary. At that time, the over two-year austerity period was coming to an end and over the next months the inflation gradually grew to reach 4.5% at the end of 2004. Will we see the same thing happen this time? Can the drop in inflation we have seen since the end of 2004 be temporary in nature? And maybe the 2004 increase in inflation was temporary under the influence of the EU accession and the Polish economy has achieved a permanent low price growth rate? In this MACROscope issue we will try to partially answer these questions.

Council is counselling

In order to answer the question about the sustainable nature of Poland's low inflation, it seems necessary to define the reasons for its drop to the existing low level. What is more, forces that may affect inflation in the future must also be analysed. The answer to this question is very important from the point of view of monetary policy prospects so primarily central bankers are attempting to answer the question about inflation. The opinions in the Council in relation to various factors which are likely to affect future inflation vary and this is why you should carefully analyse statements made by central bankers, to track how their opinions change as impacted by the economic news.

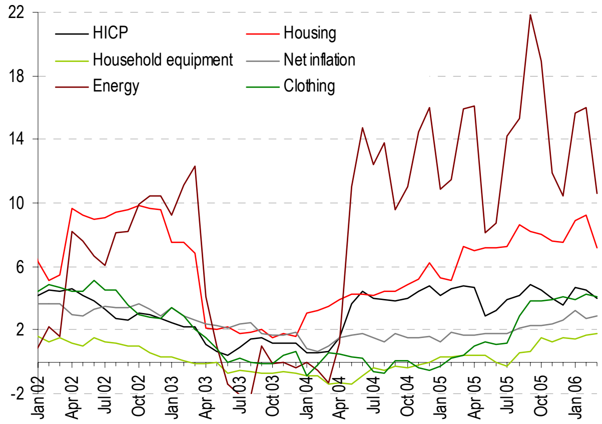
Interest rate cuts introduced by the Monetary Policy Council (MPC) early this year triggered a strong reaction from the "hawkish" officials in the central bank. After the February MPC meeting, Leszek Balcerowicz, the NBP Governor and the MPC Chairman, presented preliminary conclusions from the analysis of low inflation cases in the years 1995-2005. He also referred to them at the March meeting. The conclusions suggested that the drop in inflation in Poland in 2005 and in early 2006 may prove temporary and that we can expect inflation to bounce soon. They might be significant as it would be necessary to change monetary policy parameters, especially if there are subsequent interest rate cuts. The analysis presented by the NBP Governor was based on experience from 12 economies which are vary in a number of aspects. It seems to us that while assessing the inflation prospects in Poland, it would be most advisable to analyse experience of countries at the similar level of economic development and similar economic structure. In this context, it seems most appropriate to compare Poland to economies from the same region who also acceded to the EU in 2004. Out of these economies, the analysis presented by the Governor covered four states: the Czech Republic, Estonia, Lithuania and Latvia. Similar warning tone was also found in article titled "Bothering Cut" by Dariusz Filar, the MPC member, published in *Rzeczpospolita* newspaper of 3 March this year, which was based on the Slovak experience.

The paper presented by the NBP Governor highlights a few elements. First of all, it lists the reasons for drop in inflation in the analysed states. For the Czech Republic it is the crown appreciation, lower growth rate of oil prices expressed in domestic currency, drop in imports growth rate and decline in growth of property prices. For the Baltic countries, the only source of disinflation identified by the authors is food prices. In terms of the drivers of subsequent growth in prices, the paper says that for the Czech Republic they were the same factors which earlier caused the inflation to drop (only that they worked in opposite direction). They include growth rate of oil prices, accelerated economic growth (private consumption in particular) and higher growth rate of property prices. In relation to the Baltic countries, the so-called EU effect was noted (i.e. growth in indirect taxes, changes in the customs and agricultural policies), along with the improvement on the labour market (growth in salaries outstripping labour productivity as a result of pressure related to the increased work migration) and strong growth in consumer demand (as a result of the improvement on the labour market and increased credit activity). Prof. Filar in the analysis of Slovak experience postulates that the reason for the inflation bounce is primarily accelerated economic growth fuelled, to a large extent, by individual consumption.

Too distant analogies

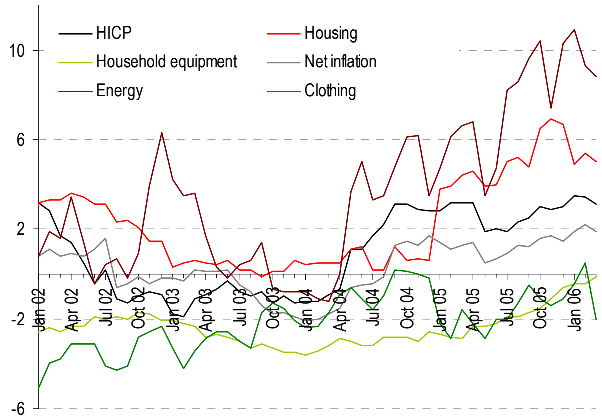
Are the presented examples of the so-called inflation bounce adequate to the Polish economy? Using the examples of the Baltic countries gives rise to the strongest doubts. This is because these are economies with fixed exchange rate. This means that the overall macroeconomic balance, including inflation processes, are determined differently than in our country. A clear evidence for this is the Harrod-Balassa-Samuelson effect (HBS), which can be a serious source of inflation pressure in countries where there is a strong increase in labour productivity in sectors producing internationally tradable goods. In more precise words, in countries that have fixed exchange rate, the growth in labour productivity makes the pressure in the economy driving machine go rapidly up. This is so because the growth in work efficiency contributes to the growth in salaries which translates into higher consumer demand growth rate. Inflation pressures occur if the growth in salaries "pours" into other economic sectors where work efficiency is growing at a slower pace than salaries or is not growing at all. This is what is happening in the Baltic countries where the steam, i.e. nominal currency appreciation, cannot go out. In those countries, HBS is promoted (in Lithuania in particular) by, among other things, low discipline of salaries in the public sector. As a consequence, the growth in salaries in the Baltic countries is nearly a two-digit one in real terms. See the graphs below for illustration of inflation in those economies.

Price change ratios in Estonia % yoy – highlights



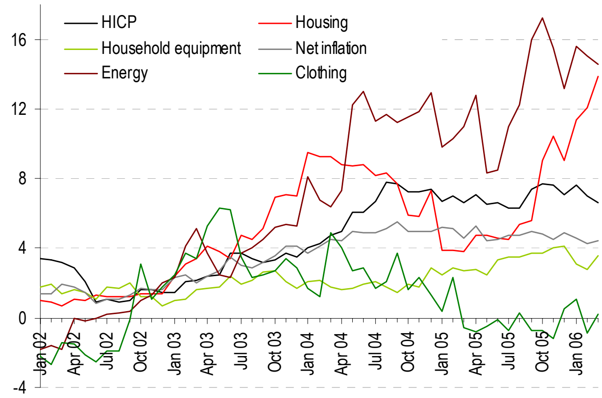
Note: Net inflation is HICP excluding prices of food, fuel, alcoholic drinks and tobacco products.
Source: Eurostat

Price change ratios in Lithuania % yoy – highlights



Note: Net inflation is HICP excluding prices of food, fuel, alcoholic drinks and tobacco products.
Source: Eurostat

Price change ratios in Latvia % yoy – highlights



Note: Net inflation is HICP excluding prices of food, fuel, alcoholic drinks and tobacco products.
Source: Eurostat

In countries with floating exchange rates, such as Poland, the HBS effect can produce different results. In such countries, a lot of the steam goes out to no avail. It just makes the currency rate appreciate in nominal terms. As a result, rapid growth in work efficiency translates into accelerated economic growth and at the same time the inflation pressure is under control. It seems that this illustrates the current situation in Poland.

Adequate degree of salary discipline is required to keep the inflation pressure under control. It must be strong enough to ensure that the salary growth rate does not exceed the growth in efficiency to an extent that could not be offset by anti-inflation effects of nominal currency appreciation. As long as currency rate appreciates in nominal terms, the salary growth rate in excess of the work efficiency growth rate does not have to mean an increase in inflation. As you can see, exchange rate regime (de facto maintaining currency rates) is of key importance for inflation processes. It has serious implications for prices of imported goods (to include fuel prices expressed in domestic currency).

In terms of the salary discipline, it is very strong in Poland relative to the Baltic countries, in spite of some acceleration in growth in average salaries in the recent months. Even if salaries continue to gradually grow it is very unlikely that it real terms they will be as high as the salaries which fuelled inflation in the Baltic countries.

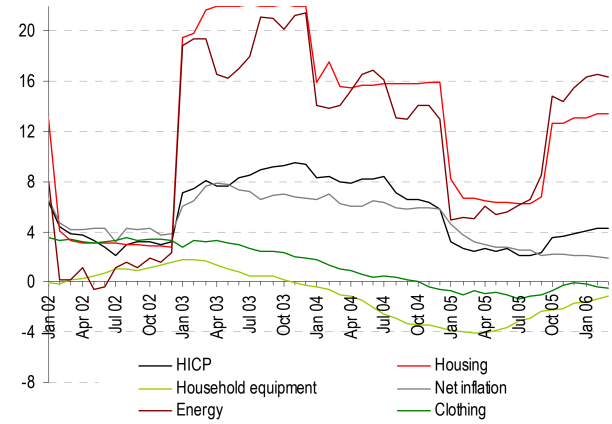
In view of the effects of the distinctness of the applied exchange rate regime, the examples of Estonia, Lithuania and Latvia do not seem adequate to the assessment of inflation prospects in Poland. There are also other reasons for which the analogies between Poland and those countries are too distant. Size of the economy is a crucial factor. Increased FDI activity in Central-Eastern Europe after the EU accession has much more serious implications for the labour market and domestic demand in states smaller than Poland, especially if they are as small economies as former republics of the Soviet Union. In states such as Estonia, Lithuania and Latvia, a few large foreign direct investments are enough to drain not only the regional labour market (which may be the case in countries as large as Poland), but also the national labour force. It is similar with potential situation related to possible implications of work migration to Western Europe.

A good example from the South

Deeming the example of the Baltic countries as not too adequate for the assessment of inflation prospects in Poland, let us take a closer look at the experience of our neighbours in the South: the Czech Republic and Slovakia.

The example of Slovakia is in a way as much problematic as that of the Baltic countries. The reason is the same, i.e. exchange rate regime. Much as there is no fixed exchange rate in Slovakia but the ERM2 mechanism instead, the objective of monetary policy in this country is the control of the exchange rate. As a result, as Dariusz Filar indicates in his article, there have been changes to monetary policy parameters which were geared towards achieving specific f/x rate changes and did not take into account inflation effects. Consequently, the domestic demand growth trend initiated by other factors strengthened. Also, the standard inflation ratio dynamics accelerated. Was there any cause-effect connection between the two phenomena? Can the same thing happen in Poland given the cycle of cutting base interest rates continuing since early 2005? It seems unlikely as even despite the cuts of nominal rates made by the MPC this year, real interest rates in Poland are much higher than in Slovakia (and in other countries of the region). A relatively high level of real interest rates in Poland can actually be considered a structural factor given the sustainability of this phenomenon. Hence, it is difficult to talk about a strong stimulation from the monetary policy in Poland as was the case in Slovakia last year. What is more, when we take a look at the structure of price changes in Slovakia (see the chart below), it turns out that in pricing categories which can be assessed as the most sensitive to demand, there are no signs of strong inflation pressure.

Price change ratios in Slovakia % y/y - highlights

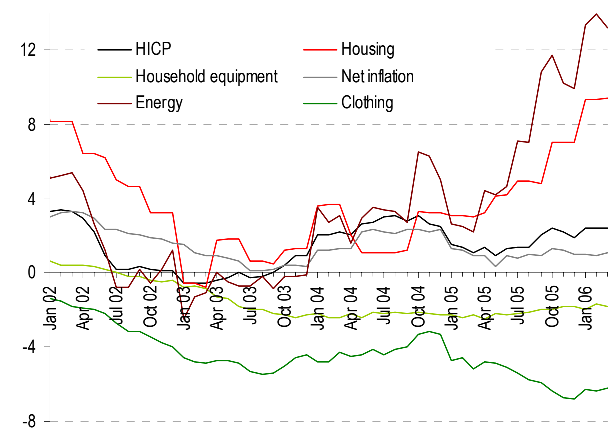


Note: Net inflation is HICP after excluding prices of food, fuels, alcoholic beverages and tobacco products.
Source: Eurostat

As the chart illustrates, inflation increase in Slovakia has primarily been driven by growing energy prices and related hikes in the costs of home maintenance. Concurrently, though, clothing or, for example, home fit-outs are becoming less expensive. Taking the HICP ratio into consideration, when we exclude factors exogenous to the monetary policy, such as prices of food, fuels, alcoholic beverages and tobacco products, it turns out that the inflation in Slovakia was still in decline in early 2006 to hit the 10 years' record low in March. This suggests that Slovakia's strong consumer demand, fuelled by real interest rates much lower than in Poland, does not trigger significant inflation pressure. The example of Slovakia, then, can rather be encouraging as regards the chance to keep a low inflation level in Poland in the circumstances of an accelerating GDP growth accompanied by a growing role of domestic demand.

Does the latest inflation record in the neighbouring Czech Republic confirm the optimistic conclusions drawn from the Slovakian experience? It seems to us it does as the recent structure of inflation processes there has been very much like in Slovakia. This is illustrated by the chart below.

Price change ratios in the Czech republic % y/y - highlights



Note: Net inflation is HICP excluding prices of food, fuels, alcoholic beverages and tobacco products. *Source: Eurostat*

Mysterious labour market

What stems from the analysis of inflation processes with our southern neighbours puts under the question mark the conviction of those economists who claim that "what is now happening in Poland's labour market poses a serious threat to the future inflation".[1] Arguments about the surging pressure on prices from the labour market have recently been used with a growing frequency. A few phenomena are mainly pointed to. First of all, a large scale of labour emigration which weakens the supply of labour force in the country and concurrently fuels consumer demand thanks to the transfers of foreign income. Secondly, an argument is often voiced that appropriately skilled labour force is missing. Both phenomena indeed concern the Polish economy which is reflected in various statistics and studies. Statistics show, however, that similar phenomena are witnessed in the Czech Republic and Slovakia on an even larger scale, but, as the above analysis of pricing processes in these countries shows, it has not triggered a surge in fundamental inflation pressure there.

Should we be apprehensive about a growing salary pressure in Poland which could translate into non-controllable inflation acceleration? The same question can be rephrased: can the Polish companies start acting irrationally and agree to salary rises which are not justified by improvement in labour productivity? Last years' experience shows that it is hard to expect such flippancy from the private sector companies. Despite a drastic improvement in labour efficiency and significant improvement in the Polish companies' financial results, the salary rise was much constrained. Perhaps, rather than agreeing to salary rises which do not bode well for an appropriately high increase in work efficiency, the companies will limit the scale of their further expansion. It cannot be ruled out, however, that certain tension in the labour market will arise. A signal indicating such a possibility is growth in unit labour costs in the economy which was witnessed throughout 2005. This tension can additionally be fuelled by the growth in the number of the economically active though there is much uncertainty as to the actual scale of this growth. The highest risk seems to be related to the possible erosion of salary discipline in the public sector. It should always be remembered, however, that experience of such countries as the Czech Republic and Slovakia shows that an increase in consumer demand does not have to translate into stronger inflation pressure. Also Poland's experience from the latest history shows that even in the environment of the strengthening demand, companies have a limited possibility to transfer the growing costs (in this case these would be labour costs) onto the goods and services they deliver.

Following the track to Far East

What prevents the growing consumer demand from translating into a price hike? The answer should be sought on the supply side. So, what forces affecting the demand in the goods and services markets prevent the demand growth from translating into price hikes? The most crucial factor seems to be globalization effects. The last years have been a period of unprecedented economic expansion of China and India, i.e. countries with very low costs of generating goods and services. A decade ago, these countries developed at the same pace as now. Today, however, their share in global trading turnover and the world GDP is much higher than back then. Some time ago, China was a manufacturer of a limited range of the most simple goods. Now, the economy of the Middle Kingdom is able to produce nearly everything at a low price in a basically unlimited amount. This creates strong competition pressure for the manufacture sector worldwide. In Poland, the growth in competition pressure is also driven by a continuous development of the internal market understood as a set of entities operating on the supply side. The example of the clothing market or household and electrical appliance one in Poland shows that the increasing number of the entities operating in a given market give rise to a tough price war effectively eliminating the potential inflation effect of the stronger demand.

The impact of globalization effects on the manufacture sector seems quite conclusive. It can be slightly differently, though, in the case of the services sector. Offshoring various services by international corporations to Poland can result in a situation where the GDP growth will stem more from the growth in employment than in labour efficiency. Such a phenomenon would not affect the forces impacting inflation favourably.

It is hard today to say which globalization effects will dominate (the evidence of which is the April NBP Report on Inflation). Important, however, is that the effects of fiercer competition seem to counteract the inflation impulses coming not only from the demand side but also from the exogenous shocks. This is evidenced by the fact that despite a high growth of raw materials and power prices, the companies do not transfer higher costs onto purchasers of the goods and services they deliver. This allows one to think that a potential increase in the fuel prices and energy costs will be confined to the direct

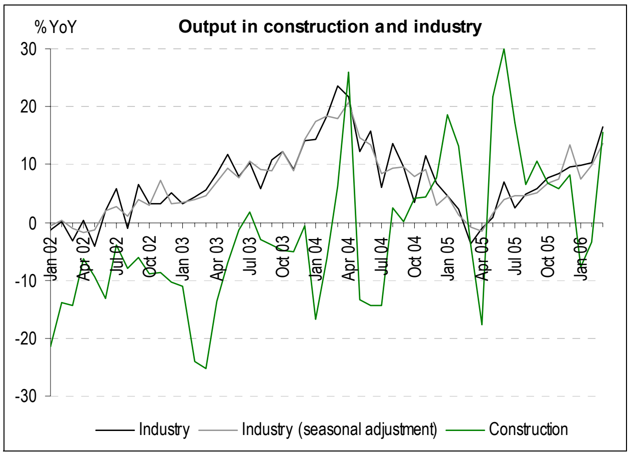
[1] The quoted opinion comes from Piotr Ciżkowicz and Andrzej Rzońca's article titled *Między nami doktrynerami,* published in the Rzeczpospolita of 26 April this year.

inflation effect and will not entail indirect effects dangerous for the “core” of inflation processes .

Favourable prospects

In a summary, despite an intensifying GDP growth, medium-term prospects for inflation in Poland seem still favourable. The experience of neighbouring countries which were subject to a strong acceleration of GDP growth a bit earlier than Poland, as well as the conclusions from our country’s latest inflation history, show that recently various forces have had a positive impact on the inflation processes in the countries of our region. Though, the influence of some factors might soon reverse, the key forces weakening the inflation pressure will not disappear soon. By all means, it is very likely that in the strong economic expansion environment, in the years to come, inflation in Poland will accelerate. We envisage that even if this year inflation hits record low values, already next year we can get near the inflation target of the central bank, i.e. 2.5%. From the central bank’s point view, a more important question is, however, to what level inflation will grow and whether the inflation target is at risk. In the context of the changes in the structure of the Polish economy and the way it is connected to the world economy, it seems to us that the risk of uncontrollable inflation hike which might pose a threat to the delivery of the inflation target in a medium-term perspective or destabilize Polish economy seems insignificant. This thesis is also supported by the Polish central bank’s conservatism not witnessed in the other countries of our region.

Economic update



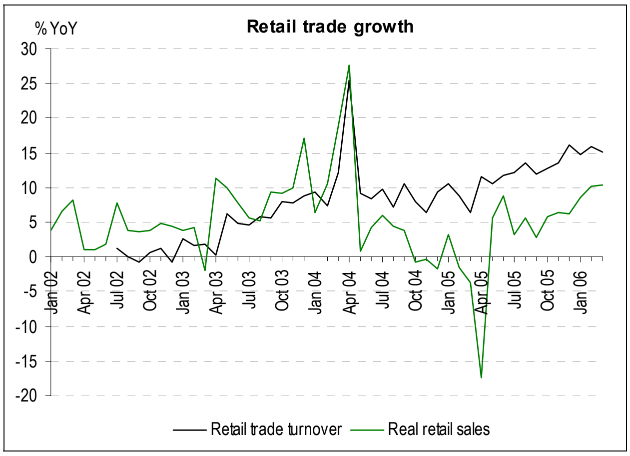
Output and construction stronger than predicted

▪ Sold industrial output increased 16.4%YoY in March, much above market prediction. Seasonally adjusted growth reached 13.6%YoY. This was the fastest rate of expansion since pre-accession boom in mid-2004.

▪ A main vehicle of production growth was manufacturing, where output soared 18.7%YoY.

▪ As much as 28 out of 29 industrial branches recorded a rise in output, and the best results were traditionally in export-oriented branches, which suggests that external demand keeps supporting economic growth in Poland.

▪ After two months of stagnation, construction output in March saw a significant pickup by 15.5%YoY. It confirms that a slowdown at the start of the year was temporary and resulted from severe weather conditions, not a breakdown in trend.

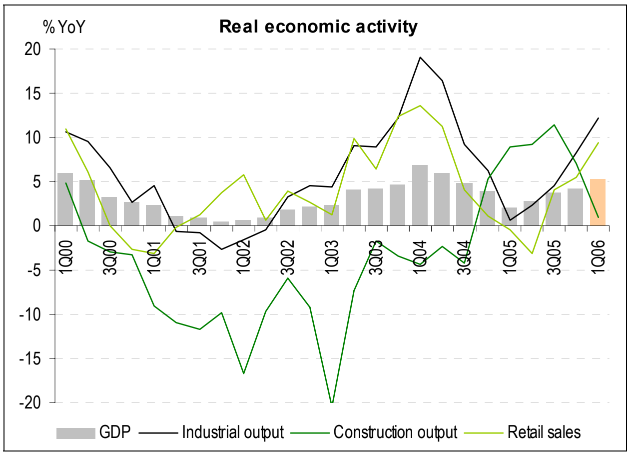


Positive surprise also in retail sales

▪ Nominal growth in retail sales reached 10.1%YoY in March, a notch below February's 10.2%. However, real growth picked up to 10.4%YoY, reaching the highest level for two years.

▪ High growth in total sales took place despite later Easter than last year, which resulted in postponement of some food purchases from March to April (annual growth of food sales declined to 2.7%YoY from 9.8%YoY in February).

▪ It was possible because sales of other goods significantly increased. E.g. sales of furniture and households appliance surged by almost 20%YoY, showing that a share of higher order goods (durables) in consumers' spending has been rising. This confirms a persistence of revival in consumption demand.



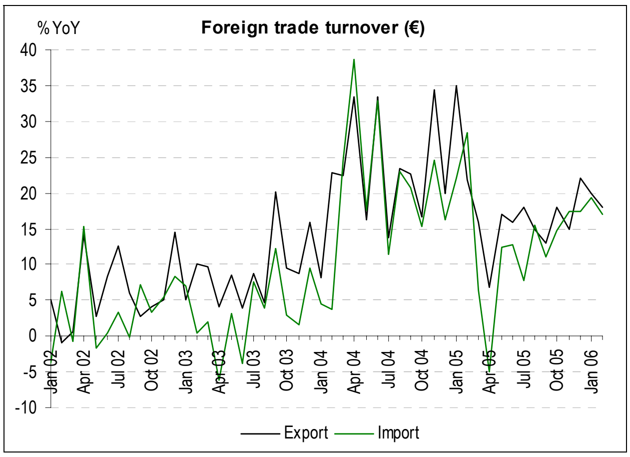
First quarter much better than expected

▪ Summing up indicators of economic activity for the first quarter it looks like the year started with economic growth much faster than initially predicted.

▪ The first quarter saw retail sales growth by 9.4%YoY in real terms, industrial production growth by 12.1%YoY, and construction output rise by ca. 1%YoY.

▪ On a basis of above-mentioned data one could estimate that GDP growth in the first quarter 2006 reached ca. 5.3%. Thus, the economy has been expanding at the fastest rate since pre-accession boom in activity in the middle of 2004. It is likely that in the whole year GDP growth could advance by more than 5%.

▪ On demand side, economic growth is promoted by both domestic demand (higher consumption and investment) and still very strong performance of foreign trade.



Source: CSO, own calculations

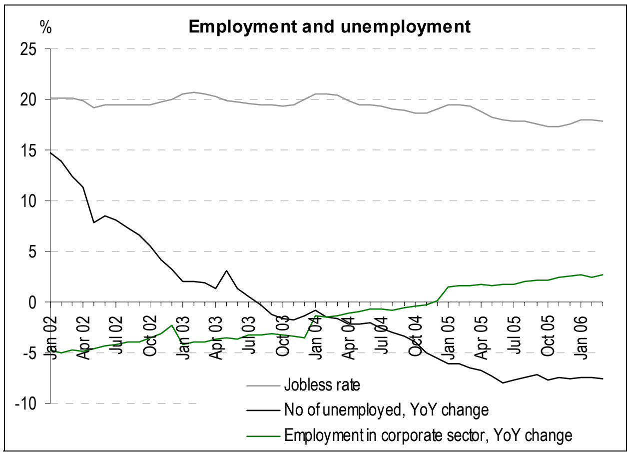
Exports still promoting economic growth

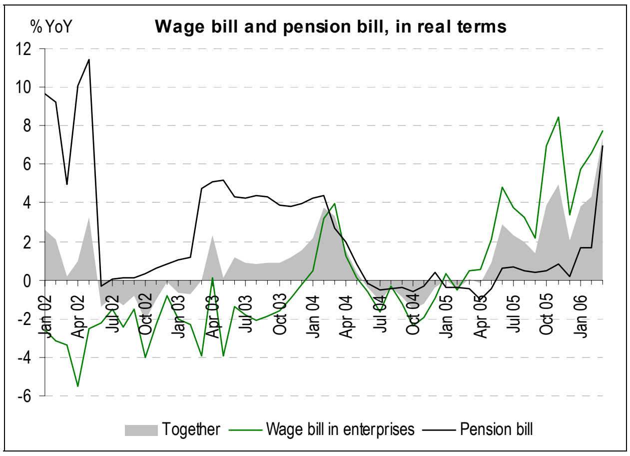
▪ Current account deficit reached €538m in February. Although the result was worse than forecasted, it resulted mainly from deterioration in current transfers account (hopefully temporary). All other elements of balance of payments recorded very good results.

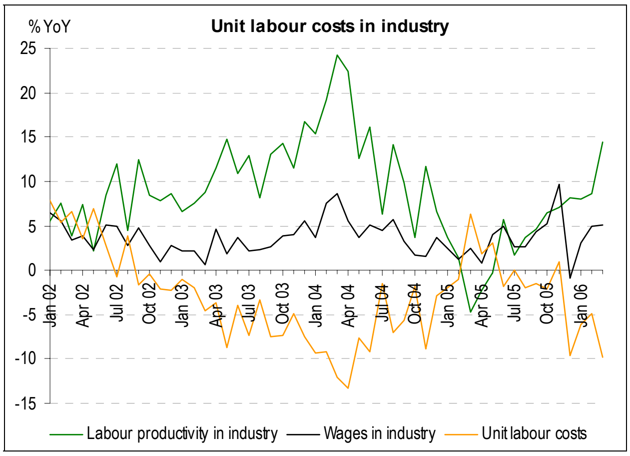
▪ Exports maintained very rapid growth, reaching 18%YoY in February for euro-denominated data, and 12.4%YoY in zloty terms. The latter shows that despite strong zloty, exporters' revenues have been rising. Imports soared 17.1%YoY in euro terms and 11.5% for zloty denominated figures.

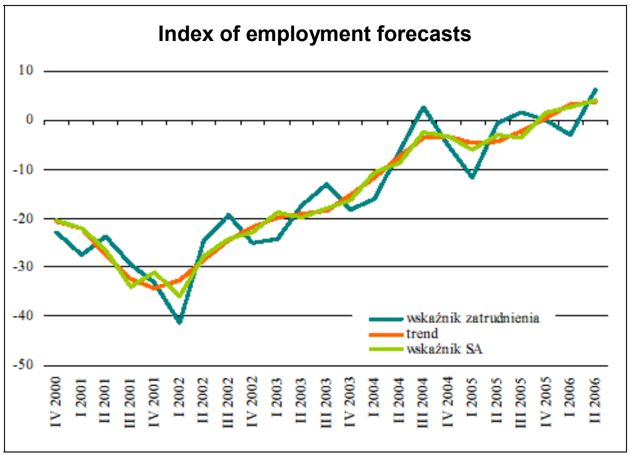
▪ Cumulative 12-month current account deficit in January and February was at record-low level of 1.3% of GDP, against 1.5% of GDP in December, which confirms lack of important threats for external imbalance of Poland's economy.

Economic update









Source: CSO, NBP, own calculations

Employment up, unemployment down

▪ Faster economic growth translates into revival on the labour market with increasing strength. Unemployment rate fell to 17.8% in March, i.e. was 1.5 pp lower than last year. According to Minstry of Labour's estimates, April saw further fall to 17.2%.

▪ This is possible because companies have been increasing demand for labour. In March, employment in enterprises sector increased 2.7%YoY, and in entire first quarter 2006 it rose 2.6%YoY, which was the fastest rate since early transformation.

▪ Interestingly, a fall in unemployment is actively supported by the government by… a hiring new staff in public administration – in 4Q05 number of jobs in administration rose 3.6%YoY against 1.7%YoY rise in manufacturing in the same period; the fastest employment rise was in services – in trade by over 6%, and in financial intermediation by almost 8%YoY in 4Q05.

Households' disposable income on the rise

▪ Wage growth has been strengthening as well. Average pay rise in enterprises sector was 5.4%YoY in March, much above market consensus forecast 4.1%. In entire first quarter wages increased 4.7%YoY, i.e. only slightly slower than 4.8% in 4Q05. However, due to lower inflation, real wage growth picked up to 4.3%YoY from 3.8%YoY in 4Q05.

▪ March saw indexation of old-age and disability pensions, so they increased on average 7.8%YoY (Q1 saw 4.6%YoY rise).

▪ Because of simultaneous rise in wages and employment, as well as higher pensions, a growth rate of households' disposable income accelerated sharply. Real wage bill in enterprises sector increased by 7.8%YoY in March, and pension fund by 6.9%YoY; sum of wage bill in enterprises and pension bill soared 7.4%YoY in real terms against 4.3%YoY rise in February and average 1.6%YoY growth in 2005. It allows forecasting further strengthening in consumption demand in 2006, probably at a bigger scale that we have predicted quite recently.

▪ While faster pay rise in enterprises, and especially in industry, finds justification in quickly rising labour productivity (in March productivity in industry jumped up by nearly 15%YoY!), one should notice that salaries are increasing also in other sectors, including public area, where since 2004 wage rise is constantly faster than in market enterprises – in 4Q05 it reached 6.6%YoY.

▪ In effect, even though in industry unit labour costs are still falling, in the economy as a whole this trend has been broken – in 4Q05 unit labour costs increased for the fist time after six years of decline (up 2.5%YoY). It is one of the factors that, if maintained, will act towards higher pressure on prices in subsequent quarters.

Business climate surveys suggest persistence of growth

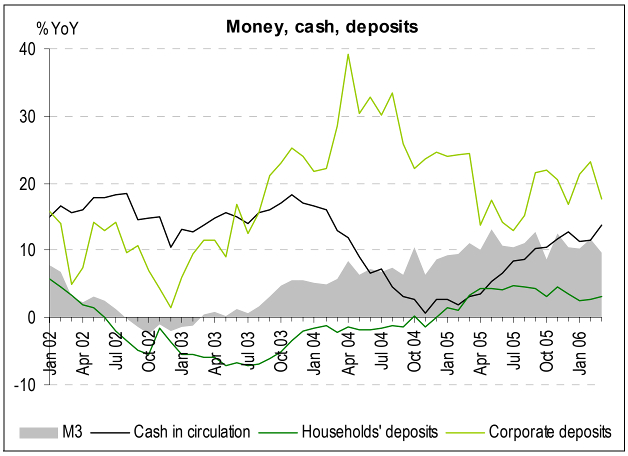
▪ Quarterly NBP report on business climate confirmed very good situation of enterprises in Q1 2006 and expectations of further improvement in Q2.

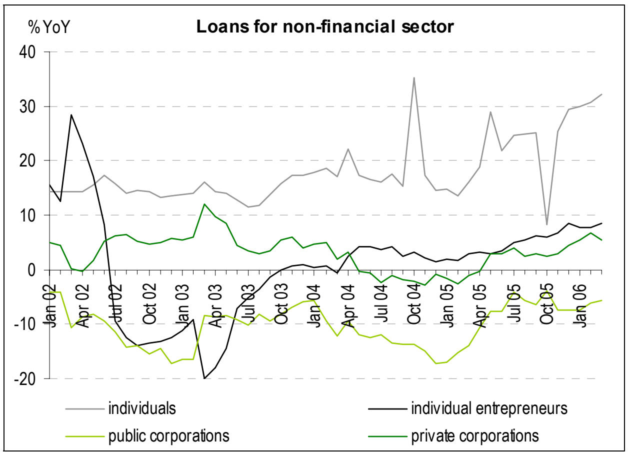
▪ According to NBP, GDP growth in Q2 2006 could be even higher than in Q1, as firms are expecting further rise in demand and orders portfolio.

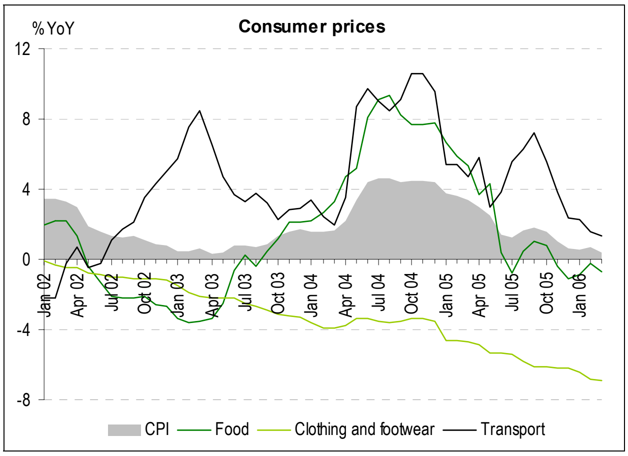
▪ Index of forecasted employment reached the highest level in the history of the survey. Many companies complained about difficulties in finding skilled working force. This is surely one of the reasons contributing to the fact that increasing ratio of enterprises plan raising salaries.

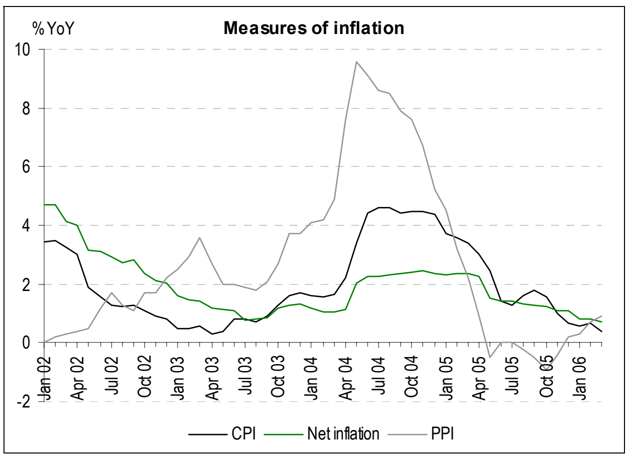
▪ The highest in survey's history was also index of new investment, as the latter are being assisted by good financial situation of enterprises and high reserves of free cash.

Economic update









Source: CSO, NBP, own calculations

Demand for loans building up

- March saw 9.7%YoY rise in money supply, which was below market forecasts and average increase in previous years. Nevertheless, this is still relatively fast growth rate, exceeding nominal growth rate of GDP.
- Annual growth in deposits of enterprises decelerated from 23.2% to 17.6%YoY, while rate of growth in households' deposits slightly accelerated (from 2.7% to 3.1%YoY).
- Total savings of households are rising much faster than suggested by monetary statistics. Growth in deposits held in banks is being capped e.g. by very fast inflow of households' savings into mutual funds (in March this inflow amounted to ca. PLN2.5bn of new money; in April it is estimated to reach PLN2bn).
- As regards factors of money creation, in March a tendency of much stronger rise in households' loans than companies' loans was maintained.
- Among corporate credit, only public companies reduce their debt in banks, while demand for loans from private sector has been rising.
- According to quarterly NBP report on credit market situation, highest demand for loans was recorded in segment of small and medium companies and resulted from growing need for financing investment, stockpiling and turnover capital.
- Banks anticipate further increase in demand for credit from households and keep relaxing credit policy as regards mortgage loans as well as consumption loans.

Inflation rate very close to zero

- Inflation rate declined in March to 0.4%YoY from 0.7% in February. On monthly basis prices fell by 0.1%, which was driven by low food prices (down 0.2%MoM), fuel prices (-0.5%MoM) and clothes and footwear (-0.7%MoM).
- It is difficult to find a demand-pull pressure on prices in the remaining categories, which is represented by the fact that core inflation also remains very low and is still falling.
- Two most important core measures – net inflation and 15% trimmed mean fell in March to 0.7%YoY from previous 0.8%. Three other measures of core inflation were below zero.
- Producer prices increased 0.9%YoY in March, which was above market expectations. However, the data still do not seem to show signs of significant inflationary pressure, at least no signs of pressure other than from prices of oil and other commodities.
- While prices in mining and quarrying rose 9.1%YoY, manufacturing experienced 0.5%YoY decline in prices. This means that so far accelerating economy has not exerted considerable pressure on price growth or it was not strong enough to offset disinflationary effect of increased competition and strong zloty.
- In April, slight increase in CPI inflation is expected e.g. due to hikes in oil and gas prices, but it still seems likely that inflation will stay below 1% for the better part of this year, and only in December will approach 1.5%, the lower end of NBP target.
- The risk factor are prices of oil and other commodities which may finally start translating into prices of other goods amid stronger demand pressure, especially if zloty exchange rate depreciates against US dollar.

Central bank watch

Fragments of the MPC statement from 26 April 2006

The Council maintains its assessment that with large probability inflation will in 2006 Q2 and maybe Q3 remain below the inflation target mainly due to short-term factors. If the developments in the economy were consistent with the April NBP inflation projection, then the current level of the reference rate of the central bank would support a gradual return of inflation to the target over the projection horizon and would also be conducive to keeping economic growth at a pace, which is consistent with the potential output growth, determined by the structural features of the Polish economy.

The fact that inflation and core inflation has stayed below the previous forecasts for a relatively long period may be an indication that the impact of the factors which may slow down the returning of inflation to the target in relation to that accounted for in the projection is stronger than previously assumed. Factors which could potentially accelerate the return of inflation back to the target include a higher wage growth than assumed in the projection, provided it would not be accompanied by sufficiently fast increase of productivity, further oil price hikes or a deterioration of the public finance situation in relation to that envisaged in the Convergence Programme.

Inflation projections NBP (% YoY)

	May 2005	August 2005	January 2006	April 2006
Q4 2006	1.2-3.8	1.0-3.1	0.5-2.3	0.5-2.0
Q4 2007	0.7-4.3	1.2-4.1	1.1-3.6	1.3-3.4
Q4 2008	-	-	0.8-3.9	1.2-3.9

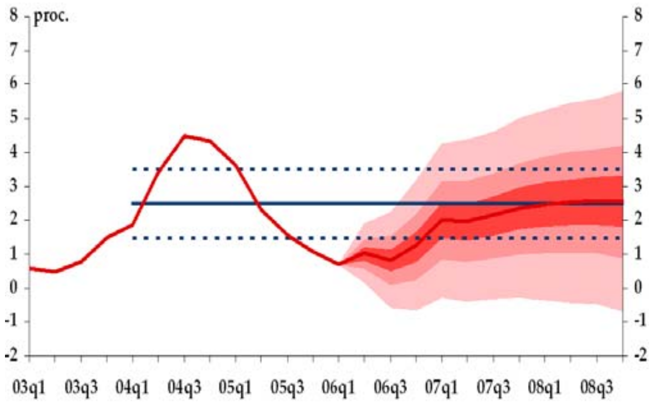
GDP growth projections (%)

	August 2005	January 2006	April 2006
2006	3.9-5.3	3.8-5.1	3.9-5.0
2007	3.8-5.6	3.4-5.2	3.4-5.8
2008	-	3.6-5.5	3.5-6.2

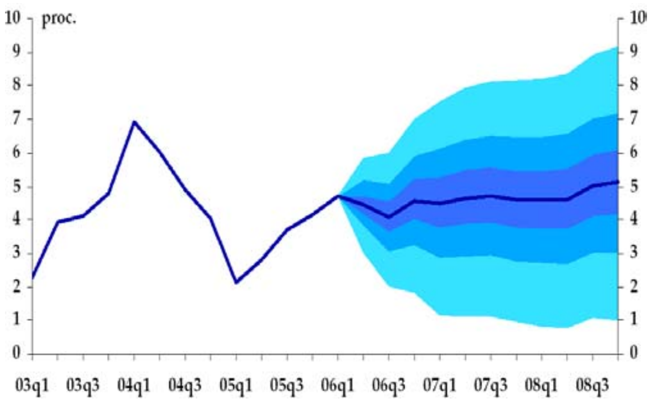
Source: NBP, Inflation Report - April 2006

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

Inflation central projection, fanchart and MPC's target



GDP central projection and GDP fanchart



Source: NBP

Interest rates at adequate level

- As expected, the MPC maintained interest rates unchanged in April, maintaining the main reference rate at 4.0%.
- In the statement the Council listed a number of factors and information that had appeared since the previous meeting, showing that while current inflation remains very low and inflationary pressure is benign, a notable acceleration in economic growth has been recorded, as well as strong revival on the labour market, and upward tendencies in oil prices.
- While it may be noticed that members of the Council have different opinions on the scale of influence of various factors on price increase (or a lack of it), both their previous statements as well as the official communiqué released after the meeting suggested that according to the majority in the Council today's level of interest rates seems to be appropriate from the point of view of current and expected economic situation.
- In our opinion, the MPC statement suggested that inflation path showed by the new inflation projection represented the most likely scenario for the time being. Therefore, we do not change our view that interest rates will remain stable (at least) until year-end.
- Factors most closely watched by the Council include recovery on the labour market, the influence of globalisation factors and development on the commodities' markets on perspective of inflation and GDP growth, perspective of improvement in public finance sector, short- and medium-term influence of UE accession on foreign exchange market and inflation.
- The key questions for the Council are (1) will the observed increase in the number of working persons prove sustainable? and (2) what is and will be the role of demand and supply factors in the rise in the number of working persons?

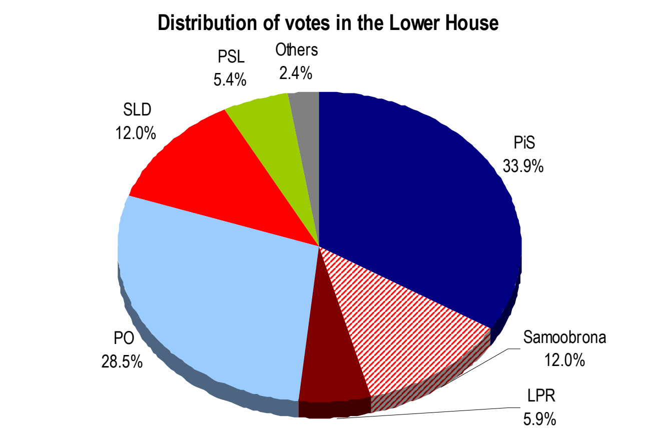
Better growth perspective, uncertainty as regards inflation

- As it is widely known, important argument in discussion about interest rates level in April was the new Inflation Report, which included new inflation and GDP growth projections.
- New projections show stronger economic growth rate within forecast horizon, especially in 2007-08, in relation to January's prediction. As regards inflation, situation is more complicated, as CPI path expected for this year is lower than before, while it goes higher than forecasted three months ago only in 2008.
- Although according to the NBP's authors of the projection, there was higher risk of inflation running above the central predicted path than the probability of running below this path, because of balance of factors not accounted for in the estimation, it seems such opinion should not influence financial markets as long as it is not shared by the majority of the MPC.
- The output gap will remain negative over the whole projection horizon and will be closing up faster than it was anticipated in the previous forecast. However, it is worth to notice that after re-estimation of model equations, some key dependencies between macroeconomic variables have changed. Weakening reaction of inflation to interest rate (it was quite weak anyway) and exchange rate changes, as well as lower importance of domestic economic factors may suggest that further rate cuts would not necessarily have significant negative impact on inflation, or alternatively, even faster than predicted economic expansion must not result in excessive rise in inflation.
- Additionally, according to the Council, the medium term path of the real zloty exchange rate accounted for in the inflation projection may fail to sufficiently account for such fundamental factors as growing demand for Polish exports following Poland's accession to the EU and the inflow of EU funds.

Central bank watch

Comments of the central bank representatives	Our remarks
Leszek Balcerowicz, NBP President, MPC chairman **MPC press conference, PAP, 26 April** [Q: What will be the effect of uncertainty factors' influence on inflation?] The MPC said what it wanted to say after the meeting today. (…) The opinion within the Council is not unanimous. According to the authors of the model inflation may be rather higher than showed by the April's projection. **Andrzej Wojtyna, MPC member** **MPC press conference, PAP, 26 April** The advantage of joint decision of the Council is the fact that MPC members have different opinions and their view is under influence of different factors. Relative power of several factors influencing inflation is different for different MPC members.	The difference in opinions of MPC members as regards uncertainty factors influencing inflation outlook was clearly visible during the press conference after the MPC meeting. While the point of view of NBP President may be identified with the opinion of the authors of new inflation projection (and/or vice versa). This view presented in the chapter IV of the *Inflation Report* (diminished importance of factors driving to lower inflation and emphasising the importance of those, which can lead to higher inflation) does not seem to be shared by the majority of the Council's members, in our opinion. This is reflected in interviews with some MPC members as well as in the MPC voting results in the first quarter, which was also presented in the *Report*. That is why, to asses probability of next moves in monetary policy, one should not take into account comments given by NBP President, but statements of those members, who form majority (e.g. professors Sławiński and Wojtyna – see below)
Andrzej Sławiński, MPC member **PAP, 19 April** I see no risks for inflation except a temporary threat connected with high oil prices. As regards oil, fundamentals factors alone would not affect such significant rise in prices as we observe today. The most important argument is international, geopolitical situation connected with the situation in Iran. Rise in oil prices is not a significant risk for inflation, as it was the case during the first two oil shocks, as in many countries difference between core inflation and CPI inflation remains quite considerable. As for the moment, the level of interest rates is favourable to keep GDP growth close to its potential level.	Professor Sławiński does not see major inflation risks except a temporary oil price increase (temporary as driven by geopolitical factors rather than by fundamentals). In his opinion the current level of interest rates is favourable from the point of view of economic growth perspective, which should be close to potential. Nevertheless, it seems that unexpectedly low CPI figures for March made some impression on Sławiński. He said that reasons of this situation will require in-depth analysis. As for now, he suggested that persistently low level of inflation in Poland results not only from one-off factors, but also from structural changes such as globalisation that affects many economies and functioning of labour markets.
Halina Wasilewska-Trenkner, MPC member **PAP, 28 March** Current level of interest rates is appropriate as there is quite high GDP growth and such level of interest rates is not slowing down the economy. But inflation risks maintain although they moved forward and we can be calmer today. We have such level of interest rates that we should be very careful not to undermine good situation in the economy by a rash decision as regards both a rate cut and a rate hike. If there is no major turmoil, NBP interest rates should be stable until year-end. We should not take any decisions, which would change conditions in the environment of accelerating economy and thus we have wait-and-see approach as for today. Rate cut by 25 bp would be a risky step in current situation. From international markets point of view (high prices of commodities, high growth) we should take into account rather hike than cut in rates in following years.	Comments made by Halina Wasilewska-Trenkner confirmed our view that interest rates should remain stable (at least) until year-end. Although among MPC members there appear already a gentle suggestion that the next move in monetary policy could a hike, in our view, however, the alternative scenario should assume a possibility of rate cut during this year if it turns out that inflation is lower than predicted and economic growth decelerates. Of course, one should notice that a perspective of a rate hike presented by the MPC member is a question of quite distant future and today such a decision would be equally "rash" as a rate cut, in her opinion. Halina Wasilewska-Trenkner added that inflation projection showed a quite long period of low inflation and no substantial rise in price dynamics should be expected. This seems to confirm that for the majority of the MPC members the scenario presented in the inflation projection may be the most likely outcome Of course, as usual, there are some risk factors for inflation (high growth, global situation) but they do not seem to create major risk for inflation target in the medium-term.
Andrzej Wojtyna, MPC member **Reuters, 19 April** I agree with opinions of my colleagues that rates are roughly at an appropriate level, but this is not a given. In the following months it may turn out that the structural factors may work more against inflation pressure than the model suggests. That would change the expected path of inflation and I do not rule out that room for fine-tuning will appear, even this year. I do not rule out that deflation of consumer prices appear in some months of this year. Anyway, inflationary pressure is still very low and CPI inflation will return to the target at slower pace than we predicted before unless some shocks appear. Inflation will return to the target in 2008, but this may be changes by shocks on the food or oil markets. As we saw during the last year, exchange rate may be subject of quite large moves in both directions, Therefore, when taking decisions the MPC should treat the impact of zloty volatility on inflation fairly neutrally as a current factor. This should not be treated as overly important form the point of view of medium-term inflation perspective, as it is very volatile. As regards the assessment of the new coalition's policy it will be important whether the finance minister will change, what will be the shape of the next year's budget. A large part of Samoobrona's proposals, which worried us, seems to be withdrew.	Opinion of professor Wojtyna seems to be very important from the point of view of possible changes in official interest rates. That is why, his views that structural factors may limit inflation pressure more significantly than it is assumed by the central bank's model and that future inflation path may improve, may be an argument to allow a possibility of another rate cut. We should remember that the opinion of the MPC as a whole may change under influence of new economic data releases. In the *Inflation Report* the MPC said "the fact that inflation and core inflation has stayed below the previous forecasts for a relatively long period may be an indication that the impact of the factors which may slow down the returning of inflation to the target in relation to that accounted for in the projection is stronger than previously assumed". Professor Wojtyna suggested also that when making decisions on interest rates the MPC should not be influenced by short-term movements on the foreign exchange market. However, according to the *Report*: "the findings of the NBP surveys indicate that the medium term path of the real zloty exchange rate accounted for in the inflation projection may fail to sufficiently account for such fundamental factors as growing demand for Polish exports following Poland's accession to the EU and the inflow of EU funds". As regards political factors, Wojtyna mentioned an autonomy of economic situation from politics, but expressed a worry about slowing down reform process and economic programme of the new coalition.

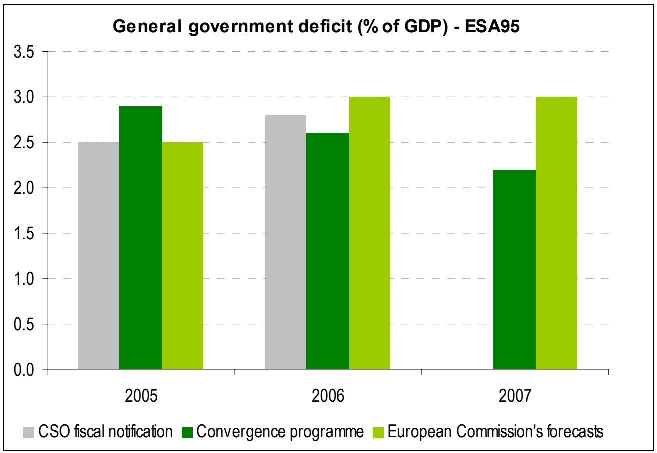
Government and politics

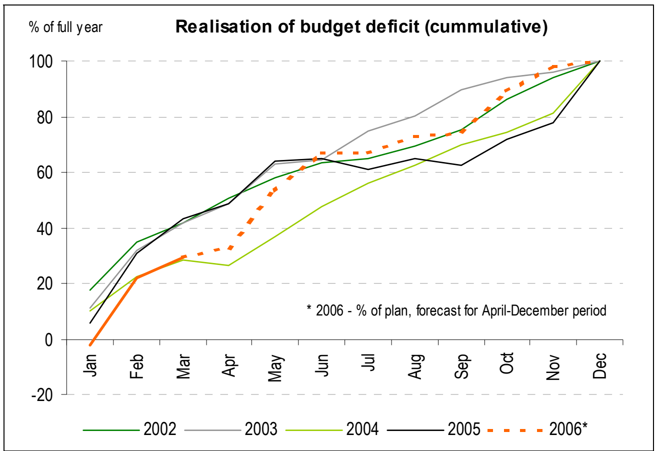


Rating/ outlook fro long-term debt

Country	In foreign currency S&P	Fitch	Moody's
Czech Republic	A– / Positive	A / Stable	A1 / Positive
Hungary	A– / Negative	BBB+ / Stable	A1 / Negative
Poland	BBB+ / Stable	BBB+ / Positive	A2 / Stable

Country	In local currency S&P	Fitch	Moody's
Czech Republic	A / Positive	A+ / Stable	A1 / Positive
Hungary	A– / Negative	A– / Stable	A1 / Negative
Poland	A– / Stable	A / Stable	A2 / Stable





Source: CSO, European Commission, Ministry of Finance, opinion polls

Majority coalition, cabinet reshuffle

▪ Law and Justice managed to gain majority support in the parliament together with two populist parties. Samooobrona and League of Polish Families (LPR) got five ministers seats (Ministry of Agriculture, Ministry of National Education, Ministry of Labour and Social Policy, Ministry of Construction, Ministry of Marine Economy).

▪ Market reaction was neutral as populists seemed to soften rhetoric withdrawing from costly and controversial proposals (see next page for details).

▪ Fast economic growth will probably allow constructing budget for the next year with the deficit of around PLN30bn even if it was connected with slightly higher spending. However, it is difficult to expect that good economic conditions will be used as an opportunity to lower fiscal deficit significantly.

S&P sees risks first (as usual)

▪ Standard & Poor's Ratings Services revised its outlook on Poland to stable from positive. At the same time sovereign credit ratings on Poland were affirmed.

▪ The revision was justified by "ongoing political uncertainty, unclear prospects for structural reform and fiscal consolidation, and a deteriorating perspective for euro zone accession", as those worrisome factors offset Poland's good macroeconomic prospects. Thus, further steps depend on economic policy.

▪ While "stable" outlook on Poland seems to be justified by the fact that uncertainty regarding political situation and government's macroeconomic policies is indeed quite substantial, one cannot forget that Poland's situation compares favourably with other countries in the region where sovereign ratings are better than ours (e.g. Hungary).

Lower fiscal deficit in 2005, higher forecasts for 2006

▪ The stat office informed that according to recent fiscal notification that was sent to the European Commission, budget deficit in 2005 was better than expected and amounted to 2.5% of GDP, and public debt 42.5% of GDP.

▪ The result is better than earlier estimations, as in the Convergence Programme update prepared in January the Ministry of Finance assumed that government deficit in 2005 reached 2.9% of GDP (whit public debt was assumed the same).

▪ CSO press release said also that according to current Ministry of Finance's forecasts, fiscal deficit in 2006 is estimated at 2.8% of GDP, which is higher than 2.6% predicted in the last Convergence Programme. the European Commission is even more pessimistic, but this is partly justified by lower GDP forecasts (of ca. 4.5% in 2006-07).

Budget realisation in line with the plan

▪ Budget deficit at the end of 1Q06 reached 29.4% of the full-year plan, i.e. almost PLN9bn.

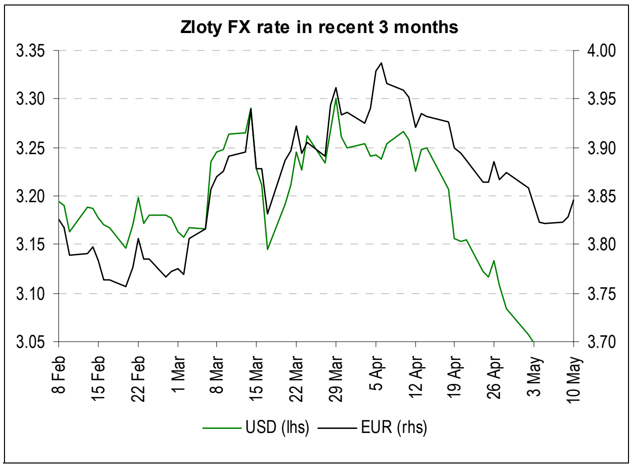
▪ In 1Q06 revenues from indirect taxes grew 12.4%YoY versus 10.6% growth targeted for the whole year. PIT inflows after March increased 10.9%YoY versus the full-year target of 6.9%. Growth in CIT revenues after March was lower than the target for the whole year (13.6% against 27.8%YoY), but this is relatively the least important item in total tax revenues. In Q1 there were no FX transactions on the market by the ministry.

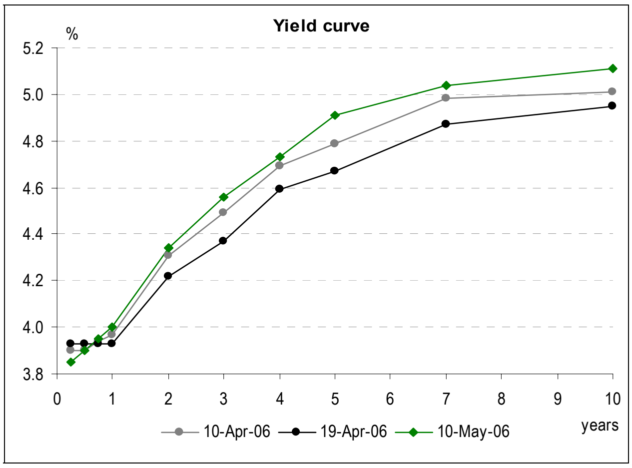
▪ The Ministry of Finance showed a detailed monthly path of predicted budget performance in 2006. This assumes very good result in April (deficit a bit above 30% of the plan), then significant increase to almost 67% of plan in mid-year and another big rise is planned in October-November.

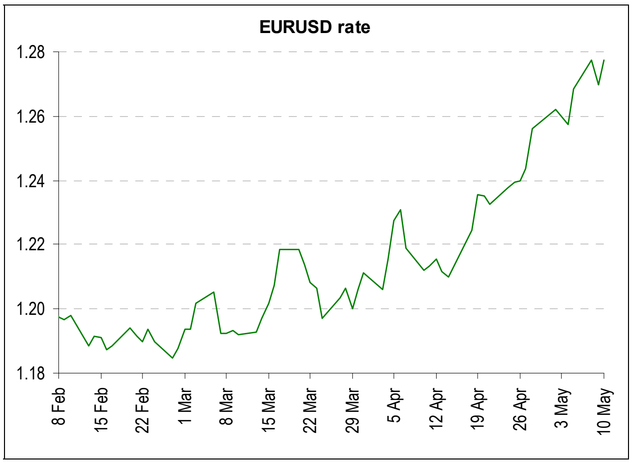
Government and politics

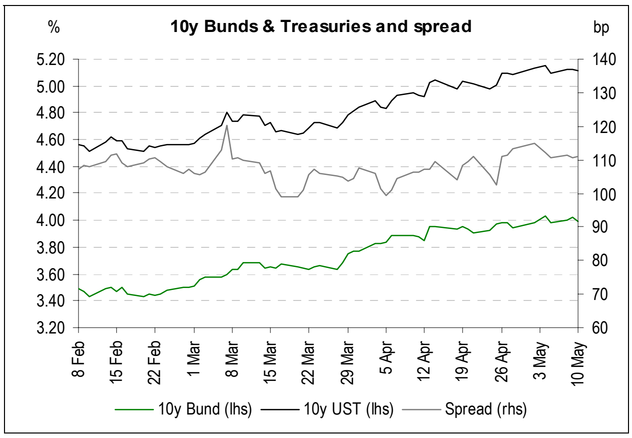
Comments of government representatives and politicians	Our remarks
Kazimierz Marcinkiewicz, Prime Minister **Parkiet, 8 May** We already have 5% GDP growth. We have fast rise in production. We have very low inflation. Moreover: economic growth is based not only on one pillar, but on three pillars: consumption, exports, and growth in investment – and not only external but also domestic. So if there are some entrepreneurs that say they are not happy with the government, and at the same time they are investing money in Poland, it means they say one thing and do another. (...) All our actions are aimed at strengthening elements of growth: consumption, export, investment. It will lead to rise in employment and will strengthen economic growth. (...) Possibly we will be forced to cut the deficit. Therefore, we will have to temporarily withdraw from some of proposals regarding tax cuts (...) We hope that since next year budget will save [on administration] PLN1-2bn net. This year it could be several hundred million PLN.	PM Marcinkiewicz was one of the first that foresaw such fast economic revival. Apparently, official optimism pays sometimes. Although there were not so many achievements of the government on the field of economic policy (bill on public orders), but clearly the government did not hurt the economy too. A positive fact is that an acceleration in domestic demand is taking place, which in fact implies that consumers and entrepreneurs are not afraid of economic future (expectations play a crucial role in economics). Nevertheless, we are most of all interested in what the government will do with such good business climate. Suggestions about possible deficit reduction are highly welcome. In interview with Parkiet Marcinkiewicz said that this year the treasury minister will proceed with IPO of Ruch and one of energy companies. Such two companies are not enough to fulfil ambitious target of privatisation revenues. Especially that after a coalition is formed, a will to privatise faster will not strengthen by any means.
Zyta Gilowska, deputy PM, finance minister **Reuters, Forbes 27 April** Perhaps I am not typical because I do not see myself as a NBP chief. NBP presidency seems dull to me, six-year tenure is a long way. I am a professor of economics and I have things to do after I quit. (...) I guess I should stay [in the cabinet], I give no guarantees. It depends on the course of events. (...) It would be good to apply new public finance law to 2007 budget. Thus, I should survive until passing it. I do not know whether it is real. **Reuters, 5 May** Government's economic policy has to be responsible. Good fiscal policy has to be government's priority. [Q: Will you stay in the cabinet?] A: If the government's policy is like this.	From the financial markets' point of view, Zyta Gilowska's position in the government is key to ensuring that implemented economic programme will not be under influence of populist parties. Thus, as long as Gilowska stays in the office and prepares 2007 budget, the market should remain fairly stable. However, the minister's sentence that she should last in place until passing the budget suggests that next year's budget and public finance bill could be her last task in the cabinet. If the budget is bad, she could quit even earlier than that. Gilowska's next job, assuming the present one ends, will not be position of NBP chief, as the interview with Forbes shows that this is not of her interest. The minister said she would have many things to do as a professor of economics, so it seems that a job of Warsaw major is also not considered.
Jacek Krzyślak, director of MinFin research Dep. **Reuters, 5 May** Our	April's inflation will be very important for the market. Higher inflation forecast of the Ministry of Finance cannot be ignored, as their estimation was the only accurate on the market in the previous month. We also assume higher prices of food gas and oil, although it seems that at slower pace, as our forecasts point to roughly stable annual inflation in both April and May as compared to March level.
Jarosław Kaczyński, PiS president **Newsweek Polska, 8 May** [Q: What is your non possumus in economic policy?] We will not agree for hitting FX reserves and for worsening relations with the European Union, and we will stick to the budget anchor. Although leftist government in Hungary boosted deficit to 8% (of GDP) spending money on development, e.g. on motorways. European Commission grumbled but did nothing. But if PM Orban did the same, he would probably be slapped by his hands.	The answer to the question "what will be the new government's economic policy?" will have to wait some time, probably until the budget for 2007 will be known. During work on the bill there will be probably many clashes, but in its final shape it should be just a budget of continuation, i.e. with no major reforms but also without unrestrained spending surge. Apart from assurances from Prime Minister and finance minister about reasonable economic policy, recently we have also heard a voice of PiS leader. He did not allow for boosting budget deficit, e.g. because of concerns of sanctions from the EU that in his opinion could apply more restrictive assessment to right-wing government (example of Hungary). Additionally, Kaczyński's comment shows that populists have no chances for reaching for FX reserves. Similar conclusions can be drawn from statements of Samoobrona and LRP leaders. The most controversial (and often economically absurd) postulates have been put aside (hopefully for long). Interestingly, even leader of LPR said that conditions of euro zone entry are disciplining for the economy. Although of course one cannot hope for acceleration as regards Poland's accession to the euro zone. Additionally, LPR insists on tax reduction. In the quoted comments of three party leaders there is no mention about change in NBP charter. However, this problem was a part of so-called stabilisation pact and we think it is still in the agenda, being a risk factor for the financial market. It remains unknown in what shape the change will be made, but if maintaining high economic growth / low unemployment will become an equally important goal for the NBP as fighting inflation, it could negatively affect the market (passing over in silence how this could be achieved in practice).
Andrzej Lepper, chief of Samoobrona **Reuters, 5 May** At this stage there is no chance in implementing our ideas of turnover tax and social minimum. Coalition agreement includes a budget anchor at PLN30bn, which we will not breach. However, we want to negotiate quotas, which was already started by minister Jurgiel. We want to have influence on distribution of EU funds.	
Marek Kotlinowski, chief of League of Polish Families **Reuters, 5 May** We want to raise a question whether FX reserves that reach ca. USD45bn are properly used. We do not put it as an ultimatum, but as a hard question. Requirements connected with euro zone accession are disciplining for the economy, on inflation and debt (...) We have our economic doctrine but we realise that we will not dominate in this area, although we want to raise several issues as open questions, i.e. one-time payment for senior citizens, that could be easily considered at the occassion of next year's budget.	

Market monitor









Source: Reuters, BZ WBK

Better moods on the emerging markets

- Since the release of April report zloty substantially strengthened, which was a consequence mainly of increased expectations on sooner pause of monetary policy tightening in the U.S. This resulted in decreased interest of investors' toward the dollar in favour of the euro and inflow of capital on the emerging markets. The influence of concluding PiS coalition with more radical parties was and rather will stay neutral. Finally zloty strengthened against the single currency by ca. 3% and versus the dollar by ca. 8%.
- In the perspective of uncertain situation on the global market (further Fed's decisions as well as EURUSD rare direction) we assume zloty will fluctuate in the short term near in not too wide range. Later on this year (Q3) in our view zloty is going to depreciate with regards to speculation of potential finance minister's resignation near the term of final work on budget 2007.

Curve steepening

- During the last month Polish debt slightly weakened at the longer end of the curve and a deeper loss was incurred at the longer end of the curve, which contributed to a steepening of the yields curve. Initially low CPI supported the short maturity papers as well as comments of some MPC's members that on a potential rate cut yet this year, however strong production data as well as situation on the core markets resulted in a weakening.
- Despite the low inflation very good data indicating rising economic growth work against the rate cuts. In the basis scenario we assume no monetary policy easing till the end of this year. If the zloty continues to strengthens and the CPI falls near zero then the MPC may venture to cut rates later on this year, though rate hikes in the euro zone and potential possible further monetary policy tightening in U.S. as well as uncertainty about the budget 2007 may be an argument against.

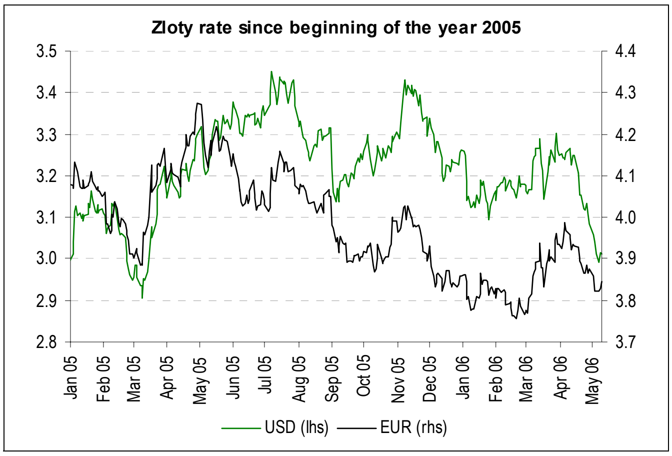
Change of rate expectations strengthens the euro

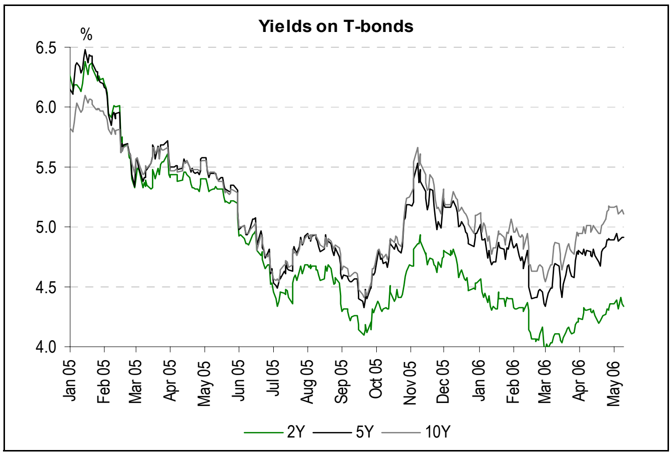
- Since the publication of the previous report the single currency appreciated against the dollar by ca. 5.5% and reached the strongest level in a year mainly in reaction to higher expectations on earlier pause of interest rate hikes in the U.S. The euro gained after the release of good economic data in the euro zone (Ifo) and on information that some central banks increase the share of euro in the currency reserves at the cost of the greenback. Another dollar-negative signal were poor U.S. non-farm payrolls and ECB's communiqué suggesting rate hikes in the EMU.
- Amid a potential pause in the monetary policy tightening in the U.S., accelerating economic activity in the euro zone and rate hikes in Japan the positive rate differential in U.S. may be of lesser importance. The dollar may be negatively affected by the structural imbalances reflected by twin deficits and next data releases, while figures in the EMU may support the euro.

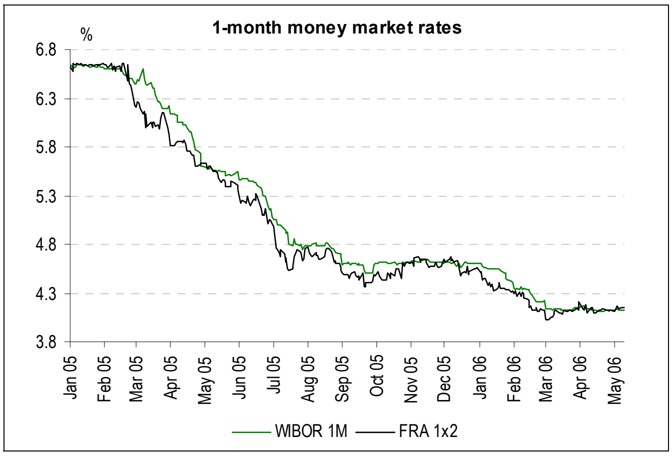
The weakening on the core markets continues

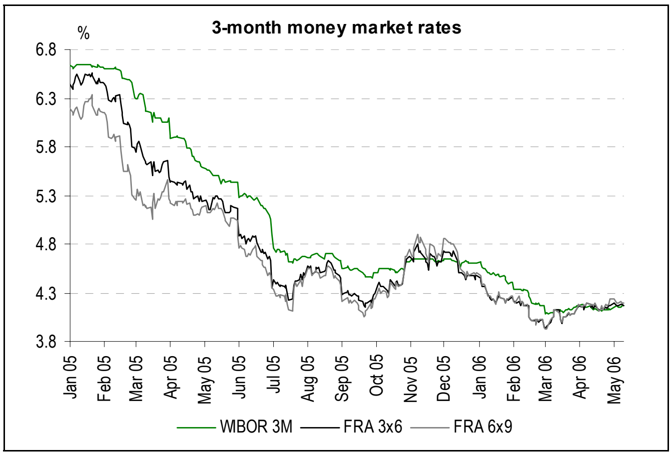
- Treasuries prices fell to the lowest level for 4 years with 10Y yields up from 4,.98% to 5.11% (the highest at 5.16%) and Bunds from 3.9% to 4.0%, among others due to higher than expected core U.S. CPI, the highest in 15 year Ifo index, good activity indices and ECB comments suggesting further rate hikes in the euro zone. Weaker than expected U.S non-farm payrolls contributed to a small correction.
- If the economic situation in the euro zone will still improve, which will be reflected in the released data, the European bond markets may be still under pressure. Even more essential than so far will be data published in United States, because after last Fed's communiqué they will be of key importance for the potential pause or even end of further rate increases in U.S.

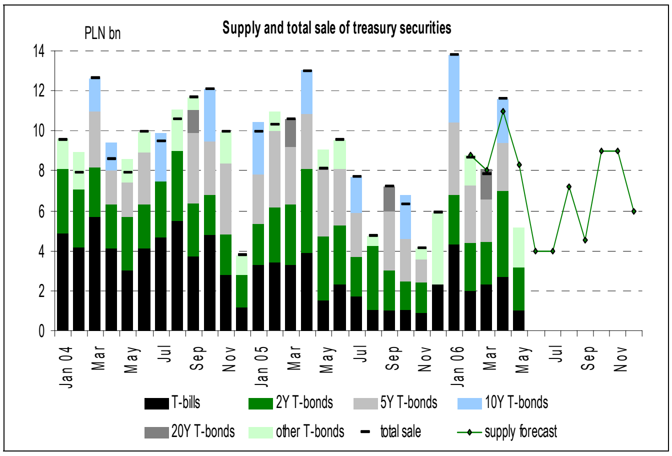
Market monitor











Treasury bill auctions (PLN m)

Date of auction	OFFER / SALE 26-week	52-week	Total
06.03.2006	-	1 000 / 1 000	1 000 / 1 000
20.03.2006	-	1 300 / 1 300	1 300 / 1 300
Total March	**-**	**2 300 / 2 300**	**2 300 / 2 300**
03.04.2006	700 / 700	1 000 / 1 000	1 700 / 1 700
24.04.2006	300 / 300	1 000 / 1 000	1 300 / 1 300
Total April	**1 000 / 1 000**	**2 000 / 2 000**	**3 000 / 3 000**
08.05.2006	-	1 000 / 1 000	1 000 / 1 000
22.05.2006	-	1 000 - 1 300	1 000 - 1 300
Total May*	**-**	**2 000 - 2 300**	**2 000 - 2 300**

* estimations based on Ministry of Finance preliminary information

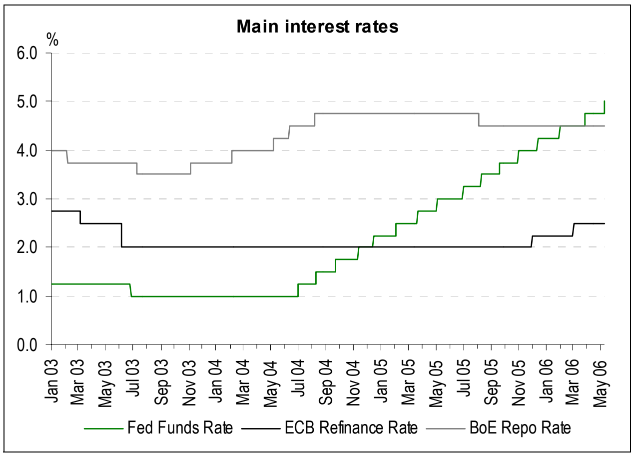
Treasury bond auctions in 2006 (PLN m)

month	First auction				Second auction				Third auction			
	date	T-bonds	offer	sale	date	T-bonds	offer	sale	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*	OK0408	2 400	2 300	08.02	WZ0911 | IZ0816	1 000 | 500	1 000 | 493	15.02*	DS1110	2 880	2 880
March	01.03*	OK0408	2 160	2 160	08.03	WS0922	1 500	1 500	15.03*	PS0511	2 160	1 880
April	05.04*	OK0408	4 320	4 320	12.04*	DS1015	2 160	2 160	19.04*	PS0511	2 400	2 400
May	04.05*	OK0808	2 160	2 160	10.05	WZ0911 | IZ0816	500 | 1 500	500 | 1 500	17.05	PS0511	1 800 – 2 800	-
June	07.06	2L	-	-	14.06	20L	-	-	21.06	5L	-	-
July	05.07	2L	-	-	12.07	10L	-	-	-	-	-	-
August	02.08	2L	-	-	09.08	7L WIBOR | 12L CPI	-	-	-	-	-	-
September	06.09	2L	-	-	13.09	20L	-	-	20.09	5L	-	-
October	04.10	2L	-	-	11.10	10L	-	-	18.10	5L	-	-
November	02.11	2L	-	-	08.11	7L WIBOR | 12L CPI	-	-	15.11	5L	-	-
December	06.12	2L	-	-	-	-	-	-	-	-	-	-

* with supplementary auction

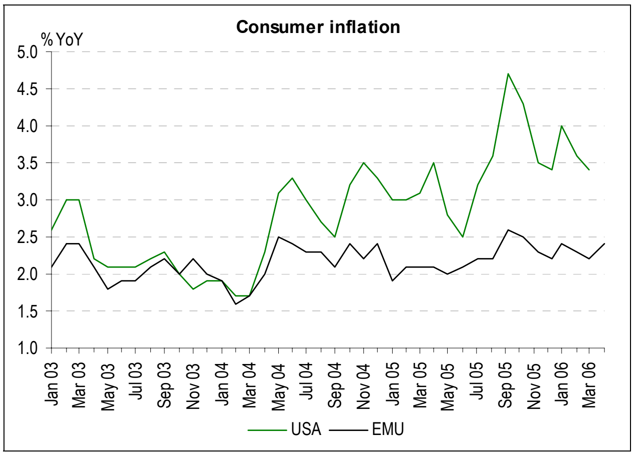
Source: Ministry of Finance, Reuters, BZ WBK

International review



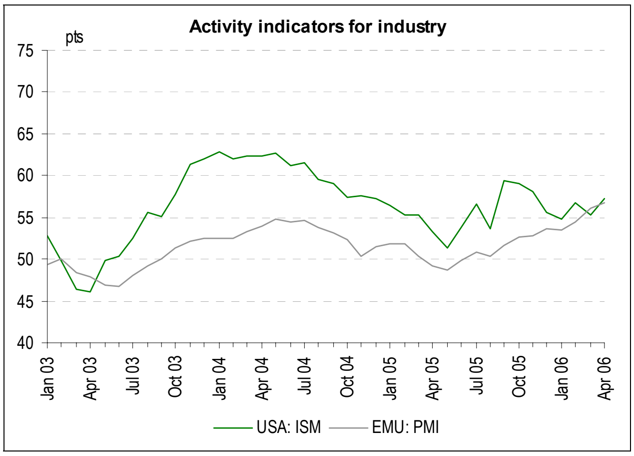
Hawkish Trichet; possible pause in rate hikes in U.S.

- FOMC raised the federal funds rate by 25 bp for the 16th consecutive time to 5% maintaining the language that "some further policy firming may yet be needed", although the statement added also that "the extent and timing of any such firming will depend importantly on the evolution of the economic outlook" by which it left the door open for a pause in rate hikes in case upcoming economic data show a deceleration in economic activity.
- At the May meeting the European Central Bank left the main reference rate in the euro zone unchanged and the ECB's president's Jean-Claude'a Trichet comments were more "hawkish" than expected. The market participants may not rule out a rate hike by 50 bp in June, although rate hikes at a pace of 25 bp per quarter are much more probable.



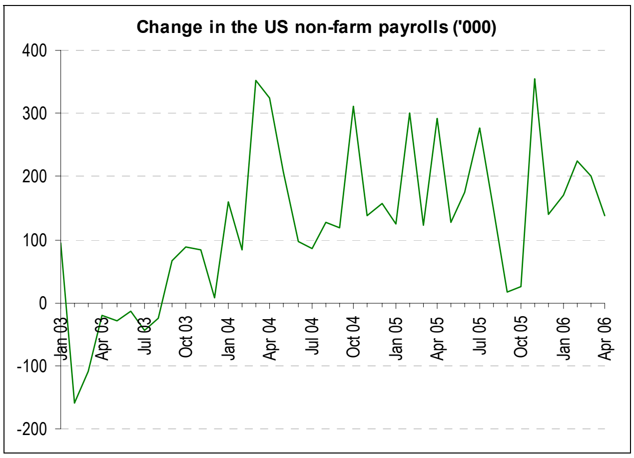
Core CPI higher than expected, core PPI the opposite

- March CPI figure in U.S. rose by 0.4%, which was in line with market consensus and was a consequence generally of increased energy prices by 1.3%. In annual terms the inflation fell from 3.6% to 3.4%. Core CPI increased in March by 0.3%MoM and 2.1%YoY, which was the highest rise in a year. Producer prices rose by 0.5%MoM, and the core figure inched up slightly by 0.1%MoM and 1.7%YoY and was above the analysts forecasts at 0.2%MoM and 0.3%MoM in February.
- Inflation in the euro zone amounted in March to 2.2%YoY as compared to 2.3%YoY in February. On the other hand preliminary estimates of Eurostat for April show an increase of HICP index to 2.4%YoY, which was above market expectations and was partly a result of higher oil prices.



Euro zone activity indices in the rising trend

- U.S. manufacturing ISM index was higher than expected and rose to 57.3 against the expected 55.0. Non-manufacturing index appeared to be higher than forecasts rising in April to 63 from 60.5 in March. Employment index increased to 56.5 from 54.6 in March, while the prices paid index jumped to 70.5 in April from 60.5 in the previous month. Data suggests, that at the beginning of the Q2 the pace of U.S. economic growth accelerated and inflation pressure increased.
- PMI index reflecting the economic activity in the euro zone increased in April to 56.7 from 56.1 in March, which was in line with expectation. The services PMI index increased in April to 58.3 from 58.2, which was slightly below market consensus at 58.5.
- Another advance Q1 GDP estimate for the U.S. economy was below market expectations (4.9%) and amounted to 4.8%. GDP deflator rose by 3.3% as compared to 3.5% in Q4 2005. Exports and imports increased respectively by 12.1% and 13%, while consumer spending by 5.5% (0.9% in Q4), the fastest pace since Q3 2003.



Source: Reuters, ECB, Federal Reserve

Disappointing labour market data

- The non-farm payrolls in April amounted to 138k and was significantly below market consensus of 200k. Moreover March data were downwardly revised to 200k and the unemployment rate remained at 4.7%.
- In the Q1 average unit labour costs in the U.S. economy increased by 2.5%, which was substantially above market expectations and increased fears of inflation pressure. At the same time labour productivity increased by 3.2%, which was close to analysts forecasts.

Economic calendar

Monday	Tuesday	Wednesday	Thursday	Friday
8 ***POL: Treasury bills auction***	**9** USA: Wholesale inventories (Mar)	**10** ***POL: Auction of 7Y floating rate bonds and 12Y CPI linked bonds*** USA: Fed meeting – decision USA: Fed budget (Apr)	**11** EMU: Preliminary GDP (Q1) USA: Retail sales (Apr)	**12** ***POL: Money supply (Mar)*** USA: Foreign trade prices (Apr) USA: Foreign trade (Mar) USA: Preliminary Michigan (V)
15 **POL: CPI (Apr)** USA: Net capital flows (Mar)	**16** GER: ZEW index (Apr) USA: PPI (Apr) USA: House starts (Apr) USA: Build permits (Apr) USA: Capacity use (Apr) USA: Industrial production (Apr)	**17** ***POL: Auction of 5Y bonds*** ***POL: Wages (Apr)*** ***POL: Employment (Apr)*** ***POL: Balance of payments (Mar)*** EMU: Industrial output (Mar) EMU: Final HICP (Apr) USA: CPI (Apr)	**18** USA: Philadelphia Fed index (V)	**19** ***POL: PPI (Apr)*** ***POL: Output in industry and construction (Aprr)*** JPN: BOJ meeting – decision EMU: Foreign trade (Mar)
22 ***POL: Treasury bills auction***	**23** ***POL: Business climate (Mar)*** ***POL: Net inflation (Mar)***	**24** ***POL: Retail sales (IV)*** ***POL: Unemployment (IV)*** GER: IFO index (May) USA: Durable goods (Apr) USA: New homes sales (Apr)	**25** USA: Preliminary GDP (Q1) USA: GDP deflator (Q1) USA: Home sales (Mar)	**26** USA: Final Michigan (V)
29 US, GB: Market holiday	**30** ***POL: MPC meeting*** EMU: M3 money supply (IV) USA: Consumer confidence (V)	**31** ***POL: MPC meeting – decision*** ***POL: GDP (Q1)*** EMU: Consumer sentiment (V) EMU: Economic sentiment (V) EMU: Preliminary HICP (V) USA: Chicago PMI (V)	**1 June** EMU: PMI manufacturing (May) EMU: Revised GDP (Q1) EMU: Unemployment rate (IV) USA: Revised unit labour cost (Q1) USA: Revised labour productivity (Q1) USA: Manufacturing ISM (May)	**2** EMU: PPI (Apr) USA: Non-farm payrolls (May) USA: Unemployment (May) USA: Factory orders (Apr)
5 ***POL: Treasury bills auction*** GER, GB: market holiday USA: ISM non-manufacturing (May)	**6** EMU: PMI non-manufacturing (May)	**7** ***POL: Auction of 2Y bonds*** EMU: Retail sales (Apr)	**8** GB: BoE meeting – decision (May) EU: ECB rate decision (May) USA: Wholesale inventories (Apr)	**7** USA: Foreign trade prices (May) USA: Foreign trade (Apr)

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	27-28	28-29	25-26	30-31	27-28	25-26	29-30	26-27	24-25	28-29	19-20
GDP*	-	-	2	-	31	-	-	30	-	-	30	-
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	23	23	26	24	-	-	-	-	-	-	-
Gross wages, employment	16	15	15	18	17	16	17	16	15	16	16	15
Unemployment	24	23	23	26	24	-	-	-	-	-	-	-
Foreign trade	about 50 working days after reported period											
Balance of payments*	-	-	31	-	-	30	-	-	-	-	-	-
Balance of payments	13[c]	13	14	12	17	14	13	11	-	-	-	-
Money supply	13	14	14	14	12	14	14	14	-	-	-	-
NBP balance sheet	6	7	7	7	5	7	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

		Apr 05	May 05	Jun 05	Jul 05	Aug 05	Sep 05	Oct 05	Nov 05	Dec 05	Jan 06	Feb 06	Mar 06	Apr 06	May 06
Industrial production	%YoY	-1.1	0.9	6.9	2.6	4.8	5.9	7.6	8.5	9.6	9.8	10.2	16.4	3.9	14.7
Retail sales [c]	%YoY	-14.4	8.0	10.5	5.0	7.9	5.4	7.5	7.3	6.3	8.6	10.2	10.1	14.4	13.6
Unemployment rate	%	18.8	18.3	18.0	17.9	17.8	17.6	17.3	17.3	17.6	18.0	18.0	17.8	17.2	16.9
Gross wages [b c]	%YoY	1.8	3.0	4.5	3.2	2.8	1.8	6.4	6.9	1.5	3.6	4.8	5.4	5.8	5.8
Employment [b]	%YoY	1.7	1.6	1.7	1.8	2.0	2.2	2.1	2.5	2.6	2.6	2.4	2.7	2.6	2.6
Export (€) [d]	%YoY	6.9	17.0	15.9	18.0	14.9	12.9	18.0	14.8	22.0	19.9	18.0	18.5	9.8	12.3
Import (€) [d]	%YoY	-5.0	12.4	12.8	7.8	15.5	11.0	14.6	17.5	17.4	19.3	17.1	15.3	8.2	9.8
Trade balance [d]	EURm	-94	-454	-80	-113	-378	-107	-28	-270	-395	139	-8	-145	0	-350
Current account balance [d]	EURm	6	-678	181	-247	-381	-237	-326	-408	-359	-76	-538	-165	140	-500
Current account balance [d]	% GDP	-2.8	-2.6	-2.2	-1.8	-1.8	-1.5	-1.5	-1.6	-1.5	-1.3	-1.3	-1.3	-1.2	-1.2
Budget deficit (cumulative)	PLNbn	-13.9	-18.3	-18.5	-17.5	-18.5	-17.8	-20.6	-22.2	-28.6	0.7	-6.7	-9.0	-10.0	-16.3
Budget deficit (cumulative) [e]	% realisation	48.6	64.0	64.8	61.1	64.7	62.3	72.1	77.7	100.0	-2.3	21.9	29.4	32.7	53.4
CPI	%YoY	3.0	2.5	1.4	1.3	1.6	1.8	1.6	1.0	0.7	0.6	0.7	0.4	0.4	0.3
PPI	%YoY	0.9	-0.5	0.0	0.0	-0.2	-0.5	-0.9	-0.4	0.2	0.3	0.7	0.9	0.9	1.2
Broad money (M3)	%YoY	10.0	13.2	10.8	10.4	11.1	12.7	8.7	12.6	10.4	10.4	11.7	9.7	9.7	8.3
Deposits	%YoY	8.7	11.9	9.2	9.4	10.1	11.6	6.3	11.1	9.4	10.2	10.8	9.0	9.4	7.9
Loans	%YoY	5.3	9.4	7.4	8.8	9.0	9.6	4.4	10.2	11.8	12.3	13.5	13.5	13.4	13.2
USD/PLN	PLN	3.21	3.29	3.34	3.40	3.29	3.20	3.26	3.37	3.25	3.16	3.18	3.23	3.20	3.04
EUR/PLN	PLN	4.16	4.18	4.06	4.10	4.05	3.92	3.92	3.97	3.85	3.82	3.79	3.88	3.92	3.86
Reference rate [a]	%	5.50	5.50	5.00	4.75	4.75	4.50	4.50	4.50	4.50	4.50	4.25	4.00	4.00	4.00
Lombard rate [a]	%	7.00	7.00	6.50	6.25	6.25	6.00	6.00	6.00	6.00	6.00	5.75	5.50	5.50	5.50
WIBOR 3M	%	5.78	5.48	5.22	4.66	4.67	4.57	4.50	4.64	4.62	4.49	4.26	4.12	4.14	4.15
Yield on 52-week T-bills	%	5.36	5.19	5.09	4.30	4.33	4.15	4.19	4.35	4.38	4.22	3.97	3.87	3.95	4.00
Yield on 2-year T-bonds	%	5.39	5.27	5.14	4.50	4.60	4.22	4.42	4.75	4.64	4.40	4.20	4.10	4.28	4.35
Yield on 5-year T-bonds	%	5.50	5.38	5.25	4.70	4.84	4.51	4.85	5.23	5.04	4.82	4.60	4.59	4.80	4.92
Yield on 10-year T-bonds	%	5.49	5.36	5.24	4.72	4.87	4.57	4.90	5.36	5.14	4.94	4.78	4.78	5.02	5.12

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	1 024.3	226.2	235.7	237.2	268.5	239.5	249.1	250.5	285.1
GDP	%YoY	3.8	5.3	3.3	5.2	2.1	2.8	3.7	4.2	5.3	5.2	5.0	5.3
Domestic demand	%YoY	2.7	5.9	1.9	4.8	1.1	-0.5	1.6	5.0	4.6	4.6	4.7	5.1
Private consumption	%YoY	1.9	4.0	2.3	4.0	1.7	1.6	2.7	3.1	4.1	4.1	4.0	3.8
Fixed investments	%YoY	-0.1	6.3	6.2	9.2	1.2	3.8	5.7	9.8	10.5	9.0	9.0	9.0
Industrial production	%YoY	8.4	12.3	4.0	9.2	0.7	2.3	4.5	8.3	12.1	8.6	8.7	7.4
Retail sales (real terms)	%YoY	3.6	7.1	1.5	11.1	-0.4	-3.2	4.1	5.4	9.4	11.8	12.0	11.1
Unemployment rate [a]	%	20.0	19.1	17.6	16.5	19.3	18.0	17.6	17.6	17.8	16.6	16.3	16.5
Gross wages (real terms) [c]	%YoY	2.0	0.8	1.2	4.5	-1.3	0.8	1.1	3.8	4.0	4.9	5.9	3.1
Employment [c]	%YoY	-3.5	-0.8	1.9	2.6	1.5	1.7	2.0	2.4	2.6	2.6	2.7	2.5
Export (€) [b]	%YoY	9.1	22.3	17.1	9.6	23.2	12.9	15.0	18.0	18.8	9.1	7.5	4.4
Import (€) [b]	%YoY	3.3	19.5	12.6	10.5	17.6	6.0	11.2	16.5	17.2	8.7	9.0	7.9
Trade balance [b]	EURm	-5 077	-4 552	-2 182	-3 064	-259	-633	-599	-691	-14	-600	-950	-1 500
Current account balance [b]	EURm	-4 108	-8 542	-3 503	-4 239	-1 043	-500	-861	-1 099	-779	-710	-1 080	-1 670
Current account balance [b]	% GDP	-2.1	-4.2	-1.5	-1.6	-3.4	-2.2	-1.5	-1.5	-1.3	-1.4	-1.4	-1.6
Budget deficit (cumulative) [a]	PLNbn	-37.0	-41.5	-28.6	-30.5	-12.3	-18.5	-17.8	-28.6	-9.0	-20.4	-22.6	-30.5
Budget deficit (cumulative) [a]	% GDP	-4.4	-4.5	-3.0	-3.0	-	-	-	-	-	-	-	-
CPI	%YoY	0.8	3.5	2.1	0.6	3.6	2.3	1.6	1.1	0.6	0.5	0.6	0.8
CPI [a]	%YoY	1.7	4.4	0.7	1.4	3.4	1.4	1.8	0.7	0.4	0.7	0.4	1.4
PPI	%YoY	2.6	7.0	0.7	1.4	3.3	0.1	-0.2	-0.4	0.9	1.0	1.4	2.2
Broad money (M3) [a]	%YoY	5.6	8.7	10.4	11.3	11.0	10.8	12.7	10.4	9.7	9.9	8.6	11.3
Deposits [a]	%YoY	3.7	8.1	9.4	11.0	10.4	9.2	11.6	9.4	9.0	10.4	8.5	11.0
Loans [a]	%YoY	8.1	2.9	11.8	15.0	4.6	7.4	9.6	11.8	13.5	15.2	17.4	15.0
USD/PLN	PLN	3.89	3.65	3.23	3.18	3.07	3.28	3.30	3.29	3.19	3.13	3.21	3.19
EUR/PLN	PLN	4.40	4.53	4.02	3.94	4.03	4.13	4.02	3.91	3.83	3.91	4.02	3.99
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	4.20	6.44	5.49	4.63	4.59	4.29	4.15	4.18	4.20
Yield on 52-week T-bills	%	5.33	6.50	4.92	4.06	5.91	5.21	4.26	4.31	4.02	4.00	4.05	4.15
Yield on 2-year T-bonds	%	5.38	6.89	5.04	4.30	5.83	5.27	4.44	4.60	4.23	4.33	4.35	4.30
Yield on 5-year T-bonds	%	5.61	7.02	5.25	4.91	5.89	5.38	4.68	5.04	4.67	4.87	5.00	5.10
Yield on 10-year T-bonds	%	5.77	6.84	5.24	5.05	5.76	5.37	4.72	5.13	4.83	5.08	5.10	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

Bank Zachodni WBK

TREASURY DIVISION

Pl. Władysława Andersa 5, 61-894 Poznań
secretary tel. +48 061 856 58 35, fax +48 061 856 55 65

This analysis is based on information available until 10.04.2006 has been prepared by:

ECONOMIC ANALYSIS UNIT

ul. Marszałkowska 142, 00-061 Warszawa, fax +48 022 586 83 40
Email: ekonomia@bzwbk.pl Web site (including Economic Service page): http://www.bzwbk.pl

Maciej Reluga – Chief Economist
tel. +48 022 586 83 63, Email: maciej.reluga@bzwbk.pl

Piotr Bielski +48 022 586 83 33
Piotr Bujak +48 022 586 83 41
Cezary Chrapek +48 022 586 83 42

TREASURY SERVICES DEPARTMENT

Gdańsk

Długie Ogrody 10
80-765 Gdańsk
tel. +48 058 326 26 40
fax +48 058 326 26 42

Kraków

Rynek Główny 30/8
31-010 Kraków
tel. +48 012 424 95 01
fax +48 012 424 21 41

Poznań

pl. Gen. W. Andersa 5
61-894 Poznań
tel. +48 061 856 58 14
fax +48 061 856 55 65

Warszawa

ul. Marszałkowska 142
00-061 Warszawa
tel. +48 022 586 83 20
fax +48 022 586 83 40

Wrocław

ul. Rynek 9/11
50-950 Wrocław
tel. +48 071 370 25 87
fax +48 071 370 26 22