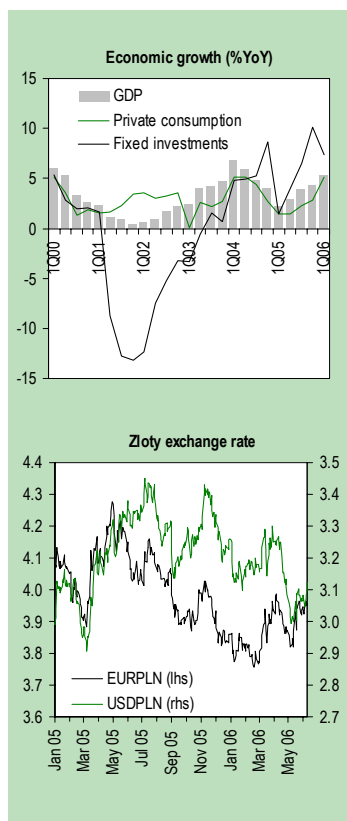


MACROscope

Polish Economy and Financial Markets

June 2006



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Strong start

▪ **Start of the year in Polish economy was definitely much better than start of Polish football team in World Cup competition.** GDP growth in the first quarter reached 5.2%, which was the best result since European Union accession. Domestic demand played significant role in this revival, as it advanced 4.5%, in line with our predictions; net exports' contribution to GDP growth gave additional 0.7 pct. points.

▪ **There is a risk of growth deceleration in the second quarter of the year because of lower number of working days, however GDP growth in entire year should be close to 5%.** April's industrial output data, although weaker than predicted by market consensus, showed strong increase after seasonal adjustment. Retail sales and employment showed robust growth as well, while unemployment rate posted the strongest fall since mid-1998, which suggests that pace of private consumption growth should remain high in subsequent quarters. Upbeat picture of economic situation was also confirmed by balance of payments statistics which indicated continuation of rapid growth in exports with slightly lower, yet still decent rise in imports. Inflation rate in April proved to be higher than predicted, but it is still not a source of serious concerns, as there are still no signs of strong demand-side pressure on prices.

▪ **Monetary Policy Council once again kept main interest rate unchanged at 4.0% in May,** and its members have made it clear that present level of interest rates is adequate for current and predicted economic situation and it should not be changed for a considerable period. It confirms our view that a rate change in the following months (or even quarters) will be possible only in case of significant surprise in economic data releases.

▪ **Credit market in Poland is experiencing increasingly strong revival.** The total loan volume increased by nearly PLN 50bn over the last 5 quarters and their share in the GDP grew by ca 2.2 percentage points. Total credit growth rate for the non-financial sector increased from ca. 3%YoY in December 2004 to nearly 14%YoY at the end of Q1 2006, mainly due to surge in personal loans that accelerated from ca. 13% to 25%YoY. This month we take a look on situation on the credit market again, trying to answer a question whether recent trends could be dangerous and how they compare with situation in other countries in the region. Conclusions from the analysis are rather optimistic. First of all, recent tendencies seem to be justified by strong economic fundamentals and factors of structural nature (low initial level of financial intermediation). Comparison with other countries that have similar level of economic development and have joined the EU together with Poland shows that size of expansion in Poland does not differ much from what was taking place in neighbouring economies, which additionally suggests that recent tendencies are closely connected with process of catching up in terms of level of economic development and financial intermediation.

Financial market on 31 May 2006:					
NBP deposit rate	2.50	WIBOR 3M	4.15	USDPLN	3.0671
NBP reference rate	4.00	Yield on 52-week T-bills	4.03	EURPLN	3.9472
NBP lombard rate	5.50	Yield on 5-year T-bonds	5.05	EURUSD	1.2869

This report is based on information available until 09.06.2006

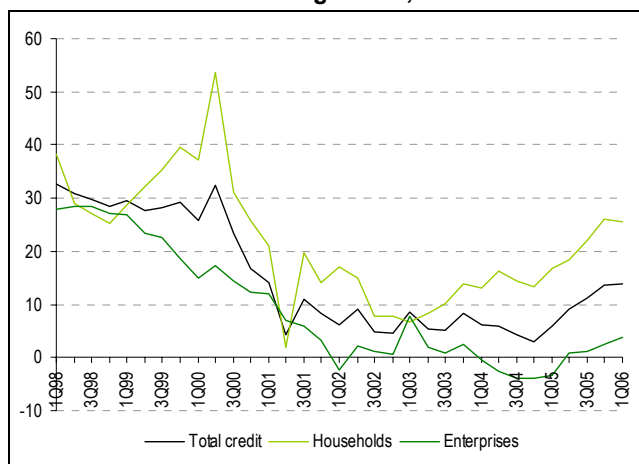
Special focus

Rapid credit growth: good or worrisome?

Over a year ago, in our monthly macroeconomic reports, we analysed trends on the credit market in the Polish banking system. The reason for our interest in the topic was slowing down pace of credit growth in 2004, in the environment where GDP was growing, and an attempt to answer the question whether this phenomenon was temporary or was it a herald of permanent weakening of economic upward trends. It should be noted that the conclusions arising from our analyses were quite optimistic. At that time, we expected that the credit growth pace would soon start to gather its momentum, and the role of money and credit would grow over time following the GDP growth, which would be primarily driven by booming mortgage loans.

And although the reports were published not so long time ago, in the light of the statistics, it can be stated that our expectations proved right. Total credit growth rate for the non-financial sector increased from ca. 3%YoY in December 2004 to nearly 14%YoY at the end of Q1 2006. Over the same period, the growth in personal loans accelerated from ca. 13% to 25%YoY, and the business loans grew from -4%YoY to ca +4 %YoY (see the figure below). The total loan volume increased by nearly PLN 50bn over the last 5 quarters and their share in the GDP grew by ca 2.2 percentage points. Both the 'tangible' data taken from the banking system and the outcome of research on credit market conditions carried out regularly by the NBP indicate that the demand for loans, primarily on the personal side, sees a strong revival.

Loans in the Polish banking sector, %YoY



Source: NBP

However, before this revival turns into a credit boom, this month we are coming back to credit focusing on a

number of issues related to the growing debt of the private sector. How much is the situation in Poland different than in other countries at the similar stage of economic development? Does it pose any threat to economy? What may be the implications of the fast credit growth to the central bank's monetary policy?

Another look at loans through magnifying glass

At the outset, it should be noted that it is not by chance that we decided to tackle credit behaviour in the economy but the interest arises from the trend evident in the recent discussions about the monetary policy worldwide. While in the 80's and 90's money aggregates were gradually receding into the background in the analyses of central banks and so were monetary policy strategies based on indirect monetary targets which were replaced by direct inflation targets, recently the importance of loans in monetary policies has been enhanced again although now the perspective is different.¹ This is so as the increasingly loose and changing over time relations between money supply and loans and consumer prices indices stemming from, e.g. development of markets and financial innovations, (i.e. the arguments which caused the money supply and loans to lose significance in the eyes of central banks) are still valid. However, at the same time as a result of the strong development of the banking sector and financial market in developed countries, credit trends proved useful in a new role – as an indicator of changes in demand to include private consumption and leading indicator of trends on the financial asset market.

In the recent years, links between stability of prices and stability of financial systems in well-developed countries have been discussed in depth in the monetary policy analyses in the world. Special focus is on cycles of financial asset price fluctuations which usually emerge in periods of credit expansion. In the light of stabilised low inflation, advancing globalisation, international competition and liberalisation of capital flows the so-called "paradox of central bank credibility" phenomenon was observed. In simple terms, the idea behind it is that the growing macroeconomic imbalance arising from relatively loose monetary policy is first of all demonstrated in the increase in prices of financial assets rather than prices of consumer goods and services (as it used to be). The thing is that if the monetary policy regime is credible and the expectations of low inflation and/or strong growth in labour efficiency are well embedded, strong economic expansion may not impact

¹ See e.g. Borio C., Lowe P. (2004) "Securing sustainable price stability: should credit come back from the wilderness?" *BIS Working Paper* No. 157; "Asset price bubbles and monetary policy" *ECB Monthly Bulletin*, April 2005

prices of goods and services for quite a long period of time. At the same time, however, the booming economy is pushing up the prices of assets (e.g. on the equity market, properties), anticipating quick and continuous expansion. As a consequence, as there are no signals warning in the CPI dynamics against growing internal imbalance, the prices of financial assets may skyrocket to the degree which is not justified by economic fundamentals. This leads to the creation of the so-called *financial asset price bubble*. Bubbles, by their nature, if overly grown may burst suddenly. The problem is that sudden correction of asset prices as a follow up of a dynamic growth can be costly as it poses a threat to the financial stability, and as a result, to the stability of prices of goods and services, putting the achievement of the central bank's major target at risk

Timely identification of the "bubble" being created on the asset market can be of high importance for the economic policy. In practice, however, it is not easy as it is usually impossible to establish whether the trends observed at a specific period of time are fundamentally justified, and to what extent, and when they are speculative in nature. As international research shows, these are the changes in the money aggregates and loans that can be helpful in terms of effective early warning against emerging price bubbles. This is one of the reasons why banks are interested in the situation on the credit market again.

It should be noted that the above considerations are primarily applicable to highly developed economies, both in terms of economy and finance, where the role of money aggregates and loans is of key importance (their value usually exceeds 100% of the GDP), and financial assets represent a substantial part of assets of households and businesses, as a result of which, their fluctuations have a strong impact on economic decisions taken. So a question should be posed whether these issues are of importance and whether they merit attention in a country like Poland where the characteristics and the stage of development of the financial market are still far from e.g. the EU average. We do hope that the information presented below will help you answer this question. For the time being, it can be suspected that the changes on the credit market and their importance for the stability of the financial systems are not indifferent for the Monetary Policy Council as Andrzej Wojtyna, one of the most influential MPC members, referred to them recently.²

Credit acceleration in the region

As noted above, recent quarters have seen evident revival on the Polish credit market. It turns out that the quick growth in loans for the non-financial sector is not a feature characteristic of the Polish banking sector only. A similar phenomenon can be now observed in the majority of the new EU member states while in some cases the trends are much stronger than in Poland (see the table).

Credit to the private sector in EU Member States, %YoY

	2003	2004	2005	2Q05	3Q05	4Q05
Cyprus	4.6	5.5	4.9	5.3	5.2	4.7
Czech Republic	-1.7	11.5	24.4	21.5	25.4	25.9
Denmark	4.8	7.7	12.2	10.6	13.3	14.0
Estonia	26.0	27.7	35.4	33.5	36.7	38.3
Hungary	18.0	27.2	18.1	17.0	16.5	15.5
Latvia	26.2	38.4	48.0	41.6	47.8	58.8
Lithuania	43.1	55.3	40.2	37.7	44.3	54.0
Malta	0.6	12.2	4.7	5.3	3.5	4.6
Poland	-8.2	4.0	18.3	19.7	17.1	14.0
Slovakia	11.0	13.7	21.7	18.2	23.7	26.9
Slovenia	9.6	23.4	21.9	21.8	22.3	24.5
Sweden	4.5	4.6	7.9	7.7	8.2	5.5
UK	10.2	11.4	10.3	10.5	10.2	10.3
EU-10	3.5	14.3	21.2	20.5	20.9	20.6
Euro area	4.9	5.9	8.4	7.8	9.1	9.7

Sources: ECB, national central banks; Note: The EU-10 aggregate comprises the ten countries that joined the EU in 2004, calculated with 2003 GDP weights.

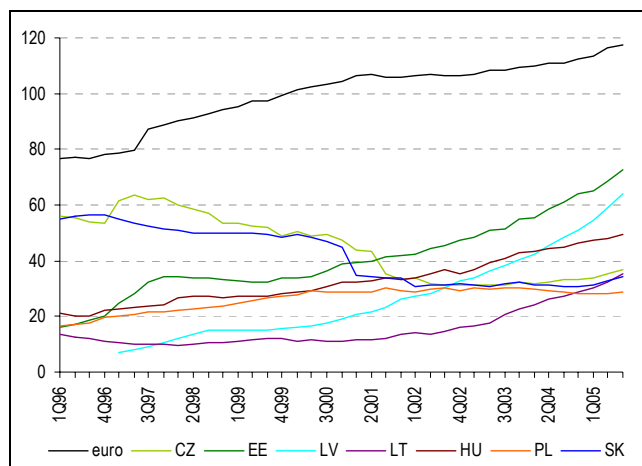
Most often, the key growth driver is – like in Poland – demand for loans from households, and rapid growth of mortgage market in particular. In late 2005, in six out of the ten new member states, the mortgage growth rate exceeded 30%YoY, while in the Baltic countries, the pace of growth was the highest at the level above 70% per annum. The growth in the business debt is much more moderate although some revival is also evident in this respect (growth in new member states on average above the growth rate in the euro zone).

It can be easily noticed that new EU member states who have recently seen the rapid growth in credit share some important characteristics. First of them is low level of development of the banking sector (financial intermediation) relative to well developed economies, which is clearly reflected in the relation between loans and the GDP³ (see the figure on the next page), as well as the general drop in interest rates in the recent years. The changes in the market and economic environment related directly and indirectly with the EU accessions also come to play: macroeconomic stabilisation, legal regulations and liberalisation of financial regulations, growth in competitiveness on the banking services market, drop in the risk premium, monetary policy focused on low inflation as well as expectations of faster economic growth and increase in income.

² Andrzej Wojtyna "Paradoks wiarygodności", *Rzeczpospolita* newspaper 28/04/2006

³ The exceptions are Cyprus and Malta, where the share of loans in the GDP, more or less, matches the average of the 'old' EU.

Loans relative to the GDP



Sources: Eurostat, own calculations

Should then the rapid lending growth in new EU member states including Poland give rise to concerns? On the one hand, it is easy to point to “fundamental” reasons for strong credit expansion in the region, which arise from the economic and structural factors. Thus, it seems that the trends observed in the region should not be considered dangerous. As indicated by the analysts of the European Central Bank, even in the new EU member states where credit growth rate is very high, the size of the credit activity is not different than this experienced by the old EU member states who once went through the phase of bridging the development gap, such as Ireland or Portugal.⁴ Additional factor mitigating the risk arising from strong credit expansion in the region is the fact that for the time being, charges of businesses and households arising from debt servicing relative to their income is low against EU-15 or the euro zone.

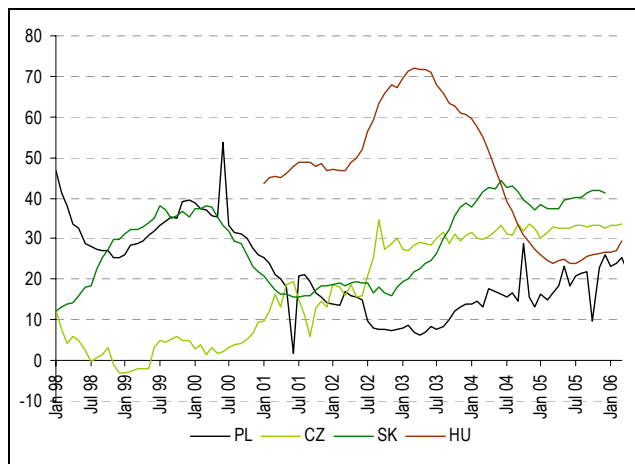
At the same time, in the period of strong growth in those states, regulators and monetary authorities need to be very careful as *ex ante* it is difficult to assess to what extent the trends stem from bridging the gaps in the development of financial markets and when overheating may take place. As the literature shows, the banking credit activity is much cyclical in nature, and credit-related risks may be understated especially in the periods of strong economic expansion, which may lead to strong corrections after a boom.

Poland against its neighbours

As compared to other countries in the region, the pace at which the Polish credit market is changing can be considered moderate (as shown in the table above) which does not give rise to concerns. Especially if we remember that the level of credit saturation in the Polish economy is one of the lowest in the group (figure above), which could justify even a much faster expansion as a

result of catching up with the more developed states. In the meantime, neither the total debt growth rate, nor the fastest growth in household debt in Poland depart from what is being observed in the neighbouring countries (figure below).

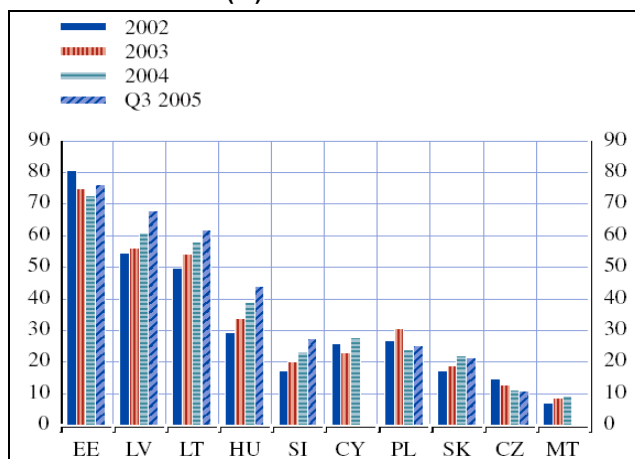
Loans to households, %YoY



Sources: National central banks

A discernible and distinct feature of the loan books in Poland is a substantially high share of foreign currency debt. Although a yet higher (and still growing) appetite for f/x credit can be observed across the Baltic States (Lithuania, Latvia and Estonia – see the chart below), those economies apply fixed exchange rate regimes which are eliminating currency risk. In Poland where exchange rates are free floating, a high share of foreign currency loans contributes to an increased vulnerability of credit portfolios in the event of major f/x movements. Insofar as a demand for foreign currency loans in our north-eastern neighbours is shown by industrial enterprises (usually international groups or companies whose turnover is made mainly in foreign currencies being also a natural hedge), Poland demonstrates the biggest f/x exposure across personal lending. And these are mostly home mortgages.

Share of foreign currency loans in total loans in the new EU Member States (%)

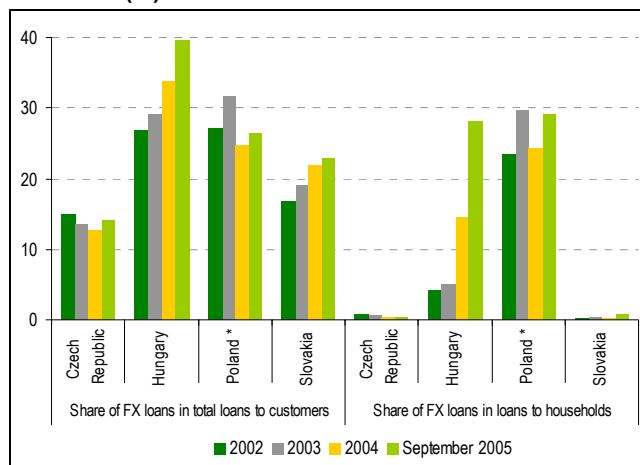


Sources: ECB, national central banks, from: Financial Stability Review, ECB, June 2006

⁴ Financial Stability Review, ECB, December 2005

Home mortgage loans certainly deserve special attention in the context of a financial stability going forward. These are not only loan books in which the share of foreign currency exposure is exceptionally high (currently ca. 2/3 of the portfolio), but also with the most rapid rate of growth (over 40%YoY), followed by soaring prices of houses and flats (various estimates show flat price hikes at 10-18%YoY in the major cities). Obviously, one should not forget that this is driven by fundamental economic and social changes. On the one hand, we see a mounting appetite for decent housing standards in the society which has been migrating to cities, growing disposable income, wider availability of home mortgage loans with attractive pricing and on the other one, housing market barriers which limit developers and translate into higher prices. All in all the very core of dynamic changes in this sector is not of speculative character.

Share of foreign currency loans in selected CEE countries (%)

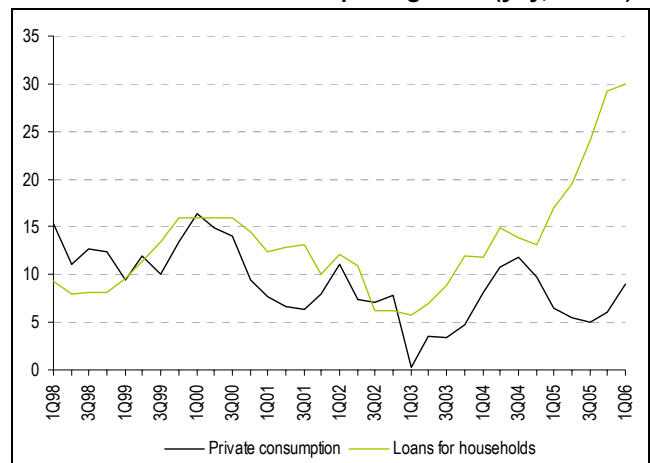


* Poland – December 2005
Sources: National central banks, from: Report on Financial Stability, MNB, April 2006

As the experience of other countries shows, speculative bubbles on the property market appear much less frequently than on the markets of financial assets (stock exchange, for example), but once they burst, collateral damage to the national economy is much more costly and its gravity is felt very strongly by financial markets.⁵ Although, mortgage portfolios in Poland are much lower in terms of volume and exposure than in the EU-15 member states (the value of mortgage loans granted in Poland represents now ca. 5% of GDP, while in the EU it is ca. 40% of GDP), however one cannot overlook a fact that the importance of such loans in the Polish banks has increased dramatically over the last several years (representing initially ca. 5% of the credit portfolio in 2001 and over 18% now). Therefore, property market fluctuations have now a much greater impact on the financial market as well as on individual households than it had until recently.

These developments also trigger another phenomenon of great importance to the central bank and inflation. Whilst home mortgage loans represent “merely” one fifth of all the loans sanctioned by banks, their share is becoming clearly dominant in “marginal” terms, i.e. when we look at increases; 2004 witnessed a growth of the home loans representing 90% of the total loan-book increase and in 2005 it was ca. 50%. Insofar as until recently movements in the volumes of loans raised by households were an indicator of changing consumption patterns, the recent quarters indicate disintegration of this relation. Changes in the bank debt balance are then losing its importance when analysing a CPI inflation outlook, but will be counted as an important indicator of trends in the property prices.

Household debt and consumption growth (yoy, PLNm).



Sources: CSO, own calculations

Room for balanced optimism?

The recent bank debt trends in Poland do not give rise to concerns. First of all, they are based on strong economic foundations and structural developments (low start-up threshold of the financial market and loan-book volumes). A comparison with other countries of similar economies which joined EU at the same time as Poland did prove that the rate of growth in Poland does not stand at variance, which proved that the underlying drivers are coupled with a broad catch up race to bridge Poland and the rest of EU. We need to remember that a fast growth of bank debt in an economy is not bad in its nature. On the contrary, international practice shows that growing financial sectors usually boost economy in a long run.⁶ Of course only if a booming market of lenders does not go beyond what is rational and viable, otherwise exposing itself to a major adjustment after a period of overheated growth. There is no gainsaying that to assess whether growing loan-books exceed safety levels or not is a difficult or next-to-impossible task. Still,

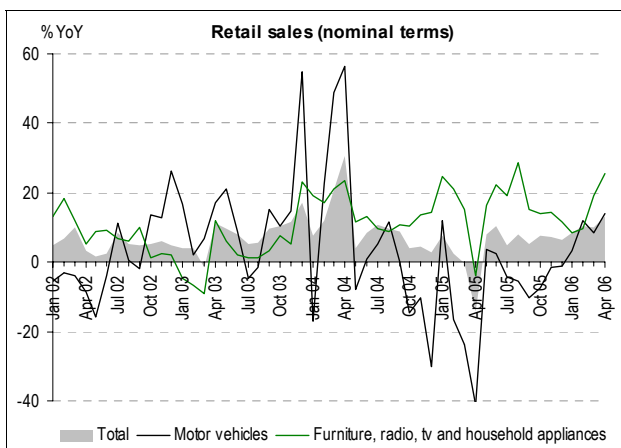
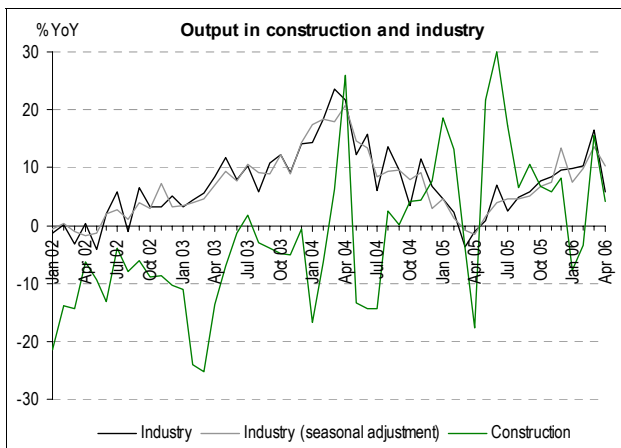
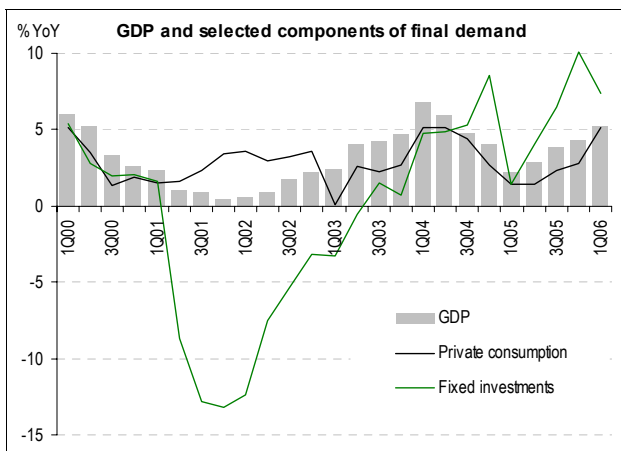
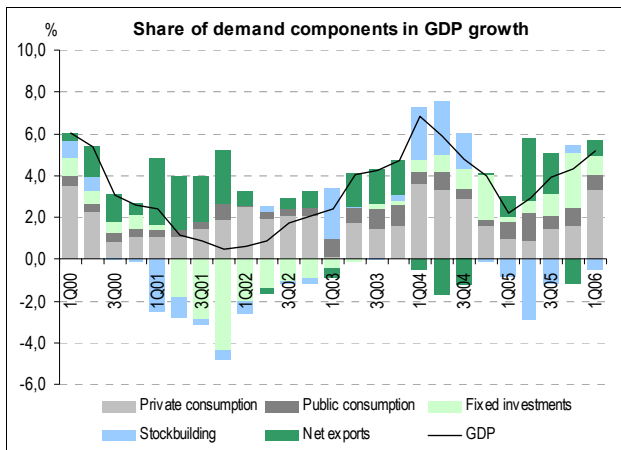
⁵ “Asset price bubbles and monetary policy” *ECB Monthly Bulletin*, April 2005

⁶ “Are credit booms in emerging markets a concern?” *World Economic Outlook*, IMF, April 2004

the pace of changes in Poland and in the newly accepted EU members does not give any rise to concerns, because it follows the same path that the old EU countries went along when going through a similar cycle of growth.

Of course, property and financial market trends are worth being monitored because in time they can play a very important role in decisions made by enterprises thereby affecting decisions of the central bank. A cursory look on the performance of the Polish economy in the last several quarters may indicate a similarity to the scenario known as “the paradox of credibility” – a fast pace of economic growth coupled with a growing disposable income do not translate into higher consumer price indexes, but instead there is a vigorous growth in the pricing of financial assets: shares, participation units, property prices. A question then might arise whether it is not already one of the arguments which might incline the Monetary Policy Council to maintain higher than in other conditions interest rates, despite a very low inflation. It seems, however, that this phenomenon should not be perceived larger than it really is. Currently, an exceptionally low share of bank loans in GDP (not only in comparison with developed economies but also with the peer ones), a low share of financial assets in the net worth of households as well as low costs of debt service borne by businesses and individuals protect them from even sudden changes in the banking sector and result in a limited impact on the country’s economy, which is the case of more advanced economies. For this reason, such trends will not be at this stage of great significance to the monetary policy of the central bank, either. However, such thoughts do occur in the heads of the MPC members as demonstrated by a recently published, and mentioned here earlier, Andrzej Wojtyna’s article.

Economic update



Source: CSO, own calculations

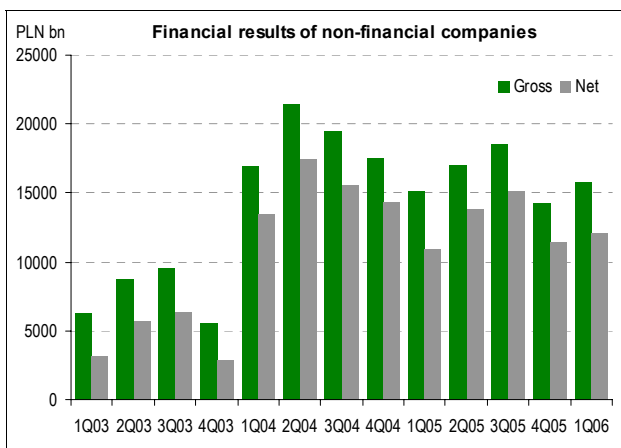
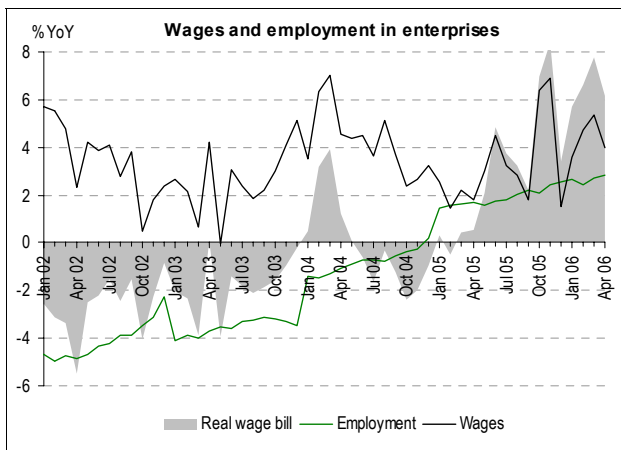
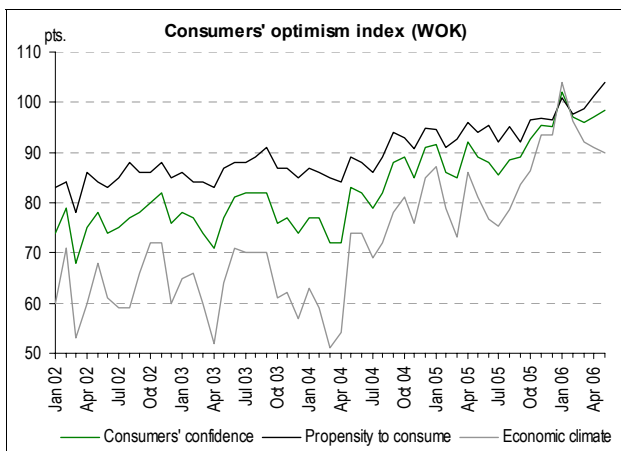
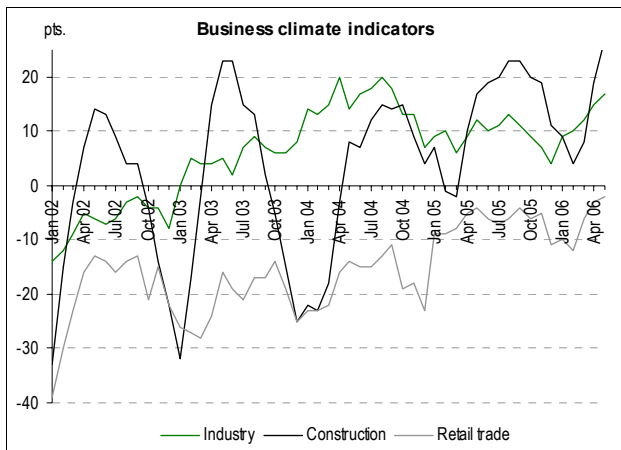
First quarter the best since EU accession

- GDP growth in the first quarter of the year amounted to 5.2%, which was slightly below our forecast of 5.3% and moderately above market consensus of 5% (according to Reuters and PAP).
- In line with our assumptions, domestic demand rose by 4.5%YoY and net exports added 0.7 pp to the overall growth.
- The structure of domestic demand was different than our expectations amid lower investments growth and negative contribution of stock building. At the same time, private consumption growth was as high as 5.1%YoY against our forecast of slightly above 4%.
- Overall, data confirmed that at the beginning of 2006 the Polish economic situation was very favourable with accelerating domestic demand (amid labour market improvement and better financial stance of Polish companies), while high foreign demand helped in maintaining positive impact of net exports on growth.
- After Q1 data release we decided to moderately change our forecasts as regards the breakdown of GDP growth in 2006 as a whole. It seems domestic demand may increase faster than we previously expected (ca. 5.2% vs. 4.8%) driven by higher private consumption (ca. 4.5% vs. 4.0%), as improvement on the labour market continues and social payments will be an additional factor boosting demand.
- We do not change our forecast of investments growth in 2006 as well as full-year GDP growth estimation, but net exports contribution may be a bit lower than we previously expected.
- The following macroeconomic data will be very important for the market suggesting whether the economy top out in Q1 or there is a chance for one (or more) quarter of solid growth. As regards Q2 the risk is on the downside amid lower number of working days (while in Q1 it was the opposite).

Beginning of the second quarter also optimistic

- It appeared that we were quite right predicting that lower number of working days will have strongly negative impact on output numbers, as industrial production in April increased 5.8%YoY, which was below market consensus pointing to ca. 9% growth and significantly below March growth of over 16%YoY.
- Nevertheless, the deceleration in headline figure did not represent a general slowdown in economic activity growth, as seasonally adjusted production soared 10.2%YoY, which was the third best result since pre-accession economic boom in 2004.
- The highest growth rate was recorded in manufacturing (6.7%YoY), which showed that economic revival is driven by competitive sectors rather than mining and energy. Construction production growth decelerated as well, to 4.1%YoY from 15.5% in March, while adjusted for seasonal factors it was up 4.9%YoY.
- In April nominal growth in retail sales amounted to 13.2%YoY, which was only moderately below market consensus of 14.5%. In real terms, retail sales increased by 13.6%YoY. Both nominal and real growth in retail sales in April were the best results since accession boom in the first half of 2004.
- Retail sales figure in April was positively affected by timing of Easter this year (last year it was in March, this year in April), but the data suggest that consumption demand gains strength. Stronger consumption partly results from favourable inflation surprise, as for a few recent months we have observed that real growth of retail sales accelerated faster than nominal growth.
- Indeed, in the two latest months real growth of retail sales was higher than nominal growth. This shows that pressure on prices is still benign. In April some rebound in sales of motor vehicles took place.

Economic update



Source: CSO, Ipsos, own calculations

In May entrepreneurs and consumers in good mood

- As expected, business climate indicators for May has not brought much new to the already known, quite optimistic picture of economic situation.
- Indices for three sectors analysed by the stat office – manufacturing, construction and retail trade – recorded increases as compared to April. It stemmed not only from typical seasonal factors, but also from a continuation of stable upward trend seen in previous months.
- Annual growth rates of indices calculated by the CSO for the three sectors were almost the same as a month ago (5pts for manufacturing, 10pts for construction and 2pts for retail trade). In construction and retail trade, assessment of business climate was the most optimistic since mid-2000. All in all, the data confirmed the economy gains strength and supported expectations of higher economic growth this year.
- Positive assessment as regards perspective of economic situation in Poland was reflected in opinions of not only entrepreneurs, but also consumers.
- It was confirmed in a survey on consumer confidence, carried out by Ipsos and presented in *Rzeczpospolita* daily. It showed three indicators (consumers' optimism, propensity to consume as well as general assessment of economic climate) rising by above 10% in May.
- In May, consumers' optimism index (WOK) rose by 5 points to 98.4 pct. Although the survey showed that number of pessimists is still higher, but a rising trend in number of optimists is well visible. Everything suggests this trend should be continued in the following months, assuming that positive performance of economic indicators maintains, while correction on the Warsaw stock exchange should not have significant impact.

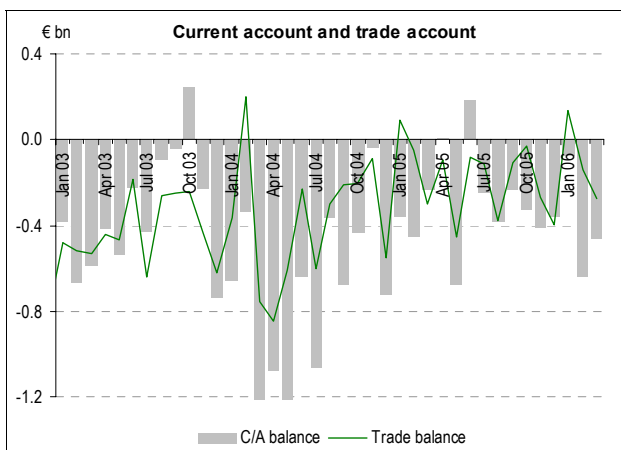
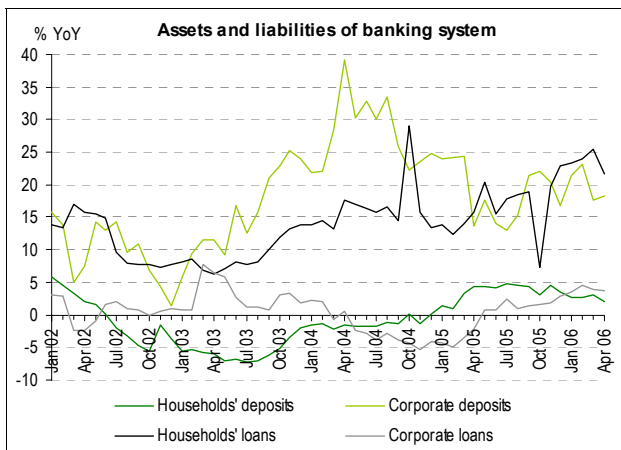
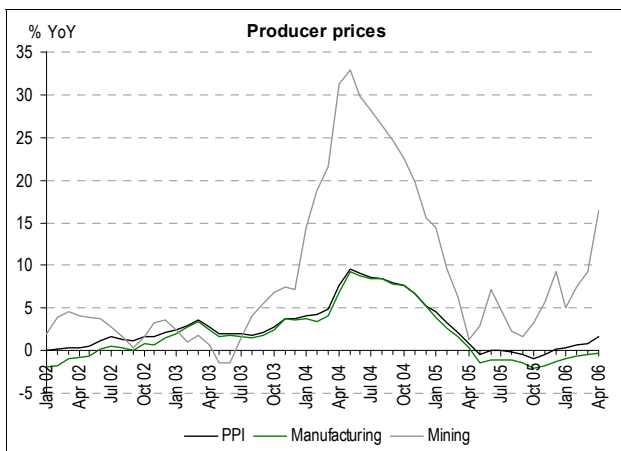
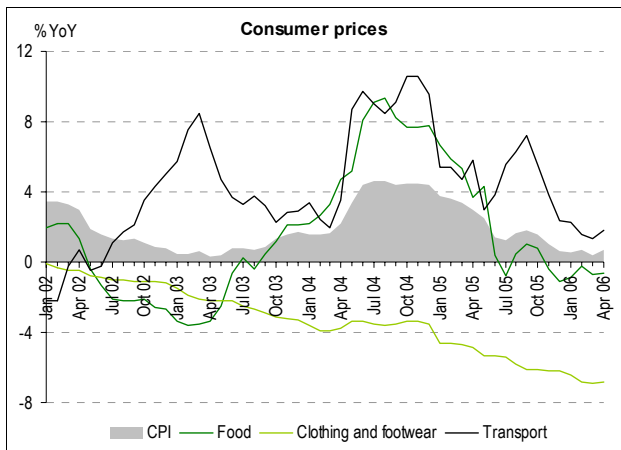
.. which is not surprising given labour market statistics

- Certainly, one of the factors responsible for positive moods among consumers is improvement on the labour market.
- Data for April showed downward trend in the unemployment has not weakened. On the contrary, the registered unemployment rate fell to 17.2% at the end of April from 17.8% in March. In annual terms, the unemployment rate dropped by 1.6pp, which represents the strongest pace of unemployment reduction since mid-1998.
- Average wage in enterprises sector increased in April by 4.0%YoY. It was below February and March results, but still above average growth in 2005 of ca. 3%. At the same time, average employment advanced slightly more than predicted, by 2.8%YoY, which resulted in robust increase in real wage bill in enterprises sector – according to our estimates it amounted to 6.2%YoY.

... and financial results of companies

- Firms' optimism as regards future economic situation stems, at least partly, from good financial results.
- Data on non-financial companies' financial results for 1Q06 showed net profit of PLN12bn or 9.4% higher than a year ago.
- Both proceeds and costs from total activity went up by over 12%YoY, much faster than in several preceding quarters. At the same time, ratios of economic performance decreased a little in comparison with last year (net turnover profitability ratio from 3.8% to 3.6%).
- This suggests that higher profits were achieved thanks to much higher volume of transactions, while companies' margins were diminishing slightly. What is interesting, despite stronger zloty exporters were still a group with much better economic and financial results than average in the sample.

Economic update



Source: CSO, NBP, own calculations

CPI and PPI above expectations, but still low

▪ April's inflation data surprised the market, showing faster than predicted rise in consumer prices – by 0.7%MoM and 0.7%YoY, up from 0.4%YoY posted in March. The overall CPI index was boosted by higher costs of fuels (up 5.2%MoM), natural gas (14.1%MoM), and foodstuffs (0.7%MoM), while prices in other groups of products and services were more or less stable.

▪ PPI inflation was also higher than forecasts in April as it amounted to 1.6%YoY (market consensus 0.9%). This was almost entirely due to sharp rise in prices in mining (16.4%YoY) and energy supply (7.6%YoY), while prices in manufacturing were still lower than last year (by 0.3%YoY). The latter information shows that most of Polish producers are still reluctant to pass through rising costs of energy and resources to prices of their own products, probably because of strong competitive pressure. This limits potential negative impact on future consumer prices.

▪ All five core inflation measures calculated by the NBP increased in April, which was in line with expectations. The most closely watched measure - net inflation – increased to 1%YoY from 0.7%YoY in March. Other measures rose weaker than net inflation, two of them by less than 0.1pp.

▪ Underlying inflationary pressure is very weak while recent increase in inflation was a matter of surge in energy and commodities prices. Of course, one has to settle whether it will not pass-through into other categories of prices, but there is no evidence of such a phenomenon as for now.

▪ Despite some negative inflation surprises in April, it still seems likely that CPI growth will not be much higher than 1%YoY for the better part of this year. An increase to some 1.5% should be expected in November-December and then CPI inflation should gradually return towards the target of 2.5%.

Money and credit slightly decelerated

▪ Money supply growth decelerated in April to 9.6%YoY from 9.8% in the previous month, roughly in line with our prediction. Total deposits were growing 8.6%YoY, after 9.1%YoY in March, while cash in circulation advanced 15%YoY against 13.7% in the previous month.

▪ Growth in households' loans weakened from 25.4%YoY in March to 21.7%YoY in April and credit for enterprises slowed down slightly from 3.9% to 3.7%YoY. Nevertheless, monetary data gave no reason to worry about pace of future economic expansion.

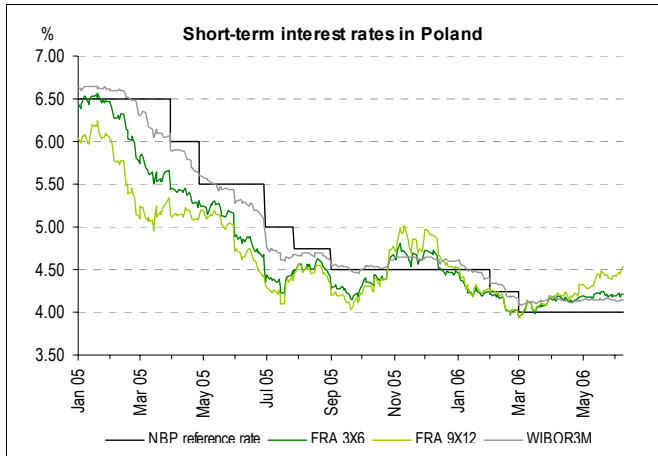
▪ Total loans growth was one of the highest in the last five years, and pace of increase in money stock was also respectable. Further pickup in loan growth in subsequent months is well possible that

Higher current account deficit again

▪ Current account deficit was wider than we predicted for the second straight month, reaching €458m in March. The difference resulted from higher trade deficit (€272m) and lower surplus in current transfers. What is more, current account deficit in February has been revised from €538m to €643m.

▪ Nevertheless, the fact is that even though the data were worse than expected, the level of current account gap in relation to GDP is still very low in Poland, as in March it amounted to ca. 1.5%, one of the lowest levels since mid-nineties. Moreover, the data showed very strong improvement in both export and import growth, which soared 23%YoY and 21.6%YoY, correspondingly (in euro terms). This reflects ongoing acceleration in economic activity, which bodes well for prospects of this year's GDP growth.

Central bank watch



Fragments of the MPC statement from 31 May 2006

The balance of risk for future inflation has not changed significantly since the Council's last meeting, yet a risk factor related to wage pressures in the budget sector has appeared.

Low level of all core inflation indices indicates that inflationary pressure continues to be low. May 2006 did not bring any significant changes to the inflation expectations of households, which also remained low.

In the recent period the declarations of wage increases as well as signals of rising wage demands in part of the public sector have intensified. If these demands are met wage pressure in the remaining part of the public sector may rise and in this way wage growth in the whole economy may accelerate. At the same time, higher wage rises would have led to increased tensions in the public finance and, consequently, would hamper the reduction of the public finance deficit. A necessary condition of sustainable acceleration of economic growth not threatening the achievement of the inflation target is to ensure that wages do not grow faster than labour productivity in the long run.

No changes in rates

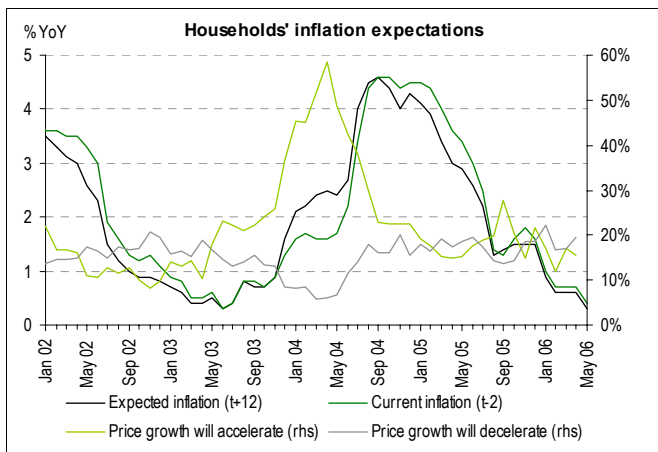
■ In line with expectations, the Monetary Policy Council left interest rates unchanged at its May meeting. The official information from the meeting of the MPC also brought no surprises. The most important sentence read: "the balance of risk for future inflation has not changed significantly since the Council's last meeting, yet a risk factor related to wage pressures in the budget sector has appeared".

■ The new hawkish argument is very conditional, as it is not certain, first of all, whether higher salaries' demand will be met and second, whether this would have an effect on wages in the economy as a whole (during the press conference the NBP President said wages in the whole economy "would have to increase", but the statement said "may increase").

■ Anyway, there are other arguments, which make us feel quite comfortable with the view that interest rates will remain stable in a foreseeable future, although they are not strong enough to expect a rate hike, even in 2007, at least as long as the scenario of gradual return of CPI inflation to target, indicated by the last NBP inflation projection, is still valid.

■ These arguments include accelerating domestic demand, driven by high consumption growth, and situation on global financial markets. As far as global situation is concerned, we see monetary tightening cycle in well-developed economies as well as in the region and higher risk aversion on financial markets, which may be important factor influencing the zloty level in the following months.

■ All in all, we maintain our earlier view that main interest rate in Poland will stay unchanged until the end of this year and probably also in 2007.



Inflation expectations still well contained

■ It is hard to expect a rate cut given strong acceleration in consumption growth (and changes in interest rate environment abroad), but it is noteworthy that more and more rapid expansion of the Polish economy has not caused a pressure on prices so far.

■ A positive factor from the MPC's point of view is that households' inflation expectations remain at very low level. Taking into account a specificity of NBP survey on inflation expectations and adaptive nature of households' inflation expectations in Poland, the calculated measure is so low due to low level of current inflation (CPI lagged by 2 months).

■ Expected acceleration in current inflation will lead to an increase in inflation expectations, but it should be moderate, likewise increase in the current inflation.

Results of Reuters survey

Bank	December'06	May'07	Hike timing
Bank Zachodni WBK	4.0	4.0	-
Handlowy Citibank	4.0	4.25	April 2007
Millennium	4.0	4.0	-
BGŻ	4.0	4.0	-
BRE Bank	4.0	4.25	April-May 2007
Bank BPH	4.0	4.0	-
DZ Bank CEE	4.0	4.0	-
Raiffeisen	4.0	4.0	-
Danske Bank	4.0	4.0	-
Getin Bank	4.0	4.25	March 2007
Pekao	4.0	4.5	January-March 2007
PKO BP	4.0	4.0	-
Societe Generale	4.0	4.5	January 2007
West LB	4.0	4.0	-

First hikes very far on the horizon

■ Among market analysts there is hardly anyone who would believe in further rate cuts.

■ Among banks, which responded to Reuters' macroeconomic survey, there is no one that would predict another rate cut this or next year.

■ At the same time, survey results showed that the market is unanimous in an opinion that monetary tightening cycle will not start soon (i.e. before the end of this year). 7 out of 12 surveyed analysts expect that the reference rate will stay at 4% until May 2007 while the other 5 analysts predicts a rate hike in first months of 2007 on a scale ranging from 25 to 50 bp. FRA contracts show market participants price in a 25 bp this year with probability notably lower than 50%.

Source: NBP, Reuters

Central bank watch

Comments of the central bank representatives

Dariusz Filar, MPC member

MPC press conference, 31 May

Situation on global financial markets is sensitive. The Polish economy, with low C/A deficit, low inflation and high economic growth belongs to group of countries with good fundamentals and this creates a kind of safety margin. However, there are no grounds to expect such strong appreciation that was observed not so long ago.

Dariusz Filar, MPC member

Reuters, 22 May

As long as next inflation projections continue to show that the path of inflation has not significantly changed, the present parameters of monetary policy are correct for reaching our goal.

Andrzej Sławiński, MPC member

Reuters, 22 May

Only if the path of events were to start significantly varying from the projection would reasons appear to start considering possible fine-tuning of rates.

Marian Noga, MPC member

Reuters, 18 May

I do not see a reason to change interest rate level neither in 2006 nor in 2007, although we are not able to predict all shocks. (...) Any nervous moves, either a rate cut or announcement of rate hikes could undermine credibility of the MPC. (...) Next year, inflation will gradually approach the target of 2.5%, but will not exceed this level. Rate increases will be needed only after it tops 2.5% and moves up from there, although I don't expect such an (inflation) increase until the end of 2007. (...) Inflation increase may be caused by low base effect, mounting wage demands and termination of favourable one-offs on food market. (...) The IMF's latest report says our channel of cheap imports is running out and may lead to inflation pressure. (...) If GDP grows fast, at the pace of above 5%, this could cause a threat of fast increase in unit labour costs which in turn could exert a pressure on prices.

Stanisław Owsiak, MPC member

PAP, 18 May

The inflation level of 2.5% should be reached at the turn of 2007 and 2008. Therefore one may expect that interest rates will remain stable in 2006 and I do not think that MPC will face a dilemma whether to hike or not in 2007. It is doubtful whether the Council in current makeup could slow down economic growth as it was in case of the previous MPC makeup.

Halina Wasilewska-Trenkner, MPC member

PAP, 16 May

[Asked whether she does not exclude a rate hike already in 2006, e.g. in the third or fourth quarter] There is a possibility that inflation may reach the level of NBP target in the second half of 2007. If such threat occurs, we would have to act in advance.

Andrzej Wojtyna, MPC member

PAP, 17 May

The lower inflation, or even deflation is necessarily an argument for rate cut. (...) Since the central bank should not react to short-term supply shocks on inflationary side, on deflationary side it should act only if there is a risk that second-round effect will occur. (...) One should not use its ammunition, because what would happen, if GDP growth and inflation decreased suddenly?

Our remarks

We maintain our forecast of average EURPLN rate in Q3 2006 at above 4.0, although we agree with MPC's Filar, who said during the press conference that Polish economy has strong fundamentals (low current account deficit, low inflation) as compared to other emerging markets, which gives a kind of safety margin. On the other hand, Filar said that given the change in global economic conditions it was hard to expect such appreciation of the zloty as it had been observed in recent past.

Comments from MPC members from the last month were quite unanimous. One of examples of growing unanimity among rate-setters are fragments of interviews with Dariusz Filar and Andrzej Sławiński published the same day by Reuters. Despite Filar and Sławiński usually had different opinions on inflation prospects and needed actions of the central bank (which was reflected in the fact that they usually voted differently on interest rate decisions), currently their views are very similar. Both of them think that despite some risk factors medium-term inflation prospects are still favourable and interest rates should remain unchanged. Rarely seen unanimity within the Council cement market participants' belief that the reference rate will be kept on hold for considerable period.

On one day of May PAP published interviews with two MPC members. One with Marian Noga who is seen by the market as moderate hawk and the second one with Stanisław Owsiak who is regarded as more doveish rate-setter than Noga. What is interesting, despite usual divergence in their opinions, this time they were unanimous. Both Noga and Owsiak clearly gave market participants to understand that the current level of interest rates is adequate to economic situation and one should not expect swift changes in monetary policy parameters. They said there were no reasons for a change in interest rates in 2006, because inflation would gradually return to the target of 2.5% from around 1.5% at the end of this year. What is important, even usually "hawkish" Noga stated that interest rates should remain unchanged also in 2007, because there was no need to change them as long as inflation did not exceed 2.5%. Both rate-setters do not expect significant threat to inflation from labour market, because high unemployment and fast increase in labour productivity should alleviate negative effect of stronger and stronger demand for labour.

Comparison of comments from Noga and Owsiak, likewise comparison of comments from Filar and Sławiński, shows that there is very wide consensus within the MPC that there is no need for further rate cuts. This does not leave doubts that monetary easing cycle has come to an end. On the other hand, apart from Halina Wasilewska-Trenkner (whose comments are presented below) no one from the MPC, even "hawks", does announce explicitly a swift need for a rate hike.

MPC member Halina Wasilewska-Trenkner once again expressed the opinion that strong economic expansion and faster inflation return to the target could induce the MPC to tighten monetary policy, possibly already in the third or fourth quarter of this year. This was her third statement in a few weeks about a need for a rate hike, so the market was not surprised. However, it does not seem that her opinion is shared by majority of central bankers.

In Andrzej Wojtyna's opinion, likewise in case of upward inflation disturbances, monetary policy should not react automatically to supply-side deflationary shocks, and adjustment in policy would be necessary only if there is a risk of negative second-round effects. Wojtyna's strong declaration that interest rates are likely to remain unchanged this year are a significant guide, suggesting that only significant deceleration in economic growth could make the MPC think about monetary easing again. This is consistent with our view on monetary policy prospects.

Government and politics

Planned measures aimed at reduction of tax wedge

A cut in mandatory disability pension contributions to 9% from 13% and reduction in health insurance contribution to 1.8% from the current 2.45%; these changes are due to come into force on Jan 1, 2007.

A promise to cut PIT rates to 18 and 32% from 2009 on. The ministry also promises to adjust for inflation tax brackets (possibly already in 2006) frozen by previous administrations in 2002 and a gradual phasing in of tax breaks for families with children.

Several measures simplifying VAT regulations and more favourable rules on amortisation.

...and ways of financing these changes

PLN3.6bn thanks to a rise in excise tax on heating oil to bring it level with diesel, a return to a level of excise tax on fuel before reduction in September 2005, adjustment in excise taxes on other products in line with EU guidelines.

PLN1.5bn rise in revenues due to changes in business taxation.

PLN4.1bn brought by the phasing out of a tax break on housing construction and repairs, and better VAT collection.

Government approved tax changes

▪ On 6 June the government finally approved a package of tax changes proposed several months earlier by finance minister Zyta Gilowska. After consultations with ministries, package has not changed much. Planned changes were designed to have neutral impact on 2007 budget, which stems from the fact that a reduction in some taxes have been offset by an increase in other areas.

▪ Although on one hand, effective taxation of labour income will decrease a bit, some indirect tax rates are about to rise. In sum, even finance minister Zyta Gilowska admitted she would not call this package of bills a "reform".

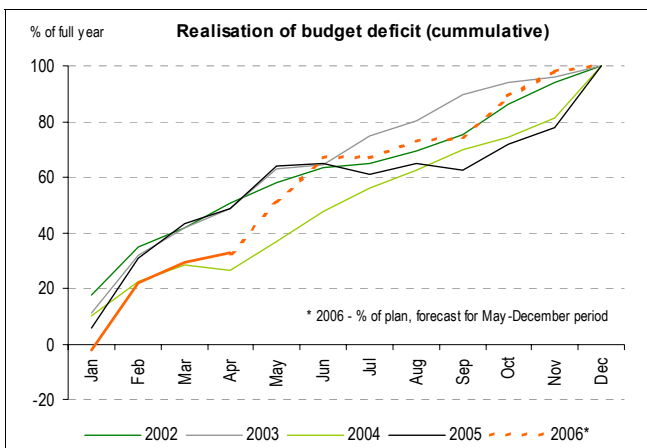
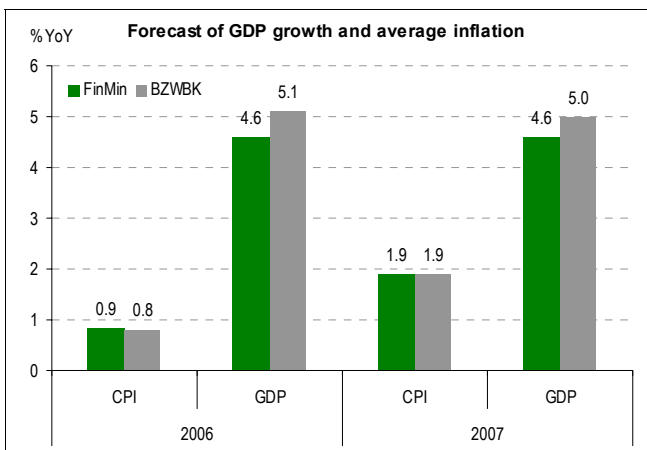
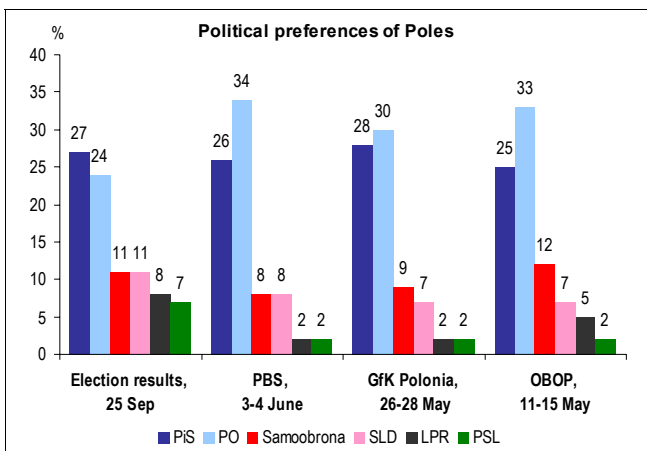
▪ One should not be surprised with such opinion, as the Ministry of Finance has withdrawn from some of previously planned changes that were anyway described as quite limited.

Support for coalition melting down

▪ Results of latest opinion polls keep showing that parties engaged in ruling coalition are slowly losing public support.

▪ If the trend proves persistent, it could negatively affect government's economic policy. Facing decreasing support, coalition parties might be less prone to implement difficult reforms. Pushing necessary bills through the parliament could be therefore more difficult.

▪ Decreasing popularity of the coalition increases a risk that its consistency could be threatened. Allies of PiS could calculate at some point that the best choice for boosting support for them is an attack on co-ruling partners. The phenomenon could intensify just before local election, i.e. during work on 2007 budget.



Source: CSO, Ministry of Finance, opinion polls

New budget assumptions to be released in June

▪ At the end of June the Ministry of Finance is planning to present official macroeconomic assumptions to 2007 budget.

▪ Deputy finance minister mentioned recently a possibility of reduction of average inflation forecast for the next year. While only recently the ministry forecasted it at 1.9%, now it agrees that due to lower prices of food and fuels it could be lower. Our prediction for 2007 is 1.9% and it seems the risk is on the downside.

▪ At the same time, the ministry does not plan to boost GDP forecast for the next year. We see it as a positive sign that the ministry tries to work out cautious assumptions (that would not overestimate revenues in order to boost spending).

Realisation of this year's budget without problems

▪ Budget deficit after April reached 32.8% of the annual plan, i.e. much lower than in analogous period of previous years (average for 2001-2005 is 46.2%). Good results were possible thanks to strong rise in revenues (14.7%YoY in April, 13.7%YoY in January-April period). While revenues from direct taxes decelerated growth from 10.6% to 6.4%YoY, indirect taxes rose more vigorously (PIT 76%YoY, CIT 20%YoY) likewise revenue of budgetary units (23%YoY).

▪ Rise in spending also accelerated (to 10%YoY in April from 5.7% in previous month) e.g. due to higher costs of foreign debt servicing.

▪ In sum, faster than expected GDP growth helps in realisation this year's ambitious targets and a risk of tax revenue undershoot is not substantial.

Government and politics

Comments of government representatives and politicians Our remarks

Lech Kaczyński, Poland's president

Reuters, PAP, 8 June

This solution [changes in tax base for artists and academics] seems so obviously unadjusted to our reality...that for the first time I felt obliged to intervene. I hope I will be able to persuade [the government] at tomorrow's meeting, because otherwise I will have to use my constitutional [veto] measures. I still believe we can solve this issue without a veto, which would be an extraordinary event given that we co-operate with each other, and without any personal changes.

PAP, 9 June

Mrs. Gilowska presented extensive justification of her view and there is still a difference of opinions between us at this point. I still maintain a view that the problem can be solved without using presidential veto or any personal decisions.

First clouds are gathering over tax changes just approved by the government at the beginning of June. First of all, the proposal to increase tax base for artists and academics met with strong resistance and if the government does not abandon the idea, the bill could be vetoed by the president. Additionally, according to information from Social Security Office, reduction of sickness premium from 2.45% to 1.8% planned by the government coupled with transition of this burden from employee to employer cannot be implemented since 1 January due to technical reasons, because it will not be possible to upgrade office's computer system until then. Nevertheless, none of the issues mentioned above have crucial financial importance for the net effect of entire package of tax changes.

Only a few days after government's approval of tax measures, some rumours appeared about minister Zyta Gilowska's dismissal. The rumours were quickly denied, however one has to take into account there is a risk that during further work on changes in public finances and 2007 budget Gilowska could lose her patience.

Ministry of Finance; www.mf.gov.pl, 1 June

The Ministry of Finance estimates that index of consumer prices in May (previous month = 100) was at 100.5.

It implies that annual growth rate of consumer prices in this particular month could reach 100.9.

On the International Children's Day the Ministry of Finance has prepared a surprise for the market participants, presenting its inflation forecast. It was a surprise because the estimate proved to be quite pessimistic. Last month, average market forecast of inflation rate for both April and May was at 0.6%. So, this is the second straight month when the Ministry of Finance presents inflation prediction higher than market consensus. It should not be ignored given the fact that their previous forecast did materialise. It seems that a risk of deflation in the summer period moves away. On the other hand, a pace of inflation pickup is still moderate and CPI is not expected to return to 2.5% target earlier than in a few quarters time. This confirms our view that interest rates in Poland should remain stable for some time.

Stanisław Kluza, deputy finance minister

Reuters, 29 May

We estimate that in May industrial output grew ca. 10%, which confirms continuation of dynamic growth in production this year after its incidental deceleration in April. Such data allow us to maintain forecast of economic growth at ca. 4.6% in 2006.

In line with what we wrote several before, April's increase in industrial production (5.8%YoY) was not a bad result, because it resulted from lower number of working days (two days less than last year). In May there will be a reversal of this effect and we believe that FinMin's forecast is too pessimistic in this regard. While the ministry maintains its GDP forecast at 4.6%, we have revised it up to over 5%. This is another example of conservative approach of the finance ministry.

Elżbieta Suchocka-Roguska, deputy finance minister

Reuters, 29 June

According to our latest estimates, the end-May budget deficit reached 49.5-51 percent. This is a better than expected figure thanks to lower spending and solid revenues.

Latest predictions of the Ministry of Finance regarding realisation of budget deficit are better than presented several weeks before (when the ministry was expecting deficit at 53% of annual plan). Lower gap has been achieved due to higher rise in revenues (confirming good economic situation) and due to restraining public expenditure (at least when it comes to central budget).

Jarosław Pietras, deputy finance minister

PAP, Reuters, 7 June

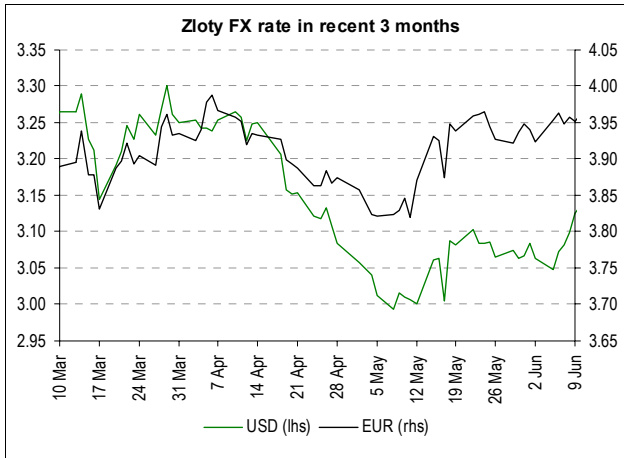
We are preparing budget for next year right now; macroeconomic assumptions are not fully accepted by the government, yesterday the government approved package of tax changes. This year budget deficit will be the same as last year (2.5% of GDP), or even if it's higher, it is unlikely to exceed 2.8% of GDP. Therefore, we are still within a limit. It is surprising though that Poland meets criteria for two straight years and still remains under excessive deficit procedure.

Lithuania should enter the euro zone. Euro zone members should not be so restrictive towards Lithuania, because many of them do not meet Maastricht criteria themselves. We believe there is a serious problem with interpretation of inflation criteria, as the Treaty says about "best performing countries", not about the lowest rates of inflation.

Soon we should learn the government's proposals regarding 2007 budget draft. According to Polish law, the government should present basic assumptions to the budget for consultations with Three-party Committee until the middle of June. Although there are only a few days left until this moment, representatives of the Ministry of Finance admit there is still no final design regarding e.g. main macroeconomic parameters, and even at the meeting with the European Commission the deputy finance minister was not able to present any specific information about fiscal plans for the next years. According to earlier declarations the deficit should not exceed PLN30bn. The question remains whether some further reduction will be possible.

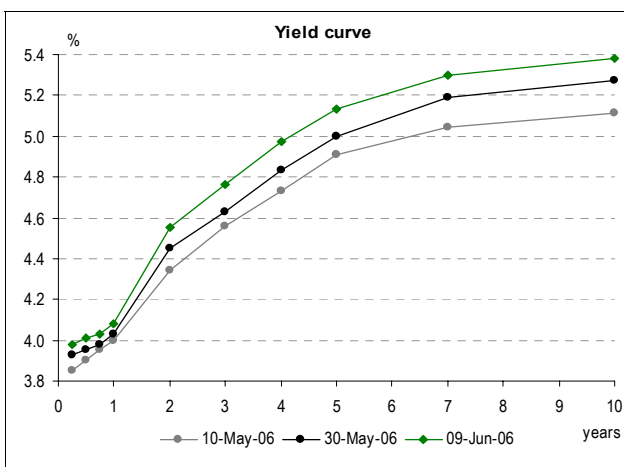
Controversies over interpretation of Maastricht treaty criteria are probably well justified by economic reasoning. Nevertheless, the fact that the European Commission is so firm in its stance suggests that we cannot count on soft treatment in assessment of convergence criteria. Anyway, this is not the number one problem in Poland right now, as according to the Prime Minister, the government does not plan to start thinking on a strategy for euro adoption until 2009.

Market monitor



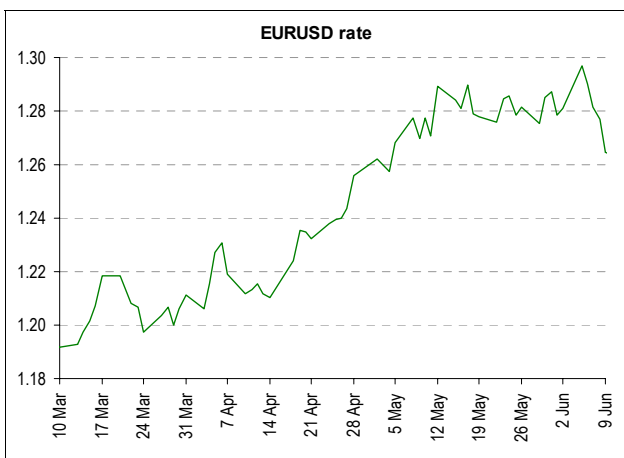
Emerging markets sell-off in May

- Financial markets are under influence of high global risk aversion, which among others is connected with increased uncertainty with regards to further moves in U.S. monetary policy. Retreat from risky assets contributed to a sell-off in the emerging markets, which was fuelled by worsening of the economic and political situation in Turkey. Zloty weakened to much lesser extent than other emerging currencies, as it was supported by sound fundamentals.
- Next month zloty will remain under influence of the situation abroad, till the decision regarding the U.S. interest rates. Fed's communiqué may be also important, as it may affect the sentiment towards the emerging markets. The ECB's comments and the communiqué may be of quite high importance for the currencies in the region. Signals from the politics may be negative, though Zyta Gilowska's resignation in the nearest time



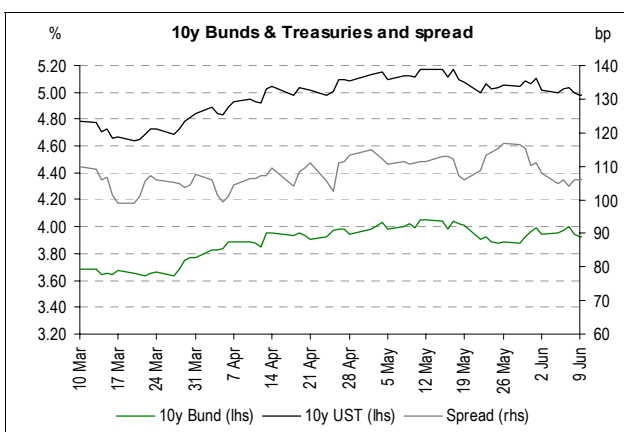
Risk aversion and CPI weakened the debt market

- The rise of risk aversion connected with global inflation fears, unknown further moves in monetary policy fuelled by the negative macroeconomic data from Turkey contributed to a heavy sell-off in the emerging markets, Polish bonds as well and yields curve steepening. Negative factor for the debt were higher than expected inflation data.
- According to the MPC members' statements interest rates are at the appropriate level and even deflation in some months is not going to contribute to any rate cuts. It is in line with our scenario that the Council will leave the rates unchanged till the end of the year. Well possible rate hikes in the United States and the euro zone as well as inflation staying at low level will work against monetary policy easing. We assume as well that rates are going to stay unchanged in the whole 2007.



EURUSD dropped after staying near one year highs

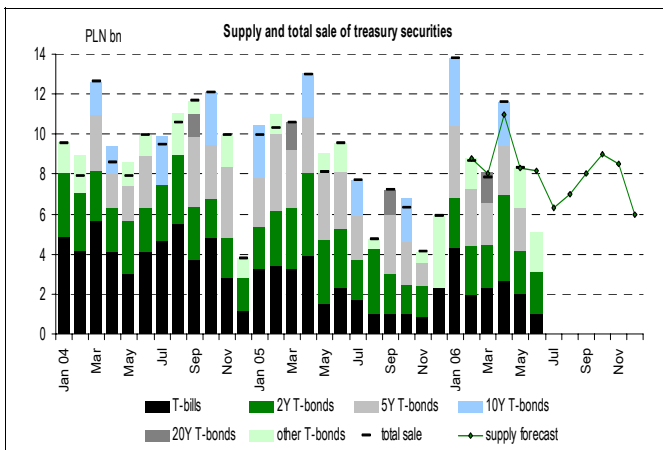
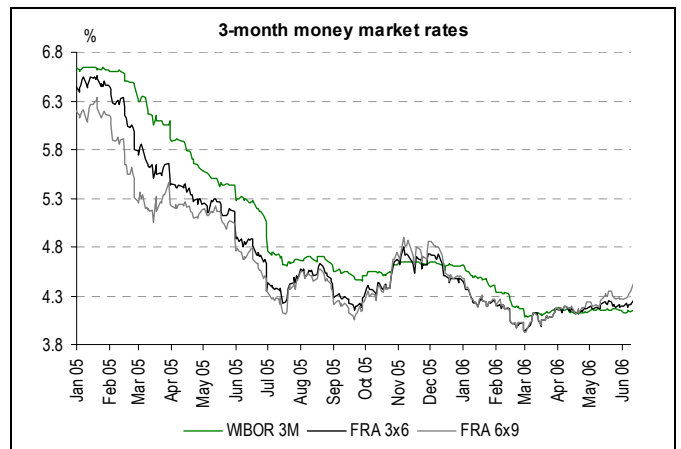
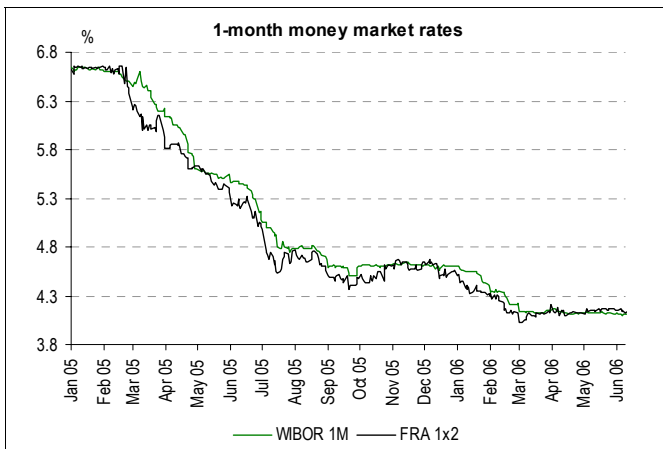
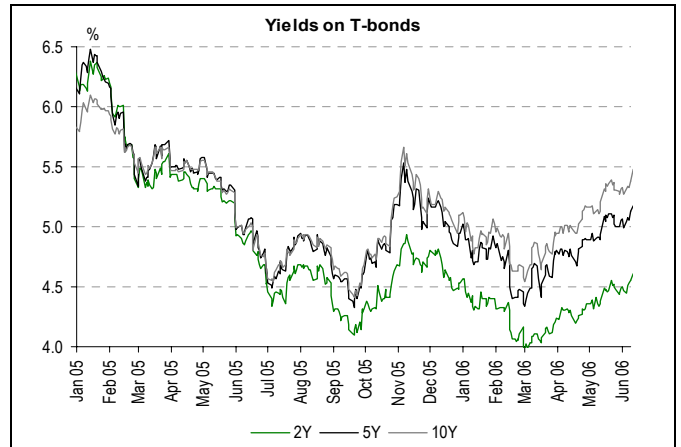
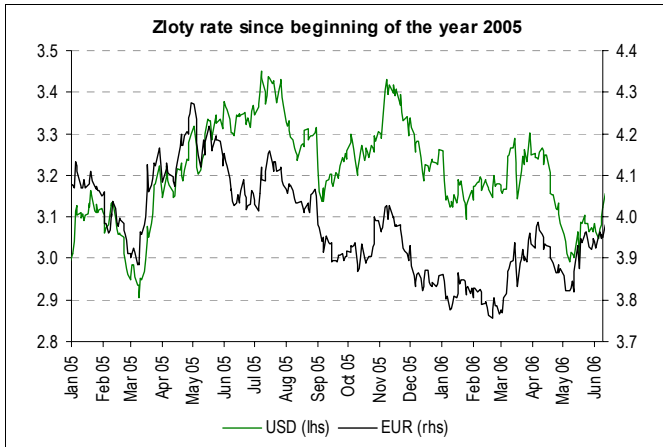
- After release of higher than expected core CPI inflation in U.S. and comments of Fed's officials, especially Ben Bernanke's on expectations of further monetary policy tightening in United States increased, which supported the dollar. Positive data in the euro zone worked in favour of the single currency, which contributed to the stabilisation of the EURUSD rate in range of 1.27-1.295, though after less hawkish than expected communiqué of the ECB the EURUSD rate declined to 1.26.
- In our view at the June meeting The Federal Open Market Committee will raise interest rates by 25 bp to 5.25%, which in the short term will support the dollar, though this should not improve the perspectives of U.S. currency in the long term amid acceleration of economic activity in the euro zone and structural imbalances and a slowdown in U.S. In the fourth quarter the EURUSD rate may rise and fluctuate around 1.30 level.



Strengthening despite hawkish Fed

- After a rise of global risk aversion foreign investors started to transfer money to „safe haven“ investments (among others U.S. Treasuries), which amid data showing economic slowdown in U.S. resulted in Treasuries strengthening. A correction occurred after Fed's communiqué and Fed's members comments, though the sell-off in the stock market effected in another strengthening of the U.S. debt. Yields of 10Y Bunds fell to 3.92%, among others after less hawkish ECB's communiqué.
- In spite of lack of explicit signals in the ECB's communiqué on the further steps in the EMU's rates tightening, we still assume that the main interest rate is going to be raised by 25 bp every quarter. Taking into consideration recently published data from the U.S. we assume that Fed will hike interest rates by 25 bp at the June meeting and they will stay at 5.25% level till the year's end.

Market monitor



Treasury bill auctions (PLN m)

Date of auction	OFFER / SALE		
	26-week	52-week	Total
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 / 1 000	1 000 - 1 000
Total May*	-	2 000 / 2 000	2 000 / 2 000
05.06.2006	-	1 000 / 1 000	1 000 / 1 000
19.06.2006	-	1 000 - 1 300	1 000 - 1 300
Total June*	-	2 000 - 2 300	2 000 - 2 300

* estimations based on Ministry of Finance preliminary information

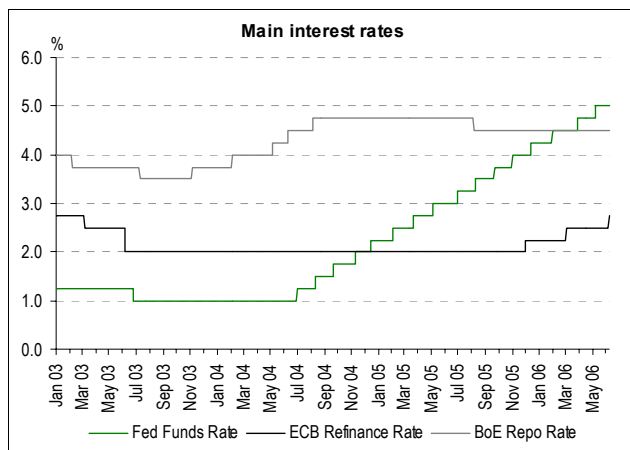
Treasury bond auctions in 2006 (PLN m)

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	2 000	2 000
June	07.06	OK0808	2 100	2 100	14.06	WZ0911 IZ0816	1 500-2 500 500	-	21.06	PS0511	1800 - 2800	-
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

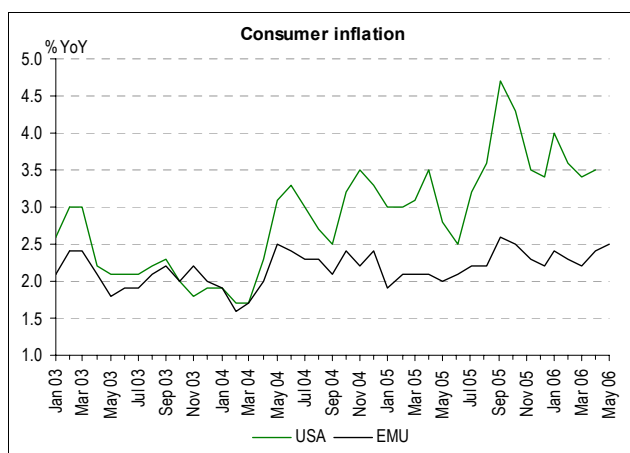
International review



Further hike in U.S. well possible

▪ Since the May rate hike expectations on further steps in U.S. monetary policy and target level of official Fed Funds rate in U.S. were changing with quite high frequency along data releases. However latest comments of Ben Bernanke suggested that despite economic slowdown (labour and housing market data), the rate hikes cycle did not end amid increased inflation fears (high core CPI).

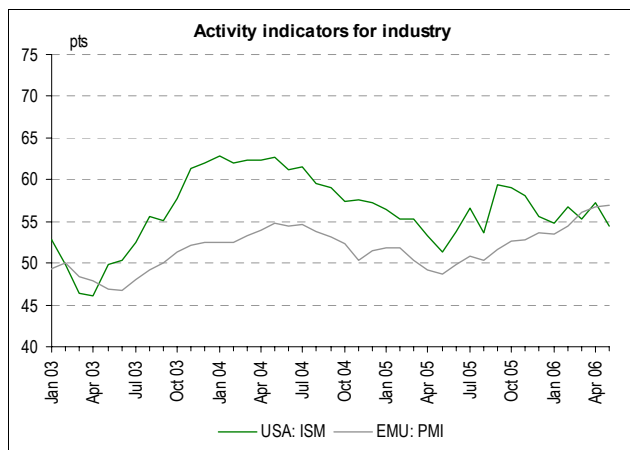
▪ At the June meeting the European Central Bank increased the main interest rate in the euro zone by 25 bp to 2.75%. At the conference the ECB's president Jean Claude Trichet did use the key word "vigilant" with reference to inflation and said that interest rates are at the appropriate at low level, while the central bank is going to monitor the development of economic situation in the euro zone.



Core CPI above forecasts again

▪ In April U.S. CPI rose by 0.6%MoM, which was mainly a consequence of increased energy (3.9%MoM) and gasoline (8.8%MoM) prices. Core CPI increased by 0.3%MoM and was above market consensus (0.2%MoM) due to rising rental prices (0.3%MoM). In annual terms the headline and core indices changed respectively from 3.4% in March to 3.5% and from 2.3% to 2.1%. PPI rose by 0.9%, however the core figure, excluding most volatile food and energy prices increased by 0.1%, slightly below forecasts at 0.2%.

▪ With reference to data of the Eurostat in April the HICP inflation rose to 2.4%YoY as compared to 2.2%YoY in March. The core CPI increased to 1.5%. According to the preliminary estimates in May the HICP increased by 2.5%YoY.

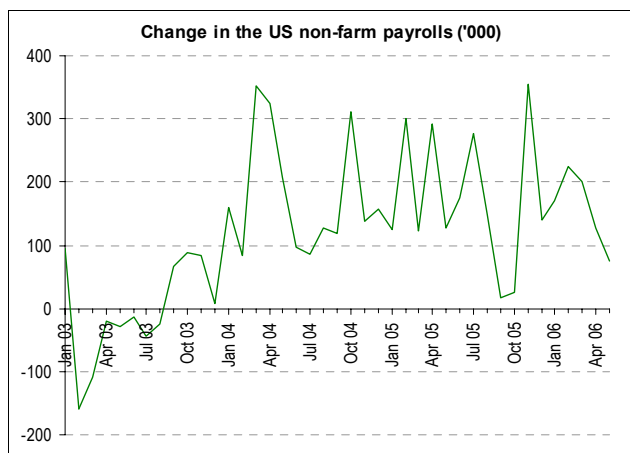


Rising activity in the euro zone

▪ ISM activity in the manufacturing sector in U.S. 57.3 to 54.4, while prices paid index increased to 77.0 from 71.5. ISM index reflecting activity in the services sector in United States dropped from 63.0 in April to 60.1.

▪ The PMI index for the manufacturing sector rose in the euro zone rose in May to 57.0, the highest level since August 2000. The output index rose to 59.5 from 59.3 the month before. The non-manufacturing PMI rose from 58.3 in April to 58.7, which showed the fastest growth since September 2000. Jobs index increased from 54.6 to 55.0 and was the highest since January 2001, while prices charged component hiked from 53.3 to 54.5, the highest level since November 2000

▪ According to the Commerce Department the U.S. GDP rose in the first quarter by 5.3% upwardly revised from 4.8%, though the result was below market consensus of a 5.7% rise. Carefully observed by the Fed inflation measure, i.e. core personal consumer expenditures excluding food and gasoline prices remained unchanged as compared to previous estimate at 2%. GDP deflator also changed and amounted to 3.3%.



Weaker data from the labour market

▪ In United States in May the non-farm payrolls increased by 75k, which was much below economists forecasts at 175k. What is more the data for the previous month were downwardly revised from 138k to 126k. The unemployment rate fell from 4.7% to 4.6%, the lowest level since July 2001.

▪ The unit labour costs in U.S. rose in the first quarter by 1.6% downwardly revised from 2.5%, and was below market forecasts at 1.9%. Q1 labour productivity rose by 3.7%. In May labour unit costs rose by 0.1% as compared to an increase by 0.6% in the previous month.

Source: Reuters, ECB, Federal Reserve

Economic calendar

Monday	Tuesday	Wednesday	Thursday	Friday
12 USA: Fed budget (Apr)	13 GER: ZEW index (jun) USA: PPI (May) USA: Retail sales (May)	14 POL: Auction of 7Y floating rate bonds and 12Y CPI linked bonds POL: CPI (May) POL: Money supply (May) POL: Balance of payments (Apr) USA: CPI (May)	15 POL: Public holiday EMU: Final HICP (May) USA: Net capital flows (Apr) USA: Capacity use (May) USA: Industrial production (May) USA: Philadelphia Fed index (VI) USA: Jobless claims	16 EMU: Industrial output (Apr) USA: Preliminary Michigan (Jun)
19 POL: Treasury bills auction POL: Wages (May) POL: Employment (May)	20 POL: PPI (May) POL: Output in industry and construction (May) USA: House starts (May) USA: Build permits (May)	21 POL: Auction of 5Y bonds	22 USA: Jobless claims	23 POL: Business climate (May) POL: Net inflation (May) POL: Retail sales (May) POL: Unemployment (May) USA: Durable goods (may)
26 USA: New homes sales (May)	27 POL: MPC meeting GER: IFO index (June) USA: Consumer confidence (June) USA: Home sales (May)	28 POL: MPC meeting – decision	29 POL: Switch auction EMU: M3 money supply (May) USA: Core PCE (Q1) USA: Final GDP (Q1) USA: GDP deflator (Q1) USA: Jobless claims USA: Fed meeting – decision	30 POL: Balance of payments (Q1) EMU: Preliminary HICP (Jun) EMU: Consumer sentiment (Jun) EMU: Economic sentiment (Jun) USA: Core PCE (May) USA: Final Michigan (Jun) USA: Chicago PMI (Jun)
3 July EMU: Manufacturing PMI (Jun) USA: Manufacturing ISM (Jun)	4 EMU: PPI (May) USA: Independence Day – market holiday	5 POL: Auction of 2Y bonds EMU: Non-manufacturing PMI (Jun) EMU: Retail sales (May) USA: Factory orders (May)	6 GB: BoE meeting - decision EU: ECB rate decision (Jul) USA: Jobless claims	7 USA: Non-farm payrolls (Jun) USA: Unemployment (Jun) USA: Non-manufacturing ISM (Jun)
10 POL: Treasury bills auction	11	12 POL: Auction of 10Y bonds EMU: Revised GDP (Q1) USA: Foreign trade (May)	13 POL: Balance of payments (May) USA: Fed budget (May) USA: Jobless claims	14 POL: CPI (Jun) POL: Money supply (Jun) USA: Foreign trade prices (May) USA: Foreign trade (Apr) USA: Retail sales (Jun) USA: Preliminary Michigan (Jul)

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	23	-	-	-	-	-	-
Gross wages, employment	16	15	15	18	17	19	17	16	15	16	16	15
Unemployment	24	23	23	26	24	23	-	-	-	-	-	-
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	12	-	-	-
Money supply	13	14	14	14	12	14	14	14	14	-	-	-
NBP balance sheet	6	7	7	7	5	7	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

		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	Jun 06
Industrial production	%YoY	0.9	6.9	2.6	4.8	5.9	7.6	8.5	9.6	9.8	10.2	16.4	5.8	16.6	6.0
Retail sales ^c	%YoY	8.0	10.5	5.0	7.9	5.4	7.5	7.3	6.3	8.6	10.2	10.1	13.2	13.0	8.5
Unemployment rate	%	18.3	18.0	17.9	17.8	17.6	17.3	17.3	17.6	18.0	18.0	17.8	17.2	16.5	16.3
Gross wages ^{b,c}	%YoY	3.0	4.5	3.2	2.8	1.8	6.4	6.9	1.5	3.6	4.8	5.4	4.0	4.5	3.9
Employment ^b	%YoY	1.6	1.7	1.8	2.0	2.2	2.1	2.5	2.6	2.6	2.4	2.7	2.8	2.8	2.7
Export (€) ^d	%YoY	17.0	15.9	18.0	14.9	12.9	18.0	14.8	22.0	19.9	19.1	23.0	22.3	24.2	19.7
Import (€) ^d	%YoY	12.4	12.8	7.8	15.5	11.0	14.6	17.5	17.4	19.3	20.3	21.6	22.9	24.0	21.2
Trade balance ^d	EURm	-454	-80	-113	-378	-107	-28	-270	-395	139	-137	-272	-150	-550	-200
Current account balance ^d	EURm	-678	181	-247	-381	-237	-326	-408	-359	-76	-643	-458	-50	-740	-300
Current account balance ^d	% GDP	-2.5	-2.1	-1.8	-1.7	-1.5	-1.5	-1.6	-1.4	-1.3	-1.4	-1.5	-1.5	-1.5	-1.6
Budget deficit (cumulative)	PLNbn	-18.3	-18.5	-17.5	-18.5	-17.8	-20.6	-22.2	-28.6	0.7	-6.7	-9.0	-10.0	-15.4	-20.4
Budget deficit (cumulative) ^e	% realisation	64.0	64.8	61.1	64.7	62.3	72.1	77.7	100.0	-2.3	21.9	29.4	32.8	50.4	66.8
CPI	%YoY	2.5	1.4	1.3	1.6	1.8	1.6	1.0	0.7	0.6	0.7	0.4	0.7	0.8	1.0
PPI	%YoY	-0.5	0.0	0.0	-0.2	-0.5	-0.9	-0.4	0.2	0.3	0.7	0.9	1.6	2.0	1.8
Broad money (M3)	%YoY	13.2	10.8	10.4	11.1	12.7	8.7	12.6	10.4	10.4	11.7	9.8	9.6	8.2	9.9
Deposits	%YoY	11.9	9.2	9.4	10.1	11.6	6.3	11.1	9.4	10.2	10.8	9.1	8.6	7.8	10.3
Loans	%YoY	9.4	7.4	8.8	9.0	9.6	4.4	10.2	11.8	12.3	13.5	13.6	12.1	11.9	13.9
USD/PLN	PLN	3.29	3.34	3.40	3.29	3.20	3.26	3.37	3.25	3.16	3.18	3.23	3.20	3.05	3.09
EUR/PLN	PLN	4.18	4.06	4.10	4.05	3.92	3.92	3.97	3.85	3.82	3.79	3.88	3.92	3.90	3.95
Reference rate ^a	%	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	4.00
Lombard rate ^a	%	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	5.50
WIBOR 3M	%	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	4.15
Yield on 52-week T-bills	%	5.19	5.09	4.30	4.33	4.15	4.19	4.35	4.38	4.22	3.97	3.87	3.95	4.02	4.07
Yield on 2-year T-bonds	%	5.27	5.14	4.50	4.60	4.22	4.42	4.75	4.64	4.40	4.20	4.10	4.28	4.44	4.57
Yield on 5-year T-bonds	%	5.38	5.25	4.70	4.84	4.51	4.85	5.23	5.04	4.82	4.60	4.59	4.80	5.00	5.15
Yield on 10-year T-bonds	%	5.36	5.24	4.72	4.87	4.57	4.90	5.36	5.14	4.94	4.78	4.78	5.02	5.26	5.37

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	923.2	980.9	1 037.5	228.7	238.2	241.0	273.0	240.3	252.7	254.6	289.8
GDP	%YoY	3.8	5.3	3.4	5.1	2.2	2.9	3.9	4.3	5.2	5.2	4.8	5.1
Domestic demand	%YoY	2.7	5.9	2.2	5.2	1.1	0.0	1.9	5.4	4.5	5.6	5.2	5.4
Private consumption	%YoY	1.9	4.0	2.0	4.6	1.4	1.4	2.3	2.8	5.1	4.8	4.5	4.1
Fixed investments	%YoY	-0.1	6.3	6.6	9.4	1.4	4.0	6.5	10.1	7.4	9.0	10.0	10.0
Industrial production	%YoY	8.4	12.3	4.0	9.1	0.7	2.3	4.5	8.3	12.1	9.4	7.3	7.5
Retail sales (real terms)	%YoY	3.6	7.1	1.5	10.4	-0.4	-3.2	4.1	5.4	9.4	11.0	11.1	10.2
Unemployment rate ^a	%	20.0	19.1	17.6	16.1	19.3	18.0	17.6	17.6	17.8	16.3	16.0	16.1
Gross wages (real terms) ^c	%YoY	2.0	0.8	1.2	3.9	-1.3	0.8	1.1	3.8	4.0	3.3	4.9	3.3
Employment ^c	%YoY	-3.5	-0.8	1.9	2.7	1.5	1.7	2.0	2.4	2.6	2.8	2.9	2.7
Export (€) ^b	%YoY	9.1	22.3	17.1	18.9	23.2	12.9	15.0	18.0	20.8	22.1	18.8	14.7
Import (€) ^b	%YoY	3.3	19.5	12.6	20.2	17.6	6.0	11.2	16.5	20.6	22.7	21.0	17.0
Trade balance ^b	EURm	-5 077	-4 552	-2 182	-3 620	-259	-633	-599	-691	-270	-900	-1 150	-1 300
Current account balance ^b	EURm	-4 108	-8 542	-3 503	-5 347	-1 043	-500	-861	-1 099	-1 177	-1 090	-1 530	-1 550
Current account balance ^b	% GDP	-2.1	-4.2	-1.4	-2.0	-3.4	-2.1	-1.5	-1.4	-1.5	-1.6	-1.9	-2.0
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	-2.9	-2.9	-	-	-	-	-	-	-	-
CPI	%YoY	0.8	3.5	2.1	0.8	3.6	2.3	1.6	1.1	0.6	0.8	0.8	1.1
CPI ^a	%YoY	1.7	4.4	0.7	1.5	3.4	1.4	1.8	0.7	0.4	1.0	0.7	1.5
PPI	%YoY	2.6	7.0	0.7	2.0	3.3	0.1	-0.2	-0.4	0.9	1.8	2.2	3.0
Broad money (M3) ^a	%YoY	5.6	8.7	10.4	11.2	11.0	10.8	12.7	10.4	9.8	9.9	9.2	11.2
Deposits ^a	%YoY	3.7	8.1	9.4	10.9	10.4	9.2	11.6	9.4	9.1	10.3	9.1	10.9
Loans ^a	%YoY	8.1	2.9	11.8	15.0	4.6	7.4	9.6	11.8	13.6	13.9	16.1	15.0
USD/PLN	PLN	3.89	3.65	3.23	3.10	3.07	3.28	3.30	3.29	3.19	3.11	3.07	3.04
EUR/PLN	PLN	4.40	4.53	4.02	3.94	4.03	4.13	4.02	3.91	3.83	3.92	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	4.07	5.91	5.21	4.26	4.31	4.02	4.01	4.10	4.15
Yield on 2-year T-bonds	%	5.38	6.89	5.04	4.45	5.83	5.27	4.44	4.60	4.23	4.43	4.55	4.60
Yield on 5-year T-bonds	%	5.61	7.02	5.25	5.01	5.89	5.38	4.68	5.04	4.67	4.98	5.20	5.20
Yield on 10-year T-bonds	%	5.77	6.84	5.24	5.21	5.76	5.37	4.72	5.13	4.83	5.22	5.40	5.40

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

This analysis is based on information available until 09.06.2006 has been prepared by:

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