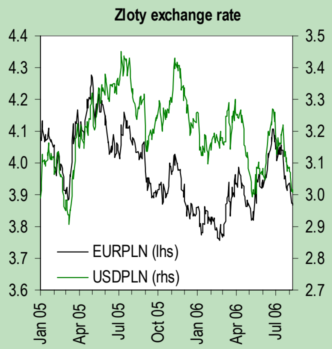
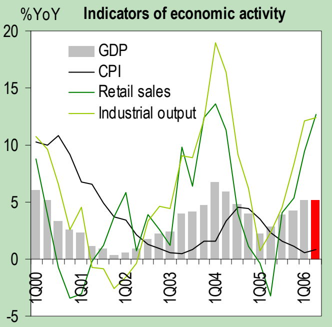
Bank Zachodni WBK

MACROscope

Polish Economy and Financial Markets

August 2006





GDP 2Q06 - BZ WBK forecast

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Silly season is over

- **We were taken by surprise by the summer scale of PLN strengthening at the turn of July and the average EUR/PLN rate in Q3 will be, most likely, lower than the rate we projected (slightly above 4.0). At the same time, we maintain our forecast for the EUR/PLN rate at the year end at 3.90.** The main reason behind the fall in the exchange rate below 3.90 was the market expectation for the pause in the interest rate hikes in the US, which resulted in a significant inflow of capital to the emerging markets. It may seem that Fed will maintain the interest rate at the level of 5.25% by the end of the year, it is not regarded certain (the Fed's announcement left the door open for increase), and the markets can nervously react to the upcoming economic data from the US, in particular on the inflation pressure. In view of the above and taking account of the scale of the last zloty strengthening, we think that the risk of the correction in the Polish currency market has increased. Our stance is also justified by the fact that the silly season, characterised with lower activity on the market, is slowly coming to an end. It is difficult to assess whether there is a chance to exceed the EURPLN exchange rate level of 4.0, as the negative information re. the fiscal policy seem to be ignored (e.g. risk of higher spending or the very likely extension of the convergence path). Yet, if the level turned out to be higher than 4.0, as a result of the impact of political factors, we would perceive it as the chance to purchase relatively cheaply the Polish currency (chance to hedge the FX risk for the exporters).

- **The bond market seems to already price in the fiscal risk (at least to some extent), as the PLN strengthening was not paralleled with significant yield drop, which complies with our scenario.** Even though the short end of the yield curve (FRA) does not price in any increases in the interest rate this year, the rates in the segment of 1-2 years are still attractive, taking account of the fact that there might be no hikes even next year. At the same time the yield curve can get steeper as its long end will remain under the influence of the yield growth risk on the core markets (possible change in the expectations as to the next decisions of the Fed and increase in the interest rate in the euro zone).

- **The very high economic growth is still accompanied by low inflation and it seems that the Monetary Policy Council has difficulties in explaining this phenomenon and its future consequences.** Although the new projection for July assumed inflation increase, particularly in 2008, in the announcement following the MPC meeting, the Council commented only the April projection. In our view, the MPC's opinion that the inflation can be higher than the one presented in April report pertains only to 2007 (and not to 2008), which is caused by the fact that some assumptions are overly pessimistic. It would mean that most of the Council members is of the opinion that the inflation will meet the target earlier than it had been previously expected, yet this excess does not have to be necessarily sustainable. Such a scenario does not require the monetary policy to be tightened, which is in line with our view.

Financial market on 31 July 2006:					
NBP deposit rate	2.50	WIBOR 3M	4.18	USDPLN	3.0831
NBP reference rate	4.00	Yield on 52-week T-bills	4.25	EURPLN	3.9321
NBP lombard rate	5.50	Yield on 5-year T-bonds	5.40	EURUSD	1.2754

This report is based on information available until 09.08.2006

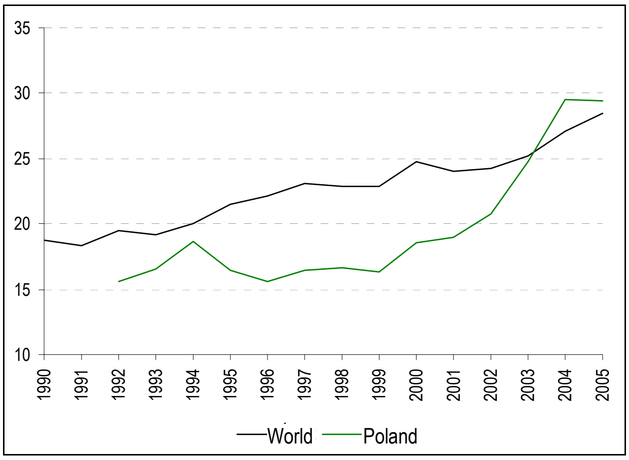
Special focus

What's up in foreign trade?

Good, getting better …

Recent years have been very favourable for the Polish foreign trade. Since the beginning of the decade, the over two-digit export growth rate has been continuously high and the role of international trade in the Polish economy has been growing. The growth in significance of foreign trade has been a world's trend for a few decades, however, the dynamics of change over the last few years in Poland is much above the average recorded in other countries. Poland, who was relatively little open to trading with foreign countries, is gradually changing to become a more open economy, and is doing it at the fastest pace on our continent. It is well illustrated by the change in the exports to GDP ratio which increased nearly twice in the last decade – from ca. 15% in the middle of the 90's to 30% at present, while the highest growth was recorded over the last three-four years.

Export of goods in relation to GDP (%)

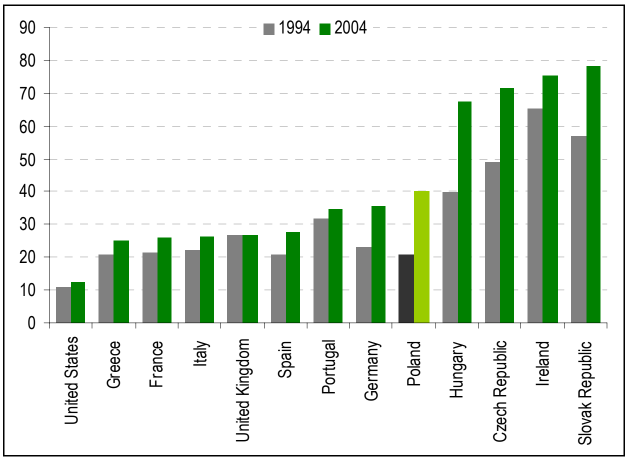


Source: IMF, CSO, own calculations

As the share of exports in the GDP in Poland is still lower than in the other countries in the region with similar stage of economic development (the Check Republic, Slovakia, Hungary), while making this comparison account should be taken of the different sizes of these economies and the world's pattern which indicates that the degree of openness to foreign trade is usually in inverse proportion to the size of the domestic market. On the other hand, over the recent years Poland has compared favourably to the majority of developed countries with quite big domestic markets.

What is interesting, the revival in Polish foreign trade over the recent years has been more dynamic on the export rather than import side and accordingly, paralleled to the significant growth in trading exchange, the trade deficit was considerably reduced. As opposed to the first 10 years of the transformation, the dynamic growth in turnover in the recent years was not followed by the growth in trade balance deficit but by the deficit reduction.

Export of goods and services in relation to GDP (%)



Source: OECD

The recent trends in the Polish foreign trade provoke thinking about what has happened in the Polish economy to cause such positive changes in foreign trade. In addition, answer should be given to the question whether these were structural permanent changes and we can expect them to continue or whether they just arose from some favourable coincidence.

In search of success sources

Careful readers of our MACROscope may remember that we analysed the Polish foreign trade in depth three years ago. At that time, we estimated the econometric model of Polish exports whilst trying to identify drivers of the boom in exports emerging then. The outcome of the calculation indicated very high income elasticity and low price elasticity of the Polish exports i.e. high sensitivity to the change in economic growth rate of Poland's key trading partners and rather moderate response to fluctuations in real exchange rate. In addition, the model suggested statistically significant, inverse dependence of exports on domestic demand (effect of "pushing out" domestic output to foreign markets in period of unfavourable business climate on the domestic market). At that time, the results did not seem fully satisfactory because, as we thought, they did not account for the high dynamics of exports in the period of austerity in EU member states and the gradually growing domestic demand in Poland. As a lot of time has elapsed since making the research and the Polish exports continue to surprise us with the continuous upward trends, we decided that it is worthwhile to make the estimates again based on the latest data to test whether over the recent years, when the foreign trade dynamics was particularly high, any significant changes happened to the mechanisms governing the Polish foreign trade. The study is also supplemented with the imports performance model which is to help us answer the question about the reasons for the gradual drop in Poland's trading imbalance in the recent years.

Econometric model

While analysing exports performance, we used – like previously – single equation model of linear regression which explains exports volumes through: foreign demand (GDP in the EU played this role), fluctuations in relative prices (effective real exchange rate), as well as domestic demand. Introduction of this last variable was justified by the relatively big size of the domestic market which, for producers, can represent an alternative to foreign demand. Additional variable is the measure of the global trade intensity (value of the world's exports/GDP), which is to partially capture the effect of changes in exports performance resulting from supply-side changes, which are not modelled directly in the adopted approach.

The estimated in similar way import model explains imports performance using the following variables: domestic demand which is to measure the income effect, effective real exchange rate, reflecting the change in price relations, and volumes of Polish exports (because it is highly import intensive).

More detailed information about econometric estimates is presented in the *Technical Annex* on page 7.

As a result of changes in the sources of the used data and minor differences in methodology, the outcomes of the estimated models are not directly comparable to these arrived at three years ago. As a result, we re-estimated current model based on respectively shorter sample (that matches the exercise we did three years ago), to compare the results attained in analogous conditions.

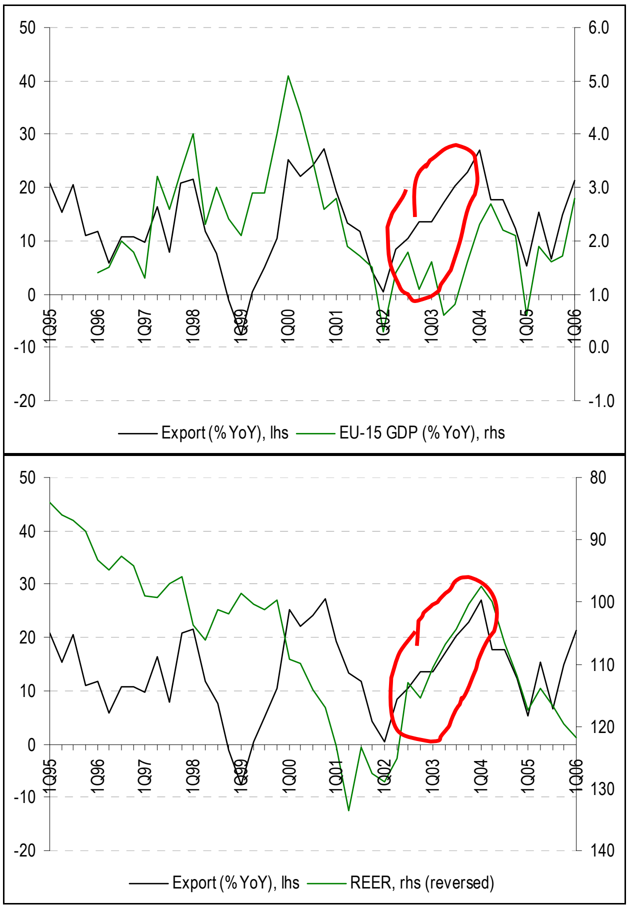
All Quiet on the Western Font?…

The outcome of the estimated exports model suggests that over the last three years when the Polish exports were growing very rapidly (indicating that a significant structural change could be happening in the economy) in fact little has changed, in terms of the mechanisms of foreign trade reaction to the triggers included in the model. The parameters of long-run relationship estimated in comparable conditions for the entire sample available (1996q1-2006q1) and for the period ending three years earlier (1996q1-2003q1) are very similar. The difference in parameters does not also seem to be significant in the equations of short-run dynamics.

According to the model outcome, Polish exports are highly sensitive to changes in external demand (GDP growth in countries who are our main trading partners), while its reaction to change in price competitiveness (real exchange rate) and the changes in domestic demand is moderately flexible. The signs of estimated parameters are compliant with economic theory and intuition and are statistically significant while the obtained equations still have appropriate econometric characteristics.

The strong exports dependence on the scale variable representing global foreign trade intensity is puzzling. This suggests significant impact of other supply-related factors, not directly included in the model, which were not precisely identified based on econometric estimates. These factors may include, e.g. effects of the inflow of foreign direct investments or changes in the structure of Polish exports reflecting its technological advancement. However, it proved impossible to confirm the impact of these factors on statistical grounds.

Growth of exports, domestic demand and exchange rate



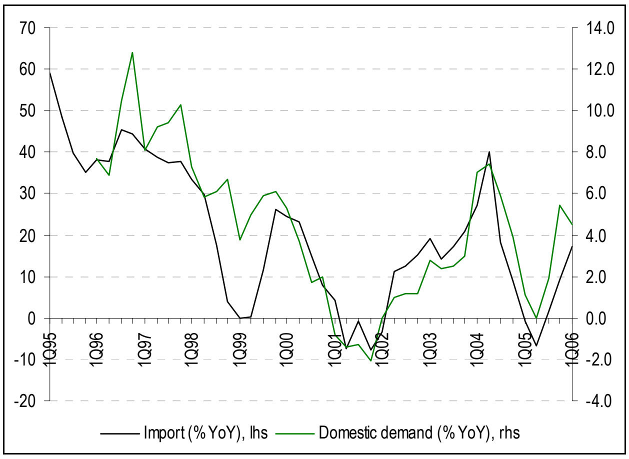
Source: CSO, Eurostat, own calculations

Stability in the time of the estimated parameters of the exports equation and the statistical adequacy of the model suggest that the high export growth rate recorded over the recent years can be explained well based on the mechanisms included in the model. Thus, it is not a result of a structural change in the Polish trade but rather a result of a favourable combination of factors influencing mainly the demand side. This thesis is confirmed even by quite superficial analysis of the export dynamics against the GDP dynamics in the EU and changes in the real exchange rate. The graphs on the previous page confirm that periods of quick expansion of Polish exports, in majority of cases, overlap with the periods of economic acceleration in the EU. In the quarters when they did not overlap, zloty strongly depreciated in real terms, e.g. in the period from 2003q3 to 2004q1 (the discrepancy in 1998 stemmed from the Russian crises).

Imports indifferent to exchange rate fluctuations

Interesting conclusions can be drawn from the estimation of the import equation. Also in this case, model parameters estimated using the full sample were not very much different from results achieved for sample ending three years earlier (in both cases they maintained statistical significance amid good properties of the model). Against our intuition, the econometric analysis failed to statistically confirm the dependence between import volumes and exchange rate. Regardless of the adopted exchange rate measure (real effective exchange rate deflated against CPI or ULC, or nominal effective exchange rate), the estimated parameter matching this variable in the model was close to zero and was statistically insignificant. The model indicates however, high demand elasticity of imports, primarily in relation to changes in the domestic demand, and also moderate positive correlation with changes in export volumes (as Polish exports are rather import-consuming).

Growth of imports and domestic demand



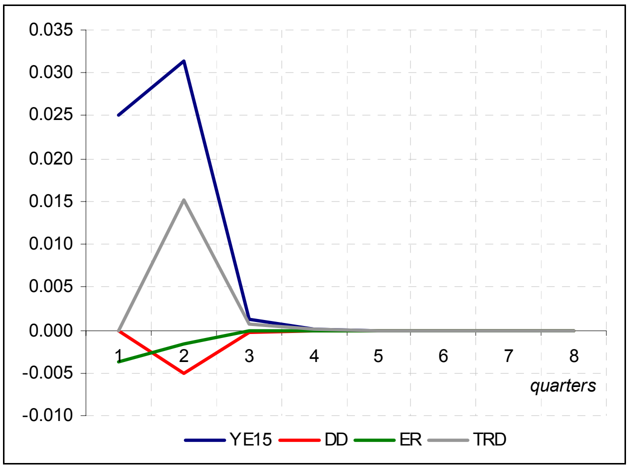
Source: CSO, own estimates

Conclusions for prospects of foreign trade

On the ground of estimated models it is possible to analyse impact of changes in particular factors on reaction of exports and imports. We have estimated such reactions through simulation assuming introduction of impulse (1% permanent change) in each of individual explanatory variables in the models, other things being equal.

Profiles of export responses to such impulses in specific variables are presented in a form of graph below.

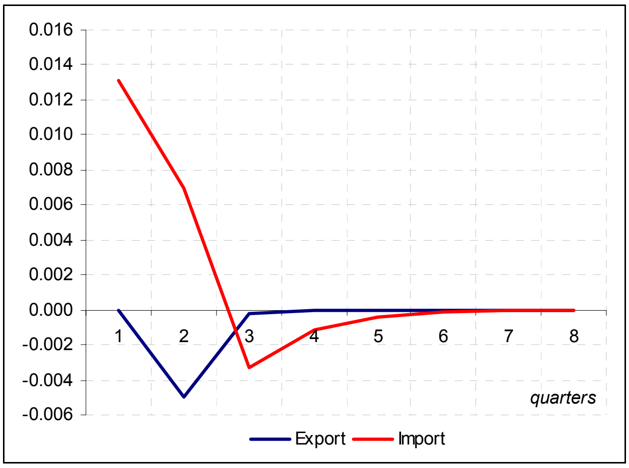
Export response to 1% disturbance in variables



Source: own estimates; Note: the chart presents change in exports (dX) in subsequent quarters in reaction to impulse in a form of 1% permanent shift in particular explanatory variable.

Outcomes of those simulations indicate that the exchange rate fluctuations in Poland have a relatively low impact on the trade balance in view of zero exchange rate elasticity of imports[1] and quite low price elasticity of exports. In reaction to permanent 1% real appreciation of the zloty, Polish real exports should decrease in total by ca. 0.5% in course of the next four quarters, while imports (though feedback effect) will drop by almost 0.2%.

Exports and imports response to domestic demand



Source: own estimates; Note: the chart presents change in exports (dX) and imposts (dI) in subsequent quarters in reaction to impulse in a form of 1% permanent increase in real domestic demand.

On the other hand, fluctuations in the domestic demand should be relatively strongly reflected in the trade balance, as the estimated parameters indicate that its changes will positively affect imports and at the same time will have adverse impact on import volumes – the

[1] This does not mean that the exchange rate fluctuations have no impact on the value of imports in the model, however, this impact materialises directly through the change in the value of exports which in turn influence imports. Low values of individual ratios show that the scale of this reaction is moderate.

first dependency being stronger. Permanent increase in domestic demand by 1% results in 0.5% total drop in exports in 4 quarters horizon, and pushes up imports by over 1.5% over the same period.

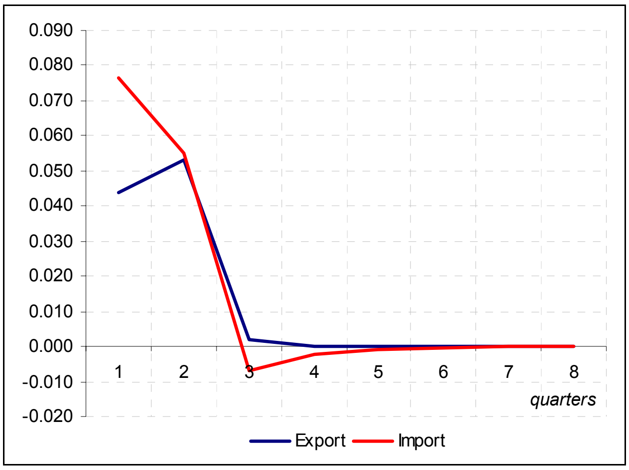
Even bigger impact on foreign trade balance have changes in foreign demand, because of its strong influence on exports. 1% pickup in EU-15 GDP will result in exports expansion by 5.7% and import growth by 1.9% during four consecutive quarters.

This all indicates that in subsequent periods the performance of Polish trade balance will be very much dependent on the tendencies in the demand factors, both foreign demand and domestic demand, and in smaller proportion will reflect evolution of exchange rate.

In view of the specific nature of the economy which is trying to bridge the development gap in the upcoming years we are likely to see progressive real appreciation of the Polish currency (Harrod-Balassa-Samuelson effect). This, taking into account the results described above, will have moderately negative impact on the trade balance. As regards domestic demand, the prospects for the subsequent quarters look very optimistic for the time being (we forecast growth of around 5%YoY). Impact of this factor on the trade balance will be also negative. As this is the case, the fast development of Poland's trading partners is a hope for keeping the high export growth rate. For the time being, the GDP forecast for EU-15 member states for the upcoming quarters are relatively favourable (current forecasts suggest over 2% GDP rise in 2007). The question is whether this factor will be strong enough and how long the good business climate in the world markets will persist...

Having estimated reaction functions of exports and imports to specific impulses, we can evaluate total net effect of changes in economic environment in the next year on Poland's trade balance, taking into account current macroeconomic forecasts. The analysed scenario assumed: growth in domestic demand in Poland by 5.2%, growth in EU-15 GDP by 2.2%, real appreciation of the zloty by 3%, rise in global export to GDP ratio by 1%. According to calculations made with the model under above-mentioned assumptions, in the four quarters horizon exports (in constant prices) should increase in total by 9.9%, and imports should grow 12.2%. It would imply an increase in trade deficit in Poland by ca. PLN10bn (€2.5bn), which represents ca. 0.8% of GDP. The scale of deterioration in current account deficit could be somewhat smaller, due to expected continuing increase in surpluses on the services balance and current transfers balance.

Reaction of exports and imports to forecasted macroeconomic scenario



Source: own estimates; Note: the chart presents change in exports (dX) and imports (dI) in subsequent quarters in reaction to the scenario assuming following contemporary impulses: 5.2% rise in DD, 2.2% rise in YE15, 3% rise in ER, 1% rise in TRD.

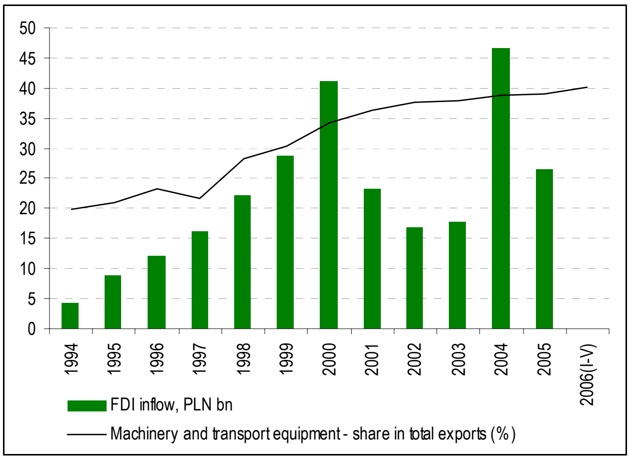
Should you believe in models?

The made econometric estimates failed to confirm changes in the mechanisms underlying the Polish foreign trade. Nonetheless, in view of the phenomena observed over the recent years it is hard to resist the impression that the Polish trade has been undergoing structural changes which contribute to the reversal of the earlier rather unfavourable trends. Intuition indicates that one of the change drivers might be the modernisation of the Polish economy as a result of the inflow of foreign direct investments (FDI) and internal restructuring of Polish businesses as a response to the 2001-2002 austerity.

Still, econometric analysis have not confirmed significant impact of such factors as FDI inflow or structure of foreign trade on the performance of exports of imports. Even a superficial analysis of trends in aggregated data suggests that recent years faced stabilisation rather than strengthening in previously observed upward trends both as regards the flow of direct investments or growth in technological advancement in Polish exports. However, it could happen that e.g. the volumes of invested funds had no key importance, but more important was the nature of this flows.

At the first stage of the economic transformation in Poland, the industry modernisation (which would have contributed to the adjustment of the export structure to customer needs) was facilitated by neither the structure of capital expenditure the bulk of which was represented by passive production factors (buildings and structures) nor the fact that the direct foreign investments focused on advanced processing sectors, which did not generate strong value adding to the growth in exports focusing rather on the exploration of the domestic market. The majority of foreign investments were made in the financial intermediation sector, trading, transport and food sector. This however, has changed in the recent years as stimulated by, e.g. the domestic demand slump early in the decade which made companies look for new selling markets abroad. And although the stream of investments is not as intensive as it used to be, the nature of new foreign investments in Poland is beginning to change – more and more often, these are investments in plants producing goods not to be sold on the domestic market only but to be sold also (and maybe primarily) on other EU markets. The number of factories producing components for international corporations has grown which directly contributed to the growth in exports and had another positive effect, i.e. made part of the market resistant to exchange rate fluctuations. These are changes which cannot be easily identified studying aggregated statistical data that we used for our calculation and this might have been the reason why we failed to confirm the changes in the Polish export performance based on the estimates made.

Foreign Direct Investment and share of highly processed goods in total exports



Source: CSO, NBP, own calculations

Technical Annex

In the econometric analysis, following statistical data with quarterly frequency has been used:

X natural logarithm of Polish exports of goods in 1995 constant prices, seasonally adjusted

Y natural logarithm of Polish imports of goods in 1995 constant prices, seasonally adjusted

YE15 natural logarithm of EU-15 GDP in 1995 constant prices, seasonally adjusted

DD natural logarithm of Polish domestic demand in 1995 constant prices, seasonally adjusted

ER natural logarithm of CPI-based real effective exchange rate (1990=100), taking into account 25 biggest trade partners

TRD natural logarithm of index measuring share of world exports in global GDP (in current prices), quarterly data interpolated from original annual time series

D98 dummy variable taking into account effect of “Russian crisis”, equal 1 since 1998q3 onwards, and 0 before

Time series used in the survey are non-stationary. Long-run equilibrium equations were estimated with Phillip-Hansen’s Fully Modified least squares approach. Short-run dynamic equations were estimated with Ordinary Least Squares method. Estimations were based on sample 1996q1:2006q1 and additionally for shorter period 1996q1:2003q1. The results together with relevant statistics are given in the tables below.

Long-run equation for exports X

$X_t = \alpha_1\ YE15_t + \alpha_2\ DD_t + \alpha_3\ ER_t + \alpha_4\ TRD_t + \alpha_5\ D98_t + \alpha_6 + \varepsilon_{1,t}$

	1996Q1-2006Q1	1996Q1-2003Q1
YE15	5.7676 (0.000)	5.5529 (0.000)
DD	-0.52017 (0.000)	-0.50283 (0.000)
ER	-0.54359 (0.000)	-0.43047 (0.000)
TRD	1.5706 (0.000)	1.4778 (0.000)
D98	-0.14187 (0.000)	-0.13800 (0.000)
C	-69.6079 (0.000)	-66.9482 (0.000)

Long-run equation for imports I

$I_t = \delta_1\ DD_t + \delta_2\ X_t + \delta_3\ D98_t + \delta_4 + \xi_{1,t}$

	1996Q1-2006Q1	1996Q1-2003Q1
DD	1.6818 (0.000)	1.7410 (0.000)
X	0.33764 (0.000)	0.36026 (0.000)
D98	-0.047909 (0.000)	-0.061684 (0.000)
C	-12.3762 (0.002)	-13.2744 (0.003)

Short-run equation for exports dX

$dX_t = \beta_1\ dYE15_t + \beta_2\ dDD_t + \beta_3\ dER_t + \beta_4\ dTRD_t + \beta_5\ dD98_t + \ldots$
$\ldots + \beta_6 + \beta_7\ ECM_{t-1} + \varepsilon_{2,t}$

	1996Q1-2006Q1	1996Q1-2003Q1
dYE15	2.5096 (0.046)	2.7539 (0.027)
dER	-0.37624 (0.001)	-0.22936 (0.026)
dD98	-0.083262 (0.002)	-0.076130 (0.002)
C	0.021404 (0.008)	0.015002 (.069)
ECM(-1)	-0.96124 (0.000)	-0.98064 (0.000)
	R^2=0.63788 DW=2.2543	R^2=0.73248 DW=2.5017

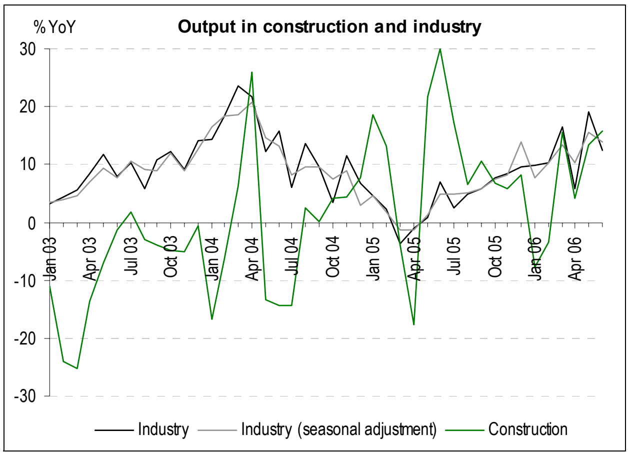
Short-run equation for imports dI

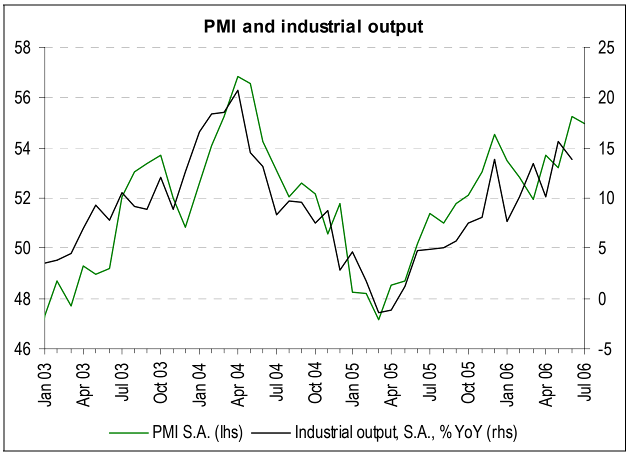
$dI_t = \lambda_1\ dDD_t + \lambda_2\ dDD_{t-1} + \lambda_3\ dX_t + \lambda_4 + \lambda_5\ ECM_{t-1} + \xi_{2,t}$

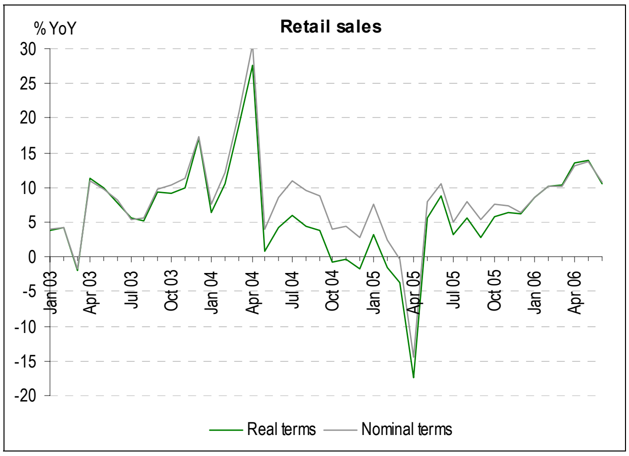
	1996Q1-2006Q1	1996Q1-2003Q1
dDD	1.3100 (0.046)	1.5406 (0.000)
dDD(-1)	0.54256 (0.001)	---
dX	0.18580 (0.002)	0.19538 (0.057)
C	0.0019056 (0.008)	0.005133 (0.289)
ECM(-1)	-0.65894 (0.000)	-0.58096 (0.001)
	R^2=0.70941 DW=1.7723	R^2=0.64649 DW=1.6265

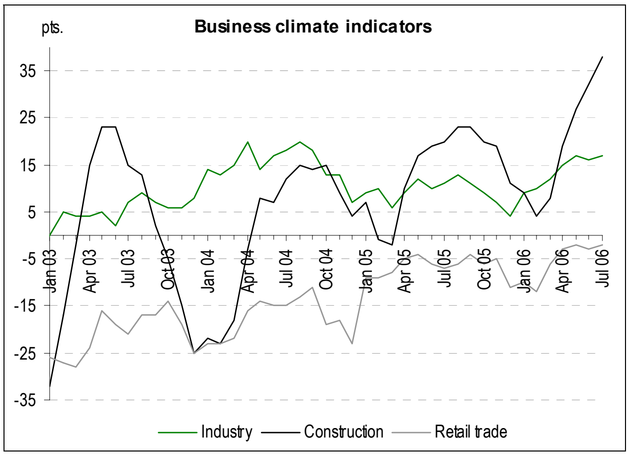
where: *d* operator denotes first difference of relevant variables; ECM_t denotes error correction mechanism, i.e. residuals from relevant long-term equation, *C* denotes constant. p-values are given in brackets, i.e. the probabilities of making mistake when rejecting null-hypothesis about statistical non-significance of a given coefficient.

Economic update









Source: CSO, Reuters, own calculations

Output growth beat expectations again

- The same as a month earlier, output figures for June were stronger than expected. Industrial output increased as much as 12.4%YoY against market consensus of ca. 10%YoY and our forecast at slightly above 8%YoY. Seasonally adjusted growth amounted to 13.8%YoY as compared to 15.6% in May and year-to-date average of 11.8%. The strongest output growth (of 13.9%YoY) was recorded in manufacturing.
- Although June's figures suggest some weakening of expansion in industrial sector, given a deceleration from 19.1%YoY growth in May, one should remember that it was an adverse effect of a difference in number of working days. In June 2006 there was one working day less than in June 2005 while in May there was one working day more than a year earlier. Taking this into account, output growth in June should be perceived as equally impressive as almost 20%YoY rise in the previous month.
- In unadjusted terms an acceleration in output growth was recorded in Q2, to 12.4% from 12.1% in Q1, despite negative effect of a difference in working days in 2Q06. This supports our estimates indicating that GDP growth in the second quarter was around the level achieved in the first three months of the year (5.2%). Actually, it seems GDP growth in 2Q06 may be at least as high as in 1Q06.
- Positive signal was also visible in the construction sector where output rose by 15.7%YoY in June, which was the highest growth rate this year. In 2Q06 construction output growth accelerated to 11.1%YoY from a mere 1.4%YoY rise recorded in 1Q06.
- Poland's PMI inched down by 0.3 pts to 55 pts in July, but the fact that it remains clearly above 50 pts, i.e. the level that separates contraction from expansion, suggests that keeps expanding robustly.

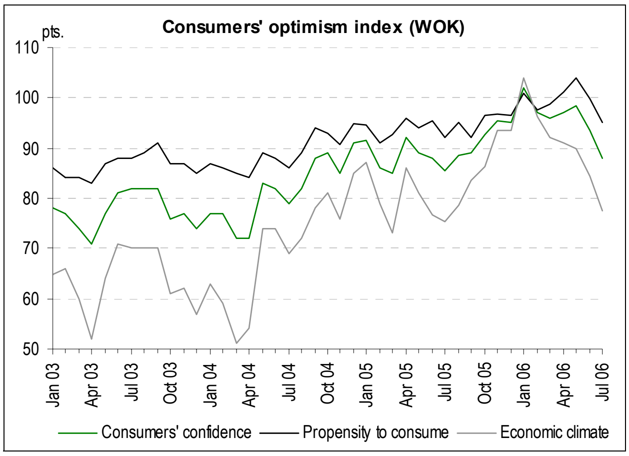
Retail sales still grow at two-digit pace

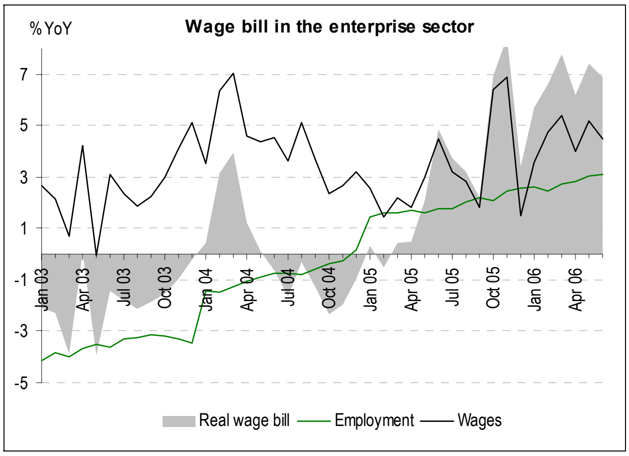
- Retail sales grew 1.8%MoM and 10.7%YoY in June. The growth was stronger than our forecast (9.2%YoY), but lower than median of market forecasts at 11.5%YoY.
- There was annual increase in almost all components of retail sales (the exception was new car sales that decreased by 0.9%YoY), which indicated broad expansion of consumption demand.
- At the same time, continuously low deflator in retail sales (real retail sales growth was only 0.2pp lower than nominal and reached 10.5%YoY) suggested inflationary pressure in case of consumption goods remains subdued.
- We predict that retail sales growth in the remainder of the year will remain at two-digit level, fuelled mainly by continued improvement of labour market conditions.

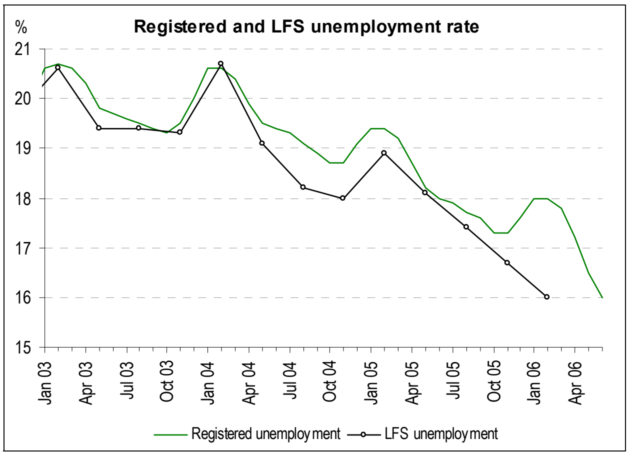
Enterprises are optimistic, especially builders

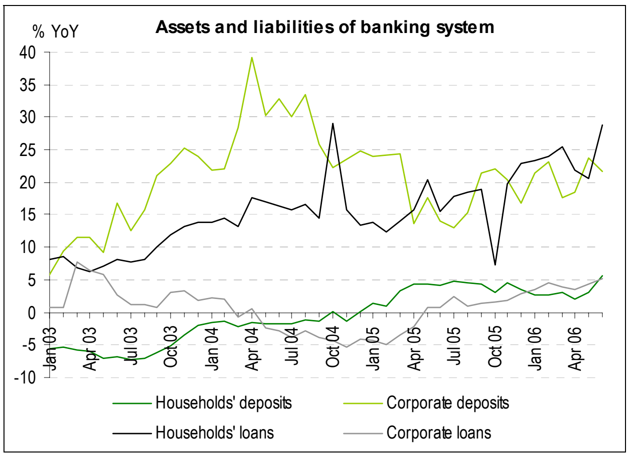
- Business climate indicators for July showed continuation of positive tendency in enterprises' moods.
- July saw increase in indicators for all three sectors taken into account in the survey: manufacturing, construction and retail trade. This was partly a seasonal phenomenon, but the indices were rising also in annual terms. In two cases, especially in construction, even some acceleration was observed.
- Enterprises from all sectors have quite similar evaluations of orders portfolio, financial situation and employment – in all these areas there is dominance of optimism. All in all, the survey confirmed very good economic situation and if we see it also in economic activity indicators for July (due for release in August) we may see another quarter of GDP growth of above 5%.

Economic update









Source: CSO, Ipsos, NBP, own calculations

Slightly deteriorated consumers' moods

▪ July results of survey made by Ipsos institute showed another deterioration in consumers' moods. While deterioration in June was rather a seasonal phenomenon, in July there was not only a monthly fall in consumer confidence indices, but also a significant deceleration in indices' annual growth rate was observed.

▪ While in the first half of the year overall consumer confidence index was rising at two-digit pace on average as compared to 1H05, in July it increased by a mere 3 pts on the year.

▪ Overall consumers' optimism was down in July mostly as a result of a fall in assessment of economic situation, which authors of the survey explained by the change at Prime Minister's post. We think this deterioration was a temporary phenomenon and we still expect that private consumption will grow quite strongly in 2H06 (although a bit slower than in H1).

Labour market conditions keeps improving robustly

▪ The factor, which supports strong consumption growth in the remainder of this year is continued improvement of labour market conditions. Data from the enterprises sector for June showed employment rose by 3.1%YoY and average wages by 4.5%.

▪ The figures confirmed that improvement on the labour market is a permanent process and still gains strength. It is noteworthy that the pace of job creation in June was the fastest since the beginning of data collection (beating highs posted in previous months). This indicates continuation of very good tendencies in the Polish economy, i.e. strong economic activity coupled with robust job creation.

▪ As regards average wage growth in June, some deceleration was visible as compared to May (5.2%YoY), but average growth in 2Q06 was exactly the same as in 1Q06 (4.6%YoY). As average employment rise in 2Q06 accelerated to 3.0%YoY from 2.6%YoY in 1Q06, there was also an improvement in total wage bill, although only marginal in real terms amid rising inflation.

▪ In line with tentative estimates, revealed earlier by the Ministry of Economy, the CSO said that the registered unemployment rate dropped to 16% at the end of June. The number of unemployed fell by 12%YoY or nearly 400 thousand people (which is the fastest pace of unemployment reduction since mid-1998) and reached 2.49m, which is the lowest level since July 2000. This heralds further increase in households' confidence and strong consumption demand in the months ahead.

▪ Thus, the unemployment rate approaches NAIRU (not accelerating inflation rate of unemployment) which according to various estimates is relatively high in Poland and stands at least at 10%. However, the current level of unemployment still seem to high to add to inflationary pressure.

Stronger credit activity, acceleration in money growth

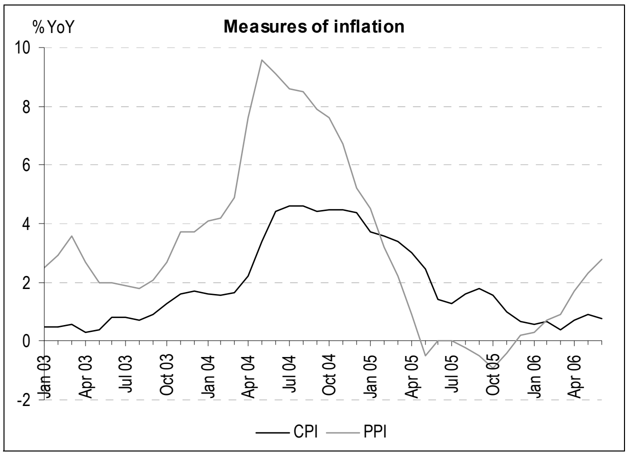
▪ Broad money M3 rose by 11.8%YoY in June. Credit market expanded by as much as 16%YoY (12.4% in May) driven mostly by higher households' credits expansion (28.8%YoY growth as compared to 20.5% rise in the previous month).

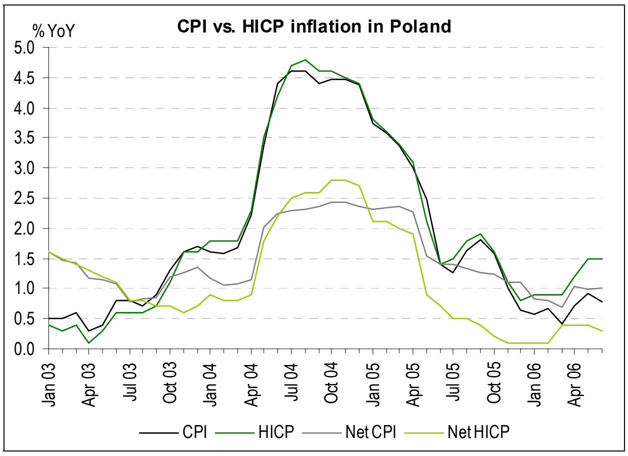
▪ This was connected to a large extent with high mortgages' growth. In recent months, activity on this market was reinforced by the new regulation introducing restrictions on access to FX mortgages. The new law was expected to come into effect since July and many people applied for credits in 1H06.

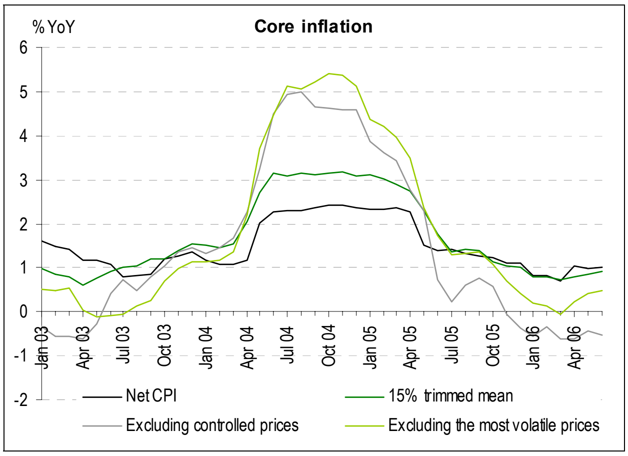
▪ Corporate loans accelerated to 5.1%YoY in June from 4.3% in May and we think this gradual process will be continued.

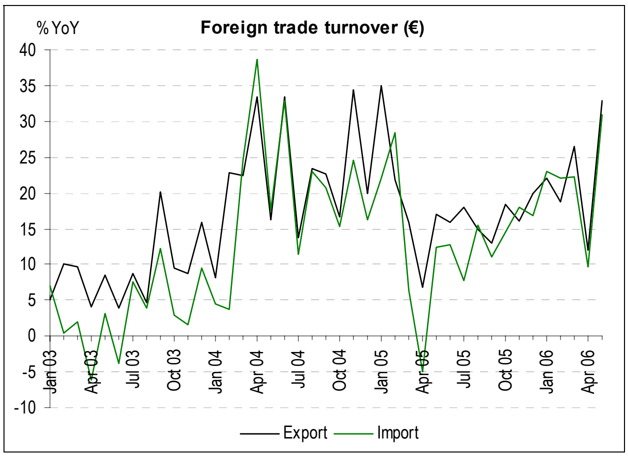
▪ Also, deposit market expanded quite substantially in June – both in case of firms and households. There were growth rates of 21.7%YoY and 5.6%YoY, respectively.

Economic update









Source: CSO, NBP, own calculations

CPI and PPI slightly up, but inflationary pressure still weak

- June CPI inflation was below forecasts. While market consensus pointed to slight inflation increase to 1.0%, the actual price growth decelerated to 0.8%YoY from 0.9%YoY in May. The reason for that was deeper than expected annual fall in food prices and quite unexpected deceleration in fuel price growth. At the same time, performance of prices of other elements of consumer basket did not show any sign of strengthening in underlying price pressure in the economy. Thus, we expect CPI inflation to remain below 1% in the next couple of months, while at the very end of the year it may rise to ca. 1.5%.
- In June, there was again wider discrepancy between annual growth rate of CPI (national inflation measure) and HICP (inflation measure used by Eurostat). The difference stems among others from the fact that in case of HICP a weight system from the previous year is used for index for the previous year while in case of CPI weights from the current year are used for both the current and previous year indices. The biggest differences in weights used in calculations of CPI and HICP for Poland applies to prices of foodstuff and beverages, other goods and services, and communications. Our comment concerning implications of difference between CPI and HICP for monetary policy is presented in *Central bank watch* section.
- PPI inflation in June accelerated to 2.8%YoY (after monthly increase in prices of 0.8%) against forecasts of 2.3-2.4%. This was driven, among others, by acceleration of price growth in manufacturing (to 1.1%YoY from 0.2%YoY in May). At the moment, it is difficult to assess whether this is a permanent tendency and to what extent producer prices growth could be transferred into retail prices. Thus, we do not change our view that inflation target is not endangered. Especially that producer price growth should be mitigated by recent zloty strengthening.

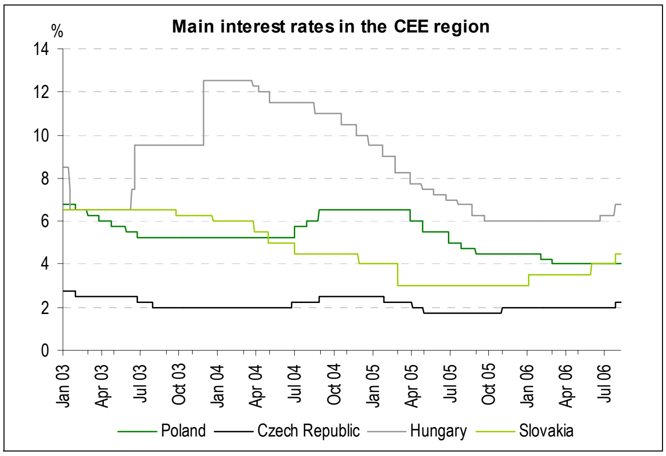
No change in core inflation: it is still very low

- As expected, the two most closely watched measures of core inflation, i.e. net inflation (CPI excluding food and fuel prices) and 15% trimmed mean remained stable at 1%YoY and 0.9%, respectively.
- As regards the other three measures calculated by the central bank, two of them inched up (CPI excluding the most volatile prices to 0.5%YoY from 0.4%YoY and CPI excluding the most volatile and fuel prices to 0.2%YoY from 0.1%YoY) and one declined to -0.5%YoY from -0.4%YoY.
- All in all, given low and stable level of core inflation, one could hardly talk about existence of underlying inflationary pressure. The fact that the highest core inflation measure is only at 1%YoY is one of the reasons why we do not predict monetary tightening in Poland at least within the nearest 12 months.

High growth in foreign trade turnover

- C/A deficit in May was lower than predicted and amounted to €209m (market consensus at above €300m). 12M cumulative C/A gap lowered to 1.4% of GDP (from 1.6% in April). This was achieved mainly due to high surplus in transfers (€866m).
- Trade balance showed the biggest monthly deficit (of €483m) since the end of 2004. This happened amid very strong increase in both exports and imports (by 33%YoY and 31%YoY, respectively), which confirmed very strong economic activity.
- Services balance was positive (€225m) and income balance was negative at €817m due to dividends outflow of €566m.
- On the capital account, a significant outflow from both equity and fixed income market was observed (of €511m and €483m, respectively). This was the result of higher risk aversion on global markets.

Central bank watch



Fragments of MPC statement, 26 July 2006
The low level of all core inflation indices indicates that inflationary pressure remains contained.
The inflation and GDP projections, which are presented in Inflation Reports, are **one of the inputs** to the monetary policy decisions.
Having considered the latest data and the July inflation projection, the Council confirms the view expressed at its meeting in June that the probability of inflation running, in the monetary policy transmission horizon, above the level assessed in **the April projection** has increased.
It should be emphasised that, **in the opinion of the authors of the projection**, the inflation projection presented in the Report does not account for all sources of uncertainty. This primarily applies to the scale of the future impact of globalisation on inflation, the impact of global imbalances on the world economic growth, the growth of workforce, the effect of drought in Poland on food prices, the shape of economic policy in the coming years, in particular, the effect of increased wage pressure on public finance in Poland and the exchange rate developments.

Inflation projections NBP (% YoY)

	January 2006	April 2006	July 2006
Q4 2006	0.5-2.3	0.5-2.0	1.0-1.9
Q4 2007	1.1-3.6	1.3-3.4	1.5-3.5
Q4 2008	0.8-3.9	1.2-3.9	1.7-4.3

GDP growth projections (%)

	January 2006	April 2006	July 2006
2006	3.8-5.1	3.9-5.0	4.7-5.3
2007	3.4-5.2	3.4-5.8	3.6-5.9
2008	3.6-5.5	3.5-6.2	4.0-6.6

Source: NBP, Inflation Report - July 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.

Fiscal policy assumptions (as % of GDP) in inflation projection

	2006	2007	2008
Structural deficit (April projection)	2.6	2.6	2.6
Structural deficit (July projection)	2.6	2.4	1.5
Central budget deficit (April projection)	3.8	2.8	1.5
Central budget deficit (July projection)	3.5	2.9	2.5

Source: NBP press conference

Source: NBP, Reuters

Interest rates up, but not in Poland

- As expected, the Monetary Policy Council did not change monetary policy parameters, which was against decisions of other central banks in the region, as rates were raised in the Czech Republic, Hungary and Slovakia. However, there is (at least) one very important difference – economic situation, especially as regards inflation prospects.
- As the outcome of MPC decision was obvious, market was concentrated on the official statement. Unfortunately, NBP gave another example of poor communication.
- The key paragraph of the communiqué, including rate-setters' judgment on inflation prospects, seems…out-of-date, as the MPC referred to April's not July's projection.
- The MPC maintained the opinion that inflation path may be higher than presented in April projection, this may refer only to figures for 2007, and not to 2008 when the projection increase is the most visible.
- This would mean that majority of MPC believes that inflation will reach the target earlier than predicted before, but would not necessarily exceed the target in the medium-term. Such scenario would not require monetary tightening in the following months (or quarters) and would be consistent with our view.
- Thus, taking into account that majority of MCP members seems to perceive inflation prospects better than it was presented by the new projection (possibly this was the reason why the MPC did not refer to July projection), interest rate hike is not necessary to keep CPI inflation close to the target in the medium-term.
- As for now, emphasising low core inflation measures is the most important element of the statement, while the projection is only one of the inputs of the decision.

The MPC rather does not accept pessimistic projection

- The new projection indicates that over its whole horizon, the rise of consumer prices will be more significant than expected in the April report.
- However, some of the assumptions adopted by authors of the projection represent rather a risk-case scenario for inflation than the most likely one. And this is the latter which should be taken into account by the council when setting interest rates.
- In the *Report* the MPC mentioned a number of arguments for lower inflation e.g. increase in labour market flexibility, factors supporting stronger zloty (situation in balance of payments), maintaining the scale of reduction of some imported products' prices. Clearly they were not entirely included in the projection or even mentioned as risk factors outside econometric model.

Strong influence of fiscal policy assumptions

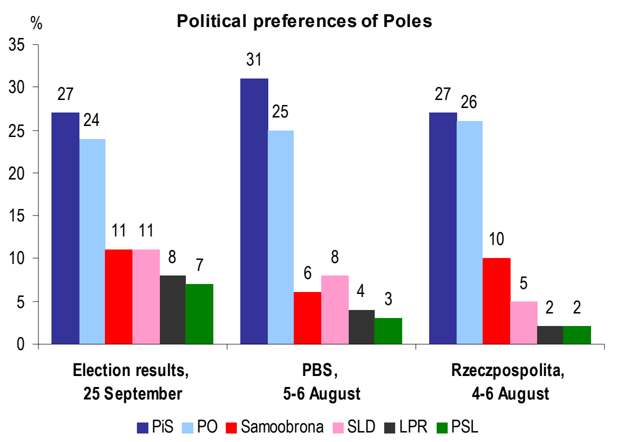
- Important factor influencing the new projection was assumption as regards fiscal policy, which increased inflation by 0.3 pp as compared to April's results.
- The new fiscal deficit path itself is not very controversial, as given current political uncertainty one can assume many different scenarios. However, its indirect effects on inflation are quite pessimistic.
- First of all, it was assumed that the public sector's wage bill growth of PLN1bn leads to a private sector wage bill growth of PLN0.3bn, which was one of reasons behind sharp acceleration in the overall wage growth in the economy (to 6.8% in 2008 as compared to 5.9% in April projection). Second, according to the projection, public finance situation is expected to bring zloty depreciation in coming quarters.

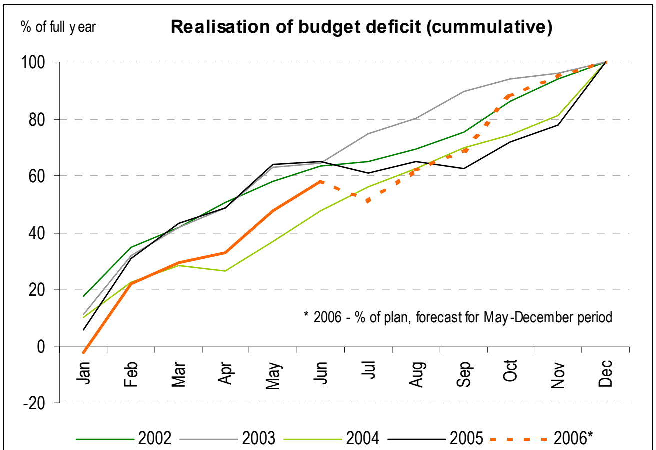
Central bank watch

Comments of the central bank representatives	Our remarks
Leszek Balcerowicz, NBP governor **MPC press conference, 26 July; Parkiet 27 July** Q: Was it possible to set the common view of the Council as regards the inflation projection? A: Reference to April inflation projection is the highest common denominator that could be achieved at today's sitting.	Everything suggests that the MPC was not able to find a common stance in July, as we find no other reason to justify no reference to July inflation projection. Referring to the previous projection the MPC brought new worthy of note element to communication policy and it will be interesting to see the statement in August. We hope the MPC will be able to find higher "highest common denominator". It is enough to say that the MPC sees inflation lower than the projection in 2008.
Jan Czekaj, MPC member **PAP, 27 July** Current level of interest rates should ensure a return of CPI inflation to the target of 2.5% in the horizon of monetary policy transmission and it does not seem that inflation will differ much from the target afterwards. Additionally, this level of interest rates is not a barrier for economic growth and does not create additional inflation pressure. Based on current information, no interest rates change (or very moderate or only "verbal intervention") is required to ensure inflation stabilisation close to the target. The MPC proved in the past that if there is a danger of inflation increase above the target permanently, interest rate would have to be increased. I think the market should not have doubts about it. However, it does not mean that if current or forecasted CPI inflation exceeds the target of 2.5% rate hike is immediate. Even in the case that CPI temporarily exceeds the target amid supply-side shocks, no monetary tightening would be necessarily required, as the tolerance band around the target is 1.5-3.5%.	As regards expectations on further interest rates decisions, statements of those members who form majority within the Council are crucial. From this point of view, comments by Jan Czekaj after July's meeting are very important as they show gradual increase of CPI inflation to the target and no need of interest rate hike In foreseeable future. Similar overtone was presented by other mainstream members of the MPC, even before the meeting. Andrzej Sławiński said that all factors should cause that inflation will rise, because we have economic expansion, but this will happen gradually. and the way to the target is quite distant. Also, MPC's Andrzej Wojtyna said that talking about interest rate hikes in Poland is premature and "a potential slowdown in world economy would make room for some slight rate cut". We do not think that the new inflation projection changed their view on inflation prospects. According to professor Czekaj, changes as regards inflation path for the following quarters (or years) are not significant enough to talk about changes in monetary policy parameters. What is more, it is not very likely that next inflation projection (to be released in October) could bring new information and GDP breakdown does not create risk for significant inflation increase.
Dariusz Filar, MPC member **Reuters, 28 July** If these differences [between HICP and CPI] deepened or became more acute one would have to consider switching to HICP (Harmonised Index of Consumer Prices). We have to watch this phenomenon because it could force us in the future to change the definition of our inflation target. (…) From the point of view of next monetary steps this discrepancy is not that important because the inflation target is based on (national) CPI, which ensures continuity. Over the longer run, however, the EU-norm index could become a logical choice. It is worth to get used to this indicator [HICP]. We should make public opinion aware of the fact that inflation can be measured in a different way. **Reuters, 27 July** Core inflation in the nearest four-six months will be key for the future decisions in monetary policy. If it will grow in this period, which is very probable, the Council will consider monetary tightening. If it stays stable, however, there will be a higher chance that rates will be left unchanged. At the end of the year it will be easier for the Council to find a common stance based on core inflation. This is the most important area of observation at the moment.	In recent weeks the difference between inflation measured as HICP and CPI (for details see section *Economic update*) was very trendy subject in discussion between economists and one of MPC members also joined this debate. July *Inflation Report* included even a special box describing the difference. At the same time, some opinions appeared that if one looks at CPI inflation measure monetary policy in Poland is restrictive enough, but taking into account higher HICP one could argue that interest rate hike should be prepare to hike interest rates. However, it is worth to remind that that professor Filar mentioned recently that the key factor to watch to assess probability of next moves in monetary policy is core inflation. Therefore, if we look at core inflation based on CPI and HICP, the difference is almost the same, but on the other side. Core inflation HICP (a few measures show similar results) amounted to 0.3%YoY. What is more, while the difference between CPI and HICP are something new (variation of 0.5pp appeared only in March 2006), the difference between core measures of some 1 pp was observed since mid-2005. It is interesting why nobody took note of this fact, for example why the *Inflation Reports* at the turn of 2005 and 22006 did not include a special box explaining the phenomenon why HICP core inflation is close to zero. While core inflation will rise in the following months, the level of 2.5% does not seem in danger.
Mirosław Pietrewicz, MPC member **PAP, 28 July** The new inflation projection did not bring major change as regards inflation prospects. It is still quite optimistic that the projection does not assume exceeding the target in the horizon of monetary policy transmission mechanism. Inflation projection is prepared with the assumption of unchanged level of interest rates and we can be optimistic as regards the level of interest rates. There is no need of hike in the horizon. Projection is quite realistic when the CPI inflation reaches the level of 2.9-3.0% at the end of 2008. this is not the level dangerous for the economy and would not require any rates changes. If there are no extraordinary situations, such as supply-side shocks, there would be no need to change rates until the end of 2007, as current level corresponds to what is needed from the point of view of economic growth. Projection shows that CPI inflation will reach 1.5% at the en of the year and this is quite likely, although the influence of drought is still uncertain.	While professor Filar represents view, which is perceived by the market as the most hawkish in the Council, opinions of professor Pietrewicz are noticed as the opposite. Fro this point of view, it is not surprising that he perceives current level of interest rates as appropriate to achieve inflation target in the medium-term and he sees no reason to change rates until the end of the next year. Of course, the remaining question is whether such view is shared by majority of the Council. The answer will be clearer when we get to know next set of macroeconomic data and next interviews with MPC members. We think that most of MPC members would agree (as ourselves) that inflation target should be treated symmetrically , as it was suggested by Pietrewicz. This would mean that even in risk-case scenario, a possible inflation increase above the target(e.g. as a result of summer drought) would not mean a hike in interest rates. Additionally, Pietrewicz quite rightly pointed out that in the European Union food price shocks are less significant and prices' volatility lower as a result of mitigating effects of EU intervention measures.

Government and politics

Fragments of Prime Minister expose, 19 July 2006
Safe currency, stable zloty is the element, which is necessary to achieve is a success, to take advantage if our resources. (...) As we all know, today the zloty is very strong. As all factors suggest we will be using zloty as the Polish currency for many years. That's why this problem is especially important (...) This is difficult and may generate conflicts but the zloty has to be strong. This is a precondition of our success.
We cannot exceed the so-called budget anchor of PLN30bn. And I would like to assure the parliament that we will do everything to be certain this limit won't be exceed.
We will also do everything to strengthen mechanisms protecting the most difficult and dramatic social situations. These mechanisms will be strengthened using also the European Unions funds. This is important opportunity related not to social benefits and payments, but to funds, which may be spend on education and effective combating unemployment.





Convergence Programme assumptions (January 2006)

***General government* balance (% GDP)**

	2005	2006	2007	2008
Total revenues	42.0	42.1	41.5	40.5
Total expenditures	44.9	44.7	43.7	42.4
Deficit	-2.9	-2.6	-2.2	-1.9
Pension funds result	1.7	2.0	2.1	2.2

Macroeconomic assumptions

	2005	2006	2007	2008
GDP growth (%)	3.3	4.3	4.6	5.0
Inflation (annual average, %)	2.2	1.5	2.2	2.5

Source: Ministry of Finance, opinion polls

Nothing new in expose

▪ In the parliamentary expose of the Prime Minister there were no new elements as regards economic policy, as compared to his previous statements.

▪ Statement that zloty will be kept as the Polish currency for long time is not surprising for the market given PiS's earlier declaration on no hurry for euro zone entry (government would like to meet Maastricht criteria in 2009 at the earliest).

▪ PM mentioned strong zloty as a guarantee of success. Well, in our opinion this is high economic growth which would guarantee keeping budget deficit at PLN30bn (amid higher revenues), while too strong zloty could negatively influence Poland's economic situation. Anyway, we think that by "strong zloty" PM meant strong fundamentals and the overall market stability.

Will local governments election influence the budget?

▪ Since parliamentary election in 2005opinion polls did not show major changes in support for political parties. However, popularity of small parties is relatively low and thus early election scenario would be comfortable for them.

▪ That is why, we perceive an ultimatum given by Samoobrona "substantial increase in spending or early election" as a kind of trying to differentiate their programme ahead of local governments election rather than real threat of parliamentary election.

▪ That's why it seems that upcoming local government election will influence more rhetoric of politicians in the coming months, but not the shape of the next year's budget.

▪ Possibly, early election scenario is more likely than budget deficit above of PLN30bn.

Low budget deficit in mid-year

▪ After June budget deficit amounted to 57.8% of the full-year plan against expectations at 59-60%.

▪ Revenues reached 47.3% and spending 48.7% of the plan.

▪ NBP profit for 2005 was transferred in July (last year NBP profit of above PLN4bn was seen in June). Excluding this effect the annual rise in total revenues amounted to 12.2%YoY in the first half of the year and 11% in June alone as compared to the planned 8.6% growth in the whole 2006.

▪ Indirect taxes inflow is the most important contributor of revenues and it increased by 9.8%YoY in H1 and 7.6%YoY in June, against the plan of 10.6%. However, other items offset this gap, namely personal income tax (16.8% increase in H1 against planed 6.9% growth), higher dividends, and higher revenue of budgetary units.

Path of deficit reduction may be longer

▪ Finance minister Stanisław Kluza said in an interview with *Parkiet* daily that Poland's fiscal deficit could reach 3.5% of GPD in 2009. This would mean the country will not meet Maastricht criteria (deficit below 3%) even in 2009.

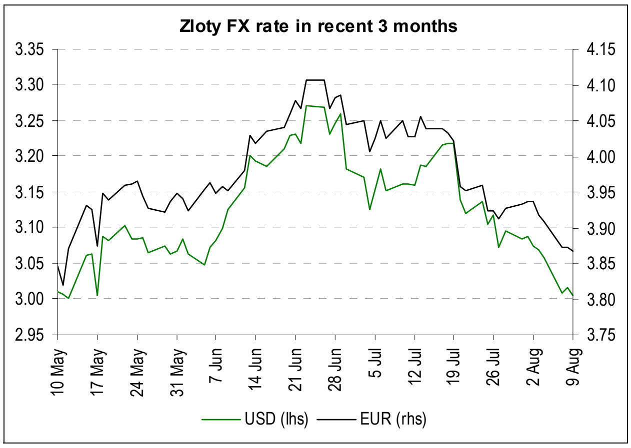
▪ It is wroth to remind that initially the target date set by the European commission was 2007. Kluza said the government is negotiating to avoid a penalty and expressed hope the EU will take into account costs of pension system reform in Poland.

▪ More significant fiscal expansion in the following years did not affect the Polish market. It seems that budgetary problems recede into the background as long as the Polish economy is expanding. However. Critical remarks from Brussels may affect the market causing some negative reaction on bond market.

Government and politics

Comments of government representatives and politicians	Our remarks
Jarosław Kaczyński, Prime Minister **PAP, 28 July** If we would like to maintain budget anchor, and we do and this is unquestionable, we cannot be extravagant in public money. We are not afraid of parliamentary election and it makes no sense to give us an ultimatum as regards coalition breakdown. We have sufficient ground for winning election again **Andrzej Lepper, deputy PM, agriculture minister** **PAP, TVP, 28 July** Definitely, nobody forces us to keep budget anchor and if this is the case this would mean that the government has no idea about economic policy and simply continues the policy of previous governments. (…) Nobody forces us to keep public debt below 60% of GDP. Of course, the constitution requires this. But Poland is the only country in the European Union, which decided to have such a requirement. **PAP, TVN24, 26 July** Coalition may be endangered if the budget is in the current shape. If our demand as regards pro-social, pro-development spending are not met.	There appeared some tensions between coalition partners as regards budget deficit. Although Samoobrona is multiplying costly ideas that could harm next year's budget, and is threatening to break the coalition in case the demands are not fulfilled, breaching PLN30bn deficit anchor next year still seems to be rather unlikely option. The government accepted already higher spending for farmers compensating for losses incurred due to summer drought. The payments will amount to PLN245m in 2006 and similar amount is planned for 2007. We agree with the Prime Minister that these are not the amounts important from the point of view of overall budget (and surely will not endanger the anchor of PLN30bn deficit), but the question is how many such small amounts will appear until work over the next year budget finalises. Until now, rumours that finance minister Stanisław Kluza threatened to resign, in case further costly proposals of Samoobrona are accepted by the government, did not have much impact on the market. Actually, taking into account that the ultimatum (if it took place) proved to be successful, may be perceived as good news for the market. As regards other statements by Andrzej Lepper, it is worth to notice that factors, which should force us to stop increase in public debt, are common economic sense and no will to increase taxes in future. And more social spending does not equal more pro-development spending.
Stanisław Kluza, finance minister **PAP, 28 July** Now, as we already know what is the stage of acceptance for tax changes in the parliament, we see that realistic level of next year revenues is PLN209bn (…) The planned increase in wages, which were already accepted, are not threatened. Preliminarily, if some assumptions are met we can count on a green light from Brussels as regards prolonging the period to meet budget deficit level of 3% of GDP. this would be profitable for everyone – for both Poland and European Commission. For Poland because we will have more time to bring deficit to the required level. For the Commission because it would penalise for such important reform as pension reform. The new date will be known later [than in September] but concrete declaration will be in autumn. I asses the first meeting with Joaquin Almunia as very promising.	Uncertainty as regards fiscal policy perspective is back on the market after finance minister Stanisław Kluza said that planned budget revenues for 2007 would be PLN4bn lower than previous assumption. This is consistent with our view that revenues were overestimated, but now the question is what will be the consequences for the budget deficit. PiS' politicians assured again that budget anchor as regards deficit (PLN30bn) should be maintained, but did not indicate how this will be achieved (lower spending, higher spending outside central budget or higher indirect taxes). The second subject related to fiscal policy, besides next year budget, is the publication of next *Convergence Programme* planned for autumn. Finance minister comments suggest that path of fiscal deficit reduction may be changed again for less ambitious and the EU officials preliminarily agreed to extend the period during which the general government deficit will have to go down below 3% of GDP.
Stanisław Kluza, finance minister **PAP, Forbes, 28 July** I am against the idea to liquidate the MPC. Discussion within the Council between hawks and doves is useful as regards monetary policy in Poland. The central bank is considering economic growth in its decisions when they fulfil their aim to achieve low inflation. Current level of interest rates is optimal and it should not be changed.	We agree with finance minister as regards reasonableness of making monetary policy decisions in join committee, as well as regards the level of interest rates and current aim of the central bank in the NBP Act. We can only hope this view is shared also by the Prime Minister as PiS' programme assumed liquidation of the MPC. It is rather impossible as it would require change in the Constitution, but some opinion appeared that discussion on NBP aim will be back on agenda after holiday period.
Elżbieta Suchocka-Roguska, deputy finance minister **PAP, 27 July** Budget gap after July would reach 50-53% of the full-year plan against initially planned 67.2%. This is the result of good budget performance as regards revenues, but also there was no acceleration in spending.	Budget realisation after July would be much below multi-year average. According to Suchocka-Roguska, good budget performance stems also from some delays in expenditures, which should accelerate in the remainder of the year. In her opinion budget gap in the whole year should not significantly differ from the plan.
Jacek Krzyślak, FinMin research department director **PAP, 1 August** In July 2006 inflation reached the level of 0.7-0.8%YoY (fall on monthly basis by 0.3-0.4%). We think that the monthly fall in July inflation was due to a drop in food prices by 2.1%. In our opinion, the effect of the drought should not weigh on the path of inflation this year, as intervention import from the EU is possible. Based on estimation by the Ministry of Agriculture and the stat office we do not think food prices will create risk factor for inflation. There might be some problem with food and vegetables but crops' decrease should be just a few percentage points on annual basis. (…) In August inflation may fall to 0.6%YoY and CPI inflation should remain below 1% until October. At the end of the year we estimate inflation at 1.5%.	The Ministry of Finance's inflation forecasts for the reminder of the year are quite optimistic and in line with our estimations. We forecast food prices fell by some 1.5% in July and CPI went down 0.2%MoM, which together with an assumption of fuel prices' increase presented by the ministry (up ca. 3%MoM) implies 12M CPI growth at 0.8%YoY. Given ministry's more optimistic assumption as regards July's food prices the risk for CPI is on the downside. As regards the following months, we see CPI decrease to 0.6%YoY in September-October and then a gradual increase to 1.5% in December. Such inflation path until year-end is positive for fixed income market and is additionally supported by the fact that increase in excise tax for fuel will be probably postponed. Preliminary it was planned for September this year, while it may take place only at the beginning of 2007.

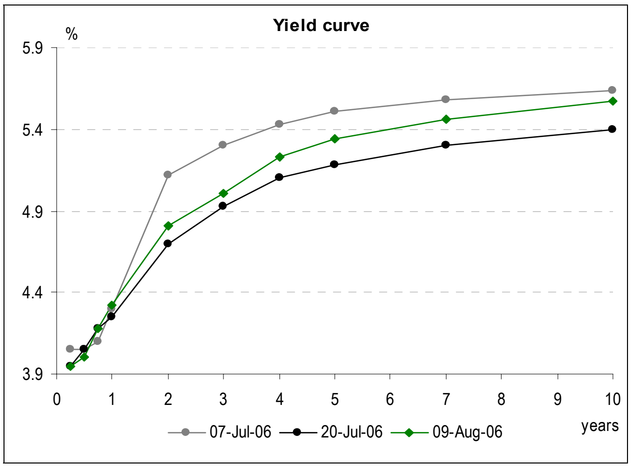
Market monitor



Zloty stronger awaiting Fed

▪ At the beginning of July the zloty fluctuated above 4.0 against the euro. The change on the PM post did not significantly influence the domestic market, while the Middle-East conflict put some pressure on the emerging markets. Less hawkish than expected Fed's chairman testimony effected in increased risk appetite, thus zloty appreciated vs. euro below 4.0. Rate hikes by the central banks in the region were an additional support for the zloty. EURPLN rate broke 3.9 after weak US non-farm payrolls.

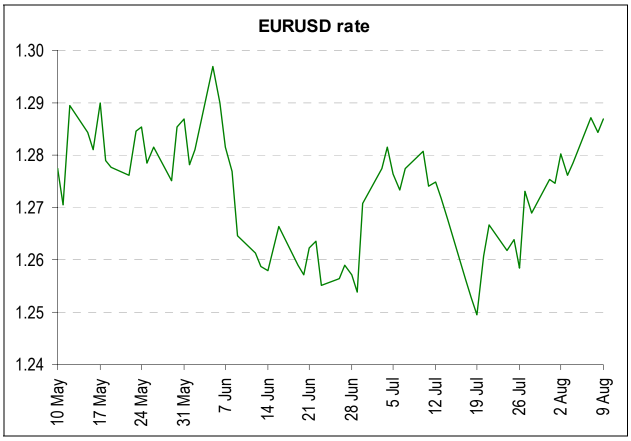
▪ Despite the lack of rate hike Fed left the door open for further tightening. On this occasion as well as taking into consideration recent strengthening of the zloty we expect some correction of the EURPLN rate rate above 3.9 in the nearest time. In the longer perspective good economic data, EU funds and possible no bad news from the emerging markets may support the zloty.



Bonds' yields drop

▪ Despite the rise of geopolitical risk resulted in higher aversion to emerging markets later on the lower than expected Polish CPI and MPC members' comments supported domestic debt. Afterwards dovish Ben Bernanke's statement before the Congress supported the core bond markets and also the emerging assets. The Council left rates unchanged, while the communiqué and the inflation report had little influence on the market. After a steady yield rise in the last few days a correction occurred after the US jobs data.

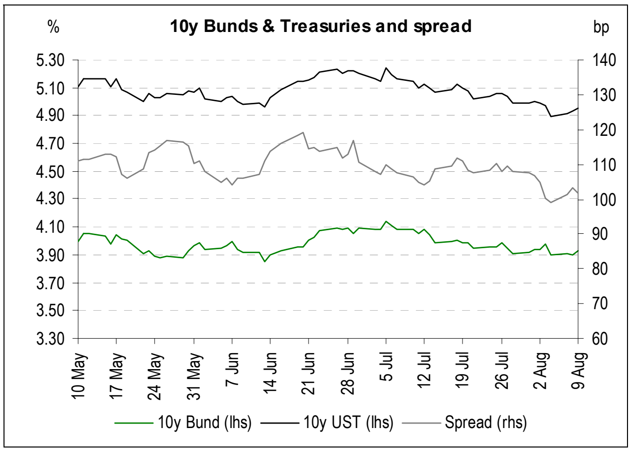
▪ The statements of the Council's members suggest that the MPC according to our scenario is not going to raise interest rates in the coming months or even quarters. This scenario will be supported by the low levels of CPI and core inflation. However, rising oil prices, high geopolitical risk as well as changing expectations of the target level interest rates in US and EMU may have some negative effect on bonds.



EURUSD rate correction, dollar weakens to 1.29 again

▪ In the mid-July the dollar started to rally against the euro in reaction to geopolitical risk rise and flight to safety. However after the comments of Fed's chief the expectations of further monetary policy tightening in US diminished, and the dollar suddenly depreciated. Further dollar weakening followed slightly dovish Beige Book and softer US Q2 GDP. Rate hike and the ECB's communiqué together with non-farm payrolls also negatively affected the US currency.

▪ The relation of the euro to the dollar may be still sensitive to the publication of further economic and inflation data in US with regards to the tone of the last Fed's communiqué. With figures above forecasts the expectations for further rate hikes may rise, though in our view Fed ended monetary policy tightening cycle. After a slight correction the greenback may weaken further.



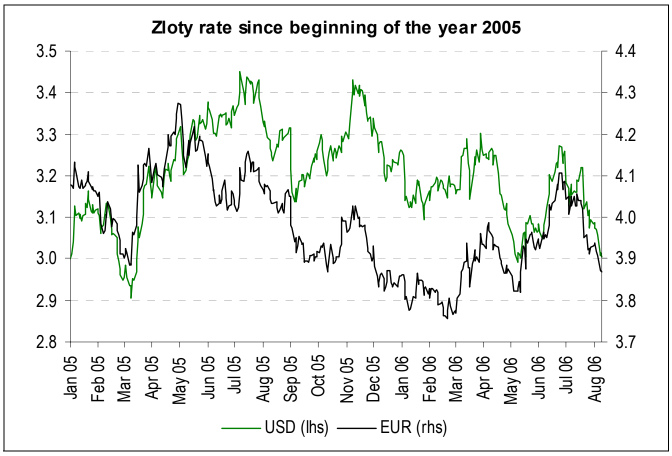
Stronger in the core markets

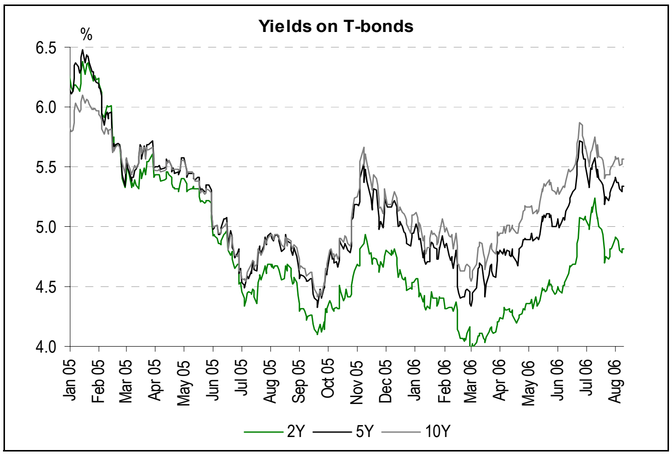
▪ The rising tensions in the international stage as well as high oil prices effected in substantial strengthening in the core markets after the release of the previous report. The falling yields came also after Bernanke's testimony and US GDP data. Bunds weakened after the ECB's communiqué, though the US payrolls boosted the market. Since last publication yields of 10Y Treasuries dropped from 5.2% to 4.9%, while of Bunds from 4.09% to 3.91%.

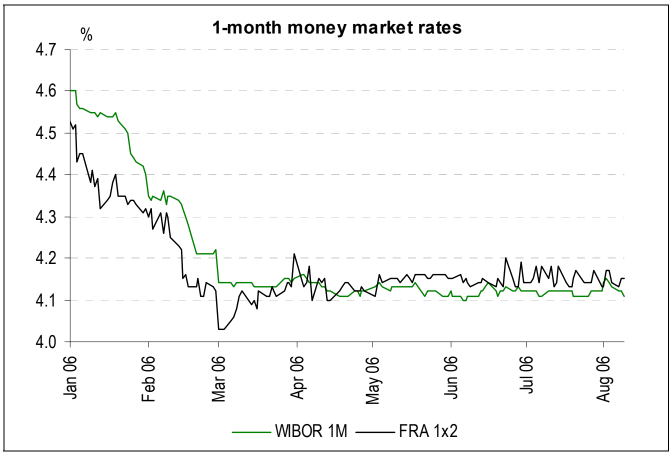
▪ Along the publication of next data in US (especially inflation) the expectations for rate hikes may return, which may contribute to a slight correction in the core markets. Figures reflecting the strength of the economy will be also important and if they confirm the weakening this may support the Treasuries. In our opinion, Fed rates will stay at 5.25% till the year's end and in the EMU rates may rise by 50 bp in Q4 and another 25 bp in Q1 2007.

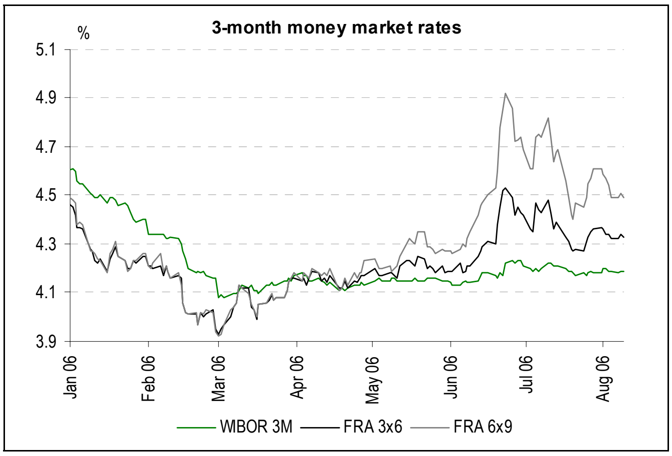
Source: Reuters, BZ WBK

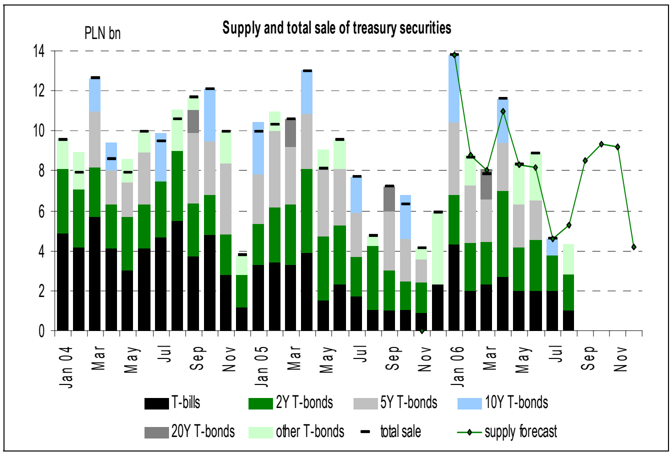
Market monitor











Treasury bill auctions (PLN m)

Date of auction	OFFER / SALE 52-week	Total
05.06.2006	1 000 / 1 000	1 000 / 1 000
19.06.2006	1 000 / 1 000	1 000 - 1 000
Total June	**2 000 / 2 000**	**2 000 / 2 000**
10.07.2006	1 000 / 1 000	1 000 / 1 000
24.07.2006	1 000 / 1 000	1 000 / 1 000
Total July	**2 000 / 2 000**	**2 000 / 2 000**
07.08.2006	1 000 / 1 000	1 000 / 1 000
21.08.2006	1 000 - 1 200	1 000 - 1 200
Total August*	**2 000 - 2 200**	**2 000 - 2 200**

* estimations based on Ministry of Finance preliminary information

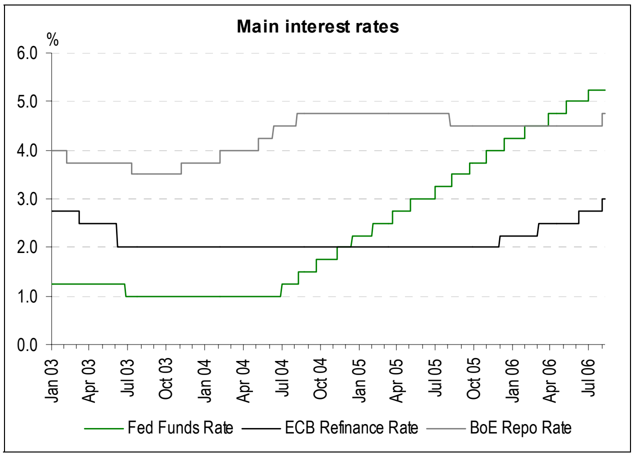
Treasury bond auctions in 2006 (PLN m)

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	2 520	2 520	14.06*	WZ0911 | IZ0816	1 800 | 500	1 800 | 500	21.06	PS0511	2 000	2 000
July	05.07	OK0808	1 800	1 800	12.07	DS1015	800	800	-	-	-	-
August	02.08	OK0808	1 800	1 800	09.08	WZ0911	1 500	1500	-	-	-	-
September	06.09	2Y	-	-	13.09	20Y	-	-	20.09	5Y	-	-
October	04.10	2Y	-	-	11.10	10Y	-	-	18.10	5Y	-	-
November	02.11	2Y	-	-	08.11	7Y WIBOR | 12Y CPI	-	-	15.11	5Y	-	-
December	06.12	2Y	-	-	-	-	-	-	-	-	-	-

* with supplementary auction

Source: Ministry of Finance, Reuters, BZ WBK

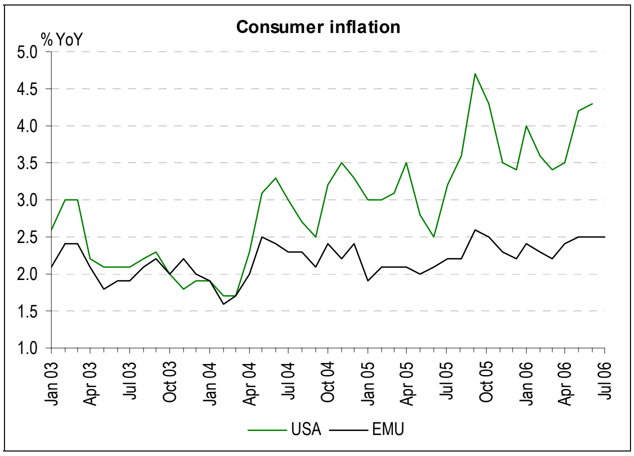
International review



Fed's on hold, ECB moves forward with rates

▪ Fed decided to pause after 17 consecutive rate hikes, which was broad in line with market expectations. Fed Funds rate was left unchanged at 5.25%. In its communiqué the FOMC emphasised that economic growth has moderated and signalled that although some inflation risks remained the price pressures seem to moderate and stay contained. Further moves will depend on the coming data on growth and inflation risks.

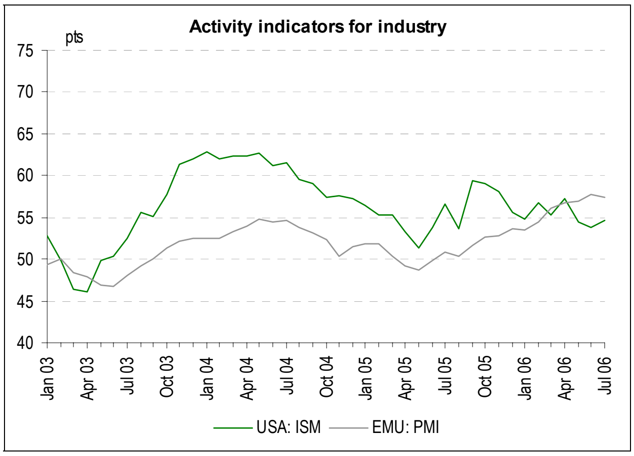
▪ The ECB increased the main rate in the euro zone by 25 bp to 3%, which was in line with market expectations. The European Central Bank signalled in its statement increased risks to prices and firm growth, while the monetary policy in the EU-12 remained accommodative. EBC's member Klaus Liebsher commented that after the rate hike, which was "a necessary adjustment" the interest rates remained low and did not pose threat to growth.



US CPI inflation still at elevated levels

▪ US June CPI inflation amounted to 0.2%MoM and 4.3%YoY as compared to 0.4%MoM in the previous month. The core figure amounted to 0.3%MoM (2.6%YoY) and was slightly above analysts' forecasts at 0.2%MoM. Producer prices index rose by 0.5%MoM (4.9%YoY) in June, which was above the market consensus of 0.3%MoM. Core PPI rose by 0.2%MoM (1.9%YoY), which met analysts expectations, as compared to 0.3%MoM rise in the previous month.

▪ According to the Eurostat the final HICP inflation in the euro zone in June amounted to 2.5%YoY (0.1%MoM) in line with forecasts and the previous reading. The core figure, excluding the most volatile food and energy prices rose by 1.5%YoY and 0.1%MoM According to preliminary estimates of the Eurostat for July the HICP inflation was unchanged in comparison to June.

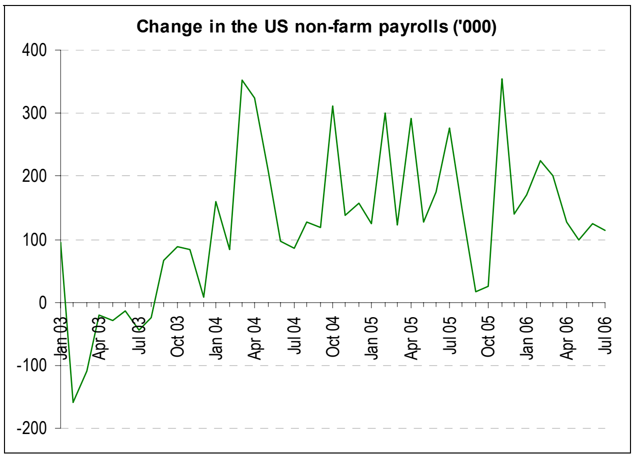


High PMI in the euro zone, weak growth in US

▪ ISM manufacturing index in United States rose from 53.8 in June to 54.7 in July. The prices paid component was higher in July as well at 78.5 as compared to 76.5 in the previous month. The employment index increased to 50.7 from 48.7, while new orders index eased to 56.1 from 57.9. ISM index for the services sector fell from 57.0 to 54.8 in July, new orders index was at 55.6 as compared with 56.6 in the previous month, whereas the employment component rose from 52.0 in June to 54.5.

▪ The PMI manufacturing index in the euro zone fell from 57.7 in June to 57.4, which was exactly in line with market expectations. The output fell from 60.1 to 59.4, whereas the employment component declined from 53.1 to 52.3. The PMI non-manufacturing index fell from 60.7 in June to 57.9 in July and was much below forecasts at 60.0. The jobs index dropped from 56.6 to 54.0, while the input prices component rose from 60.1 to 60.2.

▪ According to preliminary data the US Q2 GDP amounted to 2.5% and was lower than market consensus of 3.0%, as compared to 5.6% in Q1 The GDP deflator was at 3.3%, the PCE price index amounted to 4.2% (3.3%YoY), while the core PCE figures was at 2.7% (2.3%YoY).



Source: Reuters, ECB, Federal Reserve

Weak data from the US labour market

▪ According to the US Department of Labour, in July 113k jobs were added to the payroll in comparison to upwardly revised 124k (121k before revision). This was below market consensus at 142k. The unemployment rate rose from June's 4.6% to 4.8%, above forecasts at 4.6%.

▪ In USA the labour productivity increased by 1.1% in the Q2, above the market consensus at 0.9%. Unit labour costs for the same period soared by 4.4%. This was the fastest pace since the final quarter of 2004 compared to 3.5% analysts' forecast.

Economic calendar

Monday	Tuesday	Wednesday	Thursday	Friday
7 July ***POL: Treasury bills auction***	**8** US: Labour productivity (Q2) US: Unit labour costs (Q2) US: Fed meeting – decision (Jun)	**9** ***POL: Auction of 7Y floating rate bonds and 12Y CPI linked bonds*** US: Wholesale inventories (Jun)	**10** USA: Foreign trade (Jun) USA: Fed budget (Jul) USA: Jobless claims	**11** ***POL: Balance of payments (Jun)*** JP: BOJ meeting - decision USA: Foreign trade prices (Jul) USA: Retail sales (Jul)
14 ***POL: Money supply (Jul)*** EMU: Preliminary GDP (Q2)	**15** ***POL: Market holiday*** USA: PPI (Jul) USA: Net capital flow (Jun)	**16** ***POL: CPI (Jul)*** ***POL: Wages (Jul)*** ***POL: Employment (Jul)*** USA: CPI (Jul) USA: House starts (Jul) USA: Build permits (Jul) USA: Capacity use (Jul) USA: Industrial production (Jul)	**17** EMU: Final HICP (Jul) EMU: Industrial production (Jun) USA: Jobless claims USA: Philadelphia Fed index (Aug)	**18** ***POL: PPI (Jul)*** ***POL: Output in industry and construction (Jul)*** USA: Preliminary Michigan (Aug)
21 ***POL: Treasury bills auction***	**22** GER: ZEW index (Aug)	**23** ***POL: Business climate (Aug)*** ***POL: Net inflation (Jul)*** ***POL: Switch auction*** USA: Home sales (Jul)	**24** ***POL: Retail sales (Jul)*** ***POL: Unemployment (Jul)*** GER: IFO index (Aug) USA: Jobless claims USA: Durable goods orders (Jul) USA: New homes sales (Jul)	**25**
28 GB: Market holiday EMU: M3 money supply (Jul)	**29** ***POL: MPC meeting*** USA: Consumer confidence (Aug) USA: FOMC minutes	**30** ***POL: GDP (Q2)*** ***POL: MPC meeting – decision*** USA: Preliminary PCE (Q2) USA: Preliminary GDP (Q2) USA: Preliminary GDP deflator (Q2)	**31** EMU: Preliminary HICP (Aug) EMU: Economic sentiment (Aug) EMU: ECB rate decision (Aug) EMU: GDP revised (Q2) USA: Jobless claims USA: Factory orders (Jul) USA: Chicago PMI (Aug)	**1 August** EMU: Manufacturing PMI (Aug) EMU: Unemployment (Aug) USA: Non-farm payrolls (Aug) USA: Unemployment (Aug) USA: Final Michigan (Aug) US: Manufacturing ISM (Aug)
4 ***POL: Treasury bills auction*** EMU: PPI (Jul) US: Market holiday	**5** EMU: Non-manufacturing PMI (Aug) EMU: Retail sales (Jul)	**6** ***POL: Auction of 2Y bonds*** US: Labour productivity – revised (Q2) US: Unit labour costs – revised (Q2) USA: Non-manufacturing ISM (Aug)	**7** GB: BoE meeting - decision US: Wholesale inventories (Jun)	**8** JP: BoJ meeting - decision & report

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

		Jul 05	Aug 05	Sep 05	Oct 05	Nov 05	Dec 05	Jan 06	Feb 06	Mar 06	Apr 06	May 06	Jun 06	Jul 06	Aug 06
Industrial production	%YoY	2.6	4.8	5.9	7.6	8.5	9.6	9.8	10.2	16.4	5.7	19.1	12.4	12.5	17.9
Retail sales [c]	%YoY	5.0	7.9	5.4	7.5	7.3	6.3	8.6	10.2	10.1	13.2	13.7	10.7	14.0	13.2
Unemployment rate	%	17.9	17.7	17.6	17.3	17.3	17.6	18.0	18.0	17.8	17.2	16.5	16.0	15.7	15.6
Gross wages [b c]	%YoY	3.2	2.8	1.8	6.4	6.9	1.5	3.6	4.8	5.4	4.0	5.2	4.5	5.8	6.1
Employment [b]	%YoY	1.8	2.0	2.2	2.1	2.5	2.6	2.6	2.4	2.7	2.8	3.0	3.1	3.2	3.3
Export (€) [d]	%YoY	18.0	14.9	12.9	18.4	16.1	20.0	22.1	18.8	26.4	12.0	32.9	21.2	17.8	20.2
Import (€) [d]	%YoY	7.8	15.5	11.0	14.6	18.1	16.8	23.0	22.1	22.2	9.6	31.0	21.2	22.0	22.5
Trade balance [d]	EURm	-113	-378	-107	3	-232	-467	64	-253	-106	47	-483	-100	-400	-600
Current account balance [d]	EURm	-247	-381	-237	-317	-291	-451	-197	-794	-351	-190	-209	-200	-620	-610
Current account balance [d]	% GDP	-1.8	-1.7	-1.5	-1.5	-1.5	-1.4	-1.3	-1.5	-1.5	-1.6	-1.4	-1.5	-1.7	-1.7
Budget deficit (cumulative)	PLNbn	-17.5	-18.5	-17.8	-20.6	-22.2	-28.6	0.7	-6.7	-9.0	-10.0	-14.6	-17.7	-15.6	-20.0
Budget deficit (cumulative) [e]	% realisation	61.1	64.7	62.3	72.1	77.7	100.0	-2.3	21.9	29.4	32.8	47.8	57.8	51.1	62.2
CPI	%YoY	1.3	1.6	1.8	1.6	1.0	0.7	0.6	0.7	0.4	0.7	0.9	0.8	0.8	0.7
PPI	%YoY	0.0	-0.2	-0.5	-0.9	-0.4	0.2	0.3	0.7	0.9	1.7	2.3	2.8	2.9	3.0
Broad money (M3)	%YoY	10.4	11.1	12.7	8.7	12.6	10.4	10.4	11.7	9.8	9.6	10.1	11.8	12.4	11.8
Deposits	%YoY	9.4	10.1	11.6	6.3	11.1	9.4	10.2	10.8	9.1	8.6	8.9	11.4	11.4	10.5
Loans	%YoY	8.8	9.0	9.6	4.4	10.2	11.8	12.3	13.5	13.6	12.2	12.4	16.0	16.6	17.0
USD/PLN	PLN	3.40	3.29	3.20	3.26	3.37	3.25	3.16	3.18	3.23	3.20	3.05	3.17	3.15	3.06
EUR/PLN	PLN	4.10	4.05	3.92	3.92	3.97	3.85	3.82	3.79	3.88	3.92	3.90	4.02	4.00	3.92
Reference rate [a]	%	4.75	4.75	4.50	4.50	4.50	4.50	4.50	4.25	4.00	4.00	4.00	4.00	4.00	4.00
Lombard rate [a]	%	6.25	6.25	6.00	6.00	6.00	6.00	6.00	5.75	5.50	5.50	5.50	5.50	5.50	5.50
WIBOR 3M	%	4.66	4.67	4.57	4.50	4.64	4.62	4.49	4.26	4.12	4.14	4.15	4.17	4.19	4.20
Yield on 52-week T-bills	%	4.30	4.33	4.15	4.19	4.35	4.38	4.22	3.97	3.87	3.95	4.02	4.20	4.30	4.30
Yield on 2-year T-bonds	%	4.50	4.60	4.22	4.42	4.75	4.64	4.40	4.20	4.10	4.28	4.44	4.75	4.95	4.80
Yield on 5-year T-bonds	%	4.70	4.84	4.51	4.85	5.23	5.04	4.82	4.60	4.59	4.80	5.00	5.33	5.37	5.35
Yield on 10-year T-bonds	%	4.72	4.87	4.57	4.90	5.36	5.14	4.94	4.78	4.78	5.02	5.26	5.54	5.55	5.55

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	1 037.0	228.7	238.2	241.0	273.0	240.3	252.7	254.3	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	13.2	0.7	2.3	4.5	8.3	12.1	12.4	13.9	14.2
Retail sales (real terms)	%YoY	3.6	7.1	1.5	11.9	-0.4	-3.2	4.1	5.4	9.4	12.7	13.3	12.4
Unemployment rate [a]	%	20.0	19.1	17.6	15.7	19.2	18.0	17.6	17.6	17.8	16.0	15.5	15.7
Gross wages (real terms) [c]	%YoY	2.0	0.8	1.2	4.3	-1.3	0.8	1.1	3.8	4.0	3.7	5.6	3.9
Employment [c]	%YoY	-3.5	-0.8	1.9	3.0	1.5	1.7	2.0	2.4	2.6	3.0	3.3	3.1
Export (€) [b]	%YoY	9.1	22.3	17.1	19.3	23.2	12.9	15.0	18.0	22.6	21.8	18.8	14.7
Import (€) [b]	%YoY	3.3	19.5	12.6	20.2	17.6	6.0	11.2	16.5	22.5	20.6	21.0	17.0
Trade balance [b]	EURm	-5 077	-4 552	-2 182	-3 280	-259	-633	-599	-691	-294	-536	-1 150	-1 300
Current account balance [b]	EURm	-4 108	-8 542	-3 457	-5 017	-1 043	-500	-861	-1 053	-1 338	-599	-1 530	-1 550
Current account balance [b]	% GDP	-2.1	-4.2	-1.4	-1.9	-3.4	-2.1	-1.5	-1.4	-1.5	-1.5	-1.7	-1.9
Budget deficit (cumulative) [a]	PLNbn	-37.0	-41.5	-28.6	-30.5	-12.3	-18.5	-17.8	-28.6	-9.0	-17.7	-21.0	-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	0.7	1.0
CPI [a]	%YoY	1.7	4.4	0.7	1.5	3.4	1.4	1.8	0.7	0.4	0.8	0.6	1.5
PPI	%YoY	2.6	7.0	0.7	2.8	3.3	0.1	-0.2	-0.4	0.9	2.8	3.3	4.1
Broad money (M3) [a]	%YoY	5.6	8.7	10.4	11.2	11.0	10.8	12.7	10.4	9.8	11.8	11.1	11.2
Deposits [a]	%YoY	3.7	8.1	9.4	9.5	10.4	9.2	11.6	9.4	9.1	11.4	9.7	9.5
Loans [a]	%YoY	8.1	2.9	11.8	15.0	4.6	7.4	9.6	11.8	13.6	16.0	18.2	15.0
USD/PLN	PLN	3.89	3.65	3.23	3.11	3.07	3.28	3.30	3.29	3.19	3.14	3.10	3.02
EUR/PLN	PLN	4.40	4.53	4.02	3.92	4.03	4.13	4.02	3.91	3.83	3.95	3.96	3.93
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	4.21	6.44	5.49	4.63	4.59	4.29	4.15	4.20	4.20
Yield on 52-week T-bills	%	5.33	6.50	4.92	4.17	5.91	5.21	4.26	4.31	4.02	4.06	4.30	4.30
Yield on 2-year T-bonds	%	5.38	6.89	5.04	4.66	5.83	5.27	4.44	4.60	4.23	4.49	4.87	4.82
Yield on 5-year T-bonds	%	5.61	7.02	5.25	5.16	5.89	5.38	4.68	5.04	4.67	5.04	5.37	5.50
Yield on 10-year T-bonds	%	5.77	6.84	5.24	5.36	5.76	5.37	4.72	5.13	4.83	5.27	5.57	5.70

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 09.08.2006 has been prepared by:

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