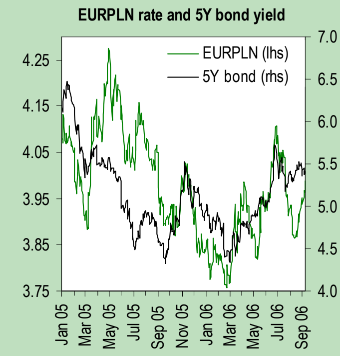
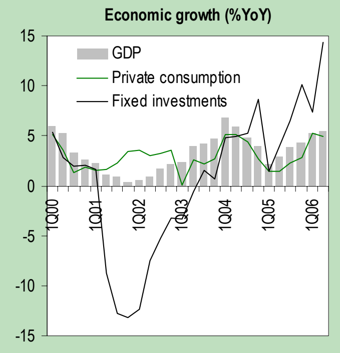
Bank Zachodni WBK

MACROscope

Polish Economy and Financial Markets

September 2006





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Fragile balance

- **In August edition of MACROscope we wrote about a possibility of correction on the foreign exchange market and indeed the zloty lost above 3% against euro and more than 4% against US dollar.** The psychological level of 4.0 for EURPLN rate was not broken until the end of holidays, but it is still likely given discussions (possible conflicts) in the governing coalition over the next year budget, which shows quite significant increase in public spending. In this month's *Special focus* we show how fragile is the (im)balance of Polish public finance sector and the budget deficit anchor adopted by the government does not guarantee meeting medium-term fiscal targets.

- **End of vacation was quite stable for the bond market, although some deterioration in moods appeared after the publication of inflation for July (1.1%) and release of the Ministry of Finance's forecast for August (1.5%).** If the forecast of the Ministry of Finance, which assumes food prices increase (untypical in this period even in difficult years in agriculture sector), materialises, market expectations as regards soon monetary tightening may be reinforced. Although it is difficult to forecast the influence of drought on food prices, in our opinion the risk is on the downside as compared to the ministry's forecast, which could give positive impulse for the market.

- **As regards central bank's policy, we still think it is too early to talk about interest rate hikes in the following months.** Although the inflation path for remainder of the year and beginning of 2007 has changed because of higher food prices, in this context it is worth to notice comments of central bank's representatives, which indicated a scenario of no reaction to inflation increase caused by supply side shocks. Our CPI forecast shows increase in annual inflation above the NBP's target in 1Q07 (higher food prices and excise taxes rise), but at the end of the next year it should fall to below 2.5% again. At the same time, net inflation should not considerably exceed the level of 2%, which means, in our opinion, that interest rate hike would not be necessary. Unless such situation will be used as an opportunity to build credibility of the new NBP governor (to be appointed at the beginning of 2007) by let's say two fine-tuning 25 bps rate hikes. However, this is not our base-case scenario.

- **GDP growth rate in the second quarter (5.5%) was exactly in line with our forecast, while fast growth in fixed investments (14.4%) was a positive surprise.** For some time we have been saying that GDP growth of 5% is well possible this year and the data for the second quarter confirmed this view. Although the second half of the year will see some slowdown, amid statistical base effect, GDP growth in Q3 and Q4 should be also around the level of 5%. Also, it is worth top notice that pressure form the unit labour costs eased somehow in the second quarter and GDP deflator was only moderately positive in this period (it was even negative in Q1), which shows moderate pressure on price growth in the economy.

Financial market on 31 August 2006:

NBP deposit rate	2.50	WIBOR 3M	4.19	USDPLN	3.0651
NBP reference rate	4.00	Yield on 52-week T-bills	4.41	EURPLN	3.9369
NBP lombard rate	5.50	Yield on 5-year T-bonds	5.36	EURUSD	1.2844

This report is based on information available until 08.09.2006

Special focus

Anchor in shallow waters?

Recently we have observed tensions within ruling coalition which concerned, among others, the shape of the next year's budget. While finance minister and Prime Minister defend the "budget anchor", coalition partner Self-Defence insist on increase in budget spending, even if it could cause that budget gap will exceed PLN30bn. An analysis carried out by us, described below, shows that even consistent implementation of the "anchor" does not guarantee achievement of medium-term fiscal goals, connected with Poland's obligations towards the European Union. Moreover, there is a question mark over long-term stability of Polish public finance, especially if there are another attempts aimed at modification of the new pension system introduced in 1999. The modifications, such as introduction of privileges for miners, financed by state budget, effectively means partial withdrawal from the pension reform.

The budgetary season is coming

The holidays are gone, the silly season has ended. It is September already, a month traditionally characterised by intensified inflow of information on the fiscal policy. The government is to pass the draft budget to the Parliament by 30 September, so the detailed analysis of the document in the version approved by the government will be presented in the October issue of the MACROscope. In November, we will get to know another updated version of the convergence programme, which the Polish government is to present each year to the European Commission. We will certainly present you the analysis of this document as well. Bearing in mind the emotional reactions to the publication of the updated convergence report by Hungary in the second half of August (strong weakening of the HUF leading to weakening of other currencies in the region), we must be aware that the presentation of Polish convergence programme can have a huge impact on the market (positive or negative, depending on the report content). It is possible however that the weakening recorded on Polish market after publication of the Hungarian Convergence Programme may be attributed to the fact that the investors had already priced-in a similar scenario in our country.

In this issue of a monthly report, before the annual key documents regarding the fiscal policy are analysed, we would like to take a look at the Polish public finance from a wider perspective. First of all, we would like to ponder over the possible consequences of using the so-called budgetary anchor in Poland, i.e. whether it will guarantee a reduction in the fiscal deficit required by the EU and allow to keep control over the public debt. Secondly, what will be the level of Polish public debt in a longer term assuming the current fiscal policy is maintained. We will attempt to examine, using the econometrics methods, whether we can avoid breakdown in the public finance, without carrying out basic reforms and significant changes in the fiscal policy being made.

Anchor cast in the shallows?

The key feature underlying the fiscal policy in Poland is the declaration provided by the government (presented, among others, in the recent updated version of the Convergence Programme) re. the so-called budgetary anchor. The anchor means stabilisation of the nominal budget deficit at the level of PLN 30bn throughout the current parliamentary term. The government intends to fulfil the obligations under the Maastricht Treaty by way of using the budgetary anchor. This means, in terms of the fiscal parameters, reduction in the deficit in the general government sector relative to the GDP below 3% and maintenance of the general government debt relative to the GDP below 60%.

Does the budgetary anchor really guarantee reduction in the fiscal deficit in Poland below 3% of the GDP in 2009? Assuming that a passive rule is applied (fixed regardless of the situation) aimed at maintaining the deficit at PLN30bn, the chance to reduce the fiscal deficit below 3% of the GDP depends on the pace of economic growth. The strategy of the reduction in fiscal deficit relative to the GDP based on stabilisation and not reduction in the nominal debt is a "growing out of deficit" strategy. Its efficiency depends on favourable economic activity. With such a strategy, an unexpected slowdown in the economic growth can lead to the inability to deliver the assumed objectives behind fiscal policy. In such a scenario, a budgetary anchor, i.e. lack of a decisive reduction of the imbalance in the public finance, would make the Polish economy wade in the swallows of low income and rapidly growing public expenses. Rapid increase in the level of expenses would stem from the fact that, similar to the past, little is done to reduce the share of fixed expenses, if not the contrary. In such a situation, in the case of deteriorating business climate and slower pace of income growth the adjustment on the side of expenses would be hampered. Increasing the deficit, i.e. the lending requirements of the State, would lead to a fast growth in the public debt. With a lower economic growth, the relation between the public debt and the GDP would deteriorate significantly and most probably the safety thresholds applied in the Public Finance Act would be breached. That would force the fiscal authorities to cut the budget drastically, which could deteriorate the business climate even further.

Fiscal simulator

To analyse the possible scenarios of changes in the fiscal deficit within the next few years, we carried out a simple simulation for various options of economy development assuming a consistent use of "budget anchor". Results of the simulation are presented in the tables below.

Table 1 presents a base case scenario based on our current projections re. basic macroeconomic variables until 2009. It assumes that the GDP will grow in nominal terms on average by 7.2% a year in 2006-2009, which is the same as in 2004-2005, when the dynamic expansion of Polish economy began. The table presents, in a detailed manner, the assumed pace of growth in the GDP in each of the analysed years, both in nominal and real terms, along with the emerging result (in form of a fiscal deficit in relation to the GDP) with the budgetary anchor in place. In our simulations we use a simplified assumption, favourable from the fiscal authorities point of view that deficit in the sector of government institutions and local authorities comprises only the deficit of the central budget, while the balance of other elements in the sector of government institutions and local authorities equals zero. Adoption of such assumption is mainly aimed at making our simple simulation more clear in terms of effects of using budget anchor. Given expected worsening of fiscal balance in sectors outside the central budget (e.g. likely rise in deficits of local authorities sector due to co-finanincing of EU aid funds). At the same time, we take into account official decision of the EU re. the classification of open pension funds. It is rather unfavourable for Poland and other countries which made an effort to reform the traditional pension systems. Poland and other countries which reformed pension systems failed to follow through the postulated deduction in total reform costs from budget deficit without time limits. The countries were allowed only to deduct from their budget expenses part of the costs related to the pension reform within five years starting from 2004 (in a regressive manner). In 2004, the countries could deduct the total reform costs, in 2005 it was 80%, 60% in 2006, 40% in 2007 and in 2008 it will be only 20%. As of 2009, the costs of pension reform will not be deducted any more. We assume in our calculations, based on the updated 2005 Convergence Programme, that the level of total costs, the part of which can be deducted from budget expenses, decreases gradually from 1.7% in 2006 to 1.5% in 2009.

Table 1. Base scenario

		2006	2007	2008	2009
GDP in real terms	%	5.2	5.0	4.5	4.5
GDP in nominal terms	%	7.4	7.5	7.2	7.1
GDP in nominal terms	PLN bn	1039.5	1117.7	1197.7	1282.6
Central budget deficit	PLN bn	30.0	30.0	30.0	30.0
Central budget deficit	% GDP	2.89	2.69	2.51	2.35
Costs of pension reform	% GDP	1.7	1.6	1.5	1.5
Fiscal deficit adjusted with the costs of pension reform	**% GDP**	**3.57**	**3.65**	**3.71**	**3.85**

Note: BZWBK projection for 2006-2009

Source: own estimates

As Table 1 shows, despite fast economic growth, even the stabilisation of central budget deficit at the level of PLN30bn would not allow to reduce the fiscal deficit relative to the GDP below 3%. Quite the contrary, with the regressive manner of deducting the growing costs of pension reform the analysed period, the deficit gradually increases and the target is fading away. The situation would be totally different if Poland could deduct from the budget the total costs of pension reform. In such a case, the fiscal deficit would be below 3% within the analysed period.

Even the Chinese pace of growth will be of no avail

Assuming that the EU will not change its decision on open pension funds, the budgetary anchor would enable to meet the fiscal criterion agreed in Maastricht provided the pace of economic growth is faster. Table 2 presents such an optimistic scenario based on the assumption that economic growth accelerates in the coming years on the pace allowing for meeting Maastricht criterion regarding fiscal deficit.

Table 2. Optimistic scenario

		2006	2007	2008	2009
GDP in real terms	%	5.2	21.8	21.8	21.8
GDP in nominal terms	%	6.0	24.2	24.4	24.4
GDP in nominal terms	PLN bn	1 039.5	1 291.1	1 606.1	1 998.0
Central budget deficit	PLN bn	30.0	30.0	30.0	30.0
Central budget deficit	% GDP	2.9	2.3	1.9	1.5
Costs of pension reform	% GDP	1.70	1.60	1.50	1.50
Fiscal deficit adjusted with the costs of pension reform	**% GDP**	3.57	3.28	3.07	3.00

Source: own calculations

As Table 2 indicates, reduction of the fiscal deficit in relation to GDP to the level of 3%, accompanied by stable nominal budget deficit at the level of PLN30bn, would be extremely difficult in practice. The economy would have to accelerate rapidly in 2007-2009, by over 24% in nominal terms and up to 22% in real terms, assuming that the GDP deflator will be close to the inflation target of the central bank at the level of 2.5%. Therefore, Polish economy would have to outperform the Chinese one. We can assume of course that in the case of faster economic growth, fiscal authorities would adopt a more ambitious principle than the budgetary anchor assuming to maintain the nominal deficit at the level of PLN 30bn. As a result, it would be much easier and faster to reduce the fiscal deficit/ GDP ratio to the level below 3%. Nonetheless, taking into account the pressure exerted by some members of the ruling coalition, reduction of the nominal deficit accompanied by faster economic growth could prove very difficult.

Lenient Commission, strict markets

What can be the results of the failure to reduce the fiscal deficit to the level below 3%. Theoretically, the EU will impose sanctions on Poland. However, it is hardly possible in reality. Based on the analysis of Treaty breach cases by some other countries (eg. Germany, France, Hungary) it can be assumed that the EU will not be too eager to punish the next countries which exceed the agreed limit of the fiscal deficit.

A reaction from financial markets is more likely. The financial market players have already verified their initial expectations re. Poland's entrance to the euro zone before the end of the decade, however further delays in this process could deteriorate the attitude towards Polish assets. The recent events in Hungary have confirmed that. When it turned out in the second half of August, that its new Convergence Programme does not allow to meet the criteria from Maastricht Treaty in 2009 and to enter the euro zone in 2012, the financial market weakened significantly not only in Hungary but across the whole region, including Poland. It seems that serious delay in Poland's accession to the euro zone is not fully priced in by financial markets and the risk of worsening public finance in case of unexpected economic slowdown is highly underappreciated. In such a case we would face serious turbulence on domestic financial market. Paradoxically, initially the debt market would probably strengthen, especially at the short end of the yield curve, as current expectations for the interest rate to increase would fade away and be even replaced with expectations for interest rate cuts. Impact of the slow down on public finance would be observed only later and followed by weaker debt market, in particular at the long end of yield curve.

Yet taking the discussed here Hungary as a benchmark, we might dare to say that the fiscal position of our country is relatively good. We do not suffer from such a high budget deficit and fast increase in public debt as our fellows from the south. Can we though, in view of the above, and taking no account of our obligations towards the EU, do nothing with public finance? Can we feel confident of Polish public finance while the to-date fiscal policy is maintained? Now we will go on to analyse, with the econometric methods in place, the long-term stability of public finance in Poland.

What about the long-term stability?

Our study of long-term stability of Polish public finance is based on the methodology applied in the work of Hamilton and Flavin as well as works of Trehan and Walsh[1]. This is a methodology built in to the stream of time series analyses. The study is divided into two stages. First of all, statistical features of a public debt time range are examined, i.e. it is checked if the time range is stationary[2]. The stationary feature of the public debt of time series means that over a long period of time it remains stable which is a sufficient, though not a necessary condition, for public finance of a given country to be declared stable in a long term perspective. In case the time range of the public debt is not stationary, there are grounds to claim that the public debt displays a long-term growth trend which means that public finance of a given country may be declared unstable over a long period of time. At the second stage, co-integration analysis of time serious of revenues and public expenses is carried out. Conclusions from both stages of the analysis together represent the basis for assessment whether a given country displays a long-term stability of public finance.

Apart from Poland, for the purpose of comparison, the described procedure of examining long-term stability of public finance was carried out also for the negative hero of our region re. fiscal policy, i.e. earlier mentioned Hungary. The outcome of our study – outlined in detail in the technical annex on page 6 – showed that from the

[1] Hamilton, J., Flavin, M. *On the Limitations of Government Borrowing: A Framework for Empirical Testing, American Economic Review*, 76 (4), str. 808-816, 1986; Trehan, B., Walsh, C. *Common trends, the government's budget constraint, and revenue smoothing*, Journal of Economic Dynamics and Control, 12 (2/3), str. 425-444, 1988; Trehan, B., Walsh, C. *Testing Intertemporal Budget Constraints: Theory and Applications to US Federal Budget and Current Account Deficits*, Journal of Money, Credit, and Banking, 23 (2), str. 206-223, 1991.

[2] The stationary feature of the time series means that its parameters such as the average and variance do not change with time.

long-term public debt stability perspective – our situation does not rudimentally differ from that in Hungary. Both in the case of Hungary and Poland, it was not possible to decline the thesis whereby public debt time series is not stationary. What is more, in the case of both countries, the analysis of co-integration for budget income and expenses indicated that there is no long-term relation between them. There is therefore no ground to claim that there is a relation between income and public expenses which allows to reduce fiscal structural deficit (after adjustment by debt service cost) over a long period of time. Consequently, the procedure carried out by us speaks in favour of defining both Hungary and Poland as countries whose public finance is not stable in a long run.

It should be borne in mind, though, that the methodology we have applied carries certain limitations. First of all, like each procedure related to time series analysis, it is, by its nature, past-oriented rather than taking account of potential changes in the analysed phenomena in the future, for example, changes driven by structural modifications. In the case of fiscal policy in Poland[3], a very important factor that can be defined as a structural change is introduction of a new pension system in 1999. This fact exerted and continues to exert a significant influence on the level of deficit and debt of the general government sector. Costs of the reform which was aimed at, e.g. long-term stabilisation of public finance, strain the state's budget and FUS (Social Security Fund) in a medium-term perspective. The costs of the pension reform comprise the reduction in FUS income equal to the value of premiums transferred to OFE, the value of premiums transferred to the Demographic Reserve Fund and the reduction caused by the limitation of the basis for calculating premiums[4]. All the above costs would not have been incurred if the pension reform had not been introduced with a view to ensuring long-term stability of public finance. The transfers from the state budget to FUS contribute to the increase in borrowing needs (and also the budget deficit under the EU methodology), and as a result they impact the level of debt of general government sector. This much deteriorates the picture of current situation in Poland's public finance and as indicated in the first part of this paper, makes it difficult to reduce the fiscal deficit measured under the EU methodology. From the point of view of the long-term public finance stability, it should be noted however, that the pension report contributed to a significant reduction in off-balance sheet liabilities of the public finance sector towards future pensioners. None of the methods of econometric analysis is able to take account of this factor. The procedure applied by us does not allow to factor this in, either. Meanwhile, its results might be different if the costs of the pension reform were treated differently. If the pension reform had not been introduced, the debt of the public finance sector would be much lower than at present.

A way of taking into account this factor could be introduction into our analysis predicted paths of public debt as well as public revenues and spending. On basis of such extended time series, an analysis of long-term fiscal sustainability would probably yield somewhat different results. However, the problem is that it is difficult to adopt a credible path of future public revenues, spending and debt. This stems mainly from the uncertainty regarding functioning of the new pension system. One has to bear in mind that the shape of Polish new pension system may be, and unfortunately is, modified in a unfavourable manner. For instance, approval of pension privileges for miners by the parliament means that burden on taxpayers with pension spending will not fall as much as authors of the pension reform planned. Moreover, ideas appeared to introduce pension privileges (financed by state budget) for another professional groups. This would effectively mean partial withdrawal from the reform (which was aimed at stabilisation of pension spending in relation to GDP) which would negatively affect long-term sustainability of the country's public finance.

The costs of pension reform are not the only factor which, in Poland and other countries of the region, require caution in interpretation of the commonly applied methods of assessing long-term stability of public finance. The fiscal deficit and the public debt in Poland over the last few years have been strongly related to the ongoing economic transformation. You should be aware that over a relatively short period of time, the Polish economy have been affected by substantial costs of different reforms aimed at stabilising the public finance in the long-run. Apart from the pension system reform, some more or less successful attempts, costly from the point of view of public finance, were made to reform different sectors[5], and outlays for infrastructure were incurred which were high relative to the capacity of a poorly developed economy. All this should be very beneficial to the economy and public finance in the long run but at present it has an adverse impact on the fiscal policy parameters. However, the key will be balance of

[3] The issue of pension reform costs also pays an important role in Hungary.

[4] The pension reform limited the basis for calculating premiums for pension and incapability pension insurance to the 30-times multiple of projected average salary in national economy.

[5] Unfortunately in many cases, such as the mining or railway reform, the public expenditure was so huge and inefficient and most likely they will not be offset by benefits expected in the long run.

costs and benefits connected with the introduction of the new pension system. Therefore, it is crucial whether the new system will not be modified in a unfavourable manner.

In addition, caution in interpretation of results of the conducted analysis is recommended in view of issues related to statistical data. See the technical annex for more information.

Mixed feelings

In conclusion, the analysis of values taken by fiscal policy parameters in the recent years indicates long-term instability of public finance. However, you should look at the conclusions from the carried out research from a perspective broader than the analysis of time series. Over the last more than ten years, a number of difficult reforms have been undertaken in Poland which represent substantial costs for the pubic finance in the short run but will produce tangible results in the longer run. It does not mean however, than the fiscal authorities can sit and do nothing. The expected results from the reforms implemented can be too easily wasted (which can be prompted by the currently high pace of economic growth). In addition, we should worry not only about the long-term stability of public finance but also medium-term fiscal objectives as they are related to Poland's commitment to the EU and the prospects of satisfying them have impact on behaviour of financial markets. From this point of view, in the light of the conducted simple simulations, the "budget anchor" is the "minimum decency" to which the fiscal authorities must feel strongly attached.

Technical Annex

Likewise in the case of many other macroeconomic researches, the best approach to analysing long-term stability of public finance would be a general equilibrium model, because in such approach not only public debt and fiscal deficit would be treated as endogenous variables, but also other macroeconomic variables between which and fiscal parameters important relations holds. For instance, partial equilibrium models do not allow to take into account relations between the size of public debt and economic growth. However, given very limited availability of relevant time series, use of the approach based on general equilibrium model is virtually impossible in case of the Polish economy.

As a result, we base our calculations on the methodology proposed by Hamilton and Flavin and then developed by Trehan and Walsh. This consist of testing stationarity of public debt with the use of Augmented Dickey-Fuller test (ADF test) and analysis of co-integration of public revenues and spending with the use of Johansen procedure.

The data used in the calculations are of monthly frequency and are seasonally adjusted. The data covers central budget only and are not adjusted with costs of pension reform.

Table 1. Stationarity test for public debt series

Country	Sample	k	ADF (k)
Hungary	1997:01-2004:12	4	-1.6347
Poland	1997:01-2004:12	5	0.8791

Note: The lag length (k) is chosen based on the Akaike information criterion.

The results shown in the table above indicate that time series of public debt in Hungary and Poland are not stationarity, which constitutes a sufficient argument for recognition of public finance in these countries as unsustainable in the long term. However, as non-stationarity of public debt series is only a sufficient and not a necessary condition for drawing a conclusion on fiscal unassailability of a given country, a cointegration analysis of public revenues and spending is needed.

Table 2. Stationarity test for public spending and revenues

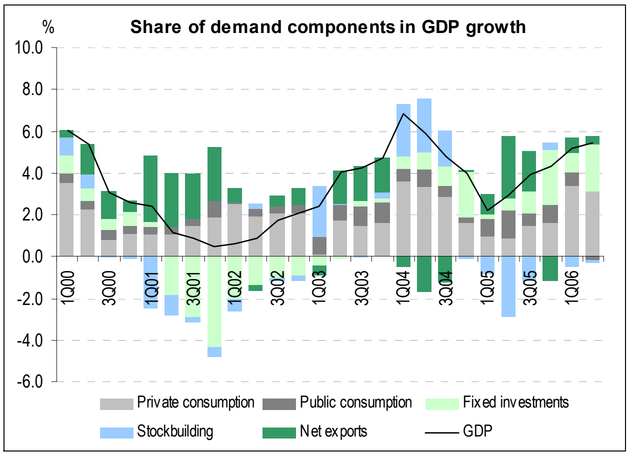
Country	Variables	Sample	Level		First difference	
			K	ADF (k)	k	ADF (k)
Hungary	Revenues	1997:01-2004:12	3	-2.678*	9	-4.4724***
	Spending		9	-2.5891	10	-4.5613***
Poland	Revenues	1997:01-2004:12	5	-2.9398**	4	-7.8946***
	Spending		6	-2.5723	7	-5.6719***

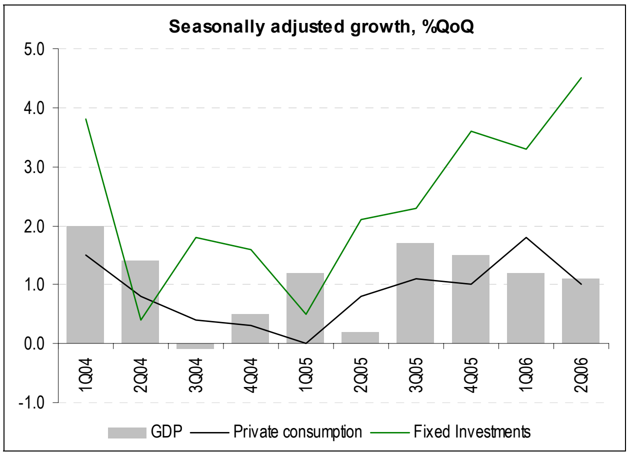
*Note: Symbols *, **, *** indicate that a series is stationary at 10%, 5% i 1% significance level, respectively.*

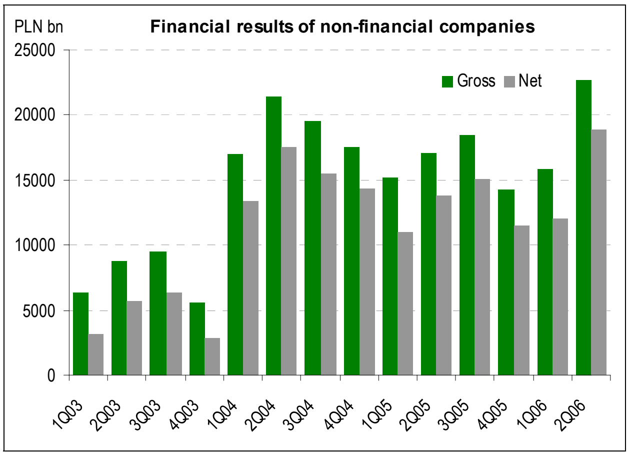
Table 3. Cointegration analysis for public spending and revenues

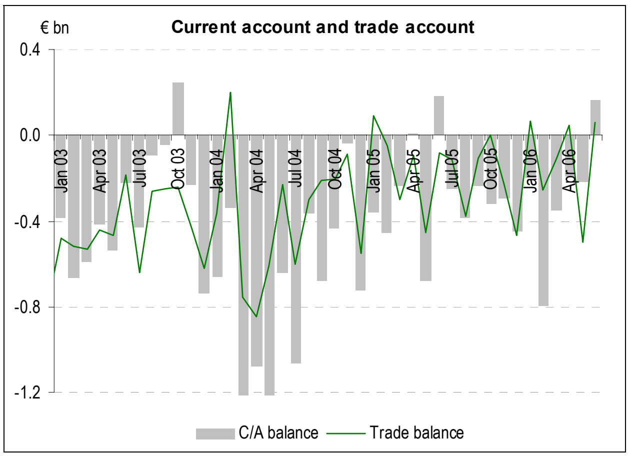
Country	Null hypothesis	Alternative hypothesis	Trace statistic	Reference value (95% quantile)	Null hypothesis	Alternative hypothesis	Maximum-Eigenvalue statistic	Reference value (95% quantile)
Hungary	r=0	r≥1	7.9865	15.4647	r=0	r=1	6.4518	14.2646
	r≤1	r≥2	2.3248	3.8415	r≤1	r=2	2.3248	3.8415
Poland	r=0	r≥1	14.6208	15.4647	r=0	r=1	10.9567	14.2646
	r≤1	r≥2	4.7957	3.8415	r≤1	r=2	4.7957	3.8415

Economic update









Source: CSO, NBP, own calculations

Excellent GDP results in 2Q06

▪ In the second quarter GDP growth reached 5.5%YoY (after 5.2 in 1Q06) and exactly matched our expectations. The growth was fuelled mainly by domestic demand that rose a healthy 5.1%, while impact of net exports was moderately positive (+0.4 pp).

▪ Private consumption growth was very close to our expectations, reaching 4.9%YoY (slight deceleration from 5.2% in Q1). Big positive surprise came from fixed investment growth that accelerated to 14.4%YoY, which was the highest pace of growth for eight years, nearly doubling 7.4% growth seen in the first quarter. The size of improvement suggests that the recovery in investment activity is broad-based, which is a good sign for prospects of economic development in Poland. Slightly worse picture of the Polish economy was presented by seasonally adjusted data – GDP growth has been decelerating since a couple of quarters.

▪ 2Q06 estimates of the productivity growth and unit labour costs, based on employment growth (1.7%YoY) and wages growth (4.7%YoY) in the economy as a whole, show some improvement. Labour productivity soared by 5.3%YoY (2.9%YoY rise in Q1), while ULC slightly declined after four consecutive quarters of annual increases. Although ULC estimates based on employment LFS data will probably show some increase, this should be lower than in previous four quarters (2.5% on average). This limits concerns about inflation prospects in the medium-term, especially as GDP deflator was only moderately positive in Q2 at 0.2%YoY (negative in Q1).

▪ For some time we have been saying that GDP growth of 5% is well possible this year and the data for the second quarter confirmed this view. Although the second half of the year will see some slowdown, amid statistical base effect, GDP growth in Q3 and Q4 should be also around the level of 5%.

Very positive financial results of companies in Q2

▪ Data on financial results of non-financial corporations in the second quarter of this year showed that net profit amounted to PLN18.9bn as compared to PLN12bn in the first three months of the year.

▪ While quarterly increase is a typical seasonal phenomenon, the result was also much higher than in 2Q05, as annual growth rate amounted to 36.1%.

▪ Both revenues and costs increased in two-digit pace, but the important fact was that for the first time since the end of 2004 revenues grew faster than costs – 13.1%YoY against 11.9%YoY.

▪ In the first half of 2006 the net turnover profitability ratio improved to 4.5% from 4.0% in 1H05. Data on financial results of companies bode well for continuation of investment growth.

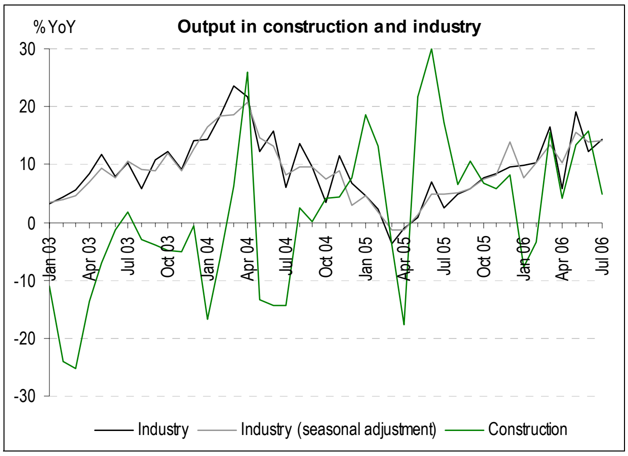
… and surplus in external balance

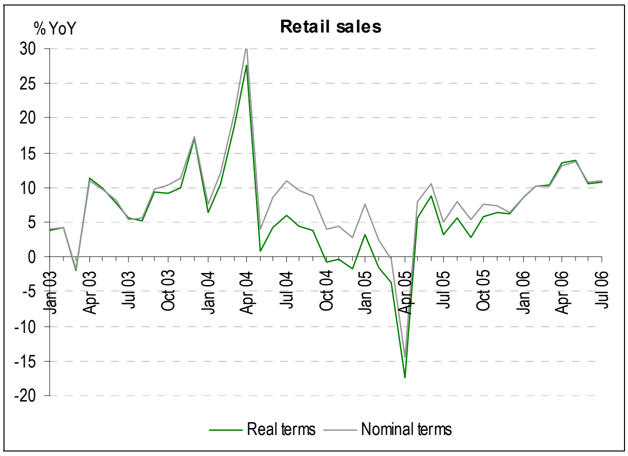
▪ Monthly balance of payments data suggested positive impact of net exports on Polish GDP in 2Q06. The net balance of trade in goods and services was in surplus of PLN814m (deficit of ca. PLN500m in 2Q05), which was the best result for many years.

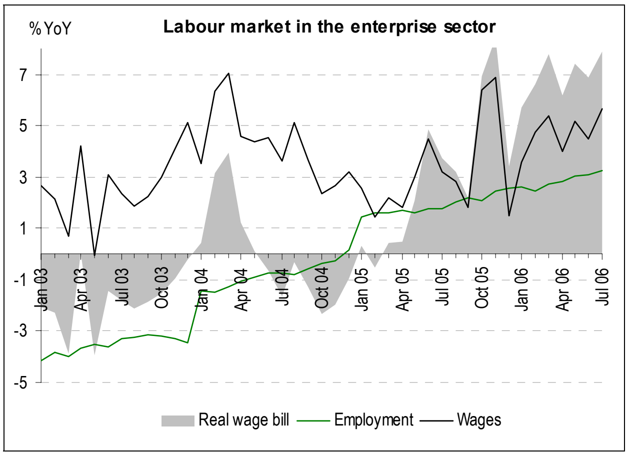
▪ Data for June showed €160m surplus in current account balance and €60m excess in trade of goods. Small surplus on the trade account was achieved amid 16%YoY rise in exports and 13.8%YoY increase in imports value (both in euro terms). While these figures showed some deceleration, they still represent reasonably fast increase in foreign trade activity, corresponding to accelerating growth in Poland's GDP.

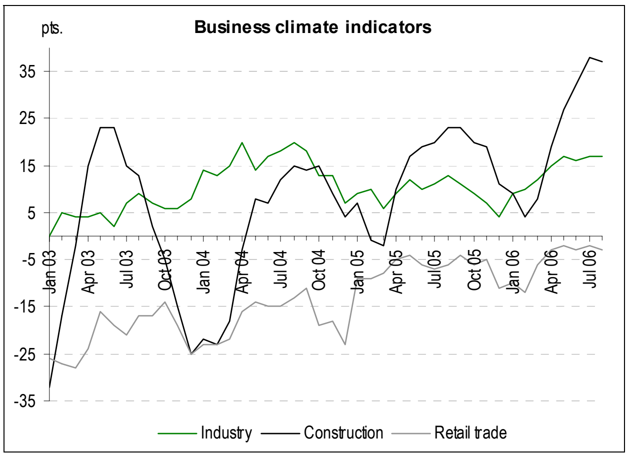
▪ What is important, growth of exports value calculated in zloty terms (15%YoY) was almost as high as the number in euro terms, which suggested rise in Polish exporters' profits.

Economic update









Source: CSO, own calculations

Beginning of the third quarter also very good

- In July industrial output grew 14.3%YoY, which was driven mainly by high growth in manufacturing sectors (15.6%YoY) while growth rates in mining and utilities sectors were weaker and amounted to 8.1%YoY and 3.1%YoY, respectively.
- Looking at output growth across branches, it is quite clear that at the beginning of the third quarter export remains an important driver of the economy's expansion, along with gradually strengthening domestic demand.
- Seasonally adjusted industrial output growth reached 14.1%YoY in July (13.8% in June and 11.8% on average in 1H06).
- Some disappointment was lower than expected growth in construction output, but this variable has been very volatile recently. Looking at 3-month moving average, an upward trend in construction output has been maintained.
- Although retail sales growth in July was below expectations it is hard to call an increase of 11%YoY a disappointment. July's result, together with sharp growth in industrial output, suggested quite promising beginning of the third quarter in terms of economic activity.
- In July, the 12M growth in retail sales was the same as the average for the first half of the year, which showed GDP growth of above 5%. There was two-digit increase in all components of retail sales (the exception was motor vehicles sector with an increase of 6.7%YoY), which indicates broad expansion of consumption demand.
- Again, retail sales growth in real terms was only moderately lower than nominal increase and amounted to 10.8%YoY. This confirmed that pressure on price growth remains muted.

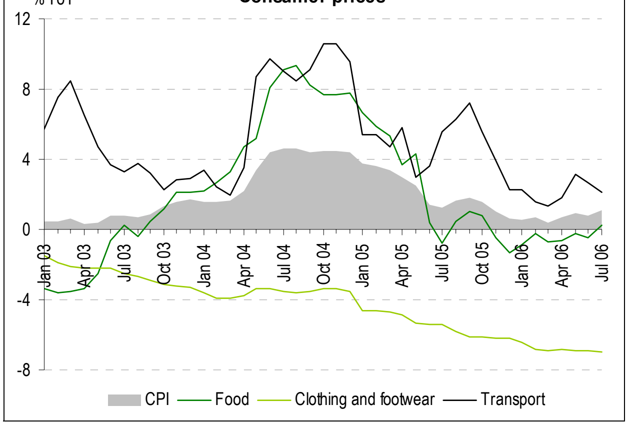
Still solid growth in wages and employment

- Average wage in the enterprise sector rose 5.6%YoY in July. Such pace of average pay rise confirmed a tendency observed for a couple of recent months, i.e. gradual acceleration in wage growth. However, simultaneous strengthening in economic activity means that wage growth still does not outpace significantly labour productivity growth.
- Average employment in enterprises increased 3.3%YoY (another record high growth). In July, nominal wage bill in the enterprise sector rose as much as 9.1%YoY (in real terms by 7.9%YoY), which shows that strong private consumption growth should be maintained.
- Strong employment growth is the key reason behind unemployment rate reduction – in July it fell to 15.7% from 16%, which means the fastest annual reduction since 1998 (2.2 pp).

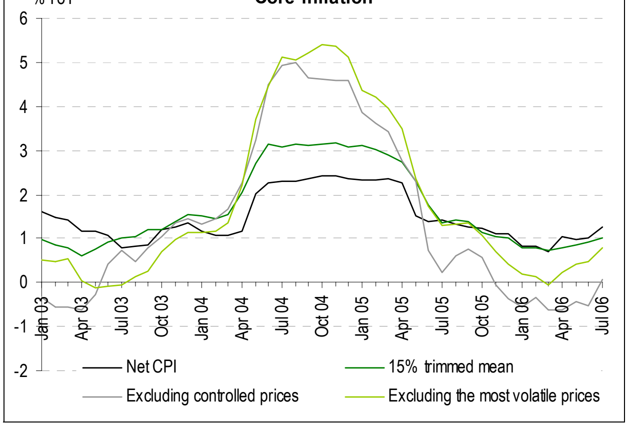
Promising business climate indicators in August

- Business climate indicators for August showed quite similar results as in the couple of previous months. The level of indices remained roughly stable as compared to July. The annual increase was the highest for construction (+14 pts) and was quite moderate for retail trade and manufacturing (+4 and +3, respectively).
- While entrepreneurs from construction and manufacturing sectors expect increases in orders, production, employment and improvement in financial situation; retail trade firms are more sceptical as they expect sales, employment and financial situation to be slightly worse.
- Nevertheless, we think that double-digit level growth in retail sales (and in industrial production) will be maintained in the following months and improvement on the labour market will be a supportive factor.

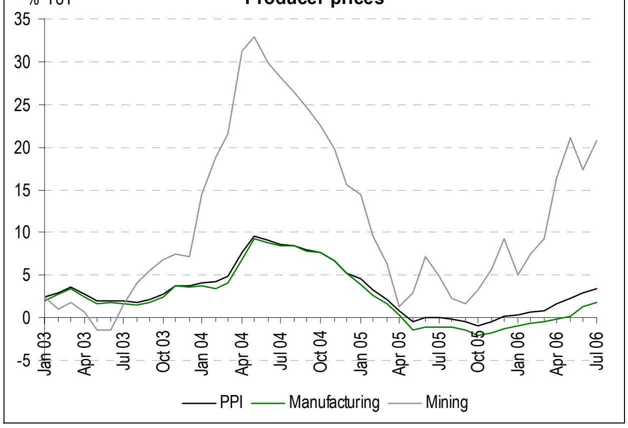
Economic update



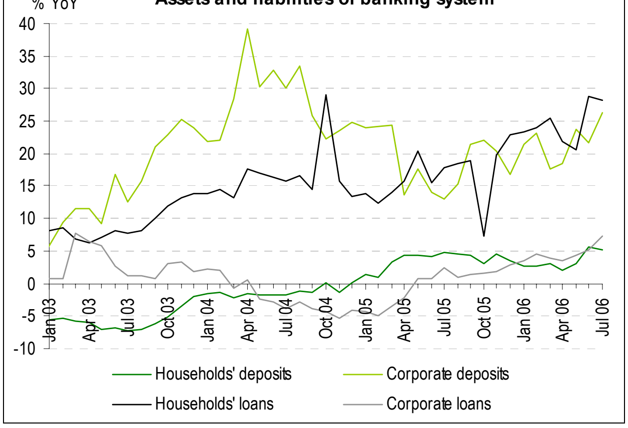
Consumer prices



Core inflation



Producer prices



Assets and liabilities of banking system

Source: CSO, NBP, own calculations

One-off factors responsible for inflation increase

- Inflation data for July was a big surprise for the market. Consumer prices were flat on a monthly basis, which drove annual inflation rate up to 1.1% from 0.8% in June. The reason for the higher-than-predicted inflation in July was prices in recreation and culture (growth of 3.4%MoM), and prices in communication (up 1.9%MoM). Food prices dropped 1.5%MoM, while transport prices increased 1%MoM.
- The same factors were responsible for increase in most of core inflation measures. Average increase of these four measures (net inflation, CPI excluding most volatile prices, CPI excluding most volatile prices and fuels, and CPI excluding controlled prices) was 0.4 percentage point. The most closely watched net inflation increased to 1.3%YoY from 1% in June
- However, it is worth to look at the fifth core inflation measure defined as 15% trimmed mean, which excluded strong, one-off increases in prices. It rose by 0.1pp to 1% from 0.9%, which shows that underlying pressure on prices in the economy remains very limited. Also, it is worth to notice that the average level of all core inflation measures is below 0.8%YoY, while the NBP inflation target is 2.5% +/- 1pp.
- Another negative inflation surprise was connected with the publication of inflation forecast for August by the Ministry of Finance (rise to 1.5% amid higher food prices). We expect slightly lower inflation (1.3%), but the influence of drought on consumer prices means that inflation path for the following months will also change, as compared to previous forecasts. Inflation will probably rise to ca. 2% in December 2006 and to above 2.5% in 1Q07. However, after one-off effects recede, the annual inflation rate should fall to below 2.5% at the end of the next year, while net inflation should not significantly exceed 2% in this period.

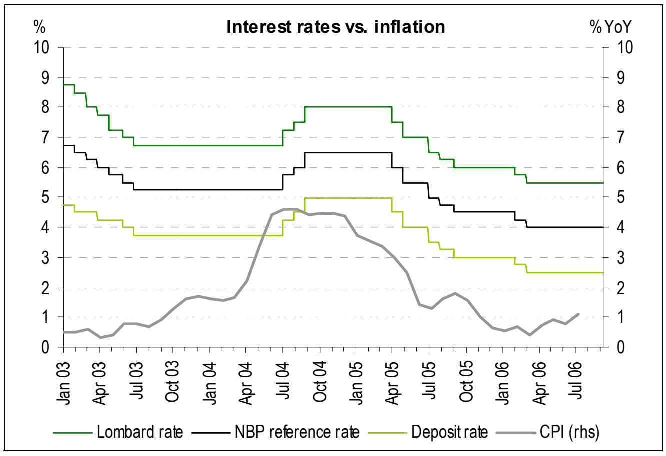
PPI above expectations, but not in manufacturing

- In July producer prices grew 0.7%MoM, driving annual growth rate up to 3.5%, higher than to 3% expected by the market. We think that recent acceleration in inflation indicators should not significantly affect assessment of medium-term inflation prospects, as they are affected by factors of transitory nature.
- PPI rise was largely an effect of fast price growth in mining while pace of price growth in manufacturing, despite some acceleration in recent months, is still moderate. Besides, acceleration in annual growth rate of producer prices, observed this year, is caused to some extent by high statistical base effect.
- Therefore, we think inflationary pressures in the Polish economy remain relatively weak and even if strengthening economic growth is likely to gradually increase pressure on prices, the medium-term target does not seem to be endangered. .

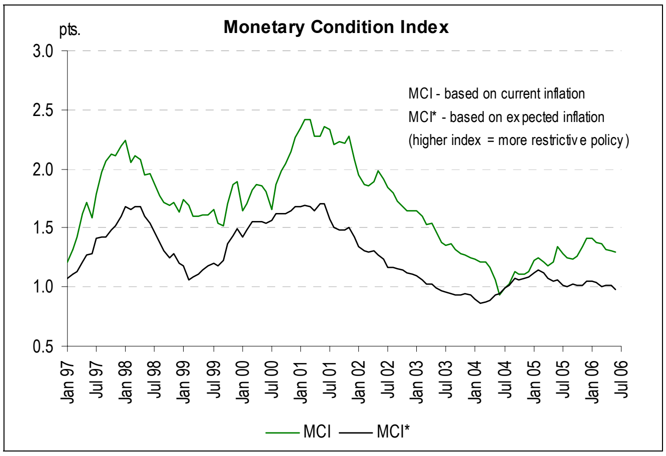
Stronger rise in money supply and credits

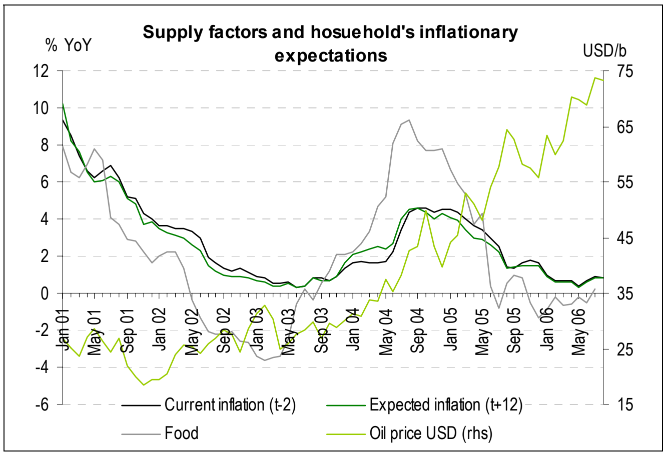
- Broad money M3 advanced 13.1%YoY in July, which was one of the highest growth rates during the last five years. Total deposits growth accelerated to 12.4% from 12.1% in June, mostly due to strong inflow of corporate deposits (26.3%YoY, i.e. the fastest pace since mid-2004).
- Nevertheless, the enterprises increased their activity not only in terms of savings, but also as regards demand for credit. Loans to companies picked up 7.3%YoY in July (5.2% in June, and average 3% in last 12 months). If this trend continues in subsequent months, it would herald even more vigorous upsurge in firms' economic activity than observed recently. Households' credit maintained its fast growth of more than 28%YoY, probably still being fuelled mainly by new mortgage loans.

Central bank watch



Fragments of MPC statement, 30 August 2006
The GUS data on GDP in 2006 Q2 confirm the acceleration of economic growth that has been observed since 2005 Q2. (...) The contribution of net exports to GDP growth and the growth of gross fixed capital formation were higher than forecast in the July projection.
The acceleration in corporate lending, which came despite the fact that enterprises are holding substantial own funds resulting from their very good financial results in the first half of 2006, may point to a further rise in investment growth.
In industry, in January-July 2006, with employment rising by 1.9% y/y, the growth of labour productivity amounted to 10.4% y/y and was higher than the growth of wages in this sector (5.1% y/y).
The rise in the annual growth of prices in relation to June 2006 was mainly the result of the acceleration in the annual growth in the prices of food and internet services.
In the opinion of the Council the analysis of the latest data indicates that the path of future inflation will be similar to that presented in the July projection.





Source: NBP, Reuters

Interest rates unchanged again

▪ In August, the Monetary Policy Council left main interest rates unchanged again, reference rate at 4.0%.

▪ This time the MPC communiqué referred to the latest inflation projection released in July (rather than to its April's version), saying that "in the opinion of the Council the analysis of the latest data indicates that the path of future inflation will be similar to that presented in the July projection".

▪ Let's remind that according to the last projection's central scenario, inflation rate approaches the 2.5% target in the first quarter of 2007, remains slightly below 2.5% throughout 2007, and goes above the target in Q1 2008.

▪ Please note that the sentence that inflation will be "similar" to the projection is not too precise, so it is possible that in the Council's view the inflation path will be somewhere between scenarios presented in July projection and its April version.

▪ In fact, it seems likely that the MPC is still quite uncertain about future inflation path, and thus will wait for more information and data that would help in assessing inflation prospects with more certainty before making any decisions on interest rates.

▪ Main interest rates should remain unchanged until the end of this year. If information available until then confirms scenario outlined in July inflation projection (CPI going above the target in a few quarters), then likelihood of rate hikes will get higher. However, if it shows up instead that inflation stabilisation around the target without clear upward drift is more likely, there will be no need to change borrowing costs for a few next quarters. As our base case scenario predicts that the latter is more likely and inflation target is not endangered in the medium run, we maintain the view that main interest rates could remain unchanged for at least the nearest 12 months.

Is monetary policy restrictive enough?

▪ Monetary policy conditions, measured by real interest rates and real effective exchange rate of the zloty, are still more restrictive than before the start of the last monetary tightening cycle in 2004 (although real interest rate deflated by expected inflation is at record low 2%YoY).

▪ From the historical perspective, restrictiveness of monetary policy in Poland is now moderately small, however this stance was enough to keep inflation very low for some time.

▪ Significant risk to our forecast of stable interest rates is a scenario of sharp, persistent zloty depreciation, as together with expected rebound in inflation it would lead to significant relaxation in monetary conditions under assumption of unchanged interest rates.

Low inflationary expectations, expensive fuels

▪ Households' inflation expectations have been continuously staying very low and close to currently observed inflation – in August they were at 0.8%YoY.

▪ One of the most important factor for the MPC in making decisions about future interest rates will be whether and to what extent a CPI pick-up caused by supply-side disturbances will trigger second-round effects in the form of rise in expectations and higher pressure on wages.

▪ Taking into account adaptive nature of households' expectations and the construction of expectation index used by the NBP, one should be aware that in line with CPI rise in the following months, also a measure of expectations will go up. However, little suggests it could be a rapid growth.

Central bank watch

Comments of the central bank representatives	Our remarks
Leszek Balcerowicz, NBP president **Reuters, 31 August** The last inflation projection shows that in Q1 2007 inflation will be at 2.3 percent, i.e. close to the inflation target. In practice, it could imply that at the start of 2007 inflation will approach the target. For some time the risk has been rising that inflation in 2007 could for a longer period exceed the target unless the Monetary Policy Council undertakes actions to prevent it. **Marian Noga, MPC member** **Reuters, 5 September** Monetary authorities cannot hide heads in the sand. We cannot wait till inflation will near 2.5 percent because we may then be too late to fight inflation. The impact of our decisions takes time - five to seven quarters. We must be on guard. When inflation is at around 2 percent, it may be the last bell to change rates. If it gets to 2.3 percent, as will probably be the case in the first quarter of 2007, it may be too late. The start of 2007 may be high time for us to act. The council, in order to fulfil its role, must be forward looking. The longer inflation is below 2.5 percent, the better. That's the council's goal.	It is not a surprise that the NBP chief sees inflation perspectives in rather dark colours, as he is perceived as one of the most hawkish members of the rate-setting panel, and his inclination to tighten monetary policy is probably higher than average in the MPC. Comments of Marian Noga show that the president is not alone in his view on the economy. It seem likely that hawks in the MPC will try to push through a rate hike decision in the following months, as the inflation rate picks up. However, we are not so certain that other MPC members share similar point of view. In particular, the statement about need to keep inflation below target seems controversial, as we have always thought that the goal is to keep inflation at the target. As we have argued before, even a rise of inflation to 2.5% (or above due to supply-side factors) would not be a sufficient for the rate hike, if medium-term inflation prospects remain optimistic. Meanwhile, the evidence of deeply-rooted fundamental pressure on prices in the economy is still benign. As shown by the quotes below, there are also less hawkish views on economic prospects present in the central bank, and even some of those MPC members who usually supported the NBP president in the voting, are not fully convinced about necessity to hike interest rate.
Krzysztof Rybiński, deputy NBP president **PAP, 6 September** NBP should react to supply side shocks only if they influence inflation processes and inflation expectations. As for now it is impossible to asses drought impact on inflation, it will be possible only in a few months time. **Jan Czekaj, MPC member** **PAP, 1 September** It is certain now that inflation will be a bit higher than we earlier predicted, but it is not a reason for despair. One has to look at the economy as a whole. At the end of the year inflation could be ca. 0.2 pp higher than shown in the inflation projection. But the situation is still changing, we don't know for sure what will be the impact of food prices on CPI. Monetary policy could remain stable because there are still no symptoms of persistent price rise that would demand chance in monetary policy parameters. And if such symptoms appear we will react. One cannot rule out that inflation will rise for some time, but more important is the nature of this growth. Monetary policy should react only to those shocks that are not transitory. **Halina Wasilewska-Trenkner, MPC member** **Radio PiN, 7 September** [Interest rate hike] depends on what is the source of higher growth in prices. If it is only summer drought and bad crops, then it is known it will last only until new year in the agriculture, i.e. middle of next year. Then, interest rate hike is not necessary. (...) Higher deficit is the element that would embed in the economy for quite long, so it acts as a driver for possible price rise for a long time and then interest rate adjustments would be needed. **Reuters, 22 August** Trend of interest rate hikes observed in the region could speed up hikes in Poland. Until the projection shows that in the projected horizon inflation breaches upper end of the range (3.5%), if such probability seems big enough, the MPC will have to make adequate decisions, although I cannot rule out MPC's action even earlier. It is not bad when inflation stays in the lower end of the range. Only its persistent rise above 2.5% is an alarm bell.	Comments of NBP deputy chief and some of the MPC members have one thing in common – in their opinion interest rate hike is not necessary in case inflation goes up only because of rise in food prices or fuel prices (broadly speaking: transitory supply-side disturbances). This is because the nature of such impulses implies that – assuming they do not trigger any second-round effects – after twelve months of higher inflation, its level comes down again, and pressure on core inflation growth should not be substantial as well. Such approach should not be surprising, as it is in line with MPC's *Monetary policy guidelines* for this year (and consistent with logic of monetary policy conducting). Thus, even taking into account several more hawkish comments of other central bankers that appeared recently, we do not change our view that it is still not the timing to think seriously about monetary tightening in Poland. Our scenario assumes that interest rates will remain unchanged for twelve subsequent months because CPI growth is likely to stabilise around inflation target or slightly below instead of continuing upward trend, and core inflation will be even higher, signalling lack of strong fundamental pressure on prices. According to Wasilewska-Trenkner, the rise in interest rates abroad could translate into faster policy tightening in Poland. However, one should notice that first of all the cycle of rate hikes abroad is gradually coming to an end (it is already over in the US, and is likely to end next year in the euro zone), so this argument will soon loose its significance. Additionally, the MPC member presented a number of strong conditions necessary for such rate hike. First of all, there has to be high risk of inflation breaching 3.5%. Meanwhile, even in Wasilewska-Trenkner's opinion inflationary pressure caused by rise in economic activity is rather subdued. It confirms that the perspective of interest rate hikes in Poland is still quite distant.

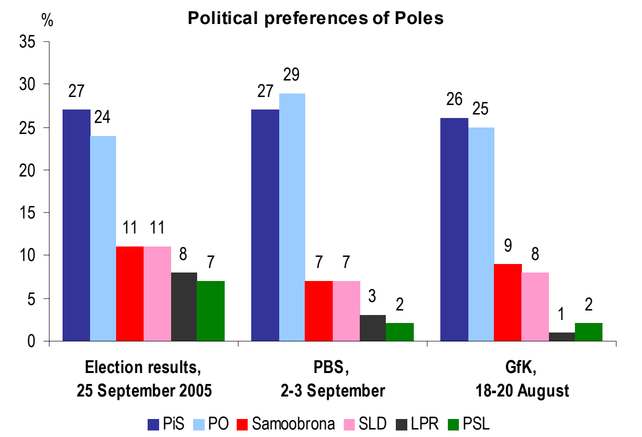
Government and politics

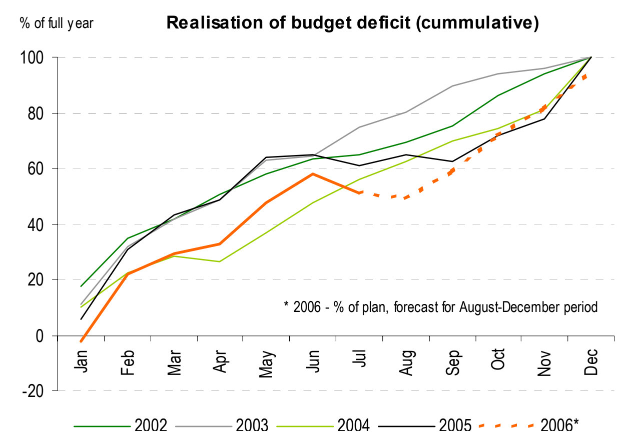
Basic parameters of 2007 budget (PLN m)

	2006 E	2007 F	change %
TOTAL REVENUES	196,511	212,234	8.0
Tax revenues	173,932	191,799	10.3
- Indirect taxes	126,132	138,191	9.6
- CIT	19,100	22,013	15.3
- PIT	28,700	31,595	10.1
Non-tax revenues	20,262	20,135	-0.6
- Dividends	3,502	4,000	14.2
- NBP profit	1,158	1,974	70.5
- Budgetary units' income	12,000	10,088	-15.9
Budget compensation payment	2,001	-	-100.0
TOTAL SPENDING	225,829	242,234	7.3
BUDGET BALANCE	-29,318	-30,000	2.3
Net borrowing needs	41,000	44,000	7.3

Macroeconomic assumptions to the budget

	2006	2007
GDP growth (%)	5.2	4.6
Export (%)	16.5	8.0
Import (%)	15.8	9.0
Domestic demand (%)	5.1	5.1
Gross accumulation (%)	9.4	10.4
CPI (average, %)	1.1	1.9
Average gross wage (PLN)	2,484	2,616
Average employment ('000)	8,985	9,107
Unemployment rate (%)	15.3	14.1
USDPLN (average)	3.11	3.04
EURPLN (average)	3.91	3.90
Current account deficit (% of GDP)	1.7	2.4
NBP reference rate (average, %)	4.1	4.3





Source: Ministry of Finance, opinion polls

Tentative shape of 2007 budget

- Budget draft prepared by the Ministry of Finance assumes PLN30bn budget deficit in 2007 against planned realisation PLN29.3bn in 2006 (details in tables on the left).
- GDP and inflation forecasts have been left unchanged, which is a conservative assumption, because our current forecasts show higher rates of growth: namely GDP by 5% and inflation ca. 2.3%. Forecasts for 2006 have been increased though.
- 2007 budget revenues are planned to rise ca. 8%. Such high rate of growth looks quite ambitious given government's conservative economic assumptions, however taking into account that inflation and GDP could be higher, it could be realised.
- Realisation of higher budget revenues will be possible e.g. due to rise in tax burden. The government plans increases in excise tax for tobacco (13%), beer (10%) and fuel, which by the way may lead to one-off increase in CPI inflation in 1Q07. Reduction in disability pension premium promised by former finance minister Zyta Gilowska has been abandoned. On the other hand, the document assumes de-freezing tax thresholds and tax-free amount, that will reduce tax revenues to some extent.
- Budget spending will rise in 2007 by 7.3%, i.e. faster than nominal GDP growth. So-called fixed expenditures (that are predetermined due to legal regulations) representing 69.6% of total spending in 2007, will increase by 2% in real terms. Meanwhile, the remaining 30.4% of total expenditures that the government has under its control are planned to grow by 18.1% in real terms.
- In general, the shape of the budget is neutral for the market, although it is hardly any step towards public finance reform, which is well reflected by the rise in borrowing needs of the budget.

Anchor stronger than the coalition?

- One should remember than presented shape of the budget has not been formally approved by the government. Meanwhile, PiS minor coalition partners have been tightening pressure on increase in spending for social goals, help for farmers, wage hikes in healthcare system and education, etc., suggesting that no realisation of their proposals could endanger the coalition.
- Nevertheless, PM Kaczyński has left no doubt he did not plan to abandon PLN30bn budget deficit anchor. The question is whether the allies will curb their demands or they will prefer to put coalition stability at risk. Uncertainty regarding the shape of fiscal policy next year and political stability will weigh on the financial sector at least until 26 September when the government is expected to pass the final shape of the budget.

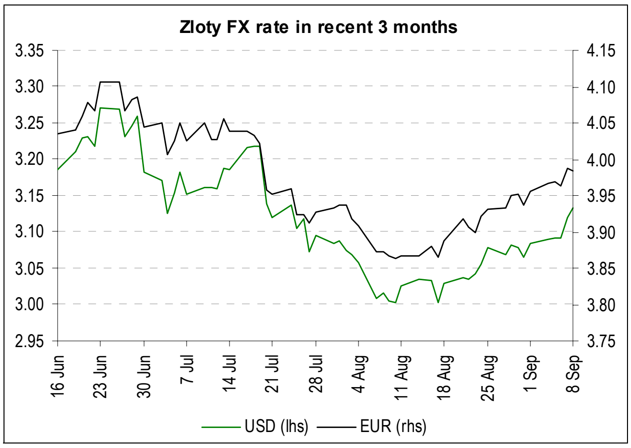
Realisation of this year's budget still looks good

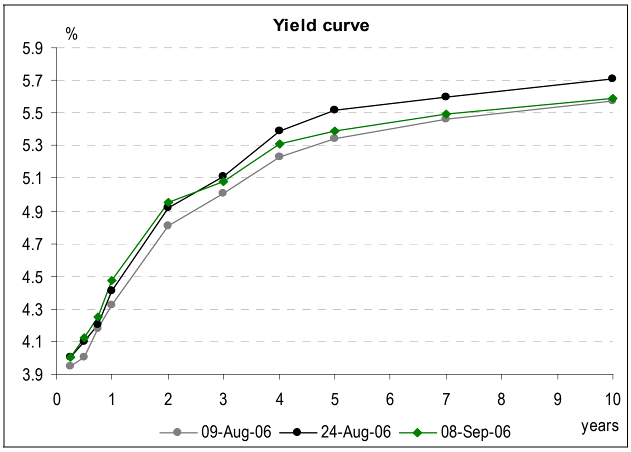
- In July, budget deficit reached 51.1% of annual plan and was much lower than in the corresponding period of last year (in 2002-2005 after seven months it was on average 64.3% of plan).
- After seven months the rise in tax revenues was close to the growth rate planned for full year. On spending side, there are some delays, e.g. in case of subsidy to social security fund.
- Delay in spending was maintained also in August. According to FinMin after eight months of the year the deficit was below 50% of annual plan, which means that August saw surplus in the budget. Accumulation of spending in the last months of the year will worsen budget performance in next months. However, good revenue growth implies there should be no problems with realisation of this year's budget. According to finance ministry, budget deficit in 2006 should be PLN29.3bn against PLN30.6bn plan.

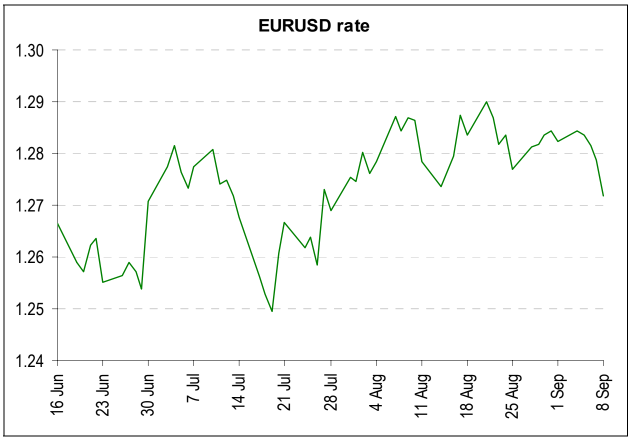
Government and politics

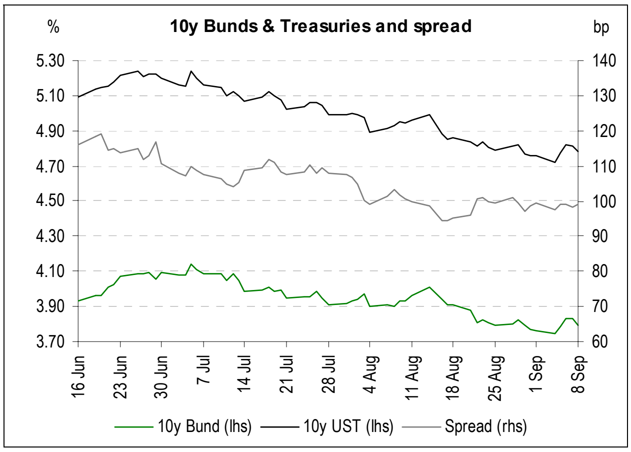
Comments of government representatives and politicians	Our remarks
Jarosław Kaczyński, Prime Minister **Reuters, 6 September** If Professor Gilowska wants, she might become a member of the cabinet over the next few days and take the post of deputy prime minister in charge of economic affairs and finance minister.	The court cleared ex-finance minister Zyta Gilowska from allegations of false declaration on no cooperation with communist-era secret police. After the sentence, the PM Kaczyński repeated that she could return to the cabinet if she wanted. Even if she will, we think the market reaction will be limited, as the most important decisions in fiscal policy will not depend on this nomination.
Jarosław Kaczyński, Prime Minister **Reuters, 5 September** Decision about preserving budget anchor is irrefutable. **Polityka, 30 August** I will not resign from PLN30bn anchor even at the expense of breaking the coalition and earlier election. **Stanisław Kluza, finance minister** **Reuters, 7 September** There is now no room in the budget put forward by us for additional spending measures. We should think about optimisation of excessive transfers to agriculture, farmers' pension system and other agencies. **Andrzej Lepper, deputy PM, agriculture minister** **Polish Radio, 11 September** The matter of the programme and the budget, those are two issues that could cause that this coalition will last for only few months more and it will end, because we (Samoobrona) will not allow to implement programme of only one party and to put our programme on the shelf. The budget will be the key. I don't agree for the budget in the shape that is currently presented.	Draft budget for 2007 was tentatively reviewed by the government. The next working meeting of the government devoted to budget draft is planned for 20 September, and its final shape is supposed to be approved on 26 September. Then, the draft will be sent to the parliament for further work. The draft, that is rather neutral for the financial market, raises quite significant concerns among minor coalition members. Samoobrona keeps insisting to secure additional funds for social security, aid for farmers, wage hikes for healthcare sector and teachers, and so on, and recommends increasing the deficit above PLN30bn. It also warns about possible break-up in the coalition in case the demands are not fulfilled. We have written many times that the budget for 2007 will be a real test of consistency and quality of this coalition, and this is taking place right now. The situation negatively affects sentiment on the financial market and will probably weigh on the moods at least until the end of September when the government is expected to agree on final shape of the budget draft. The Prime Minister Kaczyński has left no doubt he would not give up on keeping the PLN30bn budget anchor, which suggests that it is rather unlikely that most of the populist proposals put forward by Samoobrona will be met. Still, the open question is whether in such situation minor coalition parties will be ready to soften their demands or will this be the beginning of the coalition breakdown.
Stanisław Kluza, finance minister **Reuters, 8 September** According to our analysis, 2009 would be optimal. We may be able to go down with the deficit to around 3 percent of GDP in 2009. It is always the role of the Commission to encourage the countries to take bigger and faster steps. More meetings will be needed to achieve a settlement. **Reuters, PAP, 7 September** We plan to present update of convergence programme at the start of December, after work on taxes ends. The plan will assume that in 2009 the deficit will be between 3.0 and 3.5 percent of the GDP. We don't want to give a date of euro zone accession in the plan. Poland should propose a date once it meets the (membership) criteria. Maintaining the fixed 30 billion zloty budget anchor will help us, with rising GDP, to reduce the deficit.	In the new update of the convergence programme that will be presented in December Poland will not indicate the target date of euro zone entry, as according to the government the date should be set only after meeting required convergence criteria. Meanwhile, it is really uncertain when this moment will come. Although in talks with EU commissioner Polish finance minister was ensuring that 2009 would be optimal for meeting convergence criteria, but one day earlier in one of the interviews (in a flash of sincerity?) he admitted that general government deficit in 2009 will reach 3.0-3.5% of GDP. This means that even in the most optimistic scenario we will be on the verge of required fiscal criterion. Poland's delay in fiscal deficit reduction may meet with unwelcome reaction of the European Commission and the financial market. On the other hand, markets are slowly getting used to the thought that Poland's euro zone entry will take place no earlier than in 2012-2013.
Piotr Soroczyński, deputy finance minister **PAP, Reuters, 1 September** Inflation in August will rise to 1.5% from 1.1% in July. The data are surprising to some extent. There should be deflation in August, but this time it was not the case (...) It could have been caused by the summer drought and lower harvest. Another important factor was still significant rise in fuel prices in August. Inflation should be around 2.0 percent at the end of the year. It will rise to 2.2-2.3 percent in the first months of next year but may fall in the second half of the year. We are worried by the jump in August but this does not have to be a lasting effect, only a seasonal shift. Simply prices of fruits and vegetables.	The news about significantly higher inflation forecast was a big surprise for the market. The FinMin's forecast is also much higher than our prediction, which assumed stable inflation in August at 1.1%. However, the July's experience showed that the ministry's forecasts can be sometimes less accurate than in the first months of this year. Of course, it is extremely difficult to forecast the influence of drought on food prices, but in our opinion the risk is on the downside as compared to the ministry's forecast. With moderate food price increase (which did not take place since many years, even with drought or flood), our forecast of 12M CPI change is 1.3%. What is more, according to the ministry's information the acceleration in price growth is fuelled mainly by food prices, i.e. transitory supply shock, so the medium-term inflation outlook does not have to deteriorate significantly. Latest comments of some of the MPC members showed that such situation does not have to trigger fast monetary policy adjustment.

Market monitor









Source: Reuters, BZ WBK

Zloty in falling trend

▪ Since the last report has been issued the zloty has, in line with our expectations, began a weakening trend, and the EURPLN rate came nearer to 4.0. At the end of August, the weakening of the Polish currency was influenced by the information of the new Hungarian convergence program. The next weakening wave was linked to the worsening of the investors' attitude towards the emerging markets and the negative undertone of MF's inflation forecast and the bonds sales resulting from this.

▪ We think that zloty may test 4.0 and the Polish currency weakening potential has not deleted in the context of budget drafts as much as the possibility of further bonds sale if the FinMin's inflation forecasts fulfils. A major factor will also be the attitude towards emerging markets, which can change with the figures coming from the American economy.

Weakening after MF's inflation forecast

▪ As compared to the beginning of August debt market saw little change in yields. However, during the month quite significant volatility was visible. Firstly, the reason of the weakening was the CPI increase, but bonds prices rose after the release of the MPC communiqué, which was rather neutral concerning rate hikes. Another wave of market weakening came after the release of higher than expected inflation forecast by FinMin.

▪ In case the inflation forecast of the Ministry of Finance do realize, debt market may keep on weakening, though we do not think a one-off consequence of the drought will have an effect on exceeding the medium term inflation target. Consequently, we keep the view that official interest rates will remain unchanged for several months.

Volatile but a bit stronger dollar rate

▪ No long after the FOMC decision in August, the strengthening of euro was not convincible enough and dollar appreciated against single currency under 1.28, which was supported by the risk of a terrorist attack in London. Later, dollar was kept under pressure because of figures showing a lower inflation and the confirmation of the economic slowdown in United States, though not long later the dollar strengthened again under 1.28. After another weakening, dollar gained over 1% vs. the euro.

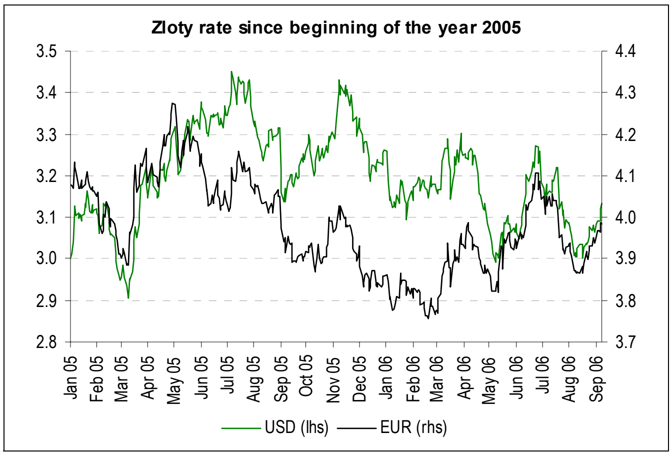
▪ Figures confirming acceleration of economic growth in the euro zone can favour the single currency, although the ZEW index as well as the expectations component of the IFO index may give some reason to worry. Further figures from the US can have an important impact on the EURUSD rate, and if they confirm the slowdown of the US economy, dollar may weaken.

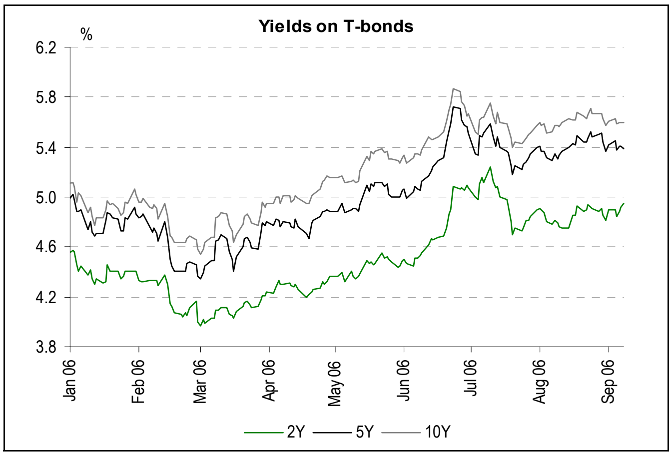
Yields are falling

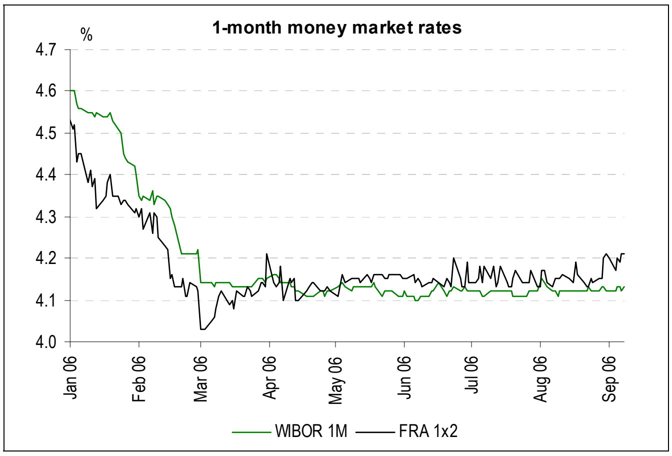
▪ Bonds on core markets have considerably gained over a few last weeks, which resulted from weaker expectations of further rate hikes in the US, after lower than expected CPI and PPI figures and weaker economic figures. The market has also strengthened in reaction to the FOMC minutes. 10Y Treasuries fell from 4.9% to 4.8% and Bunds from 3.91% to 3.8%.

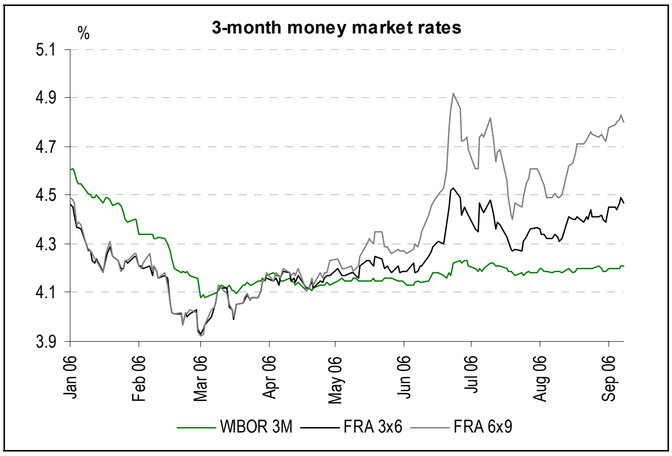
▪ Figures showing economic growth will be of decisive importance for the prospect of the interest rates in the US. If they are quite good and inflation remain on a high level, than the expectations for further monetary policy tightening may return. In our base scenario we assume the interest rate will remain unchanged till the end of the year, and for euro zone we keep the view that rate will rise by 50bp in Q4 and another 25bp in Q1 of 2007.

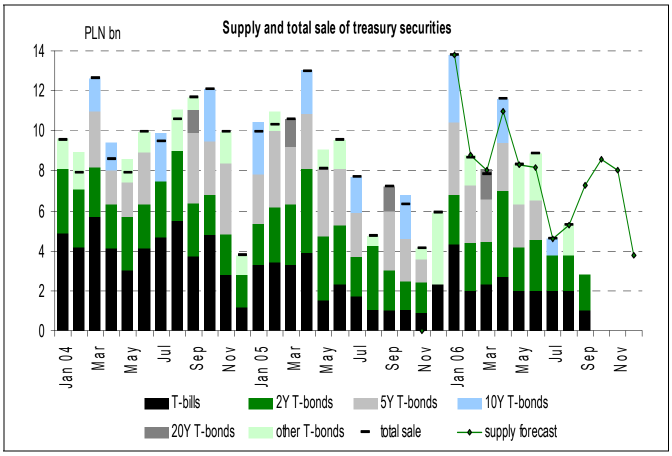
Market monitor











Treasury bill auctions (PLN m)

Date of auction	OFFER / SALE	
	52-week	Total
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 / 1 000	1 000 / 1 000
Total August	**2 000 / 2 000**	**2 000 / 2 000**
04.09.2006	1 000 / 1 000	1 000 / 1 000
18.09.2006	1 000 - 1 200	1 000 - 1 200
Total September*	**2 000 - 2 200**	**2 000 - 2 200**

* estimations based on Ministry of Finance preliminary information

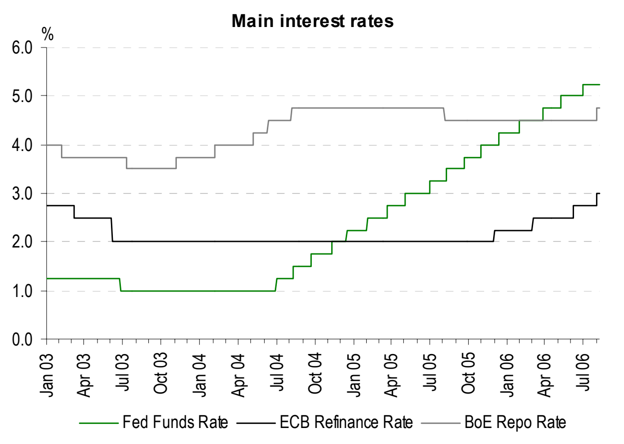
Treasury bond auctions in 2006 (PLN m)

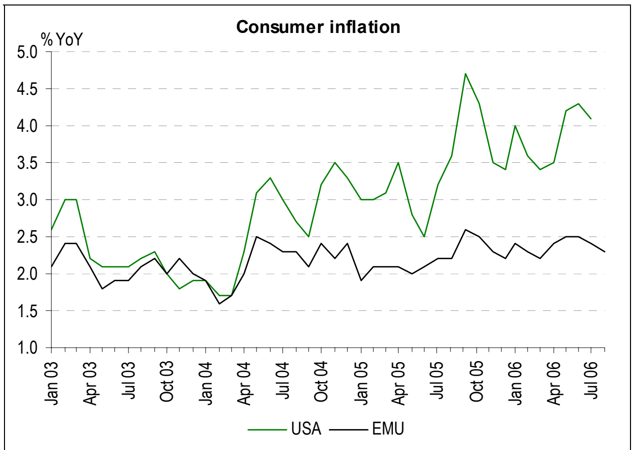
month	First auction				Second auction				Third auction			
	date	T-bonds	offer	sale	date	T-bonds	offer	sale	date	T-bonds	offer	sale
January	04.01	OK0408	2 500	2 500	11.01*	DS1015	3 360	3 360	18.01*	DS1110	3 600	3 600
February	01.02*	OK0408	2 400	2 300	08.02	WZ0911 | IZ0816	1 000 | 500	1 000 | 493	15.02*	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	0-2000	-	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	-	-	-	-	-	-	-	-	-	-

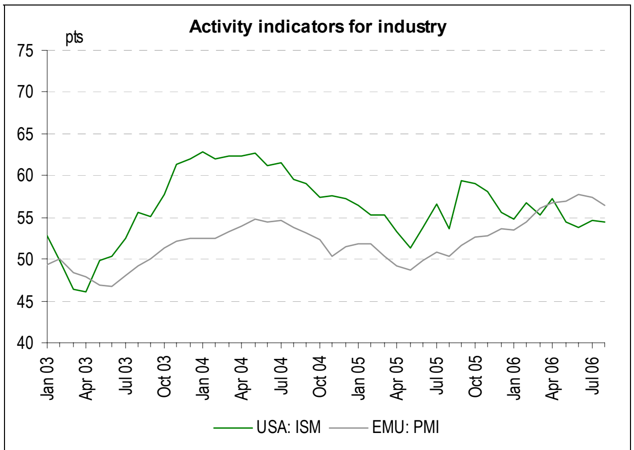
* with supplementary auction

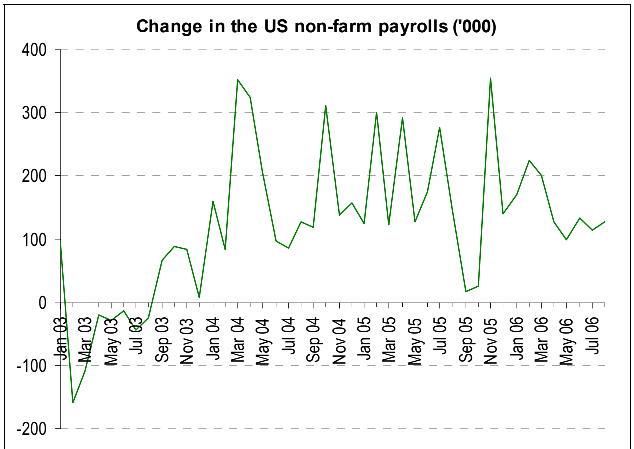
Source: Ministry of Finance, Reuters, BZ WBK

International review









Source: Reuters, ECB, Federal Reserve

Rate hike expectations diminish in the US and grow in EMU

▪ Since our last monthly report expectations concerning a return to the tightening of the monetary policy in US diminished, which was due to, among other things, lower than expected inflation figures. The minutes from the last Fed's meeting did not contain any signals of necessity of further rate hikes. The report also confirmed the FOMC members' concern about the economic growth over fighting against price pressure and the importance of the next figures.

▪ ECB made a decision to keep the interest rates unchanged (3.0%) which was in line with the market expectations. ECB's president Jean Claude Trichet underlined that the bank has to stay very strong vigilant against the inflation threat and the tone of his declaration was rather hawkish. Simultaneously, the ECB increased its inflation forecast for 2007.

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Better inflation figures in the US

▪ Consumer prices in the US rose in July by 0.4%MoM (4.1%YoY) after a rise of 0.2% MoM (4..3% YoY) in June. Core CPI indicator rose below expectations by 0.2%MoM and 2.7%YoY, the highest growth level for many years. PPI rose only by 0.1% in the US, which is considerably less than 0.4% expected by the market. Core PPI fell by 0.3% while analysts were expecting a rise by 0.2%.

▪ HICP in the euro zone increased by 2.4%YoY in July after a 1% prices fall in the previous month. The market was expecting the indicator to remain unchanged at 2.5% YoY. According to the flash estimates for August, inflation may reach 2.3%YoY. With regards to Eurostat's data, in the euro zone producer prices rose by 0.6%MoM and 5.9%Yo,Y while expectations and last month's figure were 5.8% YoY.

Positive surprise in the EU-12 GDP growth, worse in the US

▪ The ISM index for the manufacturing sector was 54.5 in August, which was near the expectations (55.0). The prices paid index in that sector fell to 73.0 from 78.5, and the employment component rose to 54.0 from 50.7. The ISM index for the non-manufacturing sector rose to 57.0 from 54.8 and were above expectations at 55.0. Employment index fell to 56.5 from 57.5 and was on the lowest level since January. Prices charged component dipped in July to 53.6 from 53.7.

▪ In the euro zone the PMI for the manufacturing sector declined to 56.5 from 57.4, below the forecasts at 57.0. The input prices component fell to 68.7 from 73.5, and the prices paid index to 55.2 from 57.3. Index for the services sector amounted to 57.1, which was below 57.9 in the previous month and below the expectations at 57.6. The employment index dropped to 53.0 from 54.0 (the lowest number since January).

▪ Revised GDP growth for Q2 for euro zone amounted to 2.6%YoY and 0.9%QoQ and was higher than the forecast at 2.4%YoY

▪ According to preliminary estimates GDP in the US for Q2 grew by 2.9% and was below the consensus (3.0%). As compared to 5.6% rise in Q1. The PCE price index rose by 4.2% (3.3%YoY) and the core index was 2.7% (2.3%).

Rising US Q2 unit labour costs

▪ Employment rise in the non-farm sectors reached 128k, which was quite inline with market forecasts at 125k. Figures for the last two months have been revised upwardly by 18k.

▪ Labour productivity growth in the US in Q2 has been upwardly revised from 1.5% to 1.6%, what was slightly above the market consensus at 1.5%. Unit labour cost rose by 4.9%, much above forecast at 3.7% after a revision from 4.2%.

Economic calendar

Monday	Tuesday	Wednesday	Thursday	Friday
11 September	**12** ***POL: Balance of payments (Jul)*** US: Trade balance (Jul)	**13** ***POL: Auction of 20Y bonds*** US: Fed Budget (Aug)	**14** ***POL: Consumer prices (Jul)*** ***POL: Money Supply (Aug)*** US: Foreign trade prices (Aug) US: Retail sales (Aug)	**15** ***POL: Wages and employment (Aug)*** EMU: Final HICP (Aug) US: CPI (Aug) US: Capacity use (Aug) US: Industrial production (Aug) US: Preliminary Michigan (Sep)
18 ***POL: Treasury bills auction*** EMU: Industrial production (Jul) US: Net capital flow (Jul)	**19** ***POL: PPI (Aug)*** ***POL: Output in industry and construction (Aug)*** GER: ZEW index (Sep) US: House starts (Aug) US: Build permits (Aug) US: PPI (Aug)	**20** ***POL: Auction of 7Y floating rate bonds and 12Y CPI linked bonds*** US: Fed meeting – decision (Sep)	**21** EMU: Current account (Jul) US: Philadelphia Fed index (Sep)	**22** ***POL: Net inflation (Aug)***
25 ***POL: Retail sales; unemployment rate (Aug)*** ***POL: Business climate (Sep)*** USA: Home sales (Aug)	**26** ***POL: MPC meeting*** GER: IFO index (Sep) US: Consumer confidence (Sep)	**27** ***POL: MPC meeting – decision*** EMU: M3 money supply (Aug) US: New homes sales (Aug) US: Durable goods orders (Aug)	**28** US: Core PCE (Q2) US: Final GDP (Q2) US: GDP deflator (Q2)	**29** EMU: Economic sentiment (Sep) EMU: Preliminary HICP (Sep) US: Core PCE (Aug) US: Final Michigan (Sep) US: Chicago PMI (Sep)
2 October EMU: Manufacturing PMI (Sep) US: Manufacturing ISM (Sep)	**3** EMU: PPI (Aug) EMU: Unemployment (Aug)	**4** EMU: Non-manufacturing PMI (Sep) EMU: Retail sales (Aug) USA: Factory orders (Aug) USA: Non-manufacturing ISM (Sep)	**5** GB: BoE meeting – decision EMU: ECB meeting - decision	**6** USA: Non-farm payrolls (Sep) USA: Unemployment (Seo)
9 ***POL: Treasury bills auction***	**10** USA: Wholesale inventories (Aug)	**11** ***POL: Auction of 10Y bonds*** EMU: Revised GDP (Q2)	**12** US: Trade balance (Aug)	**8** ***POL: Balance of payments (Aug)*** ***POL: Money Supply (Sep)*** JP: BoJ meeting - decision & report US: Foreign trade prices (Sep) US: Preliminary Michigan (Oct)

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	25	-	-	-
Gross wages, employment	16	15	15	18	17	19	17	16	15	16	16	15
Unemployment	24	23	23	26	24	23	25	24	25	-	-	-
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

		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	Sep 06
Industrial production	%YoY	4.8	5.9	7.6	8.5	9.6	9.8	10.2	16.4	5.7	19.1	12.2	14.3	17.8	11.2
Retail sales [c]	%YoY	7.9	5.4	7.5	7.3	6.3	8.6	10.2	10.1	13.2	13.7	10.7	11.0	10.2	12.1
Unemployment rate	%	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	15.4
Gross wages [b c]	%YoY	2.8	1.8	6.4	6.9	1.5	3.6	4.8	5.4	4.0	5.2	4.5	5.6	6.0	7.0
Employment [b]	%YoY	2.0	2.2	2.1	2.5	2.6	2.6	2.4	2.7	2.8	3.0	3.1	3.3	3.4	3.4
Export (€) [d]	%YoY	14.9	12.9	18.4	16.1	20.0	22.1	18.8	26.4	12.0	31.4	16.0	17.8	25.2	18.1
Import (€) [d]	%YoY	15.5	11.0	14.6	18.1	16.8	23.0	22.1	22.2	9.6	30	14	22.0	22.5	18.4
Trade balance [d]	EURm	-378	-107	3	-232	-467	64	-253	-106	47	-497	61	-400	-300	-150
Current account balance [d]	EURm	-381	-237	-317	-291	-451	-197	-794	-351	-190	-220.0	160.0	-400	-50	-300
Current account balance [d]	% GDP	-1.7	-1.5	-1.5	-1.5	-1.4	-1.3	-1.5	-1.5	-1.6	-1.4	-1.4	-1,4	-1,3	-1,3
Budget deficit (cumulative)	PLNbn	-18.5	-17.8	-20.6	-22.2	-28.6	0.7	-6.7	-9.0	-10.0	-14.6	-17.7	-15.6	-15.0	-18.0
Budget deficit (cumulative) [e]	% realisation	64.7	62.3	72.1	77.7	100.0	-2.3	21.9	29.4	32.8	47.8	57.8	51.1	49.1	58.9
CPI	%YoY	1.6	1.8	1.6	1.0	0.7	0.6	0.7	0.4	0.7	0.9	0.8	1.1	1.3	1.2
PPI	%YoY	-0.2	-0.5	-0.9	-0.4	0.2	0.3	0.7	0.9	1.7	2.3	3.0	3.5	3.8	4.2
Broad money (M3)	%YoY	11.1	12.7	8.7	12.6	10.4	10.4	11.7	9.8	9.6	10.1	11.9	13.1	12.5	11.9
Deposits	%YoY	10.1	11.6	6.3	11.1	9.4	10.2	10.8	9.1	8.6	8.9	11.4	12.4	11.2	10.5
Loans	%YoY	9.0	9.6	4.4	10.2	11.8	12.3	13.5	13.6	12.2	12.4	16.0	16.7	17.1	18.4
USD/PLN	PLN	3.29	3.20	3.26	3.37	3.25	3.16	3.18	3.23	3.20	3.05	3.17	3.15	3.05	3.11
EUR/PLN	PLN	4.05	3.92	3.92	3.97	3.85	3.82	3.79	3.88	3.92	3.90	4.02	4.00	3.90	3.98
Reference rate [a]	%	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	4.00
Lombard rate [a]	%	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	5.50
WIBOR 3M	%	4.67	4.57	4.50	4.64	4.62	4.49	4.26	4.12	4.14	4.15	4.17	4.19	4.19	4.20
Yield on 52-week T-bills	%	4.33	4.15	4.19	4.35	4.38	4.22	3.97	3.87	3.95	4.02	4.20	4.30	4.35	4.40
Yield on 2-year T-bonds	%	4.60	4.22	4.42	4.75	4.64	4.40	4.20	4.10	4.28	4.44	4.75	4.95	4.85	4.85
Yield on 5-year T-bonds	%	4.84	4.51	4.85	5.23	5.04	4.82	4.60	4.59	4.80	5.00	5.33	5.37	5.41	5.40
Yield on 10-year T-bonds	%	4.87	4.57	4.90	5.36	5.14	4.94	4.78	4.78	5.02	5.26	5.54	5.55	5.61	5.60

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

		2004	2005	2006	2007	1Q05	2Q05	3Q05	4Q05	1Q06	2Q06	3Q06	4Q06
GDP	PLNbn	923.2	980.9	1 039.2	1 117.7	228.7	238.2	241.0	273.0	240.3	251.9	256.0	291.2
GDP	%YoY	5.3	3.4	5.2	5.0	2.2	2.9	3.9	4.3	5.2	5.5	4.9	5.0
Domestic demand	%YoY	5.9	2.2	5.1	5.0	1.1	0.0	1.9	5.4	4.5	5.1	5.3	5.4
Private consumption	%YoY	4.0	2.0	4.9	4.2	1.4	1.4	2.3	2.8	5.2	4.9	5.0	4.5
Fixed investments	%YoY	6.3	6.6	10.5	10.0	1.4	4.0	6.5	10.1	7.4	14.4	10.0	10.0
Industrial production	%YoY	12.3	4.0	13.2	8.0	0.7	2.3	4.5	8.4	12.4	12.1	14.4	14.1
Retail sales (real terms)	%YoY	7.1	1.5	10.0	9.0	-0.4	-3.2	4.1	5.4	9.0	11.8	10.2	8.8
Unemployment rate [a]	%	19.1	17.6	15.4	14.2	19.2	18.0	17.6	17.6	17.8	16.0	15.4	15.4
Gross wages (real terms) [c]	%YoY	0.8	1.2	4.0	2.5	-1.3	0.8	1.1	3.8	4.0	3.7	5.0	3.2
Employment [c]	%YoY	-0.8	1.9	3.1	0.0	1.5	1.7	2.0	2.4	2.6	3.0	3.4	3.2
Export (€) [b]	%YoY	22.3	17.1	19.5	15.0	23.2	12.9	15.0	18.0	22.6	19.5	20.4	15.9
Import (€) [b]	%YoY	19.5	12.6	19.4	17.0	17.6	6.0	11.2	16.5	22.5	17.6	21.0	17.0
Trade balance [b]	EURm	-4 552	-2 182	-2 583	-4 864	-259	-633	-599	-691	-294	-389	-850	-1 050
Current account balance [b]	EURm	-8 542	-3 457	-3 638	-6 851	-1 043	-500	-861	-1 053	-1 338	-250	-750	-1 300
Current account balance [b]	% GDP	-4.2	-1.4	-1.4	-2.4	-3.4	-2.1	-1.5	-1.4	-1.5	-1.4	-1.3	-1.4
Budget deficit (cumulative) [a]	PLNbn	-41.5	-28.6	-29.0	-30.0	-12.3	-18.5	-17.8	-28.6	-9.0	-17.7	-18.0	-29.0
Budget deficit (cumulative) [a]	% GDP	-4.5	-2.9	-2.8	-2.7	-	-	-	-	-	-	-	-
CPI	%YoY	3.5	2.1	1.0	2.4	3.6	2.3	1.6	1.1	0.6	0.8	1.2	1.5
CPI [a]	%YoY	4.4	0.7	2.0	2.4	3.4	1.4	1.8	0.7	0.4	0.8	1.2	2.0
PPI	%YoY	7.0	0.7	3.4	2.0	3.3	0.1	-0.2	-0.4	0.9	3.0	4.2	5.4
Broad money (M3) [a]	%YoY	8.7	10.4	11.3	10.8	11.0	10.8	12.7	10.4	9.8	11.9	11.9	11.3
Deposits [a]	%YoY	8.1	9.4	9.6	10.4	10.4	9.2	11.6	9.4	9.1	11.4	10.5	9.6
Loans [a]	%YoY	2.9	11.8	15.0	13.0	4.6	7.4	9.6	11.8	13.6	16.0	18.4	15.0
USD/PLN	PLN	3.65	3.23	3.11	2.94	3.07	3.28	3.30	3.29	3.19	3.14	3.10	3.03
EUR/PLN	PLN	4.53	4.02	3.92	3.89	4.03	4.13	4.02	3.91	3.83	3.95	3.96	3.93
Reference rate [a]	%	6.50	4.50	4.00	4.00	6.00	5.00	4.50	4.50	4.00	4.00	4.00	4.00
Lombard rate [a]	%	8.00	6.00	5.50	5.50	7.50	6.50	6.00	6.00	5.50	5.50	5.50	5.50
WIBOR 3M	%	6.21	5.29	4.21	4.30	6.44	5.49	4.63	4.59	4.29	4.15	4.20	4.20
Yield on 52-week T-bills	%	6.50	4.92	4.21	4.35	5.91	5.21	4.26	4.31	4.02	4.06	4.35	4.40
Yield on 2-year T-bonds	%	6.89	5.04	4.61	4.90	5.83	5.27	4.44	4.60	4.23	4.49	4.88	4.82
Yield on 5-year T-bonds	%	7.02	5.25	5.15	5.60	5.89	5.38	4.68	5.04	4.67	5.04	5.39	5.50
Yield on 10-year T-bonds	%	6.84	5.24	5.35	5.80	5.76	5.37	4.72	5.13	4.83	5.27	5.59	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

Bank Zachodni WBK

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