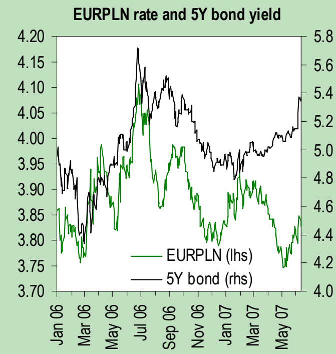
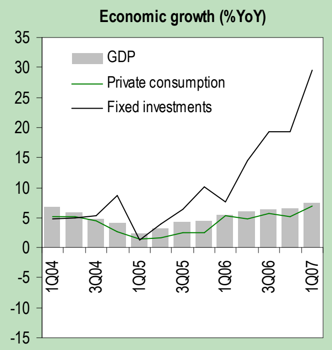
Bank Zachodni WBK

MACROscope

Polish Economy and Financial Markets

June 2007





In this issue:

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Second quarter a bit weaker

- **In line with our expectations presented last month, after zloty strengthening observed in May, a correction took place in the foreign exchange market.** We think the zloty may still weaken moderately, but we do not change our forecasts for the remainder of the year. At the same time, increase in Polish yields was more significant and took place earlier as compared to our forecasts, which was mainly connected with rise in yields in core markets, to which the Polish market has been staying immune for quite long time.

- **GDP growth in 1Q07 was higher than expected reaching 7.4% and the main factors responsible for that were components of domestic demand (private consumption growth by almost 7% and investment surge by nearly 30%).** At the same time, April's data showed some slowdown in growth rates of production and sales, suggesting weaker economic activity in Q2. Inflation rate remains relatively low staying close to the inflation target despite booming economic activity. Most likely, inflationary pressure will be mounting in the medium term amid quickly growing consumption demand and tightening labour market conditions. Nevertheless, we predict that this will be a gradual process and core inflation and CPI will remain under control.

- **Most of the Monetary Policy Council's members must have similar opinion, as the MPC left main interest rates unchanged in May, in line with market expectations.** In the statement released after the meeting the MPC said that the risk of inflation running above the target in the medium term had decreased, although was still higher than probability of inflation running below the target. This means that an informal restrictive bias in monetary policy is binding. At the same time, the official statement and comments from MPC indicate that further decisions will depend on incoming data.

- **The key element for future MPC decisions will be developments on the labour market, which we analyse in the Special focus section**. Our analysis leads us to the conclusion that the forthcoming quarters will be marked by a fast wage growth, resulting from rapidly falling unemployment and emigration amid extremely low occupational activity of the Polish society. At the same time, however, one may expect that labour productivity gains will remain solid thanks to substantially increased investment activity and high economic activity. Nevertheless, wage growth will most likely be stronger than labour productivity gains, which is equivalent to acceleration in unit labour costs growth, but this process should not be rapid enough to translate into uncontrolled inflation acceleration. We predict that in the medium-term inflation will remain close to the inflation target of 2.5%. This is consistent with our assumption that after a rate increase in April the MPC will not decide for further aggressive rate hikes, yet gradually raise borrowing costs: in two moves of 25bp in July and at the turn of the year.

Financial market on 30 May 2007:

NBP deposit rate	2.75	WIBOR 3M	4.44	USDPLN	2.8415
NBP reference rate	4.25	Yield on 52-week T-bills	4.37	EURPLN	3.8190
NBP lombard rate	5.75	Yield on 5-year T-bonds	5.15	EURUSD	1.3440

This report is based on information available until 12.06.2007

Special focus

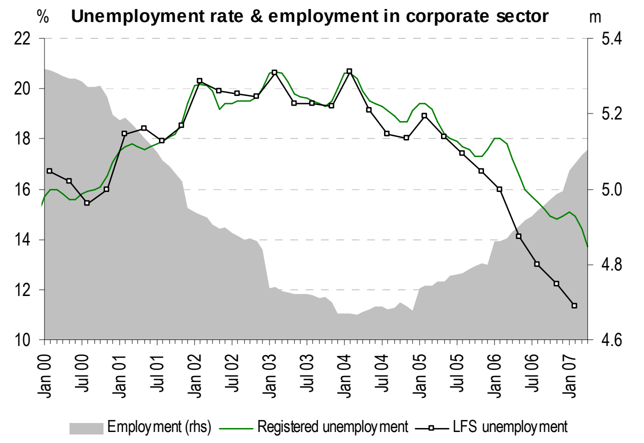
What about wages?

The situation on the labour market is the element of the macroeconomic puzzle that central bankers and financial markets participants are watching very closely now. At present, the relation between the wage growth rate and the labour productivity gains is considered to be the key indicator for the monetary policy – this clearly stems from the comments made by the members of the Monetary Policy Council. Thereby, developments on the labour market are the key factor for assessment of medium-term inflation prospects and the associated subsequent movements in the domestic monetary policy. This is why, in this MACROscope issue, we are having a closer look at the trends on the domestic labour market and are trying to assess its prospects and to define the macroeconomic implications they may have.

From the time perspective

In order to better assess current phenomena on the labour market, it is worth viewing them as a part of a longer process. In the years 2000-2004, the major phenomena on the Polish labour market were the drop in employment and growth in unemployment rate to the record level of over 20%. This is illustrated in chart 1.

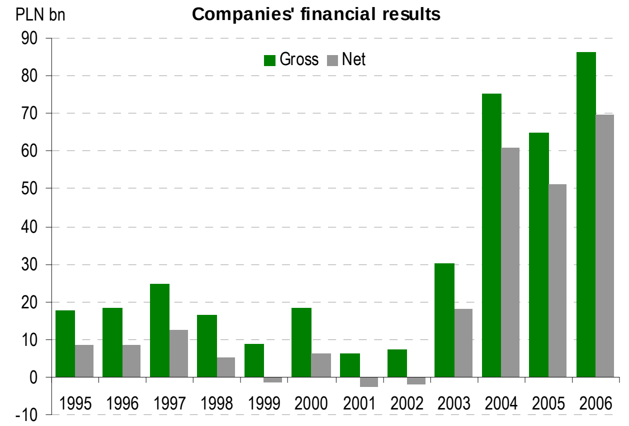
Chart 1



Source: CSO, own calculations

What is important, the drop in labour demand was not only observed in the period of economic slowdown (2000-2002) but also when the Polish economy started to recover (2003-2004). This is when the notion of *jobless recovery* became popular (see MACROscope dated May 2003). The strong growth in labour productivity allowed for a rise in output without an increase in labour demand and even with a reduction in employment. This contributed to the drop in the total labour costs in the Polish enterprises and to a significant improvement in their international competitiveness. There was a rapid positive change in the financial results of Polish companies which is illustrated in chart 2.

Chart 2



Source: CSO

The notion of "jobless recovery" had been valid until the end of 2004 when a few months after Poland's accession to the EU employment started to grow faster and faster leading to the unemployment fall. Initially, the improvement in the situation of employees was not too significant. Recently, however, the pace of labour demand growth and unemployment reduction reached their record high.

Revolution on the labour market

As a result of the rapidly growing labour demand, both in case of qualified and unqualified workers, which was coupled with melting stock of free labour force, the employer market has turned into an employee market. In a natural way, as it is on the market of each good or service, this is reflected in the growth in the price of work, i.e. wage growth. In the recent months, average wage in the enterprise sector have started to grow much quicker than for a few previous years. What is more, the accelerated wage growth rate has not only been witnessed in the highly productive enterprise sector but also in the entire economy (see chart 3).

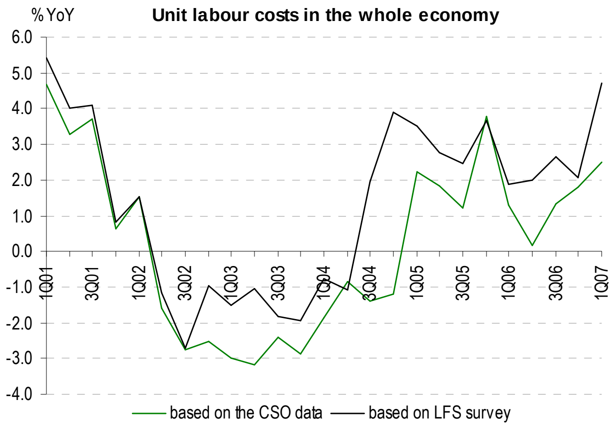
Chart 3

Source: CSO, own calculations

In Q1 2007, the nominal growth in average wage was 8.3%YoY for the industry sector and 7.1%YoY for the whole economy. Given inflation at ca 2%, the real growth rates of average wage are 6.3%YoY and 5.1%YoY, respectively. This indicates that in the industry sector, the real wage growth rate was lower than the labour productivity gains that are still very solid (nearly 10%YoY in Q1), but it has already started to exceed the labour productivity growth for the entire economy (in Q1, productivity gains in the whole were ca. 4%YoY).

When the wage growth in real terms exceeds the labour productivity gains in the long run, higher pressure on growth in prices may be expected. This is so as two factors driving inflation are coming to play at the same time: growing consumer demand and growth in labour costs incurred by enterprises, expressed in unit labour costs. The strong growth in consumer demand that we have been able to witness for some time and the growth of unit labour costs (see chart 4) make central bankers worry about medium-term inflation prospects.

Chart 4



Source: CSO, own calculations

The growing tensions on the labour market were one of the key elements which triggered the first increase in interest rates since 2004, introduced by the MPC in April this year. For the time being, the somewhat worse relation between the average wage growth rate and labour productivity does not seem dangerous for macroeconomic balance as there is a kind of buffer in a form of high profit margins arising among others from the fact that in the previous years, labour productivity was growing faster than wages (see charts 2 and 3 above), but there is a lot of uncertainty around future developments. While making decisions at the subsequent meetings, each MPC member will need to, based on various analyses and their own assessment of economy, answer the question about the growth rate of unit labour costs in the medium-term.

Pressure on wage growth in the public sector

According to central bankers, one of the factor that will exert pressure on wage growth is intensification of wage demands in the public sector. Stanisław Owsiak, one of the MPC members whose vote is important from the point of view of the distribution of the voting power in the Council, spoke on that issue recently. In an interview with the Polish Press Agency (PAP), dated 21 May this year, he stated that "it is important whether what is going on with wages in the enterprise sector may influence the public sector". The MPC member expressed his concerns that the good budget situation "might provoke wage demands". Increasingly frequent wage demands from different social groups (e.g. employees of the health care sector) show that the concerns are warranted. As service sectors characterised by low growth in labour productivity prevail in the public sector, if the wage demands are satisfied by the government, the relation between the wage growth rate and the labour productivity gains will deteriorate in the entire economy. Even if we assume that in the private sector the wage growth will be similar to the labour productivity growth.

Structural mismatches

The factor that contributes to the acceleration of the wage growth, the one that central bankers also focus on, are the structural mismatches on the Polish labour market. They primarily include the mismatch between qualifications of employees and needs of employers (arising partially from the fact that a substantial population stayed unemployed for a lengthy period of time) and low staff mobility that is a result of the imperfect housing market (rather high costs of renting apartments relative to average wage) and poor transport infrastructure – in terms of travelling between regions and also within the largest agglomerations.

Structural mismatches are the reason why the so called NAWRU (non-accelerating wage rate of unemployment) is relatively high in Poland. NAWRU estimates under the ECMOD model used by the NBP to produce inflation projections indicate that it is much above 10%. This suggests that the actual unemployment rate (latest estimates indicate it was 13% as at the end of May), although still high relative to other EU states, may be below NAWRU. This is confirmed by information from enterprises that report problems with finding appropriate employees even in regions where the registered unemployment rate is very high.

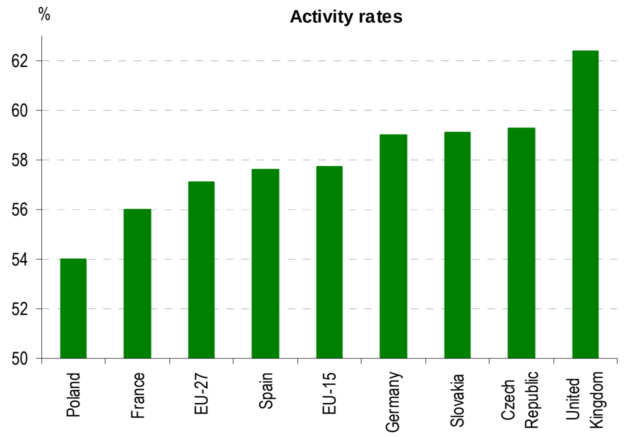
Low occupational activity

Relatively low level of effective work supply in Poland is not only related to a high level of structural unemployment but also, and maybe primarily, to low level of occupational activity of the Polish society. Even if all the unemployed found jobs the employment rate would grow only to a mere 54%, i.e. close to the EU average that in the light of the Lisbon Strategy is considered significantly insufficient (the target is 70%). This shows that the growth in the employment level in Poland to the level considered desirable would only be possible through activating people other than those employed or classified as unemployed. There are two key reasons for the low level of professional activity in Poland:

- a very high number of people using pre-retirement benefits,
- number of people that are entitled to disability pension that is much higher than in other states.

As a result, the professional activity of the population aged 55-64 is limited to the level of almost 30% in Poland and is lower than the EU average of above 40%. This reduces the level of occupational activity of the entire Polish society. The chart below shows that the occupational activity ratio in Poland is much lower than the EU average and major economies in the region.

Chart 5



Source: Eurostat

Emigration accelerates convergence of wages

Emigration is an additional factor that contributes to the growth in tensions on the domestic labour market. Mass emigration of Poles to the old EU states who opened their labour markets reduced the supply of free labour force at home. The important thing is that the emigrants are primarily young people with relatively high productivity. The problem of job emigration can escalate in the years to come as subsequent old EU states will open their labour markets to Poles. Even if some of the emigrants decide to return from countries who have already opened their labour markets, we will see another wave of emigration in 2011 when Germany and Austria will be forced to open their labour markets to employees from new member states. The high number of Poles working abroad adds to the acceleration of the wage convergence in Poland and other EU member states. While competing for staff on the common EU market, domestic enterprises increasingly often must accept wage hikes.

In Poland, however, the problem of job emigration is of lesser importance than in the Baltic states. Based on the data of the British immigration office and the Eurostat, the proportion of the number of Poles working in Great Britain against the total number of occupationally active Poles is lower than the same ratio in the Baltic states. This is why it is hard to assume that in case of Poland the job emigration will cause such a strong wage pressure as is in the Baltic states.

Can wage growth acceleration be stopped?

Counteracting the above factors that are exerting pressure on wage growth seems difficult. As there is an ongoing tension on the political scene, the government may not be able to resist the wage demands in the public sector. The limitation of the scope of pre-retirement and disability benefits, which could lead to an increase in occupational activity, will not be easy also for political reasons. On the contrary, recently we have seen a growing pressure on increasing the scope of pre-retirement benefits, in particular, the pressure on extending the application of bridging retirement benefits. Overcoming structural mismatches on the labour market is a long term task that will not produce tangible results over a short period of time. Moreover, it seems unrealistic to stop the emigration process. There are signals about the net outflow of staff to the British Isles being lower, however, within the next few years, Germany and Austria will become new and very attractive job destinations, in view of the small distance to them and their huge labour markets. Possible method of improving the net migration balance is opening the Polish labour market for employees from the East. This, however, requires the approval of the European Commission, and its obtainment is not very obvious. It is also uncertain whether the employees from the Eastern Europe or from the Far East will prefer better paid but illegal work in the old EU or legal yet worse paid jobs in Poland.

What about the growth in labour productivity?

Much indicates that the acceleration of the wage growth in the upcoming years as compared to the average growth rate in the previous years cannot be avoided. However, the question emerges whether it is possible that this will be offset by the dynamic growth in labour productivity.

The factor that is conducive to further growth in labour productivity is primarily the potential arising from much lower labour productivity level in Poland than in better developed states. The release of this potential in the upcoming years will be promoted by the continuously growing flow of foreign direct investments, dynamic growth in fixed investment of the enterprises sector, and increasingly higher public infrastructural investments that to some extent dismantle the barriers on the labour market and enhance Poland's attractiveness in terms of foreign capital investments in spite of the gradually growing labour costs. What is important, the share of investments aimed at employment reduction in total business investments is growing. The gradually growing relation between the capital and labour speaks in favour of maintaining the quick growth in labour productivity in the medium and long term. The growth in the labour productivity of the enterprise sector and the entire economy will also be fuelled by the change in the employment structure that will consist in growth in the share of young employees with relatively higher productivity, although the scale of this process is limited by the above mentioned job emigration.

Are there also factors that can hinder the growth in labour productivity in Poland? Some economists suggest that the factor that may hinder the labour efficiency growth is the planned reduction in the disability pension contribution paid by employees[1]. In their opinion, if the disability pension contribution is reduced based on the formula proposed by the government, the optimum staff behaviour will consist in reducing either the working time or the efforts required to do the work. This suggests that "if an employee is to be paid more for the same work, why should they make an effort".

In our opinion, such argumentation is not convincing. If we assume that employees behave in a rational manner, one can draw other conclusions about their response to the growth in net salaries caused by the reduction in the pension premium paid by employees. Namely, the employees will make a decision about the distribution of time between work and leisure (and about work commitment) based on the perceived interim changes in business climate and net wages in real terms regarded as normal in a given period of time[2]. In the conditions of prosperity that allowed to reduce the disability contributions to be paid by employees (from the employee's point of view, this may seem temporary in view of the commonly discussed threat to public finance in the medium term) and the growing level of net wages in real terms, the employees will increase their working time and efforts put in the work currently expecting that they will recover their free time in the future when, according to the expectations, the real net wages will be lower than the level regarded as normal. This reaction from employees is referred to as intertemporal substitution.

In our opinion, the growth rate of labour productivity will be maintained at a healthy level although in the conditions of record growth in employment, productivity gains will not be as significant as in the years 2000-2004 when the national income grew while the employment was falling.

How will employers behave?

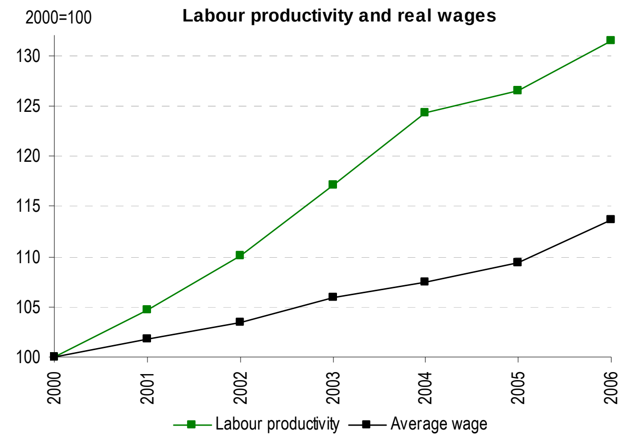
Even assuming that the fast pace of the growth in labour productivity is sustainable, the acceleration in wage growth will make the unit labour costs grow. Whether the deterioration of the relation between wage growth and labour productivity gains is strong enough to upset the Poland's macroeconomic balance will depend on the employers' response to the shrinking labour resources and growing wage demands. In our opinion, it is not very likely that the wage growth in the private sector might, in the long run, exceed the labour efficiency growth and even if it happens on a temporary basis, it is very unlikely that it will be reflected in pricing policies of enterprises.

While facing rising wage demands, employers have a few options. First of all, to some extent, enterprises can afford to increase wages as they have high profit margins and financial surpluses retained in the previous years. This is so as the previous years saw unprecedented growth in profitability of enterprises, primarily thanks to the very favourable relation between wage growth rate and labour productivity in the years 2000-2004. From this point of view, the currently observed acceleration in wage growth is a kind of a natural offset for employees for the very strong growth in labour productivity that they have not been paid for before. According to our estimates, cumulated labour productivity growth in 2001-2006, i.e. since the bottom of the current economic cycle, has reached slightly above 31% while real wage growth nearly 14%.

[1] J. Jankowiak i M. Gronicki, *O klinie na poważnie*, Rzeczpospolita daily, 5 March2007.

[2] por. R. Lucas, L.A. Rapping, *Real Wages, Employment and Inflation*, Journal of Political Economy, September/October 1969.

Chart 6



Source: CSO, own calculations

The difference between cumulated labour productivity gains and real wage growth illustrates what is a room for hikes in real wages that would lead to full compensation of labour productivity growth since the beginning of the current decade. Levelling of the real wage growth rate and labour productivity increase in the long run should not have negative inflation implications amid tight internal and external competition, although this would be at the cost of lower profitability of enterprises. In such a case, the GDP growth does not need to slow down as lower investment demand (with lower profits) would be offset by stronger consumer demand. The latter in turn, on the assumption that the international competition will grow (as a result of growing openness of the Polish economy)[3], would have limited inflation implications although it might contribute to the increase in the external imbalance of the Polish economy.

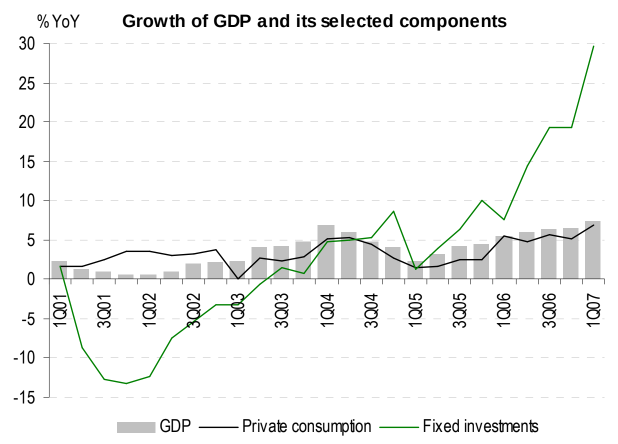
Apart from the buffer in the form of very high profits, also the hypothesis of efficiency wage speaks in favour of the scenario where enterprises accept wage growth and it does not cause any strong inflation effects. It assumes that wage growth is conducive to growth in labour productivity through attracting employees with better qualifications. In the Polish economy, this effect might be achieved by, e.g. return of some employees from job emigration as a response to the narrowing difference between salaries in Poland and abroad. Wage growth having a positive impact on labour productivity growth would have limited inflation implications and would not cause significant deterioration of financial standing of enterprises.

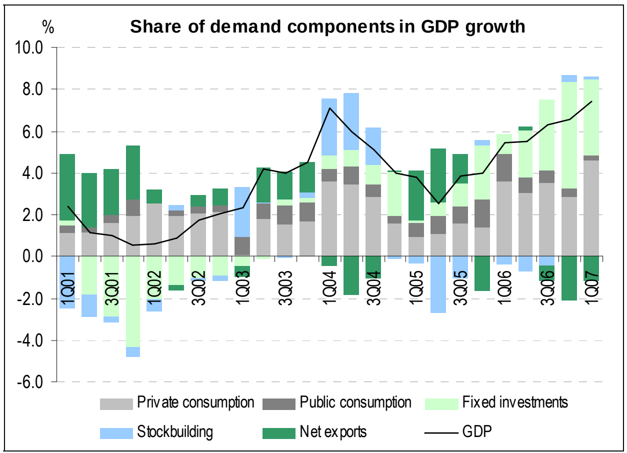
Another possible response of enterprises to staff shortage and growing wage demands might be limitation of the business expansion scale, at least domestically. If enterprises do not want to grow wages (or accept growth in costs) and cannot raise prices (meaning income) because of strong foreign competition in the conditions of growing scale of globalisation, Polish companies can transfer part of their operations or launch new production capacities in countries where production costs are lower, primarily in the Commonwealth of Independent States or in the Far East. In this scenario, we would most likely see the GDP growth in Poland slow down. At the same time, given the intense international competition, and lower economic activity, it would be difficult to talk about stronger inflation pressure.

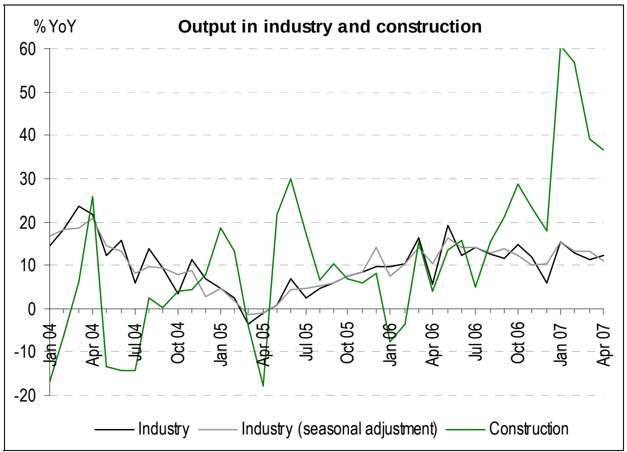
To sum up, the forthcoming quarters will be marked by a fast wage growth, resulting from rapidly falling unemployment and emigration amid extremely low occupational activity of the Polish society. At the same time, however, one may expect that labour productivity gains will remain solid thanks to substantially increased investment activity in the economy. Nevertheless, wage growth will most likely be stronger than labour productivity gains, which is equivalent to acceleration in unit labour costs growth, but this process should not be rapid enough to translate into uncontrolled inflation acceleration. Therefore, we predict that in the medium-term inflation will remain close to the inflation target of 2.5%. This is consistent with our assumption that after a rate hike in April the MPC will not decide for further aggressive rate hikes, yet gradually increase borrowing costs: in two moves of 25bp in July and at the turn of the year.

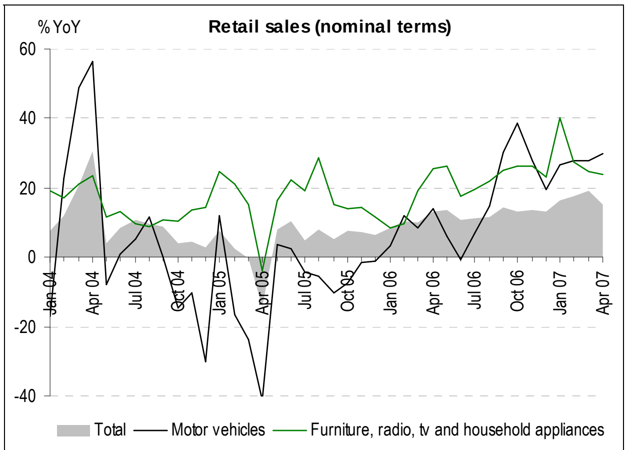
[3] Importance of this factor has been highlighted by some members of the MPC, recently by Stanisław Owsiak and Andrzej Sławiński.

Economic update









Source: CSO, own calculations

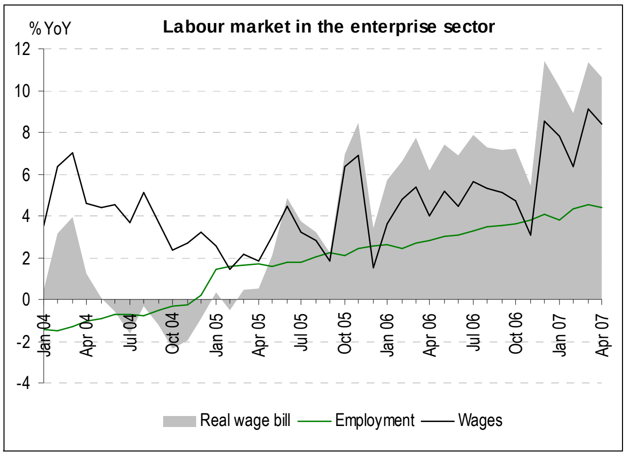
GDP growth above 7%YoY in Q1

- 1Q07 was another quarter when Polish economy expanded faster than predicted. GDP growth reached 7.4% and was the fastest for more than 10 years.
- The main factor responsible for such strong GDP growth was private consumption that increased 6.9%YoY (against ca. 5% in 4Q06 and on average last year) with contribution of 4.6pp to the overall GDP growth.
- At the same time, fixed investment growth experienced a considerable acceleration to nearly 30%YoY from 19.3%YoY in 4Q06 and 16.5% rise on average in 2006.
- Both factors translated into robust increase in domestic demand which reached 8.6%YoY, i.e. the same as in 4Q06.
- Net export had negative contribution to GDP growth, at 1.2pp with exports and imports growing by 11.8%YoY and 14.7%YoY, respectively.
- A pace of GDP growth in Q1 was surely above the potential growth and additionally it was driven to a large extent by private consumption. This may cause an increase of inflationary pressure, triggering some reaction of the MPC.
- On the other hand, a positive factor is surge in investment, which increase potential growth in medium-term, which should mitigate inflationary pressures in future.
- One should also remember that fast pace of GDP growth in 1Q07 was to an extent related to extraordinary good weather conditions (which is reflected among others is extraordinarily strong results in construction output – value added in construction increased by ca. 40%YoY).

... but start of Q2 slightly weaker

- Industrial output increased 12.4%YoY in April (11.3%YoY in March) against market predictions at slightly above 15%. It was below average production growth recorded in the first quarter (13.2%YoY).
- Production in manufacturing sector rose 14.1%YoY, which was also higher than in March (13.7%) but below average growth in Q1 (16.2%).
- Comparison of relevant growth rates for seasonally adjusted output gives similar conclusion – 10.9%YoY increase in April and slowdown by over 3 pct. points in relation to the average growth in Q1.
- A positive feature was data from construction sector that showed upsurge by almost 37%YoY in April.
- Retail sales growth reached 15.1%YoY in nominal terms in April (market consensus at 20%YoY), slowing down by a few percentage points from a healthy 19.2%YoY nominal increase in March, and real growth stood at 13.4%YoY.
- The breakdown of the growth indicated the strongest sales growth in “motor vehicles” and in “furniture and household appliances” while only one-digit growth was noted in sales of “food and beverages”.
- April’s data on sales and production confirmed there was some slowdown in economic expansion observed at the beginning of the second quarter, which had been widely anticipated. But at the same time it is hard to claim that two-digit pace of growth in sales and production was a weak result. We maintained forecasts of GDP growth reaching 6.5% in Q2 and above 6% in the entire 2007.

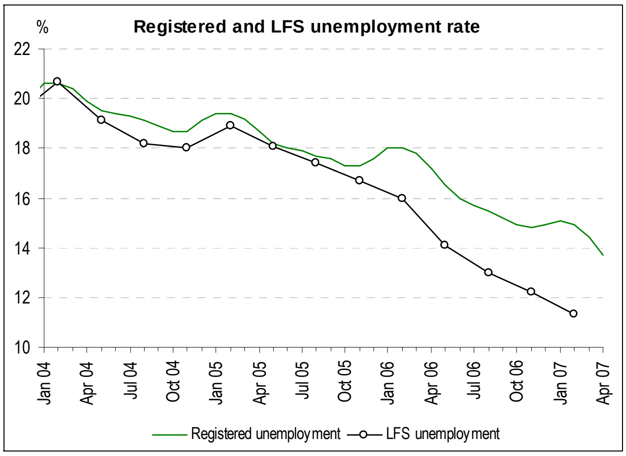
Economic update



Wages keep growing, yet slightly slower

▪ Average wage in the corporate sector grew 8.4%YoY in April, slower than forecasted (8.8%) and slower than in March (9.1%). Possibly, the March's result was to an extent elevated by bonuses' payments in some large companies. Still, underlying wage growth remains high (excepting March, wage growth in April was the strongest since January 2001) and indicates there is some wage pressure in the economy.

▪ Average employment in corporate sector increased 4.4%YoY in April, slightly less than in March (4.5%). All in all, wage bill in enterprises in April increased 13.2%YoY in nominal terms and 10.6%YoY in real terms. Such strong growth of households' income will support private consumption growth in 2Q07 and subsequent quarters.

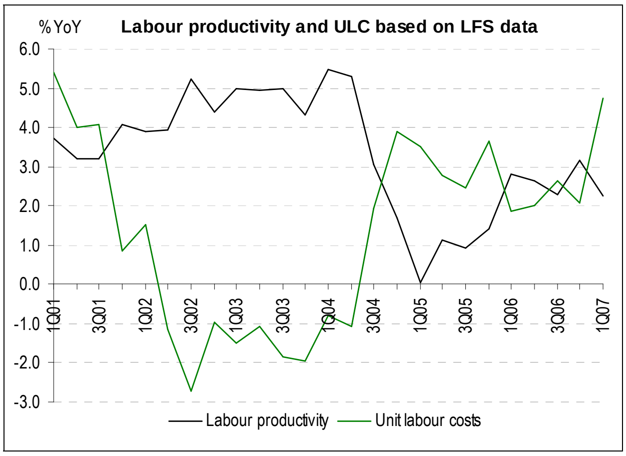


Strong job creation in Q1 according to LFS survey

▪ Quarterly report from the labour market (Labour Force Survey), released by the Central Statistical Office, has shown significant strengthening of positive trends in the first quarter of the year.

▪ There was a strong decline in the number of unemployed in Q1 (by almost 30%YoY) and acceleration in drop of unemployment rate (to 11.3%, which means as much as 4.8 pct. points YoY), amid simultaneous slowdown in decrease of economically active population (-0.3%YoY against average -1% in 2006).

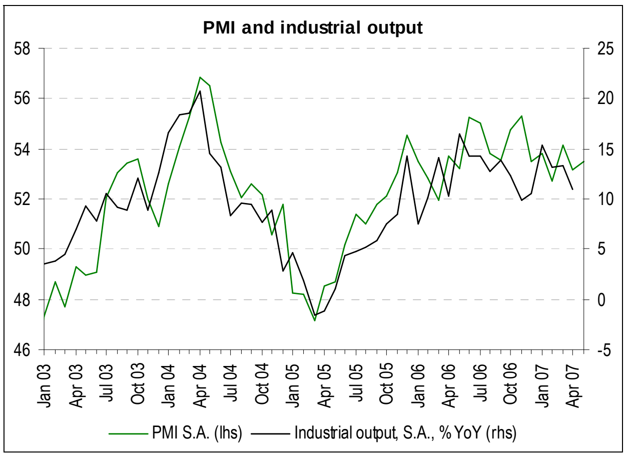
▪ The number of jobs increased by as much as 5.3%YoY, which is a strong acceleration in comparison with 3.6%YoY in 4Q06 and 3.4%YoY average in 2006. Such rate of growth has never been recorded before in this survey.



▪ Estimates of unit labour costs based on the LFS data and GDP numbers in 1Q07 yield as high rate of growth as 4.7%YoY.

▪ Obviously, it would be an alarming signal for the central bank. On the other hand, our estimates of employment in the entire economy based on monthly data from enterprises sector show a growth rate of ca. 3%YoY, which implies growth in unit labour costs by ca. 2.5%YoY. Even if a risk for this estimate is on the upside, the difference between LFS and those data is significant.

▪ Besides, one should remember that the analysts of the central bank used to underscore in the past that the LFS data and calculations based on them are subject to significant uncertainty (likely overestimation of unit labour costs).



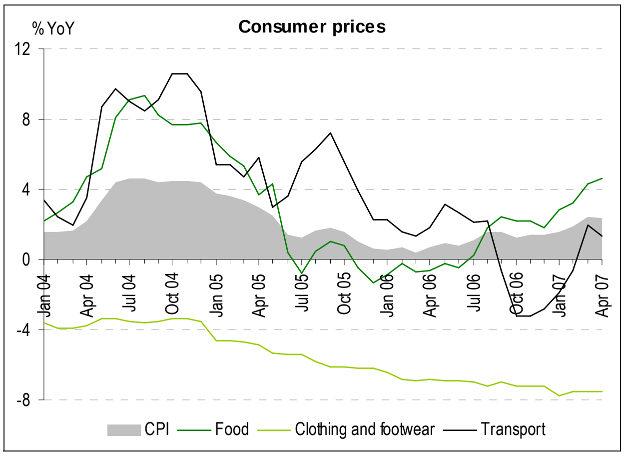
Source: CSO, NTC Research, own calculations

Results of business climate surveys still optimistic

▪ CSO business climate indices showed that entrepreneurs' optimism in Q2 has been the highest for many years. In May, in all analysed sectors firms planned rise in employment and expected improvement in their financial situation. Predicted future prices growth was lowered in manufacturing, while in construction and retail trade companies anticipated faster rise in prices.

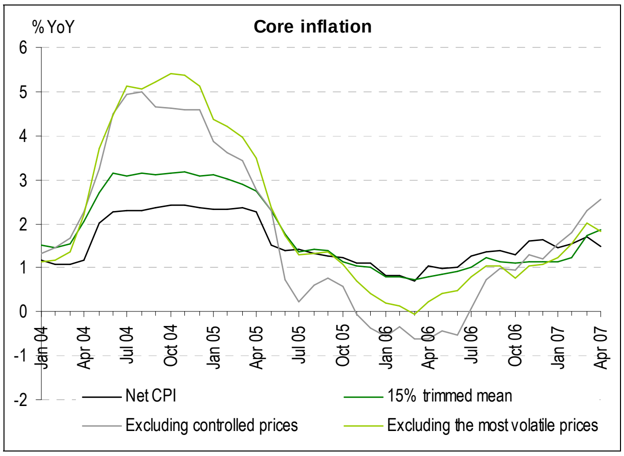
▪ PMI index for Poland rose in May to 53.5 from 53.2 in April. The survey showed continuation of fast rise in new orders, although in case of export orders a drop was recorded for the first time in a year. Employment growth accelerated to record high level. Stocks of finish goods were depleting. Companies were raising prices although at slower pace than in April.

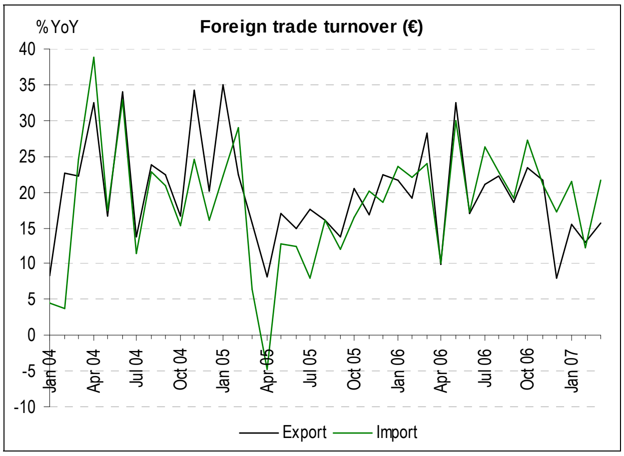
Economic update



Inflation still under control

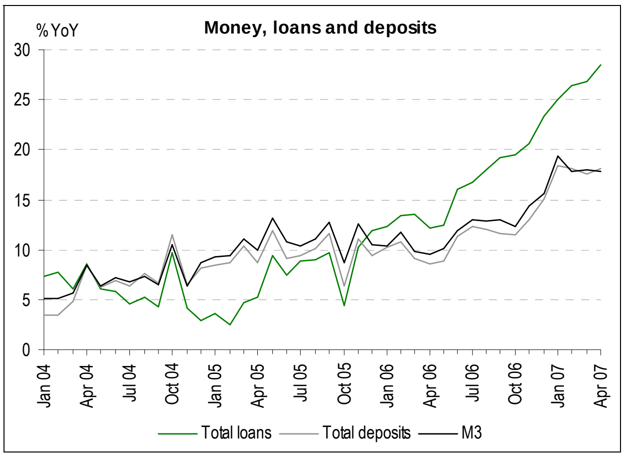
- In line with expectations CPI inflation in April decreased to 2.3%YoY from 2.5% in March, falling below the central bank's inflation target again.
- Main factors pushing inflation rate up were still prices of food and fuels that soared in April 4.6%YoY and 2.6%YoY, correspondingly.
- CPI excluding those two elements, i.e. net inflation, dropped in April and reached only 1.4%YoY against 1.7% in March.
- Other core inflation measures remained low and only one of them was higher than 2% (CPI excluding controlled prices that increased 2.6%YoY in April). This shows that fundamental pressure on prices remains moderate and the MPC does not have to hurry up with next interest rate hikes.
- Similar conclusions were confirmed by PPI data that showed a slowdown in annual growth to 2.3% from 3.3% in March, deeper than expected.
- Amid strong economic expansion, with stronger consumption demand, price pressure is going to mount. We forecast, however, this will be a gradual process and net inflation will reach maximum of 2.0% until the end of the year.
- The CPI inflation is going to stay under influence of rising food and gasoline prices and it is going to stay above 2% in the next 2-3 months.
- According to Ministry of Finance's forecast, inflation rate in May dropped to 2.1%YoY. It suggests that negative impact of frosty weather in May on food prices was not dramatic and although in June the annual CPI growth rate could rise again among others due to low base effect, an increase above 2.5% seems to be relatively little likely.





Fast rise in exports, even faster in imports

- Current account deficit in March was at €539m against €561m in February and market expectations at €453m.
- Cumulated 12-month current account deficit remained at low level, below 2.5% of GDP.
- Export growth accelerated again to 15.8%YoY, which suggests that foreign demand for Polish goods stays at very high level. At the same time, imports accelerated significantly with the annual rate of growth of 21.7%. Nevertheless, the National Bank of Poland informed that import value in March was affected by a one-off transaction. Thus, trade balance in subsequent months should not be deteriorating at the same pace as recorded in March, though strong domestic demand is very likely to keep imports at high level.

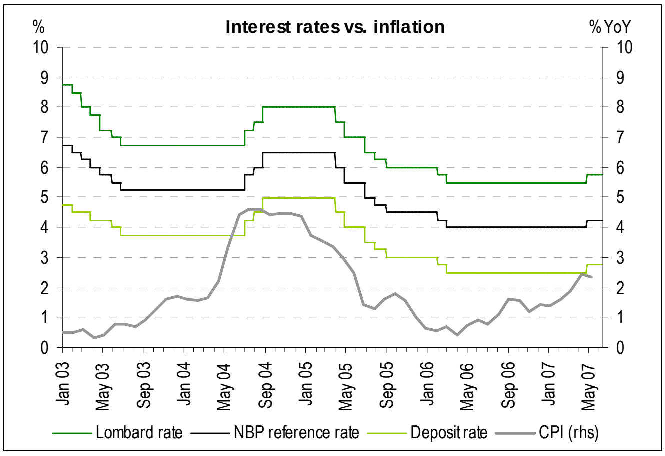


Source: CSO, NBP, own calculations

Credit boom continues

- While money and deposit growth has stabilised since the start of the year at ca. 18%YoY, the boom in credit market has been uninterrupted.
- In April, growth in loans to enterprises accelerated to 19.2%YoY, and loans to households rose by as much as 39%YoY. In both cases, these were the best results since late 1999.
- Companies' deposits growth remains at very high level (30%YoY), showing that Polish enterprises are still enjoying very rapid revenue increase, and their financial standing is very good.
- Growth in households' deposits decelerated a little, to 9.2%YoY in April, but to large extent this could have resulted from quickly rising interest in alternative savings products.

Central bank watch



The MPC did not surprise in May – rates on hold

- In line with expectations, the Monetary Policy Council decided to leave rates on hold at its meeting in May. The reference rate still stands at 4.25%.
- Both the statement (see below) and comments of MPC members (see the next page) did not bring much new information to the already known picture.
- We maintain our expectations that another interest rate hike is likely in the third quarter (possibly in July), but this will depend on incoming macroeconomic data releases, in particular regarding the labour market situation and the pace of economic expansion.
- We still expect that after another rate hike by 25 at the turn of the year the monetary tightening cycle will end with the official rate at the level close to 5%.

Information from the meeting of the MPC in May (new elements in bold)
The Polish economy is still in the period of strong growth encompassing all its sectors. The data released **in May** confirm previous assessments that strong economic activity should be sustained for at least next few quarters, **even though economic growth in the next quarters will be probably slightly lower than in 2007 Q1**. The continuation of fast economic growth in Poland will be supported by strong activity in the world economy and, particularly, the consolidating recovery in the euro area, which is taking place in the conditions of stable inflation. **In April the annual growth of consumer prices in Poland amounted to 2.3%, which was close to the NBP's inflation target of 2.5%.**
In the Council's assessment the high growth of domestic demand, which most probably exceeds the growth of potential GDP, will be sustained in the next quarters. The latest data on labour market developments point to a further build-up in wage pressure, which may lead to an increase in inflation. The Council assesses, however, that in the medium term inflation increase will be constrained primarily by a probable continuation of high productivity growth supported by high investment growth, very good financial results of enterprises and low growth of external prices, related to globalisation and the ensuing intensified competition in the market of internationally traded goods and services.
In the Council's assessment in 2007 Q3 CPI inflation may temporarily fall below its present level.
In the Council's assessment, in the medium term, the probability of inflation running above the inflation target **decreased owing to the last month's NBP interest rate increase, though it** remains higher than the probability of inflation running below the target. A more comprehensive assessment of the scale of risk of inflation overshooting the inflation target will only be possible after analysing the data to be released in the coming months. The Council will be closely monitoring the relation between wage and labour productivity growth, zloty exchange rate, the impact of globalisation on the economy and other factors.

Statement suggested the MPC will wait and see

- In the statement released after the meeting the MPC said that the risk of inflation running above the target in the medium term had decreased, although was still higher than probability of inflation running below the target. This means that an informal restrictive bias in monetary policy is biding.
- Despite the fact that a few new elements appeared in the statement (see details in the table on the left), it was neutral for the debt market. This is because it did not change, in our opinion, the expected scenario of monetary policy decisions.
- The Council did not refer to LFS results for 1Q07. However, it does not mean that rate-setters are not concerned about an acceleration in unit labour costs growth suggested by the data, as they noticed that the new labour market statistics indicate that wage pressure keeps mounting.
- There was one new paragraph in the statement, including risk-factors, which may lead to worsening inflation prospects, as well as arguments limiting price pressure in the future. It seems, however, that the content was nothing new as compared to the minutes of the April decision-making meeting (details below). The Council added in the statement that "the economic growth in next quarters will be probably slightly lower than in 1Q07", although it is hard to state this means a change in expectations.
- What is interesting, the MPC said that April's inflation level of 2.3% was close to the NBP's inflation target of 2.5%. As we think that majority of the Council perceives the inflation target symmetrically, a possible inflation increase to 2.7% should not be itself a major argument in favour of another rate hike. Nevertheless, one should remember that for some MPC members it may be easier to take decision on monetary tightening when inflation is above the target.

Selected fragments of the minutes of the April's meeting
The discussion revealed three different assessments of the April projection. Some Council members accepted the inflation outlook outlined in the April projection as probable. Other discussants, however, assessed that inflation may prove higher than that indicated by the projection, due to the projection's possible underestimation of wage and GDP growth. Finally, other members of the Council pointed out that, in line with the April projection based on the ECMOD model and other forecasts prepared at the NBP, in the short term inflation will be running clearly below the inflation target, while in the longer term it will be lower than it is outlined in the projection.
Most Council members were of the opinion that it is necessary to tighten monetary policy, yet there were different views on the right timing of the interest rates increase.
[The majority of Council members] assessed that a slight monetary policy tightening should have only slight, if any, impact on economic growth.

Source: NBP, Reuters

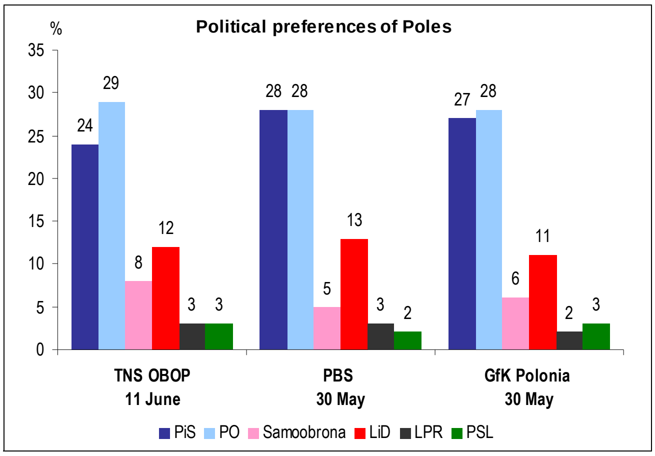
Minutes also neutral

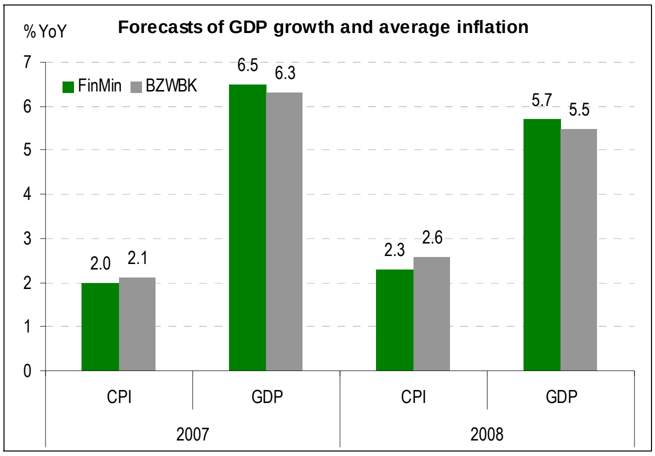
- In line with earlier announcements, starting from May, the Monetary Policy Council started publishing minutes of its meetings on a regular monthly basis. From now on, the document will be published every month, on the last Thursday before the next MPC meeting.
- The report of the April's meeting confirmed our assessment of the distribution of views among the MPC members. Situation on the labour market and perspectives of economic growth remain the key risk factors for inflation perspectives in the opinion of the majority of Council's members.
- The rate hike in April was a signalling move and thus far, the MPC members, even those with hawkish views, do not seem to be convinced about a need for strong and swift monetary tightening.

Central bank watch

Comments of the central bank representatives	Our remarks
Sławomir Skrzypek, NBP governor **PAP, 5 June** As for now we are on the safe side. According to our forecasts inflation will remain within the inflation target band, which is acceptable in the direct inflation targeting framework, in the next twelve months. However, risks connected with higher wage pressure will be seriously taken into account when taking next decisions in monetary policy. **PAP, MPC press conference 30 May** Wage pressure will rise, which should have an influence on inflation. On the other hand, share of wage cost in enterprises is falling and this requires further analysis. Enterprises have large potential stemming from restructuring efforts.	According to the Polish law, the positions taken by Council members during votes shall be published after a period of six weeks. This period already passed and we still do not know the voting result as regards the motion to hike rates in April. This piece information should appear quite soon and this may be important for the market, as comments and statements of those members, who form the majority in the Council should be closely watched. What is more, taking into account that the MPC justified the decision as the move to strengthen credibility of monetary policy, it is interesting to see the view of the chairman of the Council. NBP President dismissed the chief of the General Inspectorate of Banking Supervision (GINB), Wojciech Kwaśniak, who will stay in the central bank as an advisor to the President. Alfred Janc was nominated as the new chief of GINB.
Jan Czekaj, MPC member **Reuters, 31 May** If rate of growth in economic indicators, which was observed recently maintains and inflationary pressure intensifies, the reaction of the MPC would be needed. One of these options [rate hike in summer or in autumn] will probably be correct, although I would not yet predetermine the specific date. […] The current growth rate is probably above the potential and sooner or later will fuel a pick up in inflation.	If the NBP President did not support the motion to hike interest rates in April (such conclusion may be drawn from some of his comments), the opinion of Jan Czekaj could have been the key for the decision (more likely than Stanisław Owsiak), assuming that Andrzej Sławiński and Andrzej Wojtyna voted in favour of a hike. Due to the fact that the Czekaj's view became crucial to form the majority in the Council, financial markets participants should analyse his comments in the media very carefully. His latest statement suggested a possibility of another rate hike in a few months time.
Dariusz Filar, MPC member **Radio TOK F, Reuters, 31 May** The April rate hike by 25 basis points did not solve the inflation problem. Previously I thought that we move rate by 25 bp with long pauses, but the fact that the first hike took place only in April makes the intervals (between increases) shorter, which points to a decision before the summer. **PAP, 22 May** In the economy as a whole productivity growth is around 2-3% in the last couple of quarters. If we take into account the inflation target of 2.5% and we assume that productivity growth may be higher, we can say that only wage growth not higher than 6% may be consistent with meeting the inflation target. If wage growth exceeds this level, this creates a risk of breaking the target. Since June, until July and August the Council may be receiving very important information leading to a need for another rate hike. In this time-frame we will also receive the new inflation projection in July, which will include data for the first quarter and thus may show higher inflation path as compared to the one presented in April.	It seems that the so-called hawkish faction within the Council (they proposed rate hike already in October 2006 and economic situation later on showed it was not a good idea) still sticks to its view. All three members – Dariusz Filar, Marian Noga and Halina Wasilewska-Trenkner – indicated recently a possibility or necessity of interest rate increase in the upcoming months. On the other hand, Stanisław Nieckarz and Mirosław Pietrewicz sometime mention a chance for rate hike, but at the same time they show a number of condition, which would have to be met (and this would be quite difficult) in order to support such motion (GDP growth in the second quarter as high as in Q1, substantial weakening of the zloty). Dariusz Filar suggested he will keep proposing rate hikes at the nearest MPC meetings in summer. But the success of the motion, as mentioned above, will depend on the support of "moderate" members. Will they become convinced by the fact (mentioned by Noga, see below) that new NBP estimates show higher inflation predictions? Or possibly, the increase in wages above productivity growth will be enough to hike rates? From this point view, Filar gave quite interesting indications, as he showed non-inflationary rate of growth of wage in the economy. Indeed, it seems that wage growth may be above the 6% mentioned by Filar, but the question is whether his view is shared by the majority of the Council.
Marian Noga, MPC member **Reuters, 8 June** New estimates of the central bank's experts show that the inflation path over the upcoming months will be higher than the April projection indicated. [...] In order to fulfil our mission [...] monetary policy requires further tightening in two steps. Further steps, beyond all doubt, should take place this year. The sooner it happens, the better. If our decisions take place later the rate increase would have to be more aggressive and their efficiency would be lower as compared to the situation if they take place today.	Marian Noga mentioned high increase in domestic demand as one of the most important factors, which make the non-inflationary economic growth era to come to an end. This means, in his opinion, that the MPC must act. However, the two moves by 25 bp, suggested by Noga, may be treated rather as a moderate monetary tightening (in line with our view), which is consistent with opinion presented by another member, Halina Wasilewska-Trenkner. What is interesting, Noga indicated he treats the inflation target asymmetrically, as he finds the situation when inflation is below the target as more comfortable. We do not think such point of view is shared by the majority of Council's members.
Halina Wasilewska-Trenkner, MPC member **PAP, 1 June** I think that some opinions that a cumulative interest rate increase by 150 pb is needed are exaggeration, but we will probably have to raise rates in order to keep inflation under control in future. We should tighten monetary policy gradually, and not too aggressively, which could be dangerous for the economy. **PAP, Reuters, MPC press conference, 30 May** Taking into account a part of information for 1Q07 (among others LFS results for 1Q07), we know there is rising probability of increase in inflationary pressure this year. We will be able to assess the strength of the pressure after receiving complete data for 1Q07.	On the one hand, Halina Wasilewska-Trenkner emphasised the MPC would have to stay vigilant amid rising inflation risks, but on the other hand she concluded that there was still some "margin of leeway" and sharp moves in monetary policy were not needed. Therefore, even hawks within the Council do not seem to share the view of e.g. the previous member of the MPC, Bogusław Grabowski, who said about a necessity of 150 bp hike. During the press conference after the MPC meeting Halina Wasilewska-Trenkner referred to the LFS results in reaction to a question from one of journalists, and mentioned a possible intensification of inflationary pressure, but at the same time she (one of hawks on the rate-setting panel) stressed that it was still difficult to assess the strength of the pressure.

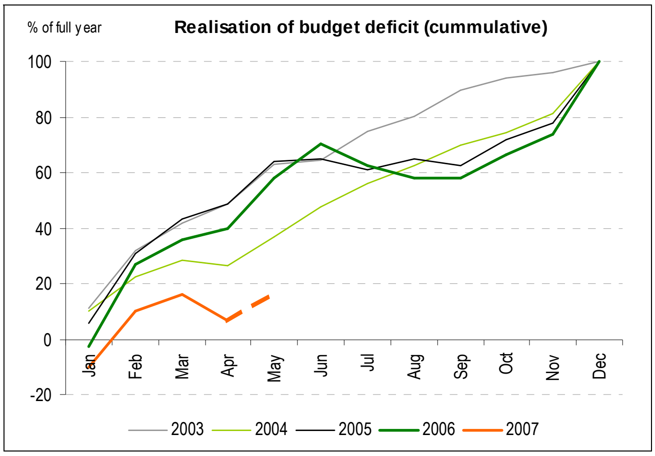
Government and politics





Macroeconomic assumptions of 2008 budget

	2007	2008
GDP growth (%)	6.5	5.7
Exports (%)	11.0	9.0
Imports (%)	15.5	11.2
Domestic demand (%)	8.5	6.8
Gross accumulation (%)	19.4	13.4
CPI (annual average, %)	2.0	2.3
Average wage (%)	7.2	6.0
Average employment (%)	2.9	2.3
Unemployment rate (%)	11.3	9.9
USDPLN (average)	2.84	2.77
EURPLN (average)	3.81	3.74
Current account deficit (% GDP)	-3.9	-4.7
NBP reference rate (average, %)	4.3	4.7



Source: BZWBK, Ministry of Finance, NBP, opinion polls

Narrowing gap between PO and PiS

- The closer to work on the budget for the next year and the accompanying bills, the more possible contentious issues between the coalition partners. They even decided to sign the annex to the coalition agreement.
- From the point of view of financial markets, such information is not very important. What is essential is the outcome of parliamentary votes on reduction in tax wedge and public finance reform, as finance minister Zyta Gilowska makes her presence in the cabinet conditional on these issues (especially the latter).
- As for now, the Prime Minister supports finance minister and a possible conflict with minor coalition partners may be solved in PiS favour, assuming recent result of opinion polls.

Work on budget 2008 in progress

- The government accepted macroeconomic assumptions to the next year's budget. The Ministry of Finance decided to increase the GDP growth forecast for 2008 from 5.5% to 5.7%, while average annual inflation is still expected at 2.3%.
- Budget revenues are planned to amount to PLN241.6bn, which means spending level at PLN271.6bn given the government decided to keep the so-called budget anchor at the level of PLN30bn.
- The Ministry of Finance assumed that the bills having budgetary consequences will be accepted by the parliament in the shape proposed by the cabinet. This is especially important in case of reduction in disability pension contribution, as the new public finance act is expected to produce savings rather in longer term (we still do not know how it will bring PLN10bn).
- If tax wedge reduction does not take place or deputies change the proposal considerably, there is a risk of increased spending (by maximum of ca. PLN20bn) for other purposes. We would not rather expect a reduction in budget deficit.
- The ministry forecasts tax and non-tax revenues growth at 12.8%. At the same time, spending growth does not seem excessive at first glance (ca. 5%).
- However, *Guidelines for budget 2008* reads that both revenues and spending may increase after financial flows between Poland and UE are taken into account. If one compares spending for 2008 with this year's level but reduced by expenditures connected with EU programmes, the planned growth in spending for 2008 reaches the two-digit level.
- Also, privatisation revenues are expected to reach PLN4.6bn in 2008 against PLN3.0bn planned for this year. However, it is worth to remind that in mid-year it was realised in one-third only.

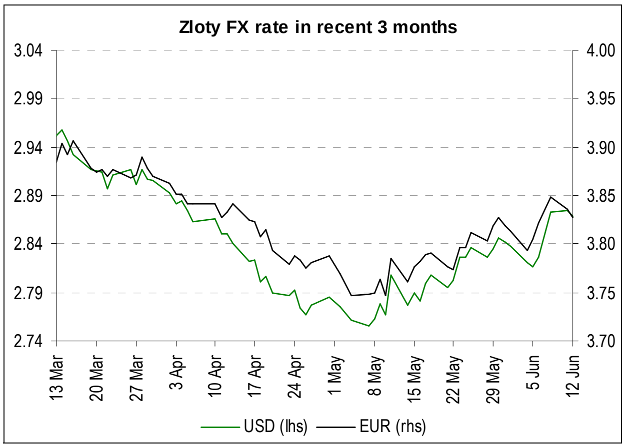
Still excellent result of central budget in 2007

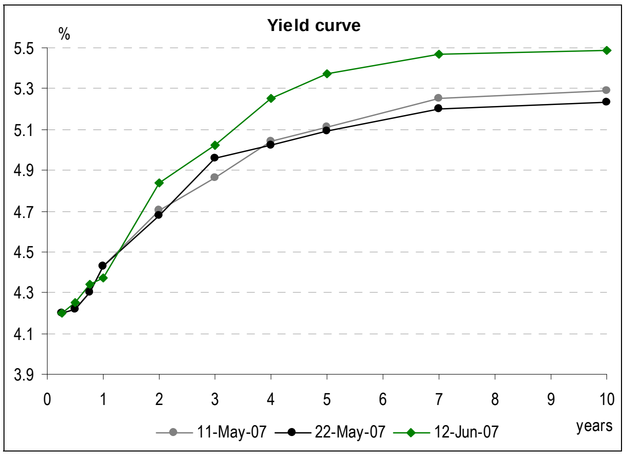
- After four months of the year budget deficit amounted to 6.9% of the annual plan (PLN2.6bn), which was below preliminary estimates of the Ministry at 7-8% and much below plans presented at the beginning of the year. Excellent result led to lowering financing needs (bond auction was cancelled).
- Though April's result, especially on the income side, was under influence of some one-off factors, this is a result of fast economic expansion.
- According to preliminary forecast of the ministry, deficit reached 16-17% of the plan after May, which was partly connected with faster realisation of planned spending.
- It seems that this year's deficit may be lower by a couple of billions zlotys as compared to the plan, even if one assumes reduction of tax wedge starting July.

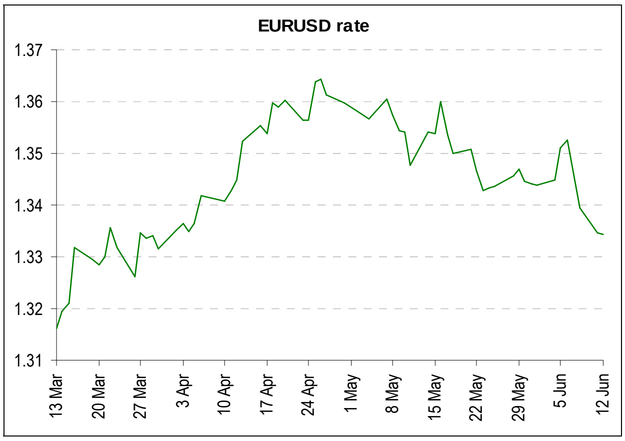
Government and politics

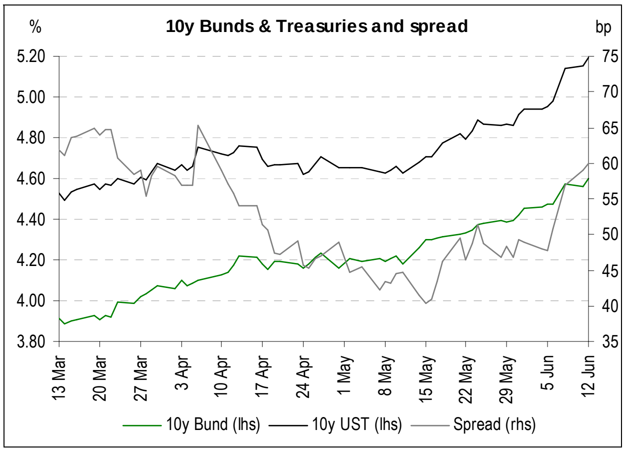
Comments of government representatives and politicians	Our remarks
Jarosław Kaczyński, Poland's Prime Minister **PAP, 28 May** There is an issue of discussion about reduction (in tax wedge) in the next year. We will discuss it indeed. As regards this year's reduction in pension premium, I am completely determined to do it, and so I am as regards public finance reform. This is a condition of further coalition existence. **Andrzej Lepper, deputy PM, agriculture minister** **PAP, 30 May** The issue has not been resolved yet and it is not known whether a reduction (in pension premium) will be in July or starting from January. (...) Absolutely there is no way (that farmers could pay healthcare contribution from direct EU payments since 2008). **Roman Giertych, deputy PM, education minister** **PAP, 30 May** Cutting a tax wedge (in a shape proposed by the Finance Ministry) (...) implies PLN19bn loss in the budget next year. This means smaller possibilities of wage hikes in the public sector (...). The consequences are that there is no majority in the Sejm for this proposal. **Przemysław Gosiewski, deputy PM** **Rzeczpospolita, 5 June** This year's reduction is already determined and regarding the next year there are two scenarios – either further reduction by 2 pct. points at the employees' side or reduction of labour fund contribution that amounts to 2.45% today.	At the end of April the government approved the motion aimed at reduction in tax wedge. The proposal assumes a reduction in disability pension premium in two steps. Since 1 July the premium paid by employees should be reduced from 13 to 10 percent of gross wage. Since 1 January 2008 the pension premium will be reduced by further 4 pct. points, from 10 to 6 pts.; this time the reduction will be split equally between employees and employers, 2 points each. According to government's estimates, planned reduction in disability pension contributions will reduce revenues of the Social Security Fund by PLN3.5bn in 2007 and PLN20.1bn in 2008. At the same time, state budget expenditure will rise by PLN3.3bn in 2007 and PLN19.3bn in 2008. Despite the motion has been accepted by the government, the proposal to cut pension premium is still raising serious concerns among ruling coalition parties. Comments of Samoobrona and LPR leaders suggest that support of their parties for the version of bill proposed by the Ministry of Finance is under big question mark. The biggest disagreement concerns the second stage of the pension premium reduction, supposed to be implemented since January 2008 and concerning both premium paid by employees and entrepreneurs. Comments of the Prime Minister Kaczyński suggested that this part of the reform could be modified or even abandoned. Additional risk factor is the time. In order to force the bill into law before 1 July, the parliament must accomplish work on the document in a record-fast pace. Until the end of June there are two more Sejm meetings in the agenda, one four-day meeting starting on 12 June and the second three-day meeting starting 27 June. The Senate has only one meeting in the agenda, on 20-21 June.
Andrzej Lepper, deputy PM, agriculture minister **PAP, 11 June** The work is in progress, this week the new coalition agreement will be finalized. The annex to coalition agreement is needed because the situation is different than it was one year ago. For example Euro 2012 that we must prepare to, implement adequate laws.	Simultaneously with work on the tax wedge reduction and the public finance reform, the talks are being held about amendment to coalition agreement. As usually, minor coalition partners are putting forward demands leading in large part to rise in public spending and consumption of fruits of fast economic growth. But – also as usually – the leading PiS could curb their appetites by a perspective of premature election in case of serious disagreement.
Katarzyna Zajdel-Kurowska, deputy finance minister **PAP, 31 May** Budget situation is very good, and thus a reduction in supply. But we will see how the situation looks like in the second half of the year. We have large liquidity cushion, there is no need to issue papers with short maturity. But we do not resign from them completely. It is hard to say how the budget realisation in the next months will look like.	Excellent budget results, achieved thanks to good economic climate boosting tax revenues, create big comfort for the Ministry of Finance in planning new debt emissions and liquidity management. Even if privatisation inflows will be much lower than planned again this year, the supply of treasury papers on the primary market will be also probably lower than initially assumed.
Katarzyna Zajdel-Kurowska, deputy finance minister **PAP, 31 May** We are very pleased to see high GDP growth in Q1, especially in the context of its structure. Investment growth in such scale [...] implies that the economy has entered a phase of revival. But we must take into account that a repeat of first quarter's results may be difficult. Economic growth may be much lower already in Q2, may be below 7%. However it is still likely that in the entire year the GDP growth will reach above 6%. In Q1, apart from strong structural factors, we had also one-off factors, like calm winter, that have influenced economic growth.	The opinion of deputy finance minister about economic situation is rather consistent with our macroeconomic forecasts. We also anticipate that after a record-fast economic expansion in the first quarter of this year, there will be some slowdown in GDP growth in subsequent quarters although it should not be dramatic so that the economic growth in the entire year will remain above 6%YoY, even if it will not be supported by exceptionally favourable weather conditions in the subsequent quarters of the year to the extent it was the case in Q1.
Anna Kalata, minister of labour and social policy **PAP, 12 June** (Unemployment) at 9.9 at the end of 2008 is realistic but it could fall even further. It is even tempting to estimate the jobless rate at 9 percent.	The Ministry of Labour's forecast is indeed realistic taking into account fast improvement on the labour market observed in the recent months and continuation of fast economic expansion assumed by us (despite slight deceleration in GDP growth from record high level seen in Q1).

Market monitor









Source: Reuters, BZ WBK

Correction in the FX market

- After significant zloty appreciation, which occurred till the start of May, Polish currency substantially weakened against the euro as well as the dollar, which was earlier suggested by signals from technical analysis. Zloty's weakening was in line with worsening sentiment toward the emerging markets as well as significant dollar firming. Stock prices falls in the Chinese stock exchange might also have contributed to higher risk aversion. The domestic currency was supported by very good economic data.
- We assume the zloty to stabilise near the current levels for some time, with some possibility of depreciation. However, sound economic data are still going to support domestic currency in the medium term, which may lead to another wave of zloty appreciation.

Significant weakening on core markets

- Since the release of the previous report yields of domestic government bonds substantially increased in reaction to situation in the core markets. The weakening occurred across the whole yield curve, which slightly steepened at 2-5Y term. As expected the MPC did not change interest rates, which did not significantly affect the market. Initially prices of Polish bonds were relatively stable in reaction to core bond market behaviour, however further jump in yields of Treasuries and Bunds was not without effect on domestic market.
- In our view the MPC is going to decide for further interest rate hikes with regards to growing wage pressure. The yield curve may stabilise, though it seems that moves in the core bond markets amid changing expectations in the US and EMU are going to be the most important for the domestic rates levels.

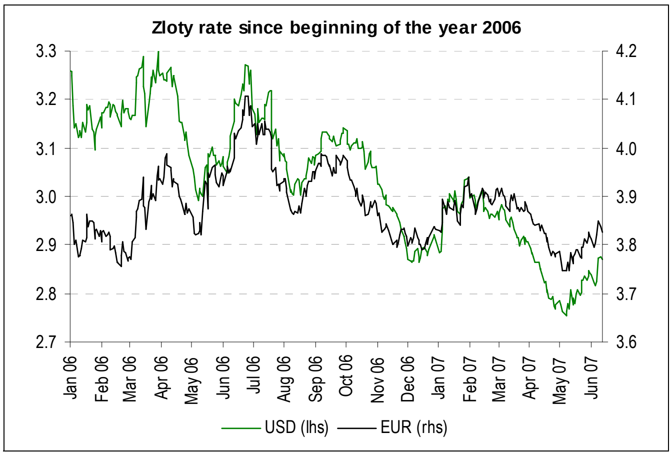
The dollar recovers

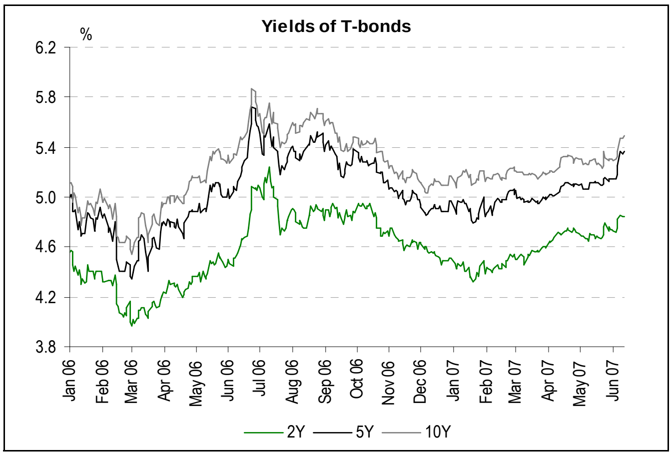
- In the past month the dollar significantly appreciated against the single currency to 1.333. This resulted mainly from falling expectations of interest rate cuts in the United States after better than expected US data (ISM, labour market data) for the last months were released and despite Q1 GDP downward revision. Moreover more weight was attributed to US inflation. Another factor was the rise of expectations of more rate hikes in the euro zone.
- In the long term we expect a recovery of economic situation in the US and dollar appreciation against the euro. Next moves will depend on further data on inflation in the US, which is the biggest concern for the Fed, as well as on other figures from US economy. If they are better than expected again they may support the dollar.

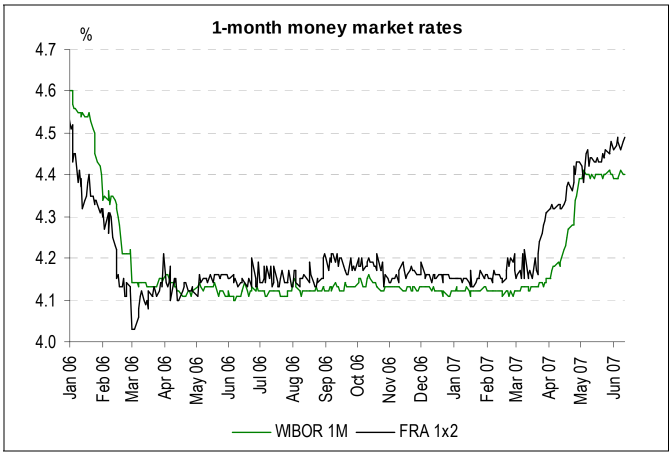
Sudden jump in yields

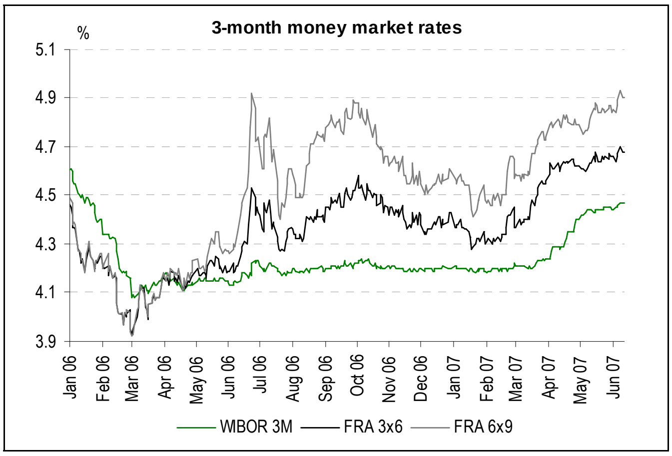
- In recent weeks yields in the core markets experienced sudden jumps, which was connected with rising expectations of interest rates hikes in the euro zone as well as fall of expectations of interest rates cuts in the United States after to release of better than expected data. Yields of 10Y Treasuries rocketed since the release of our last report from 4.73% to 5.14% and of 10Y Bunds from 4.20% to 4.55%.
- We hold our view that the US central bank may cut interest rates twice by 25 bp till the end of this year in case of more data suggesting problems in the US housing market and weakening in the labour market. On the other hand, there may be more hikes in the euro zone, first in September and another at the start of next year. After such significant weakening there may be some stabilisation of rates before firming occurs.

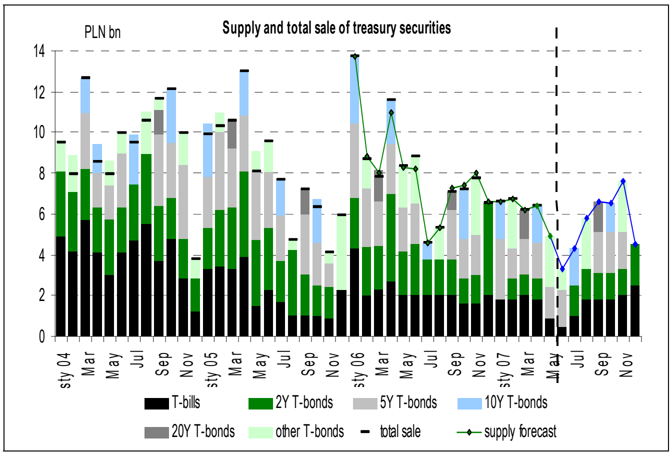
Market monitor











Treasury bill auctions (PLN m)

Date of auction	OFFER / SALE 52-week	Total
02.04.2007	900 / 900	900 / 900
23.04.2007	900 / 900	900 / 900
Total April	**1 800 / 1 800**	**1 800 / 1 800**
07.05.2007	900 / 900	900 / 900
21.05.2007	-	-
Total May	**900 / 900**	**900 / 900**
04.06.2007	500 / 500	500 / 500
18.06.2007	-	-
Total June	**500 / 500**	**500 / 500**

* estimations based on Ministry of Finance preliminary information

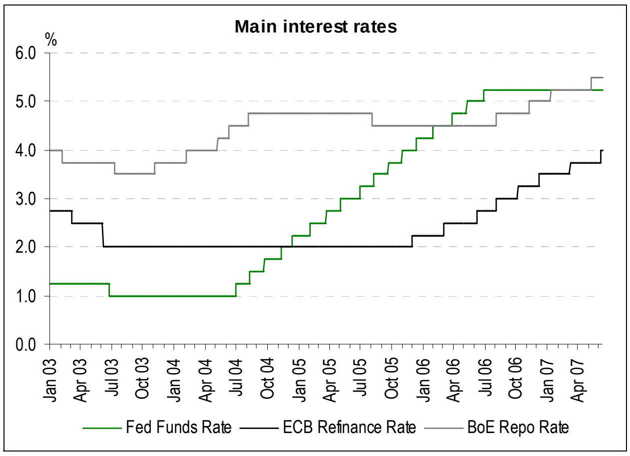
Treasury bond auctions in 2007 (PLN m)

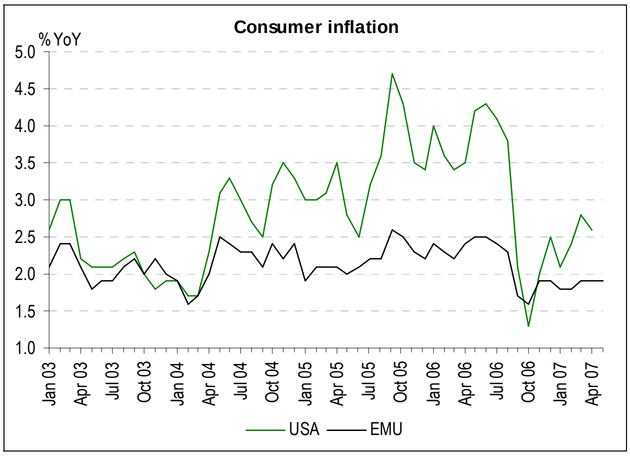
month	First auction date	T-bonds	offer	sale	Second auction date	T-bonds	offer	sale	Third auction date	T-bonds	offer	sale
January	-	-	-	-	10.01	DS1017	1 800	1 800	17.01	PS0412	3 000	3 000
February	07.02	OK0709	1 000	1 000	14.02	WZ0118 | IZ0816	2400 | 0	2400 | 0	21.02	PS0412	1 500	1 500
March	07.03	OK0709	1 000	1 000	14.03	WS0922	1 400	1 400	21.03	PS0412	1 800	1 800
April	04.04	OK0709	1 000	1 000	11.04	DS1017	1 800	1 800	18.04	PS0412	1 800	1 800
May	-	-	-	-	09.05	WZ0118 | IZ0816	2000 | 500	2000 | 498	16.05	PS0412	1 500	1 500
June	06.06	-	-	-	13.06	WS0437	1 000	-	20.06	PS0412	1 000 - 2 000	-
July	04.07	2Y	-	-	11.07	10Y	-	-	-	-	-	-
August	01.08	2Y	-	-	08.08	10Y WIBOR | 12Y CPI	-	-	-	-	-	-
September	05.09	2Y	-	-	12.09	20Y	-	-	19.09	5Y	-	-
October	03.10	2Y	-	-	10.10	10Y	-	-	17.10	5Y	-	-
November	07.11	2Y	-	-	14.11	10Y WIBOR | 12Y CPI	-	-	21.11	5Y	-	-
December	05.12	2Y	-	-	-	-	-	-	-	-	-	-

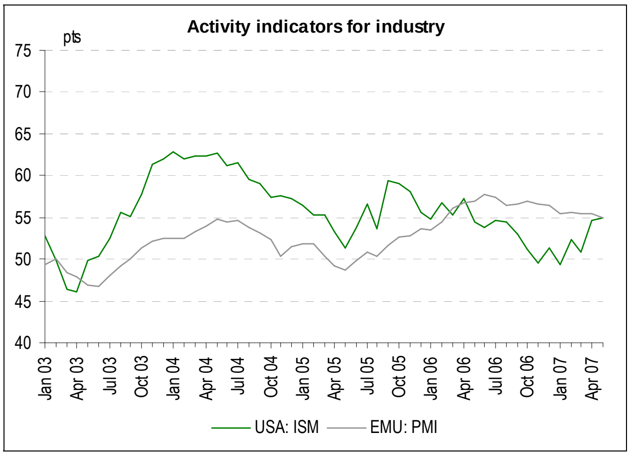
* with supplementary auction

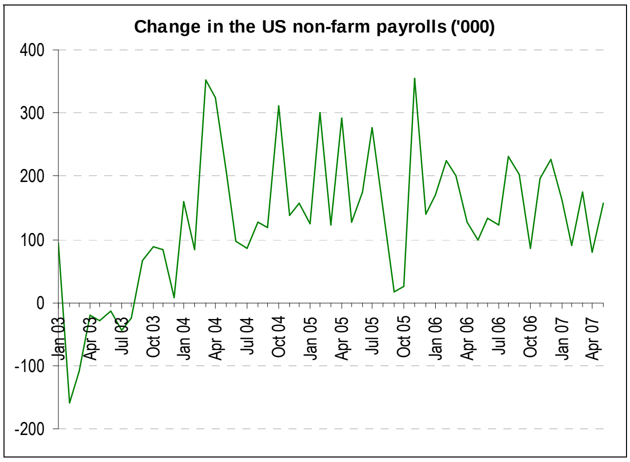
Source: Ministry of Finance, Reuters, BZ WBK

International review









Source: Reuters, ECB, Federal Reserve

More rate hikes expected in the EMU

- After US central bank left the main interest rate unchanged at 5.25% at its May meeting it emphasised in the statement that the inflation remains still the main concern. The FOMC minutes from the meeting also confirmed fears over core inflation underlining upside risks, which might negatively affect the inflation expectations. In his latest comments Ben Bernanke also concentrated on inflation.
- ECB raised the main interest rate in the euro zone in June by 25 bp to 4.0%. The statement included the expression, that the monetary policy remains accommodative, however this time the communiqué lacked wording on moderate level of rates. ECB still notes upside risks for prices stability in the medium term, among others with regards to high economic activity and good situation in the labour market.

Slight slowdown of core CPI in the US

- Consumer prices in the US rose in April by 0.4%MoM against the expectations of 0.6%MoM. Core inflation was in line with forecasts at 0.2%MoM. In annual terms CPI increased by 2.6% as compared to 2.8%YoY in the previous month and market consensus at 2.7%, while core inflation fell from 2.5%YoY to 2.3%YoY versus the expected 2.4%. Data on producer prices for April, pointed to a rise by 0.7%MoM, while market analysts expected lower rise by 0.6%.
- According to the final data for April inflation in the EMU amounted in April to 1.9%YoY, slightly above the expectations of 1.8%. According to preliminary estimates of the Eurostat inflation in May remained unchanged at 1.9%YoY. Producer price index rose in April by 2.4%YoY, against forecasted 2.3% and 2.7% in March.

High activity indices in the US, downward Q1 GDP revision

- The ISM activity index in the US manufacturing sector rose in May to 55 pt from 54.7 pt in April, while analysts forecasted that the index declined to 54.0. The ISM index for the services sector in the United States rose in May to 59.7 from 56.0 and was above the market expectations of 55.3.
- On the other hand the PMI index for the euro zone fell in May to 55.0 from 55.4 in April, reaching the lowest level in a year. Analyst expected an increase of the index to 55.5 and read it as a signal that the pace of economic growth in the euro zone may fall in the later part of this year after record high growth reached in Q1. The PMI index for the services sector in the EMU rose in to 57.3 from 57.0 against a forecast of 57.1. The employment index increased to 55.6, the highest level in 11 months from 54.1.
- GDP growth in the US was downwardly revised in Q1 to 0.6%, the lowest level in 4 years from the previous estimates of 1.3%. Analysts expected a revision to 0.8%.
- According to new data the Q1 GDP growth in the euro zone amounted to 3.0%, which is a slight correction as compared to the early estimates 3.1%.

Quite good situation in the US labour market

- Data on labour costs in Q1 in the United States after revision pointed to an increase by 1.8%, and on labour productivity by 1.0% against expectations of 1.2% and 1.1% respectively.
- Non-farm payrolls increased in May by 157k and significantly exceeded market forecast of 125k. Simultaneously, data for April and March were slightly downwardly revised. The unemployment rate in May was in line with expectations at 4.5%.

Economic calendar

Monday	Tuesday	Wednesday	Thursday	Friday
11 June	**12**	**13** ***POL: CP*** ***POL: Auction of 30Y bonds*** US: Retail sales (May)	**14** ***POL: Money supply (May)*** EMU: Final HICP (May) US: PPI (May)	**15** ***POL: Balance of payments (Apr)*** JP: BOJ meeting – report after decision US: CPI (May) US: NY Fed index (Jun) US: Industrial output (May) US: Capacity utilization (May) US: Preliminary Michigan (Jun)
18	**19** ***POL: Wages and Employment (May)*** GER: ZEW Index (Jun) US: House starts (May)	**20** ***POL: PPI (May)*** ***POL: Industrial Output (May)*** ***POL: Auction of 5Y bonds***	**21** ***POL: MPC minutes (May)*** US: Philadelphia Fed index (Jun)	**22** ***POL: Core inflation (May)*** ***POL: Business climate (Jun)*** GER: Ifo Index (Jun)
25 US: Home sales (May)	**26** ***POL: Retail sales (May)*** ***POL: Unemployment (May)*** ***POL: MPC meeting*** US: New homes sales (May)	**27** ***POL: MPC meeting – decision*** US: Durable goods orders (May)	**28** EMU: M3 money supply (May) US: Preliminary GDP (Q1) US: Core PCE (Q1) US: GDP deflator (Q1) US: Fed meeting - decision	**29** EMU: Business climate (Jun) EMU: Preliminary HICP (Jun) US: Core PCE (May) US: Chicago PMI (Jun) US: Final Michigan (Jun)
2 July EMU: Manufacturing PMI (Jun) US: Manufacturing ISM (Jun)	**3** EMU: PPI (May) US: Factory orders (May)	**4** ***POL: Auction of 2Y bonds*** US: Independence Day – market holiday EMU: Non-manufacturing PMI (Jun) EMU: Retail Sales (May)	**5** EMU: ECB meeting - decision US: ADP report (Jun) US: Non-manufacturing ISM (Jun)	**6** US: Non-farm payrolls (Jun) US: Unemployment (Jun)
9 ***POL: Treasury bills auction***	**10** US: Wholesale inventories (May)	**11** ***POL: Auction of 10Y bonds***	**12** EMU: GDP (Q1) EMU: Industrial production (May) US: Trade balance (May) US: Federal budget (May)	**13** ***POL: Money supply (Jun)*** ***POL: CPI (Jun)*** ***POL: Balance of payments (May)*** US: Foreign trade prices (Jun) US: Retail sales (Jun) US: Preliminary Michigan (Jul)

Source: CSO, NBP, Finance Ministry, Reuters

MPC meetings and data release calendar for 2007

	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
MPC meeting	30-31	27-28	27-28	24-25	29-30	26-27	24-25	28-29	25-26	30-31	27-28	18-19
MPC minutes	-	-	-	-	24	21	19	23	20	25	22	13
GDP*	-	-	2	-	31	-	-	30	-	-	30	-
CPI	15	15[a]	14[b]	13	15	13	13	14	13	15	14	13
Core inflation	22		23[b]	23	23	22	23	23	24	22	23	21
PPI	19	19	19	20	21	20	19	20	19	18	20	19
Industrial output	19	19	19	20	21	20	19	20	19	18	20	19
Retail sales	29	23	23	25	25	26	-	-	-	-	-	-
Gross wages, employment	16	15	15	17	17	19	16	16	17	15	16	17
Unemployment	29	23	23	25	25	26	-	-	-	-	-	-
Foreign trade	about 50 working days after reported period											
Balance of payments*	2	-	30	-	-	29	-	-	-	-	-	-
Balance of payments	16[c]	12	14	13	18	15	13	13	12	-	-	-
Money supply	12	14	14	13	14	14	13	14	14	-	-	-
NBP balance sheet	5	7	7	6	7	6	6	7	7	-	-	-
Business climate indices	23	22	22	23	23	22	23	23	24	23	23	21

* quarterly data, [a] preliminary data, January, [b] January and February, [c] November 2006, [d] January, [e] February

Source: CSO, NBP

Economic data and forecasts

Monthly economic indicators

		May 06	Jun 06	Jul 06	Aug 06	Sep 06	Oct 06	Nov 06	Dec 06	Jan 07	Feb 07	Mar 07	Apr 07	May 07	Jun 07
Industrial production	%YoY	19.1	12.2	14.3	12.6	11.6	14.8	12.0	5.9	15.4	13.0	11.3	12.4	11.4	9.9
Retail sales [c]	%YoY	13.7	10.7	11.0	11.5	14.5	13.3	13.6	13.3	16.5	17.5	19.2	15.1	15.0	13.8
Unemployment rate	%	16.5	16.0	15.7	15.5	15.2	14.9	14.8	14.9	15.1	14.9	14.4	13.7	13.0	12.6
Gross wages [b c]	%YoY	5.2	4.5	5.6	5.3	5.1	4.7	3.1	8.5	7.8	6.4	9.1	8.4	8.0	7.4
Employment [b]	%YoY	3.0	3.1	3.3	3.5	3.5	3.6	3.8	4.1	3.8	4.3	4.5	4.4	4.4	4.4
Export (€) [d]	%YoY	32.5	16.9	21.0	22.3	18.6	23.4	21.7	8.0	15.5	13.1	15.8	16.3	13.3	10.9
Import (€) [d]	%YoY	29.9	17.2	26.2	22.9	19.2	27.4	21.0	17.2	21.5	12.3	21.7	20.2	16.0	17.2
Trade balance [d]	EURm	-439	-103	-519	-434	-212	-283	-339	-1119	-398	-201	-627	-403	-716	-609
Current account balance [d]	EURm	-374	-300	-527	-646	222	-728	-738	-1201	-733	-561	-539	-413	-716	-529
Current account balance [d]	% GDP	-1.9	-2.0	-2.1	-2.1	-1.9	-2.0	-2.1	-2.3	-2.5	-2.4	-2.4	-2.3	-2.4	-2.5
Budget deficit (cumulative)	PLNbn	-14.6	-17.7	-15.6	-14.5	-14.5	-16.6	-18.5	-25.1	3.1	-3.0	-4.8	-2.1	-5.1	-8.1
Budget deficit (cumulative) [e]	% of FY plan	58.2	70.4	62.3	57.9	57.8	66.3	73.9	100.0	-10.3	10.1	16.1	6.9	16.9	26.9
CPI	%YoY	0.9	0.8	1.1	1.6	1.6	1.2	1.4	1.4	1.6	1.9	2.5	2.3	2.2	2.4
PPI	%YoY	2.3	3.0	3.5	3.3	3.6	3.2	2.5	2.6	3.1	3.5	3.3	2.3	2.1	1.5
Broad money (M3)	%YoY	10.1	11.9	13.0	12.9	13.0	12.3	14.4	15.6	19.3	17.9	18.0	17.8	17.6	16.9
Deposits	%YoY	8.9	11.4	12.3	12.0	11.6	11.4	13.1	15.0	18.4	18.1	17.5	18.0	17.8	17.4
Loans	%YoY	12.4	16.0	16.7	18.0	19.2	19.5	20.7	23.4	25.0	26.5	26.8	28.5	25.9	25.4
USD/PLN	PLN	3.05	3.17	3.15	3.05	3.12	3.09	2.97	2.88	2.98	2.98	2.94	2.83	2.80	2.86
EUR/PLN	PLN	3.90	4.02	4.00	3.90	3.97	3.90	3.82	3.81	3.88	3.90	3.89	3.82	3.78	3.83
Reference rate [a]	%	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.25	4.25	4.25
Lombard rate [a]	%	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.75	5.75	5.75
WIBOR 3M	%	4.15	4.17	4.19	4.19	4.21	4.22	4.20	4.20	4.20	4.20	4.22	4.32	4.44	4.45
Yield on 52-week T-bills	%	4.02	4.20	4.30	4.35	4.44	4.35	4.29	4.20	4.14	4.07	4.23	4.36	4.43	4.35
Yield on 2-year T-bonds	%	4.44	4.75	4.95	4.85	4.87	4.84	4.65	4.54	4.41	4.46	4.55	4.71	4.70	4.75
Yield on 5-year T-bonds	%	5.00	5.33	5.37	5.41	5.31	5.24	5.01	4.91	4.90	4.97	4.98	5.07	5.11	5.25
Yield on 10-year T-bonds	%	5.26	5.54	5.55	5.61	5.48	5.39	5.18	5.10	5.16	5.18	5.18	5.27	5.28	5.40

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] 2006 - % of Dec, 2007 - % of plan

Quarterly and annual economic indicators

		2005	2006	2007	2008	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07
GDP	PLNbn	983.3	1 057.9	1 149.8	1 244.0	242.4	253.9	261.4	300.1	267.1	276.7	282.2	323.8
GDP	%YoY	3.6	6.1	6.2	5.5	5.5	6.0	6.3	6.6	7.4	6.5	5.9	5.4
Domestic demand	%YoY	2.4	6.6	7.2	6.5	5.3	5.4	6.9	8.6	8.6	7.3	6.5	6.6
Private consumption	%YoY	2.0	5.2	5.8	5.5	5.4	4.8	5.6	5.1	6.9	5.5	5.5	5.5
Fixed investments	%YoY	6.5	16.5	17.3	13.0	7.6	14.5	19.3	19.3	29.6	18.0	15.0	14.0
Industrial production	%YoY	4.0	12.5	12.2	10.0	12.4	12.1	12.3	10.8	13.0	11.2	11.9	12.7
Retail sales (real terms)	%YoY	1.5	11.9	14.5	11.0	9.0	11.8	13.8	12.6	17.4	12.9	13.8	14.1
Unemployment rate [a]	%	17.6	14.9	11.5	10.0	17.8	16.0	15.2	14.9	14.4	12.6	11.8	11.5
Gross wages (real terms) [c]	%YoY	1.2	4.2	5.4	5.8	4.3	3.9	4.1	4.5	5.9	5.5	5.7	4.7
Employment [c]	%YoY	1.9	3.2	4.3	4.3	2.6	3.0	3.4	3.8	4.2	4.4	4.3	4.1
Export (€) [b]	%YoY	17.8	20.2	13.5	15.0	23.3	19.5	20.7	18.0	14.8	13.4	13.0	13.0
Import (€) [b]	%YoY	13.4	21.8	16.8	17.0	23.3	19.0	22.8	21.9	18.5	17.7	15.5	16.0
Trade balance [b]	EURm	-2 242	-3 896	-7 660	-11 080	-352	-646	-1 165	-1 733	-1 226	-1 729	-1 932	-2 773
Current account balance [b]	EURm	-4 130	-6 273	-7 960	-9 780	-1 396	-1 266	-949	-2 662	-1 833	-1 659	-1 241	-3 227
Current account balance [b]	% GDP	-1.7	-2.3	-2.6	-2.9	-1.9	-2.0	-1.9	-2.3	-2.4	-2.5	-2.5	-2.6
Budget deficit (cumulative) [a]	PLNbn	-28.6	-25.1	-26.0	-30.0	-9.0	-17.7	-14.5	-25.1	-4.8	-8.1	-17.0	-26.0
Budget deficit (cumulative) [a]	% GDP	-2.9	-2.4	-2.3	-2.4	-	-	-	-	-	-	-	-
CPI	%YoY	2.1	1.0	2.1	2.6	0.6	0.8	1.4	1.3	2.0	2.3	1.9	2.4
CPI [a]	%YoY	0.7	1.4	2.6	2.8	0.4	0.8	1.6	1.4	2.5	2.4	1.9	2.6
PPI	%YoY	0.7	2.5	2.4	3.0	0.9	3.0	3.6	2.6	3.3	2.0	1.6	2.8
Broad money (M3) [a]	%YoY	10.5	15.6	14.4	13.9	9.8	11.9	13.0	15.6	18.0	16.9	15.9	14.4
Deposits [a]	%YoY	9.4	15.0	15.0	12.0	9.1	11.4	11.6	15.0	17.5	17.4	17.1	15.0
Loans [a]	%YoY	11.8	23.4	22.3	18.0	13.6	16.0	19.2	23.4	26.8	25.4	24.3	22.3
USD/PLN	PLN	3.23	3.10	2.87	2.86	3.19	3.14	3.10	2.98	2.97	2.83	2.85	2.82
EUR/PLN	PLN	4.02	3.90	3.82	3.72	3.83	3.95	3.96	3.85	3.89	3.81	3.84	3.76
Reference rate [a]	%	4.50	4.00	4.50	4.75	4.00	4.00	4.00	4.00	4.00	4.25	4.50	4.50
Lombard rate [a]	%	6.00	5.50	6.00	6.25	5.50	5.50	5.50	5.50	5.50	5.75	6.00	6.00
WIBOR 3M	%	5.29	4.21	4.48	4.93	4.29	4.15	4.20	4.20	4.20	4.40	4.63	4.70
Yield on 52-week T-bills	%	4.92	4.18	4.41	4.75	4.02	4.06	4.37	4.28	4.14	4.38	4.52	4.60
Yield on 2-year T-bonds	%	5.04	4.57	4.76	5.20	4.23	4.49	4.89	4.67	4.47	4.72	4.85	5.00
Yield on 5-year T-bonds	%	5.25	5.03	5.21	5.55	4.67	5.04	5.36	5.05	4.95	5.14	5.30	5.45
Yield on 10-year T-bonds	%	5.24	5.22	5.39	5.75	4.83	5.27	5.55	5.22	5.17	5.32	5.45	5.60

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

This analysis is based on information available until 12.06.2007 has been prepared by:

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