



TOP NEWS FROM THE POLISH MARKET

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- M. Pietrewicz: CPI rise should be moderate, no need to hike rates
- S. Skrzypek: no serious threat to inflation, NBP target should be treated symmetrically
- We expect the MPC to raise interest rates by 25 bps in April
- MinFin sees inflation to edge up to 2.4% in March
- The unemployment rate fell to 14.4% in March, far below the earlier estimates
- Very strong budget data - the budget deficit to amount to 14-15% of the plan after March
- Polish government sees savings at 1% GDP within 2 years, but higher pace of economic growth and savings related to consolidation and reorganization of public finances may prove to be insufficient

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MACROECONOMICS

A. Sławiński: economic growth clearly above potential, in such cases interest rate hike is necessary

J. Czekaj: rate hikes will come within months rather than quarters

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S. Skrzypek: no serious threat to inflation, NBP target should be treated symmetrically

We expect the MPC to raise interest rates by 25 bps in April

MinFin sees inflation to edge up to 2.4% in March

Last week brought a number of comments from MPC members that in general confirm our view that the majority required to raise interest rates by 25 bps may be formed in April.

A. Sławiński claims that the MPC should decide to raise interest rates as the economy is clearly growing above potential. He added that the overheating of the economy may lead to an excessive rise in wages, above the levels implied by productivity growth. His message is directly characterized by one statement – when output grows above potential, central banks buy insurance from higher inflation by tightening the monetary policy. Sławiński admits that the CPI outlook is fairly stable and the rise in inflation should not be dramatic, but an early reaction by the MPC may be rationalized by the forward looking character of the monetary policy.

J. Czekaj underlined that the probability of interest rate hikes is higher than keeping them unchanged, and repeated that the hike horizon should be counted in months rather than in quarters. He pointed to some conditions under which a hike would not be necessary – if the growth rate dropped to 5%, but this should rather be considered a hypothetical condition, as the MPC is seeing significantly higher growth rates at the moment. Czekaj also added that the hike may be difficult to justify with CPI below target, but with significant risks surrounding the CPI path in the next year, “we are in the MPC to make such difficult decisions as well”.

On the other hand, M. Pietrewicz reckons the interest rates should be kept unchanged in the first half of the year. In his opinion the economic growth remains well balanced and wages growth is still moderate. He does not exclude a rise in CPI, but the rise should be moderate and the CPI will remain below 2.5% in 2008 as well. He also underlined significant growth in potential output, which should diminish inflationary pressure. Among factors which will influence inflationary outlook in the coming months Pietrewicz included full GDP data.

Finally, the NBP President S. Skrzypek stated that CPI in the years 2008-09 should not significantly exceed 2.5%, though the MPC should monitor developments regarding the labour market and the output gap very closely. He also expects the inflationary projection to be significantly lower than the previous one. Skrzypek added that the MPC should treat the target symmetrically.

Our comment:

We expect the MPC to raise interest rates in April by 25 bps. Recent statements by the majority of MPC members (Sławiński and Czekaj in particular) seem to confirm that view. Most MPC representatives are already certain that the economic growth in Q1 exceeded the potential. Monthly data available so far (and the data forecasted for March), indicate that the growth rate probably exceeded 7% y/y. Even with a fairly safe CPI path this year, we think the MPC will address rising risks to next year's inflation path (closing output gap, expected further pick up in wages growth) by such a preemptive hike.

According to the Ministry of Finance, March's inflation rate is to edge up to 2.4% y/y vs. 1.9% recorded in February. Deputy finance minister K. Zajdel-Kurowska sees a bounce in the annual inflation rate as related to higher food and fuel prices. Note that temporarily higher inflation for March has been widely anticipated by the analysts, as it partly resulted from a low base effect. The base effect will, however, dampen both headline and core inflation in April. Purely statistical effects may also affect the inflation in July, when it may drop to below 2%. We expect that demand driven inflationary pressure will become more visible in autumn, when the headline inflation may rise to 2.5% and the core inflation exceeds 2.0%.

The unemployment rate fell to 14.4% in March, far below the earlier estimates

Very strong budget data - the budget deficit to amount to 14-15% of the plan after March

Polish government sees savings at 1% GDP within 2 years

Higher pace of economic growth and savings related to consolidation and reorganization of public finances may prove to be insufficient

The Ministry of Labour and Social Affairs announced that the unemployment rate had fallen to 14.4% in March as compared to 14.9% recorded in February. This figure is much better than our earlier estimates and had not been anticipated by neither the analysts nor the ministry. Note that in March seasonal factors usually drive the unemployment rate down by not more than 0.2-0.3 pct. points. The extraordinary drop in unemployment rate clearly indicates a rising labour demand in the Polish economy, which in our opinion is to be linked to the boom in investment (infrastructural investment in particular). We expect the unemployment rate to fall below 13% at the end of the year but, as it seems, the high level of structural unemployment may limit more significant decreases in the unemployment rate in the future

Finance Minister deputy, Mrs. Suchocka-Roguska announced that the budget deficit after March may amount to 14-15% of the plan, i.e. about 4.5 bn PLN. The earlier estimates of the ministry stood at 18%. Both actual and earlier estimates are much lower than the 22% officially scheduled. It also did not come as a surprise when Mrs. Suchocka-Roguska noted that the whole year deficit may be lower than the plan. For now it is very likely that the budget revenues will surpass the plan and the social transfers will be limited due to a stronger labour market. In our opinion, the full year figure will, however, depend on the implementation of tax rate cuts scheduled for the second half of 2007.

The Polish government announced consolidation and reorganization of public finances. The fiscal strategy presented last week assumes liquidation of over 10,000 local government funds and some 4000 other agencies and funds. Among the key moves deputy prime minister Gilowska sees the introduction of external audits for all public spending and shifting the farmer social security system KRUS and social security office ZUS back to the central government budget and thus limiting their ability to take external debt. The consolidation, according to the government's estimates may bring 10 bn PLN savings within 2 years. For now it is difficult to assess the credibility of these estimates, as it is not clear how ineffective the public finances system is in its current form. Moreover, the target funds to be established in place of agencies and special funds will have very similar duties and thus the savings related to liquidation of employment overhang may be limited. We cannot rule out that the 10 bn PLN saving seen by the government includes some amounts related to a reduction of social transfers and in general is attributable to faster economic growth.

As a counterweight to the budget savings newly announced we see spending related to the valorization of pensions, which is to be introduced starting in 2008, the decline in revenues associated with the tax reduction plan and spending related to the pro-family programme, aimed to increase the shrinking population in Poland. The proposed valorization assumes that the pensions will be adjusted by the inflation rate and 20% of the real wage growth. The cost for the 2008 budget will amount to 5.7 bn PLN. The decline in revenues related to the tax reduction plan may exceed 18 bn PLN and the pro-family programme may cost 1 bn PLN. In our opinion higher pace of economic growth and savings related to consolidation and reorganization of public finances may prove to be insufficient to compensate for the decline in revenues due to tax cuts, valorization and the pro-family programme. Therefore, we expect that the government may eventually limit the scale of tax cuts to come in 2008.

FIXED INCOME

Very quiet week on the market

Last week, with the holidays ahead, the market stayed within very narrow spread amid low turnover. This week also starts fairly quiet, and it might stay this way till CPI data scheduled for Friday. However tomorrow's 10y bond auction may worsen the sentiment a little, as 1.8bio seems a lot, and we don't expect this auction to be very successful one. We stick to our bearish view on

the curve, we think there is still room for the rates to go up, and the downside potential seems very limited. Therefore we recommend pay position across the curve.

RECOMMENDATION:

Pay rates.

MONEY MARKET

Carry above the main rate

Carry above the main rate just as we were forecasting last week. Shortage of the money will also be visible next week, since again the CB offered too many money bills compared to their own liquidity projection. Moreover, the system again bought the whole amount. OMO size was 20 billion PLN versus 22.2 billion PLN last week. The reduction rate remained very low (15.77%) and maybe this unimportant fact makes the CB happy. To sum up next week's carry above the main rate.

Probability of rates hike in April is growing

Slightly higher than expected March CPI projection by MinFin (2.4%) plus frequent bearish comments from the MPC side keep the rates high. Probability of the hike in April is growing. Substantially lower budget deficit according to the plan (14% vs 22%) seemed to be unnoticed.

T-bills yield up

The average yield on the Polish benchmark 52-week T-bill sharply up to 4.37% from 4.26%. This movement was fully expected since other MM curves were way higher. The Ministry sold all 1 billion PLN of 52-week with the demand of 1,54 billion PLN.

RECOMMENDATION:

Pay 3M, receive 6M.

FOREIGN EXCHANGE

Zloty stronger

Last week the Zloty strengthened. EUR/PLN declined to 3.8400 whereas USD/PLN to 2.8670. The EUR/USD traded around 1.3420.

Volatility lower

As a result of the appreciating Zloty, we saw another sell-off of volatilities last week. The volatilities have declined in short tenors only: 1Y EUR/PLN remained at 6.3 (mid) on Friday close, 1Y USD/PLN at 8.2. 1M EUR/PLN dropped from 6.3 to 6.1, whereas 1M USD/PLN from 8.2 to 8.1.

RECOMMENDATION:

Zloty stable/bullish

Spot:
Main supports / resistances:
EUR/USD: 1.3275 / 1.3450
EUR/PLN: 3.8200 / 3.8600
USD/PLN: 2.8500 / 2.9100

In the following week we still may see Zloty trade within a range, however due to recent strong appreciation, we may see a correction this week up to 3.8600 (EUR/PLN). That is why we recommend selling EUR/PLN around 3.8600.

Short Gamma

Options:

Given that EUR/PLN remains within a range, we still recommend shorting Gamma.

MARKET PRICES UPDATE**MONEY MARKET RATES**

| Money market rates (Closing mid-market levels) | | | | | | |
|--|-------|-------|-------|-------|-------|-------|
| date | 3M | | 6M | | 1Y | |
| | FXSW | WIBOR | FXSW | WIBOR | FXSW | WIBOR |
| 02-04-07 | 4.18% | 4.24% | 4.33% | 4.44% | 4.57% | 4.64% |
| 03-04-07 | 4.18% | 4.24% | 4.33% | 4.44% | 4.57% | 4.64% |
| 04-04-07 | 4.22% | 4.24% | 4.41% | 4.46% | 4.66% | 4.64% |
| 05-04-07 | 4.23% | 4.27% | 4.42% | 4.47% | 4.66% | 4.67% |
| 06-04-07 | 4.23% | 4.29% | 4.41% | 4.47% | 4.66% | 4.68% |

FRA MARKET RATES

| FRA Market Rates (Closing mid-market levels) | | | | | |
|--|-------|-------|-------|-------|-------|
| date | 1X4 | 3X6 | 6X9 | 9X12 | 6X12 |
| 02-04-07 | 4.41% | 4.53% | 4.71% | 4.82% | 4.81% |
| 03-04-07 | 4.41% | 4.57% | 4.73% | 4.85% | 4.82% |
| 04-04-07 | 4.42% | 4.60% | 4.75% | 4.88% | 4.83% |
| 05-04-07 | 4.42% | 4.59% | 4.74% | 4.87% | 4.82% |
| 06-04-07 | 4.42% | 4.58% | 4.77% | 4.87% | 4.83% |

FIXED INCOME MARKET RATES

| Fixed Income Market Rates (Closing mid-market levels) | | | | | | | | |
|---|-------|-------|-------|--------|-------|--------|-------|--------|
| date | 1Y | | 2Y | | 5Y | | 10Y | |
| | WIBOR | TB | IRS | OK1208 | IRS | PS0511 | IRS | DS1017 |
| 02-04-07 | 4.64% | 4.37% | 4.88% | 4.61% | 5.07% | 5.05% | 5.15% | 5.23% |
| 03-04-07 | 4.64% | 4.37% | 4.90% | 4.62% | 5.07% | 5.03% | 5.15% | 5.22% |
| 04-04-07 | 4.64% | 4.37% | 4.89% | 4.61% | 5.06% | 5.03% | 5.15% | 5.22% |
| 05-04-07 | 4.67% | 4.38% | 4.89% | 4.62% | 5.06% | 5.02% | 5.15% | 5.21% |
| 06-04-07 | 4.68% | 4.38% | 4.88% | 4.62% | 5.07% | 5.02% | 5.14% | 5.21% |

PRIMARY MARKET RATES

| Last Primary Market Rates | | | | | | | |
|---------------------------|----------|----------|-----------|-----------|--------|--------|------|
| | au. date | maturity | avg price | avg yield | supply | demand | sold |
| 52W TB | 07-04-02 | 08-04-02 | 95.766 | 4.37% | 900 | 1543 | 900 |
| OK0709 | 07-04-04 | 09-07-25 | 89.970 | 4.69% | 1000 | 2463 | 1000 |
| PS0412 | 07-03-21 | 12-04-25 | 99.009 | 4.97% | 1800 | 4979 | 1800 |
| DS1017 | 07-01-10 | 17-10-25 | 100.070 | 5.24% | 1800 | 4148 | 1800 |

FX VOLATILITY

| date | USD/PLN 0-delta stradle | | | | 25-delta RR | | 25-delta FLY | |
|----------|-------------------------|------|------|------|-------------|------|--------------|------|
| | 1M | 3M | 6M | 1Y | 1M | 1Y | 1M | 1Y |
| 02-04-07 | 8.10 | 8.10 | 8.20 | 8.20 | 1.20 | 1.30 | 0.35 | 0.60 |
| 03-04-07 | 7.75 | 8.20 | 8.30 | 8.30 | 1.20 | 1.30 | 0.35 | 0.60 |
| 04-04-07 | 7.75 | 8.20 | 8.30 | 8.30 | 1.20 | 1.30 | 0.35 | 0.60 |
| 05-04-07 | 7.50 | 8.15 | 8.20 | 8.20 | 1.20 | 1.30 | 0.35 | 0.60 |
| 06-04-07 | 7.20 | 8.00 | 8.20 | 8.20 | 1.20 | 1.30 | 0.35 | 0.60 |

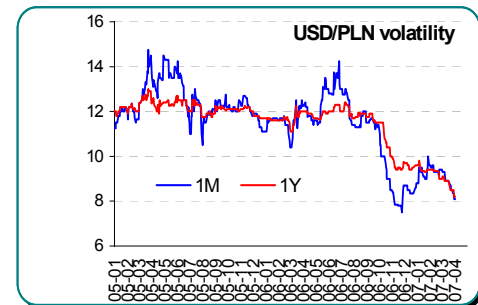
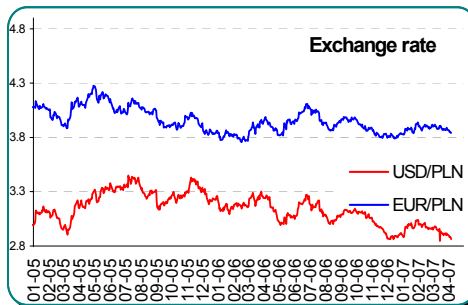
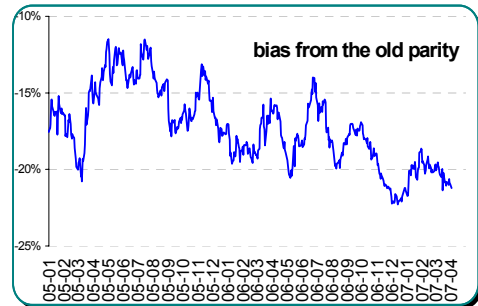
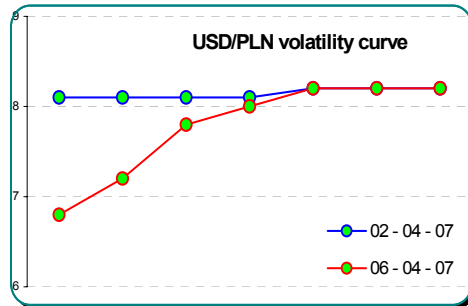
PLN SPOT PERFORMANCE

| PLN spot performance | | | |
|----------------------|---------|---------|---------|
| date | USD/PLN | EUR/PLN | bias |
| 02-04-07 | 2.8930 | 3.8623 | -21.21% |
| 03-04-07 | 2.8817 | 3.8515 | -21.47% |
| 04-04-07 | 2.8846 | 3.8509 | -21.44% |
| 05-04-07 | 2.8746 | 3.8420 | -21.66% |
| 06-04-07 | 2.8629 | 3.8415 | -21.80% |

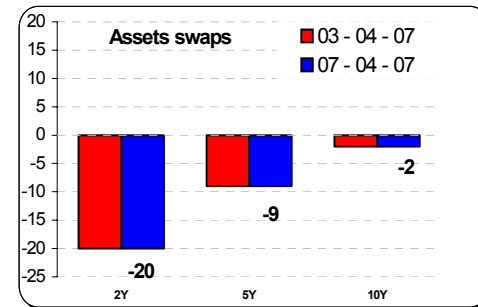
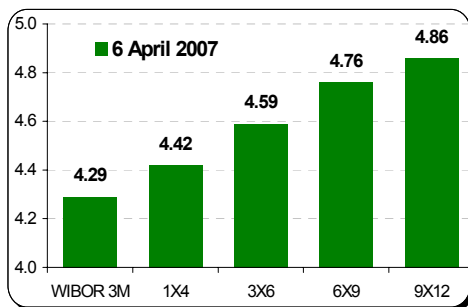
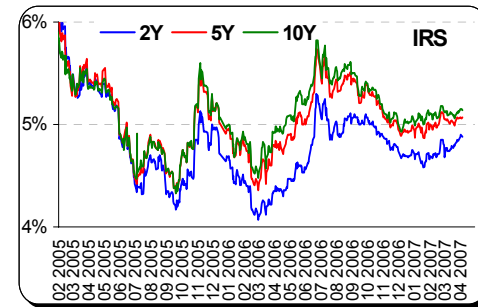
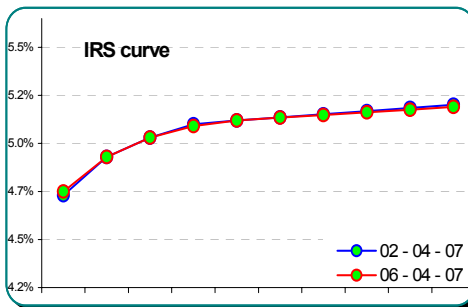
Note: parity on 11/04/00 – USD= 4.3806, EUR=4.2196, basket share 50:50
Mid-market volatility of vanilla option strategies

CHARTS

Foreign Exchange



Fixed Income



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CALENDAR

Macro

| | January | February | March | Data Release | BRE Bank forecast |
|--|---------|----------|-------|--------------|-------------------|
| CPI m/m | 0.4% | 0.3% | | 13-04-07 | 0.4% |
| CPI y/y | 1.6% | 1.9% | | 13-04-07 | 2.4% |
| PPI m/m | 0.6% | 0.3% | | 20-04-07 | 0.7% |
| PPI y/y | 3.1% | 3.6% | | 20-04-07 | 3.5% |
| Industrial production growth m/m | 0.2% | -2.1% | | 20-04-07 | 15.3% |
| Industrial production growth y/y | 15.4% | 12.9% | | 20-04-07 | 11.8% |
| Average wages in enterprise sector [PLN] | 2663.6 | 2687.5 | | 17-04-07 | 2791.0 |
| Average wages in enterprise sector y/y | 7.8% | 6.5% | | 17-04-07 | 6.8% |
| Unemployment | 15.1% | 14.9% | | 24-04-07 | 14.6% |
| Budget realisation (%) | -10.3% | 10.1% | | 15-04-07 | 14.0% |
| Current account [EUR mn] | -678 | | | 13-04-07 | -725 |
| Balance of foreign trade in goods (transaction basis) [EUR mn] | -387 | | | 13-04-07 | -585 |
| Exports growth y/y (transaction basis) | 15.5% | | | 13-04-07 | 14.8% |
| Imports growth y/y (transaction basis) | 21.3% | | | 13-04-07 | 19.3% |
| Current account [% of GDP] | -2.1% | -2.2% | | 13-04-07 | -2.2% |
| Money supply (M3) | 485.3 | 490.5 | | 13-04-07 | 498.7 |
| Money supply growth y/y | 19.3% | 17.9% | | 13-04-07 | 19.5% |
| Total PLN loans [PLN bn] | 376.6 | 383.6 | | 13-04-07 | |
| Households PLN loans | 194.2 | 197.0 | | 13-04-07 | |
| Corporate PLN loans | 144.4 | 148.3 | | 13-04-07 | |
| Total PLN deposits [PLN bn] | 404.7 | 410.7 | | 13-04-07 | |
| Households PLN deposits | 226.3 | 228.6 | | 13-04-07 | |
| Corporate PLN deposits | 124.1 | 126.1 | | 13-04-07 | |
| NBP intervention rate | 4.00% | 4.00% | 4.00% | 30-04-07 | 4.25% |

Auctions

| | next auc. | offer | avg yield last | last auction date |
|-------------------|-----------|-------|----------------|-------------------|
| 13 Week T-bills | - | - | 4.208% | 16-01-06 |
| 26 Week T-bills | - | - | 3.943% | 24-04-06 |
| 52 Week T-bills | 23-04-07 | - | 4.373% | 02-04-07 |
| 2Y T-bond OK1208 | 06-06-07 | - | 4.694% | 04-04-07 |
| 5Y T-bond PS0412 | 18-04-07 | - | 4.967% | 21-03-07 |
| 10Y T-bond DS1017 | 11-04-07 | 1800 | 5.240% | 11-10-06 |
| 20Y T-bond WS0922 | 12-09-07 | - | 5.309% | 14-03-07 |

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