



POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

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PREVIEW: The week of August 6th to August 10th

Indicator	Date of release	Period	BRE forecast	Con-sensus	Last	Comment
No relevant releases of Polish data						

In Focus / Macroeconomics

MPC member Noga predicts the NBP repo rate at 5.50% in mid 2008

Czekaj doggedly considers the wages/productivity ratio as crucial for the further decisions

An ease in inflation during the summer has already been anticipated by the MPC

Any figure above 2.0% would convince the Council that the inflationary risks are mounting

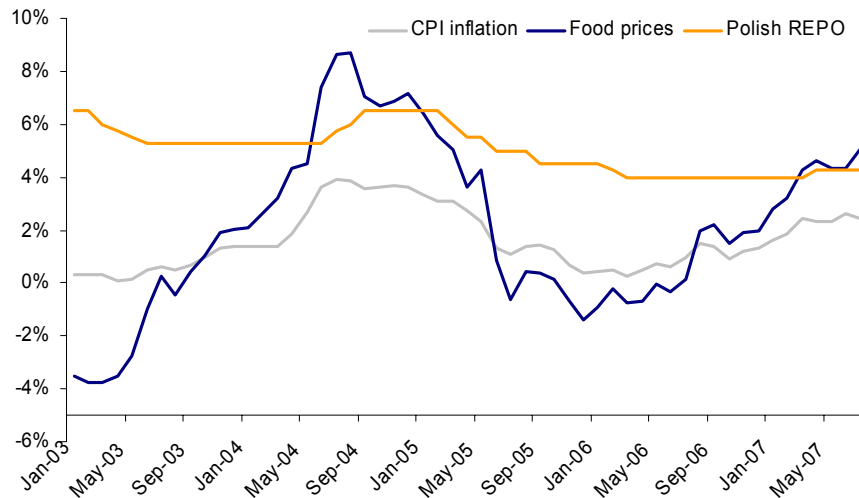
Another pre-emptive strike likely in the very near future

Despite keeping the rates unchanged in July, comments made by the MPC members continue to sound hawkish. Noga, widely regarded as a hawk, said that interest rates in Poland would rise by 50 bps by the end of 2007 and by a further 50 bps in 2008. In his opinion, the GDP constantly remains at levels beyond its potential, which clearly increase inflationary pressure. The major risk factors for inflation are the high capacity utilization and strong growth in consumption. Moreover, he emphasized that the MPC would pay closer attention to the productivity/wages ratio and rising unit labor costs throughout the economy.

A very similar opinion has been expressed by Czekaj - perceived as a swing voter. He claims that, despite the decelerating GDP growth, the MPC would be forced to increase interest rates soon. Moreover, he has suggested an answer to the crucial question of whether the MPC would act if wage growth exceeded productivity: In his opinion "the worst case scenario would be if the GDP growth declines while the growth for domestic demand and wages remain strong. Then inflation would be pushed by costs and pulled by demand simultaneously. In such a case the Council would be forced to hike the rates". This announcement indicates that there is a consensus in the MPC to hike rates in the short term - most likely in August. In the longer term, however, a deterioration in GDP growth may lead to uncertainty about the scale of further tightening. On balance, we believe that pressure over wages in Poland remains strong and will ultimately drive inflation to the upper bands of the inflation target next year. More precisely, we expect inflation to rise to 3.1-3.2% at the end of 2007; exceeding the expectations disclosed by J.Czekaj (2.5-3.0%). Consequently, we consider that the scenario presented by MPC member Noga - with NBP repo rate at 5.50% in the middle of 2008 - seems to be a fairly likely outcome.

Lower inflation in summer not an obstacle for monetary tightening

The release of the July FinMin forecast for inflation and subsequent comments triggered speculations about the possible downside surprise to the fairly well priced-in interest rate hike scenario. Although the FinMin envisages only a limited drop in inflation in July, (inflation rates will possibly decline to 2.4% in July from the 2.6% recorded in June), it predicts that inflation will fall below the 2.0% mark in August. Note that a few months ago analysts projected, on average, that inflation was to significantly ease off in summer owing to high base effect; but rising food prices, especially for fruit, became more and more evident since. We found partial evidence of higher food prices even while examining the detailed breakdown of the FinMin's July inflation forecast (the FinMin has an edge over commercial banks when forecasting realized inflation as it has an access to the VAT tax data and the consequent unit price of goods, but is unlikely to apply more powerful methods while forecasting future inflation). As of today, the ground frost of late Spring is starting to affect the prices of fruits, so that the most recent data from the Polish Agriculture Ministry, and the wheat prices on the European markets are climbing to a five-year high. All this may, according to our estimates, balance the high base effects - owing to extraordinary high pork and poultry prices in August 2006. To our minds, an ease in inflation has been already anticipated by the MPC, and any figure above 2.0% would further act to convince the Council that inflationary risks are mounting. This hypothesis was recently explicitly confirmed by comments made by Noga of the MPC.

MEDIUM-TERM FORECASTS

Indicator	2006	2007	2008
GDP y/y (%)	6.1	6.2	5.7
Inflation rate (%)	1.0	2.4	3.2
Current account (% of GDP)	-2.1	-3.3	-4.1
Unemployment rate (end-of-year)	14.9	10.7	9.9
NBP repo rate (end-of-year)	4.00	5.00	5.50

Source: GUS, NBP, BRE Bank, **bold** change on last week

Fixed Income

Polish debt market unaffected by sell-off in the global credit market

Last week was rather calm on the FI market. Despite huge sell-off in the credit markets, which spilled over some high yielding currencies, PLN market remained rather unaffected. Looking from a bigger perspective one should expect higher volatility on the rates: probability of early elections is growing, predictability of the MPC is dropping, economic outlook is less certain, international environment is very unclear. However, the facts are that PLN has become one of the least volatile markets in the region. We think that this situation is due to rebalancing of positions that have happened over the last 2 months, we think that market position is relatively neutral and it is hard to expect any big moves in the nearest future. With market almost fully pricing hike in August we remain on the sidelines and we still prefer paying spreads, especially 1y2y and 1y5y (especially that market is playing other way round). We have two reasons standing behind - forward curve is negative past 2y and we think we are pricing almost no risk to such factors as negative outcome from elections, further risk unwinding trades, worsening of economic picture. Outright we run flat positions.

RECOMMENDATION:

Pay 1y2y and 1y5y

AUCTIONS

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	4.208%	16/01/2006
26 Week T-bills	-	-	3.943%	24/04/2006
52 Week T-bills	06/08/07	-	4.816%	09/07/2007
2Y T-bond OK1209	05/09/07	-	5.185%	01/08/2007
5Y T-bond PS0412	19/09/07	-	5.480%	20/06/2007
10Y T-bond DS1017	10/10/07	-	5.658%	11/07/2007
20Y T-bond WS0922	12/09/07	-	5.309%	14/03/2007

Money Market

Very cheap end of the reserve period

Some comments from the MPC members in opposition to the official statement

Fly to quality

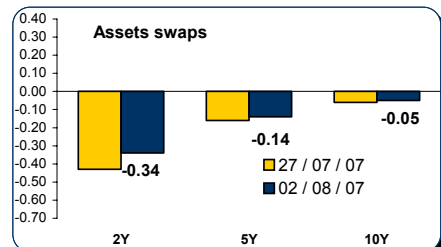
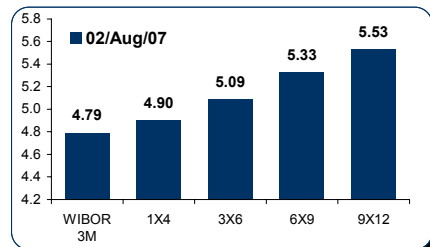
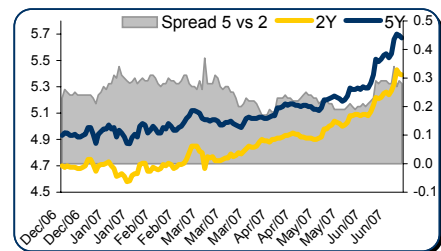
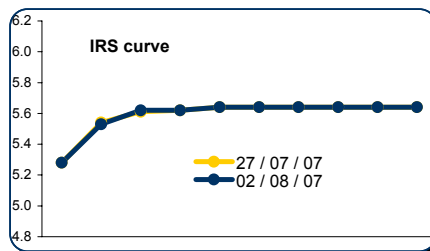
RECOMMENDATION:

FIXED INCOME & MONEY MARKET CHARTS

Extremely cheap end of the reserve was quite a surprise for everyone. The central bank offered PLN 23 bn of money bills which would square the market; however the market bought only PLN 16 bn of the papers. Hence, huge surplus of the cash occurred just at the end of the reserve period, which always ends up one way, deposit in the central bank at 3%. What was the reason of such a low demand? Maybe someone made a mistake sending the mistyped offer or maybe the market did not like to repeat last months squeeze and it cumulated like this? Anything is possible.

As for longer terms just after dovish MPC statement, some of the MPC members gave few just opposite comments. The market became a bit confused and good sentiment disappeared. If we add global escape from the emerging markets we have the big picture. Rates moved up, and they should stay at current levels until next figures are released. Yesterday we had CPI forecast by MinFin which was not too optimistic (2.4% against lower expectations). August rates hike very likely.

Build pay position before the figures.



Foreign Exchange

Zloty in a range

Volatility consolidating

This week zloty was still driven by global sentiment variations in 3.7840-3.8140 range. Correlation with EURJPY cross was approaching 100%. We are expecting zloty to gradually regain its ivalue, with 3.7700 as first support and long term resistance at 3.8200.

Implied volatility hasn't really moved much. Trading underlying asset on higher levels with worse sentiment even lowered 1Y from 6 to 5.9 and 1M to 6.3 from 6.7. In our opinion it indicates further fall in implied volatility when spot calms down.

RECOMMENDATION:

Zloty stronger

RECOMMENDATION:

Spot:
 Main supports / resistances:
 EUR/PLN: 3.7700 / 3.8200
 USD/PLN: 2.7400 / 2.8100

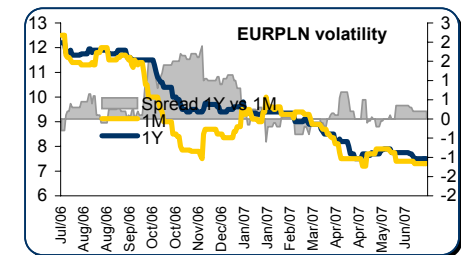
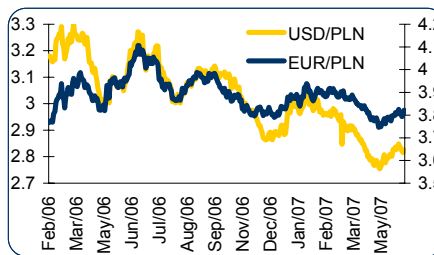
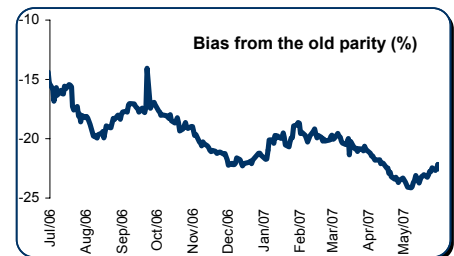
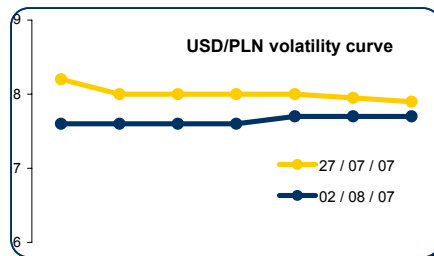
We have bought zloty ag EUR at 3.8200 targeting 3.7700 with the stop loss at 3.8400.

Options:

Sell Vega via puts

We sold EUR put PLN calls in 6 mth and 1 year with the aim to have a negative vega when PLN will regain these uptrend. We hope that longer term volatility will turn south again.

FX CHARTS



MARKET PRICES UPDATE**MONEY MARKET RATES**

Money market rates (Closing mid-market levels)						
date	3M		6M		1Y	
	FXSW	WIBOR	FXSW	WIBOR	FXSW	WIBOR
27/07/07	4.80%	4.79%	4.95%	4.95%	5.24%	5.24%
30/07/07	4.81%	4.79%	4.95%	4.96%	5.24%	5.25%
31/07/07	4.81%	4.79%	4.95%	4.96%	5.24%	5.27%
01/08/07	4.81%	4.79%	4.95%	4.96%	5.24%	5.27%
02/08/07	4.81%	4.79%	4.95%	4.96%	5.24%	5.27%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)					
date	1X4	3X6	6X9	9X12	6X12
27/07/07	4.87%	5.07%	5.33%	5.53%	5.47%
30/07/07	4.87%	5.08%	5.33%	5.53%	5.47%
31/07/07	4.90%	5.09%	5.33%	5.53%	5.47%
01/08/07	4.90%	5.09%	5.33%	5.53%	5.47%
02/08/07	4.90%	5.09%	5.33%	5.53%	5.47%

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
27/07/07	5.24%	4.72%	5.53%	5.10%	5.64%	5.48%	5.64%	5.58%
30/07/07	5.25%	4.72%	5.53%	5.15%	5.64%	5.49%	5.64%	5.59%
31/07/07	5.27%	4.72%	5.54%	5.19%	5.64%	5.50%	5.64%	5.59%
01/08/07	5.27%	4.72%	5.53%	5.19%	5.64%	5.50%	5.64%	5.59%
02/08/07	5.27%	4.72%	5.53%	5.19%	5.64%	5.50%	5.64%	5.59%

PRIMARY MARKET RATES

Last Primary Market Rates							
	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	07/07/09	08/07/09	95.357	4.82%	500	1114	500
OK0709	07/08/01	09/07/25	90.485	5.19%	2000	2084	1399
PS0412	07/06/22	12/04/25	96.925	5.48%	1000	2673	1000
DS1017	07/07/11	17/10/25	96.817	5.66%	1800	2997	1800

FX VOLATILITY

date	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
	1M	3M	6M	1Y	1M	1Y	1M	1Y
27/07/07	8.20	8.00	8.00	7.90	1.00	1.10	0.30	0.35
30/07/07	7.80	7.80	7.80	7.80	1.00	1.10	0.30	0.35
31/07/07	7.40	7.60	7.70	7.70	1.00	1.10	0.30	0.35
01/08/07	7.60	7.60	7.70	7.70	1.00	1.10	0.30	0.35
02/08/07	7.60	7.60	7.70	7.70	1.00	1.10	0.30	0.35

PLN SPOT PERFORMANCE

PLN spot performance			
date	USD/PLN	EUR/PLN	bias
27/07/07	2.7870	3.8095	-23.05%
30/07/07	2.7800	3.7999	-23.24%
31/07/07	2.7653	3.7900	-23.53%
01/08/07	2.7939	3.8125	-22.93%
02/08/07	2.7786	3.7970	-23.29%

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

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