POLAND WEEKLY REVIEW
MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of February 22nd to February 29th

Indicator	Date of release	Period	BRE fore-cast	Consen-sus	Last	Comment
Retail sales y/y	**Feb 25**	Jan	**18.5%**	16.4%	12.4%	Recent fall in retail growth was triggered by the substantial dip of food sales; we see them to rebound, as well as other categories.
MPC decision	**Feb 27**	-	**5.50%**	5.25%	5.25%	Hawkish stance conforming to the scenario sketched by D. Filar has been gaining (at least temporary) support of other MPC members.
GDP y/y	**Feb 29**	Q4	**6.2%**	6.0%	6.4%	Investment remains the main engine of growth.

In Focus / Macroeconomics

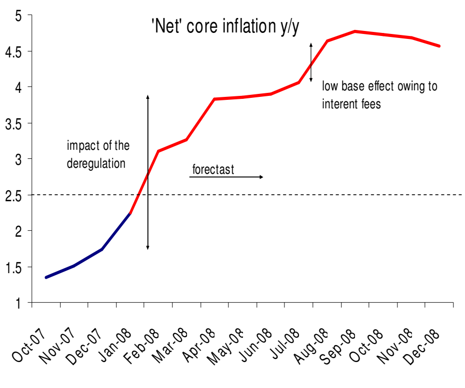
Deregulation of state-controlled prices to boost core inflation to above 4% y/y in 2008

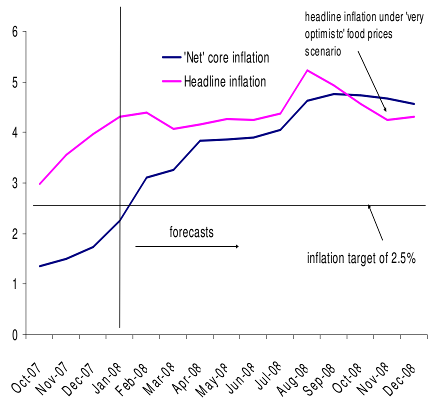
Polish CPI inflation soared to 4.3% y/y in January from 4.0 recorded in December. The rise can be only partially attributed to rising food prices. What seems to be of much higher importance the core inflation, which edged up to 2.2% from 1.7% recorded in December 2007, has been boosted by the deregulation of state controlled prices (litter disposal, water supply and electricity etc.). The information we gathered form the Central Statistical Office and various energy distributors lead us to the conclusion that the deregulation process may boost core inflation to above 4% in the coming months.

Our reasoning is as follows:

- January inflation data have included only the higher prices of energy distribution (40% of the energy bills; the remaining part consist of energy costs itself) and the increase reflected in tariffs reported by some regional energy providers – appropriate bills were sent to consumers in January despite the fact that consumer watchdog allowed the price-lists to be altered no sooner than in February 1.
- Increases of prices of the pure energy (60% of the energy bill), however, will be included in February CPI (apart form the already accounted tariffs of few regional providers), thus the main impact of higher energy prices is about to come.
- According to our estimates, the prices of energy rose in February by 12-16%. Taking into account the 60% weight of the component we may expect another spike in core net inflation (January core measure surged 0.7% m/m; in February we may see another jump of 0.7-0.9% which will lead annual net core inflation beyond 3% mark).
- Other hikes of state-regulated prices to be implemented in spring will lead core inflation to above 3.5%; price of natural gas is likely to increase by 15-30% starting from April 1. Moreover, another increase in energy prices cannot be ruled in late spring.

Taking into consideration the second-round impacts of the controlled prices hikes (increases in producer prices and higher prices in other categories in CPI basket, with hotels and restaurants as the most obvious example) we expect the core inflation to reach the interval 3.5-4.5% at the end of 2008. One should note that the persistence in inflationary processes may be additionally-fuelled by soaring wages and employment - contributing to fast rises of wage fund. Employment increased 5.9% y/y in January and wages jumped to annual 11.5%. Though the rises have been mainly generated by the change of the sample on which the Statistical Office performs calculations, fast growing enterprises are those who can afford to pay a better remuneration - the data only confirms that the so far published figures were biased, leading straight to conclusion that this year the internal demand will still play havoc with core inflation measures.





In our opinion a substantial rise of core inflation will probably neutralize the widely expected (mostly by the MPC members) fall of prices of food and fuels, allowing the CPI inflation to stay above the upper bound of the Central Bank's tolerance band.

Infectious hawkish stance among the MPC members

Hawkish MPC fraction lost much steam along with the release of December figures. However, February publications altered the picture significantly. Bearish figures (probably together with “raw output” of inflation projection) made D. Filar picture the most hawkish scenario – since then we observe a gradual proliferation of such an attitude among other rate-setters. It seems the local factors have once again gained on importance, driving rate expectations upwards.

Professor Filar regards the reference rate at 5.75-6% as the one guaranteeing a gradual return of inflation towards the target. In his opinion, the best timing of hikes is Q1 – it is then when the monetary policy has the greatest influence on inflation. He sees the fast tightening as the action influencing inflation expectations, making expected second-round effects less severe. Professor Filar believes that the sketched scenario would allow the MPC to lower the rates in 2009 i.e. in times when economic growth may loose some steam. Commenting on this scenario we could not believe that such an extreme view, directly conforming to the mid term objective of the euro adoption, might find much support among the other members. In fact, it appears now it really did.

The clues offered by H. Wasliewska-Trenkner, M. Noga and A. Wojtyna suggest their stance remains hawkish. Recent comments released by S. Owsiak (to be honest – so far quite press-inactive MPC member) suggest the hawkish moods are gaining support relatively fast. He estimates economic growth quite optimistically at 6% in 2008 and largely neglects any influence of the slowdown in the U.S. citing buoyant domestic demand. In his opinion, recent releases of CPI and wages have considerably reduced the range of possible MPC movements. Professor Owsiak regards the occurrence of the second-round effects as highly probable and says he “cannot rule out a hike in February”.

S. Owsiak belongs to the more reserved wing of the MPC. That is why his statement gives a good impression not only about his own, private comments, but also about the tone of discussion running within the MPC. We think there is a good chance that 25 bps. base rate increase will be put under consideration already in February and will gain sufficient support.

MEDIUM-TERM FORECATS

Indicator	2006	2007	2008
GDP y/y (%)	6.1	6.5	5.6
Inflation rate (%)	1.0	2.4	4.0
Current account (% of GDP)	-2.1	-4.5	-5.3
Unemployment rate (end-of-year)	14.9	11.4	9.8
NBP repo rate (end-of-year)	4.00	5.00	**6.00**

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

Fixed Income

Inflation becoming an issue again.

Set of economic data published recently has changed the sentiment significantly. Apparently the whole rally was based mainly on one lower industrial output data, that caused some worriness about economic growth. However this doesn't seem to be a problem at all, the problem we can be facing in the nearest future is inflation. For the past few month market was influenced by opinions that inflation would somehow slow down by itself, without any actions taken against it. But it seems that, beeing neglected by everyone, inflationary pressure has been building up in the background and now we start seeing it in the data. Furthermore, predicted price increases along with wages demands don't make the picture any more positive. Even the rethorics of council members if changing, dovish council memebers 'do not exclude hike during the next meeting'. Looking at current CPI level, we cannot imagine next inflation projection to show inflation going close to the target i second half of the year. We think MPC will finally have to undertake necessary actions. From that perspective, we think current short end yields are low and we recommend building pay positions up to 2y and using any strenghtenings to add to these positions. We're more positive for the long end of the curve - wide spread to the euro curve, rating outlook and talks about possible euro-zone entry limit losses and give some room for strengthening.

RECOMMENDATION:

Pay short end. Add on dips.

AUCTIONS

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	4.208%	1/16/2006
26 Week T-bills	-	-	3.943%	4/24/2006
52 Week T-bills	3/10/2008	-	5.652%	2/11/2008
2Y T-bond OK0709	4/4/2008	-	6.189%	1/2/2008
5Y T-bond PS0413	3/5/2008	-	5.729%	2/6/2008
10Y T-bond DS1017	4/9/2008	-	5.785%	2/13/2008
20Y T-bond WS0922	5/14/2008	-	5.794%	1/9/2008

Money Market

Carry still above the main rate; Open market operation a little bit larger than expected

As far as liquidity is concerned, last week was quite stable with short rates just above the main market rate. Open market operation (13.5 billion PLN against 13.3 billion PLN maturing papers) was a little bit higher then expected. It is a bit too early to predict rates at the end of the reserve but there were many players selling short Polonia OISs at relatively low levels.

Bearish sentiment after CPI, PPI, IO and wages figures; No signs of recovery in the nearest future

Figures were definitely the highlights of last week. Polish CPI, wages and producer prices rose faster than expected in January, boosting expectation of a rise interest rates on February. Polish producer prices rose 2,8% year-on-year, when analysts had predicted a rise of 2,1%. Statistical office showed CPI grew 4.3% y/y last month, above the 4.1% forecast and up from 4,0% in December. Industrial output rose 10,8%. Those figures brought another bearish wave. It made rates go up 20 bps at the long end of the curve at the end of the week and left us with bearish view for the coming days. MM curve discounts 50 bps rate hikes till the end of the year.

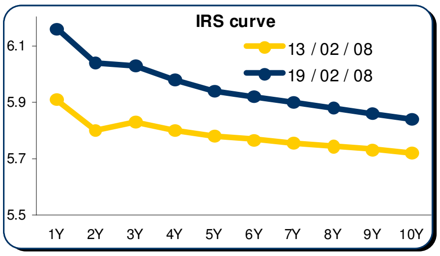
No T-bills auction

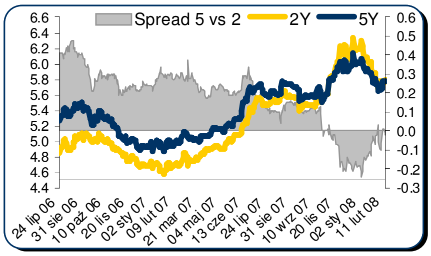
No T-bills auction. Next one is on Monday, 10th of March.

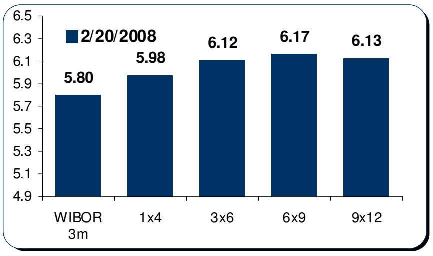
RECOMMENDATION:

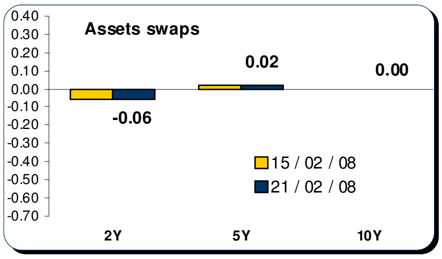
Buy 1Y swaps and Wibor OISs.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty stronger

This week złoty was traded between 3.5650 and 3.5920. Combination of warming global sentiment with both, higher expectations for rate hikes and possibility of rating upgrade made positive outlook for PLN what worked with support testing.

Volatility untouched

With stronger Zloty but still traded in range volatility curve stays untouched.

RECOMMENDATION:

Spot:
Main supports / resistances:
EUR/PLN: 3.5550 / 3.5950
USD/PLN: 2.3800 / 2.4700

Sell on upticks

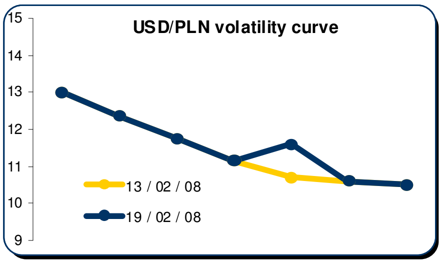
With improving both, global and local sentiment we see selling EURPLN on upticks as most profitable idea these days

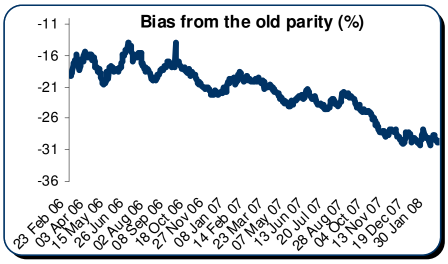
Options:

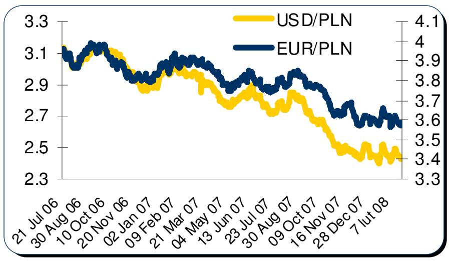
Short EURPLN gamma/Short USDPLN vega

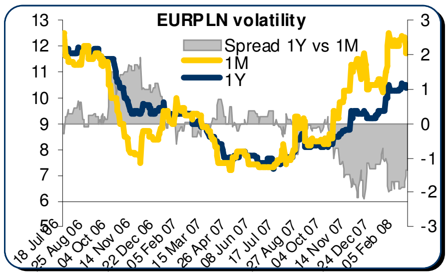
We advice to trade small amounts of short EURPLN gamma. We see 11.0 for 6M and 10.80 for 1Y as good entry level in short USDPLN vega position.

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
13/02/08	5.55%	5.57%	5.73%	5.76%	5.89%	5.99%
14/02/08	5.56%	5.57%	5.77%	5.76%	5.96%	5.98%
15/02/08	5.66%	5.57%	5.89%	5.76%	6.14%	6.00%
18/02/08	5.65%	5.61%	5.85%	5.82%	6.06%	6.06%
19/02/08	5.71%	5.67%	5.90%	5.86%	6.20%	6.07%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
13/02/08	5.77%	5.84%	5.84%	5.80%	5.86%
14/02/08	5.78%	5.87%	5.89%	5.84%	5.94%
15/02/08	5.83%	6.01%	6.03%	5.98%	6.04%
18/02/08	5.89%	6.10%	6.12%	6.12%	6.16%
19/02/08	5.92%	6.09%	6.12%	6.09%	6.15%

FIXED INCOME MARKET RATES

Fixed Income Market Rates (Closing mid-market levels)

date	1Y		2Y		5Y		10Y	
	WIBOR	TB	IRS	OK0709	IRS	PS0511	IRS	DS1017
13/02/08	5.99%	5.08%	5.57%	5.29%	5.72%	5.69%	5.73%	5.76%
14/02/08	5.98%	5.05%	5.57%	5.29%	5.71%	5.68%	5.72%	5.76%
15/02/08	6.00%	5.05%	5.57%	5.34%	5.71%	5.67%	5.71%	5.76%
18/02/08	6.06%	5.05%	5.56%	5.30%	5.71%	5.65%	5.72%	5.75%
19/02/08	6.07%	5.03%	5.56%	5.34%	5.70%	5.68%	5.70%	5.75%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	07/12/03	08/12/03	95.415	5.74%	2000	33116	2000
OK0710	08/01/02	09/07/25	85.730	6.19%	1800	2047	1654
PS0413	08/02/06	13/04/25	97.852	5.73%	2500	4206	2500
DS1017	07/10/10	17/10/25	96.607	5.70%	1800	5061	1800

FX VOLATILITY

	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
date	1M	3M	6M	1Y	1M	1Y	1M	1Y
13/02/08	12.40	11.30	10.80	10.55	0.75	0.85	0.30	0.35
14/02/08	12.35	11.15	10.70	10.50	0.75	0.85	0.30	0.35
15/02/08	12.35	11.15	10.70	10.50	0.75	0.85	0.30	0.35
18/02/08	12.35	11.15	10.70	10.50	0.75	0.85	0.30	0.35
19/02/08	12.35	11.15	10.70	10.50	0.75	0.85	0.30	0.35

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
13/02/08	2.4453	3.5902	-29.55%
14/02/08	2.4461	3.5793	-29.67%
15/02/08	2.4290	3.5759	-29.90%
18/02/08	2.4342	3.5838	-29.75%
19/02/08	2.4255	3.5761	-29.94%

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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