BRE BANK SA

THE BEST FINANCIAL INSTITUTION FOR DEMANDING CUSTOMERS

FINANCIAL MARKETS DEPARTMENT

PAGES: 9

WARSAW, SEPTEMBER 12, 2008

POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of September 12th to September 19th

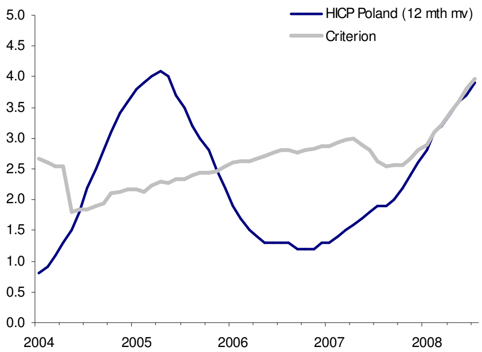
Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
CPI inflation	**15 Sep**	Aug	**4.9%**	5.0%	4.8%	Substantial drop in fuel and food prices. Net inflation up from 3.5% in July to 4.0%. New core inflation measure up from 2.2% to 2.7-2.8%. Annual rate pushed up by arithmetical base effects.
Corporate sector wages	**15 Sep**	Aug	**10.7%**	11.1%	11.6%	Consistent with the underlying trend. Less working days and weaker output on the monthly basis. Wage rise in the main government-owned post company.
Corporate sector employment	**15 Sep**	Aug	**4.5%**	4.5%	4.7%	Deteriorating sentiment indexes for employment both in m/m and y/y terms. Employment reduction seen in manufacturing (sentiment indexes in the negative territory).
Industrial output	**18 Sep**	Aug	**-2.3%**	0.2%	5.6%	Two days less on an annual basis. New orders trending heavily downwards.
PPI inflation	**18 Sep**	Aug	**1.6%**	2.1%	2.3%	Heavily falling PLN-denominated oil prices (16%). 5% fall in PLN-denominated prices of main industrial metals. Stable EUR/PLN and USD/PLN rates. Price expectations of entrepreneurs decreasing by 3.3 pp.

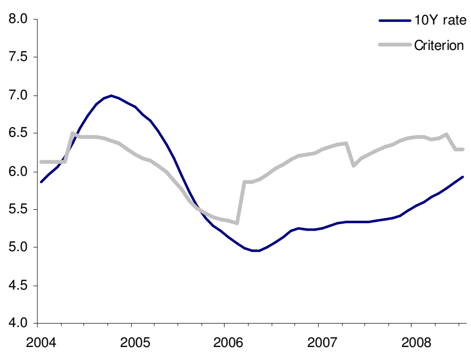
In Focus / Macroeconomics

Polish PM declares joining the euro zone in 2011. The convergence game has started.

The annual Economic Forum gave PM Tusk the opportunity to announce, for the first time since the Civic Platform won the parliamentary elections, 2011 as the possible euro adoption date. This declaration was fully unexpected not only by Forum participants but also by market stakeholders and analysts. Although the plan to join the euro zone in a 3 year's time appears very ambitious and pretty hard to realize, which was admitted by PM Tusk himself, it is not impossible from the legal-technical point of view. Moreover, Polish government showed in that way a strong willingness to adopt the euro soon, while it had been formerly believed to postpone that issue. Hence, this willingness appears even more important than the exact date itself.

Before joining the EMU, Poland has still to meet the set of Maastricht criteria. So far fiscal convergence criteria (public sector deficit below 3% of GDP and public sector debt below 60% of GDP) have been met and the fiscal convergence path put forward by the government seems to be quite realistic (see the piece below). Price convergence (12-month average HICP rate may not exceed the reference value by more than 1.5 pp.) had been not an issue by the end of 2007, but starting from 2008 the rising inflation rate caught-up the reference level and began to co-move with the latter (see chart below). If inflation in Poland rises faster then the EU average, this criterion will be violated, though recent price developments (declining food and energy prices) show that might be only a temporal threat. Nevertheless, it is the HICP data for Poland, as well as the reference level, which should be closely monitored in the coming months.





Some concern arises over the exchange rate stability criterion, as Poland, before joining the euro zone, has to access the ERM-II and the EUR/PLN exchange rate is to remain within the fluctuation band for at least two years. That means the ERM-II would have to be implemented not later as in mid-2009, which is not a problem itself, calling only for a unilateral declaration of the Polish government. However, a serious challenge is posed then for the Polish MPC, which will have in fact to stabilize both the exchange rate and price level. That would not be a simple exercise. Diverging interest rates (see chart above) and contracting economy (watch the industrial output data next week) may clearly limit the scope for further monetary tightening.

Last but not least, it is the Constitution Act, which is to be changed before converting to the euro. There may arise some problems to force such a change, though with a historically strong support of the leading Civic Platform it is not impossible. That would mean the last Maastricht criterion (legislation consistency) has been fulfilled. As 2010 will bring new Parliament elections, it cannot be excluded this matter will be discussed already next year, especially that the Polish MinFin has strongly claimed, it would like to avoid the presence in the ERM-II without legal issues having been clarified.

We cannot rule out that the euro adoption date can be effectively postponed (MPC and government officials point to 2012 as a more realistic date). No one should however expect the PM to stand up and dismiss the news in a way he announced the euro adoption. We would rather expect the government to eventually postpone the euro adoption date in response to certain changes in macroeconomic or political environment. The official announcement of euro adoption date is to push financial markets to re-assess the country risk and price in the more credible convergence path in the weeks and months to come. In short, we declare the convergence game started.

Poland's government approved 2009 budget draft

Poland's government approved 2009 budget draft on Tuesday, as expected setting the deficit at 18.2 PLN bn. The government also cut this year's deficit estimates to 23 PLN bn from 27.1 envisaged in 2008 budget bill. According to the official document, these new estimates have been used to derive the 2009 budget revenues and expenditures projections. Thus, next years revenues have been estimated at 369.9 PLN bn (or 19.5% of GDP), 8.9% up from this year's projected revenues. 2009 budget expenditures are to amount to 369.0 PLN bn (or 20.9% of GDP) 5.3% up from 2008 projected expenditures. Both estimates do not account for EU co-financing.

Turning to the revenues side, 2009 budget sees the tax revenue to decelerate to 9.4% y/y from 11.6% y/y recorded in 2008 mainly due to lower PIT rates (new tax rates are said to reduce the PIT revenues by 8 PLN bn). Given the underlying macroeconomic assumptions (GDP growth at 4.8% - a bit to high in our opinion and average inflation of 2.9% - a bit to low in our opinion) we see the 2009 budget revenues estimates as rather optimistic. The same is evident on the spending side. The government sees the spending to decelerate from this year's 9% y/y to a mere 5.3% y/y. These estimates are, according to the government, justified by lower spending on pensions and social insurance which may be related to both a new legislation aiming at reducing the number of earlier retirements and constantly improving situation on the labor market, which we really doubt to last for long. This notwithstanding, we do not expect the budget to run out of money next year, as the government may use well the same mechanism as in 2007, when budget deficit come out about 10bn below plan, up front paying the pension fund subsidies for the year to come.

Turning to budget financing, Polish government sees borrowing needs to drop to 38.4 PLN bn from 42.7 PLN bn estimated for 2008, 32.5 PLN bn of which will be issued in a form of a local currency denominated debt. These overly optimistic estimates are due to lower deficit and to be accelerated privatization. The MinFin estimates privatization revenues to amount to 12 PLN bn, out of which 6.8 PLN bn is to be used to fund the budget.

Although we assess the revenues and spending reduction estimates as optimistic, we do not see the risk of budget amendment due to the possibility of up front paying various budget subsidies in 2008. Moreover, we do not expect the budget issue to attract much of investors attention, as the outstanding 2008 budget record with YTD budget deficit of 0.7 PLN bn makes it really difficult to believe in budget collapse to come.

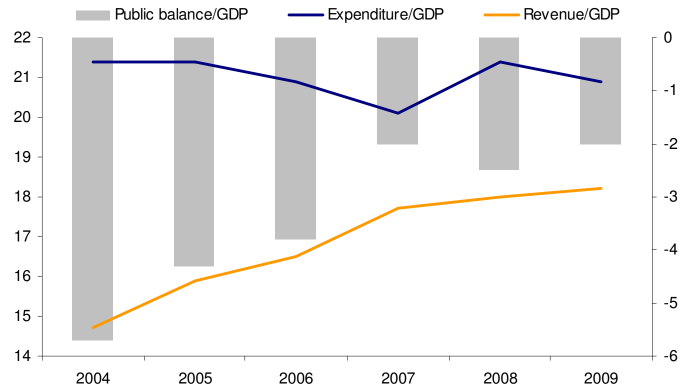
	Plan		Growth (%)	
	2008	2009	2008/2007	2009/2008
Revenue, of which:*	247.8	269.9	8.3	8.9
Taxes, of which:	230.4	252	11.6	9.4
VAT	108.9	119.6	13.0	9.8
PIT	39.2	40.3	10.9	2.7
CIT	28.5	33.1	16.1	16.2

**excl. EU funds*

	Plan		Growth (%)	
	2008	2009	2008/2007	2009/2008
Expenditire, of which:*	273.7	288.1	8.5	5.3
Donations and subventions (incl. social security funds)	132.8	137.6	16.8	3.6
Social transfers	22.2	20.2	-3.5	-9.3
Operating expenditure	61.8	66.8	35.8	8.0
Capital expenditure	16.9	18.1	27.1	7.1
Public debt service	27.8	32.8	1.1	17.9
EU contribution	12.1	12.6	14.2	4.1

**excl. co-financed EU fund projects*

Public balance, expenditure and revenue as % of GDP



MEDIUM-TERM FORECATS

Indicator	2006	2007	2008	2009
GDP y/y (%)	6.1	6.5	5.1	4.0
Inflation rate (%, avegage)	1.0	2.4	4.5	3.7
Current account (% of GDP, average)	-2.1	-4.5	-4.6	-5.3
Unemployment rate (end-of-year)	14.9	11.4	9.8	9.6
NBP repo rate (end-of-year)	4.00	5.00	6.00	5.25

Indicator	2008			2009	
	Q2	Q3	Q4	Q1	Q2
GDP y/y (%)	5.8	4.7	4.0	3.8	3.8
Inflation rate (%, average)	4.3	4.7	4.0	3.9	3.7
NBP repo rate (end-of-quarter)	6.00	6.00	6.00	6.00	5.75

Bold denotes chages from the last release with arrows showing the direction of chages

Fixed Income

ERM2 next year?

Market has been very interesting in recent days. The volatility on the core markets as well as on the FX market is making significant impact on the FI market. However the biggest market driver of the last week was long forgotten politics. PM surprised market by setting Euro entry date to 2011. We don't think it is necessarily the 1 January 2011 that we speak of but nevertheless news was huge enough to make 5y5y forward move 40 bp. down to 45 points over. There is one thing that we would like to strongly underline. ERM 2 entry is positive from rates perspective. Both short term and long term. We question the need for any rate hikes in short or long term. Polish economy has at moment 2 significant assets first is 175 bp premium over Euro repo rate and secondly free floating currency which is poised to strengthen while in ERM 2. It is also worth looking at CPI criteria from a pragmatic perspective. The criteria for the last month was set at 3.9, exactly in the place where Polish HICP came at. Effectively in ERM2 RPP will be not targeting 2%, 2,5% or any given number, but it will be trying to be below reference value, and that is enough to fill Maastricht criteria. It is also worth looking back at picture we had before Mr. Tusk declaration. Simple question we ask is why rates should be higher because of ERM 2 entry? Should they be?

RECOMMENDATION:

Stay receive PLN rates, add 5y IRS receive position at current levels.

AUCTIONS

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	6.061%	4/14/2008
26 Week T-bills	-	-	6.220%	4/14/2008
52 Week T-bills	9/8/2008	-	6.490%	8/18/2008
2Y T-bond OK0710	12/3/2008	-	6.471%	8/6/2008
5Y T-bond PS0413	10/1/2008	-	6.114%	9/3/2008
10Y T-bond DS1017	10/8/2008	-	6.054%	4/9/2008
20Y T-bond WS0922	9/12/2008	-	6.080%	5/14/2008

Money Market

Relatively high cost of carry

Cost of carry relatively high for the whole week due to substantial open market operation last Friday. The central bank offered 14 billion pln of money bills (7.5 billion was maturing at the same date) and despite of the fact that their own forecast showed cash lack of around 1 billion PLN in the system, players decided to buy all the papers even with small reduction rate. Probably tomorrow's demand will not be that aggressive and maybe the offer itself will be more balanced.

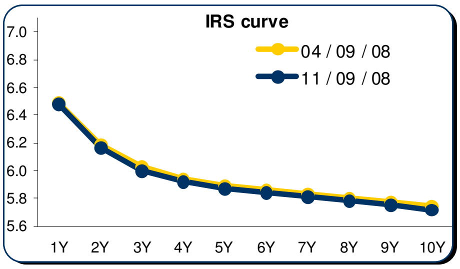
Euro in Poland in 2011?

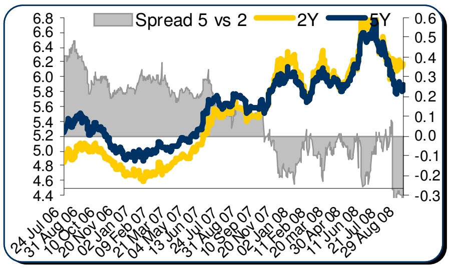
Only one event this week was able to breach the range trading. It was of course the speech the PM gave during local economic forum. He said that Poland is willing to join monetary union in 2011. This date is sooner then anyone has assumed so far, that is why market reaction was quite aggressive. First, all the rates dropped, then 1-6M sector moved up again discounting rates hike possibility. We think that politicians talk needs to be written down in any official paper before we uncork Champaign. Next weeks figures will probably support bullish sentiment.

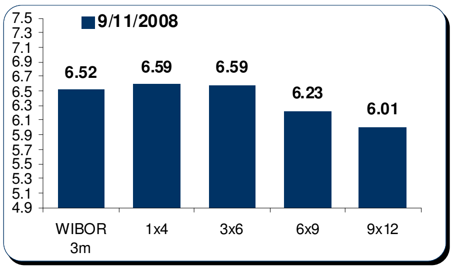
RECOMMENDATION:

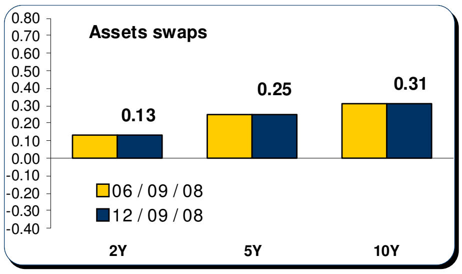
Pay 6M Polonia.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty stronger

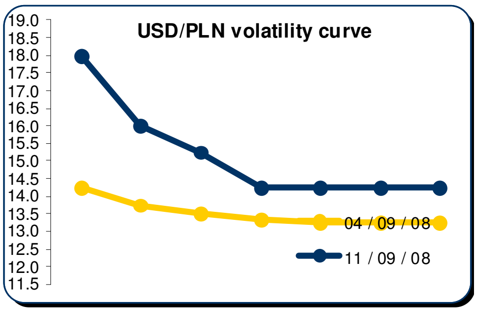
The rollercoaster !

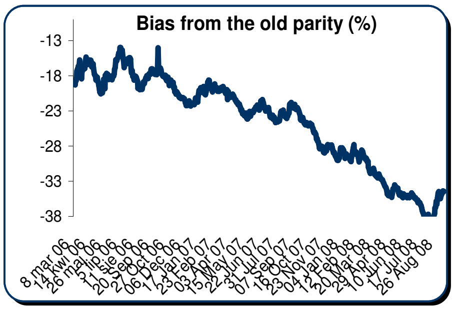
Week started with rally on new high at 3.4905 in EURPLN and 2,4775 USDPLN. After the short period of consolidation between 3,4430 and 3,4900 for EURPLN and respectively between 2.4250 and 2,4700 for USDPLN, the news about EUR accession in 2011 hit the market. The EUR/PLN has dropped from 3,4700 to 3,3800 ! and after the rebound to 3,4290 (the next day) with the move up in EURUSD, EURPLN took another hit falling over night from 3,4150 (Thursday close) to 3,3350 (Friday Low).

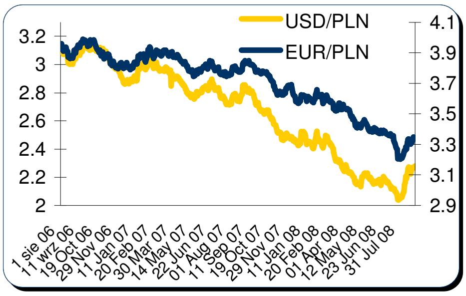
Volatility curve higher

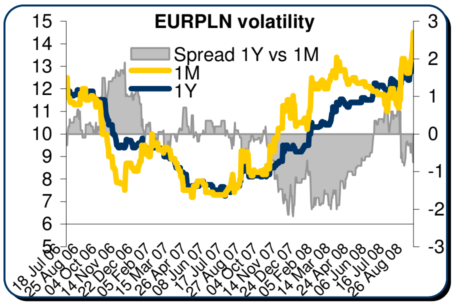
Volatility curve moved higher – we have seen new extreme levels: EUR/PLN 1M moved from 7,5 to 9,8 and 1Y moved from 6,75 to 7,40 , 2 years were traded at 7,15 and 3 years at 6,85. The news about 2011 EUR adoption added to the market confusion, while wild moves of spot have elevated the short end of the EURPLN curve, the backend has collapsed to 2 years 6,4

FX CHARTS









and 3 years to 6,2. USDPLN run was none existed but the single trades showed healthy appetite for USDPLN gamma.

RECOMMENDATION:

Play range

SPOT

Main supports / resistances:
EUR/PLN: 3.3350 / 3.3,3950
USD/PLN: 2.3500 / 2.4250

Hold short vega

Our idea about going long zloty at 3,4250/3,4500 level is the story of success under one important condition – You had to ignore the stop/loss. We expect same consolidation in wide 3,3350/3,3950 range. We will try to play that range.

OPTIONS

We have added to short vega position in mid and long end EURPLN, still hoping that volatility curve will reverse to its mean.

MARKET PRICES UPDATE

MONEY MARKET RATES

Money market rates (Closing mid-market levels)

date	3M		6M		1Y	
	FXSW	WIBOR	FXSW	WIBOR	FXSW	WIBOR
05/09/08	6.40%	6.51%	6.48%	6.49%	6.52%	6.59%
06/09/08	6.37%	6.52%	6.45%	6.49%	6.30%	6.54%
09/09/08	6.41%	6.51%	6.46%	6.46%	6.52%	6.53%
10/09/08	6.44%	6.52%	6.49%	6.49%	6.32%	6.54%
11/09/08	6.42%	6.53%	6.47%	6.50%	6.52%	6.54%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
05/09/08	6.55%	6.50%	6.23%	6.02%	6.17%
06/09/08	6.55%	6.53%	6.25%	6.03%	6.19%
09/09/08	6.55%	6.53%	6.25%	6.00%	6.25%
10/09/08	6.54%	6.48%	6.17%	5.93%	6.09%
11/09/08	6.59%	6.59%	6.23%	6.01%	6.16%

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
05/09/08	6.59%	5.08%	5.57%	5.29%	5.72%	5.69%	5.73%	5.76%
06/09/08	6.54%	5.05%	5.57%	5.29%	5.71%	5.68%	5.72%	5.76%
09/09/08	6.53%	5.05%	5.57%	5.34%	5.71%	5.67%	5.71%	5.76%
10/09/08	6.54%	5.05%	5.56%	5.30%	5.71%	5.65%	5.72%	5.75%
11/09/08	6.54%	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	08/08/18	08/08/18	93.842	6.49%	500	2330	500
OK0710	08/08/06	10/07/25	88.390	6.47%	1800	3724	1830
PS0413	08/09/03	13/04/25	96.459	6.11%	2200	8986	2200
DS1017	08/07/09	17/10/25	91.480	6.50%	700	2461	705

FX VOLATILITY

	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
date	1M	3M	6M	1Y	1M	1Y	1M	1Y
05/09/08	14.50	14.00	14.25	13.75	0.00	0.00	0.00	0.00
06/09/08	14.50	14.00	14.25	13.75	0.00	0.00	0.00	0.00
09/09/08	17.00	15.00	14.75	14.25	0.00	0.00	0.00	0.00
10/09/08	17.00	14.50	14.50	14.50	0.00	0.00	0.00	0.00
11/09/08	16.00	14.25	14.25	14.25	0.00	0.00	0.00	0.00

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
05/09/08	2.4094	3.4325	-35.10%
06/09/08	2.4094	3.4325	-35.10%
09/09/08	2.4513	3.4677	-34.77%
10/09/08	2.4500	3.4670	-34.43%
11/09/08	2.4505	3.4106	-34.45%

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

Contact Details

BRE BANK SA

Ul. Senatorska 18
00-950 Warszawa
P.O. Box 728
Poland

Reuters Pages: BREX, BREY, and BRET

Bloomberg: BRE

SWIFT: BREXPLPW

www.brebank.pl

Forex (BREX) - FX Spot &Options
Marcin Turkiewicz (+48 22 829 01 84) Marcin.turkiewicz@brebank.pl
Jakub Wiraszka (+48 22 829 01 73)
Tomasz Chmielarski (+48 22 829 01 78)

Fixed Income (BREP) - FRA, IRS, T-Bonds, T-Bills
Łukasz Barwicki (+48 22 829 01 93) Lukasz.barwicki@brebank.pl
Paweł Białczyński (+48 22 829 01 86)

MM (BREP) - MM, FX Swaps
Bartłomiej Małocha (+48 22 829 01 77) Bartlomiej.malocha@brebank.pl
Tomasz Wołosz (+48 22 829 01 74)

Structured Products (BREX)
Jaroslaw Stolarczyk (+48 22 829 01 67) Jaroslaw.stolarczyk@brebank.pl
Jacek Derezinski (+48 22 829 01 69)

Institutional Sales (BRES)
Inga Gaszkowska-Gębska (+48 22 829 12 05)

Research
Ernest Pytlarczyk (+48 22 829 01 66) Research@brebank.pl
Marcin Mazurek (+48 22 829 0183)
Radosław Cholewiński (+48 22 829 12 07)

Financial Markets Department
Phone (+48 22 829 02 03)
Fax (+48 22 829 02 45)

Treasury Department
Phone (+48 22 829 02 02)
Fax (+48 22 829 02 01)

Financial Institutions Department
Phone (+48 22 829 01 20)
Fax (+48 22 829 01 21)

Back Office
Phone (+48 22 829 04 02)
Fax (+48 22 829 04 03)

Custody Services
Phone (+48 22 829 13 50)
Fax

Disclaimer

Distribution and use of this publication