FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of July 16th to July 20th

Indicator	Date of release	Period	BRE forecast	Con-sensus	Last	Comment
Wages y/y	**Jul 16**	**June**	**9.4%**	8.8%	8.9%	Wage pressure stronger than previously
Employment y/y	**Jul 16**	**June**	**4.3%**	4.4%	4.4%	The employment starts growing slower due to higher real wages
Budget execution	**ca. Jul 18**	**June**	**12.7%**	13.0%	14.2%	Budget execution better than in plan due to higher revenues
Industry output y/y	**Jul 19**	**June**	**8.3%**	8.2%	8.1%	Negative trading day effect. After seasonal adjustment IO growth at ca 10.0%
PPI y/y	**Jul 19**	**June**	**1.6%**	1.9%	2.2%	Drop of PPI due to positive base effect

In Focus / Macroeconomics

The crisis within the coalition may increase medium-term political instability

PM J.Kaczyński dismissed the Deputy PM Lepper but The Self Defence Party remained in the governing coalition

On Monday the PM J. Kaczyński dismissed the Deputy PM and A. Lepper - a leader of Self Defence political party (Samoobrona). The decision was due to Lepper's alleged involvement in corruption by the Central Anticorruption Bureau. Initially, Lepper announced that his party intended to withdraw from the governing coalition, but a day later, under pressure from party deputies, he decided that his party would remain in the coalition with The Law and Justice and League of Polish Families. Accordingly, Lepper is no longer a member of the government and his position at the Ministry of Agriculture will be taken over by another Self-Defence party member. Lepper's decision to stay in the coalition is conditional – he has requested that the evidence supporting the allegations be published by Friday, however it is believed that The Self Defence Party does not intend to review the decision at the present time.
We are of the opinion that the immediate crisis in the coalition has passed and short term risk to political stability has been minimised.
Long term implications, however, could be more significant. On the one hand, The Self Defence Party's resistance to abandoning the governing coalition revealed that Lepper's position within his own party is somewhat weaker than he anticipated.

This turn of events has markedly increases the standing and influence of PM Kaczyński and the Law & Justice – the ruling party. If Lepper attempts to obstruct government actions, Kaczyński may respond by threatening to weaken The Self Defence Party by persuading some deputies to cross the floor from The Self Defence Party to The Law and Justice Party. On the other hand, as Lepper will no longer be involved in government, he may well have more time at his disposal to aid in strengthening his position in the party. Given he is now effectively an 'outsider' he is well situated to attack the government on a number of issues.

In the medium term Lepper's influence outside the government may increase political instability

Consequently, political instability may, in the longer term, increase; the next crises may occur in Autumn, linked to the proposed 2008 budget bill. We do not, however, anticipate an early election since this would create a high level of risk for The Law and Justice Party, as support from the Civic Platform (27%) and The Left and The Democrats (12%) could potentially win the election and form a government (support for Law and Justice Party is ca 25%).

The zloty, according to our calculations, should appreciate in the longer term due to anticipated interest rates hikes in Poland – although some suspect appreciation may be limited due to political instability. Hence, we cannot rule out the possibility that, in Autumn 2007, the zloty may temporary depreciate due to political unrest and speculation. We consider that such a decline in the zloty's value will only be temporary and by the end of this year EUR/PLN is set to rise to 3.70 with USD/PLN at 2.70.

MPC members see a risk for inflation but the rate increase in July is less likely

The latest comments of Polish MPC members indicate that they see a risk of inflation but the next rise may not occur in July.

Pietrewicz: MPC may be forced to raise the rates

Professor Mirosław Pietrewicz said that if the consumption boom and growing wages will increase inflationary pressure MPC will be forced to raise interest rates. Pietrewicz added that "*the wages pressure may cause a dangerous situation in 2008 and he wouldn't say that increases are not needed*". This comment is a bit surprising because Pietrewicz was always seen as a dovish MPC member and till now he never voted for the increases. We cannot exclude that Pietrewicz may vote for tightening in the future.
The open question is only the timing of the further increases. In Pietrewicz's opinion the accumulation of rate rises may negatively influence economic growth. Moreover he said that the increase in June was intended to precipitate an increase in July and MPC has now more time to look at the current data.

A slightly more dovish view has been presented by another MPC member Halina Wasilewska-Trenkner. She said that MPC would investigate carefully current macroeconomic data, particu-

Wasilewska Trenkner: MPC may raise the rates in this year only once

larly information from the labour market, fiscal policy and the global situation. In her opinion MPC may raise the rates in this year only once.

Nieckarz: real GDP is still below the potential output

A very controversial opinion has been expressed by MPC member Stanisław Nieckarz. He revealed that in the next two years the real GDP will be below the potential output and the output gap will be negative. He argues that the high unemployment rate is the highest in the region and the investments to GDP ratio still remains low. In his opinion the favourable structure of investments would gradually increase the potential. On the other hand Nieckarz sees some signals of slowdown. That is why Nieckarz expects the potential output to grow faster than the real GDP.
It is noteworthy that Nieckarz presents the view opposite to the official statement published by MPC after the last two meetings. MPC wrote that real GDP was growing at a faster rate than the potential one and they expect that GDP growth will remain strong in the next quarters.

We expect a 100 bps increase in the next 12 months but the increase in July is less likely

All above mentioned comments indicate that MPC members are a bit concerned by the rapid market overreaction after last increase in June and they want to calm the market opinion. We think that MPC is now less hawkish than the market expects. We still believe in our medium-term scenario that due to growing inflationary pressure MPC will raise the rate by 100 bps in the next 12 months. Thus we think that the increases may be more separated chronologically and the expected increase in July is less likely.

MEDIUM-TERM FORECATS

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

Is another 100bp hike priced in the curve really too much?

Apparently recent upside moves in yields pushed the curve high enough that POLGB's started to look attractive again. Quite dovish statements made by MPC members Wasilewska-Trenkner, who doesn't see need for aggressive policy tightening and Nieckarz, who already sees some signs of slowdown in the economy also supported the rally. We think that players' optimism is becoming a bit overreacted here. Upcoming data releases - CPI and corporate wages should not be positive for the curve. We estimate inflation at 2.7% y/y with risk on the upside, and wages at 9.4% y/y, so both quite consistent with current rates scenario, giving little room for further strengthening. Moreover, we see industrial output slowing down a bit, which, combined with wages growth, shows potential inflationary pressure and will definitely have impact on Council comments/decisions. Therefore we suggest building pay position from current levels, preferably in the short end of the curve.

RECOMMENDATION:

Pay 1y and 2y IRS.

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	06-08-07	-	4.816%	09-07-07
2Y T-bond OK1208	01-08-07	-	4.694%	04-04-07
5Y T-bond PS0412	19-09-07	-	5.480%	20-06-07
10Y T-bond DS1017	10-10-07	-	5.658%	11-07-07
20Y T-bond WS0922	12-09-07	-	5.309%	14-03-07

Money Market

Carry should remain stable

Carry in a range 4.5/4.6 will probably carry on next week. Tomorrow's open market operation should not disturb the system. PLN bn 21.3 maturing money bills will be corrected by the settlement of the 10-bond auction (PLN bn 1.7 cash outflow) and by the slight surplus of the cash which could be seen this week. In total there is room for PLN bn 21-22 offer and this range will provide another stable week for cost of carry.

Waiting for CPI and wages

Some bullish statements by the MPC members

For the longer term deals market is waiting for Friday's CPI and Monday's wages. Those figures will clarify the trend for the coming weeks, up to the MPC meeting. We believe that mentioned figures will show arising inflationary pressure, and the rates will go up again soon. Hence, now it can be good opportunity to take long position especially that some bullish comments from the MPC side has occurred lately. No reaction as far as politics is concerned. Even coalition break possibility could not influence the rates or currency. Polish market became politic resistant.

Polish market became politic resistant

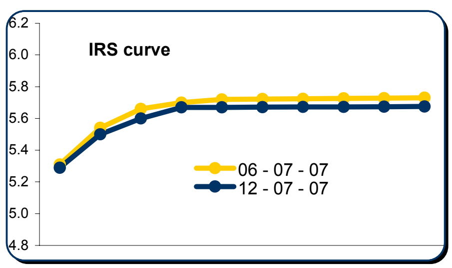
Expensive T-bills auction

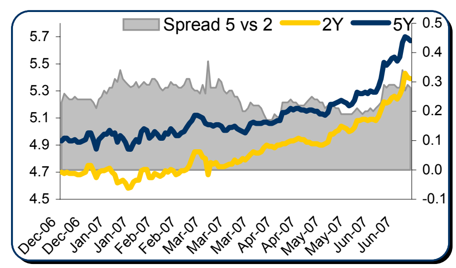
T-bill auction was very small and papers were expensive. 4.81% for the average yield is quite low taking into consideration other MM curves. This price is purely driven by small and rear auctions - read extremely reduced supply.

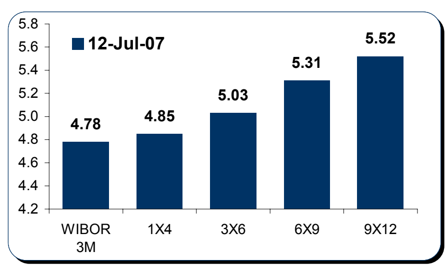
RECOMMENDATION:

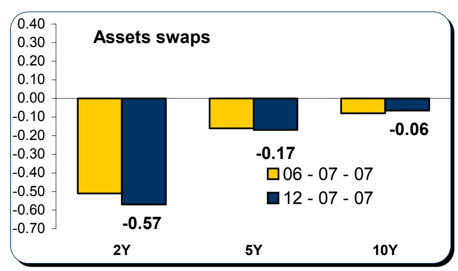
Build pay position on dips.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty range trade

Last week zloty traded range-bound between 3.7450 and 3.7800. Breaking of resistance, caused by threats Self Defence leaving government, failed and range held. With EUR/USD breaking 1.3700 and heading higher, USD/PLN traded much lower, down to 2.7240.

Volatility stable

Implied volatilities traded at slightly higher levels than a week before: the 1M EUR/PLN traded. The USD/PLN volatility curve traded also a touch higher at 7.4 (1M) and 7.6 (6M).

RECOMMENDATION:

Zloty stronger

Spot:

Main supports / resistances:
EUR/USD: 1.3500 / 1.3700
EUR/PLN: 3.7450 / 3.7800
USD/PLN: 2.7000 / 2.7900

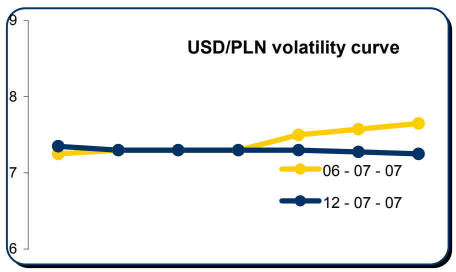
Despite of political risk growth, PLN remained in 3.745-3.78 range. Political pressure is slowly diminishing which makes attack for upperside of the range less likely. Additionally with weakening of USD against other currencies sentiment we recommend opening short EUR PLN with 3.8150 as strong resistance.

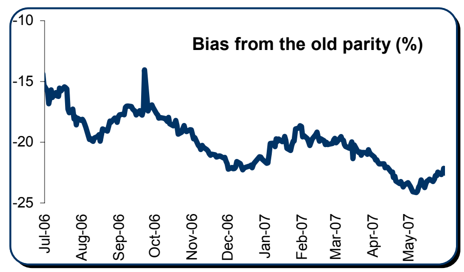
Short Gamma

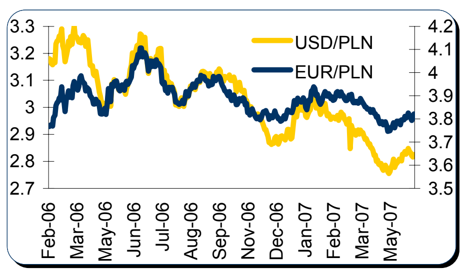
Options:

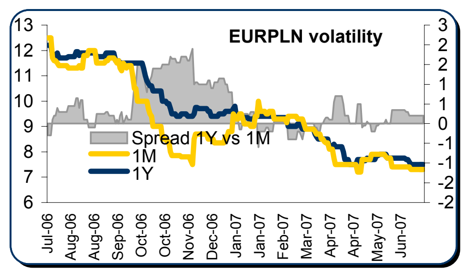
Despite of low vols and political disturbances we recommend square/offering vega

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
06-07-07	4.74%	4.78%	4.91%	4.95%	5.27%	5.25%
09-07-07	4.73%	4.78%	4.91%	4.95%	5.27%	5.25%
10-07-07	4.74%	4.78%	4.91%	4.95%	5.24%	5.26%
11-07-07	4.74%	4.78%	4.91%	4.95%	5.24%	5.26%
12-07-07	4.72%	4.78%	4.89%	4.95%	5.23%	5.25%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
06-07-07	4.87%	5.07%	5.37%	5.57%	5.51%
09-07-07	4.86%	5.06%	5.37%	5.57%	5.50%
10-07-07	4.86%	5.06%	5.37%	5.57%	5.50%
11-07-07	4.86%	5.06%	5.36%	5.56%	5.48%
12-07-07	4.85%	5.03%	5.31%	5.52%	5.46%

Fixed Income Market Rates (Closing mid-market levels)

date	1Y		2Y		5Y		10Y	
	WIBOR	TB	IRS	OK1208	IRS	PS0511	IRS	DS1017
06-07-07	5.25%	4.60%	5.54%	5.03%	5.72%	5.56%	5.73%	5.65%
09-07-07	5.25%	4.82%	5.55%	4.99%	5.74%	5.56%	5.74%	5.66%
10-07-07	5.26%	4.78%	5.53%	4.99%	5.73%	5.56%	5.74%	5.65%
11-07-07	5.26%	4.75%	5.53%	4.96%	5.71%	5.54%	5.71%	5.65%
12-07-07	5.25%	4.75%	5.50%	4.93%	5.67%	5.50%	5.68%	5.61%

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	07-04-04	09-07-25	89.970	4.69%	1000	2463	1000
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

	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
date	1M	3M	6M	1Y	1M	1Y	1M	1Y
06-07-07	7.30	7.30	7.50	7.65	1.25	1.20	0.30	0.40
09-07-07	7.30	7.30	7.50	7.65	1.25	1.20	0.30	0.40
10-07-07	7.30	7.30	7.30	7.25	1.25	1.20	0.30	0.40
11-07-07	7.30	7.30	7.30	7.25	1.25	1.20	0.30	0.40
12-07-07	7.40	7.45	7.50	7.50	1.25	1.20	0.30	0.40

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
06-07-07	2.7755	3.7730	-23.61%
09-07-07	2.7520	3.7505	-24.15%
10-07-07	2.7595	3.7655	-23.88%
11-07-07	2.7464	3.7735	-23.94%
12-07-07	2.7244	3.7573	-24.38%

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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