FINANCIAL MARKETS DEPARTMENT

PAGES: 9 WARSAW, JULY 19, 2007

POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of July 23rd to July 27th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
Unemployment rate	**Jul 24**	**June**	**12.5%**	12.5%	13.0%	In line with the underlying downward trend that has been evident over the past months.
Retail sales y/y	**Jul 24**	**June**	**16.2%**	14.9%	14.8%	Retail sales stronger due to the widespread optimism about the economy and rising purchasing power of households.
MPC rate decision	**Jul 25**	**July**	**4.5%**	4.5%	4.5%	Another hike expected in August/September.

In Focus / Macroeconomics

Wages to weight more and more on the monetary policy

Wage growth to rise to double-digit rates in the coming months.

June wages, rather than the country's shaky political situation or the recent more favorable inflation figure (2.6% y/y vs. expected 2.7%) drew attention of the investors in the passing week. The data showing a 9.3% wage rise year-on-year, compared with analysts' average forecast for a 9% rise, will, in our opinion, prompt the central bank to tighten its monetary policy soon. Going into more details and examining the set of cross-sector wages data from previous months we found that the wage hikes expectations have already spilled over the vast majority of sectors. Consequently, we come up with the estimates that solely due to cross-sector convergence in wage levels, the wage growth may rise to double-digit rates in the coming months. The vast coverage of the topic in the media, in our opinion, has to affect the expectations of the workers and thus additionally support our "double-digit wage growth rates" scenario.

Even though we acknowledge that there may still be some potential for a non-inflationary economic growth in Poland (that is mainly attributable to unfavorable labor market conditions in the past and thus incremental financial situation of companies), the situation may reverse rapidly in the coming months. Rising demand for labor, that has been only recently confirmed by the employment data (+4.6% y/y), as well as the aforementioned rising wages will most likely bring about an increase in the labor costs as measured by their share in the overall costs of companies. Consequently, the historically favorable trade-off between productivity and wages would deteriorate rapidly and the unit labor costs may start to rise. This mechanism, though some substantial delay is involved, would ultimately lead to higher inflationary pressure. Thus the wages are to weight more and more on the upcoming monetary policy committee decisions.

Polish MPC satisfied with the implemented monetary tightening and keen to damper the expectations for a rate hike in July

The MPC satisfied and more univocal in the assessments of the implemented policy

It was the passing week when the information agencies posted comprehensive inter-views with the members of the Polish Monetary Policy Committee. Pulling those together, one may conclude that though the Committee perceives the rising wages as the main threat to the price stability, it is strikingly satisfied with the effects to result from the pre-emptive interest rate hikes already implemented. Even though the MPC might be willing to continue with the monetary tightening this year the particular members seem to be overoptimistic in predicting moderation of the inflation. They also pretty differently assess the prerequisites for the tightening scenario.

In the most explicit way these prerequisites have been listed by S. Owsiak, seen as a swing voter, who would back the hikes only if inflation breached the level of 3% and the wage growth rate exceeded 10%.

Filar, a hawk, in turn, seemed to condition the monetary tightening on the macro data for the second quarter, including GDP, to be released on the 30th August, and wages for the whole economy. In his opinion GDP growth rate breaching 6% may prompt the Committee to hike the rates more aggressively. Professor Filar seemed also to closely monitor inflation expectations that, also in our opinion, might not be permanently anchored at a low level.
We were however quite surprised that Filar emphasized the effect of, say, moderate pre-emptive interest rate hikes on the next year inflation and that he does not seem to really believe in an inflation rise at the end of this year.

Next hike unlikely to come in July.

Turning to the timing of the next interest hike, Filar unveiled the reasoning behind the last MPC's decision. He stated that the MPC just brought forward the rate hike from June to buy more time to "coolly" analyze the state of the economy. In his opinion, the next fortunate time point to assess the economic situation is the date of the release of the quarterly data in late August. Thus, we recommend sticking to the idea that the next interest hike is very likely then as well.
Some further insights about the timing of the next interest rate hike offered also a comment by Pietrewicz, a Dove, who indicated that monetary tightening would be implemented in the coming months but it would be unlikely to happen in July.

We expect, however, the central bank to respond to wage and GDP data and continue with tightening late summer.

Most influential members of the MPC, Sławiński and Wojtyna also indicated that there were still hikes in the pipeline, as the wages had got to a worrying level. Wojtyna, in a more comprehensive interview, emphasized, however, the implications of the pre-emptive interest rate hikes on the price stability by arguing that given the currently low inflation level a 50 bps rate hikes had more impact than the similar step implemented in a high inflation environment. He also asserted that the Committee continuously upheld tightening bias which also fitted well with the policies implemented by other central banks. In the interview we found many dovish opinions as well. For instance, Wojtyna predicted the investment to result in an almost immediate positive supply effects that should neutralize the effects of rising demand (at this point he emphasized the role of wage tax cut on the spending power of households). He also expected that the scale of the tightening, given his inflation scenario, would be only moderate. His bottom line: "the Committee wishes further interest rate hikes were unnecessary in 2008" we interpret, however, as a commitment to implement further pre-emptive rate hikes this year.

In our opinion, it is also very unlikely that there will be no rate hikes in 2008.

We envisage at least one more interest rate hike to come in late summer. This step could be interpreted as a pre-emptive strike. Furthermore, one or even two more hikes are expected to come in response to the rising inflation rate in autumn this year. According to our estimates the inflation will top 3% by the end of this year, which would ultimately force the Committee to continue with the tightening policy in 2008.

Country's shaky political situation not an issue for the moment

Investors paid much less attention to the political situation this week. Firstly, they seem to be more immune to political jitters in Poland, in general, and secondly, there is no decisive resolution of the political deadlock at the horizon.

Any decisive resolution of the political deadlock, so the next political crises, unlikely until Autumn.

The leaders of two junior euroskeptic parties in Poland's government announced that they were joining forces and form a new party, the League and Self-Defense (LiS), in an effort to strengthen their voice in the governing coalition. The decision came a week after Jaroslaw Kaczynski, the Prime Minister, fired Andrzej Lepper, the leader of the farm-based Self-Defense party, from his posts as deputy prime minister and agriculture minister, citing suspicions he was involved in corruption. In response to the establishment of the new party, the PM Kaczynski has threatened to call a November election. The extraordinary meeting of the Law and Justice high ups on Tuesday ended, how-ever, inconclusive. There are at least two reasons why the market shouldn't worry about the next political crisis this summer. Firstly, the parliamentary holidays already started and the next meeting of the parliament at which the early election could be voted is scheduled for September. Secondly, according to the latest poll the new Self Defence & LPR alliance got just 5% of the vote and has everything to fear from an election. The PiS, on the other hand, still ranked behind the Civic Platform in terms of the popularity, has not much to win on the early elections and has nothing to fear yet from the coalition. Any decisive resolution of the political deadlock is unlikely soon. Consequently, political instability will not be a reason to worry for financial markets this summer.

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

Very calm week on the PLN market

Last week was rather calm on the FI market. Economic releases, despite being a little away from the consensus have changed neither shape nor the market levels. The biggest reaction that we have seen on the market was closing receive positions after wage figure came in at 9.3% beating market expectations. We continuously think that rate hikes will come but we move timing a little ahead into the future. We still prefer steepening trades, especially 1y2y spread (currently trading at 23 bp). Furthermore, we recommend scaling back outright positions, as liquidity is drying up.

RECOMMENDATION:

pay 1y2y, reduce outright risk

AUCTIONS

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	4,208%	2006-01-16
26 Week T-bills	-	-	3,943%	2006-04-24
52 Week T-bills	06-08-07	-	4,816%	2007-07-09
2Y T-bond OK1208	01-08-07	-	4,694%	2007-04-04
5Y T-bond PS0412	19-09-07	-	5,480%	2007-06-20
10Y T-bond DS1017	10-10-07	-	5,658%	2007-07-11
20Y T-bond WS0922	12-09-07	-	5,309%	2007-03-14

Money Market

Relatively expensive week

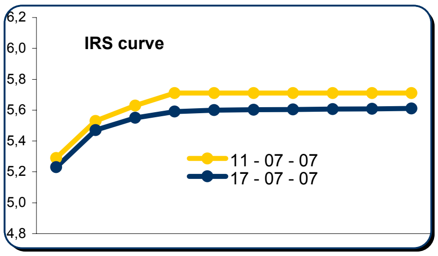
Retail sales will be crucial for volatility before the MPC meeting

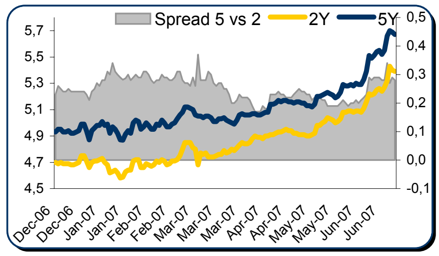
Relatively expensive week (carry 5-8 bps above the main rate) without any particular reason. Open market operation was quite supportive (PLN bn 20,7 vs. PLN bn 21,3) and lots of time to build up the reserve is left. However, last week may indicate that similar levels can be seen the week ahead unless significantly lower money bills supply will occur, which is not very likely.
For longer terms bullish sentiment took the field. It was triggered by lower than expected CPI figure (2.6 vs. 2.7%) and the scale would be much more advance, but after the weekend wages stopped the rally (9.3 vs. 8.8% expected). However, the market did not bounce back it just stopped waiting for next figures (PPI and IO). The most important figure will be retail sales next Tuesday. High level should boost volatility just before the MPC meeting. The probability of raising the rates in July we see 70:30 against, certainly as of today.

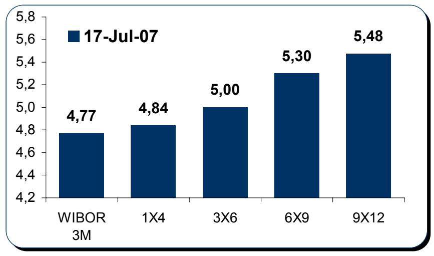
RECOMMENDATION:

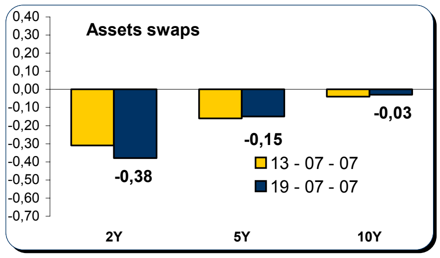
Stay pay.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty stable

Last week the Zloty traded once again range-bound between 3.7420 and 3.7640. It was lower than previous week range and traded with lower turnover. As political threats became quieter and more balanced only influence we saw was USD world sentiment and close option expiries. So with EURUSD traded 1.3760-1.3840 Zloty stopped in 220 pips range.

Volatility mixed

Implied volatilities traded at slightly lower levels than a week before: the 1M EUR/PLN traded 6.1 and 1Y at 6.0. Bigger difference we saw on USD/PLN volatility curve, which was traded 0.25 vol higher: 7.6 (1M) and 7.7 (1Y).

RECOMMENDATION:

RECOMMENDATION:

Zloty stronger

Spot:
Main supports / resistances:
EUR/PLN: 3.7380 / 3.7850
USD/PLN: 2.6300 / 2.8000

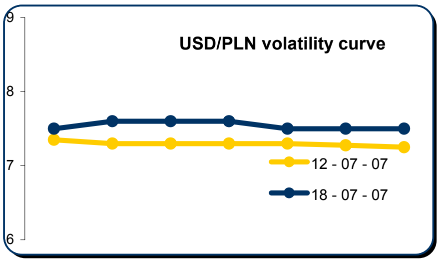
With weakening USD sentiment, as main present factor, and with low likelihood of decreasing PLN rate hikes expectations we advise opening short EURPLN around 3.79 with stop loss 3.8150 and profit taking at 3.7000. On USDPLN this move may be intensified by EURUSD upper pressure

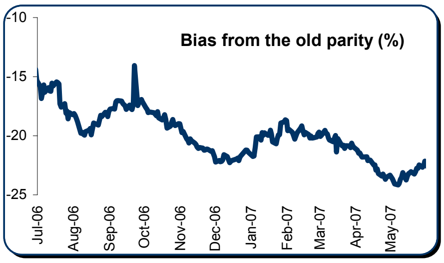
Stay square

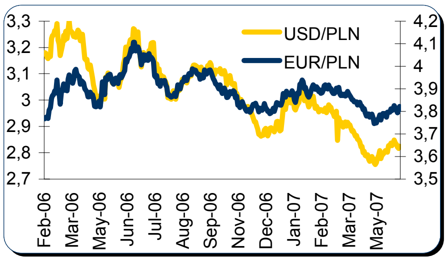
Options:

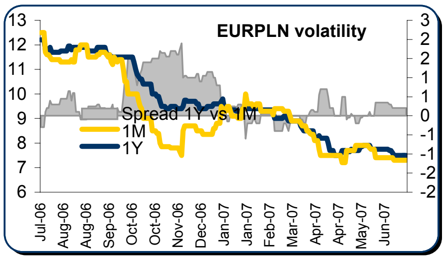
Because of low implied EURPLN volatility curve and RR levels we advice to avoid short vega and short RR positions on that cross. One can bet on a stop loss scenario one we break the well defined support on 3,7400 and buy out of the money put because of that.

FX CHARTS


USD/PLN volatility curve
12 - 07 - 07
18 - 07 - 07


Bias from the old parity (%)


USD/PLN
EUR/PLN


EURPLN volatility
Spread 1Y vs 1M
1M
1Y

MARKET PRICES UPDATE

MONEY MARKET RATES

Money market rates (Closing mid-market levels)

date	3M		6M		1Y	
	FXSW	WIBOR	FXSW	WIBOR	FXSW	WIBOR
11-07-07	4,74%	4,78%	4,91%	4,95%	5,24%	5,26%
14-07-07	4,72%	4,78%	4,89%	4,95%	5,23%	5,25%
15-07-07	4,72%	4,78%	4,89%	4,95%	5,23%	5,25%
16-07-07	4,73%	4,76%	4,91%	4,93%	5,24%	5,24%
17-07-07	4,75%	4,76%	4,89%	4,93%	5,22%	5,25%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
11-07-07	4,86%	5,06%	5,36%	5,56%	5,48%
14-07-07	4,85%	5,03%	5,31%	5,52%	5,46%
15-07-07	4,85%	5,03%	5,31%	5,52%	5,46%
16-07-07	4,86%	5,05%	5,35%	5,51%	5,47%
17-07-07	4,83%	5,00%	5,31%	5,47%	5,44%

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
11-07-07	5,26%	4,75%	5,53%	4,96%	5,71%	5,54%	5,71%	5,65%
14-07-07	5,25%	4,75%	5,46%	5,15%	5,63%	5,47%	5,63%	5,59%
15-07-07	5,25%	4,75%	5,46%	5,15%	5,63%	5,47%	5,63%	5,59%
16-07-07	5,24%	4,75%	5,49%	5,17%	5,62%	5,48%	5,63%	5,60%
17-07-07	5,25%	4,75%	5,47%	5,12%	5,60%	5,45%	5,62%	5,57%

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	07-04-04	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

FX VOLATILITY

	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
date	1M	3M	6M	1Y	1M	1Y	1M	1Y
11-07-07	7,30	7,30	7,30	7,25	1,25	1,20	0,30	0,40
14-07-07	7,40	7,45	7,50	7,50	1,25	1,20	0,30	0,40
15-07-07	7,40	7,45	7,50	7,50	1,25	1,20	0,30	0,40
16-07-07	7,50	7,50	7,50	7,50	1,25	1,20	0,30	0,40
17-07-07	7,50	7,50	7,50	7,50	1,25	1,20	0,30	0,40

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
11-07-07	2,7464	3,7735	-23,94%
14-07-07	2,7210	3,7510	-24,50%
15-07-07	2,7223	3,7535	-24,45%
16-07-07	2,7285	3,7615	-24,29%
17-07-07	2,7146	3,7508	-24,57%

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
Jacek Kotłowski (+48 22 829 01 83) Research@brebank.pl
Ernest Pytlarczyk (+48 22 829 01 66)

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