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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of August 10th to August 17th

Indicator	Date of release	Period	BRE forecast	Con-sensus	Last	Comment
C/A (EUR bn)	**Aug 13**	**June**	**-807**	-799	-1202	Seasonal improvement in C/A. Trade deficit at EUR 577 bn.
M3 y/y	**Aug 14**	**July**	**14.6%**	14.8%	14.9%	In trend.
CPI y/y	**Aug 14**	**July**	**2.4%**	2.3%	2.6%	Temporary lower annual CPI due to favorable base effect. Net inflation at 1.5%.
Wages y/y	**Aug 16**	**July**	**8.8%**	9.1%	9.3%	Lower wages growth due to postponing bonuses in mining, but still high enough to increase inflationary pressure.
Employment y/y	**Aug 16**	**July**	**4.6%**	4.6%	4.6%	In an upward trend.

In Focus / Macroeconomics

No end of political turmoil in sight

Political situation is highly unlikely to seriously impact on the financial markets

After a few days lull in the battle of words, the ruling coalition parties have returned to the fray. Although the leaders of the respective parties do not mince words regarding the issue of bullying, investors have already become accustomed to such political jitters and the situation is highly unlikely to seriously impact on the financial markets.

To keep you up to date with recent developments, PM Kaczyński dismissed the Deputy PM Lepper, leader of the 'Self Defence' Party (Samoobrona). 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. Since then speculations about snap elections have re-emerged on a number of occasions. A similar set of circumstances followed the Polish Electoral Commission discovery of irregularities in the ruling party' financial statements. If the Supreme Court upholds the Electoral Commission's judgement, then the party would not receive subsidies from the central budget until the end of the parliamentary term. As central budget financing is the main source of funding for political parties in Poland, leaders of the junior coalition parties and some political analysts have envisaged that the PiS may be forced to push for snap elections immediately. The irregularities in the finances of the PiS are, by all standards, relatively minor and it is not clear whether the Supreme Court will share the Polish Electoral Commission's view. In a very similar case involving the ruling president of Warsaw, Hanna Gronkiewicz-Waltz, the Supreme Court decided in her favour.

Another event that potentially could have led to the collapse of the coalition and a snap election was a special meeting held by the Self-Defence (Samoobrona) party on Sunday. During the meeting Samoobrona leaders concluded that the coalition was effectively over, blaming the PiS in a move typical in the ongoing war of words as neither party is willing to shoulder responsibility for such a collapse. Samoobrona also decided to accept the withdrawal of their ministers from the government in case the PM decides to proceed along these lines. However, for all extents and purposes, the coalition still exists and neither of the two ministers have been withdrawn from the government.

We continue to anticipate that the political deadlock will last at least until late August, when the first parliamentary meeting after the summer break is scheduled

This week's major development took the form of the Samoobrona Leader's accusation that the PM may be involved in some sort of corruption scandal. There are rumours that the leader of Samoobrona may possess tapes, recorded during cabinet meetings, to support his accusations. No details have been released so far. Initially, the accusations were echoed by the second junior coalition party, LPR, but for the time being the leaders of LPR refuse to comment on the matter. Given that the recording of cabinet meetings is a crime according to Polish law, the Samoobrona leader, Andrzej Lepper, might well fear releasing the tapes – whose existence, it should be noted, is seriously doubted by almost all political analysts.

We continue to anticipate that the political deadlock will last at least until late August, when the first parliamentary meeting after the summer break is scheduled. Until then the PiS is very likely to continue its efforts to attract individual MPs from the junior coalition parties in an effort to avoid snap elections. As the ruling party still lags behind the PO in opinion polls, early elections may present too much of a political risk to consider.

Dovish MPC members strongly oppose rates hikes

NBP chairman sees no need for a hike in rates.

The NBP chairman Sławomir Skrzypek disclosed that he would only vote for a rates hike if it will be high risk that inflation exceeds 3.5%. He explained that, according to the official NBP model, the risk for the inflation is rather balanced and there is currently no need to tighten monetary policy. Skrzypek emphasized that it is not merely the level of inflation that is important but overall economic growth as well. In assessing the pressure from the labour market, Skrzypek stated that very good financial results should stimulate investments and a possible increase in potential output during the medium-term.

The conclusion is rather straightforward: In his reaction function Skrzypek pays more attention to the output gap than to inflation - when compared to MPC median voters - and assesses the risk for inflation to be lower than would other MPC members; it seems clear that next month he would look to vote against a hike in rates.

MPC member Nieckarz: MPC shouldn't react if inflation remains below 3.5%

An almost identical view has been expressed by one of the most dovish of MCP members, Stanisław Nieckarz. He drew attention to the fact that the previous quarter was the eighth one in a row where inflation remained below its target of 2.5%. This, in his opinion, indicates that previous monetary policy was too restrictive. He emphasized that the MPC should interpret the inflation target symmetrically and not react if inflation is in the range of 2.5-3.5%. Moreover, despite the high economic growth, the risk for inflation is not high. According to Nieckarz, the exchange rate and globalization process would work to limit the pressure on prices in Poland and stronger domestic demand may result in a higher import volume.

The dovish view presented by both members is not common in the MPC

Both MPC members present highly dovish approaches to the issue of inflationary pressure, paying more attention to the GDP growth and accepting inflation in the upper bands of the inflation target. Until the risk of inflation materializes they will doubtless vote against the rates hikes. However, they represent the dovish wing of the MPC and are not the median voters. In our opinion the next decisions will depend more on the behaviour of J.Czekaj - who may assess the inflation risk more seriously than Skrzypek and Nieckarz. We maintain our view that the MPC will seek to hike the rate by 100 bps towards the middle of 2008.

Anticipated impact of fiscal policy on the markets - positive in the short term and neutral in the mid-term

A budget surplus may also be achieved after August

The fiscal policy contributes - even though no structural reform has been implemented - to a positive surprise: This week, the Deputy Finance Minister Suchocka-Roguska, confirmed that a cumulated budget surplus has been recorded since July. Recent Ministry estimates indicate that the surplus may exceed PLN 100 mn - the figure envisaged a few days ago. It has to be emphasized that, according to a schedule, the deficit would top PLN 16 bn by the end of July. Suchocka-Roguska has also suggested that a similar surplus may be achieved after August, which will be due to a shift in expenditure (PLN 10.5 bn in total) and strong revenues. Notwithstanding, Suchocka Roguska has ruled out the possibly that the whole year's budget deficit could drop below the PLN 25 bn mark. Today's economic conditions, including stronger domestic demand, are favourable for the budget, limiting the state's need to borrow and consequently the number of bonds issued.

Revision of the 2008 budget assumptions will not impact the planned budget deficit.

Even though the Deputy Finance Minister Zajdel-Kurowska has let it be known that her team is working on the revision of the macro assumptions underlying the 2008 budget, the fiscal policy perspectives remain neutral for the next year. We expect that the growth forecast may be adjusted downwards to about 5.4% y/y and the forecast of the annual inflation rate will be upgraded to 2.6-2.8%. The changes will, in our opinion, have only minor implications on projections for budget revenues and expenditure, as the ongoing change in the economic growth structure combined with higher inflation may balance the decrement - owing to lower real GDP dynamics. Currently, there is also no indication that the government would be willing to change the budget deficit for 2008 (seen at PLN 30 bn).

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

Polish market has become the least volatile one...

It has been another very, very quiet week on the polish FI market. No economic data releases along with complete invulnerability to the situation on the global markets kept the market within a few-tick spread amid low turnover. The following week will bring this month's first data publications, i.e. CPI on Thuesday and corporate wages on Thursday. Our inflation prediction of 2.4% y/y is in line with market consensus and should be taken neutrally by the players, especially that expectations are for the figure to come out lower next month. Wages data, on the other hand, we see at 8.8% y/y, slightly lower than the average estimate. Such data set would be used by Council's doves as an argument for postponing the next hike. Since the move seems to be almost fully priced in already (with 3M Wibor at 4.86% and 1x4 FRA at 4.93%), there is some room for a positive reaction on the short end of the curve if the rates are actually kept unchanged. That should also support our view of curve steepening, that we shared with you last week. In directional terms, we still do not see good value, therefore we remain flat. We think that after long term of low volatility, whenever it starts improving, first moves shouldn't be big, and it may be profitable to try counteracting them.

RECOMMENDATION:

Stay positioned for steeper curve.

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	20-08-07	-	4.816%	06-08-07
2Y T-bond OK1209	05-09-07	-	5.185%	01-08-07
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

Boring week for liquidity and for trading

Very boring week for liquidity as well as for trading. Cost of carry nearby the main market rate with no prospects to bigger changes in the nearest future. Open market operation was PLN 22.5 bn, however the market absorbed only PLN 21.2 bn. Although the short surplus of the cash was visible it did not influence the shortest rates, because it is just the beginning of the reserve requirements settlement period.

Nothing interesting for longer terms, mainly waiting for figures and thinking of possible rate hikes scenarios. As of today 25 bps hike in August is priced in plus another one in autumn and another one early next year.

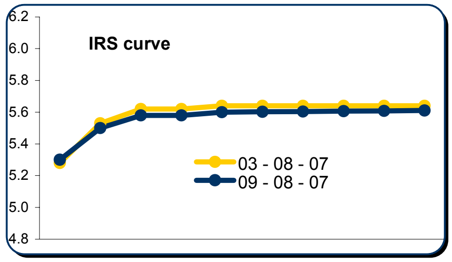
T-bills stable at the tender

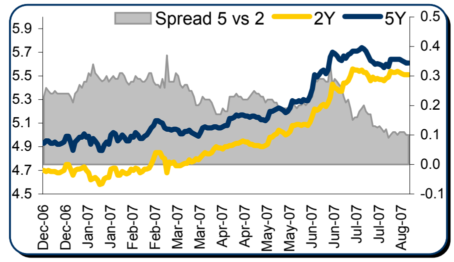
T-bills auction did not bring any changes to average yield. Still 4.816% just like during the last tender, which makes the papers expensive. Main reason – huge reduction in supply side.

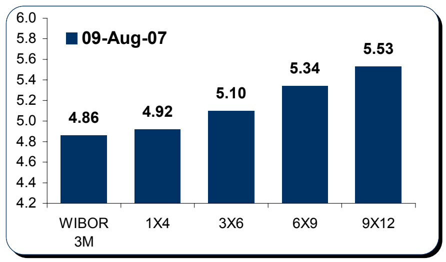
RECOMMENDATION:

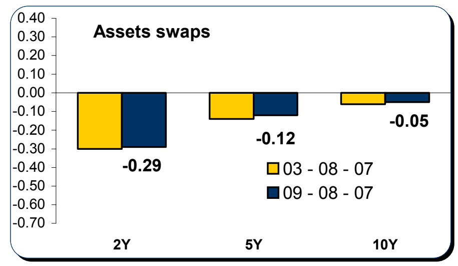
Take advantage of any miss-pricing to the mentioned scenario.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty stronger

This week złoty was traded within a range of 3.7950 and 3.7620 in a strengthening trend. Main reason for that was a rising appetite for risky assets on the global markets. However, as less open positions are left on the market, domestic signals may carry weight on FX rates. That's why we expect the zloty to keep appreciating with 3.7500 being a mid-term target.

Volatility lower

Implied volatilities for 3M-1Y tenors slipped from 6.0 to 5.85 so that end at 5.9. And as złoty becomes less vulnerable for outer influence market is well offered.

RECOMMENDATION:

Spot:
Main supports / resistances:
EUR/PLN: 3.7500 / 3.7950
USD/PLN: 2.7000 / 2.7700

Zloty stronger

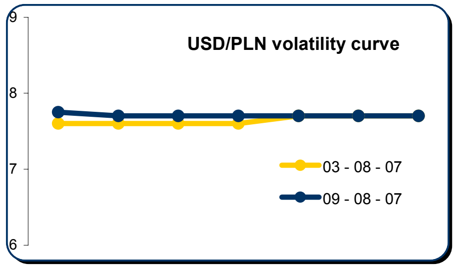
We are EURPLN seller at 3.7950 with 3.8050 S/L and 3.7500 target.

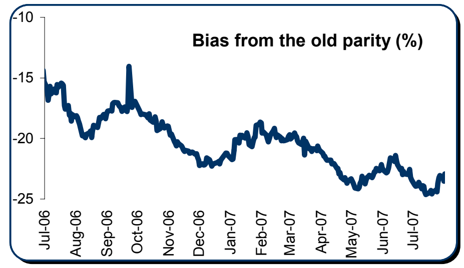
Sell Vega, buy gamma

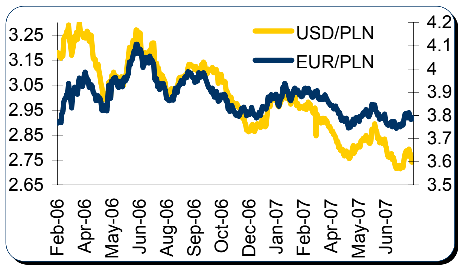
Options:

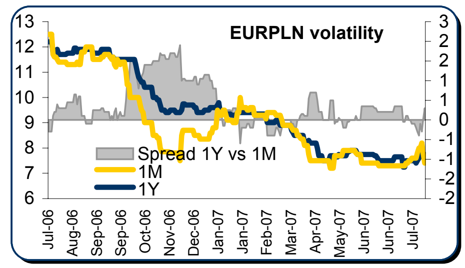
We see long gamma, short vega as strategy best matching present market, so we bought 1W EURPLN and sold 6M EURPLN ATMs.

FX CHARTS


USD/PLN volatility curve
03 - 08 - 07
09 - 08 - 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
03-08-07	4.82%	4.79%	4.95%	4.96%	5.24%	5.27%
06-08-07	4.79%	4.83%	4.95%	4.98%	5.26%	5.27%
07-08-07	4.80%	4.83%	4.97%	4.99%	5.27%	5.28%
08-08-07	4.80%	4.84%	4.95%	5.00%	5.26%	5.30%
09-08-07	4.82%	4.86%	4.97%	5.02%	5.24%	5.31%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
03-08-07	4.92%	5.10%	5.33%	5.53%	5.47%
06-08-07	4.92%	5.10%	5.34%	5.54%	5.48%
07-08-07	4.92%	5.10%	5.34%	5.53%	5.47%
08-08-07	4.92%	5.10%	5.34%	5.53%	5.46%
09-08-07	4.92%	5.10%	5.34%	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
03-08-07	5.27%	4.75%	5.51%	5.21%	5.62%	5.48%	5.62%	5.56%
06-08-07	5.27%	4.85%	5.51%	5.20%	5.61%	5.49%	5.61%	5.56%
07-08-07	5.28%	4.85%	5.51%	5.21%	5.61%	5.48%	5.60%	5.55%
08-08-07	5.30%	4.85%	5.50%	5.22%	5.60%	5.50%	5.61%	5.56%
09-08-07	5.31%	4.85%	5.52%	5.23%	5.62%	5.50%	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	07-08-01	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

	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
date	1M	3M	6M	1Y	1M	1Y	1M	1Y
03-08-07	7.60	7.60	7.70	7.70	1.00	1.10	0.30	0.35
06-08-07	7.60	7.60	7.70	7.70	1.00	1.10	0.30	0.35
07-08-07	7.60	7.60	7.70	7.70	1.00	1.10	0.30	0.35
08-08-07	7.70	7.70	7.70	7.70	1.00	1.10	0.30	0.35
09-08-07	7.70	7.70	7.70	7.70	1.00	1.10	0.30	0.35

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
03-08-07	2.7786	3.7970	-23.29%
06-08-07	2.7420	3.7916	-23.77%
07-08-07	2.7450	3.7855	-23.81%
08-08-07	2.7451	3.7740	-23.95%
09-08-07	2.7382	3.7735	-24.03%

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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