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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of September 1st to September 6th

Indicator	Date of release	Period	BRE forecast	Con-sensus	Last	Comment
FinMin's inflation forecast	**Sep 3**	**Aug**	**1.8%**	-	2.3%	A temporary inflation drop is owing to lower food prices and high base effect in 2006.

In Focus / Macroeconomics

Polish Monetary Policy Council hiked rates

The MPC noted that the wedge between productivity and wage growth narrows quicker than previously anticipated

In line with market expectations, the MPC raised rates by 25 bps to 4.75% at its August meeting. The decision should be seen as another pre-emptive strike; the Committee decided to raise the rates amid mounting risks of higher inflation in the future and anticipation of a temporary drop in the CPI in the third quarter of 2007. In analyzing possible triggers for the decision, one should note that the Committee still places much more emphasis on local factors - and the rising wage pressure in particular - than on turmoil in the global market or the changing interest rate outlook for the EMU and the US. This argument has also been reiterated explicitly by influential MPC member Slawinski during the Q&A session following the announcement of the decision.

Strikingly, the MPC noted in its statement that the wedge between productivity and wage growth is becoming narrower much more quickly than previously estimated. This phenomenon already captured our attention a few weeks ago, when we recalculated that the unit labour costs dynamics may rise to about 9% this year, while the figure estimated by the experts from the Central Bank remains at 5.6%. The implications of this may be quite severe from an inflation point of view, because, firstly, the experts may have underestimated future wage growth rates and secondly, estimates on the relationship between wage growth and inflation are the main cause of uncertainty in the inflation projection based on the official central bank's model – ECMOD.

Even though the Committee listed the usual factors which may limit inflationary pressure - such as globalization or booming investment - the diagnosis was this time quite unambiguous; on balance, these factors are insufficient to anchor the inflation around its target. Moreover, the Committee skipped the usual passage stating that they would await further data to get confirmation of the tendencies observed and added that the GDP growth rates would exceed the potential growth rates in some quarters going forward.

The statement was quite hawkish and pointed to an ongoing monetary tightening

To summarize, the MPC statement was overall quite hawkish and pointed to ongoing monetary tightening. Even though, in the last sentence of the communiqué, the MPC added that it will scrutinize the state of play in the global financial markets, we do believe that domestic factors are the most important to watch. As the Committee has already hiked the rates three times in the last two quarters, it may decide to implement a 'wait and see' strategy and postpone its next move until the release of the new inflation projection. This scenario is even more likely in light of the latest GDP data and all the ambiguities surrounding their interpretation (see the section below). Taking into account their historical track record, we do not believe that the MPC would hike the rates in those months when inflation drops significantly. We envisage such a drop in August (below 1.9%) and in September. The next rate hike is likely to be implemented in October or November. In the mid term, we stick to our old baseline scenario and expect the base rate to top 5.5% by the mid of 2008.

The inventories pushed the GDP up to 6.7%

The GDP growth amounted to 6.7% above market expectations

GDP growth in Q2 amounted to 6.7%, which was above BRE Bank (6.1%) and the market forecast (6.0%). This relatively good figure is due to the enormous growth of inventories. Contrary to expectations, individual consumption increased by only 5.1% y/y which, in face of strong retail sales and employment data, remains below the medium-term trend. We believe that in the next few quarters consumption growth will return to ca 6%.

Thus investments stay in line with expectations. The annual investment dynamics amounted to 22.3%. This figure is slightly lower than in Q1 but, due to higher weight in the GDP, investments' contribution to GDP growth remained at a rather stable level (+3.8 vs. +3.6 in Q1).

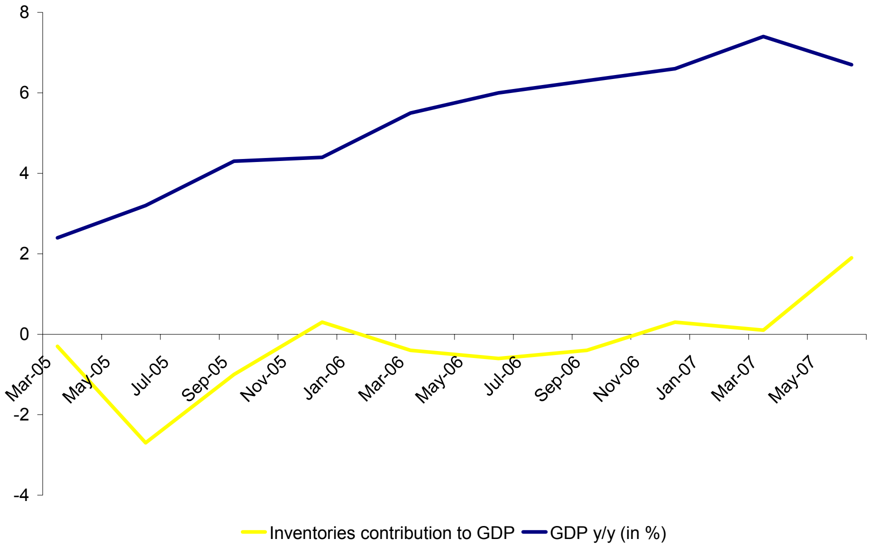
The extraordinary growth of inventories added ca 2.0% to GDP growth

The crucial issue is the inventories. If the impact of inventories on GDP was neutral (as in the previous quarters) economic growth would be 5.0% instead of 6.7%. The extraordinary growth of inventories demonstrates that, on the one hand, firms rebuild their stocks after several good quarters but, on the other hand; they expect further growth in the future. The growth of inventories may threaten growth in the short term, but we believe that the risk of slowdown is very limited. A strong performance in July's retail sales shows that growth in consumption should stay strong and GDP growth would remain in the range of 5-6% during the next few quarters.

It is worth noting that the inventories are a residual value and, in the next publication, this figure may be revised in favour of consumption and investments. Due to strong inventories, the growth rate of domestic demand increased to 9.3% from 8.5% in Q1.

GDP data may provide arguments for both "hawks" and "doves" in the MPC

The GDP data provides arguments for both proponents and opponents of rate hikes in the MPC. The "hawks" will emphasize that the high growth of GDP and domestic demand, while the "doves" will draw attention to lower consumption and the increase of potential output resulting from high investments.



MEDIUM-TERM FORECATS

Indicator	2006	2007	2008
GDP y/y (%)	6,1	**6,4**	5,7
Inflation rate (%)	1,0	2,4	3,2
Current account (% of GDP)	-2,1	-4,0	-4,8
Unemployment rate (end-of-year)	14,9	10,3	9,8
NBP repo rate (end-of-year)	4,00	5,00	5,50

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

Fixed Income

Are there reasons to be receive?

The market seems to have reached equilibrium here. Yields fluctuate within very tight spreads, MPC's decision to hike rates has no impact for the market, neither council members' comments or economic data change the general outlook. With a period of low volatility ahead, it seems to be a good time now to rethink the picture, and possibly find some imbalances and opportunities. Consensus for the repo rate is to reach 5.50% - another three 25-point steps. Historically, when there are no expectations for rate change, 3M Wibor is on average 20bp above the main rate, so at the moment this scenario is hardly priced in the curve (2 year swap curently implies 21x24 FRA at 5.67%). And the risks are still on the upside - still fast GDP growth, lower and lower unemployment, strong wages growth. Yet market doesn't want to price in any risk to the rates scenario, which the Council itself (overall a dovish one), defines as necessary means to keep inflation in check. For us it's definitely walking on a thin ice. Yes, we will most likely see low CPI reading for August (possibly as low as 1.8%), mostly due to food prices, but how does it change the medium term outlook, if everyone agrees it will go up from this point? Yes, we're observing very good budget performance this year, but since governing party, facing early elections will have to spend more and more to buy votes, how would the next year's look like? After all we are getting more and more bearish.

RECOMMENDATION:

Close steepeners. Pay 2y

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	03-09-07	-	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

Very cheap end of the reserve

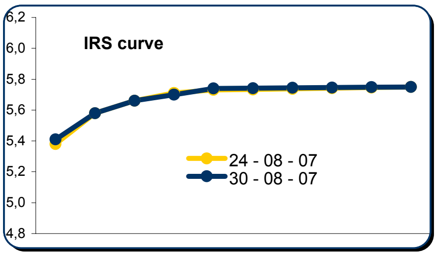
The MPC increased all the rates by 25 bps

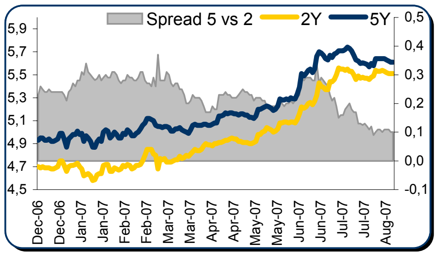
Just as we were forecasting very cheap end of the reserve became a fact. Last day and the day before the market was finishing with a substantial deposit in the central bank. Starting from Friday the new reserve will bring some new levels for cost of carry 4.7-4.8% is our best guess.
The MPC increased all the interest rates by 25 bps, just as everyone had expected.
The comments confirmed that the MPC will stick to a gradual tightening path in response to rising wage and demand pressures. The main rate reached 4.75%, the discount rate 5%, the Lombard rate 6.25%, and the overnight deposit rate 3.25%.
We still see room for another 75 bps hike, with the first 25 bps late autumn.

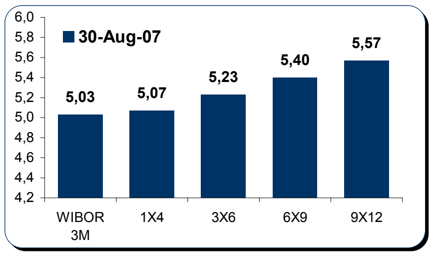
RECOMMENDATION:

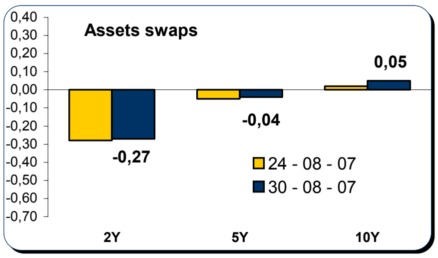
Close pay position waiting for wages.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty stable

This week złoty was traded between 3.8230 and 3.8500 and we may sincerely say its copy-paste with previous week. We were still driven by global sentiment with lower turnovers each day. Market looks slightly short PLN and any next day zloty won't explode above 3.8550 breaking of downside of range is getting more likely. In such situation we advise range trading with closely watching EURUSD, EURJPY crosses and global stocks as those are main indicators of

EURPLN direction.

Volatility stable

Implied volatility for 1M was traded between 5.9 up to 6.6 and from 5.75 to 6.1 for 1Y. Trades at 1Y below 6.0 gives signals for trades on lower levels on short tenors.

RECOMMENDATION:

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Zloty in side trend

Spot:
Main supports / resistances:
EUR/PLN: 3.8050 / 3.8550
USD/PLN: 2.7700 / 2.8800

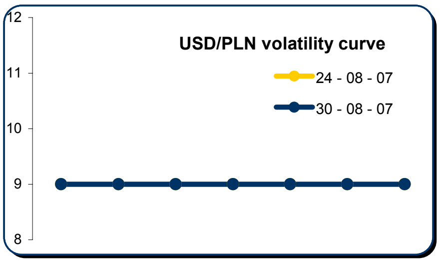
We see zloty in side trend, so we will be 3.8550 offerers. We also advice to stay careful around 3.8050 levels as probability of breaking 3.8000 is likely to be a little bit higher in coming week.

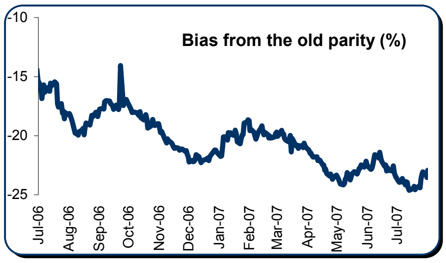
Keep short vega

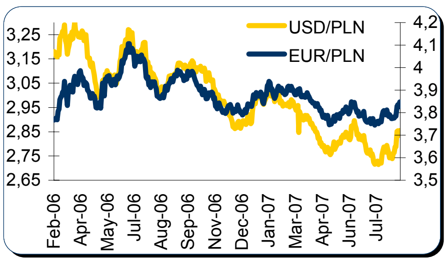
Options:

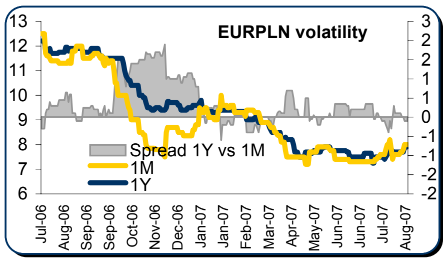
Implied volatilities above 6.2 for 1Y looks like good entry level for short EURPLN vega strategy. In case of worsening of global sentiment USDPLN 1M looks relatively cheap trade for long gamma.

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
24-08-07	4,92%	4,95%	5,05%	5,14%	5,30%	5,43%
27-08-07	4,92%	4,95%	5,05%	5,14%	5,30%	5,43%
28-08-07	4,92%	4,95%	5,06%	5,15%	5,30%	5,44%
29-08-07	5,01%	5,03%	5,10%	5,18%	5,32%	5,46%
30-08-07	5,01%	5,03%	5,10%	5,18%	5,32%	5,46%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
24-08-07	5,03%	5,21%	5,42%	5,58%	5,54%
27-08-07	5,04%	5,20%	5,40%	5,58%	5,52%
28-08-07	5,05%	5,20%	5,40%	5,57%	5,52%
29-08-07	5,06%	5,20%	5,40%	5,57%	5,52%
30-08-07	5,07%	5,23%	5,40%	5,57%	5,52%

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
24-08-07	5,43%	4,90%	5,58%	5,30%	5,73%	5,68%	5,75%	5,77%
27-08-07	5,43%	4,90%	5,58%	5,30%	5,73%	5,67%	5,75%	5,75%
28-08-07	5,44%	4,90%	5,58%	5,29%	5,73%	5,68%	5,74%	5,76%
29-08-07	5,46%	4,90%	5,59%	5,30%	5,74%	5,71%	5,75%	5,79%
30-08-07	5,46%	4,90%	5,58%	5,31%	5,74%	5,70%	5,75%	5,80%

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
24-08-07	8,80	8,60	8,50	8,40	1,30	1,30	0,30	0,35
27-08-07	9,00	8,70	8,60	8,50	1,30	1,30	0,30	0,35
28-08-07	9,00	8,80	8,70	8,60	1,30	1,30	0,30	0,35
29-08-07	9,20	8,80	8,70	8,55	1,30	1,30	0,30	0,35
30-08-07	9,10	8,75	8,75	8,50	1,30	1,30	0,30	0,35

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
24-08-07	2,8228	3,8380	-22,30%
27-08-07	2,8055	3,8306	-22,59%
28-08-07	2,8084	3,8328	-22,53%
29-08-07	2,8310	3,8477	-22,09%
30-08-07	2,8072	3,8278	-22,60%

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

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