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FINANCIAL MARKETS DEPARTMENT

PAGES: 8

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of September 14th to September 20th

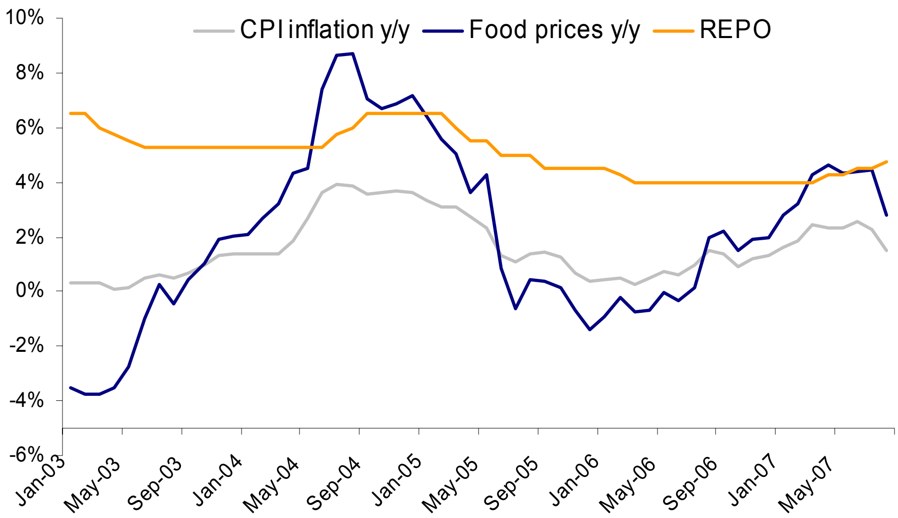
Indicator	Date of release	Period	BRE forecast	Con-sensus	Last	Comment
Corporate wages y/y	**Sep 17**	**Aug**	**9.5%**	5.5%	9.3%	In majority of sections a double-digit wage growth rates have been recorded. In addition, the recent figure has been skewed downward by earlier payment of bonuses in mining industry.
Industrial output y/y	**Sep 19**	**Aug**	**9.5%**	10.4%	10.4%	Preliminary estimates point to the strong growth in production of motor vehicles.
PPI y/y	**Sep 19**	**Aug**	**1.7%**	1.8%	1.5%	Lower oil prices have been outweighed by depreciation of the zloty in August

In Focus / Macroeconomics

Inflation sharply down in August

Low August inflation will temporarily ease expectations regarding further monetary tightening in Poland

In August CPI inflation declined to 1.5 % y/y from 2.3% y/y in the previous month, which was far below market expectations (1.9%) and preliminary FinMin estimates (1.9% y/y). Although our forecast (1.8% y/y) was below the consensus, such a decrease in the inflation rate is surprising and cannot be attached only to declining food prices and statistical base effects, which we have foreseen correctly. In fact, a strong price reduction in internet services contributed to a lower price dynamics. Excluding this changes the CPI inflation would amount to 1.7% y/y.
We expect that this fall in the CPI inflation will translate into the net inflation rate of 1.2% y/y. As a consequence of a drop in August inflation the path of future inflation will be pulled downwards. This month's CPI inflation rate, which is far below market consensus, will also temporarily ease expectations regarding further monetary tightening in Poland and provide arguments for the dovish part of the MPC. Strength of these arguments may alter only marginally after the August data concerning wages and employment growth is released. We envisage that only higher inflation in September and subsequently Central Bank's inflation projection may turn around the currently prevailing dovish view on the Polish monetary policy.



2008 budget deficit below 30 PLN bn but higher than in 2007

2008 budget draft does not account for the effects of the latest legislative changes

The government approved the 2008 budget draft this week. In line with earlier rumours, the budget revenues were set at 246.99 PLN bn while spending was planed at 275.1 PLN bn. Thus, the 2008 budget deficit is to reach 28.16 PLN, i.e. about 5 PLN bn higher than previously estimated for this year (the Finance Ministry expects the budget deficit to reach only PLN23bn this year). The borrowing needs are expected to rise by 16% to 45.69 PLN bn. The numbers released this week, however, fail to account for the EU flows and thus making it difficult to compare with this year's data. Given the high tax revenues base from this year, tax revenues planned for the next year seem pretty realistic; in fact, tax revenues are expected to rise by 12% y/y, while a 16.5% rise was recorded in 2007.
Even though the Ministry of Finance has clearly emphasized the reduction in the deficit to below the PLN30 billion anchor, maintained in previous years, there is a risk that bills put forward by the Sejm a week ago, concerning tax exemptions in particular, may reduce budget revenues by an extra 2-3 bn. This has even been explicitly noted by Minister Gilowska, who stated that the draft does not account for the effects of the latest legislative changes. Potential changes in taxation are due to be voted on in the upper house of the Polish parliament today – in our opinion they are very unlikely to be rejected or amended. If implemented, the costs of these tax exemptions and adjustments to pension payments may present a serious threat to the nominal convergence path in the coming years.

Budget estimates have been, in our opinion, based on pretty realistic assumptions that differ little from the consensus of analysts' forecasts. The Ministry of Finance revised down its forecast for growth next year to 5.5% from 5.7%, but left the CPI unchanged at 2.3%. Although we expect CPI inflation to top 3% next year, the FinMin's forecasts are safe in terms of their implications on the next year's budget revenues. The FinMin has also upgraded its estimates of the next year's base interest rate level to 5.2%, which is pretty close to what is priced in by the market.
Markets did not react to the above information and we think the market will continue to ignore this kind of news in the coming weeks, as investors seem more focused on the credit crisis developments than Poland's fiscal policy. We expect, however, the fiscal policy to regain its importance in the coming months. We are also pretty confident that the fiscal stimuli will induce excessive inflationary pressure next year.

The highest CA deficit since 2004

We expect this trend to continue, with export dynamics at 12-16 per cent yoy and significantly higher import dynamics

In July the CA balance amounted to -1.300 bn EUR - which was in line with our forecast (-1.253 bn EUR) and fairly below market consensus (-1.115 bn EUR). That corresponds to a CA/GDP ratio of approximately 3.3%. Thus the Polish CA recorded the highest deficit level since 2004 - mainly due to the expanding gap in the trade balance. In July import dynamics accelerated to 24.3% y/y, while export dynamics remained at a level of 15.8% y/y. The discrepancy between the import and export growth is the result of very strong domestic demand. The latter is supported by increasing consumption, which is due to the fast wage growth (9.3% y/y in July), and booming investment (18.8% y/y in Q2).
An expanding trade gap, negatively affecting the CA balance, characterises the majority of developing economies as household income growths fast. Consequently, we expect this trend to continue, with export dynamics at 12-16% y/y and significantly higher import dynamics. As a knock on effect, the CA deficit will expand faster than the Polish GDP's growth. So we foresee the CA/GDP ratio as having declined to -4.0 per cent by the end of this year. In 2008 it may exceed even the 5.0 per cent level. A worsening CA balance may also restrict the Zloty's appreciation. Thus it might gain more attention from the MPC, becoming one of key factors analyzed by Committee members.

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

And still no inflation…

Yesterday's CPI number came out at 1.5% y/y, way below market consensus of 1.9% and our expectations (1.8%). This caused a very rapid move down in yields - 2y fell by 25bp down to 5.34%. Now the curve hardly prices in just one more rate hike in this cycle. Apparently our perception of the rates being too low was wrong. Now the main question is, whether such low inflation is real, or is it just a statistical fluke. We think it cannot stay at this level for a long time, and pay position in the short end seems to be a free bet. On the other hand, rate hikes will be postponed, and probably the scale will be smaller, which makes bond yields attractive, so the flattening should continue.

RECOMMENDATION:

Pay short end. Receive 2y/10y spread.

AUCTIONS

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	4.208%	1/16/2006
26 Week T-bills	-	-	3.943%	4/24/2006
52 Week T-bills	17/09/07	-	5.084%	9/3/2007
2Y T-bond OK1209	03/10/07	-	5.327%	9/5/2007
5Y T-bond PS0412	19/09/07	-	5.480%	6/20/2007
10Y T-bond DS1017	10/10/07	-	5.658%	7/11/2007
20Y T-bond WS0922	-	-	5.796%	9/12/2007

Money Market

Stable carry

Stable carry all over the week plus again open market operation above the expectations (21,3 billion PLN vs 21.0 billion PLN previous week – 20.5 billion PLN expected). The reduction rate remained very low (6,54%) Moreover, again CB's liquidity projection shows nice surplus of the cash.

Poland's parliament dissolved itself

Poland's parliament dissolved itself Friday triggering an early election. It has no impact on the market.

Polish C/A gap above expectation

Polish July current account gap above expectation – without influence.

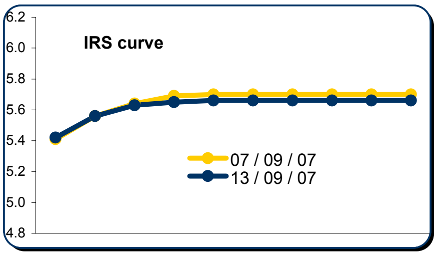
No T-bills auction this week.

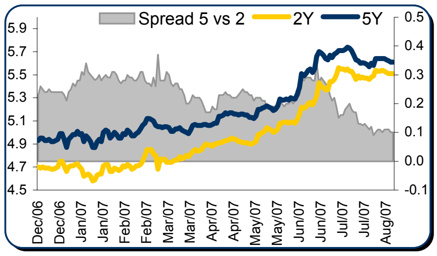
No T-bills auction this week. Next T-bill auction on September 17.

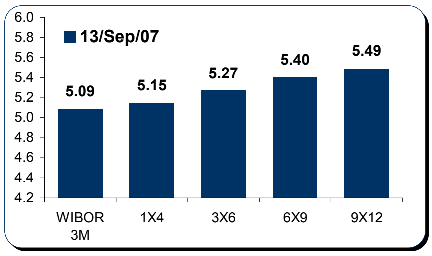
RECOMMENDATION:

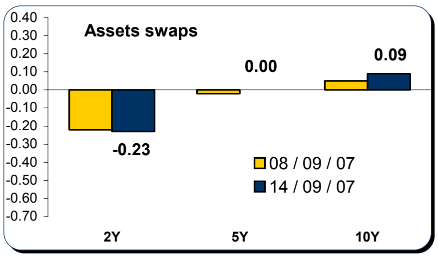
Pay 9M and 1Y Wibor OISs after good CPI figures.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty stronger

Ones again the global sentiment won with the local news. The early elections, all the political turmoil in Poland are much less important to the global investors than the global equity performance, or EUR/USD and EUR/JPY uptrend. As the result Zloty gained ground again USD

(2,7070 low) and EUR (2,7690 low). The move, especially against USD was quite impetuous; some stop losses were triggered on the way down.

Stronger zloty, better global sentiment, constant supply from local hedgers. Volatility is down again, with trades - 6 month given at 5,75 and 1 year at 5,8 , short dated vega also being sold heavily as long gama did not really paid it s theta bill.

Volatility lower

RECOMMENDATION:

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Zloty stronger

Spot:
Main supports / resistances:
EUR/PLN: 3,7400,3,7600 / 3.7900, 3,8150
USD/PLN: 2.6850, 2,7000 / 2.8250, 2,7500

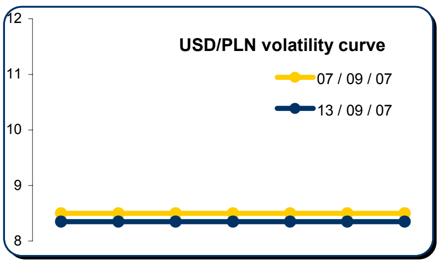
The PLN train is already running, we don’t feel comfortable to jump into zloty at the current levels. The possibility of the pull back is quite high. Looking at US figures, equity etc. searching for clues. If you believe in the uptrend in EUR/USD uptrend, the short USD/PLN is a long EUR/USD with carry.

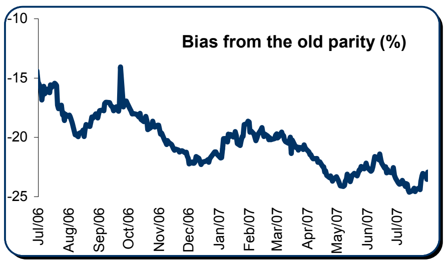
Keep short vega EUR/PLN, Buy longer RR in USD/PLN

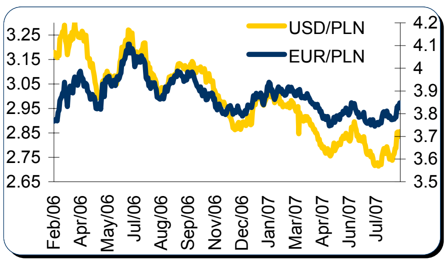
Options:

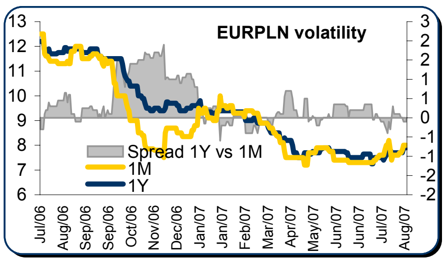
We stick to our last (and the earlier) recommendation, keeping short vega in EUR/PLN. With the better global risk appetite conditions we may see the test of the downside, targeting 5,5 % mid vol on 1 year. The USD/PLN is the different thing, we are buyers longer term risk reversals in USD/PLN, seeing the good value in current lows in USD/PLN risk reversals. We are also the biders for gama in USD/PLN hoping that crowded US calendar will keep EUR/USD bell ringing

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
07/09/07	4.89%	5.10%	4.98%	5.22%	5.20%	5.49%
10/09/07	4.99%	5.10%	5.05%	5.23%	5.22%	5.50%
11/09/07	4.99%	5.10%	5.05%	5.23%	5.22%	5.50%
12/09/07	4.99%	5.10%	5.05%	5.23%	5.22%	5.50%
13/09/07	5.09%	5.09%	5.09%	5.24%	5.26%	5.50%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)					
date	1X4	3X6	6X9	9X12	6X12
07/09/07	5.12%	5.24%	5.35%	5.50%	5.47%
10/09/07	5.14%	5.25%	5.35%	5.48%	5.44%
11/09/07	5.14%	5.25%	5.35%	5.48%	5.44%
12/09/07	5.14%	5.26%	5.37%	5.47%	5.45%
13/09/07	5.15%	5.27%	5.40%	5.49%	5.48%

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
07/09/07	5.49%	5.08%	5.57%	5.29%	5.72%	5.69%	5.73%	5.76%
10/09/07	5.50%	5.05%	5.57%	5.29%	5.71%	5.68%	5.72%	5.76%
11/09/07	5.50%	5.05%	5.57%	5.34%	5.71%	5.67%	5.71%	5.76%
12/09/07	5.50%	5.05%	5.56%	5.30%	5.71%	5.65%	5.72%	5.75%
13/09/07	5.50%	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	07/09/03	08/09/03	1.000	5.08%	900	1295	900
OK0709	07/09/05	09/07/25	90.694	5.33%	1800	4232	1800
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
07/09/07	8.15	8.10	8.10	8.10	1.30	1.30	0.30	0.35
10/09/07	8.15	8.10	8.10	8.10	1.30	1.30	0.30	0.35
11/09/07	8.15	8.10	8.10	8.10	1.00	1.00	0.30	0.35
12/09/07	8.35	8.20	8.20	8.20	1.00	1.00	0.30	0.35
13/09/07	8.40	8.20	8.20	8.20	1.00	1.00	0.30	0.35

PLN SPOT PERFORMANCE

PLN spot performance			
date	USD/PLN	EUR/PLN	bias
07/09/07	2.7853	3.8120	-23.04%
10/09/07	2.7619	3.8075	-23.36%
11/09/07	2.7513	3.7946	-23.63%
12/09/07	2.7233	3.7736	-24.20%
13/09/07	2.7126	3.7756	-24.30%

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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