



POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

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**FI
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MONEY MARKET

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- Fast rates hike expected, October scenario almost fully priced in

**MM
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- Buy shortest OISs starting from Monday if the levels preserved

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- Short tenors of volatility higher

**FX
RECOMMENDATION**

- Zloty overbought – look for correction
- Sell mid-curve vega

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PREVIEW: The week of October 24th to October 31st

Indicator	Date of release	Period	BRE forecast	Con-sensus	Last	Comment
Polish MPC meeting	Oct 31	-	5.0%	4.75%	4.75%	Elevated inflation projection may convince the Committee to hike the rates. The most recent appreciation of the zloty poses the main risk for a hike scenario.

In Focus / Macroeconomics

As the winning fraction's program is said to be liberal, the markets rallied on the elections outcome

The sharp appreciation of the zloty in response to the elections outcome may however prove to be overdone from the perspective of the coming months.

We expect the MPC to react to rising ULC and higher mid-term inflation prospects by hiking the rates in October

Outcome of snap general elections in line with opinion polls but at a surprise for the markets

The snap elections gave the majority of seats in the Parliament to the Civic Platform (PO). The voting attendance reached record high 53.88% - this very high for Polish elections turnout is widely believed to be detrimental to the election's outcome for Law and Justice (PiS).

Civic Platform occupied 209 (out of 460 total) seats in the parliament whereas the ex-ruling party, Law and Justice, gained 166 mandates. The coalition of Social Democrats (LiD) was able to collect 53 seats and the Peasants Party – 31; 1 mandate was given to the German minority.

As the winning fraction's program is said to be liberal, the markets rallied on the elections outcome - contrary to our view the foreign investors did not price in the outcome suggested by the latest opinion polls that indicated an outstanding victory for the PO. The in-fact-realized vision of the state will depend on demands of the potential coalition partner – the Peasants Party (PSL). The preliminary talks between PO and PSL have already begun and it is said that the parties have almost fully agreed on parliamentary cooperation. Negotiations concerning the frame of the government are still in progress and their outcome is planned to be announced on Tuesday. The papers speculate on future Finance Minister nominee – it is very likely that the candidate will be rather an expert than a person from political surrounding. These nominations may, in our opinion, trigger further positive reactions on the FX and FI market. Other key positions in the cabinet are believed to be taken by PO representatives, other – mainly deputy offices – are designated for PSL members.

The aforementioned coalition (PO+PSL) will possess 240 votes, 10 votes more than required for an ordinary majority. It is sufficient to pass bills, but insufficient (lack of 36 votes) to suppress presidential veto. It seems the latter issue is of major importance as the reforms, mainly focused on privatization and cuts in welfare spending, announced by the PO are believed to be harshly criticized by the President. It is also unlikely that LiD, due to its support among socially oriented voters, will back the coalition in issues concerning cuts in social expenditures. To summarize, the plans concerning the serious revision of the 2008 budget bill are likely to fail. In particular, the tax wedge cuts (a total cost for the 2008 budget estimated at PLN 19.8 bn), indexation of pension benefits (a total cost of PLN 5.7 bn) and tax exemptions for families (PLN 6.5 bn) are unlikely to be cancelled out. Thus, the sharp appreciation of the zloty in response to the elections (which was partly owing to stop-losses and expiring of the barrier options) outcome may prove to be overdone from the perspective of the coming months.

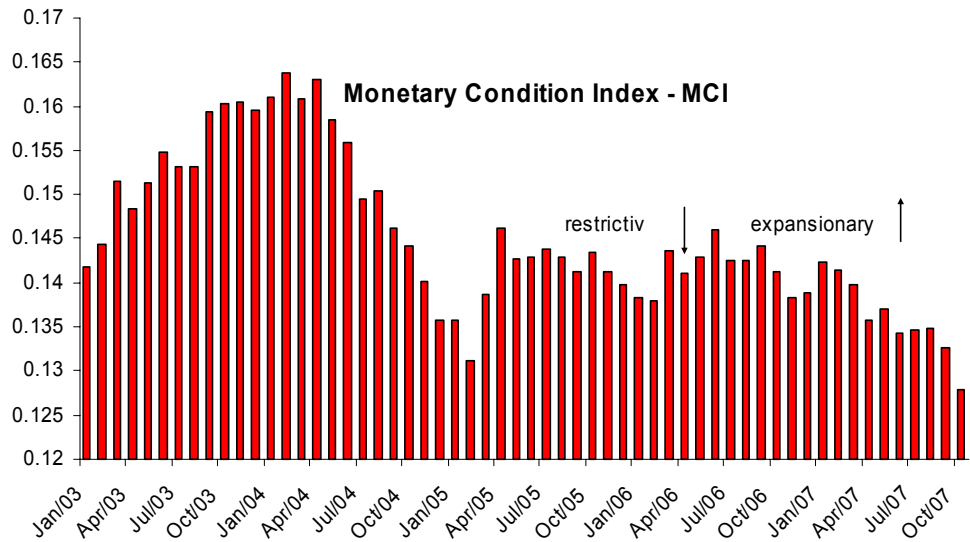
October hike highly probable, but why?

The decision of the MPC will be announced on Wednesday. We believe that costs of credit will be lifted by 25 bps; we assess the probability of such a move at 70%. Our opinion stands in contrast with the view of the majority of the analysts, however, the arguments in favor of a fast hike are solid and have been recently mounting; the only question remains the strong zloty.

Our calculations based on the relation between the unit labor costs and the inflation in the ECMOD model (an official central bank projection model) clearly show that the path of inflation should be lifted (simple base effects imply the core inflation will drift towards about 3% in coming months). The analysis shows the price growth presented in official projection will surpass the upper tolerance band of the central bank's target in medium term. Recent hawkish comments of the key MPC members suggest that they may also be worried about the mid term inflation prospects. Rising food prices (a global trend as some MPC members are trying to communicate) and elevated oil costs speak for a hike. The impact of dearer oil is partly offset by strong zloty which also makes imports of goods cheaper – according to our calculations the current level of the EUR/PLN exchange rate reduces headline inflation up to about 0,3 pp. in Q2 2008). However, there are doubts, echoed by A. Stawiński from the MPC, that strong Polish currency stems from one-off factors and the trend may be reversed. Those concerns make the October's hike more probable, but of course not a done deal. Finally, the outcome of August voting – when the MPC

decided to raise the reference rate to 4.75% - showed a tightening bias of the whole body: the motion of lifting the borrowing costs was passed with 9 members in favor and one against (apparently the only dissenter was the president of MPC, S. Skrzypek).

Having all those facts in mind it is reasonable to assume that the hike will occur in October. The view is consistent with expectations drawn from money market – the implied hike probability reaches 80%. In those circumstances the MPC may simply not act against market consensus. The decision in June clearly showed that the pursued monetary policy is independent and truly forward looking. In our opinion, the only factor which may prevent the members from a hike is the strong zloty.



MEDIUM-TERM FORECATS

Indicator	2006	2007	2008
GDP y/y (%)	6.1	6.5	5.7
Inflation rate (%)	1.0	2.4	3.2
Current account (% of GDP)	-2.1	-4.5	-5.3
Unemployment rate (end-of-year)	14.9	11.0	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

Time for inverted curve

Even though we disagreed with steepening of the curve and called for flatteners, the scale and pace of recent move surprised us a little. However, giving it a second thought, political environment became very friendly for the long end of the curve, and further narrowing of 5y5y forward spread to euro seems quite likely. Nevertheless at the very moment we definitely prefer short end of the curve. We stick to our view, that 25bp hike will be delivered already next week, and the inflation projection will show inflation path higher than the previous one. In that case, short term of the curve represents big value, with very limited downside potential. Therefore we recommend keeping pay position up to 2y and use corrections on the longer end to add to flatteners.

RECOMMENDATION:

Pay 3x6 FRA

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	05/11/07	-	5.144%	10/22/2007
2Y T-bond OK1209	07/11/07	-	5.284%	10/3/2007
5Y T-bond PS0412	21/11/2007	-	5.718%	10/17/2007
10Y T-bond DS1017	14/11/2007	-	5.658%	10/10/2007
20Y T-bond WS0922	-	-	5.796%	9/12/2007

Money Market

Cheap end of the reserve very likely

Fast rates hike expected, October scenario almost fully priced in

T-bills yields up

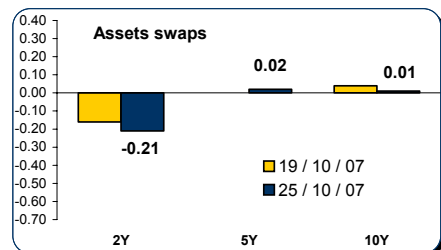
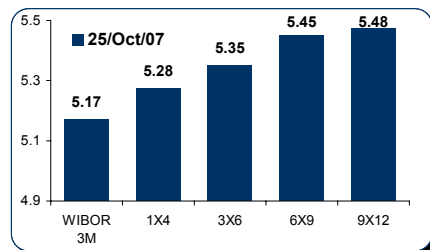
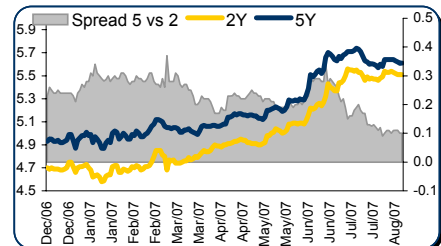
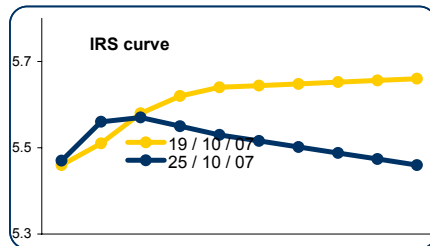
The amount of the money in the system has significantly grown. Size of the deposit of the MinFin placed in commercial banks last week was really impressive, hence the central bank will have lots of trouble to sterilize the market before the end of the reserve requirements settlement period. We think that probability of a very cheap carry during last days of the reserve is 70%, As for longer terms another comments from the MPC member Noga sustained and even intensified fast rates hike expectations. The OIS curve has already priced in October hike in more or less 80% and cheap carry is the only reason why shortest OISs are so low. For longer terms there is practically no doubt, and potential tightening of the monetary policy next week will surprise no one.

Also T-bills were under the pressure during the auction and average yield finally went up from 4,99% to 5.14%. Nonetheless comparing to other MM instruments those papers still remain expensive and only lack of liquidity can justify the fact.

Buy shortest OISs starting from Monday if the levels preserved.

RECOMMENDATION:

FIXED INCOME & MONEY MARKET CHARTS



Foreign Exchange

Zloty stronger

This week zloty was traded between 3.6970 and 3.6260. It was the outstanding win of the Civic Platform in the snap elections and expectations for aggressive rate hikes combined with breaking of PLN barrier options drove PLN to such high levels.

Short tenors of volatility higher

RECOMMENDATION:

Zloty overbought – look for correction

Sell mid-curve vega

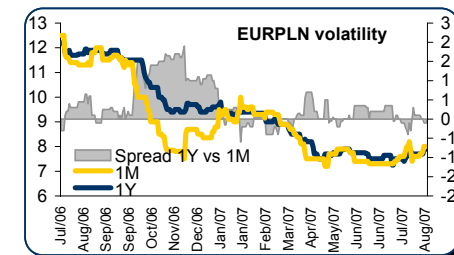
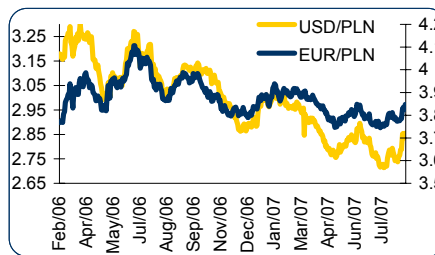
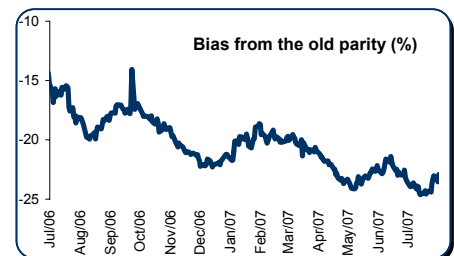
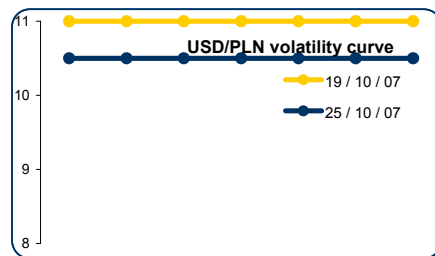
FX CHARTS

EURPLN volatility curve was lifted to 7.2 for 1M and 6.4 for 3M from 6.7 and 6.1 respectively with 1Y still traded around 5.9-6.0. Move was strictly correlated with zloty strengthening and breaking many of barriers what left traders with short gamma and vega positions.

Spot:
Main supports / resistances:
EUR/PLN: 3.6000 / 3.6800
USD/PLN: 2.5000 / 2.5900

As good news has been already priced in and significant part of move was triggered by breaking of options barrier we see higher probability of correction toward 3.68/3.70 levels.

Options:
Growth of vega and gamma demand appeared as barriers were broken and was covered on interbank market. So as customers supply had time unfit it should be just matter of time when supply of vega will exceed demand. In medium term we see curve back below 6.0 once again.



MARKET PRICES UPDATE**MONEY MARKET RATES**

Money market rates (Closing mid-market levels)						
date	3M		6M		1Y	
	FXSW	WIBOR	FXSW	WIBOR	FXSW	WIBOR
19/10/07	5.20%	5.15%	5.17%	5.30%	5.36%	5.50%
22/10/07	5.22%	5.16%	5.17%	5.32%	5.33%	5.52%
23/10/07	5.22%	5.16%	5.14%	5.33%	5.30%	5.53%
24/10/07	5.22%	5.15%	5.16%	5.33%	5.34%	0.00%
25/10/07	5.22%	5.17%	5.18%	5.34%	5.35%	5.53%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)					
date	1X4	3X6	6X9	9X12	6X12
19/10/07	5.22%	5.31%	5.42%	5.46%	5.48%
22/10/07	5.22%	5.30%	5.40%	5.45%	5.46%
23/10/07	5.25%	5.31%	5.41%	5.42%	5.46%
24/10/07	5.25%	5.32%	5.44%	5.46%	5.48%
25/10/07	5.28%	5.35%	5.45%	5.48%	5.50%

FIXED INCOME MARKET RATES

Fixed Income Market Rates (Closing mid-market levels)								
date	1Y		2Y		5Y		10Y	
	WIBOR	TB	IRS	OK0709	IRS	PS0511	IRS	DS1017
19/10/07	5.50%	5.08%	5.57%	5.29%	5.72%	5.69%	5.73%	5.76%
22/10/07	5.52%	5.05%	5.57%	5.29%	5.71%	5.68%	5.72%	5.76%
23/10/07	5.53%	5.05%	5.57%	5.34%	5.71%	5.67%	5.71%	5.76%
24/10/07	0.00%	5.05%	5.56%	5.30%	5.71%	5.65%	5.72%	5.75%
25/10/07	5.53%	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	07/10/22	08/10/22	95.056	5.14%	500	1177	500
OK0709	07/10/03	09/07/25	91.123	5.28%	1800	3571	1800
PS0412	07/10/17	12/04/25	96.188	5.72%	2300	38750	2300
DS1017	07/10/10	17/10/25	96.607	5.70%	1800	5061	1800

FX VOLATILITY

date	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
	1M	3M	6M	1Y	1M	1Y	1M	1Y
19/10/07	9.50	8.70	8.50	8.50	0.60	0.90	0.30	0.35
22/10/07	9.20	8.80	8.60	8.50	0.50	0.55	0.30	0.35
23/10/07	9.20	8.80	8.60	8.50	0.50	0.55	0.30	0.35
24/10/07	9.20	8.80	8.60	8.50	0.50	0.55	0.30	0.35
25/10/07	9.20	8.80	8.60	8.50	0.50	0.55	0.30	0.35

PLN SPOT PERFORMANCE

PLN spot performance			
date	USD/PLN	EUR/PLN	bias
19/10/07	2.5761	3.6792	-27.00%
22/10/07	2.5753	3.6835	-26.96%
23/10/07	2.5730	3.6566	-27.30%
24/10/07	2.5702	3.6555	-27.35%
25/10/07	2.5522	3.6436	-27.69%

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)

Jarosław Stolarczyk (+48 22 829 01 67) Jaroslaw.stolarczyk@brebank.pl
Jacek Dereziński (+48 22 829 01 69)

Institutional Sales (BRES)

Inga Gaszkowska-Gębska (+48 22 829 12 05)

Research

Ernest Pytlarczyk (+48 22 829 01 66) Research@brebank.pl
Marcin Mazurek (+48 22 829 0183)
Radosław Cholewiński (+48 22 829 12 07)

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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