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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of November 2nd to 9th

Indicator	Date of release	Period	BRE forecast	Con-sensus	Last	Comment
NO SIGNIFICANT DATA RELEASES						

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In Focus / Macroeconomics

Polish MPC – still “wait and see”

The projection does not imply that inflation will stabilize on a comfortable level – thus it should have made the MPC members act. But it did not…

The MPC decided to leave the borrowing costs unchanged at 4.75% - in line with market expectations, contrary to our forecast. The statement issued after the meeting uncovered the inflation path presented in the newest projection. Just as we expected, inflation is projected to rise in medium-term and surpasses the upper limit of the tolerance band in 2009 (namely – 3.5%), however, the path till the mid 2008 has been lowered. The projection does not imply that inflation will stabilize on a comfortable level – thus it should have made the MPC members act. But it did not…

Among the reasons which triggered the postponement of the decision to November (in line with expectations) we may enumerate the strong zloty and concerns of the MPC that higher interest rates may make the zloty appreciate further (which is good news for the price stability but stands in contrast with other central bank target – stability of the exchange rate). Moreover, there have been signals that economic growth may fall slightly short of expectations and thus we cannot exclude that this fact raises some concerns among MPC members. However, none of those presumptions has been exemplified in the statement.

The tone of the statement in fact did not vary from the text issued after the previous meeting.

The tone of the statement in fact did not vary from the text issued after the previous meeting. It stresses some fears that higher wage growth may pass through to inflation, but the transmission mechanism has not been working yet as the financial conditions of enterprises are favorable. Upside risk to inflation is also posed by higher food prices and expansionary fiscal policy. However, the pressure is limited by the ongoing globalization and expected slowdown in the global economy. The statement ends with information that the inflation risk has been limited owing to the tightening steps taken so far but, still, the hazard of exceeding the target dominates. The more comprehensive assessment of this risk will be possible with the inflowing data.

It seems the inflation concerns will outweigh in November whereas the growth concerns will come into foreground in coming year. Thus we see a tightening in November.

November comments given by J. Czekaj suggest that the MPC is likely to hike this month and estimates the probability of the hike at 55%. He also points out that further rate increases in 2008 may be needed, however, the necessity depends much on the prospects for GDP growth (according to the latest release of the PMI index, Polish manufacturing may decelerate slightly owing to falling new orders). The comments of this MPC member confirm our view that the MPC may be concerned with a slight lower GDP growth but stands ready to act to offset inflationary pressures. According to our forecasts, November will bring higher inflation for October, relatively low industrial production, solid retail sales growth and deepening C/A deficit. Those facts, combined with higher HICP inflation in EMU may trigger higher inflation expectations. On the other hand, the divergence of the data from market consensus may indicate the fundamentals of economic growth. Base effects and slowly rise of inflation to the vicinity of 3% should trigger expectations for more pronounced hikes in 2008. As for now, it seems the inflation concerns will outweigh in November whereas the growth concerns will come into foreground in coming year. Thus we see a monetary tightening in November.

Situation after snap elections – follow up

The picture emerging from the latest snap elections is still blurred although some new pieces of information have already come into the light.

The rumors concerning the future finance minister are now focused on Jacek Rostowski…

The shape of the government is to be announced on 5. November – the Peasants Party appear to be a tough negotiator and prolong the coalition talks. At the moment, PSL is believed to take up 3 Ministries. The rumors concerning the future finance minister are now focused on Jacek Rostowski, former advisor to Leszek Balcerowicz in the National Bank of Poland. The candidate is known as an utter supporter of a possibly fast entering the European Monetary Union. His proposals, exemplified in many articles, include even an “euroization” – adopting a single currency by a simple conversion of all FX reserves into euro and withdrawing the zloty from circulation. Such a version of “joining” the EU strongly violates the legal route to single currency and will definitely fail to gain support from the central bank.

Investors have already given a trust credit to the winning party (its program includes, among

Much of future reforms have been already priced in – the FX market awaits now concrete actions of the ruling party.

others, lowering budget deficit, simplifying tax system along with implementation of linear tax rate, introducing task oriented fiscal planning, scrapping of capital gains tax and interest income tax, faster privatization and deregulation, revamping pension system for farmers). The zloty strengthened considerably versus the euro after the elections and now consolidates around low levels. The scale of appreciation (counted from the date when opinion polls began to point to a PO victory, i.e. approximately 3 weeks) has amounted to almost 3% - a distance usually covered within a whole year in times of solid economic growth and large FDI inflow (about $15 bn for 2007). Thus much of future reforms have been already priced in – the market awaits now concrete actions of the ruling party.

Political stabilization gives the recent zloty appreciation a solid footing.

Political stabilization will probably attract more private equity funds (already being quite active in the Polish market). This gives the recent appreciation of the zloty a solid footing – the achieved levels are likely to be sustained, despite growing imbalance of current account. On the other hand it is difficult to expect the FDI to beat the figures recorded this year – investors have been seeing Poland as a very attractive country to invest for a couple of years, thus we expect the FDI inflow to be sustained on current levels. Potential risk factor remains the EUR/USD exchange rate which pushes the EUR/PLN downwards – as soon as the economic growth in the U.S. recovers, the depreciation of the dollar is very likely to be reversed, however, no sooner than in the second half of 2008.

Regardless of the outcome of coalition talks, we sustain our view that the 2008 budget bill will be left intact (or be subjected to cosmetic changes). There have been rumors that the payroll tax cuts (a total cost for the 2008 budget estimated at 19.8 PLN bn), planned for 2008, may be halted to raise revenues and limit the fiscal deficit. We do not expect such a movement and believe that extra revenues will be gathered rather by intensified privatization, to begin form the end of 2008 on. That is why indexation of pension benefits (a total cost of 5.7 PLN bn) and tax exemptions for families (6.5 PLN bn) are unlikely to be cancelled out.

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

Rates unchanged. Market unchanged.

The MPC's decision to leave rates unchanged didn't surprise the market at all and the rates didn't move more than a tick. Apparently the new inflation projection and comments from the council members suggest this month hike is very likely, but that's almost fully priced in. It seems like the oncoming week will be a boring one, no data releases till mid month, 2Y bond auction which hardly ever causes any excitement. Only longer end of the curve is likely to move, being vulnerable to core market movements and possible political news after new government is formed. Short end of the curve, up to 2Y still seems to have more upside than downside potential in the mid-term.

RECOMMENDATION:

Stay pay short end.

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	05-11-07	-	5,144%	2007-10-22
2Y T-bond OK1209	07-11-07	-	5,284%	2007-10-03
5Y T-bond PS0412	21/11/2007	-	5,718%	2007-10-17
10Y T-bond DS1017	14/11/2007	-	5,658%	2007-10-10
20Y T-bond WS0922	-	-	5,796%	2007-09-12

Money Market

Unexpected liquidity squeeze

The MPC left all the rates unchanged

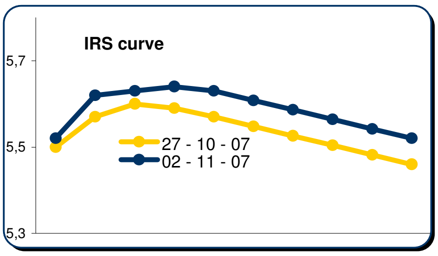
Very strange week for liquidity. Despite the fact that there was nice surplus of the cash in the system we had 5 days of regular squeeze. We have seen such a situation for the first time, and we have seen a lot. Some banks were taking Lombard credit and some were locating huge amounts of money in the central bank, so 3% spread occurred. Of course it was not the first time of such awkward market behavior, however this time we cannot find any reasonable explanation. We leave the question "WHY?" opened.

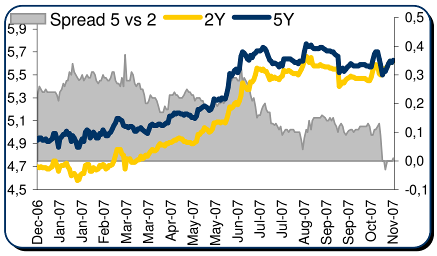
Liquidity problems dominated almost all other MM activities. Waiting for the MPC was being disturbed by few more bets. The stake was of course whether there will be hike or not. Now we know the answer, which is: not this time. Hike in November is very likely though.

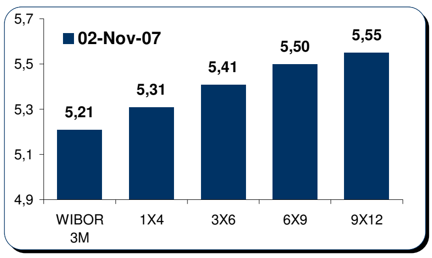
RECOMMENDATION:

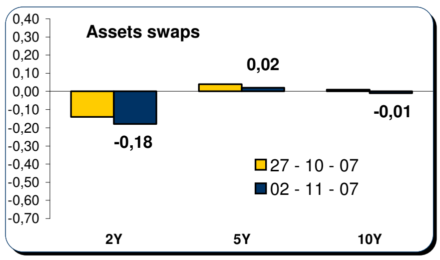
Sell OISs up to 3M buy longer ones.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Consolidation and then reverting to the trend.

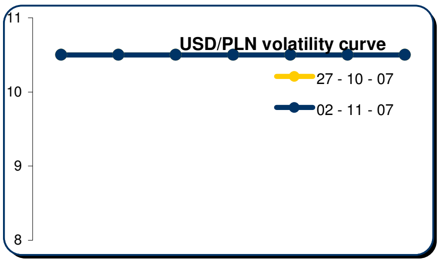
This week zloty reached two supports 3.6000 on EUR/PLN and 2.5000 on USD/PLN. No rate hike decision on Wednesday and sell off on US stock Exchange on Thursday gave signal for stronger corrections above 3.6600. Now we can see consolidations around 3.6300-3.6600 before reverting to downward trend.

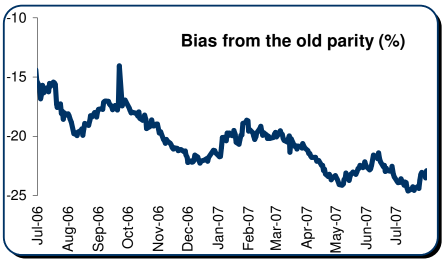
Spot:
Main supports / resistances:
EUR/PLN: 3.6000 / 3.6800
USD/PLN: 2.5000 / 2.5900

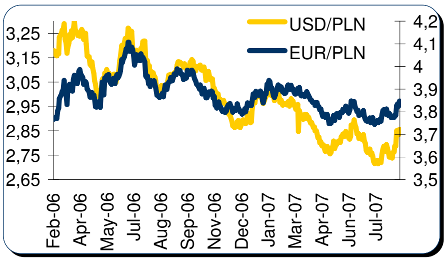
RECOMMENDATION:

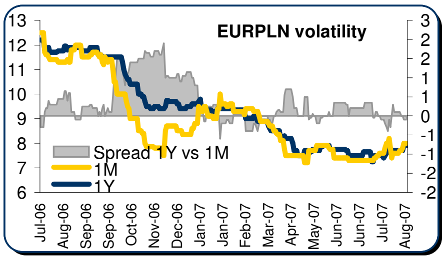
As correction is almost done we recommend sell on rally with target at 3.6000.

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
27-10-07	5,22%	5,17%	5,18%	5,34%	5,35%	5,53%
30-10-07	5,24%	5,18%	5,20%	5,35%	5,38%	5,55%
31-10-07	5,24%	5,21%	5,23%	5,38%	5,42%	5,56%
01-11-07	5,24%	5,21%	5,23%	5,38%	5,42%	5,56%
02-11-07	5,25%	5,21%	5,25%	5,38%	5,42%	5,57%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
27-10-07	5,28%	5,37%	5,47%	5,51%	5,53%
30-10-07	5,30%	5,39%	5,50%	5,53%	5,56%
31-10-07	5,29%	5,40%	5,50%	5,52%	5,54%
01-11-07	5,29%	5,40%	5,50%	5,52%	5,54%
02-11-07	5,31%	5,41%	5,50%	5,55%	5,57%

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
27-10-07	5,53%	5,08%	5,57%	5,29%	5,72%	5,69%	5,73%	5,76%
30-10-07	5,55%	5,05%	5,57%	5,29%	5,71%	5,68%	5,72%	5,76%
31-10-07	5,56%	5,05%	5,57%	5,34%	5,71%	5,67%	5,71%	5,76%
01-11-07	5,56%	5,05%	5,56%	5,30%	5,71%	5,65%	5,72%	5,75%
02-11-07	5,57%	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

	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
date	1M	3M	6M	1Y	1M	1Y	1M	1Y
27-10-07	9,20	8,80	8,60	8,50	0,50	0,55	0,30	0,35
30-10-07	9,80	8,80	8,80	8,60	0,50	0,55	0,30	0,35
31-10-07	9,80	8,80	8,80	8,60	0,50	0,55	0,30	0,35
01-11-07	9,80	8,80	8,80	8,60	0,50	0,55	0,30	0,35
02-11-07	9,80	9,00	9,00	8,70	0,50	0,55	0,30	0,35

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
27-10-07	2,5227	3,6247	-28,26%
30-10-07	2,5238	3,6313	-28,16%
31-10-07	2,5155	3,6306	-28,27%
01-11-07	2,5155	3,6306	-28,27%
02-11-07	2,5184	3,6467	-28,04%

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
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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