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FINANCIAL MARKETS DEPARTMENT

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WARSAW, DECEMBER 14, 2007

POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of December 14th to December 21st

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
Corporate wages	**Dec 17**	**Nov**	**11.5% y/y**	11.0%	11.0%	Bonuses in mining may lift the November wage figure.
Industrial output	**Dec 19**	**Nov**	**8.3% y/y**	9.1%	10.6%	No working day effects. In line with the underlying trend.
PPI	**Dec 19**	**Nov**	**2.7% y/y**	2.8%	2.2%	Low base effects. Higher oil prices and lower for metals.

MPC meeting	**Dec 19**	**Nov**	**5.25%**	5.0%	5.0%	The chances for a rate hike are like 50/50. The fundamentals may weigh on the decision.

In Focus / Macroeconomics

Guessing the outcome of December MPC meeting

Looking back at historical MPC decisions it is striking that the Committee did not alter the rates in December with the only one exception in 2001 when the cost of credit was lowered. The unwillingness of the MPC to act at the end of the year has been transformed recently to a word "tradition", coined to justify the unjustified. Arguments based on tradition were supported by most MPC members till early December when the inflation forecast of the Ministry of Finance was announced at 3.5%, hitting the upper band of tolerance interval. This fact abruptly altered the "traditional" view of some rate-setters.

December differs from other months as the MPC meeting takes place before Christmas, limiting the scope of available data on which the decision is based. However, this year the key figures are published before the MPC members cast votes on rates (19. December): inflation, wages, employment, industrial production. Our purpose is then to estimate the extent to which the inflowing data may concrete the already born concerns and willingness of the MPC to act against habit. According to official data, inflation in November surpassed the earlier forecasts and hit 3.6% on a wave of food and fuel prices. According to our calculations net inflation stayed largely unchanged at 1.5%. Employment is likely to be consistent with recently observed trends and reach 4.9-5.0% on annual basis (we do not regard the last month's reading as an outlier but rather as a result of a large inflow of graduates). As for the average wages in enterprise sector, they can be a real shocker for the MPC. The tightening labor market, together with an earlier payment of a variety of bonuses, may push the annual growth rate of average remuneration a way above 11% (the risk is skewed to the upside). This fact combined with a growth rate of industrial output above 8% cast some shadow on the relationship between real wage and productivity of labor (there is some risk that the MPC will be unable to calculate the aforementioned relationship on real data as the production figures are published just about the time of the decision; however, in the light of elevated job market figures it is sufficient to found on the forecast of industrial output).

All the abovementioned figures speak for a fast rate hike and signal mounting inflationary pressures which are now regarded as limited owing to good financial standing of companies. The MPC fears now of second round effects – revealed data on CPI inflation (and consumer-essential categories: food and fuels) make them more and more likely to occur (in December the headline CPI may touch the psychological barrier of 4.0%). The view is supported by tight labor market which significantly increases the bargaining power of employees. It is then against any theory to refrain from lifting the rates already in December. Our supposition is backed by recent comments of some MPC members who parallel the contemporary situation to fighting with fire. The thing is, whether there will be sufficient number of votes to break the power of habit...In our assessment, there might be.

Income balance a drag on the C/A deficit

Polish current account recorded in October a deficit of 1.3 EUR bn, i.e. 4.1% in GDP terms (market consensus stood at 0.9 EUR bn, our forecast 1.6 EUR bn). Surprisingly, a higher-than-expected C/A deficit was not a result of the widening trade gap which improved a bit reaching 587 mn EUR. The main trigger was strongly negative income balance that dropped to -1.4 EUR bn. Dividend expatriation and reinvested profits (that clearly confirm the superior financial standing of Polish enterprises) were among the reasons of the decline. It is important to note that the reinvested profits (though reported in C/A) did not propel the demand for the foreign currencies. Turning to the trade gap, only a moderate import growth (+17.0% y/y) and a significant increase in exports (+15.7% y/y vs. +8.4% y/y in the previous month) was recorded. The balance in services remained at a stable level of 330 mn EUR, while transfers dropped sharply from 945 mn EUR in September to 350 mn EUR which was due to a lower balance of Poland-EU accounts.

The aforementioned factors indicate a temporary change in the C/A structure which in fact may be regarded as positive for the Polish currency. Owing to the one off origin of the change, we maintain our fundamental view on the C/A which we expect to widen to 4.7% of GDP by the end of 2007 and to 6% in 2008. The mid-term implications for the Polish currency are thus rather unclear. The C/A deficit is still backed by the inflow of the portfolio and direct investments. The decoupling hypothesis, if confirmed, may also positively impact the mid-term zloty perspectives. On the other hand the current levels of the EUR/PLN (a 5% appreciation has been in fact a result of discounting the future economic miracle) make it more open to reverse in response to global risk aversion or political jitters.

MEDIUM-TERM FORECATS

Indicator	2006	2007	2008
GDP y/y (%)	6.1	6.5	5.6
Inflation rate (%)	1.0	2.4	4.0
Current account (% of GDP)	-2.1	-4.5	-5.3
Unemployment rate (end-of-year)	14.9	11.5	9.8
NBP repo rate (end-of-year)	4.00	5.00	>6.0

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

Fixed Income

Nothing to worry about

What is very visible on the market is the coming holiday season. Liquidity is rather poor and moves are becoming rather sharp. Main trend of last week was rates to drift lower and that was mainly and only due to comments from MPC members. As surprisingly as it sounds (at least to us) after giving hawkish statement after last rate decision, and after publication of Ministry of Finance CPI forecast at 3.5 most of the MPC members find very little to worry about. If there is any actual worry it is the GDP growth that is expected to slow, or the strength of the PLN to EUR, which may hamper export. What is possibly ahead of us is MPC meeting on which council will leave rates on hold, and some still very calm, and dovish comments suggesting that there is really nothing to worry about. CPI figures for last 4 months 1.5, 2.3, 3,0, 3,6 in that period MPC has hiked 25 bp. We think it is high time to get worry.

RECOMMENDATION:

Recommendation: pay 1y3s

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	12/17/2007	-	5.740%	12/3/2007
2Y T-bond OK0709	1/2/2008	-	5.676%	12/5/2007
5Y T-bond PS0413	2/6/2008	-	5.943%	11/21/2007
10Y T-bond DS1017	2/13/2008	-	5.699%	10/25/2007
20Y T-bond WS0922	1/9/2008	-	5.796%	9/12/2007

Money Market

Extremely cheap cost of carry

Extremely cheap week for carry, since the market bought only 14 billion pln of money bills out of 20 on offer. Surplus of the cash significantly built the reserve for the whole system, which in turn increases probability for further cheap days. For sure tomorrow's OMO will be large, the question is whether the system will absorb it.

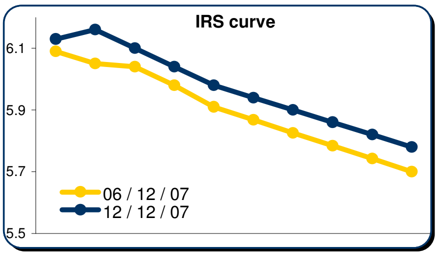
CPI above expectations

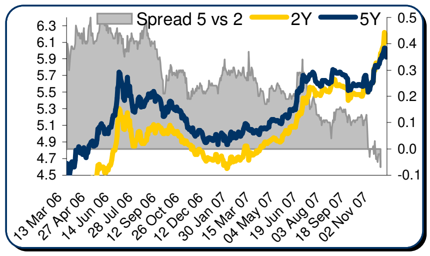
As for longer rates the CPI figure was the highlight of the week. Higher then expected (3.6% vs 3.4%) pushed the curve slightly up. Nonetheless, we see the next rates hike in January.
Sell 2M Polonia.

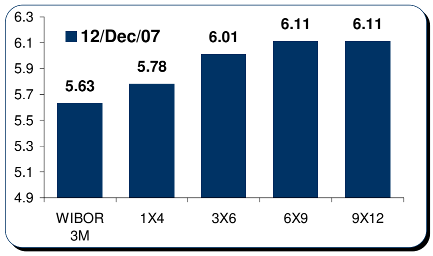
RECOMMENDATION:

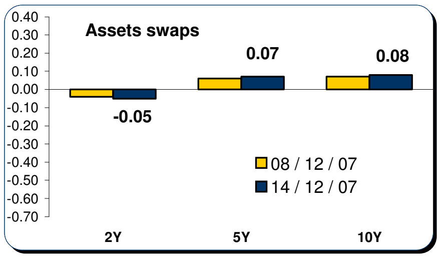
Pay 9,12 months in OISs.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Consolidating zloty

This week zloty was in narrow range between 3,5630 and 3,5950. This is consolidation after the zloty achieved the highest level since first quarter of the 2002. As all financial preparing to Christmas we believe EUR/PLN will stay in that range.

Spot:

Main supports / resistances:
EUR/PLN: 3.5630/ 3.5950
USD/PLN: 2.4160 / 2.4560

RECOMMENDATION:

Play range 3,5600 / 3,6000

Volatility curve flattened

Zloty curve finally make a step to its natural shape with longer term volatilities above shorter ones. Reasons were two: most of barriers on EURPLN were broken, so downside lost most of black hole effect, and Christmas effect. So far curve is more flattened with 1M traded at 6.4 (with reaching 7.8 around 10 days ago) and 1Y still traded at 5.9.

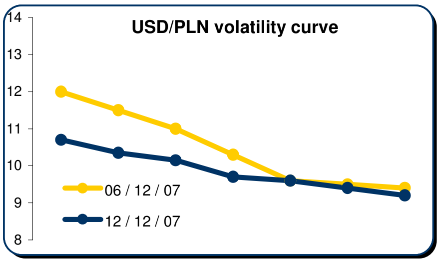
Options:

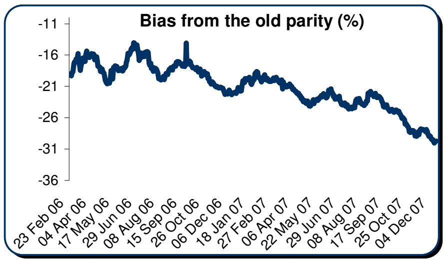
We see option dated up to 1M as good sell opportunity because of relatively high value of Christmas time priced in it.

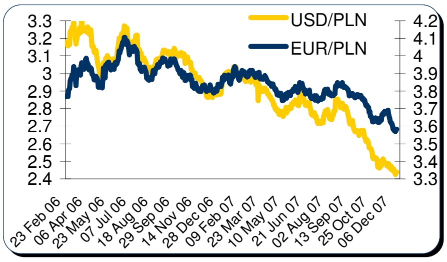
RECOMMENDATION:

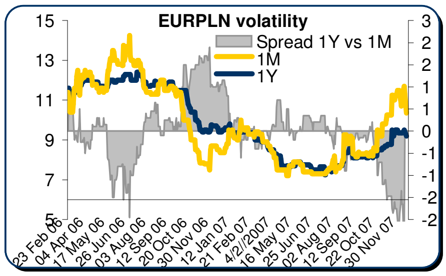
Sell mid-curve vega

FX CHARTS


USD/PLN volatility curve
06 / 12 / 07
12 / 12 / 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
06/12/07	5.53%	5.53%	5.74%	5.80%	5.96%	5.99%
07/12/07	5.52%	5.55%	5.88%	5.80%	6.18%	6.00%
10/12/07	5.58%	5.55%	5.78%	5.80%	6.00%	6.00%
11/12/07	5.57%	5.54%	5.75%	5.80%	6.00%	6.00%
12/12/07	5.54%	5.54%	5.79%	5.80%	5.99%	6.00%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
06/12/07	5.76%	6.00%	6.10%	6.10%	6.12%
07/12/07	5.78%	6.00%	6.09%	6.08%	6.14%
10/12/07	5.80%	6.03%	6.11%	6.11%	6.16%
11/12/07	5.79%	6.04%	6.12%	6.12%	6.19%
12/12/07	5.81%	6.07%	6.15%	6.15%	6.21%

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
06/12/07	5.99%	5.08%	5.57%	5.29%	5.72%	5.69%	5.73%	5.76%
07/12/07	6.00%	5.05%	5.57%	5.29%	5.71%	5.68%	5.72%	5.76%
10/12/07	6.00%	5.05%	5.57%	5.34%	5.71%	5.67%	5.71%	5.76%
11/12/07	6.00%	5.05%	5.56%	5.30%	5.71%	5.65%	5.72%	5.75%
12/12/07	6.00%	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	07/12/03	08/12/03	95.415	5.74%	2000	33116	2000
OK0709	07/12/05	09/07/25	90.689	6.17%	2200	7340	2200
PS0413	07/11/21	13/04/25	96.810	5.94%	2200	2611	2200
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
06/12/07	11.00	10.20	9.60	9.35	0.60	0.75	0.30	0.35
07/12/07	11.50	10.30	9.60	9.40	0.70	0.75	0.30	0.35
10/12/07	11.70	10.20	9.60	9.50	0.70	0.75	0.30	0.35
11/12/07	11.30	10.00	9.60	9.40	0.70	0.75	0.30	0.35
12/12/07	10.70	9.90	9.60	9.30	0.70	0.75	0.30	0.35

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
06/12/07	2.4525	3.5865	-29.51%
07/12/07	2.4378	3.5739	-29.83%
10/12/07	2.4260	3.5699	-30.01%
11/12/07	2.4359	3.5773	-29.81%
12/12/07	2.4373	3.5820	-29.74%

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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