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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

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PREVIEW: The week of December 21st to December 29th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
Retail sales	**Dec 21**	**Nov**	**19.7% y/y**	19.1%	20.4%	Private consumption is entering its boom phase being stimulated by rising income and consumer optimism.
'Net' core inflation	**Dec 21**	**Nov**	**1.5% y/y**	1.5%	1.4%	Core inflation is set to rise gradually on the back of higher services and utilities

In Focus / Macroeconomics

MPC identifies risks and (only) promises some action

Contrary to our expectations, the MPC has not decided to lift borrowing costs and the reference rate stayed at 5.0%. “Tradition” and “lack of relevant data” influenced the decision. However, we consider the maintained policy of repeated steps (tightening-pause-tightetnig…) to be the most important rationale behind the voting.

The statement after the meeting should be still regarded as “hawkish”, largely unchanged in content from the last session. It is striking that the hint on second round effects (appearing in November’s statement) was omitted - the MPC regards the rise of inflation to be temporary (stemming mainly from supply shocks in food and fuels). We believe that inflation exceeding the tolerance band (which was given fairly large media attention) and wages soaring at 12% pace constitute a very fertile ground for increased wage expectations and are likely to fan the flame of inflation. There is an asymmetric risk for headline CPI to reach the level above 4% in Q1 2008 and then fail to trend downwards (the first month of the next year will bring increases in utilities and then we will see slowly revealing pressure on core measures stemming form buoyant demand stimulated by solid wage increases). We clearly see that the MPC has identified the risks to inflation and simultaneously postponed the reaction.

As for the cumulative scale of next year hikes, we maintain our view that the reference rate is likely to reach 6% in 2008 (the same view is expressed by D. Filar – one of the most hawkish MPC members). As for the timing, there is much more uncertainty. For now we may take the January hike for granted. February tightening decision may be motivated by the fresh inflation projection (owing to the rise in ULC we may see an elevated inflation path; some uncertainty is posed by the growth forecast which may limit the influence of wages via the ULC channel). Taking into consideration a rather dovish attitude of the MPC as a whole, we may even consider a postponement of the hike to March (instead of February) which will be consistent with a path the MPC has just embarked on. What is more, from the perspective of monetary policy the decision to deliver a hike month earlier or later seems irrelevant (we learnt such a lesson from the MPC in October and December).

Rising wages fuel inflation worries

Employment growth reached 5.0% y/y in November, which proved to be consistent with our forecast and in-line with market consensus. Employment data confirmed recent trends and the large inflow of graduates in October, which permanently lifted the annual indicator. As for the average wage, its pace of expansion hit in November 12.0% on annual basis, above our forecast (11.5%) and market consensus (11.2%). The growth rate can be decomposed into two components: underlying trend consistent with a rise in average wage observed in October (roughly about 10.5-11.0%) and seasonal factors (bonuses in mining) which added 1-1.5 pp. to the growth rate.

Back-on-the-envelope calculations suggest the growth rate of real wage reached slightly above 8% in November, whereas the productivity expansion is heading towards about 3%. The relation between the two figures has remained almost unchanged in November, adding thereby to the cost pressure and reflecting the potential threat of second round effects which is now by far the highest in the whole tenure of the MPC.

Industrial output and PPI inflation in line with the underlying trends

In November the industrial output was up by 8.3% in annual terms vs. 10.6% recorded in October. This difference may be, however, completely explained by the working days effects. Thus, the November data are completely in line with the underlying trend. Strong growth has been recorded in such categories as machinery, motor vehicles and utilities. The latter sections benefited form relatively low temperatures in November.

Producer price rose almost in line with expectations reaching 2.6% y/y. On monthly basis PPI have not changed at all, which can be attributed to moderate rises in manufacturing (+0.2% m/m) and decreases in mining owing to a sharp fall of base metal prices (-3.5% m/m). Prices in utilities maintained the level from the last month. It is interesting to note that Polish producers are fairly invulnerable to rises in oil prices observed worldwide (compare the rise with ones recorded in Germany and the U.S.). Part of this immunity stems from the strong zloty, although the lion's share should be attributed to the outstanding financial situation which allows the producers to maintain prices despite rising costs.

Data from industry are neutral for the monetary outlook - the productivity growth is strong but lagging behind the rising wages. The data also do not change our view on the real sphere of the economy – we estimate that the real GDP expanded at a solid 6% y/y in the fourth quarter of 2007. The question of whether the monetary tightening may hurt the economic growth is thus still not on the forefront.

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	11.3	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

Falling behind the curve

Last week was very interesting on the FI market. After CPI and wages surge bond market collapsed on Monday, with yields reaching year high on 5y breaking 6.25 level. Short rates also creped higher to 6.25 on the 9x12 PLN FRA. The corrective move was as sharp as the spike. During next 24 hours yields dropped as much as 7-10 bp and another 5-7 bp after decision about rates was announced (current level of 5y is 6.00) with curve again flattening in the 2y10y. We see market as highly illiquid and we try not to make any assumptions about what is discounted in the curve before year end. Our base scenario is still RPP falling more and more behind the curve with CPI and wages continuing to rise. We also see chances of PLN weakening to EUR and USD and the back of mounting imbalances in the Polish economy, which would trigger sell of in rates, and probably change in RPP rhetoric.

On behalf of our FI team we would like to wish you Marry Christmas and Happy New Year, and good luck in New 2008 year. Best wishes.

RECOMMENDATION:

Pay 3x6 ag 9x12 spread, hold 1y3s pay position.

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

Cheap December is almost certain

Be careful on 31st

Rates will go up in January for sure, February is likely

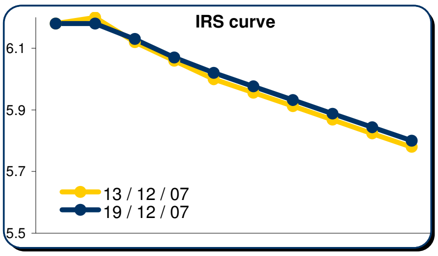
Another very cheap week for carry. Even settlement of quite unusual T-bills tender (5.5 billion pln net cash outflow) did not support the shortest rates. This shows clearly that probability of the very cheap December is nearly 1. Average surplus in the system, as far as the reserve requirements are concerned, counted taking remaining days into consideration amounted to 5 billion pln. This definitely speaks for itself. The only expensive day this year may be 31 of December.

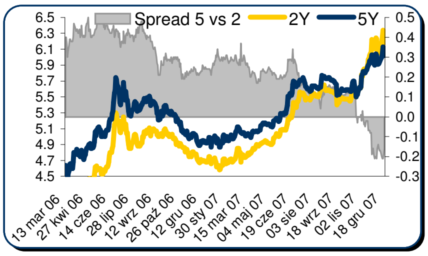
As for longer terms, despite of the high CPI figure (3.6 ag 3.4% expected) and very high wages figure (12 ag 11% expected) the MPC did not change any of the monetary parameters. It seems that tradition took the floor before the fundamentals, which leaves no doubts that January rates hike is a done deal. Question is whether February is done too or they will pause and wait for March. Anyway the liquidity of the market is very limited now and trades are rear with wide spreads. This will definitely not be improved until the end of the year.

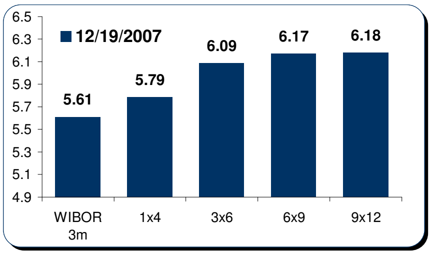
RECOMMENDATION:

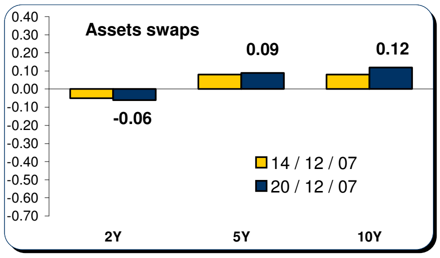
Stay neutral. Liquidity of the market has gone.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty in tight range

Dollar strengthening all over the word after higher that previously expected inflation figure pushed EUR/PLN to 3,6400. EUR/USD consolidation around 1,4400 by the rest of the week stopped farther depreciation of the zloty. We think that EUR/PLN will stay in tight range by the end of the year.

Main supports / resistances:
EUR/PLN 3,6000 – 3,6600
USD/PLN 2,4200 – 2,5300

RECOMMENDATION:

We still prefer selling on rally

Volatility curve slightly steepened

Option PLN market was focusing on improving USD global sentiment and weakening zloty, what made volatility curve became slightly steepened with 1W volatilities traded 1 percent higher than previous week. Tenors like 1M was traded around 6.8 and 1Y still at 5.9 levels.

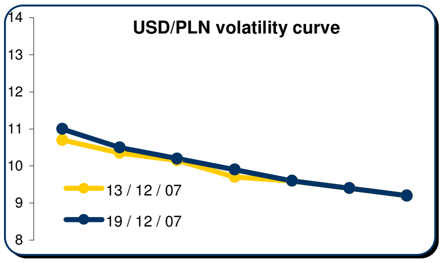
Options:

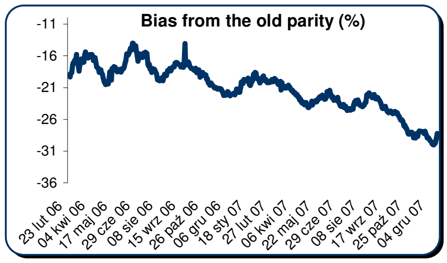
We still see option dated up to New Year's day as good selling opportunity because of relatively high priced in Christmas holidays. We expect January turnover to perform better than yearly average what should make market sentiment more transparent.

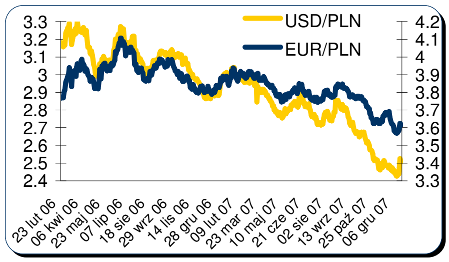
RECOMMENDATION:

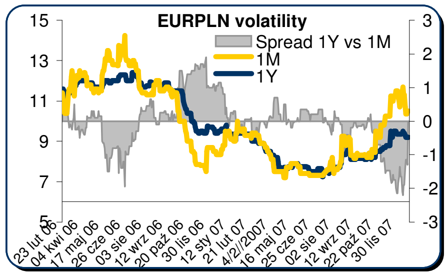
Sell short dated options

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
13/12/07	5.65%	5.55%	5.95%	5.81%	6.05%	6.00%
14/12/07	5.54%	5.57%	5.81%	5.81%	6.01%	6.01%
17/12/07	5.55%	5.57%	5.90%	5.81%	6.10%	6.01%
18/12/07	5.55%	5.59%	5.83%	5.84%	6.03%	6.05%
19/12/07	5.50%	5.61%	5.80%	5.88%	6.10%	6.09%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
13/12/07	5.81%	6.07%	6.15%	6.15%	6.21%
14/12/07	5.86%	6.10%	6.20%	6.18%	6.24%
17/12/07	5.90%	6.14%	6.22%	6.22%	6.27%
18/12/07	5.91%	6.16%	6.28%	6.28%	6.33%
19/12/07	5.86%	6.13%	6.25%	6.25%	6.29%

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
13/12/07	6.00%	5.08%	5.57%	5.29%	5.72%	5.69%	5.73%	5.76%
14/12/07	6.01%	5.05%	5.57%	5.29%	5.71%	5.68%	5.72%	5.76%
17/12/07	6.01%	5.05%	5.57%	5.34%	5.71%	5.67%	5.71%	5.76%
18/12/07	6.05%	5.05%	5.56%	5.30%	5.71%	5.65%	5.72%	5.75%
19/12/07	6.09%	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
13/12/07	10.35	9.70	9.60	9.20	0.70	0.75	0.30	0.35
14/12/07	10.35	9.80	9.60	9.20	0.70	0.75	0.30	0.35
17/12/07	10.50	9.90	9.60	9.20	0.70	0.75	0.30	0.35
18/12/07	10.50	9.90	9.60	9.20	0.70	0.75	0.30	0.35
19/12/07	10.50	9.90	9.60	9.20	0.70	0.75	0.30	0.35

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
13/12/07	2.4373	3.5820	-29.74%
14/12/07	2.4747	3.6017	-29.08%
17/12/07	2.5237	3.6235	-28.26%
18/12/07	2.5133	3.6162	-28.46%
19/12/07	2.5115	3.6159	-28.49%

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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