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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

IN FOCUS / MACROECONOMICS	• *The data and rate-setters: an odd correspondence this month* • *Polish monetary policy less effective according to the newest official forecasting model of the Central Bank*	• *pages 2-4*
FIXED INCOME	• *Illiquid and volatile market*	• *page 4*
FI RECOMMENDATION	• *Pay on bottoms, receive on tops.*	
MONEY MARKET	• *June 08 maturity will flood us with cash* • *The MPC decision seems to be obvious this month*	• *page 4-5*
MM RECOMMENDATION	• *Offer 1Y polonia above 6.5%.*	
FOREIGN EXCHANGE	• *Zloty consolidation/ slightly stronger* • *Volatility curve lower*	• *pages 5-6*
FX RECOMMENDATION	• *Stay aside* • *Stay aside/hold short gamma position*	
MARKET PRICES		• *page 7*
CONTACT LIST		• *page 8*
DISCLAIMER		• *page 9*

PREVIEW: The week of June 20th to June 26th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
Core "Net" Inflation y/y	**Jun 20**	May	**3.3%**	3.3%	2.8%	It is the last month in which the "net" inflation serves as a headline for base measures. The focus is switching towards the new measure after excluding food prices and energy – consistent with other core publications used in the euro zone and USA.
Retail sales y/y	**Jun 24**	May	**13.7%**	15.0%	18.8%	Record high number of days (four) with trade officially banned in large stores – it may be of utmost importance especially in case of Pentecost Sunday. As an effect we expect a drop in annual dynamics of retail sales, contrasting with relatively stable business indicators. The reasoning backed by the lower dynamics of wages and I/O.
MPC Decision	**Jun 25**	-	**6.00%**	6.00%	5.75%	More hawkish "Minutes" from the last meeting together with the recent dedication towards fighting inflation processes expressed by the rate-setters allow us to take the hike for granted.

In Focus / Macroeconomics

The data and rate-setters: an odd correspondence this month

Real sphere surprised to the downside in May. The overture came along with the publication of employment report in the enterprise sector which showed a softer dynamics of wages and employment (both figures below consensus). The gloomier picture was confirmed by industrial production. At the same time nominal processes have been thriving, adding to the more hawkish consensus among the MPC members expressed by S. Owsiak.

Corporate wages rose by 10.5% y/y – clearly below the last reading – reaching 12.6% y/y which is consistent with recent trend corrected for working days effect. It is most likely that the figure was not distorted by extra payments (at least we do not registered any in the largest enterprises) but we shall find a confirmation for this thesis as soon as the detailed breakdown is published (Tuesday). As for the employment, it came out a touch below consensus at 5.4% y/y and posted another month of deceleration. The figure is consistent with business indicators; since the beginning of the year we have been backing the scenario of slowly fading labor demand, now it seems it is really coming true. We naturally expect this tendency to be extended in coming months.

Industrial output fell short of expectations (6.9% y/y) reaching 2.3% y/y. The lower reading stems from negative split of one-off factors: lower number of working days and two long weekends which, in fact, depressed the exact number of working days further. This notwithstanding, business indicators continuously show that softer growth stays in the cards for the coming months and it remains our baseline scenario.

Turning back to the nominal sphere, **headline inflation** reached 4.4% y/y in May after 4.0% recorded in April. The main contribution to the rise was given by food prices (the same seasonal pattern as a year ago), regulated prices (gas and electricity hikes) and fuels. Some feedback effects are visible in core categories: another substantial monthly rise in hotels and restaurants, health care and "other" goods and services. We expect these effects to be visible in the coming months as a result of the most immediate impact of dearer fuels and more persistent pressure from rising wages which is affecting prices of services. In the months to come we expect the **price pressure to steadily mount on the producer's side** as well. The main culprit lies here in fuels which slowly feed through the other categories – the prelude to the process was visible in the data for May (upside surprise with annual dynamics at 2.8%).

Just before the publication of the data on industrial output, the rate-setter's comments had become more hawkish. A lot was said but, in our opinion, the key comments were uttered by S. Owsiak, whose arguments seem to shape the consensus among the MPC quite well. He suggested two more hikes: the nearest one already taken for granted and the second to follow in early Autumn. Among the arguments there were second round effects (already started as public sector employees are citing dents in purchasing power) and the risk that recent zloty appreciation trend had recently stopped. The shield from exchange rate developments may be thus insufficient to stop the pressure from rising wages; it is then necessary to return to monetary tools.

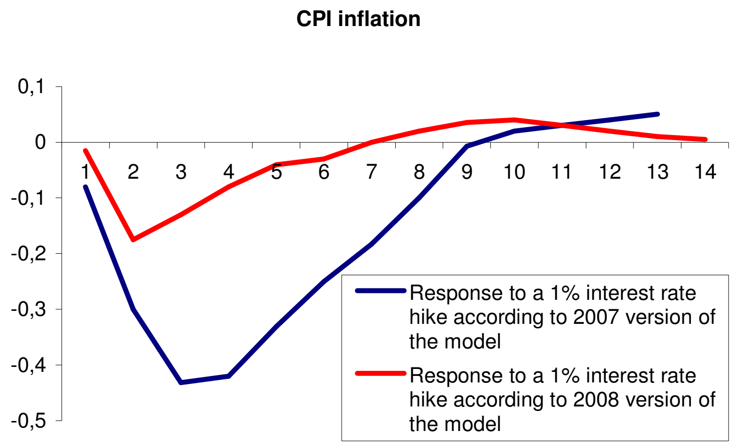
Polish rate-setters have recently become more prone to monetary tightening. The abrupt change of attitude may be partially explained by the behavior of the ECB, but not the domestic figures alone. The MPC seems to have lost the track of the economy: there is too much noise and uncertainty in the data to simply rely on them (a flavor of the MPC concerns is given in "Minutes" which, to be honest, convey more hawkish view than a month ago). That is why the rate-setters turn to inflation projection – a kind of baseline scenario which envisages inflation to stay beyond the target in monetary policy horizon. Should the speculations of inflation path confirm itself, there will be no other way than to hike again. We take thereby the June hike for granted, however, being at the same time aware of the MPC concerns. We cannot exclude a scenario in which one more hike will become obsolete when the slowdown suggested by the business tendency indicators will come true (the readers easily agree that it is much easier to play down pessimistic forecasts than to reject real figures) and the ECB will stop at 4.25%. Making the long story short, the MPC may become dovish as fast as it has become hawkish – we underline then the downside risks to the market scenario which may emerge one or two months after the June's decision.

That is all as far as risks are concerned. Other factors connected with the fresh projection are exemplified in the following piece.

Polish monetary policy less effective according to the newest official forecasting model of the Central Bank

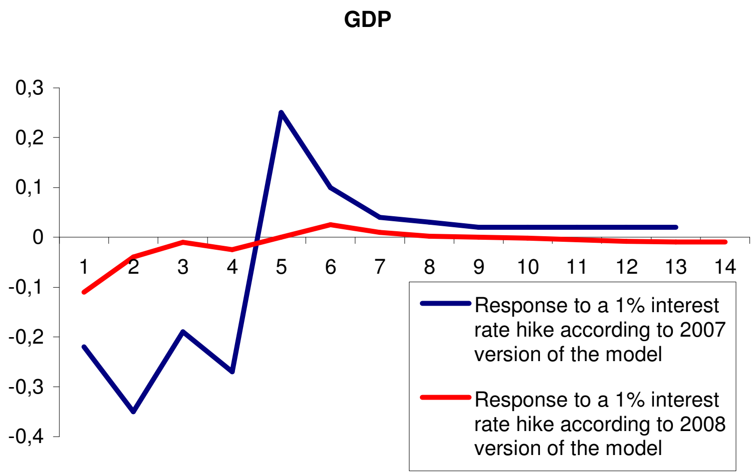
This week, the National Bank of Poland released substantially revised version of its official forecasting model, from now on known as NECMOD. Although the fresh inflation projection has not been disclosed yet, the model itself offers many interesting insights about the estimated effects of monetary policy in the Polish economy.

First of all, according to the NECMOD, the instantaneous impact of a one pctg point change in unit labor costs dynamics on inflation has been reestimated to only 0.028 as compared to 0.056 in the previous version of the model, making inflation less sensitive to rising wages (good news for inflation prospects). On the other hand, impulse response functions attached to the model (see the graphs below) indicate that monetary policy is in fact less effective in fighting inflation and at the same time less harmful to growth (which translates directly into the lower effectiveness in cooling excessive demand in the economy).



What does it all mean for the monetary policy prospects? First of all, bringing inflation to the target quickly would clearly require more rate hikes than previously anticipated. However, our baseline scenario assuming two more rate hikes may be now more easily accepted by the doves as the cost in terms of foregone GDP growth, according to the new model, is negligible.

Turning to mid-term implications, the Polish economy seems to be less sensitive to local monetary policy, being at the same time exposed to many external factors. Thus, on the back of the model one may expect the MPC to closely follow the trends set by its euro zone counterpart.



Explanatory note: The impulse response functions have been calculated in 2007 and 2008 models under slightly different assumptions. In 2007 the Central Bank simulated the model under the assumption of higher rates prevailing over 8 consecutive quarters. In 2008 the model is simulated assuming active monetary policy rule. As the rate persistency parameter in Taylor type rule is set to 0.88, the rates will in fact stay at higher level for many consecutive quarters, making in fact the simulation results quite comparable across the models.

MEDIUM-TERM FORECATS

Indicator	2006	2007	2008
GDP y/y (%)	6.1	6.5	5.3
Inflation rate (%)	1.0	2.4	4.5
Current account (% of GDP)	-2.1	-4.5	-4.6
Unemployment rate (end-of-year)	14.9	11.4	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

Illiquid and volatile market.

Last week we saw rates declining after steep move up on Thursday and Friday. CPI which came at 4.4% was already in prices and market took opportunity to cash some pay positions. Market also did not react to MPC comments (all members took the stage). In our opinion the relative hawkish note is due to fact that MPC already decided to hike rates and is trying to introduce decision to the market. Production and PPI data were a bit surprising but mixed and we saw some profit taking on receive positions this time around. Next week decision seems to be deal done, but what we find worth looking at is retail sales which we see lowest in market and with risk it may come even lower. We would be looking at analysts' gymnastics, trying to play it all down by the number of working days phenomena. We see market as illiquid, jumpy, volatile and rangy, for now we don't see big case to support any side in significant risk. We are payers on bottoms and receivers on tops. Good luck.

RECOMMENDATION:

Pay on bottoms, receive on tops.

AUCTIONS

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	6.061%	4/14/2008
26 Week T-bills	-	-	6.220%	4/14/2008
52 Week T-bills	7/14/2008	-	6.760%	6/16/2008
2Y T-bond OK0709	7/2/2008	-	6.193%	4/2/2008
5Y T-bond PS0413	9/3/2008	-	6.155%	5/7/2008
10Y T-bond DS1017	7/9/2008	-	6.054%	4/9/2008
20Y T-bond WS0922	9/12/2008	-	6.080%	5/14/2008

Money Market

June 08 maturity will flood us with cash

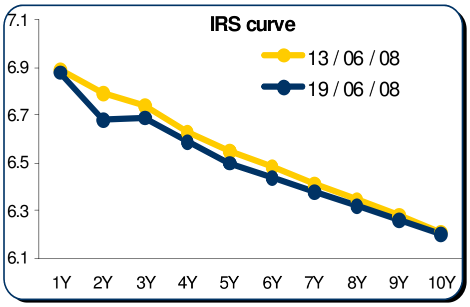
The MPC decision seems to be obvious this month

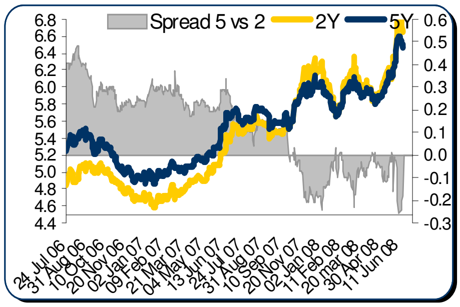
Cheaper and cheaper as far as cost of carry is concerned. Not all money bills were purchased on Friday (5.5 billion vs. 8 billion on the offer side) and the reserve is being overbuilt more and more every other day. Does it mean that another cheap end of the reserve is ahead? Probably yes, since on Tuesday benchmark bond June 08 is maturing, giving net cash inflow of 13 billion PLN. Flooding with cash is simply inevitable this month unless something unexpected happens. Figures are not emotional this month, since all just know that the rates will go up next week. Now everyone is trying to figure out where we are going next. We bet on another hike in autumn. Logic says October would be the best fit. Main reasons behind this theory are: the CPI peak will become a fact and there will be also another inflation projection issue.

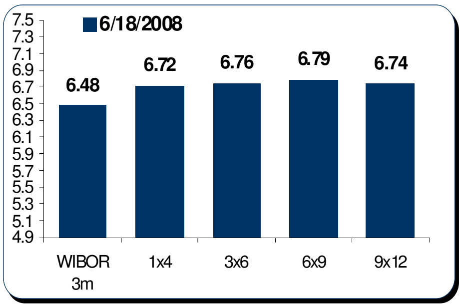
RECOMMENDATION:

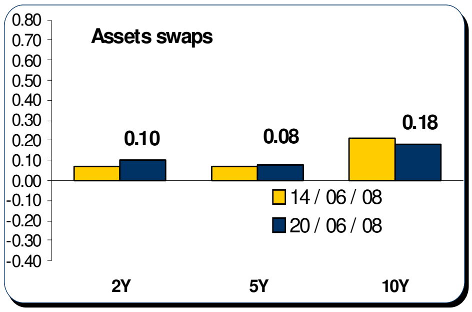
Offer 1Y polonia above 6.5%.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty consolidation/ slightly stronger

Zloty is consolidating in the tight range 3.3650-3.4050. The big barriers are being reported at 3.600 and 3.5500. The market is really slow and reacting stronger only for interest related news.

Volatility curve lower

EUR/PLN volatility run is lower by 0,5 % in 1 month (6,2 % mid now from 6,7 %mid). For the longer term curve, 1 year, it has translated into 0,15 % drop (6, 05 % mid now from 6,2 % mid earlier).

RECOMMENDATION:

Spot:
Main supports / resistances:
EUR/PLN: 3.3600 / 3.4200
USD/PLN: 2.1400 / 2.2200

Stay aside

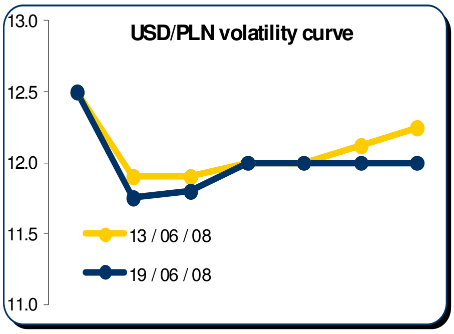
Big barriers at 3.36/3.35 are producing potential stop loss selling scenario, once broken. On the other side we can not exclude upside correction (3.4200) due to possible dollar upside reversal. Having said that, we prefer to stay aside in this market environment.

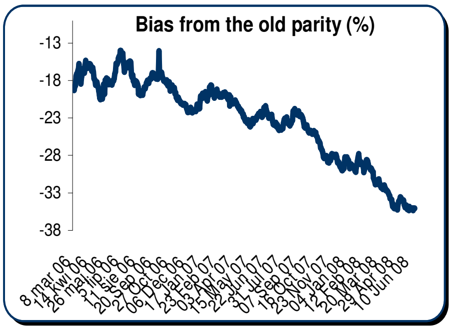
Options:

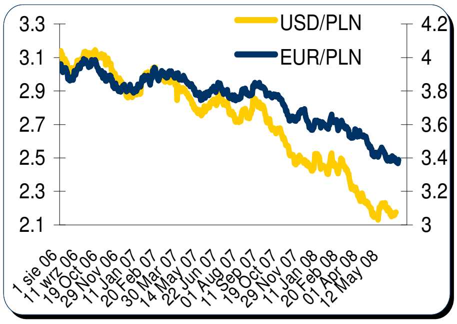
Stay aside/hold short gamma position

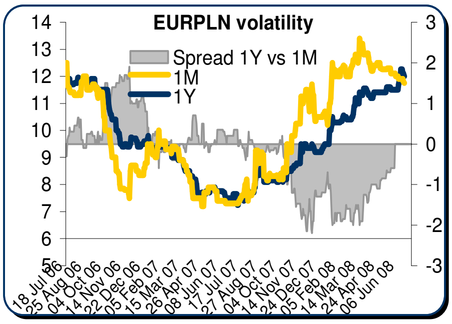
We are keeping our short gamma position. The short term volatility is significantly lower, one week has fallen from 6.7 % to 5.85 % , so we are not adding to this position at this less favourable levels.

FX CHARTS


USD/PLN volatility curve
13.0
12.5
12.0
11.5
11.0
13 / 06 / 08
19 / 06 / 08


Bias from the old parity (%)
-13
-18
-23
-28
-33
-38
8 mar 06
14 kwi 06
26 maj 06
5 lip 06
11 sie 06
20 Sep 06
27 Oct 06
06 Dec 06
17 Jan 07
23 Feb 07
03 Apr 07
15 May 07
22 Jun 07
31 Jul 07
07 Sep 07
16 Oct 07
23 Nov 07
04 Jan 08
12 Feb 08
20 Mar 08
29 Apr 08
10 Jun 08


USD/PLN
EUR/PLN
3.3
3.1
2.9
2.7
2.5
2.3
2.1
4.2
4
3.8
3.6
3.4
3.2
3
1 sie 06
11 wrz 06
19 Oct 06
29 Nov 06
11 Jan 07
20 Feb 07
30 Mar 07
14 May 07
22 Jun 07
01 Aug 07
11 Sep 07
19 Oct 07
29 Nov 07
11 Jan 08
20 Feb 08
01 Apr 08
12 May 08


EURPLN volatility
Spread 1Y vs 1M
1M
1Y
14
13
12
11
10
9
8
7
6
5
3
2
1
0
-1
-2
-3
18 Jul 06
25 Aug 06
04 Oct 06
14 Nov 06
22 Dec 06
05 Feb 07
15 Mar 07
26 Apr 07
08 Jun 07
17 Jul 07
27 Aug 07
04 Oct 07
14 Nov 07
24 Dec 07
05 Feb 08
14 Mar 08
24 Apr 08
06 Jun 08

MARKET PRICES UPDATE

MONEY MARKET RATES

Money market rates (Closing mid-market levels)

date	3M		6M		1Y	
	FXSW	WIBOR	FXSW	WIBOR	FXSW	WIBOR
12/06/08	6.47%	6.36%	6.62%	6.49%	6.80%	6.59%
13/06/08	6.45%	6.48%	6.64%	6.64%	6.78%	6.74%
16/06/08	6.31%	6.48%	6.62%	6.64%	6.92%	6.75%
17/06/08	6.31%	6.47%	6.64%	6.64%	6.90%	6.75%
18/06/08	6.33%	6.48%	6.66%	6.65%	6.94%	6.76%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
12/06/08	6.72%	6.78%	6.80%	6.78%	6.85%
13/06/08	6.70%	6.76%	6.79%	6.78%	6.84%
16/06/08	6.70%	6.74%	6.76%	6.75%	6.81%
17/06/08	6.69%	6.74%	6.75%	6.71%	6.79%
18/06/08	6.72%	6.76%	6.79%	6.74%	6.81%

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
12/06/08	6.59%	5.08%	5.57%	5.29%	5.72%	5.69%	5.73%	5.76%
13/06/08	6.74%	5.05%	5.57%	5.29%	5.71%	5.68%	5.72%	5.76%
16/06/08	6.75%	5.05%	5.57%	5.34%	5.71%	5.67%	5.71%	5.76%
17/06/08	6.75%	5.05%	5.56%	5.30%	5.71%	5.65%	5.72%	5.75%
18/06/08	6.76%	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	08/06/16	09/06/16	93.601	6.76%	1400	4385	1443
OK0710	08/01/02	09/07/25	85.730	6.19%	1800	2047	1654
PS0413	08/04/07	13/04/25	96.211	6.16%	1800	3129	1800
DS1017	08/02/13	17/10/25	96.048	5.79%	2000	2785	2000

FX VOLATILITY

	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
date	1M	3M	6M	1Y	1M	1Y	1M	1Y
12/06/08	11.90	12.00	12.00	12.25	0.70	0.85	0.30	0.35
13/06/08	11.90	12.00	12.00	12.25	0.70	0.85	0.30	0.35
16/06/08	11.90	12.00	12.00	12.25	0.70	0.85	0.30	0.35
17/06/08	11.90	12.00	12.00	12.15	0.70	0.85	0.30	0.35
18/06/08	11.80	12.00	12.00	12.10	0.70	0.85	0.30	0.35

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
12/06/08	2.1728	3.3823	-35.12%
13/06/08	2.1750	3.3836	-35.08%
16/06/08	2.1611	3.3745	-35.35%
17/06/08	2.1843	3.3763	-35.06%
18/06/08	2.1845	3.3708	-35.12%

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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