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FINANCIAL MARKETS DEPARTMENT

PAGES: 9

WARSAW, FEBRUARY 5, 2009

POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of February 6th to February 12

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
C/A balance (bn EUR)	**Feb 12**	Dec	**-1.86**	-2.0	-1.75	Lower production of intermediate and investment goods, fall of auto sales, very low growth rate of wholesale trade. 16% y/y fall of exports, 12.7% y/y fall of imports. Trade balance at -1700 mln EUR, negative EU transfer account.
CPI inflation y/y	**Feb 13**	Jan	**2.9%**	2.9%	3.3%	MinFin's inflation forecast stands at 3.2% a notch lower than previous month's reading. There is a downward risk stemming from food prices and electricity hikes (at least half of them will be reflected in CPI). Core inflation at 2.1%-2.2%.

In Focus / Macroeconomics

Government announces crisis measures

The government is clearly thriving to leave assumed budget deficit (18.2 bln PLN) intact. In one-week time various ministries were pressed to lower their plans for expenditures…and it is what they actually did. The state is ready to cut expenses by 19.7 mld PLN – only half of this sum actually relates to "real" spending, the rest of savings stems from changes in qualifying funds for EU co-financed investment projects.

The details of spending cuts are usually not exciting…Nevertheless, as we expected, the government is unwilling to interfere with social spending, trying at the same time to economize on administrative expenses and, to some degree, on business equipment. As for the other part of savings, it is only a matter of accounting – spending on infrastructure projects will be controlled by a separate, special fund and financed by issuing debt and incurring credit in international institutions. Although it lowers the burden for the central budget the cost of such financing may be much higher.

As far as the financing issues are concerned, there is a close link between the burden of the general government debt and the strength of the zloty. Although the foreign part of the debt constitutes only 25% of the total, rapid PLN depreciation may pose some serious risk to the perception of "health" of the public finances. General government debt constituted roughly 48% of GDP in 2008. Our back-of-the-envelope calculations show that this burden may rise in 2009 to 52% (the range of calculations is from 49.4% if EURPLN stays close to 3.8 to 52.7% if we play the crisis scenario of EURPLN exchange rate close to 4.8). This calculation is based on assumption that the net borrowing needs in 2009 fall within the interval of 20-30 and a quarter of this will be financed in foreign currencies; we also assume nominal GDP growth of 3.5% in 2009. Even pessimistic scenario implies the convergence debt criteria will be met. However, the debt above 47% of GDP automatically initiates budget reform procedures with the stricter one enforcing the government to plan 2010 deficit on the level conforming with reduced burden of general government debt to GDP ratio. The implications of this "finding" are so far negligible as the projected levels are not appalling. We perform them only in case when the debt-to-GDP ratio becomes an issue once again.

Turning to the crisis measures enacted by the government, they seem reasonable at the moment – at least they buy some time for further considerations (the officials do not rule out that budget bill will be amended mid-year). Of course one may complain the savings are shallow, and omit the part of rigid expenditures. So far there are no signals that the government will be looking for higher revenues (a come back of higher pension and health contribution, at least temporarily higher taxes).

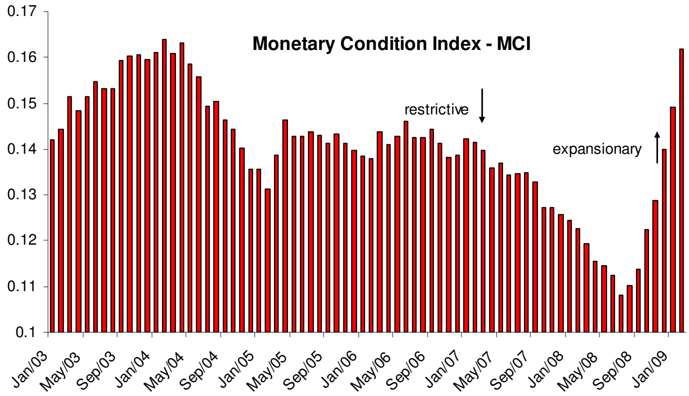
The actual state of the budget will be known in 2-3 months. So far it is running a surplus of 2-3 bln PLN (part of the VAT taxes were transferred to January) and the program of savings speaks clearly the Polish government is leaning against the wind at times when the whole Europe broadens government intervention. It may be a reasonable "emerging market" strategy, especially when the costs of financing are sky high owing to elevated risk aversion. As soon as risk appetite returns, it will be much easier to finance a larger deficit. Moreover, the government expects (quite reasonably) signs of real sphere recovery in H2 2009 and larger absorption of EU funds (it is worth to note that the growth rate of co-financed expenditures amounted sometimes to 100% in a year).

Weaker zloty and Polish monetary easing

Amid deteriorating economic outlook, lower wage growth and easing demand-pulled deflationary pressures, the most recent developments on the Polish FX market have some potential to influence the MPC decision process, though. As a matter of fact, the estimated exchange pass-trough in the Polish economy is much lower as compared with the regional peers (the openness of the Polish economy is much lower as well) and, in addition, it is negatively skewed in the period of weaker economic growth.

Despite weaker pass-through, we cannot neglect the trends in commodities. The most recent zloty depreciation may pretty fast translate into higher PLN denominated gasoline prices and consequently set a limit for the short-term disinflation. Because of the very rapid PLN deprecaition we are not sure whether the weaker zloty will impact the prices of imported food as well.

The risk for the MPC to be involved in a Hungarian style play with the market (the MNB policy is to a large extent determined by the FX market development) is pretty low as the MPC is rather focused on macro factors besides the exchange rate. We do not view the lower NBP rates as a main factor behind the latest zloty underperformance as well; the long term rates risk premium is the key factor determining the attractiveness of the currency from the portfolio investors view-point (see the case of Hungary).



The fresh comments made by MPC members have been clearly inspired by the zloty developments. NBP governor Skrzypek has ruled out any intervention on the zloty though. Hawkish Filar directly opts for thorough analysis of the linkages between zloty exchange rate and NBP rates. In his opinion the MPC should cut the rates by at most 25bps at its February meeting. Influential Slawinski emphasized that the decision environment is getting very dynamic but continuously points to the newest inflation projection as a main factor to be taken into account at the next MPC meeting. Pivotal voter Czekaj sees the room for further monetary easing but his impressions are mixed as far as the zloty's impact on inflation is concerned. We cannot rule out that the market view on the pace and scale of monetary easing may change within the next few days (the monthly economic data are to be released in two weeks). We are inclined, however, to link the recent zloty depreciation (and in fact lax monetary conditions) with a somewhat less aggressive monetary easing ahead (50bps instead 75bps rate cut in February and a target repo at 3.0-3.50% in the first half of 2009).

MID-TERM FORECATS

Indicator	2006	2007	2008	2009
GDP y/y (%)	6.1	6.5	5.0	<1.5
Inflation rate (%, average)	1.0	2.4	4.3	**3.0**↑
Current account (% of GDP, average)	-2.1	-4.5	-5.3	-5.7
Unemployment rate (end-of-year)	14.9	11.4	9.5	12.2
NBP repo rate (end-of-year)	4.00	5.00	5.00	3.00

Indicator	2008			2009	
	Q2	Q3	Q4	Q1	Q2
GDP y/y (%)	5.8	4.7	3.0	1.5	0.5
Inflation rate (%, average)	4.3	4.7	3.8	**3.1**↑	**2.8**↑
NBP repo rate (end-of-quarter)	6.00	6.00	5.00	3.00	3.00

Bold denotes chages from the last release with arrows showing the direction of chages

Fixed Income

Another cut. And more to come.

Last week was rather interesting on the FI market. Everything seemed to be going old path with lower Wibor, lower FRA, nice 75 bp cut, until it broke. For sometime forward curve was pushing higher with spot rates staying relatively unchanged. The trigger was EURPLN move which was moving substantially north in pace of 10 cents every day on the average. The pace of the weakening put a question mark on the pace of lowering interest rates in Poland. Market consensus moved from expected repo rate of 2.75% to 3.50% currently, with risk of 3.75% at the end of the year. Some fuel to the fire was added from poorly Tbills and Tbonds tenders rising question of the supply of bonds. Overall move was from 30 to 70 bp depending on contract, quite an impressive move. Where we see value from here? We will see rather weak data (CPI probably lower than expected by MinFin, IP again negative double digits), RPP will see inflation projection and with that also GDP projection which in our opinion will be pointing for both lower CPI (most likely in target) and GDP (this can be very low, much lower than potential GDP). We think that major Central Banks will continue easing policy accompanied with quantitative at least into first half of the year. Our base scenario is that MPC will carry on with cutting rates (maybe not with the same pace) but we still expect repo rate to be cut to the level of 3.00 if not lower. We still like holding short bonds. We also like receiving 2y 1y3s at current levels on up ticks.

RECOMMENDATION:

Hold short bonds, receive 1y3s around 4.25 level.

AUCTIONS

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	6.142%	12/9/2008
26 Week T-bills	-	-	6.197%	12/9/2008
52 Week T-bills	2/2/2009	-	4.436%	2/2/2009
2Y T-bond OK0711	3/4/2009	-	5.022%	2/4/2009
5Y T-bond PS0413	3/4/2009	-	5.307%	2/4/2009
10Y T-bond DS1019	2/11/2009	-	5.724%	12/17/2008
20Y T-bond WS0429	2/11/2009	-	5.369%	1/14/2009

Money Market

Stable cost of carry

Carry stable nearby the main market rate. Some repo with the central bank is maturing this and next week (total of 9.7 billion pln) and I would not expect that majority of it will be rolled-over on Tuesday. Decrease of the money bills in circulation is far more likely though. To sum up shortest rates should not change much for the week ahead.

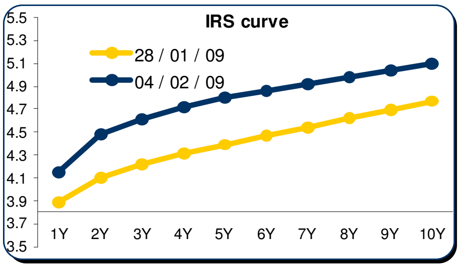
Volatility for interest rates due to sharp depreciation of the currency.

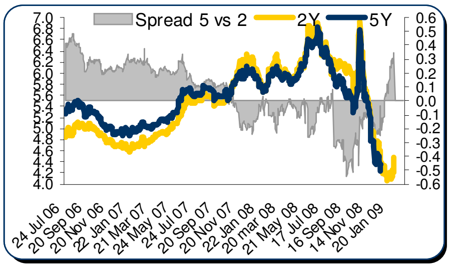
As for trading, one thing we can not complain about is volatility. Of course the liquidity is still the biggest issue; hence majority of the move was without the trades. Slightly worse then expected (3.2 vs 2.9%) CPI projection by the MinFin was ignored. But then sharp and deep depreciation of the local currency hit everyone. One can discuss about the reason probably without reaching consensus, therefore we just focus on the fact itself. This unexpected, huge in scale movement, made the interest rate market very nervous. Since such currency depreciation can be treated as a substitute for the monetary policy easing, market discounts less and less rates cuts. On Monday there was 75 bps expected this month and another 50 bps in March. As of now less then 50 bps each month is built in, and if the currency stays high, it will be driven towards 25-0 bps this month.

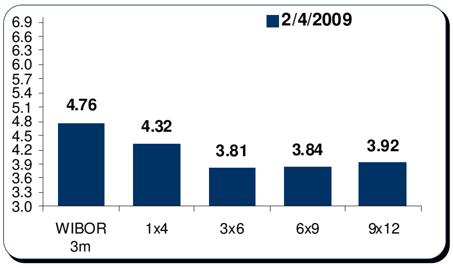
RECOMMENDATION:

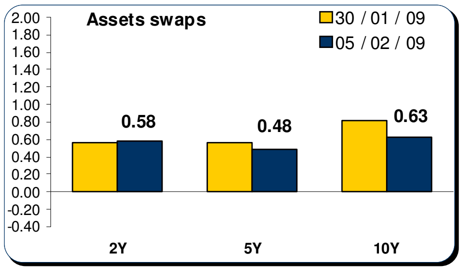
Pay 3M polonia below 3.2%.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty weaker

This week zloty opened at 4.4100 and weakened toward 4.6985. We have observed buyout all across region.

Volatility a bit lower

With next high on EURPLN, implied volatility curve steepened a bit, while 1Y tenor is still traded around 20, 1M was traded at 32 against to 27 in previous week.

RECOMMENDATION:

SPOT

Main supports / resistances:
EUR/PLN: 4.2700 / 4.7000
USD/PLN: 3.4000 / 3.7500

Short EURPLN/stay away

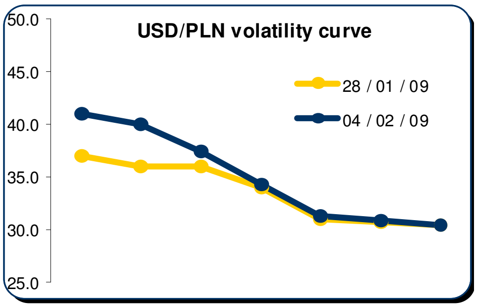
Trend is obvious, we see no positive signals nor from region or local (number of budget deficit is a question mark). So far only opportunity for stronger zloty is profit taking on long positions. 4.70 held but real resistance could be at 4.93 (march2004 high).

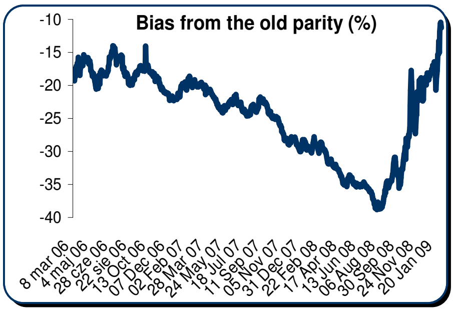
Short vega

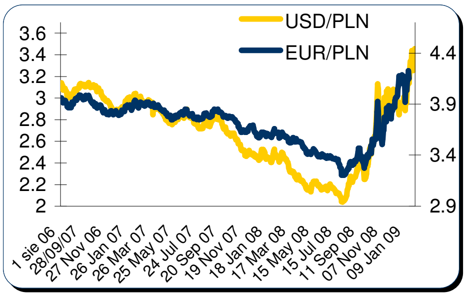
OPTIONS

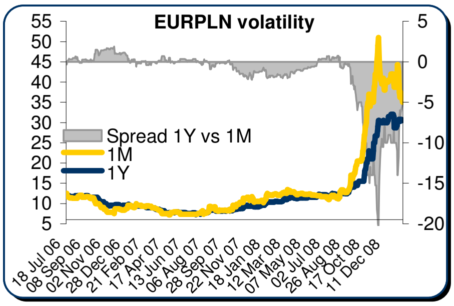
We believe in receiving some benefits from selling vega, especially 6M-1Y tenors.

FX CHARTS


USD/PLN volatility curve
28 / 01 / 09
04 / 02 / 09
50.0
45.0
40.0
35.0
30.0
25.0


Bias from the old parity (%)
-10
-15
-20
-25
-30
-35
-40
8 mar 06
4 maj 06
28 cze 06
22 sie 06
13 Oct 06
07 Dec 06
02 Feb 07
28 Mar 07
24 May 07
18 Jul 07
11 Sep 07
05 Nov 07
31 Dec 07
22 Feb 08
17 Apr 08
13 Jun 08
06 Aug 08
30 Sep 08
24 Nov 08
20 Jan 09


USD/PLN
EUR/PLN
3.6
3.4
3.2
3
2.8
2.6
2.4
2.2
2
4.4
3.9
3.4
2.9
1 sie 06
28/09/07
27 Nov 06
26 Jan 07
26 Mar 07
25 May 07
24 Jul 07
20 Sep 07
19 Nov 07
18 Jan 08
17 Mar 08
15 May 08
15 Jul 08
11 Sep 08
07 Nov 08
09 Jan 09


EURPLN volatility
Spread 1Y vs 1M
1M
1Y
55
50
45
40
35
30
25
20
15
10
5
5
0
-5
-10
-15
-20
18 Jul 06
08 Sep 06
02 Nov 06
28 Dec 06
21 Feb 07
17 Apr 07
13 Jun 07
06 Aug 07
28 Sep 07
22 Nov 07
18 Jan 08
12 Mar 08
07 May 08
02 Jul 08
26 Aug 08
17 Oct 08
11 Dec 08

MARKET PRICES UPDATE

MONEY MARKET RATES

Money market rates (Closing mid-market levels)

date	3M		6M		1Y	
	FXSW	WIBOR	FXSW	WIBOR	FXSW	WIBOR
29/01/09	4.75%	4.88%	4.82%	6.49%	4.86%	6.59%
30/01/09	4.74%	4.86%	4.80%	4.81%	4.81%	4.84%
02/02/09	4.60%	4.80%	4.80%	4.77%	4.83%	4.80%
03/02/09	4.71%	4.78%	4.69%	4.76%	4.70%	4.78%
04/02/09	4.71%	4.76%	4.75%	4.74%	4.80%	4.76%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
29/01/09	4.68%	3.73%	3.36%	3.41%	3.43%
30/01/09	4.48%	3.64%	3.32%	3.39%	3.40%
02/02/09	4.28%	3.63%	3.33%	3.45%	3.44%
03/02/09	4.27%	3.58%	3.41%	3.48%	3.54%
04/02/09	4.23%	3.62%	3.47%	3.62%	3.61%

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
29/01/09	6.59%	4.25%	4.14%	4.78%	4.45%	5.10%	4.86%	5.75%
30/01/09	4.84%	4.25%	4.25%	4.81%	4.52%	5.08%	4.89%	5.71%
02/02/09	4.80%	4.25%	4.20%	4.83%	4.52%	5.07%	4.85%	5.67%
03/02/09	4.78%	4.55%	4.26%	4.84%	4.61%	5.09%	4.93%	5.68%
04/02/09	4.76%	4.57%	4.48%	5.06%	4.80%	5.28%	5.10%	5.73%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	09/02/03	10/02/04	95.707	4.44%	1000	764	733
OK0711	09/02/04	11/07/25	88.631	5.02%	2200	1065	722
PS0413	09/02/04	14/04/25	101.935	5.31%	1600	1600	1186
DS1017	08/12/17	19/10/25	98.186	5.72%	4500	3521	2340

FX VOLATILITY

	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
date	1M	3M	6M	1Y	1M	1Y	1M	1Y
29/01/09	35.00	33.25	30.75	30.50	8.00	8.50	1.40	1.40
30/01/09	35.00	33.25	30.75	30.50	8.00	8.50	1.40	1.40
02/02/09	38.00	33.25	30.75	30.50	8.00	8.50	1.40	1.40
03/02/09	38.00	33.25	30.75	30.50	8.25	8.50	1.40	1.40
04/02/09	40.00	34.25	31.25	30.50	8.25	8.50	1.40	1.40

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
29/01/09	3.3653	4.3916	-15.01%
30/01/09	3.4561	4.4392	-11.85%
02/02/09	3.4828	4.4366	-10.61%
03/02/09	3.5230	4.5147	-10.49%
04/02/09	3.6070	4.6747	-11.24%

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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