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FINANCIAL MARKETS DEPARTMENT

PAGES: 8

WARSAW, AUGUST 5, 2010

POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of August 6th 2010 to August 12th 2010

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
C/A	Aug 11	Jun	**EUR -789 mn**	-	EUR -28 mn	Narrowing of a trade gap due to rising exports. Higher C/A deficit due to lower EU transfers and higher dividends.

In Focus / Macroeconomics

Polish four-year fiscal strategy - no plans for radical reforms

Poland's government approved a four-year fiscal plan committing the country to lower the deficit to below 3% of GDP in 2013, which means that Poland will miss the deficit reduction deadline set by the European Commission for 2012.

Along with the plan the 2011 budget figures have been presented. The government aims to lower the next year deficit to PLN 45bn vs. 52.2bn planned for this year. As a matter of fact, the sub 4% GDP growth rates are not sufficient to curb Polish deficit, which permanently widened by more than 2% of GDP after personal income tax cuts implemented in 2009. That is why the 2011 budget planning process probably started with a deficit estimate close to PLN 60bn (the figure already included the effects of public salaries freeze and the so-called fiscal rule). In order to avoid negative market reaction, the government decided to reduce the deficit further by applying a series of one-off measures, the impact of which, however, will not be felt in the coming years. The measures include the increase of value-added tax on non-food items to 23%, which is to boost budget revenues by 5.5 bn. The government also plans to use the extraordinary dividends from state owned BGK, Central Bank profits and probably temporarily lower central budget subsidy to social security system. As it was the case in 2010 the government will also use a wide range of off-balance instruments to fund the budget gap.

Although the net borrowing needs due to extraordinary measures including utilization of surpluses/spare deposits in public sector and sale of stakes at PZU and PKO BP are to drop to 57.5 bn in 2011 as compared to 82.4 bn in 2010, the general government deficit reduction will be very limited. The general government deficit (EU methodology) is set to stabilize at 8% of GDP next year. According to the Polish methodology it will drop to 6% of GDP from about 8% seen this year.

Indicator/ Year	2010	2011	2012	2013
Central budget deficit (PLN bn)	52	45	40	30
Net borrowing needs (PLN bn)	82.4	57.5	62.8	38.6
General government deficit (Polish methodology, in PLN bn)	80	75,8	47,8	23.4
Public debt (Polish methodology as % GDP)	54.7	54.4	54.6	53.7

One has to bitterly acknowledge that the presented fiscal path for further years (2012-2013) is a matter of assumptions, and is not backed by any legislative actions so far. Given the political situations (local and parliamentary elections in 2010 and 2011) the government is very unlikely to back any unpopular reforms before Autumn 2011. PM Tusk openly admits that the government seeks to steer a "middle course" to curb the public debt while avoiding investment cuts and tax increases that would hurt families and economic growth. Poland is also to continue growth stimulation by spending more on EU co-funded infrastructure projects. These are the EU infrastructural projects that lifted the Polish GDP growth path by more than 0.5 pctg points.

Conclusions:

The deficit figure at 45 bn slightly upset the investors expecting a sub 40bn figure. More dangerous for Polish assets, as we think, is, however, the possibility of a shift in investor's perception. It cannot be ruled out that their focus may change from budget liquidity, which is by far satisfactory, to deficit sustainability issues (the consolidation strategy hinges on one-off measures and does not assure deficit sustainability in the coming years). In the mid term, the FinMin may be also proved wrong betting on exploding deficits in Spain and Portugal. Polish fiscal developments (the 'middle course') may then diverge with those in the euro area. In such a scenario investors may be demanding higher risk premia in Polish debt. Relatively high economic growth rates may be not sufficient to revert this tendency as economic growth will not prevent the deficit from rising.

Although it did not happened yet, quite disappointing fiscal consolidation strategy and expansive 2011 budget may finally trigger an action of rating agencies (as for now S&P and Fitch labeled Polish government's plan as credible which calmed the markets and allowed investors to profit from a massive carry on Polish debt). Last but not least, the proposed fiscal strategy and the risk of VAT increases being channeled into inflation have already upset the MPC (some MPC members have already signaled the necessity to hike rates in response to not credible fiscal plan and weaker zloty).

MID-TERM FORECATS

Indicator	2007	2008	2009	2010	2011
GDP y/y (%)	6.5	4.8	1.7	3.6	4.2
Inflation rate (%, average)	2.4	4.3	3.5	2.8	3.5
Current account (% of GDP, average)	-4.5	-5.3	-1.6	-1.8	-2.9
Unemployment rate (end-of-year)	11.4	9.5	11.9	12.1	10.9
NBP repo rate (end-of-year)	5.00	5.00	3.50	3.75	5.00

Indicator	2009		2010			
	Q3	Q4	Q1	Q2	Q3	Q4
GDP y/y (%)	1.7	3.1	3.0	3.8	4.0	4.1
Inflation rate (%, average)	3.5	3.3	3.0	2.1	2.6	3.2
NBP repo rate (end-of-quarter)	3.50	3.50	3.50	3.5	3.5	3.75

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

Fixed Income

Fiscal consolidation plan versus our investment plan. And football.

Last week was quite interesting on the FI market. On Friday Prime Minister Tusk announced (announced?) fiscal consolidation plan for next 3 years together with the budget plan for 2010. There are two highlights that we would like to point out. First one is the VAT change (over all the rate rises by 1% point) and second one is a lot of one off's maneuvers that are lowering the deficit and borrowing needs in 2011 (dividends, consolidation of agency spendings etc.). We view the plan as very short sighted and really putting no attention to the public finances issue. We see the deficit for the whole sector rising in 2009, 2010 and 2011 and staying well above convergence plan forecast. Market reaction to that plan was negative but not to the extent we had expected. Sell of of 40 cents in 5y bonds is the least what we have expected. We have to acknowledge the fact that PO and MinFin especially is going a great job in managing expecta-tions. It doesn't however change the fact that budget and generally fiscal side is very expansion-ary and becoming unstable in middle term. Similar reaction we had also on the short curve, but this is more related to VAT effect on the prices and RPP members commenting on inflation (some hawkish statements from Glapinski, Kazmierczak, Chojna-Duch). In our view the VAT effect will amount to 0.5% pint increase in the yearly CPI figure for 2011. Market right now is betting RPP will move rates sometime in 2010. What we would like to stress is that CPI has already rising dynamic, driven by weaker EURPLN, food prices and strong labor market. This month all the base effect will be washed out and CPI will be climbing onwards. One also have to remember that there can be additional regulated gas price hike happening in autumn (additional 0.1%/0.2%). All in all inflation picture is not looking pretty to say at least. All this effects will most likely add to the inflation expectations with economy growing at close to potential rate (we expect GDP figure to come at 3.8% for 2Q).

To sum up, we had modest negative reaction in bonds as a reaction to budget 2010 and fiscal plan, followed by a record tender in PLN bonds. Market priced in a hike related most likely to VAT effect. Curve is flattening on the back of low global rates environment, so any move on rates from RPP is viewed as a normalization.

In 2002 after Poland dropped out from World Cup in Korea, all commentators were praising the style which Poland played (we lost 2 games and won the last one that didn't matter at all). Fa-mous coach (the one that won all medals for polish football) said "if everything is so good, why it is so bad". If everything is so good with Polish economy why WS0922 is trading at 6%? Effects of loose monetary policy and very loose fiscal policy will spill over.

AUCTIONS

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	6.142%	12/9/2008
26 Week T-bills	-	-	4.456%	5/4/2009
52 Week T-bills	8/2/2010	-	3.976%	7/26/2010
2Y T-bond OK1012	9/1/2010	-	4.759%	8/4/2010
5Y T-bond PS0415	9/1/2010	-	5.373%	8/4/2010
10Y T-bond DS1020	9/15/2010	-	5.790%	6/16/2010
20Y T-bond WS0429	9/15/2010	-	6.170%	9/23/2009

Money Market

Lazy Money Market with low turnover

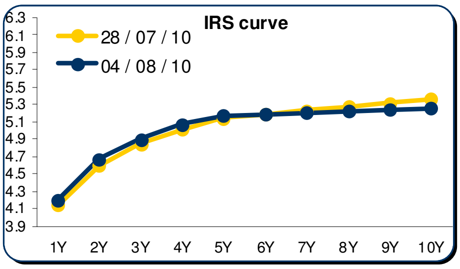
During last OMO NBP offered the highest amount of short term bills we have ever seen (83 bln PLN) but banks bidded much less approx 78 bn PLN. Therefore at the beginning of new reserve short term depo rates are above 3% and market is almost square. In general market is quite lazy this week and turnover on Polonia index is very low (even under 1 bln PLN). We don't expect tomorrow's tender will change much.

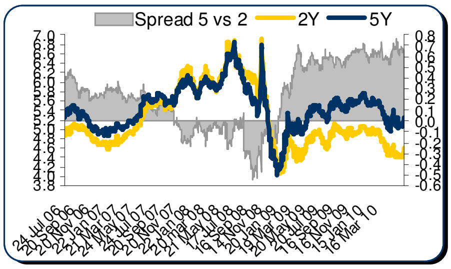
Low demand on buyback tender

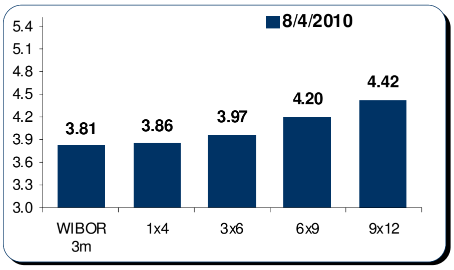
On Monday MinFin bought back 89 ml PLN bills maturing between August and September.

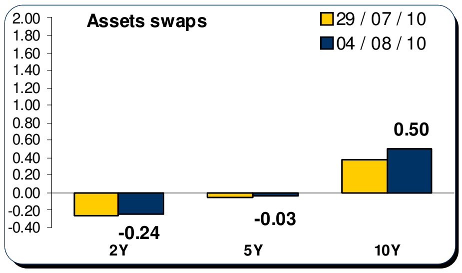
Money Market curve was driven mainly by fiscal consolidation plan announced by government. The long end of the curve increased by approx 10 bps this week when some of the MPC members were claiming that increasing VAT will increase inflation and inflation expectations

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty consolidates

This week Zloty has been traded in 3.9770-4.0260 range.
In our opinion another week of side trading around 4.00 level indicates phase of consolidation has been started. On one hand low potential for further strengthening (in common market opinion) and decent demand for risk on other hand have trapped EURPLN here and made it run out of steam.
Highest correlated benchmarks are, invariably, EURUSD, EURJPY, S&P (respectively -0.6, -0.85, -0.9)

Fact that range bounds were traded several times has elevated weekly realized volatility up to 9.25%. Summer (last 2M) close-close realized volatility values at 9.9%.

Implied volatility bit lower

When compared those facts to present implied ATM curve – 1M 10.5, 3M 11.75, 1Y 12.5% - we see that, at least short end, “emerging premium” is in decreasing phase. This week drops were 1M 0.25, 3M 0.25, 1Y 0.1.
Chance for higher spot is more reflected by RR’s levels: 3M 25D EURPLN RR is still traded at 3.0%. EURPLN vs USDPLN currency spread is priced at 6.75% level.

Short-term forecasts:

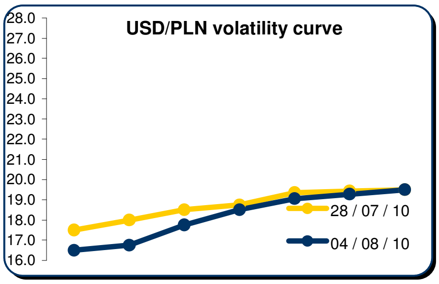
SPOT
Main supports / resistances:
EUR/PLN: 3,9400 / 4.0700
USD/PLN: 3.0000 / 3.1400

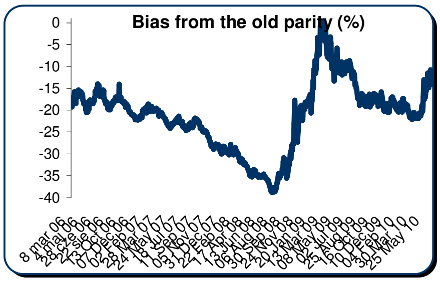
As we wrote in previous – its low potential for move down. Breaking lower through 3.94 needs new, stronger signal. Price action around 4.0250 has exposed decent Zloty demand there. Three inputs then, one output = wait and sell spikes.

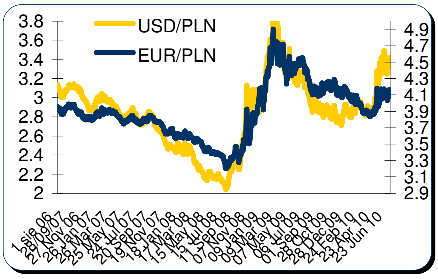
OPTIONS

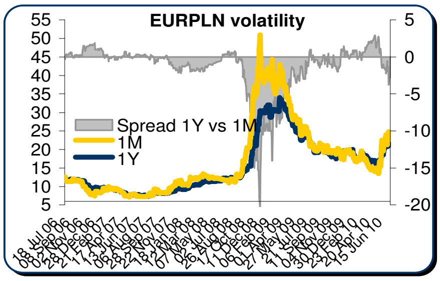
Current underlying performance is likely to push implied lower, aiming this year lows level. Still play vega range slightly more eager to sell on upticks.

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
29/07/10	3.73%	3.82%	3.80%	3.89%	4.05%	4.14%
30/07/10	3.65%	3.82%	3.96%	3.89%	4.21%	6.59%
02/08/10	3.67%	3.82%	3.92%	6.49%	4.17%	4.13%
03/08/10	3.70%	3.81%	4.01%	3.89%	4.14%	4.13%
04/08/10	3.70%	3.81%	3.90%	3.89%	4.15%	4.13%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
29/07/10	3.86%	3.96%	4.18%	4.39%	4.36%
30/07/10	3.86%	3.96%	4.18%	4.39%	4.36%
02/08/10	3.85%	3.95%	4.17%	4.37%	4.36%
03/08/10	3.87%	3.95%	4.17%	4.37%	4.35%
04/08/10	3.85%	3.97%	4.20%	4.42%	4.35%

FIXED INCOME MARKET RATES

Fixed Income Market Rates (Closing mid-market levels)

date	1Y		2Y		5Y		10Y	
	WIBOR	TB	IRS	OK0112	IRS	PS0511	IRS	DS1017
29/07/10	4.14%	3.98%	4.59%	4.33%	5.14%	5.08%	5.34%	5.72%
30/07/10	6.59%	3.90%	4.61%	4.32%	5.15%	5.12%	5.35%	5.77%
02/08/10	4.13%	3.85%	4.66%	4.38%	5.18%	5.12%	5.33%	5.76%
03/08/10	4.13%	3.78%	4.71%	4.42%	5.19%	5.15%	5.30%	5.77%
04/08/10	4.13%	3.70%	4.67%	4.43%	5.17%	5.14%	5.26%	5.76%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	10/07/26	11/07/26	96.135	3.98%	1800	5831	1800
OK0712	10/04/07	12/07/25	89.301	4.54%	3000	6726	2999
PS0415	09/07/14	15/04/25	100.483	5.37%	3000	2807	2027
DS1019	10/06/16	19/04/25	95.807	5.79%	3000	2965	2430

FX VOLATILITY

	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
date	1M	3M	6M	1Y	1M	1Y	1M	1Y
29/07/10	18.00	18.75	19.35	19.50	3.75	5.15	0.75	0.95
30/07/10	18.00	18.75	19.35	19.50	3.75	5.15	0.75	0.95
02/08/10	18.00	18.75	19.35	19.50	3.75	5.15	0.75	0.95
03/08/10	18.00	18.75	19.35	19.50	3.75	5.15	0.75	0.95
04/08/10	18.00	18.75	19.35	19.50	3.75	5.15	0.75	0.95

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
29/07/10	3.0618	3.9993	-15.43%
30/07/10	3.1383	4.0080	-14.77%
02/08/10	3.1373	3.9852	-14.89%
03/08/10	3.0861	3.9875	-14.70%
04/08/10	3.0756	4.0200	-14.95%

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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