



## POLAND WEEKLY REVIEW

### MACROECONOMICS AND FINANCIAL MARKETS

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#### PREVIEW: The week of April 1<sup>st</sup> 2011 to April 7<sup>th</sup> 2011

Indicator	Date of release	Pe- riod	BRE forecast	Consen- sus	Last	Comment
MPC decision	Apr 5		4.00%	3.75%	3.75%	After the recent surge in inflation expectations MPC has to do nothing but to hike. As for the other reasons supporting fast hike, there is almost certain ECB tightening and the possibility of a high inflation reading in March (should be somehow anticipated by the MPC).

## In Focus / Macroeconomics

### No surprises in quarterly BoP data

The much expected release came almost unnoticed as there were no substantial changes, whereas the market was prepared for the worst. Current account deficit in Q1 amounted to EUR 5.27bn and was slightly larger than could have been derived from the monthly data. The difference stems from the fact that quarterly data include also the small companies which are not obliged to report to the NBP on monthly basis; the revision is simply sticking to the underlying trend. Errors and omissions account stayed at elevated level of EUR 3.5bn in Q4.

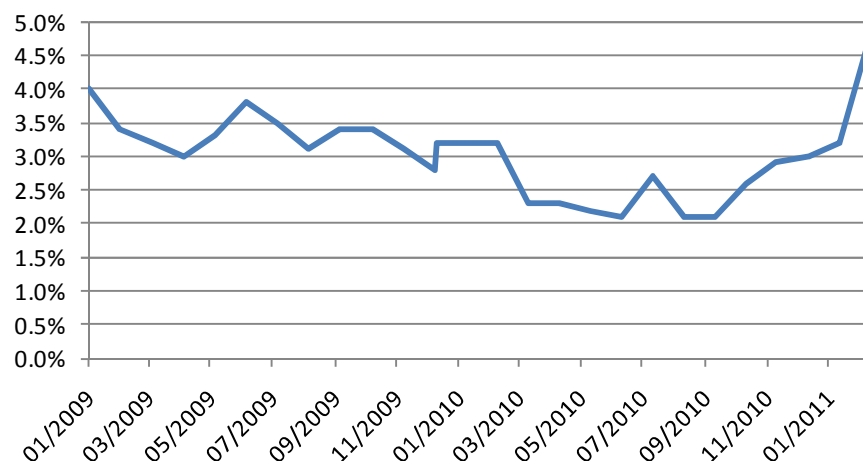
Finally, NBP decided to comment a little more (a comprehensive interview with Mr. Sobota, the Statistics Department Director in NBP) on the errors and omissions account (ERROM) hypotheses. It turns out that the story of underreported imports seems a bit exaggerated as eventual miscalculation applies mainly for used car imports and low scale, shadow imports connected with tourism. Therefore it does not put into question the Polish growth model, nor it entails any downward revision to the historical GDP data. As for the other reasons behind large ERROM it is possible that part of it stems also from overblown current income receipts from income earned abroad (NBP can only estimate those flows, probably basing on too optimistic assumptions). What is interesting, the NBP turned completely down the swap-story behind the ERROM.

The ERROM puzzle is going to be (at least partially) resolved in June (as Mr. Sobota promised). In either case, it would entail some sort of C/A widening (probably, gradually towards 4-5% of GDP) and zloty equilibrium exchange rate revaluation (weaker equilibrium, probable closer to 4 in EURPLN terms) on the back of the most common econometric models. However, in the light of the recent NBP explanations, the negative market impact may be lower than previously thought as it does not compromise the Polish growth model among the other CEE economies. It seems that once again the long cited market proverb hold: buy rumors, sell facts...

### Inflation expectations surged in March

Inflation expectations surged to 4.6% from 3.2% a month ago. Although those expectations are adaptive by nature (they usually track CPI inflation with a 2 month lag), the rise is by and large substantial and obviously reflects the price rises of social-sensitive categories including food (sugar...) and fuels (EurosUPER95 above psychological 5 PLN per litre mark).

#### Consumer-derived inflation expectations



Substantially higher inflation expectations carry straightforward implications for MPC which can do nothing but to tighten monetary policy at April's meeting. What is more, we cannot exclude speculations that in current circumstances (mind that in August, when expectations accelerated only slightly compared to recent reading, there was a motion for 50bp hike) even 50bp hike is likely. However, we only expect regular hike by 25bp as high unemployment rate remains a thorn in the eye for the MPC. Adding to this a relatively dovish inflation projection, possibility of falling CPI in H2 and rising concerns about the real sphere of the economy (fiscal consolidation, unwinding

extraordinary monetary policy measures abroad) we will end up with a cycle closing with cumulative 75bp. hike. Moreover, as the publication of inflation projections was postponed to July and November, MPC would be likely to postpone another hike debate (hike in April can be – in our opinion – considered done) until July, but then falling CPI would encourage MPC to embark on a more dovish stance and forget about further monetary tightening. We are sure that such a scenario may be slowly reflected in fixed income instruments, however, its realization will much depend on the balance between the scale of investment pickup and the assessment of inflation persistence among MPC members. We would be rather inclined to see MPC more on a dovish side in medium-term perspective even if fixed capital formation proves to be better than expected.

## Polish Multiyear Financial Plan – no surprises

The government remains relatively optimistic about GDP growth according to Polish Multiyear Financial Plan (PMFP) for 2011-2014, especially after 2012 (smooth decrease slightly below 4%), when public investment should decrease (although investment in energy sector may support it). Interestingly, relatively flat growth path was forecast together with decreasing employment growth (from 2.2% in 2011 to 0.5% in 2014) and unemployment rate. Implicitly one can assume that the government expects significant labor productivity growth, probably related to accelerating private investment. Productivity growth is indeed reflected in upside wage momentum.

Flatter GDP growth path will coincide with progressive (but slow) country budget consolidation (starting with PLN 37 bn in 2012 ending with PLN 28 bn in 2014) and significant general government deficit consolidation (from PLN 46 bn in 2012 through PLN 18.5 bn in 2013 and PLN 15.0 bn in 2014; government thus assumes a surplus of local government. 3% general government deficit to GDP ratio should be achieved in 2012. Borrowing needs will be reduced over the coming years from PLN 51.9 bn in 2012 to PLN 35.1 bn (net) in 2014. Thanks to planned consolidation debt to GDP ratio should be consequently reduced below 50% of GDP in 2014.

Fiscal consolidation, as it is generally put in the PMFP, will be accomplished through cuts in expenses (on the central as well as local level), while system changes (already announced) coming to force in 2011 and better GDP growth as well as conditions on the labor market will result in better income effects. Only 0.6 pp of the total 4.4 pp consolidation effort for the years 2011-2012 agreed with EU Commission will be a result of increased tax rate and tax deductions.

Multiyear Financial Plan – in accordance with law – sets a limit for planned budget deficit in the coming years. Therefore the document was neutrally/positively welcomed by investors. On one hand putting more pressure on local government which is more difficult to monitor may cause some unrest as it is much more difficult to keep fiscal discipline of local government. On the other hand this is exactly why the government is looking for a safety buffer right there.

### MID-TERM FORECASTS

Indicator	2007	2008	2009	2010	2011
GDP y/y (%)	6.5	4.8	1.7	3.8	4.2
Inflation rate (% , average)	2.4	4.3	3.5	2.8	3.7
Current account (% of GDP, average)	-4.5	-5.3	-1.6	-3.1	-3.8
Unemployment rate (end-of-year)	11.4	9.5	11.9	12.3	11.9
NBP repo rate (end-of-year)	5.00	5.00	3.50	3.50	4.25

Indicator	2010		2011			
	Q1	Q2	Q3	Q4	Q1	Q2
GDP y/y (%)	3.0	3.5	4.2	4.4	<b>4.4↑</b>	<b>4.4↑</b>
Inflation rate (% , average)	3.0	2.1	2.6	2.9	3.7	3.7
NBP repo rate (end-of-quarter)	3.50	3.5	3.5	3.50	3.75	4.25

*Bold denotes changes from the last release with arrows showing the direction of changes*

## Fixed Income

Rates have been constantly moving higher, along with the steepening tendency, especially in the 5y-10y area. At the same time asset-swaps spreads in 10y sector narrowed significantly. These moves were quite in line with our earlier expectations. Inflation expectations surprised strongly on

*No reason to receive*

the upside (came out 4.6% y/y vs. 4.0% expected), making Tuesday's rate hike almost a done deal. Comments after such decision would likely point out risks that have led to such outcome. Considering that ECB will probably also tighten their policy next week, MPC's rhetorics can evolve towards even more hawkish tone. Another important event in the near future will be March CPI reading. Our forecast stands at 4.0% y/y, and we think risks for the figure is on the upside. From that perspective, the rising trend in rates that we've observed for a while now is likely to continue, maybe even accelerate; definitely we cannot find good reasons to receive rates at current levels.

**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	5/30/2011	-	4.458%	3/28/2011
2Y T-bond OK1013	4/13/2011	-	5.113%	3/9/2011
5Y T-bond PS0416	4/20/2011	-	5.642%	1/5/2011
10Y T-bond DS1020	4/20/2011	-	6.210%	1/12/2011
20Y T-bond WS0429	4/20/2011	-	6.246%	1/12/2011

**Money Market**

*Huge turmoil on the liquidity squeezed the market*

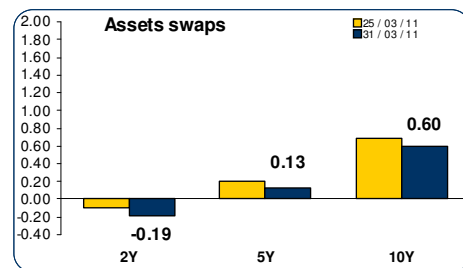
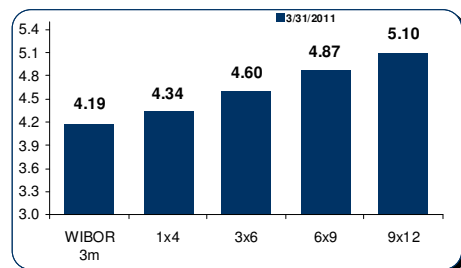
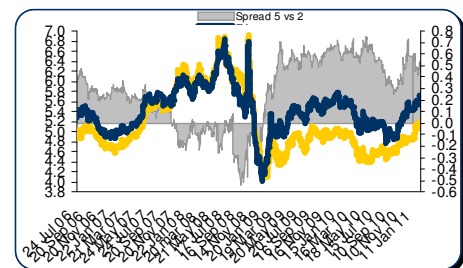
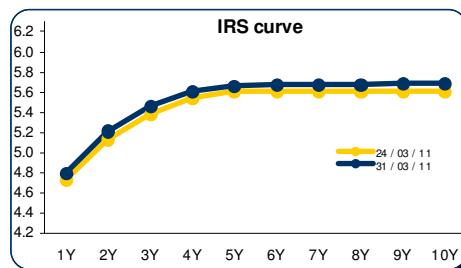
Huge turmoil the liquidity last week since the pln 11 bln was blocked in the central bank instead of supporting the market. The most probable version is that the money was pledged as a guarantee for the WBK stock call. The end of the reserve and quarter was therefore squeezed with the cost of carry much above the main market rate. This made the pln 91 bln of money bills really bad investment. Tomorrow's OMO should be well thought over and the demand should be much lower if the market does not want to repeat the scenario.

*Rates hike very likely next week*

Yields went up this week along with the growing probability of the rate hike next week. Some comments from the MPC side suggest that they are willing to tighten the policy before expected much higher March CPI figure.

New T-bills benchmark was well bid and the average yield was 4.46%. Those papers should be a bit cheaper on Monday. Worth noticing is the fact that this issue will be continued till the end of May.

**FIXED INCOME & MONEY MARKET CHARTS**



## Foreign Exchange

*Zloty relief rally*

Although PLN rally has extended to 3.9820 low (EURPLN), momentum has clearly exhausted and on back of possible revision of C/A data Zloty has started to trade on a weaker side. As a result cross has broken through strongly offered 4.00 area and topped with 4.02 rate.

In weekly realized volatility terms we have faced decent drop last weeks. Top record 12.2%, boosted by fast upside move, was followed by 6.8% bottom which reflect slow rate of consolidation phase.

*Vols lower*

It has added more pressure on short-end implied and selloff has continued: 1M has lowered to 8% (8.7 last week) while longer tenors has reacted softer: 3M 9.1 (9.4) and 1Y 10.6 (10.75).

**Short-term forecasts:**

SPOT

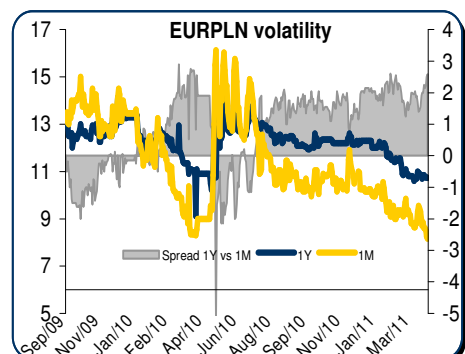
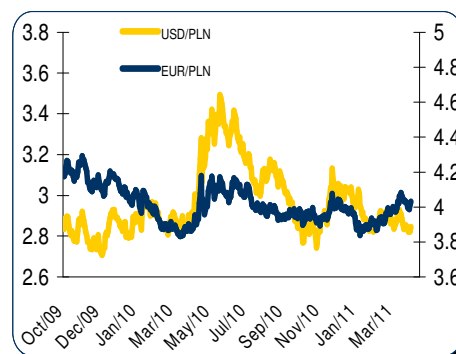
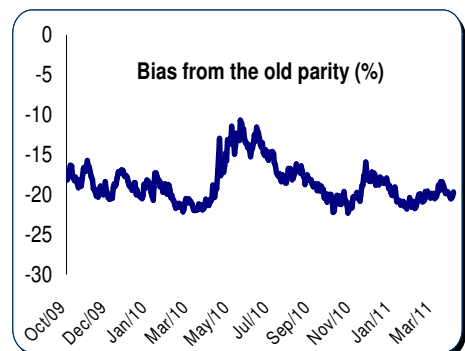
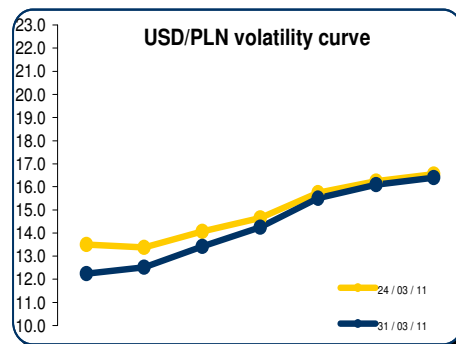
Main supports / resistances:  
 EUR/PLN: 4.9700 / 4.1250  
 USD/PLN: 2.8000. / 3.9500

We are long at 4.01 , S/L 3.97 and T/P 4.08.

OPTIONS

We think it offers a good bargain to buy a 2 month ATMs for Gamma and longer end ATMS for Vega position. EUR/PLN run is just above this year's lows and we think it may revisit the higher levels.

### 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
25/03/11	4.05%	4.19%	4.28%	4.31%	4.45%	4.47%
28/03/11	4.09%	4.19%	4.28%	4.31%	4.49%	6.59%
29/03/11	4.08%	4.19%	4.32%	6.49%	4.45%	4.47%
30/03/11	4.08%	4.19%	4.30%	4.31%	4.18%	4.47%
31/03/11	4.08%	4.19%	4.30%	4.31%	4.48%	4.47%

**FRA MARKET RATES**

FRA Market Rates (Closing mid-market levels)					
date	1X4	3X6	6X9	9X12	6X12
25/03/11	4.29%	4.54%	4.81%	5.01%	4.98%
28/03/11	4.32%	4.56%	4.84%	5.05%	5.01%
29/03/11	4.33%	4.57%	4.85%	5.06%	5.02%
30/03/11	4.33%	4.56%	4.84%	5.05%	5.02%
31/03/11	4.33%	4.56%	4.82%	5.05%	5.02%

**FIXED INCOME MARKET RATES**

Fixed Income Market Rates (Closing mid-market levels)							
date	1Y		2Y		5Y		
	WIBOR	TB	IRS	OK0112	IRS	PS0511	IF
25/03/11	4.47%	4.54%	5.14%	5.04%	5.61%	5.81%	5.6
28/03/11	6.59%	4.54%	5.16%	5.01%	5.65%	5.81%	5.6
29/03/11	4.47%	4.54%	5.16%	5.02%	5.64%	5.79%	5.6
30/03/11	4.47%	4.56%	5.19%	5.01%	5.67%	5.80%	5.7
31/03/11	4.47%	4.55%	5.22%	5.03%	5.67%	5.80%	5.6

**PRIMARY MARKET RATES**

Last Primary Market Rates							
	au. date	maturity	avg price	avg yield	supply	demand	sc
52W TB	11/01/31	12/01/31	95.841	4.35%	2000	2968	19
OK0113	11/03/09	13/01/26	91.054	5.11%	4500	10808	45
PS0416	10/10/13	16/04/25	99.300	5.14%	3000	3414	24
DS1020	11/01/12	19/04/25	93.022	6.21%	2250	4252	22

**FX VOLATILITY**

date	USD/PLN 0-delta stradle				25-delta RR		2
	1M	3M	6M	1Y	1M	1Y	
25/03/11	13.38	14.65	15.65	16.45	1.80	3.55	0.
28/03/11	13.08	14.55	15.65	16.50	1.70	3.55	0.
29/03/11	12.98	14.45	15.65	16.50	1.65	3.55	0.
30/03/11	12.83	14.40	15.55	16.50	1.65	3.55	0.
31/03/11	12.53	14.25	15.50	16.40	1.70	3.55	0.

**PLN SPOT PERFORMANCE**

PLN spot performance			
date	USD/PLN	EUR/PLN	bias
25/03/11	2.8425	4.0240	-19.9%
28/03/11	2.8431	3.9980	-20.2%
29/03/11	2.8227	3.9930	-20.5%
30/03/11	2.8277	3.9878	-20.5%
31/03/11	2.8229	4.0119	-20.2%

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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