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Financing Nigerian growth

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We are releasing this edition of the *New Markets Analyst* later than usual to coincide with the increase in the oil price forecast by our colleagues in Commodity Research. We are publishing selected revisions to our current account and inflation forecasts for 2008 and 2009. As one would expect, the impact of such a large increase in oil prices on the current account surpluses of oil producing countries is substantial, exacerbating the dilemma they face in managing inflation and restraining currency appreciation. We expect the inflationary consequences to be felt mainly in 2009—particularly in Russia, where we now expect inflation to return to above 14% after a dip towards the end of this year.

In this week's focus, we look at another oil producing country, Nigeria, which has experienced two major positive changes in its financial picture in recent years. Most obviously, high oil prices have raised export and fiscal revenues (despite declining production volumes); higher prices mean even more of the same, and we now expect export revenues to surge to $90bn in 2008 (from $58bn in 2006). But another development is potentially more important for the longer run: private capital inflows have increased dramatically. Investment has flowed not only into the oil sector but also into other areas of the economy, especially the financial sector. This did not occur in previous booms and is important both because of the economic development it will finance, and also as a vote of confidence in the overall economic management of the country. Hence, the oil and non-oil economy should both sustain strong growth. The flip-side of this is that inflation pressure will increase, although the greatly improved financing picture will allow the central bank to counter this by allowing the currency to appreciate.

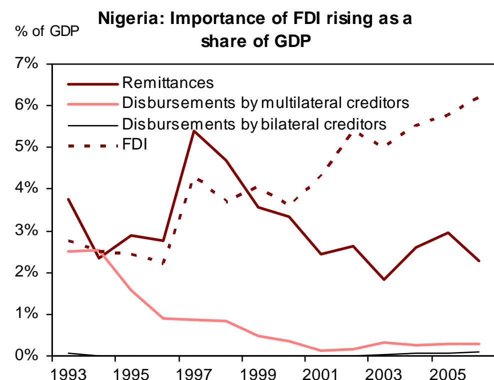
Current account balance as % of GDP

	2008		2009	
	new	old	new	old
GCC	32.1	27.5	26.8	22.7
Russia	8.6	6.4	6.2	2.3
Kazakhstan	1.6	-5.4	0.9	-4.4
Turkey	-7.0	-6.2	-7.0	-6.2
South Africa	-7.8	-7.3	-8.3	-8.0

CPI, average for the year, %

	2008		2009	
	new	old	new	old
Czech	6.9	6.8	4.0	3.7
Hungary	6.1	5.8	4.3	3.5
Kazakhstan	17.0	17.0	10.2	9.8
Poland	4.4	4.3	4.5	3.9
Russia	13.8	13.8	14.2	11.8
Slovakia	3.7	3.7	4.5	4.2
South Africa*	10.2	9.8	8.3	8.1
Turkey	10.1	9.6	6.5	10.1

*CPIX (CPI excl mortgage payments)



Source: Haver Analytics, IMF, World Bank

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Goldman Sachs

Week ahead

On the data front, we expect the Q1 GDP release in Israel to show some moderation in growth after a strong performance in 2007H2. Poland will publish core inflation measures, which are likely to point to rising core inflation pressures. The National Bank of Poland will also release the Minutes of its April rate-setting meeting. We expect the overall tone to be skewed towards hawkishness, but the current wait-and-see mode implies that we are unlikely to have a clear indication of the future path of policy rate. Lastly, Russia will publish April industrial production numbers at some point next week, which we expect to show continued solid growth momentum.

In **Israel**, we expect the **Q1 GDP** release to show growth moderating from 6.4%qoq annualised in 2007Q4 to 4.0%, marginally below the 4.2% consensus. Export growth decelerated in Q1—largely reflecting a negative base effect given the stellar export growth numbers in the previous quarter. This was probably partly offset by weaker imports of durable goods (both for consumption and for investment), given the recent stabilisation in the ILS exchange rate. On the domestic side, growth in consumption and investment is likely to have declined only moderately, while growth in the construction sector together with fiscal spending may have picked up. Overall, we think the underlying growth fundamentals in the economy remain very strong, but some moderation from the exceptionally high rate of growth in 2007H2 is warranted, particularly in the context of the slower growth across many industrial countries.

Poland will publish **core inflation** indicators for April on Wednesday. We expect net core inflation to increase further to 3.0%yoy, and the second-most watched index, the trimmed mean, is likely to go up as well. The other three core inflation measures may show a more mixed picture, but all of them should stay at high levels. The situation so far has been unfolding as we expected: headline and food inflation are somewhat better behaved, but core inflation pressure is increasing. We think the NBP will have to raise interest rates, and the PLN will have to strengthen, to offset these developments.

We will have more on the current thinking of the NBP on Friday, when it releases the **Minutes of the April MPC meeting**, when interest rates were left on hold for the first time this year. Our expectation is that the tone will still point to upside risks, but there will be a lot of discussion about a potential growth slowdown and the effects on the inflation outlook. Also, the PLN appreciation is proving more permanent than the MPC seemed to expect at previous meetings, which means that there is likely to be some discussion of the effects of the stronger currency on production and inflation. Overall, in line with the "wait-and-see" stance, we do not expect a lot of clear pointers about the future direction of interest rates, and we think there will be a lot of two-sided argumentation.

Russia will announce **industrial production growth** for April at some point over the next few days. We believe growth momentum remains solid, and the headline figure may be further inflated by the working day effect—although there is some uncertainty about when people left for their long May holidays. If we are right about the working days, then the effect will be most visible in the manufacturing series. We have been forecasting a slowdown in GDP growth this year, particularly in heavily credit-dependent areas such as construction, but thus far, apart from a very mild slowdown in credit growth (which is still over 50%yoy), there are no signs that the economy may slow from last year's 8.1%. At this point, even the CBR freely admits that the economy is overheating.

Anna Zadornova

Calendar – Key Economic Releases and Other Events

Country	Time (UK)	Economic Statistic/indicator	Period	Forecast mom/qoq	Forecast yoy	Previous mom/qoq	Previous yoy	Consensus
Friday 16 May								
Czech Rep	8:00	Minutes of MPC Meeting	May-07	—	—	—	—	—
Hungary	8:00	Gross Average Wages	Mar	—	—	—	+13.4%	+10.4%
Czech Rep	8:00	Producer Prices	Apr	—	—	—	+5.3%	+5.1%
Turkey	8:00	Consumer Confidence	Apr	—	—	82.0	—	—
Hungary	13:00	Minutes of MPC Meeting	Apr-28	—	—	—	—	—
The Week Beginning Monday 19 May								
Poland	—	Retail Sales	Apr	—	—	—	+15.7%	+19.0%
Russia	—	Industrial Production	Apr	—	—	+11.7%	+6.5%	+7.0%
Monday 19 May								
Czech Rep	8:00	Retail Sales	Mar	—	—	—	+6.3%	+3.9%
Poland	13:00	Gross Average Wages	Apr	—	+9.0%	—	+10.2%	+11.5%
Wednesday 21 May								
Poland	13:00	Net Core Inflation	Apr	—	+3.0%	—	+2.7%	+2.9%
Poland	13:00	Producer Prices	Apr	—	—	—	+2.9%	+2.8%
Poland	13:00	Industrial Output	Apr	—	—	—	+0.9%	+14.2%
Thursday 22 May								
Russia	—	Gross International Reserves	w/e May 16	—	—	$536.8bn	—	—
Friday 23 May								
Hungary	8:00	Retail Sales	Mar	—	—	—	–2.5%	—
Turkey	8:00	Foreign Tourist Arrivals	Apr	—	—	—	+18.7%	—
Poland	13:00	Minutes of MPC Meeting	Apr-30	—	—	—	—	—
Sunday 28 May								
Israel	—	GDP	Q1	+4.0%ann	—	+6.4%ann	—	+4.2%ann

Oil price revisions

We have timed this issue to coincide with our Commodity Research team's substantial upward revision of its oil price forecasts; they now expect the Brent crude price to average $124/bbl in 2008, up from their previous forecast of $104/bbl. They have also unveiled a new 2009 average forecast of over $140/bbl in 2009. In the table alongside, we summarise the impact of these numbers on the current accounts and CPIs in our region. The direction of the impact should not be surprising, but the magnitude of the increases in the current account surpluses of the oil-exporting countries is impressive, further exacerbating the dilemma they are facing in grappling with appreciation pressure and inflation. The impact on inflation mainly shows up in 2009—the largest change we are making is in Russia, where we have inflation returning to over 14% rather than coming down, as we had been expecting.

Rory MacFarquhar

Current account balance as % of GDP

	2008 new	2008 old	2009 new	2009 old
GCC	32.1	27.5	26.8	22.7
Russia	8.6	6.4	6.2	2.3
Kazakhstan	1.6	-5.4	0.9	-4.4
Turkey	-7.0	-6.2	-7.0	-6.2
South Africa	-7.8	-7.3	-8.3	-8.0

CPI, average for the year, %

	2008 new	2008 old	2009 new	2009 old
Czech	6.9	6.8	4.0	3.7
Hungary	6.1	5.8	4.3	3.5
Kazakhstan	17.0	17.0	10.2	9.8
Poland	4.4	4.3	4.5	3.9
Russia	13.8	13.8	14.2	11.8
Slovakia	3.7	3.7	4.5	4.2
South Africa*	10.2	9.8	8.3	8.1
Turkey	10.1	9.6	6.5	10.1

*CPIX (CPI excl mortgage payments)

Nigeria: Strong financing flows point to sustained growth, currency strength

Nigeria's financial picture has seen two important improvements in recent years. Most obviously, high oil prices have boosted export and fiscal revenues (despite declining production) and will continue to do so. We forecast that export revenues will surge to $90bn in 2008 (from $58bn in 2006) on the back of our Commodities team's forecast that the oil price will approach $150/bbl by end-year. But another development is potentially more important for the longer run: private capital inflows, including FDI, have increased dramatically. This is important both because of the economic development it will finance, and also as a vote of confidence in the overall economic management of the country. Hence, the oil and the non-oil economy should both sustain strong growth. The flip-side of this is that inflation pressure will increase, although the greatly improved financing picture should allow the central bank to counter this by allowing the currency to appreciate.

Nigeria's growth has accelerated to an average of 7% over the past five years, a sharp break with prior decades. A number of factors have contributed to this turnaround, including improved macroeconomic policies, the rehabilitation of the country's financial sector, official debt relief and high commodity prices. But in order to sustain growth at a high level, the country will need to invest, both in the oil sector itself and in other areas of the economy. Part of the capital needed for this investment is likely to be accumulated through export revenues, which will in turn permit a higher level of domestic investment; foreign capital inflows, both private (foreign direct investment, remittances) and public (foreign aid) should provide a second source of financing. Lastly, in order to maintain economic stability and finance infrastructure spending, the government must be able to raise adequate revenues. We look at each of these components in turn.

Nigeria's trade surplus is burgeoning

Since 2002, Nigeria's trade surplus has tripled, largely on the back of increased oil and natural gas prices and revenues (Chart 1). With daily production of around 2mn bpd, oil represents 98% of Nigeria's total export revenue, and amounted to $58bn in 2006 (the most recent reliable data available).

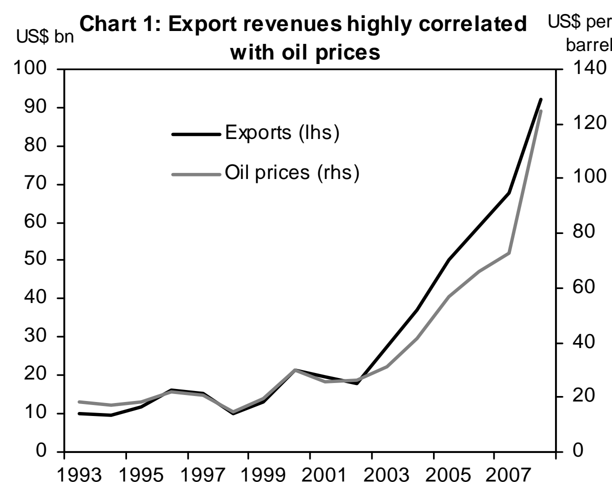
Oil production has fallen recently due to work stoppages, including the ongoing dispute in the country's Niger Delta region (Chart 2), which has reduced oil output by around 265,000 bpd, costing the country roughly $4bn at current prices. According to the US Energy Information Administration, Nigeria's oil production averaged just 1.85mn bpd in April 2008—far short of its OPEC production quota of 2.16mn bpd and our estimate of its potential output of 3mn bpd.

Despite this disappointing loss of production volumes, higher prices have more than compensated. Based on the new GS Commodities team's forecast that oil will approach $150/bbl by end-2008, we now expect exports to grow to $92bn in 2008, assuming oil production of 2mn bpd. Imports have also risen rapidly (Table 1), much of this in the form of investment goods for the oil sector. Nevertheless, the trade surplus has risen to $40bn (up from $28bn in 2006 and only $5bn in 2002). We expect the current account to run a surplus of 9% of GDP in 2008, up from a deficit of 3% in 2003.

Capital inflows also rise

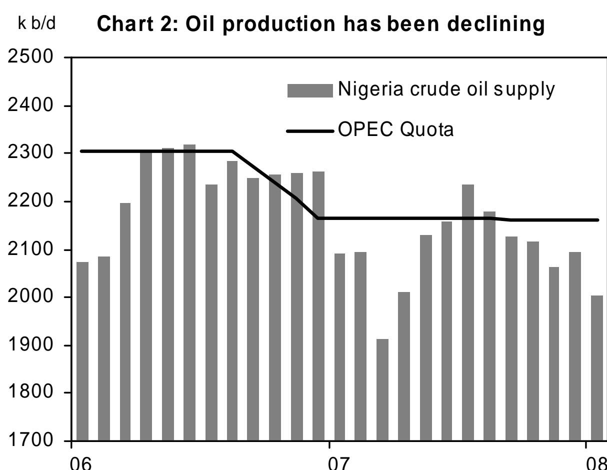
In addition to export revenues, Nigeria's improving economic climate has attracted an increasing amount of private capital inflows. In 2006, the total influx of

Chart 1: Export revenues highly correlated with oil prices



Source: IMF, Goldman Sachs

Chart 2: Oil production has been declining



Source: OPEC, Oil & Gas Journal, IEA

Table 1: Balance of payments dynamics

	US$ bn			
	2005	2006	2007 (est)	2008F
Trade Balance	24	28	29	40
Exports	50	59	68	92
Oil & gas	49	58	67	91
Other	1	1	1	1
Imports	-26	-31	-38	-52
Oil & gas	-12	-13	-15	-26
Other	-14	-18	-23	-26
Services (net)	-7	-6	-8	-9
Income (net)	-13	-11	-13	-16
Oil & gas	-12	-12	-13	-16
Transfers (net)	3	3	3	3
Current Account Balance	**8**	**14**	**12**	**19**
Official capital (net)	-8	-17	0	0
Other capital (net)	0	-1	-1	0
FDI	7	9	10	11
Debt Forgiveness	7	11	0	0
Capital and Financial	**5**	**2**	**9**	**11**
Errors and omissions	3	-2	0	0
Overall Balance	**16**	**14**	**21**	**30**
Exceptional financing	-5	0	0	0
Change in reserves	-11	-14	-21	-30

Source: Goldman Sachs, IMF

investment and loan capital was $13bn, equivalent to almost 10% of Nigeria's GDP. Foreign direct investment (FDI) to Nigeria totalled $9bn in 2006 and remittances (cash transfers to Nigeria from Nigerians living abroad) were around $3bn; meanwhile, total disbursements from official creditors (multilateral and bilateral aid donors) were around $550mn.

The shift from public to private financing is a relatively recent (and, in our view, very important and positive) phenomenon. Until the early 1990s, nearly as much of Nigeria's financing came from public as from private flows. The shift towards greater private financing started around the late 1990s. FDI flows have been a dominant feature of the private flows, representing some 70% of total foreign inflows (FDI, remittances, multilateral and bilateral aid) and 6% of Nigeria's GDP in 2006 (see Charts 3 and 4). Unsurprisingly, the bulk of FDI inflows (55% in 2006) went to the oil and gas sector. But other sectors have also benefited, particularly the banking and infrastructure sectors.

This combination of a very large current account surplus and substantial capital inflows underpins the strong appreciation pressure on the NGN.

A strengthening fiscal story

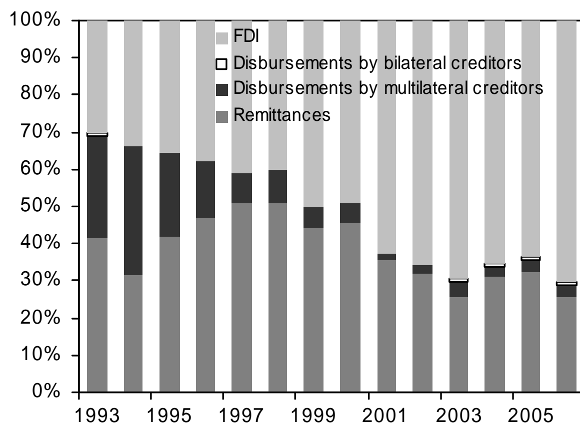
The importance of the recent commodity price upsurge as a source of revenue is also evident on the fiscal side. Oil and gas revenue contributed 85% to the government’s coffers (mainly via taxes, corporate profit sharing and royalties) in 2006, whereas non-oil total revenues were only 15% of the total (Chart 5). Furthermore, in 2006 oil and gas revenues accounted for nearly 40% of the country's GDP (Table 2).

Although Nigeria has consistently posted fiscal surpluses (averaging 6% in the past three years), in its April 1 communiqué, the Monetary Policy Committee noted that the proposed federal budget contained significant increases in expenditures, which would lead to projected budget deficits in the next two quarters of the year. But, given our view on oil prices, we expect revenues to remain strong and continue to outpace spending

Table 3 underscores just how much oil assumes a central role in Nigeria's fiscal position. Without oil, Nigeria's fiscal deficit would be around 33% of GDP.

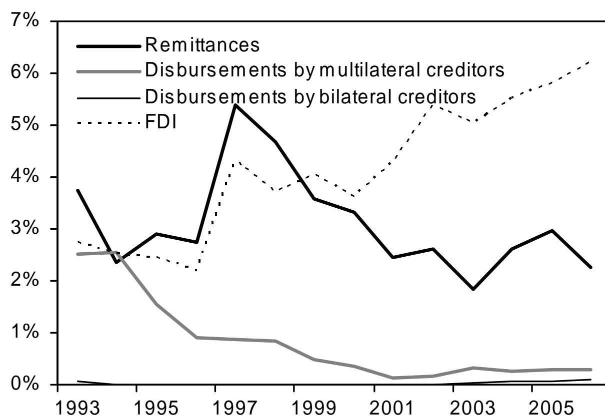
Nigeria has tended to finance itself through substantial domestic and foreign capital market borrowing. Nigeria has utilised domestic debt issuance across the yield curve to finance part of its expenditures. Federal government domestic debt today stands at around 12% of the country's GDP, over 50% of which is centred around the 2-year bond maturity.

Chart 3: Shift in composition of finance towards FDI

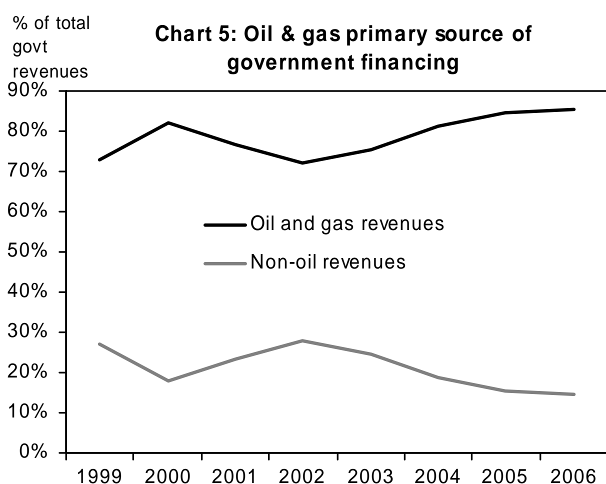


Source: Haver Analytics, IMF, World Bank

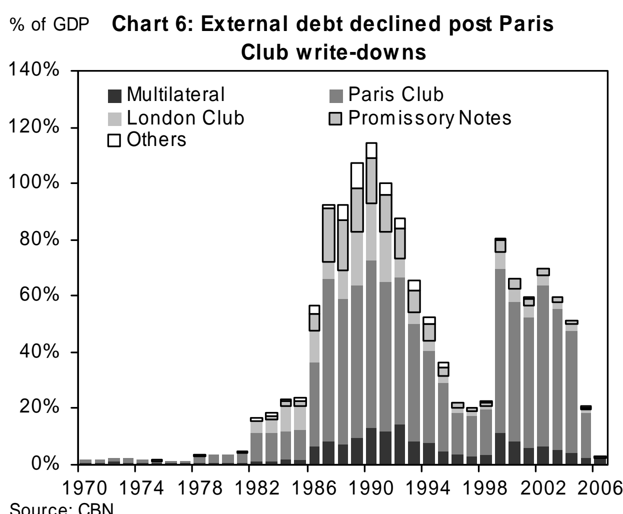
Chart 4: Importance of FDI rising as a share of GDP



Source: Haver Analytics, IMF, World Bank



Source: IMF



Source: CBN

Historically, Nigeria has depended on international borrowing (from international donors such as the World Bank and Paris Club, and private bond financings). But following the debt write-downs of 2006, its international debt to GDP ratio now stands at just 3% compared with highs of 59% in 2003 (see Chart 6). Nigeria's credit rating is stable at BB-; however, the sovereign has not issued any new foreign currency denominated debt in the capital markets since 1992. That said, since January 2007 there have been at least two international financings from Nigeria's corporate sector.

Government drawing down on excess crude account to finance infrastructure

The Nigerian government has saved much of its budget surplus in an "Excess Crude Account", which currently holds around $17bn.

As we discussed in a previous issue, all budget revenues due to prices or volumes above the conservative level assumed in the budget—around $60/bbl in 2008 and 2.45mn bpd in 2008—go into the account, helping to shield the budget and the economy from oil price fluctuations, and absorbing some of the inflationary impact of high oil prices.

Table 2: Nigeria's Consolidated government revenues as % of GDP

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Oil and gas revenues	11%	11%	7%	22%	34%	32%	26%	28%	35%	37%	37%
- *of which: petroleum profit tax, royalty and other taxes*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	7%	10%	12%	15%	14%
Non-oil revenues	9%	9%	9%	8%	7%	10%	10%	9%	8%	7%	6%
- *of which:* taxes	5%	5%	6%	8%	7%	9%	7%	7%	6%	5%	5%
Total revenues	20%	20%	16%	31%	41%	42%	36%	37%	43%	43%	43%

Source: IMF

Table 3: Non-oil primary fiscal deficit is very high

	% of non-oil GDP		
	2004	2005	2006
Nonoil revenue	**11%**	**10%**	**8%**
Tax revenue	8%	7%	6%
Taxes on net income, profits and capital gains	2%	2%	2%
Domestic taxes on goods and services	2%	2%	2%
Taxes on int'l trade and transactions	4%	3%	2%
Nontax revenue[1]	3%	3%	2%
Expenditures	**44%**	**48%**	**43%**
Recurrent expenditure	19%	21%	16%
Interest payments due	3%	4%	2%
Capital expenditure	4%	4%	5%
State and local governments	21%	22%	20%
Other	0%	1%	2%
Non-oil primary balance	**-30%**	**-34%**	**-33%**

Source: IMF, Goldman Sachs

1 State and local governments' internal revenues and federal government independent revenues are assumed to belong to this category

In the past few months, the Nigerian authorities have outlined a programme to roll out increased infrastructure across the country. Part of this is to be financed by drawing down on the stabilisation fund. Nevertheless, because the current budget oil price assumption is so far below our average oil price forecasts for 2008 and 2009 ($124/bbl and over $140/bbl, respectively), we expect the Excess Crude Account to grow (and remain in positive balance) over the next couple of years.

Nigeria's financing path is sustainable

There are two main issues in relation to Nigeria's financing strategy: the likely stability of the different sources of finance, and the levels and quality of investment finance that can be expected.

In terms of stability, since the largest proportion of Nigeria's financing comes from the oil and gas sector (Table 4), the country's revenues are disproportionately susceptible to oil price declines, and production stoppages (for example due to strikes). With respect to oil prices, we forecast further oil price increases over the coming two years, and do not envisage a fall in oil revenues solely as a result of adverse price changes.

In terms of oil output, however, there is some cause for concern given the recent trend of declining oil production, and the fact that Nigeria is already failing to meet its allotted OPEC quota. Production stoppages can have serious implications for the stability of the flows. For example, a month on month decline of 155,000 barrels (as was the case between March and April 2008) translates into reduced cash into the economy—a daily loss of around $20mn, annual loss of $5bn.

Clearly, production shocks could quickly turn around Nigeria's financing situation, jeopardising growth as well as the stability and strength of the currency. Nevertheless, we remain confident that there will be progress towards a resolution on the Niger Delta dispute over the next year, and we also note a growing trend towards greater off-shore oil production, which (broadly) has tended to be less vulnerable to disruptions.

As for the level and quality of investment finance, we believe Nigeria is well placed to continue to attract sizeable foreign investment flows. Importantly (all things being equal), we expect the country to be able to sustain the levels of resources it needs to maintain GDP growth rates of above 7%, given the notable economic and financial reforms, the advent of democratic elections, and the opening of the economy to international capital. Each of these key milestones points to greater overall stability in the country, and bodes well for further investment from both foreign and domestic investors.

In terms of quality of capital flows, we are confident that much of the money that will continue to flow into Nigeria will be in a form that promotes efficient allocation. For example, we expect continued investment in greenfield FDI into industries such as consumer goods and agriculture, rather than into the banking sector. Based on recent trends, we expect much of this investment to be supported by private international inflows, mainly from China, Russia and the Middle East. We also expect a continued steady influx of capital from the official donor sector, which will likely be targeted towards longer-term large-scale infrastructure investments, as well as Nigeria's budget.

Going forward, we believe that the oil and the non-oil sectors will both sustain strong growth. Although we expect inflationary pressure to increase, we are confident that Nigeria’s overall financing picture will enable the central bank to counter this with allowing the currency to appreciate.

Dambisa Moyo and Gokce Hagnesten*

* Gokce Hagnesten is an intern in the Economics Department and is currently studying for a PhD in Economics at Harvard University.

Interest rate and exchange rate forecasts

Interest Rate Forecasts

		%	3-Month Horizon		6-Month Horizon		12-Month Horizon	
		Current*	Forward	Forecast	Forward	Forecast	Forward	Forecast
Czech Republic	2-week repo rate	3.75	na	**3.75**	na	**4.00**	na	**4.00**
	3M	4.14	4.27	**4.00**	4.20	**4.10**	4.06	**4.10**
	5Y	4.20	4.44	**4.20**	4.44	**4.30**	4.53	**4.30**
Hungary	2-week deposit rate	8.25	na	**9.00**	na	**9.00**	na	**9.00**
	3M	8.22	8.76	**8.90**	8.87	**8.90**	8.39	**8.90**
	5Y	8.49	8.48	**8.20**	8.39	**7.80**	8.26	**7.50**
Poland	7-day intervention rate	5.75	na	**5.75**	na	**6.00**	na	**6.50**
	3M	6.33	6.55	**6.10**	6.46	**6.30**	6.16	**6.70**
	5Y	6.02	6.12	**5.80**	6.10	**5.70**	6.05	**5.60**
Slovakia	2-week repo rate	4.25	na	**4.00**	na	**4.00**	na	**4.00**
	3M	4.46	4.41	**4.20**	4.37	**4.20**	4.27	**4.20**
	5Y	4.32	4.33	**4.40**	4.33	**4.40**	4.36	**4.40**
South Africa	Repo rate	11.50	na	**12.00**	na	**12.00**	na	**12.50**
	3M	11.88	12.56	**12.20**	12.90	**12.20**	11.65	**12.60**
	5Y	9.90	9.82	**9.80**	9.75	**10.30**	9.64	**10.30**
Turkey	3M	17.49	18.16	**16.50**	16.22	**19.50**	16.88	**17.90**

Exchange Rate Forecasts

			3-Month Horizon		6-Month Horizon		12-Month Horizon	
		Current*	Forward	Forecast	Forward	Forecast	Forward	Forecast
Czech Republic	EUR/CZK	25.00	24.96	**25.50**	24.93	**24.50**	24.85	**24.00**
Hungary	EUR/HUF	249.73	252.13	**252.00**	254.52	**245.00**	259.65	**235.00**
Israel	USD/ILS	3.43	3.46	**3.40**	3.48	**3.50**	3.51	**3.65**
Poland	EUR/PLN	3.40	3.41	**3.45**	3.42	**3.35**	3.45	**3.25**
Russia	$/RUB	23.78	23.86	**23.60**	24.04	**23.20**	24.24	**24.10**
Slovakia	EUR/SKK	32.02	31.96	**32.50**	31.90	**32.50**	31.86	**32.50**
South Africa	$/ZAR	7.66	7.85	**8.75**	8.03	**8.75**	8.41	**9.00**
Turkey	$/TRY	1.25	1.30	**1.40**	1.34	**1.40**	1.44	**1.35**

Global Interest and Exchange Rate Forecasts

			3-Month Horizon		6-Month Horizon		12-Month Horizon	
		Current*	Forward	Forecast	Forward	Forecast	Forward	Forecast
Interest Rates (%)								
Euroland	3M	4.86	4.75	**4.7**	4.58	**4.7**	4.17	**4.3**
	10Y**	4.23	4.28	**4.0**	4.34	**4.0**	4.46	**3.8**
UK	3M	5.83	5.53	**5.7**	5.26	**5.5**	4.87	**4.6**
	10Y	4.82	4.83	**4.6**	5.82	**4.5**	4.90	**4.3**
Exchange Rates								
	EUR/$	1.55	1.54	**1.51**	1.53	**1.51**	1.52	**1.40**
	EUR/¥	162.72	161.18	**154.02**	159.74	**154.02**	157.18	**154.00**
	EUR/CHF	1.63	1.62	**1.60**	1.62	**1.60**	1.60	**1.62**
	EUR/£	0.80	0.80	**0.81**	0.80	**0.81**	0.80	**0.78**

Close 14 May 08, mid-rates for major markets. We are currently using June 2008, September 2008 and March 2009 contracts for 3-month forward rates.

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Macro thoughts on trade ideas

From our Global Markets Strategists

Top Ten 2008 trades

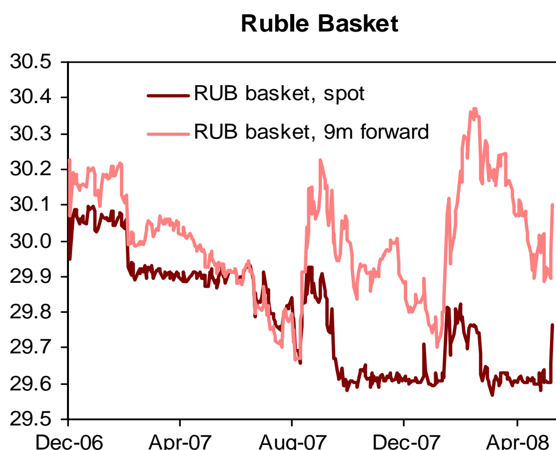
Stay long a 'Globalisation basket' of BRL, RUB and CZK funded in CAD, GBP and US$

Since 2006, we have recommended various 'globalisation' baskets of currencies. The idea is that the ongoing globalisation process is likely to support trend real appreciation of EM currencies, either through nominal appreciation or higher inflation (and higher carry). This year, we have selected EM countries that have a robust external balance position, which should make them resilient to increased global risk aversion. On the funding side, we have selected currencies with weak external balances and/or overvaluation, and with signs of cyclical slowing. Specifically, we are funding the trade in 1/3 CAD, 1/3 GBP and 1/3 USD. Opened on 28Nov07 at 100 with a target on 107.00, now 109.34; carry-adjusted return of +9.48% as of 14May close.

Tactical trades

Stay long RUB in 12-month forwards versus basket of US$0.55 + EUR 0.45

Inflation in Russia has been on the rise since summer 2007, causing the CBR to miss its inflation target by 290bp in 2007, and we expect it to miss the 2008 target by a similar margin. At the same time, the RUB forward points have widened notably in the last couple of months related to global money market tensions. We expect the CBR to resume its use of the spot exchange rate as a tool to bring down inflation, and see this as an opportunity to take advantage of unusually high carry. We would set a stop on a one-day close of the basket (0.55* USD/RUB +0.45* EUR/RUB) above 29.97. Opened on 11Oct07 at 30.01, now 29.76 as of 14May close.



Stay short 3X6 ZAR FRAs on worsening inflation outlook

In South Africa, we expect the central bank to hike rates by another 100bp by the end of the year, with 50bp coming before the end of 2008Q2, as the inflation outlook deteriorates. The reasons for our view are: the latest SARB report indicated that expected inflation has moved from 5.9% to 7.8% in 2008, and from 5.6% to 7% for 2009; the possibility of a higher than previously expected electricity tariff increase; and unfavourable external conditions (Rand depreciation, and higher food and energy prices). At the moment, the market is pricing in very little chance of hikes up to the end of the year. In the light of our view on the path of monetary policy, we think this offers good risk-reward. We recommend staying short 3x6 ZAR FRAs for a target of 12.50% (raised from 12.25%) with a stop on a close below 12.25% (raised from 12.00%). Opened on 14Apr08 at 11.86%, now 12.37% as of 14May close.