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Markets watch

Nigeria ● May 2008

Niger Delta unrest remains a security risk

Irrespective of the improved policy framework, Nigeria's economic progress continues to be mired by unrest in the oil-producing Niger Delta region. Continued attacks on oil facilities led to significant disruptions in oil production such that for the first time, during April 2008, Angola's oil output surpassed that of Nigeria. Nigeria continues to take advantage of high international oil prices to enact positive and progressive economic reforms that will lead to sustainable growth and macroeconomic stability. However, economic performance is still less than optimal judging by the vastly untapped natural resources, significant infrastructure deficit, poor energy supply, political instability and security risks. Thus, higher growth rates will remain elusive in the medium term even as oil prices remain elevated. The non-oil sector will continue to drive the economy in the medium term. Revenue should also increase as oil revenue remains strong due to high oil prices. This should facilitate strong government expenditure, which should contribute significantly to overall economic activity.

The prospect for single-digit inflation during 2008 seems to be fading as the economy remains vulnerable to increased inflationary pressures in the medium term. The Central Bank of Nigeria (CBN) continues to tighten monetary policy in its attempt to keep inflation within single digits. However, the Nigerian economy is oil-based and with oil prices at an all-time high, the CBN is faced with the challenge of managing increasing liquidity in the system. Also, due to poor agriculture sector performance, Nigeria continues to be a net importer of food. Global food shortages have contributed to increased overall inflation. The continued disbursement of windfall oil savings to the federal and state governments (with another disbursement scheduled for end of June 2008) will continue to put considerable pressure on the CBN to manage the excess liquidity.

We expect the exchange rate to remain relatively strong, which should help mitigate imported inflation. The CBN's plans to improve the convertibility of the naira should help facilitate the use of the naira both domestically and internationally and should smooth further integration into the global economy. Overall, medium-term prospects depend on, among others, continued positive political developments, improved security in the Niger Delta region, commitment to prudent macroeconomic policies and continued attempts to diversify the export base.

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Inflation

The macroeconomic policy landscape continues to improve. However, inflationary pressures are mounting both domestically and internationally. Externally, higher oil prices continue to generate excess liquidity that is posing a significant challenge to the monetary authorities' commitment to maintaining the single-digit inflation experienced since June 2006. A global shortage of food is also pushing the food component of the index higher as Nigeria is a net food importer. Currently, food imports constitute about 5% of GDP. Agriculture's performance is not expected to improve in the near term and will continue to push food prices higher during 2008.

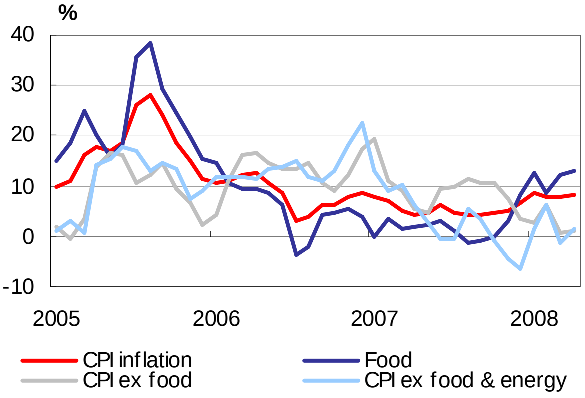
Increased fiscal expenditure driven by government's commitment to infrastructure development should also fuel inflation in the medium term. Another inflationary pressure will come from increased expenditure by different states when they start spending their allocations from the Excess Crude Account.

Inflation increased from an average of 5.5% in the fourth quarter of 2007 to 8.1% in the first quarter of 2008. The upward pressures originate mainly from the food component, which constitutes about 63.8% of the CPI basket. Food inflation averaged 11.3% in the first quarter of 2008 compared with an average of 3.8% in the fourth quarter of 2007. .This year food inflation increased from an average of 12.7% y/y in January to 13.1% y/y in April. The latest overall inflation recorded for April 2008 was 8.2% y/y. This was an increase from 7.2% y/y recorded in March 2008. Excluding agricultural produce, CPI inflation declined from an average of 7.2% in the fourth quarter of 2007 to an average of 3.2% in the first quarter of 2008. This component increased from an average of 0.5% y/y in March to 1.2% y/y in April 2008.

High international energy prices, although boosting Nigeria's exports, continue to exert upward pressure on domestic energy prices due to high import costs. Excluding energy and food, CPI inflation increased from an average of negative 3.9% in the fourth quarter of 2007 to an average of 2.2% in the first quarter of 2008. The transport component of CPI declined from an average of 11.1% in the fourth quarter of 2007 to an average of negative 0.9% in the first quarter of 2008.

Overall, the single-digit inflation envisaged remains under threat as inflationary pressures, especially from food, continue to increase. The CBN Monetary Policy Committee (MPC) has expressed its concern about mounting inflationary pressures. Thus, monetary policy has been tightened three times since December 2007 to current levels of 10.25%. We expect that the recent release of stock from government's strategic grain reserves would help slow the pace of increases in food prices. Also, the strong naira exchange rate should help keep imported inflation subdued. However, we have revised our inflation forecast from an average of 7.5% to 10.3% in 2008.

INFLATION



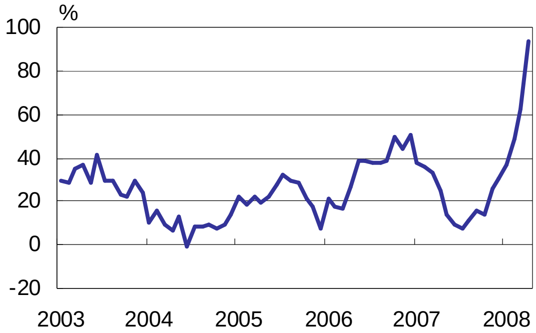
Source: NBS

Money supply

Broad money supply (M2), comprising money and quasi-money aggregates, declined significantly in the first half of 2007 from 38% in January to 7.7% in July. This rapid decline in broad money enabled the CBN's MPC to loosen monetary policy by 200 basis points. However, broad money supply increased rapidly in the second half of 2007. During the fourth quarter of 2007, M2 grew by 7.7% compared with 9.3% in the third quarter of 2007. The increase in broad money continues to be influenced by an increase in domestic credit and net foreign assets of the banking system.

The increase in M2 in the second half of 2007 led the MPC to tighten monetary policy. In the first three months of 2008, M2 grew by 34.8%. This was also fuelled by a significant increase in M2 during March and April 2008 when broad money increased by 62.2% and 93.8% respectively. This rapid growth was driven by continued increases in net foreign assets of the banking system and private sector credit extention (PSCE). We expect broad money to continue its upward path in 2008, which heightens the possibility of more tightening.

BROAD MONEY SUPPLY (M2)

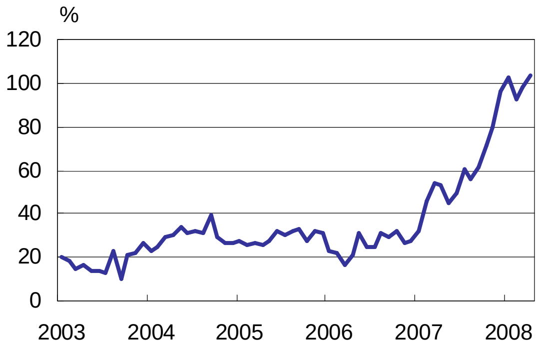


Source: Central Bank of Nigeria

Private sector credit

Having remained relatively stable in 2006, claims on the private sector surged significantly during 2007 and the first quarter of 2008. PSCE increased from 31.7% in January to 96.5% in December 2007 due mostly to reforms in the banking sector and continued reduction in credit extended to government. Overall, PSCE increased by 96% during 2007. During April 2008, PSCE increased by 103.8% compared with 98.5% in March. Credit extended to government increased by 6.2% in April 2008 compared with 56.2% in December 2007. Continued banking sector reforms and strong economic growth should improve demand for credit.

PRIVATE SECTOR CREDIT GROWTH



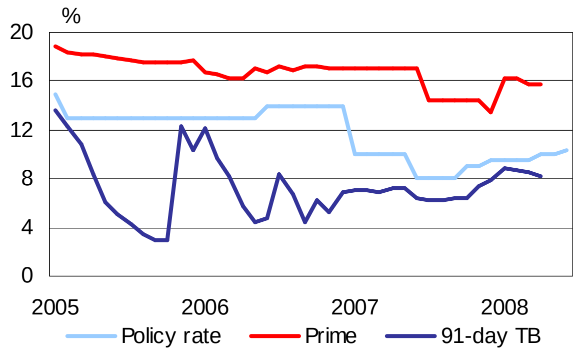
Source: Central Bank of Nigeria

Interest rates

The CBN MPC continues to demonstrate its commitment to fighting any threat to price stability stemming from food and fiscal policy expansion. During 2007, the CBN's monetary policy goals were price stability and the commitment to the International Monetary Fund's (IMF) Policy Support Instrument (PSI) targets set for monetary aggregates. The two-year PSI was completed in mid-October 2007. The benign inflation environment during 2007 led to the lowering of the Monetary Policy Rate (MPR) by 200 basis points from 10% to 8% in June 2007. The interest rate spread for CBN lending and deposit rate was also reduced from 600 basis points to 500 basis points. However, inflationary pressures heightened in the fourth quarter of 2007. This led to the CBN starting to tighten monetary policy. The policy rate was increased in October and December 2007 to 9.5%.

Since January 2008, there have been significant threats to price stability stemming from rising food prices and liquidity pressures from higher oil prices and fiscal expansion. The MPC has since raised the MPR by 75

INTEREST RATES



Source: Central Bank of Nigeria

basis points to its current level of 10.25%. The commercial banks' average prime lending rate increased from 14.2% in the fourth quarter of 2007 to 16.1% in the first quarter of 2008. During April 2008 the prime lending rate declined marginally to 15.72% from 15.78% in March. The yields on the 91-day T-bill rate, which remains the reference rate on which other rates are based, increased from an average of 7.2% in the fourth quarter of 2007 to 8.8% in the first quarter of 2008. During April 2008, yield on the 91-day T-bill was 8.2%.

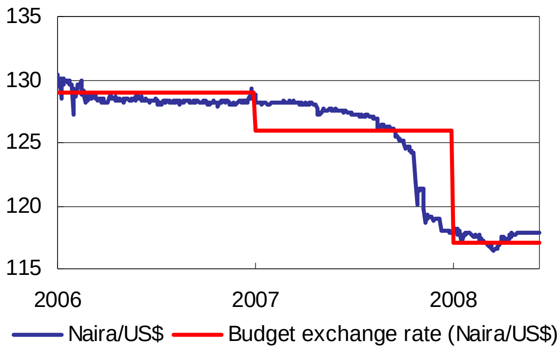
We expect the MPC to remain vigilant on inflation pressures in 2008. Monetary policy will therefore remain restrictive during 2008 and 2009 as the CBN expects inflationary pressures to persist due to food prices and increased government expenditure. Also, expenditure at state level is expected to increase as states access their share of the Excess Crude Account.

Exchange rate

Since liberalising the foreign exchange (forex) market in 2006, the MPC believes that currency stability impacted positively on the economy and indicated that it intends maintaining the stability of the naira. The naira remained relatively stable in 2006 and the first half of 2007. However, during the second half of 2007, the CBN allowed the naira to appreciate by about 7.3% from an average of 127.46 per US dollar in June to 118.21 per US dollar in December 2007. The strengthening of the naira was due to depreciation of the US dollar and high international oil prices. Oil constitutes about 96% of Nigeria's total exports. With continued surges in oil prices and weakness of the US dollar, the naira will continue to strengthen.

Since January 2008, the naira has been relatively stable around the NGN117.00/US$ mark set in the 2008 budget. The economy will also continue to accumulate foreign reserves. During March 2008, the economy accumulated gross official reserves of US$59.2 billion, which is equivalent to 27 months of import cover. Announcing the June MPC decision, the governor of the CBN indicated that the authorities are ready to increase the sale of foreign exchange as needed. We expect the naira to remain relatively stable and not deviate substantially from the NGN117.00/US$ set in the 2008 budget. We therefore forecast the naira to average 117.50 per US dollar during 2008.

EXCHANGE RATE AGAINST THE US DOLLAR



Source: Bloomberg & Federal Ministry of Finance

Oil production

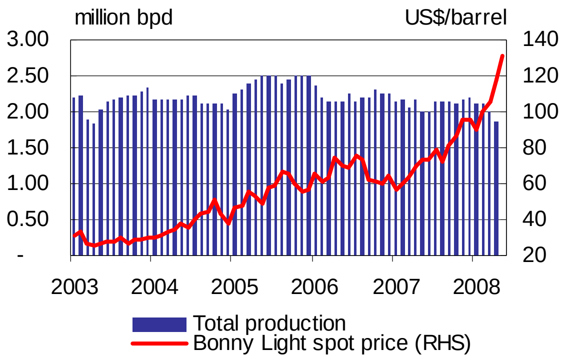
The violence and unrest in the Niger Delta continues to disrupt oil production. The oil industry has been mired by industrial action and rebel attacks on oil facilities since February 2006 when militant groups demanded a greater share of hydrocarbons revenue from the oil-producing regions of the Niger Delta.

The attacks have been predominantly targeted at onshore installations with limited attacks on offshore facilities. Even though the current attacks are not of the same magnitude as in 2006, they continue to render the environment hostile and also pose significant threats to personnel.

Following the damage sustained in the Nembe creek area in February 2008, Royal Dutch Shell announced that it would suspend exports of Bonny light oil for two months from one of Nigeria's busy export terminals. This led to a loss of about 130 000 bpd in oil output. In April 2008, Shell declared another *force majeure* (which indemnifies a company from legal actions from not meeting contractual obligations because of events that are beyond its control) following an attack on one of its major oil pipelines. This led to a shut in of about 169 000 bpd. On 25 April, ExxonMobil began shutting down its crude oil output following an industrial strike at one of its subsidiaries, Mobil Producing Nigeria (MPN). The strike was organised by members of Nigeria's white-collar oil union, the Petroleum and Natural Gas Senior Staff Association (PENGASSAN), which was demanding better working conditions, 25% salary increases and an improved pension scheme. This led to a shut in of virtually all of ExxonMobil's estimated oil output of about 800 000 bpd. After eight days of protests, staff returned to work.

The Nigerian government has been under tremendous pressure to address the Niger Delta unrest that is not only limiting oil production but is becoming a major threat to national security. The sabotage and threats to personnel are rendering the operational environment in the Niger Delta regions impossible. It is estimated that this has resulted in a reduction of oil output by about one-fifth The International Energy Agency estimates that Nigeria's oil output declined from an average of 2.14 million bpd in the fourth quarter of 2007 to 2.02 million bpd in the first quarter of 2008. During April 2008, oil output declined to about 1.86 million bpd, which saw Angola surpass Nigeria's oil output for the first time.

OIL PRODUCTION AND PRICE



Source: International Energy Agency

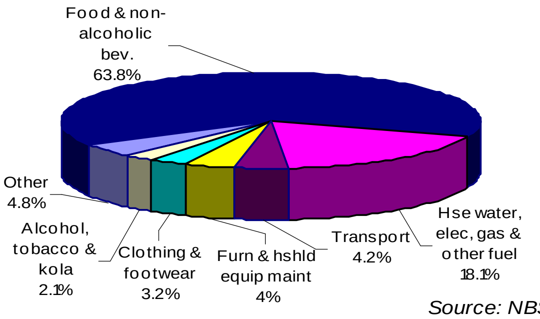
Summary forecasts

	2003	2004	2005	2006	2007	2008f	2009f
National income and prices (%)							
Real GDP growth	10.3	10.6	5.4	6.2	6.4	9.1	8.3
Oil GDP	26.5	3.3	0.5	-4.5	-5.6	9.0	7.5
Non-oil GDP	6.5	13.2	8.6	9.4	9.6	9.0	8.5
Exports (US$ billion)	-	36.9	50.2	59.1	61.3	78.9	80.3
Imports (US$ billion)	-	-19.4	-25.6	-31.1	-38.8	-44.3	-49.9
Inflation (average)	14.0	15.0	17.8	8.3	5.5	8.6	8.5
Consolidated government – cash basis (naira billion)							
Total revenue	2 795	4 127	5 621	6 376	5 886	7 741	8 510
Oil and gas revenue	2 106	3 355	4 759	5 445	4 555	6 262	6 762
Non-oil revenue	689	773	863	931	1 331	1 479	1 747
Total consolidated expenditure	2 795	3 177	4 234	4 933	5 795	6 190	7 170
Total federal expenditure	1 605	1 654	2 223	2 428	3 022	3 384	3 853
Recurrent expenditure	1 338	1 393	1 879	1 866	2 246	2 468	2 703
Capital expenditure	267	261	344	562	776	916	1 150
Overall balance (cash basis)	0	951	1 387	1 443	92	1 552	1 340
Reserves							
Gross official reserves (end of period, US$ billions)	7.5	17.0	28.3	41.8	52.1	73.2	91.0
Months of imports	3.4	5.8	8.3	10.1	11.2	14.1	16.6
External debt indicators							
External debt stock (US$ billion)	30.9	35.9	20.5	3.5	3.3	3.4	4.2
In % of GDP	57.2	41.3	18.2	2.4	2.0	1.6	1.8
In % of exports	115	93.1	39.2	5.7	5.1	4.2	5.1

Source: IMF CR, Nos.08/64 & Regional Economic Outlook, April 2008

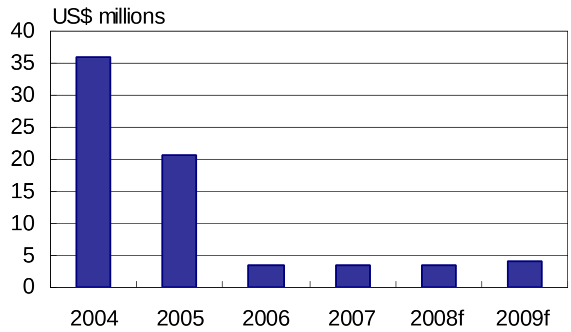
Picture Gallery

FIGURE 1: CPI WEIGHTS



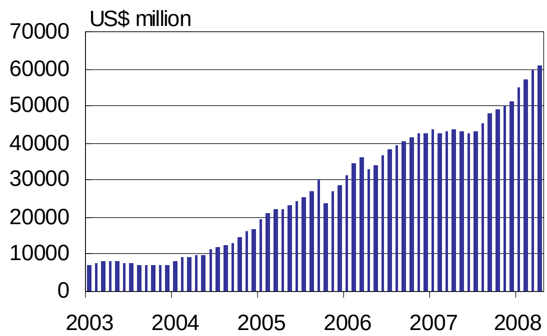
Source: NBS

FIGURE 2: TOTAL EXTERNAL DEBT



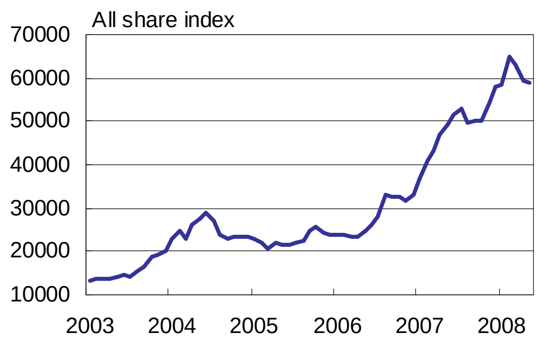
Source: IMF

FIGURE 3: FOREIGN EXCHANGE RESERVES



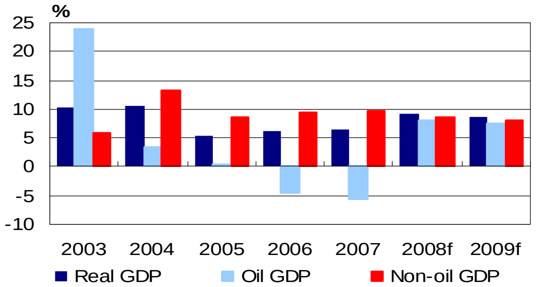
Source: Bloomberg

FIGURE 4: NIGERIAN STOCK EXCHANGE



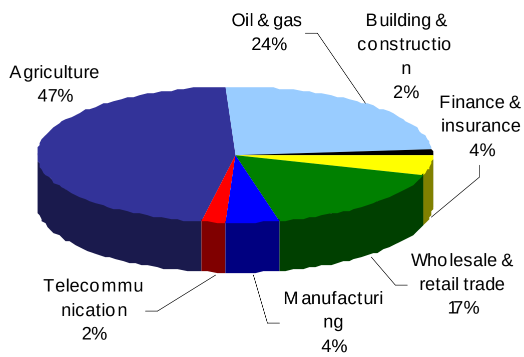
Source: Bloomberg

FIGURE 5: REAL GDP GROWTH



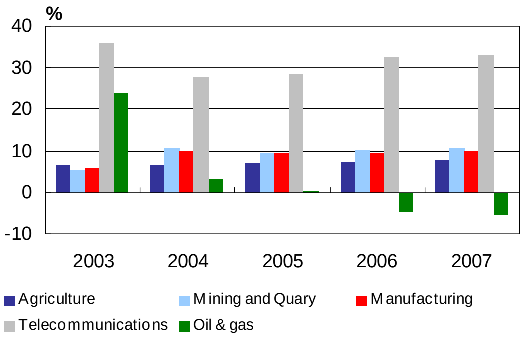
Source: NBS & Standard Bank

FIGURE 6: COMPONENTS OF GDP (2006)



Source: NBS

FIGURE 7: REAL SECTORAL GDP GROWTH



Source: NBS

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