FDC Economic Bulletin

March 08, 2016

Exchange rate turmoil to push Headline Inflation above 10%

We are projecting the YoY headline inflation rate for February 2016 to spike to 10.1%. This is the first time the price level has reached double digits since 2012. We are deviating from the usual practice of a single inflation projection by examining extenuating circumstances that led to such a significant increase in prices, and thereby providing an alternative scenario. February was a unique month because of an aberration in the forex market. The month of February can be divided into two parts with respect to the impact of foreign exchange on consumer price levels. The first half (Feb 1 - Feb 13) could be described as the "pre-exchange rate calm" when prices were not affected by any unusual exchange rate movement fuelled by uncertainty. The second half (Feb 14 – Feb 29) that can be called the "exchange rate frenzy period" when the naira depreciated to as low N395/$ at the parallel market due to heightened uncertainty about forex availability for educational and medical purposes. If not for the extreme volatility of the naira, headline inflation rate would have remained at 9.8%.

Though the factors driving inflation are unchanged, the impact of exchange rate pressures on inflation was accentuated by fear and speculation. Income effect is bearing more significance than cost pressure because a depreciating naira erodes consumer disposable income. In order to compensate for lost income, producers and retailers are increasing prices of goods. The resulting effect is that consumers run to substitutes, thereby increasing demand and prices for these substitutes.

Pre-exchange rate calm

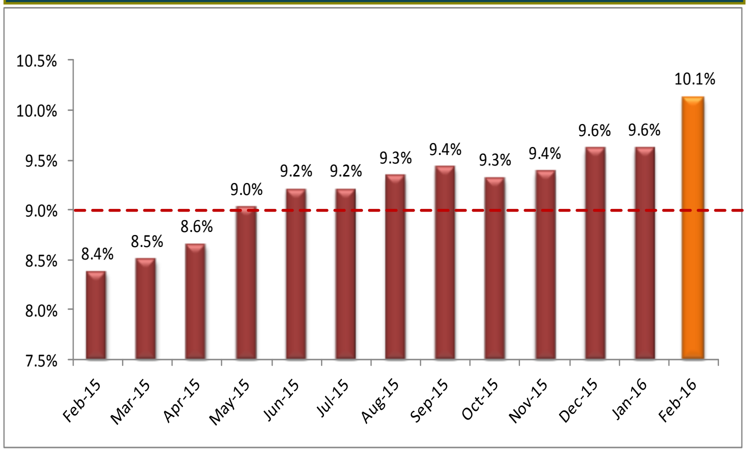
During the first half of the month, when the naira was trading at N307/$, headline inflation is estimated to have spiked to 9.8%. This increase was spurred mainly by traditional cost-push factors.

Exchange rate frenzy period

In the second half when the dollar scarcity panic set in, traders and manufacturers increased prices

arbitrarily. Under the guise of naira weakness, even items without import content were repriced. Consumers are now resisting further increases and we see prices decreasing in the near term.

Chart 1: Headline Inflation Rate



CBN Inflation Ceiling

Source : NBS, FDC Research

Inflation likely to normalize in March

In March we expect the 2016 budget to pass and spending commence. The impact of the increased spending and its multiplier impact on money supply are expected to feed into the price level.

Regional Inflationary Trend

In SSA, there has been a generally rising inflationary trend. South Africa's inflation rate increased significantly by 100 bps from 5.2% in December 2015 to 6.2% in January 2016. It was driven mainly by higher cost for electricity, food, transport and alcoholic beverages. Ghana's inflation rate spiked up from 17.7% in December to 19.0% in January driven by prices of fuel, food and utilities following raised tariffs for electricity and water in December. Uganda's inflation numbers for February 2016 came in at 7.7%, up by 0.1% due to the rise in core consumer prices. Inflation rate in Kenya, on the other hand, declined to 6.84% in February from 7.78% in January. This was due to the decrease in prices of key food items and reduced fuel cost.

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Other Facilities:

1. Gym, squash court, steam bath, sauna, swimming pool with bar and barbeque stand
2. 24hrs power supply
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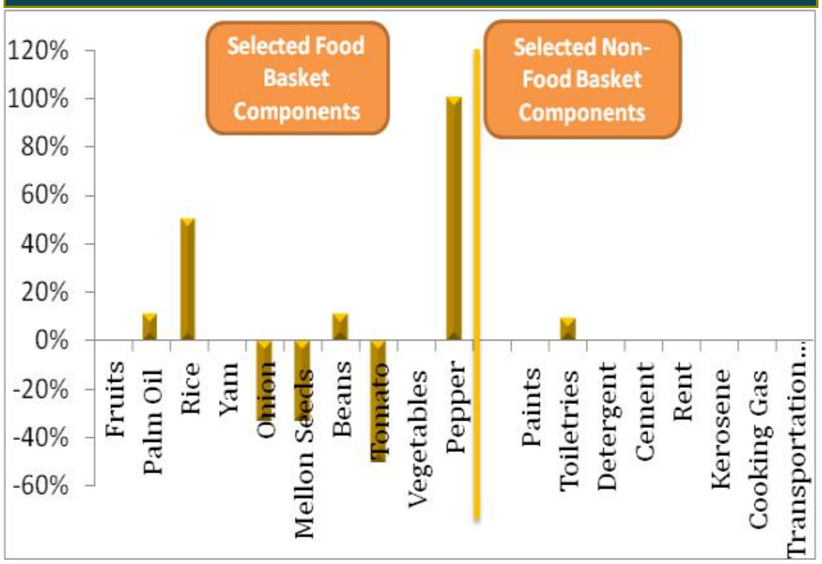
Urban prices accelerated in February

The FDC Lagos urban inflation index increased by 0.16%, from 10.52% to 10.68%. This increase in urban inflation was driven by a significant increase of 0.91% in the food index. The prices of rice, beans and garri increased by 50%, 11% and 15%, respectively.

The year-on-year (YoY) food index increased to 12.22% from 11.32%, while the YoY non-food index decreased to 9.90%, from 10.11% in January. We expect preparations for the Easter season to add inflationary pressures to the food segment of the urban inflation.

Chart 2: FDC Urban Index



Source : FDC Research

Upcoming MPC meeting

The next MPC meeting on March 21 presents the CBN with an opportunity to deliberate on key policy issues that could impact the slowing Nigerian economy. Given the increasing risk of stagflation, the MPC urgently needs to consider a monetary policy that will complement the fiscal countercyclical stimulus package of the 2016 budget.

Likely Market Response

Interest Rates

The average NIBOR which is currently at 5.99% p.a is likely to trend upwards as the CBN continues to mop up liquidity in order to stem inflationary pressures. The passage of the budget in Q2'16 is likely to boost liquidity, and this may prompt the CBN to adopt tightening measures to curb excess liquidity in the second quarter of the year.

External Reserves

Oil prices have increased to $41 pb, the highest level since November 2015 but production is still flat at 1.9 mbpd. This means that oil revenue and dollar inflows will remain anaemic and keep reserves thin. The current external reserves level is $27.9 billion.

Stock Market

The stock market has recently returned to winning ways. It had closed positive throughout last week but has dipped again today. An increase in inflation and the possibility of a hike in interest rates could easily erode the newly found investor confidence.