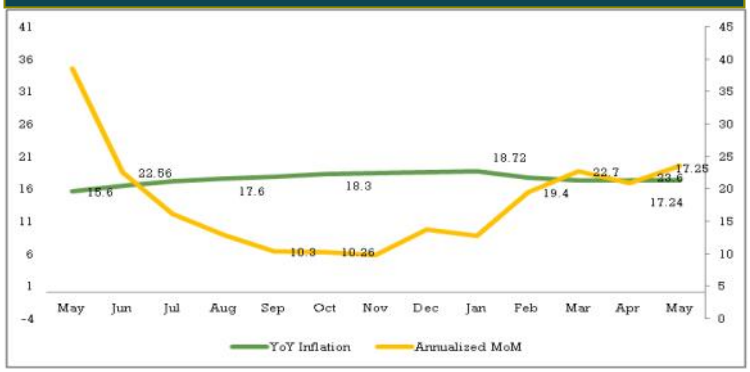
FDC Economic Bulletin

June 12, 2017

May Headline Inflation to decline sharply to 16.1%

Our forecast for headline inflation in May is likely to confound many. This is because a decline of over 100bps to 16.1% may not reflect the price reality. With that said, the anticipated decline in inflation in the month of May can be justified through the analysis of key factors which influence inflation dynamics in Nigeria. While headline inflation is expected to decline, month-on-month (MoM) inflation is projected to increase from 1.6% to 1.78% (annualized MoM is expected to increase from 22.7% to 23.6%).

Chart 1: Headline Inflation vs Month-on-Month Inflation (%)



Source : NBS, FDC Think Tank

To paint a clearer picture of the inflation trend, we will analyze the impact of some key factors on the inflation trend. These factors include:

- Money supply contraction
- High interest rates
- Strengthening naira (with focus on the parallel market rate) and increased forex supply
- Improved power supply
- Higher diesel prices

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Money supply contraction

According to the monetarist view on inflation dynamics, changes in the supply of money in an economy are a major influence on the movement of prices. An inverse relationship exists between these two variables. In its most recent MPC meeting in May, the MPC disclosed that broad money (M2) supply contracted by a dramatic 25.44% in April, with further expectations of a decline in the coming months. This supports a decline in the inflation rate given this trend in money supply. Optimistic caution has to be exercised as information on M1 supply growth (the main influence on consumer prices theoretically) is yet to be disclosed.

High interest rates

Nigeria still sustains a high interest rate environment and as such, the high interest expense on manufacturers and households has curtailed spending activity in the economy. Lending rates remain sticky downwards at an average of 25%, while the yields on Nigerian Treasury Bills range between 18.52% - 18.69% in the secondary market. Due to the high cost of funding interest payments that are accruing, manufacturers on the one hand are holding longer cash positions relative to inventory to facilitate settlement of interest rate requirements.

On the other hand is the household. Theoretically, high interest rates should encourage savings. However, the level of savings has not risen in tandem with the direction of the cost of funds. Instead, the opposite is the case. People are spending more and this is especially the case when the macroeconomic environment is in a recession or on the path to recovery.

Strengthening naira and increased supply of forex

The exchange rate maintained a relatively slow appreciation path in the month of May, closing at a rate of N380/$ in the parallel market. Currently the market has appreciated further to N366/$, narrowing the spread between the parallel market rate and the interbank rate to N60 from N76 in the previous month. This upward movement in the currency came with increased transparency in the FX market as well as improved dollar liquidity. The CBN has sold approximately $8bn YTD, while at the IEFX window, about $1bn has been traded. Nigeria's major source of forex is from oil proceeds. Whilst production may be inching upwards towards 1.6mbpd, oil prices have taken a hit, falling to as low as $48pb. This price level is 7.2% above the budget benchmark price of $44.5pb. Lower oil prices pose a threat to the sustainability of the CBN's Forex interventions.


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Higher diesel prices

On the supply side is the renewed increase in the price of diesel. As May drew to a close, diesel was trading at a month high of N180/ltr coming from lows of N160-170/ltr at the beginning of May. A reason for this might be attributed to the rising arrears to oil importers to the tune of $2bn. This puts pressure on the price of refined products. As this development occurred towards the end of the month, we anticipate a marginal effect on consumer prices.

Improved power supply

Power supply in Nigeria remains a major bottleneck for output and productivity. However, in the month of May, we saw improvements in the average rate of power generated. Average power output in May was 3,587MW/hr relative to April's average of 3,521MW/hr. This increase is likely to have a marginal impact on consumer prices as increased power supply mitigates supply side influences on inflation.

Outlook

We await the assent of the budget and spending to commence as the month of June rolls on. This will boost market liquidity and heighten demand pull pressure on the consumer price level. Disbursement of funds also has an indirect impact on prices through the creation of jobs and an increase in output.