FDC Economic Bulletin

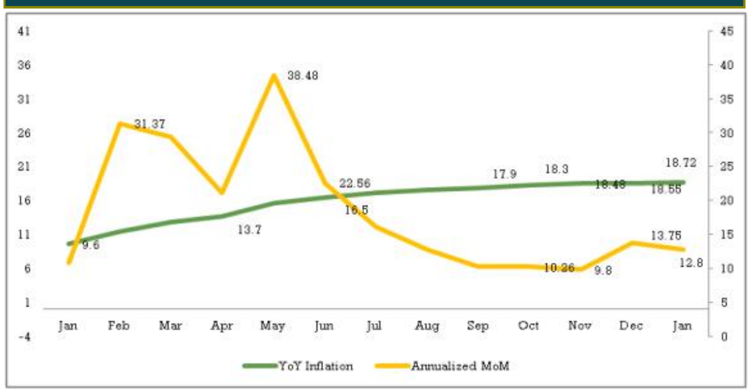
February 15, 2017

Inflation climbs once again to 18.72%, the 15th consecutive month of increase

Headline Inflation increased by 0.17% to 18.72% in January. Though the magnitude and direction of the increase was contrary to expectations and consensus, a decomposition of the inflation numbers shows an imminent reversal in the inflation trend. This is because both core (inflation less seasonal factors) and monthly inflation rates tapered in January. The month of January is a period of post festivities in which consumer purchasing power typically contracts.

Both core and month-on-month inflation declined in January. The pace change in the core sub-index declined 0.2% to 17.9%. This movement was mirrored in the monthly rate of 1.01% (12.8% annualized) recorded in January, in comparison to 1.06% (13.75% annualized) in December 2016.

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



Source : NBS, FDC Think Tank

NBS January Consumer Price Breakdown

The food basket was the major contributor to the surge in the headline rate. The food basket recorded an inflation rate of 17.82%, up 0.43% from 17.39% recorded in December. This was attributable to price increases across major food groups such as bread, cereals, meat, fish, tubers, oil and fats. Bread and cereals

are exchange rate sensitive while meat, fish, tuber, oil and fats are less exchange rate sensitive. Therefore, forex market disequilibrium and structural supply bottlenecks most likely pushed up the prices of bread and cereals. However, a price war orchestrated by the Dangote group ensued in the flour industry late January, with a downward revision in the price of flour from N11,500 to almost N10,500. What this means is that we can expect a tapering in the price of bread in the coming months depending on the sustainability of this price trend.

Distribution and logistics costs were responsible for the increased price movements recorded for more exchange rate insensitive food items. Higher diesel prices, trading at an average of N270/ltr in January (92% higher YoY), pushed distribution and logistics costs up. Low power generation (measly 2500 MW at the grid) increased the demand for diesel and contributed to its price surge in January.

The core inflation on the contrary recorded a slower pace of increase for the second consecutive month. Rural and urban inflation rates increased by 17.34% and 20.31% respectively, from 17.2% and 20.12% the previous period.

Monetary policy trajectory in response to inflation

At its next meeting, the monetary policy will have to factor certain macroeconomic statistics in its decision-making process. These include Q4 2016 GDP numbers, February inflation numbers (as the MPC meets towards the end of March) and the Purchasing Managers' Index. Depending on the outcome of the data, the MPC will either consider embarking on an accommodative monetary stance agenda or holding off until a later period.

M1 remains a challenge to the Central Bank of Nigeria and it is growing at an increasingly fast pace relative to other monetary aggregates. Thus the CBN is tasked with not only controlling the supply of narrow money but also reducing the velocity of circulation to avoid further exaggerations in the price level.

In the near term, in the month of March, the central bank will have the opportunity to simultaneously curb high financing costs in the private sector and induce spending for increased economic activity. With the government borrowing at an effective interest rate of 20%, private sector firms will have to offer higher rates to compensate for higher risks. In terms of consumer spending activity, higher interest rates on a riskless asset like T/bills dissuades spending in order to capture gains from a high interest rate environment. The success of the Eurobond road show could offer CBN the resources needed to settle government debt which will help clamp down on these high interest rates.

Outlook

We expect that base year effects will begin to kick in February and as such we anticipate a likely reversal in the inflationary trend. This reversal in the trend of inflation is further reinforced if core and monthly inflation maintain their contracting trends. A major downside risk to this, minus supply side bottlenecks from distribution and logistics and the exchange rate impact, is the risk of food insecurity due to export smuggling. Export smuggling has become a major threat to domestic food supply and increased scarcity could further exacerbate y pressures from the food basket.