

Nigeria Strategy Report

H2 2020

Domestic Economy and Markets

Nigeria Inflation: A dance to the rhythm of Regulations

Executive Summary

In our H1 2020 NSR, we postulated an upward trend in inflation this year, hinged on a trio impact of higher food prices from the land border closure, increased VAT from 5% to 7.5% and an anticipated increase in electricity tariffs by April. While the electricity hike did not materialize as expected, unanticipated shocks owing to the COVID-19 pandemic further amplified the inflationary pressures seen over the first half of the year. For context, the total lockdown implemented in March in a bid to curb the viral spread, led to supply chain disruption and a lot of panic buying, spiraling into artificial increase in food prices. Consequently, headline inflation ticked 80bps higher to average 12.26% over the first half of 2020¹, relative to the average of 11.46% recorded over H2 2019. The uptick emanated from a rise in both food and core basket.

For the rest of 2020, we believe regulations will determine inflation trajectory. For context, the inception of the pandemic led to implementation of various regulations including devaluation in currency, restrictions in movement, adoption of the market-based pricing mechanism by the PPPRA² and postponement of hike in electricity tariff beyond 2020. For us, while dissipating base effects and curtailed PMS prices should provide respite for CPI, currency depreciation and elevated transportation costs informs our projection of higher inflation rates. Precisely, we expect inflation to abate from September 2020 as the unfavourable base effect dissipates. That said, we project mean inflation rate of 12.3% YoY (2019: 11.40% YoY) and MoM inflation to flatline at 1% over FY 2020, which serves as our base case scenario. The downside to our forecast is a further devaluation in currency should crude oil prices fall significantly. This informs our bear case scenario of 13.4% YoY over FY 2020.

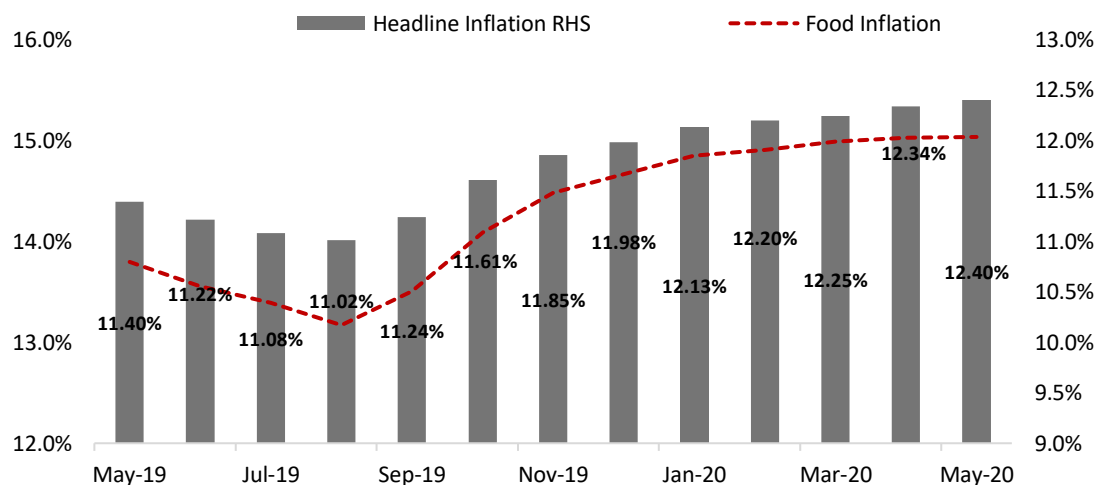
In this report, we focus on the major themes that steered consumer prices over H1 20 and delineate our outlook for inflation over FY 2020.

¹ January to May 2020

² Petroleum Products Pricing Regulatory Agency

H1 2020 Inflation: Base effect and the pandemic anchored Lofty food inflation

Food prices maintained an upward trajectory, despite the buoyant market supplies observed over the review period. According to FEWSNET, carryover stocks from the main harvest season late last year coupled with the off-season harvest in April, kept market well-supplied over the first half of the year. However, the unfavorable base effect as a result of the border closure in August 2019 coupled with the panic buying in anticipation of the lockdown implemented in April kept food prices elevated. For context, average prices of imported food such as rice (+25% YoY), vegetable oil (+5% YoY), frozen Chicken (+14% YoY) and other commodities remained inflated over H1 2020, according to the NBS. Ergo, average food inflation ticked up by 108bps to 14.96% over H1 2020 relative to H2 2019.

Figure 1: Historical YoY headline and food inflation

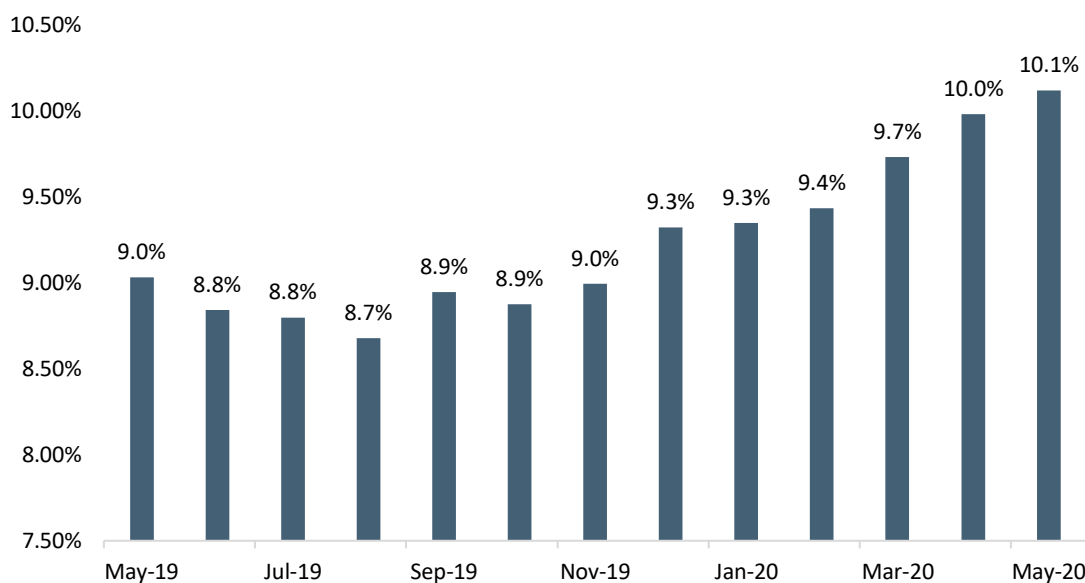
Source: NBS, ARM Research

Core inflation bore the brunt of new regulations

Similarly, core inflation rose 79bps to average 9.62% YoY over the first half of the year, reflecting a troika of the closure of the border, currency depreciation as well as restrictions in movements due the pandemic. For context, while the impact of land border closure filtered into core inflation, key policies taken by the government to combat the economic impact as well as the spread of the pandemic further intensified the pressure. Precisely, the CBN technically devalued the Naira to ₦360/\$ at the official window (previously: ₦306/\$) and ₦380/\$ at the IEW (previously: ₦360/\$), owing to the ripple effects of the Covid-19 pandemic on crude oil prices and the foreign reserves. Consequently, the Naira depreciated by 9% to an average of ₦396/\$ in the parallel market relative to ₦359/\$ in H2 2019. Furthermore, demand for health services in the wake of the pandemic

coupled with restriction of movements across the country in subsequent months, incited pressures on health and transport inflation amongst other core-sub indices. Meanwhile, the FG finally broached the discussion on deregulation of the downstream sector, replacing the existing price cap on PMS³ with a market-based pricing mechanism. This came in after a two-time slash in PMS prices to ₦123.5/liter from ₦145/liter, mirroring the plunge in crude oil prices. Consequently, average petrol prices declined by 2.6% to average ₦141.75/litre over H1 2020, relative to H2 19 average of ₦145.47. However, pressures from the above stated policies more than outweighed the decline in PMS prices. Consequently, all core sub-indices expanded with Health (+84bps to 10.13% YoY) and Transport (+62bps to 9.62% YoY) experiencing the largest increase.

Figure 2: Historical YoY core inflation



Source: NBS, ARM Research

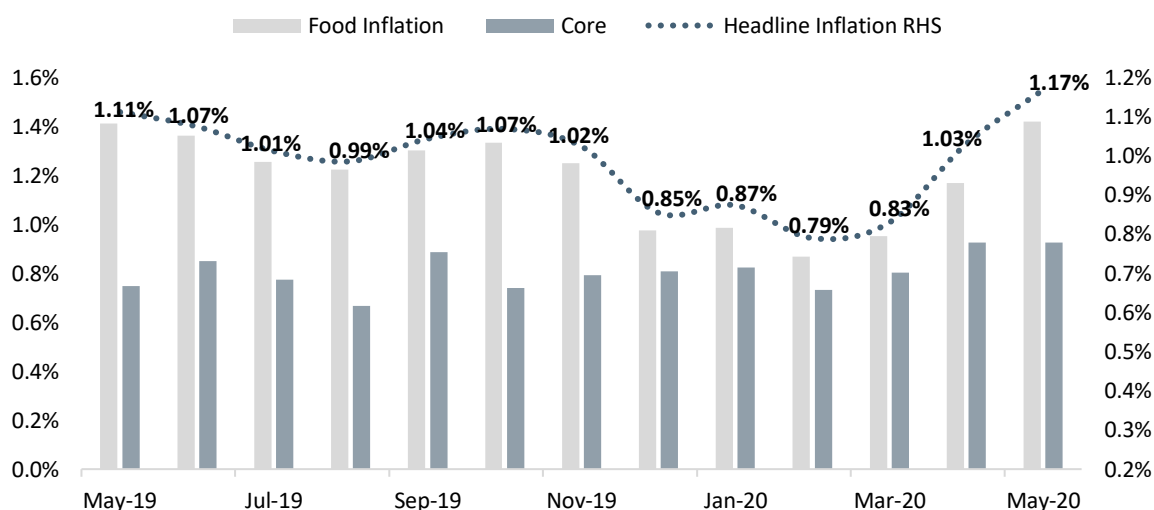
Contrary to the annual trend, we observed contrasting movements in food and core inflation on a MoM basis. Nonetheless, average inflation moderated by 6bps to 0.94% MoM anchored by a dip in food inflation. Notably, while food inflation maintained an uptrend for most part of H1 20, the 12-bps MoM decline observed in February kept average food inflation lower for the review period. According to FEWSNET, carryover stocks from the prior year and reduced trader demand led to increased market stocks in stable and food cash crops in

³ Premium motor spirit

February. Meanwhile, food inflation edged up slightly in January (+2bps to 0.99% MoM) owing to marginal uptick in farm produce. However, elevated transportation cost and panic buying in anticipation of the lockdown led to a cumulative increase of 54bps in food inflation between the month of March and May. As a result, food inflation for the month of May soared to 1.42%. Nonetheless, the dip in February left average inflation over HI 20 lower by 14bps to 1.08% MoM, relative to H2 19.

On the other hand, devaluation in currency, increased cost of transport and health services adversely impacted core inflation numbers, which rose 5bps to 0.83% MoM compared to H2 19. Precisely, increases were seen in Health (+15bps to 0.93% MoM), Transport (+9bps to 0.86% MoM), Furnishing (+7bps to 0.82% MoM), amongst others. Unsurprisingly, HWEGF flatlined at 0.62% MoM, echoing the pass-through impact of lower energy prices.

Figure 3: Historical MoM Core, Food and Headline inflation



Source: NBS, ARM Research

A dance to the rhythm of Regulations

As mentioned earlier, the inception of the pandemic led to implementation of various regulations including devaluation in currency, restrictions in movement, adoption of the market-based pricing mechanism by the PPPRA and postponement of hike in electricity tariff beyond 2020. We believe these regulations will determine inflation trajectory for the rest of the year. In framing the outlook over the second half of the year, we begin with currency which in our view is paramount, as it filters through both food and core inflation. We do not expect a significant depreciation of the Naira from current levels this year due to the fair position of the reserves. That said, we expect the rates at IEW and parallel market to fall within the range of ~~N380-N400/\$~~ and ~~N400-N450/\$~~.

As mentioned earlier, our expectation on electricity tariff never materialized, as the scheduled date was postponed beyond 2020 in a bid to mitigate the economic impact of the pandemic. Media sources revealed the tariff hike will be implemented in the first quarter of 2021, with no exact date stated. That said, we rule out the case of a hike in electricity tariff in our FY 2020 estimates.

Elsewhere, the adoption of the market-based pricing mechanism by the PPPRA to reflect subsequent market conditions implies volatile PMS prices henceforth. Coalescing our expectation for average crude oil price of \$40.5/barrel over FY 2020 and IEW exchange rate of ₦385/\$, we estimate PMS prices to average ₦142.4/litre for FY 2020. This is lower relative to FY 2019 average of ₦145/litre, which bodes well for inflation. While this should provide a breather to inflation numbers in 2020 – increased transport and health costs are expected to sustain the uptick in core inflation.

Table 1: PMS Retail price/Liter Scenarios

Exchange rate	365	385	400
\$30/bbl	110	114	117
\$40/bbl	135	140	144
\$50/bbl	159	166	171
\$60/bbl	183	191	197

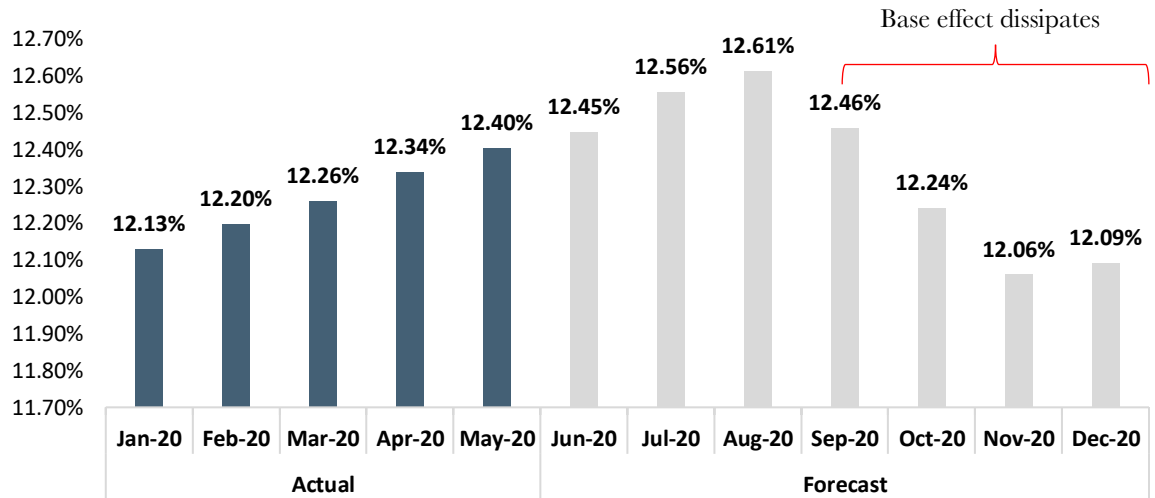
Source: ARM Research

Switching to food inflation, the low base effect mirrored in YoY food inflation is expected to peter out over the second half of 2020, signaling a moderation in food inflation during the period. However, this will be curtailed by elevated transportation cost due to interstate restrictions as a result of the pandemic. In addition, NIMET⁶ forecasts a dry spell season (a period without rain) between the months of July and August (after planting season). Consequently, crops already planted may die or witness retardation during this period. Furthermore, most households are expected to face difficulty engaging in a normal level of agricultural activities and cultivation due to COVID 19 income related issues and market constraints, according to FEWSNET. Hence, areas planted for crops as well as the main harvest is likely to stay below average in most areas for FY 2020. Coalescing these factors, we expect food inflation to decline at a slower pace over the rest of the year, barring the occurrence of flooding activities.

⁶ Nigerian meteorological agency.

Overall, our analysis suggests that while base effects and curtailed PMS prices should provide respite for CPI, currency depreciation and elevated transportation costs informs our projection of higher inflation rates. Precisely, we expect inflation to abate from September 2020 as the unfavourable base effect dissipates. That said, we project mean inflation rate of 12.3% YoY (2019: 11.40% YoY) and while we expect MoM inflation to flatline at 1% over FY 2020, which serves as our base case scenario.

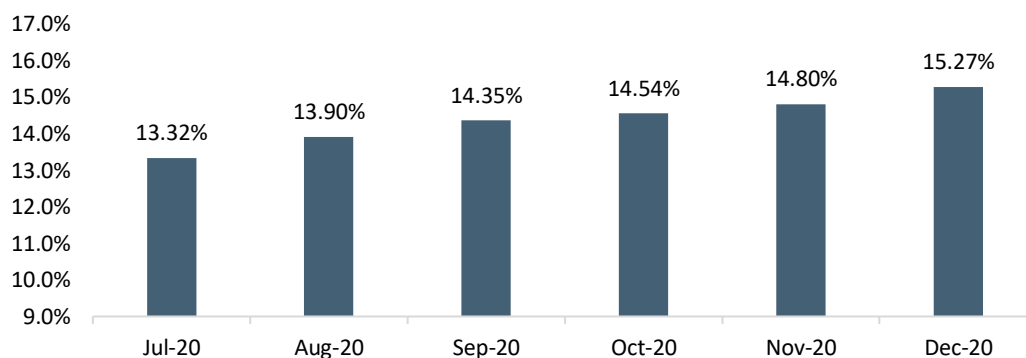
Figure 4: Monthly inflation forecast for July to Dec 2020 (Base)



Source: NBS, ARM Research

The downside to our forecast is a further devaluation in currency should crude oil prices fall significantly. Any occurrence of this factor would aggravate inflationary pressures in the second half of the year, which informs our expectation of an uptick in the average inflation rate over 2020 to 13.4% YoY which is our bear case scenario. On the flipside, should the rebasing of inflation occur in 2020, we believe it could lead to a downtrend in inflation.

Figure 5: Monthly headline inflation forecast for July – Dec 2020 (Bear)



Source: ARM Research

Would inflation be rebased in 2020?

With the completion of the Nigerian Living Standard Survey (NLSS)⁹ in March 2020, the question of rebasing inflation – a long overdue exercise – comes to mind. Precisely, this exercise involves updating the items and weights in the overall CPI basket, based on consumption expenditure data extracted from the NLSS. This is done in order to reflect the latest consumption pattern of resident households. According to the NBS, the process to rebase is ongoing following the completion of the NLSS which spanned from September 2018 to October 2019. Based on the NBS report, analysis and validation of the responses which started in November 2019, was concluded in March 2020. Against this backdrop, we expect inflation to be rebased in the later part of H2 2020, and latest in 2021. While, the NBS is yet to publish intended changes to the current CPI basket, we believe the overall impact could lead to a downtrend in inflation. Taking a cue from Ghana, after the re-basing exercise was completed last year, inflation rate for the month of August dropped by 160bps to 7.8%. The downtrend persisted over the rest of the year (2019), leaving average inflation rate for 2019 at 8.7%, which is 110bps lower than the average of 9.8% reported in the prior year. Therefore, we see room for a downtrend in inflation on completion of the re-basing exercise, albeit we believe the outcome is purely technical.

⁹ Last official survey was conducted in 2009/2010.

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