

Nigeria Strategy Report

H1 2021

Domestic Economy and Markets

Nigeria Inflation – Sailing in the sky

Executive Summary

In our H2 2020 NSR, we projected a northward trend in inflation hinged on the implementation of several policies by the government's arms in order to combat the adverse impact of the pandemic on the economy. Precisely, we expected the twin impact of currency devaluation and the hike in transportation cost to push inflation upwards. In addition, we anticipated an underwhelming harvest owing to NIMET's forecast of a dry spell season and lower level of agricultural activities due to the lockdown implemented between the land preparation and planting season. While these factors came to fruition, the pressure on food prices was further aggravated by the flooding experienced in key Northern states in the latter part of the year. Elsewhere, due to the deregulation of the downstream sector, PMS price saw a twin hike in H2 20, reflecting gradual recovery in global crude oil price. Furthermore, electricity tariff was increased by an average of 108% from ₦25.2/kwh to ₦52.4/kwh on average. Consequently, headline inflation rose 179bps to 14.11% YoY over the second half of 2020 (H1 20: 12.31%) propelled by increases in both food and core basket.

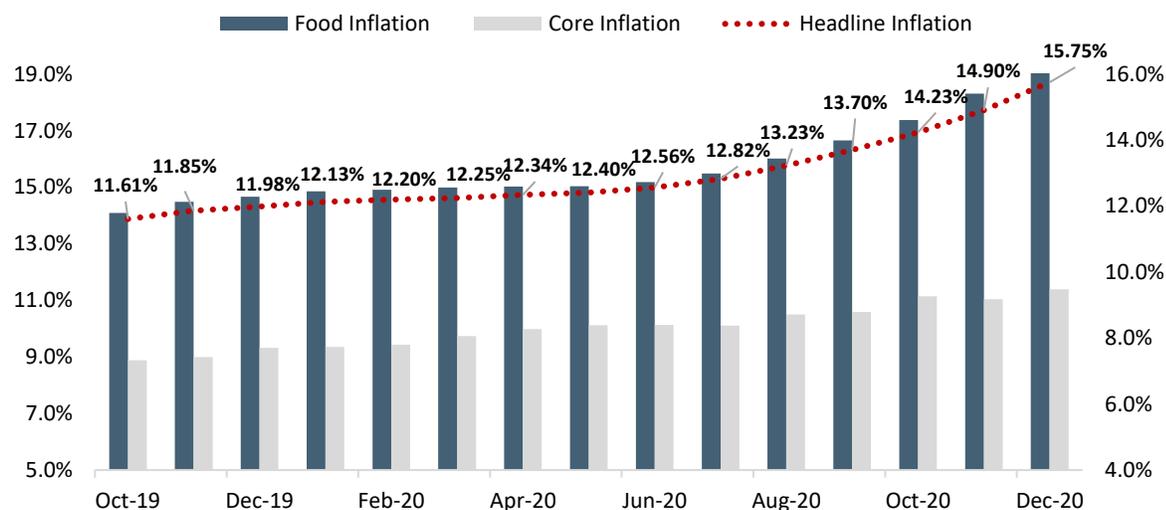
In setting our views, we analyze possible shocks to the CPI - highlighting our expectation on the market-determined PMS prices, currency and reopening of the land border. For starters, we believe PMS prices will remain a stoking influence on inflation in 2021, due to the deregulation of the downstream sector. Precisely, we estimate PMS prices to fall within the range of ₦168 – ₦176/litre on average for FY 2021 (2020: ₦146.1/litre). Overall, we employed two scenarios in our forecast for FY 2021. On the first scenario, our assumption of the reopening of the land border on the 31st December 2020, the interplay of seasonal factors, uptick in PMS prices due to the deregulation of the downstream sector and hike in electricity tariff which kicked in September 2020, informs a mean inflation rate of 17% YoY (FY 20E:13.2%) and 1.21% MoM which is our base case. On the downside, a higher than anticipated hike in PMS prices and further devaluation in currency should aggravate inflationary pressures over 2021. This informs our projection of an uptick in inflation rate over 2021 to 18.5% YoY and 1.49% MoM, which is our bear case scenario.

In this report, we focus on the major themes that steered consumer prices over H2 20 and delineate our outlook for inflation over FY 2021.

Regulatory policies and Structural bottle necks push food inflation northwards

Over H2 2020, food prices sustained the upward trajectory induced by the lingering impact of higher transportation cost – a fall out from the pandemic and higher PMS prices, flooding in the North as well as the dry-spell season. To begin, following the deregulation of the downstream sector, PMS prices rose by 13.65% to ₦156.4 on average in H2 20, translating to higher transportation cost, with the pass-through effect on food prices.

Figure 1: Historical YoY headline inflation, food inflation and PMS Prices

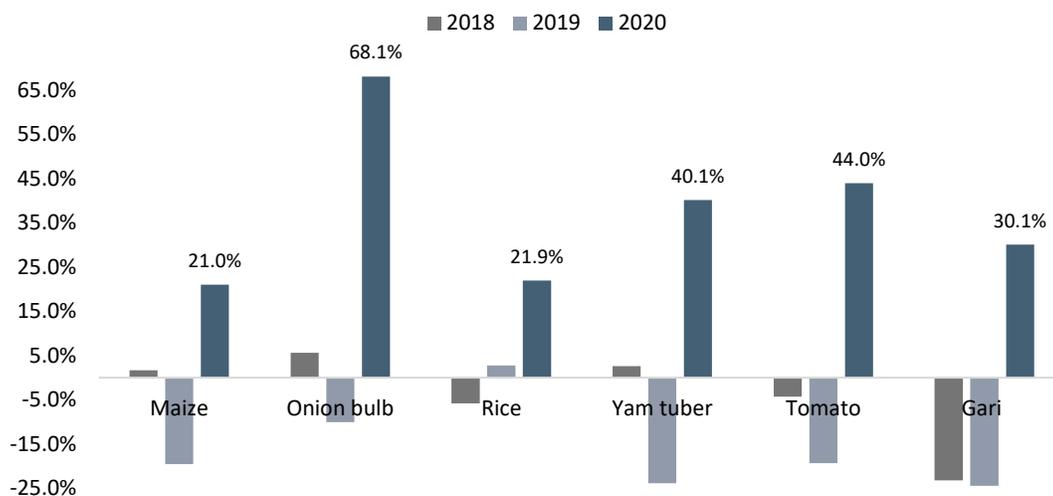


Source: NBS, ARM Research

In addition, pressures on farm produce were underpinned by unfavorable supply shock factors. For context, the lengthened dry spell season² in localized areas of Niger and Benue states which resulted in wilting of some crops, weighed heavily on food prices according to FEWSNET. Furthermore, the release of water³ from Goronyo dam and upstream floods from Niger republic which damaged farmlands in Kebbi, Jigawa, Niger and Sokoto state aggravated pressures on food prices. Consequently, we saw a double digit rise across staple foods including rice (+25% YoY), maize (+36% YoY) and other commodities such as vegetable oil (+18% YoY), yam tubers (+32% YoY), etc. Hence, average food inflation ticked up by 224bps to 17.23% over H2 2020 relative to H1 2020.

² A period without rain between the months of July and August

³ This occurred in August 2020, consequently impacting the harvest season which began in October 2020

Figure 2: Trend in price changes of major food crops in Nigeria⁴ (%)

Source: NBS, ARM Research

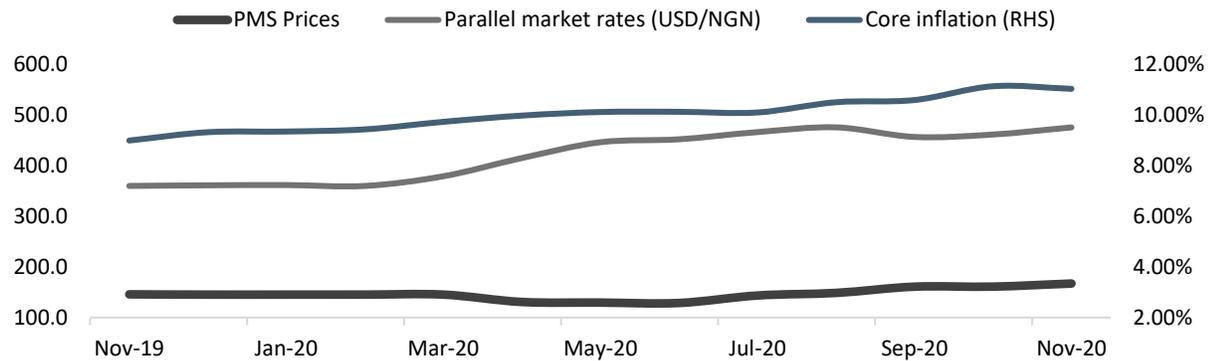
Key regulations reverberated through core inflation

Similarly, core inflation rose 100bps to average 10.79% YoY over H2 2020, mirroring the confluence of regulations implemented such as currency devaluation, higher energy prices and hike in electricity tariff. For context, over H2 2020, the CBN devalued the Naira at the official window to ₦381/\$ in July 2020 (previously: ₦361/\$) and ₦393/\$ at the IEW (previously: ₦385/\$) owing to the ripple effects of the pandemic on the foreign reserves. Consequently, the Naira depreciated by 13.6% to ₦468/\$ on average at the parallel market (H1 2020: ₦404.7/\$).

Furthermore, the hike in electricity tariff, which was formerly postponed till 2021, was implemented on the 1st September 2020. Precisely, the new electricity tariff translates to an average increase of 108% (from ₦25.2/kwh to ₦52.4/kwh on average), which is higher than the tariff hike implemented in 2016. Meanwhile, as mentioned earlier, the deregulation of the downstream sector resulted in a 13.65% increase in PMS prices to ₦156.4 on average in H2 20 (H1 2020: ₦138/litre), reflecting the gradual recovery in global crude oil prices. Elsewhere, demand for health services in the wake of the pandemic continued to incite pressures on health inflation. Consequently, all core components expanded including HWEGF (+65bps to 8.44% YoY), Health (+254bps to 12.83% YoY) and Transport (+214bps to 11.90% YoY).

⁴ 2020 figures represent January to November 2020.

Figure 3: Movement in core inflation, PMS prices and parallel market rates

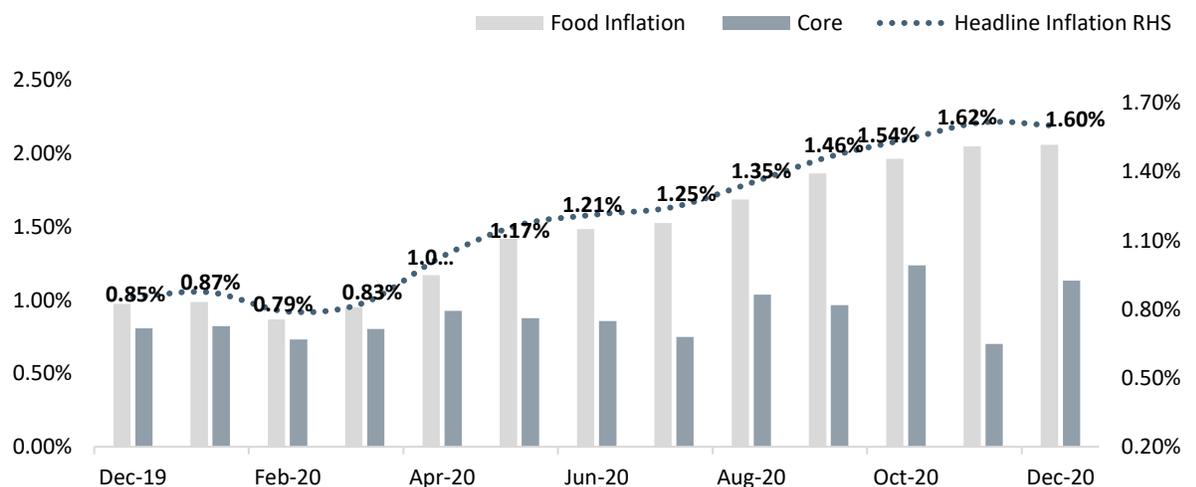


Source: NBS, Aboki FX, ARM Research

On a MoM basis, average inflation advanced 49bps to 1.47% MoM, bulk of which emanated from the uptick in food inflation. Specifically, food inflation tracked higher by 71bps to an average reading of 1.86% MoM. Notably, after a marginal rise in July (+4bps to 1.52% MoM), food inflation rose sharply in August (+16bps to 1.69% MoM) and September (+18bps to 1.86% MoM) coinciding with flooding in localized areas in the North as well as the extended lean season, according to FEWSNET. Pressures in food inflation during this period reflected in farm produce (+89bps to 2.05%) and imported food (+4bps to 1.31%) over H2 20.

On the other hand, average core inflation ticked 13bps to 0.97% MoM. Specifically, increases were seen in Health (+25bps to 1.23% MoM), HWEGF (+17bps to 0.81% MoM), Transport (+28bps to 1.17% MoM), Furnishing (+14bps to 0.97% MoM), amongst others.

Figure 4: Historical MoM Core, Food and Headline inflation



Source: NBS, ARM Research

Despite the reopening of the border, inherent pressures will tow inflation northward

In setting our views, we analyze possible shocks to the CPI - highlighting our expectation on the market-determined PMS prices, currency and reopening of the land border. For starters, we believe PMS prices will remain a stoking influence on inflation in 2021, due to the deregulation⁶ of the downstream sector. Precisely, PMS prices is now determined by prevailing market conditions. Coalescing our expectations for average oil price of \$52.47/barrel over FY 2021, and IEW exchange rate range of ₦380/\$ to ₦415/\$, we estimate PMS prices to fall within the range of ₦168 – ₦176/litre on average for FY 2021 (2020: ₦146.1/litre). We expect this to tow inflation northwards.

Table 1: PMS Retail price/Liter Scenarios

Exchange Rate	395.0	415.0	430.0
\$40/bbl	142.6	147.9	151.9
\$50/bbl	168.8	175.5	180.5
\$55/bbl	182.0	189.3	194.8
\$60/bbl	195.1	203.1	209.0

Source: ARM Research

As earlier mentioned, the hike in electricity tariff in September 2020 as well as naira devaluation at the IEW and parallel market is set to adversely impact inflation trajectory in the coming year on a YoY basis. On the currency front, we expect the rates at IEW to fall within the range of ₦380 - ₦415/\$.

The reopening of the Nigerian border – a respite to MoM food inflation

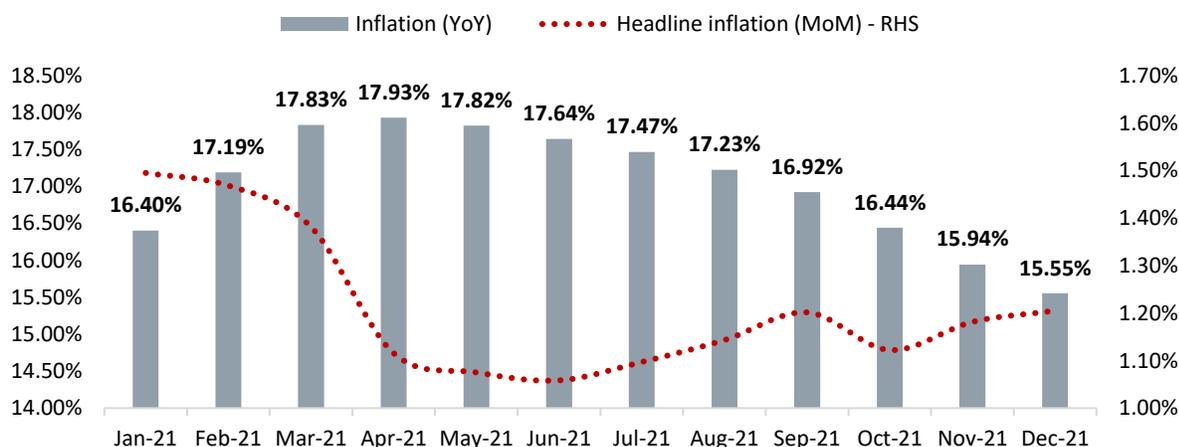
On food inflation, we believe the reopening of the Nigerian border on 31st of December 2020 as stated by the government, will provide some respite to food inflation, precisely on a MoM basis. To recall, the closure of the land borders in August 2019 had an inimical impact on food inflation, sending food prices on a northward trajectory during this timeframe, amongst other factors. While the underwhelming harvest in October 2020 is expected to put a strain on the supply of agricultural commodities into the market over Q1 21, we believe the reopening of the land border should improve supplies, and consequently ease pressures on food prices in 2021.

On the flipside, the acceleration in the second wave of the COVID-19 pandemic across the country, fused with the possible hike in PMS prices, poses a downside risk to food inflation. For us, while we do not expect a total lockdown of the economy in 2021, our anticipation of

⁶July 2020

a hike in PMS prices due to the deregulation of the downstream sector is suggestive of further price pressures in 2021. To delineate the impact of PMS prices on food inflation, we carried out a series of regression using monthly historical data, dating back to 2014. In our first regression analysis, we uncovered a statistically significant positive relationship between PMS prices and transport inflation, wherein a ₦1 rise in PMS prices leads to a 137bps increase in transport inflation. In our second regression analysis between food and transport inflation, our results show that a 1% increase in transport inflation should result in a 144bps increase in food inflation. Summing up our expectations across both food and core inflation, the trajectory for headline inflation points northward. **We expect inflation to fall within the range of 17% YoY and 18.5% YoY over FY 2021.** For clarity, we came up with two possible scenarios for headline inflation numbers in 2021. On the first scenario, our assumption of the reopening of the land border on the 31st December 2020 and the interplay of seasonal factors, barring any shock, informs a mean inflation rate of 17% YoY (FY 20E:13.2%) which is our base case. On a MoM basis, we expect inflation rate to abate, with an average of 1.21% over FY 21 (FY 20E: 1.27%). Towards the latter part of the year, we expect to see some decline in inflation rate owing to the impact of the high base effect from the prior year.

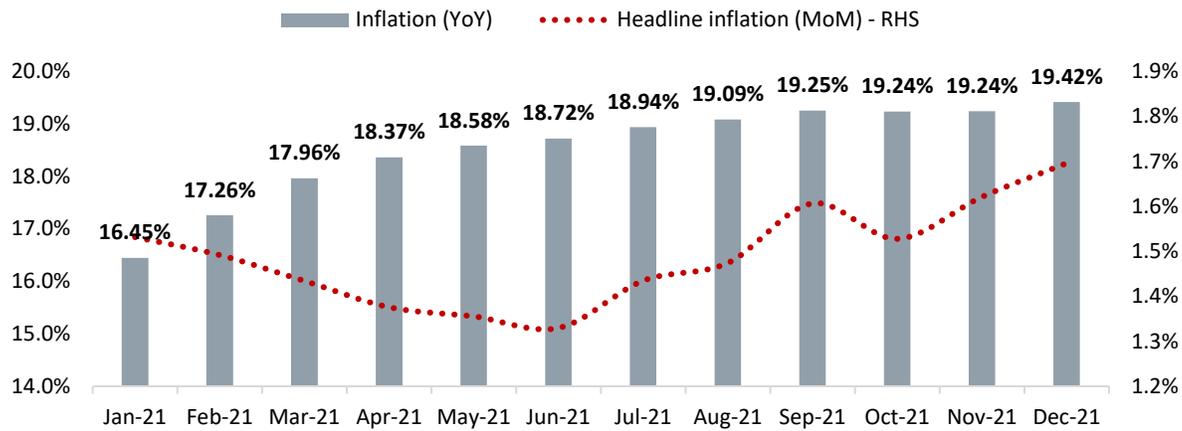
Figure 5: Monthly inflation forecast for 2021 (Base case)



Source: NBS, ARM Research

On the downside, a significant hike in PMS prices, and further devaluation in currency should aggravate inflationary pressures over 2021. This informs our projection of an uptick in inflation rate over 2021 to 18.5% YoY and 1.49% MoM, which is our bear case scenario.

Figure 6: Monthly inflation forecast for 2021 (Bear case)



Source: ARM Research

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