Flashnotes

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Inflation higher before Impact of Subsidy Removal and FX rate Convergence

Highlights

- **Inflation rises to a new high of 22.41% in May from 22.22% in April 2023**
- **The FGN has taken two key decisions relating to subsidy removal and FX convergence that have the potential of placing the economy on a sustainable long term macroeconomic growth path but will come with short-term costs to households, though net effects are positive in the long term.**
- **The combination of the subsidy removal and the reported removal of the peg on FX will likely witness a short-term increase in the monthly and yearly rate of inflation translating in an increase in headline inflation to within 24.4% to 25.6% for June and July 2023.**

Event

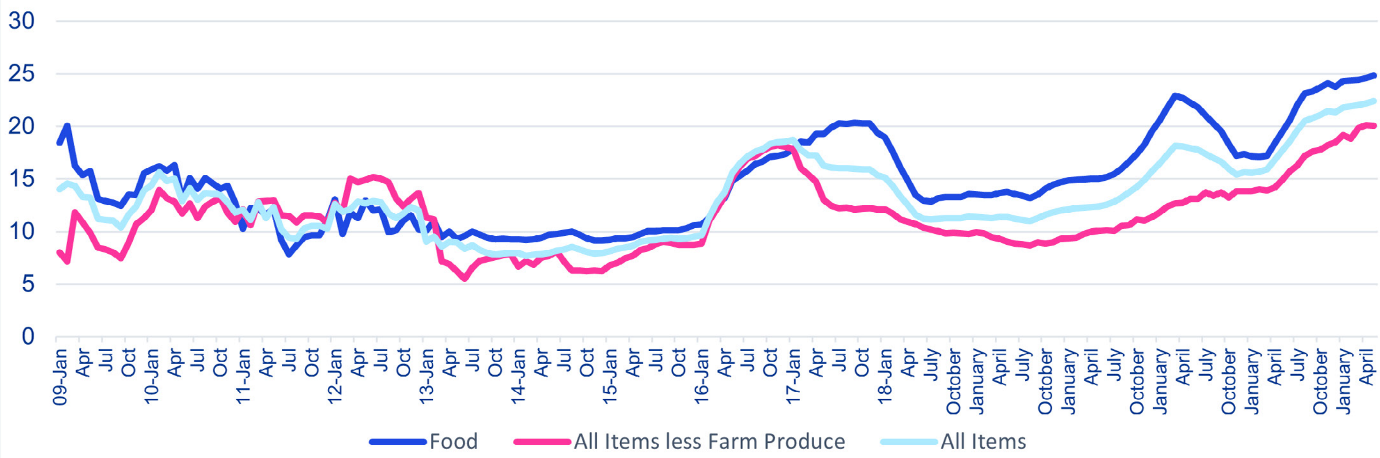
The Consumer Price Index (CPI), which measures the costs for goods and services in the Nigerian economy for May 2023 show consumer prices rising to yet another new high.

On a year-on-year basis, the headline CPI rose to a new 2 decade high of 22.41% in May 2023 compared to 22.22% in April 2023. On a monthly basis, the CPI rose for the third consecutive time to 1.94% in May 2023, from1.91% in April 2023 and 1.71% in February 2023. This represents the highest month on month inflation rate since May 2016.

Food prices, which dominates the CPI basket, continued to rise on a yearly basis to 24.82% in May 2023 from 24.61% in April 2023, while monthly, food prices surged higher to 2.19% in May 2023 from 2.13% in April 2023.

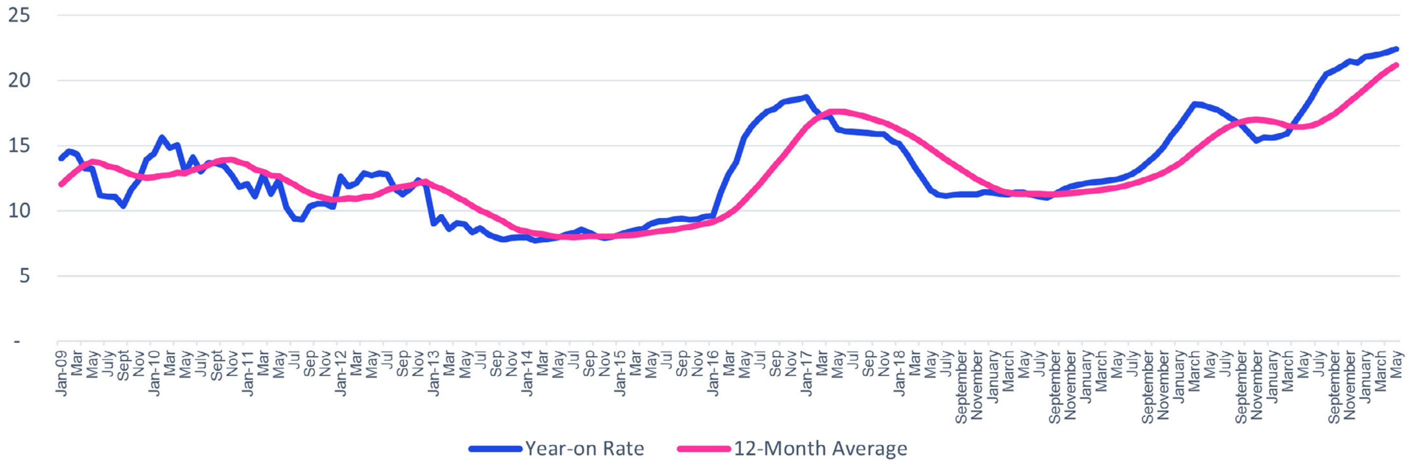
The core CPI which excluded prices of food and energy, however declined year on year to 20.06% in May 2023, from 20.14% in April 2023, while on a month-on-month basis it rose considerably to 1.81% in May 2023 from 1.46% in April 2023.

Inflation: Composite Year-on Change (%)



Source: NBS

Inflation -Composite All Items (%)



Source: NBS

At the same time, the CBN issued a communique 14th of June 2023, indicating it had collapsed all its multiple FX windows into its I & E window. By this decision, the CBN has granted commercial banks and dealers in the forex market the authority to sell forex freely at any rate. While no further details have been made about broader changes to the FX policy regime or monetary policy in general, (especially regarding the 41 items import restrictions, clearing FX demand backlogs etc), this move has inspired domestic and international confidence in the Nigerian economic environment and together with the earlier removal of PMS subsidies, will likely support an imminent sovereign ratings upgrade.

Analysis/Opinion

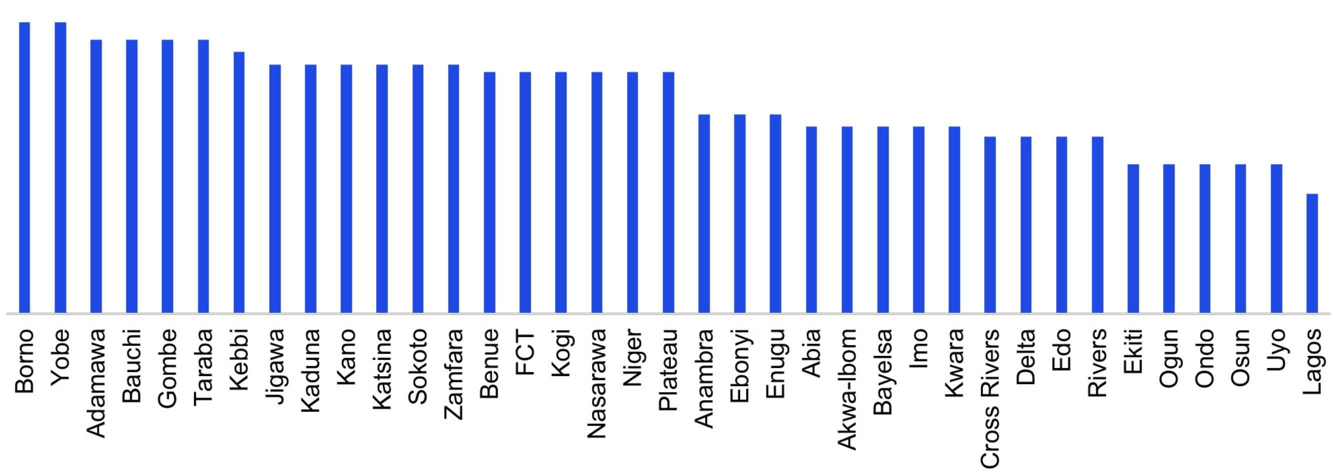
Consumer prices have remained high and at double digits for 88 consecutive months, since February 2016, and has remained above 20% for ten consecutive months. The average headline year on year inflation rate since the beginning of 2022 and 2023 stands at 19.74% and 22.08% respectively. Cumulatively, monthly inflation has risen by 28.79% since January 2022 and 9.28% since January 2023.

A breakdown of inflation in May 2023 on a yearly and monthly basis, shows that it was driven principally by food, transport and related costs, education and related expenses and miscellaneous goods and services. Transport inflation, in particular, rose by 23.87% on a yearly basis and 2.2% monthly and has tracked headline and food inflation almost perfectly since 2022.

During the period under review, the president has taken two key decisions that could have considerable inflation and interest rate implications but that may also have the potential of placing the economy on a sustainable long term macroeconomic growth path, by fixing some key challenges in the real, fiscal, monetary, and external sectors. These key, yet necessary decisions will however come with significant short-term costs to households and businesses, especially relating to inflation, consumer demand, business earnings and margins and interest rates.

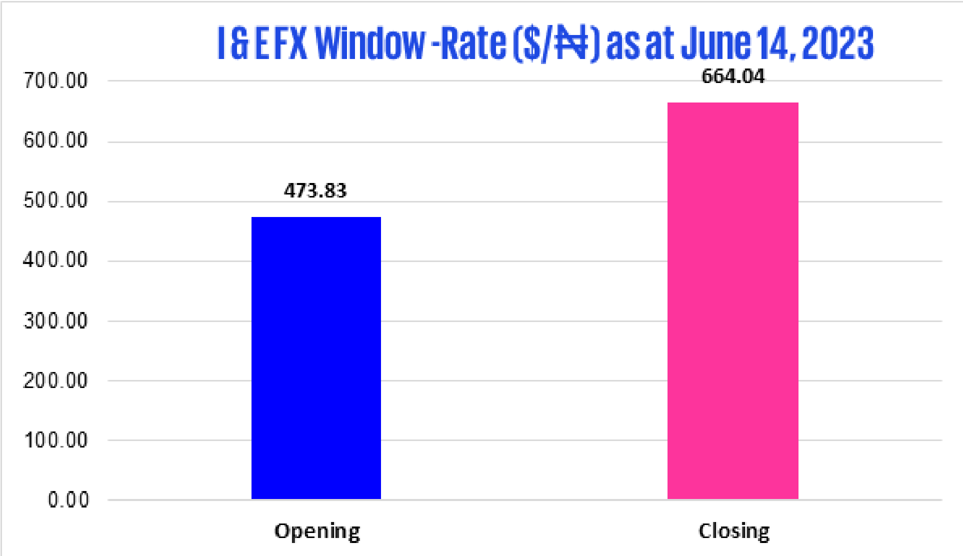
Firstly, during his Inaugural Speech on 29th May 2023, the president took the bold step of announcing that: "the Fuel Subsidy is gone!" signalling the end of the fuel subsidy regime on Premium Motor Spirit ('PMS'). This was immediately followed by increases in PMS prices nationwide, with the Nigerian National Petroleum Company Limited (NNPCL), on 31st May 2023, adjusted retail prices for PMS ranging between NGN 488/litre in Lagos State to NGN 555/litre in Maiduguri, Borno State. Nevertheless, this decision, though potentially inflationary, is expected to reduce pressure on government finances, debt and on FX demand.

New Pump Price per litre 31st May 2023



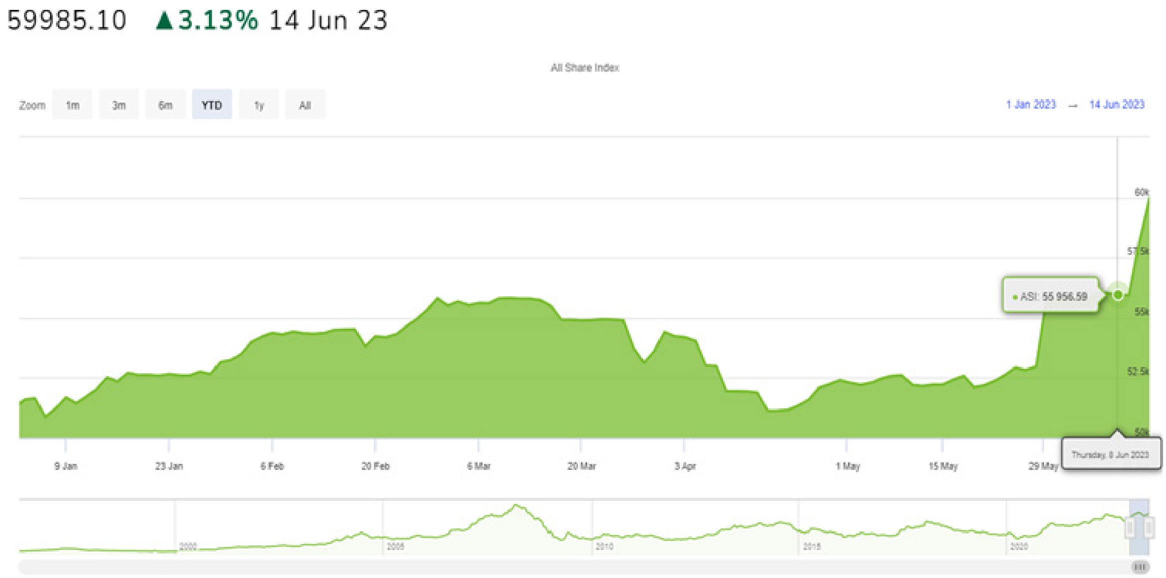
Source: NNPCL

Secondly, by collapsing all its official multiple FX windows into its I & E window and granting commercial banks and dealers in the forex market the authority to sell forex freely, the government has initiated the first of several steps it needs to take to unify the FX rates. The immediate reaction was a jump in the official I & E window which closed at N664/$ on the day of announcement compared to N473/$, the day before. We estimate that the FX rate will range within N650-750/$ in the near term and relative equilibrium will depend on how quickly supporting policies are introduced that also encourage and guaranty FX supply. This will require amongst other things, proper decentralisation of the FX supply environment where the CBN still act as the primary supplier of FX.



Source: FMDQ

At the same time, Nigeria's capital market surged higher with investors taking position in anticipation of a likely surge in foreign portfolio investor's participation.



Source: NGX

By taking this bold yet risky decision, however, the gap in the official and parallel markets will likely narrow overtime, thereby eroding the FX gap and the opportunities for roundtripping as the arbitrage opportunity reduces. A necessary though not sufficient move in the right direction.

Furthermore, this will overtime encourage capital inflows from FPI, FDI and deepen the forward's market. Moreover, net export proceeds from exporting companies and GOEs which earn FX as well as home remittances, will likely now be incentivised to bring in FX through the official channels, thereby boosting FX supply given the anticipated smaller gap between the official and parallel FX rates. The eventual anticipated convergence of the FX rates will also immediately improve much needed government FX related revenue which helps to slow the pace of debt accretion and improve expenditure on physical and social infrastructure.

This may, however, bare unintended consequences, such as a reduction in VAT and CIT should consumption expenditure shrink, resulting in a reduction in corporate earnings as demand for corporate goods and services decline. There might also be a possibility of increased costs to businesses from FX losses from having to deal with a higher FX rate in between the financial year they may not have anticipated and not planned for.

Furthermore, total government debt in naira terms and accordingly debt to GDP and debt service ratios may worsen compared to immediate post PMS subsidy levels unless measures are urgently taken to boost revenue and further rationalise government expenditure. The price of PMS may also have to be adjusted upwards in the short term to consider the adjustment in the market FX rate, putting further pressure on inflation which may ultimately inch closer to 30% before the end of 2023, holding all other things constant. This may consequently lead to an increase in interest rates. Arguably less important is the fact that Nigeria will move from the largest economy in Africa to the third behind Egypt and South-Africa with its GDP dropping from $504 billion to about $304 billion.

Rank	Country	GDP (Billion US$)	Per Capita (US$)
1	Nigeria	504	2,326
2	Egypt	469	4,504
3	South Africa	411	6,738
4	Algeria	187	4,151
5	Morocco	142	3,715
6	Angola	124	3,790
7	Ethiopia	113	1,097
8	Kenya	110	2,081
9	Tanzania	76	1,245
10	Ghana	75	2,368
11	Ivory Coast	68	2,418
12	Democratic Republic of the Congo	63	660
13	Uganda	48	1,105
14	Tunisia	46	3,915
15	Cameroon	44	1,584
16	Sudan	42	916
17	Libya	40	6,025
18	Zimbabwe	38	2,420

Overall, we believe the net effect of these 2 key decisions targeting monetary and fiscal policy are potentially positive especially in the long term despite the anticipated short-term difficulties.

Nevertheless, the immediate consequence of a combination of the subsidy removal and the removal of the peg on FX in June 2023 will, however, result in a short-term increase in the rate of inflation for June and July 2023. We estimate that these developments will lead to an increase in the monthly rate of inflation by between 3.4%-4.4% in June from 1.94% in May 2023, translating in an increase in headline inflation to within 24.4% to 25.6% for June and July 2023.

To avoid any reversals to gains experienced in the last few weeks and sustain the positive momentum and atmosphere of cautious optimism currently being witnessed, it is important that clarity especially relating to the remaining FX and monetary policy supporting structures are worked out. This includes the role of the CBN as primary FX supplier and for FX supply to be properly decentralised. Furthermore, it is important government communicates and introduces erstwhile promised inflation support post PMS subsidy removal to minimise disruptions in consumer demand and business earnings. To do this we once again reiterate our preference for short to medium term income tax, VAT and corporate tax reliefs and other non-cash-based incentives which will tend to be less inflationary. We also advise government to lead by example by also reviewing and cutting out wasteful expenditure just as it advocates for the public to bear the short terms pains from needed restructuring and reforms.

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