Policy Brief

Rising Inflationary Pressures: Will the MPC Raise the Policy Rate or Support Economic Growth?

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INSIDE THIS ISSUE

1 Background
2 Petrol Subsidy Reduction
3 Conclusion

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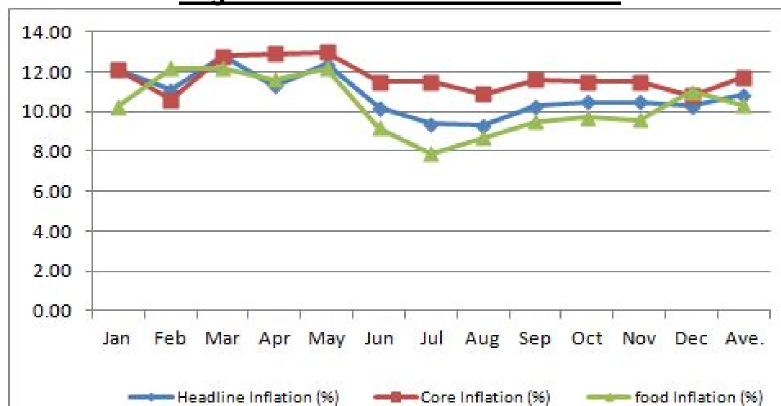
1. Background

The Monetary Policy Committee (MPC) of the Central Bank of Nigeria (CBN) holds its first meeting for 2012 on January 30th, taking into consideration global and domestic developments since its last meeting in November 2011. While events in the global economy will remain in the front burner due to the effects of projected slowdown in economic growth of OECD countries and other key oil consuming nations on the Nigerian economy, the key domestic issue that will influence the interest rate decision is the partial reduction in petrol subsidy by the federal government. Therefore, without taking eyes off the effects of global events on the domestic economy, the MPC will again be faced with the dilemma of either raising the Monetary Policy Rate (MPR) in order to prevent the economy from overheating due to the inflationary effects of petrol price increase, or better still maintain a neutral policy stance. In December 2011, headline and core inflation rates moderated from 10.5% and 11.5% to 10.3% and 10.8% respectively, while food inflation rose from 9.6% to 11%. However, the MPC will be concerned with the trend of core inflation since for the whole of 2011, core inflation which discounts seasonality, averaged 11.7% compared to headline and food inflation average rates of 10.8% and 10.3%.

Nigeria's Inflation Rates 2011



National Bureau of Statistics

2. Petrol Subsidy Reduction

With respect to the effect of the petrol subsidy reduction, the MPC will have to decide whether to respond to the contractionary effect of the policy and the attendant effect on aggregate demand and economic growth, or try to prevent

the economy from over-heating due to the short-term inflationary effects. Specifically, the inflationary effect of the subsidy reduction will be felt more through the transportation and distributional channel given that transportation has the 3rd highest weight of 7% in the inflation basket. Also, given that the food basket has the highest weight of 51% and that transportation cost is vital in distribution of food commodities, the prognosis is that we are most likely going to see a spike in both food and core inflation rates when the National Bureau of Statistics releases the January 2012 inflation data. Aside from the impact of transportation and distribution costs on the food index, another factor that may lead to a spike in the food prices is that, with consumers' disposable income less by the extra money spent on transportation, the proportion of income that will be spent on food may increase.[1]

"Specifically, the inflationary effect of the subsidy reduction will be felt more through the transportation and distributional channel given that transportation has the 3rd highest weight of 7% in the inflation basket.

The partial reduction in petrol subsidy will however help provide some breather for monetary policy since it will reduce the federal government's fiscal deficit. The table below shows the correlation between the percentage increase in petrol, inflation rate and fiscal deficit as percentage of GDP between 1990 and 2012. While there is a positive relationship between petrol price increase and inflation at 0.535, there is a strong negative relationship between petrol price increase and the fiscal deficit. This implies that while partial deregulation of the downstream sector through the increase in petrol price has contributed to inflationary pressures since 1990, it has also helped in checking government's fiscal deficit. This confirms the position of fiscal policymakers that borrowing by government to fund the subsidy on petrol is one of the factors that has consistently pushed up the average fiscal deficit. Nevertheless, despite the expected reduction in pressure on the deficit level as a result of the subsidy reduction, there are risks associated with oil production and consequently oil revenue. This means that the government will require a supplementary budget in order to accommodate the Subsidy Reinvestment and Empowerment (SURE) programme, thereby raising the overall fiscal deficit for 2012.

"The partial reduction in petrol subsidy will however help provide some breather for monetary policy since it will reduce the federal government's fiscal deficit."

Correlation between PMS, Inflation and Fiscal Deficit (1990-2012)

	PMS (% Change)	Inflation (%)	Fiscal Deficit (% of GDP)
PMS (% Change)	1.0000	0.5351	-0.6481
Inflation (%)	0.5351	1.0000	-0.2939
Fiscal Deficit (% of GDP)	-0.6481	-0.2939	1.0000

The MPC members will also be looking critically at the trend of other key macroeconomic variables to make a policy decision. In the official foreign exchange market, the naira has depreciated only 0.09% this year and the MPC may allow the naira float further if it decides to leave the MPR unchanged. Besides, with external reserves closing 2011 at $32.9bn and only able to finance 7.3 months of imports, the Central Bank may move from a creeping to a sharp devaluation of the naira if fiscal expansion drives inflation further, and foreign exchange demand intensifies to meet importation. Therefore, we may see naira trading at the upper band of N160/$1.

However, given that propensity to import in Nigeria is high, depreciation of the naira means that imports will be more expensive in domestic currency terms, thereby having a feed-back effect on the economy through imported inflation. Therefore, fixing the supply-side of the economy will help in making monetary policy more effective, either through the use of interest rates or exchange rate manipulation in the future. The trend of the oil variables show that Nigeria's Bonny Light crude has averaged $99.12 per barrel price since the last MPC meeting, while oil production dropped from 2.087 million barrels per day in November to 2.043 million barrels per day in December 2011, lower than the budget benchmark of 2.480 million barrels per day. Conversely, the total oil rig count, a leading indicator of future oil production, shows that in 2011, offshore rigs totalled 124 and onshore 54, implying that future revenue accruable to the government may not rise as much as expected given that offshore fields are explored on the basis of the Production Sharing Contract (PSC) which have less favourable fiscal terms for the government than the Joint Venture Agreement (JVA). On the contrary, onshore fields which are mostly explored through the JVA have been affected by operational and security risks, resulting in the deployment of resources by oil companies to deep offshore operations.

Despite the short-term inflationary effect of the petrol subsidy reduction and the over-heating consequence, the MPC may maintain a neutral stance in order to ease the contractionary effects of current fiscal policies.[1] The Committee may also consider the loss to the economy due to the industrial action brought about by the temporary removal of the fuel subsidy, and leave the policy unchanged. Different estimates of this loss have been provided; with the National Bureau of Statistics noting that the economy lost N207 billion while the Ministry of Finance through the minister gave a higher estimate of N300 billion. Furthermore, the Central Bank through the Governor estimated a daily loss of N100 billion, making it a total loss of N500 billion for the 5-day strike, while a private sector firm[1] estimated that the economy lost about N720 billion. Putting these figures together however, the economy may have lost an average of N492 billion as a result of the strike.[1]

3. Conclusion

In conclusion, the rule of thumb is that rising inflation should make any Central Bank increase its policy rate. In the present scenario however, the MPC may use its discretion and leave the official interest rate unchanged at the current level of 12% in order to boost the real sector. Maintaining a neutral stance will complement the federal government's efforts at boosting economic activities through the SURE programme, and the policy emphasis on job creation and inclusive growth. Nonetheless, with the CBN expecting inflation to rise to about 14–15% by mid-year due to the effect of the subsidy reduction, the MPC should return to restrictive stance in the coming months. In the medium term however, prices may moderate as efforts are channelled towards addressing the infrastructure deficit in the economy through the subsidy re-investment programme.

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