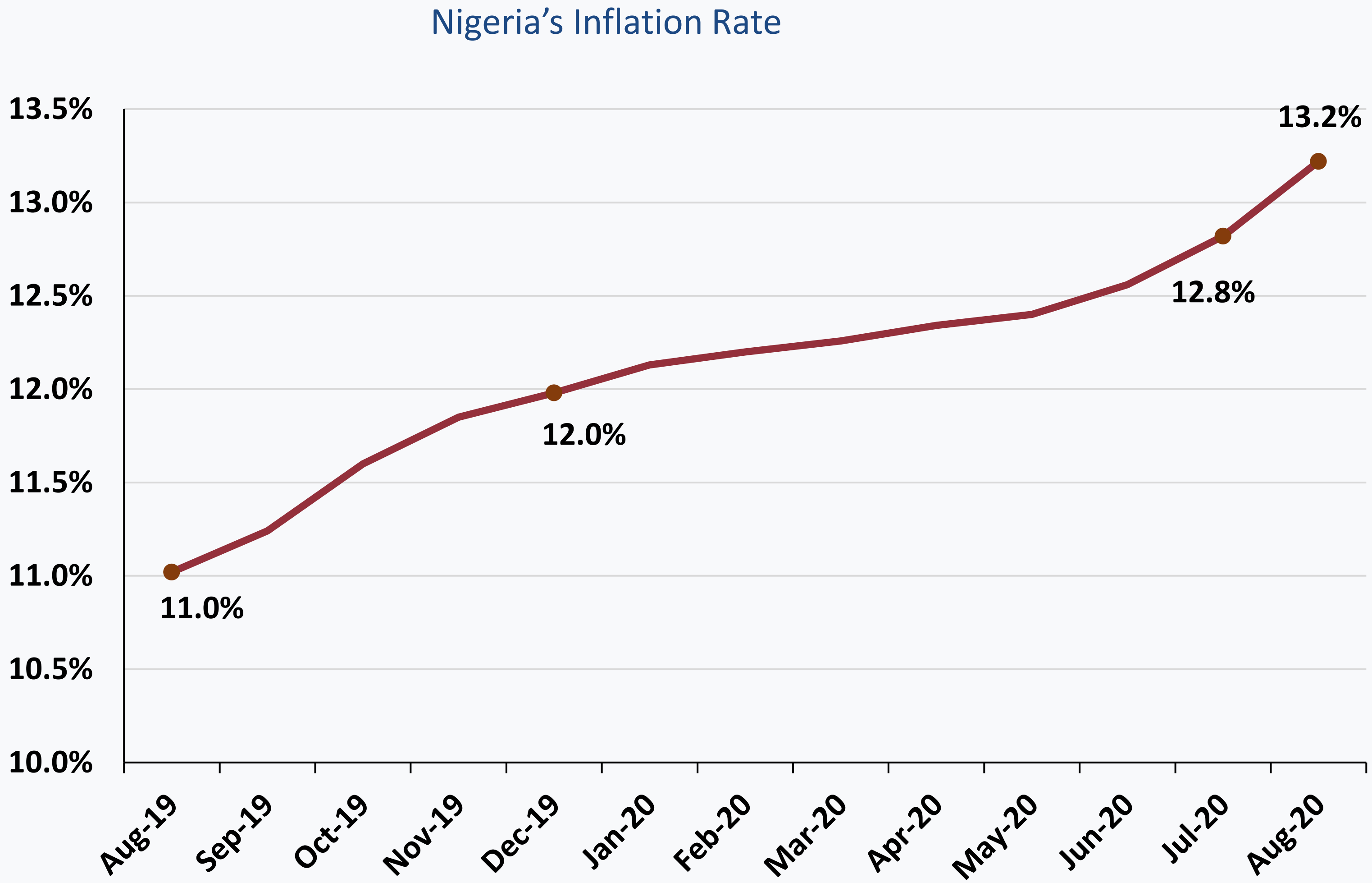
CAPITAL LTD

Macroeconomic Update: Inflation and CBN MPC outcome

September 2020

Inflation rate rose faster to 13.2% in August 2020



- **Nigeria's inflation rate rose significantly to 13.2% in August 2020 from 12.82% in July.**
- **This represents a 40 basis points increase, the highest increase since October 2016.**
- **Inflation rate has increased consistently since August 2019 following the effect of the land border closure along with structural challenges.**
- **As in previous months, food inflation continued to be the major driver of inflation in Nigeria.**
- **In August, average prices rose by 1.34% on a month-on-month basis.**
- **Issues of insecurity, increase in VAT, structural factors relating to infrastructure and power supply deficit as well as exchange rate depreciation continue to drive up average prices in Nigeria.**

Data Source: National Bureau of Statistics

Food inflation continued its upward trend to 16% in August 2020

Nigeria's Food & Non-Food Inflation Rate

	Food Inflation	Core Inflation
Jan 2020	14.8%	9.3%
Feb 2020	14.9%	9.4%
Mar 2020	15.0%	9.7%
Apr 2020	15.0%	10.0%
May 2020	15.0%	10.1%
Jun 2020	15.2%	10.1%
Jul 2020	15.5%	10.1%
Aug 2020	16.0%	10.5%

Data Source: National Bureau of Statistics

- **Food inflation rate increased to 16% in August from 15.5% in July.**
- **According to the NBS, the increase in food prices was driven by increases in prices of Bread and cereals, Potatoes, Yam and other tubers, Meat, Fish, Fruits, Oils and fats and Vegetables.**
- **Non food inflation rate also rose to 10.5% from 10.1% in July 2020, triggered by rise in prices of transport services, hospital services and pharmaceutical products among others.**
- **In addition to legacy structural factors such as infrastructure and power deficits, the disruption of supply chain as well as exchange rate depreciation will lead to higher prices in the fourth quarter of 2020.**
- **We estimate that inflation rate will average 12.9% in 2020.**

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In August, Health maintained the highest year on year increase in inflation

	Categories	Inflation Rate	Note
1.	Health	12.1%	Higher demand for health care services due to COVID-19 led to an increase in health inflation to 12.1% in August 2020. Health inflation stood at 9.1% in August 2019.
2.	Food & Non-Alcoholic Bev.	15.9%	Higher transport costs and insecurity challenges have resulted in a 2.8 percentage points increase in food & non alcoholic beverages inflation to 15.9% in Aug 2020.
3.	Transport	11.2%	Transport recorded the third highest price increase (from 8.8% in Aug 2019) following higher fuel costs and supply chain disruption.
4.	Miscellaneous Goods & Services	10.7%	Miscellaneous goods & Services Inflation rate rose to 10.7% in August 2020. Currency depreciation and high cost of doing business are major factors driving inflation.
5.	Recreation & Culture	9.7%	Lockdown, movement restrictions and social distancing rules are key drivers of inflation in this segment.
6.	Restaurant & Hotels	9.9%	This segment is among the most affected following the restrictions and social distancing. Inflation rate in this segment has risen from 8.1% in August 2019 to 9.9% in 2020.

Key drivers of Inflation in the last one year include closure of land borders, infrastructure deficit, exchange rate depreciation, rising transport costs, lockdowns & movement restrictions and VAT increase.

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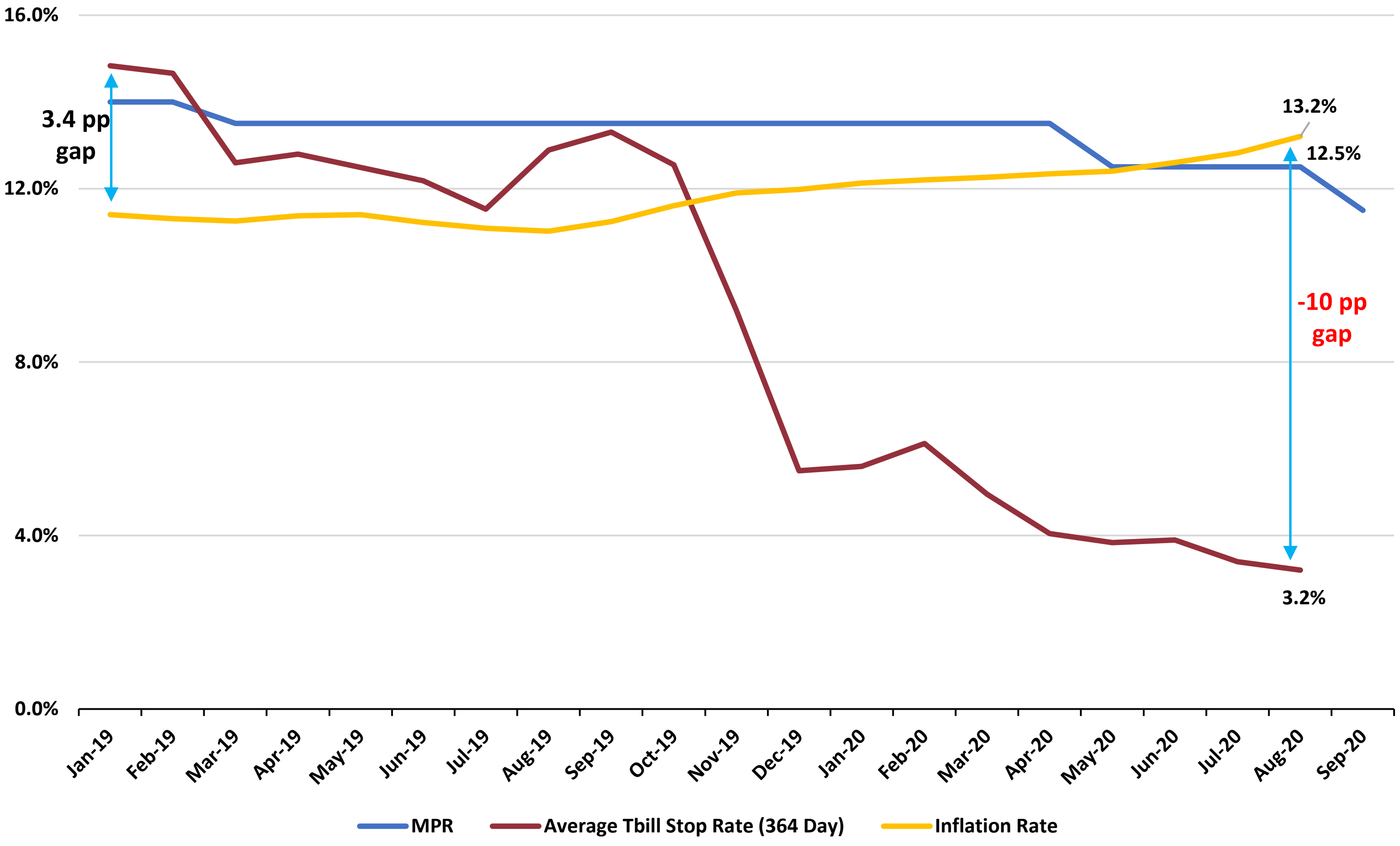
Data Source: National Bureau of Statistics

Real interest rate maintained its negative trend, extends to -10pp in August 2020

Real Interest Rate: MPR, 364-Day Treasury Bill Average Rate vs Inflation Rate



*pp - percentage points

- **The gap between interest rate (1 year Treasury Bill) and inflation rate widened further to -10 percentage points in August (July: -9.4pp).**
- **Excess liquidity in the fixed income space led to a further decline in interest rate, while structural factors and FX challenges resulted in an upward movement of Nigeria's inflation rate.**
- **These structural factors, coupled with insecurity in some parts of the country, and currency pressures are expected to drive up inflation in the fourth quarter.**
- **With this, the gap between interest rate and inflation is expected to expand further in coming months with implications on real investment earnings.**

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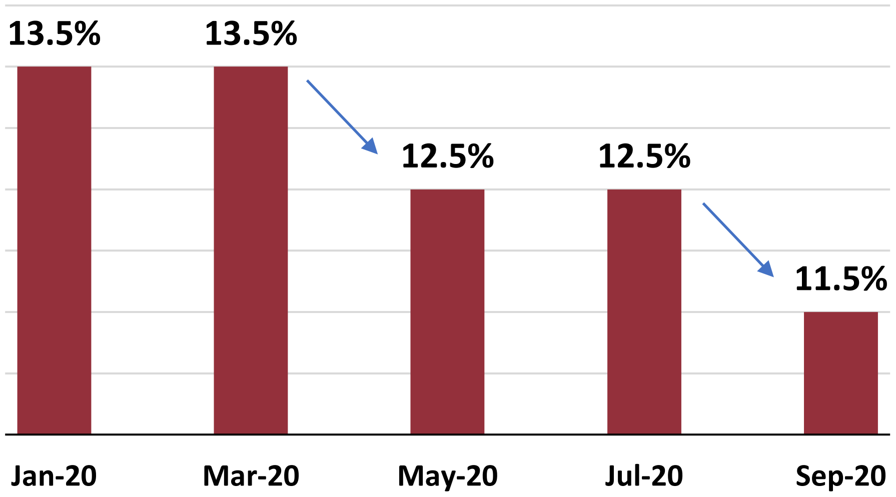
Data Source: National Bureau of Statistics & Central Bank of Nigeria

CBN MPC reduces MPR to 11.5% from 12.5%, cites the need to support growth

Movement of Monetary Policy Rate in 2020



- *CBN MPC has reduced MPR twice so far in 2020*
- *Liquidity Ratio has remained unchanged at 30%*
- *Cash Reserve Ratio was changed in January to 27.5% in 2020.*

- The CBN Monetary Policy Committee (MPC) held its fifth meeting of the year on September 21 and 22, 2020.
- At the meeting, the Committee took the following decisions:
  - Reduce the MPR by 100 basis points from 12.5 percent to 11.5 percent;
  - Adjust the asymmetric corridor from +200/-500 basis points to +100/-700 basis points around the MPR;
  - Retain the CRR at 27.5 percent; and
  - Retain the Liquidity Ratio at 30 per cent.
- An analysis of the voting pattern showed that six members voted to reduce the MPR by 100 basis points; one member voted to reduce the MPR by 50 basis points and three members voted to hold the MPR.
- In addition, nine members voted to change the asymmetric corridor while one voted to hold. All members voted to hold the Cash Reserve Ratio (CRR) and Liquidity Ratio (LR).
- Earlier in the third meeting of the year, the Committee reduced the Monetary Policy Rate (MPR) from 13.5% to 12.5% and cited the need to support economic growth following the impact of COVID-19.

Data Source: Central Bank of Nigeria

Monetary Policy Review: Key Considerations

Key Considerations of the MPC

The following are key considerations that influenced the Committee's decision:

- **Low crude oil price**
- **Possibility of an economic recession in 2020Q3**
- **Rising inflation rate and heightened inflationary pressure**
- **Exchange rate adjustment**
- **Dwindling capital inflows in the financial markets**
- **Rising public debt**
- **The need for Deposit Money Banks to lower the cost of credit**
- **The need to stimulate local production, support the recovery of the economy and stimulate aggregate demand**
- **Adverse weather conditions which could affect agricultural output and prices of commodities**
- **Security challenges in the country**
- **The increase in petroleum pump price**
- **Deregulation in electricity tariff**

The MPC noted that evidence has not supported that rising inflation is driven by monetary factors. Rather, evidence suggests non-monetary factors (structural factors and supply shocks) are responsible for the rising inflation rate.

Monetary Policy Rate Cut: Implications and Outlook

Implication of the rate cut and expectations in Q4

- As noted by the MPC, inflation is mainly driven by structural factors which are mostly beyond the control of the Committee. A reduction in the MPR is expected to have little to no effect on movement of prices.
- Following the existing market liquidity, the rate cut by the MPC could result in a suppression of bond yields, which have remained higher when compared with yields on short term instruments.
- In addition to the CBN's measures to improve lending such as the LDR and reduction of interest rate on CBN loans, the MPR cut could further incentivize banks to reduce lending rates.
- This could therefore support businesses and overall economic growth. However, key structural factors including deficient power supply, supply chain disruption, will need to be addressed for maximum impact.
- In the last one year, several key factors that have triggered rising inflation include closure of the land borders, movement of exchange rate and availability/management of foreign exchange.
- We note that the CBN and fiscal authority's ability to effectively manage the country's foreign exchange challenges are crucial in suppressing inflation and preventing a deep recession in 2020.

These factors are expected to influence monetary policy decisions in the fourth quarter of 2020:

- High inflation expectation
- Possibility of a deep recession
- Contraction in real aggregate demand
- Lower inflows of foreign investments
- Declining external reserves
- Huge distortion between the MPR and other interest rates
- Lower crude oil prices/output and government revenue
- Sustainability of public debt
- Exchange rate movement
- Balance of payment challenges

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Several Countries have embarked on rate cuts in 2020

Following the economic challenges associated with COVID-19, several countries have embarked on rate cuts. So far, Nigeria has cut the MPR twice – first in May and second in September, 2020.

COUNTRIES AND THEIR BENCHMARK RATE CUTS

COUNTRIES	LAST CUT (Basis Points)	DATE OF LAST CUT	BENCHMARK RATE	NUMBER OF ADJUSTMENTS IN 2020
USA	100	15/03/2020	0 - 0.25%	2
UK	15	19/03/2020	0.10%	2
Argentina	200	10/03/2020	38.00%	7
Canada	50	27/03/2020	0.25%	3
Russia	25	24/07/2020	4.25%	4
China	20	20/04/2020	3.85%	2
South Africa	25	24/07/2020	3.50%	5
Egypt	300	16/03/2020	10.25%	1
Kenya	25	29/04/2020	7.00%	3
Zambia	125	19/08/2020	8.00%	2
Tunisia	100	18/03/2020	6.75%	1
Turkey	50	22/05/2020	8.25%	5
Nigeria	100	22/09/2020	11.50%	2

Data Source: Various Countries Central Banks

Revised Macroeconomic Projection

	2017	2018	2019	2020
Real GDP Growth	0.8%	1.9%	2.3%	-4.6%
Inflation rate	16.5%	12.1%	11.4%	12.9%
Exchange rate (BDC, N/US$)	395.4	361.8	359.5	420.0
Investment as a % of GDP	14.7%	19.0%	24.6%	19.0%
Monetary Policy Rate	14.0%	14.0%	13.5%	12.0%
External Reserves (Average, US$ Billion)	31.3	44.6	43.0	35.0