CHAPTER 5

DOMESTIC PRICE DEVELOPMENTS AND THE REAL ECONOMY

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5.1 Introduction

Inflationary pressures were sustained during the review period. In this chapter, we review domestic price developments and the measures taken to contain inflationary pressure. Against the backdrop of the high level of political activities in the second half of 2010 and rising government spending toward the general elections in April 2011, the CBN implicitly targeted the achievement of single digit year-on-year headline inflation during the review period.

5.2 Domestic Economic Activity

..GDP grew at an average of 8.53 per cent in the second half of 2010.

Despite the global financial and economic crises, domestic output was generally satisfactory in 2010. Growth in real GDP in the second half of 2010 was estimated at an average of 8.53 per cent. In the second quarter, GDP grew by 7.69 per cent compared with 7.45 per cent in the corresponding period of 2009. In the first quarter, estimated GDP growth was 7.36 per cent while it was 5.01 per cent in the corresponding period of 2009. In the third quarter, real GDP grew by 7.86 per cent and was estimated at 8.29 per cent for the fourth quarter. The annual rate of real GDP growth was projected at 7.85 per cent in 2010, which was significantly higher than the 6.96 per cent recorded in 2009.

..non-oil sector remained the major driver of growth.

The non-oil sector remained the major driver of growth. This was complemented by the sharp increase in oil sector production following the relative peace in the Niger Delta during the second half of the year and general world oil price increases. The major challenges to output growth in 2010 were the deficiencies in electricity generation and distribution, especially during the first three quarters of the year.

The index of manufacturing production, estimated at 93.7 (1990=100) rose by 0.3 per cent and 0.2 per cent over the levels in the preceding quarter and the corresponding period of 2009, respectively. The improved performance of the manufacturing sub-sector was largely attributable to improved investor confidence resulting from policy actions to unlock credit to the real sector. The poor state of electricity generation and distribution adversely affected activities in the manufacturing sub-sector, particularly the small and medium scale sub-sector. Thus, average manufacturing capacity utilization estimated at 54.90 per cent rose by 1.1 percentage points, compared with the corresponding period of 2009.

..food constitutes at least 51.80 per cent of the weights of items in the CPI basket

Nigerian agriculture which is still largely rain fed was exposed to the dictates of climatic conditions which played a key role in determining the level of agricultural output. Since food constitutes at least 51.80 per cent of the weight of items in the CPI basket, favourable weather conditions impacted positively on price developments in the country. In the second half of 2010, adequate and timely rainfall in most parts of the country aided good agricultural harvests of food crops, notwithstanding the severe flooding experienced in some food producing areas, especially the northern parts of the country.

..non-oil sector remained the major driver of growth.

The aggregate index of industrial output, however, improved during the fourth quarter of 2010 relative to the preceding quarters. Consequently, the index of industrial production rose by 0.9 and 2.0 per cent, over the level attained in the preceding quarter and corresponding period of 2009, respectively. The improvement was traced largely to manufacturing and mining production, which rose by 0.3 and 0.4 per cent, respectively. Similarly, the index of mining production rose by 0.4 and 0.5 per cent over the levels attained in the preceding quarter and the corresponding period of 2009, respectively. The rise was accounted for by the increase in crude oil and gas production.

.. year-on-year headline inflation rate remained at double digit throughout the second half of 2010......

5.3 Inflationary Trends in the Second Half of 2010

The year-on-year headline inflation rate remained at double digits throughout the second half of 2010. It closed at 11.8 per cent at end-December 2010, compared with 14.1 per cent in June 2010 and 13.9 per cent in the corresponding period of 2009.

Similarly, the year-on-year core inflation rate trended downwards at end-December 2010; the rate was 10.9 per cent, against the 12.7 per cent recorded in June 2010 and 11.2 per cent in December 2009. The high inflation rates during the review period were partly attributed to structural factors and the rebased and enlarged index of consumer prices in November 2010 to reflect current consumption patterns in the economy.

Generally, the 12-month moving average inflation rate persistently trended upwards during the review period. Thus, the 12-month moving average headline inflation rose from 12.5 per cent in December 2009 to 13.1 per cent in June 2010 and 13.7 per cent at end-December 2010. Also, the 12-month moving average core inflation rate trended upward, from 9.2 per cent in December 2009 to 10.9 per cent in June 2010 and accelerated to 12.4 per cent at end-December 2010 (Table 5.1, 5.2 and 5.3, Figures 5.1 and 5.2).

Table 5.1
Measures of Consumer Prices
(July 2008 – December 2010)

	Headline Inflation		Core Inflation		Food Inflation	
Date	**Y- Y**	**12-MMA**	**Y- Y**	**12-MMA**	**Y- Y**	**12-MMA**
Jul-08	14.00	7.80	4.80	5.40	20.90	9.00
Dec-08	15.10	11.60	10.40	5.10	18.00	16.10
Jul-09	11.10	13.40	8.30	8.60	12.90	16.80
Dec-09	13.90	12.50	11.20	9.20	15.50	14.80
Jul-10	13.00	13.30	11.30	11.20	14.00	14.50
Dec-10	11.80	13.70	10.90	12.40	12.70	14.70

Source: National Bureau of Statistics (NBS)

Table 5.2
Inflation Rate
(December 2009 – December 2010)

Date	Headline Inflation			Core Inflation			Food Inflation		
	CPI	Y- Y	12-MMA	CPI	Y-Y	12-MMA	CPI	Y- Y	12-MMA
Dec-09	102.2	13.90	12.50	101.9	11.20	9.20	102.7	15.50	14.80
Jan-10	103.1	14.40	12.60	102.6	12.10	9.60	103.9	15.90	14.70
Feb-10	105.0	15.60	12.70	105.0	14.00	10.10	105.4	16.20	14.40
Mar-10	104.9	14.80	12.80	104.6	13.20	10.30	105.3	15.80	14.40
Apr-10	105.7	15.00	12.90	105.1	12.80	10.40	106.7	16.30	14.50
May10	105.7	12.90	12.90	106.5	11.70	10.60	106.2	13.00	14.30
Jun-10	108.8	14.10	13.10	108.6	12.70	10.90	110.2	15.10	14.40
Jul-10	109.9	13.00	13.30	108.8	11.30	11.20	112.0	14.00	14.50
Aug-10	111.9	13.70	13.50	110.4	12.40	11.50	114.1	15.10	14.70
Sep-10	112.4	13.60	13.80	111.7	12.80	12.00	113.5	14.60	14.90
Oct-10	112.7	13.40	13.90	112.0	13.20	12.30	114.1	14.10	14.90
Nov-10	112.8	12.80	13.90	111.3	11.70	12.40	114.3	14.40	15.00
Dec-10	114.2	11.80	13.70	112.5	10.90	12.40	115.5	12.70	14.70
Source: National Bureau of Statistics									

The CPI maintained an upward trend throughout the second half of 2010. Thus, in December, the all-items CPI rose by 6.8 per cent to 114.2, (November 2009=100) over the level in June 2009. The all items CPI was 108.8 (November 2009=100) in the preceding period, compared with 102.2 in December 2009.

The Bank's price stability objective implicitly targeted single digit inflation in fiscal 2010. However, headline inflation remained generally above that target due mainly to structural factors as growth in money supply remained below its long term trend.

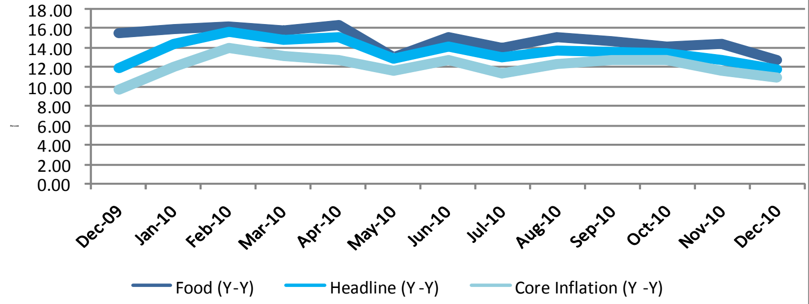
Table 5.3
Quarterly Consumer Price Developments in 2010
(November 2009=100)

	March		June		September		December	
	Y-on-Y (% Change)	12 Mths (Avg. % Change)	Y-on-Y (% Change)	12 Mths (Avg. % Change)	Y-on-Y (% Change)	12 Mths (Avg. % Change)	Y-on-Y (% Change)	12 Mths (Avg. % Change)
HEADLINE	14.8	12.8	14.1	13.1	13.6	13.8	11.8	13.7
CORE	13.2	10.3	12.7	10.9	12.8	12	10.9	12.4
FOOD	15.8	14.4	15.1	14.4	14.6	14.9	12.7	14.7

Source: National Bureau of Statistics (NBS)

Figure 5.1

Headline, Core and Food Inflation (Y - Y) (Dec. 2009 – Dec. 2010)

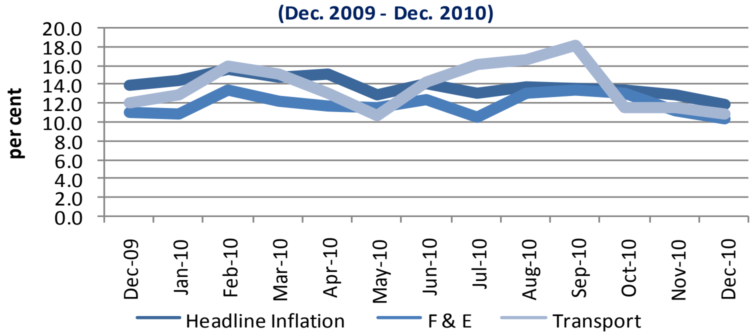


Source: National Bureau of Statistics

The breakdown of CPI index indicates that food and non-alcoholic beverages, housing, water, electricity/gas and other fuel, contributed most to the overall change in prices. Specifically, the index for food and non-alcoholic beverages rose by 9.06 percentage points in July 2010 compared with 4.8 per cent in December 2010 and the 97.8 per cent in December 2009.

The composite price index for utilities (which ranks next to food in the CPI basket), rose from 104.8 in June 2010 to 113.2 in December 2010, compared with 96.3 and 100.2 in June and December 2009, respectively (Figure 5.2). Overall, the all items CPI grew by 5.0 per cent in the second half of 2010. The increase was a reflection of the impact of the generally weak infrastructure base of the economy, the effect of which was transmitted to production.

Figure 5.2
Headline Inflation (Y-Y): Selected Items 2010
(Dec. 2009 - Dec. 2010)



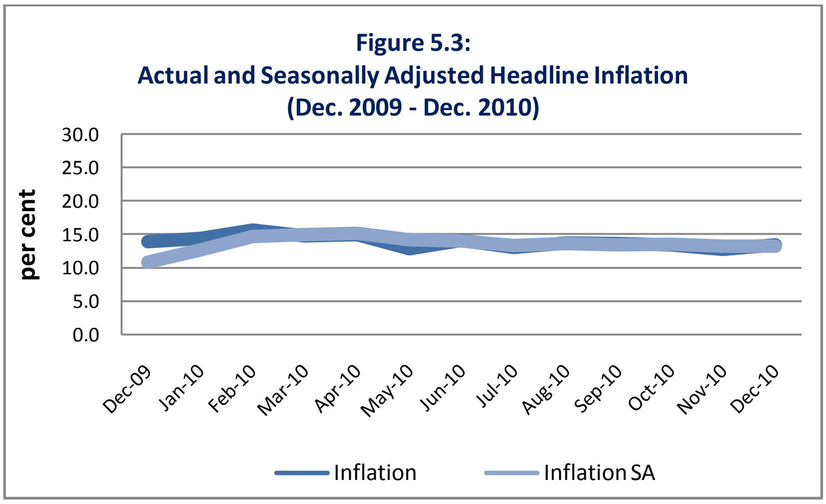
Source: National Bureau of Statistics

5.4 Actual and Seasonally Adjusted Headline Inflation

Analysis of inflation developments in the second half of 2010 indicated evidence of seasonality during the period. Seasonality played a key role in dampening the headline inflationary pressures in the second half of 2010; implying that holding seasonal factors constant (or in their absence), would result in higher headline inflation.

Notwithstanding the effects of seasonal factors, inflation remained at double digit throughout 2010

The low inflation outcome in some months was influenced in part by the bumper harvest of food items, such as yam and maize, which had a dampening effect on the food index (food items are a component of the CPI most susceptible to seasonality). Notwithstanding the effects of seasonal factors (particularly off-farm produce supply period and year-end festivities), inflation remained at double digits throughout 2010 (Figure 5.3).



Source: National Bureau of Statistics

5.5 Factors Responsible for Inflationary Pressures

Inflationary pressure in 2010 was heightened by the global food and energy crises, adverse weather conditions in some parts of the country, increased spending on political activities preparatory to the 2011 general elections and poor infrastructure.

The focus of the 2010 budget was spending on key infrastructure in the areas of works, power, education and health. Although, expenditure on infrastructure was expected to have major foreign components, the domestic components of infrastructure financing generated substantial domestic demand pressures that fuelled inflationary tendencies.

5.5.1 Domestic Aggregate Demand

Growth in aggregate demand was a major factor that fuelled upward price movements in the review period. Although broad money supply grew by ₦643.22 billion or 5.93 per cent in the second half, it was below the target growth level for the period and lower than the level in the preceding period. Accordingly, rising global energy and commodity prices reflected in high domestic import bills which impacted on prices. Although credit to the private sector was phenomenally low, credit to government grew. Thus, government expenditure on settling local contractor bills, funding preparations for the

April 2011 general elections and paying the increase in new salaries may have fuelled further inflationary pressures in the economy.

The Federal Government embarked on stimulus package, financed mainly by borrowing through the issuance of sovereign bonds, resulting in a provisional deficit of about ₦1,105.43 billion or 3.7 per cent of GDP. This phenomenon might have played a key role in the deterioration of inflation outcome in 2010. In the first and second halves of the year, fiscal policy continued to be largely expansionary, (Box 5.1 and Table 5.4).

Box 5.1
CORE INFLATION IN NIGERIA

Core inflation measures the general level of prices in the economy excluding certain items that face volatile price movement, like energy and food from headline inflation. More commonly, core inflation is the structural or underlying inflation in the economy. Like in most other countries, food and energy are more sensitive to price changes than other components of inflation in Nigeria. Natural and environmental factors such as tsunami, earthquake, floods, landslides, drought, and oil spills, often ravage large expanse of cropped land and distort the economic landscape in the country. This creates substantial supply bottlenecks with negative impact on the general price level. In addition, fluctuations in oil prices may create supply shocks which may affect prices of certain commodities or the general price level in the economy. Food and energy prices are often more readily related to temporary shocks which may reverse later when the situation stabilizes. Thus, rising food and energy prices are not necessarily indications of mounting inflationary trend as including them could be distortionary to the trend in the general price levels.

The National Bureau of Statistics has indicated that Nigeria's food and energy supply is often affected by a number of seasonal factors. While agriculture is largely rain-fed, the mostly hydro based electricity supply network depends on large harvests of rainfall to operate optimally. A large portion of the country's fuel consumption is dependent on international oil price movements. However, an existing fuel subsidy absorbs the shocks associated with the vagaries of the international oil price movements from impacting optimally on domestic prices. Thus, while prices of the affected goods may change rapidly, the price distortions may not be related to a trend change in the overall price level in the economy.

By measuring core inflation in Nigeria, we attempt to isolate what is happening to general prices without distractions arising from spikes in volatile food and energy prices. To alter the base of core inflation in the economy requires a substantial transformation of the underlying foundation of economic activity in the country, which will reduce structural bottlenecks to production. Nigeria is in that transformative stage as it tackles its dilapidated power infrastructure through massive investment to improve power generation, storage, distribution and sales.

Box 5.2
Federal Government of Nigeria (FGN) 2010 Amended and Supplementary Budgets (I and II)

Introduction

The 2010 FGN Stimulus Budget was prepared against the background of the global economic and financial crisis. The thrust of the budget was to stabilize the financial system, increase the liquidity of the banking system with a view to stimulating aggregate demand which had been severely constrained by the impact of the crises. Thus, the overall objective of the 2010 budget was to accelerate the pace of economic recovery through targeted fiscal interventions intended to stimulate the economy and support private sector growth. Accordingly, improving critical infrastructure such as power was a key priority of the budget.

The key macroeconomic assumptions of the budget were summarized as follows: Oil production of 2.088mb/d; benchmark oil price of US$60/barrel; joint venture cash calls of US$5.0 billion; average exchange rate of ₦150/US$1; targeted GDP growth rate of 6.1 per cent; and target inflation rate of 11.2 per cent by Government. Based on the stated assumptions, a total retained revenue of ₦3,179.87 billion was projected, of which oil revenue accounted for almost 80.0 per cent. Total spending was estimated at ₦5,159.66 billion of which ₦2,669.01 billion was earmarked as recurrent non-debt expenditure (51.33%), ₦1,764.69 billion for capital expenditure (34.20%) while ₦542.38 billion was earmarked for debt service (10.51%). Consequently, an initial overall budget deficit of 5.32 per cent of GDP was estimated for fiscal 2010 but this was to change after the supplementary I and II budgets were consolidated into the revised budget.

With the two supplementary budgets, the budget deficit increased from ₦1,550.8 billion to ₦2,725.827 billion or 9.37 per cent of GDP. The deficit was to be financed largely by domestic borrowing from the market, amounting to ₦1,346.55 billion, Net FGN Consolidated share of proposed ECA of 2010 (US$2.1 billion), privitization proceeds worth ₦107.21 billion and international bond issuance of ₦75.00 billion. Actual domestic borrowing for deficit financing was ₦1,647.86 billion.

This highly expansionary budget had far reaching implications on monetary management as the borrowing activities of government exerted pressure on domestic interest rates as well as crowd-out private sector borrowing. This precipitated high inflationary tendencies in the economy and constrained the attainment of the single digit inflation objective of the CBN, at end-December 2010.

Fiscal Operations of the FGN in 2010

The review of the 2010 budget and the approval of two supplementary budgets were motivated by the following reasons: The proposed salary increase for civil servants; Nigeria's 50th Anniversary Celebrations; Funds for the Independent National Electoral Commission (INEC) to conduct the 2011 general elections; Government programme for infrastructure provision; and Capital expenditure bunching.

Table 5.4
Fiscal Operations of the FGN in 2010

S/No	2010 Approved Budget	2010 Appropriation (₦'billion)	Approved Amendment (₦'billion)
1	Federally Collected Revenue	₦8,061,352 .0	₦6,999.149
2	FGN Retained Revenue	₦3,086,706.0	₦3,187.7105
3	Total expenditure of the FGN	₦4,637,597.0	₦4,427.185
4	1st Suppl. Appropriation Act 2010		₦644.752
5	2nd Suppl. Appropriation Act 2010		₦87,723
6	Total FGN Budget 2010	₦4,637,507.0	₦5,159.659
7	Primary Deficit/Surplus	(₦1,550,800.0)	(₦1,972.1833)
8	Domestic Borrowing by DMO to finance 2010 deficit	₦917.591	₦1,647.864
10	Deficit Financed by FGN Bonds in 2010		₦1104.2955
11	Other Deficit Financing Sources		₦88.8917

Source: Federal Ministry of Finance (Budget Office of the Federation)

5.5.2 Aggregate Supply Constraints

Supply constraints may also have played a critical role in the upward trend in domestic prices during the review period. Thus, supply gap issues associated with agricultural output; which became apparent due to inclement weather conditions in some parts of the country, may have explained high headline inflation in some months during the review period. In addition, raw material constraints reflected in demand pressure in the foreign exchange market, which impacted negatively on the naira exchange rate. The pass through effect from the exchange rate to inflation had already been empirically determined to be significant for Nigeria. Thus, supply constraints, high imported inflation from rising global food, energy and commodity prices may have combined to increase the upward pressure on domestic prices.

5.5.3 Exchange Rate Developments

.naira/dollar exchange rate remained relatively stable around N150.52/US$, especially in the second half of 2010.

The naira/dollar exchange rate remained relatively stable around ₦150.52/US$, especially in the second half of 2010. The premium between the official and the BDC rates narrowed by ₦3.68 or 2.45 per cent compared with ₦17.94 or 12.11 per cent in the second half of 2009. However, with effect from November 8, 2010, the CBN withdrew the licenses of all Class 'A' BDCs. This withdrawer was designed to enhance the prudent utilization of officially sourced foreign exchange in order to foster growth in the real sector and also to eradicate money laundering, curtail speculative activities and stem gross abuses which characterized the activities of the Class 'A' BDCs. The stable exchange rate of the naira in 2010 impacted positively on the CBN anti-inflation efforts by helping to lock-in exchange rate-induced inflation expectations.

5.6 Rebasing the Consumer Price Index (CPI)

The National Bureau of Statistics (NBS) rebased the CPI from May 2003 to November 2009. The newly rebased CPI was released by the NBS in November 2010. The exercise involved a re-classification and re-assignment of weights to major items in the CPI basket. Consequently, items which had been understated in explaining the domestic consumption pattern in Nigeria but which had over time constituted major recurrent expenditure items were included in the new CPI basket. For instance, food which had been assigned very high weight (637.6) in the basket was assigned new weight (507.03), implying that Nigerians now spend less on food and more on other items like education (39.4 instead of 2.1 in the old), telecommunications (6.8 instead of 1.1 in the old), health (30.0 instead of 13.6 in the old), transport (65.08 instead of 42.4 in the old), energy (167.3 instead of 181.0 in the old), etc (Box 5.5).

The exercise produced a CPI Index that was fundamentally higher in magnitude than the old series. However, the lower weights assigned to the more volatile food and energy items indicated that a smoother inflation rate would emerge over time and that higher food and energy prices may not necessarily result in very high price levels as previously experienced (Box 5.3).

Table 5.5
Revised Weights of the Composite Consumer Price Index

Commodity Group	Composite Weight (Old CPI)	Composite Weight (New CPI)	Difference (New -Old)
Food & non Alcoholic Beverages	644.1	518	-126.1
of which Food	-637.6	-507.03	(-130.57)
Alcoholic Beverages, tobacco & Kola	20.6	10.87	-9.73
Clothing and Footwear	32.1	76.5	44.4
Housing Water, Electricity, Gas & Other fuel	181	167.34	-13.66
Furnishings, Household Equipment & Maintenance	38.2	50.26	12.06
Health	13.6	30.04	16.44
Transport	42.4	65.08	22.68
Communication	1.1	6.8	5.7
Recreation & Culture	8.9	6.91	-1.99
Education	2.1	39.44	37.34
Restaurant & Hotels	12.9	12.12	-0.78
Miscellaneous goods & Service	3	16.63	13.63
Total	**1000**	**1000**	-

Source: National Bureau of Statistics (NBS)

Box 5.3
The New Consumer Price Index
(November 2009 = 100)

The National Bureau of Statistics (NBS) in November 2009 rebased the Consumer Price Index (CPI) base year from May 2003 to November 2009. The NBS indicated that the change in base year became necessary in order to adjust the composite weights of the major commodity groups. The new basket contained new products of growing importance in the expenditure profile in line with the changing consumption pattern of Nigerians. Consequently, while hitherto under-valued items such non-food items such as clothing and footwear, furnishings, household equipment and household maintenance, health, transport, communications, and education were assigned new weights commensurate with their degree of importance in the expenditure basket a few items which had ceased to be of strategic importance in the basket were removed.