Inflation in Nigeria – are the authorities doing enough to combat the existing problem?

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What you should know

i. **Nigeria's inflation is mostly supply-side driven.**
ii. **Nigeria has been responding to combating inflation using demand-side policies.**
iii. **For Nigeria to be able to combat the problems of rising prices, then supply-side policies must be enforced to combat rising inflation and boost economic growth.**

Context and Rational

The onset of the Covid-19 pandemic, the war on Ukraine, and their effects on global output and supply chain have led to inflationary pressures globally. The Covid-19 pandemic has continued to disrupt the global supply chain, especially in China, while the war between Russia and Ukraine has affected commodity and food prices, leading to inflation rising to levels not seen globally since the global financial crisis in 2008. Inflation has been a pressing issue for policymakers globally. In November 2022, US inflation climbed down to 7.1% from a peak of 9.1% in June, the highest ever in many decades. Even though this figure represents a drop of 8.5% from its October inflation report of 7.7%, we would need to stretch back to 1981 for us to get a period when inflation was that high in the US, averaging 10% that year.

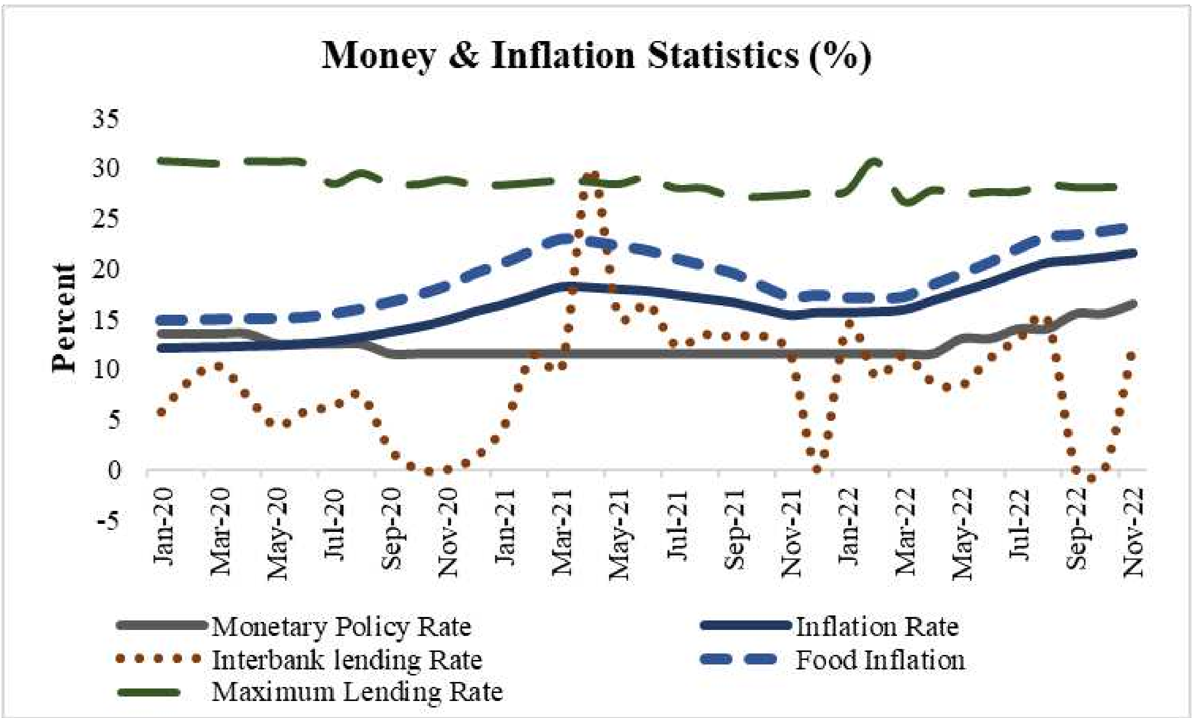
The Fed was initially slow to react to rising inflation; however, because of the expansion of economic activities, brought about by the relaxation of lockdown restrictions, higher Covid-19 vaccination, and restoration of normal pre-Covid-19 activities, the Fed raised its fund rate (the benchmark interest rate) from between 0%-0.25% at the beginning of the year to 4.25%-4.5% in its last meeting in 2022, pushing borrowing costs to the highest level since 2007. In response to a rise in the Feds fund rate, the Central Bank of Nigeria (will be known as CBN henceforth in the article) raised its monetary policy rate (the equivalent of the Fed fund rate in the US) from 11.5% in January to 16.5% in November 2022. The raise according to them was to address the rising challenge of inflation in the country. In the words of the central bank governor, "the committee resolved that the most rational policy option will be to further strengthen its tightening stance in order to effectively curtail the unabated rising trend of inflation". The

CBN's hawkish decision implies that businesses and people seeking loans from banks would have to pay a higher borrowing cost.

If prices remain elevated and interest rates hike continue in the US (as expected), this may pose a problem to a developing country like Nigeria since investors may want to withdraw their investments for the more appealing US markets, thereby resulting in massive capital outflows for Nigeria and inflows for the US. By implication, a higher borrowing cost for Nigeria would tighten liquidity and investments, thereby curbing rising inflation as well as spurring foreign capital inflows. Furthermore, given the country's continuous exchange rate peg against the dollar at the official market, the scarcity of foreign exchange has continued to widen the premium between the official exchange rate and the black-market rate. In essence, Nigeria should not be maintaining its peg against the US dollar because the policy is not sustainable in the long run due to our economic fundamentals, while raising interest rates to tackle rising inflation is not the solution for Nigeria.

Interest rates rise is not the solution to cooling demand

In the current situation, raising interest rates to cool demand and hence inflation is not the best approach because the current inflationary pressures, especially in food and energy, have been driven mostly by supply chain shocks and the war in Ukraine. During the Covid-19 lockdowns, global manufacturers and suppliers were unable to properly create and distribute items to customers. More recently, sanctions imposed on Russia have also reduced the supply, mostly of goods, thereby disrupting prices. If these two points are established as the main reasons for the hike in prices, then taming demand (by raising the prices of goods and services) is not the right approach to resolving the inflationary pressures. Moreover, Nigeria's headline and food inflation are well above the monetary policy rate as evident from the chart, while raising the policy rate implies that the maximum lending rates remain elevated, hampering the cost of borrowing for sub-prime borrowers.



How then do we Resolve the Existing Challenges?

Supply-side inflation is very difficult to manage. In fact, the Fed as well as other central bank authorities mentioned that monetary policy is weak in solving supply shocks. Even though most of these central banks have gone against their word, it is evident that their responses have been driven by pressure to intervene in combating inflation. However, with supply shocks popping up from time to time, central banks would struggle to keep firm control of inflation. To solve this quagmire, Nigeria needs to look no further than the fiscal authorities to combat supply-side inflation. This is because markets are now less efficient, nations are economically separated, and employees are less able to traverse borders and, in certain situations, less easily accessible inside borders. Therefore, tightening monetary policy conditions when supply performance has worsened so dramatically would almost certainly worsen the problem.

As a result, fiscal policy must be deliberate about bringing down the burden of inflation, especially on the most vulnerable homes. Whether or not the government offers a net fiscal boost, fiscal policy can undoubtedly help achieve other goals that monetary policy cannot. By implication, the fiscal authorities can play three important roles in alleviating inflationary pressures. These roles include redistributing the pain caused by high inflation, interest rate hikes, and the economic downturn; limiting the possibility of a negative long-term consequence from the short-term economic slowdown; and increasing the country's productive capacity. Nigeria can implement these by adopting some of the existing policies in the UK, whereby the government targeted the most vulnerable homes and provided energy subsidies on their monthly bills due to higher energy rates, and they also cater to the bills of the poor and most vulnerable by providing shelter and unemployment allowances. By playing these roles, they are reducing the effects of rising inflation on the poorest and most vulnerable households in Nigeria.

A final note

Even though interest rate hikes remain the popular antidote for fixing inflation, in the current scenario, using an interest rate hike to combat inflation may trigger a recession because the challenges posed by inflation are more supply-side-driven than demand-driven. In summary, an increase in interest rates in an advanced economy like the US will always impact a developing country like Nigeria due to our large dependence on imports and the resulting outflow of capital from Nigeria, triggering pressures on foreign exchange and external reserves. As a result, the authorities will most likely continue to respond by increasing interest rates to keep attracting capital inflows into the economy. However as earlier mentioned, this tends to inhibit domestic growth since interest rates are already very high in Nigeria. The way to discover immediate and long-term solutions to inflation problems is to address issues that would improve the supply capacity of the country and pursue structural reforms that would aid the productive capacity of the Nigerian economy.