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Exchange Rate Volatility and its Effect on Inflation in Nigeria (Jan 2024 – April 2024)

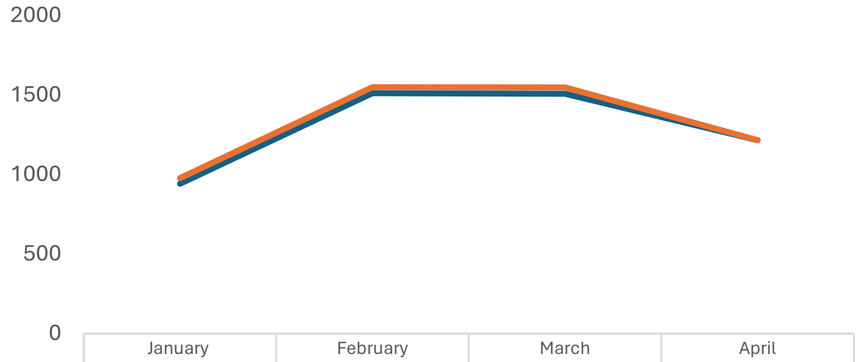
Most sub-Saharan African currencies have depreciated against the US dollar, exacerbating inflationary pressures across the continent as import prices surge. This, together with a growth slowdown, leaves policymakers with difficult choices as they balance keeping inflation in check with a fragile economic recovery[1].

Exchange rate policies in developing countries can be a source of sensitivity and controversy due to the structural changes they entail. These changes often involve reducing imports or increasing non-oil exports, which typically leads to a depreciation of the nominal exchange rate. These domestic adjustments are seen as harmful to the economy because of their immediate effects on prices and demand. Interestingly, developing economies that rely on imports for production and consumption rarely discuss the distortions caused by an overvalued exchange rate regime[2]. There appears to be a general consensus that devaluation or depreciation has the potential to increase domestic production by encouraging net exports. It is assumed that the rise in international competitiveness of domestic industries will result in a shift in consumer spending from expensive foreign goods to more affordable domestic goods.

However, this is usually not the case in Nigeria, where appetite for foreign goods has remained high over the years. Furthermore, in Nigeria, exchange rates significantly influence foreign travel, import payments, overseas remittances, and the daily price of commodities, among other factors. The economy is feeling the effects of the naira devaluation on trade, capital flows, inflation, and interest rates after recuperating from the shock of the naira re-design in February 2023[3]. External factors such as lower risk appetite in global markets, interest rate hikes in the United States, a decline in foreign exchange earnings, and a large budget deficit may contribute to the depreciations in Nigeria[4].

In the first quarter of 2024, the naira experienced significant volatility and depreciation against the USD, which has led to economic uncertainty, challenges for businesses, and rapid fluctuations in commodity prices. In the first quarter, food inflation changed rapidly alongside the USD. In January 2024, the exchange rate was an average of ₦942/USD, with food inflation at 35.41%. The exchange rate peaked in March, with an average of ₦1,507/USD, and food inflation reached an all-time high of 40% (Figure 1). This suggests that food prices increased significantly as the exchange rate surged, reducing the citizens' purchasing power as the minimum wage remained static at ₦30,000.

[1] https://www.imf.org/en/Blogs/Articles/2023/05/15/african-currencies-are-under-pressure-amid-higher-for-longer-us-interest-rates
[2] https://www.cbn.gov.ng/out/2012/ccd/cbn%20jas%20vol%202%20no%202_article%20one.pdf
[3] https://adfi-ci.org/currency-redesign-what-implication-does-it-have-for-socio-economic-development-in-nigeria/.
[4] https://www.imf.org/en/Blogs/Articles/2023/05/15/african-currencies-are-under-pressure-amid-higher-for-longer-us-interest-rates



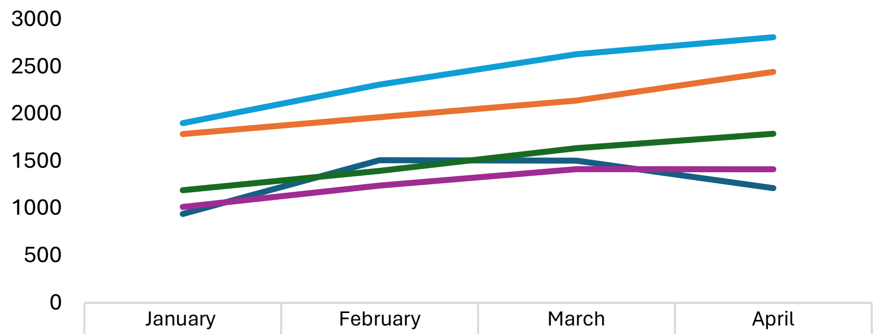
	January	February	March	April
Food Inflation Rate (Year on Change)	35,41	37,92	40,01	
Naira/USD	941,76	1 510,83	1 507,06	1 214,50

Figure 1: Exchange Rate and Food Inflation

Naira/USD

Source: Computed from Data on CBN Database (2024)

At the micro-economic level, food prices have also increased simultaneously with the dollar; for instance, the price of one mudu (0.66kg) of rice, one mudu (0.66kg) of beans, one mudu (0.66kg) of sugar, and a loaf of bread were about ₦1,700, ₦1,200, ₦1900, and ₦1000 in January, respectively, and about ₦2, 400, ₦1,800, ₦2,800, and ₦1400 in April. This indicates a surge of 27%, 33%, 32%, and 28% in the prices of rice, beans, sugar, and a loaf of bread, respectively. According to Figure 2, there was a 24% drop in the exchange rate between March and April 2024; however, the food price did maintain an upward trend, reflecting a 12%, 9%, and 6% increase in the price of one mudu (0.66 kg) of rice, one mudu (0.66 kg) of beans, one mudu (0.66 kg) of sugar, respectively. This suggests that other factors, such as the price of diesel, the road network, customs duties, etc., contributed to the price increase. Figure 3 shows a 15% surge in diesel prices from ₦1,153 in January to ₦1, 350 in April 2024. Diesel prices have an impact on the economy's production costs, transportation costs, input costs, and ultimately consumer prices.



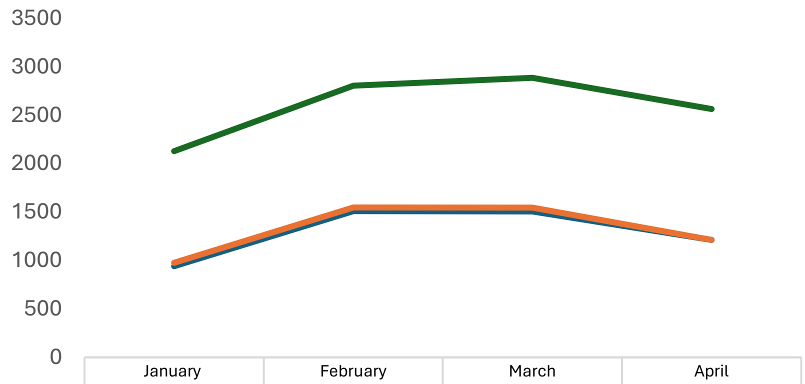
	January	February	March	April
US DOLLAR	941,76	1 510,83	1 507,06	1 214,50
Rice (one Mudu about 0.66Kg)	1 787,93	1 967,31	2 142,59	2 446,15
Beans (one Mudu about 0.66Kg)	1 193,10	1 396,75	1 637,50	1 791,07
Sugar (one Mudu about 0.66Kg)	1 903,57	2 312,96	2 631,48	2 812,96
A loaf of Bread	1 016,07	1 241,07	1 416,07	1 414,29

US DOLLAR
Rice (one Mudu about 0.66Kg)
Beans (one Mudu about 0.66Kg)
Sugar (one Mudu about 0.66Kg)
A loaf of Bread

Figure 2: Exchange Rate and Food Prices

Source: Computed from Data on CBN Database (2024)

Several factors have contributed to the fluctuation in the exchange rate in Nigeria, including falling oil prices, foreign exchange reserve depletion, and capital flight. The Nigerian government and central bank have implemented various measures to stabilise the currency and shore up foreign exchange reserves. These measures include foreign exchange interventions and efforts to diversify the economy away from oil dependence.



	January	February	March	April
Diesel	1 153	1 257,06	1341,16	1 350
Food Inflation Rate (Year on Change)	35,41	37,92	40,01	
Naira/USD	941,76	1 510,83	1 507,06	1 214,50

Naira/USD

Figure 3: Trend in Exchange Rate, Diesel Price, and Food Inflation

Source: Computed from Data on CBN Database (2024)

Various policies implemented over the period under review must have yielded some results, as the exchange showed signs of decline before reversing again (Figure 4). The naira appreciated against the dollar in April, gaining over 31%, from about ₦1,662/$ peak in February to about ₦1,150/$1 in April 2024. As the naira recovers, Nigerians expect a significant reduction in food and basic commodities prices, but this hasn't been the case with the cost of living still high. Despite the Naira's rebound, Nigeria's inflation rate jumped to 33.20% in March 2024 compared to the headline inflation rate in February 2024, which was 31.70%, representing an increase of 1.5% points[5].

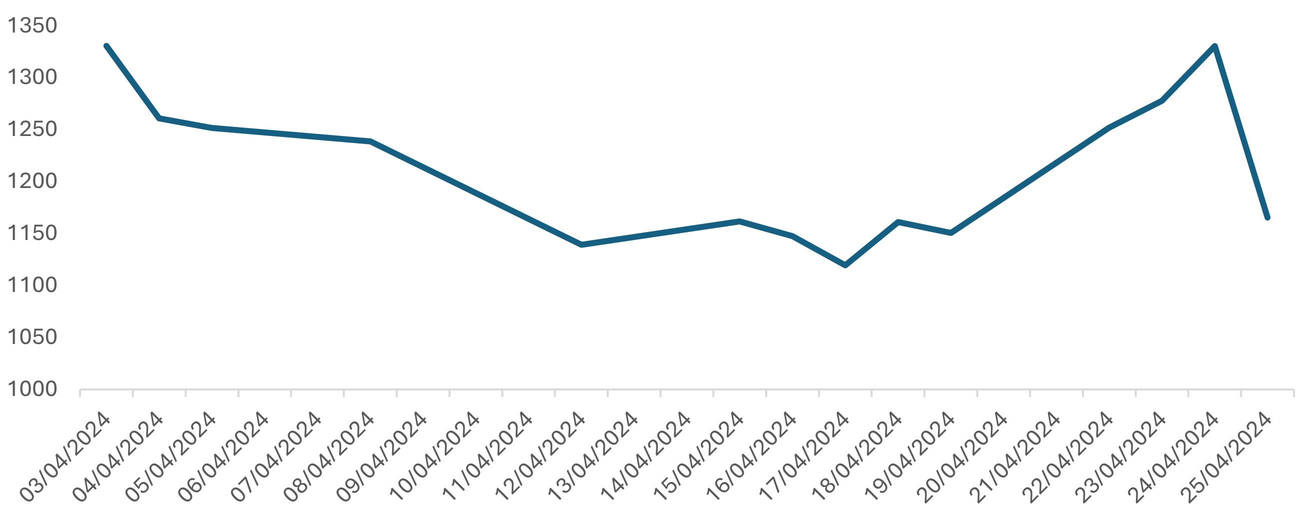


Figure 4: Trend in Exchange Rate April 2024

Source: Computed from Data on CBN Database (2024)

[5] The National Bureau of Statistics (NBS).

The Financial institutions in Nigeria are not left out of the macroeconomic effect of exchange rate fluctuation on the economy. Exchange rate increases contribute to growing production costs and commodity prices, increasing the demand for banking finance and impacting bank performance. It also increases economic uncertainty, loan spread, and non-performing loans (NPL). Exchange rate volatility directly affects bank performance since banks engage in foreign exchange-related operations, indirectly impacts the behaviour and performance of depositors and borrowers, and has a negative impact on banking risk and performance.
Furthermore, Prices surge will affect the contract pre-warded before the devaluation of the Naira, hence influencing completion time and surge in the cost of production. Investors may also be deterred from investing in the banks, given the uncertainty of the economy. Going forward, some measures can be put in place by stakeholders and the federal government to stabilize the economy:

- Adjustment of Interest Rate: To encourage foreign investment and strengthen the naira, the CBN may hike interest rates. Higher interest rates might make Nigerian assets more attractive to international investors, increasing demand for the naira.
- Foreign Exchange Market Interventions: By selling foreign currency reserves, the CBN could intervene in the foreign exchange market in order to increase the supply of Naira and depreciate its value relative to other currencies. This would aid in mitigating the depreciationary forces exerted on the naira.
- Tightening Monetary Policy: Monetary policy measures that the CBN could implement more stringently include increasing reserve requirements for banks or decreasing liquidity in the financial system. Stabilising the naira and reducing inflationary pressures would be the results of this.
- Fiscal Policy Measures: Implementing fiscal policy measures that improve the nation's economic fundamentals and reduce reliance on imports could be among the objectives of the Nigerian government. This may encompass strategies aimed at augmenting tax revenues, decreasing government expenditures, and enhancing domestic production.
- Structural Reforms: The government could implement structural reforms to mitigate fundamental economic disparities and foster sustained economic stability. Reforms to enhance the business climate, entice foreign investment, and diversify the economy away from oil dependence are all potential initiatives.
- Enhanced Exchange Rate Management: A more adaptable exchange rate regime, which permits greater exchange rate flexibility while maintaining stability, could be implemented by the CBN. One potential approach is to implement a managed float system, which operates under the condition that the exchange rate is determined by market forces with periodic interventions by the central bank to curb excessive volatility.
- Communication and Transparency: Relations between the CBN and the government concerning exchange rate interventions and policies could be made more transparent and communicative. Effective and consistent communication has the potential to enhance market confidence and mitigate ambiguity pertaining to the naira.

It’s important to note that stabilising the value of the naira requires a comprehensive and coordinated approach involving both monetary and fiscal policy measures, as well as structural reforms to address underlying economic challenges. Additionally, the effectiveness of these measures may depend on external factors, such as global economic conditions and commodity prices.