



Inflation Developments and the Inflation Targeting Framework

Inflation targeting is considered generally successful than other frameworks at improving coordination between monetary policy and other economic policies...

Background

Inflation has been a concern for a majority of countries over time. This has in turn given rise to various monetary policy regimes, namely; exchange rate targeting, monetary targeting, inflation targeting and monetary policy with an implicit nominal anchor. Each one of the regimes will be briefly discussed below.

Many monetary policy regimes that have been adopted have had a problem of clearly establishing a nominal anchor. Defining a nominal anchor is the technique of fixing a nominal variable in the economy as a means of reducing inflation. For example, by pegging a nominal exchange rate, a monetary authority restricts its own ability to expand the money supply.

Exchange rate targeting is a regime in which a domestic currency is fixed or anchored to some commodity. In the past some countries fixed the value of the local currency to gold, but in recent times the local currency is usually anchored to some large, stable and low inflation country's currency. In the same regime an alternative is to adopt a crawling peg with an allowance of a set limited fluctuation below and above the

anchor. There is documented measurable success of this method, though its main problem is that it results in the loss of discretion in the conduct of monetary policy.

The monetary targeting framework is based on the chosen monetary aggregate that has a close relationship with inflation, for instance M2. The major weakness of this approach is that if the chosen monetary aggregate does not map the movement in inflation, achieving the target will not produce the desired outcome on the goal variable.

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Eclectic monetary policy involves an implicit conduct of monetary policy that is considered an expression of concern over inflation. It involves forward looking

behaviour in which there is constant monitoring for signs of future inflation coupled with periodic policy action against the threat of inflation.

Inflation targeting involves various elements namely; public announcement of the medium-term numerical inflation target, institutional commitment to price stability, information inclusive strategy, with less emphasis on intermediate targets, and increased accountability of the central bank in achieving the inflation target.

In the presence of various regimes many countries have resorted to the adoption of inflation targeting since the 1990s.

Inflation Targeting Framework

Inflation targeting regime was first adopted by New Zealand in 1990, followed by Canada in 1991, the United Kingdom in 1992, Sweden in 1993 and Australia in 1994. This highlights that the framework was initially adopted by developed countries. Developing countries adopted the framework subsequently. South Africa in particular, adopted the framework in 2000.

The intention of a country to pursue the inflation targeting framework should be backed by some element of freedom in the conduct of the policy. The targeted inflation is generally set by the government in consultation with the central bank, but more importantly the central bank must be awarded instrument independence.

Instrument independence implies that the central bank has the right to choose and set the policy instrument. The foregoing therefore implies that although the central bank has instrument

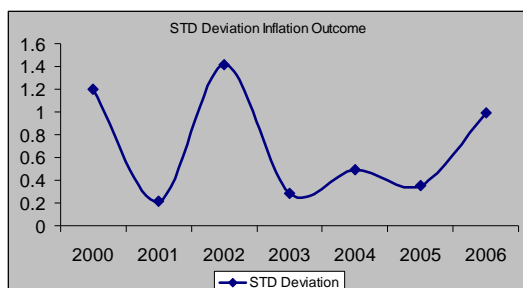
independence, it does not have goal independence. The effectiveness of the framework is with the understanding that the pass-through between interest rates which is a tool for inflation control is estimated between 12 and 24 months.

Inflation Convergence between SA and Lesotho

The Common Monetary Area (CMA) for Southern Africa started far back in 1961 with the informal monetary union with the Pound Sterling circulating as the common currency. Further developments took place in 1974 with the signing of the treaty on Rand Monetary Area (RMA) between South Africa, Botswana, Lesotho and Swaziland. In 1976 Botswana withdrew from the treaty, and in 1986 the RMA was formally changed into the CMA. Namibia joined CMA in 1992 after its independence from South Africa. The CMA agreement is a pact that there will be free movement of capital among member countries and the Rand will be legal tender alongside respective national currencies. In addition, South Africa compensates other members for loss of seignorage. This meant that inflation developments in Lesotho and other CMA countries would closely follow those of South Africa.

In this context, price developments in Lesotho should be expected to follow those of South Africa closely. Figure 1 traces absolute inflation convergence between the two countries using the standard deviation. The analysis indicates a clear pattern where the two rates show co-movement.

Figure 1



It is however observable that there are periods of divergence associated with the massive depreciation of the Rand during some periods. There are also periods of convergence.

It is therefore vital for Lesotho to draw policies to counter any shocks. It is argued that Lesotho has two issues of concern. First, the increase in inflation rate itself in the light of the recent developments in April 2007. Any persistence in this trend is an obvious threat to livelihoods and macroeconomic stability. Second, divergence from the two rates as South Africa is used as an anchor state in this regard. Divergence might affect Lesotho's investor perception and long term capital flows.

Inflation Developments in Lesotho and South Africa

The inflation outturn in South Africa as depicted in the Table 1 indicates that since the adoption of the inflation targeting framework, inflation rate has on average declined over time, and remained within the target band. A similar trend is observable in Lesotho though it is not as explicit.

The observed downward trend was however constantly threatened by depreciation of the Rand that started in 2001, and variability in the prices of oil and food sub-categories.

Table 1: South Africa and Lesotho experience with Inflation (Percent)

Year	Target (CPIX)	Average Inflation Outcome in SA (CPIX)	Average Inflation Outcome in Lesotho
2000	N/A	7.8	6.1
2001		6.6	6.9
2002	3-6	9.3	11.3
2003	3-6	6.8	7.2
2004	3-5	4.3	5.0
2005	3-6	3.9	3.4
2006	3-6	4.6	6.0

Source: www.statssa.org and Bureau of Statistics Lesotho, CPIX is inflation for metropolitan areas excluding mortgage interest costs

The latter sub-category has also been blamed for the recent increases in inflation. The latest monthly Inflation figures (April) are higher than expectations. The rate of inflation exceeded the target band in April 2007 for the first time in three years when CPIX, which is the target variable, registered a monthly rate of 6.3 percent. For Lesotho, this is an undesirable outcome as Lesotho imports more than 70 percent of its inflation from South Africa.

Lesotho's inflation rate for April jumped from 5.9 percent in March to 8.1 percent in April. This jump is blamed on the double increase in the pump price of fuel which was estimated at around 16 percent for petrol, 6 percent for diesel and 10 percent illuminating paraffin on quarterly basis. The latter is used by the majority of households for cooking and heating in Lesotho.

Lesotho's inflation is influenced by price developments in South Africa and domestic interest rates track those in South Africa, with Lesotho's prime rate higher than its South African counterpart reflecting the risk premium.

Conclusion

There is no direct solution to the current challenge since Lesotho does not have a direct tool to control external price developments. However in the context of a fixed exchange rate regime with limited discretion on monetary policy, it

is prudent to guard on the sufficient level of reserves to maintain the value of the currency and the peg. On the domestically generated inflation there is a possibility of managing expectations by reducing the frequency of changing and adjusting administered prices.

2. Persistent Increase in International Oil Prices: Implications for Lesotho

International crude oil prices continued to rise during May. This increase was amid both the demand and supply concerns evident in international markets. On average, the price of Brent crude oil increased by 1.7 per cent from US\$63.35 per barrel in April to US\$64.42 per barrel in May. It ranged between a minimum and maximum of US\$61.84 and US\$64.71 per barrel in May, compared with US\$61.89 and US\$66.74 per barrel in April, respectively.

International oil prices increased in response to, among others, the persistent expansion in oil consumption in China and India. Furthermore, uncertainties in Iraq and elsewhere in the Middle-East also continued to exert upward pressure on the international oil prices. In addition, continued violence in the Nigerian oil-producing region contributed to market fears about potential supply shortages.

Figure 2: International oil price movements during May 2007 (US\$/barrel)

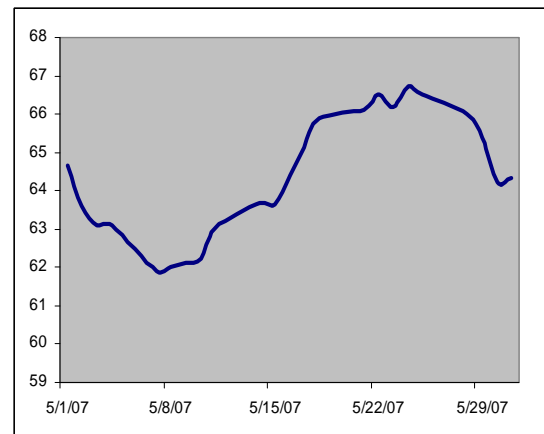


Figure 2 depicts that throughout the month of May, international oil prices generally remained high. This upward trend has been persistent even in the previous months.

As a consequence of higher international oil prices during the first quarter of this year, fuel prices in Lesotho continued to be revised upwards in February, April and May.

Table 2: Lesotho Fuel Price Changes

<i>Date</i>	<i>Petrol</i>	<i>Diesel</i>	<i>Paraffin*</i>
23-Feb	M5.45	M6.10	M4.00
1-April	M5.70	M6.20	M4.15
17-April	M6.35	M6.50	M4.40
11-May	M6.70	M6.75	M4.60

Source: Lesotho Petroleum Fund, May 2007

*Illuminating paraffin

Prices of oil products in Lesotho closed the review month higher at M6.70 per litre of petrol, M6.75 per litre of diesel

and M4.60 per litre of illuminating paraffin. These compare with M6.35 per litre of petrol, M6.50 per litre of diesel and M4.40 per litre of illuminating paraffin at the end of April.

Persistent increase in international oil prices and hence upward revision of fuel prices in Lesotho does not augur well for the economic prospects of the country in terms of higher inflationary pressures.

3. Regional Economic Outlook: *Sub-Saharan Africa*

For the third year in succession, Sub-Saharan Africa (SSA) recorded economic growth rate in the range of 5 – 6 per cent...

Economic Developments in 2006

The International Monetary Fund (IMF) recently released the Regional Economic Outlook for Sub-Saharan Africa (SSA). The report highlighted that for the third year in a row, SSA recorded economic growth rate in the range of 5 to 6 per cent. Economic growth in 2006 remained robust at 5.4 per cent, following growth rate of 6 per cent in 2004 and 2005. Growth in the region was supported by both domestic investment and government spending on the back of higher oil revenues and debt relief initiatives. Furthermore, a healthy global environment in 2006 raised the demand for the region's exports.

Inflation in the region remained subdued in 2006 due to prudent macroeconomic policies and generally a good harvest. In aggregate, inflation rate (excluding Zimbabwe) decelerated to 7.2 per cent in 2006 from 8.1 per cent in 2005. This

was despite persistently higher international oil prices.

The reserve position in SSA improved markedly on the back of strong capital flows. On average, the region (excluding South Africa) managed to raise the import cover to about 6.2 months of imports in 2006.

SSA's external debt continued to decline in 2006 due to comprehensive debt relief from the enhanced Heavily Indebted Poor Countries (HIPC) Initiative. Consequently, debt in SSA (excluding South Africa) declined to 24 per cent of GDP. Usually, investors' confidence in the region is usually boosted by economic performance, the commodity boom and debt relief. Net foreign direct investment (FDI) (excluding South Africa) nearly doubled since 2002 to US\$18 billion in 2006. A large proportion of FDI was attracted by oil-producing countries (OPC).

The report also indicated that food security has also improved in the region as a result of a good harvest in 2006. However, floods and outbreaks of diseases, high inflation rate and exchange rate shortages, poor agricultural policies, and climate change in some parts of countries in the region are threatening food security.

Prospects for 2007

Economic growth in SSA is projected to accelerate from 5.4 per cent in 2006 to 6.7 per cent in 2007 largely emanating

from oil-producing countries. Inflation rate (excluding Zimbabwe) is expected to decelerate to 7.1 per cent in 2007. However, in Zimbabwe, inflation is expected to accelerate further to 3,000 per cent.

Positive economic outlook for SSA augurs well for the economy of Lesotho. This could enhance the product and market diversification initiative by the Government. However, the risk of higher inflation is still eminent due to high international oil prices and food security risks.

**Table 3: Sub-Saharan Africa: Selected Indicators, 2004 - 2007
(Annual Percent)**

	2004	2005	2006*	2007+
<i>Percentage Changes</i>				
Real GDP	6.0	6.0	5.4	6.7
Of which Oil exporters ¹	8.7	7.9	5.6	11.6
Of which Oil importers	5.2	5.4	5.3	5.2
Consumer Prices (average) ²	6.1	8.1	7.2	7.1
Of which Oil exporters	12.5	13.2	7.7	6.6
Of which Oil importers ²	4.3	6.7	7.1	7.3
<i>Per cent of GDP</i>				
Exports of goods and services	36.0	39.3	42.1	40.6
Imports of goods and services	34.6	35.9	38.8	39.6
Fiscal Balance (including grants)	-0.4	1.5	4.1	-0.1
Current Account Balance	-1.8	-0.6	-0.6	-1.7
Reserves (in months of imports) ³	4.9	5.3	6.2	6.8

SOURCE: IMF Regional Economic Outlook April 2007: *Sub-Saharan Africa*

Notes: ¹includes Angola, Cameroon, Chad, Republic of Congo, Cote d'Ivoire, Equatorial Guinea, Gabon and Nigeria

²Excluding Zimbabwe

³Excluding South Africa

*Estimates

+Projections

4. Monetary Policy Operation Report for May 2007

The CBL's objective of maintaining price stability in the present policy framework is attained through the maintenance of an adequate level of foreign reserves and fighting domestically generated inflation. The objectives of the operations were:

- (i) to attain a reserve money target of between M200m and M250m;
- (ii) to ensure that the discount rate on GOL treasury bills moves in line with regional interest rates movements; and
- (iii) through (i) and (ii), to attain the minimum required NIR target of

\$450.0 million for the review period.

Table 4 shows amounts auctioned and discount rates that prevailed for each of the auctions. The level of competitiveness in the market, as estimated by the number of participants in an auction, increased during the auction. The recent auction saw a participation level of 8 bidders who submitted 27 bids for the auction and all bidders became partially successful. There were 18 successful bids against 7 bids that were observed in the previous auction.

Table 4: Treasury Bill Auctions

Type of Security	Auction Date	Maturity Date	Auction Amount (million)	Amount Issued (million)	Discount Rate	RSA Disc. Rate
91-day TBs	01 Nov 2006	01 Feb 2007	M170.0	M170.0	6.76%	8.20%
182-day TBs	08 Nov 2006	11 May 2007	M50.0	M16.5	7.00%	8.48%
91-day TBs	29 Nov 2006	02 Mar 2007	M170.0	M170.0	6.76%	8.41%
91-day TBs	03 Jan 2007	05 Apr 2007	M160.0	M160.0	7.02%	8.49%
182-day TBs	09 Jan 2007	13 Jul 2007	M50.0	M50.0	7.30%	8.58%
91-day TBs	31 Jan 2007	04 May 2007	M170.0	M170.0	7.30%	8.87%
91-day TBs	28 Feb 2007	01 Jun 2007	M170.0	M170.0	7.46%	8.41%
182-day TBs	06 Mar 2007	07 Sep 2007	M20.0	M20.0	7.46%	8.35%
91-day TBs	03 Apr 2007	06 Jul 2007	M160.0	M160.0	7.49%	8.27%
91-day TBs	02 May 2007	03 Aug 2007	M170.0	M170.0	7.50%	8.32%
182-day TBs	08 May 2007	09 Nov 2007	M50.0	M30.2	7.45%	8.38%
Total for reporting period			M220.0	M200.2		

Although the Lesotho 91-day treasury bill continued to increase in May, it was still below its SA counterpart rate. The Lesotho 91-day treasury bill increased by one basis point to 7.50 per cent. The counterpart SA rate also rose from its

previous level of 8.27 per cent in April to 8.32 per cent in May. Hence, the margin between the two rates widened from 78 basis points to 82 basis points at the end of the review period, as depicted in figure 3 below.

Figure 3. Measuring the Success of Monetary Policy Objectives:

Performance of Lesotho 91-Day T-Bills vs RSA T-Bills

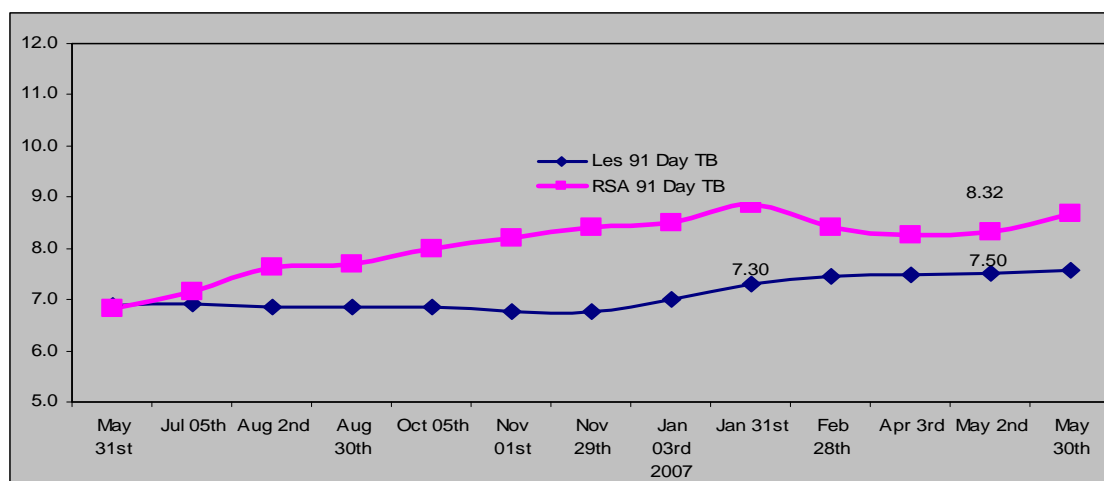


Table 5. Selected Monetary and Financial Indicators+`

	2007		
	Mar	Apr	May
1. Interest rates (Percent Per Annum)			
1.1 Prime Lending rate	13.58	13.67	13.67
1.2 Prime Lending rate in RSA	12.50	12.50	13.00
1.3 Savings Deposit Rate	2.68	3.01	3.01
1.4 Interest rate Margin(1.1 – 1.3)	10.90	10.66	10.66
1.5 Treasury Bill Yield (91-day)	7.46	7.49	7.50
2. Monetary Indicators (Million Maloti)			
2.1 Broad Money (M2)	3724.7	3788.3	3621.95
2.2 Net Claims on Government by the Banking System	-2275.2	-2977.1	-2710.10
2.3 Net Foreign Assets – Banking System	7159.2	8014.3	7476.49
2.4 CBL Net Foreign Assets	5326.8	6013.5	5680.84
2.5 Domestic Credit	-1280.4	-1956.3	-1673.25
2.6 Reserve Money	409.8	455.4	470.42
3. Spot Loti/US\$ Exchange Rate (Monthly Average)	7.3571	7.1151	7.0142
4. Inflation Rate (Annual Percentage Changes)	5.9	8.1	7.6
5. External Sector (Million Maloti)	2006		2007
	QIII	QIV	QI
5.1 Current Account Balance	151.78	18.50	709.50
5.2 Capital and Financial Account Balance	-23.94	-81.15	178.50
5.3 Reserves Assets	-641.50	-32.81	-1023.89

+These indicators refer to the end of period. Prime and deposit (savings) rates are averages of all commercial banks' rates operating in Lesotho. The Statutory Liquidity Ratio in Lesotho is 25 percent of commercial banks' short-term liabilities.