



## Economic Review

July 2008

### “FFF” Conundrum: The Effects of Rising Prices of Fuel, Food and Finances.

*The world is experiencing rising fuel prices, whose consequences are felt in all sectors of economies, with more on food prices. This is particularly so, due to the intermediary role played by fuel in production process. In response cost of finances is rising. What is the implication .....*

#### Background

The world is experiencing rising fuel prices which are, to some extent, attributable to geopolitical tensions in the oil producing countries. Oil price has almost doubled over the past year and has broken through the \$100 level at the start of the year.

As a result, petroleum products' prices have also been rising, with the price of petrol trading at M10.40 per litre in July, up from M8.65 in April 2008. There has been a M3.20 increase since January 2008. The worst hit is the urban poor who depend on paraffin for domestic use (cooking, lighting and heating). Road transport fares were also revised in April in response to surging oil prices (See April 2008 Economic Review for details). It is anticipated that the road transport board will again revise prices upwards, on fear that some transport operators might be forced out of business.

#### The Impact of Fuel Prices on Food Prices

Since fuel is one of the intermediaries in the production processes, the overall corollary has been the increase in

#### INSIDE

2. Multilateral Institutions' Response to the Rise in Food and Fuel Prices.....4
3. Monetary Policy Operations.....6
4. Selected Monetary and Financial Indicators .....8
5. Selected Economic Indicators ....8

commodity prices, with food inflation rising faster. It should be highlighted that agricultural inputs are produced from petroleum products. This is reflected by the rising price of fertilisers and other inputs.

It is also acknowledged that the agricultural sector is mechanising to cope with the current developments. Therefore, the rising fuel prices impact on productivity as some farmers fail to use the relevant technology which is, in turn, translated into high food prices. In addition, unfavourable climatic conditions affected food production negatively in recent years, leading to supply shortages. In an effort to develop alternatives to crude oil, Scientists have

also engaged in production of biofuel. This has created more demand – supply imbalances in the food industry, resulting in further increases in food prices, especially cereal prices.

Although it is more efficient and less pollutant, biofuel production leads to shortage of food, and thus contributes to the general price increase. This biomass energy production poses a threat of diverting agricultural production away from food crops in countries experiencing food shortages. This leads to increasing food prices and possible mass starvation in the poor countries.

### The Impact due to Climatic Conditions

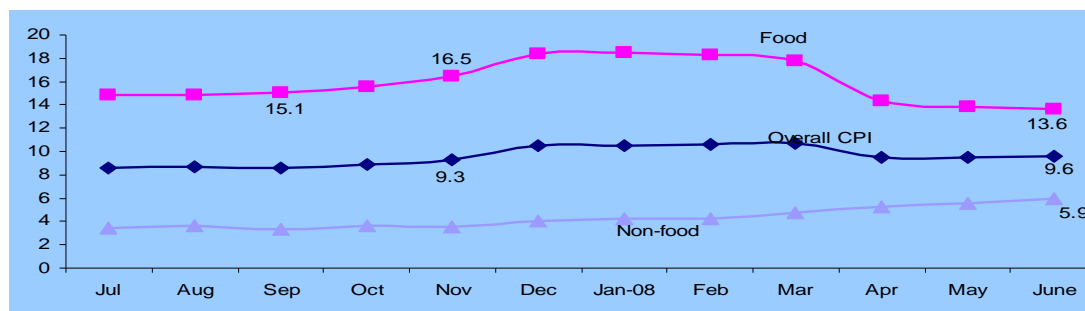
The Southern Hemisphere is facing more challenges to cope with demand for food. One such a challenge is the prolonged drought experienced in

Southern Africa, which is worsening the already poor state of affairs.

According to a report produced by the Food and Agricultural Organisation (FAO) and World Food Programme (WFP) in June 2007, Lesotho was faced with a shortfall of about 42 per cent in cereal production. A large proportion of this would be imported commercially. Indeed, that was reflected by 21.0 per cent increase in imports from the second quarter to the third quarter of 2007. If sustained, this has potential to worsen the current account balance.

Although agriculture used to be the backbone of Lesotho's economy, its importance has been surpassed by that of other sectors, as reflected by its declining contribution to national output. Accordingly, unemployment is also rising, fuelled by, among others, retrenchment of migrant mineworkers.

**Figure 1: Lesotho's Inflation**



**Source: Bureau of Statistics**

### The Impact of Food Prices on Inflation

The food inflation component registered a double digit figure in June 2006, and has since maintained the upward trend, peaking at 18.5 per cent in January 2008. Food has the largest weight of 39.8 per cent in overall consumer price index (CPI). Therefore, a slight movement in food components drives the overall inflation movement. It is shown in figure 1 above that the CPI

moves in tandem with the food component.

### Response by Monetary Authorities

High inflation is one of the worst enemies of the economy. Monetary authorities use different instruments to fight inflation, while at the same time

preserving sustainable economic growth. Interest rate is one such instrument at the disposal of the authorities to fight inflation. It is a primary tool for controlling the supply and velocity of money in an economy.

This is evident in central banks that target inflation. The high and rising inflation is often associated with high interest rates. It is noted in the previous sections that Southern Africa is a victim of food shortages, and rising fuel prices. This is shown by the increase in inflation rate that reached more than a five year high in the Common Monetary Area (CMA) during the period under review. In response, official interest rates in South African (SA) have gone up by 5 percentage points since June 2006, adding to the stress on households' finances.

The rising official interest rates are translated into higher cost of credit to the private sector. Cost of finances is higher in Lesotho relative to the other CMA member states. The rising interest rates make it even more difficult for Basotho to access finances and, to some extent, compromise growth. It becomes more expensive to supplement the falling purchasing power, hence the increase in default rates. This claim is substantiated by a decline in general residential property market, which is more pronounced in SA. According to some indicators, the second quarter of 2008 saw the index slumping to its lowest level since its inception in the fourth quarter of 2003.

In view of that, an overall slowdown in consumer spending was observed in June 2008. This was consistent with credit extension which slowed down during the period. However, household debt as a ratio of disposable income increased from 77.6 per cent to 78.2 per cent due to the high interest rates, while

debt service cost to disposable income rose from 10.9 per cent to 11.3 per cent.

## **Conclusion**

It is observed from the above discussions that the rising fuel prices and the apparent demand – supply imbalances in the food industry contribute to high inflation rate. As a result, Central Banks are often caught up in a dilemma to control inflation through raising interest rates. Interest rates are raised to curb demand pull component of inflation. This response to inflation developments has the same bearing as the rising prices on consumers in the short-run. They both squeeze disposable income, leading to a fall in aggregate demand and high default rates in some instances.

The use of interest rates to curb inflation is very delicate; therefore, a number of considerations need to be brought forth before its implementation. Currency stability is dependent on its use to curb capital flight, while investment spending is inversely proportional to interest cost. It is, therefore, important to have the right prescription in place. The apparent rising prices are explained by all types of inflation (mainly built-in inflation) which are sensitive to different policy actions. It is, however, acknowledged that the culprit to most of this is mainly the rising fuel prices, which is compounded by food shortages.

## 2. Multilateral Institutions's Response to the Rise in Food and Fuel Prices

*Multilateral organizations have responded to the threat to food security and poverty reduction that the surge in food and fuel prices is posing .....*

### Introduction

International organizations including the International Monetary Fund (IMF), the World Bank, the United Nations (UN) through the Food and Agricultural Organization (FAO) and the Southern African Development Community (SADC) have invented programmes for supporting countries in easing the negative effects of high food and fuel prices. It is believed that the current surge in food prices may offset some of the gains towards the achievement of the Millennium Development Goals (MDGs). The assistance offered by these institutions is mainly in the form of financial support, policy advice and provision of financial instruments for managing the weather related risks that the agricultural sector is susceptible to.

### Financial Support

The IMF, the World Bank and the FAO have allocated financial resources for access by countries that have been hit hardest by the surge in food and fuel prices.

The IMF is assisting countries to deal with Balance of Payments (BOP) problems that arise as a result of the hike in food and fuel prices. The IMF has always been providing financial assistance to countries facing BOP

difficulties through the Poverty Reduction and Growth Facility (PRGF) programme. For purposes of assisting countries that are badly affected by the price increases, the IMF is providing augmentations of PRGF arrangements for countries that are having PRGF-supported programmes. Moreover, the IMF is in the process of revising the Exogenous Shocks Facility (ESF) to moderate its stringent conditions so that it could be used to assist countries that do not have a PRGF programme but face BOP difficulties as a result of an exogenous shock like the current surge in food and fuel prices.

For a country to qualify for this financial support, it should be eligible for assistance under the PRGF and also be faced with a BOP need caused primarily by an exogenous shock. The current soar in food and fuel prices is likely to have increased the food and fuel import bill for Lesotho. Nevertheless, the current account balance of the BOP for Lesotho is in surplus and the international reserves are currently around 7 months of imports coverage as indicated in Table 1 below. The strong performance of exports appears to have cushioned Lesotho's BOP position from the negative impact of the increase in these prices.

**Table 1: Current Account balance and Import Coverage**

Period	2007QI	2007QII	2007QIII	2007QIV	2008QI	2008QII
CAB in million Maloti	694.68	36.83	440.15	328.39	506.26	851.16
Reserves in Months of Imports	6.7	6.6	7.5	7.7	7.2	7.4

*Source: Central Bank of Lesotho*

The World Bank has established the Global Food Crisis Response Programme (GFCRP) under which Bank members and non-members, that the Bank has interest in assisting, who are adversely affected by food and fuel price increases will be eligible to access up to \$1.2 billion. This includes \$200 million of grant funding aimed at providing relief to “the most fragile, poor and heavily impacted countries” with no alternative sources of financing to meet their immediate needs. Each country can access up to \$10 million out of this grant funding. The remaining funds in the

GFCRP would be availed to countries in the form of loans and credits.

Lesotho could benefit under the GFCRP. Domestic food production in Lesotho has deteriorated significantly over the years due to, among other things, drought that has devastated this country for a very long time; inappropriate farming practices; lack of proper irrigation facilities and, to some extent, lack of funds to purchase the necessary agricultural inputs. As a result, the number of food insecure people in Lesotho is very high.

**Table 2: The Number of Food Insecure People in Lesotho**

	2003/04	2004/05	2005/06	2006/07	2007/08
Food Insecure Population	270,000	948,300	541,000	245,700	553,000
% of Total Population	15.0	52.3	30.1	13.7	30.7

*Source: SADC (2008), Background Paper on Measures to Reduce Current and Future Food Crises in the SADC region.*

The FAO has allocated some funds for the provision of productive safety nets including boosting agricultural production by small farmers. In addition, improved agricultural inputs would be provided and the technical knowledge of farmers improved. To boost production and ensure sustained increase in food production the national seed distribution systems would be strengthened to enhance access to quality seeds by farmers. Crop and livestock losses would be reduced by addressing deficiencies and constraints in post-production handling of food including storage, distribution and preservation.

The FAO (April 2008) classifies Lesotho among 37 countries that are in crisis due to food insecurity and require external assistance. The FAO assistance could address the immediate needs resulting from the food crisis and also promote sustainability of food production in Lesotho.

### **Risk Management**

To enable food producers to hedge their finances against severe weather events, the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA) will offer index-based weather derivatives. The World Bank will act as an intermediary. Clients, whose agricultural produce is adversely affected by severe weather conditions, will get a payout from the Bank.

Agricultural production in Sub-Saharan Africa is inherently risky due to the poor quality of soil and high dependence on rainfall as well as lack of the necessary means for controlling animal and crop diseases, to name a few. Consequently, farmers sometimes experience substantial income losses. Thus, the World Bank’s intermediation could be useful in terms of reducing weather related losses by farmers.

Agricultural production in Lesotho is mainly subsistence in nature and commercial farming is done by only a few farmers and on a small scale. As such the agricultural sector may not be able to take advantage of this risk management opportunity.

### **Policy Advice**

In recognizing the importance of appropriate policy responses to food price hikes, these multilateral organizations have allocated some funds for policy analysis and policy advice. This is to enhance understanding of the implications and overall costs of policy measures undertaken by countries to mitigate the effects of food price increases. Countries have implemented different measures in response to food and fuel price increases.

The importance of this type of assistance arises from the fact that while some of the policy responses adopted by countries could be effective, some could do more harm than good. For example, some countries reduced tax rates and increased price subsidies. While these measures may present serious fiscal challenges, they may not be very efficient and are not well targeted. Reducing one tax rate without increasing some other source of government revenue implies more pressure on the fiscal position. This may reduce the gains from fiscal and

structural reforms and put countries at risk of running unsustainable fiscal and debt positions. In addition, not only the poorest and most vulnerable could benefit from these types of measures but even the affluent because tax reductions and subsidies accrue to everyone.

The Southern African Development Community (SADC) region is facing a situation of food insecurity as a result of stagnation in food production in the region. The recent rapid increase in food and fuel prices is presenting more challenges to the region. SADC has produced a document outlining measures that its member countries could implement to ease food insecurity as well as the rise in food prices.

Some of the measures proposed by SADC are mainly aimed at increasing food production in the region. Farmers' access to agricultural inputs and farm machinery and as well as to credit to meet the agricultural financial requirements should be increased. In addition, there is a need to address the immediate needs of the part of the population which is most vulnerable to food insecurity. This could be addressed through the establishment or enhancement of food safety nets, for example, food assistance and cash transfer programs. Measures should also be taken to strengthen disaster preparedness including strengthening early warning systems and establishing a regional food reserve facility.

### **3. Monetary Policy Operations for July 2008**

This article reports economic and operational issues surrounding the monetary policy operations conducted in July 2008. The Bank issued government securities in response to liquidity conditions that prevailed in the economy. Following the assessment made on the sources of liquidity, M150

million worth of securities were offered during the auction. Table 3 below shows amounts auctioned and discount rates that prevailed for each of the auctions. In addition to the 91-day treasury bills issued, a 182-day treasury auction worth M25.0 million was held.

The level of competitiveness in the market is estimated by the number of participants and bids as reflected in Table 3 below. The recent auction saw a participation level of 6 bidders who

submitted 18 bids. This was the same as May's figure of 6 bidders. All bidders became partially successful and 10 bids were successful against 11 that were successful in the previous auction.

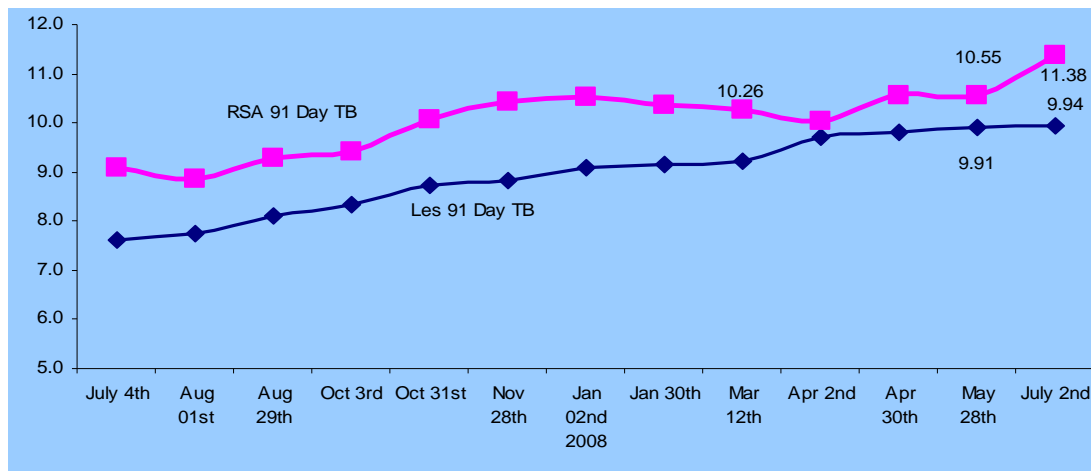
**Table 3: 91 and 182 Day Auctions of Treasury Bills**

Type of Security	Auction Date	Maturity Date	Auction Amount (million)	Amount Issued (million)	Discount Rate
91-day TBs	02-Apr-08	02-Jul-08	M150.0	M150.0	9.71
91-day TBs	30-Apr-08	1-Aug-08	M150.0	M150.0	9.81
182-day TBs	07-May-08	7-Nov-08	M30.0	M30.0	10.45
91-day TBs	28-May-08	29-Aug-08	M150.0	M150.0	9.91
91-day TBs	02-July-08	02-Oct-08	M150.0	M150.0	9.94
182-day TBs	09-July-08	09-Jan-08	M25.0	M25.0	10.70
<b>Total for reporting period</b>			M175.0	M175.0	

Success of the CBL in achieving its monetary policy objectives could also be assessed by monitoring the movement of the intermediate target (treasury bill rate) against trends in the region. A

successful policy would result in a treasury bill rate that moves in line with comparable rates in the region, given the free movement of funds within the CMA region.

**Figure 2: Performance of Lesotho 91-Day T-Bills vs RSA T-Bills**



As Figure 1 shows, the Lesotho 91-day treasury bill rate remained below its SA counterpart rate in July. The Lesotho 91-day treasury bill rate rose marginally to 9.94 per cent, from 9.91 per cent on

28 May. The counterpart SA rate rose by 83 basis points to 11.38 per cent during the same period. Consequently, the gap between the two rates widened to 144 basis.

**Table 4: Selected Monetary and Financial Indicators**

	2008		
	April	May	June
<b>1. Interest rates (Percent Per Annum)</b>			
1.1 Prime Lending rate	15.92	15.92	16.25
1.2 Prime Lending rate in RSA	14.50	15.00	15.50
1.3 Savings Deposit Rate	4.57	4.84	5.04
1.4 Interest rate Margin( 1.1 – 1.3)	11.35	11.08	11.21
1.5 Treasury Bill Yield (91-day)	9.08	9.81	9.91
<b>2. Monetary Indicators (Million Maloti)</b>			
2.1 Broad Money (M2)	4591.71	4626.55	4909.50
2.2 Net Claims on Government by the Banking System	-4049.23	-3741.15	-3531.18
2.3 Net Foreign Assets – Banking System	10151.90	9746.02	9431.07
2.4 CBL Net Foreign Assets	7400.80	7205.83	6638.62
2.5 Domestic Credit	-2689.44	-2325.60	-2059.84
2.6 Reserve Money	489.40	617.67	521.45
<b>3. Spot Loti/US\$ Exchange Rate (Monthly Average)</b>	<b>7.7769</b>	<b>7.6179</b>	<b>7.6707</b>
<b>4. Inflation Rate (Annual Percentage Changes)</b>	<b>9.5</b>	<b>9.5</b>	<b>9.6</b>
<b>5. External Sector (Million Maloti)</b>	<b>2007</b>		<b>2008</b>
	<b>QIII</b>	<b>QIV</b>	<b>QI</b>
5.1 Current Account Balance	440.15	328.39	517.63
5.2 Capital and Financial Account Balance	248.60	-83.21	310.40
5.3 Reserves Assets	-870.86	-116.19	-774.19

+ 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

**Table 5: Selected Economic Indicators**

	2004	2005	2006	2007+
<b>1. Output Growth( Percent)</b>				
1.1 Gross Domestic Product – GDP	4.2	2.9	7.2	5.1
1.2 Gross National Product – GNI	7.9	5.5	3.1	4.9
1.3 Per capita –GNI	7.9	5.5	3.1	4.0
<b>2. Sectoral Growth Rates</b>				
2.1 Agriculture	-1.9	-1.7	1.7	-39.3
2.2 Manufacturing	2.1	-8.6	10.5	11.0
2.3 Construction	-4.4	-3.4	0.6	3.5
2.4 Services	2.1	4.1	6.6	6.3
<b>3. External Sector – Percent of GNI</b>				
3.1 Imports of Goods	86.3	83.1	80.1	86.5
3.2 Current Account	-4.7	-5.7	3.5	9.5
3.3 Capital and Financial Account	5.8	3.6	0.7	8.2
3.4 Official Reserves (Months of Imports)	5.2	5.5	6.7	7.6
<b>4. Government Budget Balance (Percent of GDP)</b>	<b>5.7</b>	<b>4.8</b>	<b>11.8</b>	<b>5.3</b>

\* Preliminary estimates

+CBL Projections