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THE ECONOMIC IMPACT OF TEMPORARY PRICE CONTROLS ON BREAD

The Ministry of Trade and Industry, Cooperatives and Marketing (MTICM) sets temporary price controls on the price of bread…

1.Background

There has emerged a growing concern in the bread industry, following an outcry by small bakeries that they were loosing the market share to big bakeries. The concern was driven primarily by 'restrictive practices' (agreements between firms with respect to prices) undertaken by the biggest bakeries, which recently were reported to be selling a loaf of bread at a price lower than the cost of production. As a result, the MTICM in collaboration with the Association of Bakeries investigated the matter and worked out the costs of producing a loaf of bread based on the information provided by all the bakeries. This investigation revealed that indeed the cost of producing a loaf of bread by the big bakeries was higher than the price at which a loaf of bread was sold with the objective of reducing competition (driving the smaller bakeries out of the market). As a consequence, in an effort to remove this collusive behaviour and maintain a more effective degree of competition, the MTICM intervened and put minimum and maximum price controls on the price of bread. The intervention is provided for under the Price Control Act 1979. These price controls would be effective from April 1, 2006 to December 31, 2006. Furthermore, due to the collusion in price setting by these big bakeries, some small emerging bakeries were at a verge of closing down as they were loosing customers. This article therefore seeks to evaluate the implications of Government intervention in the pricing of bread.

2. Price Controls in the Lesotho Bread Industry

As depicted in table 1 below, for all the bakeries, the minimum price of brown bread has been set at M3.60 per loaf while that of white bread has been put at M3.90. For retailers, the minimum prices have been set at M3.90 and M 4.10 for a loaf of brown and white bread, respectively. On the other hand, the maximum price of a loaf of brown bread has been set at M3.90 whereas that of white bread has been set at M4.00 for all bakeries. With regard to retailers, the price of a loaf of brown bread has been fixed at M4.10 while the price of a loaf of white bread has been set at M4.20. The minimum prices of bread were set based on the costs of producing a loaf of bread. While minimum are aimed at protecting smaller bakeries which were loosing customers due to low prices charged by big bakeries, maximum prices are targeted at protecting consumers.

Table 1. Minimum and Maximum bread prices

	Brown Bread (Min. Price)	Brown Bread (Max. Price)	White Bread (Min. Price)	White Bread (Max. Price)
Bakeries	M3.60	M3.70	M3.90	M4.00
Retailers	M3.90	M4.00	M 4.10	M4.20

3. Impact on the Economy

Although this intervention is intended to protect small bakeries in the industry and consumers, it has negative implications for the economy. Ideally, intervention in an industry is justified if it is expected to result in a net increase in economic welfare measured from both the producer and consumer side.

On the positive side, the intervention would mitigate the collusive behaviour and try to maintain a more competitive environment in the bread industry. Therefore, following the end of the of price controls the expectation is that prices will stabilise and as a consequence both consumers and bakeries will benefit. Collusive behaviour would ultimately reduce competition by pushing smaller bakeries out of business. Subsequently, the market structure would be characterised by a small number of producers competing with each other with surviving bakeries charging high prices and earning abnormal profits. This situation would negatively affect consumers' welfare with low income earners being affected most. Furthermore, the closure of smaller bakeries as a result of the loss in the market share would exacerbate the already high level of unemployment as the small bakeries would cease operations.

On the negative side, market intervention in the form of price controls tends restrict competition in the industry as it eliminates market determination of prices and therefore undermines the efficiency of the market. Price controls usually create shortages or surpluses, compromise quality and generate inconveniences for consumers when they are imposed in markets that are competitive. The competitive price of bread in the absence of price controls is determined by the quantity that bakeries are willing to supply at various prices and the amount consumers demand at various prices. In the presence of price controls, the market price is imposed on producers and hence produces a sub-optimal outcome.

When the price is set above the competitive equilibrium level there will be excess supply of the product relative to its demand. Similarly, setting prices below the equilibrium level causes customers to want more of the product than producers have available. Generally in both cases of price controls, there are welfare losses. As a result of price distortions introduced by controls, the market produces distorted signals that cannot be relied upon by producers, consumers and policy makers alike.

In the current situation, for consumers who bought bread at the price below the set prices (prior to price controls) they may perceive price controls to mean an increase in the general price of bread, and hence may switch to close substitutes of bread. As a result, there is likely to be a situation whereby there is a fall in demand for bread whereas supply remains unchanged. However, bakeries would not be able to cut their prices below the set minimum price level, in response to the fall in demand for bread because of price controls. On the other hand, for consumers who bought bread at a price above the government determined price, it appears as if the price of bread has fallen. The usual response would then be for the demand for bread to rise. On the other hand at that lower price the response of producers would be to supply less in order to avoid losses. The eminent result in this instance would be a shortage to which bakeries would respond by raising prices in the absence of controls.

A further dimension of the inefficiency of the market in the presence of price controls is that the market fails to identify and eliminate weak enterprises because of distorted signals. Under a competitive environment these entities would fail to compete and naturally be eliminated from the market.

4. Conclusions and Recommendations

This article highlights the short and long-term costs and benefits of government intervention. In general, while the policy works to protect consumers and small bakeries and is used in this case justifiably to prevent unfair competition, with foresight to promote a culture of healthy competition coupled with future

price stability, it tends to stifle competition and results in efficiencies in the market.

Therefore, there is need for competition policy do provide guidelines towards economically sound competition and guard against potentially destructive strategic behaviour in the industry.

Table 1: Monetary and Financial Indicators+

	Feb.	Mar.	Apr.
1. Interest rates (Percent Per Annum)			
1.1 Prime Lending rate	11.50	11.50	11.50
1.2 Prime Lending rate in RSA	10.50	10.50	10.50
1.3 Savings Deposit Rate	1.24	1.24	1.24
1.4 Interest rate Margin(1.1 – 1.3)	10.36	10.36	10.36
1.5 Treasury Bill Yield (91-day)	6.90	6.90	6.80
2. Monetary Indicators (Million Maloti)			
2.1 Broad Money (M2)	2587.90	2566.93	2610.78
2.2 Net Claims on Government by the Banking System	-1196.48	-1027.20	-1694.13
2.3 Net Foreign Assets – Banking System	4396.27	4376.67	5035.30
2.4 CBL Net Foreign Assets	3873.20	3238.38	4364.59
2.5 Domestic Credit	-381.91	-169.84	-882.79
2.6 Reserve Money	437.98	461.96	429.78
3. Spot Loti/US$ Exchange Rate (monthly average)	6.1221	6.2537	6.1064
4. Inflation Rate	**5.0**	**5.1**	**5.1**
	2005		
5. External Sector (Million Maloti)	QII	QIII	QIV
5.1 Current Account Balance (Excl. LHWP)	-122.41	34.71	-51.90
5.2 Capital and Financial Account Balance (Excl. LHWP)	187.88	-102.54	102.73
5.3 Reserves Assets	-94.55	26.53	-86.9

+These indicators are for 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 2: Selected Economic Indicators

	2002	2003	2004	2005*
1. Output Growth(Percent)				
1.1 Gross Domestic Product – GDP	3.5	3.1	3.1	1.2
1.2 Gross Domestic Product Excluding LHWP	2.9	2.9	3.7	1.1
1.3 Gross National Product – GNI	1.6	6.0	6.1	0.3

1.4 Per capita –GNI	-0.2	3.7	3.9	-0.9
2. Sectoral Growth Rates				
2.1 Agriculture	-4.2	-1.8	1.2	1.8
2.2 Manufacturing	6.9	5.2	5.9	-8.3
2.3 Construction	6.9	4.3	0.4	2.0
2.4 Services	2.2	3.9	4.4	4.2
3. External Sector – Percent of GNI Excluding LHWP				
3.1 Imports of Goods	93.9	80.1	81.3	76.0
3.2 Current Account	-11.6	-5.8	1.0	0.5
3.3 Capital and Financial Account	6.4	3.8	1.4	0.4
3.4 Official Reserves (Months of Imports)	6.2	5.8	5.2	5.8
4. Government Budget Balance (Percent of GDP)	-2.8	-0.3	8.4	1.5

* Preliminary estimates