



## **THE IMPACT OF FOOD PRICES ON OVERALL INFLATION IN LESOTHO**

*The decline in domestic cereal production as a result of drought and cereal demand from biofuel producers, exert upward pressure on food prices and overall inflation...*

### **Introduction**

The increase in prices of food is becoming a common phenomenon worldwide. Lesotho has not been immune in this regard with food inflation accelerating in recent months. The widely used measure of inflation is the Consumer Price Index (CPI) which is based on a standard market basket of goods and services purchased by a typical household. It is a weighted average of a number of component price indices. Each item, however, has its own weight that indicates its relevant importance in the basket.

component has a greater influence on the overall change in the average price level of goods and services.

### **INSIDE**

2. FAO/WFP Assessment Report.....	5
3. Monetary Policy Operations for June.....	6
4. Selected Monetary and Financial Indicators.....	8

### **Components of Lesotho's CPI**

Table 1 shows the weight derived from the consumption pattern of households in Lesotho. The food and non-beverages items account for 39.8 per cent of total household expenditure, of which food represents 38.4 per cent. This implies that the majority of households spend most of their income on food. Consequently, a change in the price level of this

The category of furnishing, household equipment and routine maintenance of house has the second largest weight at 17.0 per cent, followed by clothing and footwear at 15.6 per cent. This article analyses the impact of food on the overall inflation.

The increase in the rate of food inflation has been the main driver of high inflation rates recently. The most important factors influencing the price of food are amongst others, drought and biofuel production.

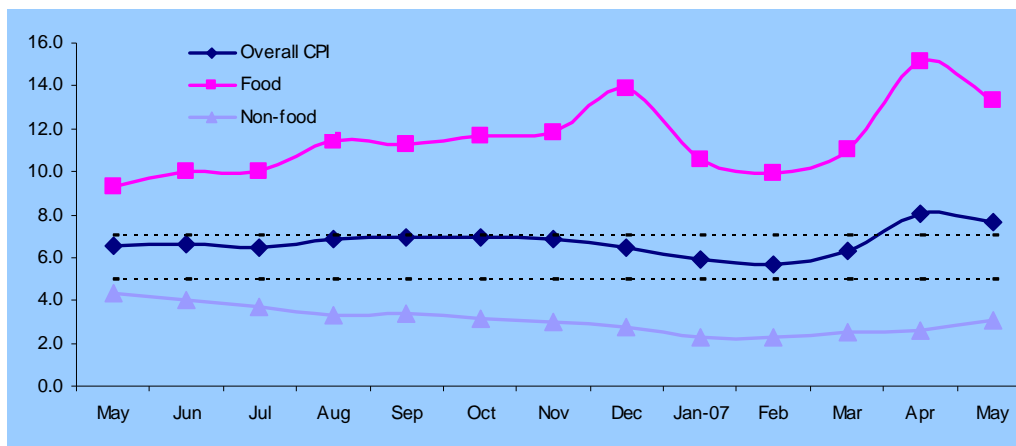
**Table 1: Construction of CPI in Lesotho**

Components	Weights
All items	100
Food and non-beverages	39.8
<i>Of which Food</i>	<b>38.4</b>
Alcoholic beverages & tobacco	6.4
Clothing & footwear	15.6
Housing, water, electricity, gas & other fuels	3.7
Furnishings, h/h equip. & Routine maintenance of house	17.0
Health	1.4
Transport	7.8
Communications	0.1
Leisure, entertainment & culture	1.2
Education	3.2
Restaurants and Hotels	0.4
Miscellaneous goods & services	3.2

### Food Prices and Overall Inflation

Owing to the importance of food prices in the CPI basket, the behaviour of the overall inflation rate moved in tandem with the former. Figure 1 shows that the food component of Lesotho’s CPI jumped to two-digits in the past twelve months to May 2007, averaging 11.1 per cent. Food inflation continued on a strong upward trend until April 2007, reaching a peak of 15.2 per cent. The overall inflation rate followed the increase in the food component during the same period, averaging 6.6 per cent. In April this year, it rose to a high of 8.1 per cent in response to the jump in food inflation. The month of May saw a slight easing, in line with the slowdown in food inflation.

**Figure 1: Inflation rate (annual percentage changes)**



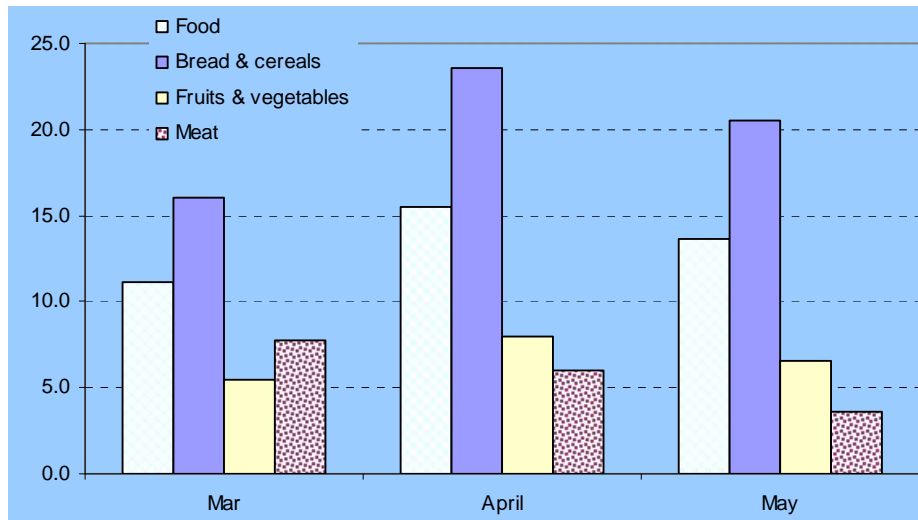
Source: Bureau of Statistics

The non-food component as a weighted average, has been on a steady decline during the period under review (see figure 1). Major sub-components of the non-food category such as clothing and footwear, as well as household furniture, equipment and routine

household maintenance remained below the overall inflation. The non-food component recorded an average of 3.2 per cent between April 2006 and May 2007, against 11.1 per cent registered by the food component. This provides strong evidence that food inflation is

important in the overall CPI in Lesotho.

**Figure 2: Food Components**  
(annual percentage changes: 2007)



In terms of sub-components of food inflation, cereals appear to be the major force behind the strong increases in food inflation. The rate of price increase in the 'bread and cereals' sub-category has been stronger than the 'fruits and vegetables' and meat sub-components in the recent months (see Figure 2). It remained above 15 per cent in the three months to May, reaching a peak of 23.6 per cent in April while the two other sub-components remained below nine per cent during the same period. In addition, 'bread and cereals' account for the largest weight in the food category, and overall CPI, with a weight of 22 per cent of the whole CPI basket. This confirms that cereal prices alone account for a large portion of the increases in overall inflation rate.

### The Effects of Drought

The combination of high temperatures and low rainfall created one of the worst drought situations for Lesotho in 2006/2007 cropping season (details on section 2). This caused large damage to crops. Compared to 2005/2006 cropping season, yields decreased dramatically for maize and sorghum by 42 per cent and 25 per cent, respectively.

Accordingly, cereal import requirements for the 2007/2008 marketing year are estimated at about 256,000 tonnes of which 219,000 tonnes are expected to be imported commercially, and 30,000 tonnes to be covered by additional government or international assistance. Southern Africa as a whole experienced food shortages, due to, among others, erratic weather conditions and poor agricultural production in countries

experiencing instability. South Africa remains the main supplier of grain in the region, since its production exceeds domestic demand. Another strong grain producer in the region, Zimbabwe, has been experiencing acute cereal shortages for years. Therefore, the observed shortage in the region contributes to upward pressure on regional and domestic food prices.

### **The Effects of Biofuel**

Increases in food prices, especially cereal prices have partially been influenced by global changes in cereal use in the recent years. Cereals are increasingly being used as inputs in industries other than food. The persistent increase in crude oil prices has forced producers to search for alternatives and biofuel has increased in importance as a possible substitute. However, the price remains high due to increasing oil prices and subsidies farmers enjoy. Consequently, biofuel has instead become a profitable venture whose price moves in line with that of oil. It is reported that bioethanol is mainly produced from crops rich in starch and sugar such as cereals and

sugar beets. Although it is more efficient and less pollutant, its 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, which leads to increasing food prices and possible mass starvation in the poor countries.

The basic argument is that energy crop programmes compete with food crops in a number of ways (agricultural, rural investment, infrastructure, water, fertilisers, skilled labour etc) and thus cause food shortages and price increases. It is important to mention that developing countries are facing both food and fuel problems. Adoption of agricultural practices should, therefore, take into account this reality and involve efficient methods of utilising available land and other resources to meet both food and fuel needs.

## 2. FAO/WFP Assessment Report

*About 400,000 vulnerable people face food insecurity during the year 2007/08....*

### Background

According to a report produced by Food and Agricultural Organisation (FAO) and World Food Programme (WFP) for Lesotho on 11 June 2007, it is estimated that a total of 401,200 people will be in food deficit during the marketing year 2007/08. It is approximated that 30,000 tonnes of cereal and additional 6,700 tonnes of non-cereals or cash equivalent will be needed to meet the 2,100 kilo calories minimum daily requirements. The assessment was commissioned by the Government of Lesotho to determine cereal production, deficit and forecast import requirements following prolonged drought and an unusually hot cropping season.

The report acknowledged that a combination of high temperatures and low rainfall during January to March 2007 created one of the worst drought situations ever experienced in the country, with lowlands being hard hit. It is estimated that average yields of maize, sorghum and wheat for the cropping season 2006/07 stood at 0.43 tonnes/hectar, 0.42 tonnes/hectar and 0.52 tonnes/hectar, respectively. This is equivalent to 42 per cent and 25 per cent decrease in yields of maize and sorghum, respectively and 4 per cent for wheat.

Furthermore, the report observed a decline in planted area of cereals over the past years, with potential

farmland left uncultivated mainly due to the uncertainty of agro-climate conditions, shortage of labour and lack of capital for inputs and investment. The decrease in planted area was estimated to range between 15 per cent and 20 per cent compared to the 5-year average.

The 2007 national cereal production forecast was estimated at about 72,000 tonnes which represents a 42 per cent shortfall as compared to 2006 harvest. Total cereal production was composed of 50,825 tonnes of maize, 11,182 tonnes of sorghum, 5,411 tonnes of summer wheat and a forecast of 5,000 tonnes of winter wheat. As a result, cereal import requirements were estimated at about 256,000 tonnes, of which 219,000 tonnes would be imported commercially. This leads to an uncovered deficit of around 30,000 tonnes after adjusting for the food aid stock and donor pledged 7,000 tonnes.

**Table 2: Estimated Lesotho Cereal Production for 2007/08**

(in tonnes)

Cereal	Output
Maize	50,825
Sorghum	11,182
Wheat	10,411
Total	72,418

According to production trends, under normal circumstances, Lesotho produces about 30 per cent of her total food requirements. The 72,000 tonnes falls short of the 328,000 tonnes required for the population.

### **Implications**

It is estimated that about 80 per cent of the population live in rural areas, where subsistence agriculture dominates the means of living. It has gained importance due to declining labour income following migrant mineworkers' retrenchments. Rural communities engage in small scale subsistence agriculture with little or no mechanisation and the accompanying necessities.

The above discussion implies that the rural population will suffer most, with possible migration to the nearest urban areas for employment. If not adequately addressed, this may result in the adverse increase in crime in urban areas and malnutrition in rural areas. Contingency plan has to be put in place to address the above. In addition, the cereal deficit has potential to fuel the already increasing inflation rate, if the market forces are to prevail. Many households have exhausted their capacity, and the escalation of grain prices due to domestic shortages and rising maize prices in South Africa will limit the access to market supplies by urbanites and further deepen food insecurity.

### **3. Monetary Policy Operation Report for June 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 are:

- ◆ to attain a reserve money target of between M200m and M250m;
- ◆ to ensure that the discount rate on GOL treasury bills moves in line with regional interest rates movements; and
- ◆ through (i) and (ii), to attain the minimum required NIR target of \$450.0 million for the review period.

Table 3 shows amounts auctioned and discount rates that prevailed for each of the auctions. The level of competitiveness in the market, is estimated by the number of participants in an auction. The recent auction saw a participation level of 6 bidders who submitted 14 bids for the auction. This was lower than the May figure of 8 bidders with 27 bids. All bidders became partially successful and 10 bids were successful against 18 bids in the previous auction.

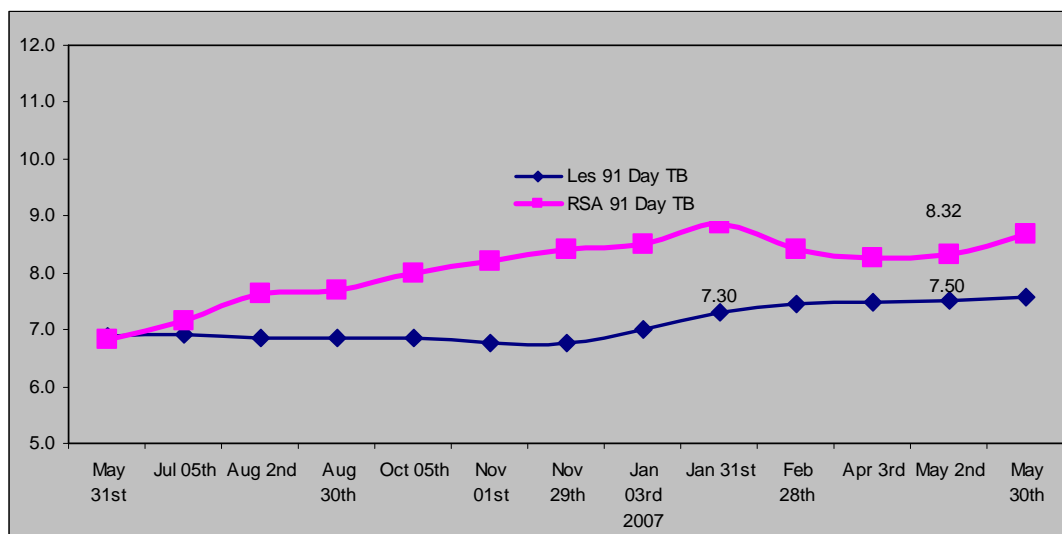
**Table 3: Treasury Bill Auctions**

Type of Security	Auction Date	Maturity Date	Auction Amount (million)	Amount Issued (million)	Discount Rate	RSA Disc. Rate
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%
91-day TBs	30 May 2007	31 Aug 2007	M170.0	M171.0	7.56%	8.68%
Total for reporting period			M170.0	M171.0		

Although the Lesotho 91-day treasury bill rate continued to increase in May, it was still below its SA counterpart rate. The Lesotho 91-day treasury bill rate increased by 6 basis point to 7.56 per cent. The counterpart SA rate

also rose from 8.32 per cent in May to 8.68 per cent in June. Consequently, the margin between the two rates widened from 82 basis points to 93 basis points at the end of the review period, as depicted in figure 3.

**Figure 3. Measuring the Success of Monetary Policy Objectives: Performance of Lesotho 91-Day T-Bills vs RSA T-Bills**





**Table 4. Selected Monetary and Financial Indicators+**

	2007		
	Mar	Apr	May
<b>1. Interest rates (Percent Per Annum)</b>			
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
<b>2. Monetary Indicators (Million Maloti)</b>			
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
<b>3. Spot Loti/US\$ Exchange Rate (Monthly Average)</b>	<b>7.3571</b>	<b>7.1151</b>	<b>7.0142</b>
<b>4. Inflation Rate (Annual Percentage Changes)</b>	<b>5.9</b>	<b>8.1</b>	<b>7.6</b>
<b>5. External Sector (Million Maloti)</b>		<b>2006</b>	<b>2007</b>
		<b>QIII</b>	<b>QI</b>
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

**Table 5. Selected Economic Indicators**

	2004	2005	2006*	2007+
<b>1. Output Growth( Percent)</b>				
1.1 Gross Domestic Product – GDP	4.0	2.7	6.2	6.9
1.2 Gross National Product – GNI	7.8	4.0	7.1	4.8
1.3 Per capita –GNI	5.5	1.9	5.8	3.5
<b>2. Sectoral Growth Rates</b>				
2.1 Agriculture	13.5	20.0	13.5	13.5
2.2 Manufacturing	2.1	-8.0	1.2	2.5
2.3 Construction	-4.4	2.5	2.8	3.0
2.4 Services	2.6	4.0	5.1	5.8
<b>3. External Sector – Percent of GNI</b>				
3.1 Imports of Goods	86.3	78.7	80.2	87.7
3.2 Current Account	-4.7	-5.5	0.3	2.8
3.3 Capital and Financial Account	5.8	4.3	2.1	5.7
3.4 Official Reserves (Months of Imports)	5.2	5.7	6.7	6.8
<b>4. Government Budget Balance (Percent of GDP)</b>	<b>5.6</b>	<b>4.4</b>	<b>9.2</b>	<b>7.4</b>

\* Preliminary estimates

+CBL Projections