POSITION PAPER

THE RISING FUEL AND COMMODITY PRICES

Background

The world is experiencing unprecedented high prices of agricultural and commodity prices. In February 2011, the World Bank Food Price Index reached its 2008 peak, after rising by 47 percentage points since June 2010[1]. Food prices are rising across the globe, driven in part by the higher transport costs that accompany rising oil prices. During the same time period, the international fuel prices have increased by at least 32% on account of strong demand growth and political instability in the Arab region[2].

The East Africa region too has experienced increased prices for fuel and agricultural prices. In Rwanda, the fuel prices have increased by 14% from RWF 887 in January to RWF 1,015 in March 2011. Kenya and Tanzania, which unlike Rwanda are not land locked, have seen increments of about 15%.

In Uganda, the prices of diesel and fuel have increased by between 15 – 18 percentage points. The prices of food and other commodities too have subsequently increased on account of bad weather that affected agricultural productivity, higher transportation costs, the depreciating shilling that has affected the price of imports and industrial inputs and imported inflation. Whereas the causes are thought to be mostly external, the private sector is concerned that if unchecked, the price spikes (particularly of fuel) will inevitably increase the cost of doing business in the country and will affect the competitiveness of the business community.

The Reasons for the Increase in Prices

There are various reasons for the current economic crisis that has seen the prices of commodities rise to unprecedented high levels. Some of the reasons are external and others domestic.

The external factors:

Rising fuel prices on the international market:

After a period of remarkable stability from October 2009 to September 2010 within a relatively narrow band, international oil prices (Brent) have risen by approximately 50% since then – first on very strong demand growth and, since early 2011 on increased regional geopolitical risk in North Africa and the Middle East, embodied by Libya's supply outage. The prices of crude oil have increased from an average of USD 90 per barrel in December 2010 to about USD 119 per barrel in April 2011. This represents a 32% increase in the global fuel prices. This coupled with a depreciating local currency and distribution rigidities would translate into a more than 50% price increase in the domestic fuel prices.

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[1] The World Bank, 2011: Responding to Global Food Price Volatility and its Impact on Food Security

[2] The International Energy Agency, 2011: Oil Market Report

Imported Inflation

Most of Uganda's major trading partners have been experiencing rising inflation. In February 2011, Kenya and the Euro Zone recorded increased inflation to 6.54 percent and 2.4 percentage points respectively compared to 5.4 and 2.3 percentage points respectively.[3] India and China have also recorded high inflation. The sharp rise in the prices of products in Uganda's most important trade partners ultimately feeds through to domestic inflation.

Global rise in food prices

Global food prices have consistently risen in the last few months. This is a major concern to the private sector because of its implications for domestic inflation, impact on the economy and adverse effects on the purchasing power especially for wage earners.

The domestic factors include:

A depreciating local currency

The Uganda shilling has continued to depreciate against most major currencies over the past one year. In February 2011 the Shilling depreciated by 17.2 percent on annual basis, to an average of Shs. 2,341 per US Dollar[4]. The persistent depreciation pressures in the last couple of months have also had adverse consequences on the domestic price level. This has a profound effect on the price of tradable goods given that most of the foreign transactions are denominated in US dollars The exchange rate like any other market-determined price depends on the relevant forces of supply and demand. The demand for dollars is determined by the imports of goods and services, while supply of dollars is determined by the exports and capital. Because expectations change frequently, so, too, do exchange rates under the current floating rate regime. However, the business community feels that the supplementary budget that could have been financed by drawing on Bank of Uganda reserves to purchase military hardware could have had a significant impact on the exchange rate as well.

Persistent drought

The country experienced delayed rains at the beginning of the year. This affected food production and consequently food supplies to the markets. This led to an increase in food prices. Now that the rains came earlier than was predicted by the Metrological Department, it is expected that the scarcity-driven rise in food prices will not continue in the medium to long term.

Private sector concerns

Gradual price increments, up to an optimal level, could potentially stimulate production while at the same time not hurting the effective demand and purchasing power. However, the private sector in Uganda is concerned that increasing commodity prices are affecting the competitiveness of the Uganda Private Sector through increased cost of doing business and reduced effective demand. The effect of increasing prices are twofold: on one hand, increasing commodity prices eat into business capital and subsequently profits,

[3] The Bank of Uganda: Monthly Economic and Monetary Development Report, March 2011

[4] Ibid

secondly increasing prices erode the purchasing power curtailing effective demand as consumers re-adjust their consumption patterns to purchase of mere essential commodities. Whereas the external factors may be out of control of Government, measures can be taken to ease doing business by addressing the domestic factors and reducing the impact of the external factors.

What could be done?

Food prices

The drivers of food prices have become more complex, extending beyond traditional factors. The average levels of food prices are driven by fundamentals such as long term demand expansion due to a growing population and income expansion; and supply side factors such as resource use and technology that determine agricultural productivity. Short term variations in prices are influenced by weather variability, volatile oil prices, macroeconomic policy and financial investments in agriculture.

Therefore, Government should consider policy actions geared towards increasing productivity and production in agriculture, while cushioning the farmers against the adverse effects of weather variability and climate change. To do so, Government could consider fixing problems along the entire value chain including Research and development for seeds and inputs, irrigation, fertilizer, agricultural extension, credit, rural infrastructure, storage and connection to the market. Specifically, Government could consider the policy options below:

- Expeditiously activate the existing national irrigation infrastructure including establishing new irrigation programmes: Defunct irrigation schemes such as Doha in Butaleja, Olwenyi in Lira, Mubuku in Kasese, and Agoro in Kitgum should be rehabilitated and made functional as a matter of priority.
- Allocate funds to establish micro-irrigation schemes on all major rivers and lakes in the country:
- Invest in climate change adaptation technologies: More Funding for agriculture research stations under NARO is urgent to be able to produce seed and plant varieties that are water efficient, can survive the perils of droughts and other adjuncts of climate change.
- In line with the NDP, increase the supply of water for animals in the cattle corridor from the current 36% to 50% and those outside the cattle corridor from the current 21% to 30%
- Strengthen the PPP approach in the construction and maintenance of irrigation schemes
- Support farmers' access to agricultural inputs and fertilizers at affordable prices
- Construct storage facilities to handle the bumper harvests and maintain phyto-sanitary and standard requirements
- Invest in Warehouse receipt systems in major grain producing districts and regions to keep farm products safe and ready for market
- Support availability of adequate storage facilities at sub counties and mainstream functional warehouses to avoid post harvest losses as well as improve commodity pricing
- Expedite the enactment of the National fertilizer policy which should consider subsides on fertilizers as a priority. This is because an ordinary farmer can hardly afford a 50kg fertilizer bag at 120,000=.currently.

Fuel and Commodity prices

Oil prices shocks have a stagflationary effect on the macroeconomy of an oil importing country like Uganda and could slow down the rate of growth, reduce the level of output, and may also increase in the price level and potentially an increase in the inflation rate. In addition an oil price hike acts like a tax on consumption.

The business community is concerned that while the general fuel prices increase, the the cost of doing business in the country will greatly increase dealing an extra blow to the competitiveness of businesses. The business community is also worried that the high cost of fuel could trigger higher costs of electricity given that the fuel cost adjustment aspect of the electricity bill will increase.

A recent private sector survey revealed that, energy including fuel accounts for as much as 45 per cent of the production cost for firms involved in cement production and metal works among others. The effects of the increased cost of doing business on effective demand is immense to the extent that sales in the soap and edible oil sector recording have dropped in the range 60% - 65% respectively[5].

Clearly, there is urgent need for the government to move in and impose a degree of control to cushion the economy from adverse effects that might be experienced if the current high prices are sustained. Although we acknowledge that fact that we are operating in a free market economy, there are many aspects that are still in State control and which the government could act on firmly to avert a crisis. These aspects could include streamlining the supply side rigidities to ensure smooth procurement and flow of oil into the country while ensuring adequate reserves of fuel are stocked. Specifically, we request government to consider:

- Renovation of fuel reserves in Jinja and complete construction of fuel depots in Nakasongola, Gulu and Kasese to cushion against fuel supply shocks

[5] Uganda Manufacturers' Association, 2011