

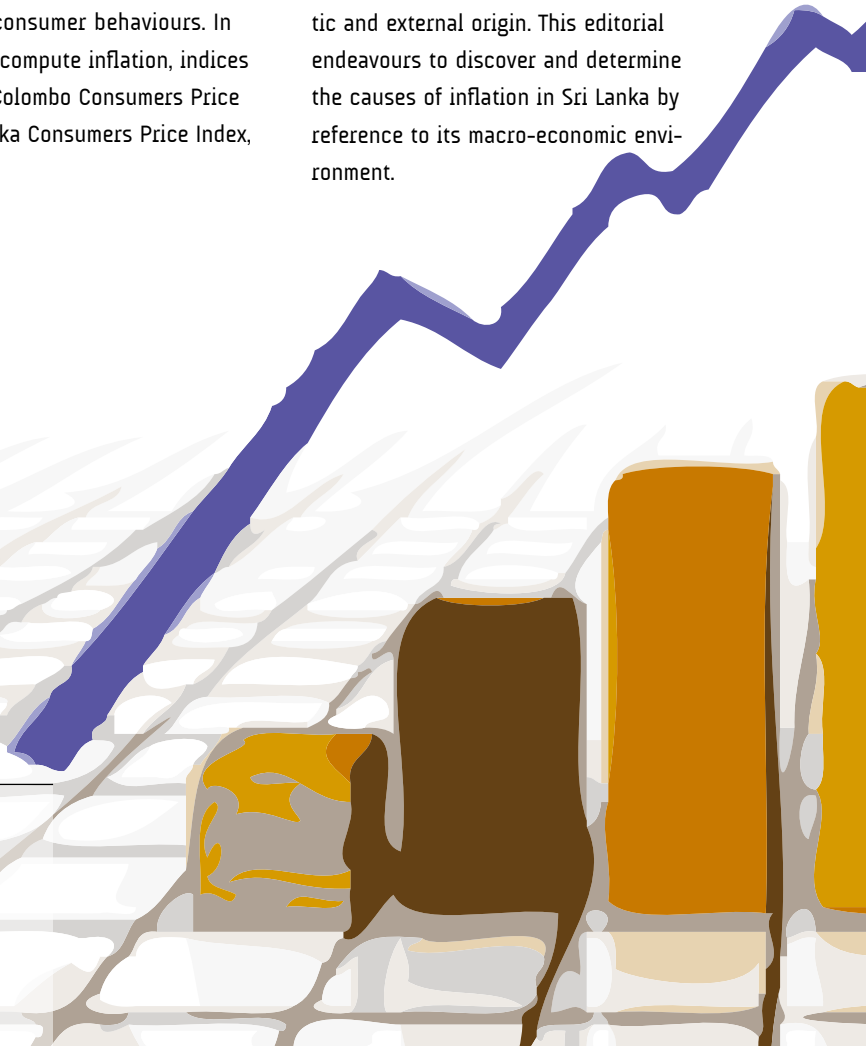


The Anatomy of Inflation in Sri Lanka

Inflation, a trendy theme, is often subjected to dialogue and symposium in public discourse. Politicians in opposition embrace and cuddle inflation in attacking their political opponents, whilst the party in power is in a constant struggle to substantiate inflation as an occurrence beyond their control. Consumers, entirely ignorant and unaware of the causes and effects of inflation, yet, being threatened by the rising prices of commodities, continually face the threat of under consumption. Policymakers and economists closely scrutinize and screen inflation to review and reassess the performance of the financial system and to frame economic policy. Economists define inflation as the rising cost of accomplishing a certain level of utility by a consumer. It is

the rate of increase in the general price level over a specified period. Gauging inflation is tricky as it engrosses the tracing of the consumption habits of the population over time. In practice, a sample of the populace is estimated by means of a survey. Using the survey results, a bundle of goods and services procured by an archetypal consumer is recognized. The value of the bundle is considered the cost of living index or the retail price index, and periodic changes in the value of this basket are taken as inflation. From time to time estimations are being embarked on to upgrade the consumer basket with the shifting consumer behaviours. In Sri Lanka, to compute inflation, indices such as the Colombo Consumers Price Index, Sri Lanka Consumers Price Index,

Wholesale Price Index, Colombo District Consumer Price Index, Gross Domestic Product Deflator, and Gross National Product Deflator are being used. From 2003 onwards the inflation (% p.a) in the economy has been on persistent increase. Measured using CCPI, in 2003, it was 6.3, while in 2004 (7.6), 2005 (11.6), 2006 (13.7), and in 2007 (17.5). Measured by the New Colombo Consumers' Price Index (CCPI (N)), inflation rate for 2004 was 9.0 while for 2005, 2006, and 2007 correspondingly they were, 11.0, 10.0 and 15.8. Adverse developments were a combined consequence of numerous dynamics, both of domestic and external origin. This editorial endeavours to discover and determine the causes of inflation in Sri Lanka by reference to its macro-economic environment.



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Anticipated-unanticipated inflation

A foremost reason for opposing inflation is that it redistributes income in a haphazard manner, from those who cannot defend themselves from the rising prices of what they buy, by raising the prices of what they sell, to those who can. It also impinges on the employment levels of the economy. In exploring inflation in Sri Lanka, it is imperative to

differentiate between the anticipated inflation and unanticipated inflation. Inflation when predictable, in drawing up contracts, the anticipated inflation would be built-in so that one party does not lose the contract to the other. As an example, when parties to a loan contract are aware of the rising price levels of the economy, the party who grants the loan could secure himself by charging higher interest rates to recompense the anticipated inflation rates. Or else in an employment contract, when the employer

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and the employee are fully aware of the anticipated inflationary forces, a clause could be inserted to the contract to prevent the depletion of the real value of the salary payments. An inflationary force could be anticipated in cases of government undertaking massive projects which inject huge expenses on the economy, existence of over-consumption patterns in the economy, huge capital investments in the economy and so on. Unanticipated inflation causes major disturbances in the market. Contracts entered prior to the inflationary effects assuming the constant prices; one party will gain at the expense of the other. Unanticipated inflation occurs in most situations due to unanticipated external shocks to the economy.

Government expenditure and inflation

Inflation in Sri Lanka is caused by various reasons. From an economist's point of view, we analyse and examine this phenomenon from the demand side and the supply side of economics. Such an enquiry will permit the general public a profound understanding of the causes of inflation and especially to determine the authenticity, genuineness of the declarations made by politicians in their never-ending game of passing the buck. From a demand side analysis, demand pull inflation transpires due to real factors as well as the monetary factors. An augment in government spending with no corresponding change in tax receipts, a decrease in tax receipts

with no change in the levels of government spending, a downward shift in the savings function, an upward shift in the export function, a downward shift in the import function and an upward shift in the investment function are the chief dynamics that pilot a rise in the price levels of the economy. These factors will result in shifting the aggregate demand curve to the right in the IS-LM framework, which would in turn lead to higher price levels. High levels of government expenditure on the economy by the Sri Lankan government is one of the primary reasons for the elevated levels of inflation. The total government expenditure and net lending for 2005 was Rs 584 bn, while for 2006 and 2007 correspondingly, they were Rs 713 bn and Rs 842 bn. Thus, it represents a 22% increase from 2005 to 2006, and 18% increase from 2006 to 2007. Government expenditure as a percentage of GDP was 23.8% in 2005 and 24.3% in 2006 and 23.5% in 2007. In current expenditure, the salary bill and transfers to households increased considerably in 2005. The salary bill increased by 30.5% to Rs 138.6 bn due to salary increases granted in 2005 and the increased recruitments to the government service. Transfers to households increased largely due to the higher subsidy on petroleum products (Rs 26 bn) as a result of the inadequate adjustment of domestic petroleum prices, higher pension payments and higher expenditure on the fertiliser subsidy. Transfers to public institutions also increased as a result of salary

increases coupled with their various inefficiencies. Total defence expenditure amounted to Rs 82 bn (3.5% of GDP), compared to Rs 73.4 bn (3.6% of GDP) in the previous year. As a per cent of GDP, public investment increased to 6.3% from 4.8% in 2004, including tsunami related investments of 1%. In 2006, the expenditure on wages and salaries increased by 26.3% to Rs 175 bn due to the increase of public sector salaries in 2006, correction of salary anomalies, introduction of monthly cost of living allowances, new recruitments of nurses, clerical staff, technical staff and home guards and the full impact of recruitment of over 40,000 graduates to the public sector. For 2007, the overrun in the recurrent expenditure was mainly due to the increases in salaries and wages, pension payments, interest payments and security related expenditure. Salaries and wages increased by 22.4% to Rs 214 bn mainly due to the full impact of the recruitments made under the graduate employment scheme in 2006 and the new recruitments to the public sector, including defence establishments, payment of incentive allowance in lieu of leave. Additional funds were required for defence related activities as the government had to intensify counter terrorism measures to ensure national security. The IDPs were provided with shelter, food and medical needs while developing infrastructure to create economic activities to bring life back to normal in the respective areas. The welfare expenditure on the provision of free textbooks, season tickets, nutritional food to school children, bursaries, assistance to disabled soldiers etc., continued to increase. In 2007, public investment continued to increase. In nominal terms, it increased by 27% to Rs 229 bn, and as a per cent of GDP also, it increased to 6.4% from 6% in the previous year. This improvement



was a result of the strenuous efforts made by the government to accelerate the implementation of development projects through local funds and foreign aid disbursements. In 2008, the budget deficit is expected to rise from Rs 257 bn in 2007 to Rs 293 bn in 2008. Heavy domestic borrowings have caused adverse macro-economic implications in the recent past. They particularly cause the interest rates to rise and the exchange rate to appreciate. Higher levels of government expenditure would fuel the inflation levels of the economy as it would create a stress on the aggregate demand of the economy. A major proportion of the government expenditure takes the form of recurrent expenditure. High levels of recurrent expenditure reduce the resources available for public investments that would have a positive impact on the growth levels of the economy. Of this recurrent expenditure, salaries and wages and related expenses such as the cost of living payments, pensions made with respect to public servants are substantial. These expenses are related to the size of the public service. Thus it is suggested that the government needs to shrink its capacity and allow the private sector to play a leading role in the market economy. The government needs to play a supportive role in the economy by fuelling the wheels of the price mechanism in providing the infrastructure facilities which are usually not undertaken by the private sector due to high levels of capital expenditure and the limitation of

technology. Playing a facilitator's role in the market economy would permit the government in drastically plummeting the recurrent expenses that will escort lower inflation rates. On the grounds of efficiency, the government spending should be directed to areas of highest social return and should complement, rather than compete with the private sector. Accordingly, the government should either finance or supply the public goods that the private sector is unable to supply due to market failures.

Money supply and inflation

On the monetary side, demand pull inflation originates through an increase in the money supply. An increase in the money supply will shift the LM curve to the right while the IS curve remains constant in the IS-LM framework. With the shift in the set of LM curves, at each price level the supply of money will equal the demand for money at a higher income level for an interest rate than before the increase in the supply of money. With the reduction in the rates of interest, the aggregate demand curve will shift to the right leading to higher levels of inflation. Continuous shifts in the LM curve to the right through a continuous process of supply of money would lead to more and more increase in price levels of the economy. The persistent expansion of the money supply is a sufficient condition for a persistent rise in the price levels of the economy. The main means of money supply is the

printing of notes and coins and the creation of money by the banking system of the country. However, the Central Bank is in a position to exercise direct as well as the indirect means for the conduct of the monetary policy in mopping up the excess liquidity in the market and thereby containing inflation. The overall budget deficit for 2005 was 8.7% of GDP. Of the deficit of Rs 205 bn, Rs 123 bn was financed through net domestic borrowings. Of this, the financing through the banking system amounted to 21%. In 2006, the budget deficit stood at Rs 235 bn of which Rs 164 bn was net domestic borrowings. Of this, 49% was from the banking system. Financing the deficit through the banking system would crowd out private investments. Also financing the budget deficit through the banking system will cripple the exercise of arresting inflation and recourse to such a means would have inflationary pressures on the economy. On the other hand, high foreign non-concessional borrowings could increase the vulnerability of the external sector to various shocks. In 2007, the overall budget deficit was Rs 276 bn, of which Rs 127 bn was financed through net domestic borrowings. Of this, only 11% was borrowed through the banking sector which is very encouraging development. A larger budget deficit always increases demand for loanable funds by the government. Some of the funds borrowed by the government from the banking sector to finance the budget deficit will find its way back to the banking sector that



would in turn pose inflationary pressures over the economy. Budget 2008 is based on the medium term macro-fiscal framework of the government published along with the budget. The overall deficit as a percentage of GDP is expected to reduce to 7.0% in 2008. In financing the deficit of 7% of GDP in 2008, net domestic financing will be contained to 3.7% of GDP compared to 5.6% in 2006. The inflationary bank financing is expected to be contained at 0.2% of GDP in 2008. The lower bank financing will supplement the efforts that will be taken to contain inflation in 2008. Most economists believe that a small budget deficit will induce mild inflation that would fuel the economic activities. What worries them is the fiscal deficit that goes on rising as a percentage of GDP. In such a situation, inflation becomes a potent danger.

Wage push inflation

From the supply side of economics, inflation in Sri Lanka occurs due to various reasons. One major aspect is the wage push inflation as a result of union action to increase the nominal wages and deliberated action by the government to raise wages in gaining political mileage. In such a case, wage push inflation transpires whenever the nominal wage rate increases at a greater pace than the growth in the productivity of labour. In turn, the firm will pass on the cost increases to the consumer by way of increased prices. Increases in money-wage rates matched by increases in labour productivity are not inflationary. In cases where the money wage rates rise as a result of increased demand for labour, this may not be classified as inflationary. Developments in wages have a significant bearing on consumer prices. Hence, assessing developments in wages is a vital input for effective policy mak-

ing. Therefore, in most of the instances, wage-push inflation is a result of exploitation of the power of the labour unions for higher nominal wage rates that is not matched by increases in labour productivity. Wages in Sri Lanka can be analysed under two main categories of employment namely public sector and private sector. The public sector consists of government and the semi-government sectors while the private sector comprises formal and informal sectors. Public sector wages and salaries are fixed by the state and revisions to these wages are made from time to time. In 2005, public sector employees were able to enjoy significant wage increases as a result of the implementation of the second salary revision of 2004 effective from 01 December 2004. The December 2004 revision granted a 40% increase of the basic salary subject to a minimum of Rs 3,250 per month and a maximum of Rs 9,000 per month, plus allowances. Parallel to the increase in public sector salaries under the Budget Proposals 2005, a new Budgetary Relief Allowance of Workers Act (2005) was enacted in Parliament with effect from 1 August 2005 to increase private sector salaries by Rs 1,000. Wages in the formal private sector are influenced by wage increases announced by the government, as well as individual contracts of employment, collective agreements, unilateral decisions by employers and minimum wage decisions of Wages Boards. In 2006, the government implemented a new salary structure for the public service by re-categorizing all posts/services based on a new set of definitions under the budget proposals. Accordingly, all government employees initially received 50% of the salary increase. The public sector employees enjoyed a significant wage increase in 2007, following the 2006 Budget proposals of the government. In addition to above salary revisions, the

government further decided to amend the salary scales of government officers other than those of the senior level groups, with effect from June 1, 2007. Nominal wages in the informal private sector are determined in a free market environment. They are influenced by various factors such as the rising cost of living, prevailing market conditions, the degree of labour intensity and skills required in their work and alternative opportunities to shift work among different activities and regions. Wage-push inflation can only occur in imperfectly competitive labour markets and the foremost imperfection is the labour unions. A usual feature of such a market is that the money-wage rate is inflexible downwards. Wage-push inflation will not occur in an economy where the wages are determined by the interaction of the market forces of demand and supply of labour. In such instances, wage rates will fall or rise in tandem with the aggregate demand for the product. It is a sufficient condition that the labour be organised to compel and force the government to raise the nominal wages above the productivity of labour. In such an instance, it is highly probable that increases in the nominal wages of the unionised labour will compel the entrepreneurs of the non-unionised labour to raise the wages of their labourers, as not to lose their most valuable employees to unionised labour. If the private sector does not respond to the increases in the nominal wages of the public sector competing in the same industry, ultimately the final products of the public sector will be priced higher than the products of the private sector. This in turn will place the public sector jobs at stake due to the erosion of their profitability.

Profit push inflation

Just as labour unions induce the wage-push inflation, profit-push infla-

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tion occurs due to the control of the market by a few sellers who aim to maximise profitability within a short span of time. This is usually sorted by monopolist and oligopolists. A monopoly is a market structure in which there is a single seller, no close substitutes for the commodity it produces and there are barriers to entry. The main causes that lead to a monopoly are the ownership of strategic raw materials, exclusive production knowledge, patent rights for the production of the product, government licensing, and the imposition of foreign trade barriers with a view to excluding foreign competition. On the other hand, an oligopoly is a market structure where there is a fewer number of sellers in the market, and each player reacts to its competitor's strategy. Markets for liquid petroleum, wheat and milk powder are classic examples of these market structures in Sri Lanka. Price increases at a greater pace outstripping the rate of growth in their cost structures would pass on as higher prices to the consumers of the market that would lead to higher prices in the economy. Apart from increases in the prices of the products as a function of the sole discretion of the sellers, in some situations, the involvement of the government in administering the market prices would escort to an inflationary pressure. A series of price revisions impacted the raising of the price levels in 2006. Significant price revisions were made on fuel, electric-

ity, transport, liquor and tobacco. The adjustment of domestic fuel prices three times during the year resulted in petrol and auto-diesel prices rising by 15% and 20%. The fuel price revisions were made with a view to removing the burden of subsidies from the government to avoid longer term inflation resulting from an expansion in the budget deficit. Several administrative price revisions took place during 2007. This had both direct and indirect impact on rising price levels of domestically produced as well as imported goods. The adjustments to fuel prices resulted in petrol, diesel, and kerosene prices rising by 20%, 18%, and 43% respectively during the year. Consequent on these revisions, transport charges were increased, including a 16.5% increase in bus fares. The electricity charges of both domestic and industrial users were also revised upward during the year. Although these price revisions had a cascading effect through increased transport expenditure and input costs, in the long run, the removal of subsidies is beneficial to contain inflation through reduced pressure on budget deficit.

Supply shock inflation

'Supply shocks' are a major source of inflation on the Sri Lankan economy. In most instances, supply shocks are unanticipated and beyond the control of the government in power. Drop in the supply side could occur due to reasons such as shortages due to bad weather condi-

tions, unforeseen catastrophes, sudden price increases by rigidly formed market powers. In 2005, the adverse effects of the drought that occurred in the previous year continued to exert pressure on prices of some domestically produced agricultural commodities during the first half of the year. The impact of the tsunami that occurred on 26 December 2004 also affected prices adversely. In 2006, the prices of vegetables increased substantially due to supply shortages exacerbated by extreme weather conditions. The prices of fresh fish were affected due to security developments that took place in the north-east. The consumers in substituting highly priced fish with meat, eggs and dried fish, caused prices to rise substantially. On the external front, the oil prices increased by 22% to US\$ 64 per barrel compared with US\$ 53 per barrel in 2005 compelling the revisions of domestic fuel prices. World prices of sugar rose sharply due to low supply in the international market as a result of sugarcane being used to produce ethanol, a substitute for gasoline. High import prices of wheat grain raised the local prices of wheat flour and bread. In 2007, the price of rice was on an escalation path since May 2007 in response to the setback in paddy production which dropped by 6.3% in 2007. The average price increases of vegetables during the year was also significant on account of low supply from main producing areas, aggravated by bad weather conditions, resulting in earth slips in



up-country areas and floods down south. Prices of major import commodities increased substantially, as a result of high international prices. World market prices of wheat grain and milk powder rose during the year as a result of low supply mainly due to the drought and dry weather conditions in Australia. The upsurge in crude oil prices was a major driving force in raising the overall cost structure in 2007. The average price

of crude oil imported in 2007 rose by around 10% from US\$ 64 per barrel in 2006 to US\$ 71 per barrel compelling the upward revision of domestic fuel prices. Similarly, the high international price of gas which rose to a peak of US\$ 1.2 per kg by December 2007 compared to a price of US\$ 0.62 at the beginning of the year, led to raise the domestic prices on several occasions during the year.

It has been argued that a 'little infla-

tion is a good thing' in that gently rising prices makes good profits, optimism, expansion of investment, a high level of employment and a generally expanding economy. This philosophy was born in the dark days of inter-war depression and for any validity it depends upon a very exact definition of a 'little inflation' and upon a very wise, strict government which will act swiftly and effectively to halt any tendency to 'too much inflation'.

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