TURBULENCE IN INFLATION IN SRI LANKA: A LOOK AT THE RECENT PAST

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In keeping with the theme of the annual conference of 'Managing Financial Institutions in Turbulent Times' this short paper attempts to analyze the recent macro-economic turbulence in Sri Lanka manifest in high and volatile inflation. It pays particular attention to the Central Bank's monetary policy management using reserve money as the operational target.

What does economic turbulence mean? For instance, structural changes taking place in an economy that is growing fast could be turbulent for workers and industry sectors. Firms in some sectors would close down while new ones will emerge in other sectors. Workers who get displaced may have to retrain and get employed in the new sectors and so on. But the process itself would lead to a better outcome for all. In this case the turbulence is not necessarily a bad thing as long as the negative impacts are managed.

This is not the case if turbulence is manifest in volatile macroeconomic variables; inflation rates, interest rates and exchange rates. Such a case would be where inflation rates are high and volatile leading to short-term decision making, interest rates are beyond what would be conducive for sustainable investments and exchange rates that are unpredictable and non-competitive. This kind of turbulence will negatively affect firm performances and impact on long term investment decisions, besides the obvious difficulties faced by the people.

Inflation outcomes; 2001 November to 2008 June

In the above context, this paper considers turbulence in the form of inflation in the recent past in Sri Lanka. The period under consideration begins in November 2001 and ends with June 2008 while inflation is measured on a year-on-year basis using the Colombo Consumer Price Index [CCPI].[1] The reason for selection of the starting date may not be immediately clear but it is to compare and contrast the level and possible reasons for the turbulence during two regimes in office; one from December 2001 to March 2004 and the other since April 2004 [to present, June 2008]. Figure 1 provides some standard descriptive statistics to understand the 'turbulence' of the variable over the period from a statistical standpoint.

[1] CCPI was replaced by CCPI[New] in 2008.

Figure 1: Some descriptive statistics for inflation, November 2001 to June 2008

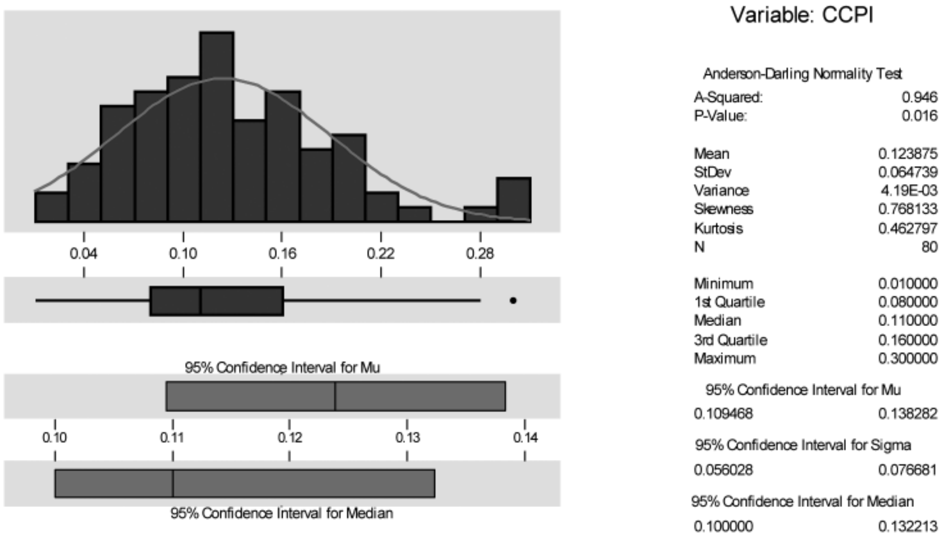
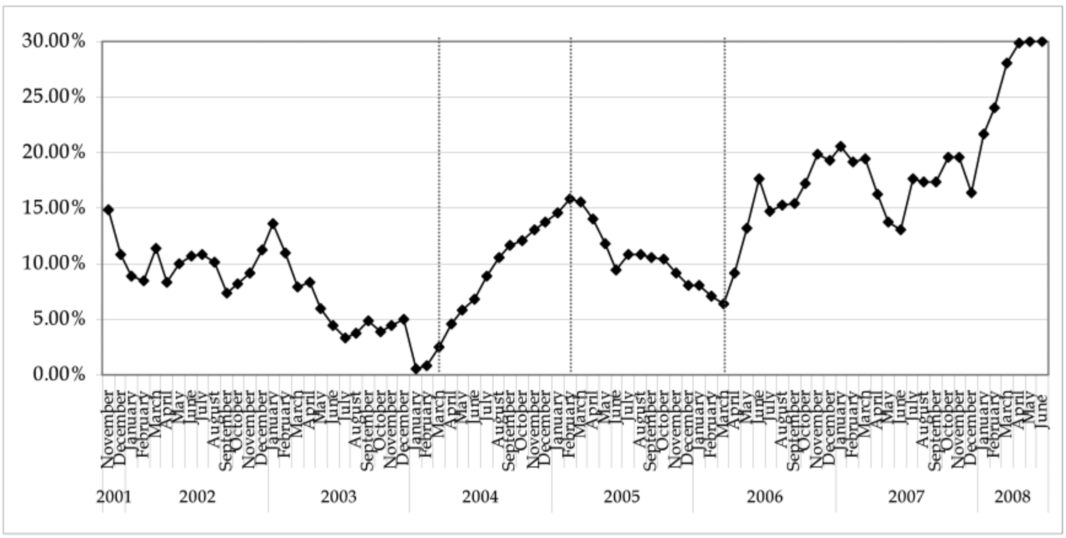


Figure 2 depicts the above turbulence in inflation from regime perspective.
Figure 2: Variation in inflation, November 2001 to June 2008



Source: CCPI data from Central Bank until April 2008. May and June 2008 are estimates and remain at the April 2008 level.

The total period in Figure 2 can logically be segmented in to four sub-periods by inflection points and or regime changes. They are end November 2001 to end March 2004; April 2004 to end February 2005; March 2005 to end March 2006; and from April 2006 to end June 2008. Let us call these sub-periods 1, 2, 3 and 4.

Sub-period 1 is the short lived administration; from December 2001 to April 2004. This sub-period was marked with a rapid decline of inflation from a start of 15 percent; the last month prior to the change of Government, to an end with 2.5 percent after having touched 0.5 percent three months prior to that. During this time the administration adopted stringent fiscal discipline. Passing legislation to bring down and limit fiscal deficits to 5 percent of GDP and total government borrowing to 85 percent of GDP was an indication of the belief that fiscal discipline was crucial to sustained macroeconomic balance.[2] In fact, during this period subsidies were slashed, global oil prices were passed through, expansion of government was halted, no new jobs were granted, an early retirement program was started and privatization of a number of state assets took place. With strict fiscal discipline came monetary discipline. Growth in reserve money, the operating target of monetary policy was very much under control with reserve money registering only 12 percent growth each in the years 2002 and 2003; moving up from LKR 112.5 billion to LKR 141.4 billion in the two years. During the period, net credit to government [NCG] comprising of Treasury bill holdings of the central bank [CBSL] and CBSL advances and loans to government dropped from a high to LKR 67 billion indicating the reluctance to use the money printing option to finance various government expenditure programs.[3] While it is difficult to speculate on the exact lag between the reduction of NCG and the fall in inflation in the 28 month sub-period, the relationship nevertheless is obvious.

Sub-period 2 was in contrast to the previous one with inflation climbing from 2.5 percent in March 2004 to 15.9 percent by February 2005. There were reasons for this outcome. Key among them was the background to the 2004 April elections where the platform consisted of pledges for tens of thousand of new government jobs, a reversal to the subsidy slashing policy, freeze on petroleum price increases [an end to the pass through mechanism], an end to the privatization program and in general greater state participation in the market. The new coalition administration that was established then went ahead with fulfilling the above pledges, at least in part. A new recruitment drive that saw some 40,000 new state jobs being offered and subsidizing the rising petroleum prices by discontinuing the pass through formula, inter alia, punched a hole in the tight fiscal restraint program.[4] With expanding fiscal deficits and a worsening exchange rate crisis that saw a rapidly worsening LKR [after a relatively stable two and a half yeas] monetary policy discipline

[2] The Fiscal Management [Responsibility] Act was passed in 2002.
[3] All reserve money figures, here and throughout the paper, are from relevant Central Bank publications.
[4] The 2004 tsunami had hardly any impact on the fiscal program for the year as it struck only on 26 December 2004.

followed the same route as the fiscal order. By the end of 2004 with new coalition policies in place and also a new Governor at the CBSL, reserve money had expanded more than the previous two years combined, or by LKR 30 billion to LKR 171 billion.[5] This expansion of 21 percent was much more than the target of 15 percent. In fact this entire increase was in terms of net domestic assets [NDA] as net foreign assets [NFA] had declined creating a balance of payments deficit as alluded to earlier with the exchange crisis. Net credit to government had increased from LKR 67 billion to LKR 105 billion during the sub-period. Monetary policy accommodation was in full swing. However it is essential to note that the increase in NCG began with a lag of some 6 months; around October 2003 with the possibility of an election becoming evident.

Sub-period 3 from March 2005 to March 2006 was again a contrast to the previous one with inflation having reached a period-wide high of 15.9 percent falling sharply to 6.4 percent. With the large inflow of foreign assistance in the aftermath of the tsunami the administration was able to avert a serious exchange crisis. The fast depreciating LKR appreciated significantly and the balance of payments turned positive. With the increasing NFA the CBSL eased the accommodating policy of the previous sub-period and tightened monetary policy. NDA fell significantly and by February 2006 net credit to government had fallen from a high of LKR 105 billion to LKR 62 billion. The reserve money target of 15 percent growth for 2005 was only missed marginally with it registering a growth of 15.8 percent, or LKR 27 billion. During this time, policy rates were revised multiple times increasing interest rates in general and restricting demand. Towards the end of the sub-period, at the end of 2005, a new President was elected.[6]

Finally sub-period 4 is in contrast to the previous with it recording inflation of almost thirty percent. With just two dips in July 2006 and June 2007, inflation continued to soar and reached a high of 29.9 percent by April 2008. The sudden abandoning of the CCPI however makes it impossible to compare the months of May and June 2008 with the past figures.[7] It is noteworthy that inflation measured as per the CCPI [New] which replaced the original CCPI recorded inflation of 25 percent in April and continued to increase to 26.2 percent in May and 28.2 percent in June.

The administration strengthened the original pledges of expanded government and subsidies. The policy of the new President envisioned macroeconomic management as follows. "The mere reduction of public expenditure and the resulting reduction of the budget deficit *per se* is not a characteristic of prudent public finance management. One of the most important factors is to

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[5] Deshamanya Mr Sunil Mendis was appointed Governor of the CBSL in June 2004. He resigned on 30 June 2006.
[6] In Sri Lanka the parliamentary elections and Presidential elections have never been held together. While the last parliamentary elections were held in April 2004, the last Presidential election took place in November 2005. Both are for 6 year terms.
[7] There is no argument that the original CCPI [with a 1952 basket] needed updating. Except for the fact that the new index has removed the alcohol and tobacco component from the basket there is little criticism on the move. However, the original CCPI basket should have been published at least for research purposes for some time instead of the abruptly stop. It is hoped that even at a later date this would be done so comparisons become possible

direct government expenditure to the essential priority areas and thereby ensure maximum returns to the national economy. I will follow such a policy"[8] This policy meant further increases in the cadre of the government, substantial increases in salaries, wages and pensions of state employees as well as continued and sometimes enhanced subsidies in petroleum, electricity, water, transport, education and numerous other welfare measures. Sarvananthan [2008] provides an interesting account of the government expenditure as follows:[9]

> "Particularly noteworthy is the phenomenal growth in the government services sub-sector since 2005. Government services include public administration, defense, education, health and other government services. While in 2003 and 2004 the growth of GDP in current prices has been greater than the growth of government services in current prices, it has been the reverse since 2005 onwards. In fact, the gap between the growth of nominal GDP and government services has been highest in 2005 (9.01%), followed by in 2007 (7.90%) and 2006 (5.05%). In 2003, while there was hardly any growth in the government services in monetary terms (0.03%), the GDP at current prices grew by 11.36%. Therefore, it is inferred that one of the primary sources of economic growth in the past three years (2005-2007) is the growth in government services. Wanton recruitment to the public sector has been the hallmark of the new government that came to power in April 2004. In 2006 and 2007 increasing recruitment to the armed forces (including to home-guard and civil defense force services] has bolstered the public sector."

It is no secret that the heightened war contributed to the deterioration of the fiscal position further. With large expenditure overruns even the substantial reductions in capital investments to meet fiscal deficit targets still meant massive and unsustainable deficits in the 8 percent of GDP range; well above the 5 percent to have been met according to the Fiscal Management [Responsibility] Act.

A noteworthy event during this sub-period was the resignation of the recently appointed Governor and the appointment of a new Governor in mid 2006.[10] Even under the new administration of the Central Bank, reserve money growth continued to grow; this time overwhelmingly exceeding the 2006 target of 15 percent by registering a 21 percent growth for the year; an increase of LKR 42 billion. Both NFA and NDA increased with net credit to government almost doubling from LKR 62 billion at the end of sub-period 3 to LKR 113 billion by end 2006. Monetary policy accommodation was back.

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[8] Mahinda Chintana [Election manifesto of President Mahinda Rajapaksa], page 40

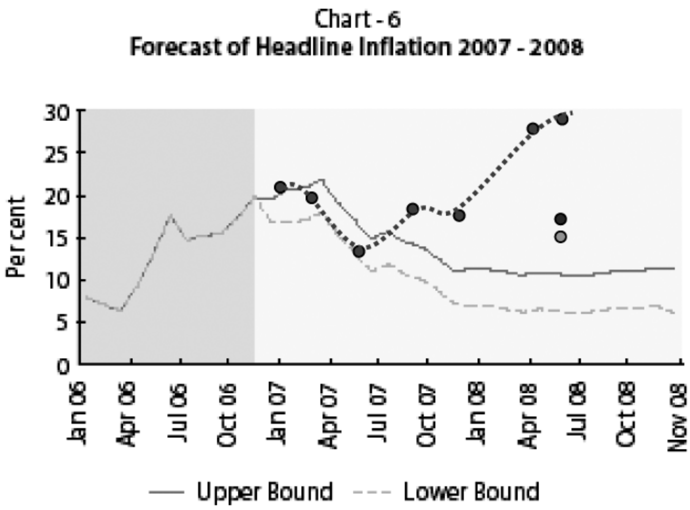
[9] *Phantom Growth of the Sri Lankan Economy*, Point Pedro Institute of Development, Point Pedro, Sri Lanka, May 2008

[10] Mr Ajith Nivard Cabraal was appointed Governor of the CBSL with effect from 1 July 2006.

With inflation becoming a serious issue and expectations of inflation increasing, the CBSL announced a 'Roadmap for monetary and financial sector policies for 2007 and beyond' at the beginning of 2007. This announcement made public its objectives, strategies and targets for the year. The CBSL seemed to have adopted a hard nosed approach towards combating inflation. It set a target of 11.6 percent increase in RM for 2007 and succeeded in meeting the target, in fact beating it; with its growth restricted to 10.2 percent or LKR 264.4 billion. Without a doubt, monetary policy was becoming tighter even with a government that was not willing to slow down its expenditure on a large public sector that was still growing, a war that was heightening and subsidies that were continuing. At same time the CBSL was facing unprecedented [for the period under consideration] external developments of high petroleum and food prices that impacted inflation.

In this background, while the CBSL met its reserve money targets, with billions to spare, inflation continued to increase. After an initial drop to 13 percent in June with net credit to government dropping from the previous close of LKR 113 billion to LKR 89 billion, inflation rose again in the second half of the year to almost 20 percent in October with NCG too increasing to a new high of LKR 136 billion. As can be seen form Figure 3, actual inflation which followed the projection until mid year, fell off the projections set in the roadmap as shown below. However it must be noted that the significant revision of retail prices of fuel during the year and the resulting adjustment of the general price level would have had an impact on inflation.

Figure 3: Projected inflation and outcome 2007-2008



Source: CBSL Roadmap for monetary and financial sector policies; 2007 Chart 6 and 2008 Chart 15. The reproduced chart is from 2007 and the two points for June 2008 marked up on the same chart with same indicative colours is from the 2008 document [adverse scenario; approximate figures for June 2008: minimum 16 percent; maximum 17.5 percent]

In this background of having met the reserve money targets but having missed the projected inflation rates in 2007, the CBSL once again announced its 2008 monetary policy roadmap with a reserve money target growth of approximately 15.8 percent at the end of 2008 over end of 2007.[11] As in the case of the previous year the CBSL continued to meet its reserve money targets and broader monetary aggregates also declined through the transmission mechanism of higher interest rates, but it did not have any impact on inflation until the end of the reference period. In the face of continuing inflation pressure the central bank once again tightened monetary policy further by bringing down the RM growth to approximately 13 percent to be met at end of 2008. Again it is important to note that monetary transmission operates with some, yet not always predictable lag and that even though RM targets have been met in the recent past, the excesses at the beginning of the sub-period could be working its way through. Immaterial of this theoretical reasoning, the CBSL's credibility suffered due to consistent under estimations of the needed policy measure to combat inflation and treating reserve targets as the only instrument available to them to slow down the growth of money supply.

The oil price puzzle

While there is no argument that global oil prices had a significant impact on 'cost-push' elements of inflation in Sri Lanka and elsewhere during the period under review, the question is, whether it is correct to apportion blame for inflation on global oil prices and various other random supply shocks ignoring the appropriateness of monetary policy?[12] The logic is that since the CBSL is meeting its reserve money targets, then the resulting inflation is completely out of its control. A typical explanation for inflation is presented below from the CBSL Annual Report for 2007:[13]

"This adverse development [high inflation] was a combined effect of several factors both of domestic and external origin. On the domestic front, the terrorist disturbances in major paddy producing areas in the North and East, bad weather conditions and higher demand for rice due to the substitution effect arising from higher wheat prices had an adverse impact on domestic rice prices... On the external front, the continued escalation of global oil and gas prices led to upward adjustments in domestic prices of these items at several occasions during the year, exerting direct and indirect impact on the prices of consumer items at varying intensities. Equally, the adverse developments in the international commodity market coupled with both global supply shortages and increased demand, raised the prices of major imported food commodities such as wheat and milk foods, particularly towards the second half of the year... These external developments and supply shocks had an overriding impact on prices, though the demand pressure was notably curtailed by implementing a tight monetary policy programme."

The independent observer would notice the almost negligible reference to demand pressure

[11] The targets were not for end of period but for an average based on daily volumes per quarter, that is why an approximation is provided.
[12] 'Cost push' cannot proceed beyond the short run without Central Banks accommodating the cost increases by increasing money supply.
[13] CBSL Annual Report, 2007, page 73

which according to the statement has been 'curtailed' by a tight monetary program. Additionally, there is no evidence to substantiate many of statements contained in the statement; particularly to account for inflation in the mid to upper 20 percent range. For instance, 'terrorist disturbances' of the implied intensity did not happen only in the year under review by the CBSL, but had taken place on many instances over the last 25 years. Then, bad weather conditions are part and parcel of Sri Lanka and cannot explain the surge in inflation over a period extending a number of years. This leaves the most often blamed global oil prices to explain most of the inflation. It is interesting therefore to note the behaviour of global oil prices during the four sub-periods.

Figure 4: Global oil price increases and local inflation

	Price of Brent crude, USD per barrel	Increase, percent	Inflation movement, percent
Sub-period 1: November 2001 to March 2004	17.80 to 34.00	91.0	Decrease from 14.9 to 2.5
Sub-period 2: April 2004 to Feb. 2005	34.00 to 52.10	53.0	Increase from 2.5 to 15.9
Sub-period 3: March 2005 to March 2006	52.00 to 66.10	26.8	Decrease from 15.9 to 6.4
Sub-period 4: April 2006 to June 2008	66.10 to 139.4	110.0	Increase from 6.4 to 29.9

Source: U.S. Energy Information Administration

Perhaps the most significant difference among the sub-periods is the direction of inflation and global oil prices. In sub-periods 1 and 3, inflation came down even though oil prices went up while in sub-periods 2 and 4 both moved in the same direction. The contrast in sub-periods 1 and 4 is most interesting with in sub-period 1 inflation falling dramatically while in sub-period 4 inflation rising dramatically while oil prices increasing by almost equal proportions.

It is also pertinent to consider the impact of oil prices on inflation of regional economies. By mid 2008, the most countries were in the 10 to 11 percent region or even less with a couple of exceptions. Thus it is clear the Sri Lanka situation is significantly different from the average outcome in the region. This fact once again substantially negates the argument of impact of global oil prices on the high and volatile inflation in Sri Lanka during the period under review and forces a re-look at monetary policy in the context of accommodating fuel subsidies.

The reserve money puzzle

As we observed earlier, the CBSL sets a target for RM every year. But even though these targets are met, inflation continues to rise. In this context it is noteworthy to consider how the RM targets are set and adjusted. RM targets are set by taking in to consideration a number of factors that would impact the real demand for money; particularly economic growth and inflation. For instance the RM target of LKR 267.6 billion for 2007 was based on the forecast of GDP growth of 7.5 percent for the year. However that year, the economy grew only by 6.7 percent; a significant decrease from the forecast, which would have resulted in a fall in the real demand for money. The question is, did the CBSL account for the slowdown in economic growth and revise the RM targets downwards during the year? The answer is no such revision took place even when it was known early on in the year that the economy was not going to achieve the optimistic growth targets. Another point to consider is if the CBSL was using its core inflation index to assess the demand for money then it is possible that inflation was understated and demand for money overstated resulting in higher than projected inflation. Thus the natural question is if the RM target which continue to be met comfortably simply too high?

Conclusions

The forgoing analysis points to the relationship between the monetary accommodation of large fiscal deficits and high and volatile inflation in the period under consideration. Sub-periods in which reserve money growth and thereby broader measures of money was tight and money printing was tightly controlled, inflation fell while in sub-periods where reserve money growth was excessive inflation increased. It is not for a moment suggested that monetary policy is working without a lag, but merely pointing to the relationship. Further study is required to ascertain the dynamics of the actual lags.

The findings naturally point to continued turmoil unless growth of state expenditure is curtailed and financing the resulting deficits through accommodating monetary policy restrained. It is suggested that the CBSL consider the possibility of having a transparent and open agreement with the Treasury about the limits on expenditure growth. It is in this context that independence of the CBSL also becomes crucial. The implementation of the amendment to the Monetary Law by which a majority of the members of the monetary board is to appointed with the concurrence of the Constitutional Council, perhaps would be good start as any in moving in that direction. The perception of the ability of the CBSL to act without fear, favour or interference of politicians makes market participants also more comfortable with believing the CBSL which is crucial in building its much needed reputation credibility. This credibility which will have to be built over a period of time will become essential in anchoring inflation expectations which will go a long way in finally bringing about a low and stable inflation regime in a disciplined fiscal and monetary policy framework.

Further, it is imperative that serious consideration is made to the current exchange rate based stabilization program. Large short-term and high cost foreign currency borrowing which is appreciating the LKR causing serious problems to exporters is certain to cause future balance of payments problems. It is no secret that a substantive reason for the current slowdown of NCG is precisely these foreign borrowings.

Lastly, it is clear that the CBSL monetary programming has not achieved the desired success thus far and it is imperative that greater attention be paid to rein in inflation in order to prevent further economic difficulties. However, it is still not too late for a more stringent and cohesive fiscal and monetary policy regime to ensure a future with low turbulence if the political leadership of the country is willing to take on the challenge. The biggest challenge for the political leadership of course is to bring about fiscal discipline. All current efforts by the CBSL to advise the administration to ensure this outcome are commended.