The maintenance of price stability is one of the two core objectives of the Central Bank of Sri Lanka. This pamphlet explains what is meant by price stability, how it is measured, why it is important and the factors that affect price stability. The pamphlet also describes the various inflation containment measures and how monetary policy is used to achieve and maintain price stability. The purpose of this pamphlet is to increase public awareness and understanding of the role of the Central Bank of Sri Lanka in achieving price stability.
WHAT IS PRICE STABILITY?

Price Stability is the economic term used to refer to a situation where the general price level covering consumer goods remains unchanged or if it does change, it happens at a low rate so that it is not strong enough to make any significant influence on economic decisions of participants in an economy, viz. households and firms. We encounter prices in different forms in our daily activities as buyers or sellers when we get engaged in consumption, investment, production or trade. In a market economy, price changes are a common phenomenon depending on the demand for and supply of goods and services. Since prices change in both directions and in different magnitudes, it is difficult to figure out the general movement in prices by examining each individual price change in isolation. Therefore, an economic concept, the General Price Level, is used to capture the overall impact of individual price movements. Thus, price stability means a relative stability in the general price level in an economy, but does not imply the stability of individual prices or fixed prices. This was aptly described in a statement by Alan Greenspan, Chairman of the US Federal Reserve System: "For all practical purposes, price stability means that expected changes in the average price level are small enough and gradual enough that they do not materially enter business and household decisions."  

HOW IS PRICE STABILITY MEASURED?

As we are more interested in the general increase (or decrease) in prices, rather than the increase (or decrease) in the price of a particular good or service, it is necessary to find a measure that will capture the changes in the general price level. The general price level is measured by a statistical tool called a Price Index. A price index is simply a weighted average of prices of a basket of selected goods and services where weights represent the relative importance of each item as reflected in its relative share in the total value of the basket. There are different price indices, e.g., Consumer Price Indices (CPIs), Wholesale Price Indices (WPIs) and Producer Price Indices (PPIs), which measure the overall trends in price movements at different stages of the process, from production to final consumption. However, CPIs are the most widely used price indices, as their changes represent the price movements faced by most people in a society as consumers. Nevertheless, computation of WPIs and PPIs is also important, as their movements are leading indicators of future movements of consumer prices.

A consumer price index measures the general movements of prices of a representative basket of consumer goods and services. Based on a survey of the spending patterns of consumers, goods and services are included in the basket and relative weights are assigned to them according to their relative importance in the total expenditure, i.e., goods and services that account for larger portions of the total expenditure of consumers are assigned greater weights. The total consumption expenditure, or simply, the Cost of Living, can vary over time due to either changes in the consumption basket, while prices remain unchanged, or due to changes in the prices, while the consumption basket remains unchanged, or due to changes in both. However, it is reasonable to assume that the average consumption basket of the society as a whole, will generally remain fairly stable during a period of 3 to 5 years, as most factors that affect the consumption pattern get adjusted slowly. If the consumption basket in the CPI is assumed to remain unchanged, its movements reflect only the net impact of price changes of items in the basket.

In the example given in Table 1, the expenditure on the consumption basket, as well as the estimated CPI, increased by 8.6 percent from year 1 to year 2, reflecting only the changes in the general price level between the first two years as the basket remains unchanged. We focus on the change in the overall price index rather than on individual prices, because what matters more to the consumer is what happens to his overall cost of living due to various price changes, and rather than what happens to the individual prices per se.

In Sri Lanka, the official price index currently used is the Colombo Consumers’ Price Index (CCPI). It is constructed based on the spending patterns of the lowest 40 per cent of households, ranked by their monthly income, within the Colombo Municipal area in 1952. The Department of Census and Statistics (DCS), which compiles the official price index, has introduced a new index, the Sri Lanka Consumers’ Price Index (SLCPI) to overcome some of the weaknesses in the CCPI such as the outdated basket of goods and services, and the limited coverage of income groups and geographical area. The SLCPI is based on the spending patterns of the lowest 80 percent of households ranked according to monthly income in the entire country, excluding the Northern

1/ At the 1989 US Congressional hearing.
and the Eastern provinces, between 1995 and 1997. However, it is yet to be adopted as the official price index. As in any developing country, the CCPI and the SLCPI assign a large weight (about 65 percent) for food and beverages, reflecting the spending pattern of the average consumer in Sri Lanka. There are two other indices available to measure movements in the general price levels in Sri Lanka: the Wholesale Price Index (WPI), which captures the price movements at the primary market level and the Gross Domestic Product (GDP) deflator, which is the broadest measure of the general price level covering all goods and services included in the computation of GDP in the country.

**WHAT IS INFLATION OR DEFLATION?**

Most people know that inflation is about rising prices. However, it is important to understand that inflation is not simply about increases in the prices of individual goods or services, as prices rise or fall all the time in a market economy. Inflation is a more general phenomenon reflecting a widespread rise in prices across the economy over a period of time. It is an economic term used to refer to a continuous rise in the general price level. Similarly, deflation refers to a continuous drop in the general price level. Inflation/deflation can be estimated based on any price index reflecting the general price level in a country. It is important to understand that a decline in inflation (sometimes referred to as ‘disinflation’) does not imply a general reduction in consumer price levels. What it indicates is a slowing down in the increase of the general price level. It is clear in the example given in Table 1 that inflation declined from 8.6 percent in the first year to 7.1 percent in the second year, although all individual prices rose in the second year too. Only a deflation indicates a general reduction in overall consumer price levels. Thus, it is clear now that the price stability means low inflation or deflation which is not strong enough to affect the economic decisions of households and firms.

According to the CCPI, the cost of the basket of goods and services used by an average household in the lowest 40 percent income category within the Colombo Municipal area was around Rs. 200 in 1952. The cost of the same basket was Rs.6,424, Rs.6,830 and Rs.7,347, respectively in 2002, 2003 and 2004, respectively. This reflects an annual average of inflation of 7.3 percent in Sri Lanka based on CCPI for the period 1952-2004 (Table 2). Inflation in 2002, was 9.6 percent. This decreased to 6.3 percent in 2003 but rose to 7.6 percent in 2004. We should remember however, that though inflation in 2004 was 7.6 per cent (i.e. the increase in the overall price level from 2003 to 2004 was 7.6 per cent), within the overall basket, the prices of some items may have increased more than others in 2004. In fact, it is even possible that the prices of some items may have actually decreased in 2004.

**WHY IS PRICE STABILITY IMPORTANT?**

Maintaining price stability is important as it has a number of benefits. Conversely, when it is not
Price Stability

Price stability maintained, the resulting outcome of inflation or deflation has a series of adverse impacts. The experience of many countries suggests that price stability promotes economic growth, as stable prices allow everyone to make better decisions regarding what to produce and how to produce, thus enabling more efficient allocation of resources. Price stability also avoids economic agents diverting scarce resources to hedging against inflation. If prices are stable, investors and savers would not demand a risk premium, such as a high interest rate, to compensate them for the risks associated with long-term savings and investments. In fact, continuous unstable prices are likely to result in demand for a high risk premium, discouraging both long-term savings and investment.

Inflation has adverse impacts as it distorts price signals, erodes savings, discourages investment, stimulates capital flow from productive investment to non-productive investment (such as precious metals and real estate), inhibits growth and makes economic planning a nightmare. It also has a disproportionate effect on the most vulnerable groups in society such as fixed income earners, pensioners and low-income groups as their ability to hedge against inflation is very limited. The cost of inflation rises with its level and volatility and in its extreme form, i.e. hyperinflation, can result in public unrest, causing huge economic, social and political costs. Similarly, deflation also has a number of adverse impacts, such as discouraging investment, retarding economic growth, increasing unemployment and poverty and in its extreme form, economic depression which could, result in economic, social and political instability in a country. Achieving and maintaining a low and a stable inflation is a foundation for many of the economic and social objectives that most people would want to see achieved. Crucially, it is an essential ingredient for sustainable growth in investment, output and jobs.

If inflation is so undesirable, someone may ask why we should not target zero inflation rather than low inflation. The answer partly relates to the measurement of inflation. “Measured” inflation is likely to overstate, to some degree, “true” inflation. Price changes should be recorded keeping the quality of goods and services unchanged in order to estimate the inflation properly. However, that is not always possible and some recorded price increases might reflect extra features or higher quality incorporated into goods and services. It is also true that some prices and wages are fairly inflexible downwards requiring a small inflation rate to facilitate changes in relative prices. Therefore, targeting zero inflation may pose the risk of unintendedly shifting to a deflation. Furthermore, as nominal interest rates charged in the market cannot be negative, some inflation might provide a cushion in extreme situations, like in a deep recession that required negative real interest rates to stimulate the economy. Hence, zero inflation need not be targeted as a goal and closer to zero inflation may be tolerable without compromising long term growth prospects. Therefore in summary, price stability provides everyone a conducive environment in which to improve their quality of life, while inflation and deflation have adverse economic, social and political repercussions.

WHAT ARE THE FACTORS THAT AFFECT PRICE STABILITY?

In a free market economy, prices signal the prevailing demand and supply conditions and their changes. In the short run, there is a large number of factors that affect demand and supply, e.g., weather, social and cultural events, purchasing power of people, consumer preferences, innovations, productivity etc. We know that rice prices fall during harvest periods due to a greater supply and prices of vegetables rise following a drought, reflecting a drop in production. Similarly, in general, prices of food items tend to rise during festive seasons, such as New Year and Christmas, due to demand being greater than regular supply. However, such price changes resulting from seasonal factors are temporary phenomena and prices readjust themselves within a short period.

People tend to demand more goods and services if they have money at their disposal. Prices will rise when...
the level of overall (aggregate) demand rises with the expansion of money supply, if the supply of goods and services does not increase at the same rate as the demand for the same. However, the expansion in supply has its own limitations such as the availability of inputs and technological capabilities. Therefore, a greater availability of money in the hands of the people, without a commensurate increase in the availability of goods and services, is the primary demand side factor contributing to inflation. This has commonly been referred to as a situation where “too much money chasing after too few goods”. Similarly, if people have too little money to spend, production suffers due to lack of demand, leading to lower economic growth and higher unemployment. At the same time, one-off increases in the average price level can occur, for example, as a result of a poor harvest increasing food prices or a rise in the oil price raising cost of production. However, such increases can lead to only a temporary rise in the general price level. For it to become inflation, it has to be fueled by an increase in money supply. Therefore, economists agree that inflation in the long run is caused by excessive monetary expansion compared with real economic growth. This was very cogently described by Nobel Laureate economist, Milton Friedman, where he said in his Nobel Laureate lecture that ‘inflation is always and everywhere a monetary phenomenon’. In other words, in the long run, no inflation can occur without an accommodating money supply increase.

**WHAT ARE INFLATION CONTAINMENT MEASURES?**

The policy measures required to be taken to contain inflation, particularly in the short run, depend on the source of inflation as there are a number of possible causal factors. It is generally recognized that, in the short term, mainly supply side factors or structural issues cause inflation. Therefore, policy measures should focus on addressing such issues and expanding production. In promoting economic growth, it is necessary to pay due attention to improving the productivity in order to prevent potential inflationary pressure associated with high income arising from faster growth and cost-push factors that raise the cost of production. In the long run, however, since inflation is primarily a monetary phenomenon, central banks play a key role in containing inflation (i.e., achieving and maintaining price stability), through adoption of appropriate monetary policy to contain monetary expansion at an appropriate level. Experiences in many countries have shown that attempts to contain inflation through price controls are unsustainable and call upon people to bear high effective prices by having to stand in longer queues and pay bribes and commissions to get the needed goods. Further, the scarcities create black markets where they have to pay still higher prices. These are total losses (known

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Source: International Financial Statistics
as dead-weight losses) to the economy and retard long term economic growth. Hence, the inflation created by excessive monetary expansion would need to be controlled on a sustainable basis through a containment of monetary expansion, while increasing production in the country, particularly by improving productivity. In this endeavour, the implementation of supportive fiscal measures as complementary policies are also critical to realise price stability, particularly when the excessive monetary expansion is caused by excessive government borrowing (i.e. as a consequence of high fiscal deficits) as seen in many developing countries including Sri Lanka.

WHAT IS MONEY?

We saw above that the changes in money supply are a primary causal factor affecting price stability. Therefore, it is useful to understand what money is and how its supply expands and contracts. As understood by the general public, money consists of currency notes and coins issued by the Central Bank of Sri Lanka but this does not capture all valuable things that serve as money. Money is a vital part of our everyday lives. It can be earned by working and it can be spent now on things we need or saved for future spending, or borrowed for immediate use. However, money in itself really is useless and its value lies in what it can buy. A rupee is always a rupee, as the generic term rupee itself does not change. But what the rupee will buy, how much it will buy, does vary with changes in prices. Thus, money supply affects prices and prices affect the value of money.

In economics, money is not only currency notes and coins issued by the Central Bank. It also includes deposits held by the public in commercial banks as they also provide holders potential purchasing power, i.e., power to buy goods and services. In general, three definitions of monetary aggregates are used in analyzing monetary developments in Sri Lanka. The first is ‘reserve money’ consisting of currency issued by the CBSL and commercial banks’ deposits with the Central Bank. This is also called reserve or base or high-powered money as commercial banks can create deposits based on reserve money which are components of broader definition of money supply through their process of creating credits and deposits. The second is the narrow money, defined as the sum of currency held by the public and demand deposits held by the public with commercial banks. The third is broad money defined as the sum of currency held by the public and all deposits held by the public with commercial banks. Studies have shown that the most appropriate monetary variable to analyze the relationship between the money supply and the general price level is the broad money supply as defined above.

WHAT ARE THE CAUSAL FACTORS AFFECTING MONETARY EXPANSION?

In Sri Lanka, the Central Bank of Sri Lanka (CBSL) is the primary source of money supply. The CBSL has a stock of minted coins and printed currency notes in its vaults to be issued as money. However, they do not become money as long as they do not become assets of the public.

There are two channels of releasing money from the CBSL to the economy. One is acquiring domestic assets by the CBSL through lending to the government and/or commercial banks. When the government spends more than its revenue, its budget runs into a deficit, which has to be financed through borrowing. The government can borrow from many sources, including the CBSL. Borrowing from the CBSL activates the outflow of currency notes and coins from CBSL vaults. Once the government uses them for payments with respect to its expenses, they become assets of the general public and the banking system. Conversely, when government settles its debt to the CBSL, money flows out of the system into the CBSL vaults and lie there idle in the form of printed paper and minted coins. Similarly, money supply expands when commercial banks borrow from the CBSL or sell domestic assets in their portfolio such as Treasury bills to the CBSL while money supply contracts when commercial banks settle their loans with CBSL or buy Treasury bills held by the CBSL or securities issued by the CBSL.

The other channel is the CBSL transactions in the foreign exchange market. When the CBSL purchases foreign exchange from the government or commercial banks it pays in rupee currency notes and coins expanding money supply. Conversely, when the CBSL sells foreign currencies from its holding to the government or commercial banks money flows back to the CBSL contracting money supply.

3/ (i) \( RM = C + CD \); (ii) \( M_1 = C_p + DD_p \); (iii) \( M_2 = C_p + DD_p + SFD_p \)

Where,

- \( C \) = Currency issued by the Central Bank
- \( CD \) = Commercial banks’ deposits with the Central Bank
- \( C_p \) = Currency held by public
- \( DD_p \) = Demand deposits held by the public with commercial banks
- \( M_1 \) = Narrow money supply
- \( M_2 \) = Broad money supply
- \( RM \) = Reserve Money
- \( SFD_p \) = Savings and fixed deposits held by public with commercial banks

Central Bank of Sri Lanka
Commercial banks’ activities with customers also contribute to changes in money supply through the process of creating deposits and credits. Since depositors as a whole will only withdraw a small portion of their deposits in the banking system commercial banks could create credit simply by creating a deposit. In this process, commercial banks’ acquisition of financial assets (both domestic and foreign) and expansion of credit to the private sector and public sector (i.e. government and public corporations) are the major causal factors affecting the money supply. Accordingly, the CBSL could make an impact on monetary expansion by inducing changes in the cost of funds and/or availability of money through purchases or sales of financial assets (mainly Treasury bills) in the domestic market.

**HOW IS MONETARY POLICY USED TO ACHIEVE PRICE STABILITY?**

Monetary policy is the means by which a central bank seeks to achieve its objective of price stability, by influencing the cost (interest rates) and availability of money (credit). A central bank has many instruments that it can use in the conduct of monetary policy. The most widely used instruments are statutory reserve requirements (SRR) and open market operations (OMO). Under the SRR, the CBSL can impose a requirement on commercial banks to keep a part of their deposits with the CBSL. By changing the SRR the CBSL can influence the credit creating ability of commercial banks and hence, broad money supply and market interest rates. Under open market operations, the CBSL influences money supply and market interest rates by changing policy interests applicable for its transactions with commercial banks and/or by trading Treasury bills and Central Bank Securities.

The process by which the changes in monetary policy instituted by a central bank affects the general price level and output in the economy is referred to as the **monetary policy transmission mechanism**. There are several channels through which monetary policy changes are transmitted through the economy (Figure 1). These are usually identified as (i) the interest rate channel (whereby the economy is impacted through changes in interest rates), (ii) the credit channel (whereby the economy is affected through changes in the availability of credit) (iii) the exchange rate channel (whereby the economy is affected through changes in the exchange rate) and (iv) the wealth channel (whereby the economy is affected through changes in asset prices and their impact on wealth). Of these channels, greater emphasis has been placed on the interest rate and credit channels, particularly in developing countries. Also it is important to note here that there are different and long lags, sometimes extending up to two years, in the process of transmitting the monetary policy impact from the policy instruments (i.e. SRR or OMO) to intermediary targets (such as broad money supply) and subsequently to the final targets (i.e. prices and output).

In Sri Lanka, the authority responsible for the formulation and implementation of monetary policy is the Central Bank of Sri Lanka (CBSL). The **Monetary Law Act** (MLA), the legislation under which the CBSL has been established and operates, has provided a wide range of policy instruments that could be used by the CBSL for monetary management in achieving price stability4. The CBSL has been following a monetary targeting framework, with reserve money as the operating target and broad money as the intermediate monetary policy target5. It has gradually moved towards more market oriented policy instruments in monetary management and at present places greater reliance on OMO.

In Sri Lanka, SRR has been used as a monetary policy instrument and the applicable ratio at present is 10 percent on all types of rupee deposits. However, the reliance on SRR has been reduced with increasing emphasis being placed on OMO. Under the present system of OMO, the CBSL signals its monetary policy stance, by changing the Repurchase (Repo) rate and/or Reverse Repurchase (Reverse Repo) rate while engaging in sales and/or purchases of Treasury bills to manage the rupee liquidity in the market to be compatible with the desired reserve money target. By reducing the policy rates (i.e. Repo and Reverse Repo rates) and/or buying Treasury bills the CBSL can ease the monetary policy stance stimulating expansion in money supply and encouraging reduction in market interest rates. Similarly, CBSL can tighten the monetary policy stance by raising its policy rates and/or selling Treasury bills from its portfolio or issuing its own securities. These OMO activities have an almost immediate impact on interest rates in the call money market (i.e., the money market among commercial banks) and the rupee liquidity available in the banking system, influencing their credit supply activities. Changes in call rates and/or availability of rupee liquidity would lead, within a very short period, to changes in other short-term market rates such as the yield on Treasury bills and the prime lending rates of commercial banks. These changes would, with a time

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4/ The objectives of the CBSL, as given in the MLA, are (i) economic and price stability and (ii) financial system stability.
5/ Details are given in the CBSL’s website under “Monetary Policy Objectives and Monetary Policy Framework in Sri Lanka”.

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lag, affect the general lending and deposit rates of commercial banks, yields on Treasury bonds and credit expansion of the banking system, thereby influencing decisions of borrowers (for consumption and investment) and savers. They also would have an impact on the exchange rate and asset prices such as equity and real estate prices. Finally, all these changes would have an impact on the general price level and output of the economy through their impact on aggregate demand.

In summary, maintaining price stability in an economy has many benefits, while inflation (or deflation) has serious adverse economic, social and political impacts. Inflation, in the long run, is essentially caused by excessive money supply, although in the short run there are other factors that could also put pressure on prices. Consequently, one of the most important goals of monetary policy is the containment of inflation, i.e. maintaining price stability. We should, however, be aware that monetary policy alone is not sufficient to maintain price stability and monetary policy cannot be carried out in isolation from other macroeconomic policies. In particular, fiscal policy (i.e. government’s policies on taxes, expenditure and deficit financing) should work in tandem with monetary policy in order to achieve effectively the goal of price stability. Income policies, i.e. policies relating to wage setting that link wages to productivity gains, should also be perused. Further, in developing countries like Sri Lanka there are other structural issues (i.e. inefficiencies in production, land, labour and capital markets resulting in high wastages and constraining productivity improvements) that also need to be addressed in order to create an environment of low and stable inflation, i.e. price stability.

RELATED KEY WORDS

Core inflation: a measure that reflects the underlying trend in inflation by excluding certain components subject to large variable price changes.

Deflation: a decline in the general price level.

Disinflation: slowing down of the rate of price increases (i.e. different from deflation).

Inflation: an increase in the general price level.

Hyperinflation: a rapid rise in inflation, usually a 100% or more increase in the general price level.

Stagflation: a situation where an economy is experiencing twin problems of stagnation (or sluggish growth) and rising inflation.

Underlying inflation: trend in the general price level, which reflects the balance between the aggregate demand and supply in the country.