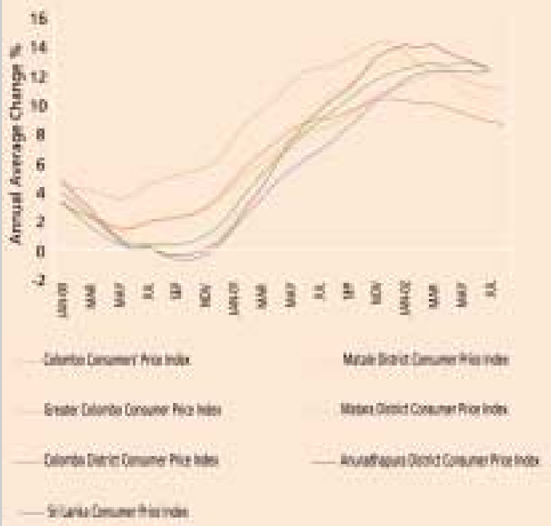
4. PRICES AND WAGES

Consumer price inflation, which had risen continuously from mid 2000 till December 2001, mainly due to the supply shortages of key food items and administered price revisions, started to fall from the beginning of 2002 with the improvements in supply and the tapering off of the impact of the administered price revisions. Recent price developments signal a further drop in inflation to a range of 8 to 10 per cent by the end of 2002 and a range of 6 to 8 per cent by the end of 2003.

Chart 4.1
Trends In Price Indices



Outlook for 2002

- Consumer price inflation in the first half of 2002 was driven mainly by supply side factors, with the monetary expansion not fuelling demand pressure.

- The year 2002 started with signs of moderation in, albeit still high, inflation, which peaked around the end of 2001- early 2002 after a continuous rising trend since mid 2000. This was indicated in all consumer price indices (CPIs), including the Sri Lanka Consumer Price Index (SLCPI), which was introduced by the Department of Census and Statistics (DCS) in early 2002 on a trial basis, and has a much broader geographical and income group coverage than all other hitherto published CPIs.

- Administered price revisions of certain key food and non-food items to reflect their costs and changes in import prices of certain imported items, contributed to the behaviour of inflation in the first half of the year. The partial recovery of domestic agriculture, the availability of imports and lower price pressure from imported items relative to the corresponding period last year, helped dampen price increases to a certain extent. The combined outcome resulted in lower inflation by the end of the reference period (January to June 2002), although, in general, inflation throughout the period was higher than in the corresponding period in 2001.

- The declining trend in inflation observed from the beginning of the year is expected to continue throughout the year, resulting in a lower annual inflation than in the previous year. Expected improvements in the production of agricultural commodities and fish, less likelihood of large revisions in administered prices following the required price adjustments made thus far, especially by way of introducing an automatic pricing policy for petroleum products and removing the subsidy on wheat flour, and lower pressure from imported prices are expected to contribute to lower inflation.

- The net impact of the Value Added Tax (VAT) introduced in August 2002 is also expected to lower market prices of many basic consumer items such as rice, wheat flour, vegetables, fish, coconut and sugar, which have high weights in the consumer basket. The improvements in the security situation following signing an MOU between the government and the LTTE, which resulted in enhanced economic activities in agriculture and fishing and improved mobility of goods between markets in the North – East and the rest of the country, are also expected to contribute to lower prices.

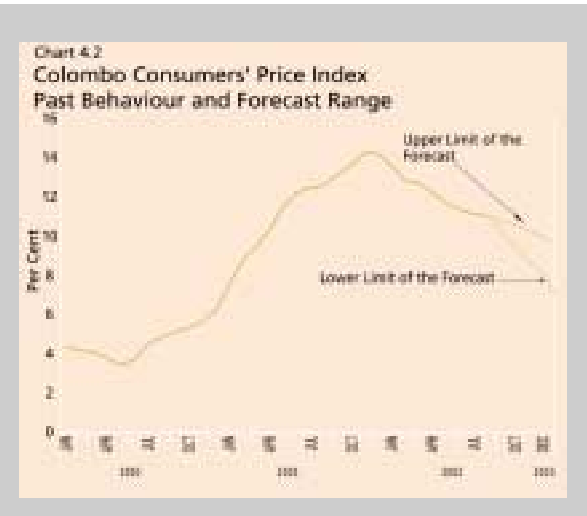
- Prospects for lower inflation in 2002 anticipate favourable weather during the second half of the year and the continuation of the prevailing ceasefire. The net benefit of the VAT is expected to be reflected in lower prices, which, however, will depend on the traders passing on benefits to customers, awareness of consumers to obtain maximum possible benefit and the commitment of the authorities to ensure effective consumer protection. On the weather front, there is some concern that rainfall would be somewhat lower than originally expected, in which event the performance, especially in the agriculture sector, could be lower, resulting in higher prices than expected.

- These factors indicate that price developments during the rest of the year will not experience any unusual shocks. Applying historical averages to price movements, the annual average inflation rate by the end of the year is projected to be around 9 -10 per cent based on the CCPI. It has been estimated that a further reduction of about 1 percentage point could arise from the net benefit of the VAT being passed down to the consumer, in which case inflation would be around 8 - 9 per cent by end 2002.

- Government employees enjoyed relatively higher nominal wages in 2002 compared to 2001 after the salary increase effected from 1 October 2001. As this rate of increase in nominal wages exceeded inflation, all non-executive categories of government employees, including school teachers, enjoyed real wage increases. All major categories of employees governed by the Wages Boards trades (minimum wages), in contrast, suffered real wages losses, as their nominal wage increases were not sufficient to compensate for inflation.

- Wages in the informal sector have a tendency to adjust gradually in response to the rising cost of living. However, poor economic conditions that prevailed during the reference period seem to have prevented a full adjustment in wages to compensate for the rise in prices. Though all major categories of unorganised sector wages increased, their rates of increase were below the average inflation rate, except in the construction sector where there was a real wage increase.

- In 2002, the overall wage increases were at a minimal level. However, following some pressure for wage revisions from the plantation sector workers, wage rates were successfully negotiated between employers and employees, without any government intervention, taking into account the prevailing economic situation in the country and welfare concerns. Consequently, the average wage of plantation workers was raised by around 21.5 per cent or by Rs. 650 per month. This signifies that both employers and employees, including trade unions, are able to negotiate bilaterally, to their mutual benefit, with rationality and maturity, without any government involvement.



- Despite some pressure for wage revisions, any overall wage revision in the government sector or the private sector is unlikely and unwise in the current economic and fiscal environment.

Outlook for 2003

- As in the recent past, price movements in 2003 too will depend primarily on supply side factors. Maintenance of monetary expansion consistent with the macroeconomic stabilisation programme will help mitigate any inflationary pressure from the demand side. Inflation is expected to moderate further to a single digit level of 7 - 9 per cent for the year on average.

- Domestic economic activity, especially in food production, movements of international prices of major imports, particularly oil, exchange rate movements and administered price revisions, if any, would influence inflation in 2003. Undue volatility or change is not expected in any of these factors during the reference period, unless an unusual shock is experienced internally or externally.

- According to the GDP forecast, production of major food commodities is expected to expand in 2003. The expected growth rates are 5 per cent for fish, 3 per cent for coconut, 2 per cent for paddy and 1 per cent for other agriculture commodities. The balance of payments (BOP) projections indicate that the international prices for major imports such as rice, wheat, sugar, other food products and fertiliser would increase by 2 to 8 per cent in 2003. Exchange rate stability is expected to improve further in 2003. The combined effects of these expected external developments would exert some pressure on domestic prices. With the introduction of an automatic pricing formula for petroleum products and the removal of the subsidy on wheat, the impact of administered price adjustments, if any, on inflation during 2003 would be marginal, as market prices would now reflect the actual cost of production of those items.

- Sporadic moves for wage increases observed at present could stimulate and consolidate currently dormant forces unless the rising trend in the cost of living is contained. However, if unemployment can be reduced by creating more job opportunities, which is possible if the expected surge in economic activity materialises, so that the rising cost can be absorbed by more incomes in the family, pressure for wage revisions would ease to some extent. Though wage increases accompanied by productivity improvements are not harmful, such productivity improvements can only be expected if efficiency is improved in all economic sectors.

- Nevertheless, with the anticipated deceleration in price inflation in 2003, market pressure for higher nominal wages would be weaker than in 2002. Also, the implementation of labour reforms that would increase flexibility in the labour market would further ease the pressure for wage revisions.