

4. PRICES AND WAGES

The trend of easing pressure on prices, observed since January 2002, bottomed out during the first half of 2004, and signaled a rising trend in the second half, projected to culminate in an annual average inflation rate of around 7 per cent by December 2004. This is slightly higher than the inflation expected at the beginning of the year. Higher international prices, especially of energy sources, and the impact of the recent drought on agriculture and power production on the supply side have pushed consumer prices up. Monetary expansion was somewhat higher than projected due to the higher than expected increase in credit to the private sector and higher than targeted borrowing by the public sector (i.e. government and public enterprises). These developments could fuel demand-pull pressure on prices. Though market interest rates indicated a rising trend towards the middle of the year reflecting expectations of rising inflation, there were signs of their becoming moderate in recent months. Early corrective measures would be required to dampen rising consumer price inflation in the coming year.

Outlook for 2004

□ The moderation of consumer price inflation observed throughout 2002 and 2003 continued during the first quarter of 2004, but bottomed out during the second quarter. This trend was seen in all consumer price indices (CPIs), and signals rising price pressure during the second half of the year. The Colombo Consumers' Price Index (CCPI), the official measure of the cost of the living, reached 3.7 per cent in May, its lowest annual average change since January 2002, and then rose continuously to reach 4.9 per cent in August. The Sri Lanka Consumers' Price Index (SLCPI), which has a broader geographical as well as income group coverage and more recent weights than the CCPI, reached its lowest annual average change of 1.2 per cent in March and started rising thereafter to reach 2.3 per cent in July. The rising trend in inflation rates based on the CCPI and SLCPI were also signaled by the point-to-point increases, which rose continuously since early 2004 and have been significantly higher than last year in recent months. Regional CPIs too indicated similar trends.

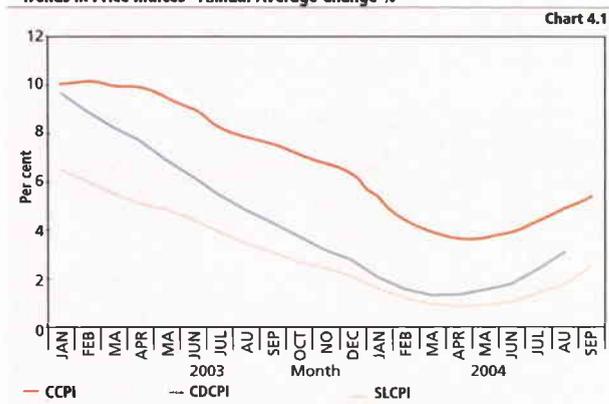
Table

Movements of CCPI and SLCPI

| Month | Point to Point Change % | | | | Annual Average Change % | | | |
|-----------|-------------------------|------|-------|------|-------------------------|------|-------|------|
| | CCPI | | SLCPI | | CCPI | | SLCPI | |
| | 2003 | 2004 | 2003 | 2004 | 2003 | 2004 | 2003 | 2004 |
| January | 13.6 | 0.5 | 7.2 | -0.9 | 10.0 | 5.2 | 9.6 | 1.9 |
| February | 11.0 | 0.9 | 5.3 | -0.2 | 10.2 | 4.4 | 8.9 | 1.5 |
| March | 7.9 | 2.5 | 4.2 | 1.2 | 9.9 | 3.9 | 8.2 | 1.2 |
| April | 8.3 | 4.6 | 3.6 | 4.2 | 9.9 | 3.7 | 7.6 | 1.3 |
| May | 6.0 | 5.9 | 2.9 | 4.7 | 9.5 | 3.7 | 6.8 | 1.4 |
| June | 4.5 | 6.8 | 2.3 | 5.6 | 9.0 | 3.9 | 6.1 | 1.7 |
| July | 3.4 | 8.9 | 1.4 | 8.3 | 8.3 | 4.3 | 5.4 | 2.3 |
| August | 3.7 | 10.5 | 1.2 | na | 7.8 | 4.9 | 4.8 | na |
| September | 4.8 | | 1.4 | | 7.6 | | 4.3 | |
| October | 3.9 | | 0.2 | | 7.2 | | 3.6 | |
| November | 4.5 | | 0.8 | | 6.8 | | 3.1 | |
| December | 5.0 | | 1.0 | | 6.3 | | 2.6 | |

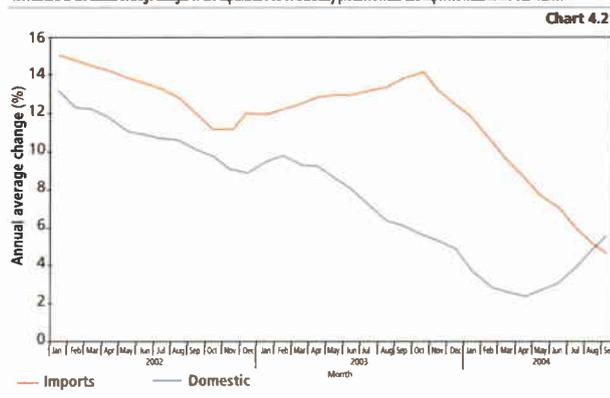
□ Price increases of both imported goods and domestically produced goods contributed to the overall inflation during the first half of the year. Domestically produced goods represent around 78 per cent of total consumption expenditure in the official measure of inflation, and are dominated by food items. Imported consumer goods represent the balance of around 22 per cent of total consumption expenditure. However, imported intermediate goods, especially crude oil and gas, impose a significant indirect pressure on consumer prices.

Trends in Price Indices - Annual Average Change %



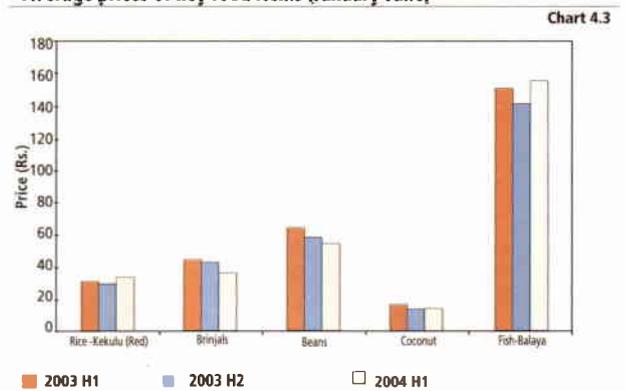
□ In 2003, import price increases caused the expenditure on imported items in the CCPI basket to increase at rates in the range of 12 to 14 per cent. This was mainly due to increases in international prices, as depreciation of the currency was negligible. The impact of such increases on the overall inflation was dampened by the moderation in price increases of domestically produced goods in a range of 5 to 10 per cent. A reversal of this trend was observed in the first half of 2004, where the increase in expenditure on imported items declined continuously from 12 per cent at the beginning of the year, while the increase in expenditure on domestically produced goods began rising after reaching its lowest level of around 2 per cent in the first quarter of 2004. These developments were attributed to the expansion in the production of some major consumer goods, especially of rice during 2003 and a reversal of that expansion during the first half of 2004 mainly due to the drought, and change in policy with respect to allowing the pass through of the rising cost on imported items to their domestic prices.

Movements in the annual average changes of the expenditure on domestically produced items and imported items in the CCPI basket



□ Although the average prices of most vegetables and leafy vegetables and coconuts were lower in the first half of 2004 than in the first half of 2003, most items indicated a rising trend in prices during early 2004. The prices of most varieties of rice, which registered significant decreases in the first half of 2003, increased significantly during the corresponding period of 2004. In the case of fish, dried fish and meats, however, prices rose in both 2003 and 2004.

Average prices of key food items (January-June)

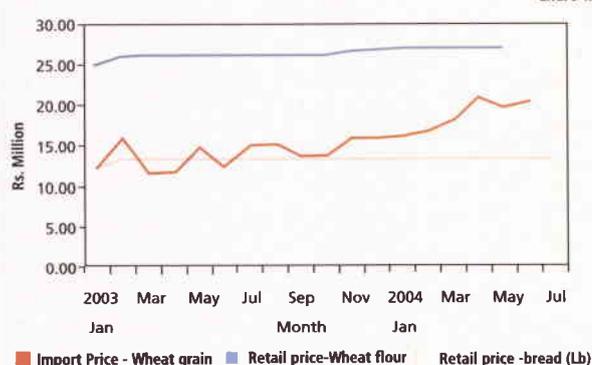


□ Unlike in 2003, where a stable exchange rate helped to limit pressure from imported prices only to changes in international prices with the higher demand for imports in 2004, the rupee depreciated in the first half, particularly in the second quarter. Some further depreciation was recorded in July. Signs of moderation in depreciation were observed in August and September. Unless international price trends move upward further, the overall inflationary pressures are expected to moderate with prudent monetary management and fiscal policies moving on a path of medium term fiscal consolidation.

- A reversal of the flexible pricing policy applied for fuel and wheat flour, to avoid unusual price shocks, was seen during the first half of 2004. Prices were kept administratively fixed, despite rising international prices and exchange rate depreciation. This policy has adverse budgetary implications, as the rising cost has to be absorbed as a subsidy. The sustainability of such a policy to maintain low prices is doubtful, as the rising cost and consequent increase in the budget deficit could force inflationary borrowings. Further, when prices are finally adjusted to reflect the cost, the required accumulated adjustments would be large and be a shock to the average consumer. The 14 per cent adjustment to petrol prices in July and 11 per cent and 14 per cent adjustments to LP gas prices in August and September, respectively, are examples.

Import and retail prices of wheat (Jan 2003-Jan2004)

Chart 4.4

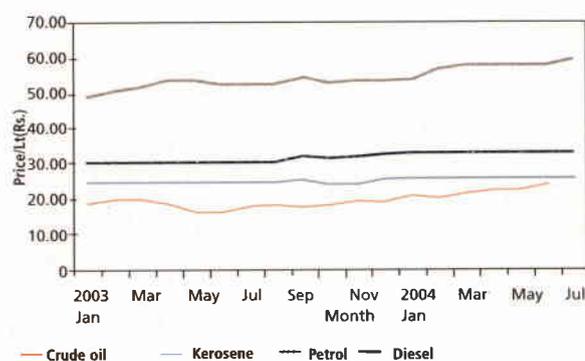


- Significant improvements to the distribution of goods in all parts of the country, subsequent to the cease fire, helped to dampen price increases for domestically produced goods and contributed to moderating inflation throughout 2002 and 2003. Conversely, any disturbance to the ceasefire could raise prices due to

rising costs, as loading and unloading at security barriers and waiting time in transit raise transport costs, as well as shortages that could arise due to limited access to certain production areas, especially in the North and the East.

Import price of crude oil and retail prices of fuel products (Jan 2003-Jul 2004)

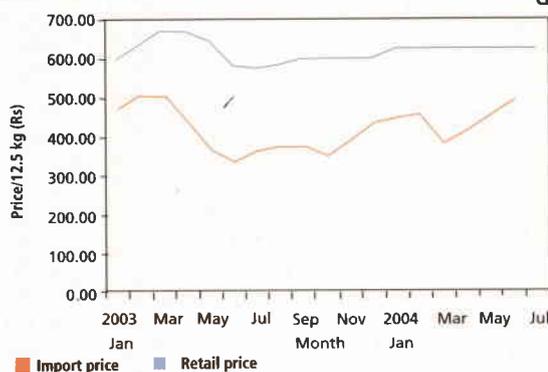
Chart 4.5



- Public sector wages were raised by 10 per cent, subject to a minimum increase of Rs 1,250, with effect from January 2004. However, minimum wages in the formal private sector increased only by around 2 per cent during the first half. Hence, the impact of wage increases on inflation has been low, as the public sector and the formal private sector represent only about 30 per cent of the total employed population in the country.

Import and retail prices of LP gas (Jan2003-Jul 2004)

Chart 4.6



- ❑ Adjustment in informal sector wages mainly reflect market developments which are tied to the seasonality and intensity of economic activities. Hence, movements in consumer prices during the second half of the year could affect this sector as well.
- ❑ Declining inflation and consequent low inflationary expectations facilitated reductions in policy rates in 2003 resulting in a declining trend in market interest rates. A reversal of this trend was observed during the first half of 2004 followed by some moderation of rates in recent months. Inflationary expectations are expected to moderate with an appropriate mix of monetary, fiscal and structural policies and greater exchange rate stability in the future.
- ❑ Overall supply side developments with respect to both domestic and international factors, thus far, suggest that the second half of the year would experience some pressure on consumer prices. This pressure is expected to arise from both domestically produced goods and imported goods. Accordingly, the annual average inflation rate by the end of the year is expected to be around 7 per cent, somewhat higher than the projected range at the beginning of the year of 5 to 6 per cent.

Outlook for 2005

- ❑ Weather conditions in 2005 are expected to be reasonable. Accordingly, the agriculture sector is expected to recover from the temporary set back experienced in 2004. This would help ease the domestic supply side pressure on CPI inflation, as agriculture prices, especially of rice and vegetables, dominate in all CPIs.
- ❑ Continuation of improvements to the distribution network in the form of road development projects and maintenance of the cease-fire, would help keep regional price variations low, with the expected further improvements to speed and access of the goods distribution network.
- ❑ Expected movements in imported prices are mixed. Among consumer items, the US dollar prices of rice and sugar are expected to rise by about 1 per cent and 12 per cent, respectively. Among intermediate goods, the dollar prices for crude oil and wheat grain, which have significant indirect impact on consumer prices, are expected to drop by 5 per cent each. A stable rupee or moderate depreciation could mitigate any external price pressure arising from international market developments in 2005.
- ❑ A consolidated policy response focused on price stability to meet expected market developments on both the domestic and international fronts could deliver a favourable inflation scenario in 2005.