Inflation – Public Enemy Number One

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Introduction

Inflation is a topic that affects every aspect of our lives. It is a force that shapes our purchasing power, influences our financial decisions, and impacts the overall stability of our society. In the year 2022, inflation accelerated to extraordinary levels globally, driven by the lagged effects of ultra-easy monetary and fiscal support following the COVID-19 pandemic, supply shortages and capacity constraints, along with supply chain issues. Affected by global as well as domestic factors, Sri Lanka also experienced inflation at unprecedented levels in 2022. However, in late 2022, Sri Lanka entered an impressive disinflation path, eventually bringing inflation down to the targeted levels within a period of one year. Sri Lanka’s swift disinflationary process was supported by a combination of policy measures implemented by both the Central Bank and the Government.

In the forthcoming sections, I will delve into international experience on the causes and consequences of inflation and related academic studies; the role of monetary policy in coping with inflation; the dynamics of Sri Lanka’s high inflation episode; and the role of the Central Bank of Sri Lanka in managing inflation and inflation expectations, with special emphasis on the new Central Bank of Sri Lanka Act, No. 16 of 2023. A better understanding of the above could help shape academic research, which would also contribute towards effective policymaking and business decisions.

Declaring inflation as a public enemy

Inflation, a fundamental concept in economics, refers to the sustained increase in the general price level of goods and services in an economy over a period of time. When inflation occurs, each unit of currency buys fewer goods and services than it did before, leading to a decrease in the purchasing power of money. Over the years, economists and policymakers emphasized the seriousness and negative impact of inflation on the economy and people’s lives.

High inflation episodes have been a recurring phenomenon in economic history, causing significant challenges for nations and their citizens. It was in this context that Gerald Ford, the 38th president of the United States, even declared inflation as public enemy number one. In one of President Ford’s addresses to Congress in 1974, he stated “Only two of my predecessors have come in person to call upon Congress for a declaration of war, and I shall not do that. But I say to you with

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all sincerity that our inflation, our public enemy number one, will, unless whipped, destroy our country, our homes, our liberties, our property, and finally our national pride, as surely as any well-armed wartime enemy.” President Ford introduced the slogan “Whip Inflation Now (WIN)” as part of his campaign to fight inflation and even started wearing buttons with “WIN”. Although the outcome of this campaign is debatable, it illustrates how much of a problem inflation was in the 1970s.

**Historical episodes of high inflation**

Indeed, many countries have grappled with high inflation - and in some cases hyperinflation. One of the most infamous cases of hyperinflation occurred in Germany during the early 1920s. Following World War I, Germany experienced a severe economic crisis exacerbated by the reparations imposed by the Treaty of Versailles. The German government printed an excessive amount of money to meet its obligations, leading to hyperinflation. Prices skyrocketed, and people’s savings became worthless. At its peak, prices were doubling every few days, and workers were paid multiple times a day. Zimbabwe, in the late 2000s, faced hyperinflation due to a combination of economic mismanagement, land reforms, and political instability. The government printed money recklessly, causing prices to soar at an astronomical rate. At its peak, in mid-November 2008, Zimbabwe’s hyperinflation reached an astounding monthly rate of around 500 billion per cent (Moyo, 2023). The Zimbabwean dollar became practically worthless, and the country abandoned its own currency, relying on foreign currencies for transactions. Similarly, countries such as Argentina, Brazil and Venezuela experienced hyperinflation crises from time to time since the 1980s.

**Why is high inflation or hyperinflation bad?**

Inflation represents how much more expensive a set of goods or services has become over a certain period, most commonly a year. To the extent that households’ nominal income does not increase as much as prices, they are worse off, because they cannot afford to purchase the same amount of goods and services. In other words, households’ purchasing power or real income (inflation-adjusted income) falls. Real income is a proxy for the standard of living. When real incomes are rising, so is the standard of living, and vice versa.

Savers and investors suffer significant losses during periods of high inflation. The real value of savings diminishes rapidly, while investors experience a decline in the real returns of their investments. Moreover, high inflation breeds uncertainty in the economy. Businesses face difficulties in planning for the future, unsure of their future costs and revenues. This uncertainty leads to reduced investments and hampers economic growth. Furthermore, nations experiencing high inflation find their international competitiveness severely compromised. As domestic prices rise,
the cost of exports increases, making products less competitive in the global market. This situation can lead to trade imbalances and hinder economic recovery efforts, further exacerbating the challenges posed by high inflation.

Although high inflation hurts an economy, deflation, or falling prices, is not desirable either. When prices are falling, consumers delay making purchases if they can, anticipating lower prices in the future. For the economy, this means less economic activity, less income generated by producers, and lower economic growth. As you may know, Japan is a country with a long period of nearly no economic growth, largely because of deflation. Given the above, most economists now believe that low, stable, and most importantly predictable inflation is good for an economy. If inflation is low and predictable, it is easier to capture it in price-adjustment contracts and interest rates, reducing its distortionary impact.

What causes inflation?

Inflation could be influenced by numerous factors. Understanding these diverse causes of inflation is essential for academics as well as policymakers to recommend and implement appropriate measures to maintain stable prices and support sustainable economic growth. Demand-pull inflation occurs when the demand for goods and services exceeds their supply. When the demand outstrips supply, businesses often raise prices to maximize their profits. Cost-push inflation occurs when the cost to produce goods and services increases, leading businesses to pass these additional costs on to consumers in the form of higher prices. This can be caused by rising wages, increased costs of raw materials, or other production-related expenses. Expectations also play a key role in determining inflation. If people or firms anticipate higher prices, they build these expectations into wage negotiations and contractual price adjustments. To the extent that people base their expectations on the recent past (adaptive expectations), inflation would follow similar patterns over time, resulting in inflation inertia.

In the long run, inflation is primarily caused by factors related to the overall increase in the money supply in an economy relative to the growth in the real output of goods and services. If the money supply grows too big relative to the size of an economy, the unit value of the currency diminishes; in other words, its purchasing power falls and prices rise. Milton Friedman, a Nobel laureate in economics, argued that “inflation is always and everywhere a monetary phenomenon.” Friedman argued that changes in the money supply, driven by central bank policies and other monetary factors, are the primary drivers of inflation in the long run, while other factors can cause short-term fluctuations in prices. While Friedman’s insight into the monetary roots of inflation remains a fundamental principle, economists and policymakers now consider a broader array of factors when analysing inflationary trends. Modern economic analysis incorporates a more holistic approach, recognising the interplay of various elements in shaping inflationary outcomes.
How policymakers deal with inflation and the role of monetary policy

The policies aimed at reducing inflation depend to a great extent on the causes of inflation. If the economy has overheated and inflation is primarily demand-driven, central banks can implement contractionary monetary policy that rein in aggregate demand. Indeed, the central banks play a crucial role in controlling inflation through monetary policy.

One of the primary objectives of monetary policy, as emphasized by many central banks around the world, is maintaining price stability. Price stability is crucial for a healthy economy as it ensures that the purchasing power of a currency remains relatively constant over time. Economists have argued that stable prices create a favourable environment for long-term economic growth and investment (e.g., Mishkin, 2007). Moreover, monetary policy also plays a role in promoting economic growth. Studies by Romer (1993) and Barro and Sala-i-Martin (2004) suggest that stable monetary policies are positively correlated with long-term economic growth.

Central banks use a range of tools to influence the money supply and interest rates, affecting inflation. Traditional tools include policy interest rates, open market operations, and reserve requirements. Following the 2008 financial crisis, central banks implemented unconventional monetary policies, such as forward guidance, quantitative easing (asset purchasing) and negative interest rates. Furthermore, central bankers are increasingly relying on their ability to influence inflation expectations as an inflation-reduction tool. Policymakers announce their intention to keep economic activity low temporarily to bring down inflation, hoping to influence expectations. The more credibility central banks have, the greater the influence of their pronouncements on inflation expectations.

However, monetary policy is faced with increasing challenges and trade-offs. For example, the Phillips curve, which describes the inverse relationship between inflation and unemployment or output, has been the subject of extensive research. Studies that integrate monetary policy, inflation, and output stabilisation have provided insights into the trade-offs faced by policymakers (e.g., Clarida, Gali, and Gertler, 1999) when achieving price stability. Furthermore, with increased globalisation, international factors can have a heightened impact on domestic inflation (e.g., Obstfeld and Rogoff, 2002). This sheds light on the complexities of maintaining price stability in a globalized world.

Across the globe, monetary policy frameworks cover various approaches, strategies, and models employed by central banks to achieve their objectives, such as price stability. Among those, inflation targeting has been a widely adopted monetary policy framework since the 1990s. Under inflation targeting, central banks set explicit inflation targets and use policy instruments to achieve them. Studies show that countries adopting inflation targeting are benefited in terms of providing clear objectives to the stakeholders and enhanced transparency (Bernanke, Laubach,
Mishkin, and Posen, 1999). Many central banks have moved toward flexible inflation targeting, a special case of inflation targeting, which allows temporary deviations from the target to accommodate shocks to the real economy. Flexible inflation targeting has its advantages in terms of stabilising both inflation and the real economy (Svensson, 2010).

**Global inflation in 2023**

Despite the advances in monetary policy frameworks, across the globe, inflation accelerated to unprecedented levels during the year 2022. According to the IMF, global inflation accelerated to 8.7 per cent in 2022, from 4.7 per cent in the previous year, reflecting the impact of the lagged effects of ultra-easy monetary and fiscal support following the COVID-19 pandemic, shortages of fuel and nonfuel commodities exacerbated by the Russia-Ukraine conflict, and capacity constraints along with supply chain issues. Many countries allowed the passthrough of high global prices to the domestic economy, as administrative price-setting measures that are not cost-reflective usually result in the government’s accrual of large subsidy bills to compensate producers for their lost income.

However, in light of substantial monetary tightening by major central banks in the world, the resultant slowing of economic activity, easing supply chain disruptions, and moderating prices of energy and other commodities, inflation started to moderate in 2023. Nonetheless, the forecast levels of inflation in 2023 and 2024 are still higher than the pre-pandemic (2017–2019) levels of around 3.5 per cent. Moreover, the underlying price pressures are proving sticky, with labour markets tight in several economies. Therefore, core (underlying) inflation is likely to decline more slowly in the period ahead. Further, with rising geopolitical tensions in the Middle East, upside risks to global inflation are on the rise.

**Sri Lanka’s economic crisis and the rise in inflation**

In 2022, Sri Lanka experienced its worst-ever economic crisis – a crisis that was in the making for many years, triggered by policy errors and exacerbated by other exogenous factors. Failure to build fiscal and external buffers over time made the nation vulnerable to domestic and external shocks, and the COVID-19 pandemic and the related shocks unearthed the vulnerabilities in the Sri Lankan economy, bringing about the worst economic crisis in Sri Lanka’s history. The resultant economic hardship led to both public anxiety and political upheaval.

By early 2022, the economy faced severe challenges due to an unsustainable macroeconomic model along with persistent budget deficits and external account imbalances. These issues, influenced by global and domestic factors, had depleted the economy’s foreign reserves. As a result, the country experienced intense pressure on its balance of payments (BOP), leading to a shortage of foreign exchange, a
weakened exchange rate, soaring inflation, and reduced economic activity.

Although Sri Lanka managed to have single-digit inflation for over 12 years since 2009, inflation rose to historically high levels in 2022 stemming from global oil and other commodity price hikes, adjustments to domestic administrative prices, domestic supply disruptions, the substantial depreciation of the Sri Lanka rupee against the US dollar and the lagged effects of an extended period of relaxed monetary policy following the COVID-19 pandemic. Contrary to the co-movement in inflation and economic growth in regular business cycles, Sri Lanka witnessed inflation and economic growth moving in opposite directions, as supply, as well as demand-driven inflation, accelerated overall inflation and economic growth stalled.

**Measures taken to overcome the sharp rise in inflation**

Several policy measures have been taken by the Central Bank to stabilize the economy and tighten monetary and credit conditions. With a view to countering rising inflationary pressures and anchoring inflation expectations, the Central Bank tightened monetary policy significantly from August 2021, with a significant increase in policy interest rates happening in April 2022. Monetary policy had to be conducted with an unprecedented level of deliberations, as the country entered a phase of high inflation and economic stagnation, and tightening of monetary conditions would not only result in a reduction in inflation, but also economic growth. In parallel, the Central Bank also implemented a series of policy measures aimed at maintaining external sector stability and reducing import demand.

Since the beginning of the monetary tightening cycle in August 2021, the Central Bank’s key policy interest rates, i.e., Standing Deposit Facility Rate (SDFR) and Standing Lending Facility Rate (SLFR), were raised by 11 percentage points till March 2023. Furthermore, during this tightening phase, the Central Bank increased the Statutory Reserve Ratio (SRR) by 2 percentage points, while several caps on interest rates were removed, allowing for greater upward adjustments in market interest rates. The unprecedented upward adjustment of policy interest rates helped arrest the further build-up of demand-driven inflationary pressures, thereby preempting the escalation of adverse inflationary expectations, easing the pressure on the external sector, and correcting anomalies observed in the market interest rate structure.

**Sri Lanka’s disinflation process**

The outcomes of the policy efforts discussed above have eventuated since late 2022. Sri Lanka’s inflation started moderating from its peak levels of around 70 per cent (year-on-year) in September 2022, marking the beginning of the country’s disinflation process. Accordingly, the Colombo Consumer Price Index (CCPI, 2013=100) based headline inflation moderated to 57.2 per cent (year-on-year) by
December 2022, and further decelerated in the nine months ending September 2023. The pace of deceleration in headline inflation was slower in Q1-2023 due to the impact of the electricity tariff revision. However, headline inflation decelerated sharply in Q2-2023, reaching single-digit levels in June 2023. The moderation in inflation continued thereafter as well, where CCPI based headline inflation eased to a low level of 1.3 per cent (year-on-year) by September 2023.

In terms of economic factors, this process was supported by subdued aggregate demand conditions due to tight monetary and fiscal policies, improvements in domestic supply conditions, improved external sector performance, some normalisation of global commodity prices, and the passthrough of such reductions to domestic prices. Statistically, the disinflation process was influenced by both the momentum effect and the base effect, with a higher contribution from the latter.

Over the medium term, following the rapid disinflation thus far in 2023, inflation is expected to stabilize at the targeted level of 5 per cent, supported by appropriate monetary policy measures, along with improving supply conditions. Moreover, Sri Lanka’s disinflation process is expected to turn around from September 2023, with the dissipating impact of the favourable base, thereby facilitating the convergence of inflation towards the targeted level. Although some upward movement in headline inflation is likely in the near term driven by the planned upward adjustments to administratively determined prices and tariffs, the impact of such measures is expected to be short-lived. Further, the ongoing geopolitical tensions in the Middle East and possible tax measures by the Government remain the major upside risks to inflation in the near term.

The new Central Bank legislation

The legislative framework introduced by the Central Bank of Sri Lanka Act, No. 16 of 2023 (CBA) would reinforce price stability in the period ahead, while ensuring that inflation expectations remain well anchored. The new Central Bank Act gives prominence to price stability by stating that the primary objective of the Central Bank shall be to achieve and maintain domestic price stability. In pursuing this primary objective, the Central Bank shall take into account, inter alia, the stabilisation of output towards its potential level. The other object of the Central Bank shall be to secure the financial system stability.

Under the CBA, there shall be a Monetary Policy Board of the Central Bank, which is charged with the formulation of monetary policy and implementation of a flexible exchange rate regime, in line with the flexible inflation targeting framework, in order to achieve and maintain domestic price stability. The creation of a separate decision-making body in addition to the Governing Board, signifies the importance placed on independent monetary policymaking for achieving domestic price stability by the new legislation.
Moreover, the CBA formally recognizes flexible inflation targeting as the monetary policy framework and requires the signing of a monetary policy framework agreement setting out the inflation target to be achieved by the Central Bank. Accordingly, the Central Bank entered into an agreement with the Minister of Finance in October 2023, where it was stated that the Central Bank shall aim to maintain the quarterly headline inflation rate at a target of 5 per cent with a margin of ±2 percentage points.

If the Central Bank fails to meet the inflation target by the margin determined in the Agreement for two consecutive quarters, the Monetary Policy Board shall submit a report to the Parliament through the Minister, which shall also be made available to the public, setting out the reasons for the failure to achieve the inflation target; the remedial actions proposed to be taken by the Central Bank; and an estimate of the time period within which the inflation target shall be achieved. These provisions, along with enhanced transparency and accountability, would ensure that inflation in Sri Lanka would be maintained at low and stable levels in the period ahead, thereby benefitting all stakeholders in the economy.

**Concluding remarks**

Headwinds due to consecutive economic shocks in recent years have severely affected Sri Lanka’s economic activity in 2022 and early 2023, inflicting hardships on individuals and businesses. The Government and the Central Bank implemented painful but unavoidable policy measures aimed at restoring macroeconomic stability. The near-term economic stabilisation measures implemented thus far are unprecedented and started delivering the expected positive outcomes. Inflation declined sharply to a little over 1 per cent (year-on-year) by September 2023 and is expected to hover around the targeted level over the medium term. External sector performance improved and the exchange rate appreciated in 2023. The IMF programme is progressing and the stability of the financial sector has been preserved amidst numerous challenges.

Monetary policy will remain focused on ensuring price stability over the medium term, while giving due regard to stabilising economic growth towards its potential, under a flexible inflation targeting policy framework. Going forward, the conduct of monetary policy will continue to be based on a forward-looking and data-driven approach, supported by recent and expected macroeconomic developments and projections, both domestic and global. Timely adjustments to policies and strategies of the Central Bank will be made under the flexible inflation targeting framework, as and when new information becomes available. Maintenance of inflation at a low and stable level would eliminate large swings in interest rates, thus creating an enabling environment for businesses.
The Central Bank of Sri Lanka Act would allow more independence to the Central Bank, limiting monetary financing, and thereby strengthening policies targeted at managing inflation and inflation expectations. With the primary object of the Central Bank being the maintenance of domestic price stability, the new Act will serve as a key buffer for the Sri Lankan economy against inflation. Moreover, the Central Bank remains committed to maintaining headline inflation at the targeted levels, thereby tackling inflation – public enemy number one – transparently and proactively.

References