

Inflation-Poverty Nexus: What do Sri Lankan Data Say?

Introduction

Is inflation a necessary evil? Is it possible that inflation is bad only for some people while it is good for the others? If that is so, who are the gainers and who are the losers? What are the implications of these questions and the answers to them for a country like Sri Lanka? Is not it true that the poor stand to lose disproportionately when there is creeping inflation? In a country where the official rate of inflation has been almost always on the high side, its impact on the poor ought to be catastrophic. Within this broad context, this paper attempts to examine the poverty-inflation nexus in a framework that is based on secondary data for the past 37 years; this long-term perspective is chosen because it helps us to identify patterns and trends of inflation that emerged and to make a few propositions regarding its impact on poverty. The approach of this paper is eclectic. It is based on the presumption that country-specific analysis generally produces relatively more useful insights. On the contrary, it is believed that cross-country studies by nature are seriously flawed on account of methodological and data problems (Ravallion, 2005 and Rodriguez and Rodrik, 2000).

The paper traces both inflation and poverty data for the past three and half decades. A point of departure at this stage is that the rate of inflation in Sri Lanka has been exceptionally high throughout this period. On average, the country has been having double digit inflation after 1977; this is very different from that of other countries in the Indian subcontinent and many other developing countries. One plausible reason could be the urban centredness of the basket of goods and the sample of population on which Sri Lanka's cost of living data are compiled (Economic Review, 2008). In other words, Sri Lanka's estimates of inflation are not representative enough to track trends of inflation by sectors, regions or even for the entire country in a long-term basis. This lacuna of not having dependable data for sectors and regions is especially relevant for this discussion where we examine the poverty-inflation nexus. It is found that poverty and economic deprivation in this country are mostly found in the rural and estate sectors and also some provinces that are found eternally backward. In fact, more than 80 percent of the poor in Sri Lanka are still housed in the rural sector while poverty trends in the estate sector are found aggravating from the mid 1990s (Department of Census and Statistics (DCS), 2008). On the other hand, cost of living estimates are based on data drawn from a sample of urban population.

The other side of the inflation-poverty relationship that needs mentioning is the definition of poverty. Ideally, poverty is considered as 'profound deprivation of capabilities'. This definition encapsulates both income-related deprivations plus the broader dimensions of capabilities such as education and health. However, head count (HC) poverty data do not incorporate these wider aspects of capability deprivation. Subject to these caveats, this paper attempts to identify a few broader patterns and trends that will provide a set of insights into this inquiry on poverty-inflation nexus. The paper is divided into five parts. Part I of this paper introduces the subject. Part II traces inflationary trends in Sri Lanka since 1970. Part III outlines the impact of inflation on social well being including poverty and malnutrition. Part IV examines the effects of inflation on real wages and income levels of agricultural workers. Part V concludes the paper.

Part II

Inflationary trends and patterns

This paper postulates that inflation makes a number of groups in the country, especially, vulnerable and deprived. They include households that belong to the two bottom-most income quintiles; wage workers in the unorganised sectors, salaried workers in the public and private sectors and small holders engaged in traditional farming. In the face of the rapid expansion of the unorganised sector and the casualisation of jobs, those who depend on daily wages for livelihood are devastated by this hazard. The monthly per-capita expenditure share on food of the bottom most quintile was more than 50 percent by 2003/04 (Consumer Finances and Socio-Economic Survey, CFSES, 2005). Hence, an increase in the prices of food grain and other food

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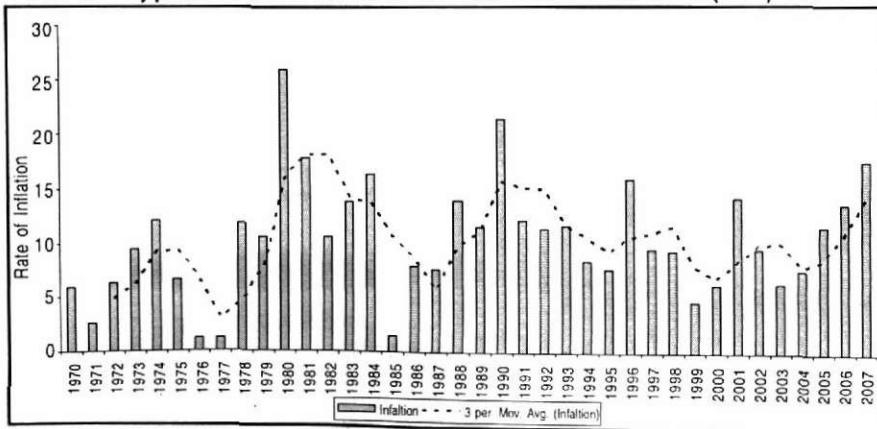
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items shrinks their already limited food entitlements leading to problem of malnutrition. It was found that even under normal circumstance, about 36 percent of the population was unable to meet the minimum energy requirements in both 1996/97 and 2003/04 CFSES surveys. It is also true that malnutrition in Sri Lanka is much higher than what is warranted given its high Human Development Index (HDI) scores. This situation becomes even worse under conditions of increased inflationary pressure where the poor resort to trim their food intake.

Alternatively, falling real incomes lead to curtail their non-food expenditure on health causing problems of unattended morbidity. Similarly, incapacity to finance educational expenses of their children adversely affects performance of children of poor households in the public examinations (Vidanapathirana, 2008). This is especially relevant when private expenditure on health and education has risen sharply during the past two decades (CFSES, 2003/04). The variations in student enrolments for secondary and tertiary education by income quintiles indicate the seriousness of this proposition (World Bank, 2007). In all three scenarios, falling real incomes of households result in a situation of profound deprivation of capabilities of those who are identified as poor.

Figure 1 shows that inflationary trends became conspicuous especially after 1977. Of the number of high episodes of inflation, the years 1974, 1979, and 2007 are exceptional as extraneous circumstances such as the escalation of crude oil

Figure 1
Inflationary pressure: the broad trends-Colombo Consumer Price Index (CCPI)-1952=100



Source: Annual Reports, Central Bank of Sri Lanka (CBSL), various issues.

prices in the international market or other crisis conditions that are responsible for most of them. Nonetheless, the general trends of inflation provide conclusive evidence to show that high inflation in Sri Lanka is a post-liberalisation legacy. Evidence from other countries that have opened up their economies in the early 1980s also have shown that high trade dependency after liberalisation made these countries particularly vulnerable to external shocks leading to an internal instability.

Part III

Effects of Inflationary trends on poverty and well being

Figure 1 above demonstrates the volatility of inflationary pressure during the period 1970-2007. It shows a few peaks in which the rate of inflation reached enormously high levels of more than 20 percent.¹ This is considered a dangerously high level and the ill effects of such an increase are felt disproportionately on the underprivileged segments of the population. Case data provide evidence to show how the low-income groups suffered on account of inflation immediately after economic reforms in 1977 (Edirisinghe, 1987 and Shan, 1988). The situation during in the 1980s became especially harmful because of the replacement of the ration scheme in 1979. The non-indexed food stamps scheme (FSS) of 1979 saw a massive reduction of its real value and within a period of three years, the value of food stamps halved thus lowering the entitlements of food stamp recipients.² This reduction in purchasing power signified the adverse impact of inflation on those who depend on the food ration benefits earlier. It is this background that it resulted in an increase in the HC in the mid 1980s; it also gave rise to a deleterious impact on the nutritional conditions of the poor (Shan, 1988).

How the rate of inflation surged immediately after reforms is depicted in Table 1. It presents a comparative analysis of changes in the exchange rate and the rate of inflation, which exemplifies the exchange rate-inflation pass through in the economy. It demonstrates how inflationary pressure increased immediately after the reforms and the changing pattern of exchange rate contributed to increased inflation in the subsequent years. This is relevant on account of two reasons. Firstly, the reforms gave rise to an immediate increase in the cost of living in the country which is somewhat contrary to the expectations of economic liberalisation. The liberalisation orthodoxy presupposes that once the market is opened up and liberalised, it would propel economic growth on the one hand and introduce self-correcting and stabilising mechanisms on the other. Accordingly,

the free market conditions should precede the establishment and the maintenance of economic fundamentals where there is no room for high inflation. Secondly, there was no turn around to the condition of price escalation initiated by reforms in the subsequent period.

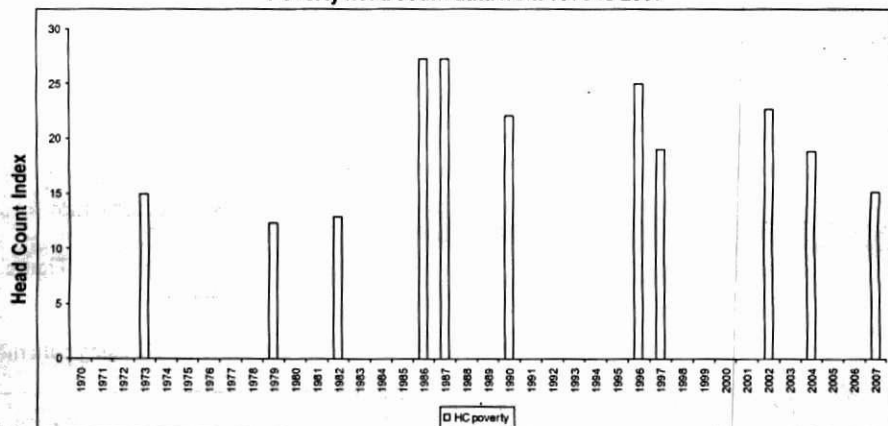
Table 1
Changes introduced in 1977 and their impact on price levels

Index	Before reforms (average for 1977)	After reform (average for 1978)	Rate of change (%)
Interest rate (%)	5.5	7.2	30.9
Exchange rate (Rs/USD)	8.83	15.56	76.2
Inflation (CCPI) (%)	203.2	227.8	12.1

Source: Annual Report, CBSL, 1978.

overall increase in the rate of inflation. The rate of inflation surged again in 2005. Much of this recent surge is attributed to extraneous factors such as oil price shocks and soaring prices of food grain in the world market. Nonetheless, the impact of this increase in the cost of living on poverty is adequately cushioned by the increased flow of production subsidies such as the fertiliser subsidy and also increases in the farm-gate prices of agricultural produce. The falling HCI by 2006/07 supports this argument.

Figure 2
Poverty head count data from 1970 to 2007



Source: Anand and Harris (1985) as quoted by W.D Lakshman, 1997 Table 6.13; Household Income and Expenditure Surveys (HIES) 1990/91, 1995/96; Consumer Finances and Socio-economic Surveys (CFSES): 1996/97 and author's estimates based on HIES (2002) DCS, (2003 and 2004); and Alailima, 2007; Table 2.1; Center for Poverty Analysis (CEPA), 2007 and DCS, 2008.

In fact, the rate of inflation, budget deficit, external reserves and debt servicing continued to deteriorate in the post reform era. The behaviour of the fundamentals was apparently more volatile, and the depth of variance also seemed to be more pronounced during the first wave of reforms (1978-1989). On this count, there was partial evidence to show how the devaluation of exchange rate in particular affected the rate of inflation in the early years of reforms. The 260 percent devaluation cum depreciation in the first wave (1978-1989) was accompanied by corresponding negative changes in the current account balance (262%) and external debt (265%) and also a substantial increase in the rate of inflation (121%). This was what was referred to as the exchange rate pass-through.

It is evident that the average rate inflation that was around 5.7 during the pre-reform era raced to an average of 12.6 during the first wave (1978-1989); although it declined mildly during the second wave (1990-2004) the average rate of inflation still remained around 11 percent per annum. Figure 1 above confirms that the rate of inflation was characterised by the incidence of volatility and also

Unsurprisingly, those who belong to the lower income quintiles suffer immensely on account of the escalation of cost of living. Historically, studies conducted by a number of authors documented how malnutrition among adults and especially among children increased as a result of this reduction of real income (Edirisinghe, 1987; Shan, 1988; Anand and Kanbur, 1999). Similarly, the escalation of the price levels of staple food during the last year too was astonishing. Since June 2007, the prices of rice and wheat flour increased by 81 and 60 percent respectively (Economic Review, 2008). Concomitant price increases in milk food, cooking oil, dhal, coconut and vegetables aggravated this situation further. This escalation especially should have affected the poorer segments of the population that spends more than 60 percent of their income on food. Two groups that suffer on account of the price fluctuation include the wage earners and the small farmers. In both cases, the affected groups are not in a position to transfer the adverse effects of inflation. Unfortunately, Sri Lanka does not produce annual data on poverty incidence which prevent us from making any comments on the impact of this situation.

Part IV

Changing patterns of real income

The distressing picture of the wage workers is documented by a number of writers. In the mid 1990s, the worst hit categories were the estate workers and the government servants such as schoolteachers (Lakshman, 1997). The reduction of real wages in the estate workers occurred despite the fact that their wages are regulated by the wage board stipulations.³ Further, this sector has an organised labour force well protected by a powerful trade union.

In retrospect, the real wage rates of the estate workers were rather stable during the pre-reform period: their real wages gained substantially during the first wave fundamentally when the leader of the Ceylon Workers Congress (CWC) became a Minister of the then United National Party (UNP) government for a long period. He was able to successfully negotiate wage agreements with the government.

However, as illustrated in Figure 3, the real wage levels of this highly unionised estate worker category too recorded a noticeable decline since 1994. The sign of reversal in 2007 has to be monitored closely. An important point regarding this decline was that it coincided with 1994, which marked the intensification of the SAP-led privatisation programme of the state-owned plantations. It is now evident that despite the fact that the estate labour is considered as one of the highly unionised form in the country, the second wave of reforms in particular has not been very conducive for the workers in this sector.

cost items included mechanical and chemical inputs that were made unavoidable when work was compressed due to the introduction of strict cultivation calendars. Also it jacked up wage rates making the demand for farm mechanisation an absolute necessity.⁴ It eventually displaced more people who otherwise make a living as agricultural workers. Case data has shown that use of wage labour in the major paddy-producing districts declined considerably in the 1990s (Jogarajnam and Niranjana, 2003, Table 3)

It is generally believed that the real wages of labour in the traditional sector improved over the years. However, the figures quoted for this computation cover wage rates of casual workers in peak seasons of harvesting and land preparation. These rates prevail for a short of time of three to four weeks when the demand for labour ascends sharply. During the lean period, these workers remain underemployed and their wage rates fall.⁵

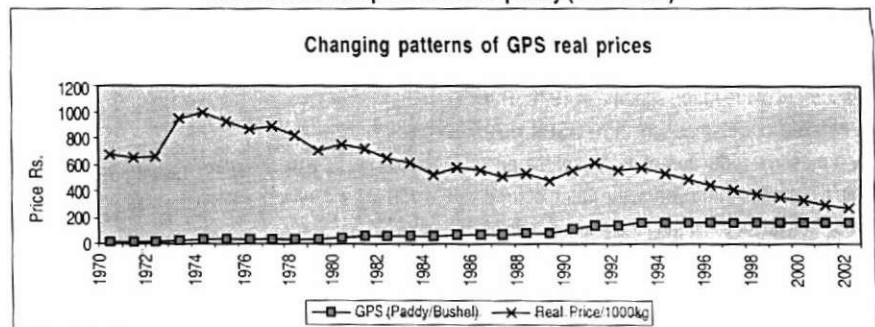
Another group that is vulnerable to inflationary pressure is the small-farmers in the traditional sector.

are well documented and showed how peasant farmers cultivating paddy under irrigated conditions suffer owing to declining producer margins (Vidanapathirana, 2007).

The falling producer margins and the real income of the peasantry are theoretically dependent on yield levels and farm-gate prices on the one hand and the cost of production on the other. However, the yield levels of paddy in Sri Lanka increased from 1361 metric tons per hectare in 1970-1978 to 2575 metric tons per hectare in 1990-2004 periods. Therefore, any fall in the real income should have arisen from falling farm-gate prices or increasing cost of living or both. In this context, it is revealed that the guaranteed price scheme (GPS) that influences the farm-gate price of paddy in particular continue to fall in real terms up till 2003.⁷

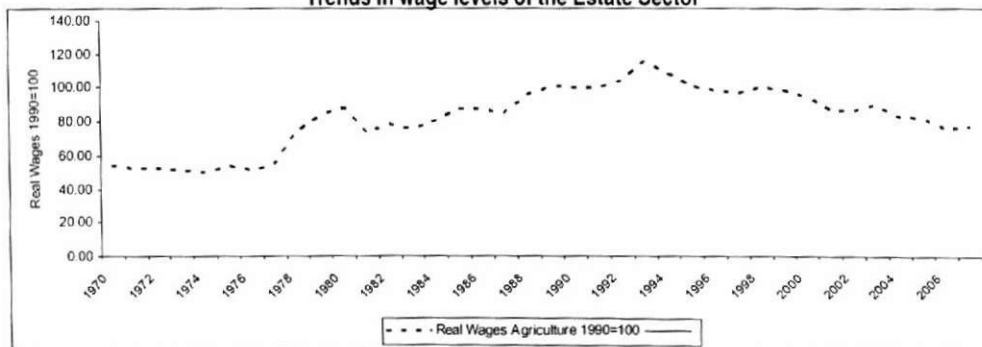
Although the purpose of the GPS was to strike a balance between consumer and producer prices, the GPS mechanism became counter productive in assuring income security to paddy farmers or food security to consumers. Figure 4 shows that

Figure 4
Movements of real price levels of paddy (1970-2003)



Source: Department of Census and Statistics

Figure 3
Trends in wage levels of the Estate Sector



Source: Annual Reports, CBSL, various reports.

The situation of the non-unionised workers in the traditional agricultural sector was even worse (this sector provides employment to about 20 percent of the labour force). Two problems contributed to this distressing situation. Firstly, economic viability of the traditional agriculture deteriorated in the face of mounting cost of production. Some of the major

They are peasant farmers whose income declined on account of falling real value of the floor prices and the increasing cost of production. This condition is referred to as the 'scissors crisis'. This group was fatally hit by a) increasing cost of production and b) increasing price levels of commodities other than food grain.⁶ The effects of the 'scissors crisis'

the GPS prices were declining persistently in terms of real value over the period 1978-2004. The real value of GPS prices deflated by the GDP deflator shows that price levels have been stable in the first two years of 1970s and picked up steeply in 1973. However, since 1974 the real prices of paddy commenced falling persistently.

This data is summarised in Table 2. It shows that the GPS price levels in real terms increased at a rate of an average 4.03 per annum during the pre-reform period but declined thereafter at an annualised rate of more than 3 percent during the first and second waves.⁸ This situation changed only after 2007, when paddy prices increased in the domestic market. Consequently, farm-gate prices surpassed Rs. 30 per kg mark for paddy; this has improved producer margins considerably

and field observations indicate that farmers have started moving away from commercial crops such as banana to paddy in the district of Hambantota.

Part V

Conclusion

It is clear that the entire country had to bear the adverse effects of mounting inflationary pressure since 1977. However, the brunt of it was felt on those categories of people who are unprotected, and they invariably were the deprived segments of the population. It was the poor who were affected worse while the asset owners manage to transfer the adverse impact of inflation to wageworkers. In short, workers in the unorganised sector, organised workers in the plantation sector and small farmers suffered mostly on account of the spiralling inflation. The inflation-poverty nexus is a long-drawn condition. The negative effects of this condition can not be assigned to a political regime per se; rather it is an inevitable outcome of unsound policy prescriptions followed by the political regimes since 1977. The longer we continue with these policies the more will be their adverse outcomes on poverty and inequality.

Table 2
Revised GPS prices of paddy and their real values, and their impact on farmer incomes

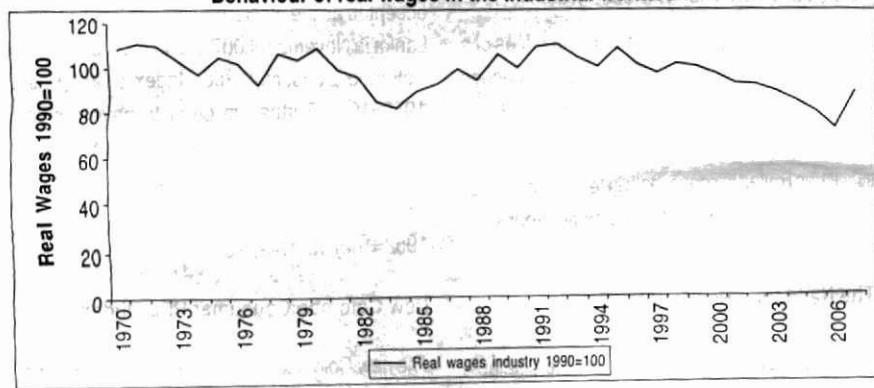
Beginning of period	1970	1977	1988	2003
Price per '000 kg (Rs.)/ GDP deflator	670.81	887.35	531.87	276.43
Percentage price change		32.27	-40.06	-48.03
Annualised price change		4.03	-3.3	-3.2

Source: Central Bank of Sri Lanka, Various issues of the annual reports

It is argued that a reduction of relative prices of staples as occurred until 2003 was beneficial for poverty reduction. This argument is rooted on the premise that a reduction of the prices of 'wage goods' increases real incomes of wageworkers. In this sense, wageworkers in both urban and rural sectors are expected to gain from this reduction of farm gate prices. However, in reality this reduction of GPS never seeped down to the retail buyers of staples as shown in the CBSL data where the retail price of rice appeared to have been more than 50-70 percent higher than the farm-gate price of paddy (CBSL, 2004, See, Chart 2.3). Thus the reduction of the GPS only provided an opportunity to monopsonist dealers and millers of paddy to further exploit the producers and retail consumers.

The evidence provided above show that the poverty-inflation nexus has worked against the poor. Here again those who belong to the rural and estate sectors were the worst hit relative to their urban counterparts. It does not mean that the working class in the industrial sector was spared of the adverse impact of falling real wages. Figure 5 demonstrates that the long-term effects of inflation on real wages were detrimental to this sector especially since 1990 to 2006. The unimpressive increase in real wages in all the major sectors thus created a sizable distress in the economy.

Figure 5
Behaviour of real wages in the industrial workers



Source: Annual Reports, CBSL, various reports.

DCS (2008) see. <http://www.statistics.gov.lk/poverty/PovertyIndicators.pdf>

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Footnotes

¹ The increase of inflation from 5.7 during the pre-reform period to more than 12 percent in the post reform period is about an increase of 122%.

² As the Food Stamp Scheme was not indexed to changes in the cost of living, its purchasing power fell sharply and consequently helped the government to secure millions of rupees through an inflation-led saving.

³ There were some stipulations of the minimum wages of the indentured workers since 1927. They include the Minimum Wages (Indian Labour) Ordinance of 1927 that was subsequently replaced with Wages Board Ordinance of No 27 of 1941 and so on.

⁴ Data compiled by the Department of Agriculture reported that the use of tractors for land preparation has increased from 42.3 in 1981 to 62.5 by 1996.

⁵ In fact off-season covers the largest chunk in terms of number of days of more than 250 per annum.

⁶ The terminology of 'scissors crisis' as coined by Gunasingha (1985) outlines how the cost of production changes outpaced agricultural revenue that reduced the producer margins persistently.

⁷ This situation changed for the better since Yala 2007.

⁸ The data were converted to 1000 kilograms and deflated by the GDP deflator for 1977=100.