

Inflation in Sri Lanka: How to explain and forecast?

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According to economic theory there are two important factors that cause inflation. Inflation can be due to an increase in total spending or aggregate demand. This is often expressed as ‘too much money chasing too few goods’. When sellers are unable to supply all the goods and services buyers demand, the typical result will be higher prices. On the other hand inflation can also be due to a general increase in the cost of production. Upward pressure on prices may be caused by cost increases for labour, raw material, equipment, borrowing, etc. Many theories and studies are in agreement that the consequences of inflation retard economic growth and social welfare. Therefore understanding the nature of inflation and its causal factors will help to control inflation in an economy. High inflation had been a major macroeconomic concern specifically during the post liberalised period in Sri Lanka. Academic investigations conducted on what causes inflation in Sri Lanka is very limited. Most studies have focused largely on the past behavior of inflation. An attempt to understand the state of inflation in the future is neglected to a greater extent. Therefore, while focusing on the past behavior of inflation, this study will also make a serious attempt to develop useful method(s) to understand the inflation in the immediate future.

There are two main objectives of this study. Firstly the study tries to understand inflation in Sri Lanka over the past few years in light of the aforementioned two theoretical ideas. Secondly, the study develops a comprehensive economic model(s) to forecast the state of inflation in the immediate future with significant accuracy. The analysis starts with identifying factors that have caused inflation in Sri Lanka and subsequently try to highlight the most important demand and cost factors that are useful to explain inflation in the immediate future. It will then develop useful methods to forecast inflation using Time series econometric techniques.

The methodology and the outcome of the research will be very significant for researchers, policy makers, students and other interested parties to understand the nature of inflation in Sri Lanka. It will also help them to forecast inflation with greater certainty. In addition, the findings of the research will help to expand the existing body of knowledge on inflation in Sri Lanka and would encourage and facilitate further research on the area. The important discovery of the study is that much of the inflation in the recent past in Sri Lanka was not only due to factors of demand but also to an increase in cost. Consequently, a comprehensive analysis on inflation in Sri Lanka will emerge.