Decomposition of the Determinants of Food Price Inflation in Sri Lanka during the Period 2016-2022

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The food inflation in Sri Lanka is rising starting from November 2021, at one of the fastest rates and has reached a peak of 94.9% (Y-o-Y) in September 2022, threatening the food and nutrition security of the population. This study attempts to identify the drivers of food inflation in Sri Lanka during the period 2016 to 2022 using Cointegration and Error-correction models to analyze monthly data. Our findings suggest that the recent price surge is a result of changes in the exchange rate, crude oil, and agricultural wages. The Impulse Response Function revealed that food inflation responds positively to the shocks in world food prices, crude oil prices agricultural wages and exchange rate. The response to exchange rate shocks was immediate. The variance decomposition analysis further revealed that food price inflation accounts for a significant portion of volatility on its own shocks. Exchange rate was found to be a major driver of food inflation in the short run, however, the effect of exchange rate diminishes with the time. Contradicting to this, the effect of changes in agriculture wages, oil prices and global food prices is higher in the long-run than in the short-run. The findings stress the importance of having appropriate policies to stabilize the exchange rate and input prices to avoid excessive food inflation in the country.

Keywords: Agricultural wages, Cointegration, Crude oil price, Error variance decomposition, Exchange rate, Vector error correction

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