Transmission of World Food Prices and Volatilities to Domestic Prices in Sri Lanka

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Food prices and their volatilities have been increasing sharply since 2003 in Sri Lanka as well as in the world. In the globalized world, the transmission of global food price increases to the domestic market determines the decision of economic agents and policy makers of the domestic economy. Thus, this study examines how the increase in international food prices affectthe domestic inflation dynamic process in Sri Lanka. To assess this situation, the study uses parametric and non-parametric econometric techniques of confidence ellipse, autocorrelation function, non-parametric regression (Kernel), GARCH model, the VAR Granger causality /Block Exogeneity Wald Tests, co-integration and error correction technique. The data set that includes monthly observations over the period from 2003M1 to 2014M12 was collected from Central Bank and FAO website. The line graph shows that the transmission effect is asymmetric. The world food price, domestic food price, and overall CPI price series in Sri Lanka are co--moved. The world food price does not significantly influence non-food price inflation in the short run. The global food price transmission is statistically significant to CCPIfood price inflation, WPIfood inflation and WPI inflation and overall (Headline) inflation in the long run and in the short run. However, the world food price inflation transmission elasticity is more for domestic producer prices (WPI) than consumer prices in the long run as well as in the short run.The volatility of global food price inflation is also positively related to domestic inflation. Granger causality reveals unidirectional causal relationship running from global food price to domestic prices and the past changes of global food price help to explain current changes of domestic prices over and above the study period in Sri Lanka. Therefore, the Sri Lankan government needs to develop a safety net program for the poor and a longer term poverty reduction strategy. The results of this study have various policy implications for monetary policy, food and agricultural policy and trade policy for Sri Lanka.

Key words: *Food Price Inflation, Granger Causality, Volatility, World Food Price Transmission*