EXCHANGE RATE POLICY AND ITS IMPACT ON FOREIGN TRADE: A CASE STUDY OF SRI LANKA

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Sri Lanka was one of the first countries to engage in a continuous and extensive economic liberalization process in the South Asian region commencing from 1977. Exchange rate reform and trade reform are main elements of the liberalization process. Since then, the data of exchange rate, import and export show an unstable trend. Hence, this study focuses on examining the impact of exchange rate policy on foreign trade of Sri Lanka using time series data over the period of 1977-2016. The data was collected from the annual reports of Central Bank of Sri Lanka and World Development Indicator (WDI) data base. This study operationalizes import and export as a function of exchange rate, money supply, consumer price index and real gross domestic product. ADF, PP and KPSS unit root test was conducted to test the order of integration. Lag length selection criteria such as AIC, SIC, LR, FPE, HQIC are utilized to select the optimum lag length that can be included in the model. The co-integration test was conducted using the Johansen approach to test the co-integrating relationship and long run relationship between variables. Error correction model (ECM) and Vector auto regression (VAR) were utilized to investigate the short run relationship between the variables. And also, the ECM test was adopted to examine the long run adjustment of the model. Moreover, the Granger causality test was performed to investigate the causal relationship between variables. All the unit root test approaches confirmed that first difference of log variables is stationary. The Johansen co-integration test detected positive relationship between export and exchange rate in the long run. And also, the Vector error correction results emphasized that independent and managed floating exchange rate regimes have a significant positive impact on export. Additionally, VAR test confirms that there is a negative relationship between import and exchange rates. The Granger causality test identified that there is unidirectional causal relationship between exchange rate and export. This study confirms that the exchange rate has significant impact on export in the long-run and that the exchange rate has a significant impact on import in the short-run. Therefore, the Sri Lankan government can use exchange rate as a policy tool to both promote export and to maintain a restriction on import.

Keywords: Exchange Rate, Import and Export, VAR Model