

The Impact of Investment and Trade on Sri Lanka's Economic Growth Since 1977

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Introduction

Investment is identified as one of the most important determinants in a country's macro-economic progress. In the journey toward stable and long-lasting economic growth, developing countries like Sri Lanka often face two main challenges: increasing local investment and connecting more with the global economy. Sri Lanka, because of its important location in the Indian Ocean and its mixed economy of agriculture, industry, and services, offers an interesting case. For a small developing country like Sri Lanka, embracing an open economy model that is, encouraging exports, foreign investment, and integration into global supply chains can be particularly beneficial.

The garment and tourism sectors are key export earners and GDP contributors for Sri Lanka, demonstrating the positive impact of foreign direct investment (FDI), trade agreements, and liberalized policies. These sectors have thrived due to trade agreements with the EU and U.S., and a more open trade environment, which has encouraged foreign investment and growth. Although Sri Lanka has implemented trade liberalization policies and encouraged investment since 1977, the long-term outcomes of these strategies remain uncertain. While sectors like garments and tourism have clearly benefited from FDI and international trade agreements, overall economic performance has been inconsistent. For example, export earnings reached a record \$16.17 billion in 2024, reflecting growth in trade-related sectors. However, despite these positive figures, Sri Lanka continues to face macroeconomic instability, trade imbalances, and low domestic savings. The labour force participation rate has not shown strong or consistent links to economic growth, and there is limited empirical consensus on how trade, investment, and labour contribute to GDP in the short and long run.

Objectives

Main objective of this study is to examine the impact of investment and trade on economic growth of Sri Lanka since 1977. Sub objective of this paper is to investigate the causal relationship between investment, trade, labour force participation and economic growth.

Methodology

This study is based on secondary data from Central Bank of Sri Lanka's annual reports and World Development Indicator of the World Bank data base for the period 1977 to 2023. The following regression model was constructed variables as suggested by Mustafa & Santhirasegaram, (2013) and Npg & Liu (2017).

$$GDP_t = \beta_0 + \beta_1 LFP_t + \beta_2 TRD_t + \beta_3 GFCF_t + \varepsilon_t$$

Where; GDP: Gross National production, LFP: Labour force participation, TRD: Trade openness, GFCF: Gross fixed capital formulation. The model was constructed based on the principles of endogenous growth theory, which emphasizes the role of domestic investment, human capital, and trade in promoting long-term economic growth. Elements of neoclassical growth theory, particularly the focus on capital and labour as growth inputs, are also considered. In addition, the export-led growth hypothesis supports the inclusion of trade openness as a key variable influencing GDP growth in an open economy like Sri Lanka.

As the first step of the estimation procedure, the study employed Augmented Dickey-Fuller (ADF) unit root test technique to check the stationarity of variables. Once we confirmed the order of integration, the Autoregressive Distributed Lag (ARDL) Bound testing approach was used to determine cointegration and the long - run relationship between variables. Error correction version of the ARDL model was employed to examine the short run relationship between variables and long run adjustment. Also Granger causality test was performed to identify the causality relationship between variables.

Results and discussion

The results of the ADF test revealed that variables are stationary at combination of I(0) and I(1). Akaike Information Criteria (AIC) advocate the use of ARDL (2,0,2,2) model for this analysis. The results of ARDL Bounds test confirmed the existence of cointegrating relationship between variables, which suggest there should be long run relationship among the variables included in this study.

Table 1: Results of Long- run Relationships

Constant	LFP	TRD	GFCF
-9.9672	-0.0530	0.1594	0.2674
0.4273	0.7878	0.0013***	0.0042***

Note: *, ** and *** represents the variables are statistically significant at 10%, 5% and 1% level of significant respectively.

Based on the long-run coefficients dried from cointegration equation, GDP growth rate exhibits a positive and statistically significant relationship with both gross fixed capital formation (GFCF) and trade openness (TRD). The coefficient of GFCF (0.2674) indicates that increased investment contributes significantly to long-run economic growth, supporting the classical view that capital accumulation drives output expansion. Similarly, the trade openness coefficient (0.1594) is also positive and highly significant, implying that greater integration with international markets enhances Sri Lanka's long-run growth. This finding aligns with the export-led growth hypothesis, suggesting that trade facilitates technology transfer, market expansion, and efficiency gains. On the other hand, labour force participation (LFP) has a negative but statistically insignificant coefficient (-0.0530), indicating that, in the long run, changes in labour supply do not meaningfully explain variations in GDP. Overall, these results highlight the crucial role of investment and trade as key drivers of long-term economic growth in Sri Lanka, while labour market dynamics may require deeper structural reforms to enhance productivity and relevance in economic expansion.

Table 2: Results of Error Correction Model

Panel A: Short-run Coefficients

Lag	Δ GDP	Δ TRD	Δ GFCF
1	-0.3829 (0.0006)***	-0.2738 (0.0001)***	0.6246 (0.0007)***
2		0.1185 (0.1054)	0.2089 (0.0034)***

Panel B: Error Correction Term

Variable	Coefficient	P-Value
ECT(-1)	-0.5440	0.0000***

Note: *, ** and *** represents the variables are statistically significant at 10%, 5% and 1% level of significant respectively

The short-run coefficients show that the previous period's gross fixed capital formation (GFCF) has a positive and statistically significant effect on GDP, indicating that increased investment activity contributes to short-run economic growth. The coefficient for GFCF (0.6246, $p < 0.01$) reflects a strong and immediate response of GDP to changes in investment. Trade openness (TRD), however, shows a negative and statistically significant effect (-0.2738, $p < 0.01$), suggesting that in the short run, increased trade may lead to a surge in imports or exposure to external shocks, which can temporarily lower GDP. The coefficient of error correction term (ECT) is negative and highly significant (-0.5440, $p = 0.0000$), confirming the existence of a stable long-run adjustment in GDP after the exogenous shocks. This means that about 54.4% of any short-run disequilibrium is corrected by each period, showing that the economy returns to its long-run path relatively quickly after a shock.

Table 3: Results of Granger causality test

Null Hypothesis:	Obs	F-Statistic	Prob.
TRD does not Granger Cause GDP GDP does not Granger Cause TRD	52	8.08321 2.36515	0.0010 0.1050
LFP does not Granger Cause GDP GDP does not Granger Cause LFP	52	0.33195 1.32177	0.7192 0.2764
GFCF does not Granger Cause GDP GDP does not Granger Cause GFCF	52	31.8602 5.05481	2.E-09 0.0103
LFP does not Granger Cause TRD TRD does not Granger Cause LFP	52	3.20054 1.89503	0.0498 0.1616
GFCF does not Granger Cause TRD TRD does not Granger Cause GFCF	52	5.72628 1.20377	0.0059 0.3091
GFCF does not Granger Cause LFP LFP does not Granger Cause GFCF	52	2.93769 0.17467	0.0628 0.8403

Granger causality results show that gross fixed capital formation (GFCF) significantly causes GDP and trade, with bidirectional causality between GFCF and GDP. Trade Granger causes GDP while labour force participation (LFP) shows weak or no causal relationships with other variables. Overall, investment and trade are key short-run predictors of economic growth in Sri Lanka.

Conclusion and Policy Recommendations

The test results indicate that, among the selected variables, domestic investment is the main driver of economic growth in Sri Lanka. It plays a vital role in enhancing growth, with a significant positive impact in both the short and long run. In the short run Trade openness shows a negative effect and in the long run a positive impact on GDP. Granger causality tests reveal that investment strongly predicts both trade and GDP, underlining its central role in the growth process. To sustain and strengthen economic growth, the study recommends policies that encourage productive investments, improve labour market participation, and manage trade openness carefully to support domestic industries with promoting value-added exports and increasing domestic savings.

Referneces

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