

An Empirical Analysis of Exchange Rate Volatility on Foreign Direct Investments in Sri Lanka

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Abstract

Foreign direct investment is considered as one of key factor in determining factors for its economic growth. However, the macroeconomic environment in the host country must be favorable to attract foreign investment. Exchange rates of its currency against other foreign currencies are one of the main factors that affect the foreign direct investment of a country. The main objective of this study is to investigate the relationship between exchange rate volatility on foreign direct investments in Sri Lanka during the period of 2000 to 2017. Real exchange rate, Real exchange rate volatility, Openness of the economy, GDP per capita, stock of foreign direct investment and political situation were selected as independent variables while foreign direct investment was selected as a dependent variable. Data were collected through annual reports of Central Bank of Sri Lanka and World Bank. Data was analyzed using Vector Error Correction model. The results indicate a negative long-run relationship between exchange rate volatility and foreign direct investment for Sri Lanka. The existence of a short-run association was not Significant in Sri Lanka.

Key Words: Exchange Rate Volatility, Foreign Direct Investment, ECM, Sri Lanka