

The Effects of Foreign Grants and Foreign Debt on the Economic Growth in Sri Lanka: An Ardl Bounds Test Approach

I. A. J. I. Arachchi¹

ABSTRACT

Foreign grants (FG) and foreign debt (FD) are important sources to finance the development program in developing countries. The relative impact of FD and FG on economic growth has not been examined in Asia including Sri Lankan context. The aim of the study is to examine the impact of FD and FG on economic growth in Sri Lanka. The analysis was carried out for the period 1977 to 2017 using the variables, Gross domestic product (GDP), economic openness (MX), FG and FD. The data were collected from the annual report of Central Bank and all these variables are in constant prices. The Phillips-Perron unit root test results show that some variables are stationary at level and some variables are stationary their first difference. The GDP was used as proxy for economic growth. The Autoregressive Distributed Lag (ARDL) Bounds test is employed to find out the long run equilibrium relationships between variables in the study. The ARDL bound test shows that there is a significant long run relationship between GDP and explanatory variables. FG affects GDP positively while FD does not affect statistically significantly in the long run. The results of error correction model estimation shows that the error correction term is significant and had negative sign which theoretically expected. The coefficient of the error correction term indicates that 23 percent of the disequilibrium error is corrected each year. This indicates that the response variable GDP moves towards long-run equilibrium path along with time. In the short run, FD and FG do not influence GDP significantly while LMX affects GDP significantly. Diagnostic tests attest that the results are robust. The CUSUM test confirms that the parameters are stable in the study period. In the Sri Lankan context, FG is favorable source compared to FD. FD has become a sensitive issue now in Sri Lanka as we need to large amount of repayment. Therefore, the government, policy makers need to design the policy regarding FD and FG considering the relative impacts of each variable.

Keywords: ARDL bound test, Foreign Grants, Foreign debts, Economic Growth, Sri Lanka

¹Department of Economics, University of Kelaniya, janakiimbulana6@gmail.com