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EXCHANGE RATE VOLATILITY AND EXPORTS: SRI LANKA'S EXPERIENCE SINCE 1990

23 JUN 2003

BY

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(M.COM/KE/RE/98/04)

This Research Study Is Submitted To The University Of Kelaniya In Partial Fulfillments Of The Requirements For Master Of Commerce Degree Programme.

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JUNE 2003

ABSTRACT

This study investigates the impact of exchange rate volatility on exports of Sri Lanka. Even though Sri Lanka has implemented export oriented economic policies since the early 1980s, the impact of exchange rate volatility on exports has rarely been studied for Sri Lanka. One major reason of this lapse could be due to the fact that the exchange rate of Sri Lankan rupee against the US dollars had been relatively stable since Sri Lanka had been implicitly pegged the US dollars owing to high weight given to the US dollar in Sri Lanka's currency basket.

Even though Sri Lanka managed to stabilize their currency values against the US dollar, it does not mean their currency values are also stable against the currencies of other major trading partners. *Bahmani-Oskooee and Ltaifa (1992)* have shown that even if a country pegs its currency to a major currency or to a basket of currencies, it cannot avoid fluctuations in its Nominal Effective Exchange Rate as long as the major currencies float against each other. In such situations, fluctuations of the major currencies could introduce uncertainty, which in turn could have an adverse impact on trade. Therefore, the impact of exchange rate volatility on exports is an issue to a country whose exchange rate against the US dollars is managed quite stable but where the United States is not the only dominant trading partner.

Against this background, this paper aims to investigate the relationship between exchange rate variability and export growth in Sri Lanka. The main hypothesis in this study is that export performance depends not only on the level of Real Exchange Rate but also on its stability. This hypothesis is tested using the technique of co-integration analysis and Error correction modeling and will be checked through deductive procedure with the level of analysis. This deductive procedure is descriptive as well as statistical in nature. This research study depends on secondary data sources, which derived from the official publications, reports and research studies published in national and international sources.

This study conducts an empirical investigation of the effects of increase in Real Exchange Rate variability on the export growth in Sri Lanka for the period 1989 to 2001. Using Cointegration and Error-Correction Modeling Techniques, it is shown that Real Exchange Rate variability has both short run and long run adverse effects on export growth. Therefore, the stabilization policy to mitigate excessive volatility should be an appropriate strategy in promoting exports.

In conclusion, researcher suggests that Exchange Rate volatility consideration is important for modeling export behavior in developing countries. As a result, the design and implementation of trade and Exchange Rate polices should benefit from knowledge of both the existence and the degree of foreign Exchange Rate volatility. Therefore, policy makers must give attention not only on the level of Real Exchange Rate but also on its stability in efforts to promote export growth.