

The Impact of Exchange Rates on Stock Market Performance in Sri Lanka

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Abstract

Introduction: The relationship between exchange rates and stock market performance in developing economies is a topic of great interest to investors, researchers and policymakers. This paper examines the impact of exchange rates on the S&P SL20 index in Sri Lanka. This includes the exchange rate behavior of the USD, EUR, GBP, AUD and JPY against the Sri Lankan rupee. Apart from other factors in the economy, the behavior of exchange rates has made a difference in economic development and investor decisions. Therefore, the purpose of the research is to explore the relationship between exchange rates and the stock market in Sri Lanka in the short and long term.

Methodology: This paper used monthly data from January 2010 to July 2024. After conducting unit root tests using ADF analysis for stationarity of all variables, the strength of association between the dependent and independent variables is measured through a correlation analysis. The ARDL model elaborates on the short- and long-run impacts, as well as using a GARCH model that captures the effect of the volatility of exchange rates on stock market returns. Descriptive statistics represent data development through the study period with the help of tables or graphs.

Findings: Descriptive statistics show positive means for all variables but non-normal distributions with skewness and kurtosis. The ADF test confirmed stationarity, thus enabling further analysis. The USD has a significant negative impact, and both short- and long-run dynamics are highlighted through the ARDL model. The ARCH test does not show heterogeneity, while the GARCH model confirms volatility clusters and emphasizes the strong influence of the USD. The results emphasize that not all exchange rate movements have the same impact on the performance of the S&P SL20, and that some currencies strongly determine its performance.

Conclusion: This paper highlights the relationship between exchange rates and stock market performance in Sri Lanka. Foreign exchange stability is important for market outcomes and suggests currency stabilization strategies that minimize market crashes. Investors should consider how to manage their investments against the exchange rate to maximize returns when investing in the stock market. Due to the large differences between past literature reviews and the current database and the differences in the variables considered, the current research is bound to shed new light on the short-run and long-run relationship.

Keywords: Exchange rate, Colombo Stock Exchange, Sri Lanka