Behavior of Exchange Rate and its Impact on Other Macroeconomic Variables: Perspective of the Sri Lankan Economy

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Understanding the behavior of Real Effective Exchange Rate (REER) of Sri Lanka with other macroeconomic variables is an important element which directly link with the external sector stability. With the aim of understanding the behavior of exchange rate based on external sector dynamics, the study performs the Vector Auto Regression (VAR) model as a tool covering the period from January 2010 to March 2019. The findings of the research revealed that the behavior of exchange rate with net intervention to foreign exchange market by the Central Bank of Sri Lanka (CBSL), the worker's remittances, net of external debt disbursement and external debt services payments, changes in policy rates of United States, changes in international crude oil prices and earnings from tourism are in line with the theoretical expectations which is positively influence on exchange rate in a country. However, research findings were contrary with the theoretical expectations of behavior of inflation, domestic interest rates and net exports. Even though the depreciated domestic currency may result in increasing net exports, Sri Lanka has been a net importing economy due to higher consumption driven economic activities. This has resulted further depreciation of domestic currency. In conclusion, the domestic currency is depreciated due to lack of robustness of the variables that cause appreciation of domestic currency. Therefore, economic fundamentals should be prudently handled by the policy makers in order to preserve the optimal level of the exchange rate of the country.

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