EM.ARTS.3

THE INTER RELATIONSHIP BETWEEN EXCHANGE RATE AND TRADE BALANCE: EMPIRICAL EVIDENCE FROM THE TRADE BETWEEN SRI LANKA AND THE USA

H. M. A. M. K. Herath, S. Sivarajasingham

Department of Economics and Statistics, Faculty of Arts, University of Peradeniya

Studying the relationship between trade balance and exchange rate is important especially for small open economies. The exchange rate behaviour plays a major role in short term and long term macro policy planning. The relationship between the trade balance and the exchange rate has attracted attention of many economists and policy makers. A number of studies in this area have employed an aggregate approach. In this study, we investigate the effects of bilateral real exchange rates on the bilateral trade balance for Sri Lanka vis-à-vis the United States of America. The main objective of this study is to examine the dynamic effects of changes in exchange rates on the bilateral trade balance between the United States and Sri Lanka for the period 1979-2011. In this study, we used Exchange rate, Trade Balance, GDP of USA and GDP of Sri Lanka as the main variables.

The results indicate that the coefficient of real exchange rate is statistically significant at 5% level. It takes 1 year to influence the trade balance. The effect is positive in the long run. The diagnostic tests and parameter stability test show that the results are reliable. The negative coefficient of GDPSL implies that the higher level of domestic income increases the demand for imports and hence causes unfavourable effects on the trade balance.

In the Sri Lankan context, the estimated results indicate that exchange rate is significant in 1 year lag time and its impact is small. The implication of this result is that a change in exchange rates is a determinant of the trade balance in the long run but not in the short term.