

The Impact of Exchange Rate Depreciation on the Performance of Balance of Payment in Sri Lanka

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Fluctuation in exchange rate in a country's economy is an important internal factor and the frequent variations due to economic performance would impact on the macroeconomic variables like imports, export prices, interest rate and inflation rate. In Sri Lanka today a floating exchange rate base is being maintained on hard economic conditions. The exchange rate of the country mainly depends on the demand for foreign exchange in the international trade and in other words in an import and export economy. The exchange rate coincides to its appreciation and depreciation nature in the volatile economy. The main purpose of the depreciation is to compete in the external affairs and improve the balance of payment in an economy and also the appreciation to face for more demand for imports. Under this situation it is apparent that the policy makers have to face certain trade-off between external competitiveness and increasing price level in formulating their policies whether the scenario is more or less applicable to Sri Lanka in policy making. Very few studies are conducted to find the impact of exchange rate regimes on BOP. Hence, the paper intends to find out the impact of exchange rate depreciation on the balance of payments (BOP) in Sri Lanka and how the effectiveness of exchange rate works on external competitiveness after the economy was liberalized in 1977. The real effective exchange rate would not create a significant impact on the trade balance improvement in the short run, but the co-integration tests reveal that there is a long-run relationship between the trade balance and the real effective exchange rate. It shows very marginal impact in improving trade balance in the long run. Research study used qualitative data in the descriptive form under the inductive approach to justify the relationship between the research study and the collected data. The data of exchange rate, import, exports during the period of 1977- 2015 were collected from various reliable resources and evaluated and compiled to obtain the expected results. The empirical findings indicates that the exchange rate depreciation tends to reduce positive BOP in the medium and long term and that a significant variation in Sri Lanka's BOP is not mainly due to the changes in exchange rate fluctuations, but also may be other critical issues in the Sri Lankan economy such as inadequate infrastructure, poor policy framework and implementation. It is suggested that the policy stance should be more focused in setting up the money market equilibrium so that to restore the external balance automatically to a considerable extent.

Keywords: balance of payment; depreciation; exchange rate
