

Dynamics of Interest Rate on Investment in Sri Lanka

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Abstract

Economic development is a function of investment in producing goods and services. The investment is universally believed to be influenced by interest rate. Most countries use the interest rate as a monetary policy instrument. There are a lot of scholarly workers connecting the interest rate and investment. Most of the literature explored to be negative relationship between the interest rate and investment. But, in Sri Lankan context, none of scholars touch this relationship. Thus, this situation needs a study to make a unique investment policy frame in Sri Lanka. The objective of this study was to analyse the dynamics of interest rate on investment in Sri Lanka. So as to attain this objective, the annual time series data of the following variables: interest rate, gross domestic product and investment from 1975 to 2016 were used and to confirm the integration order of using variables, the Augmented Dickey Fuller (ADF) test was employed. Further, the Johansen Cointegration technique and vector error correction model (VECM) were considered to test the relationship among the variables in both long run and short run periods. In this study the interest rate was employed as independent variable, the investment was considered as dependent variable and the gross domestic product was as control variable. According to the ADF test and cointegration techniques, this study concludes that all variables using in this study were stationary at first difference $I(1)$ and the interest rate and the investment were inversely cointegrated in long run period and positively correlated in short run period. Therefore, due to the importance of the interest rate on the investment, this study recommends that the interest rate should be maintained in steady level to increase the domestic investment.

Keywords: Economic development, Investment, Interest rates, and Gross Domestic Product