Abstract ID: 053

MACROECONOMIC DETERMINANTS OF FOREIGN DIRECT INVESTMENT IN SRI LANKA: EVIDENCE FROM AN ARDL APPROACH

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Abstract

Foreign Direct Investment (FDI) plays a vital role in the economic development of emerging economies by providing capital inflows, generating employment, facilitating technology transfer, and enhancing competitiveness. This study investigates the impact of two key macroeconomic variables namely, the Colombo Consumer Price Index (CCPI) and the real exchange rate on FDI in Sri Lanka, using annual time series data from 1991 to 2021 obtained from the reports of Central Bank of Sri Lanka and World Bank. The Auto-Regressive Distributed Lag (ARDL) bounds testing approach is employed to examine both short-run dynamics and long-run relationships. The results confirm the existence of a long-run equilibrium relationships among FDI, CCPI, and the real exchange rate. The ARDL estimates indicate that FDI inflows are highly persistent, with the lagged dependent variable showing strong significance ($\beta = 0.6914$, $p < 0.01$). In addition, CCPI has a negative and significant effect on FDI ($\beta = –0.0125$, $p < 0.05$), implying that rising domestic prices discourage foreign investors. In contrast, the real exchange rate shows a positive and significant effect on FDI ($\beta = 0.6089$, $p < 0.05$), indicating that favourable exchange rate movements enhance investor confidence and attract foreign capital. The negative and statistically significant error correction term ($\beta = –0.0374$, $p < 0.01$) confirms the presence of long-run equilibrium, with approximately 3.7% of disequilibrium corrected each year. The findings provide valuable insights into the macroeconomic determinants of FDI in Sri Lanka and offer useful implications for policymakers and potential investors.

Keywords*:* *ARDL, FDI Inflows, Cointegration, Macroeconomic Variables, Policy Maker*