A Casual Relationship Between Fluctuations in Foreign Exchange Rates and Foreign Direct Investment

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Abstract: The study aims to analyze the causal relationship between fluctuations in foreign exchange rates and foreign direct investment. For this purpose, data from January 2015 to November 2023 was analyzed using EViews software. An ADF unit root test was conducted to determine if the data contained a unit root. Lag order selection was used to identify an optimal number of lags, and the VAR Granger causality test was employed to investigate the causal relationship between variables. The results indicate unidirectional causality from FDI to Euro, JPY to GBP, and FDI to GBP at twelve lags. Additionally, bidirectional causality is observed from JPY to FDI and USD to FDI at the 5% significance level when twelve lags are applied. In March 2016, FDI experienced a decrease due to a global financial crisis, but this did not impact the country's exchange rate. Similarly, the outbreak of COVID-19 in March 2020 did not significantly affect the exchange rate. However, the political crisis in Sri Lanka in March 2022 had an adverse effect on the exchange rate, showing a negative pattern during this period. The fluctuations in exchange rates and changes in foreign direct investment are greatly influenced by government policies and practices. It is therefore crucial for policymakers to make well-informed decisions to sustain stable FDI and exchange rates, particularly during financial crises, to maximize benefits.

***Keywords**: foreign exchange rate fluctuations, foreign direct investment, JPY, GBP, Euro, USD*

01. Introduction

In this context, foreign direct investment (FDI) is a more stable and desirable source of financing to address domestic saving deficits. Therefore, attracting FDI is an essential goal for developing countries, as it not only improves their balance of payment accounts but also creates new job opportunities. In a free-market economy, the exchange rate is crucial in a country's international trade volume, including imports and exports. Extreme volatility in the exchange rate can have a direct or indirect adverse impact and hinder a nation's economic progress. For instance, Sri Lanka earns significant foreign exchange from tourism, which the COVID-19 pandemic has globally impacted. Sri Lanka still needs to work on reviving tourism in 2022.

Companies in Sri Lanka participating in international trade, either by importing or exporting, are exposed to exchange rate fluctuations. In 1977, Sri Lanka's economy was opened up for international trade, encouraging foreign direct investment through investment incentives, export-led growth, and financial aid from international financial institutions. Sri Lanka followed a fixed exchange rate regime until November 15, 1978. From then until 2001, it adopted a floating rate regime, which has continued.

The growing globalisation of ASEAN economies has made FDI more dependent on exchange rate movements. For instance, the global financial crisis (GFC) led to the implementation of the Unprecedented Monetary Policy (UMP) by the Federal Reserve, which caused highly appreciated exchange rates and massive capital inflows into