
Impact of the Exchange Rate on USA-Sri Lanka Bilateral Trade

N. Keembiyahetti

Department of Economics, Faculty of Humanities and Social Sciences, University of Ruhuna, Sri Lanka

Corresponding author: nandasiri2007@gmail.com

USA is the topmost export destination for Sri Lanka. USA solely provides market place for 24% of Sri Lanka's total exports. USA's contribution in Sri Lankan export market is even bigger than the combined market share of the next three top trading partners, namely; UK, Italy and India. In terms of imports, USA stands at the 6th place sharing 2.5% of the total imports of Sri Lanka. Also, the USA is the prime export destination of Sri Lanka's textile and garment industry solely buying 45% of the total exports. Sri Lanka has been maintaining a substantial trade surplus in the bilateral trade with USA over decades. This study attempts to answer the research question whether the bilateral exchange rate is a decisive factor determining the USA-Sri Lanka trade controlled for the other economic fundamentals, with the objective to examine whether Sri Lanka will gain or lose by the continuous currency depreciation in USA-Sri Lanka trade. Using quarterly data from 2004Q1 to 2019Q4, obtained from the Central Bank of Sri Lanka and IMF, the researcher estimated the standard real export (RXP), real imports (RMP), and trade Balance (TB) functions developed by Rose (1989) with slight modifications to include dummy variable to capture structural breaks. The empirical results suggest that 1% increase in domestic price level causes 0.8% drop in real exports to USA, while 1% depreciation of local currency causes to improve real exports to USA by 0.01% in the long-run. The two conclusions drawn above are effectively endorsed by the estimated TB function too. It suggests that 1% increase in domestic price level causes nearly 0.7% drop in bilateral TB ratio, while 1% depreciation of local currency causes to improve TB ratio by 0.9% in the long-run. Accordingly, the study concludes the depreciation of Sri Lankan rupee against US Dollar is beneficial for Sri Lanka provided the local price level is under control.

Keywords: Bilateral trade, Currency depreciation, Exchange rate, Sri Lanka, USA