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EXCHANGE RATE BEHAVIOUR IN SRI LANKA

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Abstract

The determination of the real exchange rate, tracing and forecasting its behaviour has been in the issue that had not received the attention that it deserves. This study models the dynamics of real exchange rate behaviour in Sri Lanka. The model is extended following the analysis of Natural Real Exchange approach. In the long run real exchange rate is cointegrated with nonstationary variables of terms of trade, productivity of nontradables, productivity of tradables, government expenditure and debt. Most of the impulse response analysis reveal that fall in terms of trade and productivity of tradables, and rise in productivity of nontradables and government debt have depreciated the real exchange rate of Sri Lanka in the long run. Medium term fluctuations of the real exchange rate are driven by the changes in the long run variables and the other stationary variables of domestic interest rate, current account deficit and budget deficit.