

## Terms of Trade and the Sri Lankan Economy: A Sign-Restricted Var Approach

Yashodha Warunie Senadheera<sup>1</sup>

### *Abstract*

The deteriorating terms of trade in the past two decades has been a concern for the policy-makers of Sri Lanka. The recent literature has argued that the effect of the terms of trade shocks on an economy depends on the characteristics of the underlying shock. Using a sign restricted VAR model, this paper examines the effect of external shocks that cause terms of trade fluctuations on the Sri Lankan economy. Three external shocks, viz., world demand shocks, world supply shocks and globalization shocks are considered in this study. The world demand shocks do not have a significant long-term effect on Sri Lanka's real output, but the negative world supply shocks are contractionary. Conversely, positive globalization shocks increase domestic output permanently. Both positive world demand shocks and globalization shocks are inflationary while negative world supply shocks increase domestic prices initially but reduce the prices after two quarters. World demand shocks have largely contributed to the fluctuations in trade balance in Sri Lanka since 2007, whereas the importance of globalization shocks on the imports, exports and trade balance has increased since 2010. Further, the contribution from globalization shocks to the variance in domestic output and price levels has increased since 2007.

**Keywords:** Terms of Trade; Small Open Economy; External Shocks

**JEL Classification:** F410; F140

---

<sup>1</sup> Crawford School of Public Policy, Australian National University, Australia

Correspondence: Economic Research Department, 30, Janadhipathi Mawatha, Colombo 01.  
Tel: +94-11-2477435. E-mail : [yashodha.ws@cbsl.lk](mailto:yashodha.ws@cbsl.lk) or [yashodha.ws@gmail.com](mailto:yashodha.ws@gmail.com)