

## Impact of the Terms of Trade on Consumption and Investment : The Sri Lankan Experience

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In this paper, the author tries to study the impact of terms of trade on consumption and investment in Sri Lanka, a highly open and a primary producing economy. By estimating two empirical functions, the paper establishes positive correlation between its aggregate private real consumption and aggregate private real investment on the one hand and its income terms of trade on the other.

### The Problem

Issues relating to terms of trade have been of perennial concern to the primary exporting economies. Terms of trade have a direct bearing on the well-being of an open economy. However, in case of developing countries these changes are more vital. In fact, it is pointed out that notwithstanding the fact that 'tropical engine was beating as fast as the industrial engine' thereby transforming some of the currently developing countries 1/ before WWI, the latter failed to become successful industrial nations. One of the most important reasons, suggested by Lewis, is their unfavourable external terms of trade 2/. With the oil shock of the 1970's, and the sad plight of the debt-ridden primary commodity exporting economies confronted with fluctuations in their prices in the 1980s, there has been renewed interest in the subject all over again.

Sri Lanka, a primary exporting economy, has experienced large fluctuations in its terms of trade over a long period 3/. As a result, there may have been an adverse impact on its domestic capital formation and the level of current consumption as well. While the latter influences the welfare of the economy in the short-run, the former impinges on the prospects of long-run growth and welfare of