14 An Empirical Study on the Impact of Political Shocks and Other Macroeconomic Variables on GDP of Sri Lanka

V. I. Amaratunge, A. R. Ajward, and R. M. A. K. Rathnayake

14.1 Introduction

Sri Lanka is a small island nation with limited economic resources. Despite this, Sri Lanka has often outperformed regional countries in terms of its economic development. In the 1940s Sri Lanka was on a par with Japan, and in the 1960s its economy was larger than that of newly industrialized countries (NICs). In 1956, on a diplomatic visit, Lee Kuan Yew declared that Sri Lanka was a country far richer in resources than Singapore (Jayaweera et al. 2003, cited in Ramanayake and Wijetunga 2017). However, the situation has now reversed for Sri Lanka, and today it has the lowest economic growth rate in comparison with its South Asian counterparts.

The country has faced much political turbulence, including the 30-year-long civil war and unrest in the 1970s and 1987/1989 periods, which has impacted economic growth (Easterly and Levine 1997). Ramanayeke and Wijetunge (2017, p. 13) observe: '[d]isagreements led to a civil war in the 1970s that lasted for three decades until the LTTE was destroyed by government forces in 2009. Sri Lanka's economic history can be divided into three major eras, namely, the colonial era (1505–1948), post-colonial era (1949–2013), and post-war era (after 2009)'. Despite having the

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lowest growth rate in the region, Sri Lanka has maintained a more 'open economy' compared to any other economy. The late President, J.R. Jayawardena, was able to initiate open economic policies in Sri Lanka in 1978–1979 (Ramanayake and Wijetunga 2017).

Despite years of civil war, the country has been able to maintain around a 5% economic growth rate on average over the last three decades. Although the agricultural sector was the largest sector prior to 1956, now its contribution to GDP is only about 8%, and it is less than that of the industrial and services sectors. The economic growth of Sri Lanka today is thus basically determined by growth determinants (Kormendi and Meguire 1985) of industrial services sectors. At present, Sri Lanka is designated as a lower middle-income country with a GDP per capita of USD 4073 (Central Bank of Sri Lanka [CBSL] 2017). The main sectors of the Sri Lankan economy are tourism, tea exports, apparel, textiles and rice production. Remittances also constitute an important part of national revenue. Amidst these fluctuations in economic development, researchers also observe that Sri Lanka had undergone several political regime changes and other political shocks. However, despite these observations, researchers have found that there is a dearth of studies that examine how these political shocks, the open economy and other economic variables impact RGDP of Sri Lanka.

Accordingly, the main objective of this study is to examine the impact of political shocks and other macroeconomic variables on Sri Lanka's GDP. The impact of opening the economy in 1978 on economic growth will also be examined. The findings are expected to fill the observed empirical dearth in the local and empirical extant literature in the area. The findings are also expected to have significant policy implications for decision-makers and regulators of the economy.

The rest of the paper is structured as follows. The next section reviews local and international literature on the topic. Section three elaborates the methodology applied in achieving the objectives of this study. Section four details the main findings. The final section provides a discussion and concluding remarks and elaborates future research directions.

14.2 Literature Review

This section reviews the main theories that link RGDP with political instability and other macroeconomic variables. It includes a review on the relevant empirical literature on the impact of political instability on the RGDP. Based on the review of the literature, both the gap in the literature is identified and the basis of the conceptual framework that links political instability and other macroeconomic variables with RGDP established.

14.2.1 Theoretical Underpinnings in Trade Openness, FDI and Economic Growth

Although there are no specific theories on political shocks and economic growth, the discussion that follows establishes the link between trade openness (which was a politically motivated move in 1978), foreign direct investment and economic growth.

14.2.1.1 Endogenous Growth Model, Neoclassical Theories and Foreign Direct Investment (FDI)

Adhikary (2011) indicates that both endogenous growth and neoclassical models can be used as theoretical underpinning to explain the economic growth fuelled by FDI of a country. Under the endogenous growth model, Romer (1986) and Pugel (2007, as cited in Adhikary 2011) postulate that, through FDI, different types of skills (managerial, technical, human skills, etc.) as well as technological advancement, innovations and new knowledge are brought to a country. Pugel (2007, cited in Adhikary 2011) further elaborates that, in the expansion of international competition and strengthening the capacity of the production and sale of goods, 'technological spill over' via FDI plays a major role leading to higher economic growth. Discussing developing economies, Romer (1986) argues that increased efficiency due to FDI assists such economies to be on a par or converge with more economically advanced economies.

Adhikary (2011) explains that endogenous growth models explain that the growth of a nation in the long run does not only depend on physical investments, but in using such investments *efficiently*. Hence authors such as Nair-Reichert and Weinhold (2001) and Adhikary (2011) claim that, under the endogenous theoretical model, economic growth in the long run depends on progress in technology, which is based on knowledge and technology transfers. Neoclassical theories explain that FDI is a comparatively less volatile and more reliable means of capital infusion for the growth of developing countries (Moosa and Cardak 2006). Edwards (1992) also claims that, by absorbing modern innovative technologies, a country can grow faster than a country with lower openness.

Accordingly, in contrast to the endogenous model, neoclassical theories assume that the growth of a country in the long term depends on the FDI channelled to productive sectors of a country that is short of capital, rather than taking into account the technology and knowledge transferred via such investments. Thus neoclassical theories take a narrow view of FDI, limiting it only to the physical aspect of FDI.

In terms of the context of a developing country that has low levels of initial capital, neoclassical theories also suggest that, if additional capital is infused, higher marginal rates of returns can be achieved. This means that in economies short of capital stocks, the marginal productivity of new investment is higher (Adhikary 2011).

14.2.1.2 Transaction Cost Theory, Trade Openness and FDI

Transaction cost theory, propagated by scholars such as Coase (1937), can be used to as an argument that higher return on investment is provided for both local and foreign investors in a more open trade economic context. It is apparent that investors will not be motivated to invest in an economy where non-tariff and tariff barriers exist and where they will be unable to take back their capital and returns to their own countries. Adhikary (2011) argues that a country with trade openness has a competitive advantage over other countries, and investors will take that into account where it is advantageous for them to invest in such countries.

14.2.1.3 Classical Economists, Mercantilism, Heckscher-Ohlin Trade Theories and Trade Openness

Under classical economist theories, it is claimed that a country may not be able to continue to enjoy an indefinite positive trade balance; such countries should produce and export goods and services with a lower cost advantage and import only items with higher cost disadvantage (Khobai et al. 2018). Based on this argument, Keho (2017) and Nduka et al. (2013) also indicate that foreign trade, which is used as a proxy for trade openness, has a strong positive impact on the economic growth of a country. However, Khobai et al. (2018) argue that the economic benefit of one country is at the cost of another country and thus a zero-sum game. Based on this argument, Adedoyin and Ademola (2015, cited in Khobai et al. 2018) and Nduka et al. (2013) explain that exports should be greater than imports and the receiving country should take steps to protect its domestic industries from import competition. Contrary to these views, Heckscher and Ohlin (Heckscher 1919; Ohlin, 1933, cited in Khobai et al. 2018) claim that two countries should trade with each other if they have similar technology, returns of scale are constant and factor intensity of final products and services are similar. They further argue that the country with higher resources will manufacture at larger scale and enhance economic growth.

The next section reviews the extant literature on the impact of political instability and macroeconomic variables on economic growth.

14.2.2 Empirical Studies on Political Instability and Economic Growth

Chawdhury (2016) defines political instability as the 'propensity of a change in the executive, either by "constitutional" or "unconstitutional" means' (p. 4) and claims that political instability has become a major issue in both developing and developed nations. An analysis by Grossman (1991) of revolutions suggests an interesting argument on the negative association between political instability and economic growth: when the governors of a nation are comparatively weak, the incidence of occurrence of revolution is higher, and hence citizens of such a country will engage in revolutions rather than productive economic activity – and vice versa. This analysis is supported by Alesina and Perotti (1996), who claim that successful, as well as attempted, revolutions, coups and collective violence indicate anarchy and that they

pose a threat to established property rights. Kuznets (1966, cited in Chawdhury 2016) argues that a basic level of political stability is required of a country so that citizens can plan for the future and ensure that they will get proper rewards for their extended contributions.

Shonchoy and Tsubota (2014) indicate that countries with conflicts and fragility are unable to develop proper governance functions or meaningful relationships within their communities. Roy and Borsha (2013) explain that political instability causes a plethora of negative impacts on a number of macroeconomic factors, such as growth in GDP, inflation and private investment. Memon et al. (2011, cited in Chawdhury 2016) argue that, when a country enjoys stability, individuals are empowered and can channel their energies to the development of their countries.

Chawdhury (2016) explains that there are at least two reasons why political instability has a negative effect on economic development. The first is that such instability disturbs market activities and relations with labour, impacting adversely on the productivity levels of a country. The second is that instability has a negative impact on the investment in a country, which negatively impacts the development.

In the Sri Lankan context, asserting the claims made by Chawdhury (2016), Herath and Amaratunge (2007) examined the association between the political changes (and other selected variables) in Sri Lanka and real effective interest rates and found that these changes had a significant impact on the interest rate during the period from January 1994 to December 2000. They had taken the Stock Market Index of the Colombo Stock Exchange to proxy the political changes and indicate that their selected period of study is a period where Sri Lanka had been seriously affected with civil war and other political instabilities. They further explain that, from the beginning of the 1994 period, Sri Lanka underwent a political change and the business community in Sri Lanka at that time believed that the government was not in favour of business.

However, MacCulloch (2005) concludes that empirical findings cited in a number of studies over two decades have produced divergent and sometimes contradictory findings on the association between conflict and inequality. Polachek and Sebastianova (2011) argue that conflicts negatively impact economic growth in the short run, but in the long run such economies recover from the negative effects between and among political parties.

The sections reviewed above identified several macroeconomic variables that could impact the economic growth of a country. They include political stability, FDI, population growth, inflation, trade openness and gross capital formation. Despite having found several local and foreign studies on the subject, the researchers did not come across recent Sri Lankan studies that had used all these variables, which indicates a gap for us to address. Another phenomenon observed was the mixed nature of evidence. The six variables cited here in some instances had a positive impact, while in others they had a negative impact on economic growth. This also warrants further investigation, particularly in light of the dearth identified in the Sri Lankan context.

14.3 Methods

This section discusses the methods deployed to examine the impact of political shocks and other macroeconomic variables on the GDP of Sri Lanka and to assess the impact of opening the economy in 1978. A quantitative approach in the positivistic research paradigm is used. Such an approach is deemed appropriate because the study examines the relationships between variables, and a similar approach is also observed in other studies.

Based on the endogenous growth model, the neoclassical theories and empirical studies discussed in the preceding section, the conceptual framework of the current study is present below (Fig. 14.1).

Based on this conceptual model, the following hypotheses are developed:

H1: *Each production factor (*i.e.*, gross fixed capital formation, population growth and FDI) has an association with real GDP.*

H2: *Each technical factor (*i.e.*, trade openness, political shocks and opening the economy) has an association with real GDP.*

In terms of data, secondary data from 1971 to 2016 are used to estimate the empirical model. RGDP, FDI, inflation, population growth and domestic capital data were obtained from World Bank databases; import and export data to calculate trade openness were collected from Central Bank reports in Sri Lanka.

Empirical Model

Since the original set of data was non-stationary, the first difference of each variable has been taken, and all variables were found to be stationary at the first difference. Accordingly, the following model has been estimated by the ordinary least squares (OLS) method.

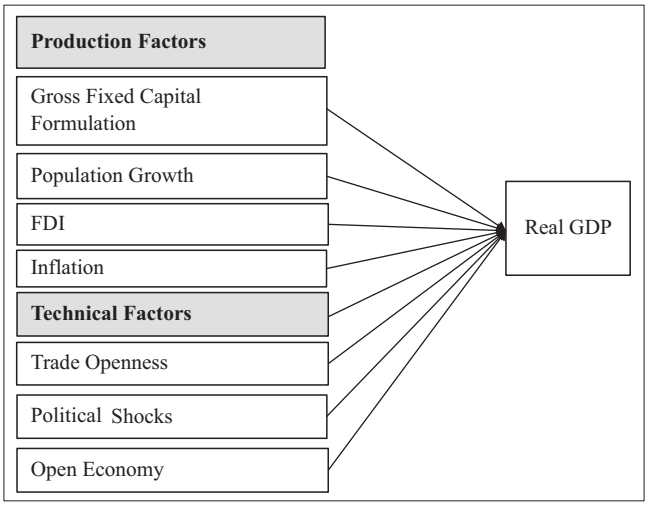

Fig. 14.1 Conceptual diagram. (Source: Authors, using the literature)

$$Y = f\left(X_1, X_2, X_3, X_4, X_5, X_6, X_7\right) \tag{14.1}$$

Y = GDP at constant prices (constant 2010 US$)
X_1 = Gross fixed capital formation (constant 2010 US$)
X_2 = Population growth rate (annual %)
X_3 = Foreign direct investment net inflows (constant 2010 US$)
X_4 = Inflation, GDP deflator (annual %)
X_5 = Trade openness
X_6 = Dummy variable which indicates whether the economy is an open economy or a closed economy (if $X_6 = 0$, Sri Lanka is a closed economy; if $X_6 = 1$ Sri Lanka is an open economy)
X_7 = Dummy variable which indicates whether Sri Lankan economy is in political instability or not (if $X_7 = 0$, Sri Lanka is in political instability; if $X_7 = 1$, Sri Lanka is in political stability)

GDP is the value of all goods and services which have been produced within the economy during a year, computed at market prices including inflationary effects. Therefore the study employed GDP at constant prices (constant 2010 US$). Capital is a crucial production factor which determines total output. Gross capital formation was employed as a proxy for capital. According to national accounting standards, gross domestic capital formation consists of three main components: gross fixed capital formation, changes in inventories and change in valuables. Since gross fixed capital formation has a direct effect on production capacity of the three components, gross fixed capital formation was employed for the model. Labour is another important production factor in any economy that determines the level of output. In many empirical studies, population growth rate has been used as a proxy for labour. Therefore the population growth rate has been employed for the model. FDI is a very important determinant of economic growth, especially in developing countries. According to data available, FDI net inflow has been employed in the model. FDI net inflow was computed by subtracting FDI outflow from FDI inflow. The relationship between inflation and economic growth/RGDP is still debated in the literature. There are a number of studies that argue that inflation has positive impact on economic growth in the short run and a negative impact in the long run. With this background, the GDP deflator (implicit price index) was employed in the model.

Trade openness is considered a crucial determinant of economic growth/RGDP in current open economies. Trade openness employed in the model is computed by the following formula.

$$TradeOpenness = \frac{Export + Import}{Gross\ Domestic\ Product}$$

X_6 is a dummy variable employed in the model to check whether an open economy has a significant impact on RGDP. Sri Lanka is a closed economy if $X_6 = 0$ and an open economy if $X_6 = 1$. X_7 is a dummy variable employed to check whether political shocks have significant impact on RGDP. Sri Lanka is in political shock/instability if $X_6 = 0$ and in political stability (free from political shocks) if $X_6 = 1$. Determination of the status of political stability or instability in each year of the sample has been based on a comprehensive analysis by an expert in political science.

Analytical Strategies
The empirical model of the study is estimated by employing time-series data. Since a non-stationary or unit root problem is an inherent problem associated with time-series data, all variables of the model must be stationary in order to derive reliable estimates. Thus the unit root problem of set of data has been tested by the Augmented Dickey-Fuller Test. Goodness of fit of the model or overall suitability of the model for a set of data is evaluated by the adjusted coefficient of determination. Overall significance of the model is tested by the 'F' test, and individual significance of each parameter estimated is tested by a 't' test.

14.4 Analysis and Findings

This section elaborates the analysis and the ensuing findings obtained via the application of the methodology elaborated in the preceding section. Accordingly, first the results of the diagnostic tests are elaborated and thereafter the results of the hypotheses testing presented.

Diagnostic Tests
The results of the outlier tests, unit-root tests and multicollinearity tests are discussed below.

Outlier Test Outliers of the set of data have been examined by utilizing Grubb's test. Outliers of the sample can reduce the accuracy of estimated parameters of the model. Therefore this test is important for identifying and removing unusual observations of the set of data.

According to Grubb's test, the 45th observation of net FDI inflows is found to be an outlier ($p < 0.05$) (Table 14.1). Therefore, the 45th observation (i.e. year 2015) of all variables has been removed from the sample in estimating the model.

Table 14.1 Outlier test

Variable	N	Mean	StDev	Min	Max	G	P
Y	46	30997085821	20176548587	8967036827	79706946035	2.41	0.595
*X*1	46	6975407408	5695566749	803142104	21361541421	2.53	0.416
*X*2	46	1.1463	0.4255	0.5551	1.9678	1.93	1.000
*X*3	46	3791005722	7338227795	-7765985	37313404649	4.57	0.000
*X*4	46	10.5890	5.7100	0.5840	24.3790	2.42	0.593
*X*5	46	0.5431	0.1445	0.2657	0.7741	1.92	1.000
*X*6	46	0.8478	0.3632	0.0000	1.0000	2.33	0.758
*X*7	46	0.5435	0.5036	0.0000	1.0000	1.08	1.000

Source: Data analysis by the authors

Variable	Row	Outlier
*X*3	45	3.73134E+10

Table 14.2 Unit root test

		t-statistics	Prob.
Augmented Dickey-Fuller test statistic		−2.319051	0.0451
Test critical values	1% level	−3.588509	
	5% level	−2.929734	
	10% level	−2.603064	

Source: Data Analysis by the authors

Table 14.3 Correlation metrics

	Y	*X*1	*X*2	*X*3	*X*4
*X*1	0.817				
	0.000				
*X*2	0.079	0.108			
	0.612	0.485			
*X*3	0.033	−0.046	0.012		
	0.833	0.765	0.936		
*X*4	−0.027	−0.049	−0.172	−0.517	
	0.860	0.752	0.265	0.0900	
*X*5	−0.083	0.140	0.141	0.168	−0.062
	0.592	0.364	0.362	0.274	0.688

Cell contents
Pearson correlation coefficient
p-value
Source: Data analysis by the authors

Unit Root Test Stationarity has been tested by the Augmented Dickey-Fuller test. Accordingly, all variables are found to be stationary at the first difference ($p < 0.05$) (Table 14.2).

Multicollinearity The multicollinearity problem is examined by correlation metrics of all predictor variables except dummy variables.

The model is free from multicollinearity, since almost all partial correlation coefficients are statistically insignificant at a 5% significance level (Table 14.3). This is further confirmed by the following matrix plot (Fig. 14.2).

Estimates of the Model

Having explored the results of the diagnostic tests in the preceding section, this subsection presents the results of the regression analysis involving the main model.

The F-test is used to check the overall significance of the model. The F-statistic is 14.89, and the p-value is closer to zero (Table 14.4). Therefore, it is concluded that the model is significant as a whole (Table 14.5).

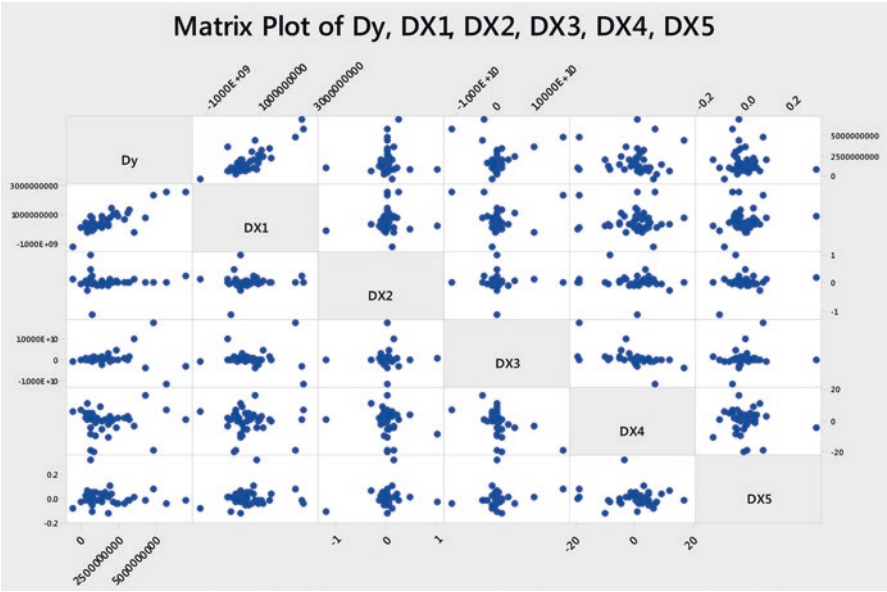

Fig. 14.2 Matrix plot of variables. (Source: Authors)

Table 14.4 Analysis of variance

Source	DF	Adj SS	Adj MS	F-value	p-value
Regression	7	7.28646E+19	1.04092E+19	14.89	0.000
*X*1	1	6.10497E+19	6.10497E+19	87.33	0.000
*X*2	1	2.41817E+17	2.41817E+17	0.35	0.560
*X*3	1	1.74097E+18	1.74097E+18	2.49	0.123
*X*4	1	8.28244E+17	8.28244E+17	1.18	0.284
*X*5	1	4.33320E+18	4.33320E+18	6.20	0.018
*X*6	1	1.67025E+18	1.67025E+18	2.39	0.131
*X*7	1	1.29932E+17	1.29932E+17	0.19	0.669
Error	36	2.51675E+19	6.99096E+17		
Total	43	9.80321E+19			

Source: Data analysis by the authors

Table 14.5 Model summary

S	R-sq	R-sq(adj)	R-sq(pred)
836,119,639	74.33%	69.34%	57.59%

Source: Data analysis by the authors

Table 14.6 Estimated parameters

Variable	Coefficient	Std. error	t-statistics	Prob.
Constant	2.9500	3.5400	0.8333	0.4100
X_1	1.5975	0.1863	0.5754	0.0000
X_2	1.9900	4.7400	0.4202	0.6768
X_3	0.0709	0.0267	2.6526	0.0117
X_4	23,114,664	18,686,006	1.2370	0.2239
X_5	−4.4400	1.8100	−2.4539	0.0190
X_6	6.3800	3.5500	1.7996	0.0801
X_7	−53,126,814	2.4400	−0.2181	0.8285

Source: Data Analysis by the authors

The adjusted R^2 value of the model is 69.34%, and this indicates that this percentage of GDP is explained by selected independent variables. Accordingly, it is observed that there is satisfactory goodness of fitness of the model with the data.

The individual significance of each variable in the model is presented in Table 14.6. It is observed that the variables population growth rate ($X2$), inflation ($X4$) and political stability ($X7$) are not statistically significant ($p > 0.10$), which means that there is no statistical evidences to confirm that these variables have significant impact on RGDP of Sri Lanka. Gross fixed capital formation ($X1$) is statistically significant at the 1% level ($p < 0.01$), and it has strong positive impact on RGDP. FDI ($X3$) is statistically significant at the 5% ($p < 0.05$), and it also has a strong positive impact on RGDP. However, trade openness ($X5$) is statistically significant at a 5% level ($p < 0.05$), but has negative impact on RGDP. The dummy variable, which indicates whether an economy is open or closed ($X6$), is found to be statistically significant at the 10% level ($p < 0.10$) and indicates that the open economy concept that was introduced after 1977 has a positive impact on RGDP.

14.5 Discussion and Conclusions

This section presents the discussion and conclusions. The first objective of this study was to examine the impact of macroeconomic variables on RGDP of Sri Lanka, and accordingly, FDI, domestic fixed capital formation, inflation, population growth rate and trade openness were taken into account. The second objective was to examine the impact of political shocks on RGDP. The third was to test whether RGDP was significantly affected by the open economy introduced in 1977. The study used secondary data from 1971 to 2016 to estimate the empirical model.

The regression results indicated that the population growth rate, inflation and political stability are not statistically significant, indicating that there is no statistical evidence to establish that these variables have significant impact on RGDP of Sri Lanka. The finding that political instability does not have a significant impact on

RGDP is consistent with the conclusions of MacCulloch (2005), who asserts that empirical findings elaborated in a number of studies over two decades have produced divergent, sometimes contradicting, findings on the association between conflict and inequality. Further, as indicated by Polachek and Sevastianova (2011), conflicts negatively impact economic growth in a short run, but in the long run such economies recover from the negative effects between and within political parties. Thus, after 30 years of war—which could be considered long-run—and political turbulence, Sri Lanka seems to be sensitized and normalized, so that such turbulence would not have any significant impact. It also could be claimed that the RGDP is quite low in the Sri Lankan context (especially compared to its Asian counterparts), and thus political instability in the long run would not have had an impact in any case. The insignificant impact of population growth rate on RGDP is also interesting to note, and this finding is consistent with researchers such as Landreth and David (2002, cited in Uddin 2016) and Feyrery (2002, cited in Uddin 2016), who claim that changes in population may not have an economic impact. Unless the *working* population grows significantly or their productivity grows significantly, it cannot be expected to have a significant impact on the economic growth (Kelley and Schmidt 2005). Therefore, mere increase of *total* population cannot be expected to have a significant impact. The findings indicate that these *internal*-oriented macroeconomic fundamentals do not have a significant impact on RGDP.

However, the findings indicate that gross fixed capital formation is statistically significant at a 1% level and it has strong positive impact on RGDP. It was also noted that FDI is statistically significant at a 5% level and has strong positive impact on RGDP. The dummy variable on the open economy is statistically significant at the 10% level. The open economy introduced after 1977 has thus positively affected RGDP and the closed economy prior to 1977 negatively affected GDP at that time. All these variables are *external*-oriented and assert that the Sri Lankan economy greatly depends on such *external* assistance. Similar to these findings, in the Indonesian context, Khaliq and Noy (2007) found that FDI had positively impacted the country's economic growth during the period from 1997 to 2006. In terms of gross capital formation, De Long and Summers (1991) indicate that there is a positive relationship between these two constructs. This positive relationship was also confirmed by Levine and Renelt (1992), Islam (1996) and Lauthier and Moreaub (2012).

Trade openness is statistically significant at the 5% level, and it has a negative impact on RGDP. Kwame (2013) found that liberalization of trade led to GDP growth in the long run, but it impacted negatively in the short run in Ghana. The period considered under this study is long run, and thus it is apparent that too many imports are detrimental to RGDP.

These findings have significant economic policy implications. Policymakers should promote FDI, open economic policies and thereby gross capital formation within Sri Lanka. Sri Lanka should promote exports over imports. In particular, through FDI, different types of skills (managerial, technical, human skills, etc.), as well as technological advancement, innovations and new knowledge, should be brought to Sri Lanka. Sri Lanka also needs to continue open economic policies and especially promote exports.

In terms of future research directions, it is proposed to examine the reasons behind some of the main findings of this study, as well as to consider additional macroeconomic variables. A comparative study with other developing nations is recommended.

Chapter Takeaways/Lessons

1. In terms of a country's economic growth, there may be various macroeconomic determinants such as foreign direct investment, inflation, population growth, fixed domestic capital formation and trade openness of a country, and 'political shocks' as a determinant has gained prominence particularly in the developing country context.
2. The endogenous growth and neoclassical models could be used as theoretical underpinning to explain the economic growth fuelled by FDI of a country.
3. The empirical evidence is mixed regarding the impact of political instability on economic development.
4. In a developing country context, the findings of this study suggest that population growth rate, inflation and political stability are not having a statistically significant impact on RGDP of Sri Lanka. But gross fixed capital formation and FDI were found to have a significant positive impact on RGDP.
5. As one of the first South Asian countries to adopt a full open economic model, the open economy concept introduced after 1977 has positively affected RGDP in Sri Lanka.
6. In an emerging country context, policymakers should promote FDI, open economic policies and thereby gross capital formation within Sri Lanka. Importantly, through FDI, different types of skills (managerial, technical, human skills, etc.), as well as technological advancement, innovations and new knowledge, should be brought to Sri Lanka.

Reflective Questions

1. Explain various macroeconomic determinants that could impact the RGDP of a country.
2. Compare and contrast the endogenous growth model and neoclassical theories on FDI and economic development.
3. 'Political instabilities will always have a negative impact on the economic growth of a country'. Critically evaluate this statement by using the findings of empirical studies.
4. What is an 'open economic system'? Discuss the benefits of such a system.
5. Evaluate why Sri Lanka as a developing country was not significantly impacted by political instability and shocks.

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