

The Causal Relationship between Foreign Direct Investment and Tourism Development:

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The Causal Relationship between Foreign Direct Investment and Tourism Development: Evidence from Sri Lanka- R.P.C.R. Rajapakse-PhD6

Abstract

Tourism is one of the most important export sectors in many developing countries. The general understanding is that it not only increases foreign exchange income, but also creates employment opportunities, stimulates the growth of the tourism industry and as a result of all this, contributes to overall economic growth. In general, there is an increasing and widely accepted belief that tourism plays a fundamental role for developing countries to achieve economic growth and development. Hence, tourism development has become an important target for most governments, especially in developing countries. Foreign Direct Investment (FDI) is an important source of capital for the development of the tourism sector in any country.

Although, Sri Lanka has always been a popular tourist destination the internal ethnic conflict which continued for thirty long years has made the foreign investment climate an extremely challenging one. With the cessation of the war in 2009, the environment is gradually changing with increased investor confidence and tourist arrivals picking up. Majority of the tourist are from Europe, and on business trips, while Indians and Japanese are the majority among the transit passengers most of whom return home from their employment overseas. The government has been awarding incentives to encourage FDI in general and specifically to the tourism sector. The Board of Investment (BOI) Sri Lanka emphasizes several priority areas in this sector and approves tourism and leisure projects in consultation with the Sri Lanka Tourism Development Authority (SLTDA)

Within the tourism sector of Sri Lanka, foreign investments are not quite popular and are channeled in favor of bigger, more established operations. The study investigated the causal relationship between foreign direct investment in tourism (FDIT) and the number of foreign tourist arrivals (TOUR) in Sri Lanka / Foreign Exchange Earnings from Tourism (FEE) using quarterly data for the period 2005:1 to 2013:4. FDIT in the tourism sector is taken as FDI in Hotels and Restaurants sector. Various time series econometric techniques such as unit root tests, cointegration and causality are used. The analysis reveals that the time series TOUR and FDIT/FEE and FDIT are not cointegrated. The VAR systems in first differences of the variables were used to investigate the causality between the variables. The results show that there is bi-directional relationship from FDIT to tourism and FDIT to FEE. That is the FDIT has a causal effect on the number of foreign tourist arrivals in Sri Lanka and foreign exchange earnings from tourism and vice versa. FDIT inflows to the tourism sector promote the growth of incoming tourism, employment and consumption and

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vice versa. This evidence emphasizes the need for appropriate policies and plans to further expand and develop tourism given that FDI flow into Sri Lanka is expected to be strong in the coming years, bringing along a demand for tourism as well. Available policies may be "soft" such as government support for eco tourism, promoting cultural heritage sites, medical tourism, Agro tourism, trade fairs and maintaining tourism internet sites or "hard" such as government providing incentives to foreign investors. Accordingly, tourist arrivals will increase making a positive influence on economic development.

Key words: FDI, Tourism, Economic Development,