Impact of Economic Uncertainty on Foreign Direct Investment Inflows of Sri Lanka

W. P. S. Rodrigo and P. A. D. D. Randika

ABSTRACT

Foreign direct investment is the heart of economic growth. Sri Lanka faces foreign reserve shortage. Therefore, the researcher studied how foreign investors react on investment flows of Sri Lanka under world, regional, and domestic uncertainty situations of Sri Lanka. The researcher studied on impact of economic uncertainty on foreign direct investment inflows using world, regional and domestic uncertainty indexes which are newly constructed indexes. This study has been used quantitative analysis for impact on economic uncertainty on foreign direct investment inflows of Sri Lanka. The researcher used secondary data for the sample period of 1st quarter, 1996 to 4th quarter, 2019. The researcher used the autoregressive distributed lag model, error correction model for analyzing the short-run and long-run impact on economic uncertainty on FDI inflows of Sri Lanka. Regional economic uncertainty has a significantly impact on foreign direct investment inflows of Sri Lanka in short run and long run. In domestic economic uncertainty has significantly impact on foreign direct investment inflows of Sri Lanka in short run and long run. However, World economic uncertainty has not significantly impacted on foreign direct investment inflows of Sri Lanka. This study has used world, regional, and domestic uncertainty of Sri Lanka indexes, which were newly built to capture uncertainties. Findings of the study could be used for the changes of policies to attract foreign direct investment inflows of Sri Lanka.

Keywords: Domestic, FDI inflows of Sri Lanka, Regional, World, Uncertainties.

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W. P. S. Rodrigo

Sabaragamuwa University of Sri Lanka,
Belihuloya, Sri Lanka.

(e-mail: rodrigowps @ std.mgt.sab.ac.lk)

P. A. D. D. Randika

Sabaragamuwa University of Sri Lanka,
Belihuloya, Sri Lanka.

(e-mail: dilini @ mgt.sab.ac.lk)

**Corresponding Author*

I. INTRODUCTION

Foreign direct investment (FDI) is the primary stable type of international capital flows. Foreign direct investment is a category of cross-border investment. An investor resident in one economy establishes a lasting interest in and a significant degree of influence over an enterprise resident in another country. FDI is vital for transferring technologies between two countries, promoting international trade through access to the foreign market (Organisation for Economic Co-operation and Development, n.d.). Moreover, Foreign direct investment is essential to economic growth and development (Suleyman, 2020). According to World Bank data, FDI net inflows of Sri Lanka were reduced in 2019.

Uncertainty means an unforeseen chance for future loss or damage. In this situation, decision-makers are not able to draw the probability of an outcome. The facts are unknown in the uncertain future. Moreover, there are types of uncertainty such as market, technical, competitive, technological, and political uncertainties. The impact of economic and political uncertainty on the FDI has been a prevalent issue in recent years (Suleyman, 2020). The International monetary fund country report suggests that uncertainty has recently become a key factor of weaker economic performance in many countries (Ahir *et al.*, 2020).

Fig. 1. World Uncertainty Index 1990Q1 to 2021Q2.

Source: Economic policy uncertainty website.

A. Research Problem

The COVID-19 pandemic has severely hit global flows of foreign direct investment after two decades. According to World Bank data, FDI net inflows of Sri Lanka have been reduced in these periods. However, Sri Lanka has significant resources, location advantages, and human capital. However, Sri Lanka has not achieved FDI targets for various reasons (Amarasinghe, 2019). Sri Lanka faces domestic economic

uncertainty situations such as the LTTE war, Easter bomb attack, political uncertainty like a hundred days government. Regional uncertainties may indirectly influence the FDI inflow of Sri Lanka, such as the conflict between India and Pakistan, the conflict between China and India. Furthermore, there were some uncertain situations such as the 9/11 attacks, the SARS outbreak, the gulf war II, the European border-control crisis, the UK's referendum vote in favor of Brexit, and the US presidential election in the world. Moreover, anyone cannot predict uncertain situations accurately. Therefore, investors delay investment until the uncertainty has been resolved. So, it led to reducing foreign direct investment. Foreign direct investment impacts foreign reserve, GDP growth, technology transferring and trade deficit. In the world context, there were limited studies on the impact of economic uncertainty on foreign direct investment using the world uncertainty index (Suleyman, 2020; Canh *et al.*, 2020; Avom *et al.*, 2020), and researchers cannot find studies of the Sri Lankan context. Therefore, the researcher wants to fill this gap on how economic uncertainty influences foreign direct investment inflows of Sri Lanka by using the world, Asia and Pacific and Sri Lanka uncertainty indexes which are constructed by Baker *et al.* (2016). This study contributes knowledge on how the world, regional, and domestic uncertainties of Sri Lanka impact foreign direct investment inflows of Sri Lanka.

II. LITERATURE REVIEW

A. Product Life Cycle Theory

Product life theory was developed by Vernon in 1966, who has used types of foreign direct investment made by US companies in Western Europe after the second world war in the manufacturing industry. Vernon explained that there are three stages of the product cycle: new product stage, maturing product stage, and standardized product stage. In the new product stage, US companies produce innovative products by using new technology. After, the second stage, Demand of the products have been increased then, US companies produce for local consumption and export their surplus. Products became more standardized. Local firms have been expended their operations in abroad. In third stage, products have become fully standardization. Less develop countries have competitive advantage as locations. In addition to that, foreign firms have been increased in abroad. This theory has been explained the specific type of investment in European Western made by US companies between 1950-1970. This theory has been used that theory of comparative advantage and relationship between product life cycle and possible FDI flows.

B. Internationalization Theory

Buckley and Casson developed the theory in 1976. The internationalization theory provides another explanation for FDI by concentrating on intermediate inputs and technology. This theory tries to explain the growth of transnational companies and their motivations for achieving foreign direct investment (Denisia, 2010). His work is considered as landmark in the study of FDI. According to Hymer, there were two reasons for internationalization such as company demission and ownership of specific assets and, existence

market failure. In addition to that, this theory demonstrated that, FDI occurred only, when firm specific advantages cover additional cost of doing business in abroad.

C. Real Option Theory

Real options theory is the modern theory on how to make investment decisions when the future is uncertain. The standard theory it modifies is the expected net present value theory of investment decision. According to NPV theory, the future cash flows of an investment project are estimated, and if there is uncertainty about those cash flows, the expected value of determined. Expected cash flows are discounted at the corporation's capital cost, and the results are summed. If NPV is positive, the project is worth it, and NPV is negative, it is not worth it. (Watkins, Valley, & Alley, n.d.) there is uncertainty in the environment; firms tend to assume a "wait and see" attitude, which results in the postponement of investment decisions (Hsieh *et al.*, 2019).

D. Empirical Review

Ahir *et al.* (2018) studied world uncertainty. There was a economic uncertainty index that was limited to advanced countries. Therefore, the researcher contributes to filling the gap new uncertainty index for 143 countries from the first quarter of 1996 by using the country report of the economist intelligence unit. This index has been reflected the frequencies of the word "uncertainty," "uncertain", "uncertainties". EIU country report covered politics, economic policy, the domestic economy, foreign and trade payment events, and country risk. Then, researchers scale counts by the total number of words in the report. World uncertainty index for unbalance weighted average for 143 countries. Moreover, the researcher has constructed income level uncertainty indexes, regional level uncertainty indexes. The income level indexes are advanced, emerging and low, and regional levels in Africa, Asia, the Pacific, Europe, the Middle East and Central Asia, and the Western Hemisphere. Income level uncertainty indexes are unbalanced weighted averages. All indices are computed by counting words uncertainty and variants in EIU reports, and The WUI is rescaled by multiplying by 1000000. In addition to that, the level of uncertainty is significantly higher in developing countries and positively associated with EUI and stock market volatility and negative with stock market growth.

Choi *et al.* (2020) studied on policy uncertainty and foreign direct investment. This study has been investigated the effect of domestic policy uncertainty on FDI inflows into 16 countries using the OECD bilateral FDI panel data set and economic policy uncertainty index from 1985-2013. The researcher concluded that higher policy uncertainty in the host country reduces FDI inflows. The impact of domestic policy uncertainty is more in less financial development countries. The researcher concluded that higher policy uncertainty in the host country reduces FDI inflows. The impact of domestic policy uncertainty is more in less financial development countries.

Suleyman (2020) studied how economic uncertainty affects foreign direct investment inflows evidence from Central and Eastern European Countries. The data period of this study is from 1990 to 2018. This study indicated that economic uncertainty in a country does not significantly affect FDI inflows, and European uncertainty and global

uncertainty dampen the FDI inflows to CEE countries. So, Ho, and Gan (2021) studied foreign direct investment and world pandemic uncertainty index: Do health pandemics matter? This study has been used unbalance panel data of 142 countries from 1996-2019. This study concluded that uncertainty caused by health pandemics leads to a decrease in FDI net inflows worldwide. In addition to that, researchers have used sub-sample such as region, income levels. In Asia-Pacific countries and emerging economies have advice affect FDI net inflows from 1996-2019.

Canh *et al.* (2020) studied the role of economic policy uncertainty, determinants of foreign direct investment inflows. The sample of this study is yearly data of 21 counties over the period 2003-2013. This study has been used the sequential (two-stage) technique of the linear panel data model. Researchers indicated that an increase in the level of domestic economic uncertainty has a significant negative influence on FDI inflows. An increase in the level of global economic uncertainty has a positive effect on FDI inflows. In addition to that, this study stated that both domestic and global economic policy uncertainty increase, only the impact of global uncertainty is still positive and significant.

Avom *et al.* (2020) studied the world economic policy uncertainty and foreign direct investment by using 138 developed and developing countries over the period 1996-2018. The sample has been differentiated based on the IMF classification. This study has been measured new world uncertainty index which includes uncertainty measure for 143 counties. A generalized method of the moment was used for analysis. This study found strong evidence that world uncertainty reduces foreign direct investment, and the magnitude of the effect more important in emerging and developing countries than in advanced countries. In addition to that, the effect of the world uncertainty index is more critical SSA region than in other regions.

Amarasinghe (2019) studied on determinants of foreign direct investment inflows in Sri Lanka. This study has been expended literature focusing on the behavior of investors in the pre-and post-civil ethnic war in the 1977-2016 sample period. The researcher studied the behavior of foreign direct investment during the pre-war and post-war periods. According to foreign direct investor behavior, there is no significant impact on foreign direct investment inflows after the civil war. During the civil war period, Sri Lanka FDI net inflows reported the highest amount in 2007-2008.

Wickramarachchi, (2019) studied on determinants of foreign direct investment in developing countries: the case of Sri Lanka. This study has been identified the key determinants of FDI inflows of Sri Lanka during the period of from 1970-2014 by using auto regressive distributed lag method. This study has indicated that policy stability and a peaceful environment are essential for attracting foreign direct investment. In addition to that, there are no significant impact of trade openness and real wage index on foreign direct investment inflows. Moreover, there is no good at increasing real exchange rate for FDI inflows. Moreover, this study provided that political stability has played a major role in FDI performance. More FDI flows had entered the country when a peaceful economic climate was prevailing.

III. METHODOLOGY

Researchers use sample period as 1st quarter, 1996 to 4th quarter, 2019 and collect secondary data from Annual reports of Central bank of Sri Lanka, world development indicators, and www.polityuncertainty.com. This study has used the Autoregressive distributed lag, error correction model based on unit root test and bound test. (Ravinthirakumaran *et al.*, 2015: Saleem *et al.*, 2021) to analyze the impact of economic uncertainty on foreign direct investment inflows of Sri Lanka.

$$FDII = \beta_0 + \beta_1 WUI_{t-i} + \beta_2 RUI_{t-i} + \beta_3 DUI_{t-i} + \beta_4 TO_{t-i} + \beta_5 GDPG_{t-i} + \beta_6 INF_{t-i} + E \quad (1)$$

FDII=Foreign Direct Investment Inflows, WUI= World Uncertainty Index, RUI= Regional Uncertainty Index, DUI=Domestic Uncertainty Index, TO= Trade Openness, GDPG=Gross Domestic Product Growth, IFL=Inflation, E=Error Term

IV. DATA ANALYSIS

A. Unit Root Test

Researcher use Augmented Dickey-fuller test for unit root test. According to the unit root test, the p-value is less than the critical value, the null hypothesis is rejected, and the alternative hypothesis is accepted. The results are indicated that inflation and domestic economic uncertainty index are stationary at level series, and foreign direct investment inflows, world uncertainty index, regional uncertainty index, trade openness, growth of gross domestic production are stationary at the first difference I (1). Variables are not stationary in the same integration. Then, variables are stationary level series I (0) and the first difference I (1).

TABLE I: UNIT TOOT ESTIMATION

Variables	Augmented Dickey- fuller- Level Series		Augmented Dickey- fuller-1 st difference		Stationary Level
	t- statistics	P-value	t-statistics	P-value	
FDI I	-1.861896	0.3489	-9.662030*	0.0000	I(1)
LWUI	-2.370988	0.1527	-14.43234**	0.0001	I(1)
LRUI	-6.615263*	0.0000	-9.997638*	0.0000	I(1)
DUI	-4.028375**	0.0020			I(0)
LTO	-0.982562	0.7569	-9.706402*	0.0000	I(1)
GDPG	-2.707033***	0.0766	-9.591681*	0.0000	I(1)
INF	-2.991074***	0.0393			I(0)

Note : *, **, *** indicates p-value less than 0.01, 0.05, and 0.1 respectively.

Sources: E-view Software output of analyzing.

B. Bound Test

In the bound test, the calculated F value is more than the upper bound of critical value; the null hypothesis is rejected alternative hypothesis is accepted. That means there is a long-run relationship among variables. If the calculated F statistic is less than the lower critical bound, null hypothesis is accepted then, there is no long-run relationship among variables. If the calculated F statistic is between the upper critical and lowers critical bound, the test is inconclusive. According to the ARDL bound test, the Calculated F statistics is 5.624916, greater than critical upper bound I (1) (2.99). The null hypothesis is rejected, then there is a long-run relationship at 90%, 95%, 97.50%, and 99% confidence levels.

TABLE II: BOUND TEST

Test Statistic	Value	Significant Level	I(0)	I(1)
F Statistic	5.624916	10%	1.99	2.99
K		5%	2.27	3.28
		2.5%	2.55	3.61
		1%	2.88	3.99

Sources: E-view Software output of analyzing.

The researcher estimates the ARDL long-run coefficient model due to variables having a long-run relationship. The estimated coefficient of the model is given in the table.

TABLE III: LONG RUN ESTIMATION

Variables	Coefficient	Std. Error	t-Statistic	Probability value
LWUI	0.096638	0.133503	0.723869	0.4727
LRUI	-0.820337*	0.137307	-5.97447	0.0000
DUI	6.365953*	0.888492	7.164894	0.0000
LTO	-5.06202*	0.332563	-15.2213	0.0000
GDPG	0.001403**	0.000325	4.312234	0.0001
INF	0.129146*	0.016793	7.690594	0.0000
C	31.98275*	2.289445	13.96966	0.0000

Note: *, **, *** indicates p-value less than 0.01, 0.05, and 0.1 respectively
Sources: E-view Software.

According to long-run estimation results, world uncertainty positively impacts FDI inflows. When World uncertainty increased 1 %, foreign direct investment inflows increased by 0.096638 % which is in logarithm form. However, world economic uncertainty coefficient has not significantly at 95 % confidence level. However, the expectation sign of the variable is negative. Regional economic uncertainty coefficient significantly negative impact foreign direct investment inflows at 95 % confidence level. When 1 % is increased regional economic uncertainty, foreign direct investment inflows decrease by 0.8203% which is in logarithm form. The result is in align with expectations. Coefficient of domestic economic uncertainty has a significantly positive impact on foreign direct investment inflows. When 1% is increased domestic economic uncertainty, foreign direct investment increase by 581.6989 %. However, the expectation sign of the variable is negative. Moreover, there are limited studies of impact of economic uncertainty on foreign direct investment.

Trade openness has a significant but negative impact on foreign direct investment inflows. If trade openness increases by 1%, foreign direct investment inflows decrease by 5.0620% which is logarithm form. However, the result is contradicted with (Ravinthirakumaran *et al.*, 2015). In addition to that, inflation has a significantly positive impact on FDI inflows. Moreover, the gross domestic product has significantly positively impact on foreign direct investment inflows. When gross domestic production increase by 1 %, foreign direct investment inflows increase by 0.0374 % which is squared roots of coefficient. However, the result is in line with Ravinthirakumaran *et al.* (2015). Inflation increases by 1%, foreign direct investment inflows increase by 1.1378 % which is exponential way. However, the expected sign and result are the same. However, it is contradicted with (Ravinthirakumaran *et al.*, 2015).

C. Estimate of the Error Correction Representation

Short-run coefficients are associated with a long-run relationship obtained from ARDL- ECM. Lag length for error correction representation is selected by Akaike Information

criteria (AIC). The researcher put the maximum lag length as eight because of quarterly data. The error correction term is negative and highly significant at 95 % confidence level, confirming the long-run relationship. Therefore, ARDL-ECM selects the lag selection as order (4,1,6,8,5,5,5) world economic uncertainty, regional economic uncertainty, domestic economic uncertainty, trade openness, growth of gross domestic production, inflation.

TABLE IV: ERROR CORRECTION ESTIMATION

Variables	Coefficients	Std. Error	t-Statistic	Prob.
D(LFDI(-1))	-0.11522	0.069149	-1.66619	0.1023
D(LFDI(-2))	-0.11557***	0.063392	-1.82312	0.0746
D(LFDI(-3))	-0.2007**	0.066122	-3.03534	0.0039
D(LWUI)	-0.03735	0.035975	-1.03834	0.3044
D(LRUI)	-0.0035	0.023257	-0.15033	0.8811
D(LRUI(-1))	0.281676*	0.037924	7.427481	0.0000
D(LRUI(-2))	0.247641*	0.036087	6.862264	0.0000
D(LRUI(-3))	0.140995**	0.034802	4.051297	0.0002
D(LRUI(-4))	0.142647*	0.028982	4.921989	0.0000
D(LRUI(-5))	0.048455***	0.024497	1.977962	0.0538
D(DUI)	0.314043**	0.083784	3.748229	0.0005
D(DUI(-1))	-1.69316*	0.2529	-6.695	0.0000
D(DUI(-2))	-1.47289*	0.235077	-6.26557	0.0000
D(DUI(-3))	-1.15099*	0.210952	-5.45614	0.0000
D(DUI(-4))	-0.91079*	0.177252	-5.13838	0.0000
D(DUI(-5))	-0.55125**	0.149124	-3.69658	0.0006
D(DUI(-6))	-0.33373**	0.128064	-2.60597	0.0122
D(DUI(-7))	-0.28**	0.094425	-2.96535	0.0047
D(LTO)	1.19101*	0.246929	4.823297	0.0000
D(LTO(-1))	2.282689*	0.411435	5.548114	0.0000
D(LTO(-2))	2.015157*	0.392335	5.136314	0.0000
D(LTO(-3))	1.797858*	0.385093	4.668628	0.0000
D(LTO(-4))	-1.13671**	0.32727	-3.47333	0.0011
D(GDPG)	0.000751*	0.00013	5.774747	0.0000
D(GDPG(-1))	-0.00012	0.00013	-0.88643	0.3799
D(GDPG(-2))	-0.00039**	0.000131	-3.00342	0.0043
D(GDPG(-3))	-0.00019	0.000124	-1.51223	0.1372
D(GDPG(-4))	0.000275**	0.000129	2.127622	0.0386
D(INF)	0.036707*	0.004354	8.430314	0.0000
D(INF(-1))	-0.02878*	0.005028	-5.72412	0.0000
D(INF(-2))	-0.02528*	0.005067	-4.9888	0.0000
D(INF(-3))	-0.01812**	0.00502	-3.61031	0.0007
D(INF(-4))	0.018715**	0.005273	3.548885	0.0009
CointEq(-1)*	-0.32883*	0.045732	-7.19037	0.0000
R-squared	0.894359			
Adjusted R-squared	0.8298			
Durbin-Watson stat	1.847059			

Note: *, **, *** indicates p-value less than 0.01, 0.05, and 0.1 respectively.
Sources: E-view Software of analyzing.

The error correction coefficient or speed of adjustment is -0.328833, 32.88%. It indicated that the previous period deviation from long-run equilibrium is corrected in the current period. Error correction terms should be negative and significant.

According to error correction estimation, the lag of dependent variables negatively impacts FDI inflows. According to AIC, the lag level of dependent variables is three. The first and second lags of FDI inflows coefficients are insignificant at 95% confidence level, but the third lag are significantly negative at 95% confidence level. When it comes to world economic uncertainty, coefficients of WUI have a negative but insignificantly impact. In addition, this result is contracted with Suleyman (2020), who finds that global uncertainty has a negative and significant impact on FDI inflows. In addition to that, coefficients regional economic uncertainty has not significantly impacted foreign direct investment inflows, but the relationship is positive.

However, lags of regional economic uncertainty coefficients have a positive and significant impact on FDI inflows. However, this result is contradicted only sign of coefficient with Suleyman (2020). Coefficient of domestic economic uncertainty has a significantly positive impact on FDI inflows. However, lags of domestic economic uncertainty up to seven lags have significantly negative impact on FDI inflows. Up to seven lags of domestic uncertainty results are in line with Canh *et al.*, 2020; Choi *et al.* (2020). In addition to that, this result is contracted with Suleyman (2020).

Coefficients of trade openness has a significantly positive impact on FDI inflows. The result is in line with (Saleem *et al.*, 2021; Amarasinghe, 2019). up to three lags of trade openness have a positive and significant impact on FDI inflows. The sign of the coefficients of the result is the same as expectation. In addition to that, the growth of gross domestic product coefficient has a significantly positive impact on FDI inflows. It is also the same with the expected sign of gross domestic product growth coefficients. Results is in line with (Ravinthirakumaran *et al.*, 2015; Amarasinghe, 2019). However, lag four of GDPG has positive, but it is significant at 90 % confidence level. In fifth lag level of GDPG coefficient has a positive but insignificant impact on FDI inflows. In addition to that, coefficient inflation has a positive and significant impact on foreign direct investment inflows, and it is identical with the expected result. The result is in line with Amarasinghe, (2019). However, up to three lags of inflation have a negative and significant impact on FDI inflows. This result is in line with (Ravinthirakumaran *et al.*, 2015). In addition to that, Accuracy of the model is 89.4359%.

D. Diagnostics Tests and Stability Tests

Diagnostic Tests are conducted to confirm the validity of the estimated result; otherwise, the result will be biased. Therefore, the researcher conducted a normality test, LM series correlation, and heteroscedasticity test.

TABLE V: RESIDUAL DIAGNOSTICS

Tests	F-Statistics	P-value
Serial correlation test	0.581109	0.3118
Normality test	1.631308	0.442350
Heteroscedasticity test	0.742607	0.7331

Sources: E-view Software output of analyzing.

According to LM serial correlation test, the probability value (0.3118) is more significant than the critical value (0.05). Then, the alternative hypothesis is rejected, and the null hypothesis is accepted. Then there is no serial correlation at 95 % confidence level.

When it comes to normality tests, the jarque-bera test is used to test normality assumptions. If p-value (0.44235) is more than the critical p-value (0.05), the alternative hypothesis is rejected, and the null hypothesis is accepted. That means residuals are normally distributed at 95% confidence level. Then normality assumption is fulfilled.

When it comes to the heteroscedasticity test, If the p-value (0.7331) is greater than the critical value, the alternative hypothesis is rejected, and the null hypothesis is accepted. That means then the model is homoscedastic at 95 % confidence level. These results fulfill the assumption requirements. Therefore, the results are valid for interpretation.

V. CONCLUSION

The researcher studied the impact of economic uncertainty on foreign direct investment inflows of Sri Lanka by using the Autoregressive distributed lag model -error correction model as sample period 1996 Q1 to 2019 Q4. Regional economic uncertainty has significantly impacted the foreign direct investment inflows of Sri Lanka in the short run and long run. It is ensured real options theory; investors take time to resolve uncertainty for their investment decisions. In domestic economic uncertainty has a significantly negative impact on foreign direct investment inflows of Sri Lanka in the short run and a significantly positive impact on foreign direct investment inflows of Sri Lanka in the long run. It is also ensured real options theory. However, World economic uncertainty has not significantly impacted on foreign direct investment inflows of Sri Lanka. Some of the results align with research and contradict research in different countries. However, there are limited studies on the impact of economic uncertainty.

A. Future Suggestions

The researcher used foreign direct investment inflows of Sri Lanka as total foreign direct investment inflows of Sri Lanka. Future studies can extend the impact of economic uncertainty on sectors vice of FDI Inflows, namely manufacturing sector, agriculture sector, service sector, and infrastructure sector. As well as researchers can extend the study impact of host countries and home country economic uncertainty of foreign direct investment inflows by using countries wise on foreign direct investment inflows. Central Bank of Sri Lanka divided foreign direct investment inflows as country-wise breakdown. It indicated how countries react under different uncertainties such as world, regional, domestic uncertainties on foreign direct investment of Sri Lanka. In addition to that, the researcher can build a new index for Sri Lanka by using newspapers that capture real uncertainty.

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Miss. P. A. D. D. Randika is a Lecturer in the field of finance and accounting. She has obtained her first degre, B.Com. (Special) in South Eastern University of Sri Lanka with a first class. She was also awarded with the Gold Medal for the best student of the batch. She completed her Masters' degree specialized in the area of Accounting and Information Management from University of Colombo, Sri Lanka and also completed Teaching

Methodology Program conduct for university lecturers from University of Kelaniya, Sri Lanka. Currently she serves as a Lecturer attached to the Sabaragmuwa University of Sri Lanka. Her research interests are on capital markets, accounting and behavioral finance.

Miss W. P. S. Rodrigo was born in Kaluthara, Sri Lanka. Undergraduate with B.Sc. Honours in Financial Management, Department of Accountancy and Finance, Sabaragamuwa University of Sri Lanka, Belihuloya.