# ABSTRACT

Air transportation has been recognized as a key industry in Sri Lanka since most of tourists travel by air and tourism plays a vital role in the economy. The purpose of this research is to test the causality between air passenger movements and economy. The study uses four-variate model of air passenger arrivals, departures, exchange rate and GDP to examine the long run and short run dynamic relationship among variables. This research paper is based on annual time series data which were obtained from period of year 1976 to 2012.Econometric tests were applied such as unit root tests, co-integration test, VEC modal and granger causality test. The result of Johansan co-integration test shows the existence of two co-integrating equations. VEC model was applied since co-integration test reveals that existence of the long run relationship between variables. Air passenger arrivals and departures forecasting models have been estimated. Finally, granger causality test was applied. It reveals that, uni-directional causality is running from air passenger arrivals to air passenger departures, from exchange rate to air passenger arrivals and from exchange rate to departures. Bi-directional causality is running between air passenger arrivals and GDP, exchange rate and GDP, air passenger departures and GDP. Analysis provide guideline for policy makers to create new policies which affecting the development of the aviation sector .Also air transportation affect for the economic growth by providing more and more direct and indirect employment. Further researchers should focus on analysis which is used panel data; provide more information.

Key words: **Air transportation, GDP, Co-integration, VEC model**