Relationship between financial development and economic growth in Sri Lanka: the post-liberalization experience

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Financial development refers to an improvement in the financial system and it is considered by many economists to be of paramount importance for economic growth. The financial liberalization shall provide the big push for a growing economy to achieve a higher economic prosperity through vibrant financial development. A major question that arises from this is whether financial liberalization in Sri Lanka is relevant in promoting economic growth. Thus, this paper investigates the casual short-run and long-run relationship between financial development and economic growth in Sri Lanka, after financial liberalization. The study uses statistical data on six variables namely, real gross domestic product (RGDP) as dependent variable, broad money supply (M_2), credit to private sector (CPS), trade dependency (TD) bank density (BD) and capital output ratio(COR) as proxies for financial development over 34 years from 1977 to 2015. The study employs empirical econometric time series analysis using ADF unit root test, Johansen co-integration test, Vector Error Correction Model (VECM) and Granger Causality test. The time series analysis results of the Vector Error Correction Model revealed that there is a long-run causality running from the financial development to economic growth. Wald statistics show that there is a short-run causality running from money supply, trade dependency and bank density to economic growth. However, proxies such as credit to private sector, and capital output ratio have no short-run causality to economic growth. Thus, the results proved that financial development through financial liberalization has enhanced the economic growth. Our empirical findings suggest that, by large financial development lead to improved growth performance in Sri Lanka.

Keywords: Economic growth, Financial development, Financial liberalization