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Financial liberalisation in Sri Lanka: an econometric analysis

Ramsh Chandra Paudel
University of Wollongong

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by

Ramesh Chandra Paudel
Master of Economics (Tribhuvan University, Nepal)
Master of Business Administration (Tribhuvan University, Nepal)
Bachelor of Business Administration (Tribhuvan University, Nepal)

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CERTIFICATION

I, Ramesh Chandra Paudel, hereby declare that this thesis, submitted in fulfilment of the requirements for the award of Master by Research, in the School of Economics and Information Systems of the Faculty of Commerce, University of Wollongong, is my own original work unless otherwise referenced or acknowledged. The document has not been submitted for qualifications at any other academic institution.

Ramesh Chandra Paudel
25/03/2007.

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ABBREVIATIONS

ADB	: Asian Development Bank
ARDL	: Auto Regressive Distributed Lag
BMR	: Bond Market Reform
BO	: Bank Ownership
BOP	: Balance of Payments
BPR	: Banking Policy Reform
CAAL	: Capital Account Liberalisation
CAL	: Current Account Liberalisation
CEPP	: Centre for Economic and Public Policy
DRR	: Real Deposit Rate
ECM	: Error Correction Model
ECS	: Easing Credit Supply
ED	: Economic Development
EG	: Economic Growth
EPZ	: Export Processing Zones
FCBUs	: Foreign Currency Banking Units
FD	: Financial Development
FEECS	: Foreign Exchange Entitlement Certificate System
FIR	: Financial Interrelations Ratio
FL	: Financial Liberalisation
FLI	: Financial Liberalisation Index

FP	: Financial Performance
FSA	: Financial Service Agency
GDP	: Gross Domestic Products
GMM	: Generalised Method of Moments
GNI	: Gross National Income
IMES	: Institute for Monetary and Economic Studies
IMF	: International Monetary Fund
IPN	: Introduction of Prudential Norms
IR	: Institutional Reforms
IRD	: Interest Rate Deregulation
IRR	: Real Interest Rate
JVP	: Janatha Vimukthi Peramuna
LBCBR	: Log of Real Borrowing by Banks from Central Bank
LBMR	: Log of Real Broad Money
LCDR	: Log of Credit Deposit Ratio
LDCs	: Least Developing Countries
LERP	: Liberal Exchange Rate Policy
LFD	: Log of Financial Deepening
LGDPP	: Log of Per Capita Gross Domestic Product
LGDPR	: Log of Real Gross Domestic Product
LL	: Liquid Liabilities
LNMR	: Log of Real Narrow Money
LPBB	: Log of Average Population per Bank Branch
LRR	: Real Lending Rate
LTBCR	: Log of Real Total Bank Credit
LTDR	: Log of Real Time Deposits

LTTE	: Liberation Tigers of Tamil Eelam
LVBTP	: Log of Per Capita Volume of Banking Transaction
LVBTR	: Log of Volume of Banking Transaction
MMR	: Money Market Reform
NI	: National Income
NRFC	: Non Resident Foreign Currency
OECD	: Organisation for Economic co- operation and Development
OLS	: Ordinary Least Square
PA	: People Alliance
RFC	: Resident Foreign Currency
RFR	: Real Refinance Rate
RR	: Reserve Requirements
SACU	: Southern African Customs Union
SADC	: Southern African Development Community
SLFP	: Sri Lanka Freedom Party
SMR	: Share Market Reform
TL	: Trade Liberalisation
UNDP	: United Nations Development Programme.
UNF	: United National Front
UNP	: United National Party
VAR	: Vector Auto Regressive Model
WAEMU	: West African Economic and Monetary Union
WB	: World Bank

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ABSTRACT

This study examines the impact of financial liberalisation on macroeconomic issues such as saving, investment, financial performance, financial sector widening, gross domestic product, and the money demands of Sri Lanka over the time series annual data from 1963 to 2005. Financial liberalisation in Sri Lanka commenced in since 1977 with most of the effort being made up to 1995. This study is based on empirical analysis using the Ordinary Least Square (OLS) base Auto Regressive Distributed Lag (ARDL) approach of cointegration, and includes a causality test.

This study contributes primarily where an evaluation of financial liberalisation impacts the financial liberalisation index as a proxy of financial liberalisation. The financial liberalisation index has been constructed with 13 policy instruments for its phase of implementation in the Sri Lankan economy.

The unit root tests were conducted by applying the DF (Dickey-Fuller), ADF (Augmented Dickey-Fuller) and PP (Phillips-Perron) methods. The cointegration tests were conducted to find out the long-run relationship among the variables concerned, and the ECM (Error Correction Model) version of ARDL was applied to test the speed of adjustment to equilibrium.

The empirical test results suggest that financial liberalisation in Sri Lanka has a mixed impact in the short term. The average population per bank branch, real interest rates, and real gross domestic product are key variables for widening the financial sector, while real gross domestic product was also a significant contributor towards widening the financial sector, which shows that economic growth fosters the country's financial sectors. The results showed that financial liberalisation did not widen the financial sector in the long term although it did in the short term through income led interest rates, savings, and investments. The results also show that financial liberalisation did not improve the financial performance of the economy, as was expected.

Our results reveal that financial liberalisation cannot by itself enhance economic growth in Sri Lanka unless followed by proper strategies with suitable sequential

procedures. The relationship between real narrow money and real broad money demand is studied with the conclusion being that the real lending rate has a significantly positive association while financial liberalisation has a significantly negative association within the narrow money demand over the long term. With broad money, the real gross domestic product and real lending rate are the key variables that have a positive association with the demand for broad money. Financial liberalisation has a significantly negative impact which means that an expansion in the demand for money is possible if economic growth is enhanced, which in turn increases real income, not by financial liberalisation as it has occurred.

This study found that in Sri Lanka the one-way causal relationship between economic growth and financial performance, based on the empirical results, showed that economic growth causes financial development and financial performance.