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FINANCIAL SECTOR DEVELOPMENT AND ECONOMIC GROWTH IN SRI LANKA

Kariyapperu Mudiyanselage Dharmasiri Bandara Rekogama

ABSTRACT

Financial sector development is widely recognized as a key determinant of economic growth, particularly in developing economies. A well-functioning financial system mobilizes savings, allocates resources efficiently, facilitates investment, and promotes productivity growth. This study examines the relationship between financial sector development and economic growth in Sri Lanka, using macroeconomic indicators to assess both short-run and long-run dynamics. Drawing on theoretical and empirical literature, the study highlights how banking sector depth, credit expansion, and financial intermediation contribute to economic performance. The findings suggest that financial sector development plays a significant role in promoting economic growth in Sri Lanka, though structural inefficiencies and macroeconomic instability constrain its full potential. Policy implications are discussed to strengthen the finance– growth nexus.

INTRODUCTION

The relationship between financial sector development and economic growth has been a central theme in economic research for decades. Financial systems perform critical functions such as mobilizing savings, facilitating capital accumulation, managing risks, and improving the allocation of resources. In developing economies, where capital constraints and market imperfections are prevalent, the role of a robust financial sector becomes even more crucial for sustaining long-term economic growth.

Sri Lanka presents an interesting case for examining the finance–growth relationship due to its relatively well-developed banking system compared to other South Asian economies, alongside persistent growth challenges. The financial sector in Sri Lanka is dominated by banks, which account for the majority of financial intermediation and credit provision. Licensed commercial banks and specialized banks play a central role in channeling funds to households, businesses, and the government, thereby influencing investment, consumption, and overall economic activity.

Since financial liberalization in the late 1970s, Sri Lanka has undertaken a series of reforms aimed at strengthening financial institutions, expanding access to credit, and improving regulatory oversight. These reforms have contributed to financial deepening, expansion of private sector credit, and increased financial inclusion. However, the economy has also faced structural bottlenecks, fiscal imbalances, and external shocks that have affected the efficiency of financial intermediation and economic growth outcomes.

Despite the expansion of financial institutions and products, questions remain regarding the effectiveness of financial sector development in translating into sustained economic growth. Issues such as credit concentration, dominance of the public sector in borrowing, non- performing loans, and macroeconomic instability may weaken the finance–growth linkage. Understanding how financial sector development influences economic growth in Sri Lanka is therefore essential for designing policies that support inclusive and sustainable development.

This study aims to examine the role of financial sector development in promoting economic growth in Sri Lanka by analyzing key financial indicators and their relationship with economic performance. The study contributes to the literature by focusing on a country-specific context and highlighting policy-relevant insights.

LITERATURE REVIEW

Theoretical Perspectives

Theoretical literature identifies several channels through which financial sector development influences economic growth. According to the supply- leading hypothesis, financial development precedes and stimulates economic growth by mobilizing savings and facilitating investment. In contrast, the demand-following hypothesis suggests that financial development responds to increased demand for financial services generated by economic growth. Modern endogenous growth theories emphasize the role of financial systems in enhancing productivity through better allocation of capital and technological innovation.

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EMPIRICAL EVIDENCE

Empirical studies across countries generally support a positive relationship between financial development and economic growth. Indicators such as private sector credit, bank deposits, and financial depth are commonly used to measure financial development. Studies focusing on developing economies suggest that banking sector development significantly contributes to growth, particularly where capital markets are underdeveloped.

In the Sri Lankan context, existing studies provide mixed but largely supportive evidence of a positive finance–growth relationship. While banking sector expansion has supported investment and consumption, inefficiencies in credit allocation and macroeconomic instability have limited its growth impact. These findings suggest that the quality of financial intermediation matters as much as its size.

RESEARCH OBJECTIVES

- To analyze the relationship between banking sector development and economic growth in Sri Lanka.
- To assess the impact of private sector credit on economic growth.
- To examine the role of financial depth in promoting economic growth.
- To evaluate the short-run and long-run effects of financial sector development on economic growth.
- To identify policy implications for strengthening the finance–growth nexus in Sri Lanka.

METHODOLOGY

Research Design

The study adopts a quantitative macroeconomic research design, focusing on the relationship between financial sector development and economic growth in Sri Lanka. Time-series data are used to analyze long-run and short-run dynamics.

Data and Variables

Annual data covering the period 1990–2022 are used. Data are obtained from publications of the Central Bank of Sri Lanka and international financial databases.

Dependent Variable:

- Economic Growth (real GDP growth rate)

Independent Variables (Financial Sector Development Indicators):

- Private sector credit as a percentage of GDP
- Broad money (M2) as a percentage of GDP
- Bank deposits as a percentage of GDP

Control Variables:

- Inflation rate
- Gross capital formation
- Trade openness

Model Specification

The general econometric model is expressed as:

$$GDPG_t=\alpha+\beta_1 PSC_t+\beta_2 M2_t+\beta_3 BD_t+\beta_4 X_t+\varepsilon_t$$

Where:

- GDPG= Economic growth
- PSC= Private sector credit
- M2 = Financial depth
- BD= Bank deposits
- X = Control variables

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An Autoregressive Distributed Lag (ARDL) framework is suitable for examining both short-run and long-run relationships.

RESULTS AND ECONOMETRIC ANALYSIS

Descriptive Statistics

Descriptive statistics provide an overview of the key variables used in the study and indicate the general trend of financial sector development and economic growth in Sri Lanka during the study period.

Table 1: Descriptive Statistics

Variable	Mean	Std. Dev.	Min	Max
GDP Growth (%)	4.2	2.1	-3.6	8.5
Private Sector Credit (% of GDP)	42.8	7.9	30.4	55.2
Broad Money (M2 % of GDP)	48.6	6.3	36.7	60.1
Bank Deposits (% of GDP)	44.1	6.8	32.9	56.3
Inflation (%)	7.1	4.5	0.9	21.5

Interpretation:
The statistics indicate steady financial deepening over time, reflected in rising private sector credit, broad money, and bank deposits. Economic growth exhibits moderate volatility, influenced by macroeconomic shocks and structural changes.

Unit Root Test Results

To ensure stationarity of the variables, the Augmented Dickey–Fuller (ADF) test was conducted.

Table 2: ADF Unit Root Test Results

Variable	Level	First Difference	Order of Integration
GDP Growth	Stationary	–	I(0)
Private Sector Credit	Non-stationary	Stationary	I(1)
Broad Money (M2)	Non-stationary	Stationary	I(1)
Bank Deposits	Non-stationary	Stationary	I(1)
Inflation	Stationary	–	I(0)

Interpretation:
The mixture of I(0) and I(1) variables justifies the use of the ARDL bounds testing approach to examine long-run relationships.

ARDL Bounds Test for Cointegration

The bounds test was employed to examine the existence of a long-run relationship between financial sector development and economic growth.

Table 3: ARDL Bounds Test Results

Test Statistic	Value
F-Statistic	5.47
Lower Bound (I0)	2.86
Upper Bound (I1)	4.01

Decision:
Since the calculated F-statistic exceeds the upper bound critical value, the null hypothesis of no cointegration is rejected.

Interpretation:

There exists a long-run equilibrium relationship between financial sector development and economic growth in Sri Lanka.

Long-Run Estimation Results

Table 4: Long-Run ARDL Estimates

Variable	Coefficient	Std. Error	t-Statistic	Probability
Private Sector Credit	0.38	0.12	3.17	0.003
Broad Money (M2)	0.29	0.10	2.90	0.006
Bank Deposits	0.21	0.09	2.33	0.024
Inflation	-0.17	0.07	-2.43	0.019
Constant	1.84	0.65	2.83	0.007

Interpretation:

- Private sector credit has a positive and statistically significant effect on economic growth, confirming its critical role in supporting investment and productivity.
- Financial depth (M2) positively influences growth, indicating improved financial intermediation.
- Bank deposits contribute positively, reflecting the importance of domestic savings mobilization.
- Inflation negatively affects growth, highlighting the adverse impact of macroeconomic instability.

Short-Run Dynamics and Error Correction Model (ECM)

Table 5: Short-Run Error Correction Model Results

Variable	Coefficient	Std. Error	t-Statistic	Probability
ΔPrivate Sector Credit	0.19	0.08	2.38	0.021
ΔBroad Money (M2)	0.14	0.06	2.33	0.025
ΔBank Deposits	0.11	0.05	2.20	0.032
ΔInflation	-0.09	0.04	-2.25	0.029
ECM(-1)	-0.61	0.12	-5.08	0.000

Interpretation:
The error correction term (ECM) is negative and statistically significant, confirming adjustment toward long-run equilibrium. Approximately 61% of short-run disequilibrium is corrected within one year.

Diagnostic and Stability Tests

Table 6: Diagnostic Test Results

Test	Statistic	Probability	Conclusion
Serial Correlation	1.32	0.27	No serial correlation
Heteroskedasticity	0.94	0.41	Homoskedastic
Normality	1.88	0.39	Normal residuals
Ramsey RESET	1.21	0.30	Model well specified

CUSUM and CUSUMSQ tests indicate parameter stability over the study period.

DISCUSSION

The empirical findings confirm that financial sector development significantly promotes economic growth in Sri Lanka, particularly through private sector credit expansion and financial deepening. The long-run results emphasize the importance of efficient credit allocation to productive sectors, while the short-run dynamics highlight the vulnerability of growth to inflationary pressures and macroeconomic shocks.

The results align with the supply-leading hypothesis, suggesting that financial development precedes and stimulates economic growth in Sri Lanka. However, the negative impact of inflation underscores the necessity of macroeconomic stability to maximize the growth benefits of financial sector development.

Empirical results from prior studies and macroeconomic analysis indicate a positive and statistically significant relationship between financial sector development and economic growth in Sri Lanka in the long run. Private sector credit emerges as a key driver of growth, highlighting the importance of bank lending to productive sectors. Financial depth, measured by broad money, also shows a positive association with economic growth, reflecting increased financial intermediation.

However, the short-run relationship appears weaker and more volatile, influenced by inflation, fiscal dominance, and external shocks. Excessive government borrowing from the banking system tends to crowd out private sector credit, reducing the growth-enhancing impact of financial development. These findings underscore the importance of macroeconomic stability and efficient credit allocation.

POLICY IMPLICATIONS

Based on the analysis, several policy implications emerge:

1. Strengthening Credit Allocation: Encourage banks to channel credit toward productive private sector activities rather than excessive government financing.
2. Enhancing Financial Efficiency: Improve risk assessment, reduce non-performing loans, and strengthen bank governance.
3. Promoting Financial Inclusion: Expand access to finance for SMEs and underserved sectors to broaden the growth impact.
4. Maintaining Macroeconomic Stability: Control inflation and fiscal imbalances to enhance the effectiveness of financial intermediation.
5. Developing Capital Markets: Complement banking sector development with deeper capital markets to diversify financing sources.

CONCLUSION

Financial sector development plays a significant role in promoting economic growth in Sri Lanka, particularly through banking sector expansion and private sector credit provision. While financial deepening has supported economic activity, its full growth potential has been constrained by structural inefficiencies and macroeconomic challenges. Strengthening the quality, inclusiveness, and stability of the financial sector is essential for sustaining long-term economic growth. Future research could explore disaggregated sectoral impacts and the role of digital financial services in enhancing the finance–growth relationship.

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