FINANCIAL DEEPENING AND ITS IMPLICATIONS FOR THE SRI LANKAN ECONOMY

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W.M.Hemachandra

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Abstract

This study formulates a theoretical framework for analysing the process of financial deepening that has occurred in Sri Lanka since political independence. Time series econometrics has been used to test modeling of financial deepening that took place in Sri Lanka in the pre and post liberalisation (1977) periods using quarterly data series for the period 1965.1-1997.4.

The empirical analysis reveals that tackling financial repression by relaxing interest rate regulation as hypothesised in the McKinnon-Shaw theory is hardly a sufficient condition to stimulate financial deepening. Ancillary measures related to credit availability, government expenditure, foreign financing and technological improvements need to support interest rate policies if financial liberalisation is to make headway. The empirical tests reveal that financial deepening has not increased domestic savings as anticipated by advocates of reforms. This is largely due to the existence of a large unorganised sector in Sri Lanka where the interest rate liberalisation has not promoted financial deepening. Therefore, any programme for effective financial deepening must address the bottlenecks that impede financial deepening in the unorganised sector.

By contrast, financial deepening and interest rate have been the cause of investments. Investments have taken place with the help from the financial institutions and they are mainly related to organised sector activities. Hence, the McKinnon–Shaw interpretations seem to be highly relevant to explain the activities of the organised sector.

The McKinnon-Shaw hypothesis therefore is relevant to explaining financial deepening in the organised sector. This study highlights the importance of the unorganised sector for financial deepening. Furthermore, in developing countries such as Sri Lanka activist policies by government play a crucial role in financial deepening. Therefore, the thesis proposes a hybrid model combining features of McKinnon-Shaw and Keynesian hypotheses to formulate a more appropriate framework for the analyses of financial sector deepening and to contrast it with neo-structuralist perspectives. The role of the government in promoting financial sector deepening by infrastructure development via telecommunication, banking sector and financial institution development cannot be overemphasised. The thesis explicitly focuses on these facets that have been ignored in the financial sector deepening analyses of developing economies.

Besides the role of the external sector in promoting financial sector deepening needs to be taken into account particularly the effects of FDI and remittances. The thesis addresses these issues.

Financial deepening can promote economic growth. For this not only the interest rate, credits and SRR do matter, but also a host of other affiliated factors that should go

together. In order to give a more robust estimation these factors should be incorporated in a model, which measures financial deepening in countries like Sri Lanka. The study also presents a model to achieve growth via the process of financial deepening. This model specifies, in addition to the variables used in McKinnon-Shaw model, a series of other variables, which influence the process of financial deepening. The econometric analysis of financial deepening has been performed using quarterly time series data. In building the model time series properties of the data have been taken into consideration while implementing tests for unit root and cointegration. Pasimonious causes and effects models of financial deepening have been conducted. Furthermore, adopting a systems approach a simultaneous equation model (SEM) of financial deepening has been empirically validated. A series of diagnostic tests has been conducted in order to maintain the validity of the models. In addition, the structural invariance of the growth model due to financial policy changes has been confirmed by conducting a superexogeniety test.