

## FINANCIAL MARKET AND ALLOCATION OF CAPITAL IN SRILANKA

C.L.S.S. Chandrasiri sandunsulochana@gmail.com

Department of Accountancy, University of Kelaniya

### Abstract

Financial markets appear to improve the allocation of capital. Across 65 countries, those with developed financial sectors increase investment more in their growing industries, and decrease investment more in their declining industries, than those with undeveloped financial sectors. The efficiency of capital allocation is negatively correlated with the extent of state ownership in the economy, positively correlated with the amount of firm-specific information in domestic stock returns, and positively correlated with the legal protection of minority investors. In particular, strong minority investor rights appear to curb overinvestment in declining industries.

It is now well established that a sounder financial system is associated with faster economic growth. Recent research that examines the details of this connection has important implications for economies in transition. Stock prices in rich countries move in highly idiosyncratic ways that convey information about changes in firms' marginal value of investment. This information is important because it facilitates the rapid flow of capital to its highest value uses. In contrast, stock prices in low-income countries tend to move up and down en masse, and thus are of scant use for capital allocation. Stock return synchronicity is highly correlated with the strength of private property rights in general - and shareholder rights in particular. Many countries have voided protecting these rights for many decades. In light of the research we survey, the persistence of such policies requires explanation. Another strand of new papers offers insights. In many countries an elite (often the descendants of industrial barons who grew rich off political "connections" during early stages of development) controls most large corporations through "pyramidal" corporate groups. This corporate control gives the elite vast rent-seeking powers, which it uses to limit outsiders' property rights and outsiders' access to capital. The latter is accomplished by keeping the stock market and financial system from functioning well. The initial stages of this process of "economic entrenchment" may be under way in many transition economies. Economic openness may limit this sort of "economic entrenchment", and thus contribute to institutional reform and economic growth. **Key words:** Capital allocation; Investment; Economic growth