The Impact of Financial Intermediation on Economic Growth:

The Case of Licensed Commercial Banks in Sri Lanka

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(FGS/02/25/01/2007/24)

A thesis submitted in partial fulfillment of the requirements for the degree of
Master of Business Administration
(MBA) Degree

At

Faculty of Commerce & Management Studies
University of Kelaniya
Sri Lanka.

August 30, 2010

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Abstract

There is a growing acceptance of the idea that financial institutions, in particular commercial banks, contribute significantly to real development. In Sri Lanka, Commercial banks play a dominant role in the finance sector particularly in savings mobilization and investment. Hence the object of the present study is to examine the commercial banks' relevance to the recent economic growth of Sri Lanka.

However, Sri Lanka has fallen short of its growth potential for a numerous reasons, the most important being the prolonged civil conflict. Structural rigidities in the economy also continue to constrain its growth. Sharpening regional disparities in growth and poverty reduction are another cause for concern. With this the increase in size and number of commercial banks are limited only in the urban areas so that banking services are not accessible to the rural mass.

The interaction between financial institutions (commercial banks) and economic growth is assessed by employing correlation analysis, regression analysis, financial ratios and other related theories.

Study revealed that commercial banks have grown rapidly which has implication in overall economy of the Country. The economic indicators such as GDP, GDP per capita, loan assets of commercial banks, investment, deposit, number of commercial banks, and inflation rate from fiscal year 1999 to 2008 are used for the analysis of this study.

The relevant ratios of commercial banks such as deposit, investment, and profitability are found to be in increasing trend. However the growth rate of GDP/per capita is volatile in the study period.

The result shows that the Deposit/GDP ratio is moderately significant to GDP/per capita economic growth although these two variables are highly correlated with the coefficient equals to 0.60 in the correlation analysis

The investment is not significantly related to the GDP per capita due to the time lag of the effect of investment on the economic development.