

Financial Market Liberalisation in Sri Lanka

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Sri Lanka followed interventionist policies for a period of two decades before 1977 during which its financial market became highly repressed by creating a monopoly power for state commercial banks and following a regulated policy of interest rates. This policy basically led to allocate available credit for sub-optimal projects in the public sector at the expense of high-return ventures in the private sector and made the cost of borrowing differ from sector to sector, resulting in reducing the efficiency of resource allocation. Credit rationing at artificially low interest rates in a repressed financial market, among other things, encouraged increase in capital intensity in production, limiting employment creation and income distribution. Thus, the dismal economic outcomes so stemming from the policies followed in the controlled era paved the way for switching over to more open and liberalised-trade policies from 1977 onwards. At the same time, in coordination with the trade liberalization, a set of financial market reforms were also introduced. Although now three decades have passed with these reforms, little attention has been given in research to evaluate the success of financial liberalisation. This study, therefore, aims at filling this gap through the assessment of reforms in terms of financial deepening and efficiency of credit allocation based on empirical evidence with the view to determining the robustness of financial market liberalisation in Sri Lanka. Accordingly, the study found that financial market reforms, as a whole, are effective in deepening financial intermediation and redistributing financial resources from the public sector sub-optimal projects to the private sector optimal projects.

Key Words: trade liberalisation, financial liberalisation, financial intermediation, financial deepening and real interest rate.