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The Impact of Bank Lending on Economic Growth in Sri Lanka

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ABSTRACT

Bank lending is considered as a key to economic growth especially in developing countries as it helps to stimulate the economy. In Sri Lanka, the bank lending plays a pivotal role within the financial system. The bank lending has a long-term impact on different sectors of the gross domestic product and is vital for sustained economic growth. However, there has been a notable absence of comprehensive studies exploring the relationship between bank lending and economic growth within the Sri Lankan context. This research addresses this gap by examining the impact of bank lending on economic growth in Sri Lanka over a thirty-year period, from 1991 to 2021. The paper uses the recently developed autoregressive distributed lag (ARDL) bounds test for cointegration. Annual time series data on GDP per capita, bank lending rate, credit to private sector, credit to deposit ratio, trade openness, inflation labour force participation rate and cross capital formation have been used in this study.

The findings of the unit root results reveal that GDP per capita, bank lending rate, and inflation exhibit stationarity at the level, while all other variables display stationarity at the first difference. Since the stationarity property of the variables under consideration is a mixture of I(1) and I(0), the ARDL bound testing technique was deemed appropriate for estimation. The bounds-testing technique show that the F-statistics of the ARDL models is 17.86, which is higher than the critical value of the upper bound level at the 1 percent significance level. The results reveal that there exists a cointegration relationship among the variables. The results reveal that while bank lending, credit to private sector, trade openness, inflation and labour force participation have positive and significant impact on economic growth, credit to deposit ratio, and cross capital formation have a negative impact. The coefficient on the lagged error-correction term is significant at the 1 per cent level with the expected sign, which confirms the result of the bounds test for cointegration. The speed of adjustment takes a value of 1.28 with a negative sign indicating a faster convergence towards long-run equilibrium. The culmination of the findings suggests that, while the impact may vary based on specific bank lending indicators, there is an overall positive contribution of bank lending to the economic growth of Sri Lanka. Consequently, this research advocates for the formulation of policies aimed at fostering further development of bank lending.

Keywords: *Bank Lending, Economic Growth, Sri Lanka, ARDL Bound Test, Financial Sector Development*