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The Study on the Impact of Capital Market on Economic Growth in Sri Lanka

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A B S T R A C T

Stock market is an indicator of an economy financial health. It indicates the mood of investors in a country. As such, stock market development is an important ingredient for economic growth. The stock market is a common feature of a modern economy and is expected to promote economic growth and development of an economy. This paper examines the impact of stock market development on Economic growth in Sri Lanka using data over the period 2009 – 2013 monthly data (60 months data). The main objective of this study is to examine the impact of stock market development on Economic growth in Sri Lanka. Towards achieving the objective of this paper, the data on market capitalization, All Share Price Index and Turnover ratio are collected from the CSE Data Library; while that of GDP information has been compiled from the CBSL annual reports and publications. Where Capital Market is the independent variable and Economic growth is the dependent variable. The studies on the relationship between stock market development and economic growth have generally taken the market capitalization (MKT), All Share Price Index (ASPI), turnover ratio (TRN) representing the stock market development and gross domestic product (GDP) as an proxy for economic growth and it has generally examined the relationship between stock market development and economic growth by using Johansen-Juselius cointegration test, maximum eigen test and multiple regression. As the data was gathered, it was entered and used to E-Views statistical package to analyses the data. This study found that stock market development has a positive effect on economic growth.

Keywords:Capital Market, Development, Economic Growth, Stock Market

1.Introduction

Stock markets are one of the major aspects of financial system, which allow enterprises to raise capital by issuing their shares and also create an environment which the shares are traded. As a result, stock market has emerged as a crucial component of firm's expansion and in turn economic growth. Schumpeter (1996) initially stated that financial intermediaries offer services which are important for economic progress Levine (1991) claimed that stock markets helped to the economic development by making the ownership of enterprises transferable and allowing investors to diversify away unsystematic risk. Moreover, Levine and Zervos (1996) argued that stock market influences savings mobility, liquidity, risk diversification, corporate control and receiving information about the businesses, therefore stock market may accelerate the economic development via these channels. Over the last several decades, internationally there has been an upswing in capital market activity and this reflects the rising acknowledgment of the capital market as a mechanism for fast-tracking economic advancement. The stock market is generally acknowledged as a method for domestic resources mobilization, enabling the provision of long-term funding for initiatives with growth potential. In a long-term view, stock markets are projected to perform numerous crucial functions. Emerging stock markets have a key role in the international economy. First, sharing the risks of long-term investment initiatives is one of the important purposes of the stock market. The rise of stock markets may lead to a cheaper cost of equity capital and hence assist investments to take place and drive growth. Second, by establishing a degree of control over the investment behaviour of corporations via continual monitoring of their share prices may help to more efficient investment. Thirdly, by attracting foreign portfolio flows, the growth of stock market may contribute to boost the

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availability of invest able money. Although the stock market would not be an alternative to banking sector in Sri Lanka, it might effectively enhance the banking services. Thus, the significance of a market for listed stocks is demonstrated; yet it has to be grasped with actual facts. This research seeks to meet this criterion by identifying causal linkages among stock market and economic factors. In this research, it is intended to analyze the link between stock market development and economic growth in Sri Lanka during the period 2009 – 2013.

2.Theoretical background and a Review of literature

A. Background

The theoretical framework for the effects of capital market on economic growth dates back to the work of (Adjasi& Nicholas, 2005), who explained that a well-developed financial system can facilitate technological innovation and economic growth by providing investors with financial services and resources. Later, the preceding argument was advanced as the hypothesis, which is a policy analysis tool for developing nations with strong recommendations and a high focus on the efficiency of financial institutions in promoting capital accumulation and financial intermediation. Levine and Zervos (1996) investigate whether a substantial empirical link exist between capital market development and long-run economic growth. According to Al-Malkawi et al. (2012), stock markets have a favorable effect on economic development through promoting individual savings and facilitating corporate financing. Theoretically, a rising body of research asserts that the rise of the stock market stimulates economic expansion. Greenwood and Smith (1997) demonstrate that huge stock markets may reduce the cost of saving mobilization, hence encouraging investment in the most productive technology. Bencivenga et al. (1996) and Levine (1991) suggest that stock market liquidity (the capacity to quickly exchange equities) is essential for economic development.

B. Review of literature

Levine and Zervos (1998) were among the first to inquire if stock markets are just expanding casinos or a key to economic progress and to empirically analyze this problem, finding a positive and strong association between stock market expansion and long-term growth. Ben and Ghazouani (2007) stated that the development of financial systems may have a negative impact on economic growth in 11 of the nations they examined, and thus advocated having a robust financial sector. Using Ordinary Least Squares regression, Osinubi and Amaghionyeodiwe (2003) evaluated the link between the Nigeria stock market and economic development from 1980 to 2000. The conclusion suggested that there is a favorable association between the stock market and economic growth and suggests pursuing policies aimed toward the stock market's fast expansion. Obamiro (2005) researched the function of the Nigerian stock market in economic development and discovered that the stock market has a strong beneficial influence on economic growth. He urged that the government develop a more conducive atmosphere in order to boost the efficiency of the stock market in order to achieve greater economic growth. Ted et al. (2005) investigated the empirical relationship between India's stock market development and economic growth. In contrast to their findings about the significance of stock market development to economic growth before to liberalization, the authors established a negative link between stock market development and economic development after liberalization. Nieuwer et al. (2005) examined the long-term correlation between economic growth and financial market development in Belgium. The authors employed a new set of stock market development metrics to show that the development of financial markets has a significant impact on economic growth. They discovered substantial evidence that stock expansion contributes to economic growth in Belgium, particularly between 1973 and 1993. Chee et al. (2003) stated that the expansion of Malaysia's stock market has a considerable favorable effect on the country's economic growth. Additionally, the research discovered that stock market growth Granger-causes economic expansion. Muhammed et al. (2008) concluded that there is a long-term association between stock market growth and economic expansion. Liu and Hsu (2006) stated that the development of the stock market in Taiwan, Korea, and Japan had a favorable effect on economic growth. Francia et al. (2007) shown that shareholder protection drives stock market growth and, ultimately, economic expansion. Using a different method ARDL, Shahbaz, et al. al., (2008) was able to confirm the positive long-run correlation between the stock market and economic growth in Pakistan, while Enisan and Olufisayo (2008) have demonstrated, using data from sub-Saharan African countries, that stock market development has a significant impact on growth in Egypt and South Africa. Rousseau and Wachtel (2000) and Beck and Levine (2003) demonstrate that the development of the stock market is substantially connected with real GDP per capita growth rates. Moreover, they discovered that the liquidity of the stock market and the expansion of the banking sector both predict the future growth rate of the economy when both enter a growth regression. Literature-based research have shown contradictory results depending on nation and country group. Some studies, including Ikikii and Nzomoi (2013), Rahman and Salahuddin (2010), Enisan and Olufisayo (2009), Agrawalla and Tuteja (2007), Buelens et al. (2006), Adjasi and Biekpe (2006), Arestis et al. (2001), and Levine and Zervos (1998), found that the development of stock markets had a positive impact on economic growth, whereas Haque The research of Azarmi, Lazar, and Jeyapaul (2005) suggests that the relationship between stock market development and economic growth is contingent on the economic policies common in the country under consideration. They analyzed the empirical relationship between stock market growth and economic growth during a decade around the "liberalization" of the Indian market (1981 – 2001). Their major objective is to determine whether or not the Indian stock market is a casino. Indian stock market development is not associated with economic growth for the period 1981–2001; the stock market was relevant to economic growth during the preliberalization era; there is a negative correlation between stock market development and economic growth for the post-liberalization era; and the Indian stock market is a casino for the post-liberalization subperiod and the entire ten-year event study period. Specifically, their research results are consistent with the notion that the Indian stock market is a casino throughout the post-liberalization subperiod and during the whole ten-year study period. Capasso (2006) explores the relationship between stock market development and economic growth over the period 1988-2002 using a sample of 24 advanced Organization for Economic Cooperation and Development (OECD) and developing nations. The research demonstrates a substantial and positive association between stock market development and economic growth, and indicates that stock markets tend to arise and flourish only when economies achieve a certain size and degree of capital accumulation. Al-Malkawi et al. (2012) in United Arab Emirates (1974-2008) utilizing ARDL technique discovered a negative association and bidirectional causation between economic growth and development of the banking sector. Using data from 1991-2007, Kagochi et al. (2013) discovered

unidirectional causation between economic growth and the development of the banking sector, and bidirectional causality between the development of the stock market and economic growth. Indicators associated to the stock market, on the other hand, had a favorable impact on economic growth, whilst indicators related to the expansion of the banking sector had an ambiguous impact on economic growth. Adusei (2013) Ghana (1971-2010) Vector error correction, completely modified ordinary least squares, generalized technique of moments He discovered that the rise of the financial sector has a detrimental impact on short- and long-term economic growth. Mohabbad (2013) evaluated the causal relationship between stock market development and economic growth in Jordan from 2000 to 2012 using a vector error correction model. (VECM). His study indicated a unidirectional cause-and-effect link between stock market growth and economic growth, with stock market growth leading to economic growth. According to Granger co-integration, which was also discovered, all t-statistics are significant, indicating a long-term relationship between the variables. Bista (2017) examined the empirical relationship between Nepal's stock market development and economic growth from 1993 to 2014. He used the market capitalization of the Nepal Stock Exchange (NEPSE) as an indicator of stock market development and the real GDP per capita as an indicator of economic progress. His analysis revealed a unidirectional causal link between Nepal's stock market growth and economic progress. Several other researchers have examined the influence of the stock market on economic development in diverse contexts. Numerous studies have shown correlations between stock market success and economic expansion. The conditions in developed markets have been simple to evaluate, as these marketplaces are sufficiently sizable to have an effect on economies. However, the scenario may be different in Sri Lanka, where the comparatively lower size of the stock market may have a limited effect on economic activity. Therefore, if feasible, practical conclusions must be drawn from sectors and parts of the economy that are affected by stock market fluctuations.

C. *Objectives of the Study*

The main objective of this study is to examine the impact of stock market development on Economic growth in Sri Lanka.

Specific objectives,

1. To identify the Characteristics and nature of stock market in Sri Lanka.
2. To classify the relationship between market capitalization and Economic growth in Sri Lanka
3. To recognize the relationship between All Share price Index and Economic growth in Sri Lanka
4. To identify the relationship between Turnover ratio and Economic growth in Sri Lanka

3.Research Methods

This section is dedicated to the study of the relationship between stock market development and economic growth in Sri Lanka, using data over the period 2009 – 2013, 60 months data. Towards achieving the objective of this paper, the data on market capitalization, ASPI and Turnover ratio are collected from the CSE Data Library; while that of GDP information has been compiled from the CBSL annual reports and publications. Based on the knowledge of above literary review, which was identified by researches, in order to identify the factors of stock market affecting the Economic growth in Sri Lanka have used multiple regression method as follows,

$$\text{Economic Growth} = f \text{ (Capital Market)}$$

Where Capital Market is the independent variable and Economic growth is the dependent variable. The variable for which economic growth was measured was the Gross Domestic Product (GDP), while the variable for which the capital market was proxied are market capitalization (MKT), All Share Price Index (ASPI), and Turnover Ratio (TRN). In specific terms, the model is given below.

$$GDP = f \text{ (ASPI, MKT, TRN)}$$

$$Y = \alpha + \beta_1 x_1 + \beta_2 x_2 + \beta_3 x_3 + \varepsilon$$

Eviews 7.0 software package was used in the analysis of the dataset. The variables used in the econometric analysis and their symbols are presented as follows.

Y (GDP) = Gross Domestic Product (Proxy for Economic Growth) denoted as Y

X_1 (ASPI) = All Share Price Index

X_2 (MKT) = Market Capitalization
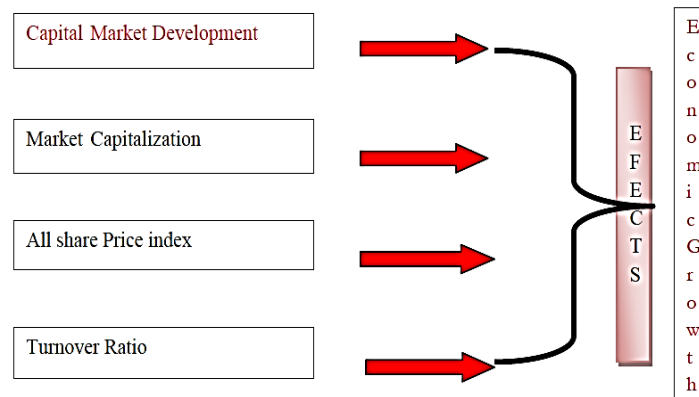
X_3 (TRN) = Turn Over Ratio

Figure no 1: Conceptual Framework

The study will make use of regression analysis as the data analysis method. However, it will incorporate multivariate co-integration and Eigen test in order to undertake a thorough examination of the characteristics of time series economic data. First, the unit root test will be carried out for each of the variables so as to ascertain the time series properties of the data set and obtain the stationary status. This is necessary in order to ensure that the variables are stationary and that shocks are only temporary and will dissipate and revert to their long-run mean.

4. Results and Discussion

To understand the tendency of variables, a primary analysis of the data is done. The data obtained is analysed with the use of E-views 7 software. According to output of EViews following analysis can be interpreted regarding the data set.

Table 1: Descriptive Statistics The summary of the distribution

	GDP	ASPI	MKT	TRN
Mean	1661775.	5148.220	1848.388	27791.37
Median	1609808.	5650.505	2122.055	19105.37
Maximum	2498486.	7798.000	2599.900	90150.13
Minimum	1116903.	1638.060	533.7500	2643.935
Std. Dev.	372319.3	1653.216	638.0253	20571.30
Skewness	0.420242	-0.693836	-0.829811	1.267258
Kurtosis	2.373517	2.443587	2.224460	3.999940
Jarque-Bera	2.747238	5.588071	8.389522	18.55912
Probability	0.253189	0.061174	0.015074	0.000093
Sum	99706482	308893.2	110903.3	1667482.
Sum Sq. Dev.	8.18E+12	1.61E+08	24017502	2.50E+10
Observations	60	60	60	60

Source: Author's compilation using E-Views 7

The summary of the distribution is presented in table 1. It is seen that Average GDP, ASPI,MKT and TRN are 1661775,5148,1848 and 27791 respectively. The GDP ranges from a maximum 2498486 to a minimum 1116903. Unit root test (Augmented Dickey- Fuller test) is conducted to check the stationary of data series. The results suggest that there is a statistically significant and meaningful relationship among the variables in the above regression model.

Table 2: Augmented Dickey-Fuller stationarity test

Variable	Calculated ADF	ADF Critical	Prob.
GDP	-9.530002	-3.574446*	0.000
ASPI	-6.757161	-3.548208*	0.000
MKT	-7.350780	-2.912631**	0.000
TRN	-10.30340	-3.555030*	0.000

Note: *and** indicates that the variable is stationary at the
1% and 5% level of significance respectively
Source: Author's compilation using E-Views 7

For the investigation of stable long run relationships among GDP, ASPI, MKT and TRN use Johanso's co-integration test and Maximum-Eigen tests statistics.

Table 3: Johanso's test of co-integration Rank Test (Trace) Unrestricted Cointegration Rank Test (Trace)

Hypothesized No. of CE(s)	Eigenvalue	Trace Statistic	0.05 Critical Value	Prob.**
None *	0.539558	85.45582	47.85613	0.0000
At most 1 *	0.436315	40.47279	29.79707	0.0021
At most 2	0.117104	7.223768	15.49471	0.0518
At most 3	1.18E-07	6.84E-06	3.841466	0.0894

Trace test indicates 2 cointegrating eqn(s) at the 0.05 level
* denotes rejection of the hypothesis at the 0.05 level
**MacKinnon-Haug-Michelis (1999) p-values
Source: Author's compilation using E-Views 7

Table 4: Cointegration Rank Test (Maximum Eigenvalue), Cointegration Rank Test (Maximum Eigenvalue), Unrestricted Cointegration Rank Test (Maximum Eigenvalue)

Hypothesized No. of CE(s)	Eigenvalue	Max-Eigen Statistic	0.05 Critical Value	Prob.**
None *	0.539558	44.98303	27.58434	0.0001
At most 1 *	0.436315	33.24902	21.13162	0.0006
At most 2	0.117104	7.223761	14.26460	0.0530
At most 3	1.18E-07	6.84E-06	3.841466	0.0894

Max-eigenvalue test indicates 2 cointegrating eqn(s) at the 0.05 level
* denotes rejection of the hypothesis at the 0.05 level
**MacKinnon-Haug-Michelis (1999) p-values
Source: Author's compilation using E-Views 7

The results of the Johansan's test and Maximum Eigen test exposed that the null hypothesis of the no co integrating equation is rejected in the 5% significance level. It can be concluded that there is a significant long run relationship among the given variables. The following tables present the estimates of the normalized co integrating vectors and their respective standard errors (in parenthesis) as to reflect how much co integration there is for the analyzed period. And also, displayed the relationships between the dependent variables and independent variables.

Table 5: Normalized co-integrating coefficients (standard error in parentheses)

Normalized cointegrating coefficients (standard error in parentheses)			
GDP	ASPI	MKT	TRN
1.000000	0.000000	-2.181967	-0.026150
0.000000	1.000000	(0.05141)	(0.00161)

Source: Author's compilation using E-Views 7

These results displayed indicate that there is a relationship between the GDP and the ASPI, MKT, TRN. Therefore, the results reveal and integrating equation, with a normalized cointegrating coefficient. According to this result MKT and TRN have negative effects on GDP and ASPI have positive effect on GDP.

Table 6: Regression Output

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	1135260.	47140.23	24.08262	0.0000
ASPI	-542.6111	58.10369	-9.338668	0.0000
MKT	1813.137	135.7614	13.35532	0.0000
TRN	-1.129331	1.199598	-0.941425	0.3505
R-squared	0.930366	Mean dependent var		1661775.
Adjusted R-squared	0.926636	S.D. dependent var		372319.3
F-statistic	249.4031	Durbin-Watson stat		1.854497
Prob(F-statistic)	0.000000			

From Table 6, we form the equation of the relationship thus,

$$GDP = 1135260 - 542ASPI + 1813MKT - 1.12TRN \quad (47140) \ (58.1) \ (135.8) \ (1.2)$$

The results of this study revealed that the model explains approximately 93% of the systematic variation in the level of economic growth in Sri Lanka between 2009 and 2013. These imply that the independent variables included in the model namely: ASPI, MKT, and TRN accounted for 93% of the total adjusted variation in the level of economic growth in Sri Lanka. In relation to statistical significance of each of the explanatory variables ASPI and MKT were found to be statistically significant at the conventional level of significance (1%, 5% and 10%). ASPI and TRN had a negative effect on GDP but TRN was not significant. Durbin-Watson (DW) statistic further confirms the statistical reliability and desirability of the estimation as there is no evidence of serial correlation. In this research, D.W. value is 1.8. It is high suggesting that there is no autocorrelation. D.W. value ranges between 1.48 and 2.52 so as to eliminate autocorrelation.

5. Conclusion

Based on the study's findings, the following conclusions are drawn. The All Share Price Index (ASPI) has a negative and significant effect on Sri Lanka's Gross Domestic Product, whereas market capitalization has a positive and significant effect. The rise of the stock market has a favorable influence on economic expansion. Johansen's test and the Maximum Eigen test revealed that the null hypothesis of the no co-integrating equation is rejected at a 5% significance level. The statistical proof relies on co integration analysis using Johansen's approach. The testing demonstrated a long-term equilibrium between the factors under consideration. Since 1911, researchers have examined the link between financial development and economic growth. Despite the fact that the earliest research focused primarily on the impacts of banking sector expansion on economic growth while ignoring the potential implications of the stock market. In the last three decades, the link between stock market growth and economic expansion has been explored in light of the stock market's fast expansion. Consistent with the conclusions of Levine and Zervos (1996) and the empirical findings of Demiguc – Kunt& Levine (1996), the results indicate that stock markets may influence economic growth. In addition, Sri Lanka's experience seems to be comparable with several previous studies conducted in the area, including India, Pakistan, Nepal, the Philippines, and a number of European, African, and Middle Eastern nations. This conclusion was consistent with the overall trend in the literature; thus, it was established that there was a long-term link between stock market development and economic growth in Sri Lanka, and that stock market development positively influenced economic growth. The analysis determined that the primary causal path runs from stock market success to economic growth. There was also modest evidence of bidirectional causation demonstrating that economic growth influences the performance of the stock market. This suggests that sustained economic expansion would result in the development of the stock market. Therefore, the research indicates that the success of the stock market affects the growth of actual sectors, therefore influencing real economic activity. The following changes are made based on the findings of this study: Government and regulatory organizations should promote local enterprises to list on domestic stock markets. Additionally, more private limited liability businesses and informal operators should be encouraged to enter the capital market for new funding. Government and regulatory agencies should create and execute policies that maintain relative stability in the economy's bank-based financial sector and market-based stock market in order to promote capital creation, increased investment, and financial system stability. The government and self-regulatory organizations should establish and ensure a strong, more transparent institutional and legal framework, as well as encourage investment in human capital, in order to increase the efficiency of stock exchanges and their ancillary services in allocating available financial resources for investment purposes. Strong financial institutions and an efficient capital market are vital for expanding investment opportunities for both local and international investors and should be promoted. Thus, market activity will expand, capital accumulation will rise, and national productivity may subsequently increase. In addition, government should encourage economic development by fostering a thriving corporate climate.

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