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Financial Liberalisation, Savings and Investments in Sri Lanka: A VAR Model Analysis

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Abstract: *Since 1970s, financial liberalization has become an emerging trend in both developed and developing countries. They have implemented financial liberalisation policies with the aim to improve the effectiveness of monetary policy though greater reliance on market forces. As a result of open economic policies introduced in 1977, financial liberalisation was stated in to Sri Lankan economy. When the new liberalized economic policies were introduced in 1977, the financial sector was highly controlled and regulated as well as being dominated by public sector institutions.*

This study examines the impacts of financial liberalisation policy on savings and investments in Sri Lanka for the period of 1977-2012. The researcher developed a framework for construction of an index to capture the level of financial liberalisation in Sri Lanka in the study period. In this framework, financial liberalisation incorporates various changes, amendments of existing policies and introduction of new policies in financial reforms as financial liberalisation policy includes several elements and it reflects a variety of restrictions that were imposed. Therefore the researcher expected to capture all these process of financial liberalisation policies in to a single index in Sri Lanka. The constructed financial liberalisation index (FLI) used as a proxy of financial liberalisation to examine the impacts of financial liberalisation on savings and investment in Sri Lanka.

The study uses econometric techniques such as Vector Auto-Regression (VAR) ,Impulse Response Function (IRF) and Granger–Causality test were applied to determine the impact of financial liberalization on savings and investments in Sri Lanka. The results of the study show that there is a significant impact of financial liberalisation on savings and investment in Sri Lanka during the study period.

Keywords: *Financial Liberalization,Vector Auto-Regression, Impulse Response Function, Granger–Causality test*