THE EFFECT OF STOCK MARKET DEVELOPMENT AND INFLATION ON ECONOMIC GROWTH IN SRI LANKA

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Degree of Master of Science

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DECLARATION

I declare that this is my own work and this thesis/dissertation does not incorporate without acknowledgment any material previously submitted for a degree or diploma in any other University or Institute of higher learning and to the best of my knowledge and belief it does not contain any material previously published or written by another person except where the acknowledgment is made in the text. I retain the right to use this content in whole or part in future works (such as articles or books).

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The above candidate has carried out research for the Master's thesis/dissertation under my supervision. I confirm that the declaration made above by the student is true and correct.

Name of Supervisor:

Signature of the Supervisor: Date:

DEDICATION

This study is dedicated to everyone who helped and provided guidance to make this work successful.

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ABSTRACT

In the modern financial system, the stock market plays a significant role. Currently, Sri Lanka is recovering from the worst economic crisis in Sri Lankan history. Various studies have been performed worldwide to explore the connection among stock market advancement and the uplift of national economies from diverse perspectives. In Sri Lanka, a limited number of studies were performed. This study aimed to determine the relationship between stock market advancement and economic uplift in Sri Lanka, utilizing four proxies called, market size, efficiency, stability, and accessibility to gauge the stock market's advancement in Sri Lanka. Market capitalization, annual turnover, all share price index, and the number of listed firms in CSE were considered to measure respective proxies and gross domestic product used to measure economic development in Sri Lanka. Annual time series data spanning from 1990 to 2022 were gathered from the Central Bank annual reports and the Colombo Stock Exchange data library for this study. Stock market development measuring proxies provide growth over the period with some significant fluctuations. GDP has increased gradually in the past 3 decades. Principal component analysis was conducted to make a collective measure using stock market development measuring variables which are highly correlated. Johanson's cointegration test indicates the existence of a long-term cointegration relationship among the variables. The Vector Error Correction model was performed to assess the long-term relationship. VECM model results indicate the significant long-term relationship between stock market advancement and economic uplift in Sri Lanka. The short-term causality relationship between variables was assessed using the Granger causality test. The Granger causality test confirms the bi-directional short-term relationship among share market advancement and the uplift of the Sri Lankan economy.

Keywords: Economic growth, Stock market, VECM model, Granger Causality

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LIST OF ABBREVIATIONS

Abbreviation	Description
ACF	Auto Correlation Function
ADF	Augmented Dickey-Fuller
AIC	Akaike Information Criteria
ARCH	Autoregressive Conditional Heteroscedasticity
ARDL	Autoregressive Distributed Lag
ASPI	All Share Price Index
AT	Annual Turnover
CSE	Colombo Stock Exchange
CUSUM	Cumulative Sum
DW	Durbin-Watson Statistic
FDI	Foreign Direct Investment
FPE	Final Prediction Error
GDP	Gross Domestic Product
HQ	Hannan-Quinn information criterion
INF	Inflation
ISE	Istanbul Stock Exchange
LC	Listed Companies
LM	Lagrange Multiplier
MC	Market Capitalization
MOSUM	Moving Sum
NASDAQ	National Association of Securities Dealers Automated Quotation System
NYSE	New York Stock Exchange
PCA	Principal Component Analysis
SC	Schwarz Criterion
SMDI	Stock Market Development Index
SEC	Securities and Exchange Commission
VAR	Vector Autoregressive

VEC	Vector Error Correction
VECM	Vector Error Correction Model