IMPACT OF BANKS' PERFORMANCE ON ECONOMIC GROWTH OF SRI LANKA: THE MEDIATING ROLE OF FINANCIAL INNOVATION

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1. Introduction

Many banking processes are now fully automated for convenience, and financial innovation is increasingly recognized as a catalyst for economic growth. Yet, its mediation effect between bank performance and economic growth remains underexplored, particularly in developing economies like Sri Lanka. Hence, this study mainly investigates the mediation effect through financial innovation on the effect of banks' performance on economic growth and also evaluates the direct effect, as previous studies have reported conflicting findings on its direct impact.

2. Research Methodology

To enrich the findings, the researcher used the quantitative method. The independent variable is banks' performance**,** measured by their lending capacity, while the dependent variable is economic growth**,** measured by GDP growth. Financial innovation**,** measured through innovation specificity, serves as the mediator variable. The secondary data was collected through annual reports of sampled banks in Sri Lanka, World Bank, and Trading Economics indicators from 2011 to 2023. The sample size is restricted to 12 banks, as some banks were excluded due to data unavailability. The Structural Equation Model (SEM) is applied to assess both direct and mediation effects, with the Sobel test (1982) used to determine the significance of the mediation effect.

3. Findings and Discussion

The findings revealed that banks' performance has a significant positive effect on economic growth, confirming that banks' performance and economic growth are mutually supportive in the Sri Lankan context. However, there is an insignificant mediation effect through financial innovation because of the limited innovation literacy and inadequate evaluation of innovative projects.

4. Conclusion and Implications

In conclusion, banks must ensure rigorous appraisal processes when investing in financial innovations and take necessary actions to enhance customers' innovation literacy to foster greater engagement with innovative financial solutions. It helps to assess whether these innovations genuinely benefit the economy rather than just the banks, which could improve the quality of financial innovation over time.

Keywords: Banks' performance, Economic growth, Financial innovation