

# A Study of Financial Sectors of Nepal and its Role in Economic Growth

Prabin Rai<sup>1</sup>, Prof. Dr. Vijit Supinit<sup>2</sup>

<sup>1</sup>MBA Student, Siam University, Bangkok, Thailand

<sup>2</sup>Supervisor, Siam University, Bangkok, Thailand

---

**Abstract:** Nepal is predominantly mountainous and landlocked country with least development and low economic size of nominal US\$ 7.23 billion. The prevailing political conflict which began in 1996, has further constrained their development, and has confined banking in urban Nepal. It is generally considered that the central bank's (Nepal Rastra Bank) supervision is weak and the non-performing lending is sizable, especially in the two major national commercial banks; Nepal Bank Ltd. and Rastriya Banijya Bank. However, formal and informal financial institutions are functioning in Nepal but, the role of their contribution are known to a minor extent. Therefore, this research was designed to analyze the scope of sound development of the financial institutions in Nepal. We made use of descriptive and causal comparative research designs, and analysis of available information for the study highlighting the recent trends in structure and development of the financial sectors. In detail study and analysis of primary data from Nepal Rastra Bank (NRB) and information from clients of selected financial institutions has brought to light some interesting information. The collective data of NRB and selected commercial banks from the fiscal-year 2000 to 2015 were analyzed using regression model. The result revealed that bank credit plays important role in Economic Growth. Nevertheless, economy has gradually increased over the years, since 2000 to 2015. Accordingly, the financial sectors are implied to design and formulate strategies that will not only minimize the acquaintances of the bank to credit risk but also enhance its profitability.

**Keyword:** Central Bank, Commercial Bank, Bank Credit, Economic growth.

---

## I. INTRODUCTION

The development of financial sectors in Nepal, as in many other countries is seen as a very important intermediation to develop economy of the country. A deep and efficient financial system can contribute robustly to sustained economic growth and lower poverty. This study examines to development of Nepalese financial sectors in the context of the overall governance environment. It provides on overview of the economy by discussing the economic performance in the post-2000 period, from 2000 to 2015 to the possible extent. In this content, the wealth of the nation in terms of natural resources, human resources and man-made infrastructure and institutions is well illustrated. And the highlights of the development of financial institutions, banks and nonbanks, has been derived through the analysis of available information.

The health of the financial system has important role in the country as its failure can interrupt economic development of the country. In commercial lending, commercial banking plays a dominant role (Allen & Gale, 2004). In many countries, commercial banks routinely perform investment banking activities by providing new debt to their customers. The credit creation process works smoothly when funds are transferred from ultimate savers to borrower (Bernanke, 1993).

### *The Economy of Nepal*

The government is unitary so far, and has been lingering on its transition since the early 2006. There are 75 administrative districts, 58 municipalities, and 3,915 VDCs. The total local administrative units or wards in the country are 36,039 altogether – 804 urban wards and 35,235 rural wards. The size of the economy increased gradually over the years in the 90s, and doubled in 15 years, from 2000 to 2015. Nevertheless, the low level of the economy implies a low level of financial transactions, and thus a limited financial sophistication and the consequent limited financial development. The

production activity was greater than the national income in the early 2000s as the ratio of GDP to GNI was greater than unity during 2000-2010, implying an increased foreign investment, especially from India and China.

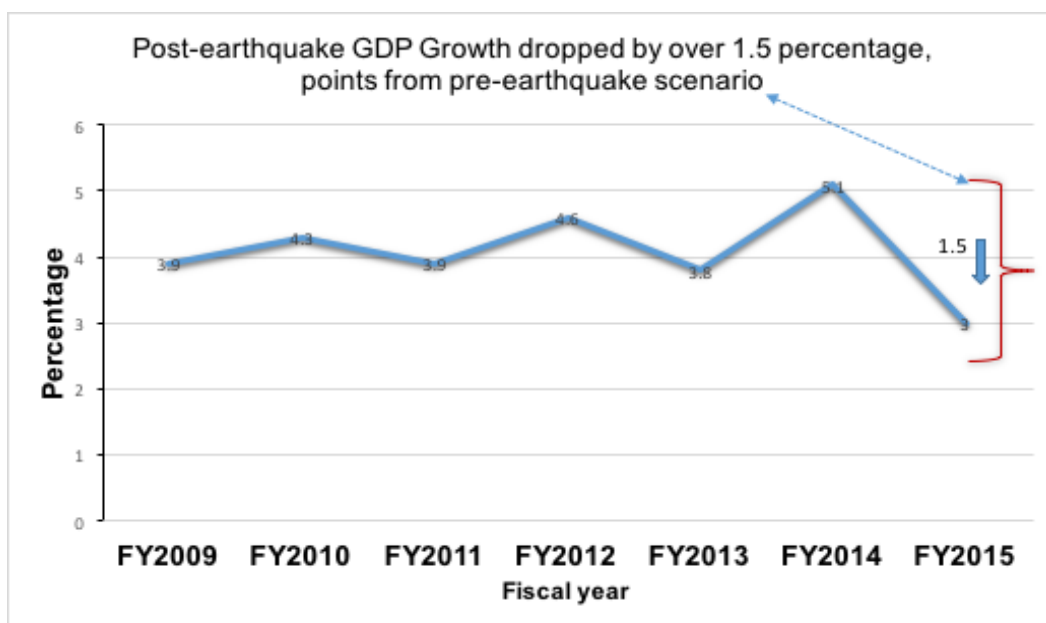
**Per Capita Income**

The real per capita income (GNI) level is low, 64 cents or 38 Nepalese rupees a day in 2000, and 89 cents or about 101 Nepalese rupees a day in 2015. In nominal terms, the per capita income was \$ 212 in 2000 and \$ 300 in 2006, and \$426.48 in 2014. Thus, Nepal remains one of the poorest countries in the world. Furthermore, the level of the per capita income has improved slowly.

**Annual Growth Rates of Population, National Income and Production**

The population of Nepal increased by 1.6% per annum during the year 2000-2015. The population growth rate was higher before 2000 than in the later period. The annual growth rates in national income (DNI) and production (GDP) decreased from one period to the other, due to the effect of the post-1995 insurgency, which has still affecting adversely the productions in all the sectors of the economy. Furthermore, the production in the early 2000 was slightly higher than that of the 90s: as the GDP during 2005–2012 increased by 5.48% per year. In general, the economic growth in early 2000, economic performance was quite low because of the nationwide insurgency, and its aftermath as the peace in the country remains indefinable. The main sector of the economy is agriculture, which employs over 70 percent of the population and accounts for 33 percent of GDP. As Nepal is home to the highest mountains in the world, tourism has been steadily growing in importance and is an important source of revenue. Also, the country has been working on exploiting hydroelectric power.

In Fiscal Year FY2015, a subpar monsoon will constrain agriculture growth, while the expected delay in getting reconstruction started, coupled with economic dislocation and damage to infrastructure, will curtail industry and services growth. Accordingly, GDP growth will likely be held moderately below the Asian Development outlook 2015 projection. The earthquake lowered GDP growth by over 1.5 percentage points from an estimate of 4.6% in a no-earthquake scenario in fiscal year 2015 (which ends 15 July 2015). Although the earthquake struck Nepal in the tenth month of 2015, the impact on GDP growth is sizable especially on the services sector, which is now expected to grow by 3.9% compared to 6% in a no-earthquake scenario. Wholesale and retail trade; tourism (including air transport, and hotel and restaurant businesses); real estate, renting and business activities; and education sub-sectors are the most affected. The slowdown in the industry sector is due to the drastic drop in quarrying, manufacturing and construction. Meanwhile, underspending of the budget has been a persistent problem, especially in capital spending, for which just 70% of planned expenditure is generally realized. The government’s capacity for expenditure has to be drastically enhanced to ensure that reconstruction is fast and efficient in 2015 onwards.



Source: Central Bureau of Statistics (CBS), Kathmandu, Nepal

Fig 1. GDP Growth (Basic prices) %

### ***1.1 Objectives of the Study***

The overall objective of this study is to explore the financial sectors and the development structure of Nepalese financial sectors, and examine its implications for future research and policymaking by central bank. The specific objectives of the study are pointed out below:

1. To understand about increasing current economic growth than in previous years.
2. To explore information and principles of financial sectors of Nepal.
3. To study the function of the central bank, Nepal Rastra Bank (NRB), in the promotion of financial development;
4. To propose guidelines for sustainable economic planning and develop implications for future research techniques.

## **II. LITERATURE REVIEW AND RESEARCH FINDINGS**

### ***2.1 The Financial Sectors of Nepal***

#### **Central Banking**

Nepal Rastra Bank (NRB), which is the central bank of Nepal has been in operation since 26th April 1956. It manages the money supply and the monetary policy of Nepal, subject to the financing requirements of the government, and is responsible to maintain price stability, and to promote sustainable economic growth. It is also entrusted with the responsibility of managing the foreign exchanges. However, it has a fixed exchange rate system with Indian rupee, which is aligned with the US Dollar but operates with the market mechanism for other currencies. It pursues banking policies and regulates credit creation through the conventional monetary instruments—the reserve ratio, benchmark interest rate, and open market operations through sells or purchases of securities, i.e. government bills and bonds. In addition, the NRB provides banking services to the government and commercial banks, undertakes supervision of the financial system, and renders, last but not least, advisory services to the government on monetary and financial policies.

#### **Commercial Banking**

The performance of the three dominant commercial banks, the Nepal Bank Ltd., the Rastriya Banijya Bank, and the Agriculture Development Bank has improved in recent years. Other private commercial banks are operating so far. There is no liquidity problem at all and their operating costs are moderate. However, investing in non-government sectors has been the challenge because of the political uncertainty. The commercial banks are concentrated in urban areas, and the political environment, especially when in insurgency period, has narrowed down their reach to rural areas. Also, the excess government intervention, especially in the Nepal Bank, has disturbed their smooth functioning. There are some other commercial banks operating in Nepal such as Standard Chartered Bank, Himalayan Bank, Nepal Investment Bank and Bank of Kathmandu.

#### **Nonbanking Institutions**

Nonbanking Financial Institutions (NBFIs) are an important subsector for the efficient functioning of the economy. They broaden the spectrum of risks to investors, encourage investment and saving. They provide competition for banks in the provision of financial services. The World Bank has classified the nonbank financial institutions as Investment Institutions, Merchant Banks, Contractual Savings Institutions (life insurance companies, mutual funds and pension funds), Securities Market, Specialized Financial Institutions (Leasing Financiers and Real Estate Financiers) and Financial Cooperatives. However, NRB has classified it as Development Banks, Financial Companies, Microfinance Institutions, NRB licensed cooperatives and the Non-Government Organizations. Similarly, the Economic Survey published by the Ministry of Finance of the Government of Nepal also classified the nonbank financial institutions as the Employees Provident Fund, the Citizens Investment Trust, insurance Companies and security markets. The deposit of the nonbank financial institutions grew significantly over the years even though the country needs to do a lot of homework to set up a strong foundation for making a healthy financial system.

#### **Nepal Stock Exchange**

The Nepalese security market is small, but growing one. During the last 14 years of its operation, the securities market has many ups and downs. Nepalese capital market is focusing on reforming the laws, regulations and policies, building institutional capacity, above all visualizing a dynamic capital market in order to tap the inherent potential and managing

the cross border issue and trading of securities. The stock exchange is a place for providing efficient trading platform for the listed companies through its members. The present legal framework has defined the responsibility of the exchange in admitting securities for trading, providing membership to the brokers and the dealers, and providing trading, clearing and settlement of securities.

### **III. RESEARCH METHODOLOGY**

The research methodology is used in this study is from a casual research related on the information collection data which got from questionnaire and data collected from NRB FY2015. The reason behind choosing the latest year periods is to include afresh data in the analysis as the data in that time period. In order to ensure both descriptive and causal comparative research design, all the data were proceeded to generate information regarding the structural development of financial sectors which were given with literature and respondents' data. The convenience sampling method was used in choosing the banks for the study. The samples were selected from the clients of "A" class commercial banks and development banks of the city(Kathmandu) which are listed in the Nepalese Stock Exchange. Data were sourced from the annual reports of the banks in the sample. The data includes descriptive data in different time period, inclusive performance of commercial banks. This research made use of simple random sampling method, so each of the data retrieved has an equal chance of been selected and analyzed.

#### **3.1 Data Collection**

Questionnaires were mailed in the month of December, 2015. It took three weeks to collect all the papers. The study research in the qualitative approach was to obtain information from the selected financial institutions clients: Nepal Bank Ltd, Rastriya Banijya Bank, Development Bank of Nepal and other Commercial Banks of Nepal like, Bank of Kathmandu Ltd., Everest Bank Ltd., Nepal Investment Bank Ltd., Standard Chartered Bank Nepal Ltd. and Citizens Bank International Ltd. on their experiences and perceptions regarding their development. A confidence level of 95% was used to benchmark the individual sample financial sectors. The analysis was carried out by the method of inferential statistics. The analyzed data was displayed across the tables and the figures.

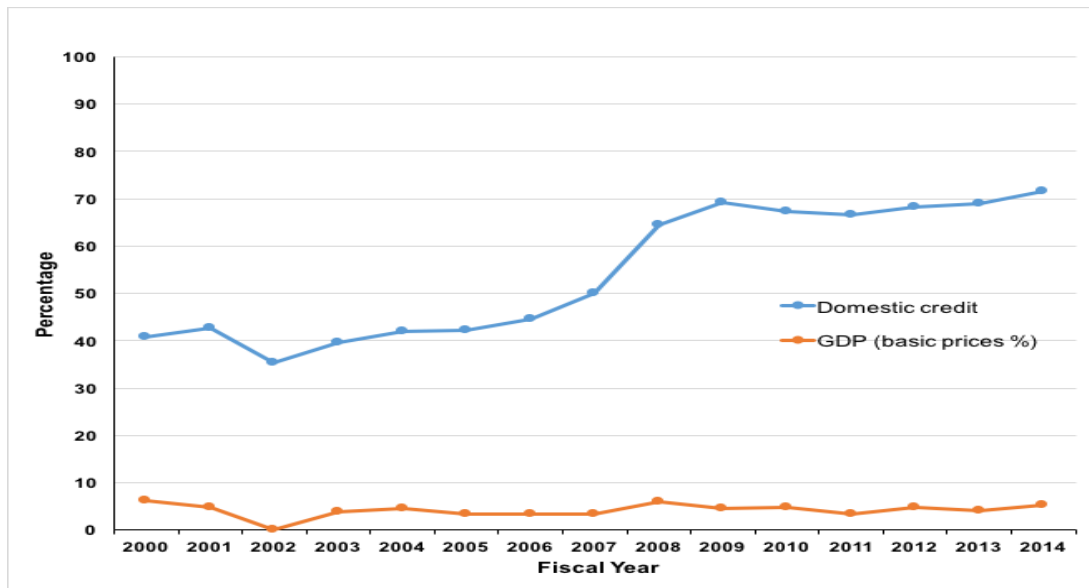
**Survey Indicators:** The following indicators are used for this survey and these indicators are specified in two parts, first: Demographic data, and second: Bank Credit facility to the economic growth.

#### **3.2 Information Processing and Data Analysis**

The researcher analyzed the results exactly after collecting qualitative data and obtained incorporated information with checking and controlling data. This study generated required information through both primary and secondary sources. The main secondary information source is Nepal Rastra Bank, FY2015. The primary information, mainly qualitative in nature, are obtained from concerned agencies customers are saved in the files carefully after well checked and analyzed their descriptive values by using frequency, and percentage. All variables were input into Statistic Package Social v18.0 (SPSS v18.0) and Word-Excel computer software program is used to analyze.

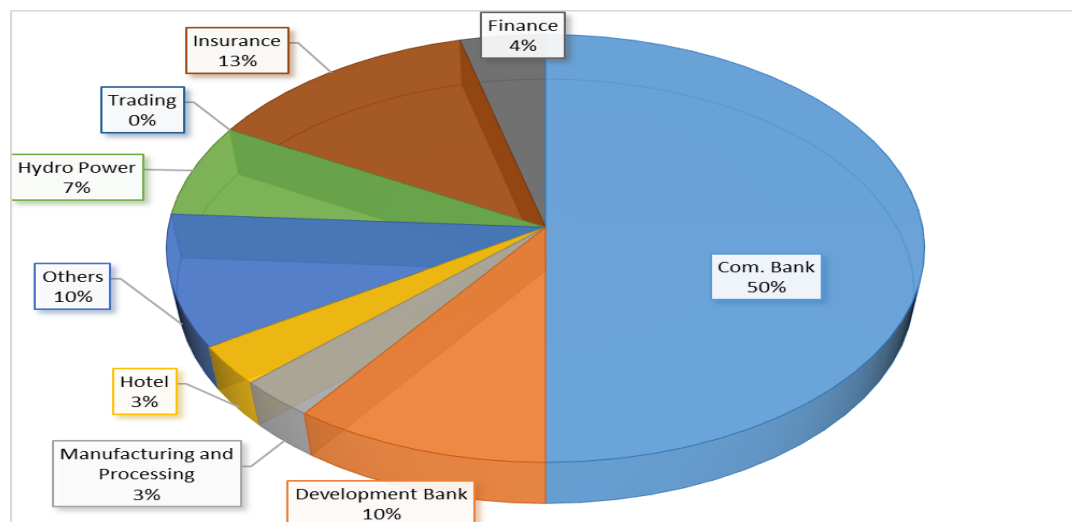
### **IV. RESULTS**

The data of NRB and survey were analyzed to find out the significant relationship between performance of different banks to develop economy and performance in credit level. Out of 75 individuals questioned and study from previous surveys, 61% percent of total individuals preferred commercial banks for their financial transactions. The result shows that 'non-performing loan' has effect on bank performance. Collectively, from the survey and literature review the Commercial banking (44% till 2015) credit facility. Thus, these banks need to follow prudent credit risk management and safeguarding the assets of the banks and protect the interests of the stakeholders. From the graph, the credit to the GDP by domestic financial sectors are shown in percentage with the freedom of financial polices by NRB. 47% people said that commercial banks have adequate facility they seek regarding banking services. Regarding the nature of investment and contribution of bank for development; the commercial banks and development banks have vital role in the development of the country. It appears that Nepal Government has been able to provide the necessary factors for example, ability to access loans, banking knowledge, ability to invest and ability to access international banking which are considered as major hindrance to the growth and success to financial sectors.



**Fig. 2: Percentage of Domestic Credit and GDP**

The above graph shows the percentage of GDP and Domestic credit by financial sectors from the year 2000 to 2014 where top Blue line is indicating the Domestic credit performances and Red line indicates GDP level. Here financial sectors have shown very well performance in credit level to develop the financial system of the country. The level of domestic credit has increased from 40.8% in FY2000 to 71.5% in FY2014. However, Nepal’s position remains uncertain; it is hard to predict how the ongoing political transitions to peace, to a republic, and to federalism will unfold. In the meantime, law and order problems will likely remain in various parts of the country, and industrial relations will continue to be difficult; a number of enterprise closure as a result of aggressive labor movements have been reported. Therefore, in FY2002 and FY2008 seems little disturbed. There are also positive developments. Despite appeared risks, later year the strong commitment of the government and its good track record maintained the economy of Nepal. Yet again, the solution may be to allow for the movements in the financial system that result to the change in policy.



Sources: Securities Board of Nepal 2015

**Fig 3. Group-wise distribution of market capitalization**

By reviewing the group-wise market capitalization composition, banks and insurance companies recorded the highest of the total market capitalization as usual. Commercial bank’s group contributes about 50.16% of the total market capitalization and insurance group contributes about 13.51% of the total market capitalization. Both commercial and insurance group has decreased by 11.86% and 5.35% respectively from the opening market capitalization for the FY2014/15. The market capitalization of development bank group and manufacturing and processing group has increased

significantly by 15.92% and 46.97% respectively as compared to the opening figure. The above group-wise market capitalization shows that Nepalese capital market is highly concentrated on banking sector during the period.

**TABLE I. Commercial Banks' Total Deposits and Its Annual Growth Rates**

Mid-Year of Fiscal three years	NRs Million	Percent per year
1995	61,045.5	22.77
2000	154,530.3	20.41
2007	334,453.3	11.66
2014	1,99,932.8	24.80

*Sources: Nepal Rastra Bank, Research Department (At current prices)*

The annual growth of total deposits increased to 24.80% in FY2014. The nominal growth of deposits has been normal as it is in line with the nominal GDP growth. The performance of the three dominant commercial banks: Nepal Bank Ltd., Rastriya Banijya Bank, Agriculture Development Bank and other commercial banks has improved in recent years.

### Challenges and Opportunities in Financial Institutions' Development

The economic performance during 2000-2015 has been gloomy because of a high political uncertainty. The major critical challenge is how to establish a legitimate, functioning government through the enactment of a legitimate constitution. Nepal is also heavily vulnerable to climate change and natural disasters. Recent records show an increasing number of droughts, floods, hailstorms, landslides and crop diseases, mostly affecting the livelihoods of the poor. Nepal is located on the edge of a tectonic plate and is subject to high earthquake risks, particularly in the Kathmandu valley.

## V. CONCLUSIONS AND RECOMMENDATION

The government is in transition, and in shambles, and there is virtually no rule of law. The long vacancies in the posts of most secretaries in the government indicate precariousness in governance. The low remuneration compels bureaucracy to drive for implicit financial gains. The ancient economy is increasing. First of all, the country needs two fundamentals- a functioning, legitimate constitution and a legitimate government, with a pragmatic policy environment. There ought to be a governor, a prime leadership in the Nepal Rastra Bank and other financial sectors as to drive smoothly. Further research on this topic is recommended to cover all other financial sectors of Nepal as well so that results can be compared from various institutions in order to identify more success factors and areas of improvements.

Undoubtedly, we still look forward to compare these findings with those of other developing countries as well to see and gauge how well there are adapting or preparing for largely effective Government policy in Nepal. As such, there is a strong need to strengthen this policy approach for financing the financial sectors. Further, in view of the findings, the government (policy makers) has to put more efforts to motivate the banks and financial institutions in increasing priority sector lending beyond the requirements laid down by Nepal Rastra Bank. The banks in Nepal are required to expand their efforts exponentially to reach out to the priority sector in providing fair and equitable financial assistance for achieving economic growth. Based on the findings of this study, it is recommended that banks in Nepal should enhance their capacity in credit analysis and loan administration while the regulatory authority should pay more attention to banks' compliance to relevant directives and prevailing rules and regulations. The result in this study therefore, suggested the need for strong credit service process management must be adopted to keep the level of Non Performing Loan as low as possible which will enable to maintain the high performance (profitability) of commercial banks in Nepal.

Further, this study might be useful to researchers as a source of knowledge for further research. The study is concentrated on only three factors and thus, further study should be carried out on the topic to point out the other factors that enhance credit to support economy of the country.

## REFERENCES

- [1] Trading Economics; <http://www.tradingeconomics.com/nepal/gdp-per-capita>
- [2] Nepal GDP and Economic Data, Global Data, Country Report 2015, Global Finance
- [3] Asian Development Bank; Nepal and ADB, Project in Nepal 2016
- [4] Franklin Allen & Douglas Gale, "Competition and Financial Stability" Money, Credit and Banking, Pg. 466

- [5] Nepal Rastra Bank, Banks & Financial Institution Regulation Department, Statistics Division 2015
- [6] Ministry of Finance, 2003 – 2016
- [7] Nepal Stock Exchange Ltd. NEPSE, 2007-2016
- [8] Central Bureau of Statistics. 2011. National Accounts of Nepal 2000-2011.
- [9] <http://data.worldbank.org/country/nepal>
- [10] Ferrari, A., Jaffrin, G., & Shrestha, S. (2007). Access to financial services in Nepal: World Bank Publications.
- [11] Ministry of Finance, Government of Nepal. 2005. Economic Survey 2004-05. Kathmandu.
- [12] Economic Survey 2014/15. Kathmandu.
- [13] Nepal Rastra Bank 2015. Banking and Financial Statistics, Kathmandu.
- [14] Research Report. Kathmandu: Financial Institutions Division, Research Department (July).
- [15] Economic and Social Survey of Asia and the Pacific, 2014. United Nations ESCAP website: [www.unescap.org](http://www.unescap.org)
- [16] Chandan Sapkota's blog, Economic Growth, Trade and Development Policy <http://blogs.adb.org/blog/final-take-economic-and-poverty-impact-nepal-earthquake>.
- [17] Ben S. Bernanke & Mark Gertler, "Inside the black box; The credit channel of monetary policy" Journal of Economic perspectives, vol. 9, No. 4-1994, pg. 27-48