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Role of Financial Sector in Economic Development of Nepal

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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. This study attempts to examine the relationship between economic growth and financial development in Nepal. The empirical evidence confirms that the financial development causes economic growth. In fact, financial development is the cause for economic growth in terms of short-term dynamics, while economic growth sustains financial development in the long-run. Based on the empirical findings, this study recommends that it is necessary to launch the reform programs in the financial system to consolidate and improve the efficiency and effectiveness of the financial system as well as to cope with the emerging changes.

Key Words: Financial Development, Economic Growth, Bank Credit.

INTRODUCTION:

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.

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.

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.

Nepalese financial system is composed of deposit taking and contractual saving institutions. The deposit taking financial institutions include commercial banks, development banks, micro-credit development banks, finance companies, financial cooperatives, non-government organizations (financial) performing limited banking activities (NRB, 2005). Likewise other contractual saving organizations (popularly known as other financial institutions) comprise insurance companies, employee's provident fund, citizen investment trust, postal saving offices and Nepal stock exchange.

Nepal Rastra Bank, the central bank of Nepal regulates the banking sector comprising commercial banks, development banks, finance companies and micro credit development banks/institutions. In addition, it also supervises the savings and credit cooperatives and financial non-government

organization, licensed by it for undertaking limited banking transactions, only. However, the regulation and supervision of Employees Provident Fund, Citizen Investment Trust, Insurance companies (life and non-life) and stock exchange, is outside the purview of the central bank. More importantly, more than ten thousand cooperatives have been undertaking financial transactions and some of them are even bigger than small development banks. They are still outside of any closed supervision and can be vulnerable for the stability financial system.

Commercial banks are the largest part of the financial sector, 51.1 percent in July, 2012 (NRB, 2012). However, the development banks are growing faster and possessing a major chunk of financial assets gradually. Hence, the central bank has started expanding monetary survey incorporating development banks and finance companies. Nepal Rastra Bank Act, 2002 and Banks and Financial Institutions Act, 2006 provide central bank with necessary legal background pertaining to the regulation and supervision of banks and financial institutions. Although Nepal Bank Ltd, the first commercial bank, was established as early as in 1937, the banking expansion took place especially with the establishment of Central Bank of Nepal, called Nepal Rastra Bank (NRB) in 1956, which later initiated the expansion of banking service in Nepal. Up to 1975, there were only two commercial banks and two development banks and until 1980's, the Nepalese financial system was characterized by a repressive financial system incorporating various controls on interest rate and exchange rates, reserve requirement and directed credit, complex rule for money and capital markets (Bhetuwal, 2007). In the mid-1980's, with the adoption of financial liberalization policy, the number of banks and financial institutions started to grow rapidly. As a result of remarkable proliferation in the financial system, there are 30 commercial banks, 84 development banks, 53 finance companies and 37 micro-credit development banks (As of July 2014). The banking sector now provides banking services through 3430 branches and contributes around 3.0 percent to gross domestic product (GDP). In order to strengthen the financial system, Nepal initiated financial sector reform programs in the late 1990's, which resulted in several positive changes in the financial sector (Bhetuwal, 2007). The reform agenda was incorporated in macroeconomic policies to improve business conditions and enhance economic activities. Consequently, the ratio of total banking sector's assets to GDP went up to 125.5 percent in July 2013 (NRB, 2013) from 35 percent in 1994 and the ratio of private sector credit to GDP also increased to 64 percent in 2011 from 20 percent in 1994 (MOF, 2012). Nowadays, the relationship and importance of financial system in economic development of many countries is well documented. However, there is still a dearth of literature about the relationship between financial system and economic growth in Nepal, along with causality between them and direction of causality amidst the financial expansion in the country. Hence, this study intends to assess relationship between financial system and economic growth and find out

the significance of financial development in Nepalese economy to draw some conclusions for further policy reforms.

REVIEW OF LITERATURE:

Several studies have measured economic impact of finance and concluded about its significance for the economy.

Shrestha and Chowdhury (2006) assessed the relationship between financial liberalization and economic development in Nepal by constructing Financial Liberalization Index based on principal component methods. Representing eight major financial liberalization components, their index examined the extent of financial liberalization in Nepal during 1984 to 2005.

Shrestha and Chowdhury (2007) examined the financial liberalization hypothesis employing autoregressive distributed lag (ARDL) modeling approach on Nepalese data. Their results showed that the real interest rate affects both savings and investment positively.

Bhetuwal (2007) undertook a study on financial liberalization and financial development in Nepal and argued about an efficient financial system could effectively mobilize and allocate resources leading to robust economic growth. Financial liberalization improves the functioning of financial system by increasing the availability of funds and allowing risk diversification and increased investment. Using financial liberalization and financial development indices generated by the principal component method, he examined about the effectiveness financial liberalization and financial sector development in Nepal.

Kharel and Pokhrel (2012) have examined the role using country specific cases of Malaysia, Pakistan, Nepal, Bangladesh and Nepal respectively.

OBJECTIVES OF THE STUDY :

The overall objectives of this study are pointed out below:

- ❖ To examine the performance of financial sector and economic growth in Nepal.
- ❖ To explore information and principles of financial sectors of Nepal.
- ❖ To study the function of the central bank, Nepal Rastra Bank (NRB), in the promotion of financial development;

METHOD OF THE STUDY:

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 secondary sources. The main secondary information source is Nepal Rastra Bank.

RESULTS AND DISCUSSION:

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 policies 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. 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. By reviewing the group-wise market capitalization composition, banks and insurance companies recorded the highest of the total market capitalization as usual. Commercial banks 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: 1
Commercial Banks' Total Deposits and Its Annual Growth Rates

Mid-Year of Fiscal three years Percent per year	NRs Million	
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.

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.

CONCLUSIONS:

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. It is necessary to undertake necessary measures to enhance the growth in both financial and economic activities considering the potential and bidirectional causality between financial development and economic growth in Nepal. Similarly, it is necessary to create investment friendly environment to encourage the investment and growth. There remains, however, the challenge of more reforms and consolidation that are needed to increase further the performance and competitiveness of the financial sector. Though the relationship seems to be strong, it would be imperative to undertake policy measures to make the financial system more inclusive without losing stability even in changing times. There can be more rooms for further research by incorporating the data of other financial institutions including provident fund, stock exchange and insurance companies as well as incorporating alternative measures of financial and economic development.

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