ASSESSING THE EFFECTIVENESS OF FINANCIAL SECTOR REFORMS IN NEPAL

A Summary of thesis

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Introduction

Landlocked in between two giant economies of the world, India and China, Nepal has limited agrarian economy, lacks industrialization and possesses few natural resources. Difficult topography, subsistence farming practices, lack of adequate credit facilities and poor irrigation facilities have adverse effect on the performance of agricultural sector resulting a slow growth of overall economy. The widening trade deficit depicts the inferior proportion of export comprising basically semi-finished goods and raw materials. However, import has always been essential for machinery, equipments, medicines and other capital goods. Although trade concentration with India is gradually declining over the years, it is still very high. It has seriously affected both the service sector and production sector.

Total population was 23.1 million in 2001, out of which 85.8 percent resides in rural area. Out of total economically active population, 65.6 percent are employed in agriculture, 8.8 percent in manufacturing, and 8.7 percent in trading sectors. Open border between India and Nepal allows free mobility of labor, capital and goods with unlimited convertibility of Nepalese rupee with Indian rupee.

Nepalese economy can be characterized by stagnated growth, mass poverty, deprivation and illiteracy. As in 2003, there was a wide fiscal and trade deficits of 2.5 percent, 15.5 percent of GDP respectively. In spite of continuous efforts to mobilize revenue is a great challenge. Further, regular expenditure has been increasing over the years in order to maintain law and order situation (and debt servicing and other social obligations as well). As a result, development expenditure has been declined sharply.

Although transfer receipts have significant contribution to reduce current account deficits in the recent years, it still is not consistent. Despite the deficit in the financial account, surplus in current account and foreign assistance has contributed to a surplus in overall balance of payments.

Investment ratio is not encouraging. Despite endless efforts to develop agricultural sector, its performance is not satisfactory and so is the manufacturing sector. In addition, the service sector is also small and highly sensitive. Tourism industry though, had flourished during the early 1990s could not produce substantial contribution in the economy. Deteriorating law and order situation and political instability seriously affected the service sector as well as the industrial sector and consequently has impeded the path of economic growth and deterred poverty alleviation activities.

The study is divided into six chapters. Chapter I is an introductory chapter which has described the background, significance of the study, statements of problems, objectives of the study, hypothesis to be examined, and sources of data and methodology to be adopted. Chapter II is the detail survey of literature. In Chapter III the financial system of Nepal is examined. It has illustrated the evolution of financial system, brief discussion of financial intermediaries and markets and the objectives, role and functions of Nepal Rastra Bank. Performance of commercial banks is analyzed by dividing the commercial banking system into three groups, namely public sector banks, joint venture banks, and domestic private sector banks. The process of and experience with financial sector reforms and components of financial liberalization are outlined in Chapter IV. The relationship among various macroeconomic, monetary and financial variables and financial development is analyzed in Chapter V. Causal relationship between financial development and economic growth is analyzed by using Vector Error Correction Method. Summary of major findings of the study are in the concluding chapter. It recommends the areas of priority and reform actions in the light of effectiveness on the assessment of Financial Sector Reform and suggests further areas financial reforms and strategy for implementation. Bibliography and appendices are included at the end of the thesis.

Reforms in the Financial Sector

Nepalese financial system can be characterized by excessive state ownership. Until 1992, all financial institutions (with the exception of three joint venture banks with foreign participation) were government-owned. It led to a scarce competitive environment, market inefficiencies, and political benefaction in the banking system. In addition, managers of the public sector banks were not obliged for sharing any risk of loss and lack of the incentive to loan recovery. It escalated problems in these banks.

As a consequence of administrated interest rates, commercial banks had no incentives to lend to private sector at low lending rates. There was excess liquidity in the baking system on the one hand, and banks had to pay interest on time deposits on the other. Such unintended consequences decreased private savings and encouraged excessive aggregate demand, which was responsible for the rise in inflation. Nepal Rastra Bank imposed credit ceilings on bank lending to the private sector to control aggregate money supply as a predominant instrument of monetary control but this policy caused negative impact on excess reserves in the banking system as a result it reduced competition in the banking sector and hindered the development of efficient financial markets in Nepal.

To cover government budget deficits, commercial banks were permitted to include short-term government treasury bills as part of liquid assets and satisfy their cash reserve requirements. As a result, commercial banks preferred to hold large portfolios in government short-term treasury bills and very little assets in private loans. Thus, small and medium-size enterprises were deprived of adequate finance to the economic activities. Further, an absence of insurance fund to cover commercial bank deposits in Nepal, the government, as the owner of commercial banks, had to cover the risk of loss for any insolvent financial institutions. Nepalese financial system lacked a well-developed capital market as a means whereby surplus funds from investors could be pulled into productive investment opportunities.

In the absence of vigorous enforcement of prudential regulations and bank supervision, less attention was paid to the provision of required reserve and capital requirements. As a consequence public sector banks became insolvent. An efficient operation of the banking systems was also constrained by the technological underdevelopment and information asymmetry.

A well functioning financial sector plays a crucial role in the process of economic development by efficiently mobilizing resources and allocating capital for productive investment projects. Realizing it the government has formulated and implemented various policies and processes during the past one and a half decade. They are permission to establish the joint venture banks, autonomy in the determination of the interest rate, scrapping of statutory liquidity ratio, implementation of the prudential guidelines, removal of the credit ceilings, and introduction of open market operations and other indirect instruments of the monetary policy.

Financial sector reforms have aimed at improving efficiency in this process. After the introduction of reforms, Nepalese financial sector has been observed a quantum expansion in terms of the number of new financial institution and instruments and payment system has been improved a lot. It has led Nepalese financial system toward an electronic era. Efforts on capital market development have been made rigorously, however it is infant yet.

The program of financial sector reforms entailed policy deregulation, institutional reforms to system of prudential regulation and supervision, improvement in financial health and competitiveness in banks and other financial institutions. Insightful efforts were made to develop capital markets and encourage the growth of (other banking and) non-bank financial institutions like finance companies and insurance companies. Since Nepalese financial system is dominated by the commercial banking system, it has been considered as a focal point of reforms. Major thrust has been laid on the reform of the banking system.

Improvement so far achieved after the introduction of reforms, mainly in the financial sector, improvements are not pleasant. Mainly, the performances of public sector banks and financial institutions have been observed poor. It called for broad and comprehensive reform program to improve the performance of Nepalese financial sector. Still there are some lacuna and loopholes making reform efforts less effective. It is, therefore, critical to assess the effectiveness of financial sector reforms in Nepal.

Objectives of the Study

This study has examined the effectiveness of institutional and policy reforms in the financial sector of Nepal. Specifically, the study has focused on policy reforms undertaken during 1980s and 1990s. The impact of the financial sector reforms on the efficiency of savings mobilization and credit allocation to the private sector is examined. Furthermore, the study has analyzed some of the problems remaining after the introduction of financial sector reforms and aims to suggest for further adjustments.

Specific objectives of the study are:

1. To analyze the performance of Nepalese commercial banking sector and to examine the effects of financial sector reforms on financial development.
2. To study the causal relationship between financial development and economic growth.
3. To identify problems and inadequacies still remained during the implementation of the improvement measures.
4. To recommend the areas of priority and further reform actions in the light of present assessment.
5. To suggest strategy for the further reforms in the financial sector.

Hypothesis of the Study

In the light of the above objectives, the study has tested following hypothesis.

1. Easing entry barriers for banks and financial institutions is associated with increased competition and efficiency in the financial system.
2. Financial liberalization raises saving, investment and economic growth.
3. Financial reform reduces the level of non-performing assets of the financial system.
4. Open market and technological development spur financial development.
5. Prudential banking regulation and effective supervision promote financial stability and enhance the safety and solvency of the banking system, and therefore increase the public confidence.

6. With the reforms in the financial sector, the performance of commercial banks improves.
7. Reforms in the financial sector lead to the development of financial sector.
8. Financial development and economic growth are affecting each other in the long run.

Sources of Data and Methodology

The study is primarily based on the secondary data published by Nepal Rastra Bank, Central Bureau of Statistics and Ministry of finance. Data from different ministries and departments, Planning Commission as well as other governmental and non-governmental agencies are used. Similarly, data from individual banks and financial institutions and Nepal Stock Exchange are used. Moreover, the publications of the International Monetary Fund, the World Bank, Asian Development Bank and other international agencies are also used.

The study uses statistical tools and methods like, regression analysis, correlation coefficient, coefficient of variation, unit root test, co-integration etc. Both quantitative as well as qualitative approaches are used to attain the objectives of the study.

Various financial, macroeconomic and policy variables have been analyzed to enquire performance, structure and concentration of financial system and economic growth. Since commercial banks are the largest financial institutions and contribution of capital market is only about eight percent, they are considered as proxy for the financial system. For this purpose, various ratios of balance sheet and income statement items of commercial banks have been analyzed. Commercial banks are grouped into three peer groups, namely, public sector banks, joint venture banks and domestic private banks.

Financial sector reform is a broader concept comprising policy liberalization, institutional strengthening and capacity enhancement. Since policy liberalization is the major thrust of financial sector reforms, throughout this study, financial liberalization is interchangeably used to financial sector reforms. In order to find out the impact of financial sector policy liberalization on financial development, indices of financial liberalization and financial development have been constructed by using Principal Component Method. Granger Test has been performed to find out causal relationship between financial liberalization and financial development. Vector Error Correction Method is applied to examine causal relationship between financial development and economic growth.

Major Findings and Conclusion

Commercial banks are the largest financial institutions dominant in the financial system occupying 68 percent of the total financial assets. Thus, they are considered as the proxy for the financial system. Analysis of various financial, macroeconomic and policy variables have been performed in order to enquire the performance, structure and concentration of financial system and its role in economic growth.

The analysis of the structure, evolution, performance and problems and challenges of financial system has clearly depicted the real picture of Nepalese financial system. Until 1984, Nepalese financial system was suffering from several problems. It was not proliferated until 1984, although there were couples of banks and financial institutions. The initiation of openness and reforms in financial sector and introduction of market oriented economic policies led a rapid expansion of financial institutions and instruments. It has resulted for diversification of financial system during a short span of time. Additionally, the development of new financial instruments and services, introduction of regulatory framework and institutionalization of savings has created new scene for economic growth and development.

Nepalese financial system has been proliferated with a varied number of financial institutions. New financial instruments and services have been introduced thus providing a space for development and growth. The banks in the public sector were suffering with severe problems making the system absolute and unproductive. Public sector banks are found responsible for the deterioration of financial system as they hold a dominant position in terms of deposit taking, credit lending and asset holding.

High Leverage Ratio of the public sector banks indicates the weak financial health and poor equity position. The ratio also confirms that such high ratio is a major source of vulnerability in the banking system.

The performance of the banking system is not satisfactory in terms of profitability. The ratio simply indicates that joint venture banks and domestic private banks are strong whereas public sector banks are very unsatisfactory. The Ratio of Net Interest Margin does not indicate the strong position for any banks rather show fair for joint venture banks, unsatisfactory for domestic private banks and very unsatisfactory position for public sector banks. Liquidity ratio shows that banks in Nepalese financial system are competent enough in terms of liquidity. The liquidity ratios for public sector banks, joint venture banks and domestic private banks clearly indicate strong position. However, non-performing loans has been chronic in Nepalese banking sector and particularly in public sector banks.

The concentration ratio of three banks in the financial system shows a mild picture in recent years. In fact, it is a positive indication for the sound and efficient financial system. The commercial banks have maintained the sectoral portfolio concentration ratio below the level of one percent. Thus, the risk posed related lending and other deposit taking institutions has been limited. However, the ratio of NPL to GDP does not seem worse, however, it does neither indicate nor confirm about asset quality and soundness of the banking sector.

The profitability ratios and some other ratios have clearly indicated for an alarming situation. There was no other option except to strengthen the financial health and soundness of the existing financial institution with the introduction of financial sector reforms. Hence, in the beginning restructuring was initiated in these banks following financial sector reforms. It has certainly drawn many positive results in terms of safety and soundness of the system.

The index of financial liberalization depicts that Nepal has implemented various policies on liberalizing its financial sector over a period of time. The estimated index of financial development also shows steady rise and thereby gradual financial development in Nepal. It reveals the bi-directional causality between financial liberalization and financial development indicating financial liberalization leading to financial development and vice versa.

The increase in loans and advances to the private sector is mainly attributed for the surge in import credit and introduction of new debt products (such as, housing loan, educational loan, etc), increased competition between commercial banks and other financial institutions. However, long-term investment could not be encouraged due to an underdeveloped capital market. Increasing regular expenditure has hindered development efforts adversely.

Nepalese financial sector requires a striking balance between potentially conflicting objectives of promoting competition and risk entailed in financial deregulation in the liberalized context. It is universally accepted that banking must be regulated and well supervised, but the banking system also needs to become more competitive.

The assessment of effectiveness of reforms to bring in changes in the financial system essentially focuses on commercial banking system. It has been clear that reform has reduced concentration in the banking industry. However, the banks are still able to coordinate their pricing decisions overtly. High profitability of joint venture and domestic private sector banks appears to have resulted from the banks' uncompetitive pricing rather than their efficiency in the cost of inefficiency of public sector banks. It requires further strengthening of regulation and comprehensive and coordinated efforts in institutional reforms.

Although entry of small-scale depository institutions (like cooperatives and NGOs) is not enough to increase competition, it could be crucial while formalizing informal finance and extending financial services in the rural mass. Due to small size of the economy, limited number of creditworthy borrowers and lack of investment climate, new banks should probably not be expected to alter the market structure.

Therefore, promoting competition requires addressing barriers to both entry and mobility. The size of the large banks has exerted a significant negative effect on competition and seems to be the barrier to mobility. Since they hold about 50 percent of total assets of the banking sector, it would be reasonable to break them to reduce concentration and improve mobility in retail banking with a reasonable number of branches. It may facilitate competition among existing banks and improve governance structure and efficiency.

Nepal still lacks the variety and healthy credit institutions. Developing a mortgage market and creating institutions for housing finance could be encouraged to widen and deepen the financial sector and avail better financial services in terms of its quantity and quality. Despite the efforts on financial sector reform, some critics argued about the reforms for the little impact on mobilization of financial savings and for high nominal interest rates on lending (rather than deposit) and continuous devaluation of its currency. The performance so far after the introduction of reforms, mainly in the financial sector, has not satisfactory. Mainly the performances of public sector banks and financial institutions have been observed poor. Still there are some structural and institutional weaknesses, making reform efforts less effective. However, reforms are continuous process, require sufficient time and budget, conducive environment and continuity in policy. Nepalese financial sector is still in the process of broad and comprehensive reform program.

Rapid development in information and communication has brought about revolution in the financial system. Plastic money has replaced currency. Credit and Debit cards as well as tele-banking have become more popular and extending wide and increased efficiency and reduced cost of services. Financial transactions and settlement may take a minimal of time. Under these circumstances, it would be critically important to regulate e-banking in a timely manner.

Since a strong and well-functioning financial sector can improve on the rudimentary nature of self-financing regime, financial development is important to the speed and direction of economic growth, by mobilizing idle financial resources for productive investment. To link up saving, investment and economic growth, the financial sector development, governance reform and economic activities in the private sector must go simultaneously to underpin the policy of generating growth and reducing mass poverty.

However, political instability, particularly, since mid-1990s has hindered its growth potential and Nepal is not yet able to reap the benefits of economic stability, which is beyond the coverage of present study.