CHAPTER I

INTRODUCTION

1.1 General Introduction

1.2 An Overview of Nepalese Economy

1.3 Background for Financial Sector Reforms

1.4 Rationale, Significance and Justification of the Study and Statement Of Problems

1.5 Objectives of the Study

1.6 Hypothesis

1.7 Sources of Data and Methodology

1.8 Organization of the Study

CHAPTER I

INTRODUCTION

1.1 GENERAL INTRODUCTION

Nepal is a small land-locked country in the lap of Himalaya, bordered in between China at the north and India on the other three sides, east, west and south. It is situated in the northern flank, in 26^0 22′ to 30^0 27′ North latitude and 80^0 4′ to 88^0 12′ East Longitude with an area of 147,181 square kilometers. Its average length (east – west) is 885 km and width (north – south) is 193 km (CBS, 2004). Total population of the country was 23.1 million in 2001, out of which an overwhelming majority (85.8 percent) resides in rural areas. Amongst the economically active population (age 10 years and above) of 16.77 million, 65.6 percent was engaged in agricultural sector. Only 8.8 percent of them were employed in manufacturing sector, 8.7 percent on trading sector and 3.0 percent in public administration (CBS, 2003). Open border between India and Nepal allows free mobility of labour, capital and goods with unlimited convertibility of Nepalese rupee with Indian rupee (Khatiwada, 1994:1).

1.2 AN OVERVIEW OF NEPALESE ECONOMY

Nepalese economy can be characterized by stagnated growth, mass poverty (38 percent below the poverty line), deprivation and illiteracy (42 percent). As in 2003, there was a wide fiscal and trade deficits of 2.5 percent and 15.5 percent of GDP respectively (Tenth Plan, Nepal). Investment ratio was not encouraging due to political instability and deteriorating situation of law and order. Ultimately, it has impeded the path of economic growth and deterred poverty alleviation activities.

1.2.1 Production Sector

Nepalese economy is dominated by agricultural sector. Its contribution to GDP was 39.3 percent in 2003 whereas it was 71.6 percent in 1975 and 50.6 percent in 1990. The shares of industry and services sectors were 8.2 and 20.2 percent in 1975. Such shares increased to 15.9 and 33.5 percent and 20.9 and 39.8 percent in 1990 and 2003 respectively. Annual growth rate of agricultural sector has not been smooth accounting to 0.5 percent, 18.5 percent and 6.8 percent in 1975, 1990 and 2003 respectively. Annual growth rate of industrial sector was 12.7 percent, 13.6 percent and 6.6 percent and service sector 12.3 percent, 13.92 percent and 8.31 percent in the years 1975, 1990 and 2003 respectively.

Table: 1.1

Sectoral Growth Rates of Gross Domestic Product

(at Factor Cost)

Particular	Annual Growth Rate			Sectoral Contribution		
	1975	1990	2003	1975	1990	2003
Agricultural Sector	0.52	18.55	6.84	71.6	50.6	39.3
Industrial Sector	12.74	13.57	6.59	8.2	15.9	20.9
Service Sector	12.30	13.92	8.31	20.2	33.5	39.8
GDP	3.90	16.16	7.37	100.0	100.0	100.0

Source: Appendix A.2

Consumption, Savings and Investment

The ratio of consumption to GDP was at a high level (92.1 percent) in 1990, compared to 90.0 percent in 1975. But the ratio declined to 84.8 percent in 2000, which increased to 88.4 percent in 2003. The ratio of gross domestic savings to GDP was 10.0 percent in 1975. It decreased by 2.1 percentage point to 7.9 percent in 1990. The savings ratio fairly improved accounting 15.2 percent in 2000. However, it declined to 11.6 percent in 2003. The ratio of investment to GDP was 14.5 percent in 1975, which increased over the years to 24.3 percent in 2000. Investment had a marginal increment of 1.7 percent in 2003 and reached at 25.8 percent of GDP in 2003. Thus, saving investment gap has widened significantly over the years. Although it was at lower level, at single digit (4.5 percent) in 1975, the gap increased to double digits recording 10.6 percent, 9.1 percent and 14.2 percent in the years 1990, 2000 and 2003 respectively.

Table: 1.2

Aggregate Consumption, Savings and Investment

Description	1975	1990	2000	2003
Total Consumption to GDP	90.0	92.1	84.8	88.4
Gross Dom. Saving to GDP	10.0	7.9	15.2	11.6
Total Investment to GDP	14.5	18.4	24.3	25.8
Saving Investment Gap	4.5	10.6	9.1	14.2

Sources: Appendix A.3

1.2.2 Monetary Sector

Narrow money (M1) was 8.07 percent of GDP in 1975. It increased to 14.27 percent in 1990, 16.65 percent in 2000 and 19.23 percent in 2003. Among major components of M1, currency (as ratio of GDP) has a higher growth than demand deposits. Broad money (M2) as share of GDP was 12.46 percent in 1975, 31.65 percent in 1990, 50.82 percent in 2000 and 56.46 percent in 2003. Time deposit is a major determinant of M2. In 1975, the ratio of time deposits to GDP was 4.39 percent. It rose to 17.38 percent, 34.17 percent and 37.23 percent of GDP in 1990, 2000 and 2003 respectively. It clearly indicates gradual pace of monetization and increased level of financial deepening in the economy. Accelerating growth rate of broad money (M2) is attributable to net foreign assets (NFA) and net domestic assets (NDA). Percentage share of NFA to GDP was 6.21 in 1975, which fairly increased to 9.37 percent in 1990. It increased remarkably to 21.97 percent and 20.99 percent in 2000 and 2003 respectively. The growth of NDA is relatively higher than NFA which was 6.25 percent of GDP in 1975 and rose to 22.28 percent, 18.85 percent and 35.47 percent in 1990, 2000 and 2003 respectively.

Table: 1.3

Factors Affecting Money Supply

Monetary aggregates	1975	1990	2000	2003
Foreign Assets, Net	6.21	9.37	21.97	20.99
Net Domestic Assets	6.25	22.28	28.85	35.47
1. Domestic Credit	9.88	29.75	43.14	52.45
a. Net Claims on Govt.	1.72	13.98	10.44	14.42
b. Claims on Financial Public enterprises	0.83	2.01	2.32	2.72
c. Claims on Non-Financial Institutions	2.60	2.03	0.49	0.65
d. Claims on Private Sector	4.73	11.72	29.88	34.66
2. Net Non-monetary Liabilities	3.64	7.47	14.29	16.98
3. Broad Money (M2)	12.46	31.65	50.82	56.46
3.1. Money Supply (M1)	8.07	14.27	16.65	19.23
a. Currency	5.53	9.75	11.51	13.06
b. Demand Deposits	2.54	4.52	5.14	6.17
3.2. Time Deposits	4.39	17.38	34.17	37.23

Source: Quarterly Economic Bulletin, 2003, Nepal Rastra Bank and Annex Table

Claims on private sector expanded with quantum growth from 4.73 percent of GDP in 1975 to 11.72 percent in 1990. Its growth rate was remarkably high accounting to 29.88 percent and 34.66 percent of GDP in 2000 and 2003. Claims on non-financial public enterprises were 2.6 percent in 1975 and declined to 2.03 percent in 1990. It came down to 0.49 percent of GDP in 2000 and marginally increased to 0.65 percent in 2003. Likewise, claims on financial public enterprises increased from 0.83 percent of GDP in 1975 to 2.01 percent in 1990, 2.32 percent in 2000 and 2.72 percent in 2003 respectively.

1.2.3 Fiscal Sector

Government expenditure was 9.1 percent of GDP in 1975. It increased to 19.7 percent of GDP in 1990. Total government expenditure, in terms of GDP, marginally declined to 18.1 percent in 2000 and 19.3 percent in 2003. During the same period total revenue was 6.1 percent, 9.3 percent, 11.7 percent and 12.9 percent of GDP indicating a slower growth than that of expenditure. As a result, the size of fiscal deficit enlarged over the period. Fiscal deficit was 1.3 percent of GDP in 1975 and 8.4 percent of GDP in 1990. Similarly, it was 4.8 percent and 3.8 percent of GDP in 2000 and 2003 respectively.

Table: 1.4

Budgetary Operation

(In terms of GDP and percentage share)

Headings	1975	1990	2000	2003
Expenditure	9.1	19.7	18.1	19.3
Regular	36.1	33.9	52.1	65.4
Development	63.9	66.1	47.9	34.6
Receipts	1.3	11.3	13.3	15.5
Revenue	6.1	9.3	11.7	12.9
tax revenue	83.5	78.4	77.3	75.7
non tax revenue	16.5	21.6	22.7	24.3
Foreign Grants	1.7	2.0	1.6	2.6
Fiscal Deficit (-)	-1.3	-8.4	-4.8	-3.8
Foreign Loan	0.6	6.0	3.2	1.0
Internal Loan	0.0	2.2	1.5	2.0
(a) Banking System	0.0	67.4	60.0	0.0
(b) Non-Banking System	0.0	32.6	40.0	0.0

Source: Economic Survey 1996 and 2003, Ministry of Finance HMG, Nepal

Out of total expenditure, the share of regular expenditure was 36.1 percent, 33.9 percent, 52.1 percent and 65.4 percent in the years 1975, 1990, 2000 and 2003, whereas the share of development expenditures was 63.9 percent, 66.1 percent, 47.9 percent and 34.6 percent respectively. Although the share of direct tax in total revenue collection is decreasing, it is still high in comparison to non-tax revenue. The share of tax in total revenue was 83.5 percent, 78.4 percent, 77.3 percent and 75.7 percent in the review years. Foreign loan has been gradually declining from 6.0 percent of GDP in 1990 and to 3.2 percent in 2000 and 1.0 percent in 2003.

Inflation

Inflation as measured by national urban consumer price index (CPI) was 16.5 percent in 1975. Over the years, rate of inflation has been fluctuating, thus, recording at its lowest to -0.65 in 1976 and reached at its maximum to 21.1 percent in 1992. The average of rate of inflation over the period 1975 to 2003 was 8.79 percent. It recorded an average growth of 9.30 percent during the period 1975 - 1989, 8.24 percent during 1990 – 2003 and 3.37 percent during 2001 – 2003. The change in the petroleum prices and Indian price trend has been influential in the overall price index of Nepal.

Table: 1.5

Average Inflation

Average	
Period	Inflation
1975-2003	8.79
1975-1989	9.30
1990-2003	8.24
2001-2003	3.37

Source: Quarterly Economic Bulletin July 2003, Nepal Rastra Bank

1.2.4 External Sector

Nepalese trade pattern is dominated by imports and characterized by dependency on India. In 2003, out of total volume of trade 56 percent was concentrated with India and remaining 44 percent with the rest of the world.

In terms of GDP, total exports were 5.4 percent, 5.2 percent, 13.6 percent and 11.5 percent in 1975, 1990, 2000 and 2003 respectively, whereas total imports were 11.0 percent, 18.4 percent, 29.6 percent and 28.6 percent. Trade deficit was 5.6 percent, 13.2 percent, 16.0 percent, and 17.1 percent during those years. Likewise, total volume of trade was, thus, 16.3 percent, 23.6 percent, 43.2 percent and 40.0 percent of GDP in the review years.

Table: 1.6

Foreign Trade

(As percentage of GDP)

Year	Export			Import			Trade Deficit			Total Trade		
	Total	India	Other	Total	India	Other	Total	India	Other	Total	India	Other
1975	5.4	4.5	0.9	11.0	8.9	2.0	5.6	4.4	1.2	16.3	13.4	2.9
1990	5.2	0.6	4.6	18.4	4.7	13.7	13.2	4.1	9.1	23.6	5.3	18.3
2000	13.6	5.8	7.8	29.6	10.8	18.8	16.0	5.0	11.0	43.2	16.6	26.6
2003	11.5	6.1	5.4	28.6	16.3	12.3	17.1	10.2	6.9	40.0	22.4	17.7

Source: Quarterly Economic Bulletin, July 2003, Nepal Rastra Bank

Balance of Payments

There is an increasing gap between import and exports. Trade deficit was 13.2 percent of GDP in 1990. It increased to 16.1 percent in 2000 and 17.1 percent in 2003. Although service sector has important contribution in the current account, it is not sufficient to meet current account deficit. Its contribution was 1.3 percent of GDP in 1975, 7.2 percent in 2000 and 2.2 percent in 2003. However, the transfer receipt from Nepalese workers abroad has significant contribution in the economy, particularly after 2000. Net transfer was 3.6 percent of GDP in 1975 and increased to 6.4 percent and 9.0 percent in 2000 and 2003 respectively. Thus, current account deficit was 0.7 percent of GDP in 1975. It rose to 7.7 percent in 1990. However, it decreased to 2.5 percent of GDP in 2000 and 6.0 percent in 2003. Overall balance of payment was favorable, accounting to 2.7 percent of GDP in 1990 and 1 percent of GDP in 2003. Major reason behind this is the flow of soft loans from international financial institutions and foreign direct investment.

Despite of endless efforts to develop agricultural sector, its performance has not been satisfactory, resulting in the slow growth of the overall economy. Major reasons behind are, its difficult topography, subsistence farming practices, lack of adequate credit facility and lack of irrigation etc. Further, floods and droughts affected the agricultural sector hard. Service sector is highly sensitive. It largely depends upon an environment of peace and security. Tourism industry had flourished during the early 1990s. Deteriorating law and order situation seriously affected the service sector as well as production in the industrial sector.

Table: 1.7

Balance of Payments

(as percentage of GDP)

	1975	1990	2000	2003
Trade Balance	-5.63	-13.23	-16.05	-17.13
Services, net	1.29	2.76	7.22	2.19
Unrequited Transfers, net	3.61	2.80	6.38	8.97
Current Account Balance	-0.73	-7.67	-2.45	-5.97
Official Capital, net	0.52	5.91	2.32	-0.10
Miscellaneous capital items, net	-1.02	4.42	4.08	7.07
Changes in Reserves, net (-increase)	2.53	-2.66	-3.94	-1.00

Source: QEB July, 2003, Nepal Rastra Bank

Over the period, loans to private sector is attributed by 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 underdeveloped capital market.

Despite of continuous efforts to mobilize revenue increasing regular expenditure has hindered development efforts adversely. It was mainly during the period 2000 onwards, due to increased security expenses to maintain law and order situation as well as debt servicing and other social obligations. As a result, development expenditure declined sharply. The analysis depicts the fact that out of total trade, export is less than its one third and has caused a large trade deficit. Import is basically machine equipments, their parts, motor vehicles, medicines and other finished products, whereas export comprises of semi-finished or raw materials. Further, trade concentration with India is very high although it is gradually declining over the years. Trade promotion and diversification could reduce the large volume of trade deficit.

Due to the larger base of imports in comparison to that of exports, trade deficit has been widening. Although transfer receipts have significantly contributed in reducing current account deficits in the recent years, it may not become sustainable. Despite of a deficit in the financial account, surplus in current account and foreign assistance has contributed to a surplus in overall balance of payments. It is therefore important to promote and diversify export trade by enhancing competitiveness in the global market so as to contribute economic growth significantly.

1.3 BACKGROUND FOR THE FINANCIAL SECTOR REFORMS

Nepal embarked financial sector reforms since mid-1980s as a part of economic stabilization and structural adjustment program. Financial sector reforms aimed to remove the ruins of financial repression and promote financial market efficiency in mobilization and allocation of resources. International financial institutions like the World Bank and International Monetary Fund as well as Asian Development Bank have been assisting the Government in this connection.

After the introduction of reforms, Nepalese financial sector has observed a quantum expansion in terms of the number of new financial institution and financial instruments in comparison to that of 1980s. New banks and other banking and non-bank financial institutions have emerged in the private sector encouragingly. New financial instruments have been introduced and payment system has also improved reasonably. Introduction of modern financial products has led Nepalese financial system toward an electronic era. Efforts on capital market development have been made rigorously, however it is yet in its infancy.

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. However, Nepalese financial sector is dominated by the commercial banking sector and has been the focal point of reforms. Major thrust has been laid on the reform of the banking sector.

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

In the supply front, commercial banks had no incentives to lend at low rates to the private sector. It created large excess liquidity in the banking 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.

To control inflation, Nepal Rastra Bank imposed credit ceilings measures 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 resulting in reduced competition and hindered the development of efficient financial markets in Nepal.

Another major feature of the Nepalese financial system was excessive government borrowing from the banking system. To cover government budget deficits, commercial banks were permitted to include short-term government treasury bills as part of liquid assets that could 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. Further, the government requires covering the risk of loss for any insolvent financial institutions due to an absence of insurance fund to face such risks.

An efficient capital market remains as the cornerstone of a market economy to facilitate the accumulation of financial capital for business expansion. 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 were turned technically insolvent. An efficient operation of the banking system was also constrained by the technological underdevelopment and information asymmetry.

1.4 JUSTIFICATION OF STUDY AND STATEMENT OF PROBLEMS

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. After the introduction of financial sector reforms, the number of banks and other financial institutions with variegated types of financial instruments has emerged up.

As a first step of initiation to liberalize the financial sector since mid-1980s, entry barriers were removed. Three joint venture banks were established in the three subsequent years from 1985. Following it, interest rates were liberalized gradually. Then, especially after the restoration of democracy in 1990, popularly elected government gave a major thrust on economic and financial liberalization in Nepal. The institutional network and volume of operations of the financial system has expanded and diversified, with the number of commercial banks going up from five in 1990 to 17 in 2003. The number of other financial institutions has likewise seen a quantum jump.

Realizing the significance of the financial system in the economic development, the government formulated and implemented various policies and processes during the past one and a half decade. They are, permission to establish joint venture banks, autonomy in the determination of the interest rate, scrapping of statutory liquidity ratio, implementation of the prudential guidelines, removal of credit ceilings, and introduction of open market operations and other indirect instruments of monetary policy. This has resulted significant improvements in quantitative as well as qualitative dimensions of the financial system.

Over the past decade, Nepal has made serious efforts to transform itself into a market-based economic system and adopted the policy of financial sector reforms. The financial sector reform aimed at enhancing savings mobilization and credit allocation to the private sector. However, growth experienced less than expectation, which also affected the performance of its financial sector. Nepal formulated a comprehensive financial sector reform to deregulate the financial markets from decades of government intervention, mainly, by late 1980s and 1990s. Despite of the efforts on financial sector reform, critics argue that the reform has had little impact on mobilization of financial savings. Instead, the reform led to high nominal interest rates on lending (rather than deposit) and continuous devaluation of its currency.

Improvements so far achieved after the introduction of reforms, mainly in the financial sector are not satisfactory. Mainly the performances of public sector banks and financial institutions have been observed to be poor. So, Nepalese financial sector is in the process of broad and comprehensive reforms. 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.

Nepal has embarked on economic reforms since mid 1980s with far reaching impacts on trade, industry and financial sector. A comprehensive economic and structural reform has achieved a relatively significant success in stabilizing its economy. As a result, inflation has reduced successfully and economic activities have expanded gradually. Most of the non-tariff barriers have been eliminated and tariff structure streamlined. Foreign investment policy has been liberalized and exchange rate policy changes have eliminated the discriminatory official exchange rates. It completely discouraged parallel market rates. 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 the present study.

The present study is unique in the sense that no comprehensive study has been made in the evaluation of policy reforms in the financial sector of Nepal. There have been wide cross-country studies in this topic. It is needed whether these findings can be generalized in case of Nepal. So, the present study aims to find out the facts in this case.

The policy dilemma facing Nepal is how to increase financial savings in order to promote economic growth. The policy dilemma originates from the realization of low yield in savings in Nepal after the reforms which provides disincentives for savings mobilization. This may lead to further widening of the savings/investment gap and deepen Nepal's dependence on foreign sources of funds for domestic investment. Dependence on unpredictable foreign sources of capital may lead to a higher debt service burden and a slowdown in foreign asset accumulation for financing domestic projects. The increased debt burden may also put severe pressures on foreign exchange rate, which may cause the depreciation of its local currency.

Major objectives of the Nepal Rastra Bank are to maintain price, exchange rate and financial stability by controlling aggregate money supply in the economy. However, in practice, the monetary policy objective of the Nepal Rastra Bank conflicts with the continuous public deficit. This calls for certain degree of autonomy to the central bank to conduct monetary and financial policy in order to maintain macroeconomic stability for growth and contribute to poverty alleviation.

1.5 OBJECTIVES OF THE STUDY

Principle objective of this study is to examine the effectiveness of financial sector reforms in Nepal. Specifically, the study examines the institutional and policy changes in the financial sector, which were undertaken during 1980s and 1990s. The impact of the financial sector reforms is examined on the efficiency of savings mobilization and credit allocation to the private sector. Furthermore, the study attempts to analyze some of the problems which continue to persistent after the introduction of financial sector reforms, and aims to provide suggestions for further adjustments.

Major objective of this study is to assess the impact of policy changes in the financial sector, on financial development and economic growth in Nepal. Specific objectives of the study are:

1. To analyze the performance of Nepalese commercial banking sector representing overall financial sector of Nepal.
2. To examine the effects of financial sector reforms on financial development.
3. To study the causal relationship between financial development and economic growth.
4. To identify problems and inadequacies in the implementation of the improvement measures so far undertaken.
5. To recommend the areas of priority and reform actions in the light of effectiveness on the assessment of Financial Sector Reform.
6. To suggest strategy for further reforms in the financial sector.

1.6 HYPOTHESIS

In the light of the above said objectives, following are the hypothesis to be tested in the present study.

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. Effective prudential banking regulation and supervision promotes financial stability and enhance the safety and solvency of the banking system, and therefore increase the public confidence.
6. Reform in the financial sector improves the performance of commercial banks.
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.

1.7 SOURCES OF DATA AND METHODOLOGY

This 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 applied.

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.

In order to examine and analyze the foregoing objectives, this study uses statistical tools and method like, regression analysis, correlation coefficient, coefficient of variation, method of 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, 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 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 causality 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.

1.8 ORGANIZATION OF THE STUDY

The study is divided into six chapters. Chapter I is an introductory chapter which deals with 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 deals with the detail survey of review of literature. It comprises of contributions since 1950s until 2004.

Chapter III examines the financial system of Nepal. It studies the evolution of financial system, brief discussion of financial intermediaries and markets and includes the functions of Nepal Rastra Bank. Performance of commercial banks is analyzed by dividing the commercial banking sector into three groups, namely public sector banks, joint venture banks, and domestic private sector banks.

Chapter IV discusses the process of financial liberalization, reform experiences, and components of financial liberalization since 1975. It also discusses reform measures adopted in the financial sector since mid 1980s. The indices of financial liberalization and financial development are generated by using principal component method and causal relationship between the two indices is examined.

Chapter V deals with the direction of causality between financial development and economic growth. This chapter analyses the relationship among various macroeconomic, monetary and financial variables and financial development. For empirical analysis, the study assesses the relationship between financial development and its impact on savings, credit allocation, interest rate and growth and their impact on financial development.

Chapter VI is the concluding chapter. It summarizes major findings of the study and conclusions. 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. Finally, bibliography and some appendices follow.