Development of the Financial System and Its Impact on Poverty Alleviation in Nepal

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The article reviews briefly the financial and monetary developments in Nepal since the mid-fifties both in developmental and poverty perspectives. Particularly, the role of the banking sector in rural financing and specific poverty targeted programs is reviewed in detail. Impact analysis is made on the basis of availability of data. The article concludes that, in spite of the tremendous growth of the financial sector in the post-liberalization period, its penetration in the rural areas has declined. There seem to be no backward or forward linkages of this financial development with the real sectors of the economy and, consequently, to poverty alleviation. Though government and non-government micro-financing institutions and also the cooperatives have grown fast in the 1990s, they are also concentrated in urban areas. The plethora of targeted credit programs has made very little dent in the rural credit market. More than 80 percent of the borrowing households have still to depend on non-formal sources for their credit needs. Majority of the targeted credit programs have been unable to directly cater to the needs of the bottom 20 percent households because the poor lack other resources and knowledge to benefit from the saving-credit programs. Lastly, inadequacy of financial and monetary data for evaluating the impact of financial development on the economy as well as on poverty is noted.

INTRODUCTION

The overall economic objective of adjustment program in Nepal has been alleviation of widespread poverty, based on sustainable economic growth achieved through all-round liberalisation including in the financial sector. Monetary management, in principle, was geared to curbing inflation and stimulating growth.

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Nepal started to implement structural adjustment reforms from mid-eighties. The process was disrupted by Nepal-India trade and transit impasse and the subsequent political upheavals. It was accelerated significantly since 1991. Various authors have assessed the impact of such reforms on the economy. An emerging consensus is that the macroeconomic indicators such as balance of payments, fiscal deficit and financial indicators did improve. A significant progress has been made in human development indicators also. But the growth rate has remained sluggish and income poverty has hardly declined (HDR, 2002, Prennusi, 1999**;** Khan, 2000; NPC, 2002; Acharya and Khatiwada, 2003). Domestic saving rate has improved only marginally.

The Tenth Plan (2002/03 – 2006/07) proposes to continue the emphasis on reduction of poverty as the overriding objective of the Plan as in the Ninth Plan. An action plan for poverty reduction has also been prepared. The target is to reduce the population below poverty level to 30 percent by the year 2007. Liberalization of the economy for accelerated growth of the modern sector and concentration of government resources on physical and social infrastructure were the primary strategies envisaged in the Ninth Plan. The Tenth Plan proposes to continue this strategy. Increased market access to farm products through expansion of road network and improved distribution of fertilizer, seeds and agricultural extension services are seen as the basic interventions for accelerating agricultural growth and achieving poverty reduction. The broad-based privatization process and wide ranging external liberalization were, and are still, expected to lead to structural transformation of the economy and accelerated economic growth, generation of more employment and income for the poor and, eventually, reduction in poverty. The fact that the country failed to achieve the goal of poverty reduction during the Eighth or the Ninth Plan, in spite of these policies, is attributed primarily to factors external to the economy and lack of good governance.

Further structural reforms, however, are to be accompanied by targeted anti-poverty programs, primarily credit-based, on a wider scale and special focus on development of remote areas and special facilities to disadvantaged communities, so as to address the issues of increasing inequality of income and access to resources and opportunities. Mainstreaming women and other disadvantaged groups into the development process is outlined as a major strategy for poverty reduction. Good governance is also underlined as a necessary condition for achieving poverty reduction.

Nevertheless, the basic questions remain. The transmission-path of impulses from market oriented macro-economic structural adjustment to growth and from growth to poverty alleviation is still not worked out in reference to the specific features of the Nepalese economy. Past failures have not been analyzed adequately to design appropriate interventions. For example, the reform in the financial sector is an important part of the package designed to accelerate growth through redistribution of credit to the "more productive sector" and hence increase employment and income of the poor automatically. But the fact that the financial liberalization in the past has not led to redistribution of credit to more employment generation, rural sectors have neither been analyzed nor effective counteracting measures thought out. This paper reviews the past financial sector developments in the country from a growth stimulation, increased access of the poor to financial resources and then poverty reduction.

II. FINANCIAL DEVELOPMENTS AND THE LIBERALIZATION PROCESS

The history of financial developments in Nepal may be divided in three phases, 1937-1956, 1956-1985 and post-1985. Nepal Bank Limited, the first commercial bank in the country, was established as a joint venture between the government (51 percent share) and the private sector (49 percent share) in 1937. That was the only bank and financial institution in the country until 1956. Before the establishment of the Nepal Bank Ltd, Nepalese nationals had to keep their savings either in cash or in the Indian banks. All external transactions were effected through Indian banks. Nepal had no central bank until 1956, when the Nepal Rastra Bank (NRB) was established. The central banking functions were shared between Reserve Bank of India and Revenue and Minting Department in the Ministry of Finance in Nepal.

NRB was established in 1956, and then on, the development of the financial system gained momentum. Within a decade, a number of institutions were established in the public sector. These included Nepal Industrial Development Corporation (NIDC), Agriculture Development Bank (ADB\N) and the Employees Provident Fund Corporation, Rastriya Banijya Bank, the Credit Guarantee Corporation, Nepal Insurance Corporation and the Securities Marketing Centre. Besides setting up new institutions, NRB partially subsidised branch expansion of the commercial banks between 1970 and 1989, because commercial banks tended to concentrate in urban areas to avoid higher cost of rural operations.

The banking habit expanded, banks were able to mobilise increased proportion of private savings and direct them for investment in newer forms of activities (Table 1). Between 1960 and 1970, both deposits with the banking system and total credit expanded rapidly.

Table 1. Selected Indicators of Banking and Monetary Developments (1960-2000)

Mid- July	Outstanding Rs. in Million				Percent Credit/ Deposit	Inflation Adjusted % Interim Period Annual Growth Rate	
	Deposit[1]	Credit[2]	Money- M_1	Broad Money-M_2		Deposit	Credit
1960	72	32	174	201	44.6	na	na
1965	130	107	446	490	82.4	na	na
1970	401	297	763	975	74.3	27.8	11.1
1975	1,166	1,222	1,338	2,064	104.8	12.3	20.3
1980	2,330	2,798	2,830	5,285	120.1	9.2	12.2
1985	8,536	5,489	5,480	12,297	64.3	18.3	4.4
1990	21,885	15,335	14,223	31,552	70.1	8.2	10.1
1995	61,046	46,915	32,985	80,985	76.9	10.4	12.5
2000	154,530	118,008	60,980	186,121	76.4	11.7	11.5

1. Excludes inter-bank deposits and government deposits, but includes foreign deposits.
2. Excludes investment in Government securities and includes foreign bills purchased and discounted.

Source: Acharya and Khatiwada, 2003.

NRB started its intervention in the credit market for the first time in 1966. In early years, interest rates were used primarily as instrument for mobilisation of financial resources and directing credit to specific activities. In 1975, the interest rates were drastically revised upwards with the objective of monetary management. The changes in interest rates led to significant increase in the collection of savings and fixed deposits and slowed down expansion of credit to a negative growth in real terms in subsequent two years. But the effect of interest rate rise was one short affair lasting only up to 1976/77.

In the next year, credit expansion rate galloped to nearly 28 percent in real terms while deposit collection decelerated to about 6 percent. By the end of 1979/80, credit/deposit ratio was up to 120.0 percent. The pressure on foreign exchange reserves, particularly Indian Rupee reserves, was turning acute. Deposit rates were revised upwards once again in 1982 to mop up the liquidity in the system for correcting the emerging balance of payment gap. A comprehensive rationalization of the interest rate structure with substantial upward revision in the priority lending rates was also effected. However, the balance of payment situation did not improve until the end of 1985 and the Nepalese Rupee was devaluated drastically in November 1985.

The financial system remained small, with limited penetration in the economy. It remained inefficient with high cost of financial intermediation, weak management, obsolete financing modalities, poor service delivery, dualism with the domination of informal financial market and low level of financial intermediation as indicated by relatively low proportion of M2 to GDP. While M1/GDP ratio indicates monetization of the economy, M2/GDP captures both monetization and penetration of the banking sector in savings mobilizations. Nepal lagged behind most of the Asian countries in fixed and savings deposit mobilisation (Table 2) and had a much lower ratio of M2 to GDP. In recent years, it is catching up fast.

Table 2. Financial Deepening in Selected Asian Countries, 1980, 1990 and 2000

Countries	M1/GDP(%)			M2/GDP (%)		
	1980	1990	2000	1980	1990	2000
Bangladesh	10.2	8.9	9.4	20.4	31.8	36.8
India	15.0	15.9	17.9	37.0	45.1	59.8
Nepal	12.1	14.3	16.7	22.6	31.6	50.9
Pakistan	28.5	29.7	27.6	41.6	39.1	46.5
Sri Lanka	14.0	12.3	9.4	32.0	28.5	38.2
Thailand	10.8	8.9	14.0	38.0	70.0	105.9
Malaysia	18.3	21.3	23.8	32.7	64.4	102.6
Indonesia	11.0	11.3	12.1	17.0	35.4	57.5
South Korea	10.1	8.9	9.2	33.2	38.4	68.1

Source: Acharya and Khatiwada, 2003.

The financial system reforms started in this background. Liberalisation of interest rates started in 1984 when commercial banks were given autonomy to fix interest rates over and above the NRB rates by 1.5 percentage points on saving and

1 percentage point on term deposits. The interest rates were completely liberalised in 1989 leaving them to the market forces.

Foreign capital was accepted in the banking business for the first time in 1984, with the establishment of the Nepal Arab Bank Limited, as a joint venture with foreign and local capital participation. The Commercial Bank Act (1974) had already set out regulations for licensing and supervision of the commercial banks in the private sector. The domestic private sector, it seems, was too weak to venture into banking on its own.

However, all these liberalisation measures and freeing of interest rates from NRB control did not result in reducing the lending rates or extending the banking facilities to new areas or to emergence of new kind of services. The commercial banks colluded to lower the term and fixed deposit rates without changing the lending rates. Banks remained with excess liquidity but did not make efforts to expand their operations by providing cheaper credit. This clearly was a move towards oligopoly in credit pricing, to exploit market imperfections for increasing the interest spread between loan and deposit rates.

On the other hand, a dearth of financial instrument was felt in the market. As a consequence, traditional informal financial activities such as *Dhikuri, Dhukuti* and other systems, characteristic to the rural economy, emerged in the urban areas as well. Initially such credit groups were small in nature and limited to special groups of family and friends. Once they started to capture the imagination of the larger number of people, and expand beyond family and friends, the risk of fraud emerged on a wide scale. The emergence of informal financial flows on a large scale became a matter of concern to the Government and the Central Bank. Measures were formulated to bring such flows within the policy net.

Further initiatives taken to promote financial development included establishment of the Housing Development Finance Company (1992) and five Grameen Bank (Bangaladesh) clones, the Regional Rural Development Banks (RRDBs) and permission to co-operatives and the non-government organisations (NGOs) to undertake limited banking transactions. Such authorisations were issued by the NRB to Credit Co-operative Societies, registered under the new Co-operative Act of 1992 and the NGOs, registered under the Social Service Registration Act of 1978, starting 1993. The main objectives intended to provide banking services and credit to the poor.

III. FINANCIAL GROWTH AND DEEPENING.

Emerging Financial Structure

As a consequence of all these liberalization measures, the number and variety of financial institutions, their financial assets and variety of instruments have grown significantly. The number of financial institutions grew from 6 to 136 between 1980/81 to 2000 (Table 3). These 136 financial institutions, registered with NRB, have more than 1060 branches, but mostly concentrated in urban areas. The emerging financial spectrum features several tiers of institutions catering to the various segments of the economy and the sections of the population. Inter-linkages among the various kinds and levels of institutions are still fluid and developing (see chart 1). With the growth in their number, financial institutions have also diversified their products and services.

The emerging institutions may be classified into three broad categories--formal financial institution, semi-formal financial institutions and co-operatives, and informal financial institutions. Chart 1 below presents a snapshot of the financial sector institutional scenario as of Mid-July 2000.

Commercial banks lend for short term trading, for meeting working capital needs of industries and business, and for consumption and social functions against sufficient collateral. They are directed by the NRB to provide credit to priority and deprived sectors. The Nepal Bank Limited and the Rastriya Banijya Bank dominate the banking system. These two older banks have branches in all the districts, but located mostly in the urban and town areas, or near the highways. Private sector banks operate only in larger cities and metropolis with concentration of business community and industries.

Table 3: Number and Total Assets of Banks and Financial Institutions (Mid-July 2000)

	Number of Institutions	***Total Assets*** (In Million Rs.)	Percent Shares
Commercial Banks	13	210894.5	66.6
(State-owned)	(2)	(99658.5)	(47.3)
(Private sector)	(11)	(111236.0)	(52.7)
ADB/N	1	25652.6	8.1
NIDC	1	2527.5	0.8
Employees Provident Fund	1	22115.7	7.0
Finance Companies	48	13058.5	4.1
Co-operatives	34	1483.0	0.5
RRDBs	***5***	1549.3	0.5
Insurance Company*	13	4074	1.3
(State-owned)	(1)	(3163)	(1.0)
(Private sector)	***(12)***	(911)	(0.3)
Others*	***20***	35298.2	11.1
Total	*136*	*316653.3*	*100.0*

**** 1998/99***

Source: NRB Economic Report, 1999/2000; Banking and Financial Statistics, 2000, NRB.

Commercial bank clients generally from upper and middle class are conscious about the credit availability. Further, the joint venture banks concentrate on export business and foreign transactions. They are dealing with the big business houses, elite population, and institutions in education, health, consulting services, etc. and do not get directly involved in the priority lending.

The two development banks, NIDC and the ADB/N, are publicly-owned. The NIDC is currently unable to meet existing loan commitments and substantial parts of its portfolio are non-performing. ADB/N also has huge backlogs of overdues. The five RRDBs are focusing on micro-credit and displaying fairly high repayment rates though some of them have been adversely affected due to the deterioration in the law and order situation until some few months back. Three NGOs, namely, Nirdhan and CSD, and DEPROSC were replicating the Grameen model in their credit transactions, until recently. Two of them, Nirdahan and DEPROSC, have now converted themselves into development banks. Recently, a Rural Micro-finance Development Centre (RMDC) has been established as an apex wholesale rural credit institution, from which all rural financing institutions may borrow including ADB/N, RRDBs and other Grameen bank clones, Cooperatives and NGOs engaged in financial operations. However, public sector financial institutions and the non-formal smaller NGOs lack access to RMDC resources as a number of stringent prudential norms need to be fulfilled by the borrowing institution.

Chart 1. Current Structure of the Financial System

The number of finance companies has grown from none to 48 within ten years. They accept fixed-term deposits, usually at higher rates of interest, attracting the shallow fund in the informal market. They offer new and more flexible investment options and have developed various instruments. They lend for longer terms than the banks on hire purchase, housing and transport vehicles like trucks, cars, scooters, etc. They are associated with a cluster of family or business "houses" and banks as well. Most of the finance companies also are located and operate in urban areas. Only a few of them, established outside the Katmandu Valley, are providing a limited amount of rural and micro credit to their clients.

Including one Deposit Insurance and Credit Guarantee Corporation, which guarantees priority sector lending of the commercial banks, there were 13 Insurance Companies as of mid-July 2000. Eleven privately-owned insurance companies have been established and have grown rapidly. The only institution dealing with the provident fund, the Provident Fund Corporation, has captive funds collected from government and corporate employees.

Among the semi-formal financial institutions, Savings and Credit Co-operative Societies have most prominent role. As per NRB Report (2000), they numbered 1574, of which, 34 were authorised by the NRB for limited banking transactions. Others operate among their own members without NRB permit, which are allowed under the Co-operatives Act. There are about 25,000 NGOs promoting savings and credit groups. They lend limited amounts to such groups. Among the NGOs, only 25 were licensed by NRB as of July 2000, to operate banking transactions. There are 116 Postal Savings Bank outlets for collection of deposits.

Financial Deepening

The ratio of all financial assets to gross domestic product indicates financial deepening in the economy. Total financial assets as of mid-July 2000 is estimated at more than Rs 277 billion, which accounted for nearly 76 percent of GDP (Table 4). The ratio was 32 percent in 1990 and 29 percent in 1985, the year when the door for foreign participation in banking industry was opened. These figures indicate increasing role of financial sector in the Nepalese economy.

The commercial bank deposit and credit ratios to GDP measure the importance of the banking system in the economic activities of the country. The deposit/GDP ratio surged up to 42 percent as of mid-July 2000, which was only 10 percent in 1980 and 22 percent in 1990. The growth in credit/GDP ratio has been slower. This ratio reached 32 percent in 2000 from 12 percent in 1980 and 15 percent in 1990. Comparing the growth during the eighties and nineties, it is clearly seen that, while the deposit/GDP ratio grew much faster during the eighties, the growth of credit/GDP ratio was much faster during the nineties. Increasing credit to GDP ratio indicates that the role of credit is expanding fast as a source of funding for economic activities in the country. This is quite in consonance with the increasing role of non-agricultural sector in the economy, which depends more on bank credit than agriculture in developing countries.

Table 4. Selected Indicators of Financial Sector Growth

Description	1975	1980	1985	1990	1995	1999	2000
Population (in million)	12.9	14.6	16.3	18.1	20.3	22.4	22.9
Overall Financial Sector:							
Total Financial Assets (Rs. million).	2322	5594	13011	32426	109597	230238	277281
Total Financial Assets/ GDP (%)	14.0	24.0	29.3	32.5	52.2	69.8	75.9
Commercial Banking:							
Total Bank Branches(no.)	216	241	380	442	444	481	478
Popn. per Com. Bank Branch (in thousand)	59.58	60.58	42.89	40.95	45.72	46.57	47.91
Bank Assets (Rs. million)	2006	4542	10535	26854	83971	172458	210894
Bank Assets/GDP (%)	12.1	19.5	23.7	26.9	40.0	52.3	57.7
Deposit/GDP (%)	7.0	10.0	19.2	22.0	29.1	38.4	42.3
Credit/GDP (%)	7.4	12.0	12.4	15.4	22.3	30.1	32.3
Credit/ Deposit (%)	104.8	120.1	64.3	70.1	76.9	78.3	76.4
Pvt. Sec. Credit/Total Credit (%)	64.1	68.5	73.5	76.2	89.4	91.4	92.7
Financial Deepening:							
Money(M1)/GDP (%)	8.1	12.1	12.3	14.3	15.7	15.5	16.7
Broad Money(M2)/GDP (%)	12.4	22.6	27.7	31.6	38.6	46.3	50.9

* Including ADB/N.

\# Includes Com. Banks, NIDC, ADB, EPF, Finance Com, Co-operatives and RRDBs.

Source: Acharya and Khatiwada, 2003.

The ratio of private sector credit to total credit indicates the degree of privatisation of organised sector economic activities. In recent years, almost total bank credit has been channelled to the private sector indicating an increasing privatisation of the economy. During the 1980s, about 1/3 of the bank credit had gone to the government sector.

Liberalisation, however, has completely failed to streamline the commercial banking system in the country as expected. Overdue loans and inefficiency had been aggravated in the 1990s. The older and the larger of the commercial banks with their wide rural networks have been made to compete with the new trim banks with no rural operations. This has two unwanted consequences. On the one hand, it has allowed the new banks to make huge profits as their operating costs are much lower than that of the older banks. On the other, the economic viability of older banks is eroding faster as all their lucrative business such as the low-cost donor transactions and export financing have been cornered by the private sector banks, while high cost rural operations remain with them. Financial liberalisation process, it seems, should have been preceded by a thorough overhauling of the older banks and a decision to infuse private sector capital and management in the same. The two older banks have a high proportion of non-performing loans, which was around 18 percent of the total loan in 2000 (Article IV Consultation Report of IMF, 2001). As a consequence, the government has contracted out their management to foreign private sector parties. But recent evidences are indicating that the newer banks also have window-dressed their balance sheets to show higher performance than warranted by reality. Overdue has been reduced to a substantial extent by rescheduling.

Moreover, the commercial banks, domestic or joint venture, have shown little innovation and positive attitude in identifying new areas of saving and investment opportunities. They have rather preferred to cater to the traditional larger urban savers and invest in safe and gilt-edged government securities and treasury bills. This kind of investment involves no additional administrative cost and is easily convertible into ready cash in the secondary window operated by NRB.

On the positive side, after 1990 when the financial sector entry was liberalised completely, the number of financial institutions and co-operatives has exploded. The micro-credit programs also have been redesigned to pay equal attention to savings and credit. The finance companies have introduced new instruments of savings and credit in the economy. The co-operatives are serving the needs of smaller urban and sub-urban borrowers and savers with their door-to door schemes and catering to a large section of the educated unemployed. However, all their activities are still concentrated in urban and sub-urban areas and hardly cater to the needs of the poor in urban or rural areas (NRB, 2001). Number of failures of co-operatives in recent months has also shown a severe lack of supervision and control of such micro-financing institutions.

IV. Impact on Poverty Alleviation

The financial sector developments may affect the poor both directly and indirectly. This sector may help in alleviation of poverty directly by spreading deposit and credit facilities with innovative instruments for the poorer sections of the population and promoting investment in rural areas, where most of the poor live, and by participating in various anti-poverty credit schemes. Indirectly, monetary policies and financial sector developments may help the poor by facilitating employment intensive productive investment in the economy, controlling inflation and providing employment to the educated unemployed. The last has been listed among the indirect channels of transmission effects of financial activities because the poor are mostly uneducated and unemployable directly in the financial sector.

As far as inflation rate is concerned, it is really difficult to measure the effectiveness of monetary policy in managing price-level in Nepal, as in all open economies. Nepal's monetary policy acts on inflation rate, largely through the Indian Rupee reserve and exchange rate with that currency, in the long run. In the short run, the exchange rate with Indian Rupee is fixed. Because of the relative openness of the economy towards the Indian market and full convertibility of Indian Rupees in Nepal, the first impact of monetary policy is on Indian Rupee reserves, but with some lag (Khatiwada, 1981). As a consequence, in Nepal, demand for money has conventionally been estimated, taking inflation rate as an independent variable along with monetization rate and real GDP growth rates. Inflation rate has fallen throughout the nineties barring 1992, when both India and Nepal devalued their currencies substantially and it has remained more or less at a moderate level for the last decade.

Savings Facilitation

The previous section dealt briefly with the fact that there has been little innovations in the pattern of banking transactions as far as commercial banks are concerned. It would have been very useful to construct a fund flow chart to study from which sections of the population do the various kinds of institutions and the commercial banks derive their funds and where they invest. Adequate information is not available for such a construct. The following analysis tries to examine the relevant issues from available information.

Given the limited scale of organised financial market in relation to the overall economy, it is hard to judge about its impact on the overall savings rate. The average domestic savings rate improved from 10.7 percent in the late eighties to 14.6 percent in the late nineties. But given the much higher interest rate in the informal market and their predominating role in the credit market, formal sector interest rates and institutional expansion can hardly be taken as a determinating factor in overall domestic savings rate. The following regression results support this conclusion:

The equation below explaining the level of real domestic saving (RS) has been specified as:

$$\ln(RS) = c_0 + c_1 \ln RGDP + c_2 RI + U$$

Where RGDP is real gross domestic product, RI real interest rate & U an error term.

Estimation of the above equation for the period 1981-2001 reveals the following result:

$$\ln(RS) = \underset{(-4.7)^*}{-8.9} + \underset{(9.5)^*}{1.6} \ln RGDP + \underset{(1.7)}{.01} RI$$

$\bar{R}^2 = 0.93$, $F= 76.6$, $DW= 1.84$, $\rho= 0.38$

(Figures in the parentheses are t ratios, ρ is auto-correlation coefficient, and * means significant at 5 per cent level).

The regression result shows real income as the significant determinant of real savings. Interest rate also positively affects savings, but it does not have statistically significant impact. This is again consistent with the economic fundamentals of the country where saving propensity is governed more by the level of income (ability to save) than the incentives provided for bank savings (interest rate).

Liberalisation policies, especially the liberalisation of financial sector, and the promotion of capital market, however, might have added impetus to financial savings. A substantial increase in bank deposits in real terms as indicated by commercial bank term deposit/GDP ratio and deposits mobilised by emerging finance companies and co-operatives in this period support this conclusion.

Theoretically, demand for time deposits is determined by the level of income (ability to save) and interest rate on deposits (willingness to save in the form of bank deposits). Accordingly, an equation explaining the changes in real time deposit (DRTD) can be specified as:

$$\ln(DRTD) = b_0 + b_1 \ln RGDP + b_2 RI + U$$

Estimation of the above equation for the period 1981-2001 reveals the following result:

$$\ln(DRTD) = \underset{(-3.7)^*}{-20.1} + \underset{(2.5)^*}{2.46} \ln RGDP + \underset{(1.5)}{.06} RI$$

$\bar{R}^2 = 0.60$, F= 13.3, DW= 2.2

(Figures in the parentheses are t ratios, and * means significance at 5 percent level).

The regression of changes in real time deposit against real output (RGDP) and real interest rate shows real output as the significant determinant of time deposits. Interest rate also positively affects time deposit collection at banks. But it does not have statistically significant impact on time deposit demand. This is once again consistent with the economic reality of the country where poverty and informal financial transactions predominate. Moreover, when there are limited financial instruments available for small savings in the formal financial market and there is a large unorganized market for credit, bank interest rate is less likely to determine the rate of deposit collection at the banks.

As regards the structure of the credit market, notwithstanding the number of financial institutions, commercial banks overwhelmingly dominate the formal credit market (Table 5). Finance companies have only about 5 percent of the credit-deposit transactions. Cooperatives or RRDBs play only marginal role. Therefore, it is most important to analyse commercial bank's lending portfolio in a poverty perspective.

Table 5: Role of Various Financial Institutions in the Credit Market, 1999/2000

Financial Institutions	Credit		Deposit	
	Million Rs.	Percent	Million Rs.	Percent
Commercial Banks	136184.8	81.8	154530.3	85.1
Agricultural Dev. Bank	12883	7.7	15803.3	8.7
NIDC	2242.9	1.3	315	0.2
Finance Companies	9057.9	5.4	9744.4	5.4
Co-operatives	875.1	0.5	1073.2	0.6
RRDBs	733.2	0.4	218.1	0.1
Total	*166545.3*	*100.0*	*181684.3*	*100.0*

Source: NRB, Economic Report, 1999/2000.
NRB, Banking and Financial Statistics, 1999/2000.

The major issue is whether the commercial bank collective lending portfolio reflects the national priorities in terms of promoting pro-poor growth in the country. A second issue is whether they do lend to the smaller households and cottage level enterprises. With the financial liberalisation and proliferation of saving-credit community groups, whether they lend directly to the poor has become secondary.

Overall Lending Portfolio of the Commercial Banks

It was stated earlier that Nepal's formal financial system caters largely to urban population and this urban bias has increased in recent years. The purpose-wise lending portfolio of the commercial banks did show a significant change in the pattern of lending in favour of agriculture and industry until 1989/90 (Table 6). In the 1990s, the share of agriculture in commercial bank lending portfolio has declined by 4.1 percentage points. Given the importance of agriculture for reduction in poverty, this is an issue of real concern. However, it is a positive trend that the share of industry in the overall lending of these banks is increasing significantly compared to other headings. It is also clear from the decline in the proportion of social and general purpose lending that smaller borrowers have been crowded out in the commercial bank lending, as most of the small borrowers borrowed pledging gold or landed property under this heading.

Table 6. Purpose-wise Outstanding Loans of the Commercial Banks (Mid-July)

Sector	1975	1980	1985	1990	1995	2000
Agriculture	0.1	0.9	3.2	13.0	12.1	8.9
Industry	5.1	12.0	18.8	32.4	39.1	45.1
Commerce	45.5	62.2	44.1	28.6	32.8	32.9
General Uses & Social	48.0	21.0	30.0	23.6	11.8	7.3
Other	1.4	4.0	3.9	2.5	4.2	5.7
Total	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*

Source: Acharya and Khatiwada, 2003

The security-wise lending portfolio of the commercial banks also shows some significant changes in their lending patterns (Table 7). The importance of gold and rice and paddy loans has declined substantially, indicating a trend of declining rural lending as also declining marketable surplus of rural households in grains. Proportionately, the importance of other agricultural products, which includes wheat, oilseeds, potatoes and other cash crops, as security has increased in the bank lending portfolio. However, the huge bulge in unclassified lending reaching up to 42 percent in 1999 does not allow for a more realistic analysis of bank lending portfolio.

Table 7. Security-wise Lending Portfolio of the Commercial Banks (Mid-July)

Securities	1980	1985	1990	1995	2000
Gold and silver	16.8	20.0	12.6	5.3	2.2
Government securities	0.9	0.7	1.7	1.1	1.1
Non-govt. securities	2.4	4.3	5.2	1.5	1.5
Rice and paddy	7.4	6.2	3.0	2.2	1.3
Other agricultural products	4.5	5.9	12.7	10.5	9.0
Cloth, yarn, machinery & other goods	19.3	11.5	7.7	5.6	5.0
Export bills, purchase & credit	5.3	5.7	2.5	2.1	2.5
Import bills, LC & other foreign bills	11.4	6.6	8.7	9.9	6.6
Domestic bills, purchase & credit	2.6	1.7	0.6	0.4	0.4
Overdraft and guarantee	22.8	20.1	14.9	21.7	22.9
House and land	3.7	9.0	0.8	4.0	5.0
Miscellaneous	2.8	8.4	29.6	35.5	42.4
Total	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*

Source: Acharya and Khatiwada, 2003

Rural Banking

Since the majority of the poor live and work in rural areas, the flow of credit to rural areas may be taken as one of the indicators of financial sector role in poverty alleviation. Until about the establishment of ADB/N and RBB, with direct incentive from NRB for commercial branch expansion, the commercial bank branches were concentrated in large cities and trading centers in the Terai. Their rural branch expansion gained speed after NRB introduced the incentive system for this purpose. Between 1980-1990, the commercial bank branches increased by 219. Of these, 146 branches were established in rural areas. The proportion of commercial bank's rural branches in total seems to have increased during 1980-1985 and 1990-1995, in spite of the discontinuation of subsidy from NRB and the financial liberalisation. However, between 1995-2000, it has come down by more than ten percentage points (Table 8).

Table 8. Rural / Urban Distribution of Commercial Bank Branches

Years	Total	Rural	Urban	Rural as % of Total
1977	216	141	75	65.3
1980	241	154	87	63.9
1985	383	267	116	69.7
1990	460	300	160	65.2
1995	444	310	134	69.8
2000	478	285	193	59.6

* Includes ADB/N's Commercial Banking Branches.

The declining trend in the proportion of rural in the overall deposit and lending portfolio of the commercial banks is already visible between 1985 and 1990 (Table 9). The figures are not available for later years.

*Table 9. Rural /Urban Credit Operations of The Commercial Banks**
(In million Rs.)

Mid-	Deposits				Credit & Investment			
July	Rural	Urban	Total	Rural %	Rural	Urban	Total	Rural %
1977	341.2	1727.8	2069.0	16.5	217.4	1423.9	1641.3	13.2
1980	634.3	2627.2	3261.5	19.4	491.6	2689.6	3181.2	15.4
1985	1474.2	6617.3	8091.5	18.2	1534.0	4930.4	6464.4	23.7
1990	3213.2	18193.6	21406.8	15.0	2740.0	13269.5	16009.5	17.1
1995	na	na	61193.3	n.a.	na	na	48412.9	n.a.
2000	na	na	154943.0	n.a.	na	na	114292.1	n.a.

* Includes ADB/N's Commercial Banking Activities.
Source: NRB, 2001

Despite the branch expansion during 1980s, the financial sector still showed little capacity to absorb small urban or rural savings and serve the credit needs of the small borrowers, rural or urban. Hills and mountains have had few financial facilities for small savings mobilisation. In Terai areas bordering India, savings also flowed to the banks across the border, although Nepal offered higher nominal and positive interest rates. The commercial banks limited their operations to large amounts--both in acceptance of deposits and lending. As far as commercial banks are concerned, this problem has been aggravated by liberalisation of the banking sector.

The minimum balance requirements in some Kathmandu Valley banks make them unapproachable even to the middle class families in the Valley. Bulk savers also have ability to negotiate on interest rates, which small savers lack. More evidences are available that average households in rural areas can save smaller amounts. But the commercial banks have shown little interest in this kind of savings. Given the oligopolistic cartelling, they are over liquid and have no need to innovate for deposit mobilisation. The supervisory and regulatory capacity of the NRB lacks required strength in order to regulate the commercial banks and finance companies properly.

Thus, the formal financial system continues to have an urban bias. Its liberalisation has helped to intensify this bias. Most of the formal credit institutions are concentrated in the urban or sub-urban areas because majority of modern sector activities take place in the urban areas and resources are concentrated there. Lack of infrastructure has further impeded financial sector activities in rural areas. The banks and other formal financial institutions have not been in easy access to the rural or urban population at lower echelons of income distribution. Liquidity position of the banking sector has remained above 40 percent throughout the nineties. The flow of credit from the finance companies has been meeting the consumption needs of the urban population.

Direct Employment Generation by the Banking System

Complete information on financial sector employment is not available. Table 10 features only commercial bank information. Employment in the commercial banks during the 1990s has probably increased only marginally in spite of the increased number of institutions, because restructuring exercises in the older bigger banks with government participation have down-sized their workforce. Similarly, while employment in the financial institutions has declined in older financial institutions, it should have expanded in the new ones. Probably large number of people is employed in co-operatives and the NGO sector. Grameen model employs much larger number per unit of credit. But no information is available on their employees.

Table 10. Direct Employment in Major Commercial Banks

Banks	Officers*	Non-Officers **	Total
Nepal Bank Limited	1024	5225	6249
Rastriya Banijya Bank	636	5208	5844
Nepal Arab Bank	120	263	383
Himalayan Bank Limited	79	246	325
Nepal Bangladesh Bank	61	252	313
Nepal Grindlays Bank	44	220	264
Everest Bank Limited	29	138	167
Nepal SBI Bank	43	88	131
Nepal Indo-Suez Bank	41	58	99
Bank of Kathmandu	27	71	98
Total	*2104*	*11769*	*13873*

* Officers and above.
** Non-Officers including Messenger.
Source: Respective Institutions, Kathmandu, December, 2000.

V. TARGETED CREDIT PROGRAMS FOR POVERTY ALLEVIATION

In spite of the establishment of ADB/N and RBB, by 1975 it was clear that they also could not reach the small borrowers or marginal farmers with their regular lending programs based on collateral and traditional savings instruments designed to cater to larger creditors/depositors. This experience of bank lending was shared by other developing countries. A search was on for new models of banking for reaching the poorer sections of the population. Hence came the first targeted credit program-SFDP-in 1975.

NRB, along with subsidising commercial bank branch expansion, introduced the concept of compulsory priority sector lending for the commercial banks in 1974 (NRB, 1979; 1996). This practice still continues. Under this scheme, the commercial banks are required to lend certain proportion of their deposits or credit to the sectors defined as the priority sector. In the year 1974, commercial banks were required to invest at least 5 percent of their total deposit liability in "small sector', latter redefined as "priority sector'. This percent has been changed many times since. The compulsory proportion for the priority sector relates to total loan portfolio since 1985. At present, the commercial banks are required to lend at least 12 percent of their loan portfolio to the priority sector, a quarter of which has to go to the deprived sector. The deprived sector comprises the households below officially defined poverty line.

The definition of the priority sector, however, has evolved through time, and currently it is quite broad including loans extended to ADB/N, RRDBs, co-operatives and NGOs by the commercial banks. Further, direct lending by the commercial banks for biogas plants, small hydro projects, captive generators, non-polluting vehicles, turbines etc. is also counted as priority lending. Moreover, credit under Production Credit for Rural Women (PCRW) and Micro-Credit for Women (MCPW), the first funded by various donor agencies including IFAD and second by the Asian Development Bank, also form part of this priority sector lending. Thus, the initial direct anti-poverty character of the priority sector lending requirement imposed on the commercial banks has been completely diluted except for the fact that within the 12 percent portfolio they are directed to lend at least a quarter (3.0 percentage points) to the deprived sector. The commercial banks, however, are allowed to count bulk lending to the RRDBs and other micro-lending institutions towards the fulfillment of the deprived sector requirements. Often, such lending comes back to the lending banks as fixed deposits.

The priority sector also comprised the Intensive Banking Program (IBP), operated on an area specific basis and based on the concept of project lending, and the Cottage and Small Industries (CSI) lending program, directed to the development of small-scale industries and funded by the World Bank between 1982 and 1991. IBP and CSI, nevertheless, may not be termed as micro-credit directed particularly to the poor. They helped grooming small entrepreneurs on a large scale and promoting employment to certain extent. But very little of such credit went to the poor directly.

Currently, there are several targeted credit programs in operation. These are mostly group-based credit programs, many of which require no tangible collateral. They individually cover limited areas but, in totality, might have significant influence in the unorganised credit market. An incomplete snapshot of their operation may be glimpsed from the table below (Table 11). Figures for total number of NGOs operating savings credit program in the country are not available. It is estimated that there are about 20,000 active NGOs in the country. All of them have some sort of saving-credit program operating through community groups. Similarly, a genuine cooperative movement has flourished with the liberalization of the financial system.

Thus, the financial market is clearly divided in two parts. The picture is very dualistic. The formal one comprising commercial banks and financial institutions caters mostly to the modern sector and the informal sector which comprises NGOs and co-operatives caters to the mass of the urban and rural small producers and consumers. The Agricultural Development Bank, the Grameen clones and the

NRB-registered NGOs seem to be playing an intermediary role catering to the needs of the agricultural and other small scale producers and consumers. ADB/N mobilises savings in urban as well and lends mostly for agriculture and agro-oriented enterprises under its development window. Grameen clones and NRB-registered NGOs may borrow from the commercial banks for further lending. No data are available on this kind of flow of funds. Therefore, we can not assess the efficacy of evolving financial structure to fulfill the financial needs of the economy as per the national priorities or poverty reduction. Only option is to review some of the targeted credit programs, which are seen as the major and primary interventions for poverty alleviation. Table 11 features information on their operations.

As of Mid-July 2000, major specialised credit institutions implementing micro-credit programs in the government sector, which includes SFDP (ADB/N) PCRW/MCPW and the Grameen clones in the government and non-government sectors, had lent a cumulative amount Rs. 11.6 billion since their start. They had organised 474 thousand men and women in slightly more than 105 thousand groups for micro-level income generating activities, and had induced them to generate group savings of Rs 481.9 million. Except for the SFDP groups, which could be mixed or involving only men or women, all other groups involve only women as members. Another Rs 426 million has been lent under UNDP-assisted Village Development Program (VDP) under Participatory District Development/Local Governance Programs (PDDP/LGP), which has been taken as a model for the operation of the proposed Poverty Fund. What is more important, this program has been able to mobilise larger amount of Rs 540 million from local savings.

Table 11. Targeted Credit Programs (Mid-July, 2000)

Programs/ Institutions	Cumulative Coverage Districts/VDCs	No of Groups Borrowers	Cumulative (Rs in '000) Disbursement	Savings
SFDP (ADB/N), 1999	75/587	21606/152595	5379664	66981
PCRW/MCPW, 1999	67/624	22346/113606	662974	53473
MCPW/NGOs,1999	17**/96	5872/19215	139273	51382
Grameen Bank Replications				
RRDBs	38/819	25989*/127107	4230305	220712
CSD+Nirdhan	17/405	14798/61786	1237283	89401
SFCL	31/105	8827/60626	380340	102046
PDDP/VDP	30/313	7311/198474	272000	130500
LGP/VDP	28/206	5509/39440	153900	410000

* 1999 figures.

** Twelve districts and 5 urban centres.

Sources: Agriculture Development Bank Paper 2000, Women Development Program, Progress Report, Women Development Division, 2001; Non-Bank Financial Statistics, Jan. 2001, NRB; LGP Annual Report, 2000; PDDP, the Year in Review, 2000; Economic Survey, 2000/ 2001,MOF, HMG.

These programs have shown that a substantial amount of resources can be generated from rural savings and credit schemes, which can be used for small-scale credit needs for facilitating income generation activities at the individual and community levels. This is of great importance in a country where most of the population is poor by international standards, and where existing domestic savings rates are very low.

SFDP was started by ADB/N in three sites in Nepal on experimental basis, with FAO funding, in 1975. Under SFDP, small and marginal farmers were organised in groups and could borrow from the ADB/N on group guarantee. Thus began the history of group-based micro-financing in Nepal. With resounding success in pilot sites, SFDP sites multiplied fast since 1980. A number of donors including the Asian Development Bank funded the program on a large scale. This fast expansion, often on political demand, led to severe delinquency problems later on and a search for new models started. SFDP also had a women's component started in 1982. This was merged with SFDP in early nineties. The Small Farmer Credit Ltds (SFCL) are federations of small farmer groups organised under SFDP. They function as co-operatives**.**

PCRW was also introduced in 1982. This was first of its kind, which aimed to mainstream women into the existing credit market. Objectives set were: (a) to increase the income levels of women from poor rural households by promoting their small-scale production activities through provision of credit, training, and other complementary inputs as a package for them, (b) to develop self-confidence among rural women so that they would be able to undertake community development activities by themselves, and (c) to develop an effective delivery mechanism to channel resources to women at the grassroots level using existing banking channels.

The program is operated by the Women Development Division (WDD), which was under the Ministry of Local Development until mid-July 2001. Since then it has been transferred to the Ministry of Women and Social Welfare. It maintains a Women Development Officer and a Women Development Section at the district level with a few staff and a few field workers at the village sites where the program operates. Although as of Mid July 2001, PCRW was operating in 67 districts, it is an area-based program covering small pockets in villages. At that date, it had covered 624 Village Development Committees (VDCs). Currently, the main source of fund of the program is from IFAD, channelled through commercial banks and ADB/N. UNICEF has been supporting the social component and the staff cost of the program. Overdue, which constitutes 18 per cent, is its main problem in operations. Non-regularisation of the PCRW administration is another major problem.

MCPW was initiated in 1994 by the Ministry of Local Development from the lessons learnt from PCRW. The project was, and is, supported by Asian Development Bank, whose fund has been canalised through Nepal Bank Ltd. and Rastriya Banijya Bank. The primary aim of the project is to improve the socio-economic status of women and mainstreaming of women in national development through credit and other training and support in social preparation. The project seeks participation of NGOs in the delivery of credit. The Women Development Division, which operates PCRW, is the executing agency for group formation and training of women beneficiaries, and institutional support to NGOs. The idea is to develop NGOs as financial intermediaries in the supply of credit. But it also funds

PCRW directly. MCPW is operated in 12 districts and involves 95 NGOs. The loan recovery rate, so far, has been 100 per cent in the program.

MCPW is aimed at lending to women's micro-enterprises on a larger scale than PCRW or RRDBs (to be discussed below). Under PCRW, maximum loan size is Rs 30,000. RRDBs, although not specific about their maximum lending size, keep lending per client below Rs 25,000. Under MCPW, loans may go up to 250,000 as these are directed primarily for micro-enterprise development rather than poverty alleviation per se.

RRDBs and Other Grameen Clones: Since early 1990s, five Regional Rural Development Banks, one each in five Development Regions of the country, have been established. Primary objective set for them was to provide institutional credit to those poorer households, which still remained outside the reach of other targeted credit programs. The primary goal was to reduce poverty. Credit is provided mainly to women from rural households around market centres. But not all borrowers from RRDBs or similar NGOs are poor by the Nepalese standard.

Under this model, credit is provided for micro-level income generating activities. They start with small loans and the size of the loan may expand with consecutive loan-cycle. The progress of the client is observed closely and loans are supervised intensively. Clients have to follow weekly repayment schedule, whether the projects generate weekly income or not. Clients with alternative sources of income have obvious advantage in this respect. But very poor can borrow and pay from their wage-income, as there is no limit on minimum size of the loan. This model of lending is successful only when there are nearby markets to generate weekly income, and operate in non-remote hill towns and Tarai areas and nearby foothills. These banks are financed mainly from the equity capital, group fund and borrowings from NRB and commercial banks.

A number of NGOs also implement savings-credit program along the *Grameen* model. But only specialised banking NGOs, modelled along the Grameen Bank of Bangladesh, Centre for Self-help Development (CSD) and Nirdhan, run large scale credit programs, and only their activities are recorded centrally. Hence this analysis covers only their lending operations. Two of such NGOs, Nirdhan and DEPROSC have converted themselves into development banks, by now. Both the Rural Development Banks and the NGOs working in the rural finance do not require tangible collateral.

Co-operatives: Credit co-operatives have emerged as the next important institutional form catering to the clients in agriculture related activities. As per the NRB Report (2000), there were 1574 such credit cooperatives in the country. Of them, only 34 had been registered with NRB as of the survey date (2002). From a survey NRB concludes that cooperatives are also concentrated in the Kathmandu Valley and urban areas, and more than one half of their lending is for trading. Table 12.and 13 below provides information on their financial operations.

Table 12. Selected Financial Indicators of the Credit Cooperatives, 2000 (Rs. in million)

Indicators	NRB Registered	NRB not Registered	Overall Average
Capital Fund	38.6	49.3	44.0
Deposits	270.0	264.0	267.0
Credit	221.7	268.3	245.0
Profit on Capital Fund (%)	18.7	13.7	-

Source: NRB, 2002. Projected from 10% Survey.

Table13. Distribution of Average Credit Flow from Credit Cooperatives by Sector, 2000

Indicators	NRB Registered	NRB not Registered
Agriculture	15.0	3.0
Services	8.0	15.0
Manufacturing	6.0	2.0
Trade	42.0	56.0
Others	29.0	24.0
Total (%)	*100.0*	*100.0*

Source: NRB, 2002. Projected from 10% Survey.

The cooperatives play substantial role in the agricultural economy (Table 14). Nevertheless, data on Sajha role in early 1990s are not available for a historical analysis of their transactions in the 1990s. A definite positive factor is that they have become people's institutions, from the government-patronized Sajha. Resource mobilization has accelerated in rural areas. Liberalization of the financial sector has definitely played a positive role in strengthening the role of people's cooperatives.

Table 14. Selected Indicators on all Cooperatives, 1999/2000

Purpose of Loans	Rs. Million	Percent
A. Total Transactions		
Agricultural Inputs	375.4	34.6
Consumer Goods	94.1	8.7
Agricultural Products	81.7	7.5
Construction Materials	52.9	4.9
Milk	480.2	44.3
Other	0.3	0.0
Total	1084.6	100.0
B. Credit	*1157.8*	
C. Share Capital	*400.0*	
D. Members (000)	*1030*	

Source: The Department of Cooperatives, as quoted in NRB, 2002.

Other Programs: Besides, other numerous government, non-government and INGO programs have adopted savings-credit as a necessary element of social mobilisation. Even health-oriented mothers' groups might have their own savings-credit activities. Government has introduced one or other new credit programs intermittently to satisfy its political constituency. Finally, it has come to realise that all such programs can, and should, be managed under one umbrella in the form of the proposed Poverty Alleviation Fund. This Fund will adopt the modalities of operation at district level, developed by PDDP and LGP.

Explicitly stated objectives of the Participatory District Program (PDDP) and Local Governance Programme (LGP) are to assist government in developing a decentralised system of governance that promote self-reliance of local governments and communities. These programs have had large-scale donor funding during last five years. The only difference between PDDP and LGP is that the PDDP is under the NPC and the LGP is under the Ministry of Local Development.

What is relevant for the current analysis is the Village Development Programs introduced by them (VDP/ PDDP and VDP/LGP). From this year, VDPs have been extended to a total of 519 villages in 58 of Nepal's 75 districts. Both these programs are funded by UNDP and replicate exactly each other. They are supposed to build local capacities by strengthening village and district-level planning and management and mobilising local resources. But VDP has adopted savings-credit as its primary group organising principle. Theoretically, VDP is also experimenting with a bottom-up participatory process for development planning. VDP modalities of operation are:

- Social mobilisation of at least 80 percent of the households in the village into groups. Groups are ward-based and entry point is savings and credit. An office set up for social mobilisation at village level is funded for three years. Districts and VDCs are supposed to take over the office afterwards. The idea is to involve at least 80 percent of the households in this process. Both men and women are mobilised.
- Equipping local bodies with skills and expertise related to social mobilisation and at the household level, and planning, programming and implementation of social sector programs for poverty reduction.
- Providing seed capital and credit fund for community development, from which the community organisations may receive grant and group-members can borrow for individual enterprise.
- Mobilising local savings in community organisations.
- Establishment of a local trust fund at the district level to be managed by DDC, from which VDP groups may borrow. Until December 2000, with PDDP/LGP assistance, Local Trust Funds had been created in 39 districts, in which the DDCs act as the support organisation to promote and replicate the VDP.

Reaching the poorest of the poor and ensuring that the poorer sections of the population benefit more from the UNDP and government sponsored programs is still a problem to be solved in VDPs. Although, in contrast to earlier government and donor approaches in organisation of user groups, the VDP approach has taken the social mobilisation process to the settlement level and made it more comprehensive and sustainable, it is still a shop-keeper approach. Those who want to come are welcome. Consequently, so far program effectiveness has been demonstrated only in already advanced VDCs in advanced districts, e.g. Syanjya, Rupandehi, Sunsari, Kaski, Kavre etc., which already have had a large number of flourishing groups mobilized under various other programs.

Whether channelling total resources to villages through the VDP process alone would address the poverty issue on a larger scale is yet to be seen. The social mobilisers are not required to do door-to-door canvassing for group formation. The whole process is based on the political structure of the VDC, which is dominated by the rural elite. But these groups are supposed to be the only functioning groups in the village encompassing all activities at the grassroots level. All government and non-government resources are supposed to be directed to the people of the village only through these groups. Two kinds of risk are inherent in such processes. One is the reinforcement of the village hierarchy. For example, no community organisation in VDP areas has been noticed to break the drinking water barrier for the *Dalit* caste children in the village schools. Secondly, they may fall under the trap of the village politicians, as they did under the old Panchatyat system, whereby the ward chairman used to be the ex-officio chairman of all user groups and tended to use the groups in his own or his group's interest.

The UNDP-supported program has supplanted all earlier village-level initiatives by the government as well as local and national NGOs, as there is no room for their participation in the VDP process. Even very successful PCRW groups are being abandoned in favour of VDP-organised groups. This could be a positive trend as PCRW had very limited scope and women had to go through regular banking procedures for credit. But this may also have contributed to increasing the delinquency of PCRW loans. Sustainability of VDP programs is yet to be proved. Until the end of 2000, in no VDP had the UNDP-funded structures been withdrawn completely.

Further experts (Vaidya and Paudyal, 1999) opine that the whole approach is paternalistic that assumes that Nepalese people are ignorant, childlike and can not come together for collective action. It kills indigenous initiatives and, instead of creating self reliance, fosters dependency.

VI. OVERALL SOURCES AND ACCESS TO FORMAL CREDIT: AN IMPACT EVALUATION

The earlier programs, PCRW and SFDP/Women Development Program, were commended for their social components rather than for income generation per se (IIDS 1991-1992, Pradhan, 1995; Goonting, 1994). Social mobilisation, group formation, informal education and credit were felt to be powerful intervention strategies for reaching women effectively and for their empowerment across all sectoral programs. More recent programs focus primarily on credit as the organising principle, follow the clients closely, give increasing amount of credit with consecutive borrowings and have been found to help women economically to a greater extent. The Rural Development Banks and the NGOs working in the rural finance do not require tangible collateral actually in practice. These schemes have been highly successful in terms of credit operations, since most of the institutions including the Rural Development Banks have more than 98 percent repayment rate. VDP, which encompasses the objective of bottom-up planning, is yet to yield tangible results as the district plans originating from even the PDDP/LGP districts are not fully integrated into the national planning and budgeting process (Acharya and Write, 2000) nor has the participatory process of annual planning and budgeting been institutionalized properly so far (IIDS,2002).

In spite of multitude of programs, as per recorded data, ADB/N remains the foremost rural and agricultural financing institution accounting for 56 percent of the total rural credit supply from formal channels. Commercial banks are the second largest institutional sources for rural credit. They account for nearly 39 percent of rural credit from the formal sources. But the cooperatives as a whole are coming up as the third largest group of lenders with a total outstanding lending of nearly Rs.1.3 billion. Even net of their loans of Rs. 667.6 million (primarily from the commercial banks and ADB/N), their outstanding credit is more than Rs 598 million. The role of the five Grameen models in rural micro financing has increased recently, but their share in outstanding rural institutional credit is still less than two percent. Moreover, since they borrow from the commercial banks for further lending, their lending is partially already accounted for in commercial bank lending. The share of financial intermediaries such as other NGOs and Savings and Credit Co-operatives in the total formal sector outstanding rural institutional credit is still negligible (Table 15).

NRB has completed three Rural Credit Surveys in Nepal so far. They provide a sort of time series data on access to credit in rural areas. Further, the 1995/96 National Living Standard Measurement Study (NLSS) by CBS provides some recent information on access to credit by expenditure quintiles. Tables 16-18 feature the relevant information.

Nepal Rural Credit Surveys and NLSS reveal no trend through time in the proportion of borrowing families. In 1969/70 only 38 percent of the rural families reported borrowing. In 1976/77, this proportion went up to 51 percent, coming down again to 39 percent in 1991/92. But the 1995/96 NLSS again reports borrowings by 63 percent rural households. The Rural Credit Survey of 1969/70 came towards the end of the land-reform decade. The land-reform package had also written off the old debts. This may account for the low proportion of borrowing households in 1969/70. The 1991/92 credit survey again reported lower proportion of borrowing households which was accounted for primarily by decline in the proportion of institutional borrowers. Compared to 1991/1992 the proportion of rural borrowers has increased by more than 24 percentage points as per the 1995/96 NLSS. Sourcewise distribution of borrowing households seems to have remained more or less the same in 1991/92 and 1995/96. However, 2.76 percent of the total sample households had borrowed from both formal and informal sources in 1991/92.

Table 15. Sources of Rural Credit Supply (Outstanding as of Mid-July 2000)

Institutions	Information Sources	Rs. in Million	Percent
Agricultural Development Bank	1	12883.1	53.25
Commercial Banks (Agriculture Only)	2	8863.7	36.64
Regional Rural Development Banks	3	733.2	3.03
All Cooperatives	4	1276	5.27
NRB registered NGO	5	10.5	0.04
PDDP	6	412.2	1.70
LGP	7	15.8	0.07
Total		*22918.5**	*100.0*

***** There is a double counting to the extent of Rs 667.6 million because the cooperatives loans from commercial banks and ADB/N was Rs. 667.6 million.***

Source: (1) Economic Survey, 2000/01 P.12 (2) QEB, Oct.2000, P.17 (3) NRB Non-Bank Financial Statistics, April 2001 P.28 (4) NRB Special Study Report on Cooperatives, 2001 (5) NRB Non-Bank Financial Statistics, April 2001, P..32 (6) Annual Report PDDP 20000 (7) Annual Report LGP 2000, Credit Capital invested by Local Trust Fund as of Dec.1999 is Rs.15.8 million. As of Dec.2000, the cumulative investment is Rs 52,46 million.

Another significant trend indicated by these figures is the fact that there has not been much change in the role of formal and informal sources of rural credit supply since 1969/70. The proportionate role of informal sources of supply of credit has remained above 80 percent throughout the period with the exception in 1976/77 (Table 16). Between 1969/70 and 1976/77, the role of banks had increased by more than six percentage points due to the concerted efforts for branch expansion of ADB/N and the commercial banks. On the other hand, by this time, the compulsory savings schemes was winded up and their assets and liabilities were taken over by the Sajhas (Cooperatives). This expansion of commercial bank supply of credit to rural areas continued through 1991/92, but seems to have declined subsequently as an aftermath of financial liberalization. Another point observed in 1991/92 was borrowings, particularly by smaller households from both informal and formal sources. About 2.26 percent of the sample households had reported doing so.

However, changes are noticeable in the role of various agents of credit supply within the formal and informal markets. In the formal sector the role of local sources such as ward committees and co-operatives has almost disappeared after 1976/77. In spite of the boom in Grameen bank replications and INGO/NGO credit interventions, they together account for only minuscule proportion of rural credit. On the positive side, the role of professional moneylenders, agricultural traders and the land lord/employer has declined significantly, while that of friends and relatives has increased. This is a positive trend if the friends and relatives did not charge exorbitant interest rates and lent on less stringent terms than the group of moneylenders.

Table16. Borrowings from Formal and Informal Sources in Nepal (in percent)

Details	Rural-- NRB Credit Surveys			NLSS, 1995/96		
	1969/70	1976/77	1991/92	Rural	Urban	Nepal
Percent of Borrowing Households	38.28	51.26	38.89	63.18	37.59	61.32
***Sources of Credit:* Formal**	*18.01*	*24.03*	*20.30*	*16.19*	*25.40*	*16.28*
Agricultural Development Bank + Land Reform Savings Corporation	0.34	4.99	9.4	9.90	9.61	9.89
Commercial banks.	2.45	4.12	8.6	2.55	10.90	2.88
Grameen Type Banks	---	---	---	1.24	0.76	1.22
Ward/Village Committees	12.35	---	---	---	---	---
Others (including Co-operatives, NGO / INGOs and Local Groups)	2.95	14.91	2.3	2.50	4.13	2.29
***Sources of Credit:* Informal**	*81.92*	*75.98*	*82.46*	*83.78*	*74.67*	*83.43*
Friends and Relatives	30.90	24.24	na	40.40	50.70	40.80
Moneylenders	43.42	36.36	na	31.6	16.00	31.00
Landlords/Employer	2.78	3.74	na	4.07	2.19	3.99
Merchants/Agricultural Traders/	3.27	11.16	na	4.76	3.91	4.73
Others	1.55	0.48	na	2.95**	1.87**	2.91**
Total	*100*	*100*	*102.76*	*100*	*100*	*100*

Source: NRB, Rural Credit Surveys, 1981, 1994; NLSS 1996, 1997 and (Data Reprocessed); Sharma and Nepal, 1997.

* For calculation of these figures households which borrowed from both sources have been included in both groups since 2.76 percent of the sample households borrowed from both sources

** Includes NGOs/INGOs, local groups, etc.

Urban households had much higher access to the organised sector credit. Generally, female-headed households had lessor access to institutional sources (Acharya, 2000). A comparison of the Tables 16 and 17 figures show that only slightly lower proportion of small and marginal farmers had access to formal sources of borrowing than the average rural households. But the quintilewise figures from 1995/96 NLSS shows that much lower proportion of households in the lowest 20 percent income quintile had access to formal sources of credit compared even to the second quintile. On the other hand, the difference between the access of the average rural households to formal sources of credit and that of the second quintile households was not large (16.2 vs 15.1).

Table 17. Access to Sources of Borrowings of Small and Marginal Households

1968 RCS	NRB--- RCSs Small and Marginal Farmers			NLSS (1995/96) Consumption Quintiles	
	1969/70	1976/77	1991/92	Lowest	2nd Lowest
Formal	***15.23***	***16.86***	***16.43***	***8.28***	***15.06***
Banks	1.72	4.79	na	8.28	15.06
Co-operatives, Ward Committees, etc	13.51	12.07	---	---	---
Informal	***82.94***	***82.57***	***88.21***	***91.72***	***84.94***
Relatives and Friends	31.07	26.53	na	38.46	36.53
Moneylenders/Landlords/Traders	51.87	56.04	na	49.61	45.90
Others	1.82	0.56	na	3.72**	2.51**
Total	***100***	***100***	***104.64***	***100***	***100***
Percent Borrowing	***76.30***	***64.45***	***39.00***	***na***	***na***

Source: NRB, Rural Credit Surveys, 1981 and 1994 (Vol.IV.pp.70-98); NLSS 1996 and (Data Reprocessed).

* For calculation of these figures households which borrowed from both sources have been included in both groups since 4.74 percent of the small and marginal households had borrowed from both sources.

** Includes NGOs/INGOs, local groups, etc.

Further, households in the mountain areas had significantly less access to formal sources of credit, although larger proportion of households in this ecological region borrowed than household in hill or *tarai* areas (Table 18) in 1995/96.

Table 18. Access to Formal Credit Institutions by Ecological Regions, Rural only (Percent of the Total Sample Households)

Regions	Borrower Households-Overall				From Formal Sources	
	NRB---- Rural Credit Surveys			NLSS	NRB-RCS	NLSS
	1969/70*	1976/77*	1991/92	1995/96	1991/92	1995/96
Mountain	na	na	35.68	67.25	4	5.18
Hill	36.52	42.37	38.07	58.97	8	13.86
Tarai	39.13	54.87	41.05	61.31	9	14.32
All Nepal	*38.28*	*51.26*	*38.89*	*63.18*	*7.13*	*10.23*

*Borrowers by Sources are not available for these years.
RSC=Rural Credit Survey.

The greatest impact the formal credit institutions have made in the credit market is probably on interest rates. The land reforms in early sixties, however incomplete, included writing off debts more than ten years old. The *Muluki-Ain* fixed ten-percent limit on the interest rate for the informal sector lending. This seems to have left a significant impact on the interest rates until late sixties. The interest rates, specially, for the small and marginal farmers, seem to have shot up again to astronomical proportions by the end of seventies. Separate figures for various farmer or income groups are not available for the nineties. But the level and range have declined sharply in the mid-nineties compared to the early nineties (Table 19). This is probably due to the proliferation of community and self-help organisations' mutual lending activities.

Table 19. Interest Rates, 1969/70-1995/96

Years	Formal	Traders/Money-lenders		Period	Average Annual Inflation Rate
		Large	Small & Marginal		
1969/70	9-10	35	50	1960s	6.7**
1976/77	8-18	50/60	100/150	1970s	10.7
1991/92	15-20	60/84*		1980s	9.3
1995/96	14-25	24/37*		1990s	9.7

Source: NRB, Rural Credit Surveys, 1972, 1981; NRB Bulletins, NLSS 1996 (Data Reprocessed).

* Figures are not available for Small and Large Farmers or high and low income groups separately.

** 1965/66.

V. Conclusions

Failure of Financial Development to Inspire Wider Level Development of the Real Sector

Earlier financial development in Nepal was an induced phenomenon as in other developing countries. The central bank (NRB) came into being only in 1956. Government established several financial institutions in the government sector or as subsidiary of these institutions, as the domestic private sector was too weak to do so. In the early years, NRB intervention in the financial market was directed primarily to resource mobilization and directing credit to specific priority sectors. Only since 1975, monetary management became a major concern. However, financial growth was slow until about mid-eighties. Only after the liberalization process accelerated since early nineties, financial development has been remarkable.

The total financial asset in the economy has increased to an amazing 76 percent of GDP from a paltry minimum of 24 percent in 1980 percent; the broad money (M2), which includes money in circulation and savings and fixed deposits with the commercial banks, has reached 51 percent of GDP. But none of the expectations of liberalization, such as extension of the organized credit market to more rural areas, increasing access for smaller borrower or more efficient and productive use of financial resources seem to have been achieved. The sector is experiencing chaos. The institutional network has expanded to meet some consumption needs of the urban middle class but diversion of resources from the agricultural sector has been substantial as illustrated by the decreased flow of bank resources to agriculture. None of the non-bank financial institutions cater for the rural population. As a source of rural credit, the role of the organized institutional sector has declined in the last decade. While the financial sector with their international connections and quick money-transfer abilities are overflowing with public funds, the productive sectors are starving for credit.

The situation is explained by the supply-side conventional economics in terms of inadequate liberalization of the financial sector, particularly the existence of the two public sector banks with huge repayment problems, their widespread loss-making rural branches and priority sector investment requirements (Asian Development Bank, 1999). Nevertheless, the financial sector has grown fast during the nineties in spite of these inefficiencies. What this line of argument seems to ignore is the specific geopolitical situation of the country, which limits its macro-economic policy options severely. Nepalese economy has been and is largely open to India. This puts severe limits to monetary, exchange rate, as also pricing and taxation policy options in Nepal (Khatiwada,1997; Acharya and Khatiwada, 2003). Conventional economic logic also ignores the huge opportunity for graft the privatization process provides to the political elite, given the inadequate institutional framework to control the fraud. It is becoming increasingly clear that inefficiencies of the commercial banks are attributable more to the political intervention and the oligopolistic tendencies in the financial sector, rather than the priority sector or the rural branches. The joint venture banks with practically no rural operations are also suffering from bad quality of their investment and credit. It is becoming public that their balance sheets are widely window-dressed.

What is of more concern from a growth and poverty alleviation perspective is the fact that there seem to be no backward or forward linkages of this financial development. On the other hand, the nexus between the political elite and the international financial capital might be getting tighter. Nepal is slowly being drawn into what Mander and Goldsmith (1996) call the "casino economy" controlled by the international financial giants with no evident benefit to the people around the world. Nepal seems to be no exception in this case. Jeffrey Sachs (2002) also notes how today's short-term financial markets are estranged from the economic fundamentals and primarily guided by a gambling mass psychology.

Limited Impact of Interest Rate and Monetary Policy on the Price Level

As in all open small economies, authorities have very little control over the price level. Nepal has a small manufacturing sector and most of its needs for the manufactures and developmental goods as well as for petroleum products have to be fulfilled through imports. Further, due to the open border with India, free convertibility of IRe in Nepal with NRe, and fixed exchange rate between Indian and Nepalese Rupees, the domestic prices of tradable in Nepal are largely a function of the Indian market. Money and monetary policy in this context become dependent variables rather than independent policy options.

Non-government Sector

Non-government sector financial institutions have grown fast in the 1990s, but they are mostly concentrated in urban areas. More than 80 percent of the borrowing households have still to depend on non-formal sources for their credit needs. In spite of the plethora of targeted credit programs, they have made very little dent in the rural credit market.

Cooperatives (financial and non-financial) are emerging as the major source of funding for rural credit. However, data on financial sector development are not amenable to analysis of urban-rural funds flows and linkages. The data generation process established earlier has been disrupted.

Impact on Poverty

The impact of financial sector development on poverty alleviation is not visible directly in terms of diversification of sources of credit supply to the rural areas or the rural poor or financing of priority areas for national development. For the urban poor we do not have comparative data. But the booming financial sector, particularly expansion of lending portfolio to include hire purchase and housing must have fulfilled some unmet needs of the urban middle class. An in-depth analysis of its indirect role in poverty alleviation is yet to be made.

Majority of the targeted credit programs have been unable to cater to the needs of the bottom 20 percent households directly because they lack other resources and knowledge to benefit from the saving-credit programs. Indirect impact of these financial developments and credit programs on poverty alleviation is yet to be assessed. Micro-credit programs leave the bottom twenty percent of the income ladder untouched. Therefore, any serious package to eradicate poverty must contain other immediate training and related employment programs for this bottom 20 percent, besides micro-credit and land-based agriculture, from which only the middle 60 percent can benefit. Emphasis on education is a correct strategy. But it will yield benefit only in the medium and long-term. The poor need alternative survival sources in the mean time.

Lack of Information

Finally, data on the monetary and financial sectors, though gathered regularly, are amenable to only macro-level monetary analysis. They are grossly inadequate for evaluating the impact of financial development on the economy or on poverty. Particularly, financial flow chart between various segments of the financial market, informal sector interest rates, rural/urban disaggregation of commercial banking and financial sector activities, etc. are a minimum necessity for a meaningful evaluation of financial sector impact on the economy as also on poverty.

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Abbreviation and Acronyms

ADB/N	Agricultural Development Bank/Nepal
CSI	Cottage and Small Industries
CSD	Center for Self-help Development
DDC	District Development Committee
GDP	Gross Domestic Product
HDR	Human Development Report
HMG	His Majesty's Government
IBP	Intensive Banking Program
IFAD	International Fund for Agricultural Development
IMF	International Monetary Fund
INGO	International Non-governmental Organisation
LGP	Local Governance Programme
MCPW	Micro-credit Project for Women
NBL	Nepal Bank Limited
NGO	Non-governmental Organisation
NIDC	Nepal Industrial Development Corporation
NPC	National Planning Commission
NRB	Nepal Rastra Bank
Rs	Nepalese Rupees
PCRW	Production Credit for Rural Women
PDDP	Participatory District Development Programme
RMDC	Rural Micro Credit Development Centre
RRB	Rastriya Banijya Bank
RRDBs	Regional Rural Development Banks
SFCL	Small Farmers' Cooperatives Limited
SFDP	Small Farmer Development Programme
UNDP	United Nations Development Programme
US $	US Dollar
VDC	Village Development Committee
VDP	Village Development Programme
WB	World Bank
WDD	Women Development Division