Commercial Banking and the Financial Sector Development in Nepal

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Abstract

Commercial banking industry in Nepal occupies a dominant role in the financial system and it is contributing to the economy by channeling credit and other services. This paper descriptively examines the role of commercial banking industry in the financial sector's development and economy of Nepal. It finds the role of commercial banks in the financial sector of developing countries like Nepal in two folds. Firstly, despite the problem of non-performing loans, banking credit to the economy is promoting financial sector to develop it in a competitive environment. Secondly, commercial banking activities are promoting various sectors of the economy through supplying loans under the central bank and the government policies such as priority sector lending and the deprived sector lending policies. These policies are playing a major role to channel bank credit contributing to promote the backward sectors such as agriculture and other sectors of the economy. Similarly, the government's deficit financing policy is also helping to channel bank activities in order to boost the financial system in one hand; and banking activities under this policy is contributing to the economy of Nepal on the other hand.

Keywords: financial sector, credit supply, commercial banks, deficit financing, deprived sectors

JEL Classification: E44, E51, G21, H62

1. Introduction

The development process of the banking system in Nepal started with the establishment of the first commercial bank: Nepal Bank Limited in 1937. It was the first representation of the formal financial system and as at then it alone handled the commercial banking activities for nearly 20 years before the establishment of the central bank in 1956. Need of commercial bank at that time was also for economic progress and for providing banking services to the people[1]. Then Nepal Industrial Development Corporation (NIDC) established in 1959 as a corporation to provide credit to the industrial sector.

When Nepal Rastra Bank (NRB hereafter) was established in 1956 as a central bank, it played an active role to develop not only monetary sector but also to develop real sector of the country. One of its main objectives was to expand the banking services through branch expansion and bank expansion. Therefore, two banks, a purely commercial bank in 1966 called Rastriya Banijya Bank and another Agriculture Development Bank in 1968 were established. Before the mid-1980's only these four state-owned banks played active role in the financial system of Nepal. Although various new types of banks and other non-bank financial intermediaries came to exist in the market after liberalization, commercial banks are playing a dominant role in the financial system of Nepal. Commercial banks occupy the highest percentage of major financial indicators.

[1]The Nepal Bank Limited Act states the objective of this bank as "In the absence of any bank in Nepal, the economic progress of the country was being hampered and causing inconvenience to the people and therefore, with the objective of fulfilling that need by providing services for the people and for the betterment of the country, this law is hereby promulgated for the establishment of the Bank and its operation" (Dahal, 2009).

Therefore, it can be assumed that the commercial banking industry in Nepal has high contribution in the development process of the financial system from the beginning[2]. In the present situation, the banking institutions are becoming a primary source of funding of the economy and they are intermediating their services in the system through the expansion of their branches, widening the range of instruments and their services and accelerating the credit activities. Therefore, it is also essential to evaluate the role of commercial banking in the financial sector's development of Nepal.

2. Objectives and the research methodology

Objectives of this study are in two folds. Firstly, its major focus is to investigate how different categorical commercial banks are contributing to the development of financial system in Nepal. Secondly, this seeks to examine the role of government to develop the commercial banking industry via financial system in Nepal.

To fulfill these objectives descriptive analysis will be employed.The bank data are collected from *Banking and Financial Statistics* published by the NRB that provides bank statistics. In this study, 14 commercial banks established before 1999 are taken as sample and they are categorized into three groups; A, B and C according to their ownership. In group A, there are purely domestic investor's owned 5 commercial banks. Group B consists of 6 joint venture banks and the group C includes three public commercial banks[3]. Data are used in the form of table and graphs to examine the role of commercial banks and government to the financial sector's development in Nepal.

3. Financial Liberalization and Commercial Banking Development

The open and liberal system initiated from the mid-1980’s created an environment to promote the financial system as well as welcomed several new financial institutions from the private and foreign sectors. Before this period, the financial system was centrally regulated, government dominated and limited to banking institutions only. Liberalization provided an opportunity for private and foreign agents to take part in economic development activities. Here we explain the performance of the system in the liberalized period.

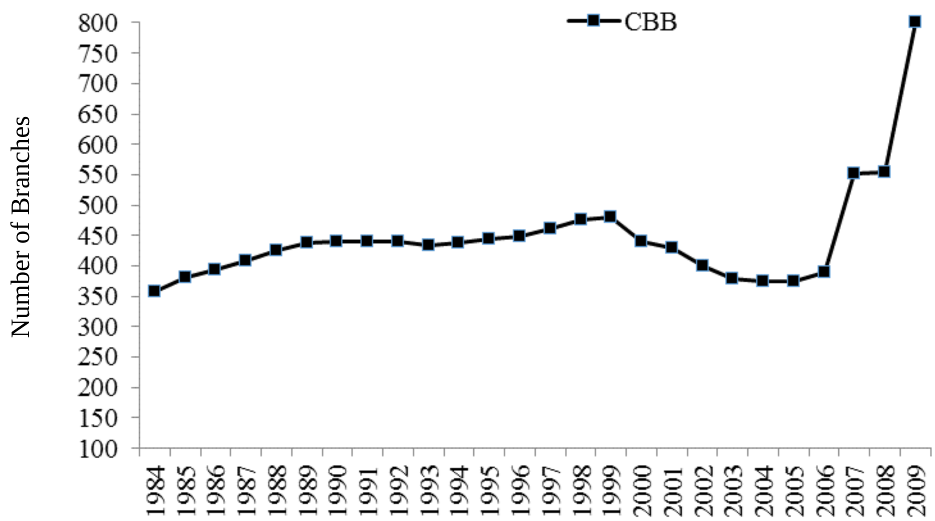
The central bank had a policy of expanding bank branches during the controlled system period. However, this policy could not meet its target[4] due to the high level of control, because it was limited to only state-owned banks. At the beginning of financial liberalization, Nepal had 357 commercial bank branches (figure 1). The number peaked to 481 in1999. Thereafter, the expansion of bank branches not only stopped but also they started to close down. This situation was raised since domestic political instability and internal conflicts, banks could not work efficiently. Secondly, in rural areas the branches of public banks which were providing financial services suffered from high loss and their services were discontinued (GOVN, 2006). After 2006, a peace process helped to reopen closed branches and open new branches.

[2]For instance, during the 1960s and 70s, the central bank put hands on policy in banks through credit regulations (i.e., control policy) but put its hands off policy with respect to loan rates that was to be charged by commercial banks on lending so that banks could mobilize their credits for economic growth. It indicates the willingness of the central bank to employ commercial banks on development activities (Sharma, 1987).

[3]A bank which is controlled directly or indirectly by the government, including banks that provide special services at the direction of the government (Banks for International Settlements, 2002) is called a public bank.

[4]The central bank aimed at achieving one bank branch per thirty thousand people by 1977 but it was limited to only 0.5 bank branch per 30,000 people by 1980 (Aghevli*et al*., 1979).

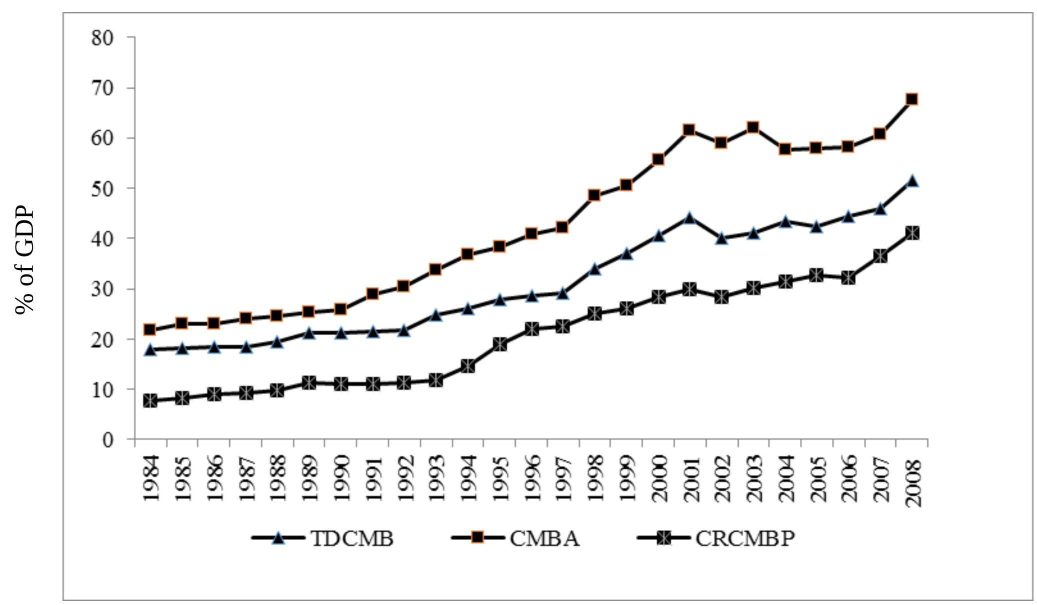
Figure 1: Development of Commercial Bank Branches



Note: CBB = Commercial Bank Branches and it includes branches of all types of commercial banks.
Source: Data are utilized from Nepal Rastra Bank, *Quarterly Economic Bulletin* (NRB, 2010b).

Banks are more likely to provide risks sharing and information services than the central bank, or other financial intermediaries (King and Levine, 1993). Principally, commercial banks select different categorical projects and expand credits in investment activities as well.Generally, the main function of commercial banks is to collect deposits and lend to borrowers. Besides it, they have a capacity to expand their credits through creation of new credits under the basis of their cash reserves. Then on the basis of their deposits and credit creation they allocate credit in the economy. Therefore, deposit of commercial banks is also a major component that the level of credit supply depends on. In the Nepalese financial market, commercial banks are assumed to be the most reliable financial intermediaries. Therefore, the growth of commercial banks is more stable in comparison to other financial institutions. The number of commercial banks reached 26 in 2009 from just two in 1984 (NRB, 2010b).

Figure 2: Commercial Banks' Activities



Note: TDCMB = total deposits of commercial banks, CMBA = assets of commercial banks, CRCMBP = loans supplied by commercial banks to private sectors.
Source: Figure constructed by author utilizing data from *Quarterly Economic Bulletin* (NRB, 2010b).

Banking institutions, especially, commercial banks are more likely to tolerate risk in financing, and their services influence many public decisions in financial activities. This is a reason that during the liberalization period, there was a dramatic increase in their banking activities. For instance, deposit collection by commercial banks reached 51.0% of GDP in 2008 from 18.0% in 1984. Other indicators such as assets and credit allocations of banks increased significantly during this period (figure 2). An increase in financial assets ratio represents an increase in the share of financial assets by commercial banks. In the liberalization period, time deposit rates and loan rates are left to be determined freely in the market implying that commercial banks are free to increase their assets and liabilities. Therefore, it can be said that banks benefitted from liberalization, and they used several monetary instruments to raise their assets. Their total assets as a percentage of GDP increased from 22.0% in 1984 to 67.0% in 2008.

Credit to the private sector also increased rapidly during this period. Credit allocation to the private sector was very low, nearly 8.0% of GDP, in 1984 but increased almost five folds and reached 42.0% in 2008. From 1989 to 1992, commercial banks' activities stagnated. This period was a political transition period, and after the political regime change in 1990, financial conditions of these intermediaries increasingly improved. Similarly, political instability appeared again in the late 1990's through the mid-2000's, and the investment environment deteriorated and it made high fluctuations in the financial sector's indicators. However, significant increases in commercial bank branches, rapid increases in their activities, and the establishment of new banks shows that access of financial services is increasing rapidly, and it is contributing to increased bank usage by the population.

4. Share of commercial banking industry in the financial sector of Nepal

Financial sector's activities diversified towards different kind of financial intermediaries in the post liberalization period, since the existing part of financial sector shared with other newly established institutions. One of the main purposes of the financial sector liberalization was to lower the responsibility of government on the state-owned limited financial institutions and to make the financial market more competitive. However, the commercial banking industry has thehighest share in the market and it is reduced at a very slow rate. Most of the indicators of commercial banks have the highest position among other financial intermediaries (see table 1).

To explain the share of commercial banks in the financial system we focus on six major indicators: capital funds, deposits, liquid funds, investment, loans and advances and ratio of total assets to liabilities of major financial intermediaries. The capital fund of financial intermediaries includes paid-up capital, statutory reserves, share premium, retained earnings and other reserves. This part of the system remained negative during 2004-2006 because retained earnings of commercial banks during 2004-2007 was highly negative[5]. The capital funds of financial intermediaries other than commercial banks remained in the increasing trend but this indicator highly fluctuated and in decreasing trend for commercial banks. For instance, this indicator for commercial banks was reduced from 1998 to 2003. Then it again lowered to negative values in 2004, 2005 and 2007. But it is always positive for finance companies, microcredit development banks and co-operatives. Another important indicator is the deposit collection and consists of demand deposits, savings, fixed deposits, call deposits and others. In the total deposit the largest share is occupied by commercial banks in all years. However, it is also in the decreasing trend for commercial banks because when various types of new financial intermediaries such as development banks, finance companies, microcredit development banks and co-operatives appear in the market, its share distributed to all other intermediaries. Finance companies appear in the second position to collect deposit and it is in the increasing trend for development banks and finance companies.

The highest portion of liquid funds[6] available in the financial system is occupied by commercial banks followed by development banks. The percentage of liquidity of commercial banks in 1998 was nearly 98.0% and the remaining portion was of other intermediaries. In 2010, it reached 65.7% for commercial banks. Part of other 4 financial intermediaries remained less than 35.0%.

[5]The retained earnings of commercial banks was positive before 2003, but after 2003 it started to be negative. For instance, in 2004 retained earnings of commercial banks fell negative by Rs. 25056.1 million from Rs. 75.7 million in 2003 and it reached to Rs. 34912.0 millions, the lowest, in 2006. Such a negative earnings increased to Rs. 32800.2 millions in 2007. The negative earnings is then gradually reducing (NRB, 2010b; table 3).

[6]It comprises of cash balance, bank balance (① in NRB a) domestic currency, b) foreign currency, ② in A class licensed financial institutions, a) domestic currency, b) foreign currency, ③ in other financial institutions and ④ in foreign banks) and money at call.

This also clearly indicates that the commercial banking industry has a major contribution in liquid liabilities of the financial system. The decreasing rate of this fund for commercial bank is the highest in comparison to other indicators.

Financial intermediaries also involve in investment activities such as investment on: a) government securities, b) NRB bond, c) government non-financial institutions, d) other non-financial institutions and e) non-residents. Investment and loans advancement activities[7] are playing major role in the financial system of Nepal. These indicators are moving opposite direction in commercial banks and in other institutions. For example, investment is increasing and loans and advances are decreasing in commercial banks but it is reversed for other institutions. When the financial system became more liberalized from the 1990s, the number of non-bank financial intermediaries increased drastically both in urban and rural sectors, borrowers attempted to substitute bank credit by non-bank credit.

Table 1: Contribution of Financial Intermediaries in the Financial System (Rs. In Millions)

Indicators	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
1. Capital Fund	**6,265.9**	**7,668.8**	**8,686.4**	**10,993.5**	**15,827.2**	**20,031.0**	**-1,474.3**	**-9,088.1**	**-7,461.5**	**6,901.7**	**25,778.0**	**52,681.8**	**80,831.7**
Com Banks (% of 1)	79.0	79.2	77.5	74.9	64.5	59.0	-692.0	-210.5	-237.8	-60.1	38.6	57.7	50.4
Dev Banks (% of 1)	5.0	4.0	3.6	5.7	17.2	20.6	282.0	52.2	-26.9	58.8	25.4	17.7	19.0
Finance Co (% of 1)	15.0	15.3	17.1	17.5	16.8	16.0	247.8	46.7	90.6	78.0	28.9	20.0	23.6
MCD Banks (% of 1)	**na**	**na**	**na**	**na**	**na**	3.1	45.3	8.1	19.3	16.2	4.9	3.7	7.1
Co-op (% of 1)	1.0	1.4	1.8	1.9	1.6	1.4	16.8	3.5	44.6	7.10	2.2	0.9	0.0
2. Deposits	**109,553.7**	**136,107.9**	**165,981.9**	**197,325.6**	**205,135.3**	**228,736.4**	**258,742.3**	**284,115.2**	**327,925.3**	**391,152.6**	**508,905.7**	**674,584.3**	**794,328.3**
Com Banks (% of 2)	94.0	93.5	93.3	92.1	90.3	89.1	90.4	88.8	88.8	86.3	83.7	83.5	79.4
Dev Banks (% of 2)	0.0	0.1	0.1	1.3	2.4	2.8	1.5	2.4	1.8	3.9	5.1	7.1	9.7
Finance Co (% of 2)	6.0	5.9	5.9	5.9	6.6	7.2	7.5	7.9	8.3	8.8	10.3	8.5	9.8
MCD Banks (% of 2)	**na**	**na**	**na**	**na**	**na**	0.3	0.3	0.3	0.3	0.3	0.3	0.3	1.1
Co-op (% of 2)	0.0	0.5	0.6	0.7	0.8	0.8	0.6	0.6	0.8	0.7	0.6	0.6	0.0
3. Liquid Funds	**33,774.6**	**40,439.1**	**50,421.4**	**58,587.3**	**55,133.5**	**43,782.0**	**53,448.8**	**45,792.5**	**47,728.06**	**58,064.2**	**97,917.7**	**142,159.2**	**156,369.4**
Com Banks (% of 3)	98.0	96.7	95.7	94.9	90.6	87.2	86.5	83.8	81.4	75.9	68.3	74.6	65.7
Dev Banks (% of 3)	0.0	0.2	0.4	1.0	3.4	5.8	4.3	4.9	3.3	6.4	10.2	11.3	16.7
Finance Co (% of 3)	1.0	2.8	3.4	3.5	5.2	6.1	8.4	8.5	11.3	12.9	18.1	11.5	13.8
MCD Banks (% of 3)	**na**	**na**	**na**	**na**	**na**	1.0	1.1	1.4	2.8	3.1	1.2	2.0	3.8
Co-op (% of 3)	0.0	0.4	0.5	0.6	0.8	0.9	0.8	1.3	1.3	1.6	2.2	0.6	0.0

[7]Loan supply is categorized into three groups: a) government organizations, b) private sector & c) financial institutions.

4. Investment	**13,094.5**	**15,972.4**	**19,488.5**	**27,398.5**	**39,279.7**	**51,457.9**	**55,903.1**	**66,499.1**	**88,959.57**	**101,888.2**	**120,335.6**	**141,347.3**	**145,461.3**
Com Banks (% of 4)	83.0	89.2	92.2	92.9	87.1	88.2	88.8	90.5	92.4	91.8	90.5	92.6	92.1
Dev Banks (% of 4)	3.0	2.4	1.3	1.8	8.3	6.7	6.3	3.0	2.4	1.5	2.8	3.5	4.7
Finance Co (% of 4)	13.0	7.9	5.8	4.6	4.1	4.6	4.5	3.6	3.1	4.5	3.60	2.3	3.0
MCD Banks (% of 4)	**na**	**na**	**na**	**na**	**na**	2.0	2.2	2.3	1.9	2.0	2.9	1.5	0.2
Co-op (% of 4)	0.0	0.5	0.7	0.7	0.5	0.5	0.3	0.6	0.2	0.2	0.2	0.2	0.0
5. LA	**74,875.6**	**90,124.4**	**106,996.0**	**124,048.9**	**148,290.7**	**165,119.1**	**184,389.1**	**209,053.7**	**230,424.7**	**291,605.8**	**391,537.7**	**511,752.8**	**620,837.5**
Com Banks (% of 5)	92.0	90.7	90.0	88.0	76.3	75.4	75.9	78.3	76.7	79.5	78.3	77.8	75.2
Dev Banks (% of 5)	0.0	0.6	0.7	2.3	14.7	14.9	13.8	9.2	8.7	5.3	6.0	8.2	10.6
Finance Co (% of 5)	7.0	8.0	8.5	8.8	8.1	8.8	9.5	10.2	11.8	12.2	13.2	11.7	12.4
MCD Banks (% of 5)	**na**	**na**	**na**	**na**	**na**	1.5	1.5	1.7	1.9	2.0	1.8	1.6	1.8
Co-op (% of 5)	1.0	0.7	0.8	1.0	0.9	0.9	0.7	0.7	0.9	1.0	0.7	0.7	0.0
6. TA/Lib	**155,444.8**	**185,555.9**	**225,553.5**	**273,946.2**	**314,567.1**	**357,050.9**	**387,432.2**	**474,325.9**	**505,958.5**	**582,477.3**	**706,324.0**	**988,878.8**	**1,026,595.1**
Com Banks (% of 6)	94.0	92.2	92.9	91.8	87.4	85.6	87.7	86.7	84.7	84.2	80.2	82.1	76.7
Dev Banks (% of 6)	1.0	0.8	0.7	1.7	6.0	7.5	4.7	4.9	5.2	3.9	5.6	6.9	10.6
Finance Co (% of 6)	5.0	5.7	5.8	5.8	5.9	6.2	7.0	6.4	7.7	9.2	11.4	8.8	10.9
MCD Banks (% of 6)	na	na	na	na	na	1.2	1.3	1.3	1.6	1.8	1.8	1.6	1.8
Co-op (% of 6)	0.0	0.5	0.7	0.7	0.7	0.7	0.6	0.7	0.8	0.9	1.0	0.6	0.0

Notes: Com Banks =commercial banks, Dev Banks = development banks, Finance Co = finance companies, MCD Banks = micr development banks, Co-op = Co-operatives, LA = loans and advances, Lib = Liabilities, TA = total assets, na = non-available
Source: Various issues of *Banking and Financial Statistics* published by the NRB.

Percentage of assets or liabilities of commercial banks and co-operatives are in the decreasing trend whereas assets of development banks, finance companies and micro-credit development banks is in increasing trend. However, commercial banks occupy the largest portion of the total asset. Among the major financial indicators, fall in liquid funds of commercial banks is the highest. It may be a reason that from time to time banks fall into the liquidity problem. This implies that commercial banks cannot maintain their liquidity in comparison to other intermediaries. Commercial banks concentrated more and more on investment activities. Although all major indicators follow decreasing characteristic for commercial banks except investment, the banking industry occupies the largest share of the financial system in Nepal.

5. Investment activities of commercial banks

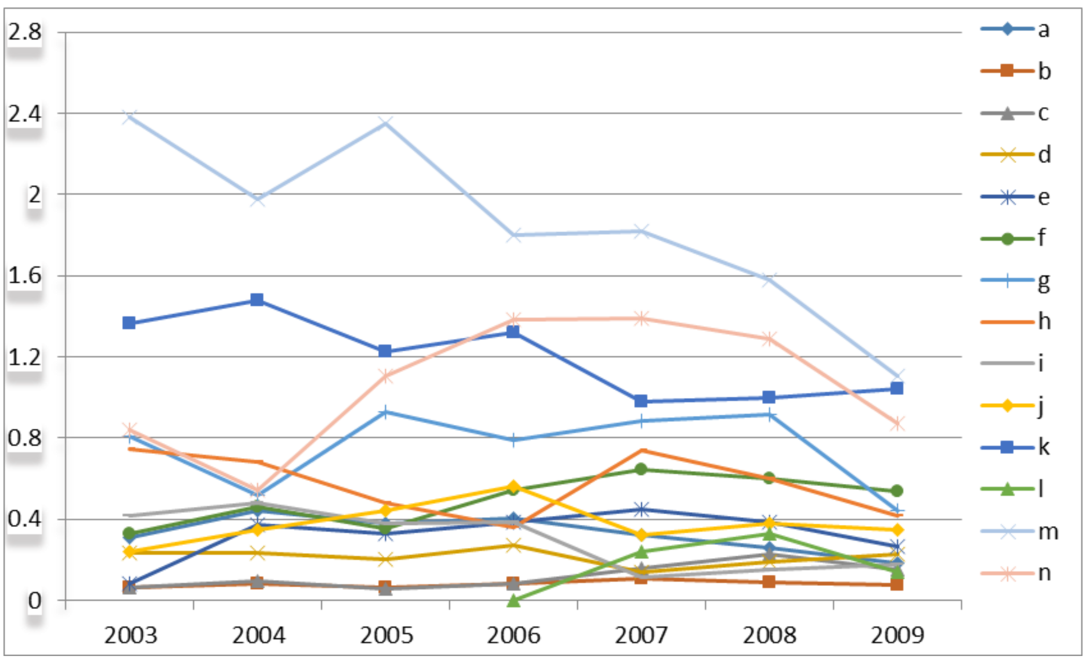
Commercial banks give priority to invest in government securities, shares and central bank bonds. There are two reasons that banks mobilize their deposits in such investment activities.

First, if the country's economic and political situation is not favorable for investment, investing in government securities and bonds is the most riskless area. Second, government issues its securities and bonds to absorb excess liquidity of banks and banks have to invest on it. It is the central bank's responsibility that management of excess liquidity of the banking industry is considered to be an important operating procedure of monetary policy.

Primarily, it helps to achieve the monetary policy of maintaining monetary stability through the necessary adjustment in the availability of credit. In addition, the change in credit availability can contribute to achieving financial sector stability (NRB, 2005). Investment of commercial banks as a ratio of GDP (see figure 3) has increased for these banks however, this indicator seems sensitive with political condition of the country. When the country was at politically unstable condition during 2000-2006, investment of the banking industry was in increasing trend because this instrument is safer than other tools during the stagnant economic condition created by political instability and other bad economic environment of the country. When a peace agreement took place in 2006, investment activities in the real sector of the economy accelerated and the banking investment in the government bonds and securities came down.

Most of the public enterprises were privatized from the 1990s due to their bad performance and banks could not return their loans from enterprises. This indicates that banks are aware of credit risks, and credit supply is reducing because of investing money in the capital market. Public banks invest more in government securities and bonds in comparison to other private banks. For instance, as of mid July 2008, the composition of investment of public banks in the form of government bonds was 75.0% while private banks invested in such a category only 61.0% (NRB, 2008) whereas it was 79.3% in mid July 2011 for public banks and 64.5% for private banks (NRB, 2012).

Figure 3: Bank Investment (as a % of GDP)



Notes: a = Bank of Kathmandu, b = Lumbini Bank Ltd., c = Nepal Credit and Commerce Bank, d = Nepal Industrial and Commercial Bank, e = Nepal Investment Bank, f = Everest Bank Ltd., g = Himalayan Bank Ltd., h = Nabil Bank Ltd., i = Nepal Bangladesh Bank, j = Nepal SBI Bank Ltd., k = Standard Chartered Bank, l = Agriculture Development Bank, m = Nepal Bank Ltd., n = RastriyaBanijya Bank

Source: Figure constructed by author using data from *Banking andFinancial Statistics* (NRB, 2011).

The role of government in the development of banking sector cannot be disregarded. Since the policies implemented by the government and the central bank highly influence the development of the banking industry and financial system in Nepal. It further motivates to investigate the role of government and the central bank in the banking sector of Nepal.

6. Role of government in the development of commercial banking industry in Nepal

Monetarists mainly concentrate on the supply of money in the financial system. They argue that in the process of money supply banks create money and the policies implemented by the central bank affect the amount of credit provided by banks. However, in the financial market, it is not purely happening as monetarists say i.e., the financial system is incomplete in the absence of real sector of the economy. Commercial banks involve not only in the monetary activities but are also intermediating-the extent of deposits that they put into the economy-at a high degree which is boosting the real sector (i.e., agriculture, service and industry).

In this section, we will try to explain how commercial banks are supplying their loans to the real sector of the economy and how their investment activities are taken place and try to shed light on how government policy is contributing to enhance the development of the commercial banking industry in Nepal.

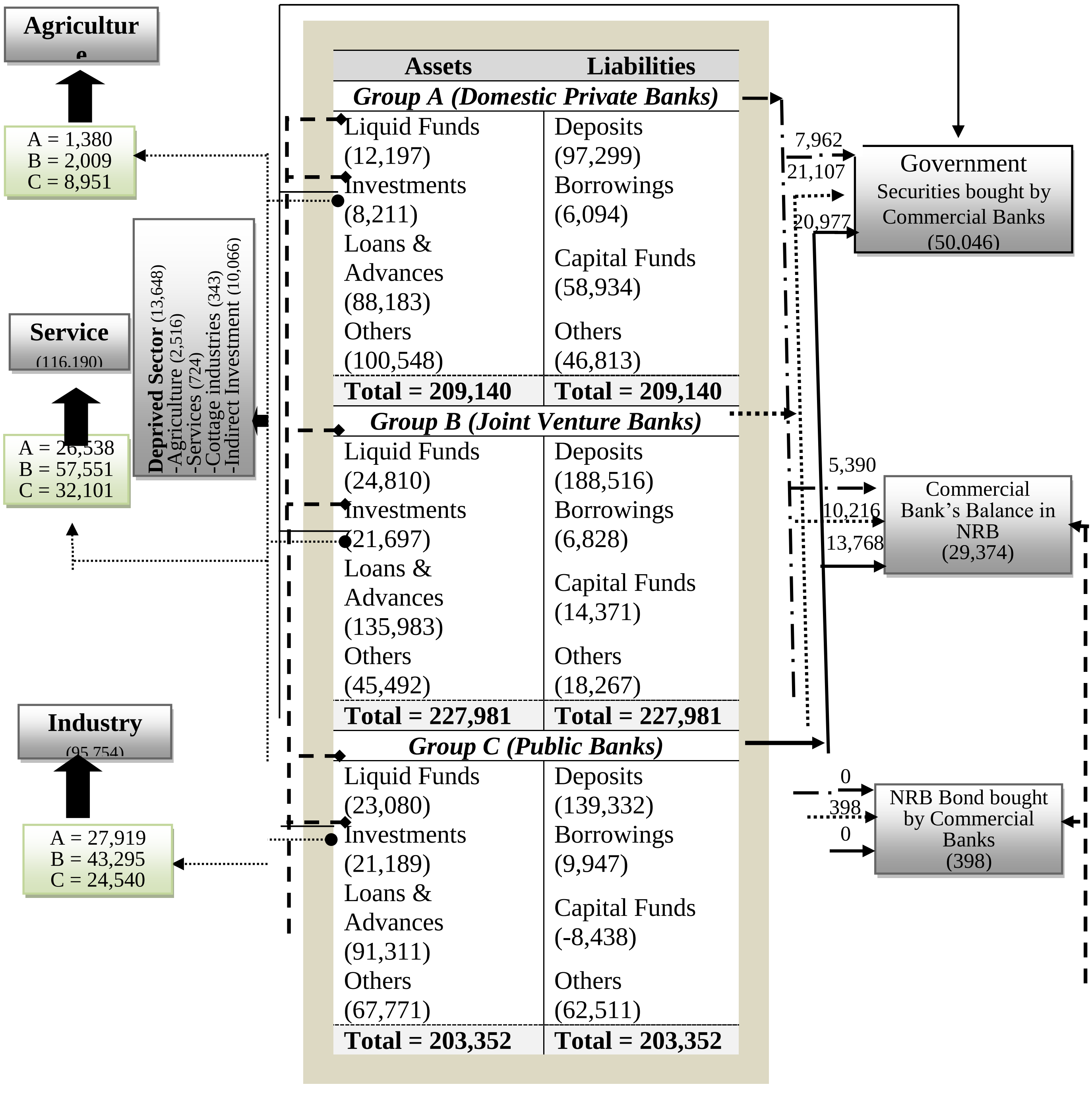
Commercial bank activities are specifically systematized in their balance sheets categorizing them into liabilities and assets. The balance sheet (figure 4) provides a picture of the formation of liabilities and asset components of commercial banks in Nepal where only the fundamental components are depicted. Each component represents the summation of all banks included in the corresponding group. The liabilities side mainly comprises of capital funds, deposits, borrowings[8] and others. The left part of the balance sheet explores the components of the asset of commercial banks. In all types ofbanks taken in the sample deposit is at a higher level than their loans and advances. Commercial banks' activities can contribute to develop financial system and boost the economy through various channels. To channel commercial banks' activities in the real sector of the economy, policies implemented by the central bank with the suggestion of the government are important mainly in developing countries like Nepal[9].

Some of the policies implemented by the central bank and the government of Nepal to develop the prioritized sectors are the priority sector lending and credit supply policy to the deprived sector. Besides these, commercial banks have to buy government securities. Buying government securities by commercial banks has a direct effect on reserves of banks. Under this policy, as of January 2010, three categorical banks bought the government securities of price Rs. 50,046 millions. Buying government securities affects the level of loans supply by banks, i.e., the amount of money used to buy government securities could be used for loans supply. When banks buy government securities, bank reserves will reduce exactly by the same amount of the purchase of securities. It leads to the increase in money market activities in the short-run and the ultimate result will be the increase in the interest rates in the long-run. When the amount of loans reduces, it is forced to raise further liquidity in the market. To this end, banks go for interbank lending activities to solve the immediate problem. If banks cannot solve this problem, they can change the interest rates.

[8]Commercial banks borrow from NRB, other banks, foreign banks and from financial institutions.

[9]For instance, commercial banks provide loans to agriculture and other sectors of the economy under the policy of priority and deprived sectors loans supply.

Figure 4: Assets and Liabilities Flow of some Commercial Banks (in Million Rs.)



Note: Numbers in parenthesis represent Rs. in Million as of January 2010. A, B and C represent 5 private commercial banks, 6 joint venture banks and 3 public banks respectively as explained in table 3.2.

Source: Author's own construction compiling data from Nepal Rastra Bank, *Banking and Financial Statistics* (NRB, 2010a).

Likewise, commercial banks are also investing in the NRB bonds which reduce bank liquidity. As of January 2010, commercial banks bought NRB bonds of price Rs. 398 millions. This amount was invested only by joint venture banks. Commercial banks focus on supplying their loans on important areas of economy such as agriculture, service and industrial sectors. Figure 4 shows that loan flow is the highest in the service sector (Rs. 116,190 millions) followed by industry (Rs. 95,754 millions) and agricultural sector (Rs. 12,340 millions). The central bank is implementing a policy of deprived sector loans supply with the guidance of government to promote economy mainly emphasizing agricultural sector. Under this policy, commercial banks are supplying some part of their loans to those areas.

There is a regular flow of loans in agriculture including other sectors for a long time. Among the three areas of deprived sector, agriculture sector is receiving the highest amount of credit (Rs. 2,516 millions) under this category.

Figure clearly depicts that amount of loan supply is the highest towards the service sector among the major areas of loan supply and loans supplied by joint venture banks is at the highest level to the service sector[10]. Development of these components of the economy is very important because they can play a key role as linkage components between backward and forward sectors of the economy in the industrial development. We also find that credit supplied by joint venture banks to the service and industrial sector is higher than the other categorical banks and credit to the agricultural sector by these banks is the least. The government and the central bank put agriculture sector as a priority sector for its development and banks supply credit accordingly. However, loan flow by foreign banks to the agricultural sector is the least. Foreign banks are more independent of domestic rules and regulations (Cardim de Carvalho, 2000). This may be a reason that joint venture banks also are not serious to follow the government rules to supply credit and they have low incentive to flow loans in low profit agricultural sector.

Nepal's Government played a dominant role as an owner and acted an operator of the financial system in the pre-liberalized period since financial intermediaries were mostly government-owned. Then during the mid-1980s, the government and the central bank adopted liberalization policies to reduce the government's role in the economy. However, government's role in the liberalization period seemed not significantly different from the pre-liberalized period mainly in the banking system because government owns the largest commercial bank, hold more than 40.0% shares of the second largest commercial bank with a dominant role and owns shares of other commercial banks (World Bank, 2002).

Government plays a key role in the financial system not only on its institutional development but also has a significant role to channel credit to the economy through its policies. Budget deficits financing policy, i.e., one of the government policies, is working effectively to channel bank credits to the real sector of the economy. Disregarding the arguments against deficit financing through public debt some strongly advocate in favor of deficit financing through debt. For instance, Chelliah (1961) argues that revenue of the country meets subsidies, other transfer payments, interest payments and higher part of the current expenditure. Therefore, debt finance will be used for meeting government’s non-remunerative capital formation; a part of current expenditure, and is designed to increase social capital and productivity requirements of financial investment.

Table 2: Domestic Borrowing

Year	DB (% of GDP)	DB (% of Resource[11])	DB (% of Rev)	DB (% of BD)	DB (% of BE)	BD (% of GDP)
1989	1.51	12.98	14.54	29.58	9.02	5.11
1990	1.24	10.79	11.94	40.13	8.50	3.10
1991	1.64	14.02	15.04	40.78	10.43	4.02
1992	1.06	9.93	10.69	18.47	6.46	5.73
1993	0.93	7.65	8.34	30.24	6.11	3.07
1994	0.89	6.59	7.23	31.47	5.45	2.84
1995	1.00	7.51	7.89	24.97	5.78	4.02
1996	1.20	8.91	9.88	41.37	7.33	2.91
1997	1.21	9.61	10.32	30.19	7.29	4.01
1998	1.56	11.28	12.64	52.35	9.28	2.99
1999	1.61	12.06	12.82	50.42	9.73	3.19
2000	1.47	10.55	11.42	35.06	8.11	4.20
2001	1.95	15.02	15.86	43.62	11.17	4.46
2002	1.93	14.68	15.79	70.61	12.16	2.74
2003	1.14	8.19	9.00	44.29	6.91	2.57
2004	1.66	11.75	12.75	62.52	9.89	2.66
2005	2.01	13.89	16.37	72.04	11.64	2.79
2006	2.74	16.79	20.40	95.36	14.28	2.87
2007	2.82	16.08	19.04	91.19	13.67	3.09
2008	2.26	10.69	12.84	53.61	8.91	4.21
2009	3.03	14.24	16.62	73.44	11.93	4.12
Average	**1.66**	**11.58**	**12.92**	**49.13**	**9.24**	**3.56**

[10]This sector includes education, healthcare, real estate service, transportation, wholesale and retail trade, communication and others.

[11]Resources implies the resource of the government and it accounts for total income of government which includes revenue, foreign grants, non-budgetary receipts (net), others, VAT, custom account, local authority account as explained in Economic Survey.

DB = domestic borrowings, Rev = revenue collection, BD = budget deficits, BE = budget expenditure.
Source: Government of Nepal, *Economic Survey*: *Fiscal Year 2009/10* (GOVN, 2010).

General expenditure occupies the largest part of the budget and it is financed mainly by revenue collection and the second category which directly links to development activities of the economy is financed through borrowings. Between the two types of borrowings, the domestic borrowing policy of the government directly links to the banking system. Table 2 depicts domestic borrowing as a percentage of various macroeconomic indicators. The last column of the table provides the ratio of budget deficit to GDP. This ratio ranges from more than 2.0% to less than 6.0% every year from 1989 to 2009. Similarly, domestic borrowing was less than 3.0% of GDP (except in 2009) and average ratio remained below 4.0%.

The average ratio of domestic borrowing during this period stood at nearly 1.7% of GDP. Domestic borrowing is mainly contributing to budget deficits. For instance, in some years it covered more than 90.0% of budget deficit. On average, ratio of domestic borrowing with respect to budget deficits remained nearly 50.0% for the review period. Similarly, this component with respect to budget expenditure ranges from the lowest 5.45% in 1994 to the highest 14.28% in 2006 keeping the average 9.24% during this period.

In the case of Nepalese economy, investing in government securities is safer than supplying loans to other sector of the economy. Agriculture occupies a major portion of the economy; however, loans supply by commercial banks is the least in this sector. At the same time, it is quite surprising that investment of banks in government securities and government bonds is far higher than the loans supply to agriculture. Various reasons are responsible discouraging loans flow to the agricultural sector of Nepal.Primarily, agriculture system in Nepal is based on traditional and non-technical methods practiced by rural poor people. People at such places are incapable of borrowing money. On the other, there is a higher probability to sink the bank loan borrowed for agricultural purpose even if people are able to pay back the loan because agricultural production relies on monsoon and if the monsoon is bad, farmers will bear high loss. Similarly, political instability for a long time contributes in lowering the bank’s confidence to invest in certain areas of the economy including agriculture. However, in recent years loan flow towards service and industrial sectors is significantly higher than in the agriculture sector. In these sectors, loans flow by three public banks is comparatively higher than the five private banks. Figure 4 clearly reveals that the loan flow by banks towards the agriculture sector (which has the highest share in national economy) is lower than the other sectors of the economy. However, the government and the central bank’s policies are enabling banks to supply loans to the agriculture sector. Similarly, bank’s investment activities on government securities are also promoting financial sector development in Nepal.

Hence, the government also has a role to play in order to develop the financial system of Nepal through some of its policies. Such government’s policies play a key role in two respects: first, government finances its deficits to develop the economy. Second, it promotes banking industry. Likewise, under the priority and deprived sectors’ loans supply policy, banks are providing loans regularly to the priority and deprived sectors.

7. Conclusion

Among the various financial intermediaries, commercial banking industry has a dominant role in the financial system of Nepal. Banks contribute to the economy by channeling credits and other services. In this paper, we conducted a short descriptive investigation on commercial banking development and their contribution to the financial system and economy of Nepal. Similarly, one of the main objectives of this paper is to shed light on the role of government and the central bank to develop the banking industry of Nepal. The liberalized environment implemented in the mid-1980s created competition on the one hand, and raised challenges in the financial system because of the entry of new financial intermediaries on the other. Therefore, one of the objectives of commercial banks expansion, via branch extension, was to capture market share and compete with the new and existing financial intermediaries.

Commercial banks are extending their loans under the government and the central bank policy in the real sector, mainly focusing on priority and deprived sectors as categorized by the government. Under such policy, high amount of loan is being supplied to the agricultural sector. Therefore, government's policy is playing a direct and important role in order to enhance the financial system especially through banking sector’s development.

In nutshell, we observed that the share of commercial banks has the largest share in the financial system of Nepal and different categorical commercial banks are playing active role to supply credit in the real sector of the economy. In recent years, their role is increased in the development of capital market also. Government is also playing a key role to channel bank credit in the economy. Therefore, a further empirical investigation in order to examine the impact of commercial banking industry in the economic growth of Nepal is essential.

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