THE ROLE OF FINANCE IN ECONOMIC DEVELOPMENT OF DEVELOPING COUNTRIES

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1. INTRODUCTION

This paper deals with the role of finance in the economic development of developing countries. It is divided into seven sections. This first section discusses the role of capital in economic development of underdeveloped countries. In section 2, some indicators of financial development are examined. The role of the central bank and of financial intermediaries is examined in section 3. Section 4 looks at the role of money and capital markets in the development process. The last section provides concluding remarks.

1.1 Role of Capital

Economic growth is customarily defined as the growth of output per head of population. Among the factors which account for the growth of output, capital has usually been accorded the key role. This is especially so in the case of underdeveloped countries where the factor endowments reveal the scarcity of capital. The importance of capital in economic development has been somewhat toned down, and the complementarity of resources or composite forces of development has been increasingly emphasized.[1] It has been argued that economic growth requires a great deal more than an outpouring of capital; it requires a minimum of natural endowments, a trained, healthy and mobile labour force, an adequate supply of entrepreneurs, engineers, teachers and administrators, the modification of social attitudes and organisation so as to make them conducive to, or at least not inconsistent with, increased production.

Experiences in the development of many underdeveloped countries have revealed that although the estimated financial availability was generally smaller than the anticipated expenditure in the development plans, the anticipated investment expenditure could sometimes not be entirely spent. There are many instances showing that because of the shortage of technical personnel, the basic survey and design required for the implementation of a project were delayed and the funds allocated for the budget unspent. Many developing countries of South

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and South-East Asia are finding that the shortages of people with required skills are even more frustrating obstacle than any limitations on capital resources.[2]

But the scarcity of personnel trained in science, sociology or administration can be overcome by the use of capital to buy them in the World Market.[3] Improvements in health and education imply the investment of capital in schools and hospitals and housing. Therefore of the many ingredients, capital is the indispensable ingredient for the economic growth of developing nations.

Let us now take the case of Nepal and see the validity of above arguments in reference to table 1:

Table 1. Financial Outlay and Expenditure of Periodic Plans in Nepal.

(in million Rs.)

Plans	Total financial outlay	Actual expenditure	Actual expenditure as a per cent of total financial outlay
1st (1956-1960)	330.0	214.5	65.0
2nd (1962-1965)	600.0	596.8	99.5
3rd (1965-1970)	1740.0	1639.1	94.2
4th (1970-1975)	2570.0	3356.8	130.6
5th (1975-1980)	7545.0	9575.1	126.9
6th (1980-1985)	21750.0*	15582.8*	71.6

Source: National Planning Commission.

* At 1979/80 constant prices.

During the 1st, 2nd and 3rd Plans, the actual expenditure could not be as planned. This was because of the unavailability of adequate trained manpower, and ineffective implementation of the Plans. During 1970, the country entered into the 4th Plan. A large amount of foreign grant and loans were made available by donor countries. Along with foreign capital, the services of a number of technical experts, advisors and administrators was made available. The actual expenditure during 4th and 5th Plans exceeded the anticipated financial outlay. During the 6th Plan period, total expenditure again fell short of the target.

The formation of capital is one of the important prerequisites to meet the increasing expenditure for economic development. Capital increases by

investment and more investment necessitates more savings or foreign assistance i.e., if investment is to increase, there must be a growing surplus above current consumption that can be tapped into productive investment channels. The process of capital formation involves three essential steps.[4]

i) An increase in the volume of real savings, so that resources can be released for investment purposes.

ii) The channeling of savings through a finance and credit mechanism, so that investible funds can be collected from a wide range of different sources and claimed by investors.

iii) The act of investment itself, by which resources are used for increasing the capital stock.

Domestic investment must be financed by domestic savings or by an inflow of foreign capital from abroad. Since the available amount of foreign aid and capital is limited, and also involves a future burden of debt servicing and repayments, a country should rely on domestic saving to finance increasing amounts of investments.[5]

Real savings in Nepal between 1975 and 1985 increased by Rs. 563.6 million. The average annual growth rate of real savings was only 4.7 per cent. Total consumption expenditure during this period increased by Rs. 2287.2 million. The real savings was not able to meet the country's expenditure need. To bridge this gap, a large foreign capital inflow was necessary and requests were made for bilateral and multilateral loans as well as for foreign grants.

From table 2 (page 36), it is clear that despite increasing foreign loans as well as real saving, Nepal has not been able to meet its expenditure needs. Deficit financing has been increased significantly in the past few years. HMG's dependency on banking sector to finance the deficit has increased significantly. According to the Economic Survey 1984/85, out of the total deficit, the bank financed part has increased by 40.7 per cent per annum from Rs. 250.2 million in 1980 to Rs. 980.5 million in 1984.

Harry Johnson[6] (1969) argues that an efficient development policy should plan on a modest degree of inflation as a means of more fully mobilizing the economy's resources; in this limited sense, inflation is an inevitable price of development. While a policy of financing development by deliberate inflation has strong attractions theoretically and politically, the possibilities of stimulating economic development by these means are quite limited and inflationary

Table 2. Real Savings, Consumption and Foreign Capital Inflow.

(in million Rs.)

Year	Real savings	Expenditure in real terms	Real foreign capital inflow loan	grants	Total resources available
1975	1204.3	10803.6	76.3	241.0	1521.6
1980	1458.3	11689.8	455.6	620.7	2534.6
1981	1476.7	12081.9	867.4	1124.9	3469.0
1982	1286.9	12646.6	705.7	592.0	2584.6
1983	1203.9	12087.8	641.1	523.9	2368.9
1984	1557.4	8698.8	861.7	364.4	2783.5
1985	1767.9	13090.8	958.2	1174.7	3900.8

Source: Economic Survey 1985/86, HMG Ministry of Finance; & Quarterly Economic Bulletin, Nepal Rastra Bank.

development policies in practice are unlikely to achieve the desired effect. On the contrary, they are likely to retard economic growth, by distorting the allocation of resources and by increasing uncertainty. This eventually is likely to have an adverse impact on the balance of payments situation resulting in the probable fostering of the inefficiencies of protectionism and exchange control.

The central planning technique seeks to mobilize and employ efficient savings with a minimum need of financial markets, assets and debts. There are several limitations of this method in the developing countries. Experience had shown that the under supplying of the Plan with needed data, and the overtaxing of administrative competence and managerial capacity have all combined to thwart the practical implementation of the Plan. This is likely to be particularly true in the case of developing countries, where deficiencies in administrative and managerial procedures have been severe impediments to planning in practice.

The fiscal technique for mobilizing savings relies on the centralization of decision making and internal finance. In this system, tax payments are imposed on individuals and business firms, and a substantial part of the tax receipts is used by the government for its own investment projects, or for lending to private

enterprises for their investment programmes. The raising of larger revenues can come only from more effective administration of tax measures and, eventually, from an increased taxable capacity. But an efficient fiscal administration is lacking in developing countries due to the lack of trained personnel with required skills. In addition, the taxable capacity in these countries is also low for several reasons, including lower per capita income, uneven income distribution, the political power of strong vested interests opposed to higher taxes, and low land taxes.

2. INDICATORS OF FINANCIAL DEVELOPMENT

Raymond Goldsmith[7] (1969) had used the ratio of financial assets to national wealth, which he called the financial interrelation ratio (FIR), as an indicator of financial development. He argues that the FIR rises with a country's economic growth and that its value reflects the degree of specialization in economy, in both production and finance.

As a country climbs up the income ladder, its financial structure usually becomes increasingly rich in financial assets, institutions and markets. Therefore, for prosperous countries the ratio of total financial assets to GNP (i.e. the financial ratio) is higher than those of the poor countries. The financial ratio rises with development for several reasons: firstly, due to the increase in net issues of primary securities in the development process; secondly, during the development process a country's monetary sector is often extended rapidly which calls for an increasing amount of money balances for transactions purposes; and finally, due to the expansion of financial intermediaries during the development process.[8]

Hugh T. Patrick[9] (1972) had emphasized that, as the economy grows, it generates additional and new demands for financial services, which brings about a supply response in the growth of the financial system. He termed this as 'Demand Following Finance' in which the creation of modern financial institutions, the financial assets and liabilities, and related financial services takes place in response to the demand for these services by investors and savers in the real economy. This approach implies that finance is essentially passive and permissive in the growth process. The nature of financial services depends upon the growth of real output and upon the commercialization and monetization of agriculture and other traditional subsistence sectors. The more rapid growth rate of real national income, the greater will be the demand by enterprises for external funds, and therefore, for financial intermediation, since under most circumstances firms will be less able to finance expansion from internally generated depreciation allowances and retained profits.

Patrick's supply leading finance involves the creation of financial institutions and the supply of their financial assets and liabilities and related financial services in advance of demand for them. It has two functions - to transfer resources from traditional sectors to modern sectors and to promote and stimulate an entrepreneurial response in these modern sectors. Supply leading finance may not be a profitable activity at least in the short-run, and institutions that engage in it may require direct or indirect government assistance to stay in existence. Supply leading finance relies on the beliefs that real economic growth can be led by financial development and the benefits of growth will outweigh, and so justify, the costs incurred in the short-run by supply leading finance.

The correlation between financial development and real growth has been noticed historically and argued theoretically, but the direction of causality has not yet been established.[10] K.L. Gupta with a time series data of sufficient length for fourteen countries tested the direction of causality between financial development and real growth. He used M_1 (currency plus demand deposits), M_2 (M_1 plus quasi money), CR (total domestic credit), PCR (total private credit) and F (total finance which is defined as M_1 plus quasi money plus postal savings deposits plus bonds held by other financial institutions plus capital accounts of other financial institutions) as indicators of financial development and the index of industrial production (IP) as an indicator of real growth.

He found that out of the fourteen countries covered, in the case of eight, there was overwhelming support for the situation in which economic growth was stimulated by deliberately planned expansion of financial development. For two countries of the sample, there was a simultaneous relationship between financial development and economic growth. In Gupta's findings, out of five indicators of financial development used in the test, for all countries, at least three indicators suggested the existence of supply leading finance (a situation in which financial development causes economic growth). Therefore, Gupta found that it was reasonable to suggest (at least for the sample of countries covered in his test) that financial development causes economic growth. There is not, however, much empirical literature testing the direction of causality between financial development and economic growth.

2.1 Savings and Investments in Developing Countries

In most of the developing countries agriculture is the main occupation providing 40 to 60 per cent of national income The income flow from agriculture is divided between the land owner the government and the cultivator. A large proportion of the farm produce has to be paid as rent and taxes. The average tenant does not receive sufficient income from his farming operations to support

his family. Debts are incurred by these tenants in the year of poor crops, and in paying rent and taxes, as well as for other social expenses. The bulk of the rural population, namely the tenants and the small holders, is mostly not the saver. The fortunate few who do save tend to invest in land, or in loans to the less fortunate, and do not go in much for capital formation. This is mainly due to the unavailability of less risky viable projects and lack of entrepreneurship among them. They provide loans within a limited circle, whom they know well and are reluctant to make loan to the new borrowers, because of the associated risk which could be very high.

In developing countries, people of low income groups are likely to save through saving banks, co-operative savings societies, mutual societies and similar institutions. Savings of these people could be augmented if government actively assisted in organising saving institutions and urged the people to step up their savings. Participation of government was expected to provide confidence for the people to rely on such institutions.

The middle class people save through co-operative savings societies, mutual societies, through insurance companies and, to a lesser extent, through investment in their own enterprises or bonds and stocks. It is also possible that the development of stock markets might further stimulate middle class savings. But in developing countries there are various factors which limit the development of securities market. The supply and demand of corporate securities is very limited in most underdeveloped economies. Underdeveloped economies are dominated by agriculture, which is usually organised on small holder lines. Public utilities (i.e. noncorporate enterprises) commonly provide power, transport and communication services, while the industrial sector is small and weak. The few domestic corporate concerns are often not in need of further capital, or are unwilling, or unable to raise funds by public subscriptions.[11]

Family or clan companies are common in underdeveloped countries and they are reluctant to admit outside capital and risk dilution of control. They may prefer early diversification as well. Firms that are bent on expansion may finance it with retained profits and, or easy availability of bank credit. The banks enjoy economies of scale; hence it could specialise in and standardise certain types of financial transactions and thus reduce risk through better expertise. The banking system has become much too specialised; consistent with its origin, it provided credit only for certain types of transactions-like stock of goods - in industry and trade. The transaction costs of lending by banks to small enterprises and agriculture are quite high. So they provide credit only to reputable firms, whose credit worthiness is known.

There are also limited demand for securities in the developing economies, because of the following reasons:

1. People are financially inexperienced to deal in the stock market.

2. There is not a sufficiently large class of well-to-do persons to sustain a corporate securities market in an underdeveloped country.

3. The generally underdeveloped financial system means that there is little or no institutional demand for securities.

4. Price uncertainty reinforces the traditional preference for money over financial assets which fluctuate in value.

5. Accurate information is scarce and the costs of obtaining it are inordinately high; market regulation is limited. Hence investment in securities is extremely risky.

The people of higher income group are not greatly handicapped by the lack of institutions. New saving institutions can still divert a part of their savings from less to more useful purposes and also increase the propensity to save.

To sum up, in most underdeveloped economies, saving institutions, widespread banking habits, and developed money and capital markets are seriously lacking. Consequently whatever little savings do exist have a tendency to go either into hoards of gold, real estate or foreign exchange or else into a limited range of investments.

2.2 Monetary Policy Problems in Developing Countries

The basic objectives of financial policy for economic growth are to develop the use of money in the economy. Money is unique among financial assets in that it alone gives immediate purchasing power, in other words, it is supremely liquid.

The existence of unorganised money markets in the rural areas of developing countries has reduced the size of monetary transactions and perpetuated nón-monetary transactions. The existence of the unorganised sector has deprived the economy of an array of financial assets with which savings could have been more effectively collected and directed toward investment for realising a higher rate of economic growth. The impact of monetary policy has been considerably weakened by the presence of the dualism in the rural money market. Therefore, monetization of the economy is extremely important in the developing countries. In developing

countries, the share of the non-monetized sector in total gross domestic products of the country can be significant. In such cases the overall rate of economic growth could be said to be determined, as much as by the performance of the non-monetized sector as by the monetized sector, as well as by their mutual interactions. Monetization is a necessary condition for both commercialization and financial intermediation (Chandravarkar[12], 1971, p. 62).

Financial policy should encourage savers to hold their savings in the form of financial rather than unproductive assets, to ensure that investment is allocated efficiently to the socially most productive uses; and to provide incentives to induce increased saving, investment and production. To achieve these objectives, policy makers must encourage the proper foundation and expansion of financial institutions.

3. THE ROLE OF THE CENTRAL BANK AND FINANCIAL INTERMEDIARIES

3.1 Central Banking

A central bank is a national financial institution created to operate, not for profit, but for the public purpose, to influence the economy in desirable directions through monetary means. The choice and use of these monetary methods of influence on the economy-the "art and essence of central banking"[13] are guided by and also reflect the central bank's monetary policy.

The essential task of a central bank is to influence the monetary situation. In exercising its influence it tries to counteract tendencies toward depreciation of the value of currency, in its purchasing power at home and its exchange value with other currencies of the world. Traditionally, its characteristic functions are to regulate the note issue, to serve as the banker to the government, to hold the cash reserve of the commercial banks, to hold and manage the external monetary reserves, to be the lender of the last resort to the banking system, to act as the bankers for the commercial banks for the settlement of clearances and to devise and give effect to monetary policy.

In the developing economy where the indigeneous credit system is either non-existent or at an extremely rudimentary stage, it has been widely believed that the above mentioned traditional role of central bank is not enough. Central banking policies will have to be formulated in such a manner as to cope with the special problems of each country. To quote Mr. Louis Rasminsky (Governor of the Central Bank of Canada), the role of the central bank is greatly influenced by

the system of government, by the stage of economic development, and by the organisation of financial markets; indeed in underdeveloped countries which are economically short of capital, central bank may in fact be devoted to improve the structure of financial institutions so that the maximum amount of domestic savings may be mobilised for economically constructive purposes and the pressures for inflationary financing of development thereby reduced.

3.1.1 Role of Central Bank in financial development:

A central bank can play a vital role in building up the financial infrastructure of economic development in developing countries. The creation of local money and capital market is an obvious and important activity under this heading. It can influence and control the activities of commercial banks and financial institutions and the level and structure of interest rates.

'V.V. Bhatt' argues that it is the central bank that has to take the leading role in evolving the credit institutions, instruments and yield structure that are essential for:

a) the efficient mobilization of saving, and

b) the allocation of resources consistent with development objectives.

The final goal of the economic development in a developing economy is to find a rationale and meaningful way of breaking the vic s circle of capital shortage and underdevelopment and of designing an efficient and optimum rate of capital accumulation.

While external capital inflow may supplement resources in order to quicken the pace of economic development, a developing country must primarily depend on its domestic resources. Mobilisation of savings and its effective use for increasing production is of crucial significance to a developing country. The central bank can make an important contribution in the process of mobilisation and transfer of savings towards productive sector through judicious use of policies. It has to play an important role in the evolution of a sound and well integrated financial system for both efficient resource mobilisation and its rational allocation.

The central bank can greatly facilitate the pooling process of the small and scattered savings and their allocation to the productive channels through the development of financial institutions. It should attempt to influence the flow of institutional credit away from traditional uses and towards capital

development activities by providing incentives and leadership to the financial institutions.[14]

3.1.2 Objective of central banking:

The essential objective to be pursued by the central bank in its strategy of developing the financial sector is to increase the demand for money at every level of GNP. As economic development proceeds, it will normally be accompanied by a decline in the relative share of non-monetary output. This declining relative share will tend to cause the demand for real money balances to grow faster than total real income. The differentiation of production, expansion of banking habits and financial transactions will also contribute to the outcome. To achieve stability with growth, the increase in money supply should be in line with the growth in real output.

The central bank should increase the income elasticity of money supply and reduce its cost elasticity, which allows a greater volume of domestic credit to be created. An accompanying objective of the central bank must be to facilitate bank lending so that the greater volume of real balances can be lent without a reduction, and where possible with an increase, in the average efficiency of investment so financed. In developing countries, where there is lack of competition for deposits, the most important device open to the central bank for increasing the demand for money is the initiation of an active policy for the encouragement of banking and banking habit. This must involve further competition in the financial sector.[15]

3.1.3 Credit management: role of the central bank:

The authority accorded to a central bank, which enables it to influence the rate of expansion of the banking system and the money market, and to act as banker and debt manager of the government, places it at the centre of the financial system. The central bank is naturally concerned that financial markets should function efficiently. They act as the channel through which the impact of monetary policy on the economy is transmitted and the channel through which the savings of the community are transferred to the ultimate users.

Toward development financing role of the central bank, it has been thought in early period that a massive injection of funds would lead to rapid entrepreneurial development and the expansion of business activities leading to a more rapid growth.[16] But experience of many countries have shown that the problem is not so simple. The problem can be divided sequentially as follows:

a) developing the institutions to administer development funds,

b) providing fund needed for development financing, and

c) developing the business climate conducive to greater business activities.

Therefore, for development financing the first function which most countries should follow is the creation of credit institutions. The second problem is the provision of fund. The most dynamic role of the central bank in development finance involves the form of credit extended to not only the development banks and the non-bank financial institutions, but more significantly to the commercial banks.[17]

The third problem lies in the use of the provided funds to generate business activities in the sectors, needed to be developed, such as small scale industries and rural areas. For effective use of credit, the absorbing capacity of the economy should be developed.

Many central banks have realized these problems and they are conscious of the need to encourage and supervise the non-credit aspects of development activities such as supervising and encouraging the development of the small scale industries and the rural sector. Therefore, the central bank's function of providing development funds is only meaningful if it is coupled with the steady, undramatic but important process of institution building and financial deepening necessary for achieving a country's long term development objectives.[18]

3.1.4 Central banking in Nepal

In Nepal, the supply of modern financial services is a recent phenomenon. The first commercial bank of the country - "the Nepal Bank Limited" - was established in the year 1937 as a joint stock company in which the government owned 51 per cent of the total share. This bank opened its branches in the main industrial and trading regions of the country. Until 1957, there were only 8 commercial bank branches operating in the country. The number of bank branches increased considerably after 1957 because it was felt that, without appropriate development in the financial sector, the planned development effort will not be successful. In this line the central bank (Nepal Rastra Bank) was established in the year 1956, under the Nepal Rastra Bank (NRB) Act of 1955. The preamble of the Act states that it has been essential to establish a central bank in Nepal in order to ensure proper management for the issue of Nepalese currency throughout the kingdom, to stabilise the exchange rate of the Nepalese currency in order to ensure the convenience and interest of the general public, to mobilise resources

for development thereby encouraging trade and industry in the kingdom and to develop the banking system in Nepal.

Up to 1965, Indian currency was free legal tender in Nepal and circulated side by side with the Nepalese currency. Therefore, NRB was then primarily involved in popularising the use of Nepalese currency within the country. Owing to lack of official intervention on stabilising the exchange rate of Nepalese rupee vis-a-vis the Indian currency, the exchange rate was very volatile and sometimes fluctuating even daily. The foreign exchange reserve of Nepal was kept with Indian banks until 1961. Exchange rate stability and control over foreign exchange reserve was the main achievement of NRB in its early years of operation.

Nepal Rastra Bank took the responsibility of providing banking facilities to the people by opening its own branches in different parts of the country. Later on, these branches were handed over to the commercial bank.

At present, NRB exercises the typical central banking functions of issuing notes and coins, helping to set monetary policy objectives and making use of monetary policy instruments, acting as the government's financial agent including managing the public debt, managing the country's official foreign exchange reserves, and regulating and supervising the banks and other financial institutions. The NRB may purchase, sell or underwrite shares and debentures of banks and other financial institutions. It regulates the activities of the commercial banks and, to a lesser extent, those of the Agriculture Development Bank (ADB/N) and Nepal Industrial Development Corporation (NIDC) and supplies credit to them.

The NRB has placed emphasis on the extension of banking services throughout the kingdom. It provides interest free loans to commercial banks to expand their branches in notified areas and compensates the losses incurred by such newly opened branches for the first few years. As at January 1986, 385 commercial bank branches were operating in the country. The comparable figure was only 125 in 1975.

Apart from the normal central banking functions with regard to the monetary situation, NRB provides loans and refinance to commercial banks and the development banks on conditions prescribed by it.

NRB had instructed commercial banks to invest a certain proportion of their credit portfolio in the priority sectors which involves agriculture, cottage and small scale industry and services. Commercial banks are required to invest 25 per cent of their total credit disbursements to the productive sectors of the economy. This requirement was in line with national objectives of financing production and creating more employment opportunities in the country. At present,

the commercial banks should invest at least 8 per cent of their total credit in the priority sector. The remaining productive sector lending will compose of lending to the other modern productive sectors, such as manufacturing, mining and quarrying, and the like.

With a view to solving the problem of rural unemployment and to provide loans to poor people, who don't have tangible assets for security, an Intensive Banking Development Programme has been launched in the country since 1980, with an initiative of NRB. The commercial banks under such programmes are providing loans under area development schemes with proper feasibility study of the projects and constant supervision of loans.

3.2 Commercial Banking

Commercial banks are the most important financial institutions in providing credit to industry and trade and in collecting savings. Normally these banks provide only short-term credit. In developing countries, special financial institutions to provide finance in agriculture and industries are lacking. It has therefore been necessary to devise measures to enable commercial banks to grant the medium term or long term loans essential for the agricultural sector and industrial sector of the developing countries.

3.2.1 Role of commercial banks in saving mobilisation:

The extension of the banking system into rural areas in certain developing countries has considerably improved the effectiveness in collection of savings. The existence of a greater number of bank offices may evoke a greater volume of real savings. For example, Lewis (1955, p. 229) claims that "Experience shows that the amount of savings depends partly on how widespread savings institutions are. If they are pushed right under the individual's nose, people save more than if the nearest savings institution is some distance away.[19]

The expansion of commercial bank branches is also necessary in the rural areas of the developing countries to promote integration between the organised and unorganised money markets and thereby to increase the efficiency of monetary policy.

R.C. Porter (1966)[20] has argued that "a greater number of bank offices can mean a greater fraction of the nation's saving is channelled into investments through the mediation of the banking system which in turn may lead to a more efficient collection of investment projects". But he is aware of the danger that commercial banks will expand their size without widening their scope, thereby those borrowers considered credit-worthy by the banks will receive cheaper

financing. He further argues that if deposits grow more rapidly than the "bankable loan" customers, the supply of investment finance will be reduced (given the total volume of saving) in the other credit markets. Bank growth may dry up, relatively if not absolutely, as a source of finance for agriculture, long term projects and small business.

Legal constraints can be critical in preventing dynamic banking.[21] In most of the developing countries there are no laws to compel the commercial banks to engage in a wider spectrum of lending activities. On the other hand, the law may be inadequate in other respects to support banking activities, e.g. with respect to cheques drawn against insufficient funds, negotiable instruments, liens on crops of livestock, seizure and or disposal of collateral on default. For example while providing loans in the rural areas, the banks may not be able to acquire adequate collateral because most of the borrowers are poor. However, in the absence of credit, their production may be adversely affected. Nonetheless, in the absence of adequate collateral, the problem of default may accentuate at least from the bank's point of view. Under such circumstances, there is strong tendency among banks of the LDC's to concentrate large chunk of their lending among handful of wealthier borrowers. With a view to persuading banks to lend to the needy farmers unable to provide required collaterals, a concessional rate could be charged on group lending comprising of such type of borrowers. The difference in interest rate could be compensated by the specified agency. However, the system of supervision and monitoring should be strengthened in such type of lending.

Inadequate legal support constraints unsecured lending and it is unsecured lending - the taking of calculated risks - which is essential for development. Where that is itself prohibited by law then the restrictive framework within which banking takes place seriously retards not only financial development but economic development in general.[22] Finally there is the initial small size of banking system itself.

Therefore, along with the creation of special institutions to lend in agriculture and industry, the commercial banks are also to be encouraged to provide medium and long term finance in agricultural and industrial sector. This can be done by granting government guarantee or insurance against the risk of default on loans made to industries and agriculture by the commercial banks.

3.2.2 Commercial banking in Nepal:

In Nepal there are five commercial banks of which two are fully domestic: the Nepal Bank Ltd. (NBL) and the Rastriya Banijya Bank (RBB). NBL is 51 per cent government owned, while RBB is 100 per cent government owned. The other

commercial bank, the Nepal Arab Bank Ltd. (NABIL) is a joint venture with a 50 per cent participation by Dubai Bank. NABIL started operations in July 1984. The Indo-Suez Bank and the Grindlays Banks came into operation in the country in the year 1986 and 1987 respectively. Fifty per cent of the Indo-Suez Bank's share capital is owned by the parent bank, while 15 per cent each is subscribed by the Rastriya Banijya Bank and the National Insurance Corporation. The rest 20 per cent goes to the general public. Regarding Grindlays Bank, 50 per cent share capital is owned by the parent bank, 35 per cent by the Nepal Bank Ltd. and the rest 15 per cent by the general public.

The RBB was established in the year 1964 in the public sector in view of the growing need for commercial bank facilities consequent upon the increasing economic activities of the country. It was stated in the draft third Plan that the NBL established in 1937 is the only commercial bank at present in Nepal. Since NBL alone was not in a position to cater all the credit requirement of the country, a new bank, the RBB, has been established in the public sector.

Following the establishment of RBB, there has been a substantial increment in commercial bank branches. By 1977, the banking service was available in all the 75 districts of the country through 216 branches.

Commercial banks in Nepal accept deposits from the public and the institutions and give loan and advances to those who need them, with an interest rate administered by the central bank. These banks maintain three type of deposit accounts: demand deposit, fixed deposit and saving deposit. No interest is paid on demand deposits, which are repayable on demand. Fixed deposit accounts for a larger proportion of total deposit of the banks. This is due to the increased preference of the people as well as the investment of some financial institutions, like Provident Fund Corporation (PFC) in the form of fixed deposit at the commercial banks because of interest advantage.

Commercial banks in Nepal are the principal source of domestic credit expansion. They have extended funds to a variety of uses namely discounting and purchasing foreign and inland bills, loans and advances to private and public enterprises, investment in government securities, and purcahse of premises and other immovable properties. Most of the bank loans are provided directly against securities. The security required is customarily in the form of a pledge of goods. Adequate collateral still determines the amount of borrowing.

3.3 Special Credit Institutions

In the loan market the crucial variable which determines the terms of lending to each class of borrowers relates to transaction cost - the administrative

cost plus the default risk. The real problem of the commercial banks has been to reduce transaction costs of lending for purposes other than financing of stocks in industry and trade. The sectors which require credit are small enterprises of all type and agriculture. One recent study by Bhatt and Roe[23] has found that the transaction costs of lending to these sectors is quite high; they are higher than 6 per cent and range between 6 per cent and 20 per cent in different countries.

Policies could establish specialised institutions that lend at subsidized interest rates - the subsidy to these institutions being provided by the government, directly taking social costs and benefits into account. The central bank can finance the specialized agencies like the development banks, agricultural credit institutions and co-operative societies by way of investment in their share capital and debentures. Refinance facilities to such institutions should be provided by the central bank in favourable terms and conditions.

The institutions specializing in industrial financing are known as Industrial Development Banks. The main business of Industrial Development Banks is to provide financial assistance for the long and medium term to industrial investment projects, usually accompanied by technical assistance in the promotion of the projects for which the financial assistance has been granted. Financial assistance, along with long and medium term loans, may also consist of participation in the share capital, or underwriting share issues by the enterprises concerned. Technical assistance may consist of various types of promotion work, from assistance in the feasibility study to start - up of new enterprises. Such institutions also serve to channel capital and expert technological knowledge from abroad to domestic industrial investment projects.

The operating cost per unit of credit provided by the development banks tends to be higher. In developing countries, where industrial development must be given special support, government participation in such specialized institutions, not necessarily on a majority basis, is often essential. Therefore, development banks must be subsidized substantially by the government. The benefit from the establishment of such institutions is obvious, because it is industrial development which is expected to bring the desired employment opportunities and technological advances to complement local programmes and generally to conform with the aspirations of development Plans.

3.3.1 Industrial development banking in Nepal:

In Nepal, Industrial Development Centre was established in 1957. In 1959, the Centre was converted into Nepal Industrial Development Corporation (NIDC). NIDC was set up with objectives of providing financial assistance for the

modernisation and expansion of the old industrial units and providing technical and financial assistance to the new industrial units in the private sector. It is the only financial institution, which is created by the government and operating at present with the sole responsibility of meeting long and medium term financial requirements of the industrial sector. The loan and investment policies of NIDC are influenced by government industrial policy and the priorities set up in the National Plans. The sources from which NIDC makes the funds available for long and medium term financing to industries are mainly share capital, reserve and surplus, borrowing, repayment of principal by borrowers and sale of stocks from its investment portfolio.

3.3.2 Agricultural credit institution:

In developing nations, agricultural progress is essential to provide food for growing population, raw materials for industrial production, savings and tax revenue to support development of the rest of the economy, to earn more foreign exchange and to provide a growing market for domestic manufacturers. There is a great imbalance between the volume of savings flowing to financial institutions from rural areas and the credit need of peasant producers in LDC's. The fundamental problem is that the financial system which sets out to meet the needs of small scale rural producers, and which aims to be self sufficient, requires access to savings from outside the agricultural sector.

Agricultural development is primarily concerned with the feasibility of increasing net agricultural surplus or net capital outflow from the agricultural sector. T.H. Lee (1971)[24] argues that in LDC's, mobilization of internal capital depends on agricultural development. In relation to the intersectoral capital outflow from agriculture he suggested four important government measures:

a) Allocation of capital to agriculture
b) Technological progress
c) Agricultural taxation and
d) Organizational improvements.

Therefore, institutions specialised in agricultural financing with a full knowledge of agricultural technology ought to be established and government must lead the way, for there are bound to be losses and only government can be expected to underwrite losses in the interest of rural betterment. The issue of rural credit bills or bonds can be a means of testing peoples' willingness to borrow and at the same time providing a local outlet for the savings of other sectors.

Agricultural financing in Nepal:

In Nepal, a financial institution to provide institutional agricultural credit was established as a co-operative bank in 1963. But the individual farmers outside the co-operatives found themselves without access to the credit from the bank, as the lending operations of the bank were confined to co-operatives members only. The need for an institution with a broader financial and operational framework was felt to meet the credit needs of the agricultural sector. Consequently, the Agriculture Development Bank (ADB/N) was established in 1968 and the co-operative bank was integrated with it. There was already another financial institution in existence which was also dealing in agricultural financing. This was the Land Reform Saving Corporation (LRSC) established to channelise the savings collected under the compulsory savings scheme under the Land Reform Act of 1964. To avoid overlapping and undue competition of functions between the two agencies, the LRSC was also merged with the ADB/N in 1973.

The ADB/N is a public sector bank with some private participation. It gives loans to the agricultural and rural sectors largely on the basis of its own capital and borrowed funds; it also issues debentures most of which are subscribed by the NRB, and accepts deposits from the public.

Thus, the ADB/N supplements its capital resources with considerable borrowing from the NRB and foreign sources, and to a much smaller extent with deposits from the public and other liabilities. The main source of foreign borrowing of this bank is the Asian Development Bank. However, in recent years the ADB/N has also included the International Fund for Agricultural Development (IFAD) and the IDA of the World Bank in its borrowing portfolio.

3.4 Postal Saving Offices

In order to promote the saving habit among the rural population without easy access to ordinary banking facilities, postal savings offices have been set up in all 75 districts of the country. However, the volume of deposits with the postal saving offices remains very small.

3.5 Co-operative Societies

In developing countries where the development banks and the commercial banks do not possess an extensive network of branches, the mobilization of private savings has to be carried out through a system of widely dispersed financial institutions, such as post office saving banks and co-operative societies.

The co-operative societies can be a vehicle of promoting the economic and financial development in rural areas without which the overall economic development of LDC's is not possible. To promote the rural credit the authorities must face up the fact that small scale rural credit institutions are likely to take a long time to become self sustaining. Hence the government should concentrate disbursing loanable funds on the rural areas, through co-operative societies, with the appropriate assessment and supervision of loans.

3.5.1 Co-operative societies in Nepal:

Among the credit co-operatives in Nepal, which number about 700, the Sajhas are the most numerous. In 1969, the government began a programme of guided Sajhas under which the Sajhas were progressively put under the control of the ADB/N, which also acted as a channel for the supply of inputs, credit and marketing facilities to the farmers. This program was interrupted in 1977, when the Sajhas were put under the control of the Department of Co-operatives under the Ministry of Land reform, but they were returned to the control of the ADB/N by a decision taken in 1983. The Sajhas cover 68 of the 75 districts of the country. Their number increased from 206 in 1974 to 293 in 1976 under the guidance of the ADB/N, and then jumped to 1142 in 1977 under a promotion programme introduced by the Department of Co-operatives, Ministry of Land Reform. However, it was soon found that many of these institutions were not viable and the number of Sajhas decreased to 688 in 1978. From 1979 to 1984, the number of Sajhas remained at around 700.

Information on the assets and liabilities of the Sajhas is available only for a sample of institutions surveyed by the NRB, which represent only one-eights of the total. Assets of the surveyed institutions consist mainly of outstanding loans. Liabilities are composed of own and borrowed funds. Own funds have share capital as the major item. The bulk of the borrowed funds is obtained from the ADB/N.

3.6 Other Non-Bank Financial Institutions

The main function of the non-bank financial intermediaries is to serve as a middlemen between two groups of people.[25] They do this by selling a particular type of financial service to one group of people and then taking this money and selling another type of financial service to another group of people. In each case, the financial service sold is one which individuals would find it difficult, if not impossible, to provide for themselves.

In most developing countries, a special group of these institutions like Employees Provident Funds, Insurance Companies, Post Office Saving Banks and

National Saving Banks have been operating. The savings collected in respect of life insurance have become a considerable factor in some developing countries. In other countries, however, the development of such savings has been hindered by the smallness of family income and also, sometimes, by a very rapid depreciation in the value of money. Compulsory saving through provident fund is becoming widespread in most developing countries, but the administrative expenses, often excessively high, present problems. Some of these saving funds that were not invested have suffered serious depreciation as a result of currency devaluations.

Government in developing countries, should therefore take proper steps to channel such savings collected by the financial intermediaries into more productive investment opportunities.

3.6.1 Provident Fund Corporation:

In Nepal, the Employee Provident Fund Corporation (EPFC) was established in 1963 as a statutory corporation under the Provident Fund Act of 1963. It covers mandatorily most public sector employees, but private sector companies may also enlist their employees with the EPF on a voluntary basis. There are also a number of other provident funds at the level of individual entities and corporations. The main functions of the EPFC are to collect compulsory savings from the employees and channelise the funds for safe deposits and earnings.

3.6.2 Insurance companies:

There are four insurance companies in Nepal of which two are local and two foreign owned. The largest insurance company is the National Insurance Company (NIC). The other local insurance company is the Nepal Insurance and Transport Co., Ltd. Both companies are public sector institutions with some private sector participation. The two foreign companies are branches of Indian Insurance Companies - the National Insurance Co. Ltd. and the Oriental Fire and General Insurance Co. Ltd. In Nepal, NIC was set up in 1968 to check the continuous outflow of capital from the country in the form of premia to foreign companies. The NIC is the only company allowed to provide life insurance in addition to general insurance.

The investment portfolio of the insurance companies consists primarily of government development bonds, commercial banks' time deposits and treasury bills. The two institutions, PFC and NIC, both have a bearing on monetary policy to the extent that they buy the government securities. Secondly, both these institutions contribute to the deposit liabilities of the commercial banks.

3.6.3 Other institutions

The Credit Guarantee Corporation (CGC) was set-up in the year 1974 on the initiative of NRB. CGC was established to provide guarantee for the commercial bank loans in priority sectors.

The Agricultural Projects Services Centre (APROSC) was set up at the initiation of NRB for supplying techno - feasibility surveys to the commercial banks in the agricultural sector to enhance their understanding of this sector.

The Industrial Services Centre (ISC) was set up in 1974 to relieve the NIDC of its non-banking functions. This centre carries functions like conducting techno-economic surveys of industrial opportunities, management of industrial districts, and so on.

A Cottage and Village Industries Department of HMG/N provides financial and technical assistance to those smaller industrial enterprises which are not covered by the NIDC. It is a government department and depends on the government budget, along with repayment, for its resources.

4. MONEY, CAPITAL MARKETS & DEVELOPMENT

4.1 Capital Markets

The capital market consists of primary market and the secondary market. The primary market deals with the selling of new securities when they are first produced by the issuing entities. Since many of the initial buyers of these securities will eventually want to resell them, there is also a secondary market for second hand, or previously issued securities.

As industrialization progresses, countries with a market economy find it useful to establish stock exchange, through which capital can be raised by stock and share issues. Starting up a securities market in a developing country, however, is frequently very difficult; the necessary judicial and administrative framework is often inadequate or non-existent; industrial companies are strictly private businesses, with the capital concentrated in the hands of the owner's family and a few friends. Inevitably, potential investors will lack confidence in the management of enterprises over which they have no direct control and whose accounts are often kept secret or fail to reveal the true situation.

Government in developing countries should, therefore, introduce measures to promote securities markets. A securities market encourages financial development

through fostering intermediation, and provides liquidity to the owners of financial assets resulting in enhanced rate of saving and investment.

4.1.1 Capital market development in Nepal

In Nepal, a modern capital market has still to develop. The only securities traded are HMG/N bonds and bills. The transactions of securities are almost confined to the financial institutions in general and the banking system in particular. Over the years there has been a tendency for the banking system's share in total government's securities to rise further. The lack of secondary market is one of the major reasons for the dormancy of capital market in Nepal. Therefore the establishment of security Marketing Centre (SMC) and its replacement by Securities Enxchange Centre (SEC) may be considered as a positive step to assist public limited companies to raise capital through the issue of shares and debentures and to create a market place where purchase and sale of securities take place through intermediaries operating on the floor of the exchange.

The Securities Exchange Centre Ltd. (SEC) was established by the Securities Market Act 1983, and in April 1984 it replaced the former Securities Marketing Centre (SMC), which had operated since 1976. Trading under the new law did not start until November 1984. Like the SMC, the SEC is wholly owned by the government and government entities (NRB and NIDC). In comparison with the SMC,the SEC has been given wider functions since, in addition to underwriting and managing new capital issues, and selling government bonds, it has been empowered to list the shares of public companies and to provide a secondary market in them, to supervise public companies, and to promote a system of professional brokers in due course.

4.2 Money Markets

The level and structure of interest rates measures the price of credit and therefore plays an important role in the economic policies of the developing countries. In most of the developing countries, the interest rate is policy determined rather than market determined in the organised sector. The law of demand and supply, therefore, will not be fully reflected in the observed interest rate. In the unorganised market, the interest rate could be determined by a number of both economic and institutional variables. The determination of the rural rate of interest is usually viewed from the supply side, given the paucity of information on the demand side. On the supply side, the rural interest rate could be determined by the risk premium, administrative costs, opportunity costs and the degree of monopoly power of the money-lenders.

Rural interest rates are mainly determined by the risk premium and uncertainty due to default in repayments rather than the monopoly power of the

money lenders. However, the power of the money lenders should not be discounted altogether, given the lack of specialisation and the complex nature of the socio-economic relationship between the farmers, landlords, merchants and money lenders. Under such circumstances, it is difficult to see how the interaction between the demand for and supply of money could determine the rate of interest.

4.2.1 Unorganised sector:

In some LDC's the only institutions operating in their unorganised money markets are the co-operative credit societies. Therefore, the interest rate in the unorganised sector range from fairly low rate charged by these co-operatives to the very high rates charged by money-lenders, merchants and landlords from borrowers with poor credit rating or to those in urgent need of funds. The high rates of interest prevailing in the unorganised money markets have been a heavy burden to the rural people and to the farmers. Their annual interest payments have been fairly large in relation to the net income, thus reducing their ability to make improvements on the land.

Governments in some LDCs have attempted to influence the cost and availability of credit in the unorganised money market through direct lending to the farmers and by controlling the rates of interest and the conditions of money lending. U. Tun Wai (1957)[26] argues that, although some success has been achieved through these measures, interest rates have not yet been lowered, partly because of inflationary pressures created by deficit financing for such lending and other expenditures and partly because controls have been evaded.

The cost and availability of credit in the unorganised money market can be influenced by the central bank by improving the link between the organised and unorganised money markets.

In LDC's the level of interest rates in the organised sector tends to be substantially below than in the unorganised sector. Myrdal argues that interest rate should be raised and selective and discretionary controls on credit and investment and concessional finance should be removed to induce economy in the use of scarce capital. Chandravarkar criticises Myrdal's argument with the following examples. He argues that even with comparatively low and stable nominal rates of interest, the growth of financial savings in Malaysia and Singapore has been impressive partly because the real interest rate has been positive, owing to prolonged price stability and the resultant confidence of investors in the financial assets. But for a majority of developing countries such as Burma, Ceylon, India, Nepal, the Philippines and Thailand, he found that Myrdal's argument appears to be valid. Chandravarkar concludes that higher interest rates would help to

extend the organised sector of finance and to promote financial intermediation and the integration of money and capital market.

U. Tun Wai in a study of interest rate outside the organised money markets of underdeveloped countries argues that between the difference of interest rate in organised and unorganised money market of developing countries, risk factor and monopoly profits each account for one-sixth, urgency of demand accounts one-third and the remainder is due to shortages of capital, inadequate collateral and other factors. He argues that, since interest rates are high, many governments are subsidizing interest rates on agricultural credit. It is better to subsidize prices of agricultural inputs rather than interest rates, since lower rates are likely to increase consumption and not investment.

M. Long in a recent study about 'Interest rates and the structure of Agricultural Credit Markets' has found that interest rates on agricultural loans in South and South-East Asia are high because of some monopoly in the credit markets, but primarily because capital is scarce, because farm loans are costly to administer, because the uncertainties of agriculture result in considerable loss through default, and because the demand for credit is seasonal. He argues that these primary problems cannot be eliminated by government flat nor can they be greatly eased by government organisations; they will be solved only as part of the general development of money markets and agricultural practices.

4.2.2 <u>Other aspects of interest rate policy</u>:

But interest rate policy has other relevant aspects than the purely monetary. For example, it can be viewed as an instrument for more effective mobilisation of savings through the offer of realistic (i.e. real) rate on monetary savings such as time and saving deposits, claims on financial institutions and government securities. Similarly it can be viewed as a social rate of discount to determine the optimum allocation of savings between consumption and investment and as a rationing device for efficient allocation among alternative forms of investments. Therefore a purposive interest rate policy has different aspects, each of which is relevant for particular phase of monetary policy or development planning.[27]

In sum, it can be concluded that interest rate should be appropriate for inducing savers to invest in bank deposits and other financial assets and to bringing about a rational allocation of resources.

Savers can be induced to keep their savings in the form of financial assets. If the yield on such assets is comparable to that on physical assets like real

estate, gold and commodities, after making allowance for risk premia and transaction costs in a climate of reasonable price stability and with such comparable yields on financial assets, it is possible to raise the rate of financial savings and thus bring about greater integration of money and capital markets.

5. CONCLUSIONS

A developed financial system is absolutely necessary for mobilizing a large volume of domestic savings and using them for productive investment particularly in the underdeveloped economies.

The underdeveloped stage of financial institutions in Nepal is reflected not only in their limited number but also in their limited variety. Another important factor associated with the growth of financial intermediaries in the country is the predominant role played by the public sector in this growth process. This is more so because most of the institutions are either fully government-owned or major part of their share is subscribed by the government. In Nepal, non-bank financial intermediaries do not accept deposits from the public barring the Agricultural Development Bank (ADB/N) which has recently started accepting such deposits. In the country, the monetary authority regulates the price of all the financial instruments. A large part of the economy is still unmonetised indicating existence of the non-institutional finance. The financial system of the country is thus still in rudimentary stage.

Since the central bank plays a vital role in building up the financial infrastructure of economic development Nepal Rastra Bank (NRB) was established as a central bank of the country in the year 1956. NRB has been influencing the economy through the judicious use of policies under its regulatory role. Regarding development role the Bank is actively participating in the creation of necessary institutions required to administer development funds. It is also providing funds to these institutions for development financing.

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