FORTY YEARS OF Nepal Rastra Bank

1956-1996

(Unofficial translation of the inaugural address on the occasion of establishment of Nepal Rastra Bank on 26th of April, 1956.)

"We are extremely pleased to have this opportunity today to inaugurate the Nepal Rastra Bank, whose establishment would help to fulfill the longfelt and urgent need for a Central Bank in Nepal, capable of contributing to the Government's endeavours in implementing various programmes of national development in a more efficient and successful manner.

The establishment of this Bank would ensure a better management of our currency besides promoting banking activities and industrial development thereby facilitating an alround improvement in the country's economic life.

Finally, we pray to Lord Pashupati Nath to bless the Bank in its quest for achieving all the noble objectives for which it is established, we would like to wish the Bank every success in its great task of serving the country for all time to come. Jaya Nepal."

— Late King Mahendra

Nepal Rastra Bank

Board of Directors

(as at mid-April 1996)

Mr. Satyendra P. Shrestha
Chairman
Governor, Nepal Rastra Bank

Mr. Ram Binod Bhattarai
Secretary, Ministry of Finance

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Dr. Prafulla K. Kafle
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Nepal Rastra Bank

Mr. Bharat K. Sharma
Deputy Governor
Nepal Rastra Bank

FOREWORD

26th April is an auspicious date in the economic history of Nepal. Nepal Rastra Bank, a pioneer institution in the economic modernization of the country was established on this day exactly 40 years ago. For central banks of many countries 40 years may be too short a period. For the financial and economic community of this country, however, Rastra Bank is almost the senior most premier institution second only to Nepal Bank Limited (the first commercial bank of Nepal), which is older to this Bank by about 19 years. In addition to Nepal Rastra Bank, today, there are 80 formal financial institutions; 10 of which are Commercial Banks, 6 Development Banks including 4 Rural Development Banks, 35 Finance Companies, 11 Cooperatives and 18 NGOs and INGOs specializing in finance. Most of the banks and some of the Finance Companies are operating as joint venture operation with Nepali and foreign investors. Missing from the list are the term lending institutions such as Provident Fund Corporation, National Insurance Corporation, and Postal Saving Banks. If one takes their branches into account the horizontal growth of Nepal's financial system has really been astronomical. In terms of financial intermediation, outstanding deposit mobilizations by commercial banks has jumped by 1720 times to nearly Rs 60 billion in July 1995 from about Rs 35 million in July 1957. In the same period, outstanding amount of domestic credit inclusive of NRB has expanded spectacularly by 2002 times to nearly Rs 72 billions. Net foreign assets of the banking system in the reference period has reached Rs 37 billion. This vertical deepening of the financial system gives a sense of pride to us today.

In the four decades of its life the Bank has come a long way in developing financial, money, foreign exchange and capital market without losing sight of the typical ground realities of the economy where poverty, illiteracy, high mortality and poor infrastructure are still endemic. Nepali economy continues to face the conflicting goal of maintaining economic stability and at the same time catering to the needs of the poor and the deprived who can also contribute to the country's development given certain amount of institutional support.

When Nepal Rastra Bank came into existence, Nepal was historically under dual currency system. Indian and Nepali currencies simultaneously served all the functions of money, with most of the payments settled in Indian currency. The primary task of the Bank was, therefore, to enforce the use of Nepali currency as legal tender money throughout the kingdom. This task was successfully accomplished by the end of the first decade of operation of the Rastra Bank. In the first 38 years (fiscal years 1956/57 – 1994/95) narrow money supply had increased by nearly 352 folds to little over Rs 32 billions. The share of currency to money supply in this period has gone down from 91 percent to about 70 percent, which clearly reflects the development of banking habit of the Nepali people. Even though this ratio is too high by international standards, for Rastra Bank which had to initiate and promote banking almost from a scratch, this extent of banking development is encouraging.

From highly regulated practices of finance and banking, Nepal Rastra Bank has ably guided the Nepali financial system to emerge as the most liberal and deregulated one in the SAARC region with no statutory liquidity ratio, freedom to banks in determination of all kind of interest rates, freedom of entry and exit to joint venture and private banks, market determined exchange rate of Rupee against convertible currencies and full convertibility of Nepali currency in the current account. The entry of Nepal into the Article VIII status of the International Monetary Fund has added further impetus to the process of liberalization, especially in the external sector.

Despite these bold attempts at financial liberalization, awareness of the fragmented and dualistic nature of the economy has made Nepal Rastra Bank undertake several measures in line with the socio-economic realities of development. In this context, channellising resources to the socially and economically deprived sectors of the economy through various directives has been one of the important function of the Bank. Priority sector credit programmes are still very much in operation with its coverages recently extended to include export-oriented production units and cooperatives. Banks are also required to extend credit to the deprived section. If some banks, specially urban based ones feel administrative constraint in participating in the socio-economic development credit programs, they have the option of routing their share of such credit through big commercial banks with nation wide network, Agricultural Development Bank and Rural Development Banks. Other aspects of socio-economic banking that are in operation are Production Credit for Rural Women, Micro Credit for Women, Rural Self Help Fund and Intensive Banking Programme.

With the further deepening of economic liberalization the supervisory aspect of the bank also needs to be changed. The Bank is quite aware that it has to concentrate increasingly on monitoring and supervision of the financial system in line with the shift in focus from a controlled and regulated regime to an open and liberalized system.

In the process of development of the financial system, the Bank has also grown over the years in terms of its organizational structure and human resources. The number of departments have increased from 4 in April 1956 to 15 in April 1996. Similarly the number of total employees have increased from 23 to 2493.

40 years is an ideal time for recapitulation and reflections of the evolution of the economy and the institution most intimately attached to it. This commemorative book is an effort towards this goal. The book consists of seven chapters. It starts with a broad macroeconomic overview and concludes with an evaluation of the institution itself. The first chapter also deals with the overall macro economic scenario with references to sectoral development in the four decades of Rastra Bank's existence. The second chapter deals with the evolution of financial system closely tracing the rationale of historical development. The third chapter covers the evolution of foreign exchange system exploring and describing factors that prompted subsequent liberalization measures. This paves the way for analysis of techniques of monetary management in the fourth chapter. This chapter makes a thorough review of the monetary measures taken by Nepal Rastra Bank during the last four decades. Directed credit may be a surprise for the highly advanced economies but Nepal has still a long way to go to completely modernize its economy. Traditional activities still dominate the national economy, which justifies the need for directed credit. It is assessed in chapter five. In the present age of economic globalization interactions with the rest of an world is the essential part of a country's development perspective. Nepal Rastra Bank's association with bilateral, regional, continental and international financial community is traced out in chapter six. Finally chapter seven introspects at the overall evolution of the Bank itself, dwelling principally on organization and management.

In this 40th year of the Bank's existence I want to pay deep respects to my esteemed predecessors whose long run vision and the ability to translate this vision into practice has made Rastra Bank what it is today. In fact this Bank has been fortunate enough for always being led by the most competent leadership. I have the same amount of regard for the past and the present members of the Board of Directors. An institution will simply turn into a physical structure if it is not manned by employees. Thousands of past and present employees, through their sincerity, hard work and dedication have helped to bring the Bank into today's pre-eminent position. The HMG/N particularly the Ministry of Finance, and National Planning Commission also deserve credit for the present status of the Bank.

Last, but not least, I would like to acknowledge the painstaking efforts of the Study Team members without whose hard work this book would not have been possible. I, therefore, express appreciation for the contributions made by Mr. Mukunda P. Sharma, Chief Economic Advisor, Research Department; Mr. Ganesh P. Adhikari, Deputy Chief Manager, Banking Operations Department; Mr. Bhagat S. Bista, Deputy Chief Manager, Development Finance Department; Mr. Krishna B. Manandhar, Deputy Chief Controller, Foreign Exchange Department; Mr. Keshav P. Acharya, Economic Advisor, and Dr. Yuba Raj Khatiwada, Economic Advisor, both from Research Department; and Mr. Bhola R. Shrestha, Board Secretary, Office of the Governor.

I appreciate the amount of hard work put by Mrs. Roza Upadhyay, Economic Advisor, Research Department for editing the whole manuscript and Mr. Jaya Shankar Maharjan who made possible to present it in this form.

I hope this book will be useful for all those interested in the economic development process in general and the monetary and financial evolution in particular in Nepal. The book could also serve as a historical reference in the sphere of finance, money and banking, foreign exchange management and other institutional matters related to central banking in Nepal.

S. Pyar

(Satyendra P. Shrestha)
Governor
26th of April 1996.

REMINISCENCES

by Himalaya Shamsher J.B. Rana
first Governor

Nepal Rastra Bank is regarded as one of the most prestigious institutions in Nepal, and I was fortunate to be entrusted with the task of drafting the enabling Act as Officer on Special Duty and of establishing the Bank as its first Governor in April 1956. My involvement in the Bank's inception and in its widely acclaimed operation during the critical first five years has etched indelible imprints on my memory lane. I would like to congratulate the concerned staff of the Bank on authoring this well researched book and to thank Governor, Mr. Satyendra Pyara Shrestha for asking me to pen this piece.

The background to the establishment of the Bank should be recorded first. The Nepalese economy was rather different then. No jet aeroplanes flew into Kathmandu. Bullock carts, horses and shank's mare were the means of travel in most parts of the country. It was a must or in most cases more convenient to go via India to reach the southern parts of the country in the East or West from Kathmandu. Barter at periodic fairs was a significant feature of internal trade. Almost all imports were from India. Exports of goods were almost exclusively to India and comprised timber and agricultural products.

Only one commercial/industrial bank served Kathmandu and some districts. Other than the Indian rupees, foreign exchange or US dollar was scarce as diamond Nepalese coins were issued by the Mint and currency notes by Mulukikhana (Govt. Treasury). There was no requirement of gold or foreign exchange reserve for issuance of currency notes. The budget of His Majesty's Government was of the magnitude of Nepalese rupees 120 million.

The Nepalese economy was not one whole due to lack of connecting roads/bridges and prevalence of the dual currency system. The economy of different vertical parts of the country tended to be closely linked to contiguous markets in India.

Most importantly, as a fall out of the dual currency system and the trade deficit, Indian rupees was slowly replacing Nepalese rupee as the medium of trade even in those parts of the country including Kathmandu where only Nepalese currency was legal tender. Furthermore, the value of Nepalese rupees vis-a-vis Indian rupees declined steadily, and the rate of exchange between these currencies in the Kathmandu, Indrachowk foreign exchange market fluctuated from day to day mostly in favour of the Indian rupees. The fall in the value of the Nepalese rupee triggered direct increase in prices of Indian goods and sympathetic increase in prices of domestic products as well in the Kathmandu valley market. Understandably, His Majesty's Government was under great pressure to take measures to arrest the rise in prices in the valley and the hills.

Expert advice taken from one quarter was to the effect that there was perhaps no need of establishing a central bank as there was not much scope for carrying out the traditional central banking functions. However, His Majesty's Government decided to establish Nepal Rastra Bank (NRB) as a central bank with the primary objectives of enforcing Nepalese currency as the legal tender throughout the country, and stabilising the rate of exchange between the Nepalese and Indian rupees. The then existing Government Departments and Nepal Bank Ltd. were not geared to do justice to such a task.

In addition to the traditional functions of a central bank like management of issuance of currency, being a banker of His Majesty's Government and regulation of other banks, two unorthodox functions were also assigned to NRB : amassing an agricultural credit fund and arranging fund for infrastructure development and heavily capital intensive industries. The concept was that NRB should play a pivotal role in unifying and stabilising the Nepalese economy and contributing to the growth in a few critical sectors.

Acceptance of this concept proposed by me and decision to go ahead with the establishment of NRB is a tribute to the nationalistic policy and programme of late His Majesty Maharajadhiraj Mahendra Bir Bikram Shah Dev and yet another testimony to the yeoman's service that late Sardar Gunj Man Singh, then Principal Royal Advisor rendered to the development of banking in Nepal.

In the event, after nearly four years of hard work, in-depth study and meticulous preparation, in June 1960, Nepalese currency was declared legal tender throughout the Kingdom and the two currencies i.e. Nepalese and Indian rupees were declared convertible without limit at the rate of exchange of Nrs. 160 for Indian Rs. 100. These declarations were complementary, inter-related measures recommended by NRB. Our finding of Nrs. 1.6 for Irs. 1.0 as the sustainable rate of exchange between the two currencies has virtually held good for nearly four decades. The twin measures were implemented smoothly and successfully despite formidable management problems. Very few believed that they could be implemented so. The reputation of NRB soared both in and outside the country.

Over these four decades the economic and financial scenario in the country has changed beyond my wildest dream.

Banks and finance companies have sprouted in dozen. Deposits in them have exceeded Rs. 73 billion. Imports and exports have diversified. The budget of His Majesty's Govt. is now of the magnitude of nearly Rs. 52 billion. The license and permit regime is under sentence of death and yielding place to market forces. Following induction of economic liberalisation, convertibility of foreign exchange on current account has been instituted to a large extent.

NRB has a wealth of experience and wide network to tackle the multifarious tasks assigned to it over these years. Perhaps the time has come for NRB to concentrate its attention on certain key areas like economic and financial analyses, monetary policy, reining in inflation, banking regulation, foreign exchange and foreign investment. The objective should be to burnish its image as <u>the</u> authority in these fields by dint of indisputably top quality performance.

Second, NRB has deservedly reaped many laurels for its sterling performance over these years. But it should not rest on its laurels. There is a challenge on the economic horizon to be geared to monitor and take timely, appropriate action on banking and financial activities in the market that will remain uncharted for many years to come in the free setting.

Last, on a personal note it was around in April 1956 the day of inauguration of NRB that I got married. My newly wed wife used to remark that I was more wedded to NRB. Such being my attachment to the Bank, I rejoice with pride at its accomplishments and grieve when its autonomy for which I had to fight hard, gets eclipsed. My best fraternal wishes to Mr. Satyendra Pyara Shrestha and Bank's staff for peak performance in country's service in the coming fluid years.

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Chapter I

MACRO-ECONOMIC SCENARIO

CHAPTER I

MACROECONOMIC SCENARIO

1.1 Introduction

Nepal is a small country with a very unique physical setting. Surrounded by India in South, East and West and by China in the North, Nepal is a landlocked country with 800 km long open border with India. It remained in self-imposed isolation for more than a century until it saw the dawn of democracy in 1951. In terms of physical features, Nepal can be divided into four main regions with wide variations in altitude and climate: (i) the Himalayan region and inner Himalays, (ii) sub-Himalayas or the mountainous region, (iii) Valley basin or inner Terai and (iv) the Terai region. With a total area of 147 thousand square kilometers and an arable land comprising 23 percent of the total area, Nepal is known as one of the most beautiful countries of the world endowed with both natural scenic beauty and rich cultural heritage.

The most important productive assets of the country are: the land with wide climatic and altitudinal variations, the perennial rivers with their origins in the Himalayas and the people. The vast potential for harnessing water resources, the abundant rainfall due to proximity of Himalayas, Indian ocean and Bay of Bengal and the scenic beauties and ancient civilization with diverse but rich cultural heritage offer tremendous scope for the all round development of the country. Nepal has been open to the outside world since the 1950s. Road links to India and the Tibet region of China as well as air links to other countries in Asia and beyond, have helped to augment openness. Access to the sea for international connections is available through the port of Calcutta, India.

The population of Nepal is estimated to be 20.0 million increasing naturally at a rate of 2.1 percent annually. Of the total, urban population constitutes about 9.2 percent.

The population is dependent on agriculture. This sector provides employment to about 75 percent of the country's labour force and contributes approximately 42 percent of the gross domestic product. Cereal crops – paddy, maize, wheat, millet and barley – comprise about 86 percent of the total agricultural production. Cash crops – potato, oilseeds, jute, sugarcane and tobacco – contribute 14 percent of the total agricultural output. In addition to cereal and cash crops, livestock has also been a major source of income, contributing about one-third of the agricultural GDP.

Nepal remains in abject poverty, the origins of which are political, social and economic and to some extent difficult geo-physical settings. The family rule under the Rana autocracy for more than hundred years, lack of concrete direction even after the establishment of democracy in 1951, the dismissal of popularly elected government and the banning of political parties in 1960 were the political impediments. Multi-party democracy was restored in 1991. This has offered scope for the development of the country.

The social factors are yet to be consolidated and improved for a favourable socio-economic transformation. Illiteracy, varied ethnic groups with diverse interests, feudalistic social order and also lack of entrepreneurial spirit to adopt to changes were some impediments to the smooth development of the country in the past. Although these issues have been addressed to some extent, additional efforts are still needed to combat them fully.

Likewise, the structure of the economy has been awaiting for widespread improvements. The subsistence agriculture implying low productivity and heavy population pressure is still a dominant feature of the Nepalese economy. Factors of production are of poor quality. The economy is characterized by redundant unskilled labour and acute shortage of skilled man power and capital. The economic scenario suggests a paradoxical case in that there is dearth of financial resources and wherewithal on the one hand and the existence of underutilization of available factors of production on the other. Even the relatively small industrial capacity whatsoever exists is not fully utilized. The managerial and administrative capabilities are yet to be standardized in the formal sectors of the economy as well. The pace of technological innovation in all spheres of economic activities are yet to be enhanced.

These factors clearly suggest that Nepal has yet to achieve a favourable record of economic management. For this, the resources raised domestically and received in aid from international agencies and friendly countries should be put to the best use. This is the only way to change the situation of malnutrition, disease, illiteracy, unemployment and high mortality. Firm commitments from all those involved in the economic management of the country towards improvement, competence and success would help accelerate the pace of development.

In the past, conscious and deliberate efforts towards improving the economic situation had been made. In order to enable the people to lead decent and dignified life, Nepal launched periodic plans with specified objectives, policies, strategies and programmes for economic development. However, all those efforts have not been able to bring about socio-economic transformation to the desired extent although some progress have been distinctly visible specially in social and infrastructure sectors.

Nepal has already undertaken four decades of planned development efforts. During these periods, infrastructure like transport, power and communication and education and health sectors have shown some signs of improvement. At the time of the start of the first plan, the literacy rate was virtually insignificant. At present at least 52 percent of the male and 28 percent of the female above 6 years of age can read and write. The number of pupils in the primary school enrollment increased from 14.4 percent in 1961 to around 90 percent in 1995. The number of primary schools has quadrupled during this period. Similarly the number of pupils attending secondary school has increased by 11 fold during these four decades. At the time of the launching of the first plan, the number of institutes of higher learning was 32. There was not a single university. Now the Kingdom has 197 institutes of higher learning and three universities.

In the health sector also, some progress has been witnessed over the years. Infant mortality has improved from 156 per thousand in 1973/74 to 102 per thousand in 1994/95. Life expectancy has increased to 56 years in 1995 from 51.5 years in 1985 Crude death rate has also reduced. The number of hospitals and hospital beds at 89 and 3,667 respectively in 1985 have reached to 114 and 4,848 respectively by1995. The above indicators show positive development in the education and health sectors but in relation to total requirement they are inadequate.

In the past, different parts of the country were not linked and many places were almost in isolation from the rest. With four decades of planned efforts, the country has been integrated to a considerable extent. Development of physical infrastructure like road and air links and telecommunication has facilitated the country's integration to a considerable extent. This has paved the way for economic integration. The government is fully aware that the potentials of various districts would be more productively exploited with further expansion and qualitative improvements in the physical as well as social infrastructures of the economy.

During the planned development efforts of four decades, discernible progress has been observed in energy sector as well. In the past, forest resources were the single source of energy followed by animal and crop residue. In the recent years, hydro-power has surfaced as an important source of energy use at least in the urban centers and its suburbs. Shortages of energy, have, however hindered economic progress in the urban areas as well as industrial centers. Despite too much of labour involved, fuelwood continues to constitute the main energy for cooking and heating in the rural areas. Non-agricultural economic activity expansion depends, among many other things, on energy availability, of which electricity is one of the important component. The supply of energy is still insufficient in relation to total demand. However, development of energy sector over the years has been quite satisfactory. For instance, electricity generation at 335 thousand MWH in 1984/85 increased by 540 thousand MWH to 875 thousand MWH in 1993/94. This 11.3 percent annual increase at compound rate can be considered by our standard, a satisfactory performance. There is however, a huge potential of hydro-power generation offered by the immense water resources which have remained almost untapped. Given the international agreements on use of river water and substantial inflow of foreign financial and human capital, exploitation of hydro-power as energy source both for domestic consumption and export would be one of the most important economic activities in Nepal. However, given the large amount of investment required for energy sector development, it would be difficult to meet this through domestic resources only. External financing and outside co-operation is therefore inevitable for this purpose.

The population of Nepal is estimated to be 20.4 million in 1994/95 increasing naturally at a rate of 2.1 percent per annum. Of the total, female population is estimated to be 50 percent. Of the total population, approximately 10 percent is urban. Nearly 65 percent of the total population falls within the age group of 10 to 59 years, which, in fact, is considered as a potential labour force. Of the total potential labour force, 62 percent is estimated to be economically active population. Thus 38 percent is either openly or hiddenly under-employed or unemployed. This itself is a big challenge facing the Nepalese economy today.

Environmental degradation is one of the major concerns of modern Nepal. More than two million Nepalese currently reside in urban areas, and, with rural-urban migration, this total is expected to shift substantially. Of the total urban population, more than half live in the Kathmandu valley. Very high concentration of population in a small area with limited public utilities and employment opportunities has already started creating problems; to resolve such urban concentration would be extremely costly. Water, noise and air pollutions in the urban centers are other issues to be resolved.

1.2 GDP Growth and Sectorol Developments

GDP data prior to early sixties are not available. However, thereafter they are available in series. Between mid-sixties to the end of seventies, increase in production has been minimal. Table I indicates the growth rate of Gross Domestic Product (GDP) and population for the period 1966–1995 covering six plans. Table 2 depicts the detailed information on GDP. Between 1966–1970, real GDP growth averaged 2.7 percent per annum which marginally kept pace with the population growth rate of 2.1 percent. This low growth is attributable to the non-agricultural sector. The average growth rates per annum for the subsequent periods for 1971–75, 1976–1980, 1981–1985, 1986–1990 and 1991–1995 were 1.8, 2.4, 5.0, 4.9 and 4.3 percent respectively. The sixth and the seventh plan periods recorded significantly higher rates of growth of GDP compared to the previous plan periods. The year 1982/83 was the worst in terms of economic performance. During that year drought affected agricultural sector, resulting in a decline in the agricultural output by 1.1 percent. In addition to the decline in agricultural output, non-agricultural output also declined by approximately 5.8 percent. Thus the gross domestic product in the year 1982/83, declined almost by 3 percent. But during the period as a whole covering 1981 to 1990, the performance of the economy in terms of GDP turned out to be satisfactory. The annual average growth in per capita income which was negative during 1971–1975 and 1976–89, was more than compensated for by growth in the subsequent periods. During the 1990s three out of four years, the performance of agricultural sector were disappointing. Except for 1993/94 the other years witnessed negative growth in agriculture output. Despite the poor performance in the agriculture sector during the period covering 1991–1995, the non-agriculture sector witnessed encouraging growth. The growth rate of non-agricultural sector at 8.3 percent during 1991–95 was marginally less than the peak growth of 9.1 percent achieved during 1976–80.

Agricultural sector accounted for about 72 percent of GDP, more than 90 percent of employment, and almost 67 percent of exports during 1966–1970. In terms of employment, it remained to be the single dominant sector as in the past. However, in terms of exports, agriculture accounted for about 64 percent. Over the years the relative importance of the agriculture sector has declined gradually and has reached 44 percent of GDP in recent years. The corollary is true with regard to non-agriculture sector. The momentum of growth of manufacturing sector is not that great. The other component of the non-agriculture sector – the services sector has shown satisfactory and steady expansion.

Table I

Share of the Agricultural and Non-agricultural Sectors in GDP and Their Growth Rate

(Period Average)

	Agriculture		Non-agriculture		GDP	Population
Fiscal Year	Share	Growth	Share	Growth	Growth	Growth
1966 – 1970	71.1	2.92	28.9	2.58	2.73	2.06
1971 – 1975	71.0	2.06	29.0	4.94	1.76	2.55
1976 – 1980	61.7	−1.05	38.3	9.05	2.37	2.69
1981 – 1985	58.9	5.15	41.1	4.86	4.99	2.17
1986 – 1990	49.3	4.10	50.7	6.17	4.88	2.10
1991 – 1995	44.1	1.75	55.9	8.25	4.33	2.08

1.3 Price Dynamics in Nepal

For economic analysis purposes, the level and dynamics of price are unavoidable pre-requisites. How the economy is behaving in real term can be judged only on the basis of the movement of prices. In Nepal there was virtually no such authentic data on price until Nepal Rastra Bank launched a household budget survey in 1972/73. Thereafter, there has been continuous publication of consumer price index encompassing all the geographical regions of the Kingdom comprising the Hills, the Terai and the Kathmandu Valley. It is to be noted that price index was available for Kathmandu during the fifties but the index was unweighted. The unweighted price index for Kathmandu was taken as a proxy for all Nepal and it formed a basis for arriving at the real figures of economic parameters/variables.

During the fifties, price movements were not found to be uniform. The available figures indicated that the change in price was extremely severe in 1958/59 due, among other things, to volatility in exchange rate of Nepalese rupees with Indian rupees, The price rise was as high as 11.3 to 11.6 percent for that year. In 1960 there was unification of currency, whereby, Nepalese currency became the sole medium of exchange. At the same time Nepal Rastra Bank successfully fixed exchange rate of Nepalese currency with the Indian currency. As a result of this, in 1960/61 changes in price were marginal. The price dynamics during the second plan show an alarming picture. Food articles price for all Nepal showed a substantial upward movement from 1961/62 and recorded the highest change in 1964/65. The average price change for three years for all commodities was 10.0 percent and for food articles it was 17.3 percent. This unprecedented rise in price particularly of food articles was attributable to adverse weather situation which caused a drastic fall in the production of foodgrains in the Kingdom. The situation was not favourable in India either. Thus the supply shortage due to poor performance of agriculture sector in the country and also due to rise in import price induced the average price to go up during the three-year period of the Second Plan.

On an average, the price situation was comfortable during the Third Plan. On the whole, the prices of food articles registered marginal rise. The change in all commodities price also remained below 3 percent. However, price movement was not uniform through the years. For instance, there was a drastic fall in the price of food articles in 1966/67 while unprecedented rise was recorded in 1967/68. In the first case, the contributory factor for the fall in prices was the appreciation of Nepalese currency vis-a-vis Indian currency. Thereafter, Nepalese currency was devalued vis-a-vis Indian currency and the price of most articles including food articles started to go up. In the following year, the overall change in price was moderate at below 4 percent with a fall in the price of food articles. During the year money supply had gone up by 15 percent due to excessive credit disbursed to the public sector and a rise in net foreign assets. The impact was, however, not instantaneous on price movement.

During the Fifth Plan period (with 1983/84 as base) the National Urban Consumer Price Index for all commodities recorded a rise of 5.3 percent on an average. The index for food and beverages rose by 4.7 percent while that of non-food and services by 6.8 percent. The movements in price in the individual years during the fifth plan were not uniform. The changes in prices of food and beverage were much erratic than that of non-food and services implying direct relationship of foodgrains production in the country and their import prices from India. Production of foodgrains in 1976/77 and 1977/78 had recorded declines. The impact of which was felt in terms of price rise by almost 15 percent in 1977/78. It was also observable that the year 1976/77 saw a substantial increase in money supply by almost 28 percent. Part of the impact on rise in price in 1977/78 may be attributable to the excessive increase in the money supply a year ago.

The average price rise in the sixth plan period was within one digit measured in terms of change in overall index. However, non-food and services group recorded a little more than 10 percent rise. During this period price movements for different years also varied considerably. For three consecutive years 1980/81 to 1982/83, the overall price index increased by more than 10 percent while for the remaining years the increases slowed down considerably. The increase in the prices of food and beverages were much higher in the first three years of the plan period while for the last two years the slow-down was substantial. The production of foodgrains in Nepal in 1979/80 and in 1982/83 had declined by 12 to 16 percent. The real GDP had witnessed decline by 2.3 percent in 1979/80 and by 3.0 percent in 1982/83. The impact on prices of changes in real sector was strongly felt during the periods under review. On the one hand real sector was weak and on the other monetary expansion was steady; the implications of which were directly noticed in terms of upward movement in the prices and adverse balance of payments situation during most of the years of the sixth plan.

The price situation was also not favourable for the seventh plan. On an average for the plan as a whole, the overall change in consumer price index at 12 percent was the highest compared to the preceding plans. Except for the year 1988/89, in the remaining years the changes in food and beverage prices almost touched two digits. Regarding non-food and services, in 1986/87 and 1987/88 the changes in price were the highest at one digit level while for the remaining periods the changes touched two digits. During the periods under review, the foodgrains production suffered severe setback. In 1985/86 import had declined substantially but the increase in money supply was the highest in the year. The year 1986/87 experienced a severe setback in foodgrains productions. The implications of these developments were well reflected in the upward pressure on prices. In some cases, the impacts were instantaneous while in others the implications were observed with some time lags.

Between the seventh plan and the eighth plan there were two years of plan holidays. During those years the performance of the real sector of the economy was in favour of non-agricultural sector. The production of foodgrains in 1990/91 was modest but in 1991/92 it declined considerably. Total imports in both the years were substantial. Despite that, supply situation of food articles was not up to market expectation. In 1992/93 Nepal suffered heavy floods which killed thousands of people and destroyed standing crops as well as disrupting transport and communication networks like roads, bridges, telephones, power etc. The consequences of the flood was felt in terms of unprecedented rise in the prices, particularly, of basic necessities. During the three years of the eighth plan, the overall price rise was within the one digit level. The modest rise in price was the outcome of several factors. The three year-period witnessed an average growth of 4.3 percent in real GDP. Of this, foodgrains productions increased by 1.6 percent. The total import increased on an average by 27 percent. At the same period money supply increased by 18.2 percent. The price rise was contained successfully. But in the last year of the three year period the balance of payments situation was affected severely. Monetary expansion found its expression not in prices but in the current account of the balance of payments.

Table II

Price Dynamics (Percentage Change)

Period	Food Articles	Other Articles	All Commodities Services
1962 – 65	17.3	9.5	10.0
1966 – 70	0.5	2.3	2.8
1971 – 75	-	-	-
1976 – 80	4.7	6.8	5.3
1981 – 85	9.4	10.3	9.7
1986 – 90	12.3	11.5	12.0
1991 – 94	11.5	10.9	11.2

1.4 External Sector

1976 – 1980

The data on balance of payments are relatively of recent origin in the Nepalese context. As such they are stated here since 1975 onwards. The trade balance over the period under study was always in deficit. The average trade deficit between 1976–80 was Rs 1,426 million per annum with slight deterioration through time. The current account was in surplus for three out of five years in the period between 1976–80 with a slight margin but the deficit for the other two years was heavy in size. However, the average annual deficit for the period as a whole was 0.2 percent of GDP of 1979/80. Owing to low level of receipts in the form of investment earnings and other invisible trade, the trade deficit cover was not big. During the period, services net and transfer net accounted for nearly 24 percent of trade deficit cover. During the period the performance of export trade was quite satisfactory. It increased approximately by 24 percent. Import trade on the other hand, grew by 15 percent. Likewise services net grew by around 25 percent and transfer net by 19 percent. Despite these developments, current account deficit grew substantially almost by 224 percent per annum. Current account deficit was the highest at the end of 1980 affected as it was by heavy trade deficit. In that period merchandise export could cover as much as 45 percent of merchandise import. During the period, official capital net was Rs 332 million of which the highest flow of Rs 577 million was witnessed in 1980. The miscellaneous capital item, a proxy of private sector capital movement, was not favourable. It turned out to be adverse by Rs 22 million per annum during the period. Of this the highest outflow was recorded in 1980 itself. It is, therefore, not surprising that despite sizable inflow of official capital, the change in reserves at Rs 358 million in 1976 and Rs 583 million in 1979 came down drastically to as low as Rs 26 million at the end of the fifth plan.

1981 – 1985

The external sector of the Nepalese economy during the period 1981 – 1985 could be considered to be the weakest compared to the preceding and subsequent periods. The drought situation affected Nepalese economy in 1982/83. The balance of payments deteriorated by Rs 194 million per annum. For three consecutive years 1983 – 1985 the situation was the worst ever recorded. Trade deficit rose by Rs 4,265 million per annum. As a result of this, despite almost the same rate of export growth compared to the preceding plan period, import capacity of export came down to 29 percent during this plan period. However, the investment receipts, transfers and services income measured in terms of services net and transfer net could cover almost 74 percent of the trade deficit. But for this, the situation would have been still worse. The emergence of such a situation prompted the decision makers to deploy corrective actions. In the process, Nepalese rupee was devalued vis-a-vis Indian currency by 14.5 percent in 1985. Economic stabilization programme was introduced in order to realise fully the gains of devaluation.

1986 – 1990

This period should be considered to be the best so far as the improvement in the external sector of the economy is concerned. A much improved economic management through better use of available as well as new tools and technique in monetary, fiscal and exchange rate fronts helped to improve overall economic situation. During this period structural adjustment programme supported by the World Bank and the International Monetary Fund was successfully implemented and was, together with other measures, instrumental in correcting the imbalances witnessed in the economy.

The balance of payments turned to a surplus immediately after 1985 and continued to remain favourable to the end of the five year period and beyond. The average balance of payments surplus was Rs 1,219 million per annum. Despite improvements in the balance of payments, trade deficit and current account deficit could not be fully addressed. Consequently import capacity of export at 29 percent per annum during the preceding plan stagnated at 28.5 percent. The other components of current account, the services net and transfer net could not offset more than 51 percent of the trade deficit during the period compared to almost 74 percent attained in the preceding plan. This clearly indicates that the improvement in the overall balance of payments position during the seventh plan was supported by capital account. Inflow of resources in the form of official loan and capital inflow under the miscellaneous capital item had continued to register growth with sizable increase. The structural weakness of the balance of payments remained a matter of concern, performance of the export sector was not impressive, as even the 24 percent average annual growth rate achieved in the past plan period could not be sustained. The export sector grew by approximately 14 percent only.

1991 – 95

During two years of plan holidays immediately after the restoration of democracy, the external sector was seen to be favourable for several reasons. The performance of the export sector was very good. There was a sizeable inflow of transfer receipts. Services net receipts grew moderately. The import capacity of export went up considerably compared to the two preceding plan periods. Reserves accumulation increased per annum by Rs 3,763 million. During the first three years of the eighth plan the overall balance of payment situation showed an erratic movement. The significant surpluses recorded in 1993 and 1994 dramatically turned to deficit, although marginally, at the end of 1995.

A Currency Note issued by the Sadar Mulukikhana

1.5 Development Efforts Through Plannings

The economic backwardness that persisted in Nepal due to historical reasons and also due to an unique difficult geo—physical setting prompted the authorities to adopt planned development efforts as soon as the awareness spread after the dawn of democracy in 1951. In the process, the historical year 1956/57, became the point of departure for Nepal from backwardness to prosperity and progress. The onset of democracy and opening to the outside world had expectations of the people towards achieving better living conditions leading to a life of human dignity. The feeling of this kind was very strong at least, among the elites. Therefore, planning as a means of national development, to transform the socio-economic order from the existing poverty stricken situation to better living conditions was adopted. National self-sufficiency and welfare orientation were the goals set in this process. This option for planned development reflected the then existing trend in the region as well as in many countries world wide. The conditions for planning were, however, constrained by lack of minimum of information, absence of appropriate manpower, and basic infrastructure and administrative capabilities. Domestic resources were not available for implementing development programmes. Therefore, a start was made towards planned development with a very small amount of Rs 330.0 million. This amount of total plan outlay was earmarked to be spent in the public sector. However, the amount set for the first plan was not fully spent in the five year period. A little more than 74 percent was actually spent. Out of the total outlay of RS 330.0 million the allocation was in the following order: transport and communication 47.3 percent, social services 24.0 percent, agriculture, irrigation and forestry 10.8 percent, electricity, gas and water 8.4 percent and the industry and mining 7.6 percent. In view of the actual need for achieving the integration of different parts of the country by road links and communication, the biggest chunk of the resources being earmarked for this sector was understandable.

The political change that occured at the end of the first plan disturbed the planning process. The second plan began with a break. It started from 1962 to 1965 for a period of three years. The curtailment in duration was perhaps due to uncertainty that prevailed both in terms of domestic and external resource mobilization. In the second plan also the total outlay earmarked was to be utilised by the public sector.

In the second plan emphasis was shifted towards the development of social sector and electricity, gas and water. Those two sectors were accorded 26.9 percent and 21.2 percent of the total outlay. The other two sectors which received relatively greater shares were construction sector and industry and mining. Transport and communication received the least priority during the second plan in contrast to the top priority obtained in the first plan. Of the total outlay of the second plan at Rs 600.0 million, this sector's share remained at 8.6 percent. Likewise, the agriculture, irrigation and forestry sector got less priority. Less than 11 percent of the total outlay was earmarked to this sector. The constraints were enormous, the absorptive capacity of the economy was alarmingly low. This became apparent after the end of the plan when the economy was witnessed not to have used even the meager amount of Rs 600.0 million in the entire three year period. The performance was poor. Just around 70 percent of the total outlay could be spent in the second plan. The limitations in implementation of the plan as reflected by dismal performance in terms of expenditure outlay was obvious. Investment climate, administrative machinery, economic decision making culture and political commitments were not conducive to attaining speedy and qualitative implementation of the programmes as envisaged in the plan.

From the third plan, the involvement of the private sector was categorically made. Accordingly, total plan outlay was divided between the government sector and the private sector. Of the total plan outlay, the share of the government sector was nearly

70 percent. The priority and the performance of the private sector activities in the planning process were not available. Therefore, reference of priority and performance is made with regard to the public sector only.

The hopes of gaining better performance remained unattained with increased shortfalls witnessed from targetted outlays in the third plan. Of the total outlay of the plan at Rs 1740 million in the public sector, the actual amount spent during the plan period was approximately 57 percent. The third plan however looked better in terms of allocation of resources. It sought to attain reasonable balance between infrastructure build up and expansion of productive base of the economy. As much as 38 percent of the total outlay was earmarked for transport and communication sector and 23 percent to social sector. Agriculture, irrigation and forestry sector got almost 17 percent of the total outlay, much higher compared to the previous two plans. A reasonable share was given to the development of electricity, gas and water. Despite prudent and balanced resource allocation, the actual implementation of the plan was encouraging. The absorptive capacity of the plan was low.

The fourth plan was much better both in terms of judicious allocation of plan outlay and the performance thereof. Transport and communication sector continued to get top priority. At the same time sufficient attention was given to the development of agricultural sector as well.

Next to transport and communication which received 45 percent of the total outlay, agriculture, irrigation and forestry got the second priority and received 21 percent followed by social sector at 18 percent. The plan implementation, measured at least in terms of actual expenditure, attained 98 percent success. The efforts made in the past plans had positive implications in terms of integration of the country by creating road net-work and establishing minimum social infrastructure. At the same time experiences in plan implementation had been gained to some extent.

Of the total plan outlay, a little more than 66 percent was earmarked to be used by the public sector. The whole amount was utilized by the public sector during the plan. The fifth plan continued to place greater emphasis on the development of the core sector of the economy. The proportion of total expenditure on the development of agriculture, irrigation and forestry was raised to almost 25 percent compared to 21 percent in the preceding plan. Similarly the proportion of expenditure on electricity, gas and water to the total outlay was almost raised by two-times to 16 percent. In terms of relative share, transport and communication received 29 percent compared to 44 percent received in the fourth plan. On the whole, allocation was biased towards improving the real sector of the economy with due weights attached to the expansion of physical infrastructures like roads, bridge, telecommunication system and also developing education and health sectors.

Like its predecessor, the sixth plan also placed considerable emphasis on agriculture and forestry development. This sector achieved highest chunk (29 percent) of the total plan outlay in the public sector. Next to this, social services got the greatest attention. The expenditure on electricity, gas and water was maintained at 17 percent as in the previous plan. The sixth plan seemed to be guided by the strategy of utilising the existing infrastructure and emphasised on the development of the core sector, i.e., agriculture. The absorptive capacity of the public sector improved considerably perhaps due to experiences attained in the implementation of the previous plans.

The Seventh plan was ambitious as reflected by increase in total outlay compared to the sixth plan. The share of the public sector in the total plan was around 54 percent. During the implementation, the actual amount incurred exceeded the target by 14 percent. In terms of distribution of total outlay in the public sector, the seventh plan was not much different from the sixth plan. Agriculture got almost the same treatment like the sixth plan although the share in total expenditure was marginally reduced to this sector. Likewise, second place was accorded to the social sector. In this case also the share in total expenditure was marginally reduced. During the seventh plan, electricity, gas and water got more emphasis compared to the previous plans. Thus productive base expansion got the top priority during this plan as well. The seventh plan clearly indicated that given the programmes and the resources thereof, the absorptive capacity of the Nepalese economy was gradually on an increase. The minimum physical and social infrastructure achieved due to past efforts and the skill of manpower gathered over the years were quite supportive to implementation of the programmes contained in the plan.

At the completion of the seventh plan, a widespread change was witnessed in the political dispensation. The people's movement for democracy restored the multiparty system of governance. Immediately after the restoration, greater attention was needed to be focused on the consolidation of political system and administrative regime. All these factors were responsible for a two-year break in the planned development process. However beginning 1993, the eighth plan was launched from 1993 with three broad objectives : to attain sustainable development, to alleviate poverty and bring about regional balance. Thus the economy of the kingdom was seen from a broad perspective. The size of the cake was to be increased that also on a sustainable basis. The poor and downtrodden became the focal point in the planning process. The remote and hitherto neglected regions of the country were to be encompassed in the broad planning framework. In the context of achieving the above objectives, private sector was considered to be instrumental. This is apparent from the fact that almost 64 percent share was alloted to the private sector in the total outlay. Thus the role of the government sector was to be limited to the status of a catalyst or facilitator.

The amount earmarked for the eighth plan increased by almost 3-fold compared to the previous plan. This was conceived not as expenditure but as investment. A major portion of such investment was earmarked for the development of the agriculture sector followed by social services and transport and communication sectors respectively. The eighth plan has already completed more than three years of its implementation. Upto the three year period as much as 79 percent of the total investment in the public sector has been actually used.

1.6 Fiscal Sector

Till the early sixties Nepal's fiscal sector was characterized by a surplus budget. Between 1956/57 and 1960/61 the annual average expenditure was Rs 115.0 million. Of this, regular expenditure approximately accounted for 72 percent. The average total resources was Rs 153.0 million per annum. Of this, the revenue and foreign grants were almost in the same proportion. Thus the budgetary operation recorded an annual average surplus of Rs 38.0 million.

After 1960/61 till 1966/67 the budgetary operation showed continuous deficits. During the period under review total average annual expenditure amounted to Rs 309.3 million. Of this, development expenditure constituted approximately 58 percent. The average total resources was Rs 285.2 million per annum. Of the total resources nearly 61 percent was from revenue. Thus revenue surplus could finance around 25 percent of the development expenditure. The average annual deficit at Rs 24.1 million was financed to the extent of 74 percent by foreign loan. Thus foreign grants and loans together financed nearly 72 percent of the development expenditure during the period. Thus the over-dependence of development efforts on foreign aid continued to grow during this period.

In the subsequent years between 1967/68 and 1969/70 the economy witnessed fiscal consolidation at a satisfactory level.

The annual average total expenditure amounted to Rs 561.0 million. Of this, almost 65 percent accounted for development expenditure. Likewise resource mobilization was also satisfactory. Of the annual average total resources over the years at Rs 596.9 million, revenue accounted for a little more than 67 percent. The revenue surplus could finance 56 percent of the development expenditure. Foreign grants inflow was also encouraging. Foreign assistance inclusive of grants and loan financed as much as 56 percent of the development expenditure. The loan component of foreign aid was less than 4 percent during this period. Before this period the loan component of aid was around 14 percent. During this period the budgetary operation could attain an annual average surplus of Rs 35.9 million, a sizeable amount in relation to total development expenditure of Rs 363.4 million during the period.

After attaining continuous surplus for three consecuitive years, the fiscal position started to show deficits from 1970/71. The average annual expenditure at Rs 1,076.5 million during 1971-75 exceeded average annual receipts by Rs 156.0 million. This deficit was financed to the extent of around 40 percent by foreign loan. On the whole, foreign assistance financed about 45 percent of development expenditure during the period under review. Thus, compared to the previous periods under analysis, the dependence on foreign aid was the least during this period. This was the outcome of revenue effort which enhanced sharply. Revenue constituted as much as 74 percent of the total resources and revenue surplus (Revenue - current expenditure) could finance a little more than 40 percent of the development expenditure during the period.

The period 1975/76 - 1979/80 merit special attention. The capacity of revenue surplus to finance development expenditure was weakened compared to two previous periods mentioned in this analysis. The magnitude of the deficit was quite large. It was almost 35 percent of the development expenditure. However, revenue effort was satisfactory. It could finance nearly 87 percent of the development expenditure and constituted almost 75 percent of the total resources. The average annual deficit amounting to Rs 615 million was financed to the extent of 53 percent by foreign loans and the remaining amount by domestic resources. During this period also total foreign assistance financed as much as 48 percent of the development expenditure. Of the total assistance received, the loan component was 38 percent. It is worth mentioning that up to this period the grant element was dominant in the total foreign assistance.

During the period 1981-85, the average annual total expenditure exceeded by Rs 2,449 million. Of the total amount of expenditure, development expenditure accounted for more than 68 percent, the highest proportion noted so far. Likewise, of the annual total average resources at Rs 4,004 million, the revenue component constituted as high as 76 percent - also the highest recorded so far. Thus during this period development expenditure was given due attention and at the same time revenue effort was greatly enhanced. Consequently, despite increased expenditure almost the same proportion was maintained at financing development expenditure like in the previous period.

However, the difference was apparent in case of loan component in total foreign assistance on one hand and the capacity of revenue surplus in financing development expenditure on the other. Unlike in the past, loan component went up to 55 percent of the total aid. Likewise, revenue surplus available for financing development expenditure had shrunk to 23 percent.

During the period 1986-90, the fiscal situation was not comfortable. The share of development expenditure slightly came down. The capacity of revenue surplus to finance development expenditure was limited to 21 percent. However, of the total resources, revenue constituted as much as 81 percent. This increase is attributable not to revenue performance but due to less than proportionate increase in the flow of foreign resources in the form of grants. During the period preceding to it, the foreign grant element financed as much as 21.5 percent of the development expenditure but in the period under review this had come down to 17 percent. The other feature of this period is the sharp decline in the share of grants in total foreign assistance. The share came down to 28 percent compared to 45 percent during the immediate preceding period. Thus the increase in tendencies of foreign loan and the decrease in foreign grants figured prominently during this period.

During the two-year plan holidays the performance of the fiscal sector remained more or less the same in many respects as in the period preceding it. Of the total expenditure, 65 percent accounted for development expenditure. Revenue surplus could finance almost the same level of development expenditure as in the preceding period. But the share of revenue went up significantly to 86.4 percent of the total resources signifying relative decline in foreign grants. Consequent to this development, loan component constituted more than 77 percent of the total foreign assistance.

During the first three-year period of the eighth plan, development expenditure was hit hard. Its share in total expenditure at 58 percent of the total, was the lowest during the whole period of the study. In the total resources, the foreign grant component touched the lowest point. But the total foreign assistance loan component at 73.5 percent was lower by 3.5 percentage points compared to the non-plan two-year period.

1.7 Internal and External Debt Situation

Nepal remained almost a debt free country till 1961/62. The accumulation of debt began since 1963. The size of the debt both internal and external was modest during the second plan. Due to low size of debt, no debt-servicing obligations were traced in the 1960s and also upto the mid-1970s. Even at the end of the 1970s total internal debt was less than one percent of the GDP.

Internal debt grew by Rs 58 million between 1965 and 1970 to reach a level of Rs. 91 million at the end of 1970. The principal and interest payments up to the end of 1975 constituted a very small size and thereby a small proportion of GDP. Thereafter, the magnitude of borrowing started to go up considerably. Internal debt outstanding at the end of the fourth plan was Rs. 605 million. The debt amount recorded an increase of Rs 898 million during the fifth plan to reach a level of Rs 1,503 million by the end of the plan period. Over the years, the size of the debt began to show an alarming tendency to increase. The magnitude of the debt at the end of 1985, the terminating year of the sixth plan was four times the amount recorded in 1980, which, in turn, had jumped up by 2.4 times to Rs 14,673 million at the end of the seventh plan. This amount as percentage of GDP was more than 14 percent compared to approximately 13 percent recorded in 1985. In the subsequent years, although the annual borrowing increased the total internal debt as percentage of GDP remained steady at around 14 percent at the end of 1995.

Likewise, external debt outstanding was also modest in the early sixties and mid-seventies. In 1975, the external debt outstanding was just Rs 346 million. This debt went up to Rs 1,807 million within a span of five years – more than five times the figure recorded at the end of 1975. Outstanding external debt increased more than five times during the sixth plan and also in the seventh plan. In the subsequent years also the magnitude of external loan continued to increase every year leading to greater external indebtedness. The amount of external outstanding loan at Rs 113,855 million was 51.3 percent of GDP.

As a result of these developments, the debt service ratio should have shown a continuous increase. But that did not happen up to 1985. Thereafter, distinct signs of increase started to show up. This is well reflected by almost 10 percent debt service ratio witnessed in 1990 and 6 percent in 1995. The comfortable debt service ratios witnessed in the economy account for concessional natures of debt incurred both in terms of interest and maturity structure of loan repayment. At this juncture it is worth contemplating as to what would have happened if market borrowings were the major source of external debt.

Table VI

Debt Situation of Nepal

(Rs in Million)

		1975	1980	1985	1990	1995
1.	Internal Debt Outstanding	604.8	1502.8	6031.6	14673.1	32057.9
2.	External Debt Outstanding	346.1	1807.3	9203.8	36800.9	113865.3
3.	Internal Debt Service	36.1	175.6	488.7	1156.8	3066.6
4.	External Debt Service	12.4	41.4	189.5	1122.3	3201.6
5.	(1) As a Percentage of GDP	3.6	6.4	12.9	14.2	14.4
6.	(2) As a Percentage of GDP	2.1	7.7	19.8	35.6	51.3
7.	As a Percentage of GDP Goods and Non-factor Services	0.8	1.4	0.3	9.8	5.8

Source: Economic Survey

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Chapter II

EVOLUTION OF THE FINANCIAL SYSTEM

CHAPTER II

EVOLUTION OF THE FINANCIAL SYSTEM

2.1 Historical Order of the Evolutionary Development of the Financial System

2.1.1 Early Era of the Historical Evolution of the Financial System

The one thread which has run through the evolution of the financial system is the prompting of financial innovation by the needs of deficit units. This innovation has been able to satisfy simultaneously the diverse asset preferences of debtor and creditor group. In almost all the countries, the logical historical order of the development of financial structure has gone through different stages.

The first stage starts from a rudimentary economy in which only one type of financial assets exists. It is the commodity money such as gold and silver coins generally accepted as a means of payment. In this context, the regular history of coinage in Nepal is generally assumed to have begun from about the beginning of the 5th century A.D. Since then efforts have been made to introduce them as the means of payment in the country. Most of the coins of that period bear images of animals and other religious symbols, but the denominations and dates of these coins are not known as they bear no inscription on them.

The advent of the 12th century marks a new epoch in the economic history of Nepal. It was in this period that silver coinage came into existence in Nepal. The introduction of the silver money as a means of exchange widened the scope for trade. The development of this stage could avoid the inefficiency and inconvenience of barter. However, no financial intermediation was possible in this stage. The intermediation was limited to the transmission of existing money balances or existing tangible asset stocks.

The second major stage in the course of logical order of development is the innovation of interest-bearing private debt, such as bonds, mortgages and loans. This stage of development permitted deficit units to issue interest bearing financial claim direct to surplus units. For both surplus and deficit groups there is a possibility of borrowing in future contingencies. This possibility reduces the need to hold money balances in the present for precautionary purposes, and provides an alternative low-risk wealth form as a store of purchasing power. In this context, in the year 879/80 A.D. we come across the term 'debt' in Nepal. It is recorded in the Nepalese Chronicle that '*Sankhdhar*' (a low caste merchant) introduced in A.D. 879/80, the new era, after having paid off all the 'debts' then existing in the country. However, the method adopted for the payment of the 'debts' is unknown. Nevertheless, the term itself is enough to prove the existence, by that time ,of money-lending operations on a wide scale in the country.

During the course of development of 'borrowing' we further come across the term '*Tanka Dhari*' at the end of the 14th century meaning money dealer, which is one of the 64 castes classified on the basis of occupation. From this it is quite clear that money changing was adopted as a profession by a section of the people in Nepal that time.

The evidence of many countries shows that the issue of primary securities started the development of financial markets. In this respect, governments were often the first to issue primary claims, in the course of the evolution of an organised market. However, this stage was missed out in Nepal in the course of historical order of development. The development of the market is seen only in the last stage. Treasury bills were only issued for

The First Governor

MR. HIMALAYA S.J.B. RANA

Tenure

(26 April 1956 - 08 February 1961)

the first time in 1962. Government bonds were introduced in February 1964.

2.1.2 Evolution of the Banking System

The history of banking in Nepal may be described as a component of the gradual and orderly evolution in the financial and economic sphere of the Nepalese life. Even now the financial system is still in the evolutionary phase. The existence of unorganised money market consisting of landlords, *Shahukars* (rich merchants), shopkeepers and other indigenous individual money lenders has acted as barrier to institutionalised credit.

These institutions although quite underdeveloped could still mobilise funds from a wide range of different sources. For many years, the indigenous individual, wealthy agriculturists, landlords, merchants and traders conducted some banking activities along with their other business occupations. The activities were fragmented and mostly localised.

The "Tejarath Adda" : the Beginning of Banking Practice

Prior to the establishment of the Nepal Bank Ltd, there was no organized financial institution in Nepal. The population was heavily dependent upon agriculture and in the absence of any organised institution providing credit to support agriculture and other necessities, people had to rely on borrowings from the unscrupulous money lenders who charged exorbitant rates of interest and other dues. The moneylenders even practised the capitalisation of interest upon failure to repay back the principal amount on time. These private money lenders used to extend loans to the people on the collateral of land, house and precious metals. This resulted in worsening the economic condition of the poor people. At many times, these poor people had to loose their land and property due to their inability to repay back the money on the stipulated time. The concept of saving in cash was virtually non-existent. Hence, in the absence of any financial institution, people used to keep their savings in the form of land and precious metals, such as gold and silver.

During the Prime Ministership of Ranoddip Singh around 1877 A.D., a number of economic and financial reforms were introduced. The establishment of the "Tejarath *Adda*," fully subscribed by the government in the Kathmandu Valley was one of them. As the system prevailed in those days, the announcement of this *"Tejarath"* was made public by the beating of drums. The main purpose of setting up of this *"Tejarath Adda"* was to provide credit facilities to the general public at a very concessional rate of interest, i.e. 5 percent. The establishment of this institution marked the beginning of extending credit through any organized financial institution in Nepal. The "Tejar*ath Adda*" disbursed credit to the people specially on the collateral of gold and silver. The government employees were also eligible to get loan from this institution. The loan was repayble from their salary. This move was taken in order to relieve the people from the exorbitant rate of interest charged by the the traditional landlords and the moneylenders. During the Prime Ministership of Chandra Shumsher the *"Tejarath Adda"* extended its services by opening branches in some cities outside the valley, including the Terai region. Legal provision was also made to prevent the practice of capitalizing the interest on loans disbursed by private dealers. Thus the establishment of the *"Tejarath Adda"* could, be regarded as the premier foundation of modern banking in Nepal.

However, the installation of *"Kausi Tosha Khana"* as a banking agency during the regime of King Prithivi Narayan Shah could also lay claim to be regarded as the first step towards initiating banking development in Nepal.

The Establishment of Nepal Bank Ltd. : Beginning of Modern Banking

For few decades, following the establishment of the *"Tejarath Adda"*, neither was there any steps taken to set up other financial institutions nor was there any effort to expand the services to *"Tejarath Adda"* to more parts of the country. Moreover, as the *'Adda'* was set up with the sole objective of providing credit, it did not accept deposits from the public. Thus, in the absence of any saving mobilization, the 'Adda' faced financial problems making it imposible to cater to the credit need of the general population throughout the country. Therefore, for quite a long time, several unorganised bankers and the indigeneous money lenders (Sarafis) continued to flourish as the sole provider of credit to the general public.

As regards trade financing, during this period, though the quantum of trade was not high, the trade with both India and Tibet flourished. Trade payments in most cases was handled through various indigenous bankers, because transfers of money could be safely made only through these bankers in the absence of any modern banking institutions. The ruling authorities in those days had their bank accounts mostly in India. The transfer of amounts as well as encashment was risky and sometimes also complicated. Hence, the need for a banking institution was felt.

The year 1923 was a momentous year for the country. A *"Treaty of Peace and Friendship"* was concluded between the Government of Nepal and the Government of Great Britain. As per the *Treaty*, Nepal could carry on import trade free of duty via India. Thus, this treaty was a landmark for Nepal in its quest to diversify its foreign trade. The need to establish a modern bank thus acquired greater urgency. However efforts towards this end was only visible after several years during the Prime Ministership of Juddha Shumsher. The devastating earthquake of 1934 A.D. in Nepal and the need for financing the reconstruction works also may have expedited the need to establish a banking institution. Accordingly, the *Udyog Parishad* (Industrial Development Board) was constituted in 1936. The *Parishad* had the following objectives:

(a) *To promote and protect the trade, commerce, industries and manufactures of Nepal.*

(b) *To consider and discuss questions connected with or affecting such trade, commerce, industries and manufactures.*

(c) *To register and incorporate joint stock companies in conformity with the Nepal Companies Act and also to examine and supervise their workings.*

(d) *To assist and advise the government of Nepal in economic and financial matters*

Thus, the *"Udyog Parishad"* helped in opening new avenues for the advent of banking, industry and commerce in Nepal and thus helped to enhance the economic status of the country.

One year after its formation, the *Udyog Parishad* formulated the Company Act and the "Nepal Bank Act" in 1937 A.D. As a step towards laying the foundation of industries in Nepal, a jute mill was set up in Biratnagar under the Company Act. In the same year, Nepal Bank Ltd. with the co-operation of Imperial Bank of India, came into existence under the "Nepal Bank Act 1937" as the first commercial bank of Nepal. Inaugurated by His Majesty King Tribhuvan, the grandfather of the present king, on November 1937, the establishment of this bank laid the foundation of modern financial system in Nepal. The significance of the launching of this bank is highlighted in the speech by the then Rana Prime Minister Juddha Shumser on the occasion of its inauguration, which is quoted as follows:

"This work which is being done in the larger interest of the nation is a great moment for me. Until today a bank could not be opened in Nepal. Therefore, this bank which is being established under the name of Nepal Bank Limited to fill that need and to be inaugurated by His Majesty the King, is a moment of great joy and happiness. The Bank's objectives to render service to the people

whether rich or poor and to contribute to the nation's development will also need the support and best wishes of all, which I am confident will be forthcoming."

The main objectives of setting up the Nepal Bank Ltd. under the circumstances prevailing at that time, are highlighted in the Preamble of the Nepal Bank Act, 1937 that states :

"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."

Accordingly, Nepal Bank Ltd. was established to render the services : to accept deposits, to extend credit facilities for the promotion of trade, cottage industry and agriculture, to render customer-related services, i.e. issue of bill of exchange, hundis, etc., to invest in government bond and securities, to perform agency functions and to act as banker to the government.

The Nepal Bank Ltd. also took over the responsibilities of all the functions of the *"Tejarath Adda"* thus making the bank the sole institution undertaking a wide range of banking and financial activities.

Before the evolution of the Nepal Bank Ltd., as described earlier, monetary transactions were monopolised by private dealers such as the *indigenous money lenders* and the *Sarafis.* The establishment of this bank contributed to a great extent towards boosting agriculture, trade and industry in the country besides relieving the people, specially the poor, from the economic exploitation of the indigenous money lenders. Unlike the *"Tejarath Adda"*, Nepal Bank Ltd. had sufficient fund to extend its services since it was a joint venture between the government and the private sector. It had a share capital ownership of 51 percent and 49 percent of the government and the private sector respectively.

It had an initial authorised capital of Rs. 10 million and paid-up capital of Rs. 842 thousand. In 1956, when its branch net work was extended to 12, the bank's paid up capital was increased to Rs. 2.5 million. NBL remained as the only commercial banking institution until the establishment of another commercial bank namely the Rastriya Banijya Bank (RBB) in 1966. It had a free hand in the commercial business of the country, and import and export trade was solely handled by this bank.

2.1.3 Era of Dual Currency System and the Establishment of the Central Bank

Era of Dual Currency System

Nepalese economy was characterised by the prevalence of dual currency system because of the open border and excessive concentration of trade with India. Indian currency was more common in use than the Nepalese currency. Even after the "*Sadar Mulukikhana Adda*" started to issue currency notes from 1945, the use of Indian Currency was still a common practice. Except in some hilly regions and the Kathmandu Valley, most people used to transact in Indian currency. People received credit from the Nepal Bank Ltd. in Indian currency. Fixed deposit accounts were to be opened in Indian currency. Even government employees received their salary in Indian currency and government revenue was collected in Indian currency. Foreign exchange reserve of the country was also kept with Indian Banks instead of maintaining at Nepal Bank Ltd. Moreover, the exchange rate of the Indian Rupee often fluctuated according to demand and supply and there was no regulating authority to stabilise the exchange rate of Nepalese currency vis-a-vis the Indian currency thereby making the exchange rate often uncertain.

The monetary system was, therefore, divided into a 'dual currency' system in that both Nepalese and Indian currencies circulated side by side, virtually without restriction. This peculiar and unique feature of currency transaction was conditioned primarily by the country's peculiar topography with more than 500 miles of open border and the almost total concentration of trade with India, Nepal maintained free convertibility of Indian currency with Nepalese currency and vice versa. The Indian currency area coincided roughly with the plain Terai and extended even up to the Indo-Nepalese border areas of the eastern and western hills. Nepalese currency was used almost exclusively as a medium of exchange in the remainder of the country. The Indian currency area occupied a strategic place in the Nepalese economy and this area was a surplus region accounting for almost all the major exports of the country.

There were great fluctuations in the open market rate of exchange of the Nepalese rupees vis-a-vis the Indian currency which proved to be a great hindrance to the economic stability as well as development of the country. The instability in exchange rate which was highly evidenced during the period 1955 to 1959 had an adverse effect on the entire economy. The instability of the rate of exchange created a problem of unifying the financial administration all over the country. Except in some of the hilly regions which were closer to Kathmandu Valley, only Indian Rupee was in circulation in almost all other regions.

Thus until 1957 Nepalese economy faced various difficulties associated with an unstable exchange rate as well as problems created by the dual currency system. The absence of any regulatory authority further accentuated the problem. Infrastructure for development of transport and communication, agriculture, industry and trade was not developed. Moreover, there was lack of knowledge and awareness about banking system among the people.

Establishment of Nepal Rastra Bank as the Central Bank of Nepal

Until mid-1940s, only mettalic coins were used as a medium of exchange. It was only in 1945 that the "*Sadar*

Mulkikhana Adda" (local treasury of the government) issued currency notes. The *"Mulkikhana Adda"* established in 1945 at the centre and the various *"Mal Addas"* (Revenue offices) in the districts also undertook the treasury function of the government. Against the background, an urgent necessity was felt for the establishment of a central bank dedicated to the development of banking and finance to promote trade and industry, to manage the circulation of national currency and to maintain exchange rate stability. Hence, the Nepal Rastra Bank Act 1955 was formulated under the coordination of the then Principal Royal Advisor, Sardar Gunjaman Singh. The draft of the Act was presented to His Majesty's Government (HMG) and was approved on April 1956. Accordingly, the Nepal Rastra Bank (NRB) came into existence as the Central Bank of the country with an authorised capital of Rs 10 million fully subscribed by the government. His Late Majesty King Mahendra Bir Bikram Shah Dev inaugurated the bank on April 26, 1956. The opening ceremony of the Bank took place in a rented building "Rain Basera" at Juddha Sadak, where the Bank started its early operations. In connection with the inauguration of this Bank, His Late Majesty King Mahendra Bir Bikram Shah Dev expressed that *"It is our belief that the establishment of this Bank will, by the proper management of our currency, promote the growth of banking, industry and commerce, and rejuvenate the economic life of the country".*

The objectives with which the central bank was set up are clearly spelled out in the Preamble of the Nepal Rastra Bank Act, 1955, which is quoted below :

"Whereas it is expedient to ensure proper management of the issuance of Nepalese currency notes, to make proper arrangement for the circulation of Nepalese currency throughout the kingdom and to stabilize the exchange rates of the Nepalese currency in order to maintain comfort and economic interests of the general public.

To mobilize capital for development and encourage trade and industry in the kingdom, and whereas a National Bank has become very essential also to develop the banking system in Nepal.

Now, therefore, His Majesty has enacted and promulgated this Act."

Nepal Rastra Bank (NRB) was established as a central bank on April 26, 1956. The Bank was empowered by Act to have direct control over banking institutions within the country. It also took over the treasury functions of *"Mulkikhana Adda"* (Government Treasury) and started issuing currency in 1959; and also thus relieved the various 'Mal Addas' (Revenue Offices) of their work in this connection. The steps towards modernisation of the treasury function and stabilization of exchange rate was thus initiated in right earnest.

The year 1956 also marked the beginning of Nepal's First Five Year Plan targetted towards building the basic infrastructure for the all round development of the country. Thus the Bank worked in line with the process of the planned economic development of the country.

Early Role, Responsibility and End of the Dual Currency System

Prior to 1957 the use of Indian currency predominated in the Nepalese economy i.e. The first challenging task for the central bank was to increase the circulation of the Nepalese currency by replacing the use of Indian currency in various transactions. Therefore, the Bank focussed its attention primarily to eliminate this dual currency system during the first decade of its inception. The initiation of the Nepalese Currency Circulation Act, 1958 and the opening of the bank's branches in various parts of the country were the important steps in this respect.

Next, the Nepal Rastra Bank took measures to stabilize the exchange rate of Nepalese currency vis-a-vis the Indian currency and make the Nepalese currency a legal tender all over the country in a real sense. In 1960, the Bank issued Nepalese currency notes for the first time. Prior to this, notes were issued by the *"Sadar Mulukikhana Adda"*, which had already issued currency notes of Rs. 1, 5, 10, and 100 denominations. Another problem was the volatile nature of the exchange rates of Nepalese Rupees against Indian Rupees. Such exchange rate was widely fluctuation in the absence of any official intervention. To eliminate this problem, the Nepal Rastra Bank fixed the exchange rate of Rs. 160/- for I.C. Rs. 100/-. Provision was also made for exchanging the required amount through branch, sub-branch and depot offices of Nepal Rastra Bank and branches of Nepal Bank Ltd. Similarly, deposit accounts opened in Indian currency at Nepalese bank branches were converted into Nepalese currency. The provision was also made to collect government revenue in Nepalese currency instead of Indian currency. These moves greatly contributed in bringing stability in exchange rate of the Nepalese currency.

In the same way, the central bank diverted its attention to make the Nepalese currency a legal tender throughout the kingdom. For this purpose, the Nepalese Currency *Circulation* Act was implemented in 1958 followed by the Foreign Ex*change Regulations Act, 1963* in various regions on phasewise basis. Rastra Bank issued its own currency notes in February 19, 1990. To facilitate currency exchange, Nepal Rastra Bank opened offices in different parts of the country including 72 exchange counters and 23 Ghumti (Moving) counters. Later on, they were handed over to the commercial banks as the latter went on increasing their branch network. Thus by the year 1966 that is, one decade after the central bank came into existence, the dual currency system was completely abolished and only the Nepalese currency became legal tender of the country. At the same time, exchange rate with Indian rupees was stabilized and foreign exchange reserves of the country came under the control of Nepal Rastra Bank.

After the establishment of the Nepal Rastra Bank as the central bank of the country, the move to set up various financial institutions for the promotion of trade, industry and agriculture was initiated in line with the objectives of the First Five Year Plan of Nepal which began in 1956 the same year in which the Nepal Rastra Bank was established. Nepal Rastra Bank took active part in setting up these financial institutions, which in due course of time, contributed a great deal in creating infrastructure for development in the field of trade, industry and agriculture.

With the gradual expansion of the development works, the need for providing more banking facilities was felt. So with a view to facilitating development works as well as to implement gradually the policy of introducing a single monetary unit within the country, the central bank was forced to open its branches, sub-branches and exchange depots in various districts. This step might be considered to be almost contrary to the accepted principles of a central banking system. But it was necessary to counteract the adverse effect created by the *'dual currency system'*. The only commercial bank existing at that time did not have any interest or inclination to open branches at places solely for development purposes where commercial viability could not be guarenteed.

However, the functioning of Nepal Bank Limited, first commercial bank and its pioneer contribution has not been insignificant. In the absence of a central bank, the first commercial bank had to manage, apart from commercial banking functions, portions of the accounts of the government. Since the central bank was founded only in 1956, the entire business of currency note, exchange and other concerned activities were also entrusted by the government to this bank. The second commercial bank namely, Rastriya Banijya Bank had also opened a number of branches in different parts of the country. Rastriya Banijya Bank (RBB) was set up in the public sector in 1966. Prior to the establishment of this bank the Nepal Bank Ltd. was the only authorised agent of the Nepal Rastra Bank. The establishment of this second commercial bank made it possible for the NRB to devote more attention to the important aspects of economic, monetary and fiscal development.

From 1957 to 1977, institutions providing long and medium term loans to agriculture and industrial sectors were also established. Institutions like the Provident Fund Corporation (PFC) and the Nepal Insurance Corporation (NIC) also came into being during the evolutionary stages of commercial and central banking institutions. Various institutions established during this period underwent different stages of merger with a view to avoiding duplication and overlapping of functions. An overview of the historical evolution of the various financial institutions is depicted in a chronological order in *Box - 1*.

Box -1 Chronology of the Evolution of Major Financial Institutions

Financial Institutions	Year of Establishment	Remarks
1. Tejarath Adda	1880	Not Existing at Present
2. Nepal Bank Ltd. (NBL)	1937	First Commercial Bank
3. Nepal Rastra Bank (NRB)	1956	Central Bank
4. Industrial Develpment Bank	1957	Converted into NIDC in 1959
5. Nepal Industrial Development Corporation (NIDC)	1959	First Industrial Development Corporation with Broader Scope and Responsibility
6. Co-operative Bank	1963	Merged with ADB in 1968
7. Employee's Provident Fund Corporation (EPFC)	1962	
8. Rastriya Banijya Bank (RBB)	1966	Second Commercial Bank in the Public Sector
9. Land Reform Savings Corporation (LRSC)	1966	Merged with ADB in 1973
10. Agricultural Development Bank (ADB)	1968	First Institution in Agricultural Financing
11. National Insurance Corporation Ltd.	1967	First Insurance Corporation
12. Nepal Insurance Corporation (NIC)	1968	
13. Credit Guarantee Corporation (CGC)	1974	
14. Securities Marketing Centre (SMC)	1977	Converted into the Securities Exchange Centre in 1984
15. Postal Saving Offices	1977	
16. The Securities Exchange Centre (SEC)	1984	Converted into Nepal Stock Exchange (NSE) Ltd., in 1992

The Second Governor

MR. LAXMI NATH GAUTAM

Tenure

(09 February 1961 - 17 June 1965)

17.	Nepal Arab Bank Ltd. (NABIL)	1984	First Joint Venture Bank
18.	Eastern Rural Development Bank	1992	First Rural Development Bank
19.	Nepal Housing Development Finance Co. Ltd.	1992	First Finance Company
20.	Nepal Stock Exchange Ltd. (NSEL)	1992	
21.	Nabajeeban Co-operative Society	1993	First Co-operative with Limited Banking Transaction
22.	Swabalamban Bikas Kendra	1994	First NGO with Limited Banking Transaction

The establishment of the Nepal Rastra Bank was the major step in the evolution of financial institutions. The establishment of NRB in 1956 and the starting of the First Five-Year Plan in the same year provided special impetus for the development of financial institutions. Hence, we can conclude that the banking system developed gradually in accordance with the structural change in the Nepalese economy.

2.1.4 Two Decades of Earlier Role of Nepal Rastra Bank

Provision of Financial Accommodation

The Nepal Rastra Bank, which was established as a central bank on April, 26, 1956, has been taking increasing interest in the activities of financial institutions. There has, in fact not only been an increase in the number of financial institutions, but a favourable atmosphere has also been created for the restructuring of the interest rate and existing small organised markets. One of the tasks of the monetary authority in development is to support the gradual expansion and proliferation of the financial machinery-commercial banks, savings banks, insurance companies, etc-which link surplus and deficit spending units. Realising the impact of the intermediation effect in the transformation of savings or investible resources into actual investment, the responsibility for the development of the banking system as incorporated in the NRB Act, 1955 clearly specifies the importance of its role in the mobilisation of capital for economic development and the development of the banking system in the country. As the creation of financial institutions and the supply of financial assets is likely to play a significant role at the beginning of the growth process, the development of the financial sector was regarded as the most important aspect after the inception of the Nepal Rastra Bank.

This approach was in line with the 'supply leading finance doctrine' advocated by development economists. However, the establishment and growth of financial intermediaries is a desirable but not a sufficient condition to facilitate the development process. In this regard, it can be suggested : that 'the creation of financial institutions and/or adoption of high interest rate policy had been helpful in mobilising resources but the transformation of savings into real capital was not encouraging'. Neverthless, in the beginning of the growth process, the creation and development of the financial sector should be regarded as an important step. So the strategy of developing the financial sector depended upon the effectiveness of the NRB to increase the demand for money through the financial sector. As a result, the most important device open to the NRB at that time was the instigation of a positive policy for the encouragement of banking and the banking habit through facilitating more competition in the financial sector.

In this regard, within the period of early two decades various activities had been undertaken by the NRB for the financial development of the country. Since its establishment, it has been active in maintaining stability in the international and external value of the Nepalese rupee, mobilisation of capital for development and the development of the banking system. With its establishment and its development role, the Nepalese rupee became the sole currency circulating throughout the country and the banking system expanded rapidly. The development of the banking system and the increasing inclination among the people to make use of banking facilities can also be gauged from the rising accredition of deposits and credit recorded by the banks.

The NRB has also been providing financial accomodation to the banking and the financial institutions through the operation of credit and refinance facilities.

The financial help through various channels has provided a firm cushion to the financial institutions in expanding further scope for mobilising resources. Apart from providing financial accomodation, the NRB has undertaken feasibility studies in unbanked areas of the country and paid compensation for the losses, if any, incurred by commercial banks for the first three years in opening and running the bank branches in places prescribed by Nepal Rastra Bank. Such facility formed a part of an aggressive commercial bank branch expansion policy adopted since early 1970's. This policy was formulated to ensure at least one bank branch is each of the 75 district headquarters. As this objective was achieved by 1975, another programme of providing at least one bank branch for 30 thousand persons by mid-1980's was announced. However, this objective could not be achieved because of over stretching cost burden of the two government owned banks in the wake of fastly growing population. Nevertheless, the *'Supply Leading Finance'* doctrine was partly effective in the beginning of the growth process.

Early Efforts of Promoting Financial Markets

Economic development demands transformation of savings or investible resources into actual investment. It is the financial market which facilitates the transfer of funds from surplus spending units to deficit units. As the banking system at that time was in the process of structural and functional changes, the development of financial markets had to be initiated by the central bank itself. In a country like Nepal, the central bank would, therefore, primarily be considered as the promoter not the controller of the financial instrastructure. The contribution of financial institutions, was negligible in promoting the growth of capital markets in Nepal. The method of financing was not done by floating obligations in the market, especially those of development banks. There was negligible investment in public limited companies and a virtual absence of underwriting operations.

Therefore, under the initiative of the NRB, the Securities Marketing Centre (SMC) was formed in April 1977, with a view to developing a capital market in the country. It is an outcome of central bank's effort and is regarded as one of the most important contributions of NRB. The development of a capital market is associated with the growth and operation of other financial institutions. In this context, the support role of the NRB would further broaden the market.

The increased share of fixed deposits of commercial banks can be used for creating longer term assets through the mechanism of the capital market, by purchasing securities of the industrial companies. So far, banks have employed a negligible portion of their resources in the long term loans and corporate securities. Consequently, the NRB has tried to activate the commercial banks and industrial development banks to foster the capital market. The various incentives and credit guarantees are some of the steps in fostering the capital market. The NRB is consistently encouraging the industrial development bank to start procuring funds from the capital market to fulfil its resource needs and to provide initial equity support. The most crucial factor faced by the NRB at that time was the lack of public confidence in business enterprises. Though, the SMC was opened in 1977, active equity trading had not taken place significantly. Nevertheless, the continuing efforts of the NRB in this direction has encouraged the financial institutions to generate a practice of underwriting new issues.

2.2 Change in the Institutional Financial Structure : A Brief Review

Nepalese financial sector is small, but fastly growing. As in the case of other countries, the Nepalese financial sector can be divided into two parts, namely the *banking system* and the non-*bank financal system*. The *banking system* comprises the Nepal Rastra Bank (NRB)- the central bank, ten commercial banks, two development banks and four grameen bikash banks. The *non-bank financial system* comprises 35 finance companies, 10 contractual saving institutions (Employees Provident Fund and Insurance Companies), 11 cooperative financial institutions, 18 non-governmental organization (NGOs), conducting limited banking activities, postal saving offices, and Nepal Stock Exchange Ltd. In addition, there are other quasi financial institutions such as the Credit Guarantee Corporation. *(Box -2)*

Of the ten commercial banks two are government controlled banks and the rest are joint venture banks. The first and the oldest commercial bank, the Nepal Bank Ltd. was established in 1937 and the Second Rastriya Banijya Bank was established in 1966. The Commercial Bank Act 1974 sets out regulations for licensing, supervision and cancellation of license of commercial banks. The joint venture banks currently comprise eight in number, the first of which started operation in 1984.

Of the two specialised development banks, Nepal Industrial Development Corporation (NIDC), established in 1959 under special charter is dedicated principally to the promotion of the private industrial sector, while Agricultural Development Bank (ADB/N) which was enacted in 1967 under the ADB/N Act, provides loan to individual farmers, cooperatives and corporate bodies.

The newly established four regional Grameen Bikash Banks (Rural Development Banks) although operating under the Commercial Bank Act, with certain exemptions granted to them, are exclusively serving the rural poor.

Finance Companies, licensed under the Finance Companies Act 1985 are the third largest group of deposit taking financial institutions in Nepal. These finance companies are the creation of early 1990's. They were established as public limited companies mainly for providing loans to procure motor vehicles and other consumer durables on hire purchase terms, land acquisition and building constructions and leasing plant and machinery. Finance companies' lending operations have tended to complement the operations of the commercial banks mainly in urban areas. But these companies are not allowed to accept demand and savings deposits from the public and have thus concentrated in mobilising funds through fixed deposits.

The Employee Provident Fund (EPF) is the largest contractual saving institution in Nepal. It was established in 1962 under the EPF Act. It covers mandatorily most public sector employees, but private sector companies may also enlist their employees with the EPFC by an agreement.

There are 6 insurance companies, 5 local and 1 foreign. The largest insurance company is the National Insurance Corporation (NIC), which is also a public sector undertaking established under NIC Act 1968. All the local companies are public companies with some private sector participations. The foreign companies are branches of Indian Insurance Companies.

The formation of the first credit cooperative in the Chitwan district in 1956 has been a source of institutional credit for rural areas. The first Cooperative Act in Nepal dates back to 1969, with various changes in the following three decades, notably the Sajha Societies Act of 1984. In the course of a major revision of cooperative promotion, a new cooperative Act came into force in 1992. There are more than 11 credit cooperatives operating in the country. Besides ten cooperative financial institutions have been established, mostly in urban areas; for undertaking banking transactions with the permission of the NRB.

Recently, even Non-government Organisations (NGOs) have also been engaged in performing saving and credit activities to their members. NRB has authorised a handful of NGOs to carry out limited lending activities to their members under certain guidance. They are required to charge a fixed interest rate on their lending and to play the role of a facilitator in deposit mobilisation.

Postal Saving Offices has been introduced in 1977 in order to promote the savings habit among the rural areas where tiny savers are reluctant to go to commercial banks. The number and volume of savings captured by the postal saving system is very small, although it has already spead over to all the 75 districts of the country.

Credit Guarantee Corporation (CGC) was established in 1974 to guarantee and compensate the loan losses incurred by the commercial banks while lending to the priority sector.

Nepal Stock Exchange Ltd. (NSEL) replaced the Securities Exchange Centre in 1992. The Securities Exchange Centre was established in 1984, by incorporating the assets and liabilities of the Securities Market Centre set up in 1977.

Besides, banks and non-bank financial institutions there is still a large informal money market operating in the economy. This refers to all the financial transactions which do not go through organised or legally registered financial institutions. The most distinctive feature of the informal money market is that few records of transactions are kept. Such transactions include lending by private money lenders, merchants and traders on an informal basis. Although this sector charges exorbitant rate of interest the informal market of money lenders performs an indispensable function.

Box -2 : Growth of Financial Institutions

Commercial Banks		Year of Establishment	Location
1.	Nepal Bank Ltd.	1937	Kathmandu
2.	Rastriya Banijya Bank	1966	Kathmandu
3.	Nepal Arab Bank Ltd.	1984	Kathmandu
4.	Nepal Indosuez Bank Ltd.	1986	Kathmandu
5.	Nepal Grindlays Bank Ltd.	1987	Kathmandu
6.	Himalayan Bank Ltd.	1993	Kathmandu

7.	Nepal SBI Bank Ltd.	1993	Kathmandu
8.	Nepal Bangladesh Bank Ltd.	1994	Kathmandu
9.	Everest Bank Ltd.	1994	Kathmandu
10.	Bank of Kathmandu Ltd.	1995	Kathmandu

Development Banks

1.	Agricultural Development Bank	1968	Kathmandu
2.	Nepal Industrial Development Corporation	1959	Kathmandu

Rural Development Banks

1.	Eastern Rural Development Bank	1993	Biratnagar
2.	Far-Western Rural Development Bank	1993	Dhangadhi
3.	Western Rural Development Bank	1995	Butwal
4.	Mid-Western Rural Development Bank	1995	Nepalgunj

Finance Companies

1.	Nepal Housing Development Finance Co. Ltd.	1992	Kathmandu
2.	Nepal Finance and Savings Co. Ltd.	1993	Kathmandu
3.	NIDC Capital Markets Ltd.	1993	Kathmandu
4.	National Finance Ltd.	1993	Kathmandu
5.	Annapurna Finance Co. Ltd.	1993	Pokhara
6.	Nepal Share Markets Ltd.	1993	Kathmandu
7.	Peoples Finance Ltd.	1994	Kathmandu
8.	Himalayan Finance & Saving Co. Ltd.	1994	Kathmandu
9.	United Finance Ltd.	1994	Kathmandu
10.	Union Finance Co. Ltd.	1994	Kathmandu
11.	Himalayan Securities & Finance Co. Ltd.	1994	Kathmandu
12.	Merchantile Finance Co. Ltd.	1994	Birgunj
13.	Kathmandu Finance Ltd.	1994	Kathmandu
14.	Investa Finance Ltd.	1995	Birgunj
15.	Narayani Finance Ltd.	1995	Narayanghat
16.	City Finance Ltd.	1995	Kathmandu
17.	Nepal Housing & Merchant Co. Ltd.	1995	Kathmandu
18.	Paschhimanchal Finance Co. Ltd.	1995	Butwal
19.	Univérsal Finance & Capital Markets Ltd.	1995	Kathmandu.
20.	Samjhana Finance Co. Ltd.	1995	Banepa
21.	Goodwill Finance & Investment Co. Ltd.	1995	Kathmandu

22.	Shree Investment & Finance Co. Ltd.	1995	Kathmandu
23.	Sidhartha Finance Ltd.	1995	Sidharthanagar
24.	Lumbini Finance & Leasing Co. Ltd.	1995	Kathmandu
25.	Yeti Finance Ltd.	1995	Hetauda
26.	Standard Finance Ltd.	1995	Kathmandu
27.	ACE Finance Co. Ltd.	1995	Kathmandu
28.	International Leasing & Finance Co. Ltd.	1995	Kathmandu
29.	Maha Laxmi Finance Ltd.	1995	Birgunj
30.	Lalitpur Finance Co. Ltd.	1995	Lalitpur
31.	Merchant Finance Co. Ltd.	1996	Kathmandu
32.	Bhajuratna Finance & Savings Co. Ltd.	1996	Kathmandu.
33.	General Finance Ltd.	1996	Kathmandu
34.	N.B. Finance & Leasing Co. Ltd.	1996	Kathmandu
35.	Epic-Everest Finance Ltd.	1996	Kathmandu

Co-operative Societies
(With Limited Banking Transaction)

1.	Navajiban Co-operative Society Ltd.	1993	Dhangadhi
2.	Nava Kshitij Co-operative Society Ltd.	1994	Kathmandu
3.	Sagun Co-operative Society Ltd.	1994	Kathmandu
4.	Nepal Co-operative Finance Society Ltd.	1994	Kathmandu
5.	Makalu Transport Co-operative Society Ltd.	1995	Biratnagar
6.	The Sahara Loan, Savings & Investment Co-operative Society Ltd.	1995	Sarlahi
7.	Bindbasini Saving Fund Co-operative Society Ltd.	1995	Kabhre
8.	Bahumukhi Co-operative Society Ltd.	1995	Jhapa
9.	Mahila Co-operative Society Ltd.	1995	Kathmandu
10.	Bahuddeshiya Saving & Loan Co-operative Society Ltd.	1995	Jhapa
11.	Rajshree Savings & Investment Ltd.	1996	Sarlahi

Non-Government Organisation (NGOs)
(With Limited Banking Transaction)

1.	Swabalamban Bikas Kendra	1994	Kathmandu
2.	Nirdhan Society	1995	Bhairahawa
3.	Jwalamukhi Club	1995	Chitwan
4.	Apurbha Siraha Development Society	1995	Siraha

5.	Economic Development Council	1995	Kathmandu
6.	Nepal Digo Samudayik Development and Research Centre	1995	Lalitpur
7.	Gramin Pratisthan Nepal	1995	Kathmandu
8.	Economic Development Community Nepal	1995	Biratnagar
9.	Pichhadiyeko Janasamudaya ResearchCentre	1995	Kathmandu
10.	Dhaulagiri Youth Club	1995	Chitwan
11.	Gramin Bikash Sachetan Society	1995	Parbat
12.	Gramin Bikash Ayojana	1995	Surkhet
13.	Deprox Nepal	1995	Kathmandu
14.	Shanti Jana Aadarsh Sewa Club	1995	Kabhre
15.	Nari Bikash Sangh	1995	Biratnagar
16.	Gramin Utthan Nepal	1995	Kathmandu
17.	Nepal Gramin Punar Nirman Sansthan	1995	Kathmandu
18.	Aarthik Bikash Prabardhan Kosh	1996	Kathmandu

2.3 Pre-Liberalization Era in the Financial System

2.3.1 Regime of Controlled Interest Rates

A system of controlled interest rates for commercial banks and other financial institutions had been in operation for a long time. Before deregulation of May 1986, there were about 20 controlled lending rates differentiated between sectors, use of funds and types of collateral. Further, interest rate structure was not very rationale and the central bank was determining the whole set of deposit rates and instruments. The interest rates had not changed much over time, although a significant and a historical upward revision in interest rate structure took place in 1975. The reasons for maintaining a few mandatory interest rates can be attributed to the fact that competitive conditions were not sufficient to introduce a fully liberalized system of interest rates, and other instruments of monetary policy had yet to be further developed. Further, the direct control of lending rates also provided an easy mechanism for credit allocation by differentiating between priority and nonpriority sectors in which the former received concessionary interest rates. The direct control of deposit rates prior to the deregulatory moves initiation of 26 May 1986 was considered a potentially effective instrument for mobilizing domestic savings.

However, some anomalies, existing in the financial system under the controlled interest rate regime, induced the central bank to move towards partial deregulation of the financial system. The abundance of resources in some institutions, while others facing scarcity and the nonflexibility of interest rate on deposits, were some of the aspects of circumstances leading to deregulation. The non-flexibility of interest rates restricted the institutions (needing more resources) in mobilizing more savings by offering higher rates. The wide margin between deposit and lending rates, the introduction of commercial banks with foreign banks' collaboration and the subsequent need to create a competitive atmoshpere for commercial banking activities were some of the main reasons motivating the regulatory authority towards financial deregulation. It may be recalled that before the deregulation of 26 May 1986, there were about 20 controlled lending rates differentiated between sectors, use of funds and types of collaterals. Therefore, it was also cumbersome to manage the interest rate structure which would change frequently in line with the competitive environment. Further, the interest rate structure was also not rationale. Instead of the central bank determining the deposit rates and instruments, it seemed logical in allowing the banks concerned to handle that. A move towards deregulation by granting commercial banks and financial institutions the authority to fix interest rates at their own discretion at any level above the minimum prescribed levels was, therefore, initiated on May 26, 1986.

The overall impact of controlled interest rates and other regulations was that the asset and liability structure of the commercial banks was tightly controlled, and changes in the assets and liability structure of the banks were possible only to a limited extent. The direct control of deposit and lending rates in this situation, therefore, became redundant. During the past decade after deregulation, banking activities developed rapidly as is evident by the growth of assets, the expansion of bank branches in rural areas and gradual decline of currency- deposit ratio over the years.

2.3.2 Pre-Liberalization Decade of Regulatory and Prudential Consolidation Measures

1. *Commercial banks seeking entry in the financial system were required to get operating licenses from Nepal Rastra Bank (Central Bank) and the location of the central office of such commercial banks and opening of their branches also needed prior approval of the central bank.*

2. *The opening of finance companies as subsidiaries of domestic or foreign banks were generally restricted except for those designed for managing trust property and safe deposit vault and being auxiliary to promote banking busness and industrial development as approved by the central bank.*

3. *Up to May 1986, the liquidity ratio was to be maintained at least at 25.0 percent.*[a/]

4. *Until 1977/78 commercial banks were obliged to maintain at least 5.0 percent of their total deposit liabilities with the central bank, which was increased to 7.0 percent and this provision remained effective until 1981/82 when statutory reserves requirement was increased to 9.0 percent, 5.0 percent to be held as balances at the central bank and 4.0 percent as cash in vault.*

5. *Effective January 1985, commercial banks were directed not to hold foreign currency balance abroad at more than 30.0 percent of their total letter of credit liabilities.*

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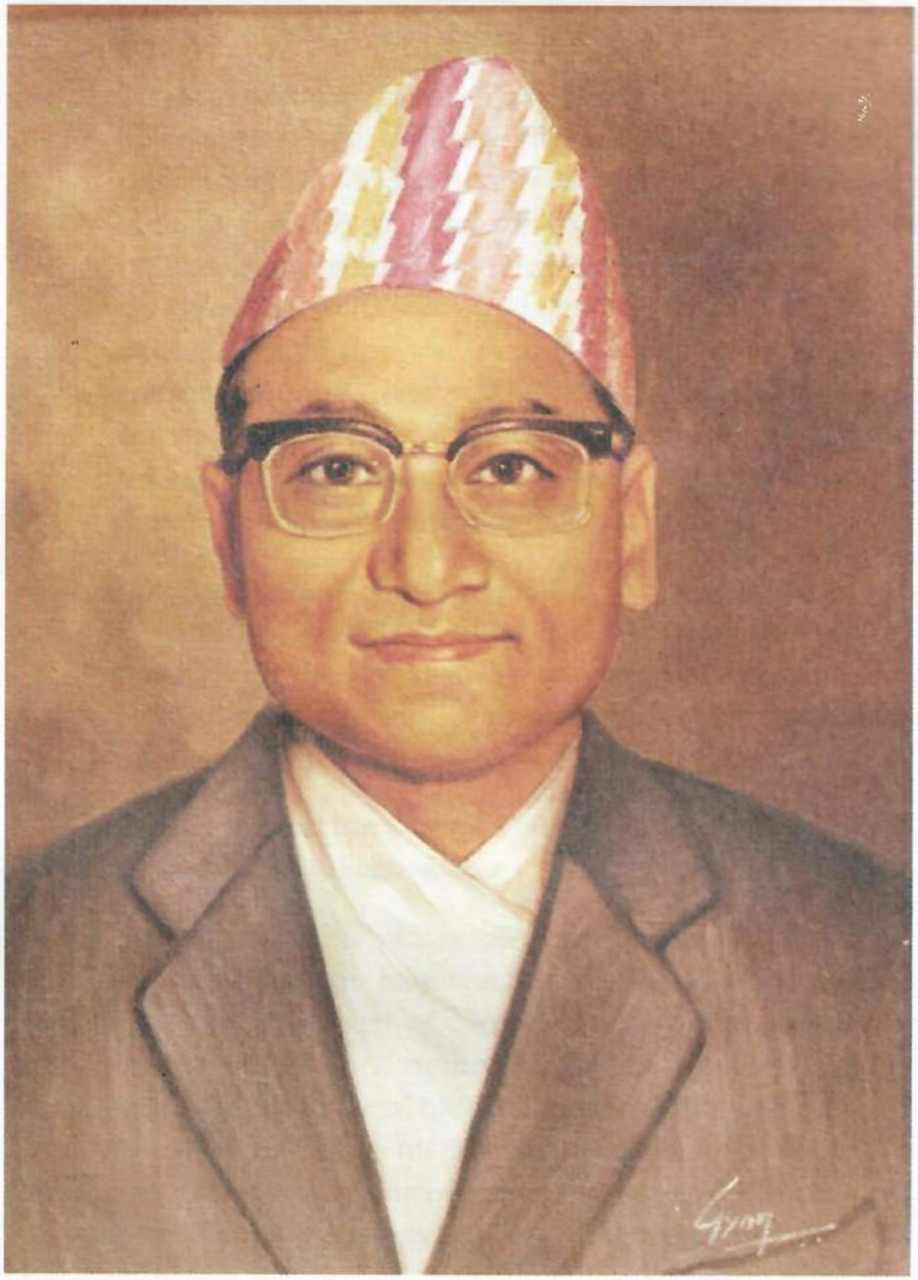
a/ The liquidity requirement and the obligation of commercial banks to invest at least 5.0 percent of their total deposits in government securities was lifted after May 1986.



The Third Governor

MR. PRADYUMNA LAL RAJBHANDARI

Tenure

(18 June 1965 -12 August 1966)

6. *The commercial banks were not allowed to lend for a period of more than 12 years and credit to the member of board of directors and that against the collateral of its own shares was also restricted. The central bank also notified from time to time restricting commercial banks from lending in certain areas and lending against the collateral of certain assets. Regarding the area of restrictive activities, the commercial banks were prohibited to extend credit on certain commercial sector (mainly the imports) from time to time taking into consideration the external balance as well as credit expansion situation in the country.*

7. *Commercial banks were not authorized to take deposits on convertible foreign currencies till July 1985. However, after July 1988, the banks were allowed to accept deposits (current and fixed) on two currencies– U.S. dollar and pound sterling.*

2.3.3 Pre-liberalization Circumstances Inducing First Phase of Financial Liberlization

During the first phase of liberalization, interest rate structure had been the major aspect of deregulatory policy in Nepal. The overall impact of controlled interest rate and other regulations resulted in a tightly controlled asset and liability structure of the commercial banks and hence, changes were only possible to a limited extent. The main reasons for controlling lending rates previously was to prevent excessive profits in a non-competitive banking system and to influence credit allocation. Further, it was noted that the competitive conditions were not fully developed and the emergence of more commercial banks might not be enough to alter the existing lack of a geniunely competitive environment. In such a situation, a liberalization of interest rates may be utilized by the banks only to increase their profit margin. This was the basic philosophy before the period of deregulation of interest rates in Nepal.

During the past decade, banking activities developed rapidly as is evidenced by the growth of assets, the expansion of bank branches in rural areas and the gradual decline of the currency-deposit ratio over the years. Assets of the combined commercial banks grew on average by 21.0 percent during the period 1977-1987. Similarly, the expansion of bank branches was stimulated under a general policy of expanding bank branches in rural areas for expanding economic activities and increased monetization. However, the currency-deposit ratio declined steadily between 1977 and 1987 from 55.9 percent in 1977 to 48.6 percent in 1987. Therefore, the interest rate deregulation decision of 29 May 1986 complemented the special emphasis laid by the Government on fostering competition and excellence in the financial sector.

An anomalous situation existed in the country before deregulation, where the commercial banks had plenty of idle money, whereas many farmers and potential entrepreneurs have had to shelve their plans because of the shortage of funds. An atmosphere of competition among the banks along with the new autonomy in fixing interest rates was thus expected to positively contribute towards achieving the intended objectives of the deregulatory measure.

The move towards deregulation was also necessitated by the non-competitive nature of the existing financial market wherein non-flexible interest rates on deposits acted as restraint on the ability and scope of the financial institutions to mobilize more resources. The wide margin between the deposit and lending rates, another indicator of the relative inefficiency and uncompetitiveness of the financial market also has tended the process towards deregulation.

Very few financial instruments had emerged within the financial system during the decade under review. Among them were the issuance of traveller's cheques by one of the commercial banks and the issuing of debenture by Agricultural Development

Bank (ADB/N) and Nepal Industrial Develpment Corporation (NIDC) within the financial system and National Saving Certificates by the Government outside the financial system. However, the establishment of Security Exchange in April 1977 had created a secondary market not only for financial instruments but also for shares, stocks and other forms of capital in the non-financial system. Therefore, a congenial atmosphere had been created to make the financial instruments more liquid. It should be noted that the financial instruments which had already existed before 1975, such as the treasury bills and development bonds issued by the Government and mostly held by the financial system, were more intensively transacted within the financial system. Agricultural saving bonds issued by the ADB/N in 1985 amounting to Rs. 50 million had emerged as a new instrument in the financial market though its sales has so far been only equal to Rs. 16.9 million

The move to allow the commercial banks to open foreign currencies accounts however, added a new instrument in the sources of fund. But the issuance of negotiable certificates of deposits (NCDs), credit cards and other financial instruments had not as yet introduced.

Interest rate policy in Nepal was characterized by an elaborate system of mandatory deposit and lending rates for commercial banks and other financial institutions before the deregulatory moves of May 1986. The reason for maintaining mandatory rates could be attributed to three main factors, namely: (1) The existing competitive conditions were not sufficient to introduce a fully liberalized system of interest rates; (2) it was necessary to gain experience with a partly liberalized system; and, (3)other instruments of monetary policy had to be further developed.

The direct control of interest rates was motivated by the following reasons :

* *First, competition in the banking sector was very limited. There were only five commercial banks, of which the two largest ones were dominating the market, while the any countervailing power in the form of increased competition offered by of the then operating three joint-venture foreign commercial banks was insufficient at that moment, considering their limited size and operation. The two largest commercial banks were controlled by the Government as the only or major shareholder, thereby providing ensufficient scope for efficient competition.*

* *The direct control of lending rates provided an easy mechanism for credit allocation by differentiating between priority and non-priority sectors, in which the first received concessionary interest rates. It was thought that concessionary rates combined with a refinancing facility were effective instruments to stimulate the supply and demand for priority sector credit.*

* *The direct control of deposit rates was viewed as an effective instrument for mobilizing domestic savings because it allowed sufficient interest rate differential to prevent capital overflow to Indian and also stimulate further development of the financial system.*

The policy issue, therefore, was whether the system of interest rate controls was the most effective vehicle in realizing the objectives of increasing savings and investments, and if not, what alternatives were available to improve the efficiency and flexibility of interest rates management. In particular, the moot question was whether the conditions for deregulation was sufficient or whether more reliance could be placed on an indirect system of controls, and the related policy requirements. It could be argued that a direct control of deposit and lending rates was redundant, and that fixing one or two important deposit rates was sufficient to indirectly control the structure and level of other deposit and lending rates.

The move towards deregulation was prompted by the anomalies created by rigid deposit rates, wide margin between deposit and lending rates, and the lack of competition among existing banks. Various moves were made towards financial liberalization through interest rate deregulation and removal of barrier to entry for foreign commercial banks although only as joint venture with local banks or private investors. However, the interest rate structure just after the deregulating moves did not give an optimistic picture about the effectiveness of deregulation. The banks were eager to preserve the old structure and level of interest rate. The depositors, instead of receiving higher interest on deposits through increased competition for funds instead saw deposit rates go down due mainly to the joint venture banks succeeding in exploiting the market imperfections by increasing the interest rate spread between the lending and deposit rates through rather low deposit rates.

2.4 Major Features and Nature of the First Phase of Financial Liberalization

The moves towards deregulation in the financial system of Nepal has been very recent and the degree and forms of deregulation have also been limited. The history of deregulation in Nepal goes back a few years only with limited deregulatory steps on assets control and deposit and lending rates but almost none towards capital and other liability controls. As such, most of the liabilities of the financial institutions were hardly regulated in the earlier years, and the question of deregulation on such liabilities therefore does not exist.

The provision regarding the entry of commercial banks, which includes approval of His Majesty's Government on the recomendation of Nepal Rastra Bank, has not undergone any change throughout the review decade. However, the entry of joint-venture banks has been encouraged since 1984. As a result, three commercial banks established with the joint investment of Nepalese individuals as well as institutions and foreign banks have commenced their operation. Moreover, some amendments have been made on the Commercial Bank Act so that the banks could extend credit for a long-term period. Accordingly, the new Commercial Bank Act of 1974 has also allowed commercial banks to extend longer-term credit to the agricultural and industrial sectors with the maximum period of long-term credit being fixed at 12 years. This has widened the scope for the commercial banks' lending activities.

The amendment made on the Agricultural Development Bank Act, which allowed ADB/N to conduct commercial banking activities, has encouraged it to mobilize more financial resources, and it has created a competitive environment for deposit collection.

The amendment of the Employees's Provident Fund Act has allowed the institution to diversify its fund in various investment activities rather than concentrating on time deposits in commercial banks. The establishment of Security Exchange Centre and the introduction of Stock Exchange Act have encouraged capital market activities in the country. The provision of Finance Company, which came into effect in 1986, has paved the way for the establishment of finance companies.

However, the chronology of deregulation details does not go very far back. It was only in November 1984 that the deposit-taking institutions were granted freedom to manage their deposit rates within a narrow range of one to one and a half percentage points after maintaining the minimum rate as prescribed by the Nepal Rastra Bank (NRB, the central bank). In other words, the preliminary phase of deregulation started when Nepal Rastra Bank on November, 1984 gave a directive to the commercial banks and other deposit taking institutions to permit an increase in deposit rates by up to 1.5 percentage points on the minimum rates of 8.5 per cent on saving deposit and 1.0 percentage point on the minimum rates of fixed deposits (12.0 percent of one year deposit). The first step towards this move was made effective on the 29

May 1986, whereby the deposit-taking institutions were granted the freedom to offer higher rates than the minimum rate as prescribed by the NRB. In other words, commercial banks were granted the authority to determine the interest rates as well as the maturity period of fixed deposits after maintaining the floor rate (one-year fixed deposit interest rate) as prescribed by the NRB. Accordingly, commercial banks and financial institutions were authorized to fix their own interest rates on both deposits and loans subject to a minimum rate of 8.5 percent on savings deposits and a rate of not more than 15.0 percent on priority sector lending. Similarly, the commercial banks were allowed to mobilize additional financial resources to expand their sources of funds and maintaining the minumum interest rate level as prescribed on time deposits.

As regards deregulation of lending rates, only a few lending rates were at the discretion of the financial institutions till 19 May 1986. After the introduction of the deregulation system only the maximum lending rates on priority sector credits were enforced by the NRB. With a view to create competitive financial environment, the Nepal Rastra Bank (NRB) on the eve of deregulation moves freed the interest rates on lending except for the priority sector credit. In the case of priority sector lending also, the provision of interest rate subsidy by the NRB was discontinued and the refinance facility which bore a general interest rate of 4.0 percent below the commercial lending rate was restricted to a few activities. The objective of Nepal Rastra Bank in this regard was to mop up excess liquidity in the system without having adverse impact on the price and balance of payments. The raising of interest rates on priority sector lending was to bring the cost of credit in line with the market sentiment. The overall objectives was to lessen excessive dependence on NRB for resources and to encourage banks to try to mobilize resources through interbank borrowing.

The upward revision of interest rates on priority sector credit from a maximum of 11.0 percent before 29 May 1986 to a maximum of 15.0 percent, thereafter, was a further step towards reducing refinancing and to discontinue direct interest rate subsidies. It is apparent that the then maximum lending rates in the priority sector credit were high enough to attract commercial banks to channel their resources towards this sector. The commercial banks were provisioned to invest at least 25.0 percent of their total loans and advances in productive sector (including 8.0 percent in priority sector). Although such a regulation seemed contrary to the deregulation moves, it was thought that it would not be wise to lift such regulation at that moment when commercial banks were more inclined to invest only in profitable business not included in the priority sector. It was also thought that maintaining regulation on a few activities would not affect the overall liberalization.

Other rates were left free at the discretion of the respective financial institutions. Effective July 1989, interest rates were completely liberalized and commercial banks and other financial institutions were allowed to fix their own deposit and lending rates.

On loans relating to security of government bonds and against fixed deposit receipts, the rate had been fixed at 2.0 percent higher than the rates against such securities and fixed deposits. The interbank lending rates were also left to the discretion of respective dealing institutions. More encouraging was the autonomy granted to the commercial banks to fix rates of interest for deposits consisting of more than two years maturity. This had to be, however, less than the rate for two-year deposits. Further, at the deposit front, commercial banks were also authorized to take deposits on convertible foreign currencies effective July 1985. Thereafter, the banks were allowed to accept deposits (current and fixed) on two currencies (U.S. dollar and pound sterling).

The next deregulatory step was the relaxation of liquidity requirement ratio. Effective 29 May 1986, the commercial banks were granted freedom from maintaining liquidity requirement. However, the provision of keeping cash reserve ratio (CRR)- 4 per cent of total deposits in their own vault and 5 per cent of the total deposits at the Nepal Rastra Bank had been retained. Prior to this, the liquidity requirement was to be maintained at 25.0 percent with the obligation of the commercial banks to invest at least 5.0 percent of their total deposits in government securities. In other words, they had still to comply with the statutory reserves ratio. A penal interest rate was to be imposed on commercial banks failing to maintain the CRR.

In the case of lending rates, except for exports and a few productive sectors, commercial banks and financial institutions were given the freedom to determine the rates. In the case of priority sector lending, the provision of interest subsidy being provided by the central bank has been discontinued, and refinance facility was restricted to few activities only.

With regard to loan limit and priority sector loans, the commercial banks continued to be regulated by the NRB from time to time *(Box -3)*.

Box -3 Regulation of Commercial Banks by Types of Instruments

Mid-July	Liquididy Ratio (%)	Statutory Reserves (%)	Loan Rates (%)	Deposit Rates (%)		Long-term Lending Deposit Ratio (%)	Loan Limit (in Million Rs.)	Priority Sector Credit Require-ment	Loans to Capital Fund Require-ment
				Fixed 1/	Saving				
1976	25	5	8-16	14	8	-	1510	5% of total deposits	
1977	-	5	8-16	12	8	5	-	7% of total deposits	
1978	-	7	8-16	12	8	15	-	7% of total deposits	
1979	-	7	8-16	12	8	15	1927	7% of total deposits	

1980	-	7	8-16	12	8	15	2638	7% of total deposits	
1981	-	7	8-16	12	8	15	-	10% of total deposits	
1982	25	9	11-17	12.5	8.5	15	-	10% of total deposits	8:1
1983	25	9	11-17	12.5	8.5	15	-	10% of total deposits	8:1
1984	25	9	11-17	12.5	8.5	15	-	10% of total deposits	8:1
1985	25	9	8-19	12.5-13.5	8.5-10.0	15	-	10% of total deposits	8:1
1986	-	9	15 a/	12.5 b/	8.5 b/	15	8341	8% of total credit	8:1

1/ One year fixed deposit rates.

a/ Maximum lending rates for priority sector credits only.

b/ Maximum rates only fixed by the NRB.

Nevertheless, banks were allowed to freely set key deposit rates above certain minimum rates, and the former complex structure of concessional refinancing rates applicable to certain sectors was replaced by a higher uniform maximum rate. All other lending rates were freed. The minimum deposits and maximum lending rates has been kept under review and were being adjusted as needed to reflect price developments and ensure positive real interest rates. In addition, the maturity structure of government securities had been improved so as to make them more attractive to potential buyers. Furthermore, the development of short-term government securities had been explored, including measures to promote a more active secondary market in government securities, with a view to placing greater reliance on open market operations in the management of bank liquidity. Accordingly, a new policy of selling treasury bills at monthly auctions was adopted in a bid to mobilize the capital market and help finance the budget deficit. Although credit ceiling was imposed on commercial banks, there was no quantitative restriction on refinance facilities to the commercial banks. However, access to concessional refinancing facilities was planned to be regulated in line with the overall monetary programme.

2.5 Move Towards Further Consolidation

Although the main feature of the liberalization measure was the deregulation in interest rates wherein the commercial banks were granted freedom in fixing interest rate applicable on their lending and deposits, the underdeveloped nature of the financial system and the excess liquidity prevailing in the banking system led the monetary authorities to initiate some regulatory moves which were as follows:

Bank Entry: *The establishment of any commercial bank (domestic or foreign) in accordance with the Company Act was allowed only with the recommendation of Nepal Rastra Bank (NRB). In order to secure such a recommendation, commercial banks seeking entry has to fulfill certain requirements sought by the NRB.*

Liquidity Requirements : *Before May 1986, the liquidity requirement was to be maintained at certain percentage of deposit liabilities. This provision was, initially withdrawn in May 1986, and thereafter it was withdrawn in 1994.*

Cash Reserve Requirements : *The provision of Cash Reserve requirements (CRR) remained effective evenafter 1986 when statutory reserve requirement was increased to 9.0 percent; 5.0 percent be held as balances at NRB and 4.0 percent as cash in vault. The ratio was, however, revised upwards from 9.0 per cent to 12.0 per cent of total deposit liabilities effective September 27, 1989.*

Credit Limit : *As regards credit limit, the maximum amount of credit which a bank or financial institution could extend to any one customer was to be determined as prescribed by the Nepal Rastra Bank (NRB) in the Commercial Bank Act.*

Credit Restriction *: The commercial banks were not allowed to lend for a period of more than twelve years. Similarly, credit to the member of Board of Directors and that against the collateral of its own shares was also restricted.*

Capital Adequacy *: Inrease in authorized capital of the bank required pre-approval of the NRB. The commercial banks had to increase their share capital as per the direction of the NRB. With effect from 1989, the commercial banks were also required to increase gradually the capital adequacy ratio.*

2.6 Second Phase of Financial Liberalization

2.6.1 Internationally Induced Factors Leading to Financial Liberalization

Financial liberalization has been sweeping through the world's financial markets and revolutionising the financial services industry in all the major industralialised countries. Price restriction, geographic limitation and legal constraints separating banks from other financial activities are progressively being removed in favour of a new regime of competitive freedom.

The blurring of boundaries between institutions and instruments, for example, has often threatened the effectiveness of the control itself and the viability of institutions within the regulated area. Preserving the control in these circumstances has often meant extending it or intensifying it. However, the economic cost exercising such control has made such an option increasingly less attractive in relation to the other alternative of increased deregulation and liberalization. The cost of standing out against the market tide has become an important constraint on the extent to which the policy makers can choose whether or not to be part of the process of financial liberalization.

The authorities in Nepal have opted to join the global move towards market friendly liberalization process. In this context, the Government of Nepal have implemented wide ranging financial sector reforms designed to promote financial savings and intermediation, increased competition in the financial sector, a deepening of financial markets and a shift toward indirect monetary control. Most of the reforms were carried out after 1987 in the context of medium-term IMF-Structural Adjustment Programme.

The general thrust of the reforms was to increase the role of market forces in the financial system. A gradual reduction of interest rate control: the elimination of credit ceilings and liquid asset requirement; changes in the reserve requirement regime; a restructuring of rediscount facilities; and the introduction of an auction mechanism for issuing treasury bills (TBs) on regular basis, were some of the important financial liberalization measures, in this respect.

Competition in the financial system was also enhanced by the entry of three joint-venture banks (Nepal Arab Bank Limited (NABIL), Indosuez and Grindlays) and by the authorisation for Agricultural Development Bank (ADB) of Nepal to collect deposits in urban areas. Consistent with the policy of competitive financial system, the government granted permission to establish finance companies including commercial banks to be wholly owned and operated by the private sector.

The introduction of an auction system for treasury bills (TBs) helped to increase the operational flexibility of the Nepal Rastra Bank to some extent by giving it more initiative in its market intervention. The liberal policy adopted towards establishing hire purchase or leasing company, finance company, merchant bank, underwriters, institutional broker in the private sector was expected to further enhance the requirement of a dynamic capital market. The policy of "Mututal Company' to be established by the govenment owned financial institutions was expected to mobilise and invest the savings of village level savers in the share of the organised industry, bonds, and government securities. The proposed establishment of a separate Security Exchange Board was expected to provide essential policy direction for the development of capital market in order to meet the increased demand of capital for the private sector.

6.6.2 Completion of Interest Rate Liberalization

In the light of financial liberalization initiated by the South Asian Countries since early 1980's, Nepal also started to adopt various financial reform measures since mid 1980's. This was initiated by amending the Nepal Rastra Bank and Commercial Banking Acts along with deregulation of interest rate administration. After a long period of low interest rate policy which discouraged savings mobilization and encouraged unproductive expenditure, Nepal Rastra Bank (NRB) made a policy shift in the mid 1970's towards a higher interest rate structure. Although the officially prescribed increase in interest rates helped to attract private funds into the banking system in the form of savings and fixed deposits, the lending rates could still not truely reflect the cost of capital. The spread between deposit and lending rates was also less than optimum. All this led the NRB initiated deregulation of interest rate administration since mid 1980's. Particularly since May 1986, the NRB allowed the commercial banks to set their deposit rate structure at any level above the minimum rate fixed by it. Regarding lending rates, the NRB continued administering the interest rate only on priority sector lending, setting other lending rates completely free.

The process of interest rate liberalization was completed in August 1989, when the NRB completely deregulated the interest rate structure of the financial institutions. Accordingly, commercial banks and term lending institutions became free to determine deposit and lending rates fully on their own discretion. The statutory liquidity requirement was also waived so as to enable the commercial banks to optimize their investment portfolio which could lead to narrow down the spread between deposit and lending rates without jeopardizing their profitability. From 1989 onwards, the NRB gave up imposing credit ceilings and thus instead of

Some Currency Notes issued during the First, Second
and the Third Governors' Tenure

opting for direct intervention in the commercial banking sector, started developing indirect policy tools of monetary control. Steps were taken to intensify open market operation by increasing the transaction of government securities in the secondary market. As treasury bills alone were not sufficient enough for mopping up excess liquidity, NRB bonds were issued for the first time in 1992 to intensify open market operations.

2.6.3 Capital Base

The commercial banks were required to increase their share capital as per the direction of the central bank and maintain capital fund at certain ratio of total deposits as prescribed by the central bank. If capital fund at the end of any fiscal year fell short of the prescribed amount, such a commercial bank had to maintain it up either by transferring the net profit amount or by issuing new shares. Nepal Rastra Bank had directed the commercial banks to gradually increase the ratio of their capital funds to total deposits. Accordingly, the commercial banks were required to maintain capital adequacy ratio of at least 2.5 per cent by mid-July 1989, 3.0 percent by mid-July 1990, and 5.5 percent by mid-July 1991 and 1992, and the percentage was in relation to total deposit of the previous year end.

2.6.4 Single Borrower Limit

As mentioned in the Commercial Bank Act, the central bank, namely Nepal Rastra Bank would prescribe the limit applicable to the amount of lending by the commercial bank or financial institution to any single client. Accordingly, single borrower limits were 50.0 percent of capital funds for direct loans and 100.0 percent of capital funds for letter of credit, guarantee, acceptance and commitment, etc.

2.6.5 Liberalization of Monetary Policy Instrument

The gradual reduction in interest rate controls since mid-1980s gave way to virtually complete deregulation, in August 1989, when the NRB eliminated all remaining restrictions on interest rates, except for the ceiling on interest rates on loans to priority sector, which was set at 15 percent. Apart from this, further policy changes were also made with regard to the following monetary policy instruments:

Refinance Policies : The NRB completely phased out the old practice of automatic refinancing for commercial banks against government securities. As part of a package of measures taken in August 1989 to increase the effectiveness of indirect instruments of monetary control, the NRB's rediscount facilities were restructured into three facilities: a general refinance facility, a selective facility applicable to export credit and priority sector lending, and a lender of last resort facility. Of these, only the general rediscount facility has been used to date, albeit on a limited basis, due to the excess liquidity in the banking system.

Reserve Requirement : The NRB introduced a lagged reserve-accounting system during the 1988/89 fiscal year. Reserve requirements were computed on an average weekly basis, with compliance of reserve holdings measured against banks' weekly average deposits eight weeks before. In September 1989, the statutory reserve requirement was raised from 9 to 12 percent, of which 8 percent would have to be kept in the form of unremunerated deposits at the NRB and 4 percent might be kept in cash. The NRB was empowered to penalize non-compliance with a part of the reserve requirement. (shortfalls in the part of the requirement that could be maintained in vault cash were not penalized)

Withdrawal of SLR and Treasury Bills (TBs) Auctions : The withdrawal of SLR in May 1986, created a vaccum with regard to captive market for government securities. In order to make government papers popular in the market, interest rate on those papers had to be made lucrative. This was possible only through the setting of interest rate by market forces. In this context, sale of treasury bills through auction system was introduced in November 1988. Since the introduction of the auction system, 91- day treasury bills were offered once a month at irregular intervals. In July 1989, 182-day bills were introduced, but until the end of 1990 were auctioned very irregularly. For most of 1991, TBs auctions had been held twice a month, one auction for 91-day paper and another for 182-day paper. Tap sales were discontinued in February 1991.

The procedure of the auctions pursued since then is as follows: two to three days before each auction, the NRB announces in the press the amount of TBs to be auctioned and the deadline for submitting bids (competitive and non-competitive). After examining the bids, the cut-off rate for each auction is decided by an Auction Committee. Settlement takes place on the day of the auction, by charging directly to the banks' reserve accounts at the NRB. Although in principle any bill can be broken into small denominations in multiples of NRs 10,000, in practice, they are issued only in large amounts.

The yield on treasury bills (TBs) has been allowed to increase close to market levels since the auction system was established. The introduction of TBs auction was an important step in the development of an indirect system of monetary control.

2.6.5 Move Towards Broadening Capital Markets and Some Aspects of Liberalization

Status of the Capital Market

The status of capital market is evident from the fact that (i) Security Exchange Centre opened its floor for secondary trading of shares from November 1981 which was restricted to Government Bond Market, (ii) Government Bond Market is still dominant in terms of value and number of trading, (iii) although the number of listed companies, paid up value and total market value is continuously growing, the turnover of shares in the market is still small, less than 3% of market capitalization, (iv) market capitalization as a percentage of GNP is rather low at about 6.0

and (v) the number of listed companies is less than 90. There is also a lack of transparency in the market due to information gap.

Moreover, the following indicators reveal the rudimentary nature of Nepalese capital market: (i) on an average day there is less than 10 deals in equity securities and less than 30 in government bonds, (ii) there are only 7-8 "blue chips", (iii) trading, clearing and settlement of the exchange are still done on manual basis, (iv) trading is carried out in a small room with a Chalk Board System, (v) broker system is yet to be developed and investors themselves, or their representatives, go directly to the exchange to transact their deals, (vi) companies are still relying on the structured banking system (In developed countries, companies are increasingly relying on capital market), and (vii) Nepalese capital market is not yet regionally or globally integrated.

In Nepal, securities exchange centre (SEC) (now Nepal Stock Exchange) opened its floor for corporate share trading in November 1984. Initially, government sector institutions itself got involved in trading of securities in its counter, providing merchant banking and other functions under a single roof. The initial efforts led to the opening of a full fledged stock-exhchange in January 13, 1994. However, the turnover of shares in the market is still very thin. It has not yet been possible to create a continuous market for shares. There could be a host of reasons for such low turnover in the market. Some of these are just natural to surface in an infant market like ours. Nevertheless, there has been continuous addition in the number of listed companies over the past 5 years. Paid up value of listed shares, have gradually expanded over the years owing to the addition of new listed companies. The market capitalization value of listed shares has been expanding continuously over the years.

However, the turnover of shares in the market is still very low. Average yearly turnover of shares is to the tune of about Rs. 20 million during the 5 years' period. The turnover trend is erratic. The percentage turnover to average market capitalization has been below 3 percent. This ratio has failed to maintain any consistent relation to the market capitalization over the last 5 years. The turnover ratio reflects the preliminary stage of secondary market development in Nepal.

Turnover ratio as a percentage of average market capitalization in other developed countries is very high. Even in India this ratio is around 20-25 percent. This ratio is thus very low in Nepal compared to any other developed and developing countries but comparable to that of Bangladesh (e.g. 2%). The host of reasons applicable to any underdeveloped capital market are obviously. The reasons could be closed structure of ownership, psychology of investors, low profitability of companies, and underdeveloped primary market.

Prevailing state of the economy demands huge amount of resources to be pumped into the economy. Nepal has to raise the maximum level of domestic resources, notw thstanding the various constraints it faces. The need for capital market development in Nepal has been an accepted reality and efforts are being made to strengthen it to foster private sector activities. As a result the capital market has become more active in recent years, the number of listed companies quadrupling in three years and the volume of turnover in the year 1994 being triple of the whole turnover during the last decade. Before the opening of the floor two years ago, there had been very little transaction in the secondary market. The total turnover of the shares in 9 years (1984-1993) period was only Rs. 248 million. Now within two years the total turnover is more than 6.7 times over the total figure of 1984-93 period. The primary market, which has raised around Rs. 500 million only during 13 years time has been able to raise more than Rs. 600 million in two years after the opening of the floor in January 1994.

Liberalization of Foreign Exchange and Foreign Capital Inflow Through the Stock Exchange

One of the most important aspects of financial liberalization in Nepal has been the lifting of foreign exchange control. There has been a great deal of liberalization in foreign exchange regime in Nepal since early 1990's. In March 1992, Nepalese rupee was made partially convertible in the current account. In July 1992, the proportion of convertibility was raised to 75 percent from the earlier ratio of 65 percent. In February 1993, full convertibility in the current account was implemented followed by various measures to liberalize capital account as well. The noteworthy ones were-entitlement to the exporters to retain cent percent of their export earning in convertible currency, freedom to open bank account in convertible currencies, provision of usance credit in certain areas, freedom for the commercial banks to extend credit in convertible currencies, and freedom for the foreign investors to repatriate cent percent of their profit and equity capital in convertible currency. As a result, Nepal has, in May 1994, attained the Article VIII status of the IMF Charter.

In 1965, Nepal implemented the Restrictions on Foreign Investment Abroad Act (RFIAA). This Act places strict controls on the rights of Nepalese citizens and all companies established in Nepal to move or invest capital abroad. There have been no significant revisions to the RFIAA since its inception, and the Act continues to govern foreign investment by the Nepalese citizens. Under the RFIAA, "investment' encompasses foreign securities, partnerships in foreign firms, accounts with foreign banks in foreign countries, houses and land abroad, and all other types of investment abroad in cash and in-kind. The Act states clearly that no Nepalese citizen or company is permitted to undertake any of the activities defined as "investment". In addition to restrictions on Nepalese foreign investment abroad, there are some restrictions on foreign investment in Nepal. Most notably, the Securities Exchange Act (1983) prohibits foreign institutions and individuals from purchasing stocks, bonds, and government securities in Nepal. Foreigners are allowed to take equity stakes in firms, but are restricted from investments in joint venture in small sectors having fixed capital upto 20 million rupees. Since May 1993, Nepalese citizens and organizations that earn income in foreign exchange have been permitted to retain the income in foreign currency accounts in Nepal. However, these resources can only be used for very specific purposes, making it difficult to transfer them as capital investment. In particular, these resources may be used for current payments such as trade, services and transfer with evidence of payment requirements. Foreign nationals are permitted to open only non-interest bearing accounts in Nepalese rupees.

Rules governing foreign participation in the Nepalese stock market has, however, been relaxed recently. The commitment of the government to allow foreign portfolio investment by allowing foreign investment or foreign capital flow through the Nepalese Stock Market, has further added a new dimension in the process of liberalizing capital inflow though the stock exchange. This has been further enhanced with the commitment of the government to creating an off-shore financial centre in Nepal.

2.7 Second Phase of Financial Liberalization and Competitive Environment

2.7.1 Competitive Financial Environment

Competition in the financial system was enhanced after 1984 by the entry of three joint-venture banks (NABIL, Indosuez and Grindlays) and by the authorization for the Agricultural Development Bank of Nepal to collect deposits in urban areas. These developments resulted in a decreased market share of the two government-owned bank. But they still hold more than 70 percent of total deposits. The three joint-venture banks have foreign management, access to more up-to-date technology and are able to attract the best local staff. They are thus far more efficient than their state-owned counterparts. Moreover, since they have few branches and so far no loan recovery problems, their overhead costs are low relative to the two larger banks. The joint-venture banks also have a much lower cost of funds than the two large banks and, as a result, are highly profitable.1/

As part of the rehabilitation program recommended by the CBPASS2/, the two larger banks viz NBL and RBB are now authorized to close nonprofitable branches and freely adjust their interest rates. Furthermore, the difference between their lending rates to priority sectors and market rates would be covered by budgetary appropriations, starting from this fiscal year. Some progress has been made to strengthen the financial position of the two large banks. It is expected that it will take few years to fully implement the recommendations of the CBPASS, specially in the area of management improvement.

The interbank market is not very active in Nepal. The joint-venture banks do some transactions between each other and they are normally net borrowers in the market while the two state-owned banks are net lenders. Transactions usually cover a period of less than a week and rates range between 7.5 and 14 percent per year.

Thus after the liberal and free market based economic policy announcement by the Government of Nepal, the financial sector has been enlarged considerably. Accordingly, 10 commercial banks and about 70 financial institutions (finance companies, rural development banks, cooperative institutions, non-governmental organisations- NGOs, and development banks) have already been established. Also, quite a large number of

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1 / Most deposits in the banking system are mobilized in the form of long-term (one to two years) fixed deposits, although banks now offer maturities as short as seven days. The difference between the average cost of funds in the two state-owned banks and in the joint-venture banks ranges between 6 and 8 percentage points.

2/ These measures follow the recommendations of the UNDP- sponsored Commercial Banks Problem Analysis and Strategy Study (CBPASS).

commercial banks and finance companies are already in the pipeline to get the operating licenses from Nepal Rastra Bank (NRB). In this way, the number of banks, NGOs and cooperative institutions applying for permission to carry out banking transactions are increasing and the product lines of the banks and other financial institutions has also been broadened (Box-5).

Box -5 : Comparative Information of the Product Lines of Commercial Banks and Other Financial Institutions

	Commercial	Other Financial Institutions				
Product	**Banks**	**PFC**	**ADB/N**	**NIDC**	**NIC**	**FC/NBFTs**
1. Transaction	√	√	√	√	√	
2. Demand/Savings Account	√		√			
3. Fixed Account	√	√			√	√
4. NDCs/CD						
5. Deposit Substitutes	√					√
6. Credit Cards	√					
7. ATM	√					√
8. Traveller Cheque	√					
9. Home Mortgage						√
10. Personal Loans	√					√
11. Consumer Loans	√	√	√	√	√	√
12. Underwriting	√		√			√
13. Brokerage	√					√
14. Equity Participation or Investment	√	√	√		√	√
15. Other Securities Activities	√	√	√		√	√
16. Promissory Notes	√					
17. Treasury						
18. Factoring						
19. Money Market Involvement	√					√
20. Capital Market Involvement	√		√			√
21. Real Estate Lending	√	√	√	√	√	√
22. Commercial Lending	√		√			√
23. Merchant Banking	√					√
24. Mortgage Lending	√					
25. Consumer Lending	√	√				
26. General Insurance Broker	√		√			

27.	Life Insurance Broker				√	
28.	Pension Fund Management			√	√	
29.	Discount Broking	√				
30.	Investment Management	√	√			√
31.	Off-Shore Services	√				
32.	Unit Trust Managers	√				
33.	Insurance Underwriting	√			√	
34.	Mutual Fund					√
35.	Others	√				

EPFC : Employee's Provident Fund Corporation
ADB/N : Agricultural Development Bank of Nepal
NIDC : Nepal Industrial Development Corporation
NIC : Nepal Insurance Corporation
FC : Finance Companies
NBFTs : Non-Banks Financial Institution

In this regard, the obvious question would be to what extent the Nepalese economy can sustain, the number of banks and how many banks should be given license to do banking business so that a healthy competition among the banks can be created.

2.8 Second Phase of Financial Liberalization Accompanied by Consolidatory and Prudential Measures

The Government of Nepal has initiated, as a part of economic liberalization, a number of financial sector reform measures since mid-1980s with a view to allow market forces to play key role, enhance private sector participation, improve and increase financial instruments and develop capital market. The reform measures has aimed at addressing the inherent imbalance by making the financial system competitive and efficient through a more robust and balanced financial structure. Financial liberalization has encompassed the deregulation of interest rate, relaxation of entry barriers, restructuring of troubled public sector commercial banks (recapitalization, classification and provisioning of loans, single borrower limit, amalgamation, consolidation and closure of loss making bank branches, retrenchment of employees, recovery of government guaranteed loans to the public enterprises) and deregulation of central bank control over portfolio management, introduction of marked- based tenders for sales of government securities and entry of finance companies and insurance companies in the private sector. Financial liberalization has also prompted to take steps towards strengthening of supervisory capabilities, and prudential regulation.

Despite the deregulation of the interest rate structure, the intermediation cost has remained high as reflected in wider interest rate spreads between deposit and lending rates caused mainly by the structure of deposits, loan portfolio quality and volume of operations. Oligopolistic nature of the financal sector, absence of well-developed equity markets, large portfolio of non-performing assets, the sequencing of reform measures and asymmetric information may have attributed to such a wider interest rate spreads. This is likely to lead towards financial disintermediation and also provide less opportunity for integration with external financial market. Government-owned commercial banks are burdened with high interest bearing term deposits while joint venture banks have been able to attract more non-interest bearing current deposits. Authorities' insistence on lowering lending rates remained more pronounced. Besides, priority sector credits continued to be subsidized at a time when interest rate have been deregulated.

The move towards financial liberalization and the subsequent increase in the number of banking and non-banking financial institutions with varied modes of operations through numerous financial instruments has made the task of ensuring adequate monitoring and control a challenging one. In the atmosphere of intense competition, the regulatory and supervisary authority assumes vital importance. The financial activities of various bank and non-bank institutions need to be strictly supervised so that financial norms and discipline are not disregarded. In this context, prudential and consolidatory measures adopted also helps to ensure a more smoother functioning of the overall financial system. The Nepalese regulatory authority has also undertaken several measures to maintain a healthy financial sector. In this context some of the consolidatory and prudential measures adopted by the Nepalese regulatory authority are as follows:

Regulatory authorities, therefore, are sometimes caught between the issues with regard to restriction on entry vis-a-vis the liberal entry of financial institutions. While outright restriction on entry may lead to oligopolistic practices and suppress competition, liberal entry into financial services may also generate unhealthy competitions. Entry restriction maynot be justified on the ground of growth in mere numbers; performance assessment needs a long track record. The regulatory authorities, therefore, have taken the following measures for entry restriction :

2.8.1 Existing Legal Framework of Establishing Commercial Bank

(a) *"Only on the recommendation of the Nepal Rastra Bank, a Bank shall be established as a company with limited liability under the Company Act. For obtaining such recommendation, an application shall be filled along with the particulars as specified by the Nepal Rastra Bank, and only in case Nepal Rastra Bank so recommends such Bank shall be registered according to the Company Act to functioning under the Act."*

(b) *The Nepal Rastra Bank may specify necessary conditions, while recommending the establishment of a Bank pursuant to sub-section (1), and it shall be the duty of the concerned Bank to fulfill the conditions so specified.*

Therefore, various legal provisions with regard to Bank establishment are already being spelled out in the Act, and those are also being guided by the Act, itself. The following provisions that have been already incorporated in the Act could be regarded as the basic legal elements in this regard:

The Fourth Governor
DR. BHEKH BAHADUR THAPA
Tenure
(13 August 1966 - 27 July 1967)

(i) *Bank Establishment Policy*
(ii) *Operational Criteria of Establishment.*
(iii) *Functioning Definition of a Bank*
(iv) *Formation of Board of Directors*
(v) *Right of the Board of Directors*
(vi) *Share Capital*
(vii) *Disqualification for the Directors*
(viii) *Function which the Bank may Perform*
(ix) *Capital & Provision of General Reserve Fund*

2.8.2 Existing Capital Requirements Criteria for the Establishment of New Banks

With a view to encourage people to open commercial banks outside the Kathmandu valley and also limiting the monopoloy of a single person, a group and/or a company in banking business, Nepal Rastra Bank announced following policy measures effective May 1, 1994.

(i) *A minimum paid-up capital of Rs. 250 million required to establish a commercial bank with the headquarter to be stationed in Kathmandu valley and operation expanding throughout the country.*

(ii) *A minimum paid-up capital of Rs. 120 million required for establishing a bank with its headquarter in any municipality expanding business in all parts of the country except the Kathmandu Valley.*

(iii) *A minimum paid-up capital of Rs. 50 million required for establishing a bank with its headquarter to be stationed in the district level and limiting its area of operation only upto 5 districts other than Kathmandu valley.*

(iv) *In addition to the above requirements, Nepal Rastra Bank also made some provision in connection with the ownership pattern. Accordingly, the bank which is to be opened is*

required to sell at least 30 percent of its share to the general public. However, no single person, firm, company and/or a person could purchase more than 10 percent of issued capital of the bank. Similarly, such person, firm, company and group of person (except His Majesty's Government, Nepal Rastra Bank, Commercial Banks and Government Financial Institutions) could not purchase more than 15 percent of issued capital of all other banks.

2.9 Prudential, Consolidatory and Capital Adequacy Norms

2.9.1 Development of Prudential Norms : Capital Adequacy

The prudential norms imposed on commercial banks and finance companies has been based on B.I.S. (Bank for International Settlement) proposal for capital measurement and capital standards.

The Basle Committee on Banking Regulations and Supervisory Practices has, for several years, been working to achieve a strengthening in the capital resources of international banks in order to help strengthen the stability of the international banking system. At the same time, achieving some convergence of capital adequacy standards in national supervisory regimes has been increasingly realised to be a desirable objective in order to remove an important source of competitive inequality for banks operating internationally. Accordingly, the G-10 central-bank Governors had decided to set up a committee which would attempt to evolve a common approach among its members to measuring banks' capital adequacy and establishing minimum standards for banks undertaking significant cross-border business.

This Committee of Bank Supervisors from the Group of Ten Countries plus Switzerland (known as the Basle Committee of Bank Regulations and Supervisory Practices- the "Cooke Committee") has set out guidelines on capital adequacy norms, which were incorporated in the first *Basle Concordat* and officially approved in December 1975, and the *Concordat* was revised in 1983. After 1987, a broad international consesus has grown up in this key area (capital adequacy).

The *Basle Committee* has defined the capital in *two tiers*, viz., *Core Capital* and *Supplementary Capital* and at least 50 percent of a bank's capital base should consist of a core element comprising of equity capital and disclosed reserves from post-tax retained earnings (tier-1) and the other elements of capital i.e. supplementary capital will be an amount equal to that of the core capital *(tier-2)*. The core capital is the sum of paid-up capital or common stock and disclosed reserves. The supplementary capital includes undisclosed reserves, asset revaluation reserves, general provisions of general loan loss reserves, hybrid capital instruments and subordinated term debt.

Capital Adequacy Framework : Nepalese Context

Nepal Rastra Bank for the first time directed Nepal Bank Limited to raise its capital base to Rs. 40 million by mid-April 1975 in the fiscal year 1975/1976. In the same fiscal year, Rastriya Banijya Bank was also asked to increase its capital fund to Rs. 20 million by mid-July 1975. Consequently, their capital base were strengthened. Later, a separate section of the capital fund ratio was enacted in the Commercial Bank Act 1974. The mandatory capital funds include paid-up capital, general reserves and balance of undistributed profits.

Nepal Rastra Bank directed the commercial banks to increase or fix their capital fund to 2.5 percent of their total deposits by mid-July 1989, 3.5 percent by mid-July 1990, 5.5 percent by mid-July 1991 and thereafter. For this purpose, deposit of the preceding mid-July has been regarded as the base for computational purposes. Similarly, the banks have been directed to meet any shortfall in capital adequacy ratio by transferring part of profit to general reserve account or by increasing their paid-up capital.

The capital requirement linking capital fund to deposits could not give the desired result, since such ratios sometimes ranged from 0.85 percent to 8.99 percent among five commercial banks. Moreover, the then prevailing norms did not cover up the risks of banking assets and also the off-balance sheet items.

Nepal Rastra Bank then imposed the new capital adequacy ratios which comply with the norms as agreed upon by the International Consensus by amending the Commercial Bank Act. The new directives in this regard were issued on 22 March 1991 to be effective from mid-July 1991.

According to Nepal Rastra Bank's latest directives, commercial banks are required to maintain their capital fund at a minimum 8 percent (minimum 6 percent to be maintained by mid-July 1991 and minimum 8 percent by mid-July 1992 and thereafter) of the risk adjusted assets, of which a minimum 4 percent must be towards the core capital. To arrive at the risk assets the transactions of the commercial banks have been categorized into *on-balance sheet* and *off-balance sheet* items. According to the risk involved on-balance sheet transactions as per the balance sheet are multiplied by the suitable risk weights which vary from zero to 100 percent. Cash in hand, balance with Nepal Rastra Bank and investment in government and Nepal Rastra Bank securities are onsidered to be of zero risk weights. Money at call and short notices, balances with banks other than Nepal Rastra Bank and all other investments are of 10, 20 and 50 percent risk weghts respectively. Loans and advances, fixed assets and all other assets are with 100 percent risk weights.

Similarly, off-balance sheet transactiosn are also multiplied by the risk weights. Since the off-balance sheet transactions are not the credit (funded facility) of the bank, it is required to convert such transactions into credit by applying generally *"credit conversion factor"*. In Nepal, the credit conversion factor for all types of off-balance sheet transactions is assumed as 1 i.e. 100 percent. The risk weight given for different types of off-balance sheet transactions ranges from 20 to 100 percent, viz. 20 for the fully secured letter of credit upto 3 months, 50 for the performance bond, bid bond and commitments of having maturity period of more than 1 year and 100 for all other off-balance sheet transactions. Thus, the off-balance sheet exposures of the commercial banks are also taken into consideration while determining the capital fund ratio of the banks.

For this purpose, the capital base has been classified into two elements, viz. *(1) Core Capital*, and (2) *Supplementary Capital*. The former includes paid up capital, preference share capital, share premium, undistributed profit and general reserves. The later elements consist of loan loss reserves, revaluation reserves, bonds or securities as specified by Nepal Rastra Bank and other reserves not included under the core capital. The amount of goodwill, however, is to be excluded.

2.10 Other Prudential Norms and Institutional Arrangement

2.10.1 Single Borrower Limit

In order to lower the risk element associated with an over concentration of bank resources on a single borrower, Nepal Rastra Bank has directed the commercial banks to limit their fund based and non-fund based lending. Accordingly, commercial banks were limited to lend a maximum of 50 percent of their capital base in case of fund-based credit and 100 percent in case of non-fund based credit effective March 1, 1989. Provision was also made for gradually lowering this ratio to 25 percent for fund based and 50 percent for non-fund-based lending by mid-July 1992.

Nepal Rastra Bank has been fixing a limit on the credit extended by commercial banks to the single borrower (individual firm, company or group of companies) since the last few years. In this connection, it had fixed the credit limit for the fiscal year 1994/95 to the tune 35 percent of the primary capital to the single borrower. Similarly, for the fiscal year 1995/96, it had directed the commercial banks to lend maximum 35 percent of their capital base in case of fund based credit and 50 percent in case of non-fund based credit. In addition to this, commercial banks can lend upto 10 percent more credit than the fixed limit in case of credit under joint financing.

2.10.2 Classification of Outstanding Loans and Advances

Nepal Rastra Bank has directed the commercial banks to classify the outstanding loans and advances into four categories such as good, substandard, doubtful and bad debt on the basis of their maturity period. Similarly, commercial banks were also asked to maintain adequate reserve fund out of their profit on the basis of the above classification.

2.10.3 Creation of Credit Information Bureau

A credit information bureau was established on May 14, 1989 under the aegis of Nepal Bankers Association. The bureau has been supplying necessary credit information to all member banks regarding the credit defaulters. The bureau was entrusted to record information on credit over and above Rs 2.0 million only.

2.10.4 Increment in the Capital of Two Commercial Banks

Nepal Rastra Bank authorised an increase in the capital of Nepal Bank Limited and Nepal Arab Bank Limited. Accordingly, Nepal Bank Limited was authorised to raise the authorised, issued and paid-up capital from Rs 305.0 million to Rs 345.0 million, including Rs 40.0 million bonus share. Similarly, Nepal Arab Bank Limited was authorised to increase authorised capital from Rs 130.0 million to Rs 250.0 million and issued and paid-up capital from Rs 65.4 million to Rs 130.9 million.

2.11 Enhancement of Prudential, Norms Restructuring and further Consolidation Under CBPASS1/ Scheme

The need for compliance with the new capital adequacy norms under the *Basle Accord* has necessiated the prudential and regulatory authorities to restructure the capital base of two government owned banks. Such compliance also is in line with the norms as recommended by *CBPASS Report.* Accordingly, Nepal Rastra Bank has given approval to increase the capital of Rastriya Banijya Bank (RBB) by Rs. 1002. 3 million. This has been done in accordance with the government's decision of March 1991 to raise capital base of the two government owned commercial banks of Nepal (Nepal Bank Ltd. and Rastriya Banijya Bank) as per the *Basle International Standards*, where the banks are required to maintain their *core capital* at a minimum level of 4% of the total weighted risk assets. The RBB's new capital structure has to be as follows:

Restructuring of Capital Base

(Rs. in million)

Type of Capital		Authorized Capital	Issued Paid-up capital
1.	Ordinary Share	40.0	20.0
2.	8% Cumulative Preference Share	215.8	215.0
3.	1% Redeemable Preference Share	787.0	787.0
	Total	1042.8	1022.8

In order to strengthen capital norms of the indigenous commercial banks, His Majesty's Government of Nepal has in the preference shares of Nepal Bank Limited and Rastriya Banijya Bank. Such investment has amounted to of Rs. 116.30 million and Rs. 215.30 million respectively. Similarly, Nepal Rastra Bank has underwritten the additional preference share of Rs. 111.70 million. Furtheremore, His Majesty's Government has made

1/ Commercial Banks Problem and Strategy Analysis Study (CBPASS)-Report of Booz Allen and Hamilton, 1992.

available development bonds worth Rs. 437 million and Rs. 787 million to Nepal Bank Ltd. and Rastriya Banijya Bank respectively to be redeemed in six years to meet additional capital.

2.12 Progress Made in Implementing Phase - I and Phase - II of the CBPASS Programme

CBPASS Phase - I

1. **Recapitalization of the Banks :** HMG has raised the capital of RBB by Rs. 215.3 million by issuing 14% government securities. Similarly, in case of NBL, 8% preference share of Rs. 116.3 million and Rs. 111.7 million has been subscribed by HMG and NRB respectively.

2. **Repayment of Government Guaranteed Loan :** HMG has issued a 14 percent government securities worth Rs.1763.72 million to the two public sector banks (Rs. 1212.79 million in case of NBL and Rs. 550.93 million in case of RBB) as repayment of government guaranteed loans which these banks extened to various public enterprises in the past.

3. **Issue of Government Securities for Provision for Loan Loss :** To make the provision non-guaranteed loan to government enterprises and private sector, HMG, has issued 1% Govt. securities of Rs. 1224.0 million (NBL Rs. 437 million) & (RBB Rs. 787 million).

   NBL has already returned Rs. 380 million worth of 1% government securities to the government as the bank adjusted required provision from its own income source.

CBPASS Phase - II

1 **Loan Recovery Area :**

   (a) Loan Recovery Department reconstructed.

   (b) Board - Level Recovery Committee formed.

(c) Appropriate staff identified & transferred to Loan Recovery Department and trained. However, due to government's retirement policy, most of the trained personnel retired from the bank service.

(d) Developed recovery strategies for large problem loans.

2. Credit Area

- Senior Management Level Credit Policy Committee formed.
- Credit Strategy & Support Department formed to provide analytical information & administration support for credit management.
- New 'Relationship' Unit formed to market and manage largest corporate customers.
- Staff for these new units partially identified, recruited & trained.

3. Other Areas :

In other areas like personnel retrenchment, branch consolidation, and privatization, little progress has been made so far.

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Chapter III

EVOLUTION OF THE FOREIGN EXCHANGE SYSTEM

CHAPTER III

EVOLUTION OF THE FOREIGN EXCHANGE SYSTEM

3.1 INTRODUCTION

Normally, in a developing country like Nepal, the external sector policy encompasses: (I) exchange rate and (II) exchange control in general and trade payment in particular. The external sector policy presently being pursued can broadly be categorized as a twin track policy. The policy prescriptions or measures differ depending on the currency concerned. The policy for Indian Rupees and other Convertible currencies differ in the degree of regulation. In this sense, Nepal's present day policy can be summarized as a liberal and open regarding import payment and market based regarding fixation of exchange rate with regard to convertible currencies.

The existing external sector policy can be summarized as follows:

Except for the Indian Rupees, the exchange rate of all the convertible currencies are determined by market mechanisms. All the commercial banks operating in the country are free to quote their own exchange rates. However, the only restriction, applicable in this case, is the stipulation that the difference between their quoted buying and selling rates should not be more than one per cent. Through this restriction, it has been ensured that commercial banks do not cross the normal banking norms . So, any bank which quotes a low buying rate is forced to sell at the corresponding selling rate. Similarly the bank quoting a higher selling rate has also to buy at the corresponding buying rate. In this type of system, obviously ups and downs in the exchange rate will be there, based on the swings in the demand and supply of the foreign exchange in the market. Normally commercial banks are expected to change the exchange rate along with the change in the demand and supply factors. If this type of movement in the exchange rates are not found to be desirable from the point of view of either the macro-economic conditions or from the point of view of the healthy growth of the trade, then Nepal Rastra Bank always has the option to intervene in the market and bring the exchange rate to the desirable level.

This type of market determined exchange rate policy however is not applicable with regard to the Indian Rupees, because the rate of Indian Rupees is still fixed by the authorities. The authorized dealers in the Indian Rupees are required to follow the same rate.

So, apparently the policy looks dualistic in the sense that the convertible currencies' exchange rates are based on the free market forces, whereas the exchange rate with regard to the Indian Rupees is being fixed by the authorities. There are economic, social and geographic reasons in pursuing this dualistic policy.

In the overall trade volume of Nepal, the share of India has been declining compared to the situation of say 2 to 3 decades back. However, even today it is a significant proportion. As such exchange rate stability is more warranted vis-a-vis Indian currency. In a regime of unstable and widely fluctuating exchange rate, trade and other business can not flourish and it can be replaced by all sorts of speculative activities. That is why Nepal has opted to maintain a fixed regime of exchange rate with regard to Indian Rupees.

3.2 PRE-ESTABLISHMENT SITUATION

Prior to the establishment of Nepal Rastra Bank the circulation of Indian Rupees in the country was widespread. Indian Rupees performed not only as a medium of exchange but was accepted as a store of value by the people based on geographical, economic and social proximity between the two countries. In those days, it was not possible to move to several parts of the country without going via India. In such a situation it was quite natural that the currency of Nepal could not be circulated in all the parts of the country. The demand for currency to act as a medium of exchange was met by, Indian Rs easily and became almost a legal tender in the country.

Against the above backdrop, the first thing before the authorities, after the establishment of the Central Bank was to eliminate the practice of dual currency system, tackling it from both the legal as well as practical consideration. In that context "Act to increase the circulation of Nepalese Currency" was enacted in 1957. Again in 1960 another act was enacted by the name of "Foreign Exchange Control Act". In 1962 this act was replaced by "Foreign exchange regulation Act" which is still prevailing. The main purpose of these various regulatory measures was to eliminate the practice of dual currency system and circulate the Nepalese Rupees all over the country as legal tender.

As it was practically impossible to do away with the circulation of Indian Rupees at once, it was to be accomplished in phases. Consequently the circulation of Indian currency was declared illegal first in Kathmandu valley and later in most of the hilly regions except Illam, Baitadi and Doti. Subsequently those regions also were brought under the domain of Nepalese Rs. It was only in 17 Sept. 1966 that Nepalese currency was made the sole medium of exchange and dual currency system was scrapped for ever.

Some other relevant factual situations prevailing in the country at the time of Nepal Rastra Bank's establishment were:

(A) No license or authorization was required for conducting foreign currency business.

(B) No restriction was imposed on purchase and sale of foreign currency i.e. Indian Rupees.

(C) Exchange rate for Indian Rs used to fluctuate frequently.

(D) However, at that time also Government used to intervene in the Foreign exchange market by fixing the exchange rate from time to time

(E) On 17 March 1956 (i.e. before the establishment of Nepal Rastra Bank) the government had fixed the exchange rate of NRs vis-a-vis Indian Rupees at Rs. 175.50 per 100.00 IC and authorized Nepal Bank LTD to make available the required Indian currency for trade purposes only.

(F) For purposes other than trade it was required to procure Indian Currency at the free market rates.

(G) On 1 July 1956, the authorization to conduct Indian Currency business was transferred to NRB and the exchange rate fixed for the purpose was NRs 150.00 per Indian Currency 100.00.

(H) Prior to the execution of First Nepal India trade and transit treaty on 12 November 1960, all the convertible currency holding of Nepal used to be deposited with the banks in India. Consequently, there used to be no separate convertible currency reserves of Nepal. Only after that date was Nepal's earning in Convertible currencies deposited into Nepal Rastra Bank's account.

Against the above backdrop which was prevalent at the time of Nepal Rastra Bank's establishment, the authorities attentions were focused on the following objectives:

(I) To do away with the situation of dual currency system

(II) To gain the confidence of the people in the local currency

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(III) To bring the stability to the exchange rate (mainly IC/NC rate)

(IV) To regulate the foreign currency transactions.

(V) To manage the external reserves of the country

In order to attain those objectives, the authorities took the following measures:

(1) Promulgation of the act to increase the circulation of Nepalese currency in 1957.

(2) Promulgation of the act to control the foreign exchange transaction in 1960

(3) Promulgation of the foreign exchange regulation act in 1962

3.3 DUAL CURRENCY SYSTEM

Nepal Rastra Bank received dual currency system as a legacy when it came into existence in 1956. The reason and background under which this came into existence has already been elaborated above. There were two factors which made its abolition a matter of urgency. One was the legal tender status of the local currency and another was the effectiveness of country's monetary policy. For the purpose of making Nepalese Rupees the one and only legal tender, it was imperative that the system of Indian Currency being freely circulating in the country was to be stopped. Without that measure, it was difficult to build full confidence in the Nepalese Rupees.

Implementation of monetary policy independently was not possible in a situation of dual currency circulation. To effectively tackle the problem the authorities required the regulatory framework and pragmatic approach. By merely declaring the circulation of Indian currency illegal, problem would not be solved.

For effective solution the root cause of the problem was to be identified. The principal reason behind Nepalese people's preference for Indian currency was because of the close geographical, social and economic ties between the two countries. Transaction demand for Indian currency was big. As such some sort of arrangement had to be made wherein the people could easily acquire and dispose of the required currency as and when necessary. That was the basis on which regulatory measure could be effectively implemented. The other issue which needed to be tackled was the maintenance of exchange rate stability to mitigate the problems arising out of uncertainty and speculative activities. Therefore the policy of free and unlimited convertibility of Nepalese Rupees vis-a-vis Indian rupees was adopted, maintaining stability in the exchange rate.

So with these objectives in mind, the authorities embarked on a policy under which Indian currency was made easily available and at the same time exchange rate also was fixed at a stable level.

Towards these objectives, the following measures were taken:

(A) With effect from 13 April 1960, the exchange rate of Indian currency was fixed at Nepalese rupees 160.00 per Indian currency 100.00

(B) Nepal Rastra Bank made the commitment to buy and sale Indian currency at the above fixed exchange rate, thus introducing the system of unlimited convertibility of Indian currency.

(C) In order to make the exchange facility for Indian Rs easier and convenient for the general public, a large number of exchanger counters were established throughout the kingdom. Moreover arrangements were made for these counters to conduct transactions from early in the morning to the late evenings.

The adoption of the above measures was effective in eliminating dual currency system .The devaluation of the Indian rupee on 6 June 1966 was also helpful towards the elimination of dual currency in Nepal. Subsequent to this devaluation of the Indian rupee in India, Nepal, for various reasons, decided not to devalue the Nepalese currency. This resulted in the appreciation of Nepalese currency in terms of Indian Rs. The exchange rate of NRs went up from 160.00 per IRs 100 to 101.00 per IRs 100. Uptill that time, Indian Rs used to be kept by various segments of Nepalese society in a significant amount. So everybody who were holding IC were compelled to incur exchange loss. As a result of this event, general public's holding of IC flowed back to the banking sector and people were found to be hesitant in unnecessarily holding the Indian rupees.

3.4 Exchange Rate System

From the very beginning of its establishments, NRB has been following two distinct policies regarding the fixation of the exchange rates. One set of policy applicable to Indian Rs and another for the purpose of Convertible currencies.

Indian Rs:

At the time of NRB's establishment, the exchange rates of Indian Rs., as fixed by the government, was NRs 154.50 per IRS 100.00. But this exchange rate was not applicable for all the transactions. Indian Rs at this exchange rate was made available only for the purpose of importing certain specified goods. For rest of the transactions the currency was required to be acquired at free market rates. So the free market rates fixed as per the demand and supply, used to be of more importance compared to the one fixed by the government.

This system went for a major change on 13 April 1960, when the government not only fixed the exchange rate of Indian currency at NRs 160.00 per IC 100.00 but also introduced the system of free and unlimited convertibility of IRS. From that day onwards the banks in Nepal started to make available the IRS, as per demand emanating from various quarters at the fixed rate. So the system of multiple exchange rates of IRS was done away with from this date.

On 6th June 1966, Indian currency was devalued by 36.5 per cent. At that time, the authorities in Nepal decided not to devalue the NRs along with the IRS. As a consequence of this decision the NRs appreciated in terms of the IC and the exchange rate was fixed at NRs 101.00 per IRS 100.00. The basis for this decision were (a) the favorable foreign trade balance of Nepal with India (b) significant reserve of Indian Currency with NRB and (c) effort to immunize the Nepalese economy from the then inflationary phenomena of the Indian economy.

One immediate and direct benefit of this decision to the economy was the significant success achieved in the process of eliminating the problem of dual currency. As the value of the Indian Rs went down overnight, people who were holding the IRS suffered a significant loss. Consequently they lost confidence in the IRS and began to exchange their holding of IRS with the local currency. This helped greatly in the authorities' effort in increasing the circulation of NRS all over the country.

On 18th November 1967, the Sterling Pound went through a bout of devaluation . Around that time a significant proportion of the country's convertible currency used to be held in that currency. This put Nepal in a very difficult position. Along with this, the declining reserve of the Indian currency also was pressuring the authorities to do something. Consequently the Rupee was devalued and the new parity fixed at Rs 135.00 per IRS 100.00 on 6 December 1967.

Between this period and 30 November 1985, this exchange rate of Indian Rs went through three revisions: (a) from Rs 135 to Rs 139 on 17 December 1971 (b) from Rs 139 to 145 on 23 March 1978 (c) from Rs 145 to Rs 170 on 30 November 1985. Until this period, the government used to fix the parity of the two currencies and on that basis NRB used to fix the buying and selling rates. This policy went through a change on 31 May 1986. On that day it was decided to include the IRS also in the currency basket and along with all other currencies NRB started to quote the buying and selling rates of the Indian Rs. also on a daily basis. So, theoretically exchange rate of the Indian currency also can change on a daily basis. However in practice it has not changed on that basis for a single time. All the changes in the rates have only been through the decision of the government either to devalue or revalue the currency.

Convertible Currencies:

With regard to the methodology for fixing the exchange rates for convertible currencies, the policy adopted by the country has been significantly different from the method followed in the case of Indian currency. However it also has gone through different versions depending on the national and international economic situations prevalent from time to time.

(1) From the very beginning (when it was established) NRB had started to buy and sell convertible currencies. But at that time the exchange rates were to be fixed by the government. And the government used to fix it in terms of Indian currency, based on the prevailing rates in India. The reason why it used to be fixed in terms of Indian currency was due to the practice of multiple exchange rates of Indian currency in the country. There used to be official exchange rate applicable only for certain specified purposes. All other transactions used to be done on the basis of free market rates. So, practically it was very difficult to fix the rate in terms of Nepalese Rs.

(2) From 13 April 1960, the exchange rates of Indian currency was fixed at Rs 160.00 and the facility of free and unlimited convertibility to the Indian Rs was provided. So it was no more needed to quote the exchange rates of convertible currencies in terms of Indian currency. As a result, this practice was done away with from 14 May 1960 i.e. the exchange rates started to be quoted in terms of Nepalese Rs itself. At first NRB used to quote only for US Dollar; St. Pound; and Swiss Franc. From 14 March of the same year Burmese Kyatt also was included in the list. Subsequently, Japanese Yen also was included from August 1961. Various currencies have been added in this list at various periods and presently NRB quotes rates for 17 different currencies

(3) Before the collapse of Bretton Woods system, along with all other countries, Nepal was also following the system of fixed parity. But after this and subsequent to the Smithsonian agreement, all the important currencies were realigned under a floating exchange rate regime, Nepal also opted for a floating system. This process was started when the exchange rate of Pound was floated on 3 July 1972. Subsequently, other currencies (DM; Sfr; and Yen) also started to float from 20 Feb. 1973 onwards. As the Rs was pegged to the US Dollar, its exchange rate remained unchanged —until and unless devalued or revalued by the government.

(4) At the beginning of 1980's, global economy was going through a significant phase of ups and downs, accompanied by wide changes in the exchange rates. Along with this, India delinked its currency from the fixed parity with St pound and floated its currency. As a result, Indian Rs exchange rate in terms of US Dollar started to change almost on a daily basis. As Nepalese Rs was having fixed parity with it, broken cross rates started to emerge between US Dollar / Indian Rs / and Nepalese Rs. Sometimes the

magnitude of this broken cross rates started to become too large. In order to rectify this, there was no way except to devalue or revalue the US Dollar exchange rate. However, the decision of this nature by the government normally took its own time. So it was felt that this sort of procedure was not adequate to meet the challenge of the day and it was decided to leave the matter of exchange rate to the NRB through adoption of a system known as Basket system.

Basket System:

Before the introduction of Basket system on 1st June 1983 the exchange rate system being followed was one of US Dollar pegged one. When we say US Dollar pegged, it means an exchange rate policy wherein the US Dollar exchange rate is fixed and the exchange rates of all other currencies, for which the bank used to quote, fluctuates on daily basis. The basis of this fluctuation used to depend on the internationally prevailing cross rates. Because of the time zone convenience as well as its international importance, the London rate has traditionally been taken by the bank as the representative international exchange rates. In this way, the US $/ NRs exchange rate used to be unchanged until and unless the parity was changed by the government either through devaluation or revaluation.

This system worked for quite a long time. It could have gone on for a longer period had the issue of IC exchange rate not been of crucial importance for the Nepalese economy. As mentioned earlier Nepal has to follow a twin track policy regarding the exchange rate. On the one hand we had to follow a policy under which Indian currency has fixed exchange rate and on the other hand similar fixed exchange rate policy was being followed in the case of US dollar also. Moreover, Indian Rs enjoyed a facility of free and unlimited convertibility. As a matter of policy, this free and unlimited convertibility of Indian Rs is restricted to current account transactions only. Exchange facility for the purpose of Capital account are not provided. But in practice it is very difficult to enforce this type of restrictions. Against this background, it was quite obvious how important it was to maintain the cross rates between NRs/IC/US Dollar. Any significant divergence in this regard could have serious repercussions for the economy.

When the Nepalese rupee was having fixed exchange rates with both IRS and US Dollar and in India US Dollar was in float, meaning the exchange rate of IRS and US Dollar was being changed on a daily basis, this type of double parity exchange rate could be sustainable only when the US Dollar/ INr exchange rate did not change much. But that was not to be. In an environment where global economy changes so much almost on a daily basis, it was very difficult for Indian Rs to remain stable. As a result significant degree of broken cross rates between US Dollar/INr and NRs used to emerge from time to time. The only way in which this could be wiped out was either by changing the INr/NRs parity rate or by revising the US Dollar/NRs exchange rate. Due to the importance of maintaining the fixed parity with IRS the option of frequent revision of this rate was almost ruled out. Regarding the other option, under the existing setup this could be done only through government decision to either revalue or devalue the local currency. However such type of decision could obviously take its own time. As a result, significant broken cross rates used to emerge from time to time.

In order to rectify it, the measure taken at that time was to introduce the Basket System. Under that system His Majesty's Government authorized NRB to change the parity of US Dollar/ Rs exchange rate, if required, on a daily basis. So from that period onwards, the exchange rate of US Dollar also started to float. As US Dollar was given the status of intervention currency, all the other convertible currency's exchange rates continued as usual i.e. they all still depended upon the international cross rates with the US Dollar.

Under this system, first the exchange rate of US Dollar was arrived upon. Once this exchange rate was fixed, the rates for all other convertible currencies was subsequently determined. For the purpose of determining the exchange rate of US Dollar, a basket was fixed. All the important currencies which were significant for the economy were included in the basket. The movement of these currencies' exchange rates in the international forex market used to influence the basket rate. As a matter of fact, Rastra Bank never published either the composition of the basket or the weight granted to each component of the basket. Even then, based on the pattern of the changes in the exchanges rates observed in that period, it was obvious that the Indian Rs must have had an overwhelming weight in the basket. The Nepalese Rs was virtually shadowing the exchange rate of Indian Rs. But based on the nature and structure of both the economies and also the inflation rate prevailing in Nepal and India this policy did not have any other alternative.

When this basket system was started, the exchange rate of US Dollar was Rs.14.20. And when this system was given a formal burial on 5th march 1992, through adoption of partial convertibility, the rate had moved to Rs 43.10. So an increase of Rs 28.90 per one US Dollar took place within this period. However, not all the increase did take place under the garb of the basket system. Within this period also His Majesty's Government had devalued the currency 3 times. First on 30th November 1985, when the US Dollar rate increased from Rs 17.40 to 20.40. Then on 2nd July 1991. On this date the rate jumped from Rs 35.30 to 38.00. Finally on 4th of July 1991 another devaluation took place and the exchange rate was fixed from 38.00 to 42.70.

In this way, out of the total increase of Rs 28.90 per one US Dollar witnessed during this period, an increase of Rs 10.40 was through Government's devaluation decision and the rest (i.e. Rs 18.50) through gradual adjustment under the basket system.

Among other things, one of the built in advantage of this system, felt during its operation, was the cushion it provided in controlling the psychological repercussions of the change in the exchange rate. Because it has been the experience of most of the countries that whenever exchange rates change in one go, it generates more adverse consequences than is justified by the quantum of the change. But on the other hand, if the same magnitude of change is accomplished in a gradual dose of small changes, it generally does not create the same repercussions. In this way economy could come to terms with changing macro economic situation in a more controlled and guided way through suitable adjustments in the exchange rate.

During this phase the authorities faced a big dilemma during July 1991. At that time Indian economy was passing through a period of severe crisis. The country was almost broke. Its foreign exchange reserves had fallen to a rock bottom level. Even the gold reserves of the country had to be flown abroad to be used as collateral for getting foreign exchange loan as part of an emergency measures. Under this circumstance the Indian Rs went through a phase of two devaluation within two days. As the macro economic indicators of the Nepalese economy was not the same as that of India, there was not much justification for devaluing the Nepalese Rs also along with the Indian Rs. However, due to the compulsion of maintaining free and unlimited convertibility of India Rs, it was neither justifiable nor sustainable not to follow the Indian measure without adjusting the NRs/IRs parity. And based on the huge trade gap with India and consequent pressure on Indian Rs balance with the banking sector, it was not possible to revalue the Nepalese rupees vis-a-vis Indian rupees. So it was decided to go along with the Indian devaluation. However when another devaluation followed within 2 days, it was decided that again to follow the devaluation to its full extent would have adverse consequences to the economy, mainly through spiraling inflationary pressures. So the choice was a two way prescriptions. On the one hand the parity of the Indian Rs was brought down from 168.00 to 165.00 and on the other hand US Dollar rate was moved up from 38.00 to 42.70.

FORWARD EXCHANGE RATE SYSTEM

Till 1st June 1983, the exchange rate of US Dollar used to be a fixed one. i.e. it used to be unchanged until and unless either devalued or revalued by the authorities. This system was providing some sort of stability to the general trading community so far as exchange rate was concerned. But once this system was discontinued from the above mentioned date, a new element of uncertainty was introduced in the domain of convertible exchange rate. The natural worry for the importer were the expected increase in the exchange rate and for the exporter were the probability of the exchange rate going down. The assumption that importer normally has always the option of passing on the additional burden of currency depreciation to the consumers, made their protection a least priority area. But this was not the case with the exporters. Exporters had to compete in the global market. So they could not be expected to pass on the additional burden of exchange rate to the foreign buyer. Any additional cost which they might have to incur due to adverse movement of the exchange rate would have to be absorbed by themselves.

With these objectives in view, the system of forward exchange rate system was introduced in the country. The main features of this system can be summarized as follows.

(A) Forward exchange facility to be made available only to the exporters i.e. banks will only buy from the customers.

(B) The facility to be made available only in the case of U S Dollar

(C) The facility to be made available through the commercial banks

(D) However commercial banks were not allowed to carry the forward exposure

(E) All the transactions conducted with the clients by the commercial banks were required to be covered with the central bank

(F) Along with spot rates, NRB was to make available forward rates for various periods. This period ranged from 1 to 6 months.

(G) As all the deals of commercial banks were required to be covered with the Central Bank through a reverse swap deal, at the prescribed exchange rates, commercial banks could avail of only the normal spread between buying and selling rates.

Since the whole philosophy behind the policy of forward exchange rate at that time was to frame a system through which exporters were to be protected from any unforeseen downward movement of the foreign currency, the rates quoted by the central bank always used to be in discount i.e. the forward exchange rates of US dollar always used to be cheaper compared to the spot rate of the day. The logic behind this was like this: If the exporter's view about the movement of future exchange rates was that it would go up, then he did not need to be worried about such a development because this was bound to benefit him. On the other hand if he thought that the rate could move down then he needed to take corrective measures. And he could avail of the forward exchange facility.

Throughout that period, the normal movement of US Dollar/ Nep Rs exchange rate was the consistent depreciation of the local currency. So, practically all exporters did not have any pessimistic view of the prospective changes in the exchange rates. As compared to this the rates used to be quoted under this regime, as explained above, was always in discount. Consequently, this

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whole exercise was found to be of academic nature only and this facility was seldom used by the exporting community.

As the exchange rate policy in particular and economic policy in general being pursued around that period did not have any direct role for the market force, it was neither desirable nor feasible for the interest rate differential factor to be taken into consideration for the purpose of fixing forward premium or discount. It had necessarily to be fixed on some sort of arbitrary basis. This policy continued until the adoption of partial convertibility in February 1991. After this period, Central bank ceased to fix the exchange rate-spot as well as forward. Commercial banks now have to quote their own rates, spot as well as forward.

The main features of the present day forward exchange rate policy can be summarized as follows:

(1) The rates will be as being quoted by the commercial banks themselves

(2) Banks are free to buy and sell forward with the clients

(3) Central Bank does not provide any cover for the commercial bank's forward exposure

(4) The facility is not limited to US Dollar only

With regard to the basis of the commercial banks' quotation of forward rates, it should be mentioned that as the financial development in the country is still in a formative phase and capital account restrictions still prevails, the global system of interest rate differential has not yet become the sole criteria for fixing the forward premium or discount. In the absence of this factor, commercial banks here have been found to be basing their quoted forward premium or discount partly on interest rate differential and partly on demand and supply factors.

As the spot rates of convertible currencies has been left to the market forces and it no no longer is arbitrarily fixed by the authorities, the movement of the exchange rates are no longer unidirectional. It can and has been found to be swinging in both the directions. Consequently, importers as well as exporters have to be careful about their foreign exchange exposure. Because of this factor, forward exchange transactions has been increasing in volume.

(5) This system continued till 5th March 1992. On this day the government decided to go for a partial convertibility system. Under this system two tiers of exchange rate came into existence. One was the NRB rate and another was the open market rate. NRB rate continued to be fixed as usual, whereas all the commercial banks were required to fix their own exchange rates based on the demand and supply of foreign currency. The exchange rate applicable to different types of transactions was also made different. Under the system, all the government transactions were required to be undertaken at the NRB rate. Similarly, all the private sector import except industrial machinery; POL products; fertilizers had to be done at the open market rates. In order to acquire the required amount of foreign currency to finance above mentioned items, commercial banks had to surrender 35 per cent of their purchased foreign currency to NRB at the NRB rate itself. So the rate offered by the commercial banks to its clients became a composite one. In that composite rate 65 per cent represented the open market rate whereas 35 per cent weight was given to the NRB rate.

(6) Subsequently, this composition was amended and the proportion of NRB rate was reduced from 35 per cent to 25 per cent on 12 July 1992. Finally with the adoption of the full convertibility on current account, this practice was done away with. Under the new system there is no NRB

rate. All the transactions has to be undertaken at the open market rate. Commercial Banks are free to quote their own exchange rates and they do not have to surrender any amount out of their purchase from the customers. Similarly, all the foreign currency required for their transactions have to be acquired by themselves either through their own purchase with the customers or in the inter bank market. NRB will either purchase or sell convertible foreign currency only at the time of intervention.

3.5 TRADE REGIME

3.5.1 Bonus System:

Nepal has been undertaking various measures with a view to promote export, diversify the export trade both commodity-wise as well as country-wise. In this connection the first measure introduced was called *"Exporter's Exchange Entitlement"* scheme. This used to be popularly known as the Bonus system. Under this system all those who manage to export goods to third country and earn convertible currency used to be provided bonus certificate. This bonus was to be used for the purpose of importing various goods from third countries. In other words if someone wanted to import goods from third countries he first had to acquire bonus certificate by exporting goods.

In order to meet the various needs of the country, the goods eligible for import were divided into various categories like consumer goods; construction goods, basic need goods and luxurious goods etc. Out of a certain specified export, the exporter used to be provided bonus for importing goods of various combinations. The actual combination of these goods and the relative weights of the various components used to vary from time to time.

The actual market value of this exporter's exchange entitlement (EEE) or the bonus thus used to depend on the relative weight of various combination of goods and the premium such goods used to carry in the market. For example assume that the entitlement allowed the exporter to import goods of three combinations—A, B and C. Now suppose the premium of group A and B remains constant and only the premium of group C goes up. In such a situation the overall premium of the entitlement would go up by the weight of the group C goods in the combination and the magnitude of the increased price of this group.

As third country goods could be imported only on the basis of the bonus and such bonus could be earned only after exporting goods to the third countries , the bonus used to emanate from the exporter and end up with the importer. The price or the premium of such bonus used to vary almost from day to day. The most deciding factor used to be the price of imported goods in India. This was not very surprising because the ultimate destination of most of the imported goods was India.

This bonus system contributed significantly in the process of diversification of Nepal's export to third countries. However certain lacunas were felt in this system. The foremost was the uncertainty factor which every exporter had to face. The premium which the bonus used to fetch was no doubt the most significant incentive for the exporter. But the problem here was the uncertainty. As explained earlier, the premium always used to vary from time to time and it used to be affected more by the development in neighboring country rather than by the events in Nepal. No exporter was sure about his final return. In such a situation it was very difficult to envisage vigorous endeavor on the exporter's part to undertake sound and persistent export efforts. Besides this, it also could not create an environment for a good supply of essential and development related goods. As a result of frequently changing bonus premium rates , a situation of price stability also was not there.

As a result it was decided to scrap this bonus system with effect from 30 March 1978 and replace it by another one known as the dual exchange rate system.

3.5.2 Dual exchange rate system:

The main features of this system can be summarized as follows:

(a) Exchange rates were categorized into two tiers—one was called basic and another was referred to as the second rate

(b) All the foreign currency earned through export was to be bought at the second rate

(c) Transactions coming under the government sector as well as services sector were to be undertaken at the basic exchange rate

(d) Imports from third countries were categorized under two headings: (1) a specified list of goods which could be imported under basic exchange rates and (2) rest of the other goods which had to be paid at the second exchange rate

(e) Except for some specified items whose imports were banned and also for some items which were under the quantitative restrictions, all other imports were made open. It was open in the sense that import licenses for these items used to be provided automatically.

(f) Throughout the existence of this scheme i.e. from 30 March 1978 to 19 Sept. 1981 the basic exchange rate remained the same at Rs 12 per one US Dollar. With regard to second rate it was Rs 16 at the beginning and subsequently it was brought down to Rs 14 on 20 February 1980.

(g) With regard to the list of goods eligible for import under the basic exchange rates, at the beginning 14 items were specified for this purpose. It was revised on 20 February

1980 when only three items (POL products; chemical fertilizers and cement) were included in this list.

Thus through this dual exchange rate system the authorities had tried to provide a stable basis for export promotion in the sense that all the exporters were guaranteed a fixed and stable exchange rate for their proceeds. They no more had to depend on the vagaries of the bonus premium rate. At the same time import trade was liberalized to a considerable extent by granting automatic license except for some specified items.

The experience however was not very pleasant. From the policy implication point of view, it was observed that export to third countries managed to increase significantly. However a big shift also was observed in the import. It shifted significantly from third countries to India. This was because currency for third country had to be acquired at the second rate while the import payment for India could be made at the official rate itself.

Similarly it was also observed that because of the higher second rate some over invoicing in the export was also detected. At the same time, in order to avoid the second rate, under invoicing of import also was detected. Consequently it was decided to scrap this system with effect from 19 September 1981.

3.5.3 Auction System :

From the very beginning Nepal had been adopting a trade regime under which imports from third countries, were highly restricted by high tariffs and quantitative restrictions. This was intended: (a) to discourage the deflection of goods to India; (b) to secure required raw materials and intermediate goods from third countries for domestic production and exports; (c) to promote import substituting industries; and (d) to maintain an adequate level of convertible currency reserves.

The economic consequence of the trade regime was an inefficient allocation of resources; and the reliance on quantitative restrictions and a widely dispersed import tariffs and similar charges, resulting in uneven effective rates of protection. The administratively controlled allocation of import licenses created large-scale rent-seeking activities. The effects of the relative incentive structure created by this system were seen in the proliferation of trading firms (many of them associating with the business of deflecting goods to India); the development of import substituting industries with little domestic value added; and the severely weakened profitability of the export industries.

The chief vehicle to achieve the import trade liberalization was the introduction of the import license auction system in July 1986 for the importation of 88 classes of commercial goods. These goods were grouped into three subgroups, for each of which a maximum allocation of licenses was determined on the basis of estimated domestic demand. Group A included essential raw materials; Group B basic consumer goods; and Group C luxury goods. The grouping of goods was further refined in May 1990, increasing the number of groups from three to five. Group D consisted of goods which were highly liable to deflection to India. Group E included only those consumer goods which were largely handled by small traders, who could not meet the minimum required amount of an import license.

Aside from generating considerable revenue for the government, this import license auction system increased the transparency and the efficiency of the import licensing, reduced administrative impediments in this area and facilitated new entrants.

This system went through a major revision when the country embarked on the policy of economic liberalization through introduction of partial convertibility. As the ultimate objective of the liberalized economic policy was to bring all the imports under

OGL and it was not practically feasible to introduce this system in one go, it was decided to gradually reduce the list of goods under auction system.

First, the list was reduced to forty three specified items. Subsequently this list also was reduced to 12, then to 6. Finally this list of six items also brought under OGL with effect from 15 July 1993. So, under the present import trade regime, except for certain specified items like gold, silver, precious stone, armaments and narcotic drugs all other items comes under OGL. Any registered firm or company can import goods from third country. The only stipulation is such import has necessarily to be done through letter of credit.

3.6 LIBERALIZATION PHASE

Until the country embarked on a policy of liberalized economic management around the beginning of 1991 , the thrust of the policy with regard to the external sector was : (a) strict and rigorous control on the foreign exchange facility to be provided to the general public (b) Official recommendation required for most of the purposes for which foreign currency was required (c) restrictive and regimented commercial import policy under which foreign currency would not be provided at the declared rate until and unless some sort of premium was paid to the government.

One of the main reason why those sorts of control were there had much to do with the nature of exchange rate policy of that period. Under that dispensation, the exchange rates of the convertible currencies used to be fixed by the central bank , staying within the policy laid down by the government. The main thrust of that policy used to be the arbitrary fixing of the rates without directly linking it with the market forces as reflected in the demand and supply factors. The exchange rates thus fixed always used to lag behind in the required adjustments. As a result most of the times the prevailing exchange rates used to carry a hefty premium. Because of the premium, the distribution of the exchange facility had to be rigorously controlled. For example, for any healthy economic development of the country, industrial sector has to be actively promoted through various policy measures. One of the most obvious incentive is by providing the required amount of foreign exchange for procuring the necessary machinery and raw material. If the foreign currency is not provided liberally , genuine industrial development would be very difficult to achieve and at the same time in a regime where foreign exchange rates does not fully reflect the scarcity value and carries a significant amount of premium, foreign exchange is bound to be misappropriated by some unscrupulous elements in the garb of industrial enterprises. The most obvious and easy solution for this type of dilemma is the industrial licensing and permit system wherein one needs the official sanction and permit at every point— registration; commissioning of operation; importing machinery as well as raw materials etc. In this type of economic regime, it is very difficult to visualize a sound and healthy industrial development scenario. In such a situation the industrial enterprises in the country can not be expected to be guided by the country's competitive strength and by the comparative advantage. The overwhelming factor, naturally, will be of rent seeking nature only. The true competitive strength of the economy can not be expected to be exploited by this type of industrial ventures.

Similar was the case with commercial trade policy. So long as the trade policy pursued by the country can not be made an open and liberal one, we can not expect to see a healthy and sound trade regime operating in a genuinely competitive environment. The importance of an open and liberal import policy can be very effectively seen from the case of the export of woolen carpets. The export of woolen carpet from Nepal was taking place for quite some time. However the boom in the export took place only when the import of raw wool required for it was made open on 28 January 1987. Before that, only certain handful of importers were allowed to import raw wool from abroad. As a result, wool always used to be in shortage and used to carry premium in the market. Consequently, the country could not manufacture and export the woolen carpets to the extent it was possible, using the competitive strength of the country. But once the raw wool was placed under the OGL it no longer was in short supply and did not carry any premium, there was practically no factor which could inhibit the export forces, based on the basic comparative strength of the country.

3.6.1 Partial Convertibility

In this background, the country opted for a liberal and open external sector policy through adoption of "Partial Convertibility" policy. Under this policy a series of measures were undertaken. The main instrument utilized for this purpose was the policy of allowing the exchange rate of the convertible currencies to be determined by the market forces. The commercial banks were permitted to fix their exchange rates. While fixing the exchange rates the commercial banks were expected to be guided mainly by the demand and supply factors. At the same time, the import procedures were made open through the policy of OGL. The facility for opening foreign currency accounts were provided to a large category of foreign currency earners (e.g. Exporters, Hoteliers, Travel Agent etc.).

This policy was called "Partial convertibility" because not all the foreign currency earnings were allowed to be converted at the market determined exchange rate. Market rate was applicable to 65 per cent of export earning at the beginning and subsequently it was increased to 75 percent.

3.6.2 Full Convertibility of Current Account

While adopting the policy of partial convertibility itself, it was made clear that it was only a transitory step. The ultimate objective was to move towards a regime of full convertibility as soon as it become feasible. Based on the experience of partial convertibility regime, it was soon found to be feasible to make the

Nepalese Rupees fully convertible at least in the current account. Consequently, within one year of the partial convertibility, the Nepalese Rupees was made fully convertible for the current account transactions. Under this policy, all the foreign currency proceeds were permitted to be converted at the market rates. Except for certain specified items, all other goods were included in the OGL import list. Exporters were permitted to retain up to 100 per cent of their earnings in their foreign currency accounts. Foreign exchange facility for a large number of items were easily made available.

Under the present set up, it is the market forces which determine the exchange rates of convertible currencies. But it does not preclude the central bank's role in its determination. Because, market determined exchange rates can not be regarded as ideal or best suited in all the circumstances. The chances of it being diverted from the basic macro-economic conditions are always there. Moreover, given the free and unlimited convertibility of the Indian rupees in the country, the magnitude of broken cross rates has to be watched closely. Besides this, NRB always has to maintain proper balance between the domestic interest rate structure, liquidity conditions and external sector transactions. In this process, NRB has been adopting a policy under which intervention in the local foreign exchange market is undertaken as and when required. From the days of adoption of partial convertibility and until now NRB has intervened 40 times in the market buying US $ 231 million and selling US $ 327 million. While undertaking these intervention NRB has been mainly guided by the objectives of exchange rate stability and liquidity management.

The ultimate target of the current policy framework being followed in the external sector is the full convertibility of the Nepalese Rupees even in the capital account. The main inhibiting factor, in this connection, is the pace of the reform in India. Due to the close relationship between Nepal and India, it is very difficult to delink the economic relationship between the two countries. Because of this constraint, the reform process in Nepal has not been able to acquire the pace, it could have, in the absence of this constraint.

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Chapter IV

FOUR DECADES OF MONETARY MANAGEMENT

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FOUR DECADES OF MONETARY MANAGEMENT

4.1 Background

At the time the Nepal Rastra Bank (NRB) was established, the country's financial and monetary system was characterised by (i) only one commercial bank operating with a few branches in the urban areas of the country, (ii) dual currency system- Indian Rupee (IRe) also into circulation along with Nepalese Rupee (NRe), (iii) financial transactions dominated by the use of Indian currency, (iv) volatile exchange rate of Nepalese Currency against Indian Currency, (v) country's international financial transactions limited with India, (vi) very low degree of monetization of the economy, and (vii) unorganized (informal) financial market dominating the economy. In such a situation, the immediate task before the Nepal Rastra Bank was to widen the circulation of domestic currency and establish NRe as the legal tender currency, stabilize the exchange rate of Nepalese Currency vis-a-vis Indian Currency, expand banking network in the country and evolve policy instruments for monetary management. So, in the first decade, efforts were focused on evolving Nepal Rastra Bank as the monetary authority and bringing monetary system under its control. The second decade of the establishment of the NRB was the period of evolution of monetary policy instruments and policy direction of the NRB. Most of the monetary policy tools were initiated in this period. The third decade of the NRB as a central bank was the period of aggressive banking service expansion and vigorous drive towards development financing. Hence, the focus of the NRB was concentrated more in widening institutional set up for monetary deepening and formulating directed credit programmes to ensure institutional financial facilities to targetted sectors and groups of the society. The fourth decade of the NRB remained more challenging as the Bank had to exercise hectic stabilization role in economic management of the country. With economic liberalization and structural adjustment programmes initiated in the country since mid 1980's, the role of the NRB was to help stabilize the economy with proper demand management through the adoption of indirect monetary policy instruments. The regulatory and supervisory role of the NRB was also necessarily widened due to gradual liberalisation of the financial sector along with marked external sector liberalisations. Liberalisation of interest rate, foreign exchange and exchange rate systems along with entry of a number of new financial institutions into the system has widened the scope of the NRB activities from attaining price and balance of payments stability to exchange rate stability and ensuring healthy growth of the financial system. Starting from the regulation and supervision of two commercial banks and two development banks till early 1980's, the NRB has now to work as a 'watch dog' of a wider financial system with 10 commercial banks, 6 development banks, 35 finance companies, and a number of cooperatives and NGO's undertaking commercial banking activities. In the mean time, the Bank has the responsibility of widening access to institutional credit facility for priority sector and weaker section of the society in tandem with the framework of liberalized financial system.

4.2 The First Decade (1956-66)

The first decade of establishment of the Nepal Rastra Bank was the period of its evolution as the central bank of the country. While assuming this responsibility, the Nepal Rastra Bank was initially confined to extending circulation of the NRe throughout country. This was initiated with the expansion of the NRB branches in various parts of the country and establishing currency chest for NRe. In the mean time, efforts were also made to stabilise the exchange rate of NRe against IRe. Besides, with the enactment of Foreign Exchange (Regulation) Act in 1963, the NRB emerged

Some Currency Notes issued during the Fourth, Fifth
and the Sixth Governors' Tenure

as the custodian of the country's foreign exchange reserves. By 1966, Nepalese rupee was established as the sole legal tender, exchange rate with IRe was stabilised and foreign exchange reserves of the country had come under the NRB's control. One more commercial bank had been also established with the sole participation of the government, and the country had observed two development plans. More importantly, the Government had initiated developing data base of the Nepalese economy as a result of which basic socio-economic statistics were collected or compiled. Gross domestic product, prices, and foreign trade statistics were published since 1964/65. These developments led to the initiation of monetary management since the second decade of the NRB's establishment.

4.3 The Second Decade (1966-76)

This period corresponds to the evolution of monetary instruments and monetary policy direction of the NRB. Most of the monetary policy instruments evolved during this period. This was necessitated by the expansion of the banking system, widening fiscal deficit and changing external sector situation due to oil price boom and turbulent exchange rate of key currencies in the international market with changes in the exchange rate system. A record upward revision in interest rate structure was made during this decade followed by the introduction of other monetary policy instruments such as liquidity and cash reserve requirement, margin rates, and refinance rates.

4.3.1 Credit Control Regulations

In exercise of the powers conferred upon it under Section 22 of the Nepal Rastra Bank Act, 1955 the Nepal Rastra Bank framed Credit Control Regulations in September 1966 with the approval of His Majesty's Government.

The Directive spelled out that the Nepal Rastra Bank might, from time to time, issue orders and directives to and advise the commercial banks and the financial institutions on matters relating to monetary, credit and banking policies and such orders and directives had to be followed by all the commercial banks and the financial institutions. Accordingly, commercial banks and the financial institutions had to fix their rates of interest with the prior approval of the Nepal Rastra Bank. The Nepal Rastra Bank might, if required, fix such rates of interest on its own initiative.

Regarding liquid assets, the commercial banks were directed to maintain a certain portion of their deposit liabilities, as fixed by the Nepal Rastra Bank, in the form of liquid assets, and the Nepal Rastra Bank might, if necessary, change the proportion of such liquid assets to be maintained by the commercial banks.

The Credit Control Regulations also spelled out the cash reserve to be maintained by the banks with the Nepal Rastra Bank. Accordingly, the commercial bank were made to maintain mandatorily a certain portion of their deposit liabilities in the form of cash reserves with the Nepal Rastra Bank as fixed by the latter, and NRB preserved the right to fix different ratios for different types of deposit liabilities of the commercial banks, taking into consideration the existing monetary situation, and vary such ratios if it deemed so necessary.

The regulation also spelled out the computation of liquid asset and of cash reserves to be maintained with the Nepal Rastra Bank. The computation of the required liquid assets to be maintained by the commercial banks and of their cash reserves with the Nepal Rastra Bank was to be made on the basis of the amount of deposit liabilities of the commercial banks outstanding on such day as specified by the Nepal Rastra Bank. The commercial banks and the financial institutions had to follow the directives and orders issued by the Nepal Rastra Bank on matters relating to loan operations and investment policies- the amount, the maturity period and the securities held against such loans and investment. The Nepal Rastra Bank preserved the right to impose necessary restrictions in the other matters. The commercial banks were also compelled to conduct their credit and investment business in accordance with the objectives laid down by the Nepal Rastra Bank and submit regularly the prescribed statements and the reports to the Nepal Rastra Bank.

4.3.2 Interest Rate

With a view to attract savings into the banking sector and to make deposit rate structure in Nepal competitive with that of India, the NRB issued directives to the commercial banks to increase their deposit rates effective August 31, 1966. Accordingly, the minimum interest rate on saving deposits was fixed at 4 per cent per annum and on fixed deposits of one year or more, 6 per cent per annum. The commercial banks were also directed to increase their loan rates, on their own discretion, and send them for the approval of the NRB. As a result of this first ever directive, the deposit rates of the commercial banks increased by 1 percentage point in savings, and by 2 percentage points in one year fixed deposits. Although these rates had been fixed on ad-hoc basis in the absence of proper study of the effects of interest rates on the various sectors of the economy, this initiative turned out to be a landmark step in the exercise of interest rate as a monetary policy instrument.

With a view to reviewing the existing interest rate structure of the commercial banks and the term-lending institutions, and also the refinance rates of the Rastra Bank and for recommending appropriate measures on a more rational basis, Nepal Rastra Bank constituted, in April 1969, a high level committee under the chairmanship of the Deputy Governor of the Bank consisting of representatives of banks, financial institutions and concerned ministries as well as the representatives of the organizations of commerce and industries. The committee submitted its report in

August 1970. On the basis of the report and also taking into account the subsequent developments in the national economy, the NRB announced a new interest rate structure, effective April 14, 1971.

The new deposit rates ranged from 5 to 8.50 percent compared to 4.50 to 7 percent prior to this revision. Interest rate on the savings account was thus raised by 1/2 percentage point while on the fixed account it was increased by 1.50 percentage point and 1.75 percentage point in one year and 2 year deposits respectively. In order to provide short term interest bearing deposit facility to business community, government corporations and the financial institutions, call deposits were introduced. The interest rates on such deposits ranged from 3.50 percent to 4.50 percent for slack and busy seasons respectively. At least one month's notice was required to withdraw money from the call deposits. Financial institutions and business enterprises in the public sector, except those with a fixed interest cost on their entire resources, viz., Provident Fund Corporation, and Land Reform Savings Corporation, were debarred from maintaining fixed deposit accounts under the new arrangement. They could, however, maintain call deposit account carrying the slack season rate of interest.

The new lending rates of the commercial banks ranged from 7 percent to 13 percent as compared to the previous rates ranging from 7.5 percent to 12 percent. Loans had been classified in detail according to the purpose for which it was taken and the rates had been fixed so as to encourage the priority sector lending.

The new lending rates of financial institutions in the agricultural sector ranged from 3.5 percent for long term loans to 10 percent for short term loans as compared to previous rates ranging from 5 percent to 10 percent. Lending rates were made more favourable for institutional borrowers compared to individual borrowers.

The new lending rates of Nepal Industrial Development Corporation had been fixed at 7.5 percent. The rates of Small Scale Industries Development Corporation were fixed at 8 percent, 6.5 percent and 5.5 percent for short, medium and long term loans respectively.

Some changes were made in the general structure of interest rate in 1972/73. In order to give more incentive to exports, interest rate on loans against the security of exportable goods was reduced to 9 percent from 13 percent earlier. Interest rate on loans against the security of coarse and medium quality cloth was reduced to 10 percent. The period required for notice of withdrawal of call deposits was reduced from one month to seven days.

Some changes were made in the commercial banks' lending rates during 1973/74. The interest rate on export bills was reduced from 7 to 6.5 percent, but the rate against the security of export documents was increased by 0.5 percentage point to 8 percent. The interest rate on pre-export credit was fixed at 9 percent. Some adjustments were made in the Nepal Rastra Bank's refinance rates as well. The refinance rate on export bills was reduced by 1 percentage point to 4 percent and the rate against the security of export documents was increased by 0.5 percentage point to 6 percent. The refinance rate on pre-export credit was fixed at 6.5 percent.

The increasing rate of inflation and the consequent expansion in credit to the private sector as well as decelerating rate of growth in time deposits necessitated certain major changes in monetary policy in 1974. Accordingly, a new interest rate structure was introduced and made effective on July 16, 1974. The interest rate on time deposits was raised upward uniformly by 2 percentage points and maximum interest rate on deposits with the maturity period of five years and more was fixed at 10.5 percent. The interest rate on saving deposits was increased by

1.5 percentage points to 6.5 percent. The lending rates of commercial banks were also revised selectively. The lending rates on essential commodities were not raised and, in some cases, even lowered. Unproductive borrowings, however, were made costlier by 2 percentage points and, in some cases, even by 3 percentage points. The interest rate on such loans was raised even upto 15 percent. The Nepal Rastra Bank's refinance limits were also revised accordingly.

From the very beginning of FY 1972/73, the rate of growth in fixed and saving deposits had started to decline, whereas the demand for credit was rising steadily. One of the main causes of the fall in deposits growth was the non-effective interest rates structure, turned negative due to spiralling prices. Although the interest rate revision of July 1974 had given some impetus to deposit growth for a few months, the same couldnot continue for long. The exploding international price situation due to oil price hike had caused Nepalese prices also to move upwards and the inflation rate was recorded at as high as 18 per cent during 1973/74 and 17 per cent during 1974/75. This resulted in a negative real rate of interest on savings discouraging deposit mobilization. To correct this, a historical upward revision in interest rate structure was made in April, 1975.

In this interest rate revison, the rate on saving deposits was raised from 6.5 percent to 8 percent, on three months fixed deposit from 3.5 percent to 4 percent, and on six months fixed deposits the rate was fixed at 10 percent. The rate on one year deposits was increased from 9.5 percent to 15 percent and on two year deposits from 9.75 percent to 16 percent. The rate on deposits for two years and above was fixed at 16 percent. Prior to the revision, deposits for a period of 3 years and more carried an interest rate of 10.0 percent. The lending rates were also revised upward accordingly. From nine different rates on loans ranging between 8 and 15 percent before this revision, the new interest rate structure had only two lending rates- 15 and 18 percent.

Loan rate to the small sector, agriculture and industry, export credit and credit against development bonds was fixed at 15 percent, while 18 percent minimum was fixed for other purposes. Prior to the change, there were seven different loan rates effective in the case of the Agricultural Development Bank on loans to the private sector ranging between 5.5 percent and 10 percent. After the change, three lending rates came into existence– 10 percent, 12 percent, and 15 percent. The lending rates of Nepal Industrial Development Corporation, were also increased from 3 - 9 percent earlier to 10 - 16 percent.

The interest rate revision aimed less at controlling credit and was geared more towards mobilization of resources to enable commercial banks and financial institutions to advance more credit. Another aim was to fix the real price of capital to be reflective of the structure of the economy and the supply of productive resources. This policy was expected to channel investments toward productive activities.

4.3.3 Margin Rates

In exercise of the powers conferred by the Credit Control Regulations, effective September 17, 1966, commercial banks were directed to charge minimum margin of 40 per cent on advances against the security of imported articles, credit to importers, and for opening letter of credit for imports. This was also the first time that the NRB had issued any directive regarding margin rate for import credit.

In order to encourage the export of agricultural products and agricultural processing industries by enabling the traders to collect and store till the prices of exports rose in India, and to run the industries in full capacity, commercial banks were directed in January, 1967 to make available credit on easier terms. Accordingly, not more than 25 per cent margin was to be taken for selected export and industrial credit.

The Nepal Rastra Bank revised the margin rates of commercial banks in 1970/71. The revised rates varied from a minimum of 15 percent for agricultural requisites to a minimum of 30 percent for others as compared to a flat rate of 40 percent for all purposes before this revision. The Nepal Rastra Bank also revised the margin rates on its refinances to the commercial banks and the financial institutions operating in agricultural and industrial sectors. The rates applicable to the commercial banks were revised downward from 20 percent to 10 percent. Margin rates applicable to the financial institutions in agricultural sector were fixed at 20 percent for short term, 10 to 15 percent for medium term and 10 percent for long term refinances. In 1971/72, in view of the shortage of sugar in the country, margin on loan against the collateral of sugar was reduced from 20 to 10 per cent, the refinance rate was fixed at 4.5 percent and the margin on refinance at 10 percent.

4.3.4 Refinance Rate

Effective January 1967, NRB announced that it would make available credit (refinance) facilities to commercial banks to encourage them to provide export and industrial credit. Accordingly, the Nepal Rastra Bank committed to make available credit to the commercial banks at the rate of 6 per cent per annum against fully secured export and industrial credit granted by the commercial banks to their clients; and bills of exchange relating to goods exported from the Kingdom of Nepal. The refinance limit was set up to 80 per cent of the amount of credit provided by the commercial banks on the afore-mentioned areas. Besides, provision was made for rediscounting bills of exchange relating to goods exported from the Kingdom of Nepal at the rate of 6 per cent per annum.

The refinance rates were revised in 1970/71. The new refinance rates of the Rastra Bank to the commercial banks were more liberal than the previous rates. While the previous rate was 6 percent for all purposes, the new rates varied, according to purpose, from 4.5 percent to 6 percent, the lowest rate being on loans provided to the priority industries. The refinance rates to financial institutions in the agricultural sector varied according to purpose and type of borrowers, from 3 to 6 percent for short term credit, from 2.5 to 5.0 percent for medium term credit and from 2 to 4 percent for long term credit. Refinance rate to Nepal Industrial Development Corporation was fixed at 5 percent.

4.3.5 Cash Reserve Regulations, 1966

In exercise of the powers conferred upon it by the Nepal Rastra Bank Act, 1955, the NRB introduced cash reserve regulations, 1966 with the approval of His Majesty's Government. Accordingly, the Cash Reserve Requirement (CRR) for commercial banks was for the first time announced in December 1966. This directed the banks to maintain with the NRB a minimum amount of cash reserve equivalent to 8 per cent of their total deposit liabilities. Regulation regarding computation of cash reserve, penalty on cash reserve deficiency, and provision for interest were also spelled out.

4.3.6 Liquidity Requirement

In mid-1970's, the NRB faced a serious monetary situation. On the one hand, the Bank had to meet the increasing demand for credit from the government enterprises and on the other, it had to contain monetary expansion for improving the deteriorating payments position. To cope up with this situation, the NRB introduced other policy measures as well along with interest rate. Such measures were liquidity and credit limit.

In fact, the pressure of demand for goods and services was continuing unabated since early 1970's due to excessive monetary expansion. The world-wide inflation had further aggravated this situation by pushing up the import prices excessively, and subsequently domestic price situation was seriously affected. The unfavourable prices in the international market had worsened the country's payments situation and the NRB had to face such a problem for the first time at the very beginning of FY 1974/75.

During FY 1974/75, besides expanding the activities of the existing government enterprises, some new enterprises were also set up which had to be necessarily provided with adequate capital. However, the credit demand of the public as well as of the private sector was not possible to be met simultaneously without further worsening the price and the payments situation of the country. To prevent this, the Nepal Rastra Bank had to control the flow of credit to the private sector by imposing Statutory Liquidity Requirement (SLR) along with credit limit. And this policy was adopted till the revision of interest rates took place in April 1975.

Due to the heavy demand for credit from commercial banks in the wake of deteriorating price and balance of payments, on October 1974, a SLR at 32 percent of total deposit liabilities was fixed for commercial banks. Prior to this, only a cash reserve ratio of 8 per cent used to be fixed by the NRB. The newly fixed liquidity ratio of 32 percent included 5 percent compulsory investment in Government bonds and 5 percent compulsory cash reserve to be maintained with the NRB. The objectives behind this new credit policy were to mobilize more savings, to channel bank credit into more productive areas and to discourage unproductive and speculative uses of credit, and hence, check excessive growth in money supply.

Because of the heavy pressure on the liquidity position of the banks, the mandatory 5 percent investment in government bonds was abolished effective March 27, 1975. Thus, banks were required to maintain liquidity to the extent of 27 percent. Under this regulation, a provision was made enabling the commercial banks to borrow against government bonds. As this arrangement had not been quite effective, the banks were, from April 2, 1975 onwards, directed to maintain only 25 percent liquidity, including 5 percent as cash reserves.

4.3.7 Credit Limit

The start of the busy season in 1974/75 was found registering a heavy demand for credit from the public sector. Given the scarcity of resources, priority had to be accorded to certain sectors, and as such the public enterprises were the prime choice mainly because of their involvement in the import of construction materials and development goods and essential consumer goods, and because of their involvement in export trade. So, the flow of credit to the private sector got squeezed, as limit was fixed on the outstanding credit to the private sector as of mid-July 1975.

However, the scramble for credit by both public enterprises and the private sector remained unabated, and arbitrary limit on private sector credit became a controversial issue. Therefore, after carefully analyzing the situation, on April 18, 1975 the Nepal Rastra Bank, decided to mobilize and distribute financial resources through pricing policy and not through administrative measures. Subsequently, the ceilings and restrictions on credit to the private sector were lifted and interest rates revised upward substantially.

4.3.8 Directed Credit

Nearly two decades of the NRB's experience on commercial banking activities had revealed that the beneficiaries of institutional credit would be only the modern sectors of the economy dominated by the rich and influential class of the society; poor class and backward areas would not have any access to such service unless some intervention was made by the NRB. Therefore, effective April 14, 1974, commercial banks were directed to invest at least 5 percent of their total deposit liabilities in small scale agricultural and cottage industries. This was done also with a view to channelling commercial banks' credit to more productive and employment oriented areas. On failing to do so, the banks were required to keep the difference as cash reserve with the Rastra Bank.

The small scale sector being a very new field for commercial banks normally accustomed to extending credit against adequate collateral, investment in small sectors raised new problems and challenges. Investment in this sector got delayed due to the lack of trained personnel in credit analysis and management. Keeping this in view, the NRB arranged training programs for the commercial banks personnel. Agricultural Projects Services Centre was established in March 1975 for helping commercial banks in project preparation and for providing technical advice. Similarly, Credit Guarantee Corporation was established in October 1974, with the aim of channelling the flow of credit to the small sector effectively. This Corporation was supposed to pay 60 to 80 percent compensation to commercial banks on non-recovered or sunk loans extended to the small sector. This preliminary arrangement took much time and the banks were not able to advance loans to the small sector as planned in FY 1974/75.

The Commercial Bank Act, 1974 was promulgated on October 22, 1974. Under the new Act, commercial banks were authorized to advance short and long-term credit with a time range between 5 and 10 years to agriculture, industry, trade promotion, canal construction and electricity. Prior to this, credit for more than one year was prohibited. As the banks were enabled to extend medium and long-term credit for feasible projects against or even without guarantee or security, the scope for capital market participation of the commercial banks widened.

4.4 The Third Decade (1976-86)

This was the decade of massive banking expansion and more active role of the Nepal Rastra Bank in development financing. Policy measures taken during this decade ranged from downward revision in the interest rate structure to credit ceilings and directed credit programmes.

The Seventh Governor

MR. KALYANA BIKRAM ADHIKARY

Tenure

(12 June 1979 - 08 December 1984)

4.4.1 Interest Rate

With a view to make use of the expanding resources of the banking sector in agriculture, industry and export promotion in the context of improving monetary, payments and price situations, the Nepal Rastra Bank made downward revisions in the interest rate structure effective mid-July 1976. Accordingly, fixed deposit rates were cut down by one percentage point fixing one year and two years deposit rates at 14 and 15 percent respectively. Commercial bank lending rates were also adjusted accordingly. Interest rates charged by Agricultural Development Bank and Nepal Industrial Development Corporation were revised down to 8-14 percent and 10-16 percent respectively

During 1976/77, the country had faced a severe drought situation and agricultural production had declined by nearly 4 per cent. To cope with this situation, changes were made in the interest rates on credit to certain areas effective April 10, 1978. Accordingly, interest on credit to pumpsets, boring and tubewell irrigation was reduced to 11 percent from 14 percent earlier and refinance for that purpose was reduced from 7 percent to 3 percent.

With a view to provide additional impetus to resource mobilization and to channelling the available resources to productive sector, the Nepal Rastra Bank, effective June 15, 1982 increased the deposit rates marginally by 0.5 percentage point and lending rates by 1.0 percentage point.

Effective November 11, 1983, Nepal Rastra Bank directed commercial banks and financial institutions to charge interest rates on pre-export credit and export bills credit at 14 percent and 8 percent respectively. Effective April 13, 1984, the interest rates on overdue loans was fixed at 2.5 percent more than specified rates upto 6 months and thereafter the lending institutions could, at their own discretion, charge upto 7 percent more than the specified rate.

Effective November 16, 1984, the Nepal Rastra Bank granted autonomy to the commercial banks in offering the rates of interest on savings and time deposits to the extent of 1.5 and 1.0 percentage points respectively above the minimum level. The Nepal Rastra Bank directed commercial banks and Agricultural Development Bank to reduce the interest rate by 2 percentage points than the normal credit rate for agricultural and cottage industries in the 18 remote districts.

4.4.2 Cash Reserve and Liquidity Requirement

To maintain an easy credit flow to the productive sectors of the economy, to control price rise (because of excess monetary liquidity) and to check the undesirable depletion of foreign exchange reserves, The Nepal Rastra Bank revised the cash reserve ratio effective March 14, 1978. Accordingly banks were required to maintain 7 percent of their total deposit liabilities in the form of cash reserve ratio. But this cash reserve ratio could not control credit expansion due to continuous upsurge in deposits.

The Nepal Rastra Bank, on March 16, 1981, directed commercial banks to maintain minimum Statutory Liquidity Ratio (SLR) at 25 per cent of total deposits effective July 16, 1981. This included 4 per cent cash reserve in their vaults and 5 per cent statutory cash reserve with the Nepal Rastra Bank. Prior to this, the statutory cash reserve with the Nepal Rastra Bank was 7 per cent of total deposit liabilities. The provision of special account was abolished subsequently.

4.4.3 Credit Ceiling

With a view to checking excessive credit expansion, the Nepal Rastra Bank fixed credit limits for 1975/76. The actual flow of credit from the commercial banks during this year, however, stood 10 percent lower than the limit fixed. Sluggishness in economic activities and moderate rate of inflation were the two factors responsible for the decline in the use of credit by private sector. The generally depressed market prices did not necessitate the amount of credit which would have been demanded otherwise for business transactions. Besides, the improved supply position of various commodities in the Indian market which curtailed the need to maintain large stocks, the decline in the prices of farm products which adversely affected trading activities and higher interest rate which urged the traders to economise in capital use, contributed to lower demand for credit in private sector.

The Nepal Rastra Bank fixed the credit ceiling for commercial banks credit effective April 17, 1978. Accordingly, commercial banks were directed to limit the growth of their outstanding credit at 12.3 percent by mid-July 1978 from the level of mid-July 1977.

With a view to keeping domestic credit expansion within desirable limits, effective mid- October 1978, the Nepal Rastra Bank prescribed ceiling on maximum lending by commercial banks. Commercial banks were induced to keep their total lending to the level which would assure that their total loans outstanding as at mid-July 1979 would not exceed a growth of 21 percent from the level of mid-July 1978. The prescribed ceiling was only for credit extended to the private sector and non-financial institutions. But during 1978/79, total outstanding loans of commercial banks increased by 1.5 percentage points above the prescribed ceiling.

The Nepal Rastra Bank directed commercial banks on May 26, 1980 to advance loans to the non-financial public enterprises and private sector in such a way that their outstanding loan at the year-end should not exceed 20 percent growth. However, at the year-end, their actual outstanding credit increased by 30 percent and exceeded the ceiling by 10 percentage points. The credit control measure could not be effective because commercial banks used their own resources while extending credit to these sectors, and further, they lacked scientific credit planning.

4.4.4 Margin Rate

In contrast to a decrease in agricultural production, steady uptrend in the price level, and widening trade deficit in 1979/80, right from the beginning of the FY 1980/81, the economy showed signs of improvement in agricultural production and thereby an increase in real GDP and exports, surplus in balance of payments, and slowdown in inflationary rate.

Notwithstanding this, as credit against import bills and letter of credit marked a rapid rise since the second quarter of FY 1980/81, commercial banks were directed on March 12, 1981 to apply 40 percent margin in cash on letter of credit against import of synthetic yarns, and on loans against these items and related documents, effective mid-April 1981. This margin rate was applicable only in commercial imports. In case of industrial imports of such items, the commercial banks, as before, were set free to fix margin rates. But then onward, margin had to be paid in cash instead of fixed assets by the industrialists.

During the fiscal year 1984/85, following revisions were introduced in import letter of credit:

(a) a 10 percent margin rate for industrial units and specified companies and agencies involved in the supply of machineries, spare parts and different forms of materials to the World Bank assisted Cottage and Small Scale Industries (CSI) Project,

(b) a 30 percent cash margin for the import of construction materials,

(c) a 40 percent cash margin for the import of dairy products, writing and printing paper, agricultural, educational and scientific instruments,

(d) a minimum of 75 percent margin in cash for the import of 29 specified luxurious items, and

(e) a miximum of 50 percent margin rate for import of other items.

4.4.5 Credit Policy

The Nepal Rastra Bank amended the credit arrangement for priority sector since mid-July 1976. The commercial banks were then required to invest 7 percent of their total deposit liabilities in priority sector, failing which the shortfall amount was to be compulsorily deposited as non-interest bearing account with the Nepal Rastra Bank. Under this scheme, the commercial banks were obliged to choose certain unit of the village sector for the purpose of assessing the possibilities of bank service in local development.

Effective June 28, 1978, commercial banks were allowed to invest 15 percent of their total deposit liabilities on long term credit. The Nepal Rastra Bank made various revisions regarding credit and interest rate effective August 17, 1982. First, banks were directed to link the fixed and working capital loans to all kinds of industries with their respective scheme of operation. Second, in order to make development bonds more attractive, the financial institutions were directed to provide loan against development bonds for a maximum period of one year at a rate of 1.5 percentage points more than the specified rates for such bonds. Third, credit to hotel and restaurant run outside the urban areas was included in tourism sector and enjoyed the same interest rate as applicable to tourism industry.

With a view to actively involving the banking system in the development of tourism industry, in December 1975 the Nepal Rastra Bank instructed the commercial banks to provide credit to hotels and travel agencies against their bill and coupons payable in convertible currency. Arrangements were made to provide credit up to 75 percent of the amount covered by such bill and coupons. The rate of interest on such credit was lowered to 10 percent effective mid-April 1976 from 15 percent earlier. The Nepal Rastra

Bank also made arrangements to provide refinancing facility on such credit without deducting any margin on the prescribed 9 percent rate of interest.

With a view to curtailing the import of non-essential goods as well as preserving the foreign exchange reserves, the following new regulations were announced regarding the opening of the letter of credit :

(a) Effective May 27, 1983, the Nepal Rastra Bank directed the commercial banks to open import L.C. accounts with a 100 percent margin in cash.

(b) Effective May 31, 1983, the Nepal Rastra Bank instructed commercial banks not to open import L.C. for those goods which were exempted from licensing procedures.

(c) Effective July 4, 1983, Nepal Rastra Bank had forbidden to open import L.C. for 60 different kinds of goods. However, this regulation was not applicable for imports from India as well as imports by His Majesty's Government offices and semi-government institutions.

Keeping in view the critical food situation in the country, on August 26, 1982, the Nepal Rastra Bank directed commercial banks to realise all credits provided against the foodgrains. It was also made mandatory for the commercial banks to obtain prior approval from the Rastra Bank either to renew or to extend such credits.

On April 6, 1983, the NRB again restricted commercial banks from providing credit against the security of food grains in the Terai region. However, commercial banks were exempted from providing such loans in the hilly regions.

On May 31, 1983, commercial banks were directed to restrict the loans only on credit against rice and paddy. These restrictions were lifted in August 1983.

To encourage private enterpreneurs towards the productive sectors by creating employment opportunities, the Nepal Rastra Bank introduced loan scheme for educated unemployed effective January 29, 1984. Under the scheme, commercial banks could provide loans amounting to Rs. 10 thousand to Rs. 25 thousand to educated unemployed.

The Nepal Rastra Bank, which had forbidden to open L.C. for 50 items of luxurious nature on July 4, 1983, lifted the restriction on 6 items from March 25, 1984 and remaining 53 items from May 30, 1984. Effective October 27, 1983, the Nepal Rastra Bank directed commercal banks to open L.C. for development materials with a maximum 30 percent margin for the import of such materials.

In June 1984, some changes were made in directed credit to priority sector. The experiene of past few years had shown the provision of lending 10 percent of total deposit of the commercial banks in priority sector not an easy job. Accordingly, downward revision was made in priority sector requirement, and "productive sector" was introduced as a new directed credit programme. Subsequently, the Nepal Rastra Bank directed commercial banks to invest 25 percent, including 8 percent in priority sector, of their total credit investment in productive sector by the end of the fiscal year 1984/85.

4.4.6 Credit/Deposit Ratio

As the country's external sector weakened substantially due to excess demand in the economy in the mid 1980's, the way out to check this in an open economy like Nepal's was to discourage imports by controlling credit and hence money supply. With the aim to keep money supply within the desirable limit, following policy measures were adopted to enable commercial banks to maintain a credit/deposit ratio of 75 percent by mid-July 1985:

(a) Margin rate for the import of luxurious goods was raised from 50 percent to 75 percent.

(b) Upward revision was made in the minimum interest rate on import credit for commercial and import bills from 17.0 percent to 19.0 percent.

(c) Overdraft credit was contained at mid-April 1985 level.

4.5 The Fourth Decade (1986-96)

The fourth decade of the NRB's establishment was a period of financial liberalization, restructuring and economic stabilization. In early 1980's, the country had faced severe internal and external imbalances mainly emanating from huge fiscal deficit, overvalued exchange rate, declining exports and stagnant output growth. Fiscal deficit (defined as expenditure minus revenue plus grants) had increased from 3.2 percent of GDP in 1980 to 8.6 percent in 1983. In the external sector, current account deficit had increased from 1.3 percent of GDP in 1980 to 5.0 percent in 1983. As a result, the country had faced critical balance of payments problem since 1983 to 1985. Balance of payments had registered a deficit of upto 2 percent of GDP in 1985, and the country's foreign exchange reserve had depleted to less than two months of merchandise imports equivalent. Against this backdrop, the policy option was to introduce demand compressing stabilization measures in the immediate run and adopt structural (supply inducing) measures in the long run. To start with these programmes, Nepalese currency was devalued by 14.7 per cent across the board in November 1985 and stabilization programme was adopted in 1986. As stabilization programme helped a bit in compressing fiscal deficit and improving balance of payment, Structural Adjustment Program (SAP) was introduced in 1987. The focus of SAP was to attain reasonable (4-5 per cent) growth of the economy, contain current account deficit (before grant) to less than 8 per cent of GDP, reduce net domestic borrowing of the government to less than 1 per cent of

GDP and contain price rise at 5 per cent by the end of the program (in 1991). To support such a programme, tight monetary policy stance had to be taken with the adoption of various monetary control measures.

As the stabilization as well as Structural Adjustment Programmes aimed at compressing excess demand, monetary policy was designed to control monetary aggregates at the desired level in the later 1980's with the adoption of even very stringent monetary policy instruments such as credit ceiling, Cash Reserve Requirement and Statutory Liquidity Ratio. But in the 1990's, with the shift in macro-economic policy environment and further liberalization of the financial system, the direct monetary control measures were abandoned and indirect policy tools such as open market operations brought under implementation.

4.5.1 Credit Ceiling

In order to contain monetary growth to the desired level, ceilings for the additional domestic credit of the banking system and its components were fixed in January 1986. Accordingly, expansion of domestic credit from the banking system was fixed at 15.5 percent. Of this, growth of credit to the government and to government enterprises was fixed at 12 percent each and to the private sector at 26 percent. Despite the credit ceiling, domestic credit, particularly credit to the private sector continued to increase rapidly in the third quarter of 1985/86. In this context, foreseeing the adverse impact on the economy of such faster credit expansion, the Nepal Rastra Bank came forward with additional credit control measures and directed the commercial banks on May 7, 1986 to make downward revisions on credit already sanctioned but not disbursed till May 7, 1986, in the proportions of 25 to 75 percent depending upon the volume of credit. Besides, margin rate on credit against gold and silver was raised to 50 percent in case the amount exceeded Rs 25 thousand per client; and overdraft as well as domestic bills purchase facilities were not to exceed the May 7, 1986 level.

Credit ceiling continued to be the instrument of monetary policy for 1986/87 as well which aimed at controlling the expansion of domestic credit from the banking sector to both the public as well as private sectors. Credit ceilings at 14.5 percent higher than the preceding year's level were fixed on the expansion of credit to the government, government enterprises and the private sector. In this connection, separate ceilings were also fixed on the expansion of credit by each commercial bank.

As the country had entered into Structural Adjustment Program since October 1987, the thrust of monetary policy was to compress excess demand emanating from the monetary sector. Therefore, in order to regulate the expansion of domestic credit in public as well as private sectors of the economy, quantitative ceilings were fixed separately on credit to the government, non-financial government enterprises and the private sector for the fiscal year 1987/88. In this respect, separate ceilings were fixed on the volume of credit to be expanded by each commercial bank. The outstanding domestic credit ceiling for the banking system for mid-July 1988 was set at 12.6 percent higher over the preceding year's level.

The Nepal Rastra Bank, in pursuance with the objective of regulating the liquidity in the economy, fixed quantitative credit ceilings on outstanding net bank credit to the government, credit to non-financial public enterprises and net domestic assets of the banking system for the fiscal year 1988/89 and 1989/90 as well.

With the shift in the mode of monetary control from direct to indirect means since 1989/90, credit ceiling was completely removed during 1990/91 and 1991/92 as well except for non-financial public enterprises where credit ceiling was fixed at the previous year's level inclusive of accrued interest.

Nepal entered into second round of structural adjustment programme under Enhanced Structural Adjustment Facility

(ESAF) in October 1992. Following a 21 per cent rate of inflation and current account deficit at 8 per cent of GDP in 1991/92, ESAF aimed at compressing excess demand through stringent monetary policy. Thus, in order to tighten monetary expansion, ceilings were fixed on bank credit to the government, to non-financial government enterprises and on net domestic assets of the NRB. Celings on net bank credit to the government and government enterprises were fixed in order to ensure higher flow of credit to the private sector remaining within the targetted growth of monetary aggregates.

The economic policies of the government took a new turn with the evolution of a democratically elected government and the implementation of the country's Eighth Five Year Plan (1992-97). Accordingly, private sector was given an enhanced role in economic activities. This thrust would be successful only if enough resources could be made available to the private sector. Thus, in order not to crowd-out bank credit to the private sector by heavy public sector borrowings, ceiling on public sector borrowing from the banking system continued for 1993/94 and 1994/95 as well. Although the first phase of ESAF could not be concluded in 1994/95 due to some lapses in structural reform measures envisaged under the ESAF programme, the indicative ceilings on public sector borrowing from the banking system continued in 1994/95. In 1995/96 the renegotiation of ESAF programme is under consideration and preliminary targets are already set for broader monetary aggregates as well as for public sector borrowing from the banking system. Monetary policy is being undertaken within this framework and monetary programming is giving a feedback in order to attain these monetary targets.

4.5.2 Liquidity and Cash Reserve Ratio

With a view to providing autonomy for choosing investment portfolio of the commercial banks, effective May 29, 1986, Nepal Rastra Bank lifted the provision of maintaining the 25 percent

SLR. However, the provision of keeping CRR- 4 percent of total deposits in their own vault and 5 percent of the total deposits at the Nepal Rastra Bank, had been retained. As per the new provision, a penal interest of 5.5 percent and 11 percent was imposed on commercial banks failing to maintain the CRR.

Effective August 31, 1989, Nepal Rastra Bank directed commercial banks and financial institutions conducting banking business to maintain a minimum nine percent cash reserves of their total deposit liabilities in the form of balance with Nepal Rastra Bank or vault cash or both. The ratio was, however, revised upwards from 9 percent to 12 percent of total deposit liabilities effective September 27, 1989 taking into account the expansion in monetary aggregates. Effective April 15, 1990, the Nepal Rastra Bank issued directives to commercial banks and financial institutions conducting banking business to maintain a minimum 8 percent cash reserve of total deposit liabilities with the Nepal Rastra Bank out of the total 12 percent statutory CRR.

As Nepal implemented partial convertibility of the Nepalese rupee in the current account in March 1992, credit demand for imports surged up. As a measure to check this trend, the Nepal Rastra Bank directed the commercial banks to maintain the statutory liquidity ratio (SLR) at 36 percent of the total deposit liabilities. This included 4 percent cash in vault, 8 percent balance with Nepal Rastra Bank and 24 percent in government securities and/or in Nepal Rastra Bank bonds.

Effective December 1992, the Nepal Rastra Bank reduced the Statutory Liquidity Ratio (SLR) by two percentage points. With this reduction, commercial banks were required to invest 34 percent of their total deposit liabilities in the form of liquid assets. This included 22 percent investment in government securities and / or Nepal Rastra Bank Bonds, 4 percent cash in vault and 8 percent balance with Nepal Rastra Bank. However, such a high SLR brought about many distortions in monetary management.

First, it encouraged government to issue bonds at lower interest rate suppressing proper development of the securities market. Second, it implied a tax on financial intermediation; as banks could not choose income maximizing investment portfolio. Third, credit to private sector was crowded-out by the provision of maintaining high SLR. And finally, this instrument was not compatible with the thrust of liberal financial system that was evolving. More interestingly, commercial banks were holding much larger chunk of their deposits in the form of liquid assets, and thus making ineffective the use of SLR in containing money supply. Taking into account these factors, the Nepal Rastra Bank completely abolished the provision of Statutory Liquidity Ratio effective July 16, 1993. However, the provision of cash reserve ratio of 12 percent (8 percent as balance with Nepal Rastra Bank and 4 percent as cash in vault) was maintained.

4.5.3 Interest Rates

Effective May 29, 1986, commercial banks and financial institutions were set free in fixing the interest rates on their deposits and lending rates above the minimum interest rates on deposits and maximum lending rates for productive and priority sectors. The minimum interests rates were 8.5 percent on saving deposit and 12.5 percent for one year fixed deposit. The interest rates on fixed deposit with a maturity period of less than one year and more than one year were left to the discretion of the banks themselves.

The banks were also instructed by the Nepal Rastra Bank regarding saving accounts operation procedure. According to the instructions, the banks were authorised to fix ceilings on periodical withdrawal, amount of minimum balance to be maintained by the saving account holders as well as the maximum balance that would be eligible for carrying interest, etc. Beside this, the Nepal Rastra Bank lifted the restriction on opening saving accounts by individuals only and institutions not motivated by profit considerations.

Regarding lending rates, the banks and financial institutions were allowed freedom in fixing the lending rates in all areas except for credit to the priority sector where the interest rate was at 15 percent maximum .

Inter-bank lending rates and the penal interest rate on overdue and misutilised loan could also be fixed by the banks and the financial institutions themselves. In addition to this, the provision of providing interest subsidy by the Nepal Rastra Bank to commercial banks and financial institutions was abolished.

Effective August 31, 1989, interest rates of banks and financial institutions were completely liberalised. Accordingly, commercial banks and financial institutions were granted autonomy in fixing their own deposit and lending rates. The rationale for ending the administered interest rate regime was to let market forces to determine the interest rates structure, bring about flexibility in the mobilization of financial savings and make efficient allocation of available resources.

Interest rate liberalization, however, could not fully meet the objectives behind this step. The oligopolistic nature of the commercial banking system produced cartelling in interest rate determination. As a result, the lending rates increased faster than the deposit rates or deposit rates declined faster than the lending rate resulting in wider spread between lending and deposit rates. Interest rate structure could not be transparent and depositors and borrowers were not treated uniformly in terms of interest rate. Thus instead of fair competition in the market, discrepancies were observed in interest rate structure after its deregulation. To correct this, effective August 22, 1992 the Nepal Rastra Bank issued the following directives to banks and other financial institutions: (i) interest rate on deposits of at least upto one year to be clearly spelt out. (ii) range of interest rates on the credit of same type or purpose not to be more than one percent, and (iii) fixation of interest rate on flat basis to be stopped.

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In addition to this, the Nepal Rastra Bank also suggested (as moral suasion) to commercial banks and other financial institutions to limit the spread of interest rates at 6 percent within mid-December 1993. This was necessary because the widening interest rate spread had not only a deleterious impact on the global competitiveness of the domestic financial system but also had created exploitative type of financial intermediation. The compliance of the financial institution to this suggestion, however, remained less than satisfactory.

4.5.4 Refinance Facilities

Effective May 29, 1986, the Nepal Rastra Bank made some adjustments in its refinance rates. According to the new provision, the Nepal Rastra Bank could provide refinance at 13 percent interest rate to the commercial banks upto 80 percent of the loans provided to the specified sectors and purposes for which maximum lending rate was 15 percent. But in case of the Agricultural Development Bank and the Nepal Industrial Development Corporation, the NRB could refinance loans provided for other purposes also.

Effective July 16, 1993, the Nepal Rastra Bank reduced the refinance rate (selective rate) from 13 percent to 11 percent. In addition to this, rediscount rate for treasury bills, government bonds and Nepal Rastra Bank Bonds was fixed 3 percent more than the latest maximum treasury bills auction rate.

In order to strengthen the effectiveness of monetary policy, the Nepal Rastra Bank redesigned the rediscounting and refinancing facilities by offering three windows: basic refinancing, selective refinancing and lender of the last resort, effective August 31, 1989. As the discount rate and refinance limits were set by the central bank, they could be adjusted periodically in accordance with market conditions and monetary policy objectives. The Basic Rate was fixed at 11 percent to regulate the refinance and rediscounting facilities of the central bank to the financial institutions and the banking system in line with the desired level of liquidity, notwithstanding the demand and supply of credit. Additionally, developing an interest rate which would guide the bank and financial institutions in determining their own lending rates was the prime objective of fixing the Basic Rate. The provision of rediscounting eligible government securities of less than one month maturity at the Basic Rate was revised from March 1989 to include treasury bills with a maturity period of 45 days or less.

The Selective Rate could be fixed on the basis of the Basic Rate. At that time, the Selective Rate was fixed at par with the Basic Rate. Under the selective window, refinance facilities were made available to the banks and financial institutions for export financing, pre-export credit and priority sector lending activities.

Lender of the Last Resort Rate was fixed with a view to encourage banks and financial institutions to meet their short term credit needs from the inter-bank money market without recourse to central bank funds, Accordingly, the Nepal Rastra Bank had fixed the lender of the last resort rate at a level which was not less than the maximum lending rate charged by the banks on their credit.

Effective May 15, 1991, the Nepal Rastra Bank revised upwards the Basic Rate from 11 to 13 percent. The Selective Rate was also fixed at par with the basic rate.

The Nepal Rastra Bank made certain changes in refinancing and rediscounting policy during the fiscal year 1990/91. Accordingly, commercial banks could avail of the refinancing facilities against treasury bills maturing within 45 days or less at the basic rate of 13 percent. Effective July 16, 1993, the refinance rate was revised downward to 11 per cent in order to make the refinance rate consistent with the declining tendency of the market interest rate structure.

4.5.5 Directed Credit Programme

(i) Priority/Productive Sector Credit

As mentioned earlier, with a view to ensure institutional credit to priority sector (agriculture, cottage industries and small service businesses), the Nepal Rastra Bank had directed commercial banks to extend 10 percent of their deposit liabilities in this area. But the banks found it difficult to comply with the directive; as the definition of priority sector was too narrow, and there were other practical problems also. To cope with this situation, commercial banks were asked to invest just 8 percent of total credit to this area.

Effective June 14, 1986, the commercial banks were, directed to invest at least 25 percent, including a minimum of 8 percent in priority sector, of their outstanding loans and advances to the productive sectors of the economy. The banks failing to do so had to deposit the residual amount in a non-interest bearing account at the Nepal Rastra Bank within three months. Otherwise, Nepal Rastra Bank would charge an interest of 11 percent on such amount of shortfalls.

Due to high inflation and increase in the open market exchange rate, Nepal Rastra Bank also raised the credit limit in priority sector projects from Rs 1.0 million to Rs 2.0 million on agriculture and services sector, and from Rs 1.5 million to Rs 2.5 million on cottage and small industry sector.

(ii) Pre-Export Credit

Effective January 22, 1986, some revisions were made in the provision for pre-export credit. Accordingly, the holders of irrevocable letters of credit were made eligible for the pre-export credit of upto 70 percent of the FOB price.

(iii) Credit to the Educated Unemployed

On July 20, 1987, Nepal Rastra Bank, with the objective of promoting self-employment among the educated unemployed, directed the commercial banks to finance upto 90 percent of total project cost for approved project loans. According to the guidelines, commercial banks were authorised to extend such credit to a maximum of Rs 50 thousand per client. However, effective May 4, 1988, the banks were empowered to extend such credit to a maximum of Rs 300 thousand, depending on the nature of the project and the credibility of the customer.

(iv) Credit to Deprived Sector

To uplift the economic condition of the poverty striken community through the banking sector, the Nepal Rastra Bank directed in 1991/92, the public sector banks– Nepal Bank Limited and Rastriya Banijya Bank to invest 2.75 percent of their total outstanding credit to the deprived sector. Accordingly, the joint venture banks were also required to invest 0.25 percent of their total outstanding credit in such sectors.

The Nepal Rastra Bank made some changes regarding credit to the deprived sector for the fiscal year 1995/96. For this purpose, the commercial banks were divided into four groups. According to new provision, Nepal Bank Limited and Rastriya Banijya Bank were included in group 'A', followed by Nepal Arab Bank Limited, Nepal Indo-Swez Bank Limited and Nepal Grindlays Bank Limited in group 'B'. Himalayan Bank Limited, Nepal SBI Bank Limited, Nepal Bangladesh Bank Limited and Everest Bank Limited in group 'C" and the new banks to be opened in the future in group 'D" category. For this purpose, each banks under group 'A', group 'B', group 'C' and group 'D' had to invest at least 3.0 percent, 1.5 percent, 0.5 percent and 0.25 percent respectively of the total outstanding credit to the poverty stricken community. Provision was also made to consider the loans extended by commercial banks to Rural Development Banks as credit to deprived sector taking into account the problem faced by some of the joint venture banks to meet such credit requirement.

4.5.6 Margin Rates

Effective July 16, 1986, the Nepal Rastra Bank directed the commercial banks to revise the margin rates on letters of credit for the import of various commodities in the range of a minimum 10 percent cash margin for the import of industrial raw materials, machinery and spare parts by the registered industries, a minimum 30 percent for the import of construction and development goods, goods of daily consumption and use, agricultural, educational, scientific and medical goods, and a minimum 50 percent on the import of other commodities not mentioned above. Besides, commercial banks were also authorised to charge additional margin in the form of cash or other securities acceptable to banks.

Effective March 5, 1989, the Nepal Rastra Bank changed the margin requirements on import letter of credit at the rates of a minimum 10 percent for the imports of raw materials, machineries and their parts, chemical fertilizers, medicines and petroleum products, a minimum 20 percent for the imports of development and construction materials, educational materials, and means of public transport, and a margin of 30 percent required for all other less essential goods. Besides, commercial banks were authorised to charge additional margin from the clients on their own discretion.

As margin rate was not a very popular monetary policy instrument in a liberalized financial system, the Nepal Rastra Bank had to opt out this instrument. Thus, effective August 1992, the Nepal Rastra Bank authorised commercial banks to fix the import margin rates themselves. This type of deregulation was adopted to provide flexibility to the commercial banks in making lending decisions.

Since early 1990's, massive liberalization took place in the external sector. As a result, imports started to grow substantially. To cope up with this problem, a number of monetary policy measures were implemented in this period. In this context, beside open market operations and introduction of SLR to contain credit, the Nepal Rastra Bank increased the cash margin rates on commodities such as palm oil, crude coconut oil, camera, calculator, plastic granules, etc in the range of 50 to 250 percent in 1992, keeping in view the import of such goods beyond national necessity. The surge in import of such goods was attributed to the implementation of partial convertibility of the NRe whereby such items came under OGL. The rates were subsequently lowered to 10 - 30 percent in a few months time as imports of these goods slowed down. For other commodities, the existing margin rate of 10 to 30 percent remained intact.

4.5.7 Open Market Operations

Since fiscal year 1989/90, monetary policy stance shifted from direct to indirect methods of control. As part of the financial liberalization policy, ceiling in the form of quarterly benchmark was fixed only on the flow of bank credit to the non-financial public enterprises whereas all other quarterly ceilings were used as indicative ceilings without any quantitative restriction on the flow of bank credit to the private sector.

In accordance with the shift in monetary policy strategy from direct to indirect methods of control, Nepal Rastra Bank laid special emphasis on open market operations as the main policy instrument to contain monetary aggregates within the targeted level. The following procedures were adopted to conduct the open market operations:

(a) Excess liquidity with the banks was to be mopped up by selling treasury bills and development bonds in the open market. To implement this, treasury bills auction system was introduced in November 1988. This led to open market determination of treasury bills rates, and as the open market rates were higher than the rate fixed by the government, they became more marketable than before.

(b) To achieve the monetary objective within the limit set by the budget for net bank financing of the budget, Open Market Operations Committee was constituted. The committee was entrusted to decide upon the amount of issue, the time of issue, the type of securities, the interest rates and the maturity date of the securities.

(c) For monetary management purpose, it was agreed that treasury bills could be issued even if there was no requirement of funds for the central government. However, the central bank under these conditions had to bear the interest payment on such treasury bills as per the average auction rate.

(d) A Monetary Programming cell was established to analyse the current liquidity situation and provide feed back to the Open Market Operations Committee on managing the issue, sales and redemption of treasury bills and bonds.

In the 1990's, Nepal Rastra Bank continued the indirect monetary policy stance initiated since 1989/90. In this perspective, monetary management was undertaken through open market operations. As a result, excess liquidity in the economy was mopped up through regular auction of short term treasury bills and development bonds at market determined rates of interest.

Treasury Bill Auctions

The operations of Treasury Bills (TB's) used to be governed by the Public Debt Act 1961 upto 1988 according to which the amount of securities to be issued for any fiscal year was fixed in the Budget Speech. And then, the Nepal Rastra Bank, on behalf of the government, used to issue the bills at face value, all at a time or in instalments, depending upon the directives of the Finance Ministry. The amount, interest rates, and maturity of the bills were fixed by the Ministry on its discretion observing the budgetary and general economic situation. The interest rate used to be fixed at a lower level-lower than saving deposit rates or three-month fixed deposit rates. As a result, bulk of the TB's used to remain undersubscribed in the issue market and NRB had to accept them as the manager of those issues.

Since the introduction of the auction system in November 1988, 91-day treasury bills were issued once a month at irregular intervals. In July 1989, 182-day bills were introduced. But until the end of 1990, these bills were auctioned very irregularly. For most of 1991, TB's auctions had been held twice a month, one auction for 91-day paper and another for 182-day paper. Since November 1989, treasury bills auction started on weekly basis. The primary issue takes place each Tuesday of the week and secondary market transaction of these bills can take place throughout the week.

The procedure of the auctions is as following. Two to three days before each auction, the NRB announces in the press the amount of TBs to be auctioned and the deadline for submitting bids. After examining the bids, allocation is made on the basis of first priority to the highest price (lowest interest) bid. If the bid is abnormally higher than the trend or if the Open Market Operations Committee feels the bid distortionary to market situation, it can impose discretionary cut-off rate for each auction. Settlement takes place on the day of the auction, by charging directly banks' deposit (reserve) accounts at the NRB.

Open Market Operation Committee (OMOC)

The OMOC comprises of Deputy Governor of NRB as Chairman, Joint Secretary, Ministry of Finance, Chief Economic

Advisor, NRB and Chief Managers of Banking Operations Department, Banking Office and the Chief Officer of Public Debt Department of NRB as members. The role of this Committee is to coordinate between the monetary and fiscal policy stance and to make the decision for the distribution of issued bills according to the bids and the market condition. The meeting of the Committee is held every Monday in order to analyse the bids, and the Treasury Bills and NRB bonds are issued on every Tuesday.

As the Treasury Bills and NRB bonds are issued at the discounted value through auction, open bids are invited for the same. The participants are normally the banks and financial institutions. Of the total amount offered, 15 percent is earmarked for non-competitive bids. Such sales take place at the average interest rate of the auction. If there is no offer from the non-competitive bidders, whole amount of the issue can be distributed to the competitive bidders.

Depending upon their liquidity position, interested banks and financial institutions offer different bids in the auction. Priority is given to them who bid higher prices (or low interest rate).

As the yield on Treasury Bills (TB's) has been allowed to increase close to market levels since the auction system was established, TB's have become popular instrument in the money market. Thus, in a sharp departure from the previous trend whereby most of the TB's used to be concentrated in the NRB's holdings, there has been growing participation of other financial as well as non-financial institutions. Introduction of TBs auction was indeed an important step in the development of an indirect system of monetary control.

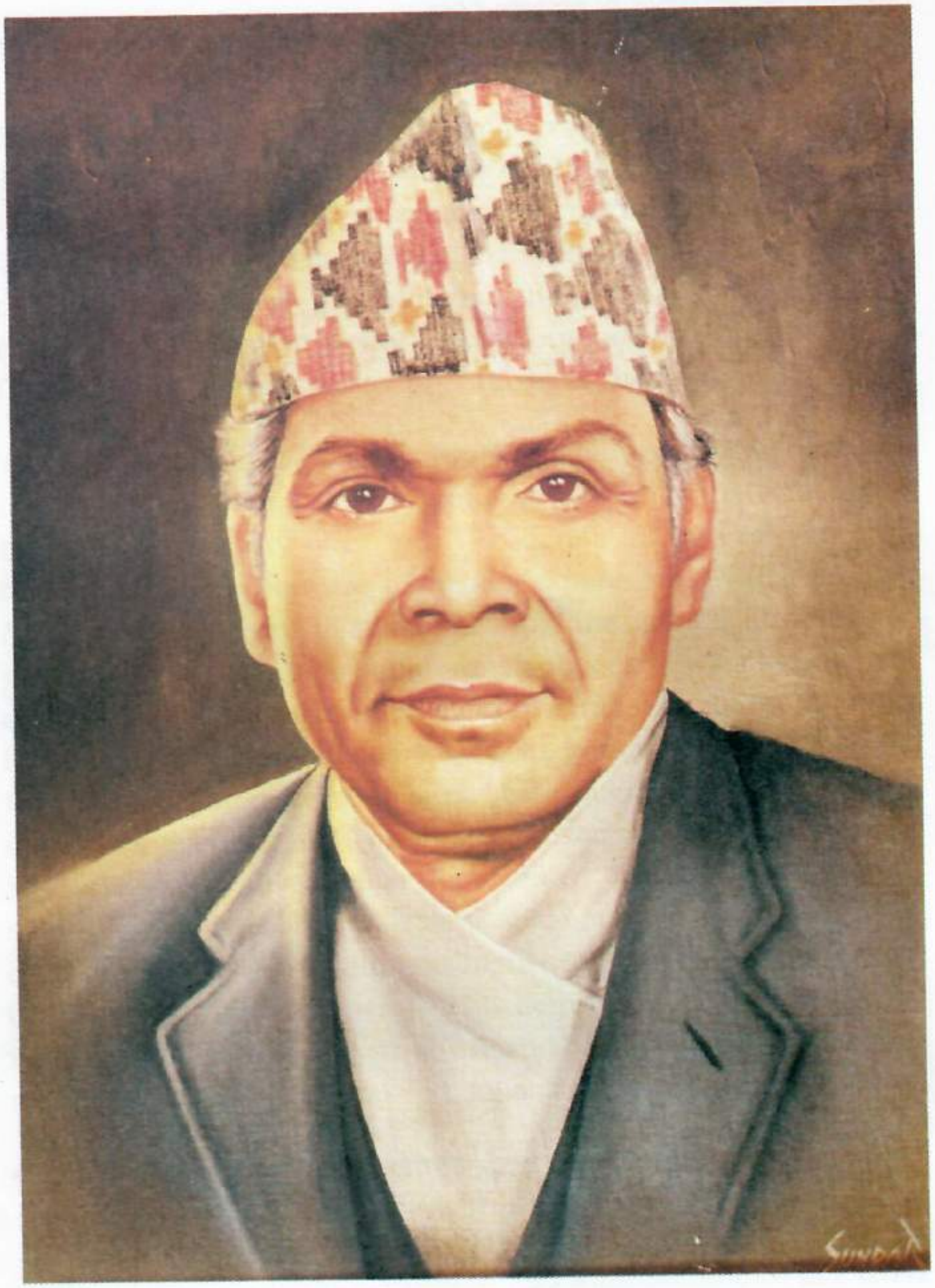
Nepal Rastra Bank Bonds

Since 1989/90, the country's balance of payments situation improved substantially and hence net foreign assets of the banking system increased significantly. This along with widening fiscal deficit and subsequently larger credit flow from the banking system to the government led to higher monetary expansion. As such a higher monetary expansion was likely to build up pressure on prices and current account balances, excess liquidity had to be mopped up. But, as available monetary instrument were not sufficient to mop up excess liquidity, especially at a time when government had no need to issue TB's, a need was felt for aditional instrument for open market operations. Thus with a view to mop up excess liquidity of the economy, Nepal Rastra Bank started issuing its own bond from 31st December 1991. By July 1992, the issue of Nepal Rastra Bank bonds reached Rs. 57.5 million. As there had been a continuous, strong liquidity upsurge in 1992/93 as well, the monetary authority had a challenge to squeeze excess liquidity through indirect monetary instnuments. With a view to mop up the excess liquidity in the economy, Nepal Rastra Bank continued the issuance of Nepal Rastra Bank bonds.

As the surge in the foreign exchange inflow continued with surplus in the balance of payments in the subsequent years as well, the NRB was compelled to issue more NRB bonds to sterilize the expansionary impact of net foreign assets on money supply. As a result, the issue of NRB bonds reached Rs. 4290 million in July 1993 and Rs. 5388 million in July 1994. With the surge in foreign exchange inflow subsiding in 1994/95, partial redemption of the NRB bonds started taking place thereafter. Thus the outstanding amount of such bills came down to Rs. 1537 million in mid-July 1995 and further to Rs. 665 million in mid-March 1996.

Operations of Secondary Market

In order to make the securities market active and attractive, Nepal Rastra Bank started to operate secondary market for Treasury bills and NRB bonds since the FY 1994/95. All commercial banks and one development bank have been actively participating in the secondary market. During the FY 1994/95,



The Ninth Governor

MR. HARI SHANKAR TRIPATHI

Tenure

(09 August 1990 - 16 January 1995)

Treasury Bills worth Rs. 9,790.7 million were purchased and Rs. 8,605.0 million worth were sold by the Nepal Rastra Bank. The volume of NRB Bills purchased and sold during the year was Rs. 4,749.8 million and Rs. 1,777.0 million respectively. The operation of secondary market has not only helped optimum liquidity management of the financial institutions but also created room for more active open market operations of the NRB.

The conduct of open market operation has had two important implications for the monetary system. First, with heavy injection of treasury bills and NRB bonds in the economy, the NRB was able to squeeze monetary expansion. With this, the NRB was successful to partly contain the growth of domestic prices. For each Rs. one billion worth of open market sale of bills and bonds, the NRB was successful to reduce the rate of inflation by o.7 percentage point, as is evident from empirical analyses. Had the NRB not resorted to such hectic open market sales of the securities even at high interest cost for the Bank, the price situation would have further deteriorated. Second, open market sales of bills and bonds in a large scale pushed up interest rate on these securities resulting in higher interest rate structure in the money market in general. This helped a lot in correcting the negative real interest rate structure and hence in inducing savings mobilization through improved deposit rate structure.

4.6 Existing Policy Issues and the Task Ahead

Monetary management of the Nepal Rastra Bank has been circumscribed by various external and internal factors like fixed exchange rate regime, free convertibility of Nepalese rupee against Indian currency, free flow of goods, services and capital across the 500 mile long open border with India, ever-widening fiscal deficit and heavy resorting to bank financing of the deficit, underdeveloped money and capital markets, and lagging information flow system. There has been substantial widening of fiscal deficit since early 1980's and a major portion of the deficit has been financed through borrowing from the banking system. As a result, fiscal deficit has remained as one the major expansionary factors of money supply. Of late, improvement in balance of payments and subsequent surge in net foreign assets of the banking system has become a significant factor contributing to excess monetary expansion. Shallow financial market with a few instruments and market participants has often made complete sterilization of the foreign exchange inflow a formidable task. Heavy recourse to sterlization by the issuance of NRB bills has had not only a upward pressure in the interest rate structure but also drained a sizable portion of the NRB profit in terms of interest cost. On the other hand, intervention in the foreign exchange market needed either to stabilize the exchange rate or to correct the cross-rate-difference between Nepalese rupee, Indian Rupee, and convertible currencies in the backdrop of fixed exchange rate regime between Nepalese and Indian rupees has often come in conflict with the goal of containing monetary aggregates at the desired level. Intervention in the foreign exchange market (by injecting Nepalese rupee for the purchase of foreign exchange) in order to prevent appreciation of the Nepalese rupee has had exerted expansionary effect on reserve money and led to substantial growth in monetary aggregates in early 1990's. On the otherhand, fixed exchange rate regime with India has worked as a transmitor to Nepal of not only positive attributes but also any shocks faced by India making policy options in Nepal highly constrained by the developments in the Indian economy.

High degree of financial integration between Nepal and India due to free convertibility of Nepalese rupee with Indian rupee at a fixed exchange rate and practically free flow of capital across the border necessitates Nepalese interest rate strcutrure to be synchronized with that of India. As a matter of fact, interest rate structure in Nepal has to be maintained at a slightly higher level than that in India in order to prevent capital outflows.

Sustained inflation at two digit level, on average, has posed a problem for bringing nominal interest rate structure downwards. The interest rate structure in Nepal is high from even the South-Asian standard and hence poses a threat to the Nepalese financial system, should the country opt for further opening of the external sector, i.e. the capital account. High spread between deposit and lending rates and high cost of financial intermediation also because of high CRR has left room for improvement in the efficiency of the financial system. The future course of NRB efforts is thus to be geared towards reducing the cost of financial intermediation and enhancing the competitiveness of Nepalese financial system necessitated by the gradual process of globalization of the Nepalese economy.

As ensuring export-friendly real exchange rate has to be the focuss of macro economic policy, efforts are to be made to contain domestic prices at the lower level. Tight money policy is therefore still warranted from the view point of ensuring export competitiveness of the economy. Success of such a measure would of course, depend upon the proper coordination between monetary and fiscal authorities.

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Chapter V

DEVELOPMENT FINANCE: INSTITUTIONAL SET-UP AND PROGRAMMES

CHAPTER V

DEVELOPMENT FINANCE : INSTITUTIONAL SET UP AND PROGRAMMES

Nepal Rastra Bank has played a crucial role in the process of resource mobilisation and its efficient allocation. In fact, as a catalyst for development, it has engaged itself in the development of financial infrastructure through participating in the establishment of various financial intermediaries for national development of the country. The central bank has facilitated the mobilization of the small and scattered savings and their allocation to the productive channels through the development of financial institutions. The central bank has attempted to influence the flow of institutional credit away from traditional sources by providing incentives and leadership to financial institutions.

Development Finance Institutions (DFI) are established to provide financial services that are not usually delivered by the commercial banks. There are two development financial institutions in Nepal, one is the Agricultural Development Bank, which has a distinct agricultural emphasis while other, Nepal Industrial Development Corporation operates in the industrial sector. These specialised institutions provide financial assistance in the form of medium and long-term loans, participation in equity capital, underwriting and other ancillary services. The operations of these institutions display in a sense the structure of the Nepali economy. These institutions have participated in specific financing programmes of international institutions like The World Bank, Asian Development Bank and International Fund for Agricultural Development. They are often given assistance by Nepal Rastra Bank to expand their activities. The role played by development finance institutions is to complement those of other major financial institutions in the country. Besides, there are four Rural

Development Banks to cater to the credit needs of the rural poor. Nepal Rastra Bank has been formulating and implementing a variety of developmental policies and programmes to provide credit access to the rural population over the years.

5.1 Nepal Industrial Development Corporation

The promotional role of Nepal Rastra Bank towards development finance has been recognised in the Nepal Rastra Bank Act 1955. Besides, traditional central banking functions, the Act provides that Nepal Rastra Bank should help in mobilising capital for development and encourage trade and industry in the country. The bank is also empowered to extend financial assistance to the financial institutions engaged in agricultural and industrial credit.

Nepal Rastra Bank has endeavoured to develop and strengthen term lending financial institution as well as to extend the banking services in order to cater to the diverse needs of borrowers. With a view to strengthen the financial position of the financial institutions, Nepal Rastra Bank, besides extending credit and refinance facilities, is also participating in the equity capital and also subscribing to debentures.

Realizing the importance of financial resources in the industrial development, the Nepal Rastra Bank participated in setting up the Nepal Industrial Development Corporation (NIDC) as early as 1959 to function as the specialized financial institution providing term credit. The Bank used to provide overdraft facilities to a few selected industries like the Birgunj Sugar Factory and the Janakpur Cigarette Factory before 1974. After the Sixth amendment of the Nepal Rastra Bank Act 1955, in 1974 the Bank has discontinued the practice of extending direct loans to industrial units and has channelled the loans through commercial and development banks. Towards this, investment in the equity share of the corporation amounting to Rs. 6.5 million in 1968/69 was the landmark in the history of Nepal's industrial finance.

The main objective of the NIDC is to provide financial assistance to private industrial enterprises in the form of medium to long-term loans, to participate in the equity investment and underwriting. The corporation generally finances project loans which distinguishes its activities from those of the commercial banks.

The main sources of funds of NIDC are its paid-up capital, long-term loans from domestic and foreign financial institutions. Nepal Rastra Bank lending to the corporation started as early as 1962/63, with just a million rupees. Over the years, the Bank has increased its equity investment to the tune of Rs. 29 million. The Bank is also holding fifteen years debenture issued by the corporation from 1981/82 to 1987/88 worth Rs. 270 million. The Bank has also made available loan amounting to Rs. 880 million to the corporation till 1995/96 of which a loan of Rs. 400 million was made available in 1995/96 for onlending to industries. The Bank has thus become the principal source of supplying fund to the corporation.

The Corporation lending to industries comprise direct loans, guarantee for loans and share participation. The bulk of the advance is through direct loans. The corporation started a modest lending of a few million rupees up to 1973, which were mainly diverted in manufacturing and hotel industry. The lending of the corporation crossed Rs. 100 million in 1974, which further increased to about Rs. 400 million in 1992. The principal categories of industries financed by the corporation include manufacturing and hotel, which are mainly concentrated in the Central Development Region.

5.2 Agricultural Development Bank

Agricultural Development Bank (ADB/N) was instituted in 1968 under the Agricultural Development Bank Act 1967 by incorporating the assets and liabilities of the then Cooperative Bank set up in 1963. The main functions of the bank is to channel funds to the agricultural sector. The bank provides short, medium and long-term credit to individuals, cooperative societies and corporate bodies for agricultural development.

Nepal Rastra Bank has been taking keen interest in rural credit from its early stage. A separate Agricultural Credit Fund was created in the Bank in 1959/60 and a certain portion of its profit was appropriated to this fund each year. The Bank handed over a sum of eight hundred thousand rupees accumulated in this fund to His Majesty's Government for the establishment of the Cooperative Bank, in 1959. Nepal Rastra Bank has participated in the equity investment of Agricultural Development Bank amounting to Rs. 2.5 million at the time of its establishment, which has gone upto Rs. 30 million.

Agricultural Development Bank is the premier lending institution specializing in agricultural and rural credit in Nepal. Its share in the institutional rural credit supply is almost 80 percent. The Bank supplements its capital resources mainly by borrowings from domestic and foreign sources. The bank borrowing's from Nepal Rastra Bank started in 1968/69 with Rs. 2 million, and rose to an all time high of Rs. 230 million in 1983/84. During the last three decade, the bank's borrowing from Nepal Rastra Bank has exceeded Rs. 2 billion which has now been paid back.

The bank's Small Farmer's Development Project introduced in 1975 is oriented towards the social and economic upliftment of the small and landless farmers. This model programme now spread to all the 75 districts through its 422 offices had contributed a lot to benefit rural poors is specially popular among the rural poor.

Beginning in 1984, Agricultural Development Bank, has been allowed to directly enter the general banking business (with certain restrictions) in selected urban areas to channelize funds to the agriculture sector. In recent years the deposit mobilisation has been the principal source of finance to the bank, which has already crossed Rs. 7 billion.

Agricultural Development Bank provides short, medium and long-term loans to individuals, cooperatives and corporate bodies for agricultural development. Short-term loans are advanced to finance seasonal operations of inputs like seeds, fertilizer and labour services. Medium term loans are extended for the purchase of farm machines, tools and machinery and implements for agro-industries. Loans for livestock raising and warehousing loans are also made for the medium term. Projects of long gestation like tea cultivation are given long term finance.

The lending operations of the bank which amounts to several billion rupees are mostly spread over production of agricultural crops, agro-industry, and marketing, are mainly concentrated in Central and Eastern Development Regions. The bank made steady progress in terms of loan disbursement, recovery and expansion of field level offices and achieved a position of a specialised agricultural financing institution. However it is only after 1990/91 that the bank accelerated the pace of its overall activities. The bank's unprecedented achievements in the last five years has surpassed the total achievement made by the bank in the last two decade.

5.3 Banking Promotion Board

In order to the develop banking system in the country, Nepal Rastra Bank set up a Banking Promotion Board, in July 1968 with the representatives of the banks, the government and the trading communities. The main objective of the board is to promote banking activities all over the country through creating awareness among the general public about the services provided by banks both in terms of deposit mobilization and credit extention for productive as well as consumption activities. In this context, the board studies and analyzes the existing policies and programmes related to banking promotion and disseminates necessary information through various forms of publicity. The Banking Promotion Board organised a first ever 10 day national level banking development seminar in Kathmandu in January 1969. The purpose of the seminar was to generate public awareness, to exchange ideas and opinions and to innovate new ideas in the field of banking. Many useful suggestions of the seminar were incorporated in policy measures which include interest free loan to new bank branches and compensation to loss making branches in the rural areas. The board set up a banking publicity sub-committee, which is broadcasting banking programme from The Radio Nepal, twice weekly, to date.

5.4 Priority Sector Credit

In order to channel resources available with the commercial banks for increasing production and employment in rural areas such as agriculture, cottage industry and service sector, Nepal Rastra Bank directed commercial banks in 1974 to lend 5 percent of their total deposit liabilities to *'Small Sector'* at preferential rate of interest. The Small Sector programme was renamed as *'Priority Sector Credit'* in 1976 and the lending percentage was also raised to 7 percent of total deposit liabilities. Since 1981, the main vehicle for the implementation of the priority sector credit policy has been through the Intensive Banking Programme (IBP). The programme is based on the "Area Development Approach" and provides credit to all the beneficiaries within a specific geographical area on the merit of project viability and relies on the regular supervision of the credit projects. It also provides credit on group guarantee basis to the poor who cannot offer collateral. The lending target was fixed at 10 percent in 1981. Nepal Rastra Bank has designed a detailed operational manual with a view to achieve the objectives, policies and procedures of the IBP programme.

In 1984, Nepal Rastra Bank changed this regulation which was based on the percentage of deposit liabilities to 8 percent of total loans and investment. This lending target has been fixed at 12 percent of outstanding loans and advances since 1990.

Although, the concessionary interest rates on priority sector lending was abolished in 1989, the commercial banks have been lagging behind in meeting the lending target. From 1991/92 onwards the commercial banks have to lend a specific percentage of their priority sector lending towards the Deprived Sector, failing which they are penalized for the shortfall. After the termination of the World Bank assisted Cottage and Small Scale Industries Project in mid-July 1992, it has been brought under the priority sector program. At present 355 branches (85 percent) of two government controlled commercial banks are engaged in financing under the IBP programme.

5.5 Credit Guarantee Corporation

The Credit Guarantee Corporation was established in 1974 at the initiative of Nepal Rastra Bank and with the joint investment of Nepal Rastra Bank, Nepal Bank Ltd. and Rastriya Banijya Bank to provide credit guarantee to the two commercial banks for priority sector loans. In order to persuade the commercial banks to extend loan in non-traditional banking such as rural sector, it was considered essential to provide guarantee compensation against default on rural lending. The corporation paid up capital is Rs. 30 million, of which 60 percent is held by Nepal Rastra Bank. Credit Guarantee Corporation charges 1 percent premium per annum on priority sector loan outstanding and guarantee compensation up to 80 percent of the loan. The scope of the corporation's guarantee has remained confined to the priority sector credit of commercial banks for more than two decades. The Corporation has started guaranteeing loans for cattle since 1987/88. The Corporation guarantee exposure under the priority sector up to mid-April 1996, stands at more than Rs. 2 billion; which far exceeds its ability to cover the risks. The Corporation is contemplating a widening of the guarantee coverage by introducing deposit insurance.

5.6 Agricultural Projects Services Centre

The Agricultural Projects Services Centre (APROSC) was set up in 1974 at the initiative of Nepal Rastra Bank for supplying techno-feasibility surveys to the commercial banks in the field of agricultural and rural sector. The Centre helps both individual and institutions interested in investing in the agricultural and rural sectors through the identification and formulation of economically sound and financially viable projects besides providing consultancy services. The Centre also helps the national and international organisations in evaluating agricultural and rural development programmes and projects and suggest improvements for effective implementation. Recently, the Centre was involved in formulating the twenty years Agricultural Perspective Plan for Nepal.

5.7 National Productivity and Economic Development Centre

National Productivity and Economic Development Centre Limited (NPEDC) was established in September 1993 by converting the then Economic Services Centre Ltd. which was operating since June 1988 and prior to it, the Industrial Service Centre since 1974. The main objectives of NPEDC are productivity promotion, productivity research and consultancy services. The Centre is committed to continue research and consultancy services in the area of economic development, industrial promotion, management, technology and environment. With a view to further strengthening the activities of the centre, Nepal Rastra Bank has made investment in the equity capital of the centre. NPEDC functions as the secretariat of the National Productivity Council and implements the programmes approved by the council and endeavours to contribute the economic development process through productivity enhancement activities in the country.

In the context of open and liberalised economic policy pursued by the nation for attainment of sustainable development, productivity and quality, NPEDC has to function on a self-sustaining basis, which calls for improved professionalism, and competitiveness, The centre also has to support services to the government and the private sector in order to create a sound industrial base and promote productivity awareness in the country. NPEDC's main areas of emphasis in the changed context will be: developing the capability to undertake project engineering services, providing consultancy services to industries for enhancing productivity, increasing bilateral co-operation between National Productivity Organisations, undertaking subsectoral policy and planning studies and establishing an industrial information system.

5.8 Cottage and Small Industries Project

Cottage and Small Industries (CSI) are the major source of employment, output and exports in the industrial sector in Nepal. CSI development has been a priority under the Fifth, Sixth and Seventh Five Year Plans. CSI Project was launched in 1982 with the World Bank (IDA) assistance of US $ 6.5 million in two zones (three districts in Kathmandu valley and six districts in Gandaki zone) and offering an opportunity to test innovative approaches to credit delivery, product and skills development and commercial services to cottage industries. Nepal Rastra Bank as an apex institution administered the Project Based Lending approach and induced all the three participating banks: Nepal Bank Ltd., Rastriya Banijya Bank and Agricultural Development Bank to promote, appraise and supervise CSI subprojects, which were responsible for channeling the term loans to CSIs, related market agents and inputs supply companies. Nepal Rastra Bank provided refinance facility up to 80 percent of the eligible subloans to the participating credit institutions from the project funds. The bank also provided Credit Guarantee Scheme of up to 75 percent of the principal amount under the CSI. CSI-I which achieved most of its quantitative targets for lending component and nearly full disbursement was initially considered a success.

As a follow-on operation to the first Cottage and Small Industries Project (CSI-I), Second Cottage and Small Industries Project amounting to US $ 10 million was approved by IDA on May 13, 1986, and became effective on July 31, 1987. The scope and scale of CSI-II was increased from 9 to 27 districts. The project contained too many components, and involved too many agencies. The project was launched and substantially enlarged in scope and complexity, before the final results of the first project began to surface. The project objectives were defined too broadly and the activities under each components were not well coordinated to support each other to achieve the common objectives. Under the CSI-II the role of Nepal Rastra Bank was not well defined, and its role from active project management, supervision and follow-up was merely limited to providing refinance and administering Credit Guarantee Scheme.

Soon after the project was launched in 1987, loans made under CSI-I, became due for repayment and the borrowers began to default on payments at a rapid rate. Alarmed by the poor collection performance IDA tightened the recovery requirements, which in turn caused two out of the three banks to become ineligible to make new loans under the project. Against this background it was agreed that the project activities be halted prematurely as of June 30, 1992 some three years prior to the closing date. The greatest achievement under the CSI Project was that it brought out greater awareness and created favourable environment to establish cottage and small industries in the project areas in general and a remarkable growth of export oriented woollen carpet industry in particular besides financing over five thousand industrial projects to the tune of Rs. 364.41 million.

5.9 Production Credit for Rural Women

Production Credit for Rural Women (PCRW) programme was introduced by UNICEF in selected districts in 1982 and gradually increased its activities to 24 districts. The principal objectives of PCRW are to improve the social and economic status

Some Currency Notes issued during the Seventh,
Eighth and the Ninth Governors' Tenure

of poor rural women through training, community development and provision of credit for women groups to engage in income generating activities. In 1988 International Fund for Agricultural Development (IFAD) provided a loan of SDR 4.75 million and a grant from FINNIDA of US $ 1.0 million to extend the programme to 37 districts in Nepal. In January 1993, the loan agreement was amended to allow the use of IFAD loan fund for training and community development in those districts which were included in the IFAD Project area. The project is executed directly by the Women Development Division of the Ministry of Local Development. But the credit is channelled by Nepal Rastra Bank through three participating banks: Agricultural Development Bank, Rastriya Banijya Bank and Nepal Bank Ltd. Out of the total IFAD loan of SDR 4.75 million, SDR 3.07 million comprise credit component. PCRW programme is based on area approach, where poor rural women form groups to obtain loan up to Rs. 30 thousand against group guarantee and without any collateral.

As of mid-July 1995 the programme had extended to 67 districts, the credit disbursement stands at Rs. 208 million, and the total number of credit group members is more than 30 thousand.

5.10 Rural Self-Reliance Fund

Rural Self-Reliance Fund was created by His Majesty's Government in 1991 to provide credit to the rural poor for income generating activities in order to improve their standard of living through Non-governmental Organisations. A corpus fund of Rs. 20 million has been allocated by the government for this purpose. One of the important objective of this fund is to encourage the growth of NGO and Self-Help Groups in rural areas by making them intermediaries between the Fund and local beneficiaries. The fund provides a small loan of up to Rs. 15,000 per borrower family which have less than one bigha of land in terai and ten ropani in hills/mountain and who cannot maintain his/her family from one's own earnings. The loan is given for quick yielding, indigenous resource based, labour intensive, and feasible micro-business. Loan is provided through NGO or co-operative societies which are actively engaged in local saving mobilization and community development. Nepal Rastra Bank is the executing agency of this programme. In the last five years the fund activities has spread over to 23 districts and has provided loan amounting to Rs. 11 million to 47 NGO's/Cooperative societies, and more than two thousand poor family households have benefitted from this programme.

5.11 Rural Development Banks

Although various rural credit programmes are in operation for more than a decade, the rural poor are either deprived from the credit facilities or they have not been able to utilise the services directed towards them. There was lack of rural orientation and effective targetting in these credit programmes. Against this background a rural development banking system closely based on the Grameen Bank Financial System of Bangladesh was introduced in Nepal in 1992, through the establishment of Rural Development Banks on a regional basis.

Rural Development Bank is a new model for banking to the poor in rural area. The basic objective of the bank is to provide easy financial services to the poor. There are four Rural Development Banks established on a regional basis in Eastern, Far-Western, Western, and Mid-Western Development region. All these banks have adopted the outreach model of Grameen Bank Financial System of Bangladesh. The distinctive features of these banks are that they adopt area approach, have well defined target group, and group lending approach, need no physical collateral, disburse loan at the client door-step, collect principal and savings on a weekly basis, provide services exclusively to the poor women and carry out banking and other activities in the centre located at the village.

Two Rural Development Banks, Eastern and Far-Western established in 1992, with an initial paid up Capital of Rs. 30 million started their lending operation in July 1993, and the other two banks, Western and Mid-Western were established in 1995. Now the paid-up capital of each of the four bank is Rs. 60 million where Nepal Rastra Bank holds more than 60 percent of the equity and the rest is held by the government, banks and financial institutions.

Till mid-April 1996, Eastern Development Bank is operating in 5 districts and 184 villages, has 35 unit offices and has disbursed loan of Rs. 272 million to 27742 women borrowers. Far-Western Development Bank is operating in 4 districts, and 63 villages, has 20 unit offices and has disbursed loan of Rs. 113 million to 10081 women borrowers. Western Development Bank is operating in 3 districts and 28 villages, has 7 unit offices and has disbursed loan of Rs. 5.3 million to 1140 women borrowers. Mid-Western Development Bank is also operating in 3 districts and 21 villages has 8 unit offices and has disbursed loan of Rs. 3.4 million to 745 women borrowers. The loan provided by these banks have spread over to petty trading, live-stock, agricultural production and micro-enterprises. As of mid-April 1996 these banks have made significant contribution to the economic upliftment of 40 thousand poor rural women and have been spearheading social awareness campaign in the fifteen terai districts in a very short period of their operation.

5.12 Micro-Credit Project for Women

Micro Credit Project for Women was launched in 1994 in selected districts with Asian Development Bank assistance. The objectives of the project is to provide skill training to women to undertake income generating activities, institutional strengthening of Non-Governmental Organisations and provision of micro-credit to women. This project supplements the activities of Production Credit for Rural Women mostly in Non-IFAD districts. The loan agreement signed on September 16, 1993 amounts to SDR 3.544 million of which SDR 2.549 million is the credit component. The project is executed by the Women's Development Division of the Local Development Ministry, Nepal Rastra Bank channels the credit through two participating banks: Nepal Bank Ltd. and Rastriya Banijya Bank. This project is a bit different than PCRW in the sense that the project can extend loan even in urban areas, and the loan limit under micro-enterprise is Rs. 40,000. But the loan limit on small business in urban area is up to Rs. 250,000; where necessary collateral may be taken for loan given to an individual. As of mid-January 1996, the project has been extended to 12 districts and 5 municipalities and has disbursed credit worth Rs. 23 million to about three thousand women beneficiaries.

5.13 Agricultural Credit Survey

Nepal Rastra Bank undertook a nationwide comprehensive Agricultural Credit Survey in 1969/70, with a view to generating data and information on different aspects of agriculture and its supporting activities. The survey, first of its kind, which conducted in 3195 households of 22 accessible districts proved to be a benchmark in the field of statistical information relating to agricultural economy in general and agricultural credit in particular. The findings of the survey indicated that in 1969/70 the proportion of borrowing farm families utilizing institutional credit was 18 percent. The recommendations of the survey which were particularly directed towards building up new organisational set up for the institutional credit were mostly implemented.

In view of the changes that had taken place in the area of agriculture after the 1969/70 survey, Nepal Rastra Bank conducted the Agricultural Credit Review Survey in 1976/77 to estimate the short, medium and long-term credit needs for agriculture and agro-processing for different farm sizes. The Review study was spread to 2655 farm families and selected from 14 accessible districts. The Review Study observed significant increases in the proportions of borrowing farm families from institutional sources which was found to increase to 24 percent. Generally, larger farmers were found to have borrowed more from institutional sources than smaller farmers. The Review Survey made a number of important recommendations relating to the role of cooperatives, banks and the government in the area of agricultural credit.

5.14 Rural Credit Review Study

After two Agricultural Credit Survey conducted by Nepal Rastra Bank in 1969/70 and 1976/77, a need was felt for a comprehensive review of the present status of rural credit to facilitate His Majesty's Government and Nepal Rastra Bank for initiating appropriate actions to strengthen the rural credit system into becoming more efficient, effective and responsive to the needs of the rural clientele. The survey conducted in 1991/92 with the technical assistance of Asian Development Bank, covered 7336 rural households from 32 districts, representing all the ecological and developmental regions of the country.

The study which commenced on mid-July 1992 took about two years to complete. The findings of the rural household survey indicated 86 percent of the economically active rural population was engaged in agriculture, average annual household income in rural Nepal at 1991/92 prices was estimated at Rs. 26 thousand, the proportion of sample households reporting borrowing from the institutional sources during 1991/92 is estimated at a low of 8 percent for all households and among the borrowing households the proportion of institutional borrowers was estimated at 20 percent for rural Nepal ranging from 12 percent in the Mountains to 22 percent in the Hills. Agricultural Development Bank and Commercial banks were the major institutions supplying credit to rural areas. A number of recommendations have been made with a view to improve the rural credit system to make it more effective, efficient, sustainable and responsive to the needs of the rural poverty alleviation. Recommendations include among others, establishment of a *"Rural Financial Markets Development*

Fund", institutional reform designed to give greater focus in three government controlled banks, involvement of non-governmental organisation in credit delivery, linking selected informal money lenders with formal financial system on a pilot basis, extending the coverage of Credit Guarantee Corporation, providing adequate training to the banking personnel, arrangements for implementation of the recommendations and monitoring there of and active involvement of Asian Development Bank in the funding and monitoring arrangements.

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Chapter VI

NEPAL RASTRA BANK IN THE REGIONAL AND INTERNATIONAL FINANCIAL COMMUNITY

CHAPTER VI

NEPAL RASTRA BANK IN THE REGIONAL AND INTERNATIONAL FINANCIAL COMMUNITY

His Majesty's Government of Nepal (HMG/N) has designated Nepal Rastra Bank (Bank) as the sole authority in the management of foreign exchange flows in the country. All foreign exchange transactions of HMG/N are ultimately effected through the Bank. To facilitate such transactions and to coordinate national economic policies relating mostly to money, finance, banking, credit and BOP with the rest of the world, the Bank represents HMG/N in various bilateral, regional, multilateral and international financial institutions. Nepal's membership in the International Monetary Fund (IMF), and the World Bank precedes all subsequent memberships in various regional and international financial institutions/groupings.

The IMF was established primarily to support and encourage a freer and orderly exchange rate system among its member countries. The Fund in recent years has assumed a prominent role in facilitating a smooth functioning of international monetary and exchange rate systems through better coordination among member countries, now numbering 181 (as of February 1996). For developing countries who need macro-economic adjustments, the Fund assumes the role of a global financial institution that extends support to formulate and implement preventive and/or corrective policy measures that leads to a more stable and sustainable growth for the national economy of the country concerned. Thus starting as an institution extending financial assistance to overcome balance of payments problems of a temporary nature, the Fund has evolved into an entity extending cooperation in the form of suitable packages of technical assistance for institutional and structural reform in the macro-economic management of the needy member country.

6.1 Nepal in the IMF

Nepal joined the IMF on the Sixth of September 1961. The IMF has total quota of SDR 144.8 billion and total voting rights numbering 1,490,550. Of this, Nepal holds SDR 52 million of the quota (0.04 percent of the total) and 770 of the voting power (0.05 percent of the total votes). Nepal exercises its voting right independently through its representative at the Governing Board of the Fund. The governor of Nepal Rastra Bank represents Nepal in the Fund's governing Board in the capacity of ex-officio governor. Nepal, in view of its small size, disseminates opinions and decisions on various policy issues regarding the fund's operations through the South East Asian voting group comprising of apart from Nepal, Fiji, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Singapore, Thailand, Tonga and Vietnam with a combined voting power of 40,885. The Group's combined voting power represents 2.74 percent of the Fund's total voting power. The voting group meets once a year just prior to the annual meeting of the Fund/Bank. At other times the members including Nepal convey their opinions on various policy issues relating to international ecoomic matters in general and the Fund's activities and policy options in particular through their executive director at the Fund's executive committee. The executive director is elected by member countries of the voting group.

6.1.1 Nepal's Transaction with the IMF

In nearly 35 years of Nepal's membership with the Fund there have been numerous transactions between the Fund and Nepal involving both financial and technical issues. What follows next is the summary of few major transactions undertaken to overcome temporary BOP imbalances encountered by Nepal in various years. Nepal had borrowed SDR 7.6 million in 1976 under

First Reserve and Credit Tranche which has already been repurchased by Nepal. Similarly Nepal had availed SDR 20 million under Compensatory Financing Facility and another SDR 13.7 million under Trust Fund Facility, both in the 1970's. All of these has already been repurchased.

Nepal faced protracted BOP difficulties around 1983-85. To overcome this, Nepal borrowed SDR 18.65 million in fiscal year 1985/86 under the Standby Arrangement. This borrowed sum amounted to 50 percent of the country's quota at that period. Late 1980s heralds a positive transformation in the evolution of IMF in respect of its support to the low income countries. Structural Adjustment Facility (SAF) was established in 1986. Under this a member country could borrow upto 70 percent of its quota. Nepal borrowed an amount of SDR 26.11 million under SAF during 1987-89. IMF's concern for structural adjustment in low income countries took a new turn with the establishment of Enhanced Structural Adjustment Facility (ESAF). Approval was granted to Nepal for ESAF fund worth SDR 33.57 million for a period of three years (May 1992 to April 1995). Of this approved amount, Nepal had already drawn SDR 16.79 million by March 1995. [For deails on these programmes please see Chapters 1 and 4]

6.1.2 Technical Assistances

The Fund has provided various technical assistance to Nepal on the latter's request. Such assistance including in some cases expert advisery support has been provided in case of various projects and programmes including the cost of Living Indices (1977), Review of Financial System (1984), Budget Projection (1984), Design and Package of Tax and Other Revenue Measures, Financial Sector Development (1987), Bank Supervision (1987), and Simplification of Export Procedures (1987). Apart from this, the IMF Institute has been a major source of training for Bank officials in the area of financial programming and policies, external sector reforms, balance of payments, public/government finance, money and banking and various other central banking topics. In addition, the Fund has also provided on-the-job-training for Bank officials.

6.1.3 Nepal's Article VIII Status in the IMF

Nepal has received article VIII status of the IMF on 30th of May 1994. Prior to this Nepal was being granted Article- XIV status since its joining of the Fund in 1961. The move towards liberalization since the late 1980s has helped Nepal to be promoted to the Article- VIII status. The acceptance of this status reflects confidence of the member in matter of managing its monetary and BOP affairs. Article VIII obligations include, among others, abolition of restrictions on payments and transfers for current account transactions, and avoidance of discriminatory currency arrangements or multiple currency practices without Fund authorisation. Once the country agrees to undertake the obligations of Article VIII, it is bound to keep the commitment towards free convertibility in the current account and eschew any move towards restrictive practices on international payments and transfers.

6.1.4 Liason with the IMF

The Governor of Nepal Rastra Bank acts as Governor of Nepal to the Fund. HMG/N also nominates a senior official, usually a joint-secretary, from the Ministry of Finance as alternate Governor to the Fund. Every year around September-October the IMF and the World Bank host annual Fund-Bank joint meeting where Finance Minister and Finance Secretary also take part along with the NRB Governor. All the major agenda come for discussion at this meeting. On the rest of the time a member country exercises its options through its Executive Director (ED). Presently J.E. Ismail of Indonesia is the ED of the South-East Asia Voting Group of which Nepal is also a member.

In Kathmandu, beginning from 1977 IMF used to be represented by an Advisor, usually an 'Economist', from the Fund. The status of IMF representation in Nepal has been upgraded to Resident Representative (RR) since 1985. It is the RR which coordinates agenda for discussion between Nepal and the Fund whether in regular article IV consultation Mission or if the country is undergoing any Fund supported structural adjustment programmes or is using other Fund facilities. Currently such discussion is centred on ESAF follow up. The RR also attends Aid Nepal consortium meeting in Paris.

6.2 Nepal and the World Bank

IMF and the World Bank, the twin institutions shaping the global economy today, are the outcome of Bretton Woods Conference held in New Hampshire, USA in July 1944. The Latter institution was basically designed to reconstruct western Europe in the aftermath of Second World war devastation. Both of these institutions are supportive of each other. While the IMF focusses its attention on short term measure to recover from BOP shocks, to manage exchange rate and design mutually consistent set of macro-economic policy agenda, the World Bank concentrates more on long term sectoral development programmes such as poverty alleviation, education, health and preservation of environment.

The World Bank Group consists of International Bank for Reconstruction and Development (IBRD), International Development Agency (IDA), International Finance Corporation (IFC), and Mutilateral Investment Guarantee Agency (MIGA).

Nepal joined the World Bank on September 6, 1961, the same day it joined the IMF. In fact prior membership of the Fund is a precondition for joining the World Bank. Nepal joined IFC on January 7, 1966, IDA on March 3, 1968 and MIGA on 1994. A brief description of the constituent units of the World Bank Group follows. IFC established in 1956 supports private sector activities through participating in equity as well as bond financing.

IDA established in 1960 is the most favourite lending institution for the low income developing countries with per capita income below US$ 600. Richer countries do not have access to IDA fund. IDA provides loans to low income countries at the most concessional rate and for the longest possible maturity period. MIGA is more an advisory rather than a lending agency. The MIGA is mandated to increase the flow of productive investment to developing member countries by providing services that are client-oriented, cost-efficient and complementary to those of relevant public and private activities.

6.2.1 Nepal's Transactions with the World Bank Group

The Bank group operation in Nepal is basically IDA operation. The Bank group operations in Nepal began in 1969 with an IDA credit amounting to U.S. $ 1.8 million for telecommunication project. Historically, the Bank assistance strategy focussed on infrastructure development, primarily hydropower, highways, agriculture, irrigation and forestry with some involvement in industry and education. Since its first operation in 1969, IDA has so far approved a total of 67 projects for Nepal involving over US$ 1.3 billion (by March 1995). The World Bank is reprioritizing its assistance in favour of poverty alleviation, human capital development, and environmentally sound and sustainable development. However, productive investment particularly in agriculture is still not out of purview of the World Bank.

IFC, which mobilizes both debt and equity financing in the international market for private companies supplemented by necessary technical assistance and advisory services to business and the government, has relatively fewer involvement in Nepal. The IFC affiliation with Nepal include US$ 3.1 million loan for the expansion of the Soaltee Hotel Ltd. in 1975 and equity participation in 690,560 shares of Rs. 100 each, and DM 14.5 million loan financing to Nepal Orind Magnesite Company in 1982.

6.2.2 Technical Assistance from the World Bank Group

The World Bank Group has been providing technical assistance in various sectoral planning activities in Nepal. Notable area of technical assistance are energy planning, irrigation, industrial finance, cottage and small scale industries promotion, municipal development, programme budgeting and remote area development. The World Bank Resident Office in Kathmandu is represented by two headquarter staff members from Washington, D.C. The Resident Office coordinates between Nepali authorities in Kathmandu, notably the Ministry of Finance and the National Planning Commission with the World Bank Head Quarter. When it comes to macro-economic aspect Nepal Rastra Bank, IMF Resident Representative and the World Bank office work in close collaboration. In the SAF and ESAF framework it is the IMF and the World Bank which work closely together with NRB, NPC and MOF in drafting policy Framework Paper (PFP) and its subsequent evaluation.

6.2.3 The World Bank and the NRB

Historically Nepal remained as busy *entre pot* between British- India, and China. Nepal was famous for woollen, wooden and metallic artefacts. Its brand of sculplure whether clay, stone and wooden had established reputation in this part of the World. With the arrival of products manufactured by assembly line technology in the west into Nepal in the early twentieth century, Nepal lost its preeminence in marketing handicrafts. The production skill was still there. Looking at the prospect of penetrating export markets, World Bank entered into an agreement with Nepal Rastra Bank in July 1982 to promote small and cottage industries in Nepal in an integrated manner. The Project was known as CSI. The project poolled the major commercial banks and ADB/N to provide financial assistance to the Nepali enterpreneurs expert in producing traditional crafts. The assistance involved all the process from collecting raw materials to marketing finished products in domestic as well as global market outlets. For details of the Project please see CSI in chapter 5. The World Bank also was actively involved in the structural adjustment programme which Nepal undertook in 1987, wherein it granted structural adjustment loan for various structural reforms including that of the financial sector.

6.3 Asian Development Bank (ADB/M)

The Asian Development Bank is a financial institution established for the development of the Asian region. The genesis of this Bank originated from the ECAFE's First Ministerial conference on Asian Economic Cooperation held in Manila, the Philippines, in December 1963. The objective of the Bank is to stimulate economic development of member countries by promoting optimal utilization of regional resources. ADB draws its membership from outside Asian continent also. Some of them are USA, Germany, Australia and Canada. This facilitates close coordination with other bilateral and multilateral donors. In the process of operation, ADB/M also collaborates closely with UN agencies.

ADB/M is one of the largest multilateral donor of Nepal, second only to IDA. ADB came into existence on 22 August 1966. Nepal is one of its founding members. Like IDA, ADB/M first started its operation in 1969. The first credit involved US$ 6 million for Air Transport. Since then ADB/M has continued to remain a reliable partner in Nepal's development endeavour. There are hardly any sector in Nepal that remain unsupported by ADB/M. Notable loan assistances have been received in the sectors of agriculture, agro-industry, transport and communication, energy, industry, education, water resources and forestry. Apart from credit financing, the Bank has also been providing technical assistance in the development of the sectors that have just been outlined above. As from the World Bank Group; Nepal receives ADB/M assistance at the most concessional terms and conditions. Virtually all the credit obtained from the

Bank has been from its ADF (Asian Development Fund) source which grants concessionary finance to the least developed among member countries. Apart from loans for sectoral development and grants (technical assistance), ADB/M has also provided programme loans for enactment of financial laws and capital market development. ADB/M has tentatively earmarked an amount of approximately US$ 597 million for the period 1995-98. The projects receiving Bank support for this period number 18.

Following a paradigmatic shift in favour of market led economic development strategy beginning early 1990s, ADB/M has also been assisting private sector companies in Nepal through both equity and debt participation. In line with this priority the Bank in 1995 has approved a loan amount of US$ 8 million for development of Tourism infrastructure in Nepal. This is further complemented by an equity participation amounting to US$ 1.25 million. This assistance will be used by Taragaon Regency Hotels Ltd., a five-star hotel coming up in Kathmandu. This represents Bank's first case of involvement in Hotel in Nepal and third case of involvement with Nepal's private sector. The earlier cases of ADB/M's involvement with Nepal's private sector include equity participation in (a) Gorakhkali Rubber Industry and (b) Jyoti Spinning Mills.

6.4 South East Asia New Zealand and Australia (SEANZA)

SEANZA (An association of Central Banks in the region of South East Asia, Newzealand and Australia) established in 1958 is a club of central bankers in the region. Nepal joined this association in 1968. SEANZA was initially founded by five central banks of the Asia-Pacific Commonwealth: Australia, New Zealand, Sri Lanka, India and Pakistan. The motivation for the establishment of this forum emerged from the need for providing central banking training courses to prepare executive staff for roles as determined by their respective national economic conditions and circumstances. SEANZA central banking courses are organized every two years on a rotational basis. The host country for the training also convenes SEANZA Governors' Council Meeting in advance of the course. The lecturers are drawn, among others, from the pool of member central bank executives. This provides excellent opportunity for sharing of experiences. The Govrnors' meeting designs the curriclumn to suit prevailing circumstance of member central banks. Nepal successfully hosted the Fifteenth SEANZA Central Banking Course in Kathmandu in April-June 1985.

Over the years the SEANZA membership has increased from initial five to 17. This membership presently is comprised of Australia, Bangladesh, People's Republic of China, India, Indonesia, Iran, Japan, Republic of Korea, Malaysia, Nepal, New Zealand, Pakistan, Papua New Guinea, the Philippines, Singapore, Sri Lanka and Thailand. One interesting feature of SEANZA is that even non members are invited to join the forum meetings and training courses. Non member central banks that regularly attend SEANZA courses are Canada, Denmark, Fiji, U.K., U.S.A. and Western Samoa. The 21st course is being held in Beijing in 1996.

6.5 South East Asian Central Banks (SEACEN)

South East Asian Central Banks (SEACEN) Research and Training Centre even though legally established in 1982, the attempt to form the Centre goes back to the mid-1960s. Nepal has been participating in the SEACEN forum either as observer or as an invitee since the first SEACEN Governors' conference held in Bangkok on 3-4 February 1966. SEACEN as an institution was set up on an informal basis in January 1977. The Centre acquired its formal legal status in 1982 when it got registered as a corporation in Malaysia.

The 13th SEACEN Governors Conference (January 16-18,1978) hosted by Nepal Rastra Bank

As the very name, Research and Training Centre, suggests the Centre is a forum for conducting research and training on topics relevant to the functioning of central banks. The Centre strives to promote better understanding of finance, banking, and economic development among member central banks. Centre's activities include carrying out research projects on policy planning and other topics of central banking, organizing seminars and training courses in money, banking, finance and economic development that are of common relevance to the member countries. The Centre undertakes economic surveys of member states as well as preparation of economic reports. The programme of activities, budget, and key policies of the SEACEN Centre are formulated by the Executive Board comprising of central bank Governors from member states.

The undertakings of the SEACEN Centre, whether conference, meeting, seminar, symposium, workshop, research, training and publications depend on decisions reached at the Governors' conference held annually on a rotation basis at each member central bank in turn. Similarly, trainings and seminars are also undertaken in different member countries with the prior approval of the Board. The Centre's Secretariat is in Petaling Jaya, Kuala Lumpur, Malaysia. Present members of the Centre are the central banks of Indonesia, South Korea, Malaysia, Myanmar, Nepal, the Philippines, Singapore, Sri Lanka, Taipei China and Thailand.

So far three Governors' conferences and two South East Asian voting Group meetings have been held in Nepal. The 9th (March 4-6, 1974), the 13th (January 16-18, 1978) and the 22nd (January 20-21, 1987) SEACEN Governors' conferences were held in Nepal. The Seventh Meeting of the South East Asian voting group was also held in Nepal in January 1976. Another Voting Group Meeting was also held in Kathmandu in October 1983.

Regarding SEACEN organized seminars three have been held in Nepal, namely :

1. Country Risk and Treatment of Non-performing Loans (November 16-18, 1983)

2. Domestic Resource Mobilisation in SEACEN Countries (September 7-9, 1988), and

3. Bank Regulation of Off-Balance Sheet Activities in the SEACEN Countries (February 8-10, 1993)

Nepal has also hosted a Centre-sponsored training course "Examination and Supervision of Financial Institution" on 13 September - 15 October of 1993.

An interesting feature of the Centre sponsored seminars and training is the use of expert from the member central banks. This gives practical insights to the problems encountered in the process of discharging day to day central banking responsibilities.

Also, the research officials stationed at the centre in KL are drawn from member banks. So far Nepal Rastra Bank had deputed three Research Officers to the Centre.

6.6 Asian Clearing Union (ACU)

The ACU was established in 1975 with the purpose of :

(a) providing a facility to settle, on a muttilateral basis, payments for current international transactions among the participating countries,

(b) promoting the use of participants' currencies in current transactions between the respective territories thereby effecting economies in the use of participant's exchange reserves, and

(c) promoting monetary cooperation among the participants and closer relations among the ACU banking systems.

Central banks of Bangladesh, India, Iran, Myanmar, Nepal, Pakistan and Sri Lanka are ACU members. Nepal is one of the founding members. The respective Governors are the directors in the ACU Board of Directors. Each central bank also deputes a senior bank executive as Alternate. NRB normally deputes Chief Controller of the foreign exchange department as alternate to the ACU Board of Directors from Nepal. Each central bank also deputes officer-in-charge to look after the transactions involving ACU in respective member Bank offices.

The Board of Directors elect a Chairman of the Board from among themselves. The chairman retains the position until the next meeting of the Board which is held in rotation every year in each of the member banks in turn. The routine administration is carried out by the General Manager who is deputed by the central bank of the Islamic Republic of Iran. The Union secretariat is located at Central Bank of Iran office in Tehran. Since Nepal joined the ACU, NRB hosted meeting of Board of Directors on three occassions: 1977, 1984 and 1991.

Asian Monetary Unit (AMU) is the unit of account for settling intra-union payments transactions. The volume of transactions cleared through the Union has gone up from AMUs 44.6 million in 1976 to AMUs 2745.5 million in 1994. Nepal's total transactions routed through ACU increased from AMU 5.06 million in 1994 to nearly AMU 6 million in 1995. This represented 36 percent of the country's total clearing transactions. Of the Nepal's total clearances through the ACU in 1995, 64 percent was settled in foreign exchange. Until 1995 one unit of AMU equalled one SDR. Beginning 1996, however, one unit of AMU has been pegged equivalent to one US Dollar.

The seventeenth Annual Meeting of the Board of Directors established SWAP arrangement which became available to members from September-October 1989. Any member finding itself in deficit, with any other members, during a settlement period, would be eligible to avail of the facility.

When ACU started operations in 1975 all individual transactions were required to be cleared through the central banks concerned. The transaction volume grew so big that in 1980 the system had to be decentralized by which all trade and payments transactions has had to be effected by the commercial banks themselves without involving central banks.

In the Union's intra-region payments process there is also a mechanism to account for interest credit/debit to the central banks. The interest rates applicable to the settlement periods of the year are the closing rates of interest of one-month Euro-Dollar deposit on the first working day of the last week of the previous calender month, announced by the Bank for International Settlements (BIS).

6.7 Asia Pacific Rural and Agricultural Credit Association (APRACA)

APRACA is a voluntary association of governments, national level financial institutions or national level federation of financial institution involved in agricultural credit, central bank/monetary authorities, and national level agriculture credit training institutes in the Asia Pacific region. The main programmes of the Association are :

(i) initiate and/or revitalize collaboration between formal banking institutions and financial self help groups (SHGs) in savings mobilisation and credit delivery in the rural areas,

(ii) institutionalize the use of selected performance indicators in monitoring and evaluating the performance of banking institutions and financial SHGs in rural financial intermediation, and

(iii) improve the skills and methods employed by banking institution and financial SHGs in developing competence in their respective areas of operation.

To translate these programmes into action, member institutions in selected countries participate in conducting research or case studies on problems/issues of common interest. APRACA also organizes international workshop, seminar, consultation or training course to discuss and reflect on feelings and recommendations of studies. These findings are then translated into practice by individual members. Practical experiences are then shared among members.

APRACA was established formally on 14th of October, 1977. To begin with, Association consisted of 28 institutions from nine countries. Size of the Association a decade later (in 1987), grew to 49 institutions from 18 countries. Presently (late 1995) the Association consists of 51 institutions from 17 countries. Nepal Rastra Bank is the founding member. The three administrative tires of Association are the General Assembly, the Executive Committee and the General Secretariat. General Assembly is composed of the representatives of all members and convenes every two calendar year. Executive Committee is composed of Chairperson, Vice-Chairperson, three members and Secretary General. Except for Secretary General, all other members of the Committee are elected by General Assembly for a period of two year. The Committee convenes once every year.

Nepal Rastra Bank's former Governor Mr. Ganesh Bahadur Thapa was elected Chairman of the Executive Committee for 1987-88.

General Secretariat which consist of Secretary General and staff is responsible for discharging Association's regular business. NRB's association with APRACA is evidenced by the fact that the present Managing Director of an APRACA affiliate called APRACA Consultancy Services Mr. Bishnu P. Shrestha is on secondment from NRB since 1988. He served as Assistant Secretary General of the Association upto 1990.

NRB used to be in the Executive Committee earlier. Since 1993 NRB is simply a General Assembly member and Agriculture Development Bank of Nepal (ADB/N) represented Nepal as the Executive Committee member. However, since 1995 Nepal has no representation in the Executive Committee. The Association members from Nepal are

(a) Nepal Rastra Bank
(b) Agricultural Development Bank/Nepal
(c) Nepal Bank Ltd. (NBL)
(d) Rastriya Banijya Bank (RBB), and
(e) Agriculture Projects Services Centre (APROSC)

In conducting its business, particularly in research, APRACA works in close collaboration with institutions such as FAO, ESCAP, ADB/M, GTZ and also directly with the member and donor governments.

At present APRACA Secretariat is situated in Bangkok, Thailand, where as its four agencies are stationed in four different countries: APRACA Regional Fund in Kuala Lumpur, Malaysia; APRACA consultancy services in Jakarta, Indonesia; APRACA center for Training and Research in Agricultural Banking (APRACA-CENTRAB) in Manila, the Philippines; and APRACA Publications in Bombay, India.

6.7.1 Centre for International Cooperation and Training in Agricultural Banking (CICTAB)

The Centre was established in January 1983 with its headquarters at Pune, India with the cooperation of FAO to serve as an international training forum in Agricultural banking and also as a sub-regional centre for India, Sri Lanka, Bangladesh and Nepal. It was envisaged that 50 percent of the cost of CICTAB would be borne by the Government of India and the remaining 50 percent would come as foreign aid though FAO. However after initial financial support from Swedish International Development Agency, FAO withdrew from its earlier commitment. Since then the activities of CICTAB have been continuing with its resources generated from annual membership fee from member institutions in four countries and some grant in-aid by the Ministry of Agriculture, Government of India. Nepal Rastra Bank is one of the founding member of CICTAB. Since the last three years CICTAB and its member institutions in Nepal have been jointly organising agriculture and rural financing training courses in Kathmandu

6.8 Standby Agreement with India

India remains the single largest trading partner of Nepal. In the last two decades there had hardly been any single year when Nepal experienced a favourable trade balance vis-a-vis India. In fact Nepal has been running a persistent trade deficit with India with the magnitude of deficit assuming ever increasing trend to such as extent that it put pressure on Nepal's Indian currency reserves. Taking this factor into account, Nepal and India have been undertaking standby loan agreements for quite some years. The standby loan agreement stipulates that when Nepal is short of Indian currency, India will provide the same, upto a maximum of mutually agreed loan amount to Nepal. The latest five year standby loan agreement (which expired on 31st of December 1995) allowed for a standby credit of IRs 500 million. Prior to it the allowed credit limit was IRs 350 million. The terms of the recently expired agreement were as follows. Whether Nepal draws or not, she is liable to pay an annual commitment charge of 0.5 percent. The annual interest rate on amount drawn is seven percent. Nepal had drawn IRs 600 million in 1992/93, IRs 230 million in 1993/94 and IRs 300 million in August 1995. The agreement is carried and enforced by NRB on behalf of HMG/N and by the Reserve Bank of India on behalf of the Government of India.

6.9 Aid Nepal Consortium

Nepal Aid Group, also called as Paris Club, was established in 1976 with the joint effort of HMG/N and its single largest donor agency, the World Bank. This club which is scheduled to meet every two year in the French capital Paris intends to bridge the resource gap of Nepal, particularly of the public sector. The members of the club include the World Bank, IMF, ADB/M, IFAD, UNDP, Saudi Trust and major bilateral donor countries from North America, Western Europe, Australia and Asia. The latest meeting of the consortium was held in Paris on April 10-12, 1996. The group of donor countries and institutions, numbering 23 altogether, have jointly committed an amount of approximately US Dollar one billion for the next two fiscal years viz 1996/97 and 1997/98.

The Nepali delegation to the meeting is headed by the Finance Minister. The meeting and its outcome is of direct consequence to NRB as the magnitude of foreign assistance committed during the meeting generally determines the public sector development programs. This in turn is reflected in the size of fiscal deficit and composition of its financing. This forms the primary benchmark of monetary planning, which is a direct domain of the central bank.

6.10 Other International Contacts

Regular periodical reports published by NRB on various macro-economic development are considered the most authoritative sources of statistical facts both in Nepal as well as abroad. This Bank has maintained contacts with all continents with various financial and other institutions in all continents in the globe by means of mailing its publications. As of April 1996, there were over 200 agencies outside Nepal regularly receiving NRB publications. Nearly 100 of them constitute libraries. Other outside agencies that regularly receive NRB publications are central and commercial banks, universities and think tanks, private researchers of repute and regional and international financial institutions. This does not include resident diplomatic and UN missions based in Nepal. Similarly NRB also receives numerous publications from central banks and various financial institutions from all over the world. Probably NRB is the only agency in Nepal to maintain mutual exchange of publications on banking, financial and economic matters with various entities all over the world on a regular basis.

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Chapter VII

ORGANIZATION AND MANAGEMENT

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ORGANISATION AND MANAGEMENT

Nepal Rastra Bank was established as the nation's central bank under the Nepal Rastra Bank Act, 1955 on April 26, 1956 as a non-profit organisation fully subscribed by the government. At that time the Nepalese economy was traditional and characterised by dual currency system, low level of infrastructural development and virtual absence of the financial system. The establishment of this Bank had coincided with Nepal's First Five Year Plan aimed at the country's socio-economic development. As the country's central bank this Bank has the sole right to issue currency notes and coins and is responsible to manage the country's foreign exchange reserves. The Bank's other important functions include: developing banking and financial system in the country, rendering advice to the government on financial and economic matters, mobilizing capital and managing public debt. The bank also acts as banker to the government besides serving as lender of the last resort. As in various other developing countries, the Bank undertakes a number of developmental functions that are intended to support the country's efforts towards accelerated development of the overall economy.

Nepal Rastra Bank (NRB) is an autonomous and corporate body having perpetual succession. However, the Bank's Act states that His Majesty's Government (HMG), after consultation with the Governor can give such directions to the Bank as may be necessary in the national interest. The Bank has a pivotal role in the country's economic system in which no other organization is likely to substitute it. As the highest monetary authority of the country, the Bank's activities on the whole are directed towards the economic upliftment of the country. Thus, Nepal Rastra Bank works in close collaboration with HMG so that the monetary and financial policies formulated by the Bank do not contradict with the plans and programmes of the Government.

This Chapter begins with the analysis of the Bank's management structure followed by the organizational pattern, administrative system, workings of various departments, physical resources, welfare and security schemes for the employees, and so on. A brief sketch on the profiles of the Bank's previous and encumbent Governors, who have performed as the Chief Executive and Chairman of the Board, has also been included.

7.1 Management

To achieve the objectives mentioned in the Preamble of the Nepal Rastra Bank Act, 1955 and to run the bank smoothly and effectively, the following provisions have been made in Sub-section (2) and (3) of Section 5 of the Nepal Rastra Bank Act, 1955 :

(2) The entire responsibility including the management of the Bank and the performance of all acts to be executed by the Bank under this Act and other Nepal laws shall lie in the Board of Directors.

(3) The Board shall make rules for the conduct of business mentioned in sub-section (2) as above. The Governor shall exercise all the powers vested in the Board, under the supervision and direction of the Board of Directors, in accordance with such rules. The Governor may, in order to carry out the business of the Bank smoothly, delegate his powers to the Deputy Governors and other employees of the Bank, on his own responsibility.

Thus the Board of Directors (BOD) is the supreme policy making body of Nepal Rastra Bank. In line with the policies and programmes of HMG, the Board mainly formulates and executes the monetary policies that ensure adequate availability of money and credit in the economy.

Governor Satyendra P. Shrestha taking oath of office from the Chief Justice

The BOD of the Bank constitutes seven members comprising of the Governor, four Directors nominated by HMG and the two Deputy Governors of the Bank. The Governor and the two Deputy Governors too are appointed by HMG. The person holding the post of Director in any commercial bank is not eligible to become the Bank's Director. However, this regulation does not apply in the case of the Governor and the Deputy Governors. Similarly, no two persons who are partners of the same firm or Directors of the same corporate body are qualified for directorship in the Board. Traditionally, two out of four Directors have been senior HMG officials at Secretary level usually from the Ministry of Finance and Ministry of Industry. Besides, high level officials from other Ministries or institutions are invited to take part in the meetings of the Board as and when necesssary.

The Governor convenes the meeting of the Board of Directors. The Board meeting should be held compulsorily at least six times a year and once every three months. Similarly, if at least two Directors having voting rights make written request together with the agenda to be discussed, the Governor convenes the meeting in accordance with such request. The Governor presides over the meetings. However, if the Governor, for any reason, is unable to attend the meeting of the Board, he can authorise one of the Deputy Governors to preside over the meeting. In such a circumstance, the Deputy Governor so authorised is entitled to exercise his voting power. To form a quorum the presence of at least two among the four Directors nominated by HMG, apart from the Chairman, is necessary. The decision of the meeting with such a quorum is deemed to be the decision of the Board. In the event of equality of votes for and against a resolution, the Governor or the person presiding over the meeting may cast the decisive vote. The Deputy Governors as members of the BOD, take part in the discussion in the meeting of the BOD. However, these officials are not entitled to vote on any subject put to vote in the meeting.

The terms of office of the Governor and the four Directors nominated by HMG are five years and four years respectively. The tenure of the Governor and the Directors can be extended for another term. The two Deputy Governors are also appointed by HMG on the recommendation of the Governor and their tenure of office is as prescribed by HMG. The composition of the present Board of Directors is given in *Annexure - I.*

7.2 Organisational Structure

For conducting the Bank's day to day operations smoothly and efficiently, various departments, divisions, branch and sub-branch offices have been set up. The workings of various offices and departments will be discussed separately. The Bank's present organizational structure is presented in *Annexure II.*

Nepal Rastra Bank has to accomplish a number of objectives consistent with other national economic objectives. Therefore, while designing the organisational structure, special attention has been paid to ensure that the Bank's dimensions and dynamic role are clearly reflected in it. The organizational structure of the Bank has been modified from time to time as per exigencies and the Bank's futuristic activities. Similarly, at times the Bank has acquired consultancy services from reputed foreign agencies to design its organisational structure.

Over the years, the Bank's responsibilities have expanded in consonance with the increase in number of banks and financial institutions. Additional regulatory framework has been designed and the number of employees has been increased to cater the needs of monitoring and follow up of the changed financial system.

7.2.1 Early Operations and Growth of Staff

The Nepal Rastra Bank started its operations with a total number of 23 employees including the Governor and the Chief Accountant. Besides the Office of the Governor, other important departments which operated at the initial period were: the Banking

Office, Accounts Department, Issue Department and the Research Department. With the passage of time, various departments and offices at the central as well as regional level were set up. At the beginning of the Bank's functioning there was an acute shortage of trained manpower. So the Bank arranged to conduct training classes for bank employees under the supervision of a senior Officer of the Bank. Similarly, some Officers were sent abroad for training on different subjects such as investment and accounts, note issue and banking, public debt, agricultural credit, economic planning, national accounting, statistics and on other relevant matters.

In the initial years of its operation, the Bank had to focuss its attention on abolishing the dual currency system, regulating the circulation of Nepalese currency throughout the kingdom and maintaining stability of exchange rates of the Nepalese currency. For this purpose, the Bank opened a number of offices and currency exchange counters in various parts of the economically active areas in the Terai regions such as Biratnagar, Birgunj, Sidhartha Nagar and Nepalgunj. Such offices were also expanded in the hilly regions like Illam, Bhojpur, Dhankutta, Pokhara, Palpa, Baitadi and Doti. The Bank adopted the policy of gradually increasing the number of offices in the country to provide banking services to HMG and to a limited extent to the public. The recruitment of staff corresponded to the expanding number of offices and widening of the activities of the Bank's Central Office. Consequently, the number of staff continued to rise over the years. The expansion of the Bank's offices as well as its employees over the period of the first ten years, (i.e. from mid-July 1956 until mid-July 1965) is shown in the following Table.

Growth of Nepal Rastra Bank Offices and Employees Over the Period of First Ten Years (1956 - 1965)

Offices	Mid-July 1956	Mid-July 1957	Mid-July 1958	Mid-July 1959	Mid-July 1960
Branches	1	2	2	3	3
Sub-branches	-	1	3	5	5
Sub-offices	-	-	-	-	-
Exchange Depots	8	13	11	9	9
Exchange Counters	-	-	-	-	1
Total Offices	9	16	16	17	18
Total Employees	73	168	214	275	368

Offices	Mid-July 1961	Mid-July 1962	Mid-July 1963	Mid-July 1964	Mid-July 1965
Branches	4	4	4	4	5
Sub-branches	5	5	5	5	5
Sub-offices	5	8	8	10	11
Exchange Depots	7	6	6	6	6
Exchange Counters	3	2	2	2	3
Total Offices	24	25	25	27	30
Total Employees	438	496	549	598	637

Similarly, the total number of staff excluding temporary employees rose to 915 by the end of F.Y. 1966/67. The employees numbered 300 at the Central Office, 192 at the Kathmandu Banking Office, 140 at the Issue Department, 113 at Branch Offices, 58 at Sub-branch Offices, 102 at the Sub-Offices and 10 at Exchange Depots. Besides, there were 319 temporary employees at the exchange counters set up in various districts.

The Bank achieved success in abolishing the dual currency system in September 1966. The Bank's next focuss of attention was to formulate and implement monetary policies suitable for the economic development of the country. Hence the Bank's responsibilities were broadened to a great extent.

The year 1965 marked the establishment of the Rastriya Banijya Bank, as the second commercial bank fully owned by the public sector. This new commercial bank began to shoulder some of the responsibilities of the central bank by working as its agent in handling government transactions. Therefore, Nepal Rastra Bank adopted the policy of gradually transferring its regional offices as well as its employees to that Bank so that it could operate its functions smoothly by the already trained manpower. Thereafter a series of expansion of departments and branches, sub-branches took place at different times. As the network of commercial bank branches expanded, Nepal Rastra Bank handed over its regional offices to them one after another.

By the end of the second and third decades of the bank's establishment the number of permanent employees had increased considerably to reach 2,066 at the end of FY 1976/77 and 2,465 at the end of FY 1986/87. The Bank recorded the highest number of employees in F.Y. 1990/91 when its staff strength reached 2,982. However, the number declined substantially in the ensuing years due to the staff retrenchment policy inacted by HMG in December 1992. According to this policy, employees reaching 58 years of age or those completing 30 years of service with the organization were retired compulsorily.

The number of existing permanent employees of NRB as at mid-April 1996 totals 2,316. The details of various levels of manpower are presented in the following Table.

Level	Existing Positions
Officer	281
Special class	7
First class	32
Second class	77
Third Class	165
Assistant	2025
First class	573
Second class	782
Third class	122
Fourth class	305
Fifth class	253
Total	2,316

Out of the total staff the percentage of male and female employees are 87 percent and 13 percent respectively. Besides, there are 172 personnel relating to surveillance, communication and other services on temporary and contractual basis. The details of principal Officers currently serving in different capacities are shown in *Annexure VI.*

7.3 Administrative System and Operational Success of Nepal Rastra Bank

Human Resource Development

The operational success of the Nepal Rastra Bank from its very inception is mostly attributed to its efficient administrative system and the capable, hard working and dedicated employees.

The Bank has given utmost importance to long-term human resource development. The Bank's, long-term human resource planning consists of package that includes training, job rotation and career development. The Bank has contributed in enhancing the quality of its manpower by providing ample opportunities for higher study. Many staff members have availed themselves of the facility of undergoing study leading to Ph.D., Master in Business Administration (M.B.A.), Master in Economics and Finance and Chartered Accountancy (C.A.) in foreign universities under financial support from the Bank itself besides scholarships, fellowships and grants provided by foreign bilateral or multilateral sources. The Bank has adopted the policy of providing opportunities for higher studies abroad in the form of long leave with full pay, financial support, and guarantee of higher position upon successful completion of studies. Under this scheme a number of employees had received various degrees and had subsequently been entrusted to key positions at the executive level. Besides, training opportunities in internationally and regionally reputed institutions are regularly provided to its staff members to broaden their experience. Every year more than 100 officers attend training programmes, seminars, workshops, meetings and observation programmes on a wide range of topics in various countries including U.S.A., U.K., Australia, Germany, Canada, and Japan. The *"Training Committee"* determines the policies with regard to requirement of study and training as well as selection of appropriate personnel for this purpose.

As a result of the liberal policies adopted in providing higher education and training opportunities to its employees, the Bank has been able to prepare a set of qualified staff. Among the total Officers, 51.35 percent Officers hold Masters Degree and 44.78 percent Officers possess Bachelors Degree. Similarly, 2.32 percent Officers hold Doctorate Degree while 1.55 percent Officers have Chartered Accountancy Degree.

From among the qualified personnel of the Bank, some individuals have also contributed in various capacities by serving ambassadors, members of National Planning Commission and chief executives to commercial banks. There is a long list of Nepal Rastra Bank officials who have worked on deputation to different Government, semi-government and financial institutions in the capacity of Economic Advisor, Chairman, Chief Executive and Director from the very beginning. Similarly, at times the Bank's officials have also been on secondment to reputed international institutions in important positions. The details of institutions presently represented by the Nepal Rastra Bank are given in *Annexure V.*

7.4 Workings of Various Departments and Offices

The exclusive responsibility of the Central Office is policy making and strategic management. Thus it is repository of all the responsibilities and authority of the Bank as a whole.

After undergoing various changes over time, the present internal organisation of the Bank consists of its Central Office in Kathmandu with 15 departments, in addition to the offices of the Governor and the two Deputy Governors. The departments include: (1) Kathmandu Banking Office (2) Issue Department (3) Personnel Administration Department (4) Banking Operations Department (5) Development Finance Department (6) Inspection and Supervision Department (7) Foreign Exchange Department (8) Research Department (9) Public Debt Department (10) Mint Department (11) Bankers Training Centre (12) Internal Audit and Inspection Department (13) General Services Department (14) Accounts and Expenditure Department, and (15) Legal Department. The Issue Department and the Banking Department are the principal operational sub-divisions of the Bank.

Currently, there are six branch offices of the Bank located in Biratnagar, Janakpur, Birgunj, Pokhara, Siddartha Nagar and Nepalgunj and two sub-branch offices in Dhangadhi and Illam. The Bank also has its office in Bhadrapur. The branch and sub-branch of the Bank comprise a unit each of the Issue and Banking Department. The difference in the workings of the branch and the sub-branch offices is in terms of volume of work handled by them. The entire branch is under the overall charge of a Manager and is assisted by the Deputy Currency Officer and Deputy Manager in matters of Issue and Banking functions respectively. Besides, the Regional Research Centres located in each branch and sub-branch offices, study and analyse the economic and banking situation of the respective geographical region. A branch office thus performs most of the on-going functions of the Bank in respect of certain geographical area. The departments and branch offices are headed by executives at Special and First Class Level and they are accountable to the concerned Deputy Governors. Besides the branch, sub-branch offices, a number of exchange counters have been operating under various branch, sub-branches in different parts of the country *(Annexure III)*. Similarly, Price Collection Units (for the computation of the national urban consumer price index) have been set up at Surkhet, Dipayal and Dhankuta. Apart from that, the "Bankers Club" has been in operation since two and half decades. The departments are supervised and guided specifically by each of the two Deputy

Governors. However, at present, the Personnel Administration and the Internal Audit & Inspection Department are directly supervised by the Governor. The IMF Resident Representative's Office has also been housed in the Central Office Building since 1977.

The operations and workings of the various departments and offices of the Bank are briefly described in the following paragraphs.

7.4.1 Office of the Governor

The setting up of the Office of the Governor dates back to the establishment of the Bank. However, it was re-organised and extended in 1970. Since the Governor is the Chairman of the Board of Directors also, the Office of the Governor has to perform dual responsibility to act as the Secretariat to the Board of Directors apart from its regular functions. The coordination role with other departments for timely dissemination of information and statistics regarding banking and economic matters is done by this office. It is responsible for appointing members of the Board in other institutions on behalf of the Bank. The membership of different officials in the Bank's Board of Directors is also formalised through this office.

The formulation of policies, programmes and operational plans within the policy framework emanate in the Office of the Governor and are discussed and decided in the meeting of the Board of Directors. The directives and policy matters on behalf of the Governor and resolutions passed by the Board of Directors are channelised through this office for implementation. Coordination for amendment of the proposals relating to different subjects in the legislation affecting the Bank and its responsibilities is made by this office. The Governor is advised and briefed by concerned officials on matters relating to monetary, banking and financial policy, foreign exchange and personnel administration as and when necessary. This office also conducts monitoring and evaluation works on various operational activities of the Bank. It also keeps in close contact with the Ministry of Finance, National Planning Commission and other line agencies of the government in the process of designing, framing, formulating, executing and monitoring various policies that affect the overall macro-economic framework and structural aspects of the Nepalese economy.

Regular meetings with the departmental heads of the Bank and with the chief executives of financial institutions are arranged by this office. The Office of the Governor is also responsible for maintaining relation with the public and the press by arranging press conferences and interaction programmes with the press and communication media as well as with the business professionals whenever new policies relating to monetary and banking are introduced. For this purpose, the Public Relation Unit was set up in 1983. This section was subsequently upgraded to a Division to work within the Office of the Governor in 1986.

The Office of the Governor is also responsible for maintaining close linkages with international agencies, other central banks and financial institutions in connection with matters of mutual interest as well as in coordinating arrangements for conferences, symposiums, meetings and other occasional events.

7.4.2 Kathmandu Banking Office

The Kathmadu Banking Office, the hub of the Bank's financial transactions, was set up on the very first day of the Bank's establishment. As the official depository of the government, the Banking Office manages and handles all the government accounts. Management of foreign debt, transactions of banking operations for the government, such as making payment and remittances, undertaking foreign exchange operations to the amount standing to the credit of HMG are also carried out. Thus this office manages the treasury funds of the government.

The Banking Office facilitates the clearance of cheques, pay orders and bank drafts to its member commercial banks through the operation of *"Clearing House"*. In addition, this office has maintained a *"Money Museum"* with a good collection of Nepalese and foreign coins as well as currency notes. The Museum is also opened to the public. The Kathmandu Banking Office has following divisions: (a) Accounts and Draft T.T., (b) Deposits and Accounts, (c) Central Government, (d) Foreign Exchange, and (e) Cash.

7.4.3 Issue Department

When Nepal Rastra Bank came into existence, Nepalese monetary system was characterised by dual currency system. Moreover, the Indian currency was more in circulation than the national currency. The basic reasons that prompted establishing the central bank was to ensure proper management of the issuance of Nepalese currency notes and to make proper arrangement for the circulation and expansion of Nepalese currency throughout the kingdom. To fulfill this objective, the Issue Department was set up on 28 September 1956. For effective circulation and expansion of Nepalese currency and to facilitate increased monetisation of the economy, HMG enacted an Act to expand the circulation of Nepalese currency on 13 April 1960. This Act facilitated the Issue Department to perform its functions more effectively.

Prior to the establishment of the NRB the note issue function used to be carried out by the *"Sadar Mulukikhana"* of HMG. Since 19 February 1960, the Bank started issuing the currency notes after taking over all the unissued currency notes printed by HMG. This totalled Rs. 15.2 million. Similarly, the liabilities and the assets maintained as security reserves for the currency notes issued by HMG were also transferred to the Bank as per the provision made in the Nepal Rastra Bank Act, 1955.

As the central bank of the country, Nepal Rastra Bank has the exclusive right to issue currency notes which are legal tender all over the kingdom. The note issue, therefore, is one of the core functions of the Bank. The dimension, design and denomination of the currency note to be issued are determined by the *"Note Design Committee"* under approval of HMG. The Committee, formed in 1971 ensures, among other things, that the currency note reflects the Nepalese culture, art and natural heritage. Upon approval of the specifications of the proposed currency notes, they are sent for printing. The currency notes are printed by reputed companies on the global tender basis.

For issuance of the currency notes, sufficient reserves are maintained as per Section 18(2) of Nepal Rastra Bank Act, 1955. HMG is liable to guarantee the payment of the currency notes issued by the Bank in case the latter fails to do so.

Till now currency notes of Rs.1, Rs.2, Rs.5, Rs.10, Rs.20, Rs.50, Rs.100, Rs.500 and Rs.1,000 denominations have been issued. The security features on the currency notes have been remarkably enhanced to check counterfeit notes. Recently currency notes having demetalised windowed security thread using silver metallic ink have been introduced to ensure additional security.

Before the Bank issued currency notes, metallic money was very much in circulation in the kingdom. However, after the Bank started issuing more currency notes, the circulation of metallic money gradually declined. These days the Bank has adopted the policy of replacing currency notes of small denominations by issuing coins.

The Issue Department has provided *currency chest* facilities with a view to ensuring the adequacy of the monetary resources needed for the smooth functioning of the banking activities. The *currency chests* also facilitate the commercial banks to deposit the excess cash accumulated with them. Such *'currency chests'*

The Tenth Governor

MR. SATYENDRA PYARA SHRESTHA

(17 January 1995 - Present)

have been maintained in the branch, sub-branch offices of this Bank as well as in the branch offices of the two government owned commercial banks, namely, the Nepal Bank and the Rastriya Banijya Bank. At present the number of *currency chests* are 9, 46 and 20 at the branch/sub-branch offices of the Nepal Rastra Bank, Rastriya Banijya Bank and Nepal Bank respectively.

The Issue Department also undertakes fund transfers between the capital and various parts of the country including the remote areas to ensure uninterrupted supply of funds to the commercial banks. The fund transfer system of NRB is more scientific now as compared to the one in the early days when the funds were packed in jute bags, and carried by porters manually from one place to another. This Department also handles the management of the torn, defaced and soiled (mutilated) notes that are not suitable for further circulation. Scientific method has been adopted to destroy the soiled notes adhering to strict regulations on the presence of concerned authorities. The branch/ sub-branch offices are authorised to destroy the unregistered notes, i.e. currency notes below the denomination of Rs. 500 whereas notes, including registered ones are destroyed by the Issue Department at central level.

The regional units under this Department are located in Biratnagar, Birgunj, Sidhartha Nagar, Pokhara and Nepalgunj branches. These regional units are responsible, among other things, for the proper management of these currency chests.

The following sections operate within this Department: (a) Note Registration Claim (b) Note Issue and Fund Transfer (c) Note Ledger (d) Note Stock Reserve (e) Currency Chest (f) Exchange (g) Claimed Note (h) Cancellation (i) Ledger Accounts, and (j) Deposits.

7.4.4 Personnel Administration Department

The Personnel Administration Department was initially set up as the Administration Department in 1958. In the early days this Department used to discharge functions relating to general services and legal matters also. Later it was reorganised and named as the Personnel Administration Department on 23 August 1977. Thereafter, this Department was made responsible for manpower planning. Hence it executes and conducts recruitment, transfer, promotion, placement, training and retirement aspects of administration concerning mainly the personnel of the Bank. Personnel records including the performance evaluation are kept updated. Besides it frames, designs and regulates the salary and allowance structure, staff loans, medical facilities, fringe and retirement benefits and insurance of Bank properties.

This Department conducts *"Management Seminar"* every year. The Organisation and Management (O & M) Division within this Department co-ordinates this activity for ensuring effective interaction among the various departments and branch/sub-branch offices. Initially formed as a Section on 11 April 1974 and upgraded in 1981, the O & M Division also conducts regular surveys for exploring alternatives for better management consistent with changing conditions.

The Computer Division within the Personnel Administration Department is responsible for maintaining proper records, processing of data and making them available to the final users. The expansion of the computer network in the Bank's various operations and the development of computer professionals are the responsibilities vested to this Division.

A Health-Care Unit under this Department has been in operation for the last two decades. Other sections of this Department include: the Staff Facilities, Personnel and the Surveillance Group. There are seperate committees looking after training and recruitment.

7.4.5 Banking Operation Department

The Banking Operation Department was set up on 21 November 1966 as *"Banking Operation and Development Department"*, a year after the "Credit Control Regulations" which empowered the Nepal Rastra Bank to direct the commercial banks in matters of monetary and credit policies, came into force. This Department was renamed as Banking Operation and Credit Department on 2 December 1974 by merging the Agricultural Credit Department (formed on 21 April 1973) and the Industrial Credit Division. An Inspection Division (for the supervision of banks) was also created within this Department on 17 November 1974 which also emerged as a separate department in 1984. This Department took the present shape on 4 April 1986.

In August 1981 the *Credit Planning* Cell was set up with a view to strengthening monetary control through better monitoring of credit development. After undertaking a special study, the Cell recommended ways and means to improve, among other things, credit activities to HMG as well as to the NRB. Later on this Cell became a part of this Department.

Significant reorganization of this Department took place on 4 April 1986 when the Agricultural Credit Division, Industrial Credit Division and the Priority Sector Credit Unit were fractioned out of this Department to form the *"Development Finance Department"*. Thus after a series of restructuring, the *"Banking Development and Credit Department"* eventually split into three different departments in order to comply with better organizational efficiency. However, the Banking Operations and the Development Finance departments remain closely interdependent for many activities, where they differ is only in formulating and implementing the respective policies.

The *Banking Operation Department* is mainly responsible for regulating banking and financial system in Nepal. Determination of interest rate policies and appropriate prudential regulations for banks and financial institutions, analysis of commercial banking statistics as well as monitoring the overall growth of banking business are the major functions of this Department. Besides, this Department conducts studies on branch expansion and the profitability of banks to evaluate the functioning of the banking system to facilitate formulation of appropriate policies. This Department also issues permission to conduct limited banking activities to the Agricultural Development Bank, Co-operative Societies and non-government organisations (NGO's) and monitor their activities.

Three important divisions under this Department include: (a) Policy Planning, Statistics and Banking Promotion, (b) Banking Regulations, and (c) Non-Banking Financial Institution (NBFI) Regulations. This Department also serves as the secretariat of the "*Banking Promotion Board*".

7.4.6 Development Finance Department

The Development Finance Department is mainly responsible for executing policies regarding industrial and agricultural finance. The function of providing refinance facilities to the ADB/N, NIDC and rural development banks are channelised through this Department.

This Department also manages the flow of credit to priority sectors of the economy and the deprived sections of the society through the '*Priority Sector Credit*' and the '*Deprived Sector Credit*' policies designed to increase the income, production and productive employment of the rural people and to help increase the income level of these people.

In the past, this Department has conducted important survey works such as the Industrial Credit Survey and the *Rural Credit Surveys* and also executed the *Cottage and Small Scale Industries* (CSI) Project under the World Bank loan assistance. During the implementation phase of the CSI Project, separate Project offices were set up at Pokhara, Bharatpur and Dang under the direct supervision of this Department.

At present there are: (a) Agricultural Credit Division, (b) Priority Sector Credit Unit, (c) Industrial Credit Division and (d) Rural Self-Reliance Fund Unit operating under this Department.

7.4.7 Inspection and Supervision Department

The responsibility of supervision and control over banks and financial institutions has been entrusted to Nepal Rastra Bank under Section 23(A) of Nepal Rastra Bank Act, 1955. This major responsibility of monetary authority is being carried out by the Inspection and Supervision Department which was established in 1984. Prior to that the supervisory task was performed by the *"Inspection Division"* set up on 17 November 1974 under Banking Operations Department. The growing competition and complexities observed in the financial system of the country, particularly after the entry of joint venture banks, necessited consolidation of existing supervision mechanism. This led to the creation of separate and full-fledged department. Hence the Inspection and Supervision Department was formed.

In order to ensure sound, healthy and efficient operation of the financial system, Inspection and Supervision Department regularly conducts both off-site and on-site supervision of banks and other financial institutions.

The off-site supervision was introduced only in the latter half of the 1980's. With deregulation of interest rate policy and adoption of the indirect monetary control framework, a greater need was felt for strengthening off-site supervision. In this direction, an important initiative was taken in the early 1990's when the off-site supervision was shifted to the Inspection Department. Under off-site examination, the Department regularly monitors portfolio structure of the banks and financial institutions to ensure strict adherence to prudential guidelines and various sectoral targets set by the NRB.

The off-site examination is also carried out as a basis for on-site inspection. If any lapses are detected thereof in the implementation of financial policies by any bank or financial institution, immediate on-site action is taken to correct such defaults. The on-site examination of banks and financial nstitution is being carried out regularly by this Department to determine whether existing laws, rules and regulations issued by supervisory authorities are strictly adhered to, assuring that the policies and procedures are being complied with. On-site inspection is also aimed at evaluating the management and effectiveness of the control system, assuring that there is adequate public confidence in the banking system and assessing the overall financial position of banks and financial institutions. This Department has been effortful to modernize itself in the mode and methods of monitoring and supervision in line with the new technology that has been emerging in banking and finance.

7.4.8 Foreign Exchange Department

The Foreign Exchange Department was formed on 21 September 1959 as *Foreign Agency and Investment Department* and evolved to the present shape by 20 November 1969. This Department headed by the Chief Controller, is particularly responsible for the management and control of foreign exchange in the country. The Department manages the foreign exchange reserve of the country through optimum investment policy to ensure highest possible return. For this purpose a *"Foreign Exchange Investment Committee"* has been constituted under the Chairmanship of the Deputy Governor.

The important functions of the Foreign Exchange Department include: keeping account of the country's foreign aid and loan, proper management of foreign exchange for export and import trade, market analysis of foreign exchange, fixation of the exchange rate of the Nepalese currency vis-a-vis foreign currencies for government transactions and regulating and monitoring foreign exchange dealers including Money Changers. This Department is also responsible for intervening in the foreign exchange market whenever the open market exchange rate fixed by the commercial banks fluctuates irratically and is not found to be compatible with the macro-economic conditions of the country. In the changed context of greatly liberalised exchange and trade regime, the analytical work of the Foreign Exchange Department is growing along with its regular operations.

This Department also coordinates with bilateral and regional institutions such as the *Asian Clearing Union* (ACU), a regional institution with seven member countries, of which the Bank is a founder member.

This Department has sections looking after import, export, investment, airlines, inspection, follow-up and exchange rate.

7.4.9 Research Department

The *Research Department* was formed during the first decade of the establishment of the Bank as the *Research and Statistics Department.* Prior to that, this Department used to operate simply as a *Research Unit* undertaking economic research activities. The Bank's role as the Economic Advisor to the government is performed by this Department. The area of study and analysis covered by this Department are primarily related to economic issues. In course of its operation, the Department analyses the overall macro-economic situation in the country besides conducting research and analytical work in various sectors of the economy. The Department also offers relevant policy prescriptions on various issues related to agricultural and industrial production, price situation, money and banking, international trade and balance of payment, foreign exchange reserves. To facilitate the conduct of the study in the above mentioned areas, this Department collects, compiles and processes necessary statistics, on various aspects of the economy. In this process, this Department is supported by nine Regional Research Centres (converted from earlier Research Units, on 27 February 1985), and three Price Units located outside the Kathmandu Valley by making necessary statistics and relevant information available to the Department. Such information dissemination process was started in 1968.

The Research Department is also responsible for collecting information regarding the policies, operations and financial activities of international financial institutions e.g. the IMF, World Bank and regional organizations such as South East Asian Central Banks (SEACEN) Research & Training Centre and the South East Asia, New Zealand and Australia (SEANZA) group. It keeps close working relationship with the IMF and World Bank and other multilateral agencies and informs the top management about their functionings and activities besides supplying economic data and other information required by the institutions. The Department acts as liaison between the SEACEN Centre and NRB with regards to various research works undertaken by the Centre on country specific and regional economic activities. For this purpose, the International Finance Division (IFD) has been entrusted to closely study and maintain appropriate records and analyse them properly.

The Research Department is responsible for submitting a status report to HMG highlighting the economic, banking and monetary situation of the country apart from submitting annual reports containing income and expenditure accounts and other activities of the Bank to HMG within four months from the closing day of every fiscal year. The Publication Division of the Department issues various publications on the country's economic situation regularly.

The Research Department has been actively involved in preparing the basic framework of generating the country's price and BoP data. In this context, the Department had conducted the *"Family Budget Survey"* in 1975 in order to prepare the National Urban Consumer Price Index. Upon completion of this Survey, the "Price Index Development Section" was set up on 30 December 1975. The Section was eventually upgraded into "Price Division" on 29 June 1978. Similarly, the "Central Balance of Payments Section" was upgraded to operate as the "Balance of Payments Division" on the same date. Other important divisions within this Department include the following : (a) Economic

Development, (b) Balance of Payments, (c) Monetary, (d) Government Finance, (e) Publications and (f) Documentation (Library). The Research Department is headed by the Chief Economic Advisor.

7.4.10 Public Debt Department

Until 1960, all operations regarding the public debt were carried out by a section of the Research Department. This section developed into a full fledged department in 1962 as part of Nepal Rastra Bank's responsibility in effectively managing the public debt of the government which had been growing substantially. In the beginning, the Department was mainly responsible for issuing and redeeming the various bonds and treasury bills as part of the government's internal borrowing. However, tentatively since the mid-1980's and more vigorously since the 1990's the Department has been involved in carrying out the open market operations of the NRB besides the overall management of the public debt of the government. For this purpose the *"Open Market Operations Committee"* has been formed. These operations involve the auction of the Treasury Bills and other government bonds in the open market every week. This operation affects the level of reserves in the banking system as required and signals interest rate movement. To mobilise capital and saving, this Department also issues saving certificates, government bonds, debentures, treasury bills and securities fully guaranteed by the government under repurchase agreement. This Department also issues the Nepal Rastra Bank Bonds. This Department has played an important role in the establishment of the "Securities Exchange Centre," presently operating as *"Nepal Stock Exchange"* for the development of capital market in Nepal.

Currently the Public Debt Department has also established a secondary market for short term securities i.e. government treasury bills and Nepal Rastra Bank Bonds. In addition, this Department is helping the finance companies to run secondary markets for long-term government securities.

7.4.11 Mint Department

The Mint Department was transferred to the Nepal Rastra Bank from His Majesty's Government on 1 December 1983. The Department issues coins for circulation, commemorative coins, gold coins, silver coins and medallions. Recently arrangement has been made to sell the ordinary gold coins (Asarfis) through the commercial banks, finance companies, money changers and the jewellers. The design, dimension and denomination of coins are determined by the "*Coin Design Committee*" to be chaired by the Governor. The specifications approved by the Committee are sent to HMG for approval before minting. This Department is also responsible for the safe keeping of the gold reserve. The modernisation of the Nepalese Mint is under way. Detailed project report has already been submitted to the Bank for the construction of a new mint complex. At present the Mint Department is emphasizing more towards the improvement in quality of the products.

7.4.12 Bankers Training Centre

Bankers Training Centre (BTC) was set up in April 1970 with a view to fulfilling the training needs of banks and financial institutions. The BTC formulates and develops appropriate curriculum for the training programmes and also identifies the training needs of all banks and financial institutions. The BTC, a pioneer institute in imparting training on banking, offers a number of functional and general management courses on central and commercial banking, middle-level management, foreign exchange, monetary policy, inspection and supervision, project appraisal, public debt, balance of payment and so on. Thus the Centre is playing a significant role in enhancing the efficiency of the professionals engaged in banking and financial system. The BTC is planned to be converted into a residential training centre in the future.

The BTC's calendar of the training programmes is finalised by a high level body, the "*Governing Council.*" The Council is chaired by the Governor and is comprised of ten members that includes two Deputy Governors, General Managers of two government owned commercial banks, Agricultural Development Bank, Nepal Industrial Development Corporation (NIDC), Executive Directors of Nepal Administrative Staff College (NASC) and the Centre for Economic Development & Administration (CEDA) and the Principal of BTC. The main objective of this Council is to formulate training policies for banks and financial institutions. The Council also reviews the progress, effectiveness and appropriateness of the training programmes.

Similarly, the *"Faculty Board"* headed by the Deputy Governor in charge of the BTC and consisting of 12 members has been constituted to formulate training programmes, curriculum and training techniques.

In the past BTC conducted in-house training courses on financing the Cottage and Small Scale Industries as well. Besides training programmes, the BTC conducts seminars and workshops. In certain specialised training courses, the BTC receives technical assistance from the specialised institutions such as Reserve Bank of India (RBI), National Insitute of Bank Management (NIBM) and the International Management Institute, India.

BTC has also organised the *"Behavioural Science Laboratory"* and the *"International Banking Course"* for the top level officers of this Bank. Till F.Y. 1994/95 BTC has conducted 256 courses on monetary policy, banking, project appraisal, banking laws, research, management, bank inspection and supervision, foreign exchange, etc. Similarly 5,816 Officer and Non-officer level employees from various banks and financial institutions, corporations and government organizations have received training from BTC during the period. Among them 35.23 percent comprises of participants from the Nepal Rastra Bank while 64.77 percent comprises of staff from other banks and financial institutions.

The BTC has a faculty of ten instructors headed by the Principal. The number, however, varies from time to time. Training programmes are conducted in Kathmandu as well as outside the Kathmandu Valley.

7.4.13 Internal Audit and Inspection Department

The Internal Audit and Inspection Department was formed in 1957 as the *Inspection and Check Department*. For some time this Department also undertook the inspection of the commercial banks before it was performed by a section of the Banking Operation Department. The main objective of this Department is to monitor and improve the internal management of NRB. This Department deals with internal auditing and inspection of the Bank's operations and is responsible for strengthening the internal control system. In the course of inspection, this Department ensures that the Bank's day to day business is run as per prevailing rules and regulations and that the operations have been carried out smoothly. It also evaluates whether the internal operations of the Bank are undertaken in strict conformity with the prevailing norms ensuring economic discipline and recommends ways to improve the overall internal management.

7.4.14 General Services Department

The General Services Department, previously operating as a section was seperated from the Administration Department on 23 August 1977 and is responsible for the management and maintenance of Bank properties and supplies such as office vehicles, machineries, furniture, office equipment, printing and stationery as well as auctioning of properties. The General Services Department also deals with the design, construction and renovation of office buildings and estimation of annual requirement of physical facilities. The Department also is responsible for a cafeteria operated for the bank staff which supplies light snack items at reasonable rates. At present this Department consists of the following Sections : (a) Construction and Transport, (b) Engineering (Technical), (c) Procurement, and (d) Press.

7.4.15 Accounts and Expenditure Department

Initially set up as the Accounts Department (popularly known as 'Hisab Bibhag') in 1958, the Accounts and Expenditure Department is responsible for formulating the Bank's annual budget, maintaining accounting records, effecting various payments and keeping accounts of various reserves of the Bank. "The Budget Section" was set up as a seperate unit of this Department in 1979 for formulating the annual budget in a more systematic way. The "Balance Sheet Section" under this Department prepares the periodical financial statements such as the annual Balance Sheet as well as Profit & Loss Account of the Bank. These accounts are duly audited by a registered Auditor appointed by the HMG. The treasury position of His Majesty's Government is highlighted every week by the Central Acconting Division. Other important sections in this Department include: (a) Reconciliation Section, (b) Provident Fund Section, (c) Branch Return Section and (d) Insurance Unit.

7.4.16 Legal Department

Until 1967, the Legal Department was operating as a unit of the Administration Department. This Department renders legal advice to the Bank as and when necessary in various matters and performs legal functions on behalf of the Bank. Besides, this Department plays a vital role in formulating various Acts and regulations relating to currency and banking, foreign exchange, public debt and other financial matters. This Department, headed by the Chief Officer, is staffed by a set of personnel specialised in law.

7.4.17 Bankers' Club

The Bankers' Club was inaugurated by the erstwhile Governor Dr. Y.P. Pant on 20 August 1971. The Club was set up with a view to enhance the mental and physical health of the Bank personnel through various recreational facilities with the funds fully borne by the bank. A few years back the Club was included as a part of the Bank. The Club is well equipped to provide facilities for indoor and outdoor games. It conducts various activities such as cultural programmes, sports and other social activities on different occasions including the Bank's Anniversary. Besides, the Club publishes *"Mirmire"* a monthly Digest containing articles on literature, economics and banking.

For the smooth operation of this Club, a Board of Directors under the Chairmanship of the Deputy Governor has been constituted. From 1993 onwards provision was made for other banks and financial insitutions to be members of this Club. The Club is housed at the premises of the Bank's Banking Office in Kathmandu.

7.5 Physical Resources

Prior to the acquisition of the *"Lalita Niwas"* where the present Central Office is located, the Bank was housed in a rented building at Juddha Sadak. Then it was shifted to a building popularly known as "Rain Basera" at the same locality. Similarly, the Banking Office was initially housed in the premises of *"Muluki Khana"* and thenafter at Bahadur Bhawan. At present the main banking office is located in a historic building popularly known as "Singha Mahal". The "Lalita Niwas" owned by the Bank since 1965 and the *"Singha Mahal"* both are historical buildings built during Rana period and are good examples of the combination of Nepalese and Victorian architecture. The Bank has modern office buildings of its own for most of its branch/sub-branch offices as well. Likewise, land has already been procured for the construction of modern mint complex in Lalitpur. The Bank has modern staff quarters and guest houses equipped with ample facilities in most of its branch and sub-branch offices located outside the valley.

Currency Notes of Rs. 1000/- Rs. 500/- and Rs. 5/- denominations

7.6 Welfare and Security Schemes for the Employees

To obtain optimum work performance from the employees the Bank has maintained generous reward system. Employees having exceptional achievement or outstanding accomplishment in relation to a their duties and responsibilities are rewarded with a maximum of three step increment in the annual grade of the staff or cash award along with a letter of appreciation. Similarly employees who complete 25 years of service with the Bank are decorated with *"25 years Service Gift"* gold medal along with Certificate of Appreciation on the Bank's anniversary celebrations.

Nepal Rastra Bank regards the employees as its most valuable asset. Therefore, the Bank has always been careful in providing welfare schemes and security not only to its employees but also to their family members. To prepare higly motivated personnel, the Bank offers attractive and generous fringe benefits to the employees. The provision of certain welfare schemes of the Bank have contributed to some extent in mitigating the financial burden of the employees thereby helping to enhance the quality of performance. Some of the facilities and welfare schemes offered to the Bank employees are summarised below.

7.6.1 Retirement Benefits

The Bank employees compulsorily get retired at the age of 58 years or completion of 30 years of service period whichever is earlier. Permanent employees are entitled to receive pension after the completion of 20 years of service in the Bank. Similarly, employees whose service period exceeds five years are eligible for gratuity payment as per prescribed regulations.

7.6.2 Provident Fund and Welfare Provident Fund

As per the Bank's regulation each employee contributes 10 percent of his/her salary to the *"Provident Fund"* each month. The Bank contributes the same amount in the account of the respective employee. The interest is provided quarterly and is capitalised. Besides, yields on the funds at the prescribed rate are deposited to the employees' account with the fund. Upto 90 percent of the total amount deposited in the fund can be withdrawn as interest free loan repayable from the employees' salary. The whole of the accumulated amount can be withdrawn only upon retirement of the employee.

Similarly, the Bank contributes one month's salary in case of Officer level and 10 percent of annual salary in case of non-Officer level to the respective employees' account known as *Welfare Provident Fund* at the end of every fiscal year. As in the case of the provident fund, the interest on the principal accumulated to this fund is capitalised annually. The accumulated amount is fully refunded at the time of retirement.

7.6.3 Housing Loan

All the permanent employees having completed three years of service period in the Bank are entitled to housing loan facility for the purchase of land or purchase/construction of house, within the limits determined by the Bank. The amount so borrowed is compulsorily insured, hence is interest free.

Similarly, loan for renovation or maintenance of house is provided to the equivalent of 36 months salary subject to a limit of three times during the service period. Employees opting to insure the loan amount are exempted from payment of interest.

7.6.4 Grants

Employees Welfare Fund has been maintained to compensate the employees for the loss incurred on account of natural calamities or unforeseen adverse situations to the tune of Rs 10,000 and the same amount in the form of funeral expenses admissible in case of the employee's parental death. The Bank has subsidised cafeterias at the Central Office, the main Banking Office and Biratnagar Branch where the employees are entitled to have their afternoon snacks at a substantially lower price.

7.6.5 Insurance

The Bank's package of insurance schemes for its employees is substantial with the premium fully payable by the Bank. The *Group Term Life Insurance* scheme covers death due to accident and death due to natural cause (converted into Endowment Policy). Similarly, the Bank has its own insurance scheme equivalent to the amount of five years salary payable at the time of retirement. In the case of early retirement, proportionate amount is payable depending upon the service period.

7.6.6 Health Care Services

Employees of the NRB and their families are entitled to free health care services. For this purpose the Bank has in-house clinics staffed with medical Doctor and Health Supervisor along with dispensaries set up at Central and Banking Office in Kathmandu. The dispensaries provide free first-aid treatment and medicines at concessional rate. Similarly, the Bank employees are entitled to reimbursement of medical bills upto a prescribed limit being fixed in terms of number of days of salary for every completed year of service. The unspent amount of such money is refunded at the termination of service. Similarly, employees are entitled to get medicines on credit from a panel of medical stores. Medical Doctors' services are available in regional offices as well. The Bank also provides subsidies for the purchase of spectacles, set of teeth and contact lenses.

7.6.7 Loans and Allowances

Besides salary, NRB provides various allowances to the staff which are quite attractive. Such fringe benefits compares quite well with benefits provided by other institutions.

In the immediate past, the Bank has introduced the vehicle loan facility and office uniform allowance for the employees. Likewise, a remarkable increase in the house allowance had been made, local allowance introduced and the tiffin (day meal) allowance reintroduced to better motivate the employees. On the occasion of the Dashain which is the most celebrated Hindu festival of Nepal, an amount equivalent to one month's salary is provided to every employee.

The Bank provides attractive travel allowances which include entertainment, incidental and clothing allowances for travel to India and abroad. Travel allowances for within the country is also quite attractive.

7.6.8 Other Entitlements

The Bank has a good package of leave facilities including leave without pay, special leave, maternity leave and three years conditional study leave.

The Officer level employees are entitled to telephone and news magazines facilities. Likewise, the Assistant level staff are entitled to interest free loans to install telephone at their residence.

As an incentive towards study for the children of the employees a lumpsum amount of money in the form of *"Talent Award"* is provided. As per this scheme the staff members' children, who secure at least one of the top ten positions in the School Leaving Certificate (SLC) Examination, are provided with an incentive of Rs. 10,000. Similarly, the employees' children who tops in the schoolwide results are awarded with a lumpsum amount of Rs. 6,000.

7.7 Bank's Contribution to the Study of Economics and Management

The Bank has been contributing to prepare qualified manpower in the field of Economics. A certain amount of money has been earmarked for the study of Economics channelised through the Economics Department of the Tribhuvan University. This amount is used as scholarship for the tuition, publication of thesis, grant for "Reputed Professorship" and arranging seminars and workshops. The scholarships are awarded to the students of Bachelor, Master and Doctoral Degree level coming from various regions of the country.

Similarly, "Dr. Bijaya Bahadur Pradhan Chair" has been instituted as a Trust in the honour of Late Special Class Officer in the Bank. The fund earmarked for this purpose is used in promoting the study of Monetary Economics in Nepal.

The Bank has also been providing financial assistance for the *Management Development Programme* undertaken by Tribhuvan University. Under this scheme, the Bank contributes certain portion of money for the study of Management and Commerce leading to Ph.D. The Bank has also made a provision to recruit the topper students from the Faculty of Economics and Commerce directly to the Officer level position at the Bank.

7.8 Publications of the Bank

Nepal Rastra Bank has a number of useful publications to its credit. These publications reflect the economic, banking and monetary situations of the country. The Research Department is responsible for publishing the Main Economic Indicators, Quarterly Economic Bulletin, Economic Reports and Annual Reports. Apart from these, special issues, survey reports and a wide range of study reports on money, banking and finance are published from time to time. The particulars of some of the important publications from the Bank are listed in *Annexure VII.*

7.9 Governors of Nepal Rastra Bank : Pioneers of Monetary and Banking Development

The Governor is the Chief Executive of the Bank. He is responsible for the overall administration of the Bank. It is the Governor through whom the Bank executes the monetary policies formulated by the Board of Directors. Thus the Governor has a dual responsibility as the Chief Executive of the Bank as well as the Chairman of the Board. The Governor represents the Bank in a number of government bodies at national level. Some of them include: the National Development Council (chaired by His Majesty the King till 1989 and by the Prime Minister since then), Industrial Promotion Board, Tourism Council, Council of Commerce, Export Promotion Board, and National Cooperative Development Board. The central bank Governor also represents the country in the International Monetary Fund as Governor.

The Bank is fortunate to have always been headed by eminent personalities with distinguished career in the Bank itself or HMG. The Governors of the Bank have played a crucial role in providing dynamic leadership to the Bank since its very inception. The present prestigious stature of the Bank is the reflection of the wise leadership displayed by the Governors as well as the dedication of the staff. The Nepalese economy has immensely benefitted from the experience, expertise and professionalism of successive Governors in the formulation and refinements of policies in areas like monetary, banking, financial, external sector, development finance, etc.

The present Governor of the Bank, Mr. Satyendra P. Shrestha, is the tenth in succession since the establishment of the Bank in 1956. A brief profile of each Governor has been presented in the ensuing paragraphs.

Mr. Himalaya S.J.B. Rana

(Tenure: 26 April 1956 - 08 February 1961)

As the founder Governor of the Bank, Mr.. Rana introduced a number of reforms and regulations to cope with the economic situation prevailing at that time. To eliminate the dual currency system from the country a law was enacted during his tenure. The Bank expanded deliberately by opening various offices and exchange counters on different parts of the country. It was during his tenure that the NRB issued currency notes for the first time on 19 February 1960. Prior to that the currency notes were issued by the *"Sadar Muluki Khana"*. Mr. Rana, after his retirement in 1961 as the first Governor, joined the UN service from 1962 until 1986 in the capacity of the Deputy Resident Representative to Sri Lanka and Afghanistan. Subsequently, he was appointed the

Resident Representative of the UN to Myanmar, Indonesia and Pakistan. For four years, Mr. Rana was the Chairman of the Himalayan Bank Ltd., a commercial bank in private sector in the joint partnership with a Pakistani Bank. Since 1986 Mr. Rana has been affiliated with the National Development Council and a number of other institutions.

Mr. Laxmi Nath Gautam

(Tenure: 09 February 1961 - 17 June 1965)

Mr. Laxmi Nath Gautam, the second Governor of the Bank led the Bank further by introducing various reforms. He revamped the operations of the Bank which had far reaching implication on monetisation of the economy and on the internal organization of the Bank. Prior to his assumption as Governor, Mr. Gautam was attached to the Bank as its Director in 1958-59. During his tenure, the "Foreign Exchange Control Act, 1962" was enacted. This Act, made NRB the sole custodian of foreign exchange reserves. Similarly, a campaign for the circulation of Nepalese currency notes throughout the country was launched. For this purpose more expansion of NRB's offices in different parts of the country took place.

Mr. Pradyumna Lal Rajbhandari

(Tenure: 18 June 1965 to 12 August 1966)

During Mr. Pradyumna Lal Rajbhandari's tenure, efforts towards circulation of the Nepalese currency throughout the country and stabilization of the exchange rate gathered further momentum. Mr. Rajbhandari, the third Governor, prior to and following his tenure as Governor has had a long and distinguished career in the HMG civil service, besides holding various diplomatic and constitutional positions.

Dr. Bhekh Bahadur Thapa

(Tenure: 13 August 1966 - 27 July 1967)

The fourth Governor, Dr. Bhekh Bahadur Thapa's tenure is marked by significant reforms. The most important event during his tenure was the success achieved in finally abolishing the dual currency system. This made the Nepali currency the only legal tender in Nepal. Besides, the credit control regulations were framed for the first time. Similarly, the interest rate policy was adopted as an important instrument of the monetary policy. The CRR was also announced for the first time in December 1966. Dr. Thapa brought to the Bank the rich experience of top positions he had earlier held in the civil service. During the latter half of the seventies, he first served as the State Minister of Finance and then Minister of Finance. Dr. Thapa also held various important positions in international organizations like UNDP and IDRC. Dr. Thapa was Nepal's Ambassador to the United States from 1980 to 1985 and has been undertaking the same assignment since February 1996.

Dr. Yadav Prasad Pant

(Tenure: 24 April 1968 - 28 April 1973)

Dr. Yadav Prasad Pant's tenure as Governor saw various institutional reforms including the formulation and announcement of a new interest rate structure in 1971. During his tenure, various promotional activities for banking development including the formation of the Banking Promotion Board were initiated. Dr. Pant had also held top civil service positions in various ministries before his appointment as the fifth Governor. He also happened to be the first Nepali to receive Ph.D. Subsequent to the conclusion of his tenure as Goveror, Dr. Pant held various ministerial positions including the Minister of Finance. He was also the Chairman of the Asian Development Bank during his tenure as the Minister of Finance. He was also appointed as Chairman of the high-level *Economic Commission* in 1979. At present, Dr. Pant is the Chairman of the Bank of Kathmandu, a joint venture with the Siam Commercial Bank of Thailand. Dr. Pant is an internationally renowned personality in the field of banking and finance.

Mr. Kul Shekhar Sharma

(Tenure: 29 April 1973 - 13 December 1978)

During Mr. Kul Shekhar Sharma's tenure, various policy initiatives were undertaken in monetary and external sector. These included the introduction of the Dual Exchange Rate System that replaced the Exporters' Exchange Entitlement (EEE) scheme, popularly known as Bonus Voucher System. During his tenure, the Commercial Bank Act, 1974 replaced the Commercial Bank Act, 1963 and the Rastriya Banijya Bank Act, 1965. Mr. Sharma also introduced the Priority Sector Credit Programme which stipulates commercial banks to advance a minimum proportion of their outstanding deposit liabilities to the traditional and small scale activities in April 1974. Mr. Sharma introduced a major breakthrough in the interest rate policy of the commercial and development banks. Mr. Sharma's tenure is regarded as the era of institutional development in the country's financial system. These include establishment of institutions such as APROSC, Credit Guarantee Corporation, Industrial Service Centre (now National Productivity and Economic Development Centre) and Security Exchange Centre (now Nepal Stock Exchange). Mr. Sharma, the sixth Governor of the Bank is a well-known administrator in Nepal. He had a long and distinguished tenure with the HMG civil service. This included the top position as the Chief Secretary of HMG. Mr. Sharma had also worked at the Secretariat of His Majesty the King. He had also served as the Royal Nepalese Ambassador to the U.S.A from 1969 to 1973 before assuming the responsibility as Governor. After leaving the Bank Mr. Sharma was honoured with the position of Vice-Chairman of the National Population Commission. Besides, he is one of the founders of a reputed and leading Non-government Organisation called *"Institute for Integrated Development Studies"* (IIDS). He also served as Chairman of the Administration Reforms Monitoring Committee in 1992.

Mr. Kalyana Bikram Adhikary

(Tenure: 12 June 1979 - 08 December 1984)

Mr. Kalyana Bikram Adhikary, who led the Bank as the seventh Governor was one of the signatories to the establishment of the SEACEN Centre as a legals entity in Kuala Lumpur, Malaysia, in January 1982. During Mr. Adhikary's tenure the dual exchange rate system was replaced by a basket system of foreign exchange. Mr. Adhikary's tenure also marked the setting-up of the banks as joint-venture arrangements with a view to impart competitiveness and dynamism to the banking system in Nepal. The first such bank was the Nepal-Arab Bank established in 1984. Mr. Adhikary, after his retirement as Governor, was nominated member of the National Development Council by His Majesty the King and subsequently appointed as the Royal Nepalese Ambassador to France. Prior to his appointment as Governor, Mr. Adhikary had worked in important capacities in the civil service and afterwards as Principal Secretary to His Majesty the King. Mr. Adhikary had also worked as the Alternate Executive Director of the Asian Development Bank in Manila.

Mr. Ganesh Bahadur Thapa

(Tenure: 25 March 1985 - 22 May 1990)

Mr. Ganesh Bahadur Thapa is the eighth Governor of the Bank. Mr. Thapa's tenure saw various reforms in the banking sector, the most prominent being the interest rate deregulation effected in May 1986. The Finance Company Act, 1985 was enacted during his tenure. Mr. Thapa had a long experience in central banking. Prior to his appointment as Governor, he had held various senior positions in the Bank including the post of Deputy Governor. Besides, he had been the Chief Executive of the NIDC and Special Officer in HMG. He also worked as Investment Planner under the UNIDO/UNDP Technical Assistance Project in Indonesia for four years. Currently, Mr. Thapa is attached to the *Foundation for Development Cooperation*, a private sector development research organisation based in Australia as a Senior Consultant since 1991. Mr. Thapa is also affiliated with some international aid agencies like the GTZ, IFAD and Micro Credit Project of the World Bank as well as the Asia Pacific Rural Agricultural Credit Association (APRACA) of which he was

Chairman in 1987/1988. Having long experience in the central bank, Mr. Thapa is still actively involved in the field of banking, finance and capital market development. He is the Chairman of a finance company set up in joint venture with a foreign company. Mr. Thapa is also the Chairman of a private consulting firm *Development Associates, Nepal.*

Mr. Hari Shankar Tripathi

(Tenure: 09 August 1990 - 16 January 1995)

The ninth Governor of the Bank Mr. Hari Shankar Tripathi's tenure is associated with the process of financial liberalisation. During Mr. Tripathi's tenure as Governor, Nepal launched remarkable economic reform programmes including the full convertibility of the Nepalese currency in the current account after passing through partial convertibility phase. Similarly, Nepal entered into the Article VIII status of the International Monetary Fund during his term. Mr. Tripathi has had long experience in the Bank in various positions including that of Deputy Governor. Mr. Tripathi has worked in the IMF as a Special Appointee during 1977-78 and as a Consultant of FAO in Somalia for a short period in 1990. Mr. Tripathi is currently a member of the National Planning Commission.

Mr. Satyendra Pyara Shrestha

(Appointed on17 January 1995)

The present Governor, Mr. Satyendra Pyara Shrestha is the tenth Governor of this Bank. Like his two predecessors, Governor Shrestha also comes from within the Bank. He was appointed Governor of the Bank on 17 January 1995 after serving for more than two years as Deputy Governor.

Since his assumption of office as Governor, the country's financial system has undergone unpreceded rate of expansion. The enactment of the Development Bank Act is also a remarkable step taken sometime back. The open and liberal policy initiative has seen the openings of a large number of banks and non-banking finance companies and introduction of various new financial instruments in the system. In view of the additional complexities in the supervision of banks and financial institutions that emerged in the context of financial liberalization, the supervisory mechanism has been strengthened considerably. Similarly, the procedure of import trade through the commercial banks has been systematised. Governor Shrestha has had an illustrious career as Senior Economist of the *'Economic Commission'* and as the Economic Advisor at the Ministry of Finance from 1981-1984. He had served as the Chief Economic Advisor in the Research Department of the Bank for many years. Governor Shrestha had also worked as Advisor in the Executive Director's Office at the IMF from 1988 to 1990.

In addition to the ten personalities illustrated above, the following have shouldered the responsibility as Acting Governors in different periods:

Mr. Puskar N. Pant	28 July 1967 - 23 Apr. 1968
Mr. Yudhir Shumsher Thapa	14 Dec. 1978 - 11 Jun. 1979
Mr. Laba Raj Sharma	09 Dec. 1984 - 24 Mar. 1985
Mr. Hiranya Lal Bajracharya	23 May 1990 - 26 May 1990
Mr. Hari Shankar Tripathi	27 May 1990 - 08 Aug. 1990

7.10 The Bank's Deputy Governors

The provision of the two Deputy Governors was made by the fifth amendment in the Nepal Rastra Bank Act introduced in 1966. However, it was only on 19 November 1969 that the two Deputy Governors, namely, Mr. Dhir Bikram Shah and Mr. Kumar Das Shrestha, took oath of office for the first time. Among the two Mr. Shah had been with the Bank as the Chief Accountant from the very beginning. Mr. Kumar Das Shrestha is so far the only Deputy Governor appointed from outside the Bank. The Deputy Governors are also the members of the BOD. The names of the former Deputy Governors from 1969 till 1995 is as follows:

Kathmandu Banking Office Building

Former Deputy Governors of the Bank

1)	Mr. Dhir Bikram Shah	Nov. 1969	- Nov. 1974
2)	Mr. Kumar Das Shrestha	Nov. 1969	- Nov. 1974
3)	Mr. Yudhir Shumsher Thapa	Dec. 1974	- Sept. 1981
4)	Mr. Ganesh Bahadur Thapa	Dec. 1974	- Nov. 1978
5)	Mr. Iswari Raj Pandey	Dec. 1979	- Nov. 1982
6)	Mr. Laba Raj Sharma	Sept. 1982	- Aug. 1987
7)	Mr. Hari Shankar Tripathi	Aug. 1985	- May 1990
8)	Mr. Hiranya Lal Bajracharya	Sept. 1987	- July 1992
9)	Mr. Achyut Prasad Poudyal	Feb. 1991	- Dec. 1992
10)	Dr. Harihar Dev Pant	Dec. 1992	- Jan. 1995
11)	Mr. Satyendra Pyara Shrestha	Dec. 1992	- Jan. 1995
12)	Dr. Puspa Raj Rajkarnikar	Jan. 1995	- Nov. 1995

Besides, the late Mr. Keshav N. Sharma, a Special Class Officer had also served as Acting Deputy Governor from December 1982 until September 1984.

7.11 The Bank's Directors

As mentioned earlier, Nepal Rastra Bank's Board of Directors, the apex policy making body, constitutes of seven members of which four Directors are nominated by HMG. The schedule of the members of the Board of Directors from its very inception is presented in *Annexure IV.*

Annexure I

BOARD OF DIRECTORS

CHAIRMAN

Mr. Satyendra Pyara Shrestha : Governor, Nepal Rastra Bank

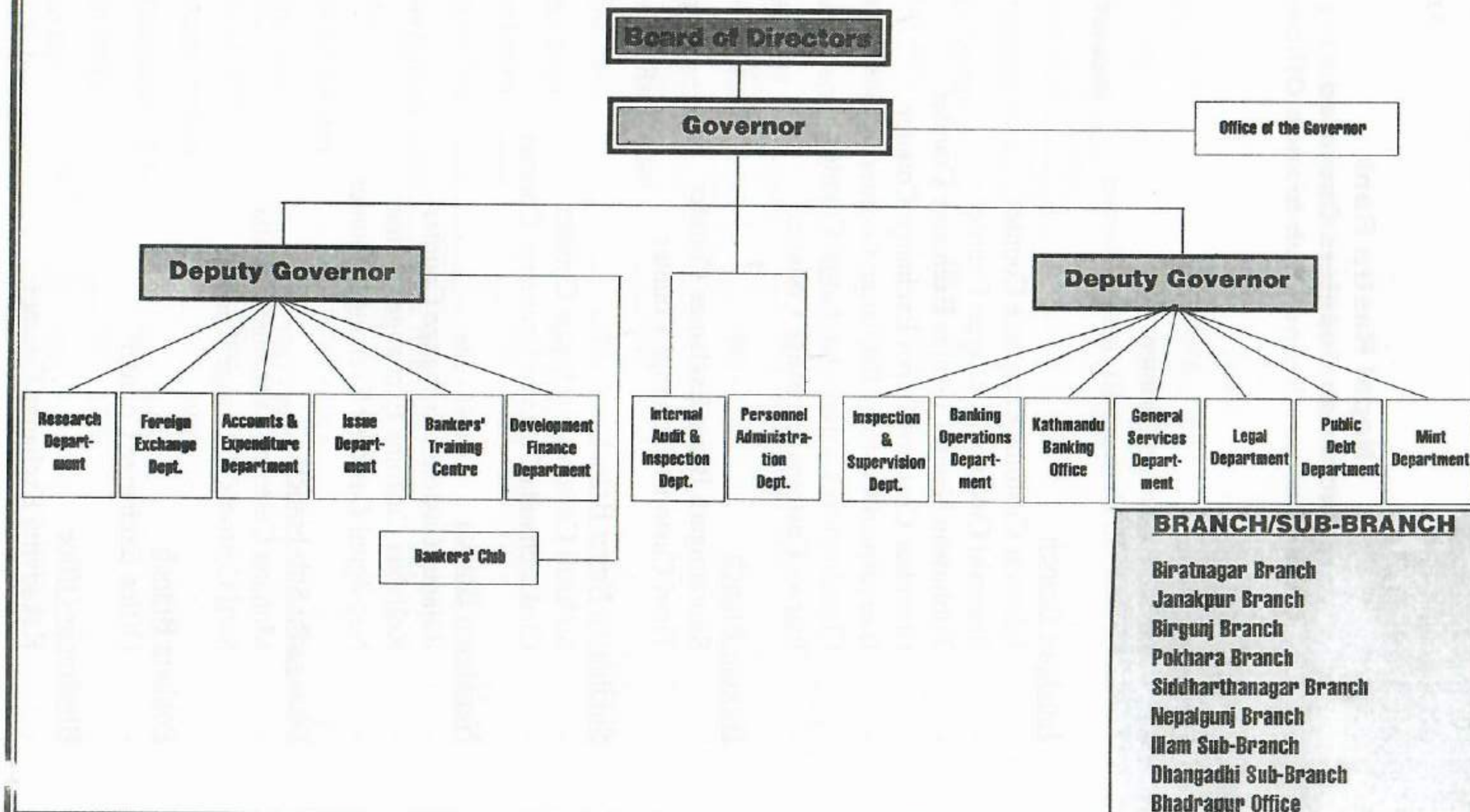
MEMBERS

Dr. Ravindra Kumar Shakya	:	Member-Secretary National Planning Commission
Dr. Bhola Nath Chalise	:	Secretary, Ministry of Industry
Mr. Ram Binod Bhattarai	:	Secretary, Ministry of Finance
Dr. Prafulla Kumar Kafle	:	Deputy Governor, Nepal Rastra Bank
Mr. Bharat Krishna Sharma	:	Deputy Governor, Nepal Rastra Bank

Annexure II

NEPAL RASTRA BANK

Organisational Structure



Annexure III

Nepal Rastra Bank
Exchange Counters Operated
Under Various Branch/Sub-branch Offices

Biratnagar Branch
- Office Exchange Counter
- Setubandh Customs Exchange Counter

Janakpur Branch
- Jaleswar Customs Exchange Counter
- Shamshi Customs Exchange Counter
- Tribhuwan Nagar Customs Exchange Counter
- Bhandsar Customs Depot Exchange Counter
- Bariyarpatti Customs Exchange Counter
- Chandraguny Customs Exchange Counter
- Inarwa Customs Exchange Counter.

Birgunj Branch
- Simraungarh Bazar Exchange Counter
- Thori Customs Exchange Counter

Siddhartha Nagar Branch
- Suthauli Customs Exchange Counter
- Chakarchauda Customs Exchange Counter

Nepalgunj Branch
- Rajapur Customs Exchange Counter
- Koilabas Customs Exchange Counter
- Nepalgunj Customs Exchange Counter

Dhangadhi Sub-branch
- Mohana Customs Exchange Counter
- Satti Customs Exchange Counter

Pokhara Branch
- Office Exchange Counter

Bhadrapur Office
- Kakadvitta Exchange Counter

Annexure- IV

Former Members of Board of Directors

	Tenure
Mr. Nara Pratap Thapa	1956 - 1960
Mr. Krishna B. Mugali Thapa	1956 - 1959
Mr. Hiranya Dhoj Joshi	1956 - 1960
Mr. Gaya Prasad Shah	1956 - 1957
Mr. Parikshit Narsingh Rana	1958 - 1959
Mr. Laxmi Nath Gautam	1958 - 1959
Mr. Ram Prasad Joshi	1959 - 1960
Dr. Yadav Prasad Pant	1960 - 1965, 1966 - 1967
Mr. Harihar Jung Thapa	1960, 1971 - 1972
Mr. Puskar Nath Pant	1960, 1965 - 1966, 1969
Mr. Sri Jung Shah	1961 - 1963
Mr. Sumer Mal Dugad	1961 - 1963
Mr. Pradyumna Lal Rajbhandari	1961 - 1963
Mr. Krishna Bam Malla	1963 - 1965
Mr. Naresh Man Singh	1963 - 1967
Mr. Lila Prasad Lohani	1963 - 1967, 1969 - 1975
Mr. Shiva Narayan Das	1965 - 1966
Mr. Kumar Mani Acharya Dikshit	1966 - 1967, 1967 - 1969
Dr. Bhekh Bahadur Thapa	1967 - 1971
Mr. Kalyana Bikram Adhikary	1967 - 1969
Mr. Mani Harsha Jyoti	1967 - 1973
Mr. Bishnu Prasad Dhital	1969
Mr. Bharat Bahadur Pradhan	1972 - 1976
Mr. Pashupati Shumsher J.B.R.	1973 - 1975
Dr. Mohan Man Sainju	1975 - 1979
Mr. Hari Prasad Giri	1975 - 1978

	Tenure
Mr. Devendra Raj Upadhyay	1975 - 1976
Mr. Nara Kant Adhikary	1976 - 1978
Mr. P. B. Bista	1976 - 1977
Mr. Ishwari Lal Shrestha	1977 - 1978, 1982 - 1986
Mr. Dirgha Raj Koirala	1978 - 1979
Dr. Devendra Raj Pandey	1978 - 1979
Mr. Indra Bhakta Shrestha	1978 - 1979
Prof. Khelendra Prasad Pandey	1979 - 1980
Mr. Bhuban Man Singh	1979 - 1983
Mr. Ram Prasad Sharma	1979
Mr. Surya Prasad Shrestha	1980 - 1982
Mr. Gorakshya B. Nhuchhe Pradhan	1980 - 1981
Dr. Parthibeshwar P. Timilsina	1980 - 1983
Mr. Jitendra Lal Maskey	1981
Mr. Karna Dhoj Adhikary	1981 - 1985
Mr. Shankar Krishna Malla	1981 - 1983
Dr. Mahesh Banskota	1983 - 1987
Mr. Janak Bahadur Shaha	1984 - 1987
Mr. Lok Bahadur Shrestha	1985 - 1989
Mr. Radha Raman Upadhyay	1986 - 1989
Dr. Badri P. Shrestha	1987 - 1991
Mr. Madhukar Shumsher J.B.R.	1987 - 1990
Dr. Shashi Narayan Shah	1989 - 1992
Mr. Bhuwaneshwar Khatri	1989 - 1990
Dr. Guna Nidhi Sharma	1990 - 1991
Mr. Ganapat Lal Rajbhandari	1991
Dr. Narsingh Narayan Singh	1991 - 1992
Mr. Prithvi Raj Ligal	1991 - 1994
Dr. Thakur Nath Pant	1992 - 1994
Mr. Punya Prasad Dahal	1992 - 1995
Dr. Dilli Raj Khanal	Feb - Dec. 1995

Annexure V

Representation by Nepal Rastra Bank Officials to Various Institutions

(as at Mid-April 1996)

Institutions	Name of the Official	Status
Nepal Bank Ltd.	Deputy Governor, Dr. Prafulla K. Kafle	Director
Rastriya Computer Kendra	Deputy Governor, Dr. Prafulla K. Kafle	Director
Eastern Rural Dev. Bank Ltd.	1. Deputy Governor, Dr. Prafulla K. Kafle	Chairman
	2. Deputy Chief Manager, Ganesh Pd. Adhikary	Director
Rastriya Banijya Bank	Deputy Governor, Mr. Bharat K. Sharma	Director
Credit Guarantee Corporation	1. Deputy Governor, Mr. Bharat K. Sharma	Chairman
	2. Chief Currency Officer, Mr. Achyut P. Bajgain	Director
Far-Western Rural Dev. Bank Ltd.	1. Deputy Governor, Mr. Bharat K. Sharma	Chairman
	2. Chief Manager, Mr. Shalik Ram Sharna	Director
Western Rural Dev. Bank Ltd.	1. Branch Manager, Mr. Lekh Nath Bhusal	Director
	2. Deputy Chief Officer, Mr. Gopal P. Kafle	Executive Director
Mid-Western Rural Dev. Bank Ltd.	1. Chief Manager, Mr. Ram Babu Pant	Chairman
	2. Deputy Chief Manager, Mr. Bhagat Bista	Director
Agricultural Projects Service Centre	1. Chief Manager, Mr. Shalik R. Sharma	Director
	2. Economic Advisor, Mrs. Roza Upadhyay	Director
Citizen Investment Fund	Chief Manager, Mr. Bhaskar P. Risal	Director
Rastriya Beema Sansthan	Chief Manager, Mr. Jaya R.S. Bohra	Director
Nepal Arab Bank Ltd.	Chief Manager, Mr. Tulak B. Rana	Director
Nepal Industrial Dev. Corporation	Principal, Mr. Bodhi B. Bajracharya	Director
Town Dev. Fund Board	Chief Manager, Mr. Ram Babu Pant	Director
Agricultural Input Corporation	Advisor to the Governor, Mr. Bimal N. Rimall	Director
National Prod. & Eco.Dev. Centre	Chief Eco. Advisor, Mr. Mukunda Pd. Sharma	Invitee
Bank of Kathmandu	Chief Eco. Advisor, Mr. Mukunda Pd. Sharma	Director
Housing Dev. Finance Corporation	Chief Accountant, Mr. Manohar Lal Shrestha	Permanent Invitee
Agricultural Development Bank	Chief Accountant, Mr. Manohar Lal Shrestha	Director
Nepal Bangladesh Bank Ltd.	Chief Controller, Mr. Bijaya Nath Bhattarai	Director
Security Board	Economic Advisor, Mrs. Nani Baba Risal	Director
Nepal Stock Exchange Ltd.	1. Deputy Chief Manager, Mr. Bhai Kaji Shrestha	Director
	2. Chief Officer, Mr. Madan Prasad Acharya	Director

Annexure VI

Principal Officers

Office of the Governor

Mr. Bimal Nath Rimall ---------------------------------- Advisor to the Governor
Mrs. Chandika Amatya ---------------------------------- Chief Public Relation Officer
Mr. Bhola Ram Shrestha -------------------------------- Board Secretary

Personnel Administration Department

Mr. Tulak Bikram Rana --------------------------------- Chief Manager
Mr. Sudarshan Poudyal --------------------------------- Computer Manager
Mr. Kishor Kumar Shah --------------------------------- Deputy Chief Manager

Accounts and Expenditure Department

Mr. Manohar Lal Shrestha ----------------------------- Chief Accountant
Mr. Dev Lal Kisi -- Deputy Chief Accountant
Mr. Surendra Man Pradhan -------------------------- Deputy Chief Accountant
Mr. Bharat Raj Joshi ------------------------------------ Deputy Chief Accountant
Mr. Madan Khatri -- Deputy Chief Accountant

Internal Audit and Inspection Department

Mr. Rajan Singh Bhandari ----------------------------- Deputy Chief Inspector

Foreign Exchange Department

Mr. Bijaya Nath Bhattarai ------------------------------ Chief Controller
Mr. Krishna Bahadur Manandhar ------------------- Deputy Chief Controller
Mr. Narayan Prasad Manandhar -------------------- Deputy Chief Controller

Research Department

Mr. Mukunda Prasad Sharma ------------------------ Chief Economic Advisor
Mrs. Roza Upadhyay ----------------------------------- Economic Advisor
Mrs. Nani Baba Risal ----------------------------------- Economic Advisor
Mr. Keshav Prasad Acharya -------------------------- Economic Advisor
Mr. Surjit Prasad Shrestha ----------------------------- Economic Advisor
Mrs. Rita Pant -- Economic Advisor
Mr. Deependra Bahadur Kshetry -------------------- Economic Advisor
Dr. Yuba Raj Khatiwada -------------------------------- Economic Advisor
Dr. Danda Pani Poudyal -------------------------------- Economic Advisor

Banking Operation Department
Mr. Ram Babu Pant ------------------------------------ Chief Manager
Mr. Ganesh Prasad Adhikary ------------------------ Deputy Chief Manager
Mr. Krishna Kumar Pradhan-------------------------- Deputy Chief Manager
Mr. Bhai Kaji Shrestha--------------------------------- Deputy Chief Manager

Development Finance Department
Mr. Shalik Ram Sharma-------------------------------Chief Manager
Mr. Bhagat Singh Bista -------------------------------- Deputy Chief Manager
Mr. Ganesh Kumar Shrestha------------------------- Deputy Chief Manager

Inspection and Supervision Department
Mr. Jaya Ram Singh Bohra--------------------------- Chief Manager
Mr. Ram Bhakta Thapa-------------------------------- Deputy Chief Manager
Mr. Damodar Prasad Sharma------------------------ Deputy Chief Manager
Mr. Tanka Nath Khanal --------------------------------- Deputy Chief Manager
Mr. Bir Bikram Rayamajhi------------------------------Deputy Chief Manager
Mr. Sudhir Kumar Regmi-------------------------------Deputy Chief Manager
Mr. Bigyan Prasad Poudyal ------------------------- Deputy Chief Manager

Bankers Training Centre
Mr. Bodhi Bajra Bajracharya ------------------------- Principal
Mr. Guru Prasad Neupane --------------------------- Vice Principal
Mr. Santosh Bahadur Gharti ------------------------- Vice Principal
Dr. Govinda Bahadur Thapa ------------------------- Vice Principal

Kathmandu Banking Office
Mr. Bhaskar Prasad Risal------------------------------Chief Manager
Mr. Madhav Prasad Aryal ------------------------------Deputy Chief Manager
Mrs. Ambika Pradhan-----------------------------------Deputy Chief Manager

Issue Department
Mr. Achyut Prasad Bajgain --------------------------- Chief Currency Officer
Mr. Bishnu Prasad Shrestha ------------------------- Deputy Chief Currency Officer

General Service Department
Mr. Bal Krishna Subedi---------------------------------Chief Officer

Mint Department
Mr. Upendra Keshari Poudyal ----------------------- Chief Officer

Legal Department
Mr. Madan Prasad Acharya --------------------------- Chief Officer

Public Debt Department
Mr. Dibya Nidhi Bista ------------------------------------ Chief Officer

Branch/Sub-Branch Managers

Biratnagar Branch
Mr. Ram Bahadur Aryal ---------------------------------- Branch Manager

Janakpur Branch
Mr. Tulsi Prasad Uprety --------------------------------- Branch Manager

Birgunj Branch
Mr. Shiva Bikram Shah ---------------------------------- Branch Manager

Pokhara Branch
Mr. Madhav Prasad Bhatta ---------------------------- Branch Manager

Siddharthanagar Branch
Mr. Lekh Nath Bhusal ------------------------------------ Branch Manager

Nepalgunj Branch
Mr. Shil Shagar Mani Tripathi ------------------------- Branch Manager

Illam Sub-Branch
Mr. Jiwan Bahadur Shrestha -------------------------- Sub-Branch Manager

Dhangadhi Sub-Branch
Mr. Satya Prakash Ojha --------------------------------- Sub-Branch Manager

Bhadrapur Office
Mr. Mahesh Shrestha ------------------------------------- Office Chief

First Class Officers on Study Abroad

Mr. Tula Raj Basyal

Nepal Rastra Bank Branch Office Building, Pokhara

Nepal Rastra Bank Guest House, Pokhara

Annexure VII

Some Major Publications of Nepal Rastra Bank

Regular Publications

1. Annual Report (in Nepali and English)
2. Economic Report (English)
3. Quarterly Economic Bulletin (English)
4. Main Economic Indicators (English Monthly)
5. Economic Review: Occasional Papers (English)
6. Socio-Economic Indicators
7. Nepal Rastra Bank Samachar Monthly (Nepali Monthly)
8. Nepal Rastra Bank Samachar Special Anniversary Issue (in Nepali)
9. Mirmire (Nepali Monthly)
10. Banking and Financial Statistics
11. Prashikshyan (Nepali Monthly)
12. Prathmikta Kshetra Samachar (Nepali)
13. "Banking Prabardhan" (Nepali Half Yearly)

Special Publications

1. Nepal Rastra Bank Silver Jubilee Year: 2013 - 2038 (in Nepali)
2. Country Profile of Members States of SAARC, 1987.
3. Monetary & Financial Development in Nepal, 1974 (in Nepali) : Published on the occasion of the Coronation of His Majesty King Birendra Bir Bikram Shah Dev.
4. Nepal Rastra Bank : An Introduction, 1974 and 1982. (in Nepali)
5. An Introduction to IMF (in Nepali)
6. An Introduction to World Bank (in Nepali)

Survey/Study Reports and Publications on Banking and Finance

1. Activities of Sajha Institutions (Survey Report of F.Y. 1976/77)
2. Multi-purpose Household Budget Survey, 1989
3. Tourist Expenditures Survey, 1989.
4. Industrial Survey Report (1977)
5. Agricultural Credit Survey, 1972.
6. Agricultural Credit Review Survey, 1980

7. Nepal Rural Credit Review, 1994
8. Impact Evaluation of Small Farmers Development Programme, 1991
9. Income and Employment Generation from Tourism in Nepal, 1989
10. Banking and Development, Y. P. Pant, 1971
11. Banking and Development Ed. H.D. Pant, 1969
12. SEANZA Lectures, 1985.

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Nepal Rastra Bank, *Quarterly Economic Bulletin,* Various Issues.

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Pant, B.D., A Short History of Banking, Currency and Commerce in Nepal, 1943.

Pant, R. D., *Interest Rate Policy in Nepal,* (A Study Sponsored by IDS and IDRC) Ottawa, Canada, 1983.

Various Publications from :

(1) IMF (2) The World Bank (3) The SEACEN Centre (4) APRACA (5) ACU (6) ADB/M and (7) SEANZA