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RURAL SAVINGS MOBILIZATION IN NEPAL

Krishna B. Harnal

Mukti P. Upadhyay

HMG-USAID-GTZ-IDRC-WINROCK PROJECT

STRENGTHENING INSTITUTIONAL CAPACITY IN THE

FOOD AND AGRICULTURAL SECTOR IN NEPAL

FOREWORD

This Research and Planning Paper Series is funded through the project, "Strengthening Institutional Capacity in the Food and Agricultural Sector in Nepal," a cooperative effort by the Ministry of Agriculture (MOA) of His Majesty's Government of Nepal and the Winrock International Institute for Agricultural Development. This project has been made possible by substantial financial support from the U.S. Agency for International Development (USAID), the German Agency for Technical Cooperation (GTZ), and the Canadian International Development Research Centre (IDRC).

One of the most important activities of this project is funding for problem-oriented research by young professional staff of agricultural agencies of the MOA and related institutions. In particular, funding is provided by the IDRC to support the activities of the Research and Planning Unit (RPU) of the Agricultural Projects Services Centre (APROSC). This research is carried out with the active professional assistance of the Winrock staff.

The purpose of this Research and Planning Paper Series is to make the results of the research activities of APROSC's Research and Planning Unit available to a larger audience, and to acquaint younger staff and students with advanced methods of research and statistical analysis. It is also hoped that publication of the Series will stimulate discussion among policymakers and thereby assist in the formulation of policies which are suitable to the development of Nepal's agriculture.

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Michael B. Wallace
Series Editor

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RURAL SAVINGS MOBILIZATION IN NEPAL

Krishna B. Hamal*
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ABSTRACT

This research examines efforts at generating greater rural savings in Nepal. Arguing that expansion of internal resources are crucial for economic growth and increased employment, the study analyzes the economics of rural areas, the process of savings generation, national banking policies, and various strategies taken by financial institutions to increase the propensity to save. The study concludes with a consideration of future difficulties with rural savings mobilization and presents a series of policy recommendations designed to tap savings within the existing banking framework as well as to increase peoples capacity to save.

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INTRODUCTION

The significant increase in public expenditure each year since 1951 clearly indicates government demand for financial resources is growing rapidly. In the absence of sufficient resources, strategies designed to achieve higher economic growth and create more employment opportunities have not been implemented. Resources, either internal or external, are essential to meet the demand for increased investments for development.

However, in the long run external resources can neither be relied upon nor increased at the same rate as investment. Dependency on external resources is increasing each year--definitely not a good sign for the country's development. During 1956-85, the share of foreign aid in the total outlay of the country is estimated to be 60 percent, 40 percent being from domestic resources. Similarly, 64 percent of the total development expenditure of the Sixth Five-Year Plan is to be financed from foreign aid. Such heavy reliance on foreign aid has not proven fruitful in the past. Rather, this aid has adversely affected domestic savings by slowing the rate of growth through the negative effects of a relatively high incremental capital-output ratio (Ligal, 1980). Realizing these facts, the present policy of the government aims to decrease dependence on external resources in the future. Thus, mobilizing internal resources is essential to meet demands for increased investment in order to achieve the objectives of increasing economic growth as well as employment opportunities.

Mobilization of savings implies transfer of resources from surplus spending units to deficit units. Mobilization of voluntary savings is the main function of financial intermediaries. The amount of savings of a typical household in Nepal is small because the people have limited opportunities for financial investment. They prefer to spend savings on commodities rather than hold financial assets. This restricts the process of financial intermediation which might otherwise bring benefits such as reduction of investment risk and increase in liquidity.

In Nepal, before the middle of the 1970s, greatest attention was paid to the flow of savings available at financial institutions experiencing excessive credit demand and little thought was given to increasing this severely inadequate supply. Numerous potential sources existed to transform savings from their unproductive forms and increase the effective volume of resources for productive investment. The financial reforms undertaken in 1974-75 directly aimed to overcome the resource constraint to development. The record so far points to considerable successes in the aspect of savings collection. However, the other vital aspect of financial intermediation, namely, the channeling of resources to productive sectors has left much to be desired. Consequently, the financial system has remained ineffective both in meeting the resource gap of the private sector and in stimulating investment activities.

There are two important reasons for the increase in the volume of savings mobilized: high interest rates, and the opening of new bank branches. Additions to the branch network in the 1970s took place mainly in the rural and remote areas. As these bank branches were thought to have amply contributed to deposit expansion, it seemed wise to use them in introducing rural credit facilities. Yet loans proved to

be more readily available to businessmen with existing deposits, marketable collateral and low supervision costs, and less accessible to small farmers. Not only in lending but in all aspects of financial intermediation, the banks operated hesitantly in the rural regions. Savings mobilization was not emphasized. Deposits collected by newer branches have remained insignificant and thus branch expansion is an associative rather than a causal factor behind impressive increases in total deposits. Although during much of the Sixth Plan (1980-85) bank savings have remained highly liquid due to slack in the effective credit demand by the trade sector, rural credit demand has remained largely unattended, further indicating urban bias.

Savings mobilization inertia in rural areas raises many questions. Is the rural economy unable to save as much as the urban? Is the rural savings pattern so different from the urban pattern as to require different savings mobilization strategies? How does rural lending policy link with the strategy for mobilizing rural savings? What have been the weaknesses in the current programs of rural savings mobilization?

Though it may be argued that rural savings do not exist, small farmers must subsist between planting and harvest times (Vogel, 1982), and must have savings to meet emergencies. Credit, available only to those who have actual or potential savings, has been extended to meet such emergencies, indicating that savings do exist in the rural sector.

One supportive argument for the idea that rural savings mobilization is an essential part of financing rural projects in developing countries is that the financial policies which encourage savings are more effective in redistributing income among rural poor than projects based on low interest rates for loans. Evidence shows that many such projects in Nepal have led to credit misuse or rationing due to over-demand. Once credit is rationed, it is likely knowingly, or unknowingly, to disadvantage small borrowers.

A second supportive argument for rural savings mobilization is that besides lending, one of the important activities of financial institutions is to pool resources from many small savers to carry out large scale projects that directly or indirectly benefit the rural poor. Therefore, mobilizing rural savings is also a viable means to bring about equity in distribution of income among the rural poor.

A third argument is that without savings mobilization, financial institutions are incomplete, for they fail to provide adequate services to rural savers. In addition these institutions make themselves less viable as observed in the high rates of delinquency and default that plague most agricultural development banks (Vogel, 1981). Moreover, borrowers may repay more promptly if they know resources come from their neighbors rather than international donors, and lenders are more likely to take responsibility for loan recovery.

Lastly, by mobilizing rural savings effectively, financial institutions may have a continual flow of resources available for lending. Those institutions neglecting savings mobilization, such as ADB/N and cooperatives, are likely to face crises as the government and donor agencies withdraw support.

Objectives of the Study

This study has the following specific objectives:

a) to examine the existing situation regarding rural savings mobilization in Nepal; and
b) to assess problems and prospects of mobilizing savings from the rural sector in Nepal.

Methodology

The study is based on secondary information collected from financial institutions, such as Nepal Rastra Bank (the central bank), ADB/N, cooperatives, commercial banks and other relevant sources. Mostly time series data have been used in analysis, primarily for the period from 1969/70 to 1982/83.

ECONOMICS OF RURAL AREAS

Rural Areas and Their Socioeconomic Condition

In Nepal, "rural area" is defined as the area under a village panchayat which covers from one to five villages whereas "urban area" is defined as the area under a town panchayat. There are 29 town panchayats and 4022 village panchayats in Nepal (1981 census). The rural population in 1981 was 14.01 million, 93 percent of the national population. About 2.08 million households exist in rural areas with an average family size of seven. The major sources of employment in the rural sector are agriculture and cottage industry. Agriculture alone provides employment to over 90 percent of the total labor force in the country, whereas cottage industry accounts for a meager 6.6 percent. During 1979/80, 93 percent of the total economically active labor force were employed partially or fully in agriculture.

According to 1981 census results, the urban population is increasing at a faster rate than the rural population. Population growth rates in urban and rural areas are respectively 6.5 and 2.5 percent per annum. Explanatory variables for the high urban rate include the comparatively low infant mortality rate (67.20 to 105.10 per 1000 live births), low child death rate (11.10 to 25.50 per children ages 1 to 4), and low crude death rate (12.20 to 18.50). An increase in the number of town panchayats as well as higher in-migration to urban areas also raise the urban growth rate. In 1977/78, immigrants to urban and rural areas were 52,700 and 23,300, respectively.

In 1977, the percentage of the population below poverty line was 37 in the countryside and 16 in towns. Estimates of 1971 indicate the per capita income of rural people was Rs.950 per year, almost 55 percent lower than the urban per capita income. The rural literacy rate is only 12 percent, whereas the urban rate is 45 percent.

The 1976/77 unemployment rates in both rural and urban areas were about six percent. The annual average under-employed days of family labor per worker in rural and urban areas were 63 and 44 percent. Employment opportunities in the nonagricultural sector in rural areas are limited. People of rural areas have fewer drinking water, health service and transportation facilities than urban residents.

Rural Areas and Gross Domestic Product (GDP)

The total GDP of Nepal in 1969/70 was Rs.9816 million which rose to Rs.33,621 million in 1982/83. The compound annual growth rate of GDP between the period 1969/70 to 1982/83 was 9.9 percent.

Agriculture contributes a high percentage of the total GDP: 70 percent in 1969/70, 67 percent in 1975/76 and 53.4 percent in 1982/83. The declining trend is due to an increase in the growth rate of the nonagricultural sector as well as stagnating agricultural productivity during the period 1970/71 to 1982/83. The agricultural GDP has increased from Rs.6875 million in the year 1969/70 to Rs.17,942 million in the year 1982/83. The compound annual growth rate of the agricultural GDP was 7.7 percent during the period.

The nonagricultural GDP is increasing at a faster rate than the agricultural GDP. During the period 1969/70-1982/83, it grew at a compound annual rate of 13.7 percent from Rs.2941 million to Rs.15,679 million (Central Bureau of Statistics).

Financial Institutions in Rural Areas

Four types of financial institutions--commercial banks, ADB/N, cooperatives, and post office saving banks, are currently operating in rural Nepal. The total number of financial institutions in rural areas has increased from 175 in 1970/71 to 1111 in 1982/83, reflecting an annual growth rate of 16.7 percent. Similarly, during the same period the compound annual growth rates of the number of commercial banks, ADB/N and cooperatives in rural areas are 10.4, 21.4, and 17.7 percent respectively. Regarding the post office savings scheme which started functioning in 1976/77, the number of savings banks in rural areas rose from three in that year to 30 in 1982/83.

In 1982/83, the shares of commercial banks, ADB/N, cooperatives and post office savings banks of all rural financial institutions were 17, 17, 64, and three percent respectively. The high percentage share of cooperatives reflects the fact that these institutions were specially developed for rural people and aim to serve every village of Nepal. The density ratio--the ratio of population to total number of institutions--is one financial institution per 13,655 rural people, while urban centers have one financial institution per 6192 people.

SAVINGS GENERATION

Policies to generate savings have two concerns: to transform the existing savings level and to enhance the rate of savings. The transformation of savings from socially-unproductive inflation hedges and real estate holdings to more productive forms is usually considered an objective in its own right, but it also contributes directly to increasing the productivity as well as the volume of investment. This chapter seeks to explain how the gross domestic savings rate has moved over time and how financial savings have grown in volume and structure. The contribution of various policies to converting savings into financial forms and the role of monetary policy are analyzed in the next chapter.

The Rate of Savings

Efforts to mobilize savings in a developing country like Nepal have to withstand controversy regarding the nation's ability to save. The contention of those favoring an "investment-first" approach over a "savings-first" strategy is that in a country where consumption levels are already low, raising the savings rate may induce further reduction. The argument raises questions regarding the identification of minimum consumption needs which a policy of savings mobilization should take into account. The problem with this approach is the skewed distribution of income in most developing countries, where a large proportion of the population live below the standard "minimum" nutritional level of consumption. Many empirical findings have shown that, given incentives, developing countries display an unexpectedly significant capacity to save. An estimate of the average propensity to save could indicate the extent to which policies might be geared toward savings mobilization.

Except for the estimates for gross domestic product, Nepal's published national income accounts reveal little of consequence, especially after 1980/81. During the preparation of the Sixth Plan, national income was estimated by demand aggregates from 1974/75 through 1979/80. Gross domestic savings were treated as the difference between income and consumption. The figures are not wholly reliable but for lack of superior estimation they are indirectly shown in terms of savings as a proportion of GDP. The average propensity to save (APS) or the savings ratio as reported by the Central Bureau of Statistics exhibits uneven growth from the 1970s onwards. Between 1974/75 and 1978/79, the APS showed an increasing trend but has fallen gradually from 9.3 percent to 8.4 percent in 1981/82. A considerable decline in real GDP in 1982/83 has probably led to the further and drastic reduction in savings rate. The estimated ratio is 5.4 percent. The basis used for the measurement of APS is current income which itself has fluctuated over the years. Assuming that consumption does not move as unevenly as GDP, particularly in years of economic slowdown, the declining agricultural productivity and poor overall performance of the economy have adversely affected savings in recent years. Consequently the savings rate has recorded an average decline of 2.6 percent per year from 1970 to 1983.

The savings-income ratio has generally followed the same trend as the GDP. Both 1979/80 and 1982/83 were drought years, witnessing a fall in national income in real terms, and a part of potential savings was used for consumption purposes. This however, is only part of the explanation of how savings rates are influenced. Another factor that has assumed significance in Nepal particularly since 1975 is the interest rate. Interest is the benefit of savings. A rise in interest rate raises the price of consumption and induces an increase in the proportion of income that is saved rather than consumed. Following substantial increases in interest rate on bank deposits in 1974/75, the savings rate also showed a tendency to rise. In 1976/77, the GDP at constant prices decreased by three percent but the savings ratio went from the preceding year's seven percent to ten percent, a growth of 41 percent.

Growth and Structure of Financial Savings

Financial savings have gradually become a more important part of gross domestic savings. In Nepal, with the relatively low rate of

monetization, currency and savings deposits serve as forms in which savings are held. If the value of money is stabilized by keeping inflation rates low, the attraction of money as a savings repository is enhanced. In this case, even the money stock narrowly defined (M1) can indicate the relative strength of financial savings. In this light, the M1/GDP ratio in Nepal has moved largely in the right direction. From 7.8 percent in 1969/70, it rose to 13.7 percent in 1982/83 recording 4.4 percent compound annual growth during those years. Most of the increase in the M1/GDP ratio came in the period of post-interest-rate reform after 1975.

Better indicators of the growth of financial savings, as well as financial development, are the savings and time deposits. The faster the rate at which fragmented financial markets are consolidated, the faster will savings take financial forms, mainly time and savings deposits. The record of deposit growth has been the most impressive of all Nepal's financial indicators. As a fraction of GDP, time and saving deposits went up from an insignificant two percent in 1969/70 to over 14 percent in 1982/83, rising almost one percent every year. The deposit/GDP ratio increased during the same period by a compound annual rate of 16.2 percent. Unlike the M1/GDP ratio, the ratio of time and savings deposits to GDP has followed a more or less sustained growth trend. Between 1970 and 1983 it increased annually by 16.3 percent. Since 1981/82, time and savings deposits have overtaken money stock as the largest contributor to broad money (M2).

The importance of increasing financial savings relative to national income stems from the fact that these assets, in public hands, serve as a conduit for savings. Besides, as cogently argued by McKinnon (1973), these assets are complementary to real investment in a society where self-finance is the only important source of investment. Self-finance is not a necessary condition for the complementarity hypothesis to prove true, if it is held that money is the channel through which real resources are made available for investment. Weakening if not removing the financial constraint by increasing the supply of financial assets (M2) was among the main objectives of interest rate reform in 1975.

An examination of institutional deposits (Table 1) reveals that commercial banks are the only major intermediaries for deposit mobilization because there are no savings institutions other than commercial banks. The Agricultural Development Bank (ADB/N) is not permitted (as of 1983) to conduct commercial banking business except where commercial banks have no office. The post office savings scheme, launched in 1975, has mobilized deposits too small to make an appreciable impact on overall deposits of financial institutions, and is excluded from Table 1. Nongovernment deposits at Nepal Rastra Bank, which are a part of demand deposits (and M1), were also excluded. In nominal terms total deposits at financial institutions expanded by 24.2 percent annually between 1969/70 and 1982/83 while in real terms annual deposit growth was 14.5 percent. Per capita deposit increased sixfold in the decade 1972/73-82/83. At constant prices the per capita deposit was 2.4 times higher.

Table 1. Total Deposits in Financial Institutions, 1969/70-1982/83 (Million Rupees)

Year	Current Value CBs	ADB/N	Total	Annual Change(%)	Real* Value	Annual Change(%)
1969/70	348.4	5.4	353.8	-	418.2	-
1970/71	441.1	3.8	444.9	25.7	490.0	17.2
1971/72	591.9	4.6	596.5	34.1	644.9	31.6
1972/73	728.3	4.9	733.2	22.9	733.2	13.7
1973/74	875.9	6.3	882.2	20.3	746.4	1.8
1974/75	1128.7	7.4	1136.1	28.8	823.3	10.3
1975/76	1530.5	9.3	1539.8	35.5	1123.9	36.5
1976/77	2055.1	51.4	2106.5	36.8	1497.2	33.2
1977/78	2405.8	49.1	2454.9	16.5	1569.6	4.8
1978/79	2812.2	40.7	2852.9	16.2	1763.2	12.3
1979/80	3239.6	35.1	3274.7	14.8	1843.9	4.6
1980/81	3964.6	31.1	3995.7	22.0	1984.0	7.6
1981/82	4699.0	35.0	4734.0	18.5	2128.6	7.3
1982/83	5865.6	36.6	5902.2	24.7	2434.9	14.4
Annual growth rate 69/70-82/83(%)				24.1	14.5	
Per capita deposits, 1972/73 (Rs)				61	61	
Per capita deposits, 1982/83 (Rs)				373	147	

* Deflated by consumer price index (1972/73 = 100). Total includes demand, savings and time deposits. Current value excludes post office savings whose share in deposits is negligible. Source: Nepal Rastra Bank Quarterly Economic Bulletin; Monetary Statistics, (mimeo), ADB/N.

Table 2. Structure of Deposits by Type (Million Rupees)

Years	Demand Value	Demand Share(%)	Savings Value	Savings Share(%)	Time Value	Time Share(%)	Total Value	Total Share(%)
1969/70	151.6	43.5	52.9	15.2	143.9	41.3	348.4	100
1974/75	438.6	38.9	172.7	15.3	517.4	45.8	1128.7	100
1975/76	524.8	34.3	198.0	12.9	807.7	52.8	1530.5	100
1976/77	725.1	35.3	269.2	13.1	1060.8	51.6	2055.1	100
1977/78	694.1	28.9	361.1	15.0	1350.5	56.1	2405.8	100
1978/79	880.0	31.3	454.5	16.2	1477.7	52.5	2812.2	100
1979/80	853.5	26.4	571.2	17.6	1814.9	56.0	3239.6	100
1980/81	1019.6	25.7	716.7	18.1	2228.3	56.2	3964.6	100
1981/82	1031.8	21.9	877.4	18.7	2789.8	59.4	4699.0	100
1982/83	1379.0	23.5	1068.7	18.2	3417.9	58.3	5865.6	100
Compound annual growth rates (%)								
69/70-74/75	23.7		26.7		29.2		26.5	
74/75-79/80	14.2		27.0		28.5		23.5	
79/80-82/83	17.3		23.2		23.5		21.9	
69/70-82/83	18.5		26.0		27.6		24.3	

Commercial banks only (deposits include foreign deposits).
Source: Quarterly Economic Bulletin; Main Economic Indicators.

The effect of policy measures on savings mobilization is analyzed in detail below. The effectiveness of these measures may be better evaluated if confined to the activities of commercial banks, as deposits at ADB/N (Table 4) and post office saving accounts have so far remained inconsequential. Hence Tables 1, 2, and 5 pertain only to commercial banks. The change in deposit structure during the past 13 years (Table 2) is attributable to the slow growth of demand deposits and a correspondingly rapid rise of time deposits. The relative share of time deposits has risen from 41.3 percent at the end of 1969/70 to 58.3 percent at the end of 1982/83. Demand deposits, on the other hand, had a declining role in the overall deposit structure. From 43.5 percent in 1969/70, the share of demand deposits fell to 23.5 percent in 1982/83. Savings deposits have risen continuously, slightly outpacing the growth rate of total deposits. In 1975/76, savings deposits had a reduced share in total deposits. In the wake of a substantial increase in the interest rate on time deposits of one or more years' duration (Tables 3 and 4), large additions were made to the deposit pool in 1975/76 mostly in the form of time deposits, reducing the proportions of both savings and demand deposits. Since then, savings deposits have occupied a share in total deposits which is slowly rising every year.

The enormous growth of deposits in 1975/76 led to a considerable rise in the proportion of deposits in total bank resources (Table 5). In 1974/75, excessive credit demand in the face of stagnating deposit resources prompted commercial banks to borrow heavily from the Rastra Bank which caused the deposit/total resources ratio to fall. In the following year the increased interest rate coupled with stable prices not only eased the pressure on bank resources but induced deposit accumulation with unprecedented speed. Consequently in 1975/76, deposits accounted for about 77 percent of total commercial bank resources--a rise of 15 percentage points in a single year. A downturn in 1977/78 continued till 1980/81 when the proportion of deposits fell to 66 percent of total resources. The uneven pattern of borrowing from the Rastra Bank and of movements in the banks' nonfinancial resources were responsible for the relative decline of deposits. However, since 1981/82 deposits have resumed their rising trend and by the end of 1982/83, about 89 percent of bank resources were deposits.

Analysis of the term structure of time deposits also provides some insights into the market response pattern to price signals. Until late 1974/75 the spread between interest rates on deposits of various maturities was narrower so the volume of deposits of up to six months was about 12 percent of total time deposits. In April 1975, the interest spread was widened considerably with three-month deposits carrying an annual four percent interest rate while two-year deposits fetched as high as 16 percent. Even savings deposits then carried an eight percent interest rate-higher than three-month deposits. As a result, most deposits tended to favor two-year maturities followed by a maturity of one year. By the end of 1982/83, deposits of up to six months had shrunk to 2.3 percent of the total. In sharp contrast, two-year deposits accounted for 79.3 percent compared to 66.6 percent in 1974/75. One-year time deposits fell slowly from 21.5 percent to 18.2 percent in the same eight year period. The longer-term bias in the deposit structure indicates a greater capacity of the banks to diversify their lending toward long-term loans rather than short-term mortgage loans.

Table 3. Interest Rate Structure by Type of Deposit (%)

Year	Demand	Savings	Time Deposits One Year	Time Deposits 2 Years or More
1969/70	-	5	7.5	8.5
1974/75	-	8	15	16
1975/76	-	8	15	16
1976/77	-	8	12	13
1977/78	-	8	12	13
1978/79	-	8	12	13
1979/80	-	8	12	13
1980/81	-	8	12	13
1981/82	-	8.5	12.5	13.5
1982/83	-	8.5	12.5	13.5

No minimum or maximum rates are specified on deposits.

Table 4. Real Rates of Interest on Deposits (%)

Year	Inflation Rate	Real Rates of Interest Savings	Real Rates of Interest Time
1969/70	10.7*	-4.7	
1974/75	16.8	-8.8	-1.8 (-12.8 to -0.8)
1975/76	-0.7	8.7	15.7 (4.7 to 16.7)
1976/77	2.7	5.3	9.3 (1.3 to 10.3)
1977/78	11.2	-3.2	0.8 (- 7.2 to 1.8)
1978/79	3.5	4.5	8.5 (0.5 to 9.5)
1979/80	9.8	-1.8	2.2 (- 5.8 to 3.2)
1980/81	13.4	-5.4	-1.4 (- 9.4 to -0.4)
1981/82	10.4	-1.9	2.1 (- 6.4 to 3.1)
1982/83	14.2	-5.7	-1.7 (-10.2 to -0.7)

Real Interest Rate = Interest Rate - Inflation Rate.

Figures in parentheses show the range of interest rates for deposits of three months to two years. The rates outside the parentheses in the last column pertain to one-year time deposits.

* Proxied by change in CPI for Kathmandu (national index is available only since 1972/73).

Table 5. Deposits as Percentage of Total Bank Resources

	Total Bank Resources (Million Rs)	Amount of Deposits (Million Rs)	Percentage of Deposits to Total Resources
1969/70	515.2	348.4	67.6
1974/75	1824.1	1188.7	61.9
1975/76	1998.2	1530.5	76.6
1976/77	2660.8	2055.1	77.2
1977/78	3193.8	2405.8	75.3
1978/79	3908.6	2812.2	71.9
1979/80	4525.7	3239.6	71.6
1980/81	5972.6	3964.6	66.4
1981/82	6227.2	4699.0	75.5
1982/83	6617.1	5865.6	88.6

Commercial banks only. ADB/N is excluded because deposit mobilization is not one of its primary functions. It is not even allowed to collect deposits where commercial banks are operating. Demand, savings and time deposits are included along with foreign deposits.

Table 6. Volume of Deposits, by Type of Institution (Million Rs.)

Year		Commercial Banks	ADB/N	Total
1969/70	Amount	348.4	5.4	353.8
	% Share	98.5	1.5	100.0
1974/75	Amount	1128.7	7.4	1136.1
	% Share	99.3	0.7	100.0
1979/80	Amount	3239.6	35.1	3274.7
	% Share	98.9	1.1	100.0
1982/83	Amount	5865.6	36.6	5902.2
	% Share	99.4	0.6	100.0

Rural Savings and Deposits

Estimates of rural (hereafter termed agricultural) savings do not exist. An indirect method was therefore used to calculate the savings rate in agriculture for 1976/77, the year of an agricultural credit review survey conducted by Nepal Rastra Bank. According to the findings of the survey, gross capital formation of an average farm family amounted to Rs.967 in 1976/77. It was assumed that the capital formation not financed by borrowings was financed by private savings. The difference between average household borrowings and average repayments yielded Rs.274 of net borrowings available for capital formation. The own-savings component of investment in agriculture thus equalled Rs.693 per household. Multiplying this by the aggregate number of farm households yielded the gross savings in agriculture. The calculations were based on the assumption that the sample results were representative of Nepal's entire agricultural sector. Gross savings thus estimated comprised 11.7 percent of the agricultural GDP for 1976/77 as compared with a gross domestic savings rate of 9.9 percent. The implicit savings rate for the nonagricultural sector would then be only seven percent.

Despite the comparability of the agricultural savings rate to the overall savings rate, the degree of penetration of the banking system in rural areas remains far from satisfactory. As shown below, the number of commercial bank and ADB/N branches operating in rural areas have increased considerably, yet in terms of deposit mobilization progress has been slow (Table 7). The figures for rural deposits are slightly underreported if an annual fixed classification of bank branches is assumed. However, with the population and urban facility extension some rural centers have grown into towns and deposits previously termed "rural" would now be reported under "urban." Second, big savers in rural areas where branches have been recently established may continue to deposit in urban branches. This may be both due to persistence of habit, and also to fear of recognition in the rural branch.

In 1976/77, the rural sector accounted for 16.5 percent of total commercial bank deposits. Since then the deposits mobilized by active rural branches have grown slightly faster than total deposits, and the share of rural in total deposits has gone up to 20.1 percent in 1982/83, reflecting a 3.3 percent compound annual growth. In absolute nominal terms, rural deposits have recorded an impressive growth of 23.1 percent annually during the six years for which data are available. But considering the vast scope for tapping rural sector savings the deposits are modest. Low savings capacity is one explanation for this situation. The "capacity-to-save" argument has been made recently with increasing force because attempts to raise the degree of monetization through expansion of the banking network have met with limited success.

A more pertinent reason is that the organized financial system has not integrated saving mobilization schemes with rural credit schemes. Banks have failed to perceptibly supplement the informal credit market in rural areas. Available evidence suggests a net outflow from small rural savings to finance urban lendings rather than meet the substantial rural credit needs. The collateral-oriented lending system that restricts credit flow to rural areas and weakens people's confidence in the banks runs counter to efforts, however aggressive, toward mobilization of small and scattered rural savings.

Table 7. Volume and Growth of Rural Deposits (Million Rs.)

Year	Rural Deposits	Total Deposits	Percentage of Total Deposits
1969/70	N.A.	348.4	-
1974/75	N.A.	1128.7	-
1975/76	N.A.	1530.5	-
1976/77	338.9	2055.1	16.5
1977/78	425.8	2405.8	17.7
1978/79	511.0	2812.2	18.2
1979/80	630.1	3239.6	19.4
1980/81	850.4	3964.6	21.4
1981/82	949.7	4699.0	20.2
1982/83	1181.9	5865.6	20.1
Compound annual growth rates (%)			
69/70-74/75	-	26.5	-
76/77-82/83	23.1	19.1	3.3

Deposits generated by branches of commercial banks operating in the countryside.

N.A. = Not available.

NATIONAL POLICIES AND PROGRAMS

National policies to encourage deposit mobilization in Nepal have a more recent history than policies of providing cheap credit for investment. In 1956 when Nepal Rastra Bank was established, the immediate objectives of monetary policy were to promote national circulation of a single legal tender (and remove Indian rupees from circulation) and to maintain the stability of exchange rates mainly vis-a-vis the Indian rupee. The emphasis was later shifted to the extension of banking services throughout the kingdom, promotion of a well-organized financial system, expansion of the monetized sector in order to broaden the scope and insure the effectiveness of monetary policy changes, and increased participation in economic development by ensuring greater flow of finance to productive sectors of the country.

Initially, Nepal Bank Limited (with 51 percent subscription from the government) was the only commercial bank in the country. The Rastra Bank broadened its activities by opening numerous branches of its own. Rastriya Banijya Bank, the second commercial bank, was established in 1966, owned wholly by the government. After this the Rastra Bank gradually transferred all commercial bank activities and most branches to the new bank, and confined itself to regulatory and promotional activities. This chapter describes and analyzes the national policies and programs pursued to enhance the rate of savings mobilization through the financial system and bring about suitable changes in deposit structure.

Branch Expansion Policy

The policy of bank-branch expansion was initially prompted by an urgent need to facilitate the sole use of Nepalese currency in domestic transactions. After 1966, when this objective was deemed fulfilled, expansion of the banking network was continued to bring more economic activities into the orbit of monetization. (Monetization may be defined in various ways, the most meaningful would be to define it in terms of the production of aggregate goods and services that are paid for in money by the purchaser. See Chandavarkar, 1980.) Besides, household savings could not be fully mobilized without developing financial institutions. Due to the fragmented nature of rural capital markets, surplus units could not transfer all their savings to deficit units. Potential investors would not be able to use their inadequate savings if borrowing facilities were not available on reasonable terms. It was probable, therefore, that small scattered savings would be mostly used for consumption. A wider geographical and functional penetration of the banking system was considered desirable in this context.

A Banking Promotion Board was set up in 1970. At a time when supply-lending financial systems were being strongly advocated for developing countries, Nepal had far too many rural and semi-urban centers in need of bank offices to support expanding commercial and other activities. The Board set a goal of promoting at least one commercial bank branch in each of the 75 districts in the country at the earliest possible time. The Rastra Bank promised to compensate any loss incurred by the banks on account of operation of branches recommended for establishment by the Board. The scheme would cover 100 percent of the losses for the first year of operation, 75 percent for the second year, and 50, 25, and 10 percent for the following three years. The compensation would be paid from the Banking Development Fund created by the Bank in 1966/67 and contributed to by the banks. A modest amount of interest-free loans were also made available for running the branches under the scheme. The vigorous drive toward branch expansion was facilitated by government control of bank management. While the banks set up branch offices in addition to what was recommended by the Bank Promotion Board, the fillip to the expansion program was provided by the Board itself. By 1976/77, the goal of establishing a commercial bank office in every district of the country was achieved, the total number of branches rising to 216 and including the offices of ADB/N, 367.

The first major objectives having been realized, there was a slack in the program for the next three years. From 1977/78 through 1979/80, only 25 new branches were added to the commercial banking network. Total deposits at the banks were growing enormously but the contribution of new branches remained small. The question arose of how far branch expansion could stimulate private savings or transform existing savings into financial forms. Even if offices did generate new savings there was the possibility that the resource cost of bank expansion was greater than the resources captured through new saving (Porter, 1980, p. 60). It became discernible that the new branches served urban lending rather than local investment purposes, though in 1980, the average population served by a bank branch was still as high as 60,000. The Sixth Plan (1980-85), therefore, targeted a branch expansion program to provide one branch for every 30,000 people by the end of 1984/85. Considering the progress made in the first three years of the plan, the goal was too

bold. ADB/N has been instructed to accept deposits in 27 of its branches beginning 1983/84, to help meet the target as well as to supplement the ADB/N's decreasing resources.

It is likely this institution will win the confidence of rural people which will in turn boost ADB/N's resources for local investment. Regarding the effectiveness of the branch expansion policy with respect to quickening the pace of monetization and raising the savings ratio, measurement problems preclude exactness in estimation. Some qualitative inferences may nevertheless be drawn from changes in the composition of monetary aggregates. Given the inadequate banking facilities and lack of banking habits the impact of monetization on the composition of money supply would be to increase the demand for currency relative to deposits, because the transition from transactions in kind to transactions in currency is psychologically and institutionally easier than that from barter to bank money (Chandavarkar, 1980). However, in Nepal the currency ratio between 1975 and 1983 has declined though the ratio itself fluctuated within a range from 68.5 percent of M1 in mid-July 1975 to 63.3 percent in mid-July 1983. The declining trend is retained even if the base year is shifted back from 1975. The indication is either the expansion of bank offices has not contributed much to monetization or a higher currency ratio in the recently monetized countryside has been more than offset by a rapid growth of deposits in urban areas.

As branch expansion since 1976/77 was concentrated in the rural areas, its effect on financial savings may be largely reflected on the growth of rural deposits. Between 1976/77 and 1982/83 rural deposits expanded by 23.1 percent a year compared to a 19.1 percent growth in total deposits (Table 7). Consequently, the share of rural deposits rose from 16.5 percent to 20.1 percent over the six-year period. The stronger relative position of rural deposits over time seems to corroborate the view that savings are institution-elastic. To quote Lewis, "...if they (the savings institutions) are pushed right under the individual's nose...people save more than if the nearest savings institution is some distance away" (Porter, 1980). This may be especially true of small savers for whom saving would become possible without a concomitant act of investment or be more profitable than traditional forms of savings like hoarding grain. There seems to be greater scope for rural savings mobilization through branch expansion but, as mentioned earlier, savings mobilization efforts integrated with vigorous lending efforts in the concerned areas are most effective.

Interest Rate Policies

The case for a realistic interest rate policy for savings mobilization rests on the argument for removal of financial constraints. A low interest rate policy fails to provide adequate incentives to save. Savings in financial forms are the major problem, as people prefer nonfinancial inflation hedges. The evolution of a high interest rate policy on deposits in Nepal was, however, a lengthy process. Active financial management by the Rastra Bank began in 1971. At the recommendation of a high level Interest Rate Review Committee appointed in 1969, the Bank revised the interest rate structure of both commercial banks and other financial intermediaries. On savings deposits the rate was raised from 4.5 to 5 percent per annum. Time deposit certificates began to carry interest rates between 7.5 and 8.5 percent depending on

the period of deposits. The increase in interest rates was small as the objective was to gradually extend the Bank's control and influence over all financial institutions, but the revised interest rates were not high enough to compensate for the loss in money value arising from inflation. The Kathmandu consumer price index had increased in 1969/70 by 10.7 percent and in 1970/71 by 4.9 percent.

The low interest rate policy reflected official thinking that investment is sensitive to the level as well as change in interest rate. Provision of cheap credit was thus necessary to boost the rate of investment. Furthermore, financial institutions were expected to shoulder the responsibility of freeing borrowers from usury practices rampant in the informal sector. The lack of incentive for savings that a low interest policy entails was the "forgotten half" of financial intermediation.

The result may be evaluated in terms of changes in the main indicators of commercial banking business. Time and savings deposits have indeed expanded by 28.5 percent per annum (Table 8), yet a significant fall was noticed in both cash reserve and liquidity ratios. The liquidity ratio of commercial banks fell to 31.6 percent by 1975. The ratio might have been still lower but for the Rastra Bank's imposition of minimum requirements. The lower liquidity and cash reserve ratios were the result of enormous pressures of credit demand on bank resources. The credit-deposit ratio shot up to an unprecedented level of 104.8 percent in mid-July 1975, the credit being increasingly financed through borrowings from the Rastra Bank. Inflation rates were high at 18 and 16 percent during 1973/74 and 1974/75 respectively. As the value of money quickly depreciated, the banks found it hard to collect a greater volume of deposits at the prevailing interest rates. This sorry state of affairs climaxed in 1974/75 (Table 8). As the price mechanism was not allowed to operate, the excess demand for credit resulted in credit rationing. Private borrowers who did not have status or could not produce enough collateral were rationed out. Public enterprises receiving loans on government guarantee absorbed a greater part of disbursement leaving the rest for established private firms or those who could somehow influence loan-approving authorities.

Table 8. Important Rates of Commercial Banks

	Mid-July 1970	Mid-July 1975	Annual Percent Change (1970-75)
Cash reserve as percent to total deposits	21.7	13.0	
Liquid assets as percent to total deposits	46.9	31.6	
Loans and advances as percent of total deposits	81.7	104.8	
Time and savings deposits			28.5
Consumer price index			9.8

Source: Quarterly Economic Bulletin, various issues.

It was only in 1975 that a positive real interest policy was adopted in Nepal. Experience showed the existing interest rate policy was seriously flawed. Meanwhile the economic research by Stanford economists McKinnon (1973) and Shaw (1973) advocated a positive interest rate policy for developing countries with ferocious zeal. The usefulness of such a policy was proven in countries like South Korea and Taiwan. In April 1975, the Rastra Bank announced a substantial increase in the nominal deposit and lending rates, indicating a commitment to maintain the nominal rates above the rates of inflation. Maintenance of a positive interest rate could be accomplished by either reducing inflation or raising nominal interest rates. The Rastra Bank chose the second course for two reasons. First, the world economy had not recovered from inflationary pressures emanating from the first oil shock of 1973/74 which quickened inflationary expectations also in Nepal. Second, Nepal was more vulnerable to inflation than India. Due to the lengthy open border with India and free convertibility between Nepalese and Indian rupees maintained by the Rastra Bank, prices of non-service items in Nepal quickly adjust to Indian prices. Nepal's monetary and trade policies are unable to restrain such adjustments except in the very short run. The attempt to raise real interest rates to positive levels by controlling inflation would thus be an unrealistic policy.

The interest rate policy is conducted through the deposit rate, the lending rate, and the margin between the two. All three convey important signals to the concerned units. The deposit rate shows the benefit of savings. The lending rate indicates the value to investors of an efficient use of saved resources. The margin or the spread between the two rates tells financial institutions that they have something to gain by efficiently processing the savings flow. In April 1975, all these rates were adjusted upward, and the number of differential rates for both deposits and lending was reduced. This cannot be said of the margin because of a complicated rate structure maintained before 1975.

The interest rate on savings deposits was raised from 5 percent before mid-July 1974 and 6.5 percent effective mid-July 1974 to 8 percent. The number of rates for time deposits was reduced from seven to four. The interest rate on one-year time deposits was raised to 15 percent from 7.5 and 9.5 percent prevailing before and since mid-July 1974 respectively. Deposits for two years or more than carried a rate of 16 percent compared to a range of 9.75 to 10.5 percent before, while three-month and six-month deposits had 4 and 10 percent rates respectively. The effect on the volume of deposits in 1975/76 was tremendous. The sharp increase in deposit rates was, however, associated with a pronounced decline in the rate of inflation (the consumer price index fell 0.7 percent). This double effect on the interest rate on deposits pushed real deposit growth to a record level (45.7 percent) in 1975/76.

The effect of change in the level and structure of interest rates on the structure of deposits may be seen from Table 2. At the end of 1974/75, the time deposits stood at 45.8 percent. A year later they were at 52.8 percent of the total. The share of demand and savings deposits fell correspondingly. The fallen share of savings deposits seemed to support the widely held view that savings deposits are relatively inelastic to interest rate fluctuations and are more a function of increase in income, access to financial intermediaries, and ease of making and withdrawing deposits. Regarding demand deposits it is

believed, as the income level rises, the public's transactions with the bank increase, and payment habits turn in favor of checks and away from cash. This postulate is also supported by Nepalese experience. While deposit volume has trebled over the last eight years, a clear trend of the declining relative share of demand deposits is discernible. This is explained by stagnating per capita income in real terms and the positive real interest rates on time deposits of one-or-more-year duration.

No change has been effected since 1975 (except a little in 1982) in interest rates on savings deposits. However, the rate on time deposits has undergone a few changes (Table 3). Boosted by record growth of deposits as a result of the rise in interest rate and the stable price level, the authorities made a downward adjustment of one percentage point effective mid-July 1976, in time deposit rates of one-year and longer duration in order to accommodate price movements. The signs of stability in price level were visible for the second successive year (1976/77) but commercial banks having no extra program of lending were facing a problem of excess liquidity. Hence, the interest rates on one-year and two-year deposits were reduced again in February 1977, this time by two percentage points (to 12 and 13 percent respectively) while the six-month deposit rate recorded a reduction of one percentage point. The interest rate on three-month deposits has stayed at four percent per annum since April 1975.

The structure of the deposit interest rate as it evolved in 1977 was carried through until June 1983, when the rates of one-year and two-year deposits were raised half a percentage point. This to keep the real interest rate at positive levels. The second oil-price shock of 1979/80 and rising food prices during the early 1980s prompted authorities to make a slight revision in the rate structure.

The main thrust of interest rate policy in Nepal is on maintenance of real interest rate on time deposits at a positive level so the value of savers' money does not depreciate. The policy has definitely paid rich dividends for mobilization of resources. As a result of data constraints it has not been possible to estimate to what extent the policy has contributed to the saving-income ratio increase. Neither is any study available showing how high interest rates have enhanced the rate and/or the productivity of investment in the country. This part of the effect of Rastra Bank's interest policy is crucial. Savings are important because they release resources for investment, but it is investment that directly causes economic growth. It may be argued that the intensive program of resource mobilization begun in 1975 was premature in that financial institutions did not then have appropriate mechanisms to support a vigorous drive for productive investment (Reejal, 1979). During frequent periods of excess liquidity, institutions, mainly commercial banks, simply invested money in government securities. The apparent lack of profitable investment opportunities for banks seemed to negate the potential benefits of the savings mobilization program. McKinnon (1973) points out that interest rate reform alone is inadequate to insure buoyant demand for investment funds. It must be supported by an appropriate exchange rate, trade, fiscal and price policies. These policies were not adjusted by the government, so the Rastra Bank's measures toward financial development were hampered (Fry, 1978).

Nepal Rastra Bank's interest policy could still be justified on

other grounds. First, it was necessary to exhibit the profitability of financial investment in the savers' opportunity set. The sudden jump in the interest rate in 1975 had a dramatic effect on public psychology which contributed to the accelerated growth of deposits. Second, the Agricultural Credit Review Survey showed that financing the tremendous credit needs in agriculture was essential to raise productivity and, hence, profitable opportunity did exist for lender institutions. The need was to discard a collateral-oriented outlook toward lending. Once this was shown, increased bank resources would find their way to profitable ventures regardless of existing investment constraints.

Closely associated with this argument is the idea that innovations in lending practices would be made by banks once they faced the problem of how to use huge deposits. In this sense the supply-lending credit situation would have greater potential for contributing to growth than a demand-following credit system. (For a discussion of the desirability of the supply-lending phenomenon, see Patrick, 1966.) Third, demand for money (currency plus demand deposits plus time and savings deposits) would increase. Where money serves as a conduit for savings, a higher return on money would increase demand and enhance the savings ratio.

The second and the third of these postulated effects remain to be contrasted against actual developments since 1975. The priority sector lending program was launched in 1974 as a part of the overall program of financial development. Commercial banks were urged to flow credit to agriculture and cottage industries (also the service sector for some years) at a minimum of five percent (later increased to seven percent) of total deposits. The program was renamed the Intensive Banking Program in October 1981 and a few activities were added. The proportion of minimum investment was correspondingly raised to ten percent of total deposits. The actual outstanding credit to the priority sectors has, however, never exceeded six percent and has frequently stood well below it. Nevertheless, a growing realization is noticeable on the part of banks that they have to actively seek attractive investment opportunities. The area development approach implicit in Intensive Banking, and group guarantee schemes for lending to group members developed by ADB/N and now being followed by commercial banks, clearly indicate the bankers' willingness to increasingly participate in investment promotion efforts. The financial constraint on investment is gradually weakening.

The effect of interest rate policy on the money supply may be analyzed by classifying the developments during 1975-83 into two periods: 1975-79 and 1979-83. In the first period the savings ratio was mainly on the rise (Central Bureau of Statistics). From a base of 4.3 percent in 1974/75 it rose to 7.0 and 9.9 percent in 1975/76 and 1976/77. The saving ratio then fell to 7.7 percent in 1977/78, only to rise again to 9 percent in 1978/79. In the second period, the ratio was mainly on the decline. From 5.3 percent in 1978/79, it eventually fell to 5.4 percent in 1982/83. A higher savings rate came about when the money supply (narrowly defined as M1) expanded seven percent a year, while the period of low savings witnessed a monetary growth of 14.8 percent annually. Price statistics reveal that a low inflation rate of 4.1 percent was registered for the first four years compared to 11.9 percent for the second. The encouraging results for 1975-79 were also carried to the external sector as the net international reserve of the country increased by Rs.1258.9 million.

In contrast, during 1979-83, the net reserve accretion drastically slowed down to Rs.323.4 million in nominal terms. Considering higher import prices and the depreciated value of the Nepalese rupee, the actual value of net foreign assets of the country at mid-July 1983 stood lower than four years before. The demand for money (M1) increased rapidly in the former four years relative to the supply of money so the consequent decline in national expenditure produced a sizable surplus in the balance of payments and helped contain inflationary pressures. (For the relationship of expenditure with the balance of payments and inflation in Nepal, see Upadhyay, 1983.) Money was being used to finance restrained consumption. During 1979-83, money supply expanded faster than the demand. Demand for money had grown slowly as a result of two severe droughts, in 1979/80 and 1982/83, which had reduced agricultural GDP (at constant prices). The rapid monetary expansion was mostly an outcome of growing budgetary deficits of the government. In the process the excess money supply tended to exhaust itself through a decline in international reserve (prevented only by a massive aid inflow) and in part through a rise in prices. The implication is that interest rate policy needs to be supplemented by, among other things, a money supply policy. In Nepal, such a policy has not been consistently practiced because of overlapping monetary and fiscal policies, when budget deficit is financed by printing money.

To sum up, the capacity of the organized financial system to mobilize resources and to raise the saving-income ratio has been well demonstrated by interest rate policy in Nepal. The process of transformation of savings into investment has, however, been slow due to government failure to bring about policy reforms in areas of trade, tax, and prices. There is ample scope for increasing rural deposit mobilization, but it will depend on how much the confidence of rural people is won through serious efforts toward provision of rural credit.

Reserve Requirements

The policy of fixing minimum reserve requirements in Nepal has been used more as a weapon of credit control than as a mechanism to influence the volume or structure of deposits. At present, reserve requirement is a part of overall liquidity requirement. Effective July 16, 1981, commercial banks are required to maintain their liquid assets, defined as domestic and foreign currency in hand, balances with Nepal Rastra Bank and those held abroad, and the investment in government securities other than those pledged with the Rastra Bank, at a minimum of 25 percent of total deposits. This includes a minimum of four percent in vault cash and five percent as statutory cash reserve with the Rastra Bank on which no interest is paid. The Rastra Bank has not followed the practice of distinguishing various types of deposits for the purpose of reserve requirement. Since deposit collection is a principal function of commercial banks alone, reserve or liquidity requirements apply only to them. Liquidity requirements were also operative before 1975/76 but were abandoned for over two years. This was because the provisions had become redundant due to high liquidity of the banks in the wake of substantial deposit expansion following the 1975 interest rate revision. Effective March 14, 1978, a seven percent cash reserve ratio to be maintained at the Rastra Bank was introduced which remained in force until July 1981 when a minimum liquidity ratio was again stipulated.

Tax on Interest Income

The prevailing tax rate is five percent of total interest earnings on deposits. The tax on depositors' interest earnings was introduced in 1977/78. The previous provision was to add interest income to other income sources and impose tax on total income. The new arrangement not only separated interest income for tax purposes but also levied the tax at the source. An exemption limit was set at Rs.1000. Above this amount, tax rates were progressively increased to income slabs. Tax rates were five percent on income above exemption and up to Rs.3250, ten percent on the next Rs.3250, 15 percent on the next Rs.6500 and 20 percent on the rest. In 1980/81, the slab system of taxing interest earning and the exemption limit were both abolished. A fixed five percent tax on total interest income from deposits was introduced. For persons with such interest as the only source of income the exemption limit as applied to personal income tax was granted.

Refinance Scheme

The refinancing policy of Nepal Rastra Bank has been pursued to make resources available to financial institutions when their liquidity position is not strong enough to support their lending operations. The policy is also being used as a mechanism to influence the flow of credit to certain specific sectors. A differential refinance rate policy is practiced corresponding to the differential loan rates of financial institutions. The existing rate structure shows that refinance rates are lower in most cases by four percentage points compared to the loan rates of the institutions. The purposes for which refinance is made available by Nepal Rastra Bank are classified into industry, agriculture, services, export bills and HMG/N development bonds. No commercial loans other than export bills are entertained by the Bank for refinance. Therefore, there is not much scope for financial institutions, mainly commercial banks, to rely on the Rastra Bank resources in lieu of resources mobilized from the public.

Commercial bank borrowing from the Rastra Bank had peaked to 31.6 percent of total deposits in 1974/75 but has since remained at much lower levies due to sizable increases in deposit resources as compared to lending. In the case of ADB/N, borrowing from the Rastra Bank has consistently remained at a higher range of one-fourth to one-third of its total liabilities. No evidence is found to support the possibility that commercial banks have been encouraged or discouraged to tap savings from rural areas as result of refinance schemes.

Deposits and Withdrawals

No specific policy regulations are made by Nepal Rastra Bank regarding depositing and withdrawing operations, except that they be kept as simple as possible. Anybody can open an account in the bank upon recommendation by a depositor or presentation of a citizenship certificate or identity card. In rural areas where a depositor may be hard to find, the recommendation of the concerned village panchayat is enough for opening an account. The only criterion is the bank branch manager should be convinced the prospective depositor can be identified and approached if the need arises. Any amount may be deposited, but the withdrawal provisions depend on the nature of accounts maintained. The

universal practice of allowing withdrawals of any amount (if covered by the depositor's account) is followed with respect to demand deposits. Withdrawals of saving deposits are allowed up to a maximum of Rs.1000 a day. Larger withdrawals are permitted but the bank will charge interest on the amount over Rs.1000 at the rate of one day's interest on Rs.1000, two days' interest on the next Rs.1000 and so on. No withdrawals may be made from time deposits during the stipulated period but borrowing facility is provided against time deposit certificates.

Interest on savings deposits is paid every six months. The amount on which interest is paid used to be the average balance for each of the six months and the monthly balance used for this purpose as the average of the minimum and maximum balances during the respective month. This method was changed April 14, 1983. Monthly balance is now computed by averaging balances on each Friday of the month. The revision was made to avoid the effect of a large deposit on the average monthly balance.

Strategies for Marketing and Campaigning

To encourage small saving deposits the commercial banks introduced the household savings account scheme in 1975/76 in the Kathmandu Valley and later to other urban centers. A small box was kept at the house of interested families who would drop money to be collected by mobile teams of bank employees in the presence of family members at fixed intervals. From the banks' point of view, the scheme, though hardly effective in generating substantial savings, was intended to induce the habit of saving small amounts not previously considered worthwhile. The commercial banks also used posters, radio programs, and advertisements in their campaign to tap small savings.

Informal Arrangements

No information is available on arrangements for savings mobilization outside the organized financial system. The exceptions may, however, be noted. One scheme, an involuntary experiment, was launched in 1965 as part of a wide-ranging land reform program, but was withdrawn a few years later. Called the Compulsory Deposit Scheme (CDS), it required a farm household to make deposits in cash or in kind in proportion to the size of their farm holding. The deposits were managed by sub-units of village panchayats called ward committees. A low interest rate of five percent was proposed for payment to depositors. Though of a forced nature, the scheme mobilized significant sums of deposits. However, deposits were scattered over hundreds of panchayat wards (where land reforms were carried out) which created a great scope for mismanagement and insecurity of the deposits. The scheme was designed apparently in haste as strict management rules were not laid down. No bookkeeping was maintained or vigorous auditing undertaken. The scheme, launched to generate a big source of rural finance, thus disintegrated.

A variant of CDS, the Panchayat Development and Land Tax (PDLT), was later tried in a few village panchayats. It aimed for extension to progressively wider areas. The main difference from CDS was PDLT was a non-refundable tax rather than a refundable deposit. Several criteria (e.g., whether the land was irrigated) were used to determine the amount of land tax. A major portion of revenue was intended for expenditure in infrastructural development and other works in the same panchayat. The

idea was that if people's contribution to public programs was sought, the programs would have to directly benefit the people. The scheme caught on in the relatively prosperous panchayats of Jhapa district and was also introduced in 1978/79 in a few other districts of the country. However, the lack of political commitment was perhaps the principal reason why the scheme was "suspended" soon after.

The above schemes may be noted as exceptions, from the historical perspective, to the usual cases of savings mobilization under formal arrangements in financial institutions. Another exception which is of greater importance at presently is the group-saving scheme launched at the initiative of ADB/N in its Small Farmers Development Projects (SFDPs). By 1982/83, 84 projects were operating covering 12,566 small and marginal farmers that formed a total of 1393 groups. The program was begun in 1975 as part of a rural development strategy and has been progressively extended. Not all project offices maintain the group savings fund and the amount mobilized so far (Rs.825 thousand at the end of 1982/83) is not great. Nevertheless, the deposit scheme (like the credit scheme in SFDPs) is a manifestation of the feeling of joint responsibility of the poor group members to further the interests of the group. The savings fund maintained by the members themselves works as an insurance against emergencies like medical, treatment, funeral and other social ceremonies. It has also been used in some cases to meet a part of production cost of the saver farmers. The savings are also collected in kind (grains) and utilized during food deficit seasons. Saving by small and marginal farmers is surprising to many. However, it only illustrates that the poor do save if there is a guarantee the savings will be available for use when the need arises.

CONCLUSION AND RECOMMENDATIONS

Conclusion

The principal source of livelihood of a vast majority of Nepal's population is agriculture, which suffers from low and stagnating productivity. The rural financial markets in Nepal are fragmented. The bulk of rural credit need is met through informal markets which are characterized by district finance and not highly susceptible to pooling scattered savings. Organized financial systems, particularly commercial banks, have done a commendable job of mobilizing rural savings. The two main policies of banks in doing so concern interest rate and expansion of banking services in wider geographical areas. High interest rates have made bank deposits attractive. Branch expansion, in conjunction with the interest rate, has made feasible the opening of bank accounts for a greater number of rural people and has tended to increase monetization of transactions. Other measures of banking promotion have also influenced the mobilization of rural savings.

At present there is considerable room for improvement in the past record of savings mobilization. Of greater concern, however, is the perception of what calls for a rural savings mobilization strategy. Banks savings have grown too liquid of late to sustain the policy of high interest rate on deposits. High liquidity is ironical since rural credit demand at the prevailing bank interest rate is enormous. Expectation of low availability of bank credit constitutes a disincentive to

save at the bank and hence reduces the volume of savings mobilized and renders the entire program of rural savings mobilization meaningless.

The ability and incentive to save are the two major determinants of savings. From the foregoing analysis it is clear that the incentive to save as reflected in Nepal Rastra Bank's real interest policy can be stretched far with profit. It is highly probable that further increase in the growth rate of financial savings can materialize if a flexible policy is pursued to keep real interest rate at a higher level than at present. But eventually the deposit expansion is bound to be constrained by people's low ability to save as indicated by stagnant per capita GDP over the past decade. For a sustained growth of deposits or of overall savings rate, increases in income levels are needed.

Recommendations

In order to continue a realistic savings mobilization strategy, policy instruments should consider two aspects. In the short run, policy should focus on the appropriate measures to tap savings within the existing banking framework while the longer-term goal should be to increase people's capacity to save. Some additional measures within the existing framework may be recommended as follows:

1. Rural savings may be increased by reducing the risk of non-availability of credit in times of need. The innovative Syndicate Bank of India launched the Farmers' Protection Deposit Scheme recognizing such a risk. The deposit only paid a low interest of five percent per annum but the depositor was granted the right to borrow up to twice the outstanding deposit at the rate of nine percent in the event of crop failure. The scheme demonstrated small farmers are prepared to save even at low rates of interest in order to eliminate, or at least reduce, a major cause of concern (Bhatt, 1978). In Nepal, poor farmers covered by SFDPs have been found to save, and the arrangement of group saving to finance emergency needs of any member, works as an incentive.

2. The household savings account scheme should be expanded. Here also the example of Syndicate Bank is appropriate. The Bank learned soon after launching the Pigmy Deposit Scheme that the cost of collecting deposits door-to-door at stated intervals was lower than the cost of other types of deposits. The deposit under this scheme soon became an important part of total deposits. The rationale for duplicating such schemes in Nepal and elsewhere is that it reduces transaction costs for the potential depositor and promotes banking habits. The transaction costs for a household would be prohibitively high in the absence of such a scheme if the savings were small.

3. The post office savings scheme should be strengthened and expanded. The potentials for this scheme are the low risk, the ease in depositing and making withdrawals from the post office savings account as compared to the bank accounts and greater accessibility. These non-price attributes were the factors mainly responsible for the success of such a scheme in Sri Lanka (Saito, 1977).

4. Savings mobilization campaigns should be intensified through effective publicity and attractive prizes. Free instant photographs for small depositors, a raffle of small radios, free items of value for

large depositors should be provided as part of a campaign in selected target branches. (For an example of a similar campaign in Peru, see Vogel, 1982.) Incentives to bank employees should be linked to the amount mobilized under time and savings deposits. Failure to take employee morale and incentives into account can undermine good office and depositor confidence, and prevent effective savings mobilization.

5. To expand availability of banking services, branch expansion policy should be continued. High short-run resource costs involved are more than likely to be offset by incentives provided for savings and by the longer-run advantages of monetization that they facilitate. A note of caution is warranted, however. Branch expansion policy should be pursued not only to mobilize resources as is the record so far but also to correspondingly accelerate lending to productive rural ventures.

Policy measures to increase savings capacity in the longer run and thus contribute to the saving mobilization efforts indirectly, may now be discussed. The measures should be adopted with a view to raising the investment rate and making investment more productive.

6. The widely publicized priority sector lending program of commercial banks has not made much headway. The outstanding credit was only 3.8 percent of total deposits as of mid-July 1982 and 3.6 percent in mid-July 1983 as against the minimum target of seven percent. Even this modicum of lending has to some extent been misutilized and consequently, the Rastra Bank imposed in 1983 a penal interest rate which is significantly higher than the subsidized rate on priority lending. What has gone unnoticed is the effect that the low interest rate has on the interest of the banks over the whole program concerning the amount of lending as well as the use of funds lent. Prices that provide input for decision-making to demanders indicate it to suppliers as well. A higher rate on credit to priority sectors on par with the rate on other loans will induce banks to act more rapidly and purposefully in search of potential investment. Monetary authorities may exploit the trade-off likely to exist between the payment of subsidy on interest rate to the banks (necessary when the banks are asked to charge a low rate on loans) and the benefits from greater monitoring of credit use and from increased lending that the banks might be induced to perform when allowed to charge a higher interest rate. It does not mean, however, that the interest rate to the priority sector should be kept low and the difference between priority and commercial rates be paid for by monetary authorities. The rate charged from borrowers should be gradually raised and the distortionary effect of the subsidy removed. As long as the banks are forced to accept interest on loans below what they have to pay to depositors, the programs of priority lending or intensive banking are not likely to achieve desired results.

7. ADB/N has been lending to rural areas substantially out of proportion to the volume of deposits it has mobilized. Involving this institution to mobilize savings and perform banking activities is a positive decision. This is expected to reduce the reverse flow of funds from rural to urban areas and help win confidence of local people that the savings collected will be reinvested in the same area. Consequently, the amount of savings mobilized should increase. However, once ADB/N begins paying a higher interest rate on deposits than the rate it has been paying on refinance from the Rastra Bank or borrowings from the

Asian Development Bank, it will face the same problems as commercial banks (indicated in recommendation 6). This aspect of the cost of funds to both the lender institution and borrowers should be resolved soon.

8. A positive real interest rate policy is necessary not only for deposits but for loans. The policy so far has been to subsidize priority credit and tax other forms of credit as well as bank profitability. This policy should be replaced by removing constraints on investment flow. There are many complementary policies the government could adopt, particularly in terms of revising existing tax and pricing policies to remove their distortionary effect on resource allocation. These policy revisions should be made after a careful investigation of existing fiscal policies.

9. The case is usually made that rural savings banks should be set up for rural savings mobilization as well as for rural lending. The case would be justified if interest rate structure of existing institutions were unable to encourage savings (Khatkhate, 1980, p.146). This is, however, not the case in Nepal. A further justification could arise from the need for increasing competitiveness among institutions, considering the present duopolistic banking market. The argument loses force because of increasing involvement of ADB/N in the rural savings market. The resource cost of establishing a new institution would be considerably larger than the cost of expanding banking services through ADB/N.

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