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# **SUMMARY OF FINANCIAL MARKETS IN NEPAL: SECONDARY SOURCE SURVEY**

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*Bureau for Private Enterprise  
U.S. Agency for International Development*

*Prepared by:*

*Arthur Young*

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A MEMBER OF ARTHUR YOUNG INTERNATIONAL

## **NOTE**

**This document was prepared by Arthur Young and summarizes existing literature describing the country. Secondary sources were obtained from the International Monetary Fund, the World Bank, the Inter-American Development Bank, the African Development Bank, the Asian Development Bank, the United Nations, and other relevant commercial sources.**

## NEPAL

### SUMMARY OF FINANCIAL MARKETS SURVEY

#### A. ENVIRONMENT

1. Stable political history:
  - a) Nepal is governed by a constitutional monarchy; for the last 24 years, the monarch has exercised autocratic control over a panchayat system of government. The panchayat system which has been called a 'partyless democracy,' consists of a five-tiered, hierarchically organized group of councils ranging from the monarch down to the village level. There is some unrest amongst outlawed political groups (consisting primarily of students) seeking to replace the panchayat system with a parliamentary democracy.
  - b) Foreign policy of political nonalignment and neutrality.
2. Unstable economic history:
  - Economy relies heavily on agriculture (which employs 90% of the labor force, and accounts for 60% of GDP and 75% of exports.) Agricultural output is entirely dependent on the summer monsoon rains, as only 13% of agricultural lands are irrigated.
3. Stable social system:
  - a) Predominantly Hindu (85%) and Buddhist (12%); little or no religious tension between groups.
  - b) Country is very diverse socially; villages are isolated due to lack of roads and difficulty of construction in mountainous areas.
  - c) Official language is Nepali, which is spoken by approximately half the population. In addition to Nepali, 20 other languages, which are mutually unintelligible, are in use.
4. Legal system based on Hindu legal concepts and English common law.

5. Substantial international assistance

- a) Bilateral assistance: Australia  
Canada  
China  
Denmark  
Germany (West)  
India  
Japan  
Kuwait  
New Zealand  
Switzerland  
United Kingdom  
U.S.A.  
U.S.S.R.  
Ford Foundation
- b) Multilateral assistance: Asian Development Bank  
International Development  
Association  
Nepal Aid Group  
OPEC  
UNO  
UNCDF  
UNDP  
UNICEF  
World Bank  
World Food Program  
World Health Organization
- c) Relationship with India:  
India is the largest source of bilateral aid to Nepal, accounting for about 25% of the total in FY1980-81. Nepal has strong economic ties to India due, in part, to geographical considerations: the border between Nepal and India is long and difficult to control; and Nepal is land-bound, relying on India for her only access to a port, and third party trade, through Calcutta. Economic ties between Nepal and India are such that free convertibility is maintained between the two currencies. Tariffs and other trade barriers are low or non-existent. This dependence on India has created a situation where the level of Nepal's major export, rice, is highly sensitive to Indian economic conditions and policies.

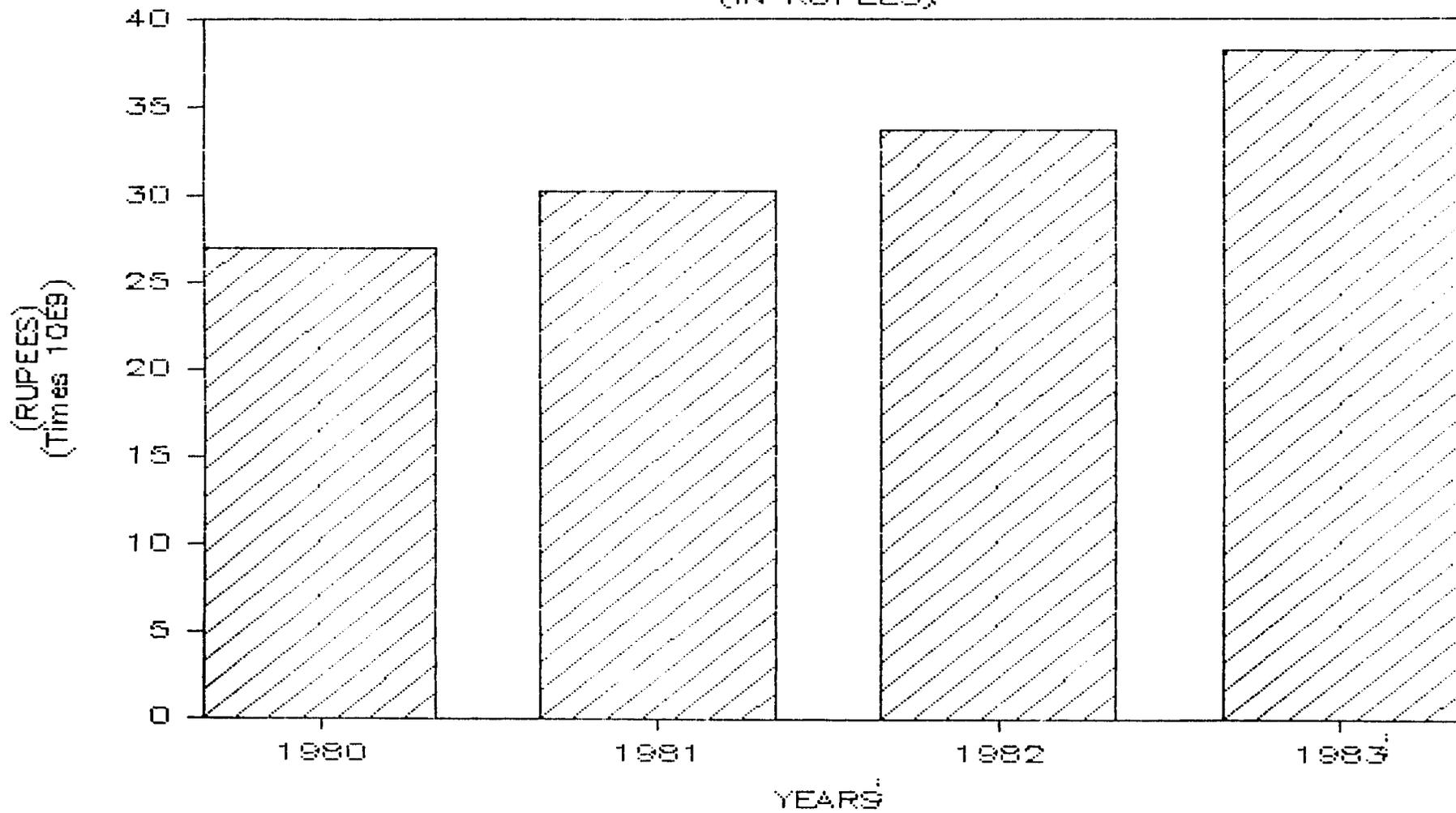
## B. ECONOMY

1. GDP growth rate:
  - a) Between FY1982-83 and FY1983-84, Nepal's GDP increased from NR 33,621 million to NR 38,184 million, an increase of 13.6%.
  - b) Per capita GDP increased 10.8% between FY1982-83 and FY1983-84, moving from NR 2,128 to NR 2,357.
2. Inflation rate:
  - a) Inflation is a serious problem in Nepal, where the the inflation rate has averaged 13-14% in recent years.
  - b) Government measures to curb inflation (including fair price shops and price ceilings on certain basic necessities) have proved ineffective.
  - c) The main causes of inflation in Nepal are periodic shortages of essential commodities; a heavy reliance on imports, and resulting sensitivity to increasing imports prices; and the expansionary effects of deficit financing.
3. Balance of Payments:
  - a) Although Nepal's balance of payments for FY1983-84 showed a deficit, there was improvement over FY1982-83. The primary contributor to the deficit is the negative trade balance, which was reduced by 14.5% between FY1982-83 and FY 1983-84.
  - b) Nepal's balance of payments situation is unlikely to improve significantly in the near future. This is due to the fact that the trade deficit is not expected to improve because of Nepal's limited export potential and continued need for development related imports.
4. Nepal has a mixed economy with a dominant public sector. GON investment in public enterprises is quite large, ranging from a low of 70.6% in FY1970-71 to a high of 88.7% in FY1972-73. Although recent data on the precise proportion of public and private sector investment was not found, sources indicate that Nepal is still predominantly a public sector economy.

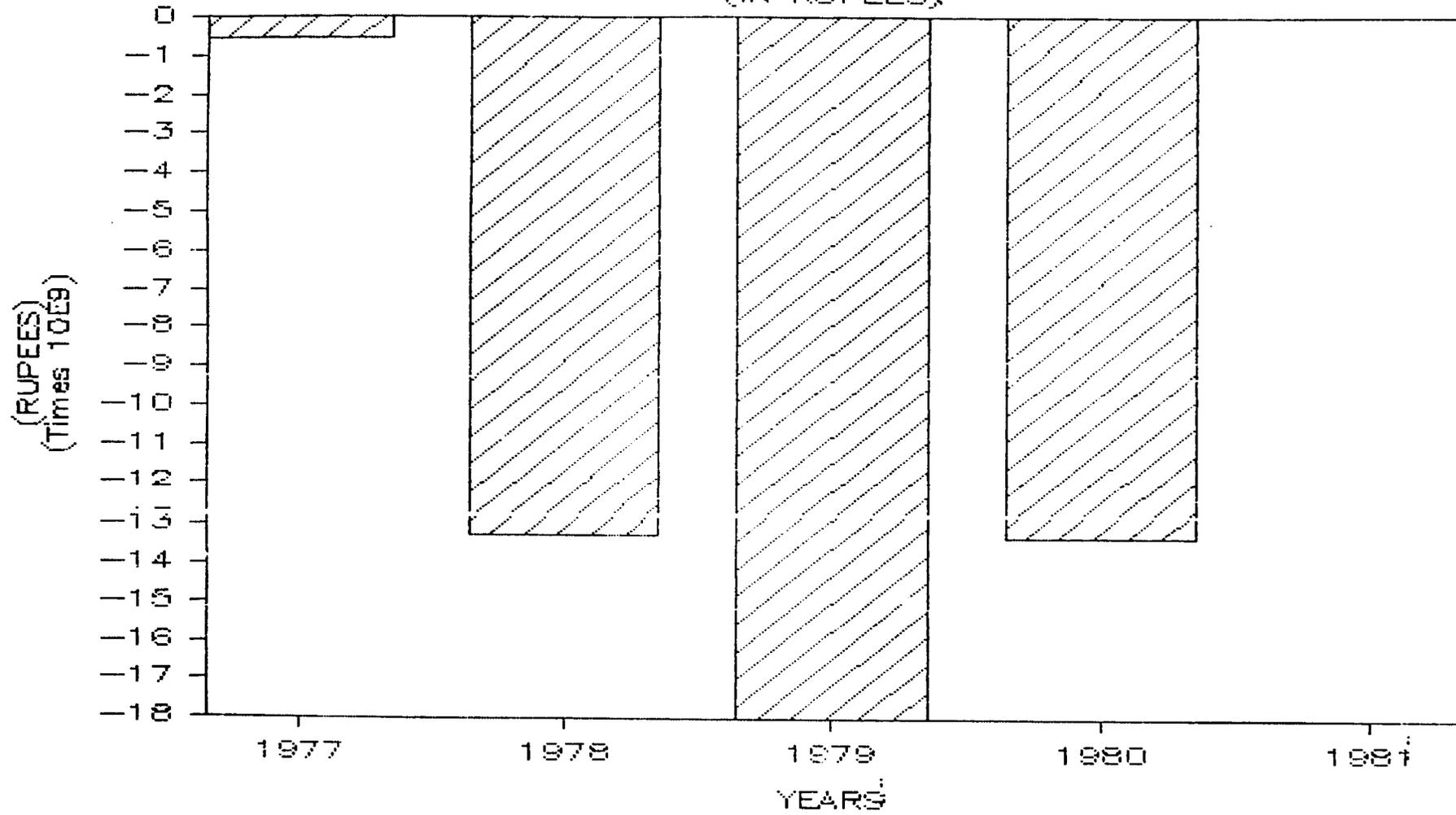
5. Labor force analysis:

- a) Population: 16.3 million  
Population growth rate: 2.6%
- b) Literacy: overall literacy in Nepal was 20% in 1984, however there are huge discrepancies in literacy rates between the rural and urban populations, and between the male and female population.
- c) Labor force: the labor force, which includes everyone ten years of age or older, was 4.1 million in 1983. Of this number, 93% were employed in agriculture, 5% in services, and 2% in industry.

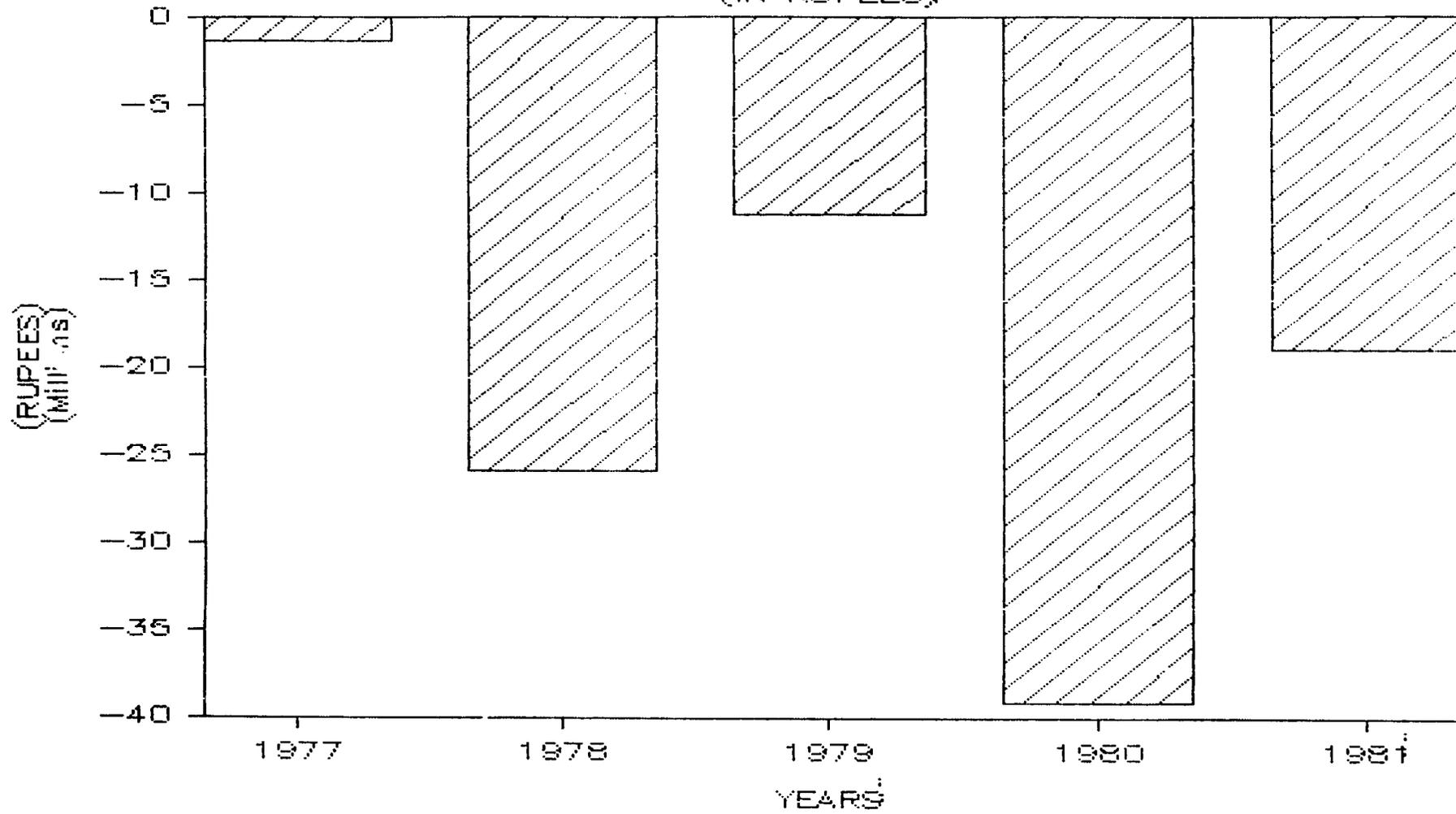
# GROSS DOMESTIC PRODUCT (IN RUPEES)



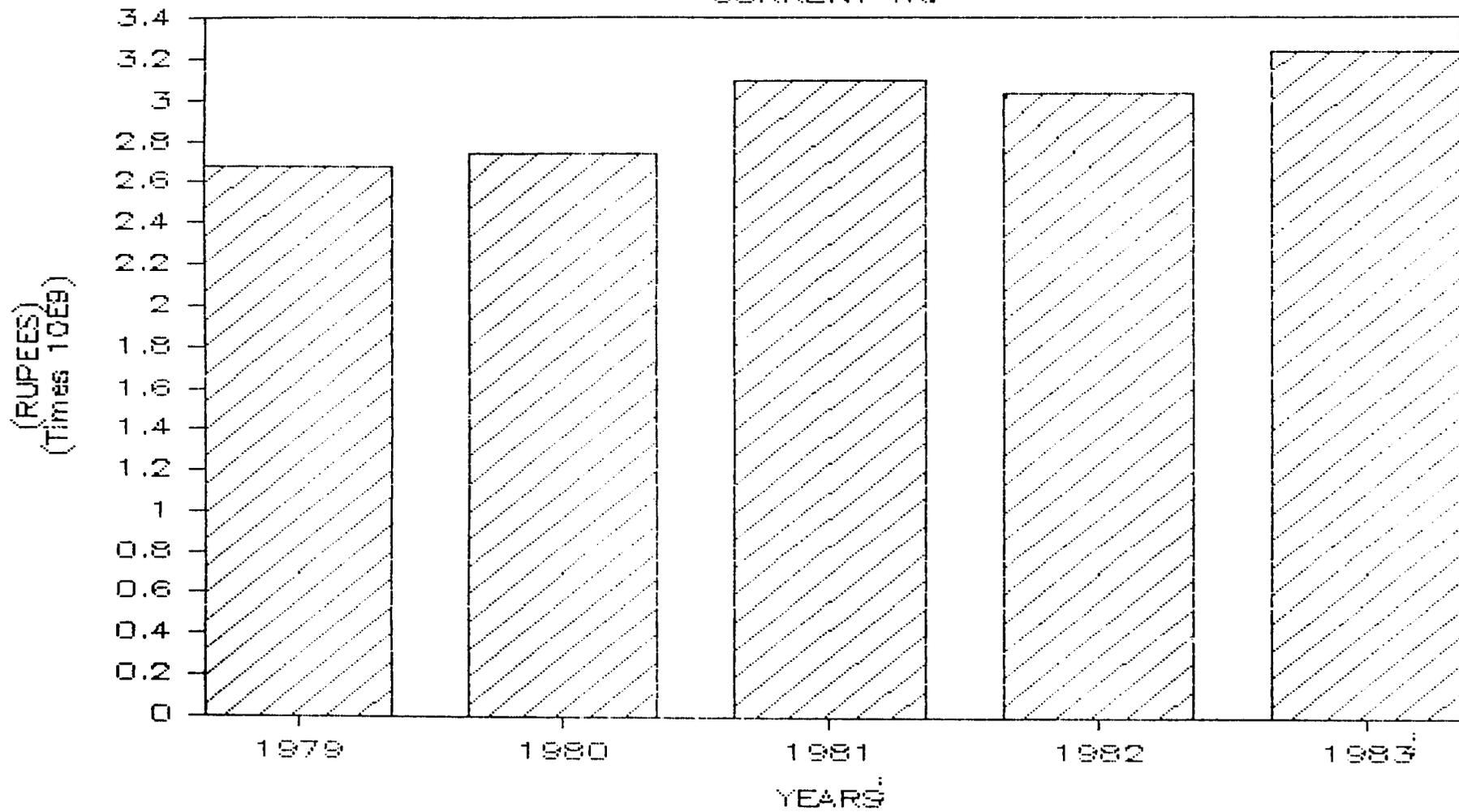
# OVERALL DEFICIT/SURPLUS (IN RUPEES)



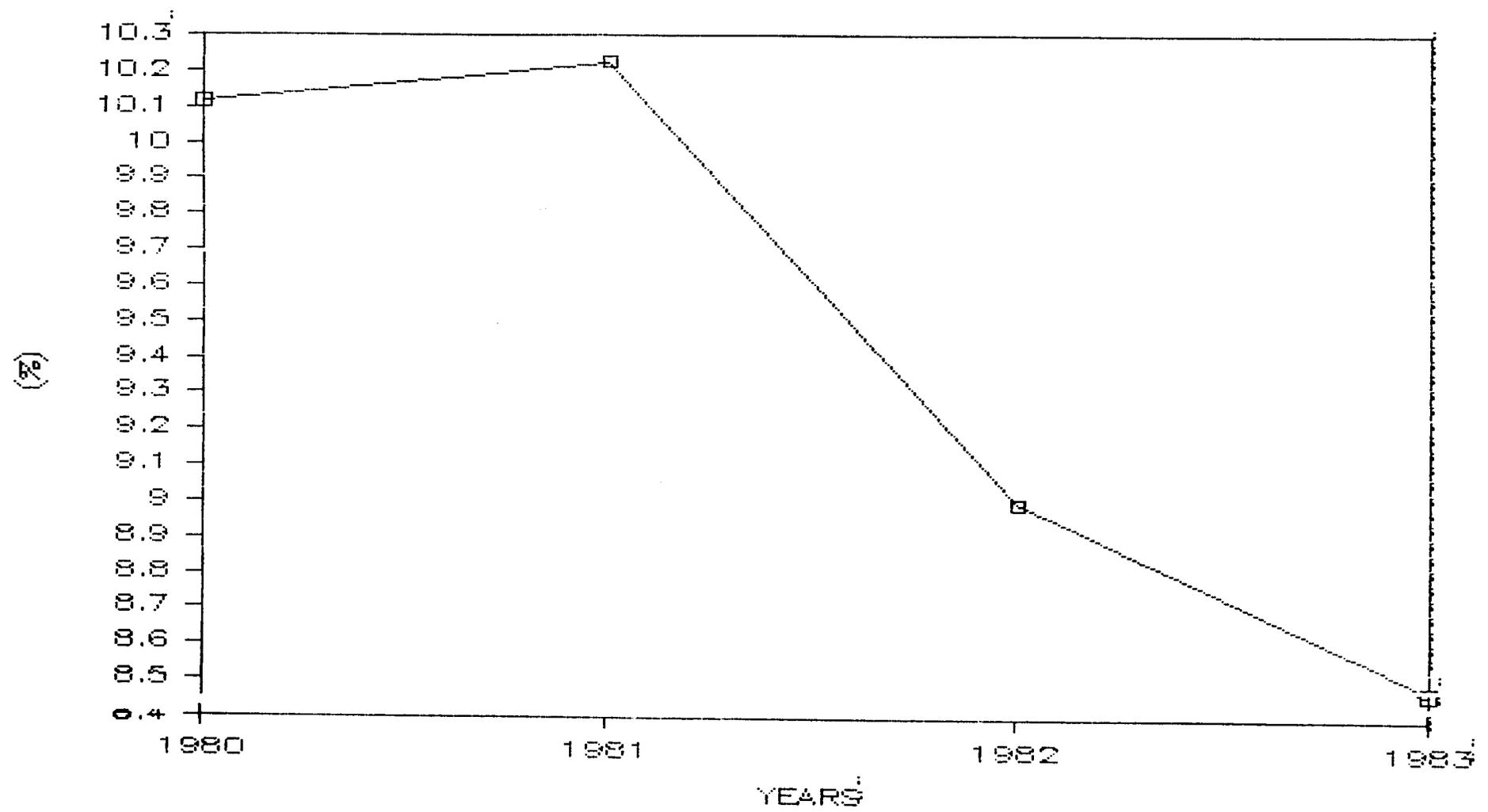
# CURRENT ACCOUNT BALANCE (IN RUPEES)



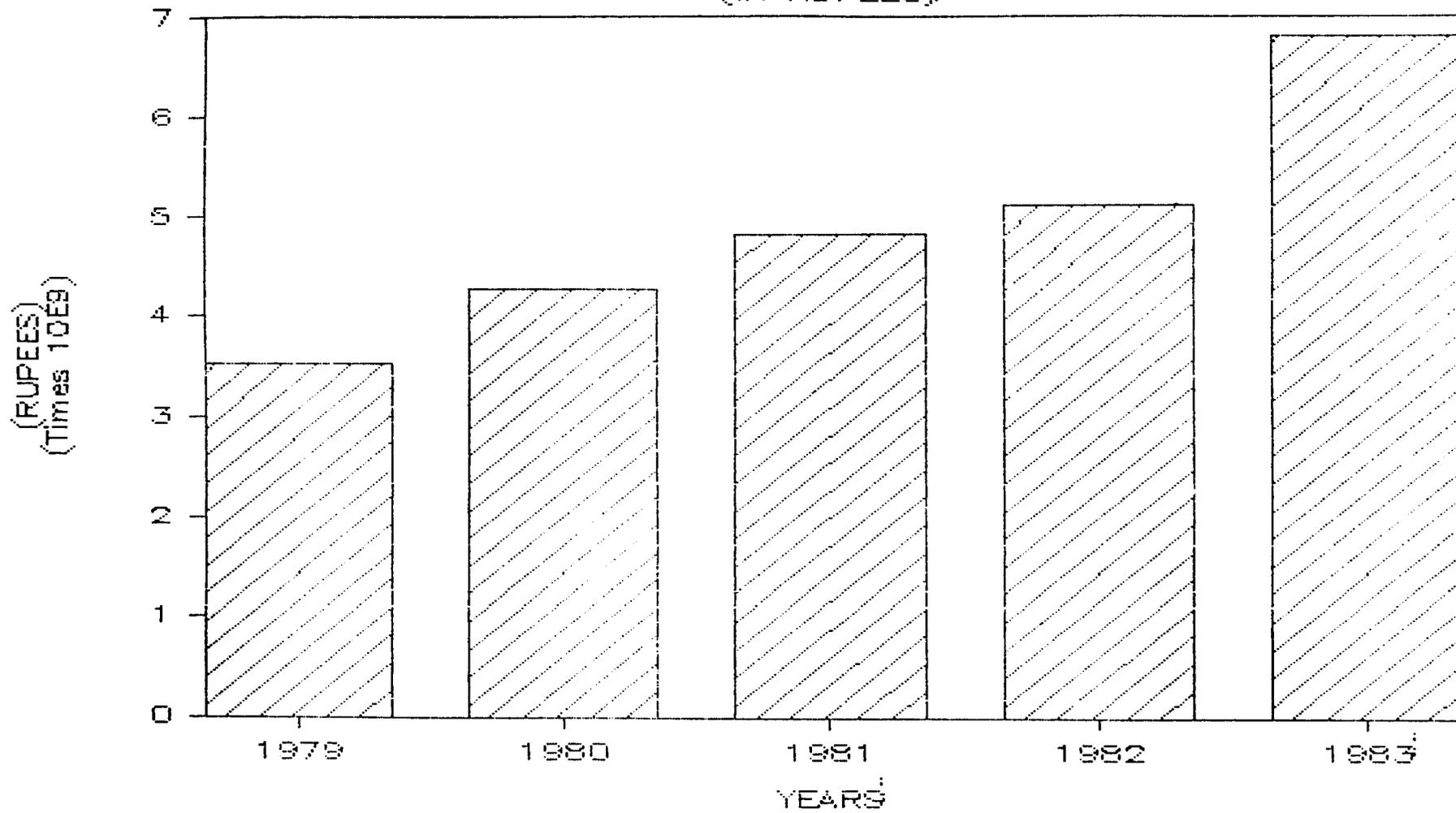
# GROSS NATIONAL SAVINGS — EXCLUDING NET CURRENT TRF



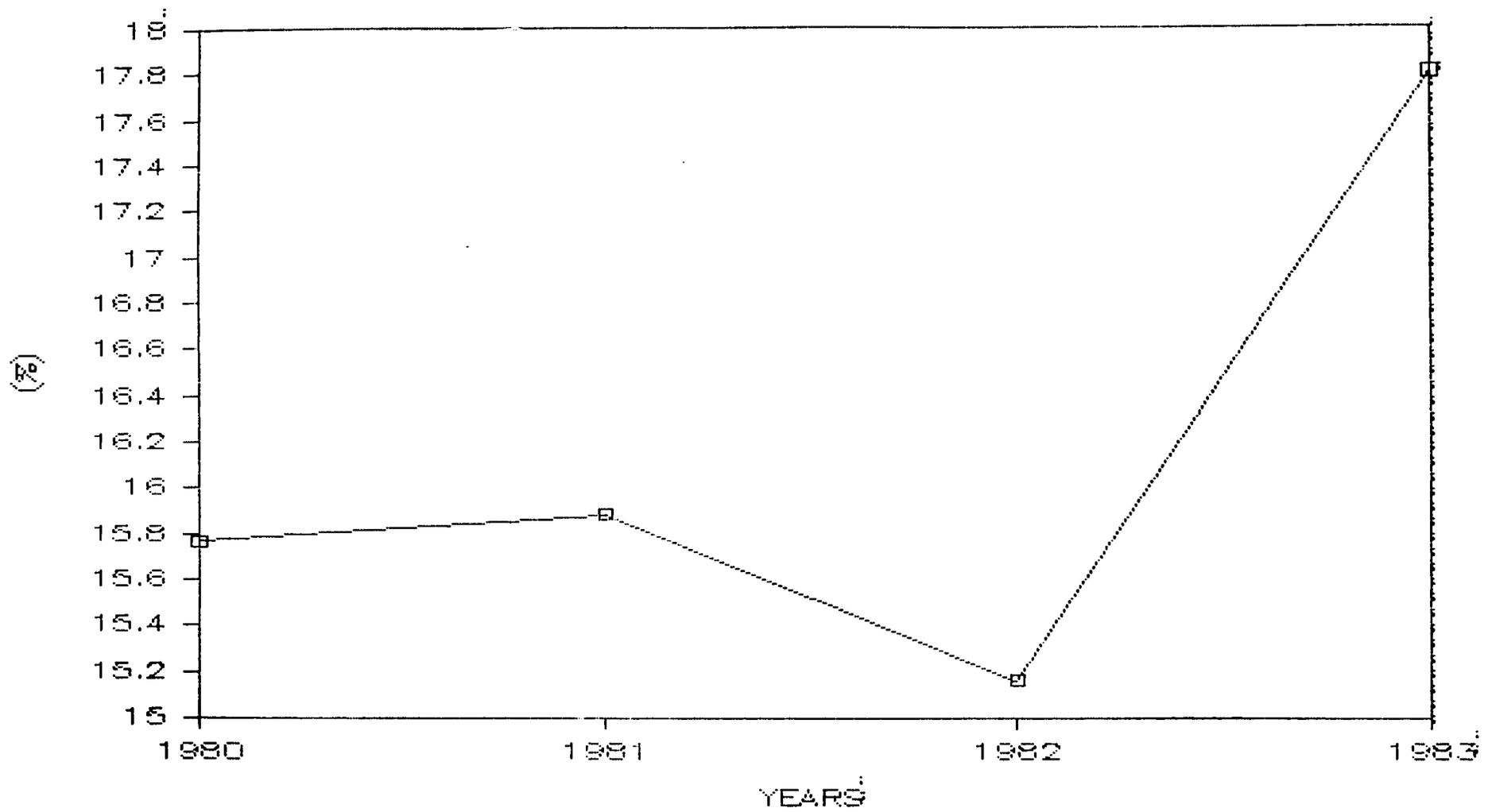
# GNS AS A PERCENTAGE OF GDP



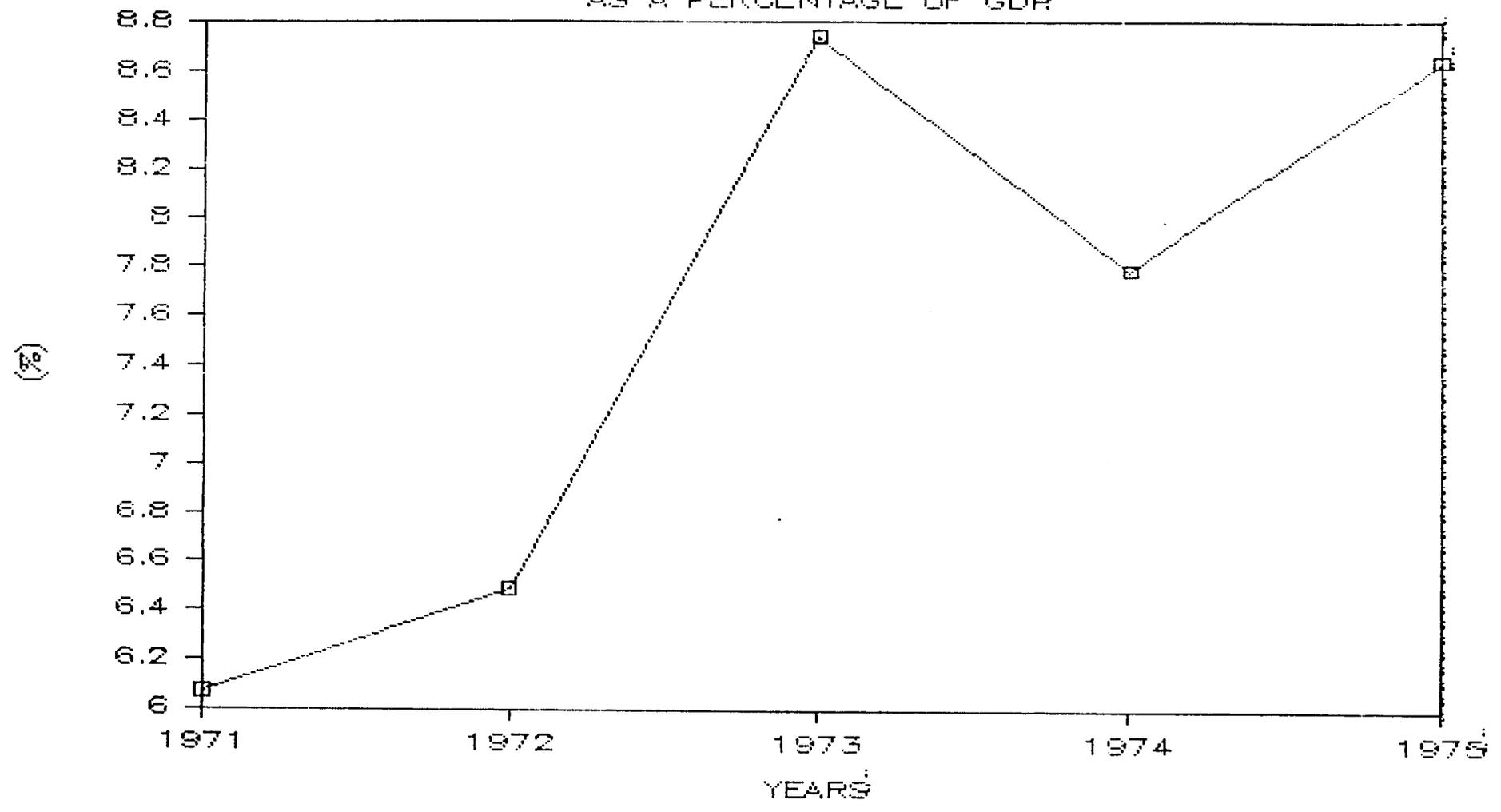
# GROSS DOMESTIC INVESTMENT (IN RUPEES)



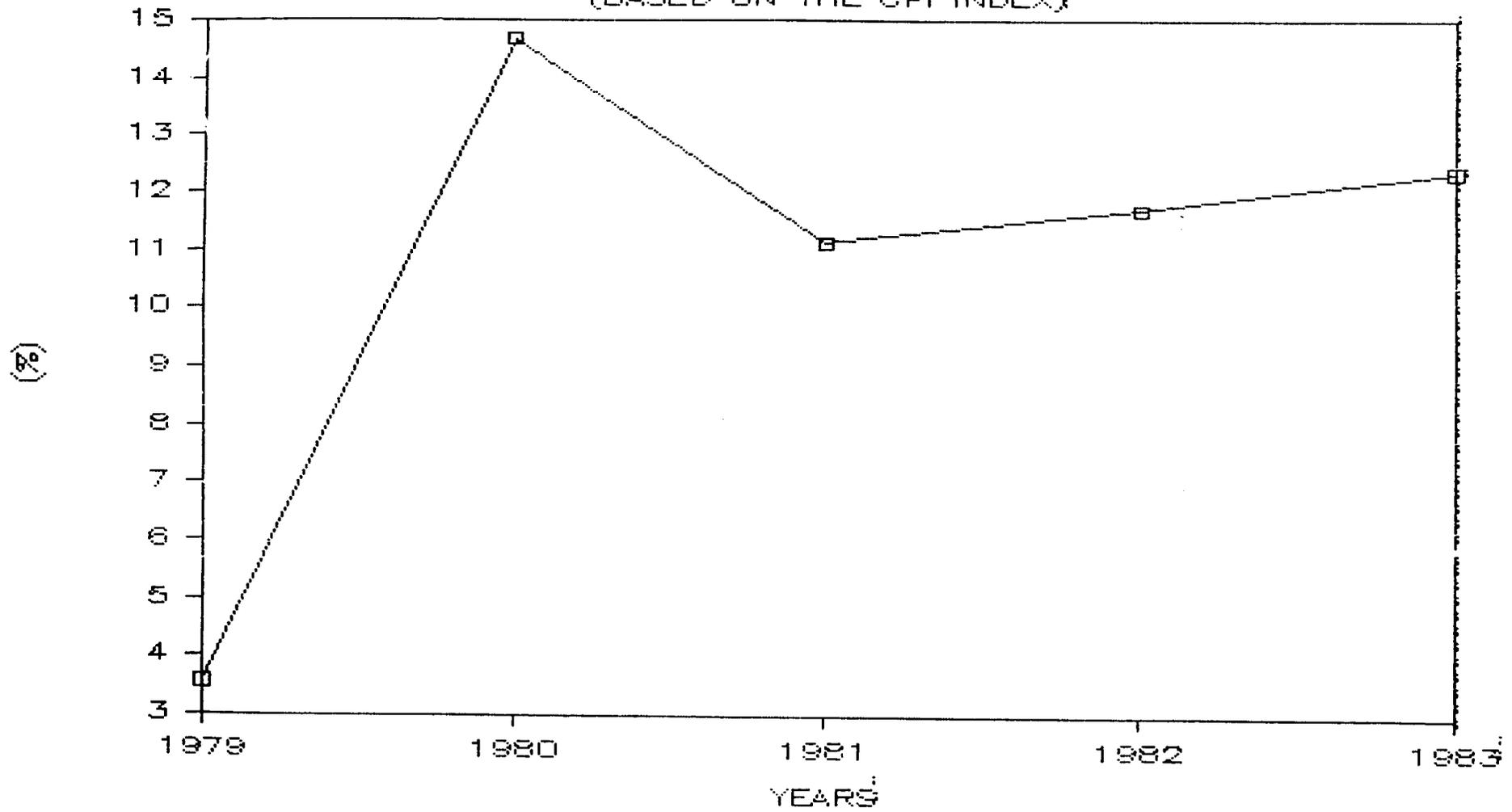
# GDI AS A PERCENTAGE OF GDP



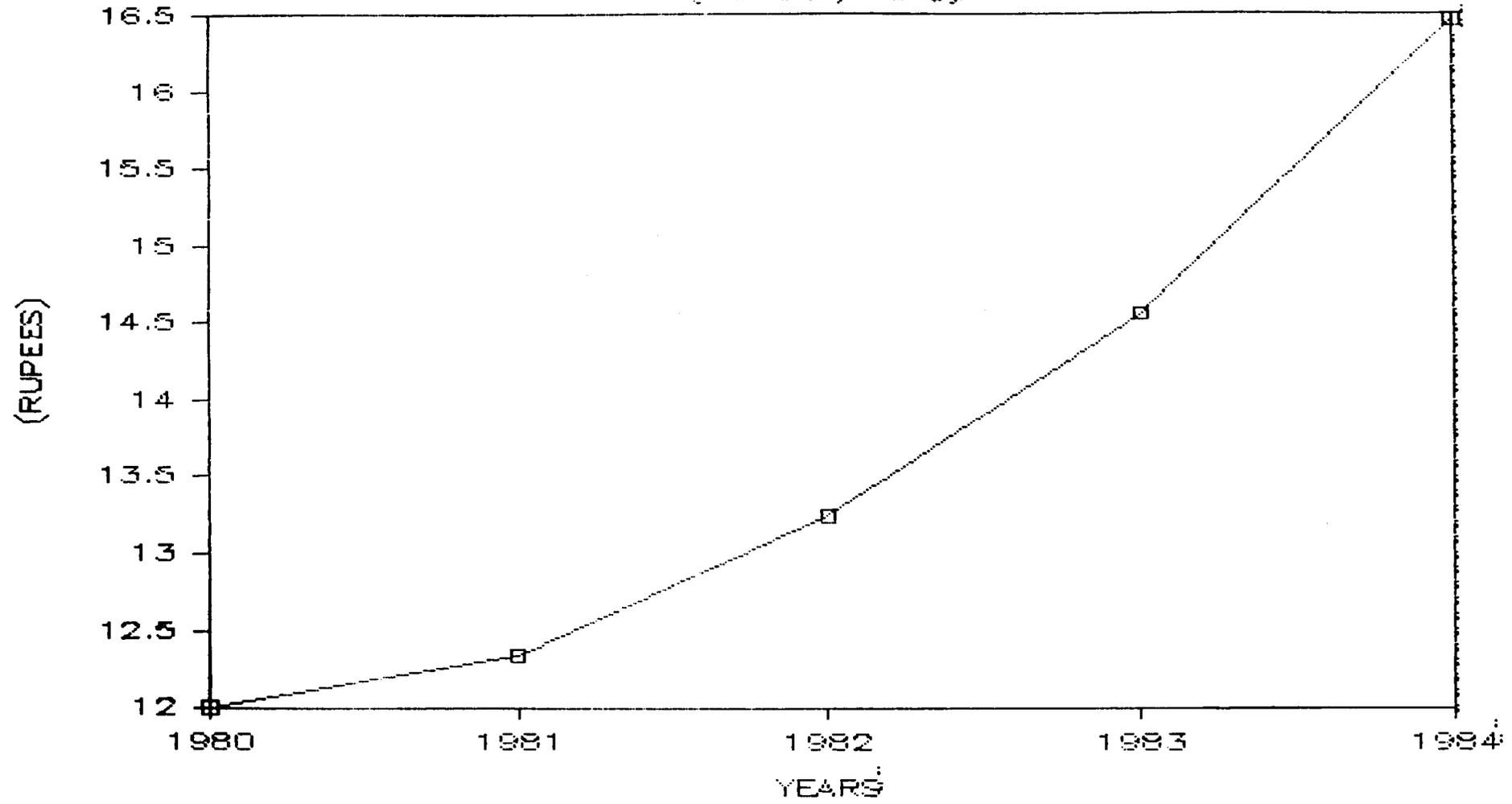
# TOTAL INVESTMENT IN PUBLIC ENTERPRISES AS A PERCENTAGE OF GDR



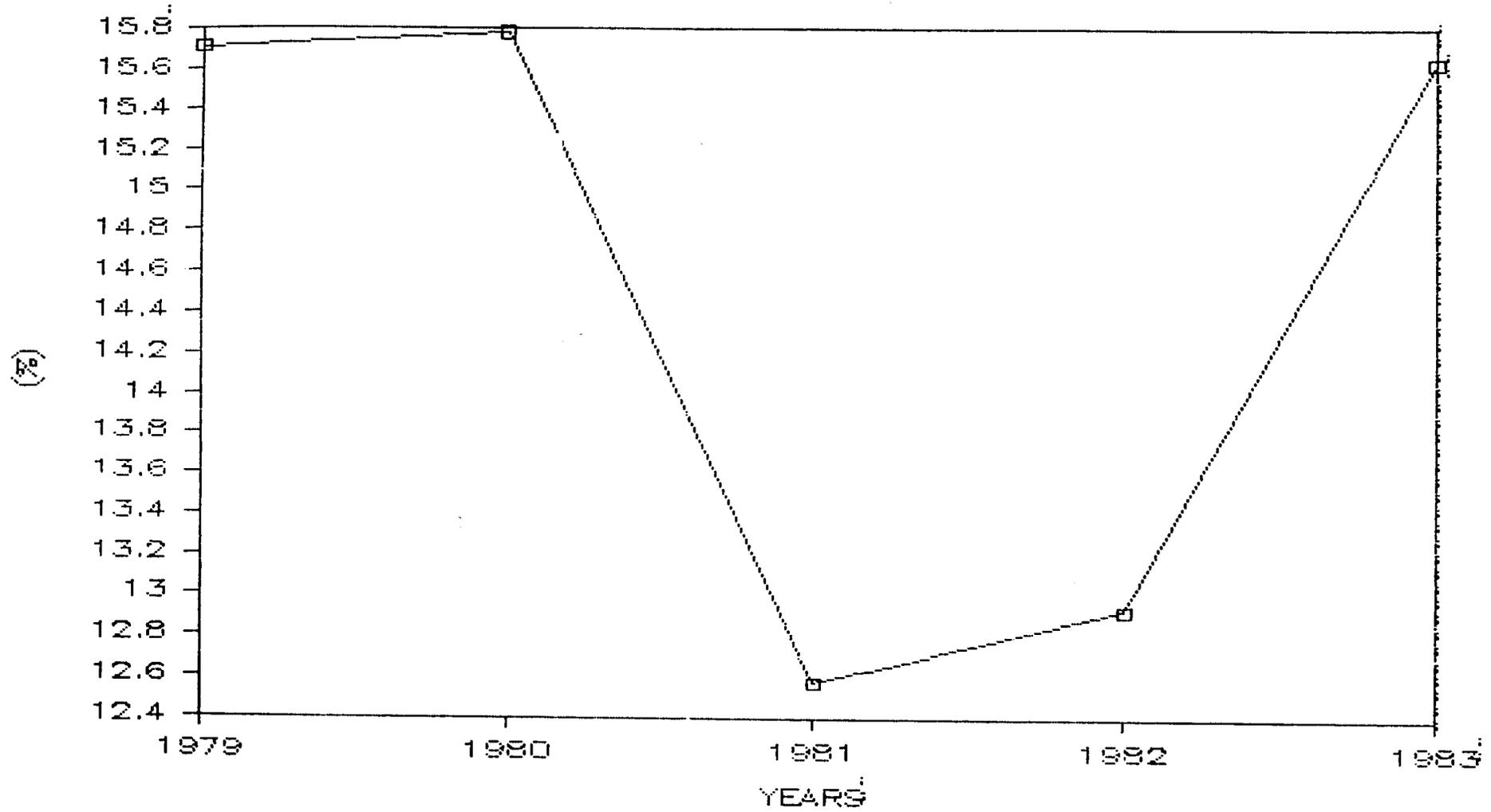
# NEPAL'S INFLATION RATE (BASED ON THE CPI INDEX)



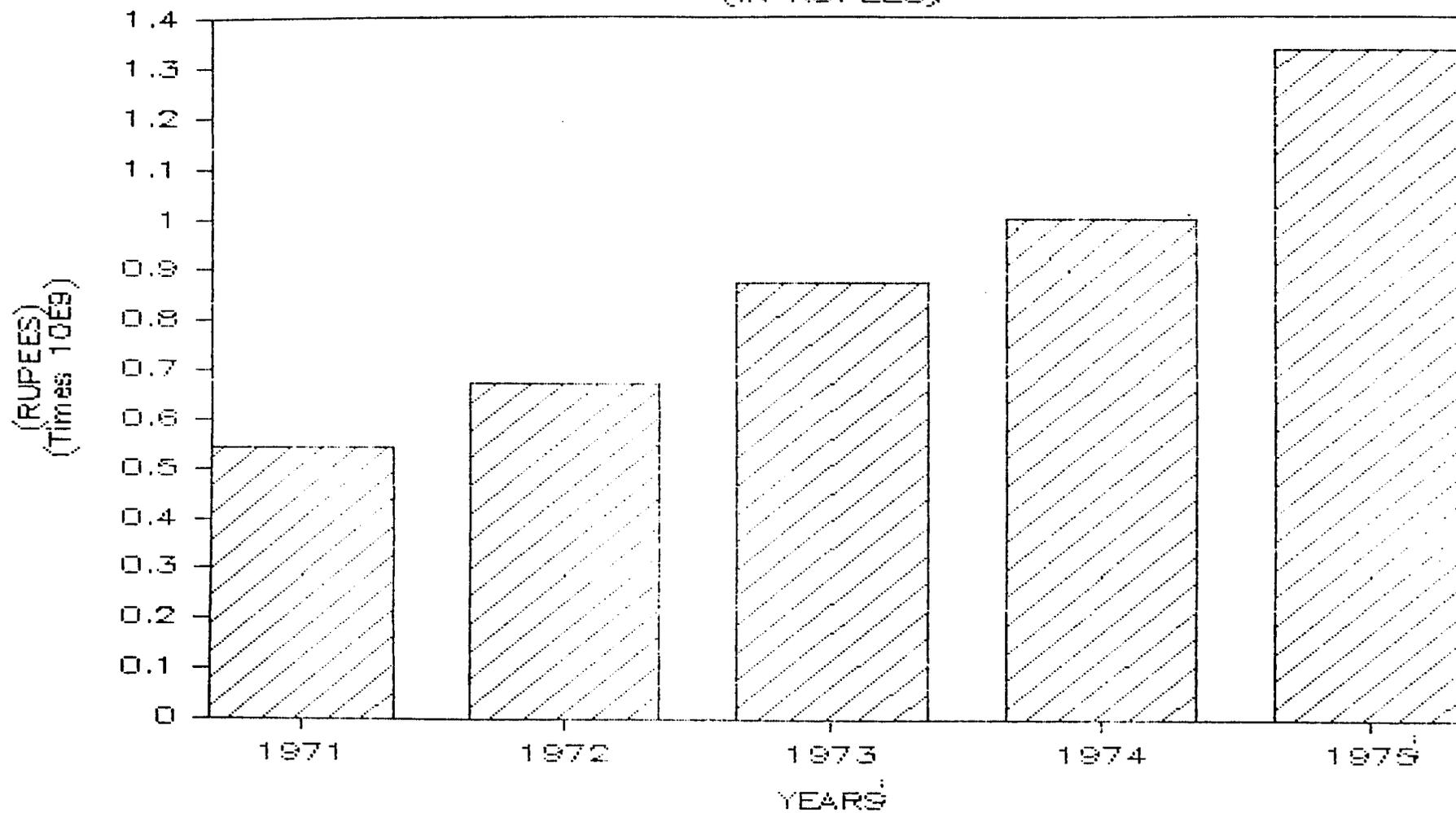
# MARKET EXCHANGE RATE (RUPEES/US \$)



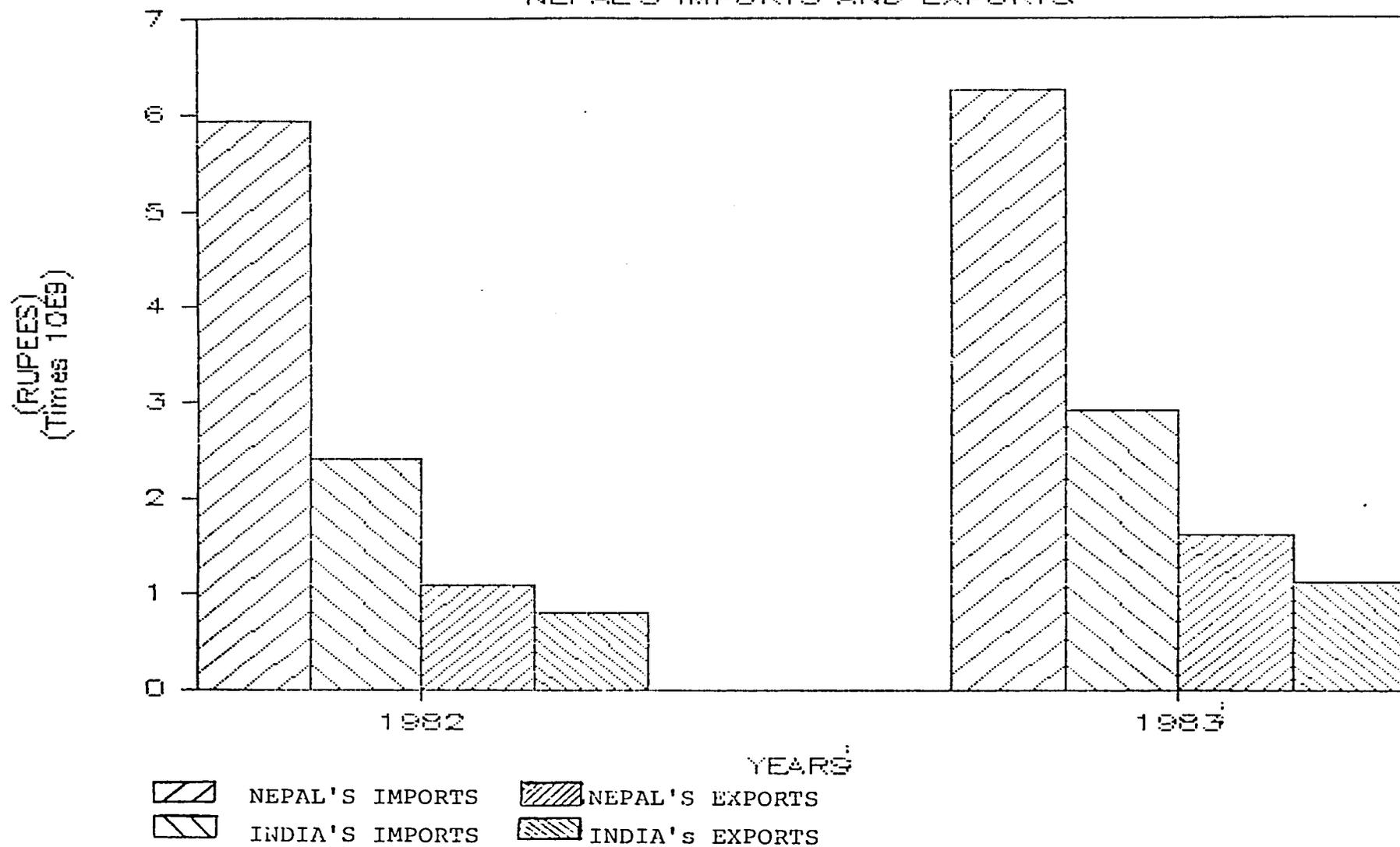
# GROWTH OF MONEY SUPPLY



# TOTAL INVESTMENT IN PUBLIC ENTERPRISES (IN RUPEES)



# INDIA'S CONTRIBUTION TO NEPAL'S IMPORTS AND EXPORTS



## C. REGULATORY CLIMATE

### 1. Foreign investment

- a) GON encourages foreign investment which will: afford Nepal improved import substitution or export promotion; utilize local raw materials; provide employment opportunities and technical training for Nepali citizens; and provide transfer of technology.
- b) Foreign investment is limited to large and medium enterprises, and must be incorporated as a limited liability company in Nepal.
- c) Repatriation of capital was at 20% in 1982.
- d) Industrial enterprises with foreign equity participation will not be nationalized, except under special circumstances.

### 2. Licenses and registration are required for starting industrial enterprises, except cottage industries.

#### D. FINANCIAL INSTITUTIONS

1. Nepal's financial institutions are in a very rudimentary stage of development, as evidenced by the limited number and variety of institutions existing at this time:
  - a) Banking Institutions
    - Central Bank: Nepal Bank Limited (NBL)
    - Commercial Bank: Nepal Rastra Bank (NRB)
    - Development Banks: Nepal Industrial Development Corporation (NIDC)  
Agricultural Development Bank (ADB)
  - b) Non-Banking Financial Institutions
    - Provident Fund: central agency which pools savings compulsorily deducted from salaries of government employees and other autonomous and private organizations which have an agreement with the Fund.
    - National Insurance Corporation (NIC): the only insuring body in Nepal, the NIC handles both life and general insurance. With total assets of NR 43.5 million at the end of FY1977, NIC accounted for just under 1% of total assets of all financial intermediaries. NIC investment consists almost entirely of government bonds and fixed deposits.
2. The public sector has been significant in the development of Nepal's financial institutions; all financial intermediaries except Nepal Bank Limited were established as public sector enterprises and are owned and controlled by GON.

## E. FINANCIAL MARKETS

### 1. Corporate securities market

a) Corporate security market is virtually non-existent.

Supply factors: - The Nepalese business community prefers to keep ownership within a small circle (proprietary, partnership, and private limited companies being the common forms of organization).  
- There are no incentives to go public. Currently the only inducement is an increase of 5% to loan limits from NIDC.

Demand factors: - Lack of secondary market to ensure liquidity of investment.  
- The majority of the population lives at subsistence level, lacking the means or education in business principles to invest in securities.  
- Those with funds and education tend to prefer riskless ventures such as real estate, commercial bank deposits (yielding 13% in 1981), and tax-free government bonds (yielding 10% in 1981).  
- The Nepalese people tend to lack confidence in the ability/trustworthiness of management due to previous experiences of fraud and abuse on the part of managing agents and directors.

b) Security Marketing Center (SMC)

- SMC was established in 1976, and acts as Nepal's stock exchange. Authorized capital was equal to NR 1 million in 1981; of that 51% was owned by NIDC and 49% by NRB.
- In 1981 SMC dealt only with government bonds and treasury bills, but was planning to begin trading corporate securities.
- Problem: lack of securities to exchange. A 1976 SMC survey identified only 11 companies meeting SMC criteria for listing (6 wholly government owned, 3 private sector owned, 2 jointly owned, with the government as the major shareholder).

2. Government securities market

- a) GON holds a virtual monopoly over the security market, dealing primarily in development bonds (yielding 10% in 1981).
- b) Government bonds provide GON with a substantial income, providing 11.5% of total government expenditure in FY1976-77.
- c) Government bonds are held primarily by commercial banks and other financial institutions (about 80% of total bond ownership in 1977).
- d) More recent sources on the government securities were not found.

3. Tax incentives:

- a) Current taxation system exempts interest earned from development bonds from taxation, however the dividends are taxed, which encourages investment in risk-free securities as opposed to stocks.

## F. TAX SYSTEM

### 1. Indirect Taxes:

- The GON receives the largest amount of revenue from indirect taxes (approximately 84% of total tax revenues in recent years.) This is probably due to the fact that 97% of the population is unable to save, and therefore has limited taxable income.
- Of the indirect taxes, the major source of revenue is the tax on customs, which accounted for nearly 50% of indirect taxes in FY1982-83.
- When introduced in 1965, the sales tax was a flat 2%. Today, the tax is levied on a 5-tier system, ranging from 1% for essential commodities to 20% for luxury goods.

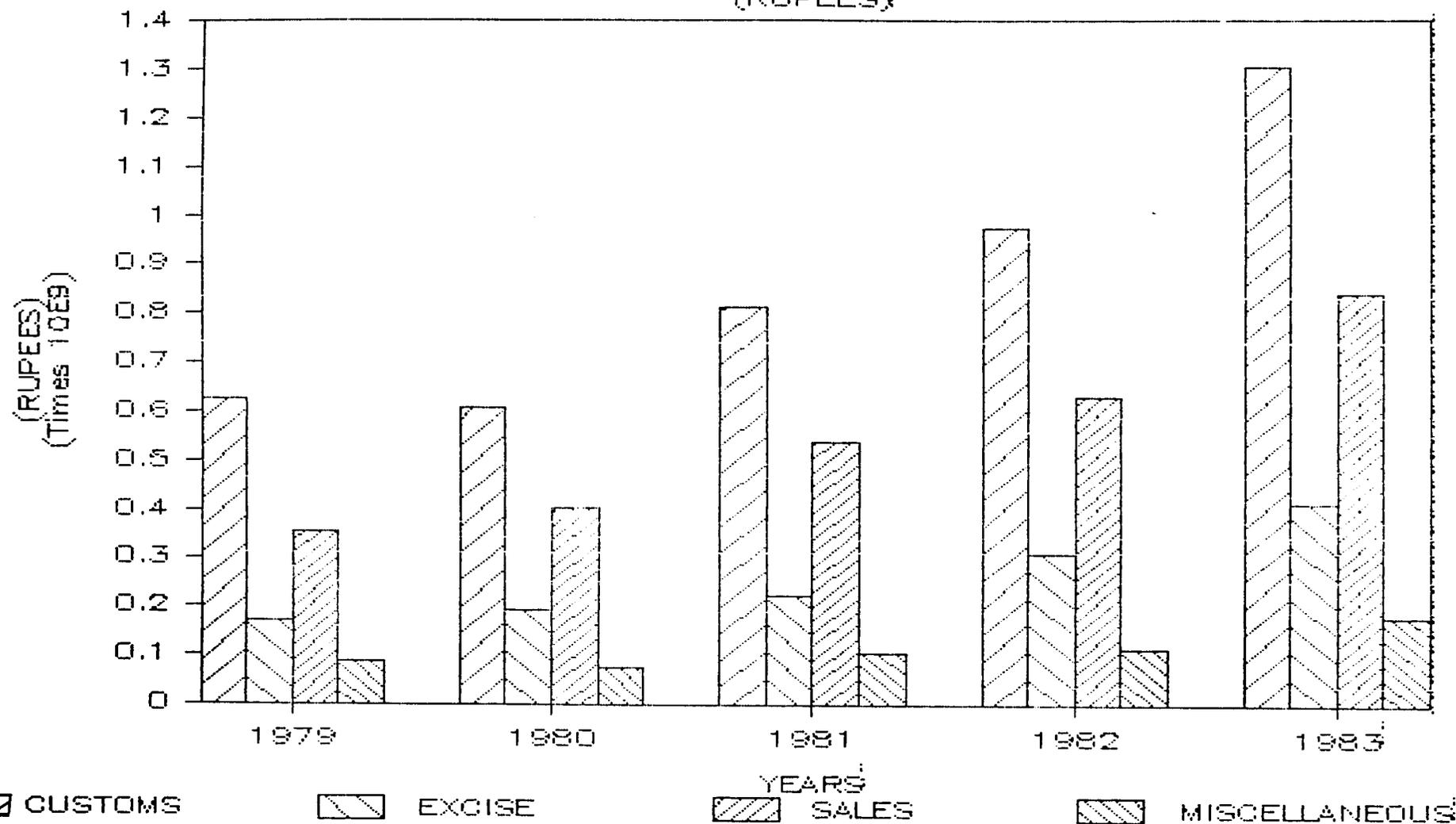
### 2. Direct Taxes:

- a) Of the direct taxes, the income tax provides the largest source of revenue for GON, contributing 47.7% of total direct tax revenue in FY1982-83.

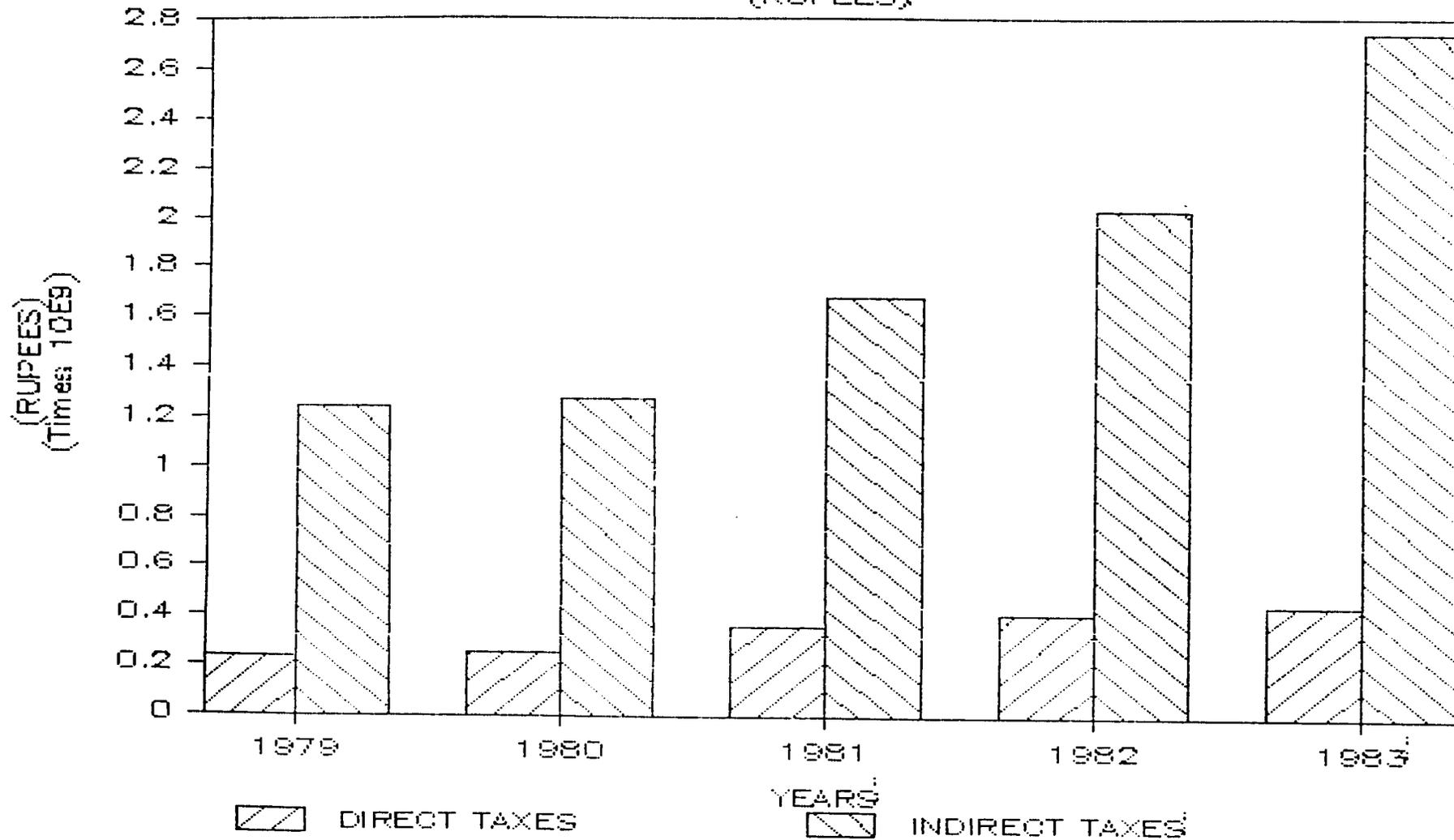
### 3. Tax Incentives:

- a) Partial and 100% income tax exemptions are granted for periods of 5-10 years to approved enterprises, such as cottage industries, manufacturing industries, tourism, energy-based mining and mineral processing, and agro-based industries.
- b) Additional exemptions are granted to firms with value added between 20-50%, to firms producing consumer goods, and to firms which export more than 25% of total production.
- c) Tax credits are granted for training expenses, in an effort to upgrade Nepalese worker skills.
- d) Import duties are only 1% for:
  - machinery, equipment, etc. to be used directly in construction/operation of enterprise,
  - mining and related equipment,
  - raw material used in production.However, if materials of suitable quality are available within Nepal, an import duty of 15% is charged.

## COMPOSITION OF INDIRECT TAXES (RUPEES)



# TOTAL DIRECT AND INDIRECT TAXES (RUPEES)



## AREAS OF INSUFFICIENT INFORMATION

No sources were found which provided information on the accounting principles used in Nepal. Data was also insufficient in the areas of government attitudes and regulatory climate.