Itahari Namuna College

Faculty of Humanities and Social Science

REPORT

APPLIED ECONOMICS

Submitted To:

Bishworaj Dulal

Department of Computer Application

Submitted By:

Aayush Shrestha

The Role of the Banking System in the Economic Development of Nepal

Introduction

The banking system plays a fundamental role in the economic development of a country by mobilizing savings, allocating financial resources, facilitating investment, and supporting overall macroeconomic stability. In developing economies like Nepal, where capital markets are relatively weak and informal finance still plays a significant role, banks act as the backbone of the financial system. The effectiveness of the banking sector therefore has a direct impact on economic growth, employment generation, poverty reduction, and overall development outcomes.

Nepal's banking system has evolved significantly over time. Prior to financial sector liberalization, the system was dominated by a few state-owned banks with limited outreach and inefficient service delivery. Since the adoption of economic liberalization policies in the late 1980s and early 1990s, Nepal has experienced rapid expansion of banking and financial institutions, including commercial banks, development banks, finance companies, and microfinance institutions under the supervision of Nepal Rastra Bank (NRB). This expansion has improved access to financial services, increased savings mobilization, and enhanced the availability of credit to different sectors of the economy.

The role of the banking system is particularly important in Nepal due to the country's structural economic challenges. Nepal's economy is characterized by low levels of industrialization, high dependence on agriculture and remittances, limited domestic production capacity, and a narrow export base. In this context, banks are expected to channel financial resources toward productive sectors such as agriculture, hydropower, tourism, small and medium enterprises (SMEs), and infrastructure development. By providing credit and financial services to these sectors, banks can support capital formation, enhance productivity, and stimulate sustainable economic growth.

Furthermore, the banking system contributes to economic development by promoting financial inclusion and social equity. A large proportion of Nepal's population resides in rural and remote areas, where access to formal financial services has historically been limited. The expansion of bank branches, digital banking services, and microfinance institutions has improved access to savings, credit, and payment services for marginalized groups, women, and small entrepreneurs. This inclusion enables households to invest in education, health, and income-generating activities, thereby supporting poverty reduction and inclusive growth.

Despite these positive contributions, Nepal’s banking system faces several challenges that may limit its developmental impact. Issues such as inefficient credit allocation, rising non-performing loans, concentration of lending in non-productive sectors, weak financial literacy, and vulnerability to external shocks pose risks to financial stability and economic growth. Additionally, Nepal’s heavy reliance on remittance inflows and import-based consumption can create liquidity pressures and distort credit growth patterns within the banking sector.

Given these opportunities and challenges, examining the role of the banking system in the economic development of Nepal is both timely and necessary. A comprehensive understanding of how banks contribute to savings mobilization, investment, financial inclusion, and economic stability can provide valuable insights for policymakers, regulators, and financial institutions. This study therefore seeks to analyze the contribution of Nepal’s banking system to economic development, review existing literature, and identify key findings and policy implications relevant to Nepal’s development path.

Objectives of the Study

The main objectives of this study are as follows:

- To examine the role of the banking system in the economic development of Nepal.
- To analyze how banks contribute to savings mobilization and capital formation.
- To assess the role of bank credit in promoting investment and economic growth.
- To review existing literature related to banking development in Nepal.
- To identify key findings and challenges associated with Nepal’s banking system.

Significance of the Study

This study is significant from both academic and practical perspectives. Academically, it contributes to the limited literature on the relationship between banking development and economic growth in Nepal. It provides students and researchers with a structured understanding of how banking institutions influence development outcomes in a developing economy.

From a policy perspective, the study helps policymakers, regulators, and banking professionals understand the strengths and weaknesses of Nepal's banking system. Insights from the study can support better policy formulation aimed at improving credit allocation, financial inclusion, and banking stability. Additionally, the study is useful for understanding how banking reforms can enhance sustainable economic growth and reduce poverty in Nepal.

Limitations of the Study

Despite its relevance, this study has several limitations. First, it relies primarily on secondary sources such as books, journals, reports, and published research, which may limit the depth of empirical analysis. Second, the study focuses mainly on commercial banking activities and does not extensively analyze non-bank financial institutions and informal financial sectors. Third, due to time and data constraints, the study does not include quantitative econometric analysis. Therefore, the findings are descriptive in nature and should be interpreted accordingly.

Literature Review

Theoretical Perspectives on Banking and Economic Development

The role of banking in economic development has long been emphasized in economic theory. Schumpeter (1911) argued that banks promote economic growth by financing innovative entrepreneurs and facilitating technological progress. Similarly, McKinnon (1973) and Shaw (1973) suggested that financial liberalization enhances savings and investment by removing interest rate controls and credit restrictions.

Levine (1997) further explained that banks support economic growth by mobilizing savings, allocating capital efficiently, monitoring borrowers, managing risks, and facilitating transactions. These functions are particularly important in developing economies where financial markets are incomplete.

Banking Development and Economic Growth in Nepal

Several studies have examined the relationship between banking development and economic growth in Nepal. Timsina (2014) found a positive long-run relationship between bank credit to the private sector and economic growth in Nepal, indicating that increased lending supports investment and output expansion. Similarly, Poudel and Acharya (2020) concluded that financial development indicators such as private credit and broad money positively influence Nepal's economic growth.

Nepal Rastra Bank (2023) reports that the expansion of the banking sector has improved savings mobilization and credit availability, contributing to capital formation. However, the report also highlights challenges such as sectoral credit concentration and rising non-performing loans, which may weaken the growth impact of banking activities.

Financial Inclusion and Poverty Reduction

Financial inclusion is another important channel through which banking contributes to economic development. In Nepal, microfinance institutions and branch expansion have improved access to financial services in rural and remote areas. Thapa (2022) noted that access to banking and microfinance services has supported small-scale entrepreneurship, income generation, and poverty reduction, particularly among women and marginalized groups.

However, studies also caution that rapid expansion of credit without proper risk assessment can lead to over-indebtedness and financial instability. Therefore, inclusive banking must be supported by strong regulation and financial literacy.

Findings

Based on the review of literature and Nepal's financial context, the following key findings emerge:

- The banking system plays a crucial role in Nepal's economic development by mobilizing savings and channeling them into investment activities.
- Bank credit to the private sector has a positive impact on economic growth, particularly when directed toward productive sectors.
- Financial inclusion through banking and microfinance has contributed to poverty reduction and social development.
- Inefficient credit allocation, rising non-performing loans, and limited rural access remain major challenges.
- Strong regulation and supervision by Nepal Rastra Bank are essential to ensure financial stability and sustainable growth.

Conclusion

The banking system plays a crucial role in Nepal's economic development by acting as the primary intermediary between savings and investment in an economy where capital markets remain underdeveloped. Under the regulatory framework of Nepal Rastra Bank, the expansion of banking institutions has improved financial intermediation, contributing to capital formation, employment generation, and overall economic growth.

Bank credit to the private sector is one of the most important channels through which the banking system influences economic activity in Nepal. Lending to productive sectors such as agriculture, hydropower, tourism, and small and medium enterprises has supported investment, income generation, and productive capacity. In addition, the expansion of microfinance institutions and banking services has enhanced financial inclusion, particularly in rural and underserved areas, thereby contributing to poverty reduction and social development.

Despite these contributions, the effectiveness of the banking system is constrained by several challenges. Inefficient credit allocation, rising non-performing loans, limited access to finance for small and rural borrowers, and Nepal's heavy dependence on remittances and imports reduce the overall developmental impact of banking activities. Therefore, the role of the banking system should be understood not only in terms of expansion, but also in terms of quality, stability, and inclusiveness. Strengthening regulatory supervision, improving risk management practices, and promoting productive lending are essential to ensure that the banking system supports sustainable economic development in Nepal.

References

Nepal Rastra Bank. (2023). *Annual report 2022/23*. Nepal Rastra Bank.

Nepal Rastra Bank. (2024). *Financial stability report*. Nepal Rastra Bank.

Poudel, R. C., & Acharya, C. P. (2020). Financial development and economic growth: Evidence from Nepal. *NRB Economic Review, 32*(1), 1–15.

Timsina, N. (2014). Bank credit and economic growth in Nepal. *NRB Economic Review, 26*(1), 1–14.

Thapa, R. (2022). Financial inclusion and poverty reduction in Nepal. *Economic Journal of Nepal, 45*(2), 67–85.

Shrestha, M. B., & Bhatta, G. R. (2018). Financial development and economic growth in Nepal. *Journal of Business and Social Sciences Research, 3*(1), 1–18.

Adhikari, G. M. (2021). Role of commercial banks in economic development of Nepal. *Pravaha Journal, 27*(1), 45–58.

World Bank. (2021). *Nepal development update: Strengthening recovery*. World Bank.

International Monetary Fund. (2023). *Nepal: Financial sector stability review*. International Monetary Fund.