

CONTRIBUTION OF INSURANCE IN ECONOMIC GROWTH OF NEPAL

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ABSTRACT

Insurance as a risk transfer mechanism may contribute to economic growth of a country by fostering long term investment through capital that is collected from accumulated savings from individuals. The main objective of this paper is to examine the contribution of insurance in economic growth of Nepal using determinants of insurance like total insurance premium, Life insurance premium, Non-life insurance premium, employment and investment using data from 2004 to 2015 based on theoretical and empirical evidence. Fortunately, in past few years, lots of research has been done to map the specific contributions made by insurance sector in economic growth of the country applying theoretical and empirical evidence. The evidence suggests that insurance may contribute to economic growth by creating investment climate and managing risk in more efficient way. Theoretically, the studies show insurance has a positive contribution to different levels of development and further suggests to examine the relationship between insurance and economic growth using appropriate model.

KEYWORDS

Contribution, Economic growth, Employment, Investment, Life and Non-Life Insurance, Risk Management

INTRODUCTION

Insurance as a financial intermediary plays a significant role in economic growth of any country. Considerable debate has been made whether financial institutions contribute to economic growth or not. Historically, more focus was made on banks rather than on insurance companies. Very little effort has been made in the field of the insurance sector. But whatever research has been made on insurance field in relation to economic growth has shown a positive relation to economic growth.

As a risk transfer mechanism, insurance provides financial protection from unpredictable losses. Today's world is full of risk and uncertainty. This risk and uncertainty are created due to globalization, liberalization, and innovation in science and technology.

Insurance is a way to minimize and provide protection against those risks which are beyond human control. It is a way to indemnify to those unpredictable losses.

The relationship between insurance and economic growth has been dealt by many researchers concluding that there is a causal and direct link between Insurance and economic growth. United Nations Conference on Trade and Development (UNCTAD) formally acknowledged that “a sound national insurance and reinsurance market is an essential characteristic of economic growth.” Development of insurance and reinsurance business is must for the economic development of any country as it reduces uncertainty and encourages long term investment (Feyen, Lester, & Rocha, 2011). More specifically, insurance as a risk indemnifier and financial intermediary can promote economic growth by managing risk in a more effective way and by mobilizing domestic savings in long term investment (Ward, 2000). Insurance uses various channel to promote economic growth like by creating an environment of greater certainty to foster investment and innovation, improves financial soundness, creating liquidity and mobilizing savings, facilitates the company to access capital, promotes sensible risk management contributing to sustainable and responsible development (CEA; Insurers of Europe, 2006). A sustained long-term economic growth and an open vibrant economy system largely depend upon an efficient financial system. The financial sector of any country plays an important role in the development and growth of the economy. Financial sector development determines how effectively it can mobilize its funds from the surplus sector to fulfill the deficit sector of the economy which helps in facilitating business transactions and economic development (Aderibigbe, 2004).

The indemnification principle of insurance mainly focuses on compensating the insured for the loss that occurs. In addition to this, as financial intermediaries, it accumulates funds and channelized the saving in national development which ultimately helps in economic growth. This shows insurance as a source of capital formation for development and growth of a country.

Insurance companies are considered as an important part of an institutional investment of any country as they invest in corporate securities as well as other collective investment schemes and in turn, they produce sufficient income to meet their obligations in the form of promised insurance benefits (Securities Board of Nepal, 2007).

Despite the significance and critical role played by the insurance companies in the economic growth of the country and a large number of empirical test and analysis made in this area which has given logical evidence that insurance sector contributes to economic growth, very little effort has been made to study the relationship between insurance and economic growth in Nepal. The study tries to examine the contribution made by insurance companies in economic growth of Nepal in two ways: First by reviewing economic growth related theoretical and empirical literature. Second, by using the database of various determinants of insurance from 2004 to 2015 like Total insurance Premium, Life insurance Premium, Non-Life insurance Premium, Investments, and employment. The study will help

to show the trend analysis of insurance market development in relation to premium, investment, and employment.

The paper is organized as follows: section two reviews the literature. Section three provides the methodology whereas section four deals with discussion part that how insurance can contribute to economic growth of Nepal with empirical data. Section five summarizes the main findings and conclusions.

REVIEW OF LITERATURE

The relationship between insurance and economic growth has become a hot issue for the debate both theoretically and empirically. The financial system has been recognized as an important sector in economic growth of the country. Different growth theories have shown that there exist a relationship between the financial system and economic growth. This chapter focuses on economic growth theories which consist of the theoretical background of the literature underlying the economic growth.

THE THEORY OF ECONOMIC GROWTH A BRIEF REVIEW

Economic growth refers to an increase in the country's production in terms of gross domestic production, over a period of time. The economic growth theory focuses on improvement in the quality life of people with an increase in productive capacity (Adamopoulos, 2010). **Endogenous growth theory** shows that economic growth is primarily the result of endogenous and not external forces. The theory holds that economic growth is possible if investment in human capital, innovation, and knowledge are made. The theory also primarily holds that the long run growth rate of an economy depends on policy measures.

Under endogenous growth model, the development of financial development can affect economic growth by increasing the productivity of investments, reducing the transaction cost thus increasing the share of savings which channeled into productive investments and improving the liquidity of investments (Pagano, 1993). Numerous economic theories have discussed the role of various factors that lead to economic growth and increases economic growth. Recent theories of economic growth are based on the hypothesis that speculation and savings are sources for economic growth. The Harrod-Domar model shows the dimension of savings and efficiency of investments as the key to stimulate economic growth (Barro & Sala-i-Martin, 2004).

In addition to this theory, **neoclassical growth model** claims on three important points: first investment and savings are the key success to economic growth. Secondly, economies will eventually reach at steady state, unless productions are enabled with improved technology with fewer resources (Sachs & Warner, 1997). Lastly, for the same amount of capital available, the less advanced economies would grow faster than the more advanced ones until a steady state is reached, and as such economic convergence is achieved (Stiglingh, 2015).

EMPIRICAL REVIEW

Insurance supports economic growth by promoting financial stability, mobilizing and channelizing savings, supporting trade, commerce, entrepreneurial activity and social programs; and encouraging the accumulation of new capital and fostering a more efficient allocation. Moreover, the sector reduces the amount of capital needed to cover these losses individually, thereby encouraging additional output, investment, innovation, and competition. Insurance companies have long investment horizons and can contribute to the provision of long-term finance and more effective risk management (Lamm-Tennant & Dominedo, 2013).

Arena (2006) test whether there is a causal relationship between insurance and economic growth using GMM for the dynamic model and found the robust evidence that there is positive and significant causal relationship between both life and non-life insurance and economic growth. Endogenous growth theories assume the causal relationship between financial development and economic growth, the direction of causality is still an empirical issue. Applying Bootstrap panel ganger causality test approach, the direction of causality between financial development and economic growth is analysed. The study reveals that the financial indicators have an impact on the development of the financial system (Kar, Nazlıoğlu, & Ağır, 2011).

Implying fixed-effect model, the short and long-run relationship between economic growth and insurance sector development in Nigerian Economy reveals that development of insurance sector positively and significantly affects economic growth (Oke, 2012), (Ćurak, Lončar, & Poposki, 2009). A research conducted by Jahfer & Inoue (2014), Shahbaz(2011) using Johansen co-integration and Vector Error Correction Model shows that there is a long run relationship between financial development, stock market development and economic growth in Japan and that financial development, stock market development causes economic growth.

An Empirical Investigation" with the help of simultaneous equation, empirically investigates the interaction between financial development and economic growth which reveals that there is a significant and positive relationship between economic growth and financial intermediary (Huang & Lin, 2007). Using GMM estimation and panel co-integration analysis, the empirical findings show that there is a bi-directional and causal relationship between financial development and economic growth in Sub Saharan African Countries. The paper suggests improving financial sector in order to support higher economic growth (Acaravci, Ozturk, & Acaravci, 2009).

Verma & Bala (2013) examines the relationship between life insurance and economic growth using the OLS regression Model to analysis the data. The Breusch-Godfrey Serial Correlation LM, Heteroskedasticity: Breusch-Pagan-Godfey, Jarque-Bera, Collinearity Diagnoses tests have also applied to check the robustness of the OLS regression model. The empirical study reveals that life insurance has both positive and significant impact on economic growth in India.

Economic developments rely on investments which are made out of savings. Insurance mobilizes saving of people into investment for economic growth (Rao, 2013). A sound developed insurance sector is a key for the economic development of a country. They provide long- term funds for the infrastructure of development and strengthen the risk taking ability of the country. A well-developed insurance market paves way for efficient resource allocation through the transfer of risk and mobilization of savings (Charumathi, 2012).

SUMMARY OF LITERATURE

Various economic theories related to economic growth shows that sustainable economic growth can be possible if effective policies are implemented in a certain economy. Additionally, various economic determinants are used as a driving factor that leads to economic growth in the financial system. Thus endogenous growth theory concludes that financial intermediation has a positive effect on steady-state growth and investment in human capital, innovation, and knowledge are significant contributors to economic growth.

Addition to this theory, neoclassical growth models highlighted the importance of capital accumulation. The main concern of this theory lies in a role of savings, investment, and technology.

Besides summarizing the various insurance and economic growth related theoretical and empirical study, most of the study finds that there is a positive relationship between insurance and economic growth, however, the degree of relationship differ as per the level of economic development and soundness and efficiency of the financial markets and insurance sector of the particular economy.

METHODOLOGY

MEASUREMENT OF VARIABLES, DATA SOURCES AND PERIOD OF THE STUDY

Six macroeconomic variables have been taken to examine the contribution of insurance in economic growth of the country. Total insurance Premium, Life insurance Premium, Non-Life insurance Premium, Employment, and Investment are taken as independent variables i.e. proxy of insurance sector whereas GDP is taken as a proxy for economic growth regarded as a dependent variable.

The paper is primarily based on secondary data, which has been collected from annual reports and publication of Insurance board of Nepal (Beema Samiti), websites of insurance board, publication of insurance industry, Economy survey an annual publication of GON ,published by Ministry of finance, insurance related news published in newspapers and magazines. Besides, the researchers have also collected data from the insurance related journal and articles published in national and international forums. The study is analysed based on the data of 12 years (2004-2015). Based on this analysis, the conclusion has been drawn.

RESULTS AND DISCUSSION

The paper mainly focuses on how insurance contributes to economic growth of Nepal using various determinants of insurance like Total insurance Premium, Life insurance Premium, Non-life insurance Premium, Employment, and Investments.

INSURANCE AND ECONOMIC GROWTH

Finance-growth nexus theory shows that economic growth is the result of financial development which channelizes saving into investment, channelize marginal productivity of capital, saving rate and technological innovation (Levine, 1997). Insurance serves numerous economic functions that are distinct from other financial intermediaries. Among various financial intermediaries, insurance companies as a risk management tool play a significant role in functioning the financial system. They accumulate capital collected from individuals through issuances of policies and transfer them to deficit economics for investment. As a risk indemnifier, they provide stabilization to finance by indemnifying those individuals and firms who suffer from the loss. This induces people to buy more goods and services which encourage production and employment and finally economic growth. In other words, it creates an environment of greater security for investment and innovation which fosters economic growth.

Ward suggests that insurance-growth relationship may be country specific. The impact may be higher for the developed countries and considerably lower for developing countries (Ward, 2000). (Arena, 2006) and (Haiss & Sümegi, 2006) found a significant impact of insurance both life and non-life insurance in economic growth. Insurance as a risk transferor can help promote economic growth by reducing the uncertainty of financial losses, gaining household economic security and promoting financial stability (Soo, 1996). Insurance mobilizes savings and channels them into a public and corporate sector which tends to accompany faster economic growth (UNCTAD, 2005). Insurance's functions help in reducing transaction costs in meeting liquidity and risks preferences which foster economic growth with a more efficient allocation of resources (Khan, 2000). Financial development affects economic growth using various channels like: by reducing risk liquidity, providing risk diversification and mitigating both ex-ante and ex-post asymmetric information between borrowers and lenders (Petrovito, 2009).

The economic environment for insurance industry has gained a momentum in 2014 globally. Total direct premium written has increased from USD 467 billion to USD 4778 billion in 2014. The total premium grew solid by 3.1% despite of currency depreciation and slowing emerging markets (Sigma, 2017).

Insurance has a positive impact on Nepal's economy as well. The sector is gradually increasing its share on country's GDP. The sector shows an increase GDP contribution of 2.03% in relation to total premium earned by the insurance sector. In addition, the sector is also increasing investment driving infrastructure of development, employment scenario in Nepal by providing direct and indirect opportunities. Although, insurance industry in Nepal

is developing, but the insurance penetration shows only 6% out of the total population of the country that means 94% of the population are far from the reach of insurance services. This provides insurance industry an opportunity to extend its market which ultimately helps in increasing the premium volume and share in GDP contribution of the country.

DETERMINANTS OF INSURANCE CONTRIBUTING TO ECONOMIC GROWTH

Insurance Premium: Premiums are the source of income for any insurance companies. Collection of premiums is done by issuance of policies to individuals and firms. These accumulated premium forms capital which is further mobilized for long-term investment.

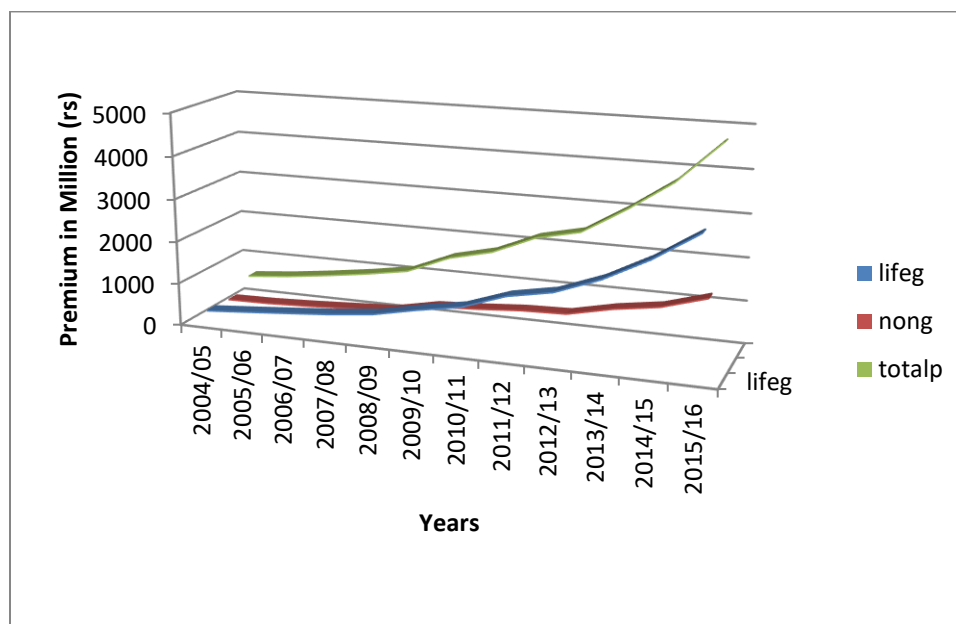


Figure 1: Insurance Premium:
(Source: Insurance Board Nepal)

Figure 1 reports insurance premium income from 2004 to 2016. As can be seen from Figure 1, the total premium income in 2016 is Nrs.4696 million with life insurance premium of Nrs.3192 million and Non-life insurance premium income of Nrs.1504 million. The figure shows an increasing trend in life, Non-life and in total insurance premium which is a positive aspect in the development of insurance industry.

Investment: Investments are the driving factor for infrastructure of development. According to Lucas (1988), the level of investment and the quality of investment will directly influence the rate of economic growth. The size and depth of financial system reflects the size of savings and investments. As suggested by Pagano (1993) financial development may affect economic growth by increasing the productivity of investment, reducing the transaction cost thus resulting in increase in share of savings channeled into productive investments and lastly

improving the liquidity of investment under endogenous growth theory. As a risk transfer mechanism, insurance industry channelized the savings into long term investment which are basis for economic growth. The following figure shows the level of investment made by insurance industry in various sector as directed by investment directives in insurance act 2049.

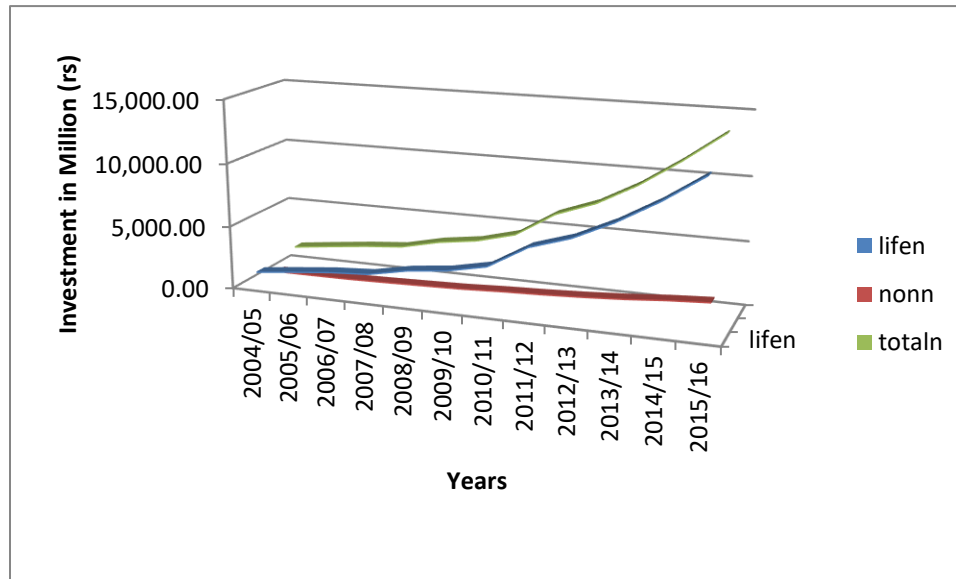


Figure: 2 Investment
(Source: Insurance Board Nepal)

Figure 2 shows the investment trend in Nepalese insurance industry in terms of Life insurance refers as lifen, Non-Life insurance as nonn and Total insurance as totaln. The figure shows that investment in life insurance sector is relatively very high compare to Non-life insurance sector. The Investment is Life insurance in 2016 is Nrs.11,812 million whereas in Non-life insurance it remains only Nrs.1695 million. As per insurance act 2049 and investment directives published by Insurance board Nepal, the major areas of investment are: Government securities bond, fixed deposit on 'A' class commercial banks, loan credit etc. Besides, certain percent of investments are done in productive sector as well.

Employment: Employment is also regarded as one of the sector contributing to economic development as it helps in improving living standard of people by increasing their purchasing power. Insurance industries in order to run its business activities requires different types of manpower like: agents, brokers, surveyors, doctors, engineers, administrators etc. So various groups of societies are benefitted from this sector.

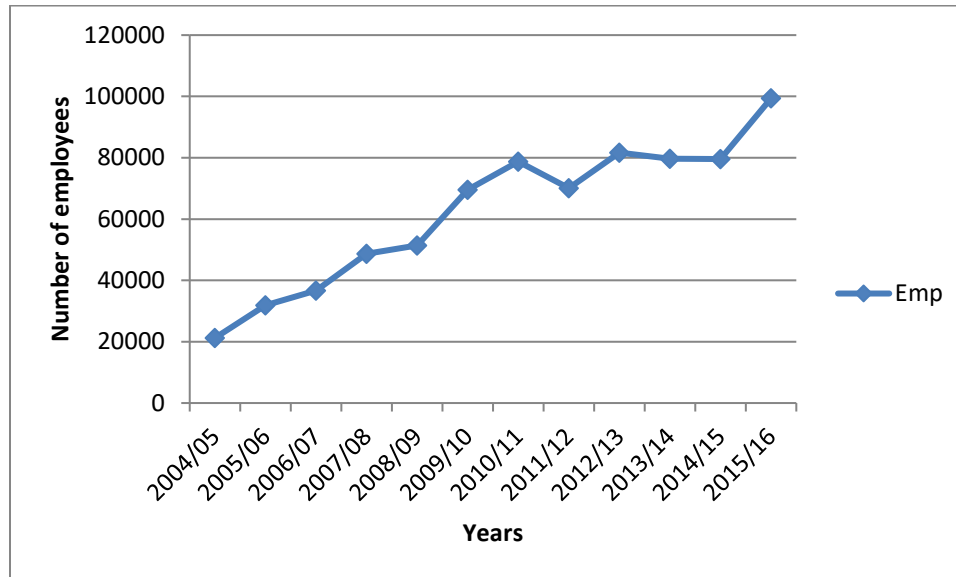


Figure 3: Employment
(Source: Insurance Board of Nepal)

Figure 3 reports the employment scenario provided by insurance industry. It shows that insurance industries are emerging as a source for employment opportunity for large number of people. The number increases from 20000 in 2004 to 1000000 in 2016. This shows that large number of groups is benefitted from this sector.

CONCLUSIONS

The paper investigated the contribution of the insurance industry in economic growth of Nepal by using various variables like: Total insurance premium, Life insurance premium, Non-Life insurance premium, investment and employment using data from 2004/05 to 2015/16 and found the positive contribution to economic growth. As the objective of the study is to examine the contribution of insurance in economic growth, economic growth related macroeconomic variables: GDP and insurance related macroeconomic variables: Life Premium, Non-Life Premium and Total Premium have been included in discussion. From the above analysis it is concluded that Life Insurance Premium and Non-Life insurance Premium influenced in GDP growth of the country by 2.03% in 2016 and It is in increasing trend. The study also shows that population density covered by insurance sector is only 6%. Still there is a large gap of population who are far from the reach of insurance service. The study suggested policymakers and regulators to recognize the role of insurance sector in economic development and frame the insurance friendly policy so that in future the contribution of the insurance sector to economic growth can be maximized with increasing number of insurance density. Further, the paper can be extended with development of an appropriate model that provides an empirical evidence to examine the relationship between insurance and economic growth.

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