

Unit 8

Possible Impacts on Nepalese Financial Service Sector Under WTO Provision

- RADHESHYAM MALAKAR*

ABSTRACT

By 2010 Nepal is going to open the Financial Service Sector (FSS) for the wholesale banking as per the World Trade Organization (WTO) commitments. Opening of the FSS brings both the positive as well as the negative impacts to the sector and to the economy. On the other hand, it may boost up the economy by properly channeling the capitals and provides the funds for the investment and on the other hand, the crisis in the sector is very harmful that can wind down the whole economy as well. At the present context, importance of FSS cannot be ignored to the economy. A poor and donor reliant country like Nepal, membership of WTO is not a matter of choice. The Capital Account Convertibility (CAC) regime is the pinnacle of the liberalization of FSS. There are some preconditioned for proceeding towards the full CAC regime to reap benefit from it.

INTRODUCTION

The word globalization just breaks the man made lines in the geography. Nepal entered in to the globalization by 2004 in the name of WTO. A small, land locked, poor and donor dependent country like Nepal the membership to the WTO is not a matter of choice. Membership of WTO was necessary; whether consequences are positive or negative. So the only choice Nepal has to mitigate the negative consequences and try to utilize potential benefits. Membership of WTO for Nepal brings both positive and negative impacts. While the benefits are only potentialities in the long run, many risks, pitfalls and costs associated with the new globalization trend are bitter realities facing most Least Developed Countries (LDCs) (Gurugharana, 2001).

* Radheshyam Malakar, M.A. Economics, He has done recent research on "Impact of WTO on Nepalese FSS" (Central Department of Economics), Lecturer of Economics, Kumari Multiple Campus, Kathmandu.

COMPONENTS OF WTO

There are three components of WTO as listed below:

- i) General Agreement on Tariff and Trade (GATT)
- ii) General Agreement of Trade in Services (GATS)
- iii) Trade Related Intellectual Property Rights (TRIPs)

'GATS' again breakdowns into 12 subsectors out of which FSS is 7th subsector. "A financial service is any service of a financial nature offered buy a financial service supplier of a member. Financial services include all insurance and insurance related services, and all banking and other financial services (excluding insurance)". Opening this section brings both positive and negative impacts on the sector itself and to the whole economy. Hence, opening the FSS, under WTO provision, brings both opportunities and

challenges. As some economists call FSS is the 'brain of the economy' and host of others accept it as 'engine of growth'. FSS is important for the economy as a whole since it allows financial transfer and payments. In other words a healthy and stable Financial Service Sector is essential for sustainable economic growth. (Maskay; Baht and Panta; 2005). Unhealthy FSS can create the problem in this sector which will harm not only in this sector but as a whole economy and sometimes, even the region (as in East Asian Financial Crisis). (Malakar 2007). Under the Nepalese commitment on WTO, the Nepalese FSS is going to open fully by 2010 only. Under the commitment, the foreign banks are allowed to establish their branches in Nepal for whole sale banking. Opening the sector implies free entry or exit of foreign bank branches into Nepalese financial market. Entry of the foreign bank branches implies the entry of the new technology and latest experiences, by which the whole economic agents can enjoy better services in lower cost. But if once the crisis occur in FSS then the foreign owned banks do not help to reduce the impact of banking crisis but in some cases it makes the crisis worst (as in Argentina)(Blejer, 2006).

IMPACT OF OPENING THE FSS

Perhaps the pinnacle of opening or liberalization of service sector is the full CAC regime. For which it must fulfill some preconditions. CAC regime is essential to reap the benefit of liberalization because our concern of liberalizing the FSS is for the inflow of foreign capital. CAC regime is essential because capital will not come inside the country unless it has the assurance that it can go out (Sigdel, 2007). And only the full CAC regime assures it. At the present situation of dual exchange rate policy (i.e. fixed with India and flexible with others) we must be clear about it , that CAC, fixed exchange rate regime and independent monetary cum fiscal policy do not go together. The experience of other developing countries depicts that CAC would not be sustainable, if exchange rate is pegged (Sigdel, 2007).

Since, Nepalese Financial market is going to open fully by 2010 it is impossible to analyze the perfect impact only the possible impact can be analyzed. Internationalization of FSS can bring both positive and negative impacts to this sector and to the whole economy.

a) Positive Impacts

Internationalization of FSS allows more stable sources of funds, it can help countries build more robust and efficient financial systems by introducing international practices and standards. It will help to improving the quality, efficiency and breadth of domestic financial institutions as well. Openness helps to increase competitiveness and in turn the economic growth. Some of the positive impacts of opening the FSS can be analyzed as follows:

i) Access to international capital market:

With the internationalization of the FSSs new foreign banks enter and establish their branches in the economy. They come with huge capital base, new technology, greater experiences, etc. which are important for a developing country like Nepal. As then insurgency has ended there will be a need for more investment for which we need huge capital, even if for the giant projects (like Arun III) we need some external resources which can be fulfilled in various ways but the established banks branches within the territory constitute the best source of such funds. Obviously the new technology implies better qualitative services at cheaper price. But we have to take care of the implications of technological innovations on the structure of financial services industries and market (S/C/W/72, WTO).

ii) Enhance competition:

Opening the sector is an open invitation to foreign players in Nepalese financial market. Higher the competition, larger the number of new players coming with international experiences, new technologies, bigger capital base, etc. for survive, the existing Financial Institutions (FIs) must increase their efficiency in term of size and quality. Hence, entry into WTO enhances the competitiveness.

iii) Decrease the cost of capital and increases investment:

Competition bounds the FIs to provide better service at cheaper price i.e. cost of capital (interest rate) has to be decreased. Opening the sector implies higher the competition with more advanced foreign competitors so the cost of capital decreases. As there is negative relationship between cost of capital and investment, a decrease interest rate would increase investment and the whole economy will be benefited.

iv) Access to the international financial market:

Opening the sector does not imply just entry of foreign FIs into the domestic market only, it also opens the door for the domestic FIs to enter into the rest of the world. Hence, after 2010 the domestic FIs will be able to establish their branches in other countries or they can expand their business throughout the world (at least in the WTO member countries).

Though, initially it is hard to provide the financial services to the foreigners in foreign countries by the banks of developing countries like Nepal (due to the smaller capital base, lack of experiences, etc), but there is possibility to establish the branches in those parts of foreign countries where the Nepalese people (workers) more obviously prefers Nepalese banks. Even the FIs can provide the service for remittance. The remittance business is good at present in Nepal. The business it self is very big (remittance contributes around 16 percent of total GDP at present). At present, more that 69 percent of the total remittances is coming through informal channel (WB 2007). If the Nepalese FIs succeeded to channelize those remittances then the business of those FIs would grow significantly.

v) Impact on debit and credit flow:

In regard to Balance of Payment (BoP), WTO membership will result in greater flow of debit and credit. A report of NRB shows that from 2004/05 to 2015/16, flow of debit and credit are expected to increase by 155 and 150 percent respectively (on average). Since FIs are the mediator of such transaction, so the business of FIs flourishes by the sum of debit and credit (i.e. more than 300 percent) in 2015 /16 comparative to 2004/05.

vi) Nepal as a financial center:

Nepal has a clear leverage in creation of international financial center that has ultimate goal to make Nepal "A Switzerland of Asia" (Collins, 1997). A poor and land locked country like Nepal with many constraints (like infrastructure and other supply side constrains) development as a financial center is comparatively easier and better way for economic development. If proper macro economic policy can be framed coupled with secure political and business environment there is possibility to become Nepal "A Switzerland of Asia". This is only possible after accession to WTO. Hence, WTO membership fulfils the necessary condition for Nepal to be "A Switzerland of Asia" in terms of financial center.

vii) Impact on the economy:

With opening the FSS, experienced and more efficient banks come with better technology and huge capital base and the comparatively low efficient banks cannot survive in same ground, so the existing FIs, having less efficiency, will be compelled to diversifying financial products and explore new products and new areas to survive. So, there are chances to establish the FIs in rural areas. Some banks have already started to think in this matter. Some banks have already started special schemes to lend to small and medium enterprises (SMEs). Presuming that foreign banks will be more interested in large size loans that go to big corporations. For instance, Himalayan Bank has revealed that it would start a special lending service for small borrowers in cooperation with the International Finance Corporation. This body operates under the World Bank and lends to the private sector. Machhapuchhre Bank has started its operation in rural areas. It has set up an Automatic Telling Machine (ATM) in Jomsom. Nabil Bank has planned to set up branches in remote areas too. It has already set up an alliance with the postal saving bank to reach remote locations (Lamsal and Gautam, 2007). These scenarios show optimistic future for SMEs and agriculture sector, both of which are most important for the Nepalese economy. As mentioned before, openness increases competitiveness decreases, cost of capital, investment and economic activities increases and employment opportunities, finally the whole economy will be benefited.

viii) CAC regime brings positive impacts:

The effectiveness of capital account convertibility depends largely on the efficiency of the financial institutions at home. As per the WTO commitment, sooner or later full CAC regime is a must. For meaningful and favorable CAC regime, quality of the domestic financial institutions must be enhanced. Hence, CAC regime brings positive impacts on FSS under WTO provision but macroeconomic, financial and exchange rate policies must be put in right place. Liberalizing inflows should be sufficient to enable the country to draw on foreign savings to the optimum extent. Of course, capital will not come inside the country unless it as the assurance that it can go out (Sigdel, 2007).

b) Negative Impacts

Experiences of other countries show that the financial distress is very harmful not for this sector only but the whole economy. In the present context of globalization, the economy is more open hence the financial crisis of an economy transfers more speedily and quickly to other economies, for example, the East Asian Financial Crisis in 1997. The crisis originated in Bangkok (Thailand) which was started from the problem in banking, but most of the east Asian countries (except Singapore) were worst hit by the crisis, hence the positive impact of liberalization of FSS brings many negative impacts as well. Some of the negative impacts are as follows:

i) Higher risk of capital flight:

As mentioned above, CAC regime is the pinnacle of the liberalization of FSS. CAC regime implies free entry and exit of the capital. Though the entry of capital has more positive impact, but the negative impact lie outflow of capital is very harmful to the developing countries like Nepal. Lack of capital is one of the common characteristics and problems of the developing country. In Todaro's view, "A Country is poor, because it is poor", due to lack of capital, investment is low and growth of the economy is low. Obviously the return of capital in the developed economy is more than LDCs. If there is CAC regime then the capital, whether it is big or small, capitalist invest it there- where the return is higher. CAC regime is more dangerous for Nepal because Nepal itself is situated between two giants and the fastest growing economies, China and India (having near to double digit growth rate).

Obviously, the return of the capital in those economies is more than the inflow in Nepal. If the capitalists are allowed then there are high chances to jump to those economies. Hence, the CAC regime creates a higher risk of capital flight.

ii) Decrease in the profit and market share of domestic banks:

As FSS opens, the new (foreign) players enter into the domestic financial market with better ideas, more knowledge and huge capital base so competitions increases. In the more competitive environment the existing FIs will be bound to provide services with interest spread rate (interest rate between lending and borrowing) which decreases the profit. As some FIs are working in break even situation, they will be collapsed.

On the other hand, as in case of China, after 10 years from the WTO accession, it is estimated that the market share of foreign banks will be increased. Increase the share of foreign banks implies decreasing the share of domestic banks.

iii) High potentialities of shifting the good credit worthy with high quality clients to the foreign banks :

Due to better services, technologies, facilities and more innovative ideas the clients (especially the good creditworthy with high quality) will shift to those incoming advanced foreign FIs. Leaving the less creditworthy clients and some business with the domestic banks. This probable shift is a major threat to domestic banks (Kim, 2002).

iv) Gap between the urban and rural areas widens further:

Recent, data published by Nepal Rastra Bank (NRB) shows that the Commercial Banks (CBs) are more urban centric. According to the data some economically active districts like Kathmandu, Parsa, Morang and Kaski have 71, 24, 24 and 47 CBs banks branches respectively. On the other hand in the whole far western development region there are just 20 branches of CBs. Opening the FSS would increase disparity as the incoming foreign bank branches will be least interested to go to the rural areas and the urban areas will be more resourceful and rural areas will become more drought. Hence, opening the FSSs will increase the disparity between rural and urban areas.

v) High risk and cost and financial crisis:

Without effective regulatory, supervisory regimes and appropriate macroeconomic policies, internationalization of financial sector is an open invitation for financial crisis. For example, the root cause of East Asian financial crisis was the serious mismanagement of the huge overseas borrowing by domestic (not foreign) banks and finance companies and business corporation (Kim, 2002). Liberal policy has been found the main cause for the huge financial crisis in the past. Cost of the crisis were too high, for example the cost of financial crisis of Argentina in 1980-82 was around 55 percent of GDP, similarly the cost was around 32-41 percent in Chile in 1981-83. Moreover the developed economies like Norway, Sweden, Finland and even the US were not free from the financial crisis and the cost were 3-4, 4-6, 8 and 2-5 percent of GDP in 1987-89, 1992-93, 1991-93 and 1984-91 respectively. The called "Black December" (financial crisis of Mexico in 1994) can be taken as a good example, of even the most resourceful (in term of human resource as well) economy not being able to block the crisis. The financial crisis of Mexico shocked the world and stunned the international financial community. A nation considered as a model of economic reform and good financial health was

suddenly bankrupt. Its international reserves had depleted, its currency was on free fall, it was about to default on its sovereign debt, and its banking system was on the verge of collapse. Uncertainty gripped the whole Latin American region (Garcia, 1997). From these experiences of the cost of such crises, we can learn the lesson for the likely worst scenario that Nepal may face from liberalization of FSS. To what extent, the LDCs like Nepal can tolerate such crisis is itself the subject of debate.

vi) High chance to loose the monetary autonomy:

Undoubtly the main motivating factor to enter the foreign FIs in an economy is 'profit'. Such FIs are guided by there parent institution prefering the favorable situation for itself. The regulatory authority of the economy will be forced to accept their terms and conditions. And even the government is bound to make new policies as they suggest, no matter the policy is beneficial or harmful to the economy. In this way internationalization of the FSS may cause a loss monetary autonomy of domestic authorities.

vii) Internationalization creates the problem of overbanking and unfair trade practices:

Overbanking suggests that there are already too many banks trying to attract business in a given financial market (Kono, Low, Luanga, Matto and Oshikawa, 1997). The overbanking creates many problems in the economy simultaneously. For example more the banks, more the cost and difficulties to regulate and supervision. On the other hand more players in the same market increase unhealthy competition. In the developing countries like Nepal, the licensing or liquidation regime cannot be accepted as an efficient tool. Hence due to internationalization of FSS, the economy has to face the crowding of FIs with unsound banking practices. Again protectionism can not be the best solution for it, for example in Russia out of 2150 banks, 450 were wound up in between 1995 and 1996. During the same period 200 banks were liquidated in Argentina. In Korea and Malaysia merger have been encouraged. Experts believe, Nepal is facing the problem of overbanking in urban areas, even before internationalization. Hence, after opening the sector, it would increase further.

CONCLUSION

Accession to WTO is not a matter of choice for the small, land-locked and donor dependent countries like Nepal. Internationalization of FSS brings both 'benefit and cost' where benefits are potential in the long run but the costs are immediate.

The positive side of opening the FSS is that opening the door to international capital market would help overcome the 'lack of capital' and can help fulfill the dream of huge and ambitious projects (likes Arun III). But, it also opens the door to enter into the foreign financial markets for the Nepalese FIs. Due to the presence of more experienced and advanced players the competitiveness of the domestic FIs also enhances, by which the cost of capital decreases and investment friendly environment will be created. And finally the whole economy will be benefited. More over internationalization fulfils the necessary condition to become Nepal 'A Switzerland of Asia' in regard to the financial center.

But the dark side of it cannot be ignored that internationalization has been the root cause for huge financial crisis in the past in other economies. From the existing domestic FI's perspective, opening the FSS may be harmful; it may even cause collapse of the institutions. Sooner or later CAC regime has to be accepted, after internationalization of the Financial Service (FS) it causes the effects of capital flight which is obviously harmful to the capital lacking and developing countries like Nepal. Due to unbalanced growth it may create social evils as well. Finally, the overbanking creates unhealthy competition, which is harmful for the players of FSS and to the economy as well.

After accession to WTO, the only choice Nepal has is to mitigate the negative consequences and try to utilize potential benefits. By 2010, the Nepalese financial market is going to open fully for the wholesale banking to foreign FIs. In order to reap the benefit from it; an effective regulatory and supervisory regime must be established with appropriate macroeconomic policies. It would be prudent to review the tax policy, i.e. different tax rate for the FIs, which operates in urban and rural areas so as to motivate the FIs to go to the rural areas, which help to decrease the unbalance growth to some extent. To reap benefit from the full CAC regime, Nepal should open capital account along in consonance with the line of India. Moreover, for the provision of full CAC regime there are some preconditions as; (a) control fiscal deficit below 3 percent of GDP (b) maintain foreign exchange reserve at least 20 percent of GDP (c) control inflation rate within 2-3 percent (d) remove the fixed exchange rate regime.

REFERENCES:

- Acharya, Meena; Y.R. Khataiwada and S. Aryal (2003); *Structural Adjustment Policies and Poverty Alleviation*. (IIDS), 2003.
- Acharya, Meena. "Development of the Financial System and Its Impact on Poverty Alleviation in Nepal". *Economic Review*, Occasional Paper no. 15, Apr. 2003, Nepal Rastra Bank, 2003.
- Bhatt, Shiva Raj. "Internationalization of Nepal's Financial Services: Role of WTO" *New Business Age*, August 2006. pp18-22
- Bhattarai, Ramesh Raj. "Nepali Membership in WTO and Insurance Supervision: A Regulatory Perspective". *World Trade Organization and Financial Service Sector in Nepal: Some Perspectives*, NRB 2006, PP.36.
- Blejer, Mario I. "The role of Central Banks in Financial Crises: General Consideration and an Analysis of Argentine Crises". *Challenges to Central Banking from Globalised Financial Sector*. Ed. Ugolini, Piero C.; Andrea Schaechter and Mark R stone. International Monetary Fund, Washington. pp 272-286.
- Carmichael, Jeffrey and Michael Pomerleano; *The Development and Regulation of Non-Bank Financial Institutions*. The World Bank 2002. pp.1.
- Claessens, Stijn and Marion Jansen. "Overview the Internationalization of Financial Services: Issues and Lesson for Developing Countries". *Internationalization of Financial Service Sector*. Ed. Claessens, Stijn and Marion Jansen, World Bank, WTO, Kluwer Law International 2000. pp. 3.
- Collins et. al; 1996; citing Dahal, Madan Kumar, "Impact of Globalization on Nepalese Economy". Ed. Dahal, Madan Kumar. *Impact of Globalization in Nepal*. Nepal Foundation for Advance Studies (NEFAS) and Friedrich-Ebert-Stiftung (FES), 1999. p-19
- Dasgupta, Amit. "WTO and New Issues", *Economic Review*. Occasional Paper, April 2001, No. 13, The Nepal Rastra Bank 2001.
- Finger, J. Michael. *The Doha Agenda and Development: A View from the Uruguay Round*. ERD Working Paper Series No. 21, The Asian Development Bank 2002.
- Fingerand, K. Michael and Ludger Schuknecht. *Special Studies-3*. The World Trade Organization, 1999. Pp.17, 19-22.
- Garcia, Valeriano F.; *BLACK DECEMBER Banking Instability, the Mexican Crisis and Its Effect on Argentina*. World Bank, n.d., pp36

International Finance Corporation. *Lessons of Experiences Financial Institutions*. Number 6. International finance Corporation, 1998.

International Trade Centre UNCTAD/WTO (ITC), Industrial Enterprise Development Institute, Nepal and Nepal Chamber of Commerce, Nepal. *TRADE SECRETS The Export Answer Book for Small and Medium Sized Exporters*. UNCTAD/ITC, IEDI and Nepal Chamber and Commerce. 2000, pp 165-184.

Kim, Yun-Hwan. *Financial Opening Under the WTO Agreement in Selected Asian Countries: Progress and Issues*. ERD. Working Paper Series No. 24. The Asian Development Bank 2002.

Malakar, Radheshyam; "Impact of WTO on the Nepalese Financial Service Sector". Unpublished Thesis, *Central Department of Economics*, TU, Kirtipur, 2007.

Maskey, Nephil Matangi, "WTO and Financial Service Sector", *Nepal Rastra Bank in 50 years*, Nepal Rastra Bank, 2005.

Nepal Bittiya Santhan Karmachari Sangh, *Arthik Mimamsha*, Year 3, No.1, 2061.

Nepal Rastra Bank Karmachari Sangh, *Arunodaya* Collection of Economic Articles. Year 10, No. 8. 2061 B.S.

Nepal Rastra Bank; *A Glimpse of Nepal's MACRO ECONOMIC SITUATION 2006*, Nepal Rastra Bank, Kathmandu, 2006.

Nepal Rastra Bank; *Economic Report* (Various Issues). Nepal Rastra Bank, Kathmandu.

Nepal Rastra Bank; *Nepal Rastra Bank Samachar*, August-Nov. 2004, NRB, Kathmandu, 2004, pp. 16-22.

Nepal Rastra Bank; *Nepal's WTO Service Sector Commitments and Its Impact on Balance of Payment*, Nepal Rastra Bank 2005.

Nepal Rastra Bank; *Quarterly Economic Bulletin* (Various Issues), Nepal Rastra Bank, Kathmandu.

Nepal Rastra Bank; SEANZA Lectures 1985, Nepal Rastra Bank 1985, Kathmandu.

Nepal Rastra Bank; *Nepal Rastra Bank in 50 years*. Nepal Rastra Bank, 2005.

Nepal Rastra Bank; *Nepal Rastra Bank Samachar* (Various issues) Nepal Rastra Bank, Kathmandu.

Nepal Rastra Bank; "Economic Integration in South Asia". The Nepal Rastra Bank 2062.

Pant, Bhubanesh. "WTO, Industrial Policy and Nepal", *The Economic Journal of Nepal*, Vol. 25, No. 2 April-June 2002, The Central Department of Economics, Kathmandu, 2002, pp 84-94.

Poudel, Dandapani, "Financial Sector Development", *Nepal Rastra Bank in 50 years*. Nepal Rastra Bank 2005, pp 158

Shrestha, Shyam K.. "The Impact of WTO Membership on Nepalese Economy" (Unpublished Research Report), 1999.

Sigdel, Bamdev; "Economic Liberalization and Prospects of Capital Account Convertibility in Nepal". *Arunodaya*, Year 13, number 11, Baisakh 2064.

Sigdel, Bamdev; "Punji Pariwartyatama Bharat ko Prayash ra Nepal le Taya Garnuparne Bato", *Mirmire*, Number 256, poush 2063.

Sinha, Narayan and K.L. Chawla. "WTO and Economic Integration: An Application of Gravity Model". *The Economic Journal of Nepal*, Vol. 26, No.1 Jan-March 2003, Issue No. 101. Central Department of Economics, Kathmandu, 2003, pp 1-14.

Stiglitz, Joseph E., "Globalization, Technology and Asian Development". *Asian Development Bank Review*, Vol. 20, No. 7, 2003.

Thompson, 1997: 161-71, citing Dahal, Madan Kumar "Impact of Globalization in Nepalese Economy". Ed. Dahal, Madan Kumar, *Impact of Globalization in Nepal*. Nepal Foundation for Advance Studies(NEFAS) and Friedrich-Ebert-Stifung(FES) 1999, P-6.

World Bank Nepal, *Financial Sector Study*, World Bank 2002.

The World Bank ; "Report of the Working Party on the Accession of the Kingdom of Nepal, Part II- Schedule of Specific Commitments in Services List of Article II MFN Exemption". *WT/ACC/NPL/16/Add.2*. 28 August 2003.

The World Bank ; "The General Agreement on Trade in Services (GATS): objectives, coverage and disciplines". <<http://www.wto.org>>

The World Bank ; *World Development Report 1989 financial System and Development World Development Indicators*. The World Bank 1989, pp 4-100.

World Trade Organization, "Technical Issues Concerning Financial Services Schedules".S/FIN/W/9, 29 July 1996

World Trade Organization; "Economic Impacts of China's Accession to the WTO", *WTO and China*.

World Trade Organization; "Guidelines for the Scheduling of Specific Commitments Under the General Agreement on Trade in Services". S/L/92, 28 march 2001. The World Trade Organization.

WTO in the New Millenium, Ed. Goyal, Arun, 4th Edi, Academy of Business Studies, 2000.

Zhuang, Juzhong; J.M. Dowling; "Causes of the 1997 Asian F. Crisis: What can an Early Warning System Model Tell us ?", ERD

Working Paper No. 26. Asian Development Bank 2002, pp 2