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MACROECONOMIC STABILITY: CONTRIBUTING FACTORS AND THEIR SUSTAINED MANAGEMENT

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Inputs from various stakeholders during interactions at Advisory Committee meetings, and the workshop organized by the EPN Focal Unit have been incorporated in the report.

Foreword

Economic Policy Network (EPN) initiated in August 2004 is an undertaking of the Government of Nepal with an Asian Development Bank (ADB) Technical Assistance (TA) to develop and institutionalize an open, responsive and result oriented economic policy formulation process based on sound economic analysis and dialogues with the partnership of public and private sector, academia, and independent professionals, to support and consolidate the Government's economic policy reforms on poverty reduction strategy. The initial focus has been in the areas of macroeconomic management; trade, investment and employment; infrastructure development; and tourism, agriculture, and regional development through four thematic advisory committees chaired by the secretaries of the respective implementing ministries, and guided by a high-level steering committee. The present study is an outcome of the initiative under the Advisory Committee for Economic Policy on Macroeconomic Management chaired by the Secretary of the Ministry of Finance.

This report has reviewed the current macroeconomic policy framework of Nepal in light of growth, investment, consumption, and savings. It has also reviewed the compatibility of fiscal policy, monetary policy, and other economic policies with respect to the macroeconomic equilibrium. Suggestions are also made to adopt the sustained macroeconomic policy measures based on the order of economic liberalization in the country. The recommendations are the outcomes of consensus reached among major stakeholders through various consultations and the EPN workshop. I hope the findings and recommendations will be helpful for policy makers for future reforms.

I would like to thank Dr. Rabindra K. Shakya for carrying out the study. I also thank all those who have provided inputs for the report during the interactions, the advisory committee meetings, and the EPN technical workshop held in Nepal Administrative Staff College, Jawalakhel, Lalitpur. The work of the Advisory committee for macro economic management is to be commended for selecting the issue and for following through with the study. I would also like to appreciate the entire EPN team for their hard work. Last but not least, I would like to thank the ADB for supporting this initiative.



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Acronyms/abbreviations

ADB	Asian Development Bank
CBS	Central Bureau of Statistics
CRR	Cash Reserve Ratio
GDP	Gross Domestic Product
GON	Government of Nepal
EAPAD	Economic Affairs and Policy Analysis Division
FACD	Foreign Aid Coordination Division
FCGO	Financial Controller General Office
FY	Fiscal Year
HIPC	Highly Indebted Poor Countries
IMF	International Monetary Fund
MDRI	Multilateral Debt Relief Initiatives
MOAC	Ministry of Agriculture and Cooperatives
MOF	Ministry of Finance
MOICS	Ministry of Industry, Commerce and Supplies
MOLD	Ministry of Local Development
NOC	Nepal Oil Corporation
NBL	Nepal Bank Ltd.
NLSS	Nepal Living Standard Survey
NRB	Nepal Rastra Bank
NPC	National Planning Commission
PAF	Poverty Alleviation Fund
PDFACC	Public Debt and Foreign Aid Coordination Committee
PDMD	Public Debt Management Department
PDMU	Public Debt Management Unit
POL	Petroleum, Oil and Lubricants
PRSP	Poverty Reduction Strategy Paper
RATC	Revenue Administrative Training Centre
RBB	Rastriya Banijya Bank
WB	World Bank

Foreword

The present study on macro economic factors contributing to the macro economic stability and their sustained management is an important area that is destined to impact the future of the Nepalese economy. A lot more study has been carried out in the past on the subject. But in the changing context, this probably is the first study of its kind undertaken recently. This study is expected to provide inputs for the sustained management of the economy, devoid of instability emerging out of the factors amenable to domestic management, and hence is expected to provide policy input towards charting out the future direction of the Nepalese economy.

The areas and topics covered in the present study qualify to be taken up separately on the basis of their own merit. Nonetheless, the study, it is expected, will provide an indication on the thrust for maintaining stability in the economy and the possible measures that need to be taken to sustain it. Only through planning present and potential factors that affect the macro economic stability of the country can provide the base for the acceleration of development of the country – a desire, among others, that has been forcefully expressed by the Nepalese people through historic *Jana Andolan II*. This success has been achieved by the sacrifice of the Nepalese people.

Hope, this study will be useful to all those interested in the economic development of the nation particularly to those policy makers, administrators and others who are involved in the making of this nation.

August 11, 2006

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Acknowledgements

The Paper of this kind has to be the product of many consultations, discussions and deliberations with authorities, policy makers and administrators, academicians, and researchers, representing different spheres of economic life. And this is what makes this Report acquire the depth and objectivity that it hopefully contains. The author takes this opportunity to acknowledge with gratitude the assistance and inputs received from all of them, but too many to include their names here. Some of them even provided to me written comments and observations as well as statistics that have been used in this Report, apart from other published and unpublished reports on the subjects.

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Executive summary

1. This Study assumes an increasing importance and has been undertaken at a time when the country is suffering from unsatisfactory state of many of the macro economic indicators and the need is in evidence to maintain macro economic stability.
2. Macro economic stability of Nepalese economy is determined by a couple of factors. These include basically the discrepancies between investment and savings (I-S), between total expenditure and total revenue (TE-TR) and between imports and exports (M-X).
3. Factors contributing to the threat to the macro economic stability come through many sources – both internal and external. As regards internal reasons, the followings are among the prominent ones.
 - i. Pervasive poverty pushing down the per capita savings to a low level
 - ii. Low economic growth rate
 - iii. Growing unemployment and underemployment
 - iv. Inequality in the distribution of income and consumption
 - v. Political instability and the insurgency problems resulting in weaker macro economic outcomes impeded the pace of the implementation of structural reforms and intensified the decline in macro economic performances.
- 3.1 In the external sector, shocks emanated from the following factors:
 - i. Heavy dependence on foreign assistance
 - ii. Fluctuations in the exchange rate of Nepalese currency vis –a- vis US Dollar
 - iii. Rise in POL prices, and
 - iv. Dwindling resources mobilization as a result of Nepal's commitment to terms of WTO.
4. The process of structural change is taking place in the Nepalese economy, albeit very slowly and with it, the types and intensity of factors contributing to stability are undergoing changes requiring effective policy responses.
5. Principal macroeconomic parameters have remained favorable, although the economic growth rate has been unsatisfactory as compared to the target of the Tenth Plan/PRSP. Total consumption has shown a tendency of a continuous increase and the saving rate has declined due to lower GDP growth rate, high inflation, and poor revenue collection of the government.
6. Generally, policies have remained compatible with fiscal, monetary and other policies. But potential exists for further reforms. The growth of total government expenditure as a percentage of GDP has increased over the years. The total recurrent expenditure remained constant at 11.5 which is already higher keeping in view the resource position of the country. The total capital expenditure shows a decelerating trend from 5.9 per cent in 01/02 to 5.1 per cent in 04/05. This has dampened the prospects of growth.
7. The fiscal situation continues to remain precarious, largely caused by the widening gap between the total expenditure and public revenue. The resulting budget deficit was 2.7 percent of the GDP in 2004/05.
8. The under-spending of the capital budget has remained a permanent feature with not more than 80 -85 per cent of the targeted budget being spent. Similarly, aid utilization has also been problematic with aid disbursement remaining around 60–65 percent of

the commitments. This implies that not only resource availability but also resource utilization capacity is a major problem in the public sector.

9. The main source of public finance is revenue. It increased to 13.1 percent (Rs. 70.12 billion) in 2004/05. The revenue mobilization is less than what is required in relation to the increasing trend of government expenditure.
10. Foreign aid continues to be the dominant instrument of resource mobilization and had further increased the dependency syndrome.
11. Nepal received an estimated US\$ 908 million in remittances in 2004/05. These have been a steadier and less volatile source of foreign exchange inflows and improved credit worthiness for external borrowings. It has helped boost national income and consumption.
12. In 2003/04, around 32 percent of the households received remittances, and the average remittance per household was NRs. 1,723. Remittances have generally a good impact on the economy. It is desirable to have a plan to make use of growing remittances for investment and employment creation within the country; an alternative source of resource flows need to be explored should the inflow from remittances dwindled or reduced and NRB should further develop system for more efficient collection and repatriation of remittances through formal channels that both reduce risks for migrants and help deepen the financial system.
13. Financial reforms, stalled for sometime in the past needs to be carried forward with vigor, particularly to drastically reduce the volume of non-performing assets particularly in the two principal government owned commercial banks amounting to Rs. 29 billion.
14. The Tenth Plan/PRSP, 2002/07 singles out 4 strategies for implementing the Plan/PRS. The total estimated allocations to these four strategies differed in different years, showing the lack of stability in the resource allocation policy.
15. It is important that poverty alleviation efforts is accompanied by the more aggressive campaign to population planning and the intervention need to match the severity of the poverty problem. Women empowerment is necessary to reduce fertility.
16. This growth in the workforce and the job creation not responding to each other breeds poverty problem at an increasing scale in the country.
17. Further, enhance agriculture productivity with supporting measures. The growth in the industrial enterprises failed to provide jobs to the workforce released from the agriculture sector.
18. Unequal distribution of income/consumption and of opportunities for better living has become one of the serious impediments of the economy for the government to maintain social harmony and avoid conflicts like the ones we have witnessed over some years now. Gini coefficient, one measure of inequality, raised form 0.34 in 1995/96 to 0.41 in 2003/04.
19. The Plan/PRSP strategies need to be supported in terms of increased resources allocation.
20. The pattern of growth in absorbing labor force indicate that unemployment and underemployment situation would further deteriorate if no interventions are made effectively and immediately. The country's major resources- tourism, water resources

and human resources—need to contribute more for attaining high growth of the economy sufficient enough for reducing poverty.

21. There is a need to do more in terms of bringing about effectiveness in implementation. It is important at this time of the year for NPC to be in place. There is a need to use existing monitoring mechanism more regularly and efficiently.
22. In the introduction of newer methods and technology, the external inputs have so far been a dominant factor and these methods have not been fully internalized largely because of institutional and human resources constraints.
23. Provide coordinated, timely and quality inputs to enhance agriculture output such as irrigation, extension services, and so on to give a push to agriculture growth.
24. Nepal's external sector is historically weak with perpetually increasing trade deficit. The trade deficit in 2004/05 increased to Rs.90.77 billion. Of the total trade deficit, the share of India was 54.8 percent.
25. The substantial increase of imports from India resulted in the share of imports from India at 63.3 percent, while from third countries it is 37.7 percent in 2004/05.
26. Due to an encouraging increase in the remittances and capital inflows mainly in the form of official aid, current account surplus is being continuously maintained. This has improved the balance of payments situation of the country and increased the foreign exchange reserves position to a record high level. The sustainability of the external sector is marred not only by the structure of trade but also by the structure of production and capital inflows.
27. Trade diversification becomes a challenge in order to increase the share of trade with other countries. Nepal's foreign trade is growingly re-concentrating towards India. In recent years, both exports to and imports from India are growing at rates faster than that the overall growth. A number of factors are attributed for such a swing in the direction of trade. The vulnerability of Nepal's export trade can be gauged from its continued concentration to a few commodities and among few countries.
28. As Nepal maintains a fixed exchange rate regime with India, any change in the exchange rate of the Indian rupee vis-a-vis convertible currencies is transmitted to the exchange rate change of the Nepalese rupee against convertible currencies. This necessitated defending the peg without creating distortions in trade and capital flows. The stability of the exchange rate of the Nepalese rupee depends on the strength of the Indian rupee against convertible currencies. It is important that the development in Indian economy needs to watch very closely to be able to take policy measures to minimize or eliminate undesirable consequences on Nepalese economy.
29. The amounts of both domestic and external debts have increased over the years. So far, the external debt position of the government seems to be at a sustainable level. As most of the country's loan is of long term nature with very low interest rate, debt servicing has not so far been a critical problem.
30. Nepal's institutional capacity for sustainable and effective public debt management is limited. Hence, the recently prepared policy document on public debt management needs to be approved for implementation. With the peace and political stability gradually returning, the country is provided with opportunities to implement programs

for accelerating the growth process. Measures need to be designed and implemented for accelerating growth process.

31. It is necessary to enhance agriculture productivity and per capita domestic food supply, enhance the share of agriculture sector in resource allocation and ensure the smooth availability of quality agriculture in time, and so on. It is necessary to review subsidy policy in favor of agriculture sector to make them able to withstand competition with those from across the border.
32. To address ineffective public resource management, it is necessary to maintain an appropriately strong fiscal position; expand tax base for raising tax revenues; revisit priority projects and so on. The process of economic liberalization need to be carried forward.
33. The process of financial reforms needs to be carried forward and strengthen.
34. Spread rate continues to remain high and this dampens the prospects of growth. Hence, this situation needs to be changed.
35. Fiscal restructure initiated in the past need to be continued. (i) As part of the fiscal restructuring, measures need to be undertaken to ensure that the government adhere to budgeted domestic borrowing ceiling and to resorting to minimum overdraft facility for financing the deficit, and non-budgetary allocation of resources, controlling recurrent expenditure, and improve tax administration, (ii) plan need to be in place to use growing remittance to create employment opportunities within the economy, (iii) Foreign Aid Policy, 2002 contains policies and strategies that remain relevant but the possibility remains to optimize the gains from the policy for accelerating growth.
36. Poverty alleviation efforts require that reorientation of fiscal policy, more aggressive state interventions in targeted sections and regions, and reconsidering the implementation of land reform with a clear-cut strategy in the broader context of increasing productivity and ensuring distributive justice, enlarging the access of the poor households to formal /institutional source of credit and so on. PAF activities need to be expanded to make a dent on poverty reduction.
47. Operational, managerial and institutional reforms need to be initiated at both the levels – the districts and central, reinforcing development efforts each other. This is because efforts regarding the decentralization of some of the basic services would minimize pressure on the recurrent expenditure, necessary legal and institutional reforms help relieve implementation impediments, and corruption can be minimized by bringing about transparency and accountability in the governance, and performance enhanced by strengthening existing institutions and the improvement in the governance of the country.

I. Introduction

1.1 The Government of Nepal recently expressed its commitment through annual policies and programs to create conducive environment for the socio-economic transformation of the country. This has given rise to hopes for the Nepalese that prospects lay ahead for the emergence of "a new, prosperous, developed and peaceful Nepal for the present generation and future posterity" (MOF, 06). This has led to a renewed interest in the study of various facets of economic growth and stability, and in the policy responses needed to promote and maintain them. Viewed in this backdrop, this Study assumes an increasing importance and has been undertaken at a time when the country is suffering from unsatisfactory state of many of the macro economic indicators and the need is in evidence to maintain macro economic stability.

II. A review of the current macroeconomic framework

2.1 Macroeconomic framework

2.1.1 The process of structural change is taking place in the Nepalese economy, albeit very slowly. The structure of the economy is such that the share of the agriculture sector in GDP at factor cost in 2001/02 is estimated to be around 39.4 percent and that of the non-agriculture sector is 60.6 percent, but in 2005/06, the share of the agriculture sector in GDP at factor cost declined marginally to 38.8 percent with the share of non-agriculture increased slightly to 61.2 percent. But, macro economic stability continued to remain a major challenge during the first four years of the Current Tenth Plan/PRSP, 2002-2007.

2.2 Economic growth:

2.2.1 Nepal's rates of economic growth during the past four years have been unsatisfactory when compared to the Tenth Plan/PRSP target. The growth has been erratic, from a negative of 0.3 percent in FY01/02 to 2.4 percent in FY 05/06, with lot of fluctuations in between. The magnitude of fluctuations in case of manufacturing is the highest, from a negative of 10 percent to a positive of 2.1 percent in FY05/06.

Table 1: Real Gross Domestic Product Growth by Sector

(% change per annum)

	FY2001/ 02	FY2002/ 03	FY2003/ 04	FY2004/ 05a	FY2005/ 06b	FY2002/03 – 2005/06
GDP Growth	-0.3	3.1	3.6	2.4	2.4	2.9
Agriculture Sector	2.2	2.5	3.9	3.0	1.7	2.8
Industry Sector+	-2.9	3.3	1.1	1.5	3.5	2.3
Of which						
Manufacturing	-10.0	1.9	1.7	2.6	2.1	2.1
Services Sector++	-1.3	3.4	4.8	2.4	2.4	3.2

a Revised estimates.

b Preliminary estimates.

+ Includes manufacturing, mining and quarrying; electricity, gas and water, and construction

++ Includes, trade, restaurant and hotel, transport, communication and storage; finance and real estate and community and social services.

Sources: Central Bureau of Statistics, Ministry of Finance, Economic Survey 2004/05; Appendix Table A2.1.

2.3 Investment

2.3.1 Total investment to GDP ratio increased from 24.2 percent in FY01/02 to 30.3 percent in FY05/06. The ratio could have been more, had it not been for the sluggishness in investment in recent years that came from both the private and the public sectors. There was a marked slow down in capital spending of the government in the last few years resulting in low capital formation in the public sector. In the private sector also, investment slowed down due also to the fear psychosis arising out of the deteriorating law and order situation. The country returning gradually to peace, the investment situation in days to come can be predicted to improve with an increase in capital spending of the government and a rise in bank credit flow to the private sector.

Table 2: National Accounts Summary

Description	2001/02	2005/06* *
Gross Domestic Product(Producers' price)	100.0	100.0
Plus Import of goods and NFS.	30.2	37.7
Total Resources Available = Uses	130.2	137.7
Total Consumption	87.8	88.8
Private	77.8	78.7
Public	10.0	10.1
Total Investment	24.1	30.2
Gross Fixed Capital Formation	19.2	18.4
Private	11.7	12.8
Public	7.5	5.6
Change in Stock	4.8	11.8
Export of goods and NFS.	18.2	18.5
Gross Domestic Savings	12.1	1.1
Net Factor Income	4.3	2.1
Gross National Savings	16.4	13.2
Gross National Product	104.3	102.1

(As % of GDP at producers' Current Prices)

** Preliminary estimates

Source: Central Bureau of Statistics

2.4 Consumption

2.4.1 Investment growth is slower while the total consumption has shown a tendency of a continuous increase. In FY01/02, the total consumption as a percentage of GDP was estimated at 87.8 percent which increased to 88.8 percent in FY05/06. Private sector consumption increased from 77.8 percent of GDP to 78.7 percent and the public sector consumption witnessed a marginal increase from 10.0 percent to 10.1 percent during the same period. With significant amount of remittances coming in, the proportion of private consumption to total consumption is likely to further increase in short to medium term as remittances are associated with increases in consumption activities.

2.5 Savings :

- 2.5.1 Nepal is a very low saving country with gross domestic savings at 12.1 per cent of the GDP in FY01/02 which further declined to 11.1 per cent in FY05/06. Recently, the savings rate has declined due to lower GDP growth rate, high inflation, and poor revenue collection of the government resulting in a marginal saving in the public sector. Gross national savings have remained higher than gross domestic savings, as a result of significant inflow of transfer and factor income. As the external labor market is very much vulnerable, it is hard to completely rely on remittance as the major financier of Nepal's external sector gap.

2.6 Inflation

- 2.6.1 The pressure on price has remained high in recent FYs due to the slow growth in agriculture production caused by the adverse weather conditions, the increase in the price of petroleum products, and the consequent rise in transport cost. The annual average inflation based on national consumer price index, recorded a rise of 5.3 percent during FY02/03 -05/06. The instability of prices has continued over the years because of several reasons: First, agricultural production which is critical factor for ensuring smooth supply of food grains is vulnerable to weather condition; and cyclical nature of agricultural production growth has also created cyclical pressure on the prices of agricultural produces. A rise in the prices of non- food and services which carries a weight of 46.8 has contributed more to an increase in the annual average inflation rate. Second, due to open border with India and free flow of goods across the border facilitated by the free and unlimited convertibility of the Nepalese rupee into Indian rupee, prices in Nepal remain deeply influenced by Indian prices. Third, gradual deregulation of the administered prices leading to price rise in critical areas like electricity, fertilizer, and petroleum products has escalated the cost of production leading to inflationary pressure in the Nepalese economy. In recent years, the price of petroleum products has increased and in all probability the trend will continue in future as well. In addition, the increase of economic activities in the country will create additional demand for POL products that will have to be met by an increase in total import, thus putting pressure on the price level of the economy. Fourthly, Nepalese market suffers from fragmentation, asymmetric information, lack of competition, and inadequate regulatory mechanism which often results in price distortions and inflation. Finally, the disturbances in the economy because of strikes, forced closures of the industrial establishments, the imposition of curfews and hindrances in the smooth transportation of good and vehicles and so on also affected the price level.

II. The compatibility of fiscal, monetary, and other economic policies with respect to the macroeconomic equilibrium: a review

- 2.1 It is important to have consistency between the overall economic growth targets of the economy and the objectives and targets of the policy instruments. Policy consistency is in fact one of the primary requirements for achieving the growth targets. Nepal displays a compatibility of fiscal, monetary and other economic policies geared

towards achieving targeted rate of economic growth. This can be gleaned in the following reviews.

a. Fiscal policy:

- 3.2 The increasing trend of total government expenditure continues, largely because of the increase in recurrent expenditure and principal repayment of debt. In FY 01/02, the total government expenditure as a percentage of GDP was 18.9 percent which in FY04/05 remained at 19.2 percent. An increase in government spending is necessary to increase in the investment of the public sector for development.
- 3.3 The total recurrent expenditure remained high at 11.5 percent of GDP in FY01/02 and in FY04/05. Of the total recurrent expenditure of Rs.61.69 billion in FY 04/05, the share of defense expenditure was 13.9 per cent, social services 37.6 per cent, economic services 11.6 per cent, debt servicing payments 10.1 per cent, other services 26.8 per cent and miscellaneous expenses accounted for 8.7 per cent. The policy was to contain the growth of recurrent expenditure to make increasing funds available to augment capital expenditure. Not much progress was achieved in this regard, as security expenditures increased at a faster rate than other heads of the recurrent expenditures.
- 3.4 This increase in recurrent expenditure has its consequence on the growth of capital expenditure. In FY01/02, the total capital expenditure was a low of 5.9 percent of GDP which decelerated to 4.7 percent in FY04/05. This deceleration has its consequences on other important sectors of the economy, pushing allocations downward in all the sectors which in the reverse situation would not have happened. Of the total capital expenditure of Rs.27.34 billion, the allocation on economic services was 15.39 billion (56.3 percent), on social services Rs.7.94 billion (29.0 percent) and on defense Rs.2.41 billion (8.8 percent). The rest 5.9 percent of the allocations was claimed by other activities.
- 3.5 In FY04/05, out of the total government expenditure of Rs.102.56 billion, 68.3 percent came from revenue mobilization, 14 percent from foreign grants, 9 percent from foreign debt and 8.7 percent from domestic debt. Foreign debt increased by 21.5 percent and domestic debt by 59.4 percent in FY04/05. The government resorted to domestic debt to meet an increasing level of recurrent expenditure.
- 3.6 The fiscal situation continues to remain weak, largely caused by the widening gap between the growth of the total expenditure and public revenue and as a percent of GDP, the total expenditure increased from 18.9 percent of GDP in FY01/02 to 19.2 percent of GDP in FY04/05. Public revenue increased from 11.9 percent to 13.3 percent. As a result, the gap between total expenditure and total revenue which was 7.0 percent in FY01/02 marginally decelerated to 5.9 percent in FY04/05. The gap between the expenditure and revenue continues to remain a critical problem of public finance in the country.
- 3.7 Revenue surplus defined as the difference between the government revenue and recurrent expenditures is the main source to meet capital expenditures and debt servicing payments. As a percentage of GDP, it was 0.4 percent in FY01/02 but was

increased to 0.9 percent in FY04/05. This increase was largely because of the improvement in revenue collection. The re-enforced value added tax system and surge in imports contributed for the better revenue performance. Around 20.6 percent of the capital expenditures and debt are paid through revenue surplus. Likewise, foreign grants account for around 35.2 percent of the above expenditures and the rest 44.2 percent are borne by deficit financing, constituting 22.7 percent of foreign debt and 21.9 percent of domestic debt and change in cash represented a negative of 0.4 percent in FY04/05. This compares drastically with the situation in FY01/02 when revenue surplus was responsible for 5.1 percent of the expenditures, foreign grants 21.4 percent and deficit financing 73.5 percent. Out of the total deficit financing, foreign debt account for 24.7 percent, domestic debt 25.6 percent and change in cash reserve a positive value of 23.2 percent.

- 3.8 Total defense and security expenditures constitute as much as 3.5 percentage of GDP in FY04/05 (Rs. 18 billion), up from 2.9 percent (Rs. 12.08 billion) in FY01/02.². Outstanding total loan has declined from 69.5 percent of GDP in FY01/02 to 57.6 percent in FY04/05. Outstanding domestic loan has also declined from 17.4 to 16.4 and outstanding external loan from 52.1 percent to 41.2 percent during the same period. Outstanding foreign loan- revenue ratio is estimated to be around 313.2 and that of exports to be around 374.1. These are positive developments. Keeping these indicators in view, the debt situation does not seem to be particularly serious but there is a need to constantly guard against the sharp rise in future. Hence, an implementation of national debt policy and the continuous review of debt situation need to be a part of on-going fiscal management to ensure that the threat to fiscal stability is minimized.
- 3.9 The foregoing discussions reveal that first, revenue has shown an improvement because of the implementation of several revenue generating instruments; secondly, the inflow of foreign grants picked up although gradually; thirdly, the magnitude of deficit financing both in terms of foreign and domestic debt has shown a declining trend and the drawing down cash balance has also declined pari passu with the decline in terms of reliance on deficit financing as a source of resource mobilization instrument. Over the years, Nepal's fiscal situation is improving and is able to maintain fiscal stability.
- 3.10 The growing need for maintaining law and order situation entailed an upward pressure on recurrent spending while structural weakness in development administration undermined the capital spending target of the budget. But as the recent trend of expenditure and revenue reveals, it may be very difficult for the government to remain in the fiscal discipline without compromising for capital spending. Any attempt to control the growth of recurrent expenditures need to be found political support to be sustainable and enforceable.
- 3.11 Nepal's fiscal sector is structurally weak and vulnerable owing to low level of revenue mobilization for financing government activities, high dependence on foreign financing of capital budget, and continued deficit in the budget. No doubt, there has been a progress towards streamlining revenue structure with the reduction of customs tariff, following the commitment made by the government to WTO and the increase in

² The White Paper presented by the Finance Minister, Dr. Ram Sharan Mahat, annex 4., 2006

the customs tariff on more than 40 items, introduction of account based tax system and strengthening of tax administration, the revenue compliance has not improved or is not likely to improve to offset the revenue loss emanating from these reforms. Fiscal imbalance leads to instability in the overall economy. Maintaining balances between peoples' aspirations and available resources continue to remain one of the biggest challenges to the government.

- 3.12 The under-spending of the capital budget has remained a permanent feature with not more than 80 -85 per cent of the targeted budget being spent. Similarly, aid utilization has also been problematic with aid disbursement remaining around 60 – 65 percent of the commitments. This implies that not only resource availability but also resource utilization capacity is a major problem in the public sector.
- 3.13 The major source of foreign capital inflow in Nepal is foreign aid. As a least developed country, Nepal has been receiving loans in a large scale, particularly from multilateral institutions like the ADB and the IMF. Besides, bilateral assistance has also been the source of financing development activities in Nepal both at the government and non-governmental level. This has developed dependency syndrome in the development process and eroded policy autonomy of the government.
- 3.14 The main source of public finance is revenue. It was 11.9 percent of GDP (Rs. 5045 billion) in FY01/02 but increased to 13.3 percent (Rs. 70.12 billion) in FY04/05. The share of revenue in total government expenditure was 62.9 percent in FY01/02 and was increased to 68.3 percent in FY04/05. Of the total revenue collection in FY04/05, the share of tax revenue was 77.2 percent (10.3 percent of GDP) whereas the share of non-tax revenue was 22.8 percent (3.0 percent of GDP). These shares were 77.9 percent and 22.1 percent in FY01/02. This shows that revenue structure is heavily dependent on tax revenue and on indirect taxes which account for almost 82 percent of the total tax revenue.
- 3.15 The extent of revenue mobilization has not been satisfactory in relation to the increasing trend of government expenditure. As a result, the gap between the total government expenditure and total revenue continues. In order to reduce the gap, unnecessary government expenditure needs to be curtailed, and management of public expenditure strengthened.
- 3.16 The government needs to adopt appropriate policy and mechanism to increase the revenue. Bringing about efficiency, competency and improvement in revenue administration is one such measure. Raising the tax revenue by widening the tax base, minimizing revenue leakages estimated to be substantial in amount and refining the tariff structures at regular intervals can contribute to more revenue mobilization. The government needs to be firm, not to allow non-budgetary transfer of resources, and contain defense and security expenditures. The government has to observe fiscal discipline in its fiscal management, so as not to exceed 5 percent limit. The Revenue Administration Training Centre needs to be revamped so as to be able to undertake research on fiscal and other issues and monitor development in these areas, and suggest ways and means to improve revenue administration in the country and impart skill oriented and refresher training courses for the revenue cadres. However, strengthening Revenue Administration Training Centre along with the development of

its curriculum and so on has never remained among the priority agendas of the government.

- 3.17 It has been observed that a substantial amount of informal trade takes place both in import from and exports to India. The total two way informal trade ranges between US\$ 368 million and US\$408 million. If this trade could be brought into the tax net, it substantially increases the revenue³. Hence, this area could be further explored as the potential source of revenue mobilization.

b. Foreign Aid

- 3.18 Nepal's foreign aid trend is characterized by the following;

- i. The consistent discrepancy between the foreign aid commitment and disbursement. Foreign aid commitment amounted to Rs. 33.23 billion in FY01/02 and the figure increased to Rs.38.15 billion in FY04/05- an annual average increase by 4.7 percent. Meanwhile, the disbursement of foreign aid amounted to Rs. 14.38 billion (43.3 percent of the commitment) in FY01/02 and this increased to Rs. 18.91 billion (49.6 percent of the commitment) in FY04/05- an annual average increase by 9.6 percent. Despite that there has been an improvement in the disbursement ratio, yet the gap between commitment and disbursement remains substantial.
- ii. Another feature is the falling or near constant proportion of bilateral aid to total aid. For instance, in FY01/02, bilateral aid commitment constituted 55.5 percent (Rs.18.44 billion) of the total aid but in FY04/05, the proportion did not increase and remained almost constant (Rs. 21.23 billion). The declining proportion of bilateral aid has been compensated by an increase in multilateral aid.
- iii. Another characteristic is the changing proportion of grants and loans. In bilateral aid, the proportion of grants is overwhelming. For instance, in FY01/02, the proportion of grants to total bilateral aid was 93.8 percent while in FY04/05, it was hundred percent. But in multilateral aid, the proportion of loan is pronounced. For instance, in FY01/02, the proportion of grants to total multilateral aid was 40.9 percent and in FY04/05, this declined to 24.6 percent. Out of the total aid, the share of grant assistance was 70.2 percent of the total in FY01/02 and this decreased to 66.6 percent in FY04/05.
- iv. Generally, aid utilization is consistently higher in loans than in grants assistance. For instance, grants aid utilization in FY01/02 was 28.6 percent of the commitment. This has increased to 56.7 percent in FY04/05. As regards, the loan utilization rate, in FY01/02, it was 77.9 percent which however declined to 72.6 percent in FY04/05 but still higher than the utilization of grants assistance.
- v. Of the total committed foreign aid, more than 90 percent of the assistance comes from the members of the Nepal Development Forum. In FY04/05, the Forum contributed 98.4 percent, totaling Rs.37.55 billion.

- 3.19 Utilization level of foreign aid in contrast to commitment is low. The optimum utilization of foreign aid in an efficient manner on areas singled out as priority areas

³ Nepal : Trade and Competitiveness Study, MICS, 2004, p.13.

such as P1 could contribute to scale up development activities and have its impact felt by the society. At the same time, it could contribute to the objective of poverty alleviation through the implementation of social programs.

- 3.20 Foreign Aid Policy 2002 contained many innovative ideas but has remained short of implementation. It is desirable to evaluate the implementation of the Policy in order to accommodate changes taking place in the management of foreign assistance. Policy planning need not be one-shot affair and needs to be reviewed as and when required.
- 3.21 Fiscal deficit has been a regular feature in the context of lower growth of revenue in comparison to the growth in government expenditures. The trend of fiscal deficit in the last few years and its ratio with GDP is presented below.

Table 3: Fiscal Deficit

(Rs. in billion)

Fiscal Year	Fiscal Surplus (Deficit)	Ratio of Fiscal Deficit to GDP (in %)
1998/99	-17.991	5.3
1999/00	17.6670	4.7
2000/01	-24.188	5.9
2001/02	-22.941	5.4
2002/03	-16.437	3.6
2003/04	-15.828	3.2
2004/05	-18.047	3.4

Source: FCGO and CBS, quoted in the ES, 2005-06.MOF, GON.

- 3.22 In FY 04/05, the fiscal deficit stood Rs.18.05 billion. There was a gradual decrease in fiscal deficit since FY00/01 and in FY04/05, the ratio of fiscal deficit to GDP was 3.4 per cent.
- 3.23 Foreign debt, domestic debt and change in cash reserves have been the source of meeting the gap between government expenditure and revenue. In FY01/02, the amount of total fiscal deficit was Rs.22.94 billion. Rs. 7.70 billion (33.6 per cent) was met by foreign debt, Rs.8.0 billion (34.8 per cent) by domestic debt and remaining Rs.7.24 billion (31.6 per cent) was met by change in cash reserves. In FY04/05, the total fiscal deficit was Rs.18.05 billion. Of the total, Rs.9.27 billion (51.4 percent) was met by foreign debt, domestic debt contributed Rs.8.94 billion (49.5 percent) and Rs. 0.16 billion (-0.9) was contributed from the change in cash reserves.
- 3.24 To maintain fiscal balance, the government needs to be self-disciplined by making the government budget economic growth friendly. Sooner, the Fiscal Transparency Act is needed to ensure that the pattern of allocation is oriented towards growth. Likewise, in order to make the public procurement systematic, transparent and productive, Public Procurement Act needs to be enacted as envisaged in the Budget Speech of the FY 06/07.

c. Remittances

- 3.25 Nepal received an estimated US\$ 908 million in remittances in 04/05 which comes to around 12 percent of GDP. The amount was higher than merchandise exports (US\$ 825 million) and significantly higher than official aid (US\$ 175 million). The

remittances helped offset the bulk of the trade deficit of US\$ 980 million, and tipped the current account balance (excluding official transfers) into a noticeable surplus of US \$225 million (3 percent of GDP). Remittances have also been a steadier and less volatile source of foreign exchange inflows. It has generated a steady stream of foreign exchange earnings and improved credit worthiness for external borrowings⁴. It has helped boost national income and consumption.

- 3.26 Nepal living Standard Survey (NLSS) revealed that in FY03/04 around 32 percent of the households received remittances, and the average remittance per household was NRs. 1, 723. The Survey also indicated that the bulk of the remittances were used to finance consumption expenditure, repay loans, buy land, construct or improve housing, and educate children.
- 3.27 It has generally a good impact on the economy. It has contributed to a decline in poverty. The IMF estimates suggest that Nepal's poverty rate could be almost 5-6 percentages higher in the absence of remittances as compared to the present rate of 31 percent. Keeping in view the growing importance of remittances, it has become urgently important to undertake the impact study of remittances on the national economy, particularly on the kind of relationship that exists between poverty alleviation and inflow of remittances..
- 3.28 Remittances are less likely to remain a permanent source of resources inflows into the country for two reasons: it is uncertain how long and what kind of labor the importing countries demand. Their requirement for labor changes both in terms of number and types of labor along with changes in the development status of the importing countries. Secondly, any changes – political and otherwise - in the labor importing countries could affect demand for Nepalese labor, on which Nepal has a little control. Hence, it is suggested that:
- i. It would be indeed worthwhile to ascertain the linkages between remittances inflows and the poverty level at regional and national levels,
 - ii. Nepal needs to have a plan to make use of growing remittances for investment and employment creation within the country.
 - iii. An alternative source of resource flows need to be explored should the inflow from remittances dwindled or reduced.
 - iv. NRB should further develop system for more efficient collection and repatriation of remittances through formal channels that both reduce risks for migrants and help deepen the financial system⁵.

d. Monetary policy

- 3.29 The Monetary Policy (MP) announced on July 23, 2006 by Nepal Rastra Bank (NRB)⁶ aims at facilitating economic growth, maintaining price stability, maintaining balance of payments surplus, and maintaining financial sector stability and increase financial intermediation. In terms of specific targets, the monetary policy is geared towards attaining the economic growth rate of 5 percent, maintaining an inflation rate

⁴ Nepal: selected Issues and statistical appendix, IMF Country Report No. 06/45, 2006, p.10.

⁵ It has been estimated that 78 % of total remittances are brought in by migrants, 6 % through financial institutions, 2 % through informal system(hundi/hawala) and the rest through other means.

⁶ NRB has been announcing monetary policy since 2002/03.

of 6 percent and the BOP surplus of Rs. 16 billion. Further, the rate of growth of broad money is projected at 16.1 percent, the net bank credit to the government at Rs. 8.3 billion, bank credit to the private sector at 18 percent and time deposit with the commercial banks at 16.5 percent. The monetary policy seeks to maintain monetary aggregates in compatibility with the stable exchange rate regime. The effective implementation of the monetary policy is expected to create congenial environment for maintaining growth impulse and fiscal and monetary stability.

- 3.30 The monetary sector continues to expand in the recent years. Broad money supply continued to increase by 8.8 percent during 2001 – 2005. This is mainly due to the surge in foreign exchange holding of the banking system coming from strong balance of payments. The continued high monetary growth has raised demand for imported goods and services, and thus exerted a negative impact on the trade account situation in the external sector of the economy. High liquidity, however, has not exerted much instability owing to improved domestic supply situation, declining international commodity prices, and inflow of foreign capital.
- 3.31 The capital market has remained more buoyant in the recent years with improvement in both the securities and non-securities market activities. In the share market, share transactions as well as share prices have grown significantly. The market capitalization of the share transaction was 11.5 per cent of the GDP in FY99/00 and is estimated to have increased to 16.6 percent in July 2006 and is likely to increase further in future.⁷ The recent share market price is, however, unwarranted by the fundamentals of the companies and the economy as well. Marked correction in the stock prices is likely to reduce demand by suppressing income and hence slow down economic activities. There is a decelerated growth rate in gross domestic credit and net non-monetary liabilities due to which net domestic assets also showed a decelerated growth.
- 3.32 There was some slackness in the commercial banks' lending and investment. Such a decline in the growth of commercial banks' loan and investment is due to conflict situation, political disturbance, and consequent slackness in industrial environment and over all economic instability. Similarly, there was decline in loans advanced by commercial banks to private sector.
- 3.33 NRB has to ensure that the monetary policy is prepared in line with the fiscal policy of the government and implement it in a manner that is subservient to the overall growth process. The White Paper notes that the government blocked the process of financial reform during the last four years. "Consequently, the non-performing assets of the two largest state-owned commercial banks still stand very high despite huge expenses made for management reform in those banks. They are still mired in bad loans willfully defaulted"⁸. In addition, the NRB's capability for effective supervision of more complex financial services transactions need to be ensured, as the future will witness the growth in complexity in banking business.
- 3.34. Some of these issues can be expected to be considered in the interim reform program which the government has promised to announce sooner to widen the scope of

⁷ There has been no study on the impact of market capitalization of share capitalization on financial stability

⁸ *Ibid.*

financial reform program so as to bring positive changes on the lives of the poor people at the earliest.

- 3.35. Financial reforms, stalled for sometime in the past, needs to be carried forward with vigor, particularly to drastically reduce the volume of non-performing assets particularly in the two principal government owned commercial banks - Nepal Bank Ltd. and Rastriya Banijya Bank amounting to Rs. 29 billion.

IV. Internal and external equilibrium and economic liberalization

a. Internal and external equilibrium

- 4.1 Macro economic stability of Nepalese economy is determined by a couple of factors. These include basically the discrepancies between investment and savings (I-S), between total expenditure and total revenue (TE-TR) and between imports and exports (M-X). These discrepancies have basically been the result of several factors, both internal and external, and constantly reinforcing each other. Each of those factors has a decisive impact on the performance of the economy and hence these constitute a major subject- matter for the study.
- 4.2 Factors contributing to the threat to the macro economic stability come through many sources – both internal and external and are causes and results of both internal and external shocks. As regards internal reasons, the followings are among the prominent ones.
- i. Pervasive poverty: NLSS II (03/04) reports that absolute poverty measured in terms of head count ratio of 30.8 percent, the corresponding figures for urban and rural areas being 9.6 percent and 34.6 percent respectively. The overwhelming number of poor people pushes down the per capita savings to a low level (Rs. 2,622 in 04/05) but investment demand is ever increasing to respond to the increasing expectations of the people.
 - ii. Low economic growth rate: Despite some very limited progress achieved in the past four years, under the current Tenth Plan/PRSP, 2002-07, Nepal remains one of the least developed countries in the world with the per capita income at US dollars 311 in 2005-06. The country's per capita income has been growing at 0.6 percent per annum (02/03–05/06) hardly enough to bring down the level of absolute poverty significantly. With an annual economic growth of 2.8 percent GDP (at producers prices) during the first four years period (02/03 – 05/06) of the Tenth Plan/PRSP when population is growing, on an average, by 2.2 per cent, the main policy issue is how to enhance a broad based economic growth with built-in-distribution of income.
 - iii. Growing unemployment and underemployment: The Tenth Plan/PRSP estimates in 02/03 the open unemployment rate of 5.0 percent and underemployment of rate of 12.4 percent, bringing the total figure of unemployment and underemployment rate to 17.4 percent. There are no indications as yet that the number of unemployment and underemployment has declined.
 - iv. Inequality in the distribution of income and consumption: Past development efforts have been associated with an increase in the inequality in the

distribution of income and consumption. The poorest 20 percent shares 6.2 percent of consumption per capita while the richest 20 percent share 53.5 percent (NPC, 06, p.6). With no effective redistributive policies in operation, the inequality may well have been on the increase.

- v. Political instability and the insurgency problems: Political instability⁹ and the insurgency problems resulted in weaker macro economic outcomes, impeded the pace of the implementation of structural reforms and intensified the decline in macro economic performances.. Many important development infrastructures were destroyed and are waiting for rehabilitation, reconstruction and repair. It was reported that a three member team of the IMF which visited Nepal ahead of the budget announcement for FY06/07 took a serious note of the status of the country's macro economic stability, especially of its fiscal imbalances in recent times. It was reported that only Rs. 3.40 billion was in the government's treasury which was just enough to meet the salaries of civil servants for a month.¹⁰

4.3 In the external sector, shocks emanated from the following factors:

- i. Heavy dependence on foreign assistance: Nepal 's heavy dependence on the external assistance continued for much of its capital spending. The supply of fund under foreign assistance differs widely from one FY to the other, sending the message that, although Nepal is a continuous recipient of foreign assistance, its disruption or a sharp decline at any time of the FY is certain to put the economy under severe stress. Uncertainty in the supply of fund results in squeezing capital expenditure thereby adversely affecting the process of economic growth.
- ii. Fluctuations in the exchange rate: Nepalese currency vis –a- vis US Dollar forms one of the sources of constant instability. Of late, fluctuations in the value of Nepalese currency in terms of US Dollars have remained quite substantial. – a decline from NRs. 78 in July 02 to Rs. 70.35 in July 05 and again climbed upwards. The wide fluctuations continue. Changes in the value of Indian Rupee in terms of US Dollars get itself transmitted to Nepal's exchange rate with US dollars as Nepal's maintains pegged exchange rate with Indian currency.
- iii. Rise in POL prices: A rise in POL prices has not only been an economic issue but also becomes a political issue since it has a wider impact on the lives of the people. This has remained one of the continued sources of external shocks. POL products accounted for 14.2 percent of total imports bill in FY01/02 and has risen since then to 20 percent in FY04/05 and are very likely to increase further.¹¹ A rise in POL products sends shock waves to all the consumers as petroleum products and coal which in National Wholesale

⁹ An IMF Study has indicated that political instability in Nepal has lost the country 0.75 percentage point of GDP growth on average per year., IMF Country Report No. 06/45, 2006, p.6,: www.imf.org.

¹⁰ The Kathmandu Post, June 22, 2006.

¹¹ The GON raised the prices of POL products on Aug 18, 06 from 11 to 39 percent over the existing process largely because of the need to bring domestic prices in line with international prices. NOC is reported to have incurred losses amounting to Rs. 830 million/month after the international prices rocketed to USD 78 a barrel. In face of the rising protests both in the parliament and on the streets, the GON revoked its decision to hike prices of all major POL products after 48 hours.

Price Index ,occupies 5.4 percent in the total weight, has recorded one of the highest rates of growth of 33.8 percent in FY 04/05 over the previous year.

- iv. Dwindling resources mobilization as a result of Nepal's commitment to term of WTO: Nepal cannot and should not remain isolated form the international community and undermine the possible gains of regional integration and multilateral agreements, despite Nepal's negligible share in the global market of 0.02 percent. Nepal's journey to international integration began with the accession to WTO in April 2004 and the failure to derive advantage from the integration might put Nepal in considerable loss in terms of generating revenue. Nepal will have to find new sources of revenue to replace the several import surcharges which were eliminated and enhance total factor productivity to maintain/increase competitive edge in export commodities. This requires a long term strategy to be pursued by the government.

- 4.4 Major source of instability is prone to be emerged from the external sector. The M-X will continue to remain the most prominent source of instability in the Nepalese economy.

Table 4: Measures of Imbalances in the Nepalese Economy

(As a % of GDP at producer's prices)

FY	Investment – Saving (I-S)	Import of goods– exports of goods (M-X)	Total expenditure – total revenue (TE-TR)
2001/02	-12.1	-14.6	-9.6
2002/03	-13.1	-14.3	-9.1
2003/04	-13.8	-16.3	-8.3
2004/05	-16.5	-16.6	-9.1
2005/06#	-19.2	-17.0	-8.3

#Estimates.

Source: Economic Survey, 2005/06, GON, MOF, Kathmandu

- 4.5 The vicious circle of low income, low saving, low investment and low growth have remained the characteristic feature of the Nepalese economy. Challenges facing Nepal relate to addressing the long-standing constraints to significantly higher growth and stability.
- 4.6 Factors acting as constrains to sustainable development process are many: low savings rate resulting in over dependence on foreign capital for investment, inefficiencies in resource management resulting in high capital-output ratio estimated to be 4.3 and making Nepal a high cost economy with low relative market competitiveness, the volatile exchange rate of the Nepalese rupee, and declining interest rates as a result of high liquidity in the economy. In addition, sluggish investments, pervasive weaknesses in the fiscal and financial sectors and high rate of inflation add further problems to the economy.
- 4.7 Then, there are structural and institutional barriers to growth. Identified structural growth constraints include vulnerable agriculture, fragile industrial base, and inefficient public enterprises and the institutional barriers include weak governance, weak implementation capacity of public institutions and so on.
- 4.8 A sustained high growth of the economy is quite unexpected without a strong turnaround in agriculture, continued surge in exports, large foreign direct investment,

and effective policy interventions of the government. Nepal is face with a very conflicting situation characterized by supply bottleneck in the agricultural sector and demand bottleneck in the non- agricultural sector that needs to be addressed by policy interventions.

b. Economic liberalization

- 4.9 The process of economic liberalization came to a grinding halt during the past years as the country devoted its attention to solving the security and insurgency problems. The trend towards liberalization is irreversible; however the pace needs to be intensified and accelerated. This requires an appropriate political environment which was entirely missing in the past. Financial system seems to have expanded much faster than the real economy. In addition, exercises on sequencing reform measures need to be undertaken.
- 4.10. What is therefore necessary is to accelerate the process of privatization of public sector enterprises, further create conducive environment for the growth of private sector, and continue the implementation of several reform measures initiated in the past. The government need to reemphasize that liberalization is viewed as an instrument for accelerating growth and alleviating poverty.
- 4.11 Hence, it is suggested that the government needs to reconfirm the commitment to privatization by presenting the revised policy statement and procedures, prepare a comprehensive privatization programs and implement them effectively.
- 4.12. Existing regulatory regimes need to be reviewed in order to make them timely and consistent with other policy instruments such as Industrial Enterprises Act, 1992, Trade Policy Act, 1992 and Foreign Investment and Technology Transfer Act 1992 and so on.

V. Economic development and planning exercises

5.1 A critical analysis

- 5.1.1 Nepal is in the terminal year of the Tenth Plan/PRSP, 2002-2007. The Plan's only development objective has been to achieve poverty reduction, with a view to reducing the number of population below poverty line to 10 percent by the end of the Twelfth Plan, 2016-17. However, because of several problems, the implementation of the Plan has been adversely affected. The poverty challenge for Nepal continues to remain the central element of Nepal's development endeavors.
- 5.1.2. The Tenth Plan/PRSP, 2002/07 singles out 4 strategies for implementing the Plan/PRS. These are high, sustainable and broader economic growth, social sector and rural infrastructure development, targeted programs and good governance. Since 2003/04 onward, the annual Budget Speech also indicates the allocations to each of the strategies. The following table shows the allocations made in the budget estimates for each of the areas strategies during FY03/04 –06/07. During the period, the total estimated allocations to these four strategies differed widely between 10.5 percent of total allocations in FY05/06 to 44.7 percent – the highest allocation so far - in FY06/07, showing the lack of stability in the resource allocation policy. On an

average, the total estimated allocation during the four year period amounted to 31.2 percent of the total expenditure. This is too low. However, the budget document does not contain an analysis of the actual expenditures in each of the above areas to do meaningful analysis.

Table 5: Allocations to four strategies of the Tenth Plan/PRSP (Rs. in billion)

Description	2003/04	2004/06	2005/06	2006/07
High, sustainable and broader eco. Growth	12.00 (41.0)	1.79 (14.8)	18.66 (35.9)	21.88 (34.0)
Social Sector and rural infrastructures development	11.22 (38.3)	2.12 (17.6)	24.62 (47.3)	29.49 (45.9)
Targeted program	2.02 (6.9)	2.76 (22.8)	3.18 (6.1)	4.50 (7.0)
Good governance	4.04 (13.8)	5.41 (44.8)	5.57 (10.7)	8.40 (13.1)
Total Rs in billion (a)	29.29 (100.0)	12.08 (100.0)	52.03 (100.0)	64.27 (100.0)
Total Expenditure	102.40	115.29	126.89	143.91
Total expenditure as a percentage of (a)	28.6	10.5	41.0	44.7

Notes: Allocations for 2002/03 are not available. Figures in parenthesis are percentages

Source: Budget speeches for various fiscal years.

a. Pervasive poverty

5.1.3 Nepal's population growth rate of 2.24 percent is still relatively higher. High fertility rate, declining infant mortality rate, improving longevity due to expanding health care facilities and health consciousness, and inadequate supply of family planning services mass illiteracy (nearly three fourth of the female population remaining illiterate)and others have remained as the major reasons behind the high population growth. It is important that poverty alleviation efforts are accompanied by the more aggressive campaign to population planning.

5.1.4 The problem of poverty is immense and requires consistent efforts spread to over a numbers of years for its reduction. But the intervention measures both from the public and private sectors do not match the severity of the problem and hence, no indication as yet that that poverty would be reduced to 10 percent by the end of the Twelfth Plan, 2012-17.

b. Rising unemployment and underemployment

5.1.5 Coupled with young population entering the work force, the increase of labor force has been about 3 per cent. When the economy is growing at a rate of less than 5 per cent, on average, and employment intensity of GDP growth is only 0.45, it is obvious that the growth of economic activities has not been able to absorb the growing labor force. This is resulting in a growing stock of unemployed, and underemployed workforce in the country, thereby aggravating the poverty situation in the country. This growth in the workforce and the job creation not responding to each other breeds poverty problem at an increasing scale in the country.

5.1.6 Further, as the GDP growth rate is largely the contribution of the non-agricultural sector, which is less labor intensive than agriculture (agriculture which contributes for

38 per cent of the GDP and provides employment to 66 per cent of the labor force grew by only 2.5 per cent on an average during the last decade). The growth in the non-agriculture sector failed to provide jobs to the workforce released from the agriculture sector. Even within the industry sector, the labor intensive cottage and small scale industries including handicraft industries failed to expand to reduce unemployment and underemployment among that workforce. Hence, one of the ways to respond to the growing proportion of unemployment and underemployment problems is to enhance agriculture productivity that will provide boost to the expansion of non-agriculture pursuits. Obviously, the supporting factors to give a boost to agriculture productivity has to a clear –cut land reform strategy with emphasis on both the production and distribution aspects, which were largely ignored in the past, the expansion of the agriculture inputs including irrigation, macro credit and tenancy reform and so on.. The implementation of APP can contribute to the creation of conducive environment also for generating employment opportunities in the country.

c. Low economic growth

5.1.7 Under the normal situation, the Tenth Plan/PRSP, 2002-07 has a target of increasing an annual rate of economic growth at 6.2 percent. In order to attain this rate of economic growth, agriculture sector has to grow at the annual rate of 4.1 percent during the Plan period, industry sector has to grow at the annual rate of 8.9 percent and social services at the rate of 7.1 percent.

5.1.8 Nepal's rates of economic growth during the past four years have been unsatisfactory. GDP grew at the annual rate of 2.9 percent during the period 2002/03 -2005/06,. Agriculture sector by 2.8 percent, and the service sector by 3.3. The gap between the target and the performance is quite large.

Table 6: Real Gross Domestic Product Growth by Sector
(% change per annum)

	The Tenth Plan target		Achievements FY2002/03 - 2005/06a	2006/07 Budget speech target
	NGS	LGS		
GDP Growth	6.2	4.3	2.9	5.0
Agriculture Sector	4.1	2.8	2.8	3.5
Industry Sector+	8.9	6.3	2.4	6.0*
Services Sector++	7.1	5.0	3.3	-

a Revised estimates for 2004/05 and preliminary estimates for 2005/06.

+ Includes manufacturing, mining and quarrying; electricity, gas and water, and construction

++ Includes, trade, restaurant and hotel, transport, communication and storage; finance and real estate and community and social services. * Non-agriculture sector target.

NGS = Normal growth scenario, LGS = Low growth scenario.

Sources: Central Bureau of Statistics, Ministry of Finance, Economic Survey 2004/05.

d. Inequality

5.1.9 Unequal distribution of income/consumption and of opportunities for better living has become one of the serious impediments of the economy for the government to maintain social harmony and avoid conflicts like the ones we have witnessed over some years now. Deprivation from basic needs of life, deteriorating economic condition due to degrading land quality (due to deforestation, soil erosion and landslide) and no additional employment opportunities in relation to population growth has forced people to migration from the mountains and hills to terai. NLSS-II has indicated that over the year's inequality is increasing between urban and rural areas and across the development regions of the country. Real per capita expenditure grew by 43 percent while poverty declined by 26 percent, during 1995/96 – 2003/04. this implies that total elasticity of poverty reduction with respect to growth has been a negative of 0.6., i.e. every one percent growth in per capita expenditure resulted in 0.6 percent reduction in the proportion of the poor. Gini coefficient, one measure of inequality, rose from 0.34 in 1995/96 to 0.41 in 2003/04.

E. Short fall in agriculture performance

5.1.10 Moreover, low agricultural productivity growth combined with a high population growth rate and high illiteracy has perpetuated widespread poverty. Very weak development administration coupled with the unstable political situation and deteriorating law and order situation to carry on programs initiated during the past years has resulted in undershooting of most of the plan target. Achievement made in the agricultural sector is a glaring example in this regard. The 2.8 percent average annual growth rate of the agricultural sector during 2002/03 – 05/06 in spite of highest priority laid on it has been the major factor hindering over all economic growth of the country.

5.1.11 The progress achieved during the past four years indicates that there is less likelihood to achieve even the low growth target of 4.3 percent. While possibility exists to meet low growth target of the agriculture sector, depending how agriculture face the weather conditions, it is less likely that the non-agriculture growth target is going to be achieved. Reasons are many but largely internal emanating from non-economic reasons particularly the conflict situation in the country, the lack of peace and security, violence and terrorism and so on which affected all aspects of economic life. Such unfavorable situation is reinforced by reasons such as unfavorable weather, slack international trade and negative impact on tourism and transport sector, and above all destruction of key infrastructure in many sectors of the economy.

5.2 Measures for further effectiveness

5.2.1. The Tenth Plan/PRSP, 2002-07 poverty alleviation objective is relevant but its fulfillment is conditional on the optimum use of a set of the four strategies that are included in the Plan. These are the strategies of high, sustainable and broad-based economic growth, implementation of social sector and infrastructure development programs, the implementation of targeted programs and the institution of good governance. However, the Tenth Plan/PRSP strategies need to be supported in terms of resources allocation.

5.2.2 The present structure of production and macroeconomic policies adopted to accelerate economic growth indicate that unemployment and underemployment situation would further deteriorate if no interventions are made immediately. Given the trend of GDP

growth rate with the existing employment intensity of economic activities, such problems would aggravate in future with unemployment rate exceeding 10 per cent in 20 years time. Even a higher GDP growth rate of 6.5 per cent would take 30 years for completely addressing unemployment problem. So, if no structural changes in the economic activities are made, and if GDP growth could not be accelerated to more than 7 per cent, attainment of better employment situation in the near future seems very unlikely¹².

- 5.2.3 The low economic growth coupled with high population growth has made poverty reduction a formidable challenge. Unless the economy grows by more than 6 per cent, addressing poverty through growth impulses is difficult when population is growing at a high rate. This is the reason why absolute number of the people in abject poverty is ever growing in the country. Attaining high and sustained economic growth requires some catalyst sectors with strong resource base taking the lead. The country's major resources - tourism, water resources and human resources--need to contribute more for attaining high growth of the economy sufficient enough for reducing poverty as well. The absence of human resources planning sector-wise and at the economy-wide level continues to hinder the process of job creation and training of increasing labor force. The growing poverty and unemployment amid high population growth has been instrumental for growing violence, social unrest and threat for the political stability of the nation in the recent years.
- 5.2.4 The trend GDP growth rate of less than 5 per cent coupled with the present income distribution pattern cast doubt on the fulfillment of poverty target by the end of Twelfth Plan, 2012 -17. In addition, attaining sufficiently high growth rate calls for huge investment which is also difficult to sustain if no proper balance between the public and the private sectors, and between the domestic and external resources are made.
- 5.2.5 P1 (high priority projects) still contains projects that need not be so categorized. Hence, it is necessary to revisit the criteria of P1 projects, and eliminate P3 projects. This will bring some more resources to the P1 projects, however little it might be. In terms of resources constraints, it is worth trying to save every rupee and best utilize it to give impetus to a culture of optimum utilization of available resources.
- 5.2.6 Poverty Alleviation Fund (PAF) is now operating in 42 districts including special window programs in 17 districts since 2004 but these areas of operation are still inadequate to make any significant dent on the problems of poverty alleviation at the national level. The activities of PAF needs to be expanded to cover increasing number of districts, with support obtained from the government as well as from the local resources on cost-sharing/public-private partnership basis. In addition, PAF needs to prepare a long term vision for its activities well linked to the perspective vision of poverty alleviation.
- 5.2.7 Extend the coverage of microfinance institutions in the country and improve their performances. Poverty alleviation efforts need to be linked with population planning and the reduction of high level of fertility is possible only through women

¹² Macro economic policies, performance, and sustainability issues, www.nssd.net/pdf/nep06.pdf

empowerment. This requires that imparting education and awareness among women need to be undertaken extensively.

- 5.2.8 Implementation is one of the basic weaknesses of the Nepalese planning process. Despite the fact that several arrangements have been made to ensure smooth implementation of development programs, no indications as yet exists that implementation has become effective. There is a need to do more in terms of bringing about effectiveness in implementation. The Budget Speech of FY 2006/07 has made innovative provisions. This includes a progress review meeting on the seventh day of each month under the chairmanship of the concerned minister in respective ministries. Similarly, a meeting is to be organized at the MOF in every two months with the participation of concerned Secretaries, for monitoring and evaluation of the projects and programs.
- 5.2.9 At present National Planning Commission as the central planning agency does not exist. The works of the Commission is being run by the bureaucracy. It is important at this time of the year for NPC to be in place, for the present Budget Speech 2006/07 makes promise for the revision of Industrial Policy, 1992, Trade Policy 1992, and Foreign Investment and Technology Policy 1992 (Para. 129 of the Budget Speech) which is already overdue. Likewise, the Budget speaks of formulating agriculture business promotion policy (Para 49) and the White Paper presented by the Minister of Finance promises to the nation to announce shortly an interim economic reform program (Para 44 of the White paper)¹³ and so on. In all these activities, the contribution of the planning agency is important. Further, NPC has to be manned by those persons who are competent and dedicated to give push to the process of development.
- 5.2.10 NPC has conceptualized three different types of monitoring - implementation monitoring, output monitoring and impact monitoring both at central and at district levels as part of the overall poverty monitoring and analysis system (PMAS). While it is true that the presence of an effective monitoring system contributes to the effectiveness of the overall planning processes, there is no indication as yet that these mechanisms are being successfully implemented. In addition the Budget Speech of FY 2006/07 provides that arrangement will be made to conduct the post-evaluation of the effects of all programs and projects costing Rs. 50 million on men and women. The introduction of these mechanism is constrained by the fact that there are institutional constraints both at central and district level; nonetheless, these need to be fully operational.
- 5.2.11 Introduction of new technology and methods in discharging planning functions has been in evidence. This has helped the planning process to become more systematic and scientific; however, in the introduction of newer methods and technology, the external inputs have so far been a dominant factor and these methods have not been fully internalized largely because of institutional and human resources constraints. Within the organization. Hence, internalization of the new technology and methods in the planning process need to take place.

¹³ White paper presented by the Minister of Finance Dr. Ram Saran Mahat to the Parliament, on 2006/5/17: <http://www.gorkhapatra.org.np/content.php?nid=646>

5.2 12. It is envisaged that planning strategy needs to strengthen the private sector in order to help it augment the capacity to lead the growth process. In addition, planning needs reorientation in favor of creating human resource development plans tied up with the programs/projects to be implemented by line agencies.

VI. International dimension of the Nepalese economy (in terms of foreign trade and currency convertibility including the exchange rate and interest rate stances)

6.1 External Sector: Nepal's external sector is historically weak with perpetually increasing trade deficit. Both exports and imports continued to surge. The export-import ratio, which was 43.7 percent in FY01/02 decelerated to 39.3 percent in FY04/05 largely because the growth rate of imports outpaced that of the exports and the trade deficit widened mainly due to the relatively larger volume of imports.

6.2 The trade deficit in 2001/02 accounted for 14.3 percent of the GDP and this increased to 17.0 percent in FY04/05 (.Rs.90.77 billion). The share of trade with India in total trade increased from 54.8 percent in FY01/02 to 61.3 percent in FY04/05 which reveals Nepal's dependence on India for much of the trade. Likewise, exports to India rose notably, and the export to other countries increased albeit slowly with the result that the total growth rate of export remained encouraging. In FY04/05, the export to India has reached to 66.3 percent of total export which was 59.6 percent in FY01/02. In recent years, both imports and exports increased and the volume of import remained very high in comparison to export.

6.3 The substantial increase of imports from India and other countries continued with the result that the share of imports from India is 63.3 percent, while from third countries it is 37.7 percent in FY04/05. During this period, especially the import of goods like petroleum products, rice, yarn, medicines and chemical fertilizer increased substantially. The import of petroleum products, a major item imported from India increased by 38.2 per cent. Goods imported from India in FY05/06 shows the share of primary goods and manufactured goods at 48.6 percent and 51.4 percent respectively.

6.4 Nepal remains dependent on a few exports and markets, making it vulnerable to external demand and external policy shocks. Commodity and geographical concentration is pretty high. Three exports – garments, pashmina and carpets- account for 23 percent of total merchandise exports and about 90 percent of exports outside India. Dependence on a small group of markets has been increasing with the US, India and German markets for 90 percent of its exports. Imports are more diversified, but India still accounts for over half of the total.¹⁴

6.5 Hence, to increase, a stronger focus is required on Nepal's comparative advantage to increase exports. Nepal's comparative advantage lies in labor and resource intensive industries, such as hydro power development, tourism, carpets, textiles, paper products and other agro-processing industries. Concentration on these commodities will help provide stability in the export sector.

6.6 Due to an encouraging increase in the remittances and capital inflows mainly in the form of official aid, current account surplus is being continuously maintained. In FY2004/05, the current account surplus was Rs.11.54 billion. As a result, the country

¹⁴ Selected Issues and Statistical Appendix,, IMFCountry Report No. 06/45, 2,006, P. 16

witnessed a record high balance of payments surplus which stood at Rs. 5.7 billion in 2004/05. This resulted in foreign exchange holding of the banking system to increase to US\$1.8 billion at mid- July 2004, ensuring a cover of more than 10 months of merchandise imports. As Nepal has received substantial foreign capital in the form of official loan and as capital outflow is limited due to low debt servicing obligation and restriction for making investment abroad, net capital inflow in a sizable amount has strengthened the capital account balance of the external sector. This has improved the balance of payments situation of the country and increased the foreign exchange reserves position to a record high level.

- 6.7 Aid imports which used to be nearly one fifth of the total imports in the 1980s has now been limited to less than 10 per cent. Such imports have witnessed a sharp dip in the recent years due to very slow implementation of aided projects. In the recent years, increase in total imports is observed mainly due to the increase of non-aid imports which went up by 9.7 per cent in 2004/05.
- 6.8 The sustainability of the external sector is marred not only by the structure of trade but also by the structure of production and capital inflows. No doubt the structure of imports is continuously switching towards industrial raw materials and capital goods contributing for exports to increase further. But as the import elasticity of GDP is very high (1.7 in the 1990s) and export elasticity very low, it implies that fast GDP growth would further deteriorate the trade balance unless the structure of production itself changes. As most of the domestic economic activities are imports based with low value added, investment requirement for high growth also calls for high imports. Nepal heavily depends on donor assistance in financing development activities most of which contains imports of goods and services. This also implies for higher imports associated with higher government spending.
- 6.9 The transit treaty between Nepal and India has been renewed and an agreement has been signed with China for the customs free export of the Nepalese goods to China. A preliminary work has been initiated towards making Nepal a transit point between China and India during the current fiscal year FY05/06. Likewise, some important decisions on trade, investment and cooperation have been made in the meetings of South Asian Free Trade Area (SAFTA), BIMSTEC and World Trade Organization. The GON has made the legal provision for the Non-Resident Nepalese to provide unlimited visa and provide other trading facilities and rights similar to those for the Nepalese till they invest in Nepal. In the present context of increased conflict and unfavorable economic situation which has influenced domestic and foreign investment. The GON has brought out the ordinance in 10 September 2005, about Non-Resident Nepalese to attract the investment of rich Nepalese residing in foreign countries. This is expected to create a favorable impact on the economy.
- 6.10 Interest rate is one of the instrument variables that can have its impact on economic growth. However, there are more than one interest rates prevailing in the market. The deregulation of interest rates was designed to help lower the financial intermediation cost in the form of interest rate spread which is the difference between deposit rate and lending rate through competition. It was expected that both depositors and borrowers would benefit because commercial banks would compete among themselves through interest rates, offering higher deposit rates and charging lower lending rates. In the process, spread rate would come down. But this did not happen.

The interest rate spread continued. High spread tends to reduce financial intermediation with obvious impact on economic growth. NRB prescribed 5 percent spread rate in 1998.

- 6.11 The present political development is likely to create conducive environment for restoring peace and bringing new opportunities for development activities. Immediately after the declaration of ceasefire, the increase in hotel booking indicates the improvement in tourism activities. Similarly, donor countries have shown their commitments for the physical reconstruction of infrastructures in the country. There is an indication of increased inflow of foreign loan and grants. It is expected that the agricultural and other economic activities in rural areas will resume due to the improvement in the situation of peace and security. It is also estimated that due to the political stability, foreign investment will be increased and domestic industry and trade activities will be enriched and this will help promote both import and export.
- 6.12 To enable the private sector to come in a wider spectrum of economic activities and not to distort the market price mechanism, the government has recently taken policy initiatives to adjust administered prices and tariffs, and has reinforced its commitment to an open trade and investment regime.
- 6.13 Nepal's foreign trade is growingly re-concentrating towards India. In recent years, both exports to and imports from India are growing at rates faster than that the overall growth. A number of factors are attributed for such a swing in the direction of trade. First, exchange rate of the Nepalese rupee vis-à-vis the convertible currencies and particularly the US dollar depreciated whereas that vis-à-vis Indian rupee remained almost unchanged. This provided incentive for higher imports from India. Second, with India opening up its trade and investment regime, the types of goods Nepal required to import from third countries could subsequently be available in India. Third, with India relaxing non- tariff trade barriers to the exports of Nepal and raising free private sector direct investment ceiling for Indians investing in Nepal, a large number of Indian private sector investment in export oriented industries has taken place. As most of their raw materials are imported from India and as most of the final products are also destined towards India, the volume of trade with India has grown significantly.
- 6.14 The structure of Nepalese trade is altering over years with the changing structure of production. From basically a primary goods exporting country, Nepal has now slowly turned to manufacturing goods exporting country. Notwithstanding the satisfactory performance in the recent years, the vulnerability of Nepal's export trade can be gauged from its continued concentration to a few commodities and countries. Readymade garments, woolen carpets, and Pashminas account for more than 60 per cent of the country's total exports and more than four-fifth of the overseas exports. With quota system for garment being over in 2004 and growing concern in the industrial countries on labor and environmental standards, Nepal's third country export market remains highly vulnerable.
- 6.15 The structure of imports is recently changing with growing imports of primary and capital goods. With swelling international oil prices, the oil import bill is likely to go up substantially in the near future. Further with Nepalese rupee depreciating at an annual rate of 5 per cent on an average in the last 5 years, its implication on the import bill of essential consumer items and capital goods has been more severe. The

depreciation of the rupee against convertible currencies has rather diverted Nepal's import destination towards India from third countries, not necessarily reducing the total volume of imports¹⁵. As Nepal maintains a fixed exchange rate regime with India, any change in the exchange rate of the Indian rupee vis-a-vis convertible currencies is transmitted to the exchange rate change of the Nepalese rupee against convertible currencies, and hence necessitated the peg to prevent distortions in trade and capital flows.

Foreign Exchange

- 6.16 Foreign exchange reserves, in 2006 March 2005/06 totaled Rs.145.47 billion. Of the total reserve, the shares of Nepal Rastra Bank and the commercial banks are 78.7 percent and 21.3 percent respectively. Share of convertible currency in the total reserve is 93.4 percent and that of non-convertible currency is 6.6 percent. From the observation of the trend of imports during the first eight months of FY2005/06, total foreign reserve is estimated to cover 9.8 months of imports of goods, and 8.3 months of import of goods and services combined. In comparison to the rate of mid-July 2005 with that of mid-March 2006, Nepali Rupee depreciated by 1.49 percent against U.S. dollar which was appreciated by 4.71 percent during the corresponding period of last FY. Nepal has been maintained pegged exchange rate with Indian rupee.
- 6.17 The stability of the exchange rate of the Nepalese rupee depends on the strength of the Indian rupee against convertible currencies. This is because Nepalese rupee is pegged to Indian rupee for practical reasons like the present trade and financial relations. As Indian rupee is freely convertible in Nepal along with free mobility of goods, services, and capital across the border, and as Nepal has to compete with India for some of its third country exports, the depreciation of the Indian rupee calls for corresponding adjustment in Nepalese rupee exchange rate as well. That was the reason behind recent depreciation of the rupee against US dollar. The exchange rate of Nepalese rupee vis-à-vis Indian rupee has remained unchanged for the last 7 years. As Nepal and India are facing similar price movements and as trade between these two countries has been prospering, there seems to be no immediate need for the exchange rate adjustment with Indian rupee¹⁶. This is the reason why exchange rate change of Indian rupee vis -a-vis US dollar is reflected in exchange rate change of Nepalese rupee as well vis-à-vis the dollar. It is therefore important to keep a close watch on the developments taking place in the Indian economy so that policy measures can be devised to minimize, if not eliminate, the adverse impact in the economy.
- 6.18 With foreign exchange reserves growing by leaps and bounds and price situation is also to improve, there seems to be no domestic reason for the depreciation of the Nepalese rupee for the time being. But as the rupee is pegged to Indian rupee and breaking the peg at the present moment is uncalled for, the stability in the exchange rate of the Nepalese rupee will largely depend on the exchange rate movement of the Indian rupee.

¹⁵ Empirical studies have shown that Nepal's import trade is less sensitive to exchange rate changes (see Options for Exchange Rate policy in the Least developed Countries in Asia, ESCAP, 1998)

¹⁶ The major non tariff barrier was indigenous input content which had to be at least 30 per cent of value added of the product for its eligibility to concessional entry into the Indian market.

- 6.19 Broadly speaking, Nepal continues to maintain capital control. Although current account convertibility of the rupee was attained back in 1993, capital account convertibility has been rather selective. Foreign investment is fully convertible in the capital account as well. Nepal has adopted for very liberal trade, industrial, foreign exchange and tax policies for encouraging foreign direct investment. As a result, foreign investment in the country is growing. Nepal has to compete with neighboring countries to attract foreign investors. In the recent years, Nepal's competitive strength in attracting foreign investment has been eroded by factors like domestic political instability and creation of more congenial atmosphere by the neighboring countries for foreign investment. The only area where Nepal could be a destination for investors is hydropower and tourism related industries. The achievements made so far in these areas are noteworthy, as a number of sole investments or joint ventures in these areas have been initiated in the recent years.

VII. An analysis on the fiscal sustainability and vulnerability (with respect to the public debt and in line with the government income-expenditure framework)

Debt and its sustainability

- 7.1 The amounts of both domestic and external debts are likely to increase over the years.
- 7.2 So far, the external debt position of the government seems to be at a sustainable level. Multilateral loan is largely concessional and of long term maturity. Hence, it does not have immediate impact on the economy. Also, as a sizable chunk of the government capital spending is foreign assistance financed, official capital comprises the major portion of capital inflow.
- 7.3 As most of the country's loan is of long term nature with very low interest rate, debt servicing has not so far been a critical problem. However, debt service burden is growing over years with old debts maturing and size of outstanding debt increasing. The debt burden has further been aggravated by the depreciation of the Nepalese rupee resulting in higher debt servicing liability in rupee terms.
- 7.5 Nepal has so far little benefited by the debt forgiveness of the bilateral or multilateral donors. As most of the country's debt is from multilateral institutions, not much relief could be expected from multilateral initiatives to forgive loan. Nepal is not yet the beneficiary from IMF-World Bank Highly Indebted Poor Countries (HIPC) initiative and Multilateral Debt relief Initiative (MDRI). However, the HIPC initiative needs to be made wider, deeper and greater so that least developed countries like Nepal could benefit from the initiative. The debt relief initiatives assist the poverty reduction efforts, make debt and debt service sustainable and help maintaining macro economic stability. One of the ways the international community can assist Nepal is through providing assistance under debt relief initiatives. This will help ease resource position so that the increasing number of pro- poor and social sector development programs could be implemented.
- 7.6 Nepal's institutional capacity for sustainable and effective public debt management. is limited. In 2005, a policy document on public debt management was prepared and is still waiting for approval and the implementation by the government. The policy

covers all dimensions of public debt management- procedural aspects, policies on domestic and external debt management, and legal and institutional framework.¹⁷ This has met a long standing need for such a policy. The strategy however needs to include concrete measures to alleviate debt burden with a long term perspective (Shakya, 1998).

7.7 One of the conclusions of the document¹⁸ is that, at present, Nepal does not have any institutions setup at the executive level. The existing institutional framework does not provide clear terms of reference and responsibilities of each of the institutions responsible for public debt management. The study proposes the establishment of PDFACC to undertake executive debt management functions and the clear demarcation of responsibilities of FCGO and FACD/MOF.

7.8 As a part of the study of debt sustainability, it concludes that Nepalese public debt appears to be sustainable. Debt sustainability analysis and stress tests suggest the debt-to- GDP ratio over the next five year period is likely to be stable at the current level of 66 percent largely because the bulk of public debt has been financed in the form of loans at favorable interest rates.

7.8 The study also includes forecasts on the debt liability of the government.¹⁹ The study predicts that first, the share of external debt in total public debt is likely to decline in future, implying that Nepal may face higher interest rates on alternative funds. This implies that interest payments are likely to rise and this in turns means the increasing the debt-to- GDP ratio. Secondly, a sharp and unanticipated change in the exchange rate is a threat to debt sustainability. Continued political instability is likely to have its consequences on foreign exchange market as well as a decline in the supply of funds. This again means resorting to unfavorable sources of funds at higher interest rates.

7.9 The study made a series of proposals:

- i. Formulate a public debt act;
- ii. Establish Public Debt and Foreign Aid Coordination Committee (PDFACC) under the Chairmanship of Minister of Finance with Vice-Chairman , NPC, Governor, NRB, and Financial Comptroller General as members with Finance Secretary as its Member Secretary;
- iii. Operational debt management functions are categorized under front, middle and back office functions. The front office functions are segregated for domestic and external debts. For external debts, negotiation functions will remain with the Foreign Aid Coordination Division (FACD) of MOF. In case of domestic debt, issuance functions will remain with Public Debt Management Department (PDMD) of NRB. The middle office function, is proposed to be handled by Debt Policy and Management Bureau (DPMB), upgraded from the present Debt Management Unit (DMU) under the Economic Affairs and Policy Analysis Division (EAPD) of the MOF. In line

¹⁷ MOF and ADB *Managing Public Debt In Nepal*. MOF, GON

¹⁸ *Ibid.*

¹⁹ The forecasts are based on the result derived from the exercise using a Nepal Macro econometric Model with 37 equations- 20 behavioral equations and 17 identities.

with the proposed functions, clear responsibilities and terms of references of each institution involved have been worked out with functions manuals, procedure manuals and job descriptions.

- 7.10 The implementation of the above proposals require human resources in each of those organizations with adequate background, skills and knowledge to undertake debt sustainability analysis which at the present moment does not seem to exist with the Government of Nepal and NRB to make the concept operational. In view of this, the implementation of these recommendations at the operational level presents a great challenge. One of the ways to deal with this challenge would be to help Revenue Training Center under MOF and/or Banking Training Center, NRB acquire necessary competency to impart training facilities to those involved/to be involved in sustainability analysis and the macro economic forecast. A new activity in Nepal's development finance, it is worth exploring the possibility of obtaining technical assistance at least in the initial phase in the operationalization of the concept of debt sustainability analysis including its testing and the use of Nepal Macro Econometric Model (NMEM) for the long term forecast of debt and its implications on the economy.
- 7.11 The amount of domestic debt outstanding amounted to Rs. 90.2 billion in mid-July 2005. Domestic debt servicing is consuming a sizable chunk of the budget. There are growing concerns that the country may fall in debt trap mainly due to the burden of domestic debt. When debt servicing is siphoning off a significant portion of the government resources, there is definitely a crowd out impact on resource allocation to social and economic sectors, which could be instrumental to poverty reduction--the overarching goal of the government. Therefore, efforts are to be made to convert domestic debt into equity by offering the shares of public enterprises likely to be privatized. Besides, the sale proceeds of public enterprises could be used in paying domestic debt. Efficiency in public debt management like borrowing at the appropriate time and rate, redeeming high interest liability bonds, and issuing long term debt instruments at a time when market interest rates are low would definitely help reduce debt servicing burden.

VIII. Macroeconomic policy measures to address imbalances: some recommendations

8.1 Acceleration of the growth process

- 8.1.1 With the peace and political stability gradually returning, the country is provided with opportunities to implement programs for accelerating the growth process. In addition, as the recent economic developments are broadly positive with international reserves continuously increasing, exports picking up, and the short-term growth outlook being encouraging, these improved macroeconomic conditions have given the government an opportunity to shift policies decisively towards accelerating economic growth process
- i. Formulate and implement a comprehensive package of structural reforms to realize Nepal's growth potential.

- ii. Strengthen private sector developments through changes in existing legislations to promote a more friendly business environment.
- iii. Additionally, the government has to decentralize authorities to accelerate local development efforts. The GON has delegated revenue generating functions to the local governments which hitherto have been utilized by the center. However, the past trends shows that the local bodies are not in a position to mobilize resources to the extent desired because of lack of appropriate enforcement authority, the reluctance of the local level leaders to aggressively pursue revenues raising activities from the local sources and so on. These problems need to be mitigated.
- iv. Additional vigorous efforts need to be undertaken in civil service reforms to have a clean, strong, efficient, accountable, productive and right sized civil service. The entire process of civil service reform are apparently guided more by considerations that are alien to the merit-based system and the impact of all these civil service reforms are yet to be seen on the ground.
- v. Pattern of resource allocation in favor of social development needs to be continued. This is because the level of education and health services, level of income and its distribution, access to work and employment, and above all access to public resources are closely linked with social development. It is observed that structural barriers impede the growth of the economy, and without growth with equitable income distribution of the productive resources, it is not possible to enhance the level of social development. Besides, economic growth alone can not enhance social wellbeing if public resources are not fairly allocated for social services like education, health, drinking water, and social security schemes. Moreover, the provisions of safety net to benefit those suffered from the implementation of structural reforms need to be made.

8.2 Slow Agriculture growth

8.2.1 Economic growth is contingent upon the improvement of the performance of agriculture sector. Better performance of agriculture is not only necessary for sustained high growth of the economy but also for ensuring food security and reducing rural poverty. Poor agricultural performance could not deliver added purchasing power for better living of the average Nepali people during the past four years causing a slow down in demand leading to a further sluggish growth of the economic activities. The non-agricultural sector also witnessed a decelerating growth due mainly to sluggish industrial activities following suppressed demand in the domestic market (because of squeezed income of the agricultural household sector) and also contracting external market. Moreover, the fear- psychosis following the disturbance in the economy, the deteriorating internal peace and security situation and so on has also dampened industrial investment activities and led the economy to a low growth path.

8.2.2 Ramesh Sharma, et.al (ed). (2204)²⁰ quote a study made by Gulati and Narayan (2003) on the detailed analysis of input subsidies provided to agriculture in

²⁰ Ramesh P. Sharma, Madhav K. Karki and Laxman K. Goutam (ed.) Implications of the WTO Membership on Nepalese Agriculture , FAO/UNDP/HMG, Kathmandu, p.30 – 37.

neighboring states of India. They found that for India as a whole total subsidies on the three main inputs – fertilizers, irrigation and electricity – rose sharply from about IRs. 384 billion (8.7 % of agriculture GDP) in 1999-00. Total subsidies per gross cropped area amounts to IRs. 2,010/ha in 1999-00. Obviously, all the subsidies withdrawn, Nepalese agriculture is at a disadvantage position, and are losses competitiveness.

8.2.3 Major policy problems associated with the agriculture sector is that Domestic support to Nepalese agriculture is not only very low but also declining in real terms, and the declining share of agriculture sector's budget in total public expenditure.

8.2.4 There has virtually been no growth of per capita income in the agricultural sector as population growth is nearly at par with the growth of agricultural sector. The real wage increase for laborers and salaried people is marginal (a rise in salary index by 0.4 percent and wage rate index by 5.7 percent against an increase of CPI by 9.1 percent on point to point basis between mid-March, 2004/05 and 2005/06) much below the average rate of increase in CPI. At the same time, there has been a marked exchange rate depreciation. During the last decade, Nepalese currency depreciated against US \$ by more than 60 per cent making imported food items very expensive²¹. The only supportive factor has been continued food surplus India with free trading provisions at a fixed exchange rate which remains unchanged for several years. Nonetheless, the poor continue to suffer because of a rise in inflation. Hence, in order to deal increase per capita income in the agriculture sector, the following tasks need to be undertaken:

- i. Enhance agriculture productivity and per capita domestic food supply.
- ii. Enhance the share of agriculture sector in resource allocation of the government which has declined over years from 15.7 percent (Rs 3.9 billion) of the total capital expenditure (24.78 billion) in 2001/02 to 9.6 percent (Rs. 2.64 billion) of the total capital expenditure (Rs. 27.34 billion) in 2004/05 despite the implementation of Agricultural Perspective Plan which envisages nearly 5 per cent growth in agriculture in the long run making the country not only food sufficient but also promoting exports of agricultural commodities. So far, the achievement is frustrating, as agricultural GDP has increased by around 2.8 percent on an average during the period 2002/03 – 2005/06.
- iii. Ensure the smooth availability of quality agriculture inputs in time.
- iv. Privatization of fertilizer supply has helped more of its import but low quality of the fertilizer has damaged crops and soil. The government policy of open trade often allowed exports of rice even when the country had a production short fall. This raised the price of rice, created food security threat for people in certain pockets of the economy particularly in the Trans-Himalayan regions, for rural landless workers, marginal and small households who are net food buyers, unskilled wage earners, laborers, and even low class formal sector employees.
- vi. Review withdrawal of subsidy in fertilizer, irrigation and credit to small farmers. This is because, in the agricultural sector, India is still maintaining substantial subsidy which leads to low cost of production for the farmers and

²¹ Macro economic policies, performance and sustainable issues, <http://www.nssd.net/pdf/nep06.pdf>.

low farm gate price. With no subsidy at home and open border with India, Nepalese products have failed to compete with the Indian products. Nepal has to synchronize her economic policies with those of India in order to sustain the reforms and adjustment. This calls for either diversification of the cropping pattern, if possible, or reintroduction of subsidy.

- vi. Other measures that need considerations are increasing investment in agriculture, reprioritizing government expenditures, and allocating more research fund for agriculture.

8.3 Ineffective public resource management

8.3.1 Failure to achieve effective public resource management for poverty reduction and sustainable development has also been one of sources of instability in the economy. Low revenue mobilization coupled with inefficient utilization of the resources and leakage in their uses hampers the growth process while at the same time de-motivate tax payers to comply with the tax system. Besides, limited resources being scattered to a large number of programs and projects, selection of projects on political considerations, and corruption on public resources have resulted in low rate of return on public investment. In order to ensure the smooth management of public resources, the following policy measures can be adopted:

8.3.2 The government's immediate economic priorities have been to develop economic infrastructure; improve investment climate; make economic programs pro-poor and inclusive; increase investment in social sector; implement programs for relief, rehabilitation and reconstruction and increase capital investment and productivity by containing consumption expenditures²². The GON promises to present a common conceptual vision incorporating social and economic development targets to be achieved in ten years. In this context the following recommendations are put forward in the hope that these will provide substantial help in making management of public resources more effective:

- i Maintain an appropriately strong fiscal position.
- ii Expand tax base to cover areas for raising taxes. High priority needs to be given to reducing tax concessions, eliminating revenue leakages and strengthening tax administration. Newer sources such as informal trade estimated to be between US \$ 368 and US\$408 million taking place between India and Nepal need to be explored for raising revenue.
- iii. Revisit priority projects which claims around 87 percent of the total allocation of the budget in 2006/07 and eliminate or reduce allocations to P2 and P3 projects.
- iv. Healthy growth of the financial sector is essential for sustainable economic development since it plays the important role of efficiently allocating funds. Allowing the financial sector to play its important role in economic development necessitates financial sector reforms. Several steps were undertaken in the past but many more remains to be done. In this context,

²² The Budget Speech FY 2006/07, MOF, GON., p..5

challenges like reducing non-performing assets, high operational expenses, and extending banking coverage needs to be addressed on a planned basis.

- v. Raise its exceptionally low revenue-to-GDP ratio in order to finance necessary public expenditure--notably, on poverty reduction and other well-targeted social programs, infrastructure, and governance reform.
- vii. The reforms process has to be intensified towards creating a prudent expenditure framework by curtailing consumption unproductive expenditure and limiting its scarce resources in viable and feasible projects. The need is to trim the size of the recurrent expenditure and create a healthy expenditure framework.
- ix.. Simplify and enforce the tax related procedures to increase revenue- to- GDP ratio.
- x. As a part of overall reform process, it is necessary to plan on increasing the scope for private involvement in such key areas as fertilizer distribution, higher and secondary education, health, energy and tourism, preferably by bringing these into the fold of community management such as community forestry, community managed schools and health posts, drinking water projects and irrigations systems and so on, and
- xi. Intensify the privatization process which has been halted in the past because of political reasons so that the losses of the 38 public enterprises totaling Rs. 5.92 billion in 04/05, up from Rs. 5.48 billion four years ago can be dealt with.

8.4 Financial Governance

- 8.4.1 It is important that the process of financial reforms need to be carried forward and strengthen financial accountability through improved accounting framework and streamlined auditing procedures.
- 8.4.2 Reduce the non-performing assets of two principal commercial banks – the Nepal Bank Ltd. and the Rastriya Banijya Bank. It will send the much needed message that the government is serious about financial sector reform and its implementation.
- 8.4.3 There is a need to reduce spread rate, make arrangement that the excess liquidity does not present itself as a threat to financial stability of the economy.

8.5 Fiscal restructuring

- 8.5.1 In view of the weak law and order situation and political disturbances in the past, the budgetary allocations have substantially raised the amount allocated for beefing up the security. In 2001/02, the security expenses was Rs. 12.08 billion or 2.9 percent of GDP which increased to a record high to Rs. 18 billion or 3.5 percent of GDP of in 2004/05²³. Now, with the chances of re-establishing peace looming large, the government need to pursue vigorously, suspended since the past few years, implementing pro-poor policy, plan and programs, through redirecting allocations away in favor of development, particularly to rural development.

²³ White Paper Relating to the Present Status of the Economy, delivered by Minister of Finance (Nepali) on 15th, May 2006, to the Parliament, annex 4

- 8.5.2 Fiscal sector restructuring aims to improve buoyancy and elasticity of the tax system, contain recurrent spending, and gradually enhance capital expenditure- to- GDP ratio. It also aims at increasing budgetary allocation to social sector as economic sector is supposed to be taken care of by the private sector with economic liberalization and privatization, reduce fiscal deficit to less than 5 percent and contain domestic debt financing to less than 1 percent of the GDP. Besides, the fiscal reform intends to minimize budgetary drain for the operation of public enterprises, streamline subsidy and transfers, opt for domestic borrowing at market rate of interest, improve quality of development outlays, and ensure better utilization of foreign assistance through enhancing aid absorptive capacity of the economy.
- 8.5.3 A number of measures were initiated in the process of fiscal reforms in order to improve the built-in elasticity in the tax structure and attain efficiency in the tax system. Some of the measures were reduction in the tax rates, consolidation of tax rate slabs to a few, withdrawal of exemptions and rebates by amendment in the Industrial Enterprise Act, introduction of value added tax, change of taxes from specific to ad valorem, constitution of a separate revenue cadre, and updating of customs valuation. This has not, however, been reflected in a growing buoyancy of the tax system, higher share of direct taxes in the revenue structure, declining dependence on imports trade as a source of revenue, and higher share of dividends and royalties in non tax revenue rather than that of fines and forfeitures and elasticity deteriorated. There has been little progress in revenue efforts even after reforms. Revenue has marginally increased from 11.9 percent of the GDP in 2001/02 to 13.1 percent in 2004/05.
- 8.5.4 If public resources could not be saved, financing high recurrent expenditure demand through limited revenue might become unsustainable in the medium term. Hence, strictly adhered to fiscal discipline by the government is necessary. In addition, the following measures need to be considered.
- i. Adherence to budgeted domestic borrowing ceiling and resorting to minimum overdraft facility for financing the deficit are indicators of the budgetary discipline of the government. The fiscal adjustment and reform programs also put a ceiling on internal borrowing of the government at not more than one per cent of the GDP. But domestic borrowing was 1.8 percent of GDP in 2001/02 and has slightly decreased to 1.6 percent in 2004/05. This is still higher in comparison to the ceiling of the domestic borrowing. Similarly, overdraft borrowing also stood as high as 2 per cent of the GDP in some of the years revealing a laxity in fiscal discipline of the government.
 - ii. It is indeed desirable to review transfers and subsidy policy.²⁴ Such transfers range from financing the operational cost of some of the public enterprises, universities, and hospitals. As these entities have very low cost recovery in their service delivery, the government needs to review the situation and improve cost recovery by more appropriate pricing of the services for those who can really afford them. For the targeted people, cross subsidization could

²⁴ About 16 percent in 1997 and 15 percent in 1998 of the resources raised by the government. There has been substantial reduction in the level of subsidy which is less than 3 percent of the budget expenditure and 0.5 percent of the GDP. More important than subsidy is, however, the problem of transfers that the government has to make through budgetary provision.

be adopted; and it has to be adopted because nearly 20 per cent of the population comprises of the 'hard core poor' who can not afford even the basic services by their own means.

- iii. Allocation of resources, outside the framework of the budget needs to be completely eliminated.
- iv. Controlling recurrent expenditure is necessary to enlarge the share of revenue surplus in development financing. Freezing defense and police expenditure is also called for. It has been proposed in the current budget (2006/07) that the total defense expenditure will not be allowed to exceed expenses of the current fiscal year but this measure, desirable on its own right, is too little to contain the already high defense expenditure. Fiscal Transparency Act and Public Procurement Act²⁵ are proposed to be enacted which will help streamline government expenditure to some extent. Public procurement of expensive cars, furniture, and office appliances is to be discouraged.
- iv. Civil service reforms could also save some public resources. Amalgamating Ministries, consolidating district offices of different Ministries and even closing down unimportant ones, closing down some regional offices of the Ministries, and voluntary lay-off of the excess employees are some of the measure adopted in the recent past. These measure along with other agenda of civil service reform need to be continued, despite political and economic problems.
- vi. A growing trend towards seeking job in the international market as domestic economic activities have failed to provide adequate job for the growing young labor force is in evidence. The flow of Nepalese workers going to South East Asia and Middle East has significantly gone up in the recent years and wage income and remittance of the workers has been a major factor for improving the national savings as well as current account balance in the external sector of the economy. In fact, remittance money which is estimated at more than 12 per cent of the GDP has been reflected in high foreign exchange reserves in the external account and high time deposit growth in the internal account of the banking system as well. Sustainability of the present expanding external labor market and receipt of huge remittances ever increasing to support trade is a question. Hence, attention is needed at two fronts simultaneously –the formulation of programs on how to use remittances for the greater benefit of the country and the search of the alternative avenues of employment/other sources of income to compensate remittances should the latter dwindled or even ceased to be an important source of income. External labor market is always vulnerable and is determined by many factors beyond the amenability of the domestic policy measures.
- vii. The contribution of foreign aid in social development during the last three decades shows three distinct natures; its magnitude has been rapidly increasing over the years, its intra-sectoral allocation has been changing and it has been increasingly channeled through the non-government organizations. Aid through the non-government organizations has somehow been instrumental in uplifting the social status whereas that through the government level, along with providing some social infrastructure, has also deterred self-reliant social

²⁵ The Budget Speech of FY 2006/07, MOF, GON, p.29.

structure, added dependency syndrome, created sustainability problem for the aided projects, and often failed to meet the local requirements. A tendency to seeking donor assistance in any type of social development activity has impeded local initiatives, local resource mobilization, and local participation in development process.

- viii. Foreign Aid Policy, 2002 contains some policies and strategies that remain relevant but yet the possibility remains to optimize the gains from the policy for accelerating growth.

8.6. Poverty alleviation

8.6.1 Nepal continues to suffer from high proportion of the population in absolute poverty. A substantial increase in per capita income is a prerequisite for achieving a meaningful reduction in poverty. Measures required relate to:

- i. Reorientation of fiscal policy, more aggressive state interventions in targeted sections and regions, and restructuring of property rights system.
- ii. Reconsidering the implementation of land reform with a clear-cut strategy in the broader context of increasing productivity and ensuring distributive justice.
- iii. Enlarge the access of the poor households to formal /institutional source of credit by opting for financial liberalization and expanding financial services network. A number of credit programs are targeted to the poor in Nepal. These programs also incorporate other activities like skill development, literacy, health, education, family planning, agro-forestry, environment protection and agro-marketing which in turn can contribute not only for income and employment generation but also for enhancing socio-economic development, and environment protection. However, many operational and institutional constraints have impeded these programs from being effective in uplifting the society. Some of them could be mentioned as – high cost of service delivery, low rate of loan recovery (except for some rural development banks for which the recovery rate is almost 100 percent), erosion of capital due to continued loss, lack of wholehearted commitment on the part of the institutions implementing these programs, defunct groups due to absence of cohesiveness and homogeneity among group members, and now growing insecurity and threat to the functioning of micro credit institutions.
- iv. Extend the operation of PAF to cover an increasing number of districts to make a dent on poverty reduction, and
- v. Extend the coverage of, and improve the performances of micro finance institutions

8.7 Operational, managerial, and institutional constraints

8.7.1 Decentralization of some of the basic services would also minimize pressure on the recurrent expenditure.

8.7.2 The current budget (2006/07) proposes to undertake necessary legal and institutional reforms through the unified civil service to be initiated from mid- April 2007. The

government would be contributing to improve efficiency of bureaucracy by not changing the civil service act and regulations for a predetermined period of time, unless absolutely required.

- 8.7.3 Control of corruption with the introduction of transparency and accountability, and strengthening of the institutions to check corruption could be the measures with which administrative efficiency could be improved and public resources saved.

IX Concluding Remarks

- 9.1 The Nepalese economy is passing through a critical stage. There are imbalances between and among pertinent sectors of the economy.
- 9.2 Macro economic policies have a critical role towards sustainable development of the country. Particularly, fiscal, financial, and external sector policies have a bearing not only on the sectoral policies like agricultural and industrial policies but also on the economic growth and its distribution over economic agencies, sectors, and regions. These have implications for sustainable development in the long run. Measures that need to be taken are given in annex I.
- 9.3 It is certain that days to come would provide formidable challenges to the Nepalese economy in terms of maintaining macro economic stability. Intervention measures need to be designed implemented simultaneously on all fronts to ensure that economy moves ahead in a balanced manner. Maintaining macro economic stability help achieve national development goals.
- 9.4 Major steps that need to be undertaken for maintaining stability in the economy are already known: what needs to be done is to translate these measures into action and keep on monitoring status of achievement effectively to have a desirable impact on the economy in terms of achieving macro economic stability.

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Annex I.: Policy Action Matrix

Constraints	Recommended policy improvements	Activities	Indicators of achievement	Responsible agencies	Time frame
1. Acceleration of economic growth	i. Introduce policy shift to accelerate growth	i. Formulate a comprehensive package of structural reforms	i. Package of structural reforms in existence ii. Financial sector plan and programs in existence	NPC/MOF	Short term
		iii. Help strengthen private sector through implementing sector development plan	iii. Private sector 's contribution to GDP increased	NPC/MOF	Short term
	ii. Enhance effectiveness of implementation	iv. Pursue governance reform to improve implementation v. Decentralize administrative and financial authorities to accelerate local development efforts.	iv. Effective local government authorities in action v. Rate of implementation increased	NPC/MOF/M OLD	Short term
	iii. Introduce effective monitoring and review process	vi. Conduct regularly monitoring activities and fully exploit potentials associated with existing and potential institutional mechanisms. Link project achievement with career promotion/development	vi. No of monitoring review and meetings	NPC/MOF/ Other Line Ministries	Short term
	iv. Stream line priority projects	vii. Revisit priority setting and progressively reduce allocations to P2 and P3 projects and if possible eliminate P3 projects.	vii. No of projects/amount of allocations to P1 projects,	MOF/NPC/ Other Line Ministries	Short term
	v. A consistent policy to increase allocations to four strategies	vii. Undertake exercises to allocate increasing resources	viii. Increased amount of allocations earmarked.	MOF/NPC	Short term

Constraints	Recommended policy improvements	Activities	Indicators of achievement	Responsible agencies	Time frame
2. Slow growth of agriculture	1.Enhance per capita income in the agriculture sector	i. Enhance agriculture productivity and per capita domestic food supply.	i. Increase in agriculture productivity		
		ii. Enhance the share of agriculture sector in resource allocation, including for research, expanding extension services and so on.	ii. Increasing allocation to the agriculture sector in the total budget		
		iii. Ensure the smooth, coordinated and timely supply of quality agriculture inputs	iii. Availability of quality and timely agriculture inputs	MOF/MOAC	Short to medium term
		iv. Review of withdrawal of subsidy in fertilizer, irrigation and credit	v. Cost of production lower and the increase in the competitiveness of the products	MOF/MOAC	Short to medium term
3. Ineffective public resource management	i. Increase revenue mobilization	i. Expand tax base to bring into tax net hitherto not included ii Minimize revenue leakages iii Simplify and enforce the tax related procedures iv. Streamline tax administration v. Reduce public sector involvement vi Intensify privatization process	i. Increased revenue receipts ii. Recurrent expenditure growth rate reduced or remain constant	MOF/NPC	Short to medium term
		ii. Enhance in the efficiency of resource utilization	vii. curtail consumption and unproductive expenditures viii. Increase people's participation in rural projects ix . Strengthen financial accountability through improved accounting framework and stream line auditing procedures	ii. Allocation to P1 projects increased, iii. Consumption expenditure reduced iii. Trim down the size of recurrent expenditures iv. No extra budgetary transfer v. Freezing of defense and	MOF/NPC/ Other Line Ministries

Constraints	Recommended policy improvements	Activities	Indicators of achievement	Responsible agencies	Time frame
		<ul style="list-style-type: none"> x. Stop non-budgetary resource transfer xi. . Redirect allocations away from security to development, particularly to rural development x. Revenue administration improved, including the capability of Revenue Administration Training Centre (RATC) 	<ul style="list-style-type: none"> security expenditure vi. More allocations to rural development vii. Institutional capability of the (RATC) improved 	MOF	Medium term
4. Financial governance	<ul style="list-style-type: none"> i. Improve financial governance ii. Ascertain the relationship between high liquidity and the prospects of financial stability. iii. Ascertain the capitalization of share value and the prospects of financial stability iv. Reduce drastically the NPA of two principal commercial banks – NBL and NBB 	<ul style="list-style-type: none"> i. Enlarge the access of the households to formal /institutional source of credit and households ii. Expanding financial services network at the rural level iii. Formulate interventions measures in the financial market and mop up liquidity iv. High cost of financial services delivery reduced v.Reduce spread rate v. Undertake a study to ascertain the relationship between liquidity and financial stability vi. Undertake a study to examine the relationship between the rising capitalization of share value and the financial stability vii. Pursue measures to curtail NPA of these banks 	<ul style="list-style-type: none"> i. The number of beneficiaries increased ii. The number of financial institutions increased iii Intervention measures prepared and implemented iv. Decline in spread rate v. The study report prepared and the recommendations implemented vi. The report prepared and the recommendations implemented vii. Reduction of NPA to a minimum viii. Reports prepared 	MOF/NPC MOF/NRB	Short to medium term Short to medium term

	reform strategy	keeping in view both the distributional and production aspects of land reform and implement it	vii. Landlessness decline		term
		vi. Extend the operational areas of poverty alleviation fund.	viii. Decline of the number of the poor in project implemented areas	NPC/PAF	Medium term
		v. Expand the coverage of micro credit institutions improved.	ix. Increased in the number of credit users x. Increase in the number of micro finance institutions	MOF/NPC	Medium term
iv. Lack of a debt management policy	v. Implement debt management policy vi.. Sustainability of debt analysis undertaken regularly	vi Approve and implement the debt management policy vii. Institutionalize and trained HR to use debt analysis framework	x.. Institutional arrangements in place xi. Increase in the number of those trained in the use of the methodology		
v. Institutions setup at the executive level for debt analysis and monitoring.	viii. Institutions established and structured	viii. Administrative works undertaken to establish required institutions	x. Institutions established and made them functional	MOF/NPC	Medium term
7. Operational, managerial, and institutional constraints					
i. Institutional constraints	i. Effective civil service system based on merit	i. Rate of project implementation enhanced	i. Rate of timely project/activity completion increased	MOGA	Short to long term
	ii. Undertake legal and institutional reforms through unified civil service	ii. Prepare plan for the reforms with time frame	ii. Efficiency of the civil service enhanced in terms of the capacity to implement	MOGA	Short to long term

	<p>iii. strengthen institutional capacity to check corruption</p>	<p>iii. Prepare plan to control corruption and publish annual report in terms of success achieved in controlling corruption</p> <p>iv. Undertake serious action against those found guilty .</p> <p>v. Undertake preventive action through streamlining rules and regulations.</p>	<p>iii. No of cases of corruption reduced</p> <p>iv. Mis-utilization of resources minimized</p>	<p>MOGA/National vigilance Centre/PM office</p>	<p>Short to medium term</p>
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Annex II: Excerpts from Terms of Reference

Current Macroeconomic Stability Factors and their Sustained Management

This assignment is equivalent to one-man month. The consultant should establish adequate interactions with key informants, stakeholders and other concerned including government agencies while conducting the study.

Task details:

1. Review the current macroeconomic policy framework of Nepal in light of growth, investment, consumption, and savings.
2. Review the compatibility of fiscal policy, monetary policy, and other economic policies with respect to the macroeconomic equilibrium.
3. Identify the factors affecting internal and external equilibrium of the economy of Nepal. Also, recommend the sequence and the order of economic liberalization in terms of the viability of economic sectors.
4. Review the economic development and planning exercises carried out in Nepal and suggest for further effectiveness.
5. Review the international dimension of Nepalese economy in terms of foreign trade and currency convertibility including the exchange rate and interest rate stance.
6. Analyze the fiscal sustainability and vulnerability with respect to public debt and in line with the government income-expenditure framework.
7. Recommend the sustained macroeconomic policy measures for policy makers.
8. Provide a policy-action matrix containing (a) constraints (policy, legal, institutional, administrative, and others if applicable); (b) recommended policy improvements; (c) activities; (d) indicators of achievement; (e) responsible agencies; and (f) timeframe (immediate, intermediate, and long-term)

Annex III: List of the persons interviewed

1. Acharya. Keshab R.
Executive Director, Research Division, NRB.
2. Bajracharya, Bhuvan Bajra
Former Team Leader,
Project Team,
Strengthening Institutional Capacity for Effective public Debt Management (ADB
TA 4017 – NEP)
3. Basyal, Tul R.
Executive Director,
Public Debt, NRB
4. Dhakal, Deependra P.
Former secretary , GON and Team Leader
EPN, MOF, Kathmandu.
5. Ghimire, Dr. Madhav Prasad
Joint-Secretary,
Economic Affairs Division, MOF.
6. Khanal, Rameshwor Prasad
Secretary, Revenue, MOF
7. Sharma, Basu
Instructor, Revenue Training Centre, MOF,
8. Sharma , Dr, Shanker Prasad,
Former Vice – Chairman, NPC
9. Shrestha, Dr. Gyanu R.
Under Secretary, Economic Affairs and Policy Analysis Division, MOF
10. Shrestha, Raj Babu
Officer – in Charge, PAF
11. Tripathy, Sunder Mani
Chief, Revenue Training Center,
Lalitipur.
12. Nepal, Vidya Nath
Former Secretary to Government of Nepal
13. Shakya,. Pushpa L.
Under-secretary, NPCCS.
14. Subedi, Shri Ram
Communication officer, Poverty Alleviation Fund

15. Suwal, Rudra
Chief, National Accounts Division, CBS

16. Thapa , Nara Bahadur
Assistant Executive Director,
Research Division, NRB.

17. Tiwari,. Ram Krishna
Former, Member-Secretary, NPC

Annex IV: Major Economic Indicators, 2001/02 – 2004/05

(As % of GDP in Producers' prices)

Variables	2001/02	2002/03	2003/04	2004/05
INVESTMENT AND SAVINGS				
Total investment	24.2	25.8	26.4	28.9
Private investment (including change in stock)	16.6	19.0	19.9	19.7
Gross national savings	16.5	15.5	15.2	14.4
Gross domestic savings	12.1	12.0	12.6	12.4
Total consumption	87.9	88.0	87.4	87.6
S – I GAP	-12.1	-13.8	-13.8	-16.5
GOVERNMENT FINANCE				
Government revenue	11.9	12.3	12.5	13.1
Tax revenue	9.3	9.3	9.7	10.1
Non-tax revenue	2.6	3.0	2.9	3.0
Total expenditure	18.9	18.4	18.0	19.2
Recurrent expenditure	11.5	11.4	11.2	11.6
Capital expenditure	5.9	4.9	4.6	5.1
Principal repayment	1.5	2.1	2.2	2.5
Government revenue – recurrent expenditure (Revenue surplus)	0.4	0.9	1.3	1.5
Total revenue – total expenditure (-deficit)	-7.0	-6.1	-5.5	-6.1
Budget deficit	-5.4	-3.6	-3.2	-2.7
Total foreign aid	3.4	3.5	3.8	3.7
Grant	1.6	2.5	2.3	2.1
Loan	1.8	1.0	1.5	1.7
Total domestic borrowings	3.6	2.6	1.7	1.8
Domestic borrowings	1.9	1.9	1.1	1.7
Cash balance (- surplus)	1.7	0.7	0.5	0.1
TOTAL OUTSTANDING LOAN	69.5	67.4	64.1	57.6
Outstanding foreign loan	52.1	48.9	46.9	41.2
Outstanding domestic loan	17.4	18.5	17.2	16.4
Outstanding foreign loan/government revenue	436.4	397.4	373.5	313.2
Outstanding foreign loan/total exports	468.9	447.5	431.8	374.1
MONETARY DATA				
Narrow money supply (M1)	18.2	18.3	18.9	18.8
Broad money supply	53.0	53.8	55.8	56.3
Total domestic credit	49.0	50.0	50.5	53.4
Net foreign assets	20.9	20.0	21.9	20.2
TRADE STATISTICS (Merchandise)				
Exports	11.1	10.9	10.8	11.0
Imports	25.4	27.2	27.4	28.0
MERCHANDISE TRADE DEFICIT	-14.3	-16.3	-16.6	-17.0
BALANCE OF PAYMENT				
Current account balance (- deficit)	4.3	2.5	2.9	2.2
Remittances	11.2	11.9	11.8	12.3
Balance of payments (- deficit)	-0.8	1.0	4.0	-1.1
Gross foreign reserves	25.0	23.7	26.2	24.3

Source: *An assessment of the Tenth Plan/PRSP*, PRSP Review 2004/05, NPC Secretariat, GON, Kathmandu, 2006.and

Economic Survey 2005/06; MOF,GON, Kathmandu, 2006.