

**TRANSFORMATION OF NEPAL'S
ECONOMY
AGENDA FOR GROWTH AND
SOCIAL EQUITY**



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TRANSFORMATION OF NEPAL'S ECONOMY AGENDA FOR GROWTH AND SOCIAL EQUITY

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FOR NEPAL DEVELOPMENT FORUM PRESENTATION

A. INTRODUCTION

Nepal is embarking on a completely new journey, a journey the beginning of which was made possible by the sacrifices of thousands of Nepali men and women of all ethnicity, caste and creed. A decade-long people's war not only succeeded in removing the last frontier of feudalism, but also raised massive awareness among people in every geographical region of the country. People have been making rightful claims for their role in every sphere of socio-economic and political life. These demands are often ventilated violently leading outside observers think that the current transition Nepal is passing through may be difficult to manage. But there have been remarkable successes in this transition phase, notable among them are: successful holding of the Constituent Assembly elections that is perhaps most inclusive in peoples' representation; evolution of strong culture of dialogue and consensus-building in resolving often complex issues, formation of high-level committee for army integration, generally sound macro-economic management.

While the political process is moving well in right direction, the country is also aiming at higher growth with equity. There are problems, however. There is a need to improve investment climate, expand infrastructures, resolve the current energy crisis and improve general skills level of the workforce. Above all, it is necessary for us to transform agriculture, which is mired in underemployment and low productivity. All of these efforts should keep in mind the requirement for creating massive employment opportunities for young people. People have high expectations from the recent political changes, and if those are not managed well and people do not see real economic transformation it will be difficult for us to sustain peace.

This paper presents an outline of what economic restructuring is needed to create a base for achieving a higher level of growth rate, ensure equity and expand employment opportunities. Before setting out to discuss the restructuring agenda, a brief outline of where the economy stands today is in order.

State of the economy and emerging challenges

Nepal's GDP per capita remains low despite decades of development efforts. Its \$470¹ per capita income ranks among the lowest in the world.

But modest growth has been achieved during the last decade despite the conflict situation. For the period 1996/97-2006/07, average real growth was 3.8 percent or 1.05 percent in per capita terms².

¹ CBS 2008

This modest growth was made possible as macroeconomic stability was sustained and inflation kept under control—providing stability for investors even during a conflict period. In particular, in spite of strong spending pressures for both development and security purposes, the government reigned in expenditures in line with resource availability and spent only on high priority and implementable activities.

During the same period, human development index improved and poverty incidence was significantly reduced from 42 percent to 31 percent. Modest growth, relative price stability, prioritized spending, and well-managed community based delivery of social services all contributed.

Most important developments were, however, a large increase in outward migration and resulting inflows of remittances from abroad. Remittances, now estimated at above 20 percent of GDP³, are seen to have directly contributed to half of the poverty reduction.

During the years in which conflict intensified, many economic reforms were launched to maintain the modest growth and to prepare the economy for achieving sustained high growth once the conflict was over. These reforms included improving fiscal management (introduction of medium term expenditure framework, tax policy reforms, and tax administration improvement), an array of financial sector reforms, restructuring of state-owned enterprises to prevent further losses, and expansion of community managed schools, to name a few. But many reforms are still incomplete and further push is needed.

Nepal is now at a historical moment of transition from conflict to peace. National political energy is devoted to preparation of a new constitution and creating an inclusive society where every citizen finds equal opportunity for excellence without any form of discrimination or oppression. But we also recognize it is not the time to let up economic transformation efforts. We only need to remind ourselves that slow growth exacerbated by insufficient and unequal provision of public services over the past several decades contributed to the recent conflict situation. Sustainable peace could not be achieved without economic development and creation of rewarding jobs, and nation building could not be sustained without economic growth; it would be suicidal to play a zero-sum game when everyone in the nation has increasingly higher expectations. There are unfinished reform agenda from the recent past and much more intensive efforts need to be made to promote reforms that promote growth, create jobs, and reduce poverty—for the transition to a peaceful and democratic society to succeed.

Macroeconomic fundamentals

The economy achieved 4.7 percent real growth (in producer prices terms) in FY08.

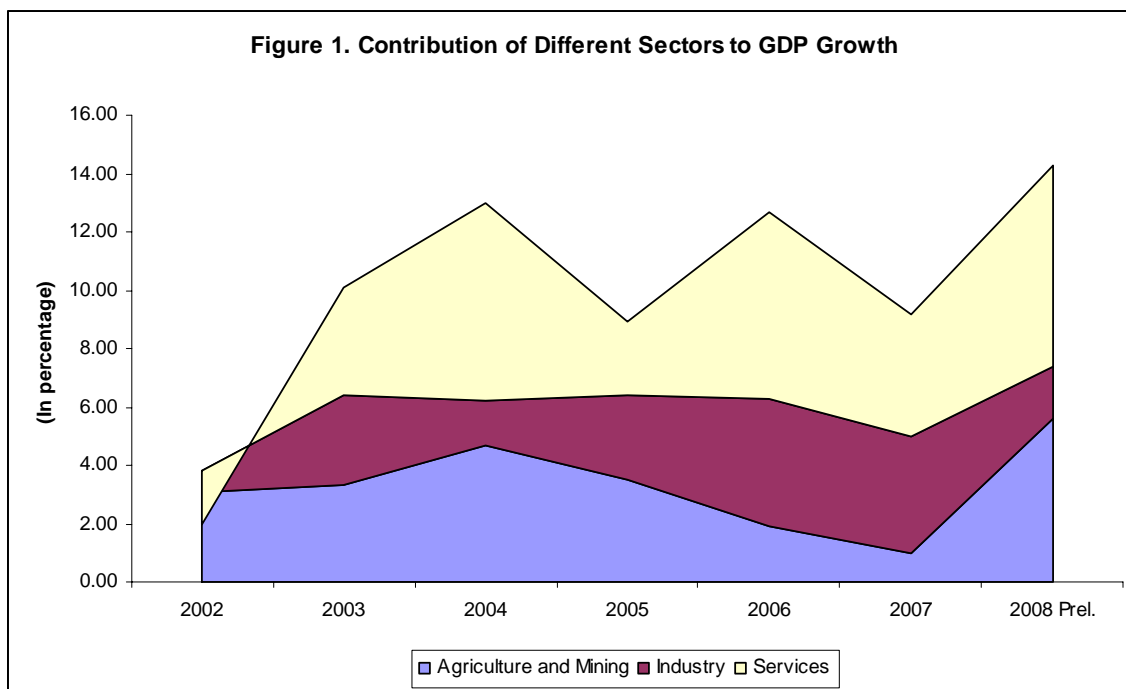
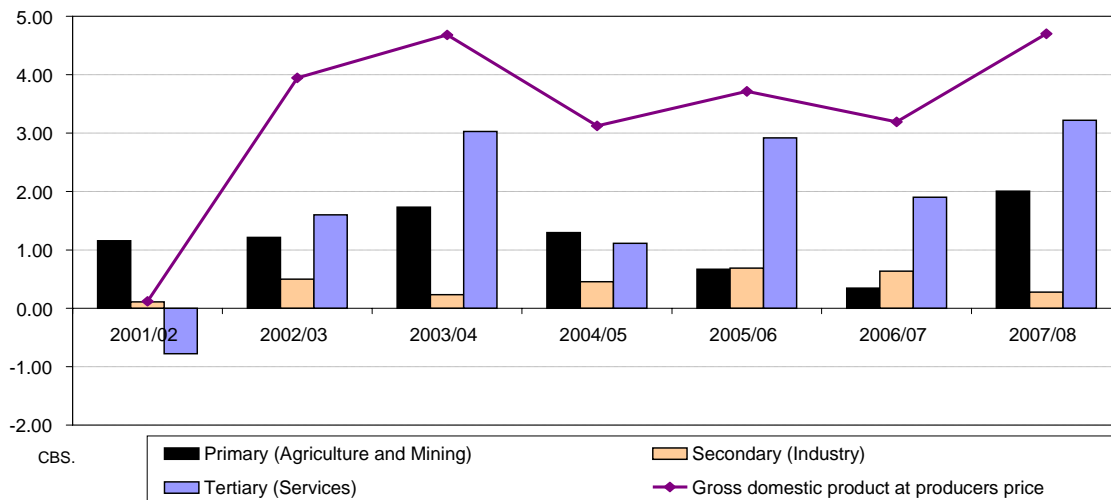
This is equivalent to average growth during the second half of the 1990s and was achieved with peace, plus good weather which raised agricultural production. This is an

² FY 2002 to FY 2007

³ NRB estimates remittances in FY08 at 18 percent of GDP but this figure excludes flows from India.

improvement over the last several years when uncertainty and intensified conflict suppressed growth to 3.1 percent on the average during FY02-FY07.

**Figure-1: Contributions to GDP Growth
(In percent)**



For FY09, however, there have been adverse real sector developments. They include: earlier floods in eastern regions, poor monsoons for crops, scheduled daily electricity cutoffs reaching 16 hours, deteriorating labor relations, intermittent unrest in Terai-Madhes leading to disruptions in movement of goods. Contrary to their expectation of improved investment climate following the Comprehensive Peace Accord, private entrepreneurs have been expressing concerns on further deterioration of the working conditions. As a result, private investment in productive sectors has declined to lowest levels in recent history. Commercial banks are financing mostly real estate transactions, home loans and trade-related activities.

Slow global growth (including in India) is also threatening to affect Nepal adversely.

The impact of the global recession would be indirect through declining exports and tourism receipts, and remittances flows. Although none of these flows have so far declined compared with those of last year, if the global recession becomes deep and prolonged, downside risks for Nepal would intensify. In particular, a decline in remittances, now nearly a quarter of GDP, would impose significant difficulties in economic management.

Prolonged dry spell throughout this winter has adversely affected all winter crops, particularly the wheat. Taking into account of these likely adverse developments and low private investment, FY09 real growth could be in the neighborhood of 4 percent or, with a downturn in remittances, even lower.

Sector Growth

Agriculture's share in GDP is 32 percent and has been declining from 36 percent in FY01. Other country experience shows that although the agricultural share may decline, its importance for growth and poverty reduction in fact would not decline as the economy expands—because of the sector's linkages to the rest of the economy such as agricultural processing industry and expanding supply chain to growing consumption. Nepal should be no exception. Over 66 percent of total population lives in rural areas, and over 80 percent of this rural population age 15 and above engaged in agriculture. Furthermore, the sector's income accounts for 71 percent of total household income, and, hence, net food-buyers. As such, there cannot be substantial poverty reduction, from the current incidence level of 31 percent, without growth and structural improvements in the agriculture sector.

Non-agricultural share of GDP rose from 64 percent in FY01 to 68 percent in FY08—and is growing. Much of this comes from the services sector (51 percent, an increase from 47 percent in FY01) as linkages of this economy to the global economy strengthen with expanding connectivity through infrastructure development. Remittance flow has enhanced growth in real estate transactions and personal consumption—together with trade sector activities. The declining manufacturing share (from 9 to 7 percent) may be an indication of Nepal's shifting comparative advantages as high remittances inflows are exerting upward pressures on real wages. The external competitiveness of manufacturing may be eroded while incentives to invest in service sector may be on the rise. With a smaller manufacturing base and increased consumption and real estate activities, the economy may be more vulnerable to the fluctuation in remittances.

The country, nonetheless, has the possibility of taking advantage from the economies of fast-growing two large neighbors, which requires connectivity and trade facilitation.

Inflation has been double digit. Inflation has been high and it will likely be around 12 percent (12 months) at the end of the fiscal year. At the end of the first half of this fiscal

year, inflation was 14.5 percent compared with 6.3 percent at the same time the previous year. This earlier inflation was caused by a significant rise in international fuel and food prices. In addition to food and fuel related factors, the upward pressure on prices comes from a 10 percent increase in general salary and wage index, supply constraints such as floods and frequent road blockages as well as 16 hours plus electricity cuts every day. Frequent road blockades, labor unrest in the second quarter of this fiscal year have all raised the cost of production and trading, which pushed the prices upwards.

In addition, the government raised civil service wages 23.5 percent (heavily favoring lower levels) from this fiscal year and raised the minimum wage by 53 percent in November 2008. Because higher wages have not been accompanied by increases in labor productivity in many sectors, they merely raised price pressures eventually eroding the purchasing power of worker wages. Increased activities of cartels are also reported in various commodity markets effectively shielding decline in prices. As a result, double digit inflation remains in Nepal despite a decline in international (as well as Indian) prices. The government, however, is increasing market surveillance with a view to controlling any market malpractice.

Fiscal and Monetary Developments

Prudent fiscal policy is maintained in the midst of competing claims on budgetary resources. This year's budget has been running in surplus with impressive revenue growth (above 30 percent), and high availability of aid money (grant growth rate, 70 percent; loan, 5 percent). Thus far, however, actual spending has been growing by much lower percentage, i.e. at just about 11 percent as against the planned budget growth of 46.3 percent. The growth in recurrent is modest at 20 percent as against the budget growth of 40 percent, which is good particularly during these inflationary times. Capital expenditures have not been commensurate with the growth targets. Delay in budget presentation pushed the implementation deadline for several new projects. It is expected that the capital expenditure will pick up in the last quarter of the fiscal year. Due to lower levels of expenditure while revenue performance remained buoyant, the government is running with huge treasury surplus.

Monetary policy is slowly being tightened in response to the liquidity level in the market. A rise in net foreign assets (mostly higher levels of remittance) and net domestic assets (increase in private sector credit) have increased monetary aggregates. Monetary authority has gradually tightened the availability of funds in the market. While this tightening has probably been slower than called for, the government's success in collecting targeted revenues while not succeeding to spend as scheduled in the first half of the fiscal year has had an unintended tightening effect. The Government is committed to keeping monetary stance at appropriate levels and when capital expenditure budget starts to be released more rapidly, monetary policy needs to be adjusted to mop up the extra liquidity injected in the market.

Financial sector—a domestic bubble

Stock and real estate prices have increased rapidly fueled by speculation in the recent past—one aspect of monetary management difficulties on account of larger incoming remittances and limited alternative investment opportunities in the country. Furthermore, there was overcrowding of financial institutions—i.e., with the liberal licensing policy, the number of banks had increased quickly, and this has led a number of banks to take on these riskier assets at more than prudent levels. Speculators have used commercial bank borrowing for their activities, therefore spreading the risks to commercial banks and to their depositors.

Nepal Rastra Bank (NRB) has taken measures to regulate risky bank activities and place the situation under control. NRB has made efforts to regulate both real estate-based and margin lending by commercial banks. As a result, according to NRB, 25 commercial banks have now reduced exposure to these types of lending to an average of less than 10 percent of total from above 20 percent earlier. The data on non-performing loans have not indicated any significant deterioration. With the introduction of prompt corrective action (PCA) for all financial institutions, financial sector is expected to remain generally healthy. However, there is a need to closely monitor market liquidity and keep it in a reasonable level through monetary measures so as not to allow large scale collapsing of asset prices.

Indeed, stock prices have stabilized and started to decline because investors have become increasingly cautious witnessing the global crisis and the difficulties in India. But land prices remain high and there are uncertainties which require NRB's close monitoring to prevent risks of hard landing as a few institutions may remain exposed excessively—and experience difficulties in the event of rapid fall of real estate prices.

In the ongoing financial sector reform, the three largest banks' restructuring is moving slowly. Rastriya Banijya Bank (RBB) reforms may be proceeding in a more orderly manner, but restructuring of Nepal Bank Limited (NBL) has slowed down in the last two years. Recent financial position of NBL indicates that if strong measures are not taken quickly then rescue efforts may even be harder in the future. NBL's payroll expenses alone are as much as total interest income. While it needs to quickly implement cost-cutting measures by implementing voluntary retirement scheme for rationalizing staff size, plan for capital restructuring also needs to be implemented. Agricultural Development Bank restructuring is moving as planned and this is going to be the first government bank fully complying with prevailing banking sector regulations. However, as this bank expands by restoring rural branches that were forced to closure during the conflict period, it is necessary to ensure that new branches are structured to be at least above breakeven.

External Sector

Trade developments: The trade deficit widened to 19 percent of GDP with a rapid increase in imports of petroleum products and consumer and construction goods while exports largely stagnated. However, in the first six months' of this fiscal year, exports have rebounded and exports to countries other than India have recorded a very high 56

percent growth, which had declined by about 7 percent in the corresponding period of last year. Most of the exports to countries other than India are primary goods. In the recent years, share of carpet, garment and pashmina products has been declining.

Remittances: International migration has become highly important for Nepal as both the number of Nepalese working abroad and the size of their remittances have recently increased dramatically. More than 200,000 workers left the country in each of 2007 and 2008 to destinations other than India and other South Asian countries (there are no official statistics on Nepalese working in these countries). From 1995-96 to 2003-04 the number of those working abroad grew from 16 percent to one quarter (and now approaching a third) of the entire male population. India constitutes the main destination for Nepalese workers and estimates of Nepalese working in India vary wildly between less than a million to more than 6 million with 1 to 2 million often quoted as reasonable. There are also Indian workers working in Nepal remitting income back to India, although little is known about these workers.

In FY08, Nepal received remittances amounting to US\$2.2 billion⁴ from these migrant workers (again excluding remittances from workers in India and other South Asian countries). This was more than 17.4 percent of GDP, the largest share in South Asia, and if we include remittances from India, it could easily exceed 20 percent of GDP. These remittances, received by about a fifth of households, have contributed to the country's recent 11 percentage point poverty reduction from 42 percent to 31 percent between 1996 and 2004. Half of this decline is attributed directly to remittances.

The overall balance of payment is positive at a 3.6 percent of GDP in FY08 in comparison to 0.8 percent in FY07. Trade deficit of 19 percent of GDP was offset by strong external net transfer (i.e., remittances), and pushed the current account surplus to 2.6 percent of GDP in FY08 compared with a near balance in FY07. Gross official reserves remain at slightly above \$3 billion, about 9.1 months of imports of goods and services—supported by high remittances inflows.

Impacts of the Global Financial Crisis

Given Nepal's limited participation in global financial markets, the direct impact of the ongoing financial crisis is expected to be small. But if the global recession were to be deep and prolonged, exports, tourism receipts, and remittance inflows would all be adversely affected. In particular, if remittance flows were negatively affected, the economy would likely suffer significantly. In addition, local banks that are exposed to risky assets such as the real estate and stocks, as discussed above, may suffer from forced price correction on account of lower remittances. Price correction has already started especially in the stock market, but if correction became faster, the banking sector and the economy could be adversely impacted.

On a more general economy-wide level, high remittances have raised the overall consumption and increased aggregate demand. They have also affected savings and

⁴ Nepal Rastra Bank. Based on their monitoring of commercial banks and money transfer companies.

investment. At the same time, higher demand and the shrinking domestic labor force have contributed to a rise in the real wage levels especially in rural areas. On the external sector, higher aggregate demand has raised an import which, together with the more appreciated real exchange rate, has widened the trade gap. This wider gap has been offset in turn by remittances, and the overall balance has been maintained with foreign reserves continuing to accumulate.

As a result, Nepal could be left increasingly vulnerable to external shocks. Especially if labor demand were to suddenly decline in destination economies, it would be difficult to expeditiously expand exports and domestic production to offset plummeting remittances and re-absorb a large number of returning migrants or those unable to leave. Un- and underemployment would rise, consumption would plummet, and balance of payments would deteriorate. Social tension would rise and the poverty situation would also likely deteriorate fast.

It appears that remittances have not so far been affected visibly—nominally, officially recorded remittances are still rising even by a higher rate. Based on information collected from commercial banks and money transfer companies, NRB projects that nominal inflows for the entire fiscal year could be similar to the last year's level. It can be a proof that remittances flows have not been affected significantly. However, migration and remittances may be affected adversely in view of economic squeeze that the destination economies are suffering lately. Unless we find new foreign employment destinations, the number of returnees may go up and remittance inflow may decline sharply in the second half of 2009.

The government realizes the risks we will be facing when remittances decline, new migrants fail to leave, and/or migrants abroad are forced to return raising social tensions significantly. The manufacturing job base has already been shrinking and jump-starting the sector would not be easy. Service sector jobs would not expand—they would be expected to stagnate if not decline with lower remittances, and the tourist arrivals have also started to decline. Some banks' liquidity position would deteriorate if real asset prices come down precipitously due to lower remittances. The government needs to be prepared for all these risks by and has already outlined its intent of preparing next fiscal year's budget with a focus on job creation and improving the investment environment. Measures have been taken to improve power supply and industrial security so that manufacturing sector can increase labor intake. In order to help tourism sector survive the global slowdown, it is necessary to promote domestic tourism and at the same time promote religious tourism as this sort of tourism is least income-elastic.

C. RESTRUCTURING STRATEGY

Given this backdrop, the government strategy is (1) focus on creating business climate conducive to private investment so that risks of secondary damage from the global crisis be reduced in the immediate future, and the foundation be laid for medium future rapid growth; (2) Transforming agriculture; (3) improve delivery of economic and social services to uplift the overall welfare levels of the citizens and allow all to enjoy the

benefit of growth; (4) improve implementation of development activities to increase government spending efficiency; and (5) sustain macroeconomic and financial stability.

I. Better investment climate (including governance)

Top priority of the government is to accelerate growth and create jobs. This is feasible only through creation of a **business environment conducive to private-sector led growth**—as public sector job creation capacity is limited. As seen everywhere in the world and in Nepal in particular, private-sector led growth has been greatest poverty reducer—and sustained high growth has been possible only when the private sector invested vigorously. Creation of a private sector friendly environment has now become critical in Nepal with the private investment, as well as private job creation, seen to have declined to historical lows—while at the same time, foreign employment is feared to decline significantly in the foreseeable future due to the ongoing global recession. The government will review a number of Investment Climate Assessments carried out by ourselves or by development partners, and identify constraints to private sector investment. The government will then quickly implement measures to mitigate these constraints. Our focus will be on (i) establishing law and order; (ii) ensuring policy stability especially toward the private sector; (iii) addressing the issue of labor rigidity; (iv) assuring private firms rights to exit; (v) streamlining licensing requirements—with particular emphasis on the first three; (vi) improving the tax environment; and (vii) improving labor skills.

(i) Law and order

It is indispensable that law and order and rule of law be maintained for private entrepreneurs to invest in an economy. The government is committed to creating this environment by taking measures to reduce crimes and militancy of labor unions and youth groups. These measures include: allowing the police to take tough stance against those who break law and penalizing the police for failing to act against criminals. It would be a crime punishable by law when any group or individual used threat of violence or actual violence while soliciting monetary or other donations from other individuals, groups, or businesses. So are corrupt activities by those involved in businesses or politics. The police force will prepare and issue a time-bound action plan with tangible targets for crime reduction—and will be held accountable for these targets. Citizens are encouraged to report criminal activities to the police. Judicial reform will continue—to make the system impartial and subject to less discretion.

(ii) Policy stability

For the private sector to operate businesses successfully, an environment of policy stability is important. The government will maintain the policy direction announced to support the private sector as one critical pillar of the economy. We maintain that our policy is to allow the private entrepreneurs to function based on market forces—including prices and wages—and on fair competition. The government will be responsible in providing public goods, basics social services, social safety nets, and physical

infrastructure. The government will be engaged in commercial activities on a very selective basis—only in cases where revival of sick industrial enterprise is necessary or where market mechanism does not work efficiently to deliver goods and services to the people.

(iii) Labor regulations

The Labor Act of 1992 imposes various rigidities on employers' ability to hire contractual workers and to lay off permanent workers. Contractual workers must be made permanent after working 240 days and permanent workers, at firms with ten or more permanent workers work, cannot be laid off without significant cost. These regulations form impediment to private operations and expansion and has led to high level of informality in the labor market. This has led to a large pool of unprotected workers who view illegal strikes and employer threats as a substitute for public sector enforcement functions. Investors and entrepreneurs shun away from employing permanent workers and often even from investing because of these rigidities and frequently violent labor demands.

What these regulations have done is to protect the vested interest of current permanent workers and prevent others in the labor force from being employed on a permanent basis. In fact, the regulations favor existing formal workers (who are a very small portion of the labor force) and discriminate against the rest of the workers as it makes it difficult to be employed as formal sector workers.

The proposed Labor Commission will look into the overall labor sector reform. The objective will be to expand opportunities for workers in the informal sector, ensure proper social security for the workers and at the same time improve labor relations.

(iv) Barriers to exits/insolvency

To encourage investment, the government is also addressing the issue of smooth closure of businesses. To encourage business entries, businesses should also know that they can exit the market when profit expectations are not met – either voluntarily or involuntarily. Today, business exit is a prolonged process with significant cost and businessmen can be reluctant to invest where there is no perceived clean exit in the event of financial difficulties. In particular, the lack of clearly defined institutions and procedures to handle recovery of debt in the event of insolvency is a key issue. To address this issue, the government issued the Insolvency Act, and is preparing its implementing regulations. The Commercial Bench is being created as mandated by this Act. The Secured Transactions Act is also being implemented to, among others, prevent multiple loans from being obtained based on the same collateral pledges. The Government is committed to designing and establishing the Secured Transactions Registry to ensure this.

(v) Licensing and inspections

The Government will address the problems created by the convoluted licensing regime, combined with the practically non-existent inspections regime—which has increased the cost of doing business without upholding the public's interest. Key reforms should be based on a review of the legal and institutional basis for licensing and inspections to take stock of all licensing requirements identifying redundancies and inconsistencies. Appropriate national legislation will

then be drafted which clarifies purpose, scope, rights and responsibilities of licensing agencies and systems for enforcement. The government sees it important to build capacity of these agencies to evaluate license applications and to conduct inspections for enforcement.

(vi) Improving the tax environment

Reforms in tax administration will continue with particular focus on reducing the cost of doing business and easing the compliance requirement. Custom reforms will focus on facilitating trade and increasing Nepal's competitiveness in the global market.

(vii) Improving labor skills

Overall labor productivity cannot improve without skills enhancement, thereby making it difficult to attract better investment and higher growth. Government will increase investments in setting up of polytechnic institutes for providing medium-to-high skills training for existing and potential labor force.

II. Transforming agriculture

Without radical transformation of agriculture, it will be extremely difficult to eradicate poverty and achieve inclusive growth. Following issues are important in transforming agriculture

(i) Reform in land ownership

Without ownership in the hands of the real farmers, productivity enhancement cannot be expected as there would not be any incentive for the farmers to produce more. This needs a correction and, therefore, government intends to implement scientific land reforms program which will ensure land to the tillers and at the same time excessive fragmentation would be checked.

(ii) Improved seeds and technology

The government will increase investments in agriculture research and dissemination of best practices so that higher productivity can be achieved. Agricultural research farms will be strengthened and at the same time private sector will be encouraged in seed development and propagation.

(iii) Market connectivity

Without connecting farmers with the markets, commercialization of agriculture is not possible. The government will, therefore, invest in market connectivity, market infrastructure development and quick and cheap access to market information to the farmers.

III. Improvement in infrastructure and service delivery

We also place a high priority on better delivery of infrastructure and social services to support economic growth, better human capital accumulation and improvement in access to basic services by all citizens of the country. Without limiting the role of private sector in the functioning of the economy, cooperative sector will be promoted as a medium of economic services delivery particularly in the rural areas and in areas dominated by low-income groups of people. Wherever necessary and feasible, government will encourage public-private-partnership (PPP).

(i) Improved infrastructure/economic services

For supporting economic growth at both national and community levels, it is important to have better infrastructure. After decades of development efforts aided by development partners, the gaps between demand for and supply of infrastructure services remain significant or, are in some instances, widening. The government realizes importance of improving the regulatory framework including the tariff structures that encourage increasing private participation in infrastructure provision. We stress in particular the importance of improving Information Technology and telecommunication services in today's world and also for the rest of infrastructure services, importance of providing adequate maintenance resources and setting tariffs at levels that provide private investors incentive to participate.

Telecommunications and Information Technology (IT): IT and telecommunication services are indispensable for socio-economic development in the globalized world today. We also realize that development of these sectors needs to be grounded firmly in enhanced regulatory framework based on private sector competition—such a framework needs to be established and implemented expeditiously so Nepal can not only survive in the rapidly transforming world, but also establish the sectors as the nation's comparative advantage. Realizing the potentially enormous contribution the sectors would make to social and economic development, the Government's policy is to operationalize the national radio spectrum management and monitoring system as soon as feasible. Along the similar line, the National Frequency Allocation Plan will be reviewed and revised to make it consistent with the operationalization of spectrum management. Looking ahead into the IT age, broadband wireless access licenses will be issued.

Road The critical measure in the road sector is to boost maintenance spending to appropriate levels. The Government is also committed to ensuring that the Roads Board is fully operational.

Power It is important to improve investment climate for the power sector. This would take a combination of IPP tariff adjustment to make it attractive for IPP investors while developing financing plan/consumer tariff rates that ensure financial health of NEA. The government realizes that there is no way to sidestep this issue in order to address the load shedding problem that plagues the economy.

Water The government policy is to create conducive environment for public private partnerships in urban water (municipalities and small towns) and ensure the water and

sewerage tariffs are reformed to encourage private sector participation. In rural water, the Government will work to bring about efficiency and harmonization through cost sharing and to implement performance based budget allocations.

Cooperative development

Government will encourage and support cooperatives for the improvement in the supplies of essential commodities in the rural areas. Cooperatives can also be good framework for enhancing access to finance and expanding rural electrification.

PPP (Private Public Partnership) In all of the infrastructure areas, the government remains cautiously optimistic that PPP would be an instrument we could use. PPP takes many forms. In the end, services need to be provided satisfactorily by the private sector while the private investors should have sufficient profit to continue the operation. In the areas of infrastructure, where commercial opportunities are not abundant, it often involves discussion of government guarantee—leading to an unsustainable level of government liabilities or higher tariffs/tolls than deemed desirable. The government is committed to examining these factors to come up with PPP activities that would best contribute to Nepal’s development.

(ii) Better Social Services

The Government will do its utmost to ensure social services are delivered equitably and efficiently.

Information Updates: One of the most critical tasks in enhancing equitable access to services involves assessing the population’s needs, especially the poor. We will thus carry out the third Nepal Living Standard Survey (NLSS III) in 2009/10 and, based on its results, conduct poverty assessment. As the last NLSS was carried out in 2003/04, and the state went through various social and political changes in the meantime, the new survey and its analysis are overdue. With development partners, we will also update PERs of key sectors such as education and health to evaluate how government spending is meeting people’s needs.

Decentralized decision making/fiscal federalism: The government is committed to improving service delivery through devolving a number of fiscal responsibilities from the central government to local levels. Closer the decision making is to beneficiaries/residents, more efficiently their preferences could be reflected in resource allocation. Local residents should also be able to hold local decision makers accountable more effectively than they could the central government. To design this improved and decentralized system of governance, studies will be conducted on the most suitable structure of local governments and the form of center-local relationship—this will be the basis of the new constitution of the country. Once the structure of local governments is determined, the government will move on to define revenue and expenditure assignments at each level of governments and, as needed, unconditional (equalization) and conditional grants to them. This process, however, will take a while—and the government will

appoint interim councils which would attend the local population's needs until the formal governance structure is established. Both these interim councils and the future local governments (whichever form it takes) will work with communities and user groups that manage provision of a number of social and economic services as seen below.

Community-based Development: The government will continue its strategy to support community and user-group based delivery of social services. Quality of services and protection of natural resources have improved after the community management of forestry, irrigation, health posts and schools.

Per Capita Funding of Education: Impressive education outcomes have been achieved, the net enrollment ratio of primary education has increased from 67.5 % in 1995 to 89.1 percent in 2007. This enrollment outcome trend needs to be sustained and the same outcome moved to next level, throughout the levels of schooling. Towards meeting this objective as well as to strengthen the skilled labor supply, necessary to attain double digit growth in medium run, the government policy is to implement, nationwide, policy of per capita funding (PCF) of students enrolled in class as education resource allocation policy. This policy shift will not only bring about education expenditure efficiency but also self regulate the existing imbalance of teachers in schools vis-à-vis student enrollment.

Health Sector Development Nepal has achieved impressive health outcomes – maternal mortality ratio has come down from 538 to 281 per thousand; infant mortality ratio has come down from 79 in 1996 to 48 in 2006 per thousand. To improve on this achievement and to expand basic health care services nation wide, especially in rural areas and remote regions suffering from inadequate health services, policy of the government will be centered, first and foremost, to provide essential health care. To bring about efficiency in health spending and timely provision of services – skilled manpower and drugs, the second priority of our sector policy is to expand and expedite contracting with competent private care givers or communities in health services.

IV. Enhancing Implementation capacity

(i) Improving Procurement:

Beneficiaries benefit from investment only if such investment is completed in the shortest period of project cycle. Recognizing some traces of deteriorating procurement environment in recent days - post-conflict; and, as the country moves back to normalcy, in close cooperation with development partners, the Government will strengthen the capacity of the Public Procurement Monitoring Office (PMO) to effectively implement procurement law, help establish procurement performance monitoring indicators, implementing e-Government Procurement (eGP) systems, and initiate the move towards full alignment of the procurement law with international standards.

(ii) Better public financial management:

Implementation of PEFA action plan is the road-map for public financial management improvements. The government will implement actions that further deepen *ex ante* planning and budgeting activities to enhance fiscal sustainability and allocative efficiency while at the same time strengthen downstream reporting and auditing (internal and external) activities starting with strengthening Integrated Financial Management Information Systems (IFMIS), audit functions of the Auditor General and moving from rules-based to principles-based accounting in line with international standards.

(iii) Better monitoring and evaluation/increased accountability

Streamlining and timely completion of national surveys and institutionalizing progress reports have ensured timely monitoring of outcomes and outputs of public investment during different plan periods. These activities provided inputs for mid-course correction of policies and/or investments and assisted in aligning annual budget allocation to high impact sectors and areas. Cognizant of the need to not only monitor progress but also to bring about allocation efficiency, sustain progress in high impact areas, and redirect funds to high priority activities, the Government will further strengthen existing monitoring and evaluation systems— particularly, EMIS and HMIS – and expand additional sector specific monitoring and evaluation systems in drinking water and sanitation, roads and power sectors. These systems will be part of the government’s on-going Poverty Monitoring and Analysis System (PMAS) and will cover monitoring of core service delivery systems of the state.

V. Macroeconomic and financial sector stability

Macroeconomic stability supports growth as it increases investors’ confidence in the future. Key to macroeconomic stability in Nepal is sustainable fiscal management. Monetary policy will support the peg to Indian currency and protect the country’s reserve levels. The financial sector is, however, growing fast and can be a source of instability. Policies need to be in place to keep financial institutions properly regulated and supervised.

(i) Fiscal sustainability

Revenue administration: The Government is committed to fiscal management that limits net domestic borrowing to values that maintains inflation and official reserves at appropriate levels. For this, intense efforts shall be continued to improve tax administration. In particular, the Large Taxpayer Office’s capacity to audit will continue to be strengthened, both on- and off-site. The government is also implementing the second phase of customs reform and modernization plan. The new Customs Act and Customs Rules were enacted in April 2008—which is helping raise customs revenue beyond historical levels. Rigorous efforts will be continued to introduce risk based customs management and implement ASYCUDA Selectivity Module together with a Wide Area Network. The government will continue the policy of giving performance-based incentives to

Reviving Medium-term Expenditure Framework (MTEF): Under annual budgeting system, projects requiring longer period to complete are broken into pieces and contractors appointed. There is, therefore, wastage of time due to tendering for work each year. In essence, due to no guarantee of continued allocation of budget as long as the project is not complete, multi-year contracting of work is not done. There was a major improvement to this during the MTEF years. In addition, MTEF also assured sector ministries of continued allocation of budget to high priority programs of the government in the outer years.

MTEF is in discontinuity for two years and already the problems are surfacing. One of the reasons for slow disbursements of capital spending this year is the absence of MTEF, because ministries did not make advance preparation for project implementation.

From next fiscal year, MTEF will be reinstated and it will be the basis for annual budgeting.

Automatic adjustments of oil product price: Inability to adjust petroleum prices in line with the movement in international prices, there was huge fiscal burden for the government. This situation should no longer continue in the future. Government has been adjusting prices in line with decline in international prices by keeping sufficient cushion for debt-servicing. This mechanism will further be refined and automatic pricing regime will be put in place so that fiscal burden does not occur in future.

(ii) Monetary policy

The basis objective of the monetary policy in the interim will be to sustain the peg maintained with Indian Rupee. This is necessary for stability, to reduce speculative tendency and to avoid uncertainties in trade. Monetary policy will also strike proper balance between competing demands of maintaining price stability and pushing higher growth rate.

(iii) Financial sector stability

Sound financial institutions are also critical for private sector development.

Continued efforts will, therefore, be made to improve the financial sector through completing restructuring the three largest commercial banks under substantial state control. Recapitalization of these banks will be the high priority for the government.

In addition, supervision capacity of NRB will further be strengthened so that any crisis in financial sector can be identified at the early stage and remedial measures taken quickly. Recently Prompt Corrective Action guidelines will be periodically reviewed and refined to ensure automatic correction. The restrictions on cross-holding will continue to be enforced.

Amendments to Banking and Financial Institutions Act (BAFIA) have been proposed to facilitate merger and acquisition and also to promote Infrastructure Bank. The proposed amendments once enacted will help financial sector consolidate further.

The government is mindful of the need to enhance access to finance in the rural areas for the transformation of agriculture. All banks will be encouraged to expand in the rural areas.

The government will continue taking strong action against large willful defaulters.

(iv) Youth Self-employment Fund

Government has created Youth Self-employment Fund from where young men and women with requisite skills and entrepreneurial zeal can get easy finance to productively use their skill and set up business. This vehicle will further be strengthened in close cooperation with commercial banks. This vehicle is expected to help generate substantial employment in all parts of the country.

(v) Facilitating remittance flows

In the recent years, much of the remittance flow to Nepal is happening through banking channel. There is still lot more to do to reduce the cost of transferring money from outside countries. Government will work out destination countries to eliminate any bottlenecks to smooth flow of remittance to the country so that the cost burden to people sending money can be reduced.

E. CONCLUSION

Nepal is in transition into a new Nepal that is just and equitable which will enjoy high rate of economic growth. For this transition to happen, our highest priorities should be: creating business environment conducive to private investment; improving service delivery; improving the government's implementation capacity; and keeping macroeconomic and financial stability.

The government's foremost focus is on creating business climate conducive to private investment. This is because economic growth is the greatest poverty reducer, and no economy has ever enjoyed high growth in a sustained manner without significant private investment. The private sector can create jobs in far greater numbers than the government. It is thus crucial that this government takes measures to encourage private investment.

And these private sector jobs are critically needed particularly now with the global recession threatening to reduce foreign employment available for Nepalese. If job opportunities abroad indeed decline, which appears likely, social tension in Nepal would rise and private investment climate could further worsen, limiting job creation further.

The process could end up in a vicious cycle—fewer jobs create higher tension, which then reduces investment creating even fewer jobs.

To prevent this vicious cycle from happening, action is seriously needed to improve law and order, respecting private property rights, and addressing issues of labor flexibility. There is no alternative to biting the bullet and taking these measures. Without these actions, the dream of every Nepalese citizen to create and live in new Nepal would remain a mere dream.

Of course, the government on its part will continue efforts to maintain macroeconomic stability and keep expenditure geared to support growth and reduction of poverty—by providing needed infrastructure and equitable social services. In particular, by reviving MTEF, the government is committed to sustainable fiscal management while tightly linking spending to priority goals of the country. The MTEF would protect priority expenditures that would most clearly contribute to achieving national and sector goals while keeping total spending in line with resources available. By focusing on priority activities and monitoring and evaluating these activities, the government will also improve implementation of these projects.

Finally, the government remains committed to improving the financial sector. The pattern of financial flows in Nepal has been that the financial institutions collect money from poor rural residents, and banks lend this money to urban rich—quite often to those who do not repay. Nowadays, hard-earned remittances flows are added to deposits and borrowers include those who take excessive risks by speculating in real property and stock markets. Either way, the poor's precious savings are often transferred to urban borrowers who take excessive risks or do not intend to repay. These practices need to be stopped. Restructuring the two largest banks who engaged in this type of “transfers” and accumulated large non-performing loans will be restructured to “fit and proper” banks and/or sold to a strategic partner. NRB's supervision capacity will be enhanced to prevent banks' excessive risk-taking with depositors' money, and will also allow banks to exit if they do get in trouble. Willful defaulters will be penalized. A financial sector that functions efficiently in line with internationally accepted standards would contribute significantly to building new Nepal.