

Structural Changes and Economic Growth in Nepal

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Abstract

This paper analyzes the structural change and performance of the Nepalese economy over the period of 1965 to 2009, specially focusing on the impact of IMF and World Bank's structural adjustment program implemented since the mid-1980s based on the Washington consensus. The performance of Nepalese economy has not improved much after the implementation of a series of structural adjustment programs in conjunction with economic liberalization policy. Instead, poverty is widespread and per capital income is still low with widening income inequality. Rather, the Washington consensus helped expand social tension with rising unemployment and inequality dragging Nepal into a decade long internal conflict with poor and weakening governance system.

1 Introduction

Nepal is a developing country situated between China and India geographically. It remained almost in isolation from outside world both economically and politically until the fall of more than one century long autocratic regime in 1951.

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Only after that, Nepal embarked on democratization and developmental process with the beginning of planned development effort in 1956. With the passage of time, many different types of political systems have been observed¹. Political system is still fragile and has now been undergoing a major political transition with yet to settle peace process since 2006.

Nepalese economy has been witnessing a gradual change along with the change in political system, from fully agrarian economy to a semi-modern system. However, Nepal is still one of the poor countries in the world. It shows that something has gone wrong. Actually, economic development requires economic transformation to constantly generate new dynamic activities(Ocampo et al., 2009) which Nepal, totally, lacks so far. Dynamic interaction among markets, forces of innovation, finance, productive sectors and stable political system can produce a virtuous circle of growth and development in any country. This requires active market, strong government and capable social institutions. More importantly, “an economy can be considered to be performing well if it has sustained productivity growth and a stable or rising employment/population ratio”(Ocampo et al., 2009, p41). Nepal lacks many of these requirements and has been slow in the development process even toady in the 21st century.

As in other many developing countries, Nepal began to implement structural adjustment program of IMF and World Bank since the mid-1980s, with a hope of accelerating economic development and growth after facing a continuous balance of payments (BOP) deficit in the first half of the 1980s. After a series of structural adjustment programs, Nepal also concluded the PRGF program with IMF recently, in 2007. Even after more than the two decades of structural adjustment program and economic liberalization process, Nepal is still in the low end of development ladder. These programs have actually weakened the government capacity and neither was it able to create institutional mechanism necessary for strong economy. Instead, the country became fragile and volatile to unstable politics, with widespread poverty and rising inequality. As a consequence of a number of factors like unemployment, poverty, isolation and lack of good governance, internal armed conflict erupted in 1996 and lasted for a decade. Only in 2006, the peace process began but it has not settled yet to a logical end. Hence, Nepal is still on the way of finalizing political agenda, leaving far behind economic development process.

With the World Bank and IMF’s suggestion, Nepal embraced neo-liberal

¹See Appendix 1 for brief account of evolution of Nepalese political system.

policy of privatization of state owned enterprises, market determined price system, trade liberalization, financial sector liberalization, fiscal consolidation and indirect monetary policy instruments as early as mid-1980s. Although Nepal is now relatively one of the most liberalized countries in the South Asian region, the economic growth has been low and stagnant, unable to increase per capita income for uplifting living standard, with sluggish exports and stagnating investment (Khanal and Shrestha, 2008).

In this context, using macroeconomic data available since 1965, obtained from the different sources such as IMF, Central Bureau of Statistics of Nepal (CBS), Ministry of Finance, and Nepal Rastra Bank (Central Bank of Nepal), hereafter NRB, this paper has explored the structural changes observed and macroeconomic performance of the Nepalese economy in order to identify the performance of neo-liberal period. This paper has followed the structuralist approach adopted in Ocampo et al. (2009) and argues that structural reform failed to make economic and social structure conducive for political stability and economic development.

The remainder of the paper is organized into four sections. Section 2 outlines the policy changes in the past, followed by the analysis of changes in economic structure and macroeconomic performance of Nepalese economy in section 3. Section 4 discusses Nepalese socio-economic situation and finally, section 5 provides some concluding remarks.

2 Structural Adjustment Program and Policy Reform

After the demise of fixed exchange rate based Bretton Wood System and declining corporate profit after oil shock, in the beginning 1970s, and particularly from the 1980s, there has been significant change in the overall framework of development policies based on the Washington Consensus all over the world. The Washington Consensus² strongly emphasizes the private sector initiatives and lowers the role of government or narrows the policy space, considering the fact that market provides a key to successful economic development (Ocampo et al., 2009)

Under the support of World Bank and IMF, Nepal also embarked on economic liberalization process through the implementation of structural adjust-

²Detail in Taylor (1993)

ment program. Nepal first time introduced the Structural Adjustment Program (SAP) in 1985 against the background of deteriorating macroeconomic situation; particularly BOP deficit during 1982/83 to 1984/85 period. Before that, Nepal had been following an import substitution policy with a focus on industrialization through setting up public enterprises. The main objectives of the SAP were to attain macroeconomic balances and raise GDP growth rate on a sustainable basis. SAP was implemented for the period of 1986/87 to 1988/89 intending to make the transition from economic stabilization to more rapid development on a sustainable basis through market oriented reform. A GDP growth rate of four to five percent per annum was targeted through fiscal consolidation and mobilization of private sector investment. For the latter, the SAP was designed to liberalize industry, trade and exchange rate, interest rate and monetary policies for promoting exports and attracting private investment, and privatization of public enterprises.

After a set back from the trade and transit stalemate from India in 1989 and change in political regime in 1990, from absolute monarchy to constitutional monarchy system with multi-party democracy (see Appendix 1), the elected government after the political change, however, expedited the economic liberalization process with a full faith on market economy. In order to increase the pace of the reforms, the second Structural Adjustment Program SAP-II was implemented in 1989/90 for three years, despite no BOP crisis at this time³. In late 1992, the government further negotiated a new Enhanced Structural Adjustment Facility (ESAF) arrangement with the Fund. This provides a framework for continued economic reform and structural adjustment as per the advice of IMF and World Bank, with a hope that it would automatically reduce poverty and create employment in the economy. Ironically, on the process of liberalization, immediately after the introduction of many market oriented policies and programs, a serious internal armed conflict broke out in 1996, reflecting dissatisfaction of people from widespread poverty and unemployment. Utilizing the people's discontent, Nepal Communist Party (Maoist) began armed struggle from villages to overthrow the monarchy and existing governance system to establish a republican government.

Amidst growing political fragility, with a view of reducing poverty to calm

³With the objectives of revamping the tax system, rationalizing the management of development spending, restructuring two large state-owned banks and opening up the financial sector, improving the distribution of fertilizer, and making irrigation more effective. (<http://lnweb90.worldbank.org/oed/oeddoelib.nsf/DocUNIDViewForJavaSearch/5992D15BFBB41E852567F5005D8D57>).

people's unrest and agitation, realizing that structural adjustment program failed to enhance the living standard of people, Nepal began to implement Poverty Reduction and Growth Facility Program with IMF⁴ and Poverty Reduction Support Credit with the World Bank in 2003, and which was extended later a year due to political change in 2006 and finally concluded in 2007. "Like all support from the IMF, it was intended to alleviate BOP pressures"(Pitt, 2008). But, during that time, Nepal had BOP surplus on the one hand and on the other hand, it is difficult to understand how and which mechanism the giving of US\$79.1 million soft loans to the coffer of Central Bank of Nepal could reduce the level of poverty⁵. For the rational of PRGF, an IMF resident representative to Nepal, Alexander Pitt (2008) argues that "the PRGF arrangement consisted not only in providing financial resources but also in supplying a framework for tackling emerging economic imbalances, and focusing and reinforcing the structural reform effort. An additional role was to provide the signal that IMF support sends to third parties, in particular multilateral and bilateral donors" (Pitt, 2008, p5). In practice, the PRGF was, however, a way of dictating the government in policy formulation and a dimension of poverty level is still high even after the PRGF(described later).

Over the course of structural adjustment process, Nepal has liberalized external account, financial sector and privatized some public enterprises, dismantled industrial policy intervention and allowed a greater private sector role in economic activities by squeezing the role of the government (detail to be followed shortly). However, all of these IMF supported structural adjustment programs failed to focus on generating employment creation to reduce unemployment problem.

Nepal opened up its current account in 1993 and lowered tariff rate substantially with new liberal Trade Policy in 1992⁶. For export promotion, the

⁴IMF established the Poverty Reduction and Growth Facility (PRGF) arrangement in September 1999. On 14 November 2003, the IMF Executive Board approved a three-year PRGF arrangement to Nepal for an amount equivalent to SDR 49.9 million (about US\$79.1 million) to support the country's economic reform programs, which was 70 percent of Nepal's quota.

⁵Areas typically covered by the IMF include advising on prudent macroeconomic and financial policies and related structural reforms such as exchange rate and tax policy, fiscal management, budget execution, fiscal transparency, and tax and customs administration (Pitt, 2008)

⁶Pre-liberalization trade policy was guided by the inward-looking import substitution strategy. Protection of domestic industries and state-led industrialization were the main policy measures. However, a license was required from the Government for involvement in export-import businesses. High tariff and quota restrictions were practiced in order to protect domestic industries, guided by the policy of self-sufficiency. Even imports of intermediate inputs

trade policy waived the license requirement for exports, introduced duty draw back scheme, and exempted exports from taxes and charges. Imports have also been liberalized fully without any sort of restriction. After the accession to World Trade Organization (WTO) in 2004, under the WTO agreement, Nepal has further committed to eliminating other duties and charges. Because of this, according to mainstream economists, there should be a higher rate of growth as a result of higher investment and sustained gains in factor productivity as a bonanza of liberalization (Franklin and Romer, 1999).

To promote investment, the government introduced market-oriented new policies and acts such as Industrial Policy 1992, Industrial Enterprises Act 1992, Foreign Investment and One-window Policy 1992, and the Foreign Investment and Technology Transfer Act 1992. These policies have given a priority to investment promotion for accelerating industrialization in Nepal by providing incentives, for example no permission required for the establishment of industry, except those related to security, public health and the environment, and substantial tax exemption. In the large and medium-sized industries, full foreign equity participation is permissible, with no restrictions on repatriation of invested funds. The Foreign Investment and Technology Transfer Act 1992 have simplified both the process of obtaining visas to foreign investors and dispute settlement mechanism (Khanal and Shrestha, 2008).

However, FDI inflow has remained at the lowest in Nepal even when compared with other landlocked countries (World Bank, 2003). No strong dynamic effect of trade on investment can be found in the Nepalese context and no one was fully satisfied with the existing policies and the investment environment (Khanal and Shrestha, 2008). Trade liberalization has been just one more adverse shock for nascent manufacturing sector in Nepal. An influx of cheap goods from China and India with the opening up the trade account has driven out many domestic industries and employment, forcing people to seek for foreign employment.

In financial sector, private sector was allowed to open financial institutions. The NRB deregulated the interest rate regime and adopted indirect monetary policy instrument in 1989. Financial sector reform program was initiated to make the central bank effective on core functions: conducting monetary policy, and effective regulation and supervision, stripping off other functions like micro finance, and restructuring the two old state-owned commercial banks in order

were subject to import licensing. Strict and rigorous control was imposed on the foreign exchange facility, which required official permission (Shrestha and Khanal, 2008).

to privatize them. Downsizing of the central bank through voluntarily and compulsory retirement schemes and not hiring adequately in the reform process has resulted in the shortage of staff with specialized skills, seriously hampering the execution of central banking functions especially when the financial institutions are mushrooming in the market.

Under the public sector reform, there was a retrenchment of civil staff, privatization and closure of some public enterprises, making the existing public enterprises defunct, which generated further unemployment and dissatisfaction among people, playing a catalytic role for destabilizing political environment. Downsizing of the government made vacancy opening very rare on public sector and the government isolated from the basic needs of public, while people had high aspiration for economic prosperity from the newly elected government after the restoration of multiparty democracy in 1990. In addition, private sector investment remained low and was not enough to generate sufficient employment for increasing labor force. Cheap imports with opening up external account wiped out many nascent and old manufacturing industries, which further aggravated the unemployment situation.

In a nutshell, IMF-supported structure reform remained more focused on fiscal austerity, inflation control, trade deficit, but less on economic growth and remained completely silent on unemployment and poverty. The tightening of fiscal and monetary policies has constrained the employment growth by lowering the effective demand. With market reform, on the other hand, the gap between the haves and the have-nots has widened, thereby aggravating the social contradictions and unrest. On external front, the worsening trade deficit because of easy imports, but lack of competitiveness in exports further worsened the domestic effective demand to increase employment in the economy.

3 Change in Economic Structure and Macroeconomic Situation

Economic structure is defined as “the composition of production activities, the associated patterns of specialization in international trade, the technological capability of the economy, the structure of ownership of factors of production, and the nature and development of basic state institutions, and the degree of development and constraints under which certain market operates” (Ocampo et al., 2009, p7). The sustained growth in successful regions was as-

sociated with the change in economic structure in several dimensions, making economic transformation to higher productivity and increasing return to scale. The rapidly growing Asian countries showed a substantial shift in shares from primary to secondary and tertiary sector with high technological content (ibid, p38). Nepal has observed a change in structure of the economy in many fronts as follow.

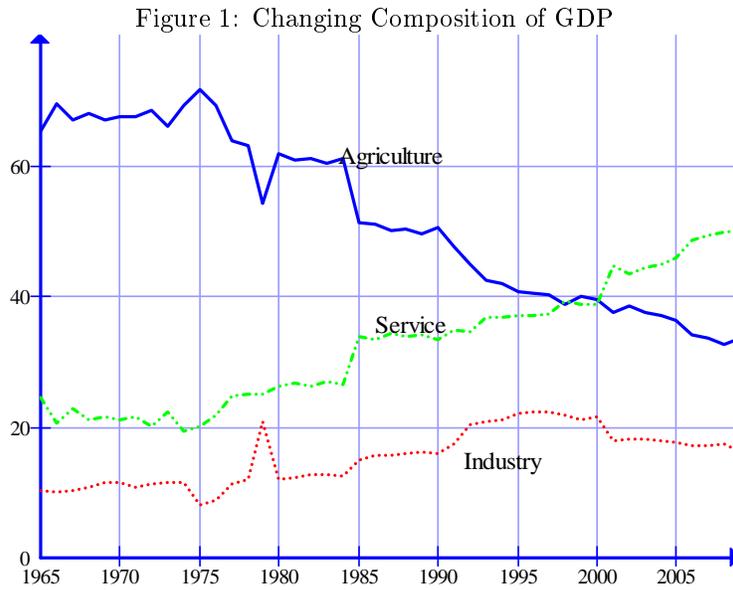
3.1 Output Structure and Per Capita Income

As in many countries, Nepal has also experienced change in structure of economy. The share of agriculture output in total GDP started to decline since the mid-1970s – from 71.6 percent in 1975 to 33.7 percent in 2008/09 – 38 percentage point decline⁷ (Figure 1). During the same time, the share of service output increased from about 20 percent to 50 percent. The contribution of industrial sector, which incorporates mining and quarrying, manufacturing; electricity, gas and water; and construction subsectors, has not increased much, just from 10 percent to 16.3 percent. Within this sector, the contribution of manufacturing sector, which can contribute to increase in productivity of the overall economy, remained just at 7.0 percent in 2009. Historically, manufacturing has almost always served as the engine for productivity growth (Ocampo et al., 2009, p9). But in Nepal, the manufacturing sector could not expand, rather its establishments are being closed, and because of unfavorable internal and external environment, capacity utilization rates for most of the major types of manufacturing units are 30–75% (ADB, 2009).

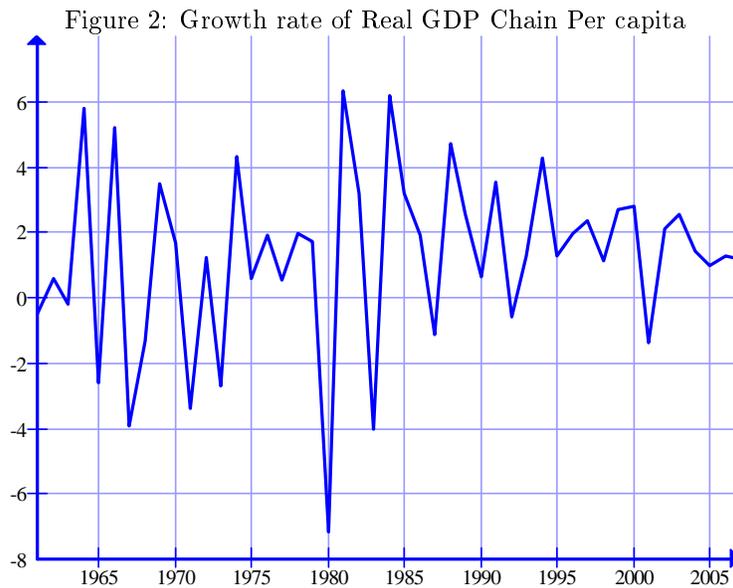
Although there is a structural shift in output production away from agriculture toward service sector, per capita income has not increased much in Nepal, as observed in many other countries as shown in Ocampo et al. (2009). During the period 1961 to 2007, the per capita real GDP grew by 1.3 percent; for the period 1965-1985, it had grown by 0.6 percent and the period after that i.e. in the neoliberal period, it increased by a slightly higher rate of 1.8 percent, but it is still lower than 2 percent that is required, as Ocampo et al. (2009) argue, to stop the widening gap with the advanced countries. Average per capita GDP growth remained not only low, but also highly volatile as seen in Figure 2.

According to the Penn World Table data (Heston et al., 2009), real GDP per capita of Nepal reached 2049 International dollar (I\$) in current Prices in 2007, increased from 230 in 1965. However, the real GDP per capita relative

⁷In Nepal, fiscal year begins from mid-July.

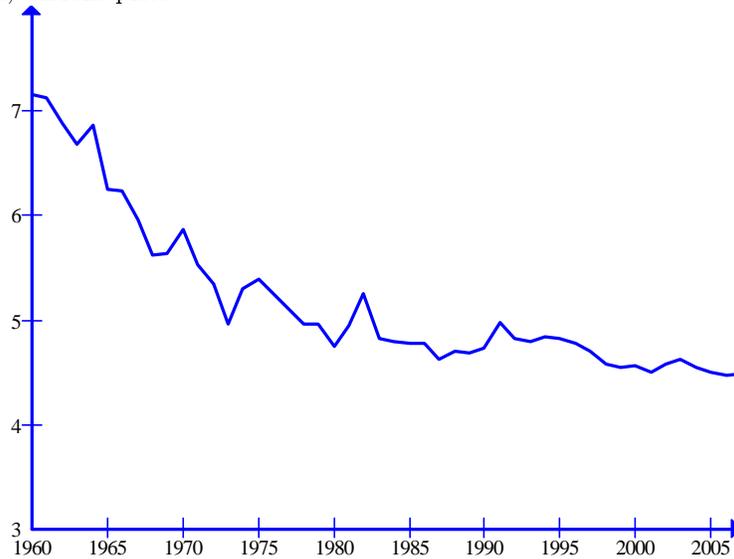


Source: Central Bureau of Statistics, Nepal (www.cbs.gov.np)



Source: Penn World Table

Figure 3: Real Gross Domestic Product per capita relative to the US , G-K method, current price

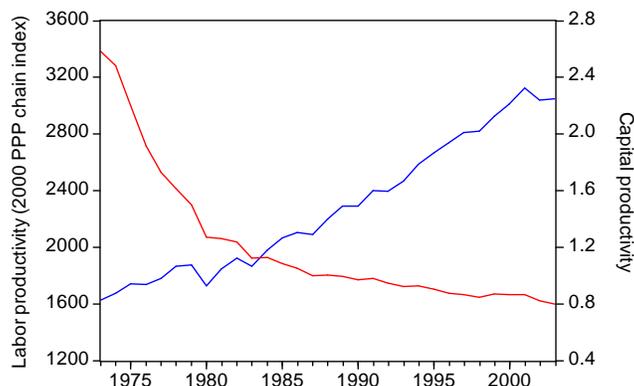


Source: Penn World Table

to the US has constantly declining (see Figure 3). Not only in terms of US per capita income, Asian Development Bank’s report (2009) shows that Nepal’s per capita gross domestic product (GDP) also remains the lowest in the South Asian region. In 2007, the per capita GDP in 2000 prices was estimated at \$243 compared with \$439 for Bangladesh, \$660 for Pakistan, \$686 for India, \$1,144 for Sri Lanka, \$1,277 for Bhutan, and \$3,668 for Maldives. ADB (2009) realizes that this lackluster economic performance has occurred despite market reforms during the 1990s and 2000s.

Between 1966 and 2009, real GDP increased on an average by 3.6 percent, while agriculture GDP by 2.0 percent, industry by 6.4 percent and service sector by 5.5 percent. If we decompose the period, real GDP had grown by 2.9 percent, agriculture GDP by 1.6 percent, industry sector by 8.3 percent and service sector by 4.9 percent during the pre-liberalization period (1965-1985). During the liberalization period, real GDP increased by 4.2 percent, and agriculture GDP by 2.3 percent which were higher than the previous period. However, industrial GDP increased by lower rate of 4.8 percent in the neo-liberal period. Service sector increased by 6.0 percent in the liberalization period which is higher than that of pre-liberalization period. In the liberalization period, agriculture

Figure 4: Labor and Capital Productivity



Source: Extended Penn World Table <http://homepage.newschool.edu/~foleyd/epwt/>

output remained almost stagnant and industrial output witnessed a deceleration. Most importantly, manufacturing sector suffered mostly with the opening up the external account because of increasing competition from cheap imported goods, with deteriorating internal investment climate.

Albeit declining, agriculture is still a dominant sector supporting almost one-third of output and two-third of employment. Its productivity growth is crucial for overall poverty reduction and for providing impetus to other sectors, but productivity increases in this sector are low, constrained by lack of access to modern technology, and low fertility of land. Removable of subsidies given to farmers in the process of liberalization has made this sector further weak and vulnerable to compete with Indian farmers. Irrigation infrastructure is very poor so that agriculture output is still highly rain fed. Nepal's irrigated area as a percentage of total arable land is one of the lowest in South Asia (ADB, 2009).

There is a dearth of data to make concrete analysis of change in productivity of different sector of the Nepalese economy over the course of reform. However, using Extended Penn World Table, for the period of 1973-2003, as in other East Asian Countries, capital productivity has been declining, while the labor productivity has been increasing (Figure 4). However, it has not been successful in generating a sustained per capita income growth because of ever rising population, but slower output growth.

On the other hand, ADB (2009) reports show that in 2006, Nepal's GDP

per worker was estimated at \$614 in 2000 terms, which was about two thirds of labor productivity in Bangladesh, one third that in India and Pakistan, and one fourth that in Bhutan and Sri Lanka.

3.2 Trade structure

Changes in the pattern of specialization in international trade are an essential part of the transformation of production structure in any economy. To be developed, a country should move its exports from raw materials to manufactured products of more technically sophisticated (Ocampo et al., 2009). Economic liberalization and globalization put more emphasis on the opening up external account to reap the benefit of comparative advantage and expedite the economic growth of any country. As I explained elsewhere, however, the economic growth in Nepal has not been satisfactory and is inadequate for reducing poverty and rising per capita income level. After the two decades of economic liberalization, trade sector has also not performed as expected; export sector has been weakening, with growing trade deficit, for example trade deficit as percentage of GDP has increased from 3.8 percent in 1965-1975 to 18.0 percent in 1996-2005 and 26.9 percent in 2009/10.

Worsening competitive capacity is also reflected in declining export/import ratio, which shows that import sustained capacity of exports has declined from almost two-third to one-sixth recently. With the opening up of the economy, it is imports, which has increased rapidly than the exports, which is also reflected in exports/GDP ratio and imports/GDP ratio. Exports/GDP ratio increased from 5.63 in 1976-1985 to 7.11 in 1986-1995, to 10.73 in 1996-2005 period, then declined to 8.44 for 2006-2009 and 5.2 percent in 2009/10 (Table 1). But, imports/GDP has constantly been increasing from 9.67 percent in 1965-1975 period to 29.35 percent in 2006-2009 period to 32.0 percent in 2009/10. Nepal has South Asia's lowest level of exports as a percentage of GDP: exports in 2007 for other countries in the region ranged from 12.1 percent of GDP for Pakistan to 23.9 percent for Sri Lanka (ADB, 2009). However, current account has turned into surplus since 2003, despite widening trade deficit, because of growing remittance inflows⁸ before becoming negative again in 2009/10 with the slowdown of remittance after the global financial crisis. Further, in the external account, out of 45 years between 1965 and 2010, BOP witnessed surplus except

⁸Because of lack of employment within the country amidst the rising labor force, people started seeking foreign employment with the opening up the economy. Hence, more than two-third labor force enter annually in the labor market go to foreign employment.

Table 1: Some External Sector Indicators (As % of GDP)

Time Period	Trade Def	Ex/Im ratio	CAC	BOP	Exports	Imports
1965-1975	-3.8	62.8		0.91	5.90	9.67
1976-1985	-9.8	38.4	-1.7	0.47	5.63	15.46
1986-1995	-14.4	32.8	-6.2	2.16	7.11	21.47
1996-2005	-18.0	37.9	-2.2	1.71	10.73	28.71
2006-2009	-20.9	28.9	2.4	3.27	8.44	29.35
2009/10	-26.9	16.1	-2.7	-0.2	5.2	32.0

Source: Various Publications of Nepal Rastra Bank and Ministry of Finance.

for nine years, initially it was due to foreign aid inflows and recently due to surplus in current account, supported by remittance inflows.

In this way, with the openness, it is leakage i.e. imports getting bigger, lowering effective demand. This has seriously been squeezing domestic employment. With the cheap imports, many nascent industries have already been wiped out and the remaining in the process of getting eroded.

Nepal's external sector has remained a quite vulnerable, which neo-liberal policies have not contributed much to change this situation. Nepal does not have any minerals to export, nor does she has goods of comparative advantage. Whatever she can export or has been exporting so far are primary products and some manufacturing products like woolen carpet and readymade garment, for which she has to compete with the big economies like India and China with other South Asian countries. Another bottleneck for trade is that Nepal is geographically landlocked country, and has to depend on India, to get the access to sea port for international trade.

India is the largest trading partner for both imports and exports for Nepal⁹. However, even in so-called neo-liberal era, being regional super-power in South Asia, India has imposed quota on the exports of some commodities from Nepal while renewing Trade and Transit Treaty in 2002. Formally and informally, India imposes tariff and non-tariff barrier on exports of goods from Nepal, handicapping the exports capacity of Nepal. These international institutions like IMF and World Bank have not done anything in this context; they only advocate the slogan of economic liberalization ignoring the ground reality.

Appendix 2 shows that there has been some shift in structure of trade in favor of low technology manufactured items. However, these items do not command competitions in the international market. As a result, Nepal's export perfor-

⁹For example, 58.7 percent of total trade was with India alone in 2009/10.

Table 2: Expansion of Deposit Taking Institutions in Nepal following the Financial Liberalization

Financial Institutions ^a	1985	1990	1995	2000	2005	2010 ^b
Commercial Banks	3	5	10	13	17	27
Development Banks	2	2	3	7	26	78
Finance Companies	0	0	30	47	60	79
Micro Finance Development Banks	0	0	4	8	11	18

a/ as of mid-July; b/as of mid-April 2010

Source: NRB (2010b)

mance has been quite low, unable to contribute enough to generate effective demand for the economy.

3.3 Financial Structure

The most important structural change occurred in the liberalization period is in financial sector. Before the liberalization process, only the government owned financial institutions were in operation, but with the liberalization process, private sector has shown great interest in this sector. Under the economic liberalization process, financial sector has expanded substantially from 2 commercial banks and 2 development banks in 1980 to 5 commercial banks and 2 development banks in 1990 to 10 commercial banks, 3 development banks, 30 finance companies and 4 microfinance development banks in 1995, which further increased to 27 commercial banks, 78 development banks, 79 finance companies, and 18 microfinance development banks as of mid-April 2010 (Table 2). It has made financial system more prone to instability¹⁰, with increasing difficulty to regulate and supervise the system because of growing inter-linkage among them.

Broad money, which includes currency in circulation, demand deposits and time deposits of commercial banks has increased from 7.1 percent of GDP in 1965 to 63.5 percent in 2009¹¹, and total assets of financial institutions has exceeded the GDP recently. Despite the financial expansion, rural areas are still out of reach of the modern financial service, only about one-third are receiving financial service from formal financial institutions. It shows that financial expansion has been heavily urban centric. The Nepalese financial system looks

¹⁰Already one development bank collapsed in 2010 and other couple of financial institutions are in the verge of collapsing.

¹¹The central bank has not produced the detailed financial survey incorporating other deposit taking institutions so far. Broad money includes only deposits of commercial banks so far.

Table 3: Some Other Macroeconomic Indicators

Time Period	Inflation	As % of GDP		
		External debt	International Reserves	Fiscal deficit
1965-1975		1.1	8.38	-0.63
1976-1985	7.5	9.9	7.77	-5.10
1986-1995	11.4	40.4	10.85	-7.45
1996-2005	5.8	49.6	17.42	-4.87
2006-2009	9.2	33.5	21.9	-4.31

Source: Economic Survey, Government of Nepal and Quarterly Economic Bulletin, Nepal Rastra Bank

like a stage II finance described in Ocampo et al. (2009), borrowing abroad is still restricted. However, inter-linkage among different financial institutions has been increasing and real sector has not been performing well so that the overall financial system seems to be more vulnerable and fragile¹².

3.4 Other Macroeconomic Situation

3.4.1 Inflation

Inflation in Nepal has remained high most of the time, but no hyperinflation so far as observed in Germany in 1923 and Latin America in the 1980s and 1990s. During the first decade of liberalization (1986-1995) average inflation stood at 11.4 percent; during that time, inflation reached as high as 21.1 percent in 1992/93. Then after, inflation slowed down to 5.8 percent for the period of 1996-2005, especially low inflation was recorded in the first half of 2000s, below 5 percent, without any inflation targeting framework¹³. However, with rise in prices of oil and food items globally in 2007 and 2008, inflation soared again to 13.2 percent in 2008/09 before sliding down to 10.5 percent in 2009/10 (NRB, 2010a). Since Nepal has been adopting more or less fixed exchange rate with India during the observation period¹⁴, inflation in Nepal is highly co-related with Indian inflation.

¹²Financial expansion has not been able to lead economic growth on account of incessant political uncertainties.

¹³Nepal has a pegged exchange rate system with Indian currency which is anchoring the monetary management. Since capital account is restricted, the NRB has been following money growth targeting monetary policy framework consistent with the pegged exchange rate.

¹⁴With the opening up the current account in 1993, Nepal officially pegged the exchange rate of Nepalese rupee with Indian currency, letting the exchange rate with other convertible currencies determined in the market. Before that, Nepal had adopted basket system since mid-1980s.

3.4.2 External Debt and International Reserves

Since capital account is still close, private sector has not been allowed to borrow abroad. Hence, external debt so far is solely of the government, mainly from the multilateral institutions like World Bank and Asian Development Bank, and some bilateral sources¹⁵. External debt was increasing immediately after the initiation of structural adjustment programs, to 49.6 percent of GDP on an average over the period 1996-2005¹⁶. Because of decreasing absorption capacity with the escalation of internal conflict and squeezing government expenditure even on needy areas like physical infrastructure in a line with a fiscal austerity measure, foreign borrowing slowed down, and finally declined to 40 percent of GDP in 2005, which further declined and as such on an average it is about one-third of GDP in recent years. It shows that Nepal is not in debt trap like Latin American and African countries, but this is heavily at the cost of low economic growth and high unemployment. Finally IMF (2010) has realized that Nepal has fiscal space to expand at the time when there is no effective government.

With the declining external debt burden, and rising remittance inflows, international reserve accumulation has been rising steadily, to one-quarter of GDP, being able to sustain ever rising imports. In 2008/09, it was sufficient to import ten months of merchandise, which has declined to 7.3 months in 2009/10 because of slow down in remittance inflows as results of adverse impact of the global financial crisis. Actually, remittance has increased to 21.8 percent of GDP as of fiscal year 2008/09, reflecting the growing dependency of the economy on remittance.

3.4.3 Fiscal deficit

During 1983-1985, there was twin deficit as advocated by mainstream, both fiscal and BOP deficits for a brief period of time; fiscal deficit reached as high as 9.6 percent of GDP in 1983; although it declined, it was still high at 8 percent in 1985, but BOP turned into surplus in 1986, which continued thereafter except in 1995, 1996, 2002 and recently in 2009/10. Fiscal deficit declined continuously to 5.3 percent in 1997, before rising to 6.1 percent following year, but then it began to decline again and recorded the lowest of 3.2 percent in 2004; then it rose slightly to above 4 percent for the period 2006-2009. IMF's fiscal aus-

¹⁵External debt of Nepal is mainly of concessional type with longer gestation period and lower interest rate, because Nepal has not borrowed from market so far.

¹⁶It was increasing until 1998.

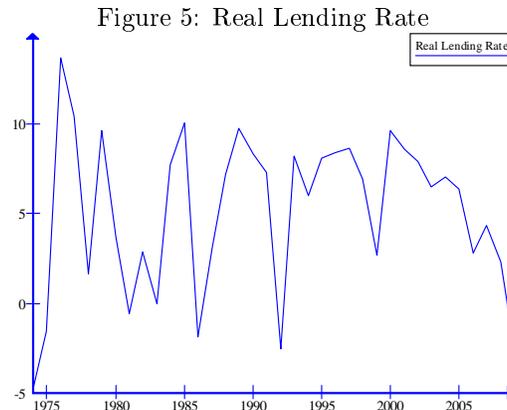
terity measure contributed to maintain fiscal deficit under control, keeping the government expenditure on about 21 percent of GDP, which is comparatively lower than in other countries. But, current account is in surplus, not due to low fiscal deficit but remittance inflows, with growing workers' demand in East Asian countries and Middle East.

3.4.4 Physical Infrastructure

Such a fiscal balance occurred at the cost of low public investment on infrastructure (Shrestha, 2009) and a little contribution to employment creation in the economy. As a result of low priority in infrastructure investment, the availability of infrastructure has remained very dismal in Nepal. Its road density is the lowest in the region, with 0.6 kilometers (km) of road per 1,000 people compared with 6.5 km in Bhutan, 4.7 km in Sri Lanka, 3.0 km in India, 1.9 km in Bangladesh, and 1.7 km in Pakistan (ADB, 2009). In Nepal, only 37 percent of households are availed with paved road within 30 minutes, while 27 percent have to travel for 3 hours or more (CBS, 2004). In 2007, nearly 57 percent of the rural population did not have year-round access to roads (ADB, 2009). Because of the poor condition of road infrastructure, the cost of exporting a container from Nepal was estimated at \$1,764 in 2008, compared to \$970 from Bangladesh, \$945 from India, and \$611 from Pakistan (ADB, 2009). Obviously, this situation discourages any private investment.

As regards the electricity development, Nepal has also remained extremely weak, despite having a tremendous potentiality. According to Nepal Living Standard Survey 2003/04, only 37 percent of the households have access to electricity in their dwellings (CBS, 2004). Nepal has been in unprecedented energy crisis for the last five years, with continuous load shedding (power-outage) of as high as 16 hours a day recently, which has been adversely impacting the economic activities in recent years. Of the feasible potentiality of 43,000 megawatts (MW), Nepal has so far utilized a mere 661 MW, i.e. just a 1.5 percent of total feasibility. The electrification rate in 2005 was 33 percent in Nepal compared to 60 percent in India's and Pakistan and 66 percent in Sri Lanka (ADB, 2009). A high economic growth is only possible with higher energy consumption.

ADB (2009) mentions that "during 1990–2007, public sector development expenditures as a percentage of GDP shrank by as much as two thirds. During that period, government spending on electricity, gas, and water as a percentage of total government expenditures declined by 58 percent; for agriculture, by 49



Source: Quarterly Economic Bulletin and Current Macroeconomic Situation, Nepal Rastra Bank

percent and for transport, by 32 percent. At the same time, investment requirements have been rising rapidly due to increasing demand and deterioration in existing infrastructure resulting from delayed and inadequate maintenance and damaged from civil war/conflict” (ADB, 2009, p6).

3.4.5 Real Interest rate and Investment

For production and employment, the real exchange rate should not be too low and the real interest rate should not be too high (Ocampo et al., 2009, p12). There is no official data about real exchange rate so that we cannot make analysis and constructing these data for the time being is beyond the scope of this paper. However, real interest rate has been computed by average (of minimum and maximum) industrial lending interest rate less inflation. This remained very volatile as shown in Figure 5 with some upward trend over all. Although in recent years, it has been declining with inflow of remittances and low investment demand because of political instability and lack of proper law and order situation.

There is no reliable data on investment. Official investment data show a higher investment rate e.g. 31.9 percent of GDP in 2008/09 which is not validated by the economic growth. This may be misleading because investment is estimated as the residual value to balance the income and expenditure account and is prone to estimation errors and statistical discrepancies as pointed out by ADB (2009). Hence, analysis on investment could not be made. However, ADB

(2009) states that Nepal's investment levels is the lowest in South Asia, which is very likely.

4 Socio-economic Situation

The persistent of unsatisfied needs, and considerable income and wealth disparity are important feature of Nepalese economy, providing a fertile ground for internal conflict and social unrest. Poverty has still persisted in Nepal because of low economic growth, inadequate social and economic infrastructure, weak social safety net and relatively high population growth. One-third of the populations are still living under the absolute poverty line as per the official data.

Despite the slower economic growth, the poverty situation showed some improvement during 1996-2004, however. The Nepal Living Standards Survey showed the ratio of population below the poverty line fell from 41.76 percent in 1995/96 to 30.85 percent in 2003/04, due mainly to the growth in the farm income, non-farm income and remittances. Out of the 11 percent decline in poverty level, remittance contributed to more than 7 percent. However, regional and ethnic disparity in poverty level is wide. Poverty incidence remains may climb further if the global recession reduces remittance flows (ADB, 2009). But, very recent official report has claimed that poverty level declined to 25.4 percent by 2008/09(NPC, 2010). However, there are some contradictions. Multidimensional poverty index (MPI) constructed by Oxford University and published in July 2010¹⁷, showed that an intensity of poverty in Nepal is as high as 64.7 percent(Alkire and Santos, 2010). Moreover, ADB (2010) also indicates that more than half the population still survives on less than \$1.25 a day in Nepal.

On the other side, income inequality has been increasing in the market based reform process. In terms of the Gini coefficient, inequality increased from 0.34 in 1995/96 to 0.41 in 2003/04 (CBS, 2004) and to 0.46 in 2008/09(NPC, 2010). This might be one of the economic reason for escalating conflict in Nepal. Moreover, there is a distributional conflict among industrialist and workers resulting in poor industrial relations during the political transition.

There is no frequent measurement of unemployment figure like inflation in Nepal. Census survey and Living Standard Survey and Labor Force Survey provide some information of unemployment. Because of heavy involvement in

¹⁷<http://www.ophi.org.uk/policy/multidimensional-poverty-index/>

agriculture including other informal sector, the full unemployment rate reported in survey is quite low. However, underemployment is quite significant as high as half of the work force. Recent official report indicates the unemployment rate of 30 percent recently (NPC, 2010). Although there is no regular publication of unemployment data as in advanced countries, facts like labor force growth of 3 percent, a large number of applications for a few advertised vacancies, and about 300 thousands workers going abroad for foreign employment annually show that unemployment is a serious issue in Nepal and it may be a root cause of political disturbance and social unrest. But, there is no serious attention paid on this matter. Because of a large number of idle youth, any political party or a small group can collect easily enough number of unemployed youths to make demonstration on their political demand.

Downsizing the government by retiring the civil staff and no new hiring under the public reform program have aggravated the unemployment issue from the very beginning of the reform process. Downsizing of government and almost defunct public enterprises have created a situation in which getting job inside the country is highly elusive. Annually, 400 thousand people enter into the labor market, two-third of them have been going for foreign employment, and remaining are either unemployed or underemployed, large enough for creating social chaos and disturbance in the name of politics. Then, the continuous act of disturbances, strikes, closures and blockade by frustrated unemployed people has made the implementation of whatever policies and programs difficult in reality.

As a result of political instability and conflict due to failed promise of economic liberalization and structural adjustment programs, Nepal witnessed a decade long armed internal conflict over the period 1996-2006, when more than fourteen thousands people were killed. Even after the Comprehensive peace deal in 2006, political issues have not been settled logically yet. "Crime and insecurity; political and criminal extortion from private business; strikes and road blocks; and trade union militancy" (ADB, 2009, p4) are part of daily affair in recent time, which has severely been affecting investment climate. The government has been so weak so that it has been unable to maintain law and order. Governance indicator has been very poor in all aspects(ADB, 2009). Actually, there is both market and government failure in Nepal. As a result, economic development and prosperity in Nepal is seemed to be a dream of far distant in future.

5 Conclusion

In the preliminary stage of development, the government should be instrumental in bringing the economy into the development path. Although the state can fail in many dimensions, but as Polanyi (1944) emphasized, the state is the central economic actor¹⁸. Historically, the state has played a crucial role¹⁹. However, structural adjustment programs by the IMF and World Bank based on the Washington Consensus minimized the role of the government in favor of market. Rather than strengthening the government and social institutions, these policies weakened the capacity of government, thereby creating a fertile ground for conflict in Nepal. Hence, Nepal is still on the way of finding the appropriate government system in the 21st century. The governance system has deteriorated in the neo-liberal period, with a systematic attempt to narrow the policy space by the structural reform programs, bypassing the role of strong and effective government needed to facilitate the market mechanism. The liberalization process has tied the hand of the government and a frequent interference by IMF and World Bank, in conjunction to other donors has made the government officials passive to craft and implement policy of their own needs.

Under the Washington consensus, macro policies were made center on reducing inflation and external deficit at the cost of employment and growth; or achievement of stabilized stagnation as mentioned by Taylor (1993). In Nepal, hence, despite external and internal balance, economic growth has remained dismal to increase per capita income to raise the living standard of people, in spite of the structural change that the economy has witnessed with declining contribution of agriculture sector. Trade liberalization has not been effective for industrialization and export promotion for driving economic development, so has been the financial liberalization for private investment. Rather, Nepal has been suffering from widespread poverty, unemployment and inequality, resulting in social and political unrest. Actually, the government should be strong and effective and devise industrial policy strategy to promote entrepreneurship to induce Schumpeterian innovation for economic growth and should also be involved actively in the construction of physical infrastructure, necessary for economic development. Without the expansion of manufacturing sector and

¹⁸Actually “the road to the free market in Western Europe was opened and kept open by an enormous increase in continuous, centrally organized and controlled interventionism” (Polanyi, 1944, p140).

¹⁹For example, in the nineteenth century, there were enormous public subsidies to support investment in canals and railroad and the highest tariffs in the world to protect industry (Ocampo et al. 2009, p11)

increasing productivity, a sustained per capita income growth is not possible; and employment creation requires effective demand in the economy from higher investment, productive government expenditure and exports growth.

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Appendix 1

A Brief Account of Nepalese Political System

After the fall of family based autocratic regime in 1951, some sort of democratic system was observed between 1951 and 1961. But the late King Mahendra first banned the political parties in 1961 and introduced party less 'Panchyat' system'. His son King Birendra continued the system after the death of his father in January 1972 until 1990, when he accepted the people's pressure and agreed to the system of constitutional monarchy with party system. Under this system, the first election was held in 1991. The elected majority government followed the economic liberalization policy blindly, believing that market would solve all economic problems and began to face criticism outside and within the party. However within three years, political instability began, because of internal conflict within the party, the then Prime Minister announced mid-term election. But, no party got a majority to form government in this election. Attempts to make coalition government in combinations of different parties began, but did not last long, so frequent change in government has become a political norm in Nepal.

On the background of a frequent government changes ignoring people's aspiration for development, radical leftist party, the Nepal Communist Party (Maoist), got a chance to encash dissatisfaction of people and started guerilla war in rural areas aiming at ousting monarch and replacing existing system by People's Republic, which ignited a decade long armed conflict that lasted until 2006, killing more than 13000 people and damaged existing physical infrastructure. In the meantime, royal massacre occurred in 2001, killing the king Birendra and his whole family, which helped further to make the political system volatile and people lost their faith on monarchy. His brother, King Gyanendra, a successor king, took direct power in February 2005 by dissolving the then parliament and declared emergency to defeat Maoists, which turned into counterproductive. Maoist rebels and main opposition political parties made an alliance to restore democracy. After a few weeks of violent strikes and protests against direct royal rule in 2006 (April), King Gyanendra agreed to reinstate the already dissolved parliament, after which a series of historically significant events happened rapidly.

In May 2006, the restated Parliament voted unanimously to curtail the king's political powers, and the government and Maoist rebels began peace talks. In

November 2006, the government and Maoists signed a comprehensive peace accord, declaring a formal end to a 10-year rebel insurgency. Then, the rebels joined in a transitional government in January 2007 and placed their weapons under UN supervision. In the meantime, violent ethnic protests erupted in the south-east Nepal demanding the autonomy for the region. In December 2007, the Parliament approved the abolition of monarchy as a part of peace deal with Maoists.

In April 2008, the election for Constituent Assembly was held as part of agreement, in which former Maoist rebels won the largest number of seats, but fail to get an outright majority. Then in May 2008, the newly elected Constituent Assembly declared Nepal as a republic country by abolishing the 250-year old monarchical system formally. In July 2008, after two months after the departure of King Gyanendra, the Constituent Assembly elected the first president of Nepal. Now, the Constituent Assembly is mandated to draft the new constitutions to make Nepal, a country of federal states. However, there are different views among political parties on designing federal states. After the election for Constituent Assembly, political parties are now basically bickering on forming the government, keeping aside the main agenda of making constitution. The first government after the election headed by the then rebel party just lasted for nine months. Then, the third largest party has been heading the government since May 2009, while the Maoist party is now in opposition. Although the new constitution should be ready within two years of the election by May 2010, it did not happen. Now, the expiration time of constitutional assembly has been extended to additional one year until May 2011. As a precondition set by Maoist party for extending life of constitutional assembly, incumbent Prime Minister resigned in June 2010. However, because of lack of political understanding among parties, the constitutional assembly, which is also acting as an interim parliament has been failing to elect another Prime Minister even after 12th round of election (4 months) so far. Hence, the politics is still in limbo in Nepal, dragging behind the economic development process.

Appendix 2

Structure of Exports

	Food and Live Animal	Tobacco and Beverage	Crude Materials	Mineral. Fuels and Lubricant	Oil and Fat	Chemical and Drugs	Manufactured goods	Machinery and Transport equipment	Mis. manufactured items	Not classified
1975-1985	42.4	0.7	29.8	0.1	1.8	0.3	18.0	0.5	6.3	0.3
1986-1995	14.9	0.1	6.8	0.0	2.0	0.5	48.4	0.2	27.2	0.0
1996-2005	10.7	0.1	1.8	0.0	7.4	6.6	41.2	0.5	31.6	0.0
2006-2009	18.6	0.2	2.3	0.0	4.8	5.6	47.7	1.6	19.2	0.0

Source: Quarterly Economic Bulletin, NRB (2010)