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NEPAL RASTRA BANK

The Editorial Board, Economic Review: Occasional Paper (ISSN 1608-6627), has the pleasure of placing this sixteenth issue of the Review, incorporating the different contemporary issues of the economy, on the occasion of the forty-nine anniversary of the Nepal Rastra Bank (NRB).

The Editorial Board expects applications of quantitative, econometric, and analytical tools and techniques as developed by the authors of the articles to draw on conclusions and suggestions to be most useful to the readers. The issue, as in the past, has incorporated analytical articles from the staff of the NRB and professionals from outside the NRB.

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Those interested in contributing to the Review analytical articles on any pertinent subject of the economy such as money, banking and finance, trade and balance of payments, government finance, broad-based and sustained economic growth, socio-economic development, poverty reduction, etc. are requested to submit the articles for publication in the forthcoming issues of the Review. Any comments queries, suggestions, and correspondence should be directed to:

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Nepalese Capital Market: Issues and Challenges

Prof. Parashar Koirala*
Prof. Pushkar Bajracharya**

Establishment of the Nepal Stock Exchange (NEPSE) market opened an avenue to investors, both large and small, to invest in the enterprise sector and participate in the secondary market. Despite apprehensions of many, the secondary market proved to be successful, with both the entrepreneurs and the investors showing earnest acceptance and participation in the process. However, the performance of stock exchange during the latter years gives only a mixed result. The enthusiasm did not last long as, after 2000/01, both the size and trend began to shrink. The NEPSE index came down to 204 in 2002/03 from a peak of 360 in 1999/00. The transaction volume came down to about Rs 575 million in 2002/03 compared to Rs 2344 million in 2000/01. This scenario, despite increasing number of listed securities and scrips, is not a favourable situation. Generally, the problem is attributed to the prevailing politico- economic situation. No doubt, it is true to a large extent but the problem is not confined to the present situation alone. The management of the companies and the attitude of the board of directors and intermediaries are to blame a lot. The actors of financial markets are loosely tied together from legal provisions, which are not effectively implemented. As the financial institutions predominate the market, it has not been able to diversify. Increasing problems noted with the corporate governance, transparency and disclosure have seriously dented the Nepalese capital market. The Board mainly acts as a superfluous body trying to fulfill formalities rather than seriously attending to corporate governance. The result has been poor security to investors, particularly minority shareholders, who are not fully aware of the risk and return considerations. Hence, to make the stock exchange a vehicle of growth, initiatives must be taken to protect investors, improve corporate governance and make the companies operate in a conducive and transparent manner.

INTRODUCTION

The establishment and operation of the stock exchange market has opened door to small investors otherwise limited by prevailing opportunities and inability to

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assemble diverse sources. The only probable option left for them was bank deposits. Thus, enterprising and venturesome small investors were deprived of opportunities to invest. However, the establishment of the securities market in Nepal in 1985 and Nepal Stock Exchange Market in 1994, has opened an avenue to them. The Securities Exchange Board (SEBO) is operating since 1993. However, to what extent, their interest is being given attention has remained an issue of concern in Nepal.

Security market is a place where buying and selling of securities takes place in an organized way. The parties involved in security market are investors, intermediaries and specialists. Investors who are willing to buy or sell securities quickly may be searching good offers or accepting poor offers with higher risk and of higher return. Securities markets provide options to all categories of investors and make the financial market most competitive in developing countries. The position of liquidity and profitability and the degree of risk embodied on it are indicators taken into consideration while selecting the best options for investment. Intermediaries take temporary positions of securities during a time period in between a flow of buy orders and a flow of sales order and make earning from the variations in supply and demand positions. Commission for security transaction is the another source of income of intermediary.

At present, it has 40 members/ intermediaries comprising of stockbrokers (27), issue and sales managers (10), security dealers (2) and market maker (1). In the security market, investors are termed as customers and customers may be individuals, firms, companies and organized institutions. Members start their work by taking orders from the customers for buying and selling their securities. Customers make agreement with issue manager, security dealer and market maker for underwriting and issue management of shares and against that they take service charge from customers. Stockbroker is a security businessperson who deals on behalf of the investors in buying and selling of securities of a listed company. Issue manager is a security businessperson who carries out functions relating to public issue of securities on behalf of the issuing company in the primary market.

Security dealer is a security businessperson who buys securities in his name at the primary market and sells them from secondary market (stock exchange) either in his own name, or on behalf of customers' name through stockbrokers. Market maker is a security businessperson who deals with bonds issued by the government or bonds issued as per the guarantee made by the government. It carries out functions relating to public issue of mutual fund, unit fund and buying and selling of equity shares in his own name of at least three organized institutions with the objectives of providing liquidity for them.

MARKET PLAYERS

Degree of risk to the stockbroker and issue manager is lower than the security dealer and market maker in dealing securities transaction. It is because the stockbroker buys and sells securities and earns commission on return and in the case of getting down the market price of share during the intermediary period he loses goodwill and a small amount of commission. The issue manager, on the other hand, deals securities in primary market where the degree of risk is comparatively lower and earns its commission. To him buying securities from the primary market in his name and selling them in secondary market through stockbroker is riskier business than mentioned before. Considering issue manager's business as a long-term liability to the company, no transaction was carried out in 2001/02. Organized institutions working as a market makers do not working in Nepal. One, which was registered and renewed before did not get renewed in 2001/02. It is all because of the weaknesses in the market position. The actors of the financial market are loosely tied together from legal provisions and their effective implementation. For effective market operation, legal rules pertaining to it should be made effective.

Legal system of securities operating in Nepal falls under following Acts, Regulations, Bye-law and guidelines:

Securities Exchange Act, 1983;
Securities Exchange Regulation, 1993;
Membership of Stock Exchange and Transaction Bye-Law, 1998;
Securities Listing Bye-Law, 1996;
Issue Management Guidelines, 1997;
Securities Allotment Guidelines, 1994;
Securities Registration and Issue Approval Guidelines, 2000;
Guidelines on Business Code of Ethics for Securities Brokers, 2001;
Bonus Share Issue Guidelines, 2001.

Improvements in corporate governance that is the inherent rights of shareholders and the mechanisms of exercising such rights promote development of the capital markets. Corporate governance deals with the market for corporate control. In order to improve the corporate governance in the concerned companies, following regulatory measures are in operation in Nepal.

Company Act 1997;
Insurance Act 1992;
Bank and Financial Institution Ordinance, 2004;
Foreign Exchange (regulation) Act 1962;
Foreign Investment and Technology Transfer Act 1992 .

Domestic firm plays a leading role to develop viable atmosphere for capital market transaction in the domestic market. A firm with good governance can attract the attention of foreign investors towards stock market and the small investors get opportunity to participate in the corporate sector. Heavy investment to only one firm is not an ideal principle of fund management. It bears a higher degree of risk. Diversification of funds in different firms with good governance reduces the risk of capital loss and improves the liquidity position of the firms. To a developing country, capital market is a best means of attracting foreign investment and that begins with the good governance of a firm. Corporate law of international standard and its effective implementation lead to good governance provided that the legal rules (tax laws and other domestic regulations) and institutional constraints like financial structure and ownership structure should not be much typical from other nations. This should be the area of primary focus not only to improve NEPSE but the economy as a whole.

PERFORMANCE OF THE NEPAL STOCK EXCHANGE

Before the establishment of NEPSE, the volume of market activity was very low though it tended to spurt at the latter period. Turnover rose from Rs 2 million in1984/85 to Rs 800 million by 1993 and it became more rapid with the commencement of NEPSE as market promotion and easier access permitted a significantly greater number of players to enter the market. The stock market became highly buoyant and turnover increased manifold as many investors, both small and big, tried to cash on this new opportunity not only with a hope to maximize benefits but also speculated on the possible capital gains in the investments. The initial spurt in NEPSE activity lasted for a little more than six months guided by spectacularly good results in a few companies, particularly in the banking sector, where some companies were paying out dividends well in excess of 50 percent. The stock market performance thus, during the initial phase, far surpassed the modest goals aimed at by the eighth plan (1992-97), which laid the foundation for NEPSE with its first policy outline.

The initial spurt did not last long nay less than a year, once it was apparent that capital gains and returns need not be consistently high across the board and the public became disillusioned and resultantly the market and prices and trading volume all declined. The situation worsened from 1995/96 onwards with the onset of political instability. Both the investment climate as well as the operational climate suffered leading to poorer results in many companies. As a result, the price at NEPSE *nose-dived* and it incurred heavy losses. The worse period was 1997 to 1998, after which the situation improved somewhat with the commencement of operations by many finance companies, which paid out dividends. The improvement, however, was only marginal just to keep enough attentions. The economic and political scenario became more volatile with the rise in insurgency which led to slowing down of economic activities resulting at worsening performance in many sectors like tourism and manufacturing, thus, leading to a more volatile and vulnerable NEPSE. The recent cease-fire does not appear so far to be able to generate enough resurgence of activities and accordingly has not helped to improve neither the index nor the trading volume. As a result, the market has never been particularly vibrant nor particularly liquid.

Some of the important performance indicators of NEPSE in the period 1999/00 to 2002/03 are presented in Appendix. It shows that the turnover volume is fluctuating. It more than doubled in 2000/01 but again recorded a sharp decline in 2001/02 with the turnover reaching Rs 1540.6 million in a total volume of 6095 thousand scrips turnover. The improvement in market operation days has not helped to improve turnover. One of the most notable features of NEPSE is the preponderance of trade in banking and financial institution scrips**.** It accounted for over around 90 percent of total turnover meaning that the scope and volume of turnover of other sectors is nominal at best. It is, however, notable that the share of banks is declining and that of others increasing. In 2002/03, the share of banks came down to only about 62 percent. But including the insurance and finance companies, the proportion is still around 96 percent or the financial sector still overwhelmingly dominates the market. Hotel industry almost accounted for 9.0 percent in 2001/02 but came down to 1.1 percent in 2002/03, other sectors hardly made any presence. The number of companies traded has remained constant more or less at 69 and the growth in number of listings has also been only marginal. The number of listed securities, however, is growing at around 8.5 percent per annum. In terms of listed securities, a little over half (54.2 percent in 2001/02) belonged to banking and financial institutions and just under 30.0 percent belonged to manufacturing sector. These proportions, however, are not reflected in trading making NEPSE one sector ie. financial sector predominating. Just to make a point, the top ten traded companies in 2000/01 all belonged to the financial sector with nine banks and one financial company. Decline in market capitalization does not indicate that the health of NEPSE is sound and it is highly pertinent to enquire into the reasons for this situation. The annual turnover rate of equity shares in Nepal varies from less than 1.5 percent in 1997/98 to 8.13 percent in 1994/95.The present article tries to make an assessment in this respect.

Table 1. Nepal Stock Exchange- Basic Information,

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03
No. of Listed Companies	79	89	95	101	107	110	115	96	108
Market Capitalization (in Rs)	12963	12295	12698	14289	23508	43123.3	46349.3	34703.9	35240.4
Trading Value(in Rs)	1054.3	215.6	416.2	202.6	1500.0	1157.0	2344.2	1540.6	575.8
Turnover Ratio	6.9	2.2	2.3	2.0	6.9	5.1			
Local Index	206.6	-	170.9	175.5	262.5	488.0	322.1	227.5	204.86
NPSE Index	5.8	-	-	2.7	49.6	85.9	-34.0	-29.4	NA
Change in index(%)	23.2	10.2	8.5	8.0	18.28	27.55	NA	NA	NA
P/E ratio	534.6	34.9	1.2	1.6	2.38	0.123	NA	NA	NA
P/BV ratio	3.6	5.6	6.2	3.9	3.71	3.1	NA	NA	NA
Dividend Yield %									

Source: Emerging Market Fact Book, 2000&2001- International Finance Corporation

Quoted in World Bank (2000), Nepal Financial Sector Study and SEBO Annual Report 2001/02 and SEBO, 2002/03

Table 1 shows some of the critical areas of NEPSE performance. It presents scenario from the commencement of NEPSE in 1993/94 to 2002/03. Market capitalization remained more or less stagnant up to 1997/98 with the capitalization of around Rs. 14.3 billion. This grew rapidly in 1999/00 and 2000/01 reaching a height of Rs. 46.3 billion in 2000/01 with the entry of new banks, and finance companies as well as rise in NEPSE index. The fall in NEPSE index could not sustain this growth recording a fall at market capitalization level reaching Rs 34.7 billion in 20001/02. In terms of trading volume, it reached the peak in 2000/01 with a total volume of Rs 2.3 billion, which declined continuously thereafter reaching only 0.6 billion in 2002/03. Trading volume and value in NEPSE are still low compared to the regional markets.

Market capitalization, in emerging market nations comes to 20-40 percent of GNP and it is 55-110 percent of GNP in developed markets. In case of Nepal, market capitalization varies from 5-11 percent of GNP. Table 1 shows market capitalization growth from less than Rs. 12300 million in 1995/96 to Rs. 46349 million in 2000/01 and fell down to Rs.34704 million due to political instability. No doubt, it shows a small size of equity market. The average market capitalization per firm is far smaller in Nepal (Rs. 483 million) compared to emerging markets ($117 million) and to developed markets ($1.4 billion).

One landmark decision is the decision though belatedly to de-list 26 companies inclusive of 15 trading, 10 manufacturing and one from other category. Rights of shareholders do not appear to be attended whole de-listing companies. It also proves the volatility of the manufacturing and trading sectors in Nepal.

MARKET TRANSACTION

Banks and financial institutions are predominating over others in stock market transaction. Of the total 96 listed companies, about 52 companies appeared in stock exchange transaction and most of them had transaction once or twice a year. Those with higher frequency of stock exchange transactions are about ten commercial banks. In terms of ownership, one is a semi-government bank and others are private banks. Share transaction, in principle, seeks to have a presence of buyers and sellers. In the absence of one party, there is no share transaction. In Nepal stock exchange, buyers are found not willing to purchase shares other than those of banks. Because, they have the knowledge of those buyers who have lost years ago a lot of money from buying shares of the manufacturing companies. Some loss-making manufacturing companies are still alive. Though they have been listed in Nepal stock exchange, they have no confidence in the market. Some other listed companies such as hotels and trading sectors are not eye catching to the buyers and their shares have no market demand. Some manufacturing companies have been liquidated. In liquidating the companies, minority shareholders' rights have not been protected. They have been treated as equal to majority shareholders of the company, because the Company Act 1997 has no provision for minority shareholders. Banking sector, in the eye of buyers, looks safest for the stock exchange followed by finance companies and other financial institutions in Nepal. It is not only the profit that has attracted the buyers, it is the capital gains, that arises within a short period of time, is taken into account while making a buying decision. It is because, some buyers have no access to the audited financial report and records of concerning companies. In the absence of transparent books of accounts, the threat of company liquidation remains in the mind of buyers. There is no report of bank liquidation in Nepal. Following table 2 shows the profit and loss situation of the companies in different sectors

Table. 2

Sector	2000/01			2001/02		
	Total Number	Profit Making	Loss Making	Total	Profit	Loss
Bank	12	10	-	12	11	1
Finance Company	30	28	-	29	26	3
Insurance Company	11	9	-	6	6	-
Hotel	4	2	-	4	-	4
Manufact. Company	28	7	7	13	9	4
Trading Company	8	3	-	3	3	-
Other	3	2	1	-	-	-

Source: SEBO, Nepal, Annual Report, Fiscal Year, 2002/03.

Table 2 shows that the manufacturing companies were the most loss making institutions in Nepal in 2000/01. In 2002/03, all hotels listed with NEPSE incurred losses due to unfavourable impact of the prevailing situation of the country on tourism. Economic reforms initiated since early nineties and political instability since the mid-nineties have seriously affected the manufacturing sector leading to poor performance. However, it needs to be mentioned that only a very small proportion of manufacturing, trading and hospitality sectors are listed with NEPSE. More importantly, services sector, which has shown tremendous growth after economic reforms, have hardly been listed except a few hotel and airline companies (both in the hospitality sector). The most affected are the manufacturing companies followed by trading and hospitality companies. Banks and finance companies, as compared to others are in better position. They look less affected then the performance of manufacturing and hotel companies. All banks made money except Nepal Bank Ltd. and in 2001/02, 3 finance companies also reported losses indicating that the golden era may be over in the finance sector except for strongly managed and robust companies. Investors not willing to buy shares of the profit making manufacturing and hospitality companies in the secondary market is the indication of confidence crisis with them and on their disclosed financial performance. Data relating to financial performance of the listed companies disseminated by the Securities Board are not sufficient to make a marketing decision. It should come in terms of financial statement analysis of each company such as detailed financial analysis. The management 'guru' Peter Drucker has different opinion on the correlation between the profitability and the respective value of the sock market. According to him the stock market increasingly values companies according to their liquidity rather than by their earnings. The quotations on every major stock exchange- New York and London, Zurich, Tokyo, and Frankfurt- correlate quite closely with cash flow and liquidity, and very poorly, if at all, with the inflation-distorted earning figures (Drunker, 2003: 13). Liquidity refers to the ability of investors to convert securities into cash at a price that is similar to the price of the previous trade. It can be measured in terms of the size of spread between the bid and asked price, smaller spreads correspond to greater liquidity of securities. Liquid securities possess the risk of holding by the investors and reduce the frequency in transaction.

It is further said that securities' holding percentage increases as the investors have little knowledge on risk and return of securities available in the secondary market. Most of the minority shareholders in Nepal hold the securities and have faced heavy losses by the declining position of the concerned companies. There is no provision made so far about to protect the interest of the minority shareholders in Nepal. Securities transaction in Nepal is made for ownership shares/common stock not for bonds and debentures. Those investors holding bonds and debentures keep concern with liquidity position of the concerned companies whereas the investors of ownership securities have to take interest on profitability position of the concerning companies. Both liquidity and profitability positions of the companies do not make any difference to the investors since the profit of the company is calculated on cash basis not on accrual basis. The corporate sector in Nepal is not transparent that is necessary for smooth operation of a stock exchange.

EQUITY MARKET CAPITALIZATION

Equity market capitalization, in the emerging market nations comes to 20-40 percent of GNP and it is 55-110 percent of GNP in developed markets (Maturing markets, IFC, 2002). In case of Nepal, equity market capitalization varies from 5-11 percent of GNP (see figure 1). Table 1 shows equity market capitalization grew from less than Rs 12300 million in 1995/96 to Rs 46349 million in 2000/01 and fell down to Rs 34704 million in 2001/02 due to acute disturbance caused by insurgency in the country though it marginally recovered in 2002/03. No doubt, it is a small size of equity market. The average market capitalization per firm is far smaller in Nepal (Rs 483 million) as compared to emerging markets ($117 million) and to developed markets ($ 1.4 billion).

Table 3 provides comparative stock exchange information for the six main stock exchanges of the South Asian Region. The comparative data is for 2000. India was by far the largest as to be expected with almost 5937 listed companies and a market capitalization in that year of $148 billion. Trading value in India was $49.4 billion. By contrast in Nepal, there were only 110 companies listed with a market capitalization of $800 million in 2001, and a total trading value of only $31.7 million. Pakistan, Sri Lanka, and Bangladesh range in between the Indian and Nepali stock exchanges in terms of relative size. Pakistan, the region's second largest stock exchange has 762 companies listed (13 percent of what India does); a market capitalization of $ 6.6 billion (4.4 percent of India); and a trading value of $1.2 billion (2.4 percent of India). Meanwhile, Bangladesh, which has the third largest stock exchange, has 211 companies listed (twice as many as Nepal); a market capitalization of $1186 million (fifty percent higher than that of Nepal); and a turnover of $768 million (more than 24 times that of Nepal). With only 13 listed companies (12 percent of what Nepal has and less than a quarter of a percent of what India has), a market capitalization of $38.0million (around 5 percent of

Nepal's) and a trading value of $3.5 million in 1999, Bhutan has the smallest exchange in the South Asian region (World Bank, 2002). Compared to Bangladesh, market capitalization is not low in Nepal in proportionate terms but in turnover terms it is miniscule, meaning that the scrips coming into the secondary market is very low probably belonging to minority shareholders only. It indicates that only through wider ownership turnover can be improved.

Table 3. Comparative Table- South Asian Stock Exchanges- Basic information, 2000 (currency in million)

	India (BSE)	Pakistan	Sri Lanka	Bangladesh	Bhutan	Nepal
No. of Listed Companies	5937	762	239	221	13	110
Market Capitalization (in US$)	148064	6581	1074	1186	38.3	799.8
Trading Value (in US$)	49,403	1184	5.2	768	3.5	31.7
Turnover ratio	33.2	19.0	0.5	74.4	9.2	5.1
Local Index	912.8	1507.6	698.5	642.7	-	488.0
Change in index (%)	-0.9	18.1	5.3	31.8	-	85.9
P/E ratio	16.8	-117.4	5.2	12.4	-	27.55
P/BV Ratio	2.6	1.4	0.7	1.8	-	0.123
Dividend Yield (%)	1.5	6.2	8.0	5.2	-	3.1
Economic Data						
Gross Domestic Product (us $)	479404	61673	16402	47864	440	5450
Change in CPI (%)	3.8	3.6	6.2	3.6	9.2	3.4
Exchange Rate (period average)	44.9344	53.9257	70.7055	52.1656	42.9850	71.0940

Data pertaining to 1998.

Source: International Finance Corporation, Emerging Stock Markets Fact book, 2000 & 2001 quoted in the World Bank 2002, Nepal Finance Sector Study.

The annual turnover rate of equity shares in Nepal varies from less than 1.5 percent in 1997/98 to 8.13 percent in 1994/95 during nine years period since 1993/94. These data suggest more liquidity risks in equity share market of Nepal, because higher volume of trading tends to reduce liquidity risks and trading costs.

LISTING OF SECURITIES

In Nepal, the company willing to sell its securities to the general public shall have to get listed with Nepal Stock Exchange. Documents needed and points to be explained to apply for listing are company objectives, ownership structure, memorandum of association, articles of association and audited balance sheets and profit and loss accounts and annual reports for the last three consecutive years to the Nepal Stock Exchange. Some documents like audited financial statements and annual reports are mandatory to furnish to Nepal Stock Exchange at the end of each year in order to renew the listed company. There are altogether 96 listed companies, in which 7 companies have renewed their licenses by submitting their respective annual reports only and one out of them has submitted financial statement within a scheduled time. To those submitting a year later are 88 in number in which five companies have submitted financial statements and the rest of other have submitted annual reports only. It is an example of a very weak regulatory discipline in the stock market of Nepal. Because, annual report is not taken as a statutory statement and it is not audited document too. Thus, the degree of manipulation can not be underestimated due to the non-audited reports. Since the audited financial statements are not accessible to Nepal Stock Exchange, there is no possibility for small investors to reach them. It is because those statements are not submitted to Nepal Stock Exchange and are to be accessible to minority shareholders. In the absence of transparency in financial and non-financial information, stock market cannot be expected to perform and grow. Regulatory discipline decides the demarcation for market players and in a weak regulatory measure, there is a least possibility of adopting market discipline by market players. Weak listing requirements mean that almost any company can be listed on the exchange merely by providing some accounting information. The NEPSE should enforce much more vigorous listing standards so that only good name institutions with financial information audited to international standards, are listed on the Stock Exchange. Any company found to be in contravention of new, more stringent, listing requirements, should be warned and ultimately de-listed from the exchange if they do not comply (World Bank, 2002.). The recent de-listing of 26 companies is expected to some extent to rectify the process. Institutions like Provident Fund Corporation can be an important player in the market. At the present time, Provident funds are restricted to investing only in the capital of banks and financial companies. This explains, in part, the relative better performance in the share market of these types of institutions. In most, well-developed markets, the funding held by these institutions forms a major part of an economy's investible long –term resources, and they are thus important players in the stock exchange. Permitting these institutions to invest in an improved stock exchange- where listing requirements were significantly tightened, account standards were at international levels, and adequate corporate governance was ensured- would have a potentially powerful positive impact upon the development of capital market activities. However, these pension funds should not be permitted to invest in an extended range of securities prior to the above changes being made. As these funds represent the future pension benefits of many, often poorer, workers- they should not be put at risk in the current lax environment (World Bank, 2000). In improved environment, however, these agencies should be allowed to play a major role thus creating a foundation for institutional growth and in return national economy as a whole.

OWNERSHIP STRUCTURE AND CORPORATE GOVERNANCE

Nepalese business ownership is concentrated in a few hands. In the tradition of many South Asian Companies, many firms in Nepal are family-owned and operated. Often inexperienced family members operate as managers, accountants, and hold other senior management positions. It is said that ten largest companies and business houses control the industry and trade sector in Nepal. Their involvement is found in trading, agriculture production, real estate business, and in stock exchange activities too. Their participation in financial sector is slowly increasing. Same businesspersons possess ownership in commercial banks as well as in different types of business and industrial activities. It is, therefore, made mandatory for newly incorporated organized institutions to issue ownership shares of 15 per cent at the minimum to 25 per cent of the paid up capital and sell them through primary market on public notice to the general public. To the bank and financial institutions, the amount of issue should be 25 per cent to 30 per cent. Through these legal provisions, it aims to represent at least one board member from minority shareholders. As per the Company Act 1997, number of members representing shareholders to the Board of Directors may range from 3 to 11 persons depending upon the size and nature of the company, but in practice, 5, 7, and 9 are the odd number selected for a composition of the board. Board directors, in great number, are non-executives among which one is made Executive Director who works as a member- secretary in the board meeting. By regulation, one can be an executive chairperson in place of executive director. Changing a hierarchy of authority for executive power is made by ad-hoc decision mainly in the interest of major shareholders in most of the organizations. So board members have to support major shareholders than to be accountable to shareholders and to the company. According to the Organization for Economic Co-operation and Development (OECD), accountability to shareholders means that an equal treatment of majority and minority shareholders and accountability to the company means that directors must ensure that the company complies with existing laws and regulations, such as tax, labor, health and safety laws, environmental legislation, and company laws (Fremond and Capaul, 2002). Business sector in Nepal is slowly realizing the importance of professional managers but their work style is still not getting free from traditional business culture that is the domination from the ownership rather than to listen to the professionals. This has also forced them to hold on to scrips thus limiting the volume to be operated at the secondary market.

Board of Directors is a composition of directors selected from different sources such as from the majority shareholders, from among the promoters by election under the support of majority shareholders, and from among the minority shareholders by election in the annual general meeting. Without the backing and support of majority shareholders, none of the contestants have chance of being represented on the board. The minority shareholder representing on boards, at present, is very close to the major shareholders and thus cannot go against the interest of them. A proxy voting is acceptable in election and a majority shareholder can transfer his votes which are over and above a limit requiring to win the election to a contestant representing the minority shareholders. The companies, as such, tend to follow a “parliamentarian model” of board representation, but majority shareholders exercise significant influence over boards directly as board members or indirectly through the appointment of board members who report to them. Disclosure of business relation and other personal interest with the company in which one becomes board member is mandatory since a new member joins the board meeting. Nepalese Company Act 1997 is not specific on the right and responsibility of the Board of Directors. It is left to the annual general meeting (AGM) which has to make decision on it. Without making the board of directors responsible to their duties, it is very difficult to make them effective. The apex body for good governance looks very privileged class in the company organization without commensurate repository of responsibilities.

These big businesspersons posses enough power to influence politics and bureaucracy, by supplying election funds to the national parties with a chance of coming in power and to major opposition benches to be able to influence the governments. Most of the minority shareholders, on the other hand, do not want or can be owners. They want to be passive investors or short-term investors. They do not buy a company. They buy shares that are sold as soon as they no longer offer good prospects for capital gains over a fairly short time. Hence, the prospective differs sharply and overwhelming domination of the majority shareholders persist. To overcome these problems companies, which are listed on the stock exchange, should have professional management and adequate checks and balances in place to protect the interests of minority shareholders to the maximum extent possible. There has been some discussion in Nepal about establishing a Corporate Governance Code. This may be one way of helping to ensure stronger corporate governance for the future thus paving way for the healthy growth of stock exchange by ensuring responsibility and accountability (World Bank, 2002:111).

RIGHTS OF SHAREHOLDERS

Voting is a fundamental right of equity shareholders in Nepal. The shareholders have the right to receive share ownership certificate within three months from the date of transferring share. It is mandatory to sell the derivatives through secondary market but the share ownership is not transferred unless it is registered to the new buyer at the office of the registrar. Shareholders are being made well informed about the financial position of the company through supplying audited profit and loss account and balance sheet in each year before the date of annual general meeting. In case of necessity, each type of information and documents such as memorandum of association, articles of association, prospectus, annual books of accounts and auditor's report are accessible to them. Advanced notice that is 21 days before the date of annual general meeting with detailed agenda for discussion is published on a national daily newspaper inviting the shareholders to attend AGM. Those subjects not mentioned in agenda are not discussed. To a subject of shareholders' interest to be discussed in AGM is to be written in the agenda before its circulation since the shareholders have noted down it.

All equity shareholders attending the AGM have equal opportunity of participating in policy decisions and in the election of board of directors. Each of them can raise questions pertaining to company performance and other matters. The objectives of possessing shares are found different in between minority shareholders and majority shareholders. To get a capital gain from holding shares is the main objective of minority shareholders while the objective of majority shareholders is to get ownership position in the decision making process of the company. However, a proportion of profit or bonus shares against taking profit are some of the options sometimes opened to the equity shareholders when the company makes profit.

Shareholders' meetings are generally organized once in a year, and is called annual general meeting (AGM) and a special general meeting is called in special conditions, AGM can make a decision to change the status of the company such as from public limited to private limited company since it fulfils the conditions mentioned in the company Act, 1997. In case of necessity, AGM can amend the memorandum of association and articles of association. With the permission taking from the company's registrar office, the AGM possesses the authority to increase and decrease the authorized capital. In case of increasing the capital, the increased additional amount is collected by selling additional shares in which a top priority is given to the previous shareholders.

The company Act 1997 makes an equal treatment of majority and minority shareholders and there is no special consideration for minority shareholders.

DISCLOSURE AND TRANSPARENCY

The family owned business in Nepal dominates the business sector as specified earlier. It has originated from personal relationship and mutual trust between the customers and businesspersons where the stakeholders had no use of corporate information. Such books of accounts and accounting information are important variables for decision-making but that were treated as secret documents. Since the government had started to impose tax on corporate income, accounting records and books of accounts started to be prepared scientifically in different forms and purposes. It generally reported in Nepal that three types of books of accounts are used e.g. one for taxation, one for taking loan from banks, one for confidential use. It is a serious issue, if correct, requiring detailed and thorough enquiry to adhere to acceptable accounting standards and ensure proper disclosure. VAT is expected to minimize these anomalies but in real practice, a lot more needs to be done. With the establishment of World Trade Organization (WTO) in 1995, a drastic change has taken place in the philosophy and practice of corporate culture. It emphasizes on stricter disclosure and transparency. A changed culture is a new culture, which encourages to maintain good relationships between a company's management, its board, its shareholders and other stakeholders and to disclose the financial and non-financial information to stakeholders. Financial information is a statement of books of account and non-financial information includes (i) company objectives (ii) off-balance sheet commitments and litigation risks (iii) the ownership structure of the company (iv) the remuneration of board members and key executives (v) material foreseeable risk factors (vi) material issues regarding employees and other stakeholders and (vii) information on governance structures and policies. It takes time to adapt a new corporate culture in Nepal.

Table 4. Status of Disclosure

Category	2001/02			2002/03		
	Total No	Disclosed Companies	Percentage	Total	Disclosed	Percentage
Banks	12	11	91.7	15	12	80.0
Finance Companies	30	28	93.3	35	29	80.3
Insurance companies	7	5	71.4	13	6	46.2
Hotels	4	2	50.0	4	4	100.0
Manufacturing and Processing Companies	28	14	50.0	29	13	44.9
Trading Companies	8	5	62.5	8	3	37.5
Others	3	3	100	4	0	0.0
Total	92	68	73.9	108	67	64.8

Source: SEBO, 2002

The disclosure status shows 2001/02 that overall only 73.9 percent companies were furnishing information to NEPSE in 2001/02, which further deteriorated to 64.8 percent in 2002/03. Out of it the finance companies with 93.3 percent disclosure (non-disclosing includes only public sector NIDC) and banks except Nepal Bank Ltd., (not disclosing after 1994/95) and one recently listed have all met requirements in 2001/02. But in 2002/03, Nepal Bank Ltd furnished the data but 20 percent banks and finance companies did not furnish it showing that the problem is becoming all pervasive across the sectors. The manufacturing, hotels and trading sectors lag substantially behind in meeting disclosure requirements. De-listing in 2001/02 is a right step but it still reflects poor disclosure status. It should also be noted that out of 68 disclosing companies, six have furnished only financial information and one has submitted only partial information. Adjustment to these would further reduce the real disclosure status, which is a very weak showing on the part of SEBO and NEPSE.

Beside poor disclosure, those who disclose also do not adhere to internationally standard practices due to poor accounting and auditing standards. The general level of accounting as well as auditing are poor meaning that investing on published financial statements are not without risk- actually could be highly risky at times. Perhaps the most important factor impeding the development of the NEPSE is poor accounting standard in corporate sector in general in Nepal. It is still poorer in other enterprises. This is a fundamental problem, which will require rectification before the market can grow beyond its current incipient state. Weak accounting and auditing standards mean that many companies' financial statements are not credible (World Bank 2002:111). In fact, some companies which are currently listed on the NEPSE have not produced accounts for several years-Nepal Bank Limited being one case in point, which has not furnished information since 1997/98.

CONCLUSION

Capital market remains important for all types of investors to participate in economic development. Nepal lags behind to develop a healthy capital market with a sound financial infrastructure though the Nepal Stock Exchange was formalized eighteen years ago in 1985 and NEPSE established only in 1994. Regulatory measures are slowly updating incorporating the contemporary issues but that has not been found effective because of governance problem in the corporate sector. Corporate sector is generally not transparent. The culture of keeping books of account secret is still alive. Minority shareholders have no access to the books of accounts kept as secret documents. Capital market in Nepal is confined to equity market only. Debt transaction is negligible in Nepal Stock Exchange. Turnover as well as market capitalization are very small relative to its GNP. Besides, NEPSE is not integrated into the world markets. Capital market, at the present position, is beneficial to the investors who can overlook the rules of game. It is yet to be rational to a discerning investor. Unless, it is changed, capital market will not contribute in a desirable way to contribute to growth. In order to improve it, accounting and auditing standards, disclosure and corporate governance need to be upgraded significantly and on the other the monitoring and policy response capacity of SEBO should be enhanced.

APPENDIX

Nepal Stock Exchange Limited
Summary Sheet of Transactions, 1999/00 to 2002/03

	1999/00	2000/01	2001/02	2002/03
Turnover(Rs in million)	1157.0	2344.1	1540.6	575.8
Banks %	75.9	82.3	76.3	62.2
Insurance and Finance %	12.4	12.6	12.9	34.0
Manufacturing and processing %	6.4	2.9	1.4	0.6
Hotels %	2.3	1.0	9.0	1.1
Trading %	1.1	0.2	0.2	2.3
Others %	2.0	1.1	0.2	0.1
Market Days	240	231	246	238
Average Daily Turnover (Rs. in Million)	32.0	10.1	6.3	2.42
Number of Transactions	29136	46095	42028	69163
Number of Companies Traded	69	67	69	81
Number of Shares Traded(Share Units 000)	7673.7	4989.2	6005	2428
Number of Companies Listed	110	115	96	108
Number of Scrips Listed	112	115	NA	NA
No. of Listed unit of Mutual Fund	5250	5250	NA	NA
Total amount of Listed Shares (000)	7347.4	7919.1	NA	NA
Market Capitalization of Listed Companies (Rs in Million)	43123.3	46349.0	34703.8	35240.4
% of Turnover to paid up value	15.7	28.7	15.9	4.5
% of Turnover to Market Capitalization	2.7	5.1	4.4	1.6
No of Listed Securities	114057	124971	134150	159958
Banks %	9.1	8.7	12.5	NA
Insurance and Finance %	30.9	33.9	41.7	NA
Manufacturing and Processing %	33.6	32.2	29.2	NA
Trading %	2.7	2.6	4.2	NA
Other %	20.0	19.1	8.3	NA
NCM Mutual Funds	1	1		
NEPSE Index	360.7	348.4	227.5	204.8

Source: Nepal Stock Exchange, Annual Report 2002 and 2003

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Improving Macroeconomic Management: Experiences and Lessons

Tula Raj Basyal*

The relationship between growth and macroeconomic stability is a well-established phenomenon. Long-term growth requires a higher level of investment and a stable economic environment contributes in promoting saving and investment. Good macroeconomic policies help attract foreign saving. Sound fiscal and monetary policies create a conducive climate for private investment and economic growth. So, the policymakers need to redress the problems of domestic and external financial imbalances by designing and implementing an appropriate mix of policies for achieving higher growth, lower price uncertainty, reduced external imbalances, and other macroeconomic vulnerabilities. So, the important issues facing the policymakers are designing sound exchange rate arrangement, making current account sustainable, and promoting financial and macroeconomic stability. In order to promote sound macroeconomic environment for attaining sustained economic growth, there is a need to pursue more flexible exchange rate regime and make progress toward adopting inflation targeting in addition to improving the financial sector soundness, strength and stability.

INTRODUCTION

As the adverse macroeconomic shocks lead to sharp declines in growth rates, the relation between macroeconomic policy and growth needs to be properly comprehended. Sustainable growth requires policies that do not give rise to price instability, unfinanceable current account deficits or significant economic imbalances. A credible reduction in the fiscal deficit is inevitable to reduce price instability and an appropriate exchange rate is needed to reduce the exchange rate instability. Lack of adjustment may result in price instability, an overvalued exchange rate, and a balance of payments (BOP) crisis which would, in turn, lead

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to low investment and slow growth. High and unstable price uncertainty is likely to reduce growth by creating an unstable economic climate, causing distortions in relative prices, and absorbing resources unproductively. Price uncertainty requires frequent price adjustments which tend to blur the information embodied in relative prices, diverting away the entrepreneurial effort from production and investment decisions. Distortions in key prices such as the real interest rate and the real exchange rate are also likely to hamper growth. Flexibility in adjusting quickly to the fiscal and monetary problems that the macroeconomic shocks cause is crucial if growth is to be sustained.

MACROECONOMIC IMBALANCES

Profligate macroeconomic management results in macroeconomic imbalances and instability. An expansionary fiscal policy is associated with the currency appreciation, adding pressures for a reversal of the reforms. Large fiscal deficits are often at the root of both external and internal macroeconomic imbalances. External imbalances express themselves as current account deficits, capital flight, and rapidly expanding external debts. Internal imbalances take the form of high real interest rates, falling private investment, and rising inflation. Prudent fiscal policy- that is, fiscal deficits consistent with low and stable inflation, a sustainable level of foreign debt, and a favorable climate for foreign investment - is indispensable to foster sound macroeconomic fundamentals. Furthermore, reforms in many other areas like financial liberalization, flexible exchange rate, price deregulation, trade reform, and so on can work only if the fiscal implications are well taken into account.

Expansionary monetary and fiscal policies are the single greatest threat to trade reform. Macroeconomic imbalances would lead to high real interest rates, declining investment rates and negative net resource transfers, volatile exchange rates, growing current account imbalances, stagnated growth rates, sluggish trade, disruptions in financial markets, more slowdown of the economy, and even protectionism. These problems are mainly the legacy of past imprudent policies and structural rigidities. They are also a consequence of the mismatch of the macroeconomic policies. Such an environment would lead to slower growth of both production and trade and the economies would be facing continuing risks and vulnerabilities. As the world experience has underscored, the macroeconomic mismanagement would slow growth substantially and result in significant declines in per capita income. The investments would fall, debts would grow, and developing countries would face negative net resource transfers as debt service obligations exceed the limited amounts of new financing, sometimes the severity of the prolonged economic slump even surpassing the level of the Great Depression in the industrial countries. As a result, poverty and unemployment is bound to rise (World Bank 1988).

MACROECONOMIC STABILITY

Macroeconomic stability is necessary for sustainable growth. As macroeconomic instability leads to the failure of external sector reforms, reforming the external sector regime usually calls for a real devaluation of the currency in response to the effects of reductions in tariffs and non-tariff barriers. Macroeconomic stability also makes reform of the financial sector more likely to succeed, and thus supports the development of capital markets that can foster private investment. For this to work, macroeconomic stability and strong supervision of the financial system require the overall review of issues related to accounting, disclosure, and corporate governance. Expectations of high price uncertainty, exchange rate devaluation, or government borrowing may push real interest rates too high, increasing the fiscal deficit and contributing to further macroeconomic instability. Excessively high interest rates and inadequate supervision of the banking system may cause defaults and instability in credit markets. Rapid interest rate liberalization under conditions of macroeconomic instability and inadequate bank supervision lead to financial crises that severely damage the economies (World Bank 1991). What is, therefore, required are vigilance and a shift from short-term considerations to tackling decisively the underlying economic and financial imbalances in the economy.

Sound management consists of the institutions and policies that would lead to rapid development and poverty reduction. A country with poor policies would be one with high inflation, large fiscal imbalances, and a closed trade regime. As there is plenty of evidence that good macroeconomic management provides a fertile environment for growth, and that large fiscal deficits and high inflation are bad for investment and growth, a stable macroeconomic climate is crucial. As trade liberalization accelerates growth, an outward orientation and a reasonable environment for fostering international transactions are essential. Fiscal, monetary, and trade policy prudence shows that a country is well-managed at the macroeconomic level. Good institutions and economic management are also needed at the microeconomic level. The strength of private property rights and the rule of law and the quality of the civil service coupled with its cleanliness are equally important as they affect long-term growth. The relationship between per capita growth and an economic management index based on the measure of openness, the budget surplus, the inflation rate, and the institutional quality reconfirms that sound management, at both the macroeconomic and institutional levels, is important for growth. This finding suggests that poor countries have been held back not by a financing gap but by an "institutions gap" and a "policy gap". If they can overcome them, they can begin to grow successfully (World Bank 1998).

MONETARY POLICY

The degree of central bank autonomy affects the conduct of monetary policy. Money creation is, in many cases, the residual source of financing. So if the central bank is obliged to finance a big deficit, it may be unable to implement monetary policy targeted at controlling price. When printing more money than the public wants to hold finances a deficit, prices will rise. Price uncertainty may bring a reduction in private wealth insofar as the value of financial assets may be eroded, the so-called inflation tax. High inflation creates uncertainty about the returns on saving and investment, thus creating a disincentive for capital accumulation. Empirical work has shown that high rates of inflation (above single digits) adversely affect growth. Inflation also makes it difficult to maintain a stable but competitive exchange rate, creating wage volatility impeding the country's ability to exploit the benefits of openness. International experience shows that governments around the world find it difficult to achieve and maintain the strong fiscal and monetary discipline required for economic stability. But reforming governments will not inspire the confidence necessary to generate growth unless people believe the new discipline will be sustained. When excessive domestic borrowing finances budget deficits, they can lead to higher interest rates that crowd out the private sector. There are limits to a rapid accumulation of domestic debt as, at some point, the public will be unwilling to hold more debt or will do so only at higher interest rates, thereby further increasing the cost of debt service. Eventually, deficits must be brought down with cuts in expenditure or through higher taxes as otherwise, the inflationary financing of the deficit along with the rise in the cost of funds for investors would be the eventual consequence.

EXCHANGE RATE POLICY

A competitive real exchange rate is necessary to support the expansion of the export sector and to avoid the emergence of BOP difficulties that might lead to calls for import restrictions. Countries that have allowed their real exchange rate to become grossly overvalued have experienced both a slowing in the expansion of the export sector and the rise in the capital flight. Exchange rate overvaluation retards growth and leads to the deterioration of the external sector. Correcting external imbalances generally requires adjusting the exchange rate toward its equilibrium level to redirect resources to the tradable goods sector and to reduce spending. In the short run, most of the nominal devaluation is also a real devaluation. If it is to endure, this real devaluation has to be supported by anti-inflationary policies including, in many cases, directed at lowering fiscal deficits. Evidence shows that a real depreciation is eroded rather quickly when fiscal and monetary policies are lax. A fixed exchange rate has sometimes been used to control inflation, serving as a nominal anchor for domestic policies and demonstrating the policy commitment to low inflation. In this case, exchange rate takes priority, restoring the credibility of the government's commitment to reduce inflation. Exchange rate will not be sustainable unless the macroeconomic fundamentals are right. Commodity booms increase spending, raise the price of non-traded goods relative to that of the traded goods, and shift capital and labor to the expanding sector. The real exchange rate appreciates, squeezing the non-boom tradable sector in a phenomenon known as the "Dutch disease." This shows how large the costs of unsustainable polices could be. The lesson of such episodes is that countries should try to keep their spending consistent with their permanent income. That is why, it is far better, whenever possible, to anticipate rather than react to emerging macroeconomic imbalances; the transition to a sustainable path will then be far less painful. Fiscal adjustment would then be more moderate, making it easier to protect investment in infrastructure, education, and health from cuts.

FISCAL POLICY

A prudent fiscal policy is the foundation of a stable macroeconomy. Taxes and public spending affect resource allocation, and fiscal deficits affect the BOP and, depending on how they are financed, the rate of price rise. Fiscal policy shapes the course of development as it affects aggregate resource use and financing pattern and, together with monetary and exchange rate policies, influences the BOP, the accumulation of foreign debt, and the rates of inflation, interest, and exchange. Public spending, taxes, user charges, and borrowings also affect the behavior of producers and consumers and influence the distribution of wealth and income in the economy. BOP crises and foreign debt problems are often caused and aggravated by imprudent fiscal policy. Their solution almost invariably involves some combination of cutting public spending and raising additional revenue, thus freeing resources for exports and debt service. However, careless fiscal austerity can lead to prolonged recession, and can place a disproportionately heavy burden on the poor. For this reason, the structural aspects of fiscal policy, how spending is allocated and revenue raised, matter as much as the overall macroeconomic balance.

The public sector affects the economy not only through its taxation and spending but also through interventions such as price controls and licensing. Although country experiences vary, the public sector now appears to be as important in developing countries as in the industrial countries. The expanded role of the public sector, however, carries with it risks and opportunities. The risks arise from the ineffective use of public resources and from the overextension of government into areas that are better left to the private markets. The opportunities arise from the government's power, in principle, to allocate resources efficiently when markets fail to do so and from its ability to provide relief to those in poverty. It is the task of public finance to balance the opportunities and risks, and thus improve the quality of government. The most important aspects of public finance within which pragmatic policies should be pursued are the management of public deficits, revenue mobilization, allocation of public spending, and decentralization of public functions.

With increased fiscal expansion or fiscal deficits, current account deficits widen and the ratio of public debt to GDP increases correspondingly. Capital flight worsens the debt problem as domestic savers could respond to unsustainable fiscal deficits by sheltering their assets abroad, the scenario of problem debtors. Those who pursue more sustainable fiscal policies accumulate smaller stocks of public debt in relation to their capacity to service it. This would also prevent the real exchange rate rising excessively. Thus, they steer clear of debt problems. With cautious fiscal management, the commodity-exporting countries could avoid destructive boom and bust cycles. Prudent fiscal policy guards against the risks of excessive foreign debt and overvalued currencies. But sound macroeconomic management is not enough. Many developing countries need to make structural changes if they are to resume satisfactory long-term growth. The ways in which governments raise revenue can substantially affect economic efficiency. Similarly, the quality and composition of public spending strongly influence development.

A prudent fiscal policy can, therefore, be defined as one that maintains the public deficit at a level that is consistent with other macroeconomic objectives: containing inflation, promoting private investment, and maintaining external creditworthiness. A deficit must be funded by the private sector lending the government some of the excess of its saving over its own investment, by foreigners lending part of their savings, by printing money, or by some mixture of the three. Too great a strain on any of these sources of finance can create macroeconomic imbalances. Over-reliance on domestic borrowing may mean high real interest rates and falling private investment. Over-reliance on foreign borrowing can cause appreciating real exchange rates, widening current account deficits, unsustainable external indebtedness, and dwindling foreign exchange reserves. Over-reliance on money creation may prompt higher inflation. Viewed from the alternative perspective of production and expenditure, an increased fiscal deficit is an additional claim on the supply of goods. The only ways to meet this extra claim are by importing additional goods from the rest of the world (that is, increasing the current account deficit), by driving up domestic inflation and interest rates to make the private sector buy fewer goods, or by increasing domestic production (World Bank 1998).

INTERNAL AND EXTERNAL BALANCE

A current account surplus is at one and the same time (a) the excess of the nation's income over its expenditures, (b) the excess of the nation's exports of goods and services over its imports, and (c) the net increment to the nation's foreign asset holdings. Expenditure-changing policies such as fiscal and monetary policies directly affect the levels of economic activity. Expenditure-switching policies such as trade and exchange rate policies change the pattern of economic activity. Finally, financial policies toward the rest of the world concern capital flows, debt management, and the net foreign assets position of a country. In addition, there are the structural policies, the objective of which is to enhance the efficiency of domestic production processes. The objective of both the expenditure-reducing and expenditure-switching policies is to transform a deficit in the current account of the BOP into a surplus. The policies of cutting domestic expenditures may cause the economy to enter into a recession and, consequently, unemployment may increase. Moreover, private investment may be reduced to such an extent that future growth may be jeopardized. In contrast, expenditure-switching policies, which increase the domestic prices of the internationally traded goods, will curtail imports and stimulate exports so that the economy can continue to grow. The problem here, however, is that the price increases of export goods may lead to demand for wage increases. This demand may lead to on inflationary spiral, which may make importing goods again attractive and production of export goods less profitable, so that the effects of the policy will be negated.

The objective of expenditure-switching is not only to increase the nominal prices of the traded goods but also to increase their real prices. A high real exchange rate means that the exchange rate is overvalued: the high value of domestic currency leads to high imports and low exports. However, no automatic mechanism will ensure that exchange rates will not become misaligned. The real exchange rate must, therefore, be considered an important policy guideline (Dornbusch and Helmers 1988). Before the Asian crisis, the fiscal balances of the crisis economies were satisfactory whereas the current account balances were unfavorable, indicating that the sustainability of the current account balance became the crucial element in generating the crisis (Appendix I).

In open and small developing economies, trade and capital flow across the borders in sufficient quantities to influence the domestic economy, particularly prices and the money supply. They are called price takers as their supply of exports nor their demand for imports has a noticeable impact on the world prices of these commodities and services. Tradable goods and services are those the prices of which within the country are determined by supply and demand on world markets. Under the small-economy assumption, these world market prices can not be influenced by any thing that happens within the country. Even if the supply of and demand for tradables changes within an economy, the local price will not change because domestic supply and demand have a negligible influence on the world price. However, the adjustment of the exchange rate does change the domestic price. Because of simplifying all tradables into one composite good, the price of tradables is best thought of as an index, a weighted average of the prices of all tradables, much like a consumer price index. Nontradables are goods and services, such as transportation, construction, retail trade, and household services, that are not easily or conventionally bought or sold outside the country, usually because the costs of transporting them are prohibitive. Prices of nontradables are, therefore, determined by market forces within the economy; any shift in supply or demand will change the price of nontradables. Nontradable prices are thus endogenous as compared to the price of tradables that is exogenous.

Therefore, macroeconomic equilibrium is defined as a balance between supply and demand in two markets: nontradable goods (internal balance) and tradable goods (external balance). When the supply of tradables equals demand, there is external balance, and when the supply of nontradables equals demand, there is internal balance. To achieve equilibrium in both the markets, two conditions must be satisfied: expenditure (absorption) must equal income, and the relative price of tradables (the real exchange rate) must be at a level that equates demand and supply in both the markets. If the relative price of tradables in terms of nontradables rises, tradables become more expensive relative to nontradables. If the production of tradables exceeds consumption of tradables, there is an external surplus, which is identical to a surplus in the balance of trade. With the economy in equilibrium, consumption of tradables is equal to production, so the balance of trade is zero. Total of the consumption and investment by both the government and the private sectors is called absorption. When export equals import and income equals absorption, the condition of the equilibrium of the economy is met (Gillis, etc. 1996). This also suggests two remedies for an economy that is out of balance: a government can achieve equilibrium or stabilize the economy by adjusting absorption, the nominal exchange rate, or both. Generally both instruments must be used to achieve internal and external balance. So, the two macroeconomic policy tools of government are: the exchange rate and the level of expenditure.

STABILIZATION VERSUS STRUCTURAL ADJUSTMENT

A distinction could be made between macroeconomic stabilization and structural adjustment. Stabilization policies work mainly on the demand side to reduce inflation and external deficits though they also have supply-side effects. Structural policies are concerned with the supply side as they address the efficiency of resource use, emphasizing reforms in specific sectors like trade, finance, and industry. While structural reforms are unlikely to succeed unless they are preceded or accompanied by stabilization, stabilization is unlikely to be sustainable without structural reforms. Stabilization addresses short-term problems that need to be dealt with urgency like inflation or deflation, loss of foreign exchange reserves, capital flight, and large current account deficits. Structural adjustment addresses obstacles to longer-term growth like distortions in the incentives for production, e.g., overvalued real exchange rates; controls on prices, interest rates, and credit; burdensome tariffs and import restrictions; and excessive taxes and subsidies. Careless structural adjustment can make the problem of stabilization more difficult as the distortions are often a source of revenue to the government. For example, high tariffs provide public revenue as well as protection to domestic industry. Equally, structural reforms are unlikely to command credibility unless stabilization policies are in place. Investors will expect trade liberalization to be short-lived if fiscal deficits imply an eventual external sector crisis.

Fiscal stabilization like cuts in public infrastructure spending to reduce the deficit may cause private investment to fall. Similarly, structural adjustment could be hampered as raising tariffs to increase public revenues may distort relative prices. Stabilization is often associated with a domestic recession characterized by rising unemployment, sharply contracting imports, and falling real wages and living standards. Lower living standards are unavoidable when the previous level has been artificially raised by unsustainable policies. But the recession can be damaging to future growth if it is too deep or too prolonged. The blow to the confidence of domestic investors may inhibit necessary new investment. The slowdown in the economy could also strain the financial system and impair its ability to finance new growth. Excessive cuts in spending risk a downward spiral of continually falling output. These risks make it vital to coordinate the contraction of demand induced by fiscal retrenchment with the implementation of structural adjustment measures to increase output.

Stabilization and structural adjustment face different institutional constraints. Stabilization is often postponed, but its implementation usually follows a crisis situation. In contrast, structural adjustment seldom carries the same sense of urgency as its results are less obvious and more gradual. It often requires the support of a broader circle of policymakers than stabilization, which is typically undertaken at the behest of the central bank and finance ministry. Structural reforms are difficult, too, because they inflict visible damage on a few and bring less obvious benefits to many. These difficulties reinforce the tendency to pursue short-run stabilization to the exclusion of structural adjustment during crises (World Bank 1998).

Responding with the right macroeconomic policy mix after an adverse shock is one of the biggest challenges policymakers face. Driven by political considerations, policymakers may postpone needed adjustment and stabilization measures because they are painful, thereby making the situation far worse. Not all problems arise from unsound macroeconomic policies. In some cases, the policy response errs in the direction of too much adjustment, with fiscal and monetary policy more restrictive than necessary to restore equilibrium in the currency market, the current account, or the capital account (World Bank 2000/01). Overreaction can cause more pain than necessary and, in some circumstances, can be self-defeating.

ECONOMIC CRISES AND IMPACTS

Economy-wide crises entail sharply falling outputs, declining incomes, and rising unemployment. Pervasive in the l990s, crises came in different forms: fiscal crises, BOP crises, terms of trade shocks, currency crises, banking crises, hyper-inflation. The economic crises in Mexico in 1995, in East Asia in 1997, and in Brazil and Russia in 1998 were not the only episodes of economic distress. Most crises were brought on by varying combinations of policy mismanagement and such external factors as terms of trade shocks, volatile capital flows, and contagion in international capital markets. Per capita GDP and per capita private consumption respectively fell by 4.1 percent and 5.6 percent in Argentina (1995), 7.8 percent and 11.1 percent in Mexico (1995), and 14.6 percent and 5.1 percent in Indonesia (1998).

Economic crises hurt both the poor and the non-poor, but they are far more devastating for those already in poverty. Real wages fall and unemployment rises, driving down labor earnings. Non-labor incomes fall as economic activity slows. Macroeconomic crises slow the accumulation of human, financial, and physical capital, weakening the ability of poor people to escape poverty. There is a strong link between macroeconomic downturns and rising income poverty. In most countries in East Asia, poverty rose as a result of the financial crises of the late 1990s. It is estimated that it rose almost by 50 percent in Indonesia and that urban poverty doubled in the Republic of Korea. In both countries, however, poverty fell as the economies recovered. In Russia, the incidence of poverty rose from 21.9 percent to 32.7 percent between 1996 and 1998. In every crisis in Latin America and the Caribbean, the incidence of poverty increased.

Capital account crises in emerging market countries-characterized by a sudden cessation or reversal of capital inflows that forces a large and abrupt current account adjustment together with a large depreciation in the exchange rate-have been associated with severe output contractions. What underlies these steep output declines? From one perspective, they are the counterpart to the massive capital outflows experienced by the countries which, in some cases, amounted to as much as 15-20 percent of GDP. To the extent that these capital outflows could not be met from existing reserves or official support, they required corresponding adjustments of the current account. With only limited scope to increase exports in the short run, this adjustment took place mainly through import compression and a corresponding slump in domestic demand.

The output losses, in turn, reflected a combination of demand-and supply-side factors. On the demand side, the salient event in all these crises was a collapse in private domestic consumption and investment spending. The recoveries, in turn, were driven mainly by a pick-up in private consumption and investment, with export expansion playing only a supportive role. Adverse shocks to aggregate supply also appear to have played a major part in the crises. The large exchange rate depreciations and temporarily high interest rates forced many firms into bankruptcy and disrupted supply and credit channels. These initial supply shocks were accompanied by negative aggregate demand shocks, because the same balance sheet and credit market effects also dampened investment and consumption spending.

Mistakes in macroeconomic management in Latin American economies have been quite rampant as evident from the disproportionate number of debt crisis. High external borrowing, low exports, and volatile fiscal policy characterized these economies' heightened vulnerability. Even though Latin American external debt levels have not been high relative to GDP, they have often still been high relative to exports. The region is subject to a high degree of macroeconomic volatility, stemming not only from terms of trade shocks, but also from volatility due to pro-cyclical fiscal policy. Historically, much of the region has suffered from financial underdevelopment and, partly associated with that, low domestic saving. As a consequence, government borrowing is disproportionately external, and disproportionately denominated in foreign currency. The resulting currency mismatch between government assets and liabilities has all too often left countries in the region quite exposed to the effects of sharp sudden exchange rate depreciation.

Table 1. Real GDP Growth
(Percent)

Country	Crisis Year	Real GDP Growth Previous Year	Crisis Year	Following Year
Argentina	1995	5.8	-2.8	5.5
Brazil	1999	0.2	0.8	4.2
Indonesia	1998	4.5	-13.1	0.8
Korea	1998	5.0	-6.7	10.9
Mexico	1995	4.4	-6.2	5.2
Philippines	1998	5.2	-0.6	3.3
Thailand	1998	-1.4	-10.8	4.2
Turkey	1994	7.7	-4.7	8.1

Source: IMF (April 2002).

These characteristics have a common starting point: problems with tax systems and expenditure controls. A weak internal tax system forces a government to rely more heavily on tariff revenue, reducing the incentive to export. Similarly, revenue shortfalls and expenditure excesses periodically force the governments to resort to monetary financing of deficits. A history of high inflation similarly makes it difficult for governments to borrow at reasonable rates. Finally, a weak tax system and poor spending controls make it difficult to adopt counter-cyclical fiscal policy. As a result, shocks to a country's terms of trade are all too often amplified rather than mitigated by fiscal policy. Though many countries in the region have made substantial progress including better fiscal systems and more flexible exchange rate systems, caution is still the need (IMF April 2002).

Box 1: The Great Depression

Macroeconomic management prudence should also consider the events leading to the great depression of the early-thirties. The US Federal Reserve tightened monetary policy in early 1928, in response to the stock market boom that began in 1926 and the belief that banks should confine their lending strictly to commercial bills and not finance stock market speculation. The contractions in central bank credit and the monetary base, along with a rise in the discount rate, precipitated a downturn in the US economy starting in August 1929 before the stock market crash of October 1929.

A series of banking panics beginning in October 1930 turned an otherwise serious recession into a depression. These panics, which resulted in the suspension of 9,000 banks, more than one-third of the total, exacerbated the economic contraction because they reduced broad money. The US Federal Reserve was insufficiently aggressive in trying to counter the collapse in broad money, for example, via open market purchases. The collapse of broad money reduced output through several channels: (i) lower aggregate demand which, in the face of nominal wage rigidity, decreased real output, (ii) disruption of financial intermediation from the bank failures, and (iii) asset price deflation, whereby declining asset prices reduced the value of collateral for bank loans, inducing weakened banks to engage in a fire-sale.

Output Loss During the Great Depression

Country	Share of World Output, 1931 (Percent)	Economic Activity		Output Loss (Percent)
		Peak	Trough	
United States	42.4	1929	1933	-29.4
United Kingdom	13.1	1930	1931	-0.5
Germany	9.5	1928	1932	-26.3
France	7.9	1932	1935	-10.4
Italy	5.4	1928	1933	-13.7
Japan	5.1	1930	1933	-14.9
Spain	4.2	1929	1931	-6.3
Canada	2.5	1929	1933	-29.7
Netherlands	2.1	1930	1934	-14.2
Switzerland	2.0	1930	1932	-6.5
Sweden	1.6	1930	1933	-12.1
Australia	1.4	1926	1931	-24.9
Denmark	1.1	1930	1932	-4.4
Norway	0.9	1930	1931	-8.0
Finland	0.5	1928	1931	-7.2
Portugal	0.4	1935	1936	-0.7

Source: WEO, April 2002

Crises can occur because of past unsustainable macroeconomic policies or inability to adjust to external shocks like terms of trade shocks, higher international interest rates, and sudden movements in capital flows as a result of contagion. In such circumstances, restrictive fiscal and monetary policies are inevitable and less costly than the alternative of delaying such measures, which could lead to a larger crash. Once adjustment policies are accepted as inevitable, the way governments introduce fiscal austerity can worsen the adverse effects on the living standards of the poor. So, the task of the policymaker is to implement the combination of macroeconomic measures that results in the lowest cost in foregone output and affords the greatest protection to the living standards of the poor. A key element of a poverty-sensitive response is the right composition of revenue-raising measures and fiscal cuts. A poverty-sensitive response should also allow for the expansion of safety nets targeted to poor people during periods of macroeconomic adjustment.

SOUTH-EAST ASIAN EXPERIENCE BEFORE THE CRISIS

In South-East Asia, before the crisis, fundamentally sound development policy was a major ingredient in achieving rapid growth. Macroeconomic management was unusually good and macroeconomic performance usually stable, providing an essential framework for private investment. Policies to increase the integrity of the banking system, and to make it more accessible to non-traditional savers, raised the level of financial savings. The economies were more successful in keeping public deficits within the limits the economy could absorb. As a result, they were better able to restrain inflation and manage both internal and external debt. Low inflation and manageable debt, in turn, facilitated realistic exchange rates and the avoidance of the appreciation that elsewhere undermined export performance. When the macroeconomy did go awry, usually due to external shocks, governments quickly responded by implementing solutions like reducing the fiscal deficit and, when necessary, devaluing the currency. In contrast, many other developing economies were less successful in keeping deficits within bounds and, therefore, experienced more trouble managing inflation, debt and exchange rates. As a result, policymakers in these economies often had less room to maneuver when confronted with a macroeconomic shock. Accordingly, their response was often hesitant and ineffective. The superior macroeconomic management record of the East Asian economies was reflected in less severe imbalances and generally lower variance in key indicators, including real exchange rates, real interest rates, and inflation.

While some governments ran substantial deficits, none financed a deficit in a manner that destabilized the economy. So, the deficit was affordable and not destabilizing, generally larger the faster the rate of growth and the higher the pool of private savings relative to private investment. Although a variety of macroeconomic policy paths were chosen because of their different economic conditions and preferences, all lay within the bounds of prudent stability and, whenever the macroeconomy appeared to be in danger of moving out of control, swift action was taken to restore stability. This was true even when the source of macroeconomic instability was policies intended to promote growth in the real economy. As the economies were remarkably successful in creating and sustaining macroeconomic stability, this became a potent encouragement for private savings, investment, exports and growth, since the private sector could count on relatively stable macroeconomic indicators like prices and interest rates. They successfully managed four macroeconomic fundamentals: budget deficits, inflation, external debt, and exchange rates.

Keeping Budget Deficits Manageable

The economies almost always kept the deficit within the limits that could be financed without macroeconomic destabilization. These limits were higher than in other developing economies because of the beneficial feedback from other good policies. International experience suggests that the macroeconomic consequences of public sector deficits depend on how they are financed. Excessive monetary financing of deficits leads to inflation; heavy government domestic borrowing drives up interest rates and crowds out private borrowing; large external financing of the deficit leads to debt crises. The economies kept each type of financing within bounds, avoiding the corresponding macroeconomic disease. During the 1980s, as a percentage of GDP, Korea's budget deficits (1.9 percent) were below even the OECD average, which explains why Korea was able to keep inflation, external borrowing, and interest rates within bounds. Because of higher growth in Malaysia and Thailand, they could absorb higher levels of budget deficit without a rapid rise in inflation as an economy can borrow more for a given debt to GDP ratio when GDP is rising rapidly. Increased domestic financing of the deficit without resorting to inflationary financing was made possible due to the high financial savings. As the initial level of external debt to GDP was very low, it meant that external financing was available when needed. Because of this, the economies avoided the inflation-inducing bursts of money creation.

Maintaining Moderate to Low Inflation

Low inflation is a corollary of fiscal prudence: East Asian governments never had to rely heavily on the inflation tax because their deficits were within financeable limits. The commitments to low inflation, a fixed exchange rate, self-imposed constraints on fiscal policies and institutional checks, altering public spending and foreign borrowing as needed, etc, generally contributed to fiscal discipline and low inflation. One result of low to moderate inflation rates particularly welcome to business is stable real interest rates. Low inflation and flexible financial policies kept real interest rates within a narrow range. For the comparable economies, the combination of nominal interest rate controls with high and unstable inflation was deadly as large increase in real interest rates created severe uncertainty for investors.

Keeping External Debt under Control

As with fiscal deficits, favorable feedback from other policies enabled these economies to sustain higher external debt to GDP than other economies. High levels of exports meant that foreign exchange was readily available to service the foreign debt. Similarly, high growth implied that returns on borrowed capital were sufficient to pay the interest. Though Korea borrowed heavily to finance private sector investment and build up foreign exchange reserves, with the foreign debt recording the fourth largest (which equaled more than half its GNP) in the world by 1984, yet because of its high export-GNP ratio and rapid overall growth, it never lost creditworthiness. Since 1986, the government pursued an active debt-reduction policy, drawing on burgeoning international reserves generated by exports to make payments ahead of schedule. By 1990, the debt-GNP ratio was down to 14 percent.

Keeping the Exchange Rate in Line

The economies avoided the severe appreciation of their currencies in contrast to other economies. The economies did not cling to a given nominal exchange rate (on inadequate rate of nominal depreciation) in the face of continuing inflation but depreciated when necessary, sometimes quite sharply. Fiscal prudence prevented the excessive demand pressures and the appreciation in the real exchange rates. After a period of pegging and devaluing, their currencies were floated or operated under managed float. Their success at maintaining remarkable stability of real exchange rates contrasts with the severe exchange rate instability in other economies like Argentina which repeatedly attempted to use the exchange rate as a nominal anchor against high inflation but failed as other macroeconomic fundamentals were not kept in line, leading to the collapse of the real exchange rate and sharp real devaluations. In contrast, these economies' pragmatic macroeconomic management enabled them to avoid swings of the real exchange rate, even in the face of major external shocks.

A reputation for macroeconomic stability is quite valuable and it is very costly to lose it. When earnings boom increase public spending, failure to cut back when such revenues fall would result in huge deficits, heavy external borrowing, a full-blown debt crisis, real exchange rate appreciation, and the collapse of investment and growth. So, correcting the mismanagement quickly would avoid turning on a couple of years' delay in adjustment. Low or moderate inflation for long periods provides a favorable environment for growth. High inflation is inevitably unstable and it reduces the efficiency of investment, discourages private investment, and reduces growth. Because real interest rates become negative, depreciations of the exchange rate lag behind inflation and real appreciations take place. As real tax collections lag inflation, the fiscal problem is intensified and public savings reduced by inflation. The real interest rate and the real exchange rate stability are crucial at guiding resource allocation more effectively (World Bank 1993). Hence, microeconomic stability is essential. Similarly, sudden reductions in aggregate demand and in investment compelled by debt crises have been the major causes of the sharp declines in growth rates, which means that fiscal and foreign borrowing prudence is imperative for sustained growth. Although macroeconomic stability and prompt responses to macroeconomic shocks were not the whole story of the success, these factors created a basis from which policies intended to affect the real economy-the supply side-could be launched in an environment of stable real interest and exchange rates, facilitating realistic and, in some cases, even undervalued exchange rates.

LESSONS DRAWN FROM THE ASIAN CRISIS

The South-East Asian economies enjoyed high economic and export growth, macroeconomic stability, and social achievements supported by: strong macroeconomic fundamentals including price and exchange rate stability, fiscal balance, and manageable BOP positions. The export-oriented industrial growth, and liberal and open foreign participation in domestic markets, with the capital account largely open to foreign capital flows, though some sectors remained closed or had limited foreign participation. As capital inflows surged, the governments intervened in the exchange markets to sterilize the inflows with the objective of curbing their adverse macroeconomic and inflationary implications. Despite these efforts, both financial and property markets came under mounting price pressure.

The policymakers and the private sector in the region indulged in higher and riskier investment and reckless offshore short-term borrowings, as they were over-confident of their success. This eventually led to over-exposure of the fragile and under-regulated financial system whose integration deepened with the growing globalization and the regional economic linkages across the trade and banking sectors. Despite the common characteristics (i.e., stable macroeconomic conditions, high growth, large capital inflows, and domestic asset price inflation), the dimensions and causes of crisis at each country level varied. Some argue that the crisis was triggered by the weaknesses of the financial systems owing to the rising imprudent lending and borrowing stemming from weak risk assessment and over-exposure to various sectors and industries with an emphasis on short-term private borrowing. Others attribute the crisis to the contagion effect and the financial panic. The subsequent capital outflows contributed to undermining the Asian currencies that depreciated significantly. This revealed the structural deficiencies of the financial and other sectors in these countries. (http://www.adb.org/Documents/Speeches/1999/ms1999033.asp).

Although high growth was sustained for almost a decade, during most of which fiscal balances were in order, monetary expansion was not excessive and inflation was generally under control, the exaggerated expansion of investment in 'non-tradables' like construction and property boom fuelled by financial sector favoring such short-term investments exacerbated current account deficits. The over-investment of investible funds, especially from abroad, in "non-tradables" only made things worse, especially for the current account. Only a small proportion of commercial bank and other lending went to manufacturing, agriculture, mining and other productive activities. The percentage is likely to be even smaller with foreign borrowing, most of which had been collateralized with assets such as real estate and share prices. Although widespread in East Asia, the property-finance nexus was particularly strong in Thailand, which made it much more vulnerable to the inevitable bursting of the bubble. Insofar as such investments did not contribute to increased production of "tradables", they actually exacerbated the current account deficit, rather than alleviated it, as they were thought to be doing. This, in turn, worsened the problem of "currency mismatch" with borrowings in US dollars invested in activities not generating foreign exchange. Insofar as a high proportion of these foreign borrowings were short term in nature and were deployed to finance medium to long-term projects, an additional 'term mismatch' problem also arose. Though the foreign exchange risk of investments generally increased, there was strong stake in defending the currency peg regardless of its adverse consequences for the economy (Jomo 1998).

The explosion of the crisis can be laid squarely on the financial panic of international and domestic investors suddenly concerned about the fate of their portfolios. But the buildup of structural vulnerabilities-sharp rises in short-term debt that far exceeded international reserves, a financial sector that had poorly intermediated international inflows and found itself saddled with huge mismatches between assets and liabilities, and corporations massively over-leveraged and exposed to changes in interest and exchange rates-provided the dynamite for the explosion. The collapse of the Thai Baht sparked a regional crisis that reflected in the failure of the affected countries to manage globalization. At the macroeconomic level, increased investment did not lead proportionally to increased growth as the East Asian investment became less productive in the 1990s. The loss of confidence that would reverse capital flows and cause a crisis should be avoided by using the inflows productively so that the resulting assets could service the resulting debt. In this respect, maintaining sound macroeconomic policies with consistency between monetary and exchange rate policies even if external or internal conditions changed is equally important. But during the 1990s, and especially after 1993, the crisis countries increasingly did not meet these conditions, thereby raising the risk of a sudden shift in funds. So, the challenge of managing globalization is to capture its benefits without suffering the high costs of sudden capital reversals or trade shocks. This requires that East Asia put in place macroeconomic and structural policies for capital flows that encourage stability (World Bank 2000).

Thus, the crisis emerged as a combination of accumulation of large short-term foreign debt in the private/corporate sector linked to the maintenance of implicit fixed exchange rate pegs that led to rising and unsustainable external pressures. Structural problems of the under-regulated national financial systems that operated without due diligence and regard to credit and market risk assessments and management were the other factors. Deficient corporate and financial sector governance encouraged excess production capacity in property-related sectors and some manufacturing, most such lending based on over-leveraging and mismatch of currency and term structure of liabilities and cash flows. Legal infrastructure problems, including weak insolvency framework for debtors as well as undefined and not implemented bankruptcy regulations and procedures, helped the process. Similarly, disruptive capital outflows created a liquidity crisis.

Box 2: Corporate Balance Sheets and Macroeconomic Policy

The links between the corporate sector and the macroeconomy are two-way. First, macroeconomic developments can affect the health of the corporate sector, especially if corporations are highly leveraged, that is, if they carry large amounts of debt relative to equity and do business in an environment that does not promote sound corporate governance. Changes in world interest rates and country risk premia can sharply alter the cost of borrowing for corporations burdened by foreign debt. Rapid exchange rate depreciation can increase the debt-servicing costs of firms with large foreign debts, destabilize the corporate sector, and even threaten the viability of many firms. A high level of short-term corporate debt denominated in foreign currency increases the vulnerability of the macroeconomy to exchange rate depreciation and sudden capital outflows. The adverse impact of tight monetary policy and high interest rates, which were used to stem rapid exchange rate depreciation on domestic demand and bank lending, was amplified by high corporate debt and could, therefore, worsen the corporate sector's financial situation. Reversionary tendencies at the global level hurt the export sector considerably.

Second, the corporate sector could also affect the macroeconomy. The restructuring of over-leveraged corporations struggling to stay afloat financially can magnify an economic downturn by triggering the rapid disposal of assets at very low prices and prompting large investment contractions. A squeeze on credit to corporations arising from a shortfall of bank capital can force governments to divert their fiscal resources to bank recapitalization. If the corporate sector is tipped into insolvency, lower investment and the prolonged period needed for corporate restructuring can significantly impair growth. Evidence from microeconomic analysis of Asian corporations showed that many were in a very weak financial condition before the crisis. But this information was not condensed and integrated into macroeconomic analysis in a way that would identify potentially serious macroeconomic consequences of, and risks from, such vulnerability.

The experience of South-East Asia shows that operational tools can be used to shed light on the links between corporate sector balance sheets and macroeconomic developments. The refinement of these tools should help policymakers design and introduce policies, both short-term and longer-term, that can reduce the risk of crisis and destabilization. Such policies include better insolvency frameworks, improved corporate governance, better asset-liability and risk management, policies on short-term capital flows, and other preventive policies at the micro and macro levels (IMF September 1999). Applying these tools to accurate and timely data can help policymakers assess corporate sector vulnerability before a crisis emerges and formulate policies to reduce the risks of a serious crisis, as well as resolve problems brought about by excessive corporate leverage.

The proliferation and frequency of currency crisis intensified the debate on the question of appropriate exchange rate policy and its management. Macroeconomic and exchange rate management required to be made sound as the rigid fixed exchange rate and tight monetary policy became incompatible. The pursuance of the fixed or crawling peg exchange rate to promote exports along with tight monetary policy to clamp down inflation served well to promote export and economic growth, foreign exchange reserve accumulation, and technological innovation and other gains. However, maintaining twin objectives of price cum exchange rate stability through fixed pegged rates and tight monetary policy created distortions. Interest rate pressures were generated as the governments maneuvered to curb the expansion in domestic and foreign assets, stemming partly from capital inflows, to maintain money supply within manageable levels. The central bank launched massive sterilization efforts to control the growth in monetary base, but absorbing the cost of these operations became unsustainable. The high interest rates and fixed exchange rates, in the absence of regulations, led private sector to borrow abroad on a short-term basis at relatively low international rates to finance domestic investments, which led to the accumulation of un-hedged foreign currency liabilities. After the crisis, with the exception of Malaysia, all economies switched to floating exchange rates. The crisis reconfirmed the inherent incompatibility of fixed exchange rate and the tight monetary policy and its inherent dangers and costs to the economy.

Traditional norms and practice in foreign reserve management have placed excessive emphasis on determining the adequacy of foreign exchange reserves based on a country's import requirements. However, the swift depletion of reserves used to defend the currencies during speculative attacks in 1997 underscored the need for emerging market economies to maintain larger levels of foreign exchange reserves as a buffer against speculative attacks, or other external shocks. Prudential foreign reserve levels for countries with open capital accounts and substantial capital inflows should be measured on the basis of a broader set of criteria that include, beyond import requirements, the cushion for short-term and volatile foreign currency obligations and debt service capacity indicators.

Theoretically, global capital mobility is advocated on grounds of increased efficiency and welfare by promoting allocation of world savings and specialization to the most productive investment opportunities; foreign resource mobilization for capital deficit economies; pooling of risks, while providing investors opportunities to exploit higher returns across the borders; and capital market integration and technological change. However, unfettered and free global capital mobility carries some risks including exposing fragile economies to the volatility of short-term speculative attacks. On balance, it is well established that benefits of global capital mobility outweigh the costs or risks. To minimize such costs and risks, greater attention needs to be devoted to encourage orderly and proper sequencing of capital account liberalization.

In these economies, the capital accounts were liberalized but without the supportive macroeconomic fundamentals and prudential regulations and safeguards for financial institutions and corporate sector to monitor risk exposures. Generally, there existed no mechanism in place to assess the composition of capital inflows, in particular, the assessment of sustainable and manageable levels of short-term debt; risks associated with sterilization operations needed to neutralize the effects of capital inflows on the monetary base; financial institutions and corporate sector credit exposure of short-term foreign borrowing and its servicing; and risks of misalignment of exchange rate systems with capital flows. As the capital inflows put pressure on exchange rates to appreciate in real terms, export growth would be affected. This experience reconfirmed that pace and sequencing of capital account liberalization is critical. While early liberalization of long-term inflows and other trade flows is key, the short-term capital inflow liberalization needs to be sequenced with sound macroeconomic fundamentals and prudential regulatory safeguards in the financial sector. (http://www.adb.org/Documents/Speeches /1999/ms1999033.asp).

So, a big challenge is to design and establish a framework for international financial markets that will put the enormous potential of private investment capital to use while, at the same time, limiting the inherent risks. Today, private investment capital is indispensable, both in terms of volume and sophistication, for promoting development and growth and for creating jobs. To avoid the devastating impact that financial and currency crises would have on the affected economies and on the people, the need to reform and strengthen the international financial architecture, especially through increased transparency of economic and financial data among the countries, is quite high (http://www.imf.org/external/np/speeches/ 2002/062102.htm). The crisis prevention initiatives to address the vulnerabilities linked to volatile private capital flows, weaknesses in banking and corporate sectors, and contagion revealed by the financial crises are the enhanced surveillance of capital markets and assessments of external vulnerability, implementing standards and codes, pursuing financial sector assessment program, and improving transparency (http://www.imf.org/external/ np/speeches/2002/ 052602.htm).

STRENGTHENING MACROECONOMIC POLICIES

There is no doubt that high priority should be given to consolidating macroeconomic stability and strengthening competitiveness through implementation of sound fiscal, monetary, and exchange rate policies. On fiscal policy, there will be a need to enhance tax efficiency and improve collection through various measures, including reorienting the tax system from foreign trade taxes toward broad-based domestic consumption taxes, curbing tax exemptions, and revamping revenue administration. Strengthening expenditure management systems and strictly limiting the overall government borrowing from the banking system is essential. Concurrently, monetary policy should seek to regulate the growth of the money supply to keep price uncertainty in check. Reliance on indirect monetary instruments and ensuring that interest rates are freely determined by market forces are important as is the increased exchange rate flexibility. Sustaining competitive real exchange rates to facilitate the integration into the global economy, attract investment, and foster export diversification and growth is essential (IMF December 2001).

There is need to create an international financial system in the 21st century that recognizes the new realities of open, not sheltered, economies; international, not national, capital markets; and global, not local, competition. The expansion of trade has now become the centerpiece for a strategy to promote sustained global growth and truly shared prosperity. Advanced countries need to open up their markets and phase out the large business of trade-distorting subsidies and the developing countries need to get rid of barriers among themselves (IMF April 20, 2002). This calls for strong leadership of the advanced industrial countries, by taking action to strengthen the prospects for sustained growth in their own economies and through leading by example in the effort to make globalization work for the benefit of all. There is a need to give as much attention to risks and vulnerabilities arising in the advanced countries as to the problems in emerging markets and developing countries (IMF July 8, 2002).

What are needed at the domestic level are vigilance and a firm policy hand to make the economy robust and more dynamic. This means the main policy forms must shift from short-term considerations to tackling decisively underlying problems. Special attention must be paid to preventing the reemergence of the fiscal and external deficits. This requires firm control over public spending and a long-term strategy to increase national saving. The economy must endeavor to reduce the instability and imbalance associated with the various macroeconomic aggregates through the disposal of non-performing loans (NPL), industrial deregulation, and restructuring of the banking and corporate sectors. Countries with sound fiscal and monetary policies and persistent with structural reforms could weather the storm better than others and have demonstrated that it is possible to decouple from contagion. Good policies always pay off in addition to improving the outlook of the global economy and international financial system (IMF April 29, 2002).

But the persistent vulnerabilities in a number of countries leave no room for complacency. Protracted external borrowing to finance public consumption, without generating sufficient external revenues, breeds disaster. There is a more general point: the expansion of global capital markets needs to be better anchored with stronger trade integration and the growth in debtor countries. The degree of trade openness of developing countries as a group should match their integration into global capital markets. Latin America's external vulnerability is higher than that of other emerging market economies because the former is relatively more integrated into global capital markets while, at the same time, they have not managed to raise the share of their exports in GDP in line with their increased external borrowing. If we understand crisis prevention as tackling the causes of crises, we need to view this imbalance as a fundamental problem. We need more integration of economies to foster growth in the economy, not least to fight poverty. But there is need to manage a better balance between the opening of capital account and the expansion of trade, to reduce the cyclical recurrence of financial crises.

This means that better trade opportunities for all and the expansion of trade must now become the centerpiece for a strategy to promote sustained growth and prosperity. The advanced countries have a main responsibility of opening up their markets and phasing out the trade-distorting subsidies. It is essential to have leadership to face and withstand the special interests of some groups for the benefit of the broad majority of the people in both rich and poor countries. But the leaders in the developing countries should be equally ambitious in getting rid of barriers to trade among themselves. Learning from experience and adapting to changes in the global economy along with focusing on macroeconomic stability and sustainable growth have become most important. To this end, concentrating increasingly on the soundness of financial sector and enhancing transparency and openness in the policy formulation and its practice has become most important. Focusing better on priorities and giving more room to ownership of reforms by the country itself is similarly important. Sound institutions and good governance are crucial for continued growth and financial stability. To resolve homegrown problems, no money in the world can substitute for self-responsibility and political commitment and unity in a society.

A well-functioning market economy is absolutely essential as it draws its strength and dynamism from competition. Good policies always pay off. It has to be accepted that some degree of overshooting and correction will always be part of the process if we want to preserve a system which continuously seeks for better results, based on freedom of choice and self responsibility. And there are limits to the ability to predict and thereby prevent crises. The objective can only be fewer and less severe crises. Concentrating more on vulnerabilities and risks, on seeking improvements in the quality and timeliness of data, and on promoting standards and codes, as "rules of the game", are most essential. Strengthening shock absorbers that make the economy more resilient to adverse external developments is crucial which points to the significance of more flexible exchange rate regimes, prudent fiscal policies, and stronger, deeper and more diversified financial systems.

Taking early action to address emerging problems and imbalances is necessary to reduce risks and vulnerabilities to the economy. Promoting standards and codes, including on corporate governance and accounting principles, along with building positive public-private partnership and dialogue become significant. Implementation of measures for strengthening the self-correcting mechanisms of markets and effective self-regulation and restraint are essential. It is an indispensable principle that debtors and private creditors must bear the responsibility for the risks they take. A clear and predictable economic environment is needed to enable investors to price risks adequately. Debt sustainability is also a major issue in this respect. There is need for better incentives and tools to allow for a timelier, orderly, and less costly restructuring of unsustainable debt.

There is wide agreement on the kind of macroeconomic and financial policies governments need to adopt to reduce vulnerability to policy-induced crises or adverse external shocks. They should avoid profligate fiscal and monetary policies, overvalued exchange rates, and unsustainable current account deficits. Triggered by weak banking systems and weak financial regulation in a world of large and volatile international capital flows, banking crises have been more numerous, especially in the 1990s. For example, the build-up of structural vulnerabilities, viz., (i) sharply rising short-term debt that far exceeded international reserves, (ii) a financial sector that had done a poor job of intermediating capital inflows and found itself saddled with hugely mismatched assets and liabilities, and (iii) corporations that were massively over-leveraged and exposed to interest and exchange rate fluctuations, suddenly created the financial panic among domestic and international investors that unfolded in the 1997 crisis in Thailand. Therefore, to prevent financial crises, governments need to improve the prudential regulation and supervision of financial intermediaries, introduce new standards for data dissemination, and implement corporate bankruptcy reform. These measures are already under way in many developing countries, but there is still a long way to go. Actions at the national level may not be enough to prevent economy-wide crises. Domestic actions will have to be complemented by actions at the international level to contribute to foster global financial stability (World Bank 2000/01).

There is need for policymakers to achieve progress toward reducing economic imbalances, restructuring economic policies especially in developing countries, and reducing the net transfer of financial resources from developing countries. Various steps are needed to enhance growth prospects and reduce the risks of further instability in the financial market and possibly slowdown in economic activity. The first is credible action to reduce large budget deficits, as this is essential to bring about a lasting reduction in the country's current account deficit and to lower real interest rates. To correct growing current account imbalances in the world economy, countries with surplus current accounts need to adopt appropriate macroeconomic and structural policies to maintain the growth of domestic demand. Although judging the appropriate stance of macroeconomic policy will be unavoidably difficult in the climate of economic uncertainty, concerted and credible change would help reduce the rising current account imbalances, lessen the risks of a recession, and stabilize exchange rates, ultimately expediting economic growth. Reducing barriers to trade is also essential in this regard.

The key to faster growth and better export performance is the more efficient use of domestic resources in both the public and private sectors. Macroeconomic stabilization needs to be supported by sectoral policy reform in trade, agriculture, industry, energy, and human resources. This affects the use of public resources directly and influences the use of private resources through improved incentives of taxes, subsidies, and regulation. Countries with relatively sound economic policies would be able to avoid major debt problems. The structural adjustment would, therefore, help raise economic growth by improving the economies' supply response.

Capital inflows from official and commercial sources can help to finance new productive capacity and provide support for policy reform and growth. This has been the rationale for the BOP support provided by the IMF and the World Bank. Favorable prices for developing country exports and unimpeded access to growing markets in industrial countries can sharply strengthen the effectiveness of both domestic policy and external finance. Long-term solvency depends directly on the cost of debt. A simple rule of thumb is that if the real interest rate exceeds the rate of growth of exports, the debt service ratio will tend to rise. Conversely, lower interest rates can significantly reduce the debt service burden over time.

Economic policies in the industrial countries - especially the stance of U.S. fiscal and monetary policy - determine interest rates worldwide. A return to low and stable interest rates would significantly improve the prospect of a gradual release from the debt overhangs. So, excessive fiscal deficits and the resulting financing requirements of the public sector have often been at the root of macroeconomic imbalances. Bringing expenditures more closely in line with revenues to ensure that the resulting deficits are consistent with other macroeconomic policies and objectives is an essential element of improving the quality of government. The goal is to raise additional revenue in the most cost effective way and to cut spending, where necessary, in the least damaging way (World Bank 1988).

AREAS FOR IMPROVEMENT

To promote a strong and sustained world economic recovery, monetary policies should remain broadly supportive of growth while keeping inflation under control. Reforms should be pursued vigorously, with the aim of improving economic flexibility and resilience, contributing to high and sustainable growth, and supporting the orderly reduction of persistent imbalances in the global economy. The recovery in industrial countries based on decisive action to reform the banking and corporate sectors, sustained progress with wide-ranging reforms to enhance the growth potential and focusing on the efforts needed over the medium-term to preserve fiscal balance will contribute to supporting activity in emerging market and developing countries. Many emerging market economies have become more resilient through the adoption of sound economic policies, including more sustainable exchange rate regimes. It will, nevertheless, remain essential to further strengthen fiscal positions and to press ahead with corporate, financial, and institutional reforms to support the emerging recovery and attract foreign direct investment (FDI). For problem emerging economies, it is urgently needed to move ahead with a sustainable economic program that would continue to receive the support of the international financial institutions and provide the basis for the establishment of stability and growth on a sustainable basis.

The commitment of the international community to improve living standards and reduce poverty through sound policies and higher and more effective aid especially for accomplishing the millennium development goals is encouraging. In this regard, strong domestic ownership, sound policies, strengthened institutions, and improved governance are most important. The overall importance of more open trade for a durable economic recovery and for sustained, broad-based growth in the developing countries in particular needs no emphasis. There is need to resist protectionist pressures and to continue to lower trade barriers, enlarge market access for developing countries and phasing out trade distorting subsidies under the WTO framework. Promoting sound economic growth, achieving economic and financial stability and preventing crises should be the focus of the policies. In this respect, strengthened assessments of vulnerabilities, with particular attention to debt sustainability and the private sector's balance sheet exposure, remain critical.

Appropriate and proactive macroeconomic policies support economic recovery. There is an ongoing responsibility to implement sound macroeconomic policies and structural reforms to sustain recovery and support strengthened productivity growth in the economy. Building on improved economic policies, many emerging markets and developing economies are also now showing clear signs of recovery. Better availability and clarity of information furnished to markets have enabled market participants to better assess and differentiate across economies the fundamental causes of market developments.

Helping developing countries strengthen the conditions for growth, poverty reduction, and debt sustainability is important. Ensuring macroeconomic stability, promoting the transparency of public finances, strengthening tax collection, and adopting appropriate policies (including debt management policies) to ensure that debt levels are sustainable becomes urgent. Implementing growth-promoting structural reforms, maintaining open trade regimes, and creating a favorable investment climate to encourage the growth of industries is important. Targeting scarce resources to priority social services, including by ensuring the adequate provision of health and education services, providing more concessional financial support as well as debt restructuring or debt relief where needed, in conjunction with strong reform program so that resources are well used, and increased access to industrial countries' markets and promotion of direct investment become necessary. (IMF April 29, 2002).

Policymakers' records in recent years give reason to believe that the risks of not getting the right policies have reduced over the years as evident from the fact that economic downturns overall have become less marked over the past 15-20 years, thanks partly to better monetary policies and, possibly, to better fiscal policies. Countries that reduced vulnerabilities, for example, by moving to more flexible exchange rates tended to weather the storm better than countries with less flexible markets and a weaker macroeconomic policy framework. As the recovery picks up steam, industrial countries would need to balance the risks of inflation against the fragility of the recovery when conducting their monetary policy. Short-term real interest rates are very low and can not be sustained indefinitely at these levels without generating inflation. One of the recent lessons is that if attention is paid to the economy and the medium-term structural issues are taken care of during the good times, it puts the economy in a much better position to weather downturns.

What the financial crises in Asia and elsewhere have also shown is that economic openness is not enough. Sound and transparent macroeconomic policies, a stable and rational regulatory and incentive framework, robust financial systems accompanied by effective supervision mechanisms, and good governance in the public and private sectors are also required if countries are to take full advantage of globalization so as to prevent the crises that have struck some emerging countries. What the countries need is a reform strategy designed to improve resource allocation and create institutions suitable for accelerated growth. The first pillar of this strategy is maintaining sound macroeconomic policies to contain inflation and avoid a recurrence of BOP difficulties (IMF December 2001).

The crises that shook Mexico in 1994-95 and East Asia in 1997-98 came as a stark reminder that economic fundamentals-sound national macroeconomic and structural policies and a sound and properly regulated financial system-were as critical as ever. The crises that erupted in Russia in 1998, Brazil in l998-99, and Turkey and Argentina in 2001 also underscored the importance of rethinking the international financial architecture to ensure a smoothly functioning and orderly international financial system, maximize the benefits of globalization for all countries, and prevent financial crises or manage them effectively if they do occur.

Reform of the international financial architecture is being undertaken on several fronts. The main elements are:

- Promotion of transparency, accountability, and good governance, which, by fostering broad discussion of economic policies and improving the provision of information to markets, can help countries bolster their economic performance;
- Adoption of international standards and codes, which provide benchmarks against which to assess the performance of individual countries;
- Strengthening of financial systems, which contribute significantly to domestic and international financial intermediation, helping to mobilize savings and channel them efficiently to productive investments;
- Orderly capital account liberalization through careful management and sequencing so that countries are able to benefit from open capital transactions while minimizing the risks of sudden capital movements;
- Implementation of sustainable exchange regimes, which are critical to macroeconomic stability and competitiveness;
- Development of modalities for the involvement of the private sector in forestalling and resolving crises; and
- Reform of the IMF's non-concessional lending facilities to focus more on crisis prevention and to ensure more effective use of IMF resources;

These initiatives for a new international financial architecture are complemented by initiatives focusing on debt relief and poverty reduction for low-income countries. To the extent that the international financial architecture is a force for macroeconomic stability, it also contributes to growth, which is crucial to efforts to fight poverty. To address the problems of poverty and high debt levels more effectively, the IMF in 1996 launched the Heavily Indebted Poor Countries (HIPC) Debt Initiative jointly with the World Bank.

In September 1999, the objectives of the IMF's concessional lending were broadened to include an explicit focus on poverty reduction in the context of a growth-oriented strategy. Reflecting the new objectives and procedures, the IMF established the Poverty Reduction and Growth Facility (PRGF), to be based on the Poverty Reduction Strategy Paper (PRSP), to replace the Enhanced Structural Adjustment Facility (ESAF). Key macroeconomic policies, including targets for growth and inflation, and the thrust of fiscal, monetary, and external policies, as well as structural policies to accelerate growth, are subjects for public consultation. Key social and sectoral programs and structural reforms aimed at poverty reduction and growth are to be identified and prioritized during the participatory PRSP process, and their budgetary impact costed taking into account the need for efficient, well-targeted spending.

The bottom-up approach to costing is to be reflected in the design of the macroeconomic framework, including the level and composition of government expenditures, and the fiscal and external deficits. The authorities need to take into account effects on domestic demand, implementation capacity, and the need to maintain an adequate level of international reserves. They need to ensure that spending programs can be financed in a sustainable, non-inflationary manner. PRGF-supported programs also focus on improvements in governance as a fundamental underpinning for macroeconomic stability, sustainable growth, and poverty reduction. The primary focus is on improving the management of public resources, achieving greater transparency, enhancing active public scrutiny, and promoting increased government accountability in fiscal management (http://www.imf.org/external/np/exr/facts/prgf.htm).

The crises in international financial markets highlighted three areas in which improvement is needed. First, there must be enhanced efforts to identify incipient vulnerabilities in national and international financial systems. Moreover, there should be concerted procedures to understand better the sources of systemic risk and to formulate effective financial, regulatory, and supervisory policies to mitigate them. Second, there should be more effective procedures to ensure that international rules and standards of best practice are developed and implemented, and that gaps in such standards are effectively identified and filled. Third, there should be improved arrangements that apply across all significant financial institutions, and that there are procedures to ensure the continuous flow of information among the authorities responsible for financial stability.

The crises have underscored the importance of assessing domestic vulnerabilities in the light of evolving global conditions, as well as of relaying such assessments to concerned stakeholders to forestall delays in correcting inadequate structures and destabilizing trends. The potential risks posed to the world economy by financial market problems and the threat of chain reactions, or "contagion," in the financial sector can not be undermined. These trends and developments have demonstrated the importance of mitigating systemic risk by better understanding and more effectively alleviating the factors that bear on it. Disabling shocks to the global financial system may arise from a variety of factors and circumstances, including macroeconomic weaknesses, the collapse of major institutions, and weaknesses in the infrastructure that underpins and connects financial systems. The answer lies in transparency, close monitoring, and, if necessary, coherent and appropriate action to forestall accelerating adverse developments. (IMF September 1999)

The South-East Asian countries have achieved progress since the 1997-98 crisis though problems in the corporate and financial sectors still linger. It is worth noting that the signs of economic recovery have since been quite evident, with the real GDP growth turning positive, BOP pressures easing and external current account deficits turning into surpluses, private consumption and exports rebounding, inflation, exchange rates, and prices stabilizing; and the stock market indices reaching or surpassing the pre-crisis levels. The economies made progress on sound macroeconomic framework, which contributed to price stability, a reduction in external vulnerability, and the rebuilding of reserves. The expansionary fiscal policy stance helped cushion the impact of the global slowdown and fiscal consolidation was the necessity to reduce the high level of public debt. The effectiveness and credibility of fiscal policy would be boosted by increased transparency. The table below shows the real GDP of the crisis-hit countries during 1997-2000, before 2001 when the world economy itself witnessed economic slowdown, and since 2002.

Table 2. South-East Asian GDP Growth

	Real GDP Growth Percent							
	1997	1998	1999	2000	2001	2002	2003	2004
Indonesia	4.5	-13.1	0.8	4.9	3.4	3.7	3.5	4.0
Korea	5.0	-6.7	10.9	9.3	3.1	6.3	2.5	4.7
Malaysia	7.3	-7.4	6.1	8.6	0.3	4.1	4.2	5.3
Philippines	5.2	-0.6	3.4	4.4	4.5	4.4	4.0	4.0
Thailand	-1.4	-10.5	4.4	4.6	1.9	5.3	5.0	5.1
Singapore	8.5	-0.9	6.4	9.4	-2.4	2.2	0.5	4.2

Source: IMF (September 2003).

In assessing the appropriate stance of policies, policymakers need to take account of the risks and costs related to the uncertainties of the forecast, within a longer-term policy framework that is consistent with a gradual reduction in the imbalances in the economy over time. Macroeconomic policies in most industrial countries should remain broadly supportive of activity, although in countries where the recovery is most advanced, attention will need to turn toward reversing earlier monetary policy easing. Aggressive action to address deflation is also required. The medium-term policy framework needs to be geared toward supporting sustainable growth and an orderly reduction in the global imbalances. As experience during the downturn has shown, it remains essential to press ahead with efforts to reduce vulnerabilities and maximize the scope for policy flexibility in response to external shocks, especially though fiscal consolidation. To address the structural problems that continue to place a damper on current conditions and the outlook and catalyze the strength and robustness of growth in the period ahead, progress with reforms are needed to strengthen financial and corporate sectors, improve fiscal positions, and boost international and domestic confidence in the emerging economies (IMF April 2002).

World economic recovery is ongoing, with the global output growth in 2003 estimated at 3.2 percent and in 2004 at 4.1 percent (IMF September 2003). While the outlook is positive, policymakers need to remain alert to several possible risks and global imbalances, high corporate and consumer debt, and other non-economic events. Despite that the recovery in the global economy has been underway, there are still uncertainties and risks overcoming which will require a shift in focus from short-term considerations, to tackling decisively the underlying economic and financial imbalances, and implementing sound fiscal and monetary policies and structural reforms. With the pace and robustness of the global recovery still unclear, and inflationary pressures low, monetary policies should remain accommodative for the time being. Fiscal policies need to focus on medium-term consideration. There also must be confidence that the international environment will hold opportunities for countries committed to reform. Trade liberalization is also an important element in crisis avoidance-the experience of Latin America where trade links have lagged behind capital market links illustrates this vividly. Resisting pressures for protectionism is key to strengthening confidence about the future prospects for strong global growth and shared prosperity in the world. Improving further the capacities for crisis prevention and management will also be crucial for sustaining global growth. The role of sound institutions and good governance for sustained growth and financial stability is indispensable. Strengthening surveillance and crisis prevention should always be the first line of defense in dealing with external shocks and vulnerabilities (http://www.imf.org/external/np/speeches/2002/070402.htm).

Participating in the Report on the Observance of Standards and Codes (ROSCs) process and the Financial Sector Assessment Program (FSAP) could help the authorities chart the path ahead and send an unambiguous signal to markets of the commitment to transparency, good governance, and reform. The low inflation, the ongoing recovery, the comfortable reserve level, and the large output gap allow the economies to maintain a bias toward easing. The policymakers need to remain vigilant with regard to the global outlook as well as important medium-and long-term challenges that should be addressed through the acceleration of reforms in the corporate and banking sectors and continued progress in addressing restructuring issues. Corporate and banking sector problems remain an obstacle to sustained economic recovery as there is still overcapacity in many sectors and leverage remains high, requiring stepped-up actions to restructure and reduce corporate debt and efforts to strengthen the financial sector health in order to foster economic growth. Action to remove obstacles for creditors to initiate bankruptcy proceedings and to insist on liquidation in the event of a failed rehabilitation is also necessary (IMF August 29, 2002). Early warning signals are critical to reduce the likelihood of crisis and to take effective and timely steps for crisis response and its management. Sound macroeconomic management is a vital preventive measure, which should focus on avoiding, among others, excessive domestic credit growth, overvaluation of currencies, and large external imbalances with excessive dependence on short-term capital flows relative to foreign exchange reserves. Also, vitally important are developing resilient and robust financial systems; encouraging financial discipline in corporate sector with sustainable debt/equity ratios supported by good corporate governance, credible accounting, auditing and disclosure standards; and adopting viable and credible exchange rate management.

Code of Good Practices on Transparency

Learning from the experiences where inadequate reporting of macroeconomic and financial data contributed to the build-up of financial imbalances and uncertainty that prompted investor panic, the international fora are encouraging higher disclosure, transparency and development of codes of conduct to guide investors to efficient and productive resource allocation. For improving the macroeconomic management and financial sector soundness, international standards of good practices for economic policies and for the financial infrastructure have been devised (Appendix II). The standards cover macroeconomic policy and data transparency (monetary and financial policy transparency, fiscal policy transparency and data dissemination). The Code of good practices along with the establishment of Special Data Dissemination Standards (SDDS) and General Data Dissemination System (GDDS) are intended to improve information availability and accuracy for risk assessments which will together help present reliable information on member countries on comparable basis (http://www.adb.org/Documents/Speeches/1999/ms1999033.asp). The international standards of good practices also cover institutional and market infrastructure (insolvency, corporate governance, accounting, auditing, payment and settlement, and anti-money laundering/combating the financing of terrorism) and financial regulation and supervision (banking supervision, securities regulations, and insurance supervision). Accordingly, in the context of strengthening the architecture of the international monetary and financial system, the Code of transparency practices for monetary and financial policies identifies desirable transparency practices for central banks in their conduct of monetary policy and for central banks and other financial agencies in their conduct of financial policies. The transparency practices listed in the Code focus on: (a) clarity of roles, responsibilities and objectives of central banks and financial agencies; (b) the processes for formulating and reporting of monetary policy decisions by the central bank and of financial policies by financial agencies; (c) public availability of information on monetary and financial policies; and (d) accountability and assurances of integrity by the central bank and financial agencies. By enabling market participants and the general public to understand and evaluate financial policies, transparency is likely to be conducive to good policy-making

Monetary and financial policies are interrelated and often mutually reinforcing, with the health of the financial system affecting the conduct of monetary policy and vice versa. However, the institutional arrangements for these two types of policies differ considerably. For some, the emphasis is on market efficiency considerations; for others the focus is on market and systemic stability, while for others the principal consideration is client-asset protection, hence, the two sets of practices. Besides, the operation of a country's payment system affects the conduct of monetary policies and the functioning of the financial system, and the design of payment systems has implications for systemic stability. Although a number of countries currently lack sufficient resources and the institutional capacity to implement all of the good transparency practices listed in the Code, these practices are included in the Code in the anticipation that countries would aspire over time to introduce such good practices.

The Code of good practices on fiscal transparency is also believed to make a major contribution to the cause of good governance. It should lead to better-informed public debate about the design and results of fiscal policy, make governments more accountable for the implementation of fiscal policy, and strengthen credibility and public understanding of macroeconomic policies and choices. In a globalized environment, fiscal transparency is of considerable importance for achieving macroeconomic stability and high-quality growth. However, it is only one aspect of good fiscal management, and attention needs to be paid also on increasing the efficiency of government activity and establishing sound public finances. The IMF being well-placed to take the lead in promoting greater fiscal transparency because of its fiscal management expertise and universal membership, the International Monetary and Finance Committee (IMFC) is, therefore, encouraging IMF member countries to implement the Code of good practices on fiscal transparency. The Code is based around the following key objectives: role and responsibilities in government should be clear; information on government activities should be provided to the public; budget preparation, execution, and reporting should be undertaken in an open manner; and fiscal information should attain widely accepted standards of data quality and be subject to independent assurances of integrity. The Code should also facilitate surveillance of economic policies by country authorities, financial markets, and international institutions. Under financial regulation and supervision, the banking supervision guidelines for the assessment of compliance with the core principles have been set out. The Basel Committee's Core Principles for Effective Banking Supervision have been given in Appendix II.4.

EXCHANGE RATE SYSTEM

One of the key lessons drawn from these experiences is that, for the emerging countries in Asia as well as countries elsewhere with heavy involvement in global financial markets, the policy requirements for maintaining a currency peg have become increasingly demanding. The experience also demonstrates that the costs of a forced exit from a fixed exchange rate regime, after a period of resistance against mounting pressures, can be huge. Against this background, floating exchange rate regimes have become the preferred choice for many emerging market economies that, by definition, have substantial involvement in global financial markets. Of course, this is not to say that, for certain economies, a pegged exchange rate regime, buttressed by the requisite supporting policies and institutions, can not be a viable alternative. First, for floating regimes to function effectively, it is important that exchange rates are allowed to actually move—in both directions—in response to market forces. Only such movements can persuade economic agents to recognize, and to manage prudently, the foreign exchange risks that are inescapable for countries open to global financial markets.

Second, this does not imply a policy of benign neglect toward the exchange rate. For emerging market countries, with their high degree of involvement with global trade and finance, movements in exchange rates have important economic consequences, and economic policies, including monetary policy and exchange market intervention, need to take account of these movements. A more flexible exchange rate regime means a need for an alternative nominal anchor. In this regard, many advanced economies and an increasing number of emerging market economies with flexible exchange rates have moved to formal or informal inflation targeting regimes. Making these efforts successful requires work on several fronts, including: developing an institutional framework that allows for greater central bank independence in the conduct of monetary policy; a strengthened analytical and forecasting framework as a basis for making monetary policy judgments; efforts to strengthen the monetary policy transmission mechanism, including through market-determined interest rates and sound financial institutions making loans on a strictly commercial basis; and greater transparency in explaining the central bank's monetary policy objectives and policy actions to enhance the predictability of those actions and build policy credibility.

Successful inflation targeting—and indeed, any form of sound monetary policy on a sustained basis—is not possible in the face of fiscal dominance. More generally, the importance of consistent implementation of sound fiscal policy with medium-term debt sustainability has been proven time and again. Though many of the countries have had a tradition of prudent fiscal management and low public debt, several of them have witnessed a significant deterioration in their fiscal balances and increases in debt levels, partly because of the huge needs related to cleaning up of the banking system. Accordingly, putting fiscal policy on a sustainable medium-term path must be a priority (http://www.imf.org/external/np/speeches/2002/052602.htm).

Exchange rate policy has always been central to the macroeconomic management. Ever since the breakdown of the Breton Woods system, there has been a widespread desire to avoid excessive volatility in the exchange rates of the world's major currencies. In a world of highly integrated global capital markets, there is no realistic alternative to floating exchange rates among the major currencies. So, currency misalignments need to be dealt with by concentrating on the fundamentals by accelerating the pace of key structural reforms.

Looking beyond the major currencies, an important conclusion is that no single exchange rate regime is appropriate for all members in all circumstances. A country that is willing to abandon all monetary policy discretion may be able to adopt a hard peg, such as a currency board arrangement. Because this deprives the country of instruments to deal with external shocks, living safely under a hard peg obliges a country to have not only a disciplined fiscal policy, but also particularly sound financial and corporate sectors and considerable wage and price flexibility. As shown tragically in Argentina, when these conditions do not hold, it can be very difficult for a country to arrange a timely exit strategy.

Emerging market countries need to be very cautious about adopting pegged or heavily managed exchange rate systems. When a country is open to international capital flows, the reaction to any hint of unsustainable macroeconomic policies can be swift and severe. And a country considering an exchange rate peg needs to be fully aware of the associated costs, including the possibility that extraordinarily high interest rates might be required at times of severe financial market pressure. Especially, its domestic financial institutions and businesses must be well prepared to live with such policy adjustments. Where there is doubt that these requirements will be met, a flexible exchange rate regime is a better choice.

For other developing countries, there is, in principle, a wider range of choice in exchange rate regime, provided these are backed by the appropriate macroeconomic and structural policies. And very few countries, advanced or developing, are indifferent to the behavior of their exchange rates. But on balance, floating exchange rates are seen as the safest solution for a wide range of countries. Unfortunately, this has the disadvantage of leaving the public and markets without a clear anchor, which can make a country vulnerable to accelerating inflation in response to domestic or external shocks.

Several countries with floating exchange rate systems, as a way to anchor inflation expectations, have adopted inflation targeting. Many other countries are actively considering this possibility. After a decade of experience, inflation-targeting regimes are in action through all phases of the business cycle. For countries that are considering the adoption of inflation targeting, the keys to success are transparency and credibility. Once a political decision has been taken to make the inflation target the primary objective of monetary policy, it is crucial for the monetary authorities to keep the public regularly informed about their actions to meet that objective and the basis for the judgments that they make. Perhaps even more than other monetary regimes, inflation targeting obliges the central bank to safeguard its credibility in pursuing the inflation goal. For this reason, inflation targeters are almost invariably countries in which the central bank has a high degree of operational independence. But it is also important to avoid a deflationary bias, which would impose unnecessary costs on society and risk undermining the political basis for the inflation targeting regime and the independence of the central bank.

In preparing for inflation targeting, most countries have adopted an existing, well-known price index as the target, generally the national consumer price index, and they have used a selection of available data series in forecasting inflation and assessing the effects of monetary policy. Moving forward, it will be important to explore whether this is the most appropriate index to target, whether some components of the CPI should be systematically excluded or added to the index, and what new statistics might be needed for related analysis and forecasting.

For countries with inflation targeting regimes, forward-looking indicators such as stock indices, real estate prices, and derivatives yields provide crucial information for assessing the appropriateness of monetary policy. This type of data is also important for promoting stability of domestic and international capital markets. While such information is generally produced by markets or private firms, there might be a role for the public sector-either in collecting these statistics, setting standards or guidelines, or at least encouraging full disclosure of the methodology that was used to assemble the data (http://www.imf.org/external/np/speeches/2002/022802.htm).

EXCHANGE RATE AND CAPITAL ACCOUNT REGIMES

Every major financial crisis since Mexico's in 1994 has in some way involved a fixed or pegged exchange rate regime. Countries without pegged rates, among them Mexico in 1984, South Africa and Israel in 1998, and Turkey in 1998, have certainly suffered from international capital market disturbances, but to nothing like the same degree as those with soft pegs. No wonder then that many have been arguing that the intermediate regimes that lie between hard pegs (currency boards, or membership of a currency union) and floating rates are not generally sustainable in countries open to international capital flows. The fundamental reason for this is the famous "impossible trinity" of Robert Mundell that, among a fixed exchange rate, capital mobility, and a monetary policy dedicated to domestic goals, a country can only have two out of three over a sustained period.

While a floating exchange rate regime reduces the risk of external crises, it is not sufficient to prevent them, for a crisis can also be caused by adverse external debt dynamics or a loss of domestic fiscal control. Second, in a floating rate regime, it should not be implied that policymakers can or should be indifferent to the exchange rate, nor that they should necessarily totally refrain from intervention in the foreign exchange markets. Changes in the nominal exchange rate affect inflation, and changes in the real exchange rate may have a powerful effect on the allocation of resources. So, it is expected that monetary policy in countries with floating exchange rate systems would respond to movements in the exchange rate. Beyond the use of interest rates, some countries intervene directly from time to time in the foreign exchange markets to try to stabilize the exchange rate. So long as they are not perceived as trying to defend a particular rate, this can be useful.

Once a country begins to float, it has to decide on the monetary policy it will follow. Many recent floaters have opted for inflation targeting under which exchange rate movements are automatically taken into account to the extent that they are expected to affect future inflation. This will generally produce a pattern of monetary tightening when the exchange rate depreciates, a response similar, but not necessarily of the same magnitude, to that which would be undertaken if the exchange rate were being targeted directly. One obvious solution to the impossible trinity is to impose capital controls. However, experience suggests that countries will in the course of their development ultimately want to liberalize the capital account and integrate into global capital markets. It is surely no coincidence that the most advanced economies all have open capital accounts, which implies that as countries develop, they will want to get rid of capital controls. Second, it is important to distinguish between outflows and inflows. For controls on outflows to succeed, they need to be quite extensive. As a country develops, controls are likely to become more distorting and less effective. And controls can not prevent a devaluation if domestic policies are fundamentally inconsistent with maintaining the peg. Policymakers have wisely abandoned fixed exchange rates before capital mobility (http://www.imf.org/external/np/speeches/2001/060010.htm).

No single type of exchange rate regime is appropriate for all countries in all circumstances. It is quite striking, however, that financial crises have invariably been linked, directly or indirectly, with fixed exchange rates. Fixed exchange rate regimes, in combination with insufficiently regulated and supervised banking systems, allow the buildup of speculative bubbles. That is why, a flexible exchange rate regime is a better and safer option, particularly for emerging market countries. Such a regime can function as a safety valve in the event of economic policy slippages. A currency board, if accompanied by disciplined economic policies, may be an option in certain circumstances—to ensure price stability. The European experience with economic and monetary integration may hold lessons for other regions of the world on how economic and monetary stability can be secured (http://www.imf.org/external/np/speeches/2001/040201.htm). The crises in Thailand, Indonesia, Korea, Russia, and Brazil were all associated with exchange rates that had been more or less fixed. This is a powerful evidence suggesting that such systems are crisis-prone. Equally striking is the evidence from other countries like Mexico, Turkey, and South Africa that faced strong financial pressures but whose flexible exchange rates allowed them to mange those pressures far better. So, it is likely that in coming years more countries would adopt flexible exchange rate systems.

In the wake of the Asian crisis, many emerging market countries adopted systems of managed floating though a number of countries still maintain fixed exchange rates. Experience has shown that heavily managed or pegged exchange rate regimes can be tested suddenly by exchange markets, and that it can be very costly either to defend them or to exit under disorderly circumstances. While such regimes can succeed, the requirements for a country to maintain a pegged or heavily managed exchange rate are daunting, especially when the country is strongly engaged with international capital markets. Countries opting for such a system must unwaveringly pursue sound macroeconomic policies and also need to be fully aware of the associated costs, including the possibility that extraordinarily high interest rates might be required at times of severe financial market pressure. Moreover, their domestic financial institutions and businesses must be well prepared to live with such policy adjustments. Where there is doubt that these requirements will be met, a flexible exchange rate regime, one in which the rate moves both up and down in response to market forces, sometimes by significant amounts, is a better choice.

A floating rate system is more forgiving of policy errors and, therefore, a somewhat safer solution for most countries, which, however, does not mean that the authorities would be indifferent to the behavior of the exchange rate. At times, it may be appropriate to adjust monetary policy in response to external developments. With a floating rate, there is no need to risk unsustainable drains on the foreign exchange reserves to defend an exchange rate target. Moreover, a country can pursue a more independent monetary policy, while receiving important signals from the exchange markets about the soundness of its policy framework. However, floating requires an alternative anchor for monetary policy and inflation expectations, such as inflation targeting. Countries can still face difficult choices, especially if they are faced with large swings in international capital flows. Still, the absence of an exchange rate target provides an important, extra degree of freedom for domestic policy management and dealing with external shocks.

A country that is willing to abandon all monetary policy discretion may find it feasible to adopt a hard peg--either through a currency board arrangement or the use of another country's currency. Argentina, Bulgaria, Estonia and Lithuania each escaped from a cycle of chronically high inflation through strategies based on the use of currency boards. Hong Kong has maintained a currency board for two decades. This type of commitment can provide greater credibility than managed floating or an adjustable peg. However, like those regimes, living safely under a hard peg obliges a country to have particularly sound financial and corporate sectors and strong support from macroeconomic policies, as well as considerable wage and price flexibility. On balance, hard pegs are appropriate only in limited circumstances--mainly for countries with a history of high inflation, that have the determination to implement very disciplined macroeconomic policies and ambitious structural reforms, but no other credible nominal anchor (http://www.imf.org/external/np/speeches/2001/011301.htm). Inflation targeting as a framework that can improve the design, implementation, and performance of monetary policy requires a considerable degree of central bank independence with no symptoms of fiscal dominance. As a country that chooses a fixed exchange rate system subordinates its monetary policy to the exchange rate objective and is not effectively able to target directly any other nominal variable, such as the rate of inflation, inflation targeting has always been associated with a high degree of exchange rate flexibility. Inflation targeting is also used as a tool to build the credibility of the general framework of macroeconomic policy (IMF March 1998).

NEPAL'S MACROECONOMIC SITUATION

GDP grew by 3.0 percent during 2002/03 compared to the negative rate of 0.6 percent during 2001/02. During 2002/03, the growth rate of narrow money was 5.5 percent and that of broad money 8.1 percent. The growth rate of narrow money was 9.3 percent while broad money grew by 4.4 percent during 2001/02. The rate of inflation during 2002/03 was 4.8 percent. During 2001/02, such rate was 2.9 percent. During 2002/03, exports increased by 4.9 percent as against a decline of 15.6 percent in the previous year. Despite a decline of exports to India following the quantitative restrictions through the trade treaty renewed in 2002, a strong acceleration in garment exports contributed to the growth of overall exports in 2002/03. The import increased by 16.9 percent in 2002/03 against a decline of 7.2 percent in the preceding year. Workers' remittances during 2002/03 amounted to Rs. 54.2 billion. Such remittances had aggregated Rs. 47.5 billion during the previous year. Because of the substantial increment in the workers' remittances, current account of the BOP recorded surplus of Rs. 8.4 billion during 2002/03. Such surplus was Rs. 17.9 billion during 2001/02. BOP surplus was Rs. 5.2 billion and gross foreign exchange reserve level was Rs. 110.4 billion, enough to cover merchandise imports of 10.6 months. BOP had recorded a deficit of Rs. 3.3 billion during 2001/02, the first such deficit after 1995/96 when BOP had recorded a deficit of Rs. 1.1 billion. Gross foreign exchange reserve amounted to Rs. 105.9 billion in mid-July 2003. For 2003/04, GDP projection is at 4.0 percent with the projections of inflation rate at 4.7 percent and BOP surplus at Rs. 6.4 billion. Government revenue/GDP ratio during 2002/03 rose to 12.4 percent from 11.9 percent during 2001/02. Budget deficit/GDP ratio during 2002/03 fell to 4.6 percent compared to the ratio of 5.4 percent during 2000/01. Outstanding foreign debt/ GDP ratio also came down to 48.9 percent during 2002/03 from 52.1 percent during 2001/02.

The monetary policy for 2003/04 is directed at keeping inflation within the control, avoiding the unnecessary depletion of the international reserves, and maintaining exchange rate stability. Along with this, the monetary policy gives priority to achieving and strengthening economic as well as financial sector stability. The growth rate of narrow money is projected at 8.4 percent and that of broad money at 11.1 percent. The bank rate is maintained at 5.5 percent in view of the relatively higher rate of inflation in 2002/03 compared to that in 2001/02. The prevailing system of the commercial banks being required to maintain 7 percent balance of their domestic current and saving deposits and 4.5 percent balance of their domestic fixed deposits with the Nepal Rastra Bank (NRB) as well as 2 percent vault compulsory ratio of total domestic deposit has been changed into a single and uniform compulsory ratio of 6 percent. The 2 percent vault compulsory ratio has been done away with. NRB will make a provision of additional refinancing facility of Rs 1.5 billion for the sick industry loans in the current fiscal year also. The refinancing rate will be lowered from the current 3 percent to 2 percent. To avail this facility, the commercial banks will have to lower the current interest rate of such loans at 6.5 percent to 5.5 percent.

Nepal has implemented the financial sector reform as a part of the overall economic liberalization process. Promoting financial stability and maintaining a secure, healthy and efficient payments system are the important objectives of the new NRB Act, 2002, which has accorded autonomy to the central bank in formulating and implementing the monetary and exchange rate policies for ensuring macroeconomic stability. With the objective of improving the NRB functions by focusing more on the core central banking activities, the ongoing re-engineering and restructuring work of NRB is being expedited on the basis of the report of the re-engineering consultants. In order to ensure a smoother functioning of the overall financial system, the NRB has directed commercial banks and other financial institutions to comply with the various prudential norms. Emphasis has been placed on improving the supervisory process in addition to implementing the international accounting standards in the banks and other financial institutions. As the critical component of the financial sector reform program, foreign management teams in the two largest commercial banks, one fully government-owned and one partly government-owned, have been undertaking the management contract responsibilities.

With a view to reducing the mounting non-performing assets (NPA) of the banking system, the legislative and other necessary work is underway for setting up the Assets Management Company (AMC). The budget for 2003/04 has earmarked Rs. 150 million for the establishment of the AMC. The Debt Recovery Tribunal constituted under the Debt Recovery Act has been in operation. The Debt Recovery Appellate Court has also been constituted. The new credit information and black listing provisions are already in place. The risk-weighted capital adequacy ratio has been fixed at 11 percent, of which 5 percent has to be the core capital for the current fiscal year. For 2004/05, the capital adequacy ratio has been fixed at 12 percent, comprising 6 percent core capital. With an objective of according priority and accelerating the financial sector reform program, HMG/N has expressed its commitment to the enactment of the draft legislations relating to the secured transactions, anti-money laundering, and insolvency. In order to fill the need for an umbrella Act, the banks and financial institutions Ordinance, 2004 has come into force since February 4, 2004. The ceiling of the foreign equity in the joint venture commercial banks, currently 67 percent, could be raised as per the request and requirement of the reputed foreign banks. With the ongoing financial liberalization coupled with Nepal's accession to WTO on September 11, 2003, the competitive environment in the financial sector is destined to intensify. Foreign commercial banks will also be allowed to operate wholesale branches with effect from January 1, 2010.

INTERNATIONAL FINANCIAL STANDARDS AND NEPAL

The relevance to Nepal of the international standards of good practices for economic policies and for the financial structure becomes apparent when we look at Nepal's priority policy agenda like consolidating macroeconomic stability, increasing investment, strengthening the financial sector, and reducing the poverty level. Experience worldwide indicates that macroeconomic stability and financial sector soundness are necessary for economic growth and that growth can raise incomes and reduce the incidence of poverty. Nepal has been successful in achieving greater macroeconomic stability though the overall growth rate has slowed down on account of internal and external factors. To make Nepal's economic stability sustainable and to raise the level of economic growth so as to make a lasting dent on poverty, significant reform initiatives need to be put in place. Secondly, in Nepal, gross domestic investment, though around 25 percent of GDP, still falls far short of what is required to accelerate the process of economic development. There is equally an urgent need to improve the efficiency and productivity of such investments. In addition, Nepal accounts for a very small amount of FDI, the kind of investment that could bring Nepal not only the capital but also the technology and know-how she so desperately needs. Nepal has to build and sustain a secure economic environment, without which both domestic and foreign investors will continue to shy away from opportunities available. Thirdly, given the still fragile state of the emerging financial sector, Nepal needs to expedite measures that will enable financial markets to mobilize savings and allocate credit more efficiently and that will make financial products and services available to more of the population.

Nepal can make progress toward achieving these objectives by applying the principles underlying the new international financial architecture. By increasing transparency and accountability and bringing the financial sector up to international standards and codes, Nepal can improve decision-making and develop sounder national economic policies while creating an environment that encourages investment and saving. More generally, by putting broad interests ahead of specific or vested interests, national authorities will be able to address poor governance in its various forms-inefficient management of public resources, reduced accountability, and less responsiveness to the public expectations and needs. As there is increasing evidence that poor governance dampens investment and growth, tackling governance problems will, in turn, help sustain economic development. Measures that promote orderly capital account liberalization and implementation of flexible exchange rate regimes will help bring the benefits of international capital flows to Nepal. And, by promoting a stable financial system, the implementation of the international standards of good practices will immensely serve Nepal's interests.

CONCLUSION

Experience worldwide indicates that macroeconomic stability is necessary for economic growth and that growth can raise incomes and reduce the incidence of poverty. Macroeconomic imbalances and macroeconomic mismanagement result in high real interest rates, declining investment rates, volatile exchange rates, growing current account imbalances, stagnated economic growth, sluggish trade, disruptions in financial markets, and even rising tendencies of protectionism. Failure to counteract the BOP deficits, excessive spending that fuels inflation, and other economic shocks create greater uncertainty and higher risk for private producers and investors, who take evasive actions that reduce future investment, worsen the crisis, and cause development efforts to suffer. Running budget deficits financed through the banking system expand the money supply and feed inflation. Investments would fall, debts would grow, debt service obligations would exceed the available financing resources, and the economies would face continuing risks and vulnerabilities because of the mismatch of the macroeconomic policies as reflected in the overvalued exchange rates, imprudent fiscal policy and instable prices. Consequently, the BOP crises and foreign debt problems arise or get aggravated. At the same time, the growth rate would be significantly reduced. The solution almost invariably involves some combination of cutting public spending and raising additional revenue as well as making the foreign exchange regime more prudent for freeing resources for debt service and exports respectively.

Priority should be given toward consolidating macroeconomic stability and strengthening competitiveness through the pursuance of sound fiscal, monetary, and exchange rate policies. To enhance the growth prospects or reduce the slowdown in economic activity, reducing the risks of instability in the macroeconomy in general and financial markets in particular is inevitable for which various steps are needed. Fiscal policy should be supportive to growth as well as stability. Credible action to reduce the large budget deficits is most urgent to bring about a lasting reduction in the current account deficit, stabilize exchange rates and lower the real interest rates. Concurrently, monetary policy should seek to contain the growth of the money supply to keep inflation in check, with increased reliance on indirect monetary instruments, particularly the open market operations. Increased exchange rate flexibility is essential to correct the fundamental misalignments in the economy. Countries that reduced vulnerabilities, for example, by moving to more flexible exchange rates, tended to weather the storm better than countries with less flexible markets and a weaker macroeconomic policy framework. Sustaining competitive real exchange rates to facilitate the economies' integration into the global economy, attract investment, and foster export diversification and growth is essential.

The expansion of trade becomes the centerpiece for a strategy to promote sustained global growth and truly shared prosperity for which advanced countries need to open up their markets and the developing countries need to get rid of barriers among themselves. What is needed are vigilance and a firm policy hand to make the economies robust and more dynamic, shifting the focus from short-term considerations to tackling decisively the underlying problems. Special attention needs to be given to prevent the fiscal and external imbalances and reduce the instability in the various macroeconomic aggregates. This requires the strengthening of the expenditure management and implementation of a long-term strategy to increase national savings. Tackling decisively the underlying economic and financial imbalances is essential for sustained prosperity. To remove impediments to investment and growth, structural reforms like reducing the level of non-performing loans, improving industrial deregulation, and restructuring the banking and corporate sectors are equally important. Measures aimed at reforming the international financial architecture would be useful in promoting economic and financial stability with growth, both at the national and global levels.

Maintaining financial stability, restoring the momentum of economic growth and reinvigorating the fight against poverty in view of realizing the millennium development goals, including halving the world poverty by 2015, are most basic issues confronting today. Continuing to work together for sustained, broad-based growth, creating opportunities for productive employment, reducing vulnerabilities, further opening up the economies to trade, and providing resources for durable poverty reduction have become important global economic agenda at the present. This will require continued vigilance and a further strengthening of medium-term policy frameworks- both to improve prospects for sustainable growth and stability and to reduce vulnerabilities.

The core principles for effective banking supervision need to be complied for improving the health of the financial system. In the context of Nepal, the basic macroeconomic risks relate to the higher level of the NPA, weak fiscal structure especially the large volume of fiscal deficits including the rising domestic and foreign debt obligations, price volatility, fragile exports and growth uncertainty. The basic risk, however, could generate from the fixed exchange rate mechanism that has been pursued in relation to the determination of the exchange rate vis-à-vis the Indian currency. So, promoting sound macroeconomic fundamentals, strengthening the supervisory process of the financial system, and making exchange rate more flexible comprise the important macroeconomic policy prudence for the medium-term.

APPENDIX I

I.1. Asian Countries: Current Account Balances as a Percentage of GDP, 1989-97

	1989	1990	1991	1992	1993	1994	1995	1996	1997
Hong Kong	11.5	8.5	6.6	5.3	7.0	2.1	-3.4	-1.0	-1.0
Singapore	9.6	8.3	11. 2	11.4	7.3	15.9	17.7	15.0	13.7
South Korea	2.4	-0.9	-3.0	-1.5	0.1	-1.2	-2.0	-4.8	-3.9
Taiwan	7.6	6.9	6.7	3.8	3.0	2.6	1.9	3.8	3.1
China	-1.3	3.9	4.3	1.4	-2.7	1.3	0.2	0.9	1.2
India	-2.3	-2.2	-1.5	-1.5	-1.5	-0.9	-1.7	-1.2	-1.1
Indonesia	-1.2	-2.8	-3.7	-2.2	-1.3	-1.6	-3.4	-3.4	-3.6
Malaysia	0.8	-2.0	-8.9	-3.7	-4.4	-5.9	-8.5	-5.3	-5.9
Philippines	-3.4	-6.1	-2.3	-1.9	-5.5	-4.4	-4.4	-5.9	-4.5
Thailand	-3.5	-8.5	-7.7	-5.7	-5.6	-5.9	-8.0	-8.0	-4.6

Source: Jomo (1998).

I.2. Asian Countries: Fiscal Balances as a Percentage of GDP, 1988-97

	1988-93	1994	1995	1996	1997
Hong Kong	2.3	0.8	-0.3	0.1	1.4
Singapore	6.8	4.0	7.6	6.7	5.1
South Korea	0.5	0.6	0.5	-0.3	-0.5
Taiwan	-1.6	-6.3	-7.4	-8.0	-5.0
China	-2.6	-2.4	-1.3	-1.2	-1.3
India	-7.4	-6.5	-5.8	-5.1	-4.9
Indonesia	-0.6	-0.4	0.8	0.7	0.5
Malaysia	-3.7	-0.2	1.2	-0.7	1.6
Philippines	-3.3	0.7	0.5	0.3	0.4
Thailand	3.3	1.5	3.0	2.2	-0.7

Source: Jomo, K. S. (1998).

APPENDIX II

II. 1. International Standards of Good Practices for Economic Policies and for the Financial Infrastructure

Subject Area	Key Standards	Issuing Body
Macroeconomic Policy and Data Transparency		
Monetary and financial policy transparency	Code of Good Practices on Transparency in Monetary and Financial Policies	IMF
Fiscal policy transparency	Code of Good Practices on Fiscal Transparency	IMF
Data dissemination	Special Data Dissemination Standard (SDDS)/ General Data Dissemination System (GDDS)	IMF
Institutional and Market Infrastructure		
Insolvency	Principles and Guidelines for Effective Insolvency and Creditor Rights Systems	World Bank
Corporate governance	Principles of Corporate Governance	OECD
Accounting	International Accounting Standards (IAS)	International Accounting Standards Board (IASB)
Auditing	International Standards on Auditing (ISA)	International Federation of Accountants (IFAC)
Payment and settlement	Core Principles for Systemically Important Payment Systems	Committee on Payment and Settlement Systems (CPSS)
Anti-Money Laundering/Combating the financing of terrorism	The Financial Action Task Force's Forty Recommendations against Money Laundering and the Eight recommendations on combating terrorism financing.	Financial Action Task Force (FATF)
Financial Regulation and Supervision		
Banking supervision	Core Principles for Effective Banking Supervision	Basel Committee on Banking Supervision (BCBS)
Securities regulation	Objectives and Principles of Securities Regulation	International Organization of Securities Commissions (IOSCO)
Insurance supervision	Insurance Core Principles	International Association of Insurance Supervisors (IAIS)

II. 2 (A). GOOD TRANSPARENCY PRACTICES FOR MONETARY POLICY BY CENTRAL BANKS (Major Points)

1. *Clarity of Roles, Responsibilities and Objectives of Central Banks for Monetary Policy*

   1.1 The ultimate objective(s) and institutional framework of monetary policy should be clearly defined in relevant legislation or regulation, including, where appropriate, a central bank law.

   1.2 The institutional relationship between monetary and fiscal operations should be clearly defined.

   1.3 Agency roles performed by the central bank on behalf of the government should be clearly defined.

2. *Open Process for Formulating and Reporting Monetary Policy Decisions*

   2.1 The framework, instruments, and any targets that are used to pursue the objectives of monetary policy should be publicly disclosed and explained.

   2.2 Where a permanent monetary policy-making body meets to assess underlying economic developments, monitor progress toward achieving its monetary policy objective(s), and formulate policy for the period ahead, information on the composition, structure, and functions of that body should be publicly disclosed.

   2.3 Changes in the setting of monetary policy instruments (other than fine-tuning measures) should be publicly announced and explained in a timely manner.

   2.4 The central bank should issue periodic public statements on progress toward achieving its monetary policy objective(s) as well as prospects for achieving them. The arrangements could differ depending on the monetary policy framework, including the exchange rate regime.

   2.5 For proposed substantive technical changes to the structure of monetary regulations, there should be a presumption in favor of public consultations, within an appropriate period.

   2.6 The regulations on data reporting by financial institutions to the central bank for monetary policy purposes should be publicly disclosed.

3. *Public Availability of Information on Monetary Policy*

   3.1 Presentations and releases of central bank data should meet the standards related to coverage, periodicity, timeliness of data and access by the public that are consistent with the International Monetary Fund's data dissemination standards.

   3.2 The central bank should publicly disclose its balance sheet on a pre-announced schedule and, after a predetermined interval, publicly disclose selected information on its aggregate market transactions.

   3.3 The central bank should establish and maintain public information services.

3.4 Texts of regulations issued by the central bank should be readily available to the public.

4. Accountability and Assurances of Integrity by the Central Bank

4.1 Officials of the central bank should be available to appear before a designated public authority to report on the conduct of monetary policy, explain the policy objective(s) of their institution, describe their performance in achieving their objective(s), and, as appropriate, exchange views on the state of the economy and the financial system.

4.2 The central bank should publicly disclose audited financial statements of its operations on a pre-announced schedule.

4.3 Information on the expenses and revenues in operating the central bank should be publicly disclosed annually.

4.4 Standards for the conduct of personal financial affairs of officials and staff of the central bank and rules to prevent exploitation of conflicts of interest, including any general fiduciary obligation, should be publicly disclosed.

II.2 (B). GOOD TRANSPARENCY PRACTICES FOR FINANCIAL POLICIES BY FINANCIAL AGENCIES

1. Clarity of Roles, Responsibilities and Objectives of Financial Agencies Responsible for Financial Policies.

1.1 The broad objective(s) and institutional framework of financial agencies should be clearly defined, preferably in relevant legislation or regulation.

1.2 The relationship between financial agencies should be publicly disclosed.

1.3 The role of oversight agencies with regard to payment systems should be publicly disclosed.

1.4 Where financial agencies have oversight responsibilities for self-regulatory organizations (e.g., payment systems), the relationship between them should be publicly disclosed.

1.5 Where self-regulatory organizations are authorized to perform part of the regulatory and supervisory process, they should be guided by the same good transparency practices specified for financial agencies.

2. Open Process for Formulating and Reporting of Financial Policies

2.1 The conduct of policies by financial agencies should be transparent, compatible with confidentiality considerations and the need to preserve the effectiveness of actions by regulatory and oversight agencies.

2.2 Significant changes in financial policies should be publicly announced and explained in a timely manner.

2.3 Financial agencies should issue periodic public reports on how their overall policy objectives are being pursued.

2.4 For proposed substantive technical changes to the structure of financial regulations, there should be a presumption in favor of public consultations, within an appropriate period.

3. *Public Availability of Information on Financial Policies*

3.1 Financial agencies should issue a periodic public report on the major developments of the sector(s) of the financial system for which they carry designated responsibility.

3.2 Financial agencies should seek to ensure that, consistent with confidentiality requirements, there is public reporting of aggregate data related to their jurisdictional responsibilities on a timely and regular basis.

3.3 Where applicable, financial agencies should publicly disclose their balance sheets on a pre-announced schedule and, after a predetermined interval, publicly disclose information on aggregate market transactions.

3.4 Financial agencies should establish and maintain public information services.

3.5 Texts of regulations and any other generally applicable directives and guidelines issued by financial agencies should be readily available to the public.

3.6 Where there are deposit insurance guarantees, policy-holder guarantees, and any other client asset protection schemes, information on the nature and form of such protections, on the operating procedures, on how the guarantee is financed, and on the performance of the arrangement, should be publicly disclosed.

3.7 Where financial agencies oversee consumer protection arrangements (such as dispute settlement processes), information on such arrangements should be publicly disclosed.

4. *Accountability and Assurances of Integrity by Financial Agencies*

4.1 Officials of financial agencies should be available to appear before a designated public authority to report on the conduct of financial policies, explain the policy objective(s) of their institution, describe their performance in pursuing their objective(s), and, as appropriate, exchange views on the state of the financial system.

4.2 Where applicable, financial agencies should publicly disclose audited financial statements of their operations on a pre-announced schedule.

4.3 Where applicable, information on the operating expenses and revenues of financial agencies should be publicly disclosed annually.

4.4 Standards for the conduct of personal financial affairs of officials and staff of financial agencies and rules to prevent exploitation of conflicts of interest, including any general fiduciary obligation, should be publicly disclosed.

Source: http://www.imf.org/external/np/mae/mft/code/index.htm

II. 3. Code of Good Practices on Fiscal Transparency (Major Points)

1. *Clarity of Roles and Responsibilities*

   1.1 The government sector should be distinguished from the rest of the public sector and from the rest of the economy, and policy and management roles within the public sector should be clear and publicly disclosed.

   1.2 There should be a clear legal and administrative framework for fiscal management.

2. *Public Availability of Information*

   2.1 The public should be provided with full information on the past, current, and projected fiscal activity of government.

   2.2 A commitment should be made to the timely publication of fiscal information.

3. *Open Budget Preparation, Execution, and Reporting*

   3.1 The budget documentation should specify fiscal policy objectives, the macroeconomic framework, the policy basis for the budget, and identifiable major fiscal risks.

   3.2 Budget information should be presented in a way that facilitates policy analysis and promotes accountability.

   3.3 Procedures for the execution and monitoring of approved expenditure and for collecting revenue should be clearly specified.

   3.4 There should be regular fiscal reporting to the legislature and the public.

4. *Assurances of Integrity*

   4.1 Fiscal data should meet accepted data quality standards.

   4.2 Fiscal information should be subjected to independent scrutiny.

Source: http://www.imf.org/external/np/fad/trans/code.htm

II. 4. CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

1. *Preconditions for Effective Banking Supervision*

   1.1. An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organizations. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking organizations and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

2. *Licensing and Structure*
   2.1 The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word "bank" in names should be controlled as far as possible.
   2.2 The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organization's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.
   2.3. Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.
   2.4. Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.
3. *Prudential Regulations and Requirements*
   3.1. Banking supervisors must set prudent and appropriate minimum capital adequacy requirements for all banks. Such requirements should reflect the risks that the banks undertake, and must define the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the Basle Capital Accord and its amendments.
   3.2. An essential part of any supervisory system is the evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.
   3.3. Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and loan loss reserves.
   3.4. Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.
   3.5 In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.

3.6 Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.

3.7 Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

3.8 Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.

3.9 Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

3.10 Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

4. *Methods of Ongoing Banking Supervision*

4.1 An effective banking supervisory system should consist of some form of both on-site and off-site supervision.

4.2 Banking supervisors must have regular contact with bank management and thorough understanding of the institution's operations.

4.3 Banking supervisors must have a means of collecting, reviewing and analyzing prudential reports and statistical returns from banks on a solo and consolidated basis.

4.4 Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.

4.5 An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.

5. *Information Requirements*

5.1 Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

6. *Formal Powers of Supervisors*
    6.1 Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking license or recommend its revocation.
7. *Cross-border Banking*
    7.1 Banking supervisors must practice global consolidated supervision over their internationally-active banking organizations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organizations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.
    7.2 A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.
    7.3 Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.

Source: http://imf.org/external/standards/agency.htm

APPENDIX III

III.1. Nepal: Macroeconomic Indicators in Amount (Rs. Billion)

		2000/01	2001/02	2002/03	2003/04
1	Money Supply				
	1.1 Narrow Money	70.6	77.2	83.7	88.9
	1.2 Broad Money	214.5	224.0	245.9	269.3
2	Credit to Private Sector	126.8	133.3	151.0	170.6
3	Time Deposits	143.9	146.8	162.2	180.4
4	Exports	55.7	46.9	49.2	56.0
5	Imports	115.7	107.4	125.9	147.0
6	Trade Deficit	60.0	60.4	76.6	91.0
7	Travel Receipts	11.7	8.7	11.7	13.5
8	Remittances	47.2	47.5	54.2	68.0
9	Regular Expenditure*	42.8	48.6	56.2	60.6
10	Development Expenditure*	37.1	31.5	28.0	41.8
11	Revenue*	48.9	50.4	55.3	62.2
12	Foreign Grants*	6.8	6.7	8.4	15.5
13	Budget Deficit*	24.2	22.9	21.0	24.7
14	Foreign Loans*	12.0	7.7	9.0	12.8
15	Domestic Loans including overdraft*	12.1	15.2	12.0	11.8
16	Total Consumption**	349.3	371.5	402.2	-
	16.1 Private	309.1	329.2	355.5	-
	16.2 Public	40.2	42.3	46.7	-
17	Gross Domestic Savings**	61.5	50.7	51.5	-
18	Total Investment**	98.8	108.2	122.2	-
	18.1 Gross Fixed Capital Formation	78.0	81.6	87.0	-
	Private	46.8	49.6	55.7	-
	Public	31.3	32.0	31.3	-
	18.2 Change in Stock	20.8	26.6	35.2	-
19	Gross National Saving**	77.7	69.1	74.3	-
20	Total Outstanding Loans	260.4	293.7	306.6	-
	20.1 Domestic	60.0	73.6	84.6	-
	20.2 Foreign	200.4	220.1	222.0	-
21	BOP Surplus (+) / Deficit (-)	5.2	-3.4	5.2	6.4
22	Foreign Exchange Reserve	105.2	105.9	110.4	112.0
	2.1 Convertible	80.2	80.3	99.2	100.0
	2.2 Non- Convertible	25.0	25.6	11.2	12.0
23	GDP at Producers' Prices	410.8	422.2	453.7	495.4
24	Nepse Index				
	(Base, Feb. 12, 1994=100)	348.4	227.5	204.9	

* *Budget Figures.*
** *At nominal prices*

III.2. Nepal: Macroeconomic Indicators (Annual Percent Change)

		2000/01	2001/02	2002/03	2003/04[P]
1	Nominal GDP Growth				
	1.1 Producer's Prices	8.2	2.8	7.4	8.9
	1.2 Factor Cost	7.3	3.0	7.0	8.9
2	Real GDP Growth				
	2.1 Producer's Prices	5.5	-0.6	3.0	4.0
	2.2 Factor Cost	4.6	-0.4	2.6	4.0
	Agriculture	5.5	2.2	2.4	3.0
	Non-Agriculture	4.3	-1.9	2.8	4.7
3	Total Consumption*	8.5	6.4	8.3	
	3.1 Private	7.3	6.5	8.0	
	3.2 Public	18.2	5.4	10.2	
4	Gross Domestic Savings*	6.9	-17.6	1.6	
5	Total Investment*	7.1	9.5	12.9	
	5.1 Gross Fixed Capital Formation	6.4	4.6	6.6	
	Private	-0.3	6.0	12.4	
	Public	18.3	2.5	-2.5	
	5.2 Change in Stock	9.7	28.1	32.3	
6	Gross National Saving*	9.9	-11.1	7.5	
7	Money Supply				
	7.1 Narrow Money	15.7	9.3	5.5	8.4
	7.2 Broad Money	15.2	4.4	8.1	11.1
8	Credit to Private Sector	20.5	5.2	11.8	13.0
9	Time Deposits	15.0	2.1	9.5	12.4
10	Exports	11.7	-15.6	4.9	27.3
11	Imports	6.6	-7.2	16.9	15.3
12	Trade Deficit	2.3	0.7	26.2	7.5
13	Travel Receipts	-3.0	-26.1	31.1	6.8
14	Regular Expenditure	23.9	13.6	16.4	7.1
15	Development Expenditure	16.7	-15.1	-11.0	49.4
16	Revenue	14.0	3.2	11.7	12.6
17	Foreign Grants	18.2	-1.0	25.2	85.3
18	Budget Deficit	36.9	-5.2	-8.7	17.7
19	Foreign Loans	2.0	-36.1	16.3	43.2
20	Domestic Loans including overdraft	20.7	25.5	-21.3	-1.3
21	Inflation	2.4	2.9	4.8	4.7
	21.1 Food and Beverages	-2.3	3.7	4.4	3.5
	21.2 Non-Food and Services	8.1	2.1	5.0	5.8

* *At nominal prices.*

III.3. Nepal: Macroeconomic Indicators as Percentages of GDP

		2000/01	2001/02	2002/03	2003/04[P]
1	Money Supply				
	1.1 Narrow Money	17.2	18.3	18.5	18.0
	1.2 Broad Money	52.2	53.0	54.2	54.4
2	Credit to Private Sector	30.9	31.6	33.3	34.4
3	Time Deposits	35.0	34.8	35.7	36.4
4	Exports	13.5	11.1	10.9	11.3
5	Imports	28.2	25.4	27.7	29.7
6	Trade Deficit	14.6	14.3	16.9	18.4
7	Travel Receipts	2.9	2.0	2.6	2.7
8	Remittances	11.5	11.3	11.9	13.7
9	Regular Expenditure*	10.4	11.5	12.5	12.2
10	Development Expenditure*	9.0	7.5	6.2	8.4
11	Revenue*	11.9	11.9	12.4	12.6
12	Foreign Grants*	1.6	1.6	1.8	3.1
13	Budget Deficit*	5.9	5.4	4.6	5.0
14	Foreign Loans*	2.9	1.8	2.0	2.6
15	Domestic Loans including overdraft*	3.0	3.6	2.6	2.4
16	Total Consumption**	85.0	88.0	88.6	-
	16.1 Private	75.2	78.0	78.4	-
	16.2 Public	9.8	10.0	10.3	-
17	Gross Domestic Savings**	15.0	12.0	11.4	-
18	Total Investment**	24.1	25.6	26.9	-
	18.1 Gross Fixed Capital Formation	19.0	19.3	19.2	-
	Private	11.4	11.7	12.3	-
	Public	7.6	7.6	6.9	-
	18.2 Change in Stock	5.1	6.3	7.8	-
19	Gross National Saving**	18.9	16.4	16.4	-
20	Total Outstanding Loans	63.4	69.6	67.6	-
	20.1 Domestic	14.6	17.4	18.7	-
	20.2 Foreign	48.8	52.1	48.9	-
21	BOP Surplus (+) / Deficit (-)	1.3	(0.8)	1.1	1.3
22	Foreign Exchange Reserve	25.6	25.1	24.3	22.6
	22.1 Convertible	19.5	19.0	21.9	20.2
	22.2 Non- Convertible	6.1	6.1	2.5	2.4
23	GDP at Producers' Prices	100.0	100.0	100.0	100.0

P Projections

Source: Calculations based on various issues of Economic Survey and NRB Publications

ACRONYMS USED

AMC	Assets Management Company
BOJ	Bank of Japan
BOP	Balance of Payments
CPI	Consumer Price Index
ESAF	Enhanced Structural Adjustment Facility
F&D	Finance & Development
FDI	Foreign Direct Investment
FSAP	Financial Sector Assessment Program
GDP	Gross Domestic Product
GDDS	General Data Dissemination System
GNP	Gross National Product
HIPC	Highly Indebted Poor Countries Debt Initiative
HMG/N	His Majesty's Government of Nepal
IMF	International Monetary Fund
IMFC	International Monetary and Finance Committee
NPA	Non-Performing Assets
NPL	Non-Performing Loans
NRB	Nepal Rastra Bank
PIN	Public Information Notice
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
ROSCs	Report on the Observance of Standards and Codes
SDDS	Special Data Dissemination System
US	United States of America
WDR	World Development Report
WEO	World Economic Outlook
WTO	World Trade Organization

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Financial Sector Reforms in Nepal

Ganesh Kumar Shrestha[*]

Financial sector is the backbone or engine of growth of any economy. It mobilizes and allocates financial resources most productively and efficiently and induces investment, increases employment opportunities and productivity, achieves growth targets and attains overall macro-economic development In a global financial system, each country has to reform its financial sector. The reform process should be properly sequenced. Nepal initiated financial sector reform in mid-1980s and HMG/N and Nepal Rastra Bank have been implementing comprehensive Financial Sector Reform Program since 2001.

HMG/N has strongly committed for the reform of the financial sector in general and RBB, NBL, ADB/N and NIDC in particular. Much depends on the proper implementation of the Financial Sector Reform Program. The financial sector may invite financial crisis which may easily transfer to other sectors of the economy. As such, we have to be extra cautious for the financial liberalization and reforms of the financial sector.

INTRODUCTION

Financial sector reform means gradual liberalization of financial market and its players and opening of all types of depository institutions and other non-depository financial institutions to the private sector. Depository institutions include commercial banks, development banks, finance companies, co-operative banks etc. Other financial institutions include life and non-life insurance companies, pension funds/provident funds/retirement funds, mutual funds, unit trusts, mutual savings banks, mutual funds, savings and loan associations, credit unions, mortgage banks, money market mutual funds, deposit insurance corporation/company, credit guarantee corporation/company and so on. In most developing and transition economies, the financial sector is dominated by the banking sector, which is a largest mobilizer of deposits and provider of credit. Deposits, commercial papers, certificate of deposits, shares, stocks, bonds, bankers' acceptances, premiums from insurance policies and employer and employees contributions are primary liabilities of financial institutions. Business and commercial loans, mortgages,

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government securities, municipal bonds, corporate bonds, corporate stocks, and money market instruments are primary assets of financial institutions.

Financial sector reform also means competition, transparency, financial discipline and governance. The process of financial sector reform begins with deregulation of interest rates on deposits and lending, phasing out of margin rates, statutory reserve requirements, and targeted credit programs, opening up of financial industry to private sector (domestic and foreign), permission to open foreign currency accounts to commercial banks, current account convertibility and completes with free entry and exit barriers to foreign investors in banking, securities trading, insurance services and financial information services, full capital account convertibility, application of international financial standards and best practices (capital adequacy, loan loss provision, auditing, disclosures etc.) central bank's prudential regulatory oversight, supervision and enforcement of depository institutions and privatization of government-owned banking and financial institutions,

Financial sector is regarded as the backbone or engine of growth of any economy whether developed or developing or in transition or emerging. It plays a very important role in the development of all sectors of the economy and actually works as a lubricator by providing financial resources. It operates as an intermediary between financial surplus units and financial deficit units i.e. lenders/savers and borrowers/spenders. It provides different avenues to savers to invest their savings in financial products and services as per their needs and makes funds available to borrowers/investors in most competitive prices. Financial markets provide playing field to financial institutions and their customers (depositors, borrowers, investors etc.) with all types of financial instruments such as deposits, loans and advances, securities, insurance policies, corporate bonds and shares etc. A modern financial sector provides electronic banking services (e-banking), ATM services, credit cards, debit cards, innovative insurance products and services, attractive pension schemes and derivatives, hedging and financial futures. It can provide a wider range of financial services at lower costs while minimizing financial risks to a large number of customers

In a highly developed and sound financial system, all types of customers, whether large or small, rich or poor, and local or foreigner get benefited with their suitable financial products and services and insurance policies. It helps the economy by mobilizing and allocating financial resources most productively and efficiently. It helps to induce investment, increase employment opportunities and productivity, achieve growth targets and attain overall macro-economic development.

But pre-mature financial sector liberalization may bring undesired risks and uncertainties in the financial industry. The financial industry has not forgotten the Mexican financial crisis of 1995 and the East Asian financial crisis of 1997 and 1998, which had a contagion effects in other countries. The negative impact of the financial crisis or turmoil in East Asia had been felt not only in East Asian financial markets but also in Russia and Brazil. But it had a positive impact on the financial markets of Europe and the USA. As a result of financial crises of the 1990s banking systems in many countries collapsed, fast growing economies suddenly felt sharp recessions and the booming international capital flows dwindled to a trickle. It has been well recognized that a pre-requisite for preventing a financial crisis is the existence of a healthy financial sector with a good regulatory framework and strong supervision system of the whole financial sector. Foreign capital or foreign investment generally flows to those countries where there are well-developed financial markets and free mobility of capital and other financial assets. The liberalization process of financial sector should be prudent and well sequenced.

Financial policy makers/planners, financial supervisors/supervision authorities and monetary authorities should be very cautious while reforming the financial sector. It should be in a systematic and sequential order. It can play a crucial role in the overall economic development by mobilizing savings and transforming it into productive resources. The recent World Bank study has revealed that countries with fully open financial services sectors grow on an average by 1 percentage point faster than other countries and more open and competitive financial markets increase economic growth rates by 1.3 to 1.5 percentage points. (Dam, 2002) In the same way, another recent WTO study of 27 emerging market economies found that allowing foreign financial firms to establish locally and engage in broad spectrum of financial activities contributed to greater financial stability. (Dam, 2002)

REVIEW OF LITERATURE ON THE ROLE OF FINANCIAL SECTOR AND FINANCIAL MARKETS

There is a large number of literature and studies on the role of financial sector and financial markets in the promotion and development of financial assets, savings and economic growth. These studies include Gurley and Shaw (1955), Goldsmith (1969), McKinnon (1973) and Shaw (1973). McKinnon (1973) and Shaw (1973) consider role of government intervention in the financial markets as a major constraint to savings mobilization, investment and growth The government's control of interest rates on deposits and loans even impedes the capital formation and low interest rates lead to capital flight. They opined that an increase in real interest rates increases the inflow of foreign capital for investment and economic growth. Collier (1990) argues that the opening of the domestic financial markets to foreign competition provides an incentive to domestic banking institutions to adopt efficient means of banking services. Stulz (1999) and Mishkin (2001) claim that financial liberalization promotes transparency and accountability reducing adverse selection and moral hazard while alleviating liquidity problems in financial markets. They argue that international capital markets help to discipline policy makers, who might be tempted exploiting captive domestic capital markets. Bekaert, Harvey and Lundbiad (2001) claim that financial liberalization and the financial development greatly facilitate economic growth.

As there are several supporters of deregulation and liberalization of the financial sector, there are many financial experts/professionals who favor some controls on financial markets. Stiglitz (1999) clamors to developing countries to put some limits on capital inflows to moderate boom-bust pattern in financial markets. Krugman (1998) argues that capital controls might help developing countries in managing, at least temporarily, retreat of foreign investors. The liberalization measures tend to increase financial fragility and susceptibility to exogenous shocks over which domestic policies have limited controls Demiriguc-Kunt and Detragiache, 1998). Sometimes investors overreact in financial turmoil and withdraw their investments at the smallest signs of financial problems even when macro-economic fundamentals do not warrant it and thus aggravate the financial turmoil (Calvo and Mendoza, 2000). Soros (2002) and Stiglitz (2002) criticized the functioning of the international financial system

Box: Recent Experience of Financial Sector Reform in South Korea

Although Korea has a developed financial sector and it has a long history of financial sector reform, the country was almost paralyzed during the East Asian financial crisis. It was found that there was a lack of market discipline. A lack of financial transparency among financial institutions and corporations, "brand-name" lending practices, and inadequate credit analysis and risk management skills were a few structural problems that caused financial crisis. The regulation and supervisory frameworks were not upgraded. The market mechanism did not function properly and there was a government intervention in the financial sector. To reform the financial sector, the Presidential Committee on Financial Reform was launched in early 1997 and the committee recommended a sweeping series of reforms for the Bank of Korea and for the financial supervisory structure.

The committee recommended the establishment of the Financial Supervisory Organizations (FSO) in August 1997 and the draft Act was presented to the National Assembly and the Assembly passed the Act on the Establishment of FSO in December29, 1997. The Financial Supervision Commission (FSC) began to serve on April 1998, as Korea's supreme financial regulatory and supervisory organization for banking, non-banking, securities and exchange, and insurance services. The Financial Supervisory Service (FSS) worked as an executive body of the FSC. The FSC/FSS closed down financial institution deemed non-viable. It also merged few financial institutions. The Korean Government earmarked US$ 57 billion to purchase non-performing loans and support re-capitalization efforts of domestic financial institutions through the Korea Asset Management Corporation (KAMCO) and the Korea Deposit Insurance Corporation (KDIC). The FSS strengthened prudential regulations. The new regulations included the Prompt Corrective Action (PCA) procedures, which means if any bank failed to meet the 8% capital adequacy ratio and a certain level of CAMELS rating will be automatically suspended, liquidated or merged. The FSS required the adoption of international best practices in accounting and disclosure standards. The deposit insurance or guarantee system was further improved.

FINANCIAL SECTOR REFORM IN NEPAL

The reform or liberalization of financial sector is a continuous process. It takes a long period to complete the process of financial reform. Even in a most developed financial market, innovation in financial products and services takes place, which necessitates the changes in rules and regulations in the financial markets. The financial sector reform of Nepal was initiated in mid-1980s and it is still being continued. The financial sector reform process in Nepal has been analyzed in three phases, which are as follows:

Phase I (1984-1990)

The first phase of the financial sector reform was initiated in mid-1980s under the liberal economic policy of HMG/N. Under this policy, HMG/N first opened up the banking sector to foreign investors. In 1984, the Nepal Arab Bank Limited was established as the first joint venture commercial bank of the country. The bank was established with 50 percent equity participation of a foreign bank. The establishment of this joint venture bank brought foreign investment in the banking industry and modern banking practices and technical skills. The Nepal Indosuez Bank Limited and Nepal Grindlays Bank Limited were established in 1985 and 1987 respectively as joint venture commercial banks. The banking operations of these three international commercial banks helped the economy to get modern banking services. It enhanced the competitive environment in the banking sector especially in the Kathmandu valley where more than 50 percent of the economic activities of the country take place.

In July 1985, commercial banks were allowed, for the first time, to accept current and fixed deposits on foreign currencies (U.S. dollar and sterling pound) Before May 26, 1986, the interest rates of commercial banks were totally controlled by Nepal Rastra Bank (NRB), the central bank of Nepal. Both deposits and lending rates were being heavily regulated by NRB. On May 26, 1986, NRB deregulated the interest rate regime and authorized commercial banks to fix interest rates at any level above its minimum prescribed levels. These bold steps of NRB had a far reaching impact in the development of the financial sector of the country, which was clearly evidenced in the growth of the assets and banking activities of commercial banks. Effective 29 May, 1986, the liquidity requirement was also lowered to 9 percent from 25 percent (NRB, 1996).

Under the Structural Adjustment Program of the IMF, the financial sector was further liberalized in 1987. The focus of NRB was placed on indirect monetary control. The emphasis was laid on increased financial intermediation, deepening of financial markets and increase in the role of market forces in the financial system. The auction mechanism was introduced for the first time to sell treasury bills (NRB, 1996).

The Agriculture Development Bank of Nepal (ADB/N) and the Nepal Industrial development Corporation (NIDC) were allowed to issue debentures to increase their financial resources. ADB/N also issued agriculture savings bonds in 1985. These debenture and bond were introduced as new financial instruments to develop the financial markets of the country. HMG/N also sold national savings certificates outside the financial system for the first time. The ADB/N was also allowed to open commercial banking branches in urban areas. Commercial banks were allowed to determine their lending rates except for exports and productive sector credits. They were granted virtually freedom to fix their interest rates on deposits in July 1989 except for the priority sector credit The Credit Information Bureau was established in 1989 (NRB, 1996).

NRB strengthened its regulation and supervision of banking and financial institutions. Commercial banks were required to increase their capital adequacy ratio (CAR) gradually. They were required to maintain CAR of 2.5 percent by mid-July 1989 and 3.0 percent by mid-July 19990. Regulation on single borrower limit was also introduced. There were some new regulations issued on refinance policy and reserve requirements. The Finance Company Act was enacted in 1986 to increase competition in financial markets and especially for the merchant banking and leasing services and to provide loans for hire purchase, term finance and housing construction. But finance companies were not established during the first phase of the financial sector reform (NRB, 1996).

There was a new development on the capital market opened its floor for corporate share trading in November 1994. The Securities Exchange Center (SEC) also started to provide some merchant banking services. The trading in the capital market was limited due to listing of very few company's shares in the SEC. There was a limited transaction of government securities. The activities of contractual saving institutions such as the Employees Provident Fund (EPF) and insurance services sector did not make any new initiatives.

Phase II (1991- 1998)

After the restoration of democracy, the democratic governments under its open and liberal economic policy gave more emphasis on the liberalization of the financial sector. As a result, the Nepalese financial sector has grown very rapidly since 1990s. There has been a dramatic rise in the number of banking and non-banking financial institutions. Till mid-July 1990, there were 5 commercial banks, 2 development banks, 2 insurance companies, and other few financial and quasi-financial institutions. As at mid-July 2000, there were 11 commercial banks, 2 development banks, 5 regional rural development banks (RRDBs), 44 finance companies, 2 insurance companies, 29 savings and credit co-operative societies and 30 NGOs licensed by NRB and few other financial and quasi financial institutions (EPF, Deposit Insurance and Credit Guarantee Corporation, Citizens Investment Trust, Nepal Stock Exchange Limited, Securities Board, Insurance Board, Credit

Information Bureau). There has been a tremendous increase in the volume of financial transactions and financial markets as well.

The commitments of HMG/N in the financial sector liberalization gave the needed boost in the confidence of the private sector for the establishment of commercial banks in the private sector. The Himalayan Bank Limited and Nepal SBI Bank Limited were established in 1993 and Nepal Bangladesh Bank Limited and the Everest Bank Limited in 1994. All of them were established as joint venture commercial banks. The Nepal Housing Development Finance company was established in the public sector as the first finance company under the Finance Company Act 1986. Soon after the establishment of the first finance company, five finance companies were established in the private sector in 1993. The rural development banks were established in five development regions to provide micro-finance services to the poor and the ultra-poor women. To provide limited banking services in the un-banked rural areas, saving and credit co-operative societies started to get operating licenses from NRB since 1993 and by 1195, there were 10 such financial institutions. Even the NGOs got licenses for micro-credit operations in 1994 and within two years' period, 30 NGOs got operating licenses to undertake limited banking transactions. The separate act for development banks was felt necessary and it was enacted in 1996.

The establishment of finance companies not only improved competition in the deposit and credit services, they also helped in the capital market through listing their shares. Their shares are being traded along with the shares of commercial banks. They have been providing merchant banking services such as underwriters and market makers.

To make the financial sector more liberal, the current account convertibility is very important. Nepal received the article VIII status of the IMF on May 30, 1994. The move towards financial liberalization helped the country to receive this status. Under this status, Nepal is obliged to keep the commitments towards the current account convertibility.

NRB further liberalized the restrictive measures for providing banking and non-banking financial institutions and especially development banks and finance companies more freedom in their business operations. The commercial banks were required to increase CAR to 3.5 percent at mid-July 1991 and 4.0 percent at mid-July 1992. The credit ceiling was removed in 1991 except for government and non-financial government enterprises under the policy of indirect monetary control and Nepal entered into the Enhanced Structural Adjustment Facility (ESAF) in October 1992. NRB laid more emphasis on open market operations as main monetary policy instrument (NRB, 1996).

Under the financial sector reforms, 3 joint venture commercial banks were established and they started to provide modern banking services to their customers. They started to compete with Nepal Bank Limited (NBL) and Rastriya Banijya Bank (RBB), one fully owned and another 51% owned by HMG/N and among themselves to provide modern and efficient banking services. As a result, they attracted most of the good clients/customers (depositors and borrowers) of the RBB and NBL. They were already ailing even before the establishment of joint venture commercial banks. Because of new developments, their financial, managerial and organizational problems became more serious. To study their financial, managerial and organizational problems and to prescribe necessary recommendations, NRB sought the financial and technical help of the UNDP and the study team presented the Commercial Banking Problem Analysis and Strategy Study (CBPASS) reports.

The *CBPASS I* recommended HMG/N to address the following critical areas:

1. Full repayment of Government guaranteed loans to state-owned enterprises and removal of lending obligations.
2. Partial re-capitalization of NBL and RBB.
3. Establishment of a new Rural Finance Institution to assume priority sector lending of NBL and RBB.

To strengthen and improve their performance, HMG/N provided Rs 443 million for the re-capitalization of NBL and RBB. HMG/N provided Rs 3.12 billion for provisioning and repayment of bad debts. HMG/N made payment of Rs 660 million for the government guaranteed bank loans to public enterprises

The *CBPASS II* report identified *four critical areas* where RBB and NBL had to make necessary improvements.

1. Loan Recovery 2. Credit 3. Personnel 4. Branch Operations and MIS

1. The CBPASS II report had revealed that an estimated 5 percent of the assets of NBL and 8 percent of RBB were problem loans and the recovery of these problem loans would significantly improve their liquidity, profitability and capital base. .
2. Both NBL and RBB earned a negative spread on all new loans. Their capital and ability to earn profits to meet essential obligations would continue to be at risk until lending practices are improved.
3. NBL and RBB faced critical human resource issues- overstaffing, lack of skills, demoralized staff, ineffective utilization of human resources, and counter-productive work culture.
4. Their low cost sources of funding i.e. current and savings accounts were found eroded and valuable customers were defecting to JV banks. Their cost structure was very high and it was nearly 4% of their assets. The reason for this higher administrative cost was overstaffing of 40 to 50 percent in the branches. Critical branch-level information was not available and other data unreliable and untimely.

The CBPASS II report recommended following new systems for full implementation by the Board and Top Management of NBL and RBB:

1. Prompt approval of changes.
2. Timely commitment of required financial and human resources.
3. Active support of new systems.
4. Active monitoring of implementation.
5. Adherence to new systems and practices.
6. Removal of key obstacles.
7. Recognition of improved results.

They also recommended for 3 years or more of technical assistance required to fully address operational weaknesses of NBL and RBB to make them healthy and effective banking institutions. They also cautioned the concerned authorities to continue the institutional process in the near future to avoid another government-sponsored financial restructuring program.

Both the CBPASS I and CBPASS II reports were implemented half-heartedly by concerned authorities. Both Banks were re-capitalized but their management and organizational structures could not be improved. HMG/N continued borrowing from NBL and RBB. They started to be run as any government enterprises. As a result, their financial health started to deteriorate and the HMG/N, NRB and the Top Management of NBL and RBB became just silent spectators and waiting for more serious financial, managerial and organizational problems in the future.

At mid-July 1998, the number of commercial banks reached 15. There were 2 development banks and 5 regional rural development banks. There were 29 co-operatives and 30 NGOs licensed by NRB for limited banking transactions. The capital market increased due to listing the shares of commercial banks and finance companies. The insurance activities also increased because of the entry of new insurance companies in the private sector.

Phase III (1999-March 2004)

Financial sector reforms introduced in the last one and a half decades made significant improvements in certain sectors such as liberalization of interest rates, creation of a basic regulatory and supervisory frameworks, development of a longer-term government securities market, secondary market of government securities, establishment of several types of banking and financial institutions, functioning of stock exchange, competitive environment in the insurance services due to establishment of more insurance companies etc. But serious problems remained with two largest commercial banks (RBB and NBL) and two largest development banks (ADB/N and NIDC). The World Bank, the IMF and the Asian Development Bank (ADB) found some weaknesses in NRB's regulatory and supervisory capacity to effectively and efficiently regulate and supervise banking and other financial institutions There were Government mandates seriously distorting operating incentives of the banking sector. Commercial banks requirement to lend in the priority and deprived sectors, problems in opening of new branches to private banks, and restrictions on entry of foreign banks in the financial market.

Taking into account these serious problems in the financial sector, HMG/N adopted the Financial Sector Strategy Statement in December 2000. It has clearly mentioned about the needs for the strengthening and autonomy of NRB so that it can regulate and supervise commercial banks and financial institutions. It has pointed out the needs for the enactment of new NRB Act to increase the independence and authority of NRB to supervise of financial institutions and take over the management of troubled banks and severely punish those financial institutions, which are found engaged in serious irregularities. It has also pointed out the need of having the Deposit Taking Institution Act, which is an umbrella act of all deposit taking institutions. Some of the main elements of financial sector reform strategy published by HMG/N in December 2000 are as follows:

1. Implementing restructuring plans for the to large commercial banks-the RBB and NBL
2. Identifying restructuring strategies for the two development banks, ADB/N and NIDC.
3. Strengthening banking sector regulation and accounting and auditing standards.
4. Strengthening the NRB's supervisory capacities and its ability to enforce compliance with prudential regulations.
5. Improving the regulation and supervision on non-bank deposit taking institutions.
6. Modernizing the legislative framework with a view to reducing legislative overlap and the segmentation and fragmentation.
7. Strengthening corporate governance and the framework for loan recovery.
8. Phasing out the role of NRB and commercial banks in providing directed credit.

As per the commitment of HMG/N to reform RBB and NBL, the Nepal Banking Reform Project was started by HMG/N and NRB with funding assistance from the World Bank (IDA) and DFID (UK). The KPMG Barents Group, the international expert team associated with the Banking Reform Project, started the reform project since 15 November 1999. They completed their study in FY 1999-00. They broadly recognized that Nepal's financial sector still faced following systemic problems:

1. Poor bank governance
    - Political interference and
    - Insider lending
2. Lack of rational banking strategies as well as modern skills and international banking experience to support them
3. Lack of independent, capable supervision
4. Weak financial and management information
5. Weak legal and accounting practices
6. Difficult and deep-seated issues of RBB and NBL to be addressed

The KPMG Barents review of the RBB and NBL found that both banks were deeply impaired in virtually all areas of their operations.

1. Overall bank governance and management weak by modern standards
2. Deep flaws in lending process, loan files and loan portfolio
3. Primitive financial accounting with large pockets of "double counting", unsubstantiated assets, and major items that should be written off by international standards
4. No business strategies, weak planning and budgeting processes, lack in foundation, follow-up, rewards and penalties

5. Low morale of employees, low pay scales, low skills and counter-productive union-oriented activities
6. Primitive management information, record keeping and control systems

The governance and management of RBB and NBL took politically driven decisions. They had negative net worth and insufficient capital adequacy. Their human resource management was found extremely weak in all areas. Their situation was clearly worse than in 1992 when the CBPASS report revealed their financial, managerial and organizational problems and weaknesses.

The KPMG Barents Group recommended following actions to be taken for RBB and NBL:

1. Support Government efforts to create an independent, commercially-run banking system and declare banking reform policies fostering sound banking system
2. Upgrade Board, senior management and staff skills, capabilities and processes
3. Design and invest in comprehensive bank restructuring programs
4. Support and assist in implementing long-range plans to correct environmental weaknesses
5. Support central bank strengthening and independence and provide full enforcement powers
6. De-politicize and commercialize the banking system

The KPMG report concluded that loan assets of RBB and NBL were highly overstated and extremely risky. As a result, both of them were technically insolvent. As of mid-1998, they had losses of around US$450 million, which was equivalent to around 46% of the annual budget of HMG/N or 8.6 percent of GDP. The assessment confirmed that the management of two banks was basically dysfunctional. It recommended the reduction of the role of HMG/N in the financial sector as a direct owner of banking and financial institutions beginning with RBB and NBL.

As per the recommendation of the KPMG report, NRB removed the NBL Board on March 8, 2002, on account of failure to manage the bank properly and replaced it with an NRB-appointed Board. In mid-July, the management of NBL was handed over to ICC Bank Ireland. For RBB, an international banking expert has been selected after Deloitte Touche Tohmatsu broke the contract. There are several international and domestic banking and financial experts who have been working in RBB. These banking and financial experts have already completed HRD Plan, Loan Policy and Guidelines, Computerization Policy and Programs, Portfolio Review and Loan Recovery and Restructuring of RBB and NBL. Both of them have implemented VRS plan and reduced their staff considerably.

HMG/N has enacted the NRB Act, 2002, the Debt Recovery Act, 2002 and the Banking and Financial Institution Ordinance, 2004. The Public Debt Act and the Foreign Exchange Regulation Act were amended in 2002. The draft of the Secured Transaction Ordinance has been sent to HMG/N for its approval, which would address the weaknesses in the legal enforcement mechanism and judiciary capacity.

The Credit Information Bureau is going to be established as a public limited company. The Debt Tribunals have already started its operation. The Asset Management Company is going to be established. The ADB has completed the studies of ADB/N and NIDC and has recommended for the restructuring of ADB/N and privatization of NIDC. NRB has issued prudential regulations to all banking and financial institutions including micro-finance development banks. The supervision manuals both for on-site and off-site have been prepared and implemented. The NRB has started the re-engineering process. The first phase of VRS is complete and the second phase of VRS has been announced. There is a special drive for the improvement of professionalism in the bank. The bank is going to formulate its long-term strategic plan in the near future. It will turn the central bank into a modern central bank.

There has been new development in the financial markets as well. New money market instruments are being introduced. The activities of the inter-bank call money market are increasing. The secondary market for government securities and company shares is being expanded. The repurchase agreements (Repos) have helped to expand secondary market of government securities. The holders of government securities can turn their securities to liquid assets. Commercial banks have introduced credit cards and debit cards. Some of them have even managed to provide ATM and electronic banking services. The clearing-house is going to be automated in the future and the modern payment, clearing and settlement system, which is one of the most important elements of the modern financial system.

Even the insurance services sector has developed with the establishment of joint-venture insurance companies. There are altogether 17 life and non-life insurance companies in the country. They have been competing and trying to attract their customers with new and innovative insurance products and services. The number of listed companies in the Nepal Stock Exchange reached 111 and the market capitalization, as of mid-February 2004 stood at Rs 39.11 billion. The trading of shares has increased tremendously. Several companies have issued preference shares and debentures. It clearly shows that new financial instruments are being introduced. But the NEPSE index decreased to 202.65 from 236.01 two year's earlier.

As a result of these financial sector reforms and new financial sector developments, as of mid-March 2004, the number of commercial banks reached to 17. There were 56 finance companies, 14 development banks, 11 micro-finance development banks, 34 savings and credit co-operative societies and 44 financial intermediary NGOs. The number of insurance companies increased to 17. Development banks and especially rural micro-finance development banks (RMFDBs) have tried to fill up the gaps created by the closure of commercial bank and ADB/N branches due to law and security problems (Maoists' insurgency). All districts of the terai (low land) region and few hill districts have been already covered by these newly established RMFDBs.

The deposits/GDP ratio of commercial banks rose to 44.9 percent at mid-July 2003, which was only 34.1 at mid-July 1998. Likewise, the credit/GDP ratio increased to 27.4 from 22.8 during the same period. But the total liquid fund/total deposit ratio declined to 20.2 from 33.6. The capital adequacy ratio improved to 5.8 from 4.8 during the same period. The deposits of the banking sector rose to Rs 189.39 billion from Rs 90.84 billion. The total gross insurance premium increased to Rs 2.93 billion in FY 2002-03 from 0.57 billion in FY 1992-93

FUTURE REFORM ACTIVITIES IN THE FINANCIAL SECTOR

1. Reforming the financial sector laws and regulations.
2. Strengthening of NRB's regulatory and supervisory functions.
3. Restructuring and privatization of RBB and NBL
4. Enhancing competition in the banking sector.
5. Implementing international accounting standards in NRB.
6. Establishment of the Banker's Training Institute.
7. Restructuring of the Credit Information Bureau
8. Strengthening of the regional rural development banks and their privatization.
9. Restructuring of ADB/N and NIDC.
10. Revamping research and financial monitoring system of NRB.
11. Broadening and deepening of financial system in Nepal

(Rawal, 2004)

PROGRESS ON RESTRUCTURING OF RBB AND NBL

The share of RBB and NBL in the assets and liabilities of the banking sector is around 50 percent. Although international financial experts have been managing these banks, the performance especially for reducing NPA is not satisfactory. The management teams were supposed to bring NPA level to 5% level. The NPA/total credit ratios of RBB increased from 20.17% in FY 1997-98 to 60.15% in FY 2002-03. It increased by 5 percentage points in FY 2002-03 than the previous year. Likewise, the NPA/total credit ratio of NBL also increased from 27.46 percent to 60.47 percent in FY 2002-03, which shows the rising trend (Rawal, 2004). Both of them had negative net-worth since FY 1998-99 and the negative net-worth figures continuously increased in the last five years. Although financial performance of both the management teams is totally unsatisfactory, they have improved in other areas. People are questioning the returns of such a huge expense. Is it going to be a futile exercise? Suppose they brought down the NPA level to a satisfactory level. But what will happen after the management teams leave the banks?

FUTURE STRATEGY AND ACTIONS

The reform of the financial sector is a gigantic task for all stakeholders. Although we have crossed few miles but we have to proceed further ahead. We have to consolidate the achievements and look upon new path. The Tenth Plan has formulated plan, program, strategies and activities for the financial sector. The Financial Sector Reform Program (FRSP) has outlined its agenda and goals. The success of the FRSP in achieving its agenda and goals will have a far-reaching impact in the whole economy and especially for the macro-economic stability. It will greatly help to attain the growth targets and the objective of poverty reduction of the Tenth Plan. The financial sector is changing rapidly. New financial products and instruments are getting introduced. Nepal has joined the WTO. It has to open its financial sector to the foreigners. With the ailing commercial banking and development banking sector and the small fund available with HMG/N for the re-capitalization and modernization of these banks, could the Nepalese financial sector compete with internationally competent financial institutions under the General Agreement in Trade in Services (GATS)? The country has to open its banking and insurance services. Financial institutions are mushrooming in the last decade. Now it is the proper time for their mergers. Even now, most of the financial institutions are being run by non-professional people. For this, NRB has to improve its regulations and implement them. The capital base of financial institutions is still very low. There is no clear-cut policy for the establishment of development banks.

The financial market is still underdeveloped. The laws related to the stock exchange needs amendment. Likewise, the laws governing the insurance services also needs amendment. We have to devise new pension funds schemes because the existing EPF cannot be sustained in future. There are thousand of savings and credit co-operative societies, who have been mobilizing deposits from their members. They have mobilized almost Rs 20 billion. But there is no government institution/body to properly regulate their activities. Till now 92 such co-operatives have run away with the public deposits of around Rs 150 million. The Registrar of Co-operatives is found helpless and the legal system is inadequate to punish such people. All over the world whether they are known as deposit taking institution but the present Banking and Financial Institution Ordinance does not cover such grass-root institutions. The number of micro-finance NGOs has reached 44. What will happen when their number crosses 100 or 200? Has the NRB capacity to supervise so many micro-finance or micro-credit institutions? Why can't we draft a special law for all types of micro-finance institutions including micro-finance development banks? Most of the RRDBs are making huge losses. They eroded their equity capital. They are not being run properly.

Several branches of commercial banks have been closed due to security problems. Most of the remaining branches in the rural areas will be closed down by the private sector buyers of RBB and NBL in the future. How are we going to provide banking services in such areas? The priority sector credit is getting phased out and later the deprived sector credit will also be phased out. What alternative mechanism do we have? The activities of the stock exchange are very limited to the Kathmandu valley. How and when is it going to expand its activities? Although there are 17 insurance service providers, their insurance service is very much limited because of their lower capital base. The National Insurance Corporation is another government-owned financial institution, which is ailing due to political interference and managerial weaknesses. Excluding co-operatives, there are three different regulators /supervisors for financial institutions. There is no co-ordination among these regulatory and supervisory institutions. The problem of one sub-sector is easily transmitted to other sub-sectors. When are we going to establish a single roof for all types of financial institutions?

We do not have a good training institute for the training of staffs about the new management skills. We still lack the Cyber Act for the electronic transactions. Many countries have enacted the separate Electronic Commerce or E-Commerce Act. In the same way, there are countries with the separate Cheque Act or the Payments Act. We still do not have the Bankruptcy Act and the Mergers and Acquisitions Act. The Negotiable Instruments Act needs amendment. These laws and related by-laws are very necessary for the smooth functioning of our financial industry.

Although new NRB Act has given more autonomy to NRB, there are different clauses, which need to be amended. It is also the same in case of newly implemented Banking and Financial Institution Ordinance. We have to improve the MIS of financial institutions. We have to strive hard for the financial reform to bear fruits for the benefit of the whole economy.

CONCLUSION

Financial sector reform plays a crucial role in the economic growth of the country. It is regarded as the engine of growth. It works as the lubricator for the economic engine. As the apex financial institution of the country, NRB has a big role to play. The Insurance Board and Securities Board also have to play their roles to expand security services. The Nepalese commercial banks and especially RBB and NBL are in distress. Financial experts have been invited to sort out existing problems and run them as vibrant and sound banking institutions. But their problem is still very acute. They need correct diagnosis and surgical operations. Because of the cumulative weaknesses of the past, they are in serious trouble. HMG/N, NRB and the World Bank are very serious to turn them into sound and efficient banking institution. The ADB/N and NIDC are other financial institutions, which need helps from HMG/N and NRB. There is no alternative financial institution in place of the ADB/N. The political interference and quick changes in the Board members and CEOs of the ADB/N and NIDC have caused serious problems.

HMG/N has strongly committed for the reform of the financial sector in general and RBB, NBL, ADB/N and NIDC in particular. Much depends on the proper implementation of the Financial Sector Reform Program. The financial sector may invite financial crisis which may easily transfer to other sectors of the economy. As such, we have to be extra cautious for the financial liberalization and reforms of the financial sector.

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The Fallout of 9/11 on Asian Economies: Policy Options

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As a result of the September 11, 2001 terrorist attacks on the United States, the immediate reaction of various economists around the globe was that the Asian economies, in particular the Southeast Asian economies, would deepen, leaving no room for an early rebound from the 1997 financial crisis. However, as events developed, the global as well as the regional economic developments gave way for greater optimism towards the immediate economic prospects of these countries. The disruption of the economy following the attacks turned out to be less disruptive than originally thought as statistics show distinct signs of improvement in the global economic situation. In the regional front, most regional stock markets rallied and consumer confidence improved, boosting domestic demand. The result of the unprecedented fiscal measures and monetary stimulus such as cuts in interest rates, income tax cuts, and post-attack government spending led to the mild rebound strengthening to more or less a full-blown economic recovery since the later part of 2002.The trend continues even at a faster pace. In nutshell, the completion of completion of initiated reform agenda and maintenance of strong economic fundamentals will provide necessary policy options for the countries in the event of uncertainty in the global recovery.

INTRODUCTION

The world has turned into a global village following the adoption of outward oriented liberal economic policies by many countries. This process of globalisation is further enhanced by the unrelenting financial innovations and rapid developments of technology in the area of information and communication. As a consequence, countries now have become increasingly integrated and more dependent on each other. This growing degree of dependence has been

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increasingly making economies more vulnerable to external shocks. Any disturbance in one part of the world, could more or less simultaneously affect the other parts.

Turbulence in financial market is not a new phenomenon and in all probability, will continue to occur with increased integration of world financial markets. Such contagion effect could be best exemplified by the financial crisis of 1997 in Southeast Asia. While policy-makers could do much to minimise peaks and troughs of business cycle of boom, recession, depression and recovery through prudent and timely policy interventions in reducing the possibility of the occurrence of a recession, careful analysis of financial crises and recessions with their causes, effects and remedies, leads to the fact that free market economy is not exempted from these irregular business cycle swings. Policymakers are often urged to strengthen macro-economic discipline and to improve the soundness of the financial system as preventive measures. However, in many cases, despite pre-emptive measures; due to unforeseen circumstances, economies may still experience recession as a consequence of global economic slowdown. The adverse impact brought forth by the incidence that occurred on September 11, 2001 in the United States is one such unforeseen event.

As the countries both in the South and East Asia are being increasingly integrated to the global economy, more prone are these economies to the business cycles of the industrial economies. These economies are not left behind in facing new challenges especially during times of synchronized downturns in major industrial countries. As such a major challenge that these economies face is in finding ways to shield the negative impact of the global economic downturn while maintaining the level of integration so as to reap the benefits of upswings, which should help them to move into higher growth paths.

The impact of the global slowdown on most of the Asian economies would depend mainly on the degree of economic integration, particularly trade linkages with the industrial countries. The fact that the volume of world trade in goods and services decelerated to negative 0.2 percent in 2001 from 12.4 percent in 2000 reflects the impact of the global slowdown accentuated by the September 11, crisis on highly trade dependent countries. As such the intensity of policy response would also depend on the degree of economic integration to the global economy. If you take the example of highly trade dependent countries in the Southeast Asia like Singapore and Malaysia, they have been adversely affected to the farthest extent than less trade dependent countries like Myanmar and Nepal. (Table1)

In particular, countries with strong trade linkages with the US, the Euro area and Japan have been severely affected as a consequence also of the September11, 2001 episode. To mitigate the impact of the external slowdown, highly trade dependant countries need more speedy and intense policy responses. Standard policy responses to this kind of external shocks, such as stimulus macroeconomic policies to boost aggregate demand, have been well documented in the literature. However, the availability and effectiveness of standard policy options depend on the existing domestic macroeconomic environment and the degree of structural rigidities in individual economies. Therefore, standard policy options may not be applicable uniformly across all countries. Individual country positions during the slowdown need to be assessed prior to prescribing specific policy responses. This requires a detailed analysis of individual country positions at the time of the slowdown. *The assessment and analysis of this paper are focused on the period 2000-2002 and a special focus is laid on the resultant effects of the terrorist attacks in the United States on September 11, 2001.*

Table 1. Trade Openness (exports plus imports as a per cent of GDP)

	1997	1998	1999	2000	2001	2002**
Indonesia	47.5	86.2	57.9	69.0	63.5	51.1
Korea	58.9	70.2	64.5	72.6	68.5	62.6
Malaysia	151.3	174.5	189.5	200.1	183.8	182
Mongolia	96.9	101.5	112.9	113.0	115.4	109.5
Myanmar	1.7	1.4	1.0	1.0	1.0	n.a.
Nepal*	41.4	38.7	36.0	41.7	41.7	36.6
Philippines	74.8	90.6	83.3	90.6	83.7	92.8
Singapore	265.0	250.9	266.1	287.3	271.0	277.5
Sri Lanka	67.8	67.4	77.4	70.1	66.5	63.9
Taiwan	79.1	78.6	81.8	90.8	79.4	86.3
Thailand	74.1	83.4	85.3	106.9	107.9	105.6

Source: Computed from IFS data and EIU data for Taiwan
* *Nepal Rastra Bank*
** *Key Indicators 2003, Vol 34, Asian Development Bank*

GLOBAL ECONOMIC SETTING[1]

Prior to September 11, the world economy was already experiencing sluggish economic growth with the south east Asian countries still in the midst of recovery following the crisis that erupted in the early 1997.[2] Policy-makers in the three major economies of the world, viz., the US, Euro area and Japan had become increasingly confronted with mostly negative developments in the economic front in the form of deteriorating corporate profits, falling stock prices, rising unemployment, and faltering investor confidence. There was a shift of focus from inflationary pressures to a foreseen recession and short-term interest rates began to fall in many economies. The optimistic view therein, that the US economic activity would rebound in the third quarter of 2001 had faded by mid-year as did subsequent hopes for a modest US rebound in late 2001. Moreover, in the second

1 This study is based exclusively on the various issues of the World Economic Outlook, IMF, Asian Development Outlook, ADB , Consensus Forecast and Asia pacific Consensus Forecast, Consensus Economics, and SEACEN Outlook.

2 The timely adoption of appropriate policy measures by the respective crisis-led countries helped their economy to recover though at a slower pace.

quarter of 2001, economic conditions in Japan deteriorated significantly, and the pace of economic activity in the Euro area had also slowed substantially. This situation was unique in the context of a global economic slowdown as these three major world economies which together account for roughly 45.0 percent of the world's output and absorb nearly 50.0 percent of total exports from the Asia and the Pacific region was simultaneous in a process of experiencing recession. The global economy too became vulnerable through an erosion of the financial position of consumers, corporations, and governments. Sentiments were also affected by the global slowdown, leading to abrupt reductions in private spending.

The US economy considered as the growth engine of the world economy had already slowed to 1.9 percent economic growth in the last quarter of 2000. It further slowed to 1.3 percent and 0.2 percent respectively in the first two quarters of 2001 before declining to 1.3 percent in the third quarter of 2001, as investment and exports continued to contract while domestic consumption slowed to 2.5 percent growth in the second quarter of 2001 the smallest expansion in four years. Even though the real GDP growth rate recovered in the fourth quarter, subsequent financial and accounting scandals and lower corporate profits weighed heavily on the US growth to reach 2.4 percent in 2002.

The Euro area was expected to be relatively unaffected by the information, communications and technology (ICT) correction in the US. However, real GDP growth, which was quite strong in the first quarter of 2001, declined during the second and third quarters. This was due to the slowing growth of exports both to the US and Asia and to the weakening domestic demand as high oil prices, slowing job growth, and declining equity values (especially in the telecommunication sector) impacted profits and real incomes. Private consumption growth slowed from 2.0 percent in the first quarter of 2001 to 1.7 percent in the second and remained stagnant at 1.7 percent in the third quarter also. The unemployment rate remained stable at 8.3 percent throughout the second and third quarters of 2001and increased slightly to reach 8.4 percent in 2002.

In Japan, the economic growth was modest and was expected to sustain. However, economic activities weakened sharply in the first quarter of 2001 (See Table 2). The unexpected severity of the global information, communications and technology (ICT) sector slowdown adversely affected the economy with a double-digit contraction in export and private investment demand throughout the year, after a strong performance in the last quarter of 2000. Consumption which sustained quarter-on-quarter growth of 2.0 percent in the second quarter, slowed down to less than 1.0 percent in the third quarter with demand weakening, industrial production on a downward trend throughout 2001, contracting by 11.7 percent in August 2001 from a year earlier. The unemployment rate reached a postwar high of 5.1 percent as at the end of the third quarter of 2001. The unemployment rate further aggravated to reach 5.4 in 2002.[3]

Inflationary pressure built throughout much of the first half of 2001, eased somewhat in the US and Europe in the third quarter. In the US, consumer prise eased to 2.6 percent in September 2001 from a year earlier, while in Europe, annual inflation measured by Consumer Price Index (CPI) eased from 3.0 percent in June to 2.5 percent in September 2001. However, in Japan, prices continued to drop by 0.8 percent in September 2001 from a year earlier.

Even before 11 September terrorist attacks, the global slowdown was turning out to be deeper, longer, and more synchronised than originally thought. Any hope of recovery was dashed following the 11 September incidents. The incident saw an even sharper and simultaneous decline in economic growth across major economies.

Assessment of the Impact of the September Event

Direct Impact on the US Economy

As noted above, the unprecedented terrorist attack of 11 September on Pentagon and the World Trade Centre in the United States came at a time of weakening global economy. The incident directly disrupted the US economic activity and significantly increased uncertainty over future economic conditions. In addition, the level of consumers' confidence in the US, which had already weakened even before the 11 September terrorist attack, was further undermined after the attacks. The 11 September attack pushed further the already slowing US economy. It has had a strong negative effect on the confidence of both the businessmen and the consumers, which resulted in an 11.0 percent contraction in private investment, and private growth slowing to 1.0 percent, the lowest in eight years.

The terrorist attacks resulted in a heavy loss of innocent lives and a huge destruction of property. In addition, because of the size and the nature of the attack, the effects were expected to last for quite some time. The loss of property from the terrorist attack of 11 September 2001 was estimated at about $16 billion. This amount worked out just above 0.15 percent of US annual GDP (US Bureau of

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[3] The weakening consumer and business sentiments towards the end of 2001 was an indication towards a long period of recession. This triggered further losses on the Nikkei 225 Index, and caused problems for the banks in their balance sheet, which since end-September 2001, were required to value stock holdings at market prices. This could in the longer run cause repatriation of Japanese bank holdings from other countries or reduce the activities of Japanese banks from the emerging Asian economies. However, the Japanese government took aggressive policy measures towards financial sector reforms in 2001 and is moving ahead towards eliminating non-performing loans by end 2004.

Economic Analysis, 2001)[4]. Although the human toll as well as the property damage may have had a limited macroeconomic impact, the short-term losses through specific industries could be beyond what has been anticipated.

As a consequence of the terrorist attacks, the US airline sector had lost around 20.0 percent of its relative value, while this percentage worked out at around 15.0 percent for Europe and Japan. Other service industries, viz., hotels, tourism, travel agency, restaurants, etc. besides airlines have also been hit hard by the attack. Relative equity values for hotels and leisure facilities were off by around 15.0 percent in the US and Europe, although in Japan they gained a little which possibly reflects that Japan has more limited need for air travel.

The terrorist attacks also resulted in a series of temporary disruptions to the network of the present mode of the economy. In the US, consumption fell significantly during September 2001, as most people stayed indoors. For example, television viewers surged by almost 50.0 percent immediately after the attacks and on an average crowd at the shopping malls fell by about 5.0 percent or more.

Table 2. Direct Cost of September 11 Attacks
(In billions of US dollar)

Losses	Costs
Structure, Equipment and Software	
Private	14.0
State and local government*	1.5
Federal government	0.7
Sub-total	*16.2*
Other Insurance Losses	
Life and related costs	2.6
Workers compensation	1.8
Homeowners and other	0.6
General government	0.2
Sub-total	*5.2*
Total	*21.4*

* Largely New York City subways.
Source: US Bureau of Economic Analysis (2001Q.b).

The closure of the US stock exchanges for four days and other financial disruption also reduced revenues. Stock prices in the US were generally seen to be falling and investors as well as consumer confidence was at the lowest level, the expectation for future earnings was low and as such the stock prices were subsided drastically. In conjunction to this atmosphere of increased uncertainty and heightened recession fears in the wake of the attacks on the US, stock markets

4 As reported in the IMF World Economic Outlook, December 2001.

underwent steep corrections in September, experiencing significant volatility. The Dow Jones Industrial Average, which was down by 11.0 percent throughout September 2001 compared to end-December 2000, fell by 14.3 percent over a period of one week, which means a drop of 23.6 percent since end-December 2000. The initial magnitude of the reduction in US demand following the attack and its spill over effects to Europe and Japan were somewhat underestimated and the extent to which world trade would be reduced was not anticipated. The subsequent US-led military operations in Afghanistan, and the anthrax scares had also introduced an extra element of risk and uncertainty. This further slowed the already weakening global economy.

Table 3. Macro economic Indicators of the Three Major Economies

	2000	2001				2002+
	Q4	Q1	Q2	Q3	Q4	Q1
			(Percent)			
Euro Area						
Real GDP growth rate	2.8	2.4	1.6	1.4	0.6	0.9
Unemployment rate	8.5	8.4	8.3	8.3	8.4	8.4
Consumer price inflation rate	2.6	2.6	3	2.5*	2.2*	2.3*
Japan						
Real GDP growth rate	2.4	1	-1.2	-0.5	-1.2	0.2
Unemployment rate	4.8	4.9	5.1	5.1	5.1	5.4
Consumer price inflation rate	-0.6	-0.5	-0.7	-0.8	-1	0.9.
United States						
Real GDP growth rate	1.9	1.3	0.3	-1.3	1.7	2.4
Unemployment rate	4	4.2	4.5	4.8	5.6	5.8
Consumer price inflation rate	3.4	2.9	3.2	2.6**	1.6***	1.3

* Refers to harmonised Index of Consumer Prices (HICP)
** Unadjusted CPI for the 12-month period ended in September.
*** Unadjusted CPI for the 12-month period ended in December.

Sources: ADO 2001 Update/ ADB
European Central Bank, September 2001, Monthly bulletin (online), available:
+WEO/IMF Sept. 2003
www.ecb.int/pub/pdf/mb200204en.pdf; Government of Japan (online), available: www.stat.go.jp/english/19.htm; US Government, (online), available: www.fedstats.gov

Impact of the 11 September Event on the Asian Economies

The terrorist attacks that affected the US economy directly generated a significant impact on Asian economies as a whole. These economies, some in the midst of recovery from the Asian financial crisis of 1997 were already adversely affected by a sharp fall in external demand even before the attack. There are a few avenues through which the effects of the deteriorating global economic downturn were transmitted to developing Asia. Firstly, in the short-run, global commerce was affected severely. The general worsening of confidence dampened the global trade further, placing additional downward pressure on export volume and commodity prices. In fact, the commodity prices were sharply lowered after the attacks. This could adversely affect trade in goods over a long period by increased transaction costs, although the magnitude of this effect was not expected to be very large. Secondly, trade in services, especially tourism and banking sector showed immediate signs of being badly affected. In the longer-run, these sectors will continue to be badly hit by increased uncertainty.

Secondly capital flows fell as risk premiums rose. As such, business was affected negatively by reduction in revenue and access to the capital at the same time. In the longer-run, this could even lead to a failure of weak companies. Although these trends were already evident, after 11 September terrorist attack, the availability and terms of financing have become even tighter both for the governments and private sector. Another prominent channel of transmission operated through financial market linkages. Portfolio investment inflows were already lowered before the attacks but many emerging economies that experienced steep stock-market corrections immediately following them have had only partial recoveries.

In summary, the extent to which the emerging Asian economies were affected depended on: (a) how much they are dependent on global trade. For example, for those economies with high merchandise exports to GDP ratio, the impact of the delayed recovery in global trade may mean a longer period of significant lower growth; and, (b) how vulnerable these economies are to heightened political uncertainty.

Financial Markets and Capital Flows

The immediate impact of the terrorist attack of 11 September on Asian countries was severe. The financial market developments across the region, with a few exceptions, was heavily influenced by the downward and post volatility trends in US stock markets, cutting of the Federal Reserves interest rate and to some extent increased uncertainty and risk aversions of market participants. The initial reaction in the equity and financial markets was where regional Asian stock prices fell sharply immediately after the 11 September attacks. For example, The Peoples' Republic of China's (PRC) Shanghai A Share Index, which was opened to local investors in February 2001 and which rose quite rapidly through May suffered a sharp correction. Although the US, European and the Japanese bourses recovered well, most major markets have not been able to do so; some emerging economies within this region faced a surge of private capital outflows, attributing mainly to the outflows of portfolio investment combined with weak FDIs mainly due to higher uncertainty and risk aversion. Furthermore, since economic activities slowed down considerably, demand for foreign credit also slipped down; however some countries made larger net repayments regarding private credits as existing loans continued to be repaid. The crisis-affected economies of Indonesia, Republic of Korea, Malaysia, Philippines and Thailand experienced net private capital outflows in 2001, having just had some capital inflows after the financial crisis; but the net outflows were still below the levels experienced in 1998 and 1999. However, in contrast, the private capital inflows in the PRC improved, attributable mainly to the increased foreign direct investment.

Trade

The volume of world trade in goods and services decelerated to negative 0.2 percent in 2001 from 12.4 percent in 2000. The severe disruption of trade was very significant in most Asian countries as economic performance of the newly industrialised economies within the region that account for over 35.0 percent of GDP in emerging Asia are very dependent on exports of goods and services. One of the most significant sectors that experienced contraction was the global ICT sector in which many emerging economies are highly dependent. The global price of semiconductor, its production and sales weakened in 2001, led by the collapse in the market for memory chips. Sales of final products, particularly computers were badly affected. Also as manufacturers[5] tend to dominate the external trade of most of the Asian economies, the high share of electronic exports in total exports and the sharp contraction in their prices suggested further weakening of the manufacturers' terms of trade from the already depressed level. The external environment also affected commodity prices, thereby changing the terms of trade of these economies in the region. The prices of most commodities fell immediately after the attack.

World oil prices declined to around \$18 per barrel by late November from \$25 prior to the attacks and the peak of over \$30 reached in 2000. However, after fluctuating at around \$20 per barrel through early November, oil prices softened further in response to OPEC's difficulties in co-ordinating global production cuts, particularly among non-OPEC producers. Most significant was the Russian commitments that fell short of the 200,000 barrels per day cut envisaged by the OPEC.[6] Nonetheless, oil prices showed upward trend in early March 2002 only to

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5 The aftermath of 11 September negatively affected exporters through both direct and indirect linkages. The direct relationship between the price and volume of commodity production is ambiguous, depending on whether lower prices reflect lower demand or more supply. A decrease in demand as seen after 11 September episode would reduce output; an increase in supply, in contrast, would raise it. The indirect effects reflect the impact of changes in the terms of trade on real incomes and spending, and are unambiguous. It is obvious that deterioration in the terms of trade will reduce spending in the producing country on both the domestic and imported goods. Domestic output will fall unless some other factors, such as policy shocks, adjust it more than what is offset in the private demand. However, these indirect effects are likely to occur with some lags, as domestic spending exhibit inertia in response to changes in income. In term of trade, Hong Kong, China, Pakistan and Singapore were to be most affected.

6 Prices clearly depend on the willingness of exporters to agree on production limits. Even if agreement is reached to a certain level, the scope for a significant increase in price is always limited by the weak global demand and also the incentives for producers to circumvent agreed limits if price rise.

renewed concerns about the stability of supply in the Middle East as well as of a stronger outlook for global recovery. This put Brent Crude spot price at US $ 23.79 a barrel by 15 March 2002.

The effect of the terrorist attack was also felt on the prices of non-fuel commodities. The aggregate index of non-fuel prices dropped by a further 6.0 percent from September to November 2001. The decline in commodity prices and oil has had a contrasting effect on Asian economies. Those who are net importers may have benefited which may have led to increasing real incomes, paving a way for monetary easing in response to global downturn. However, for net exporters, lower prices caused deterioration in terms of trade and lower real income.

Tourism

The 11 September attacks had an immediate and significant global impact on tourism. According to the World Travel and Tourism Council (WTTC), tourism contribution to World GDP in 2001 registered a contraction of about 1.0 percent against the previous projected growth of 3.0 percent. Although the big losses in tourism were borne by US and Europe, the impact spilled over to the Asian economies also. Particularly tourism in the South East Asia contracted by 1.8 percent in 2001.

Sector-wise, tourism and airlines were the two major sectors that have been most affected by the 11 September attacks. The effect was seen to be most significant in those economies with large tourism sectors, viz., Cambodia, Maldives, Nepal and Thailand. As expected, the effect on tourism varied highly across countries, depending on the share of tourism in the economy ranging from 0.9 percent of GDP in Mongolia to more than 7.0 percent in Malaysia (Table 4). In addition to this, a dropout in tourism arrival heavily affected a countdown on related industries such as hotels, restaurants, travel agencies, etc., with a very high

Table 4. Tourism Receipts As Percent of GDP, 2001

Indonesia	3.6
Korea, Republic of	1.5*
Malaysia	7.8
Mongolia	0.9
Myanmar (Burma)	n.a.
Nepal	2.9
Philippines	2.4
Singapore**	6.0
Sri Lanka	1.3
Taipei, China***	1.4
Thailand	5.8*

* Refer year 2000 data
** Refer to travel credit as percent of GDP
*** Refer to general merchandise: export fob as percent of GDP
Source: SEACEN member Central Banks
Asian Development Bank

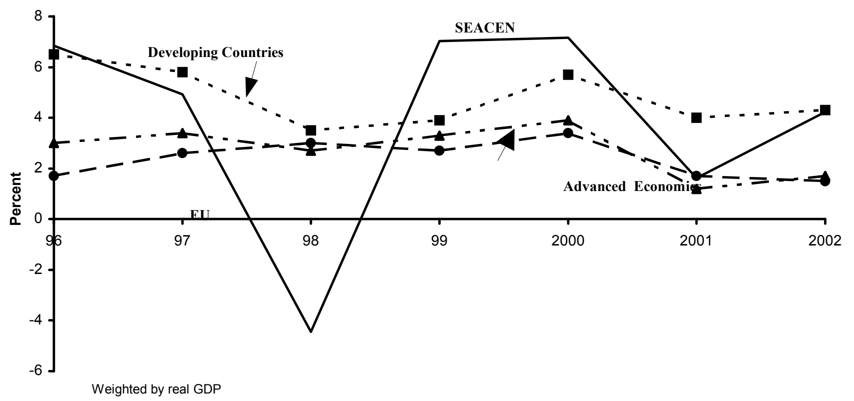
cumulative impact. Tourism is a big source of foreign exchange earnings. In Thailand alone, Net travel receipts account ranges for about 50.0 percent of its current account surplus, while the figures for Malaysia, Indonesia and the Philippines is 31.0 percent, 22.0 percent and 14.0 percent, respectively. Another immediate impact of the attack was on the airline industry. The sudden fall in the volume of passengers and the increase in the insurance costs after the attacks worsened the already ailing industry. In most of the cases, increase in insurance costs was passed on to the consumers in the form of surcharge. In other cases, such as in Korea and Singapore, the respective governments had offered subsidies to varying extents.

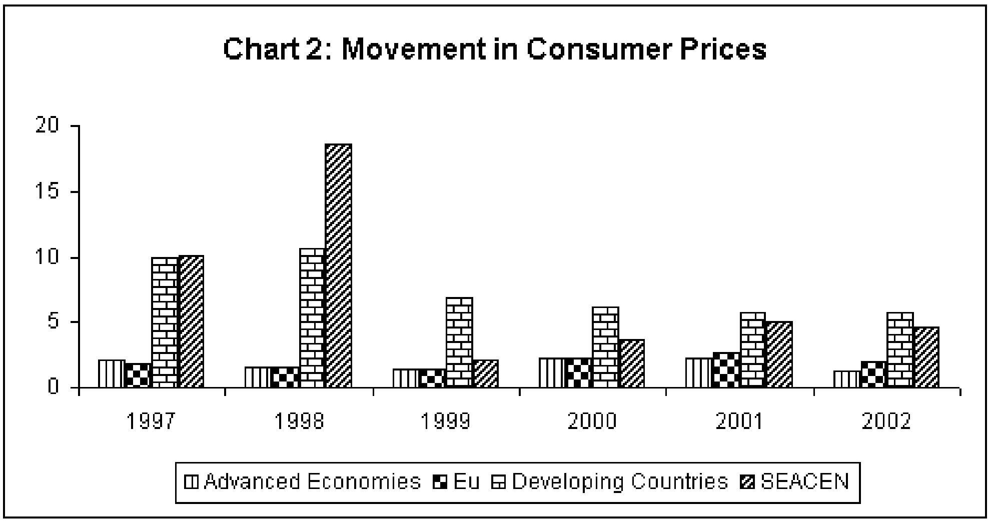
Impact of the September Event on SEACEN Economies

Considering the overall economic growth, in 2001, the *SEACEN* economies as a whole postulated a growth of 1.6 percent compared to 7.2 percent growth in 2000, while inflation edged up to 5.0 percent from 3.5 percent a year ago. (See, chart 1 and 2) However the inflation was still at the lower single digit. The aggregate merchandise exports of these countries fell down in 2001 (See, chart 3). In comparison, real GDP growth in the emerging Asia slowed down to 4.1 percent in 2001 from 7.1 percent in 2000.

The developing Asian economies that depend heavily on electronic exports suffered a contraction of about 10.0 percent. The south Asian economies in 2001 experienced a nominal growth of 0.5 percent in merchandise exports as against a growth of 17.3 percent in the year 2000. However, the exports of the People's Republic of China (PRC) and south Asian economies whose economies are more diversified and traditional expanded but at a much slower rate than that in 2000. The Central Asian economies, together with Mongolia also experienced a decline of 0.6 percent in merchandise export growth, mainly due to the contraction in the global commodity demand.

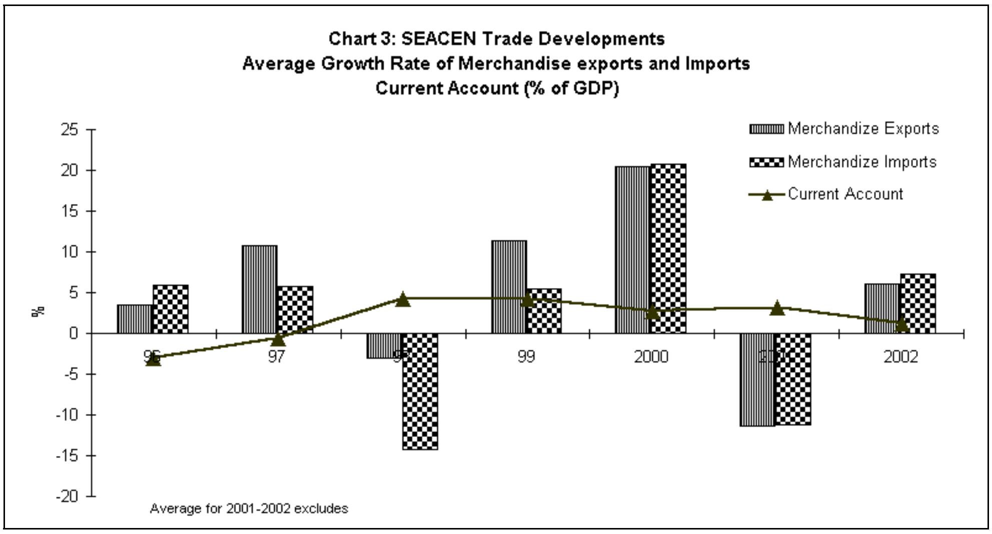
Chart 1: Rate of Growth of Real GDP

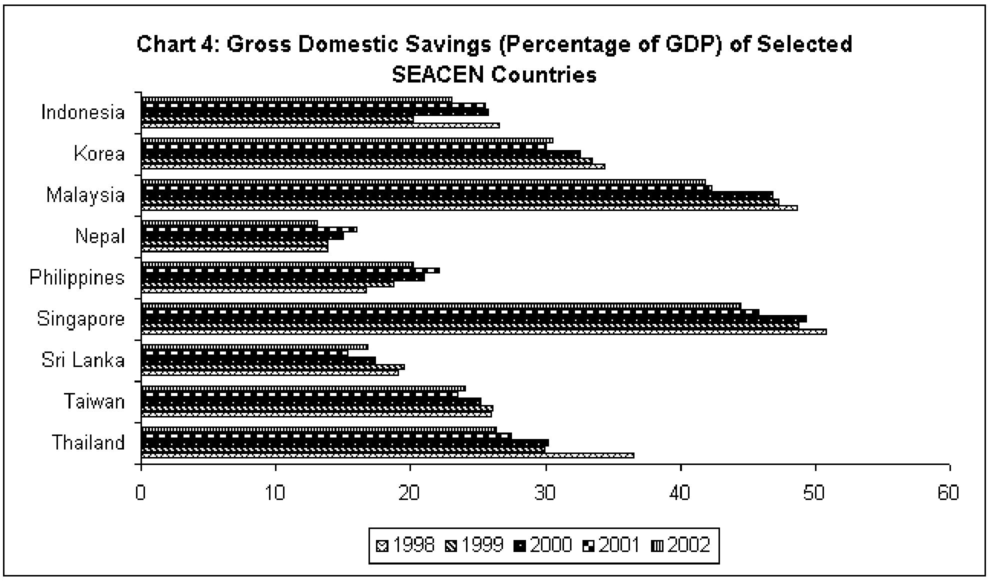




As a result of the terrorist attacks of 11 September, the macroeconomic policies of virtually all-emerging Asian economies, have become more accommodative. In addition to this, most also took relevant fiscal policy stances to counter the effects of global slowdown. For example, Singapore perhaps one of the most affected economies because of its limited domestic sector, had undertaken a very little monetary or fiscal stimulus prior to 11 September terrorist attack but in the wake of the attack, the authorities resorted to additional fiscal stimulus packages of about 7.0 percent of GDP in October 2001. Malaysia too announced a second fiscal stimulus package of 1.3 percent of GDP in October 2001. Korea resorted to a mix of fiscal and monetary policies. However in countries, such as the Philippines, fiscal constraints have limited the usage of additional fiscal stimulus.

It is therefore seen that those countries, which are more closely tied-up with the global economy, were affected more adversely. Singapore, which is the most open economy amongst the member countries, witnessed its GDP shrink by 2.4 percent in 2001 as against a growth of 9.4 percent in 2000. Similarly, Taiwan's economic growth shrank by 2.2 percent. The GDP growth in Malaysia, the Republic of Korea and Thailand also slowed down to 0.4 percent, 3.1 percent and1.9 percent respectively in 2001 while those of Indonesia, Mongolia and Nepal also decelerated to 3.3 percent, 1.1 percent and 4.6 percent respectively. Sri Lanka, on the other hand experienced a contraction of 1.4 percent, due to exacerbated drought and security problems. Philippines experienced only a modest slowdown in economic growth of 3.2 percent compared with 4.4 percent in 2000, in spite of a decline in exports by 16.2 percent, mainly attributable to the robustness of its agriculture sector, which remained resilient in the face of the external shocks.





The global slowdown had the most severe impact on the manufacturing sector in the south east Asian region. Singapore's manufacturing sector shrank by 12.0 percent as against an average growth of more than 14.0 percent in the previous two years. Likewise, in Malaysia, the manufacturing sector shrank by 5.0 percent in 2001 as against an average growth of more than 17.0 percent in the previous two years. Meanwhile, the manufacturing sector in Korea grew only by 2.0 percent as against an average growth of more than 18.0 percent in the previous two years, and in the Philippines, its manufacturing sector witnessed a decelerating growth in spite of a very mild slowdown in its GDP growth.

On the external front, the slowdown of the growth in the south *SEACEN* region in 2001 was also a direct outcome of a sharp fall in its exports. As a result of a slowdown in the global economy, world trade[7] in 2001 decelerated, thereby reducing the demand for the region's exports particularly for ICT and affected especially countries like Korea, Malaysia, Philippines and Singapore whose major chunk of the exports are electronic goods and depend heavily on the US market.

In some of these countries, the situation was worsened by the declining export coupled with a net outflow of private foreign capital, the largest outflows being in the form of net portfolio investments and net inflows from non-bank creditors. Net foreign direct investment also declined, albeit at a slower rate. The large net outflows in non-bank credit from the region were mostly repayments made especially by Indonesia, Korea and Thailand. In Indonesia, the net outflows were mainly the continuing repayments of inter-company loans while in Korea and Thailand, net repayments were for cheaper domestic loans.

The economies in the region poised a diverse experience regarding domestic demand in 2001. In Malaysia, Singapore and Thailand, the growth in the domestic demand was generally seen to have declined but it went up in Korea, stayed somewhat unchanged in the Philippines and decelerated sharply in Indonesia. Since exports declined sharply, economic growth in these economies in 2001 was mainly the reason of the growth in domestic demand, which although was slower in many countries of the region, remained positive.

The weakening exports and decelerating growth however helped to contain inflation in most of the *SEACEN* countries with an exception of Indonesia. Singapore, which had a low inflation at 1.3 percent in 2000, experienced a mild deceleration, whereas in Malaysia, inflation rate was maintained at about 1.4 percent throughout 2001. However, in Korea and Thailand, inflation edged up somewhat in the beginning of 2001, but gradually declined since then to reach 4.1 percent and 1.6 percent respectively. In the Philippines, annual inflation accelerated to 6.1 percent in 2001 from 4.4 percent in 2000 whereas in Indonesia inflation in 2001 reached double digit at 11.5 percent from 3.7 percent in 2000.

The equity markets in the *SEACEN* countries although poised a declining trend till the third quarter of 2001, rebounded significantly towards the fourth quarter. In local currency term, these gains have ranged from 23.0 percent in Malaysia to 73.0 percent in Korea. The main factors attributable to the surge in the regional stock prices were the upswing in the US stock market after falling sharply as a result of 11 September terrorist attack and a better than expected growth among many of the economies in the region in addition to the declining interest rates.

However, most of the economies in the region posted a decline in stock market capitalization in spite of the surge in the stock prices during the fourth quarter in

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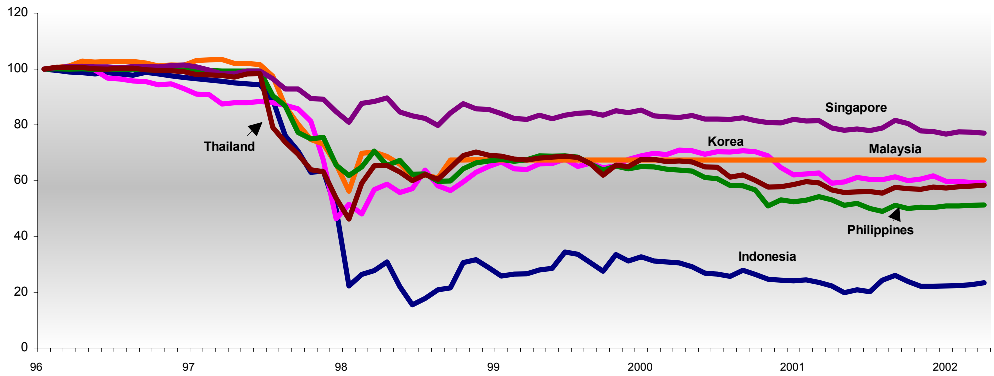
7 The World Bank's estimates puts forth a decline in the world trade by 1.0 percent in 2001 as against a growth of 13.0 percent in 2000.

2001. The market capitalization of these economies ranged from about 11.0 percent in Thailand to about 35.0 percent in Indonesia in terms of dollar values. The decline in market capitalization as a percent of GDP in 2001 was about 32.0 percent for Indonesia, 15.0 percent for Singapore, 24.0 percent for Malaysia and 6.0 percent for Thailand. However, in the Philippines, it increased though mildly, attributing mainly to the contraction in the dollar value of the country's GDP in 2001.

Exchange rates in the *SEACEN* region remained relatively stable in 2001 on the whole, despite the fact that some of these countries have adopted flexible exchange rate regimes (Chart 3). The Indonesian rupiah and the Korean won each depreciated by about 4.0 percent, whereas the Singapore dollar depreciated by about 5.0 percent in 2001. However, the countries that have maintained stable nominal exchange rates against the US dollar experienced a modest appreciation of their currencies against the Japanese yen. The major portion of the appreciation was seen after the 11 September attack, when the Japanese yen started to depreciate against the US dollar. The appreciation of the SEACEN regional currencies against the yen ranged from about 7.0 percent for the Singapore dollar to about 13.0 percent for the Malaysian ringgit.

Chart 5: Bilateral U.S Dollar Exchange Rates of Selected SEACEN Countries
(U.S dollare per currency unit, January 1996=100)



The real effective exchange rates of several of these economies, with an exception of Singapore[8] started to appreciate gradually. This appreciation since 11 September 2001 is roughly about 2.5 percent for Indonesia, about 5.0 percent for Korea, about 6.0 percent for Malaysia, about 8.0 percent for Thailand and about 9.0 percent for the Philippines. Although the real effective exchange rates are still lower than the pre-crisis level, the continued real appreciation of the currencies could erode the export competitiveness of the economies.

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8 Singapore has had a remarkably stable real effective exchange rate for many years now, even at the height of the Asian crises.

Policy Responses and Assessment Undertaken by SEACEN Countries

However, it is clear that *SEACEN* countries recognize that a crisis may be eminent following the 11 September terrorist attacks with the implementation of some very tangible response to precipitate a fast response. The *SEACEN* countries were concerned about the spill over effects to the economy and many of the policy response were geared towards re-establishing confidence. It is also to be noted that the attack came at a time when the crisis-affected Asian countries were in the midst of recovery.

The major challenge faced by the *SEACEN* countries was how to strike a balance between the gain in output and the deterioration in the external payments position. The *SEACEN* economies with comfortable external payments and fiscal positions and low inflation were in a better position to relax their fiscal policy and reduce interest rates. For example, Malaysia and Singapore adopted aggressive stimulus measures. Malaysia expanded the fiscal deficit, relative to GDP, with supplementary spending and in Singapore substantial off-budget fiscal stimulus was introduced in the face of rapidly slowing economic conditions, while the other governments pursued less active counter cyclical policies. However, monetary policy across the SEACEN region was mixed as monetary authorities, with varying tools, worked out competing objectives. For example, monetary policy was relatively accommodative in Malaysia, Korea, Philippines, Singapore and Taiwan while in Indonesia and Thailand, it was relatively tight.

For Indonesia, it was hard on the part of the Indonesian government to formulate appropriated monetary as well as fiscal policy in response to the external shock of 2001. Inflation has been on the rise from about 9.4 percent in 2000 to 12.6 percent in 2001, constraining the policy makers from reducing the interest rates. In addition, interest rates have to remain high because of weak exchange rate, and the need to attract financing for public debt. The short- term interest rate was increased from about 15.0 percent in December 2000 to 18.0 percent in February 2002. Although the fiscal deficits were not very large in recent years, Indonesia had the highest public debt to GDP ratio amongst the SEACEN countries. In addition, shortfall in revenue collection limited the country from any probability of further fiscal expansion in 2001. As such, to counter the external shock, the Government had to take on various austerity measures in 2001 viz., hiking domestic energy prices, increasing the tax on interest income from bank deposits, increasing sales tax on agricultural products, and cutting down on public spending. In spite of these austerity measures, fiscal deficit of the central Government for 2001 turned out to be larger than in the previous year.

Although Korea had planned to run a small fiscal deficit in 2001 as against a surplus of 1.1 percent of GDP in 2000, the actual government expenditures fell short of the budget target, while the total revenues surpassed the original target. This has resulted in a budget surplus of about 1.3 percent of GDP, thereby nullifying the original intentions, which was mainly the result of various problems faced in implementing the fiscal policy. As such, monetary policy is seen to have played a decisive role in responding to the external shock in Korea. As a result of a significant cut in the interest rate by the Central Bank, the three-month inter-bank lending rates fell from 6.9 percent in December 2000 to 4.0 percent in December 2001 to 4.4 percent in February 2002. The reductions in the interest rate were helped along by the gradual decline in inflation from more than 5.0 percent in the second quarter of 2001 to 4.1 percent in the last quarter to 2.7percent in 2002.

The Malaysian government opted for a substantial fiscal expansion as the interest rate was cut by 50 basis points only once in late September 2001. In 2001, inflation remained low and stable at 1.4 percent reaching to 1.8 in 2002 and the short-term interest rate was maintained at 3.0 percent. As Malaysia's stock of public debt was at about 35.0 percent of GDP, a number deemed low by international standard, the country had larger scope for fiscal expansion. As the economic slowdown in 2001 had warranted for a substantial fiscal stimulus, the original budget for 2001 was supplemented by two additional spending packages mainly on public works and infrastructure development. Hence, Malaysia ran a fiscal deficit of more than 5.0 percent of GDP for a second year in succession.

In the Philippines, there was a substantial reduction in interest rates. The three-month inter-bank lending rate was brought down to about 7.8 percent in February 2002 from 15.9 percent in December 2001. The reduction in interest rate was as well helped by the gradual decline in inflation. However, since the national government's debt was already 4.1 percent of GDP in 2000, the authorities did not institute major fiscal stimulus measures. In addition, since the country's public debt had hovered around 70.0 percent of GDP, there had been a consensus that the country needed to gradually reduce the fiscal deficit, consolidate the fiscal position, thereby restoring the already lost fiscal credibility. As such, the underpinning policy measures taken by the government was directed towards fiscal restraint rather than fiscal expansion. The fiscal deficit in the Philippines contracted mildly to below 4.0 percent of GNP in 2001. This is an important accomplishment in face of the deterioration of fiscal performance in the latter part of 2000.

In Singapore too, interest rates and inflation were low. The already low inflation of about 1.0 percent gradually yielded to mild deflation of 0.4 percent in 2002. The three-month inter-bank lending rate gradually declined from 2.8 percent in December 2000 to less than 1.0 percent in February 2002. Singapore's fiscal stimulus measures mainly consisted of tax rebates and reductions, rather than expenditure increases. The measures considered were rebates on corporate and personal income, and property taxes, as well as on rentals on public properties used for commercial and industrial purposes.

In response to the external shock, Thailand made a significant cut in its interest rate and as a result, the three-month inter bank lending rate gradually came down from 5.0 percent in December 2000 to 2.3 percent in 2002. Prior to the attack, the weakening condition of Thai bhat and the fear of capital outflows had led Thailand to raise official interest rate in mid-2001. Similarly, tax cuts and special schemes at spurring activities in the rural economy, small and medium enterprises, and the tourism sector were the main components of the stimulus packages in the fiscal front. Thailand's public debt level in 2001 stood at about 58.0 percent of its GDP. The rate of increment of public debt in the recent years has been fast on the rise from less than 15.0 percent of GDP in 1996. Hence, such trends seen in public debts raise issues whether expansionary fiscal policy is sustainable in the long run.

OUTSTANDING ISSUES OF CONCERN

The process of globalisation of the world economy that started in the 1990s has a much significant role in increasing the degree of dependence between the inter-economies and the same has been responsible for increasingly making economies more vulnerable to the external shock. The experience of financial crisis of 1997 in South East Asia has clearly demonstrated that market economy enhanced by the unrelenting financial innovations and rapid development in new technology is not exempted from the irregular business cycle swings. The fact that the world economy non the less the South Asian economies is much dependent on the performance of the three major economies, namely, the US, the Euro area, and Japan is once again demonstrated by the 11 September terrorist attacks on the US.[9] In a globalizing world, the external environment plays a key role. The slowdown in the global economy in 2001, which sharply reduced export demand of the south Asian economies and caused deterioration in external trade activities, deepened sharply following the 11 September terrorist attacks. As a consequence, the economic contraction in the region was widespread even to the extent in recording a negative growth rates with higher inflation in some of the countries in the region. Such adverse developments in the region in 2001 clearly demonstrated the vulnerability of these economies to external shocks and the need for measures to strengthen the resilience of the economy.

With investment and exports expected to be among the engines of growth, the region’s dependency on the global economic rebound is considerably high. While domestic conditions play crucial role in creating conducive environment for investment, global economic conditions would also be important. Global economic slowdown will induce foreign investors to withdraw investment worldwide. As such the investor’s confidence is always prejudiced by the unfavourable global as well as the regional environments. The prolonged weakness in investment could slow down the economic activity and trade globally, and an increased transaction costs on international trade could also reduce the US propensity to import goods for a given level of aggregate demand. In addition, the weakening of non-oil

9 The three major world economies together account for roughly 45.0 percent of the world’s output and absorb nearly 50.0 percent of total exports from the Asia and the Pacific region.

primary commodity prices may hurt some south east Asian countries such as Mongolia that rely on commodity exports.

A possible source of a faltering global rebound is the inability of the US economy to sustain its emerging recovery because consumption slowed and exports remained lethargic. Also an adjustment to the US current account balance could have been a good reason for the lower external demand even in the event of a US recovery. There is also the possibility that, with US emerging out from the economic slowdown ahead of Euro area and Japan, its current account deficit will widen further before it begins to shrink, thereby increasing the chance of a sharp adjustment being precipitated by events that erode the global attraction for US financial assets. This would reduce the US propensity to import. The increase in trade costs in the wake of heightened security concerns would also add to the tendency.

Furthermore, any doubt on the people's mind about US ability to manage properly the prolonged critical situation that has been ever persisting especially after the 11 September crisis is likely to negatively affect the confidence in US economy. As a result, financial flows may reverse, and exchange rate correction as has been seen can be disruptive which may further slacken the import demand in US. While on the other hand, if instability starts to appear elsewhere in other region, investors could still consider US as a safe place to invest and thus pull out funds from the emerging markets. This is a potential hindrance for the Southeast Asian regional long-term growth.

In the medium term, there is also some uncertainty regarding world oil price hike. A hike in oil prices will significantly harm the Asian economies as was experienced due to ongoing unrest in Middle East, Palestine- Israel confrontation and political upheaval in Venezuela etc. Also, the risk of an extended period of global economic malaise is accentuated by the possibility of a prolonged period of turbulence caused by acts of terrorism or even by the military operations led by the US in attacking Iraq and elsewhere. Countries like Nepal and Philippines in the region that rely on worker remittances could be hurt by such political turmoil in the Middle East

It is evident that fluctuations of the exchange rates among the dollar, the yen, and the euro can exacerbate trade deficits of emerging market economies, precipitating balance of payment crisis. A country that has dollar denominated liabilities but that earns yen or euros from its exports could see its ability to service its debts suffer if the dollar appreciates relative to the other currencies. The rise of the dollar in the 1980 hurt Latin American economies, the fall of the yen in the mid- 1990s hurt the economies of Southeast Asia, and the decline of the euro exacerbated Argentina's trade deficit. Hence the emerging market economies should act on the assumption that the major exchange rates will be volatile. That implies a further reason to avoid debt that is denominated in dollars or any other single currency[10]. A country that borrows abroad might protect itself from currency fluctuations by borrowing in mix currencies.

An area of concern is the banking sector. However, the banking sector of most of the economies in the Southeast Asia have shown some encouraging signs. The ratio of non-performing loans (NPLs) continued to decline in most of these countries; with the exception of Malaysia and the Philippines, banks' capital adequacy ratio stayed above the 8.0 percent norm, and the bank profitability, except for a few exceptions is seen to be increasing.

The capital adequacy ratio of the banking sector in most of the *SEACEN* countries has shown signs of improvement. The banking sector profitability, as measured by the average return on equity, has also shown improvements in many of the countries in the region. For example, the average return on equity ranges from 4.4 percent in the Philippines to 15.8 percent in Korea.

The sharp decline in the non-performing loans (NPLs) in the banking sector is the result of the transfer of problem loans from bank's balance sheets to publicly funded asset management companies (AMCs). However, if the NPLs held by the AMCs are also added to those still in the banking system, the picture is a little bleak. These aggregate NPL ratios are as high as 50.0 percent in Indonesia and 25.0 percent in Thailand, thereby reflecting the fact that these AMCs have been able to dispose only a small proportion of the NPLs transferred to them by the banks. For example, in Indonesia, by December 2001, about 88.0 percent of the bank's problem loans had been transferred to the Indonesian Banks Restructuring Agency (IBRA), of which only about 7.0 percent was able to be disposed.

The situation of AMCs in Korea and Malaysia is a little different. About 7.0 percent of the banking sector's NPLs in Korea had been transferred to the Korea Asset Management Corporation (KAMCO) by December 2001 and it was able to dispose about 58.0 percent of the NPLs by January 2002. In Malaysia, about 40.0 percent of the banking sector's NPLs had been transferred to its Asset Management Company, Danaharta, of which about 88.0 percent was disposed by the year-end. The reason behind a high aggregate NPLs ratio can be accounted for the slow progress in the operational restructuring of the corporate sectors in most of the countries in the region. In recent years, these countries have made some progress in financial restructuring of their corporate sectors through debt rescheduling, debt-equity swaps, debt forgiveness and indexation of interest payments to earnings. However, progress made especially in the operational sides has been very slow. In many cases, changes in the management have not come into effect even in corporate restructuring. In addition, banks as well as AMCs are observed to be reluctant in taking tough measures such as selling off non-performing assets or converting debt into equity and also in forcing corporations to close non-viable

10 Private and public borrowers must also take into account the possibility of interest rate movement that are not based on local conditions, making the optimal debt level less than it would otherwise be and increasing the optimal maturity of that debt.

businesses, sell over-valued assets and undertake other means of operational restructuring.

It is seen from country experiences that AMCs can be effectively used for financial restructuring than operational restructuring. The main reason behind this besides the skills that the commercial banks and AMCs lack to conduct these operations is the political factors, which have limited the ability of publicly owned agencies to conduct difficult corporate restructuring. For example, governments are reluctant to fire excess workers and close non-viable business.

Another possible area of vulnerability is the possibility of growing public debts. With the slower growth and larger fiscal spending, growing public debts is seen as emerging risk. However as the economies in the region recover, pressure on public debt burden and future contingent liabilities would be reduced to a large degree.

There is also the fear that amidst weakening economic conditions, erratic movements in the stock market and political uncertainty have constrained the structural reforms, and focus will be more on pursuing short-term stability instead of carrying out the much needed structural reforms

THE NEPALESE SCENARIO

As a landlocked and relatively closed economy, the impact of the slowdown in industrial countries was seen to be lower for Nepal compared to most other countries in the Southeast Asian region. The ratio of total merchandise trade to GDP was 42 per cent of GDP in 2001. Nepal recorded a GDP growth of 5.5 per cent during the fiscal year 2000/01. However, the impact of the global slowdown, particularly the events of September 11, affected the performance for the fiscal year 2001/02. GDP growth slowed down to negative 0.6 per cent during the period. Tourism as well as exports of ready-made garments, carpets, pashmina shawl and woollen carpets have been affected severely.

Table 5. Key Economic Indicators

	1998	1999	2000	2001	2002
GDP Growth (%)	2.9	4.5	6.1	5.5	-0.6
Export Growth (% of GDP)	10.4	10.4	13.1	13.6	11.1
Openness (trade as a % of GDP)	38.7	36.0	41.7	41.7	36.6
Inflation (%)	8.3	11.4	3.5	2.4	2.9
Debt Service Ratio*	4.7	5.0	4.7	4.4	4.9
Government Budgetary Deficit (% of GDP)	-5.9	-5.3	-4.7	-5.9	-5.4

* *In relation to exports of goods and services (excluding re-exports) and private transfers*
Source: NRB

The fiscal deficit remained at 4.7 per cent of GDP during the fiscal year 2000/01 despite adopting a structural adjustment program with a number of fiscal reform measures. Both higher expenditure growth and slower revenue growth contributed to the higher deficit. With persistent fiscal imbalances due to structural problems in tax administration, monetary policy was the preferred option to support domestic activities.

Accordingly, several monetary policy easing measures were introduced in response to lower external demand: a) Cash reserve ratio was reduced by one percentage point to 9 per cent; b) Bank and refinances rates were reduced by one to two percentage points; and c) Refinancing facilities were provided to the affected industries at concessional rates. Despite the monetary policy package, demand for private sector credit was sluggish due to poor performance of manufacturing and tourism industries. Therefore, the full impact of the accommodative monetary policy could only be felt with some improvements in investor confidence.

The Nepal Rastra Bank also introduced several reforms in the financial sector. A new Nepal Rastra Bank Act and the Loan Recovery Act 2002 have been enacted. It has implemented the financial sector reform as a part of the overall economic liberalization process. Compared to the private sector banks, the government-owned banks have weaker health, reflecting the major problem in the financial sector. The restructuring of the government -owned banks and strengthening their management has become the prime strategy of the financial sector reform. Under the Debt Recovery Act, Debt Recovery Tribunal (DRT) has been set up to create a sound banking environment through reduced non performing asset. Also an assets management company is being established. However, in spite of all these, persistent fiscal deficits over the years indicate the need for continuous efforts to implement structural reforms in fiscal management as well.

Increasing defense related expenditure due to the internal conflict exerts more pressure on the fiscal deficit. Addressing structural rigidities in the fiscal sector should be the key to achieving macroeconomic balance, which will provide more policy options for Nepal to reduce its external vulnerability.

POLICY ISSUES AND CHALLENGES

However, it must be pointed out that the *SEACEN* economies in particular the crisis-inflicted economies because of recent reforms after the 1997 financial crisis, are in a better position to handle any exchange rate as well as the financial market corrections. It is to be noted that as far as *SEACEN* economies are concerned, the slowdown after the 11 September crisis is characterised as more of an ICT sector correction that deepened into a global cyclical slowdown. This is in contrast to the corrections to domestic demand and substantial capital outflows suffered by many emerging Asian economies during the 1997/98 financial crisis. Hence, the basic weakness is seen as one that stems from trade rather than capital flows or lack of economic fundamentals.

Monetary and Fiscal Policies

In general, monetary polices were considerably relaxed after the attack and this was in line with the developments in the United States. Fiscal policy was also eased substantially and in many cases, supplementary budget spending was proposed. However, as far as monetary policy is concerned, with interest rate already at a very low level, there may have not been much room left for monetary simulation. There was also the fear of possible deflation as in the case of Japan's zero interest policy if monetary policy was used to the extreme. However monetary policy still played a major role in stabilizing the economy.

Prior to the 11 September attacks, in some of the crisis-affected countries, a large part of the public debt had already been incurred as a result of financial restructuring. In spite of this, fiscal policies still remain a very viable policy option as with weak external environment, expansionary fiscal policy can have desirable supply-side effects. The worrying factor is the rising of sovereign debt as the slowdown of the economy and the increased government spending could lead to the deterioration of the balance sheet of the public sector. However, it must be emphasized that sovereign debt rating for most countries in the south Asian region, remain reasonably good. Most of these countries are able to maintain a current account surplus and this is important for those countries like Indonesia and the Philippines, which have a large external debt burden. In addition, the level of reserves is at a comfortable level after years of experiencing current account surpluses. Furthermore, the risk of debt crisis, similar to that in Argentina is ruled out, as there is a favourable expectation of sufficient domestic liquidity due to the high domestic savings.[11] There is also very little new risk as debt levels are manageable; hence the need for a "Ponzi" type of financing therefore does not exist. However, there is a fear of overreaction of fiscal policy. It must be emphasised that in the longer run, "expansionary policies", whether it is fiscal or monetary must still be assessed against the risks to long-term sustainability. In the case of fiscal policy, persistent deficit spending could affect on the structure of public finances, such as a permanently higher tax level, as well as the economic costs of an eventual policy reversal.[12] However, fiscal policy looked appropriate in the situation despite the very open economy, "leakage" is minimized as the marginal propensity to import out of government expenditure is offset by voluntary import compression and lower income. It is also important to encourage capital inflow since financing persistent budget deficits without international capital, may result in a rise in real interest rates, rising deficits and larger issuance of bonds (Rojas-Suárez, 1992). It should be noted that one reason for the faster than expected economic recovery after the 11 September is that macroeconomic policies were conducted with greater clarity and coherence.

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[11] Rating and Investment Information, Inc, Japan, R&I Asian Focus, Sovereign Rating Outlook for Asia in 2002, Growing Public Debt Emerges as new risk December 20, 2001.

[12] Monthly Report, ECB, April 2002

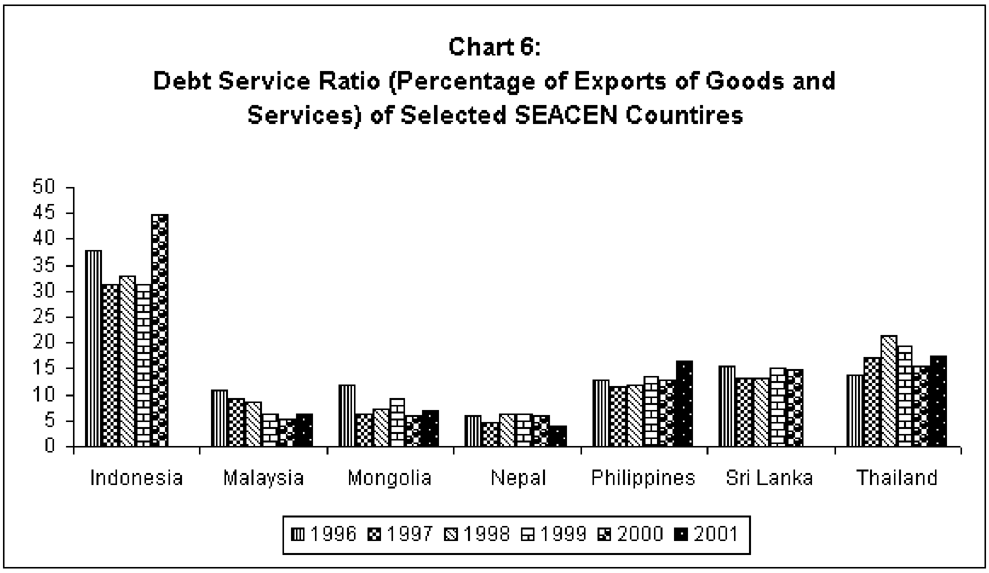

*Table 6. The Standard & Poor's Sovereign rating of Selected SEACEN Countries**

	Long-Term Rating	Outlook
Indonesia	B-	Negative
Korea	A+	Stable
Malaysia	A	Stable
Mongolia	B	Positive
Philippines	BBB+	Stable
Singapore	AAA	Stable
Taiwan	AA	Negative
Thailand	A-	Stable

** On April 2002*
Source: Standard & Poor

Trade Ties

An obvious linkage is through the trade as many south Asian countries have a high trade ratio to the US and the US forms the single biggest market for many of these countries. A longer run strategy is to strengthen the multilateral trade ties[13]. Investment in the area of information, infrastructure, technology innovation and skill development must continue to be encouraged[14]. Singapore, due to the slowdown of high-tech exports, as a result of decline in high-tech investment by the US, has diversified into biotechnology products. Since countries in the region

[13] US Department of State, International Information Programs, Excerpt from Joint Statement of Thirteenth APE Ministerial, 18 October 2001.
[14] The World Bank, Issues Brief, Progress over the last 40 years, September 2001.

have either joined or are in the process of joining WTO, the basic terms of reference like tariff etc. should be made compatible to the WTO standard. Furthermore, the member countries should work out in developing the competitiveness of each other based on comparative advantages such as that in the area of forest product, high-tech production, tourism etc. It is obvious that there is a heightened need for other countries in the region to adapt to the increasing competitive challenges from the economic growth of the People's Republic of China

Structural Reforms

At the domestic level, reforms must effectively address the structural factors that contribute to the vulnerability of the financial system. The microeconomic distortion-referring to asymmetric information and moral hazard-that lead to over borrowing and /or over lending must be reduced. This can be achieved by the appropriate pacing and sequencing of liberalization but more with the necessity of implementing institutional reforms prior to easing restrictions on capital flows. The economies in the region would be well served by continuing to move ahead with structural and institutional reforms that bolster domestic sources of growth. This can be achieved by creating a more conducive climate both for domestic and foreign investment and also by fostering a more stable as well as an encouraging environment for consumers

The Southeast Asian region has undergone tremendous reforms but is far from completion. In a constrained setting, policymakers have a dilemma as to the timing of such financial reforms. It must be emphasized that even as priority is to be given to stabilizing the economy, there should not be any delays of structural reforms. Any possible policy slippages and lags in implementation could add further chaos to the entire financial system. As such, in due time, mergers and acquisitions should be encouraged. Besides mergers and acquisitions, strategic alliance between different types of financial institutions aimed at an ultimate universal banking system to improve efficiency and productivity should also be encouraged.

Appropriate reforms could strengthen the banking system. At the same time, there must also be reforms to strengthen the long-term supervision and regulation to develop a strong code of “safe and sound” financial regulations. The long-run aim of improvement in supervision should not be to protect these industries. On the contrary, market forces should be allowed to play their part. International standards in prudential risk management must also be adopted; however, the supervisory authority should not overreact. In addition, the regulatory authority as well as the public should be given access to accurate and timely information. Strict public disclosure on the current condition of financial institutions must be initiated without delay, as bank assets are by nature opaque.

In addition, the domestic capital market- the corporate bond market in particular- must be deepened. This would improve domestic resource mobilization, minimize maturity mismatch, and enhance the ability of the economy to absorb greater capital flows.

Research and Development

Research and development must necessarily led to create, absorb, and adapt new technology for commercial use. In its early stages of development, most of the countries in the region brought technologies form outside the region (emulation or imitation) rather than develop new technologies (innovation). This made some sense for those countries that were relatively late to develop and could take rapid strides simply by importing and assimilating foreign technologies. But these countries now have already drawn themselves to the technological frontier. As the frontier is approached, the opportunities for rapid progress through emulation diminish and the ability to innovate becomes increasingly important.

Unemployment and Social Reforms

The social impact of the slowdown of the economy is a loss of real income directly as a result of unemployment. The relatively slow growth rates in 2001 meant further delays in meaningful improvement of the welfare of the poor - particularly in Indonesia, Nepal, Thailand and the Philippines, where the severity of the economic contractions associated with the crisis partially eroded past progress in reducing poverty to some extent. As social instability is one factor that can prevent the return of investors' confidence, the benefit of adjustment, in particular that of fiscal policy, must trickle down to the poor and middle-income groups.

Outward Looking Policies

In the longer run, even though globalisation can be a source of macroeconomic volatility, policymakers must continue to be alert and responsive to both the opportunities and the challenges of globalisation if the countries are to continue to capitalize on this process. There also exist risks to the globalisation strategy and policies must be formulated to minimize them. Greater volatility is probably the biggest risk that accompanies globalisation. For example, although the positive impact on growth of trade and FDI flows is now widely recognized, the benefits of portfolio capital flows continue to be questioned. As such, policies should be directed towards monitoring and regulating capital flows, developing an appropriate exchange rate regime, minimizing fluctuations in productivity and investment, and strengthening social safety nets.

Concerted Efforts

To some extent, the external shocks associated with the forces of globalisation or crisis can be moderated by regional initiatives and this creates an argument for coordination at the regional level. Frame works for addressing such problems at the regional level have been developed in other parts of the world, providing precedents that countries in the region should follow suit. Interest in the regional option has attracted new attention on Asia in the wake of the 1997 financial crisis and has given rise to discussions for the establishment of an Asian Monetary Fund. Similarly the Chaing Mai initiatives and the SAARC Finance network can be seen as a way of addressing the regional financial pressure. Measures such as the safeguard measures incorporated in the SAFTA agreement are also expected to enable the countries within the SAARC in building and improving the capacity in terms of infrastructure and export promotion with a view to enhance competition and meaningful benefit from intra-regional trade. These initiatives, which forms part of regional cooperation is useful to eliminate the distortions that would otherwise cause such liberalization to heighten volatility and crisis risk.

There have been many proposals as regards to collective efforts at times of economic slowdown Bergsten (1998) proposes the "Concerted Asian Recovery Programme" in which fiscal and monetary stimulus are undertaken simultaneously by various countries. The centrepiece of this proposal is for Japan to take the lead. The World Bank believes that a 1.0 percent GDP increase in fiscal-deficit spending of Japan, Asia NIEs, ASEAN4 and China could generate East Asia's economic growth by as much as 2.0 percentage points of GDP. However, concerted efforts related to economic policy require careful coordination, and experiences have shown that it is virtually impossible to form any kind of consensus on domestic economic policies.

While the long-term solution of a common currency similar to the Euro may be far-fetched, it is fair to say that in some areas, a concerted effort in regional mutual cooperation such as member countries developing joint ventures have resulted in making the regional development more sustainable.

CONCLUSION

Experiences suggests that, although the impact to the global economy, of the slump in external demand is higher for highly integrated economies strong macroeconomic fundamentals to a significant extent can shield the economies from adverse impacts of the external shock. The stronger the macroeconomic fundamentals, the broader the policy options available to minimise the impact of the external shock. The effectiveness of the policy responses would depend on the status of the domestic banking and financial as well as corporate sectors. Policy responses trickle down the economy faster if there are less rigidities in these sectors.

Experience also suggests that the recovery is most advanced in countries where these reforms have been implemented successfully. For example, the recovery is most advanced in Korea, as Korea had already implemented major reforms in financial and corporate sectors successfully. Therefore, completion of initiated reform agenda and maintenance of strong economic fundamentals will provide necessary policy options for the countries in the event of uncertainty in the global recovery.

For countries with macroeconomic imbalances, priority should be given to address structural rigidities that cause macroeconomic imbalances while attempting to use available stimulus polices to cushion the effect of lower external demand in the short term. However, these countries may have to face cyclical fluctuations of the global economy until domestic macroeconomic imbalances and structural rigidities are resolved. Concerted efforts among countries such as reducing trade barriers through multiple trading arrangements could also pave the way to reduce the impact of slowdown in industrial countries by diversification of export markets and products.

ACRONYMS

ADB	Asian Development Bank
AMCs	Asset Management Companies
ASEAN	Association of South-east Asian Nations
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GNP	Gross National Product
ICT	Information, Communications and Technology
IFS	International Financial Statistics
IMF	International Monetary Fund
NIEs	Newly Industrialised Economies
NPLs	Non-Performing Loans
OPEC	Organisation of the Petroleum Exporting Countries
PRC	Peoples' Republic of China
SEACEN	The South East Asian Central Banks Research and Training Centre
US	United States
WTO	World Trade Organisation
WWTC	World Travel and Tourism Council

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Nepal's Budgetary Exercise During the Nineties: An Assessment

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Budgetary policies of His Majesty's Government of Nepal (HMG/N) during the Nineties were directed towards economic liberalization, privatization, poverty reduction and decentralization. Policies and programs of the budget during the Nineties were essentially concerned with agriculture modernization, employment promotion, women empowerment, financial sector reform, government expenditure management, tax reform, good governance, social service and the development of basic and physical infrastructure. The budgetary policy measures adopted by the first two budgets deserve appreciation at least in terms of the direction towards liberalization though they were still inadequate in terms of achieving the desired results.

Budgetary analysis reveals that HMG/N spent regular expenditure as budgeted but development expenditure and revenue lagged behind the targets. This is a gloomy fiscal scenario-- low development expenditure, high regular expenditure, low revenue collection and high fiscal deficit with high foreign loan inflows. So far, the donors have provided loans at concessional interest rates and with high gestation period. But, we can not expect the same situation to continue in the coming years in the changing world scenario where there is drying up of the flows of foreign aid and the donors are reluctant to provide concessional loans. Hence, managing national budget has become increasingly challenging for HMG/N despite its sole objective of poverty alleviation.

INTRODUCTION

Nepal's budgetary evolution spanned more than five decades since 1951when the budgetary process was initiated. It may be recalled that the budget, the main instrument of economic policy, incorporates policies, programs and activities

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related to government expenditure, revenue and other sources of financing. In other words, the fiscal policy is translated into practice through the budget. Thus, the budgetary policy occupies an important place in the overall economic policy of HMG/N.

HMG/N, after the restoration of multi-party democracy, adopted the open and liberal economic policy and, in the process, has been repealing the prevailing restrictive rules, regulations, laws and directives governing the economic policies one after another with great zeal and vigor. Budgetary policy has also undergone changes to that direction since the very first budget (1991/92 budget) of the multi-party democratic government. In this context, it seems pertinent to study the budget objectives, government commitments and budget policies to know the trend and direction of fiscal policy during the Nineties. The present paper analyzes the budgetary policy framework, makes statistical analysis of the budget expenditure, resources and deficits, reviews the budgetary problems, and suggests measures to improve the budgetary process and impacts in Nepal.

ANALYSIS OF POLICY FRAMEWORK

The following discussion makes an attempt to highlight the policy framework underlying each of the budgets during the Nineties. The main goal of the budget presented by the interim government formed after the establishment of the multi-party for 1990/91 was to extend all possible support from economic front toward the task of formulating new constitution and establishing the popularly-elected democratic government in deference to the wishes and expectations of the people's movement. While formulating this budget, HMG/N adopted the basic principle of promoting a balance between personal interest and social responsibility in setting development priorities and economic policies. From the statement ".... we are not in favor of unnecessary extension of the public enterprises and their activities. In reality, it is very difficult to bear the economic burden of public utility-oriented corporations that grew extensively during the Panchayat regime" (Budget: 1990/91), it can be concluded that the budget did identify the vital significance of the role of the private sector and accordingly adopted the privatization concept. Realizing the dimension of poverty, it was proposed to establish the "Rural Self-Reliance Development Fund" to assist deprived people to self-organize for income and employment generation activities. This was an experimental approach taken to reduce the poverty. HMG/N was committed to improve the prevailing industrial policy and to make necessary changes in the Industrial Act and related regulations. The budget was so designed as to provide the ensuing government a solid foundation for eradicating the disparities and distortions inherent in the economy and that its major thrust was to lessen the hardships of the people.

The government of the Nepali Congress (NC), that secured absolute majority in the general election held after the restoration of multi-party democratic system, presented the budget for 1991/92 to the first session of the parliament. This was the first budget in the direction towards the liberalization of the Nepalese economy in true sense. It gave a new vision to encourage participation of the private sector in productive areas. In this budget, it was realized that the government's role in the industrial and other enterprises should gradually be decreased with corresponding increased participation of the private sector. As a step to reduce government's role in industry and corporations, the budget declared to privatize three public enterprises (namely, Harisiddhi Brick and Tile Factory, Bansbari Leather and Shoe Industry and Bhrikuti Paper and Pulp Industry) and five public agriculture farms under newly legislated Privatization Act, 1991. In another step, to bolster the private sector, the budget allowed the establishment of finance companies including commercial banks to be wholly owned and operated by the private sector.

HMG/N, with an objective of making secondary education free in a phased manner, made education free till grade six since 1991/92. This program, however, covered only those schools which were running under government grants. During 1991/92, several important and far-reaching steps were undertaken to further open and liberalize the economy. Of them, the introduction of the system of partial convertibility of the Nepalese Rupee vis-à-vis the convertible foreign currency on trade account, revisions in the Industrial Policy, Trade Policy and Foreign Investment Policy, etc were few of the cases. As a result, almost all items, except a few re-exportable items, were brought under the Open General Licenses (OGL) system. The required foreign exchange for the import of these goods was made easily available at market rate through the commercial banks. Likewise, HMG/N allowed almost all the industries, except a few, to be established without the license. HMG/N also concentrated its efforts on laying down the basic framework and providing services to the poor and the destitute.

Many critics, however, opined that the budget incorporated only limited changes. On the revenue side, it could introduce hardly any new measures except for some minor changes in the existing tax rates. On the expenditure side, some new thinking was incorporated as the proportion of the development expenditure allocated for rural areas was increased and low priority and low return foreign-aided projects were put under review. In addition to this, an avenue was open to put a restraint on the growth of the regular expenditure, but the budget itself could not bring out any significant reforms in this respect.

The NC-government also presented the budget for 1992/93, the first budget under the Eighth Plan (1992-97) which incorporated the liberalization concept. The Rs. 33.6 billion budget identified three major challenges of the Nepalese economy, namely; country's development, reconstruction and alleviation of poverty. Timely completion of development projects and enhancing their effectiveness, strengthening of the local organizations geared toward rural development through decentralization, and administrative reforms to make the government machinery efficient, clean and accountable to the people were the cardinal aspects of the budget. The major policy thrust of the budget was to develop complementary program in order to maximize benefits from the economic potentiality that existed in the rural areas. The objective of such a program was to improve the economic conditions of the poor and disadvantaged groups, large majority of whom live in rural areas. In order to achieve this, the commercial and development banks, the rural development banks, co-operatives and the rural self-help fund and the technical training capacity of the cottage and village industry department were mobilized in a coordinated manner so as to provide package services like capital, technology, marketing and management to the entrepreneurs engaged in the activities designated for rural development.

The Eighth Plan contained objectives of attaining a sustainable economic growth rate, alleviation of poverty and maintaining regional balance. And the basic foundations of the development philosophies of the Plan were rural development, liberal economic policy, decentralization and people's participation. In order to realize the overall objectives of the plan, this budget laid down development policies and programs by categorizing them into four policy based groups. The budget introduced several far-reaching fiscal measures. Tariff schedule and income taxation were two important areas wherein the path-breaking reforms were affected. However, sales tax and excise duties did not see many changes. Limited but important reforms took place on the expenditure side. There were not much changes and reforms in other taxes.

The budget identified two serious problems existing in the economy. Firstly, there occurred a heavy pressure on the reserve of the Indian currency on the one hand and the glut in the reserve of the convertible currencies on the other. This finally led to a situation of selling of convertible currency to finance the imports from India. Secondly, revenue receipts from the customs duties, the largest source of government revenue, could not increase as projected on account of the decline in the high tariff attracting imports from the third countries and increase in the low tariff bearing imports from India.

Accordingly, the tax proposals for 1992/93 incorporated measures to correct the above anomalies and reform the tax structure so as to make it consistent with the new macroeconomic policies adopted by HMG/N. The first target towards this direction was to slash down the high tariff wall. Accordingly, the prevailing basic import duties rates above 100 percent were reduced to 100 percent and the number of duty rates was also reduced from 13 to 8. The objective of this measure was to open up the economy further on the one hand and to simplify the system on the other. Another important measure taken in the area of import tariff was to drastically cut down the additional duty rates from 15, 30, 40 and 50 percent to 5, 10, 15 and 20 percent respectively. The objective underlying this measure was to help open the economy and make the imports from the third countries cheaper so that Nepal's import trade is diverted toward the third countries. Besides, taking into account the importance of physical infrastructures in the development of the rural economy, special emphasis was laid down on the rural road construction program.

The budget for 1993/94 reviewed the achievements, strategies and economic activities undertaken during the past two years. In view of the huge expenditure for Arun III and Khimti Hydel with the participation of the private sector, on which work was to be started that year, allocations for other projects were made on the basis of priority. The budget proposed drastic increase in land revenue. It declared to provide subsidy at Rs. 10,000 per family in the Hills and Rs. 7,000 in the Terai as grants for bio-gas plants.

Interestingly, two budgets were presented for 1994/95, the first on July 15, 1994 on behalf of the NC. But the NC government was dissolved and election took place. Later on, Communist Party of Nepal-Unified Marxist and Leninist CPN (UML) formed the minority government and the second budget for the same fiscal year was presented on December 26, 1994, by the order of His Majesty, under Article 77, Section (1) of the constitution of the Kingdom of Nepal, 1990. The characteristics of this latter budget were: (a) provisions for dearness allowance of Rs. 300 to the employees including teachers, army and police, (b) free education up to grade nine from 1994/95, (c) increase in regular expenditure and decrease in development expenditure in terms of percentage, (d) allocation of Rs. 300,000 to all the Village Development Committees (VDCs) to carry out development works at their discretion, and (e) feasibility study to be undertaken for implementing ration card system.

Due to political instability and changes in the government, two budgets were presented in 1995/96, too: the first, on behalf of the minority government of the CPN (UML) and the second, with legal validity, on behalf of the coalition government of the NC, Rastriya Prajatantra Party (RPP) and Nepal Sadbhavana Party (NSP). This was the first budget of the coalition government in Nepal.

In this budget, major thrust was given to the economic liberalization, stating that it would be a major strategy for economic development and fiscal stability. HMG/N decided to introduce VAT system from that fiscal year bearing in mind the need to make sales tax more scientific. A bill was said to be introduced during that session of the parliament to implement VAT. HMG/N also decided to establish a dry port in Birgunj to facilitate international trade.

This budget made an honest attempt to give a definite direction to the future courses of development, correct the existing imbalance in the economy and enforce a prudent fiscal management and discipline. It formulated dual policy packages, one designed to expand and strengthen the modern sector with liberal, open and market-oriented economic policy and the intervention by the State. The packages for the modern sector contained a number of commitments including establishment of Export-Import Bank, expansion of Export Development Fund, introduction of Build-Operate-Transfer (BOT) system, and establishment of Tourism Development Authority, Technology Information Bank and Off-shore Financial Center in addition to rationalization and simplification of the various tax measures. Obviously, these measures were intended to strengthen the modern sector so that it could gradually integrate with the world market through competitive capacity. Likewise, for improving the rural economy, similar commitments were made for the establishment of Village Development Fund and small and Cottage Industrial Development Bank, expansion of rural banking activities, Rural Women Production Loans, social safety nets and, above all, an effective implementation of Land Reform Program. All these fundamental changes in developmental policy approach experienced during the past few years were based on the vision that once the modern and the rural sectors would go on expanding, one overlapping the other, the dualistic nature of the economy will gradually get diluted and some kind of a unified and integrated economy would eventually emerge.

One of the major features of this budget was to allocate development grant of Rs. 400,000 to each member of the house of the representatives and Rs. 250,000 to each member of the national assembly so as to implement development projects of their choice in their constituencies. Similarly, another important proposal of the budget was to run the private schools and colleges under company law. It was expected that this policy would help decrease the burden on the universities and check the tendency of going abroad for better higher education. HMG/N was also committed to make arrangements to provide long-term loans to such educational institutions for the improvement of their infrastructure.

The revenue and expenditure estimate for 1996/97 was presented on behalf of the coalition government of the NC, RPP and RSP. Self-employment program, land reform program, women development program, dearness allowance to government servants, allocation of budget for infrastructure development of Visit Nepal Year (VNY) 1998 program and budget allocation to respect the national talents were some of the major programs of the budget. While announcing the budget for 1996/97, then Finance Minister vowed to pick up one VDC from each of the development regions and raise the living standard of the people in such VDCs above the poverty line within one year.

Similarly, the budget emphasized on self-employment generating activities, for which a high level Central Coordination Committee and the District Coordination Committee were said to be constituted. This program proposed to provide employment for around 66,000 unemployed people from employment generation activities which was said to be prompted through reactivating the governmental, non-governmental and financial institutions. This, however, was hardly translated into reality. Besides this, the budget also announced a program to provide loan assistance to the unemployed youth for their participation in foreign employment. This might have led to a good source of foreign exchange earning if it was practically converted in reality.

The budget gave major thrust to export promotion, agricultural development, employment generation and poverty alleviation. Various measures were taken to minimize the unnecessary government expenditure overheads. The major challenge, which the budget itself confessed, was on the revenue front. "In the last fiscal year, the expenditure shore up but tax mobilization could not be effective" (Budget, 1996/97). The revenue target was set at an increase of Rs. 6 billion.

According to some critics, the basic policy orientation of the budget was essentially the hesitant continuation of the previous year's budget, in the sense that the budget speech was misery in spelling out the dualistic nature of the economy and its underlying problems of poverty, underemployment and structural imbalances and address them clearly and specifically, probably due to some psychological inhibitions and bias in favor of liberal, open and market-friendly economic policy as a panacea even for the deep-rooted problems of the overwhelmingly larger part of the economy with very little to do with the market.

The first budget of the Ninth Plan, the budget for 1997/98, was presented on behalf of the coalition government of the RPP, CPN(UML) and RSP. The budget emphasized on the development of agriculture for providing impetus to rural development. For this, it further mentioned the already implemented Agriculture Perspective Plan (APP) as the tool to carry out a package program of fertilizer, irrigation, technology, road, electricity and market. In order to remove obstacles to higher economic growth, it envisaged broadening and strengthening the liberalization and market-oriented economic policy. The budget also envisaged to pursue the major objectives of the Ninth Plan, i.e., poverty alleviation. It vowed to implement sectoral and targeted program of poverty alleviation in a more coordinated and integrated manner since 1998/99. Education was accorded a priority as the budget vowed to implement a special literacy program as a campaign to wipe out illiteracy from the country. The budget was committed to formulate a 20-year transport policy for the long-term development of transport sector and to formulate and implement a five-year road transport program under the said policy. According to the budget statement, rural telecommunication services was said to be expanded by establishing telephone exchange in 11 districts of Far-Western, Mid-Western and Central Development Regions.

Among the most important aspects of the budget, it vowed to give more autonomy to the Central Bank. "Initiation will be taken in this direction (autonomy) for the formulation and implementation of effective monetary policy" (Budget, 1997/98). Further, the budget was committed in such a way that "National Planning Commission (NPC) will be made more active in project selection, monitoring and evaluation. The Ministry of Finance (MOF) will be required to prepare budget on the basis of three-year rolling expenditure plan. The mid-term evaluation of the budget would be conducted on time and the budget managed accordingly" (Budget, 1997/98). The budget announced to provide continuity to some of the past programs. It reaffirmed the pledge to continue with Build-Our Village-Ourselves (BOVO), poverty alleviation, social security to senior citizens and handicapped and support for various activities to be carried out through the banking and financial system. With regard to direct tax, the budget reduced the maximum rate of tax on profit of industries from 33 percent to 25 percent, individual and partnership firms from 30 percent to 25 percent, and banks and financial institutions from 33 percent to 30 percent. The revenue proposals of the budget for 1997/98 seemed to be capitalistic but some social and local development programs reflected socialistic orientation.

The new individual activities subjected to a priori income tax clearance certificates were deposits in banks and finance companies and purchase of share issued by companies in excess of Rs. 500 thousand, and purchase of any property including motor car in excess of Rs. 1 million. This clause discriminated not only against deposit-taking financial institutions but also against saving-investment-growth trajectory. This was contrary to the spirit of liberalization. The maximum rate of income tax was reduced by 13 percentage points for industry, by 8 percentage points for corporate and by 5 percentage points for partnership and individual income. Such reduction was only 3 percentage points for banks and financial institutions. This, in fact, was a discrimination against the financial sector (Shrestha, B.P.:1996).

A budget of Rs. 69.69 billion was proposed for 1998/99. The revenue projection was highly criticized, as it was in no way a realistic target. The budget projected high expectations on the side of foreign assistance. In the wake of contagious economic slowdown in South-East Asia including Japan, the principal donor of Nepal, it was likely that the flow of fund to developing countries like Nepal from the bilateral donors would contract. One of the basic reasons behind the over-estimation of revenue and foreign assistance seemed to be rooted in artificially inflated development expenditure. The finance minister vowed to raise development expenditure by a hopping 25.7 percent, which was not consistent with the historical trends of the absorptive capacity of the Nepalese economy. Since the 1990s, the average development expenditure has been observed to grow by barely 10 percent.

The budget attempted to pursue some programs in the social sector like the poverty alleviation, training for self-employment generation, decentralization, etc.. These programs, characterizing the permanent features of the post-liberalization budgets, were, however, rarely implemented in true sense. Sectorwise, the budget gave special attention to the agricultural sector. It expressed commitment to the effective implementation of the 20-year APP though the commitment was not materialized. As envisaged by the APP, the budget identified surface irrigation system as the key factor for the development of agriculture in the Terai region and allocated Rs. 3.34 billion for irrigation, 41.5 percent up from previous year's budget. In terms of resource allocation, the education, health, drinking water, agriculture, irrigation, transportation, and hydropower attained high priority, with these sectors respectively drawing 6.1, 7.2, 7.0, 6.2, 9.2, 16.9, and 21.7 percent of the total development expenditure. Social sector as a whole continued to draw a large chunk, 35.3 percent of the proposed total development expenditure.

As the third budget under the Ninth Plan, the budget for 1999/00 was presented on behalf of the majority government of the NC, which was elected through the third general election following the restoration of multi-party system. An in-depth analysis of the existing challenges of the Nepalese economy was presented in the budget in a sensitive manner. The major challenges identified by the budget were: traditional agriculture and low productivity, slackness in industrial and commercial investment, resurgence of poverty and unemployment, burdensome public corporations, sluggish financial sector, development project and foreign aid, inadequate utilization of foreign aid, inconsistency of NGOs with the programs and efforts of HMG/N, ad hoc selection of projects and ineffective implementation, diminishing institutional capability and administrative morale, corrupt behavior and financial irregularity, budget deficit and increasing imbalance between revenue and expenditure, increasing debt, etc. So far as the development policy and program of the budget was concerned, it focused on 12 major sectors, namely; poverty alleviation, employment promotion, empowerment of women, financial sector reform, industry-commerce-tourism and foreign exchange, computer policy and software development, government expenditure management and reform in the budget system, increase in the agriculture productivity, tax administration and revenue mobilization, development administration and good governance, social services and the development of basic and physical infrastructure.

On the poverty alleviation front, the budget was committed to launch a nation-wide poverty reduction campaign called *"Bishweshwar Among the Poor"* which was targeted to those absolutely poor people who were deprived of minimum basic necessities like cloth, shelter, food, basic health services and education and whose access to land capital, skill and employment opportunities were non existent. Under this scheme, about 100 absolute poor families from each parliamentary constituency would be identified and a loan up to Rs. 30,000 at 5 percent interest rate would be provided so as to enable them for their better living. Another remarkable feature of this budget for poverty alleviation was the proposal to set up *"Poverty Alleviation Fund"*. The Fund was proposed to be utilized for the growth of markets through co-operatives, conducting training programs, and extending micro financing.

The budget also introduced the rehabilitation program called *"Ganeshman Singh Peace Campaign"* to provide amnesty and financial assistance for livelihood of those who surrendered, with their weapons, to live the life of law-abiding citizens by giving up the path of crime and murder. This budget made available of textbooks free up to grade five in governmental schools. It was committed to initiate extensive financial sector reform measures including submitting a bill in the ongoing session of the parliament to amend Nepal Rastra Bank Act for making it propitious and strengthening its supervisory capacity.

GOVERNMENT EXPENDITURE

Nepal being a developing country, there is an urgent need of expanding development expenditure. However, there is also a growing compulsion to maintain law and order as well as debt servicing. Financing expenditure requires increment in revenue collection. Situation of revenue receipts determines the amount necessary for foreign assistance and internal borrowing. The growth of government expenditure in Nepal has been phenomenal as evident from the fact that every finance minister ever since the beginning of the budgeting system in 1951 has presented a public expenditure program larger than that of the previous year. The total government expenditure in Nepal increased significantly during the 1990s. It was Rs. 23,549.8 million in 1991, increased by 13.0 percent per annum and reached Rs. 66,272.5 million in 2000. As a percentage of GDP, total expenditure remained at 18.0 percent during this period and showed a declining trend: 19.6 percent in 1991 to 17.5 percent in 2000. However, in real terms, growth rate of total expenditure stood at an average annual of 4.2 percent during this period (Table 1).

During the first half of the 1990s, Nepal went through a period of fiscal consolidation as an integral part of an economic liberalization and reform program. Nevertheless, the expansionary fiscal policy adopted by a succession of short-lived governments during the latter half of the 1990s resulted in an increase in fiscal deficits, debt stock, and debt-servicing obligations.

Regular Expenditure

Government expenditure is classified in terms of regular and development expenditure. Virtually all regular expenditures are typically recurrent expenditure, while another 20 percent of the development budget is also recurrent type expenditure in terms of salaries, subsidies and transfer payments to public enterprises (WB, 2000). These expenditures are further classified into various functional headings. However, there is no published data according to the economic classification of expenditure so far.

The regular expenditure shows an interesting phenomenon. It has a tendency to double in every five year. The regular expenditure of HMG/N has gone up from Rs. 7570.3 million in 1991 to 34523.3 million in 2000. It has increased by 18.5 percent on an average during the last decade, which was higher than the growth rate of development expenditure and total expenditure. Regular expenditure in real terms has increased by 9.3 percent during the review period, which is also higher than both the total expenditure and development expenditure.

As percentage of GDP, regular expenditure surged up from 6.3 percent in 1991 to 9.1 percent in 2000. Expansion of government offices and employees, growing burden of debt payment, and increasing responsibility of maintaining law and order are attributed for such a rise in regular expenditure. Increasing trend of regular expenditure has pre-empted much of HMG/N revenue, leaving only a small surplus for financing development activities. Almost 85 to 90 percent of regular expenditures consist of wages and salaries as well as debt service payments. In effect, allocations for operations and maintenance activities in the regular budget have been highly inadequate. However, the average compensation payments per government employees do not seem to be high in comparison to other South Asian countries. Likewise, a ratio of 7.8 percent of Nepal's external debt service payments to the earnings from exports of goods and services suggests that Nepal is unlikely to get into debt servicing problems in the near future (WB, 2000). Regular expenditure has been increasing at a higher pace due mainly to the responsibility of maintaining law and order, salary-hike and debt servicing obligation. Therefore, it seems hard to control regular expenditure in the future.

Development Expenditure

Development expenditure went up from Rs. 15,979.5 million in 1991 to 31749.2 million in 2000, with an average annual growth rate of 9.8 percent. The increase in development expenditure is a reflection of the rising development activities of HMG/N in the development process. In order to meet the minimum needs of food, clothing, health, education, drinking water, transport, communication and other services, the rate of growth in development expenditure should increase both in absolute as well as relative terms. However, the growth of development expenditure remained lower than the regular expenditure because of weak implementation of development projects resulting from political instability and lack of commitment.

Development expenditure in real terms during the review period increased by only 1.3 percent (Table 3). In terms of GDP, development expenditure stood at 10.1 percent on an average during the Nineties, declining from 13.3 percent in 1991 to 8.4 percent in 2000, reflecting a gloomy picture of development works. This is also demonstrated by the low realization ratio of the development expenditure. During the Nineties, only 86.3 percent of development budget was actually spent compared to 96.8 percent accomplished for regular budget.

Several new projects were launched every year, which almost tripled the number of projects under the development budget during the Nineties. Similarly, budget allocations for such projects doubled from Rs. 4 to Rs. 6 billion in mid-Nineties to about Rs. 11 billion in FY 1999. If inflation is considered, in 1999/00, expenditures per project in real terms amounted to little more than half the level of such expenditures ten years ago. In many cases, especially with regard to road projects, allocations have been miniscule-- a few million rupees per project-- so 40-50 years were required to complete them (WB: 2000). In many cases, allocations have been barely sufficient to pay wages and overheads, leaving little for capital investment/construction work. The consequence of the fragmentation and frittering away of resources is that few projects were completed in time, leading to substantial cost over-runs, and benefits from development spending not being realized.

Inter-Sectoral Expenditure Pattern

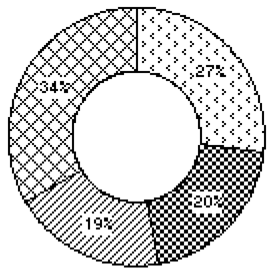
The sectoral pattern of development spending has important implications for the overall growth and poverty reduction in the economy and for the effectiveness of the public expenditure program. If we look at the sectoral expenditure pattern during the Nineties, it is found that priority has been accorded to the social sector, mainly education. Actual expenditure on social services, which had stood at 18.3 percent of total actual expenditure in 1990/91, increased to 30.58 percent in 1999/00; on an average, it stood at 27.0 percent during the Nineties. Within the social sector, education received the highest priority compared to other social services absorbing 12.7 percent of total expenditure and 47.1 percent of total expenditure on social service sector.

Despite HMG/N's high priority to the education sector in general and the basic and primary education along with adult literacy in particular, the actual achievements in terms of indicators like the literacy rate, participation and cycle completion rate have always fallen short of the targets (WB, 2000). While the policy of wider coverage has been achieved at the cost of quality, appalling rates of internal inefficiency combined with rapid growth in private schooling and huge disparity between examination pass rates in public and private schools are indications of erosion in the quality of public schools.

On expenditure, education sector is followed by local development and health sectors. However, there has been considerable wastage and leakages of resources. In recent years, the share of total government expenditure devoted to health services has increased. Health sector expenditures have risen on an average by about 12.2 percent per annum in real terms between 1991 and 2000 and their share in total government expenditure have risen from 2.8 percent to 4.9 percent over the same period (Table 4). Nevertheless, public expenditures on health in per capita terms is very low in Nepal, i.e. $3.10 per head in FY 1998. It is about one-fourth the level of resources required to be needed to provide a package of essential health services in a developing country. Meanwhile, rapidly growing population has increased the demand for public health services, while the institutional capacity to plan and implement health sector strategies and program remain weak. Over the past decade, a significant proportion of health budget allocations have not been spent. Since 1990/91, actual expenditure as a proportion of allocation in the development budget averaged only 8.7 percent (WB, 2000). Weak institutional and management capacity are attributed to such a low absorption capacity in the health sector.

Decentralized expenditure programs became the main instrument of successive governments in promoting economic development. Originally started on a small scale in the early-nineties as an initiative to involve District Development Committees (DDCs) in development activities, these programs have been expanded rapidly since 1995, i.e. 1.4 percent of total expenditure in 1991 to 6.22 percent in 1995 and, after that, remained stable at 6 to 7 percent of total expenditure. However, the involvement and empowerment of beneficiary groups has been limited, contributing to the poor use of resources and weak management of those programs. In many instances, the benefits have been largely captured by local elite groups. Compared to other sectors, its implementation rate has been significantly higher through utilization of almost all budget allocation. The sector's recent performance in terms of the quality of its spending has a crucial bearing on how well or badly scarce resources have been used within the development budget. Technical capacity is limited virtually at all levels: for project preparation, design, implementation and monitoring, and ensuring effective use of funds and accountability. Various studies revealed that, in many cases, the relatively better-off population benefited most from the DDC/VDC programs.

Figure 1
Sectoral Allocation of Total Expenditure (Average 1991-00)



Examining the inter-sectoral expenditure pattern indicates that social service sector is followed by the expenditure on economic services. Expenditure on this sector stood at 20.3 percent of the total actual expenditure during the period, 1991 - 2000. Such expenditure is found to decline from 36.5 percent in 1991 to 16.7 percent in 2000 because of the weak implementation of the economic projects. Expenditure on every sector under economic services is declining (Table 5). Expenditure on agriculture as a proportion of total actual expenditure fell from 6.7 percent in 1991 to 3.8 percent in 2000. Likewise, expenditure on irrigation declined from 6.8 percent in 1995 to 5.4 percent in 2000. Similarly, forest and industry as well as mining also depicted the declining share of expenditure during the Nineties.

Agriculture is a key sector in the Nepalese economy from a development and poverty reduction perspective because nearly 90 percent of the population and the large majority of the poor live in rural areas and depend on agriculture for most of their incomes and employment. Past policies aimed at accelerating agricultural development mainly consisted of efforts to expand infrastructure and the provision of key inputs through public interventions. However, these efforts met with limited success for a variety of reasons, including poor project design and implementations, and inefficiencies of public sector agencies involved, among others. In order to reverse this trend, the Agricultural Perspective Plan (APP), a twenty-year growth framework, was developed and incorporated in the Ninth Plan with the objectives of accelerating growth in the agriculture sector by increasing productivity for reducing poverty especially in the rural areas. In the mean time, the declining share of agriculture sector's expenditure has been responsible for the ineffective implementation of APP. Such a declining expenditure in agriculture is due to HMG/N's decision to give priority to local development, health and power generation.

During the review period 1991-2000, the share of expenditure on infrastructure increased from 15.6 percent to 18.24 percent and stood at 19.4 percent on an average. Within the infrastructure sector, electricity received the biggest chunk followed by transport. This reveals HMG/N's priority to the infrastructure sector, especially electricity and transport. HMG/N has been earmarking a substantial part of its on resources for new construction, especially new roads linking district headquarters. Many of these projects lacked proper economic justification and generally received a few million rupees each. However, collectively they added up to a few hundred million rupees, representing a significant misallocation of the scarce resources.

Although the share of expenditure on transport sector has remained more or less at constant proportion of 8 to 9 percent during 1991-2000, the realization ratio has averaged only about 73.7 percent of the allocation during the Nineties. The wide gap between the budget allocation and actual expenditure reflects a number of constraints such as over-programming of the budget, delay in fund release, limited absorptive capacity and various implementation problems including procurement delays, frequent transfers of staff, delay in contract management, political interference and corruption. There is a considerable wastage and frittering away of resources associated with the new construction and the multiplicity of small and uneconomic projects. Although, substantial resources were provided for local road construction and maintenance activities, much of these were poorly utilized or misused.

Under the infrastructure sector, electricity consumed 7.04 percent of total expenditure on an average during 1991-2000. Its share in total actual expenditure increased from 5.8 percent in 1991 to 8.4 percent in 2000 mainly because of the implementation of some big projects like the Kali Gandaki-A. Despite the relatively high public investment in power, domestic power supply is still insufficient to meet domestic demand. Only 322 MW out of a potential estimated hydropower generating capacity of 43000 MW has been developed so far. Per capita electricity consumption is only about 42 KWH (WB, 2000), which is among the lowest in the world, and a large proportion of the population, about 85 percent, remains out of access to electricity. The quality of supply is poor with inadequate dry season generation capacity.

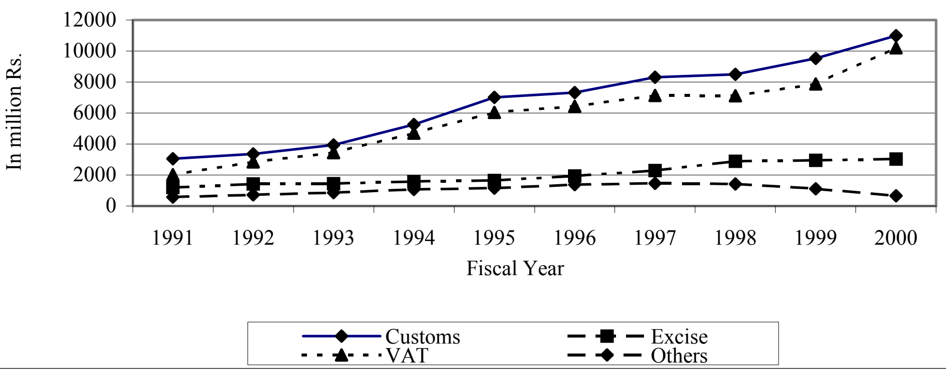
BUDGETARY RESOURCES

Government Revenue

In order to meet the requirements for day-to-day administration and development, government collects resources through various sources, the principal among them being the government revenue collected through tax and non-tax sources. But low rate of growth of economy, low level of income as well as the rate of saving, and inefficient tax administration make the collection of tax revenue a difficult task in Nepal. Besides, high taxation often adversely affects the private enterprise and initiative, and contributes to a decline in the net investment capacity, and thereby in the employment too, of the economy. As a result, the proportion of the government revenue in national income stands less than 11 percent in the developing countries whereas it remains as high as 40 percent in the developed countries.

Nepal's revenue/GDP ratio has stagnated at around 10.3 percent of GDP during the last decade (Table 6). In the early-nineties, as part of its economic reform program, HMG/N made strong efforts to raise its revenue ratio from about 8.9 percent of GDP in 1991 to 11.2 percent in 1995. However, the ratio remained almost stagnant after that. Still, the revenue during the period of 1991 through 2000 increased on an average by 16.7 percent and 7.5 percent in nominal and real terms respectively (Table 6). On an average, 96 percent of budgeted revenue target has actually been met.

Figure 2
Movement of Indirect Tax Components
(1990/91-1999/00)



The growth of public sector revenue, although increasing steadily, does not yet give a sense of satisfaction for the simple reason that the revenue potentialities available in the economy have not yet been fully exploited. Some of the factors responsible for this situation are lax efforts toward revenue mobilization, lack of perspective vision in this respect, and the practice of undertaking ad-hoc short-term adjustment without due regard to long-term growth prospect of the economy.

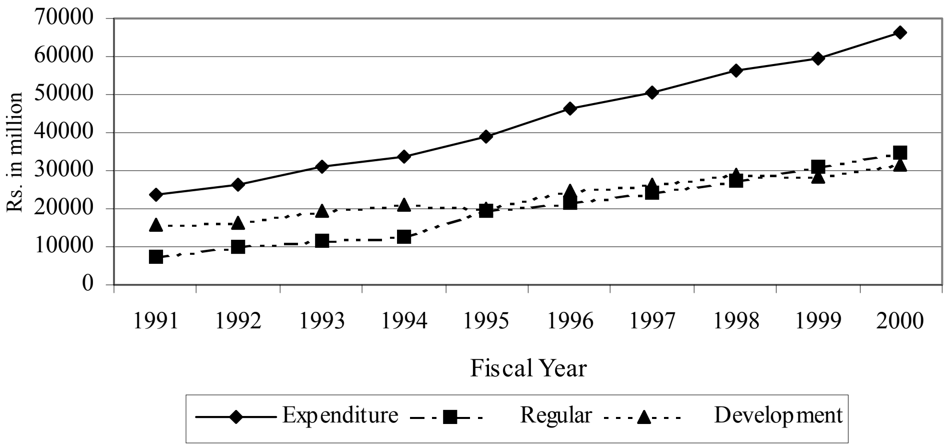
During the period 1991-2000, on an average, tax revenue contributed 77.7 percent while non-tax revenue provided 22.3 percent of the total revenue. Tax revenue is heavily dependent upon indirect tax, which contributed 78.5 percent of tax revenue and 62.0 percent of total revenue. However, the contribution of direct tax was also increasing, from 12.3 percent in 1991 to 19.8 percent in 2000, because of the expansion of income tax revenue (Table 7).

Indirect tax revenue was heavily derived from customs duty, providing an average 43 percent share in the indirect tax revenue. In this way, the tax system was steadily dependent upon the customs-based revenue. The Value Added Tax (VAT) followed the customs duty by contributing 36.3 percent of the indirect taxes. However, the excise duty stood at only 13.6 percent of indirect taxes during the period, 1991-2000. Among the direct taxes, income tax formed a major share of 72 percent during the review period.

Fiscal Deficit

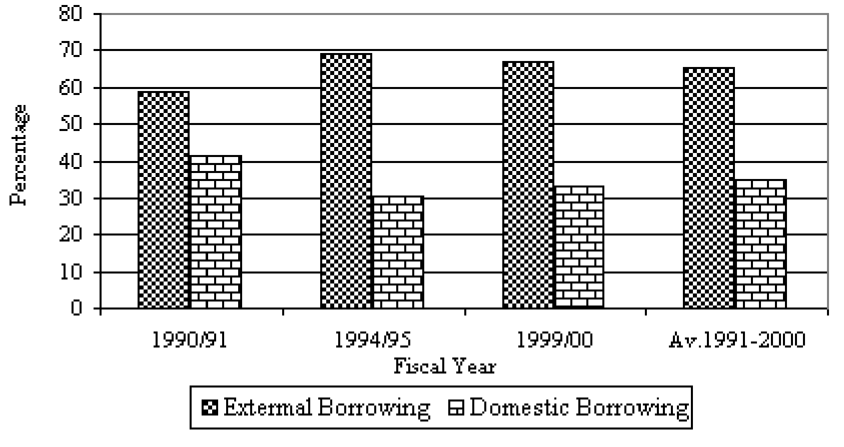
In the government budgetary operation, the expenditure always outstripped the revenue. The contribution of revenue for the total expenditure remained at an average 57.3 percent during the period 1991-2000 (Table 8).

Figure 3
Government Expenditure & Sources of Finance
(1990/91 - 1999/00)



Such contribution, which remained almost stagnant, indicates the low performance of revenue collection and the growing trend of government expenditure. Because of the low internal revenue mobilization, the government expenditure was heavily dependent on foreign assistance (loan and grant) which, on an average, contributed 30.9 percent during the Nineties. The contribution of loan was comparatively higher than the grant, thereby increasing the debt burden to the future generation. About 11.8 percent of expenditure was derived from internal borrowing, thus increasing domestic debt liability also.

Figure 4
Financing Fiscal Deficit



In fact, the development expenditure of Nepal is heavily dependent on foreign assistance. Of the total development expenditure, only 23.8 percent was derived from revenue surplus. The remaining major chunk of 55.3 percent was fulfilled through foreign assistance and 20.9 percent through internal borrowing during the review period (Table 9). Low revenue surplus led to high fiscal deficit, most of which, as explained above, was financed by foreign aid (Table 10).

As a result of higher expenditure compared to the revenue mobilization, large fiscal deficit was observed throughout the review years. Generally, fiscal deficit is measured by subtracting revenue plus grant from government expenditure. Such a deficit increased from Rs. 10,655.1 million in 1991 to Rs. 17,667.0 million in 2000, more than one-and-a-half fold compared to that in 1991. The average growth of such a deficit stood at 8.5 percent in nominal terms and at 0.08 percent in real terms during the Nineties. As a percentage of GDP, such a deficit remained at 6.1 percent still considered substantially higher despite lower than the 8.9 percent of GDP in 1991.

Grant is not revenue in actual sense. In fact, it is foreign assistance provided by the donors. If the grant is excluded from the resources side, the fiscal deficit would be comparatively higher, 7.7 percent of GDP during the Nineties, at an average growth of 9.1 percent.

Implications of Fiscal Deficit

As the government has to resort to both foreign and internal borrowing to finance fiscal deficit, higher fiscal deficit has many implications on the economy including creating a liability to the nation. More than half the fiscal deficit has been fulfilled through external borrowings (Table 10), 21.9 percent through foreign grants, 17.2 percent through internal borrowing, and the remaining as an overdraft from the NRB. Because of the growing fiscal deficit and its fulfillment through foreign loan as well as internal loan, the debt stock has been increasing steadily. Total debt stock was Rs. 80,361.2 million in 1991, which increased to Rs. 245,048.2 million in 2000 at an average annual growth of 17.6 percent. As a percentage of GDP, total debt stock was 69.2 percent in 1991 and 67.1 percent in 2000 (Table 12). Almost 77.8 percent of debt stock is constituted by foreign debt. Such a debt stock scenario is obviously a great liability to the coming generation.

MAJOR SOCIO-ECONOMIC INDICATORS DURING THE NINETIES

To what extent the policies followed during the Nineties were successful could be assessed by looking at some of the important socio-economic indicators. Although these indicators indicate some positive changes in socio-economic sector, their performance is still low compared to the international standards. Gross domestic saving increased from 9.6 percent of GDP in 1991 to 13.2 percent of GDP in 2000. Import financing capacity of export increased from 32 percent in 1991 to 48 percent in 2000. Similarly, per capita GDP went up from US$ 186 to US$ 242 during the review period. Current account balance also became positive in 1998/99. Inflation also came to a lower single digit level (Table 13). Likewise, on social side, crude birth rate declined from 41.2 per thousand to 33.6 per thousand. Crude death rate also declined to 10.0 per thousand from 13.3 per thousand during the review period. Infant mortality rate plummeted to 64.1 per thousand from 97.5 in 1991. Literacy rate was estimated to be above 60 percent in 2000 compared to 39.6 percent in 1991. Life expectancy at birth also reached 58 years from 54 years in 1991. Still, the overall socio-economic situation is far behind the international standard. A large proportion of the people is still living under poverty line, lacking basic necessities. Only 15 percent of the population is able to get electricity supply. Infrastructure is very insufficient vis-à-vis the national requirement.

PROBLEMS REGARDING BUDGETARY FRAMEWORK

Higher incidence of poverty, underdeveloped stage of the economy and the lagging private sector, etc. still demands the active role of the government apart from the traditional role of maintaining law and order. Therefore, government has to incur expenditure to perform several regular as well as development works. However, the slow pace of revenue collection compared to expenditure growth has been creating the fiscal imbalance for which the nation has to depend upon foreign assistance. Due to the tendency of declining foreign grants and increasing foreign loans, Nepal's debt burden has been increasing, with almost one-third of the regular expenditure required to be allocated for the debt service. If fiscal imbalances increase continuously over the coming years, or debt stock as well as debt service payments increase steadily emptying Nepal's narrow coffer, there would be problems for earmarking resources for productive projects while complying with the need for maintaining macroeconomic stability.

Nepal's budgeting process has been highly unrealistic. In almost all the years in the review period, the budget targets have been set at unduly high levels, particularly for the revenue and foreign aid. This over-estimation of resources has in turn enabled HMG/N to set similar unrealistic targets for the development budget and to accommodate too many new projects. However, the actual budget outcomes fell significantly short of the optimistic expectations every year. It has been found that the government expenditure is increasing fast compared to the revenue collection. Among the expenditures, regular expenditure, has been increasing rapidly due to growing burden of debt service payments, maintaining law and order and providing salary to civil servants. Growing regular expenditure has become a major concern to policymakers because it has been narrowing the revenue surplus necessary to finance development expenditure.

Since there is little scope for cutting back regular expenditures, the brunt of fiscal adjustment has been made through cutbacks in development spending. During the recent years, because of political instability, the development expenditure stood even below the regular expenditure. Obviously, such declining situation of development expenditure would erode the productive capacities of the economy constraining the basic socio-economic infrastructure and services. Many structural weaknesses are responsible for Nepal's unsatisfactory performance in the case of development expenditure. There have been persistent weaknesses in the planning and budgeting systems especially for development expenditure. Chief among these have been the lack of effective mechanisms to ensure realistic budgeting, prioritizing the public expenditure programs and screening new projects before they are included in the development budget. There is an unrealistic target for the development budget attempting to accommodate too many new projects. However, the actual budget outcome has fallen significantly short of these optimistic expectations.

The budget, particularly its development component, is heavily over-programmed as the average realization rate during the review period was 86.3 percent. Because of the political pressures to accommodate several new projects, there are unmanageable projects for development budget. There is a concrete lack of cost-benefit analysis and prioritization of development projects. Despite a series of fiscal reform, both in revenue and expenditure fronts, the fiscal deficits remained above five percent of GDP. This may be due partly to ascendant impact of development expenditure which was dominated by a few but popular and even costly entitlements like social services, rural infrastructure, and power generation, generally tied with demographic and economic factors. In order to finance these entitlements, revenue policy has been skewed, making it more difficult to meet resource gap through increased taxes.

The budget document presented to the parliament appears to be a unified one. But, in reality, the regular budget and the development budget are normally prepared following different procedures. The MOF prepares regular budget on the basis of past experience and historical accounting whereas NPC prepares the development budget with a view of achieving targets as laid down in the national plan. In such cases, difficulties are frequently encountered in meeting macro objectives where the two budgets are prepared without full co-ordination, or on different economic assumptions.

To boost the revenue collection by broadening tax base, HMG/N introduced the VAT by replacing sales tax, hotel tax, contract tax and entertainment tax during the Nineties. However, due to the lack of proper implementation, the VAT could not succeed to generate revenue as expected. HMG/N also tried to expand income tax base during the review period. Nevertheless, the revenue collection is still far below the level of expenditure. There is still excessive leakage in revenue collection. Due to inefficient government revenue system, the revenue collection has not become responsive to the need of the expenditure. As a result, only about one-fifth of the development expenditure has been fulfilled from revenue surplus. Revenue growth even lacks behind the growth of regular expenditure.

To fill the resource gap from domestic front, though HMG/N introduced various tax policies with multiple objectives, in substance, the revenue-related objectives of HMG/N stated in the annual budget speeches were hardly achieved to increase the share of direct tax for reducing economic inequality in the society, to reform the tax administration in order to increase the domestic resource mobilization, to reduce the tax rate which contributes for liberalization and provides relief to the people at large, to provide long term direction to revenue policy by making tax composition appropriate to consolidate tax revenue with economic activities, and to make it elastic.

There is a haphazard flow and use of foreign aid. Such a situation has been creating aid dependency syndrome in the Nepalese economy. Over reliance on foreign aid has been creating the situation of loss in self-dignity. There is a severe lack of monitoring mechanism during budget execution. Consequently, there is a widespread leakage of resources and tardy pace of project implementation. There is also lack of co-ordination between government organizations. There has been a conspicuous trend toward loans rather than grants in the composition of foreign aid in Nepal. This has imposed the growing burden of debt servicing charges in the form of commitment charges, interest payment and amortization. Debt servicing burden in Nepal, though not acute and alarming as yet, is increasing fast. Unless HMG/N takes measures to alleviate the situation, it will not only bring instability in the economy but will also slow down the pace of development and thus produce consequences that are undesired both economically and socially.

There was severe lack of multi-year planning in Nepal during the Nineties. As such, there was lack of coordination between necessary budget required and budget allocation for the important development projects. Because of the lack of such a planning, many development programs were not completed and their implementation condition became gloomier. There is also a lack of commitment from the concerned sections including the lack of effective reward and punishment system. Hence, there is an excessive leakage of the government resources and preponderance of weak performance. No one takes the responsibility of the project failure. In this way, there is sheer lax of public responsibility and accountability. In other words, there is an absence of good governance that is resulting in the weak fiscal management, among others.

SUGGESTIONS

Instead of the current practice of allocating resources on an incremental basis, it is necessary to look at the resource need for Organization and Management (O & M), other recurrent activities and the ongoing development projects/programs in an integrated manner. It is, therefore, necessary to integrate the regular and development budgets. It is vital to provide the required resources for meeting the priorities for growth, poverty reduction and service delivery objectives. Development projects should be screened based on cost-benefit analysis. Enough resources should be allocated to finish such projects on time. To streamline the development budget and minimize the waste of resources associated with over-programming; it is essential to ensure greater realism in resource forecasting. Projections of revenue, aid inflows and the size of the development budget would need to be in line with the recent performance and reasonable expectations.

The budget process needs to be made more responsive, less "top-down" and more "bottom-up", in terms of accommodating programs so long as they are consistent with sectoral strategies and priorities proposed by local level constituents and line ministries to improve the effectiveness of public spending. It is necessary to promote greater local ownership of the public expenditure program. This will require actions both from HMG/N and the donors. For example, HMG/N will need to take the lead in designing, financing and implementing the development program and, even more importantly, in aid co-ordination itself. It will need to decide what its own development priorities and programs are, and ask the donors to support such programs. Where donor aid does not fit its priorities and program objectives, HMG/N needs to reject such 'donor-driven' aid. This will, of course, require building up its institutional capacity and greater degree of self-financing/self-reliance through stronger efforts to mobilize revenues, which may take considerable time. Donors need to come forward to support this process. Clearly such a strategy will entail risks for both donors and HMG/N. But, if it works, it may help ensure greater sustainability and effectiveness of Nepal's development efforts. The effective implementation of the Foreign Aid Policy, 2002 will be instrumental in deriving such benefits from the foreign aid available to

Nepal. Another element, which is vital for improving public resource management, is strengthening the institutional capacity for carrying out development activities. Despite considerable technical assistance, institutional capacity remains weak virtually at all levels; but improvements in the two areas are particularly important: civil service reform and decentralization.

The multi-target aspects of the use of customs duties highlight their historical importance, which may decline along with the recent developments in the liberalized framework involving regional and international trade organizations like SAPTA, WTO and other trade liberalization initiatives. Thus, there is an urgent need to reform the domestic taxes even for maintaining the current tax-GDP ratio, while to raise it over time is another equally important issue. HMG/N should confine its activities to social services and infrastructure sector and encourage the development of private sector in all other economic activities through the development of appropriate environment. HMG/N should introduce the multi-year planning approach for the effective execution of the development projects. The Medium-Term Expenditure Framework (MTEF), which HMG/N has been currently implementing, points to the priority given to the issues of public expenditure reform. Such arrangements need to be implemented with earnestness and on more comprehensive basis. Rewards and punishment system should be made effective so that public accountability and responsibility will increase, which then will help in the effective implementation of HMG/N policies and development programs through, among others, the reduction in the rampant misuse of public resources.

CONCLUSION

During the decade after the restoration of the multi-party system in 1990, the democratic governments, despite their serious attempts, seem unable to mobilize adequate domestic resources as evident from the less than expected revenue/GDP ratio, higher fiscal deficit/GDP ratio, narrowing revenue surplus, and large outstanding government debt/GDP ratio. Recently, a major feature of the budgetary development has been the growing dependence on foreign loans for deficit financing. Around 66 percent of the development expenditure has been proposed to be financed through the foreign sources. This is not a happy situation for Nepal, which already accumulated the foreign debt liability of Rs. 190.7 billion till 2000. The past tradition of banking its development expenditure upon foreign assistance (grants plus loan) could not be broken even by the democratically-elected government. So, much remains to be done in the area of budgetary policy if it has to be made consistent with the sustainability of the overall macroeconomic policy framework.

HMG/N, during the Nineties, followed the policy of economic liberalization, giving primary focus on private sector activities. Although there was a series of changes of the governments on a frequent basis, there has been no major diversion during the Nineties at least in the major policy framework of HMG/N. However, despite HMG/N adopting the policy to boost the private sector, in actual sense, private sector has not been able to come up as expected since frequent changes of governments created policy confusion and uncertainties in the economy. Such political instability resulted in the lack of commitment to pursue, in a smooth and coordinated scheme, development activities due to excessive political interference for party politicizing. As a result, most of the development projects were halted without completion. Although the number of projects increased on account of the political pressure, there was a severe ineffectiveness in the implementation of these projects.

HMG/N failed to contain the growth of regular expenditure because of the increasing liability of maintaining law and order, debt service payments, salary increment and other overhead expenditures. As a result, regular expenditure began to outstrip development expenditure during the last years of the Nineties. The control of the expenditure mainly included the control of the wage and salary, which averaged 30 percent of the regular expenditure and 7 percent of the development expenditure, leaving untouched other headings where the possibility of leakage of resources has been equally high. On the revenue side, mainly the customs duty, sales tax and income tax have been reformed. But the reform in the customs duty has not been able in rectifying the anomalies contained in the foreign trade regime. These reforms could neither boost the import revenue from the third countries nor enhance the domestic revenue collection in a remarkable manner. Though reform in income taxation in line with what is prevailing around the world today is by far a welcome step, no serious steps have been taken to compensate the revenue loss caused by the tax reforms.

The major indicators of socio-economic development including the achievements with respect to poverty reduction pointed toward the ineffectiveness of the budgetary framework, primarily arising from the limited achievements in the real terms in relation to the lofty goals and ambitious policy pronouncements. To sum up, despite the sincerity of purpose and the urgency to address the rising popular demands, the popularly-elected governments could not transform their budget policies, priorities and programs into realistic outcomes mainly because of the inadequate political vision and limited capacity of HMG/N in transforming the plans and programs into outcomes. Therefore, the urgency for the future governments is to enhance the institutional and bureaucratic capacity to implement the promises and plans in an effective and efficient way in addition to chalking out a sound development strategy most beneficial to the economy of Nepal and the Nepalese people.

Table 1. Characteristics of Government Expenditure (1990/91 - 1999/00)
(In Percentages)

	Nominal Growth Rate	Real Growth Rate	As % of GDP	As Percentage of GDP		
				1991	1996	2000
Total Expenditure	13.0	4.2	18.0	19.6	17.8	17.5
Regular Expenditure	18.5	9.3	7.9	6.3	8.8	9.1
Development Expenditure	9.8	1.3	10.1	13.3	9.0	8.4

Source: Economic Survey 2003 and Author's Calculations.

Table 2. Realization Ratio of Government Expenditure (1990/91 - 1999/00)
(In Percentages)

Heads / FY	1990/91	1994/95	1999/00	Average 1991-2000
Total Expenditure	91.9	91.5	87.5	91.9
Regular Expenditure	94.0	97.4	96.9	96.8
Development Expenditure	90.8	86.4	79.6	86.3

Source: Budget Speeches of FY 1990/91 through 1999/00, Economic Survey 2003 and Author's Calculations

Table 3. Development Budget (1990/91 - 1999/00)
(Amount in Rs. Million)

Heads / Fiscal Year	1995	2000	Average 1991-2000
Development Budget	19794.9	31749.2	23363.7
No. of Projects	532	704	623
Expenditure per Project	37.21	45.10	37.5

Source: MOF and NPC.

Table 4. Sectoral Pattern of Allocation and Realization of Total Expenditure (In Percentages)

Heads	1990/91	1994/95	1999/00	Average 1991 - 2000
1 Social Service	*18.3*	*27.3*	*30.6*	*27.0*
Education	8.8	13.0	13.2	12.7
Health	2.8	3.8	4.9	4.1
Drinking Water	2.3	2.8	3.3	3.4
Local Development	1.4	6.2	6.3	4.8
Others	3.0	1.4	2.9	2.0
2 Economic Services	*36.5*	*18.9*	*16.7*	*20.3*
Agriculture	6.7	6.9	3.8	5.2
Irrigation	4.8	6.8	5.4	6.3
Land Reform and Survey	0.6	0.7	0.9	0.7
Forest	2.0	2.0	1.9	2.3
Industry & Mining	7.5	1.2	1.7	2.9
Others	15.0	1.3	2.9	2.8
3 Infrastructure	*15.6*	*17.5*	*18.2*	*19.4*
Communication	0.9	4.8	1.7	2.5
Transport	8.9	8.2	8.1	9.9
Electricity	5.8	4.5	8.4	7.0
4 Others	29.6	36.3	34.5	33.4
Total Expenditure	*100.0*	*100.0*	*100.0*	*100.0*
Realization Ratio of Major Sectors				
1 Social Service	*93.2*	*89.4*	*86.0*	*89.5*
Education	100.2	70.2	88.0	91.1
Health	74.7	94.6	75.6	78.7
Drinking Water	78.8	84.9	81.2	88.0
Local Development	87.3	253.4	83.0	107.0
Others	116.8	64.6	120.3	87.8
2 Economic Services	*193.5*	*92.8*	*88.8*	*100.3*
Agriculture	127.2	101.4	85.9	90.0
Irrigation	100.7	110.5	85.8	101.5
Land Reform and Survey	92.8	107.8	95.2	92.4
Forest	79.6	58.5	90.0	89.0
Industry & Mining	209.2	60.2	88.7	101.2
Others	701.8	96.6	96.6	130.6
3 Infrastructure	*105.3*	*91.6*	*77.5*	*86.6*
Communication	95.2	166.9	91.7	95.3
Transport	107.7	95.1	88.4	97.3
Electricity	103.5	59.3	67.3	73.7

Source: Budget Speeches and Detailed Expenditure Estimates for FY 1990/91 through 1999/00 and Author's Calculations.

Table 5. Inter-sectoral Allocation of Actual Development Expenditure (In Percentages)

Heads	1990/91	1994/95	1999/00	Average 1991-2000
Total Development Expenditure	*100.0*	*100.0*	*100.0*	*100.0*
1 Social Service	22.3	31.5	39.1	33.8
Education	10.7	7.4	8.1	10.0
Health	2.3	4.3	6.7	4.8
Drinking Water	3.4	5.6	7.6	6.1
Local Development	2.0	12.2	13.0	10.1
Others	3.9	1.9	3.6	2.8
2 Economic Services	53.2	33.1	25.6	30.3
Agriculture	9.6	13.3	6.6	8.6
Irrigation	7.0	12.9	9.6	10.8
Land Reform and Survey	0.7	1.0	0.8	0.9
Forest	2.9	2.1	1.6	2.5
Industry & Mining	11.0	1.4	2.6	3.6
Others	22.0	2.5	4.4	3.9
3 Infrastructure	21.3	31.9	33.1	33.8
Communication	0.4	7.7	0.9	2.9
Transport	12.4	15.2	14.8	17.2
Electricity	8.5	8.9	17.4	13.6
4 Others	3.2	3.6	2.2	2.1

Source: Economic Survey 2003, MOF, HMG/N and Author's Calculations.

Table 6. Characteristics of Revenue (1990/91 - 1999/00) (In Percentages)

	1991	1995	2000	Average 1991-2000
Growth Rate in Nominal terms	15.5	25.5	15.2	16.7
Growth Rate in Real terms	5.6	17.8	10.7	7.6
As Percentage of GDP	8.9	11.2	11.3	10.3
Realization Ratio	103.1	98.3	96.4	96.3

Source: Economic Survey 2003, MOF, HMG/N and Author's Calculations.

Table 7. Composition of Revenue (1990/91 - 1999/00)
(In Percentages)

	1991	1995	2000	Average 1991-2000
Indirect Tax	*63.9*	*64.6*	*58.5*	*62.0*
Direct Tax	*12.3*	*15.4*	*19.8*	*15.7*
Tax Revenue	76.2	80.0	78.3	77.7
Non- tax Revenue	23.8	20.0	21.7	22.3
Total	100.0	100.0	100.0	100.0

Source: Economic Survey 2003, MOF, HMG/N and Author's Calculations.

Table 8. Financing Government Expenditure (1990/91 - 1999/00)
(In Percentages)

	1991	1995	2000	Average 1991-2000
Revenue	45.6	62.9	64.7	57.3
Foreign Grants	9.2	10.1	8.6	9.3
Foreign Loans	26.6	18.7	17.8	21.6
Internal Borrowing*	18.7	8.3	8.8	11.8

** including cash balance.*
Source: Economic Survey 2003, MOF, HMG/N and Author's Calculations.

Table 9. Financing Development Expenditure (1990/91 - 1999/00)
(In Percentages)

	1991	1995	2000	Average 1991-2000
Revenue surplus	19.8	26.8	26.4	23.8
Foreign Assistance:	52.7	56.8	55.2	55.3
Grant	13.5	19.9	18.0	16.8
Loan	39.2	36.9	37.2	38.5
Internal Borrowing*	27.5	16.3	18.4	20.9

** including cash balance.*
Source: Economic Survey 2003, MOF, HMG/N and Author's Calculations.

Table 10. Financing Fiscal Deficit (1990/91 - 1999/00)
(In Percentages)

	1991	1995	2000	Average 1991-2000
External Borrowing	58.7	69.3	66.9	65.2
Internal Borrowing*	41.3	30.7	33.1	34.8

** Including cash balance.*

Table 11. Characteristics of Fiscal Deficit (1990/91 - 1999/00)
(Amount in Rs. Million)

	1991	1995	2000	Average 1991-2000
Fiscal Deficit with Grants	10655.1	10547.7	17667.0	13766.6
Fiscal Deficit without Grants	12819.9	14484.3	23378.7	17786.3
Annual Growth Rate				
Fiscal Deficit with Grants	26.7	-9.3	-1.8	8.5
Fiscal Deficit without Grants	23.5	3.3	4.7	9.1
As percentage of GDP				
Fiscal Deficit with Grants	8.9	4.8	4.7	6.1
Fiscal Deficit without Grants	10.7	6.6	6.2	7.7

Source: Economic Survey 2003, MOF, HMG/N and Author's Calculations.

Table 12. Government Debt Stock (1990/91 - 1999/00)
(Amount in Rs. Million)

	1991	1995	2000	Growth Rate 1991-2000
Internal	20855.9	32057.8	54357.0	14.55
External	59505.3	113000.9	190691.2	18.78
Total	80361.2	145058.7	245048.2	17.59
As Percentage of GDP				
Internal	18.0	15.3	14.9	15.1
External	51.2	53.8	52.2	52.2
Total	69.2	69.1	67.1	67.3

Source: Economic Survey 2003, MOF, HMG/N and Author's Calculations.

Table 13. Major Indicators

Items	1990/91	1994/95	1999/00
GDP Growth Rate (%)	6.4	3.3	6.1
Investment/GDP(%)	20.83	25.20	20.94
Gross Domestic Saving/GDP(%)	9.57	14.81	13.17
Per Capita GNP in NRs.	6695	11170	17284
Average Exchange Rate (NRs./US$)	36	49.94	68.98
Per Capita GDP in US$	183	219	242
Per Capita GNP in US$	186	224	251
Inflation (1995/96 = 100)	9.72	7.68	3.50
Balance of Payments (- increase)	-4132.2	313.9	-14433.0
Crude Birth Rate (in 000)	41.2	37.8	33.58
Crude Death Rate (in 000)	13.3	11.7	9.96
Total Fertility Rate	5.6	5.1	4.3
Infant Mortality Rate (in 000)	97.5		64.1
Life Expectancy at Birth	54.3	56.1	58.95

Source: Economic Survey 2003, MOF, HMG/N, CBS and NRB.

ACRONYMS USED

APP	Agricultural Prospective Plan
BOP	Balance of Payments
BOT	Build-Operate-Transfer
BOVO	Build-Our-Village-Ourselves
CBS	Central Bureau of Statistics
FY	Fiscal Year
GDP	Gross Domestic Product
HMG/N	His Majesty's Government, Nepal
IDS	Integrated Development Systems
IMF	International Monetary Fund
MOF	Ministry of Finance
MTEF	Medium-Term Expenditure Framework
CPN (UML)	Nepal Communist Party (Unified Marxist and Leninist)
NPC	National Planning Commission
NRB	Nepal Rastra Bank
OGL	Ordinary General License
RPP	Rastriya Prajatantra Party
RSP	Rastriya Sadbhavana Party
Rs.	Nepalese Rupees
UNDP/N	United Nations Development Program, Nepal
VAT	Value Added Tax
VDC	Village Development Committee
VNY	Visit Nepal Year 1998
WB	World Bank
WTO	World Trade Organization

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Trends of Nepal's Import Duties: Implications with Future Trade Liberalization

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Nepal is accelerating the process of trade liberalization that had commenced in the mid-eighties; this is reflected in membership of WTO, agreement of a framework for a free trade area (FTA) in south Asia and entering an FTA with BIMST-EC. Since import duties are presently an important source of government revenue, the likely impact of trade liberalization on this important revenue source has to be evaluated. The study addresses this felt need through an elasticity and buoyancy analysis of import duties over the span of fiscal year 1980/81 to 2001/2002 as well as analyzing the responsiveness of Nepal's import duties through empirical regression and five year ahead projection. The paper finds low measure of elasticity and buoyancy as well as low elasticity of import duties, although five-year projections do not suggest a decline in contribution to government revenue. The prior indicate low productivity and responsiveness of the domestic tax base suggesting a need to accelerate reforms of the tax administrative system while the latter indicates that diversification of the import basket would be appropriate.

INTRODUCTION

Nepal has undertaken the process of trade liberalization that had commenced over two decades back (discussed in greater detail below). Some recent examples of this are Nepal's membership in the World Trade Organization (WTO);[15]

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[*] *Remarks*: This paper is based on the Special Studies Division (SSD) Annual Project for 2060/2061 which had been completed through the joint effort put forward by members of the SSD namely Dr. Nephil Matangi Maskay, Deputy Director and Mr. Rajan Krishna Panta, Assistant Director along with the guidance of Dr. Govinda Bahadur Thapa, Director, Research Department. The views and suggestions made in this paper do not necessarily reflect the views of Nepal Rastra Bank.

[15] The fifth Ministerial Conference at Cancun, Mexico which took place on 10–14 September 2003 had approved the membership of Nepal into the World Trade Organization (WTO) on 11 September 2003 (WTO, 2003) with Nepal recently ratifying it.

adoption of the framework for a South Asian Free Trade Area;[16] and signing of a free trade agreement with BIMST-EC.[17] As trade liberalization in Nepal will have likely impact on import duties[18], which presently are an important source of government revenue contributing about one quarter of total tax revenue (Economic Survey, 2003), it is important to examine both the trends of Nepal's import duties and to determine likely scenarios resulting from trade liberalization.

The research objective is to assess the impact on Nepal's import duties with greater trade liberalization. Specifically:

- Examine the trends of Nepal's import duties;
- Assess the productivity of the Nepalese import duty base and calculate the historical responsiveness of import duties;
- Determine alternative scenarios for five-year perspective on import duties; and
- Put forward a discussion on implications along with some recommendations which fall out of this analysis.

The study is organized into seven sections: the first section gives a brief introduction, the rationale and expected outcomes of the study and an overview of trade liberalization measures taken in Nepal during the second half of the twentieth century; the second section reviews the relevant studies done with regard to both the impact of trade liberalization on custom revenue and the buoyancy and elasticity of Nepalese tax system; the third section outlines the analytical framework for the calculation of elasticity and buoyancy by proportional adjustment method using the standard functional relationship between tax revenue and the tax base, the section also gives the modified econometric estimation equation which is used for simple projection of possible impact of trade liberalization measures on import duties; the fourth section discusses the methodology and specific econometric equation used in the present study; the fifth section gives the detailed empirical results and analysis including the trend analysis; the sixth and the last sections give recommendations, summary and conclusion of the study.

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16 The framework agreement for a South Asian Free Trade Area (SAFTA) was adopted at the 12th SAARC Summit held in Islamabad, Pakistan, on 4-6 January 2004 (SAARC, 2004), where Nepal is also one of the signatories.

17 Nepal had signed a free trade agreement on 8 February 2004 with BIMST-EC [Bangladesh, India, Myanmar, Sri Lanka and Thailand Economic Cooperation].

18 His Majesty's Government of Nepal defines custom's revenue as a commodity tax based on foreign trade and breaks it down into six components: (1) Import duties; (2) Indian Excise Refund; (3) Export Duties; (4) Other Income of Customs; (5) Agriculture Improvement Duties; and (6) Other Duties. However, for this study focus will be mainly on import duties (general, additional ….) levied and extracted on commodities imported from abroad to Nepal shown in the first Appendix [Arthic Nyam 2057, Duffa 2(1)].

Background to Trade Liberalization in Nepal[19]

Trade liberalization in Nepal has been an ongoing process since the mid 1980s with membership in the above mentioned organizations being simply a salient reflection of this trend. This subsection attempts to give a short background of this process of trade liberalization in Nepal.

The period prior to FY 1985 can be considered *a period of inward-looking import substitution with a restrictive trade and foreign exchange regime.* Nepal's trade and industrial policies have been shaped by its situation of access to the markets of the rest of the world;[20] secondly, Nepal has a long an open border with India and is surrounded by it on three sides with Nepal having granted almost free access to Indian goods ever since its first agreement on trade and transit with British India in 1923. More than formal provisions of trade treaties, the open border with India and the high cost of access to the markets of the rest of the world have been decisive factors in putting Nepal in the situation of *de facto* integration with India which has constrained policy choices for Nepal by compelling it to adopt a protection and incentive structure similar to that of India. Any attempt to create trading relations with the rest of the world through standard instruments of trade policy would be thwarted by unofficial and unrecorded movement of goods and services across the open border with India.

Lower tariff structure in Nepal provides incentive for trade deflection to India of the goods imported by it from the rest of the world causing drain in its foreign exchange reserves. If Nepal provides export incentive, Indian goods would be re-exported causing a fiscal drain. Thus, Nepal followed restrictive trade policies with respect to the rest of the world while maintaining relatively open trade relation with India ever since it embarked on the periodic development planning exercise in 1956. To attain its economic development goals, Nepal followed inward-looking, import-substituting industrialization with public sector planning and regulation of the private sector. These policies included stringent barriers to international trade, with many quantitative restrictions, high tariffs, export controls and taxes [but duty drawback and bonded warehouse], and regulated foreign exchange regime such as Exporters' Exchange Entitlement Scheme and Dual Exchange Rate System although later a trade-weighted basked].

This was followed by a period of Liberalization Initiatives: (FY1986-FY1990). In response to unsustainable and internal macro-imbalances, toward the beginning of the Seventh Plan (1986-1990), the government implemented a stabilization program, which was supported by an IMF standby arrangement in December 1985. Realizing that macroeconomic stability and structural adjustment would be vital to lead to accelerated growth, the government undertook a structural adjustment program to address some of the longer-term constraints to economic growth. The

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[19] This is a synthesized version of Karmacharya and Maskay (2004).

[20] The nearest port for access to world economy, other than immediate neighbors, is more than 900 kilometers away from Nepal's border.

program was supported by an IDA structural adjustment credits in 1987 and 1989 and IMF Structural Adjustment Facility in FY 1988. In addition, financial sector reforms were undertaken which included interest rate deregulation in 1989 among others. It should be pointed out that these developments occurred despite disruption caused by the lapse in March 1989 of the trade and transit treaties between Nepal and India. [21]

Finally, with a period of Substantial Economic Reforms: (1990/1991-2000/2001). A number of political and economic events in 1990 and 1991 provided Nepal with an opportunity to review its past economic policies and to devise new ways of approaching its development problems, in part, reflected in the re-establishment of cordial relationship with India and, later, the signing in December 1991 of the new trade and transit treaties of the Eighth Five Year Plan by the new elected government covering the fiscal years (1993-1997) signaled a major shift in Nepal's development strategy. The aim was to promote more open and market-oriented system, with increased reliance on the private sector for the production of goods and services with the public sector focuses on developing the necessary physical and social infrastructure. During the early 1990s, Nepal initiated a series of market-oriented economic reforms intended to facilitate its integration with the global economy and to spur economic growth. The comprehensiveness of the reforms clearly demonstrated the government's desire to radically change the prevailing business environment. This improved business confidence and the climate for private investment. Major reforms included liberalization of trade and industrial policies and rationalization of foreign exchange regime. Following trade liberalization, tariff rates were reduced, restructured and rationalized with quantitative restrictions and import licensing eliminated. Likewise the exchange rate was unified and made fully market-determined, and full convertibility was introduced for all current transactions; this is reflected in Nepal's acceptance of Article VIII of the IMF on May 30, 1994.

LITERATURE REVIEW

The examinations of revenue implications are important, especially to developing countries which obtain a significant amount from such. However, the revenue implications of trade liberalization are, in general, uncertain; this conclusion is drawn by Ebrill, Stotsky and Gropp (1999) and citations therein after

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[21] The trade and transit impasse, which lasted for about fifteen months, was expected to severely disrupt Nepal's external trade, lead to acute shortages of critical imports, curtail growth prospects for the economy particularly in the industrial, trade and construction sectors, and accelerate inflationary pressures. However, the impact of the impasse, while severe, was not as crippling as expected earlier. After a few months of shortages, the supply situation of key imports improved, both because of informal trade between the two countries were allowed to continue and because good weather led to good agricultural crops in FY 1989 and 1990.

examining the literature, in this regard. Ebrill et al. (1999) also estimate two equations relating to trade liberalization and revenue development – the discussion is limited to the first equation as they are based on a common framework and also have similar results. The first estimation equation takes the below form:

$$TR = b_0 + b_1 M + b_2 w + b_3 D + e$$

where *TR* is import (or trade) tax revenue as a percentage of GDP; *M* is imports as a percentage of GDP; *w* represents one or more other continuous variables, such as exports and the exchange rate; and *D* is the set of trade liberalization and other dummy variables. Specifically, the authors used for independent variables, imports as a percentage of GDP, exports as a share of GDP, per capita income in 1990 US Dollars, some dummy variables such as acceptance of IMF Article VIII (a possible indicator of liberalization of the trading regime) and a real exchange rate index. The authors estimate this equation for 27 countries from Africa, Asia and the Western Hemisphere with a data sample spanning 1980 to 1992. The results of this regression were largely that tariff reforms, for a given level of imports, have not been significant in reducing trade tax revenue.

The above conclusion concerning tariff reform and trade tax revenue may lean towards more advanced countries with alternative sources of financing. In a recent paper looking at South Africa, Matlanyane and Harmse (????) examine this question for the data span from 1974 to 2000, utilizing the theoretical underpinnings of revenue productivity. That is the specific equation estimated is:

$$\ln TR = \gamma_0 + \gamma_1 \ln M + \gamma_2 \ln w + \gamma_3 \ln D + \gamma_4 \ln r + \eta$$

where *TR* is customs revenue as a percentage of GDP, *M* is imports as a percentage of GDP representing the import base, *W* is the exchange rate, *D* is a dummy variable for liberalization and *r* is the average overall tariff rate and η is the error term. Their empirical results point to customs revenue as being highly productive with trade liberalization having a significant influence on customs revenue.

Looking at Nepal, there are a number of studies which look at the responsiveness of revenue to discretionary changes in taxes however they do not employ the previous empirical analysis utilizing the estimation equations, but mainly use the analytical tools of elasticity and buoyancy. Elasticity measures the relation between proportional change in tax revenue and a broad measure of national income or output, usually GDP or GNP. In strict usage, elasticity has come to refer to only a change in tax revenue that occurs automatically without any alternation in tax (also introduction and elimination) rates or administration. This is sometimes called “built in flexibility”. This is distinguished from buoyancy, which reflects both automatic response of revenue and discretionary changes in the tax system or administration. There have been a number of studies for Nepal such as by Dahal (1983), Agrawal (1980), Reejal (1976), Pant (1991), Gurugharana (1993) along with that of IDS (1987) and have been reviewed by Nepal (1995).

It is useful to examine one fairly recent study in this regard by Adhikary (1995). The author first cleans the revenue series to correct for discretionary changes, by both the Chand and Sahota Proportional Data Adjustment Method,[22] over the time period 1974/75 – 1993-94. The author then utilizes simple bi-variate regressions of major taxes with respect to GDP. For example, the author does pair wise estimates of Import Duties; Tax on Consumption; Income Tax; and Total Revenue to GDP. The empirical analysis, of the whole sample period as well as for sub-samples, finds that the low level of automatic tax responsiveness (i.e. elasticity). The author concludes that this empirical result suggests that there is poor inbuilt flexibility of the Nepalese tax structure.

More relevant to this study is that of Shrestha (2001), who looks at Elasticity and Buoyancy of Nepalese Taxes – With Special Reference to Custom Duties in Nepal. The author produced annual data for FY 1980/81 – 1993/94 from the budget speeches, where discretionary changes were addressed (such as changes in tariffs, new tariffs etc.). The author then examined tax buoyancy and elasticity of tax with different variables such as Nominal GDP and Tax Base etc. through simple bivariate regressions. The authors' conclusion is similar to Adhikary (1995) who pointed to the poor built in flexibility and the importance of discretionary tax changes for the Nepalese tax system.

ANALYTICAL CONCEPTUAL FRAMEWORK

The above discussion suggests that the concept of the responsiveness of quantity produced to a change in price is essential for understanding revenue implications of trade liberalization in Nepal. Based on the textbook definition of elasticity of demand (or supply), Suppose that $x = f(p)$ is a demand (or supply) curve, where $p = price$ and $x = quantity\ demanded$, then this is defined as:

$$\varepsilon = \lim_{\Delta p \to 0} \frac{\Delta x / x}{\Delta p / p} = \lim_{\Delta p \to 0} \frac{p}{x}\frac{\Delta x}{\Delta p} = \frac{p}{x}\frac{dx}{dp}$$

If $|\varepsilon| > 1$, the curve is called elastic reflecting that quantity is more responsive vis-à-vis price; if $0 < |\varepsilon| < 1$, the curve is called inelastic reflecting that quantity is less responsive vis-à-vis price.[23] The above concept is used in this study to examine revenue, movement of imported goods with changes in income [i.e. income

[22] See the second Appendix for a discussion.

[23] Note that supply and demand curves are usually plotted with the dependent variable *x* on the horizontal axis with the slope *dx/dp* is thus the reciprocal of the usual slope.

elasticity of demand][24], through two main perspectives (1) the concept of buoyancy and elasticity; (2) estimation of an equation for import duties; and finally (3) the coefficients from the previous section will be used for projections of import duties to examine the relevant trends.

Buoyancy and Elasticity

The concept of buoyancy and elasticity are intertwined as both are measures of tax productivity. However, elasticity of tax is relatively harder to measure as it involves estimation of the actual effects of discretionary changes in tax policy in the current year and subsequent year, while an estimate of buoyancy by definition does not control for discretionary changes in tax policy. In theory, tax revenue can change because of changes in the tax rates and rules that are discretionary (these are generally based on budget estimates and are generally made in the budget speeches) or from changes in the tax base and result from the growth of the tax base. The combined effect of these two factors gives the buoyancy of a tax. The automatic component of the total effect is the elasticity of the tax. On the other hand the buoyancy of a tax measures the responsiveness of tax revenue to changes in income without controlling for discretionary changes in tax policy. It is important to note that there are different methods to control for this. For example constant rate structure method, dummy variable technique, proportional adjustment method etc. The study utilizes proportional adjustment method using Sahota's formula, as discussed in the second appendix, because the "use of this method is relevant particularly in the context of developing countries where data arrangements are not very good" (Dahal, 2000). Once the revenue effects of discretionary changes have been excluded from a tax series (using Sahota's formula), the elasticity of this tax series with respect to GDP must be estimated. Generally, the elasticity concept assumes the following functional relationship:

$$T^* = \alpha Y^{\beta} \varepsilon$$

where T* is the tax revenue, y is the tax base (or GDP in aggregate level), α and β represent parameters to be estimated and ε is the multiplicative error term, assumed to be normally distributed. Here β is the income elasticity of the tax with respect to GDP. Taking logs the equation is linearized as below:

$$\log T^* = \log\alpha + \beta \log Y + \log\varepsilon$$

[24] Of course, import prices are composed of the price of the good as well as the tariff rate, thus customs revenue is simply the product of the quantity and the tariff rate.

which is of the standard form:

$$\log T_t^* = \alpha + \beta \log Y_t + v_t$$

To obtain T_t^*, the proportional adjustment (PA) method is used to eliminate (isolate) the discretionary effect from the series. The PA method is used because of its superiority over other available methods, which also explains its prevalence in earlier studies. Likewise, buoyancy of taxes with respect to their bases (or GDP) is derived from logarithmic regressions of unadjusted revenue data on their base (or GDP), such as:

$\log T_t = \beta_0 + \beta_1 \log Y_t + \varepsilon_t$, where β_1 is the buoyancy ratio.

In sum, the examination of buoyancy and elasticity essentially give an indication of the health, efficiency, productivity and responsiveness of the domestic tax base.

Econometric Estimation Equation

The above analysis on buoyancy and elasticity simply discusses the productivity of the tax base. An econometric estimation is essential to supplement the analysis and determine the magnitude by which revenue will respond to a change in taxes, with there being other control variables. In this regard, an econometric estimation will be used which is similar to that of Ebrill et al. (1999) and Matlanyane and Harmse (????) but will be modified for the Nepalese context, as produced below:

$$TR = b_0 + b_1 M + b_2 w + b_3 D + e$$

Simple Projection

The prior discussion suggests that the usage of both analytical methods of estimation equation and buoyancy and elasticity is appropriate for the analysis of the present situation. However, the above studies simply focus on an empirical assessment of past performance – i.e. the given figures during a determined time period. The paper attempts to take these concepts and project forward utilizing the coefficients from the above estimation equation, as well as a number of projected values.

It is important, however, to note that the time perspective is essential. This observation is because elasticity changes across time (from being inelastic to more elastic) and is similar to discussion on the J-curve which shows that in the short term goods are less responsive (i.e. low elasticity), while in the longer term they are more responsive (i.e. more elastic). This is, of course, in addition to the assumption that the past values help determine the future, with there being a *ceteris* *paribus* assumption. While it is difficult to fully control for those, being aware of the possibilities will appropriately guide interpretations.

METHODOLOGY AND DATA SOURCES

The proposed methodology and data sources proceed as:

- The first objective will be achieved through examining annual import duty figures from 1980/81 till 2001/2002; these will be taken from the publications of International Monetary Fund, Ministry of Finance [various budget speeches], HMG/N and Nepal Rastra Bank and viewed from different perspectives (i.e. percentage of total revenue, total imports, GDP etc.) along with graphical (i.e. "eye-balling") analysis.
- The second objective will be achieved through an analysis of elasticity and buoyancy of the Nepalese import duties; along with the sum of import duty and Indian excise refund [with base of imports CIF and nominal GDP] using bivariate regressions for an assessment of the productivity of the Nepalese import duties.[25] This will in large part entail developing a time series from the budget speeches through cleaning the data series to determine automatic and discretionary changes, whose methodology is given in the first appendix.
- The third objective will be achieved via the application of an econometric estimation. The estimation equation to be used in the study will be similar to Ebrill et al. (1999), and will be as below:

  $$\ln IMPY = b_0 + b_1 \ln MY + b_2 \ln REER + b_3 \ln DUMMY + e$$

  where *IMPY* is import duties as share of GDP; *MY* is imports CIF as a share of GDP; *REER* is the real effective exchange rate index (base 1990) of the Nepalese Rupee as provided by the International Monetary Fund; and DUMMY is the structural break to be determined by the data. For consistency over the period 1980/81 till 2001/2002, the data will be taken from *Economic Survey* of His Majesty's Government of Nepal, Ministry of Finance. Likewise prior to running OLS, the individual time series will be tested to make sure that they are healthy and do not have a unit root etc., along with suitable testing of the equation. The goal of this empirical estimation is to determine the values of the coefficients (e.g. b_1, b_2 and b_3), to be used for the next section.
- The fourth objective will be achieved through five year projecting import duties resulting from trade liberalization determined by the impact of volume of imports CIF utilizing the above estimating equation where values for b_1, b_2 and b_3 have been obtained along with projected values for *M* from concerned

[25] It is important to note that buoyancy for import duties and the sum of import duties and Indian excise refund will have similar elasticity. This is because the changes in IER are exogenous, thus there is no amount budgeted by the Nepalese government.

divisions in Nepal Rastra Bank and from other agencies, likewise REER will be linearly projected from historical ten year averages; these projections are assumed to be the best available projections which incorporate future possible scenarios.

- The final objective will be achieved through an analysis of the above information. Necessary discussion and feedback will be undergone with the relevant people at Nepal Rastra Bank and, if appropriate, outside. These will result in some recommendations.

EMPIRICAL RESULTS AND ANALYSIS

The following section provides the empirical results for the above objectives in three separate sections which include both discussion on data sources and empirical investigation. The next section first puts forward a discussion on trends.

Trends of Import Duties

The time series are provided in appendix third with the data being obtained for 1980/81 to 2001/2002 from various issues of *Economic Survey*. Some descriptive statistics of the ratios of import duties to: customs revenue; total tax revenue; imports CIF; and GDP are provided below:

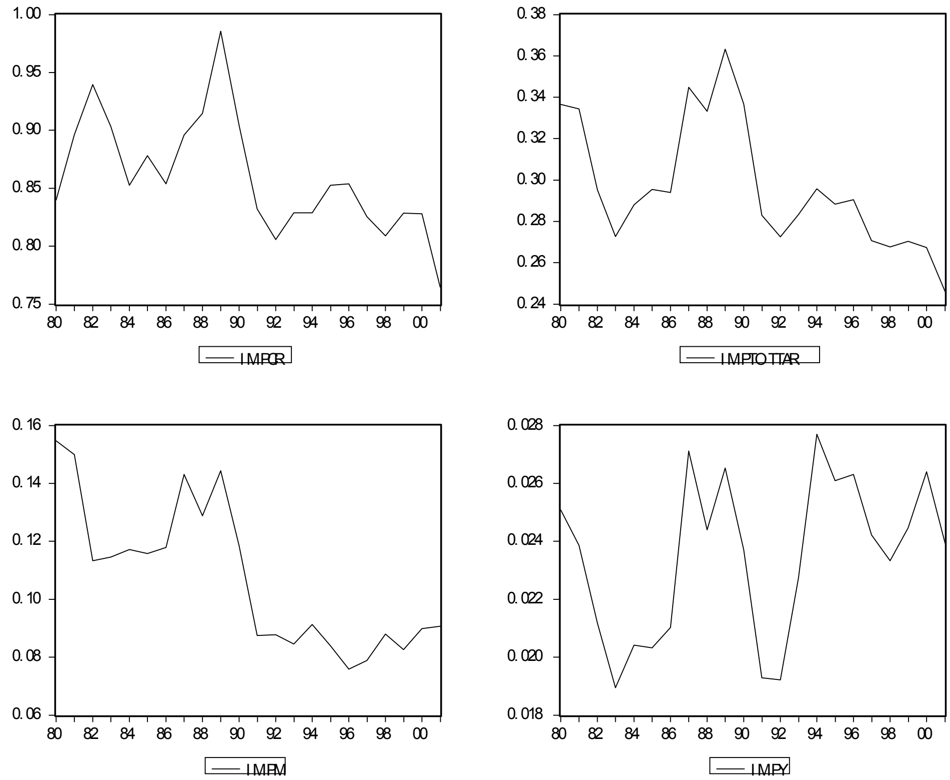
Table 1: Some descriptive statistics

	IMPCR	IMPTOTTAR	IMPM	IMPY
Mean	0.860037	0.296804	0.107216	0.023467
Median	0.852527	0.289348	0.102271	0.023897
Maximum	0.985505	0.363264	0.154722	0.027698
Minimum	0.764556	0.246077	0.075820	0.018943
Std. Dev.	0.050254	0.030903	0.025019	0.002732
Observations	22	22	22	22

Note: IMPCR is ratio of import duty to customs revenue; IMPTOTTAR is ratio of import duties to total tax revenue; IMPM is ratio of import duties to imports CIF; and IMPY is ratio of import duties to nominal GDP.

These trends are presented graphically below:

Figure 1: Some Graphical Trends



Note: Same as for the prior where first graph is IMPCR; second is IMPTOTTAR; third is IMPM; and last is IMPY.

The first two graphs of import duties to both customs revenue and total tax revenue, from "eye-balling" demonstrate a decreasing trend and is further suggested since the minimum for both IMPCRR and IMPTOTAR occur in 2001/2002 being 76.4% and 24.6% respectively. The decreasing contribution of import duties as a source of tax revenue may reflect greater levels of tariff reduction which have not been compensated for by the volume of imports suggesting that the import demand is inelastic. The third graph of the ratio of import duties to imports CIF, similarly shows such a trend up to the early 1990's, from whence it stabilizes at around 9% suggesting that economic liberalization had some effect on import duties and that perhaps liberalization stabilized during this time. The final graph suggests that it has been quite volatile in terms of GDP but that the trend, from "eye-balling", has been flat at around 2.3% of GDP – this suggests that the growth of import duties is fairly matched by the growth of national income.

Another aspect which is also important is to examine the above trends of import duties with that of Indian Excise Refund (IER), as shown below:

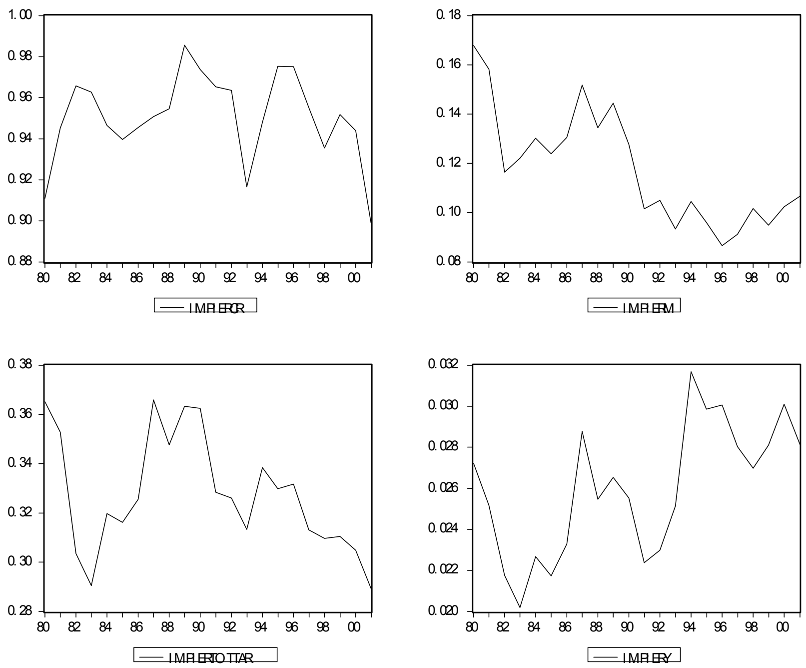
Table 2. Some Descriptive Statistics

	IMPIERCR	IMPIERM	IMPIERTOTTAR	IMPIERY
Mean	0.950472	0.117776	0.327622	0.025990
Median	0.951229	0.111497	0.325780	0.026033
Maximum	0.985505	0.167842	0.365977	0.031686
Minimum	0.898921	0.086606	0.289323	0.020187
Std. Dev.	0.021415	0.023141	0.023615	0.003211
Observations	22	22	22	22

Note: IMPIERCR is ratio of import duty to customs revenue; IMPIERTOTTAR is ratio of import duties to total tax revenue; IMPIERM is ratio of import duties to imports CIF; and IMPIERY is ratio of import duties to nominal GDP.

These trends are presented graphically below:

Figure 2. Some Graphical Trends



The first graphs of import duties including IER to both customs revenue, from "eye-balling" demonstrate a neutral. The second and third graph of import duties and IER to total tax revenue and imports CIF demonstrate a decreasing trend while the last graph in relation to GDP suggests a neutral, if not positive, trend.

The inclusion of IER into import duties seems to change the trends suggesting that IER seems to be an important contribution.

Buoyancy and Elasticity

The data for import duties (IMP), Indian Excise Refund (IER) and import duties – cleaned (IMPC), with the calculation over the period 1980 – 2001, are given in appendix 5.2.1 for the period 1980/81 to 2001/2002. These are taken from various budget speeches of His Majesty's Government of Nepal. The time series for IMP, IER, IMPC, Imports C.I.F. (M), and nominal gross domestic product (Y) over the period 1980 – 2001, are given the fourth appendix. These are taken from Budget speeches and various issues of *Economic Survey*, of His Majesty's Government of Nepal. Some descriptive statistics of the data in log levels, which are also supplemented by graphical representation, are given below:

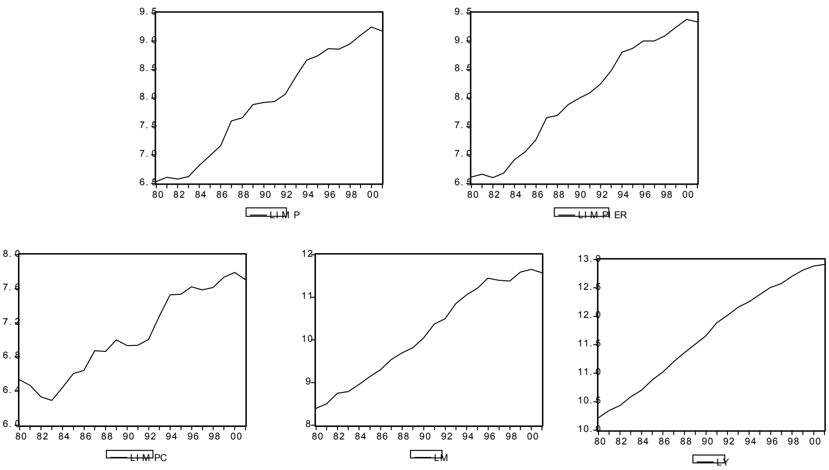
Table 3. Some Descriptive Statistics

	LIMP	LIMPIER	LIMPC	LM	LY
Mean	7.922961	8.024301	7.059935	10.18093	11.68177
Median	7.927985	8.039268	6.968149	10.21233	11.77323
Maximum	9.248778	9.379920	7.792463	11.65865	12.91036
Minimum	6.529623	6.599619	6.290608	8.395748	10.21490
Std. Dev.	0.953245	0.985920	0.508654	1.139206	0.902385
Observations	22	22	22	22	22

Note: in logs as explained above.

These trends are presented graphically below:

Figure 3. Some Graphical Trends



Note: As explained above.

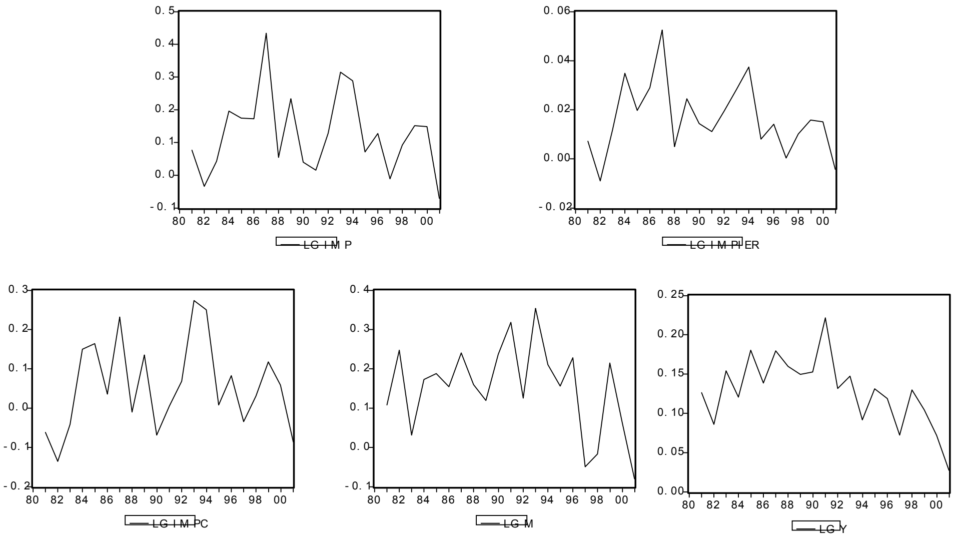
The time series are examined for unit roots. The results suggest the existence of a unit root in levels which are generally corrected for in growth with the results not being clear on the choice of log levels or growths.[26] Some descriptive statistics of the data in log growths, which are also supplemented by graphical representation, are given below:

Table 4. Some Descriptive Statistics

	LGIMP	LGIMPIER	LGIMPC	LGM	LGY
Mean	0.126096	0.016453	0.056043	0.151539	0.128355
Median	0.127123	0.014314	0.035970	0.159236	0.131092
Maximum	0.434214	0.052490	0.273945	0.353742	0.221587
Minimum	-0.071131	-0.008989	-0.135717	-0.080576	0.027358
Std. Dev.	0.122708	0.014471	0.114487	0.113362	0.043367
Observations	21	21	21	21	21

Note: As explained above.

Figure 4. Some Graphical Trends



Note: As explained above.

[26] Some Results Test of Unit Root in level and growths: LIMP (-0.856091, -2.784801*); LIMPIER (-0.861767, -2.910797*); LIMPC (-0.734845, -3.149741**); LM (-1.564621; -2.056434); LY (-2.009460; -0.473351). Note: LIMP, LIMPC and LY are series for import duties, cleaned import duties and nominal GDP; ****, ***, **, * are those significant at 1%, 5%, 10% and 15% respectively. -2.6467 is the 10% for NGDP thus the value is about 11% only, and may be acceptable.

Buoyancy and elasticity can be estimated for two bases - M and Y – whose empirical results and analysis are given below:

- Regressions are run on level and growth of LIMP, LIMPIER and LIMPC on LM. The regressions in levels have very high R2 and F statistics but indication of significant positive serial correlation (DW statistic). Likewise the regressions in growths suggest R2 [close to 20%] and F statistic significant at 5% level, with no statistically significant serial correlation for both LIMP and LIMPIER to LM although indeterminate presence of serial correlation for LIMPC to LM.

Table 5. Some preliminary regression results in log levels and growths base M

	Regression in Levels			Regression in Growths		
	LIMP	LIMPIER	LIMPC	LGIMP	LGIMPIER	LGIMPC
Variable	Coefficient	Coefficient	Coefficient	Coefficient	Coefficient	Coefficient
C	-0.529212	-0.736451	2.622607	0.052946	0.008552	0.039036
	(0.0390)	(0.0023)	(0.0000)	(0.2196)	(0.1045)	(0.7753)
LM	0.830196	0.860506	0.435847	0.482718	0.052143	0.208055
	(0.0000)	(0.0000)	(0.0000)	(0.0427)	(0.0660)	(0.0459)
R-squared	0.984368	0.988620	0.952855	0.198874	0.166847	0.193630
Adjusted R-squared	0.983587	0.988051	0.950498	0.156710	0.122997	0.151190
Durbin-Watson stat	0.912830	1.059226	0.833518	1.942835	1.967944	1.601314
F-statistic	1259.435	1737.400	404.2266	4.716629	3.804934	4.562389
Prob(F-statistic)	0.000000	0.000000	0.000000	0.042739	0.066009	0.045912

Note: Author calculation.

- Regressions are run on level and growth of LIMP and LIMPC on LY. The regressions in levels have very high R2 and F statistics but indication of significant positive serial correlation (DW statistic). Likewise the regressions in growths suggest low R2 and F statistic, with no statistically significant serial correlation for both LGIMP and LGIMPIER to LGM although indeterminate presence of serial correlation for LGIMPC to LGM.

Table 6. Some preliminary regression results in log levels and growth base GDP

	Regression in Levels			Regression in Growths		
	LIMP	LIMPIER	LIMPC	LGIMP	LGIMPIER	LGIMPC
Variable	Coefficient	Coefficient	Coefficient	Coefficient	Coefficient	Coefficient
C	-4.333858	-4.675956	0.674687	0.010805	3.68E-05	-0.032348
	(0.0000)	(0.0000)	(0.0761)	(0.8980)	(0.9970)	(0.6869)
LM	1.049226	1.087186	0.546599	0.898220	0.127899	0.688636
	(0.0000)	(0.0000)	(0.0000)	(0.1608)	(0.0863)	0.2534
R-squared	0.986536	0.990166	0.940321	0.100773	0.146911	0.068044
Adjusted R-squared	0.985863	0.989675	0.937337	0.053445	0.102012	0.018994
Durbin-Watson stat	1.063383	1.092857	0.768691	1.836130	1.980940	1.532121
F-statistic	1465.483	2013.848	315.1268	2.129251	3.272006	1.387227
Prob(F-statistic)	0.000000	0.000000	0.000000	0.160847	0.086324	0.253417

Note: Author calculation.

- Given the positive indication of regressions in levels, and with regard to earlier studies done in Nepal, the empirical results in log levels are undergone: for base

M, suggest that buoyancy is 0.830196 and 0.860506 for LIMP and LIMPIER respectively and elasticity is 0.435847 – this is similar with Adhikari (1995) for 1974/75 to 1993/94 who obtained result of 0.8 and 0.4 for import duties in reference to value of import. The empirical results in log levels for base Y are consistent with this result and suggest that buoyancy is 1.049226 and 1.087186 for LIMP and LIMPIER respectively and elasticity is 0.546599 – this is much lower than that calculated by Shrestha (2001) who find for the period 1980/81 – 1993/94 buoyancy and elasticity of import tax of 3.194831 and 1.288670 respectively.

The results suggest that import duties are not very responsive to changes in merchandise imports although positively related when the base is taken to be GDP. This prior conclusion is also confirmed by the fact that despite a substantial increase in import in the early and mid-1990s, the import duties did not increase in that proportion. Thus, the potential custom revenue that could have been obtained due to increased trade was partially offset by the decrease in tariff rates, removal of quantitative restrictions and other measures taken to liberalize trade. It is surprising that elasticity for both base merchandise imports and GDP is about half of buoyancy. These results, therefore, suggests that there is low natural growth of the tax system [i.e. the "build-in flexibility"] and that the discretionary role of taxes has been able to contribute to overall revenue growth, but again still not similar to the growth of merchandise imports.

The reason for low elasticity and buoyancy of import duties also need an explanation, the details of which are beyond the scope of this study. A simple explanation may be due to the composition of imports where imported items such as raw materials, capital goods etc. form the bulk of imports which only attract low duties. Still another explanation may be the large informal trade between Nepal and India.[27] One other explanation may be the inefficiency and/or revenue leakages at various customs point. This last will be the source of some recommendations at the end of the paper.

Econometric Estimation Equation

The econometric estimation follows the above methodology. The span data is from 1980/81 – 2001/2002[28] and are provided in the first appendix; they include: actual import duties (IMP); nominal GDP (Y) and merchandise imports CIF (M) taken from various issues of *Economic Survey* from various budget speeches; the real effective exchange rate index (base 1990) of the Nepalese Rupee (as provided by the International Monetary Fund for 1979 – 2001) recalculated for fiscal year (i.e. July to June as mid months are not available). Some descriptive statistics of

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[27] A recent estimate by Karmacharya et al (2002) show the volume of informal trade is one third of formal trade – thus the volume of trade would be much higher if this channel could be captured.

[28] Note: 2001/2002 is provisional

the data in ratios, as described in the fifth appendix and are also supplemented by graphical representation, are given below:

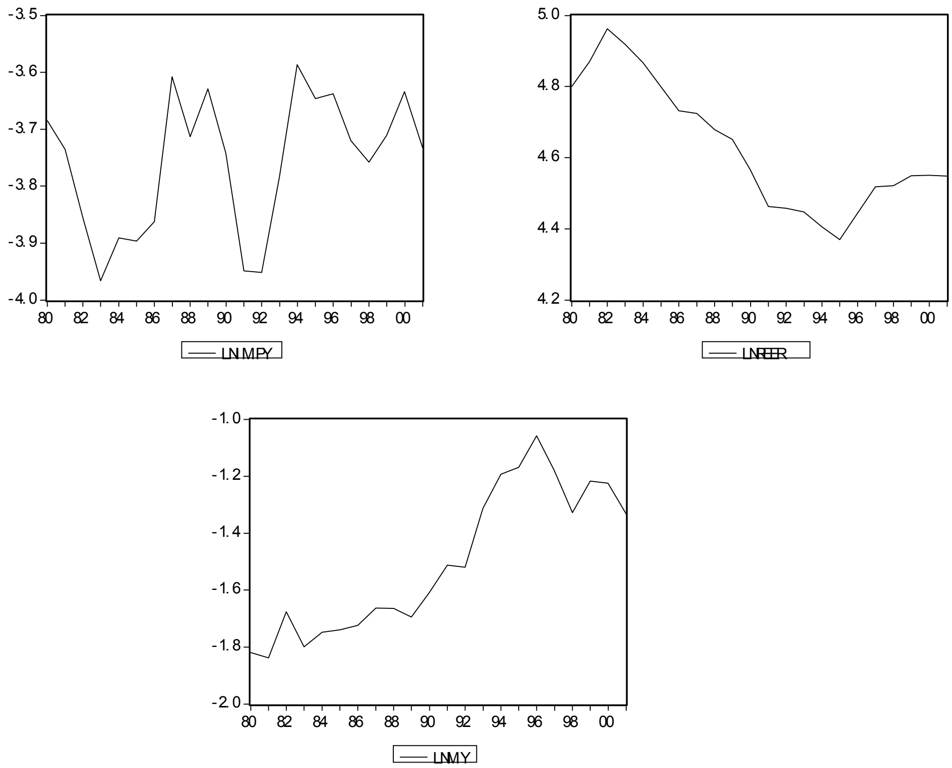
Table 7. Some Descriptive Statistics

	IMPY	MY	REER
Mean	0.023467	0.230040	104.0777
Median	0.023897	0.209486	95.42828
Maximum	0.027698	0.347047	142.9414
Minimum	0.018943	0.159104	79.01754
Std. Dev.	0.002732	0.059722	19.26749
Observations	22	22	22

Note: *IMPY* is actual import duties as a share of NGDP; *MY* is merchandise imports CIF as a share of NGDP; *REER* is the real effective exchange rate index (base 1990) of the Nepalese Rupee provided by the International Monetary Fund and calculated earlier

These are presented graphically below:

Figure 4. Some Graphical Trends



Note: As discussed above.

The time series are examined for unit roots. The results suggest the absence of a unit root in log ratios, at a looser level of confidence.[29] This suggests that the analysis in log ratios is in line with other empirical studies and can thus be considered as appropriate. Preliminary regressions are therefore run on the proposed estimating equation; that is of lnIMP to lnM, lnREER. The results are given below in Table 8 & 9, but have poor degree of fit, poor F-statistic (p=0.113887) with positive and significant serial correlation (DW statistic). Eyeballing the graph suggests a break in the early 1990's in line with the elimination of the trade impasse with India and acceptance of ESAF, not to speak of the ongoing trade liberalization which had been initiated in the mid-1980's namely being: removal of quantitative restriction on imports; lowering of the peak import tariff rates; and reform in import cash margin rates.[30] Chow test confirms that there is a structural break during this period, whose three years are given below:

Table 8. Chow Break Point test (1990 and 1992)

	1990	1991	1992
F-statistic	2.397612	5.630784	2.235801
(Probability)	(0.103573)	(0.007878)	(0.123503)
Log likelihood ratio	11.60413	15.85433	7.702251
(Probability)	(0.020551)	(0.001215)	(0.052583)

However, the most significant Chow statistics is chosen which is 1991/1992 – this is more significant than a factor of ten vis-à-vis 1990/1991 and 1992/1993. As such the estimating equation is modified such that lnCR is regressed on lnM, lnREER along and a dummy for fiscal year 1991. The initial regression has some degree of fit with significant F-statistic although still having positive and significant serial correlation (DW statistic). This is shown in the table below. The regressions are rerun as an AR (1), including lagged dependent variable, with greater fit and more power in F-statistic. As there is a lagged dependent variable in the regression, the DW statistic is no longer valid. Looking at the autocorrelation and partial autocorrelation function together with the Ljung-Box Q-statistics for higher order serial correlation, which suggest that the there is no serial correlation

[29] Some Results Test of Unit Root in ration levels: lnIMPY: -2.965987**; lnMY: -1.252762*; lnREER: -1.835011*. ****, ***, **, * are those significant at 1%, 5%, 10% and 15% respectively. The lower level of confidence may be acceptable given the limited degrees of freedom

[30] There are a number of publications which discuss on this, for example Karmacharya and Maskay (2004).

present at the 10% level of confidence.[31] The final estimation equation is represented as below:

$$\ln IMPY = b_0 + b_1 \ln MY + b_2 \ln REER + b_3 \ln DUM1991 + b_4 \ln IMPY(-1) + e$$

The results are given in the table below.

Table 9. Some preliminary regression results LNIMPY

	#1	#2	#3
Variable	Coefficient	Coefficient	Coefficient
C	-3.579850	-1.380902	-0.813382
	(0.0011)	(0.1865)	(0.4301)
LNMY	0.232995	0.641978	0.615149
	(0.1971)	(0.0030)	(0.0055)
LNREER	0.036878	-0.270345	-0.241607
	(0.8828)	(0.2350)	(0.2479)
D1991		-0.325725	-0.298604
		(0.0038)	(0.0067)
LNIMPY(-1)			0.202674
			(0.2633)
R-squared	0.204425	0.506864	0.629952
Adjusted R-squared	0.120680	0.424675	0.537440
Durbin-Watson stat	1.045401	1.240430	1.898454
F-statistic	2.441044	6.167039	6.809402
Prob(F-statistic)	0.113887	0.004529	0.002124

Note: Author calculation.

The analysis thus uses the second equation. The general implications of the second equation are that:

- Imports CIF to GDP has a positive [0.616149] and significant [greater that 1% level] relationship with the dependent variable;
- REER does not have has a significant effect on the dependent variable;

[31] These results are presented below:

Autocorrelation	Partial Correlation		AC	PAC	Q-Stat	Prob
. | . |	. | . |	1	-0.036	-0.036	0.0308	0.861
. | . |	. *| . |	2	-0.057	-0.059	0.1142	0.944
***| . |	***| . |	3	-0.349	-0.355	3.3756	0.337
***| . |	***| . |	4	-0.355	-0.450	6.9467	0.139
. | . |	. *| . |	5	0.033	-0.171	6.9803	0.222
. |**. |	. |* . |	6	0.317	0.140	10.224	0.116
. |* . |	. | . |	7	0.174	-0.034	11.269	0.127
. | . |	. *| . |	8	0.049	-0.103	11.357	0.182
.**| . |	. *| . |	9	-0.243	-0.159	13.729	0.132
.**| . |	. *| . |	10	-0.212	-0.079	15.697	0.109
. | . |	. | . |	11	0.036	0.063	15.758	0.150
. | . |	. *| . |	12	0.064	-0.120	15.975	0.192

- o D1991 has a negative [-0.298604] and significant [greater than 1% level] effect on the dependent variable;
- o Lagged dependent variable does not have a significant effect on the dependent variable.

The first result suggests that greater imports CIF to GDP will have a positive effect on import duties to GDP; this makes sense as greater imports will result in more revenue from import duties. However, the elasticity of this is less than unity suggesting, in line with that of the previous section, that the basket of imported goods may be inelastic, thus any change in imports is not matched by a similar level of revenue from import duties.[32] The second result is surprising and suggests that the REER does not have a significant effect on import duties to GDP, which may be explained by levels of informal trade [explain]. The third variable suggests that the trade liberalization which had taken place in the early 1990's has had a negative effect on the ratio of import duties to GDP and supports earlier results implying that the basket of imported good are inelastic, thus trade liberalization would not have a positive effect on import revenue to GDP. The last variable supports the earlier conclusion that serial correlation has been addressed as there is no relationship between the present and lagged variables.

The analysis of the regression results, in general, is in line with our expectation; as such the coefficients for the regression will now be used in the following section to aid in the projection of import duties to GDP.

Simple Projection

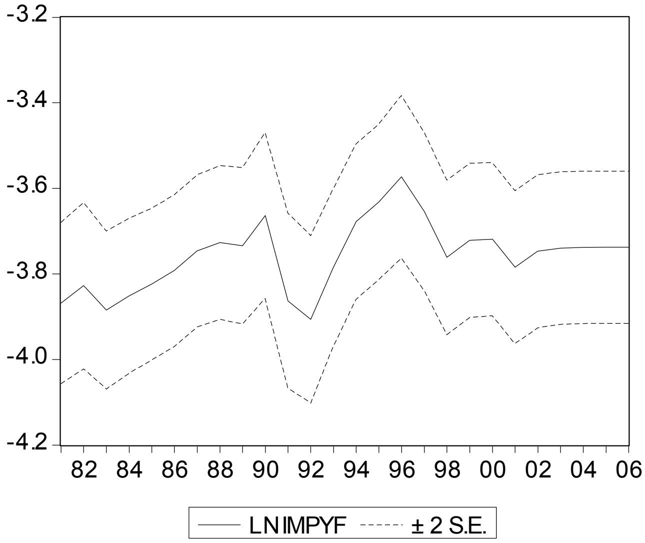
The projection follows the above methodology and uses the below equation from the previous section, and is reproduced below:

$$LNIMPY = -0.8133823006 + 0.6151486903*LNMY - 0.2416072088*LNREER - 0.2986041153*D1991 + 0.202674476*LNIMPY(-1)$$

The projected data for the independent variables (e.g. mainly LNMY and LNREER) are given in sixth appendix and are used to forecast the values of LNIMP. These forecasted values are shown graphically below:

[32] This is in line with imports being inelastic with respect to income in both levels [0.025709] and growths [0.464122 but not statistically significant].

Figure 5. Some Graphical Projections



The forecast is acceptable with Root Mean Square and Mean Absolute Error of 0.072333 and 0.060949 respectively. As such, it is appropriate to analyze the forecasted time series.

The forecasted time series, which are for the ratio of import duties to GDP, are in general stable except for 2002/2003 where there was a dip in the trend. It should be noted that this forecast is based on projection taken from official sources. As such, the results of the projection suggest, on average, that the ongoing process of trade liberalization will not have a significant effect on import duties (in relation to GDP).

SUMMARY AND CONCLUSION

An assessment of the impact on Nepal's import duties with greater trade liberalization has been made. Examining the trends of Nepal's import duties pointed out that it is a significant contributor to total revenue of HMG/N. However, buoyancy and elasticity analysis suggest that the Nepalese import duty base is not very responsive, suggesting a role for discretionary measures. One interpretation of this result is that there is inefficiency in the collection of import duties. An econometric examination further suggests that with liberalization, there has been a decreasing contribution of import duties based on five year ahead projection[33]and implying that there will be neutral contribution in line with growth of national income implying that *ceteris paribus* there will **not** be significant budget deficit.

[33] This is based on the official projections which are assumed to accurately capturing the future picture of Nepal.

As such, it is concluded that there will be limited pressure on the monetary authority and monetary policy, the limitations are put forward in the Nepal Rastra Bank Act, 2002. [34]

RECOMMENDATIONS

The recommendations put forth spring from the empirical results and analysis of the previous section.

1. The low measure of elasticity and buoyancy indicate the low efficiency, productivity and responsiveness of the domestic tax base. Further the measure of elasticity and buoyancy of import duties with respect to income being higher than with respect to the proxy base imports suggests that increased imports resulting from increase in income has not been able to increase import base. All these point to the importance of timely revision of rates structure [discretionary] although suggesting that implementation of various administrative reforms such as improving the customs valuation procedure, enhancing the activities of customs patrolling group, use of communication network and introduction of modern technology is also of essence.

2. Increase the diversity of the import base such that import demand will become more elastic. Since trade liberalization is decreasing the tariff rate and increasing trade facilitation, a more elastic demand will have a facilitating impact on import revenue. Likewise, it is also important that there be greater trading partners, as this will diversify the basket of trading partners.

3. Since there is a large amount of informal trade between Nepal and India and also Nepal and Tibet, a substantial amount of revenue is lost in this way. One of the reasons for this huge informal trade is the cumbersome administrative procedures and real cost involved in doing the trade through formal channel. This issue also needs to be addressed properly so as to facilitate the formal trade and discourage and minimize informal trade.

[34] This is more elaborately discussed in Article 75 to the mentioned Act.

APPENDIX I

Original text in Nepali of Arthic Niyam 2057, Duffa 2 (1)

आर्थिक ऐन, २०५७

२. भन्सार महसुल

१. विदेशबाट नेपाल अधिराज्यभित्र पैठारी हुने माल वस्तुहरुमा अनुसूची-१ बमोजिम भन्सार महसुल (साधारण भन्सार महसुल, थप भन्सार महसुल र समकारक महसुल) लगाइने र असुल उपरि गरनेछ ।

२. नेपाल अधिराज्यबाट विदेशमा निकासी हुने माल वस्तुहरुमा अनुसूची-२ बमोजिम भन्सार महसुल लगाइने र असुल उपर गरिने छ ।

APPENDIX II

Adjusting the Revenue Series with Focus on the Proportional Data Adjustment Method

There are a number of methods for obtaining adjusted revenue series viz. constant structure series; dummy variable technique; Divisia index; and Proportional adjustment method (see Dahal 2002 for a discussion). However the two popular methods presently utilized to clean time series are the Prest and Sahota proportional adjustment method. The method adjusts the revenue yield for each to derive a revenue yield based on the structure of rate and exemptions for a reference year. The Prest formula may be developed symbolically as follows:

- $T_1, T_2, ..., T_t, ...T_n$ are actual tax yields for a series of years
- $D_1, D_s, ...D_t, ...D_n$ measures the effect of discretionary changes in the year tth year on the tth year's revenue collection
- T_{ij} indicates the jth year's actual tax yield adjusted to the tax structure that existed in year i

If i=1 is the reference year, the series T_{11}, T_{12}, T_{13} ... T_{1t} ... T_{1n} represents what the tax receipts would have been if the tax structure had remained as in year 1 with the years following year 1. It is this series that forms the basis for measuring the elasticity of a tax. The series is developed as follows:

$$T_{11} = T_1$$

$$T_{12} = T_2 - D_2$$

$$T_{13} = T_{23} \times \frac{T_{12}}{T_2}$$

$$T_{14} = T_{34} \times \frac{T_{23}}{T_3} \times \frac{T_{12}}{T_2}$$

.

.

.

$$T_{1j} = T_{j-1.j} \times \frac{T_{j-2.j-1}}{T_{j-1}} \cdots \frac{T_{23}}{T_3} \times \frac{T_{12}}{T_2}$$

Sahota Method:

$$NR_t = \frac{AR_t - DR_t}{AR_{t-1}} \times NR_{t-1}$$

Where,

NR_t = Net or adjusted revenue series in year "t"

AR_t = Actual revenue collection in year "t"

DR_t = Proportional revenue collection through discretionary change in year "t"

AR_{t-1} = Actual revenue collection in the preceding year (t-1)

NR_{t-1} = Net revenue series in preceding year (t-1)

Note: These two methods, while appearing quite different, yield the same estimates of income elasticity (Dahal, 2000).

APPENDIX III

Time Series of Trends

	Import Duties	Customs	Tot Tax Revenue	Imports CIF	NGDP
1980	685.14	815.80	2035.70	4428.2	27307
1981	739.54	825.10	2211.30	4930.3	30988
1982	714.82	760.90	2421.10	6314	33761
1983	746.16	825.90	2737.00	6514.3	39390
1984	907.57	1064.50	3151.20	7742.1	44441
1985	1081.13	1231.00	3659.30	9341.2	53215
1986	1285.33	1505.70	4372.40	10905.2	61140
1987	1984.23	2214.60	5752.90	13869.6	73170
1988	2094.36	2289.90	6287.20	16263.7	85831
1989	2645.98	2684.90	7283.90	18324.9	99702
1990	2752.66	3044.30	8177.40	23226.5	116127
1991	2795.17	3358.90	9875.60	31940	144933
1992	3178.06	3945.00	11662.50	36205.6	165350
1993	4356.05	5255.00	15371.50	51570.8	191596
1994	5815.87	7018.10	19660.00	63679.5	209976
1995	6246.45	7327.40	21668.00	74454.5	239388
1996	7093.20	8309.10	24424.30	93553.4	269570
1997	7019.41	8502.20	25939.80	89002	289798
1998	7698.28	9517.70	28752.90	87525.3	330018
1999	8959.90	10813.30	33152.10	108504.9	366251
2000	10391.86	12552.10	38865.10	115687.2	393566
2001	9678.36	12658.80	39330.60	106731.3	404482

Note:
1. 1980 represents fiscal year 1980/81 and so on
2. Import Duties (in millions Rs.) from various Budget Speech of HMG/N
3. Customs from various issues of Economic Survey and includes: imports, exports, Indian Excise Refund and others
4. Total Tax Revenue from various issues of Economic Survey
5. Import C.I.F. (in millions Rs.) from various issues of Economic Survey
6. NGDP (in millions Rs.) from various issues of Economic Survey

APPENDIX IV

Calculation of Cleaned Series

	ESTIMATED				ACTUAL			
FY	NG	ADJ	TOTAL	NG/TOTAL	NG	ADJ	Total	CLEANED
1980	556,977.00	46840	603,817.00	0.92242683	631991.5	53,148.48	685,140.00	685140.00
1981	774,128.00	114600	888,728.00	0.87105166	644174.1	95,361.94	739,536.00	644174.06
1982	990,000.00	106000	1,096,000.00	0.90328467	645681.4	69,133.57	714,815.00	562421.88
1983	850,000.00	75000	925,000.00	0.91891892	685658.7	60,499.30	746,158.00	539481.49
1984	700,000.00	32500	732,500.00	0.9556314	867299.5	40,267.48	907,567.00	627068.31
1985	1,125,400.00	12000	1,137,400.00	0.98944962	1069723	11,406.32	1,081,129.00	739107.08
1986	1,280,000.00	188000	1,468,000.00	0.8719346	1120725	164,606.55	1,285,332.00	766176.94
1987	1,383,500.00	310000	1,693,500.00	0.81694715	1621011	363,218.95	1,984,230.00	966272.75
1988	2,293,000.00	150000	2,443,000.00	0.93860008	1965766	128,593.53	2,094,360.00	957281.45
1989	2,130,000.00	220000	2,350,000.00	0.90638298	2398273	247,708.95	2,645,982.00	1096192.77
1990	2,215,200.00	252300	2,467,500.00	0.89775076	2471203	281,457.39	2,752,660.00	1023784.15
1991	3,020,000.00	30000	3,050,000.00	0.99016393	2767673	27,493.44	2,795,166.00	1029367.71
1992	3,240,000.00	200000	3,440,000.00	0.94186047	2993288	184,770.87	3,178,059.00	1102329.57
1993	3,553,140.00	150000	3,703,140.00	0.95949383	4179602	176,446.84	4,356,049.00	1449721.06
1994	4,820,800.00	190000	5,010,800.00	0.9620819	5595343	220,526.72	5,815,870.00	1862166.15
1995	6,830,000.00	450000	7,280,000.00	0.93818681	5860338	386,113.04	6,246,451.00	1876404.21
1996	6,630,000.00	300000	6,930,000.00	0.95670996	6786136	307,064.98	7,093,201.00	2038523.03
1997	8,160,000.00	200000	8,360,000.00	0.97607656	6851484	167,928.54	7,019,413.00	1969055.84
1998	7,865,800.00	500000	8,365,800.00	0.94023285	7238174	460,104.11	7,698,278.00	2030421.71
1999	9,093,400.00	313000	9,406,400.00	0.96672478	8661754	298,142.52	8,959,897.00	2284538.74
2000	10,245,879.00	961770	11,207,649.00	0.91418628	9500100	891,764.46	10,391,864.00	2422276.22
2001	11,772,000.00	175700	11,947,700.00	0.98529424	9536034	142,327.66	9,678,362.00	2222787.87
2002	12,360,000.00	250000	12,610,000.00	0.98017446	10397005	210,295.40	10,607,300.00	2387835.43
2003	11,312,000.00	780000	12,092,000.00	0.93549454				

Source: Calculated from various budget speeches of HMG/N

Note: “NG” is normal growth; “ADJ” are tariff adjustments and administrative reforms; “TOTAL” is the sum of “NG” and “ADJ”; and “NG/TOTAL” is the ratio of NG to TOTAL.

Time Series for Regression Analysis

Fiscal Year	Regression Time Series				
	Import Duties	IER	NGDP	Imports	REER
1980	685.14	58.10	27307	4428.2	121.5387
1981	739.54	40.40	30988	4930.3	130.4029
1982	714.82	20.00	33761	6314	142.9414
1983	746.16	49.00	39390	6514.3	136.7808
1984	907.57	100.00	44441	7742.1	129.8711
1985	1081.13	75.60	53215	9341.2	121.4683
1986	1285.33	138.30	61140	10905.2	113.4999
1987	1984.23	121.2	73170	13869.6	112.6737
1988	2094.36	91.6	85831	16263.7	107.6848
1989	2645.98	0	99702	18324.9	104.7148
1990	2752.66	211.7	116127	23226.5	96.22336
1991	2795.17	447.4	144933	31940	86.78105
1992	3178.06	623.5	165350	36205.6	86.31514
1993	4356.05	460.4	191596	51570.8	85.36669
1994	5815.87	837.5	209976	63679.5	81.94095
1995	6246.45	899.9	239388	74454.5	79.01754
1996	7093.20	1009.1	269570	93553.4	85.16989
1997	7019.41	1102	289798	89002	91.69997
1998	7698.28	1206	330018	87525.3	91.93909
1999	8959.90	1331.7	366251	108504.9	94.58363
2000	10391.86	1456.2	393566	115687.2	94.6332
2001	9678.36	1700.9	404482	106731.3	94.46258

Note:

1. 1980 represents fiscal year 1980/81 and so on
2. Import Duties (in millions Rs.) from various Budget Speech of HMG/N small differences came up in 1988 and 1994 between Budget Speech and Economic Survey which were 2133.9 and 5840.1 respectively
3. Indian Excise Refund (in millions Rs.) from Economic Survey
4. NGDP (in millions Rs.) from Table 1.1 of various issues of Economic Survey
5. Import C.I.F. (in millions Rs.) from Table 6.1 of various issues of Economic Survey
6. From monthly data provided from IMF for fiscal year average - thus 1980/81 is taken to be July 1980 to June 1981

APPENDIX VI

Time Series for Projection Analysis

Fiscal Year	Regression Time Series				
	Import Duties	Imports	NGDP	REER	Dummy
1980	685.14	4428.2	27307	121.5387	0
1981	739.54	4930.3	30988	130.4029	0
1982	714.82	6314	33761	142.9414	0
1983	746.16	6514.3	39390	136.7808	0
1984	907.57	7742.1	44441	129.8711	0
1985	1081.13	9341.2	53215	121.4683	0
1986	1285.33	10905.2	61140	113.4999	0
1987	1984.23	13869.6	73170	112.6737	0
1988	2094.36	16263.7	85831	107.6848	0
1989	2645.98	18324.9	99702	104.7148	0
1990	2752.66	23226.5	116127	96.22336	0
1991	2795.17	31940	144933	86.78105	1
1992	3178.06	36205.6	165350	86.31514	1
1993	4356.05	51570.8	191596	85.36669	1
1994	5815.87	63679.5	209976	81.94095	1
1995	6246.45	74454.5	239388	79.01754	1
1996	7093.20	93553.4	269570	85.16989	1
1997	7019.41	89002	289798	91.69997	1
1998	7698.28	87525.3	330018	91.93909	1
1999	8959.90	108504.9	366251	94.58363	1
2000	10391.86	115687.2	393566	94.6332	1
2001	9678.36	106731.3	404482	94.46258	1
2002		124352.1	434294	94.46258	1
2003		132061.9	461220	94.46258	1
2004		140249.7	489815	94.46258	1
2005		148945.3	520184	94.46258	1
2006		158179.9	552435	94.46258	1

Note:
1. 1980 represents fiscaly year 1980/81 and so on.
2. Import Duties (in millions Rs.) from various Budget Speech of HMG/N.
3. NGDP (in millions Rs.) from Table 1.1 of various issues of Economic Survey.
4. Import C.I.F. (in millions Rs.) from Table 6.1 of various issues of Economic Survey.
5. From monthly data provided from IMF for fiscal year average - thus 1980/81 is taken to be July 1980 to June 1981.
6. Figures for 2002/2003 are taken from Nepal Rastra Bank.
7. Figures for 2003/2004 - 2006/2007 are projected based on linear growth of 6.2% in line with 10th Plan.

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