ECONOMIC GROWTH AND THE PRIVATE SECTOR OF NEPAL

EDITED BY
PRATEEK PRADHAN

Published by
SAMRIDDHI, THE PROSPERITY FOUNDATION

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Samriddhi, The Prosperity Foundation
P. O. Box : 8973, NPC 678
416, Bhimsengola Marga, Minbhawan Kharibot
Kathmandu, Nepal

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ISBN 978-9937-2-3991-2

First edition : July, 2011

Price : Rs. 499.00

Content

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Dipendra Purush Dhakal has held several key positions in the government of Nepal. He has remained the Secretary of Ministry of Tourism, Culture & Civil Aviation and has also served as the Governor of Nepal Rastra Bank, the Central Bank of Nepal. He has worked as a consultant with various national and international agencies, including being a Team Leader of the Economic Policy Network that was developed to facilitate a network for economic policy dialogue and analysis and undertake policy research and analysis, and information dissemination on several policy issues.

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An expert on local governance and decentralization, Dr. Paudyal has extensive research experience on rural development issues across the Asia-Pacific region. Besides offering consultation to various national and international organizations, he has worked as the Executive Director of Rural Self-Reliance Development Centre (1999-2004), Nepal. He was also a professional staff-member of Centre on Integrated Rural Development for Asia and the Pacific (CIRDAP) from 1986-1995. He has contributed a lot in the policy-making process of Nepal as a member of the High Level Decentralization Coordination Committee (1997) chaired by the Prime Minister of Nepal and also as a Member-Secretary of the High Level Committee to Strengthen Local Bodies (2003) constituted under the Chair of Minister of Local Development. Several papers and articles have been published to his credit, in both Nepali and English, in leading national and international newspapers and journals. Dr. Paudyal assumed the position of the Director General of CIRDAP from 6 July 2004.

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Er. Gyanendra Lal Pradhan, Chairman Executive at Hydro Solution, is an Electrical Engineer by training. He is also the Executive member of Independent Power Producers Association, Nepal (IPPAN), Federation of Nepalese Chambers of Commerce & Industry (FNCCI), Nepal Russia Chamber of Commerce &Industry (NRCCI), Nepal German Chamber of Commerce & Industry (NGCCI), Nepal China Chamber of Commerce & Industry (NCCCI) and SAARC Chamber of Commerce & Industry (SAARC CCI). Er. Pradhan is has received various awards and recognitions for his contributions to the field of hydropower and clean energy, recent one being Best Entrepreneur Award by Nepal Engineers' Association in July 2011 and HYDRO Nepal Excellence Award in Energy (Hydropower) for the year 2010 for his outstanding performance and untiring, tenacious and entrepreneurial efforts in hydropower and energy development in Nepal.

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Dr. Jagdish C. Pokharel has held several high level public positions in Nepal such as the Vice Chair of the National Planning Commission. He was appointed the Chairman of the Commission twice, from April 2010 to March 2011 and April 2006 to April 2008. Before being appointed as Vice Chair of National Planning Commission, Nepal, Dr. Pokharel was Member of the same Commission for five years, from 1997 to2002. As an independent professional, Dr. Pokharel has provided consulting and advisory services to Nepal government and international agencies such as The World Bank, Asian Development Bank, UN agencies on environmental protection, evaluation, strategic planning, governance, decentralized governance and other related fields. Dr. Pokharel has taught for over 10 years in the Engineering Institute, Tribhuban University. He has published several articles and papers in daily news papers, conferences, journals and has published a book on the role of power in bargaining and negotiation. He is also the President of Center for Consolidation of Democracy, a national think tank institution established immediately after the 1990 democratic changes in Nepal.

Prem K. Khanal

Prem K. Khanal did his Master of Arts in Economics and Bachelor of Arts in Economics and History from Tribhuvan University. Currently, he is working as an Associate Editor at Republica English daily. He is also a lecturer at Himalayan Whitehouse College where he teaches Public Finance and Business Journalism to Undergraduate students. He has written 'A Handbook for Business Journalists' in 2010. He has also co-authored 'Financing Education in Nepal, 2007, Action Aid International'. Mr. Khanal has also undertaken research on various topics such as 'Problems and Prospects of Reforms in Nepal (A case Study of Ten Different sectors), 2003 for The World Bank, 'An Analysis of Public Expenditure in Nepal (With Focus on Key Issues), 2005, Action Aid Nepal', and 'A study on government Plans, Programs, and Budget Affecting Children in Nepal' in 2002. He also completed a study on Economic Reforms in Nepal for National Endowment for Democracy.

Rameshore Prasad Khanal

With more than 31 years of experience in civil service, Rameshore Prasad Khanal sought voluntary retirement from service of the Nepal Government to be active in teaching, social service and work as development missionary. At the time of his retirement, he was a Finance Secretary, a position which he held for nearly three years. He led the team to introduce reforms in government accounting and reporting, public procurements, tax policy and administration. He served as a Chairman of the Board in Agricultural Development Bank and was in the Board of Directors in Nepal Rastra Bank, RastriyaBanijya Bank, Nepal Telecom Company and Nepal Airlines. He was also the Council member and Executive Committee member of the Institute of Chartered Accountants of Nepal for four years. He led Nepalese delegations in a number of bilateral economic cooperation consultations with foreign governments. Also the Alternate Governor for Nepal in the World Bank and Asian Development Bank, he was Political Focal Point for Nepal in Global Environment Facility. Mr. Khanal has a teaching experience of over 16 years in different academic institutions.

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Shiv Raj Bhatt, a National Program Manager at Nepal Enhanced Capacities for Trade and Development Project (NECTRADE) holds double masters in Economics (1992) from Tribhuvan University and in Development Studies, with specialization in Economics of Development (2001) from Institute of Social Studies (ISS). He has a decade long experience as a Lecturer of Economics. Previously he also worked as National Program Manager, Trade Policy Analyst and Program Officer at various United Nations Development Programme (UNDP) supported projects under the Ministry of Commerce and Supplies. He was a Research Economist at South Asian Watch on Trade, Economics and Environment and a Research Officer at Institute for Integrated Development Studies, Nepal. He has published more than a dozen research papers in national and international journals and more than 100 articles in national dailies, weeklies and online news magazines and worked as a Team Leader/ Lead Researcher/Researcher on various studies conducted and published by the affiliated institutions.

Siddhant Raj Pandey

Siddhant Raj Pandey is the Chief Executive Officer (CEO) of Ace Development Bank. Chosen as the "Top CEO" of 2006 by a business publication based in Kathmandu, The Boss, he has worked in a number of organizations in several positions such as CEO of Trinal Management; Director of RIGGS Bank, London and Vice President (Financial Consultant) of Merrill Lynch International Bank, London. Besides this he has also worked at Food and Agriculture Organization, Alliance International, Nepal Arab Bank Ltd. and in the marketing and the business news divisions at Bloomberg Financial Markets, London and New York. He received his Bachelor's Degree in Business Administration and History from Virginia Tech in USA and a Master's in Science in Development Studies (Economics & Policy Management) from University of Bristol, United Kingdom. He has also attended a Summer Executive Programme in International Finance for Executives at London School of Economics and has won several accolades such as the 'Rastriya Sanskriti Award 2007 and National Youth Award 2009. He has published several publications on economic liberalization and banking and finances.

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Tarka Raj Bhatta has been affiliated with the Government of Nepal as a Planning Officer in National Planning Commission since 2004. An expert in issues of Macroeconomic Management and Financial Policies, Mr. Bhatta received his Master's in Economics from Ritsumeikan University, Kyoto, Japan and has presented papers in various national and international seminars in Intellectual Property and other related topics.

Acknowledgement

The compendium is an effort to build a greater understanding of Nepalese Economy and the role of private sector by putting together a range of perspective from experts who have spent a significant amount of time in their respective expertise areas. This rigorous process of putting down the analysis and learning in the form of articles has been possible due to the continuous support and contribution from different individuals and institutions. Samriddhi, The Prosperity Foundation deeply acknowledges the effort taken by the contributors and the editor in making this publication possible. Our sincere thank you to the contributors Dr. Dandapani Paudel, Dipendra Purush Dhakal, Dr. Durga P. Paudyal, Er. Gyanendra Lal Pradhan, Jagdish C. Pokharel, Prem K. Khanal, Rameshore Prasad Khanal, Ratish Basnyat, Shiv Raj Bhatt, Siddhant Raj Pandey, Tarka Raj Bhatta and the editor, Prateek Pradhan.

Similarly, the book would not have been possible without the continuous guidance and support from three individuals, Mr. Keshav Gautam, Editor, Arthik Abhiyan, renowned economist Dr. Bhola Nath Chalise and Mr. Khem Raj Nepal, Executive Chairperson, Institute of Local Governance and Studies. Thanks are also due to our partner organizations for encouraging us in our struggle for prosperity in Nepal. Finally, we would also like to thank all those who have contributed directly and indirectly in making this publication possible.

Samriddhi, The Prosperity Foundation
July, 2011

Foreword

Private sector and its role in an economy is a topic that always generates a considerable amount of discussion everywhere. While many view private sector simply as a bunch of greedy and profit hungry people, others view them as entrepreneurs, the engine of growth, who come up with innovative and cost effective solutions to the problems people face every day. Both the views are true in their own right. Profit is the motive behind any private sector enterprise and true business enterprises are those that sustain for a long time in the profit making business by providing what its customers really need and want and by satisfying them. It then becomes a win-win where both the parties get what they want. However, as much as we have those business enterprises around us which are known for their quality and consistency over the years and have turned into successful ventures due to these qualities, the Nepalese private sector, like any around the world, is also full of malpractices. Cartels, syndicates, adulteration, fraud etc. are the few examples of such malpractices rampant in the private sector of Nepal. These malpractices have turned so widespread in the recent times that it has almost become the image of the Nepalese Private sector among the general population. However, in this scenario, it is also important for us to notice that from quality medical services to quality education, from access to modern day telecommunication to media, the private sector has been indispensable in the social, political and economic life of the Nepali people. Though the role of private sector in the economy of Nepal has noticeably evolved in the past two decades, the private sector is still in its nascent phase in the context of Nepalese economy. Considering it has only been a few decades that Nepal has opted to relatively free markets, the private sector of Nepal is yet to mature fully. However, having said that the sector still remains undercapitalized even in the present context and this could be one of the reasons why Nepal has not been able to expand its economic horizon over the years. This publication addresses a range of such issues concerning the private sector of Nepal in relation to the achievement of economic prosperity and adds to the discussion by presenting facts, figures, analysis and perspectives.

Written by established experts, this book is a collection of eleven articles highlighting Nepal's possibilities and problems in economic growth. These articles examine topics such as fiscal and monetary policies, export diversification, competition, democracy and economic growth, financial markets, trade agreements, investment environment, foreign employment and remittance. It puts special focus on the policy angles involved in all these issues. These articles are written not only by government officials and bureaucrats but also the members of the business community, journalists and academicians to help analyze and understand the economic situation of Nepal through a diversified lens.

Expected to be useful for students, opinion makers, policy makers, researchers and others, this book will provide an updated analysis on various aspects of the role of the private sector and the economic growth of Nepal. I am extremely thankful to all the contributors for making this publication so valuable by sharing their ideas that have come from their extensive experience and academic understanding. I believe the publication will be very important for anyone interested in understanding the economy of Nepal and its growth. We look forward to your feedback and comments.

Robin Sitoula
Executive Director
Samriddhi, The Prosperity Foundation

July, 2011

Introduction

The April Movement of 2006 was a milestone in the political history of modern Nepal. The movement overthrew the regime representing more than 235 years of hegemony of monarchy. Besides this, the movement also initiated major shifts in the prevailing power structures and power centers. Though the movement was initially against the autocratic rule of the King, there is no doubt that the movement was a culmination of general public's frustration over the political as well as economic performance of the country for decades. Despite immense possibilities of economic development, Nepal remains one of the poorest countries in the world with the per capita income of just 1271 international dollars[1]. Around 13 percent of the total population lives under absolute poverty line[2] and Nepal ranks 141st in the human development index[3]. *Just 25 years ago Nepal had slightly higher per capita income (in PPP $) than that of China and the same of India at around 900; now China's GDP (in PPP $) is 6 times more at 6000 and India's 3 times more at 3000. Stagnancy of average living standard in Nepal in last 25 years is very frustrating. A simple calculation shows that Nepal should grow around 14.6 per cent per year if she likes to catch up to China and about 11 per cent per year if she likes to catch up to India in 50 years' time*[4].

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[1] World Economic Outlook Database- April 2011, International Monetary Fund

[2] Nepal Living Standard Survey 2011

[3] HDI Index 2010, Human Development Report Office, United Nations Development Programme

[4] http://www.accessecon.com/pubs/PET08/PET08-08-00061S.pdf

The ensuing three years after the movement, however, haven't been as peaceful and as promising as expected by Nepalese people. The constitution assembly's deadline has been extended for a third time making the current deadline 30 November 2011.Political instability, lack of cooperation between parties even in issues of national interest, increasing anarchy and impunity is taking its toll in the living standard of Nepalese citizens. Amid the chaos and political wrangles, the agendas of economic growth and economic vision for Nepal's development have been subdued. Major political parties lack a clear vision regarding the economic development and upliftment of general people's living standards. Considering the fact that the real longing for democracy in Nepal comes from the country's long history of economic deprivation and alienation from civil liberties, now that the establishment of civil liberties is ensured, the economic growth aspect needs to be taken seriously. If the economic growth agenda is not taken seriously now, another major political setback is almost imminent in the future.

In the last budget, the government decided to adopt a tri-pillar economic model for Nepal consisting of government, co-operatives and private sector. The decision has attracted severe criticisms from private sector and civil society alike. The major criticism stems from the fact that despite its appreciable contributions in micro-finance sector, co-operative sector is far small as compared to private sector in making contributions to the national economy. The decision has also been seen as government's attempt to undermine open economy, abolish private sector and introduce socialism in Nepal[5].

However, the crucial role of private sector and entrepreneurship in economic development has been widely recognized by now. Private

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[5] http://www.myrepublica.com/portal/index.php?action=news_details&news_id=33377

sector can create jobs and entrepreneurial opportunities, enable technology transfer, build human capital and physical infrastructure, generate public revenue for governments, and offer a variety of products and services to consumers and other businesses, including those operating at what has been termed the "base of the economic pyramid"[6]. Each of these impacts has multiplier effects on social and economic development[7]. Private sector development has also been considered instrumental for the achievement of Millennium Development Goals (MDGs). The need to explore new opportunities and to develop new initiatives that could unleash the expertise, investment and technology of the private sector to support growth in developing countries has been stressed[8]. Even once private-sector less nation like China has realized the importance of role of private sector in economic growth and has been encouraging and facilitating private sector's involvement in the economy[9].

In this context, think tanks and civil society play an instrumental role in guiding the public discourse of a country by conducting researches, bringing issues to the attention of public and making contributions to shape up the public opinions, educating public about the issues and engaging in advocacy. Samriddhi, The Prosperity Foundation believes that economic priorities of Nepal have to be set and acted upon, free from political party-specific ideologies or principles. Economic agendas have to be brought under public debates and discourse so that multiple dimensions of issues that matter to economic growth and prosperity are addressed and wider support for these programs is generated.

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[6] Prahalad, C.K. and Stuart L. Hart. 2002. "The Fortune at the Bottom of the Pyramid." Strategy+Business 26: 54-67.

[7] Nelson, Jane. 2003. Economic Multipliers: Revisiting the Core Responsibility and Contribution of Business to Development. International, Business Leaders Forum (IBLF) Policy Paper 2003 No.4.

[8] http://www.un.org/apps/news/story.asp?NewsID=26580&Cr=mdg&Cr1

[9] http://www.chinadaily.com.cn/en/doc/2003-11/05/content_278830.htm

Hence, this publication is an attempt of Samriddhi, The Prosperity Foundation to put together an overview of Nepalese economy and its major sectors to the public. The compendium intends to bring forward the major issues of different priority sectors and the role of private-sector in them.

The book contains eleven articles written by respective experts on different major sectors of Nepalese economy. Economic reforms, macroeconomic stability, state owned enterprises, tourism, hydropower, financial markets, Nepalese exports and international market access and regional development are some of the areas covered in the book with its relation to private sector's role in them.

Although open economy, private sector development and entrepreneurship have received universal acceptance as the prerequisites for economic growth, the political system that is most conducive for economic reforms is still a highly debated issue. Democracy and autocracy, the two sides of the divide have equally compelling examples and arguments in their side. There are democracies like UK, New Zealand, India and Australia who have successfully implemented economic reforms and achieved significant growth whereas on the other hand autocratic countries like China and Vietnam have too achieved equally impressive economic growth. However, there are also countries that adopted democracy after the economic reforms such as South Korea, Chile and Malaysia. In his article, Mr. Prem Khanal argues that Nepal has tried various forms of economic systems without desirable results and the primary result behind this has been the political, bureaucratic and institutional resistance to the economic reforms. In this context, one of the major areas for reform is macroeconomic stability as it is a prerequisite for growth encouraging economic environment. However, macroeconomic stability which is very important for realizing the growth potential of a country remains elusive for Nepal. In his article Dr. Dandapani Paudel highlights the importance of macroeconomic stability and the steps Nepal has initiated to achieve it. He mentions that Nepal has entered into many donor supported programs which have helped Nepal directly and indirectly but the results have been far below expectations. Besides the macroeconomic stability, Mr. Poduel highlights that it is necessary that political parties live up to their promises as well. Lack of commitment from the political parties has been one of the major causes derailing the reforms.

In the larger economic context, there are few sectors that require prime attention as they could be our sectors of comparative advantage. Being a landlocked country with an almost non-existent manufacturing and production base, seeking sectors of comparative advantage is one of the few things we can do to escalate the economic growth of Nepal. To start with, tourism sector remains the most promising and unexploited areas of Nepalese economy. Tourism sector development could help reduce the imbalanced regional development of the country and augment the foreign exchange earnings. Since tourism is mostly a labor intensive industry and more so in the case of Nepal, it could be the primary employment provider to majority of the population. Various tourism products exist in Nepal, some of them being unique to Nepal only and each of them with a very high potential in contributing towards the growth of Nepalese economy. For e.g. the making of the Great Himalayan Trail, which is one of the longest and highest walking trails in the world, stands as an example of unique products Nepal can offer. In this scenario, Mr. Dipendra Purush Dhakal traces tourism related policies of Nepal and analyses them in his article. Given the dynamic role private-sector has played in the tourism sector, he argues it could be further encouraged and involved further incorporating lessons learned from past experiences.

Another sector, hydropower stands as the most talked about sector in the economic development discourse of Nepal. Yet Nepal suffers from power cuts as high as sixteen hours a day during the dry season, especially in economically active areas due to the disparity between supply and demand of electricity. Hydropower development in Nepal has been a costly and unsuccessful affair due to reasons such as heavy reliance on bilateral and multilateral aid financing; extensive employment of international contractors and consultants; fragile geology of hydropower sites and small economy of scale. In his article, Mr. Gyanendra Lal Pradhan, an entrepreneur working in hydropower sector explains the necessity of hydropower development in Nepal and the bottlenecks in the sector. He has also outlined the steps that could be taken to ensure private-sector's greater participation in hydropower development.

Despite the government offering encouraging words to the private sector and acknowledging their importance in the economic growth of the nation, the state has always posed an active role in almost all sectors of Nepal, owning monopolies in most of them such as petroleum, electricity etc. Though state owned enterprises (SOEs) play a very important role in an economy (especially in a yet-to-be-industrialized economy like ours), SOEs in Nepal have been a drain in the economy. Not only have they failed to meet their objectives, they have failed to provide any competitive threat to their private counterparts, if any. Among the many reasons for SOE's weak performance, the most prominent one is poor liability management, leading to liquidity and solvency related problems. Mr. Rameshwor Prasad Khanal talks about the liability issues with the state owned enterprises and the ways to make them more accountable and competitive in his article. As state owned enterprises in Nepal have constantly demonstrated disappointing performance, the argument has also developed that the services provided by SOEs need to be opened and extended to the private sector. The role of the government, rather than being a major player in the economy should be more facilitating that encourages private sector to come in, avoids monopoly and works for consumer protection. A successful example of liberalization in Nepal is the financial sector.

Financial sector is among the most benefited sector by the liberalization attempts of Nepal in early 1990s.Before the reforms Nepalese financial sector was characterized by excessive state control and use of obsolete technology. The financial sector today stands vibrant and very competitive. In his article, Mr. Siddhant Raj Pandey discusses the reform process of the financial sector and future scenario of the sector after the foreign banks enter the market. The liberalization measures taken the 90's are mentioned in most of the articles as it is a very important time in Nepalese history of economic growth. According to ILO (2003)[10] , *the average annual growth rate of GDP increased from 4.8 percent to 5.2 during 1985-1996. Employment and value-addition in the manufacturing sector also grew. Manufacturing employment rose 36 percent in the first few years after the reforms, and the growth rate of manufacturing value added increased from 5.3 percent to 13 percent. Gross national savings improved from around eleven percent to over 16 percent during the decade.*

Hence, it is evident that Nepal has tremendous possibilities. It is a country which is geographically as well as culturally diverse. It is thoroughly connected with two large friendly economies, India and China. This interconnectedness offers plenty of opportunities

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[10] http://www.ilo.org/wcmsp5/groups/public/@asia/@ro-bangkok/@ilo-kathmandu/documents/publication/wcms_116688.pdf

for Nepal's development. In terms of population, growth and urbanization, Nepal is much smaller than many states and provinces in India and China. Thus, even a small penetration of these markets can make very large difference in Nepal's economy. To take full advantage of the opportunities, Nepal should combine market interaction with its neighbors and the growth of industries and markets within the country. Dr. Jagadish Chandra Pokharel reviews the current situation of Nepal in the context of its two rapidly developing neighbors and the opportunities provided by the scenario for Nepal to enhance its economic growth.

In an attempt to expand its presence in the world economy and increase its market, Nepal has been a part of various trade organizations and has made trade agreements with many countries. Nepal became the 147th member of the World Trade Organization (WTO); a multilateral rule based global trade related organization, on 23rd April 2004. It became the first Least Developing Countries (LDC) to accede WTO. On the regional front, Nepal became a founding member of South Asian Association for Regional Cooperation (SAARC) in 1985 and also a signatory of another sub-regional framework called Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC). Nepal has also signed bilateral trade treaties with many countries, including its two neighboring countries- India and China. There are diverse issues that are to be addressed in order to accelerate the country's pace in economic development. Mr. Ratish Basnet explains about the current scenario for Nepal regarding the bilateral and multilateral trade agreements. He also discusses the threats and opportunities posed by these treaties and agreements.

Despite the numerous opportunities presented by the rapid economic growth of India and China and Nepal's access to international markets, Nepal has been unable to promote its exports satisfactorily. The country's overall exports barely meet the import demand of single product- petroleum. Nepal exports insignificant amount of goods and has limited number of export partners. In order to reduce the adverse effects of this scenario such as export volatility, it is imperative that Nepal have export diversification strategy in place. Mr. Tarka Raj Bhatta explains the current scenario of Nepalese exports and steps Nepal could take to diversify and increase its exports in his article. In that very context, Mr. Shiva Raj Bhatt, who is currently working as a National Program Manager at Nepal Enhanced Capacities for Trade and Development Project (NECTRADE) under the Ministry of Commerce and Supplies, further explains the bilateral and multilateral treaties signed by Nepal with a special emphasis on US-Nepal trade relationships. He stresses the need for Nepal to update the trade agreements with countries except India as well so that they are relevant for the changed current scenario.

Hence, the compendium 'Economic Growth and The Private Sector of Nepal' offers detailed information and analysis on some of the most pertinent and pressing issues of the Nepalese economy in the current time. However, it is noteworthy that in major economic issues of Nepal, despite the unanimous acknowledgement of importance of private sector in economic growth, the involvement is not as much as it should have been. It is certainly debatable as to why the involvement has been limited. A side of the argument has been that the legal and regulative environment has been too stifling for the private sector leaving no room for active involvement. Other arguments indicate that the private sector itself has not been proactive enough. In any case, the role of private sector cannot be undermined in the Nepalese economy drawing from successful examples such as the thriving financial sector, foreign employment, education, health, transportation, etc.

This indicates that the best role of the state is a facilitating one rather than being an economic agent on its own. Ensuring a level playing field for entrepreneurs by administration of justice such as contract enforcement, maintaining competitiveness, avoiding monopoly, cartels and syndicates etc. should be the role of the government in the national economy. The case of tourism presented in one of the articles in the book is an exemplary one when it comes to demonstrating the role of private sector in encouraging economic growth. As far as international trade is concerned, Nepal should look beyond its traditional approach to international trade and capitalize on sectors where it has comparative advantage and expand its trade opportunities.

Samriddhi, The Prosperity Foundation
July, 2011

CHAPTER I

Resistance To Economic Reforms
How It Weakens Democracy ?

- Prem K. Khanal

Which one, democracy or autocracy? Which system provides the most conducive environment for economic reforms? This debate has long been ongoing among economists and political scientists, but without any definite conclusion. Group of scholars have provided strong theoretical arguments and numerous examples in support of the idea that a certain degree of autocracy is congenial for implementing economic reforms. They argue that most of the contemporary emerging economies were under undemocratic regimes when they underwent massive economic reforms and achieved their magnificent economic progress. They have also provided reasons as to why less democratic regimes provide suitable landscape for economic reforms and growth. Since the short-term outcomes of reforms generally bring painful changes to the middle and lower classes, democratically elected governments are often hesitant to introduce sweeping reforms as these could cause a massive decline in popular support. In addition, a fully democratic regime can fall prey to interest groups, which put their rent-seeking goals before the general wellbeing and make attempts to block economic reforms.

However, pro-democratic school of thought reject the arguments and say that functioning democracy is better than any other system of governance for a sustained economic prosperity and private sector development, the essence of a liberal economic policy. They argue that only a free society ensures reward to talented and innovative minds, which is a determining factor for economic growth and prosperity in the modern world. That is the reason why more than 90 percent of the modern innovations take place in developed and democratic countries, which have always helped those countries to propel their economic superiority. They argue that economic reforms are more likely to succeed in a democratic context, as political pluralism open platforms at various levels that, in turn generates more and better information to use in decision making. A free press and political opposition serve as important 'early warning system' by means of which policy mistakes can be corrected[1] .

The world has seen a surge in the number of developing countries adopting democracy and liberal economic policy since early eighties. The fall of communist states in early nineties triggered a new wave of democratization and economic reforms worldwide. Based on the system of governance and adaptation of economic reforms, countries that have undergone through massive economic reforms can be broadly divided into three categories. There are a number of fully democratic countries, like the UK, Australia, India and New Zealand, where not only reforms were successfully implemented, they also produced enchanting results. Though, India is showing the positive impact of democracy on the economy only from the last few years. There are a bunch of countries where economic reforms were launched when autocratic or military rulers were in power but they slowly adopted democracy after achieving a level of economic prosperity. Chile, South Korea, Malaysia, Argentina and Singapore are some examples in this

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[1] Larry Diamond and Marc F Plattner, "Economic Reforms and Democracy" The Johns Hopkins University Press, 1995

category. However, there are some countries like China and Vietnam where massive economic reforms took place and they also produced astonishing results but a few or no steps have been taken toward democracy.

This literature doesn't argue which of the three categories of the governance mentioned above is conducive to economic reforms. This paper argues that protracted resistances to reforms have been one of the obstacles in strengthening democracy in the least developed democratic countries like Nepal.

Reforms initiatives in Nepal

History of economic reforms in Nepal can be traced right from 1950 when country's first-ever people's uprising toppled over a century old Rana oligarchic rule and established a democratic system of governance. The government formed after the 1950 revolution announced the annual budget, which for the first time made income and expenditure of the country transparent. Despite political instability owning to mistrust among political parties and the King, the governments coming to power thereafter took a number of remarkable steps in economic front, like forming a commission to draft the first five-year development plan and establishing a central bank.

In the first-ever multiparty election held in 1959, Nepali Congress secured absolute majority, contrary to all expectations. The government led by a young democratic leader B. P. Koirala initiated various social as well as economic reforms. Koirala government initiated a radical change in the tenure system and ownership through redistribution of land to tenants and landless people, and unveiled a blueprint for industrial development. The government also formed district development boards with authority to take decisions related to development activities at the local level. It was the first major reform to decentralize the power that was heavily concentrated at the center as a legacy of Rana regime. Similarly, the government also introduced fiscal reforms and introduced domestic borrowing to generate additional resources to finance growing development needs. But the wave of change did not last long. King Mahendra ousted the democratically elected government in a military coup in 1960 and imposed a party-less Panchayat regime that lasted for 30 years till 1990, impoverishing the country to the brink.

Mid-eighties' financial crisis and the beginning of economic reforms

Beginning from early seventies, a number of flaws like exchange rate rigidity, slow economic growth coupled with high inflation, widening mismatch between revenue and expenditure was providing a breeding ground for an economic crisis, which ultimately hit the country in mid-eighties. One of the major reasons for the crisis was that the state massively misused and manipulated the state resources to ensure the victory of Panchayat regime during the referendum of 1980. As a result, the economy experienced a massive 19 percent rise in money supply between the period of 1979 and 1983, whereas average economic growth rate was 3.15 percent and the inflation was almost 10 percent.

The massive rise in the money supply increased people's purchasing power that fueled imports. However, the rigid exchange rate regime was barring timely depreciation of Nepali currency against the dollar, thereby encouraging imports but making exports uncompetitive. As a result, imports increased by almost 120 percent during the fouryear period, thus putting numerous pressures on foreign exchange reserve of the country. In contrast, exports, one of the few sources of foreign currency for the country at the time, dwindled by 12 percent, thanks to over valuation of Nepalese currency against the dollar that was weakening competitiveness of Nepali products in the international market. As a result, trade deficit swelled by over 75 percent, causing a rapid depletion of foreign currency reserve, just enough to finance one-month's imports. Along with the foreign exchange crisis, Nepal for the first time recorded a deficit in its balance of payments in 1983 and internal borrowing jumped to 4 percent of GDP. After winning the referendum, the Panchayet regime massively increased recurrent expenditures by raising civil servants' salary and promoting welfare activities, whereas it paid little attention to increase resources, thus ballooning budget deficit.

In order to avert a financial meltdown, the government sought emergency assistance from the International Monetary Fund (IMF), and arranged a stand-by credit arrangement under the Economic Stabilization Program (ESP). The government subsequently negotiated with the IMF and the World Bank for a three-year Structural Adjustment Program (SAP). As per the conditions attached with the loan program stipulated, the government brought about a series of changes in its economic policy. Thus, internal financial crisis primarily compelled the then governments to initiate economic reforms from the beginning of 1985/86. The first phase of reform under the ESP and SAP lasted up to 1989/90.

The reform initiatives

The initial economic reforms were focused on correcting distortions in the real exchange rate by adjusting real exchange rate and capping budget deficit through curtailing public expenditure and increasing public revenue. Accordingly, Nepali currency was depreciated by 14.7 percent as an essential tool to curb imports and provide incentives to exports. This was followed by announcement of some austerity measures in curbing the burgeoning government expenditure and reduce government deficit, and certain restrictions were also imposed on commercial bank loan to the government[2]. Similarly, government removed quantitative restrictions on imports and replaced them with an import license auction system in 1986. Under this system, import licenses were issued to those who offered the highest premium to the government.

Targets and outcomes of reforms

Indicators	**87/88**	**88/89**	**89/90**	**Targeted**
Real GDP growth rate	7.0	5.2	4.5	4.2
Internal Borrowing to GDP	2.58	1.47	3.78	1.5
Government Revenue to GDP	9.36	9.56	8.91	12
Development spending to GDP	11.55	12.26	13.28	16
Regular Expenditure to GDP	6.48	6.08	6.29	7
Foreign aid to GDP	6.25	7.66	7.0	10
Fiscal deficit (excluding grants)	12.1	13.9	12.4	11

Source: Economic Survey (various issues), Ministry of Finance

Though the Panchayat regime initiated reform as it had no option than to accept the SAP conditions of reforms to save the economy from a grave crisis, it always remained half-hearted toward the

2 Dilli Raj Khanal and Pushpa Raj karnikar, "Understanding Reforms in Nepal: Political Economy and Institutional Perspective" Institute of Policy Research and Development, 2005

measures. So, reforms were either frequently delayed or postponed and only the most compelling reforms were adopted just to ensure the timely release of loans from the IMF and the World Bank. As a result, though the SAP remained successful in averting a looming financial crisis and opening new avenues like banking sector, foreign trade and industrial sector for private players, it failed to bring a tangible change to the sluggish economy.

A New Pace of Reforms after Restoration of Democracy in 1990

The worldwide wave of democracy that began to spread from the East European countries in the late eighties reawakened the Nepalese people. The historic people's moment called by an alliance of Nepali Congress and Unified Communist Front brought down the three-decade old Panchayat regime under the King's direct leadership and restored multiparty democracy with constitutional monarchy. Despite some hiccups, a new constitution was promulgated and as per the constitutional provision, a general election for 205-member of House of Representative was held on May 1991 in which Nepali Congress secured majority with 112 seats and formed a government, while with 69 seats, CPN-UML became the main opposition in the parliament. With the simple majority in the parliament, the Nepali Congress formed a government headed by Girija Prasad Koirala in 1992. Soon after coming into the power, the Koirala led government initiated sweeping economic reforms in exchange rate, trade, industry, monetary, financial and fiscal policies.

The government also successfully negotiated with the IMF and entered into another three-year Enhanced Structural Adjustment Framework (ESAF). Along with the reform policy framework embodied in the

ESAF, sweeping reforms initiated in India were the major influencing factors in shaping the speed and sequencing of reforms back home. Apart from that, public commitments made by major political parties through their respective election manifestos, which had vowed to act against worsening poverty by accelerating economic growth and industrial development, policy reform liberalizing foreign trade, rationalizing tariffs, revising subsidy policy, deregulating the financial sector by allowing commercial banks to set interest rates both on deposit and lending, privatizing public enterprises and allowing exchange rate to be determined by market forces also created conducive political landscape for reforms. The post 1990 economic reforms were focused on the following three sectors:

- Financial Sector,
- Labor Laws Reform
- Public Expenditure Management

Financial Sector

Nepal's problems in its financial management was first traced in 1989, when a report reckoned that the two largest state-owned and semi-state-owned banks of Nepal, namely Nepal Bank Limited (NBL) and Rastriya Banijya Bank (RBB) were in serious trouble mainly due to imprudent and risky lending decisions and weak recoveries. As per the recommendation of the report, government injected some $98 million in 1991-93 into the banks but paid no attentions toward recovering past loans, thanks to strong nexus between notorious borrowers and politicians. As a result, the financial condition of the banks further deteriorated and another study in 1999 revealed alarming findings and declared that two banks were financially insolvent with huge negative net worth due mainly to the refusal of big defaulters to payback the loans just because of their right political connections.

The central bank disclosed that 53 business houses willfully defaulted some $350 million from the two banks and it was the root cause of their financial crisis. In order to avert possible financial disaster, Nepal initiated massive financial sector reforms in 2005 with loan supports worth Rs. 5 billion mainly form the World Bank and the management of the two troubled banks were handed over to foreign management teams so as to accelerate recovery drives.

Despite a series of tough actions that includes seizing passport and freezing assets, the foreign management teams largely remained unsuccessful in recovering the loans from 'financially powerful and politically influential defaulters' mainly due to half-hearted and cosmetic actions against them. As a result, the financial condition of two banks is still fragile with huge negative net-worth.

As a result, Nepal is losing one percentage growth prospects in the non-agriculture sector due slow process in financial sector reform, particularly dealing with the willful defaulters[3].

In addition, strengthening the monitoring and supervision capacity of the central bank was one of the major components of the financial sector reform project. Since the project was against the interests of those notorious businessmen engaged in hijacking billions of rupees from banking system in the pretext of industrial loans, they hatched a conspiracy and managed to file an ill-intentioned corruption charges against then governor of central bank, suspending the pro-reformer governor for more than three years from his post. The incident completely derailed the mega financial reform project.

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[3] Dr. Shankar Sharma, former vice-chairman of National Planning Commission, The Kathmandu Post, February 19, 2007

As a result, monitoring and poor supervision capacity of the central bank is still so weak that it was even unable to trace huge financial embezzlement running into millions perpetrated by former bosses of Nepal Share Market for years. The financial calamity that recently hit Gorkha Development Bank was so rapid that thousands of depositors had to rush to the bank to withdraw their life savings. These latest developments have not only badly dented the credibility of Nepali banks, but also exposed billions of rupees of deposits at a grave risk. It is no exaggeration to say that had the financial sector reforms been duly implemented at the central bank in their original spirit, most of the banking-related problems that NRB is now confronting could easily have been averted[4].

Labor Law reform

Several studies have concluded that Nepal's rigid labor law is one of the biggest obstacles in accelerating industrial development in the country and it is turning away domestic investment, to say nothing of foreign investment. Industrial relations in Nepal assumed a new dimension after the restoration of democracy in 1990 and enactment of Labor Act 1992. However, even after nearly two-decade of its issuance, the Act has failed to satisfy both the employees and the employers. The act acknowledges universal labor rights like trade unionism, collective bargaining, and their social security and arranged a tripartite consultative mechanism to solve disputes between the employers and employees and the government to ensure smooth industrial relations.

However, employers have long been reluctant to fully own the Act, citing that it heavily favors laborers at the cost of core interests of

[4] Republica Editorial, "Wise Acknowledgement," , May 19, 2011

businesses and industries. While workers say that they are unhappy with the successive governments that they constantly failed to fully implement provisions of the Act, like payment of bonus, health insurance, gratuity and creation of employees housing. Employers say that the financial burden of the provisions inducted into the act is impossible to bear for industries operating in Nepal.

As a result, years long attempts to put good industrial relations in place by bridging mistrusts between employees and employers have not only failed completely but in fact there has been a remarkable increase in tussles between the two major actors of production.

Whatever the arguments may be, it has been clear that the current labor laws neither serve the interest of investors nor laborers. For Investors, the law is discouraging in the sense that there are a number of rigid provisions in the act that prevents them from becoming competitive. The Enterprise Surveys 2009 has also identified rigid labor regulations as one of the four major constraints to investment and doing business. One of the provisions that employers are fiercely protesting is a term as per which anyone working in a factory with more than 10 workers is entitled to become a 'permanent' worker after a 240-day probationary period. And, once made 'permanent' he cannot be fired unless he commits acts of criminal offence.

This provision became a recipe for a disaster for order-based industries like carpet and garments and season-based industries like tourism and hotel. Such provisions have greatly contributed to inflate the cost of production, making domestic products uncompetitive even in the domestic market. Industrialists argue that not only the individual cost of labor goes up 31 percent after providing permanent status to a worker, but there are evidences that the productivity of an individual remarkably decreases once he is made permanent because of the fact that he intends to do less work since he is not bothered of being fired.

For the laborers, the rigid law is barring them from widen their job prospects to raise incomes, as rigid provisions are baring new investments to set up factories or to expand existing production capacity. In fact, those industries that are in operation are also reducing their productive capacity because of the fact that they are constantly losing their competitiveness. As a result, the labor market is hardly expanding, thus no new opportunity is coming up. In fact job opportunities are getting squeezed in real terms if more than 325,000 fresh laborers that enter the labor market each year are taken into consideration. It is fueling unhealthy competition to retain jobs in the shrinking pie of domestic job market.

Even those laborers enjoying a permanent status in a factory have not seen their salaries and perks increased for years because the factory in which they are employed is struggling hard to survive because the goods it produces are no longer competitive in the market. The law also rigid to lay off workers as the process of discharging a worker is extremely difficult and estimated dismissal cost is equivalent to 90 weeks of wages, which is the highest in the world[5].

As a result, despite the fact that Nepal has one of the lowest labor cost per worker in the South Asian region providing it a competitive advantage for its products in the international market, it has the worst labor productivity when gauged in terms of unit labor cost.

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[5] Govinda P Regmi, "Nepal Five Background Studies: Labor," International Finance Corporation, May 2009

Nepal lacks credible literatures that quantify the actual cost of rigid labor regulations to the economy, but Nepal Enterprises Survey has reckoned that 9.28 percent of the firms recognized labor regulation as the main obstacle to additional investment after political stability and power shortage. It is well recognized that a reformed and flexible labor market is key to a friendly business environment because flexibility allows employers to change the quantity, quality and price of labor to reduce the cost of production and make their output competitive in the market. Therefore, there is almost unanimity to the fact that labor regulations should be redesigned in such a way that they protect the core interests of laborers and provide enough flexibility for investors.

Public Expenditure Management

Nepal's poor public expenditure management, which is causing a waste of scarce resources, running in billion of rupees, has also been a major stumbling block for accelerating development efforts. Various governments formed after the political change of nineties have constituted a number of commissions to recommend measures to ensure optimum utilization of public expenditure and streamline its management. Some of the recommendations were implemented, but with half-hearted commitments.

Low capital expenditure, which mainly finances development activities, comes on the top in the list of the major challenges that is wracking Nepal's public expenditure management. Though capital expenditure has also increased over the years, it is still below 35 percent of the total public expenditure and more worrisome is the fact that only 80 percent of the earmarked development expenditure is spent. According to a quick estimate, the gap between the earmarked and actual capital expenditure stands at around Rs 80 billion between 2001/02 to 2009/10.

If the huge loan investment that the government makes each year to loss-making public enterprises is deducted from the 'actual expenditure', then the expenditure that is used specifically for development activities would be much more less than what the government document claims. There are many causes for the low capital expenditure but the long-running practice of inducting development programs in the budget without detail feasibility study and extremely weak implementation capacity of government institutions are some of the prominent reasons why more than a quarter of the allocated budget remains unspent each year.

Similarly, increasing non-budgetary expenditure, a practice of expending state resources on activities that are neither enlisted in the fiscal budget nor approved by National Planning Commission due mainly to protracted political instability, is also weakening financial discipline and contributing for opaque financial transactions. Oddly enough, a recent study has reckoned that Ministry of Finance, the key ministry which is supposed to play an important role in maintaining financial discipline, has itself been exposed as the biggest abuser of non-budgetary expenditure. Though the amount of non-budgetary expenditure varies widely from year to year, knowledgeable officials say that such amount stands around Rs 4 billion on average during each fiscal year.

Likewise, the ongoing huge subsidy on petroleum products has also emerged as the biggest challenge in maintaining fiscal balance. It is disturbing that the scarce state resource, which should have been used in financing development activities, is being used to cover a monthly loss of Rs 2 billion in oil business just because successive governments have been failed to adjust domestic petroleum prices at par with international oil price. The government has already provided loan worth around Rs 17 billion rupees to cover the loss to bankrupt state-owned Nepal Oil Corporation. The million-dollar question is who is enjoying from such generous fuel subsidy?

Clearly, it is relatively better-off urban families that own vehicle, big hotels, restaurants, gas-run automobile operators and tourists that benefit from this subsidy regime[6]. Wastage of such a huge amount of money carries a big meaning for a poor country like Nepal in the sense that the amount could have changed fate of millions of people had it been used to finance infrastructure development projects, education and health. For example, the oil loss that the government has so far bore was enough to complete Sikta Irrigation Project, enabling farmers in mid-western region irrigate additional 42,000 hectares of cultivable land and switch to three harvest a year from single harvest at present. Or, with the amount, the government could have constructed one-third stretch of the four-lane Mid-hill Highway (1,776 km). The completion of the highway would have brought instant income and social benefits to about two million people and also opened up the prospect of developing hydropower projects in 16 places, tourism destinations in 15 places and housing and agricultural projects in 15 places.

The long presence of loss-making public enterprises is also putting a big strain on fiscal balance. Financial statistics of the Nepal's 36 PE's paint a gloomy picture. Though the total value of fixed assets was Rs 134 billion and the total equity investment stands at Rs 86 billion by the end of 2008/09, the rate of return was just 4.03 percent and the state received dividend worth Rs 3.74 billion in 2008/09. Total loan investment to those PEs stills stands around

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[6] Bimal Prasad Koirala, Former Chief secretary, The Kathmandu Post, February 2007

Rs 75 billion and the 18 PEs, which are running in loss, have no more social as well as economic significance[7]. Despite such a pessimistic performance, the government is still making fresh investments and extending loans to sick enterprises. The government made a total investment worth of Rs 7.50 billion in 2008/09 to public enterprises where such investment went up to Rs 14.2 billion in 2009/10.

The cost of resisting reforms

Resistance is probably the first encounter that economic reform initiatives face, much before going to implementation because there is always a bias toward the current situation and against taking the risk of change. No matter how positive the outcome may be. Undoubtedly, a strong political leadership and political stability are the most crucial factors that a country needs, not only to initiate economic reforms but also to withstand resistances, and economic hardships and controversies that most of the reforms bring in the short-run. However, country experiences have demonstrated that economic reforms ensure broad-based, stable and participatory economic opportunity like in India in the long run. Political stream being a complex entity, its economic policies are affected largely by factors like level of general economic development, public opinion, international events particularly development in comparable and neighboring countries, and campaigns from interest groups[8].

Almost all the elected governments come to power with agenda of economic development and welfare schemes but with little knowledge or no idea how to initiate policy implementation to achieve improve

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[7] Expenditure Review Commission Report, Ministry of Finance, 2066

[8] Johnney Munkhammar, “The Guide to Reform” Timbro Publishers, 2007

growth, incomes, employment, social security, and general living standards[9]. So, in that situation, independent think tanks, media and civil society can play a big role in creating a conducive environment for greater public debates for policy advice. This can also act as a powerful tools to educate people about the need of reforms and what we are losing in the absent of reforms. But, the government plays the most crucial role in deciding whether or not to pursue the complex path from idea to political agenda to decision and to implementation.

However, despite have glaring examples in the neighborhood how they adopted economic reforms and accomplished enchanting economic outcomes by uplifting millions of people out of poverty, why the successive governments in Nepal is not learning from their success ? Why the governments in Nepal have failed to understand the fact that reforms are the actions that are implemented to remove obstacles to progress and wealth creation by producing more value per hour worked. Despite the strong faith that Nepali have shown toward democracy, why democracy in Nepal has constantly failed to bring much-desired economic change for the people that brings new job opportunities for commoners and new business entrepreneurs? The straight answer to the question is the political resistance to economic reforms, which is depriving the country and its people of the economic opportunity that Nepal can create by ensuring the optimum utilization of the resources.

The government was happy to take a huge loan worth Rs 5 billion for financial sector reform to prevent a possible banking crisis but was least interested in compelling the bank defaulters to repay the loans. The leaders showed no hesitation in dumping the multi-million rupees reform program just because it attempted to crush interests

[9] Bimal Prasad Koirala, Former Chief secretary, The Kathmandu Post, February 2007

of some notorious business houses, reliable sources of party funding. None of the political leader bothers to think about the cost that the economy is bearing as the result of demise of the reform initiatives. Oddly enough, no major political parties were found talking explicitly about economic reforms in their election manifestoes announced for Constituent Assembly. No major political leaders have recently been heard expressing concern over the weak monitoring and supervision capacity of the central bank and rigid labor law that is distracting potential investments worth billion of rupees each year.

They hardly care about the ballooning financial risk that is ticking like a time bomb due to weak regulatory capacity of the central bank that is also obstructing a planned expansion of banking services in the rural areas. As a result, access to formal financial services in Nepal is lowest in the region with less than 26 percent Nepali households having a bank account, 45 percent of these households preferring to save at home and only 15 percent of households taking loans exclusively from formal sectors[10]. Fuelled by a number of hidden costs, the cost of borrowing is highest in region and informal money lenders still dominate the market, particularly in the rural areas. In addition, the weak supervision capacity of the central bank has also risked losing billions of lifetime deposits of commoners held at the urban financial institutions.

Leaders have been told thousand times that rigid labor regulation is obstructing to adjust workers as per the demand and fueling cost production, making domestic products uncompetitive in the home market. The unfortunate demise of Nepal's largest exporting woolen carpet industry, the largest labor-intensive and one of the

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[10] Aurora Ferrari,Guillemette Jaffrin and Sabin Raj Shrestha , "Access to Financial Services in Nepal, The World Bank

two largest exporting industries of Nepal, is the glaring example of devastating impact of inflexible labor law. The inflexible labor law is forcing hundreds of industries to shut down, as they no longer have a competitive edge against cheap Chinese imports. Leaders are turning their deaf ears toward the repeated pleas to tackle inflexible labor law that is distracting potential investment worth millions of rupees which could create thousands of additional employment opportunities. Leaders extend their half-hearted support toward attempts to reform the law because they enjoy keeping the politically influential trade unions under their auspices so as to use them for political maneuvering.

Political leaderships are less interested in paying attention to the fact that reforms in public expenditure can save billions of rupees, which can be invested in rural infrastructures to create jobs for thousands of voiceless youths. Sadly, they are pleased to provide subsidy worth billions of rupees on petroleum products, which is mostly consumed by those section of society who doesn't need state subsidy to buy petrol or cooking gas. But, resist attempts to revise oil prices at par with international prices because they have no guts to take any action that might irritate influential dwellers.

And, its impact on democracy

Economic development transfers a society in several ways that makes it more difficult to sustain the concentration of power in one man, one party or narrow, unaccountable elite[11]. Countries that have gone through massive economic reforms experienced that initial phase of reforms would be so crucial and challenging that their tactful management largely determine how long and how effectively reforms

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[11] Larry Diamond, "Sprit of Democracy", Times Books , 2008

can be implemented. For instance, majority of reforms begin with withdrawal of state subsidy to curtail bloated fiscal deficit, a common financial ill of closed economy and market deregulation to lure private investments. Subsidy withdrawal immediately hurts lower section of society that comprises a sizable chunk of the population of least developed countries. As a result, it would be difficult for democratically elected governments to defend and to cope up with the contradictions that people see on the ground, since majority of them come with pledges of increased welfare to lower section during the election campaign.

Similarly, when market is deregulated those who have access to capital and skill to do business will first come to take risky ventures in newly opened opportunities and reap benefits, often more than in normal situation. And obviously, rewards first come to habitants of urban areas, which is equipped with basic infrastructures like market and power, among other, and they enjoy a tangible surge in their incomes. As a result, urban dwellers get new opportunities to raise their living standards whereas majority of the people living the rural areas see no change even during the post economic liberalization period.

Nepal's own experiences also portrait more or less similar picture. When the democratic government formed after the 1990 political change initiated massive economic reforms, it was first greeted with rising economic growth and expansion in the initial years, but thereafter it was blamed for creating disparity between rich and poor. During the first five years of reforms, Nepal achieved a five percent GDP growth on average and its economy expanded accordingly. There was an impressive reduction in poverty, as the proportion of the population below the absolute poverty line declined to 30.8 percent in 2004 in from 42 percent in 1996 and during this period, per capita income increased by 1.7 percent. The reason: The initial phase of reforms that was focused mainly on privatization and financial sector reforms generated new opportunities and even windfalls for upper-income groups, who had wealth, right political connection and, of course, entrepreneurship.

The architects of reforms were in expectation that when economic activities at the city center expand, it would create numerous economic opportunities, and would gradually spill over to rural areas, benefiting rural mass. However, what they failed to understand was the fact that rural area without the basic infrastructures, like power and road connection, was in no position to grasp the opportunities, sprouting at the cities. The democratically elected governments paid much less attention in allocating enough resources for infrastructure development in the rural areas; rather they were too focused on meeting needs of influential urban populace to secure votes for the future elections.

It was the lack of basic infrastructure that obstructed much-anticipated trickle down effect to rural area from urban areas and that resulted in an accumulation of wealth, means of production and opportunities within the core city area. For instance, even after the one and half decade of adopting liberal economic policy, the Kathmandu valley, which had only 7 percent of Nepal's population in 2008, was consuming 45 percent of the total electricity generation, using 75 percent of all fixed telephone lines and 90 percent of the mobile phone connections, and accommodating 90 percent all cars and 80 percent of all motorcycles[12]. The uneven distribution or availability of economic opportunities also contributed to widen the income inequality between the urban and rural populace. The income inequality, measured in terms of Gini Coefficient,

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[12] Sujeev Shakya, "Unleashing Nepal: Past Present and Future of the Economy," Penguin Books, 2010

increased to 0.34 in 1996 from 0.24 in 1996 again to 0.41 in 2004, though there was an 11 percentage point decline in poverty between[13].

Though the periodic development plans unveiled by the democratic governments talked in length about the plan to develop rural infrastructure and did allocate handsome amount of resources for that purpose. However, the actual achievement on rural infrastructure development remained far less than the target set. For example, the Tenth Plan had set a target to construct roads to connect 10 districts headquarters and to construct additional 220 bridges by 2007/08. But during the five-year plan, it was able to establish road connection to just 3 district headquarters and constructed only 112 bridges. The assessment of the plan blamed budget constraints for the pessimistic progress made in rural infrastructure, as the governments failed to mobilize required resources form both internal and external sources.

Though resource mobilization might have been less than targeted, the reality, however, is that the country is wasting billion of rupees each year just because of strong political resistances to economic reforms. Speeding up financial sector reform can increase financial accessibility of rural populace to formal lending channel, at least halving the cost of borrowing. Labor Law reform can lure huge domestic as well as foreign investments and generate thousands of jobs for the rural mass. Ending nonsense subsidy on petroleum products, privatizing or scraping loss-making state owned enterprises, checking huge non-budgetary expenditures can save billions of rupees each year from the state coffer and that can be invested in rural infrastructure developments.

Political leaders ignored the fact that well planned economic reforms that ensure new opportunities for earnings for rural populace were

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[13] Shiva Sharam, "Income Inequality in Nepal", United National Development Program

crucial in maintaining the credibility of the democratic governments among populace at large. Where new elected government fail to adopt coherent reforms and economic crisis deepens, the credibility of the government and democratic processes more gradually erodes[14]. That was actually what happened in 1996. The failure of democratically governments formed after 1990 change to deliver economic opportunities to coincide with a rapid rise in public awareness, resulted in deep-seated anger and frustration toward political system, paving a way for anti-democratic forces to instigate frustrated and annoyed people, who were not lucky enough to grasp opportunities unveiled by reforms, to united in protest against democratic system. The Maoists' movement was not a temporary phenomenon without social bases, but had roots deep in the country's social and economic order, and a by-product of unsuccessful development endeavors[15].

The Maoists were the one of such forces that tactfully used public frustration and anger and instigated the jobless rural youth that democracy is only for rich people, but it is the worst system of governance for poor and rural populace. It took no time for the rural youth, who had experienced a dire rural-urban gap in terms of economic opportunities and had not felt any economic change in their personal life for years, to be ready to take up arms to topple the democratic system and to form a communist state that ensures 'equal society free from poverty.' As a result of general erosion of faith in the capacity of democratic governments to manage the economy and deliver new opportunities, the rural youth of Eastern Nepal lured

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[14] Larry Diamond and Marc F Plattner, "Economic Reforms and Democracy" The Johns Hopkins University Press, 1995

[15] Deepak Thapa, "Kingdom Under Siege: Nepal's Maoists Insurgency, 1996 to 2004," The Print House, 2004

toward authoritarian solutions to meet their end needs and explore opportunities for prosperity.

The ten years of conflict that claimed 14,000 lives, have done immeasurable damage to Nepal's economy, society and culture. According to an estimate, the total cost of infrastructures destroyed or vandalized in 1841 VDCs during the ten-year armed conflicts was Rs 30.55 billion[16]. Similarly, the total spending on security forces during the ten years of insurgency totaled whopping Rs 107.8 billion, enough to generate 625 MW of power[17]. It is estimated that conflict cost of the nation was 2.5 percent of the GDP growth per annum since the escalation of violence from 2000[18].

Summing up

The literature argues that any attempt to foster and consolidate democracy by preventing possible rise of anti-democratic forces, or by a return to autocracy, will remain a pipe dream as long as the state or the government fails to give people a sense of economic prosperity. And broad-based and participatory economic reforms that not only harmonize development priorities with available resources but also unveil opportunities for the rural populace are the most powerful means to raise the quality of life in a least developed country like Nepal. However, success of the economic reforms in accelerating development efforts largely depends on how effectively a country can overcome political, bureaucratic and institutional resistance to reform.

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[16] Suraksha Bina ko Suraksha Kharcha, Himal Khabarpatrika, Feb 2005

[17] Sujeev Shakya, "Unleashing Nepal: Past Present and Future of the Economy," Penguin Books, 2010

[18] UNHCR Nepal Factsheet, November 2008

CHAPTER II

Macroeconomic Stability
A New Approach For Fiscal And Monetary Policy

- Dr. Dandapani Paudel

INTRODUCTION

Google search on macroeconomic stability says it is a situation in which a country has low inflation accompanied by falling budget and trade deficits and a low rate of expansion of the money supply. Obviously, price stability, sustainable and higher economic growth, prudential fiscal and monetary policy, sustainable debt burden, public private partnership, inclusive employment opportunities and poverty reduction, etc, should be the major theme of the macroeconomic policy in practice. In other words, an ideal situation of demand – supply equilibrium which mitigates the rising price effect shows the stability in the economy. However, the factors affecting the macroeconomic stability may differ with the structure of the economy like free market, controlled regime, so-called communist dogmatic system and mixed economy. In a free market economy though, it is a relative term rather than a purely market based economy in practice where the market decisions have free hands to make the economy more stable or vice versa. In a controlled economy, the market decisions are at least not perceived by the policy makers so that only the policy of the government is solely responsible for maintaining macroeconomic situation. In a mixed economy, the ideal situation is the interplay of market forces and the government policy, where the economy can shape its position and performance. Similarly, in the present context the factors affecting the macroeconomic stability depend more sensibly whether the economy has adopted open capital accounts or not. There are lots of evidences in different economies in adopting the economic structure and policies for their (un)successful experiences in reaping the growth and stability benefits. At the level of macro policy, the key elements for restoring the growth momentum are successful fiscal consolidation, the evolution of a more flexible, market-responsive exchange rate policy and a supportive monetary policy (Acharya, 2001).

Macroeconomic stability is at the core for every country while formulating the policy and the basic fundamental in evaluating the economic performance, and also in creating the investment friendly climate both for the domestic and international investors. In other words, macroeconomic instability may hamper growth potentiality in the long term with the disincentive phobia among the investors. For improving the macroeconomic stability, most of the emerging economies have placed emphasis from import substitution to export promotion due mainly to two successive oil shocks, persistently high global inflation, the collapse of the Bretton-Woods System, wide spread recession in view to promote economic efficiency, capacity utilization and growth (Paudel, 1994).

Bretton Woods Initiatives

The International Monetary Fund (IMF) and the World Bank are the first twin organizations which represent an important attempt in the history of economics to apply scientific conception of economic forces to the world economy through their stabilization and structural adjustment programs (SEN, 1999). As such, IMF focuses on stabilization programs for a short and medium term through monetary side whereas World Bank deals with structural adjustment programs through real economy for the macroeconomic management and stability of the member countries.

The major differences between the IMF and the World Bank

In terms of	The IMF	The World Bank
Characters	Monetary Institution	Developmental instiitution
Orientation	Demand side of the economy	Supply side of the economy
Goal	Monetary stability Financing temporary deficits in the economy	Promotion of economic development Financing economic development
Credit	Providing program lending to all members- both industrial and developing countries	Providing project lending to developing countries
Credit-term	Short-term / medium-term	Long term

SEN : 1999, p.2

Review of Past Efforts

The IMF and the World Bank had not only prescribed the stabilization and structural adjustment program but also supported to the least developed and developing countries in this regard. Nepal's macroeconomic management had been envisaged towards liberalization from mid-1980s which was further liberalized in early 1990s. Nepal has never recorded a positive trade balance in its history, based on the available data. As such, the increasing trend in the remittance income, from the recent past, among others, remained in assisting the current account surplus and also a surplus in the balance of payments

(BOP) accounts in many occasions. But the increasing trend in trade deficits alarmingly contributed in pushing macroeconomic instability. Obviously, the liberalization efforts certainly had helped reap the reasonable high growth in the economy in the 1st half of 1990s, which was adversely affected by internal conflict caused by the Maoists insurgency. The communists were nurtured by one party Panchayti system led by the dictatorial kingship. They had philosophical proximity in undermining democratic forces. This was the root cause for Nepal lagging behind in the economic development. The concern of economic development with sustainable macroeconomic stability was never placed as a main agenda but a formality for periodic planning concept in Nepal. However, most of the policies and strategies in all the development plans were commendable in spirit but failed in the implementation process. Despite the low economic growth and alarming trade deficits in the past, the country's macroeconomic indicators looked favorable flittingly due to the foreign assistance for one project or the other.

Donors' Supported Programs and Policies

The macroeconomic instability caused basically through larger fiscal deficits, overvalued exchange rate, declining exports, sluggish economic growth among others, was attempted to correct by adopting the stabilization measures for the short run through demand compression and supply inducing measures for the medium to long term, which was a common pill prescribed by the IMF and the World Bank. As such, the Structural Adjustment Program (SAP) was implemented in 1987 in Nepal. In line with the spirit of economic liberalization, the financial sector was further liberalized and the 2nd phase of the

SAP known as Enhanced Structural Adjustment Facility (ESAF) was implemented in 1992 in order to incentivize private sector.

In view of restructuring and reforming (i) financial sector, (ii) public sector, (iii) governance and, (iv) private sector's development based on the poverty reduction strategy paper (PRSP) (which was the tenth plan document), Nepal took the poverty reduction growth facility (PRGF). PRGF is a concessional but conditional credit from the IMF effective from 2003. This PRGF program was in line with the Nepalese macroeconomic restructuring, economic growth through social sector policy and the broader concept of poverty reduction aiming at maintaining sustainable macroeconomic stability. In view to implement the PRSP, which was the core theme of the 10th development plan, among others, basically focused on (i) generating economic growth, (ii) improving service delivery, (iii) promoting social inclusion, and (iv) improving governance, Nepal took part in 2003 in the poverty reduction support credit program (PRSCP) initially developed by World Bank for Uganda and Vietnam which resulted in an exemplary experience.

Nepal aiming at breaking the vicious circle of low growth, pervasive poverty, and insurgency, with a comprehensive reform agenda based on the PRSP entered into the PRGF program with Special Drawing Rights (SDR) of 50 million in 2003. The PRSP was intended to push up the growth rate followed by the poverty reduction with the set targets. The strategy in the PRSP included a four pillars framework of broad-based economic growth; social sector development; targeted program for the poor and deprived groups; and good governance. The policy actions in achieving the targeted goals were focused on macroeconomic stability; structural reform; sectorial policies; social sectors; and targeted poverty reduction.

The PRGF supported program as the medium-term framework focused on:

- The higher growth in view to help reduce poverty;
- Implementing fiscal strategy in mobilizing revenue, prioritizing expenditure, and reducing domestic financing;
- Reforming the financial and public sectors for improving intermediation and resource allocation; and
- Improving governance in reducing corruption, increasing accountability, and enhancing implementation capacity.

Similarly, the government of Nepal has had implemented the economic reform program with the economic reform technical assistance (ERTA) of International Development Association (IDA Grant) of the World Bank of US$ 3 million since 2005/06 which mimicked the earlier PRGF objectives. The Asian Development Bank (ADB) under governance reform program (GRP) and public sector management program (PSMP) has had supported some reform programs.

Nepal also entered into the financial sector reform program supported by the World Bank and DFID aiming at improving and strengthening the highly problematic government owned commercial banks and Nepal Rastra Bank (NRB), the central bank of Nepal, in view to enhance the financial sector stability which was undoubtedly remained a crucial part for economic stability. As such, all these programs together with the internal reforms in terms of structures, acts and regulations in the major macroeconomic fields have been initiated during the review periods which to some extent have revealed some positive trend in safeguarding the overall economy.

Stability Indicators and Poverty Analysis

Among the various sensitive indicators in measuring the macroeconomic stability, the Maastricht criterion has focused on low and stable inflation, low rate of long term interest rate, low national debt relative to GDP ratio, and currency stability as the major indicators in assessing and measuring the economic stability. It is but natural that all Maastricht criterion based in the context of developed economies might not fit well to Nepal's context which bears a bottom line status of the least developed economy. However, one can easily refer the Maastricht criterion as the basic benchmark to evaluate and assess the macroeconomic stability for all types of economies, if the policy makers would dare to take ethical and moral steps.

It is a preconceived notion that Nepal through the liberalization efforts has had pitched some positive signals in many areas, but because of the internal conflict and the unstable political environment, including the overall micro/macro economic situation, deteriorated from every corner to take smooth momentum in the economic stability. The maximum public initiatives, however, surrounded forcefully to safeguard multiparty democracy even though with anti-democratic threatening. Virtually, the remittance income earned by the Nepalese workers working abroad has had a tremendous impact for the sustainability of the Nepalese economy. If one observes the using patterns of the remittance income most of the parts have been used for consumption purpose, and most of the consumption was imported. Looking at the ever increasing alarming trade deficits, the role of remittance income in the economic growth could not be ensured since such income does not contribute in investment part. It is difficult to deny with the argument that remittance income certainly has helped to reduce the number of people below the poverty line but unfortunately helped increase the cost of land and building prices and the import of costly vehicles, among others. The general poverty is a relative concept whereas below the poverty line is a defined concept based on a certain level of income. The major components in the poverty concept include the incidence, the inequality, and the intensity. It is mostly an acceptable fact that Nepalese like poverty is inter-generationally transmitted through capital and other assets. Comparing the income and poverty indices,that income poverty is volatile as compared to the human poverty in Nepal (Acharya, 2004).

Population Below the Poverty Line

Development Plan	Target in %	Achievement in %	Gini Coefficient	Survey
8th Plan	42	41.76	0.342	NLSS-I 1995/966
9th Plan	32	38	-	-
10th Plan	30	30.85	0.414	NLSS-II 2003/04
TYIP	24	25.4	0.460	TYIP
TYP	21	-	-	-

Source: Plan Document and Economic Surveys

Looking at the progressive trend of the people living below the poverty line, remittance income and its multiplier effect has shown some positive trends. But unfortunately the disparity in income inequality between the haves and have nots has been more intensely skewed (The Gini-coefficient is a barometer to test income disparity, which reveals the early warnings that the richer are becoming richer while the poorer are becoming poorer). In a free and liberalized context, it is the basic duty of the government to provide equal opportunities to all but without being biased nor providing free lunch to people without work. It is not only a theoretical challenge but also an acid test to those who advocate the so-called state controlled regime as a progressive philosophy, though which has been a failure in the global context.

Among the major available indicators of macroeconomic stability, the Maastricht criterion, although not exactly be replicated to Nepalese context, could be a good reference or guidelines in building ethical and moral standards for economic stability. Nepal has a pegged exchange rate system with India whereas the major currencies have a flexible exchange rate which has undoubtedly cast a shadow of the currency we are pegged with. India has been gradually and sequentially liberalizing its capital account convertibility (CAC), wherein Nepal is far behind towards this strategy. Nepal may face an unexpected high cost if India fully opens up its CAC. So Nepal should work out sufficiently in time with reference to pegged system. The currency stability criteria which was very high in the partial liberalization period was one of the main reasons for the weak strength of the peg currency in general, and also a reason for the lack of full-fledged liberalization inside the country in particular. Moreover, the overall average of Nepalese currency stability represented with the US Dollars is more than double with Maastricht criteria which may suggest to further alliance with major currencies with a solid backup impact analysis of the pegged range.

Another stability indicator is the long term interest rate for a sustainable development. For this, the government development bond (DB) rate has been a prosy to compare the standard criteria. As such,having a higher growth with positive liberalization impact in the former period has had a higher long term interest rate definitely compatible with other macroeconomic indicators. However, the overall average of Nepalese government development bond rate during the review period was marginally higher than the referred rate.

Major Indicators in Measuring the Macroeconomic Stability

Year	Currency Stability	% change	5 Years Average	LT Interest Rate DB	5Years Average	Budget Def / GDP %	5Years Average	Inflation	5Years Average	Total loan/ GDP%	5Years Average
1988/89	25.63										
1989/90	28.64	11.74		10.50		8.10		11.50		49.80	
1990/91	31.95	11.56		10.50		8.80		9.80		66.70	
1991/92	42.69	33.62		10.50		7.50		21.00		62.90	
1992/93	45.65	6.93		10.50		7.00		8.90		65.80	
1993/94	49.25	7.89	14.35	10.50	10.50	5.80	7.44	8.90	12.02	66.60	62.36
1994/95	49.94	1.40		10.50		4.80		7.60		66.20	
1995/96	55.21	10.55		11.00		5.60		8.10		65.20	
1996/97	57.02	3.28		11.00		5.10		8.10		59.90	
1997/98	61.95	8.65		12.00		5.90		8.40		66.40	
1998/99	67.95	9.69	6.71	12.00	11.30	5.30	5.34	11.40	8.72	64.10	64.36
1999/00	69.07	1.65		10.50		4.70		3.50		64.40	
2000/01	73.83	6.89		8.00		5.90		2.40		63.30	
2001/02	76.88	4.13		10.50		5.00		2.90		69.50	
2002/03	77.79	1.18		8.00		3.30		4.80		67.40	
2oo3/04	73.79	-5.14	1.74	8.00	9.00	2.90	4.36	4.00	3.52	59.40	64.80
2004/05	72.06	-2.34		8.00		3.10		4.50		52.10	
2005/06	72.32	0.36		6.80		3.80		8.00		50.30	
2006/07	70.49	-2.53		6.80		4.10		6.40		44.00	
2007/08	65.02	-7.76		8.00		4.10		7.70		44.90	
2008/09	76.88	18.24		9.00		5.00		13.20		40.30	
2009/10	77.14	0.34	1.05	9.00	7.93	3.90	4.00	10.70	8.42	40.30	45.32
Overall Average			5.96		9.68		5.28		8.17		59.20
Maastricht Criterion*			2.50		9.00		3.0		3.00		60.0

Source: Various Economic, Surveys, MoF /Quarterly Economic Bulletin, NRB. * reut-institute.org/publication.aspx

The budgetary deficit as a percentage of GDP is the core concern for macroeconomic stability. It is but natural that without any biased classical Keynesian view, if the higher budgetary deficits could be mobilized for the development / capital expenditures, it could be regarded as positive achievement elsewhere. As such, the budgetary deficits were higher in the earlier period which could easily be justified if one compares the overall infrastructural and social development indicators during the referred periods. On the whole, the budgetary deficit in case of Nepal was nearly double on average than the Maastricht set rate of 3 percent. However, as mentioned earlier, one should not worry with the higher deficit rate if it could reveal the reciprocating development results which was not really translated into practice during the later period of the study compared to earlier period which might be partially justified just because of heavy security expenditure due to internal conflict and its pass through effects, among other things.

As other indicators, the inflation rate was also higher in the earlier period which was in line with the higher economic growth, higher interest rate, among others. But the higher inflation during the recent past years could not be justified looking at the gloomy trend in other macroeconomic indicators. However the central bankers, which are responsible for controlling inflation in coordination with the fiscal authority, are not very much transparent to convince the public in the event of unnatural movements in the inflation. Anyway, the review period analysis shows that the overall average inflation of Nepal is more than three times the compared criteria.

For the least developed countries like Nepal the national loan to GDP ratio which as referred to the given criteria has remained in a safe side. Looking at some of the indicators,it is likely that Nepal would be eligible in achieving the facility provided to the highly indebted poor countries (HIPC). Basically, the HIPC's initiative is to reduce the external debt burden of eligible country to sustainable level. This initiative is limited to countries which are eligible for PRGF and International Development Association (IDA) loans with the conditionality of:

- Established strong track record of policy performance under PRGF and IDA - supported program; and
- Being not capable in achieving a sustainable debt situation even after using fully the traditional debt relief mechanism.

The conditions for the eligibility of assistance under this program include (i) unsustainable loan burden, (ii) adopted the reform policy as guided by IMF and the World Bank and (iii) prepared PRSP. Also the debt sustainability analysis for the eligible member country is evaluated on the basis of the following numerical targets.

- Net present value (NPV) debt/exports > 150 percent
- NPV debt/revenue > 250 percent
- Export/GDP ratio < 30 percent
- Revenue/GDP < 15 percent

Though it is likely that Nepal be recognized as HIPC, it has to weigh pros and cons properly before applying for such a status, because some of the major donors would not provide further support to the country which has received facility under HIPC.

Additional Indicators for Stability

As mentioned earlier, there are some more sensitive indicators which might have direct/indirect role to play in maintaining macroeconomic stability. As such, the positive real interest rate is a crucial factor in mobilizing all categories of savings which is deemed necessary for inducing investment in the desired productive sector to enhance economic growth and employment generation. But in Nepal's case, may be due to lack of other financial assets in the past, financial sector was able to monopolize the financial savings. But unfortunately with the fact of statistical support not only the illiterate and innocent ordinary people but also the intellectual so-called elites have been ignoring the positive real returns on their savings which is the fundamental basic philosophy of tying up of inflation with wages and salary all over the world. It is undoubtedly a surprising fact that how the saving mobilization and mushrooming growth of the financial saving institutions have been sustaining their feasibility status with no more empirical facts in contributing the overall economic stability.

The real economic growth which was on average about 5 percent in the earlier period, which was attributed by many development indicators came down to less than 4 percent in the latter period. For this, the major factor was political instability and internal conflict, which could not maintain a development tempo as initiated in the earlier period.

The concerned authority in Nepal has not been publicly informed with latest updating about the net effect of the impact of monetary growth to inflation and others. It is also an interesting fact that there is no an authoritative views on how much the impact and effect does have the monetary growth in the inflation, and thereby, on economic stability. However, containing inflation is the basic goal of monetary policy the growth of money supply should have a direct impact on the inflation. Also being an import-base economy, the imported price inflation does have some impact in the Nepalese price movements. But it has never been authoritatively assessed and analyzed and made public that how these factors are responsible in price volatility and its impact on the whole macroeconomic stability.

Similar is the case that the merchandise trade deficit as a percentage of GDP remains a very sensitive factor, if the imported commodities should not have a positive role as an input for productive value addition in the domestic economy. For example, Malaysia has been successful by the traditional model of using natural resources with efficient use while Singapore has proven its success with the ideas and innovations based on the imported inputs. But in the Nepalese case, most of the imported items are mostly for consumption purpose rather than for productive purpose. Therefore, the ever increasing and alarming trade deficit has remained a crucial factor for the increasing macroeconomic instability.

Review and New Approach for Fiscal Policy

The basic synthesis of the fiscal policy is to promote growth facilitation and to reduce income disparity and income redistribution through tax policies and expenditure allocation. There have been lots of reform efforts in the fiscal policy front in terms of institutions, compliance, computerization, incentive for motivation, among others, but still there are big rooms left to reform. In view to prioritize the important projects, Nepal has categorized the projects into P1 / P2 / P3 levels so that the projects as identified with top priority should not be suffered due to resource crunch. Similarly, Nepal also developed the medium term expenditure framework (MTEF) in view to enhance the efficiency of the expenditure patterns. However, there is no scientific base in forecasting / estimating revenue and expenditures rather they have planned on ad hock basis,and if one compares them as a ratio

Additional Indicators for Measuring Macroeconomic Stability

Year	Inflation	5 years Average	One year Deposit rate	5 years Average	Real Interest	5 years Average	Real GDP Growth	5 years Average	Broad money (M2) Growth	5 years Average	Trade Deficits/ GDP %	5 years Average
1989/90	11.50		11.75		0.25		4.60		18.60		12.70	
1990/91	9.80		11.75		1.95		6.40		19.50		13.20	
1991/92	21.00		12.00		-9.00		4.10		21.10		12.20	
1992/93	8.90		12.00		3.10		3.90		27.70		12.80	
1993/94	8.90	12.02	8.80	11.26	-0.10	-0.76	8.20	5.44	19.60	21.30	16.20	13.42
1994/95	7.60		9.00		1.40		3.30		16.10		21.10	
1995/96	8.10		9.00		0.90		5.30		14.40		22.00	
1996/97	8.10		9.50		1.40		5.30		11.90		25.30	
1997/98	8.40		9.75		1.35		2.90		21.90		20.40	
1998/99	11.40	8.72	8.60	9.17	-2.80	0.45	4.50	4.26	20.80	17.02	15.20	20.80
1999/2000	3.50		6.75		3.25		6.10		21.80		15.50	
2000/01	2.40		6.12		3.72		5.50		15.20		14.60	
2001/02	2.90		5.25		2.35		0.20		4.40		14.30	
2002/03	4.80		5.00		0.20		3.80		9.80		16.30	
2003/04	4.00	3.52	4.25	5.47	0.25	1.95	4.40	4.00	12.80	12.80	16.60	15.46
2004/05	4.50		3.60		-0.90		3.20		8.30		13.10	
2005/06	8.00		3.60		-4.40		3.70		15.60		14.70	
2006/07	6.40		3.60		-2.80		2.80		14.00		15.20	
2007/08	7.70		4.25		-3.45		5.80		25.20		16.50	
2008/09	13.20		5.75		-7.45		4.00		27.70		18.90	
2009/10	10.70	8.42	6.75	4.59	-3.95	-3.83	3.50	3.83	26.50	19.55	28.40	17.80

Source: Various Economic, Surveys, MoF /Quarterly Economic Bulletin, NRB of GDP there is an increasing trend, which favors policy makers in claiming good performance. But it is not analyzed from the point of view that whether it was because of the low GDP growth compared to revenue/expenditure growth. Such targets setting are normally based as a percentage of GDP on the basis of tax potentiality and taxable capacity of the people.

Being a member of the World Trade Organization (WTO) and with agreed commitments, the import base revenue collection as in the past may not be feasible until and unless Nepal could aggressively move towards export promotion with market diversification. From the recent past, the emerging and potential item in the Nepalese tax structure is the value added tax (VAT) but unfortunately very recently it has been facing the largest ever scandal of fake billing of a significant amounts,which needs immediate strong actions against the culprits. Otherwise, the VAT contribution in the total revenue cannot be ensured. Also the VAT could be expanded in many areas to make it more vibrant. The direct tax basically the income tax which has a close correlation with the income level of the people which obviously needs the higher and a broader base economic growth with employment generation. The excise duties including other tax and non tax items should have to be rigorously analyzed with their potential capacity in broadening the revenue network.

The sensitive issues raised by the tax payers are mostly related with proper use of the tax that they have paid on the related field, otherwise the time may come when tax compliance would be very low. For example, the vehicle users are paying the sizable tax in the name of road tax but not even in the capital city a single road is in a usable condition. Similarly, the polluters' tax can be introduced more effectively in controlling the ever increasing pollution, for this even many tourists who travel to Nepal happily will pay some additional duty if they could enjoy a clean and green environment in Nepal. Similarly, Nepal, with minor success until now, would have to make herculean effort to meet the targets of MDGs within a short period of time. Several times announced and prioritized economic diplomacy has remained nobody's responsibility, which could be effectively used for trade expansion and investment generation.

Nepal has already promised to move into federal structure, which needs the new fiscal federalism on a sustainable base looking at the size and demographic composition of Nepal's population and economic strength. Even during unitary system, Nepal has always remained at the verge of economic collapse, in such a situation 7 to 14 states could move Nepal into further flailing or failed state. That's why Nepalese political parties and so–called professional experts should have to think for the economically sustainable federal states which should not be more than 3 to 4 states with having north to south demographic corridors. Similarly, the main agenda of the new fiscal federalism should have to focus on the economic power sharing, new taxes on the new context for the sustainable economic structure.

Review and New Approach for Monetary Policy

The Nepalese monetary policy framework for the last many years has been setting its objectives in attaining (i) price stability, (ii) financial sector stability, (iii) balance of payments surplus, (iv) broad based economic growth, among others, as the final targets. In achieving these major targets NRB has been using monetary aggregates as intermediate targets due mainly to the stable demand for money function in relation to income and prices. Obviously, intermediate targets are selected on the basis of the central bank's confidence in relative controllability and predictability together with a significantly more valid economic relationship with the major targets. In achieving the major targets through the comfortable tracking of the intermediate targets, the NRB as a central bank has been focused on the operating indicators like the excess reserve of commercial banks or short term interest rate through the monetary policy instruments like (i) Cash Reserve Ratio(CRR)/ Statutory Liquidity Ratio (SLR), (ii) bank/refinance rate and (iii) open market operations (OMOs), which are known as the indirect monetary policy instruments. As such, looking at the operating targets, one cannot deny with the argument that monetary policy in Nepal has explicitly being used as a tool to liquidity management.

As a quick review, for the last many years with so much of concessional attitude also, the bank/refinance facility has remained the least effective instrument which has virtually remained like a ceremonial theoretical tool of monetary policy in Nepal. The CRR/SLR, which by nature are not very short term phenomenal instruments like in the developed context. Not only in normal situations but also in the abnormal situations the NRB has not been considered to facilitate the problematic situation of liquidity crunch to set some legal limit and pay for the amounts above the set legal limit which has a direct impact on raising the intermediation cost of the financial sector. As such, the mushrooming growth without the back up support on the basis of situational and symmetric analysis, the Nepalese financial sector may have to face an uneven path of sustainability.

As mentioned above, the OMOs to some extent has been a successful instrument for the purpose of liquidity management. Since all of the available monetary policy instruments could not be equally effective enough, the final targets cannot be achieved fully. It could be that there is some fundamental driving force that has reduced state ownership of commercial banks' assets, introduction of explicit deposit insurance, improved monetary policy efficiency and macroeconomic stability all at the same time (Cecchetti, S. G. and Krause, S. 2001).

The monetary policy can attribute to the overall economy if its transmission mechanism is more efficient and effective. The monetary transmission mechanism shows the channel through which a change in monetary policy affects the economy. Similarly, it also shows the choice of monetary policy rules to guide central bank decisions. Number of empirical studies have found that the monetary policy can have short-run effects on real variables such as output while in the long-run, monetary policy has no effect on output but merely on prices. It is common to all that monetary policy affects the real sector with long and variable lags whereas its short-term implication can easily be observed in financial markets. The monetary policy effect is transmitted to other sectors through the transmission process of (i) interest rate channel, (ii) exchange rate channel, (iii) credit channel, and (iv) asset price channel (Paudel, 2002).

Interest rate channel : It reveals that the present value of capital and durable consumption goods is negatively related to the real interest rate, which is also the marginal efficiency of capital function. A lower real rate of interest implies a higher present value of existing durable goods. In a highly inflationary economy, the interest rate channel loses its strength due to relevant concept of the real rate of interest that must be modified to take into account the high volatility of inflation and vice versa. The interest rate channel impulses in Nepal are transmitted indirectly in various sectors. The institutional credit availability is very low as a result there is still low monetization.

Due to institutional inefficiencies and existence of a large non-monetized sector, interest rate movement in Nepal does not behave as theoretically expected. The financial sector is somehow practicing cartel to suppress the market determined interest rates. Domestic demand for consumption and investment is still not sensitive enough to interest rate changes. Empirical analyses in some cases either reflected unexpected relationship or insignificant results. In the context like in Nepal, where there is low level of income and large size of informal credit, the availability of formal credit is more important than its interest rate.

Exchange rate channel : Since 1994 Nepal has been adopting full convertibility in the current account,wherein banks are free to quote their own exchange rate in the case of convertible currencies. Officially Nepali Rupee has been pegged with the Indian currency, which provides not much of space for the independent adjustment with foreign currencies. However, it is true that as India is gradually and selectively opening up its capital account, which will cause difficulty for NRB to manage its operational independency without shifting into flexible exchange rate regime. It is, hence, obvious that the exchange rate channel would be more effective where the economy is highly open together with floating exchange rate regime. One of the major indicators in measuring the openness of the economy is the total foreign trade as a percentage of GDP which has remained lowest in Nepal as compared to the south Asian countries. In the import front, demand for essential consumption is less elastic to the real exchange rate changes compared to the demand for luxurious goods. Due to limited goods, and also the small scale and low potentiality of the existing exportable items, the export is less responsive to real exchange rate changes. With the facility of free convertibility with IC, currency substitution, at least on theoretical ground, cannot be ignored in a situation if there is a large gap between the two countries in the tariff rates on import of similar goods from other countries, which calls for adjustment in the tariff rates.

Credit channel: The monetary policy affects not only the interest rates but also the difference between the cost of funds raised externally and the opportunity cost of internal funds. Such difference is very much similar to that of the spread charged by banks between deposit and lending rates. Also it is an important determinant of investment and spending decision. The credit channel is not really an independent alternative to the traditional interest rate mechanism but rather an amplifying mechanism.

In other words, in a stabilizing economy, as long-term debt gradually increases, the balance sheet channel becomes effectively operational. In an environment of higher credit operations, changes in the interest rate produce higher impact on the relative prices of financial assets and on the valuation of capital assets. The bank lending mechanism works through the conditions of supply of bank loans. A tightening of monetary policy reduces the supply of loans from the regular banks, which force to search new lenders with new credit relationships resulting in costly activities of the increase of the cost of external finance.

Asset price channel : The asset market in the real sector in Nepal is informal and un-organized. Purchase and sale of the real estate such as land and building is all mostly done on individual basis rather through land and building development companies. In such dealings, people should register the case(s) at the Department of Land Revenue of the government to get the ownership certificate. The organized intermediation for land and building though attempted in the past could not be materialized. Culturally, Nepalese people would like to own a piece of land and house for the sake of social prestige rather than from a business point of view. Also due to overall unorganized activity the prices of land and buildings are much volatile. Such prices in urban areas recorded a peak unexpectedly in the recent years due to pass through effects of internal conflict and remittance income. Most of the loans of commercial banks are collateralized with land and buildings which basically known as traditional banking lacking the presence of project base lending.

Although there are no direct credit control measures, the credit channel no doubt is still the effective one in the contest like Nepal's. The rate channels, specifically interest rate impulses, are transmitted indirectly in other sectors. However, due to meager flow of institutional credit on agriculture sector the interest rate cannot play its expected role. As mentioned earlier, asset price channel, which is not institutionalized yet, cannot satisfy the theoretic implication of transmission mechanism. Similarly, with the limited base in terms of commodities and markets, Nepal could not benefit as other countries in export front even with the depreciation of the domestic currency. Rather Nepal incurs a higher import bills in such a situation since the major exportable have high import contain, among others. In Nepalese context, where markets are not integrated enough, policy actions cannot be quickly transmitted from one sector to others. Thus, the overall transmission mechanism is not being sensitive and successful in Nepal though it needs considerable feedbacks and interactions to each other.

The monetary policy not only in the present federal concept has been loosing its credibility but also in the existing transitional period also the NRB has not been successful in upgrading the monetary aggregates which can make people to convince about how much is the total monetary aggregates which represent the total liquidity in the financial system. If one raises the question of the money demand in the Nepalese currency, the aggregate forecasting is a serious issue which virtually has no proven path to believe in the monetary aggregates and their impact on the various macroeconomic variables including the validity of the Nepalese monetary policy targets and their implications. Theoretically, there may not be a problem of currency substitution effect but the basic root cause is whether the Nepalese money supply has been very much underestimated and also may be beneficial for the currency printing cost but without the net economic effect by this on the whole economic stability. Unfortunately, there has not been any analytical study done by the authentic and responsible authority in this regard to convince the general public that how the people and the economy are benefiting from this situation.

It is but natural that the financial sector growth in Nepal is urban centric due to financial viability but until and unless the monetary policy could not concretely incentivize the rural finance, the financial deepening, inclusive sustainable growth and macroeconomic stability cannot be maintained as desired. Similarly, the performance of the problematic government owned banks after the financial sector reform program recorded positive trend, among others, mainly because of the mandatory book write off effects without the supporting mechanism for the management of such significant write of amounts. The monetary policy,which is responsible for financial stability, should have to sincerely analyze how the supervisory capability risk can be minimized. Looking at the number and size of the financial sector and the supervisory capacity of the NRB, it shows a far behind capacity as the ratio of the staff involved in the supervisory function with that of the number of banks and financial institutions as well as the high-tech mechanism adopted by many banks which needs more intelligent capacity of NRB for suffocated computer auditing.

Since the country is going into federal structure, the NRB has to develop a compatible mechanism in the financial structure that makes the monetary policy more efficiently functional in the new system. It is also high time to think about to establish a separate independent supervisory authority so that the NRB may be more efficient in conducting an independent and effective monetary policy as has been practiced successfully by many countries.

Conclusion

Going through the above review and analysis the macroeconomic stability is vital for the overall economic development. Those economies who could maintain a more stable situation have shown a faster economic development. Nepal in view to develop the various sectorial as well as overall economic development has entered into many donor supported programs which have directly/indirectly helped in institutional capacity buildings, policy reform, improvements in various Acts and regulations even though not as expected. However, with many factors the people below the poverty line has been declining over the period but the increasing income disparity/inequality has shown a disappointing situation.

The stability indicators of Nepal compared to international criteria with the exception of national debt with respect to GDP showing a situation of no debt overhang, all other indicators are far above than the Maastricht criteria. Obviously, it reveals that Nepal has not been successful in maintaining the macroeconomic stability, that's why Nepal has been facing the bottom line status in the global economy. For this, the policy makers, the private sectors, and the various sectorial stakeholders should learn the lessons to correct the macroeconomic instability so that the overall development could take a momentum.

In the fiscal front initiatives have been started in reforming some institutional capacity, efficiency, restructuring the taxes and broadening the tax base, but still tax payer friendly environment is lacking which has discouraged the tax payers. Similarly, less transparency, proper use of the taxes in the proper sectors, and broadening the tax base on the basis of tax potentiality and improving the compliance are the basic problems which still needs to reform for efficient revenue collection. Also the expenditure patterns need a lot of reform with more transparency according to the set priority and the set framework. The estimation/forecasting of the revenue and expenditure should be standardized rather than the existing ad-hoc basis. The immediate workout on the fiscal federalism together with central and state level sharing is essential since the country is adopting the federal states. Also the new possible taxes should be explored in broadening the tax base.

There are lots of reforms in the financial sector in acts, regulations, restructuring, re-engineering, and also this is the fastest growing sector in the economy. Thus, the monetary policy should have to be more focused in attaining its set targets which are becoming vulnerable in the recent past. Similarly, the supervisory capacity should be strengthened in line with the mushrooming growth in this sector in view to strengthen the financial sector stability even with the option of establishing a separate and independent supervisory authority. Among the monetary policy instruments, only the OMOs is becoming effective which clearly indicates that monetary policy in Nepal is only acting for the liquidity management. Unfortunately, the domestic money demand is overtly underestimated looking the free flow of IC in circulation in Nepal but still the central bank has not developed any proxy indicator for estimation that how much the IC is replacing the NC in circulation and what would be the policy implication of this to the economy is a crucial issue to be addressed in the monetary policy.

Similarly, in the absence of the broader monetary aggregates nobody knows about the total liquidity in the economy in Nepal. The overall financial services is urban centric, which needs immediate mechanism for rural financing in view to enhance the financial deepening, inclusive growth, poverty reduction through employment generation and ultimately to facilitate the macroeconomic stability. Also it is high time to workout immediately on the modality of the financial structure and monetary policy framework compatible to the federal system.

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CHAPTER III

Stability, Prosperity And Equality

Development Agendas For The New Nepal

- Dr. Durga P. Paudyal

Over the past 15 years, Nepal is passing through an unprecedented scale of transition in her history of nearly 250 years as a nation state. During the past ten years (1995-2005) of Maoists' insurgency, around 15000 lives were lost, hundreds of thousands families displaced and countless public and private properties were destroyed throughout Nepal. It was followed with a popular uprising to overthrow the "Autocratic Monarchy" (*Nirankush Rantrantra*). Finally, the Maoist joined the mainstream politics through a peace agreement with the Seven Party Alliance in order to frame a new constitution by electing the Constitution Assembly. The 240 years old "Hindu Unitary Kingdom" was transformed into a "Secular Federal Republic" through a political decision, which is yet to be defined and institutionalized by the Constitution Assembly. However, after the peace agreement between the Maoist Party and the Seven Party Alliance, the issue of the establishment of inclusive democratic governance has been interpreted differently by different political parties, which, in effect, has resulted only a struggle for scarce resources and opportunities rather than a historic transition for change. Moreover, the strategic location of Nepal as "yam between two stones", as depicted by King Prithvi Narayan Shah has been vindicated as several regional and international stakeholders are entering into the battleground. In this scenario, unless the scale and magnitude of change is clearly understood and managed by Nepali political forces, the lingering "transitional period" may turn to be the harbinger of an endless regional level conflict.

There is also an argument that defining, managing and institutionalizing such scale of change is beyond the intellectual and institutional competence of Nepalese themselves. Therefore, they should have sought help from international community. The UNMIN, which was sent by the UN Security Council to monitor the Maoist combatants, departed before completing its job. For example, the nationwide agitating mass was peacefully controlled, almost instantly. The armed Maoist insurgency was brought into the political mainstream. The 240 years old monarchy was ejected peacefully. These are historic changes, in every senses of the term. However, the political parties failed to determine common political goal. Similarly, they also failed to recognize the importance of intellectual and professional homework to define the current agendas for change and prepare several options for political considerations. Instead, each party has taken stiff stance in favor of its ideology and vision that resulted into chaos and political impasse in drafting the constitution within the stipulated time frame. People are, again, questioning the competence of Nepali political parties in managing changes. In this background, I propose to reflect on the dynamics of change, based on my own understanding and experiences. In this process of reflection, I am neither making any desk research to corroborate my understanding with the current intellectual discourse in Nepal, nor doing any statistical simulation to depict the trend of events. Hence, this article will have the limitation of being purely my own reflection.

Managing Change

The present crisis is the continuation of several agitation, uprising and revolutions of the past. After the unification of Nepal from several ethnic based principalities by King Prithvi Narayan Shah, there was a brutal power struggle between the palace and the powerful military courtyards (*Bhardars*), which ultimately yielded to a century long oligarchic Rana Regime. The armed struggle of 1951, led by the Nepali Congress, overthrew the Rana Regime. However, due to the power struggle within the ruling party, the structural and cultural change of democratic Nepal could not be defined and institutionalized. Rather, the elected government of the Nepali Congress was succumbed to the royal coup in 1960 that established another totalitarian *Panchayat* regime for another 30 years. The *Panchayat* regime was also overthrown by the popular uprising called Movement for Restoration of Democracy (MRD) in 1990 and a democratic constitution was promulgated in 1991. However, the institutional and moral base of the change agents remained very weak. The political parties could not function as vision based democratic institutions, nor could work in unison with other political parties for a common goal. In 12 years after 1990, there were over 12 governments. Similarly, several political leaders in high offices have been found indulged in corruption, misuse of resources and nepotism.

On the other hand, the Maoist party reached to the conclusion that the parliamentary democracy is only a pastime of bourgeoisies and the parliament is no more than "a place selling dogs' meat by showing goats' head". Hence, they decided to initiate a long-term armed uprising (*Dirgha Kalin Jana Yuddha*) in order to establish a new people's republican order. After ten year long armed conflict they realized that such change is not possible only through the 'barrel of gun'. Hence, they signed the peace agreement with the alliance of seven political parties, for writing a new constitution through the popularly elected Constitution Assembly.

One of the main problems that we are witnessing today is our inability to break the legacy of tradition, culture, values and norms of the past regimes, in all spares of life. The dictatorial attitude, monopolistic thinking, feudal habit and aristocratic lifestyle, to name a few, are noticeable characteristics of leading political figures who are fighting for forward looking changes (*Agragami Paribartan*). Similarly, the political parties are neither functioning as a vision based democratic institutions, nor have been working together with other political parties for common goals such as concluding the peace process and writing the constitution. Similarly, we are also witnessing that most of the political leaders in high offices are indulged in corruption, misuse of resources and nepotism.

POLITICAL STABILITY

During the Rana period the political stability was maintained through the nexus of Rana family members and powerful military courtyards (*Bhai-Bhardars*) and local feudal landlords (*Mukhiya-Jamindars*). High military commanders and *Badahakims* were appointed from the family members, based on the 'rule of succession' andother civilian positions were appointed on the basis of favoritism (*Chakari* system). The main agenda of the administration was to maximize the revenue collection and maintaining "law and order". Suppression of the dissent voice and impunity to the supporters were the hallmark of the system. Property acquisition and extortion by the *Mukhiya-Jamindars* were common, which are also illustrated in the contemporary literature.

After 1951 revolution, the fundamental legacy of the oligarchic system of governance should have been transformed into the corporate governance based on the rule of law. Such change would have curtailed the arbitrary power and privilege of the ruling classes, as well as the *Mukhiya-Jamindars* at the local level, that had continued from the *Rana* period. There were some attempts of reforms by the elected government in 1958-59, but they face resistence from the ruling class. One example can be cited about the fundamental reform that the elected government of B.P.Koirala attempted. It is said that King Mahendra was prompted to take over executive power in 1960, when the elected government of the Nepali Congress prevented the Royal Palace to sell one of the forests (Kings considered all national resources as their personal property). The Panchayat System was a centralized one-party system, under the active leadership of the King that prevailed for 30 years from 1960-90. Political stability during the Panchayat period was maintained with the nexus of *Bhai-Bhardars* – *Panchas* (who were mostly the *Mukhiya-Jamindars*) and government establishment. The suppression of the dissent voice (labeled as anti social elements or *Arastriya Tatwa*) and impunity for the supporters continued to remain as the hallmark of the system.

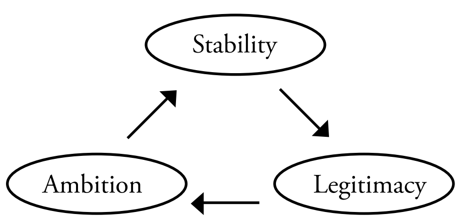
After the establishment of the multiparty parliamentary democracy in 1990, the expectations were huge. Some knowingly and many unknowingly had anticipated that the new government would institutionalize the democracy and define the basic characters of the democratic system., To start with, there would be a simple, transparent and cost effective election system where even a poor can participate; a system for rule of law would be made; constitutional bodies would be strengthened; anti-graft establishments to control abuse of authority and resources would be strengthened; power and resources would be devolved to the local self governments; investments in education, health and nutrition would be made for making children, women, Dalit and backward classes healthy and competitive; and a long term economic plan would be designed for employment and income generation for the masses. It was seen, however, that there was a sharp contradiction between what the political parties promised during the mass movement and what they actually practiced once they were in power. The constitution had guaranteed all fundamental principles of a pluralistic liberal democratic framework. However, the constitutional provisions were interpreted as per the convenience of the party in power. Similarly rampant corruption was seen at the high level; educational institutions were made as the breeding ground for party cadres, and impunity of the party cadres became the norm, among others.

At this stage, young people led by the Maoist, began to think that the twin-pillar theory established by the 2047 Constitution i.e. Constitutional Monarchy and Multi-party Democracy was not working in Nepal. The relevance of Monarchy in Nepal was questioned on three grounds, among others. The *Janajaties*, led by the Maoist, argued that the Monarchy could not act as 'the symbol of unity' of the socio-cultural diversity of Nepal. It was rather seen as an implant of urban-based feudal institution. On the other hand, the mainstream political parties led by the Nepali Congress felt that the royal institution never supported democracy in this country. During the past 60 years, the king always looked avenues for crossing the constitutional barriers to have his say in the governance. Finally, the youths felt that the royal institution was very expensive for a country like Nepal and also an impediment for establishing a rule of law. Therefore, the *Jana Andolan II* was directed towards removing the monarchy and instituting a republican order.It was achieved through the overwhelming support of the people. But again, instead of preparing the constitution for institutionalizing the achievements made in *Jana Andolan II*, the political parties are infighting for power, money and personal ambition. People are shocked and awe stricken. They are asking with dismay as to why the political leadership is not interested in institutionalizing the rule of law? Why do they indulge in corruption? Why they did not require money until they were struggling for the change and why they suddenly required so much of money now? Who will be responsible if the earlier gains are lost? Is it a pathological or systemic problem?

I think there are two fundamental problems namely cultural legacy and systemic problems that prevents the new political system functioning. The cultural legacy such as the monopolistic thinking of governance, feudal behavior and aristocratic lifestyle are inherited from the past regimes. But when the system changed, the pluralistic democratic governance demanded a new mind set and behavior. The multi-party democracy meant a fair competition of several political parties working together for the larger interest. People at large may change their position depending on the fulfillment of promises made earlier. The political leaders are also required to have a high moral character and simple lifestyle in order to face the public scrutiny.

But it has been very difficult for the political establishment to adapt this new code of conduct. Each party wants sole authority in the system. They don't want to provide an inch to the opposition. Maoist went one step further by killing other party workers to vacate their political arena. Similarly the political parties are not functioning with democratic values and norms at the institutional level. Each party is divided into several factions headed by various party stalwarts. Few leaders make decisions, which the members have to follow. Rare examples of inter-party coordination are noticed, except for making alliance to change the government. Similarly, households, teachers, professionals, public servants and intellectuals are patronized in party line and are expected to follow the party position. On the other hand, the Maoist Party, which fought for a 'forward looking changes' (*Agragami Paribartan*), is not yet sure whether it should go to the competitive polity or continue the armed insurgency, even after five years of signing the peace agreement. Hence Political parties have actually inherited the totalitarian ethos of the past regimes.

On the systemic problem, there is a 'safety-net' function of the political party and the individual leaders. The political parties need resources for maintaining party stability through a permanent office in the capital with a few party workers and some budget for office management. Similarly, they have to maintain their political legitimacy through various political activities of the party. For example, the party-leaders have to make visible presence in several discussion meetings, media interview and organize agitations. Similarly, they have to make frequent visits to the constituencies and organize public meetings. At the individual level, the political leader who will be spending his/her prime time for the party work, also needs to fulfill his/her political and individual needs and ambitions (as shown in the figure below).



During the *Panchayat* period, the *Panchas* were part of the state establishment, and hence, all financial support to the political activities such as traveling to various seminars and organizing Pancha Bhela were adjusted somewhere in the state expenditure. Since the system functioned under the "active leadership" of the King, the political activities got priority from the state. The King used to make regional tour to boost the political support for the system. Similarly, there was an official mechanism to provide support to the "government candidate" during the election. Therefore, it was relatively easy to run the political activities in the *Panchayat* politics.

After the restoration of democracy in 1990, the establishment and functioning of political activities changed at both institutional and individual level. The state establishment and the political parties were separated; therefore political parties had to find their own ways and means to run their activities. Moreover, since multi-party system is a 'competition' among the political parties, the effective presence of major political parties at the local level became more imperative than ever in order to engage the local populace and provide them the sense of people's governance. But keeping existence in local level was pretty expensive for the parties

At the individual level the story is even tragic. The election campaigns, political rally, posters and pamphlets, volunteers and, of course, maintaining the muscles and buying votes, are all costly affairs. Similarly, after the victory in any political office, the relocation to the district headquarters or to the capital, food and shelter for the frequent visitors from the constituency and, of course, maintaining the high dignity of family as expected from one's high position require money. Therefore, there is no wonder if any aspiring political leaders would be expecting a house, a four-wheel-jevep and a 'reasonable' bank balance to run the show. Similarly, the human nature of aspiration for a comfortable future while in power may also play when one goes to the high office, despite the history of sacrifice and struggle one may have in the past.

As a result, an open negotiations within and between the political parties to allocate a "good ministry" during the formation of the government was commonly observed in all parties after 1990. All "good positions" came with a price tag in them. One after another governments fell in scams like *Dhamija Kanda*, *Lauda Kanda*, *Chase Air Kanda*, *Sun Kanda* etc, where the political leaders were allegedly the hand in glove with businessmen. In order to meet their voracious financial requirements, the UML charged a levy to their supporters. Maoist resorted to extortions, and each and every party were involved in swindling money from the state coffer. When the masters themselves were indulged on the lookout for money, it naturally encouraged the bureaucrats in making a triangular alignment between political leaders, bureaucrats and trading houses for misusing public resources.

Therefore, there is no point of bashing the individual political leaders, because there is a serious flaw in the system. The political activities should be made simple, transparent and cost effective. Similarly, like in the industrial western countries, the public education, health, transport and communication systems should be made cheap, or good quality and reliable, so that a political leader in high office do not have the temptation to make money for these basic necessities. At the same time the anti-graft laws, law enforcement and judiciary establishments should be strengthened to check the misuse of authority and resources.

Prosperity

After the restoration of democracy in 1990, the Supreme Commander of MRD Mr. Ganesh Man Singh declared that the political goal has been achieved and time had come to launch a movement for economic prosperity (*Aarthik Kranti*). It is hard to explain as to why the Nepali Congress opted to marginalize Mr. Singh from the Party, instead of initiating the movement of *Aarthik Kranti*. Was it not the priority agenda of the party ? We can make three explanations, among others, for the lack of political interest. First is related to the lack of understanding by the political parties about the underlying factors that led Nepal to be a poor country and the dynamics of the functioning of the economy. Even with the brilliant start of promulgating the constitution within the stipulated time and conducting a free and fair election, the political leadership gave very little energy in doing enough homework for preparing a common political goal and priority agenda. Instead, political capital evaporated in a few obvious popular sentiments such as the exploitation of feudal landlords and local frauds (*Shamanti Jali Fataha*) and the domination of Kathmandu centric mentality, among others, which could have easily addressed though good governance and decentralization policies. But no efforts made to understand the basic characters of the economy, such as, who controls the trade, industries, financial institutions and major economic policies? How the trade and industries are financed? What are the conditionality of aid and trade, how the aid/trade negotiations are done and who benefits from them? What are the impacts on the common people of Nepal as a result of these arrangements ?

Donors also played important role in keeping the system functioning and, perhaps, developing a "cargo mentality" in Nepalese mind that someday, someone will come and "develop" our country. They provided projects and budgetary support to run the system. After the liberalization policy several public corporations, donated under foreign aid, were sold to private sector at nominal prices . Several donor-driven NGOs and INGOs entered in education, health and community development sectors. Consequently, political leaders looked at donors as their constituency, accepting their aid conditionality and policy prescriptions, than listening to their own people. Successive finance ministers boasted his success on the amount of foreign aid he could muster.

The second explanation could be the lack of visualization of economic progress based on the geographic, cultural and social factors of Nepal. The present debate on the issue of state restructuring shows the inabilities of the political leaders to understand the imperatives of the regional inter-dependence for the economic prosperity of Nepal. For example, without the protection of *Chure* Jungle, the fertility of Terai land cannot be restored and without the sustainable management of the steep land and forest of the hills and mountains, the effect of climate change on the Himalayan glaciers cannot be mitigated. Similarly, major hydro/irrigation projects cannot be built without addressing the regional inter-dependence. If the present political proposal for ethnic/region based federation of state is established, it will be a Herculean task to develop mega projects, which will require inter-regional cooperation.

Similarly, Nepal has only 18 percent of arable land. In order to meet the food security with these precious lands, the Nepali society has developed, through the adaptation of knowledge over several centuries, a local method of augmenting a proper balance between sloppy upland (*Pakho Bari*) and the fertile lowland (*Bensi*). They used to have their house, homestead garden and dry land crops in the *Pakho Bari* while growing wetlands crops intensively in the *Bensi* land. Now, while the productivity of Pakho Bari is decreasing due to the lack of land augmentation, the low lands such as *Tumling Tar*, *Salyan Tar*, *Khaireni Tar*, *Shandi Kharka* and fertile valleys such as *Kathmandu*,*Pokhara*, *Dang*, *Surkhet*, *Simikot* valleys are increasingly used for construction of infrastructure and urbanization. Hence, the available land for food production is sharply decreasing. Now the communist parties see that the redistribution of land is the main policy agenda for New Nepal. Undoubtedly, land and agrarian reforms must be an important agenda. But it would have a limited impact in transforming the economy. The most important imagination at the political level could have been how the remaining 83% non-arable land, and the vast amount of natural resources, could be utilized in generating employment and income.

The agriculture sector cannot provide year-round employment. Therefore, as an alternative strategy to support the livelihood, seasonal or permanent migration to India (*Muglan*) had been a centuries old tradition of Nepali society. The pensionable job in British and Indian Army (*Lahure*) has a good social prestige. During the past few years, especially after the Maoist insurgency when there was no working environment in the villages, the size of international migration especially to the Gulf States galloped. The size of the remittance has been providing a cushion to support the economic stability during the difficult period. However, there are also the painful parts of the stories. Girls' have been trafficked to Indian brothels for quite sometime, and now the destination has extended to other countries. During the *Panchayat* period several influential drug dealers used innocent boys and girls as piggybacks for transporting the narcotic drugs to several international destinations. Hundreds of poor Nepali drug-traffickers are said to be languishing in jails of several countries. Similarly, in the recent case of migrant workers to the Gulf States, several anecdotal evidences are available that the workers are deceived by the manpower companies, abused by the owners and no support services provided for returning home during the difficult times.

The third problem is the lack of imagination for taking advantage with the strategic partnership with India and China. One of the important lacunas in the quest of the progress of Nepal has been the lack of imagination of its comparative advantage and the price it must pay to achieve it. As Nepal is almost India-locked country, it can not progress without the strategic partnership with India. We need to reflect very coolly that why Bhutan could triple its per capita income just by selling 1400 MW electricity to India, while, despite three "joint" mega size multi-purpose projects: *Koshi*, *Gandaki* and *Mahakali*, Nepal is unable to bargain a fair share of benefits from India. It appears that those projects were narrowly designed for irrigation purposes and located at the Indo-Nepal border area in order to provide maximum benefit for India from minimum investment in Nepal. Similarly, there were no in-built provisions for sustainable natural resources management and watershed development of the respective river basins. Now the environmental dynamics is more precarious due to the effect of climate change, there is even more urgency to generate resources through such projects for sustainable management of Himalayan ecosystem and restoring the depletion of water resources in their river basins. Without the investment for generating employment and income, the people will continue to deplete more resources for livelihood.

Now that we have 14 hours load shedding everyday and India is also looking for clean energy, it is a high time to initiate a new beginning. Recently, during the visit of the French President, India signed a deal with France to procure several nuclear power plants, each costing over US$ 6 billion to generate 1650 MW. Nuclear technology, though environmental friendly, also poses alarming risks as seen in Japan's *Fukusima Daiichi* disaster in 2011. On the other hand, there are several mega projects like *Koshi* High Dam (3000 MW), *Karnali Chisapani* (12000 MW), *Mahakali Panchashwer* (6600 MW) and *Budi Gandaki* (1000 MW) which can provide clean energy with comparatively low cost and risk. Additionally, these project also provide controlled irrigation water for millions of hectares of land to address the food security problem; mitigate the massive damage of recurring flood and generate substantial employment and income for both countries. Besides the direct products, these projects can also generate resources for sustainable management of Himalayan environment and restoring the depletion of water resources in their basins. We should make a good homework to convince India to consider these options that have comparatively low cost and risks.

Indeed, there are some fundamental problems in the mindset of both sides. On the Nepali side, there is deep perception that Nepal has been deceived by India in several treaties. But instead of generating knowledge and engaging with India in a constructive manner, several political parties preferred to select provocative and destructive path. Such strategy has resulted mistrust with India and, at the same time, a spiral cycle of conflict and political instability erupted at home under different guise that brew more unemployment, hopelessness and conflict. Such situation in Nepal is not good even for the Indian interest. Similarly, on the Indian side, there is a lack of visualization of the larger interest from Nepal. The Indian security and economic interest from Nepal can be achieved only through economic integration for taking comparative advantage with a win-win framework of agreement. The Indian rupees can be used in Nepal; therefore the Indian investors can make investment in Indian currency. Similarly, Indian investors can use the benefits of open border for transporting goods and services without any hassle. Once the economic integration between the two countries is achieved, the politics of provocation will automatically subside.

Equality

One of the main agendas of the popular uprisings of the last 100 years or so has been for the equal access on power, resources and opportunities. Great leaders along with and countless men and women have made enormous sacrifice to organize and accomplish several popular uprisings. But when they achieve their first objective, the revolutionary forces could not unite and sustain the momentum for defining and institutionalizing the change agendas. It appears that they failed to understand the fundamental problems of the system and the political capital evaporated in a few evident face symptoms. As a result, even after the fall of Rana Regime in 1951 or the change of the *Panchayat* System in 1990, the monopolization and domination of a few feudal and urban elites on state power, resources and opportunities continued.

Similarly, one of the most important agendas of the *Jana Andolan II* 2005 was to end the despotic monarchy (*Nirankush Rantantra*) and establish an inclusive democracy (*Samabesi Loktrantra*), which was interpreted, through the political consensus, as ending of "Hindu Unitary Kingdom" and establishing a "Secular Federal Republic". Accordingly, the interim constitution was framed and a Constitution Assembly elected. Now the main issues before the Constitution Assembly are to define the basic characters and framework of the state and draft a new constitution.

In order to define the inclusiveness, the Maoist party proposed to restructure the unitary framework of the state into ethnic and region based 14 federal states while the *Madhesh* based parties demanded one *Madhesh* state (One-Madhesh-One-Pradesh). It was also proposed that the state should have guarantee on full autonomy, including "self-determination" (*Atma Nirnaya*), and ethnic preferential right (*Jatiya Agradhikar*). Several ethnic groups demanded their ethnic identity and ethnic preferential right to be reflected in the constitution. One may have a serious doubt that whether the proposal would, indeed, address the desire of the people for inclusive democracy. In fact, the popular aspiration should have divided into structure (which would be included in the constitution), policy and programs (which would be implemented by the parliament through the annual program and budget), as shown in the following table.

Structure	**Policy**	**Program**
Inclusive Democracy	Participatory Governance	Inclusion of women, Dalit and Backward communities in governance
		Decentralization of power and resources to local bodies
		Capacity building of governance at all levels
	Rule of Law	Pro-people law reform
		Capacity building of law enforcing agencies
		Capacity building of anti-graft and judicial establishments
	Capacity Building	Good/reliable public transport/communication system
		De-politicization and quality improvement of education and health sectors
		Priority investment and reservation in capacity building of deprived classes and communities
	Development of culture and identity	Research and development of various culture and language
		Development of education in mother language
		Development of cultural identities such as festivals, songs, arts, dress and ornaments etc.

The main problem now is that political parties have promised too much at the beginning while they have no idea how to fulfill those promises. On the other hand, there is a tremendous erosion of faith among the people with the political leaders that they will, indeed, deliver their promises. Therefore, the people want everything included in the constitution. But in doing so more problems may emerge then addressing them.

There is also a deep perception that India has a "grand design" to bring Nepal under its security umbrella, like Bhutan. Therefore, the present crisis could have been orchestrated by India. Some have offered several examples that the Maoist were trained and sheltered in India[1]. The "federal republic" is an Indian idea, in which "One *Madesh* State" with the right of self-determination is embedded. *Madhesi* parties are trying to establish Hindi as second language in the Parliament, and so on. It is unfortunate if India is supporting these ideas, because India will be ultimately affected. To start with, the Maoist has now become the "biggest internal security threat of India". Moreover, if the state is restructured under ethnic and territorial considerations as proposed, the mega water resources projects in Nepal, which would require inter regional cooperation, can not be developed.

Similarly, one can also put a serious doubt whether New Delhi is, indeed, aware of all these events in Nepal. It may also be the case that these are the designs of 'pseudo India' or regional power groups for their own interest. A parallel can be drawn with the western orchestrated "communist insurgency" of Indonesia of 1960s for capturing and monopolizing the rich mineral resources[2]. In the present context of South Asia, the ethnic states with right of self-determination might have been devised in Nepal for using elsewhere such as Kashmir, Arunachal Pradesh, Nagaland, Manipur or even the Tibet of China. It

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[1] The Ex-Military Secretary of the King Mr. Bibek Saha wrote in his memoir (Maile Dekheko Durbar 2010, Yeti Publication, Nepal) that he had credible information from his army sources that the Maoist gorillas were trained by Indian Security Forces in Chakrata Camp near Deheradun. One Inspector of Armed Police Force, who was just returned from training in Chakrata Camp, informed him that Maoist Gorillas were also trained in the same Camp. More interestingly, the stand model that was prepared for the training was used by Maoist in Mangalsen, Satbariya and Chainpur attack

[2] Mr. Roland Challis (Shadow of a Revolution – Indonesia and the Generals. Sutton Publishing Limited, 2001) has a made beautiful illustration, by using the CIA data, that how the western power orchestrated the rise of communist insurgency in various islands of Indonesia during 1960s, with the demand for "autonomy with self determination" which were later ruthlessly massacred and suppressed by the ambitious young General Suharto and, with the help of western power, established military dictatorship for 30 years.

might also be a ploy for containing the emerging Asian Super Powers: India and China, by using the "area specific" issues.

The overemphasis on ethnic factors, for the problems as well as solutions of Nepal, could also be the idea of the western experts. For example the Nepal Human Development Report (NHDR) 2009 by UNDP emphasizes the ethnic factors for exclusion, poverty and deprivation. However, the NHDR 1998 pointed out that the territorial remoteness and exclusion was the main factor for deprivation and poverty. Interestingly, the NHDR 2009 does not refer to NHDR 1998, although both were published by UNDP. Similarly, the "secularism", which was also added along with the federal republic, has been the conduit of the Christian Missionaries to enter into the cultural sphere of Nepal for conversion into Christianity, especially the ethnic minorities.

The same paradox is seen in dealing with the issue of equitable distribution of resources and opportunities. The Maoist party, in particular, viewed that a few feudal families hold the land and properties, which should be confiscated and distributed to the people i.e. to the Maoist cadre. They have already implemented this idea in several Maoist dominated districts. Similarly, as a part of redistribution of wealth and generating resources for the party, they also allowed various means of extortion for donation (*Chanda*) to their cadre. Over the last five years, more than 100 other armed insurgency groups, mostly in *Terai*, have emerged with different political demands and used violent tactics in the name of *Terai* politics. As a result, a lawlessness and anarchy is created throughout the country, which has forced to close several industries and disrupted development.

Public debate

The mindset of the present political leadership is that everything of the past was bad; therefore the past policies and institutions must be destroyed to create a "New Nepal". Reference to the past policy is labeled as *Pratigamankari* (regressive). Apart from the wall-gratifies of ideological rhetoric or the position papers of the party-affiliated intellectuals (*Budhijibi*) there is a real dearth of open public debate by independent intellectual community that could generate new ideas for formulating forward looking (*Agragami*) policies. Criticisms are taken personally; therefore one would play a 'safe' game of innocuous explanation of the current thinking rather than taking a 'risk' of breaking a new ground.

But this is not a new practice. During the period of *Panchayat* system, which was claimed as *Nirbikalpa* (having no alternative); the supporter of any alternative political ideology were labeled as *Arastriya Tatwa* (Anti National Elements) and given harsh punishment. After 1990, the constitution was framed under liberal democratic ideology, which, however, reserved some provisions in the constitution including monarchy as unchangeable. Under this pretext, the earlier legacy of discouraging open public debate continued. The same tendency was seen on the donors' side, even though they had immense contribution in knowledge generation for initiating public debate. They were critical on the recipient side but desired to remain themselves out of the critical scrutiny. In one occasion, the Peer Review of Decentralization Policy of Nepal, when I raised some questions on the donors' side, I was expelled from the Team and my report was excluded from the final output[3].

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[3] In 2001, several donors working in the areas of decentralized development in Nepal, constituted a team of experts for "Peer Review" to learn from the past policy and experiences and recommend better policy alternatives for the future. Seven experts each from donors and recipient side were included in the Peer Review Team. I was one of them from the recipient side.

Nine indicators were identified for reviewing the performance which included, among others, transparency, accountability and cost effectiveness. I insisted that donors' performance on these issues should also be evaluated.

In my report, I pointed out that the capital expenditure is subjected to follow a set of rules of procurement and accounting, therefore there is some level of transparency. But for the expenditure of the technical assistance (TA), as well as bilateral grants, such procurement rules are not followed.

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In fact, there were several good policies during the *Panchayat* era. The institutional framework of local governance was good, which, however, was used as local power base for the legitimacy of the centralized and totalitarian character of the *Panchayat* System. After 1990, the local governance system was built based on the earlier experience (even though the name "*Panchayat*" was changed) but the fundamental reforms such as the devolution of power and resources could not be accomplished. It is easy and cost effective to improve upon the existing system then design a new one. But it looks that the current political leaderships are not interested to develop policy and institutional framework from our own experience and expertise. They rather want to create entirely a new federal structure, learning from the experience of Denmark, Norway, Switzerland or America[4]. Even

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For example, when a staff is hired by the government, there is a system of minimum qualification, salary scale and a competition among candidate, which was generally absent on the TA side. Similarly there is a system of accountability of the government, from auditing by the Auditor General to the scrutiny by the Public Account Committee of the Parliament, which is absent in the donors' side. It is said that they are accountable to their own Parliament and taxpayers back home, and, hence, they are out of the reach of accountability at the local level. Finally, on the cost effectiveness, donors make huge expenditures on logistics such as vehicle, communications and supplies for monitoring their projects. However, most of the projects of their counterpart agencies are suffering due to the lack of minimum support services.

I concluded that the recipient countries look donors as role models and try to learn from them that how their own system can be made more functional and effective. But when the donors themselves show insensitivities to the ideals they preach and promote ad-hocism, it will give a wrong message.

[4] Recently, a high level meeting was planned under the auspice of ADDCN (Association of District Development Committees of Nepal) to discuss issues of restructuring of the state, in order to initiate expert opinion on the issue for the consideration of the policy makers. I was asked to prepare a model for the restructuring of the state based on our experience and expertise in Nepal. I prepared a model recommending three salient features, among others, (a) a comprehensive package from centre to the local level (b) based on the earlier policy and institutional framework and (c) inclusion of women, Dalit and backward communities at all level.

I suggested a four tier model: Gaun Sabha as the foundation level; Gaun Palika/Nagar Palika as the executive level; Jilla Palika as the coordination level and Chhetriya Shabha as the policy making level. Since it was a major transition I suggested a role of the centre for policy coordination, capacity building and monitoring.

I had also suggested some prerequisites such as (a) make it a priority policy and budget for the next 10 years (b) de-politicize the education and health system and improve the quality of services in order to make all citizens equally competitive (c) de-politicize the government bureaucracy and make it impartial to establish the rule of law. My paper was considered Pratigamankari and, hence, cancelled the discussion meeting.

if a new structure is designed, a huge expenditure will be required to build the infrastructure, develop institutions and train new manpower. Similarly, there will be risk that such new system will necessarily give a good result.

Similarly, there were several good policies and institutions established during the Panchayat era that provided immense contribution. For example, the New Education Policy and public health policy extended the school education and health network to all nook and corner of the country. Several think tank institutions such as APROSC, CEDA, LDTA etc. generated knowledge on the policy development and implementation process. Similarly agricultural research stations, community health training institutions, vocational training institutions are scattered all over the country. Priority attention to these, and several others, policies and institutions would not necessarily mean reversing to the earlier totalitarian system. But they would generate immense knowledge and expertise at a very nominal cost.

New Beginning

Nepal is at the crossroad of a new beginning in its nearly 250 years old history of an independent nation state. During the past, Nepal survived under the shadow of India and the goodwill of China. Had Nepal maneuvered these arrangements quietly for its prosperity, like Bhutan, perhaps nobody would have noticed us. However, by our own inability to maneuver the changes, the earlier equilibrium of "yam between two stones" has been broken down. Moreover, in the new globalized geo-political context, the strategic location of Nepal in between the two emerging Asian powers is also exposed. Now, both India and China have focused their attention to Nepal to settle their concerns.

India seems to have two interests, among others, namely economic and security interests from Nepal. On the economic side, India wants to take advantage from the huge potentials of water resources, flood control and sustainable management of Himalayan eco-system, to mitigate the effect of climate change. Such ambitious and long-term projects need political stability, a system of governance, rule of law and a dependable socio-economic environment. On the security issue, India wants Nepal not to become a safe transit point of terrorists from any third countries. The open border regime has made Indians more sensitive.

On the Chinese side, there is also a growing apprehension that Nepal is increasingly becoming a play ground for Free-Tibetan activists. The visit of several Nepali law makers to *Dharmashala* and meeting with Dalai Lama; the unregulated northern border of Nepal and the several messages coming from several political parties have made the Chinese establishment more concerned.

In order to address these issues, the present political impasse must be ended and the new constitution must be promulgated and institutionalized. The issue of Maoist combatants, along with several armed groups operating in several parts of Nepal and from the other side of the Nepal-India border, must be settled. The political parties must renounce violence and participate in competitive political process. All the "anti-Indian" and "anti-Chinese" activities must be stopped. A new framework of engagement with India and China must be found out and agreed upon[5].

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[5] In my article on EU Approach to 1950 Indo-Nepal Treaty (2008), published in Nepalnews online, I argued that Nepal and India have been enjoying most of the benefits of the EU nations, except a few, and, hence, the 1950 Treaty can be developed in the European Union model, adding those shortcomings. First, there is no joint political forum like the European Parliament, where the political concerns could be understood, debated and resolved. The bureaucratic establishment, which is

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Unfortunately, the political forces, which initiated and led the popular uprising for dismantling the earlier establishment, have failed to define, manage and institutionalize the change agendas and establish a new order. Similarly, there seems to be a dearth of intellectual capital to develop an acceptable roadmap for the political and social transformation and leverage the political forces to proceed further. As a result, there is a total chaos, which may remain for some time to come.

In this context, the biggest challenge for the young generation of Nepal, those who do not want to leave the country for a decent life like many of their brothers and sisters, is to find answers for several questions. How can we develop and institutionalize an inclusive democracy, where all Nepalese can prosper? How can we de-politicize the education and health institutions and provide access of quality services to all Nepalese? How can we de-politicize the government institutions, including the security establishment, and develop a responsive governance system? How can we establish a moral character and discipline in government, private, political and social institutions? How can we decentralize power and resources to the local self-governments and establish participatory development process? How can we negotiate with India and China, while addressing their concern, to exploit the huge potentials of Nepal? And so on. The youth communities have to reach out to all people of Nepal,

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currently handling the Indo-Neal relationship, has been slow, static and self serving. Therefore, an Indo-Nepal Joint Parliamentary Committee (INJPC) could be set up with a permanent secretariat, which could, among others, monitor policies, generate knowledge and debate and resolve emerging issues at the political level. Second, there are no resources for start up or equalizing the level playing field of the backward region, like in EU. Hence, Nepal could not exploit its potentials for the growing market of India and minimize its trade imbalance. Therefore, an Equalization Fund could be set-up for leveraging the public and private sector of Nepal, for initial preparations in larger projects for joint investment. Finally, there is no policy synchronization between the two countries, which could have discouraged the border smugglers, criminals, trade monopolists and market cartels. Similarly, an immigration control mechanism, for screening and monitoring immigration from third countries, could have been established at the diplomatic missions of both countries while issuing the visa, like the Schengen visa of EU.

irrespective of the political thinking, ethnic communities and gender groups, and create a “critical mass” to initiate an open public debate for a new beginning. Dr. APJ Abdul Kalam, the ex-President of India, advised the young people “Be more dedicated to making solid achievements than in running after a swift but synthetic happiness” (Wings of Fire 1999, University Press, India).

CHAPTER IV

Tourism Policies To Augment Economic Growth

- Dipendra Purush Dhakal

Tourism has been officially recognized as the alternative economic activity of the country, which has the potential to rectify regional economic imbalances and assist the deprived and poor section of the population. Tourism has often received priority status in the national plans due to its strong potential to also augment foreign exchange earnings as well as creating employment opportunities (including self-employment), especially in the rural areas. Nepalese tourism, on the one hand is not capital intensive, while at the other, is also a smokeless service industry with special competitive advantages in the South Asian Region.

WHO SAID WHAT ABOUT NEPAL ?

Nepal, as a multi-faceted product, lures tourists to experience the grandeur of the Himalayan and mountain ranges; the tranquil natural environment; the ancient traditions, the culture and religion; the ecological dreamland and the diverse array of ethnic groups. To visit Nepal is to see 'life in a land without wheels' (Kunwar, 1997, p 201).

The brand of Nepalese tourism is - 'Naturally Nepal', which is a true representation of the products that the country has excelled in through establishing a prestigious tourism image in the originating markets. The brand also reveals that travelling to Nepal – 'Once is not enough'. Nepal was promoted in 1998 as a 'Land of its own'.

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The others have to say following about Nepalese tourism:

- Nepal among 50 places to see before one dies: BBC
- Climb Mt. Everest: among BBC's 50 things to do before you die
- Everest base camp among 20 Journeys of a lifetime: Observer, UK
- Annapurna trail: Among 12 best walks in the world - US Travel Magazine
- Annapurna circuit voted first in iExplore's hiking and trekking trips, 2003 and afterwards
- Nepal ranked 2nd among 180 countries in 'the most prepared country category': UK
- Best Ecotourism destination in the world: World overview of Tourism Market Trends

Policy development scenario in Nepal

A policy document is an expression of commitments, which outlines the vision of a government for a reasonable period. Therefore, it demands a revisit at certain intervals to accommodate the national and international advancements observed in the related sectors. It is important to revisit these timely in order to realize the opportunities of a nation to achieve its desired results. Each successive revision should take the tourism industry with a more pragmatic, transparent and forward-looking approach.

Historical Perspectives In Initiating Policies In Tourism

Nepal had entered into pragmatic tourism policy milieu for almost forty years when a Tourism Master Plan was developed in 1972, with policies and strategic orientation for a period of 12 years. The following initiatives and attempts were made to steer the process further:

- Update of the Master Plan in 1984
- A time-bound action plan jointly developed by GoN (Government of Nepal) and private sector in 1986
- Asian Development Bank (ADB) financed technical assistance to review institutional aspects and devise projects for implementation to help Nepalese tourism in 1989
- The first-ever ADB investment into tourism as the Tourism Infrastructure Development Project, which was also later extended to the second phase.
- ADB also provided technical assistance to propose projects for funding under ecotourism development in 2000, however, the Bank did not take up the projects.

The priority of the GoN in the tourism sector can be judged from the fact that the Department of Tourism,which was established in 1956, had to frequently move under the patronage of several ministries till the Ministry of Tourism was established in1976. Such weary attitude of the GoN in the sector made tourism wait for nearly 40 years to have its own sector-specific consolidated Tourism Policy in 1995. Though belated, it has to be appreciated that the policy was very pragmatic and forward-looking. Prior to this, the policy had remained a corollary of the overall economic policy of the country and had to be sought out in the pages of the National Plans. (Dhakal, 2010)

The first consolidated Tourism Policy, 1995

Supporting Nepalese economy through increased international visitors and tourist spending along with the extended opportunities for employment had remained as the main objectives of tourism development and promotion. The Policy had emphasized income generating activities at the central as well as rural level; natural, cultural and human environment from a tourism perspective; establishing linkages between tourism and agro-based and cottage industries; and involving local communities in different tourism activities. In theory, the recycling of certain portion of income raised from tourism to the economically deprived and remote areas was a very commendable step proposed by the Policy, however it could not be developed uniformly across different tourism sites.

Tourism Policy, 1995

- A forward looking proposition
- Narrowing regional imbalances
- Distinct roles of GoN and private sector
- Reinventing the prestigious and attractive international tourism image of the country
- Sustainable tourism; environment protection; community participation

Overlooked aspects

- Non-degradation of product quality
- Conservation of national heritages
- Maintenance of ecological balances
- Production and sale of local souvenirs
- Local governance
- Poverty alleviation
- Packages of ecotourism and rural tourism
- Self employment opportunities
- Access of under privileged groups
- Model community tourism villages

On an institutional front, the role of the GoN was assigned to act as a catalyst, leader, coordinator and facilitator, and the private sector as an engine for economic and commercial activities. A high level

Tourism Council, chaired by the Prime Minister and a Nepal Tourism Development Board, was conceptualized. The Council was established as intended, however the Nepal Tourism Board was established with a slightly different concept and design after three years. This policy was also instrumental to transforming the Department of Civil Aviation into Civil Aviation Authority of Nepal.

The Policy has been criticized to be weak on the issues of quality of services and products; environment protection and visible improvement of the livelihood of poor and deprived families. It loosely discussed employment promotion in the Preamble but had been completely omitted on the main frame. It also recommended implementing Tourism Environment Guideline and Local Code of Conduct for the tourism entrepreneurs but was never materialized. The Policy is also silent in the areas of frontier formalities and associated fees.

Tourism Vision 2020

Following the positive experiences gained from the existing Tourism Policy, GoN has now declared a Vision of tourism for 2020, which emphasizes economic development and distribution of benefits to the wider stakeholders.

The Vision reads as: 'Tourism is valued as the major contributor to a sustainable Nepal economy, having developed as an attractive, safe, exciting and unique destination through conservation and promotion, leading to equitable distribution of tourism benefits and greater harmony in society'.(MoTCA,2009)

Implementing the Vision will begin with identifying 18 districts from all ecological belts to serve as the hub for development, management and promotion of tourism activities.

Tourism Policy 2009

The objective of the Policy is to develop the country as an internationally attractive, pleasant and safe destination. The goal is to sustainably utilize national heritage for tourism, increase the national income and uplift the living standard of the people.

Tourism Policy, 2009

- Increasing national income & uplifting living standard
- Self employment
- Foreign investment in large industries; BOO, BOOT
- Ecotourism/ rural tourism/ model community tourism villages
- Recycling of resources
- District Tourism Development Plan;
- Travel incentive leaves and local travel concessions
- Reclassification of industry based on capacity
- Industry labour relationship
- Local government,
- 2nd international airport; regional airports;
- Nepal Airlines -public-private.

Ambitious areas

- Five, ten and twenty years master plans at the regional level
- Engaging cooperatives to benefit deprived people
- Five, ten and twenty years master plans at the regional level
- Engaging cooperatives to benefit deprived people

Inadequate attention/overlooked areas

- Effective marketing and promotion of tourism - roles of diplomatic missions?
- Sustainable development
- Community management of local tourism products and infrastructure
- Retention of tourism earning at the local and national level
- Use of local products and services
- Tourism Environmental Guideline
- Code of Conduct of the tourism entrepreneurs

The discernible new areas include self-employment through tourism; utilization of man-made heritages; land transportation; creating environment to augment foreign investment and such like.

A few innovative steps are also expected such as the declaration of a tourism village every year; implementation of travel incentive leaves and Local Travel Concessions for the Nepali working population; sports, education, health, and agro – tourism. Borrowing from the successfully completed Tourism for Rural Poverty Alleviation Project, the Policy also talks about the issues of poverty, women, community, environment, linkages of tourism with the local government, district tourism development plans, and the Buddhist sub-circuit around Lumbini and other pilgrimages related with Lord Buddha in the surrounding areas.

The distinctive role of GoN on specified sectors; optimum use of ICT; safety and security; harmonious relationship between industrialists and labourers; distribution of tourism benefits to the larger mass of people, and recycling of resources to the tourism centres are also a few visible improvements from the past initiatives.

The policy will be a landmark if it can succeed in bringing up a second international airport, the development of regional airports and organizational restructuring of the Nepal Airlines into a public-private model as envisaged. These issues are most essential for the sustainability of the development and promotion of tourism as it is obvious that 'aviation makes or breaks tourism'.

Nepalese tourism contribution towards economic enhancement

Foreign exchange earning

In the year 2010 Nepal earned NPR 23.429 billion (US$ 329.98 million), a slight decline by 12.5% than during the last year, from the tourism sector. Consequently, the average income per visitor per day also declined to the level of US$ 43.20 from US$ 65.30. However, the foreign exchange earning has jumped significantly with an annual average of 22.25% since 2006 (NPR 11.785 billion in 2006 to NPR 23.429 billion in 2010). This level of earning constitutes around 7-8% of the total foreign exchange earning of the country. The tourism sector has been performing well in real terms but experiencing sharp fluctuations in terms of percentage to the total earning, which at times stood at around 21-22%, and 3.5–4.1% as the contribution to the nation's GDP during early 90s. The current level of contribution of tourism to the GDP in 2010 stands at around 2.4% and it also significantly represents over 40% of the total value of merchandise exports. In nutshell, the level of foreign exchange earnings is quite encouraging as it has been almost steadily increasing since 2005, when it was only US$ 148.44 million.

Tourism products

Following paragraphs attempts to assess the major available products of tourism and their potential contribution towards economic enhancement of Nepal and its people:

1. Mountain Tourism

Currently, different types of mountain tourism exist in Nepal such as mountaineering, trekking, and tourism in and around national parks in these regions. These segments have significantly contributed towards the growth of the Nepalese economy in various forms, such as revenue for businesses and entrepreneurs and providing employment for local population for the last six decades.

The inhabitants of these mountainous regions are generally the poor and deprived. Most mountains have abundant plants and animals but are environmentally fragile due to the low regenerating capacity of flora. Additionally, these regions are also the most aesthetically pleasing to tourists with their rich culture, grand vistas and indigenous tribes and heritage, however, they are also the least developed regions in the country. This is due to lack of infrastructure support and education in these regions. Further, these regions are also the source of watershed, providing hydropower, irrigation and drinking water to the rest of the country. Therefore, tourism in the mountains is key towards the development of these areas, which should also be perceived as a benefit to the inhabitants of these regions, rather than a burden.

Mountaineering: Nepal boasts 8 out of the 10 highest mountains in the world, which has become part of the Nepalese national identity. Nepal is also home to 22 out of 31 Himalayan peaks that are higher than 7,600 metres. Experts have estimated that there are 9 additional unnamed peaks in Nepal that are over 8,000 meters but not officially or internationally yet recognized.

Mountaineering in Nepal is a noncompetitive adventure and also the sustainable pioneering product of the country. It is a great source of generating royalties to the GoN from the expedition teams {USD 3.03 million was generated from 280 teams in 2010 (MoTCA, 2011, p64-65)}. In addition, the Nepal Mountaineering Association (NMA) had also issued permits to 1,209 teams represented by a total of 6,032 members from 56 nationalities to climb 23 peaks. The total royalty collected by NMA through these permits stand at NPR 37.67 million {(around US$ 0.53 million)(ibid p66-72)}. The NMA is authorized to utilize these royalty for its purposes of mountain development and promotion activities. Mountaineering is not only a low volume high yielding sector but also boasts a high spend per mountaineer compared to other sectors within Nepalese tourism. A quick survey on this aspect has revealed that a mountaineer spends 27.07 times more than an ordinary tourist visiting Nepal.

Mountaineering contributes enormously to local people and communities by generating income, reviving culture and providing other forms of livelihood support. However, there are also several detrimental impacts on the environment and local communities of this form of adventure tourism.

The potential of growth in this sector is enormous as the GoN has only permitted 325 mountains out of 1,300 peaks for mountaineering thus far.

Trekking: Almost a quarter of the international tourists visiting Nepal undertake trekking. The GoN has waived trekking fees for all destinations, except a few areas where trekking is controlled or regulated. This has the added disadvantage of not being able to effectively confirm the number of trekkers to these areas. The statistics published by the Ministry of Tourism and Civil Aviation (MoTCA) for 2010 reveals that there were 9,015 trekkers who were permitted to go to the controlled areas such as Mustang, lower and upper Dolpa, Humla, Manaslu, Kangchenjungha and other areas.

It is often said that trekking is the 'best form of reaching poor and deprived' and free individual trekkers (FITs) contribute more to local economy than group trekkers handled by trekking agencies. The reason for this is that FITs mostly consume local food, products and services. Revenue generated from the controlled areas, in the form of trekking permits, is deposited in the GoN Treasury. Currently, the communities have been demanding the GoN to share a proportion of this revenue towards the upkeep of the local community.

The trekking trails such as, Annapurna Sanctuary Trail; Khumbu; Langtang, Ghalegaun-Siklesh; Kangchenjungha; Dolpa; Mustang; Manaslu; Rolwaling, etc. are well established in the world map. But most of these trails are now under threat along with the opening of roads to these areas. Thus, gradual shifts to newer destinations are essential to protect trekking tourism in the country.

A new trekking product, Great Himalayan Trail (composition of 43 Nepalese trekking trails) has recently been developed aiming to exploit the significant potential and marketing synergies existing between the Himalayan countries. The trail starts in west Nepal (Karnali), crossing the entire northern ranges including Mustang, Manang, Manaslu, Ganesh Himal, Rolwaling, Everest and Kangchenjungha (SNV and ICIMOD 2006, p 2).This new initiation could be a boon to the locals.

Tourism in and around protected areas: Protected andconservation areas serve as a strong bases for tourism, as almost a third of tourists coming to Nepal visit these areas. According to the Department of National Parks and Wildlife Conservation (DNPWC), a total of 145,468 foreigners had visited 14 Parks/Reserves managed by DNPWC, which include Sagarmatha, Chitwan, Langtang, Khaptad, Shey-Phoksundo, Bardiya, Rara, Dhorpatan, Shivapuri, Parsa, Koshi-Tappu, Shukla-Phanta, Makalu-Barun, Kangchenjungha, etc. in 2010 (MoTCA, 2011 p63). In addition, there are additionalvisitors to the conservation areas managed by the Nepal Trust for Natural Conservation (NTNC), which prominently includes Annapurna circuit, upper Mustang and Manaslu area.

The mountain parks and reserves offer both hard and soft adventure, e.g., mountaineering, paragliding, sky diving, trekking, elephant safaris, canoeing, rafting, jungle drives, and nature walks. Tourism in these areas is influenced by the concept of '*tourism friendly conservation management*' rather than the rudimentary '*carrying capacity*' approach. Participatory approaches of tourism in these protected areas have set new records and an exemplary model to the rest of the world.

The Buffer zones of the respective protected areas, which are established for minimizing biotic pressure and sustainable management of natural resources, are also bestowed further responsibilities for development and management of tourism. Conciliatory and partnership approach has been successful in management of forests by user groups. This has also been instrumental in devising a similar long-term objective to motivate the local populace and win their support to gradually involve them in nature and wildlife conservation (DNPWC 2008, p4). This concept has emerged as a successful initiative to resolve park and people conflict.

A model for recycling of revenue to the buffer zones, which would be handled and managed by those committees, is discussed in the later parts.

2. Non-Traditional Areas Of Nepal Tourism

Nepal has abundant products capable of being optimally utilized for the benefit of tourism. Developments of new and innovative models would benefit better harnessing of Nepal's unlimited tourism potential. The tourism products around social and cultural events could be developed and newer areas such as sports and endemic tourism could also be explored. (Shakya 2007, p 11).

Sport Tourism: Sport events have so far only been spending ventures organized for specific purposes. Sport has the power to ignite passion in individuals and also evoke patriotism, which can facilitate harmony, nation building and a sense of belonging to the nationals. From an economic perspective also, the matches could be a good source of income for the parties involved.

Nepal has great potential to use sports as a tourism venture. In order to promote Nepal as a sports destination, it is essential that there is a concerted effort from the GoN and other stakeholders to highlight this. Following are some examples of sport, with potentials of promotion along with the assigned themes:

Golf: Nepal already has its own national level tournaments, participated by limited players from Nepal and India. With the added advantage of the coveted Himalayan vistas added to the scenario, this could be an entry point of promotion for higher level Golf tournament in Nepal.

Cricket: Nepal has gradually made its breakthrough in junior level cricket matches and has established some regional prestige in this area. These momentums can be enhanced by developing Nepal as a permanent venue of international level competitions, such as '*international veteran matches*'.

Rafting: Nepal has embarked upon this sector for quite some time, but the desired success has not yet been achieved. Therefore, the efforts should be concentrated on optimal utilization of *overlooked/ underdeveloped world-class rapids* in Nepali rivers. It would lead to organizing international events and competitions in Nepal to attract 'adrenaline junkies'.

Elephant polo: This game has already contributed to be a '*unique gift to world sport*'. Therefore, it should be protected and explored rather than being ousted in the name of less known or competitive sports.

Paragliding: Pokhara is recognized as the '*World's fifth best location*' for paragliding. This theme needs to be internationally promoted to attract more paragliding enthusiasts to Nepal.

Mountain biking: The bikers have expressed that Nepal is *'one of the world's best destination' for mountain biking'.*

Bungy jumping/ Ultimate swing: The adventurers also share that Nepal is the '*World's 4th country operating it professionally*'. The effort on this new game is only by the promoter so far. Thus, there is a need for the GoN and Nepal Tourism Board(NTB) to collaborate with private sector organizers. Given the location of the Last Resort, there are potentials for other sport activities, which have been mentioned above and could be harnessed further to maximize opportunities within this sector.

There are several solitary successful special events organized in Nepal, to name a few, Rock skii at Thorang La Pass done by a French team for 8 days in 2003 and a Rugby match by the UK team on the Everest trail in 2005. Such events could be used by NTB as incentives to lure more tourists into these regions, however these have been currently been overlooked.

There are also other forms of tourism that are being carried out, which need a more planned and strategic approach to maximize benefits to the country and stakeholders, including private sector such as domestic tourism; ecotourism; MICE tourism; cultural and religious tourism; and recreational tourism. There is also scope to develop educational, research, agro, medical, political tourism and ceremonial events.

Institutional Development In Tourism

Strategic orientation of tourism related institutional development have little guidance, influence or intervention from GoN. This has been more of a concerted effort on the part of non-state actors so far. The role of GoN has been more to facilitate than exercise control over the tourism industry.

In order to ensure cooperation between Governmental organizations and other stakeholders, a high level Tourism Council is established with the Prime Minister as its Chair and 9 out of 34 members represented by the non-governmental sector. Similarly, the Tourism Development Coordination Council, which is responsible to carry out decisions of the Council, is chaired by the Minister of Tourism and Civil Aviation with 8 out of its 32 members from the non-governmental sector.

It is interesting to note that the status of the Ministry has frequently changed without any credible reasons by the merger of portfolio of Culture in the MoTCA, which was then subsequently de-merged. However, the previously run Department of Civil Aviation, and Tourism had been converted into autonomous forms of Civil Aviation Authority of Nepal (non-Government) and Nepal Tourism Board (Private/Public) respectively in 1998.

There had been a significant departure in the approach followed by tourism administration from *centrally controlled by GoN* entities to the engagement of local bodies. Consortium of GoN entities (other than tourism) that are contributing directly or indirectly to the purposes of tourism; civil society and private sector organizations are developed and encouraged to engage in strategizing at the local level. As a consequence, there are now Tourism Divisions/Sections in the District Development Committees (DDC)/ Municipalities Needless to say, the dynamic private sector has been a key player in tourism administration at all levels.

Appraisal Of The Exemplary Broad-Based Tourism Management Models Contributing To Local Development

The GoN has recognized the nongovernmental sector as the engine of growth and therefore extended several innovative tourism management and financing models that are implemented in the country. The following matrix clarifies the approach, procedure and respective benefits and lapses:

Management model (Benefit/lacking)	**Financing model (recycling of resources)**
A.Institutional a. Nepal Mountaineering Association (NMA): • Key players are tourism entrepreneurs (one GoN representative on the Board) • Authorized to issue permit to climb 13 peaks and retain the revenue for its annual activities • Authorized to issue permit to climb additional 15 peaks and use the revenue in agreement with the GoN • Financing of mountaineering related development and promotional activities - do not encounter GoN's procedural hassles, • Benefits to the local community are minimal so far. Thus increased role of local people in the NMA activities are being considered B. Community owned: approach to empower and benefit local people and conserve environment a. Buffer Zones: managed by all locals • User Groups constitute User Committee (UC: 9-11 members) and UC Chairs represent in the Buffer Zone Management Committee (BZMC) and also elect BZMC Chair. The Warden is the only GoN official facilitating as BZMC Member Secretary • BZMC approves and UCs implement programs	**Model 1:** Non Governmental entities are authorized to collect, utilize and manage resources. Examples are: • NMA • Annapurna Area Conservation Area Project **Model 2:** 30-50% of revenue is recycled and funds managed/ utilized by local committee. Example: • National parks **Model 3:** Managed by Non Governmental entities without commitment of GoN budget

- BZMC of Sagarmatha received the Tenjing – Hillary Mountaineering Award 2009 from the GoN

b. Sagarmatha Pollution Control Committee (SPCC): Since 1991

- A local NGO with 11 member Executive Committee - all locals
- Involved in preservation of environment and control pollution

c. Model Tourism Village - Siruwari: Since 1997

- Managed by locally owned Village Tourism Development Committee
- Received Pacific Asia Travel Association Gold Award 2001
- Model replicated in other areas such as Briddhim in Rasuwa, as it was successful

d. Kangchenjungha Conservation Area (KCA): First and only protected area managed by local community

- KCA Management Council is elected based on the Management Plan - all members are non government individuals - DDC also represented
- The Council formulates, approves and implements programmes through the user groups

C. Blend of Institution and Community: Community groups are legally empowered and actions are supported by Institutions

- ACAP and Manaslu Conservation Area Project (both managed by the NTNC) are the models of local participation, conservation, economy and tourism
- These collaborative projects are widely appreciated by communities and also internationally
- Recently tourist village in Ghandruk has banned construction of concrete buildings

- Upper Mustang
- Manaslu
- SPCC
- Siruwari
- KCA

Model 4:
30% of tourism revenue to the DDC to implement tourism related projects/ activities

- Not implemented yet

Another successful experience is with a programme focused to alleviate rural poverty through tourism, addressing the most relevant issues of poverty, community, women, and environment. This six years long project ended in 2006 with following lessons, which had direct linkages to the economic enhancement of local regions:

- local tourism helps enhance livelihood and alleviate poverty to a certain level, however, the investment packages should begin with small traditional projects

- inclusive planning secures community's role, enhances social empowerment and increases ownership
- Emphasis on capacity development through training should focus on skills, entrepreneurship, hospitality and microfinance
- Self administered loans by locally established Community Organizations are the best models of financing, which also helps to tie in with the local GoN and increase sense of ownership
- Community's engagement in managing environment should be emphasized, and
- Local culture could emerge as a new tourism product

Challenges- The Way Ahead

The new Policy has addressed numerous drawbacksthat are faced by the stakeholders and has also presented opportunities to introduce new innovative ideas. Therefore, an integrated effort of central and local Government, private sector, community and the beneficiaries iskey to accomplishing the vision set out in the Policy.

The economy will highly benefit if proper marketing strategy along with effective promotion of tourism is adopted in the country and able to use this internationally. This will hopefully contribute towards an increase in foreign as well as domestic tourism within new regions.

Additionally, there needs to be a policy shift from the number of arrival-based approach to the tourism receipts, average duration of stay and the quality of services. The motto for tourism in the medium term should be quality and also focus on being value-based.

The policy makers should introduce appropriate economic tools to gauge the widening income disparity, which is causing a handful of entrepreneurs benefiting from tourism. The attention is also needed to stabilize market price at tourist areas, which artificially shoots up during tourist seasons making affects the livelihood of the local residents.

Continuation of controlled tourism is still emphasized in the Policy, which may hinder local areas to reap the direct benefits from the FITs. Emphasis on use of local products and services would enable increased retention of tourism earning, helping to boost local economy. Similarly, community managed local tourism products and heritage would also significantly contribute in this endeavor.

Long awaited development and implementation of Tourism Environmental Guideline will contribute to the betterment of ecotourism and similar Code of Conduct for tourism entrepreneurs will contribute to promote ethical tourism business environment, which will have positive impact on the economic progress of the country.

The diversification of the products, effective establishment of regional tourism hubs, encouraging tourist visitations to the new areas, incorporation of local culture as a product, and eco-tourism should be the overriding strategies for the medium term.

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CHAPTER V

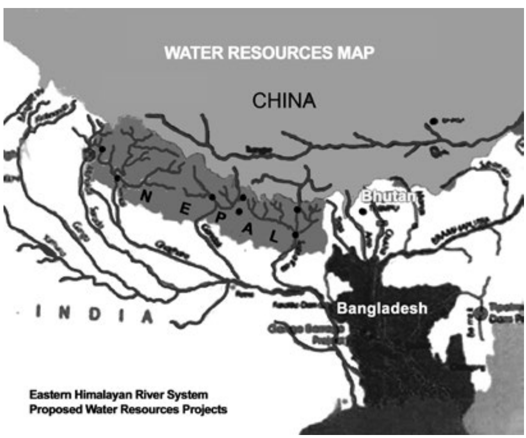
Growth Through Private Sector Led Hydropower

- Er. Gyanendra Lal Pradhan

Out of all the water on Earth, less than 3 percent is fresh water. Water regeneration is still very costly affair. In the context of rapidly expanding world's population, economies growing and the competition for limited water supplies intensifying, Nepal stands rich and tall in having water abundance with over 20,000 litres of water available to a person per day with an annual 224 billion cubic meter of surface run-off. According to the study made by Hydro Solutions, a private company, the total hydropower potential of Nepal stands at around 200,000 MW against the popularly assumed figure of 83,000 MW. From more than 6,000 rivers and rivulets of Nepal, around one million GW hours of electricity can be generated. This potential is adequate enough to meet the domestic and part of the regional clean energy demands. But in spite of its immense hydro and energy potential, there is no water in household taps and the country is engulfed in darkness, reeling under up to 18 hours of load shedding in a day in dry seasons making it the only country in the world with the maximum load shedding hours, not to mention severe crippling of the industrial productivity. About 60% of the Nepali population is still living in darkness. Not only Nepal, the total region including countries like India, Bangladesh, and Pakistan are facing load shedding problems. This region with population of over 1.6 billion will consume each other's share of agro/energy output if energy is not managed in a sustainable manner.

Today more than ever, a secure and economic supply of energy is of utmost importance for industry, business and private users. Energy is basic human need like food, clothes and shelter. Energy consumption is one of the indicators of a country's development. Nepal is positioned very low in the list of countries by total energy consumption per capita. Nepal's abundant water resources and geophysical features provide ample opportunities for hydropower generation.

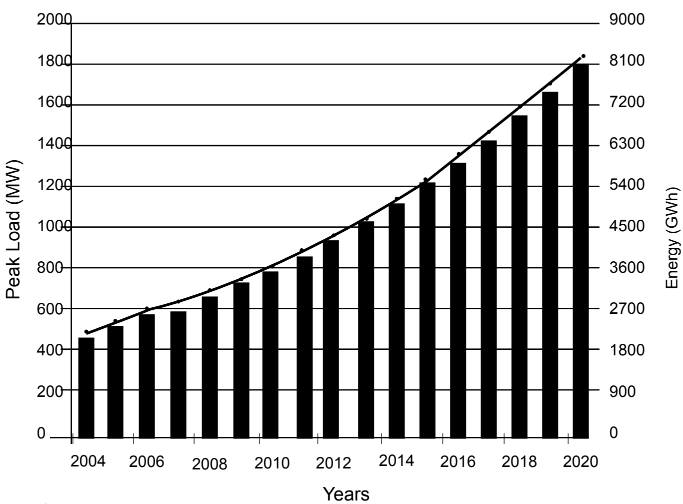
Nepal being an agrarian economy, rapid rural development is the need of the hour. This requires resources. Nepal is not a prosperous economy. Therefore, Hydropower can be a potent means for achieving economic well being for rural Nepal.



The country is currently producing 600 MW of hydropower with 174 MW from the private sector. About 105 MW of hydropower by

IPPs is under construction and 587MW is being developed by Nepal Electricity Authority (NEA). The country needs at least 2500 MW from runoff and/or equivalent storage projects to end load shedding problem by 2015. The Nepali projects are generating less than 300 MW in the dry season. There is already a demand of around 1000MW. Can we expect that the country, which is reeling under power crisis, would get a relief with these projects coming into operation and would help cut the load shedding hours across the country? The answer is NO. Load shedding will never go with today's traditional approach.

Nepal Electricity Authority's Forecast



Source: NEA

Energy Sources in Nepal

Fuel wood is still a potent source of energy (78%). It is also renewable provided the rate of afforestation is greater than the deforestation rate. But the alarming rate at which the forests are being depleted, the once used *Hariyo Ban Nepal Ko Dhan* (Green Forest is Nepal's Wealth) can no longer be considered true. Once Nepal had more than 60 percent forest cover but it is less than 30 percent now. Analyzing the present trend at which the country's vegetation cover are being depleted and consumed (16.7 million tonnes) with a sustainable supply of 9.6 million tonnes, this supply of wood cannot be sustained (deficit of 7.1 million tones). On top of that the impact of massive deforestation has been humongous on the environment with increased occurrences of landslides, erosion etc. Nepalese can never make themselves rich by selling forests.

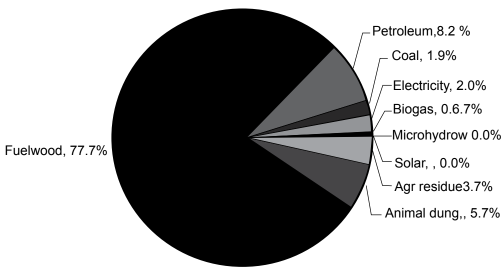


Fig: Nepal Annual Energy Consumption

Table : Status/Achievement of Alternative Renewable Energy Technology

Technology	Potential	Total (Nos)	Achievement
Improved Cooking Stoves (ICS)	50,00,000	350,000	7%
Solar Heating homes	Over 20,00,000	1,00,000+	5%
Biogas homes	20,00,000	300,000	17%

Use of 2 million bio-gas homes will save 6 million metric tons of wood and use of ICS all over Nepal and bio-gas in Terai can significantly help in forest conservation. But only 17% of the bio-gas plants are being installed of the total capacity of 2 million. This cannot be an alternative to hydropower. Although alternate sources of energy such as solar and micro-hydro have their own role to play in the energy sector but the rural energy with no connectivity, industries cannot run by solar or micro energy. The wastes collected from Kathmandu can hardly generate 10 MW of energy. Wind energy, on the other hand, due to its short installation period can render temporary relief to the power outage issue. Optimistically large wind power installation could feed power to the national grid while small ones could light up the scattered Nepalese rural areas that have less potential of micro hydropower and demand more investment for national grid extension. The problem with it is the required massive infrastructure (such as 12m wide road) needed for turbine transport and installation, besides favorable tax laws and subsidies. Wind energy is 200 percent costlier than hydropower. Moreover, wind exploitation pockets are very few in the country. Hydropower is the only alternative to meet the ever increasing energy demand of the country. It is an irony that the nation's total export income is less than the total petroleum imports by the country. This can never be sustainable.

Hydropower in Nepal

Nepal needs many more of big projects like *Tamakoshi* in terms of the size and cost, if it wants to address the power deficit issue and attain economic prosperity. It is interesting to note that even amidst strong political divergence and incongruity, there exits common understanding among all in accepting hydropower as the only sector that can facilitate in bringing economic revolution in the country. This is evident from the fact that different governments have been claiming to develop hundreds of megawatt of electricity during their respective terms.

It should be understood that the poor level of hydropower utilization in Nepal is neither due to lack of demand nor commitment (at least today). It is rather due to financial resource constraints and inherent delays in the project implementation that cause supply to lag behind demand. To date, hydropower development in Nepal has been a costly affair due to reasons such as heavy reliance on bilateral and multilateral aid financing; extensive employment of international contractors and consultants; fragile geology of hydropower sites and small economy of scale and limited manufacturing capability in products related to hydropower plants.

One of the key characteristics of Nepal's electricity is its high tariff rate with domestic electricity charge being one of the major cost in household expenditures. The reasons for high tariff include high cost of hydropower development (including transmission and distribution); power purchase agreements with private sector generators at rates that are initially expensive; high transmission and distribution losses (both technical and theft); inefficient management of NEA; and non-payments or arrears from public sector companies and offices. The donor driven policy also need to be blamed for this. Projects implemented with donor assistance employ massive imported materials, resulting in higher cost of production. As Nepal has access to cheaper materials for construction and capable local expertise, we need not depend on exorbitant foreign experts and costly foreign goods.

Another reason for expensive electricity tariff is the undersized projects. For example, Likhu was initially licensed for 51MW. An

Indian investor has licensed the same project for 121MW. It is not necessary to construct a big dam for a big project. Just changing the size of machines used at the dam site will increase the project capacity. The benefits of making the project as big as possible are clear. It will yield economy of scale. Another factor to be taken under consideration is time management. If we complete the project before or on the stipulated time, the project cost will definitely come down and result in lower electricity charges. The operation cost of power projects usually goes down in later days unlike in other industries. Expensive electricity through expensive project is just not workable.

To meet the targets, there is a need to highlight the need for hydropower development to categorically occur within national energy policies informed by strategic assessment processes guided by well crafted roadmap, strategies and implementation framework and mechanisms. Government looks keen to make things happen. This is a positive aspect. With this support, power generation as expected is possible if there is willingness to engage in trade of electricity, establishment of power tariff that is attractive to both the buyers and the sellers and the removal of certain technical as well as socio-political constraints. Over the next five years, there is a need for creation of enabling environment that will allow the hydropower subsector to meet the domestic needs as demanded, while laying the groundwork for viable export of hydropower based electricity.

ROLE OF PRIVATE SECTOR

Role of private sector for sustained economic development is always at the forefront. The present global economic experiences reaffirmed the notion that the invisible hand of the market would always contribute to accelerate growth process in a sustained manner.

Market oriented development strategies encourage increasing private sector involvements, limiting the government's role as a facilitator & developer of the private sector through creating environment conducive for private sector development.

Although realized by all, the role of private sector in hydropower development has not been strongly enforced and explored. Government's resources are not adequate for investments in hydropower development. Development of hydropower is essentially a very capital-intensive affair. Until recently, 80 percent of the hydropower investment in generation was funded through multilateral and bilateral donor assistance. Now a change has happened in multilateral lending policy resulting in limits on the financing of power projects through the public sector. So, Nepal has no option but to attract private sector investment in hydropower generation, transmission and distribution. Hydropower is commercially viable and if the Government can play the role of a facilitator through investment-friendly policies and legal framework, sufficient financial investment can be mobilized from both local and international private sector.

Through its various acts and regulations, Nepal has tried, albeit slowly, to attract private investors and IPPs to develop hydropower projects. However, in view of ever increasing demand for electricity, and minimal private investments coming in, the laws and regulations are considered to be inadequate. However, as the cabinet has already approved the Hydropower Development Policy, way back in December 2001, there is no reason why the process of revising the Electricity Act and Regulation cannot be expedited now.

Table : Status of Private Sector in Hydropower development

Status	Total Installed Capacity	No. of Projects
Under Operations(Construction Completed)	174MW	23
Under Construction (PPA concluded)	105MW	11
Pre Construction (PPA concluded)	112MW	6
Implementation under BOOT	193MW	6
PPA Applied	974MW	118
Feasibility Study	2000MW	

To stimulate private sector investments, besides legislation, Nepal needs to establish a reputation for defending and honorably upholding the long term contracts. For greater private sector investments, there is a need to develop policy and regulation mechanisms, including the establishment of an effective regulatory body with a mandate to address issues such as price-fixing and the development of investment security packages. Ministry of Energy (MoE) and Department of Electricity Development (DoED) will have to improve technical and economic review and clearance of proposed projects, set up competitive and transparent selection procedures, and ensure open access to the national grid and access to distribution areas. Investments are required in expansion of the transmission network as will in tandem with new generation capacity creation. The State does not have adequate wherewithal to make these investments and therefore it will need to be brought in either from private sector participation or multilateral funding route.

Nepali private sector is not much capable and enthusiastic enough in hydropower. But there are many foreign companies that are willing to invest in white gold. Therefore, the government needs to create conducive environment for both domestic and international investors.

Nepal Electricity Authority (NEA), a government entity cannot remain apathetic to extended hours of power cuts to Nepali people and not sign the Power Purchase Agreement (PPA) with the private investors. An example, a project capable of generating 180 MW was able to sign only for 7 MW with the NEA. How would the private sector invest in projects if there is no guarantee of purchase of the power they generate? It's a total different factor that the existing power purchase rates and high interest rates are dissuading factors for the investors.

The lack of security at hydropower project sites has also discouraged private developers from starting work. It has discouraged the lenders as well to finance the projects. Hydropower developers have not been able to carry out field survey work, construction, operation and maintenance due to increased threats, incidents of extortion and manhandling of officials at hydropower project sites across the country. Two types of insecurities are paramount in hydropower-one against arms and life threats and another social threat to plant and its operations. Such incidents will pose hurdles in the realization of the set vision. The local people's unjustified demands and aspirations, and lack of policies or legal framework to check them; confusion on the part of country's political regime; lack of capability to facilitate the developers; not so confident market development; lack of development of other related infrastructure; negative effects of imported electricity; lack of accountability on the part of employees and the concomitant poor governance; lack of a strong monitoring mechanisms etc are the other factors contributing to the current menace. The Government must do something to ensure security for hydro-projects, which have been under construction or in the process of starting operation in the near future.

The highest strategic priority could be to meet Nepal's domestic need for electricity at affordable cost. And this can indeed be done. Government should identify and implement hydropower plants with high head, high sustained base flow throughout the year, fewer seasonal hydrological fluctuations, lower sediment load and dependable geology. If such sites are distant from the road head, access roads should be constructed as part of local development activities. At the same time, the focus should be to identify and implement a mix of different projects so that there will be a combination of some high head run-of-the-river plants and some medium sized storage projects. This will ensure optimum generation mix allowing cheap energy delivery. Activities to be carried out to achieve this objective should include progressively upgrading of the inventory of identified potential projects and developing small and medium scale projects using local resources.

It is desirable for NEA to initiate and expedite joint venture power generation schemes. Considering NEA's limited resources for capital investments, financial resources available in the local market should be tapped for the equity contribution. The successful commissioning of the Chilime hydropower project under NEA-private partnership was indicative of the beginning of a new era of public-private sector cooperation in Nepal's electricity sector. This should act as a springboard for NEA to adopt an effective joint venture investment policy to meet the growing demand of energy in the country.

There has been a national consensus among the political parties for the first time about the importance of developing the hydropower sector. It is one the few sectors that has attained such national consensus. Nepal has a huge potential of hydropower development, and the desired market is just next door. Investors from around the world are ready to invest in this sector. To make them actually invest the money, the government has to create an investment friendly environment. If the government is able to retain investors' confidence for the next five years, then no one can stop FDIs (Foreign Direct Investment) for big projects.

CHAPTER VI

The Weaker Competitor
How Poor Liability Management Make SOEs Weak Competitors ?

- Rameshore Prasad Khanal

Background

State-owned, but autonomous, enterprises should ideally operate as commercial entities limiting their liability to the level of their assets and not transferring any liability to the government. However, this is not happening in Nepal. In recent years, many enterprises that were either forced to close down because of continued losses and cash drainage, or enterprises that saw erosion in their in their assets due to debt obligations, transferred huge liabilities to the government. Even under the incorporation set up of "limited liability", the government could not deny accepting the obligations invoking this clause. Government was forced to settle all the dues to the banks, to the employees, to other creditors due to political and stakeholders' undue pressure. Such liabilities far exceeded the amount actually shown in the balance sheets of such enterprises, because of the existence of contingent liabilities that was neither disclosed in the balance sheets nor properly estimated and documented.

There are reasons for the need of SOEs even in a highly liberalized market economy . In the first place, they can be a good player to bring order to the market. Syndicates or cartelling was least talked about in freight and passenger transport business as long as wholly owned government entity Nepal Transport Corporation or government-backed Sajha Yatayat were in operation. Both of them had to shut down their operations because of liquidity and solvency problems. Both these cases are best examples of poor liabilities management. When Nepal Transport Corporation had to be shut down, government had shouldered the responsibility of discharging its financial obligations by dispensing close to a billion rupees. With the departure of these two carriers, transportation market has become inefficient. Experience shows that urban commuting cannot be left to private sector alone.

Second, there are areas where private sector does not see much opportunity for growth or high margins. Food supply in rural inaccessible areas is one such example, and rural electrification is another. As we are yet to see the private sector stepping into the urban and energy-dominant areas, a role for the state-owned agencies to address market inefficiencies cannot underplayed.

Third, there are plethora of areas where private sector are left unescorted. In such areas they are engrossed in profit-mongering without any regards to the consumer well-being, what so ever. However, where there is presence of SOEs, the market has not be that brutal. Air services to rural hinterlands are an example. Dairy business can be another example. Strong state enterprises with the existence of private sector, as well, in these sectors can create competition and enhance market efficiency.

Even the staunchest market supporter would not deny the role of state agencies, but every one would expect state agencies also to operate as efficiently as a perfect private enterprise would. This is even more necessary because state enterprise get their investments from taxpayers' money.

State-owned enterprises in Nepal, however, have not shown their mark. Nepal Telecom has somehow given some solace in terms of its ability to generate reasonable returns for government and its shareholders. Incidentally, this is also the first SOE whose shares are quoted and traded in the stock market. Agriculture Development bank limited (ADBL) followed the suit. But Nepal Telecom has, of late, lost customer loyalty due to declining quality of services. Talking about liability management, it is no better because of its hefty retirement benefit schemes for the employees. ADBL is yet to prove its worth in the market, because its past performance was not impressive. With financial restructuring and government's rescue package with the assistance of Asian Development Bank, it has been able to produce a reasonably good balance sheet, but still much less impressive that private-sector banks .

There are many reasons for SOE's weak performance and consequently their standing in the market as a competitor to private sector is very poor. Prominent among them is poor liability management leading to both liquidity and solvency related problems. This problem has crippled many of SOEs leading to the threshold of dissolution.

This paper describes the nature of liabilities, how they arise and what can be done to properly manage them? The final section then recommends policy measures that would help government in achieving prudential liability management.

The nature of liabilities

Both commercial and non-commercial (in other words, both for-profit and not-for-profit) state-owned enterprises have basically two types of liabilities: the *explicit liabilities* and the *contingent liabilities*.

The **explicit liabilities** are the ones that appear in the balance sheet, are raised or incurred normally for the creation of some sort of assets. In some cases, however, if the management is not careful and prudential, this type of liabilities can be raised to finance day to day expenditures. The examples of this type of liabilities are loans from Bank or the government itself, debts raised by using market instruments. They can also include credits obtained from suppliers or accrued expenditures. They can be of various time-frames: short, medium or long-term .

The basic feature of explicit liabilities is that there is normally a corresponding asset cover, the return from which can be used to discharge the obligations (principal payment and applicable interest) arising from the liability. If there is no sufficient return then the same assets can be liquidated and the proceeds be used for the settlement of obligations. However, if asset is perishable and/or subject to market volatility of some kind, such as change in demand pattern, then the liability raised to finance such assets may erode in value but the corresponding liability obligations would not. This is a case of inventory financing. Similarly, if management is not prudential in allocating a share of returns coming from the usage of assets to finance the repayment of loan obligations then that can lead to a situation of imbalance. This happens because assets are subject to depreciation due usage, wear and tear and obsolescence. But the same thing does not happen to liabilities. They do not depreciate; rather they appreciate in value if the interest is not served as and when they are due. In some cases, assets' value may also appreciate increasing the net worth of the enterprise.

Contingent liabilities, on the other hand, do not appear in the balance sheet, unless provided for. Normally, as per the new generally accepted accounting policies, these should be estimated and disclosed in the annual financial statements. Contingent liabilities are not real obligations for the present, but they might turn out to be real in the future on the occurrence or non-occurrence of certain event.

There can be two types of contingent liabilities. The first group of contingent liabilities, such as pension obligation, retirement benefits of employees, income tax payable, etc, is more or less predictable. The monetary amount of future obligations can reasonably be estimated. Prudential managements would normally provide for them and would also back up by earmarked funds, such as estimated pension obligations backed up by a separate pension fund. The second group of contingent liabilities includes items of financial transaction that might arise in the occurrence or non-occurrence of certain event. They include, for example, compensation payable in the case of a lost litigation, claims payable for damages or risks not insured, warranty payable, etc.

How do the liabilities arise?

The **explicit liabilities** in the state-owned enterprises arise due to deliberate decision of the management. Which level of management and who actually in the management is involved in raising these liabilities depends upon the nature of the liability itself. Accrued expenses and suppliers' credit can be raised by a decision of the lowest level of management. These might often happen when expenditures are incurred or purchases of inventories are made in excess of the permitted budget and upper level of management simply becomes complacent. In several years, they accumulate to become huge liabilities. In fact, most of the current liabilities excluding the bank overdraft are the result of the actions or the decisions of lower and middle level of management. The bank overdraft due to a permanent line of credit or revolving credit arrangement normally occurs because of the decision of the Board, the top layer of management. The Board will actually authorize a ceiling or delegate powers to management below it. Almost all of the medium-term and long-term liabilities arise because of the deliberate decision of the SOE Board of Directors. Typically, in some cases the medium-term and long-term loans from government are raised for the SOEs even without the decision of the Board. They come attached with a specific project or activities or an "anticipation" of the government. Nepal Electricity Corporation receives huge loans from the government almost every year tagged with certain power development projects. The case of "anticipation" happened or is even now happening with the Agricultural Development Bank. The government anticipates that the bank will lend out to targeted groups (such as, small farmers or poor and marginalized people, women) in targeted places (such as terai or mid-hills or far-western region) and maybe for targeted purposes (such as, tea farming, shallow tube-well, or growing a particular crop that government thinks good but farmers think otherwise—sericulture in the east, cotton farming in the west, grape farming in mid-west terai).

While short-term liabilities are typically used for financing current assets, in most of the SOEs, the management of current assets is so poor that the substantial portion of money that is used up in accounts receivable and inventories becomes irrecoverable. Many SOEs cannot even collect advances made to staff. Instances of purchase of excess inventories (led by desire of personal benefit of store-keeper or procurement officer) are rampant in almost every SOE. In general, inventory management in SOEs is very poor. And, this leads to build up of current liabilities, which virtually turn into long-term liabilities because of non-payment in time.

Medium-and-long-term loans are raised mostly for the creation of some form of productive assets, such as loans and investments or fixed assets in the form of plant, machinery, land and buildings.

Strangely, in many financially poor SOEs, the schemes for employees loan are not suspended or restructured even when they are not able to discharge their own loan obligations. As a result, it is often seen that Employee Loan Schemes in loss-making SOEs are almost entirely financed by either medium-term or long-term loans borrowed for business operations. Loans extended to employees come in various forms and sometimes look like a proxy for direct financial allowances and every now and then Employee Unions of SOEs coin new loan schemes and press management to introduce them. Computer Loan, Furniture Loan, Education Loan, Housing Loan, Loans for Family Contingencies, Refrigerator Loan are some of the examples. The rate of interest on such loans is so low that they appear like direct financial benefits. In some cases they are even waived. Waiver is normal in the case when an employee dies while in job.

The **contingent liabilities** have been identified as a serious problem in many SOEs, because many of them are not funded or provided for. Most significant of these liabilities is the employee retirement benefits, namely, accumulated leave encashments, accumulated medical expense allowances, gratuity or pension. Strangely, SOEs also do not make adequate provision for income taxes payable and they often have assessment arrears of several years and, at the time of liquidation or closure, the tax obligation comes in as a contingent liability. Some SOEs did not even deposit the Value Added Tax (VAT) they collected and did not also make any provision for. Such cases were later discovered and their incidence became a sort of contingent liability. There are also cases of purchase orders placed and after the change of management the order was simply ignored thereby letting the supplier make claims for non-fulfillment of contractual obligations. This also adds to contingent liabilities. A precise estimate of the total contingent liabilities of all SOEs has always been difficult.

Why has SOE liabilities become unmanageable?

Lack of policy directives : There are strange anomalies in the way autonomy has been granted to SOEs. In areas where autonomy needs to be regulated by specific policies, guidelines and standards, SOE management has full discretionary authority. For example, right to borrow a loan by mortgaging an asset is at the discretion of SOE management. There are no specific policies or guidelines. So is the case with accounts payable and inventory management. While in other areas, such as, filling vacancies in upper positions through promotions (without increasing the number of staff) or raising meeting allowances by a marginal amount, prior approval of concerned ministry is required. Some line ministries also require from SOEs under their jurisdiction to get approval for normal procurement decisions, provide written instruction on how a decision should be made by the Board. In the absence of specific policies concerning explicit liabilities and also for the better management of contingent liabilities, the SOE liabilities have become unmanageable. Some years ago, Ministry of Finance instructed all SOEs to make their Staff Retirement Obligations fully funded, but that is not being monitored and no action has been taken against SOE management which failed to comply. While staff salary and allowances regime is largely regulated (pressure tactics do succeed sometimes but Ministry of Finance has not rampantly approved hikes), staff loan provisions are not regulated. As a result, there are many instances of myriad of loan schemes at heavily subsidized interest rates. There have also been lapses in other segments of staff benefit packages. Salary and allowances were generally construed to be strictly under government regulation, but other items with no direct and immediate financial consequences but of value to employees were considered at the liberty of the SOE Board of Directors. Consequently, boards of many SOEs have approved personnel by-laws containing hefty gratuity payment provisions, automatic promotion upon completion of certain number of years and so on. These are the provisions that add to contingent liabilities.

Board of Directors without any personal stake : SOE Board of Directors does not have any personal stake in the financial management of SOEs. If the Board member happens to be the government official then his performance in the Board does not count in his career development. If he/she is an outsider picked up due to a political acquaintance or approach then again he/she has no personal stake. No gains for them if SOE makes a huge profit or is in proper financial shape due to better management. Similarly, they have nothing to lose, no erosion in the value of shares or their personal wealth, if SOE loses due to poor financial management. None of the ministries responsible for appointing board members issue guidelines to the appointed person as to what he/she is expected to do. A plain four-five-line letter is handed at the time of appointment. Many directors attend meetings without knowing which laws or policies govern the SOE they are representing. Being a director used to be fun, and the fun is going on rampant. Why would such a bunch of people take due care while making certain decisions? This is another reason why liability managements in SOEs have been very poor. After 1990, every SOE witnessed surge of several employees' unions, each affiliated to one or the other political parties. These unions have grown stronger over the years and political patronage has become even stronger. In demanding additional benefit to employees posing imminent and future liabilities, all unions unite. They put pressure on Board of Directors and the latter easily yield because they have no personal stakes hence no accountability. "*Gaye sarkar kai janchha, aaphoo kina chhuchcho hune* ?" (If anything goes wrong, its' governments', why should one be miser ?) This is the general syndrome. Hefty retirement benefits, loan schemes of different sorts and automatic promotion regimes are all the products of weak boards and strong employee unions.

Unfunded retirement benefits : As discussed previously, most of SOEs do not have proper provisioning for employee retirement benefits. In cases of a funded scheme, the fund is terribly inadequate. For instance, the ADBL had a funded scheme, but was totally exhausted when it implemented a Voluntary Retirement Scheme few years ago, retiring only about 8 percent of its total employees. This indicates how inadequate the fund was. Large corporation and with huge retirement benefits, such as, Nepal Airlines Corporation has not yet sincerely started earmarking separate fund for meeting such obligations.

Weak "current assets management" practices : This remains very weak in almost all SOEs. Even in case of SOEs that trade in goods and services, the attention to current assets management is very weak. It is this reason that leads them to frequently run out of stock of the critical items they deal, such as, petroleum products or food items. Cigarette and cement factories under government ownership often suspend production for lack of critical raw materials in the inventory. Not only inventory management, the management of receivables, too, is very poor. Nepal Telecom is fortunate to have technology that enables it collect on a prepaid basis and hence does not have much of receivables in the books in the recent years, but its landline operation is still fret with receivables that have gone uncollectible. Nepal Electricity Authority (NEA) has the worst record of current assets management, particularly the accounts receivables. Its average collection period is too high compared to operators in other comparable countries. In many cases, it is unable to collect arrears for a long time because of lack of teeth in enforcement. And it seems to be doing nothing to change this.

Weak budgetary control system : Few SOEs prepare budgets in advance of the accounting year. In Nepal Airlines, for example, budgets are presented to the board at the close of accounting year for the ensuing year, but approval by board takes two to three months. Some others just go on with board approval for ad hoc expenditures and then get the budget approved three to four months into the accounting year.

Budget undoubtedly is the means of controlling finances so that drain of resources can be prevented and liabilities can be brought within manageable limits. When budgets are not prepared timely and budget performance analysis is not done periodically at the Board level, the control system weakens.

Weak accounting, reporting and disclosure : Many SOEs do not get their accounts prepared and audited in time. In recent years, Rastriya Banijya Bank and Agriculture Development Bank have improved financial reporting timing and standards. Nepal Industrial Development Corporation recently cleared all of its audit backlogs and published financial statements of nine financial years at one go. From now on it promises to be on time and hold Annual General Meeting within the legally stipulated deadline. Rastriya Beema Sansthan is a chronic laggard and so is the Nepal Airlines Corporation. NEA is in no better position either. Although there has been general improvement in the timing of reporting, but the standards financial disclosure is still very poor. Delayed and poor financial reporting conceals much of the financial problems and when they are known much damages would have already been done. Delayed knowledge of problems is also the reason why corrective measures are not taken in time so as to prevent losses and consequently manage liabilities properly.

What needs to be done to make SOE liabilities manageable ?

The first and foremost, of course, is the **recruitment of SOE top executive through a competitive merit-based selection process**. Many examples show that a dedicated leadership can make substantial difference. The CEO should not only be given competitive compensation package but also be made accountable to the critical indicators that measure precisely the following three category of indicators:

a. **Performance** (basically measured by turnover profitability and return on investments)

b. **Liquidity** (basically measured by the efficiency achieved in accounts receivable and inventory management. This should certainly include cash management, as “cash” cushion is always required to keep the business going during thick and thin. Several SOEs have landed into trouble because of cash crunch during peak business times and conceded the business to competing private sector. Nepal Food Corporation cannot buy rice and wheat during peak season due to cash constraints and loses market to private vendors. This is exactly what National Trading Limited does.)

c. **Solvency** (basically measured by financial leverage, net worth and composition and asset-liability matching)

Although a good CEO can do a lot, the Board should also be professional, and effective measures should be taken so that they become accountable for the performance of SOE. Government should make a roster of competent professionals. These may also include retired top bureaucrats with proven competence. An independent recruitment committee should be given the task of selecting board members including the selection of chairperson. Fair selection is one good step. This alone will not ensure a competent and accountable board. The board members should be given clear instructions in writing as to what they are expected of. This should be accompanied by monetary reward package that compensates their participation in meetings and also gives a percentage share in the profit. To begin with, a one percent share of profit or maximum of Rs 500,000 per annum per person to board members at the year-end can be a good financial package. This can prompt board members to pay attention to better financial management of SOEs.

Issuing guidelines for better asset-liability management: These are sketchy at the moment. There are standing instructions by government how SOEs can use their land and property. But there is no such guideline how other assets, long-term liabilities and particularly current assets should be managed. Detailed instructions are necessary for better inventory and accounts receivables management and mention must be made of what standards does government expect.

Unfunded retirement benefits should immediately be stopped. This might invite employees' wrath, but this must be encountered in the course of time.

Staff loans: SOEs must not be allowed to operate any staff loan scheme; all staff loan schemes in operation now needs to be closed forthwith and all loan balances collected within a defined time period. SOEs can make arrangement with either Employees Provident Fund or Citizens Investment Trust for staff loan. Staff Welfare Funds created as per the existing Bonus Act should not be mixed up with SOE finances and should be allowed to operate as an autonomous agency within the SOE.

Offering SOE shares to public: Offering the shares in the market and getting shares listed for trading also helps in toning up management. This mechanism, as seen in other countries, creates public pressure, particularly investors' pressure for better management. It can also be an effective means of control. In Nepal, however, earlier experience has not been that encouraging. Nepal Bank adopted that mechanism, but the bank got into trouble and had to be rescued by the government. Perhaps the mechanism falied due to the absence of dynamic secondary market during Nepal Bank's heydays. In the case of recent entrants, such as Nepal Telecom and ADBL, however, the pressure for better management is visible. Top management is now more agile in financial operations and there is increasing concern for profitability.

Conclusion

While we speak of private sector development in Nepal, we cannot simply ignore the role of SOEs. In an environment where SOEs are not operating well, the private sector also gets inflicted by the similar diseases. In countries where private sector have succeeded and grown bigger, the state-sector also has grown equally strong and big. There are some business sectors, such as hospitality and tourism business in Nepal, where private sector has gained enough expertise and market has requisite competition to ensure quality and better prices. In such sectors, one cannot and should not expect state presence. However, in sectors where private sector is not operating efficiently or private sector cannot simply get in because of the sheer size of operation, the role of government is still there.

CHAPTER VII

Financial Market Openness And Capital Flows

- Siddhant Raj Pandey

INTRODUCTION

Well functioning financial systems are central to meeting the challenges of accelerating economic growth. The degree of success in any economy is judged by the free flow of capital and the extent of openness of the financial market. Globalization of the financial markets has led to the integration of emerging economies to the international capital markets. In the region, the countries of South Asia all commenced reform measures in the 1990s. While some nations are ahead of the others, all have either under gone the same problems or are in the process of solving them. A few of the countries have led the way; India has been notable in developing the capital markets and since the mid 1990s, external sector developments in India have been marked by strong capital flows. Although Nepal's liberalization drive commenced in the mid 1990s, capital flows have not played a major role in the financial sector. Besieged by unstable political regimes, lower growth rate of macroeconomic indicators, and unskilled and militant labor, Nepal has not been able to attract FDI compared to other countries in the region. Nepal has been losing competitive advantage due to lack of clear policies and implementation factors to attract foreign investments.

World Trade Organization (WTO) mandated from 2010 that Nepal open up the financial sector for wholesale banking to international players. It was deemed by opening up would boost the economy by providing funds from abroad for investments. A year has passed and none of this has transpired. This paper elaborates on various aspects of capital flows to Nepal and the role of financial market openness. It evaluates the effect of international capital flows on the development of the financial markets. The risks attached and the rewards that have been reaped. The international scenario will be briefly discussed with India's case as broad example from the region. A detail on Nepal as a case study will be presented.

Historical backdrop in the region

The reform measures in the banking sector in the region began in the 1990s. The problems across the region were similar with excessive state control over the banking and financial sector. The main problems were: high rate of non-performing loans, lack of strong regulatory control, poor access to finance, poor financial infrastructure, lack of coordination between the various government agencies and lack of good governance.

The problems have been dealt by:
- Efforts to free up interest rates and credit allocation
- Modernize central banks
- Reduce government ownership
- Foster competition
- Improve financial sector regulation and supervision
- Develop capital markets and gradually open up the capital markets

The reform measures commenced by starting with modernizing the central banks by improving financial sector regulation and supervision, reduced government ownership in state owned banks, allowed private sector banks to operate and compete with foreign investments, and efforts were made to free up interest rates and credit allocations. Gradually the capital markets were encouraged to develop and open the capital account. In the region, some countries have been more successful than others in the process of financial sector development, but all have gone through the process and some are ahead while others are beginning to show positive change. One common problem all face is that long term financing for investments that remains to be scarce and domestic resources for growth continues to be lacking.

India cautiously opened up its capital account since the early 1990s to meet the country's enormous investment needs. In liberalizing its capital flows, India adopted a discriminatory approach towards various forms of capital flows (Mohan). FDI was considered the most preferred form. India followed a gradualist approach to liberalization of its capital account. India managed to create a robust capital market to address this issue by opening up the capital markets and allowing capital flows. Strong capital flows to India in the recent period reflect the sustained momentum in domestic economic activity, better corporate performance, positive investment climate and favorable liquidity conditions and interest rates. The large excess of capital flows over and above those required to finance the current account deficit (1.5% of GDP) resulted in reserve accretion of \$ 110.5 billion during 2007/08 (this figure dropped to \$50 billion in 2010 due to the international financial crisis). India's total foreign exchange reserves were \$307.4 billion in May 2011.

International Scenario

Globalization of the financial markets has deepened financial markets especially in the industrialized and emerging markets. Cost of capital due to financial deepening has decreased, which in turn has facilitated investments and entry into markets (Levine, 2005). On the other hand, it has also led to risky behavior. The Asian crisis of 1997 and the international bond crisis of the late 90s and the recent sub prime loans and collateralized mortgage Obligations (CMOs) that generated in the United States had negative effects throughout the industrialized nations' financial sector with ripple effects in the emerging markets. However, research has evidenced that higher integration in world capital markets has enhanced the development of domestic financial markets by raising bank credit, total assets of the banking system, reducing net interest rate margins and increasing stock market capitalization (Calderon, Kobuto). This has been possible in countries that have provided laws and systems that are in place to protect investors. The management of capital flows is a complex process encompassing a spectrum of policy choices, which include appropriate level of reserves, monetary policy objectives related to liquidity management, and the maintenance of healthy financial market conditions with financial stability (Mohan). The intensified pressures due to large and volatile capital flows in the recent period in an atmosphere of global uncertainties make the task significantly more complex and critical.

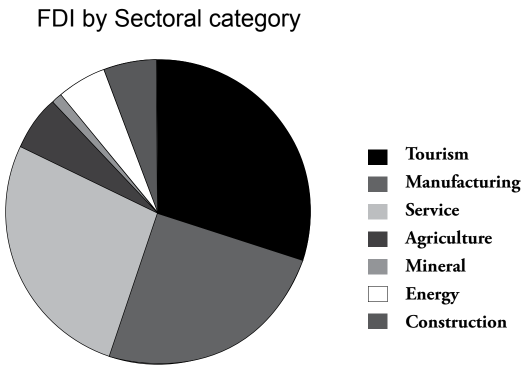
Case Study Nepal

Although Nepali Rupees was made fully convertible in the current account transactions in 1993 Nepal has not yet adopted the capital account convertible policy, except for the repatriation of income (Aryal). While foreign direct investment inflows are encouraged, debt flows in the form of external borrowings and portfolio investment in government securities, corporate bonds, and in the stock market are subject to restriction. The non financial sector is not allowed to invest abroad or acquire companies.

According to Central Bureau of Statistics survey of 2010, there were 1,897 firms operating with foreign investment from 139 countries. India has the largest investment in Nepal consisting 393 areas of investments followed by China with 179, Japan 132, South Korea 94, UK 94, Germany 61 and Switzerland 27. Manufacturing has the largest number of FDI investments, which stood at 565 companies with FDI followed by hotel and resort sector with 370 investments. Textile and garment with 210 and energy, water and gas sector had 32 companies. These industries together have a fixed investment or capital of Rs. 119730 million and a project cost of Rs. 57,987.67 million.

Tourism dominates the FDI inflow in Nepal with 30% followed by the service industry with 27% and manufacturing industries with 25%. Energy and mineral sector have the least number of FDI, agriculture only has 6%. On the basis of scale of firms majority of FDI are small and medium scale. India has the largest FDI investments followed by the United States, China third, South Korea, Norway, Japan and the sixth is the investments from the British Virgin Islands (DOI). The FDI inflow in Nepal's case is invested in joint venture due to non commercial risks by offering shares to local partners. Most are in Greenfield–type investment rather than acquisition.

Practically liberalization of the financial sector started in 1984 with the commencement of operations of the first joint venture commercial bank, Nepal Arab Bank Ltd. This made way for ANZ Grindlays Indo Suez, and The Himalayan Bank, a joint venture partnership with Habib bank of Pakistan to open up operations in Nepal.



Source: Dept. of Industry

Stake of Foreign Entities In joint venture banks in Nepal

The advent of these international partnered banks added enormous value to the banking system in Nepal, which was otherwise dominated by poorly managed state sponsored banks. It was not until the 1990s that the financial sector development took a rapid pace. The joint venture banks transformed the manner in which banking was operated in Nepal. It helped improve the quality and efficiency of the financial systems by introducing best practices and standards. Competition for the first time led to innovation and the beneficiaries to this were the consumers. However, capital injection as investments was nominal from abroad. It would have been expected if higher integration in world capital markets were pursued, with sound domestic systems in place, would have enhanced the development of domestic financial markets by raising bank credit, total assets of the banking system, reducing net interest rate margins, increasing stock market capitalization.

Banks Name	Paid up Capital (NRs in '000)	% of Stake of Foreign Entities	Name of Foreign Entity	Country
Himalayan Bank Ltd.	2,000,000	20	Habib Bank Ltd.	
Everest Bank Ltd.	1,279,607	20	Punjab National Bank Ltd.	India
Standard Chartered Bank Ltd	1,610,168	75	Stnd.chrtd. Grinlays Ltd. 50% Stnd.chrtd. Bank Ltd. 25%	Australia UK
Nepal SBI bank Ltd.	1,869,303	55	State Bank of India	India
NMB Bank Ltd.	1,651,650	12.54	Young Lion Royal SDNBHD	Malaysia
NABIL Bank Ltd.	2,029,769	50	NB International	
Clean Energy Dev. Bank Ltd.	1,054,981	14	FMO Bank	Nederland

Source: NRB

Conclusion

Recent volatility and episode of capital flows in emerging Asian economies have had negative impact on the exchange rate, and overheating of the economy and asset price bubbles. Large capital flows can be a stress on economies through exchange rate appreciation and sterilization. However, a continued focus on financial market development can mitigate the challenges of capital flows. Long term effects have historically shown enormous advantages to the economies that have opened up. India's Reserve Bank has pro actively dealt with the effects of outflows of investments by utilizing instruments for capital account management complemented by prudential regulations.

The need for FDI in Nepal is enormous as the resource mobilization capacity is limited, and in recent years, the economy has been facing a liquidity crisis, which has led to lack of credit flows in the economy. However in Nepal, without total capital account convertibility the prospect of capital inflows will be incomplete. Furthermore, lack of domestic factors, such as strong macroeconomic fundamentals, a resilient financial sector, deep and liquid capital market compounded by political instability have been the main reasons for dismal FDI investments.

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CHAPTER VIII

Nepal's Development From A Regional Perspective

- Dr. Jagadish C. Pokharel

Nepal's uniqueness as a country linked with India on three sides and China on the other presents a distinct dimension of opportunities for development. These opportunities are cultural, economic, social and political. Hence, Nepal's development hinges on the ability of individuals and the nation to appreciate, understand, manage and maximize this inter connectedness.

One of the most significant aspects of Nepal in relation to the region as a whole is that its high level of diversity. Physically, the country is at the most 885 km long and 193 km wide, and has an area of 147181 square kilometers. However, its altitude varies between 70 meters in the south to 8848 meters in the North. Its population is growing at a rate of 2.25% and it is projected to be close to 28 million people. Administratively it is divided into 75 districts, 58 municipalities and 3915 Village Development Committees. And according to recent projections Nepal's 28 million population contains over 100 ethnic groups, 92 languages with three predominant religions and 6 smaller ones. Hindus make up 80.6%, followed by Bhuddhist 10.7%. Muslim 4.2% and Kirant 3.6% and several other religions (CBS, 2001).

These are important facts about Nepal without which any analysis of development is incomplete. Moreover, their regional implications reveal an astounding array of development options with respect to trade in goods, knowledge and services as well as the movement of ideas.

Nepal is largely open and accessible along three sides due to its open border with India, and its flat geography in the south. In the north, it has access where the geography and bilateral relations permit - usually along passes and ancient trade routes. From a trade perspective, there are many more points of connection to India's transportation network than to China's and these connections can handle a greater volume of exchange. Similarly, due to geography, the nature of goods that can flow to the north and south differs. Over time, the southern connections have become more highly developed than north. However, as Nepal moves forward it intends to develop the northern connections further. This difference in the nature of the connection to the north and south is important to bear in mind, as the types of opportunities and constraints are not the same on the two sides.

If we examine the regional transportation networks in and around Nepal, what becomes immediately apparent is that there are many more major market centers in close proximity to Nepal on the Indian side than on the Chinese side. Figure 1 also reveals that the northern connections are through regular roads and trails while the south connects to national highways, railways and express ways . This transport network which will be further developed in the future connects economic centers in Nepal's border with neighboring countries- India, China and Bangladesh.

Historically, Nepal's connectedness with the two big neighboring countries has been perceived as a blockage or barrier. However, Nepal is now moving away from this position, and towards capitalizing on these connections and proximity to two undisputed emerging economic powers in order to innovate in its development approach.

Fig. 1

Source National Planning Commission, 2007

Thinking beyond land-lockedness has opened up a new and wider development horizon for Nepal. We are beginning to understand that Nepal is a diverse country intricately connected with two large friendly economies which offer plenty of opportunities to exploit for its development. Making this the centerpiece of our national mentality will prepare us to fully innovate in the future.

The significance and scale of opportunities for Nepal can be imagined when we look at the scale of the economy, the population and the pace of growth of the two countries nearby. China is about 65 times bigger in size, 45 times in terms of population, and 168 times larger in terms of the size of Nepal's economy. India is about 20 times Nepal's size, 41 times its population, and 44 times its economy (see Table 1). Again this daunting scale and size of the neighbors should not intimidate or shrink us rather they should be taken as open space for our growth.

Table 1: National level indicators (Approximate to indicate scale)

	Nepal	China	India
Population (2010 projection)	29 million	1.3 billion	1.2 billion
Land area (Sq Km)	0.147 million	9.6 million	2.9 million
Total GDP in 2010 (nominal $)	.035 trillion	5.88 trillion	1.53 trillion
GDP growth (% in 2010)	4.6%	10.46%	8.5%
GDP Per capita($) (2010)	1,200	4,200	3,500
Nepal's export to ($) 2010	-	300 million	556 million
Nepal's import from ($) 2010	-	0.68 billion	3 billion

In terms of population, economic growth and urbanization, Nepal is many times smaller than many states and provinces in India and China (see table 2). Hence, the extent of market potential that these two countries provide for Nepali products and services can be enormous. Hence, even a small penetration of these markets can make very large difference in Nepal's economy. Matching Nepal's production centers with demand in these two regions will be a key to innovative entrepreneurship. What we produce and what we serve to these countries can range from basic agricultural products to sophisticated tourism services. For example, the Chinese market has a huge demand for herbal medicine; In India there is a huge demand for energy and in both the countries there is a great interest to visit Nepal for religious and cultural tourism. These demands are likely to grow with the further development of these countries. Nepal should make its goal to meet part of these demands. (See figure 2).

Table 2: Nepal compared to states and cities in India and China (Current Approximations)

Country/ State	Population (2010)	2010 GDP ($, nominal)	Area (sq. km.)
Nepal	29 million	35 billion	147,181
New Delhi	16.7 million	46 billion	1,483
West Bengal	91.3 million	84.5 billion	88,752
Bihar	103 million	35.6 billion	94,163
Uttar Pradesh	199.6 million	110 billion	243,286
Beijing	19.6 million	173.7 billion	16,801
Guangzhou	12.7 million	163 billion	7,434
Shanghai	23 million	256 billion	6,340

Source : Estimates collected from various sources

In order to maximize the benefits from these markets we need to establish industries for domestic products and then develop reliable and stronger commercial links with the markets in these countries. The border regions on all sides of Nepal typically develop faster than inland regions as the infrastructure links become better developed. Given the size and shape of Nepal, as well as the specialization of existing economic centers (see figure 2), the linkage with these two countries is not as difficult as starting from scratch. Though towards north the terrain is difficult, they have been accessed consistently. Foot and mule trails along the river valleys and mountain passages have been successfully used since historical times. They can be developed to meet the new demand. Recent development of East West railway line in Tibet region of China has opened new linkages and transport network to connect the northern region of Nepal with market in Tibet and mainland China.

Source : National Planning Commission, 2007

Nepal as a whole can grow with increased trade, socio-economic interaction and linkages with its neighboring countries. To take full advantage of the opportunities it should combine market interactions with its neighbors and growth of industries and market within the country. The growth can be particularly high in bordering regions and existing economic centers in Nepal that are well connected to the transportation network.

Urban and Regional Perspectives

A regional perspective for Nepal's national development was introduced back in the 4th national development plan where the growth centers and growth poles and development axis were planned. Even today, infrastructure and development are guided by these plans. The east west high ways, north south corridors and regional administrative centers were introduced at that time. These centers have now evolved as major economic centers of the regions, and some have grown faster than others. The fast growth in the density of land transport network after 1990's has also significantly increased the connectivity of these centers and the small markets and production centers in the periphery.

There are several government projects that will have significant impact on regional opportunities. The development of Mid Hill East West Highway, the upgrading of Mail Road (*Hulaki Sadak*) once completed, along with Mahendra Raj Marg (the existing East West High Way) will significantly enhance the east west connectivity in the three ecological regions. As a result of these possibilities, there has been significant growth in the market centers along these high ways. Development along these corridors that connect with major urban centers follows a ribbon pattern on two sides.

Figure 3: Regional Road Network, major roads. (Credit: Suresh Pokharel)

Urbanization and regional development is also taking a definite shape with the increase in the number of municipalities. With recent declaration of 41 new municipalities, the total number of municipal areas has increased to 99. This includes the Kathmandu metropolis also. The government is also planning to create 12 planned cities along the Mid Hill highway.

There are five points in the North from which the north-south roads connect Tibetan markets with the southern plains. The planned east west railway and upgrading of existing airports in all three ecological zones have further strengthened the existing transport network. All these networks have furthered the potential for the growth of different regions of the country. The following figure shows the current road network in the region.

THE FUTURE

In the future, further development of Nepal's transport network, and its growth of economic centers is likely to take the following shape.

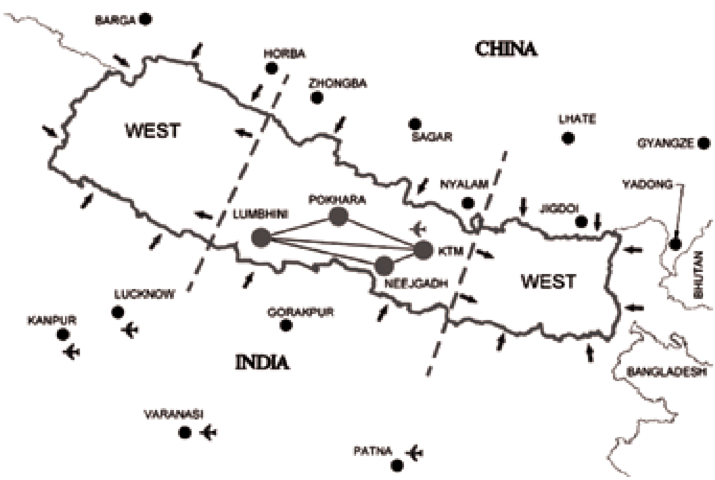

Figure 4 : Nepal's Future Development (Credit: Suresh Pokharel)

There is likely to emerge a strong center in the middle of the country. Geographically this can include largely the area east of Karnali river and West of Koshi river. There will be several economic centers within this area while Kathmandu, Nijgad, Lumbini and Pokhara will gain centrality (see following Map). The future plan to upgrade and build international airports in Kathmandu, Nijgad (major hub), Lumbini and Pokhara (regional) and connect them with fast speed roads that are at least four lanes wide will further strengthen its centrality in the near future. Of course, other infrastructure network such as telecommunication, electricity, inland ports and others will back up transport network. This central region will push economic development to the east and west and links with India and China will help them grow. This larger central region is likely to evolve into the administrative and economic capital of the federal Nepal.

CHAPTER IX

International Market Access

Where We Stand ? What We Need To Do ?

- Ratish Basnyat

World Trade Organisation (WTO)) is a multilateral rule based, member driven global organization that deals with the rule of trade between the nations. It came into existence on 1st January 1995 with 128 founding member countries who were already a signatory of General Agreement on Tariffs and Trade (GATT). The focus of GATT was mainly related to Trade in Goods whereas the WTO covers Trade in Services and Trade Related Intellectual Property Rights.

Nepal after many years of strenuous and continuous negotiation became the first Least Developing Country (LDC) to accede the WTO membership through full working party negotiation process. The Fifth Ministerial Conference that took place on 10-14 September 2003 in Cancun, Mexico adopted Nepal's protocol of accession into the WTO regime and the membership was formally ratified by Nepal and thereafter formally became the 147th WTO member on 23rd April 2004.

Nepal is a landlocked country having no direct access to the sea port. Nepal has been enjoying the access to the sea port at Kolkata through The Transit Treaty signed in 1971 between Nepal and India. In 1989 due to certain political disputes this treaty could not be renewed and as a result Nepal's trade came to a standstill. To put it more bluntly Nepal could not export or import anything through this route, not even the basic essential items because there was a trade embargo by India who was supporting the change in the political regime. Therefore, in search of alternatives Nepal applied to become a member of GATT and obtained the observer status in 1989. But the change in the political regime in 1990 led to the renegotiation and renewal of the transit treaty and again the urgency to become the GATT member died down. However, Nepal adopted a liberalization policy in 1991 in view of integrating itself with the global market. The issues of market access for Nepalese exports and importance of foreign investment for overall economic development were the driving force behind this liberalization policy. This led to the renewed interest to become a WTO member and hence Nepal again submitted an application to become a WTO member in 1998. Then the formal negotiation with the WTO members began and eventually in 2004 Nepal was granted a WTO membership.

There are both pros and cons of becoming a WTO member. At least during the time of negotiation there were opinions from government, private sector, civil society organization and other stakeholders both supporting and cautioning our membership into WTO. Being a LDC it was argued that there are opportunities like greater duty free market access, possibility of enhancement of efficiency of Nepali enterprise, well defined trade/transit rights, policy stability, predictability and transparency, possibility of increased foreign investment, possibility of special and differential treatment among others. In the similar manner threats or rather challenges like fulfilling WTO preconditions, meeting international standards, promulgating and complying with all the rules and regulation, competition with foreign investors, revenue implication due to commitment to reduce tariff rates etc were also highlighted as major issues of concern.

In general, the government usually makes policies whereas the impact falls majorly on the private sector. Therefore, during the pre and post WTO membership the private sector representatives among others were consulted for inputs which became useful to lobby for the greater interest of the Nepalese private sector and for the welfare of the nation as a whole. In this regard, various awareness building programs with the business community and the concerned stakeholders were carried out throughout the country. The idea was also to disseminate the actual reality about the WTO as well as to clarify the misconception about this multilateral trading system if there were any.

It is difficult to specify the actual and direct gain or loss through the WTO membership. However, there are few positive things that are worth listing. At first, the awareness about the multilateral trading system in general and the importance of intellectual property rights can be taken as a step forward. Just to cite an example, effect of Nepal's liberalization policy had already started showing its colour in the telecommunication sector. WTO membership played a catalytic role in further opening of this sector. The process of liberalization was expedited and subsequently benefit from this sector started accruing at a faster rate. The telecommunication sector has had immense impact in the Nepali society. After WTO membership the private sector's investment started to pour in thick and fast. As a result, there are now 8 network service providers, 3 GMPCS service providers, 2 cellular mobile service providers, 45 internet service providers, 3 basic telephone service providers, 2 rural telecommunication service providers, 6 rural internet service providers and 8 rural VSAT users. This massive growth in telecommunication sector in Nepal, meanwhile, is attributed to the WTO.

Similarly, technical support for building trade capacity and competitiveness has started coming in. The recent example of Nepal Trade Integration Strategy (NTIS) 2010 is a good example in this regard. 19 products and services with SWOT (Strength/Weakness/Opportunities/Threat) analysis have been identified which have export potential and the effort to commercialize and market these products is praiseworthy. The project is working closely with the private sector organizations and important stakeholders. This is a very good beginning and we need to support this initiative by strengthening the supply side capacity by replicating this effort and also working to upgrade the quality and standards to meet the international level. In addition to this, the concept and the effort can also be simultaneously emulated into various other products and services.

According to the NTIS 2010 seven agricultural products, five crafts and industrial goods and seven service sectors are identified which have substantial export potential.

Export Potential Products/Services identified by NTIS 2010

Agricultural products	Crafts and Industrial Goods	Service Sector
Cardamom	Handmade Paper and Paper Products	Tourism
Ginger	Chyangra Pashmina Products	Labor Services
Honey	Silver Jewellery	IT and BPO Services
Lentils	Iron and Steel Products	Health Services
Tea	Wool Products	Education Service
Medicinal Herbs and Essential Oils		Engineering Services
Noodles		Hydro Electricity

Source : NTIS 2010

With regard to challenges, the issue of non tariff barriers is creating more problems than the tariff barriers. Whether in the name of Sanitary and Phyto-Sanitary (SPS) or Technical Barriers to Trade (TBT), Nepal is facing difficulty to penetrate the global market. The supply side constraint, lack of proper infrastructure and the internal political situation among others have also played a part to keep Nepal away from reaping benefits through this platform.

SAARC

On the regional front, Nepal was already a founding member of South Asian Association for Regional Cooperation (SAARC) since 1985. It was more of a diplomatic agreement between the governments with the objective of accelerated economic growth, social progress and cultural development in the region. The core economic issues were not a priority and therefore to bring about improvement in the business environment and to disseminate information about potential tradable goods and identify joint ventures in the SAARC region, a regional private sector representative body namely SAARC Chamber of Commerce and Industry (SCCI) was established in 1994. The national apex federations of the member countries are the founding members of SCCI. By this time the business interest had also started getting its due importance and as a result a formal agreement, South Asian Preferential Trading Agreement (SAPTA) was signed in 1993 which came into force in 1995.

The process of economic integration in South Asia gathered momentum with the implementation of SAPTA, which laid the foundation for cooperation in trade. The agreement had a provision to allow preferential treatment for the goods originating in the SAARC region and the negotiation was on the product by product basis and according to the offer list of member states. However, the initiative could not deliver as envisioned. The major factor for this is that the offer list for preference was limited and on top of that the member countries that were being offered such preference did not have enough capacity to export. Therefore, despite SAPTA, intra SAARC trade marginally increased from 3% in early 90s to 4% in late 90s.

With a view to do away with this stagnancy phenomenon and to improve and open up trade and economic relations in the region, a free trade agreement was signed in 2004 which entered into force in 2006. It intended to provide a fresh boost to the integration process and unlike the earlier preferential trading agreement, South Asian Free Trade Agreement (SAFTA) adopted a negative list approach with the intention that South Asian countries would phase out import tariffs to other member countries on all goods apart from the items reserved under a "sensitive" list.

As per the agreement, India, Pakistan and Sri Lanka are categorized as Non-Least Developed Contracting States (NLDCS) and Afghanistan, Bangladesh, Bhutan, Maldives and Nepal are categorized as Least Developed Contracting States (LDCS). Afghanistan which became the eighth member of SAARC during the 14th SAARC Summit held on 3-4 April 2007 in New Delhi became a party to the SAFTA Agreement as an LDC member in early 2010. Under the proposed tariff liberalization program (TLP), SAFTA will become fully effective by 2013 for NLDCs and by 2016 for LDCs.

As far as the Trade Liberalization Policy is concerned, the approach adopted makes a commitment towards a top–down reduction of tariffs in which non-LDC member states are required to reduce existing tariffs to 20 percent within 2 years of implementation of the agreement, and thereafter to further reduce tariffs to a range of 0–5 percent in the next 5 years. 3 LDC member countries are required to reduce existing tariffs to 30 percent in 2 years and further ensure a reduction to a range of 0–5 percent in the next 8 years

Another key area is Rules of Origin (ROO). There are generally three methods used to determine whether 'substantial transformation' of goods has taken place. Each rule could be applied in isolation, in the alternative, or in tandem. The SAFTA agreement requires domestic value addition (DVA) of 40 percent for India and Pakistan (as non-LDC member countries), 35 percent for Sri Lanka (as a small economy), and 30 percent for LDCs, in combination with a change of tariff heading (CTH) as classified at the four-digit Harmonized Commodity Description and Coding System (HS) code. However, derogation from the General Rule has been permitted under SAFTA because some products may undergo substantial transformation and allow the DVA criteria to be met without CTH at the four-digit code and vice versa. Besides the single-country ROO, there is also provision for cumulative ROO with a minimum aggregate content of 50 percent with the provision that the minimum input from the exporting country should be 20 percent.

With regard to the sensitive list it was decided to retain 20% of the total 5,224 tariff lines at the HS 6 digit level. Although 20% of the products in the sensitive list may not be that big but the problem was most of the tradable products fell under this list and therefore trade liberalization did not really help. Recently there was a negotiation to further downsize the number of sensitive products by 20% by all member countries. In the process Nepal has identified around 260 items that can be removed from the sensitive list considering their impact in the domestic market. A preliminary offer list from Nepal is already circulated but it is yet to be accepted.

Comparative Sensitive List

Countries	Afghanistan	Bangla desh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka
Items	-	1254	137	865	671	1335	1183	1065

In 2009/10 Nepal's percentage of export in SAARC region compared to total export is 73.85% whereas Nepal's percentage of import from SAARC region compared to total import is 57.37% during the same period. This shows the dependency of Nepal with regard to trade in the region. Besides the few products that go to the European and US market, most of the items are confined to India. Out of the total export in the SAARC region, Nepal's export to India constitutes a massive 88.65%. Similarly out of the total imports from the region. Nepal's import from India is again a staggering 99.42%.

Bangladesh comes next to India in terms of Nepal's export (7.5% of Nepal's total export to SAARC region). There is also some export going to Bhutan from Nepal (3.45% of Nepal's total export to SAARC region). Apart from these figures the export to and import from other SAARC countries is negligible.

Nepal's export to SAARC member countries

Country	2005/2006		2006/2007		2007/2008		2008/2009		2009/2010	
	Value	%	Value	%	Value	%	Value	%	Value	%
Afghanistan	457	0.00	12,461	0.03	922	0.00	2,346	0.00	973	0.00
Bangladesh	234,323	0.57	521,499	1.22	4,664,363	10.73	4,710,402	9.67	3,373,718	7.50
Bhutan	238,275	0.58	310,958	0.00	142,688	1.00	194,826	0.40	1,554,824	3.45
India	40,714,700	98.40	41,728,800	97.71	38,555,700	88.68	43,574,482	89.41	39,902,811	88.65
Maldives	47	0.00	1,028	0.00	89	0.00	4,007	0.01	589	0.00
Pakistan	186,228	0.45	126,944	0.30	80,681	0.19	86,003	0.18	78,971	0.18
Srilanka	2,207	0.01	3,123	0.01	35,147	0.08	161,544	0.33	100,263	0.22
Total to SAARC	41,376,237	100.00	42,704,813	100.00	43,479,590	100.00	48,733,610	100.00	45,012,149	100.00
Total Export	59,776,874		58,927,097		58,474,359		68,596,852		60,949,603	
% of SAARC in Total Export		69.22		72.47		74.36		71.04		73.85

Nepal's Import from SAARC Members Countries

(Value in '000 Rs.)

Country	2005/2006		2006/2007		2007/2008		2008/2009		2009/2010	
	Value	%	Value	%	Value	%	Value	%	Value	%
Afghanistan	221	0.00	6,184	0.01	25,323	0.02	6,225	0.00	7,384	0.00
Bangladesh	104,646	0.10	286,477	0.25	491,211	0.34	418,014	0.25	764,830	0.35
Bhutan	127,301	0.12	119,478	0.10	136,425	0.10	352,367	0.21	133,152	0.06
India	107,143,100	99.56	115,872,300	99.46	142,376,500	99.40	165,119,002	99.35	214,261,109	99.42
Maldives	45	0.00	106	0.00	311	0.00	71	0.00	--	--
Pakistan	191,380	0.18	171,455	0.15	179,766	0.13	248,893	0.15	281,240	0.13
Srilanka	52,019	0.05	46,192	0.04	24,929	0.02	58,224	0.04	54,773	0.03
Total from SAARC	107,618,712	100.00	116,502,192	100.00	143,234,465	100.00	166,202,796	100.00	215,502,488	100.00
Total Import	160,677,924		195,808,412		237,030,276		291,000,944		375,605,870	
% of SAARC in Total Import		66.98		59.50		60.43		57.11		57.37

Source: Compiled by Research and Information Division of FNCCI from various sources.

Nepal's major trading items (value wise) with SAARC countries

Country	Export items	Import items
Bangladesh	Lentils (Edible vegetables & certain Roots and tubers) Goats and meat Oil seeds & oleaginous fruits Rubber and articles thereof Synthetic organic tanning substances	Electric machinery, equipment's & parts thereof Pharmaceuticals products Woven fabrics of cotton unbleached Plastics and articles thereof Non wired glass having an absorbent Woven label, badges of textile materials
Bhutan	Uncooked pasta, prepared food Soaps Woven clothes for steel or iron; grill Sacks & bags; cotton tent; blanket Works of arts; collector pieces & antiques	Coal Articles of plastics Gypsum Sorbitol
India	GI Sheet Threads Polyester Yarn Vanaspati Ghee Textiles (Cotton, Synthetic & Other)	Petroleum Products Transport Vehicles and Parts MS Billet Medicine Machinery Equipment and Spare parts
Maldives	Woollen and pashmina goods Painting , drawing and pastels	Penicillins and their derivatives Turn table, record players, cassette players
Pakistan	Large Cardamom; black and green tea fermented Cotton Jacket; Woollen shawls, scarves, mufflers, mantillas, veils and the like Spectacle lenses of glass; Optical equipment; electro-medical instruments & appliances Hand knotted woollen carpet Plants & Parts of Plants (including seed and fruits)	Cotton textiles Edible fruits and nuts peel of citrus fruit or melons Plastics and articles thereof Coffee, tea, mate, spices Optical, photographic, cinematographic, measuring, checking, precision, medical or surgical instruments

Srilanka	Rawh Rawhides and skins and leather Articles of apparel and clothing accessories Artists brushes Vapor generating boilers hybrid boiler Worn clothing and worn articles ides and skins and leather	Cathode ray oscilloscope & oscilograph Mixture of odoriferous substance Single flax yarn Rubber and articles thereof Colouring matter

Source: Compiled by Research and Information Division of FNCCI from various sources

The list of products traded with all the member countries in the SAARC region looks longer. But in terms of value, the products exported to and imported from India dominate which seems obvious as the export and import data reveals a huge dependency with India.

South Asia which houses almost a quarter of the world's population accounts for only 2.5 percent of global gross domestic product, 2 percent of world export and 1.6 percent of world foreign direct investment. Even after implementation of SAFTA the intra SAARC trade is still less than 5 percent which shows that the trade in the region over the last 15-20 years is almost stagnant. This also means that there is a huge potential and room for improvement in this region. And recognizing this potential for accelerating South Asian regional cooperation and integration a report on "Key Proposals for Harnessing Business Opportunities in South Asia" suggested some short and medium term specific actionable issues for improving the business environment for private sector led integration in the region.

The recommendation included expanding the list and duration of SAARC visa exemption stickers which will enable frequent visits of business persons thereby creating higher chances of business development. Similarly it also suggested adopting a SAARC regional motor vehicle agreement which will allow vehicles to move beyond the border areas. The issue of dealing with NTBs, improving land customs facility through expansion of parking, warehousing facilities and establishment of regionally accredited laboratories is also highlighted.

BIMSTEC

Nepal is also a signatory of another sub-regional framework called Bay of Bengal Initiative for Multi Sectoral Technical and Economic Cooperation (BIMSTEC) which was formed on 6th June 1997. Nepal became an observer of this group in December 1998 and was granted full membership in July 2004. The member of this group comprises of countries like Bangladesh, Bhutan, India, Myanmar, Nepal, Sri Lanka and Thailand. This framework is actually a result of India's Look East policy and Thailand's interest in the South Asian region. It is also considered as an effort to link ASEAN and SAARC.

BIMSTEC covers 14 Priority Sectors led by member countries in a voluntary manner namely, Trade & Investment, Technology, Energy, Transport & Communication, Tourism, Fisheries, Agriculture, Cultural Cooperation, Environment and Disaster Management, Public Health, People-to-People Contact, Poverty Alleviation, Counter-Terrorism and Transnational Crimes and climate change. As per the Framework Agreement signed in 2004, this grouping is supposed to establish a free trade area by 2012, leading to liberalization of trade in goods, services, and investment, as well as to undertake economic cooperation. This framework is an added platform for Nepal in terms of market access in the South East Asian market. However, till date there has been no concrete agreement in terms of tariff liberalization, setting up of negative list, liberalization of services, promotion of investment and other areas of cooperation. The implementation process is kind of stalled at the moment.

Nepal-India

Nepal and India share a unique economic relationship due to historical, geographical, cultural, linguistic, ethnic, social and family links between people living in these two countries. Trade relation with India is rather crucial to Nepal particularly due to her landlocked geographic characteristics. The Indo- Nepal economic co-operation has flourished after the signing of Treaty of Friendship of Trade and Commerce in 1950.

During the early 1970s, India absorbed almost all of Nepal's exports. In 1970/71 India accounted 98.7% of Nepal's total export Likewise import from India was 88.2% of Nepal's total import. However, over the period there was a declining trend with regard to trade with India. The export figure slowly started falling and export to India was 18.5% in 1995/96. Similarly the imports from India also declined to 32.8% in the same period.

This was a major concern especially for the private sector of both countries. Therefore, the private sector representative organizations FNCCI from Nepal and Confederation of Indian Industries (CII) from India created a special task force and jointly commissioned a study to identify ways and means which will increase Nepalese export to India and at the same time there will be a flow of Indian investment in Nepal. The report prepared in 1995 was presented to the respective Prime Ministers of both countries and this report became instrumental and a major basis for signing a Treaty of Trade between Nepal and India in 1996.

The Treaty had a provision to allow duty free market access to all the Nepalese products on the basis of the Certificate of Origin issued by the Nepalese authority. This was a non-reciprocal preferential access which played a significant role in the diversification and expansion of

Nepalese industrial base. It also paved way for Indian investment. In the next few years trade scenario took a positive turn in favour of Nepal, with the increasing tendency of export from Nepal and increasing investment from India. However, this trend slowly started fading out. In the year 2009/10, India's share in Nepal's total export is 65.6% whereas the share in Nepal's import is 57.5% in the same period.

In 2009/10 Nepal has a trade deficit of Rs. 177.84 billion with India. Our import is Rs. 217.9 billion whereas our export is just Rs. 40.1 billion which means we import 5 times more from India than we export. This is a worrisome picture and therefore again the two private sector organization signed a Memorandum of Understanding in witness of the Nepali Visiting Prime Minister to India in 2008 and formed a joint task force to again study about the possibility of increasing exports from Nepal and increasing Indian investment. This time the joint task force is also looking for possible cooperation in sectors such as hydro-electricity, tourism, surface-air-water transport and agro forestry.

Nepal's Trade with India

With regard to major items of import from India, petroleum products top the chart. Data of 2009/10 reveals that it constitutes almost one fourth of the total import from India where as vehicles and spare parts, the second most imported products constitute little more than 10% of total import from India. M. S. Billet which is the third most imported product accounts to 6% of the total import.

Similarly with regard to major export items to India, polyester yarn and textiles have the highest contribution of little more than 8%. Next is thread which constitutes around 7% of total export to India.

The Nepal-India Treaty of Trade and Agreement of Cooperation to Control Unauthorized Trade renewed/signed on 27th October 2009 which will be valid for the next 7 years have expanded the scope for trade, precisely the export from Nepal. Also an effort has been made to curb the malpractices and bring a huge amount of unauthorized trade into a formal channel. In addition to that the Nepal India Treaty of Transit renewed in March 2006 for a validity of 7 years allows 15 transit routes for movement of goods from Nepal.

Treaty of Trade created a good margin of tariff preference for Nepal with regard to raw materials such as crude palm oil, copper scrap, acrylic fiber and zinc ingot. The tariff of these products in India were 75%, 35%, 20% and 35% respectively in 2001/02 which came down to 0%, 5%, 10% and 5% respectively by 2008/09. Many industries in the border of Nepal were set up to exploit the opportunity of duty differential in favour of Nepal. However, with the progressive liberalization by India, tariffs of these items in India came down at par with the preference given to Nepal. The preference enjoyed by Nepal eroded and subsequently also lost the competitive edge. As a result some of the industries even closed down.

Besides, there are a lot of issues that need to be dealt with regard to Nepal India trade. The issues related to non tariff barriers in the name of quarantine, testing and certificate, standard, transit, infrastructure at border points, the mind set of the customs official are some of them hampering and restricting the smooth flow of trade.

Nepal's Trade With India

(Value in Million Rupee)

Description	1970/71	1980/81	1990/91	1995/96	2005/06	2006/07	2007/08	2008/09	2009/10
Nepal's Export to India	395.2	992.4	1552.2	3682.6	40714.7	41728.9	38555.7	41005.9	40114.9
Percentage Share in Total Export	98.7	61.7	21.0	18.5	67.6	70.3	65.1	60.9	65.6
Nepal's Import from India	616.8	2179.2	7323.1	24398.6	107143	115872.3	142376.5	162437.6	217960.4
Percentage Share in Total Import	88.2	49.2	31.5	32.8	61.7	59.5	64.2	57.6	57.5
Trade Balance	**-221.6**	**-1186.8**	**-5770.9**	**-20716**	**-66428.4**	**-74143.4**	**-103821**	**-121432**	**-177846**
Country's Total Export	**400.6**	**1608.7**	**7387.5**	**19881.1**	**60234.1**	**59383.1**	**59266.5**	**67247.1**	**61126.8**
Country's Total Import	**699.1**	**4428.2**	**23226.5**	**74454.5**	**173780.3**	**194694.6**	**221937.7**	**284571.0**	**378795.6**

Source: Nepal Rastra Bank.

Major items of imports from india

S.N.	Major Commodity	2005/06	2006/07	2007/08	2008/09	2009/10
1.	Petroleum Products	33657200	33567600	40815700	41407100	51558000
2.	Transport Vehicle & Spare Parts	5213700	9798700	11874600	16158600	23773800
3.	M.S. Billet	3883400	4384200	8145400	7106800	13720700
4.	Other Mach. Equip. & Spare Parts	3509400	3556300	4682000	7296900	8401500
5.	Medicine	4389000	4442500	5434100	6558100	7962800
6.	Cold Rolled Sheet incoil	797700	2079600	4005800	6073000	6802600
7.	M.S. Wire Rod	1065200	1418700	2595300	3701000	6107600
8.	Electrical Equipment & Goods	1561300	2365200	3587300	3942500	6081400
9.	Hot Rolled Sheet incoil	1144800	2052700	3575900	2851700	4111300
10.	Cement	1933600	2519900	2337000	4226600	4092400
11.	Agricultural Equipment & Parts	671600	1073100	1483800	2490600	3353800
12.	Chemicals	3281400	2590900	2719800	2784600	3115000
13.	Thread	2166900	3158800	3056300	2597200	3022500
14.	Chemical Fertilizer	1052300	624000	315700	130200	2951100
15.	Textile	2051700	1753800	1663600	2461900	2404100

Source: Nepal Rastra Bank.

Major items of imports from india

S.N.	Products	2005/06	2006/07	2007/08	2008/09	2009/10
1.	Polyester yarn	3476300	2241000	2618000	2499800	3397300
2.	Textiles	2154600	3056900	2114800	3193500	3360500
3.	Threads	1898300	4055900	4134800	2525400	2771500
4.	Sacks	1265400	1408600	1219900	458800	2016500
5.	GI Sheet	2409000	3579900	4416900	2821700	1794800
6.	Juice	1139600	1591300	1836400	1952200	1750100
7.	Catechue	382400	542800	543700	1217100	1682000
8.	Cardamom	608100	848100	1034800	1216000	1316000
9.	Other wire	1504100	1610700	1546700	895000	1200100
10.	MS Pipe	105700	761900	979500	571200	695100
11.	Tooth paste	730800	663400	475600	813200	673200
12.	Copper Wire Rod	305800	206000	617400	571800	643600
13.	Noodles	414700	237400	532900	803200	576400
14.	Shoes and sandals	237800	244400	348600	750100	568000
15.	GI Pipes	519300	127800	242700	1098400	567900

Source: Nepal Rastra Bank.

Still Nepal's bilateral agreement with India is more attractive to Nepal than SAFTA, BIMSTEC or even WTO because of nonreciprocal and zero tariff access for Nepalese manufactured products to Indian market.

Nepal-China

Nepal also shares a very important relation with China. Due to the geographical proximity and similarity in terms of culture, religion, daily habits especially in the bordering areas, there is a huge potential for business opportunity. The three Agreements signed by Nepal and China: (1) 'to Maintain Friendly Relations Between China and Nepal and on Trade and Intercourse between Tibet Region of China and Nepal' (in September 1956), (2) 'on Trade and Payments Agreements' between Governments of Nepal and China (in November, 1981) and (3) 'on Trade and Other Related Matters between Nepal and the Tibet Autonomous Region of China (in July, 2002), are the foundations on which the modern trade relations between Nepal and China are based.

Having realized the need to maintain mutual cooperation to a higher level and involve active participation of business community, Nepal – China Non Governmental Cooperation Forum was established under the mutual agreement between the two governments in 1996. The Federation of Nepalese Chambers of Commerce and Industry (FNCCI) and All China Federation of Industry and Commerce (ACFIC) from Nepal and China respectively have been entrusted the task of chairing this Forum. The Forum meets on a regular basis both in China and Nepal and has been successful in increasing contacts between business communities and identifying new avenues of cooperation.

Trade Statistics show that Nepal's export to China was only Rs. 0.55 billion in the year 1995/96 which increased to Rs. 2.35 billion in

Nepal's Trade With China P.R.

(Value in Million Rs)

Description	1995/96	1999/2000	2003/04	2006/07	2009/10
Nepal's Export to China P.R.	549.3	514.3	2348.2	378.0	1008.2
Percentage Share in Total Export	2.8	1.0	4.4	0.6	1.6
Nepal's Import from China P.R.	4067.4	12530.1	9299.9	16678.6	39218.2
Percentage Share in Total Import	5.5	11.5	6.2	8.6	10.4
Trade Balance	**-3518.1**	**-12015.8**	**-6951.8**	**-16300.6**	**-38210.0**
Country's Total Export	19881.1	49822.7	53910.7	59383.1	61126.8
Country's Total Import	74454.5	108504.9	149473.6	194694.6	378795.6

S.N.	Major Export Items (Value Wise-recent)	Major Import Items (Value Wise-recent)
1.	Preparation of cereals, flour, starch	Electrical machinery, sound recorder, television
2.	or milk	images and parts and accessories thereof
3.	Articles of Copper	Wool, fine or coarse animal hair; woven fabric
	Furniture; bedding, mattresses,	Machinery and mechanical appliance electrical
	illuminated signs, illuminated name-	equipment & parts
4.	plates and the like; prefabricated	Garlic, Chickpeas & dried peas
5.	buildings	Articles of apparel and clothing accessories not
	Oil seeds and Oleaginous fruits	knitted or crocheted
6.	Cornea, Antibiotics, homeopathic	Iron and steel
7.	medicaments	Footwear, gaiters, and the like; parts of such
8.	Cereals	articles
9.	Carpet, Knotted of wool or fine	Optical, photographic, measuring, medical or
	animal hair	surgical equipment, parts and accessories thereof
10.	Raw Hides and Skin	Cotton woven fabric & sewing thread
	Animal or vegetable fats and oils and	Silk including silk worm (cocoons)
	their cleavage products	
	Yarn of combed Wool, fine wool	

Source: Compiled by FNCCI

2003/04 drastically fell to Rs. 0.38 billion in 2006/07. However, in 2009/10 there has been some improvement and our export to China for the first time has crossed Rs. 1 billion mark.

On the import side the story is quite different and it is very much in favour of China. Nepal's import from China was Rs. 4.1 billion in 1995/96 which has substantially increased to Rs. 39.2 billion in 2009/10. The trade deficit has enormously increased from Rs. 3.5 billion in 1995/96 to Rs. 38.2 billion in 2009/10. This is again a matter of great concern for the Nepalese side.

In terms of export from Nepal, China's share is less than 3% of Nepal's total export. Likewise China's share in Nepal's import is little more than 11% of total import.

In order to promote balanced trade with the LDCs and encourage the exports from LDCs to China, recently in July 2010, the Government of China unilaterally granted special preferential treatment for imports from the LDCs. It has offered duty free access to 4,721 products that are being imported by China out of which 361 products are relevant for Nepal, meaning we already have some business transaction taking place in these items. This is also an opportunity for us to exploit the Chinese market. Now, instead of trying our luck in all those items maybe we need to focus on some specific products in which we have potential for comparative and competitive edge without the limitation of supply constraint.

What needs to be done?

It is clear that Nepal as a LDC enjoys market access facility in all different forums be it at the multilateral trading level or regional platforms or at bilateral level. We have every opportunity to reach the global market through these platforms and at the same time can also attract foreign investment through the provision of the agreements at different levels. Forget about the rest of the world, if only we could take benefit from our neighbours, China and India, we can set ourselves in the right track of progress and prosperity. But the trade and investment scenario of Nepal is a reflection of our inability to build upon the opportunities. Nepal's growth rate in the last 10 years is less than 4%. So what is the problem? Here are some of the issues that are suggested as a food for thought.

The first and foremost important issue is the need for the change in mind set. From now on we need to start thinking in a positive manner. One positive attitude can deliver a lot of good and make a difference. We have already witnessed such efforts in the recent past. We don't need to influence things beyond our control but instead if we could only make a positive mark in the purview of our influence, the multiplier effect will be quite exemplary. I believe there are few good/positive people and few bad/negative people but most of us are generally in the middle. If good people lead, then people in between will be influenced accordingly and results are bound to come in a positive manner and if the bad lot leads, then the effect and results will be similarly matched.

Everyone will agree to the fact that one of the major reasons for Nepal to lag behind is the influence of politics in all aspects of life. Be it government organizations, private sector, civil society, trade unions, professionals or a simple citizen, everyone is to some way or the other involved and active in politics. The issue of labour is another thing that we keep hearing about. We say our labours are comparatively cheap but they are considered less productive. Moreover, with the mushrooming of political parties in Nepal, the number of trade unions has also increased accordingly and their influence is creating problem. I feel that all these issues are not our core problems. Therefore, to address the core issues we need to make economic agenda the main driving force, politics for business and not otherwise.

Another aspect that requires attention is the implementation of the plans and policies which are already there on paper. Only if we could implement what has been agreed and put in paper we can see a lot of change. And in the process of implementation what we lack is the role of governance. We seem to be too much aware of our own democratic rights only, where as we have forgotten our responsibility that is a part and parcel of a democratic system. To put it more directly it is the discipline that we are lacking. Therefore, maybe we need to think about disciplining each and every one of us, training to build patience and respect the right of others is the need of the hour. Also actions and punishments/reward need to be matched - bigger the wrongdoing harsher the punishment should be and vice versa.

Besides these general issues which seem very small but a small positive change in these issues can have a huge impact in the overall development of the economy, here are some of the specific issues for consideration.

Creation of infrastructure Development Fund: The sectors like infrastructure, energy and tourism is always in the top list of any person or organization in the development plan. Everyone talks about the potential and the positive effects that will come if these sectors are developed. However, nothing has happened till date. Is the blame only limited to political leaders, government bureaucrats, private sector, the so-called mafia's especially in energy development sector who neither do enough to develop this sector themselves nor want or rather allow new players to come into this sector thereby enjoying the control all by themselves?

Therefore, I think there needs a change in the working mechanism. Is there a possibility to create Infrastructure Development Fund, something similar to the Provident Fund? Nepal's budget in recent years has almost reached the Rs. 400 billion mark. It can allocate maybe 25% of the total budget every year in this fund and the resource from public can be generated simultaneously through the mechanism similar to the provident fund. Public can be a part of this fund as a shareholder and incentives like income tax rebate and profit sharing mechanism for all shareholders can be made in order to attract funds. Also a Public Private Partnership approach can be exercised giving full authority and autonomy to the private sector management team whereas the government can supervise and monitor periodically. This way the control of benefit to some excluded class can be minimized and at the same time public participation and ownership of the projects can be developed. The support and cooperation of the development partners can also be channeled into this fund thus harmonizing all the efforts through this one window.

Priority of this fund will be purely into energy generation projects, road building projects (fast tracks, highways), east west railways, and cable cars in the higher hills area.

Tourism is another area in Nepal with huge potential and contributes significantly to the national economy. Infrastructure development for health, education and religious tourism can also be a priority of this fund.

Skill development : Once I happened to listen to a conversation in which a girl residing abroad was telling some prominent Nepali businessmen that in some countries abroad owning a Phillipino maid is like a status symbol. It seems that the Phillipino maid has a whole package of services from the skill of using vacuum cleaner, washing machine, dish washer and the skill to operate modern equipment. In addition to that they have basic English language knowledge which is an important tool for communication. Therefore, they earn much more than a maid coming from other countries, paying them more is also not an issue. Whereas on the other hand, thousands of men and women from Nepal going to various countries in search of greener pastures are generally raw, without any skill or with some limited skill. They also have very little or no knowledge of using modern technology. As a result, they are less competent and hence paid less and desired less. Even in these circumstances they send more than Rs. 250 billion every year which is five times more than the foreign investments coming into Nepal. Contribution of remittance in the Nepalese economy is almost one third of the total Gross National Income (GNI). Therefore, only if we could train these people and impart them at least some basic skills and knowledge they will become much more competent and the repercussion effect will be massive.

For that we need to develop vocational training institutes. There is a double benefit from this. One, we can impart skills to our people and make them competitive. Second, with the skill development if we could create a mechanism to avail these people with some seed fund, they can be self employed in the country itself.

With an objective to conduct technical and vocational training programs, Trade School, has already been set under the public private community partnership concept in 2004. This program is implemented by the private sector representative organization FNCCI with the support from government and local chambers. At present there are 9 trade schools in 9 zones and have trained only around 4,000 people out of which more than half are self employed. I think the government, private sector, development partners need to think seriously and work together to strengthen, develop and replicate this concept nationwide. The sooner we start developing Trade Schools all around the country and start helping to train and develop skills, the faster we will be able to see increased number of self employed people who can also create further employment. Also we will be able to see increased productivity and increased income opportunities whether from within or outside Nepal.

Area specific product development: There is already a mechanism in place by the name One Village One Product (OVOP), a strategic movement designed especially for regional development through identification and promotion of product having local essence. The concept already adopted by more than 70 countries was launched in Nepal in 2006 as a Public Private Partnership program between the Ministry of Agriculture and Cooperatives and Agro Enterprise Centre of FNCCI. Currently, there are 8 products included in OVOP program within 11 districts. Lapsi in Bhaktapur, cymbidium orchid in Lalitpur, junar in Ramechhap and Sindhuli, rainbow trout in Nuwakot and Rasuwa, bel in Bardiya and Siraha, agro tourism in Lekhnath Kaski, lokta in Dolakha and coffee in Syangja are being developed in partnership with the local chambers of commerce and industry.

The rate of progress in each of these products is quite satisfying. The socio-economic impact that this program has made in the local level is also noteworthy. In the first stage the collective production of the identified products to some extent has helped to lower the gap between the demand and supply. Also the quality of the product and commercialization of the product has helped to increase income of the farmers who are directly involved in these activities. Now in some products the backward and forward linkages have also started. Activities like processing, manufacturing, branding, marketing etc have started. The need and the focus of the hour is to carry forward from this point onward. We need to replicate this effort all over the country, maybe in a more systematic and refined manner, in each and every district in the most urgent way There is a need for a proactive partnership between the local representatives of the private sector and the government. The development partners can also be roped in and all the efforts need to be synchronized.

These are some of the areas that require immediate attention and action. However, they are not exhaustive but just a starting point.

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CHAPTER X

Nepal's Exports Orientation

Diversification And Competitiveness

- Tarka Raj Bhatta

Background

Exports play a pivotal role in the overall economic growth and poverty reduction of a country. Increasing global integration has created new dimension in world trade. Newly emerging economics BRICS (Brazil, Russia, India, China and South Africa) has been increasing their share in world trade. Fast growing technology, increasing cutthroat competition and rapidly changing behavior of consumers in the world market have somehow created problems to the least-developed and landlocked countries. More advanced developing countries have already been moving towards advance technology and knowledge intensive products and processes. In such global context, developing countries like Nepal are lagging behind.

Nepal's neighbors India and China have been achieving high and sustainable growths Average exports growth rate of China and India have been 18.81 percent and 14.3 percent,respectively,from 1989 to 2009 (WDI).Exports have boosted the growth of Indian economy substantially and surmounted to 1.69 percent of the total world export in 2009.

At the same time,China's export ratio to the world export has reached 8.39 percent and jumped the second largest economy of the world in the last quarter of 2010. In the process of transformation, China has shifted from a centrally-planned to a market-oriented economy; an agriculturally-based to a manufacturing and service based economy; a closed one to an open economy. The growth of China has favored with having benefit of the sheer size, the location advantage, a low-wage labor market, and economies of scale. Exports sector has grown with the strong implementation strategy having a long-term vision, with sustained high growth rates. Chinese authorities had set an ambitious central and local-level objective with the aim of promoting the continuous improvement of the country's position in the international economy. Proactive industrial and technological policies were adopted and serious attentions were given in access to domestic credit and ensuring a tangible improvement in education.

Export Orientation of Nepal

The exports of Nepal have not been impressive despite liberalizing the economy. Nepal's export share in total world export is nominal and it was just to 0.012 percent in 2009/2010. An average export growth rate has been increased to 9 percent from 1990 to 2010. It is a matter of concerns to all that the country's overall exports earning merely meet the import demand for petroleum products only, in recent days. Export diversification is very important to reduce the export volatility. Concentration on few commodities can lead to serious economic and political risks. Economic risk such as volatility and instability in foreign exchange earning which have adverse macroeconomic effects on growth, employment, investment, export capacity, cash flow, inflation, capital flight. Political risks such as maintenance problems and instability in the government. With limited export commodities in terms of quantity and limited numbers of major export partners,the export has not been diversified as expected. India, Germany and the United States are the major export trade partners, with over 80 percent of total exports occurring to these countries alone. Only 20 percent of export trade occurs with the rest. Moreover, out of total export the export with India constitutes about 65 percent in 2009/2010. With existing limited export basket, Nepal has been facing difficulties to stabilize export earning, upgrade value added products and achieve export-led growth.

Export diversification is defined as the change in composition of a country's existing export products,destinations or spread of production over sectors. Progression from traditional to non-traditional exports is a part of the adoption of export-led growth strategy. It helps to improve technological capabilities and facilitation to set of forward and backward linkages. There are two forms of export diversification known as Horizontal diversification and Vertical diversification. Horizontal diversification takes place with the same sector (primary, secondary or tertiary). Vertical diversification is known as shift from primary to the secondary or tertiary sector. Therefore, the vertical diversification is understood as the change in existing products by means of increased value added activities such as processing, marketing or other services.

Nepal's export sector has not diversified well as the country has depended on traditional export items. Nepal's major export items are; knotted woolen carpets, ready-made garments, polyester yarn, iron products, jute bags and sacks, tea, cardamom, lentils, tubes and pipes, and vegetable products. After the liberalization(to some extent), Nepal's export of manufacturing products has been increased substantially to European and US markets. However, the Nepal-India trade treaty signed in 1991, which was renewed in 1996, 2002, 2007 and 2009,has increased share of trade with India tremendously. According to the renewed trade treaty of 1996, India provided preferential treatments to many of primary products and duty free access of fixed quotas to some manufactured articles.

As spoken earlier, Nepal's exports has been limited both country wise and commodity wise. Following figure portrays the real picture of the export of hand knotted woolen carpets and ready-made garments,the major export items to third countries except India. The share of both commodities was above 80 percent in total trade till 2000. Due to inability to compete in the international market, the share of both commodities has been declining sharply, and stands at 40 percent of total trade in 2008/09.

Shares of Woolen Carpet and Ready-made Garments Exports in Total Exports with Other Countries (except India) 1987/88-2008/09

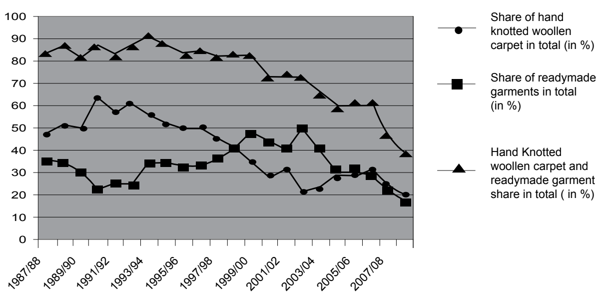

Figure : 1

Source: Economic Survey (2009/10), Ministry of Finance, Government of Nepal

Factors That Could Affect Exports

Export is affected by both supply side and demand side factors.

Supply side: Exports could rise when the export prices decline relative to foreign prices and vice versa. Increase in domestic demand diverts export supply towards domestic consumption, leading to a fall in exports. The role of FDI (Foreign Direct Investment) is crucial in increasing exports. However, in developing countries its role has been quite ambiguous. If the motive of FDI is to grasp the comparative advantage then it could contribute export growth. But if its motive is to bypass the trade barrier and catch the domestic market, then it is called the tariff jumping type of investment, and it does not contribute to the export growth. Thus, the nature of the link between FDI and export performance is not clear-cut.

Demand side: Increase in real effective exchange rate (REER) reduces the export demand; world income appears to have a positive impact on export demand.

Moreover, population size, remoteness and natural shocks, and quality and timely delivery of product could affect to export growth of a country. In addition to that, merchandize export concentration and instability in agricultural production could show the structural bottleneck of country's export growth.

Role of Private Sector in Export Development and Theory of Competitiveness

Because of its profit oriented nature the private sector could grow fast, and harnessed for development in open and competitive environment. In this context, global integration is necessary for success in exports. However, success depends largely on increasing the competitiveness of exporting firms. Theory of competitive advantage includes both cost advantage and differentiation advantage. Cost advantage can be achieved through productivity, economies of scale, better relationship with suppliers and the like. Differentiation advantage can be achieved through innovative products, a better customer service and so on.

How to create competitive advantage?

Firms are the prime movers to create competitive advantage by perceiving or discovering new and better ways to compete in an industry and bringing them into market. It is an act of innovation, which can shift competitive advantage by wining to rivals in a competition. Early movers responding to innovations can get significant benefit of economies of scale. Innovation in new technologies, new or shifting buyer needs, and the emergence of a new industry segment, shifting input costs or availability and changes in government regulations can shift competitive advantage.

How is competitive advantage implemented?

Innovation is related with product, process, design or organizational form which can cause significant departure from the existing product. Innovation helps to increase productivity, creating new markets, contribute to the competitiveness and profitable to the organization. For a national economy, innovation can lead to rising exports, increase real wages and contribute to increase the overall GDP.

Innovation has come to be viewed as a panacea for firms and economies in a hurry. For innovation sustained knowledge, expertise, tacit understanding and production skills have to be accumulated. Moreover, sound policy, effective institutions, entrepreneurship and enabling culture of industrial learning are essential.

Innovation depends on three strategic positions that influence the configuration of a firm's activities: variety-based positioning, needs-based positioning, and access-based positioning.

East Asian economies did the enormous efforts to achieve the miracle with focusing on competitiveness. They did enormous investments in human capital, educating large numbers of skilled engineers able to absorb and adapt the most advanced technology and accepted FDI.

Comparative Advantaged or Potential Competitive Export Items in Nepal

Like other South Asian countries, Nepal has comparative advantage in cheap labor in relation to rest of the world. With a variety of agro-climatic conditions, many unexplored natural resources, ancient cultural heritages and scenery beauties, water resources, higher ratio of working age population are the major comparative advantageous areas as well as competitive products in Nepal.

Hydro-electricity

Nepal has huge hydro power potentials as the country has many high current rivers flowing from mountains. A conservative estimate claims that 83,000 MW hydro-electricity can be generated, of which 44,000 MW is technically feasible for production. The recent estimates have claimed many folds higher than this figure. Currently less than 1 percent of the total potential has been exploited and the domestic demand has not been fulfilled with current supply capacity. It is imperative that Nepal exploited water resources to meet domestic demand and to export to India. The demand of electricity in northern India is increasing exponentially, every year. At present the deficit of north India is around 5,500 MW[1] in peak season. An appropriate policy for attracting FDI and reducing political intervention in licensing, built

[1] Nepal Trade Integration Strategy 2010

and operation and increasing negotiation capacity of public sector could reap the benefit from this sector.

Tourism

Nepal is rich in cultural heritages and natural beauties, having many attractive trekking destinations, mountain climbing, and many sacred religious places such as birth place of Lord Buddha and Lord Pashupatinath temple and myriad of other destinations of tourist interest. With many spectacular natural assets such as Mount Everest – the top of the world, seven other peaks of 8,000 meters and higher and long ranges of all weather snow covered Himalayas from east to west offers adventure as well as entertainment to tourists in the country. As the service trade is emerging in global economy, public private partnership program are needed for tourism development. The private sector can play a very important role to be involved in infrastructure development, promotion and upgrade the quality of tourism.

Herbal Products

The growing preference for organic and herbal-based products in world markets and the existing biodiversity in the country offers possibility to explore new and high-value products for exports. As a Himalayan country Nepal has lots of medicinal plants and raw materials for medicines and cosmetics goods. There is a high potential to cultivate more as the different geographic and climatic conditions, andwith the use of easily available cheap labour. Currently, these raw products are transported to wholesale markets in India. Therefore, efforts are needed to add the value of these products by technological up-gradation. Moreover, the research and development activities are needed for innovation and commercialization of these products.

Opportunities and Challenges of Export Development in Nepal

Nepal has acceded to the WTO (World Trade Organization) as the 147th member in 2004 and became the member of SAFTA and joined BIMSTEC group in the same year, and trying to be a member of Asian Free Trade Area. Having well-positioned between two large and fastest growing economies in the world, India and China, Nepal faces window of opportunities. However, in recent years, the country has been facing double digit inflation; widening trade deficit; slow growth of remittance and a deteriorating overall balance of payments situation. Further, depleting gross foreign exchange reserves has ultimately led the slow pace of growth. Other challenges of trade sectors are, growing unemployment in the country, power shortages, weak workers-entrepreneur relations, poor infrastructure, and a political stalemate culminating in lower production and decreasing competitiveness. Heavy import penetration for consumption purpose limited the technological transmission in the economy. Moreover, weak institutional capacity, inter and intra coordination among the stakeholders, information asymmetry has created additional challenges for export sector.

Exports Development Efforts in Nepal

Nepal provided an important role to the external sector in development within its national development plans, which was commenced in 1956. To diversify exports sector both in terms of products and destinations, the government has adopted various exports promotion schemes since mid 1970s. Foreign exchange rate facilities, export incentives, institutional set up, promotional supports policies etc could be named as a few of such initiatives. Nepal initiated new economic reforms program after 1985 in the name of structural adjustment program with the recommendations of the World Bank and IMF. The reform program was implemented aggressively after the political change in 1990. The government has reduced its role in the market and encouraged the private sector to take the leading role in the economy. The entire macro-economic policies; monetary, fiscal, trade, foreign exchange, had been brought under this reforms program. The government has introduced various policies and acts such as Trade Policy 1992, Industrial Policy 1992, FDI and Technology Transfer Act 1992 .The Privatization Act with the aim of increasing economic efficiency, maintaining stability, liberalizing economic activities and improving the international reserve position and balance of payments became one of the cornerstones of the open economic policy. Priority was given to increase industrial production, employment creation and diversification of trade for maintaining favorable trade balances in periodic plans as well as annual budgets. Furthermore, the government emphasized the policy to tie imports with exports, and export sector has been diversified by products and destinations both. In addition, institutional arrangements have been made for trade promotions and facilitations.

Due to various dynamics in international trade and development, the Trade Policy 1992 was replaced by a new Trade Policy in 2009. The new trade policy addressed to utilize the open market opportunities in goods and services trade and protection of intellectual property rights. Moreover, it has addressed sanitary and phyto-sanitary (SPS) measures and technical barrier to trade (TBT) for sustaining exports trade. Furthermore, it gives priority to the development of thrust areas that have been high comparative advantages. Also the service sectors such as tourism, education, health and IT sector has given priority for promotion and development for exports. Moreover, an institution namely Service Trade Promotion Council has envisioned for the promotion of service trade.

With the support of various international organizations, the government of Nepal has taken initiation for development of the trade sector through research and development. Recently the government of Nepal has announced Nepal Trade Integration Strategy 2010, with the support of various donor agencies under the UNDP project. This strategy identified and suggested for development of 19 priority exports potential products which has high comparative advantages. Among the priority exports; seven agro-based products include large cardamom, ginger, honey, lentils, tea, noodles, medicinal and essential oils; five industrial products include handmade paper, silver jewelry, iron and steel, pashmina and wool products; and seven service areas include tourism, labor, health, education, information technology & Business processing office, engineering and hydro-electricity are included. Furthermore, the government has adopted the policy of economic diplomacy in which trade sector is one of the major components.

Export Development Agenda in Three Years Plan 2010/11-2012/13

The new plan gives high priority to mainstream the trade sector into the national economy. The plan has set objectives to get maximum benefits from goods and services trade by identifying comparatively new beneficial goods and services with the participation of private and government sector by making price and quality more competitive in internal and external market;And to alleviate poverty by promoting exports of local raw material using more resources and skills, and to expand the benefits from the activities of commercial sector up to the rural level.

Moreover, the new three year plan has envisioned following six strategies for trade enhancement:

- Develop trade as an important engine of national economy and enable it to compete at the international level.
- Value adding program in production and productivity will be conducted to improve the export capacity of goods and services. Necessary support and facilitation will be provided to achieve this goal.
- Promote export by emphasizing the promotion of identified exportable goods, their marketing and establishment of value chain, and also identifying and developing new exportable goods and services.
- Strengthen the necessary infrastructure and institutional capacity in order to promote export, substitute import and diversify trade.
- Mobilize foreign aid to promote export by increasing the competitive capacity of export trade.
- Provide encouragement, facilities and concessions to the comparative advantage exportable goods and services for export trade promotion.

Flaws in Earlier Plans and Policies

The export sector has been given high priority in earlier plans and policies. However, the result oriented programs has not been formulated and implemented in trade sector. The export sector strategy has not been clearly identified, concentrated on limited markets and products, lack of seriousness in trade intelligence and institutions capacity building. Supply side constraints (infrastructure, institutions, and trade facilitation) have not been well addressed in previous plans and policies. The constructing ICD and ICP have not been into complete use which could help trade facilitation. The investment in the productive sector has not been expanded due to lack of industrial friendly environment and weak situation of peace and security. Appropriate policies for protecting and promotion of traditional skills, technological adaptation and intellectual property rights have not been taken. Despite these, Nepal's economic condition has not been improved as compared to other neighboring countries due to lack of effective implementation of such policies and programs.

Where We Failed ?

International trade is a dynamic sector. Globalization has increased openness of economies to international trade, financial flows, and direct foreign investment. As a low income, least developed and land locked (LLDC) country; Nepal has been facing various problems (infrastructural and operational) like; in production and exports of primary commodities, simple processing procedure and labour intensive products. Trade sector has been given high priority in previous plans. However, due to rapid changing in the global context our production and supply capacity has not been strengthened. And the policy reflected in plans has not been implemented due to various constraints such as capacity in government as well as private sector. The private sector could not come up with strong player in the market. Rent seeking tendencies, curtailing, taking benefit of information asymmetries created obstacles to innovation and competitiveness to the private sector. The government has failed to regulate these tendencies due to inefficiencies in bureaucracy and lack of political vision.

Way Forward

Nepal is facing various economic and political challenges such as poverty and growing inequality, unemployment, double digit inflation, increasing trade deficit as well as balance of payment deficit. Various supply side and demand side constraints hinder the development of export sector. The export-led growth is necessary to overcome such big challenges with diversified and competitive export products. As

Nepal has been joining various regional and global trading agreements in the process of liberalization, various efforts were made with reduced tariff rates, liberal policies relating trade, FDI and technology transfer. However, it could not boost exports as expected. There is no single solution to adopt export-led growth strategy. Following are some suggestions that could help to increase the diversification and competitiveness of export of Nepal:

- It is urgently needed to strengthen institutional capacity and increase coordination among the related agencies with harmonizing fiscal and monetary policies, FDI, tourism, agriculture, forest, and physical infrastructure policies with the trade policy.
- Trade negotiation capacity, trade intelligence and proper marketing strategies are precondition for export sector development. The government should play an active role to enhance the capacity of government and private sector.
- To achieve export-led growth, export basket (qualitative, competitive and high value added goods) and market destination has to be expanded gradually with the pro-active role of the private sector.
- Transaction cost has to be reduced by improving transit facilities, procedural simplification, and institutional reform.
- The role of private sector is crucial to the export sector development. Therefore, the private sector has to invest with long term goals selecting competitive areas of exports.
- The government has to play a motivator, facilitator and regulator role for increasing competitiveness of private firms.
- To reduce the import penetration to the economy domestic demand should be well managed; imports should be tied up with export development.
- Research and development should be encouraged for innovation,

protection of property rights and market intelligence.

- Special Economic Zones and Export Promotion Zones have to be established for increasing competitiveness of export products.
- The government has to create conducive environment for investment and give assurance of policy stability and return their investment.
- The government has to encourage FDI whose motive is to grasp the comparative advantage for export development.

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CHAPTER XI

Nepal-USA Trade and Investment Framework Agreement (TIFA)

How Can It Help Revive Nepal's Trade With USA ?

- Shiv Raj Bhatt

Background

In recent years,regional and bilateral trade agreements (RTAs/BTAs)[1] have become very prominent feature of the global trading system. This second trend[2] in the global trading system is rapidly gaining momentum and establishing a very different set of rules[3]. As a result, the number of RTAs has more than quadrupled since 1990s. At present, more than 400 RTAs have been notified to the GATT/WTO[4] and the number is increasing.

Many factors contributed in the proliferation of RTAs, which includes, among others,

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[1] BTAs are a form of RTAs, we use the word RTA hereafter to cover agreements between two or more than two countries. Broadly, RTAs are the agreements among a group of countries that reduce barriers to trade on a reciprocal and preferential basis. It encompasses both reciprocal bilateral free trade or customs areas and multi country (plurilateral) agreements.

[2] Multilateralism is the first trend in global trading system, while second (new) trend is the proliferation of regional (including bilateral) trade agreements (RTAs).

[3] See the World Bank, Global Economic Prospects 2005.

[4] source: http://www.wto.org/english/tratop_e/region_e/region_e.htm

1. As a complement to the multilateral trading system, the WTO allows to form/implement RTAs, which is an exception to its basic principle of Most Favored Nation- MFN[5];
2. RTAs have a number of advantages (e.g. less diverse interest, therefore easy and quick to handle and reach in consensus, trade creation, less dispute etc.);
3. RTAs can address specific needs of the member countries;
4. Slow progress in the WTO negotiations due to the diverse nature and level of development of the member countries.

These factors pushed countries to adopt the two-pronged strategy of multilateral and regional arrangement of economic integration simultaneously. Nepal too adopted the same strategy when it initiated economic reform programs for economic integration in mid 1980s[6]. The process was further boosted up after the restoration of multiparty democracy in the 1990s[7]. In addition to the unilateral reforms, Nepal entered into bilateral, regional and multilateral trade agreements to further consolidate its reform process and integrate with the world economy.

As a result, Nepal signed bilateral trade agreements with 17 countries[8]. These include: Bangladesh, Bulgaria, China, Czech Republic, Egypt, India, Korea, Mongolia, Pakistan, Poland, Romania, Sri Lanka, UK,

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[5] However, RTAs must comply with two main requirements outlined in the GATT Article XXIV. First, the agreement must lower trade barriers within the regional groups. Second, the agreement cannot raise trade barriers for non-participating members.

[6] A new Commerce Policy aimed at transforming the trade sector to make it open, competitive and market oriented was formulated and implemented during the Eighth Plan of Nepal (1987-1992).

[7] The Ninth Plan (1997-2002) sets a long-term goal of integrating the trade sector into the globalization process by making it fully competitive and market-oriented.

[8] Some of those are not relevant and therefore not operational at present.

USA, Russia and Yugoslavia. Apart from bilateral trade agreements, Nepal is a contracting party/member of two regional trade agreements, namely the Agreement on South Asian Free Trade Area (SAFTA) and the Bay of Bengal Initiative for multi-sectoral Technical and Economic Cooperation (BIMST-EC).

However, most of the bi-lateral trade agreements of Nepal are static[9] in nature and outdated[10]. The trade agreements with none of these countries have ever been reviewed and assessed except the one with India. As the scope and coverage of bilateral and regional trade agreements is expanding rapidly the world over,and as these agreements are covering the issues of services, investment, intellectual property and labour mobility, in addition to the merchandise trade, the new issues should be included in Nepal's trade treaties as well, either through amendment of existing treaties or by signing new trade treaties.

In this context, it is felt necessary for Nepal to review and assess the existing trade treaties and explore potential countries and areas to be covered in the Free Trade Agreements (FTAs). The government has realized that a system to review/assess and updating these trade treaties is necessary, if the country wants to reap the benefits of such treaties in the rapidly changing global and national context. The Ministry of Commerce and Supplies has commissioned various studies,and has been engaged in stakeholders' consultations to suggest necessary measures to overhaul Nepal's bilateral and regional trade agreements. The studies and consultations have reviewed and analyzed Nepal's existing trade treaties and suggested new countries and new dimensions that have

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[9] Never reviewed and updated.

[10] Most of them were signed prior to 1990, some even prior to 1950 (e.g. USA 1947, Britain 1965, and Russia 1970).

to be covered in future trade agreements in order to make Nepal's export trade competitive and sustainable. However, before concluding FTA with prospective country/countries, the Government needs to prioritize the list of countries, on the basis of trade potentials, and the content/dimensions that have to be covered in new agreements.

The current trade data show that India, USA, Bangladesh, Bhutan, China, EU (Germany, UK, France, Italy, Switzerland, Portugal and Belgium), Canada and Japan are the most valuable trade partners of Nepal[11]. Therefore, these countries can be considered as most important for Free Trade Agreements (FTA). Nepal's trade agreements with India are timely updated and reviewed. Therefore, USA can be the second and EU (a comprehensive and collective trade treaty with EU as a single trading entity) can be the third priority of Nepal for advancement of FTA proposal. In this context, it can be said that Nepal should now prioritize these countries for expansion of trade relation through signing and implementation of new (or amended) trade agreements.

Nepal-US historic trade and economic relations were formally established by signing a 'Friendship and Commerce Agreement' between the two countries on 25 April 1947. The Agreement established the diplomatic and consular relations and helped to further commercial activities between the two countries. However, recently both sides realized that a bilateral trade agreement signed more than six decades back and never reviewed or updated thereafter is outdated in the present situation. Moreover, in the present context, when the scope and coverage of bilateral trade agreement is expanding rapidly

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[11] The share of India, USA, Bangladesh, Germany, Bhutan, UK, France, China P.R., Canada and Italy in Nepal's total export is 65.5%, 6.3%, 5.5, 3.9%, 2.6%, 2.0%, 1.9%, 1.7%, 1.3% and 1.2 percent respectively in year 2009/10 (TEPC: Foreign Trade Statistics 2009/10).

beyond the merchandise trade and is including services, investment, intellectual property (IP) and labor mobility, among others, it is wise to update/fresh start the economic/commercial relations by signing a new agreement.

In the above background, to enhance the economic relations between Nepal and USA, a Trade and Investment Framework Agreement (TIFA) was signed by the representatives of both the governments on 15th April 2011 in Washington DC, USA. The TIFA includes new areas like investment cooperation, services trade, IPR, labor mobility and technical assistance, among others,and this will definitely help Nepal to boost up its economic ties with world's economic leader. USA has also remained one of the most important development and trading partners of Nepal since long. Therefore, the conclusion of TIFA is imperative to expand the bilateral economic and trade cooperation, and sustain the export trade of Nepal.

This paper first analyses current scenario, prospects and problems in Nepal-USA trade and investment, and finally concludes with some recommendations to make Nepal-USA Trade and Investment Framework Agreement (TIFA) an instrument of trade and investment promotion between the two countries.

Nepal-US Trade Scenario

Nepal possesses limited export products and their marketing is concentrated in few markets. This has been increasing their vulnerability - if things go wrong in these markets, their export will plummet substantially. Thus, it is exigent to take double edged approach; first increasing the product range through improvement in design and quality of existing products as well as through development of new products and second identifying niche markets and ensuring access to such markets by getting the tariff and non-tariff barriers removed. This would require enhancing the current supply-side capacity which in turn requires a coordinated trade development plan in place.

USA has remained one of the leading trading partners of Nepal since long[12]. The volume of export however declined from US$ 180 million in 1999/2000 to US$ 52 million in fiscal year 2009/10 and the share of USA in Nepal's export declined from 27.6% in 199/2000 to 6.35 in fiscal year 2009/10 (Table 1). However, despite such decline over the period, the USA is still the second largest export destination for Nepalese products after India. Though the volume of trade with USA in absolute terms is not that significant and the export to USA is decreasing over the time (Table 1).

Table 1: Share of USA in Nepal's Total Export

(Value in US$ million)

Fiscal Year	**Total Exports**	**Exports to USA**	**Share of USA in total exports (%)**
1999/00	652	180	27.6
2000/01	717	194	27.1
2001/02	614	121	19.8
2002/03	644	163	25.4
2003/04	730	131	18.0
2004/05	805	104	13.0
2005/06	823	124	15.1
2006/07	838	75	8.9
2007/08	899	62	6.9
2008/09	892	68	7.2
2009/10	818	52	6.3

Source: Trade and Export Promotion Center, Nepal Foreign Trade Statistics.

[12] USA remains among top ten trading (export) partners of Nepal throughout the period 1997-2008/09.

The fall in export volume is mainly attributed to the decline in a few products such as ready-made garments and pashmina that could not withstand competition from other countries. The most important reason behind the decline in the export in the US market is the phasing out of quota system for ready-made garments with the conclusion of Multi Fiber Agreement (MFA) from 1st of January, 2005. Therefore, there should be some new concessions in place if Nepal wants to achieve growth of export of Nepalese ready-made garments to the USA.

Table 2: Exports of Ready-made Garment

(US$ million)

Fiscal Year	Total Exports	Exports to USA	% Share of US on Total Export
2000/01	15.75	14.08	89.4
2001/02	10.36	8.61	83.1
2002/03	15.53	13.19	85.0
2003/04	13.83	9.81	70.9
2004/05	9.30	6.56	70.5
2005/06	9.13	5.04	55.2
2006/07	6.52	3.15	48.3
2007/08	5.60	1.75	34.3
2008/09	5.66	1.31	23.1
2009/10	5.04	1.08	21.5

Source: Trade and Export Promotion Center, Nepal Foreign Trade Statistics.

The above table shows that the export of ready-made garments to USA was dramatically decreased during the last decade from US$ 14.08 million in fiscal year 2000/01 to US$ 1.08 million in 2009/10. The share of USA in Nepal's ready-made garments export declined from 89.4% to 21.5 % in the same period.

Table 3: Exports of Woollen Carpet

(US$ million)

Fiscal Year	Total Exports	Exports to USA	% Share of US on Total Export
2000/01	11.66	2.04	17.5
2001/02	7.95	1.74	21.9
2002/03	6.87	1.60	23.3
2003/04	7.42	1.85	24.9
2004/05	8.24	2.53	30.6
2005/06	8.21	2.95	36.0
2006/07	7.33	2.27	30.9
2007/08	8.58	3.51	40.9
2008/09	6.96	2.83	40.7
2009/10	5.71	2.04	35.7

Source: Trade and Export Promotion Center, Nepal Foreign Trade Statistics.

USA is the second largest importing country of Nepalese carpets. Nepal's carpet export to USA was highest during 1992/93 (US$ 3.3 million). But in the succeeding years, it declined and reached US$ 2.04 million in the fiscal year 2009/10. However, the share of USA in Nepal's carpet export increased from 17.5% in 200/01 to 35.7% in 2009/10.

Table 4: Exports trend of Pashmina items

(US$ million)

Fiscal Year	Total Exports	Exports to USA	% Share of US on Total Export
2000/01	5.51	1.55	29.2
2001/02	1.62	0.38	23.4
2002/03	1.39	0.27	19.7
2003/04	1.48	0.31	21.3
2004/05	1.44	0.31	21.2

2005/06	1.54	0.33	21.2
2006/07	1.54	0.47	30.6
2007/08	1.85	0.51	27.6
2008/09	2.37	0.41	17.3
2009/10	1.77	0.21	17.4

Source: Trade and Export Promotion Center, Nepal Foreign Trade Statistics.

Pashmina is one of the main exportable products of Nepal. But its export decreased sharply in the recent years, which adversely affected the pashmina industry and employment opportunities in the country. Nepal exported US$ 5.51 million worth of pashmina items in 2000/01, which declined to US$ 1.77 million in 2009/10. Similarly, the export to USA declined from US$ 1.55 million to US$ 0.21 in the same period and the share came down from 29.2% to 17.4%.Almost similar is the story about the export handicraft items.

Table 5: Exports trend of Handicraft Products

(US$ million)

Fiscal Year	Total Exports	Exports to US	% Share of US on Total Export
2000/01	0.43	0.12	28.5
2001/02	0.41	0.12	30.0
2002/03	0.55	0.15	26.8
2003/04	0.62	0.18	29.0
2004/05	1.03	0.18	17.0
2005/06	1.02	0.21	20.4
2006/07	0.61	0.11	18.5
2007/08	0.56	0.14	23.9
2008/09	1.61	0.10	6.5
2009/10	0.75	0.13	16.9

Source: Trade and Export Promotion Center, Nepal Foreign Trade Statistics.

Investment Prospects

Nepal provides immense opportunities for investment in manufacturing industries and services like education, health, tourism, hydropower, ICT etc. Moreover, Nepal has committed to open more than 65 sub-sectors under 11 service sectors during the accession to WTO. Foreign investment is allowed in these sub-sectors from 51 percent to 100 percent and there are no market entry barriers as such. Such openness of services sector requires building the internal capacity of the enterprises in various sectors and sub-sectors to become more competitive and efficient. Besides, a favorable investment climate needs to be ensured to bring in more investment in the manufacturing and services sector which basically relies on improved law and order situation, political stability, overcoming the problem of labor unrest, strike and lock-out, and availability of electricity. Performance of the public sector needs to be improved, which of course demands promoting rule of law, transparency, accountability and predictability in the governance. There is also need for promoting public private dialogue in order to create a stake of the businesses, farmers and civil societies in international trade. These reform measures are crucial from the perspective of trade development.

USA has remained one of the largest investors in Nepal. There are altogether 146[13] projects with US investments, mainly in the areas of services like insurance, banking and other financial services, tourism, hydropower and manufacturing (Table 7). The total investment made in these projects is around Nepalese Rupees 13687.8 million and altogether more than 11000 people are estimated to be employed in these US joint ventures.

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[13] Up to the year 2008-09.

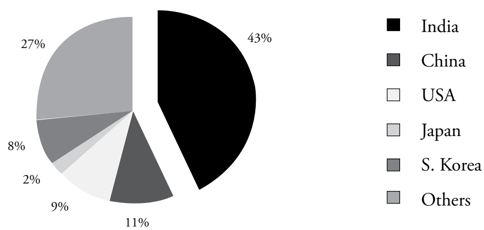
Table 6 : FDI in Nepal

Fiscal Year	Number of industries registered	FDI (Rs. in million)	Employment
Upto 2046	58	449.56	10586
2046/47	30	398.51	9515
2047/48	23	406.28	2974
2048/49	38	597.84	5615
2049/50	64	3083.67	13873
2050/51	38	1378.76	4734
2051/52	19	477.59	2386
2052/53	47	2219.86	8032
2053/54	77	2395.54	9347
2054/55	77	2000.28	4336
2055/56	50	1666.42	2146
2056/57	71	1417.61	4703
2057/58	96	3102.56	6880
2058/59	77	1209.65	3731
2059/60	74	1793.77	3572
2060/61	78	2764.8	2144
2061/62	63	1635.77	5559
2062/63	116	2606.31	7358
2063/64	188	3226.79	7389
2064/65	212	9811.00	10677
2065/66	230	6245.09	11068
2066/67	94	3746.98	4368
Total	1820	52634.65	140993

Source : Department of Industry, Government of Nepal

The bilateral agreement TIFA will open the opportunity for increasing collaboration further and protecting the interest of the investors to a larger extent. Besides, there are potentials for investing on manufacturing based on minerals (e.g. cement), high value agriculture and non-timber forest products including medicinal herbs, condiment and spices and extraction of essential oils.

Shares of top 5 investor countries in FDI upto FY 2066/2067



Source: Department of Industry, Government of Nepal

Table 7: Top Investor Countries in Nepal

Country	No. of Industries	Total Cost (Rs. in million)	FDI (Rs. in million)	Employment
India	429	48747.24	21229.55	50917
China	254	11320.99	4857.72	16634
USA	146	13686.81	4781.16	11456
Japan	138	3072.37	1089.51	6196
S. Korea	105	8057.67	4052.89	5066
UK	87	4554.08	1452.54	7434
Germany	67	2203.81	844.22	3522
Total (Top 7)	1226	91642.97	38307.59	101225
Others	420	33819.62	9690.53	32637
Total	1646	125462.59	47998.12	133862

Source : Department of Industry, Government of Nepal

Challenges

Export development and investment promotion have always been the priority issues as well as challenging topics in the Nepalese context. Various reform initiatives were taken up in the past in order to enhance the export sector and promote investment, including Foreign Direct Investment (FDI). The major steps in this regards were: Exporters Exchange Entitlement Scheme introduced in early 60s, creation of public, sector undertakings like Trade and Export Promotion Centre (TEPC) during 60s and 70s, creation of highly powered Export Promotion Council in mid-eighties, exchange adjustment, implementation of Structural Adjustment Programme (SAP) during the mid 1980s and 1990s, introduction of trade, industry and investment policies in 1990s and implementation of renewed trade and industry policy recently along with the formulation and implementation of Nepal Trade Integration Strategy 2010 (NTIS).The process of liberalization also touched upon all related aspects ranging from de-licensing of exports and imports (excepting a few products in which quantitative restrictions were maintained), liberal foreign exchange controls, unified customs tariff with fewer slabs and application of HS classification. During the period beyond 1995, Nepal faced many challenge due to growing dynamism in the trade and export sector as Nepal geared up on liberal market economy and globalization. However, even today challenges are enormous in linking Nepal with the global trade through sustaining the export base. Some of those challenges are:

- Lack of trade related infrastructure- road, railways, ports, communication etc. that unlock producers' link to global markets.
- Institutional deficiencies- customs, tax and product standard that drive up the cost of trading.
- Linking production centres with the market centres: the

production centres in the high mountain and hills are not connected to national highways.

- Knowledge gap: producers are unaware of global or even national trade and market opportunities.
- High transit transportation cost: there is need to bring down the cost of transit operation through the use of ICT, use of alternative corridors, developing effective connectivity between dry port and sea port for creating synergy through promotion of inter-modal transport system.
- Identification and development of new products for moving to the higher value chains, in the context of lost market share of some important products. The new emerging products may include tea, large cardamom, Chyangra Pashmina, honey, and non-timber forest products as suggested in NTIS 2010.
- Strengthening institutional and human capacity to take up the reform measures. Nepal also desperately needs support for a well functioning trade related support agencies like Trade and Export Promotion Center and business organizations (e.g. district chambers) for reliable production of trade statistics and carry out trade related research and training.
- Protecting IPR on bio-diversity, traditional products and new innovations- Nepal is immensely rich in genetic resources and bio-diversity. Nepalese herbal products are very much liked for their medicinal values. However, there is a need of protecting the IPR through creation of appropriate national legislation and also registering them internationally under GI. Besides, there is need of creating greater public awareness on the domestic front about the need and usefulness of the IPR to an LDC like Nepal.
- Aligning trade policies in line with the commitments made under the multilateral and regional trading systems- Nepal introduced new Trade Policy in 2009 and Industry Policy in 2010, and is in

the process of revisiting its FDI policy. It is obvious that those policies are to be realigned with the objectives of reaping optimum benefits from the multilateral and regional trading systems.

Conclusions and Recommendations

The TIFA will definitely help Nepal to boost up its economic ties with world's economic leader – USA, which has also remained one of the most important development partners as well as trading partners of Nepal since long. USA is among top ten trading partners of Nepal throughout the period 1990-2010. The volume of export however declined from US$ 180 million in 1999/2000 to US$ 52 million in fiscal year 2009/10 and the share of USA in Nepal's export declined from 27.6% in 199/2000 to 6.35 in fiscal year 2009/10. Though declining over the period, the USA is still the second largest export destination for Nepalese products after India.

The fall in export is mainly attributed to the products like ready-made garments and pashmina,which could not withstand competitionfrom other countries, particularly after the phase out of quota system under the WTO regime.

In this context, sustaining the export of existing but declining exportable items like garments, carpet, pashmina and handicrafts and development and promotion of new products and services as identified in Trade Policy 2009 and Nepal Trade Integration Strategy 2010 (NTIS 2010) will be one of the most important tasks for Nepal in the coming days.

The TIFA may and should play an instrumental role in this regard. Enhancement of domestic supply capacity and promotion of export potential products abroad needs creating a suitable investment climate in the country. Nepal, at the time of WTO accession, committed to open-up various service sectors for foreign equity participation. Such commitments of Nepal and prospects for investment in the country should be widely disseminated, so that FDIs, including from USA would be attracted.

Foreign Direct Investment (FDI) can become one of the prominent sources for Nepal's economic development. Nepal has enormous potentials in the areas of hydropower generation, tourism, manufacturing and services sectors. Therefore, attracting FDI to assist and facilitate development activities and process remains one of the priorities of Nepal. Apart from introducing 'Foreign Investment and Technology Transfer Act (FITTA - 1992), Nepal has also committed to open many service sectors during the accession to WTO. Foreign investment is allowed from 51% to 100 percent and market entry barriers are almost non-existent. In addition, Nepal has already introduced new Trade Policy, 2009, and Industrial Policy, 2010. Both trade and industrial policy have given priority for attracting foreign direct investment (FDI) in Nepal. In this context, TIFA should play an instrumental role to promote US investment in Nepal, particularly in hydropower, agro based industries and tourism related industries.

The conclusion of TIFA will be an appropriate mechanism to start bilateral process to strengthen trade and economic relations between two countries. The TIFA provisioned to establish a Nepal-United States Council on Trade and Investment that shall meet at least once a year. The main tasks of the Council are to monitor trade and investment relations between the two countries, identify opportunities for expanding trade and investment, identify relevant issues, such as those related to the protection of intellectual property rights, worker rights,the environment, and identify and work to remove impediments to trade and investment.

Such task however can't be completed simply by signing the agreement. A functional, effective and proactive 'Council' will be needed to achieve the desired goal of TIFA, viz.'expand trade, investment and technical cooperation and to strengthen economic relations between the Parties', which will definitely demand for development of proper instruments and modalities in the days to come.

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