Journal of Economics, Business and Market Research (JEBMR) 2024
SciTech Central Inc., USA Vol. 5(2)
766-772

HOW TO REINVIGORATE THE NEPALESE ECONOMY

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Received 09 July 2024; Revised 17 July 2024; Accepted 20 July 2024

ABSTRACT

Nepalese economy has been experiencing deeper problems especially in the external, financial, and public finance fronts mainly caused by the deterioration in the saving-investment gap which, as percent of GDP, remained at -3.7 in 2020/21 and -8.0 in 2021/22. So, the effective remedy would call for adopting measures for balancing the saving and investment ratios. Further, as percent of GDP, exports have been witnessing downward spiral for the last 2.5 decades while the trade deficit is widening. Such a development raised concerns for the prospects of soundness, stability, and sustainability of the external sector. The bank borrowers have concerns that the credit flow has been affected due to the higher interest cost. However, the problem is fiscal, not monetary as generally perceived. The fiscal deficit should be turned to surplus mainly by correcting fiscal management, including drastic reduction of recurrent expenditure. These concerns are quite valid given the fact that Nepal, a least developed country with narrow production base, low comparative advantage, volatility in exports, excessive dependence on essential imports, and ever-rising debt financing requirements needed to carefully manoeuvre its economic development trajectory by optimizing the associated benefits of globalization as well as by coordinating and sequencing the policies and strategies in such a way that the favorable macroeconomic effects including the external sector viability are well ensured.

DEFINING THE EXTERNAL SECTOR TRANSACTIONS OF THE ECONOMY

An economy is comprised of internal (domestic) sector and external sector. Transactions in the external sector comprise the transactions between the residents of the economy and the residents of the rest of the world. The balance of payments (BOP) is a statistical statement that summarizes such transactions during a given period. The national income identity equation expresses the gross domestic product (GDP) as the sum of consumption, investment, government purchases, and net exports, with the net exports denoting the excess of exports of goods and services over the imports of goods and services. By the same token, the transactions among the residents of the economy, i. e., consumption, investment, government purchases, could be referred to as the domestic transactions, or aggregated as absorption, of the economy. Besides the absorption, the trend and size of net exports would have significant impact on the GDP and exert deep implications throughout the economy.

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Total trade of Nepal has shown significant rise over the years. In 2022/23, Nepal's total trade (imports and exports) in goods and services as percent of GDP was 41.7 percent (imports 34.7 percent and exports 7.0 percent). A decade earlier, viz., in 2012/13, the total trade as percent of GDP was 41.9 percent (imports 32.6 percent and exports 9.3 percent). The share of exports in the total trade fell from 22.2 percent in 2012/13 to 16.7 percent in 2022/23. In other words, the share of imports in the total trade went up from 77.8 percent in 2012/13 to 83.3 percent in 2022/23. This shows wide deterioration in the share of exports over the years. The net exports/GDP ratio for Nepal has always been negative, ranging between 10-20 percent during 2001/02 to 2006/07, between 20-30 percent during 2007/08 to 2016/17, between 30-35 percent in 2017/18 and 2018/19, which even crossed 35 percent in 2021/22. (Source: Government of Nepal, Ministry of Finance, Economic Survey, Various Years).

During the past decade (2013/14-2022/23), with respect to goods and services trade, the annual compounded growth rates of exports, imports, and trade deficit were 7.5 percent, 11.3 percent, and 10.0 percent respectively. As ratios of GDP in 2012/13, the exports, imports, and trade deficit represented 9.3 percent, 32.6 percent, and 23.3 percent respectively which changed to 7.0 percent, 34.7 percent, and 27.7 percent respectively in 2022/23. Thus, imports have been galloping, exports have been decelerating, and the trade deficit has been accelerating year by year. This scenario must come to an end soon if the pace and process of economic development has to be accelerated in a sustained manner. The present article discusses the comparative developments with respect to the exports as well as the net exports of goods and services and examines the saving and investment gap before concluding that the macroeconomic risks arising from deficit in resource balance (i.e., Saving-Investment) as signaled by the recent developments of the economy merit urgent corrective actions.

Nepal's Deteriorating Ratio of Exports as well as External Balance on Goods and Services as Percent of GDP in the Global Comparison

According to the World Bank data, the exports of goods and services as percent of GDP in Nepal in 2023 was 7.0 percent, the sixth lowest in the world following the world's lowest 1.2 percent in Sudan, then 5.3 percent in Burundi, 5.3 percent in Haiti, 5.4 percent in The Gambia, and 6.6 percent in Ethiopia. Other south Asian neighbors have comparatively better exports/GDP ratio in 2023, namely, 10.4 percent in Pakistan, 13.2 percent in Bangladesh, 18.4 percent in Afghanistan, 20.4 percent in Sri Lanka, 21.9 percent in India, and 22.5 percent in Bhutan. Such ratio in Nepal was the highest (26.3 percent) in 1997 which had risen from 8.9 percent in 1975 and 10.5 percent in 1990. After 1997, the ratio consistently fell and the ratio has remained at 7.0 percent in 2023, as noted above (https://www.data.worldbank.org/indicator/NE.EXP.GNFS.ZS). Such downward trend, and precarious level, of the exports ratio reflects the gross negligence in the overall management of the economy in general and the export sector in particular.

Trade balance as percent of GDP for the reporting 149 economies for the year 2022 (source: the globaleconomy.com/ratio/Trade_balance) shows Nepal's position at the eighth lowest (-35.9 percent) following the lowest -86.7 percent in Kiribati, then -61.2 percent in Somalia, -52.5 percent in Lesotho, -48.8 percent in the Palestine, -44.1 percent in Micronesia, -40.4 percent in Samoa, -38.9 percent in Vanuatu, 35.9 percent in Nepal, and so on. Other south Asian neighbors have comparatively better trade balance/GDP ratio, namely, -12.0 percent in Pakistan, -8.0 percent in Bangladesh, -3.7 percent in India, -3.6 percent in Sri Lanka. The large trade deficit of Nepal evidences that, as compared to most of the countries around the world, the dependence on imports of the Nepalese economy is widening at a precarious level while production, productivity and exports have not seen expected progress. Thus, serious efforts need to be made for making widening imports more productive as well as utilizing the foreign trade and payments mechanism for the all-round interest and sound development of the economy.

EXPORT SECTOR IN NEPAL'S CONSTITUTION

Nepal's Constitution in the directive principles stipulates development visions like developing an independent, self-reliant, and prosperous economy in a sustainable manner by attaining rapid economic growth and development through maximum mobilization of the available means and resources by all sectors of the economy. The State policy on economy, industry, and commerce as mentioned in the Constitution also envisages diversifying and expanding markets for goods and services while promoting exports through development and expansion of industries based on identified areas of comparative advantage. The policy also stipulates encouraging foreign capital and technological investment in areas of import substitution and export promotion in consonance with the national interest. Despite such constitutional provisions, the performance of Nepal's trade, industry, and commerce sectors is not desirable, which poses greater challenges to the national authorities in the area of economic management in the days to come.

15TH AND 16TH DEVELOPMENT PLANS AND FOREIGN TRADE

The 15th Plan (2019/20-2023/24) target is to raise the ratio of exports of goods and services as percent of GDP to 15 percent by the end of the Plan, i.e., 2023/24. The BOP will be favorable and the foreign exchange reserve will be maintained at a level sufficient for imports of seven months' imports. The strategies will comprise development of sectors having comparative advantage like agriculture, herbs, hydro-power, tourism, raising production of goods and services together with managing imports, expanding and diversifying product-wise and country-wise destinations, promoting balance of payments and external sector balance, and maintaining and managing foreign exchange reserve. Since imports are estimated to reach 49 percent of GDP in 2023/24, the trade deficit will reach 34 percent, similar to the deficit at 35.1 percent in 2021/22. So, from the perspective of reducing trade deficit, the envisaged strategies and working polices of the 15th Plan do not seem to be so

instrumental, according to the Plan document itself (15th Plan, 2019/20-2023/24, National Planning Commission).

The 16th Plan (2024/25-2028/29) has targeted to raise the ratio of exports of goods and services as percent of GDP to 8.5 percent by the end of the Plan, i.e., 2028/29. The ratio of imports will be 31.0 percent, with the trade deficit/GDP ratio at 22.5 percent by 2028/29. By the end of the Plan, the BOP will be favorable at Rs. 200 billion and the foreign exchange reserve will be maintained at a level sufficient for imports of seven months' imports. As percent of GDP, the 15th Plan estimated imports to reach 49 percent, exports at 15 percent, and trade deficit at 34 percent in 2023/24. In comparison, the 16th Plan's imports, exports, and trade deficit are all projected at lower side. The 16th Plan's projected exports/GDP ratio at 8.5 percent is 6.5 percentage points lower than the 15th Plan's projection, estimating very discouraging progress in the export sector during the Plan period (16th Plan, 2024/25-2028/29, National Planning Commission). If the Plan itself targets trade deficit/GDP ratio at 22.5 percent by 2028/29, where is the government commitment to vigorously pursue the agenda of achieving the trade balance in the medium-term future?

SAVING AND INVESTMENT GAP

By definition, the current account balance could be interpreted as the difference between saving and investment in the economy. Therefore, the situation of higher average current account deficit signals more investment in relation to saving while the situation of more current account surplus represents more saving as compared to investment. Saving can be raised when fiscal deficit is drastically reduced and luxurious consumption in the private sector is controlled. Unnecessary administrative and recurrent expenditure should be reduced. Revenue net should be broadened while the tax procedure should be further simplified and the tax rate should be reduced. The revenue should exceed the recurrent expenditure by a wide margin. When fiscal balance is positive, it is called the fiscal surplus, which contributes to overall saving in the economy. Nepal's ongoing economic problem is mainly explained by the deterioration in the balance between the saving and investment. Raising the saving as the ratio of GDP would be a crucial step along the path of balanced, self-sustained, and healthy growth momentum. This means Nepal's current economic problem is more to do with fiscal management than with monetary management. Widening fiscal deficit can be financed only by higher interest rate. If the government borrows heavily, there would also arise crowding-out effects like hurting the private sector involvement, initiative, entrepreneurship, and investment. So, without curtailing the fiscal deficit, it would be impossible to bring the interest rate at one's desired level. Blaming the central bank or the banking sector for the interest rate rise is not fair when the fiscal deficit is maintained at unsustainable level. As a first step toward reducing the recurrent expenditure and reinvigorating the fiscal management, the Pradesh (regional) structure of the federal set-up should be dismantled. Other expenditures of the government should be similarly rationalized.

Otherwise, it would become almost impossible to revive the already fragile fiscal structure of the government.

The difference between saving and investment as ratios of GDP have been depicted as follows **(Table 1).**

Table 1. Difference between Saving and Investment (As Percent of GDP).

Fiscal Year	As Percent of GDP		
	Gross National Saving	Gross Capital Formation (Investment)	Difference between Saving and Investment
2001/02	24.2	20.2	4.0
2002/03	23.8	21.4	2.4
2003/04	27.2	24.5	2.7
2004/05	28.2	26.5	2.0
2005/06	29.1	26.9	2.2
2006/07	28.6	28.7	-0.1
2007/08	33.2	30.3	2.9
2008/09	35.9	31.7	4.2
2009/10	35.9	38.3	-2.4
2010/11	27.5	27.7	-0.2
2011/12	33.9	28.6	5.3
2012/13	34.4	29.7	4.7
2013/14	39.1	31.0	8.1
2014/15	38.3	31.2	7.1
2015/16	34.8	28.3	6.5
2016/17	41.7	37.3	4.4
2017/18	40.5	39.6	0.9
2018/19	42.1	41.4	0.7
2019/20	32.2	30.4	1.8
2020/21	31.5	35.2	-3.7
2021/22	29.6	37.6	-8.0
2022/23	33.8	31.7	2.1

Source: Economic Survey (Various Years), Appendix 1.8 and 1.9, Government of Nepal, Ministry of Finance

In 2020/21, gross national saving (GNS) declined 0.7 percentage points of GDP from 2019/20 while gross capital formation (GCF) rose 4.8 percentage points of GDP from 2019/20. As a result, in 2020/21, difference between saving and investment (S-I) as percent of GDP remained -3.7. In 2021/22, GNS decreased 1.9 percentage points of GDP from 2020/21 while GCF rose 2.4 percentage points of GDP from

2020/21. As a result, in 2021/22, S-I as percent of GDP remained -8.0. In 2022/23, in comparison to 2021/22, GNS increased 4.2 percentage points of GDP while GCF declined 5.9 percentage points of GDP. As a result, in 2022/23, S-I as percent of GDP remained 2.1. The S-I as percent of GDP at -3.7 in 2020/21 and -8.0 in 2021/22 were the factors that destabilized the external sector of the economy as indicated by the abrupt fall of the BOP surplus at Rs. 282.4 billion in 2019/20 to only Rs. 1.2 billion in 2020/21 and the BOP deficit incurred in each of the 12 months in 2021/22, resulting in the BOP deficit aggregating Rs. 252.4 billion in 2021/22. As a result, foreign exchange reserve as expressed in the import capacity of goods and services in equivalent months came down from 12.7 months in 2019/20 to 10.2 months in 2020/21 which further shrank to 6.9 months in 2021/22 and then recovered to 10.0 months in 2022/23. The BOP deficit amounting to Rs. 252.4 billion in 2021/22 also contracted reserve money and narrow money (M1) by 11.4 percent and 9.3 percent respectively.

CONCLUSION

Nepal has traditionally been facing deeper imbalance on the net exports of goods and services especially due to substantial export shortfall even as measured at the global level. The government neither incentivized the export sector nor helped mitigate the numerous problems facing the sector. Besides, unfavorable resource balance as measured by the saving-investment/GDP ratio has at times created turbulence in the critical sectors of the macroeconomy. Such turbulence could be expressed in the form of occasional BOP deficits, reduction in the import capacity of the foreign exchange reserve level, derailment in the smooth growth and operation of the monetary aggregates, and creation of related liquidity problems in the economy, especially hurting the investment climate and smooth production process in the country. To mitigate such environment, Nepal needs adequate homework for rejuvenating the economy and making the external sector sound and sustainable. As the remittance effect in the economy is ultimately destined to slow down, with its far-reaching short-term and long-term effects and implications, Nepal should initiate homework for preparing the economy to face such eventuality. Cutting unproductive public sector expenditure and unnecessary private sector consumption comprise the viable remedy. Although it will be painful to bear the macroeconomic and microeconomic effects of such a move, in the long-term interest of the economy and for the interest of the future generations, there will be no other alternative except for tightening the belt and making optimal utilization, especially focusing on investment, of the resources available in the economy. The huge recurrent expenditure required in the process of implementing the federal set-up as per the new Constitution may not be consistent with such requirement for downsizing the recurrent expenditure. Making most productive allocation and use of the resources including promoting an enabling environment for the private sector investment besides requesting the donor community for necessary non-debt resources would constitute the priority national agenda and action for Nepal. The solution of the problem would comprise preventing or reversing the appreciation of the real exchange rate of the currency. Faster rise in wages as well as prices of domestic inputs would make the

domestic inflation exceed that of the world inflation, causing exporters' profits to decline. In most cases, the cure requires the government budget restructuring and strong restraints over money creation by the central bank, both aimed at economic stabilization. The government needs to plan and undertake sensible, sound, well-targeted projects with prospects of high returns. Among the stabilization tools, Nepal's inflation should remain around the levels of her trading partners' inflation so as to make the real exchange rate positive while expenditure would have to be reduced through restrictive fiscal and monetary policies that would also reduce the inflation. These are the pre-requisites for attaining macroeconomic stability and soundness for sustainable development and prosperity of Nepal, especially building on the foundations of external sector viability and sustainability. Lastly, to avoid the macroeconomic instability as harshly experienced by the Nepalese economy in the recent years, the saving and investment ratios need to be regularly tracked for adopting timely measures so as not to allow the resource balance (i.e., S-I) to enter the negative region. Saving needs to be raised by drastically reducing the fiscal deficit and discouraging the import-based, superfluous/luxurious consumption in the private sector while rationalizing unproductive and inessential government expenditure.

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