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Economic Reform:Theoretical Consideration And It's Macro Impact On Nepalese Economy

Vishnu Prasad Sharma*

INTRODUCTION

To answer the question what sort of reforms are most likely to help poor people in developing countries, most economists in 1950-75 would have replied, state actions to transfer claims, access, rights, credit, perhaps food and income, toward poor people, and to reduce their liabilities, duties and barriers. In 1950-75 reform almost always connoted such redistributive reforms.

Since 1980, more and more economists and officials used reform to connote market reforms: fiscal stabilization, desubsization, deregulation, deprotection, devaluation and privatization, which normally involve reductions in public sector employment and outlay. Market reforms aim at faster growth as subsidies to employment displacing inputs are removed; and the removal price distortions often accelerates growth and increases labour intensity.

The aim of structural adjustment programme is to achieve micro-economic stabilization and structure reform through government expenditure cuts, tight monetary policy and structuring of capital markets, removal of distortion inducing controls on private sector activity and an effective exit policy for closure or restructuring of loss making firms in either the private or the public sector.

The Structural Adjustment Programme was introduced in Nepali in 1985 with components of:

- Generation and sustaining of macro-economic stability;
- Reduction of fiscal deficit;
- Improvement in current account and balance of payment position;
- Decontrolling of price, interest and exchange rates;
- Reduction and/or removal of government subsidies;
- Privatization of public sector industries;
- Stabilizing real wage rates; and
- Liberalization of the economy.

* *Mr. Sharma is Associate Professor in the Central Department of Economics, T.U., Kirtipur, Nepal.*

SCOPE OF STRUCTURAL ADJUSTMENT

Introduction

Structural adjustment is an integral part of the process of economic growth and development, as economic development has the twin objective of achieving balanced and sustained economic growth with equitable distribution of incomes and wealth. In the recent decade considerable focus has been given in national economic and social development plans to the issue of structural adjustment because of the severe economic and social problems arising out of indebtedness, slow economic growth and balance of payments problems provoked largely by the oil price hikes in 1973 and 1979, the economic recession in the developed countries in the early 1980s and the increase in interest rates especially between 1981 and 1983.

All nations are bound together in the international community through a web of political and economic relations which influence economic growth and the structure of economies. The need for Structural Adjustment Polices (SAPs), therefore, arises out of both domestic causes for sluggish economic performance and external factors such as the impact of changes in the international economic conditions and political situations. There is, therefore, the realization that all nations must be sensitive and respond positively through appropriate policy measures to cope with the negative consequences of fluctuations in economic growth, especially with regard to the deterioration of employment and quality of life of the population.

SAPs are therefore, formulated to overcome crises in the economy and to achieve the objectives of economic development. Structural adjustment is not a one time policy intervention in the economy:SAPs are part of a continuous process of economic and social development policies to bring about structural changes in the economy. Structural adjustment, therefore, refers to changes in a range of economic policies, both in the short term and the long term, that have the overall effect, firstly, of achieving the objectives of economic development by changing the importance and the roles of the different elements and sectors of the economy; and, secondly of major signficance of altering the basic relationships between the government and the economy.

These policy reforms bring about a greater reliance on market forces for determining the outcomes of the economic process of production and distribution of goods and services both at the national and international levels. There is, therefore, a shift in emphasis from the government sector as the engine of economic growth, to the private sector which takes on a dominant pro-active role to accelerate economic growth.

The Policy Instruments Of Structural Adjustment

SAPs are designed to take into account national situations in terms of the efficient utilization of resources for balanced and sustained economic growth with equitable distribution of incomes and wealth. Such policies are dynamic and sensitive to the continuous process of cumulative change and its ramifications vary in society within the nation and between nations especially with regard to economic relations. All nations experience cycles of booms and slumps in their economies. There is, therefore, the need for such short-term and long-term policies to cope with the fluctuations in economic growth and the social problems arising out of these fluctuations.

In the short term, stabilization policies are adopted to check the immediate negative consequences in the business cycles. They are aimed at reductions in the current account deficits in the balance of payments and the fiscal deficits to sustainable levels. In the long term, SAPs, focus on strategies for balanced and sustained economic growth with equitable distribution of incomes and wealth through reforms in micro and macro economic policies and institutions in the economy. The immediate objectives of these reforms are to improve the efficiency of resource use through changes in certain incentives and improvements in infrastructure. The overall objectives of SPAs are to achieve a broad based and sustainable economic recovery in which all economic agents contribute and from which all benefit, and to overcome structural obstacles through a process of institutional reforms leading to the alleviation of poverty, fuller levels of participation and comprehensive growth in productivity. Structural adjustment, therefore, is the endeavour to achieve stabilization, adjusting prices to reflect the supply and demand conditions in the market and adaptation of policies, institutions, technology, and management practices to promote efficiency and economic growth with equity. The main policy instruments in structural adjustment are as follows:

Trade and Investment Liberalization

This policy involves measures to make economies more open to competitive participation in the world economy. This is done through improvements in the determination of import and export composition and volume based on competitive domestic market processes. In developing countries, increasing the export orientation of an economy has been a major thrust among reform strategies. Specific policy measures include the removal of import quotas and reduction of tariffs, improvement of export incentives, revision of industry incentives systems, improvement of support for agriculture and industry, and promotion of both domestic and foreign investments through special incentives, improved infrastructure and the abolishment of barriers of entry especially in the case of foreign direct investment.

Monetary Reform Devaluation and Financial Liberalization

This involves measures to strengthen competitive market-based processes in monetary and financial systems. Such measures focus on exchange rates and interest rates that are sometimes unrealistic and occur as a result of inappropriate government interventions. It also focuses on the encouragement of higher savings rates, e.g. by maintaining macro economic stability, and attraction of foreign private investment. Specific policies also include revision of exchange rate and interest rate policies and the strengthening of financial and capital markets.

Budget Deficit Reduction

This policy involves reducing deficit financing of public investment. It focuses on specific measures to rationalize and reduce budget expenditures along with measures to improve revenue collection mobilization. Specific policy measures include the revision of current expenditure, reprioritization of investments especially for the improvement of productivity, production and the strengthening of the capacity for public investments.

Market Deregulation

This policy involves reducing the role of government in regulating participation and performance in specific markets in the economy. These measures may include closing some government regulatory operations. Specific policy measures include the revision of agricultural input and product prices and energy prices through the withdrawal of subsidies and direct intervention in these markets.

Privatization

This involves reducing the role of government as a direct and competing praticipant in the economy through state-owned and state-protected enterprises. This will usually involve divestment, sale of state-owned corporations and significant equity holdings in private companies, and removal of special protection granted to other types of corporations. At the minimum, this will involve steps to make public enterprises more internally efficient and possibly more market-accountable. Specific policy measures include reform in public enterprises with a view to increase the efficiency of public enterprises.

All the above policy measures which are market friendly, outward oriented, and macro economically stable are interwoven and reinforce one another in achieving the objectives of stabilization in the short term and structural adjustment in the long term. So structure of the economy, which has evolved through a process of economic development planning, changes in this process, especially in the characteristics of composition, ownership, and distribution of economic activities, can be broadly grouped as follows:

- Changes in location, origin or spatial distribution of activities, e.g. changes in the regional distribution of industrial activities. These occur with expansion of the economy and re-orientatin and diversification of economic activities which inevitably open up new locations and regions for economic development.
- Changes in the different types of activities, e.g. shifts in the composition of economic activities from predominantly agricultural to a mix of agricultural, manufacturing, industrial and service activities. Such changes help in diversification of the economy to spread the risks in export trade and markets.
- Changes in characteristics of participants in the activities, in terms of gender, ethnic or religious group, or socio-economic class. These occur with the expansion of the economy and increased demand for labour. There is, therefore, greater response to opportunities for employment from all social groups in society.
- Changes in the scope of the structure of the industries, e.g. shifts from production for local to national markets, or from domestic to export markets. This results from policies to expand export potential and earnings.
- The changes referred to above are linked together in a dynamic process of economic and social change. SAPs which are sensitive to the dynamics of economic and social change are, therefore, a pre-requisite to generate balanced and sustained economic growth with equitable distribution of incomes and wealth and to serve as objective solutions to economic and social problems.

Privatization

One other important strategy adopted by the government to reduce the government budget deficits and shift towards a market oriented economy is the privatization of government owned industries which are part of the government budget. It is the opening of public enterprises to market forces in respect of both inputs and outputs. Privatization, therefore, involves a shift in the balance between the state and market in the economy in favour of the market. The process of privatization is governed considerably by the overall government policies of liberalization and deregulation which help in promoting an open economy and reduce factor immobilities, e.g. imperfections in capital and labour markets within a sector or among different sectors of the economy.

The Overall Objectives of Privatization are :

- To scale down the government's direct initiative in economic activities, and to minimize the involvement of government bureaucracy in enterprise operations;

- To reduce government budgetary costs arising from subsidies and capital expenditures;
- To promote competition and improve the efficiency of enterprise operations;
- To encourage wide ownership of shares to achieve the objectives of distribution of wealth in society;
- To promote the growth of capital markets;
- To derive capital incomes for the government.

Forms of Privatization

Policies for privatization are carried out carefully after due consideration is given to the economic and social impact of such action on the respective industries identified for privatization. Privatization policies can be classified as follows:

- The total transfer of ownership and control of selected industries from the public to the private sector;
- The partial transfer of ownership and management of selected industries from the public to the private sector;
- The selective privatisation of functions within public sector corporations through the contracting out of selected work normally carried out by the public sector corporations;
- The privatization of only the management of public sector corporations through management agreements and leasing out of such corporations.

The Government's role in the various sectors of the economy will have to be considered carefully before privatization policies are foumulated so that it achieves the economic objectives of efficiency in resource utilization and the welfare objectives of equitable distribution of social costs and benefits in society. Each enterprise will need careful consideration according to the merits of each case.

In agricultrue the total privatization of large plantation type land development projects is relatively easy through the distribution of ownership titles to land to the settlers or equity participation in private sector corporations organized for such privatization. However, when we consider the services of support facilities in the agricultural sector by government owned and operated corporations such as drainage and irrigation facilities, distribution of subsidized fertilizers and other agricultural inputs, processing and marketing services through agricultural commodity marketing boards and rural and agricultural banking services for low cost development and operating finances for this sector, the impact on the human element has to be taken into consideration seriously before any policies for privatization can be formulated. It is common knowledge that without the subsidies and government support programme the agricultural sector, especially the food producing sector comprising of small farmers, will be adversely affected leading to serious social costs of indebtedness and increase in landless farmers and consequential decline in employment, incomes, nutrition and fulfilment of other basic needs. Although there is scope for privatizing these services in theory, the impact, if practised, will create strong trends in polarizing society between extremes of very poor people and the rich. It is, therefore, extermely important for individual corporations to be evaluated, both from economic and social considerations, before embarking of implementation of the privatization of public corporations.

In transport services total and partial privatization policies are implemented. In the case of land transport the building of infrastructure such as roads, rail and ports are all privatized through corporations either wholly owned or partly owned and managed on a joint venture basis between governments and private sector corporations. There are also situations where these activities are privatized on a *build-operate-transfer* basis. The operating aspects of the modes of land transport, especially road transport, is usually privatized and controlled through licensing to ensure transport services to all areas and avoid wasteful competiton. It is, therefore, common to see public road transport corporations being privatized wholly to private sector transport operators who specialize in freight services and passenger traffic. Similar situations also exist in inland water transport services.

Airline is another government owned and operated corporation in many countries. This has also been privatized wholly or partly in many countries. There are two considerations with regard to airlines i.e. air traffic requirements for domestic routes and international routes. In many developing countries where road, rail and inland water transport systems are not well developed, air transport services are crucial and subsidized. However, there is ongoing review of the profitability of routes, both domestic and international, and privatization is carried out through mergers and linkages. In the case of shipping facilities, privatization of ports and government owned shipping corporations has taken place in whole or in part through management contracts and mergers with private sector corporations.

In the case of provision of electricity privatization is carried out on a partial basis. The majority of the shares is owned by the government with the minority being distributed to private investors and corporations involved in the generation of electricity. As investments in this industry are heavy, the corporatization and distribution of ownership and control through linkages in the generation and the distribution systems help to resolve demand for capital in a short period of time for generation of power during rapid economic growth.

In many cases large multinational enterprises involved in the manufacture of electricity generation plants and installation of power generating stations invest in privatized electricity supply corporations to maintain the markets for their equipment and assist in increasing the capacity for supply of electricity consistent with demand.

Similarly, postal services are also privatized and expanded through courier services corporations in the private sector. Services such as health services are also privatized through the support of health insurance schemes which cater especially for workers in the formal employment sector. These services are parallel to governments health care services which are accessible to all in society.

Financial services, in particular development banking which is a sources of long term soft loans and subsidized loans to critical sectors e.g. food producing sectors, are also privatized by governments to ensure effective management of financial resources. Other services which are popular for privatization by government include telecommunications, tourism, supply of potable water, public sector housing, radio and television services and education and training institutions.

The mechanics of privatization, therefore, result in changes to the ownership, control and management of public sector corporations. Whatever the mode, the change to independent cost centre operation is inevitable. However, the discipline of private sector profit motivated management systems and its implications on workers cannot be treated lightly. Privatization must, therefore, be carried out with extreme caution. The UNDP Human Development Report (1993) highlighted the following cautions to be observed in the process of privatization:

- For the wrong reason--many privatization strategies have aimed at maximizing short-term revenue rather than building competitive markets for the long term. For example, the sale of a telecommunications company as a monopoly would probably get a better price from a buyer who thought the company's activities would not be closely regulated which results in short-term revenue for the government but long-term losses for consumers and the efficiency of the economy as a whole. It is better to create a competitive environment than to maximize short-term revenue from sales into protected markets.

- In the wrong environment--privatization is reasonable only if enterprises are released in an environment that allows then to become competitive and efficient. Where the market functions poorly and enterprises are still vulnerable to arbitrary government edicts, transferring ownership to the private sector is unlikely to achieve much. Similarly, the creation of private monopolies without an effective system of monitoring and control opens up the danger of exploitation of consumers.

- With non-transparent procedures--privatization has sometimes been accopmanied by allegations of corruption, and claims that the process has enriched a few privileged cronies of the government. The disposal of assets should be open and public to avoid such allegations. It should start with a publicity campaign explaining the rationale for the privatization and the method of selling and then proceed through competitive bidding, preferably through the stock exchange. The entire process of transferring ownership should be kept open to outside scrutiny-and should clearly state the national objectives that privatization hopes to accomplish. There should also be a detailed report on the sale to evaluate if the objectives have been achieved. Public accountability is vital in privatization.

- Only to finance budget deficits--government are often tempted to sell state assets to cover their current budget deficits. The sale of public assets should be seen instead as a way of reducing the national debt. These debts were often incurred in the first place for the establishment of such enterprises. Selling assets to meet current liabilities is mortgaging the options of future generations.

- With a poor financial strategy--the best way to dispose of assets is through the capital markets. Selling shares to the public is difficult in many developing countries because capital markets are underdeveloped. Some governments try to private while at the same time issue high-yield, low-risk, tax-free government bonds. Many governments have also narrowed their options by restricting sales of shares to foreigners. The aim instead should be a widespread distribution of shares to nationals and foreigners alike - with a timing and a distribution of shares that both maximize revenue and protect national interests.

- With unrealistic labour strategies--some governments are concerned about labour agitation in privatized industries. They, therefore, have demanded guarantees from prospective buyers that no workers will subsequently be laid off. In some cases they have sought labour cooperation by offering golden handshakes that exceed the asset's sale value. Employment is one of the most difficult and sensitive areas of privatization and experience shows that it is better to have an open and free dialogue with the trade unions in advance. This should cover the possibilities of worker ownerhip and retraining schemes, as well as the inevitable job losses. False promises in the initial stages will create worse problems later. Tripartite consensus on all issues concerning labour is absolutely necessary for the government implementation of privatization.

- With no political consensus--privatization is not merely a technocratic exercise. It is also a political process. A hasty privatization forced through executive orders risks immediate conflict and reversal after a change in government. There are many contending schools of thought on privatizations, and unanimity is unlikely. Governments should attempt to build as broad a consensus as possible and use democratic parliamentary procedures to minimize violent lurches in policy.

The macro economic dimensions of SAPs which involve trade liberalization, monetary and fiscal policies, budget regulations, market deregulation and privatization have all a combined effect in accelerating economic growth, stabilization and structural change in the economy. This combination of policies, however, have specific implications on issues of concern to trade unions which focus on employment, industrial relations, distributions of incomes and wealth, social secutity and access to goods and services to fulfil basic needs such as health, housing, education, potable water, electricity etc. The scope for consideration of these issues of concern in the planning and implementation of SAPs is important to ensure that the shocks and social costs in the adjustment process are minimized.

MACRO IMPACT OF ECONOMIC REFORM ON NEPALESE ECONOMY

Least developed countries, have been increasingly marginalized in development mainly owing to their high dependence on the production and exports of primary commodities. Economic reform has been recommended to these countries with the aim of expanding GDP and exports and diversifying the production and export structure into manufactures. However, there has been no clear and systematic association since the early 1980s between economic liberalization and devaluation, on the one hand, and the growth and diversification of output and exports of Nepalese economy on the other. In fact, economic liberalization has been accompanied by deindustrialization, and even in export expansion it was not always accompanied by the expansion of supply capacity.

It has been argued that Nepal irrespective of her level of development and industrial base, should liberalize her trade regimes in order to expand production and exports, particularly exports of manufactured goods, and consequently promote her economic development. The proposal is made not only for a universal but also for an across-the-board liberalization of all industries and sectors.

Features Of Economic Liberalization

There is no general understanding on what is meant by liberalization policy reform. As recommended to developing countries in recent years, it generally involves greater reliance on markets for channeling investment and other resources into the decontrolled sector. An important component of this process is lessening dependence on direct and indirect controls in economy. It is this more limited process that is the subject of the present analysis and is referred to hereafter as "Economic Liberalization". Although the details, modalities, pace and sequencing of economic liberalization measures vary from one country to another, such measures have a number of common features. They are the core of a more comprehensive set of structural adjustment measures which have often been adopted in response to the conditional finance available from multilateral financial institutions, in particular the World Bank and IMF. They have generally involved neutralizing incentives for market forces, export and imports at low tariff levels through:

- Removal of important quotas and other quantitative restriction or their conversion into tariffs;
- Subsequent reduction of the level and the dispersion of import tariff rates;
- Compensatory devaluation of the national currency;
- Removal or reduction of export taxes.

The table 1 suggests that the country has a relatively small tariff dispersion. Since 1987, Nepal has undertaken further liberalization measures, including the binding of tariffs.

In contrast of most other LDCs trade liberalization in Nepal has been selective. High tariff rates and some NTMs continue to apply to light consumer goods, but very low ones to imported intermediate inputs and machinery necessary for output and export expansion. In Nepal, a some what similar policy was pursued, although the degree of tariff dispersion has been smaller. In this country most of the existing quantitative restrictions were removed in 1992. Moreover while export promotion has been emphasized, import substitution remains an important element of its industrial strategy.

Table 1
Indicators Of the Level Of Tariff And Non-tariff Barriers In Nepal 1995

Country	Manufactures			C[c]	NTMs[b]	All imports			C[c]	NTMs[b]
Nepal	Tariffs[a]				Frequency[d]	Tariffs[a]				Frequency[d]
	Mean	Min	Max			Mean	Min	Max		
	26.7	24.4	29.0	26.7	13.7	22.6	20.8	24.6	22.6	10.7

Source: Compiled by the Author Based on UNCTAD, Least Developed Countries Reports 1991, Economic Survey 1994/95, and Budget Speech of 1995/96, HMG/N.

(a) Tariff rates and total charges are calculated as follows: (i) *mean tariff rates:* the mean tariff rate at a CCCN heading is calculated by taking a simple average of all national tariff lines concorded to the heading; (ii) *minimum tariff rates:* average of the lowest tariff rate within each CCCN heading belonging to a product category; (iii) *maximum tariff rates:* average of the highest tariff rate within each CCCN heading belonging to a product category; (iv) *mean total charges* (C): same as the calculation of mean tariff rates, with the addition of additional charges (see note c). **(b)** Quantitative restrictions (QRs) in the form of licenses (discretionary licence, import authorizations, licences for selected purchasers), quotas (global quotas) and prohibitions (total prohibitions, temporary prohibition, suspension of issuance of licence). Also included are, such measures as advance import deposits, foreign exchange restrictions, fixed customs valuations and State-trading monopolies. **(c)** Total charges (i.e. tariffs plus additional charges). Additional charges include customs surcharges and surtaxes, stamp tax and certain other fiscal charges, and tax on foreign exchange transactions. Excluded are sales and consumption taxes and taxes on actual services rendered such as statistical tax and port tax. Certain other charges, such as licence fees and consular invoice fees, are also excluded for lack of consistent data. **(d)** The percentage of products within a category that is affected by an NTM. It is calculated by first defining the frequency of a NTM for a national tariff line to be zero if no NTM applies to the tariff line, 50 per cent if an NTM affects a part of the products specified under the tariff line, and 100 percent if the tariff line is fully covered by a NTM. It is also defined 100 percent if two or more NTMs apply to a tariff line.

Liberalization And Economic Performance In Nepal

The extent of trade liberalization appears, to have been quite impressive but has it improved economic performance? To answer this question, one has to bear in mind what liberalization was supposed to achieve, namely an expansion of exports through a diversion of resources from the domestic to the export sector. Such export orientation would in turn, it is maintained, lead to faster growth of GDP. Moreover, by removing the traditional bias against exports and production of manufactures, trade liberalization would lead to a diversification of production and exports in favour of manufactures.

Economic liberalization is not, of course, the only factor affecting economic performance. Moreover country varies in her resource endowment, initial level of development, export capacity and initial degree of openness, other policy stances, as well as in the timing and pace of their liberalization. Consequently, measuring the impact of economic liberalization is not easy. An approach sometimes used is to construct a measure of the degree of openness as an indicator of the degree of economic liberalization, and relate it to economic performance. An alternative approach is to distinguish between *successful* and *unsuccessful* sectors, experiences and attempt to analyse the underlying factors behind their success, or failure, including the role of liberalization. The main disadvantage of the first approach is that it cannot capture the impact of other factors affecting economic performance. Hence, concentration has given to the alternative approach.

Trade Liberalization

Three proxy measures are used in this analysis in attempting to assess the degree of liberalization in an economy within a given period: the ratio of imports to GDP, the share of revenue from import tariffs to total government revenue and the average foreign exchange premium on the black market. The assumption is that as trade liberalization progresses the import-GDP ratio will increase, the relative importance of tariffs in government revenue will decline and the black market premium for foreign exchange will narrow. Relevant information available is shown in table 2.

Table 2

Indicators Of Economic Performance Of Nepal From the Year 1990 to 1995

(Percentage)

Country	Output and Export Growth[a]			Export and Output Diversification	
Nepal	Real GDP	Real MVA	Export Volume[c]	Exports[b]	Production[c]
Low Liberalizer	1.6	1.4	-0.5	-3.4	-0.2

Note: Data Refer to Change Between 1990 and 1995, Unless Otherwise Indicated.

Source: As of the Table 1.

a Annual average.

b Increase (in percentage points) of the share of the major exports in total exports. A minus sign indicates diversification.

c Manufacture value-added (MVA) as a share of GDP: increase in terms of percentage points.

The table 2 shows, three indicators of economic performance over the 1990-95 (annual growth of real GDP, manufacture value-added (MVA) and exports) and two indicators of diversification (one for output and one for exports). The export diversification indicator is constituted by the change over the period in the share of the three main export items of the country in the total value of exports, while that for production is constituted by the ratio of MVA to GDP. Accordingly the economy tended to perform not better, no positive GDP, MVA and export growth, and a lower degree of production and export diversification during the period.

Exchange Rate Policy

The empirical evidence on the impact of devaluation on growth and the structure of exports is inconclusive and no significant association between devaluation and export growth has been revealed by any study previously. The present study found that the country resorted to exchange rate adjustment did not lead to a real depreciation of the currency because of inflationary impact. However, from second half of 1993 real depreciation was achieved as shown in Table 3. In that table changes in real effective exchange rate (REER) is shown for two periods - 1990-92 and half and 1992 and half to 1995.

Table 3
Changes In Real Effective Exchange Rates (REER) And Export Growth Of Nepal

	1990 to 1992 half [a]	1992 half to 1995 [b]
REER that declined by 10-30 percent	Average Export Growth[c] (in percentage)	Average Export Growth[c] (in percentage)
	4.4	3.0

Source: As of the Table 1.

a Change from annual average for 1990-92 to that for 1992-1995.
b Average annual change.
c Unweighted country average.

In this period on the average annual REER for 1990 to 1992 half is compared with that for 1992 and half to 1995 where average annual change from 1990 to 1995 is shown. In two cases, a contrast picture emerges: for period 1, there is a rise in REER, and for period 2 there is decline. It was a real depreciation of over 10 to 30 percent during both periods.

The table 3 also indicates that there is no clear relationship between REER and export growth. In general, real devaluation (a fall in REER) tended to have the lowest export growth, while with the smallest devaluation, or appreciated in real terms, tended to have higher export growth, particularly in period 2.

Table 4
Real Effective Exchange Rates (REER) And Indicators Of Production And Export Diversification Of Nepal In the Year 1990-95

		(In Percentage) Diversification of	
Wih REER that declined by under		Production[a]	Exports[b]
	10-30%	1.7	0.7

Source: As of the Table 2.

a As defined in note c to table 1.
b As defined in note b to table 1.

In table 4 a similar exercise is undertaken with respect to changes in REER, on the one hand, and export and output diversification, on the other, using the same indicators of diversification as before. Again, there is no clear association. As far as diversification into production of manufactures is concerned, it appears from the table that with a rising REER, or with a relatively small real depreciation on average, had a greater structural shift towards manufacturing than in those where there was a substantial real devaluation. The opposite holds true with respect to export diversification. It should, however, be borne in mind that the apparent export diversification is partly due to the decline in prices of primary commodities, which are usually among the three main export items of the country.

The lack of a significant and clear association between economic liberalization and exchange rate adjustment, on the one hand, and economic performance, on the other, can be explained by a number of factors, as discussed below. For the present, two points are worthly of note. First, a number of *other factors*, including exogenous ones, has been of greater importance in the country. For example, the relationship between REER and exports may have been affected by movements in the terms of trade—in which case changes in the real exchange rate my have followed—rather than by shifts in exports. A real appreciation (depreciation) may indicate an improved (worsened) external environment or adverse domestic shocks, such as droughts or natural distress. Some support for this premise is provided by considering average terms of trade movements. For the period 1990-1995, there is a clear tendency for the country with real appreciation or relatively small deprecation (below 30 percent) to have a smaller decline in the terms of trade than with larger depreciations. The terms of trade losses may also have been partially intensified by the *fallacy of composition* effect of collective devaluation by the country producing the same commodities.

Secondly, the positive association between liberalization and economic performance shown does not necessarily imply a causative relationship owing to two methodological deficiencies. Moreover, the measurement of liberalization used above reflects to a large extent actual import performance rather than trade liberalization: a rise in the ratio of imports to GDP may simply rëflect a greater availability of foreign exchange. Similarly, where imports have been liberalized a fall in the import-GDP ratio is due to import compression on account of foreign exchange shortage, generally excerbated in the 1990s by debt service obligations. Likewise, the fall in the ratio of import tariff revenue to total government revenue reflects an increase in other taxes rather than a decline in import tariff revenues; or a rise therein is attributable to a conversion of quantitative restrictions and other NTMs into tariffs.

Finally, as already mentioned, trade and exchange rate policies are not the only factors affecting economic performance, and it is consequently necessary to consider also these other factors.

Main Factors Behind Unsuccessful Economic Performance

In many LDCs rapid expansion of exports requires, *inter alia,* the development of supply capacity and diversification into production and exports of manufactures, which in turn necessitates increased investment and imports.

Growth in GDP and MVA

Table 5 classifies growth performance during the 1990-1995 distinguishing between annual growth above the LDC average and those below the average. To compare the relative performance of the country over time, a further distinction is made, between that where growth was faster than in the 1992 and that where it was lower than in1995.

Trade liberalization does not appear to have contributed to GDP growth, and Nepal has not undertaken substantial trade liberalization in its usual sense, and if her low performance can be attributed at all to trade liberalization, it is due to its *selective* nature. It is also worthy of note that the worst performer is Nepal which had extensive trade liberalization and/or currency depreciation. Thus, there does not appear to be any clear relationship between trade liberalization and exchange rate movements, on the one hand, and GDP growth, on the other.

Where growth has been dynamic in the other LDCs, it has been mainly due to the manufacturing sector. With a few exceptions, countries where real MVA growth is above average are also those where GDP growth is high.

Table 5
Growth Performance: Investment And Imports Of Nepal 1990-1995
(In Percentage)

	Annual GDP Growth	Average Investment/GDP Ratio		Annual Growth of Real Investment	Annual Growth of Import Volume	Average Growth Rate of GDP in Percentage	
	1990-95	1990-92	1992-95	1990-95	1990-92	1992-95	1990-95
Growth in the 1990	4.6	22.0	23.8	6.2	3.4	2.0	
Growth in 1995 Slow than 1990	4.3	18.1	16.2	4.0	1.7	0.5	5
All LDCs 41	2.1	16.0	15.0	0.5	1.30	-0.4	

Source: As of the Table 1.

Investment and Imports

Investment and imports are two key factors determining supply capability in developing country like Nepal of low-income ones. This study provides an empirical evidence on this issue for sample of high-and middle-income sectors. Investment in expansion of productive capacity takes on more importance in low-income than in other developing sectors of their lower supply capacity base; the role of imports in investment in new capacity and/or the utilization of existing capacity is likewise more important.

Table 5 also shows ratios of investment to GDP and the growth of real investment and import volumes during the 1990 and 1995. There is evidently a very close association between investment and imports, on the one hand, and output performance, on the other.

Lack of adequate imports seems to have played an important limiting role in investment and output expansion. In the country both the import and the investment volume declined in the 1990. Similar conclusions hold if one considers the experience of the other sectors.

An analysis of individual sector's porformance confirms these general conclusions. For example, as fas as investment is concerned, all sectors have negative growth rates of investment in the 1995 where investment declined. Most of that economic liberalization explains the unfavourable investment performance, there is nevertheless non-evidence that structural adjustment programmes did affect the incentive to invest.

Export Expansion and Supply Capacity

Any export expansion is likely to be short-lived if not accompanied by the expansion of the supply capacity. Table 6 provides some information on export performance and supply capacity, taking the value of exports of manufactures and the share of manufacturing sector in GDP as indicators of the export and production base for such goods. Growth in real MVA and a rise in the ratio of investment to GDP are taken as indicators of an increase in supply capacity. Unfortunately, disaggregated data for investment are not available, and total investment has to be used as a proxy for investment in manufacturing. The table includes only exports of manufactures around or exceeding US $40 million in 1990. This is the period where the country attained relatively high share of manufactures in total exports and in GDP. Growth of exports and output are shown for 1990-1995, since most liberalization policies were initiated or intensified in the 1992.

As is evident, the manufactures export base is still small, as exports exceed US $ 100 million in 1990, despite their relatively fast expansion. Moreover, the expansion did not lead to a noticeable growth of total exports during 1990-95. Indeed, exports were on a declining trend, because of the high dependence on primary commodities.

While some diversification into exports of manufactures has taken place, it has not been accompanied by supply capacity-building in most cases. Real MVA growth was negative or negligible and the volume of investment also declined.

An export and industrial base also requires a wide and modern production structure. In the country such structures cannot be founded on the basis of simple processing and traditional industries. For example, the expansion of manufactured exports, and to a large extent of MVA, has been concentrated on simple processing and on hand-made carpets. Moreover, in the most successful case the value-added involved in export of clothing is very small; imported inputs account for about three-quarters of the value of exports. Exports of garments have been facilitated by foreign direct investment in the garment industry, attracted mainly by the country's high export quota under MFA. Nevertheless, because of the low quality of domestic textiles, there have been no important backward linkages from the garment industry.

Table 6
Indicators Of Supply Capacity For Exports Of Manufactures Of Nepal From 1990-1995

Export Values			Manufacture Value added		Investment			
Manufactures		Total Exports	Share of GDP	Annual Growth[a]	Annual Growth[a]		Share of GDP[b]	
US $ Million	Growth[c]	Growth[c]						
1990	1990-95	1990-95	1991	1990-95	1990-92	1992-95	1990-92	1992-95
140	12	2.0	21.2	1.0	1.6	3.3	19	21

Source: As of the Table 1
a. In Real Terms.
b. Derived from Data in Current Prices
c. Annual Average.

Reasons For Policy Failure

There are three main reasons why economic liberalization failed in the country when it was undertaken under external pressure; they are related to how the reforms were perceived, their context and timing and the particular circumstances of country. In almost all cases influenced by the orthodox approach, trade policy reform has been regarded as synonymous with *uniform* import liberalization applicable universally to all developing sectors and the level of development, industrial base and special structural characteristics of individual sectors were disregarded. Moreover, such an approach to liberalization is based on a general theoretical abstraction, i.e. the theory of static comparative advantage. This theory, in turn, involves unrealistic assumptions such as a perfect functioning of markets in all sectors no externalities and no other causes of market failure, and constant returns to scale.

One premise of this theory is that economic liberalization will lead to an efficient reallocation of resources, and the free play of market forces will take care of industrialization and export expansion in each sector, in accordance with the principle of comparative advantage. Since there is no market failure, and no sector or industry plays a particular role in providing positive externalities, it is maintained that there is no need for government intervention, whether functional or selective. Moreover, according to this theory, all sectors are at the same level of technological development, and technology is readily and freely available to all of them and all their firms. Moreover, firms do not play an active role in pricing, technological development, capacity building and the learning process.

These assumptions are particularly unrealistic for Nepal where the industrial production and export base is usually very small, where existing industrial capacity often reflects the production of scattered, light manufactured goods, made at high cost owing to across-the-board import substitution and low capacity utilization, the latter being due to a shortage of foreign exchange and skilled manpower.

Economic liberalization policy should aim at the long-run development of supply capacity. Such development cannot, however, be left to market forces alone. The Nepalese economy suffers from structural rigidity, low skill capacity, poor infrastructure and a weak learning process. Reallocation of resources from one sector to another requires adequate availability of investment funds and skilled labour, predictability of the market and a willingness to make investment decisions. However, markets are either non-existent, fragmented or imperfect, and consequently have to be created or corrected. Both capital and labour markets fail to channel resources easily from one sector or industry to another; and producers have imperfect foresight; externalities exist in technology, learning and trade infrastructure and support services. Hence, some government intervention is required to build up infant industrial capacity, whether or not for export, and to create markets or correct market failure.

Industrial production in the country is dependent on imports for more than half its inputs. In the country there is a chronic shortage of foreign exchange and skilled manpower, resulting in low capacity utilization, particularly in large-scale industries, which often does not exceed fifty percent. External factors, such as world demand, falling terms of trade, and the burden of debt service, exacerbated by domestic disruption have accentuated the shortage of foreign exchange for industry. The loss of earning in 1990, caused by changes in the terms of trade since 1980, has been estimated to range from 2 to 13 percent of 1990 GDP (UNCTAD 1993).

The traditional approach to economic liberalization appears to have neglected the important role of investment and imports in expanding capacity, as well as the external obstacles to industial expansion. Indeed, structural adjustment programmes have tended to depress investment.

When the industrial base is small and the supply structure is rigid, liberalization puts competitive pressure on the manufacturing sector, while contractionary macroeconomic management reduces demand for domestically produced goods. The combination of reduced effective demand and import shortages leads to lower capacity utilization and a decline in productivity. Neglect of the need for enhancing productivity and overemphasis on devaluation has been an important weekness of trade and economic liberalization schemes. In most cases nominal devaluation fuelled inflation because of supply rigidities and shortages of imports. It has been estimated that for every 10 percent nominal devaluation during the period 1980-1995 with per capita income of less than $200 there was only about a 3 percent decline in the real effective exchange rate (Shafaeddin 1993). Moreover, real depreciation was often partially or entirely offset by the decline in labour productivity.

While *uniformity* of economic liberalization worked against exports of manufactures, its *universality* adversely affected export earnings from primary commodities. Manufactured exports were handicapped in a number of ways. First, existing and potential export industries were deprived of scarce imported inputs, while imports of other goods, including luxury consumer items, for which quantitative restrictions were removed, rose. Secondly, failure, for the same reason, to ensure that industries with large externalities could secure requisite foreign exchange prevented capacity building and fuller capacity utilization in productive industries. Thirdly, the impact of devaluation on production costs in manufacturing, particularly for export, was greater than for other sectors and industries because of its higher import intensity (amounting to about two-thirds of export sales). Fourthly, devaluation resulted in uniform price changes over the whole range of tradable goods rather than for selected products. Supply response to prices is much lower when all the outputs of a sector are equally affected; it is stronger when relative prices increase only for one good, or for a few goods. Even in industrialized countries there is some evidence that reallocation of resources from non-tradable to tradable sectors, and within tradables from importables to exportables (and in the latter from traditional to new products), might be more responsive to targeted incentives such as subsidies than to exchange rate adjustment. Finally, devaluation, as well as import liberalization, tended to turn the domestic terms of trade in favour of agriculture and against manufacturing, because in the country it removed the previous bias in favour of the latter and also because of differences in the nature of price determination in the two sectors. While this may have a welcome positive effect on food production, it would seem that cash crops benefit more than foods to the context of applying structural adjustment programmes.

Simultaneous currency devaluation by the countries producing the same commodity, as before resulted in terms-of-trade losses due to the *fallacy of composition*, as exemplified by the case of jute and other commodities which constitute the major exports of the country.

It must also be borne in mind that the country has liberalized her import regimes in the context of intensified protectionism, particularly as regards products of export interest to the country. These protectionist pressures, together with the influence of transnational corporations in international trade, undermined the stability and predictability of the trading environment essential for supply capacity development in the country.

CONCLUSION

The country has been increasingly marginalized in international trade, owing mainly to her high dependence on production and exports of primary commodities. Economic liberalization has been recommended with the aim of expanding GDP and exports and diversifying the producing and export structure into manufactures. On the whole, however, there is no clear and systematic association between trade liberalization and devaluation, on the one hand, and the growth and diversification of output and exports, on the other. In fact, the performance of economic liberalization has been worse than that of other countries.

Manufacturing has not been the dynamic force behind GDP growth and the country's expanding capacity in manufacturing even where successfully achieved, has not contributed to rapid export expansion. Success or failure in this respect has been attributable to, inter alia, the volume of investment and the availability of imports.

In the country exports of manufactures did not increase; indeed, it witnessed deindustrialization. Where there was some export expansion, it was not accompanied by a building up of supply capacity. In most cases the expansion was based on simple processing and other traditional manufacturing activities.

Certainly a variety of socio-economic, structural and external factors goes some way to explaining why liberalization did not work. Nevertheless, the design of policy reforms, and of structural adjustment programmes in general, has also been an important factor. Insufficient attention was paid to structural conditions including the low level of development, low or non-existent industrial base, and an unfavorable external environment in the early 1990s. The orthodox recommendations on economic liberalization neglected the importance of long-run development of supply capacity and the limitation of market forces in building up such capacity. Further they overemphasized the role of currency devaluation, overlooking the adverse effects on productivity, and the important role of imports in improving capacity utilization and increasing exports.

An Alternative Approach

If a further marginalization of the country is to be avoided, an alternate approach to economic policy reform is required. It must take into account the experience of the past, as well as country's particular situation. Some general elements of this approach are outlined in the paragraphs which follow:

Economic liberalization policy should be development-oriented aimed on a selective basis at building up supply capacity, both at the national level and at the level of the firm; it should be an integral part of industrial and development strategy. As a tool of development, economic policy is not necessarily synonymous with economic liberalization, and success in *liberalization per se* in not a guarantee of *success* in development. Economic policy should serve to achieve the long-run objectives of development. it may comprise the liberalization of trade in some goods, and it may at the same time strengthen, or loosen, the degree of protectionism accorded to others; it may include tariffs and/or quantitative restrictions for particular goods, or any other measures suitable for achieving the objectives of industrial and development strategies.

Economic liberalization policy may vary from one sector to another depending on its particular needs, objectives and socio-economic characteristics. For sectors with little or no industrial capacity, such as in the agriculture, the main requirement is to develop supply capacity and lay the foundation for an expanding export sector. For sectors which have already undertaken some degree of import substitution capacity the main issue is to make these industries competitive at home and abroad and to expand exports. Those with some export capability should aim at product upgrading and development so as to exploit new opportunities in the domestic and international market. Economic policy has also to be dynamic, taking into account changes in the domestic and external situation.

Building up supply capacity and improving productivity requires selective government intervention in situations where no market yet exists, or the market is segmented or fails owing to the prevalence of dynamic externalities. Some initial protection of infant industry, whether aimed at the domestic or the external market, is thus warranted, but it should be gradually phased out. Moreover, trade policy can be mixed. Both import substitution and export development may constitute elements of a trade policy, both at any period in different industries and in a particular industry over time.

Since resources are scare, and all industries do not posses the same linkages and externalities, there is a need for establishing clear criteria in selecting those industries destined for development, upgrading and export expansion, particularly where, the initial infrastructure is very small.

Supply capacity building requires the development of a physical, institutional and organizational capability, which calls for investment in physical assets (including infrastructure), human resources development, technological learning and/or innovation. It also calls, *inter alia*, for better information, and the creation of marketing channels. More importantly, in order to reduce the possible risk of *government failure*, the machinery of government also needs to be improved, so as to make for more effective decision-making and analysis, and to ensure the appropriate design, implementation and correction of policies over time. Another important requirement is the availability of consumer goods, through higher domestic food output where possible, and other wage-goods in order to satisfy the demand of urban industrial workers and prevent inflation induced by shortages of such products.

Nepal with a high ratio of imports to GDP, where manufactures are a small fraction of total exports and the manufacturing sector is highly import-intensive, incentives for exports of manufactures can be provided by selective measures aimed at improving their competitiveness, rather than through currency depreciation. Such measures could include, for example, subsidies and other fiscal and financial measures for particular manufacturing activities. Devaluation may serve other purposes, but it is not necessarily the most desirable measures for promoting manufactured exports, since it provides a uniform incentive for all tradable goods. Moreover, it disrupts the economy through its inflationary impact, particularly on production costs, through imported inputs. Such selective measures, however, should be tied to performance of the firms involved in order to ensure that they achieve the desired objectives.

Finally, the success of alternative economic reforms requires external support in terms of finance, technical assistance and, most important, market access.

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