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Government Budget Deficits and Inflationary Pressure in Nepal

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Abstract

Over a long period of time, Nepal has been making a continuous practice of budget deficit and the size of which has been from 1.34 percent of GDP in 1974/1975 to 6.14 percent in 2000/2001. However, the effect of budget deficits on economic growth, inflation as well as other related macroeconomic variables has not been well understood in the context of Nepal. In this reference, an attempt has been made in this paper to examine the effect of budget deficits on inflation using time series data of fiscal year 1976/1977 to 2000/2001. Empirical study based on these data reveals that budget deficits do have significant direct and indirect effect on price level in Nepal.

Introduction

The main purpose of this paper is to examine the effect of budget deficits on inflation in Nepal using time series data of fiscal year 1976/1977 to 2000/2001, since getting inflation under control... through reduced government expenditure is one of the goals of macroeconomic stablization. (Todaro, 1990). "Among the possible determinants of inflation, budget deficits maybe one whose importance might have grown since the oil price hike of 1973/1974 and 1979. For many developing countries, these increase in oil prices have been responsible for massive current account deficits as well as rapidly increasing budget deficits of the last decade or so (Shabbir and Amehad 1994: P. 955).

In Nepal, rate of inflation of consumer goods has reached to 9.25 percent in 2003 at 1965 price and 6.59 percent at 995/1996 price. By the same token, both current account deficits and budget deficits have shown increasing trend. In the early 1990s, the amount of current account deficits was Rs. 9.65 billion, which reached to Rs. 10.95 billion in 2001/2002. Similarly, the amount of budget deficits reached from Rs. 10.65 billion to Rs. 24.66 billion during the same period (HMG/N, 2002/2003). There is need to examine the effect of budget deficits and current account deficits on inflation rate with reference to different macroeconomic variables in the context of Nepal. However, this paper has been confined only to examine the effect of budget deficits on inflation. The impact of budget deficits on

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economic growth inflation, as well as other macroeconomic variables can only be understood by the reliable empirical studies, which, are lacking in Nepal.

Budget Deficits and Different Schools of Thought

The excess of government expenditures over government receipts in any one fiscal year is known as budget deficits. However, the definition of deficits changes from country to country and even in the same country overtime. One country may include aid receipts as revenue whereas another treats them as deficit finance (Fisher and Easterly, 1990). In Nepal, budget deficits refer to total estimated expenditure minus total estimated revenue to existing sources and new proposals plus foreign aids (HMG/N, 1997/1998).

The first annual budget of Nepal was prepared in 1951 with a deficit of Rs. 22 million (Bhattarai, 2003). Since then to date, Nepal has been continuously practicing budget deficits. Nonetheless, the effect of budget deficits on economic growth as well as on the other macroeconomic variables has not been well understood.

In general, budget deficit has been considered as an important and useful fiscal weapon in the underdeveloped economies such as Nepal in order to create more employment opportunities and mobilize physical as well as human resources through higher level of government spending. However, larger deficits do not always produce desired effect in the economy.

Dalmagas (1987) using an aggregated econometric model on a large international annual cross-countries data set from nine OECD countries has came to the conclusion that the economics consisting of both commodity and financial (flow and fund) sectors with sustained increase in government spending, financed either strictly by borrowing or by tax receipts and borrowings, has an expansionary impact on income known as "crowding out effect" and exerts inflation. Easterly and Fisher (1990) have come to the conclusion that budget deficit do sooner or later tend to create inflation and countries with very high budget deficits are likely to confront with extremely high rate of inflation.

Thus, based on these empirical studies, it can be concluded that larger budget deficit create undesirable effect on economic growth and development. Eonomists have perceived them from different schools of thought, which are briefly discussed here classifying them into (i) classical and neoclassical school of thought (ii) Keynesian school of thought and (iii) thought of political economy (Zaidi, 1995).

Classical and Neoclassical School of Thought

The Classical School of Thought was against budget deficits and in favour of small balanced budget. According to J.B. Say, "The very best of all plans of finances is to spend little and the best of all taxes is that which is least in amount." They assumed full employment in the economy and if the budget would be deficits, government had to borrow from the market which could lead to inflation on the one hand, while on the other, it would reduce

private productive investment and thereby hindrance would be emerged in economic growth. In this way, classical school of thought was in favour of small balanced budget. Subsequently, neoclassical school of thought regarding budget deficits came to prevail which was very close to classical thought. "For the orthodox, neoclassical view... a higher and/or growing budget deficits is the mother of all evils, and is the primary cause of all major ills of the economy and must subsequently be eliminated since budget deficit is held responsible for causing high inflation, low growth, the current account deficit and the crowding out of private investment and consumption (Zaidi, 1995: P.115).

Keynesian School of Thought

Since the Classical Thought did not function in the great depression of 1930s, the Keynesian School of Thought came into prominence after the publication of Keynes' "General Theory of Employment, Interest and Money in 1936. Since then, the concept of balanced budget philosophy was severely criticized justifying progressive tax, increasing public spending and deficit finance to overcome depression caused by deficiency of effective demand. According to Keynes, "True inflation starts only after the full employment." As long as unused human and material resources exist in the economy, an increase in deficit finance caused to increase output and employment and inflation was supposed to be a distanced problem.

Following this perception, governments of underdeveloped countries translated Keynesian solution of depression deficit into development deficits (Mithani, 1980). Since then, until now most of the developed and developing countries have been exercising budget deficits. However, the view ofthis School of Thought as stated by Zaidi (1995: P. 115) has appeared as minority view usually not heard in clamour of the orthodox view, which argues that budget deficits can ever be good for the economy and at times need to be increased further rather than elimination.

Institutionalist Thought

The third school of thought regarding budget deficit has been developed recently in the arena of public choice and is referred to as political economy or institutionalist thought. According to this School of Thought "The budget deficit is perceived not just an abstract number or quantity, but rather a relationship among numerous factors which are economic, political as well as institutional (Zaidi, 1995: P. 114). Roubni and Sachs (1989) concluded that larger budget deficit was found in those countries where there were multiparty coalitions and government of short tenures rather than majority governments. "All of the partner of the coalition may prefer comprehensive budget cuts to a continuation of larger deficits but each coalition partner may have the incentive to protect its particular part of the budget against austerity measures" (Quoted by Zaidi, 1995: P. 117). Thus, according to this School of Thought, the size of the government budget deficits largely depends upon the composition of government.

Model Specification in Nepal

The following two equations liner and log liner models respectively of inflation and money supply have been considered to examine the effect of deficits on inflation in Nepal.

$P= a_0 + a_1 BD + a_2 MS + a_3Cr + a_4 Forex$...............(1)

$lnMS=b_0 + b_1lBd+ b_2lnCr + b_3lnForex$................(2)

Where P=GDP deflator

BD= Budget deficits

MS= Money supply (M_2)

Cr= Domestic credit

Forex=Foreign Exchange reserve

The first model is specified to understand the direct effect of budget deficits on inflation whereas the second model is specified in order to capture the effect of budget deficits on inflation through increasing money supply i.e. indirect effect. Time series data are collected from different issues of economic survey from 1976/1977 to 2000/2001 from which GDP price deflator is calculated taking the base of 1974/1975 price. Similarly, total foreign exchange reserves are found by adding foreign exchange reserves of Nepal Rastra Bank and commercial banks.

Empirical results

Having obtained the data and specified the model, multiple regressions are run which provides the following results:

P= 1.046+ 0.00035BD-0.0004MS+0.00017Cr+ 0.00013Forex

(2.60)* (3.634)* (-1.988)*** (1.306) (4.072)*

F= 269.106* R^2=0.982 R^2=0.978 DW=2.184

(*=Significant at 1 percent level

***= Significant at 10 percent level

DW= Durbin Watson Statistics)

Estimated equation shows that the coefficient of budget deficit is positive and significant at one percent level. The implication of positive coefficient of budget deficit(BD) is that one percent increase in budget deficits leads to 0.00035 percent increase in price level. The coefficient of money supply (MS) is found negative and insignificant at one percent level. However, it is significant at 10 percent level. The coefficient of domestic credit is found positive but insignificant. Similarly, the coefficient of foreign exchange reserves (Forex) is found positive and significant at one percent level. 't' statistics of the model is presented in the parenthesis where 'F' statistics is significant at one percent level and the specified

model explains more than 98 percent variation in the dependent variable. DW statistics 2.18 indicates that the model is free from autocorrelation.

The next log liner model is designed in order to capture the indirect effect of budget deficit on inflation via increase in money supply. The following is the result of regression:

$$\ln MS = -0.477 + 0.458 \ln BD + 0.565 \ln Cr + 0.466 \ln Forex$$

$$(-2.286)^{*} \quad (2.850)^{*} \quad (1.373) \quad (3.740)^{*}$$

$$F = 162.519^{*} \quad R^2 = 0.959 \quad R^2 = 0.953 \quad DW = 1.58$$

In second model also, the coefficient of (lnBD) is found positive and significant at one percent level which implies that budget deficits also effects indirectly to price level via increase in money supply. The coefficient of (lnCr) is found positive but insignificant and the coefficient of (lnForex) is found positive and significant at one percent level. 't' statistics of the model is presented in parenthesis and 'F' statistics significant at one percent level. The model explains nearly 96 percent variation on dependent variable. DW test indicates that there is absence of autocorrelation in this model as well.

Conclusions

Budget deficits have been considered as an important fiscal weapon to an underdeveloped economy that of like Nepal in order to create more employment opportunities and mobilization of physical as well as human resources through higher level of government spending. Accordingly, Nepal has been doing so by making a practice of budget deficit over a long period of time and the size of which has been 6.14 percent of GDP in 2000/2001. However, how it has contributed on economic growth, inflation and other macroeconomic variables has not been well understood in the context of Nepal. Empirical studies conducted in both developed and developing countries in the past indicate that larger budget deficits pose real threats to macroeconomic stability, economic growth and development. Larger deficits tend to have exerted inflationary pressure in the economy in the long run. In this reference, the present study is a small effort to examine the effect of budget deficit on inflation using time series data of fiscal year 1976/1977 to 2000/2001. Based on these data, the present study has found that budget deficits do have significant direct and indirect effect on price level. In fact, one percent increase in budget deficits is shown to lead 0.00035 percent increase in price level, also exerts pressure indirectly on price level through increase in money supply.

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Book Review

Schuurman J. Frans (2003) *GLOBALIZATION AND DEVELOPMENT STUDIES: CHALLENGES FOR THE 21ST CENTURY* (edtd) Vistar Publications, New Delhi, Reprinted, PP.212 including, Notes on Contributors and Index.

Globalization, or the increasing economic integration among nations, has accelerated sharply over the past half century, driven largely by the remarkable expansion of international trade and capital flows, as well as by the extraordinary advances in information and communication technologies. As this process has grown intensity, it has brought great benefits in terms of worldwide economic and social development, as evidenced by unprecedented growth in global output and real per capita income and, more generally, by major improvements in human welfare. However, these benefits have not been evenly distributed, and income disparities between rich and poor countries, as well as within many countries, have increased. The persistence of abject poverty and their problems, including those posed by the volatility of international capital flows, have been a matter of serious concern. But this does not imply that the growing openness of the world economy is the cause of income inequality and financial instability. Although it is not an entirely benign phenomenon, globalization is a powerful engine of world prosperity. The basic issue is what policies and reforms are most likely to bring about sustainable economic growth for the benefits of all the people of the world.

Development studies, as a typical post-World War II branch of the social sciences, have experienced its share of criticism of its central paradigms. To put it another way it has received more than its share because of its normative and interdisciplinary character. Some of these paradigms seemed to have been lost for good and, from the mid 1980s onwards, the contours of what became known as an impasse in development studies became clearly visible. When in the following decade, the concept of the globalization swept through academia and policy-making institutions it became clear that development studies would probably not make it as such into the next century. Its proposed replacement, global studies, already presented an enticing prospective. Nevertheless, development studies did cross the millennium threshold, through admittedly, not with a gracious jump. The challenge for development studies is to re-establish its continued relevance to study and understand processes of exclusion, emancipation, and development. It can not be achieved by clinging to its once treasured paradigms, but can be achieved by incorporating creatively the new Zeitgeist, without giving up its normative basis.

The book under review is a collection of contributions and gives in depth comprehensive introduction to the concept of globalization and its challenge to the contemporary study of development. This book comprises ten chapters divided into two parts. Contents include: Part I entitled "The Challenges and Their Limits" comprises four chapters. Part II entitled "Globalization and Central Issues in Development Studies" contains six chapters. Part I introduces the theoretical issues and debates surrounding globalization, illustrates the often

contested nature of the concept, and considers the implications for the future of development studies. Part II reviews more specific theory and policy and implications by assessing the impact of globalization on a number of key areas of study in development studies. These include the environment, general, human rights, multinationals, and urban development.

In the first part, contribution entitled " Globalization after Modernization: a New Paradigm for Development Studies" by Martin Albrow emphasizes that globality is not the latest form of modernity. Globality is non-technological and, infact, consists of multiple globalizations without the totalizing character of the modern project, which neglected everything that resisted the advance of modernity. He ties development studies to a particular historical period (the Cold War with its development aid programmes) and, as such, sees it as the product of an old and dated modernity, which has collapsed in the Global Age. Arie de Ruijter in his contribution on "Globalization: a Challenge to the Social Sciences" concentrates on the cultural content of hybridization, which in his view has provided social science with a more constructivist perspectives, leading to a more fruitful balance between structure and process, between actor and system. He warns against the risk of a too great emphasis on diversity, and an absence of mutually attuned interests and representations. Social scientists have a responsibility to take standpoints and to articulate possible solutions to alleviate the extreme unequal access to scarce resources in a global world. John Tomlinson in his contribution titled "Vicious and Benign Universalism" separates vicious universalism (as the ugly face of free-market capitalism and neo-liberalism) from, what he calls, benign universalism, which is the project of universal emancipation in a cosmopolitan civilization. He condemns the 'new wars' (Bosnia, Rwanda, Kosovo) emerging from the political clefts between the politics of particularistic identity and the politics of cosmopolitan or humanist values. Frans J. Schuurman in his contribution entitled "The Nation-State, Emancipatory Spaces and Development Studies in the Global Era" observes that the nation-state is still important as a political arena for human emancipation, in the North and certainly in the South, although it has lost its historic primacy. Emancipatory struggles in the North, during the period of modernity, as well as in the south, in the period of gaining national independence after, always had the nation-state as the political arena.

In the second part, in his chapter on "Globalization and Human Rights: Some Development Reflections" Reinhart Kossler takes up two issues which figured in Part I, notably universalism versus relativism, and the declining role of nation-states. He emphasizes that human rights are not an intrinsic cultural trait of western culture but are historical products of fierce struggles, which are upheld by people's vigilance and active efforts. Kristoffel Lieten in his contribution titled "Multinationals and Development: Revisiting the Debate" seeks to re-establish the importance of the debates on the developmental impact of multinational corporations. He attributes the weaning power of western capitalism to the effects of lopsided development, the reinforcing momentum of asymmetry and the downsizing of the role of the state. M.A.Mohamed Salih in his chapter on "Globalization, Sustainable Development, and Environment: a Balancing Act" argues that the social sciences are confronting the formidable challenge of unpacking concepts deeply entrenched in the confines of disciplinary research, yet are beginning for an interdisciplinary understanding of issues that traverse, encompass and expand several social science disciplines. The next two chapters by Marianne

Marchand and Anne Sisson Runyan entitled "Feminist Sightings of Global Restructuring: Conceptualizations and Reconceptualizations" show that globalization is simultaneously reinforcing gender roles in certain arenas and opening up new spaces for resistance. Tine Davids and Francien Van Driel in their contributions titled "Globalization and Gender: Beyond Dichotomies" purpose a different approach to globalization and, as such, draw attention to the usefulness of a multi-dimensional gender model as an analytical and methodological tool of deconstruction. In examining the interconnectedness of the global and the local, they expose a dichotomous way of thinking and the production of stereotypes and cliches in related scientific research. In their conclusion, they explicitly aim at stimulating the wider applicability of the multi-dimensional gender model as a pattern of thought and inspiration in the globalization debate. The contribution entitled "Cities and the Globalization of Urban Development Policy" by Ton Van Naerssen points to salient differences between the mega-cities of the North and the South. Reviewing two urban development programmes, Naerssen draws the conclusion that existing and future problems can only be solved by a combination of action from above and from below (e.g. Community Based Organizations), depending on the socio-political situation in particular cities.

No doubt, the book provides a comprehensive introduction to the concept of globalization and its challenge to the contemporary study of development. A key underlying theme is whether a seeming transition from development studies to global studies is offering anything new and fruitful for our future understanding and study of development. It is an essential reading for all students and academics of development and globalization across development studies, politics and international relations, geography, and sociology.

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