

NPA Present a Major Risk to the Banking System as well as to the Budget

Interview with Sukhwinder Singh
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Q1. How do you see the overall economic health of the country at present?

The economy is going through difficult times and has been since 2001/02 when real GDP contracted. This year we don't expect real GDP growth to exceed 2.5 percent implying negligible per capita income growth. Agriculture has suffered after a poor first paddy crop. In other sectors, the performance is mixed. Some industries like steel, ghee, textiles, and chemicals seem to be doing well vis a vis the Indian market; but other sectors – such tourism, hotels, and construction - are struggling. For instance, tourist arrivals in the first four months of this year are down by 30 percent over the already low level of last year. And construction - both private and public – has slowed as government's development spending has been constrained by the security situation and costs of raw materials have increased.

The trade picture is also rather grim – exports through 10 months are only up 5 percent but more revealing is the fact that imports are down 4 percent from last year. Trade with non-Indian markets has suffered in particular, hit by the sharp decline in the apparel sector following the end of the Multi-Fiber Arrangement at the end of 2004. There appear to be few obvious investment opportunities out there for the banks, hence their focus on consumer loans.

However, successive governments have managed to maintain macroeconomic stability. While inflation has picked up somewhat due to fuel prices and higher tax rates, it remains largely under control as long as prudent macroeconomic policies are followed and there is price stability in India. The budget deficit is not excessive at the moment, although we are concerned with the increase in public debt in recent years. Remittances have fortunately provided a safety valve for the economy, supporting consumption and domestic activity. This has also allowed international reserves to remain at comfortable levels.

Q2. What has been the impact of the on-going conflict on the country's economy?

The conflict has had a serious impact on the economy. I believe that in the absence of the conflict, the economic reforms of recent years could have raised real GDP growth rates to over 5 percent. As you may know, in some years in the early 1990s and before the conflict intensified, growth rates of 6-7 percent had been achieved. In terms of specific costs, the conflict has: reduced public and private investment, including foreign direct investment; damaged infrastructure; diverted scarce fiscal resources to security and reduced revenues;

disrupted production, trade and transport including through bandhs; damaged tourism; contributed to capital flight; and led to both internal displacement and external migration which has affected agricultural production.

Q3. Is Nepal in a situation to bear soaring security expenditure at a time when the revenue collection is said to be dwindling? What is your advice for this budget?

Security spending - total spending for the RNA, armed and Nepal police – averaged about 1 3/4 percent of GDP over the second half of the 1990s. But over the first five years of this decade, as the conflict has intensified, it has averaged just over 3 percent of GDP. While in a comparative context this security spending may not be excessive compared with some other countries in South Asia and below that in other conflict situations, these comparisons should be interpreted with caution as the Nepalese figures exclude assistance provided by some governments outside the budget on which data is limited. We understand that every country has a right to defend its sovereignty. Nevertheless, there are concerns over the pace at which security spending has been rising, in view of low levels of capital formation and the implications for future growth. An appropriate balance between security and development spending needs to be found. And vigorous efforts should be made to minimize waste that can occur in any country when security budgets are increased rapidly under a security threat.

As for whether Nepal can bear this, there are several ways to approach this. One general question, which is beyond my expertise, is to ask whether increases in spending will have an impact on achieving peace or look at the consequences of not increasing security spending. Its financial sustainability depends very much on future growth in Nepal, which in turn is dependent on the conflict and economic reforms, and on resources available for crucial public investments in infrastructure, education and health. Fortunately, so far we have seen higher social spending in parallel with increases in the security budget. But we also need to recognize that higher security spending imposes future recurrent liabilities, such as salaries and pensions, which may not be appropriate in peace time. And in recent years, higher security spending has contributed to growing domestic borrowing and public debt. We would like to see domestic borrowing reduced for fiscal sustainability, so that interest rates don't rise, investment prospects are not hurt and more productive spending is not crowded out. And whether Nepal can afford to increase security spending without jeopardizing macroeconomic stability will depend on the revenue effort and external financial support. I suspect, however, that key donors will be reluctant to provide financial assistance if it is seen to support security spending at the cost of development outlays.

In our view, the 2005/06 budget should be consistent with the medium-term fiscal objectives of the PRSP/the 10th Plan. It should remain focused on raising revenues, prioritizing spending in line with Nepal's Medium Term Expenditure Framework, striking an appropriate balance between development and security needs, and limiting domestic borrowing to sustainable levels. We believe it should provide for a significant increase in the allocation for capital and social/poverty spending, include efforts to improve incentives at Customs and the Inland Revenue Department, reduce leakages in the excise regime and reduce export taxes. Special incentives or exemptions that introduce distortions and an uneven playing field for the

private sector in order to influence growth in specific sectors, should be avoided. And, the budget should clearly signal a major reinvigoration of the economic reform effort that has been stalled for the past year.

Q4. What is the pace of economic reforms in the country? How optimistic are you that the forthcoming budget would be able to accelerate the pace of reforms?

By enhancing economic opportunities and improving public services, we believe economic reforms are a crucial investment in peace and security. Since the middle of 2004, unfortunately, the pace of reforms has slowed down markedly. For example, the economic reform packages of each of the World Bank, Asian Development Bank and the IMF, which support the implementation of HMGN's own PRSP/10th Plan, are currently on hold, pending the implementation of actions committed to by Nepal's government. The Royal Proclamation and senior officials of HMGN in subsequent discussions have expressed strong commitment to accelerating reforms and poverty reduction. Important issues such as fuel pricing, labor market reform, public sector reform, action against defaulters, issuance of key economic laws, the governance act, as well as important sectoral reforms in agriculture, roads, water, electricity, telecoms and the social sectors need to be addressed.

Accelerating development will require reinvigorating the reform process which has slowed down over the past year, and this requires close monitoring and follow-through at the highest levels of government. It is important to act quickly to prevent the economy from slowing further, and risking macroeconomic instability. I am sure that the government understands the importance of the reform and development agenda for securing peace and poverty reduction in Nepal and hope this translates into action through the budget.

Q5. Are you satisfied with what the government is doing to recover 'bad debt' from the 'willful bank defaulters' especially after Feb. 1 this year?

The issue of "bad debt" is a huge problem – the non performing assets (US\$450 million or so) are the same size as the entire development budget and clearly present a major risk to the banking system and to the budget. This is a major fiscal, development, and governance challenge for the nation. Why should government and the general public of this country pay the price for the excesses and corruption of a minority?

I was pleased with the report on dealing with willful defaulters that was approved by cabinet in mid May of this year. But it is important that these commitments are translated into action and a significant proportion of the misappropriated resources recovered. Up to now, despite some notable improvements in the debt recovery framework, the actual recoveries from the largest defaulters have been insignificant despite tremendous efforts from bank management. These big willful defaulters remain defiant and are lobbying hard using the economic situation as an excuse. However, many of them have resources and were refusing to pay even before the economic downturn. And some of these borrowers appear able to continue their operations despite being blacklisted. His Majesty's emphasis on banking discipline and anti corruption in his Proclamation should translate into vigorous action against those that have

abused the hard earned savings of depositors, through implementing the measures approved by cabinet. We are awaiting such action against those that fail to cooperate with the banks, including government's plan to seize passports and property if necessary, and strict enforcement of prudential rules.

Looking ahead, we also need to look beyond the non performing asset recovery effort, towards privatization of public banks to "fit and proper" owners, as is the government's stated policy.