

Accelerate Reforms or Be Left Behind

Interview with Sukhwinder Singh

IMF Resident Representative in Nepal

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Sukhwinder Singh has been the International Monetary Fund's (IMF) resident representative to Nepal since October 2002. A British citizen, Singh served in the Policy Department of the IMF, working on developing country issues, such as the PRSP, PRGF and HIPC Initiative, and on African economies. Prior to this he was with the Bank of England, served in South America as advisor to the Central Bank of Guyana, and worked at the Canadian International Development Agency. **Prem Khanal** of *The Kathmandu Post* recently talked to Singh about the IMF's development partnerships with Nepal. Excerpts.

TKP: How do you define the current macroeconomic situation of Nepal?

Singh: The macroeconomic fundamentals are sound but the economy is under considerable stress. Inflation remains low and the foreign exchange holdings of the Nepal Rastra Bank are comfortable. But with little progress towards peace, we project real GDP to grow by only 3½ percent this fiscal year, at the most. While some manufacturing sectors – especially those relating to urbanization and construction appear to be doing well – others, such as textiles and apparel, are in deep decline. Productivity remains low.

Though the fiscal deficit appears manageable, rising recurrent spending and government liabilities from public enterprise and financial sector reforms threaten to increase the budget gap. This could also pose risks for the public debt stock. Efficient sources of revenue, such as the value added tax (VAT) are required to ensure fiscal sustainability. Little public and private investment is taking place, with the growth of credit mainly in consumer and trade finance.

Clearly the blockades, extortion, and security impact of the insurgency are imposing significant costs on the economy. Economic activity and the external balance continues to be sustained by remittance inflows and, increasingly, by growth in the Indian economy. This picture of low growth and vulnerability make it even more important to undertake far-ranging structural reforms to improve the investment climate and diversify activity, so that a serious reduction in poverty can be achieved.

TKP: How far has the government been successful in implementing the understandings reached during the PRGF agreement and are there areas of progress?

Singh: When the PRGF program was approved in November 2003, there were skeptics on the IMF's Board. But I'm pleased to say that many of the understandings have been implemented, although there have been delays in some areas. Political instability that led to the resignation of the Thapa government delayed the first review, but the current

administration followed through and this review was completed in October 2004. In some areas this government has been extremely courageous and taken long awaited crucial actions that previous government's shirked. The decision to increase petroleum prices last week and move to an automatic pricing mechanism is one such example.

This government has recognized that no company can sell for less than it pays indefinitely, that the subsidy barely benefited the real poor, and leaked across the border. By approving an automatic petroleum pricing mechanism it has decided to depoliticize such pricing decisions which would be an important bequest to future administrations. And there has been considerable progress made in strengthening the legal framework for the financial sector and performance of the public banks. The government's continued efforts to maintain macroeconomic stability, to reform customs, and improve public expenditure management also deserve praise.

TKP: But according to reports, the IMF is not happy with some aspects of the government's performance. What are the major concerns?

Singh: Progress has indeed been mixed. A number of reforms have slowed in recent months. In the financial sector, many promises on action against willful defaulters have not yet been matched by action. Some reforms to modernize the central bank and address inefficiencies at the development banks are still pending. Little has happened with liquidating or privatizing loss-making public entities. Some tax administration reforms, such as introduction of better excise revenue controls, have stalled. Civil service reforms continue to be slow. We still await revisions to make labor legislation more flexible, which we believe will help increase employment and training opportunities. Acceleration of reforms in these areas can restore the government's credibility and help ensure Nepal is not left behind in the global economy.

TKP: What are the major challenges in the financial system of Nepal and why are the donors putting pressure on willful defaulters to clear their liabilities?

Singh: There is a lot of work ahead if Nepal is to create a healthy, efficient financial sector capable of supporting economic development. I would say there are four immediate challenges. First, to deal with the non-performing loans in the banking system and privatize public commercial banks. Second, to improve the regulatory framework of the financial system to safeguard depositors' money. Third, to strengthen the central bank, the apex institution in the financial system. And last, but not least, to improve the provision of banking services for the rural poor.

The issue of the willful defaulters is very important for the government and Nepal's citizens. The amounts owed were often secured through a corrupt nexus between these borrowers, politicians and officials of the public banks. Put simply, an enormous amount of resources - that could have been invested to boost growth and reduce poverty - were essentially stolen from the depositors of these institutions by a small affluent minority. Unless this money is paid back, the government will have to use its scarce resources to fill this hole. Why should the taxpayers of Nepal pay for these excesses and why should the government use scarce

resources that would be better used in developing Nepal? Progress in this area will show the government is serious about governance and merits the support of the international community. It will send a clear signal that banking and business culture in Nepal is changing and there must be accountability for ones actions.

TKP: What do you think about the whole controversy over the appointment of the NRB Governor?

Singh: The issue seems to have become overly politicized. The appointment procedures enshrined in the central bank act are very sound, and aim to depoliticise selection including through a separation of nomination from appointment. At times it seems we might have lost sight of the main objectives of the process. That is to select a highly qualified and professional individual with strong integrity, capable of deepening and accelerating financial sector reforms and dealing with political and other pressures from vested interests. I still hope those entrusted with building this institution will look for such an outcome which would be in the interests of Nepal's economy and send a clear signal to the international community that the government is serious about financial sector reforms.

TKP: The IMF has been constantly raising concerns over the slow privatization process. Why do you think privatization should be accelerated and what are the obstacles to do so?

Singh: A wealth of cross country evidence now exists that suggests privatization is associated with improvements in the efficiency, financial health, output and investment of enterprises. In Nepal, we have encouraged privatization as the state owned enterprises have become a large drain on the budget, with most accumulating additional liabilities. They are inefficient, governance and accountability are weak, competition is impeded, and they use scarce financial resources. Ours is not a blanket approach however, and the modalities of enhancing the private sector's role may vary from country to country. The social impact of public enterprise reforms certainly needs to be carefully taken into account in the privatization strategy.

I think progress in this area has been slow for four reasons. First, political will has been lacking, for instance seen by the absence of a clear privatization policy and lack of transparency of the privatization program. Second, institutional arrangements and procedures are weak, with inadequate resources or incentives provided to the privatization effort. Third, laws and regulations, such as the land act or the absence of a labor policy relating to privatization, complicate the process. And finally, government personnel lack the expertise and mix of skills required to carry out these complex transactions. We should not confuse poor management of the privatization process in Nepal with the economic sense of the policy itself.

TKP: How can soaring recurrent expenditures destabilize the fiscal system and what are the corrective measures you have suggested to the government?

Singh: Along with higher productivity, raising investment rates – both public and private – are crucial for higher growth and tackling poverty in Nepal. So recurrent spending needs to be kept under control, otherwise it will either crowd out capital spending or lead to levels of borrowing that could result in debt problems. Some recurrent spending - such as on wages, debt service, and on operating and maintaining the capital stock - is of course necessary. And every country has a right to spend on security to defend its sovereignty. It's a question of balance and priority - of how to use resources for future growth without jeopardizing financial stability. We have advised that recurrent spending be kept under control, social spending be protected, and emphasis placed on accelerating development spending. Revenue effort also needs to be improved through the use of more efficient revenue sources such as the VAT and better administration. And given the country's existing levels of public debt, domestic borrowing should be contained to levels that can be serviced without difficulties.