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469A Bukit Timah Road
#07-01 Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isasijie@nus.edu.sg
Website: www.isas.nus.edu.sg

Nepal: Political Uncertainties and Economic Challenges

Malminderjit Singh[1]

Nepal, the last surviving South Asian monarchy, is hoping for a fresh start as it attempts to establish a republic. This change to the constitution by the interim legislature in December 2007, however, has to be endorsed during the Constituent Assembly elections proposed for April 2008. Nevertheless, there is a shadow of doubt over the probability of these elections as they have been postponed twice before in 2007.

The fresh waves of protests in the south of Nepal by activists of the United Democratic Madhesi Front (UDMF) since 12 February 2008 has resulted in a curfew and deployment of armed-police in several districts of the Terai region which borders India. The UDMF failed to register any candidates by the 24 February 2008 deadline set for nominations. The Madhesis threaten to boycott the April 2008 general elections unless the government meets their demand for autonomy in the southern Terai region. Ironically, these elections were to be the first since the government signed a peace accord with the Maoist rebels in November 2006. The UDMF has now been joined by the Rastriya Janashakti Party (RJP) in boycotting the elections. Led by former Prime Minister Surya Bahadur Thapa, the RJP also did not submit any candidates for the April elections as it wants the Madhesi crisis to be settled first.

The implication of these latest protests in the Terai, an agricultural land, is damaging the economy as well. The protests blocked major roadways and highways, thus causing food and fuel shortages in other parts of the country, especially in Kathmandu. As 62 percent of Nepal's imports come from India, the Terai-Kathmandu network is central to the country. As such, the government imposed curfew helped to unblock the main east-west road. Fuel tankers and gas trucks that arrived from India last week, were finally escorted by police to Kathmandu to ease the shortage there. This block in supply has already created a system of fuel rationing in the capital, with the government creating a fuel quota system where vehicles are only allowed to be filled every second day based on the odd or even numbered registration plates. Even though Prime Minister Girija Prasad Koirala has confirmed that his government is willing to meet the Madhesi demands for greater rights, provided they take part in the April elections, he has rejected the Madhesi autonomy demands. With both sides not willing to give in, there is little hope of the political protests ending anytime soon.

The constraints to the supply of fuel and key food products may result in inflationary pressures on the prices of goods in the country. Crude oil prices have more than tripled over

[1] Mr Malminderjit Singh is a Research Associate at the Institute of South Asian Studies, an autonomous research institute at the National University of Singapore. He can be reached at isasms@nus.edu.sg.

the last five years from around US$30 to more than US$100 per barrel. Due to global increase in crude oil prices, the Nepal government hiked up the prices of petroleum products last month, only to be confronted by angry protests. Not wanting to such hostilities in the wake of the Constituent Assembly elections, the government retracted its price hike decision. In doing so though, the government has added to the financial woes of the Nepal Oil Corporation (NOC). As the debts on petrol imports from India worsen, the government needs to ask itself if it is willing to continue to pursue the costly policy of shielding consumers from increasing global fuel prices. Undoubtedly, its decision against fuel price increases in January 2008 managed to prevent the prospects of the Constituent Assembly elections from being completely diminished. However, the misalignment of domestic market fuel energy prices with global energy prices could be detrimental to the petroleum sector of the economy as well as worsen a deteriorating balance of trade with India.

Further, if the government continues to subsidise petroleum consumption in Nepal, its burgeoning national debt would probably lead to higher future taxes and, therefore, further add to poverty among the Nepalese people. As subsidies lead to increasing macroeconomic problems for the country, a scenario with decreasing supply and increasing demand would only lead to higher prices. In this case, larger subsidies would be needed from the government which would, inevitably, worsen the country's macroeconomic problems.

Critics have commented that the Nepalese government should cut fuel taxes instead of introducing further subsidies. They argue that the fuel tax, and not fuel price, is too high. The current Nepalese tax schedule on fuel, paid by the NOC as revenue to the government, consists of custom duties, charged at a flat rate on the volume of imports – value added tax (except on kerosene), local development tax and road maintenance charges. In 2006, the NOC ended up paying Nepali Rs.8 billion as tax revenue to the government. It is unlikely that the government will compromise on such lucrative revenue, especially since it claims that this income is being re-employed in social sectors such as healthcare and education for the benefit of the poor. The government argues that, if it does not provide subsidies, then in a current scenario where inflation pressures have been building up, higher fuel prices could possibly lead to hyperinflation. Given the recent starving of fuel supplies, the government's argument may hold some weight. However, its needs to realise that these subsidies, designed to protect the poor from escalating fuel costs, are in fact subsidising the relative well-off people who stock up on fuel. Moreover, the fact that fuel prices may still increase due to current political instability, shows that inflation is inevitable. Hence, the Nepal government has to focus more on curbing the seemingly inevitable inflation as opposed to attempting to drive down fuel cost.

A major issue associated with inflation in Nepal lies with the policy adopted to combat it. The Nepal Rastra Bank (NRB), the central bank of Nepal, has contained inflation within the country at 5.5 percent over the last five years through its pegged exchange rate regime with the Indian currency. Although pegging the exchange rate provides a nominal anchor for Nepal to control inflation, the anchor used in this case may not be appropriate. With inflation lurking within the Indian economy itself, Nepal may be exposing itself to inflationary pressures from its neighbours. Thus, maintaining an exchange rate peg is not the ideal solution to Nepal's inflation problems. In addition to exposing itself to transmission shocks from India, it is also increasing the likelihood of external speculative attacks. Furthermore, an exchange rate peg entails a loss of independent monetary policy which possibly undermines the accountability of policymakers to pursue anti-inflationary policies. To make matters worse, such a strategy also exacerbates the financial fragility of the country and increases the probability of a financial crisis in Nepal. The Nepal government has to recognise the importance of monetary policy sovereignty and accord independent status to the NRB. The NRB, on the other hand, will have to complement this strategy by adopting an inflation-targeting regime that will effectively control price increases in the economy. This double-edged monetary policy strategy has worked in several countries such as the United Kingdom and Canada in controlling inflation.

Other economic challenges include the sluggish performance of the economy which has grown at only between two and three percent since 2005, owing to the decline in the tourism and agricultural sectors. Forming almost 40 percent of Nepal's gross domestic product, agriculture has declined in its annual growth since 2005 at levels below two percent. Nevertheless, a bumper harvest this year in the vicinities of Kathmandu has kept the prices of agricultural products relatively low. Tourism, which had declined significantly in previous years due to the Maoist insurgency, picked up late year with improvements in the political climate. Particularly, tourism flows from India and South Asia increased to help provide a much needed stimulus in the economy. However, with the escalation of political tensions in the country again, the tourism sector can be expected to push the economy into further decline. Furthermore, as the Terai region is an industrial hub, instability there will be costly to the economy. As protestors attacked the primarily Indian-owned mills and factories and even shot an industrialist, Shashi Kant Agrawal, businesses remained closed under the curfew climate. This has caused a shortage of essential commodities such as rice, in the capital city. With current supplies estimated to last barely more than a week, prices of such food items have soared by at least 10 percent over the last fortnight. These indicators do not paint a healthy picture for the economy in Nepal.

The political uncertainties do not seem likely to end in the near future. Given the differences between the government and several of the political parties, it is also fairly certain that the elections are unlikely to take place in April 2008. At the same time, increases in prices of basic necessities have placed the Nepalese economy in a highly precarious situation. Indeed, an economic dilemma such as escalating inflation may jeopardise any hopes of political reforms, for the latter must be accompanied by economic liberalisation. With such mammoth challenges, only time will tell if Nepal will move on the path to becoming a republic or continue in its current state of political and economic uncertainties.

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