

CHAPTER - I

INTRODUCTION

1.1 Background Information

Over pessimism occurs among the business due to the fear. Due to closure of some businesses, it is natural for other businessmen to become apprehensive. Hence, the investments, replacement, expansion are closed. The producers cancel the order of raw materials. This has a chain reaction on the consumer and capital good industries. The wages and interest decrease. The consumers postpone demand in the expectation of further fall in prices. The investment declines. Consequently, production, employment, income, bank credit, expenditure, profit all decrease. The reverse multiplier begins to work i.e. called recession. According to M.W. Lee- “A recession, once started tends to build upon itself much as forest fire, once underway, tends to create its own draft and give internal impetus to its destructive ability” (Joshi, Shyam, 2003).

A recession is where an economy that had previously been growing slows down. The level of production declines, unemployment rises and consumer spending dries up - in the worst case scenarios, as happened in the depressions of the 1930s and the 1980s, so few people are spending money that businesses sack staff to cut costs.

Financial institutions in the world are identified as entities to survive as sound institutions in perpetuity. If a financial institution is in difficulties, it becomes concern of the several stakeholders. Any problem in one bank or financial institution may transmit to other, ultimately inflict to the entire and to the globe. To maintain the confidence in the financial system, the authority always tries to keep on its fingertips the financial standing of each financial institution and respond in time to overcome the crisis if and when it emerges. In this respect, timely identification of the banks' problems and its resolution are considered as one of the important components of the regulatory measure. In this resolution process some banks are bailed out while some are closed irrespective of their size and the market share. In this respect we are sometime obsessed with the questions of some big banks are being bailed out? At the same time, why some other are being allowed to close down?

The first week of September 2008 was one of the big shocks to the US financial system when the Freddie Mac and Fannie Mae were in problem. Being a highly developed financial market, US has in place advanced resolution framework for such crisis. The US authority promptly responded to the crisis and appointed an administrator to manage these ailing financial entities. The response was an unexpected measure in the world, which surprised the liberals and the advocates of the market economy. The final assessment of the US authority was that, these two giant financial entities need to survive in the market and hence the need for bailing them out by the treasury. At the same time, when one of the world's largest insurance companies namely the AIG was in problem, US has responded in the same fashion as was decided in the case of Freddie Mac and Fannie Mae. Everybody wondered why the leaders and the advocates of the liberal and market economy are behaving like protectionist? It was the question in mind of every economist and the student of the financial market. However it is the fact, the assessment is also based on fact and the decisions is made on factual ground that it must be the authorities' need to intervene to gain the confidence of the market. The shake of confidence upon the US financial system was not confined to the US alone, it transcended far and wide beyond the US.

The problem in US financial system continued to persist. Within a fortnight, other financial institutions started to declare bankruptcy. On 15 Sept 2008, Lehman Brothers, one of the biggest investment banks in the globe declared itself failed. This has further blown the financial market turmoil into the full-fledged crisis in the US economy. It spread the feeling among the market players that size alone does not matter. The bank of any size is subject to bankruptcy.

This decision by the US authorities to declare the Lehman Brother as failed and bankrupt entity has awakened even the Nepalese banks to look into their portfolio and the amount of loss to be booked in the current profit. Fortunately virtually no bank in Nepal is in such a precarious position. The issue is not confined to a bank; the impact also spills over to an individual in this globalised era, as anyone with some deposits with such failed bank may suffer from the erosion of its individual net worth. In such a way the failure of such big bank in the world market has compelled all market participants to think about their investment decisions. Within one month following the bankruptcy of Lehman Brothers, the European stock exchanges crashed by about

30%. This was the historic record fall in the European stock exchange. In this respect some can presume that, if Lehman Brothers was not allowed to fail, the contagion to the global financial market would have been very limited. The steps taken in several parts of the globe were not working properly as per the expectation. This has resulted in the declaration of more package and particular commitments from the sovereign authorities in several advanced countries. The Australian government came out with the assurance of government guarantee for all deposits for three years to regain the confidence into the financial system. The European, US, Australian and Asian authorities are working together in a coordinated manner to minimize the loss caused by the crisis and to recover from it.

In this sense, unwanted efforts are being made by all the authorities in the case of rescuing the Lehman Brothers which is the root cause of the latest crisis of confidence in the market. In other words, it seems warranted that the failure of Lehman Brothers should have been avoided. We can see several cases of such resolution modality to rescue the big and medium size entity in the system through any safety net measures such as by merger, buy out, bailout etc. that has helped to control the spread of contagion in time.

In such a rich system of resolution, how the US decided to close the Lehman Brothers as its resolution modality is a question that is perplexing to many minds.

US authority had in mind that it must be protected considering its size and its international networking. However, the timing was really a bad one. It was done immediately after the bailing out of the Fannie and Freddie which was criticized by the entire gamut of economists, politicians and also by the international market. How much taxpayers' money is used to benefit the private sector investment bank? In the similar way, the US congress rejected the first rescue package proposed by the US treasury. In this particular time, it was obvious for the US treasury to escape from the charge further use of public money to save one investment bank and deciding against the market sentiments. This resolution of parliament might be the key reason for the closure of the Lehman Brothers without considering the alternate options. It shows that the public sentiment and the political decision may not always be in the interest of the financial stability. Their concern on the one hand is right; however the cost of

subsequent correction is much bigger than the use of public fund at the beginning. Each decision was justified; however the non-responsiveness by the global system in the subsequent period proved that those justifications were wrong. This is one of the important lessons to the regulator to identify the size and the possible consequence as a matter of systemic risk and decide accordingly, rather than to ponder over the public opinion and the political justifications. It is the duty of the regulator and the treasury to explain the rationale behind the proposal rather than the size of the rescue package.

The crisis that emerged in the US is really a complex one. On a daily basis one after another decision has to be taken by the authority on the fate of the different financial institutions. Those decisions could not be the same in all situations. Such crisis creates further complexities on the resolution modalities that are being adopted by the most advanced economy. The decision made by the regulator may affect the daily lives of the people in the world; the resolution modality has to capture the sentiments of the worlds' investors. Hence, the resolution of crisis is becoming more complex, not only in terms of costs to the community, but also in the financial system i.e. of systematic importance to the economy. In spite of the various other arguments on the contrary, the stability of the system is therefore in the public interest.

The situation in the US is of a global concern. Such criticism of use of public money and regulatory arbitrage were highly criticized even in countries like the US. We can recall the intervention and control over NB Bank in Nepal, though the package was not extended towards the treasury, the major chunk of the market participants criticized it. We cannot compare the resolution modality adopted in developed and huge economies with the resolution made in the relatively primitive markets like ours. Nepalese government is not in a position to guarantee the depositors like in Australia and propose the package like in the US and Europe. We need to prepare the market to be self-sustainable. The system of privatizing the earlier profit by the private owner and nationalizing the future loss to the government or to the central bank would be highly costlier to our small economy and also to be decision maker. Hence, our circumstances are a little different from the issues and the resolution modalities we are talking about with other developed countries. Still, the Identification of the problem and the resolution modalities by advanced countries currently facing the

crisis is a big and complex issue but the accepted principle of the resolution remains the same that "a weak bank must be allowed to fail." (Adhikari, P. Maha, 2008).

The Nepalese economy has been substantially monetized. The quantum of broad money to gross domestic product reached to 60.40 percent in mid-July 2008 from 8.70 percent in mid-July 1965 and the amount of total deposit of the banking sector to gross domestic product stood at 51.40 percent in mid-July 2008 from 2.32 percent in mid-July 1965. When we include the exposure of finance companies and development banks, the ratio will be still higher. The Nepalese macro variables have been found bearing historical relationship and while examining the causality between financial development and economic growth, it is found finance leading economic growth in Nepal. The empirical findings prove the supply leading hypothesis, implying financial development stimulates real economic growth in the long run. Thus, the result strongly supports the prerequisites of the expansion and deepening of financial sector for economic development. This entails an overriding role for Nepal Rastra Bank in the economic development of Nepal in the long run and, therefore, must concentrate upon expanding and accelerating the financial institutions, building up their capability to mobilize resources efficiently and chalk out policies that guide financial sector to be sound, healthy, capable and credible institutions (Dangal. Madhav, 2008).

The global financial crisis which began from sub-prime lending and consequential share market crash and continued economic crisis had created tremendous challenges to political and business leaders all over the world. Therefore political leaders from all the major countries are trying to come up with a co-ordinated solution to the problem. Their governments and central banks have worked hard to sort the problem out. However the results so far seem far from satisfactory performance. In this background Nepal, in the short run has not been hard hit by the situation. This cannot be interpreted that Nepal is completely insulated from the global turmoil. In fact, sectors such as remittance, foreign aid and export have already started to show preliminary symptoms of negative effects.

Continuously reducing petroleum price will result in contraction of Gulf economies which might result in reduced demand in construction and tourism sectors in those

countries in which Nepalese workers are mostly employed, negatively affecting remittance which has become a catalyst of the economy.

Manufacturing industry is suffering from labour and energy related problems. Hence international economic improvement and political stability is the key for Nepal's future growth.

In order to address the problem developed countries are injecting money to enhance lending, Nepal Rastra Bank considered monetary policy as prudent measure to clean up liquidity from market. It is evident that Nepal is not left insulated from ongoing financial crisis. However the matter of concern to all is the extent to which this crisis is going to affect the Nepalese economy. Because Nepal lies far away from the epicenter of this financial-quake, the tremors are believed to be felt in distant times of a year or so.

The fear of inflation remains a matter of concern because the appreciation of US dollar has caused Indian currency to appreciate. Consequently, Nepal's general level of prices also has risen. The double digit inflation remained throughout the year. The inflation was driven by significant rise in food and beverages as well as non food and services.

While the crisis has brought sense of uncertainty among all groups of people and government throughout the world, but it has ignited policy debate in Nepal. As a result, proponents of regressive economic policies are trying to find some kind of validation towards what they believe. The present global crisis has forced Nepal to rethink about various policies that GON (Government of Nepal) has been embracing till now. Although Nepalese financial sector looks stable, it still faces risks such as exposure to the unproductive loans to construction, land purchase, vehicles and share purchase. The speculative investments in some of these sectors could be likely to bring crisis if these investments are not regulated. The global economic crisis has had a multiplier effect throughout the economies of the world. Two major reasons for all this are the uncontrolled and left alone investment banks in the name of innovation that provided loans in the form of mortgage to the risky customers. The next is the

lack of government intervention in these sectors, which fuelled the financial companies to offer such products.

Nepal's ranking remained at 121 in global "Doing Business Ranks" with no major reforms recorded during the year; Nepal's rank against South Asian nations was as follows.

Afghanistan in 162, Bangladesh in 110, Bhutan in 124, India in 122, Maldives in 69, Pakistan in 77 and Sri Lanka in 102. So there is a sort of consolation that we ranked very near to all of our neighbors. However, this could not be taken in the light of growing competition among nations to attract foreign direct investment and other business opportunities. We may fall behind in this ranking if we do not sufficiently work on making progress on policy reforms which has been halted for quite some time.

The economy of Nepal remained heavily dependent on remittances from the people working in the different part of the world, especially in the Gulf. This accounted for 10 percent of GNI (Gross National Income) in Nepal (*UNCTAD, 2008*). (Shrestha, Madhavji, 2009).

The year 2008 was the bankruptcy and collapse of huge investment banks of US and Europe one after another trillions of dollars of losses to investors, share holders, lenders, borrowers and common people resulting in credit/liquidity crunch, crisis of consumer confidence, and low output and employment in the west and its spill over into the rest of the world. This research begins with a probe into the underlying causes of the crisis. It will be followed by a description of the innovation in financial engineering and the policy errors that triggered the crisis. The next section will deal with the rationale for intervention in the financial market. It will be followed by an attempt to derive the likely implication of the crisis in the Nepalese economy. Finally, this research will close with the overall lessons that we can learn from this crisis and its impact on Nepalese Economy.

1.1.1 The primary Causes of Crisis

- J Crash in the value of securities invested by investment banks that were backed by sub-prime mortgages. Since, such securities lacked transparency particularly about the quantum in the banks' books.
- J Misuse of credit card since borrowers are reported to hold up many cards.
- J US real estate prices began to plateau and then fall.
- J With falling property prices and increasing interest burden, borrowers were unable to pay up and banks sold off mortgaged properties.

All these developments forced all banks to simultaneously disclose all their sub-prime related exposures and losses which added to the panic.

1.2 Statement of the Problem

The countries that are in the grip of crisis are normally the countries that stand as the source of FDIs in Nepal. This means unless the crisis is resolved, Nepal cannot expect accelerated inflows of FDIs. For the last several years, for meeting its growing investment requirements, Nepal has been pinning its hope on NRN. Slow down in the countries in which the NRNs are residing may adversely affect their earning and thereby countries that they are residing in may attract them to invest in Nepal. The current crisis is resulting in a competitive cut in interest rates across the crisis ridden advance countries. Nepal holds its foreign exchange reserves on these countries. The interest rate cut is sure to result in depressed interest income to Nepal. The research explores some key questions that still remain unanswered.

- J What really has happened?
- J Why did it happen?
- J How did it happen?
- J What was the political/legal basis of such developments?
- J Why did governments/central banks of industrialized countries intervene?
- J What could be likely impacts on Nepal?
- J What are the lessons to be learned?

1.3 Objectives of the Study

The objectives of this research are to gain an insight into the impact of recession on Nepalese economy. More specifically, this study investigates on the following variables of Nepalese Economy:

-) To study the impact on balance of payments
-) To study the impact on inflation
-) To study the impact on foreign employment & remittance, and
-) To study other miscellaneous impacts.

1.4 Limitations of the Study

This research explains and analyzes the subject matter with the help of published data, therefore as a conclusion oriented research, it doesn't concern with fundamental and decision oriented research. Considering the above matter, following are the limitations of the research:

-) Since very few researches have been done in this area in the context of Nepal, the study depends upon the published data.
-) The research is mainly based on the published secondary data.
-) This study was conducted to fulfill the requirement of the MBS programs of T.U. for a prescribed time, not for generalization purpose.
-) As a research student the study is unbiased but resources and time period is limited.
-) The truth of the research result is based upon the published data

1.5 Organization of the Study

The research is organized into following chapters:

Chapter 1: Introduction

Chapter 2: Review of Literature

Chapter 3: Research Methodology

Chapter 4: Data Presentation and Analysis

Chapter 5: Summary, Conclusion and Recommendations

CHAPTER - II

REVIEW OF LITERATURE

This study aims to analyze the impact of Global Recession on Nepalese Economy. For this purpose, a review of related literature in concerned area is must which will help the researcher to get clear ideas, opinions and relevant concepts on the topic. Therefore, Conceptual frameworks given by different authors and intellectuals for the topic on different books, journals and research works, are reviewed.

2.1 Conceptual/Theoretical Review

2.1.1 The manifestation of Crisis

- J March/April 07; New Century Financial Corporation stops making new loans.
- J September 7; the Government seized control of Fannie Mae and Freddie Mac (the source of largest mortgage fund) for \$200 billion;
- J September 15, 2008; 158 years old investment banker Lehman Brothers declared \$600 billion bankruptcy. Another huge investment bank Merrill Lynch was acquired by the Bank of America.
- J September 17; bailing out of American International Group (AIG) insurance giant for \$ 85 billion
- J October, 2008; passage of \$700 billion bailout package by the US Congress.
- J December 1, 2008; \$300 billion help to Citibank
- J December 2, 2008; US Federal Reserve announces \$800 billion rescue package.

The adverse financial developments soon started to transmit to the advanced economies of Western Europe and with the passage of time to the rest of the world.

2.1.2 Spill Over of US Crisis to the Western Industrialized Countries

The UK government nationalizes Northern Rock on September, 2007, and the UK government and the Bank of England guarantee its depositors. The German Banks with exposure to US sub-prime real estate crisis admit problem in that portfolio in July, August, 2007. Similarly, in January, 2008, prominent Swiss Bank, UBS writes down \$18 billion assets exposed to the US sub-prime. On September 29, governments of UK ENELUX, Germany and Iceland announced bail out plans for key banks in

their respective countries. The impact was that banks in the western world stopped lending which resulted in credit/liquidity crunch, stock markets collapsed and growth rate projections were lowered for across the world. The crisis spread from Wall Street to the main street with the danger of lowering output and increasing unemployment, and depress consumer confidence.

2.1.3 The Underlying Causes of Crisis

The unfolding crisis was an outcome of crash in the value of securities invested by investment banks that were backed by sub-prime mortgages. Such securities lacked transparency particularly about the quantum in the banks' books.

Sub-prime mortgages became popular in the US after 1986 when the Tax Reform Act prohibited deduction of interest expenses on consumer loans but allowed such deductions on mortgages for a primary residence, and one additional home; furthermore, this Act also allowed the provision of variable interest rates; whereby the lenders can charge borrowers the fluctuating interest rate as per their changing risk perception. This made the rate and amount of interest liability of the borrowers unpredictable.

The promulgation of this Act culminated in soaring property prices. Even home owners with poor credit history could easily refinance their loans. Sub-prime loans are also called NINJA loans, meaning people with "no income, no job, and no assets" could also easily find loans for home purchase. Mortgage lenders paid young salesmen bonuses on the volume of loans they signed up. Borrowers were given loans even without putting any equity. With the global escalation of demand for securities, the investment bankers resorted to reckless lending. Without doubt, modern finance has been found seriously wanting. Some influential banks seemed to assume that markets would be constantly liquid. Risky behavior garnered huge rewards; caution was punished. Even the best bankers took crazy risks. For instance, by the end of 2007, Goldman Sachs, by no means the most daring, had one trillion dollar of assets teetering atop a mere \$43 billion of equity. Lack of regulation encouraged such gambling. Financial innovation in derivatives soared ahead of the rule setters. Somehow the world ended up with \$62 trillion worth of **CDSs** (Credit Default

Swaps), none of them traded in the stock exchanges. Not even the most liberal libertarian could imagine that was sensible.

Credit card companies too became over liberal. Borrowers were reported to hold up to 27 cards. By 2005-2006, US house prices began to plateau and then fall. With falling property prices and increasing interest burden, borrowers were unable to pay up and banks sold off mortgaged properties. Lending banks resorted to foreclosing. The share of sub-prime origination in foreclosures increased from five percent in 1994, to 13 percent in 1999, and to 20 percent in 2006. Increasing magnitude of foreclosures resulted in the fall of real estate prices and lenders could not get their money back. As a result over 25 US sub-prime lenders had gone bankrupt by February, 2007. All these developments forced all banks to simultaneously disclose all their sub-prime related exposures and losses which added to the panic.

2.1.4 The Implication of Policy Errors

The 1993 Glass-Steagall Act had separated the works and domain of commercial and the investment banks. This Act set up the system of federal regulation over the financial system. This Act and subsequent practices and developments had mandated investment banks to confine their activities to:

-) Help business raise money
-) Facilitate restructuring, mergers and acquisitions
-) Advise investors on what to do with their money.

This Act was repealed by Gramm Act, 1999 (the last of the second term of the Clinton Administration) which allowed investment banks to freely create and trade mortgage backed securities such as CDOs (Collateralized Debt Obligations) and CDSs, which are now considered responsible for the current imbroglio. The 1999 Gramm Act was amended in 2000 under the name of Commodity Futures Modernization Act, 2000 which paved way for the creation of "Shadow Banking System" which allowed the creation of new firms and legalizing the authorization/creation of these new firms to combine the trading of insurance, investment banking and commercial banking.

Thus, the crisis is the product of unreal expectations, insatiable appetite for profit, profit, and more profit by whatever means, and lack of systematic controls which culminated in a situation where it becomes considerably difficult and expensive to raise funds for banks as well as for business, which the economists describe as a situation of liquidity crunch. The major reason behind the crisis is the securitization of sub-prime loans, rather than sub-prime loans in themselves. Talking of the lack of systematic control, the Federal Reserve had broad authority to prohibit deceptive lending practices under a 1994 law called the Home Owners' Equity Protection Act. But the Fed took little action during the long housing boom, and less than one percent of all mortgages were subjected to restrictions under the law.

2.1.5 The Rationale of the Need for Intervention

The classic feature of financial crisis is that failure of one firm inflicts losses on its creditors, and they in turn fail to repay their debts, bringing down a widening circle of firms resulting in the epidemics of failure. This in turn results in general decline in production and employment. If banks are allowed to collapse one after another without any care to their creditors, the eventual situation may result in slowdown, recession, depression and even deflation. The worst case scenario for the global banking system is the collapse of the entire financial system. But the situation is not as grim as there is still scope to further reduce interest rate, the government can guarantee for creditors or to directly buy assets. However, if policy interventions fail to lift up the expectations, any amount of resource injections into the financial system may fall into the Keynesian liquidity trap. Similarly, as the recent Japanese experience has shown, very low or even negative interest rate may fail to trigger aggregate demand. Fortunately, the newly installed Obama administration appears to have rekindled hope in the United States. In his campaign speeches and recently also president Obama has committed tax reform to the benefit of the poor and the middle class. Furthermore, he has also promised to bolster spending on infrastructure. But still, the current scenario does not completely preclude the fear of deflation.

The pressure on the US administration to intervene began to emerge from the early 2007. Around July/August, 2007; the US president George Bush rejected the increasing requests for government intervention to ease the crisis in the home mortgage market and kept his strong faith on the ability of market to clear the

financial mess. But the crisis began to so deepen that he later pledged help for struggling home owners to help ease the mortgage crisis. But, as the situation began to worsen further, the White House on September 19, 2008; requested for \$700 billion plan for all financial firms with bad mortgage securities to free up tightening credit flow. The House of Representatives on September 29 rejected the mammoth bailout plan. On October 1, the US Senate adopted the plan by adding sweeteners to get House acceptance. With such bailout package, the Fed and Central banks in the west are moving rapidly from a lender of last resort to an investor of the last resort. The \$700 billion figure was the limit set for acquisition of the troubled assets, whose total value has been guesstimated at upward of \$ 3 trillion. This Figure would have been even higher had the US Treasury been given discretion to add any other assets it considered worthy of similar support. It should be expected that the money would be used to by the worst assets and "unclog" the system to that the less impaired and frozen securities can find their values. The private financial sector too strongly lobbied or such a move since the worst assets are the securities they want off their books. This implies that \$700 billion is enough to clear the mess of these securities though the basis for that assumption is by reserve announced a new package of another US Dollar 800 billion in addition to the \$ 700 billion announced by the George Bush White House. The cost of rescuing the financial system has now risen to US Dollar 1.5 trillion, or an astonishing 10 percent of the US GDP. Of the latest \$800 billion package, the Fed will use \$600 billion to buy the mortgage-backed assets and the remaining 4200 billion is to be used to support consumer and small business loans. This study has dealt at length about the US and partly with the European crisis, this does not mean that the rest of the world is immune from the crisis. Countries such as Japan, Russia, and Singapore are also feeling the pinch of the crisis. It has also spread to countries near our home to India, China and Pakistan.

The question that now arises in the manner in which prices of these securities to be acquired are set. The bailout plan seeks to use market-based methods, including reverse auctions in which sellers looking for a buyer bid down the price at which they are willing to sell their assets. Since the most impaired securities are near worthless, their prices should be closer to zero for every dollar worth of such assets in terms of their accounting or par values. Setting them there would also permit the government to acquire a substantial volume of securities when seeking to unclog the system or to

even save a part of tax payers' money it is authorized to spend to achieve this objective (Acharya, P.K., 2009).

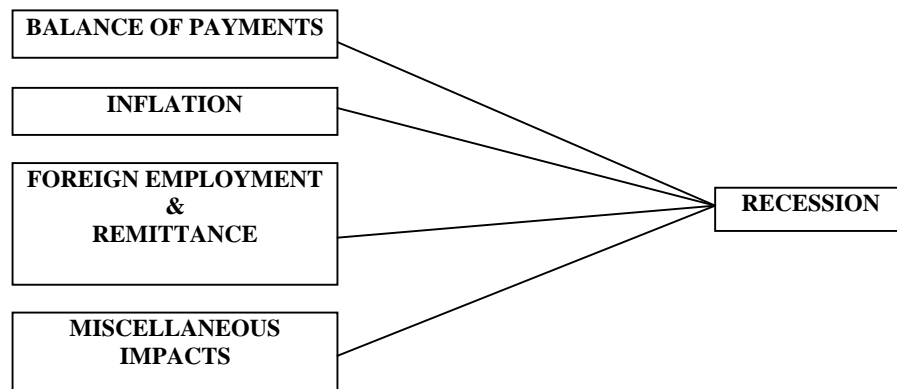
On the basis of the above arguments, we can theorize that there would be some correlation between Recession and each of the following variables in the context of Nepal:

-) Balance of Payments
-) Inflation
-) Foreign Employment and Remittance, and
-) Miscellaneous Impacts

The theoretical Framework can be depicted as shown in Figure:

Figure 2.1

Diagram of the Theoretical Framework



2.2 Review of Books and Research Works

Recession starts when there is a downward descend from the 'peak' which is of a short duration. "It marks the turning period during which the forces that make of contraction finally win over the forces of expansion. Its outward signs are liquidation in the stock market, strain in the banking system and some liquidation of bank loans, and the beginning of the decline of prices." As a result profit margins decline further because costs start overtaking prices. Some firms close down. Others reduce production and try to sell out of accumulated stocks. Investment, employment, incomes, and demand decline. This process becomes cumulative.

Recession may be mild or severe. The latter might lead to a sudden explosive situation emanating from the banking system or the stock exchange, and a panic or crisis occurs. "When a crisis, and more particularly a panic, does occur, it seems to be associated with a collapse of confidence and sudden demands for liquidity. This crisis of nerves may itself be occasioned by some spectacular and unexpected failure. A firm or a bank, or a corporation announces its inability to meet its debts. This announcement weakens other firms and banks at a time when ominous signs of distress are appearing in the economic structure; moreover, it sets off a wave of fright that culminates in a general run on financial institutions...Such was the experience of the United States in 1873, in 1893 and in 1907." (Jhingam M. L., 11th Revised Edition).

Nepal is a fairly open economy with the value of its international trade accounting for about a third of its GDP. The undergoing crisis is expected to reduce output, increase unemployment reduce the social security transfers to the people in the countries that are in the grip of financial crisis. This is sure to depress their consumption and thereby demand for our exports. Falling external demand for our goods and services may stall Nepal's economic recovery. As a Least developed Country (LDC), Nepal depends on foreign aid, particularly concessional ODA in supporting over three-fifths of its capital budget. Nepal's major donors are the countries which are now suffering from acute crisis. The advanced countries suffering from ongoing crisis have been diverting their revenue to bailout/rescue the edifice of their economy in general and the financial system in particular. This may either eliminate or squeeze the amount of assistance that they can provide to us. If this happens, it is sure to constrain the implementation of our budget. The experience in the last decade has seen a surge in remittance from Nepali workers working abroad. The expectation of economic slowdown in the countries of destination of Nepali work force may depress the magnitude of remittance inflows and thereby add to the economic hardship of people who depend on it for their livelihood. Tourism is a potential growth trigger for Nepal, whose value added depends on the prosperity of foreign tourists. Falling income of people in the countries of origin of tourists to Nepal may dampen the income from tourism that is currently flowing into the country; let alone our expectation of increasing earning from this source. Last decade has also seen a surge in the outflow of Nepali students both under self finance and under scholarship particularly to the

English speaking countries of US, UK, Canada and Australia; are the countries most affected by the crisis. Because of diversion of budget of crisis countries to rescue their ailing financial industries they will have lower allocation to scholarship grant, and the Nepali students who are financing their education by working in those countries may be subjected to layoffs. Recession in these countries could also tighten the work permits, permanent residence and diversity visa to the Nepali nationals in those countries. Nepal is currently undergoing a revolution of rising expectations, where everybody is asking for better living conditions through accelerated FDI inflows.

The countries that are in the grip of crisis are normally the countries that stand as the source of FDIs in Nepal. This means unless the crisis is resolved, Nepal cannot expect accelerated inflows of FDIs. For the last several years, for meeting its growing investment requirements, Nepal has been pinning its hope on NRNs. Slow down in the countries in which the NRNs are residing may adversely affect their earning and thereby their investment prospect in Nepal. Here the silver lining is the depressed demand in the countries that they are residing in may attract them to invest in Nepal. The current crisis is resulting in a competitive cut in interest rates across the crisis ridden advanced countries. Nepal holds its foreign exchange reserves in these countries. The interest rate cut is sure to result in depressed interest income to Nepal.

Other Channels through which the current western financial crisis could influence the economy of Nepal are the foreign exchange, money, debt, credit and capital markets. But given capital controls and the shallowness of these markets in Nepal in comparison to the size of its overall economy, the impacts would not be that horrific. Slowdown in the western world vis-à-vis Nepal should have pushed pressure for the appreciation of the Nepali Currency which could have worsened BOP and eased the inflationary pressures and foreign debt servicing burden. On the contrary, the crisis stressed Indian foreign exchange market and the Nepali currency depreciated along with the Indian currency, with which Nepal maintains a fixed peg. Foreign institutional investors (FIIs) like Lehman Brothers and Merrill Lynch held Indian stocks worth \$80 billion across 30 firms that constitute the SENSEX (Bombay Stock Exchange Sensitive Index). This comprised about 18 percent of the SENSEX market value. After collapse, FIIs stepped back from investing in India. They became net sellers since January 2008. Between July-September, they have sucked back IRs

403.2 billion. This coupled with lower export of IT and real estate in the aftermath of crisis put tremendous pressure on the Indian Currency to depreciate, given fixed peg Nepali rupee too followed suit.

Consequently, India is facing increased cost of borrowing because of risk aversion, deleveraging and frozen money markets. All these contributed to the sharp depreciation of the Indian Currency. The simultaneous depreciation of Nepalese currency should normally augur well for our exporters and remitters if the crisis in the west does not compress their demand for Nepalese goods, services and labour; if Nepal could improve its supply responsiveness in pace with the change in global demand. Rather, rupee depreciation if remains sustained may fuel already elevated inflation and add to foreign debt servicing burden. Recently, the world is experiencing a fall in oil prices, which is an outcome of the crisis. This should normally be favourable to Nepal's BOP and also in easing inflationary spiral. But, if the oil price fall continues and the Gulf oil producers cut back oil production, this may result in the layoff of hundreds of thousands of Nepali workers currently working in the gulf countries. If this happens the gain from all of oil prices to BOP and to inflation will be offset by the drastic fall in remittance income (Acharya, P. Keshav, 2008).

2.3 Review of Related Articles, Journals, & Periodicals

2.3.1 Meltdown in Nepal

Recession is an economic term that refers to the phase of the business cycle in which the existing policies and activities fail, and the economy heads towards a crisis. A business cycle is a process in which economic activities vary around its long-term growth trends. The cycle in values shifts over time between periods of relatively rapid growth of output, which is termed as recovery and prosperity. The same cycle later turns into a period of relative stagnation or decline in economic activities, namely, the phase of contraction or recession.

The occurrence of these phases one after another and their repetition in the short as well as long run is a natural process of the business cycle. There are a number of indicators that exhibit particular phases in the business cycle, but they are conventionally measured using the real Gross Domestic Product (GDP).

While dealing with recession, it is relevant to cite an old proverb, “A recession is when your neighbour loses his job, and depression is when you lose your own job.” Recession is the phase of contraction in the business cycle when economic activities are slow. Accordingly, a period of general economic decline, specifically a drop in real GDP for two or more consecutive quarters, indicates recession.

The United States, Britain, the European Union and even Asian countries including Japan are almost in recession according to the rule of thumb of two consecutive quarters of falling GDP.

The International Monetary Fund (IMF) has also set a benchmark for recession which is a growth rate of less than 3 percent in real GDP implying a world recession. Its world economic outlook published on Nov. 6, 2008 predicts that the world GDP growth rate would fall to 2.2 percent in 2009 based on purchasing power parity (PPP) weights from 5 percent in 2007 and 3.7 percent in 2008.

Private firms are forecasting an even gloomier situation in 2009 with a number of them predicting that global GDP growth would be no more than 1.5 percent. If the predictions are true, the world is heading for serious trouble.

At this rate, middle-income countries are likely to suffer from recession from early 2009. The fast growing economies of East Asia including China and the countries of South Asia including India will be affected by the recession sooner or later. The Middle East and ASEAN will also be affected by the global economic crisis. Nepal’s economy will be jeopardized as a result of the drop in the economic activities of these countries.

Advanced and middle-income countries are the main sources of livelihood for lower-income countries like Nepal. The country’s economy in particular depends on agriculture and foreign employment which provide massive employment to the growing population. The Middle East, East and South Asia, Britain, Euro-zone, Australia, the USA and Canada are the places where hundreds of thousands of Nepali youths are employed. In recent years, remittances from these countries alone account for over 20 percent of the GDP.

Real estate is a fast growing business sector on Nepal's domestic economic front. Private investors have sunk big money into land and buildings by borrowing from banks. The probability of this sector becoming paralyzed by the present crisis is high because there is a high correlation between the real estate business and remittances. Past experience proves that almost all the money from remittances has been invested in this sector in urban areas. If our youths lose their foreign jobs, their income will diminish as a result of which they will lose their capacity to buy real estate on a greater scale. Consequently, this sector will be affected faster than others.

Reduction of poverty depends on remittances. According to the Nepal Living Standard Survey of 2003/04, poverty decreased from 42 percent at the beginning of the Ninth Plan period (1997) to 31 percent in 2003/04. Despite the protracted violent conflict that marked the period and consequent slowdown in the economy, the country achieved remarkable progress in reducing poverty. This achievement was not made possible by domestic economic progress but remittances. At this juncture, the nation's poverty reduction strategy will be affected by the global economic crisis.

The global economic crisis will have a serious impact on Nepal. Thousands of youths will lose their jobs in foreign countries resulting in reduced remittances. These young people will return home because the countries where they work will probably ban foreign employees to protect their own jobless. In essence, the foreign employment sector will become more vulnerable which will have a huge impact on the Nepali economy (Dhungel, Kamal Raj, 2008).

2.3.2 Economic Flux and Nepal

The Current Global Economic crisis can have multitude of effects on our small economy and further aggravate our economic well being. The decade long Maoist conflict which ended in 2006, subsequent Madhesh movement and the recent labour union problems have to a large extent decimated our industrial sector outside of the Kathmandu valley. Hence, from tourism to remittance to foreign aid, we are dependent on outside income to move our economy forward. Reports from the Middle-East and Malaysia suggest that the economic crisis has taken its toll on their respective economies. Workers are already returning back from these regions and more Nepali migrants workers are expected to come back as companies in these

regions scale back on production. These developments have put remittance income, which contribute close to 20 percent of our Gross Domestic Product (GDP), into jeopardy. Similarly, with most of the developed economies either in or expected to be in prolonged recession, our tourism sector, which was starting to recover from the lost-years of conflict, could be struggling again as tourists from United States, Europe and other developed countries cut back on their travel plans.

The few industries that have survived the people's war and the Madhesh movement are now teetering under the worst possible energy crisis. Up to 16 hours of power cuts in 2009, production levels are down and operating costs are up, affecting a firm's profitability and return on investment, and consequently an investor's investment decision. The energy crisis is particularly crippling to small scale enterprises that cannot afford ancillary sources of energy generators. The cut in production as well as high operating costs partly explains the current high inflation figures. Since the energy crisis, according to the Nepal Electricity Authority (NEA), is expected to continue for at least five more years, policymakers need to get their acts together to resolve the power crisis if they expect to either facilitate existing industries or bring any substantial new private investment (Pokharel, Santosh, 2009).

2.3.3 Global Recession is not over

There is a greater probability that financial crisis will limit the possibility of global commitment to allocate US\$ 16 billion to accelerate the realization of Millennium Development Goals.

In November 2008, at the Asia Pacific conference, world leaders had assured the world community that the global financial crisis would be arrested in 18 months. This timeline may have been mutually agreed because of International Monetary Fund's estimates that developed countries would grow merely by 0.1 percent in 2009 giving little hope on quelling the crisis soon.

It is a common belief that the recovery from recession begins after 18 months. From this perspective, if we consider United States' official acknowledgment that recession began in December 2007, it was already 11 months when the world leaders gathered for the Asia Pacific conference in November 2008. Taking December 2007 as the

base year for the historic recession, 17 months have already passed. The only memorable achievement as of today from these estimates is the realization by world's larger economic powers that new protectionist barriers should be discouraged and WTO talks initiated again. The speculation of the head of France's biggest listed bank, BNP Paribas, that the phase of exceptional turbulence on the markets should end by the second half of 2008 also turned out to be wrong. Nobel Prize laureate Paul Krugman observes that the worst maybe over but massive lingering debts make early recovery unlikely. In the USA, housing investment is below 3 percent of GDP. Although US Federal Reserve has cut the key borrowing rate to near zero, says Krugman, business sentiment is not affected by a discounted rate. The problem is in the three fronts of real economy i.e., the savings rate, housing and business investment.

The chief economist of Merrill Lynch says, for each \$1 increase in the price of oil, Russia's government budget earns about \$1.7 billion a year. Last winter, oil dipped below \$40 a barrel. Now oil price is above \$60 per barrel. The Dean of the New Economic School in Moscow writes "If oil prices go back to where there is no budget deficit, then it will be business as usual". Reacting to this scenario, International Herald Tribune wrote "The problem is that rising oil prices have turned around Russia's prospects so quickly that economists are now warning of a different risk: the crisis may be too short." Is this the global reality?

Dominique Strauss-Kahn, MD of IMF recently said that global downturn is not over, the world is still in the grips of a "Great Recession" and, therefore, it would be wrong to be complacent. IMF estimates that the world economic growth will increase by 1-3 percentage points by the end of this year since a global fiscal stimulus equals to 2 percent of the world's GDP. Although the global economy is handled on the coordinated policies of major global players, the fundamental question unanswered is how much and how long stimulus is needed. Therefore, mitigating the slump is one side of the story but policies for recovery is another (Pyakuryal. Bishwambher, 2009).

2.3.4 Bring the Derivative market into the range of Oversight Radar

There is a highly mysterious 'financial underworld' of derivative market that is well beyond comprehension of a common man. When Warren Buffet, the 'investor with

Midas touch', termed derivatives as the 'financial WMD (Weapons of mass destruction)' in 2003, it was then taken as a mere retort to Greenspan policies. But now, his statement appears to have vindicated. It is so huge in size; any single government in the world can neither regulate nor streamline it. According to an estimate by the Bank of International Settlement, the cumulative value of derivatives world over stands now at shopping US \$345 trillion. Very nature of its products, clandestine and incomprehensible nature of operation and separate lexicons used for trade are deliberately aimed at evading any form of regulation. Products like currency and interest rate swaps, parallel loans, forward and option that sell across any national boundary are designed and named to evade the oversight regimes of any country to name.

Unquestionably, present financial crisis is largely an outcome of this irresponsible trade. Interestingly, its influence is so all-encompassing that the political leadership of the world is simply not prepared to take the risk of antagonizing the nouveau-riche by regulating and streamlining it, in fear of reprisal. Arguments are also floating that the disturbance caused to this trade would further aggravate the crisis, since the investors in this dirty trade are thought to have capacity to manipulate the media and political equations in many countries. May be true, but it will be one-time burn, worth bearing. It is unwise to consider bringing entire business to a halt, but there must be a woggle-a pass hole for all cash transactions, which can be monitored by law. Instead, if we fail to bring this huge market effectively under regulatory radar of universal nature, the world financial architecture will continue to suffocate under this Damocles' sword; and the crisis like the present one might become a norm than exception. (Wagle, Achyut, 2009).

CHAPTER - III

RESEARCH METHODOLOGY

The main objectives of this study are to examine the impacts of Global Recession to Nepalese Economy. To achieve these objectives the study requires an appropriate research methodology. Therefore, this chapter highlights about the methodology adopted in the process of present study.

Research means to research the problems again and again to find out something more about the problem (Fotheri, 1999). Methodology refers the various steps that are generally adopted by a researcher in studying his research problem along with the logic behind it. Thus, research methodology is a way to systematically analyze the logic behind problems so as to find out something about the problems.

An appropriate choice of research methodology is a difficult task, which is, must necessary to support the study in realistic term with sound empirical analysis. So that, the study uses the following research methodology:

-) Research Design
-) Population and Sample
-) Sources of Data
-) Methods of Presentation and Analysis, etc.

Explanations of the above points are given below which seems appropriate to understand methodology in details.

3.1 The Research Design

Research design is the main part of the thesis or any research work. "Research design is the plan, structure and strategy of investments conceived so as to obtain answers to research questions and to control variances" (Wolf, H.K. & Pant, P.R., 2008). It tends to collect the right quantum of accurate information. A research design is the arrangement of conditions for collection and analysis of data in a manner that aims to combine relevance to the research purpose with economy in procedure (Selltiz, C., Wrightsman, L.S., & Cook, S.W., 1981)

Research design means an overall framework or plan for the activities to be undertaken during the course of a research study. The research design serves as a framework for the study, guiding the collection and analysis of the data, the research instruments to be utilized, and the sampling plan to be followed.

The Research design is an organized approach and not a collection of loose, unrelated parts. It is an integrated system that guides the researcher in formulating, implementing, and controlling the study. Useful research design can produce the answers to the proposed research questions. The research design is thus an integrated frame that guides the researcher in planning and executing the research works.

3.2 Population and Sample

Nepal is a small country surrounded by China in north and India in the east, south, and west. Nepal is a landlocked country surrounded by mountains. The nearest distance to reach ocean from here is 2000 kilometers. Likewise, it has 500-miles open border with India. Since the recession has influenced in both the countries, Nepal can not lonely be apart from it. So, the population for this study comprised of all economic indicators Economy. Since all of them would not be possible to include in this study some of them such as BOP, inflation, foreign employment, Remittances and other factors are taken for sample in this study.

3.3 Sources of Data

At the present study is being undertaken to evaluate the impacts of Global Recession on the overall economic development of the country, the secondary sources of data are used in the study. The supplementary data and information are obtained from various reports of the Department of Labour, various published and unpublished periodicals, magazines and dissertations, available reports and materials of Nepal Rastra Bank (NRB) and Economic Survey of FY 2008/09 published by Government of Nepal, Ministry of Finance.

Beside these, various concerned individuals are directly approached to gain required relevant information.

3.4 Methods of Presentation and Analysis

Since the presentation of data is the basic organization and classification of the data for analysis. In this chapter, data collected from various relevant sources would be presented and analyzed by using various tools. There are number of methods, which can be used to analyze the data. The easiest way to understand data is by examining it in charts, tables, Bar Graphs and Line graphs. But even before one can arrange data in tables and charts, it is necessary to rearrange the raw data. Organization and processing of data require knowledge of some technical methods. There is a definite sequence for analyzing data. The overall process of analyzing data can be viewed as involving a number of separate and sequential steps. The activities in data processing include editing, coding, classification, and tabulation of information (Sekaran, U. 1992).

CHAPTER - IV

DATA PRESENTATION AND ANALYSIS

4.1 The Assessment of the Impact of the Crisis on Nepal

The Channels through which the current global financial crisis could transmit to the economy of Nepal are foreign exchange, money, debt, credit and capital markets. Nepal has refrained from opening its capital market to the rest of the world. There is no foreign portfolio investment in Nepal's capital market and FDI is also very small. One, Nepal's foreign exchange, money, debt, credit and capital markets are not integrated with the sophisticated global market; and two, these markets are very shallow even in comparison to its GDP. Thus, apparently there is no direct impact of the crisis in Nepal. However, Nepal is a small open economy, with international trade constituting around a third of its GDP. Thus, one may expect the impact of global contraction through trade channel. The change in global interest rate, exchange rate, and prices a reflection of the crisis are expected to transmit the impacts, to some extent in Nepal.

There could be varieties of consequences. In this, for the sake of brevity, the likely impacts are broadly grouped into:

-) Balance of payments
-) Inflation
-) Foreign Employment & Remittance, and
-) Miscellaneous.

However some of these impacts are cross cutting and, hence, are mutually inclusive. The impact on balance of payments primarily occur through remittances, exchange rate, tourism, exports, and falling interest income due to fall in interest rate in advance countries; whereas the impact on inflation will emanate from exchange rate and from changes in global prices due to change in consumer demand in countries of crisis origination. The impact on employment, particularly employment of Nepalese workers working abroad, will result from demand contraction in those countries as spillover effects of contraction in advanced countries. Miscellaneous impacts include perception on foreign aid, shrinking job and scholarship opportunities for Nepali

students in foreign universities, and increased burden for parents in financing their children's education overseas in rupee term.

4.2 Definition of Terms

4.2.1 Balance of Payments

In general, the difference between the amount paid by a national government to other countries and the amount it receives from them.

"The countries having economic transactions with other countries prepare periodically their final accounts with a view to taking stock of their foreign receipts and payment and their assets and liabilities that arise out of international transactions. This account is known as balance payments (BOP). The BOP of a country can be defined as a systematic statement of all economic transactions of a country with the rest of the world during a period of time, usually one year. The BOP can also be defined as a systematic accounting of all economic transactions between the residents of a nation and the rest of the world during a period of time, usually one year" (Dwivedi, D.N. 2001).

The balance of payments is officially known as the Statement of International Transactions and includes two main accounts. The first, the current account, tracks activity in merchandise trade exporting and importing; income earned from investments abroad; money paid to foreign investors; and transactions on which the government expects no returns. The second, the capital account, tracks both loans given to foreigners and loans received by citizens. Because the balance of payments is one reflection of a nation's financial stability in the world market, the International Monetary Fund (IMF) uses these accounts to make decisions such as qualifying a country for a loan. The IMF also provides the information to its members so that they can make informed decisions about investments and trade.

All balance of payments transactions have an offsetting receipt. Although a country might have a deficit in merchandise trade (indicating that it is importing more than it is exporting), it will show a surplus in another area, such as its investment income.

The balance of payments can be used as an indicator of a nation's economic stability. Changes in the balance of payments can affect the exchange rate of a country's currency. For example, a deficit in merchandise trade means that the currency of that nation is flooding the world economy, since it is being used to buy the imports that cause the deficit. Unless government controls are used, the value of the currency will most likely depreciate (Sidney, L.J., 2009).

4.2.2 Inflation

An increase in the supply of currency or credit relative to the availability of goods and services, resulting in higher prices and a decrease in the purchasing power of money.

Inflation, in economics, terms used to describe, respectively, a decline in the value of money, in relation to the goods and services it will buy. Inflation is the pervasive and sustained rise in the aggregate level of prices measured by an index of the cost of various goods and services. Repetitive price increases erode the purchasing power of money and other financial assets with fixed values, creating serious economic distortions and uncertainty. Inflation results when actual economic pressures and anticipation of future developments cause the demand for goods and services to exceed the supply available at existing prices or when available output is restricted by faltering productivity and marketplace constraints. Sustained price increases are historically directly linked to wars, poor harvests, political upheavals, or other unique events. According to Friedman, "Inflation is always and everywhere a monetary phenomenon." (Shrestha, Rajendra Gopal & Adhikari, Gyan Mani). Likewise, According to Y. P. Venieries and F.P. Sesold remark: "Inflation is a sustained tendency for the general level of prices to rise over time" (Joshi, Shyam, 2003). According to this definition, there are three features of inflation:

-) Inflation is the real increase in price, which may be called open inflation.
-) Inflation is not a minor or temporary fluctuation in price, but is a sustained and appreciable increase in prices.
-) Inflation means the increase in general price level, not the increase in individual prices.

4.2.3 Foreign Employment and Remittances

As the output of migratory movement, foreign employment is the engagement in income generating job in the country of which the worker is not the national. A decent employment in the foreign job market calls for ensuring the rights of migrant workers, advancement in job, social protection and worker-friendly environment, safe return and reintegration. As the strategic dimension, foreign employment expands and diversifies the job markets, develops skilled human resources, uses migration as vehicle for acquiring new skills and know-how, and strengthens the economic diplomacy. In its developmental dimension, it reduces the consequences of unemployment, generates greater foreign exchange earnings through remittances, increases the rate of savings and increases the social returns on investments in human resource development. Underscoring its social dimension, it is more concerned with ensuring the decent employment and healthy social well being.

As a labour sending country, Nepal is in line to promote labour migration for two basic reasons comprising of domestic unemployment pressures and earning of foreign exchange in the form of remittances. As a major contributing source of remittance, migration for foreign employment and meeting the aspirations of under educated and educated workers for higher wages. It is estimated that above half a million Nepalese workers are working abroad as documented migrant workers. But the estimated total number of Nepalese workers is more than a million including the undocumented migrant workers.

Remittances by international migrants to their home countries have grown dramatically in recent years. They are now the largest source of external finance for developing nations after foreign direct investment (FDI). For many countries, remittances are larger than FDI, and in some cases, larger even than official development aid.

Nepal, to a large degree, depends on remittances to sustain its economy. Remittances have sustained the present day Nepalese family budget, paying for schools fees, debt payments, and daily household needs. They appear to be part of a livelihood and poverty reducing strategy at the individual and household level. As the rise in the inflow of remittances is the upshot of the increase in the outflow of mainly semi-

skilled and unskilled workers who come from poor households, the money they send back has positive impact on the living standards of the families left behind.

Various mechanisms have been employed by the Nepalese workers in sending money back home. For example, earlier, there was growing interest in the relative performance of informal channels such as the hundi system of money transfer that normally lie outside the formal and regulated banking sector, and cost half or less than formal banking with respect to commission. However, this has changed and there is considerable interest among policy makers in drawing more remittances into formal, regulated, channels.

4.3 Data Presentation and Analysis

Table 4.1
Selected External Sector Indicators of Nepal

(In Us \$ Million)

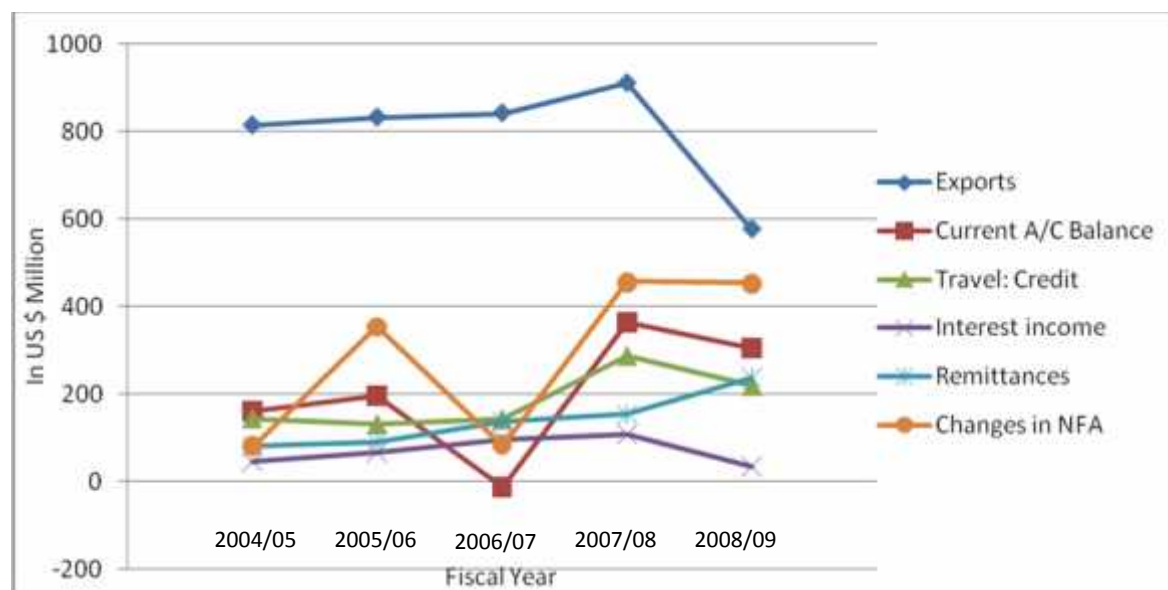
Indicators/Fiscal Year	2004/05	2005/06	2006/07	2007/08	2008/09*
Exports	814.68	832.88	842.43	911.51	576.47
Of which; overseas	274.62	269.90	250.45	318.53	228.73
Current A/C Balance	160.21	196.70	-12.80	364.20	304.42
Travel: Credit	145.21	132.13	143.64	286.88	218.96
Income: Credit	1,710.64	2,175.02	2,553.09	3,643.91	1,949.84
O/W ¹ , Interest income	45.58	66.58	97.50	108.15	35.01
Remittances	81.31	90.62	138.59	154.01	238.17
Changes in NFA ²	79.68	353.95	83.76	456.39	453.02
Gross Forex ³ Reserves	1,802.61	2,281.98	2,342.54	3,270.13	3,643.94
Prd. ⁴ end Exchange Rate	72.06	72.32	70.49	65.02	76.84

Source: *Economic Survey Fiscal Year 2008/09*

* *First Eight Months (Provisional)*

1. of which 2. Net Foreign Assets 3. Foreign Exchange reserves 4. Period

Figure 4.1
Selected External Sector Indicators of Nepal



4.3.1 The Impact on Balance of Payments (BOP)

Comparison of selected external sector indicators for Fiscal Year (FY) 2004/05, 2005/06, 2006/07, 2007/08, 2008/09; show that the period-end exchange rate of Nepali rupee vis-a-vis US Dollar appreciated by 0.36 percent in FY 2005/06, depreciated by 2.53 and 7.76 percentage in Fiscal Years (FYs) 2006/07 and 2007/08 respectively and in FY 2008/09 it is again increased by 18.18 percentage. Consequently the current account balance as well seems fluctuating as dropped to a negative of \$12.80 million in FY 2006/07 from a surplus of 160.21 million and 196.70 million in FY 2004/05 and FY 2005/06 respectively and again increased to 364.20 in FY 2006/07 and decreased to 304.42 in FY 2008/09. It was mainly a reflection of a steady increase in remittances from USD 81.31 million in FY 2004/05 to 238.17 in FY 2008/09. Following the crisis, characterized by liquidity crunch and a sharp contraction in consumer demand in the advanced countries, one would expect a fall in export, tourism receipts, and remittances which has been true as shown in the table and figure and ultimately Nepal would be affected by the crisis.

One interesting reading from the table is that, the gross foreign exchange reserve of the Nepalese banking system in USD term increases by 26.59 percent to US \$2.2 billion in FY 2005/06, and further up by 2.65 percent, 39.60 percent, and 10.26 percent to 2.3 billion, 3.2 billion, and 3.6 billion in FYs 2006/07, 2007/08 and

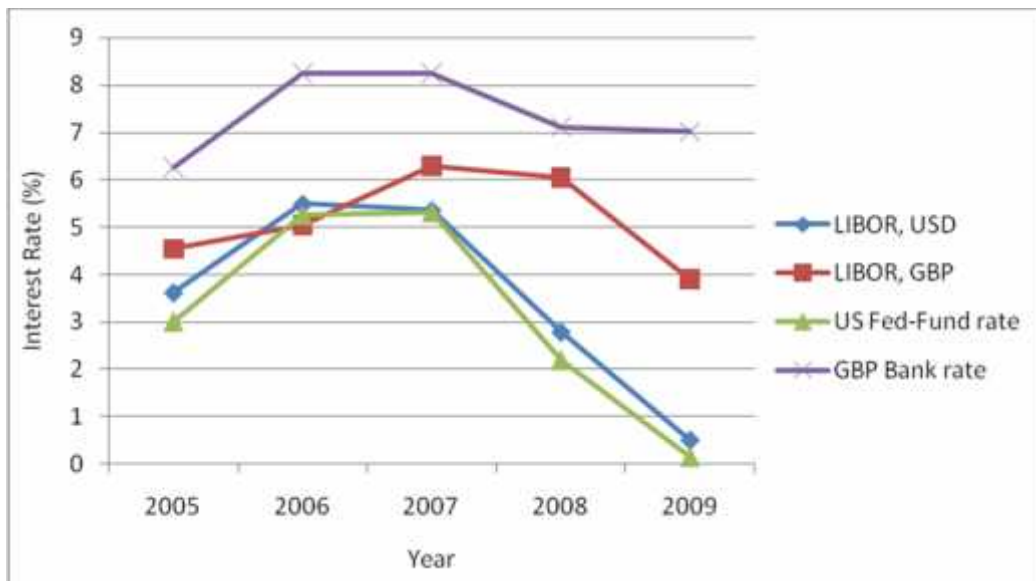
2008/09 respectively. Whereas interest income increases by 46.07 percent to US Dollar 66.58 million in FY 2005/06, 46.44 percent to US Dollar 97.5 in FY 2006/07, 10.92 percent to US Dollar 108.15 in FY 2007/08 and decreases by 67.95 percent to US Dollar 35.01 in FY 2008/09. This means that placement of additional foreign exchange reserves in interest bearing instruments failed to generate additional returns. This is an outcome of a fall in the interest rate in the countries where Nepal invests its foreign exchange reserves; both factors are the consequences of the global meltdown. The exchange rate depreciated in line with depreciation of the Indian rupee following the massive withdrawal by foreign institutional investors (FIIs) from Indian capital market in the immediate aftermath of the crisis, particularly by big US investment banks such as Lehman Brothers and Merrill Lynch. On the one hand, FIIs were withdrawing from their investment in the Indian Capital market and on the other, India is also facing increased cost of borrowing because of risk aversion, deleveraging and frozen money market in the advanced creditor countries. These developments resulted in the depreciation of Indian currency, given fixed peg the Nepali rupee too depreciated by the same magnitude. Another cause behind first decline and then stagnation of the Nepalese investment income is the fall in the global interest rate, again a reflection of the crisis. Following table presents the global interest rate development.

Table 4.2
Global Interest Rates (Percent/Year)

Instrument	Mid- July 2005	Mid- July 2006	Mid- July 2007	Mid- July 2008	Mid- July 2009
LIBOR, USD	3.62	5.49	5.36	2.79	0.51
LIBOR, GBP	4.55	5.05	6.3	6.05	3.91
US Fed-Fund rate	3.00	5.25	5.31	2.19	0.15
GBP Bank rate	6.25	8.25	8.25	7.11	7.01

Source: Bloomberg.net (2009)

Figure 4.2
Global Interest Rates



It is clear that there has been a steep decline in both the market and the policy rates. For example, the LIBOR USD is decreasing up to 0.51 percent in Mid-July 2009 from Mid-July 2006 except increase to 5.49 percent from 3.62 percent in Mid-July 2005. Similarly, even though GBP LIBOR is in increasing trend from Mid-July 2005 to Mid-July 2007, it is dropped to 3.91 percent in Mid-July 2009 from 6.05 percent in Mid-July 2008 which was also decrease from 6.3 percent from Mid-July 2007. The drop in policy rate is far more drastic than the market rates. This table is just an illustration of falling interest rate in US and UK. Similar trend is observable for Euro, Japanese Yen, Swiss Franc, Canadian and Australian Dollars. Thus, the foregone interest income that Nepal lost through sharp fall in global interest rate is the direct impact of the crisis. This is one of the reasons why net foreign assets of Nepal fluctuating as shown in table 1.

4.3.2 The Impact on Inflation

The crisis may have both positive and negative impact on inflation. On the positive side, the price of oil has dropped from a peak of \$145 per barrel to around \$50 should contribute favourably to ease the inflationary pressure. The fall in oil price is also accompanied by global fall in food prices and in the prices of construction materials. On the negative side, depreciating exchange rate puts upward pressure on inflation

through imports. Another channel through which crisis affects inflation is the expectation effects. Notwithstanding the virtue of low inflation, if policy measures fail to revive consumer and investors' confidence in the US, Europe and the emerging countries, the net effect for Nepal will be negative.

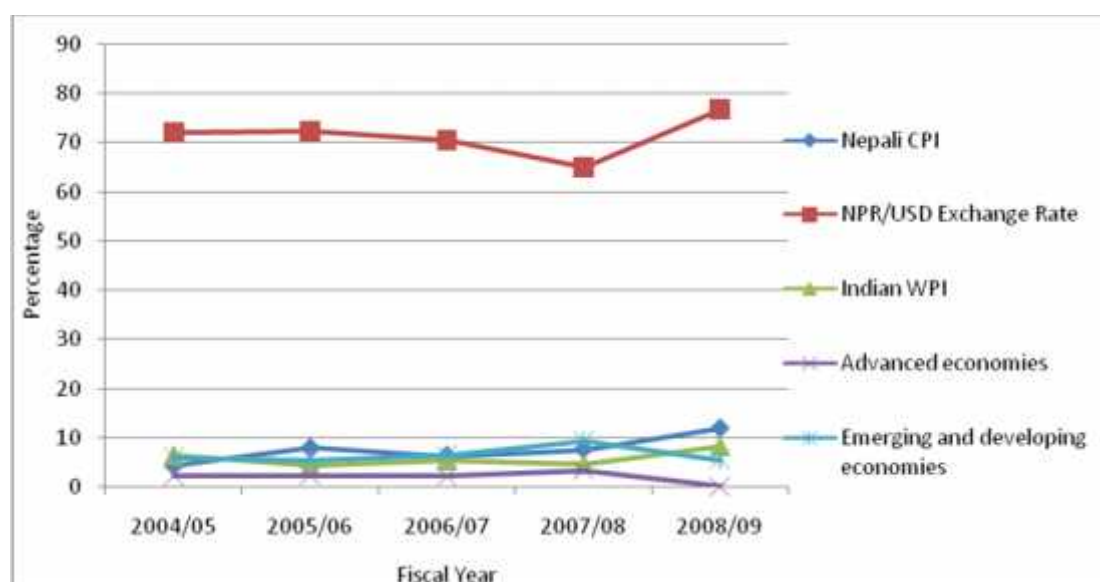
Table 4.3
Comparison of Global, Indian and Nepalese Inflation

(in %)

Fiscal-Year	2004/05	2005/06	2006/07	2007/08	2008/09
Nepali CPI	4.5	8.0	6.4	7.7	12.0
NPR/USD Exchange Rate	72.06	72.32	70.49	65.02	76.84
Indian WPI	6.48	4.38	5.42	4.75	8.34
World CPI (annual)					
Advanced economies	2.3	2.4	2.2	3.4	0.1
Emerging and developing economies	5.9	5.6	6.4	9.3	5.5

Source: 1. Economic Survey Fiscal Year 2008/09, 2. Reserve Bank of India, and 3. Economic and Financial Survey 2009, International Monetary Fund.

Figure 4.3
Comparative Inflation



In the table, Nepal's and world inflation is measured in terms of consumer price index (CPI), and Indian inflation is measured in terms of the wholesale price index (WPI).

As shown in the table and figure all CPI and Indian WPI seem fluctuating. Except 1.98 percentage lower CPI of FY in 2004/05 Nepal's CPI exceeded Indian WPI by 3.62, 0.98, 2.95, & 3.66 percentages respectively in FYs 2005/06, 2006/07, 2007/08, & 2008/09. This is as expected and normal, because CPI inflation generally exceeds WPI inflation, and there is a time lag in the transmission of Indian WPI inflation to Nepal's CPI inflation. But they vary by a huge magnitude in FY 2005/06 and 2008/09. The gap in the in FY 2005/06 and FY 2008/09 rate of inflation between Nepal and India is very wide (3.62 and 3.66 percentage). One of the reasons, for such deviations could be a sharp depreciation of the Nepali currency vis-a-vis US Dollar. But, Nepal's exchange rate with Dollar is the mirror image of Indian rupee's exchange rate with the dollar. If exchange rate depreciation pushed up the pace of inflation, then Indian WPI should also have gone up by the same magnitude as in Nepal. Furthermore, Nepal's exchange rate with Indian rupee has remained stable for last 17 years. Furthermore, Nepal maintains open border with India and India is Nepal's largest trading partner. The huge deviation of Nepal's inflation from India's in FY 2005/06 and 2008/09; despite Nepal's trade concentration with India and long stability in the nominal exchange rate between the two currencies; is a perplexing issue. There could be two reasons behind this huge deviation between Nepali and Indian inflation. One could be India's strong network of public distribution system with regulated and administered prices; compared to Nepal's lax regulation and absence of well functioning public distribution system. Another reason could be supply bottleneck in Nepal resulting from power cut, worsening industrial relations resulting in strikes and closure of business and frequent blockading of roads as well as cartelling and syndication. Still other reason could be hoarding, artificial shortage and black marketing in Nepal. In any way, Nepal's current high inflation is not the only outcome of global crisis. It is more a reflection of domestic factors, rather than global.

4.3.3 The impact on Employment and Remittance

There are two channels through which the current crisis can affect employment opportunity for Nepali work force. The first is the employment prospect of blue color workers particularly in oil producing Arab countries and in Malaysia. The fall in oil prices may dampen the investment demand in these countries until the oil price revives to a higher level. This will compress the demand for low skill work force. The remittance data (table 1 above) however, has dispelled this apprehension.

Nevertheless, the prospect definitely warrants caution. The second channel is the fear of lay off in export oriented industries of Nepal. Recession has considerably dampened consumer confidence in the western countries. In such scenario, one normally expects a fall in exports, which adds to the domestic unemployment and until the situation does not normalize, foreign employment may face set back. The worrisome situation is the fall in oil prices. Notwithstanding, a positive contribution to inflation, if falling oil prices continues to persist in days ahead, it will result in contraction of demand for Nepali workers in Arab countries. The resultant loss in remittances would offset the gain from lower inflation. If the Nepali work force returns from these countries, it may result into a horrible socio economic disruption by fuelling already high magnitude of unemployment and under employment. Given fragile political transition, the addition of millions to the existing stock of unemployed may disrupt the fragile peace building process that is currently under way in Nepal. In case of Nepal, domestic employment situation is getting worse day by day. Domestic factors such as power cuts, labour unrest, security situation in Terai, and supply bottleneck present a bleak investment and thereby worsening employment scenario within Nepal itself.

4.3.4 Miscellaneous Impacts

) The impact on Debt Servicing

Regarding foreign debt servicing, exchange rate volatility and uncertainty makes debt servicing plan and projection complex. The current crisis resulted in a sharp depreciation of the Nepalese Rupee. This definitely adds to debt servicing amount. For example, FY 2008/09 budget has allocated an amount of Rs. 9770.4 million for repayment of principal and interest obligations. At the July, 2008 exchange rate of Rs. 69 dollar, it works out to USD 141.6 million. Thus, a rupee equivalent of depreciation will add Rs. 144.6 million. Assuming in 2009 exchange rate will average Rs. 75; to a dollar; the additional burden would work out to Rs. 850 million. One should also add to it the additional burden to Nepal Electricity authority for complying with power purchase agreement in US dollar. Furthermore, depreciating exchange rate will also add to cost of new project construction and repair of the old ones, as almost all of the equipment, machineries and materials are imported. One may argue that continuous depreciation in exchange rate adds to external debt servicing burden, it also increases revenue by increasing the rupee value of import. This is true. But, should the strategy

be to encourage imports to augment revenue? The answer is no, for following two reasons: One, customs revenue does not come in Dollar. It comes in rupee, whereas debt should be repaid in foreign currency. The another important reason is the focus of development strategy should be to make export competitive and to strengthen domestic demand by increasing employment opportunities to the poor, disadvantaged unemployed and under employed particularly in the rural area. It needs additional imports of raw materials and intermediate as well as capital goods. Depreciation would only escalate the cost of investment for producing the same number of unit of physical output. Thus positive revenue implication of depreciation will be outweighed by the negative consequence of increased incremental capital output ratio (ICOR).

) Impact on Health

The global financial crisis has threatened the sustainability of health service delivery largely in the less developed countries and on the health of urban poor. The cuts in social spending – health, education and social protection – can severely damage health, development, security and prosperity. Global Statistics reveals richest countries spend on an average over US\$ 3000 per person per year compared to \$30 in poor countries and even this amount is contributed by external finance. The rich countries thus spend 8-10 percent of their national income on health.

) Impact on Human Development

The development challenge of global recession is to give continuity to achieve the Millennium Development Goals (MDGs). There is a greater probability that financial crisis will limit the possibility of global commitment to allocate US\$ 16 billion to accelerate the realization of MDGs by fighting poverty and hunger in resource poor countries. The obstruction to maintain progress towards this end would mean to accept failure in generating employment, restoring growth, accessing basic service delivery especially in healthcare and education to the poor and vulnerable.

Shaohua Chen and Martin Ravallion estimate that the crisis will add 64 million people to the population living under \$2 a day. The “Global Monitoring Report 2009: A Development Emergency” by the World Bank estimates that up to 90 million extra people worldwide (62 million in Asia) will live in extreme income poverty with less

than US\$ 1.25 per day in 2009. Since current crisis has a multiplier effect on the physical quality of life, this crisis seems affecting the lives beyond our quantitative exercise.

) Impact on Security

Security has different dimensions. Recent study shows nearly three-quarters of security professionals think the recession has significant impact on their purchasing of technology. The same result shows a further 72 per cent of IT security professionals said their budgets had been reduced in the past seven months due to the downturn.

The crisis has also shown the impact on national social protection systems. It has weakened the prospect of shaping social policies that promote economic and social stability. Some already suspect that there will be a severe impact on certain types of pension schemes. Effective government guarantees for social protection is going to be extremely difficult.

) Impact on Prosperity

Prosperity is linked to the ability to deliver basic standards of living and well-being in the developing countries. The authors in Sustainable Development Commission in UK believe, their “debt-driven consumption has created an unstable system which has put jobs and livelihoods at risk, as well as damaging them psychologically and socially”. The experts argue that the desire for economic growth has contributed to growing environmental crisis by undermining well-being in developed countries and therefore, it is one of the root causes of the current financial crisis. As the challenge is to reduce the shocks and negative impacts from excessive reliance on growth by switching over to fair, sustainable, low-carbon economy, it is now time to initiate intellectual discourse to find out the answer if prosperity without growth is possible.

) Other Impacts of the Crisis Are

- Bleak employment and; school admission, grant, and scholarship opportunities for Nepalese national and students currently residing in advanced countries and those who are planning to go there.
- Lower expectation of official development assistance from advanced countries.

- There is also a silver lining. When rate of return on investment is falling, and investors are shying away from investing in advanced countries, if the government of Nepal is smart enough, they can be invited to invest in Nepal. This applies to both FDI and NRN. What this calls for is the confidence of foreign investors. We are already late in this direction as this will require series of policy and structural reforms.

4.4 Major Findings of the Study

The empirical observations up to the period of FY 2008/09 suggest that there has been no let up in the number of Nepalese students emigrating for higher studies abroad. On the contrary there has been an increase in their number. Similar is the case for those applying for settlement and work abroad. Similarly, there has not been any drop in committed official development assistance (ODA) from both bilateral and multilateral sources. This however, does not leave room for complacency. If the crisis persists and deepens further for long, the ODA may suffer. So far, tourism earning has not dropped. But again if crisis prolongs, this may suffer too. Thus, continuation of the crisis for a longer period if associated with falling oil prices, Nepal will lose its remittances, merchandise exports and ODA. If all these developments come together, the situation would be very worse, every Nepali will suffer, but poor will suffer most. We saw from table 1 above that Nepal's BOP scenario remains robust. The remittances, exports and tourism have so far escaped from the crisis. But, despite increased foreign exchange reserves, a net foreign asset is fluctuating and global interest rate is falling which is the direct outcome of the crisis (table 2). It is the time that Nepal should seriously review investment strategy of its foreign exchange reserves. Till now major placement is in US Dollar, the result was a drastic fall in interest income. The authority should also explore the viability of investing a part of its reserves within SAARC and other countries with stronger economic fundamentals.

Despite the above facts findings from this study can be pointed as follows:

-) Following the crisis, characterized by liquidity crunch and a sharp contraction in consumer demand in the advanced countries, one would expect a fall in export, tourism receipts, and remittances which has been true as shown in the table and figure and ultimately Nepal would be affected by the crisis.

- J Placement of additional foreign exchange reserves in interest bearing instruments failed to generate additional returns. This is outcome of a fall in the interest rate in the countries where Nepal invests its foreign exchange reserves; both factors are the consequences of the global meltdown.
- J The foregone interest income that Nepal lost through sharp fall in global interest rate is the direct impact of the crisis. This is one of the reasons why net foreign assets of Nepal fluctuating as shown in table 1.
- J Nepal's' current high inflation is not the only outcome of global crisis. It is more a reflection of domestic factors, rather than global.
- J Fall in oil prices will result in contraction of demand for Nepalese workers in Arab countries. The resultant loss in remittances would offset the gain from lower inflation. If the Nepalese work force returns from these countries, it may result into a horrible socio-economic disruption by fuelling already high magnitude of unemployment and under employment.
- J Continuous depreciation of exchange rate adds to external debt servicing burden, it also increases revenue by increasing the rupee value of import. This is true. But, should the strategy be to encourage imports to augment revenue? The answer is no, for following two reasons; One, customs revenue does not come in dollar. It comes in rupee, whereas debt should be repaid in foreign currency. The another important reason is the focus of development strategy should be to make export competitive and to strengthen domestic demand by increasing employment opportunities to the poor, disadvantaged unemployed and under employed particularly in the rural area.
- J The global financial crisis has threatened the sustainability of health service delivery largely in the less developed countries and on the health of urban poor.
- J The financial crisis will limit the possibility of global commitment to allocate the funds to accelerate the realization of Millennium development goals by fighting poverty and hunger in resource poor countries.

- J Effective government guarantees for social protection is going to be extremely difficult due to reduction on security budget.

- J The desire for economic growth has contributed to growing environmental crisis by undermining well-being in developed countries and therefore, it is one of the root causes of the financial crisis.

CHAPTER - V

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Summary

The current crisis is an important event in the economic history of the world. This event has been generating political, sociological and economic debate. However, confines to draw lessons from economic stand point. The first lesson is that we live not in a Robinson Crusoe's but in a globalized economy where development in one place affects all over the world directly or indirectly. What this calls for is the need for every country of an institution which can closely monitor the global economic/financial developments and timely warn the national authorities for precaution. Financial institutions are considered as backbone of the US economy which now many believe is in the verge of collapse. There was a general belief that the self-interest of lending institutions would automatically protect shareholders' equity and that market left on its own has in-built self correcting mechanisms. But in this crisis, the financial markets failed to work, rather contagion crossed the US border and affected financial institutions in other countries which have a big exposure to US sub-prime based mortgage securities in expectation of windfall profits.

The current experience suggests that given market imperfection characterized by asymmetric information, adverse selection and moral hazard; the market on its own is not self correcting. Therefore, for all the markets in general and for accountable oversight, regulation, supervision, and disclosure requirement, this new experience suggests that the pace of reform needs to be regulated by the decision makers. Regulators and policy makers have to think of reform in term of benefits that will accrue not only to the well off and fraudulent speculators but also to the small investors and household depositors. Another lesson is that bailing out, rather than punishing the Chief Executive Officers (CEOs) and Chief Financial Officers (CFOs) who earned billions at the cost and misery of the common people all over the world may result in moral hazard and set bad precedence.

The central bank and all the public policy makers and regulators have been found to be focusing their attention only on the consumer and wholesale inflation. The

undergoing financial crisis has taught us that as the economy advances financially, asset prices (the price movement of real estate, stocks, and bond debts) are more important; hence movement in asset prices should also be made the policy target. For economies like Nepal which is in its early stage of modernization, the central bank, the government and the media needs to constantly monitor the asset portfolio of banks and financial institutions, particularly to real estate, stock market and consumer lending. Those who play on public money need to be closely monitored, and the management and the board who are found to be involved in reckless lending practices should be made personally liable for any loss they can inflict on the owners of the money that they play with. The bailout has been an example of privatizing gains and socializing or nationalizing losses. This should teach us a lesson that such perverse situation does not recur in future. This means that designing complex products like CDOs and CDSs should be subject to prior public approval. What is surprising is that the crisis originated in countries that are advanced, highly literate and have access to varieties of information including on the financial developments. If people in US, UK, Switzerland, and Germany can be cheated, there is apprehension that the mass of illiterate and uninformed Nepali people can easily be cheated. What this calls for is the need for financial education financed by the resources made by huge profit making financial institutions. Still another lesson is that dependence of the global economy into a single economy entails risk. This lesson may contribute to lessening of the over dependence of the global economy on the US economy.

Since the late 1970s, and more particularly since the 1980s and 1990s, there had been a paradigm shift in economic development strategy. The shift suggested too much emphasis on export led industrialization. This strategy worked for east, and south East Asian countries and recently for Indo-Chinese countries, in particular, Vietnam. These are the countries which are worst effected from the current crisis, and are planning to encourage domestic demand. In the same vein, as consumerism as a mode of life provided the initial basis for eruption of the crisis, unbridled consumerism fuelled by unsustainable fiscal deficits needs to be monitored. Similarly, the current crisis also teaches us the virtue of enhancing domestic savings. Thus, while planning growth strategy for Nepal, the policy makers should take this lesson in the back of their mind.

Finally, people are also raising philosophical question of whether finance and money should be means to some other ends or are an ultimate end in themselves. This question is worth pondering as the current crisis emerged not from the real but from malfunctioning of the financial sector. The economic and political policy makers need to deeply reflect on the role the finance needs to play vis-à-vis the rest of the economy, particularly to the real economy.

5.2 Conclusion

Western industrialized countries in particular and rapidly globalizing emerging economies in particular suffered from the worst economic crisis after the great depression in the 1930s. However, there is a vast difference in the approach of resolving the crisis. The 1930s crisis was resolved by labour and popular movements shifting the burden of crisis onto capital through mechanisms such as social wage contract, collective bargaining and workers' rights, national unemployment and insurance relief and social security. The 1980s crisis, on the contrary, was resolved by shifting the burden onto working class by aggressive tax policies, financialization and construction of global debt regime. The response to current crisis is more akin to the 1980s than the 1930s. The current crisis surfaced in liquidity and credit crunch. The root cause of the crisis was injecting enormous amount of liquidity into lending and speculation. In expectation of profit, financial institutions and Wall Street companies created complicated derivatives. The lax monetary policy resulted in historically low interest rate. Regulation and supervision of financial institutions was very lax. This encouraged banks to take risk. This stressed the banking system. Losses mounted. There was severe erosion in banks capital which ultimately resulted in bank failures. Consequently banks, even with good portfolio, refused to lend despite liquidity assurance form governments and the central banks. The whole processes were assisted by legal backups, which eliminated the scope of operation of various categories of banks. This encouraged excessive risk taking. From 1970s onwards, the post-war empire based on credit turned into an empire based on debt. Governments, central banks, and influential multilateral donors that had been preaching the gospel and virtue of downsizing and right sizing the government poured in billions of Dollar in rescuing the fraudulent banks with tax payers' money.

The paper also attempted to look into the impact of crisis in Nepal. As there is capital control in Nepal, apparently there is no direct transmission of the impact. However, some impacts occur through trade and exchange rate channel. Rupee depreciated following depreciation of the Indian rupee, which depreciated after withdrawal of investment by FIIs, and worsening expectation of foreign investment. The depreciated exchange rate definitely adds to the external debt servicing burden. Another direct impact, amounting to approximately \$68 million per year, was the fall in interest income to Nepal, as a consequence of fall in interest rate in US and Europe. One would also expect a fall in earning from remittances, export, tourism and ODA. But data until November, 2007 dispel this apprehension. On the contrary, receipts from these sources have in fact increased satisfactorily. The crisis is deepening, and may stretch few more years. The persistence or further deepening may adversely feed into various aspects of the Nepali economy primarily through the BOP channel. There is no room for complacency. The authorities should remain alert on the fiscal front, supplemented by monetary measures, if necessary.

The crisis has taught us all that financial system should be well regulated and supervised. The managers and executives of the banks should be closely monitored by the government on behalf of the depositors and shareholders. It has also taught that one size does not fit all. Dependence, whether in terms of exports or investment is very risky, is another important lesson. The crisis has also taught us the benefits of diversification in exports, investment, tourism and employment of its workers across countries.

5.3 Recommendations

Continuously dwindling figures and plummeting graphs belied the presumption that Obama, successor of the Oval Office would help stop the ongoing excessive bleeding in the world economy. Surprisingly, the wound appeared deeper in the Euro zone than in the epicenter of the crisis, the USA, where the sub-prime effects had first hit. According to recent revelations by the International Monetary Fund, the European economy in 2009 would contract by two percent, the US by 1.6 percent and overall global growth would however around 0 to 0.5 percent, the lowest after the Great War II.

Meanwhile, the International Labour Organization has predicted that year 2009 would see some 50 million job cuts world over. Our own remittance-sustained economy has started to feel the pinch along with the countries like Malaysia that has announced the termination of new recruitments of foreign labourers and kept them at the first row of lay-offs.

Labour-exporting economies like Nepal, Thailand, Philippines, Bangladesh, India, Pakistan, Sri Lanka, Vietnam etc. in Asia and several South American economies like that of Mexico, Chile, Bolivia and others are also likely to face severe balance of payment situation due to drastically reduced rate of remittance returns.

Given the pervasiveness and magnitude of the problem, new US President Obama's 825 billion dollar stimulus package will make very little impact to turn around the situation, even if, unlike Bush's US\$ 700 billion, he spends it all and spends for the right cause.

Apparently, stimulus packages and instant bailouts are not the long-term solution of the financial disaster of this kind. First, focus must be diverted to diagnose the problem and, then only prescribe solutions, whatever they may be. It would be cynical to think that the world leaders are as clueless as generally thought, but their preferences of window-dressing over diagnostic solutions manifest lack of determined political will and well-devised action plans. Such plans have to not only avert the current crisis but forestall the chances of its reoccurrences in the future. To protect the global financial architecture and make it more predictable for the future investors, there is but no alternative to the following reviews and redresses:

) Review risk-weighting patterns against the wealth created through Stock Markets

The Secondary market has started to pose as the mainstay of every monetized economy. This is the first danger. Along with the over-speculated transactions of share certificates through the exchange, estimation of the real worth of any company has practically become impossible. As is the case, apart from the book value any particular company received from IPO, the added value on the price of the shares by stock trading never enters into the company coffers. In addition, rights and bonus

shares without additional cash injection. But the bet worth of the company is computed on the basis of market price of per unit share at particular point of time.

Unlike manufacturing and other service industries, this practice makes the business of bank and financial institutions (BFI) highly vulnerable. It is because, the investment limit of any BFI is, generally, linked to its combined strength of net worth and deposits. In this scenario, BFIs are allowed to lend exceedingly larger amount than their real worth and risk-bearing capacity. If the share price drops, even without any convincing reason, the net value of the company (which in fact was never with it but was with the member of the public with share certificate) momentarily plummets; leaving it instantly cash-starved.

Also, the deals made in share transactions have proved impossible to keep under the regulatory purview as 'insider trading', manipulation by a handful of players and, lately, (mis)use of media to overstate the company's health and swing the price according to the vested interests of influential trades have become open secret. Therefore, the oversight authorities should introduce new regulations so as to calculate net worth of BFIs under new framework, revisit the system of setting investment benchmarks against the quantum of risk and real value of the investor and to bring all transactions under legal lens.

) Put to an end to anti-free market practices like Bailouts

The hasty decisions like that of US and several other governments to bailout mainly the troubled financial institutions are the most unfortunate development in the light of the nature of present crisis. It will only open the Pandora's Box encouraging more and more companies to announce bankruptcy and the government, any government for that matter, can neither remain biased to particular sector in supporting revival nor could it manage enough resources to meet all demands. The BFIs must be supported, but such support must come in the form of monetary policy instruments. In the same way, the manufacturing and other sectors might be supported by policy options like marginal subsidies, rebate or tax holiday and product-based incentives-not the outright liquid cash to the manufacturers.

Some, even big, BFIs and other companies unable to compete may collapse. They must be smaller but efficient, will emerge, and grow in future. This is the rule of the game – the basic norm for competition in the capitalism. Of course, the governments must have rescue and contingency plans in place to ameliorate the hardship of common man emanated as the aftereffects of such collapses. But, it is important to note here that the ultimate right point which public coffers should be opened for the revival of the economy is after a series of collapses of unsustainably managed corporate structures; invariably for faster profit earnings than they actually deserved.

) Reducing the repayment range of investment to Logical Limits

The crisis like the sub-prime, among other factors, are the result of imprudent consumer financing. The indolent and unscrupulous lenders, instead of exploring new markets, concentrate in urban areas and compete for longer periods of repayment at less interest rate than other player in the market. Lending for a period of thirty to fifty years, which now has become a common practice, is absolutely amateurish proposition. During such a long time, a lot of changes in technology, social, political and economic fronts and, natural and demographic set ups are sure to take place. For example, before two decades, nobody had thought that cyberspace and microchips would hold such a huge business potential and entrepreneurs related to this high-tech world would become billionaires. Similarly, if a bank invests heavily now in fossil fuel project with repayment range of, say, next fifty years, in all likelihood, it is sure to be doomed once the alternative fuels replace the fossil fuels. But it could still be wise decision to lend for a decade.

These periodic shifts in the very nature of economic activities also alter the earning of borrowers with particular skills, which in turn will have bearing on the repayment schedules of the borrowings. The point here is: there must be rethinking on the current term-lending practices. Except in large infrastructure projects, consumer financing for unforeseeable periods are always prone to leave the lenders' future in peril.

) Rationalize the expansion of Service Sector

Like the manufacturing sector, service sector is equally important to any economy, Many economists also argue, larger the service sector proportionately, the more

developed the economy is. The link between the producers and the end users of any product is possible only by means of services-transport, communication or marketing. But for some products, like the financial products, 'service sector' of unnecessarily swollen proportion has emerged between the product and the user. The intermediary services like the aftermarket and derivative market, investment banking, hedge funds and mortgage managers are on the one hand impeding the direct communication between actual buyers and sellers of the financial services and, often from their unethical greed for money.

Banks, financial institutions and insurance companies themselves are service providers. Therefore, their expansion should be capacity and new practices should be introduced to reduce the role of the secondary services provides like facilitators, mediators, intermediaries and brokers, as far as possible. The enforcement of KYC (know your customer-customer as the end user) rules by BFIs would solve a larger chunk of the problem.

) Focus on Financial Education

The underlying importance of financial education had never been realized so intently before the outburst of the present crisis. It is urgent and necessary for all levels-from decision-makers, service producers and providers and users and public at large. To simplify, a four-tier financial education and awareness programs could be appropriate, not only to help rescue the world from present downturn but also for a continuous understanding of developments in this sector.

First, such education is required at the leadership level. It is interesting paradox that political leadership in all developed countries and international institutions like The World Bank and International Monetary Fund, except for a very few exception, is not trained to understand the minute intricacies of the financial as well as economic systems; and the people who are better versed have no access to decision making. This is the reason why the policies are formulated just as reaction to crisis. In many cases like in derivative market, the regulations are never able to catch-up the arbitrage.

Second, the providers and users of the financial services in the financial services in the developed world must be trained to stop overuse of the services. Many BFIs try to push their products to limited clientele. Normally in a certain time period, undiversified investment bandwagon is followed by investors, posing a question on the existence of creative faculty in the brains of so exorbitantly paid executives of the financial world. Investment in residential properties was one of such investment bandwagons that caused sub-prime disaster. Similarly, one carries a dozen cash cards in wallet, as a clear sign of overuse, and trend of misusing them by family and kids is growing at alarming level.

Third, considering the fact that more than half of the world population is completely deprived of access to any form of formal financial services, a different sort of awareness schemes to sensitize them to use the simplest products like deposits, borrowings and insurance are also equally necessary-to integrate these people in the monetization processes of economies. It will help the BFIs now competing for the same piece of pie in the urban areas to diversify and expand their services to newer clients. The expanded operation networks help reduce the risk and contribute to more balanced growth of economies; with built-in better shock-absorption capabilities.

Fourth, it has become extremely important to train the mass media on financial reporting. Despite so much of combined potential of Television, newswires, news portals, radio and newspapers. To steer the crisis towards resolution with informed, well investigated and analyzed, timely and correct version of the news, the world media largely acted more as a havoc-creator than the informer. Only basis of their reporting appeared to be stock market, not the real sector. It grossly failed to report even the simplest factors like where the aftermarket was distorted and where the oversight authorities overlooked and failed.

This clearly demonstrated either lack of properly trained manpower even in the leading corporate media or their lack of will to dig out and serve the real stories about the mammoth scale of world's financial architecture.

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