

e-Seminar Title: Nepal PSD

Subject: Hydropower, Prospects for PSD, and Federal Structure – Summary of February 27, 2007 Deliberations

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Mallika Shakya:

(During February 26 deliberations) AmbikaJi suggested that local/regional investors better adapt to demands at lower prices but cannot influence the Indian giant, while larger FDI are worse in former and better in latter. But need this impose a policy trade off for Nepal? Can we not have the good of both the worlds? Let's develop a hypothetical model where a hydropower project is divided into three clear components: A. infrastructure and connectivity; B. core power generation; C. international/regional mediation for market. Components A and C are clearly public goods while B is private.

An efficient and competitive PPP (this could be a restructured NEA or a different institution) can manage component A (with some donor funding). Component B should be private -- the choice between local, regional and international investment -- will be decided by pure competition (bidding prices + environmental/social CBA). Component C can be headed by the PPP but subcontracted to a top-notch private business strategy MNC that can bring business leaders from India on board.

Whether or not local capital is better than FDI should be left to the market on purely commercial products. The State should have a role on public goods. This will not only increase the number of private bidders but also will bring down the total costs substantially.

Whether India is interested or not on Nepali hydropower should be concluded only after we have tried the Indian private sector. Nepal is probably not capable enough (yet) to tackle the Indian businessmen, but there are many brokers in the international market that can do this job for fees. All this only emphasizes the need for a better business enabling environment and investment climate, which is the State's responsibility.

I very much agree with AmbikaJi about increasing local demand for power. This may even make Component C redundant. To encourage local absorption of hydropower, it is imperative that the hydro strategy doesn't stand in isolation but is closely linked with SME development strategy. The ongoing safa tempo strike in Kathmandu to protest the power cut reminds us of the direct connection here.

There are other connections that have gone unnoticed. When the Garment Association of Nepal was lobbying in the US Senate for a duty-free access to US for readymade garments after the concessional multi-fibre-agreement (MFA) ended in 2004, one of the

biggest hurdles it faced was from Panda Energy Group and its political contacts in DC.

Keshav Acharya, Chief Economic Advisor, Nepal Rastra Bank (currently working at the IMF)

1. Nepal's economy holds tremendous potential in the long run, among others, in bio-diversity, hydro-electricity and tourism.
2. For any meaningful, comprehensive and sustainable transformation of the Nepali economy, one should begin from agriculture where nearly 21 of the 28 million Nepali people depend for their livelihood. In the last 10 years, Nepal's traditional farm production such as rice, wheat, pulses and oilseeds have been almost displaced by Indian production for the following reasons:
 - a. India is in the process of completing its second generation of green revolution, whereas Nepali farming practices remain traditional even today. This has created a huge productivity differential between the Nepali and Indian food production. As such, given the open border, it is quite natural for the Indian food grains to substitute Nepali produce.
 - b. In the process of liberalization, Nepal has withdrawn all forms of subsidies from agriculture, whereas India continues to heavily subsidize the use of chemical fertilizer, seeds, electricity, diesel, farm credit, extension services and railway and sea freight for farm produce. Furthermore, India is accelerating public investments on infrastructure such as irrigation, rural roads, rural electrification, and extension of railway connection to rural India. In Nepal public capital allocation for agriculture is subsequently declining. Naturally, competitiveness of Nepal's agriculture is successively eroding.
 - c. Yet, there are lots of prospect for Nepali agriculture. The prospect lies in the rich bio-diversity of Nepal. The inflow of Indian FDI in the form of Dabur, Hindustan Lever and a few others is a clear indication of this competitive advantage of Nepal vis-a- vis India. What the state needs to do is to inject sufficient investment on infrastructure such as irrigation, electricity and road or cable-car connectivity, by mobilizing donor support; and enforce the property rights.
 - d. In the last several years, there has been a massive build-up of infrastructure in Tibet and a tremendous increase in Tibetan purchasing power. If Nepal endeavours to supply the food demand of Tibetan consumers, it can transform the livelihood of Nepal's northern hills and mountains; it requires the provision of infrastructure and technical know-how.
3. The talk has been going on in the last couple of years to develop Nepal as a transit corridor between India and China. The geographers and engineers have advocated that there are several prospective road projects which can considerably narrow the distance between these two fast growing countries. Given the rapidly growing trade flows between the two giant economies, the Nepali authorities can approach these neighbouring countries to invest on mutually beneficial road projects through Nepal. Such road connectivity would also help to explore the possibility of developing pasture in Nepal's northern highlands, which in turn would support sheep farming which would substitute the import of raw wool, for making carpets and pashmina.

4. Nepal Government's Department of Mines and Geology needs to undertake massive survey to find out which gems are available in commercial quantity. After this, the Government will have formulate laws, rules, and regulations governing extraction, processing and export of gems and jewellery by the private sector with international joint ventures.
5. Provision of infrastructure and public utilities is too costly in hills and mountains, as compared to terai and the valleys. There should be inducement and incentive given to people to resettle or conglomerate in areas that are wide enough and free from geological and other natural hazards such as land slide, from the perspective of cheaper cost of providing modern basic amenities of life. Furthermore, such resettlement would create space for private sector in terms of construction and repair.
6. Regarding development of private sector in Nepal, the Nepali authorities have mostly played on tariff differential (arbitrage) with India. Goods imported to Nepal were illegally smuggled into India against the payment in Indian Currency. Such a trade policy generated customs revenue and brought Indian currency into Nepal and offset the trade gap with India. Things have changed now. India is fast lowering its tariff structure to allow no space for arbitrage in Nepal. Now is the time for Nepal's private sector to look into the country's long term comparative advantage. In this context, the following things need to be done to facilitate the development of private sector in Nepal.
 - a. Provide macroeconomic stability, particularly in its fiscal and monetary policy. Have political consensus on not making frequent changes in the rate of tax. It is right time for the economic policy agenda to get space in the debate on constitution. As there is a general drift towards federal structure of government, the constitution should clearly spell out the basis of resource sharing between the federal and the provincial governments.
 - b. The constitution should layout the blueprint categorically for the space of state and the area for public private partnerships, so that the private sector can plan its activities accordingly.
 - c. Private enterprises of certain size and above should be made to follow nationally defined accounting standards and disclosure norms for increased transparency of financial statements, and there should be some mechanism to constantly monitor to increase public investment in stocks.
 - d. The private financial sector is urban centric. In the rural area there is a very thin and sparse presence of financial services, especially in the hills and mountains. Some intervention seems imperative in expanding financial services to rural areas in general and in the hills and the mountains in particular. The preferred nature of intervention would be budgetary and tax incentives, rather than the government itself operating financial services.
 - e. Since the last few years, annual remittance inflows have exceeded the combined total receipt from exports, tourism and foreign aid. But, the contribution of remittances is confined to sustaining consumption, imports and somewhat real estate investment. There should be a plan to pool some resources from remittances for undertaking productive investment in areas

such as hydro or microfinance with full legal guarantee of returns to the remitters.

- f. There has been a tremendous proliferation of bank and non-bank financial institutions in the urban areas, which puts a limit on the supervisory capacity of the central bank. There is an urgent need to set up a second tier supervisory institution and also a need for some kind of self regulation of these institutions.
- g. Nepal should reorient its focus on the development of self regulated cooperative societies and microfinance institutions in the rural areas, with some kind of initial budgetary support.
- h. To reduce the cost of operation of financial services in rural and deprived areas, rather than opening a new branch or a full-fledged institution in such areas, one can look for a local agent, train him and assign him with the task of lending and recovering for a certain fee.
- i. Finally, the. One can also look into the prospect of formalizing, organizing and consolidating the informal financial services that have been in existence in Nepal since time immemorial into modern type of microfinance institutions, without much financial and bureaucratic cost.

Alok K. Bohara:

The federalism issue is quite complicated in the current context and any link to the PSD will be overshadowed by numerous other contentious issues. It is the institution that makes a long-lasting difference in the making of a nation and the people. That is, federalism is not the only real issue; the problem should also address the degree of centralization/decentralization including both the political and economic. One of the issues that I have raised constantly is the issues of revenue sharing 50/50 from the hydro resources. Giving some economic clout to the regional governments is a good start. But, such revenue must not be spent anything other than education, health, and the infrastructure.

A complete version of my article on federalism is linked to the following website as a February 26, 2007 attachment:

http://nepalstudycenter.unm.edu/SeminarsWorkshopsConferences/e-Seminars/e-SeminarN012007/e-SeminarNo12007_PaperAccess.html

Also, it may be worth reading the following interview with Mr. Yash Pal Ghai:

<http://kantipuronline.com/kolnews.php?&nid=101887>