Abstract

The financial crisis of 2007-08 had negatively affected several economies around the world. While some economies were badly affected, others were mildly affected. And while some economies experienced a direct impact of the crisis, others experienced an indirect impact of the crisis. This paper subtly analyzes the effect of global financial crisis on Nepalese economy and suggests policy recommendations to overcome the effects of global financial crisis on Nepalese and regional economy.

Introduction

The global financial crisis primarily emerged due to sub-prime lending in developed economies, especially in the US. The growth in competition among mortgage lenders for market share and revenue as well as relaxation of underwriting standards by mortgage lenders originated sub-prime mortgage lending in the US (Simkovic, 2011). The housing bubble that lasted from 2002-06 ultimately crashed, resulting into financial crisis of 2007-08. Besides sub-prime lending, the complicated financial products developed at the time were equally responsible for the global financial crisis.

The financial crisis of 2007-08 had negatively affected several economies around the world. While some economies were badly affected, others were mildly affected. And while some economies experienced a direct impact of the crisis, others experienced an indirect impact of the crisis.

Economists argue that if financial recovery heads toward a positive direction in the US and the EU, then the world economy will grow by 3.9 percent in 2013. But while the US economy is recovering from economic turmoil, the recovery does not seem fast for the EU and other developed economies. Moreover, the growth rates of fast emerging economies like India and China have taken a plunge in recent years. Given the backdrop, this paper subtly analyzes the effect of global financial crisis on Nepalese economy and suggests policy recommendations to overcome the effect of global financial crisis.

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Literature Review

Berkmen et al. (2009) examine the impact of global financial crisis on developing and some of the emerging economies of the world. They show that financial crisis can transmit to the developing and emerging economies via a number of ways such as trade and financial linkages. The study basically focuses on revision of growth forecast before and after the crisis. Based on cross countries regression analyses, they find that financial vulnerabilities evidently contribute to the severity of growth impact. Countries with more leveraged financial system and with rapid growth in lending tend to suffer more in their growth outlook. Countries that export advanced manufacturing products are more severely affected by the crisis as compared to countries that export agricultural products. Countries with exchange rate regime, especially pegged exchange rate regime will be affected more in times of financial crisis.

Furceri, D. and Zdzenicka, A. (2010) study the impact of financial crises on output for 11 European transition economies (CEECs). They evaluate the short and long-term impact of financial crises on output in the CEEC economies (Furceri, D. and Zdzenicka, A., 2010). Findings of the study show that financial crises have a significant and permanent impact, reducing the long term output by 12 to 17 percent. The impact is more in smaller countries in which there is more financial disequilibria. They argue that fiscal policy is the most efficient tool in dealing with financial crises whereas monetary policy is considered to be modest. Likewise, flexible exchange rate regime helps reduce the impact of crises in the short and medium term but aggravates the problem in the long run.

Viswanathan (2010), in his study entitled Global Financial Crisis and Its Impact on India, states that shocks of global financial crisis have been transmitted to Indian economy through various channels such as trade, finance and business confidence. The paper highlights various policy responses taken to control the impact of crisis on Indian economy. Regarding the severity of impact, there were noticeable contractions observed in the economic indicators of US and European economies while the impact was less severe in the cases of emerging economies. During the crisis, India adopted various proactive measures such as injecting adequate liquidity, stabilizing interest rate and inflation. At the same time, fiscal stimulus was also provided.

And Brambila-Macias et al. (2011) study shows that global economic downturns have negative and significant impact on export flows of developing countries, and especially of Latin American and Sub Saharan African countries. Interestingly, they find that banking crises do not have any significant impact on most developing economies.

Effect of Global Financial Crisis on Nepalese Economy

Findings show that the Nepalese economy was mildly affected by global financial crisis. The effect was mild because the country’s financial market is least integrated with the global financial market. As such, there was no direct effect like sharp decline in GDP, drop in income level and employment rate, and insolvency of financial institutions, among others. Nevertheless, Nepal had experienced decrease in tourism receipt, foreign aid commitments from developed economies, and export (in
value) to developed economies. The effect of global financial crisis on various facets of Nepalese economy is detailed as follows:

(i) Remittance

Western Asian countries constitute the major source of remittances to Nepal. 21.3 percent of remittance comes from Qatar followed by Malaysia at 19.2 percent, Saudi Arabia at 14.9 percent, India at 13.4 percent, United Kingdom at 2.2 percent and other countries at 29 percent (CBS, 2011). As the Western Asian countries were less affected by global financial crisis, the effect of crisis on remittances inflow to Nepal was not detrimental. Nevertheless, the growth rate of remittance inflow had declined during and after the crisis period (Figure 1).

Figure 1: Remittances Inflow to Nepal

While the remittance inflow had increased over the years, the rate of remittance increment had subsided since the financial crisis of 2007-08. For example, remittance inflow increased by merely 9.4 percent in 2009, which was comparably lower than that of previous year. And with signs of financial recovery, the rate of remittance inflow had increased by 16.2 percent in 2010, 21.6 percent in 2011 and 17.5 percent in 2012 (Figure 1).

(ii) Export

Nepal mainly exports readymade garments, carpets, handicrafts and pashmina-shawls, among others. These items are mainly exported to the US, UK, Germany, and Russia. But since, Nepalese exports do not constitute a significant share of GDP; the effect of global financial crisis on Nepalese export did not have any significant negative impact upon the economy. Despite an increasing trend of export, the growth rate of export had decreased from third quarter of 2009 till second quarter of 2010 due to global financial crisis. (Rai, n.d.).
With the onset of financial crisis of 2007-08, Nepalese exports (in value) had decreased to major destinations such as the US, Germany, France, and Italy (Table 1).

(iii) Foreign Aid
Nepal, being one of the least developed economies, has to rely on foreign aid for various developmental activities. In the aftermath of financial crisis, the inflow of foreign aid was assumed to decline due to hard time for donor countries. However, despite the crisis, the effect was very low on Nepalese economy. With regard to overseas development assistance, there was a contraction during the crisis period. Foreign aid especially from developed economies such as the US, Japan and the EU had decreased given the economic turmoil in these countries. Most alarmingly, the foreign aid commitment in USD had decreased by 81.53 percent in 2006/07 (pre-crisis year), 44.05 percent in 2007/08 (crisis year), and 17.51 percent in 2008/09 (following the crisis year) (Budha, 2012).

### Table 1: Export trade to Major Trade destination countries (US $ million)

<table>
<thead>
<tr>
<th>Years</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
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<tbody>
<tr>
<td>Total</td>
<td>720.7</td>
<td>753.5</td>
<td>610.3</td>
<td>641.2</td>
<td>729.5</td>
<td>812.6</td>
<td>829.6</td>
<td>877</td>
<td>893.1</td>
<td>668.1</td>
<td>781.5</td>
<td>832.6</td>
</tr>
<tr>
<td>India</td>
<td>307.2</td>
<td>352.6</td>
<td>363.6</td>
<td>339.8</td>
<td>417.1</td>
<td>540.1</td>
<td>563</td>
<td>592.5</td>
<td>562.9</td>
<td>388.3</td>
<td>460.6</td>
<td>492.5</td>
</tr>
<tr>
<td>United States</td>
<td>198</td>
<td>202.8</td>
<td>122</td>
<td>163.1</td>
<td>131.4</td>
<td>105.1</td>
<td>96.7</td>
<td>74.9</td>
<td>67.1</td>
<td>54.6</td>
<td>60.2</td>
<td>76.4</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>1.9</td>
<td>7.1</td>
<td>3.1</td>
<td>5.3</td>
<td>5.7</td>
<td>4</td>
<td>3.2</td>
<td>39.6</td>
<td>66.5</td>
<td>41.9</td>
<td>48.4</td>
<td>25.8</td>
</tr>
<tr>
<td>Germany</td>
<td>108.7</td>
<td>83.7</td>
<td>52.6</td>
<td>45.7</td>
<td>48.3</td>
<td>43.3</td>
<td>39.3</td>
<td>36.2</td>
<td>36.1</td>
<td>33.9</td>
<td>37</td>
<td>43.3</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>17.3</td>
<td>13.3</td>
<td>10.5</td>
<td>13.8</td>
<td>22.7</td>
<td>14.6</td>
<td>16.4</td>
<td>15.3</td>
<td>17.5</td>
<td>17.4</td>
<td>18.3</td>
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</tr>
<tr>
<td>France</td>
<td>10.7</td>
<td>9.2</td>
<td>6.2</td>
<td>5.8</td>
<td>7.9</td>
<td>8.6</td>
<td>17.9</td>
<td>14.1</td>
<td>15.1</td>
<td>15.5</td>
<td>16.9</td>
<td>17.7</td>
</tr>
<tr>
<td>Canada</td>
<td>4.1</td>
<td>5</td>
<td>4</td>
<td>4.9</td>
<td>7.4</td>
<td>7.3</td>
<td>8.9</td>
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<td>10.7</td>
<td>11.8</td>
<td>14.9</td>
<td>15.9</td>
</tr>
<tr>
<td>China</td>
<td>0.2</td>
<td>0.4</td>
<td>1.6</td>
<td>0.7</td>
<td>1.5</td>
<td>8.3</td>
<td>17.7</td>
<td>4.8</td>
<td>10.4</td>
<td>12.6</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Italy</td>
<td>43</td>
<td>9.1</td>
<td>7.4</td>
<td>6.8</td>
<td>8</td>
<td>8.1</td>
<td>9.8</td>
<td>9.3</td>
<td>10</td>
<td>8.4</td>
<td>10.2</td>
<td>10.4</td>
</tr>
<tr>
<td>Japan</td>
<td>10.2</td>
<td>18.2</td>
<td>6.4</td>
<td>6.1</td>
<td>7.1</td>
<td>7.4</td>
<td>7.9</td>
<td>7.7</td>
<td>7.5</td>
<td>10.5</td>
<td>8.9</td>
<td>11.1</td>
</tr>
</tbody>
</table>

Source: Key Indicators for Asia and the Pacific 2012.

### Table 2: Foreign Aid Disbursement (USD million)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Bilateral</td>
<td>31.94</td>
<td>54.93</td>
<td>115.77</td>
<td>103.89</td>
<td>106.39</td>
<td>88.27</td>
<td>189.10</td>
<td>117.65</td>
<td>107.57</td>
<td>263.96</td>
<td>297.95</td>
</tr>
<tr>
<td>Grant</td>
<td>25.18</td>
<td>52.88</td>
<td>108.20</td>
<td>103.13</td>
<td>104.94</td>
<td>87.80</td>
<td>85.31</td>
<td>110.37</td>
<td>100.51</td>
<td>211.51</td>
<td>250.55</td>
</tr>
<tr>
<td>Loan</td>
<td>6.76</td>
<td>1.00</td>
<td>7.57</td>
<td>0.76</td>
<td>1.46</td>
<td>0.47</td>
<td>103.79</td>
<td>7.29</td>
<td>7.06</td>
<td>52.45</td>
<td>47.40</td>
</tr>
<tr>
<td>Multilateral</td>
<td>184.73</td>
<td>111.91</td>
<td>67.32</td>
<td>114.10</td>
<td>166.28</td>
<td>165.78</td>
<td>108.91</td>
<td>104.81</td>
<td>311.42</td>
<td>309.69</td>
<td>370.53</td>
</tr>
<tr>
<td>Grant</td>
<td>52.66</td>
<td>24.18</td>
<td>22.58</td>
<td>26.93</td>
<td>60.95</td>
<td>71.57</td>
<td>96.81</td>
<td>8.59</td>
<td>203.58</td>
<td>241.07</td>
<td>278.75</td>
</tr>
<tr>
<td>Loan</td>
<td>132.03</td>
<td>87.73</td>
<td>44.83</td>
<td>87.17</td>
<td>105.34</td>
<td>94.21</td>
<td>0.56</td>
<td>96.22</td>
<td>107.84</td>
<td>76.91</td>
<td>91.78</td>
</tr>
<tr>
<td>Total</td>
<td>216.67</td>
<td>166.84</td>
<td>183.10</td>
<td>217.99</td>
<td>272.68</td>
<td>254.05</td>
<td>298.01</td>
<td>222.46</td>
<td>418.99</td>
<td>573.66</td>
<td>668.48</td>
</tr>
<tr>
<td>Grant</td>
<td>77.84</td>
<td>77.07</td>
<td>130.78</td>
<td>130.05</td>
<td>165.89</td>
<td>159.38</td>
<td>182.12</td>
<td>118.96</td>
<td>304.09</td>
<td>452.58</td>
<td>529.30</td>
</tr>
<tr>
<td>Loan</td>
<td>138.80</td>
<td>88.73</td>
<td>52.40</td>
<td>87.93</td>
<td>106.80</td>
<td>94.68</td>
<td>104.35</td>
<td>103.50</td>
<td>114.90</td>
<td>129.36</td>
<td>139.19</td>
</tr>
</tbody>
</table>

Source: Based on Economic Survey, 2011/12. (Note: 1 USD=NPR. 86.76)
Foreign Direct Investment

Foreign direct investment (FDI) had substantially decreased during the crisis period. However, it has substantially increased following the crisis period partly due to gradual recovery from financial crisis in developed economies over the years.

Figure 2: Foreign Direct Investment

![FDI graph]

Source: Based on Data from World Development Indicators, World Bank, 2012

The FDI in 2008 was 0.9 US million dollars, and it has been significantly increasing in recent years (Figure 2). Besides gradual recovery from crisis, the significant increase in FDI is also due to creation of favorable business climate.

Tourism

Tourism is one of the major sources of foreign exchange reserves for Nepal. The country being rich in ancient heritage and natural beauty has remained as one of the main destinations for many tourists across the globe. But with the onset of global financial crisis, the inflow of tourist was affected as many people had to cut down their expenses.

Figure 3: Number of Tourist Arrival

![Tourist arrival graph]

Source: Based on Data from World Development Indicators, World Bank, 2012
The economic turmoil had affected the number of tourist arrival in the country. Figure 3 shows that the number of tourist arrival decreased in 2008 compared to previous year’s arrival. And there was no significant improvement in the number of tourist arrival in 2009 compared to the last year’s arrival.

Figure 4: Total Earnings from Tourism

Although tourism receipt in USD has increased over the years, the rate of increment had decreased following the financial crisis of 2007-08. While the total earnings from tourism increased by 52.6 percent in 2008, it increased by a mere 7.2 percent in 2009 (Figure 4). More alarmingly, the receipt decreased by 12.5 percent in 2010 (Figure 4). These statistics show the impact of global financial crisis on Nepalese tourism sector.

Policy Suggestions

The economic downturn in Europe and the US has negative repercussions on developing economies like Nepal. First, it tends to negatively affect the export potentiality of developing economies. With financial crisis, the developing economies will suffer from declines in terms of trade, especially in the case of commodity exports. Second, developing economies like Nepal receives substantial amount of foreign aid from developed economies. Such assistance will decrease given the economic downturns in the western world. Third, South Asian growth has also been fuelled by remittances from abroad. But with financial slowdown in the western world, South Asians are unlikely to get employment opportunities abroad, thus affecting amounts of remittances from developed economies. More importantly, foreign direct investment from developed economies to developing ones will subside if financial meltdowns continue to persist.

In order to avert domestic financial crisis, developing economies like Nepal needs to strengthen its macroeconomic policies. The country needs to better manage its sovereign debt. It needs to take quick, systematic, and decisive measures to prevent bank collapses locally (Yifu Lin, 2008). In 2010-11, Nepalese financial institutions had faced severe liquidity crisis. The crisis was mainly due to reckless lending out by banks and financial institutions in unproductive sectors such as real estate and housing business. This reckless lending in real estate and housing business coupled with high
demand had artificially upped their market prices. But with slowdown in real estate sector, borrowers were unable to repay their loans resulting in the liquidity crisis. The crisis resulted in increased interest rates in both deposit and lending products. Hence, to avoid such crises from happening locally, the Central Bank of Nepal needs to take quick, prudent and systematic measures. There must be a periodical review of Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) to ensure that liquidity crunches do not happen. Likewise, the Government of Nepal must maintain sound fiscal policies. The fiscal deficit must be lowered by increasing resource mobilization and maintaining prudent governmental expenditures.

In order to overcome effects of global financial crisis and achieve rapid economic growth, Nepal needs to collaborate with its neighboring countries on several fronts such as facilitation of intra-regional trade and share of energy resources at the regional-level. Without attaining greater economic integration through regional cooperation, a sustainable economic growth in Nepal as well as in the region is impossible. In order to achieve rapid economic growth and become resilient to global financial crisis, Nepal and its neighbors must focus on following key aspects:

**Regional Trade**: South Asia holds an immense potentiality of achieving greater economic welfare through regional trade. Currently, the intra-regional trade is merely 5 percent of the total external trade. This shows a bleak scenario of economic integration in the region. Despite signing a treaty on SAFTA (South Asian Free Trade Area), the region has not been able to increase its trade volume. Various trade distortionary measures and distrust among member countries have limited intra-regional trade to a minimum level, thereby eroding massive consumer welfare in the region. If the region can focus on greater economic integration, then it will not only enhance region’s economic welfare but also improve regional resilience to global financial crisis.

**Regional Connectivity**: South Asian countries are not well-connected to one another. The existing regional air-connectivity is inadequate. The prevalent road connectivity is limited and of sub-standard. If regional trade is to be promoted for greater economic welfare, then road, rail, and air networks need to be significantly increased. Especially, Nepal does not have roads of international standard, which is essential for facilitation of intra-regional trade. The country therefore needs to invest massively on infrastructural development such as roads and dry ports to bolster intra-regional trade. This will help Nepal achieve greater economic integration with the region and the world. Likewise, tourism is one of the sectors where Nepal can focus on enhancing its capacity. The country holds great potentiality in tourism thereby increasing its foreign exchange earnings. But unfortunately, the lack of proper road connectivity, hotels and other logistics has negatively affected the sector. So Nepal needs to focus on improving tourism sector.

**Regional Cooperation**: The region must cooperate on various fronts such as an efficient utilization of natural resources for an overall economic welfare. For instance, Nepal is rich in water resources. The country can generate an estimated 40,000 MW of hydroelectricity, which is economically feasible. But a mere 1.5 percent of the total capacity has been harnessed so far. If neighboring countries can jointly work in sharing water resources either for electricity generation or irrigation purposes, then the region will achieve greater economic prosperity.
Bibliography


