External debt and Economic Growth of Nepal

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Abstract

This paper examines the effect of external debt and economic growth of Nepal over the period of 1978-2020.The external debt of Nepal has been significantly increasing during the study period. The objective of this study is to examine the effect of external debt on economic growth of Nepal by ARDL model. Descriptive and analytical research design has been used by using secondary data. The finding of the study concluded Balance of payment has positively significantly impact on the growth in GDP respectively at 5% level of significance. Total external debt and Total reserves haspositive insignificant effect economic growth respectively. The findings of this study revealed that increase in balance of payment increases the growth of the economy of Nepal. The optimal use of external debt should be for national growth in order to expand the size of the market, improve the skill and productivity of workers, decrease geographic fragmentation, and boost the profitability of private investment to increase the GDP of the country.

Key words: External debt, Balance of payment, Economic Growth, ARDL, bound test

I. Introduction

External Debt is a tool to operate a fiscal deficit in any country. To meet national wants amidst limited resources, nations might resort to borrowing (Nwannebuike et al., 2016).Sustainable economic growth is a major challenge for all nations, particularly developing economies, which frequently have growing budget deficits due to inelastic current spending. In any economy, external debt is one of the sources of financing capital production. The goal of government financing is to raise funds while considering cost and risk factors, as well as macroeconomic and monetary repercussions. Governments, without a doubt, borrow to bridge the fiscal gaps between anticipated expenditure and expected revenue within a fiscal term.Due to a vicious cycle of low productivity, low income, and low savings, rising economies in Africa are experiencing insufficient internal capital accumulation. So, in order to close the resource gap, western nations offer technical, administrative, and financial support. Governments borrow money on a theoretical basis to pay for public services that raise economic growth and wellbeing for the general public. The costs must be covered either by taxes, profits, or

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Borrowing (Adepoju et al., 2007). With a population of 21.2 million, an annual GDP of $81.3 billion, $11.6 billion in revenue, and expenditures of $ 18 billion, it seems sense that the Sri Lankan state, like many others in the region, would go to the outside world for financial support to strengthen its economy. What makes the Sri Lankan situation unique is its increasing reliance on one nation, namely China, for financial support in recent years.The nation's foreign exchange holdings, which fell by 70% in the last two years to $2.31 billion, prevent it from paying for essential imports like food and fuel. The financial crisis was exacerbated by a severe lack of foreign currency, which prevented dealers from financing imports(Behuria, 2018).

Nepal's government uses public debt as a crucial instrument for budgeting because the country routinely suffers budget deficits. The Nepalese government has access to three forms of deficit financing: internal loans, loans from abroad, and changes in cash reserves(Bhattarai, 2015). Among the three sources of financing government debt, the share of a foreign loan seems to be highest in the deficit financing, which is followed by internal loans and then the change in cash reserves. As per recent reports, Nepal's outstanding debt was approximately Rs1.41 trillion in fiscal year 2019-20, accounting for 40.16 percent of GDP. Even while the country's debt liability grew slowly until fiscal year 2015-16, it exploded as the country needed to raise significant funds for post-earthquake reconstruction. According to the Post Disaster Risk assessment, the catastrophic earthquake in 2015 claimed over 8,000 lives and damaged properties valued over Rs700 billion. After the 2017 elections, the country needed more resources to institutionalize the federal structure, and the Covid-19 pandemic negatively impacted the country's economy, resulting in lower revenue generation for the government. As a result, the government has been increasingly relying on domestic and external loans to bridge the resources gap(Shrestha, 2021).

Data and trends show that external debt financing is high in Nepal, and most of the financing is used to meet current expenditure rather than capital expenditure. Though Nepal's external debt is highly concessional and has a long term maturity, certain factors such as the continuous depreciation of the Nepalese currency vis-a-vis the US Dollar, increased debt servicing resulting in the higher budget deficit, crowding-out effects of such debt servicing on the private sector investment, a higher portion of loans than grants, substantial multilateral credits than bilateral ones and the inflationary effect of foreign borrowing, among others, should be watched carefully (Bhatta, 2003).

There would undoubtedly be a significant financial burden on Nepal if the accumulated debt is not put to beneficial use. Kharusi and Ada (2018) asserts that due to ineffective management, borrowing has a detrimental effect on the financial stability and economic progress of developing nations. It is crucial to finance profitable investments with the borrowed funds in order to produce future income. The main concern connected to the accumulation of external debt is that it can surpass a sustainable level in respect to national repayment capacities.

Okonjo-Iweala et al. (2003) stated that countries borrow for two broad categories, macro-economic reason (higher investment higher consumption i.e., education and health or to finance transitory balance of payment deficit to lower nominal interest rates abroad lack of domestic long-term credit or to circumvent hand budget constraint.Thus, the economy uses debt to increase economic growth and decrease poverty without suffering from macroeconomic instability policies or major negative shocks. As a result, growth will probably pick up and make it possible to pay off debt on time. Growth will have a favorable impact on per capital when the circle is sustained over time, which is necessary for reducing poverty. The predictions are known to be accurate, even in theories built on the more realistic premise that nations could be unable to borrow at will due to the possibility of having their debts denied.

Problem statement

Bhatta (2003) issued a warning that Nepal's mounting debt is a constraint to the country's ability to grow its economy and prosper. This was due to the issues linked with debt and debt servicing. Campbell (2009) expressed a similar viewpoint when he claimed that government debt could easily weigh down the economy and weaken its foundation. she also cautioned that authorities should understand that increasing debt also means increasing risks because it increases claims on unrealized future income.

The assumption going in was that external debt would stimulate economic growth. An excessive focus on the negative effects of debt will lead to obsessive fear of debt, which will lead people to avoid taking on debt when doing so would have boosted the economy by providing the much-needed funding for infrastructure development and investment.(Nwannebuike et al., 2016)

Given the above, it is clear that there are different opinions on the effects of external debt on the economy. As a result, policymakers must have a thorough understanding of these effects at different stages of debt accumulation in order to make well-informed decisions. This is the case because there are times and circumstances when taking on debt is beneficial and required, while other times debt should be avoided.

Research question:

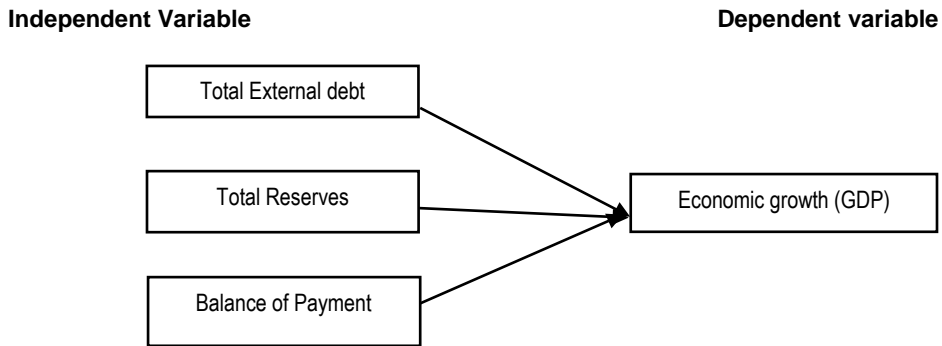Does External debt have effect on economic growth of Nepal ?

Objectives:

To analyze the effect of External debt in economic growth of Nepal.

II. Theoretical Framework

Research framework:
Figure 1

Independent Variable   **Dependent variable**

Note: *author's research framework*

Theoretical review

There are many different economic theories, but it was decided that the Keynesian theory of increased government action as a driver of economic growth was the most appropriate one. This economic theory bears the name of a British economist named John Maynard Keynes. According to the thesis, active government intervention is necessary for an economy to expand and remain stable. According to Keynesian economists, macroeconomic results can occasionally be inefficient as a result of private sector actions. Therefore, the central bank's monetary policy and the government's fiscal policy are needed to guide the economy. These measures will lead to output stability over business cycles.

According to Keynes, a combination of two strategies, a drop-in interest rates (monetary policy) and government investment in infrastructure—must be used during a depression (fiscal policy). Both Keynesians and Monetarists assert that monetary and fiscal policy have an impact on aggregate demand (Blinder, 2008).Government spending on infrastructure stimulates the economy by generating demand, jobs, and business prospects. External borrowing when there is a budget imbalance is one of the sources of funding for infrastructure development.

This suggests that the Keynesian hypothesis, which regards capital accumulation as a catalyst for economic growth, supports foreign loans since they infuse money into the economy to boost economic activity, which leads to growth. As a result, it supports the idea that external debt and economic growth are closely related.

Empirical review

Historically, nations have viewed foreign borrowing as a supplement to domestic saving in order to close the investment-savings gap and achieve quicker growth. However, there have been various opposing and supportive viewpoints on external financing. Excessive foreign debt, according to some, weakens a country's economy by making the external sector susceptible. To pay off its huge external debt, the government must borrow more, putting it in a debt trap. Hence, efforts are made in this part to evaluate important literature on the subject in order to determine its relevance to the Nepalese situation.

Ayadi and Ayadi (2008)investigated the impact of external debt in economic growth, a comparative study of Nigeria and south Africa. The study shows that there is the negative impact of debt and economic growth is confirmed in Nigeria and South Africa. However, South Africa performs better than Nigeria in the application of external loans to promote growth. In addition, external debt contributes positively to growth up to a point after which its contribution becomes negative in Nigeria.

Presbitero (2012) observed that developed countries use debt more productively than emerging countries. Poor debt management in developing countries has negative effects for external debt. Public debt has a negative influence on output growth until it reaches 90% of GDP, according to findings from a panel of low and middle income of 114 developing nations from 1990 to 2007.

Kharusi and Stella (2018) claimed external debt has a negative and considerable impact on Oman's economic growth. Furthermore, gross fixed capital was discovered to be positively significant in predicting Oman's growth performance. As a result, the study suggests making better use of the external debt fund in order to boost growth.

Bhatta (2003) found the external debt flow having positive effect on economic growth. However, the analysis of external debt stock and debt servicing shows that the equally important that external borrowing be made to supplement but not replace domestic savings in the long run.

Paudel et al. (2009) examined the role of foreign debt, trade openness and labor force in the economic growth of Sri Lanka, for the period 1950-2006.The author used Johansen maximum likelihood approach of cointegration.Economic growth, foreign debt, trade openness, and labor force all have a cointegration relationship, according to the study. Furthermore, the findings imply that labor force, trade openness, and foreign debt have a favorable impact on Sri Lanka's economic growth in the long run.

Safdari and Mehrizi (2011)investigated five variables: gross domestic product, private investment, public investment, foreign debt, and imports, as well as their interactions. The author employed a vector autoregressive model (var), a dickey-fuller test for variable stability, and a Johnson test to see if the five variables were converging. External debt had a detrimental impact on gross domestic product and private investment, according to the report. Furthermore, governmental investment and private investment exhibited a beneficial relationship.

Shah and Pervin (2012) explored the significance of Bangladesh's economy's reliance on external public debt. The purpose of the study was to determine the impact of external public debt on economic growth in Bangladesh from the perspective of the economy from 1974 to 2010. To reflect the effect, the study looks into the debt overhang and crowding out effect of external public debt. This study discovered that foreign public debt service has a large negative influence on GDP growth in the long run, whereas external public debt stock has a favorable effect. Only external debt servicing has a negative effect in the short run, whereas the debt stock has no significant effect.

Awan et al. (2015)used the ARDL model to study the macroeconomic factors that affect Pakistan's external debt and discovered that the balance of payment, the nominal exchange rate, and trade openness are statistically significant factors that affect external debt because they raise Pakistan's debt load.

Adeleye   et al. (2015) examined at how trade with other countries affected Nigeria's economic growth, using net export and the balance of payments as stand-ins for export and import, respectively, and gross domestic product as a proxy for economic growth. Regression analysis was used in the study to determine the long-term association between economic success and global commerce utilizing co-integration and error correction modeling techniques. Nigeria is operating a monocultural economy where only oil serves as the sole support of the economy without any discernible assistance from other sectors such as industrial/manufacturing and agricultural. Only Total Export (TEX) stays positive and substantial while others remain negligible.

Akanni and Bukola (2016)studied the handling of external reserves and its impact on the expansion of the Nigerian economy between 1985 and 2013. Data were conducted to diagnostic tests including the unit root test (Augmented Dickey Fuller) and Johansen co-integration test to determine whether the data were stationary or non-stationary as well as the long-term connection between the dependent and independent variables. The findings revealed that FDI, MPR, and GDP significantly contribute to Nigeria's position in terms of external reserves.

Nwafor (2017) looked at external reserves in Nigeria as a way to stimulate economic growth. With data spanning from 2004 to 2015, two hypotheses were investigated using the Ordinary Least Squares (OLS) regression approach. However, the results showed that external reserves had no positive significant impact on economic growth in Nigeria over the review period and that they have no positive significant impact on the country's exchange rate.

Smyth and Hsing (1979) discovered that the ideal level of debt in the selected emerging countries is 38.4% of GDP. It concludes that while the foreign debt ratio increased in the early 1980s, it stayed below 38.4, and debt financing tended to support economic growth at the same time. However, debt as a percentage of GDP increased from 40.7 to 50.9 percent between 1986 and 1993. Later, it was over the optimal debt ratio (38.4), indicating that external debt had a negative impact on economic growth. The time period covered was 1960 through 1991.

Bordo and Meissner (2006) looked at the effects of public debt on economic development and investment in Sri Lanka from 1975 to 2014. According to the study, public foreign debt has aided economic growth in Sri Lanka, but debt servicing has a negative association with per capita GDP and investment. The external debt had a critical influence in the development of the country's civil war. In Sri Lanka, however, debt servicing is a big challenge. The link between domestic debt and per capita GDP is positive and strong.

Lin and Sosin (2001) explored the relationship between government foreign debt and per capita GDP development in 77 countries and sub-samples of various areas. Data from African countries show a strong negative relationship between foreign debt and per capita GDP development. This association was negative but statistically negligible for industrialized and Latin American sub groups. A positive but negligible link exists between Asian and other emerging countries in the sub-sample.

Hayati and Rahman (2012) discovered that excessive domestic debt has a long-term negative influence on economic growth using quarterly data from the first quarter of 2000 to the fourth quarter of 2011,particularly in Malaysia. However, during the same time span, the level of external debt has no meaningful impact on economic growth. Domestic and external loans have no substantial impact on economic growth in the short run.

Lee and Ng (2015) studied Malaysia's public debt contributed to the country's economic growth from 1991 to 2013. It also looks at how other debt load measures, such as the budget deficit, budget expenditure, external debt payment, and government consumption, affect economic development. The findings show that public debt has a negative influence on GDP over time. Furthermore, the budget deficit, government consumption, and external debt service are all found to be declining functions of GDP.

Table 1

Description of variables

Variable notation	Description	Source
GDP (Gross Domestic Product)	GDP at purchaser's prices is the sum of gross value added by all resident producers in the economy plus any product taxes and minus any subsidies not included in the value of the products. It is calculated without making deductions for depreciation of fabricated assets or for depletion and degradation of natural resources.	World bank (2022)
Total external debt	Total external debt is debt owed to nonresidents repayable in currency, goods, or services. Total external debt is the sum of public, publicly guaranteed, and private nonguaranteed long-term debt, use of IMF credit, and short-term debt. Short-term debt includes all debt having an original maturity of one year or less and interest in arrears on long-term debt.	World bank (2022)
Total Foreign Exchange reserve	Foreign exchange reserves are assets held on reserve by a central bank in foreign currencies. These reserves are used to back liabilities and influence monetary policy. It includes any foreign money held by a central bank.	(Marshall Hargrave, 2022)
Balance of payment	Current account balance or Balance of Payment is the sum of net exports of goods and services, net primary income, and net secondary income.	World Bank (2022)

III. Research Methodology

The nature of the study is descriptive as well as analytical. This research study has based on the secondary data published by different governmental as well as non-governmental organizations. The secondary information and data have been collected from following sources: World development indicators and government financial statistic 1978 to 2020.For this article, it has used Total external debt, Total reserves and Balance of payment as an independent variables. So, the general model that shows the relationship between the external debt and economic growth can be written as:

GDP = β0 + β1TED + β2 TR + β3BOP + ei…………… (1)

 Where, GDP = Gross Domestic Product

TED= Total external debt

TR= Total reserve

 BOP = Balance of Payment

ei = Stochastic Error term

IV. Results and Conclusion

Unit root test

Regression analysis utilizing non-stationary data produces erroneous conclusions because the mean and variance of the estimates derived from such data are not constant. To ensure that the results were accurate and not fabricated, the study therefore attempted to determine the stationarity of the data or the sequence in which they were integrated. Unit roots were checked using the Augmented Dickey Fuller (ADF) algorithm.

Variables	Adj. t-stat (at level)	Adj.t-stat (at first difference)	conclusion
GDP	-5.665527	-	I (0)
TED	-2.639491(0.0933)	-6.587874	I (1)
TR	-4.210608(0.0019)	-	I (0)
BOP	-6.62693(0.0000)	-	I (1)

Note: Computation from the E-view 12 SV, 2022

Table 1 clearly shows on TED is stationary at first difference because their p-value is less than 5% at first difference. Other variables are stationary at level because their p-value is less than

5% at level. Thus, we have case of a mixed order of integration of variables I(1) and I(0) and so this support using ARDL co-integration approach.

Bound test for co-integration relationship

Pesaran (1997)recommends that the limits test can be used to examine the long-term relationship of the equation above. If the F-test exceeds each variable's corresponding critical value, regardless of the sequence in which the variables were integrated, it can be concluded that there is proof of a long-term relationship between the variables.

Table 2

Bound test

level of significance	F-statistic	lower bound	upper bound
10%	12.98102	2.27	3.2
5%		2.79	3.67
2.50%		3.15	4.08
1%		3.65	4.66

Note: Computation from the E-view 12 SV, 2022

The estimated F-statistic in Table 2 is 12.98102, which is greater than the values for both the lower bound and upper bound at all levels of significance. This demonstrates that the null hypothesis—that there is no long-term link between the variables—is rejected. In other words, the variables have a long-term link. The relevant variables are thus co-integrated.

Table 3

Coefficient of Long Run Relationship in the ARDL Co-integration Form

variables	coefficient	t-statistic	prob.
TED	0.002622	0.028773	0.9772
TR	0.033215	0.708419	0.4840
BOP	0.004719	4.441927	0.0001
C	5.623096	3.716480	0.0008

Note: Computation from the E-view 12 SV, 2022

Autoregressive Distributed Lag (ARDL) Model

Table 4

Autoregressive Distributed Lag (ARDL) Model

Variables	Coefficients	T- Value	P- Value
TED	0.002911	0.028784	0.9772
TR	0.067337	1.424292	0.1644
BOP	0.002538	4.595125	0.0001
C	6.241326	3.106640	0.0040
R2 = 0.536467		Akaike Info Criterion = 6.758856	
Adjusted R2 = 0.416845		Schwarz Criterion = 7.138854	
F - Statistics = 4.484704 [0.001076]		Durbin- Watson Stat = 1.763079	

Note: Computation from the E-view 12 SV, 2022

The result of time series data is based on the ARDL model as presented in table 3 shows that Balance of Payment (BOP) among the External debt variables to have statistically significant effects on GDP. Here overall model is significant with respect to the dependent variables at the 5% level of significance. However, total external debt has a negative and insignificant relationship with GDP at a 5- percentage level of significance. The relationship of ED and GDP implies that a 1 percent increase in ED causes a 0.002911 Percentage increase in GDP. In addition, the above table represent that Total reserve has a positive and insignificant relationship with GDP at a 5-percentage level of significance. The relationship of TR and GDP implies that a 1 percent increase in TR causes a 0.067337 Percentage increase in GDP.Furthermore, table stated that BOP has a positive and significant relationship with GDP at a 5-percentage level of significance. The relationship of BOP and GDP implies that a 1 percent increase in GDP causes a 0.002538 Percentage increase in GDP. Thus, country's healthy Balance of payment condition helps in economic growth. The R-squared and adjusted r-squared shows that there is the overall significance of the model. This implies that 53.64 percent of the variation in dependent.

The null form of the test is DW>R2, which states that the Durbin-Watson result should not be greater than the R-squared figure. As seen in the analysis's results, DW = 1.763079 and R2 = 0.536467, rejecting the null hypothesis, indicating that the regression estimate result is valid. The value for R-squared is 0.536467 which means that 53.64% of the variation in GDP is explained by the explanatory variables in the model while the remaining 46.36% changes in GDP is caused by other factors outside the scope of this study.

Diagnostic test:

Table 4

Diagnostic test

| Diagnostic test	Obj. R2	p-value	Decision rule
Breusch-Godfrey Serial Correlation LM test	0.848959	0.7327	No serial correlation
Heteroskedasticity Test:	2.001216	0.9880	No heteroskedasticity, autocorrelation

The diagnostic tests against serial correlation (Breusch-Godfrey test) and heteroscedasticity (White) errors showed insignificant at 5% level which revealed that there is no serial correlation; free from heteroscedasticity and autocorrelation; and normally distributed residuals. These results confirmed that the regression model was fit to predict the relationship between external debt and economic growth.

Stability Test

The stability of the long -run parameters together with short run movements for the estimated equations should be examined. For this the article relied on cumulative sum of recursive residuals (CUSUM) and cumulative sum of squares of recursive residuals (CUSUMSQ) tests proposed by(Borensztein et al., 1998). The graphical presentation of CUSUM test is given in Figure 2.

Figure 2

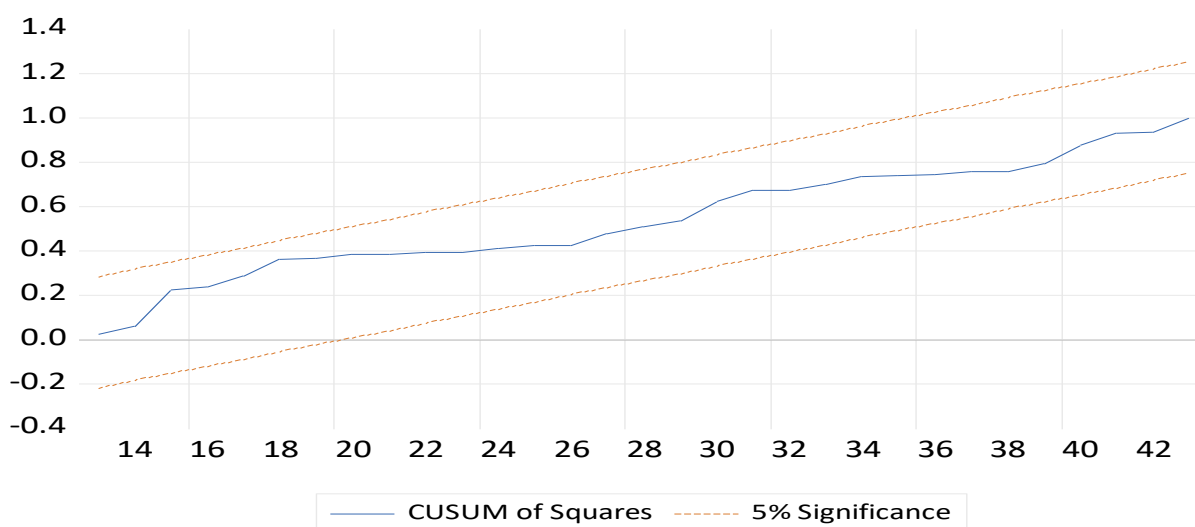*Cumulative Sum of Recursive Residuals (GDP)*
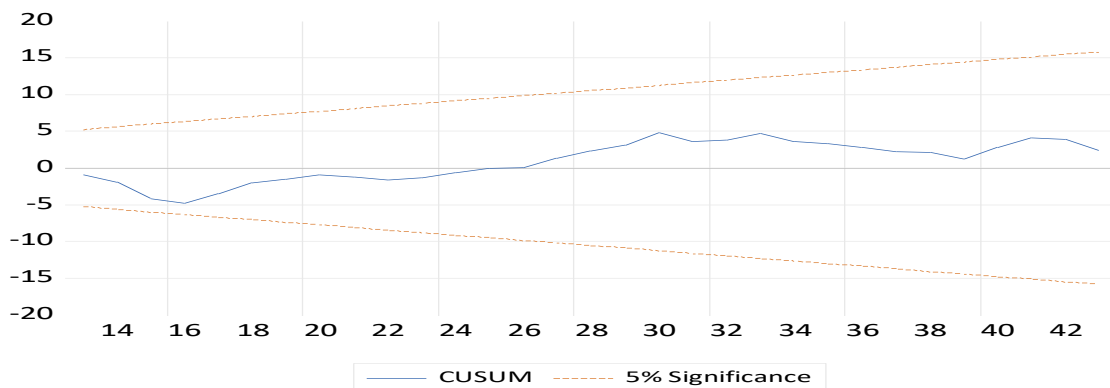
Note: Computation from the E-view 12 SV, 2022

Since, the plots of CUSUM statistic for GDP are within the critical lines at the 5% significance level, long run coefficient of the GDP function is stable. Similarly, the graphical representation of the CUSUMSQ is given in Figure 3.

Figure 3

Cumulative Sum of Square of Recursive Residuals (GDP)

Note: Computation from the E-view 12 SV, 2022

The long run coefficient of the GDP function is stable since the plots of the CUSUM statistic for GDP are within the crucial lines at the 5% significance level.

Discussion

The study examined the relationship between Nepal's external debt and economic growth from 1978 to 2020. The empirical discoveries made in this way are discussed. In Nepal, it was discovered that the balance of payment had a strong, positive association with economic growth. This implies that the balance of payment significantly influenced Nepal's economic growth. This empirical study supports Awan et al. (2015) conclusion that BOP has a considerable, favorable impact on economic growth. However, Adeleye et al. (2015) observed, the findings show that BOP has insignificant effect on economic growth in developing nations. The study found a insignificant Positive association between Total external debt and economic growth in Nepal.As a result, it may be concluded that Nepal's productive sector has not adequately utilized its external debt.The research supports the findings of (Ayadi & Ayadi, 2008) who discovered a long-term association between the effect of external debt on economic growth.Although the results go against the assertion made by Bhatta (2003) and Paudel et al.

(2009)that external debt has a favorable effect on economic growth.Additionally,Kharusi and Ada, (2018), Bordo & Meissner, (2006), Shah and Pervin, (2012), Presbitero, (2012) discovered that external debt has a negative significant impact on economic growth, which may be the result of poor debt management in those emerging nations.It was discovered that Nepal's economic growth had a negligible negative association with external reserves.The empirical analysis backs up Nwafor, (2017) findings that managing external reserves has no discernible impact on economic growth.Additionally, it conflicts with research by Akanni and Bukola, (2016) who found that having an external debt has a favorable effect on economic growth in emerging nations.

Conclusion and Implication

The research found that Nepal's economic growth is greatly influenced by its balance of payments.Based on the analysis completed, it was determined that the balance of payments had a considerable positive impact on GDP growth at a 5% level of significance.External reserves and total external debt both have a slight beneficial impact on economic growth.To lessen geographic fragmentation and boost the profitability of private investment, external debt should ideally be used to enhance infrastructure, education, and social services.External financing should be available in accordance with a policy framework that is consistently upheld with credibility (fiscal stance, exchange rate policy, interest rate policy, pricing policy, etc.). To inspire investor confidence for both domestic and foreign investments, policymakers need to establish credibility and political will.Political unrest in Nepal is an issue, and as a result, investors have lost faith in the nation. In order for investors to invest in the nation and for the nation to be less heavily dependent on foreign debt, it is necessary to restore that confidence. By implementing the appropriate policies, Nepal still has a potential to resolve its foreign debt issues, but she will require a lot of assistance from programs for debt relief and reduction.

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