Sanjaya Acharya. Pro-poor growth and liberalization in developing economies: The case of Nepal. New York: Routledge. 2012.

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This book examines the conditions under which globalization can lead to pro-poor growth in developing countries. Globalization in this context refers to liberalization of a country's external and internal economic environments. The main analytical framework used in the text is a computable general equilibrium (CGE), which is calibrated using data organized in a social accounting matrix (SAM). This framework is applied to examine different strategies that may be adopted to achieve pro-poor growth with liberal economic reforms. Nepal is the focus of the study, but it is suggested that the findings and policy implications are also applicable to other small developing countries characterized by widespread poverty, traditional agriculture, a low industrial base, and a weak external sector.

Prior to a detailed discussion of the CGE model and its applications, four interrelated issues are addressed. The first issue is the nature of the theoretical relationship between economic liberalization and pro-poor growth; economic theory suggests that liberalization can lead to pro-poor or pro-rich growth. The second is the empirical evidence on the link between economic liberalization and income distribution. The vast empirical record points to an inconclusive relationship—liberalization-led economic growth may reduce or exacerbate income inequality. The third issue is the formulation of international and national policies in light of the liberalization-inequality nexus. In this regard, the World Bank and IMF were the main forces that promoted the controversial Structural Adjustment Program in the 1980s. Following the program's limited success and widespread criticism, the Poverty Reduction and Growth Facility was subsequently introduced. The fourth issue is the relationship between liberalization and poverty in Nepal amidst the liberalization policies that were adopted over the past two decades.

The second chapter examines Nepal's trade policies, which have witnessed a gradual transition from import substitution to export promotion, a trend characteristic of most developing countries including India. The discussion includes Nepal's trade and transit treaty with India in 1950, its regional trading arrangement, which is dominated by trade with India, and its entry into the World Trade Organization in 2004. In order to improve its international trade position, it is argued that Nepal needs to reduce transactions costs in production and trade, negotiate market access to other developing countries, and seek preferential treatment for its exports to industrialized countries. The study emphasizes that poor reliability and access to power as well as weak physical connectivity represent the most critical bottlenecks to international trade and investment in Nepal. Trade policy should focus on Nepal's comparative advantages, which have shifted in recent years from agricultural raw material to labor-intensive manufactured products.

Chapter 3 provides a survey of the literature on liberalization and reform in developing and transition economies. The review includes liberalization of the international economy under fixed and flexible exchange rate systems, as well as that of the domestic economy, mainly budgetary reforms. The extensive empirical evidence on the effects of economic liberalization on economic growth, income distribution, and poverty during the past two decades is mixed and inconclusive. While most studies show a positive impact of external and internal liberalization on economic growth, the effect on income inequality is ambiguous. It appears that economic growth that results from globalization will not necessarily lead to a reduction in poverty; specific and targeted interventions are often required. In Nepal, it is claimed that economic liberalization has worsened poverty and income inequality. This claim is inconsistent with data from the Nepal's

National Living Standards Surveys, which show a substantial decline in poverty and an improvement in income equality over the past decade.

The next chapter discusses the SAM for Nepal, which serves as the main database for calibrating the CGE model. This study incorporates a Nepal SAM developed by Sapkota (2001), which is based on data for 1996. A SAM shows the circular flow of income and expenditure in an economy, with each cell representing a payment from a column account to a recipient in a row account.[1] A SAM is square, and, following the conventions of double-entry bookkeeping, each actor's account must balance: income must exactly equal expenditure. Column sums must therefore equal the corresponding row sums. A SAM is a large scale macroeconomic data scheme and is a suitable conceptual framework to analyze the interrelationships between major economic variables in the system. It integrates the supply side of the economy, represented by input-output transactions, with the demand side, which is represented by households and other final demand for output. A SAM also contains other accounts found in the economy such as the government sector, trade, and the financial system. The main motivation for organizing data in a SAM framework is to describe the economic transactions in their entirety and to capture all economic linkages and feedbacks which exist in an economy so that a more complete policy analysis can be undertaken.

Chapter 5 provides the specification and calibration of the Nepal CGE model, which is largely based on the one developed by the International Food Policy Research Institute. The chapter also reports the economic effects of reforms of the external and internal economic environments. External liberalization policies simulated include (1) reductions in import tariffs by Nepal and export barriers by trading partners under fixed and flexible exchange rate systems and (2) a devaluation of the domestic currency. Internal reforms simulated include a reduction in the government's budget deficit. The simulation results show that external liberalization leads to expansions in agricultural and industrial trade, resulting in higher economic growth. Households also tend to benefit from these reforms, mainly due to higher wages and lower average prices. However, wealthier households gain more than poorer ones, who realize insignificant gains. Similarly, budget reform policies also have a favorable effect on economic growth. It is worth noting that the CGE model discussed in this chapter focuses on the operation of the model in a given year (1996) and is thus static; it does not show the effects of changes in investment spending over subsequent time periods. By contrast, a dynamic model assumes that each period solves independently and variables assumed to be exogenous within each year are updated between periods. Such a dynamic model is presented and discussed in the next chapter.

Chapter 6 explores the conditions under which liberalization and reform measures can lead to pro-poor growth in Nepal. For this purpose, the static CGE model in Chapter 5 is transformed into a dynamic one. The baseline for a restructured economy in 2006 is projected, a prospective SAM for 2006 is constructed, and the dynamics of the economy's path towards the end of the ten-year gestation period is modeled and examined. The results of these simulations are compared to those from the static model to examine the potential for liberalization policies to achieve pro-poor growth. The major differences between the static and dynamic models is the treatment of capital stock and labor supply, both of which are treated as endogenous in the dynamic model. Overall, the dynamic model performs better with regard to controlling the price level, promoting export growth, attracting foreign investment, and reducing the budget deficit. These results suggest that liberalization and reforms can lead to higher and pro-poor economic

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[1] This discussion of the nature of SAMs is based on Pradhan, G., "A Computable General Equilibrium Analysis of the Economic Effects of the Octroi," unpublished Ph.D. dissertation, American University, 1996.

growth provided that the poor and low-skilled workers are able to participate in the fastest-growing economic activities. The provision of skills training pertaining to employment in the high-growth sectors can help in the transformation of labor from low to high skills. Employment promotion programs that facilitate the entry of low-skilled workers will result in higher wages of high-skilled labor, help to raise the return on capital, and promote higher economic growth. Thus, the sectors with the highest growth potential should be identified and public policy should seek to channel the factor endowments of the poor into the fastest growing sectors of the economy; these interventions can help external liberalization and internal reforms achieve pro-poor economic growth.

CGE models have been developed to study a wide range of issues. In order to analyze the effects of economic liberalization on economic growth and income distribution (a policy question with potentially significant macroeconomic effects) a CGE model is an appropriate tool. The CGE model used in the study is properly developed and contains an appropriate specification of the optimization problems facing the actors in the economy. Outcomes can be traced to the relevant structural features, and it is possible to analyze the importance of model assumptions with respect to results. The limited data requirement of the CGE model makes it particularly useful. While it is customary to use econometrically-based macroeconomic models to study policy issues, the lack of adequate disaggregated time series data for Nepal often renders this approach impractical. Lack of data means that many parameters required by such models cannot be estimated, making such models subject to uncertainty. By contrast, CGE models are calibrated around a base-year SAM with a small amount of additional data used to estimate certain parameters. Based on the functional forms, most model parameters can be calibrated without reference to additional data, which, when required, is usually limited to elasticities of substitution and transformation. These parameters may either be estimated or adopted from studies of countries with a similar industrial structure. Policy analysis based on partial equilibrium models can sometimes be misleading in that the same policy has the potential of producing conflicting final outcomes. This weakness provided one of the important motivations for the development and use of general equilibrium models for policy analysis. This class of models also has other useful appeals for developing countries, one of which is the incorporation of distributional aspects within the overall analytical framework, an issue this study addresses quite effectively.

Although analysis based on CGE models has strong claims to policy applicability, it has its shortcomings, just like any approach to the analysis of any economic issue. Many assumptions are made to calibrate and run the model, and data problems further constrain the accuracy of the analysis. Given these considerations, it is important to emphasize the broad themes of results rather than attempt to draw direct policy conclusions.

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