



Nepal

Over the last four years, Nepal has made important progress toward achieving fiscal stability and removing major restrictions that impede the development of a more vigorous market economy. Many prices are now market determined, there are few barriers to international trade, and foreign investment and interest rates have been deregulated. Substantial progress has been made toward macroeconomic stabilization; the Government's domestic borrowing requirements have been curtailed, inflation has been reduced, and international reserves have risen. However, the performance of the economy moderated in 1995; agriculture was adversely affected by poor weather and industrial activity was subdued. Although macroeconomic imbalances were reduced as inflation eased, the resource and external balances remained fragile. Saving performance improved slowly while investment was strong. An increase in the pace of economic growth is expected in 1996 and 1997, contingent upon a recovery in agriculture and industry and a resumption of economic reforms designed to increase efficiency and promote an outward-looking industrial strategy.

The implementation of further structural reforms has been seriously delayed owing to a sequence of political events during the last year and a half. A coalition government led by the Nepali Congress party took office in September 1995 following the defeat of the United Marxist Leninist (UML) minority government. With a lack of a political consensus, reform efforts have been at a virtual standstill since July 1994. Moreover, the external

position has weakened because of structural problems in the two main export industries – carpets and ready-made garments. The new Government has indicated a strong commitment to fiscal discipline and economic liberalization and has taken steps to revitalize major reform programs on privatization. These steps include the expected introduction of the VAT in 1997, simplifying the tax and tariff structures and strengthening their administration, and improving the environment for foreign investors. However, the Government still faces the formidable challenges of ensuring consistent fiscal and monetary policies and macroeconomic stability.

The main constraints on development continue to be weaknesses in infrastructure and shortages of trained and qualified personnel. A large portion of the population depend on agriculture with continued low productivity. The rugged terrain has made transportation, communications, power supplies, and social infrastructure difficult. Power shortages also continue to impede industrialization. Economic liberalization and fiscal discipline remain the two fundamental elements in the achievement of sustainable market-oriented growth.

Recent Trends and Prospects

Growth, Investment, and Employment. The strong recovery of agricultural output in 1994 boosted real GDP growth to 7.3 percent despite extensive flood damage. GDP growth in 1995 is estimated to have slowed down to 2.3 percent, reflecting a drought-related decline in

agricultural production and slow growth in the industry and services sectors. Although cash crops and livestock output increased by 6.3 percent and 3.2 percent, respectively, the production of food crops, which contributes about 37 percent of the total agricultural output in Nepal, declined by 7.3 percent. As a result, overall output of the agriculture sector decreased by 0.7 percent.

Industry sector growth contracted to 2.9 percent in 1995, mainly because of a sharp fall in the growth of manufacturing output to only 1.7 percent compared with 8.1 percent in 1994. Services sector growth remained strong in 1995 at 5.4 percent as a result of rapid expansion in transportation, communications, finance, and real estate services.

The capacity to mobilize domestic resources is inadequate. Domestic saving has been stagnant at about 10 percent of GDP, while domestic investment was more than 20 percent of GDP in 1995. As a result, the resource gap has been widening. Required foreign financing to bridge this gap increased to 10 percent of GDP compared with 8 percent of GDP in 1994.

Nevertheless, reform measures have begun to take effect, thereby stimulating saving and investment. Liberalization of the financial sector proceeded rapidly in 1995. New commercial banks and two rural development banks were established and limited progress was made toward restructuring the two large banks, the Nepal Bank Limited (NBL) and the Rastriya Banijya Bank (RBB), that account for over 70 percent of total deposits. The number of finance companies has increased sharply and this should enable the financial sector to provide enhanced facilities to middle-level entrepreneurs. Cooperatives and nongovernment organizations (NGOs) were also permitted to undertake limited banking services, particularly in the rural sector, subject to additional prudential regulations reflecting such portfolio diversification. The increase in the number of cooperatives, NGOs, and rural development banks is an important modality for improving resource mobilization as well as access to and availability of rural financing in Nepal. Furthermore, Nepal Stock Exchange activities

Table 2.16 Major Economic Indicators: Nepal

		1993	1994	1995	1996	1997
Gross Domestic Product	% change	3.3	7.3	2.3	5.6	5.2
Agriculture	% change	-0.6	7.2	-0.7	5.5	4.5
Industry	% change	4.8	8.4	2.9	5.0	5.0
Services	% change	7.3	6.8	5.4	6.0	6.0
Gross Domestic Investment	% of GDP	21.2	20.5	20.2	22.1	23.4
Gross Domestic Saving	% of GDP	11.6	12.4	10.3	10.0	10.6
Inflation Rate	% change in CPI	8.9	8.9	7.6	7.0	7.0
Money Supply Growth	% change	27.7	19.6	14.8	12.0	13.7
Merchandise Exports	\$ million	380.0	397.0	360.0	346.0	365.0
	% change	20.8	4.4	-9.2	-3.9	5.5
Merchandise Imports	\$ million	-863.0	-1,072.0	-1,337.0	-1,480.0	-1,687.0
	% change	14.7	24.2	24.7	10.7	14.0
Current Account Balance	\$ million	-219.0	-179.0	-289.0	-347.0	-340.0
	% of GDP	-6.3	-4.4	-6.5	-7.8	-6.9
External Debt Outstanding	\$ million	2,004.0	2,320.0	2,368.0	2,586.0	2,824.0
Debt-Service Ratio	% of exports	7.6	6.8	7.8	6.6	6.8

Note: All data except for that on external debt and debt-service ratio are on a fiscal year basis.

Sources: His Majesty's Government, Ministry of Finance, *Economic Survey (Revised) Fiscal Year 1994-95* (Kathmandu, October 1995) and *Budget Speech of the Fiscal Year 1995-96* (Kathmandu, October 1995); International Monetary Fund, *International Financial Statistics* (Washington, DC, February 1996); World Bank, *World Debt Tables 1996*, Vol. 2 (Washington, DC, 1996); and staff estimates.

have expanded, with the number of registered companies increasing by 11 to 79 during 1995. The value of total share transactions during 1995 reached Nepalese rupee (NRs) 1.1 billion compared with NRs400 million in 1994.

About 90 percent of the total labor force depend on agriculture. According to labor demand projections in the country's Eighth Plan, about 23 percent of the total labor force are unemployed. The problem of underemployment is widespread and surplus labor, mainly in the agriculture sector, often lack the skills and training required for employment in other sectors of the economy. The Government is seeking to provide employment-oriented training to alleviate this problem. The size of public sector employment has remained fairly stable for the past few years, reflecting efforts to streamline civil service administration.

Overall, real GDP growth is expected to increase to 5.6 percent in 1996. Agriculture sector performance is very much determined by the monsoon; as weather conditions were quite favorable during the first quarter of 1996, agricultural GDP is projected to increase by 5.5 percent for the year as a whole, with a significant increase in paddy production. This is a dramatic turnaround from 1995 when output declined. As agriculture accounts for more than 40 percent of GDP and provides livelihood for most of the population, raising agricultural productivity is essential. Accordingly, the Government gives central importance to agricultural development as indicated in its Agriculture Perspective Plan (APP) which emphasizes the complementary roles of the public and private sectors in both investment and support services. Public sector investments in agriculture will concentrate on growth-enhancing projects, such as irrigation, feeder roads, and agricultural research and extension services, and will be supported by arrangements for adequate operation and maintenance.

Industrial GDP is estimated to grow by an average of 5 percent in both 1996 and 1997, aided by the expected removal of the existing restriction on foreign investment in industries having minimum fixed capital of NRs20 million.

Power supplies should improve with strong growth in the energy sector, although some shortages are still likely to be experienced. Power shortages have hampered growth in manufacturing, tourism, and other services sectors. Hence, the exploitation of Nepal's

abundant hydropower resources, estimated at around 25,000 MW being economically exploitable, is an important element in the country's overall development strategy. Hydropower development should also improve Nepal's external accounts through power exports to India. The Government intends to undertake large-scale donor-supported hydropower projects, while also creating an environment conducive to private investments in small- to medium-size hydropower projects.

In services, the financial sector, which has been expanding rapidly in recent years, is expected to continue to mature in the next two years as private sector participation increases following economic liberalization efforts. The aviation industry is likewise expected to benefit from a more liberal operating environment. The necessary legal framework will also be established to provide a conducive environment for investors. As a result, services sector growth is estimated to recover to 6 percent in both 1996 and 1997. With good weather, implementation of the APP, and revitalization of reform efforts, GDP growth may continue to exceed 5 percent in 1997.

While domestic saving and investment are both expected to increase in the next two years, the resource gap is likely to widen. Although savings mobilization will be encouraged, particularly through the establishment of rural financial institutions and a growing network of branches, the economic liberalization program not only encourages new investment opportunities for investors but also encourages higher levels of consumption. Therefore, the growth rate in investment is likely to remain greater than that of saving.

Despite relatively buoyant growth, unemployment and underemployment will continue to be a challenge. The unemployment rate is unlikely to fall much and underemployment will remain high. Furthermore, fiscal prudence will mean only a modest expansion in employment opportunities within the Government.

Budget, Money, and Prices. Containment of the fiscal deficit has been one of the goals of fiscal reform. Efforts have been made to mobilize domestic resources, expedite implementation of development projects, and prioritize government expenditure. Fiscal policy has also aimed at achieving an efficient tax system, ensuring adequate resources for critical and productive spending, and

continuing strict control on domestic borrowing. The Government began the process of prioritization in 1995 by classifying development spending into core and noncore projects with social sector development expenditure being given high priority. Also, necessary legislative amendments and other actions are now under way to prepare for the introduction of VAT in 1997. This will further enhance domestic revenue by improving tax collection and administration. Other improvements include reducing the number of bands in the import tariff and introducing an Automated System of Customs Data at the international airport. As a result, domestic sources have contributed a rising share of total government revenue which rose to 67 percent of total expenditure in 1995 compared with 59 percent and 43 percent in 1993 and 1994, respectively, and the share of domestic revenue in GDP increased from 8.5 percent to 10.5 percent between 1993 and 1995 (Figure 2.21). Nevertheless, domestic revenue generation remains low relative to that in a number of other countries in the region. As a result, the overall budget deficit (including grants) declined steadily from 7 percent of GDP in 1993 to 5.2 percent in 1995. Also, domestic borrowing of the Government fell from 2.7 percent of GDP in 1993 to 0.5 percent of GDP in 1995.

Domestic credit policy is guided by developments in money demand and movements in international reserves. In 1994, the Central Bank – the Nepal Rastra Bank (NRB) – used open market operations in the sale of securities to offset the expansionary impact of rising external reserves; monetary and credit growth were contained. In 1995, the contractionary pressure from declining foreign exchange reserves prompted the NRB to ease the supply of domestic credit, mainly through purchases of Treasury bills at the newly established secondary open market window. Monetary expansion (M2) continued to slow down from nearly 28 percent in 1993 to about 20 percent in 1994 and further to 15 percent in 1995.

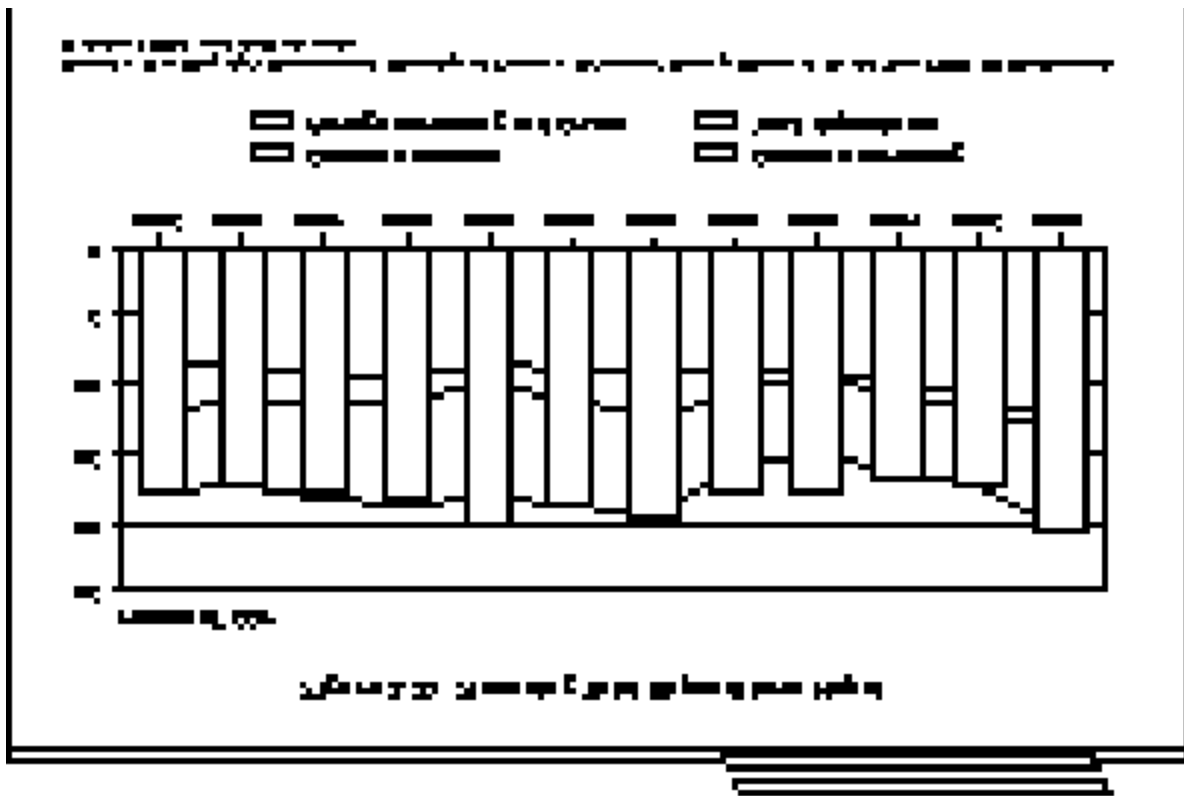
Because of a long common border, price movements in Nepal largely reflect those in India. Nevertheless, there is some scope for independent action on the part of the monetary authority to influence the rate of inflation through appropriate and prudent monetary management. Consumer price pressures moderated in 1995 with the rate of inflation

falling to about 7.6 percent compared with 8.9 percent in the previous year.

The budget for 1996 provides for an increase in revenue to 12.6 percent of GDP from 11.1 percent in 1995. Total expenditure is planned to increase to 20.7 percent of GDP from 17.5 percent in 1995, with much of the rise coming from higher capital expenditure, especially on infrastructure improvement. The overall budget deficit, including grants, in 1996 will, therefore, be higher than in 1995 at 5.8 percent of GDP. Virtually all of the deficit will be covered by foreign grants and loans.

The Government has realized the primary importance of improving fiscal management and expenditure control to achieve medium-term fiscal targets. Thus, it will continue wide-ranging reforms to rationalize both the expenditure program and the budget planning and execution procedures. By prioritizing both donor-supported and fully government-funded development projects, controlling fund releases, strengthening the administration of project implementation, and improving project monitoring, the Government aims to improve the overall efficiency of its development spending, raise the disbursement rate of committed foreign aid, and reduce significantly the time lag between expenditure incurred in foreign-assisted development projects and reimbursements by external donors. The Government will continue to pursue a comprehensive agenda for reforming Nepal's tax system aimed at improving tax efficiency and significantly broadening the tax base.

For the next two years, monetary policy will continue to aim at ensuring adequate liquidity growth to meet growing money demand while maintaining a comfortable foreign reserves position, consistent with preserving the country's fixed exchange rate regime vis-à-vis the Indian rupee. Control of annual credit expansion, which is related to annual inflation and foreign reserves targets, will be maintained through indirect monetary management by the NRB. The monetary authorities plan to establish in 1996 an effective mechanism to limit the Government's use of NRB credit, further limiting the scope for financing fiscal deficits through the banking system. Expected improvements in fiscal management and restraint on financing of the budget deficit will permit further growth of bank credit to the private sector in the medium term. Growth of broad money supply is,



therefore, expected to be contained to an average of about 13 percent in both 1996 and 1997. As the fiscal deficit and monetary expansion are expected to be contained, the rate of inflation is likely to be no higher than 7 percent on average during 1996. Inflation fell below 7 percent during the early part of 1996; however, depreciation of the Indian rupee is likely to lead to upward pressure on prices in Nepal during the balance of the year and in 1997.

External Trade and Payments Considerable progress has been made during the past three years in rationalizing Nepal's trade and exchange system. The external sector has been transformed from a highly distorted and inward-looking trade and payments system to one of full *de facto* convertibility for current account transactions with a liberalized tariff structure. The number of tariff bands was reduced to five and the export fee has been reduced from 2 percent to 0.5 percent. Further action to reduce the number of bands, level, and dispersion of tariff rates will be coordinated with implementation of the broader tax reform agenda to ensure that the Government's revenue objectives are achieved. Low and non-discriminatory import tariffs and eventual qualification for WTO membership continue to be important policy objectives.

During 1995, total exports decreased by 9.2 percent to \$360 million compared with an increase of 4.4 percent in 1994. However, imports increased sharply by 24.7 percent resulting in a trade deficit of \$976.6 million, the equivalent of 22 percent of GDP.

Nepal's exports are still heavily concentrated in three markets - Germany, India, and the US - and two products - carpets and garments - which account for 72 percent of total exports. Exports of both carpets and garments decreased significantly by 19.9 percent and 13.7 percent, respectively, between 1994 and 1995. However, exports to India, after a long decline in relative importance, increased by 30.6 percent in nominal terms as a result of the new Trade and Transit Treaty and now account for about 18.8 percent of the total.

Major import items in 1995 included machinery and transport equipment and manufactured goods. Although both service receipts and transfers increased, they were not sufficient to offset the trade deficit in 1995. The current account deficit, therefore, widened by \$110.3 million, reaching \$289 million or 6.5 percent of GDP compared with 4.4 percent in 1994.

Despite rapid growth in the current account deficit, the overall balance-of-payments position remained favorable. The foreign exchange reserves of the banking system are estimated

at \$838 million, sufficient to cover seven-and-a-half months of imports. Although outstanding external debt increased to more than 50 percent of GDP in 1995, the debt-service ratio is manageable at 7.8 percent of exports.

The foreign trade position of Nepal is not expected to improve much in the next two years. Power shortages and inadequacies of transport and other infrastructure will continue to be major constraints for the expansion of the export base. Total exports are expected to decline by 3.9 percent to \$346 million in 1996. While the carpet industry might recover after the resolution of the child labor and environment issues, the garment industry faces the prospect of a loss of competitiveness after the eventual removal of the quota system. Tourism has considerable growth potential; however, it has been adversely affected by the worsened solid waste management and air pollution situation, particularly in Kathmandu. Government efforts to deal with such problems through infrastructure investment, and to expand the range of export items and markets through its liberalization policies and encouragement of the private sector give rise to the possibility of export growth of about 5.5 percent by 1997.

Imports are projected to grow at 10.7 percent for 1996 and 14 percent for 1997. Under the Government's new Open Sky Policy, private sector airlines are allowed to operate on international routes and that will possibly increase the inflow of service receipts. However, the increase in the surplus on services and transfer accounts will not be sufficient to cover the growing trade deficit. The current account deficit is, therefore, likely to remain high at 7.8 percent and 6.9 percent of GDP in 1996 and 1997, respectively. It is expected that the overall balance of payments will deteriorate slightly and, as a result, official reserves will decline slowly, although they are projected to remain at a comfortable level of six months of imports. The debt-service ratio is likely to stay below 7 percent over the next two years as most of the foreign loans are concessional and substantial repayments are not due to begin for some time.

Policy and Development Issues

To maintain steady and sustainable growth, fiscal discipline and monetary management are crucial. Fiscal management will be

improved by prioritization of the expenditure program, and implementation of the three-year rolling expenditure plan and the VAT.

The Government's privatization program is critical to future development. Restructuring and eventual privatization of the two state commercial banks are an important component of private sector development, as are the Government's efforts to establish a liberal and more transparent incentive system. The shortage of skilled and trained labor for large-scale and internationally competitive manufacturing development will require special efforts in human resource development.

Economic liberalization in the industry sector has expanded economic activities and opened new opportunities for income generation. The amendment to the recently approved Foreign Investment and Technology Transfer Act of 1992 to remove the investment floor of NRs20 million will attract small- to medium-scale investors. With financial liberalization, the financial sector has been growing and private sector access to credit has been enhanced. However, interest rates need further liberalization and greater competition is required to lower interest rate spreads.

The cancellation of the Arun III Hydropower Project in August 1995 heightens the need for a review of future power supply development. Private sector participation in small-scale power projects to meet local demand is one avenue that should be explored.

The Government's decentralization policy aims to delegate authority, with appropriate budget allocations, to the local level for development activities, particularly in the social sectors. It aims to strengthen the capacity of local level administration and improve the effectiveness of project outcome. However, given the divergence in institutional capacity among the authorities, close monitoring of performance and capacity building and institutional strengthening might be necessary.

To reduce poverty and improve income distribution, Nepal will need to continue to build the foundations for broad-based economic development, including instituting programs for promoting human resource development and for slowing the high rate of population increase. Economic liberalization and fiscal discipline remain the two crucial planks of the Government's strategy to achieve sustainable market-oriented economic growth. This agenda must be pursued more vigorously.