Nepal

Growth will continue to be weak, while inflation should remain moderate. Structural weaknesses relate to external trade, resource mobilization, and fiscal imbalances.

RECENT TRENDS AND PROSPECTS

GDP growth declined to 4.3 percent in 1997, compared with 6.1 percent in 1996. The slowdown was evident in all sectors, particularly the nonagriculture sectors. Although the rapid growth of nonagriculture sectors in recent years reduced the share of agriculture in GDP from about 50 percent in 1990 to 41 percent in 1997, agriculture is still the single most important determinant of overall economic performance. About 80 percent of the total labor force depend on agriculture for their livelihood. Aided by the favorable monsoons, agriculture grew 4.1 percent in 1997, close to the average annual growth rate of the sector for the past two decades.

Industrial growth slowed from 5.9 percent in 1996 to 3.2 percent in 1997, mainly because of slow growth in construction. Although manufacturing grew by a respectable 5.7 percent, this was lower than in 1996. The major obstacles to further industrial development are limited infrastructure, power shortages, and a lack of skilled human resources. The public sector has reduced its involvement in many areas, and private sector participation has been enhanced since 1992 through privatization, institutional reforms, and economic liberalization. In addition, in September 1997 amendments to the Industrial Enterprises Act reduced distortionary tax holiday incentives.

The service sector grew by 5.0 percent in 1997, down from 7.9 percent in 1996. This reflected a significant slowdown in finance, real estate, and community and social services. Increasing concerns about environmental pollution, natural disasters such as flash floods and landslides, malaria in India, and political disturbances had an adverse effect on tourism. Unemployment stood at about 23 percent of the total labor force in 1997 and underemployment remains widespread.

Total budgetary revenues grew by almost 12 percent, less than half the government's target, and remained at about 11 percent of GDP in 1997. Tax revenues have gradually increased their contribution to 80 percent of total revenues (excluding grants), and grew from less than 7 percent of GDP in 1992 to 9 percent in 1997. The continued weakness in revenue collection since 1995 reflects reduced growth of imports and changes in import composition toward low tariff commodities. Imports account for almost 30 percent of tax revenues through custom duties, and sales tax generates another 20 percent. In September 1997 the government amended the Customs Act to improve customs valuations in preparation for the introduction of an automated customs system at the international airport.

With low revenue collections and lower than expected foreign grants, the government's fiscal performance would have deteriorated in 1997 if not

1997 refers to fiscal year 1996/97, ending 15 July.

Table 2.14 Major Economic Indicators: Nepal, 1995-1999
(percent)

Item	1995	1996	1997	1998	1999
Gross domestic product, growth[a]	2.8	6.1	4.3	3.7	4.0
Gross domestic investment/GDP	23.4	23.2	23.4	24.9	25.0
Gross national saving/GNP	15.2	10.3	12.5	13.1	13.0
Inflation rate (consumer price index)	7.6	8.1	7.8	7.5	8.0
Money supply (M2) growth	16.1	14.4	10.7	12.0	12.0
Fiscal balance/GDP[b]	-4.6	-5.6	-5.3	-5.6	-5.8
Merchandise exports growth	-9.6	1.7	10.3	4.0	6.0
Merchandise imports growth[c]	21.9	9.0	10.3	5.0	6.0
Current account balance/GDP	-7.8	-12.8	-7.2	-8.7	-8.8
Debt-service/exports	7.9	8.4	8.2	8.4	8.2

Note: All data are on a fiscal year basis.

[a] At factor cost.
[b] Including grants.
[c] Cost, insurance, and freight.

Sources: Asian Development Bank (1998); Central Bureau of Statistics (1997a, b); Ministry of Finance data; and staff estimates.

for a significant shortfall in development expenditures, which rose just 6 percent rather than the 33 percent envisaged in the budget. This was partly due to a slowdown in project implementation resulting from political disturbances and staff changes after local elections. The fiscal deficit (including foreign grants) improved slightly to 5.3 percent of GDP in 1997.

Money supply (M2) growth slowed to 10.7 percent, down from about 14 percent the previous year. Net domestic assets, which account for more than 90 percent of the change in money supply since 1995, rose by 17 percent in 1997. Domestic credit grew by 13 percent, and credit to the private sector posted a relatively modest, but still respectable, increment of 18 percent.

The auction of Treasury bills and securities from the Central Bank is now an integral part of the monetary program. Open market operations are a principal instrument for controlling domestic liquidity. In addition, the authorities took steps to reduce the government's automatic recourse to the Central Bank's overdraft facilities, which had complicated the conduct of monetary policy in the past, by placing a binding annual limit on its annual overdraft of NRs1 billion as of the beginning of 1998. The commercial banking system was strengthened through the recapitalization of the two government-owned commercial banks—Nepal Bank Limited and Rastriya Banijya Bank—which account for about 65 percent of total deposits. The government reduced its ownership in Nepal Bank Limited to 40 percent in early 1997 as part of its privatization efforts. The Rastriya Banijya Bank is undertaking major restructuring and is high on the government's priority list for privatization.

Inflation declined from 8.1 percent in 1996 to 7.8 percent in 1997, reflecting moderate price changes. Because of the open border trading with India, price developments in Nepal closely reflect those in India.

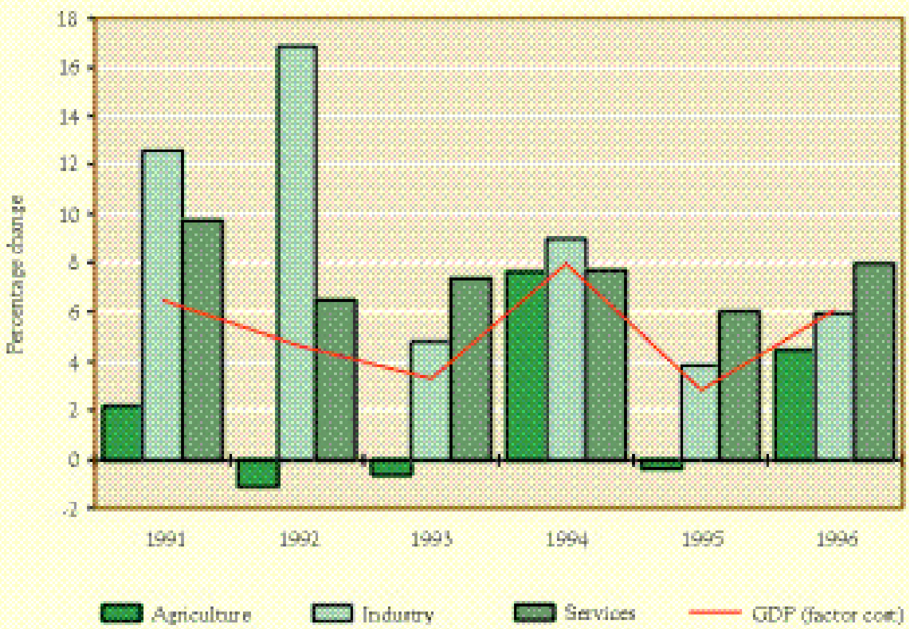
The exchange rate was relatively stable in early 1997, with the Nepalese rupee depreciating about 3 percent against the US dollar, and thereby exerting little inflationary pressure on the economy. The currency's depreciation since July 1997 reflects adjustment of the Indian rupee as well as the alignment of the real effective exchange rate to maintain the competitiveness of Nepalese products.

Exports continued to recover, with an increase of more than 10 percent in 1997, compared with 1.7 percent the previous year. Imports showed a similar increase, up slightly from 9 percent in 1996, thus maintaining the trade deficit at 23 percent of GDP. Nepal generally has a large trade deficit because of its low export base and high import levels. Remittances from overseas workers were an important source of earnings. Higher investment income also contributed to the improvement in the current account. As a result, the current account deficit (excluding grants) improved by 38 percent to $354 million, or 7.2 percent of GDP. Inflows of official grants and concessional aid continued to finance a substantial portion of the current account deficit. By the end of 1997, the balance of payments had registered a surplus of $161 million and foreign exchange reserves had grown to $812 million, equivalent to more than six months' worth of imports of goods and services.

Projections indicate that in 1998 real GDP growth will be 3.7 percent, with increased crop production and continued normal growth trends in the financial, manufacturing, and service sectors. With implementation of the Agriculture Perspective Plan, revitalization of reform efforts, and favorable weather, real GDP growth may reach 4 percent in 1999; however, agricultural growth is expected to decelerate to 2.0 percent following unfavorable weather conditions during the first quarter of 1998.

The government continues to encourage private sector development in industry by pursuing macroeconomic stability and removing distortions in prices and regulations. The industry sector is therefore forecast to grow by 4.6 percent in 1998 and 4 percent in 1999. Hydropower development should also improve Nepal's long-term development prospects through power exports to India. In 1997 Parliament ratified the Mahakali Integrated Development Treaty between India and Nepal, a joint hydroelectric, irrigation, and flood control project, and an agreement was also signed between the two countries for possible investment in and financing of hydroelectric projects by the private sector and lending agencies. More development projects in sectors like power, transportation, and irrigation would support a gradual recovery in construction activi-

Figure 2.10 GDP Growth by Sector: Nepal, 1991-1996



Source: Central Bureau of Statistics data.

ties. The strength of export demand for carpets and garments will largely determine the prospects for manufacturing.

Increased tourist arrivals and trading and financial activities will support growth in services, although at a lower rate than in the past. Providing the necessary legal framework and continuing economic liberalization efforts will foster greater private sector participation. Service sector growth is expected to exceed 4 percent in 1998 and 1999.

While forecasts indicate that domestic savings and investment will increase in 1998 and 1999, the resource gap is likely to widen. Economic liberalization programs have not only helped to open up new investment opportunities for investors, but have also encouraged consumption and savings mobilization, particularly through the establishment of rural financial institutions. Therefore, the government's commitment to continue its efforts to improve resource mobilization will be crucial, including major tax reforms and measures to ensure efficiency in the financial sector and revitalize the capital market.

The 1998 budget includes programs to facilitate development activities and improve the stagnant revenue performance by strengthening tax collection and administration. The value-added tax introduced in November 1997 will further enhance domestic revenues by expanding the tax base. While the full impact of proposed tax reforms and revenue mobilization measures will not be apparent for a few years, government expenditures are expected to increase in 1998, mainly because of adjustments in civil service salaries and the implementation of major projects. Thus despite the anticipated increase in domestic revenues, the fiscal deficit as a percentage of GDP is likely to deteriorate in 1998. Net domestic borrowing in 1998 will be contained at about 1 percent of GDP if revenue targets and anticipated foreign grants and loans are realized.

Merchandise exports and imports are likely to grow at roughly the same rate in 1998 and 1999, and the current account will stabilize at just under 9 percent of GDP, compared with 7.2 percent in 1997. The expected increase in tourist visits as a result of the "Visit Nepal Year 1998" campaign and the operation of international flights by private sector airlines could raise net service receipts during the next two years. However, the increase in the service and transfer accounts surplus will not be sufficient to cover trade deficits. Official capital inflows should increase substantially in 1998 and subsequent years, reflecting improved use of external aid. Net transfers are projected to increase temporarily because of the return of a large number of Gurkha soldiers formerly stationed in Hong Kong, China. Increased remittances can also be expected from the increasing number of Nepalese workers in the Middle East and India. The government's total outstanding external debt will increase to more than 55 percent of GDP in 1999, but the debt-service ratio will remain below 9 percent of exports during the next two years, as most foreign loans are on concessional terms and substantial repayments are not due to begin for some time.

POLICY AND DEVELOPMENT ISSUES

Even assuming favorable results from economic policies to increase private sector participation, substantial government support will be needed to boost overall development in the next few years. However, the extent of government support will be constrained by its limited capacity to mobilize domestic resources and the country's weak implementation and monitoring capabilities. Measures are needed to address the economy's structural weaknesses, particularly in the areas of external trade, resource mobilization, and fiscal imbalances.

Reducing fiscal expenditures will be difficult without further cuts in operation and maintenance expenditures and/or local counterpart funds for new development projects. However, the country cannot afford any slippage in its fiscal targets, particularly in revenue mobilization and domestic borrowing, unless it accepts lower growth and/or higher inflation and external imbalances. Under these circumstances, the government will need to tackle the structural weaknesses that are at the root of the fiscal imbalances. This should include efforts to reduce public service overstaffing, contain the burden of loss-incurring public enterprises, prioritize development expenditures effectively to avoid project underfunding, and find new sources of revenues.