

ADB

QUARTERLY ECONOMIC UPDATE

NEPAL

December 2006

Asian Development Bank



QUARTERLY ECONOMIC UPDATE

NEPAL

VOLUME III NO. 3

December 2006

Asian Development Bank

© 2006 Asian Development Bank, Nepal Resident Mission

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, without the prior written permission of the Asian Development Bank (ADB). ADB does not guarantee the accuracy of the data included in this publication and accepts no responsibility for any consequences of their use.

This issue of the NRM Quarterly Economic Update (QEU) was prepared by a team comprising:

Paolo Spantigati, Head, Macroeconomic, Governance, Finance, Regional, and External Relations/Senior Country Specialist
Md. Shahid Parwez, Programs/Project Implementation Officer
Shreejana Rajbhandari, Assistant Programs and Operations Analyst

The views expressed in the QEU are those of the authors and do not necessarily reflect the views of the ADB, or its Board of Directors, or its member governments.

Asian Development Bank
Nepal Resident Mission
Srikunj, Kamaldi, Ward No. 31
Post Box 5017
Kathmandu, Nepal
Tel: + 977 1 422 7779
Fax: + 977 1 422 5063
adb^{nrm}@adb.org
www.adb.org/^{nrm}

Officer-in-Charge: P. Spantigati



CONTENTS

MACROECONOMIC REVIEW

	Page
A. Overview	1
B. Output	1
C. Policy Developments	2
D. Fiscal Performance	2
E. Monetary Developments and Inflation	4
F. Balance of Payments (External Sector)	5

APPENDIXES

Table 1: Country Economic Indicators	6
Table 2: Country Poverty and Social Indicators	7

ACRONYM

CTEVT	Council for Technical Education and Vocational Training
IOC	Indian Oil Corporation
M2	Broad Money
NR	Nepalese Rupee
VAT	Value Added Tax

Note

The fiscal year (FY) of the Government ends 15 July. FY before a calendar year denotes the year in which the fiscal year ends. For example, FY 2006 ended on 15 July 2006.

MACROECONOMIC OVERVIEW

A. Overview

1. The prospects for economic growth in FY2007¹ have improved with the positive political developments in 2006. The Peace Agreement between the Seven Party Alliance (SPA) Government and Communist Party of Nepal, Maoist (CPN/M) led to signing of the Interim Constitution of Nepal. A detailed code of conduct has been agreed upon to ensure a permanent ceasefire with strict provisions against the use of weapons by both parties, recruitment of armies, and extortion activities. These developments present enhanced opportunities for achieving lasting peace, and accelerating development and social transformation.

2. Following improvement in security situation, the signs of economic recovery are appearing but still may take some time to revive. The FY2007 budget has aimed an ambitious gross domestic product (GDP) growth at 5%. Agricultural output has been severely affected by adverse weather conditions and pose threats to the agricultural production and its significant contribution to the economy in terms of enhancing the growth. Industrial sector is yet to respond to the recent positive political and security development. The main reason for the sluggish revival in the industrial sector is low business confidence due to frequent demands put forward by the labor unions. The industrial environment has not been conducive to take initiatives for expansion of the activities. The service sector continues to show poor performance. The decline in tourist arrivals in the first quarter of FY2007 is discouraging although revival in the remaining period can be expected with continued improvement in the security and political situation.

3. The fiscal situation improved in the first quarter of FY2007 due to a strong growth in revenue collection which grew at 26.7% as compared to a negligible increase of 0.6% in the same period of FY2006. The Government expenditure registered a growth of 17.7% in the first quarter of FY2007. However, the recurrent expenditure accounted for the major share of the Government expenditure. The year-on-year inflation at mid-October of FY2007

moderated to 7.5% from 7.8% in the same period of FY2006. In the first quarter of FY2007, the current account deficit stood at 48.3%. It declined from 235% in the same period of FY2006 due to weak imports. This resulted in narrowing trade deficits to 10.6% as compared to that of 30.3% in the first quarter of FY2006.

B. Output

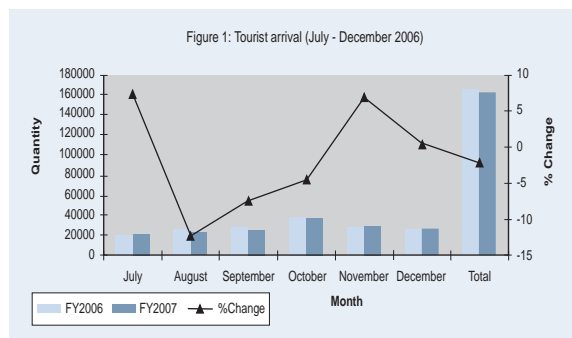
4. Agricultural output has been affected by unfavorable weather conditions. The summer crops were affected by floods in the mid and far western regions of Nepal and a prolonged draught in the plains of eastern Nepal. The Ministry of Agriculture and Cooperatives in an initial estimate reported a decline of 15-20% in paddy production due to the drought. Whereas, in several districts of mid and far western regions, maize harvest declined by 20-50% due to floods. The decline in the production of summer crops does not only pose a serious threat to the recovery in the economic growth but also to the food security of the country. Many mountain/hill districts have been identified as food deficit. Market prices of cereals are rising which would affect the availability of the food to the vulnerable groups. Shift from traditional agriculture and adoption of modern agricultural techniques to decrease dependency on weather has become very important to improve agricultural production.

5. The industrial sector continues to show sluggish growth. Though there has been improvement in security situation, the disruptive activities such as *bandhs* and blockades continue to hamper the industrial growth. Continued disruptions in industrial production by the ambitious demands of labor and low business confidence has been affecting the performance of the sector.

6. The service sector is showing signs of revival but has not materialized so far. The total tourist arrival in Nepal between July and December 2007 have declined by about 2% as compared to the same period last year (Figure 1). The decline has been observed to be about 12% in the first quarter of FY2007 as compared to that of FY2006. However, there has been slight revival in the latter three months (October – December), which is encouraging. Among

¹ FY2007 covers the period from 15 July 2006 to 4 July 2007.

other things, the tourist arrivals particularly from the Western countries have to revive. This will require improvement in the security situations and adoption of confidence building measures by the Government. The Government must consider innovative ways to improve tourism sector by promoting existing as well as new tourism destinations.



Source: Nepal Tourism Board monthly release

C. Policy Developments

7. In order to improve the governance in civil services in Nepal and make it more inclusive, the Government tabled a Bill on Amendments to Civil Service Act 1993 in the Parliament in September 2006. The Bill includes several reforms envisaged by the Governance Reform Program in the Nepal civil service, including measures to increase the representation of women and other disadvantaged groups in the civil service. The Bill is currently under the review of Parliament's State Affairs Committee.

8. The Government approved a policy for agro-enterprise promotion/development in November 2007. The Agro-Enterprise Promotion Policy, 2063 (2006) aims to promote market-oriented and competitive agriculture production, develop agro-industries to produce for internal consumption and export promotion and reduce poverty through agriculture commercialization. The Government, for the first time, has prepared such a policy which envisages diversification and commercialization of agriculture sector with involvement of the private sector. Both internal and external market promotion will be given emphasis to materialize the objectives of the policy. The policy seeks partnership between the private sector and Government to develop marketing network for export of agro-products in light of

world trade order such as the World Trade Organization.

9. Parliament approved a new legislation on Water Supply Management Board, which allows the transfer of Nepal Water Supply Corporation's (NWSC) assets and liabilities to the Board. This legislation is critical for the transfer of assets and liabilities of NWSC to Kathmandu Valley management board under Melamchi and other boards formed in Bharatpur and Hetauda.

10. The Government tabled new Petroleum Bill in the House of Representative which will make the provision to open imports as well as retailing of petroleum imports to private players. However, several issues remain to be addressed before the new bill is passed. There exists an agreement signed in 1974 between the Government of Nepal and Government of India that consists of a Memorandum of Understanding citing Indian Oil Corporation (IOC) as the sole export agency of petroleum products to Nepal. This calls for review of 1974 agreements by the two Governments in order to abolish the monopoly of IOC in the Nepalese market and open up the petroleum sector for the private sector and global market.

11. Parliament approved the Amendment of Council for Technical Education and Vocational Training (CTEVT) Act in October 2006. The amendment will streamline the business process, governing structure and functioning of CTEVT. The Act also addresses the issue relating to the legal standing of CTEVT's management structure.

D. Fiscal Performance

12. The hard hit fiscal situation of the Government is showing signs of improvement. The Government experienced a revenue surplus of NRs133.7 million in the first quarter of FY2007 as compared to a deficit of NRs2 billion in the same period last year. The surplus was mainly due to revenue growth and increase in foreign grants (52.5%) in light of the political developments in the country.

13. Revenue recorded a growth of 26.7% in the first quarter of FY2007 in contrast to a mere 0.6% growth in the same period of FY2006 (Table 1). The remarkable increase in revenue collection which achieved 19% of the total

revenue target has been contributed by increasing worker's remittances, customs revenue due to tariff adjustments as well as income tax collection. It is worth noting that the tax revenue grew by 23.3% in the first quarter, achieving 20% of the targeted tax revenue collection of FY2007 in contrast to only 3.4% increase in the same period of FY2006. Similarly, non-tax revenue grew by 54% in first quarter of FY2007 as compared to a negative growth of 17.1% in the first quarter of FY2006. However, value added tax (VAT) collection in the first quarter of FY2007 declined by 10.1% compared with a growth of 525% in the same period of FY2006. The reduction in VAT collection is a cause of concern and requires a concerted effort for strengthening administration of VAT.

14. On the spending side, total government expenditure was 5% higher in the first quarter of FY2007 achieving 12% of annual expenditure targeted. The recurrent expenditure grew by 28.5% – achieving 19% of the annual target in the review period and accounted for the major share of the increase in expenditure. Increase in the civil service allowances and administrative expenses contributed to the

growth of current expenditure. The capital expenditure remained sluggish achieving only 2.9% of the total target during the first quarter of the FY2007.

15. The growth in volume of recurrent expenditure is a matter of concern. A still more worrying fact is that spending under capital expenditure, that is mainly used for financing development activities, did not show progressive growth. There has been delay in fulfilling the commitments to deliver development results due to the absence of local bodies and an agreement on all party committee at local level to undertake the development activities. The stagnation in the public spending questions the Government's efforts to undertake the development activities effectively.

16. The declining trend in public expenditure mainly indicates the Government's inability to pursue development activities, especially during the transition. The Government needs to step up development activities in order to ensure the access to public services to all the sections of the society.

Table 1: Fiscal Performance in the First Quarter

Item	First Quarter		% Change in the First Quarter	
	FY2006	FY2007	FY2006	FY2007
Revenue and Grants	14614.1	19677.0	1.8	34.6
Current Revenue	12794.6	16209.9	0.6	26.7
Tax Revenue	11380.2	14031.1	3.4	23.3
Non Tax Revenue	1414.4	2178.8	(17.1)	54.0
Foreign Grants	1516.1	2312.3	(8.5)	52.5
Value Added Tax	308.2	277.2	525.2	(10.1)
Expenditure	16606.2	19543.3	12.4	17.7
Recurrent Expenditures	12236.5	15723.1	6.2	28.5
Capital Expenditures	1450.9	1288.6	77.0	(11.2)
Principal Repayment	610.9	417.4	(41.5)	(31.7)
Others	2307.9	2114.2	66.0	(8.4)
Deficit (-) Surplus (+)	(1992.0)	133.7	375.2	(106.7)
Financing of Overall Balance	1992.0	(133.7)	375.2	(106.7)
Domestic Financing	918.2	(750.6)	(366.8)	(181.7)
Foreign Financing	1073.8	616.9	40.7	(42.5)

* Change in outstanding disbursement

Source: Nepal Rastra Bank

E. Monetary Developments and Inflation

17. In terms of monetary developments, broad money (M2), on year-on-year basis, grew by 17% in the first quarter of FY2007 as compared to a growth of 8% in the same period last year (Table 2). The net domestic credit and foreign assets which grew at 15% and 22% respectively contributed to the growth in M2. In view of huge foreign assets, its growth was limited by payment done by Nepal Oil Corporation to IOC. However, growth in credit declined sharply in the first quarter of FY2007. Financial sector claims on Government and financial enterprises declined by 44% and 54%, respectively. Financial sector claims on non-financial enterprises declined by 22% in first quarter of FY2007 as compared with an increase of 50% in the same period last year.

18. The liquidity situation remains high due to continuous rise in the workers' remittances and appreciation of Nepalese Rupee (NR) against the US dollar. The commercial banks added to the liquidity by selling their foreign exchange to the Nepal Rastra Bank. Despite ample liquidity in the banking sector, M2 increased by 17% due to reluctance of the commercial banks to lend credit at low interest rates. Default on loans by large private firms remain unaddressed though Government has acknowledged the concern and made commitment to address it. The Government requires fulfilling its commitment to pursue

corporate governance based on financial discipline that could provide stimuli and help in reviving the financial sector.

19. Though the private sector credit expanded by 22% in the first quarter of FY2007 compared to an increase of 13% in the same period of FY2006, the market remains flush with liquidity. The instruments such as open market operations, outright sales auction and reverse repo auction were used to mop up the liquidity which to certain extent helped but could not prove to be effective in stabilizing the excess liquidity.

20. The year-on-year headline inflation remained at 7.5% at mid-October 2006 as compared to 7.8% in mid-October 2005. The core inflation in mid-October 2006 increased to 6.2% from 4.4% in the same period of 2005. Average annual inflation in FY2006 was 8% compared with 4.5% in FY2005 owing to higher food and oil prices. Given the prolonged drought in some and floods in other parts of the country, the food prices are less likely to come down. Increase in domestic oil price is also on the card which would put inflationary pressure. The Government target of achieving an average inflation of about 5% in FY 2007 is rather challenging.

21. Nepal's foreign exchange reserve grew by 2% to \$2.3 billion in mid-October 2006 from \$2.2 billion in mid-July 2006. This is equivalent

Table 2: First Quarter Monetary Survey
(NRs million)

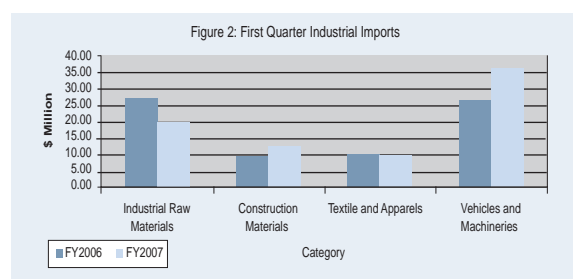
Item	FY2006	FY2007	% Change in the First Quarter			
			FY2006		FY2007	
			Amount	Percent	Amount	Percent
Net Foreign Assets	112,852	137,671	6,127	6	24,819	22
Domestic Credit	286,784	330,533	26,785	10	43,749	15
Net Claims on Government	62,895	69,884	1,402	2	6,989	11
Claims on Government Enterprises	18,558	10,364	1,626	10	(8,194)	(44)
Claims on Financial Enterprises	12,674	5,803	(325)	(2)	(6,871)	(54)
Claims on Non-Financial Enterprises	5,884	4,561	1,951	50	(1,323)	(22)
Claims on Private Sector	205,331	250,285	23,821	13	44,954	22
Liabilities	90,689	107,788	171,814	(212)	17,099	19
Broad Money Supply (M2)	308,948	360,416	23,350	8	51,469	17

Source: Nepal Rastra Bank

to about 10.8 months of imports of merchandise goods and 8.8 months of services imports. Convertible currency reserves declined by 0.6% in the first quarter of FY2007 compared to a slight increase by 2.1% in the same period of FY2006.

F. Balance of Payments (External Sector)

22. Weak public and private demand, conflict related disruptions and political instability affected the external sector development. Exports declined by 4.3% in the first quarter of FY2007 as compared to a growth of 20.6% in the same period last year. Similarly imports increased by only 4.8% in the first quarter of FY2007 as compared to an increase of 26.3% in the first quarter of FY2006. Imports of industrial raw material and apparels declined by 25.8% and 2.4% respectively in the first quarter of FY2007 as compared to that of FY2006 (Figure 2).



Source: Nepal Rastra Bank

23. Due to a slowdown in the imports, the current account deficit declined to 48.3% in the first quarter of FY2007 which was about 235% during the review period last year and that led to narrowing the trade deficit to 10.6% which was 30.3% in the first quarter of FY2006.

24. Nepalese garment industry was hardest hit by the expiration of the Multi Fiber Agreement (MFA) in January 2005. It led to the closure of many garment factories in the country. The closure of Cotton Comfort, one of the largest garment exporters, in December 2006 is only an example of the deterioration in the business confidence and industrial environment in the country. Moreover, the situation is further exacerbated by unreasonable demands of the workers, threats of physical harm and lack of initiatives to make the industry more competitive and promote the sector. The garment industry used to provide employment to about 200,000 people and its export was about NRs14 billion a couple of years ago which has declined to NRs50 million in recent years. If appropriate measures are not taken on time to address the underlying causes of the deterioration, the garment industry is reaching the verge of collapse in the post-MFA era. Given its importance, the government requires to devise a long-term policy to improve the business environment and make the sector competitive in the world market.

Table 3: Balance of Payments
(\$ Million)

Item	First Quarter		% Change in the First Quarter	
	FY2006	FY2007	FY2006	FY2007
Current Account	(40.1)	(20.7)	(234.7)	(48.3)
Trade Balance	(352.0)	(389.4)	30.3	10.6
Good: Exports	225.4	215.8	20.6	(4.3)
Good: Imports	(577.4)	(605.2)	26.3	4.8
Net Services	(19.0)	(29.1)	(635.0)	53.3
Tourism	22.8	27.3	(34.9)	19.7
Net Current Transfer	317.1	397.9	5.0	25.5
Workers' Remittances	259.2	322.2	22.4	24.3
Capital Account Balance	13.3	11.3	250.6	(15.1)
Financial Account	16.1	55.5	(124.6)	245.0
Balance of Payments	(50.1)	(13.9)	(363.2)	(72.2)

Source: Nepal Rastra Bank

APPENDIXES

Table 1: Country Economic Indicators

Item	Fiscal Year				
	2002	2003	2004	2005	2006 ^a
A. Income and Growth					
1. GDP per Capita (\$ current)	233	242	272	292	311
2. GDP Growth (% in constant prices)	(0.4)	3.0	3.5	2.3	2.3
Agriculture	2.2	2.5	3.9	3.0	1.7
Industry	(2.9)	3.3	1.1	1.5	3.5
Services	(1.3)	3.4	4.8	2.4	2.4
B. Saving and Investment (current and market prices)					
			(% of GDP)		
1. Gross Fixed Capital Formation	19.3	19.1	19.1	18.9	18.5
2. Gross National Saving	16.5	15.5	15.2	14.4	13.3
C. Money and Inflation					
			(annual % change)		
1. Consumer Price Index ^b	2.9	4.8	4.0	4.5	8.0
2. Total Liquidity (M2)	4.4	9.8	12.8	8.3	15.4
D. Government Finance					
			(% of GDP)		
1. Revenue and Grants	13.1	14.5	14.4	15.6	14.9
2. Expenditure and Onlending	16.9	16.0	15.5	16.5	16.7
3. Overall Fiscal Surplus (deficit)	(3.9)	(1.5)	(1.0)	(0.8)	(1.8)
4. Security Expenditure (as % of GDP)	2.8	3.0	3.0	3.4	3.4
E. Balance of Payments					
1. Merchandise Trade Balance (% of GDP)	(12.6)	(15.4)	(15.6)	(16.1)	(18.9)
2. Current Account Balance (% of GDP)	4.3	2.5	2.9	2.2	2.4
3. Merchandise Export (\$) Growth (annual % change)	(20.3)	(13.8)	14.8	11.0	4.2
4. Merchandise Import (\$) Growth (annual % change)	(15.3)	7.1	15.9	12.1	18.4
5. Remittance (as % of GDP)	11.6	12.4	12.4	12.7	17.1
F. External Payments Indicators					
1. Gross Official Reserves (including gold, \$ million)	1,030.6	1,158.8	1,446.6	1,475.5	1833.9
Months of current year's imports of goods	7.4	7.7	8.1	7.4	7.2
2. External Debt Service (% of exports of goods and services)	8.5	9.7	8.8	9.4	8.5
3. Total External Debt (% of GDP)	50.8	48.8	46.1	41.2	40.1
G. Memorandum Items					
1. GDP (current prices, NRs billion)	422.8	456.7	496.7	533.5	582.9
2. Exchange Rate (NRs/\$, average)	76.7	77.9	73.8	72.2	72.3
3. Population (million)	23.7	24.2	24.8	25.3	25.9

GDP = gross domestic product; NRs = Nepalese rupees.

^a Revised estimates.

^b Annual percentage change (period average).

Sources: Ministry of Finance. 2006. Economic Survey. Kathmandu; Central Bureau of Statistics. 2005. National Accounts of Nepal. Kathmandu; Nepal Rastra Bank. Macroeconomic Situation, 2006, and additional information provided to Asian Development Bank staff.

Table 2: Country Poverty and Social Indicators

Item	Period			
	1985	1990	Latest Year	
A. Population Indicators				
1. Total Population (million)	16.2	17.9	25.3	(2005) ^a
2. Annual Population Growth Rate (% change)	2.1	2.1	2.3	(2005)
B. Social Indicators				
1. Total Fertility Rate (births/woman)	5.9	5.3	3.7	(2000-2005)
2. Maternal Mortality Rate (per 100,000 live births)	—	850.0 (1991)	415.0	(2000)
3. Infant Mortality Rate (below 1/1,000 live births)	115.4	102.1	61.0	(2005)
4. Life Expectancy at Birth (years)	50.9	53.6	61.6	(2003)
Female	50.0	52.9	62.0	(2003)
Male	51.6	54.2	61.2	(2003)
5. Adult Literacy (%)	26.5	30.5	48.6	(2003)
Female	9.8	14.0	34.9	(2003)
Male	42.7	47.5	62.7	(2003)
6. Primary School Net Enrollment (%)	—	61.0	71.0	(2003)
7. Secondary School Gross Enrollment (%)	25.2	33.1	50.5	(1997-2000)
8. Child Malnutrition (% below age 5)	69.1 (1975)	57.0 (1990)	53.0	(2000)
9. Population Below Poverty Line (international, %) ^b	—	—	37.7	(1990-2003)
10. Population with Access to Improved Water Sources (%)	—	69 (1990)	81	(2005)
11. Population with Access to Improved Sanitation Facilities (%)	—	12 (1990)	39	(2005)
12. Public Education Expenditure (% of GDP)	2.7	2.0	3.4	(2000-2002)
13. Human Development Index	0.42	0.42 (1990)	0.52	(2003)
14. Rank/Total Number of Countries	114/130 (1987)	152/173 (1990)	136/177	(2005)
15. Gender-Related Development Index	—	0.33 (1995)	0.51	(2003)
16. Rank/Total Number of Countries	—	148/163 (1995)	106/177	(2003)
C. Poverty Indicators				
1. Poverty Incidence	—	42 (1996)	31.0	(2004)
2. Proportion of population below poverty line				
Urban	—	23 (1996)	9.6	(2004)
Rural	—	44 (1996)	34.6	(2004)
Mountain	—	56 (1996)	32.6	(2004)
Hills	—	41 (1996)	34.5	(2004)
Terai	—	42 (1996)	27.6	(2004)
3. Poverty Gap	—	11.75 (1996)	7.55	(2004)
4. Poverty Severity Index	—	4.67 (1996)	2.7	(2004)
5. Inequality (Theil L Index)	—	—	—	
6. Human Poverty Index	—	—	38.7	(2004)
Rank	—	—	74	(2004)

— = not available; GDP=gross domestic product.

^a Central Bureau of Statistics estimate.

^b \$1 a day at 1985 international prices, adjusted for purchasing power parity.

Sources: United Nations Development Programme (UNDP). 2005. Human Development Report. New York; Central Bureau of Statistics. 2005. Nepal Living Standards Survey Report. Kathmandu; UNDP and National Planning Commission. Millennium Development Goals – Progress Report. 2005. Kathmandu.

Nepal Resident Mission
Srikunj, Kamaldi, Ward No. 31
Post Box 5017
Kathmandu, Nepal
Tel: + 977 1 422 7779
Fax: + 977 1 422 5063
adbdrm@adb.org
www.adb.org/nrm