ADB

QUARTERLY ECONOMIC UPDATE

NEPAL

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Acronyms and abbreviations

ADB	Asian Development Bank
ADB/N	Agriculture Development Bank of Nepal
CaR	cost at risk
CPI	consumer price index
CRR	cash reserve ratio
CSD	Central Security Depository
GDP	gross domestic product
HIPC	Highly Indebted Poor Countries Initiative
IMF	International Monetary Fund
IOC	Indian Oil Corporation
IR	Indian Rupee
LMF	liquidity monitoring framework
LTO	large tax payers office
MFA	Multi-Fiber Agreement
NEPSE	Nepal Stock Exchange
NOC	Nepal Oil Corporation
NPV	net prestent value
NPLs	non-performing loans
NPC	National Planning Commission
NR	Nepali Rupee
NRB	Nepal Rastra Bank
PRGF	Poverty Reduction Growth Facility
PRS	Poverty Reduction Strategy
PRSC	Poverty Reduction Support Credit
RBB	Rastriya Banijya Bank
VAT	value added tax
WTO	World Trade Organization

MACROECONOMIC REVIEW

A. Output

1. The prospects for higher economic growth in FY2006 have improved with the unilateral ceasefire by the insurgents in September 2005. Fighting and disruptions such as 'bandhs' and blockades have abated during the first few months of FY2006, and there are signs of revival in the trade and tourism sub-sector, which had declined sharply in FY2005. Tourist arrivals increased 24% during the July-October period (Figure 1.1), with robust growth in both Indian and third country tourist arrivals. Other key sectors such as manufacturing and construction could also revive if the ceasefire is sustained and the security situation continues to improve.

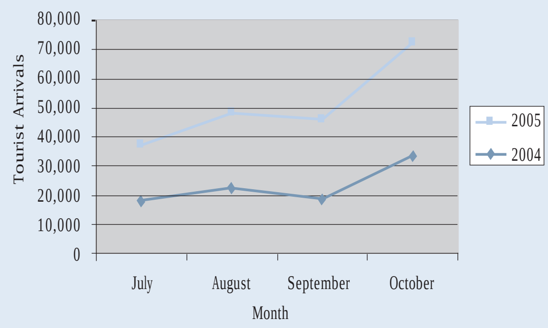
2. The growth outlook for FY2006 is, however, not without major risks. The delayed monsoon in 2005 has already affected paddy production – 2% decline according to Ministry of Agriculture and Cooperatives' preliminary estimates. Overall performance of the agriculture sector will therefore depend on the winter crops to some extent.

3. A second major risk to achieving higher growth is the rise in international oil prices. Minor adjustments notwithstanding, consumers continue to be cushioned from higher prices by large government subsidies. However, these subsidies are unsustainable and government must take actions to establish an automatic price adjustment mechanism to make energy prices market-oriented and flexible. Should oil prices increase further, it could impart a major external shock including a recession.

4. A third major risk comes from the weaknesses of the external sector. With the expiration of the Multi-Fiber Agreement (MFA) in 2004, Nepal's readymade garment exports declined sharply in FY2005. With no signs of revival in garment exports so far and no other export products emerging to compensate for the loss, the trade balance and economic growth are expected to weaken in FY2006.

5. On the demand side, economic growth will continue to be driven by consumption. Investment has not responded significantly to the short-term ceasefire. A credible peace process and resolution of the current political impasse are critical for improving the investment climate. It will be difficult for Nepal to achieve a robust growth with the current level of investment (less than 20% of GDP). Nepal requires an investment rate in the order of 27% of GDP to achieve a GDP growth of 6% or more.

Figure 1.1 - Tourist Arrivals (July-October)



Source: Nepal Tourism Board

6. In addition to restoring peace and stability, structural rigidities in the economy need to be removed to enhance the investment rate. Effective implementation of financial sector reforms, steps to deepen the capital markets, policies addressing weaknesses in the investment climate, accelerating institutional restructuring and improving governance will help increase the investment rate.

B. Policy Developments

7. The environment for reforms has become increasingly challenging since the dissolution of parliament in 2002. The political instability and government's focus on fighting the insurgency have slowed the pace of the reform agenda of the Tenth Plan/Poverty Reduction Strategy (PRS). Important structural reforms in the financial sector, public sector, and governance aimed at promoting investment and boosting productivity have lagged behind. There has, however, been some progress in reviving the reform process in recent months.

8. The long-pending Securities, Company, Insolvency, and Secured Transactions ordinances–key for Nepal's private sector development–were promulgated in September/October 2005. These important laws will help improve governance, transparency, and accountability in the corporate and financial sector, which will in turn reduce transaction costs and enhance private sector investments and competition.

9. Recognizing that a well-developed financial system promotes growth, by mobilizing savings and channeling them to market-determined investment opportunities, the government is continuing with efforts to reduce the proportion of non-performing loans (NPLs) of the state-owned Nepal Bank Limited (NBL), Rastriya Banijya Bank (RBB) and Agriculture Development Bank of Nepal (ADB/N). Restructuring of NBL and RBB has helped to improve bank profitability, lower costs, and introduce prudent banking practices. NPLs of the two banks declined from 61% and 60%, respectively in July 2003 to 53% and 51% in July 2005. Plans to restructure ADB/N into a more sustainable rural finance institution with efficient financial intermediation, greater outreach and poverty reduction impacts are well advanced.

10. Based on a preliminary assessment, Nepal is considered potentially eligible for debt relief under the extended 'sunset' clause of the enhanced Heavily Indebted Poor Countries Initiative (HIPC: Box 1). Debt relief under the initiative could help Nepal increase Nepal's public spending on health, education and other social services, and reduce poverty. However, the government will need to accelerate the reform process to fully qualify for participation in the HIPC program and attain the intended benefits.

C. Fiscal Performance

11. Low capital spending combined with improved revenue collection over the last three years helped the government offset the rapid increase in recurrent expenditures and maintain fiscal stability. The fiscal deficit averaged 1.9% over the FY2002-FY2005 period compared with 4.9% over the FY1991-FY2001 period. Fiscal stability is likely to continue in FY2006, primarily due to continued low capital spending. However, shortfalls in revenue collection, and external assistance targets, continued deterioration of the state-owned Nepal Oil Corporation's (NOC) financial health, and rising security expenditures pose downside fiscal risks.

12. NOC's losses pose the most serious threat to the fiscal stability. NOC has been incurring losses of about NRs500 million per month from the beginning of the fiscal year. NOC's cumulative losses amount to over NRs7.5 billion and its debt servicing costs are about NRs30 million per month. Unless petroleum prices in Nepal are fully adjusted to reflect import costs, NOC's liabilities could grow to as much as 2% of GDP by the end of 2006. Given that high international prices are likely to persist in the foreseeable future, implementation of an automatic price adjustment mechanism has become a top priority.

13. Underachievement of the revenue target is also a key risk. The government has targeted revenue growth of 14% in FY2006—higher than the 13.3% growth achieved in FY2005. In view of the GDP growth outlook, the government's revenue target for FY2006 could be difficult to achieve. The government met the revenue target in FY2005 due to a significant transfer of income (NRs3.6 billion) from the state-owned Nepal Telecommunications Limited and increase of the VAT rate from 10% to 13%. Since a similar transfer is not likely and no major increase in tax rates have been introduced in FY2006, only a stronger tax administration would help to achieve the revenue target. In this context, revenue administration reforms, including the introduction of performance-based incentive schemes and merit-based recruitment in the Large Taxpayer Office (LTO), need to be accelerated.

14. Initial estimates indicate that revenue collection grew nominally (less than 1%) in the first quarter of FY2006, compared with a growth of over 17% in the same period in FY2005. In contrast, government expenditures grew 10.7% in the first quarter of FY2006 compared with a negative growth of 6% in the same period in FY2005. While capital expenditure increased by 70%, this was mainly due to the budget transfer (NRs1 billion) to NOC to enable it to meet its obligations to Indian Oil Corporation (IOC). Excluding the budget transfer to NOC, capital expenditure is estimated to have declined by 45% in the first quarter of FY2006.

Box 1 - Nepal's Debt Situation and Eligibility for HIPC Initiative

External debt has been playing an increasingly important role in financing Nepal's overall budget deficit and development expenditures. Nepal's external debt increased sharply from US$1,861 million in 1993 to US$2,628 million in 2001. At the same time, Nepal's economy and exports also grew robustly during the 1990's and, according to most conventional indicators, Nepal's debt situation was found to be manageable up until 2001. The net present value (NPV) of Nepal's external debt as a percentage of exports and revenue stood at 94.2% and 193.4%, respectively, and Nepal was hence classified as a less indebted country.

However, Nepal's economic performance was adversely affected by the escalation of the Maoist conflict since the second half of 2001. Economic growth slowed to an average of 1.9% in the FY2002-FY2004 period compared with an average growth of 5% in the FY1993-FY2001 period. Similarly, exports declined on an average by 6.8% in the FY2002-FY2004 period compared with a growth of 10.6% in the FY1993-FY2001 period. Meanwhile, the country's external debt stock continued to increase, and reached US$3,402 million at the end of 2004. The NPV of the external debt stock in 2004 is estimated at US$2,281 million (Table 1). The NPV of the external debt

Table 1: Nepal's Debt Indicators, 2004

Before traditional debt relief (US$ millions)	
Nominal External Debt	3,402
NPV of External Debt	2,281
NPV of External Debt / Export Ratio	209%
NPV of External Debt / Revenue Ratio	273%
After traditional debt relief - NPV (US$ millions)	
Multilateral	1,975
Bilateral and Commercial (non-ODA)	1
Bilateral ODA Debt	211
Total	2,186
NPV of External Debt / Export Ratio	200.7%
NPV of External Debt / Revenue Ratio	261.4%

Source: IMF

stock as a percentage of exports and revenue stood at 209% and 273%, respectively as of FY2004. After taking into account the traditional trade relief that can be provided to Nepal, these ratios still stand at 201% and 261%, respectively.

Nepal currently appears to meet most of the criteria for participation in the HIPC initiative. NPV of Nepal's external debt as a percentage of exports of 201% after the application of traditional debt relief mechanisms is higher than the eligibility threshold of 150%; Nepal is eligible for highly concessional assistance from multilateral donors; and the government has already adopted a PRS. However, the uncertain political environment and the slowdown in the reform process including those relating to the World Bank-supported Poverty Reduction Support Credit (PRSC) and IMF-supported Poverty Reduction Growth Facility (PRGF) could hamper Nepal's participation in the HIPC initiative.

According to HIPC criteria, if Nepal is found to be meeting all the conditions needed to reach the decision point (World Bank's and IMF's approval of a country's a participation in the HIPC initiative) based on income and indebtedness criteria applied to end-2004 data, a loan by loan debt sustainability analysis will be carried out to determine the level of indebtedness and the amount of debt relief it may receive. Nepal could begin receiving interim relief on a provisional basis from this stage. The interim period between the decision point and the completion point (when a HIPC country satisfactorily completes the agreed terms and conditions) will depend on how rapidly Nepal can implement its PRS and maintain macroeconomic stability. For Nepal to reach the completion point, it will have to maintain macroeconomic stability under a PRGF-supported program, and carry out key structural and social reforms as agreed upon at the decision point. Once Nepal reaches the completion point, it would be able to receive the full amount of debt relief, which would then become irrevocable.

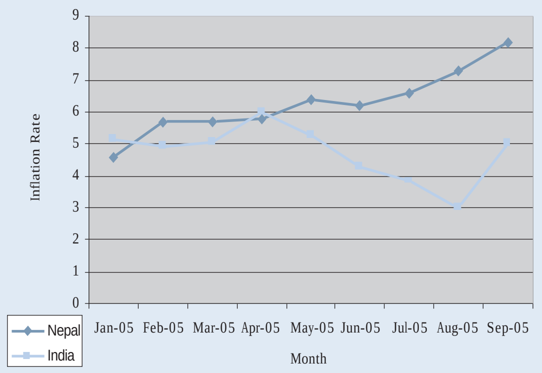
D. Monetary Developments and Inflation

15. There is increased inflationary pressure on Nepal's economy. Urban consumer price index on a point-to-point basis accelerated to 8.2% in mid-September 2005 from 2.6% in mid-September 2004. The national wholesale price index on a point-to-point basis accelerated to 9.5% in mid-September 2005 from 6.1% in mid-September 2004. The sharp rise in inflation reflects the high oil price shock even though price transmission to consumers has been only partial. Higher food grain prices resulting from lower supplies are also contributing to inflation.

16. With the recent increase in prices, inflation in Nepal has begun to diverge from the inflation trend in India (Figure 1.2). Despite the increase in fuel prices, the Indian wholesale price index on a point-to-point basis dropped from 6% in April 2005 to 5% in September 2005, led by lower food prices. The underlying inflationary pressure in India is considered to be moderate. A sharp divergence in inflation would be unwelcome for Nepal, given the Nepali rupee's (NR) peg with the Indian rupee (IR). A large gap between the inflation rates of India and Nepal would over valuate the NR against the IR and exert pressure on the currency peg.

17. Given the low level of growth, aggregate demand is not a problem for Nepal on the inflation front. Credit growth has picked up, but still remains under control. Broad money growth in FY2005 was contained at 8% compared with 13% in FY2004 (Table 1.2). As a result, Nepal Rastra Bank (NRB) has avoided making any drastic changes to its monetary stance[1]. However, NRB will need to remain

Figure 1.2 - Inflation (Nepal and India)



Source: NRB and Reserve Bank of India

Table 1.2: Monetary Survey (NRs million)

Item	July 2003	July 2004	July 2005	% change during FY2003/04 Amount	Percent	FY2004/05 Amount	Percent
Assets							
Net Foreign Assets	91,407	1,08,805	1,07,744	17,398	16	-1,060	-6
Net Domestic Credit	2,28,444	2,51,089	2,85,032	22,645	10	33,943	14
Claims on Government (net)	62,825	62,314	68,686	-511	-1	6,372	10
Claims on Government Enterprises	14,662	16,259	19,329	1,597	10	3,070	16
Financial Enterprises	11,829	13,344	12,763	1515	13	-581	-4
Nonfinancial Enterprises	2,833	2,915	6,566	82	3	3651	125
Claims on Private Sector	1,50,957	17,2517	197,017	21,560	14	24,501	14
Liabilities							
Broad Money Supply (M2)	2,45,911	2,77,306	3,00,440	31,395	13	23,134	8

Source: NRB

[1] The bank rate was increased to 6% from 5.5% while the cash reserve ratio (CRR) has been left unchanged at 5%.

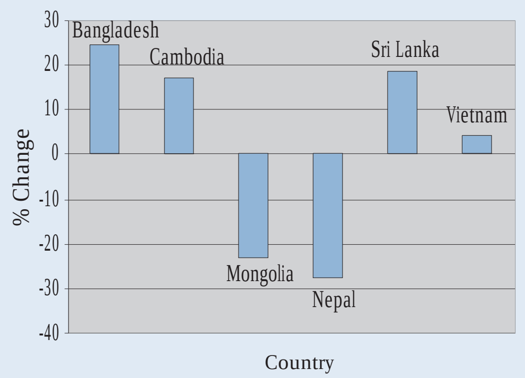
vigilant to the threats of a possible takeoff in inflation, especially through the second round effects of higher oil prices. NRB needs to closely monitor the global situation, notably the impact of high oil prices on the Indian economy and on the economies of Nepal's other main trading partners.

E. Balance of Payments

18. Nepal recorded a current account surplus in FY2005 for the fourth consecutive year. Moreover, the current account surplus widened, despite weak export performance, due to sluggish growth of non-oil merchandise and continued growth of remittances. Nepal's merchandise imports declined 0.5% in FY2005 while exports grew 10% (Table 1.3). Despite soaring oil prices, weak demand for industrial inputs led to a narrowing of the trade deficit, 13% of GDP compared with 16% in FY2004 indicating the sluggishness of Nepal's economy. If it were not for the 32% increase in the oil import bill, the trade deficit would have narrowed even more sharply. Non-oil imports declined by 9% in FY2005, driven by weak import demand for industrial inputs. Capital goods imports declined by 8% year-on-year, indicating weak investment demand.

19. Meanwhile, agricultural exports to India (which increased 38% year-on-year) remained the key driver of export growth. As stated above, readymade garment exports declined by 37% following lapse of the Multi-fibre Arrangement in December 2004 (Figure 1.3). The trade deficit

Figure 1.3 - Percent Change in Garment Export, January-May 2005



Source: IMF

Table 1.3: Balance of Payments Summary (US$ million)

Items	Annual FY2004	Annual FY2005	% of GDP FY2004	% of GDP FY2005	% change
Current Account	197.9	404.2	2.9	5.5	104.2
Trade Balance	1,053.2	946.0	-15.7	-13.3	-10.2
Good: exports f.o.b	748.8	823.1	11.1	11.3	9.9
Good: imports f.o.b	-1,808.2	-1,799.1	-26.8	-24.6	-0.5
Net Services	123.0	6.4	1.8	0.1	-94.8
Tourism	246.0	143.7	3.7	2.0	-41.6
Net Current Transfer	1,150.9	1,349.0	17.1	18.5	17.2
Workers' remittances	943.7	1,111.1	11.8	12.4	17.7
Capital Account Balance	19.7	21.8	0.3	0.3	10.7
Financial Account	292.0	391.3	-4.3	-5.3	34.0
Balance of Payments	16,005.2	5,744.5	-3.2	-1.1	-64.1

Source: NRB

was US$107 million lower than a year ago, resulting in a current-account surplus of US$404 million, up from a surplus of US$198 million in FY2004. Overseas remittances rose 17.7% to US$1.1 billion, and helped offset the sharp decline in tourism receipts by 71% in FY2005.

20. The current account surplus can be expected to continue in FY2006. Low level of imports due to weak industrial activity and continued growth in remittance inflows are likely to be more than offset the impacts of high oil prices and weak export performance, resulting in continuation of the current trend. However, the surplus is forecast to decline progressively over the next few years, if economic growth picks up and imports revert to trend growth. Since the current account surplus reflects the decline in investment, it is not a positive sign. Continued current account surpluses could also put an upward pressure on Nepal's currency and contribute to undermining the competitiveness of Nepal's exports.

21. The NR has been appreciating against the US dollar since August 2002. In July 2005, the currency reached a five-year high of NR70.31:$1, before falling back to NR72.7:$1 in October 2005. The appreciation mirrors the US dollar's weakness in the international currency market and the strength of the IR against the US dollar. The IR has been supported by strong capital inflows attracted by India's strong exports and overall growth. The strength of the IR, oil prices, and the value of the US dollar will be crucial in determining the NR's value. On balance, NR can be expected to continue to appreciate in FY2006.

22. Since the NR's peg with IR has helped in price and monetary stability in Nepal, it continues to be an appropriate arrangement for Nepal. Given the stability of the real effective exchange rate since January 2001, the level of the peg also appears broadly appropriate for the time being. However, the monetary policy will need to target inflation and steer it closer to the rate of India.

Table A1.1: Country Economic Indicators

Item	2001	2002	2003	2004[a]	2005[b]
	Fiscal Year				
A. Income and Growth					
1. GDP per Capita (US$ current)	241	233	242	271	289
2. GDP Growth (% in constant prices)	4.8	(0.4)	3.0	3.2	2.0
Agriculture	5.5	2.2	2.5	3.9	2.8
Industry	3.2	2.9	3.6	1.0	0.7
Services	5.3	(1.3)	3.4	4.0	2.1
	(% of GDP)				
B. Saving and Investment (current and market prices)					
1. Gross Fixed Capital Formation	19.0	19.3	19.1	19.2	19.3
2. Gross National Saving	19.0	16.5	15.5	15.0	14.2
	(annual % change)				
C. Money and Inflation					
1. Consumer Price Index[c]	2.4	2.9	4.7	4.0	4.5
2. Total Liquidity (M2)	15.2	4.4	9.8	12.8	8.0
	(% of GDP)				
D. Government Finance					
1. Revenue and Grants	13.0	13.1	14.5	14.5	15.4
2. Expenditure and Onlending	17.5	16.9	16.0	15.5	16.5
3. Overall Fiscal Surplus (deficit)	(4.5)	(3.9)	(1.5)	(1.0)	(1.1)
4. Security Expenditure (as % of GDP)	2.2	2.8	3.0	3.0	3.3
E. Balance of Payments					
1. Merchandise Trade Balance (% of GDP)	(13.7)	(12.6)	(15.4)	(15.7)	(13.3)
2. Current Account Balance (% of GDP)	4.9	4.3	2.5	2.9	5.5
3. Merchandise Export (US$) Growth (annual % change)	11.7	(20.3)	(13.8)	14.9	9.9
4. Merchandise Import (US$) Growth (annual % change)	6.7	(15.3)	7.1	16.0	(0.5)
5. Remittance (as % of GDP)	11.5	11.2	11.9	11.8	12.4
F. External Payments Indicators					
1. Gross Official Reserves (including gold, US$ million)	1,001.3	1,030.6	1,158.8	1,446.5	1515.9
Months of current year's imports of goods and services	6.9	7.4	7.9	8.2	8.2
2. External Debt Service (% of exports of goods and services)	6.8	8.5	10.3	9.5	9.4
3. Total External Debt (% of GDP)	47.1	50.8	48.8	46.2	44.0
G. Memorandum Items					
1. GDP (current prices, NRs billion)	411.3	422.8	456.7	495.6	529.0
2. Exchange Rate (NRs/US$, average)	73.7	76.7	77.9	73.8	72.3
3. Population (million)	23.2	23.7	24.2	24.8	25.3

GDP = gross domestic product, NRs= Nepalese rupees.
[a] Revised estimates
[b] Prelimenarly estimate & staff estimates.
[c] Annual percentage change (period average)

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

Table A1.2: Country Poverty and Social Indicators

Item	1985		1990		Latest Year	
A. Population Indicators						
1. Total Population (million)	16.2		17.9		24.8	(2004)[a]
2. Annual Population Growth Rate (% change)	2.1		2.1		2.3	(1991-2001)
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	(1991)	740	(2002)
3. Infant Mortality Rate (below 1/1,000 live births)	115.4		102.1		61.0	(2003)
4. Life Expectancy at Birth (years)	50.9		53.6		61.4	(2000-2005)
Female	50.0		52.9		59.4	(2002)
Male	51.6		54.2		59.9	(2002)
5. Adult Literacy (%)	26.5		30.5		48.6	(2003)
Female	9.8		14.0		26.4	(2002)
Male	42.7		47.5		61.6	(2002)
6. Primary School Gross Enrollment (%)	—		61.0		71	(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)	48.0	(1995-2003)
9. Population Below Poverty Line (international, %)[b]	—		—		37.7	(1995)
10. Population with Access to Improved Water Sources (%)	—		69	(1990)	84	(2002)
11. Population with Access to Improved Sanitation Facilities (%)	—		12	(1990)	27	(2002)
12. Public Education Expenditure (% of GDP)	2.7		2.0		2.9	(2003)
13. Human Development Index	0.42		0.42	(1990)	0.53	(2003)
Rank/Total Number of Countries	114/130	(1987)	152/173	(1990)	136/177	(2005)
14. Gender-Related Development Index	—		0.33	(1995)	0.48	(2001)
Rank/Total Number of Countries	—		148/163	(1995)	116/177	(2001)
C. Poverty Indicators						
1. Poverty Incidence	—		42	(1996)	30.8	(2004)
2. Percent of Poor to Total Population	—		42	(1996)	30.8	(2004)
Urban	—		23	(1996)	9.6	(2004)
Rural	—		44	(1996)	34.6	(2004)
Mountain	—		56	(1996)	32.6	(2004)
Hills	—		41	(1996)	34.6	(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	(2005)
Rank	—		—		74	(2005)

— = not available; GDP = gross domestic product.

[a] Staff estimate.
[b] US$1 a day at 1985 international prices, adjusted for purchasing power parity.

Sources: United Nations Development Programme. 1993, 1998, 2003, and 2004. Human Development Report. New York; Ministry of Finance. 2004. Economic Survey. Kathmandu; Nepal South Asia Centre. 1998. Nepal; Human Development Report. Kathmandu; Central Bureau of Statistics. 1996. Nepal Living Standards Survey Report. Kathmandu; World Bank. 2004. World Development Indicators. Washington D.C; HMG Nepal/United Nation Country Team. 2002. Millenium Development Goals – Progress Report. 2002.