



# Nepal

## Economic Assessment

In FY2004 (ended 15 July 2004), the economy grew by 3.6%, somewhat lower than the 4.0% projection in *ADO 2004*, mainly due to the breakdown of the cease-fire with the insurgents in August 2003. Industry underperformed, expanding by only 1.8%, down from 2.3% a year earlier, due to the security situation. Growth in construction (0.3%) was particularly sluggish; however, performance of agriculture and services strengthened. Agricultural output increased by 3.7%, from the previous year's 2.5%, boosted by favorable weather that lifted paddy production by 7.8%. Services showed a slightly better growth rate of 4.2% against 3.3% in FY2003, on account of some strengthening in tourism and strong performance of the transport, communications, and storage subsector.

On the expenditure side, gross fixed capital formation as a share of GDP continued its slide of recent years to 18.7% in FY2004—well below the average of 20.8% of GDP for the last decade. Both public and private investment shares declined, ascribable to the deterioration in the investment climate in the country. Total consumption grew by 3.0%, underpinning the expansion in GDP, based on the rise in government recurrent expenditures and private consumption that was boosted by higher worker remittances. Trends in aggregate expenditures and output indicate a recovery from the FY2002 recession, albeit anemic and fragile.

The continued insurgency adversely affected FY2004 government expenditures. Only 88% of the targeted level of NRs91 billion was achieved, primarily due to a 16% shortfall in capital spending. While disbursements in the education sector were on target, health, drinking water, roads, and agriculture all recorded significant underspending, reflecting the constraints caused by the insurgency on undertaking development activities in rural areas. Recurrent expenditures

related to development activities also fell short, but security expenditures rose by 8.0% from the FY2003 level. Revenue collection increased by 11.0% from FY2003, aided by some improvement in income tax and excise duty collection. Nevertheless, the revenue effort at 12.3% of GDP remains weak. Given these developments, the budget deficit after grants amounted to 1.5% of GDP for the second year running.

Broad money (M2) grew by 13.5% during 2004, above the 11.2% target. Weak investor confidence resulted in lower private sector credit growth than in FY2003 and in interest rates falling for the second consecutive year. Inflation was contained at 4.0%, benefiting from declining food prices.

On the external side, the improvement in the global economy helped push up exports by 13.1% to \$737 million while the economic recovery, limited as it was, pushed up imports by 15.4% to \$1.8 billion. The trade deficit widened slightly to 15.8% of GDP from 15.5%. Export growth was supported by a rebound in exports of woolen carpets, leather goods, and polyester yarn, which offset the decline in exports of readymade garments, vegetable ghee, and agricultural products. Import growth stemmed from 23% and 16% increases in raw material and machinery imports, respectively. The trade deficit was outweighed by stronger tourism receipts (58%), worker remittances (17%), and grants (70%). The sharply higher net surplus on the services and transfer accounts raised the current account surplus to 3.5% of GDP in FY2004 from 2.6% in FY2003. Official foreign exchange reserves climbed by 24.8% during FY2004 to \$1.4 billion, providing import cover of about 10 months.

## Policy Developments

A new prime minister, appointed in June 2004, has formed a coalition Government that enjoys support from some of the political parties, despite

**Table 2.15 Selected Economic Indicators, Nepal, 2004–2005, %**

Item	2004		2005	
	<i>ADO 2004 Update</i>		<i>ADO 2004 Update</i>	
GDP growth	4.0	3.6	5.0	3.7
Inflation (CPI)	4.5	4.0	5.0	5.5
Current account/GDP	1.0	3.5	0.5	4.0

Source: Staff estimates.

the fact that Parliament remains suspended. The FY2005 budget announced in July aims to implement the priorities identified in the Government's poverty reduction strategy. In view of the slowdown of development activities, against a backdrop of security concerns, the budget proposes various measures to accelerate development spending. To this end, it has expanded allocations for local-level, community-led development projects, and has announced incentives for more effective utilization of block grants to local governments. It has also proposed the devolution to local communities of management of public schools and health posts, of agriculture extension services, and of electricity distribution. Reflecting these initiatives, total expenditures are slated to rise by 22% with recurrent expenditures up by 19% and capital expenditures by 29%. Revenues are targeted to rise by 12.4% and the overall deficit is to increase to 2.5% of GDP.

Tax reforms are under way, focusing on improving administration of VAT, simplifying the Income Tax Act, implementing a 3-year customs reforms and modernization program, and establishing a large taxpayers' office within the Inland Revenue Department. Nevertheless, stronger policy efforts are needed to broaden the tax base, especially of VAT; eliminate the wide range of tax exemptions; and address the burgeoning tax arrears, as recommended by the 2003 Fiscal Reforms Taskforce.

The Nepal Rastra Bank's monetary policy announced in August 2004 aims to maintain low inflation and the domestic currency's parity peg with the Indian rupee. It also targets broad money growth of 12.5% in FY2005. More widely, the

policy seeks to be accommodative so as to support a fuller economic recovery and, with this in mind, reduced the mandatory cash reserve ratio from 6.0% to 5.0%.

### Outlook for FY2005

Assuming no substantial deterioration in the security situation and normal weather conditions, GDP is now forecast to grow by 3.7% in FY2005. The projection has been downgraded from 5.0% in *ADO 2004* due to the worsening insurgency, including the negative impact of intensified disruptions in the first quarter of the fiscal year on manufacturing output and tourism. With anticipated robust growth in summer crops following a favorable monsoon, the agriculture sector is expected to expand by 3.7% in FY2005. Services are likely to falter, rising by 3.8% in FY2005, as gains in tourism slow from a year earlier, while industry is forecast to strengthen to 3.3% in FY2005 on the back of a remittance-driven recovery in construction and some improvement in manufacturing. Nevertheless, the ending of MFA quotas will further hit garment production and exports, which have already declined over the past year.

Inflation is forecast to increase to 5.5% in FY2005, slightly higher than the *ADO 2004* figure of 5.0%, reflecting price developments in India and continued high international oil prices. Money supply (M2) growth in FY2005 is likely to be limited to 12.5%, as targeted by the central bank. The fiscal deficit is now projected at 2.5% of GDP in FY2005, in line with the government target. *ADO 2004* had forecast a higher deficit of 4.5% of GDP on the basis of greater internal security that would have allowed larger development expenditures and aid utilization.

The trade deficit is expected to widen in FY2005, mainly due to an expected decline in garment exports. Growth in tourism receipts is likely to slow. A continued expansion in worker remittances and development grants is expected to underpin the balance of payments, keeping the current account in surplus in FY2005 at the equivalent of 4.0% of GDP.