

# Nepal

Economic growth rebounded in FY2008 from a slump in FY2007, aided by an improved security situation and emerging political stability following the end of the decade-long civil conflict, and by favorable weather. Sustaining this growth and the poverty-reduction gains of the past decade will, though, remain challenging given the protracted and complex post-conflict political transition. Additionally, the downdraft from the deepening global downturn could damage the country's growth prospects to a greater extent than earlier expected.

## Economic performance

Nepal's peace process took a key step forward with the orderly conduct of the historic constituent assembly elections in April 2008, which raised hopes of economic recovery and improved living standards. Although the election results were not decisive enough to usher in a majority government, the Communist Party of Nepal, Maoist (CPNM)—an insurgent political force until April 2006—emerged as the largest party in the constituent assembly, giving it the lead role in the new coalition Government formed in August. The new administration envisages an ambitious economic recovery and development agenda in the difficult transitional political environment.

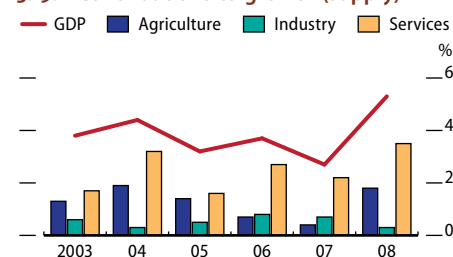
Aided by the improved security situation, overall GDP growth went back up to 5.3% in FY2008 (ended mid-July 2008) from 2.7% in FY2007 (Figure 3.19.1). This rebound, which reflected the sustained expansion of services and a weather-induced recovery in agriculture, could have been greater had it not been for the deceleration of industry due to input supply disruptions and labor agitation.

Services, with a 48% share in overall GDP (Figure 3.19.2), expanded by 7.0%, contributing 3.6 percentage points to overall growth (Figure 3.19.1 above). Growth was broad-based within the sector. In particular, hotels and restaurants as well as financial intermediation, which grew by 8.5% and 13.8%, respectively, benefited most from a sustained increase in tourist arrivals and the entry of new financial institutions. Real estate-related businesses, however, decelerated to 4.4% from 11.8% growth in FY2007, as rural households displaced by the conflict started to return from urban areas to their homes.

Agriculture, with a 36% share in overall GDP, also registered strong growth of 4.7%, underpinned by a significant increase in paddy and other crop output, which was aided by favorable monsoon rains. Agriculture's contribution to GDP growth in FY2008 improved to 1.8 percentage points, from only 0.4 percentage points in FY2007.

Industrial growth, however, slackened to 1.9% in FY2008 from 3.9% in the previous year—a combined effect of long-standing structural weaknesses, such as low productivity and the inadequate infrastructure

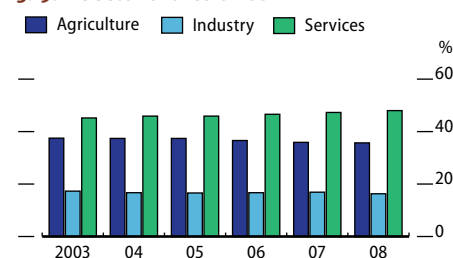
3.19.1 Contributions to growth (supply)



Source: Ministry of Finance, available: <http://www.mof.gov.np>, downloaded 9 March 2009.

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3.19.2 Sector shares of GDP



Source: Ministry of Finance, available: <http://www.mof.gov.np>, downloaded 9 March 2009.

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base, as well as disruptions caused by growing labor unrest and acute power and fuel shortages. (The power shortages are due to additional peace-time demand and low water levels in reservoirs.) Although manufacturing was hard hit by these disruptions, construction activities continued to grow moderately.

On the demand side, the economy continued to be driven by private consumption, in turn fueled by workers' remittances. However, private consumption's share declined marginally to about 77% of GDP as investment picked up—gross fixed capital formation increased to 21.1% of GDP from 20.4% in the previous year—in response to the improved security situation and emerging political stability.

Average consumer inflation rose to 7.7% in FY2008 from 6.4% a year earlier, mainly reflecting rising fuel and food prices and the higher inflation in India. Nepal's inflation is closely linked to India's, given the currency peg to the Indian rupee, close trade ties, and the open border. Inflation rose to 12.1% on a 12-month basis by July and remained high through mid-January 2009 (Figure 3.19.3). Steeper transport costs that reflected fuel price adjustments, and a shortage of rice partly caused by India's temporary export ban, contributed to the increase in food prices. Given the hike in food prices (which make up 53% of the consumer price index basket), inflation has imposed a particular hardship on the poor.

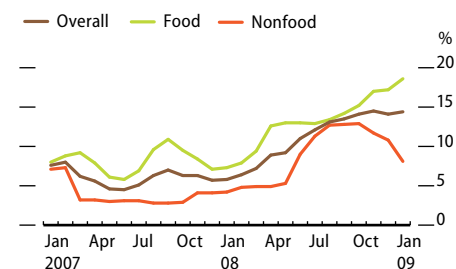
The central bank kept its main policy (bank) rate unchanged at 6.25% and the cash-reserve ratio at 5.0% in FY2008. A sharp rise in net foreign assets during the year, generated by stronger remittance inflows, expanded banking system liquidity and raised reserve money by 21.2%, compared with 7.5% in FY2007. This led to a 25.2% expansion in broad money (M2), up from 14.0% in FY2007. To rein in rising inflation, the central bank adopted a tighter monetary policy for FY2009 by lifting the bank rate to 6.5% and the cash-reserve ratio to 5.5%.

Improved revenue mobilization helped contain the budget deficit at 2.0% of GDP (1.8% a year earlier) despite a surge in expenditure (Figure 3.19.4). Recurrent spending swelled by nearly 19%, mainly on account of peace process-related expenditures such as the constituent assembly elections and operation of the temporary camps for former CPNM combatants until they are integrated into society. Capital spending also jumped, by 40.5%, in an improved project implementation environment. Total revenue (including taxes, nontax revenue, and grants) grew robustly by 24.5% in FY2008—even after sturdy growth of 21.2% a year earlier—supported by stronger tax administration. It increased to 15.6% of GDP, a gain of about 1.5 percentage points from a year earlier.

The improved security and political situation facilitated increased use of external assistance (both grants and loans), although spending still fell short of the budget target. The lower than budgeted fiscal deficit helped contain domestic financing at the budgeted level of 1.6% of GDP.

On the external front, the current account in FY2008 moved to a surplus of 2.6% of GDP from a deficit of 0.1% a year earlier, buoyed by large workers' remittances (17.4% of GDP) and improved tourism receipts (2.3% of GDP), which more than offset a widening trade deficit (Figure 3.19.5). Export growth picked up to 12.8% (from 1.9% in FY2007), because of a significant rise in shipments to markets other than India. Still, the trade deficit widened by about 2 percentage points to 19.2%

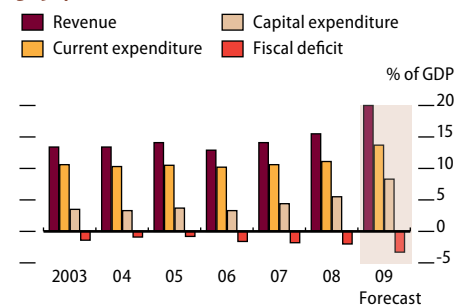
### 3.19.3 Inflation



Source: Nepal Rastra Bank, available: <http://www.nrb.org.np>, downloaded 24 February 2009.

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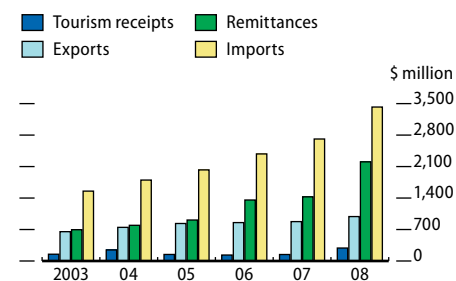
### 3.19.4 Fiscal indicators



Sources: Ministry of Finance, available: <http://www.mof.gov.np>; Nepal Rastra Bank, available: <http://www.nrb.org.np>, downloaded 24 February 2009.

[Click here for figure data](#)

### 3.19.5 Trade, tourism, and workers' remittances



Source: Nepal Rastra Bank, available: <http://www.nrb.org.np>, downloaded 24 February 2009.

[Click here for figure data](#)

of GDP as imports surged by 26.3%, fueled mainly by large remittance spending on consumer goods and by higher oil prices.

With increased aid flows, the overall balance-of-payments surplus grew to 4.1% of GDP. Foreign exchange reserves climbed markedly to \$2.5 billion at end-FY2008 (mid-July), and subsequently rose to \$2.6 billion by mid-January 2009 (Figure 3.19.6). Reserves are equivalent to about 7 months of imports of goods and services.

The Nepalese rupee depreciated by 5.3% against the United States dollar over the course of FY2008 due to its peg to the Indian rupee (Figure 3.19.7). The trade-weighted real effective exchange rate also depreciated, by 3.4%.

## Economic prospects

Medium-term growth and development prospects rest largely on continued macroeconomic stability, a smooth and rapid political transition, and the impact of the global economic slowdown. The fragile political situation and the adverse external environment pose significant downside risks. The expansionary FY2009 budget—with an expenditure outlay of NRs218.6 billion or a 52.0% increase from the estimated expenditure in FY2008—presents a challenge for maintaining fiscal and macroeconomic stability.

The more disruptive is the post-conflict political transition, the less focus will there be on the pressing reform and development priorities. A rapid political transition, in parallel with renewed structural reform and development efforts to boost rural incomes, is therefore vital. Although the global economic slowdown has not yet affected Nepal, some impact is inevitable on exports, remittances, tourism receipts, and external assistance, especially if it is prolonged. The authorities will, therefore, need to remain vigilant and be prepared to take necessary fiscal and monetary policy measures.

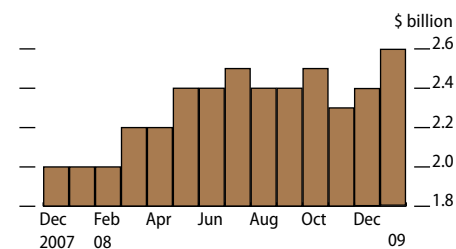
Lower international oil prices augur well, as the economy is fully dependent on imported fuel. An upswing in oil prices could, though, once more disrupt supply, which combined with power shortages would have a detrimental impact. Current low international oil prices present an opportunity to put in place an effective market-oriented pricing mechanism and import deregulation.

Against this backdrop, the baseline assumptions for Nepal's economic performance in FY2009 and FY2010 are that normal weather conditions will prevail, the political transition will progress without serious disruption, prudent macroeconomic policies will be continued, and business confidence will strengthen somewhat. It is also assumed that the exchange rate peg to the Indian rupee will be maintained and that the domestic oil supply situation will remain normal, but that power shortages will not ease significantly.

Based on these assumptions, GDP growth is forecast to slow to 3.0% in FY2009, following the high cyclical rebound in services and the exceptional gain in agriculture in FY2008, and then pick up somewhat to 3.5% in FY2010. Growth in each of these 2 years will be led by a 4.0% expansion in services.

Services growth in FY2009 will be supported by trade, financial

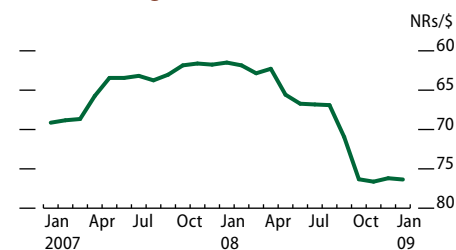
3.19.6 Foreign exchange reserves



Source: Nepal Rastra Bank, available: <http://www.nrb.org.np>, downloaded 24 February 2009.

[Click here for figure data](#)

3.19.7 Exchange rate



Source: International Monetary Fund, *International Financial Statistics* online database, available: <http://www.imfstatistics.org>, downloaded 2 March 2009.

[Click here for figure data](#)

3.19.1 Selected economic indicators (%)

	2009	2010
GDP growth	3.0	3.5
Inflation	10.0	8.0
Current account balance (share of GDP)	1.5	1.0

Source: Staff estimates.

intermediation, transport and communications, and tourism (though the likely significant shortfall in the Government's capital spending due to delayed budget approval will limit growth in certain subsectors). Financial expansion will be aided by the new Government's efforts to boost rural financial services, while the expansion of transport and communications, and of tourism, will be bolstered by improved fuel supply.

Although the growth of some subsectors such as trade and tourism will weaken in FY2010 because of the lagged impact of the global downturn, this will be offset by higher public spending and continued expansion of the financial and the transport and communications subsectors.

Agriculture is expected to expand by 3.0% in FY2009, underpinned by the good summer crop (mainly paddy), but damped by a poor winter crop (mainly wheat and barley) due to drought. Assuming normal weather conditions and smoother transport services from improved fuel supply and political stability, the sector is expected to expand by 4.0% in FY2010.

Industry's performance will likely remain sluggish, as power shortages and labor unrest continue to affect manufacturing. While utilities output will not improve (with the decline in output of major power plants and the delayed commissioning of the Middle Marsyangdi Hydroelectric Project), construction activity is expected to pick up in response to the fall in prices of construction materials. Industry is, therefore, projected to grow by a mere 1.0% in FY2009, but with some concrete steps to improve industrial relations and the overall business environment, it is expected to expand by 2.5% in FY2010.

On the demand side, consumption will stay buoyed by remittances, which are likely to continue rising as a result of new labor agreements with several host countries. However, the slowdown in the outward flow of migrant works and the increasing repatriation of some workers from certain host countries in recent months suggest that remittance inflows will likely slow, especially in FY2010.

Owing to high prices of some food items, and of fuel and transport, year-on-year inflation in mid-January 2009 remained high at 14.4%. This reflected supply constraints caused particularly by high transport costs (since domestic fuel prices have not yet been adjusted downward commensurately in response to the drop in world oil prices), increases in the minimum wage and civil service salaries, and the deepening power crisis. Domestic oil and transport price adjustments will likely be made, easing supply bottlenecks in FY2010 when average inflation should moderate to about 8%.

The wide trade deficit will persist. Import growth, though slowing, will be driven by a higher oil import bill stemming from more oil-fired power generation, continued remittance-induced consumer spending, and greater outlays on investment goods. Export growth will be sluggish due to weak external demand and long-standing structural weaknesses. Remittances and tourism receipts should continue to grow, albeit more slowly because of the global economic downturn, but they will still offset the trade deficit.

These developments suggest that the current account surplus will likely shrink to about 1.5% of GDP in FY2009 and to 1.0% in 2010. Although significant increases are unlikely, aid flows are expected to maintain the capital and financial accounts in surplus, which will ensure a continued overall balance-of-payments surplus.

### 3.19.1 Development challenges

Despite significant poverty reduction from 1996 to 2004 (largely due to remittances), poverty is still widespread and inequality is rising. These are key development challenges, especially in light of the increasingly difficult global and domestic economic environments.

In the complex political transition, the potential weakening of the reform and development focus, which is intended to generate employment and boost rural incomes, poses a major risk to sustaining the poverty reduction gains of the past decade. The drop in remittance inflows and any reduction in aid flows may also undermine these gains.

Generating widespread domestic employment opportunities has become crucial, especially with a burgeoning labor force and repatriation of migrant workers. Improving the business and investment environment will be important to achieve strong employment growth. To this end, various bottlenecks need to be tackled, particularly growing management-labor tensions, lack of skilled labor, inadequate (especially power-related) infrastructure, and limited access to rural finance.

The entry of a large number of financial institutions in the past couple of years poses a major challenge for the central bank with its limited institutional capacity to effectively supervise and regulate them. However, losses due to the international financial crisis do not affect local banks and the housing market is expected to remain stable.