Nepal

Macroeconomic Update

VOLUME 10, NO. 1 | APRIL 2022

ASIAN DEVELOPMENT BANK

ADB

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ABBREVIATIONS

BFIs = bank and financial institute
COVID-19 = coronavirus disease
FY = fiscal year
GDP = gross domestic product
M2 = broad money
NRB = Nepal Rastra Bank
WB = World Bank

NOTE

i. The fiscal year (FY) of the government ends in mid-July. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2022 ends on 16 July 2022.
ii. In this report, "$" refers to US dollars.
iii. Data cut off date for this report is 28 March 2022.

Executive Summary

1. Gross domestic product (GDP) is estimated to have modestly expanded by 2.3% in the fiscal year 2021 (FY2021, ended 15 July 2021) after contracting by 2.1% in FY2020. The recovery was underpinned by continued monetary and fiscal stimulus, global economic recovery, and lifting of nationwide lockdowns early in FY2021 as the coronavirus (COVID-19) infections ebbed, although the second wave of infections in the final quarter again disrupted economic activity.

2. Agriculture, contributing about a fourth of GDP, is estimated to have expanded by 2.4% in FY2021, up from 2.2% a year earlier owing to a good monsoon and increased acreage under cultivation. Industry, after contracting by 3.7% in FY2020, grew by 1.7% on stronger domestic demand and a surge in exports. Services, accounting for about 60% of GDP, which contracted by 4.0% in FY2020, expanded by 2.5% on increased mobility for shopping and work as most wholesale and retail trade establishments resumed operations. However, international tourism, a major foreign exchange earner and services mainstay, which collapsed after March 2020, saw arrivals in 2021 at only 12.5% of the 2019 level.

3. On the demand side, preliminary estimates indicate private consumption grew by 4.6%, bolstered by a return to strong growth in remittance, and dominated spending in FY2021. Fixed investment is estimated to have expanded by 3.8 %, reviving from a 12.4% contraction in FY2020, on better implementation of public projects and stronger private investment. There was a marked expansion in stocks, as inventories were rebuilt from the decline in the year earlier. Net exports were a drag on growth on a large increase in imports despite strong exports.

4. Annual average inflation fell significantly to 3.6% in FY2021 from 6.2% a year earlier. Food inflation dropped to 5.0% from 8.1% a year earlier, thanks to higher domestic production and much smoother supply chain distribution following the end of lockdown restrictions in July 2020. Nonfood inflation averaged 2.5% largely owing to muted prices of housing and utilities, which grew by only 1.0%.

5. The current account deficit in FY2021 substantially widened to $2.8 billion —8.0% of GDP from 0.9% of GDP a year earlier— on a 26.5% increase in imports that increased trade deficit to $11.5 billion. Exports grew by 31.0% but had a minimal impact on the trade deficit as they are relatively small at about 10% of imports. Workers' remittances increased by 8.2% to $8.1 billion, but net services declined on lower tourism income. Primary income fell by about $200 million. Financing, nevertheless, was adequate to meet the large current account deficit and gross foreign exchange reserves increased marginally to $11.7 billion, providing cover for 10.2 months of current imports of goods and services.

6. Government debt increased to 41.4% of GDP in FY2021 from an average of 25.1% during FY2016-FY2019 on higher fiscal and current account deficits stemming from increased spending needs during the COVID-19 pandemic. Despite the rise, Nepal's risk of debt distress is low given the high level of official concessional borrowing at long maturity.

7. GDP growth is forecast to modestly increase to 3.9% in FY2022 underpinned by the ongoing vaccination campaign that will repress infection flare-ups, fostering a gradual normalization in economic activity and a steady path to higher growth supported by accommodative macroeconomic policies. However, slowing growth in advanced economies exacerbated by the Russian invasion of Ukraine along with disrupted trade flows and higher prices of oil and other commodities are expected to push inflation and exert pressure on the external sector.

8. Agriculture was previously expected to grow faster in FY2022 on abundant rainfall during the summer monsoon. However, unexpected rains and floods in mid-

October damaged a ready-to-harvest crop cutting paddy output by about 9.0% that is expected to trim agriculture growth to 1.3 %, from 2.4% a year earlier.

9. Industry growth is expected to edge up to 4.1% in FY2022 on increased consumer and investment demand, as well as from the full operation of the Upper Tamakoshi Hydropower Project. Services will likely grow by 5.2% as wholesale and retail trade, transport, and financial services have picked up owing to a significant containment of COVID-19 infections and the removal of mobility restrictions. International tourism has remained depressed, although it is benefiting from the opening of trekking routes and expeditions. On the demand side, private consumption will continue to be underpinned by still sizeable remittances. Private investment is forecast to grow on increased credit availability for production activities for most of the year and better economic prospects on COVID-19 containment.

10. Inflation in FY2022 is forecast to average 6.5% reflecting the transmission of increased global oil prices and subsequent higher transportation costs. The Russian invasion of Ukraine has increased petroleum and commodity prices adding to domestic inflationary pressure. A gradual recovery in domestic demand and a modest rise in inflation in India, the major trade partner of Nepal, have also intensified inflationary pressure. Average inflation edged up to 5.2% in the first seven months of FY2022 higher than 3.6% in the corresponding period a year earlier. With a sharp rise in vegetable oil prices and transportation costs, both food and non-food inflation hovered at 6.0%y/y in the first seven months.

11. Growth in non-oil imports will remain elevated in FY2022 as investment activity has intensified on the gradual revival of economic activities. Workers' remittances contracted by 5.8% in the fiscal year through mid-February 2022 after expanding by 6.8% y/y in the year-earlier period partly attributed to the shift from formal to informal remittance. The current account deficit consequently rose to a record $3.5 billion in the first seven months of FY2022. But import growth in the remaining part of this fiscal year will likely remain subdued as various measures to curtail the import of non-essential and luxurious items, including an increase in cash margin from 50% to 100% while opening letter of credit accounts with commercial banks announced by the central bank. Based on developments to date, the full-year current account deficit is forecast to nonetheless widen to 9.7% of GDP in FY2022 from 8.0% a year earlier.

12. GDP growth is forecast at 5.0% in FY2023 on the expectation that immunization of the population against COVID-19 continues to progress, enabling further revival of economic activities that have gradually picked up since FY2021. The other underlying assumptions are that the geopolitical and economic risks stemming from the Russian invasion of Ukraine is contained and oil and commodity prices are normalized over the forecast horizon. The forecast is also dependent on normal monsoon and timely availability of farm inputs, particularly chemical fertilizers, absence of natural disasters, and smooth conduct of local, provincial, and federal elections.

13. Inflation is forecast to marginally decline to 6.2% in FY2023 restrained by a better harvest, normal supply chain distribution, and somewhat subdued oil prices. The current account deficit is expected to moderate to 6.1% of GDP in FY2023 as monetary policy becomes less expansionary, health-related imports will have moderated, and hydroelectricity generation eases fossil fuel consumption.

14. Downside risks to the outlook center on exogenous shocks such as the emergence of strong, new variants of the COVID-19 pandemic; intensification of the current global turmoil; and recurrence of natural calamities like floods, landslides, and earthquakes that have devastated lives and livelihoods in the past.

15. This edition of Macroeconomic Update features a special analysis of the effect of remittances on financial development, investment, and economic growth in Nepal. It highlights the importance of shifting from consumption-led growth to an investment-led growth strategy. It also discusses the importance of channeling remittance into productive activities and argues for policy-level interventions to promote remittance inflows through formal channels.

MACROECONOMIC UPDATE

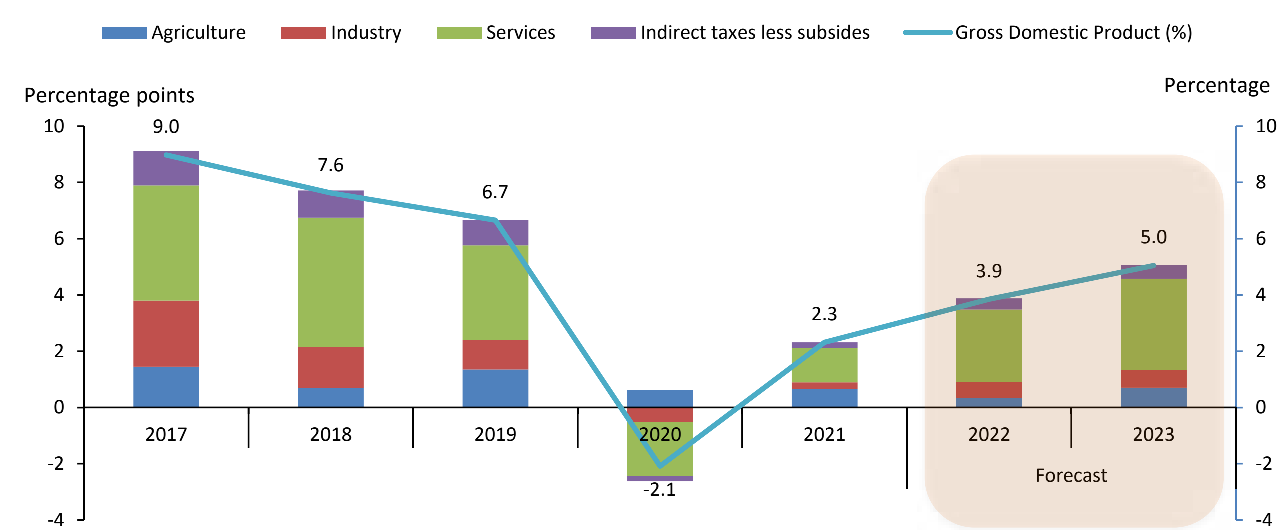
A. Economic performance

1. Gross domestic product (GDP) is estimated to have modestly expanded by 2.3% in fiscal year (FY) 2021 after contracting by 2.1% in FY2020, largely supported by a low base effect, lifting of nationwide restrictions as the coronavirus disease (COVID-19) ebbed earlier in FY2021 and a global economic recovery (Figure 1). The other underlying factors are a favorable monsoon leading to better harvest, better execution of capital expenditures, strong private sector credit growth, and a buoyant remittance growth-stimulating private consumption.

2. Agriculture, contributing about a fourth of GDP, is estimated to have expanded by 2.4% in FY2021, up from 2.2% a year earlier owing to a good monsoon and an increased acreage under cultivation. Industry, after contracting by 3.7% in FY2020, is assessed to have grown by 1.7% on stronger domestic demand and a surge in exports. Services, which had contracted by 4.0% in FY2020, probably accelerated by 2.5% on increased mobility for shopping and work as the majority of wholesale and retail trade had resumed operations since the lifting of the nationwide lockdown. However, international tourism, a major foreign exchange earner and services mainstay, which collapsed after March 2020, saw arrivals in 2021 at only 12.5% of the 2019 level.

Growth modestly expanded in 2021 as COVID-19 restrictions were eased and economic activities steadily picked up.

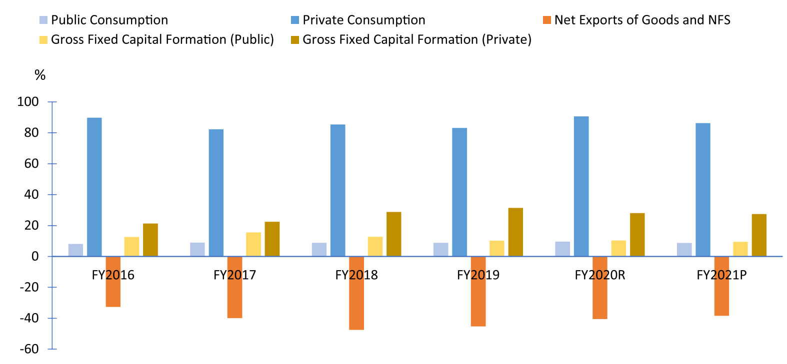
Figure 1: Supply-side contributions to growth



Note: Years are fiscal years ending in mid-July of that year.
Source: Central Bureau of Statistics. 2021. National Accounts of Nepal 2020/21. http://cbs.gov.np/ and staff estimates

On the expenditure side, growth was supported by high private consumption.

Figure 2: Share of GDP by expenditure



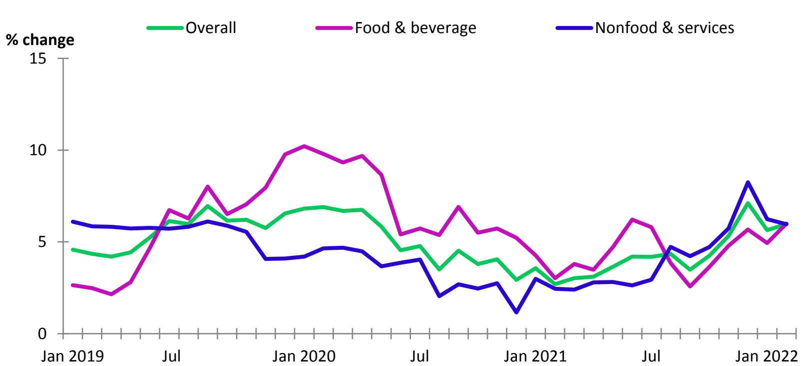
Source: Central Bureau of Statistics. 2021. National Accounts of Nepal 2020/21. http://cbs.gov.np/ and staff estimates

3. On the demand side, high private consumption, on the back of strong remittance growth and liquidity measures coupled with a cut in the policy rate, dominated spending in FY2021 (Figure 2). Fixed investment is estimated to have expanded by 3.8%, reversing a contraction of 12.4% in FY2020, partly as the implementation of public projects accelerated compared with that in FY2020. There was a marked expansion in stocks, as inventories were rebuilt from the year-earlier decline. Net exports were a drag on growth on a large increase in imports despite strong exports.

4. Annual average inflation edged up to 3.6% in FY2021, significantly down from 6.2% a year earlier (Figure 3). Food inflation edged down to 5.0% from 8.1% a year earlier, thanks to higher domestic

Food inflation moderated owing to better yield and smoother supply chain distribution.

Figure 3: Monthly inflation



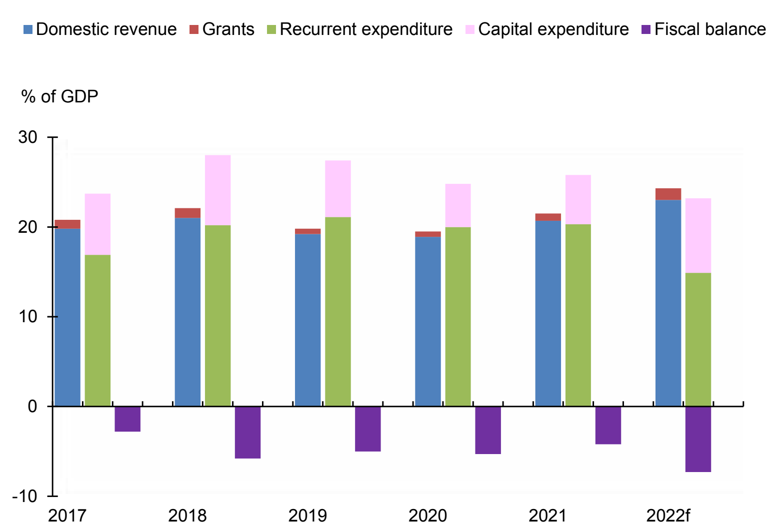
Source: Central Bureau of Statistics. 2021. National Accounts of Nepal 2020/21. http://cbs.gov.np/ and staff estimates yield and smoother supply chain distribution following the end of the national lockdown in July 2020. Nonfood inflation tempered down to 2.5% largely owing to muted prices of housing and utilities, which grew by only 1.0%.

5. Fiscal deficit narrowed to 4.2% of GDP in FY2021 from 5.3% a year earlier owing to 16.8% increases in revenue from large customs-related duties and deferred tax receipts that brought total revenue to 24.2% of GDP (Figure 4). Total expenditure increased by 10.4% to 28.4% of GDP, mostly reflecting an 8.3% increase in current expenditure that continued substantial social benefits and transfers. Capital expenditure increased by 21.0%, largely offsetting the decline in FY2020.

6. Government debt to GDP ratio significantly increased to 41.4% in FY2021 from an average of 24.5% during FY2015-FY2019 to higher fiscal and current account deficits (Figure 5). High uncertainty over revenue growth amid increasing spending needs during COVID-19 pandemic prompted Nepal to borrow more from domestic and foreign sources. Internal debt increased to 19.2% of GDP, up from 15.7% a year earlier, and external debt to 22.2% of GDP, up from 20.8% in FY2020. Despite the rise, Nepal's risk of debt distress is low given the high level of official concessional borrowing at long maturity. Efficient utilization

Fiscal deficit narrowed on revenue increases from customs-related duties.

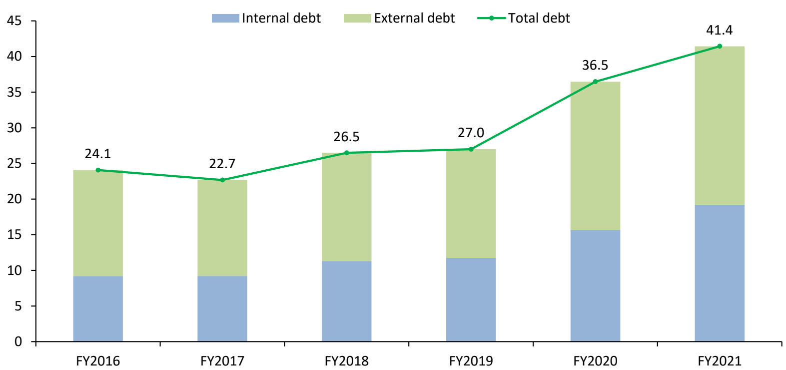
Figure 4: Fiscal indicators



Note: Years are fiscal years ending in mid-July of that year.
Source: Ministry of Finance. Budget Speech 2022

Public debt rose sharply in 2021 on increased borrowing to mitigate the effects of COVID-19.

Figure 5: Public debt



Source: Central Bureau of Statistics; Financial Comptroller General Office; Public Debt Management Office

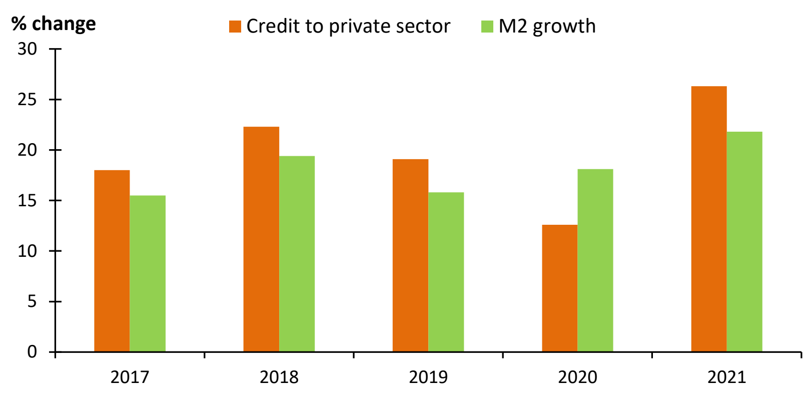
of public resources and scaling up domestic productivity would be crucial to building resilience to shocks such as the COVID-19 outbreak.

7. In line with the central bank's monetary policy, broad money (M2) growth accelerated from 18.1% in FY2020 to 21.8% a year after on rising net domestic assets and a modest increase in net foreign assets (Figure 6). The policy/repo rate at which banks could borrow from the central bank was cut by 50 basis points to 3.0%. Private credit growth accelerated from 12.6% in FY2020 to 26.3%, owing to a gradual resumption of economic activities further strengthened by various liquidity measures. The refinancing fund was increased five-fold to an estimated $1.7 billion for affected businesses due to COVID-19. Credit to government and financial institutions also surged with the gradual opening of economic activities after the lifting of the nationwide lockdown starting in July 2020.

8. The current account deficit substantially widened to $2.8 billion – 8.0% of GDP from 0.9% of GDP in FY2020 on increased trade deficit amid a massive cut in services income particularly from inbound tourism (Figure 7). Import growth of transport equipment and manufacturing raw materials rapidly surged in the latter half of FY2021, mainly reflecting pent-up demand following the ease of restrictions. Merchandise exports sharply rose by 31.0% after declining by 6.9% in FY2020 but had a minimal impact on the trade deficit as they are relatively small at about 10% of imports. Workers' remittances increased by 8.2% in FY2021 after contracting

Broad money growth accelerated driven mostly by private sector credit growth.

Figure 6: Credit to the private sector and M2 growth

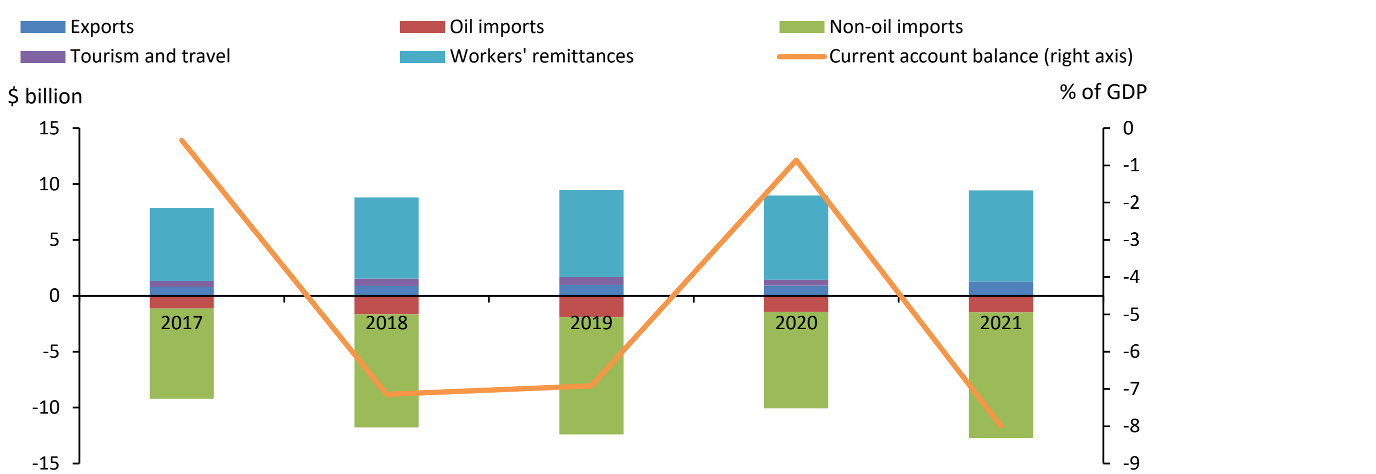


Note: Years are fiscal years ending in mid-July of that year.
Source: Nepal Rastra Bank. 2022. Recent Macroeconomic Situation. http://www.nrb.org.np

by 3.3% in FY2020, but fell far short of the trade deficit, widening the current account deficit. Financing, nevertheless, was adequate to meet the large deficit and gross foreign exchange reserves grew marginally to $11.7 billion, providing cover for 10.2 months of imports of goods and services (Figure 8).

Current account deficit substantially widened on increased trade deficit.

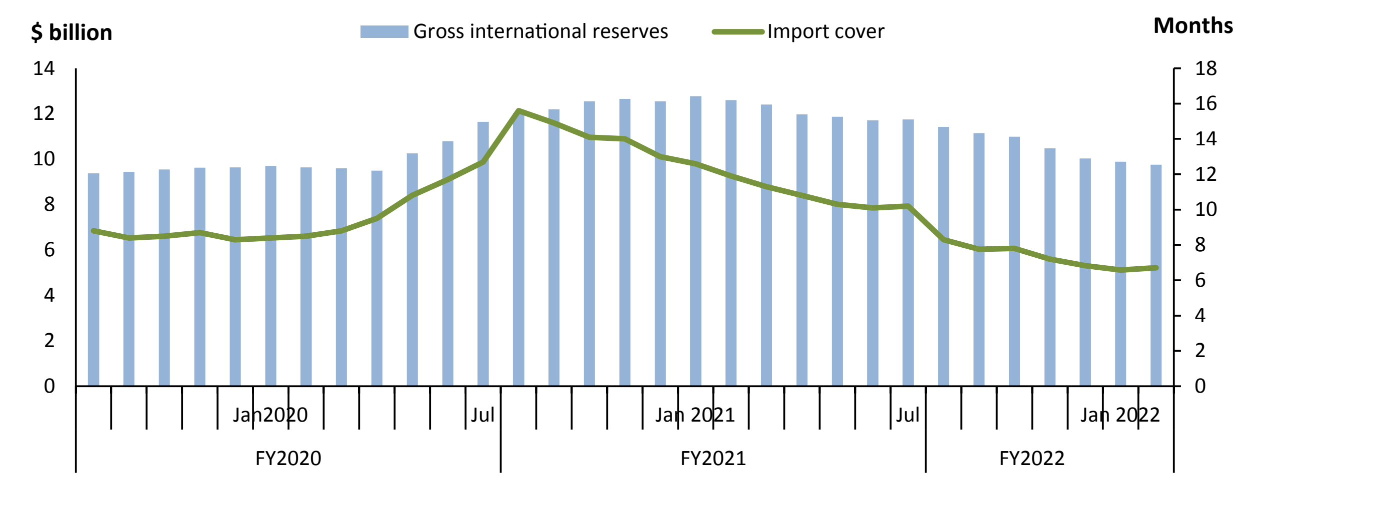
Figure 7: Current account indicators



Note: Years are fiscal years ending in mid-July of that year.
Source: Nepal Rastra Bank. 2022. Recent Macroeconomic Situation. http://www.nrb.org.np

Broad money growth accelerated driven mostly by private sector credit growth.

Figure 8 : Gross international reserves and foreign exchange adequacy



Source: Nepal Rastra Bank. 2022. Recent Macroeconomic Situation. http://www.nrb.org.np

B. Economic prospects

9. GDP is forecast to slightly increase to 3.9% growth in FY2022 underpinned by the ongoing vaccination campaign against COVID-19[1] that will repress infection flare-ups, fostering a gradual normalization in economic activity and a steady path to higher growth supported by accommodative macroeconomic policies. However, slowing growth in advanced economies exacerbated by the Russian invasion of Ukraine along with disrupted trade flows and higher oil and other commodity is expected to push inflation and may exert pressure on external sector. Local level elections scheduled in May 2022 will also stimulate spending, supporting GDP growth.

Table 1: Selected economic indicators (%)

	2020	2021	2022	2023
GDP growth	-2.1	2.3	3.9	5.0
Inflation	6.2	3.6	6.5	6.2
Current account balance (share of GDP)	-0.9	-8.0	-9.7	-6.1

Source: ADB estimates

10. Agriculture was previously expected to grow favorably as paddy plantation had been promising owing to abundant rainfall this summer monsoon. However, unexpected rains and floods in mid-October that

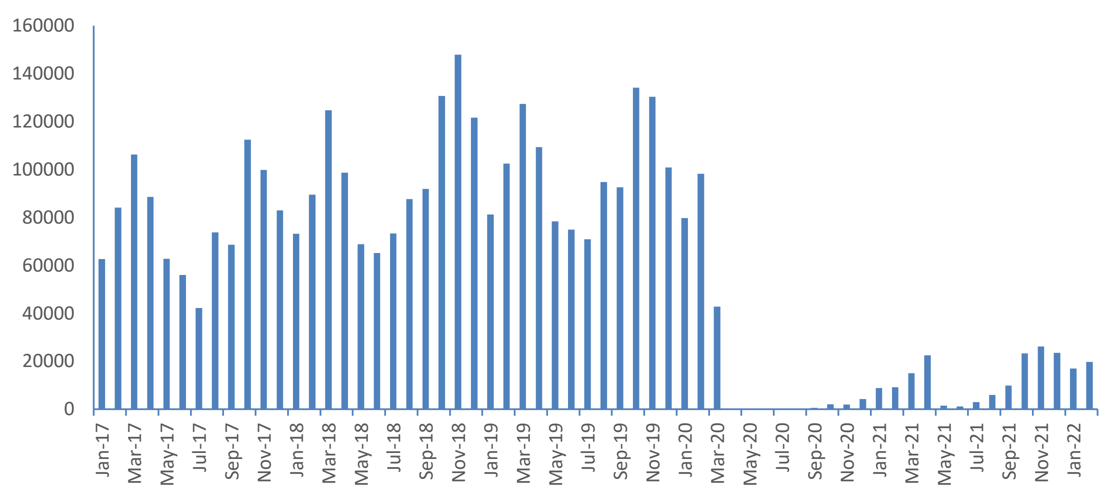
1 The vaccination program remains the main instrument of the coalition government in the near-term for Nepal's economic recovery. The government plans to vaccinate 100% of people above the age of 18 by 13 April 2022. As of 28 March 2022, 83% of this population have been fully vaccinated.

damaged ready-to-harvest crops shrank paddy output by about 9.0% this fiscal year.

11. With the waning of second wave since 22 June 2021, average capacity utilization of manufacturing and service-oriented industries increased from a low of 28.8% at the end of FY2020 to 74.7% by mid-November 2021.[2] Industry growth is expected to edge up to 4.1% in FY2022 on increased consumer and investment demand, as well as from full output by a large hydropower project that will further accelerate growth by 4.8% in FY2023. Services will likely grow by 5.2% as wholesale and retail trade, transport, and financial services have picked up owing to a significant containment of COVID-19 infections and removal of restrictions on mobility. International tourism will remain depressed, although it is benefiting from the opening of trekking routes and expeditions (Figure 9). On the demand side, private consumption will continue to be underpinned by still sizeable remittances. Private investment is forecast to grow on increased credit in production activities for much of the year and better economic prospects on COVID-19 containment.

Tourist arrivals have gradually picked up in recent months compared to COVID-19 period.

Figure 9: Monthly tourists' arrival

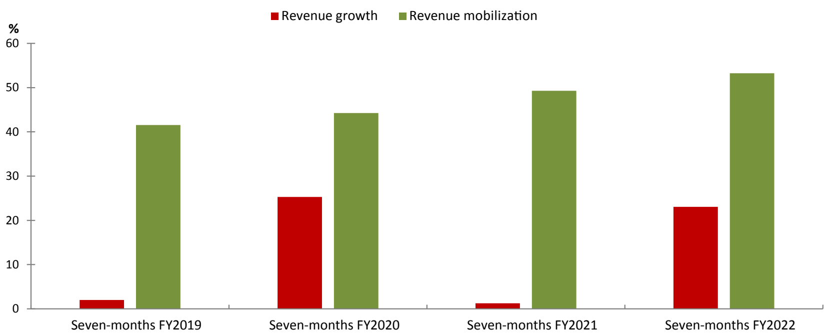


Source: Nepal Rastra Bank. 2022. Recent Macroeconomic Situation. http://www.nrb.org.np

2 NRB (2021). A Follow up Survey on the effect of COVID-19 on the economy. Available online at: <https://www.nrb.org.np/contents/uploads/2021/11/20780808-3rd-Follow-Up-Final.pdf>

Revenue growth has remained impressive on increased customs duties, Value-added tax (VAT), and income tax.

Figure 10: Revenue mobilization

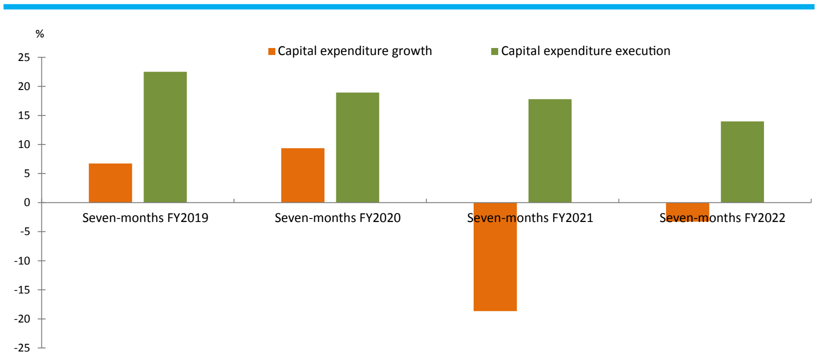


Source: Ministry of Finance, Budget speech various years; Financial Comptroller General Office.

12. Fiscal policy in 2022 is expansionary with a continued focus on strengthening healthcare and providing economic relief measures. Total expenditure is budgeted to increase by 28.9 %—with large increases in both current and capital spending—reaching 35.7% of GDP, from 30.3% a year earlier. Revenue is estimated to increase by 20.1% to 23.8% of GDP. Data as of mid-February 2022 show that revenue increased by 23.0% year-on-year after rising by 1.3% a year earlier, on a strong rebound in Value-added tax (VAT), customs duties, income tax, and non-tax receipts (Figure 10). Budget execution on large infrastructure projects has been tepid in the first seven months of FY2022, reflecting long-standing challenges tied to procurement, project readiness and management. While recurrent expenditure increased by 16.9% y/y, capital expenditure

Capital budget execution has been tepid owing to long-standing challenges, further hampered by political instability in early FY2022.

Figure 11: Capital expenditure growth and execution

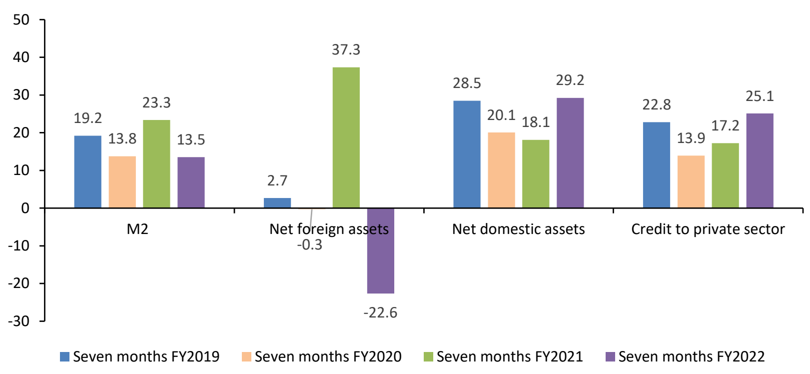


Source: Ministry of Finance, Budget speech various years; Financial Comptroller General Office.

3 This is based on the initial budget estimate for FY2022.

Credit to private sector accelerated in the first half of FY2022 on monetary stimulus.

Figure 12: Monetary sector (y-o-y % change)



Source: Nepal Rastra Bank

contracted by 3.3% to mid-February 2022 (Figure 11). As usual, capital expenditure is expected to ramp up in the remaining portion of the fiscal year. The budget deficit is forecast at 7.3% of GDP,[3] significantly higher than 4.2% in FY2021, but will likely be lower than anticipated largely owing to shortfalls in capital budget execution.

13. While the monetary policy for 2022 was intended to be accommodative, the mid-year policy review announced tightening measures to restrain credit growth and inflation. M2 expanded by 13.5% year-on-year in mid-February 2022 on increased net domestic assets. Credit to private sector surged by 25.1% year-on-year in the fiscal year through mid-February 2022 (Figure 12). By contrast, deposit collection of banks and financial institutions grew marginally by 2.9% y/y on decreased inflows of remittances. To restrain high credit growth, the floor rate was raised by 300 basis points to 4.0% and the repo-policy rate by 250 basis points to 5.5%. The interest rate applicable under refinancing facility for end borrowers has been raised by 200 basis points to 7.0% per annum. The intention is to restrict private sector credit growth to 19.0% by the end of FY2022.

14. Inflation in FY2022 is forecast to average 6.5%. Higher inflation is on increased global oil prices and subsequent higher transportation costs. The recent uptick in petroleum and commodity prices owing to Russian invasion of Ukraine has added further inflationary pressure. A gradual recovery in domestic demand and a modest rise in inflation in India, the major trade partner of Nepal, have also intensified inflationary pressure. Average inflation edged up to 5.2% in the first seven months of FY2022 higher than 3.6% in

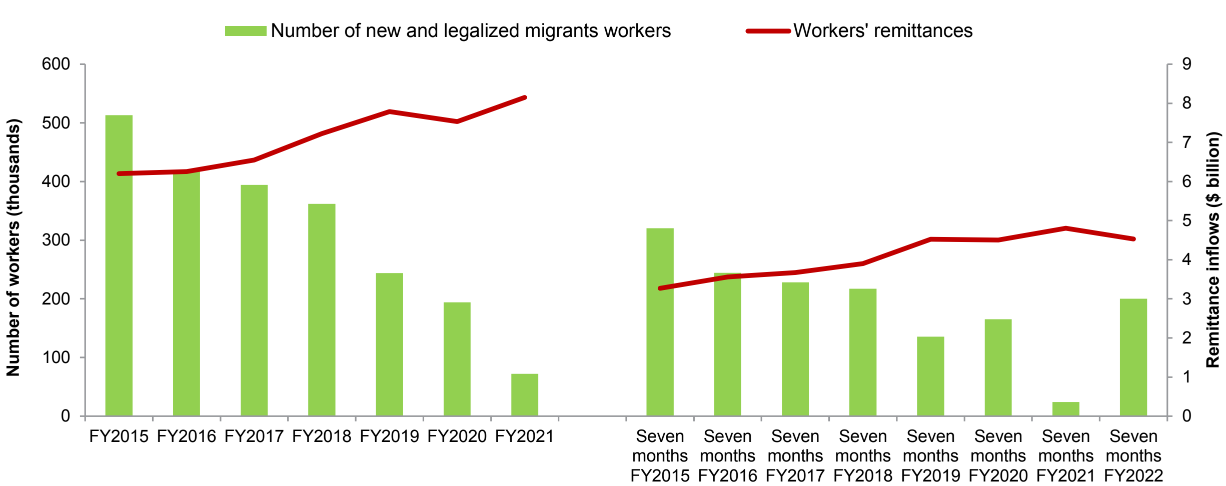
the corresponding period a year earlier. With a sharp rise in vegetable oil prices and transportation costs, both food and non-food inflation hovered at 6.0%y/y.

15. Growth in non-oil imports will remain elevated in FY2022 as investment activity has intensified on the gradual revival of economic activities. Imports surged by 40.5% in the first seven months of FY2022, reversing a contraction of 4.2% in the corresponding period a year earlier (Figure 13). Exports too have risen sharply by 87.7% in the fiscal year through mid-February 2022 after contracting by 6.9% in the year-earlier period. But due to low export base, trade deficit nonetheless widened by 35.8% y/y in mid-February 2022, reversing a contraction of 3.9% in the year-earlier period.

16. Workers' remittances, on the other hand, contracted by 5.8% in the fiscal year through mid-February 2022 after expanding by 6.8% y/y in the year-earlier period (Figure 13). The current account deficit consequently rose to a record $3.5 billion in the first seven months of FY2022 (Figure 14). But import growth in the remaining part of this fiscal year will likely remain subdued as various measures to curtail the import of non-essential and luxurious items, including an increase in cash margin from 50% to 100% while opening letter of credit accounts with commercial banks announced by the central bank. Based on developments to date, the full-year current account deficit is forecast to nonetheless widen to 9.7% of GDP in FY2022 from 8.0% a year earlier.

While outmigration has picked up, remittance inflows have dipped.

Figure 13: Number of Migrants and Remittance Inflows



Source: Nepal Rastra Bank. 2022. Recent Macroeconomic Situation. http://www.nrb.org.np

Current account deficit has widened amid subdued workers' remittances.

Figure 14: External sector

Source: Nepal Rastra Bank. 2022. Recent Macroeconomic Situation. http://www.nrb.org.np

17. GDP growth is forecast at 5.0% in FY2023 on the expectation that the entire eligible population is vaccinated will enable the further revival of economic activities that have gradually picked up since FY2021. The other underlying assumptions are that the geopolitical and economic risk stemming from the Russian invasion of Ukraine is contained and the oil and commodity prices are normalized over the forecast horizon. The forecast is also dependent on normal monsoon and timely availability of farm inputs, particularly chemical fertilizers, absence of natural disasters, and smooth conduct of local, provincial, and federal elections.

18. Inflation is forecast to marginally decline to 6.2% in FY2023 restrained by a better harvest, smoother supply chain distribution, somewhat subdued oil prices, and a modest inflation decline in India. The current account deficit is expected to moderate to 6.1% of GDP in FY2023 as COVID-19 related imports will have substantially decreased and hydroelectricity generation will hydroelectricity generation eases fossil fuel consumption.

19. Downside risks to the outlook center on exogenous shocks such as the emergence of strong, new variants of the COVID-19 pandemic, intensification of the current global turmoil, and recurrence of natural calamities like floods, landslides, and earthquakes, that have devastated lives and livelihoods in the past.

THEME CHAPTER

Effect of remittances on financial development, investment, and growth in Nepal

Manbar S. Khadka*, Pujan Adhikari**

A. Introduction

1. Remittances from Nepali workers abroad are an important source of household welfare and a major source of foreign exchange earnings for the country. While at the household level, remittances have contributed toward human capital formation through increased access to education, health, and entrepreneurship development; at the national level, remittances have helped finance imports and maintain external sector stability. Remittances play a significant role in improving a country's creditworthiness for external borrowing, expanding innovative financial mechanisms, enhancing access to capital, and stimulating economic growth [World Bank (WB), 2005]. Interestingly, workers' remittances have grown as one of the largest sources of financial flows to developing countries, often overshadowing other sources such as official aid and private capital flows (Giuliano and Ruiz-Arranz, 2009; Williams, 2016).

2. Many South Asian countries depend on remittances to partly finance their imports. India, Bangladesh, and Nepal receive a significant share of personal remittances to GDP every year (Figure 1). In Nepal, remittances have become one of the major sources of foreign exchange earnings. During the last five years, remittances have contributed about two-thirds of gross foreign exchange earnings [Nepal Rastra Bank (NRB), 2021]. Remittances have grown after the country adopted a liberal policy for outmigration in the 1990s (Sharma et al., 2014). From 2002 to 2021, remittance inflows to Nepal have increased at an average annual rate of 17.2 percent (NRB, 2021). The civil unrest in 1996 that lasted for a decade and political instability forced hundreds and thousands of unemployed youths to migrate for foreign employment (Dahal, 2014). As per the latest statistics, around one-fifth of the total population, about 6 million Nepalese are in foreign countries, and on average 696 people have left the country per day for foreign employment in the last five years (NRB, 2021). In absolute amount, Nepal receives about $8.0 billion workers' remittances every

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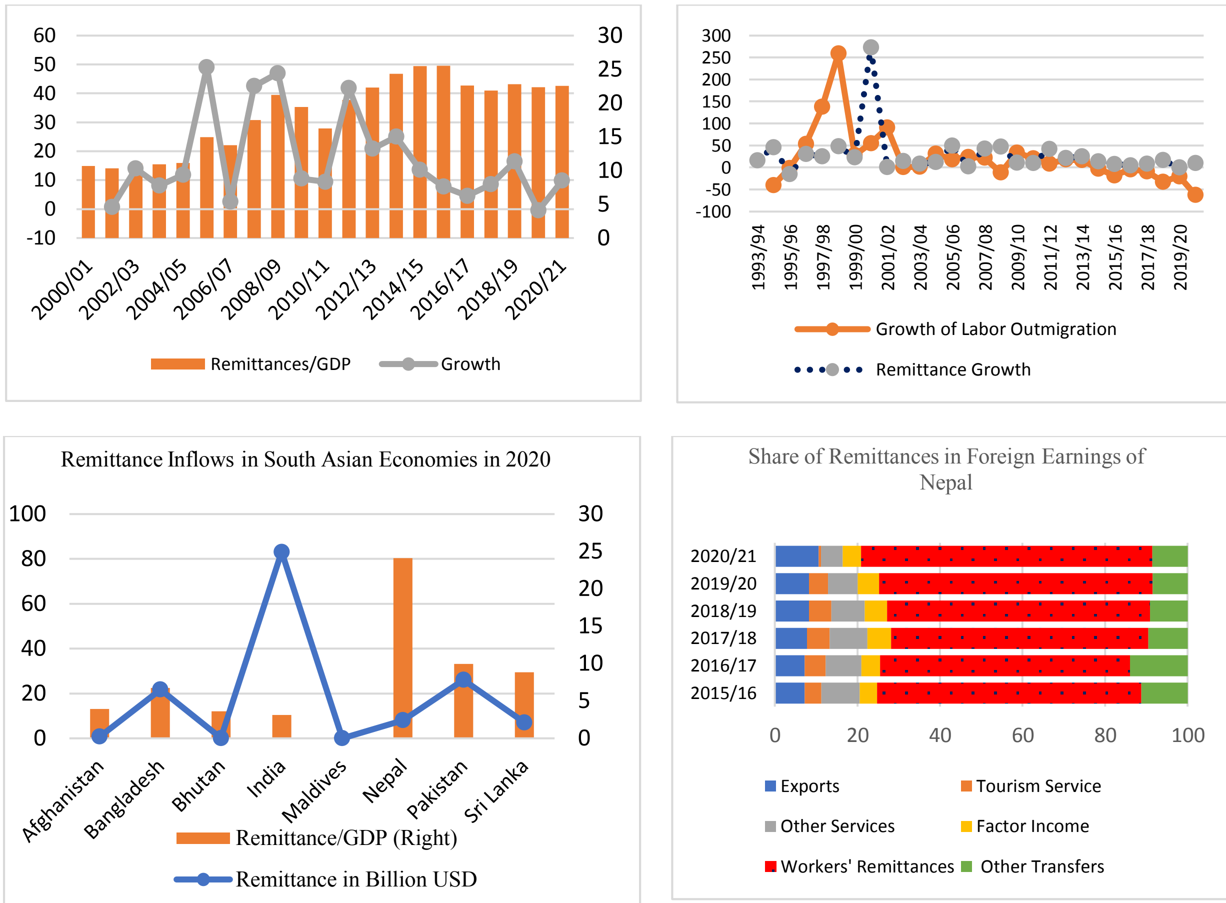
Figure 1: Remittance Inflows in Nepal and South Asia



Source: Nepal Rastra Bank (2021) and WB (2021)

fiscal year.[1] Nepal was among the top 25 remittance recipient countries and was the fourth in the world in 2019 in terms of remittance as a percent of GDP (WB, 2021).

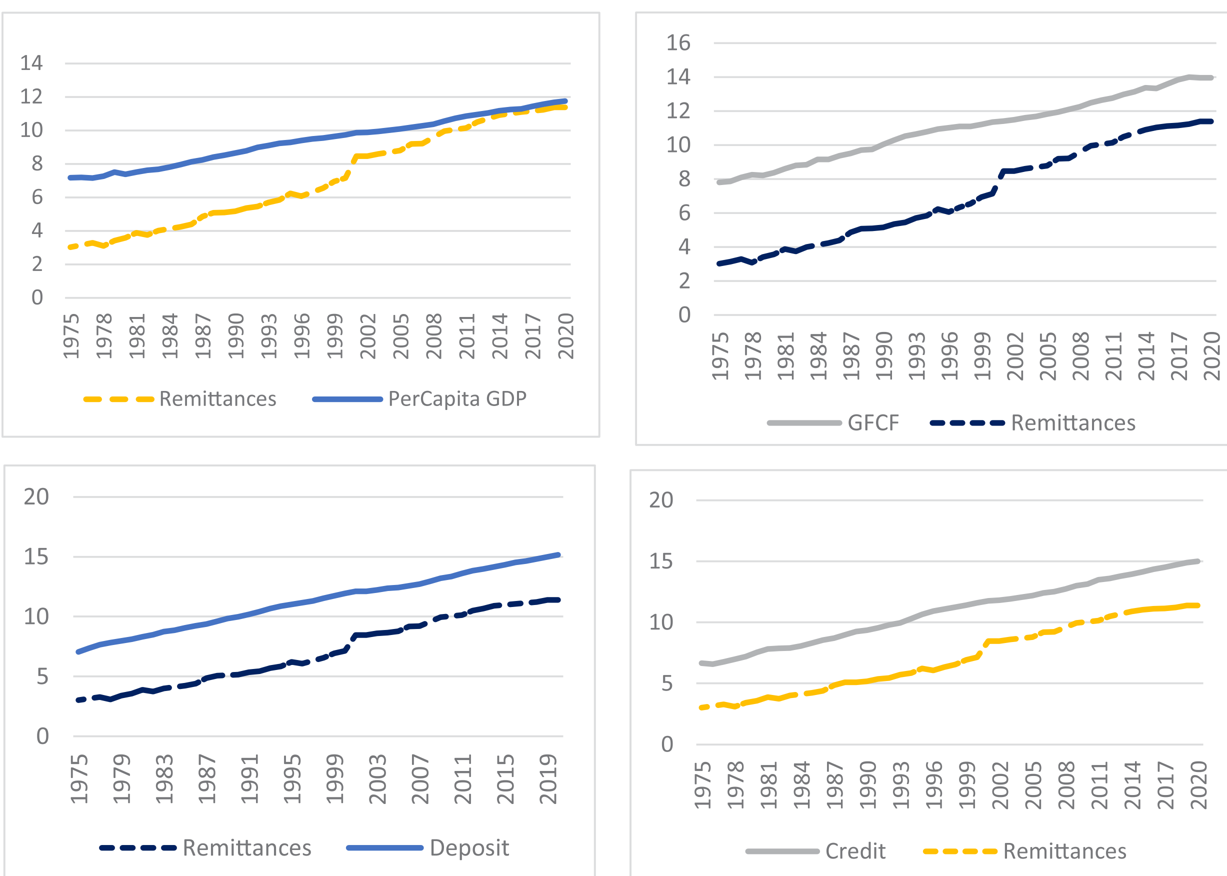
3. A good investment climate with a well-developed financial system and sound institutions is likely to imply that a higher share of remittances is invested in physical and human capital (IMF, 2005). However, remittances have been used in the unproductive sector and financing of imports, thereby creating inflationary pressure, and resulting in little investment (Glytsos, N. P. (2002). Given the backdrop, this study discusses the effect of remittances on economic growth, investment, and financial sector development in Nepal and suggests policy recommendations.

1 This is the amount received through formal channel recorded by Nepal Rastra Bank.

II. Effect of remittance on economic growth, financial development, and Investment in Nepal

4. Studies that have investigated the macroeconomic impact of remittances have found mixed results. The macroeconomic impact of remittances on growth, financial development, and investment is based on three conceptual frameworks. First, remittance inflows provide additional resources for households, thereby improving the accumulation rate of physical and human capital and, eventually productive capacity of the economy (Chami et al., 2005). Second, remittances increase the availability of the quantity of fund in the domestic market and ease liquidity constraints, and hence contributes toward the financial development of the economy, especially deposits and credit flows. Third, remittances as additional resources affect domestic capital accumulation. This may happen especially in countries with a lack of abundant resources for investment (Giuliano and Ruiz-Arranz, 2009).

Figure 2: Remittance Inflows in Nepal, economic growth, financial development, and investment



Note : All data are in log scale. Data except per capita GDP are in millions.

5. Remittances have direct and indirect impacts on various aspects of the economy and hence on economic growth (Rao and Hassan, 2010). Remittances are instrumental in raising welfare at the household level and maintaining external sector stability in many developing economies. The historical series of remittance and macroeconomic variables of interest suggest their positive association (Figure 2).[2] An econometric estimation shows an existence of long run and short run dynamic relationship between remittance and economic growth in Nepal.[3]

6. With the adoption of liberalization policy, the banking and financial sector has visibly grown and gradually strengthened. This period of financial sector development also coincides with a gradual increase in workers' remittances. Financial development can be represented via indicators such as bank deposits and credit inflows to the private sector (Coulibay, 2015; Chowdhury, 2011; Aggarwal and Peria, 2006). Deposit measures the ability of banks to attract financial savings and provide a liquid store of value (Giuliano et al., 2009). Credit shows how much intermediation is carried out by the banking sector. The empirical results find that remittances significantly contribute to deposit mobilization but do not find similar significance in credit flow.[4]

7. In the investment-remittance relationship, the empirical analysis examines whether remittance inflows provide additional resources and increase capital formation. Gross fixed capital formation, as a proxy of investment, is a measure of additional investment in productive assets by private and public sectors. The empirical result indicates that remittance has a positive association, but it is not statistically significant.[5]

III. Policy Implications

8. The empirical result of this study has some important policy implications for Nepal. Remittances, about a quarter of GDP, have been stimulating private consumption that amounts to slightly above 80% of GDP. Further, remittances have financed Nepal's imports considerably (Bhatta, 2013). But increased expenditures on consumer

2 All the data has been taken from Nepal Rastra Bank, the annual data between 1975 to 2020

3 RPCGDPt=-3.314+0.006 EDUC+0.109 LNGFCF+0.776 LNWPOP+0.005 FISBLNC+ 0.024 _ LNREM+0.053 LNPR
t-test: (-2.736) (4.028) (1.251) (10.776) (-1.494) (2.581) (1.050)

4 LNDeposit =-2.63+1.36 LNPCGDP+0.10 SDRATE+0.17 LNREM
t- test: (-3.16) (8.48) (1.66) (1.82)
LNCREDITt=-4.64+1.66 LNPCGDP-0.01 SDRATE+0.17 LNREM
t-test: (-1.77) (10.43) (1.54) (0.39)

5 LNGFCF=-0.2814+0.9231 LNPCGDP-0.0266 RINT+0.0328 LNREM+0.2696 LNFISDFCT
t-test: (-0.36) (4.81) (-2.31) (0.58) (2.48)
Source: Staff calculations

goods will further deepen Nepal's import dependency. While such an increase in consumption, as well as imports, have promoted economic growth, Nepal needs to shift from the current consumption-led growth to investment-led growth.

9. Gross fixed capital formation in Nepal is about 28.0% of GDP which is relatively low (WB, 2021). Given that remittance inflows account for a significant share of foreign exchange earnings, this important source of income should be channelized toward investment and production activities. Karki (2017) discusses the experiences of several countries on productive utilization of remittances. For instance, Bangladesh offers different savings and investment schemes, such as Non-Resident Foreign Currency Deposit, Wage Earners' Development Bond, and Non-resident Investor's Taka Account. India has focused on establishing a strong institutional framework through initiatives such as Pravasi Bharatiya Divas, Overseas Indian Facilitation Center, and India Development Foundation of Overseas Indians to engage migrant workers in the development process through investment. In the Philippines, commercial banks offer migrants specialized investment products and services such as insurance, pensions, and real estate with direct payment schemes to aid beneficiaries. In 2011, the central bank released Overseas Filipino bonds allowing migrant Filipinos to invest in bonds for as low as $100. The central bank has also supported microfinance institutions to help channel remittances sent to rural households to invest in Micro, Small & Medium Enterprises (MSME).

10. In Nepal, 23.9% of remittance is diverted toward household consumption and 1.1% toward productive activities (NRB, 2019). The NRB, on behalf of the government, has been issuing foreign employment savings bond every fiscal year since FY2010. The aim is to allow migrant workers to invest in this financial instrument to channel the fund in nation-building activities. Despite offering a stable interest rate[6] of 10% per annum on this instrument for a maturity period of about 5 years, its subscription has been low every fiscal year. The subscription is NPR37 million and NPR55 million in FY2019/20 and FY2020/21 respectively (NRB, 2021a). The low level of subscription is largely due to a lack of awareness of the advantages of investing in such secured financial instruments among migrant workers. The second issue could be that finance companies and cooperatives offer higher interest rates for a shorter period (1 year) than the returns on these bonds. Third, it could be that migrant workers' immediate priorities are huge and so are reluctant to park their savings on such bonds for a longer period.

6 This is the NPR interest rate.

11. Nonetheless, the government and concerned authorities should prioritize such and other means through which remittance income could be channelized in the productive sector. The low level of awareness should be addressed through information sharing on benefits of investment on such financial instruments. For instance, in Philippines, banks and financial institutions are required to post remittance charges on their websites, thereby allowing migrant workers to make informed decisions on channeling remittances (Karki, 2017). The foreign employment savings bond in Nepal can possibly be targeted among high income earners abroad. The government should come forward with specific project shares/bonds for remittance recipient households to mobilize remittance for investment. The Remit Hydro Limited[7] is a recent initiative in this respect that can be expanded to other investment projects. At the household level, remittances could be diverted toward productive uses by providing entrepreneurial skills to household members to initiate their own enterprises.

12. Finally, a positive long-run association between remittance and deposit mobilization is evident of remittance being an impetus to financial sector development. Banks and financial institutions have gradually flourished with the adoption of liberalization policy since the 1990s. This period also coincides with the gradual increase in out-migration for foreign employment. During sluggish remittance inflows, banks and financial institutions in Nepal have intermittently faced liquidity constraints, signifying its increased importance in deposit mobilization. But more concrete policy-level actions are needed to further promote remittance inflows through formal channels. The policymakers should promote ways of reducing remittance transfer costs and provide further incentives for channelizing remittances into productive activities. The cost of sending remittances to Nepal was 4.54 percent in 2020 which is high, even though it is lower than the global average (WB, 2020). High transaction costs are due to underdeveloped financial infrastructure, limited competition, inadequate access to banking sector, and lack of necessary identification documents (ibid). Cutting such transaction costs through the digitalization of remittance businesses would encourage formal means of remittance.

7 Remit Hydro Limited (RHL) is a hydroelectricity project based on remittance. This is a subsidiary company of Hydroelectricity Investment and Development Company Limited (HIDCL).

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Appendix 1: Country Economic Indicators

Item	Fiscal Year				
	2017	2018	2019	2020[R]	2021[P]
A. Income and Growth					
1. GDP per Capita ($, current)	1005.1	1133.2	1154.6	1122.0	1165.8
2. GDP Growth (%, in market prices)	9.0	7.6	6.7	(2.1)	2.3[a]
a. Agriculture	5.2	2.6	5.2	2.2	2.4[a]
b. Industry	17.1	10.4	7.4	(3.7)	1.7[a]
c. Services	8.4	9.3	6.8	(4.0)	2.5[a]
B. Saving and Investment (current and market prices, % of GDP)					
1. Gross Domestic Investment[b]	30.6	32.4	33.8	28.4	27.9
2. Gross National Saving	41.7	40.5	42.1	32.6	32.1
C. Money and Inflation					
1. Consumer Price Index (average annual % change)	4.5	4.2	4.6	6.2	3.6[c]
2. Total Liquidity (M2) (annual % change)	15.5	19.4	15.8	18.1	21.8[c]
D. Government Finance (% of GDP)					
1. Revenue and Grants	20.8	22.2	22.4	22.1	24.2[d]
2. Expenditure and Onlending	23.6	28.0	27.3	27.4	28.4[d]
3. Overall Fiscal Surplus (Deficit)[e]	(2.8)	(5.8)	(5.0)	(5.3)	(4.2)[d]
E. Balance of Payments					
1. Merchandise Trade Balance (% of GDP)	(29.1)	(32.9)	(33.3)	(27.1)	(32.5)[c]
2. Current Account Balance (% of GDP)	(0.3)	(7.1)	(6.9)	(0.9)	(8.0)
3. Merchandise Export ($) Growth (annual % change)	9.8	15.8	12.5	(7.6)	31.0[c]
4. Merchandise Import ($) Growth (annual % change)	29.4	27.9	5.2	(18.9)	26.5[c]
5. Remittances (% of GDP)	22.6	21.8	22.8	22.4	23.0[c]
F. External Payments Indicators					
1. Gross Official Reserves ($ million)	10,494.2	10,084.0	9,500.0	11,646.1	11752.6[c]
Months of current year's imports of goods)	11.4	9.4	7.8	12.7	10.2[c]
2. External Debt Service (% of exports of goods and services)	10.8	8.3	8.2	10.9	4.6[f]
3. Total External Debt (% of GDP)	13.5	15.2	15.2	20.8	22.2[f]
G. Memorandum Items					
1. GDP (current prices, NPR billion)	3,077.1	3,455.9	3,858.9	3,914.7	4,266.3
2. Exchange Rate (NPR/$, average)	106.2	104.4	112.9	116.3	117.9[c]
3. Population (million)	28.8	29.2	29.6	30.0	30.4

GDP = gross domestic product; P = preliminary; R = revised; … = not available
Note: FY2021 covers 16 July 2020 to 15 July 2021.

[a] ADB estimates
[b] Refers to gross fixed investment and does not include change in stocks
[c] Based on FY2021 annual data. Nepal Rastra Bank
[d] Based on FY2022 Budget Speech. Ministry of Finance; and Financial Comptroller General Office
[e] Includes revenue sharing to subnational governments
[f] Based on FY2021 annual data. Public Debt Management Office

Sources: Ministry of Finance. FY2022 Budget Speech. Kathmandu; Nepal Rastra Bank. 2021. Current Macroeconomic and Financial Situation. Kathmandu; Central Bureau of Statistics. April 2021. FY2021 National Accounts Statistics. Kathmandu; Financial Comptroller General Office. 2021. Daily Receipts & Payments Status (as of 15 July 2021). Kathmandu; Central Bureau of Statistics. 2014. National Population and Housing Census 2011 (Population Projection 2011 – 2031). Kathmandu.

Appendix 2: Country Poverty and Social Indicators

Item	Period					
	1990s		2000s		Latest Year	
A. POPULATION INDICATORS						
1. Population (million)	18.5	(1991)	24.8	(2006)	30.0	(2020)
2. Population growth (annual % change)	2.1		1.2		1.3	(2020)
B. Social Indicators						
1. Fertility rate (births/woman)	5.1	(1996)	3.6	(2004)	2.3	(2016)
2. Maternal mortality ratio (per 100,000 live births)	539.0	(1996)	281	(2006)	239.0	(2018)
3. Infant mortality rate (below 1 year/1,000 live births)	82.0	(1991)	48.0	(2006)	28.4	(2016)
4. Life expectancy at birth (years)	55.0	(1991)	62.0	(2001)	70.5	(2018)
a. Female	54.0	(1991)	63.0	(2001)	71.9	(2018)
b. Male	55.0	(1991)	62.0	(2001)	69.0	(2018)
5. Adult literacy (%)	35.6	(1996)	48.0	(2004)	66.8	(2017)
a. Female	19.4	(1996)	33.8	(2004)	57.2	(2017)
b. Male	53.5	(1996)	64.5	(2004)	77.8	(2017)
6. Primary school gross enrollment (%)	57.0	(1996)	122.0	(2004)	118.5	(2017)
7. Secondary school gross enrollment (%)	43.8	(2001)	54.4	(2004)	79.0	(2016)
8. Child malnutrition (% below 5 years old)	57.0		49.0 (2006)	36.0	(2016)	(2016)
9. Population below poverty line (international, %)	68.0	(1996)	30.9	(2004)	18.7	(2018)
10. Population with access to safe water (%)	45.9		82.5	(2006)	92.7	(2017)
11. Population with access to sanitation (%)	22.0	(1995)	24.5	(2006)	87.6	(2017)
12. Public education expenditure (% of GDP)	2.0		2.9	(2005)	4.4	(2016)
13. Human development index	0.341		0.429	(2005)	0.602	(2019)
14. Rank/total number of countries	152/173		136/177	(2003)	142/189	(2018)
15. Gender-related development index	0.33	(1995)	0.511	(2003)	0.897	(2018)
16. Rank/total number of countries	148/163	(1995)	106/140	(2003)	147/189	(2018)
C. Poverty Indicators						
1. Poverty incidence	42	(1996)	31	(2004)	25.16	(2011)
2. Proportion of poor to total population						
a. Urban	23.0	(1996)	9.55	(2004)	15.46	(2011)
b. Rural	44.0	(1996)	34.62	(2004)	27.43	(2011)
c. Mountain	57.0	(1996)	32.6	(2004)	42.77	(2011)
d. Hills	40.7	(1996)	34.5	(2004)	24.32	(2011)
e. *Terai*	40.3	(1996)	27.6	(2004)	23.44	(2011)
3. Poverty gap	11.75	(1996)	7.55	(2004)	5.43	(2011)
4. Poverty severity index	4.67	(1996)	2.7	(2004)	1.81	(2011)
5. Inequality (Theil Index)	...		...		...	
6. Multidimensional poverty index[1]	...		...		0.148	(2018)

... = not available, GDP = gross domestic product,

Sources:

Central Bureau of Statistics. 2012. National Population and Housing Census 2011. Kathmandu; Central Bureau of Statistics. 2014. National Population and Housing Census 2011 (Population Projection 2011-2031). Kathmandu; Central Bureau of Statistics. 2017. Annual Household Survey 2016/17. Kathmandu; Ministry of Health. 2017. Nepal Demographic and Health Survey 2016. Kathmandu; United Nations Development Programme. 2019. Human Development Report 2019. New York; Central Bureau of Statistics. 2011. Poverty in Nepal (2010/11). Kathmandu.

1 UNDP replaced Human Poverty Index with Multidimensional Poverty Index from Human Development Report 2011.

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