Nepal

The global economic crisis had a limited impact, but despite that, political uncertainties, poor weather, and infrastructure bottlenecks restrained economic growth in FY2009. With the political uncertainties remaining and macroeconomic challenges emerging, GDP growth will be below par in FY2010. But it is likely to pick up in FY2011, on account of continued sound fiscal management, strengthening global economic recovery, and some easing of supply disruptions.

Economic performance

The continuing peace process—marked by controversies over the rehabilitation of the Maoist combatants and transformation to a federal structure from the current unitary system—led to frequent strikes and transport blockades, which acted as a break on the much anticipated postconflict economic recovery in FY2009 (ended July 2009). Coupled with unfavorable weather, these setbacks slowed GDP growth to 4.7% in FY2009, from 5.3% the year before.

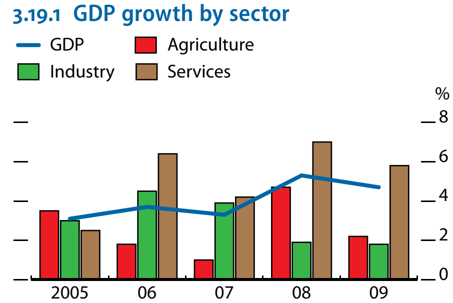
Although the deceleration was broad-based (Figure 3.19.1), services still grew by 5.8%, mainly supported by sturdy remittance-related spending. Agricultural growth fell by more than half to 2.2% due to a delayed monsoon and prolonged winter drought, which reduced both the cultivated area and productivity. Industry remained a sluggish performer, as labor unrest and persistent fuel and power shortages led to a contraction in manufacturing, which was marginally offset by increased activity in the remittance-driven construction industry.

On the demand side, rapid growth in remittances continued to fuel consumption spending and imports, further raising the share of private consumption in GDP from 77.1% in FY2008 to 79.2% in FY2009. The share of private fixed capital formation decreased modestly to 17.1% of GDP from 18.0% over the same period, reflecting uncertainty in the political landscape and limited investment opportunities other than real estate and housing.

Slower agricultural growth and disruptions to transportation produced shortages of foodgrains in several parts of the country, especially remote districts, driving up inflation to an average of 13.2% in FY2009 from 7.7% a year earlier. While food price inflation has been generally trending up in the last few years, the increment in FY2009 was more pronounced (Figure 3.19.2). Inflation was exacerbated by a strong expansion in the broad money supply in FY2008 and FY2009, which reflected larger remittance inflows and the buildup of net foreign assets.

To rein in the rising inflation and to curb the remittance-driven real estate bubble in urban areas, Nepal Rastra Bank (NRB), the central bank, tightened monetary policy by raising the cash-reserve ratio from 5.0%

3.19.1 GDP growth by sector



Source: Ministry of Finance. 2009. *Economic Survey Fiscal Year 2008/09*. July. http://www.mof.gov.np

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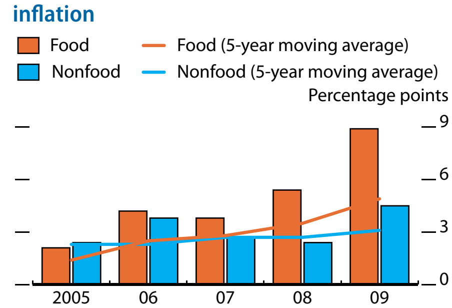
3.19.2 Contribution to consumer price inflation



Source: Nepal Rastra Bank. 2009. *Recent Macroeconomic Situation*. September. http://www.nrb.org.np

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This chapter was written by Yubraj Acharya of the Nepal Resident Mission, ADB, Kathmandu.

to 5.5% (effective November 2008) and the policy rate from 6.25% to 6.5% (effective October 2008).

On the fiscal side, the government undertook several reforms on revenue mobilization, including the introduction of an income disclosure scheme and implementation of a performance-based incentive system for tax offices and officers. These reforms widened the tax base substantially and curtailed leakages, resulting in a record 32% growth in domestic revenue mobilization in FY2009 (well above the 3-year trend). For the first time, income tax collection exceeded customs revenue (Figure 3.19.3). External grants also swelled, by 70%, as donors sought to support Nepal during its political transition.

Despite the delayed approval of the budget (due to disagreements among various factions in the Constituent Assembly) and a difficult project implementation environment, capital spending picked up in the latter part of FY2009, increasing by 30% from a year earlier (Figure 3.19.4). Political pressures to raise salaries and wages of civil servants and security forces resulted in 33% growth in recurrent expenditures, contributing to the 32% growth in overall spending (excluding net lending). The resulting deficit, equivalent to 1.9% of GDP, was financed mainly through domestic borrowing.

On the external front, import growth markedly slowed to 8.3% from 24.1% in FY2008, mainly because of a decline in oil imports. (Nepal Oil Corporation, the state-owned and sole supplier of petroleum products, struggled to clear its dues with the Indian Oil Corporation.) Imports of other items continued to grow in line with the historical average. Exports contracted by 4.7% in FY2009, the first decline since FY2003, as some domestic enterprises shut their operations, both because of intense foreign competition in a weak market and domestic labor disruptions, and because of the long-standing structural bottlenecks such as poor infrastructure and skills shortages.

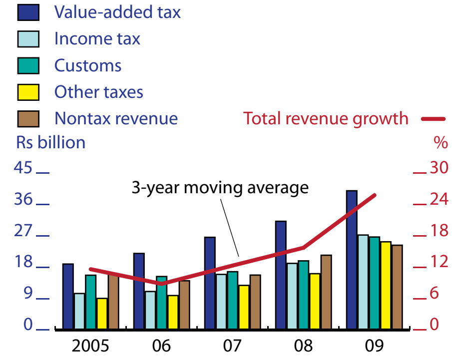
The resulting wider trade deficit (21.8% of GDP after 19.1% in FY2008) was, however, more than offset by remittance inflows, which grew by 24.2% (mainly due to the relatively inelastic demand for the unskilled Nepalese workers) and by a 26.7% increase in tourism receipts (Figure 3.19.5). With a strengthening current account surplus—from 2.9% of GDP in FY2008 to 4.3%—the overall balance-of-payments position became stronger, with over $2.8 billion in reserves (equivalent to 7.7 months of total imports).

Given the continued peg to the Indian rupee, the Nepalese rupee mirrored the former currency—depreciating rapidly against third country currencies at the onset of the global crisis and appreciating after May 2009. However, the real effective exchange rate has been appreciating since August 2008 (Figure 3.19.6), reflecting relatively high domestic inflation.

Economic prospects

Nepal's medium-term growth and development prospects hinge on progress in the political transition, macroeconomic stability, and the pace of global economic recovery. With a high share of agriculture in GDP, much of which relies on rainfed irrigation, prospects also heavily depend on weather conditions.

3.19.3 Revenue indicators



Source: Nepal Rastra Bank. 2009. *Recent Macroeconomic Situation.* September. http://www.nrb.org.np

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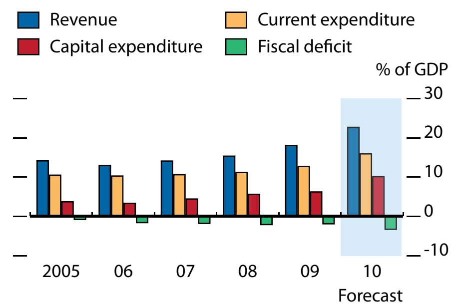
3.19.4 Fiscal indicators



Sources: Ministry of Finance. 2009. *Economic Survey Fiscal Year 2008/09.* July. http://www.mof.gov.np; ADB estimates.

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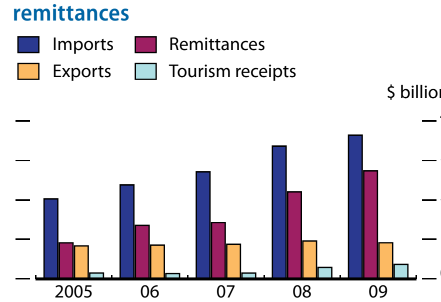
3.19.5 Trade, tourism, and workers' remittances



Source: Nepal Rastra Bank. 2009. *Recent Macroeconomic Situation.* September. http://www.nrb.org.np

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A range of factors are challenging the sound macroeconomic management seen in previous years (despite the political turmoil then). Notably, the initial resilience seen in remittances and exports faded in the first half of FY2010 and reserves have declined modestly since July 2009 (Figure 3.19.7), raising concerns that a lagged effect of the crisis may still be felt.

Growth in all sectors is expected to decelerate in FY2010 from FY2009 with overall GDP expansion expected to ease to 3.5%, on the assumption that, with the emerging global recovery, remittance inflows and tourism receipts will not decelerate further. The possible delay in writing the new constitution before the 28 May deadline constitutes the key downside risk to the outlook, as political uncertainties can affect the investment climate and the project-implementation environment. Assuming continued recovery in the global economy and a domestic political landscape more conducive to economic activity, growth is expected to pick up to 4.5% in FY2011 (on a par with that in FY2009).

Agriculture is expected to grow by only 1.0% in FY2010, assuming normal winter weather, as the production of paddy and maize, two major summer crops, was severely affected by the delayed and reduced monsoon. Assuming a return to normal weather and no disruptions to the transportation of fertilizers and seeds, the sector is expected to grow by its historical average of 3.0% in FY2011.

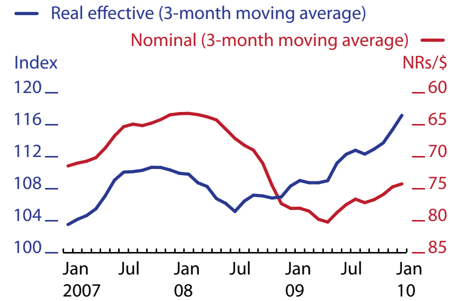
Industry's performance in FY2010 will be checked by fuel and power shortages and sporadic labor tensions, all of which will restrict recovery in manufacturing. Construction activity will also slow due to reduced credit from commercial banks. Consequently, industry is expected to grow by only 1.5% in FY2010. Growth is expected to pick up to 2.5% in FY2011 as power shortages ease somewhat (several micro-hydropower projects are slated for completion in FY2010) and as strikes lessen (the political parties have signed an agreement not to organize any *bandh*—politically inspired economic shutdowns—during Visit Nepal Year 2011).

Services are expected to continue to drive growth, although real estate renting and business activities will be hit by credit limitations that the NRB has placed on commercial banks to counter price pressures. Expansion in services is expected to moderate to 5.5% in FY2010. As performance in agriculture, industry, and tourism is expected to improve in FY2011, growth in services will be pushed up to 6.0%.

While the NRB's tighter monetary policy from FY2009 seems to be working to reduce inflation, the pass-through from the policy rate and cash-reserve ratio to inflation has been slow and small. Consumer price index inflation remained in double-digits in January 2010, suggesting that nonmonetary factors, such as reduced grain production, rising transportation costs, and delays in importing certain items like sugar, may be driving up inflation. Therefore, 10.0% inflation is expected in FY2010, with moderation to 8.0% in FY2011 as supply disruptions lessen.

The current account is expected to move into deficit in FY2010. Rising oil prices will have a significant bearing on imports as oil constitutes 17% of Nepal's total imports. Imports of other items will moderate, adjusting to decelerating remittance inflows, but this moderation is unlikely to fully offset the effect of rising oil prices on overall imports. With reduced competitiveness from the appreciating real exchange rate and domestic

3.19.6 Exchange rates



Source: International Monetary Fund.

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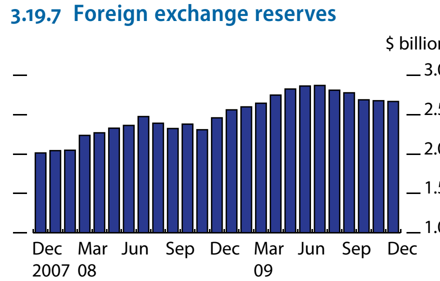
3.19.1 Selected economic indicators (%)

	2010	2011
GDP growth	3.5	4.5
Inflation	10.0	8.0
Current account balance (share of GDP)	-0.5	1.0

Source: ADB estimates.

3.19.7 Foreign exchange reserves



Source: Nepal Rastra Bank. 2010. *Recent Macroeconomic Situation*. March. http://www.nrb.org.np

Click here for figure data

structural shortcomings that continue to plague key industries, exports will continue to decline in absolute terms. Remittances and tourism receipts, growing at their current pace, will fail to offset the trade deficit, leading to a current account deficit of approximately 0.5% of GDP.

In FY2011, remittances are expected to strengthen as the majority of Nepalese workers are employed in oil-exporting countries in the Middle East that are seeing a revival in growth. Moreover, improved industrial activity and some moderation in the appreciation of the real exchange rate are expected to support growth in exports. Aided by larger tourism receipts, the current account is expected to recover to a surplus of 1.0% of GDP.

Development challenges

The infrastructure deficit—particularly in transport infrastructure, power, and irrigation—is a major bottleneck to economic growth and to development prospects. In particular, power shortages could have adverse social and political implications if not addressed expeditiously.

Despite the large hydropower potential of around 80,000 megawatts, half of which is economically viable, Nepal is a net importer of electricity. The electrification rate, at 48% in 2006, is one of the lowest in South Asia, and means that more than 13 million mainly rural people are without access to electricity. In urban areas, current peak demand is more than 720 megawatts, of which only 40% is available, leading to up to 16 hours of daily power cuts. A range of factors have contributed to underinvestment in power generation, including the uncertain investment climate, poor road access, and lack of transmission lines.

The government is preparing a new energy strategy to promote the power sector, but its implementation is likely to remain challenging unless a political consensus is built. Two draft bills—the Nepal electricity bill and the Nepal electricity commission bill—are currently before the Constituent Assembly. In the meantime, the government is focusing on repairing and upgrading existing generation, transmission, and distribution infrastructure. It is also planning to expand existing transmission links to India, and develop new high-capacity cross border lines, to enable importation during dry periods. Recognizing the capital-intensive nature of hydropower projects, the government should develop a policy framework to encourage public–private partnerships, clearly delineating public and private sector roles. The policy should include other modes of power generation including solar, wind, and thermal.

In the restructuring of policies, the government should give to private power producers economically viable market access by clarifying and liberalizing connection and tariff policy, and should provide related infrastructure, such as access roads and distribution lines. A fast-track approval process for hydropower projects needs to established. Policy efforts should go beyond rural electrification and mitigating power shortages in urban areas, to include a focus on export of electricity to make hydropower a major source of foreign currency earnings.

To facilitate some of these changes, the capacity of the newly created Ministry of Energy should be augmented and the financial health of Nepal Electricity Authority, the key buyer and distributor of electricity, needs to be improved.