Nepal

Contrary to expectations of an economic revival in the wake of the historic political breakthrough in April 2006 to end the decade-long Maoist insurgency, economic growth slowed in FY2007 owing mainly to unfavorable weather and renewed political unrest. The political transition is complex and remains the key risk to growth and development prospects. However, the renewed commitment of the main political parties to the peace process offers hope that the country can continue to make headway in its aspirations for social and economic transformation and in the delivery of a tangible peace dividend.

Economic performance

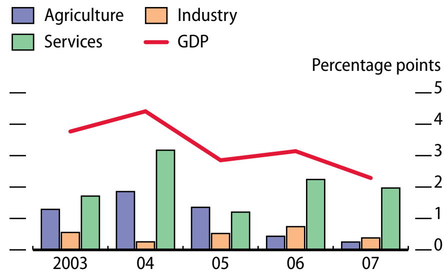
The peace process was set back by two major developments in 2007: violent unrest in the Terai region (the lowlands bordering India) over political, economic, and social exclusion of the Madhesi (Terai-based) people; and postponement, twice, of the constituent assembly elections due to differences among the coalition partners over the proclamation of a republic and the electoral process. Still, the prospects for the constituent assembly elections—a key milestone in the peace process—improved significantly following a December 2007 agreement among the political parties on the main issues. The twice-postponed polls were rescheduled for 10 April 2008 and the Communist Party of Nepal–Maoists, in the wake of this agreement, rejoined the interim Government, which they had left in September 2007. A political deal reached with Madhesi groups in late February 2008 enhances the likelihood that the elections will proceed in April.

The improved security conditions in the wake of April 2006's cease-fire are expected, in time, to lead to a more stable environment for the economy. However, the peace dividend has been slow to materialize and overall GDP growth slackened to 2.3% in FY2007 (ended mid-July 2007) from 3.1% in FY2006 (Figure 3.19.1). The deceleration stemmed from poor weather and renewed political disturbances, which crimped the performances of agriculture and industry, respectively. However, activity in services was reasonably robust due in part to a rebound in tourism.

Inclement weather continued to hamper agriculture (with a 36% share in overall GDP—Figure 3.19.2) in FY2007, which decelerated to 0.7% from 1.1% the previous year. Poor monsoon rains caused paddy output to fall by 12.5%, and affected other major crops, such as potatoes and oilseeds. Agriculture's contribution to GDP growth in FY2007 was thus limited to only 0.3 percentage points.

Long-standing structural weaknesses, such as low productivity and input supply and transport disruptions, slowed industrial activity. Industry expanded by only 2.2% in FY2007 (contributing 0.4 percentage points to GDP growth), compared with 4.3% in the previous year.

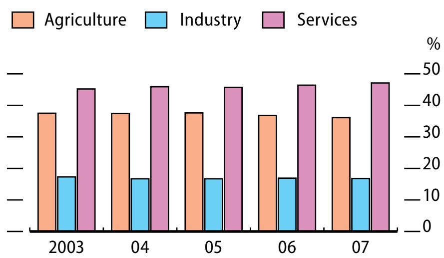
3.19.1 Contributions to growth (supply)



Source: Ministry of Finance, available: http://www.mof.gov.np, downloaded 7 March 2008.

Click here for figure data

3.19.2 Sector shares of GDP



Source: Ministry of Finance, *Economic Survey Fiscal Year 2006–07*, available: www.mof.gov.np, downloaded 1 February 2008.

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This chapter was written by Shyamal Shrestha and Raju Tuladhar of the Nepal Resident Mission, ADB, Kathmandu.

Construction, manufacturing, and utilities were particularly hard hit by labor agitation, political unrest, and oil supply and electricity disruptions, all of which raised transaction costs.

While services also slowed for many of the same reasons, the sector maintained a reasonable pace at 4.1%, contributing 2.0 percentage points to overall growth. Its performance was underpinned by expansion of the transport, real estate, storage, and communications subsectors, which benefited from the improved mobility of people and goods. Hotels and restaurants also grew, albeit more slowly, reflecting a sharp increase in tourist arrivals after a 5-year slump.

On the demand side, the economy came to depend even more heavily on private consumption as investment remained dormant due to the continued political uncertainty. The share of gross fixed capital formation (in GDP) fell to 20.3% in FY2007 from 20.9% a year earlier, while private consumption continued to increase its share of GDP on the basis of sustained remittance inflows.

Average consumer inflation moderated to 6.4% from 8.0% in FY2006 despite higher food prices. The unwinding of the base effect of the hike in petroleum products in March 2006 kept the growth of nonfood goods and services in check at 5.5%, while the Nepalese rupee's appreciation also made imports cheaper. Monthly inflation increased to 5.7% by mid-December 2007, from a July low (Figure 3.19.3).

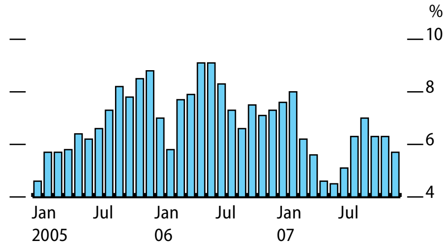
The central bank kept the bank rate unchanged at 6.5% in FY2007, and maintained the exchange rate peg to the appreciating Indian rupee, damping inflation pressure to some extent. A slower rise in net foreign assets, partly caused by the appreciation of the Nepalese rupee and slowing remittance inflows, also helped rein in the surge in banking system liquidity. Broad money (M2) growth therefore slowed to 14.0% compared to 15.4% in FY2006. Reserve money also slowed to only 7.8% in FY2007, down from 14.0% in FY2006.

The budget deficit widened marginally to 2.0% of GDP in FY2007, from 1.6%, despite a significant increase in expenditures (Figure 3.19.4). While recurrent spending swelled by 20%—on account of costs related to rehabilitation of former Maoist combatants, compensation to victims of the conflict, and a hefty pay rise for civil servants—it was lower than budgeted on savings from the deferred constituent assembly elections. Capital spending surged by 32%, reflecting the increased scope for development activities following the initiation of the peace process.

Total receipts grew by 19% owing to improved revenue collections. Tax revenues went up by 22%, mainly on improvements in tax administration and a broadening of the income and excise tax bases. As foreign aid receipts fell short of the budgeted amount by nearly 1% of GDP, domestic financing rose to 1.6% of GDP, marginally exceeding the budgetary provision.

The current account surplus declined to 0.5% of GDP in FY2007 amid a widening trade deficit and slower remittance inflows. With capital inflows also slowing, the overall balance of payments surplus declined from 4.3% of GDP in FY2006 to 0.9% of GDP in FY2007. Foreign exchange reserves stood at $2 billion in mid-December 2007 (Figure 3.19.5), equivalent to about 8 months of imports of goods and services.

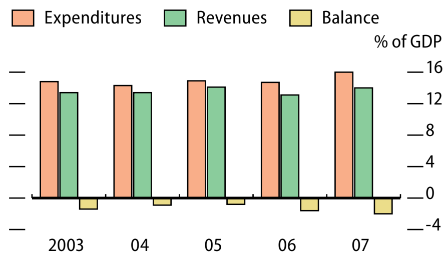
3.19.3 Inflation



Source: Nepal Rastra Bank, available: http://www.nrb.org.np, downloaded 6 March 2008.

Click here for figure data

3.19.4 Fiscal indicators



Source: Ministry of Finance, *Budget Speech*, various years.

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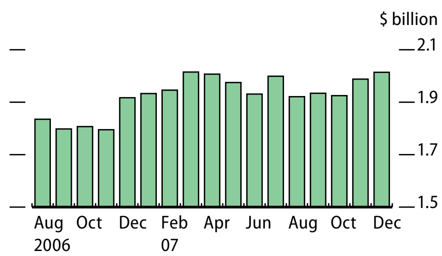
3.19.5 Gross international reserves



Source: Nepal Rastra Bank, *Current Macroeconomic Situation*, 2007 and 2008.

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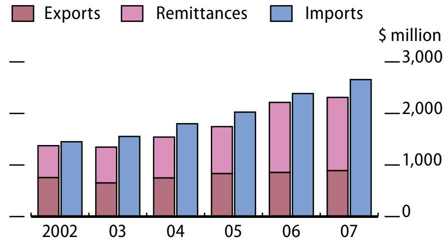
The trade deficit remained large at 17.3% of GDP in FY2007 as merchandise export growth remained sluggish at 4.3% (though up from 2.6% in the previous year). This was caused mainly by decelerating exports to India, from 6.5% in FY2006 to 2.8%. Exports to third countries declined by 1.3%, continuing the contraction of 1.4% a year earlier, reflecting reduced competitiveness in readymade garments, pashmina, woolen carpets, and other handicrafts. Imports (of which oil imports from India constituted 22%) rose by 11.3%, compared with growth of 17.8% in the previous year.

Travel receipts grew by 8% to reach $143.5 million, switching from the previous year's 8% decline, but overall net services remained negative at 1.2% of GDP. Workers' remittances—a major source of foreign exchange earnings, which had jumped by 49% in FY2006 reflecting a significant rise in overseas migration as well as increased remittance receipts through official channels—slowed to just over 4% in FY2007 to reach $1.4 billion (14.2% of GDP). Even then they remained nearly high enough to cover the trade deficit (Figure 3.19.6).

The Nepalese rupee appreciated by 14.3% against the US dollar during FY2007 as a result of the domestic currency's peg to the Indian rupee. However, the trade-weighted real effective exchange rate appreciated by 6.9%.

3.19.6 Trade and workers' remittances



Source: Nepal Rastra Bank, *Recent Macroeconomic Situation*, available: http://www.nrb.org.np, downloaded 14 February 2008.

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3.19.1 Selected economic indicators

	2008	2009
GDP growth	3.8	4.3
Inflation	7.0	6.5
Current account balance (% of GDP)	1.0	1.0

Source: Staff estimates.

Economic prospects

Medium-term growth and development prospects hinge on achieving lasting peace and stability, preserving macroeconomic stability, and effectively implementing key structural reforms in the fiscal, financial, labor, and governance sectors (Boxes 3.19.1 and 3.19.2). Further scaling up capital spending, especially on infrastructure and social sectors in rural areas, is also required to stimulate economic activity and support the peace process. The FY2008 budget is appropriately focused on boosting infrastructure and social sector spending within the framework of the Three-year Interim Plan (FY2008–FY2010). Rehabilitation, reconstruction, and recovery from the decade-long insurgency are key priorities of the Plan, which targets annual GDP growth of 5.5%.

The rise in global oil prices could constrain Nepal's prospects somewhat as the country is fully dependent on imported oil. Timely adjustment toward a market-oriented pricing mechanism (including a move toward their deregulation) would be important to overcome chronic fuel supply disruptions and give impetus to the ailing industry sector. Power shortages have also hit domestic industries hard, lowering their capacity utilization. Hence, it is encouraging that the Government has recently taken steps to attract private investment to hydropower.

Assuming normal weather conditions and continued progress in the peace process, GDP is forecast to rise by 3.8% in FY2008 and 4.3% in FY2009. Agriculture is likely to expand by 4.0% in FY2008 on the basis of strong growth in rice output, with a similar performance expected in FY2009 if weather patterns remain favorable. Improved security conditions in rural areas should facilitate transport of agricultural inputs and greater output.

Industry can be expected to pick up marginally with the probable

3.19.1 Development challenges

Taking the ongoing peace process to a logical conclusion and establishing lasting peace and stability are undoubtedly the immediate challenge to Nepal's development. However, Nepal also faces a number of other longer-term development challenges, even assuming a smooth transition to a new political order. Among these is the need for labor market reforms, which are long overdue given the existence of a low-skilled workforce compounded by rigid labor laws.

political stability and some improvement in the business environment. However, a significant upturn is unlikely in view of the lingering political uncertainties, long-standing structural weaknesses of low productivity, underemployment, and persistent economywide infrastructure bottlenecks. While manufacturing is likely to remain subdued, construction and utilities (such as predicted generation of 70 megawatts of electricity from the Middle Marsyangdi Hydroelectric Project by late 2008) could contribute to a modest increase in industrial output. On this basis, industry is forecast to grow by 2.5% in FY2008 with modest pickup to 3.0% in FY2009.

Expansion in services is seen continuing, on the back of a sustained recovery of tourism. The renewal of air service agreements with the People's Republic of China, Malaysia, and Thailand, as well as additional local air services, should help lift tourist arrivals further. The overall boost to services by the rebound in tourism, its knock-on effects on other subsectors, and continued increase in construction and real estate activities can, however, be expected to be moderated by the impact of fuel and power shortages, especially on the transport and communication sub-sector. On balance, services growth is forecast to be sustained at 4.2% in FY2008 and pick up moderately to 5.0% in FY2009.

On the demand side, remittances will remain the main driver of consumption. New labor agreements with Asian and Gulf countries, such as Republic of Korea, Malaysia, and Qatar, last year should keep pushing up employment numbers abroad. However, the rapid growth in emigration underscores the limited job creation in the country. Raising investment in activities that could boost employment growth will depend on a conducive business climate in which disruptions are minimized and economywide bottlenecks resolved.

Inflation is expected to remain above the central bank's targeted 5.5% in the next 2 years given the rising fiscal imbalances and the need for further upward adjustments of fuel prices. Despite its salutary impact on paddy production, the 2007 monsoon flooded some parts of the country, destroying vegetable crops. This, combined with the rice shortages caused by India's temporary restriction on foodgrain exports, could lift food prices. The 17% hike in civil servants' salaries in the FY2008 budget is also likely to contribute to inflation pressure. Inflation is, therefore, forecast to increase to 7.0% in FY2008, but moderate to about 6.5% in FY2009.

On the external front, the trade deficit is expected to widen further as the domestic currency's appreciation would make imports cheaper while exports are forecast to gradually recover following the renewed bilateral trade treaty with India, which exempts Nepalese exports from certain customs duties. However, until persistent economywide bottlenecks are eased and exports are diversified, export performance is likely to remain sluggish. Imports are projected to rise, reflecting economic recovery and appreciation of the Nepalese rupee. Higher tourist arrivals and a sustained inflow of remittances should help offset the trade imbalance and sustain a current account surplus of about 1% of GDP in the forecast period. The overall balance of payments is also expected to remain in surplus on account of increased aid flows.

3.19.2 Employment and labor reform

While the Labor Act of 1992 provides limited flexibility for employers to rationalize business operations, the rights and interests of workers are also inadequately protected. For instance, under the Act, a worker performing 240 days of work is guaranteed a permanent position irrespective of productivity, thus encouraging employers to resort to contractual employment or foreign labor to avoid the costs associated with regular employment. Yet there is no mechanism in place for reviewing minimum wages or ensuring proper working conditions.

Largely because of these constraints, productive job creation has lagged far behind the large number of new entrants to the labor force each year. Fortunately, overseas migration has emerged as a major source of employment for Nepalese workers over the past decade, providing significant remittance income (rising from $641 million in FY2001 to $1.4 billion or about 14.2% of GDP in FY2007), which far exceeds the combined earnings from exports and tourism.

Further, remittance income was the key contributor to the 11% decline in poverty between FY1996 and FY2004. However, there is still much scope for policy and administrative reforms to better manage overseas migration, improve overall conditions for migrant workers, and upgrade their skills for more remunerative employment.

Poor labor relations remain a key constraint to achieving higher and more broad-based economic growth, even with the rapid expansion in overseas employment. With the end of the conflict and the integration of leftist parties into mainstream politics, trade union activities have in fact escalated, resulting in frequent disruption of business activities.

This recent deterioration in labor relations therefore suggests an urgent need for a comprehensive reform of the labor laws, to ensure adequate flexibility required by private businesses while protecting the rights and interests of employees in the new political context.