Nepal

Economic growth remained hobbled by the long-running insurgency, political instability, and poor weather. Yet there is now guarded optimism on the political, and thus economic, front, due to major political breakthroughs starting in April 2006. These brought a comprehensive peace agreement that officially ended the 11-year armed insurgency and started a political process that holds promise of peace and a transition to a more productive economy. Nevertheless, the challenges are huge, and include widespread poverty, pervasive social inequality, low economic growth, and the legacy of a quasi-feudal political structure.

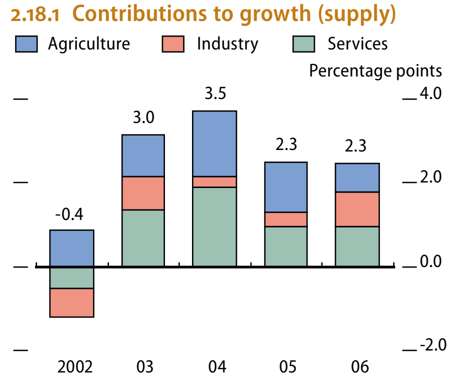
Economic performance

Political developments were the main event of the year, and moved rapidly from late-April 2006 when parliamentary government was restored following nationwide demonstrations. A few days later a cease-fire was declared by the Maoist insurgents. Subsequently in November, a comprehensive peace agreement was signed that officially ended the 11-year insurgency. Then in January this year the parliament approved an interim constitution that will be effective until a constituent assembly, scheduled to be elected by June 2007, approves a new constitution. Also in January, the Communist Party of Nepal (Maoist) joined the interim legislature.

Many difficult issues of course remain, but the current peace process holds the best promise yet of a new beginning for the country.

The economy continued its passage through the doldrums in FY2006 (which ended mid-July 2006), undermined by the continuing insecurity and political turmoil (the restoration of parliamentary rule and the cease-fire came late in the fiscal year). GDP grew at 2.3% (Figure 2.18.1), a rate unchanged from a year earlier. Weak conditions in agriculture largely offset industry's slight improvement.

2.18.1 Contributions to growth (supply)



Source: Nepal Rastra Bank, available: http://www.nrb.org.np/, downloaded 12 December 2006.

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Inclement weather hampered agriculture, damaging the production of the main food and cash crops. Agriculture, which accounts for about 40% of GDP and the livelihoods of 80% of the population, grew by 1.7% in FY2006 (contributing 0.7 percentage points of GDP growth), down from about 3.0% the previous year. Production of key agricultural crops declined by 2%, with paddy output, which accounts for one fifth of the value of food crops, falling by 1.8%.

Industry grew by 3.5% (contributing 0.8 percentage points), primarily due to a 4.2% expansion in construction after 2 years of stagnation. Utilities output was also well above the previous year's level. However, manufacturing remained weak, slipping to 2.2% growth, largely on tumbling garment production (exports slid 35%), continued supply and transport bottlenecks, and more frequent work stoppages and disruptions.

Services growth stayed at 2.4% (making a 1.0 percentage point contribution to growth). Performance was mixed as a recovery in trade, restaurants, and hotels was offset by slower growth in transport,

communications, and storage; finance and real estate; and social services. Tourist arrivals were little changed.

In terms of aggregate demand, both public and private investment stayed sluggish, reflecting the weak investment climate and security-related limitations to making development expenditures in much of the countryside. At 18.5% of GDP, the gross fixed investment rate continued its decline of recent years, moving by about 0.5 percentage points below the level of FY2005 (Figure 2.18.2). As for that year, growth in GDP was mostly driven by expansion in private consumption, which was made possible by the continued large, rapidly expanding inflows of remittances.

The budget deficit widened slightly to 1.8% of GDP, from 0.8%, indicative both of weakness in attempts to expand total revenues and of a decline in grants. Receipts (including current revenues, capital receipts, and grants) increased by 4% (compared with 16% in FY2005) due to low economic activity, poor export growth, and a shortfall in aid flows. Government spending, growing by 11%, fell substantially short (about 15%) of initial budget targets, thereby limiting the deterioration in the deficit.

Both current and capital expenditures missed budget plans, reflecting the difficulties in undertaking spending because of conflict-related disruptions. With foreign aid financing falling below both the budgeted and FY2005 levels, domestic financing of the deficit amounted to 1.4% of GDP (up from 0.2%).

Continued strong growth in remittances boosted liquidity in the banking sector. Broad money (M2) rose by 15.6%, with about two thirds of that coming from a rise in net foreign assets. Private sector credit picked up by 8.9%, in good part reflecting higher import credit, while credit to government rose by 14.5%.

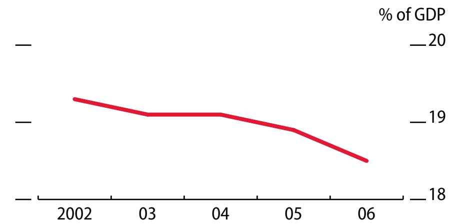
Over the year, bank lending rates rose to about 11.6%, while deposit rates declined marginally to 2.3%. Little progress was made in the effort to accelerate loan recoveries from large, willful defaulters, yet this is essential to bring down high levels of nonperforming loans and improve banks' operations.

Inflationary pressures grew in FY2006 with the consumer price index averaging 8.0%, nearly double the prior-year rate (Figure 2.18.3) and marking the largest rise in 6 years. Lower farm output drove up agricultural prices while upward adjustments to petroleum-product prices in February pushed up fuel and transport costs. The impact of the upward revision in value-added tax in May 2006 was a factor in commodity price rises.

Nepal Rastra Bank sought to tighten monetary policy through raising the discount rate by 25 basis points to 6.25% in February 2006, though this has a weak impact and reserve money still increased by 14% over the year. As the central bank has only limited means to engage in market operations to offset large inflows of remittances, monetary aggregates such as reserve money and money supply are very difficult to control. Still, given that the Nepalese rupee is pegged to the Indian currency, domestic inflation is broadly kept to India's. This link was evident in the rapid growth of imports in FY2006, which muted price pressures. In view of the rise in foreign exchange reserves and the very comfortable level of reserve holdings, this safety valve on price pressures remains securely in place.

Lackluster export growth, higher imports, and a trade deficit widening to $1.5 billion characterized the external sector. Merchandise

2.18.2 Gross fixed investment



Source: Nepal Rastra Bank, available: http://www.nrb.org.np/, downloaded 12 December 2006.

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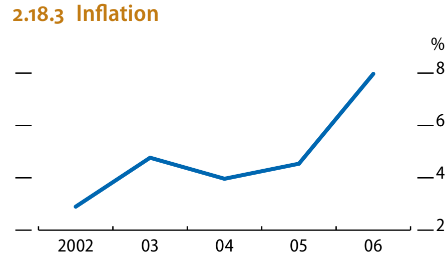
2.18.3 Inflation



Source: Nepal Rastra Bank, available: http://www.nrb.org.np/, downloaded 12 December 2006.

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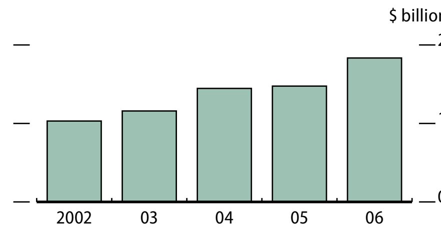
exports climbed by only 4.2%, reflecting slower growth in exports to India (accounting for nearly 70% of the total). They decelerated to 5.4% from 28.2% a year earlier. Stimulated by preferential trade arrangements, exports to India have grown rapidly in recent years, and the growth slowdown bore witness to a sharp drop in shipments of vegetable ghee, a major export that was affected by countervailing duties.

Exports to other countries improved by 1.8%, following a steep 14.5% decline in FY2005, when a sharp fall in garment sales was recorded. Performance in FY2006 underlined the facts that the country's export base is not well diversified and that traditionally large earners such as garments, as well as carpets and pashmina shawls, face stiffer competition, which has eroded sales both to India and to the rest of the world. Imports rose by 18.4%; oil-product imports accounted for about one quarter of the increase and remittance-financed consumption expenditure most of the rest.

Tourism receipts are estimated to have declined by about 10% to $132 million from a year earlier, but total net services and income receipts are small and were little changed. Nepal is increasingly dependent on remittances as a source of income and foreign exchange: they reached $1.3 billion in FY2006, an almost 50% year-on-year jump.

The remittance surge more than offset the wider trade deficit and kept the current account in surplus for the seventh consecutive year (at $191 million or 2.4% of GDP). Taking account of developments in the capital account and valuation changes, gross foreign exchange reserves rose by 24.3% to reach $1.8 billion (Figure 2.18.4)—equivalent to about 8 months of imports.

2.18.4 International reserves



Source: Nepal Rastra Bank, available: http://www.nrb.org.np/, downloaded 1 February 2007.

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Economic prospects

The peace process has rekindled hopes of economic revival in Nepal (Box 2.18.1). Whether the 2.1% average growth of the past 5 years can be substantially lifted to bring the country nearer to its real potential depends crucially on sustaining peace, including timely (and nonviolent) constituent assembly elections scheduled for June this year. The transition to higher growth will also require political stability (including law and order) and better labor relations, the latter to restore business confidence and allow normal economic activities to resume.

Besides political stability and the weather, the populace's ability to cope with price rises for petroleum products (to eliminate the large operating losses sustained by the Nepal Oil Corporation) will substantially influence growth and economic developments. Renewing the bilateral trade treaty with India, which is scheduled to expire in March 2007, could provide a fillip to exports if Nepal can again achieve beneficial terms from its dominant trading partner.

Over the medium term, the economic outlook will depend on how fast the new Government can both step up the pace of structural and governance reforms, and maintain macroeconomic stability. It will concurrently need to boost investment in infrastructure and basic services, education, and health. Reviving conflict-hit industries is also important.

Major donors have already pledged to boost aid to facilitate economic recovery. Moreover, in November 2006, the Government and the International Monetary Fund agreed on a resumption of the poverty

2.18.1 Selected economic indicators

	2007	2008
GDP growth	2.8	2.8
Inflation	5.3	5.4
Current account balance (% of GDP)	1.0	1.0

Source: Staff estimates.

reduction and growth facility arrangement that defined comprehensive economic and financial policies for FY2007. To help get the economy back on track, the Government will soon unveil a 3-year interim development plan, which aims at reconstruction of infrastructure, rehabilitation for displaced people, basic service delivery, and reforms to boost investment.

GDP is seen picking up to about 2.8% in FY2007 and FY2008. Agriculture is likely to grow by the same amount, but this will depend on the weather, since irrigation is patchy. Weather conditions in the early months of FY2007 have not been the best, but expansion penciled in for the year still seems achievable. Better rural security should bring some areas back into cultivation, improve distribution of inputs and services, and generally raise farm productivity, especially after FY2008.

Industry is forecast to grow by 2.2–2.5% in the next 2 years. Increased construction expenditures and better operating conditions in manufacturing, along with continued strong, remittance-based, consumer spending, are expected to provide the stimulus. However, reviving many "sick industries" will prove difficult since this requires overcoming long-standing weaknesses, such as low labor productivity, high transport costs, and keen competition for external markets. Moreover, power outages have become a grim reality: the wider problem is that energy demand is rising by 10% annually, but supply constraints remain unaddressed.

Expansion in consumption will continue to be the main driver of aggregate demand and this, with some expansion in tourist arrivals, is expected to generate services growth of 3.3%. Investment spending is also likely to rise substantially. At first, this would largely stem from greater budget allocations for rehabilitation and investment and from the more secure countrywide conditions. Private investment in construction and equipment is expected to expand. However, for investor confidence to return, labor relations will have to improve (and the number of work stoppages fall), and the authorities will need to ensure a supportive climate for entrepreneurship.

Inflation is expected to trim to about 5.3–5.4% in the next 2 years, as supply bottlenecks ease, but two factors will have a heavy impact on this forecast: agricultural output and prices may be less than assumed because the weather in early FY2007 was unfavorable, and the magnitude and timing of upward adjustments of Nepal Oil Corporation's fuel prices cannot be predicted with certainty.

The external sector is set to remain manageable, though reflect a widening trade deficit. Merchandise exports are projected to grow by 4.7% and 6.0%, respectively, in FY2007 and FY2008. Exports to India are likely to be relatively brisk on account of the expected renewal of the existing bilateral trade treaty, but exports to other countries will be attenuated until new strategies to compete in the garment trade, as well as new products, are developed.

Imports are likely to continue growing at relatively high levels of 6.5% and 10.0% in the forecast period, in view of expected double-digit expansion in remittances from abroad as well as fiscal and monetary polices that focus on fostering economic revival. Tourism should see steady improvement, but the overall services and income net balances are unlikely to record major gains. The current account surplus is set to decline moderately to 1% of GDP.

2.18.1 A peace dividend?

Nepalis are upbeat following the formal cessation of armed hostilities and, it is hoped, an end to the devastating human cost. Economically, the insurgency has relegated Nepal to being one of the world's poorest countries. Growth in the medium term, however, clearly depends on how political events unfold in the next couple of years.

On the assumption that peace becomes embedded, a higher growth trajectory requires increased resource mobilization and productivity gains. An investor-friendly climate would create more employment, generate technological spillovers, and contribute to overall economic competitiveness, while a skilled labor force would contribute to raising domestic productivity.

As regards infrastructure—largely neglected in recent years—despite Nepal's huge reserve of water resources, the country faces scarcity in meeting its irrigation, energy, and drinking-water needs.

Agroprocessing industries and light manufacturing provide much further scope for widening the industrial base, and tourism and remittances also represent lucrative sources of income. With its unique location between the two fast-growing Asian giants, Nepal could benefit from the spillovers of their rapid growth.

But benefits will only fully materialize if peace is consolidated.