

Nepal

The economy faltered in the year to mid-July 2005, reflecting a weather-related decline in paddy production and the adverse impact of the conflict on tourism and industry. Inflation picked up in response to higher world oil prices, upward adjustment in value-added tax, and the fall in paddy output. Nepal Rastra Bank raised its policy rate, though liquidity remained ample and commercial lending rates relatively low. The fiscal deficit was lower than planned, reflecting significant underspending of the Government's development budget. Looking forward, the outlook does not significantly differ from the recent past. An early settlement of the insurgency and regeneration of reform momentum are required for the economy to get back onto the higher growth path from which it has strayed in the last few years.

Economic performance

The modest economic recovery of the past 2 years from the recession in FY2002 lost momentum in FY2005 (ended mid-July 2005). Gross domestic product (GDP) rose by only 2.3%, mainly reflecting escalation of insurgency-related disruptions to the economy and the effect of weak monsoon rains on agricultural output.

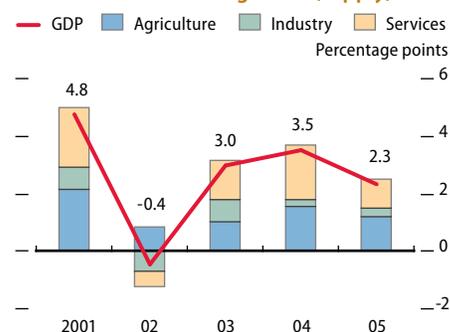
Agriculture grew by 3.0% in FY2005, contributing 1.2 percentage points of GDP growth (Figure 2.18.1). It achieved this fair performance despite the fact that paddy production (which accounts for almost 20% of agricultural GDP) fell by 3.7% due both to a poor monsoon, and to a decline in the cultivated area in response to low prices after a bumper crop a year earlier. The outweighing factor was significantly stronger production of winter crops, such as wheat, maize, sugarcane, and jute, due to better winter weather.

Industry grew by only 1.4% in FY2005, reflecting disruptions such as strikes and restrictions on the movement of people and goods—general unrest that also affected services output and investment. Construction (about 50% of industry) was particularly hard hit and fell by 0.4%. Manufacturing (about 40%) expanded by 2.6%, but this gain was still much lower than the average of 7.5% in the less turbulent decade before FY2001.

Services sector growth fell sharply to 2.4% in FY2005 (though the sector contributed 1 percentage point to the GDP expansion). The slowdown was caused entirely by a 2.6% conflict-linked decline in the trade and tourism subsector. However, the transport, communications, and storage subsector, and the finance and real estate subsector, remained buoyant, growing by 5.3% and 4.3%, respectively. The former gained from an expansion in domestic air services and an upsurge in mobile telephone services, and the latter benefited from an expansion of urban financial services, especially consumer loans.

On the demand side, both public and private investment remained sluggish in FY2005, reflecting a weak investment climate in which large

2.18.1 Contributions to growth (supply)



Source: Ministry of Finance, available: <http://www.mof.gov.np/publication/budget/2005/table/table1.pdf>, downloaded 30 January 2006.

infrastructure and hydropower project investments are stalled by security problems. The investment rate (gross fixed capital formation as a share of GDP) fell slightly to 18.9% in FY2005 (Figure 2.18.2). As in FY2004, the expansion in GDP was, thus, almost entirely driven by consumption (i.e., 2.0 percentage points of FY2005's 2.3% growth). Most notably, the investment rate remained below the 25–26% of GDP level required to meet the country's medium-term growth and poverty reduction targets.

A tight fiscal stance was planned for FY2005, with the overall budget deficit targeted at 2.5% of GDP; the outturn, however, was narrower than budgeted at 1.1% of GDP. On the income side, government revenue increased by 0.75 percentage points to 15.2% of GDP, buoyed by an increase in the value-added tax (VAT) rate from 10% to 13% and a significant collection of dividends from state-owned Nepal Telecommunication Company Limited. On the expenditure side, spending fell 14% short of the Government's budget target because the conflict slowed implementation of development activities, and therefore associated foreign loan financing was lower. As a result, actual budget spending did not provide the fiscal stimulus intended by the budget.

Total debt service in FY2005 rose to Nepalese rupees (NRs) 19.8 billion, representing a heavy fiscal burden at almost a third of total government revenue. Burgeoning debt servicing is of particular concern given recent years' sharp fall in foreign loan financing. Security outlays increased to NRs17.5 billion, to account for about one fifth of total government spending.

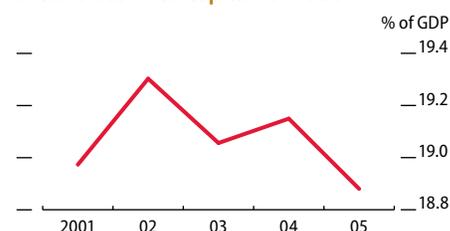
On the monetary side, broad money growth slowed to 8.3% in FY2005, reflecting a sharp deceleration in the expansion in net foreign assets. However, growth in domestic credit was robust, encouraged by commercial bank efforts to expand consumer loan volumes through attractive packages and heavy marketing. Commercial banks' liquidity tightened slightly in 2005, but remained ample, and their deposit rates showed no upward movement, staying well below inflation. The large intermediation spread of commercial banks also changed little. The somewhat tighter liquidity position, however, contributed to pushing up the 91-day treasury-bill rate to 3.9% in July 2005, though this remained below the average inflation rate.

Inflationary pressures, which had eased at end-FY2004, picked up in the second half of FY2005 with the year-on-year rate in mid-July (end-FY2005) at 6.6%, compared with a 4.5% average for the year. Increases in the prices of petroleum and rice, the VAT rate, as well as civil servants' salaries were the main contributors. This move in prices represented a divergence from inflation in India (Figure 2.18.3), an unwelcome development given the peg of the Nepalese rupee to the Indian currency.

In response to accelerating inflation and the rising interest rate differential with India, Nepal Rastra Bank departed from the accommodative monetary policy of recent years and announced a measure of monetary tightening for FY2006. It raised the discount rate to 6.0% from 5.5% and the refinance rate for export credit and agricultural credit to 3.5% from 3.0%. The cash-reserve ratio and the refinance rate for "sick industries" were left unchanged at 5.0% and 1.5%, respectively.

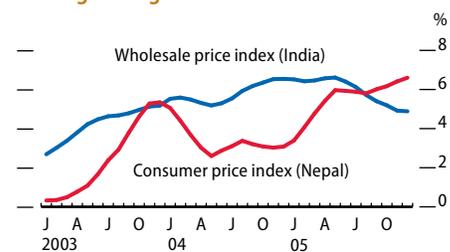
On the external front, imports in FY2005 remained stagnant while

2.18.2 Gross fixed capital formation



Source: Ministry of Finance, available: <http://www.mof.gov.np/publication/budget/2005/table/table1.pdf>, downloaded 30 January 2006.

2.18.3 Monthly inflation, 12-month moving average



Sources: Reserve Bank of India Database on Indian Economy, available: <https://cdbmsi.reservebank.org.in/cdbmsi/servlet/login/>, downloaded 24 February 2006; Nepal Rastra Bank, *Recent Macroeconomic Situation*, available: <http://www.nrb.org.np/index.htm>, downloaded 15 March 2006.

exports grew by 10.3%, narrowing the trade deficit. Weak demand for industrial inputs and for capital goods outweighed the impact of soaring world oil prices and the resultant 32% increase in the oil import bill, highlighting the sluggishness of the economy. Meanwhile, agricultural exports to India (which were up 38.4% year on year) remained the key driver of export growth. Stronger overall exports to India reflected a continued structural shift of exports from other markets, following a preferential trading agreement signed in 1996 and renewed in 2002. Since 1996, exports to India as a share of overall exports have risen from less than 20% to over 50%.

Overseas remittances rose by 17.6% to \$1.1 billion in FY2005, and helped offset the pronounced (41.4%) decline in tourism receipts as well as the traditional trade deficit. The current account surplus, the sixth in as many years, doubled from a year earlier to \$405 million (5.5% of GDP) owing to sluggish import growth and continued acceleration in remittances. Foreign exchange reserves rose by about \$29 million to \$1.5 billion (equivalent to 8 months of imports of goods and services) (Figure 2.18.4). The modest gain in reserves reflected a switch into deficit of the capital and financial account (including errors and omissions). It also masked a 68.5% decline in reserves in Indian rupees. While a part of the decline in rupee reserves is explained by the increase in imports of petroleum products and a decline in tourist arrivals from India, its steepness suggests a possible decline in remittance inflows from India and, perhaps, speculative outflows of capital to that country. If these outflows continue unabated, the currency peg with India could come under strain.

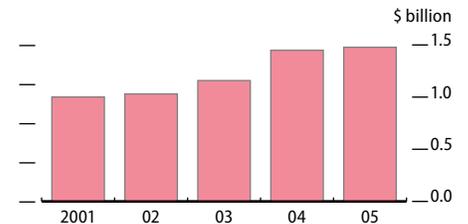
Economic outlook

The economic outlook is rendered uncertain by recent worsening of the insurgency; political instability; and the growing polarization between the Government, on the one hand, and the insurgents and the political parties, which have reached an accord, on the other. GDP growth is expected to weaken in 2006, primarily because of the adverse impact of poor summer and winter weather on agricultural production. Beyond 2006, the pace of growth will hinge on political stability and credible progress in finding a political solution to the conflict. The underlying assumptions of the following projections are that, fundamentally, the insurgency will not escalate further and that all parties will make some headway to resolving the conflict in 2007; the currency peg with the Indian rupee will stay; the preferential trade arrangement with India will remain in force; the Indian economy will grow by about 7–8%; and weather conditions will revert to normal in 2007.

Prospects for FY2006 and FY2007

GDP growth is forecast to slow to 2.0% in FY2006 and then recover to 3.4% in FY2007 (Figure 2.18.5). Despite the intensification of the conflict in FY2002, Nepal has managed to maintain a relatively solid annual economic expansion of 2–3% since then, for two main reasons. First, manufacturing—the sector in an economy usually most sensitive to conflicts—contributes less than 10% of GDP. Second, the economy

2.18.4 Foreign exchange reserves



Source: Nepal Rastra Bank, *Quarterly Economic Bulletin*, Volume XXXIX, Mid-July 2005, Number 4.

2.18.1 Selected economic indicators

	2006	2007
GDP growth	2.0	3.4
Inflation	8.0	6.5
Current account balance (% of GDP)	4.6	3.2

Source: Staff estimates.

has benefited from a steady inflow of workers' remittances, which has underpinned consumption and helped alleviate the worst effects of the conflict. These factors should, it is hoped, continue to operate.

On the output side, agricultural growth is expected to be pulled down to 1.5% in FY2006 by the weather-related decline of both winter and summer crops. It is projected to pick up to 3.5% in FY2007. Industry in FY2006 is forecast to grow by only 1.3%, reflecting continued conflict-related disruptions and the sharp decline of the readymade garment industry since the abolition of quotas under World Trade Organization agreements on 31 December 2004. Expansion in services is projected to improve by 2.8% in FY2006, reflecting a slight rebound in tourism, and is forecast to rise further by 3.9% in FY2007, assuming that the number of tourist arrivals from Europe and North America picks up.

On the demand side, economic growth will remain dependent on consumption in FY2006, as investment failed to respond appreciably to the short-term cease-fire that ended on 2 January 2006. Investment should edge up in FY2007, with both public and private investment spending contributing to its modest recovery.

Inflationary pressures are likely to increase further as the full effects of high oil prices are passed through to consumers, and as low paddy production plays out in higher market prices. Inflation is, thus, forecast to rise sharply to 8.0% in FY2006 (Figure 2.18.6)—well above the average of 4.4% of the past 3 years—and then to moderate to 6.5% in FY2007, as the effect of upward adjustments in petroleum prices and VAT begins to subside and food production returns to normal levels.

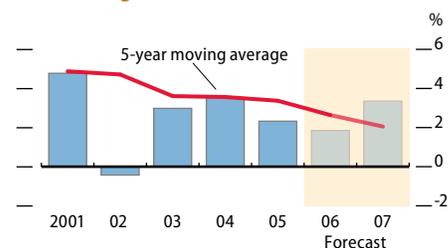
Nepal has consistently posted current account surpluses, reflecting insufficient investment against the backdrop of the conflict. The current account surplus is projected to narrow to 4.6% of GDP in FY2006 and to 3.2% in FY2007 (Figure 2.18.7), as imports rebound from the low base in FY2005 and the investment climate improves in FY2007. Export growth will be limited to 10–13% because of the pressure of stiffer external competition on sales of readymade garments—though exports to India should remain brisk. Tourism receipts are seen as improving slightly in FY2007, but it is the projected steady expansion in workers' remittances that is set to maintain the current account in surplus.

Medium-term outlook

Even with the recent decline in economic performance, Nepal is positioned to achieve higher levels of growth—of about 5–6%—over the medium term. Beginning in the early 1990s, the Government embarked on a wide array of reforms to liberalize the import regime, investment and licensing regulations, entry of firms, and the financial sector, and to improve fiscal and financial management. These measures accelerated GDP growth to about 5% in the 1990s. But once the conflict intensified in 2001, growth slowed to an average of about 2.0%—well below the rate achieved in the 1990s and rates currently being seen in other South Asian countries.

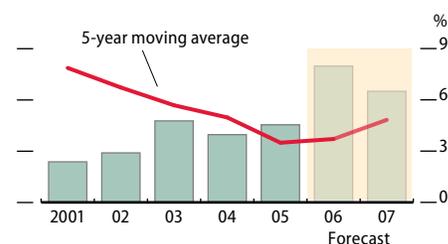
If the conflict can be resolved or significantly reduced and the reform process can be revived, the economy can move back into the higher growth trajectory of the 1990s. Agriculture still accounts for about two fifths of GDP and employs more than two thirds of the labor force.

2.18.5 GDP growth



Sources: Ministry of Finance, available: <http://www.mof.gov.np/publication/budget/2005/table/table1.pdf>, downloaded 30 January 2006; staff estimates.

2.18.6 Annual inflation



Sources: Nepal Rastra Bank, available: <http://www.nrb.org.np/>, downloaded 30 January 2006; staff estimates.

More than half of the population are under the age of 30. If the country can hasten its transformation from an economy based primarily on agriculture to one based primarily on services and industry, while raising productivity in agriculture, growth could show a marked upturn. In this regard, the rapid economic development of its two large neighbors—the People's Republic of China (PRC) and India—offers important opportunities for the country to emerge as a transit point for their trade as well as a locus for increased investment. Nepal's comparative advantages lie in processing agro-based and herbal products, tourism, and hydropower, and these have yet to be fully exploited.

Progress in resolving the conflict, normal weather, and an increase in investment constitute a relatively benign baseline scenario. However, the outlook has significant downside risks, and the most important comes from the insurgency. Any exacerbation would further restrict both public and private investment and undermine the attainment of growth targets and, in the worst case, could lead to economic turmoil. Weather is another source of uncertainty since agriculture is dependent on rain-fed irrigation. A third risk arises from a further large escalation in world oil prices.

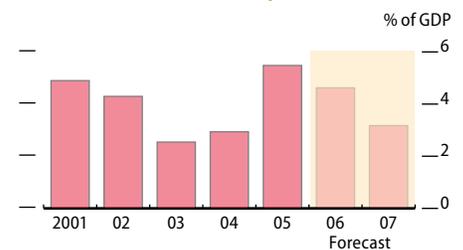
Trade issues

With a trade-to-GDP ratio of more than 50%, an average tariff rate of about 8%, and virtually no quantitative restrictions, Nepal is one of South Asia's most open and trade-dependent economies. Following the market-oriented reforms of the early 1990s, exports rose at an annual rate of 20% on average in the 1990s (Figure 2.18.8) and their contribution to economic growth increased to 24% in 1991–2001, compared with a negative 2% in 1976–1985. Export performance during 1991–2001 was driven by the rapid growth in exports of readymade garments and carpets, which together surged by 77% during the early 1990s. Despite the rapid 14.2% annual gain in exports over the 1990s, exports relied heavily on a few markets (in order of size, India, US, and Germany) and products (garments, carpets, and vegetable ghee).

These vulnerabilities came to the fore as exports declined on average by a little over 2% a year after FY2001. This slide can be attributed to both external and internal factors. The readymade garment industry is symptomatic of both. Emerging in the late 1980s and early 1990s in response to quotas, it has been unable to adapt to economic life since their termination on 31 December 2004. Its exports fell by more than half in FY2005, and the number of operational readymade garment factories has fallen to less than 20 from over 100. The industry has wilted in the face of increased competition from countries such as India and the PRC, as well as preferential access of Caribbean and African countries to the US market under the Caribbean Basin Initiative and the African Growth and Opportunity Act. Various domestic factors include the insurgency (which has disrupted production and transport activities in some parts of the country), low labor productivity, outdated production methods, and high transport costs.

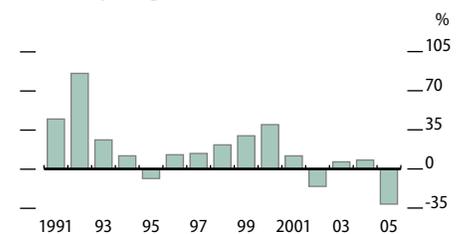
This steep slide in the industry has occurred despite Nepal's nonreciprocal preferential access to the European Union, Canada, and India. Also, under the December 2005 Hong Kong, China Ministerial

2.18.7 Current account surplus



Sources: *Macroeconomic Indicators of Nepal* December 2005, Nepal Rastra Bank, available <http://www.nrb.org.np/>, downloaded 30 January 2006; staff estimates.

2.18.8 Export growth



Notes: Exports are based on customs data. The 2005 value is for the first 8 months only.

Source: Ministry of Finance, available <http://www.mof.gov.np/publication/budget/2005/table/table6.pdf>, downloaded 15 March 2006.

Agreement, least-developed countries (such as Nepal) will get duty- and quota-free market access for at least 97% of their products to developed-country markets from 2008, though the margin of preferential access is likely to be eroded by the Doha round of tariff liberalization. The garment industry therefore needs to revamp its business strategy to adapt to the new environment. It needs to make fundamental changes to both manufacturing and marketing, investing in more efficient technology to improve workflow, quality, and productivity. These investments should take advantage of the growing supply of software and equipment designed for small-scale manufacturing. At the same time, the industry must identify markets where it would have a product niche and establish relationships with buyers in these markets.

In addition, inadequate mechanisms and incentives for firms throughout the economy to acquire new technology, poor infrastructure, and an unfriendly investment climate are also constraining integration with the global economy. Bureaucratic burdens, rigid labor markets in the formal sector, inadequate bankruptcy and foreclosure provisions, and an unpredictable operating climate inhibit investment and raise the costs of doing business. Weak infrastructure, transport and transactions delays, high power costs, and an unpredictable regulatory framework further burden price competitiveness. Removing these constraints would enable the country to raise its export competitiveness markedly.

While Nepal has significantly opened up to global trade—a trend that has been further reinforced by its joining the World Trade Organization in April 2004—the country will need to continue removing behind-the-border constraints for its significant trade with India. High costs associated with formal border trade with India, for example, have led to a large share of that trade running through informal channels. A survey carried out in 2000 revealed that institutional factors such as prompt payment, no paperwork or procedural delays, and lower transport costs were instrumental in driving traders to use informal channels. Reducing costs and removing the hurdles at the border will be important in expanding trade with India.