Nepal

Political uncertainties, unfavorable weather, and weakening remittances from workers abroad restrained economic growth in FY2010. Fiscal prudence continued. Growth will fall below the 5-year average of 4.0% in FY2011, primarily reflecting the protracted postconflict transition process, but a modest pickup is foreseen in FY2012, supported by tourism and more vibrant construction activity. Key risks to growth are further delay to completing the transition, high food and oil prices, and potential impact of unrest in the Middle East.

Economic performance

GDP growth inched up to 4.0% in FY2010 (ended 15 July 2010) from 3.8% in FY2009 (Figure 3.19.1). The marginal improvement was made possible by a turnaround in growth in the relatively small industry sector (helped by fewer political strikes), and sustained expansion of services. A deceleration in remittance inflows due to the lagged impact of the global financial crisis weighed on economic activity, as did slowing agricultural output (for a second year) due to a sparse monsoon.

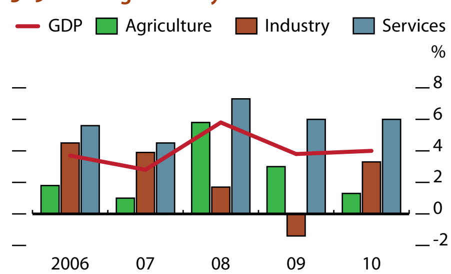
The deceleration in remittance growth, alongside commercial banks' excessive lending to real estate and reduced liquidity in banking, drove interbank borrowing rates to a record high. Inflation stayed close to double digits owing to high food prices in the first half of FY2010 (Figure 3.19.2), which in turn originated in a low domestic crop and India's high food-inflation.

Exports as a share of GDP have been dwindling in the last few years, because low productivity and infrastructure bottlenecks have undermined competitiveness. Conversely, imports as a share of GDP have been showing a trend increase over several years, with growth more pronounced in FY2010, as gold imports swelled. (Gold was the investment of choice, given paucity of attractive alternatives in a correcting real estate market.)

The widening trade deficit, coupled with slowing remittances, took the current account deficit to 2.7% of GDP in FY2010 from a surplus of 4.2% of GDP the year before. This led to a $113 million decline in official reserves. The authorities accessed $42 million from the International Monetary Fund through its Rapid Credit Facility, which provides concessional assistance to low-income countries to tide them over external shocks.

Previous years' fiscal stability was maintained, with the deficit narrowing from 3.3% of GDP in FY2009 to 2.0% of GDP, though this apparent improvement stems from delayed approval of the FY2010 budget and from a continued difficult environment for implementing projects, which kept capital spending to only 70% of target. Revenue collection

3.19.1 GDP growth by sector



Source: Central Bureau of Statistics.

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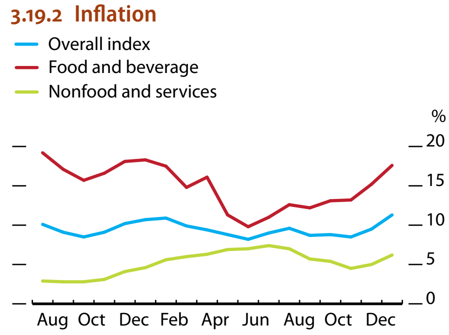
3.19.2 Inflation



Source: Nepal Rastra Bank. 2011. *Recent Macroeconomic Situation*. January. http://www.nrb.org.np

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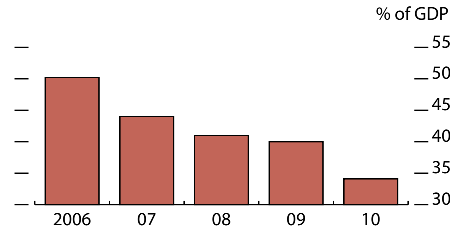
This chapter was written by Yubraj Acharya of the Nepal Resident Mission, ADB, Kathmandu.

preserved its recent positive momentum, helping to offset the continued surge in recurrent spending, notably on civil servants' and teachers' salaries. Small fiscal deficits and large grants by multilateral agencies have helped to improve the public debt position in recent years (Figure 3.19.3).

Despite a challenging political environment, the share of the population living below the national poverty line of about $160 a year is estimated to have declined to 25% in 2010 from 31% in 2004, largely owing to robust remittance inflows, rapid urban growth, a decline in fertility, and rising agricultural wages.

Strides have also been made in other Millennium Development Goals, such as child and maternal mortality, although greater efforts are needed to achieve similar progress in areas such as productive employment and child malnutrition. Efforts are also needed to reduce inequality—currently the highest in South Asia, with a Gini coefficient of 0.47.

3.19.3 National debt



Sources: Ministry of Finance. Financial Comptroller General Office; ADB estimates.

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3.19.1 Selected economic indicators (%)

	2011	2012
GDP growth	3.8	4.0
Inflation	10.0	8.0
Current account balance (share of GDP)	-0.5	-0.5

Source: ADB estimates.

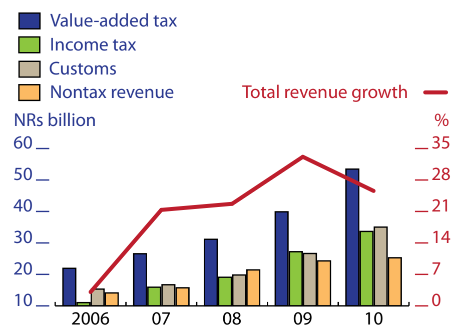
Economic prospects

Economic performance in FY2011 and FY2012 will rest primarily on progress in the postconflict transition process—currently slow as seen in the 1-year extension, to May 2011, of the tenure of the Constituent Assembly that was elected to draft a new constitution. The political vacuum and drift created following the Government's resignation in June 2010 ended only in February this year. The FY2011 budget was promulgated only by ordinance 4 months into the fiscal year.

All these delays reflect the difficult transition that Nepal is suffering. With little time left for writing the constitution, many of the contentious issues, such as army integration and state restructuring, have yet to be resolved.

The protracted transition and the associated political disruptions have hit the economy. The delay in announcing the FY2011 budget, for example, has undermined solid progress made recently in revenue mobilization, which achieved 25% average annual growth in the last 4 years (Figure 3.19.4). More important, it has deprived the population of a much hoped-for peace dividend, including greater capital spending (Figure 3.19.5) and development benefits.

3.19.4 Revenue indicators



Source: Ministry of Finance. 2010. *Economic Survey Fiscal Year 2009/10*. July. http://www.mof.gov.np

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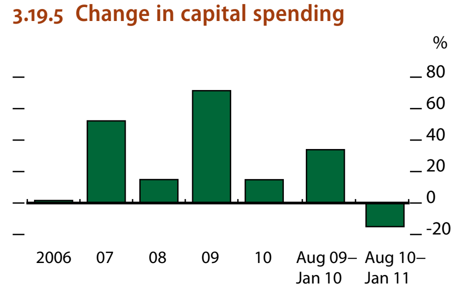
GDP growth is forecast to weaken slightly to 3.8% in FY2011. Agriculture is expected to grow by 4.0% in FY2011 (up from 1.3% in FY2010), largely due to a weather-induced recovery in the output of key summer crops (Figure 3.19.6). This improvement will not, however, be enough to offset the deceleration in nonfarm activities.

Political uncertainty, as well as power cuts (lasting as much as 14 hours a day since mid-February this year) will continue to take a toll on nonfarm activities. The tightening FY2011 monetary policy of Nepal Rastra Bank (NRB, the central bank), aimed at stabilizing the real estate market, will further curtail services expansion, to 4.5% growth in FY2011, down from 6.0% in FY2010. A slowdown in construction activity and higher fuel costs will limit industry's growth to 1.0% in FY2011, compared with 3.3% a year earlier.

3.19.5 Change in capital spending



Source: Nepal Rastra Bank. 2011. *Recent Macroeconomic Situation*. January. http://www.nrb.org.np

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GDP growth is expected to improve modestly to 4.0% in FY2012 (assuming continued normal weather conditions). A pickup in tourism-related activities driven by the Nepal Tourism Year 2011 campaign should

raise services growth to 5.5%. A modest uptick in construction activity, as NRB's policy is absorbed, should lift industry's growth to 1.5%.

Year-on-year inflation reached 11.3% in January, largely reflecting food and fuel price increases. A revision of the consumer price index—lowering the weight for food in line with the Fourth Household Budget Survey, 2005/06—has pulled calculated inflation down by about 1 percentage point relative to the previous method.

Average inflation for FY2011 is expected to be 10.0%. High food and oil prices and the domestic distortions such as power cuts will continue to exert upward pressure, only part of which will be offset by the good harvest. With likely moderation in Indian prices (see the chapter on India) and the government's measures to prohibit transport syndicates' restrictive practices (which have contributed to higher prices), 8.0% average inflation is expected in FY2012.

It is assumed that NRB will not tighten monetary policy further in the rest of FY2011 and FY2012 for two main reasons. First, the current policy stance has already considerably slowed real estate activity. A further tightening could trigger a disruptive correction in house and land prices, worsening the quality of commercial banks' loan portfolios and potentially posing a threat to macroeconomic stability.

Second, the expected moderation of Indian inflation will probably obviate any need for monetary tightening. NRB's attention is likely to be focused on establishing confidence in the banking system and enhancing its supervision capacity. The vulnerability of the commercial banking system has increased significantly in recent years due to a rapid emergence of other financial institutions (Figure 3.19.7). Recurring bank liquidity crunches are manifestations of this vulnerability, as deposits have reportedly been shifted from major commercial banks toward smaller financial entities that offer higher deposit rates, are difficult to supervise, and appear to take on riskier lending.

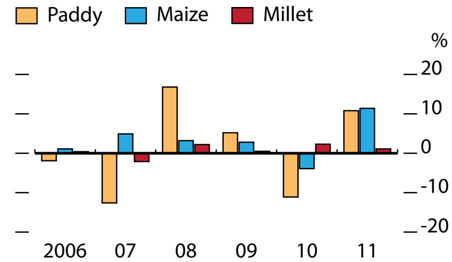
After sharply deteriorating in FY2010, the external position has since recovered significantly (Figure 3.19.8). Although the oil import bill is soaring because of higher prices, overall import growth has slackened, mirroring remittance inflows.

Exports have picked up, partly in response to the tax incentives for exporters announced in the FY2011 budget. As a result, the merchandise trade deficit has been limited to $2.0 billion in the first half of FY2011. Remittances and tourism receipts have offset 90% of this deficit. After an approximate 4% fall in FY2010, external reserves recovered this loss in the first half of FY2011, to reach $2.8 billion in January 2011, worth about 6 months of imports (Figure 3.19.9).

Both domestic and external factors will challenge any further strengthening of the balance of payments in FY2011. Domestic manufacturing is plagued by low productivity and poor infrastructure. Import growth will likely accelerate on higher oil prices, although it will be somewhat offset by remittance inflows, which were growing at about 18% in the first half (Figure 3.19.10). A current account deficit of 0.5% of GDP is expected in FY2011 and FY2012, reflecting little change in trends.

An escalation in political disruptions, if the peace process bogs down, is the key downside risk to growth prospects. A further risk is an abrupt downward correction in the real estate market, which would

3.19.6 Change in summer crop output



Source: Ministry of Agriculture and Cooperatives.

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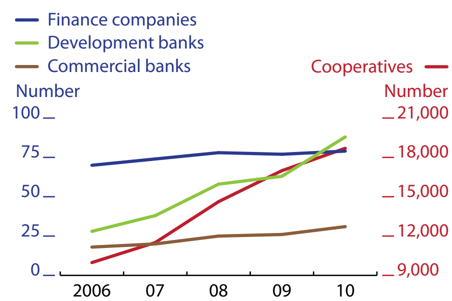
3.19.7 Financial institutions



Source: Nepal Rastra Bank. 2011. *Banking and Financial Statistics*. January.

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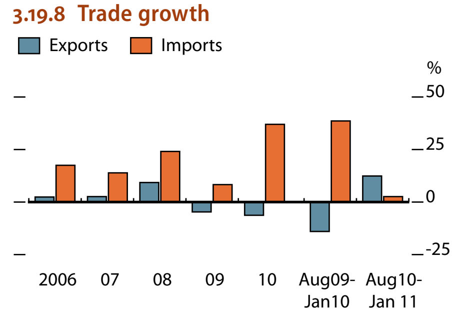
3.19.8 Trade growth



Source: Nepal Rastra Bank. 2011. *Recent Macroeconomic Situation*. January. http://www.nrb.org.np

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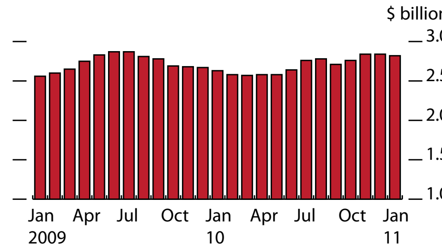
no doubt severely undermine revenue mobilization efforts and put many construction-related jobs in jeopardy. Given the high volume of commercial bank lending for real estate, surging loan defaults would repress normal financial activity.

Externally, the unrest in the Middle East is an emerging risk to the steady remittance inflows as the region is a key destination for Nepalese migrant workers. The recent earthquake in Japan could also hit Japanese tourist arrivals and aid flows to Nepal. An additional external risk is the surge in oil prices which could severely strain Nepal's external position and cause a supply shock if domestic prices are not adjusted accordingly. Nepal also remains vulnerable to high global food prices.

3.19.9 Foreign exchange reserves



Source: Nepal Rastra Bank. 2011. *Recent Macroeconomic Situation*. January. http://www.nrb.org.np

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Development challenges

Creating jobs for the country's burgeoning young population is a major challenge; unless managed properly, it could put at risk the country's economic growth prospects. Some 450,000 workers enter the labor market annually. More than half of them seek—and get—jobs in the Middle East and East Asia, particularly low-end work in construction and manufacturing. But it is Nepal that bears the social costs.

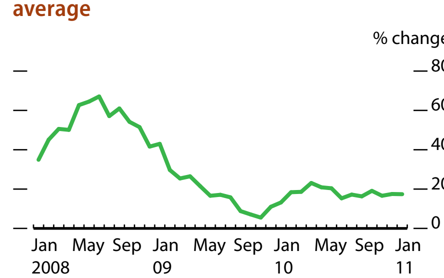
While under- and unemployment are widespread in all segments of the population, the position is particularly depressing for youth. Their nationwide unemployment rate is twice the national average. It is even worse in urban areas, where the decade-long conflict, lack of job opportunities in rural areas, and the concentration of higher level education institutions there have contributed to an influx of younger people.

Labor laws in Nepal—the most rigid in South Asia—are a major block to job creation, and need to be reformed to facilitate quicker recruitment and release of workers. Moreover, the academic curriculum needs to be modified to reflect labor market needs and to facilitate self-entrepreneurship, in part to capitalize on close ties to India and its prominence as a business services hub.

Progress toward completing the peace process, thereby leading to stronger investor confidence, will be important for faster job creation. The policy agenda should aim to strengthen business security, reduce red tape on firms' entry and exit, and scale up current initiatives, such as incentives for entrepreneurs in tourism.

Finally, the authorities should continue to work on developing a clear policy for public–private partnerships. It would assist the country to unlock the massive hydropower potential, paving the way for large infrastructure projects—their implementation has so far remained elusive.

3.19.10 Remittance inflows, 5-month moving average



Source: Nepal Rastra Bank. 2011. *Recent Macroeconomic Situation*. January. http://www.nrb.org.np

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