Nepal

Growth picked up with a favorable monsoon and robust services growth. Inflation moderated on declining food prices, and the current account posted a large surplus on a surge in remittances and modest imports. Political uncertainty intensified with the dissolution of the Constituent Assembly, affecting budget operations and government policies. Growth is expected to slow following a poor monsoon. Improving economic performance depends on resolving political uncertainty and creating an enabling environment for business and investment.

Economic performance

GDP growth rebounded to 4.6% in FY2012 (ended 15 July 2012), boosted by a favorable monsoon and robust services growth despite a slowdown in industry and lingering political uncertainties (Figure 3.19.1). Agricultural output grew by 4.9%, the highest rate in 4 years, while the 5.1% advance in services reflected a pickup in tourism and consumer spending of remittances. Industry continued to perform poorly, growing by a mere 1.7%, because of an unfavorable business and investment climate caused by labor disputes, persistent electricity shortages, and the prolonged and disruptive political transition.

Inflation eased slightly to average 8.3% in FY2012, as food prices declined during most of the year because of good harvests in FY2011 and FY2012 (Figure 3.19.2). Stubbornly high inflation is increasingly driven by rising prices for nonfood items that echo inflation in India, which is Nepal’s largest trading partner by far and to whose currency the Nepalese rupee is pegged. Other drivers are upward adjustment to administered fuel prices, depreciation of the Nepalese rupee against the currencies of third countries, rising wages, and persistent supply-side constraints.

The budget deficit narrowed marginally to 2.2% of GDP, owing to lower capital expenditure and greater revenue mobilization (Figure 3.19.3). Improved efficiency in tax administration and a wider tax base boosted tax revenue by an impressive 22.5%, lifting it by a percentage point to 13.6% of GDP. However, the ratio of total revenues including grants to GDP improved by only half a percentage point to 18.3%. Total expenditure amounted to 20.4% of GDP, from 20.2% in the previous year. Recurrent expenditure jumped by 42.7% to cover large fuel subsidies and ad hoc expenditure programs, while capital expenditure contracted sharply from a year earlier due to lower project disbursements arising from lack of political consensus on a timely budget.

A sharp drop in real estate prices in FY2011 caused a liquidity squeeze and credit problems at financial institutions, whose property lending had substantially expanded in recent years. Several required emergency
lending from the central bank, as the amount of nonperforming loans rose and depositor confidence eroded. In FY2012, banking stress eased as robust remittance inflows boosted deposits and strengthened bank liquidity to comfortable levels. Interbank rates dropped to 1.1% from 8.1% in FY2011 (Figure 3.19.4). Regulatory lending caps on certain sectors and the lack of bankable projects kept credit growth moderate, as the central bank intensified its supervision and monitoring.

The current account balance recorded a large surplus of 4.9% of GDP in FY2012, mainly reflecting a large gain in worker remittances bolstered by an earlier marked increase in workers going abroad (Figure 3.19.5). Though merchandise exports grew modestly by 5.4%, to equal 5.2% of GDP, import growth of 4.5%—also modest partly because of low demand for construction materials and equipment—marginally widened the trade deficit to 24.0% of GDP. The overall balance of payments reached a record surplus of $1.6 billion, and foreign exchange reserves grew to $4.2 billion, equivalent to 7.9 months of imports of goods and services (Figure 3.19.6).

**Economic prospects**

The economic outlook hinges on how political uncertainties are resolved, the weather, and remittance inflows. Investor confidence is depressed by concerns over the political transition, now in its fifth year, following the dissolution in May 2012 of the Constituent Assembly, which failed to agree on a constitution. Recently, the political parties agreed to form a caretaker government led by the Chief Justice, which is expected to hold a Constituent Assembly election by 21 June 2013.

In view of the unfavorable monsoon, the shortage of fertilizers during the peak paddy planting season, low business confidence, the lack of a parliamentary-approved full budget, and subdued growth in India, GDP is projected to slow to 3.5% in FY2013. Production of paddy is projected to fall by 11.3%, maize by 8%, and millet by 2%. The lack of a full budget is causing funding shortages for ongoing development activities. While the industry sector performance is expected to remain weak, services growth is expected to continue to grow at around 5.4%. With a favorable monsoon, adequate fertilizer supplies, the timely adoption of a budget, and moderate expansion of remittances, GDP growth would rebound to 4.2% in FY2014.

Prospects for a lower agricultural harvest, wage pressures, further upward adjustment of administered fuel prices, continued power shortages, and other supply-side constraints are expected to push inflation to 10.5% in FY2013, above the central bank’s midyear estimate of 9.5% but below the inflation average of 10.7% in the first half of the fiscal year. Assuming instead a good harvest and cautious monetary policies, inflation in FY2014 is projected to ease only slightly to 9.0% as most of the underlying pressures of the previous year persist.

On the external front, the trade deficit is expected to markedly widen in FY2013. Given subdued growth in India, sluggish activity in the euro area and the US, and the rising cost of domestic production, export growth is projected to slow to 0.2% in FY2013. Allowing for the usual lag between remittance growth and spending on imports, imports are expected to markedly expand by 18.7%. With the large increase in the
trade deficit and more moderate remittance growth, the current account surplus will likely contract sharply to a deficit of 0.5% of GDP in FY2013 and then slide more slowly to a 1.8% deficit in FY2014 as high import demand moderates and stepped up exports reflect somewhat improved economic conditions in trading partners.

Without a budget for FY2013, revenue policy is guided by the Finance Act, 2012, meaning that rates of taxes, duties, fees, and other charges remain unchanged while actual expenditure should not exceed previous levels. With the widened tax base and improved collection capacity, revenues will likely be largely sufficient to cover expected total expenditure, which will again show low capital spending. The budget deficit is expected to be around 2.5% of GDP.

The budget continues to suffer stress from subsidies, including on diesel and liquefied petroleum gas. Prices should be rationalized, making provisions for the welfare of the poor. The FY2014 budget needs timely passage to allow the revision of tax rates, authorization for domestic borrowing, and provision of funding to accelerate development activities. Further, legislators need to address the quality of public spending, effective utilization of foreign aid, and governance issues.

**Policy challenge—financial sector vulnerability**

The sharp drop in real estate and housing prices and slowdown in remittances in FY2011 caused a series of problems for banks and other financial institutions (BFIs), which fall into three categories: commercial banks, development banks, and finance companies. Commercial banks dominate these deposit-taking institutions, holding 80% of the system’s deposits and loans (Figure 3.19.7). The problems included more nonperforming loans and a liquidity squeeze as depositors lost confidence in the safety of their deposits. The balance sheet of BFIs deteriorated, and a number of development banks and finance companies sought assistance from the central bank.

In response to BFIs’ difficulties (apart from offering emergency assistance and allowing forbearance), the central bank rolled out a number of regulatory and monitoring directives to deal with banking sector issues. It directed banks to limit real estate and housing loans to 25% of total loans, and it stiffened capital adequacy requirements. Commercial banks were able to comply with the directive and brought real estate lending down to 16.9% of total lending in FY2012. To diversify loan portfolios and direct credit to more productive sectors, the central bank directed banks to extend at least 10% of total loans to agriculture and/or energy. Moreover, banking institutions were required to publish base interest rates to improve transparency and competition in their operations and policies. Further, separate departments are being established in the central bank to supervise development banks and finance companies.

While prompt central bank action managed to handle the sector’s immediate problems, issues that remain unaddressed include structural changes needed to shield the banking sector and the economy from internal and external shocks. The first unresolved issue is the liberal licensing regime that created an excessive number of BFIs—213 BFIs by
FY2012—and thereby fomented unhealthy competition and fueled the bubble. BFIs need to be significantly consolidated in the coming years to ensure a sound financial sector. 

Second, ensuring sound corporate governance should be priority, as many of the troubles in development banks and finance companies emanated from their managers’ and directors’ misuse of credit, often for personal gain. This issue calls for strengthening central bank monitoring, supervision, and regulatory capability. 

Third, apart from diversifying lending, BFIs need to strengthen internal project and loan analysis, innovate loan products, and enhance their operational efficiency. At the macro level, the government needs to improve the business and investment climate, which would underpin loan quality. 

Fourth, BFIs are still vulnerable to large fluctuations in remittance inflows that make deposit and lending flows volatile, which points to the need for more effective monitoring and control over developments in banking system liquidity. Notably, a recent stress test the central bank conducted on 32 commercial banks revealed that a routine credit shock would push capital holdings in 20 banks below the regulatory minimum. 

Fifth, the activities of the largely unregulated cooperatives, which fall under the purview of Department of Cooperatives, need to be better understood and monitored, as does the nexus between these cooperatives and the banking system. Any major shock to the deposit and lending practices of cooperatives, whose combined deposits and lending portfolios are larger than those of either development banks or finance companies, would likely harm the entire banking system and economy. In this regard, the International Monetary Fund has estimated that a financial crisis in Nepal could cause GDP loss of 30% in the first 4 years before growth recovered to the baseline trend, reserves to fall by 50% in the first 2 quarters of the crisis, and a fiscal cost as high as 23% of GDP.