Asian Development Bank
Asian Development Outlook 2019
Strengthening Disaster Resilience

Nepal

The economy remained healthy in fiscal 2018, though growth moderated. The outlook is for stable growth fueled by buoyant domestic demand as the government improves infrastructure and the investment climate. The current account deficit will widen on an expected increase in imports coupled with weak export competitiveness, building pressure on external stability. The authorities can smooth the transition to federalism by developing institutional capacity, clarifying legislation, and ensuring sufficient resources to subnational governments.

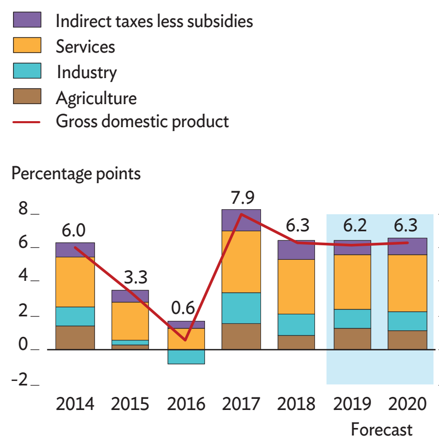
Economic performance

GDP growth moderated to an estimated 6.3% in fiscal year 2018 (FY2018, ended 16 July 2018) as economic activity recovered and normalized after earlier devastating earthquakes and trade disruptions (Figure 3.19.1). A continued expansive fiscal policy underpinned robust domestic demand. This kept industry growth high at 8.8% as construction expanded by 10.6%, bolstered by government capital spending and accelerated earthquake reconstruction, and manufacturing expanded by 8.0%, benefiting from more and better electricity supply. Services, the largest sector, grew by 6.6% as tourism increased and economic activity normalized. Floods early in the year crimped rice production to limit growth in agriculture to only 2.8%.

On the demand side, high consumption expenditure induced by faster growth in remittances dominated spending in FY2018. Fixed investment soared by 15.7% on higher private investment in manufacturing, energy, and tourism, to provide nearly one-third of GDP. Strong growth in construction spurred higher imports of building materials and capital goods, widening the trade deficit and making net exports a drag on growth.

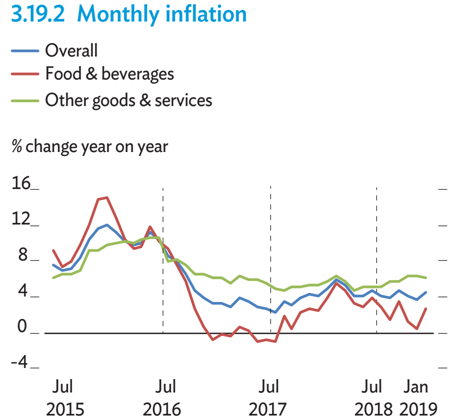
Inflation eased from 4.5% in FY2017 to average 4.2% in FY2018, mainly tracking subdued inflation in India, the main source of supplies and to whose currency the Nepalese rupee is pegged (Figure 3.19.2). Despite a spike in domestic oil prices, the supply of goods improved, inflation for health care and education services moderated, and prices for clothing and footwear and housing and utilities remained subdued.

3.19.1 Supply-side contributions to growth



Note: Years are fiscal years ending in mid-July of that year.
Sources: Central Bureau of Statistics. 2018. *National Accounts of Nepal 2017/18*. http://cbs.gov.np/; ADB estimates.

3.19.2 Monthly inflation



Source: Nepal Rastra Bank. 2019. *Recent Macroeconomic Situation*. http://www.nrb.org.np.

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Budget policy continued to be expansionary with higher recurrent and capital expenditure. The fiscal deficit doubled from the equivalent of 3.2% of GDP in FY2017 to 6.7% in FY2018 (Figure 3.19.3). Capital expenditure rose by 28.0% with reform to budget implementation, and recurrent expenditure climbed by 34.3% on transfers to subnational governments (SNGs) equal to about 8.0% of GDP, as well as election expenses. Reflecting buoyant tax revenue from high import growth, revenue increased by 19.1% to equal 24.2% of GDP.

Broad money (M2) supply increased by 19.4% in FY2018 as rising net domestic assets pushed growth in supply above 15.5% in the previous year (Figure 3.19.4). Credit to the private sector grew by 22.3%, with a significant share going to wholesale and retail trade, manufacturing, and construction. Nepal Rastra Bank, the central bank, sought to tighten credit by forcing banks to maintain their ratio of loans to core capital plus deposits at 80% and lowering the ratio of mortgages and consumer loans to purchase value, which moderated lending for real estate and vehicle purchases.

Continued rapid growth in imports, particularly of construction materials and capital goods, reached 27.5% in FY2018, pushing the trade deficit to $10.9 billion and taking it as a percentage of GDP from 34.5% in FY2017 to 37.7%. Despite healthy remittance growth at 10.5%, the current account deficit ballooned from $95.4 million in FY2017 to $2.3 billion, equal to 8.2% of GDP (Figure 3.19.5). The deficit was partly financed by government borrowing.

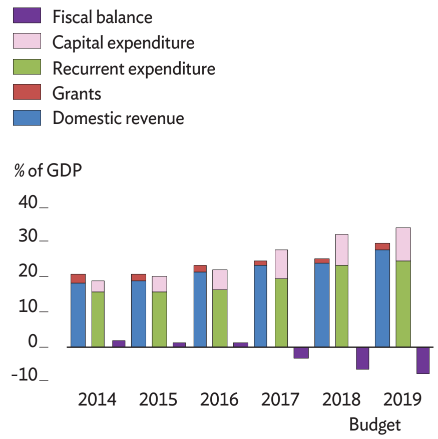
Financial inflows could not fully offset this deficit, so gross foreign exchange reserves fell slightly to $10.1 billion, still providing 9.4 months of cover for imports of goods and services (Figure 3.19.6). The Nepalese rupee depreciated by 6.0% against the US dollar in FY2018, in line with Indian rupee depreciation. In real effective terms, the currency has been appreciating in recent years, indicating erosion of export competitiveness, but the trend reversed in FY2018 with slight depreciation.

Economic prospects

Economic growth is anticipated marginally down in FY2019 at 6.2%. A normal monsoon is expected to boost rice production to 5.5 million tons, for an 8.4% rise from a year earlier. The production of maize, the other important summer crop, is projected to rise by only 1.8%. Winter rainfall has been timely and will likely boost the production of cash crops like potatoes, vegetables, and fruit to boost agriculture growth overall to 4.5%.

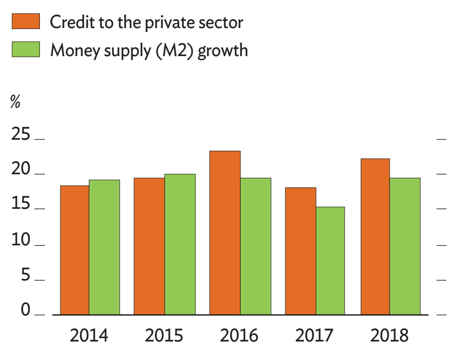
Industry will likely grow by 7.1% in FY2019, buoyed by higher expectations for political stability. With no major electric power cuts since May 2018, more manufacturing firms have launched operations, and capacity utilization has

3.19.3 Fiscal indicators



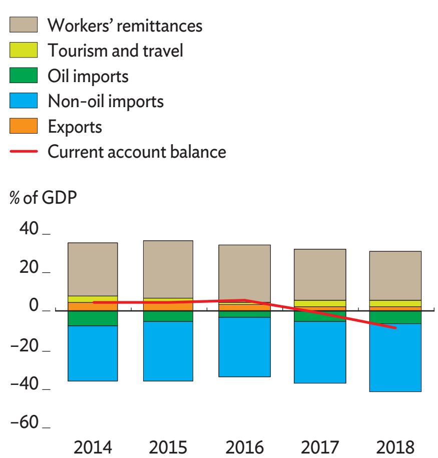
Note: Years are fiscal years ending in mid-July of that year.
Source: Ministry of Finance. FY2019 Budget Speech.

3.19.4 Credit to the private sector and money supply growth



Note: Years are fiscal years ending in mid-July of that year.
Source: Nepal Rastra Bank. 2019. *Recent Macroeconomic Situation*. http://www.nrb.org.np.

3.19.5 Current account indicators



Note: Years are fiscal years ending in mid-July of that year.
Source: Nepal Rastra Bank. 2019. *Recent Macroeconomic Situation*. http://www.nrb.org.np.

improved at existing plants. Construction gained momentum in the first half of FY2019, to mid-January 2019, and will continue to do so in the whole year in light of development needs, larger budget allocations made to SNGs, and accelerated reconstruction. Growth in services will edge up to 6.4% on expansion in wholesale and retail trade, hotels and restaurants, and finance.

Growth in FY2019 will find support in private investment, public infrastructure spending, and buoyant government recurrent spending. Data for the first half of FY2019 show capital expenditure up by 14.7% over the year-earlier period. SNG spending will similarly stimulate growth in FY2019. The budget for the year envisages a deficit equal to 8.0% of GDP, but it will likely be lower as capital expenditure underperforms allocation. Private consumption will likely remain strong with robust growth in remittances (Figure 3.19.7).

The trade deficit will widen further in FY2019 as domestic demand pushes up imports of oil and other products, and as the economy continues to struggle with its low manufacturing base and weak export competitiveness. The current account deficit is projected to deepen from 8.2% in FY2018 to 9.3% with increased imports of capital and consumer goods and services, and despite lower oil prices and healthy growth in remittances.

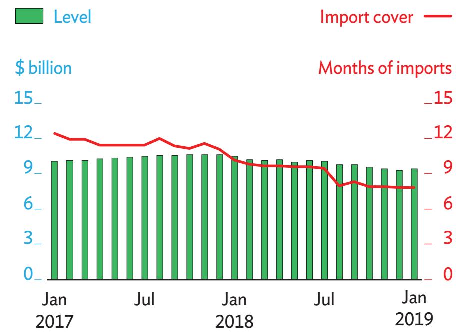
Average annual inflation will edge up from 4.2% in FY2018 to 4.4% in FY2019, having averaged 4.2% in the first 6 months of FY2019. Inflationary pressure will be kept largely in check by increased crop production, better supplies of goods and electricity, subdued oil prices, and expected moderation of inflation in India.

GDP growth is envisaged at 6.3% in FY2020, assuming a normal monsoon and no untoward circumstances such as floods devastating crops. Support for growth will come from the ongoing mechanization of agriculture, efforts to accelerate the implementation of large infrastructure projects, and the likely implementation of proposed legal reform to promote investment.

Average annual inflation will stay moderate at 5.1% in FY2020, assuming a better harvest, subdued oil prices, and only modestly higher inflation in India. The current account deficit is expected to narrow to the equivalent of 8.1% of GDP as import growth moderates thanks to fuel imports for generators replaced by better hydroelectricity supply. Remittances will continue to grow robustly.

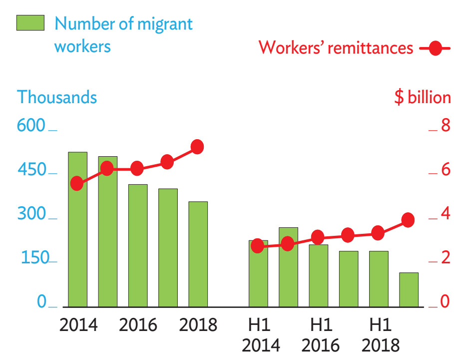
Downside risks to the FY2020 outlook center on the challenges pertaining to the smooth implementation of fiscal federalism. SNGs face uphill tasks in program and project development, project implementation, and grant utilization. Separately, financial institutions may be vulnerable to risk from the recent buildup of credit to real estate and construction in the absence of strong risk management.

3.19.6 Gross international reserves and foreign exchange adequacy



Source: Nepal Rastra Bank. 2019. *Recent Macroeconomic Situation*. http://www.nrb.org.np.

3.19.7 Migrant workers and remittances



H = half.
Note: Years are fiscal years ending in mid-July of that year.
Sources: Department of Foreign Employment; Nepal Rastra Bank.

3.19.1 Selected economic indicators (%)

	2019	2020
GDP growth	6.2	6.3
Inflation	4.4	5.1
Current account balance (share of GDP)	−9.3	−8.1

Source: ADB estimates.

Policy challenge—smoothly implementing fiscal federalism

Nepal transitioned from a unitary system of government to a federal one after the successful conclusion of federal, provincial, and local elections in 2017 and the subsequent formation in 2018 of government in three tiers. The first year of the implementation of federalism yielded mixed results, full of challenges and learning experiences. While the Constitution broadly specifies the rights and responsibilities of the three tiers, the smooth implementation of federalism stumbled over ambiguities in enabling legislation and a lack of capacity and appropriate human resources and capacity in SNGs.

The central government found it a challenge to quickly realign the existing national civil service with a federal system. A lack of requisite staff, both technical and administrative, affected the delivery of services and project execution. However, legislation passed in early 2019 set favorable promotion and pay grades for staffers who meet specified criteria, encouraging thousands of civil servants to apply for transfer to SNG positions. Additional legislation now in the works addresses other administrative staffing constraints on SNGs.

The budget for FY2019 apportioned fiscal transfers to SNG units in four modes: fiscal equalization grants, conditional grants, complementary grants, and special grants (Table 3.19.2). SNG budget execution in the first 6 months of FY2019 was low, mainly owing to a lack of staff capacity to carry out programs and project implementation.

Responsibility for expenditure has been decentralized (Figure 3.19.8). However, revenue mobilization remains with the national government, which collects the major revenue streams like income tax, value-added tax, and customs and excise duties to fund intergovernmental transfers to SNGs to cover their spending. Alternatively, though, local constituencies would have more choice in prioritizing local government services, and spending efficiency would likely improve, if SNGs had their own clearly defined sources of revenue.

Ensuring greater coordination among the tiers of government is key to effective service delivery and project execution, as are legislation and directives to further clarify the mandates and responsibilities of the different tiers of government.

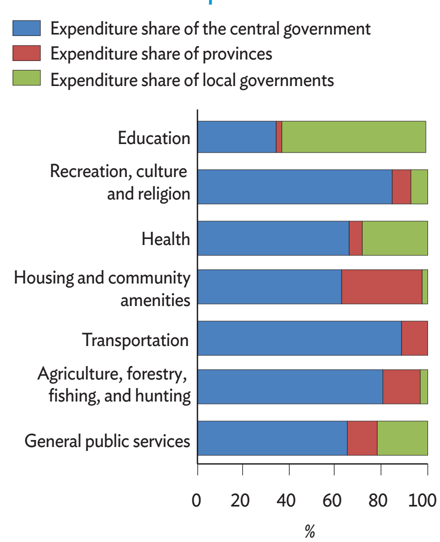
To make expenditure more efficient, SNGs should augment their own revenue collection by improving taxpayer databases and accountability. The success of federalism hinges on maintaining cooperation, transparency, accountability, and fiscal discipline at all three tiers of government. And, finally, so does macroeconomic stability.

3.19.2 Fiscal transfers to subnational governments (% of GDP)

	FY2019
Transfer to provincial governments	3.6
Fiscal equalization grant	1.5
Conditional grant	1.8
Complementary grant	0.1
Special grant	0.1
Transfer to local governments	6.0
Fiscal equalization grant	2.5
Conditional grant	3.2
Complementary grant	0.1
Special grant	0.1

Note: Percentages may not total 100% because of rounding.
Source: Ministry of Finance. FY2019 Budget Speech.

3.19.8 Functional expenditure



Source: Ministry of Finance. FY2019 Budget Speech.