Nepal's Economy Set for Challenging Times Ahead

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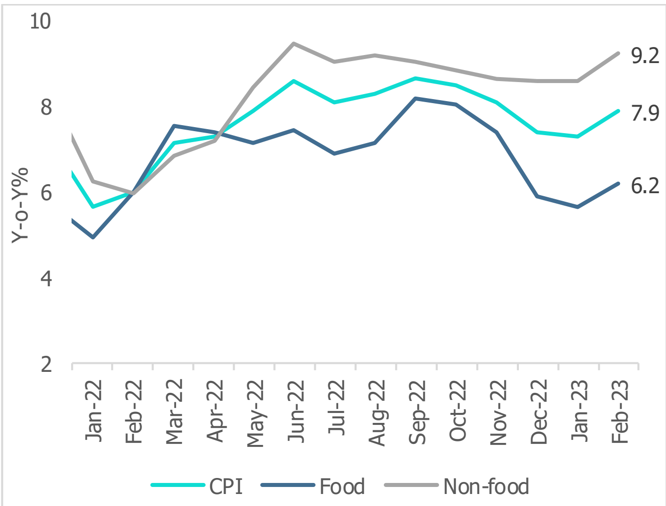
The path to Nepal's economic recovery in FY23 is likely to be a bumpy one. While a revival in the tourism industry, pick up in remittances and replenishing of forex reserves bodes well for the economy, there are several headwinds that could offset the positive impact. Stubborn inflation, declining exports, and discouraging foreign direct investment flows pose as a threat to the economic outlook.

Retail Inflation Snaps a Four-Month Decline in February

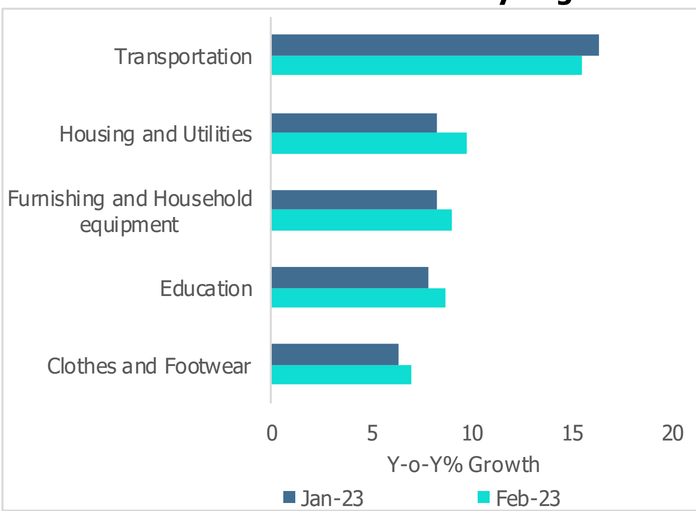
Retail inflation snapped a four-month decline in February, rising 7.9% as costs of both food and non-food and services segments increased. Food inflation rose 6.2% in February from 5.6% in the previous month, on account of rising price pressures in cereals and protein-based items. Non-food and service inflation rose to its highest level since August 2022, to 9.2% in February 2023, from 8.6% in the previous month. The non-food and services component remained elevated on account of high inflation in the housing, education and clothing & footwear categories.

In contrast, wholesale inflation eased marginally to 9.7% in the month ended mid-February from 9.8% in the previous month. The moderation was driven by softening in two of three categories -- primary products (4.5% y-o-y in February vs 5.3% prior) and the fuel and power component (31% y-o-y in February vs 32.4% prior). Meanwhile, the manufactured products segment reported higher inflation of 9.5% y-o-y in February compared to 9.1% a month ago. In the coming months, an easing of metals prices, oil prices and good agricultural harvest (assuming normal monsoons) could offer respite.

Trend in Retail Inflation



Non-food & Services Inflation by Segment



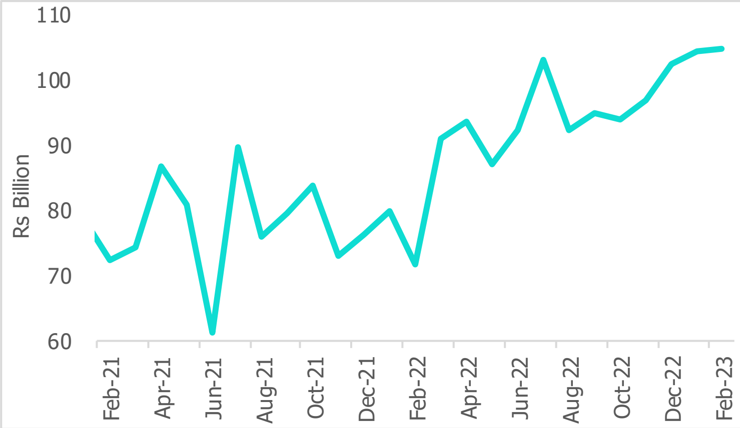
Source: Nepal Rastra Bank

Improving Trade Balance, Healthy Remittances and Pick-up in Tourist Arrivals Support Economy

Nepal's merchandise exports dropped by 1.4% (y-o-y) to Rs 12.6 billion in the month ending mid-February, as against an increase of 40% (due to base effect) in the same period of the previous year. Meanwhile, merchandise imports decreased 15% to Rs 126 billion against an increase of 4% a year ago in the month ending mid-February. The total trade deficit narrowed marginally from Rs 114.4 billion to Rs 113.8 billion in the month to mid-February. In the first seven months of the current fiscal year (August-February), the trade deficit narrowed to Rs 826 billion from Rs 1,016 billion in the same period a year ago. Given that petroleum products account for nearly 20% of the import basket, moderation in prices of crude oil in the international market has supported Nepal's trade balance.

Meanwhile, remittances continued to record healthy growth as foreign employment permits increased by 57% in FY23 (August-February). Remittances stood 27% higher at Rs 690 billion in February, compared to a year ago. With the rise in remittances income, Nepal's foreign exchange reserves increased by 10% (y-o-y) to USD 10.5 billion in the month ended mid-February. The current level of forex reserve is sufficient to cover imports of goods and services for 9.4 months, higher than the import cover of 6.7 months in February 2022 and the average import cover of 7.1 months in 2021-22.

Remittance Flows Remain Supportive



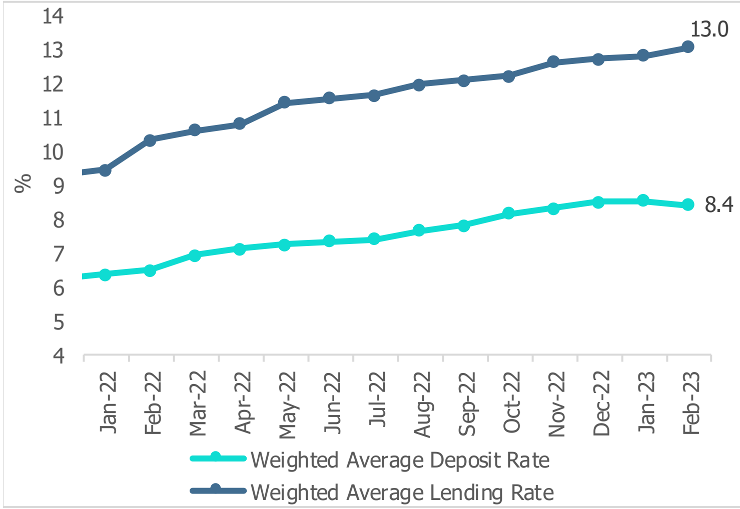
Source: Nepal Rastra Bank

Foreign direct investment continues to remain discouraging. FDI flows stood at USD 22 million in the seven months ending mid-February, 84% less in the current fiscal year (August-February) compared to the same period last year. Structural issues, challenging business climate and political uncertainty are some of the reasons why overseas investment in Nepal has not seen any notable increase despite several measures over the years to attract investment. The sequential decline in the trade deficit and healthy remittance inflows have nonetheless helped in improving the overall balance of payments. Nepal's balance of payments reached a surplus of Rs 133 billion in FY23 (August-February), compared to a deficit of about Rs 247 billion last year.

Lending Rates Move Higher in February

The policy repo rate was hiked by 150 bps to 7% in August 2022, following which lending rates have been moving higher. This has helped in controlling credit expansion which was necessary to discourage imports and stem a consequent decline in foreign exchange reserves. A steady rise in weighted average lending rates during the year (from 10.3% in February 2022 to 13% in February 2023) could be one of the reasons for the slump in credit growth (2.7% in the first seven months of FY23, from 12% a year ago). Looking ahead, lending rates could decline given that Nepal Bankers Association (NBA) decided to lower the premium rates on loans. The premium rate banks charge over and above the base interest rate has been reduced to 5% at a maximum from 6%, effective March 15. Moreover, the minimum interest on deposits has also been reduced by 42 bps to 6%. As the premium rate on loans is reduced and the interest rate on deposits has also decreased, banks are likely to reduce their lending rates to provide relief to creditors, as liquidity conditions have eased.

Trend in Weighted Average Lending & Deposit Rates

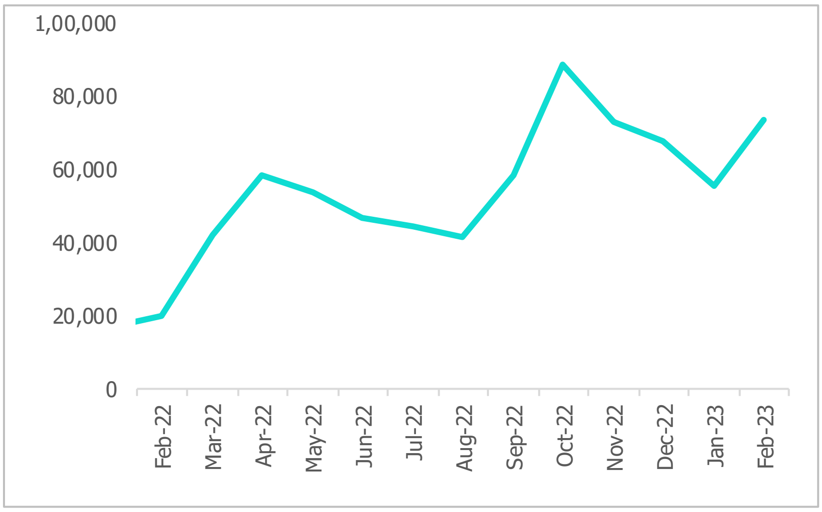


Source: Nepal Rastra Bank

Start of Tourist Season Sees Sharp Rise in Tourist Arrivals

The tourism industry, a key source of employment, revenue, and foreign exchange for Nepal, has shown promising signs of recovery. Tourist arrivals have risen nearly four-fold from a year ago, in the first seven months of FY23, as many countries eased travel restrictions. Tourist arrivals rose to 4,57,744 in the August-February period from 1,25,525 in the same period last year. With February being the start of the peak season, tourist arrivals for the month being higher than in previous years bodes well for the industry.

Monthly Tourist Arrivals Rise to a Four-Month High in February



Source: Nepal Rastra Bank

Going forward, the outlook for Nepal's economy remains clouded. As most major economies are expected to slip into a recession, there may be a decline in tourist arrivals and fresh foreign employment permits in the latter part of 2023. Moreover, the uptick in inflation in February is also concerning as this could hurt consumption demand and particularly impact the purchasing power of the low-income section of society. In fact, if weather conditions turn unfavourable this year, inflation and imports of essential items could see a notable increase.

Monthly Data of Key Economic Variables

Indicators (Mid-Month)	October 2022	November 2022	December 2022	January 2023	February 2023
Consumer price inflation (y-o-y%)	8.5	8.1	7.4	7.3	7.9
Wholesale price inflation (y-o-y%)	13.7	10.0	9.1	9.8	9.7
Export growth (y-o-y%)	-37.5	-24.1	-39.7	-32	-29
Import growth (y-o-y%)	-22.3	-23.3	-29.8	-20.7	-20
Trade deficit (Rs billion)	114.3	118.7	119.5	114.4	113.8
Worker's remittances (Rs billion)	281.1	378	480.5	585.1	689.9
Foreign exchange reserves ($ billion)	9.5	9.6	9.8	10.3	10.5
Domestic credit (y-o-y%)	10.5	10.5	10.1	8.7	8.6
Deposits (y-o-y%)	8.2	8.6	9.5	9.4	10.5
Bank rate (%)	8.5	8.5	8.5	8.5	8.5
Weighted average deposit rate (%)	8.16	8.32	8.46	8.51	8.41
Weighted average lending rates (%)	12.19	12.65	12.74	12.79	13.03

Source: Nepal Rastra Bank

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