Nepal Economy: Tough Times Ahead

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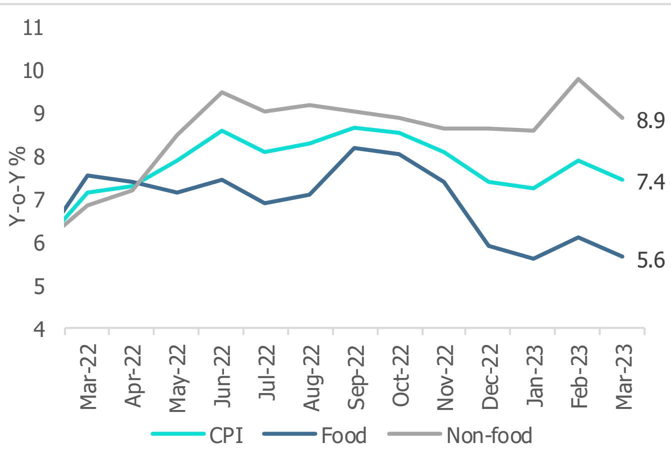
The growth outlook for Nepal's economy remains highly uncertain. While robust tourist arrivals, healthy remittances flows and forex reserves provide comfort, several headwinds could offset the positive impact. Heavy reliance on imports, dismal foreign direct investment flows, and a rise in global oil prices pose a threat to the economic outlook. Multilateral development partners- World Bank and Asian Development Bank (ADB), have trimmed Nepal's growth outlook. Both ADB and World Bank now expect GDP growth of 4.1% in FY23 (down from previous estimates of 4.7% and 5.1%, respectively), significantly lower than the government's 8% target. ADB attributes the downturn to tight monetary policy, slack in domestic demand, the unwinding of Covid-19 stimulus, and persistent global headwinds. Meanwhile, World Bank cited the impact of import restrictions, higher inflation, and shrinking government revenue, as a reason for waning economic momentum.

Retail Inflation Moderates on the Back of Softening Food Prices

Retail inflation moderated 50 bps to 7.4% y-o-y in March, on the back of a sharp slowdown in costs of food items. Food inflation eased to 5.6% in March from 6.2% in the previous month, as prices of vegetables cooled. Vegetable prices contracted for the fifth straight month in March (-8.8% y-o-y), the steepest decline since October 2021. However, prices of items such as cereals and protein items (accounting for over 20% of the overall CPI index) increased. Meanwhile, non-food and services costs also cooled. Non-food and service inflation came off a near-seven-year high of 9.2% seen in February, to 8.9% in March. Amongst services, barring healthcare, all sectors reported moderation in price pressures in March. Meanwhile, wholesale inflation softened to 7.1% y-o-y in March from 9.7% in the previous month. The moderation was driven by waning price pressures in all three categories -- primary products (1.8% y-o-y in March vs 4.5% prior), fuel and power component (25.8% y-o-y in March vs 30.9% prior) and manufactured products (7.3% y-o-y in March vs 9.5% prior).

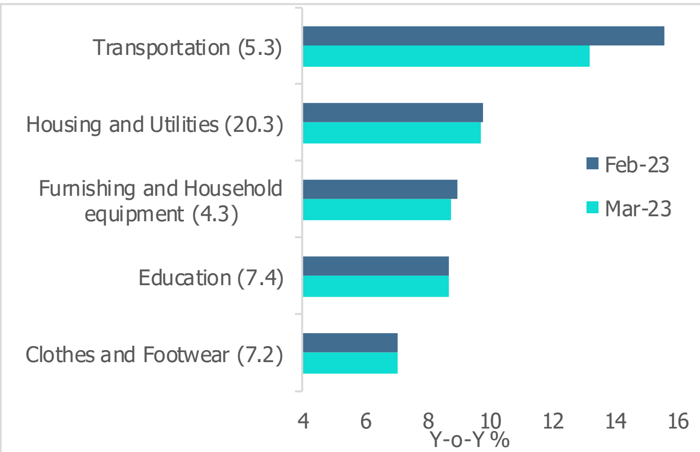
Looking ahead, retail inflation numbers could witness further moderation in the remainder of FY23 due to a favourable base effect, possibly bringing the monthly headline number below the central bank's 7% target. However, upside risks emanating from a potential rise in global commodity prices in the second half of 2023 and unfavourable weather conditions remain a concern going ahead.

Retail Inflation Trends Lower in March



Source: Nepal Rastra Bank

Non-food & Services Inflation by Segment (Top 5)

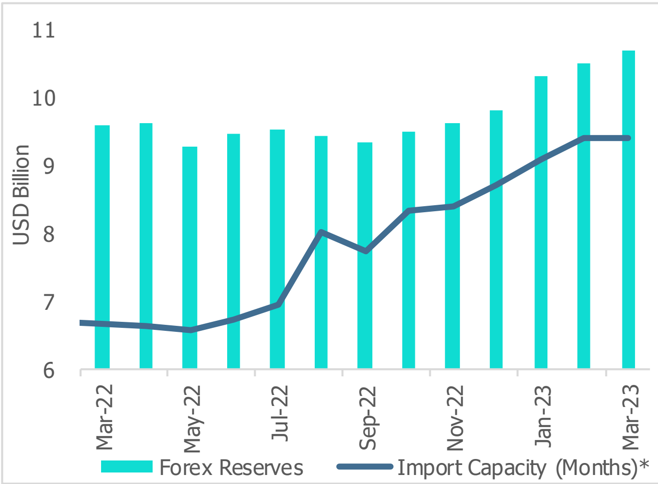


Source: Nepal Rastra Bank; Figures in bracket are weight in overall index

Trade Balance and FDI Flows Remain a Concern; Healthy Remittances Offer Support

Nepal's merchandise exports dropped 29% y-o-y to Rs 11.4 billion, and imports decreased 14% y-o-y to Rs 139 billion in the month ending mid-March. The trade deficit worsened to a six-month high of Rs 128 billion in the month to mid-March. The worsening of the trade position can be attributed to the sequential rise in imports for three consecutive months, reflective of the removal of the eight-month-long ban on the import of luxurious goods in December 2022. Subsequently, Nepal Rastra Bank also removed the provision of cash margin, which the importers need to maintain against their letters of credit (LCs) while importing goods. However, for FY23 (August-March), the trade deficit was lower at Rs 954 billion from Rs 1,161 billion in the same period a year ago. Given that petroleum products account for nearly 20% of the import basket, a further rise in crude oil prices in the international markets following OPEC and Russia's voluntary production cuts could worsen Nepal's trade position going ahead.

Import Capacity Steady at a 2-year High in March



Source: Nepal Rastra Bank (*Import Capacity for Goods & Services)

Meanwhile, remittances continued to record healthy growth as foreign employment permits increased 54% in FY23 (August-March). Remittances stood 25% higher at Rs 794 billion in the first eight months of FY23. With the rise in remittances income, Nepal's foreign exchange reserves increased 11% (y-o-y) to USD 10.7 billion in the month ended mid-March. 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 a year ago.

Foreign direct investment continues to remain discouraging despite Nepal's efforts over the years to attract overseas investment. FDI flows stood at USD 23 million in the eight months ending mid-March, 84% less in the current fiscal year (August-March) compared to the same period last year. That said, Nepal's balance of payments remained at a surplus of Rs 148 billion in FY23 (August-March), compared to a deficit of about Rs 258 billion last year, thanks to steady remittance flows and a lower trade deficit.

Government Revenues Under Pressure

Government revenues declined 15% y-o-y in the first eight months of the fiscal year to Rs 583 billion. Tax revenues, which makes up over 90% of total revenue receipts, fell over 16% during the period under review. A further break-up of tax revenues reveals that lower customs (-22% y-o-y) and excise duty (-5% y-o-y) collections contributed to the overall decline, indicating Nepal's heavy reliance on imports as a tax base. The imposition of import restrictions since May 2022 as a measure to curtail the depletion of foreign exchange reserves has taken a hit on government revenues in FY23. The government slashed the FY23 budget by 14% to Rs 1.55 trillion during its mid-year review due to the inability to meet the revenue targets. In the eight months of the current fiscal year, the government has been able to meet merely 50% and 54% of its revenue and expenditure targets, respectively. On the expenditure front, the total expenditure of the federal government stood at Rs 779 billion in FY23, up 15% from a year ago, on higher recurrent expenditure. Consequently, the budget deficit in FY23 has widened to Rs 217 billion from Rs 186 billion in the same period in FY22. Meanwhile, government debt has been rising rapidly since the pandemic, with the debt-to-GDP ratio climbing to 43% at the end of Q2 FY23 from 41% in the previous quarter. This compares to the pre-pandemic level of 27%. However, it is worth noting that as per ADB's April Outlook Report, Nepal's risk of debt distress remains low in light of external debt-to-GDP and external servicing-to-exports remaining low.

Tourism Industry a Bright Spot

The tourism industry, a key source of employment, revenue, and foreign exchange for Nepal, has supported post-pandemic recovery. Tourist arrivals in March 2023 stood at 99,426, its highest since March 2021, taking the FY23 (year so far) footfall to 556,540. This compares to 167,531 arrivals seen in the corresponding period a year ago.

Monthly Tourist Arrivals at 2-year High in March

Source: Nepal Rastra Bank

Going forward, the Nepalese economy is expected to remain vulnerable to the evolving global backdrop. An impending global growth slowdown, elevated oil prices, weak FDI flows, and continued dependence on imports could put Nepal in a tough spot. While easing inflationary pressures at the current juncture provides some respite, an unfavourable monsoon could result in higher food prices and the need to ramp up imports of essential items. Worsening of the fiscal position too remains a concern. ADB recommends accelerating capital budget spending through focused investment planning, financial management, and project readiness to help spur Nepal's economic growth over the coming years.

Monthly Data of Key Economic Variables

Indicators (Mid-Month)	November 2022	December 2022	January 2023	February 2023	March 2023
Consumer price inflation (y-o-y%)	8.1	7.4	7.3	7.9	7.4
Wholesale price inflation (y-o-y%)	10.0	9.1	9.8	9.7	7.1
Export growth (y-o-y%)	-24.1	-39.7	-32	-29	-29
Import growth (y-o-y%)	-23.3	-29.8	-20.7	-20	-19
Trade deficit (Rs billion)	118.7	119.5	114.4	113.8	127.8
Worker's remittances (Rs billion)	378	480.5	585.1	689.9	794.3
Foreign exchange reserves ($ billion)	9.6	9.8	10.3	10.5	10.7
Domestic credit (y-o-y%)	10.5	10.1	8.7	8.6	8.1
Deposits (y-o-y%)	8.6	9.5	9.4	10.5	10.5
Bank rate (%)	8.5	8.5	8.5	8.5	8.5
Weighted average deposit rate (%)	8.32	8.46	8.51	8.41	8.37
Weighted average lending rates (%)	12.65	12.74	12.79	13.03	13.03

Source: Nepal Rastra Bank

Contact

Rajani Sinha	Chief Economist	rajani.sinha@careedge.in	+91 - 22 - 6754 3525
Sonali Vahadane	Senior Economist	sonali.vahadane@careedge.in	+91 - 22 - 6754 3459
Mradul Mishra	Media Relations	mradul.mishra@careedge.in	+91 - 22 - 6754 3596

Corporate Office: 4th Floor, Godrej Coliseum, Somaiya Hospital Road, Off Eastern Express Highway, Sion (East), Mumbai - 400 022
Phone : +91 - 22 - 6754 3456 | CIN: L67190MH1993PLC071691

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