

# Nepal Economy: Challenges to Growth Outlook Persist

June 28, 2023 | Economics

## Government Announces GDP Growth and Inflation Target for FY24

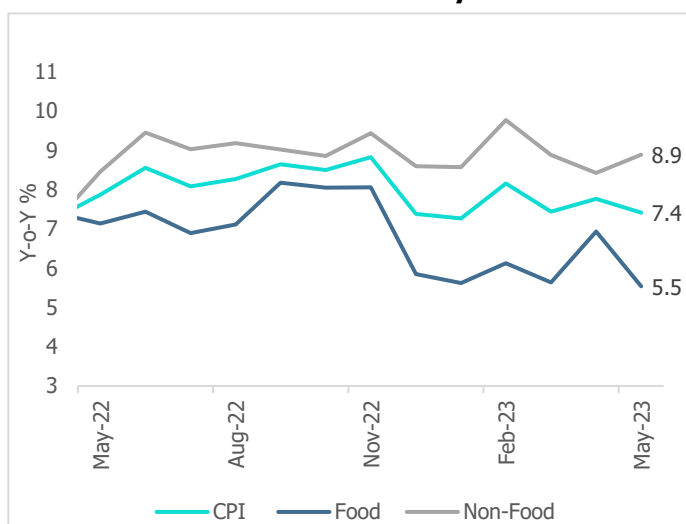
After lowering the growth estimate for FY23 to 2%, the government now forecasts GDP to rise 6% in FY24 (starting mid-July 2023). The FY24 growth projection is well above forecasts of around 5% by World Bank and International Monetary Fund (IMF). Meanwhile, the government expects inflation to remain within 6.5% in the coming fiscal year, lower than the FY23 target of 7%. Although headline inflation has come off its peak seen in November 2022, it is worth noting that the FY23 average at 7.9% continues to be 90 bps higher than the central banks' target.

## Retail Inflation Eases to a Four-Month Low in May

Retail inflation eased 40 bps from a month ago to a four-month low of 7.4% y-o-y in May, on the back of moderation in food inflation. Food inflation softened to 5.5% y-o-y, the slowest pace in 16 months, driven by easing costs of vegetables and meat & fish items. Vegetable inflation contracted 2% y-o-y, while meat & fish inflation contracted (-0.4% y-o-y) for the first time in nine months. In contrast, non-food and services inflation picked pace in May. Non-food and service inflation rose 50 bps from a month prior to 8.9% y-o-y in May. The uptick was led by the miscellaneous goods and services segment, which registered double-digit growth of 13% y-o-y, the highest level in nearly 3 years. Inflation in segments such as housing & utilities and education also rose in May.

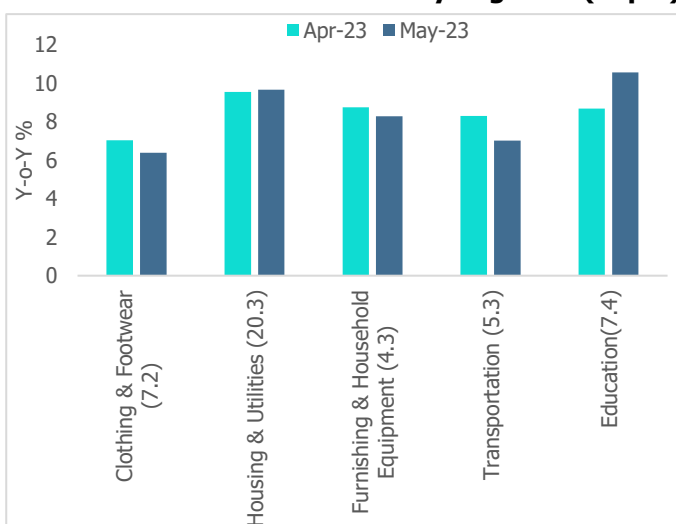
Wholesale inflation too softened to a 20-month low of 3.3% y-o-y in May (from 5.6% a month ago). The moderation was driven by waning price pressures in the fuel and power component (11% y-o-y vs 15.1% prior) and manufactured products (3.3% y-o-y vs 6.2% prior). Inflation in the primary goods category too moderated from 2% to 1.3% y-o-y in May.

### Retail Inflation Moderates in May



Source: Nepal Rastra Bank

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



Source: Nepal Rastra Bank; Figures in brackets are share in overall index

**Trade Deficit Narrows in May as Import Pressure Eases; Remittances Remain Supportive**

Nepal’s merchandise exports contracted 1% y-o-y to Rs 12.6 billion, while imports contracted (-3% y-o-y) for the 10<sup>th</sup> straight month to Rs 134 billion in May. Consequently, the trade deficit narrowed to Rs 121 billion in May from Rs 125 billion in the corresponding period a year ago. Meanwhile, in the 10 months of the current fiscal year, the trade deficit narrowed 16% y-o-y to Rs 1.2 trillion. A 34% (y-o-y) decline in crude oil prices in the international market in May has likely supported the trade balance position.

Remittances continued to record healthy growth as foreign employment permits increased by 51% in FY23. Remittances stood 23% higher at Rs 1,005 billion in the first ten months of FY23, touching its highest level since July 2022. With the rise in remittances income, Nepal’s foreign exchange reserves increased 21% (y-o-y) to USD 11.2 billion in May. The current level of forex reserve is sufficient to cover imports of goods and services for 9.7 months, the most since July 2021.

Meanwhile, weak foreign direct investment (FDI) flows continue to be a pain point for the economy. FDI flows stood at USD 47 million in the ten months ending mid-May, 70% less in the current fiscal year compared to the same period last year. That said, Nepal’s balance of payments remained at a surplus of Rs 215 billion in the fiscal year so far, compared to a deficit of Rs 289 billion in the same period of the previous year.

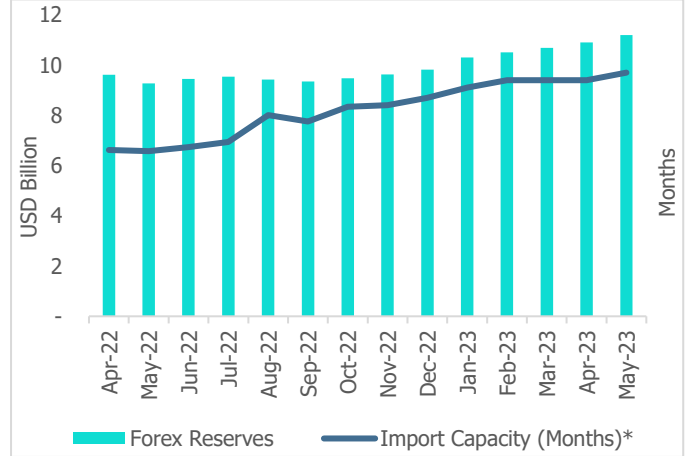
**Tourism Industry Remains Supportive**

The tourism sector in Nepal, which had experienced a significant decline due to the Covid-19 crisis, is slowly bouncing back. Tourist arrivals in May 2023 stood at 77,703, taking the FY23 (year so far) footfall to 733,016. This compares to 282,969 arrivals seen in the corresponding period a year ago. Going ahead, tourist arrivals are expected to dip in the off-season period of June-September. Over the near term, however, the contribution of the tourism industry in the growth of the contact-intensive sub-services sector such as accommodation and transportation is expected to remain positive.

**Lending and Deposit Rates Ease in May**

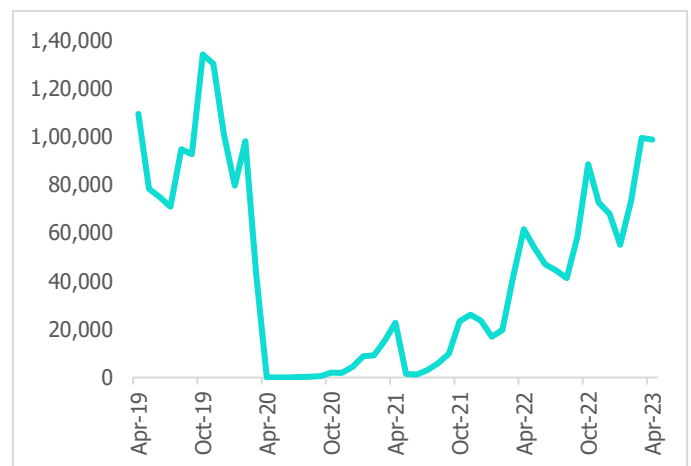
The weighted average lending rate declined 10 bps to 12.7%, while the weighted average deposit rate eased 20 bps to 8.1% in May. An increase in deposits (11.4% y-o-y in May vs 9% at the start of the fiscal year) in the banking system, also led to a decline in the credit-deposit ratio to 84% as on June 23. The credit-deposit ratio below the requirement of 90% fixed by the Nepal Rastra Bank (NRB), reflects sluggish credit growth. Credit growth slowed to 8.4% y-o-y in May from 19% a year ago. An increase in bad debts is likely to have hurt lending capability. According

**Import Capacity Rises to Near-2-Year High in May**



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

**Tourist Arrivals Dip as Peak Season Ends**



Source: Nepal Rastra Bank

to the monthly report on Banking and Financial Statistics of NRB, the ratio of non-performing loans to total loans has increased to 3.34% in May, from 1.44% a year ago. The 100-bps cut in the bank rate to 7.5% last month is reflective of the need for lower rates to spur lending and economic activity. Going ahead, weighted average lending and deposit rates may decline further if the central bank decides to adopt a softer monetary policy stance for FY24.

### Way Forward

Going forward, the Nepalese economy will remain exposed to several headwinds. Continued import dependence, lower government revenue (-13% y-o-y in the fiscal year so far) and still-elevated inflation could contribute to waning economic momentum. The inflation target of 6.5% for FY24 could be difficult to achieve if the climate-driven risks play spoilsport. With less-than-average rainfall predicted this year, the outlook for the agricultural sector remains bleak. The Department of Hydrology and Meteorology (DHM) has estimated that there will be 35-55% less rain than average this year. Reduced agricultural production could lead to food shortages, putting pressure on imports. Additionally, slow capital expenditure (~43% of the budgeted amount for FY23) and discouraging revenue collection (61% of the FY23 budget target) amidst rising borrowing are indicative of the government's difficult financial position. Moreover, slowing exports on the back of moderation in external demand could continue to weigh on the growth outlook. As a result of these looming domestic and external headwinds, we believe that it will be difficult for Nepal to achieve the growth target of 6% for FY24.

(Note: Data for May is for the month-ending mid-May)

### Monthly Data of Key Economic Variables

Indicators (Mid-Month)	January 2023	February 2023	March 2023	April 2023	May 2023
Consumer price inflation (y-o-y%)	7.3	7.9	7.4	7.8	7.4
Wholesale price inflation (y-o-y%)	9.8	9.7	7.1	5.6	3.3
Export growth (y-o-y%)	-32	-29	-29	5	-1.2
Import growth (y-o-y%)	-20.7	-20	-19	-9	-3
Trade deficit (Rs billion)	114.4	113.8	127.8	129.6	121.1
Worker's remittances (Rs billion)	585.1	689.9	794.3	903.3	1,005
Foreign exchange reserves (\$ billion)	10.3	10.5	10.7	10.9	11.2
Domestic credit (y-o-y%)	8.7	8.6	8.1	8.6	8.4
Deposits (y-o-y%)	9.4	10.5	10.5	11.0	11.4
Bank rate (%)	8.5	8.5	8.5	8.5	7.5*
Weighted average deposit rate (%)	8.5	8.4	8.4	8.3	8.1
Weighted average lending rates (%)	12.8	13.0	13.0	12.8	12.7

Source: Nepal Rastra Bank (\* Bank Rate was slashed to 7.5% on May 14)

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