Nepal Economy: Inflation Concerns Worsen as Food Prices Soar

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Asian Development Bank (ADB) Downgrades FY24 GDP Growth

As per ADB's September outlook report, Nepal's economy has been projected to grow by 4.3% in the current fiscal year 2023-24, down from the 5% foreseen in April. The revision has been attributed to weaker projected growth in major developed markets, amidst continued fiscal challenges in the domestic economy. It expects economic activity in FY24 to be curtailed by low domestic and external demand, continued weakness in investor confidence, high-interest rates, and weak agricultural output. Even with the revised GDP growth forecasts, the economy is nonetheless seen growing from an estimated 1.9% in FY23. The improvement from FY23 is seen on the back of improved performance of the services sector, with expansions coming from real estate, wholesale and retail trade and accommodation and food services. Meanwhile, ADB sees little risk to external balance given the progress of foreign exchange reserves. Regarding inflation, the forecast for FY24 is retained at an average of 6.2%.

Separately, ADB approved a USD 100 million policy-based concessional loan to strengthen the country's fiscal management under the Strengthening Public Financial Management and Devolved Service Delivery Program. The ADB program will introduce reforms to enhance the quantum and quality of capital spending, reform public enterprises to mitigate fiscal risks, digitize to enhance fiscal transparency and efficiency, leverage additional resources from development financing institutions, and implement a gender- and climate-responsive medium-term expenditure framework at the subnational level.

	FY22	FY23	FY24e	
			Apr	Sep
GDP Growth (%)	5.2	1.9	5.0	4.3
Inflation (%)	6.3	7.7	6.2	6.2

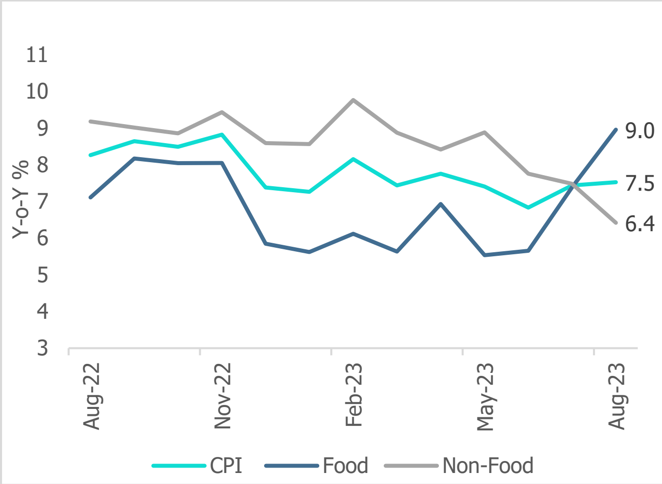
Source: Asian Development Bank (Note: Data for FY24 are ADB estimates; FY22 and FY23 are actuals; Inflation data is FY average)

Retail Inflation Climbs to a 5-Month High as Food Inflation Soars

Retail inflation rose to 7.5% y-o-y in August, its highest level in five months, driven by food inflation. Food inflation rose 8.9% y-o-y, the largest increase since April 2020. Food inflation skyrocketed on the back of inflation in items such as cereals, vegetables, and protein items. The firming up of headline inflation was however countered by moderation in non-food and services inflation. Non-food and services inflation eased to 6.4% y-o-y in August, registering the smallest increase since February 2022. Softening of inflation pressures was witnessed in all components within non-food & services, barring transportation. Meanwhile, wholesale price index (WPI)-based inflation moderated 60 bps to 4.3% y-o-y in August. While inflation in the manufactured commodities and fuel & power components cooled, that of primary goods inched up marginally.

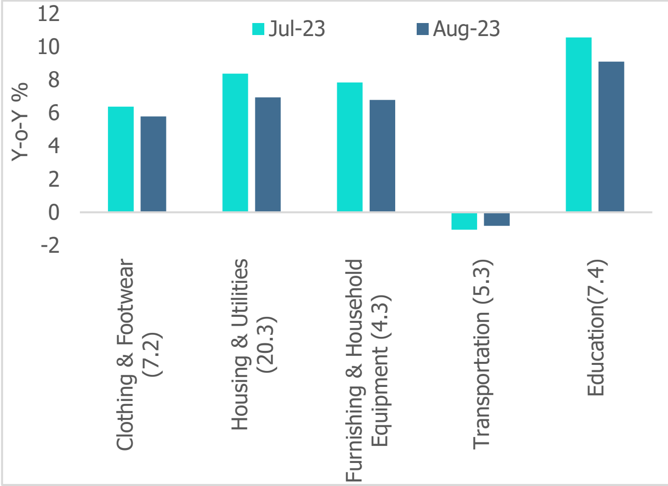
Going ahead, inflationary pressures are likely to worsen given the uptick in crude oil prices. Moreover, the rise in costs of food items (~8% of total imports), especially that of edible oils could further add to domestic price pressures. This could challenge the central bank's target of bringing average inflation around 6.5% in FY24. For the year FY23 that ended mid-July, headline inflation missed the 7% target by 70 bps.

Food Inflation Worsens in August



Source: Nepal Rastra Bank

Non-Food & Services Inflation- Top 5



Source: Nepal Rastra Bank (Figures in bracket represent share in overall CPI basket.)

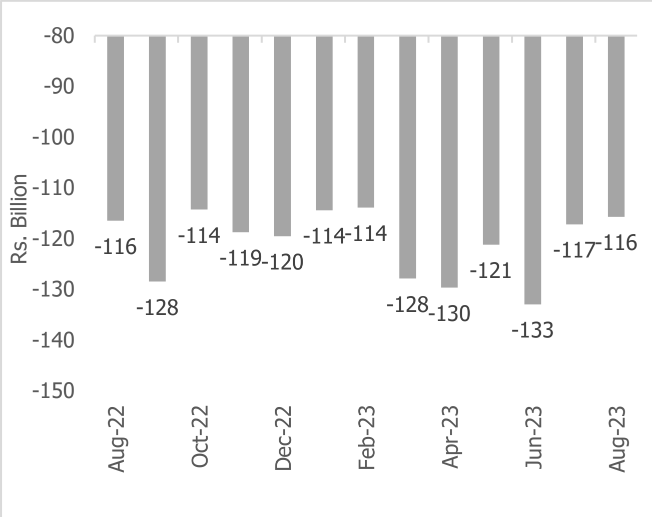
Trade Deficit Narrows to the Lowest Level in Six Months

In the first month of the fiscal year, Nepal's trade deficit narrowed to Rs 115.7 billion, its lowest level in six months, compared to a deficit of Rs 116.5 billion in the same period a year ago. The narrowing of the deficit was on account of a fall in both exports (-8.7% y-o-y) and imports (-1.6% y-o-y). The narrowing trade deficit seen in August was on account of a sharp fall in the share of petroleum products. Although petroleum products made up the largest chunk of overall imports, its share declined to 15% in August from nearly 20% in the same period a year ago. Moreover, an 11% (y-o-y) fall in crude oil prices in the month also helped lower the import bill. Imports of other key items i.e. 'transport equipment, vehicle & vehicle spare parts' and 'other machinery and parts', too contracted in the month. Improvement in the trade position helped Nepal's current account balance move to a surplus of Rs 13 billion in August, compared to a deficit of Rs 15 billion a year ago. The current account balance moved to a surplus for the first time since November 2020. Looking ahead, the trade position could worsen given the sharp rise in crude oil prices over the last month. Brent crude oil prices have risen above $90/bbl in September, levels last seen nearly a year ago. Additionally, the rise in global food prices, especially that of edible oils, could further play spoilsport. For FY24, ADB expects the current account deficit to widen to 1.8% of GDP from an estimated 1.4% in FY23.

Worker's remittances, which account for nearly 25% of GDP, continued to record healthy growth in the first month of FY24. Remittances stood at Rs 116 billion, up 26% from the corresponding period last year. Going ahead however, Nepal Rastra Bank expects the growth rate of remittance inflows in 2023-24 to moderate given the higher base of remittance inflows in 2022-23.

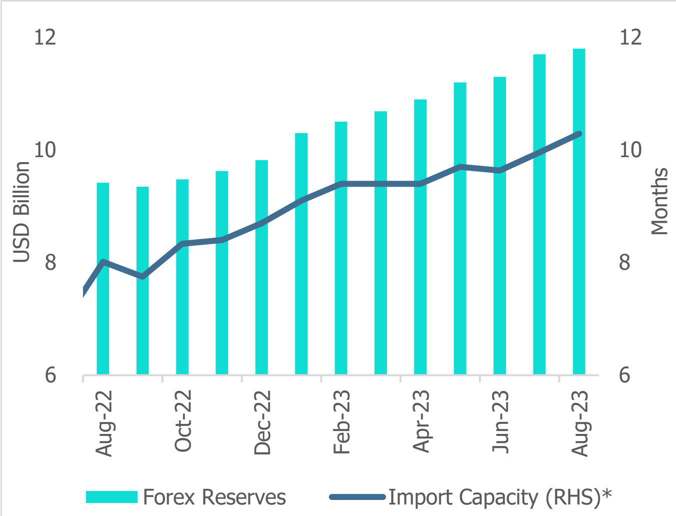
With the rise in remittances income, Nepal's foreign exchange reserves increased 26% (y-o-y) to USD 11.8 billion in August, the highest level since May 2021. The current level of forex reserve is sufficient to cover imports of goods and services for 10.3 months, up from 8 months a year ago. As per NRB's FY24 monetary policy, the central bank aims to keep foreign exchange reserves at levels sufficient to cover at least 7 months' imports of goods and services. However, if remittances moderate and imports grow significantly in FY24, we could see reserves come under pressure. Further, foreign direct investment (FDI) flows continue to remain a pain point for the economy. FDI inflows declined 46% over last year to USD 20 million in August. That said, the overall balance of payment remained at a surplus of Rs 33 billion in August, as against a deficit of Rs 20 billion in the year-ago period.

Nepal's Trade Deficit Narrows



Source: Nepal Rastra Bank

Forex Reserves and Import Cover Improve



Source: Nepal Rastra Bank (*Import capacity includes cover for merchandise & services)

Nepalese Rupee Falls to Record Low

The Nepalese rupee (NPR), which is pegged to the Indian rupee, depreciated over the last month to a record low of 133.2, amidst the strengthening of the US dollar index. Expectations of US interest rates remaining higher for longer against the backdrop of a resilient economy have weighed on the Indian rupee and consequently the NPR. For the Nepalese economy, the performance of the domestic currency has a significant bearing on the economic outlook, with depreciation of the NPR adding pressures on inflation, foreign debt and import bills. However, the Reserve Bank of India's active FX intervention to defend the Indian rupee and keep volatility in check will aid in limiting NPR weakness.

Way Forward

The Nepalese economy continues to remain surrounded by challenges as it steps into FY24. Weak agricultural output, higher taxes on food, curbs on food exports by India, and rising crude oil prices are expected to aggravate inflation and worsen external sector balances in the coming months. Moreover, a lot depends on whether the government will be able to meet its revenue target for the current fiscal year, failure of which could worsen its fiscal position. ADB expects the fiscal deficit to narrow to 2.4% of GDP in FY24 (from 6.1% in FY23) but remain higher if the government does not meet its target. Additionally, high dependence on remittances considering slowing global growth could make it difficult for the economy to achieve its growth target of 6%. That said, the tourism and services industry remains a bright spot that could be tapped into and expanded to improve its positive contribution to economic growth. ADB recommends a boost to the tourism sector along with structural changes and an improved business climate for better facilitation of foreign direct investment.

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

Monthly Data of Key Economic Variables

Indicators (Mid-Month)	April 2023	May 2023	June 2023	July 2023	August 2023
Consumer price inflation (y-o-y%)	7.8	7.4	6.8	7.4	7.5
Wholesale price inflation (y-o-y%)	5.6	3.3	3.1	4.9	4.3
Export growth (y-o-y%)	5	-1.2	1.58	-4.5	-8.7
Import growth (y-o-y%)	-9	-3	-8	-17	-1.6
Trade deficit (Rs billion)	129.6	121.1	132.9	117.2	115.7
Worker's remittances (Rs billion)	903.3	1,005	1,112	1,220	116.0
Foreign exchange reserves ($ billion)	10.9	11.2	11.2	11.7	11.8
Domestic credit (y-o-y%)	8.6	8.4	8.8	8.7	7.3
Deposits (y-o-y%)	11.0	11.4	12.2	12.3	11.9
Bank rate (%)	8.5	7.5	7.5	7.5	7.5
Weighted average deposit rate (%)	8.3	8.1	8.0	7.8	8.0
Weighted average lending rates (%)	12.8	12.7	12.5	12.3	12.2

Source: Nepal Rastra Bank

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