

NEPAL

Growth slid in fiscal 2023 as tight financial conditions replaced pandemic stimulus, and inflation flared as prices for oil and other commodities spiked. The current account deficit narrowed with a smaller trade deficit. Growth will pick up this year and in fiscal 2025 as domestic demand gradually revives, hydroelectric output increases, and recovery in tourism continues. Inflation will subside as oil prices moderate, and the current account deficit will substantially narrow on further reduction of the trade deficit and buoyant remittance inflow. As Nepal approaches graduation from the least-developed-country group, it must intensify its trade facilitation efforts.

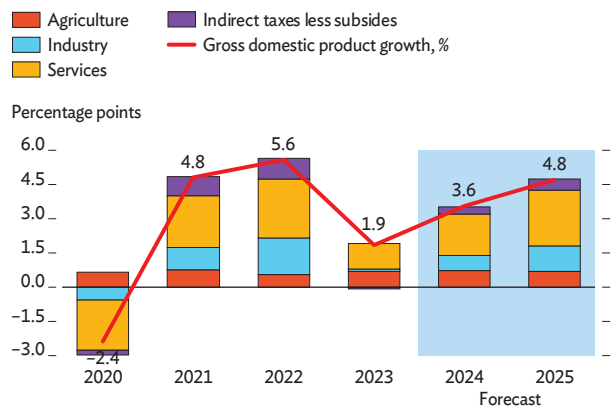
Economic Performance

Preliminary official estimates show GDP expanded by 1.9% in fiscal year 2023 (FY2023, ended mid-July 2023) after rising by 5.6% in FY2022 (Figure 2.19.1). Agriculture grew by 2.7% in FY2023, improving on 2.2% a year earlier as cereal output increased on a favorable monsoon and the use of improved crop varieties. Industry grew by only 0.6% as manufacturing and construction contracted—affected by higher interest rates, import restrictions in the first 5 months of FY2023, and slackened external and domestic demand—and despite the energy subsector expanding by 19.4% as electricity generation increased. Service growth fell by nearly half to 2.3% in FY2023 as wholesale and retail trade contracted under dampened domestic demand, and as transportation and storage expanded only slightly. Accommodation and food services, however, registered robust growth of 18.6% on increased international tourist arrivals.

On the demand side, lower investment slowed growth in FY2023. Both public and private investment stalled (Figure 2.19.2). Fixed investment slumped by 10.9%, mainly from higher interest rates that dampened credit growth to the private sector, and on lower imports of both intermediate and capital goods, subtracting 3.9 percentage points from GDP growth. Despite sizeable remittance inflows, private consumption growth slowed to 4.1% from 6.8% a year earlier as purchasing power dipped. The merchandise trade deficit contracted

Figure 2.19.1 Supply-Side Contributions to Growth

Economic growth slowed in FY2023 but will trend upward this year and next, driven by services.



Note: Years are fiscal years ending in mid-July of that year.

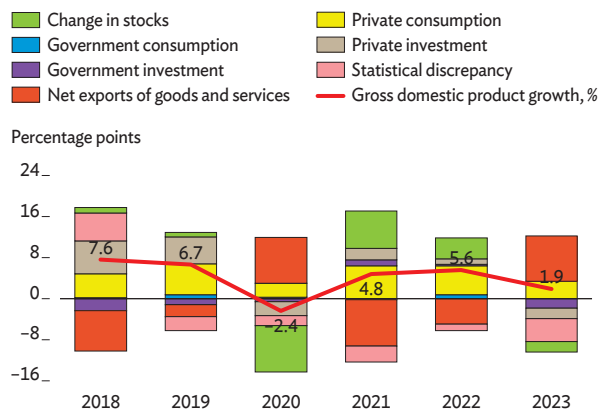
Sources: National Statistics Office. 2023. *National Accounts of Nepal 2021/22*; Asian Development Bank estimates.

by 21.7%, in real terms, on import and credit control measures. Services deficit also contracted by 11.6% as services' export growth surpassed import growth on higher tourist arrivals, pushing the contribution of net exports to GDP to 8.9 percentage points.

Inflation increased in FY2023 on higher oil and commodity prices, somewhat tempered by the tightening of monetary policy. Average annual inflation rose to 7.7% from 6.3% a year earlier

Figure 2.19.2 Demand-Side Contributions to Growth

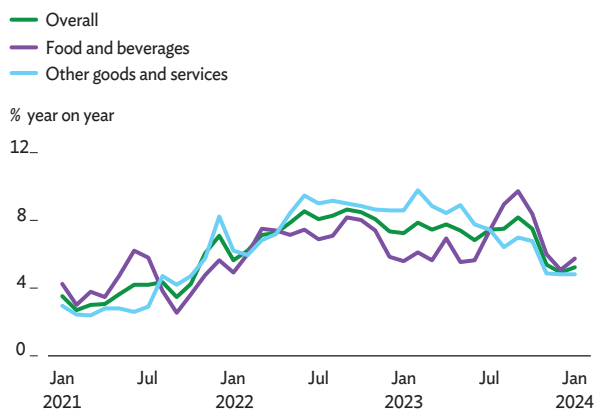
Lower investment stalled growth in 2023.



Note: Years are fiscal years ending in mid-July of that year.
Sources: National Statistics Office. 2023. *National Accounts of Nepal 2022/23*; Asian Development Bank estimates.

Figure 2.19.3 Monthly Inflation

Tightened monetary policy moderated an increase in average annual inflation in FY2023.



Source: Nepal Rastra Bank. 2024. *Recent Macroeconomic Situation*.

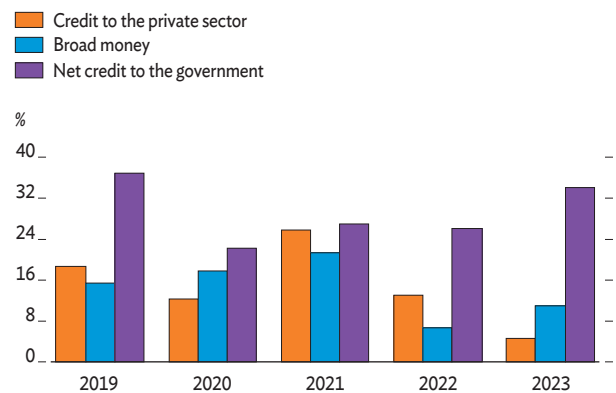
(Figure 2.19.3). Food inflation averaged 6.6% with prices up for cereals owing to supply-side shocks, particularly from India’s wheat and rice export restrictions and Nepal’s removal of value-added tax exemptions and price support for select food items. Nonfood inflation averaged 8.6% as prices rose for transportation, health care, education, housing, and utilities on rising oil prices and growing demand for these services. Average inflation decelerated to 6.4% in the first 6 months of FY2024 in line with subdued oil and commodity prices.

Nepal Rastra Bank, the central bank, tightened monetary policy in FY2023 to curb rising inflation and pressure on foreign exchange reserves. It raised

the policy rate and rolled back its lending to banks, which had increased fivefold during the COVID-19 pandemic, leading to a surge in market interest rates. Consequently, private sector credit growth slowed to 4.6% in FY2023 from 13.3% a year earlier. Nevertheless, broad money (M2) growth increased to 11.2% on increased borrowing by the government and more net foreign assets held by banks (Figure 2.19.4). As inflation moderated and foreign exchange reserves increased, the central bank lowered the policy rate by 100 basis points to 5.5% from December 2023. This has marginally softened commercial interest rates (Figure 2.19.5).

Figure 2.19.4 Credit and Broad Money Growth

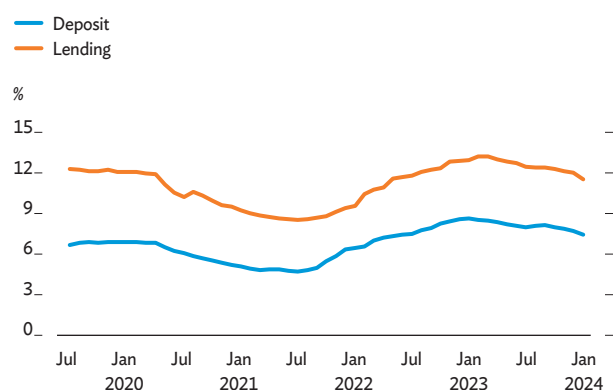
Growth in credit to the private sector slowed in FY2023 as credit to the government increased.



Note: Years are fiscal years ending in mid-July of that year.
Source: Nepal Rastra Bank. 2023. *Recent Macroeconomic Situation*.

Figure 2.19.5 Weighted Average Commercial Bank Interest Rates

Interest rates have trended downward so far in fiscal 2024.

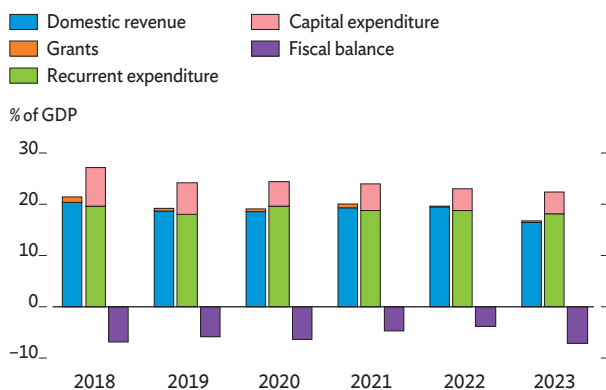


Source: Nepal Rastra Bank. 2024. *Recent Macroeconomic Situation*.

The FY2023 fiscal deficit widened to 6.1% of GDP from 3.2% a year earlier on sharp revenue shortfalls (Figure 2.19.6). Central government revenue fell to 16.6% of GDP as both direct and indirect tax collection weakened, mainly because of lower imports. Recurrent expenditures decreased marginally, largely owing to reduced fiscal transfers from the federal government to subnational governments.

Figure 2.19.6 Fiscal Indicators

The FY2023 deficit widened as revenues declined sharply.

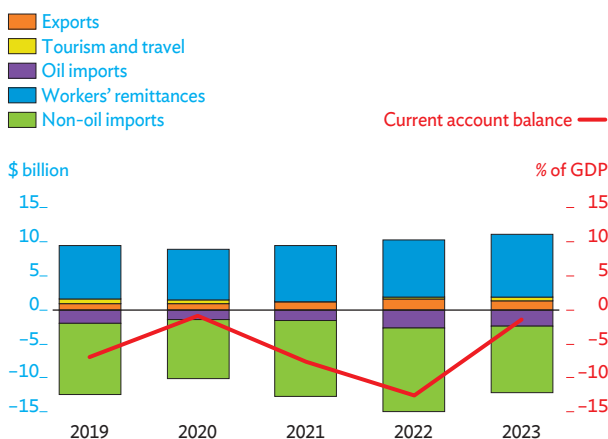


GDP = gross domestic product.
 Note: Years are fiscal years ending in mid-July of that year.
 Source: Ministry of Finance. Budget Speech 2023.

The current account deficit narrowed to 1.4% of GDP in FY2023, reflecting both an easing trade deficit and buoyant remittance inflows. Imports of goods declined because of credit controls and a ban on imports of some nonessential and luxury items. Exports of goods also decreased as India lowered its tariffs on refined edible oil imports, eroding Nepal’s advantage from its tax-exempt export of edible oil to that country. Nevertheless, the merchandise trade deficit narrowed by 22.2%. Imports of services rose on an increased number of students traveling abroad for education, but this was outweighed by rising remittances, which grew by 12.1% in FY2023 as more workers migrated for employment overseas. Consequently, the current account deficit narrowed massively by 89.2% (Figure 2.19.7). Coupled with broadly stable net financial inflows, foreign exchange reserves increased to \$11.7 billion, providing 10.0 months of import cover—a marked improvement from 6.9 months a year earlier (Figure 2.19.8). Reserves rose to \$13.7 billion, or 12.1 months of import cover, in the first 6 months of FY2024 on stable financial inflows.

Figure 2.19.7 Current Account Indicators

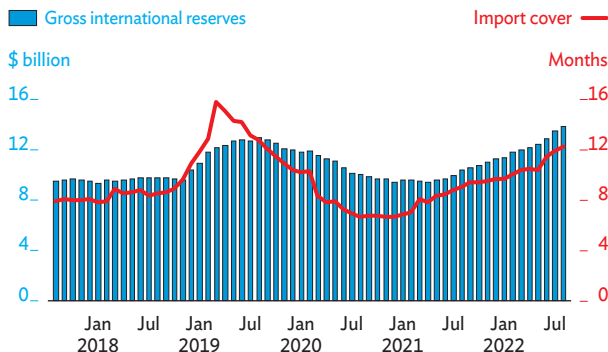
The balance of payments improved with lower imports, higher remittances, and stable financial inflows.



GDP = gross domestic product.
 Note: Years are fiscal years ending in mid-July of that year.
 Source: Nepal Rastra Bank. 2023. *Recent Macroeconomic Situation*.

Figure 2.19.8 Gross International Reserves and Foreign Exchange Adequacy

Foreign exchange reserves rose markedly in FY2023.



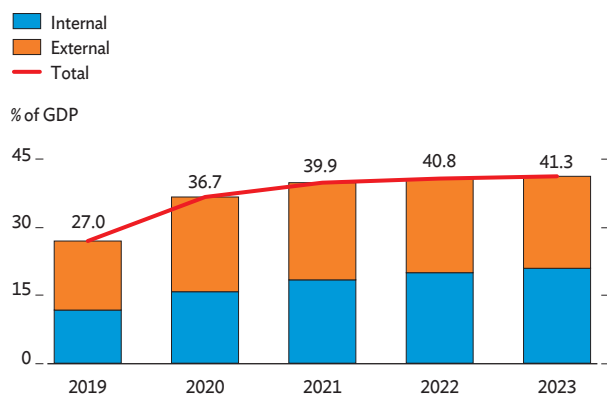
Note: Years are fiscal years ending in mid-July of that year.
 Source: Nepal Rastra Bank. 2024. *Recent Macroeconomic Situation*.

Public debt increased to 41.3% of GDP in FY2023.

Growth in total public debt has moderated since 2021 with the tapering of one-off COVID-19 expenses (Figure 2.19.9). However, domestic debt increased by 14.3% in FY2023 as the government ramped up borrowing to finance its burgeoning expenditures. External debt rose by 6.6%, and external debt service averaged 7.7% of exports during FY2019–FY2023. Despite the rise in public debt, Nepal’s risk of debt distress is low, as the ratio of external debt to GDP remains low, as does that of external debt service to exports.

Figure 2.19.9 Public Debt

Relative to GDP, external public debt has stabilized but domestic public debt has risen.



GDP = gross domestic product.

Sources: National Statistics Office; Financial Comptroller General Office; Public Debt Management Office.

Economic Prospects

GDP growth is forecast to accelerate to 3.6% in FY2024 (Table 2.19.1). The lingering weakness in domestic demand that continued in the first quarter of FY2024 will gradually dissipate in the remainder of the fiscal year as government investment outlays accelerate. Private consumption expenditure will rise as remittance inflow strengthens and prices moderate, while private investment expenditure will expand on monetary easing and financial sector reforms encouraging term loans. After contracting by 20.2% in FY2023 and a slow start in FY2024, public investment is expected to expand by 1.5% under the FY2024 budget as development projects are implemented. Overall fiscal policy will support growth despite the deficit being slated to decline to about 3.0% of GDP from 6.1% in FY2023. Exports will rise on higher electricity exports as Nepal continues to expand its

production and transmission infrastructure. However, merchandise imports, particularly of capital goods, will rise as capital expenditure ramps up, and service imports will rise on higher transport payments and travel costs for Nepalis going abroad. On balance, net exports will subtract from growth.

Gradual relaxation of monetary policy in FY2024 and improving consumer and investor confidence will stimulate economic activity.

Key areas of the economy that contracted in FY2023, notably manufacturing and construction, have begun to expand, and all production sectors are expected to grow in FY2024. Industry will grow more rapidly than in FY2023 as capital spending by the government is ramped up in the second half of the fiscal year, and as an additional 900 megawatts of hydroelectricity comes online by the end of FY2024. Service sector growth will also likely accelerate as credit controls ease, interest rates further decrease, and tourism revenues expand. Agriculture growth may increase marginally from 2.7% in FY2023 to 2.8% as a record rice harvest is tempered by a shortfall in winter crops and other agricultural production, given the expectation of deficient rainfall this season.

GDP growth is expected to pick up to 4.8% in FY2025. Increased capital expenditure and continued progress in tourism and related services will push growth higher, assuming a favorable harvest. The successful conclusion of the International Monetary Fund's third review of the Extended Credit Facility on 14 December 2023 showed Nepal's medium-term outlook to be still favorable as strategic investments in infrastructure, especially in the energy sector, will support growth.

Inflation is forecast to moderate in FY2024 and FY2025. Given expected moderation in both international oil prices and inflation in India, the deceleration of inflation that began in the first half of FY2024 is expected to continue in the rest of the year. Inflation will average 6.5% in this fiscal year and decelerate to 6.0% in FY2025, assuming that the harvest is normal and oil prices are subdued.

The current account balance is forecast to fall into deficit in FY2024 after registering a surplus in the first half of the year. As the trade deficit contracted by 4.7% year on year in the first 6 months of FY2024,

Table 2.19.1 Selected Economic Indicators, %

Growth will accelerate in 2024 and 2025 as inflation declines.

	2022	2023	2024	2025
GDP growth	5.6	1.9	3.6	4.8
Inflation	6.3	7.7	6.5	6.0

GDP = gross domestic product.

Note: Years are fiscal years ending in mid-July of that year.

Sources: Government and Asian Development Bank estimates.

and as workers' remittances expanded by 22.6% year on year, the current account recorded a surplus of \$1.2 billion. However, amid stable remittance inflows and higher imports in the remainder of the fiscal year, the FY2024 current account deficit is forecast at 0.7% of GDP. It will widen to 1.9% of GDP in FY2025 as imports increase, pushing up the deficit in goods trade, and net service payments expand on higher transport and outbound travel.

The economic outlook faces several downside risks. A downturn in the global economy would affect Nepal's tourism and remittance receipts. Any intensified geopolitical turmoil causing supply disruptions that push up global inflation and tighten global financial conditions could lead to a tightening of domestic monetary policy, undermining investment and consumption, and dragging down growth. Delays in the implementation of public projects could weigh heavily on growth as well. As Nepal is always at high risk from natural hazards, catastrophes can substantially reduce economic growth.

Policy Challenge—Trade Facilitation through Customs Reform and Modernization

Nepal needs to ramp up its trade facilitation efforts as it graduates from least-developed-country (LDC) status in 2026. Graduation will likely affect access to its traditional exports market, as Nepal will no longer enjoy preferential tariffs for LDCs. A 2022 International Trade Centre report titled *Nepal after LDC Graduation: New Avenues for Exports* indicates that graduation could result in the loss of export revenue but suggests that customs reform may offset some of these losses.

Some reforms have already been implemented since 2003. These reforms have helped align customs policies and legal documents with international best practices, automate some customs procedures, and build capacity in the customs administration. The government now plans to move toward paperless customs operations to facilitate foreign trade and make cross-border trade more cost effective and predictable, but further steps are needed.

The government should further automate customs processes and improve customs officials' productivity and the quality of physical infrastructure at border points. First, as suggested by the World Customs Organization's Framework of Standards to Secure and Facilitate Global Trade, the government should facilitate trade by strengthening automated risk-management systems to identify risky consignments even while reducing the physical inspection of goods. This requires installing equipment like scanners and sophisticated X-ray machines at customs offices. The framework recommends that the images thus generated should be tallied with customs declarations through an automated system of customs data. This will help Nepal avert risks, map new risks in key customs operations, and gather intelligence to further strengthen risk management. Second, Nepal must prioritize its training of Department of Customs (DOC) employees. The training program has already helped DOC to execute behind-the-border functions more effectively, but DOC still lacks well-trained people who can make maximum use of modern information and communications technology. Third, Nepal needs high-quality infrastructure at borders to facilitate trade. It has built dry ports in major customs points and integrated check posts, and it plans to build more check posts at major custom points. It should link these facilities with high-quality access roads to remove bottlenecks constraining cargo movement. It should also build logistics facilities such as accredited plant quarantine laboratories at appropriate locations to facilitate exports of herbs, food products, and other agricultural produce.

In sum, Nepal must pursue customs reform that includes hard infrastructure as well as soft reforms. DOC's ongoing customs reform modernization plan, 2022–2026 should be accelerated and strengthened. Requisite resources for these reforms are limited, but several development partners have provided financial and technical support with continued and renewed support to simplify, harmonize, and modernize customs procedures. Nonetheless, Nepal faces challenges to implement reforms smoothly because procurement contracts are poorly executed and DOC management changes frequently. The government should address these systemic issues to facilitate the implementation of reforms, which not only facilitate foreign trade but also help generate more financial resources for development.