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NEPAL DEVELOPMENT UPDATE

POVERTY REDUCTION AND ECONOMIC MANAGEMENT
SOUTH ASIA REGION

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THE WORLD BANK GROUP

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This report was prepared by a team composed of Aurélien Kruse, Roshan Darshan Bajracharya and Deb Narayan Mahato with inputs from Johannes Zutt, Tahseen Sayed, Johannes Widmann and Rajib Upadhya.

Summary

Nepal's political developments continue to overshadow and impede its economic development. Since the end of the monarchy, politics have trumped economics, a trend that needs to be reversed to put Nepal on a higher growth trajectory. With elections for a new Constituent Assembly expected in November, political volatility and uncertainty continue to hamper growth-oriented fiscal policies and have prompted the private sector to adopt a wait-and-see position regarding future investment. While the Government of Nepal (GoN) has tackled some of the bottlenecks (particularly with respect to budget preparation and execution) that hampered public policy in FY13, it will need to continue and expand this effort in FY14, which will be a challenging year.

Over the short term, whether the scheduled elections are held and, if so, whether they achieve a modicum of consensus will be a major test. If elections are held successfully, both public and private investments are expected to recover from the low levels seen in recent years. But increased political stability and a short-term economic recovery in themselves would not be enough to put Nepal on a solid growth path. Over the medium term, political stability needs to be followed by structural reforms that tackle enduring sources of fragility, including financial sector consolidation, public financial management reform, investment climate improvements, and a strategy to address the gradual erosion of Nepal's external competitiveness.

Political instability clouded the outlook in FY13 and remains the principal source of vulnerability going forward. The delayed adoption of a full budget in FY13 depressed public spending and negatively affected investor sentiment, while agriculture sector activity suffered from a weak monsoon. Overall, economic growth is estimated to have dipped to a relatively anemic 3.6 percent, with average inflation just under the double-digit mark.

While Nepal's macroeconomic fundamentals remain stable, sources of vulnerability have not disappeared. Despite a large – and growing – trade imbalance, the current account remained in surplus and significant foreign exchange reserves were accumulated in FY13, thanks to the countervailing impact of remittances, which continued to grow robustly (albeit at a slower pace than in previous years). However, whether Nepal's dependence on remittance income is sustainable or desirable in the long run is an open question. On the fiscal side, the combined effect of low spending and continued impressive revenue growth has allowed the government to reduce its overall stock of debt as a percentage of GDP, but low public investment also negatively affected the economy's future growth potential.

Although the financial sector has rebuilt strength, it remains an important source of weakness. All key indicators of financial sector health –credit-to-deposit ratio (CDR), exposure to real estate, non-performing loans (NPLs)– have registered significant improvements, on the back of resolute policy interventions by the Nepal Rastra Bank (NRB) though concerns about underlying asset quality data remain and accommodative monetary policy has facilitated rapid credit growth. Even so, further consolidation is needed, with key policy actions still pending or in progress, and it may also be necessary to adopt a tighter monetary stance in coming months.

Important initiatives to improve the governance environment have been taken, but these initiatives could be amplified further. In past months, the government has taken steps to address major bottlenecks to public expenditures and private sector development. These include streamlining the budget preparation/adoption process (which could be further institutionalized), undertaking high-profile anti-corruption initiatives (as part of a broader effort to strengthen public financial management (PFM)), and establishing the Investment Board Nepal, which appears to be on track to approve several transformational infrastructure projects in the coming months.

For FY14, the baseline scenario is a gradual return to trend, with higher growth and sustainable fiscal expansion. If elections are held on time and the result achieves broad consensus, macroeconomic projections point to a gradual return to economic growth of 4.0 to 4.5 percent, with inflation remaining in single digits. The government of Nepal has ample scope to increase spending, while maintaining overall fiscal sustainability targets - an opportunity that ought to be put to good use by boosting capital spending.

While important psychologically and for some sectors of the economy, the recent depreciation of the Nepal rupee is not expected to hold back growth or to threaten macroeconomic stability. Nepal does not share the twin current account and fiscal deficit problems of the Indian economy and it has important buffers against currency shocks, including most notably strong remittance inflows. That said, specific sectors of the economy will suffer. Of particular concern are (i) the financial health of major state-owned enterprises (SOEs) facing increased import costs, and (ii) possible inflationary pressures, which may need to be managed proactively. While a revision of the peg with India may eventually be warranted, the report agrees with Nepali policy makers that this is not the time – when markets are unstable – to move impulsively. Instead, such a major policy shift should be based on clear policy objectives and in-depth analysis of likely economic outcomes, including the long-term impact on Nepal's trade competitiveness.

Recent Economic Developments

Economic growth fell to 3.6 percent in FY13, as shortfalls in public expenditure depressed aggregate demand and agricultural output suffered from poor rainfalls. Political uncertainty continued to hamper industrial activity, with services providing the only source of dynamism in the economy. While fiscal balances improved, this was partly a result of low public spending, which contracted in real terms. Despite lackluster growth and fiscal contraction, inflation remained high and significantly above target. On the external side, Nepal's growing trade deficit continues to be financed by robust remittance transfers.

Economic growth slowed as political uncertainty accentuated structural weaknesses

The overall growth rate for FY13 is estimated to have been 3.6 percent, down from 4.9 percent in FY12. This weak performance is essentially due to historically low levels of activity in both the agriculture and industrial sectors, which grew respectively at only 1.3 percent and 1.6 percent in FY13. For agriculture, this was the weakest performance of the past five years and for industry an improvement only relative to FY09, when industrial output contracted (Figure 2). By contrast, services growth reached 6 percent, accounting for over 80 percent of total GDP growth.

Low agricultural output reflected adverse climatic shocks as well as undersupply of key inputs. The agriculture sector, which accounts for 34.4 percent of gross value-added, grew by just 1.3 percent in FY13, compared to 5.0 percent and 4.5 percent in FY12 and FY11. The impact of an unfavorable monsoon was compounded by shortages in chemical fertilizers during the peak planting season as public procurement of fertilizers to be provided at subsidized prices was affected by delays in budget adoption, and informal cross border trade was unable to fill the gap. Beyond its impact on overall economic growth, the poor performance of the agricultural sector is bound to have adversely impacted the incomes and consumption of some of the poorest segments of the population.

Industrial output performed only marginally better, as structural bottlenecks were compounded by weak public demand and political uncertainty. In FY13, the industrial sector grew at a weak 1.6 percent, down sharply from 4.3 percent and 3.0 percent in FY11 and FY12. Manufacturing activity growth slowed to 1.8 percent (from 3.6 percent the previous FY) as unresolved structural bottlenecks were compounded by political uncertainty. Although construction activity picked up from FY12 (1.6 percent vs. 0.2 percent growth), when the real estate bubble burst, it remained constrained by delays in budget execution, low levels of public spending on capital projects, restrictions on bank lending to the real estate sector as well as investor nervousness over possible further price corrections in Kathmandu and other major cities. In addition, the depreciation of the rupee –though modest during FY13– led to higher costs of imported inputs and raw materials.

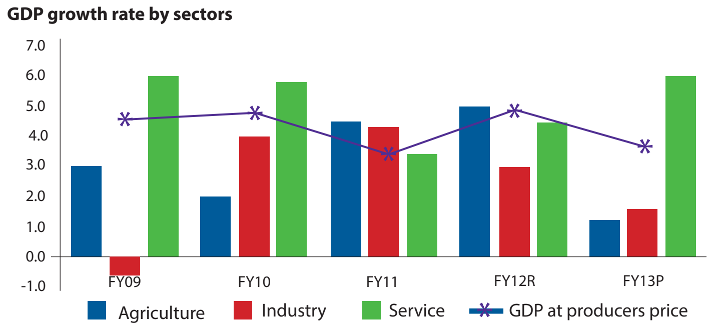
The only source of relief came from the services sector, which accounts for an ever-growing share of total value-added (Figure 2).In FY13, the services sector experienced a healthy growth of 6.0 percent, up from 4.5 percent and 3.4 percent in FY12 and FY11. Within the sector, wholesale and retail trade (+9.5 percent), hotels and restaurants (+6.8 percent), transport, storage and communications (+6.7 percent), and financial intermediation (+6.6 percent) saw considerable growth, whereas in the remaining sub-sectors (real estate and public/community services) it was more muted. Interestingly, services sector growth has been unaffected by the deceleration in remittance growth in FY13, possibly because of lag effects (Figure 3).

Cost-push inflation close to double digits

Inflation rose in FY13, reversing a trend of steady decrease since FY09. Overall inflation reached 9.9 percent in FY13, closing well above the NRB's initial target of 7.5 percent (and the mid-term revised target of 9.5 percent). It remained above 10 percent until mid-March 2013 (except in mid-January 2013 when it dipped to 9.8 percent) and moderated only in the last four months of the fiscal year. Despite the onset of the depreciation in May, inflation was down at the end of the fiscal year, reflecting seasonal trends, similar movements in Indian prices, and the ability of firms to mobilize inventories.

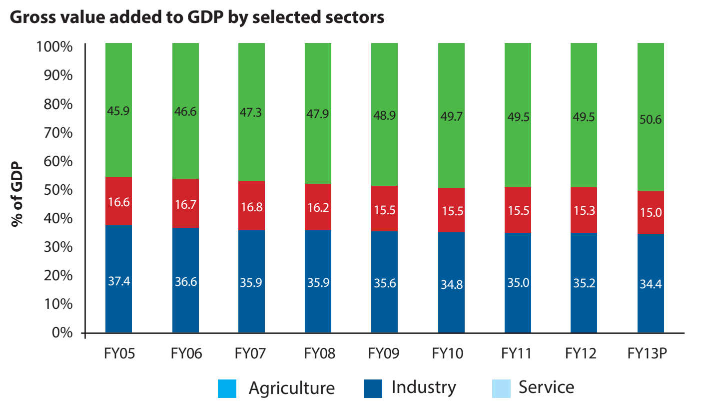
The persistence of high prices despite low growth is essentially attributable to "cost-push" factors (Figure 4). The disappointing harvest in FY13 triggered a surge in imports of food items (with imports of rice and vegetables from India growing at 98 percent and 76 percent) and an upswing in food prices, which increased by 9.7 percent in FY13, compared to 7.6 percent in FY12. In parallel, non-food prices also increased by 10 percent in FY13, compared to 9 percent in FY12. The increase was

FIGURE 1: Historically low levels of agricultural and industrial activity depressed growth in FY13



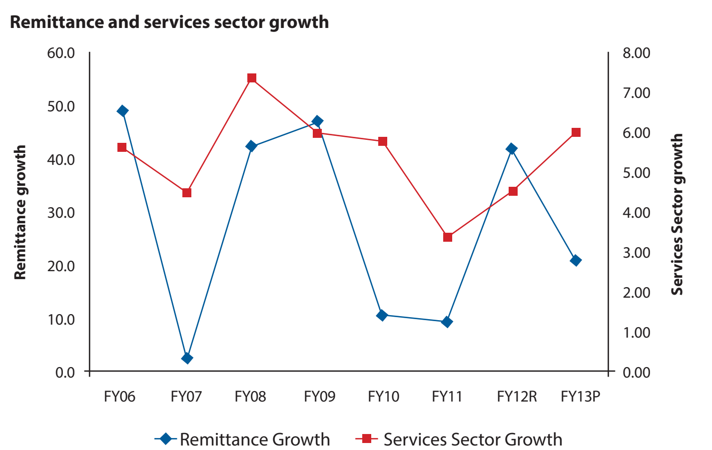
Source: CBS

FIGURE 2: Services account for over half of total value added



Source: CBS+WB Staff estimate

FIGURE 3: The services sector unaffected by lower remittance growth



Source: NRB+CBS

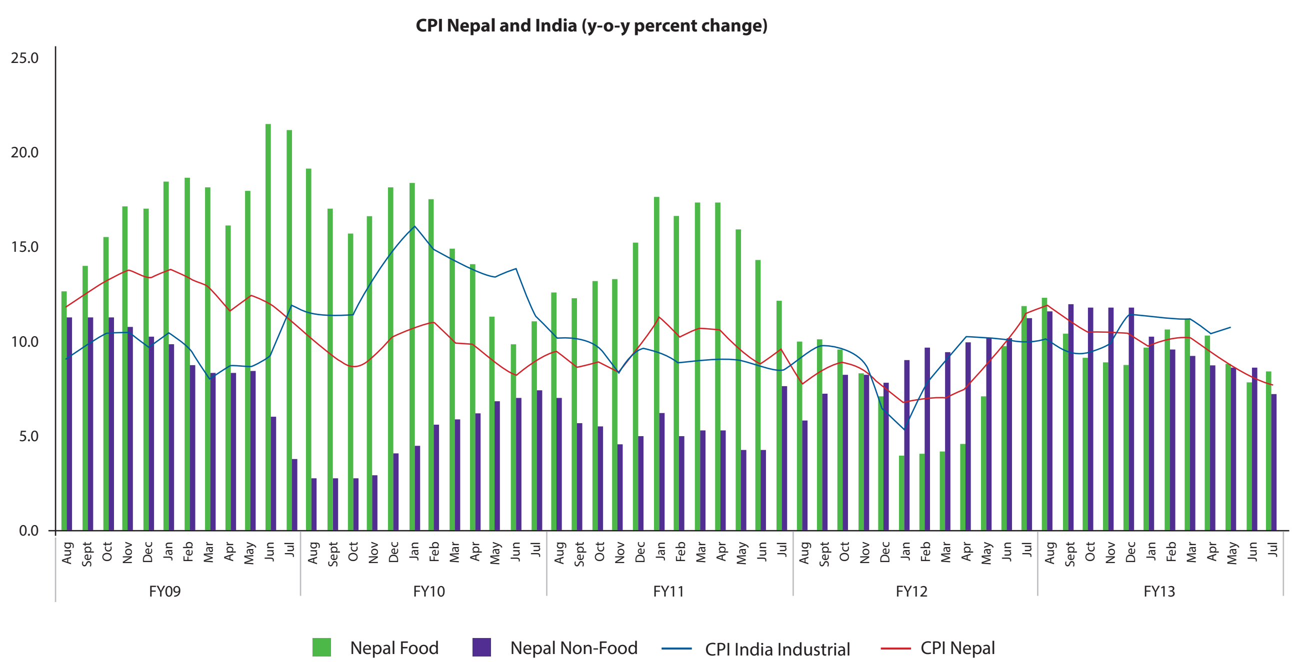
FIGURE 4: **Inflation close to double digits**

Source: NRB+WB Staff estimate

largely due to structural factors –supply-side rigidities– and adverse developments such as (i) higher prices of petroleum products (following needed increases in administered prices for diesel, petrol, and LPG in September and December 2012) that raised transport costs, and (ii) the onset of the rupee's depreciation against major convertible currencies, affecting simultaneously the price of (foreign currency denominated) imported goods and domestic costs of production (via imported inputs and raw materials).

Given Nepal's close integration with the Indian market and its currency peg with the Indian rupee, inflation in Nepal has closely followed price trends in India (Figure 5). Indeed, with the open border between the two countries, any sharp misalignment in prices –particularly of foodstuffs and petroleum products – would give rise to informal trade on a vast scale.

FIGURE 5: **Overall price movements are closely aligned to India's**



Source: NRB and RBI

A growing trade imbalance matched by robust remittance

Nepal's trade balance continued to deteriorate in FY13, with adverse developments in both exports and imports. The trade deficit reached 27.1 percent of GDP in FY13, a record low (down from 24.3 percent the year before). Export growth decelerated to a mere 3.6 percent in FY13 (compared to 15.4 percent in FY12), while imports growth rose to 20.6 percent in FY13 (compared to 16.5 percent the previous year). Merchandise imports as a share of GDP reached 32.2 percent, from 29.6 percent in FY12, while exports accounted for barely 5 percent of GDP. The structural drivers of import growth include (i) increased demand for fuel in a period of rapidly increasing prices, (ii) adverse relative prices that induced agents to substitute domestic products for foreign ones, and (iii) increased domestic demand driven by remittance inflows (Figure 6).

Growing remittance transfers are both a driver of import growth – and possibly export atrophy – and a lifeline. Workers' remittances grew by 20.9 percent in FY13 on top of the remarkable 41.8 percent increase in the previous year (in local currency terms). As a result, officially recorded private transfers amounted to over 25.5 percent of GDP in FY13 and 79.4 percent of the total merchandise import bill (over four times the oil import bill). Private transfer volumes are 13 times higher than official grant assistance received by the government. While contributing to Nepal's staggering import growth (via demand for imported consumer goods and food), private transfers are also a lifeline allowing Nepal to finance its trade deficit and maintain current account balance.

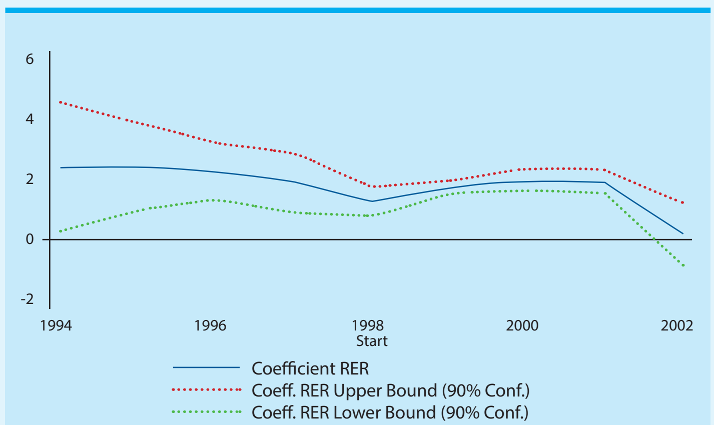
The current account remained in surplus in FY13, although by a smaller margin than in FY12. With a modest net surplus in services trade

BOX 1: Domestic agents substituting foreign for domestic products

Nepalese firms and consumers appear to be substituting foreign for domestic products. The ratio of Nepalese imports of industrial supplies to GDP has been growing from about 0.1 to more than 0.25 over the last five years, suggesting that Nepalese firms are increasingly moving to technologies more reliant on foreign inputs. Analogously, at the consumption level, the ratio of imports of consumer goods to GDP accelerated after 2008, growing from 0.1 to slightly less than 0.25 in a three-year period.

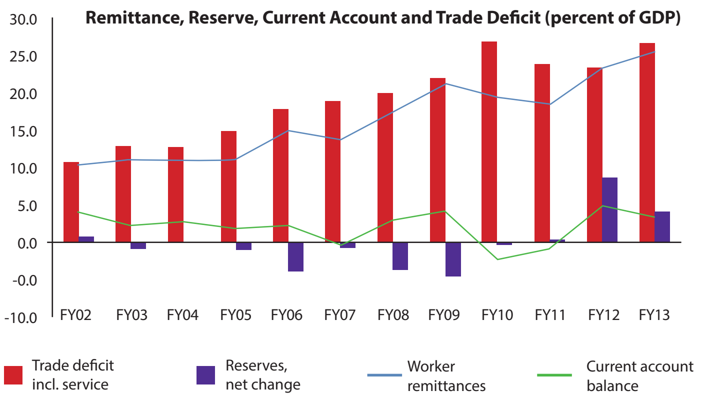
The Nepali rupee's real appreciation as a result of fast increasing domestic prices combined with the nominal exchange rate peg to the Indian rupee partly explain this dynamic. During the 2003-10 period, the ratio of the CPI to the official nominal exchange rate increased at an annual rate of 8 percent, and simple regression analysis shows a robust positive correlation between the real exchange rate (RER) and import trajectory conditional on income (GDP and remittance).

Rolling relationship between RER and imports conditional on GDP and remittance



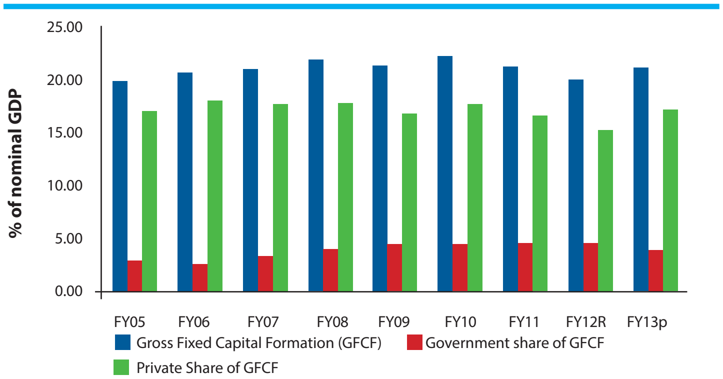
NB: Ten year rolling relationship; 2002 data point includes ten years onward (to 2012)
Source: Trade Competitiveness Assessment of Nepal, World Bank (forthcoming)

FIGURE 6: The trade deficit, growing with remittance inflows



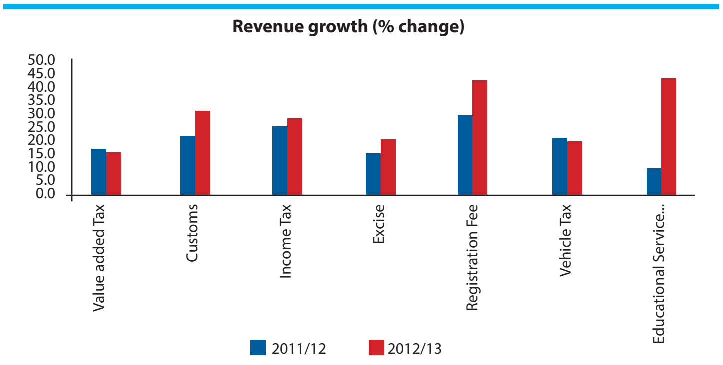
Source: NRB+WB Staff estimate

FIGURE 7: Lackluster investment over the past decade



Source: CBS+WB Staff estimate

FIGURE 8: Revenue growth driven by customs and income tax



Source: NRB

(0.45 percent of GDP) and stable net income receipts (0.77 percent of GDP), the current account surplus recorded in FY13 (3.3 percent of GDP) is almost entirely attributable to net current transfers (29.3 percent of GDP). Transfers also account for the steady build-up in gross official reserves from USD 4.3 billion to USD 4.97 billion between FY12-13. Import coverage remained at a comfortable 7.6 months of imports, up from 7.2 in FY12.

The Nepal government underspends on both recurrent and capital outlays

Nepal experienced a (real) fiscal contraction in FY13. Significant delays in budget approval (a full budget was adopted only in the fourth quarter) depressed public spending, which grew modestly in nominal terms (by 1.75 percent on a cash basis, excluding "financing" expenses) and declined in real terms. Recurrent expenditures, which accounted for 71 percent of total government spending, grew by a modest 1.55 percent in nominal terms, while capital expenditures recorded a 2.7 percent increase. As a result, public expenditure as a share of GDP declined from 19.2 percent in FY12 to 18.8 percent in FY13. Actual spending was significantly below budgeted amounts, reaching 90.5 percent of plan for recurrent expenditures and only 81 percent for capital expenditures, reflecting both some degree of fiscal responsibility (moderate recurrent spending) as well as Nepal's chronic inability to upgrade its public infrastructure, despite having ample fiscal space to do so.

Indeed, in contrast to expenditures, total revenue continued to rise sharply – above ambitious budget targets – owing to both higher imports and greater tax efficiency. Total revenue

[1] Particularly vehicles and spare parts for which the import duty ranges from 32.88 percent to 138.66 percent.

growth was above 20 percent for the second year in a row (21.2 percent in FY13 vs. 22.2 percent in FY12). Total revenue amounted to 17.4 percent of GDP in FY13, and taxes alone accounted for 15.3 percent of GDP. The increase was driven by custom receipts (31.1 percent growth on the back of sharp import value and volume growth[1]) and income tax payments (28.1 percent growth) as efforts to strengthen the Inland Revenue Division[2] continued to pay off (Figure 8). As a result, customs and personal income tax (PIT) together accounted for just under 42 percent of total revenue. While value-added tax (VAT) receipts also grew at a healthy rate (15.7 percent), their share in the total declined from 29.6 percent to 28.2 percent (Figure 9).

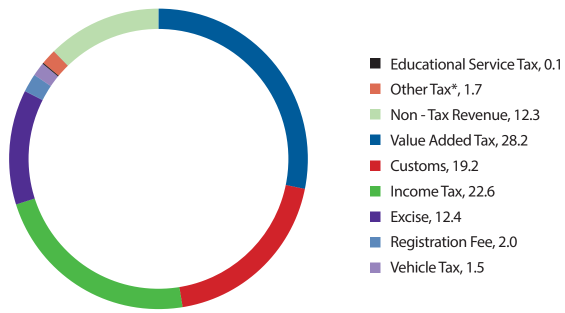
Strong revenue growth shrank the overall budget deficit (after grants) to its lowest level in years. After grants, the budget balance as reported by the NRB ended up in a deficit position equivalent to 1.1 percent of GDP – against a deficit of 1.45 percent and 3.7 percent in the preceding fiscal years[3]. Given limited alternative spending opportunities, the government chose to channel domestic borrowing to draw down previous debt.

With limited financing needs, domestic borrowing was partly channeled to retire high interest bearing debt and to cover past overdraft balances. In FY13, domestic borrowing amounted to 1.1 percent of GDP. Of that, 41.4 percent was used to cover the government's financing needs (including "financial expenditures", which increased by 51 percent in FY13 from FY12), while the remaining 58.6 percent went toward past overdraft clearance.

Overall debt levels are comfortably – and increasingly – low. In spite of low GDP growth, total public debt declined to 30.8 percent of GDP

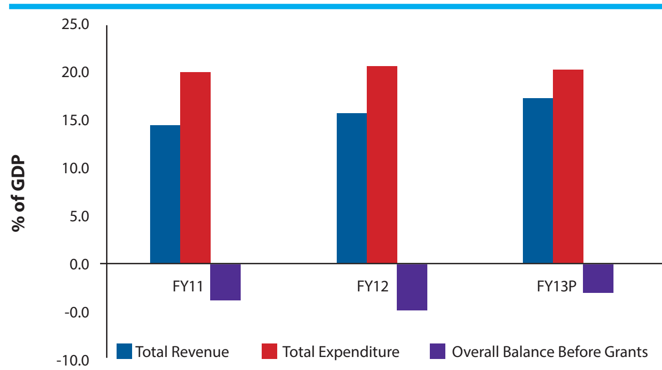
FIGURE 9: Composition of total revenue in FY13

Composition of total revenue in FY13



Source: NRB

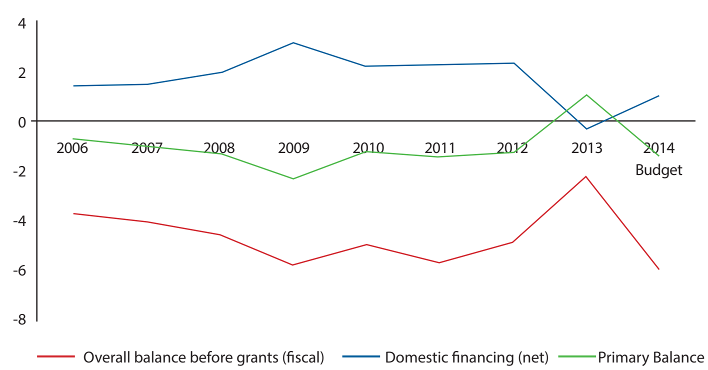
FIGURE 10: Revenue, expenditure and overall balance before grants as a share of GDP



Source: NRB

FIGURE 11: Overall and primary balance

Overall and primary balance (In percent of GDP)



Source: NRB+WB Staff estimate

2 Including measures to increase tax compliance (links to the company registrar's office) and reduce the cost (online filing and payments and Any Branch Banking Services) as well as to promote greater internal supervision.

3 Following IMF data and classification of Government Operations, the GON was a net lender in FY13 with total revenues and grants in excess of total expenditure by 2 percentage points of GDP.

(from 33.6 percent the previous fiscal year) as total domestic and external debt shrank (to 11.1 and 19.7 percent of GDP from 12.9 and 20.7 percent the previous year). While significant fiscal revenue growth has limited the need for domestic borrowing, the government of Nepal's prudent stance is also a reflection of limited productive spending opportunities, when significantly higher levels of domestic borrowing – up to 2 percent of GDP – would remain perfectly consistent with debt sustainability.

Debt service remains low and sustainable. While total debt service payments (interest and amortization) amounted to just under 9 percent of total expenditure in FY13 (1.63 percent of GDP), the external debt service (interest and amortization) accounted for roughly half – 53 percent – of the total.

Although fiscal balances are healthy, quasi-fiscal liabilities are believed to be significant. Improvements in the government's fiscal position should be welcomed with some caution as quasi-fiscal liabilities are believed to have increased significantly. The Nepal Oil Corporation (NOC) and the Nepal Electricity Authority (NEA) have been accumulating net losses for years in excess of 1 percent of GDP, which will increase further in FY14 as a result of the rupee's loss of value relative to the dollar (in which both IOC sales to the NOC and NEA's power purchase agreements with some independent producers are denominated). In parallel, the government's pension related obligations have increased to over 2 percent of GDP in FY13 with no provision to cover them.

Monetary policy

Money growth slowed in FY13. Slower remittance growth, higher imports relative to exports and a decline in foreign grants led to a slowdown in the growth of Net Foreign Assets (NFA) – to 18 percent in FY13 from 59.5 percent in the previous year. As a consequence broad money (M2) growth declined to 16.3 percent in FY13 from 22.7 percent in FY12 (Figure 12).

Financial sector consolidation is gradually paying off

The financial year ended with a significant easing of liquidity pressure, rising profits, declining reported NPLs, and an improved capital position. However, only once the results of ongoing stress tests and in-depth diagnostics of financial sector institutions are known will it be possible to confirm that risks from real estate and other credit exposure as well as vulnerability to potential loss of depositor confidence have been substantially lowered.

After increasing sharply at the end of FY12 and in the first three quarters of FY13, liquidity pressures eased. The overall credit-to-deposit ratio of commercial banks (local currency) reached a peak of 83.4 percent in Q3 before declining back to 79.2 percent (as deposits grew sharply in the last quarter in synch with public spending). This is still significantly above 76.2 percent in Q4 of FY12 as credit grew faster than deposits (21.7 percent vs. 17.7 percent) (Figure 1). Overall risk declined as only three commercial banks (9 percent market share) recorded CDRs in excess of 90 percent, compared to seven (17 percent of market share) the previous fiscal year.

With abundant liquidity, commercial banks posted record annual net profits. The commercial banking industry posted a record annual net profit of NRs 20.1 billion in the fourth quarter of FY13 compared to NRs 15.5 billon in the same period of FY12 – a year-over-year (y-o-y) growth of 30 percent. This was thanks to higher net interest income (NII – growth by 35 percent), foreign exchange earnings and write back of loans. NII accounted for 79 percent of the Total Operating Income. Based on data from 28 (of 31) banks, although the average yield declined from 11.7 percent in Q4FY12 to 10.3 percent in Q4FY13, the interest spread increased from 4.0 percent to 4.6 percent with the decline in average industry cost of funds from 7.4 percent to 5.6 percent. With an improved liquidity position, banks were able to reduce interest on deposit, while there was a lag in reduction of lending rates. One private sector bank (Kist Bank, 2.1 percent of the system) incurred a net loss of NRs 89 million due primarily to making loan loss provisions of NRs 720 million for realty sector related loans. All three state-controlled banks registered net profits (totaling NRs 4.6 billion).

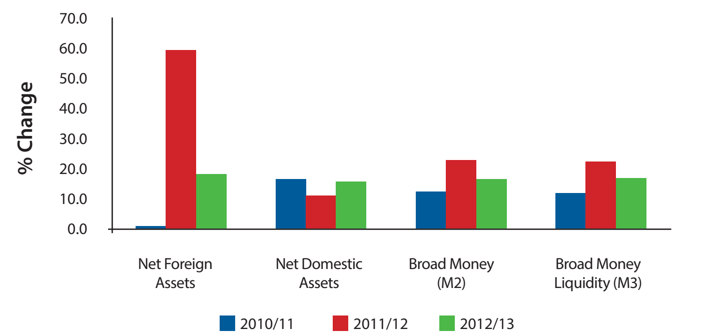
The overall capital position of the commercial banking industry has improved significantly owing to capital injections in state-controlled banks and increased retained earnings. The average Capital Adequacy Ratio (CAR) is computed as 14.2 percent compared to 12.1 percent last year. All banks meet the minimum CAR of 10 percent (plus 1 percent buffer capital) except two state-controlled banks (representing 14.8 percent of the system). These banks – NBL and RBB – have improved their CAR y-o-y from (-) 5.5 percent to (-) 0.5 percent and (-) 9.3 percent to (+) 3.3 percent respectively as a result of equity injection from the government (recapitalization plan) and operational profits.

Real estate exposure has decreased to historically low levels. Total exposure to real estate declined y-o-y from 17.1 percent to 14.9 percent of the total loan portfolio between the last quarters of FY12 and FY13 (as overall portfolio outstripped real estate credit growth –). As a result, in FY13 only six commercial banks (16 percent of the system) had exposure in real estate in excess of 20 percent as opposed to 13 banks (33 percent of the system) in the previous fiscal year. None of the banks today have real estate exposure in excess of 25 percent.

Reported non-performing loans (NPLs) have also gone down sharply as a share of the total loan portfolio. NPLs made up 2.5 percent of the total loan portfolio as of Q4FY13, the lowest

FIGURE 12: **Evolution of key monetary aggregates**

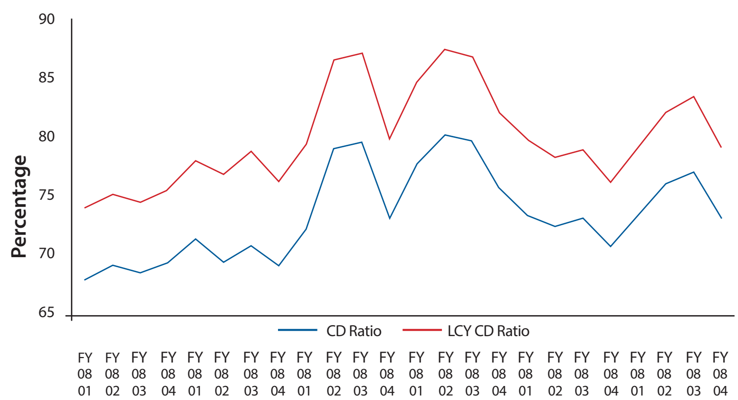
Monetary Sector (% change)



Source: NRB+WB Staff estimate

FIGURE 13: **Strong deposit growth in Q4 eased liquidity constraints**

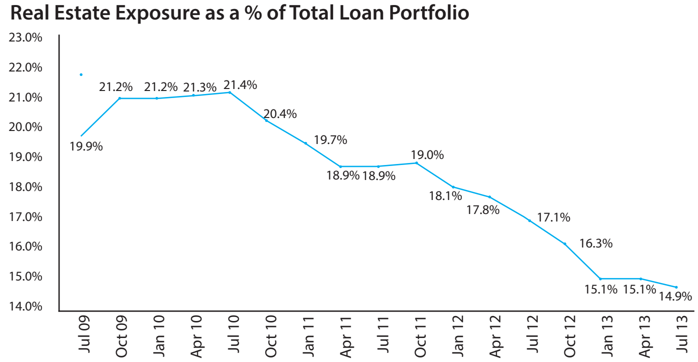
Credit-Deposit Ratio of Commercial Banks



Source: NRB

FIGURE 14: **Real estate exposure down significantly**

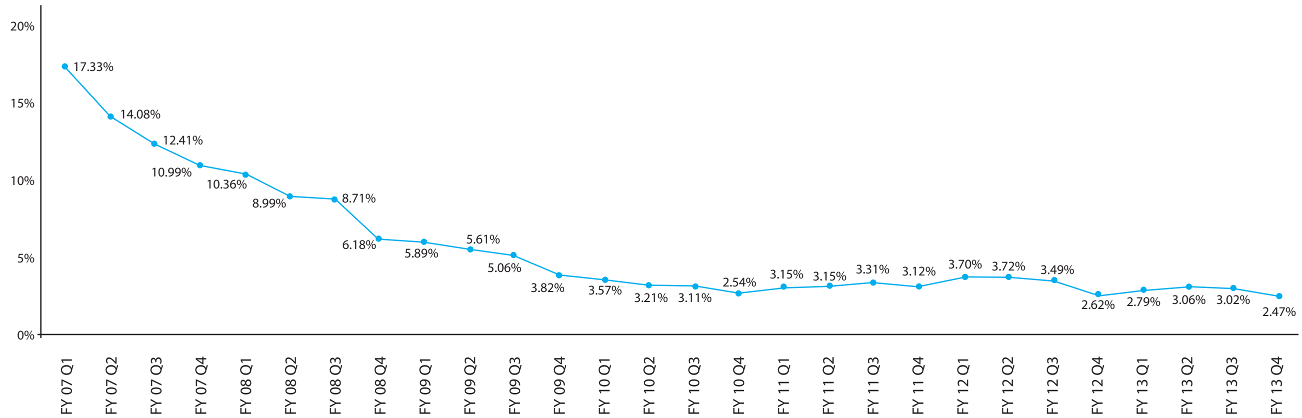
Real Estate Exposure as a % of Total Loan Portfolio



Source: NRB+WB Staff estimate

FIGURE 15: NPLs at a decade low

Total Non Performing Loan (NPL) of Commercial Banks



Source: NRB

NPL ratio recorded in the last 10 years and a further improvement from the same period of the last financial year (2.6 percent –). At the same time, there is some risk that officially reported NPL data may understate the asset quality problem owing to ever-greening and other reporting issues. Total loan loss provision coverage vis-à-vis the total NPLs is 134 percent for the commercial banking industry, although significant variations exist among institutions; three banks had coverage of less than 100 percent. Six banks (28 percent of the system) reported NPLs in excess of 3 percent, of which only two (8 percent of the system) had NPLs in excess of 5 percent, including one state-controlled banks (ADBL – 6 percent of the system). Eight banks (22 percent of the system) recorded NPLs below 1 percent of the total loan portfolio. Most of the remaining banks had NPLs between 1 percent and 2 percent. The two state-owned banks, NBL and RBB, appear to have achieved a significant turnaround in loan recovery.

With ample liquidity in the system, the cost of borrowing has remained low. High deposit and slow credit growth in the last quarter of the fiscal year brought down the cost of borrowing, with Treasury-bill (91 days) and average interbank rates falling to 1.1 percent and 0.47 percent.

Policies and Short- to Medium-term Development Challenges

Fiscal year 2013 has been exceptional, as the constitutional vacuum resulting from the dissolution of the Constituent Assembly added to overall political uncertainty and significantly hampered the budget preparation and adoption process, which both depressed investment in the economy. To some extent, this was only an amplification of deeply-rooted pre-existing structural problems, which remain to be tackled. Moreover, new sources of vulnerability have surfaced: the depreciation of the Indian rupee, to which the Nepali currency is pegged, will undoubtedly affect the Nepalese economy, of which specific segments will suffer. Managing the fallout of the rupee's depreciation will require policy makers closely to monitor macroeconomic developments and to deepen their efforts to consolidate financial sector reforms.

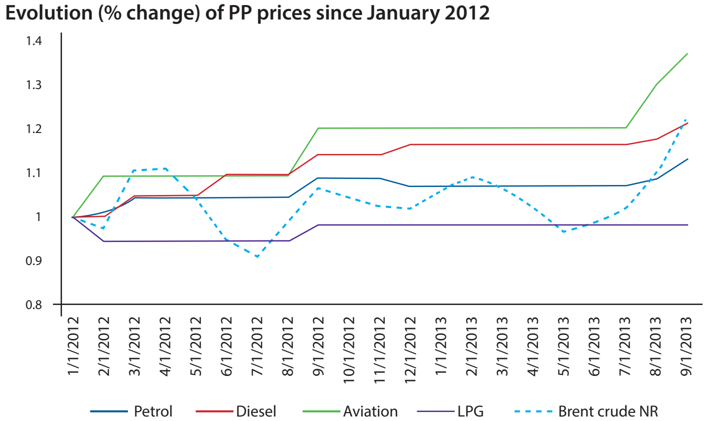
Short term challenges include (i) managing the impact of the rupee's depreciation on prices, and (ii) deepening financial sector consolidation

Although the overall effect of the depreciation of the rupee on the economy is likely to be ambiguous, policy makers will need to address specific challenges in the coming fiscal year. (Fuller discussion of this is contained in the Special Focus section below.)

The depreciation of the rupee will affect the financial health of key public sector enterprises, most notably the Nepal Oil Corporation and the Nepal Electricity Authority. While the NOC imports all of the petroleum products it sells from the Indian Oil Corporation, the IOC prices, too, vary with exchange rate fluctuations.[4] Unless the NOC is able to reflect increases in the purchase price of petroleum products into retail prices, its balance sheets will be affected negatively. Since January 2013, retail prices for petrol, diesel, and aviation fuel have been increased twice, in August and September. By contrast the retail price of LPG was left unchanged. Even at the higher prices, the NOC continues to operate at a loss equivalent to NRs 1.69 billion per month, of

FIGURE 16: NOC profits eroded by higher world prices and depreciation

Evolution (% change) of PP prices since January 2012



Source: NOC and NRB data

[4] IOC export prices for petrol and diesel are adjusted fortnightly while those of kerosene, aviation fuel, and LPG are adjusted on a monthly basis.

which 52 percent is accounted for by LPG alone (Figure 16). The tradeoff for the government to consider, therefore, is whether to absorb additional losses through the budget (via mounting quasi-fiscal liabilities) or to allow higher import prices to translate into retail prices, with an impact on overall inflation, consumer purchasing power, and operating costs faced by firms. Likewise, the NEA has power purchase agreements with independent producers, denominated in dollars, while its sources of revenue are in local currency.

Both companies are already struggling financially and are a source of large quasi-fiscal liability. The NOC and NEA alone accounted for the bulk of public enterprise net losses in FY12 (respectively NRs 9.5 billion and NRs 9.9 billion, or jointly 1.26 percent of GDP)[5]. They have also accumulated large – albeit difficult to quantify – unfunded liabilities linked to the pension benefits of their staff. There is anecdotal evidence that the two SOEs have further struggled in FY13 and FY14, as they have asked the government for exceptional lending (as recently as September 2013, a NRs 2 billion loan was made to the NOC – short of the NRs 4 billion requested – via the Citizen Investment Trust and the Employee's Provident Fund to cover debt to the IOC). In the short term, given the additional pressure put by the exchange rate on the companies' balance sheets, the government of Nepal could consider taking steps to:

- **Reduce system losses at the NEA.** NEA system losses, and therefore the cost of service, are very high at about 27% vs. 10% in comparable countries such as Laos or Cambodia; therefore reducing system losses ought to be a priority to restore NEA's financial health;

- **Rationalize the pricing of retail petroleum products, with specific consideration for poverty impacts.** While the NOC makes net profits on the sale of petrol, kerosene and aviation fuel, the bulk of losses are accounted for by diesel (which is sold at a 12.5 percent premium relative to IOC prices) and LPG (which is sold at a 5.2 percent mark-down relative to IOC prices). Given that LPG is consumed essentially by urban, non-poor households and firms, and that inflationary effects would be minimized (since LPG prices do not affect transport costs), the centerpiece of a cost recovery strategy could focus on LPG pricing. Complementarily, social safety nets could be mobilized to cushion the effect of retail price increases on the most vulnerable;

- **Bring quasi-fiscal liabilities on budget.** Until such time as cost recovery is achieved, and given Nepal's overall comfortable fiscal position, interim losses should be accommodated within the budget and a roadmap adopted for gradually clearing outstanding debt and arrears.

Another key – related – policy challenge will be to contain inflationary pressures brought about by the rupee's relative loss of value. The depreciation of the rupee will add significant pressure on prices via (i) higher prices of imports – with fuel prices translating into transport prices, (ii) higher remittance inflows – with both volume and value effects, and (iii) generally-higher inflation expectations and second-round effects via wages. Given that the government is committed to an expansionary fiscal policy (see section on short- and medium-term economic projections) to tackle the country's large public infrastructure needs and to honor a significant wage increase of civil service employees, Nepal's monetary authorities will need to closely monitor the evolution of prices and may need further to dampen the accommodative monetary policy stance followed in recent years.

[5] See ADB Macroeconomic Update August 2013, volume I #2

Financial-sector consolidation will need to be deepened, especially in a context of possibly tighter monetary policy. Tighter liquidity management by the NRB would affect the profitability of banking and financial institutions. Moreover, the impact of the rupee's relative loss of value on corporate indebtedness could raise risks in specific financial institutions via an increase in NPLs. To insulate the sector from risks and address issues in problem institutions the government will need to maintain the reform momentum. Key possible next steps include:

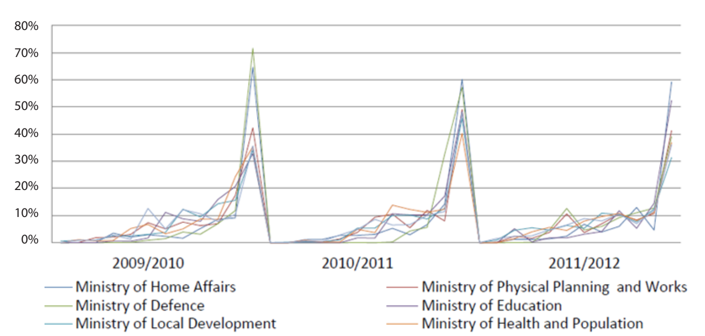
- **Enacting key pieces of draft legislation** including the revised NRB Act and the new bill on Deposit and Credit Guarantee; and building the capacity of regulatory bodies to enforce the legal/regulatory framework;
- **Developing and adopting a comprehensive Financial Sector Development Strategy,** including measures to expand access to finance, based on the findings of the upcoming Financial Sector Assessment Program (FSAP);
- **Enforcing capital requirements for banking financial institutions (BFIs),** including state-controlled institutions, by either (i) increasing paid-up capital, (ii) issuance of shares, or (iii) mergers (such as the successful merger of NIC bank with Bank of Asia Nepal); and implementing the Prompt and Corrective Action (PCA) and Problem Bank Resolution (PBR) frameworks for weak institutions;
- **Enhancing supervision of cooperative institutions,** following an internal NRB assessment that 27 cooperatives were 'troubled' and imposing caps on deposit and lending; and
- **Extending the moratorium on new class A, B, and C Banks.**

Medium term challenges involve promoting investment-led growth by (i) reforming PFM and (ii) facilitating private investment.

The sharp delays in budget adoption and implementation had important ripple effects on the economy in FY13. While delays in FY13 were dramatic – a full budget was adopted only in the fourth quarter – the extension of budget discussions well into the fiscal year and the bunching of capital expenditure near its end are recurrent problems in Nepal; similar, if smaller, delays occurred in previous years as well (Figure 17). In FY14, the government has managed to reverse this trend by adopting a full budget on time and fast-tracking the review and approval process for key capital projects by the NPC. The government could use this momentum to streamline and institutionalize these improvements, possibly by:

- **Initiating joint consultations with the MoF, NPC, and line ministries** to reach a common understanding about restructuring the budget process to promote a clearer separation between planning, formulation and execution phases;
- **Simplifying the budget release process for capital projects** through prior (to budget ap-

FIGURE 17: **Timing of capital expenditures for different government ministries, 2009 to 2012**

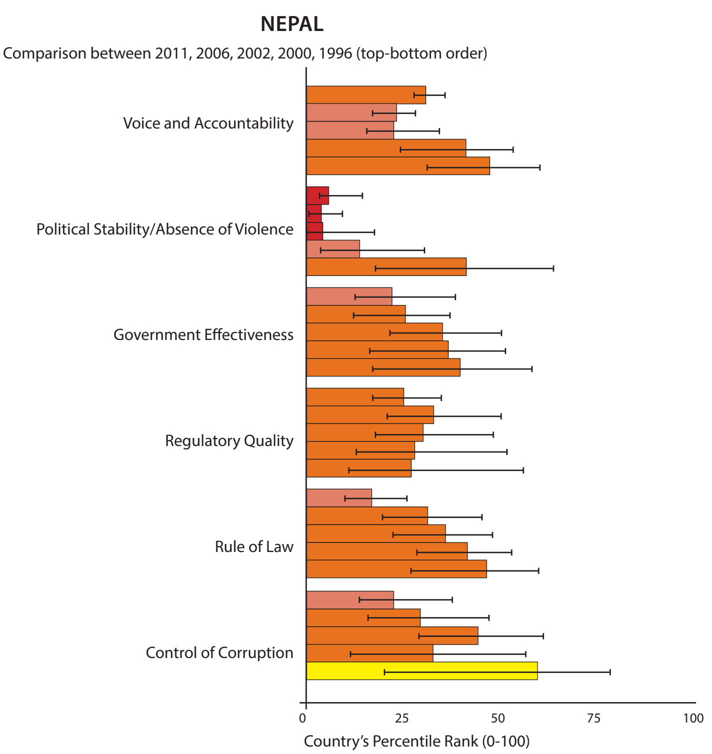


Source: ODI Operational Risk Assessment of PFM Reform in Nepal proval) completion/approval by the NPC of work and procurement plans for capital projects; and

- **Developing national-level norms for project costing.**

Removing structural bottlenecks to private investment will be a long-term endeavor, but there are important policy steps which the government can take in the short term. Firm-level surveys confirm that political instability, regulatory uncertainty, and corruption are key bottlenecks for private sector development and investment in Nepal. Indeed the country performs poorly (in the bottom quarter) on World Governance Indicators for (i) political stability, (ii) government effectiveness, (iii) rule of law, and (iv) control of corruption (Figure 19). Unsurprisingly, a 2012 regional study of firm level surveys found that political instability, electricity, transport, and corruption are the top-ranked constraints to firms in Nepal (in order of importance).

FIGURE 18: **World Governance Indicators for Nepal 1996-2011**



Source: Kaufmann D., A. Kraay, and M. Mastruzzi (2010), The Worldwide Governance Indicators: Methodology and Analytical Issues

Short-term measures to address these concerns could include:

- **Managing the electoral process.** The elections scheduled for November 2013 constitute an important milestone and test of Nepal's institutional maturity. Successful and legitimate elections would go a long way to boost private-sector confidence in the economy;

- **Maintaining and amplifying good-governance initiatives.** The appointments in 2013 of top executives to key constitutional accountability offices, including the Auditor General and the head of the Commission for Investigation on the Abuse of Authority (CIIA), are welcome signals that the government is willing to tackle corruption head on. Going forward, it will be important to maintain this momentum and empower the relevant agencies to bring wrong-doers to account;

- **Strengthening the capacity of the Investment Board Nepal.** By establishing the Investment Board Nepal (IBN) in 2011, the government sought to facilitate the identification and conclusion of public-private partnerships for large industrial and infrastructure projects. A milestone may be reached in 2013, if the IBN approves – as anticipated – a first significant investment proposal. A further test will be the IBN's ability to reach closure on a large hydroelectric project, as this would constitute a precedent and provide template agreements for structuring other such deals in the future.

Short- and Medium-term Economic Projections

The outlook for FY14 and beyond is predicated on a return-to-normal scenario, after an exceptional fiscal year. Under this baseline scenario, most macroeconomic aggregates are projected to revert to medium-term trends. That said, a number of largely unpredictable developments could significantly tilt the outlook, most importantly, the outcome of the scheduled elections and economic developments in India.

Economic growth is projected to recover from the FY13 dip to reach 4.0-4.5 percent in FY14, short of official budget and Three-Year Plan (TYP) targets. Agricultural production is expected to recover, on the back of a good monsoon and adequate supply of chemical fertilizers – with paddy planted in over 95 percent of land used for rice production, against 64 percent the previous year. Likewise, increased mechanization should boost productivity[5]. While manufacturing growth may remain subdued, the construction sector is expected to rebound, thanks in part to resurgent and timely public expenditure on capital projects. Finally a surge in remittance, reflecting both higher numbers of migrants and greater incentives to remit, could further boost services sector growth.

Remittance will continue to support services sector growth and aggregate demand. In the baseline scenario, remittance transfers are projected to grow at a rate of 7 percent (in dollar terms). This is a conservative estimate. Indeed, the number of Nepalis seeking employment abroad has continued to grow sharply over the past year, and therefore the number of potential remitters: in FY13 the number of approvals granted by the Department of Foreign Employment grew by 18 percent over the previous year to exceed 450,000. At the same time the depreciation of the Nepali rupee constitutes a strong price incentive for migrants to remit a larger share of their income, whose rupee value is higher. There is evidence from India that such price incentives are indeed powerful.

Public spending is projected to pick up sharply in FY14, although fiscal balances should remain consistent with macroeconomic sustainability objectives. Two factors should contribute to boost spending in FY14:

- **First, the proposed budget is expansionary to start with.** The total budgeted amount for FY14 is NRs 517.2 billion, which constitutes a 40 percent increase over the previous year's total. Compared with actual spending realized in FY13 (NRs 347.7 billion), the proposed budget represents a whopping 49 percent increase;
  - **Second, the efforts of the government to streamline budget preparation and execution should pay-off.** A full budget for FY14 was presented and adopted on time on the first day of the fiscal year. Moreover,

[5] According to the Department of Transport Management, registration of tractors and power tillers grew significantly in recent years (9,795 in FY13 against 4663 five years ago)

the clearance of priority capital projects by the NPC has been fast-tracked and over 90 percent of projects have already been cleared. The Ministry of Finance has furthermore begun implementing a system for real-time monitoring of budget execution and project implementation.

While recurrent expenditure is expected to grow significantly, actual spending on capital projects is likely to undershoot the – ambitious – budget targets. Recurrent spending is expected to rise "mechanically" as a result of the government's firm commitment to increase public service wages and benefits (by 18 percent) and to account for election-related expenses. The envelope set aside for capital spending (NRs 85.1 billion) amounts to 4.4 percent of GDP, which is well above the average of 3.2 percent of the past five years.

The government has set ambitious revenue targets, with the depreciation of the rupee providing an unexpected boon to the budget. The budget anticipates further significant growth in tax and non-tax revenues of 20 percent in FY14 (on the back of a 21.1 percent and 22 percent increases in FY13 and FY12). If this target were achieved, the ratio of total revenue to GDP would reach 18.3 percent, up from 15.9 percent and 17.4 percent in the preceding years. While it may not in fact be realistic to expect revenues from the PIT or the VAT to continue to grow out of synch with overall economic activity, the depreciation of the rupee against major convertible currencies combined with further growth of imports is expected to boost customs receipts significantly.

The overall deficit is expected to widen although remaining compatible with debt sustainability objectives. The overall budget deficit, before grants, is expected to reach 2.9 percent of GDP and (net) domestic and foreign borrowing to grow to 1.7 percent and 0.3 percent of GDP.

With the uptick in economic growth and resilient remittance inflows, the current account is expected to remain in surplus, but by a narrower margin. The trade balance is projected to deteriorate further, from 27.1 percent of GDP in FY13 to 29.5 percent in FY14 as export growth picks up (to 4 percent) and imports continue to rise at a rate of over 10 percent (in dollar terms). With remittance growth slowing down from 11.7 percent to 7 percent (in dollar terms), the current account is expected to remain slightly positive (0.1 percent of GDP) before grants, and 1.4 percent of GDP once transfers to the government are accounted for.

While inflation should ease somewhat, down to 9 percent, this is a conservative estimate. With food accounting for close to 47 percent of the CPI basket, a rebound in agricultural production – in both Nepal and India – is expected to significantly alleviate inflationary pressures. At the same time, adverse developments could tilt the outlook in the other direction. These include:

- **Further depreciation and/or persistent weakness of the Indian and Nepalese currencies against other currencies** raising domestic prices of imported goods and expectations of further inflation;
- **Wage pressures following the government's commitment to raise civil service salaries** (by 18 percent) and allowances (by NRs 1,000 per month) and the minimum wage for non-agricultural workers (by 29 percent), which will trickle down to the broader economy and affect production costs for firms; and
- **Election-related spending** as well as the possible disruptive effect of strikes and social movements on distribution and supply of goods.

Given planned fiscal expansion and election-related spending, monetary policy will be the main variable of adjustment to contain inflationary pressures. The monetary policy document for FY14 assumes somewhat optimistically that inflation will be contained at around 8 percent. Based on this premise, it maintains a relatively accommodative stance with total credit and money (M2) growth targets of 17 percent and 16 percent, designed to support overall economic activity and lending to productive sectors. It remains to be seen whether price stability and economic growth objectives can be pursued jointly in a context of high cost-push inflationary pressure and low productivity growth potential.

Both lending and deposit rates have remained particularly low in early FY14. On the one hand, deposit levels have grown significantly, thanks to private-transfers growth ahead of the Dashain festivals and to the rupee's loss of value relative to convertible currencies. At the same time, with the announcement of elections for November but considerable uncertainty about their outcome, investors have been postponing loan decisions for expansion and new ventures.

Looking ahead, the main sources of weakness are related to the fate of the rupee and the outcome of elections. Despite the improvement in NPLs over the past two years, the recent fall in the rupee has led to concern over corporate indebtedness and the impact on the banking sector via rising NPLs. Moreover the outcome of the elections, particularly whether it is perceived as broadly legitimate and representative, will affect investor sentiment.

Bank Support and Activities

- A Country Partnership Strategy (CPS) for FY14-17 is under preparation. The new CPS will focus on two pillars – (i) increasing economic growth and competitiveness; and (ii) promoting human resilience while addressing vulnerability – while also seeking, in a cross-cutting manner, to enhance governance, accountability and citizens' empowerment. There will also be some ten specific outcomes for Bank Group contribution. Given Nepal's fluid political situation, the CPS has been developed through extensive consultations with key stakeholders, including political parties, which are remarkably aligned around Nepal's development priorities.
- Total IDA commitments to Nepal averaged about US$1.4 billion over the past three years (FY11-13), which is a sharp increase since FY09 when total commitments were only about US$0.9 billion. Average new commitments per year during FY11-13 were about US$330 million. Under IDA16 (FY12-14), Nepal's indicative allocation is about US$634 million (with a grant/credit share of 45 percent to 55 percent). Despite its fragile country context, Nepal has maintained a relatively stable track record in IDA disbursements, better than similar countries. IDA disbursement ratios (disbursements during a fiscal year versus the undisbursed balance at the beginning of a fiscal year) have been above IDA averages for previous years and reached 33 percent in FY11 and 24 percent in FY12. While FY13 was a challenging year, due mainly to political uncertainties, IDA disbursements still reached 26 percent.

Nepal: Selected Economic Indicators – 2010-2014

	2010	2011	2012	2013 Estimates	2014 Projections
Annual percent change					
GDP	4.8	3.4	4.9	3.6	4.5
CPI (period average)	9.5	9.6	8.3	9.9	8.9
Broad Money	14.1	12.3	22.7	16.3	18.8
In percent of GDP					
Total Revenue and Grants	18.0	17.6	18.6	19.2	20.3
Expenditure	18.8	18.5	19.2	17.2	20.7
Net incurrence of Liabilities	1.8	2.0	2.2	-0.9	2.0
Foreign	0.0	-0.3	-0.2	-0.3	0.3
Domestic (above the line)	1.7	2.3	2.4	-0.6	1.7
Current Account	-2.4	-0.9	4.8	3.3	1.4
Trade Balance	-25.5	-23.4	-24.3	-27.1	-29.5
Gross official reserves (in months of goods and services)	5.4	5.8	7.2	7.6	7.7
Public Debt	35.4	33.1	33.6	30.8	30.4

Source: WB / IMF

- The current IDA portfolio comprises of 19 active projects with a net commitment of about US$1.53 billion. Current cumulative disbursements, as of August 31, 2013, amount to US$805 million (about 52.6 percent of net commitments). In addition, there are three regional projects with net commitments of US$240 million, about US$11.5 million of which (about 4.8 percent of net commitments) have been disbursed. One of the three regional projects, Nepal India Regional Trade and Transport project (US$99 million), was approved at end-June 2013. The portfolio also includes three active Trust Fund projects with commitments above US$5 million each. The total commitment of these three projects is US$87.50 million.
- The portfolio consists primarily of investment lending operations with sector-wide approaches in education and health. A Program-for-Results operation of US$60 million supports the government's objective of "providing safe, reliable and cost effective bridges" on Nepal's Strategic Roads Network. A US$30 million development policy operation, approved in FY13, will provide support to the implementation of a financial sector reform program initiated by the Nepalese authorities to reduce the vulnerability of the banking sector and increase its transparency. New projects are planned in energy, transport, and water and sanitation including additional financing for an ongoing irrigation project.

IDA engagement in Nepal contributed to development results in health, including reductions in maternal mortality, education, including increases in school enrollment and gender parity, poverty reduction, including providing safety nets to poor communities, and connectivity, including linking people to markets.

Special Focus

The Falling Rupee: Cause for Concern but no Panic

On Monday August 26 2013 a symbolic threshold was crossed when the dollar traded for over 100 Nepali rupees. This was the first time since the Nepali currency was pegged to India's at 1.6/1, in 1993. The falling value of the rupee (following the fate of India's currency) caused some alarm in the public and triggered calls from pundits and some experts to rethink the country's exchange rate policy. Policy makers have also focused on the fate of the currency with the Prime Minister carrying out "internal consultations" with MoF and NRB officials in September 2013.

This report argues that fears of serious negative economic consequences are mostly exaggerated, although some specific groups and sectors of the economy might lose out. First, we consider the basic pros and cons of the currency peg and nuance the perception that a 'falling' currency is necessarily bad for the economy. Second, we show that Nepal -unlike India – has important buffers against the adverse macro and micro effects of currency depreciation. Nonetheless, we also recognize the need to carefully manage the effect of the recent depreciation, particularly in relation to inflation and social outcomes.

How bad is it really? More than a mere realignment but no full-fledged crisis

The recent, sharp fall in the value of the rupee reflects specific weaknesses in the Indian economy, but also broader global shifts. Since the beginning of May, the Indian Rupee lost some 15 percent of its value vis-à-vis the US dollar. While the drivers of depreciation are partly internal (i.e., linked to specific weaknesses of the Indian economy), the fate of the rupee is also reflective of broader emerging market trends (as institutional investors reacted to a possible earlier-than-anticipated withdrawal of the US's quantitative easing policy and associated increase in expected returns on US investments) (Figure 19). Therefore, the perception that the Nepali rupee would have remained unscathed in the absence of a peg is speculative at best. Presumably it would have still depreciated vis-à-vis the dollar, although by less than the Indian currency.

While significant, the fall of the rupee is unlikely to translate into full blown crisis. Indeed, we are still far from observing the types of movements that accompanied the balance of payment crises of 1997-1998, (Figure 20) when exchange rates shot widely out of line with the trend. Such a scenario remains unlikely as, today, the basic fundamentals of emerging market economies (most notably the level of dollar denominated debt and levels of reserves) including India are incomparably healthier than they were in the late 1990s.

Basic pros and cons of a currency peg

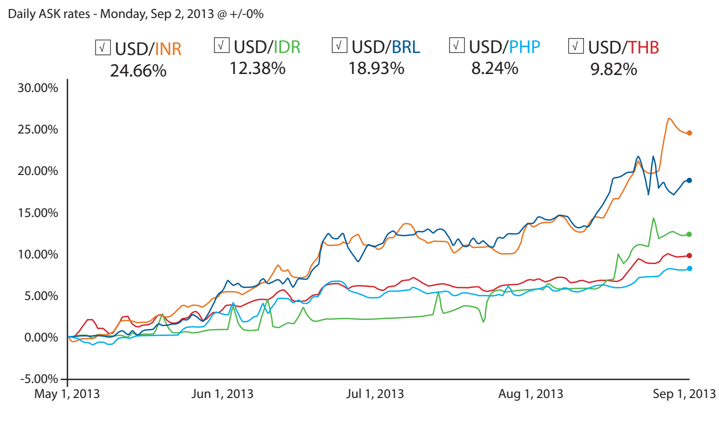
Under the currency peg, Nepal has no control of the rupee's exchange rate. Given the peg of the Nepali rupee (NR) to the Indian currency and the relative size of the two economies, movements of the NR against major currencies are entirely determined exogenously, following the vagaries of the INR. In other words, any depreciation of the INR against major currencies must be met with commensurate depreciation of the NR, despite the fact that Nepal exhibits none of the fundamental weaknesses that are behind the current crisis in India (large current account deficits, exposure to short term capital flows, a ballooning budget deficit and slowdown in growth).

But there are advantages to tying one's own hands. Currency pegs are constraining (often compared to tying one's own hands). All other things equal, this is good (i) for pairs of countries that have significant trade and investment relations, and (ii) in nations with limited ability to carry-out prudent monetary policy autonomously or high levels of perceived country risk. On the flip side, a peg can become problematic if there is a divergence in economic needs or interests between the pegging country and that to which it has anchored its currency. A recent example has been the case of Greece, committed to a strong Euro, when the state of its external current account would have required a weaker currency. In the analysis below we focus on the specific case of Nepal.

No reason to "throw the baby out with the bathwater"

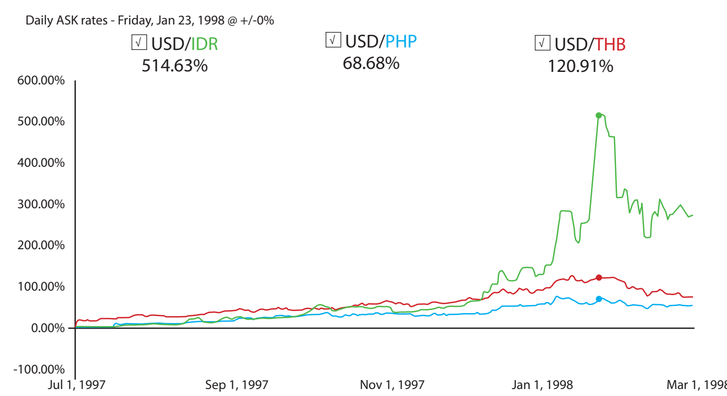
Given the significant integration of the Nepali and Indian economies, the peg makes a lot of sense. Currency pegs (and their extreme form of monetary unions) make particular sense for nations that trade intensively in goods and capital. This is because the stable exchange rate eliminates currency risk from cross-country transactions. For instance traders can agree on delayed payments without fear that the value of these payments would be affected by unanticipated movements of the exchange rate and without the need to procure sophisticated insurance against such risks. The same goes for investments whose earnings can be repatriated safely. The importance of Nepal's trade and investment relations with India was certainly at the core of the decision to establish a currency peg to start with. If anything, that rationale has grown stronger over time. Today, India is more than ever a dominant partner for Nepal, accounting for 67 percent of its exports and 65 percent of its imports (2011/12), up 20 percentage points from a decade ago. Likewise Indian investments in Nepal amounted to 32.6 percent of total FDI in FY12 (65 percent the year before).

FIGURE 19: The depreciation of the rupee is reflective of emerging market woes



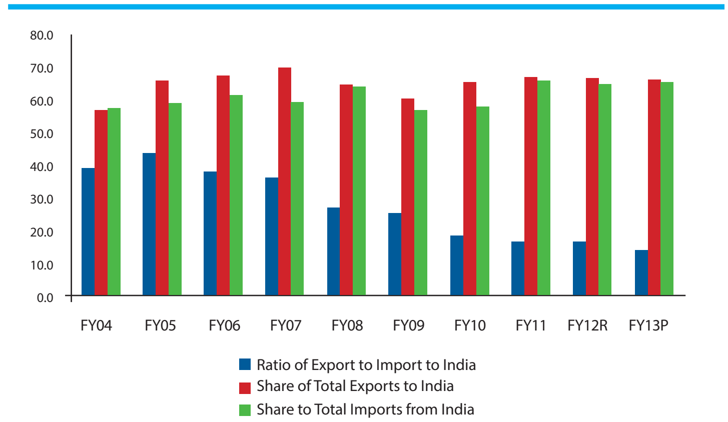
Source: Oanda (http://www.oanda.com/currency/historical-rates/)

FIGURE 20: Exchange rates during the 97-98 Asian crisis



Source: Oanda (http://www.oanda.com/currency/historical-rates/)

FIGURE 21: Evolution of Nepal's trade with India



Source: NRB

Abandoning the peg would come at a cost. Any adjustment to the peg (whether a redefinition of the peg or the decision to abandon it altogether) would sharply disturb the flow of goods and capital between the two countries by adding significant uncertainty to trans-border transaction. Moreover there is no good model to predict how well the NR would fare if delinked to its Indian homonym: while Nepal's macroeconomic fundamentals are sound, perceptions of political stability and country risk also play a large part in driving exchange rates and it can be questioned whether the NRB would be ready and trusted, tomorrow, to carry out a fully independent monetary policy.

A stronger NR vis-à-vis the Indian currency would translate into a greater trade deficit with the southern neighbor. In the current environment, the immediate effect of an exit from the peg would presumably be (i) an appreciation of the Nepali rupee vis-à-vis the Indian currency; (ii) an even greater trade gap with Nepal's neighbor (as Indian imports become cheaper in domestic currency terms), and (iii) additional stress on Nepali producers competing with Indian imports (most notably farmers who would have to lower prices or face decreased demand for their products). Ironically the end result could be greater long-term dependence on India, rather than less.

Therefore, to assess the 'opportunity cost' of the currency peg it is important to understand how the current depreciation is affecting the Nepali economy. As discussed above, the flipside of a predictable exchange rate with the INR is that the exchange rate with all other major convertible currencies is exogenously determined. Today, the fall of the Indian rupee is taking the Nepali currency along. The key question, therefore, is to determine if and to what extent the lower value of the rupee is hurting Nepal's economy.

Nominal depreciation correcting for real appreciation?

While unintended and exogenous, the rupees' depreciation may benefit the Nepali economy, though there are important caveats. The peg of the NR to the INR at a rate of 1.6/1 was decided in 1993 and not adjusted since. Arguably, in recent years the Nepali rupee was modestly overvalued. According to the IMF's November 2012 Article IV report (Figure 22), overvaluation was in the range of 9 percent (macroeconomic balance approach), 11 percent (external sustainability approach) and 16-19 percent (Purchasing power parity approach).

From that perspective, the depreciation of the NR vis-à-vis foreign currencies would amount, at least in part, to a welcome if unintended realignment with equilibrium levels. It does not address possible misalignment with the Indian currency itself but, then again, achieving greater trade competitiveness vis-à-vis India would require a depreciation/devaluation – not an appreciation – relative to the Indian currency. Given Nepal's fast growing trade deficit, a real depreciation (driven by nominal depreciation) could spell good news for the country's ailing export sector and introduce automatic adjustment mechanisms on the import side.

Impact on the current account

Currency depreciation serves to restore current account balances, but only over time. In India, the battered rupee is both a reflection and an aggravating factor (at least in the short run) of a deteriorating current account. The weakening rupee reflects growing trade imbalances: with the trade deficit ballooning, importers need more foreign exchange to purchase foreign goods while ailing exports fail to earn the country the required hard currency. Excess demand for foreign exchange over supply drives the rupee's depreciation, which is compounded by significant capital outflows. In theory, the depreciation serves to restore equilibrium: while the unit price tag of imports grows (price effect), domestic demand for imports is expected to slow (volume effect) and foreign demand for exports to grow (as domestic goods become cheaper in foreign currency terms).

However, in the short run things have to get worse before they can get better. The price effect on the import bill is immediate, while volume effects (imports and exports) are slower to materialize. This initial deterioration followed by gradual improvement is known in economics as the J curve (Figure 24).

Nepal's ability to reap the full trade benefits of depreciation is modest. The country's trade balance is heavily tilted toward imports which, in dollar value terms, are more than six times larger than exports and it is fair to assume that the elasticity of imports and exports to the exchange rate is limited. Unlike in well diversified economies that are not overly dependent on foreign sources of energy, the ability of Nepal to quickly curb import demand in response to price shocks is modest (i.e., imports are largely price inelastic). This is because domestic substitutes to imported goods (whether consumer or manufacturing) and services are limited and because of the sheer weight of petroleum products in Nepal's total import basket (Table 1). Likewise, a quick rebound in exports is unlikely given structural bottlenecks to rapidly expanding production capacity (from a very narrow base) as well as the significant import content (including oil) of export products both leading to higher domestic costs of production.

FIGURE 22: Estimated NR misalignment

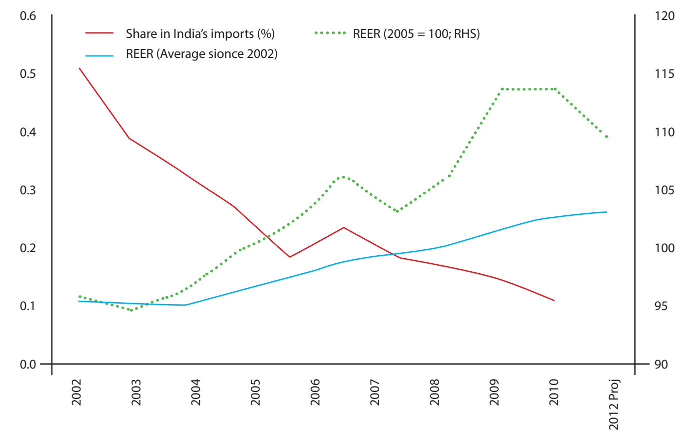
Nepal: Estimated Exchange Rate Misalignment (in percent)

	Misalignment (+ is overval.)
MB approach [1]	9.1
ES approach under alternative benchmarks (mean)[2]	11.6
Stabilize NFL-to-GDP at 3.4 percent	2.0
Stabilize ext. debt-to-GDP at 24.1 percent	17.1
Stabilize ext. debt-to-GDP at 26.9 percent	15.6
PPP approch	16.3

[1] The current account norm underpinning the derived misalignment is an average estimate from pooled and fixed-effect models in CGER.

[2] The benchmarks of 3.4, 24.1 and 26.9 represent end -2011 rations to GDP of Nepal's NFL its ext. debt, and average ext. debt of LICs.

Nepal REER and Export Share in India's Imports



Sources: IMF INS and Direction of Trade Statistics (DOTS) database.

FIGURE 23: The J curve showing the impact of depreciation (at time t) on the current account balance

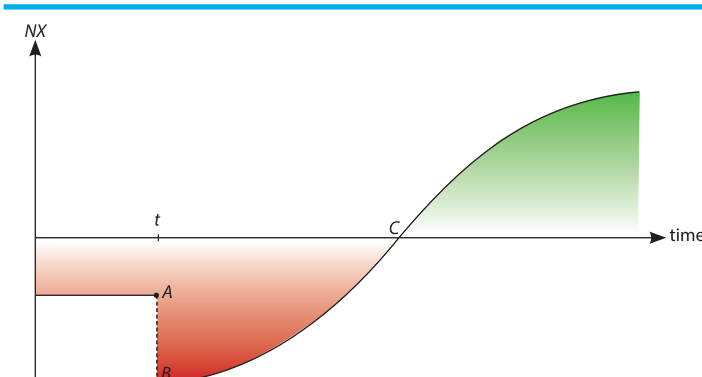


TABLE 1: Nepal's import basket, price inelastic.

Nepal Top 10 Imports from India	FY13 value (NRs million)	Currency	Existence of local substitute	Elasticity of demand
1. Petroleum products	107,138.8	Quoted in $	None	Low
2. Vehicles and spare parts	26,297.6	Paid in dollars	None	Medium
3. M.S. Billet	22,303.6	Paid in dollars	Limited supply	Medium
4. Medicine	13,337.4	Paid in dollars	None	Low
5. Other machinery and parts	12,014.3	Paid in dollars	Limited supply	Medium
6. Cement	9,425.2	Paid in INR	Limited supply	Medium
7. Chemical fertilizers	8,485.5	Paid in INR	Imperfect substitutes	Medium
8. Rice	8,455.8	Paid in INR	Limited supply	Low
9. Agric equipment and parts	7,380.3	Paid in INR	None	Medium
10. Coal	7,009.9	Paid in INR	None	High
Nepal Top 10 Imports from ROW	**FY13 value (NRs million)**	**Currency**	**Existence of local substitute**	**Elasticity of demand**
1. Gold	26,113.9	FX	None	Medium
2. Telecom equip.	13,489.4	FX	None	Medium
3. Crude soybean oil	10,627.5	FX	Yes	High
4. Silver	8,783.1	FX	None	High
5. Other machinery and parts	8,131.0	FX	Indian substitutes	High
6. Electrical goods	5,795.0	FX	Indian substitutes	High
7. Readymade garments	5,454.5	FX	Imperfect substitutes	High
8. Chemical fertilizers	4,838.7	FX	Indian substitutes	High
9. Computer and parts	4,543.3	FX	None	Medium
10. Polythene granules	4,524.6	FX	None	Medium

Source: Authors' elaboration. (Nb Imports from ROW not all for domestic consumption)

In the same boat with India but with a life jacket

While the Nepali currency's fate is tied to India's, unlike its southern neighbor, the country has important additional buffers to mitigate the macro and micro impacts of the currency shock. In India, the rupee's depreciation has (i) severely affected the overall trade balance, (ii) exposed the country to capital outflows and, as a result, (iii) its current account position has deteriorated sharply. Nepal's situation – and exposure to the currency shock – is very different in all of these respects.

First, Nepal's trade is overwhelmingly with India to begin with. Most of Nepal's trade is with India with which no exchange rate impact, by construction, will be felt. At most, imports from India may become more expensive to the extent that they themselves use imported inputs or are subject to overall inflationary pressures. All in all, therefore, the brunt of the import bill shock will be borne on imports from other nations or those imports from India, which are priced in foreign currency (i.e., dollars).

Second, relative to India, Nepal is much more moderately exposed to capital flow reversals and investor sentiment. In India, the fall of the rupee has triggered (in a reinforcing spiral) significant outflows of capital as investors seek safer havens.

BOX 2: Nepalese firms highly reliant on imported inputs

Nepalese large firms and exporters are, on average, highly reliant on foreign inputs for production. For the sample of 2006/07, a 10 percent increase in sales is associated with a 6 percent increase in the import content of sales. In fact, while the average import content of sales for small, non-exporting firms was 1.66 percent, it jumps to 2.69 percent for medium sized non-importing firms and to 15.47 percent for large non-exporting firms. For large exporters, the indicator reaches 30.46 percent. On average, the import content of sales is 7 percentage points higher for exporters than for non-exporters, and this shows in higher shares of imported inputs from third countries, rather than from India. Interestingly, unlike exporters, foreign firms do not show a higher intensity of use of imported inputs in production. This type of firms exports predominantly to the Indian market.

Exporters are particularly vulnerable to energy costs fluctuations. Reliance on diesel fuel (that increased by a factor of 2.5 on average, from 2001/02 to 2006/07) falls more heavily on exporters. Already in 2001/02, exporters displayed a higher reliance on diesel than non-exporters. Within a given manufacturing sector, the ratio of expenditure on diesel over total fuel expenditure was about 3 percentage points higher for exporters than for non-exporters. This premium increased to 6 percentage points in 2006/07. The exporter/non-exporter gap in diesel reliance is particularly high in Textiles (21 versus 11 percent) and Apparel (29 versus 16 percent) – the most important export sectors in the economy, as well as in Non-Metallic minerals (50 versus 19 percent) and Basic Metals (45 versus 13 percent).

Source: Trade Competitiveness Assessment of Nepal, World Bank (forthcoming)

In Nepal, because of its shallow capital markets and because much of the investments into Nepal take the form of FDI (more stable/virtually no portfolio investment) or trade credits and originate from India to start with, such rapid reversal is unlikely to happen. Nepal has accumulated substantial foreign currency reserves equivalent to over 5 billion dollars (over 25 percent of GDP) or 7.6 months of imports.

Finally, remittance inflows from the Nepali diaspora constitute a robust "countercyclical" buffer. At over 25 percent of GDP, remittance transfers constitute a stable source of foreign exchange. Contrary to more traditional exports, remittances can adjust quickly. For instance, there is some evidence that private transfers are significantly responsive to price incentives. Given the now higher local currency value of their income foreign workers may seek to repatriate a larger share of their income. Higher volumes of remittances would provide needed foreign exchange (macro buffer), while their higher local currency value would help insulate household from price shocks (micro buffer).

TABLE 1: Impact of depreciation on the current account

Components of the current account and the impact (price effect) of depreciation

			Effect
Trade	Imports	($ denominated)	↑
		(INR denominated)	≈
	Exports	(NR)	≈
Services	Receipts	(NR)	≈
	Payments	(INR denominated)	≈
		($ denominated)	↑
Income	Credit	($ denominated)	↓
		(INR denominated)	≈
	Debit	(NR)	≈
Transfers	Credit gov	($ denominated)	↓
		(INR denominated)	≈
	Credit private	($ denominated)	↓
		(INR denominated)	≈
	Debit	(NR)	≈

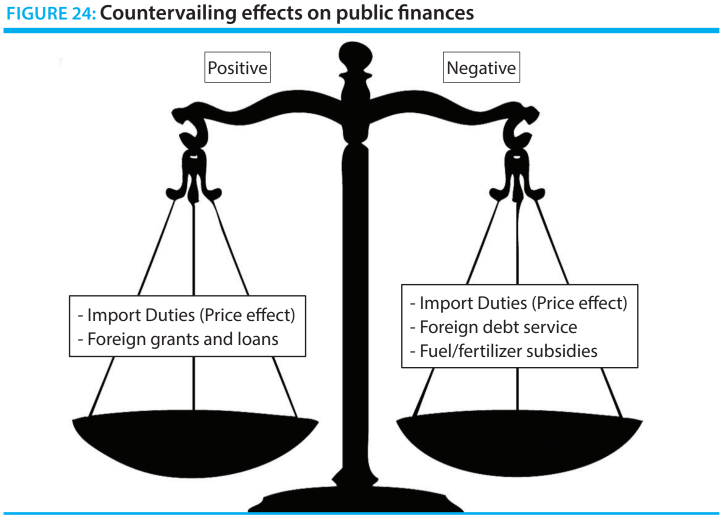
Still there are important clouds on the horizon

While Nepal is largely insulated from shocks to its current account, the weakening rupee will have an impact on the government's fiscal position and add inflationary pressures. None of these shocks are expected to have a sizeable macro or micro impact but they will require careful monitoring and management by policy makers.

Fiscal impact via subsidies and debt

Public finances may come under stress. The impact on customs revenues will depend on the relative importance of price and volume effects. However given the low elasticity of Nepal's import basket (on foreign currency denominated goods) the price effect is likely to dominate in the short run. Likewise, payments/amortization on foreign-currency denominated obligations (debt) will rise but, they will be more than offset by the rising domestic value of inflows via fresh grant and loan disbursements. Total government debt is 27.8 percent of GDP of which external debt represents 16.2 percent of GDP. Current external debt servicing costs are relatively low (total repayments amounted to 0.9 percent of GDP in FY13 and the budget allocated for foreign debt repayment in the FY14 budget is NRs 18.57 billon or 0.96 percent of GDP), as the bulk of the government's external debt is to official entities (multilateral organizations or bilateral partners) with low interest rates. Domestic bonds have been issued in FY13 (T-Bills worth NRs 19 billion) at low rates of 1.48 percent. Assuming that the government meets its budget deficit target, total financing needs would be below 2 percent of GDP and therefore, even with higher interest rates, the impact on fiscal balances would not be too severe. The most significant source of pressure will be via subsidies for fuel and fertilizers.

FIGURE 24: **Countervailing effects on public finances**



Adjusting fuel subsidies involves a delicate trade-off between fiscal, monetary and political considerations. The government subsidizes fuel and fertilizers although in largely ad hoc and therefore possibly adjustable manner. Fertilizers are provided at discounted price as part of the government's agriculture promotion programs. The actual extent of the subsidy varies from year to year depending on budgetary allocations and needs. In fact their actual amount is difficult to gauge as it is not reflected in any specific budget line (but lumped together with transfers). Likewise the government does not directly subsidize petroleum products – it does so indirectly by bailing out the NOC and by clearing increases in retail rates. With the depreciation, despite successive increases in retail prices, the NOC's monthly losses amount to NRs 1.7 billion (or annually NRs 20.4 billion amounting to over 1 percent of GDP). Therefore, a key question will be whether and to what extent the government will allow higher oil prices (in domestic currency terms) to be passed through to customers.

Corporates and banks are largely insulated. Short term external debt remains moderate and corporates need prior NRB clearance to contract foreign currency denominated debt. The largest component of this is short-term trade credits but these are largely hedged.

The risk of contagion to the financial sector via NPLs is therefore limited. After the significant stressed experienced in 2011, banks have taken aggressive steps to clean up their balance sheets (Section ii).

Inflation, poverty and social impact

The fate of the rupee has garnered such high media attention in Nepal because of its impact on the purchasing power of citizens. The depreciation of the rupee will put upward pressure on prices principally for two reasons. First, imported goods that are paid for in foreign currency will become dearer (as importers pass-on some of the loss at least to consumers). Second, inflation in India will affect the price of all tradable goods as any significant discrepancy between retail prices in the two countries would lead to informal trade and de facto arbitrage. In turn second round effects will be at work via (i) higher production prices in industries dependent on imported inputs, and (ii) expectations of further depreciation / inflation affecting wage demand in the public and private sectors.

The price of petroleum products in particular has a tangible effect. Higher fuel prices directly

TABLE 3: **Main items in the consumption basket of Nepalis**

	Share of Total Consumption (Percent)		
NLSS ITEMS	**Poor**	**Non-Poor**	**All**
Coarse rice	19.4	7.4	8.7
Rent Housing	7.2	13.4	12.7
Wheat flour	4.8	1.8	2.2
Educational and professional	4.4	8.6	8.1
Milk	3	3.6	3.5
Maize flour	2.9	0.8	1
Mustard oil	2.8	1.8	1.9
Ready-made clothing and a	2.6	2.5	2.5
Cloth, wool, yarn	2.2	1.6	1.7
Chicken	2.1	2	2.1
Potatoes	1.9	1.3	1.4
Mutton	1.9	2.3	2.3
Cigarettes	1.7	1.1	1.2
Wine	1.6	1.1	1.2
Fine rice	1.5	3.4	3.2
Lentil (Musuro)	1.5	1	1
Public transportation (buses, etc.)	1.4	2.4	2.3
Ghee	1.3	1.5	1.4
Millet	1.2	0.3	0.4
Curd/Whey	1.2	1.1	1.1
Green leafy vegetables	1.2	0.9	0.9
Fish	1.2	1.1	1.1
Beer/jandh	1.2	0.8	0.8
Kerosene oil	1.2	1.8	1.7
Footwear (shoes, slippers	1.2	1	1
Maize	1.1	0.5	0.5
Buffalo meat	1.1	0.8	0.8
Sugar	1.1	1.1	1.1

Source: Nepal Living Standards Survey 2010-11 affect the price of transport (for households and firms alike) and production costs for firms. The extent to which the authorities allow administratively controlled prices, including fuel and indirectly transports, to reflect higher purchase prices will affect the pass-through. So far price increases have been modest – since May 2012, retail prices of petrol, kerosene and LPG have increased by 8 percent, 15 percent and 4 percent respectively – and most of the burden has been absorbed by the government/NOC.

From a social point of view the key is to understand how inflation will affect the purchasing power of poorer households specifically. In Nepal the vast majority of poor households are rural and 'local' consumers of food products which account for 67 percent of the total consumption basket of a poor family. Nepal's poor tend to consume relatively less imported goods (other than food). Rising transportation costs would have a marginal effect as public transportation accounts for 1.4 percent of the consumption basket of the poor, although the urban poor (a fraction of the total) may be much more severely impacted. All in all, from a social standpoint the quality of the harvest and strength of agricultural output will be the single most important determinant of well-being in FY14.

Winners and losers: the impact on the private sector

Although the overall impact on the economy is ambiguous, the depreciation of the currency will create winners and losers. The table below summarizes the effect on households and firms.

Conclusions and policy options

From the discussion above it is not clear that Nepal is losing out from the current weakness of the Indian currency. While (some) consumers will be hurt in the short term by rising prices for imports, the overall effect will be overcompensated

TABLE 4: Winners and losers from depreciation

Firms	Winners	Losers
Energy intensive activities		Higher prices of fuel impacting production costs
Firms reliant on imported inputs		Higher domestic price of imported inputs
Import competing industries	Domestic price advantage relative to foreign competitors	
Firms with $ denominated debt		Higher cost of debt servicing affecting balance sheets
Services	Greater demand via remittances	
Households	Winners	Losers
Urban households		Higher transportation costs and price of imported goods
Rural households	Net food producers gaining from higher food prices Limited exposure to transport costs Limited exposure to price of imported goods	
Remittance receiving households	Higher local currency value of remitted income	
Remittance sending households (students)		Higher local currency cost of foreign expenditure
Net borrowers		Higher interest rates (all other things equal)

by the more-than-proportional increase in the local currency value of remittances. Moreover, the Nepali rupee's depreciation – if it is followed up by structural reforms – could help address the steady decline of Nepal's export and import competing industries.

In the short run, in the absence of a well thought out plan and in a context of significant remaining political uncertainty, abandoning or revising the peg appears to be a risky strategy. Instead the authorities should adopt mitigation/management strategies including:

- Closely monitoring inflation, particularly on items prominent in poor people's baskets;
- Maintaining a tight, and possibly tighter, monetary policy so as to avoid too wide a spread with India;
- Carrying out a detailed assessment of the NOC and NEA, including pricing policy and subsidies;
- Updating existing calculations of RER equilibrium and developing exchange rate policy scenarios in the context of a thorough assessment of their economic –particularly trade competitiveness- impacts.

The depreciation could be used as an opportunity to revive Nepal's ailing export industries and activities. While the country has lost market share over the years in its most important export products and markets the variety of its export basket has doubled since the mid-1990s, meaning that there is a broad export base from which export-led growth could be triggered. While the nominal depreciation of the rupee can provide a short term boost to import competing and exporting industries, translating such short term gains over time will only be possible via structural reforms to address the weak business climate.

The World Bank Group
Nepal Office
P.O. Box 798
Yak and Yeti Hotel Complex
Durbar Marg, Kathmandu, Nepal
Tel.: 4226792
Fax: 4225112
Email: infonepal@worldbank.org

www.worldbank.org/np
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