Nepal Development Update

APRIL 13, 2022

WORLD BANK GROUP

Global Challenges and Domestic Revival

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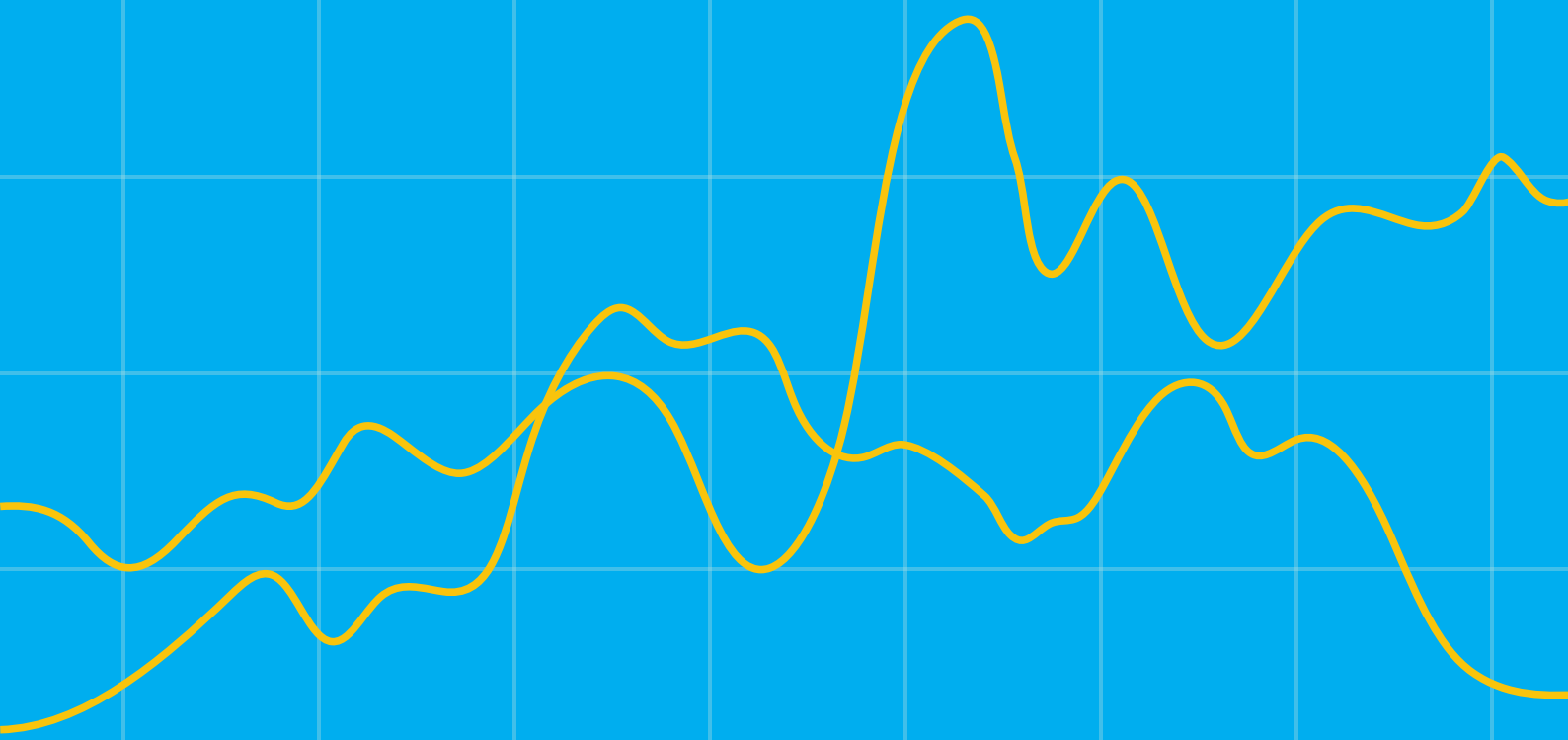
NEPAL DEVELOPMENT UPDATE

April 13, 2022



Acknowledgements

The Nepal Development Update is produced once a year to report on key economic developments that occurred during the year, placing them in a longer-term and global perspective, and to examine topics of particular policy significance. The Update is intended for a wide audience including policy makers, business leaders, the community of analysts and professionals engaged in economic debate, and the general public.

This Update was produced by the World Bank Macroeconomics Trade and Investment (MTI) team for Nepal consisting of Alice J. Brooks (Senior Economist, MTI), Nayan Krishna Joshi (Economist, MTI), and Florian Blum (Senior Economist, MTI). Inputs were also received from Nethra Palaniswamy (Senior Economist, POV). The team thanks Zoubida Allaoua (Regional Director, Equitable Growth, Finance, and Institutions (EFI), South Asia Region), Faris Hadad-Zervos (Country Director for Maldives, Nepal and Sri Lanka), Lada Strelkova (Manager, Operations), Shabih Mohib (Practice Manager, MTI), and Tae Hyun Lee (Lead Country Economist, EFI) for their guidance and comments on the report. Akash Shrestha managed media relations and dissemination. Anima Maharjan managed the publication process.

The cutoff date is March 31, 2022, and includes data released up until that date.

Abbreviations

BFIs	Banking and Financial Institutions
CY	Calendar Year
DSA	Debt Sustainability Analysis
ECF	Extended Credit Facility
FDI	Foreign Direct Investment
GRID	Green, Resilience, and Inclusive Development
H1FY	First Half of Fiscal Year
INR	Indian Rupee
IRC	Interest Rate Corridor
kWh	Kilowatt hour
LPG	Liquefied Petroleum Gas
M2	Money Supply
NPR	Nepali Rupee
NPB	National Project Bank
REER	Real Effective Exchange Rate
SDR	Special Drawing Rights
USD	United States Dollar
VAT	Value Added Tax

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EXECUTIVE SUMMARY

Recent Economic Developments

Nepal continues to struggle with the COVID-19 pandemic, but the ongoing COVID-19 vaccination drive has helped to reduce the fatality rate. The country experienced a first wave in March 2020, a second wave in mid-April 2021, and a third wave in January 2022. In response, social distancing measures were imposed but gradually became less stringent as COVID-19 progressed from the first to the third wave, driven in part by the COVID-19 vaccination drive that began in January 2021. Vaccination also contributed to a reduction in the fatality rate. As of March 2022, more than 60 percent of the population has received two doses of COVID-19 vaccines.

High frequency indicators suggest that the economy continued to recover in the first half of FY22 after rebounding in FY21 from a contraction in FY20. The services sector is estimated to have been a primary driver of growth in the first half of FY22, with mobility data indicating a strong recovery in wholesale and retail trade, transport, and financial services, supported by an increase in vaccinations and continued COVID-19 related fiscal and monetary stimulus packages. Tourism and tourism-related activities have also recovered with a rise in international tourist arrivals, although they remain below pre-pandemic levels. The industrial sector also contributed to growth on the back of higher installed capacity of electricity, including from the recently completed Upper Tamakoshi Hydropower Project (456 MW). However, the agricultural sector is estimated to be a drag on the growth due to a significant drop in main season paddy production following unseasonal rains in October 2021.

Labor market exposures to the COVID-19 crisis in Nepal were significant, and vulnerable households in Nepal face the risk of falling back into poverty. New analysis based on the SAR COVID-19 phone monitoring survey[1] suggests that job recovery, for those who lost jobs during the pandemic, was low and accompanied by a decline in job quality and earnings. Of those employed in January 2020, 52 percent experienced a job or earnings loss during the first COVID-19 wave in 2020, the highest in the region. While men and women experienced a similar overall shock, more women reported permanently losing a job (30 percent versus a 23 percent for male workers), and the employment effects were concentrated amongst women and younger age cohorts. Inflation will increase the cost of basic needs, which will adversely impact the poor and vulnerable, although this may be partially mitigated by rising remittances.

Inflation is accelerating due to higher non-food inflation. Non-food price inflation rose with higher transportation prices associated with the increase in global fuel prices, alongside increased educational fees, and housing prices. However, food inflation slowed reflecting a continuation of lower vegetable price increases. Government policies to subsidize the electricity tariff for lower-income households and liquefied petroleum gas prices has helped to keep inflation manageable despite increasing global commodity prices.

Private sector credit growth remained strong in the first half of FY22, and efforts have been taken to reduce the pace of credit growth. Credit expansion was broad-based with credit to the agriculture, industry, and services sectors all increasing in an environment of accommodative monetary policy. At the product level, overdraft, real estate loans, and vehicle loans were primary drivers of private sector credit growth. However, deposit growth remained low in the first half of FY22, leading to a considerable gap between credit and deposits, and consequently a liquidity shortage for banking and financial institutions. In response, the central bank raised its policy rate by 2 percentage points in February 2022 to 5.5 percent, higher than the pre-pandemic rate of 5 percent.

Higher merchandise imports and lower remittances contributed to a widening of the current account balance. The current account deficit widened in the first half of FY22 to 7.9 percent of projected GDP, up from 1.2 percent of GDP in the same period of FY21, as remittances declined, and imports continued to grow. In the absence of significant FDI inflows, the current account deficit was largely financed by trade credits, external concessional loans, and reserves drawdowns. As a result, foreign exchange reserves fell to United States dollar (USD) 9.9 billion in mid-January 2022 from USD 11.8 billion in mid-July 2021, equivalent to 6.6 months of imports and below the central bank's target of 7 months.

Fiscal revenue growth remained relatively strong in the first half of FY22, the fiscal balance improved, and debt declined as a percentage of GDP. Revenue collection expanded on the back of strong import growth and a recovery in housing and stock markets. Recurrent spending also expanded as public social assistance payments – including those for senior citizens, single women, widows, and child protection – were increased by 33 percent, and more conditional grants were devolved to subnational governments. However, capital spending declined marginally due to a delay in FY22 budget implementation, thereby limiting overall spending growth. As a result, the federal fiscal balance recorded a surplus, as in the first half of previous fiscal years. Following the fiscal surplus, debt declined to 38.2 percent of projected FY22 GDP from 48.1 percent of GDP in end FY21. Nepal continues to remain at low risk of debt distress.

[1] Conducted during the latter half of 2020. The data covers 6389 individuals in Nepal, about half of which were a follow up to previous representative rural panel survey, the Household Risk and Vulnerability Survey implemented over 2016-18.

Outlook, Risks, and Challenges

The Russia-Ukraine conflict presents new challenges. While Nepal's direct trade with Russia and Ukraine is limited, higher global commodity prices are expected to increase the costs of fuel, agricultural products, metal, and mineral imports. These higher prices are expected to widen the current account deficit, reduce the growth rate, and increase inflation. A conservative estimate is that the current account deficit as a share of GDP will widen by around 1.5 percentage points in FY22 and FY23 relative to the January 2022 forecast. Transportation prices, construction costs, and other consumer prices are rising which will dampen overall demand and in turn reduce the real GDP growth rate by an estimated 0.2 and 0.6 percentage points in FY22 and FY23, respectively. Services exports are expected to be less affected given the relatively low share of tourist arrivals from these two countries. On the bright side, higher fuel prices may lead to stronger demand for migrant workers in the oil exporting GCC countries, and consequently an increase in remittances.

Taking into account the impact of the war, the Nepali economy is expected to recover gradually over the medium-term under a baseline scenario. Assuming the absence of new nationwide strict containment measures, a near complete vaccination of the eligible population by the end of FY22, and a gradual increase in international migration and tourist arrivals, the economy is projected to grow by 3.7 percent in FY22, accelerate to 4.1 percent in FY23, and rise further to 5.8 percent in FY24 close to its estimated long-term potential growth rate. Higher commodity prices, recently spurred by the war in Ukraine, are expected to increase construction costs as well as consumer prices, dampening overall demand and in turn reducing growth by an estimated 0.2 and 0.6 percentage points in FY22 and FY23 as compared to previous projections. Inflation is expected to average around 6 percent annually in the medium term.

The current account deficit is projected to narrow over the medium term after widening in FY22. The current account deficit is expected to widen in FY22 reflecting higher merchandise imports and lower remittances, and narrow thereafter. The forecast anticipates a moderation in merchandise imports, reflecting the completion of most post-2015 earthquake reconstruction and the gradual replacement of imported fossil fuels by electricity use in households and firms as the country generates an additional 4,000 MW of hydropower electricity. Remittances are expected to stabilize as a share of GDP, supported in part by new overseas employment opportunities. Goods exports are expected to grow in FY22 as Nepal continues to take advantage of tariff exemptions on exports of palm and soybean oil to India under the South Asian Free Trade Area agreement. An increase in electricity exports under an energy exchange and trade agreement with India is expected to drive merchandise export growth from FY23 onwards. Services exports and imports are expected to recover robustly but remain below their pre-pandemic levels through FY24.

The fiscal deficit is projected to continue falling in the medium term. Revenues are expected to remain strong due to growing import-related revenues, efforts to widen domestic tax bases, stronger economic activity including the recovery of tourism, and a rollback of COVID-19 related tax breaks beginning in FY23. Expenditures are likely to peak in FY23 due in part to electoral spending, and then decline from FY24 onwards as COVID-19 related support programs are unwound and measures to reduce duplication of spending responsibilities across levels of government are enacted. As a result, the fiscal deficit is projected to narrow in the medium term. Total public debt is expected to reach 43.1 percent of GDP in FY22 and rise further to 44.5 percent of GDP by FY24. However, the country's debt is expected to remain sustainable.

A downside scenario highlights growth and fiscal risks. A downside scenario considers a situation in which the central bank uses stronger import control measures to maintain foreign exchange reserve cover at 7 months of imports and in which expenditure consolidation progresses less swiftly than projected under the baseline. This scenario results in adverse growth impacts following the import contraction, depressing domestic output as well as consumption. Limited spending consolidation could also result in reduced capital spending to compensate for persistent elevated recurrent spending, which could depress growth further. The fiscal deficit would be larger under this scenario reflecting higher spending and a decrease in import-related revenues, which would jointly lead to substantially higher debt levels.

The economic outlook is subject to additional downside risks. A new COVID-19 variant reducing vaccine effectiveness could require the re-imposition of stricter containment measures, weakening the rebound momentum. Climate-related and natural disasters are a perennial risk which could impact agricultural production, government finances, and consumer prices. The unwinding of accommodative fiscal and monetary policy will need to be carefully sequenced to avoid large shocks to the private sector.

Staying the course on policy reforms to address fiscal imbalances, improve spending efficiency, accelerate private sector growth and bring into focus the pandemic's impact on the financial sector can help mitigate downside risks. The government has committed to efforts to improve revenues and reduce spending while continuing to protect the vulnerable. Efforts are underway to allow subnational governments greater flexibility in their use of conditional grants, which can raise their low budget execution rates and provide greater responsiveness to local needs. Simplified approval procedures can help attract foreign direct investment to Nepal to support job creation and growth. Revised financial sector regulations will strengthen identification of non-performing assets and provide clear guidance on restructuring and rescheduling. Maintaining traction on these and other ongoing reforms is important as the country's fiscal space has been reduced and households are yet to fully recover from the past two years' job losses and border closings.

Revenues are expected to remain strong due to growing import-related revenues, efforts to widen domestic tax bases, stronger economic activity including the recovery of tourism, and a rollback of COVID-19 related tax breaks beginning in FY23.

The economic scars from two years of the pandemic run deep, and the policy response must be bold. Recovery of tourism and services exports remain muted, job losses have been extensive, and buffers have been reduced to meet large financing needs. The government has done an admirable job providing vaccinations to a large swath of the population, but more can be done on economic reforms to stimulate the domestic economy. Encouraging foreign direct investment (FDI) inflows, currently the lowest in the region, would not only support foreign exchange reserves but also make the private sector more competitive through skill transfers and know-how. A more dynamic and competitive private sector will boost production for both domestic and external markets and create jobs. FDI has the added benefit of not adding to the country's debt[2] and reducing pressure on foreign exchange reserves, thus mitigating the risks that further import and capital flow restrictions could have on growth. As households and firms confront the challenges of a warming climate and a nascent economic recovery, the government's commitment to a green, resilient, and inclusive development (GRID) approach should build a foundation for greener and more resilient growth ensuring that no one is left behind.

[2] Excluding the portion of FDI represented by inter-company loans.

A. Recent Economic Developments

A.1 Context

Global activity rebounded in 2021 after a COVID-induced contraction in 2020. The global economy is estimated to have expanded by 5.5 percent in 2021, the highest rate in 80 years.[3] South Asia and the Gulf Cooperation Council countries – the main recipients of labor migrants from Nepal - are also estimated to have recovered from the pandemic, with growth estimated at 7 and 2.6 percent, respectively, in 2021.[4] Prior to the war in Ukraine, the global recovery was forecast to continue in 2022 with an expected growth of 4.1 percent.[5] Current estimates suggest that the war will lower global growth and increase inflation due to the two countries' significant share in the global market for select commodities.[6] The magnitude of the economic impact is highly uncertain, and will depend on the duration and severity of the war.

In addition to volatile global growth, Nepal continues to struggle against the COVID-19 pandemic. Nepal was first hit by the pandemic in March 2020 which led to a strict nationwide lockdown through July 2020. Localized lockdowns followed in various municipalities including the Kathmandu Valley in late August 2020 with restrictions on land and air transportation, educational institutions, and tourism. Movement restrictions and other social distancing measures helped to reduce the number of daily new cases from 3,000 in October 2020 to less than 100 cases

[3] World Bank. 2022. Global Economic Prospects, January 2022. Washington, DC.

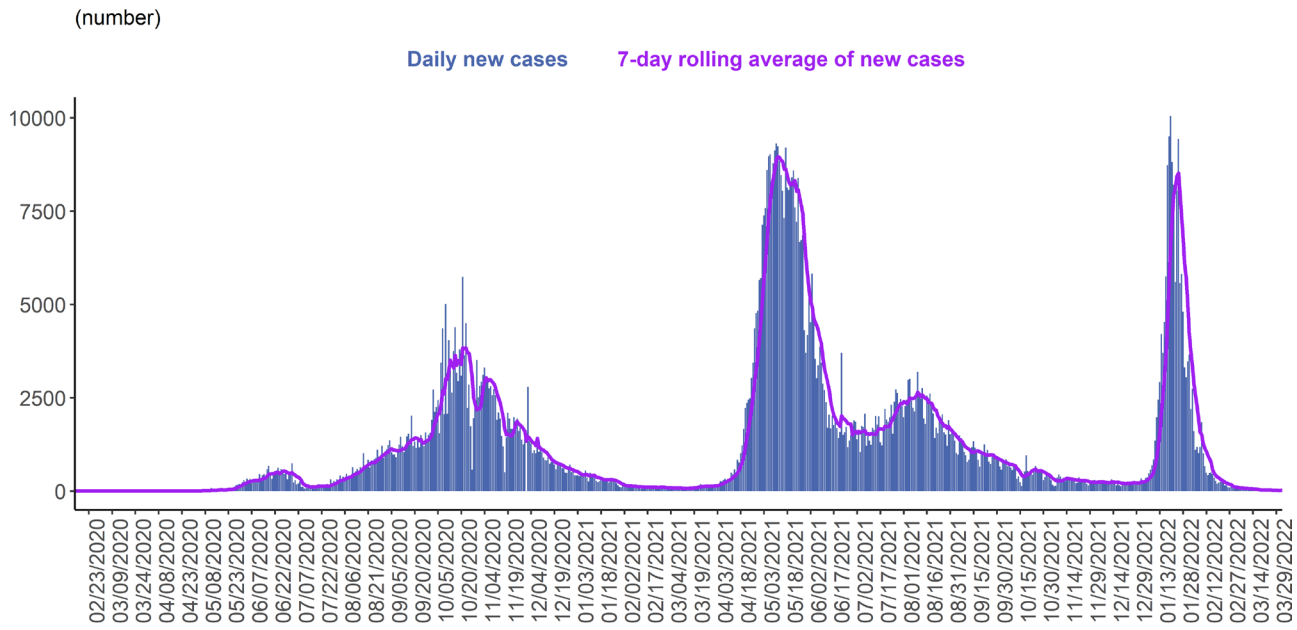
[4] World Bank. 2022. Global Economic Prospects, January 2022. Washington, DC.

[5] World Bank. 2022. Global Economic Prospects, January 2022. Washington, DC.

[6] Russia and Ukraine account for about 30 percent of global wheat exports, 20 percent of corn, mineral fertilizers, and natural gas exports, and 11 percent of oil exports.

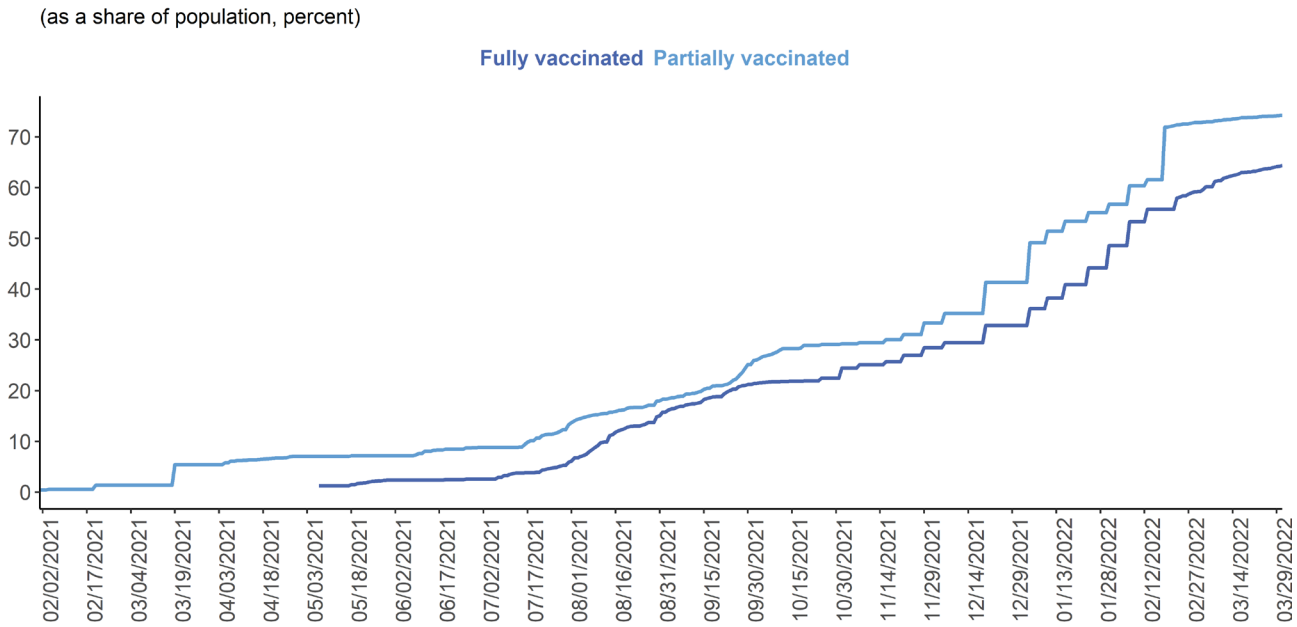
in mid-March 2021 (Figure 1). The country saw a severe second wave starting mid-April 2021 leading to renewed but less strict containment measures. These were gradually phased out by mid-October 2021 in accordance with a drop in new cases. During the third wave in January 2022, movement restrictions were reintroduced in the Kathmandu Valley through March 2022, with a focus on contact-intensive services to reduce pressures on the health system.

Figure 1 Daily COVID-19 cases fell sharply by March 2022...



Source: Ministry of Health and Population and World Bank staff calculations.

Figure 2 ...supported by acceleration of the vaccination drive



Source: http://ourworldindata.org

The COVID-19 vaccination drive that started in January 2021 has helped to reduce the fatality rate. As of March 30, 2022, 74.2 percent of the population has received at least one vaccination dose and 64.2 percent of the population has received full dose of vaccine (Figure 2). Vaccination efforts have relied on a variety of vaccines that were either procured directly or received as donations from abroad, including VeroCell, Covishield, AstraZeneca, Moderna, Pfizer, and Johnson & Johnson. The World Bank, the Asian Development Bank, COVID-19 Vaccines Global Access, the World Health Organization, and the United Nations Children's Fund have been supporting Nepal in its vaccination efforts.

Recognizing the challenges ahead, the Government of Nepal (GoN) has transitioned to a green, resilient, and inclusive development (GRID) path through the Kathmandu Declaration in September 2021. The Declaration notes that achieving GRID outcomes requires an increase in quantity and quality of financing from all sources, coordination across institutional and sectoral boundaries, and an enabling policy and institutional environment. The GoN is preparing a GRID Strategic Action Plan backed by 17 Development Partners to address the inter-related challenges of a sustainable economic recovery from COVID-19, climate risks, natural capital depletion, and continued exclusion of vulnerable people from economic opportunities and development benefits.

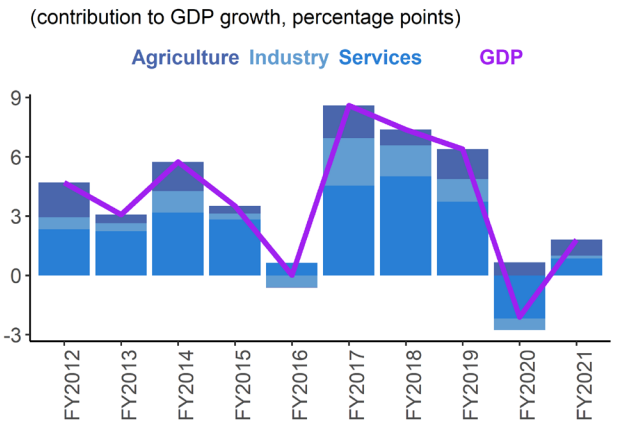
A.2 Real Sector

The recovery's momentum continues in FY22

The economy continued to recover in the first half of FY22 (H1FY22).[7] Real GDP is estimated to have rebounded in FY21, growing 1.8 percent after a 2.1 percent contraction in FY20 (Figure 3). The recovery in FY21 includes a low base effect, a recovery in domestic demand (Figure 4), and the limited economic impact of the second wave of the pandemic in the last quarter of FY21 as compared to the first wave in FY20. While the recovery continued in H1FY22 as indicated by four rounds of firm surveys[8] conducted by the central bank through November 2021, production and transactions undertaken by businesses remain lower than observed prior to the pandemic.

A recovery is expected despite a recent contraction in agricultural output. The agricultural sector is estimated to have grown by 2.7 percent in FY21 on the back of favorable summer monsoons.

Figure 3 GDP is estimated to have expanded by 1.8 percent in FY21



Sources: Central Bureau of Statistics and World Bank staff calculations.

However, a significant contraction is estimated during H1FY22 due to a drop in main season paddy9 production following unseasonal rains in October 2021 (Figure 5).

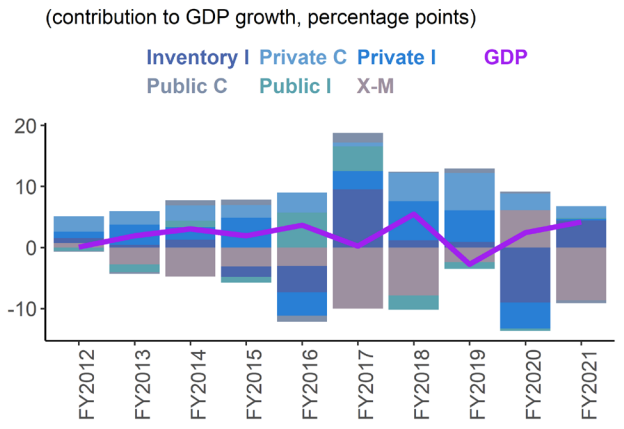
By contrast, mobility data suggests that services carried growth in H1FY22. In FY21 the services sector is estimated to have grown by 1.6 percent

[7] The Nepali fiscal year begins in mid-July.

[8] https://www.nrb.org.np/contents/uploads/2021/11/20780808-3rd-Follow-Up-Final.pdf

[9] The share of rice paddy in agricultural GDP is around 20 percent. Main season paddy production in H1FY22 is estimated to have contracted by 9.5 percent (y-o-y), leading to an estimated decline of total paddy production in FY22 of 8.7 percent.

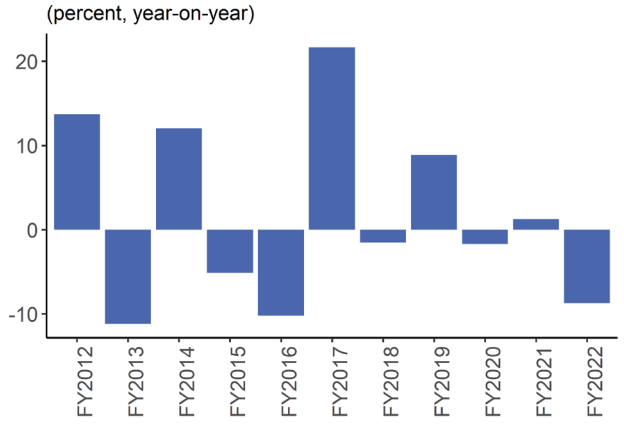
Figure 4 Private consumption and investment supported growth on the demand side in FY21



Sources: Central Bureau of Statistics and World Bank staff calculations.

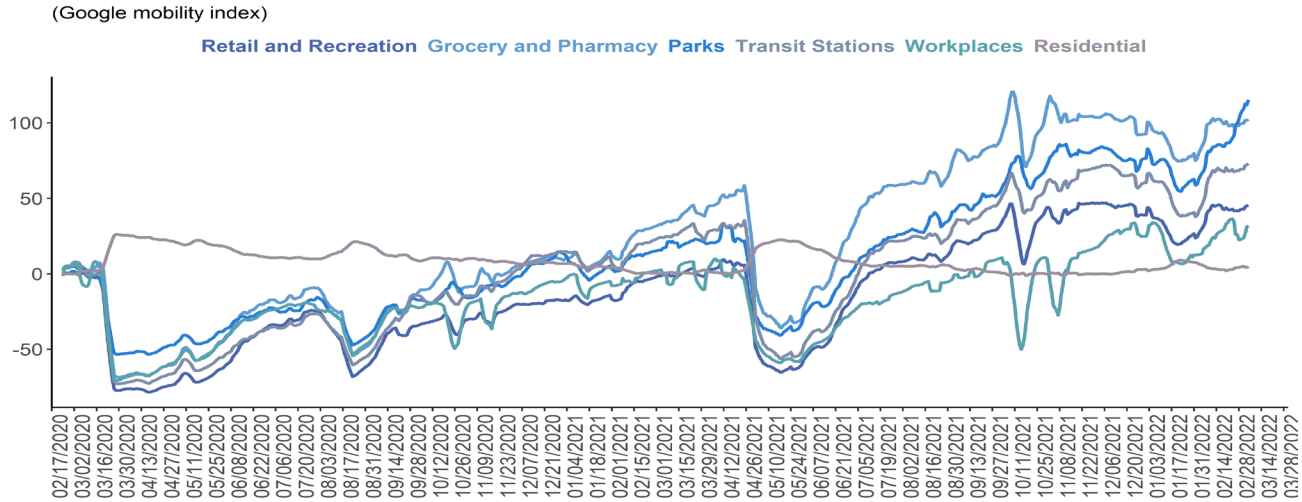
Note: I, C, X, and M stand for investment, consumption, exports, and imports

Figure 5 Main season paddy production contracted in H1FY22



Sources: Ministry of Agriculture and Livestock Development and World Bank staff calculations

Figure 6 Mobility to nonresidential locations has been increasing during H1FY22



Source: https://www.google.com/covid19/mobility/

after contracting by 4 percent in FY20. Beginning in FY22, the Google mobility index registered significant improvements in visits to non-residential locations as indicated by tracked mobility indicators (Figure 6), consistent with the relaxation of social distancing measures, an increase in vaccinations, and continued COVID-19 related fiscal and monetary support. Increased mobility suggests a strong recovery in wholesale and retail trade, transport, and financial services. Tourism and tourism-related activities which were greatly affected by the pandemic have also begun to recover as shown in increased international tourist arrivals, but they remain below pre-pandemic levels (Figure 7). Real estate activities have also increased as indicated by the rise in land title registrations of around 50 percent (y-o-y).[10]

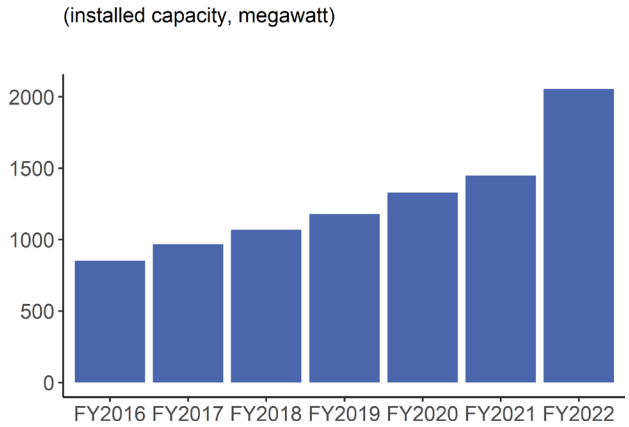
Increased installed electricity capacity indicates that the industrial sector also contributed to growth in H1FY22. The industrial sector is

[10] Department of Land Management and Revenue

Figure 7 Tourism has begun to recover but is still below the pre-pandemic level

Sources: Department of Tourism and World Bank staff calculations.

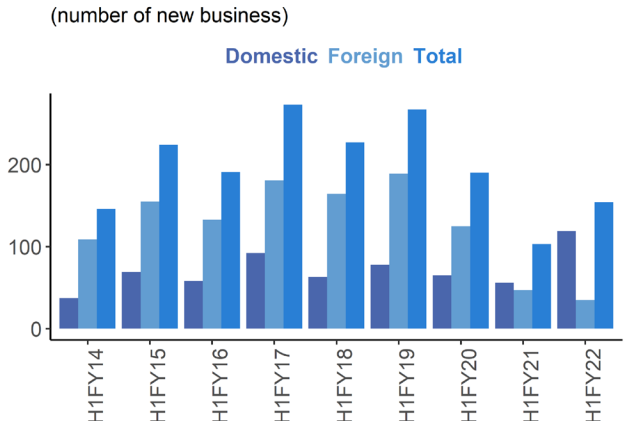
Figure 8 Installed capacity of electricity grew by 598 MW in H1FY22



Sources: Nepal Electricity Authority and World Bank staff calculations.

Note: Data for FY22 is for the first six months.

Figure 9 H1FY22 witnessed a revival of new domestic business openings



Sources: Department of Industry and World Bank staff calculations

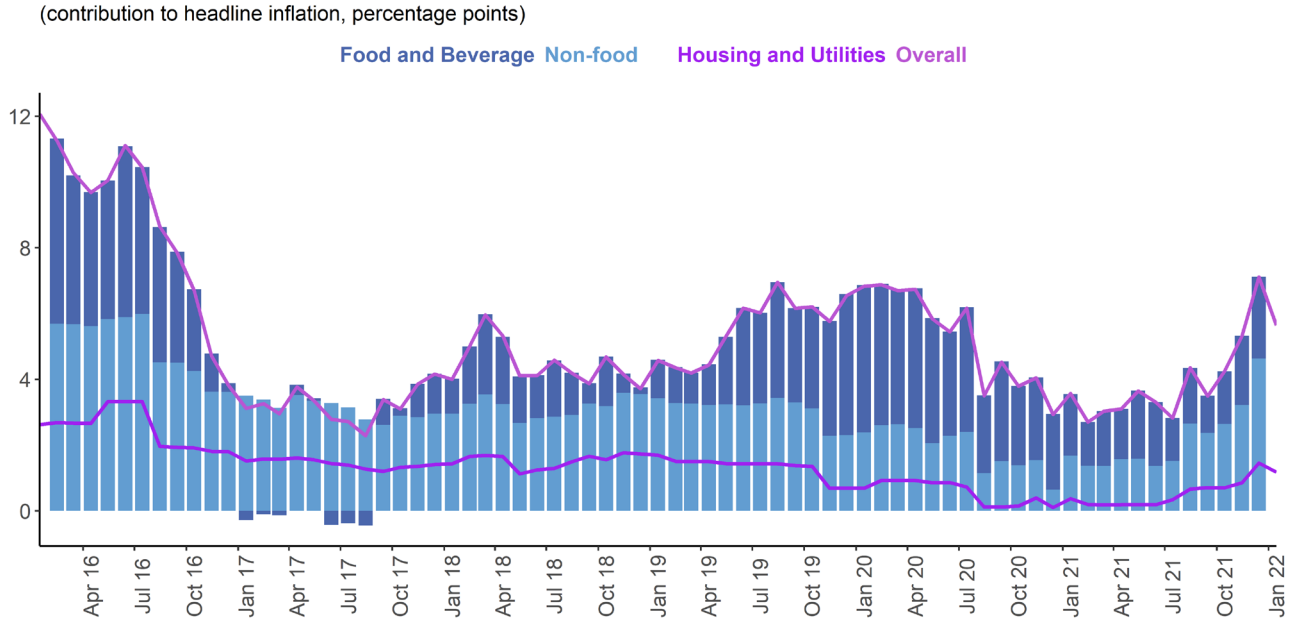
The industrial sector is estimated to have grown by 0.9 percent in FY21, up from a contraction of 3.7 percent in FY20, driven by an expansion of hydroelectric power.

estimated to have grown by 0.9 percent in FY21, up from a contraction of 3.7 percent in FY20, driven by an expansion of hydroelectric power. Momentum continued in H1FY22 when 598 MW of installed capacity of electricity was added to the national grid, including 456 MW from the Upper Tamakoshi Hydropower Project, the largest jump on record (Figure 8).

Private consumption and investment supported growth on the demand side. In FY21, private consumption expanded on the back of increased remittance inflows, while accommodative domestic monetary and fiscal policy supported private investment (Figure 4). In H1FY22, a surge in digital transactions[11] and a rapid expansion of new businesses indicate that private consumption and investment have continued expanding. However, while the registration of new businesses rose to 154 in H1FY22 as compared to 103 in H1FY21 (Figure 9), the structure of new firm openings experienced a divergence: while the opening of domestically owned firms reached an all-time high, foreign-owned firm openings continued to decline and stood at an all-time low.

[11] Monthly Macroeconomic Report, Nepal Rastra Bank.

Figure 10 Average consumer price inflation increased in H1FY22



Sources: Nepal Rastra Bank and World Bank staff calculations.

Inflation has begun to accelerate

Consumer price inflation fell significantly and reached a record low in FY21. Average inflation decreased to 3.4 percent in FY21, considerably below the FY20 inflation rate of 6.3 percent and the central bank's FY21 ceiling of 7 percent. The low inflation rate was driven by a decline in both food and non-food inflation. Average food inflation fell to 4.6 percent in FY21 from 8.6 percent the year before, mainly due to slower vegetable price increases and the easing of pandemic-induced supply disruptions. Non-food inflation also fell to 2.5 percent from 4.6 percent in FY20, chiefly due to a significant fall in housing and utilities costs.

Over the first half of FY22, average inflation increased to 5 percent driven by higher non-food inflation. Food price inflation slowed to 4.2 percent (y-o-y) from 5.5 percent in the same period of FY21, reflecting a continuation of lower vegetable price increases (Figure 10). However, non-food price inflation rose to 5.6 percent (y-o-y) in H1FY22, the highest price increase since H1FY17, due largely to higher transportation prices12 associated with the increase in global fuel prices. Additional factors behind the increase in non-food prices are increased educational fees and housing prices.

Government policies have contributed to keeping inflation manageable despite increasing global upward pressure on commodity prices. Key measures include the government's policy of waiving monthly electricity fees for households consuming up to 20-Kilowatt hour (kWh) and reducing monthly tariffs for households consuming between 150 to 250 kWh to incentivize the usage of electric appliances. The Nepal Oil Corporation – the state-owned fossil fuel import monopoly – has continued to sell liquefied petroleum gas (LPG) below market prices, using a combination of cross-subsidies and drawdowns from a price stabilization fund to finance the difference. This has kept LPG prices in check. In contrast to previous practice,

[12] To account for the rise in global fuel prices regulated domestic prices for petroleum products were increased four times in H1FY22. The federal government raised public transportation fares operating at the inter-provincial level in July 2021, and Bagmati province raised the fares of public transportation operating within its area in October 2021.

the government also did not raise the price of unprocessed milk at the beginning of the fiscal year, keeping it constant for 2.5 years and only adjusting the price on January 30, 2022. This contributed to lower-than-normal price increases for milk.

Job losses have been significant

Labor market exposures to the COVID-19 crisis in Nepal were significant, and vulnerable households in Nepal face the risk of falling back into poverty. New analysis based on the SAR COVID-19 phone monitoring survey13 also suggests that job recovery, for those who lost jobs during the pandemic, was low and accompanied by a decline in job quality and earnings. Of those employed in January 2020, 52 percent experienced a job or earnings loss during the first COVID-19 wave in 2020, the highest in the region. For those who recovered from a job loss, 45 percent also reported switching sectors and taking jobs with lower earnings and skill requirements. During this time, job losses in the service sector were highest with 29 percent of jobs lost. While men and women experienced a similar overall shock, more women reported permanently losing a job (30 percent versus a 23 percent for male workers), and the employment effects were concentrated amongst women and younger age cohorts. Among the self-employed, 31 percent of household-based enterprises and own-account workers operating in January 2020 shut down, with new firm openings being concentrated in the non-services sectors. While the negative labor market effects define a risk to increasing poverty and inequality in the short to medium term, new data on jobs and recovery from January 2022 will help better understand the longer-term outlook for poverty.14 Inflation will increase the cost of basic needs, which will adversely impact the poor and vulnerable, although this may be partially mitigated by rising remittances.

A.3 Monetary and Financial Sector Developments

Money supply growth surged in FY21, driven by high credit growth

Money supply (M2) growth was very high in FY21, driven by credit growth to the private sector. M2 grew by 21.8 percent in FY21, higher than the FY21 monetary policy target of 18 percent, on the back of 27.1 percent growth in credit to the private sector.[15] Credit to the private sector stood at 105.6 percent of GDP at the end of FY21. M2 growth moderated in H1FY22 to a low 2.8 percent, compared to the end of FY21 (Figure 11), well below the FY22 annual target of 18 percent, as a contraction in net foreign assets - largely foreign exchange reserves - offset much of the strong credit growth in the first half of the year. The credit expansion was broad-based with credit to the agriculture, industry, and services sectors all increasing (Figure 12). At the product level, overdraft, real estate loans, and vehicle loans explained 40 percent of private sector credit growth[16] (Figure 13).

Private sector credit surged on the back of accommodative monetary policy. Major policies enacted by the monetary authority focus on supporting the recovery of COVID-19 affected

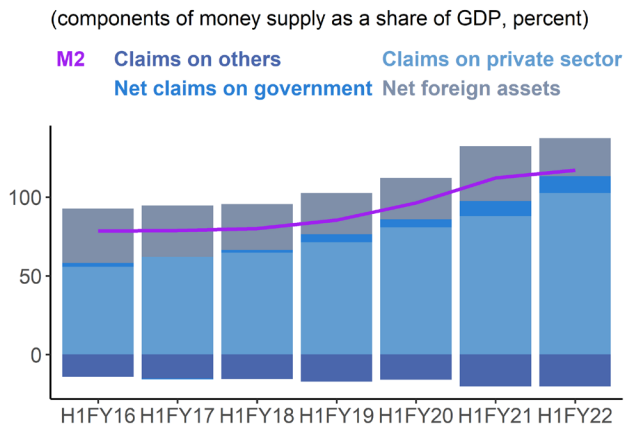
[13] Conducted during the latter half of 2020. The data covers 6389 individuals in Nepal, about half of which were a follow up to previous representative rural panel survey, the Household Risk and Vulnerability Survey implemented over 2016-18.

[14] Analysis will be completed before the next PEB.

[15] Credit to the private sector grew faster than that observed in FY20 (12.4 percent) and the central bank's FY21 target of 20 percent growth.

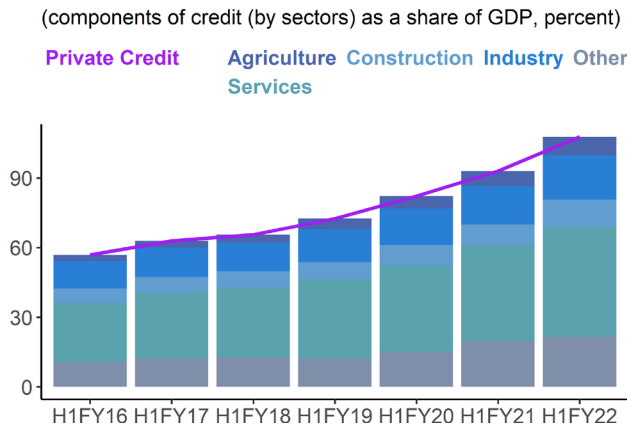
[16] See footnote 16.

Figure 11 M2 growth was high in FY21 but moderated in H1FY22



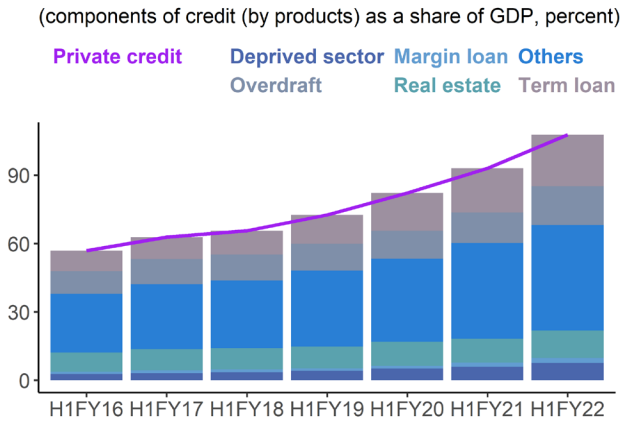
Sources: Nepal Rastra Bank and World Bank staff calculations.

Figure 12 Credit to the private sector grew strongly in H1FY22



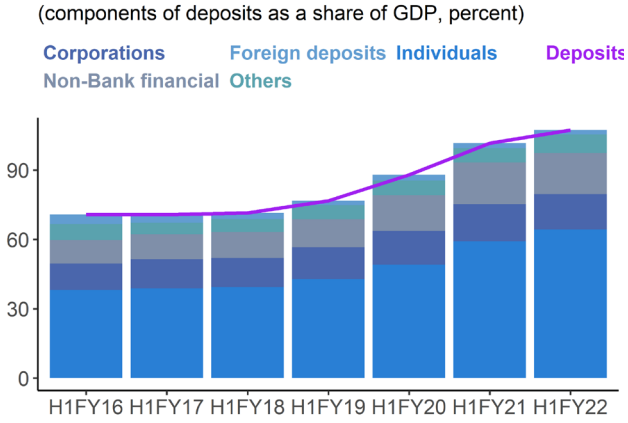
Sources: Nepal Rastra Bank and World Bank staff calculations.

Figure 13 Significant amounts of private credit were used for overdraft, real estate lending, and margin lending



Sources: Nepal Rastra Bank and World Bank staff calculations.

Figure 14 By contrast, deposit growth slowed in H1FY22



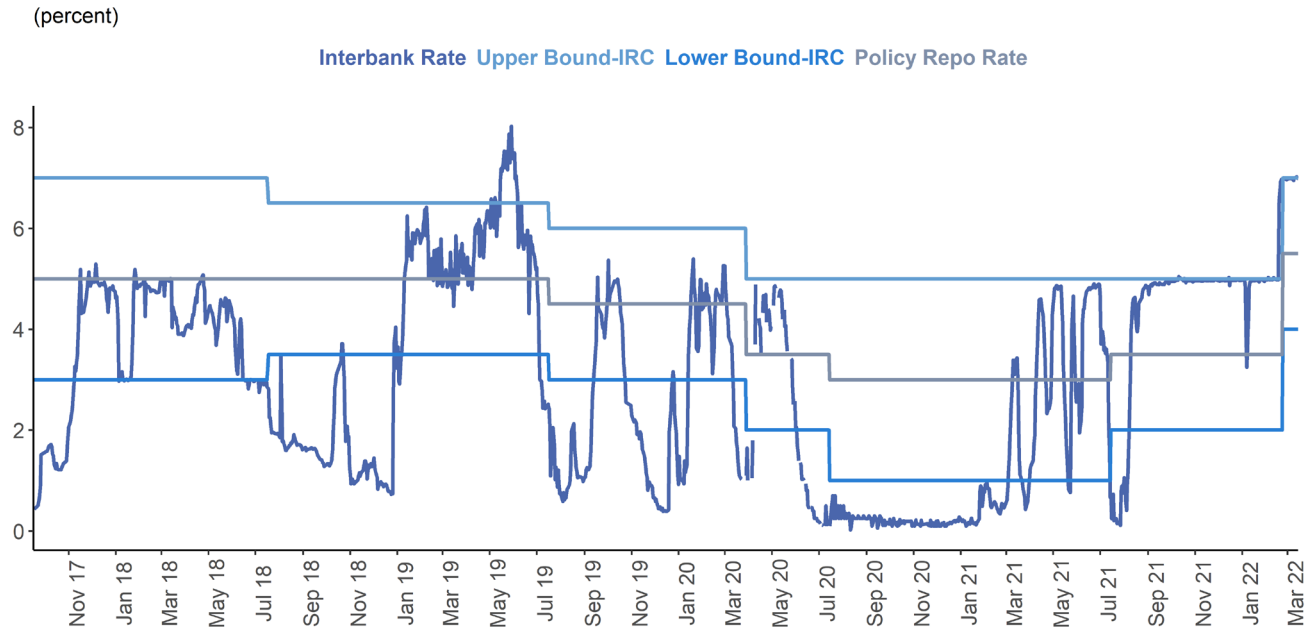
Sources: Nepal Rastra Bank and World Bank staff calculations.

sectors and consist of an expansion of a loan refinancing facility[17] by the central bank that supports credit allocation to cottage, micro, small, and medium-sized enterprises, and a facility that helped expand loan repayment periods for sectors affected by COVID-19. In FY21, 48,890 borrowers benefited from the refinancing facility of Nepali rupee (NPR) 148.8 billion (3.6 percent of outstanding credit) and 41,403 borrowers from the extension of the loan repayment period facility of NPR 222.8 billion (5.3 percent of outstanding credit). With the economy gradually recovering, uptake of these programs has slowed. During H1FY22, 24,267 borrowers took advantage of the refinancing facility and 15,381 borrowers of the repayment period facility.

Monetary policy remained accommodative relative to before the pandemic, but efforts have been taken to slow credit growth more recently. Since FY17, Nepal's central bank has been using an interest rate corridor (IRC) to manage liquidity and short-term interest rates. The corridor is

[17] Under the existing refinancing facility, the central bank provides funds to BFIs at lower interest rate (1-3 percent). The BFIs disburse these funds to debtors affected by COVID-19 at a maximum interest rate of 5 percent on their existing loans.

Figure 15 The interbank rate was close to the upper bound of the interest rate corridor in H1FY22



Sources: Nepal Rastra Bank and World Bank staff calculations.

centered around the interest rate on the overnight repo auction, which is referred to as the policy rate. The lower bound of the IRC is defined as the interest rate on 7-day deposit auctions, designed to absorb excess liquidity from the market if short-term interest rates fall below it. The upper bound of the IRC is defined as the interest rate on the standing liquidity facility. The central bank injects liquidity to the market if the short-term interest rate exceeds the upper bound.[18] To slow credit growth and begin unwinding accommodative policy, the central bank raised the policy rate by 0.5 percentage points in August 2021 after having kept it unchanged at 3 percent for a year. This was accompanied by a 1 percentage point increase in the lower bound to 2 percent. Despite the recent rise in rates, both the policy rate and the bounds of the corridor had remained below pre-pandemic levels until a 2-percentage point increase in the policy rate and the bounds on February 23, 2022.[19]

Deposit growth slowed, leading to liquidity shortages in banks

Deposits also expanded, albeit at a lower rate, and were outpaced by credit growth. Deposits increased to 107.3 percent of GDP in H1FY22, from 101.6 percent of GDP in H1FY21 (Figure 14), despite rising deposit interest rates.[20] Institutional deposits (non-banking financial institutions and corporations) grew sluggishly, in part due to deposit drawdowns by the Nepal Oil Corporation to import petroleum products at higher prices. Individual deposit growth also fell slightly on the back of declining

[18] The interbank rate is not expected to exceed the upper bound rate as BFIs can borrow from the central bank at SLF rate if the interbank rate is above the SLF rate.

[19] On February 23, 2022, the central bank introduced a risk weight of 150 percent for real estate loans for land acquisition and development, individual overdrafts, and consumer vehicle loans; 120 percent for trust receipts of trading firms; and increased the risk weight on margin lending to 150 percent from the existing 100 percent. The impact of these measures is to raise the capital BFIs must hold against these assets in the event of unexpected losses and increase the provisioning to be held against expected losses.

[20] BFIs are allowed to change the interest rate on deposits once a month. In October 2021, the central bank set the maximum increase in the deposit interest rate to 10 percent of the interest rate of the previous month. In November 2021, this limit was revised such that the maximum and minimum increase in interest rates on deposits of BFIs could be at most 10 percent of the average of maximum and minimum interest rates of BFIs of previous month.

remittances. As a result, the credit to deposit ratio climbed to around 90 percent during H1FY22, which is the regulatory maximum for BFIs.

The growing gap between credit and deposits resulted in a liquidity shortage for banking and financial institutions (BFIs). As a result, interbank interest rates started to rise, leaving them above the policy rate and closer to the upper bound rate of the interest rate corridor for most of H1FY22 (Figure 15). In response, the central bank injected liquidity of NPR 3.4 trillion in the banking system through repos (overnight, 7-, and 14-day repos), outright purchases, and the standing liquidity facility (7 days). In addition, the central bank provided targeted liquidity support to BFIs through the refinancing facility and allowed BFIs on January 3, 2022, to increase the percentage of local governments' funds that BFIs can count as deposits from 50 to 80 percent.[21]

Despite liquidity shortages, official statistics suggest that BFIs remain well capitalized, and that asset quality is sound. The capital adequacy ratio of BFIs fell from 14.2 to 13.4 percent H1FY22 but was well above the regulatory requirement of 11 percent. In addition, the total volume of non-performing loans of BFIs - loans that are overdue by 90 days or more –also declined marginally, driven by the extension of loan repayment schedules as part of the central bank's repayment period facility. As a result, the ratio of nonperforming loans to total loans was in the low single digits (1.3 percent). Efforts to enhance the accuracy of asset quality assessments are being supported by the government's Extended Credit Facility (ECF) agreement with the IMF, to better capture existing risks, provide an accurate assessment of BFI asset quality, and enhance the quality of supervision.

A.4 External Sector

The current account deficit widened markedly in H1FY22 as the trade deficit widened and remittances fell. The current account deficit widened from 0.9 percent of GDP (USD 340 million) in FY20 to 8.1 percent of GDP in FY21 (USD 2.8 billion), as higher remittances only partially offset a larger trade deficit. The current account deficit widened further in H1FY22 to 7.9 percent of projected GDP (USD 3 billion), up from 1.2 percent of GDP (USD 441 million) in H1FY21, as remittances declined, and imports continued to grow (Figure 16). In the absence of significant FDI inflows (0.3 percent of projected GDP, USD 95 million), the current account deficit was primarily financed by trade credits, external concessional loans, and reserves drawdowns (Figure 17).

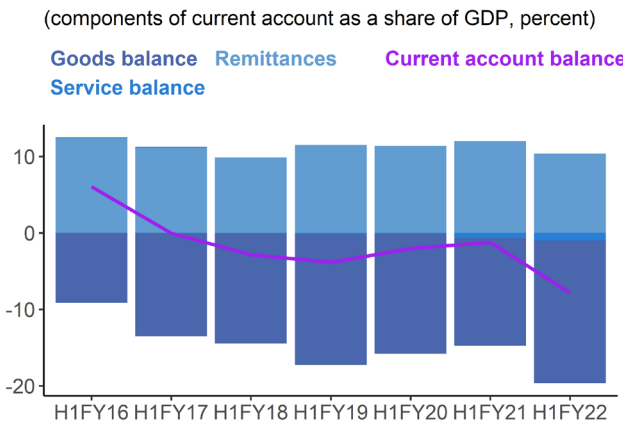
Import growth was the main driver of the current account deficit

Rapid import growth widened the trade deficit. Total imports of goods and services increased by 6 percentage points of GDP in FY21 and continued expanding to 23.5 percent of projected GDP in H1FY22 (Figure 18). Similarly, exports of goods and services rose to 3.8 percent of projected GDP in H1FY22, after dropping by 1.4 percentage points of GDP in FY21. With import growth outpacing export growth, the trade deficit widened by 7.4 percentage points to 34.5 percent of GDP in FY21. The trade deficit continued expanding during H1FY22 and stood at 19.7 percent of projected GDP, up from 14.8 percent of GDP in H1FY21.

Imports of goods and services rebounded strongly and surpassed pre-pandemic levels in the first half of FY22. Merchandise import increased by 5.9 percentage points to 36.3 percent of GDP in FY21, boosted by a revival in domestic demand and a

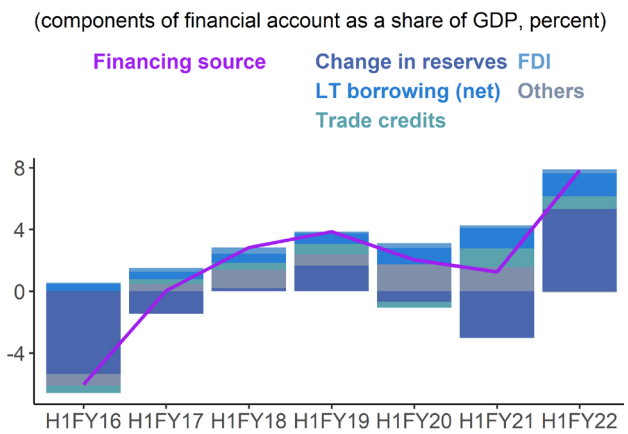
[21] Fiscal deposits are not counted as deposits unless an exception is made by the government and the central bank to allow those for credit expansion. As such, this measure led to the temporary increase of deposits in BFIs. The measure will be effective only until the end of FY22. The central bank allowed BFIs to use those additional funds for extending credit to only productive sectors and not to import and trading businesses.

Figure 16 Lower remittances and a higher trade deficit widened the current account deficit in H1FY22



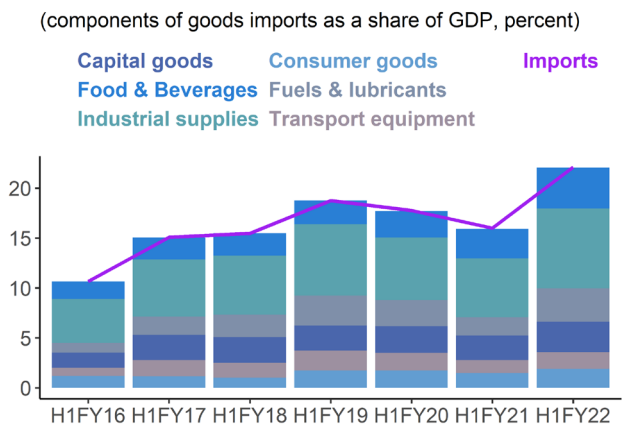
Sources: NRB and World Bank staff calculations.

Figure 17 ...which was largely financed by the drawdown of reserves



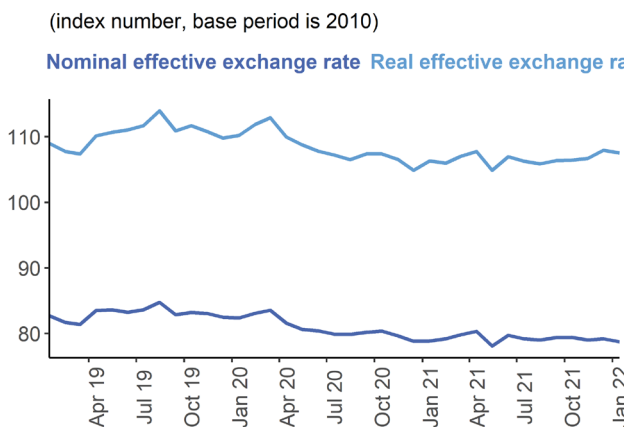
Sources: NRB and World Bank staff calculations.

Figure 18 Imports of goods and services rebounded strongly...



Sources: Department of Customs and World Bank staff calculations.

Figure 19 ...partly due to the appreciation in the real effective exchange rate



Source: IMF

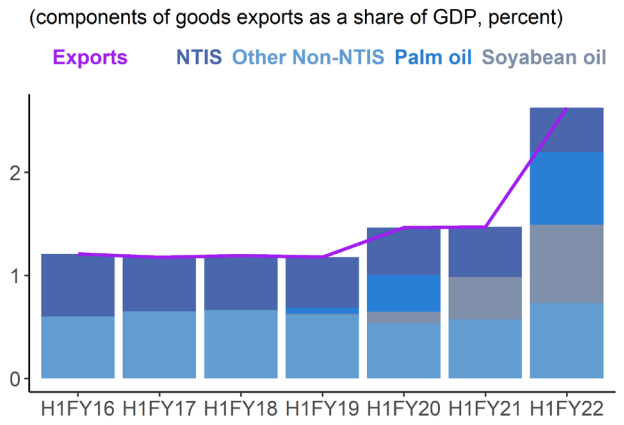
higher remittance. The increase was broad-based and was strong for industrial supplies (Figure 18), reflecting the recovery in construction activities, and the policy measures that include an expansion of the daily import quota of gold by the central bank from 20 kg to 30 kg and the purchase of COVID-19 vaccines. The growth momentum also continued in H1FY22, with merchandise imports expanding from 15.6 percent of GDP in H1FY21 to 21.4 percent of projected GDP in H1FY22, the highest in more than a decade. Services imports also rose to 2.1 percent of projected GDP in H1FY22 from 1.6 percent of HDP in H1FY21, after declining marginally by 0.3 percentage points in FY21. Services imports in H1FY22 were aided by an easing of travel restrictions which facilitated travel for study and work.

An appreciation of the real effective exchange rate (REER) in H1FY22 further contributed to strong import performance by lowering import prices. The NPR is pegged to the Indian rupee (INR) at a fixed rate of NPR 1.60 per INR. This rate has remained unchanged since February 12, 1993. With the nominal exchange rate to Nepal's main trading partner fixed, REER movements are driven by domestic price changes in each country and,

Figure 20 Domestic inflation relative to the major trading partners drove the real exchange rate appreciation

Sources: Department of Customs and World Bank staff calculations.

Figure 21 Exports also expanded



Sources: Department of Customs and World Bank staff calculations

to a lesser extent, variation in the INR's exchange rate with other currencies. Following a period of continued depreciation between August 2019 to December 2020 the REER appreciated by 1.2 percent in H1FY21 (Figure 19). This was driven by higher domestic inflation in Nepal when compared to price increases in India (Figure 20).[22]

Exports also expanded and reached an all-time high in H1FY22 but remain significantly lower than imports. Merchandise exports climbed by 0.7 percentage points to 3.5 percent of GDP in FY21, primarily due to higher exports of refined soybean oil which have remained relatively resilient during the pandemic. This complemented the resumption of exports of refined palm oil from July 2021 – which had been stalled for 14 months due to a restriction on imports by India – and contributed to an expansion of merchandise exports to 2.7 percent of projected GDP in H1FY22 from 1.5 percent of GDP in H1FY21 (Figure 21). Nepal achieved record-high growth for these products even though India had reduced their import duties for countries other than Nepal[23] in late 2021. Services exports also rose from 0.9 percent of GDP in H1FY21 to 1.1 percent of projected GDP in H1FY22, a sharp improvement from the contraction of 2.1 percentage points in FY21, as international tourist arrivals resumed gradually.

Remittance inflows declined in H1FY22. Remittances continued to show remarkable resilience in FY21,24 growing by 0.9 percentage points to 23.2 percent of GDP, helped in part by a strong economic recovery in migrant destination countries and a repatriation of savings by returnees. However, remittances fell from 12 percent of GDP in H1FY21 to 10.4 percent of projected GDP in H1FY22 (Figure 22) as remittances began switching back towards informal channels after the pandemic and relied increasingly on digital currencies, reducing official remittances recorded in the current account.

The widening current account deficit is exerting downward pressure on reserves

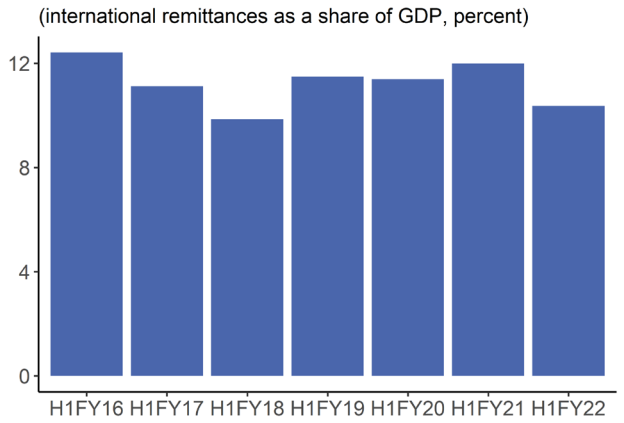
The combination of a rising trade deficit and declining remittance flows exerted downward pressure on foreign exchange reserves. Foreign

[22] The nominal effective exchange rate depreciated by 0.6 percent in H1FY22, lower than the depreciation of 1.3 percent in H1FY21.

[23] Nepali traders have been importing crude oils from third world countries at lower tariff rates and exporting the refined oils to India at zero-tariff under South Asia Free Trade agreement.

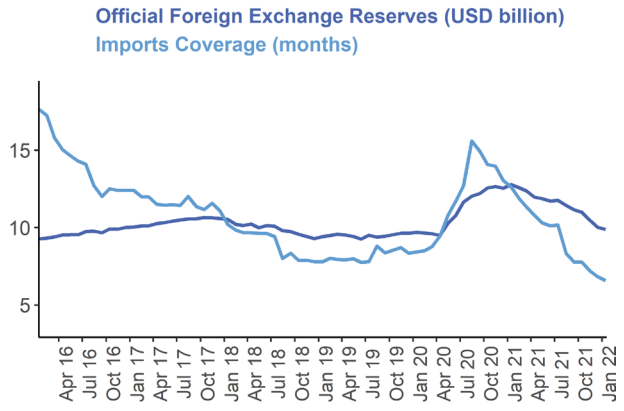
[24] The remittance data presented in this analysis do not include remittances sent through informal channels, as they are not registered by the central bank.

Figure 22 Remittance inflows declined in H1FY22...



Sources: Nepal Rastra Bank and World Bank staff calculations.

Figure 23 ...putting downward pressure on foreign exchange reserves



Sources: Nepal Rastra Bank and World Bank staff calculations.

exchange reserves fell to USD 9.9 billion in mid-January 2022 from USD 11.8 billion in mid-July 2021, covering 6.6 months of imports (Figure 23). While foreign exchange reserves declined, they remained close to the policy target of 7-months of import coverage. In an effort to support reserves and ensure the credibility of the exchange rate peg, the central bank adopted several measures to curtail imports. These include a reduction in the daily import quantity of gold from 20 kg to 10 kg and the restriction on one-time silver imports to less than USD 35,000. The central bank also made it mandatory for importers to deposit 50 to 100 percent of imports value in their banks[25] when opening Letters of Credit for the import of various consumption and luxury goods. The central bank also introduced a cap on the frequency with which Nepalis traveling abroad for tourism can withdraw the foreign exchange quota of USD 1,500, limiting the number of withdrawals to two per year.

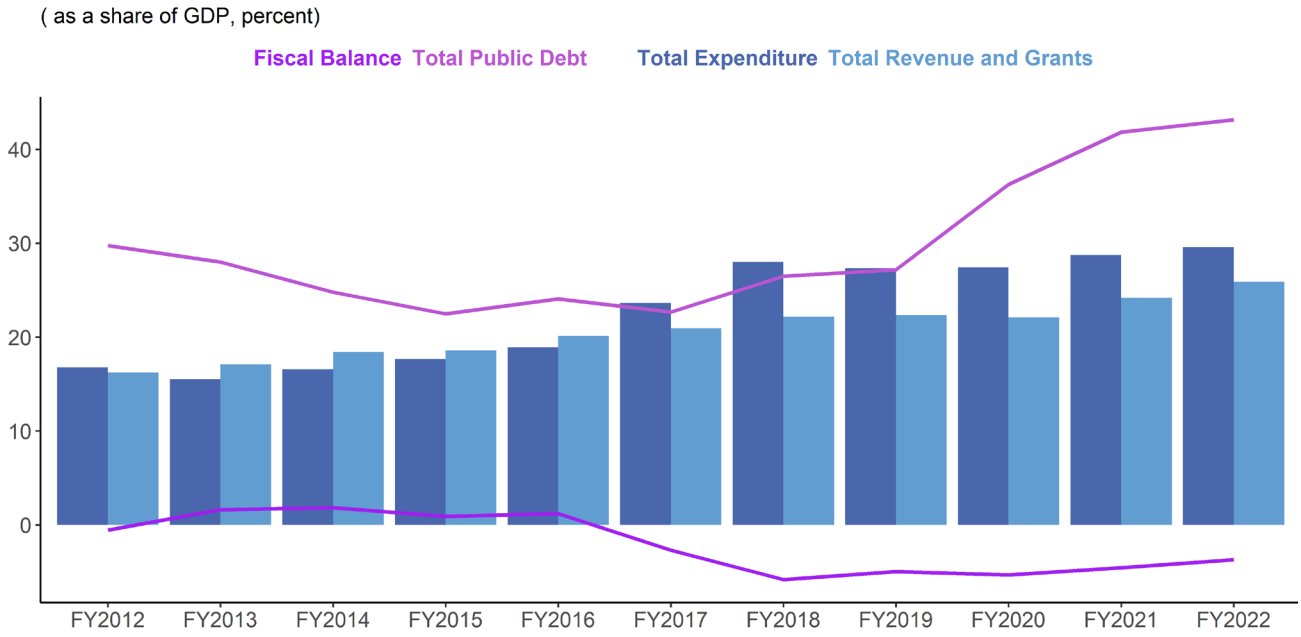
The current account deficit was mostly financed by a drawdown of reserves in H1FY22. In FY21, the current account deficit was mainly financed by concessional long-term borrowing (net) and trade credits (Figure 18). However, in the first half of FY22, the drawdown of reserves was the primary source of current account financing (5.3 percent of project GDP, compared to reserve accumulation of 3 percent of GDP in H1FY21). Concessional long-term borrowing (net) also contributed 1.5 percent of projected GDP, including disbursement under the IMF's Extended Credit Facility (0.8 percent of GDP) (Figure 17). FDI remained marginal, after having contributed only 0.5 percent of GDP in FY21.

A.5 Fiscal sector

Nepal has historically maintained a balanced budget, but this legacy has been overturned by earthquake reconstruction spending, COVID-19, and the transition to federalism. Between FY13 and FY16 Nepal recorded a budget surplus driven by revenue collections that exceeded regional and global peers, fueled by a high reliance on import-based taxes (Figure 24). Following discrete jumps in expenditure in FY17 and FY18 related to higher spending needs for earthquake reconstruction, increased administrative costs associated with the transition to federalism, and a collapse of imports

[25] This provision is expected to discourage imports by raising the cost of imports, since importers do not earn interest on such deposits.

Figure 24 Nepal's fiscal balance has been in deficit since FY17 due to earthquake reconstruction spending, the transition to federalism, and COVID-19



Sources: Ministry of Finance and World Bank staff calculations.

Note: Data for FY22 is projected.

during the pandemic in FY20, deficits rose and reached 5.3 percent of GDP in FY20. Large deficits led to debt rising from 22.7 to 36.3 percent of GDP between FY17 and FY20.

The fiscal deficit narrowed in FY21

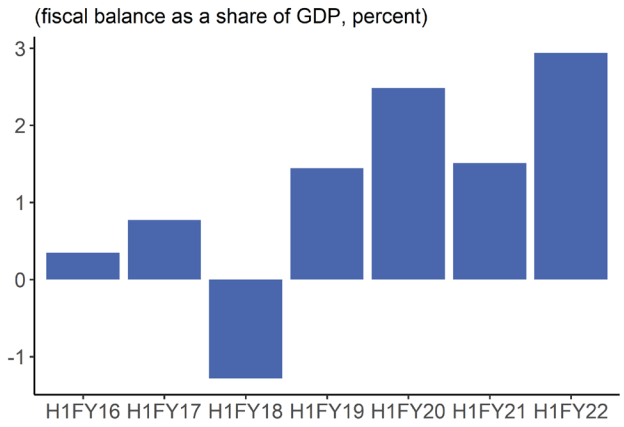
Beginning in FY21, Nepal turned a corner, and the fiscal deficit has started to narrow on the back of a strong post-COVID recovery of import-based taxes. The fiscal deficit of the central government narrowed to 4.6 percent of GDP in FY21. Underlying the narrowing deficit was a strong rebound in revenues, with total revenue and grants increasing from 22.1 to 24.2 percent of GDP between FY20 and FY21. This was driven by a recovery in trade-related taxes including Value Added Tax (VAT), excise, and custom duties in line with higher goods imports. By contrast, non-tax revenues declined due largely to lower dividends, tourism-related royalties, and visa fee collections, as tourism remained subdued throughout FY21.

Expenditures also rebounded in FY21. Total federal expenditure increased from 27.4 to 28.8 percent of GDP from FY20 to FY21 reflecting higher recurrent spending, including expenditure targeted specifically for COVID-19 related economic recovery and relief programs. To ramp up subnational service delivery, the federal government also increased conditional grants to local and provincial governments. Capital expenditures also rose, reflecting higher spending on buildings and public construction. However, capital expenditure remains below its pre-pandemic level as social distancing measures slowed the progress of government funded construction work during the second wave of COVID-19, leading capital expenditure execution rates to remain low at 64.7 percent.

The fiscal balance is cyclical during the year, registering surpluses in the first half of each fiscal year

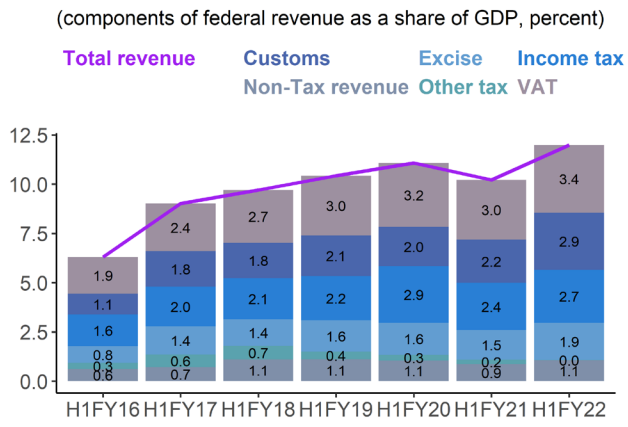
As in the first half of previous fiscal years, the federal fiscal balance recorded a surplus in H1FY22. During the first six months of the FY22, Nepal's federal government collected 2 percentage

Figure 25 The federal fiscal balance recorded a surplus in the first half of FY22...



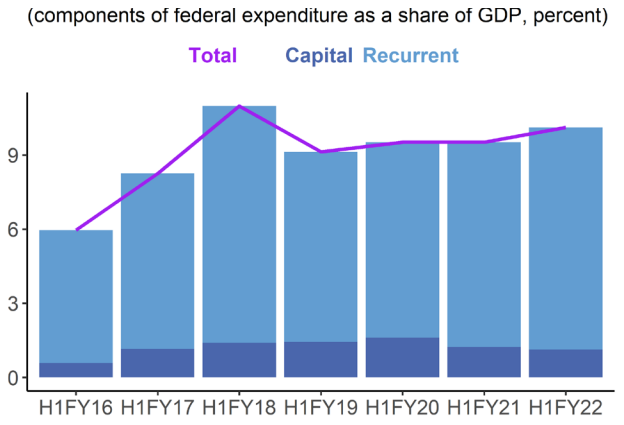
Sources: Ministry of Finance and World Bank staff calculations.

Figure 26 ...as revenue collection remained strong



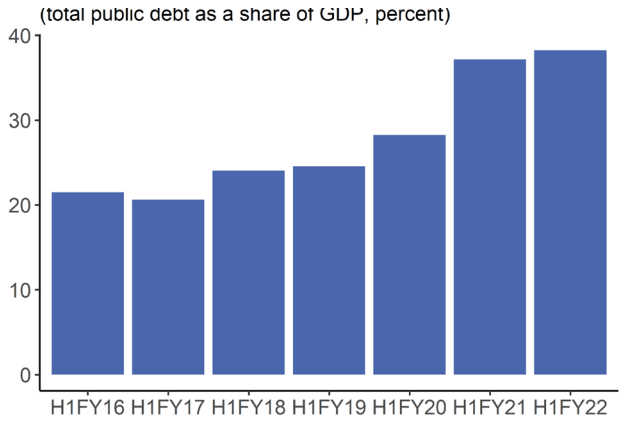
Sources: Ministry of Finance and World Bank staff calculations.

Figure 27 Low capital expenditure dampened total spending...



Sources: Ministry of Finance and World Bank staff calculations.

Figure 28 ...contributing to a deceleration of growth in the debt stock



Sources: Ministry of Finance and World Bank staff calculations.

points of GDP more revenue and grants than expenditure (Figure 25). While a fiscal surplus is common for the first half of the fiscal year, the positive fiscal balance in H1FY22 was larger than in previous years (Figure 25).

The continued strong recovery of revenues underlies this performance. Revenue collection expanded from 10.2 percent of GDP in H1FY21 to 12 percent of projected GDP in H1FY22 (Figure 26). This was driven primarily by continued strong import growth. At the same time, income tax also expanded on the back of increased individual capital gain taxes, driven by higher returns in housing and stock markets26. Non-tax revenues also rose, chiefly due to higher royalties, dividends, and passport and visa fee collections, as tourism gradually began to resume.

Capital expenditure decreased marginally due to a delay of the FY22 budget implementation. Nepal frequently records a fiscal surplus in the first half of the fiscal year as expenditure is bunched in the last quarter. In FY21, more than 50 percent and

[26] In FY21 and H1FY22, the secondary stock market contributed in the form of capital gain taxes around 1.5 percent of federal government revenue.

35 percent of actual capital spending occurred in the last quarter and last month of the fiscal year, respectively. This pattern is likely to continue in FY22 as well, given that in H1FY22 only 11.6 percent of budgeted capital expenditure was spent, a decrease from 13.4 percent for H1FY21. The lower budget execution in H1FY22 also led to midyear downward revision of the budget, as has happened in past years. As a result, capital expenditure stood at 1.1 percent of projected GDP, down from 1.2 percent of GDP in H1FY21.

Due to limited growth in capital expenditure, total expenditure only grew marginally. Total expenditure rose from 9.5 percent of GDP in H1FY21 to 10.1 percent of projected GDP in H1FY22 (Figure 27). Compared to previous years, higher spending was recorded for social security as all publicly distributed social assistance payments – including those for senior citizens, single women, widows, and child protection – were increased by 33 percent. The federal government also devolved more resources to subnational governments through conditional grants to ramp up social service delivery in the aftermath of the pandemic.

Public debt continues to rise, albeit more slowly

Due to the narrowing fiscal deficit, the public debt stock rose at a slower pace in H1FY21 as compared to H1FY20. Public debt stood at 41.8 percent of GDP at the end of FY21. Following the (temporary) surplus in H1FY22, debt decreased to 38.2 percent of projected FY22 GDP. However, this is higher than 37.1 percent of GDP in H1FY21 (Figure 28).

Nepal's external public debt stock remains largely concessional. In FY21, external debt and domestic debt constituted 54 and 46 percent of total public debt, respectively. This composition remained similar in H1FY22. Long term external debt is primarily denominated in Special Drawing Rights (SDR) but is paid in USD and is composed of multilateral and bilateral concessional debt. The World Bank and the Asian Development Bank are the largest creditors. Interest rates are low, averaging only 1 percent across the portfolio, and external debt also benefits from long average maturities of 14.1 years. In addition to beneficial financing terms, the external debt stock also benefited from the appreciation of Nepali rupee against the US dollar in the first half of FY22, leading to a 0.3 percentage points of GDP reduction in the debt stock expressed in US dollars over the same period.

Domestic debt includes mostly treasury bills and development bonds.[27] Treasury bills account for 16 percent of the domestic debt stock and development bonds account for 30 percent. Treasury bills have a maturity period of less than a year, and development bonds have a maturity period of 3 to 15 years. Domestic debt carries an average interest rate of 4.6 percent and average time to maturity of 3.8 years.

The risk of debt distress remains low. New domestic borrowing by the federal government in Nepal is regulated by the National Natural Resource and Fiscal Commission, which stipulated a ceiling of 5.5 percent of GDP of new domestic borrowing for FY21. This is complemented by a medium-term debt strategy that aims to maintain total public debt below 50 percent of GDP for FY21-FY24 and which was approved by Cabinet in November 2021. Despite rising in recent years, debt levels have not breached these limits. The most recent Joint Bank-Fund Debt Sustainability Analysis (December 2021) finds that the risk of debt distress is low for both external and public debt.[28]

[27] Domestic debt also includes a small amount of citizen saving bonds and foreign employment bonds.

[28] Private external debt figures are not published by the government and are not included in external debt figures.

Subnational governments continue to assume expenditure responsibilities

Subnational governments are primarily financed through federal grants and revenue sharing.[29] Federalism is composed of three tiers of government – municipal, provincial, and federal – and was established with the promulgation of Nepal's new constitution in 2015. In FY21, total federal transfers to subnational governments, including grants and revenue sharing, accounted for 12.3 percent of GDP (Table 1). The main sources of grant financing include fiscal equalization and conditional grants. Fiscal equalization grants are not earmarked and are intended to help subnational governments meet their expenditure needs. In FY21, total equalization grant transfers accounted for 3.5 percent of GDP. Conditional grants are earmarked grants for specific sectors and expenditure items to enable subnational governments to meet service delivery standards. In FY21, they accounted for 5.6 percent of GDP.[30] The federal government also shares 30 percent of revenue from VAT and domestic excise duties and 50 percent of all natural resource royalty receipts with subnational governments. Revenue sharing accounted for 2.7 percent of GDP in FY21.

Federal grants and revenue sharing to subnational governments increased in H1FY22. Total grants transferred increased from 3.7 percent of GDP in H1FY21 to 4 percent of projected GDP in H1FY22, primarily due to an increase in fiscal equalization grants from 1.4 percent to 1.6 percent of projected GDP. Revenue sharing also rose to 1.3 percent of projected GDP from 1.2 percent of GDP in H1FY21, on the back of a strong recovery of federal revenue (Table 1).

In addition to grants, subnational governments also collect own-source revenue. The latest available data on own-source revenue31 covers FY21 and highlights that the ability of provincial and local governments to independently finance their expenditure is still limited. During FY21, provinces collected revenues equivalent to 2.4 percent of GDP, and local governments jointly collected 6.1 percent of GDP.

These revenue sources are used to finance the gradual absorption of expenditure responsibilities. Nepal's 2015 constitution has devolved spending responsibilities for key service delivery sectors to subnational governments, including for primary healthcare and education. In FY21, provinces spent 4.6 percent of GDP on fulfilling these mandates, 0.6 percentage points more than in the previous fiscal year. Local governments play a more significant role in general government spending. Their joint expenditure amounted to 9.7 percent of GDP in FY21, 1.5 percentage points higher than in FY20.

Subnational governments continue to struggle with low budget execution rates. In FY21, provincial and local governments spent 62.9 and 75.4 percent of their approved budgets, lower than the federal budget execution rate of 82.9 percent. Persistent low subnational budget execution continued in H1FY22. During this period, provincial and local governments spent 15 and 24.3 percent of their total FY22 budgets, compared with 32.9 percent for the federal government (Table 1). The lower budget executions of provincial and local governments reflect not only a lack of technical capacity but also mirror many of the problems observed at the federal level, including the bunching of spending towards the end of the fiscal year.

[29] Please refer to the World Bank's 2021 Public Expenditure Review for Nepal, entitled "Fiscal Policy for Sustainable Development", which contains a description and analytical assessment of the intergovernmental framework.

[30] Subnational governments also receive complementary and special grants, but their value is comparatively small.

[31] This includes revenue sharing between provinces and local governments and miscellaneous revenues (consisting of opening cash balances).

Table 1 Revenue and spending performances of federal, provincial and local governments

Expenditure/Revenue	Actual (share of GDP, percent)						Budget execution (percent)	
	FY18	FY19	FY20	FY21	H1FY21	H1FY22	H1FY21	H1FY22
A. Federal								
Expenditure	28.0	27.3	27.4	28.7	10.7	11.5	31.1	32.9
Recurrent	20.2	21.1	22.6	23.2	9.5	10.3	36.6	39.1
o/w: Fiscal transfer to SNGs	7.0	8.3	9.0	9.6	3.7	4.0	42.1	46.3
o/w: Revenue sharing to SNGs	0.0	2.5	2.6	2.7	1.2	1.3	40.5	47.0
Capital	7.8	6.3	4.8	5.5	1.2	1.1	14.4	13.4
Revenue	21.0	21.8	21.5	23.7	10.9	12.7	44.5	48.8
Tax revenue	18.5	19.1	17.9	21.1	9.3	10.9	42.3	46.3
o/w: Trade-related	9.4	9.6	8.0	10.6	4.7	5.9	44.2	50.4
o/w: Non-trade related	9.2	9.5	9.9	10.5	4.6	5.0	40.6	42.1
Non-tax and other revenue	2.5	2.7	3.6	2.6	1.5	1.8	64.3	73.0
Grants	1.1	0.6	0.6	0.5	0.1	0.1	9.3	10.4
Fiscal balance	-5.8	-5.0	-5.3	-4.6	0.3	1.4		
B. Provincial								
Expenditure	0.1	2.9	4.0	4.6	0.9	0.9	14.9	15.0
Recurrent		1.3	1.7		0.5	0.5	15.8	19.8
Capital		1.6	2.3		0.5	0.3	14.1	11.0
Revenue	0.2	4.8	5.9	6.4				
Fiscal balance	0.1	1.9	1.9	1.8				
C. Local								
Expenditure	6.4	7.9	8.2	9.5	2.5	2.8	21.5	24.3
Recurrent				5.7				
Capital				3.8				
Revenue	7.6	9.9	10.3	11.9				
Fiscal balance	1.2	2.0	2.2	2.5				

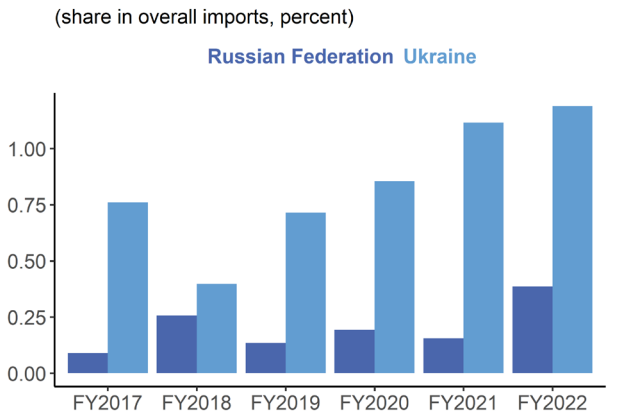
Sources: Ministry of Finance, Financial Comptroller General Office, and World Bank staff calculations

B. Outlook, Risks, and Challenges

The war in Ukraine presents new challenges. Nepal's trade with Russia and Ukraine is limited to less than 2 percent of total imports – including mostly sunflower oil, dried peas, and colza seeds - but the share of fuel, agriculture, metals, and minerals in total imports is large (Figure 29, Figure 30). As such, Nepal is less likely to face an immediate negative supply shock because of the direct trade linkage. Instead, higher global commodity prices are expected to increase the import bill indirectly. Services exports are expected to be less affected given the relatively low share of tourist arrivals (less than 3 percent) from these two countries. On the bright side, higher fuel prices may lead to stronger demand for migrant workers in the oil exporting GCC countries, and consequently an increase in remittances.

Higher commodity prices are expected to widen the current account deficit, reduce the growth rate, and increase inflation. If the war pushes fuel, metal, and mineral prices 20 percent higher in 2022 and 2023 than they were projected in January 2022 (Figure 31), a conservative estimate is that the current account deficit as a share of GDP will widen by around 1.5 percentage points in FY22 and FY23 relative to the January 2022 forecast (Figure 32). Higher prices will be reflected in increased construction costs as well as consumer prices, dampening overall demand and in turn reducing the real GDP growth rate by an estimated 0.2 and 0.6 percentage points in FY22 and FY23, respectively (Figure 31). The direct impact of higher global fuel and edible oil prices on consumer inflation is expected to be low given that the share of these products is only around 5 percent of consumers' expenditure. As such most of the higher inflation is likely to come from indirect effects, for example, through an increase in transportation prices and other food and non-food items.

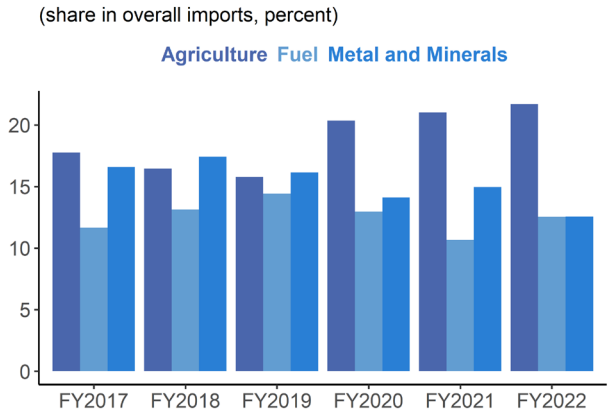
Figure 29 Nepal's trade with Russia and Ukraine is low...



Sources: Department of Customs and World Bank staff calculations.

Note: Data of FY22 is for first six months.

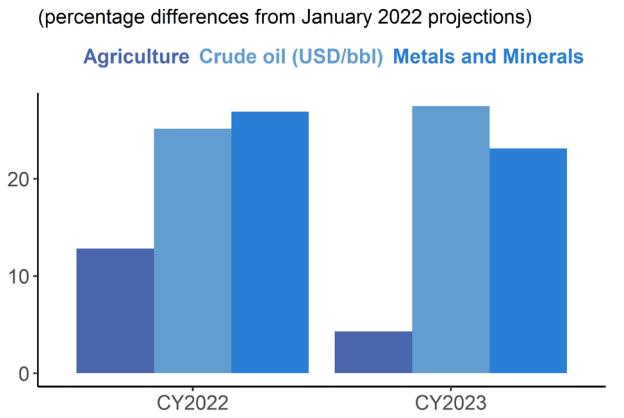
Figure 30 ...but Nepal imports many commodities whose prices will be affected by the war



Sources: Department of Customs and World Bank staff calculations.

Note: Data of FY22 is for first six months.

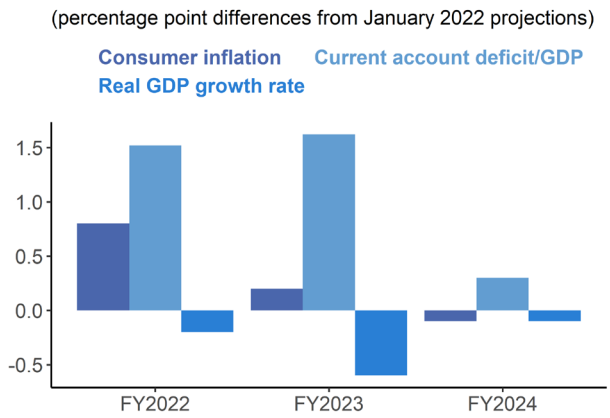
Figure 31 The war is projected to increase commodity prices by more than 20 percent...



Sources: Global Economic Prospects, World Bank

Note: CY refers to calendar year.

Figure 32 ...which will impact Nepal's growth, inflation, and current account deficit



Sources: World Bank staff calculations.

Taking into account the impact of the war, the Nepali economy is expected to recover gradually over the medium-term under a baseline scenario. The baseline scenario assumes: i) that no new nationwide strict containment measures are imposed; ii) a near complete vaccination of the eligible population by the end of FY22; and iii) a gradual increase in international migration and tourist arrivals, reaching pre-pandemic levels by FY24. In this scenario, the economy is projected to grow by 3.7 percent in FY22 (Table 2), accelerate to 4.1 percent in FY23, and rise further to 5.8 percent in FY24 close to its estimated long-term potential growth rate.

In the services sector, the deployment of effective vaccines to the eligible population is expected to unleash pent-up demand and aid a recovery of the wholesale and retail trade, transportation, financial, insurance, real estate, and education sectors. The ongoing war in Ukraine may lower travel demand globally through the negative impact on global growth and dampen the recovery of tourism and tourism related sectors in FY22 and FY23. Service

sector growth is expected to average 5.7 percent over FY22-FY24, below the pre-pandemic average annual growth rate of 6 percent.

Growth in agriculture is projected to decelerate in FY22. Key drivers are a decrease in paddy production from unseasonal rains in October 2021 and projected transitory increases in global fertilizer prices that may cause domestic shortages. The domestic shortage is expected to be partially mitigated by a five-year agreement signed between the governments of Nepal and India in February 2022, whereby India would supply a fixed quantity32 of chemical fertilizers to Nepal on an annual basis. Considering this, agricultural sector growth is projected to average 2 percent per year over FY23-FY24.

The industrial sector is expected to continue supporting growth. The manufacturing and construction sub-sectors are projected to drive industrial sector growth over the medium-term. The recently completed 456-MW Upper Tamakoshi Hydropower plant, the targeted increase in hydropower production to 6500 MW from the existing 1900 MW by FY24, and the completion of the Melamchi Drinking Water Project by FY22 are expected to accelerate growth in the industrial sector.

The ECF program with the IMF provides a policy anchor. Key policy actions under the program, approved in January 2022, include measures to boost revenues and public spending efficiency, strengthen financial sector regulation and supervision, and support fiscal transparency, as well as measures to enhance governance and combat corruption.

Inflation is expected to average around 6 percent in the medium term. Inflation during FY22 is expected to increase to 6 percent due to higher global oil prices, most recently spurred by the war in Ukraine. However, the increase is expected to be partially moderated by government policies to ensure low-income households receive lower utility and LPG prices. A decline in paddy production and higher deposit requirements on the import of select goods through Letter of Credit are also likely to push prices upward. Inflation is expected to remain elevated at 5.7 percent in FY23 under the expectation of continued higher oil prices before declining to 5.2 percent in FY24.

The central bank is expected to continue unwinding accommodative monetary policy in the medium term. The exchange rate peg with the Indian Rupee will continue to serve as a nominal anchor of the monetary policy in the medium term. Through monetary policy, the central bank aims to maintain price and foreign exchange reserve balances while supporting the economic growth target set out in the government's fiscal policy statement. As the economy continues to recover from the pandemic, the central bank is expected to continue tightening monetary policy as signaled recently through increasing the policy rate during the mid-term review of its FY22 monetary policy and beyond.

[32] For FY22, this is set at 150,000 tons.

Table 2 Macroeconomic projections of selected key indicators

	FY19	FY20	FY21 e	FY22 f	FY23 f	FY24 f
Real GDP growth, at constant market prices	6.7	-2.1	1.8	3.7	4.1	5.8
Private Consumption	8.1	3.6	2.4	2.1	1.9	2.5
Government Consumption	9.8	3.8	-5.0	23.6	0.8	-4.1
Gross Fixed Capital Investment	11.3	-12.4	1.2	7.6	5.5	9.6
Exports, Goods and Services	5.5	-15.9	-19.8	30.7	12.5	15.1
Imports, Goods and Services	5.8	-15.2	16.9	10.2	2.3	3.1
Real GDP growth, at constant factor prices	6.4	-2.1	1.8	3.7	4.1	5.8
Agriculture	5.2	2.2	2.7	1.3	1.8	2.3
Industry	7.4	-3.7	0.9	5.1	5.3	6.9
Services	6.8	-4.0	1.6	4.7	5.0	7.4
Inflation (Consumer Price Index)	4.6	6.1	3.4	6.0	5.7	5.2
Current Account Balance (% of GDP)	-6.9	-0.9	-8.1	-11.9	-9.5	-6.8
Fiscal Balance (% of GDP)	-5.0	-5.3	-4.6	-3.7	-3.5	-3.4
Debt (% of GDP)	27.2	36.3	41.8	43.1	44.2	44.5
Primary Balance (% of GDP)	-4.5	-4.7	-3.7	-2.8	-2.5	-2.3

Sources: Ministry of Finance, Nepal Rastra Bank, and Central Bureau of Statistics for history. World Bank staff for estimates and forecasts.
Notes: e = estimate; f = forecast.

Nepal's large trade deficit is expected to persist in the medium term. The trade deficit is expected to widen from 34.5 to 36.4 percent of GDP between FY21 and FY22 and then decline to 35.1 percent of GDP in FY23. Merchandise imports are expected to grow at a more moderate pace from FY23 onwards, reflecting the completion of most post-2015 earthquake construction and the gradual replacement of imported fossil fuels by electricity use in households and firms as the country generates an additional 4,000 MW of hydropower electricity. Goods exports are expected to grow in FY22 as Nepal continues to take advantage of tariff exemptions on exports of palm and soybean oil to India under the South Asian Free Trade Area agreement. An increase in electricity exports under an energy exchange and trade agreement with India is expected to drive merchandise export growth from FY23 onwards. Services exports and imports are expected to recover robustly but are expected to remain below their pre-pandemic levels through FY24.

The current account deficit is projected to widen to 11.9 percent of GDP in FY22 and narrow thereafter. Remittances are expected to stabilize at around 22 percent of GDP over the next two years, supported by new overseas employment opportunities. This development, together with new incentives for formal remittance transfers announced through FY22 monetary policy, is projected to contribute to narrowing the current account deficit beginning in FY23. In the absence of significant FDI inflows, the current account deficit will continue to be primarily financed by external borrowing and reserves drawdowns. Gross foreign exchange reserves are expected to fall to 4.8 months of imports by FY24 under the business-as-usual scenario.[33]

The fiscal deficit is projected to continue narrowing in the medium term. The fiscal deficit is

[33] The target has been adjusted in the past following pressure on external reserves.

projected to narrow from 4.6 to 3.7 percent of GDP between FY21 and FY22, as the growth rebound continues supporting revenue collection. Fiscal policy is projected to provide continuous support to households and firms in FY23 but tighten from FY24 onwards as support programs are unwound and measures to reduce duplication of spending responsibilities across levels of government are enacted. Expenditures are also likely to peak in FY23 due in part to electoral spending. Revenues are expected to recover with a rollback of COVID-19 related tax breaks, growing import-related revenues, efforts to widen domestic tax bases (including through reforms supported by the IMF ECF program), and stronger economic activity, including the recovery of tourism. The deficit is expected to be financed partly through concessional bilateral and multilateral borrowing, including from the IMF, the World Bank, and the Asian Development Bank, and partly through domestic sources. Total public debt is expected to reach 43.1 percent of GDP in FY22 and rise further to 44.5 percent of GDP by FY24.

The government is taking measures to limit the bunching of expenditure in the last quarter of the fiscal year. To improve the capital project selection and enhance their execution, the government has established the national project bank (NPB). All capital projects costing more than NPR 500 million are required to be included in the NPB prior to their inclusion in the budget. To operationalize the NPB, the unified guidelines are being currently developed. The guidelines will lay out detailed sector-specific technical preparation and selection requirements, including climate considerations.

Debt is expected to remain sustainable. The most recent Joint Bank-Fund Debt Sustainability Analysis (DSA, December 2021) finds that the risk of debt distress is low for both external and public debt. While the analysis resulted in a mechanical rating of moderate risk of debt distress, staff judgement was applied to assess Nepal's external debt to be at low risk of debt distress noting that remittances, rather than exports, are the major source of foreign exchange to finance the current account and service external debt. Stress tests show a vulnerability to growth and export shocks.[34] The findings from the DSA stress the importance of implementing reforms to increase the economy's resilience to external shocks through, for example, encouraging diversification, improving productivity and competitiveness, and enhancing the monitoring of risks related to contingent liabilities.

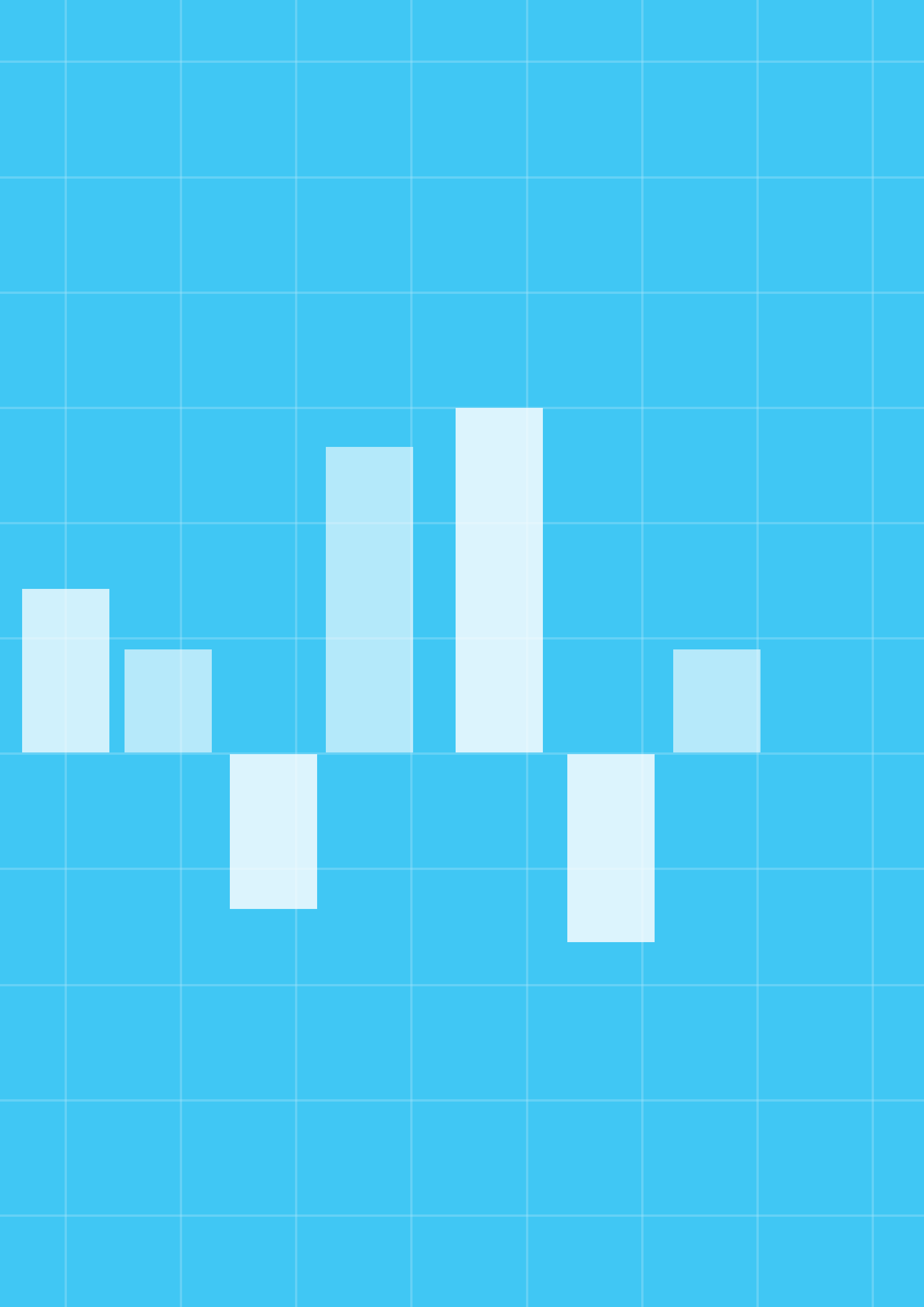
A downside scenario highlights growth and fiscal risks. A downside scenario considers a situation in which the central bank uses stronger import control measures to maintain the foreign exchange reserve coverage at 7 months of imports and in which expenditure consolidation progresses less swiftly than projected under the baseline. This scenario results in adverse growth impacts following the import contraction, depressing domestic output as well as consumption. Limited spending consolidation could also result in reduced capital spending to compensate for persistent elevated recurrent spending, which could depress growth further. There would be a mechanical increase in the fiscal deficit as well as a decrease in import-related revenues, which would jointly lead to substantially higher debt levels.

The economic outlook is subject to additional downside risks. A slower than expected vaccine rollout or a new COVID-19 variant reducing vaccine effectiveness could require the re-imposition of stricter containment measures, weakening the rebound momentum. Climate-related and natural disasters are a perennial risk which could impact agricultural production, government finances, and consumer prices. Depending on the pace of policy tightening, the

[34] The short and medium-term macroeconomic projections used in the DSA assume (i) a larger near-term primary deficit, (ii) a faster consolidation of primary deficits and (ii) a larger current account deficit in the near term than in the preceding section of this World Bank macroeconomic outlook. Considering the application of staff judgement, the conclusion of the DSA is unlikely to change if the World Bank macroeconomic outlook was applied.

unwinding of accommodative fiscal and monetary policy will need to be carefully sequenced to avoid large shocks to private sector activity.

Staying the course on policy reforms to address fiscal imbalances, improve spending efficiency, accelerate private sector growth and bring into focus the pandemic's impact on the financial sector can help mitigate downside risks. The government is examining the cost of tax exemptions and reporting on government spending for the COVID-19 response to inform adjustments to fiscal spending and revenues while continuing to protect the vulnerable. Efforts are underway to allow subnational governments greater flexibility in their use of conditional grants, which can raise their low budget execution rates and provide greater responsiveness to local needs. The government is also evaluating options to attract more growth-enhancing investment to Nepal. Central bank amendments to financial sector regulations will strengthen identification of non-performing assets and provide clear guidance on restructuring and rescheduling. Maintaining traction on these and many other reforms is especially important as the country navigates higher global commodity prices, the potential of a protracted war in Ukraine, and the possibility of new COVID-19 variants leading to renewed movement restrictions and border closings.



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