ACKNOWLEDGEMENTS

The Nepal Development Update is produced twice a year to report on key economic developments that occurred during the year, placing them in a longer-term and global perspective. 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 report was produced by the World Bank Macroeconomics, Trade and Investment (MTI) team for Nepal led by Alice J Brooks (Senior Economist, MTI) and Nayan Krishna Joshi (Economist, MTI) and consisting of Gonzalo J. Varela (Senior Economist, MTI), Prabin Dongol (Consultant, MTI), and Anima Maharjan (Team Assistant, MTI). The report benefitted from consultations with Dr. Prakash Kumar Shrestha (Executive Director, Nepal Rastra Bank), Mr. Suman Dahal (Joint Secretary, Ministry of Finance), and Mr. Hikmat B. Bhandari (Undersecretary, Ministry of Finance). The team thanks Mathew Verghis (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 Ali Mohib (Practice Manager, MTI), and Tae Hyun Lee (Lead Country Economist, EFI) for their guidance and comments on the report. Akash Shrestha and Avinashi Paudel managed media relations and dissemination.

The cutoff date is March 10, 2023, and includes data released up until that date.
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EXECUTIVE SUMMARY
A timing misalignment between high import demand and still-recovering remittance inflows created an external funding mismatch during Nepal’s growth recovery in FY21 and FY22. As imports outpaced foreign currency earnings during the recovery phase, Nepal used its reserves to finance imports, chipping away at the reserves stock until it was once again at pre-pandemic levels. Now that remittances and service exports are rising and the import boom abating, reserves are stabilizing at levels above the monetary authority’s policy floor of 7 months of import cover.

The policies deployed to initially support and boost private sector growth, and then subsequently to reduce credit and import growth, all come with unintended consequences.

- The expansive monetary policy enacted during and immediately following the pandemic drove the growth of credit to the private sector up to 35 percent nominal growth year-on-year (y-o-y) by November 2021. Credit growth enabled strong import growth, at a time when the traditional sources of foreign exchange such as remittance inflows were yet to fully recover. The unintended consequence of the expansive monetary policy was a drawdown on reserves.
Approximately half of all fiscal revenues are trade related. As imports soared, fiscal revenues grew over 14 percent in nominal annual terms by July 2022. Subsequently tighter monetary policy combined with a suite of import restrictions lead to a sharp decline in imports. As a result, fiscal revenues have underperformed significantly during in the first half of FY23 (H1FY23), falling by 15 percent y-o-y by January 2023. The unintended consequence of import restrictions and tighter monetary policy was a decrease in fiscal revenues.

The suite of import restrictions imposed during FY22 and continued through January 2023 were wide ranging and impacted not only consumer goods but also capital and intermediate goods. Nepal’s economy is largely services-driven, with wholesale and retail trade alone representing over 16 percent of the nation’s GDP. Government estimates for growth in the first quarter of FY23 show that industrial sector growth contracted. The unintended consequence of import restrictions was a slowdown in growth.

An early assessment of whether dislocations are likely to be temporary or permanent should guide consideration of the appropriate policy tools to deploy. Communicating intended policy changes with the public before they are enacted when possible, taking action in a timely fashion, and fine-tuning policies during the course of implementation have served policy makers well in other countries.
Executive Summary

A. Recent Economic Developments

After the strong rebound in FY22, economic growth slowed in H1FY23 reflecting tighter monetary policy, higher international prices, and the continuation of import restriction measures. Real GDP growth slowed in Q1FY23 despite positive growth in the services and agricultural sectors, as the industrial sector contracted.

A decrease in construction activities, the lower registration of new businesses, slower credit growth to the private sector, and lower imports of intermediate and capital goods suggest a decline in private investment during H1FY23.

Inflation has been broad-based, with food prices expanding by 7.5 percent y-o-y and non-food price inflation increasing to 8.7 percent (y-o-y) in H1FY23. Contributing factors to the price increases include higher vegetable prices associated in part with supply shocks in India, cereal grain prices triggered by India’s export ban on wheat and rice, higher transportation prices associated with the increase in global energy prices, and housing and utility prices.

The current account deficit widened from 7.8 percent of GDP in FY21 to a historic high of 12.8 percent of GDP in FY22, associated with a drop in remittances and a larger trade deficit. During H1FY23, a combination of lower goods imports and higher remittances narrowed the current account deficit to 0.5 percent of GDP, the lowest since H1FY17.

The smaller current account deficit allowed for renewed accumulation of foreign exchange reserves during H1FY23. Foreign exchange reserves climbed to USD 10.5 billion in mid-January 2023 from USD 9.5 billion in mid-July 2022. This stock covers 9.4 months of concurrent imports, higher than the policy floor of 7 months of imports coverage.

There is no guarantee that imports will not surge again in the future. To avoid a repetition of imposing damaging import restrictions, continued import demand management through interest rate policies and attracting additional sources of external financing will be critical.

Capital adequacy indicators remain above minimum floors, and non-performing loans (NPLs) remain very low by international standards. Total average capital to risk-weighted assets ratio – a measure of bank capital adequacy – ended H1FY23 at 13.1 percent, above the regulatory minimum of 11 percent. At the same time, the NPL ratio ticked up to 2.6 percent at the end of H1FY23. Although financial institution soundness indicators remain reassuring, some forbearance measures in place through the end of FY23 may be masking actual asset quality in the banking sector.

Monetary policy at the start of FY23 was designed to balance support for the economic recovery with the tightening required for economic and financial stability. The policy rate was increased by 200 basis points (bps) in H2FY22, followed by an additional increase of 150 bps in H1FY23 August 2022. The combined impact of higher international prices, requirements for importers to make cash deposits in bank accounts prior to obtaining letters of credit for importation, and policy rate hikes led to further slowdowns in credit to the private sector during H1FY23. The last remaining import restrictions were lifted in January 2023.
Continued high demand for liquidity was met by the standing liquidity facility in H1FY23 along with the overnight liquidity facility introduced at the beginning of FY23. These windows proved effective at shifting the interbank lending rate to within the interest rate corridor beginning in December 2022. Tighter restrictions on credit-to-deposit ratio contributed to limiting the credit supply.

Nepal relies heavily on imports as a tax base, which contribute about half of total tax revenues through VAT, excise and import duties. For the first time in five years, Nepal’s fiscal balance was negative in the first half of FY23 at -0.3 percent of GDP as revenues fell across the board while expenditures remained flat. The downturn in revenue growth reflects not only lower imports, but more sluggish economic activity as well. Expenditures, on the other hand, remained broadly stable during a period of electoral activity. The H1FY23 fiscal deficit increased the public debt to GDP ratio from 35.6 percent to an estimated 38.3 percent between H1FY22 and H1FY23.

The government’s FY23 Finance Bill incorporated an ambitious tax revenue target of 21.3 percent nominal growth for the year, which a mid-term review adjusted downwards. The mid-year FY23 budget review undertaken by the Ministry of Finance in February 2023 reduced the budgeted revenue estimate downwards from 26 percent of GDP to 23 percent of GDP (a 2.9 pp of GDP reduction). The mid-term review cut expenditures by a greater amount, from 28.9 percent of GDP to 24.7 percent of GDP (a 4.2 pp of GDP reduction), narrowing the budgeted budget deficit for the year from 5 percent of GDP to 3.6 percent of GDP (a 1.3 pp of GDP reduction).

### B. Outlook, Risks, and Challenges

The high demand for imports witnessed as Nepal emerged from the pandemic has moderated, foreign exchange reserve buffers are accumulating, credit is growing in a more sustainable fashion, tourists are returning to the country, and remittances are growing strongly as outmigration surges.

The less positive aspects of the economy’s evolution include lower growth prospects than previously anticipated, a fiscal deficit in the first half of the year, and the continuation of a challenging external environment as global interest rates continue to rise and commodity prices remain moderately high as Russia’s invasion of Ukraine continues.

The assumptions built into the baseline scenario of this macroeconomic forecast include: (i) a gradual easing of Nepal’s monetary policy repo rate, (ii) declines in global commodity prices in FY24 and FY25 relative to FY23; (iii) a gradual increase in international tourist arrivals, reaching pre-pandemic levels by FY25; and (iv) the commitment of the central bank to maintain foreign exchange reserves at a minimum equivalent of 7 months of concurrent imports during FY23-FY25.

The forecast projects growth declining to 4.1 percent in FY23 before accelerating once again to 4.9 percent growth in FY24 and further to 5.5 percent growth by FY25, close to the country’s estimated long-term potential growth rate of 5.4 percent.

The services sector is expected to continue to be the primary driver of real GDP growth over the medium term, slowing to 5.2 percent in FY23 then averaging 5.8 percent in FY24-FY25. Agricultural sector growth is projected to average 2.6 percent.
Average annual inflation is expected to rise to 6.8 percent in FY23 as the impact of Russia’s invasion of Ukraine keeps commodity prices elevated. Inflation is projected to then decline to 6 percent in FY24 and 5.5 percent in FY25, reflecting a moderation of global commodity prices and the containment of domestic price pressures through monetary policy.

Strong remittance inflows, the country becoming a net exporter of electricity beginning in FY23, and moderate growth of imports are projected to narrow the current account deficit from 12.8 percent of GDP in FY22 to 2.8 percent of GDP in FY23. While imports are expected to rise in the later years of the forecast, their growth is projected to be gradual which is reflected in the current account deficit forecast of 4.2 percent of GDP for FY24 and 3.6 percent of GDP in FY25.

The fiscal deficit is expected to remain under 3.5 percent of GDP throughout the forecast, as underspending of the budget continues, and revenues pick up alongside the growth revival beginning in FY24. This forecast includes measures to avoid the duplication of spending among the three tiers of governments, the adoption of revenue-enhancing reforms such as the removal of VAT tax exemptions, and improved capital spending with the implementation of new guidelines for the National Project Bank. Total public debt is projected to reach 41.7 percent of GDP in FY23 and then decrease marginally to 41.6 percent in FY24 and further to 41.5 percent in FY25 as GDP growth outpaces debt accumulation in the outer years of the forecast.

No new shocks are included in the forecast; given the increasing frequency of shocks in recent years, this may be optimistic. Local elections in May 2022 and national and provincial elections in November 2022 were followed by successive changes in administration, the most recent being the collapse of the ruling coalition in March 2023. Political stability remains important to manage the economy and ensure continued pursuit of development priorities. Higher than expected inflation would reduce household purchasing power and drag growth. Welfare recovery remains uncertain due to rising inflation and risks to agricultural production. Reduced investments in human capital, especially amongst those yet to recover from a job loss following COVID-19, also impose risks to rising inequality.
RECENT ECONOMIC DEVELOPMENTS
A.1 REAL SECTOR

GROWTH HAS LOST MOMENTUM, WHICH WAS EXPECTED AS MONETARY POLICY TIGHTENED AND IMPORT RESTRICTIONS WERE IMPOSED

The economy grew at a slower pace in the first half of FY23. After the strong rebound in FY22, economic growth slowed in H1FY23 reflecting tighter monetary policy, higher international prices, and the continuation of import restriction measures. The central bank raised the policy repo rate in February 2022 and again in August 2022, and the measures were effective at cooling credit growth and inflation. Import restriction measures were first imposed on December 29, 2021 and were continued until January 19, 2023.

**On the supply side, growth was driven by the services sector.** Increased activity in accommodations, food services, and finance and insurance contributed to growth in the services sector, although at a slower pace than in FY22 (Figure 1). The agricultural sector also grew with an expansion in main season rice paddy production. However, industrial sector growth declined as construction activities slowed.
GROSS DOMESTIC PRODUCT BY INDUSTRIAL CLASSIFICATION

**Figure 1.** Growth slowed in Q1FY23 despite growth in the services and agricultural sectors, as the industrial sector contracted…

Sources: National Statistics Office and World Bank staff calculations.

**Industrial Sector**

First quarter (Q1) GDP data of FY23 points to a slowdown of growth in the industrial sector, particularly construction (Figure 1), and high frequency indicators suggest that the contraction continued in the second quarter (Figure 2). Electricity was the bright spot with installed capacity increasing by more than 100 MW in H1FY23 (Figure 3).

**Figure 2.** …associated with reduced credit flowing to the construction sector throughout the first half of the year.

Sources: Nepal Rastra Bank and World Bank staff calculations.

**Figure 3.** Within the industrial sector, continued new electricity production partially mitigated the contraction in the construction sector.

Sources: Nepal Electricity Authority and World Bank staff calculations.

Note: Data shows the increased capacity for the first half for FY22 and FY23 and for full years for other fiscal years.
The construction sub-sector contracted for various reasons. First, prices of construction materials rose significantly (Figure 4). Second, credit extended to the construction sector declined (including residential housing) due to a lack of loanable funds and higher interest rates. Third, the temporary closure of illegal crusher industries in January 2023 lead to a shortage in construction materials such as sand and gravel. The construction activities in Nepal takes place mostly between October/November (after festivals) and May (before monsoon), with the significant share of government capital spending occurring mostly in the second half of fiscal year.

Services Sector

Growth in the services sector helped offset the contraction in the industrial sector. Quarterly GDP data for FY23Q1 suggests financial and insurance activities drove services growth (Figure 5), which may be associated with higher interest rates. Greater dynamism in the financial sector was offset, at least partially, by the slowdown in activities in wholesale and retail trade, as indicated by a 27.1 percent (y-o-y) decrease in goods imports, and a slowdown in the real estate sector. Tourism and tourism-related activities grew substantially compared with the previous year but are yet to recover fully to pre-pandemic levels (Figure 6).\(^1\) The number of real estate transactions fell by more than 50 percent y-o-y in H1FY23 (Figure 7).

Figure 4. Construction sector contracted in part due to high prices of constructional materials

Sources: Nepal Rastra Bank and World Bank staff calculations.

Figure 5. The most dynamic sectors of the services sector in the first quarter of FY23 were financial activities, despite the slowdown in credit growth.

Sources: National Statistics Office and World Bank staff calculations.

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\(^1\) On March 15, 2023, Chinese tourist groups were allowed to return when Nepal was included as an approved group tour destination by the Ministry of Culture and Tourism of the People’s Republic of China.
Figure 6. While increased international tourist arrivals supported growth in the services sector...

Sources: Nepal Rastra Bank and World Bank staff calculations.

Figure 7. … there was a marked slowdown in real estate transactions.

Sources: Department of Land Management and Archive and World Bank staff calculations

Agricultural Sector

The agricultural sector expanded by 1.5 percent year-on-year in the first quarter of FY23. It is expected that further growth will register in the second quarter reflecting an increase in main season rice paddy production (8.6 percent y-o-y) (Figure 8) even with shortages in chemical fertilizers, reflecting a good monsoon and improved seed varieties. Despite the increase in production and productivity of rice paddy, Nepal continues to import rice, mainly from India. Agricultural imports including rice contributed to almost one-fifth of overall imports in H1FY23.

Figure 8. Agriculture grew on the back of an expansion in paddy production.

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

On the demand side, indications are that private consumption remained the main driver of growth. While the decline in digital payment transactions (Figure 9) suggest there may have been a slowdown in private consumption, wages grew faster than inflation in H1FY23 as they did last year (Figure 10). However, as it is estimated

Figure 9. Lower digital payment transactions suggest a slowdown in private consumption growth.

Sources: Nepal Rastra Bank and World Bank staff calculations.

Figure 10. …despite an increase in real wages.

Sources: Nepal Rastra Bank and World Bank staff calculations.
that only a quarter of the labor force earns a wage, it is unclear whether these gains were extended to the remaining three-quarters of the labor force. For households who rely on transfers, increased remittances inflows (13.8 percent nominal increase, y-o-y) could have supported the private consumption, as proxied by imports of consumption goods. However, this is not evident for the post-pandemic period (Figure 11). Public consumption remained robust with the increased wages and spending on provincial and national elections, as discussed in the Fiscal section of this report.

Private investment cooled. The decrease in construction activities, lower registration of new businesses (Figure 12), slower credit growth to the private sector, and lower imports of intermediate and capital goods (Figure 13) suggest a decline in private investment during H1FY22. These declines were partially offset by a rise in public investment.

**Inflation has accelerated**

Average consumer price inflation rose in H1FY23 driven by food prices, non-food prices, and services. Average inflation surged from 5 percent y-o-y in H1FY22 to 8.2 percent y-o-y in H1FY23, above the central bank's ceiling of 7 percent and the highest inflation registered since FY16 (Figure 14). Inflation has become broad-based, with food prices expanding by 7.5 percent y-o-y in H1FY23 from 3.8 percent in the same period of FY22, reflecting higher vegetable prices associated in part with supply shocks in India, and cereal grain prices triggered by India's export ban on wheat and rice. Similarly, non-food price inflation increased to 8.7 percent (y-o-y) in H1FY23, primarily due to higher transportation prices associated with the increase in global energy prices, and housing and utility prices.

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Elizabeth Ruppert Bulmer, Ami Shrestha, and Michelle Marshalian. 2020. “Nepal Jobs Diagnostic.” World Bank. Over half of employment is in subsistence activities, and 60 percent of employment is in unpaid work.
After peaking in mid-September 2022 at 8.6 percent y-o-y, price increases stabilized and have subsequently declined to 7.3 percent inflation by mid-January 2023. The central bank expects the increase in prices in FY23 from elections spending, the rise in salary, and the expansion of social security. To contain the price increases and limit the inflation within the ceiling rate of 7 percent, the central bank increased the policy rate of interest rate corridor by 1.5 percentage points, relative to the mid-term review of FY22, to 7 percent in FY23, as discussed in the Monetary section of this report.

Figure 14. Inflation increased in H1FY23 and was broad-based.

After peaking in mid-September 2022 at 8.6 percent y-o-y, price increases stabilized and have subsequently declined to 7.3 percent inflation by mid-January 2023. The central bank expects the increase in prices in FY23 from elections spending, the rise in salary, and the expansion of social security. To contain the price increases and limit the inflation within the ceiling rate of 7 percent, the central bank increased the policy rate of interest rate corridor by 1.5 percentage points, relative to the mid-term review of FY22, to 7 percent in FY23, as discussed in the Monetary section of this report.

Figure 14. Inflation increased in H1FY23 and was broad-based.

A.2 EXTERNAL SECTOR

EXTERNAL SECTOR IMBALANCES HAVE BEEN REDUCED IN THE FIRST HALF OF FY23

The current account deficit narrowed significantly in H1FY23. The current account deficit widened from 7.8 percent of GDP in FY21 to a historic high of 12.8 percent of GDP in FY22, associated with a drop in remittances and a larger trade deficit. During H1FY23, a combination of lower goods imports and higher remittances narrowed the current account deficit to 0.5 percent of GDP, the lowest since H1FY17. The trade deficit narrowed from 18.4 percent of GDP in H1FY22 to 13 percent of projected GDP in H1FY23, the lowest level since H1FY16 (Figure 15).

Figure 15. Lower goods imports and higher remittances narrowed the current account deficit in H1FY23

Sources: Nepal Rastra Bank and World Bank staff calculations.
Imports plunged and reached a seven-year low in H1FY23. Goods imports expanded by 2.4 percentage points to reach a record high of 38.6 percent of GDP in FY22, driven by a rapid increase in domestic demand and higher commodity prices. In response, the government continued the import ban that was first imposed in April 2022 on select goods through December 2022. In addition, the central bank also extended through January 2023 the cash margin requirement that was first imposed in December 2021 on the import of select goods through a letter of credit. As a result, goods imports declined from 20 percent of GDP in H1FY22 to 14.2 percent of GDP in H1FY23 (Figures 16 and 17). The authorities removed the import bans, cash margin (deposit) requirements on import, and mandatory letters of credit for importation on December 16, 2023, and January 19, 2023, respectively. In contrast, services imports rose marginally from 2.1 percent of GDP in H1FY22 to 2.2 percent of projected GDP in H1FY23, after expanding by 1.1 percentage points of GDP in FY22.

**Figure 16.** Goods imports as a share of GDP dropped to a seven-year low in H1FY23

![Goods imports as a share of GDP dropped to a seven-year low in H1FY23](image)

**Figure 17.** The decline in imports decline was broad-based …

![The decline in imports decline was broad-based …](image)

**Figure 18.** … while exports declined as arbitrage opportunities in edible oils disappeared

![Exports fell marginally in H1FY23](image)

Food and beverage, industrial supplies, and capital goods primarily drove the fall in imports (Figure 16). The decline in foods and beverages was mainly due to lower crude edible oils (palm, soybean, and sunflower), reflecting lower import duties by India (Table 1). The fall in COVID-19 vaccine and construction materials (iron and steel) primarily led to lower industrial supplies. Capital goods decreased chiefly on the back of lower telephones for cellular networks or for other wireless networks.

Exports fell marginally in H1FY23. Goods exports climbed by 0.9 percentage points to 4.4 percent of GDP in FY22, primarily due to exports of refined soybean oil and the resumption of exports of refined palm oil in July 2021. Goods exports subsequently declined from 2.5 percent of GDP in H1FY22 to 1.8 percent of projected GDP in H1FY23, as refined palm and soybean oils exports dropped abruptly. Arbitrage opportunities for Nepali exporters disappeared when India reduced customs duties on these products sourced from other countries to rein in local price increases (Figure 18). Electricity exports were a bright spot, with electricity exports outpacing imports from India in a historic first during H1FY23 (discussed in the Real Sector section of this report). Services exports expanded by 0.5 percentage points of GDP to register 1.8 percent of projected GDP in H1FY23, reflecting higher numbers of international tourists although visitors remain below pre-pandemic levels.

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3 Nepali businesses import crude palm oil from Malaysia, Indonesia, and other producing countries, which is then processed within Nepal and exported to India. Indonesia, the world’s biggest producer and exporter of palm oil, periodically halts palm oil exports to control domestic prices. India periodically introduces bans on refined palm oil imports to protect its local refining industry.
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<tr>
<th>HSCODE</th>
<th>Description</th>
<th>BEC</th>
<th>Amount NPR mm</th>
<th>Import Ban Date</th>
<th>Cash Margin Rqmt Date</th>
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<td>Transport equipment</td>
<td>-1,110</td>
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</table>

Source: Department of Customs and World Bank Staff calculations

Note: The threshold for the requirement to use a letter of credit for imports from India was decreased from INR 50 million to INR 30 million in January 2022. The impact of this change could not be captured in the table above as the firm-level data is not publicly available. Negative NPR amounts indicate a decline in imports; BEC stands for broad economic categories.
Official remittance inflows remained robust in H1FY23. In FY22, official remittances inflows declined by 2.8 percentage points of GDP to a ten-year low of 20.8 percent of GDP despite new incentives. Official remittances expanded from 9.7 percent of GDP in H1FY22 to 10.8 percent of projected GDP in H1FY23 (Figure 19 and Table 2) reflecting the appreciation of US dollar vis-a-vis the Nepali rupee (Figure 20) and the delayed impact from higher numbers of international migrants leaving the country after the pandemic border restrictions were lifted. While the higher numbers of Nepali migrants working overseas suggest official remittance inflows are likely to remain robust in the medium term, the uncertainty introduced by Indian rupee to US dollar exchange rate fluctuations may make this element of higher official remittances short lived.

**Figure 19.** Remittances inflows expanded in H1FY23 …

![Graph showing remittances inflows expanded in H1FY23](image1)

**Figure 20.** … partly due to the appreciation of the US dollar to the Nepali rupee.

![Graph showing NPR/USD](image2)

**Table 2.** Selected External Sector Indicators

<table>
<thead>
<tr>
<th></th>
<th>H1FY17</th>
<th>H1FY18</th>
<th>H1FY19</th>
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<th>H1FY21</th>
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<td>-2.8</td>
<td>-3.9</td>
<td>-2.0</td>
<td>-1.2</td>
<td>-7.3</td>
<td>-0.5</td>
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<tr>
<td>Balance of Goods &amp; Services (% of GDP)</td>
<td>-13.4</td>
<td>-14.5</td>
<td>-17.3</td>
<td>-15.8</td>
<td>-14.8</td>
<td>-18.4</td>
<td>-13.0</td>
</tr>
<tr>
<td>Total Exports of Goods and Services (% of GDP)</td>
<td>3.7</td>
<td>3.7</td>
<td>3.8</td>
<td>4.0</td>
<td>2.4</td>
<td>3.6</td>
<td>3.4</td>
</tr>
<tr>
<td>Total Imports of Goods and Services (% of GDP)</td>
<td>-17.1</td>
<td>-18.2</td>
<td>-21.1</td>
<td>-19.8</td>
<td>-17.2</td>
<td>-22.0</td>
<td>-16.4</td>
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<td>Remittances (USD billion)</td>
<td>3.1</td>
<td>3.3</td>
<td>3.9</td>
<td>3.9</td>
<td>4.2</td>
<td>3.9</td>
<td>4.4</td>
</tr>
<tr>
<td>Net Foreign Direct Investment (USD million)</td>
<td>68.0</td>
<td>140.4</td>
<td>38.8</td>
<td>107.0</td>
<td>65.2</td>
<td>94.7</td>
<td>5.7</td>
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<tr>
<td>Gross Official Reserves (USD billion)</td>
<td>10.0</td>
<td>10.5</td>
<td>9.4</td>
<td>9.7</td>
<td>12.8</td>
<td>9.9</td>
<td>10.3</td>
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**Sources:** Nepal Rastra Bank and World Bank staff calculations.

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<tr>
<td><strong>Table 2.</strong> Selected External Sector Indicators</td>
<td></td>
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<tr>
<td><strong>Sources:</strong> Nepal Rastra Bank and World Bank Official calculations</td>
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The true size of remittance inflows is likely to be higher because official remittances data do not capture informal remittances. Remittances enter Nepal informally mostly through the hundi system, which is illegal in Nepal. The estimated size of informal remittances is not available for Nepal but estimates for the Africa region suggests that the size of informal remittances could be 2.5 times the size of official remittances. When informal channels such as hundi are used, Nepal does not receive foreign currency as informal agents in the host foreign country purchase convertible currencies from migrant workers, and informal agents within Nepal provide the remittance to families of migrant workers in Nepali rupees. As the convertible currency remains outside of Nepal when the hundi system is used, in H1FY23, the government adopted two measures to promote the use of formal remittance channels. First, in November 2022, the government required companies issuing equity shares in an Initial Public Offering on the Nepali stock exchange to allocate 10 percent of its shares to Nepalis working abroad. Second, in December 2022, the government issued guidelines to expand social security benefits to migrant workers living and working abroad beginning on March 10, 2023. The guidelines of this benefit expansion require social security benefits to be paid to migrant workers or their nominees through bank accounts within Nepal.

The current account deficit was financed by external borrowing. External borrowing (private and concessional public borrowing) more than offset the current account deficit in H1FY23 (Figure 21). This led to an accumulation of foreign exchange reserves, a significant improvement from H1FY22 during which foreign exchange reserves were the primary source of current account financing. Net foreign direct investment (FDI) remained at record lows as FDI inflows only slightly outweighed the repatriation of profits. In October 2022, the government reduced the minimum threshold on FDI by 60 percent, to NPR 20 million (approximately USD 153,000), to attract foreign investors interested in smaller-scale investments in Nepal. In addition to medium- and long-term external borrowing, short-term trade credit also contributed to the accumulation of reserves. As such, foreign exchange reserves climbed to USD 10.5 billion in mid-January 2023 from USD 9.5 billion in mid-July 2022. This stock covered 9.4 months of concurrent imports, higher than the policy floor of 7 months of imports coverage (Figure 22).

![Figure 21](https://openknowledge.worldbank.org/server/api/core/bitstreams/f2118cf1-0d28-5847-a05b-455643f573df/content)

**Figure 21.** A smaller current account deficit and continued external borrowing flows...

![Figure 22](https://openknowledge.worldbank.org/server/api/core/bitstreams/f2118cf1-0d28-5847-a05b-455643f573df/content)

**Figure 22.** ... led to a renewed accumulation of foreign exchange reserves during H1FY23.

**Effective external management is critical to mitigate risks of structural imbalances**

Nepal has a fixed exchange rate with India which disables pricing mechanisms that would otherwise have moderated the imbalance between imports and their financing sources. The Nepali Rupee has been pegged to the Indian Rupee at a constant rate since 1993. The peg provides stability to domestic import-dependent businesses and investors and anchors expectations which, among others, moderates inflationary pressure. At the same time, the fixed exchange rate eliminates a key pricing mechanism as its inability to depreciate during the post-covid import boom likely delayed a rebalancing of foreign currency demand and supply.

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1. https://openknowledge.worldbank.org/server/api/core/bitstreams/f2118cf1-0d28-5847-a05b-455643f573df/content
There is no guarantee that imports will not surge again in the future. To avoid a repetition of imposing damaging import restrictions, continued import demand management through interest rate policies and attracting additional sources of external financing will be critical. Nepal’s trade deficit is structural and unlikely to narrow materially in the medium-term. External policy thus requires a two-pronged approach. First, Nepal must actively manage import demand through restrained monetary (and fiscal) policy, expanding upon the monetary measures already taken (see the discussion in the Monetary section). Second, the attraction of additional and new external financing sources is key. To date, remittances, service exports, and concessional loans have provided reliable inflows. These can be complemented by the attraction of FDI, currently the lowest in the region through the easing of regulatory approval procedures, which would generate foreign currency inflows and stimulate growth through capital and technology transfers.

A.3 MONETARY AND FINANCIAL SECTOR DEVELOPMENTS

Indicators of BFIs soundness remain strong despite liquidity constraints. Total average capital to risk-weighted assets ratio - a measure of bank capital adequacy – ended H1FY23 was at 13.1 percent, above the regulatory minimum of 11 percent. Non-performing loans (NPLs) of class A, B, and C banks and financial institutions (BFIs) - loans that are overdue by 90 days or more – have been increasing from a very low base. After the ratio of NPLs to total loans declined to 1.3 percent in July 2022, the NPL ratio ticked up to 2.6 percent at the end of H1FY23. While this is the highest NPL ratio registered in the past six years, it remains very low by international benchmarks.

The Nepali stock market is large in terms of market capitalization, but volatile.7 The NEPSE Index grew 25 percent between H1FY21 and H1FY22, before shrinking 24.8 percent between H1FY22 and H1FY23, partly due to the higher interest rate. This drop represents a material loss of value, as the market capitalization to GDP ratio fell from 94 percent to 64 percent between the end of H1FY22 to H1FY23. Life insurance companies fell the most in H1FY23, losing over 33 percent on average in their share prices. The traded value and volume also decreased considerably over the same period, leading to lower revenue for the government. There are 249 listed companies in the Nepal stock exchange and the top 10 companies represent almost 30 percent of the market.8 By sector, financial institutions dominate with 66 percent of shares traded on the exchange, followed by hydropower with 12.3 percent.

Monetary policy has tightened, and credit growth has slowed

Credit growth was exuberant in FY21 and FY22, and a host of measures were subsequently deployed to slow credit growth. Monetary policy at the start of FY23 was designed to balance support for the economic recovery with the tightening required for economic and financial stability. The central bank’s Monetary Policy for FY23 published in July 2022 aims to reallocate credit to the productive sector rather than focus on credit growth.9 The inflation ceiling was set at 7 percent (0.5 percentage points higher than the previous year’s ceiling), the policy floor of foreign exchange reserves covering 7 months of imports was maintained, and growth of broad money and credit to the private sector were projected at 12 and 12.6 percent, respectively.

The policy rate of the central bank was increased further in H1FY23 to continue slowing credit growth. The policy rate was increased by 200 basis points (bps) in H2FY22, followed by an additional increase of 150 bps in H1FY23 August 2022 (Figure 23). Contextually, these policies are viewed as a normalization of the monetary stance following the expansive policies during and immediately following the COVID-19 dislocations in the private sector. Before the policy rate was raised to 7 percent in August 2022, the policy rate was range-bound between 3 and 5 percent from FY18 to FY22.

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6 As noted previously, import restrictions damage growth prospects, distort the efficient allocation of resources across the economy, and negatively impact fiscal revenues.
7 By comparison, market capitalization as a share of GDP in neighboring countries was 11.4 percent in Bangladesh (June 2022), 10.4 percent in Pakistan (June 2022), and 103.8 percent in India (Dec 2022), as per CEIC calculations.
8 While this degree of concentration seems high, it is similar to or less than that of many neighboring countries on average from 1989-2011 including Sri Lanka (43 percent), Bangladesh (30 percent), India (15 percent), and Pakistan (54 percent). Source: Bae, Kee-Hong, Warren Bailey and Jisook Kang, 2021 “Why is Stock Market Concentration Bad for the Economy?” in Journal of Financial Economics 140, pp 436-459.
9 Nepal Rastra Bank, July 22, 2022 “Monetary Policy for 2022/23 (unofficial translation)” delivered by Governor Mr. Maha Prasad Adhikari
Industry
Transportation
Construction
Housing and utilities
Overall index
Upper bound rate
Lower bound rate
Policy rate
Others
Private credit

were lifted during H1FY23 to shore up foreign exchange reserves

The combined impact of higher international prices, requirements for importers to make cash deposits in bank accounts prior to obtaining letters of credit for importation, and policy rate hikes led to further slowdowns in credit to the private sector as a share of GDP during H1FY23. While credit to the private sector did shrink from 100 percent to 94 percent of GDP from H1FY22 to H1FY23 (Figure 24), nominal credit to the private sector did not contract. Rather, GDP grew at a faster rate than credit expanded. Year-on-year nominal credit growth slowed from 31 percent at the end of H1FY22 to 11 percent at the end of H1FY23, applying a 6-month moving average (Figure 25).

The final distortionary import restrictions to shore up foreign exchange reserves were lifted during H1FY23

Two financial sector regulatory restrictions intended to curb imports were applied during FY22 and subsequently removed. Key regulatory provisions include (i) raising letter of credit and cash backing (cash margin) requirement on selected “non-essential goods”; and (ii) introducing higher risk weights on trust receipt loans. 10,11

Cash margin requirements were defined through central bank circulars in December 2021 and February 2022. A cash margin is a deposit held in the importers bank account. Trust receipt loans are loans provided to importers for the payment of imports made through letters of credit. Personal overdraft loans are loans provided to individuals to meet short-term obligations, while personal hire purchase loans are loans provided to individuals for the purchase of vehicles. Margin loans are loans against marketable securities listed in the organized stock exchange and are provided to individuals and firms.

Risk weights on personal overdraft loans, real estate loans relating to land plotting, and personal hire purchase loans for the purchase of vehicles were also increased to slow credit growth and improve asset quality. In addition, the risk weight of margin lending was increased.

Sources: Nepal Rastra Bank and World Bank staff calculations.

Figure 23. To reduce demand for credit the NRB raised interest rates in February and August 2022

Figure 24. Strong credit growth beginning in H1FY17 moderated in H1FY23.

Figure 25. As a result, import growth contracted on an annual basis while credit growth continued to slow.

Sources: Nepal Rastra Bank and World Bank staff calculations.
The NRB’s Monetary Policy for FY23, released on July 17, 2022, announced additional tightening for the new fiscal year, including a further increase in the policy rate and a reduction in the eligibility for the refinancing facilities (Figure 26). The policy shifted monetary policy priority away from a focus on credit growth and towards reallocating credit to ‘productive’ sectors. In the updated policy, the central bank removed COVID-19 related credit relief measures such as the extension of grace periods for industries or projects under construction, the extension of loan payment schedules, and generous provisions on restructuring and rescheduling of loans.

Figure 26. The lending rate increased with the higher interest rate on deposits.

Real deposit interest rates turned positive in H1FY23, but deposits by individuals fell as a share of GDP

Real deposit rates returned to positive territory in November 2022. The weighted average deposit rate among commercial banks did not respond quickly enough to stay in positive real territory from March to October 2022 (Figure 27), but the situation was reversed in November 2022 with an increase in the nominal weighted average deposit rate to 8.3 percent. In a liberalized market, when faced with a shortfall of loanable funds, banks would be expected to raise the deposit interest rates offered to the public to encourage them to increase their deposits. There are several mechanisms in the Nepalese banking sector that make this type of dynamic adjustment more difficult for deposit-taking institutions, including monthly caps on adjustments to interest rates that cannot exceed 10 percent of the previous month’s rate. Deposit rates have increased in nominal terms continuously since June 2021, registering 8.5 percent on average by the end of H1FY23.

Government and non-government corporate deposits continued to decline in H1FY23. Total deposits fell from 105 percent of GDP to 98 percent of GDP between the end of FY22 and the end of H1FY23. Individual deposits, the largest category, fell by 3 percentage points of GDP – from 64 to 61 percent of GDP - in the first half of FY23 (Figure 28). This is a surprising result given the higher real deposit interest rates (Figure 27) observed during that period.

Sources: Nepal Rastra Bank and World Bank staff calculations.

12 Nepal Rastra Bank, July 22, 2022 “Monetary Policy for 2022/23 (unofficial translation)” delivered by Governor Mr. Maha Prasad Adhikari
Narrow monetary aggregates (M1) contracted, while time deposits continued expanding on the back of higher deposit interest rates. At the end of H1FY23, M1 had fallen 2.9 percentage points of GDP over the half year. It is possible that the higher deposit interest rate structure offered by time deposits brought about a shift in the term composition of deposits. During the same period time deposits, the largest category of deposits, experienced continued growth from 54.3 percent of GDP at the end of H1FY22 to 58.8 percent of GDP by end FY22, then rising further to 59.1 percent of GDP by H1FY23 (Figure 29). Savings and call deposits fell 5.4 percentage points of GDP over the half year, contributing to a decline in M2 from 113.5 percent of GDP at the end of FY22 to 105.5 percent of GDP by the end of H1FY23.

**The increase in the policy repo rate contributed to reducing credit demand, while policy measures reduced credit supply**

Financial market liquidity remained tight despite two successive policy rate hikes for a cumulative 350 bps increase in the repo rate between February and August 2022. Not only did the interbank rate peg to the upper bound of the interest rate corridor begin in July 2021 (Figure 23), the volume of liquidity demand has also grown substantially. The amount transacted in the standing liquidity facility (SLF) in FY22 was more than twenty-fold the volume provided in FY21 even with the higher prices (Figure 30). In the central bank’s FY23 monetary policy statement, the SLF borrowing period was reduced from 7 days to 5 days, and limits were set at 1 percent of the financial institution’s total deposits in the preceding week. Continued high demand for liquidity was met by the standing liquidity facility in H1FY23 along with the overnight liquidity facility introduced at the beginning of FY23. These windows proved effective at shifting the interbank lending rate to within the interest rate corridor beginning in December 2022.
RECENT ECONOMIC DEVELOPMENTS

Tighter restrictions on credit-to-deposit ratios contributed to limiting the credit supply. In August 2021 the central bank announced that Banking and Financial Institutions (BFIs) would be required to limit the credit to deposit (CD) ratio to no greater than 90 percent by mid-July 2022. Banks complied with this directive, as the banking system’s credit to deposits ratio remained close to 90 percent for the majority of FY22. As of end H1FY23, the CD ratio averaged 86.6 percent across class A, B, and C banks.\(^{13}\)

Although financial institution soundness indicators remain reassuring, some forbearance measures in place through the end of FY23 may be masking actual asset quality in the banking sector. As noted in the central bank’s FY23 mid-term review of monetary policy, under the government’s concessional loan program as of H1FY23 a total of NPR 210.5 billion in loans has been provided to 148,342 borrowers at subsidized interest rates. The refinance facility provided to productive sectors affected by the COVID-19 pandemic including agriculture and micro enterprise stands at NPR 11.8 billion as of mid-January 2023. The central bank is carrying out a study on the utilization and effectiveness of the refinance facility and concessional lending programs with the objective of extending more loans to productive sectors. Other examples of continued forbearance measures cited in the central bank’s FY23 mid-term review of monetary policy include waiving penalty interest charges on repayments when payment is made within one month of the maturity date; and that to support SMEs, loans under NPR 20 million can be restructured, rescheduled, and classified as performing loans.

A.4 FISCAL SECTOR

MAINTAINING FISCAL PRUDENCE IN FY23 WILL BE CHALLENGING, AS EXPENDITURES EXCEEDED REVENUES IN THE FIRST HALF OF THE YEAR

Import restrictions were a contributing factor to slower growth and lower revenues in the first half of the year. Nepal relies heavily on imports as a tax base, which contribute about half of total tax revenues through VAT, excise and import duties and allowing Nepal to raise higher revenues than most other countries in the region. The import restrictions imposed in FY22 and eventually lifted in FY23 reduced the current account deficit and stabilized foreign exchange reserve stocks as intended in H1FY23. The unintended consequences of this policy include a steep drop in fiscal revenues and slower growth in H1FY23 as goods imports fell.

For the first time in five years, Nepal’s fiscal balance was negative in the first half of FY23. Revenues fell across the board while expenditures remained flat, opening an estimated fiscal deficit of 0.3 percent of GDP in H1FY23 (Figure 31). It was expected that import restrictions and slower credit growth would directly impact trade-related revenues in customs and excise revenues, which together fell by an estimated 1.6 percentage points of GDP between H1FY22 and H1FY23. As around 60 percent of VAT and 40 percent of excise

\(^{13}\) Nepal Rastra Bank, 2079 Poush “Banking and Financial Statistics (Monthly)”

Figure 31. The previous trend of fiscal surpluses in the first half of the year was reversed in H1FY23 as revenues fell 2.8 pp of GDP...

Sources: Ministry of Finance and World Bank staff calculations.
collections are based on trade, VAT revenues and income tax receipts combined fell 1.1 percentage points of GDP between these two periods as well (Figure 32).

**The downturn in revenue growth reflects not only lower trade flows, but more sluggish economic activity as well.** Continued high international prices, reflected in higher unit prices of Nepal’s imports, present important headwinds to private sector activity. High-frequency economic activity indicators point to a slowing of the economy in the first half of FY23, with the number of housing sales declining by 54.1 percent y-o-y in H1FY23, non-performing loans in the financial sector rising from 1.3 to 2.6 percent of total loans from H2FY22 to H1FY23, and GDP growth in the first quarter of FY23 expanding a mere 1.7 percent.¹⁴

**Expenditures, on the other hand, remained broadly stable during a period of electoral activity.** Recurrent spending represented the bulk of spending in the first half of the year, remaining broadly equivalent at 8.4 percent of GDP during the period which included provincial and national elections held in November 2022. Capital expenditure execution remained anemic at 1 percent of GDP during H1FY23, equivalent to capital spending in H1FY22 but lower than capital spending as a percentage of GDP in previous years (Figure 33). Chronic underspending of the capital expenditure budget limits progress on development goals and prolongs the duration of infrastructure gaps throughout the country. In the absence of greater public capital spending, the private sector can play a crucial role which will require building a conducive institutional and regulatory environment.¹⁵

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¹⁴ National Statistics Office.

¹⁵ World Bank Group, 2019 “Nepal Infrastructure Sector Assessment: Private Sector Solutions for Sustainable Infrastructure Development”
RECENT ECONOMIC DEVELOPMENTS

A MID-TERM REVISION OF THE BUDGET REDUCED BOTH REVENUE AND EXPENDITURE TARGETS

The government’s FY23 Finance Bill incorporated an ambitious tax revenue target of 21.3 percent nominal growth for the year, which a mid-term review adjusted downwards. While the government has been able to meet more than 95 percent of its revenue targets in most previous years, performance in the first half of FY23 was lower than planned. To reflect lower revenue performance in the first half of the year, a mid-year FY23 budget review undertaken by the Ministry of Finance in February 2023 reduced the budgeted revenue estimate downwards from 25.9 percent of GDP to 23 percent of GDP (a 2.9 pp of GDP reduction). The mid-term review cut expenditures by a greater amount, from 28.9 percent of GDP to 24.7 percent of GDP (a 4.2 pp of GDP reduction), narrowing the budgeted budget deficit for the year down from 5 percent of GDP to 3.6 percent of GDP (a 1.3 pp of GDP reduction). As a result, budgeted net domestic borrowing for FY23 now stands at 2.8 percent of GDP while planned net external borrowing stands at 2.4 percent of GDP. Government investments in public enterprises via equity and debt injections were reduced from 1.8 percent of GDP to 1.5 percent of GDP during the budget revision.

WHILE SUBNATIONAL GOVERNMENTS SHARED THE BUDGET CUTS, IMPROVING BUDGET EXECUTION IS THE BIGGER CHALLENGE

As revenues were lower in H1FY23 relative to H1FY22, revenue shared with subnational governments was reduced accordingly. Fiscal transfers to subnational governments across the board have been impacted by the expenditure cuts, falling from 7.9 percent of GDP to 6.8 percent of GDP from H1FY22 to H1FY23 (Figure 35). The greatest reduction was observed in revenue sharing which fell by 0.8 percentage points of GDP between the two periods, reflecting the lower revenue collection by the federal government. Grant transfers were less affected in the first half of the year, with equalization grants reduced by 0.2 percentage points of GDP and conditional grants reduced by 0.1 percentage points of GDP.

**Figure 35.** While lower fiscal revenues reduced the revenue sharing provided to subnational governments …

![Graph showing revenue sharing, equalization, conditional, and special grants from H1FY22 to H1FY23](image)

*Sources: Ministry of Finance and World Bank staff calculations.*

**Figure 36.** … provincial spending accelerated in the first half of FY23, with an expansion in capital spending.  

![Graph showing provincial spending as a share of GDP](image)

*Sources: Ministry of Finance and World Bank staff calculations.*

**Figure 37.** Budget execution at the provincial level ranged from 11 percent to 25 percent of the annual budget over the first six months of FY23.

![Graph showing provincial budget execution](image)

*Sources: Ministry of Finance and World Bank staff calculations.*

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16 Data for municipal spending in H1FY23 is not yet available.
While provincial governments were able to execute more of their budgets in H1FY23 relative to H1FY22, spending remains uneven across provinces. The size of provincial governments is still relatively small, as collectively the seven provinces spent less than 1 percent of GDP during H1FY23 (Figure 36). During this period, execution of the annual budget ranged from 11 percent in Madhesh to 25 percent in Koshi (Figure 37). It is expected that budget execution will accelerate in the second half of the year, not only because planning and preparing for investments takes time at the beginning of the fiscal year, but also because new officials took office following the provincial elections in November 2022.

**STRUCTURAL CHALLENGES CONSTRAIN EFFECTIVE FISCAL POLICY AND A FULL TRANSITION TO FEDERALISM**

A large share of subnational spending continues to be earmarked. Nepal’s intergovernmental transfer system distinguishes between resources that can be spent at the discretion of subnational governments, such as equalization grants and revenue sharing, and resources that are earmarked for specific sectors and projects, such as conditional grants. While conditional grants conceptually intend to complement subnational spending from untied resources, they have been used extensively during the federalism transition period with the intention to maintain service delivery while local and provincial governments become operational. In FY22, five years after intergovernmental transfers were first paid, conditional grants remain the most important grant used in Nepal, accounting for 4.5 percent of GDP in FY22. Conditional grants are especially prevalent for transfers to local government, accounting for 3.6 percent of GDP in FY22 and financing over half of their spending.
OUTLOOK, RISKS, AND CHALLENGES
Data from the first six months of FY23 paint a mixed picture. The high demand for imports witnessed as Nepal emerged from the pandemic has moderated, foreign exchange reserve buffers are accumulating, credit is growing in a more sustainable fashion, tourists are returning to the country, and remittances are growing strongly as outmigration surges. The less positive aspects of the economy’s evolution include lower growth prospects than previously anticipated, a fiscal deficit in the first half of the year, and the continuation of a challenging external environment as global interest rates continue to rise and commodity prices remain moderately high as Russia’s invasion of Ukraine continues.

The assumptions built into the baseline scenario of this macroeconomic forecast include: (i) a gradual easing of Nepal’s monetary policy repo rate, (ii) declines in global commodity prices in FY24 and FY25 relative to FY23; (iii) a gradual increase in international tourist arrivals, reaching pre-pandemic levels by FY25; and (iv) the commitment of the central bank to maintain foreign exchange reserves at a minimum equivalent of 7 months of concurrent imports during FY23-FY25.
REAL SECTOR

As detailed in the Recent Developments discussion, growth underperformed expectations in FY23Q1. The baseline forecast has been adjusted downwards accordingly and the current forecast projects growth declining to 4.1 percent in FY23 before accelerating once again to 4.9 percent growth in FY24 and further to 5.5 percent growth by FY25, close to the country’s long-term potential growth rate.

The services sector is expected to continue to be the primary driver of real GDP growth over the medium term. Contact-intensive services sub-sectors such as accommodations and transportation are expected to normalize and reach pre-pandemic levels by FY25, as mobility restrictions in all tourism source countries are finally lifted. Key growth drivers for these sub-sectors include the addition of two new international airports and ongoing construction of more than 10 five-star hotels, and the resumption of tourists arriving from China, through its decision to allow its citizens to travel to Nepal as of mid-March 2023. However, wholesale and retail trade are likely to drag on services sector growth in FY23 given tighter credit conditions before gradually easing from FY24 onwards. Considering these factors, service sector growth is projected to slow to 5.2 percent in FY23 and average 5.8 percent in FY24-FY25.

Agriculture growth is expected to pick up marginally in FY23, supported by a projected increase in rice paddy production amid a good monsoon. Unlike the situation experienced in FY23, the shortage in chemical fertilizers is expected to be less severe in FY24 as the government has set aside almost NPR 38.7 billion (0.7 percent of projected FY23 GDP) in FY23 for the purchase of chemical fertilizers at an elevated price for paddy transplantation in June 2023. In addition, the expected fall in global fertilizer prices in FY24 should provide relief in FY25. A delay in global procurement of fertilizers is projected to be partially offset by the five-year agreement signed between the governments of Nepal and India in February 2022, whereby India would supply a fixed quantity of chemical fertilizers to Nepal on an annual basis. Building these considerations into the forecast, agricultural sector growth is projected to average 2.6 percent per year over FY23-FY25.

Industrial sector growth is envisioned to pick up as newly commissioned hydroelectric power plants drive electricity production higher. The electricity sector is expected to drive the industrial sector growth over the medium-term. Over 3200 MWs of electricity generation capacity is currently under construction and these plants are expected to be completed by FY25. However, higher borrowing costs will weigh on this sector in FY23.

Consumer price inflation is expected to peak in FY23 before declining gradually. Average annual inflation is projected to rise to 6.8 percent y-o-y in FY23, remaining close to the central bank’s ceiling of 7 percent as the impact of the Russia’s invasion of Ukraine continues to keep commodity prices elevated. In the outer years of the forecast, average annual inflation is expected to decline to 6 percent in FY24 and further to 5.5 percent in FY25, reflecting the moderation of global commodity prices and the containment of domestic price pressures through monetary policy.

EXTERNAL SECTOR

The trade deficit is forecasted to narrow over the medium term from a record high in FY22. The trade deficit is projected to narrow significantly from 37 percent of GDP to 28 percent of GDP between FY22 and FY23, respectively, and then to widen slightly to 29 percent of GDP in FY24 and FY25 as growth accelerates. Goods imports are expected to fall in FY23 reflecting the import restriction measures through January 2023, tighter credit conditions, the decline in imports of crude edible oils (as arbitrage opportunities fade), reduced COVID-19 vaccine imports, and a decline in electricity imports as the country becomes a net exporter of electricity beginning in FY23. Greater hydroelectricity production over the medium term is expected to further offset imports of fossil fuels as firms, households, and governments switch to cleaner energy, and to support increased electricity exports to India and Bangladesh. Currently, India allows Nepal to export of 452 MW of hydroelectricity produced from ten different projects into their country. Higher electricity exports in FY23 are unlikely to be enough to replace the lost market of refined edible oils exports due to India’s concessional custom duty on these products from other countries. While service exports are forecasted to increase with a rebound in the tourism sector, they are likely to remain less than services imports over the medium term.

The current account deficit (CAD) is expected to remain lower over the medium term relative to the historic high in FY22. The CAD is projected to narrow to 2.8 percent of GDP in FY23, well below 12.8 percent of GDP in FY22, reflecting a smaller trade deficit. In FY24 and FY25 the CAD is expected to narrow further as service exports begin to grow faster than service imports.
to expand gradually as credit conditions ease and in the absence of new import restrictions. Remittances are expected to grow slightly faster than the pace of the economy, rising from 20.8 percent of GDP in FY22 to 22.1 percent of GDP by FY25. Remittance inflows will be supported by the increased international migration following the pandemic and will likely expand over the medium term supported by the migrant-friendly policies recently adopted by the government. These measures include removing the provision of fixed period (two-year) labor approvals and instead aligning the approvals with the duration of the work contract (March 2023); and ii) issuing labor permits from all seven provinces (January 2023). South Korea’s recent decision to provide jobs to an additional 40,000 Nepali workers in 2023 is likely to push up migration as well.

The forecast assumes financing of the current account deficit will retain the same composition as in the past. FDI is expected to remain low in the forecast period despite recent measures lowering the minimum threshold for FDI inflows. Consequently, the current account deficit is expected to remain financed by concessional borrowing, short-term trade credits, and private external borrowing. Long-term borrowing is expected to finance around 60 percent of CAD in the forecast period, while short-term trade credits and other items finance the remaining amount.

**FISCAL SECTOR**

The fiscal deficit is expected to remain under 3.5 percent of GDP throughout the forecast, as underspending of the budget continues, and revenues pick up alongside the growth revival beginning in FY24. The fiscal deficit is projected to stabilize at FY22 level of 3.5 percent of GDP in FY23. This is lower than the originally budgeted deficit of 5 percent of projected GDP, as the government reduced spending mid-year to accommodate the unexpected revenue shortfall. The deficit is expected to narrow slightly in FY24 and FY25 as measures to avoid the duplication of spending among the three tiers of governments are implemented, the government adopts revenue-enhancing reforms such as the removal of some VAT tax exemptions, and capital spending improves with the implementation of new guidelines for the National Project Bank. The deficit is expected to be financed by external concessional borrowing and domestic borrowing in a ratio of 37:63, similar to the financing mix of the last 10 years. Total public debt is projected to reach 41.7 percent of GDP in FY23 and then decrease marginally to 41.6 percent in FY24 and further to 41.5 percent in FY25. The most recent Joint Bank-Fund Debt Sustainability Analysis of January 2022 finds Nepal’s risk of debt distress to be low for both external and public debt.

Risks to the outlook are tilted to the downside. No new shocks are included in the forecast; given the increasing frequency of shocks in recent years, this may be optimistic. Local elections in May 2022 and national and provincial elections in November 2022 were followed by successive changes in administration, the most recent being the collapse of the ruling coalition in March 2023. Political stability remains important to manage the economy and ensure continued pursuit of development priorities. Political stability may not be achieved in the forecast period. Higher than expected inflation would reduce household purchasing power and drag growth. Welfare recovery remains uncertain due to rising inflation and risks to agricultural production. Reduced investments in human capital, especially amongst those yet to recover from a job loss following COVID-19, also impose risks to rising inequality.

**Table 3. Macroeconomic projections of selected key indicators**

<table>
<thead>
<tr>
<th></th>
<th>FY20</th>
<th>FY21</th>
<th>FY22e</th>
<th>FY23f</th>
<th>FY24f</th>
<th>FY25f</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth, at constant market prices</td>
<td>-2.4</td>
<td>4.2</td>
<td>5.8</td>
<td>4.1</td>
<td>4.9</td>
<td>5.5</td>
</tr>
<tr>
<td>Private Consumption</td>
<td>3.6</td>
<td>4.3</td>
<td>5.4</td>
<td>2.5</td>
<td>3.7</td>
<td>4.5</td>
</tr>
<tr>
<td>Government Consumption</td>
<td>3.8</td>
<td>-1.7</td>
<td>5.5</td>
<td>6.3</td>
<td>3.5</td>
<td>6.6</td>
</tr>
<tr>
<td>Gross Fixed Capital Investment</td>
<td>-8.9</td>
<td>9.8</td>
<td>4.6</td>
<td>-15.7</td>
<td>21.7</td>
<td>13.3</td>
</tr>
<tr>
<td>Exports, Goods and Services</td>
<td>-15.9</td>
<td>-21.1</td>
<td>35.0</td>
<td>9.1</td>
<td>21.6</td>
<td>18.4</td>
</tr>
<tr>
<td>Imports, Goods and Services</td>
<td>-20.8</td>
<td>16.3</td>
<td>15.0</td>
<td>-12.3</td>
<td>17.5</td>
<td>12.3</td>
</tr>
<tr>
<td>Real GDP growth, at constant factor prices</td>
<td>-2.4</td>
<td>3.8</td>
<td>5.5</td>
<td>4.1</td>
<td>4.9</td>
<td>5.5</td>
</tr>
<tr>
<td>Agriculture</td>
<td>2.4</td>
<td>2.8</td>
<td>2.3</td>
<td>2.5</td>
<td>2.6</td>
<td>2.8</td>
</tr>
<tr>
<td>Industry</td>
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<td>10.2</td>
<td>3.2</td>
<td>6.5</td>
<td>8.9</td>
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<tr>
<td>Services</td>
<td>-4.5</td>
<td>4.2</td>
<td>5.9</td>
<td>5.2</td>
<td>5.6</td>
<td>5.9</td>
</tr>
<tr>
<td>Inflation (Consumer Price Index)</td>
<td>6.1</td>
<td>3.6</td>
<td>6.3</td>
<td>6.8</td>
<td>6.0</td>
<td>5.5</td>
</tr>
<tr>
<td>Current Account Balance (% of GDP)</td>
<td>-0.9</td>
<td>-7.8</td>
<td>-12.8</td>
<td>-2.8</td>
<td>-4.2</td>
<td>-3.6</td>
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<tr>
<td>Fiscal Balance (% of GDP)</td>
<td>-5.4</td>
<td>-4.1</td>
<td>-3.5</td>
<td>-3.5</td>
<td>-3.2</td>
<td>-3.3</td>
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<tr>
<td>Debt (% of GDP)</td>
<td>36.9</td>
<td>40.6</td>
<td>41.5</td>
<td>41.7</td>
<td>41.6</td>
<td>41.5</td>
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<tr>
<td>Primary Balance (% of GDP)</td>
<td>-4.7</td>
<td>-3.3</td>
<td>-2.6</td>
<td>-2.1</td>
<td>-2.1</td>
<td>-2.4</td>
</tr>
</tbody>
</table>

**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.