

Nepal Development Update

October 2023

Restoring Export
Competitiveness



WORLD BANK GROUP

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NEPAL DEVELOPMENT UPDATE

October 2023

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 Sebastian Michael Essl (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. Baburam Subedi (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), Shabih Ali Mohib (Practice Manager, MPSTI), Lada Strelkova (Manager, Operations), and Meriem Slimane (Program Leader, EFI) for their guidance and comments on the report. Akash Shrestha and Avinashi Paudel managed media relations and dissemination.

The cutoff date is September 15, 2023, and includes data released up until that date.

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EXECUTIVE SUMMARY

EXECUTIVE SUMMARY

The economy faced a slowdown in FY23 primarily due to monetary tightening and import restriction measures.

Hydropower production contributed to the industrial sector growth.

Total investment cooled while private consumption remained strong.

Inflation rose for a third consecutive year in part due to supply shocks and domestic policy changes.

External imbalances improved significantly as goods imports fell and remittance inflows increased.

Recent Economic Developments

Real GDP growth decreased to an estimated 1.9 percent in FY23, the lowest rate since FY20 and substantially below the 10-year average growth rate. Monetary tightening and the effects of import restrictions contributed to the slowdown. Economic activity was particularly subdued in the industry and services sectors, while agricultural output remained more resilient.

Strong energy sector growth helped to avoid an industrial contraction, since manufacturing and construction outputs shrank. Hydroelectric generation increased significantly for the second year in row and added close to 500 megawatts of hydroelectric power to the national grid. Nepal nevertheless remains a net energy importer.

Slow credit growth and import restrictions contributed to a reduction in private investment on the demand side. Lower capital expenditure and revenue underperformance drove lower public investment. As a result, total investment decreased by more than 10 percent, a sharper reduction than in FY20. Private consumption remained robust, owing to strong remittance inflows.

Inflation increased for the third successive year in FY23, and the increase was broad-based. Food prices rose due to supply side shocks and domestic policy changes. Non-food prices were pushed by higher housing and utility prices. The persistence of high inflation impedes an effective policy mix to stimulate growth while containing external imbalances.

Domestic policies and India's trade restriction measures invoked a steep reduction of goods imports. Remittance inflows increased in FY23, following high outward migration in the previous year. Exports stagnated below their pre-pandemic level, caused also by a real appreciation due to Nepal's persistently high inflation. Overall, the current account deficit decreased significantly, and the level of foreign currency reserves increased above its policy floor.

The central bank raised its policy rate in early FY23 to slow credit growth to the private sector and to support the correction of external imbalances. In synergy with import restrictions and higher international prices, credit growth to the private sector slowed compared to the previous year. Deposits grew at the same time, supported by higher real interest rates and several government incentives targeting remittance deposits.

Credit growth to the private sector slowed owing to policy measures taken to help correct the external imbalances.

The contraction of imports caused a sharp decline in fiscal revenues, as more than half of total revenues are trade related. Because expenditures contracted at a much slower pace than revenues, the fiscal deficit nearly doubled to 6.1 percent of GDP, the highest deficit recorded in more than two decades. Overall, public debt increased due to the weaker fiscal performance to 41.3 percent of GDP.

Fiscal space diminished further with the contraction of revenues.

Outlook, Risks, and Challenges

Growth is expected to rebound to 3.9 percent in FY24 and 5 percent in FY25, supported by the lagged impact of lifting import restrictions and the gradual loosening of monetary policy. The continued expansion of hydroelectric production through the commissioning of new projects is expected to carry stronger growth in the industrial sector. Wholesale and retail trade are expected to benefit from the lifting of import restrictions and boost service sector growth. Only agricultural sector growth is expected to slow in FY24, due to the impact of the lumpy skin disease on livestock and a decline in rice paddy production. Inflation is expected to remain elevated, weighing on people's real disposable incomes and private consumption.

Economic activity is expected to gradually gain momentum.

Looser monetary policy and the lifting of import restrictions imply an increase in goods imports over the medium-term. Policies to contain credit growth and lower one-off imports, including of COVID-19 vaccines, are expected to keep imports below its FY22 historic high. Near-record migration of Nepali workers should be reflected in strong medium-term remittance inflows which, however, are not expected to balance the goods and services trade deficit. Consequently, the current account deficit is expected to widen to 3.7 percent of GDP in FY25, and 4.6 percent of GDP in FY25.

The current account deficit is expected to increase moderately.

Revenues are expected to increase in line with higher goods imports, given that taxation focuses heavily on trade. The FY24 budget envisions lower federal spending on capital investment and fiscal transfers to subnational governments, yet higher debt servicing costs. Overall, the recovery of revenues is expected to reduce the fiscal deficit to 3.5 percent in FY24 and 3.3 percent in FY25. Together with the rebound in growth, tighter fiscal policy is expected to keep the overall public debt burden contained at around 41 percent of GDP in FY24 and FY25.

A rebound in revenues should reduce the fiscal deficit and contain public debt.

High inflation expectations continue to weigh on the outlook and require a careful balancing of policies to stimulate growth and to contain external imbalances and inflation. Lumpy skin disease and an erratic monsoon could weigh more than expected on agricultural output, and services and industry could be affected by higher-than-expected import prices or further export bans from India. The recent sharp increase in debt servicing costs highlights the importance of containing the fiscal deficit and ensuring sufficient fiscal space to undertake longer-term investments.

Prudent policies to stimulate growth and contain downside risks are key.

Special Focus

Nepal's export performance has continuously declined.

The special focus section presents first empirical results of how exchange rate and productivity dynamics have contributed to Nepal's dwindling external competitiveness. Exports of goods and services have fallen substantially compared to the early 2000s and have reached a level substantially below that of peer countries. Stronger exports could help Nepal achieve stronger growth, create better domestic jobs, and increase resilience by decreasing dependence on remittance inflows.

A real appreciation of exchange rate and productivity deficit negatively affected exports.

The analysis finds that the real appreciation of bilateral exchange rates contributed significantly to lower exports. Larger firms were more affected by exchange rate movements, but diversification in terms of products and export markets helped. Nepal also accumulated a sizeable productivity gap across all sectors compared to peer countries and its main trading partner, India. This deficit likely contained labor market movements and had a negative effect on Nepali firms' ability to compete for export markets in terms of prices and product quality.













The budgetary process needs further strengthening to better support planning.

This requires budget to be based on a more realistic macroeconomic framework so that policy makers would be able to better determine the expenditure envelope that can be afforded, given expected revenues and the level of deficit that can be safely financed. Ongoing efforts by the Ministry of Finance and other government entities to improve their evidence-based macroeconomic forecasting capabilities are expected to provide a more realistic macroeconomic framework in the future.

Increasing domestic productivity and containing domestic inflation key to improving external competitiveness.

Increasing the domestic productivity requires (a) changing the current tax model by shifting taxation away from the border and reducing high import tariffs; (b) improving the implementation of fiscal federalism which would facilitate effective investments in infrastructure and services; and (c) simplifying and streamlining processes to attract more FDI which would create significant knowledge and spillover effects. In addition, containing domestic inflation would reduce the inflation differential with trading partners. This would help avoid further real appreciation of the exchange rate.

Key Recommendations

	MYR		1	55.26
	CNY		1	27.79
	THB		1	17.67
	KRW		100	3.59
	KWD		1	9.73
	BHD		1	420.74
				344.10







A RECENT ECONOMIC DEVELOPMENTS

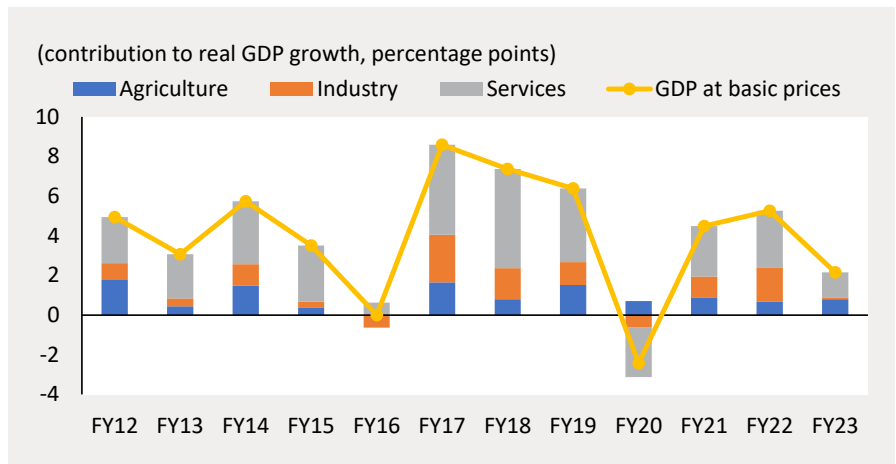
A RECENT ECONOMIC DEVELOPMENTS

A.1 REAL SECTOR

ECONOMIC ACTIVITY WEAKENED

Real GDP growth slowed sharply to an estimated 1.9 percent in FY23, the lowest rate post FY20 (Figure 1). The slowdown occurred on the back of import restrictions and the continued tightening of monetary policy, aimed at addressing the significant widening of external imbalances. The central bank raised its key interest rate by 150 basis points (bps) in July 2022, on top of the 200-bps hike taken during FY22. Import restriction measures were introduced by authorities on December 29, 2021, and were in place until January 19, 2023.¹

Figure 1. Real GDP growth slowed in FY23.



Sources. National Statistics Office and World Bank staff calculations.

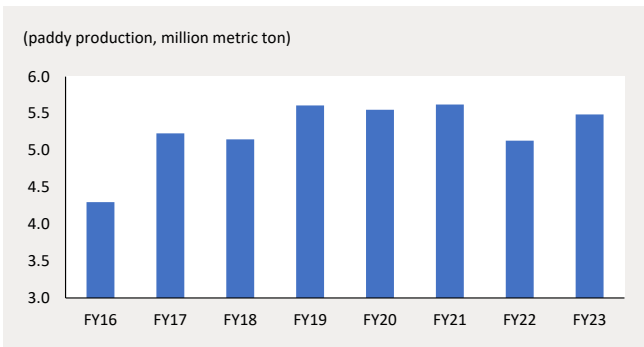
¹ The combined impact of higher interest rates and import restrictions reduced credit growth as intended. A more detailed discussion follows in the Monetary and Financial Sector section of this report.

GROSS DOMESTIC PRODUCT BY INDUSTRIAL CLASSIFICATION

Agricultural Sector

Agricultural output remained resilient and expanded by 2.7 percent in FY23. Rice paddy production supported the sectoral growth and increased by 6.9 percent, reflecting a good summer monsoon and improved seed varieties (Figures 1 and 2). However, a lumpy skin disease has affected livestock as of early April 2023, infecting more than 1 million and killing close to 50,000. The resulting lower dairy product and meat production could negatively affect agricultural output growth. Updated statistics will be released by the National Statistics Office in April 2024.

Figure 2. Rice paddy production expanded in FY23, but the yield was the second lowest since FY18.

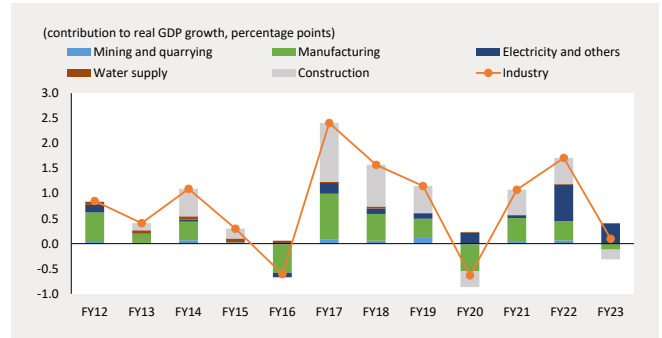


Sources. National Statistics Office and World Bank staff calculations.

Industrial Sector

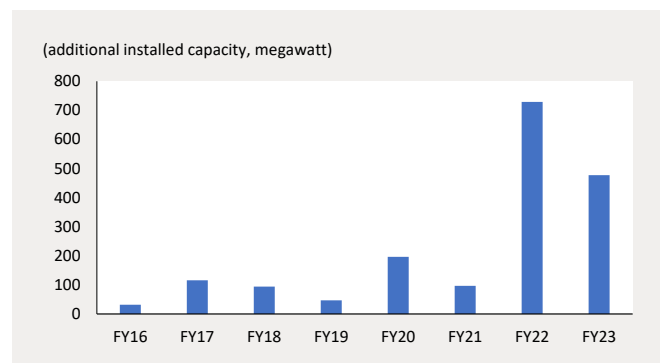
Strong growth in the electricity sub-sector helped to avoid a contraction of the industrial sector. Electricity production expanded by 23 percent in FY23, after close to 500 megawatts of hydroelectric power were added to the country’s grid (Figures 3 and 4). Manufacturing and construction, on the other hand, shrank by 2 percent and 2.6 percent, respectively. The decline was partly due to lower production of key construction materials (cement, basic iron, and steel) and vegetable oils² in the first half of FY23 (Figure 5). Higher frequency indicators suggest that the decline continued in the second half of FY23 (Figure 6). Lower demand resulting from the elevated prices of manufactured goods and construction materials (Figure 7) further weighed on industrial output, which increased by a meager 0.6 percent (Figure 3).

Figure 3. Strong growth in the electricity sub-sector prevented a contraction of industrial output in FY23.



Sources. National Statistics Office and World Bank staff calculations.

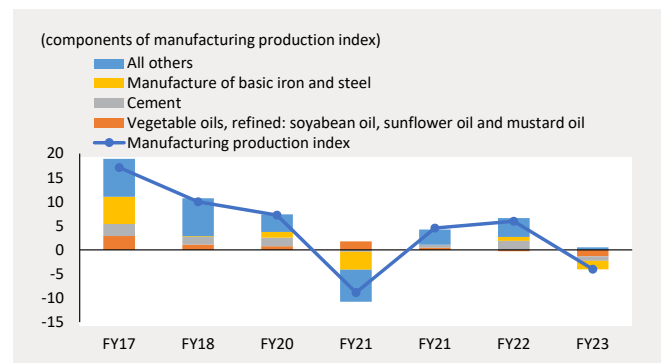
Figure 4. Hydroelectric generation expanded by almost 500 megawatts during FY23.



Sources. Department of Electricity Development and World Bank staff calculations.

Note. Includes only hydropower installed with a capacity greater than 1 megawatt.

Figure 5. The manufacturing and construction sectors contracted during the first half of FY23 due to lower production of edible oils and construction materials...

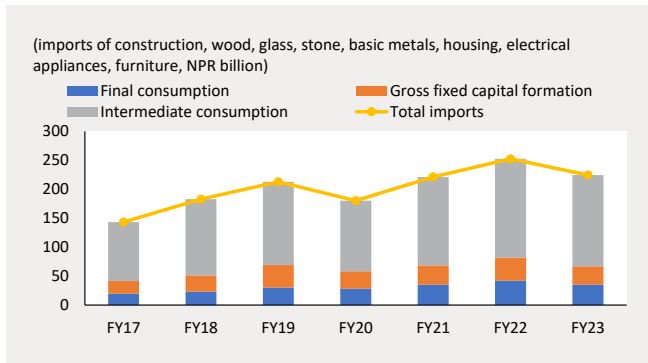


Sources. National Statistics Office and World Bank staff calculations.

Note. FY23 includes the data for the first 2 quarters only

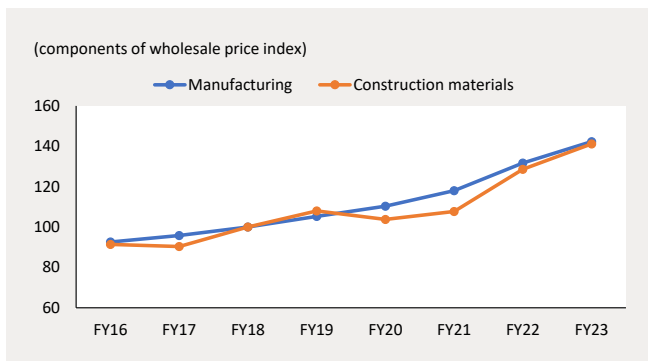
² A more detailed discussion of the edible oils export market follows in the External Section of this report.

Figure 6. ...and imports data show that the contraction continued in the second half of FY23.



Sources. Department of Electricity Development and World Bank staff calculations.

Figure 7. Lower demand reflecting higher prices of manufacturing goods and construction materials further weighed on industrial output.



Sources. Department of Customs and World Bank staff calculations.

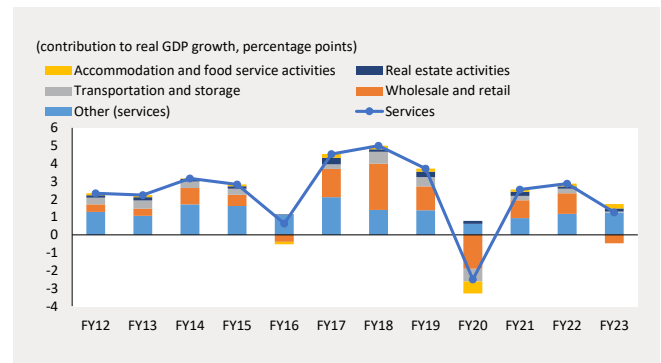
External factors also contributed to the contraction of manufacturing output in FY23. India implemented a complete export restriction on wheat beginning in May 2022, followed by a partial restriction on wheat exports beginning in December 2022. These measures led to the closure of a significant number of Nepali flour mills and consequently reduced the production capacity of manufacturing firms using wheat flour as raw material.

Services Sector

Sluggish wholesale and retail trade slowed the pace of services sector growth. Authorities estimate that the services sector expanded by 2.3 percent in FY23, the slowest pace since FY20 (Figure 8). Growth of the wholesale and retail trade sub-services sector declined 0.5 percent due to high inflation and lower goods imports. Tourism and tourism-related activities, which were severely impacted by COVID-19, continued to experience double-digit growth, boosted by a significant rise in international tourist arrivals. The number of arrivals nevertheless remains below pre-pandemic levels

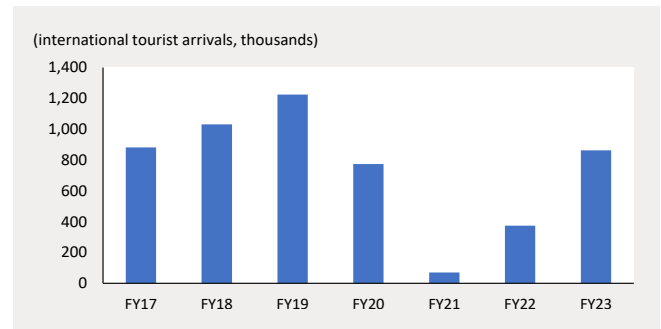
(Figure 9). Real estate transactions plummeted by 39.4 percent in FY23 (Figure 10), due to the inability of more than 500 local governments to implement the 2022 Land Use Regulations, which require a classification of land into agriculture and non-agriculture use. Credit growth of real estate lending also slowed (Figure 11) and contributed to the lower real estate transactions, but the growth of the real estate sub-sector was relatively unchanged due to an increase in housing rental activities (Figure 8).

Figure 8. Services sector growth slowed due to the contraction in the wholesale and retail trade sub-sector.



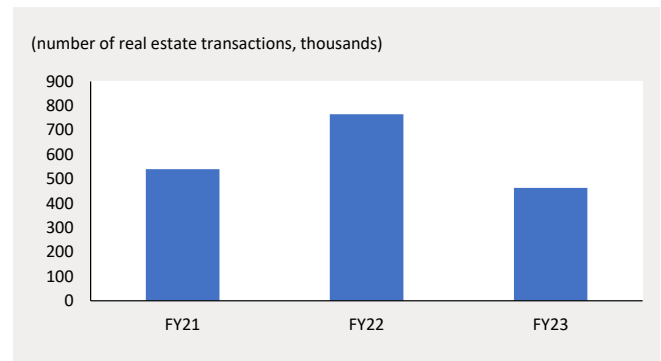
Sources. National Statistics Office and World Bank staff calculations.

Figure 9. International tourist arrivals rose in FY23 but remained below pre-pandemic levels.



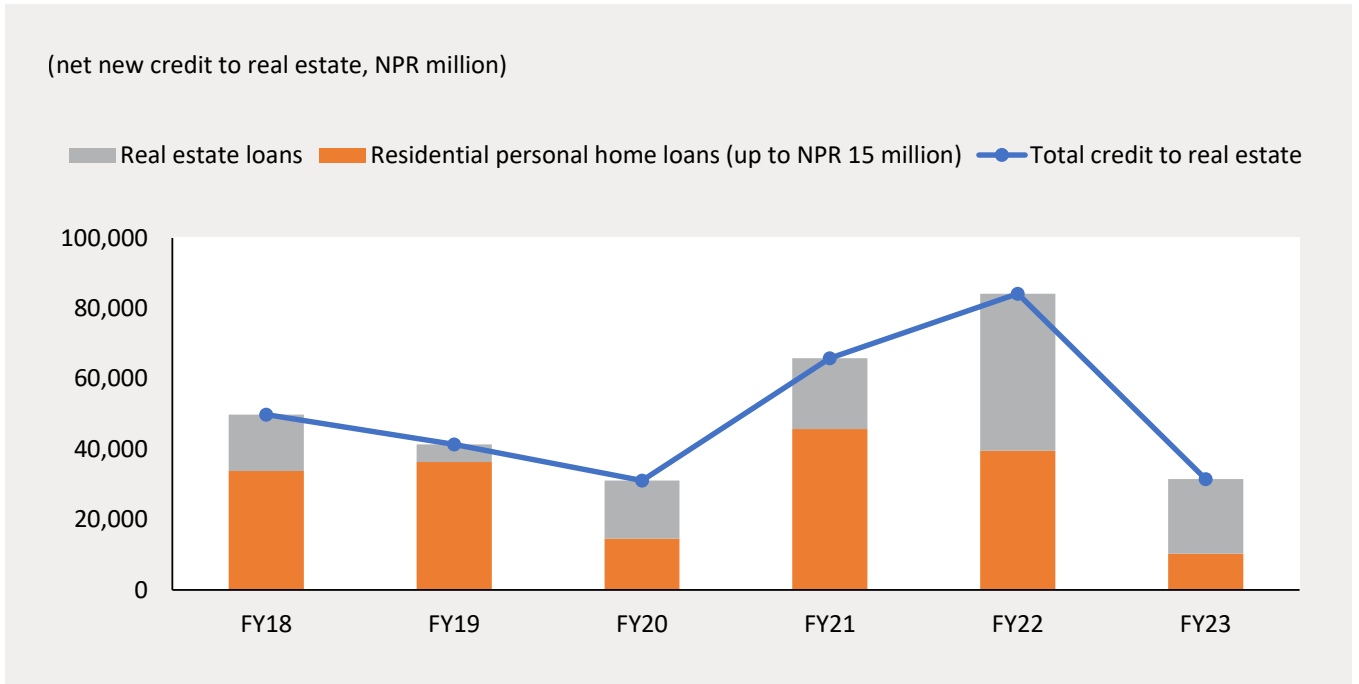
Sources. Nepal Rastra Bank and World Bank staff calculations.

Figure 10. Real estate transactions decreased in FY23...



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

Figure 11. ...in part to the decrease in net new credit to real estate.



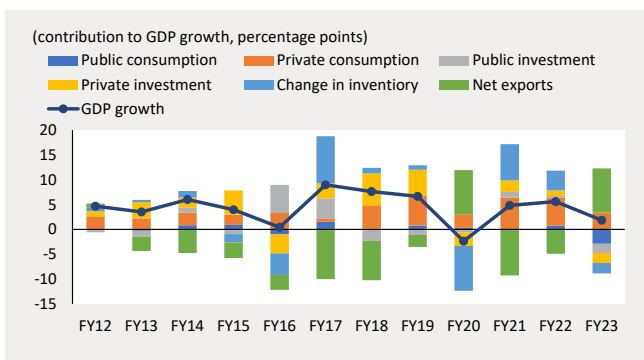
Sources. Nepal Rastra Bank and World Bank staff calculations.

GROSS DOMESTIC PRODUCT BY DEMAND

The reduction in public and private investment contributed to the slowdown in overall real GDP growth (Figure 12). Total investment declined by 10.9 percent in FY23, greater than the contraction registered in FY20. Private investment fell by 7.6 percent and provided a negative contribution of 2 percentage points (pp) to the overall real GDP growth. The main drivers of this decrease were slower credit growth to the private sector,

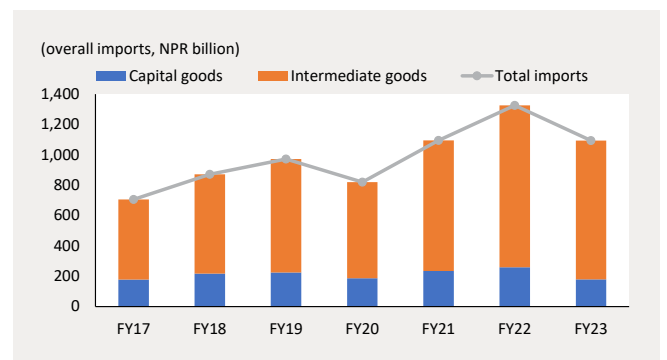
lower domestic production of construction materials, and lower imports of intermediate and capital goods (Figure 13). Public investment declined by 20.2 percent and contributed negatively by 1.9 pp to the overall real GDP growth, driven by reduced capital expenditure and reflecting revenue underperformance.³

Figure 12. Lower investment slowed growth on the demand side...



Sources. National Statistics Office and World Bank staff calculations.

Figure 13. ...in part due to lower imports of intermediate and capital goods.

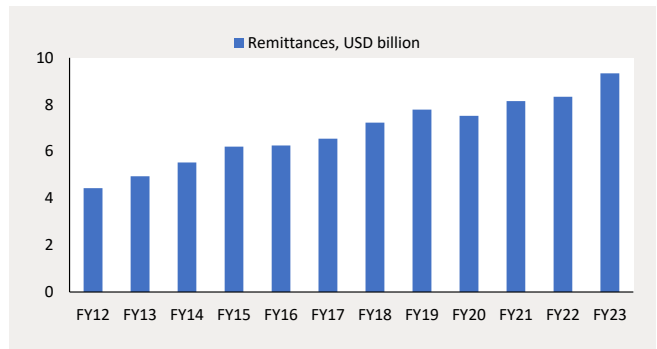


Sources. Department of Customs and World Bank staff calculations.

³ A discussion on the evolution of fiscal revenues and expenditures during FY23 follows in the Fiscal Section of this report.

Private consumption remained robust owing to strong remittances inflows. Remittances rose by 12 percent in FY23 and fueled the increase in private consumption of 4.1 percent during the year (Figure 14). The decline in goods imports and domestic goods production suggest that services consumption, rather than goods consumption, contributed to the growth in private consumption. Public consumption declined in part due to lower fiscal transfers to subnational governments, as discussed in the Fiscal Section of this report.

Figure 14. Private consumption remained strong reflecting higher remittances.



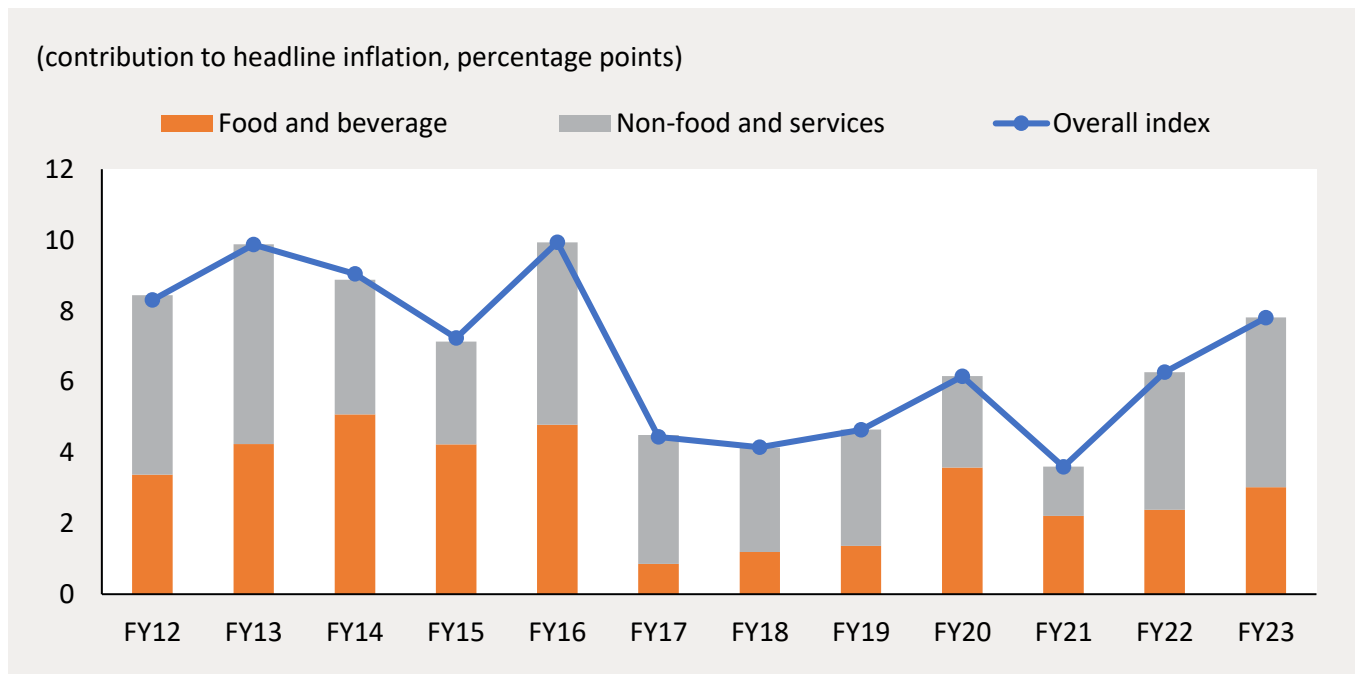
Sources. Nepal Rastra Bank and World Bank staff calculations.

Inflation has accelerated

Average consumer price inflation reached a seven-year peak in FY23. Average inflation amounted to 7.8 percent in FY23, above the central bank’s 7 percent policy ceiling, driven by both food and non-food prices (Figure 15). Key drivers of food prices, which increased by 6.9 percent, included supply side shocks such as India’s wheat and rice export restrictions⁴, and domestic policy changes including the removal of VAT exemptions on multiple basic food items and price support to producers of rice paddies, milk, and wheat⁵. Non-food

prices rose by 8.5 percent, driven by higher housing and utility prices, and an increase in the consultation fee of medical doctors in May 2023. The decline in edible oil prices from February 2023 onwards, reflecting global price reductions, had an offsetting effect on prices. The persistence of high inflation impedes policies to stimulate growth. Particularly, Nepal’s vulnerability to external shocks implies a difficult trade-off between policies that boost growth and those that contain inflation.

Figure 15. Average consumer inflation increased in FY23 due to both food and non-food inflation.



Source. Nepal Rastra Bank and World Bank staff calculations.

⁴ India introduced bans on wheat exports in May 2022. During September to November 2022, India also introduced an export ban on broken rice and a 20 percent custom duty on various types of rice exports.

⁵ Authorities announced the removal of VAT exemptions in May 2023.

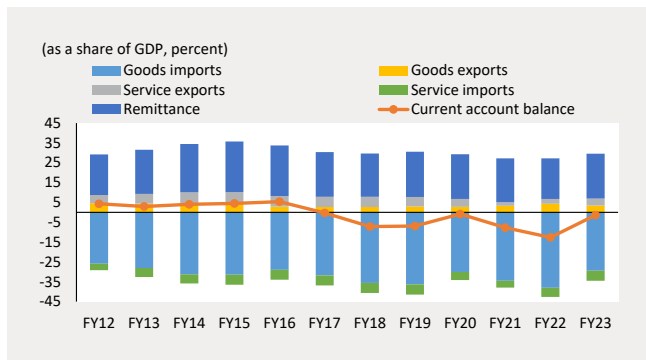
A.2 EXTERNAL SECTOR

EXTERNAL SECTOR IMBALANCES HAVE IMPROVED

The current account deficit narrowed to a six-year low in FY23, driven by lower imports and higher remittances.

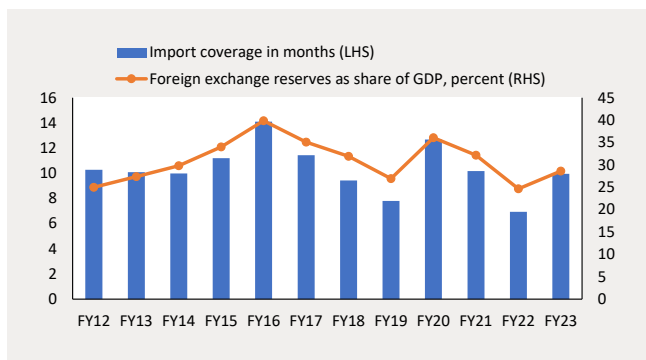
The current account deficit fell from 12.6 percent of GDP in FY22 to 1.3 percent of GDP in FY23 (Figure 16). The reduction occurred through lower imports of goods and services, which fell from 42.6 percent of GDP in FY22 to 34.5 percent of GDP in FY23. Exports on the other hand remained stable, and remittances rebounded strongly. Foreign reserves ended FY23 at a comfortable level of 10 months of concurrent import cover, above the policy floor of 7 months of import cover (Figure 17).

Figure 16. The current account deficit narrowed significantly in FY23...



Sources. Nepal Rastra Bank and World Bank staff calculations.

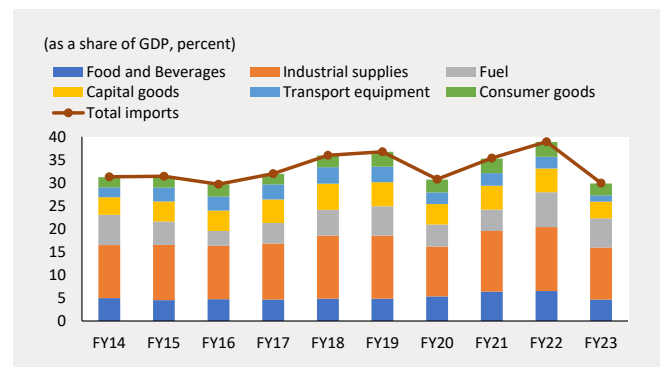
Figure 17. ...leading to an accumulation of reserves.



Sources. Nepal Rastra Bank and World Bank staff calculations.

Domestic policies and external factors contributed to a significant reduction in goods imports. Industrial supplies were the goods category that experienced the most pronounced reduction (Figure 18). Overall, key reasons for lower goods imports included (Table 1): i) the government’s ban on the import of select luxury goods from April 26, 2022 to December 15, 2022 (0.4 percent of GDP⁶); ii) the central bank’s imposition of a 50-100 percent cash margin on the import of select goods through a letter of credit from December 20, 2021 to January 19, 2023 (- 2 percent of GDP); iii) India’s restrictions on the export of broken rice and levying of a 20 percent customs duty on the export of other rice varieties from September to November 2022 (-0.5 percent of GDP); iv) India’s ban on the export of wheat beginning May 2022 (-0.2 percent of GDP); v) a reduction in COVID-19 vaccine imports (- 0.5 percent of GDP)⁷; vi) reduced edible oil imports (- 0.7 percent of GDP)⁷; vii) the government’s policy to discourage billet imports and promote the domestic production of billet by reducing the customs duty on raw materials (sponge iron, scrap iron, pig iron and ferro alloys) used to produce billets (0.4 percent of GDP) and levying the custom duty and excise duty on billets import (-0.5 percent of GDP); and viii) transition from fossil fuel to electricity by manufacturing firms and households⁸ (-0.7 percent of GDP).

Figure 18. Goods imports plunged in FY23.



Source. Department of Customs and World Bank staff calculations.

Note. Goods imports do not include electricity imports.

⁶ Increase of imports suggests that imports increased in the second half of FY23 after lifting of restrictions, leading to the overall increase in FY23 relative to FY22.

⁷ Nepal has benefitted in the past from trade preferences in edible oils, despite not producing crude edible oil itself. During FY23, India reduced its import duties with non-SAARC countries on crude and refined edible oils (palm, soybean, sunflower). As the advantage that Nepal previously enjoyed by refining imported crude edible oils and exporting those oils to India dwindled, Nepal’s imports of crude edible oils declined accordingly.

⁸ Total sales (Gigawatt hour) increased by 5.7 percent between FY22 and FY23.

Table 1. Impact of key policy changes on import value and import revenue of FY23.

Key policy changes	Import value		Import revenue	
	NPR million	share of GDP, percent	NPR million	share of GDP, percent
Imposition of import restriction and cash reserve requirement on select goods	-186880	-3.5	-97735	-1.8
o/w: Imposition of import restriction on select goods	22256	0.4	4467	0.1
o/w: Imposition of cash reserve requirement on select goods	-105820	-2.0	-40499	-0.8
o/w: Imposition of cash reserve requirement and import restriction on select goods (both)	-103316	-1.9	-61703	-1.1
India's trade restrictions on select goods	-76084	-1.4	-5066	-0.1
o/w: export of broken rice and levying of a 20 percent customs duty on the export of other rice varieties	-28090	-0.5	-2530	0.0
o/w: export of wheat	-11262	-0.2	-199	0.0
o/w: reduced custom duties on imports of edible oil	-36732	-0.7	-2337	0.0
Dissipation of one-off import of COVID-19 vaccine	-25981	-0.5	0	0.0
Government policy to discourage imports of billet and encourage the domestic production of billet	-7422	-0.1	-2780	-0.1
o/w: Reduction in the custom duty on raw materials (sponge iron and pig iron) used to produce billet	21015	0.4	3072	0.1
o/w: Imposition of the custom duty and excise duty on import of billet	-28437	-0.5	-5852	-0.1
Transition to electricity	-35238	-0.7	-15057	-0.3
Total	-331604	-6.2	-120637	-2.2

Sources. Department of Customs, National Statistics Office, and World Bank staff calculations.

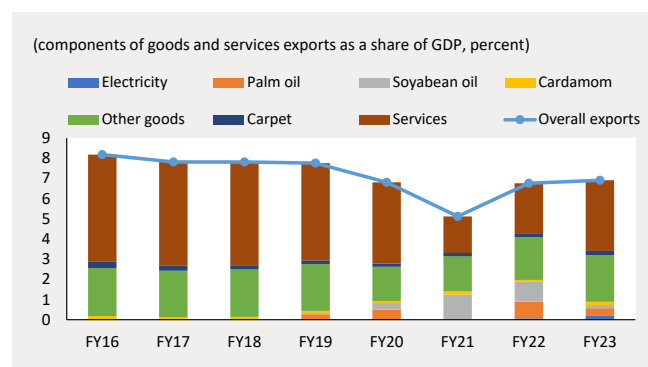
Note. Negative sign indicates decrease.

Imports of services, on the other hand, expanded by 0.4 pp to 5.1 percent of GDP.

Educational service imports rose to 1.9 percent of GDP in FY23. During FY23, the authorities issued more than 100,000 no objection certificates (NOC) to students for studying abroad, as required by the Ministry of Education.

Exports of goods and services stagnated and remained below their pre-pandemic level.

Total exports rose by a meager 0.1 percent of GDP between FY22 and FY23, from 6.8 to 6.9 percent of GDP (Table 2). Goods exports decreased by 0.9 percent of GDP, owing to lower exports of refined edible oils (Figure 19). This was offset by a 1 percent of GDP increase in services exports, due to higher international tourist arrivals. Electricity exports to India continued to increase

Figure 19. Exports of goods and services increase marginally.


Sources. Department of Customs, Nepal Rastra Bank, and World Bank staff calculations.

Table 2. Selected External Sector Indicators (percent of GDP).

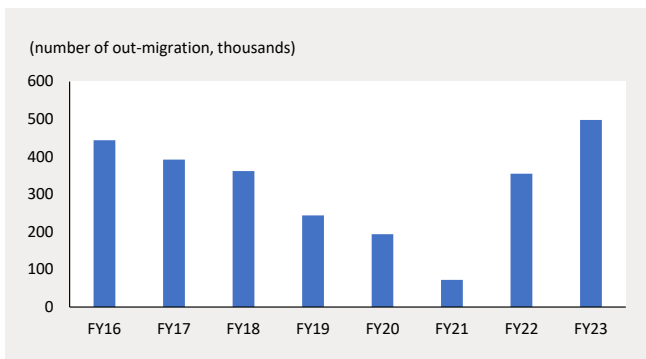
	FY17	FY18	FY19	FY20	FY21	FY22	FY23
Current Account Balance	-0.3	-7.1	-6.9	-0.9	-7.7	-12.6	-1.3
Balance of Goods and Services	-29.1	-32.9	-33.3	-27.3	-31.1	-33.7	-26.0
Total Exports of Goods and Services	7.8	7.8	7.8	6.8	5.1	6.8	6.9
Total Imports of Goods and Services	36.8	40.6	41.4	34.1	37.9	42.6	34.5
Remittances	22.6	21.8	22.8	22.5	22.1	20.4	22.7
Net Foreign Direct Investment	0.4	0.5	0.3	0.5	0.4	0.4	0.1
Gross Official Reserves (USD billion)	10.2	10.6	9.2	12.1	11.9	10.1	11.8

Sources. Nepal Rastra Bank and World Bank staff calculations

alongside higher domestic production of hydroelectricity and rose to 0.2 percent of GDP in FY23, up from less than 0.1 percent of GDP in FY22. Nepal, however, is still a net importer of electricity.⁹ Exports of cardamon and carpet rose by approximately to 0.1 percent of GDP.

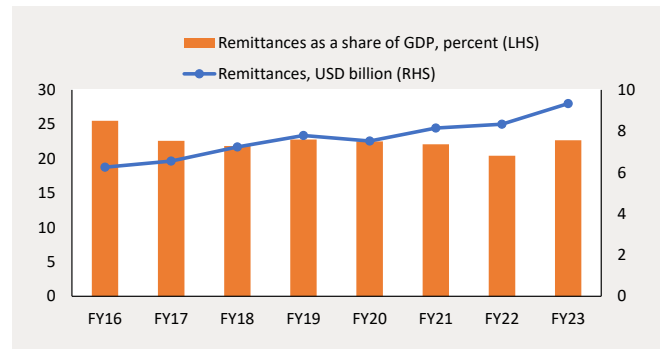
Official remittance inflows surged to a five-year high in FY23. Remittance inflows climbed from 20.4 percent of GDP in FY22 to 22.7 percent of GDP in FY23 (Figure 21). The increase reflected i) the lagged impact of high outmigration in the previous year (Figure 20); ii) the 8.2 percent depreciation of the NPR against the US dollar; iii) the regulatory requirement to set aside 10 percent of Initial Public Offering (IPO) shares of Nepali companies for Nepalis working abroad, beginning in November 2022; and iv) the expansion of social security benefits to Nepalis working abroad, beginning in March

Figure 20. Outmigration of Nepalis for work outside the country surged following the pandemic and the lifting of movement and border restrictions...



Sources. Nepal Rastra Bank and World Bank Staff calculations.

Figure 21. ...increasing the remittances inflows sent back, with a lag.



Sources. Nepal Rastra Bank and World Bank Staff calculations.

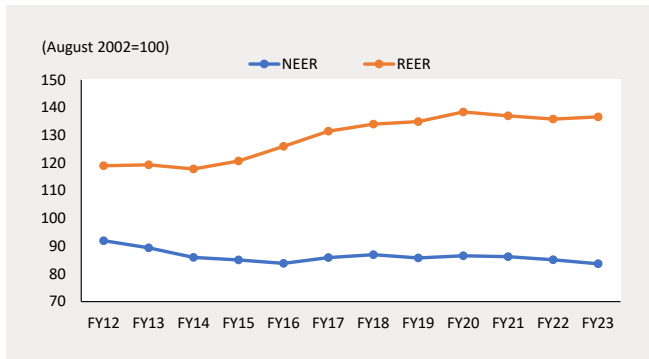
2023.¹⁰ Previous remittance incentives include a one percentage point fixed deposit interest rate boost for Nepali migrant workers that open a remittance-funded account with domestic banks or financial institutions. In the first 10 months of FY23, the share of such remittances deposits in the overall fixed deposits stood at 2.3 percent.

Despite a nominal depreciation, the Nepali rupee (NPR) appreciated in real terms against the currencies of trading partners during FY23, as it has in many prior years. The real effective exchange rate (REER) of the NPR appreciated by 0.6 percent in FY23 (Figure 22), reflecting higher inflation in Nepal relative to trading partners. Removing inflation from the calculation, the nominal effective exchange rate (NEER) depreciated by 1.7 percent against Nepal’s trading partners (Figure 22). The NEER depreciation reflects the US

⁹ Imports of thermal-produced electricity from India during the dry season rose to 0.4 percent of GDP in FY23.

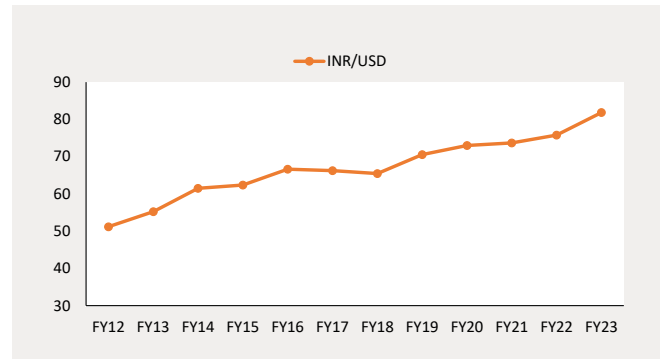
¹⁰ By the end of FY23, more than 237,000 migrant workers have enrolled in the social security plan.

Figure 22. Nepal’s real effective exchange rate (REER) appreciated during FY23 reflecting higher prices in Nepal relative to that of trading partners.



Sources. World Bank staff calculations.

Figure 23. The depreciation of the NPR against the USD directly reflects the depreciation of the INR against the USD.



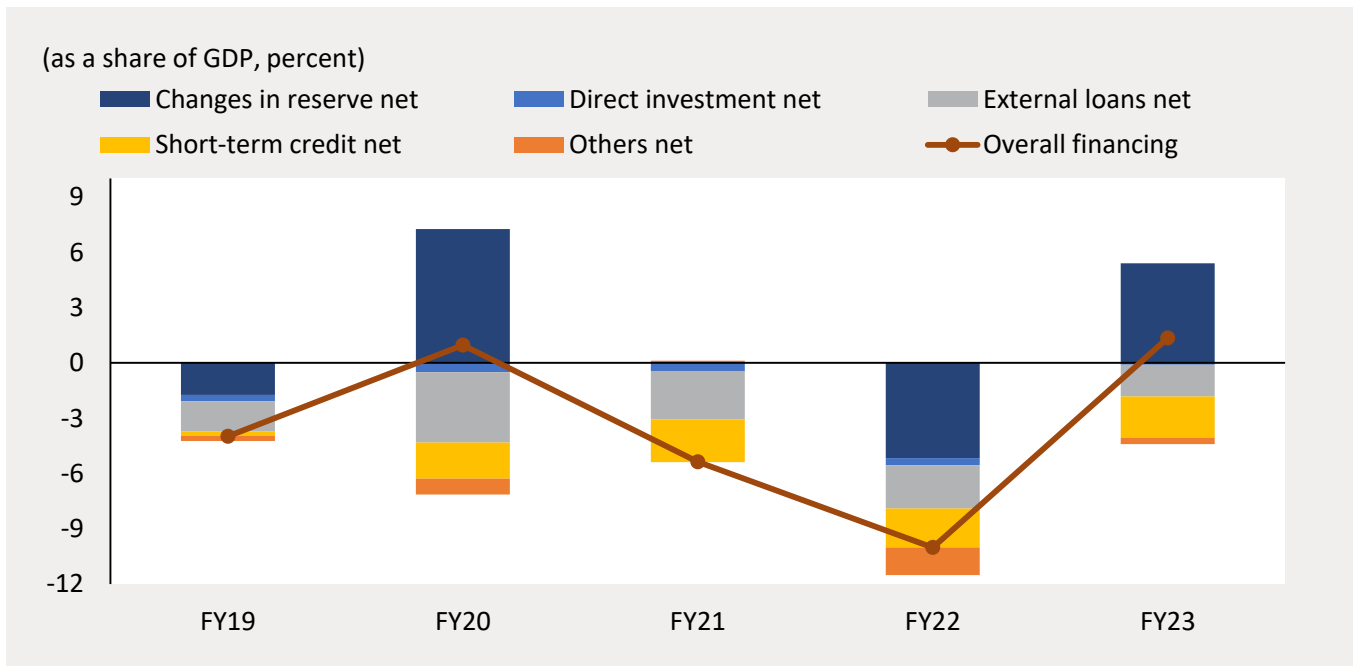
Sources. IMF

Dollar (USD) appreciation relative to the Indian rupee (INR) and other major currencies. Due to the peg, Nepal’s nominal exchange rate with convertible currencies is exogenous to Nepali policy and instead directly reflects movements between the INR and other currencies (Figure 23).

As the current account deficit narrowed and external debt servicing obligations remained low, foreign reserves increased during FY23. Net external borrowing provided 1.7 percent of GDP in financing to the current account deficit

(Figure 24). Foreign direct investment remained negligible and contributed a mere 0.1 percent of GDP. Trade credit and advances contributed 2.2 percent of GDP, while errors and omissions in the balance of payments are estimated by the central bank to have reached USD 1.1 billion during the year, equivalent to 2.5 percent of GDP. As the financing exceeded the current account deficit, foreign exchange reserves rose by 4 percent of GDP in the year to 28.6 percent of GDP in FY23, equivalent to 10 months of concurrent imports of goods and services.

Figure 24. Current account deficit was financed by net external loans and other sources.



Sources. Nepal Rastra Bank and World Bank staff calculations.

A.3 MONETARY AND FINANCIAL SECTOR

Monetary policy objectives and challenges

The primary objective of the central bank, Nepal Rastra Bank (NRB), is to implement monetary and exchange rate policy to achieve price and balance of payments stability for economic stability and sustainable economic development.¹¹ During FY23 particular attention was paid to closing the wide current account deficit resulting from high import demand and the nominal depreciation of the NPR against convertible currencies.

When the FY23 Monetary Policy was released, NRB anticipated difficulties in maintaining foreign exchange reserves above the policy floor of seven months of import cover, even if all foreign grants and loans in the government's budget were to materialize.¹² Continued gradual removal of regulatory pandemic-era forbearance was planned, as well as reducing the concentration of credit.

The final import restriction imposed during FY22 was dismantled in January 2023. In January 2023, the requirement of a cash deposit (cash margin, equivalent to 50-100 percent of import value) to be placed in a bank account when an importer opened a Letter of Credit was removed. The central bank noted that the three import restriction measures imposed in FY22 – bans on specific goods imports, requirements to open a Letter of Credit for importation, and the further requirement of cash deposits (cash margins) backing such Letters of Credit – contributed to the 21 percent decline in goods imports during the first half of FY23.¹³

NRB's inflation ceiling of 7 percent for FY23 was not met.

As described in more detail in the Real Section of the current report, average consumer prices rose by 7.8 percent in FY23. High inflation weighs on growth and aggregate demand, in addition to appreciating the country's real effective exchange rate and reducing the competitiveness of Nepali firms. Further discussion of these impacts is provided in the Special Focus of the current report.

Liquidity and solvency indicators in the banking sector appear healthy

The number of banks and financial institutions (BFIs) continued to fall in FY23. Following the introduction of a merger and acquisition policy by the regulator in previous years, the combined number of commercial banks, development banks, and finance companies fell from 60 to 54 during FY23.¹⁴

Indicators of bank soundness appear strong. Total capital to risk-weighted assets ratio among BFIs - a measure of bank capital adequacy – ended FY23 at 13.4 percent, relatively unchanged compared to FY22. Non-performing loans (NPLs) of BFIs, –those loans that are overdue by 90 days or more, have increased to 3 percent of total loans by end-FY23.¹⁵ While this is the highest NPL ratio registered in the past six years, it remains low by international standards.

Although financial institution soundness indicators remain reassuring, some forbearance measures in place through the end of FY23 may mask actual asset quality in the banking sector. As of mid-July 2023, NPR 197.1 billion in loans has been provided to 147,778 borrowers at subsidized interest rates under the government's concessional lending program. 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 the possibility to restructure SME loans under NPR 20 million.

The government envisions a closer look at the asset quality of Nepali banks. As part of its larger reform program, by end-April 2024 the government will launch in-depth on-site inspections of the largest 10 banks. These inspections will be assisted by independent international third-party auditors with the aim of reviewing loan portfolios in line with the new regulatory framework, paying special attention to loan and collateral valuation, evergreening, group borrowing,

¹¹ Paragraph 1 of the Nepal Rastra Bank "Monetary Policy for 2022/23" statement

¹² Paragraph 58 of the Nepal Rastra Bank "Monetary Policy for 2022/23" statement

¹³ Paragraph 40 of the Nepal Rastra Bank "Half-Yearly Review of Monetary Policy for 2022/23"

¹⁴ The combined number of commercial banks, development banks, and finance companies has fallen steadily since 2018, when they numbered 86. (NRB Financial Stability Report FY 2021/22).

¹⁵ Nepal Rastra Bank, "Banking and Financial Statistics, Monthly", Mid-July 2023

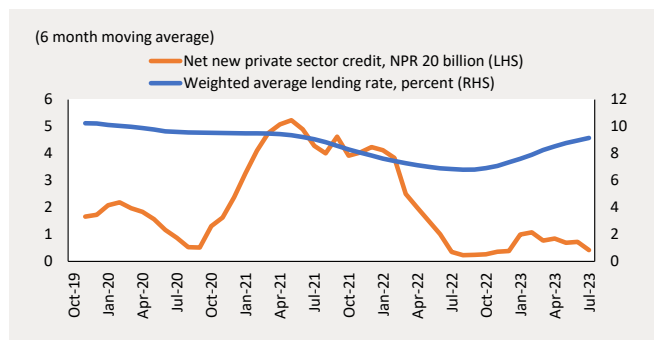
and concentration risks.¹⁶ Following these assessments, the government intends to develop a plan to address the review’s findings, and any bank with a capital shortfall will be required to submit a capital management plan that sets out how they will return to full compliance with regulatory requirements.

Market capitalization of the Nepali stock market relative to GDP fell for the second year in a row during FY23. Market capitalization ended FY23 at 57.3 percent of GDP, 0.9 pp lower than at the end of FY22 and 34.9 pp lower than at end FY22. Two years of successive contraction in market capitalization when the economy grew at 5.6 percent and 1.9 percent suggests there is not a close relationship between economic growth and equity market expansion. Instead, within the confines of an economy subject to capital controls, Nepali investors have relatively few investment choices.¹⁷ The top three sectors in terms of market capitalization ending FY23 were commercial banks (30.9 percent), insurance companies (15.4 percent), and hydropower companies (13.2 percent).

Policy focused on moderating credit growth and thus import demand

Credit growth was exuberant in FY21 and FY22 (Figures 25 and 26), and a host of measures were deployed during FY22 and FY23 to moderate credit growth and thus import demand. 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. NRB’s Monetary Policy for FY23 aimed at reallocating credit to the productive sector rather than focusing on credit growth.¹⁸

Figure 25. Higher average lending rates, higher international prices, and import restrictions led to new credit declining sharply.



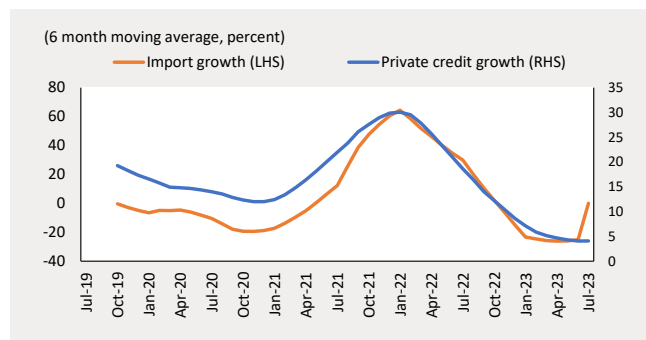
Sources. Nepal Rastra Bank and World Bank staff calculations.

NRB 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. The inflation ceiling was set at 7 percent (0.5 pp 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.

NRB raised the policy rate at the beginning of FY23 to continue slowing credit growth. The policy rate (the repo rate) was increased by 150 bps to 7 percent in August 2022 (Figure 27) and maintained at this level throughout the year. Contextually, higher rate 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 5.5 percent from FY18 to FY22. The bank rate was set at 8.5 percent and the deposit collection rate at 5.5 percent. These rates, together with the policy rate, determine the interest rate corridor (IRC).

NRB announced that a deposit collection auction would be established and activated when the interbank rate decreases by more than 1.5 pps below the policy rate. However, as shown in Figure 27, two episodes of excess liquidity lowered the interbank rate below the tolerance limit during FY23. It is unclear why excess liquidity was not absorbed during June and July 2023, as excess liquidity can lead to higher inflation.

Figure 26. As a result, import growth contracted on an annual basis while credit growth continued to slow.



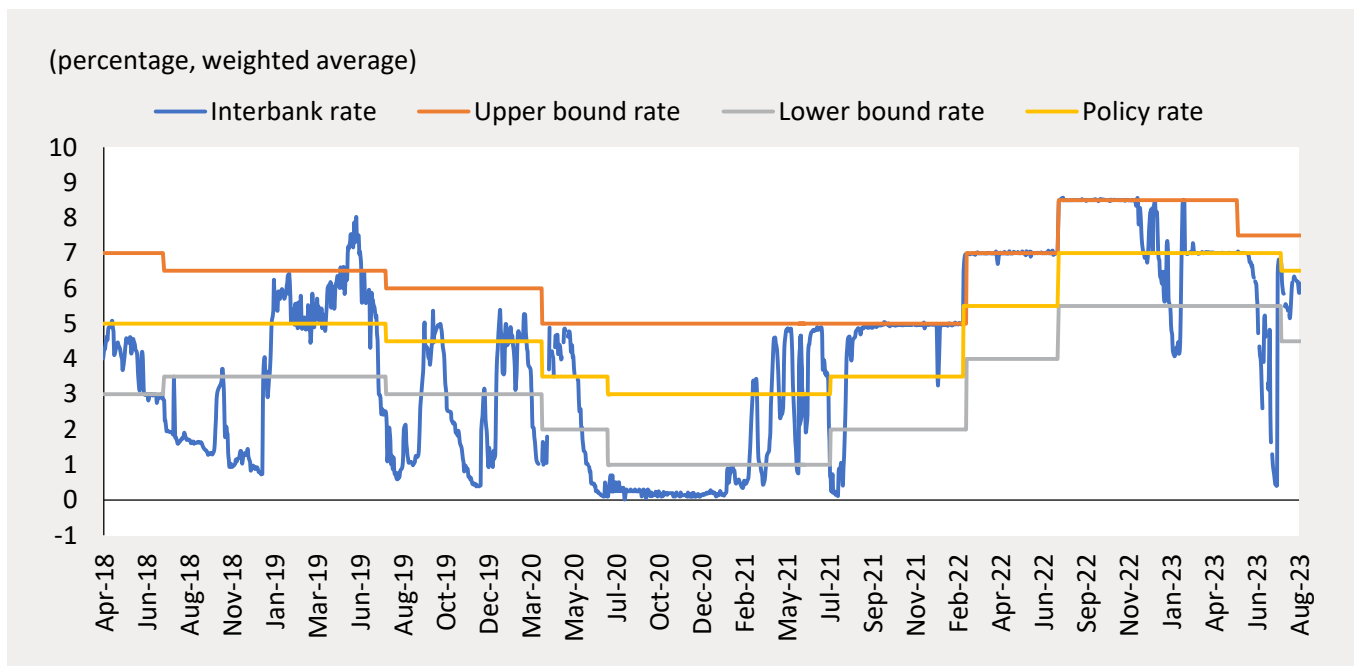
Sources. Nepal Rastra Bank and World Bank staff calculations.

¹⁶ IMF, April 12, 2023. Attachment 1 “Memorandum of Economic and Financial Policies” of the “Nepal: Staff Report for the 2023 Article IV Consultation, First and Second Reviews under the Extended Credit Facility Arrangement, Requests for Waivers of Nonobservance of Performance Criteria, Extension of the Arrangement, and Rephasing of Disbursements”

¹⁷ Foreign participation in the Nepali stock market is not permitted. A proposal to allow investments by non-resident Nepalis in the stock market is currently under consideration by the Nepal Securities Board.

¹⁸ Nepal Rastra Bank, July 22, 2022 “Monetary Policy for 2022/23 (unofficial translation)” delivered by Governor Mr. Maha Prasad Adhikari

Figure 27. A gradual reduction in the upper bound of the Interest Rate Corridor was observed at the end of FY23, accompanied by lower interbank lending rates in the second half of the year.



Source. Nepal Rastra Bank and World Bank staff calculations.

Notes. The Interest Rate Corridor is composed of (a) an upper bound, the Standing Liquidity Facility (SLF), (b) the policy rate, which is the central bank's repo rate, and (c) a lower bound, the Deposit Collection Rate.

NRB expanded liquidity facilities for commercial banks.¹⁹

These consisted of: (a) an Intraday Liquidity Facility (ILF) at the bank rate; (b) an Overnight Liquidity Facility (OLF) at the bank rate; (c) a Standing Liquidity Facility (SLF) provided for a maximum period of 5 days at the bank rate; and (d) lender of last resort facilities available once all other liquidity provision is exhausted, at 2 pp above the bank rate.

Several regulatory settings for the financial sector were revised midway through FY23, though interest rates remained unchanged.²⁰ The OLF facility was activated and set at the policy rate of 7 percent, and the ILF was set at the bank rate of 8.5 percent. Working capital loan guidelines were amended, and the Intraday Liquidity Facility Procedure was amended.

The combined impact of higher international prices, import restrictions, and policy rate hikes led to a slowdown in credit to the private sector as a share of GDP during FY23.

Nominal credit to the private sector grew at a slower rate than GDP during FY23. Hence, relative to GDP, credit to the private sector shrank from 100 percent to 94 percent of GDP

from FY22 to FY23 (Figure 29). Year-on-year nominal credit growth slowed from a peak of 30 percent in FY22 to a trough of 5 percent in FY23, applying a 6-month moving average (Figures 25 and 26).

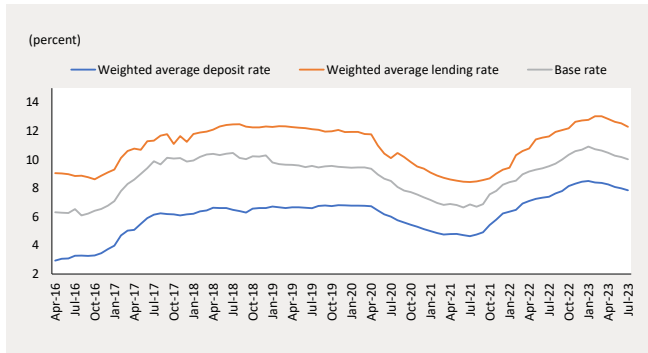
Once credit growth was controlled, gradual policy rate relaxation could commence

Financial market liquidity conditions began to ease in the second half of FY23, as evidenced by greater interbank rate fluctuations and lower banking sector demand for central bank liquidity. After pegging for months at the upper end of the IRC, the interbank rate fell below the SLF rate in December 2022 and began fluctuating within the corridor as the interbank market was able to supply sufficient liquidity to its members within the prevailing interest rate regime (Figure 27). The amount of liquidity requested by the banking system of the central bank also declined relative to that of FY22 (Figure 32).

¹⁹ ILF, OLF, and SLF liquidity available to commercial banks on demand, collateralized with government securities.

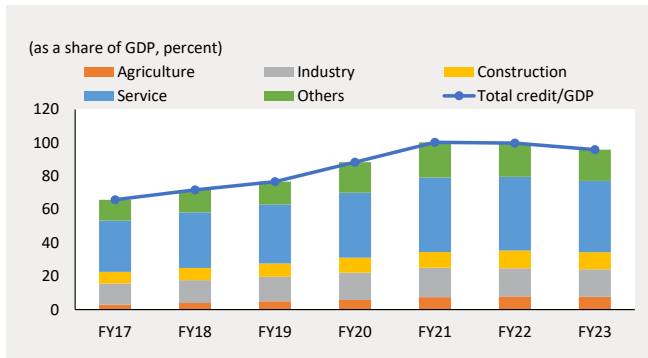
²⁰ Regulatory changes in the financial system announced in the Nepal Rastra Bank "Half-Yearly Review of Monetary Policy for 2022/23" include requirements for commercial banks to maintain a statutory liquidity ratio (SLR) of 12 percent, while development banks and finance companies are required to maintain an SLR of 10 percent as of January 2023. The counter-cyclical buffer was reinstated in July 2023 following suspension of the measure during the pandemic.

Figure 28. Nominal interest rates have been falling since they peaked in March 2023



Source. Nepal Rastra Bank and World Bank staff calculations.

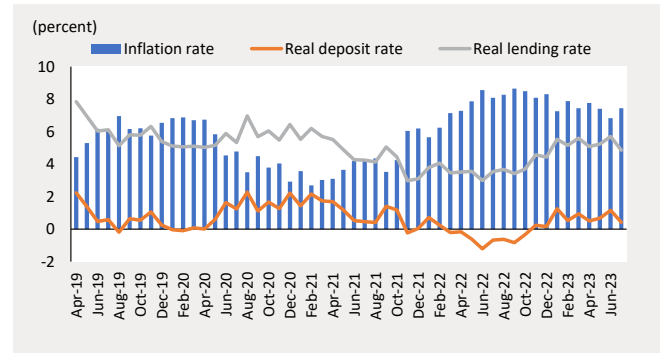
Figure 29. Strong credit growth beginning in FY17 moderated during FY23, while ...



Sources. Nepal Rastra Bank and World Bank staff calculations.

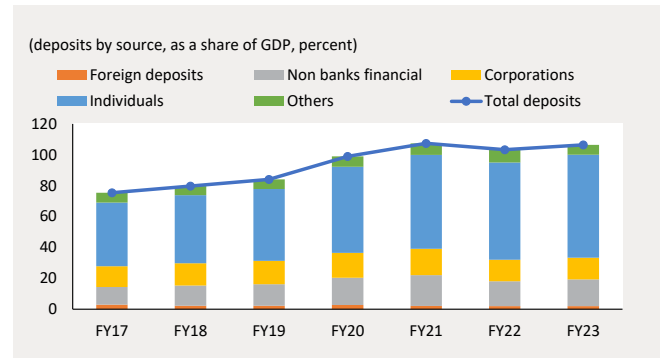
Real deposit rates have remained in positive territory since November 2022, but are falling again. The weighted average deposit rate among commercial banks did not respond quickly enough to stay in positive real territory from March to October 2022 (Figures 28 and 30), but the situation was reversed 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. Nominal deposit rates declined monotonically each month in the second half of FY23, driving down the real deposit rate to 0.4 percent by mid-July 2023. At the end of FY23, the nominal weighted average deposit rate was 7.9 percent.

Figure 30. ...real deposit rates remained positive following interest rate hikes ...



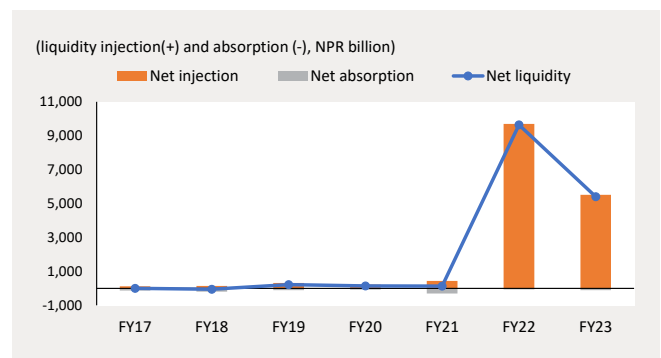
Source. Nepal Rastra Bank and World Bank staff calculations.

Figure 31. ...and deposits rose as a share of GDP...



Source. Nepal Rastra Bank and World Bank staff calculations.

Figure 32. ...leading to improved liquidity conditions in the financial system and a moderation of demand for liquidity injections.



Sources. Nepal Rastra Bank and World Bank staff calculations.

The incentives of positive real deposit rates have boosted deposit growth. During FY23, total deposits grew to 106 percent of GDP, up 3 percent of GDP compared to FY22 (Figure 31). Deposits by individuals remain the largest category, accounting for 62 percent of total deposits at the end of FY23.

Once credit and import growth moderated, reducing pressures on foreign exchange reserves, a gradual relaxation of rates began at the beginning of FY24. The new Monetary Policy for FY24 enacted a 50 bps reduction in the policy rate

to 6.5 percent, and a 100 bps decline in the deposit collection rate to 4.5 percent²¹, thus compressing the upper segment of the IRC to 100 bps while expanding the lower segment of the IRC to 200 bps.

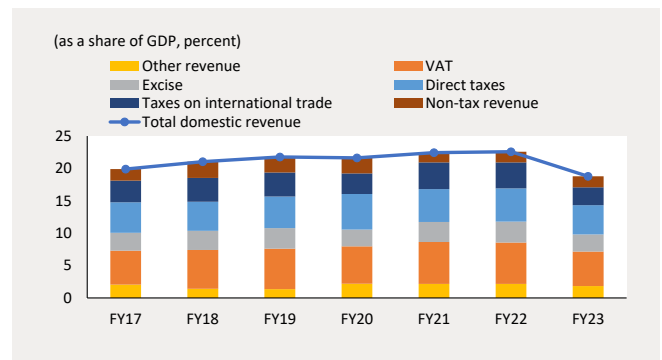
A.4 FISCAL SECTOR

Fiscal revenues declined significantly during FY23, as over half of all revenues are trade related and imports fell sharply. Expenditures also fell as a percentage of GDP, but by much less. The resulting fiscal deficit of 6.1 percent of GDP is the largest since the 1990s.

Nepal’s high reliance on goods imports to generate fiscal revenues exposes government finances to volatile trade flows. Over half of all fiscal revenues are levied on goods imports and collected at the border through VAT, excise, and customs duties. This vulnerability crystallized in FY20 during the pandemic when borders were closed, and again in FY23 when import restrictions led to a sharp drop in goods imports. One of the ways that the fiscal authority can reduce this vulnerability is by changing the composition of revenue collections. Pivoting revenue collection toward domestic sources such as income taxes and strengthening of the domestic VAT net, and away from import taxation, could be done without lowering total revenue collection. An additional benefit of shifting revenues away from trade taxation would be a reduction in tariff rates, which are high in Nepal and discourage exports and job creation.²²

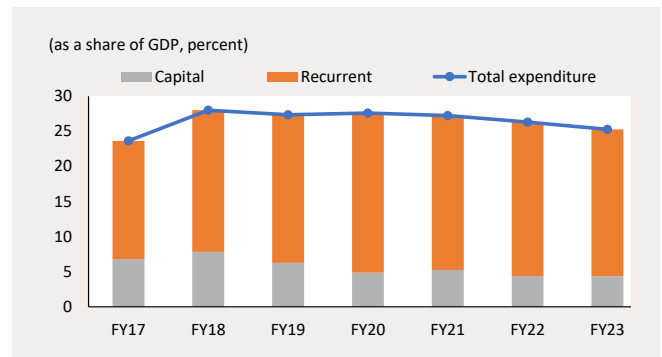
As goods imports fell in FY23, revenues declined by 3.8 pp of GDP between FY22 and FY23 (Figure 33). The import restrictions imposed in FY22 and eventually lifted in January 2023, plus slower economic growth, reduced the current account deficit and stabilized foreign exchange reserve stocks as intended. The unintended consequences of this policy include a broad-based decline in revenues, with total tax revenues declining 3.9 pp of GDP, taxes on international trade by 1.3 pp of GDP, and VAT by 1.1 pp of GDP, among others. The FY23 revenue collection including grants of 19.2 percent of GDP is the lowest ratio since FY15 (18.6 percent) when the earthquakes and trade blockade affected the country.

Figure 33. As import-related revenues fell, total revenues dropped by 3.8 pp of GDP between FY22 and FY23.



Sources. Ministry of Finance and World Bank staff calculations.

Figure 34. Expenditures fell by 0.9 pp of GDP, with reductions in both recurrent and capital expenditures.



Sources. Ministry of Finance and World Bank staff calculations.

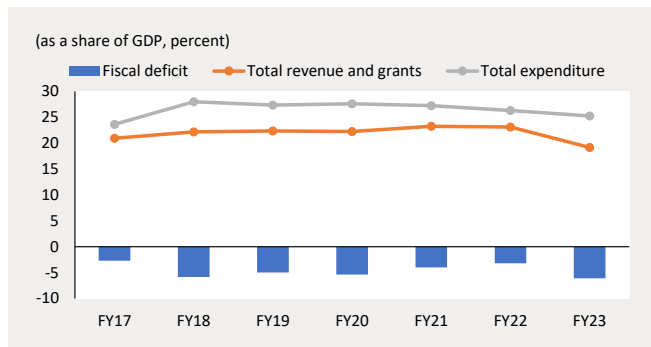
²¹ Nepal Rastra Bank, July 2023 “Monetary Policy for Fiscal Year 2023/24”

²² Nepal has a simple average effectively applied tariff rate of 10.2 percent, placing it among the world’s top quartile of most-protected countries. For a more detailed discussion, please see Chapter 3 of World Bank (2021).

Total expenditures also declined but by a smaller amount of 1.1 pp of GDP (Figure 34). Fiscal expenditures are difficult to reduce in the short term due to their recurrent nature. The FY23 budget included a 15 percent salary increase for government employees, leading to a 0.6 pp of GDP increase in wages and compensation during the year.

The result of the stronger decline in revenues than expenditures was a deficit of 6.1 percent of GDP in FY23, almost double the deficit of 3.2 percent recorded in FY22 (Figure 35). This deficit figure does not include the net acquisition of financial assets (NAFA),²³ which amounted to an additional 0.8 percent of GDP during the year. The deficit figure and the associated debt figures presented in this current report also do not include changes in the Treasury Single Account (TSA) balance with the Nepal Rastra Bank in FY23.²⁴ Public debt is estimated to have increase in line with the higher deficit to 41.3 percent of GDP.

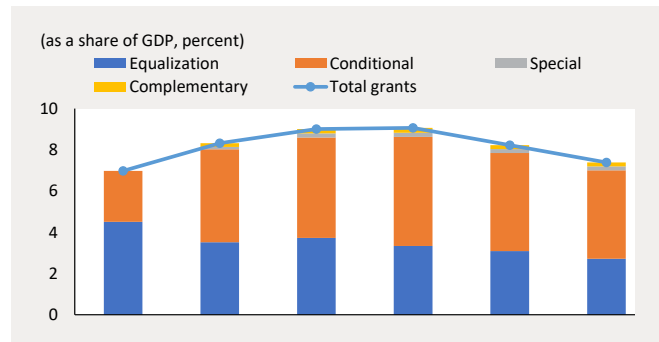
Figure 35. A historic drop in revenues and a smaller decline in expenditures led to a deficit of 6.1 percent of GDP in FY23.



Sources. Ministry of Finance and World Bank staff calculations.

Areas where expenditures were reduced include fiscal transfers from the federal government to provincial and local governments, which fell from 8.2 to 7.4 percent of GDP between FY22 and FY23 (Figure 36). After peaking at 9.1 percent of GDP in FY21, total grant transfers to subnational governments have fallen two years in a row as a share of GDP. Between FY22 and FY23, equalization and conditional grants were reduced due to the shortfall in federal revenue. Conditional grants, which are earmarked for special sectors and projects by the federal government, remain the largest grant type transferred to SNGs. Equalization grants are untied resources that can be spent at the discretion of the recipient SNG.

Figure 36. Fiscal transfers to subnational governments fell for the second year in a row as a percentage of GDP.



Sources. Ministry of Finance and World Bank staff calculations.

The authorities significantly increased total fiscal expenditures after the transition to federalism in FY18, as the federal government began transferring resources through grants to subnational governments (SNGs), without a commensurate reduction in federal government direct spending levels.²⁵ While grant transfers to SNGs should be complemented over time by rising own-source revenue raised by provinces and local governments, SNGs have not yet raised much revenue in the first five years of fiscal federalism. Prematurely reducing grant transfers from the federal government to SNGs could place the provision of goods and services at local levels at risk, until and unless own source revenue generated by provincial and local governments gains momentum.

The fiscal deficit and NAFA were financed by net new domestic and external borrowing, and positive fiscal account balances accumulated in previous years. Net new domestic borrowing was 2.6 percent of GDP and net new external borrowing was 1.3 percent of GDP in FY23 (Table 3 and Figure 37). The remaining 3 percent of GDP in financing to complete FY23 financing needs may have come from accumulated surpluses in government accounts with the central bank. At the time of this publication, the financial controller’s office (FCGO) has not yet published the FY23 closing balance of the Treasury accounts in the central bank to verify the account drawdowns (Table 3).

The government’s FY24 Budget Speech assumes a real growth rate of 6 percent and an inflation rate of 6.5 percent during FY24. Budgets in the past have been subject to significant growth optimism (Figure 38). Basing the budget

²³ NAFA is largely loans and capital injections to state-owned enterprises from the government.

²⁴ The government does not include the negative TSA balance in its calculation of public debt. The IMF and the World Bank include the negative TSA balance in the public debt stock assessed in the periodic Debt Sustainability Analysis (DSA) estimations, per the Government Finance Statistics Manual and Public Sector Debt Statistics Guide. World Bank NDU publications follow the government convention, excluding the negative TSA balance from the public debt stock, to help the reader compare the data reported here with government publications.

²⁵ For further discussion, please see the World Bank (2021).

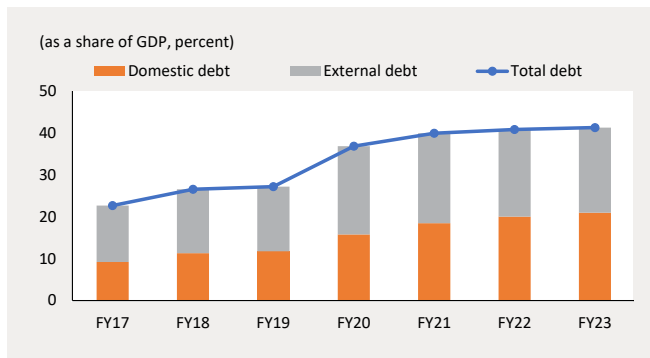
Table 3. Central Government Fiscal Balance and Financing (share of GDP, percent).

	FY19	FY20	FY21	FY22	FY23
Revenues and Grants	22.4	22.2	23.3	23.1	19.2
Expenditures	27.3	27.6	27.2	26.3	25.3
Fiscal Deficit	-5.0	-5.4	-4.0	-3.2	-6.1
Financing Needs Including NAFA (A)	-7.5	-6.9	-5.4	-4.5	-6.8
Financing Sources					
Domestic Net Borrowing (B)	1.6	4.1	4.3	3.8	2.6
External Net Borrowing (C)	2.7	2.4	3.4	2.1	1.3
Total Net Borrowing (D=B+C)	4.3	6.5	7.7	5.8	3.9
Financing Other Sources* (E=A-D)	-3.2	-0.4	2.4	1.4	-3.0

Sources. Financial Comptroller General Office, Ministry of Finance, National Statistics Office, and World Bank staff calculations.

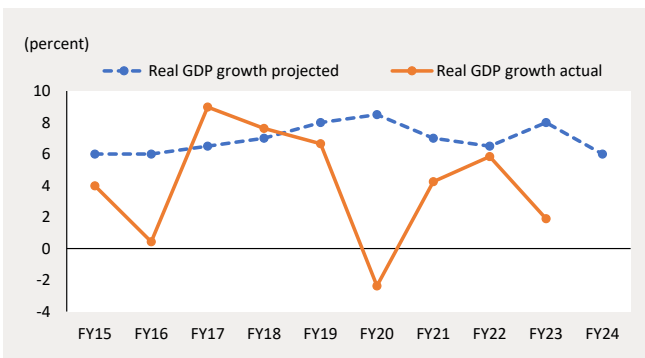
Note. *Including fiscal account surpluses from prior years. A positive figure indicates a balance accumulation, while a negative figure indicates a balance drawdown.

Figure 37. The deficit was financed by new external and domestic debt, and possibly by drawdowns on accumulated savings in Treasury accounts.



Sources. Ministry of Finance and World Bank staff calculations.

Figure 38. Budgets tend to overestimate next year’s growth...

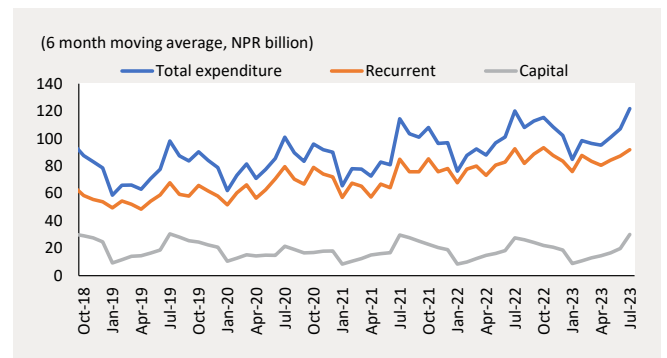


Sources. Ministry of Finance and World Bank staff calculations.

on a more realistic macroeconomic framework would enable policy makers to better determine the expenditure envelope that can be afforded, given expected revenues and the level of deficit that can be safely financed. Ongoing efforts by the Ministry of Finance and other government entities to improve their evidence-based macroeconomic forecasting capabilities are expected to provide more realistic growth forecasts in the future, thus improving the usefulness of the budget as a planning tool.

Spending continues to be skewed towards the end of the fiscal year. Bursts of spending clustered at the end of the fiscal year not only place in question the efficiency of spending, but these large seasonal spending variations also impact aggregate demand and inflation. “Use it or

Figure 39. ... and spending rises sharply at the end of every fiscal year.



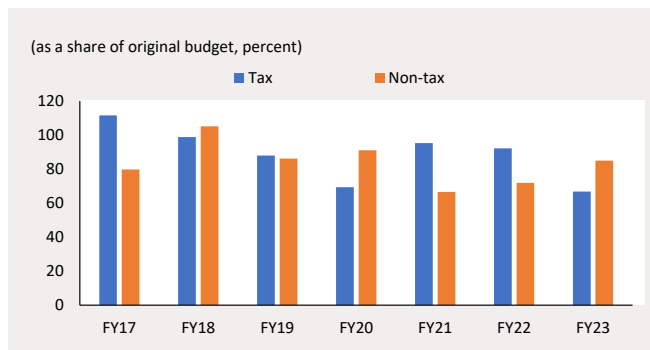
Sources. Ministry of Finance and World Bank staff calculations.

lose it” budget rules and spending bunching at the end of the year have been shown to result in lower quality project investment.²⁶ Significantly higher spending at the end of the year can lead to less effective management of these investments due to staff time constraints. As shown in Figure 39, fiscal expenditures surging at the end of the year has long been evident in Nepal in both recurrent and capital spending. Smoothing expenditures throughout the year would support spending efficiency and avoid inflationary pressures resulting from spending spikes.

Budget execution across expenditures and revenues has been low over the past five years in Nepal. On the revenue side from FY19 to FY23, tax revenues have averaged 82 percent realization compared to budget, while non-tax revenues have averaged an 80 percent realization rate (Figure 40). Over the same period, the execution of budgeted recurrent spending has averaged 86 percent, while the average execution rate of capital expenditures was 61 percent (Figure 41). Increasing budget execution, especially for capital investments, would support growth and help to close Nepal’s wide infrastructure deficit. It was estimated in 2018 that Nepal needs to invest between 8 and 12 percent of GDP each year in infrastructure to meet its development aspirations.²⁷ Capital expenditure in FY23 was 4.3 percent of GDP and has been falling year on year since FY21.

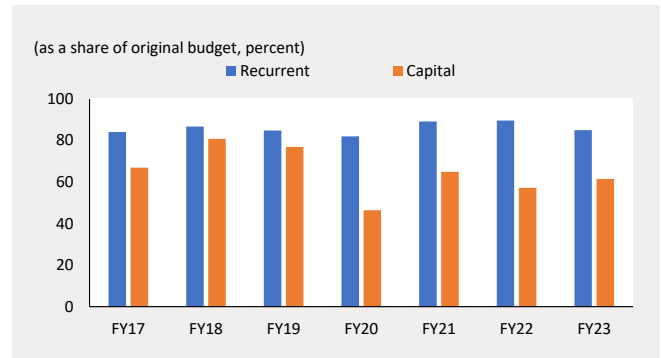
On the financing side, the Nepal Natural Resources and Fiscal Commission (NNRFC) sets the ceiling on domestic borrowing each year. For FY23, the ceiling was set at 5.5 percent of forecast GDP, and almost all of the budgeted

Figure 40. Revenue realization has been volatile ...



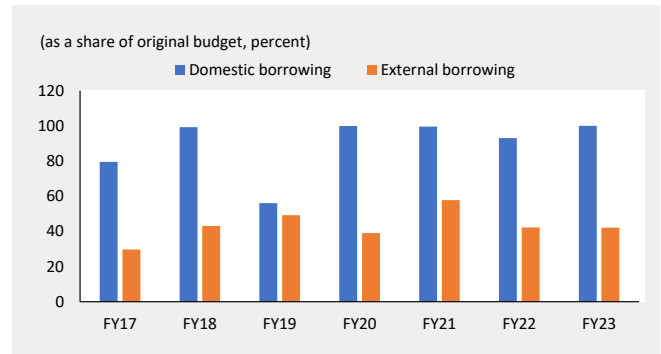
Sources. Ministry of Finance and World Bank staff calculations.

Figure 41. ... and capital budget execution has been consistently low.



Sources. Ministry of Finance and World Bank staff calculations.

Figure 42. While domestic borrowing has materialized close to planned, less than half of planned external borrowing has materialized.



Sources. Ministry of Finance and World Bank staff calculations.

domestic borrowing in FY23 was obtained (Figure 42). External financing exhibits a very different trajectory – on average over the past five years, only 47 percent of planned external borrowing has materialized. External borrowing is the most affordable source of financing to the government of Nepal, given the country’s access to long maturity concessional financing.

The stock of public debt was roughly equally divided between external and domestic financing in FY23 (Table 4). Multilateral concessional financing represents the largest category, comprising 44 percent of total public debt, followed by domestic development bonds (29 percent) and Treasury bills (20 percent).

²⁶ For an examination of expiring budget spending in US federal procurement, see Liebman and Mahoney (2018) “Do Expiring Budgets Lead to Wasteful Year-End Spending? Evidence from Federal Procurement”, National Bureau of Economic Analysis NBER, Working Paper 19481.

²⁷ For further discussion, see World Bank (2017).

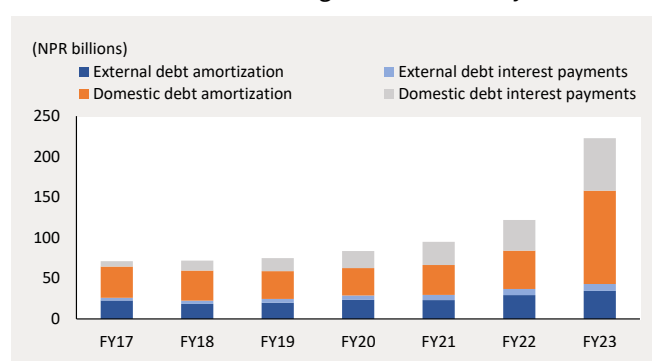
Table 4. Stock – Public and Publicly Guaranteed (PPG) External and Domestic Debt.
(NPR billion unless mentioned otherwise)

Financing Source	FY20			FY21			FY22			FY23		
	Stock	Share of total (%)	Share of GDP (%)	Stock	Share of total (%)	Share of GDP (%)	Stock	Share of total (%)	Share of GDP (%)	Stock	Share of total (%)	Share of GDP (%)
External	819.7	57.2	21.1	934.7	53.8	21.5	1025.8	51.0	20.8	1132.8	50.2	21.1
Multilateral	709.5	49.5	18.2	822.0	47.3	18.9	894.5	44.4	18.1	993.5	44.0	18.5
o/w World Bank	386.1	26.9	9.9	471.2	27.1	10.8	509.7	25.3	10.3	572.4	25.3	10.6
o/w ADB	268.8	18.8	6.9	293.8	16.9	6.8	315.0	15.6	6.4	349.1	15.5	6.5
o/w IMF	26.4	1.8	0.7	32.8	1.9	0.8	43.7	2.2	0.9	45.7	2.0	0.8
Bilateral	96.7	6.7	2.5	112.7	6.5	2.6	131.4	6.5	2.7	139.4	6.2	2.6
o/w Non-Paris Club	52.7	3.7	1.4	63.9	3.7	1.5	75.8	3.8	1.5	77.4	3.4	1.4
o/w China	26.1	1.8	0.7	31.3	1.8	0.7	35.3	1.8	0.7	34.2	1.5	0.6
o/w India	24.9	1.7	0.6	30.8	1.8	0.7	36.4	1.8	0.7	38.4	1.7	0.7
o/w Paris Club	44.0	3.1	1.1	48.8	2.8	1.1	55.6	2.8	1.1	62.0	2.7	1.2
Domestic	613.7	42.8	15.8	802.9	46.2	18.4	987.4	49.0	20.0	1128.3	49.9	21.0
Treasury Bills	215.2	15.0	5.5	279.6	16.1	6.4	355.8	17.7	7.2	457.8	20.3	8.5
Development Bonds	389.9	27.2	10.0	513.9	29.6	11.8	620.4	30.8	12.6	656.4	29.0	12.2
Others	8.6	0.6	0.2	9.4	0.5	0.2	11.2	0.6	0.2	14.1	0.6	0.3
Total	1433.4	100.0	36.9	1737.6	100.0	39.92	2013.30	100.0	40.81	2261.1	100.0	42.1
Nominal GDP (NPR billion)	3888.7			4352.6			4933.7			5381.3		
NPR/USD avg	116.3			117.9			120.8			130.8		

Sources. Financial Comptroller General Office and World Bank staff calculations.

Notes. External debt is as of FY23Q3. Domestic debt is for all four quarters of FY23. Paris Club creditors include Japan, Korea, Belgium, and France. Non-Paris Club creditors include India, China, Kuwait, and Saudi Arabia.

Figure 43. Domestic debt servicing rose quickly in FY23, while external debt servicing rose more slowly.



Sources. Ministry of Finance and World Bank staff calculations.

Public debt servicing grew significantly during FY23 (Figure 43). Although Nepal's external debt is largely denominated in convertible currencies, the 8.3 percent depreciation of the NPR against the USD during FY23 (see Table 4) did not have a large impact on either external debt amortizations or interest repayments. Domestic debt servicing was affected by both large redemptions and by higher domestic interest rates, as the tighter liquidity conditions in the financial sector increased the Treasury Bill rate. Total domestic and external debt servicing amounted to 4.1 percent of GDP in FY23.





B

OUTLOOK,
RISKS, AND
CHALLENGES

B OUTLOOK, RISKS, AND CHALLENGES

The lower growth (1.9 percent), wide fiscal deficit (6.1 percent of GDP), and high inflation (7.8 percent average) registered during FY23 represent significant headwinds to Nepal's macroeconomic outlook in the short and medium term. While there are reasons for optimism in FY24, including robust remittances, tourist inflows, and hydroelectric production, the authorities are facing difficult tradeoffs in the context of a slowing economy with high inflation.

Nepal is not facing these difficult choices alone. In June 2022 the World Bank observed a steep slowdown in growth across emerging market and developing economies, associated with the fallout of the war in Ukraine and the rise in energy and food prices globally.²⁸ At that time, global growth was projected to slow by 2.7 pp and the danger that above-average inflation and below-average growth would persist for several years was deemed considerable.

Nepal's policy choices are constrained. Monetary policy cannot simultaneously raise interest rates to control inflation, and lower interest rates to support growth. Greater fiscal stimulus for growth is hampered by still-recovering revenues following the historical drop in revenues registered in FY23. The authorities remain rightfully wary of credit booms and import spikes, concerned that foreign exchange reserves may be used again to finance a large current account deficit, as occurred during FY22 when reserves fell below the 7-months of import cover policy floor. Relative prices (the exchange rate between the NPR and the currencies of trading partners) cannot automatically adjust within the confines of Nepal's fixed exchange rate peg to the INR.

Staying focused on the long-term investments necessary for sustainable development remains crucial, even as the short-term recovery consumes the attention of policymakers. Frequently the conversation in Nepal focuses on the needs of the business community for firms to grow and remain profitable. It is equally important to prioritize the needs of the most vulnerable members of the community during the economic downturn. Rising consumer prices are more worrisome for those who spend a greater share of their income on basic goods and necessities. Investing in human capital through education and health and improving the conditions for job creation are long-term investments that can take years to bear fruit. As policymakers weigh the balance of stimulus and prudence going forward,

²⁸ World Bank Blog, June 10, 2022 "The supply solution to stagflation"

the Special Focus section of the current report outlines some of the pending productivity and competitiveness challenges that remain largely unaddressed in Nepal. A host of measures are identified that require years of sustained effort to yield

results, but which have the potential to leverage Nepal's demographic dividend and improved domestic electricity provision to make workers and firms more productive and competitive in the decades to come.

THE UPDATED MACROECONOMIC FORECAST ENVISIONS GROWTH RISING FROM A LOWER BASE

The baseline forecast scenario assumes the following: i) a gradual reduction in interest rates in FY24 and FY25 relative to FY23; ii) that lumpy skin disease, first reported in April 2023 and which has infected more than 1.3 million animals, will be under control by mid-January 2024; iii) that India's export ban on select cereal and vegetables will be withdrawn by the beginning of FY25; iv) that electricity exports to India and Bangladesh will reach 1000 MW by FY25; and v) that foreign exchange reserves remain above equivalent of 7 months of concurrent imports during FY24-FY25.

Real Sector

Under the baseline scenario, GDP growth will rebound to 3.9 percent in FY24 and 5 percent in FY25 (Table 5). The lagged impact of lifting the final import restriction measures in January 2023 and the gradual loosening of monetary policy are expected to support growth in the industrial and services sectors. Sub-sectors that suffered the brunt of the import restrictions and monetary policy tightening in FY23, including wholesale and retail trade, construction, and manufacturing, are expected to gradually recover over the forecast period.

Growth of the industrial sector is projected to be 3.2 and 6.3 percent in FY24 and FY25, respectively. The electricity sub-sector will continue to grow robustly with significant new hydroelectric capacity scheduled for commissioning during the projection timeframe.

The services sector is projected to accelerate growth to 5.1 percent in FY24 and to 5.9 percent in FY25 (Table 5). The real estate services sub-sector should benefit from the recent amendment of the 2022 Land Use Regulations for land zoning, and the raised ceiling for lending to first time homebuyers to NPR 20 million. Accommodation and food service activities will be supported by growing numbers of

international tourists and new hotels, but the removal of the former VAT exemption²⁹ on air transport (domestic flights and the outbound international flights) and the imposition of a luxury tax on services provided by four and five-star hotels and resorts could weigh on sub-sector growth.

Agricultural sector growth is projected to slow to 2.1 percent in FY24, due in part to lumpy skin disease, then rise to 2.5 percent growth in FY25. A decline in the main season rice paddy plantation area and paddy planted area by 1.1 and 0.7 percent in FY23, respectively, relative to the previous year would also contribute to lower agricultural growth in FY24.

Inflation is expected to remain elevated in FY24 reflecting the removal of VAT exemptions on select basic food items and necessities, India's food export restrictions, and the recent international increase in fuel prices. High inflation in FY24 will weigh on real disposable income and in turn private consumption growth. Inflationary pressures are expected to recede and remain within the central bank's ceiling in FY25 alongside a projected decline in commodity prices.

External Sector

The trade deficit is projected to widen over the medium term, rising to 30.1 percent of GDP in FY24 and then to 31 percent of GDP in FY25 reflecting higher goods imports. Merchandise imports are expected to rise from a seven-year low in FY23 with the lifting of import restriction measures and the gradual easing of monetary policy. However, goods imports are not expected to return to FY22's historic high by the end of the forecast period as the central bank also tightens working capital loan regulations and focuses on greater productive use of credit rather than an expansion of credit to private sector. Lower international commodity prices and the

²⁹ For international flights, VAT is not applicable on the inbound flights. Thus, the removal of the VAT exemption is not expected to impact international tourists coming to Nepal but may make the outbound flights more expensive.

Table 5. Macroeconomic projections of selected key indicators.
(annual percent change unless indicated otherwise)

	FY20	FY21	FY22	FY23e	FY24f	FY25f
Real GDP growth, at constant market prices	-2.4	4.8	5.6	1.9	3.9	5.0
Private Consumption	3.6	8.0	6.8	4.1	3.7	4.5
Government Consumption	3.8	-1.7	9.6	-35.2	-19.3	8.5
Gross Fixed Capital Investment	-8.9	9.8	3.8	-10.9	14.5	8.5
Exports, Goods and Services	-15.9	-21.3	34.1	5.5	12.1	18.4
Imports, Goods and Services	-20.8	18.8	15.1	-17.2	10.3	9.7
Real GDP growth, at constant factor prices	-2.4	4.5	5.3	2.2	3.9	5.0
Agriculture	2.4	2.8	2.2	2.7	2.1	2.5
Industry	-4.0	6.9	10.8	0.6	3.2	6.3
Services	-4.5	4.7	5.3	2.3	5.1	5.9
Inflation (Consumer Price Index)	6.1	3.6	6.3	7.8	7.5	6.4
Current Account Balance (% of GDP)	-0.9	-7.7	-12.6	-1.3	-3.7	-4.6
Net Foreign Direct Investment (% of GDP)	0.5	0.4	0.4	0.1	0.3	0.5
Fiscal Balance (% of GDP)	-5.4	-4.0	-3.2	-6.1	-3.5	-3.3
Revenues (% of GDP)	22.2	23.3	23.1	19.2	19.8	20.8
Debt (% of GDP)	36.9	39.9	40.8	41.3	41.4	41.2
Primary Balance (% of GDP)	-4.7	-3.2	-2.3	-4.7	-1.8	-1.9

Sources. Ministry of Finance, Nepal Rastra Bank, and National Statistics Office for history. World Bank staff for estimates and forecasts.

Notes. e = estimate; f = forecast.

reduction of one-off imports including COVID-19 vaccines will also help maintain goods import below that of FY22 over the medium term. Electricity trade is expected to reach surplus by FY25 as the country continues to expand production and exports of electricity to India and Bangladesh. Higher domestic production and the consumption of electricity should also lower fossil fuel imports. The size of Nepal's trade in edible oils is projected to shrink over the next two years as India is expected to continue its policy of low custom duties on imports of edible oils from non-SAARC countries. The services account will remain in deficit over the medium term as transport and travel costs, reflecting a significant number of Nepalis going abroad for work and study, continue to form a large part of the services import bill. A recovery in services exports as international tourist arrivals rise is not expected to be sufficient to completely offset services imports in FY24 and FY25.

Remittances inflows are expected to remain robust over the medium term, reflecting the lagged impact of near-record worker out-migration in FY23. The government of Nepal has currently opened 111 countries for foreign employment, but most Nepali worker migrants are concentrated in only 10 countries.

The current account deficit is forecast to slowly widen over the next two years, while remaining significantly below the historic high of FY22. The current account deficit

(CAD) is expected to widen to 3.7 percent of GDP in FY24 and further to 4.6 percent of GDP in FY25, reflecting a persistent goods trade deficit that is not completely compensated for by remittance inflows. The CAD is expected to be largely financed by concessional external borrowing, in the absence of significant foreign direct investment (FDI). Private external borrowing is highly regulated and while it represented only 0.5 percent of GDP in FY23, it is expected to expand gradually over the forecast. FDI is expected to increase from a low base in the forecast period due to the recent policy of lowering the minimum threshold for FDI inflows, but the contribution of FDI towards financing the CAD will continue to remain low until further significant reforms are implemented.

Fiscal Sector

The fiscal deficit is expected to narrow over the next two years, reaching 3.3 percent of GDP by FY25 as revenues recover. Revenue growth will increase with stronger GDP and goods imports growth. The FY24 federal budget envisions lower capital spending, lower fiscal transfers to subnational governments, and higher public debt servicing costs. Public investment execution is expected to rise through FY25 alongside the rebound of revenues. Implementation of the National Project Bank integrated guidelines, issued in March 2023 by the National Planning Commission, is expected to facilitate the development, selection, and prioritization of

projects within the National Project Bank, boosting capital spending execution by FY25. The fiscal deficit is expected to be financed by external concessional borrowing and domestic borrowing in a 40:60 ratio, similar to the financing mix over the last 10 years. Total public debt is projected to decline to 41.2 percent of GDP by FY25 from a peak in FY24, reflecting smaller fiscal deficits and higher growth.

Monetary Sector

A gradual reduction in the policy rate through FY25 is incorporated in the forecast. The central bank's stated intent of setting the FY24 policy stance such that the real interest rate on deposits remains positive is incorporated in the

projection through a gradual expansion of real base money. The projection ensures that foreign exchange reserves remain sufficient to cover at least seven months of imports throughout the forecast horizon.

The forecast is subject to multiple downside risks. An erratic monsoon could dampen agricultural growth, which alongside potential livestock losses, would negatively impact the poor and vulnerable. Political uncertainty could hold back investment. A renewed spike in commodity prices or continued food export bans by India would raise prices and widen the current account deficit. Higher inflation could keep policy rates elevated, increase domestic debt servicing costs, and drag on growth.







C

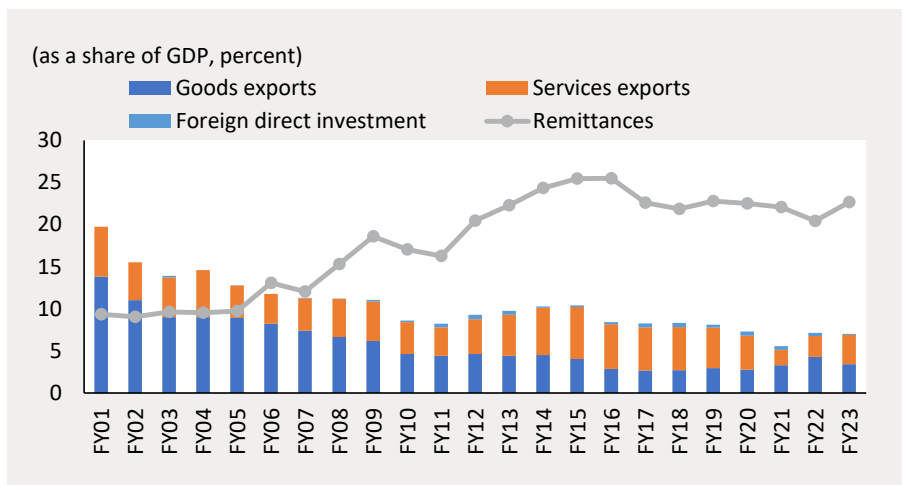
**SPECIAL FOCUS:
DRIVERS OF EXTERNAL
COMPETITIVENESS**

C SPECIAL FOCUS: DRIVERS OF EXTERNAL COMPETITIVENESS

C.1 INTRODUCTION

Nepal’s dependence on the export of workers and remittance inflows increased sharply over the past two decades. Goods and services exports have fallen significantly since the early 2000s as a percentage of GDP. In FY23, total exports amounted to 6.9 percent of GDP, only one-third of what the average South Asian middle-income country exports. Not surprisingly, the 2019 World Economic Forum Global Competitiveness Index ranked Nepal 108th out of 141 countries.³⁰ Net foreign direct investment (FDI) has also underperformed. Remittance inflows on the other hand increased to 22.7 percent of GDP in FY23, are the main source of foreign currency, and the main driver of private consumption and economic growth (Figure 44).

Figure 44. Nepal’s sources of foreign exchange earnings.



Sources. Nepal Rastra Bank and World Bank staff calculations.

³⁰ https://www3.weforum.org/docs/WEF_TheGlobalCompetitivenessReport2019.pdf

A country’s export performance depends on many factors, but productivity and real exchange rate dynamics are key determinants. More productive countries can produce more goods and services at lower costs, which can lead to higher export volumes and earnings. Favorable real exchange rate dynamics can further boost exports. A depreciating real exchange rate would make them more affordable abroad and could increase demand. An appreciating exchange rate could have the opposite effect. Productivity and real exchange rates themselves are linked most prominently through the Balassa-Samuelson effect, which suggests that more productive countries have higher levels of non-tradeable goods prices, which appreciates their real exchange rate. However, it is of course important to note that several other factors determine external

competitiveness, including domestic and foreign policies, infrastructure, and innovation, to mention a few.

This special focus is a preview of a comprehensive forthcoming analysis of the interplay between productivity, exchange rates, and exports in Nepal. The analysis is not exhaustive but precedes a more detailed discussion that will be published in the forthcoming Country Economic Memorandum, a recurring flagship publication of the World Bank that was most recently published in 2017 for Nepal.³¹ This special focus chapter is intended to spur a debate among analysts and policymakers on Nepal’s continuous lackluster export performance, the associated productivity and exchange rate dynamics, and opportunities for improvement.

C.2 NEPAL’S PRODUCTIVITY CHALLENGES

Productivity growth is a key driver of external competitiveness, the main source of lasting per capita income growth, and therefore the primary driver of poverty reduction.³² Productivity measures the amount of output produced with a given set of inputs. The more productive a worker or country is, the more it can produce and export. This brief measures it at the national level in two ways: i) as labor productivity (the output produced by the average worker); and ii) as aggregate or total factor productivity (TFP, the economy-wide output produced with factor inputs).

As a region, South Asia’s labor productivity underperformed considerably over the past decade (Figure 45b). Labor productivity data come from the World Development Indicators (WDI) and measure the value added per worker in each sector.³³ In agriculture and services, South Asia significantly trailed other regions and only marginally outperformed Sub-Saharan Africa (Figures 45a and 45c). The labor productivity gap to other regions was even more pronounced in the industry sector, where the average South Asian worker is the least productive by a margin, adding only roughly one-fifth of the value the average East-Asian worker adds.

Figure 45a. Agriculture value added per worker.

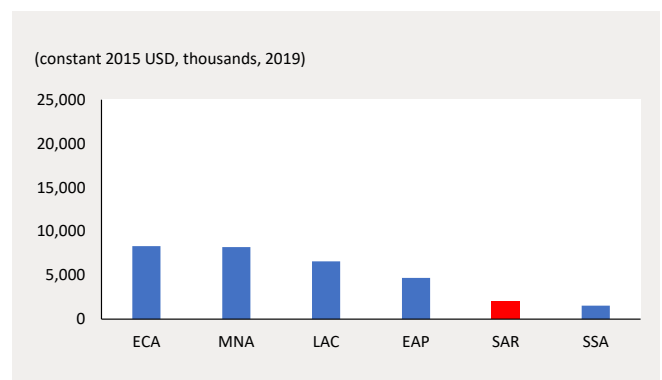
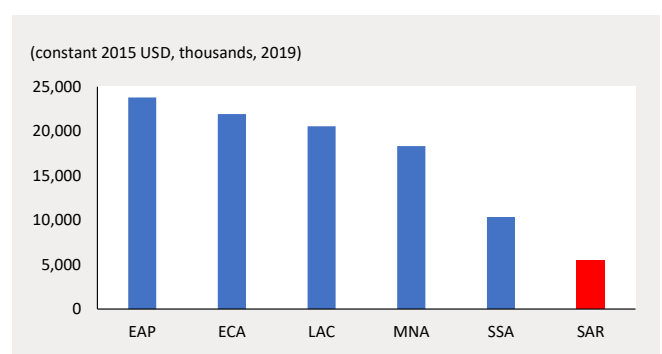


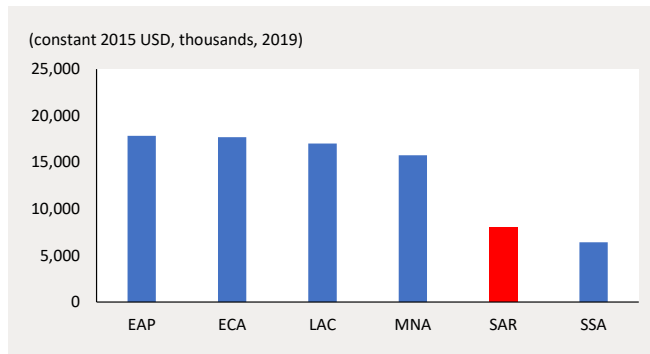
Figure 45b. Industry value added per worker.



³¹ World Bank (2017)

³² Dieppe (2021)

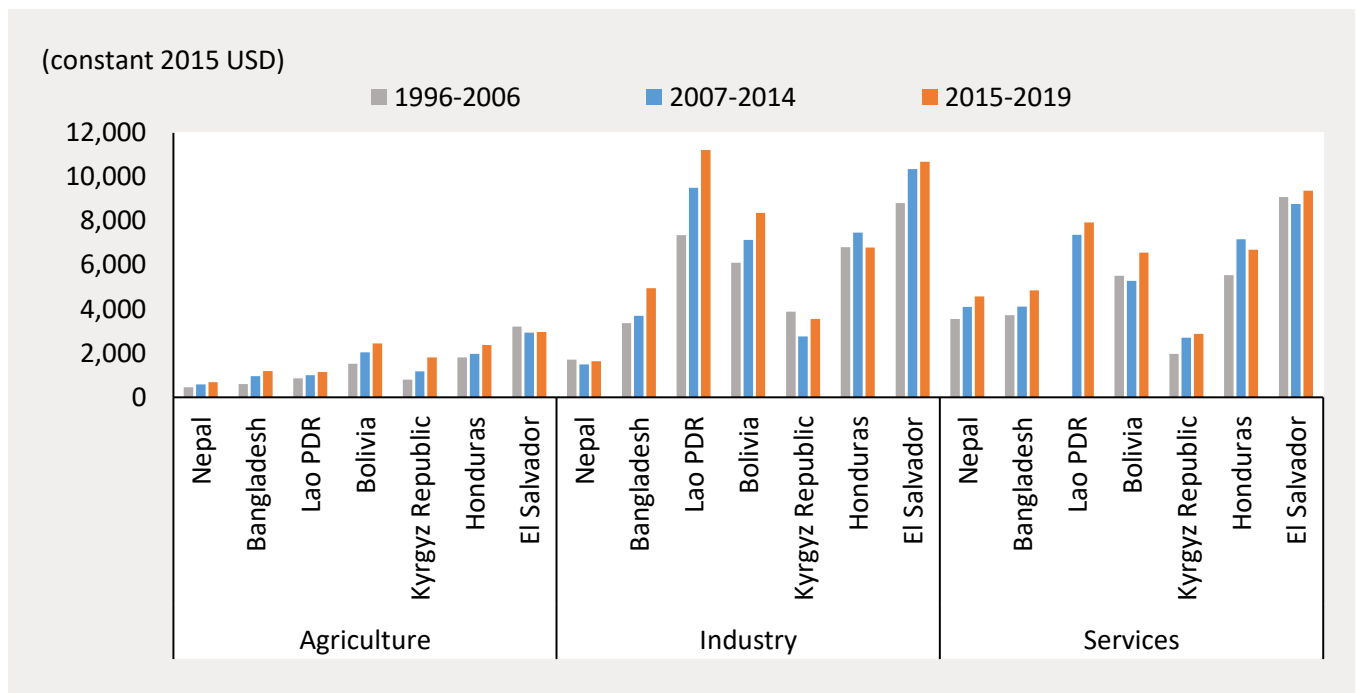
Figure 45c. Services value added per worker.



Sources: World Development Indicators.
Notes: i) LAC = Latin America and Caribbean; EAP = East Asia and Pacific; ECA = Europe and Central Asia; MNA = Middle East and North Africa; SAR = South Asia; and SSA = Sub-Saharan Africa
 ii) Regional averages exclude high income countries

Nepal suffers from a considerable labor productivity deficit compared to its regional and structural peers, and the gap to India widened. The comparator countries used in Figures 46a and 46b are structural peers, those countries that share similar characteristics with Nepal, e.g., landlocked, high remittances. Some of them are also regional peers. Nepal’s labor productivity gap against peers is especially striking in the agriculture and industry sectors, where Nepal’s productivity is lower than in any other peer country (Figure 46a). In the industry sector, the average Nepali worker adds less than one-third of what the workers in peer countries add on average. The value added by an industrial worker in Nepal is less than half of that of a domestic service worker. However, even though labor productivity in services was higher, compared to peer countries Nepal again lags, with the average service worker adding around 80 percent of the value that workers in peer countries add. Figure 46b shows that Nepal’s productivity gap relative to India widened across all sectors over the past decades.

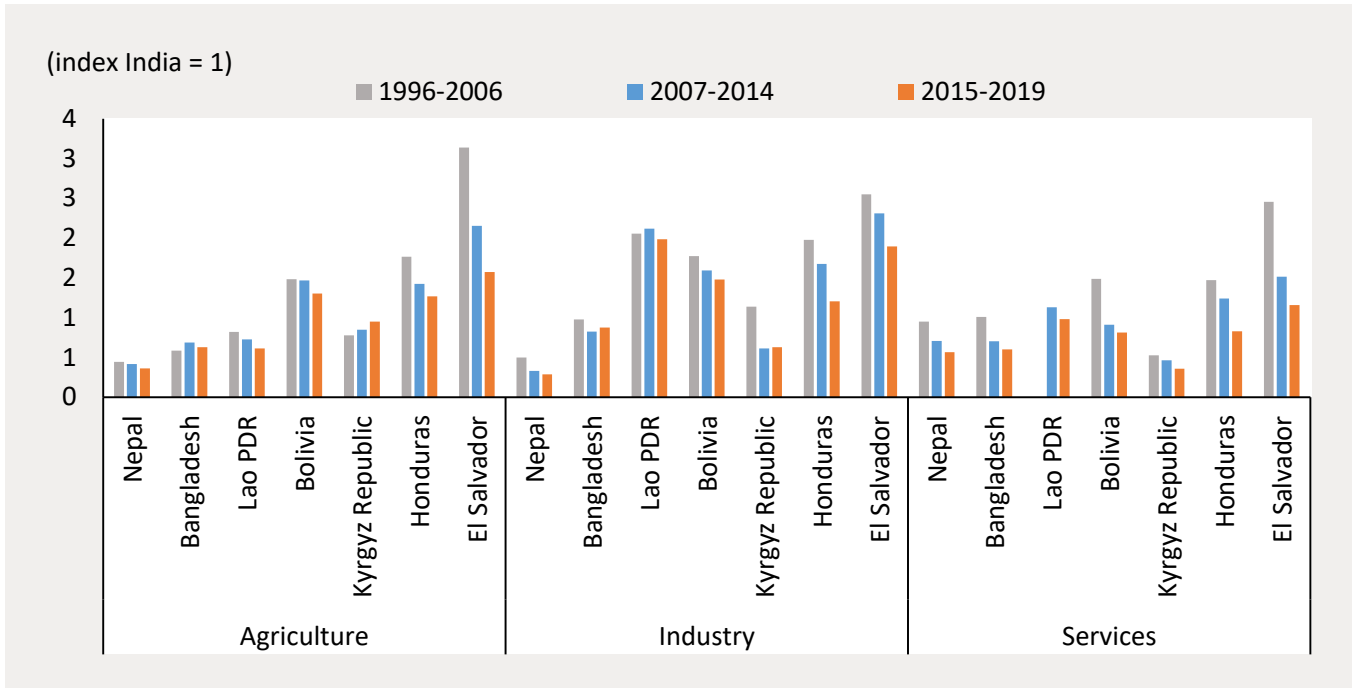
Figure 46a. Labor productivity by sector.



Sources. World Development Indicators.

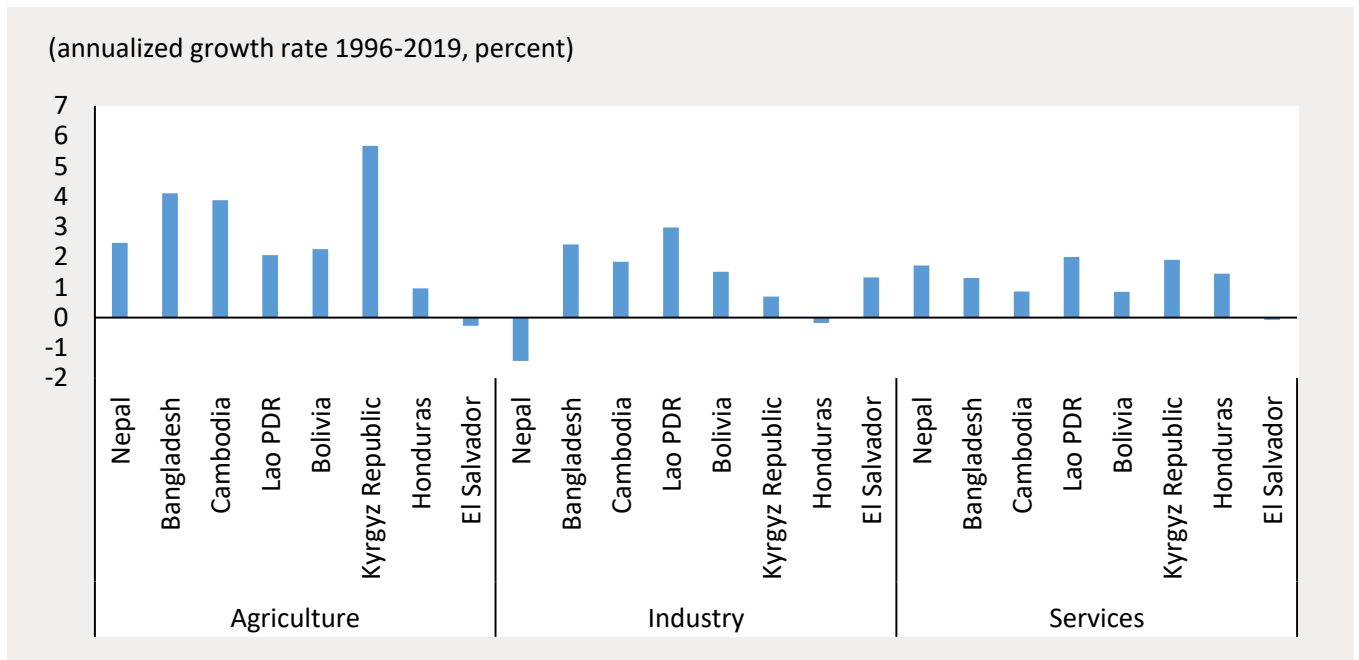
³³ Value added is the value of the gross output of producers less the value of intermediate goods and services consumed in production before accounting for consumption of fixed capital in production. Value added per worker is calculated by dividing the value added of a sector by the number employed in the sector.

Figure 46b. Labor productivity by sector.



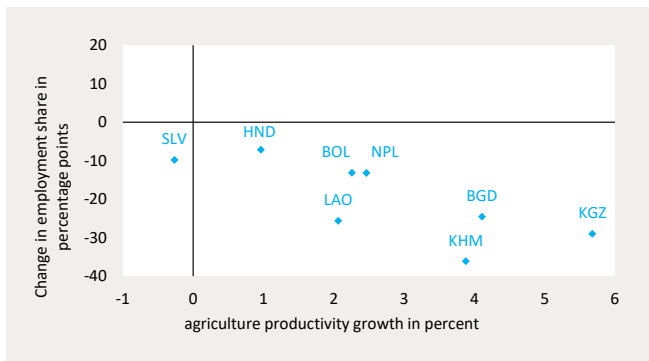
Sources. World Development Indicators.

Figure 47. Labor productivity growth by sector.



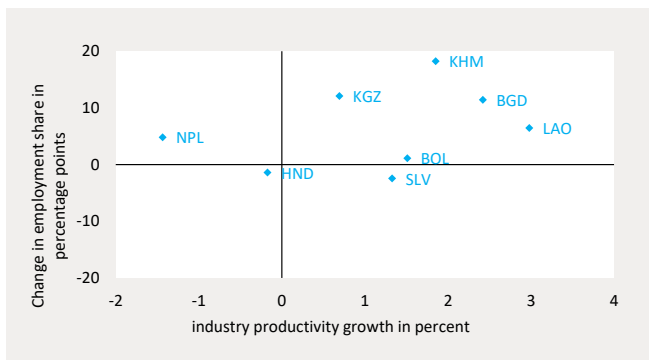
Sources. World Development Indicators.

Figure 48a. Agriculture 1996-2019
Productivity Growth vs. Change in Employment.



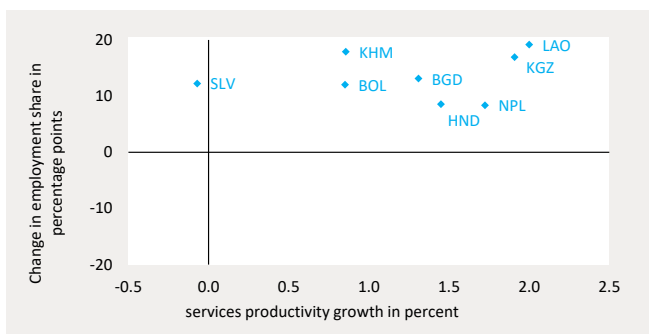
Sources. World Development Indicators

Figure 48b. Industry 1996-2019
Productivity Growth vs. Change in Employment.



Sources. World Development Indicators

Figure 48c. Services 1996-2019
Productivity Growth vs. Change in Employment.



Sources. World Development Indicators and International Labor Organization

Nepali labor productivity dynamics are particularly dire in the industry sector. Nepal and Honduras were the only countries in the sample to experience decreasing productivity between 1996 and 2019. Figure 47 shows how labor productivity within each country has changed over time, and that in Nepal the average output of an industrial

worker was higher in 1996 than it was in 2019.³⁴ Nepal's decline in industrial output per worker was particularly pronounced during 2007-2014.

Nepal's labor productivity deficit in the non-agriculture sectors manifests in slower structural labor market shifts.

Labor movements away from agriculture were lower in Nepal than in most peer countries included in the analysis (Figures 48a-48c). From 1996 to 2019, employment in agriculture as a share of total employment fell by 25 pp in Bangladesh and 36 pp in Cambodia for example, while the reduction in Nepal amounted to 13 pp. As a result, Nepal continues to exhibit the largest share of workers employed in agriculture by a margin, with more than 60 percent as of 2021, more than double the average of peer countries' share.³⁵ Employment shares in the industry and services sectors increased moderately, but productivity gains from these movements were limited due to the inherent low sectoral productivity in these sectors.

Several factors hinder labor productivity growth in Nepal, including the continuous large-scale emigration.

The substantial outflow of workers can result in a brain drain, where the country loses its most talented workers to foreign markets. This can lead to a shortage of skilled labor in the domestic market and suppress labor productivity growth. High emigration can also have negative effects on domestic labor force participation among the recipients of remittances. These factors may outweigh some positive effects of emigration, such as increased investments in education by remittance-receivers. Other factors that contributed to low productivity include low levels of capital investment and technology. High import tariffs and capital flow restrictions were key disablers of technological advances, preventing foreign investments and knowledge and technology transfers.

Another challenge in Nepal is the slowing overall productivity of the economy (Figure 49).³⁶

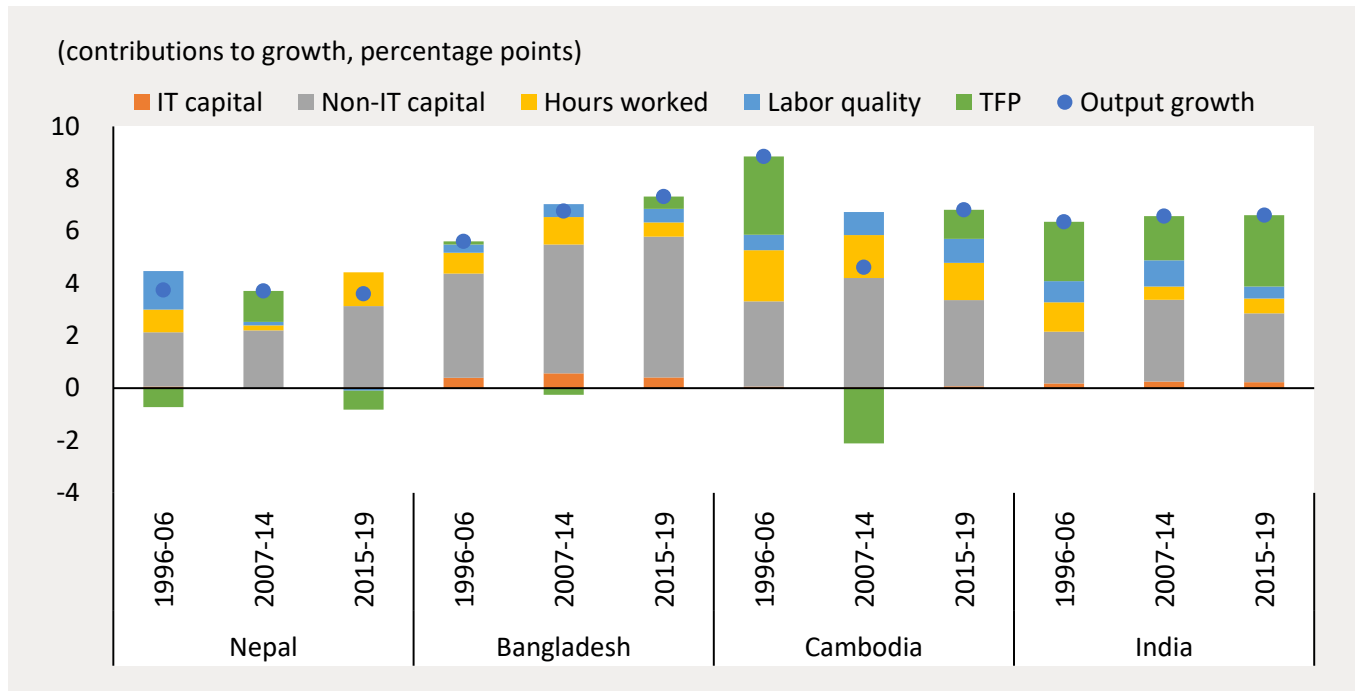
In the period immediately following the end of the armed conflict (2007-2014), TFP contributed 1.2 pp of growth on average to Nepal's total growth. In the previous and subsequent periods, however, the contribution of TFP to economic growth in Nepal was negative, illustrating the underperformance of the Nepalese economy given the factor inputs. Low TFP in Nepal can be linked to several factors, including high emigration if the net effect of it on human capital development was negative. Inefficient technologies have also impeded production processes and efficiency and therefore suppressed TFP. Other factors include the inefficient use of resources, and poor management and functioning of firms. Again, Nepal underperforms compared to its peer countries as well as India, particularly during the later 2010s.

³⁴ Measured in constant 2015 US dollars, data series NV.AGR.EMPL.KD, NV.IND.EMPL.KD, and NV.AGR.EMPL.KD at data.worldbank.org.

³⁵ Data can be found with code SL.AGR.EMPL.ZS on data.worldbank.org

³⁶ Due to data limitations, less peer countries are included in this figure, while India, Nepal's main trading partner, was added.

Figure 49. Drivers of growth.

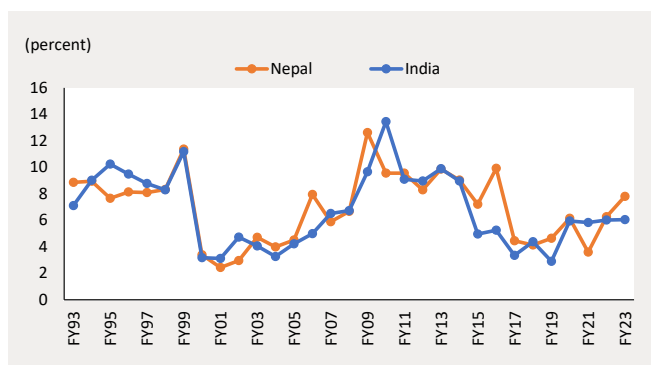


Sources. World Development Indicators

C.3 HOW HAVE REAL EXCHANGE RATE DYNAMICS AFFECTED EXPORTS?

February 2023 marks the 30th anniversary of Nepal’s current exchange rate peg of 1.6 NPR to the INR. From the time Nepal’s exchange rate peg was set in FY93 to FY14, annual inflation in Nepal was on average 0.1 pp lower than in India. (Figure 50). From FY15 onwards, annual inflation in Nepal was on average 1.1 pp higher than in India, due in part to the 2015 Gorkha earthquakes and India’s 2015 trade blockade on Nepal.

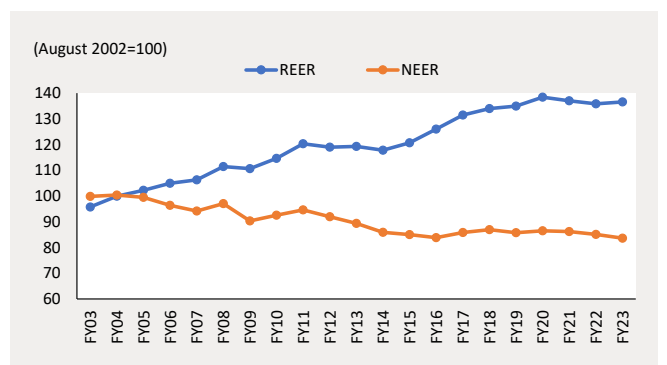
Figure 50. Annual average consumer inflation of India and Nepal FY93-FY23.



Sources. Nepal Rastra Bank and IMF

Nepal’s real exchange rate appreciated against its trading partners, despite a nominal depreciation (Figure 51). The nominal effective exchange rate (NEER) measures the value of the NPR against the currencies of its main trading partners. The real effective exchange rate (REER) measures the price-level adjusted value of the NPR against the same currencies. The dynamics of the two rates began to diverge from FY05, when the NEER index depreciated, and the REER index appreciated.

Figure 51. Exchange rate dynamics FY03-FY23.



Sources. World Bank staff calculations

The following analysis investigates how the real appreciation of the NPR affected Nepal's export performance. The empirical approach follows the literature examining how bilateral real exchange rates (BRER) affect firm-level export outcomes. The most relevant paper methodologically is Fitzgerald and Haller (2018), who lay out the theoretical foundation for this type of analysis using an exporter decision model. The empirical analysis and theoretical foundation are also similar methodologically to a large firm-level literature examining the effect of exchange rates on prices (partly reviewed by Burstein and Gopinath, 2014).

The analysis comprises annual data for two time periods, 2010-2014 and 2018-2021, determined by data availability.³⁷

Export data are expressed in USD, stem from the Nepali customs dataset, and differentiate between firms, products, and destinations. World Bank GDP deflator data are used by default for the price index, IMF consumer price index data are

used as a robustness test. Nominal exchange rates data stem from the IMF. The BRER is measured such that an increase corresponds to an appreciation and is lagged one year throughout the analysis to avoid mechanical simultaneity. Standard errors are clustered at the destination level. All regressions include firm, product, destination, and year fixed effects (i.e., dummy variables) to control for potential omitted variables. These are referred to as the “baseline” set of fixed effects. The “extended” set of fixed effects includes firm-product-year interaction fixed effects and destination fixed effects.

The baseline estimates imply that a 10 percent appreciation of the BRER is associated with a 3 percent decrease in Nepali exports. Table 6 presents evidence that the BRER has a significant negative effect on exports (Specification 1, (S1)). The results are similar when using the CPI instead of GDP deflator to calculate price indices S2 and when using the extended set of fixed effects S3.

Table 6. Baseline Regressions: Impacts of bilateral RER on exports

	(S1)	(S2)	(S3)
Log(BRER)	-0.294 *** (0.111)		-0.299 ** (0.136)
Log(BRER), CPI		-0.284 ** (0.122)	
Observations	91,408	91,315	44,041
R-squared	0.524	0.524	0.63
Fixed Effects	Baseline	Baseline	Extended

Notes. i) Dependent variable is the log of exports; ii) Robust standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.1

Analysis including data on the size of firms shows that the effect of BRER movements is stronger for larger firms (Annex Table A1). This could be because small exporters engage in less systematic and possibly experimental participation in export markets, in which case the amount they sell may be less responsive to exchange rates. For larger exporters, the relationship between changes in their price competitiveness and export value may be more elastic.

The BRER effect is weaker for firms that export to more destinations or that export more products. A possible explanation is that these firms are more diversified and can ride out BRER shocks more easily. They may not have to cut exports as much in response to short-term fluctuations in exchange rate conditions.

Nepal's exports to India are more sensitive to variations in the BRER than exports to other destinations. Annex Table A3 shows that the net effect for India - the sum of the coefficients - is about 1.2 While both coefficient estimates are statistically significant, they are based on limited observations, only 9 distinct values of the BRER with respect to each trading partner, one for each year in the sample.

The effect of a BRER change on exports generally materializes in the subsequent year. As mentioned previously, by default we lag the BRER variable by one period to avoid mechanical simultaneity. In Annex Table A3 (S14) we also include the 2-year lag and the contemporaneous year values. We see that the results are driven by the one-year lag, with the two-year lag and contemporaneous RER effects being very close to zero.

³⁷ The analysis was designed and carried out by Rishi R. Sharma, Associate Professor of Economics, Colgate University

The data suggest that a 30 percent appreciation of the BRER could account for a 13 percent reduction in Nepal's total goods exports when accounting for export shares.

Alternatively stated, a 10 percent appreciation could account for a 4.2 percent reduction in Nepal's goods exports. This specification uses a weighted least squares (WLS) regression that weights destinations according to their share of total exports (S15, Annex Table A3). While this estimate is less precise with the coefficient significant at the 10 percent level, the weighting makes it a more natural analog to the commonly used REER measures.

Finally, we investigate the relationship between the number of exported goods and the real exchange rate. There are two ways that a country's export flows can expand. First, over time Nepal can export more of what it already produces which is called the intensive margin – deepening existing markets. Second, over time Nepal can begin exporting new products which is an extensive margin – opening new markets.

The regressions test whether the BRER has a significant impact on Nepal exporting new products over time. We could expect a negative coefficient, meaning that a depreciation (fall in BRER), which increases external competitiveness, would lead to more types of products being exported. For this analysis, the data are aggregated to the firm-destination-year level and the dependent variable is the (log) number of products. The baseline set of fixed effects are used in S16 and S17 of Annex Table A4, the extended one in S18.

The effect of the BRER on the number of products exported by Nepal is not as strong as the BRER effect on export values of existing products found in the earlier tables. While S16 provides a statistical significance of 10 percent that the BRER negatively affects the number of products exported, this finding is not statistically significant across the different specifications.

C.4 CONCLUSIONS AND RECOMMENDATIONS

Nepal is experiencing a sizeable productivity deficit and poor export performance. Labor productivity is low compared to peers across all sectors and the mobility of labor across sectors has been slower. Low productivity impedes domestic firms' ability to compete with foreign firms for export markets, both in terms of prices and product quality. It hinders the diversification of export products and labor market shifts away from less productive agricultural jobs to more productive jobs in manufacturing or services that could stimulate exports. Low productivity also likely disincentivizes FDI inflows, which can enhance productivity through knowledge and spillover effects.

The evidence suggests that prices inside Nepal may be increasing due to strong and sustained foreign exchange inflows (remittances), rather than to improvements in productivity.³⁸ According to theory, productivity and the real exchange rate would move in the same direction as an economy develops. The first glance at the dynamics undertaken in this chapter, however, suggests this was not the case in Nepal. While the real exchange rate appreciated

continuously over the past decade, productivity increased only sluggishly. A more detailed analysis will be necessary to confirm these dynamics, including the role remittances played in the real appreciation.³⁹

There is significant empirical evidence that Nepal's real appreciation has hampered its export performance. Results show that a 10 percent appreciation of the bilateral real exchange rate (BRER) is associated with around a 4 percent decline in exports. The results were more pronounced for larger firms and exports to Nepal's main trading partner, India. Firms that export more products and to more markets appear less affected by BRER movements, underscoring the importance of diversification.

Increasing Nepal's productivity is one of the most important efforts the country can undertake to improve export performance.⁴⁰ Changing the current tax model by shifting taxation away from the border and reducing high import tariffs⁴¹ could increase firms' productivity and export orientation. A review of capital control measures could help

³⁸ Productivity and real exchange rates themselves are linked most prominently through the Balassa-Samuels effect, which suggests that more productive countries have higher levels of non-tradeable goods prices, which appreciates their real exchange rate. The present analysis did not uncover evidence of this relationship in Nepal.

³⁹ See Narayan, Narayan, and Mishra (2011) for the impact of remittances on inflation.

⁴⁰ Cusolito and Maloney (2018) offer a detailed framework for enhancing productivity.

⁴¹ A discussion of tariffs can be found in World Bank (2021).

identify those that could be lifted to allow for imperfect capital mobility and international payment flows without jeopardizing usage of monetary policy. A more complete implementation of fiscal federalism could facilitate effective investments in infrastructure and services, which in turn could boost productivity. Evidence in other countries has also shown that FDI inflows, which are negligible in Nepal so far, can create significant knowledge and spillover effects. In general, Nepal’s productivity deficit compared to peer countries strongly suggests that authorities should shift their focus towards policies that enhance the ability of workers, firms, and industries to produce and compete.

Getting a better grip on inflation would support real exchange rate stability. Simply changing the value of the peg is unlikely to realign the real exchange rate, as the second order impacts of a devaluation include higher inflation resulting from an increase in import prices. Inflation in FY23 continued to remain above the central bank’s target. Reducing the inflation differential with trading partners would suppress domestic prices, help avoid further real appreciation, and help Nepal preserve external competitiveness. More analysis and discussion are also required to better understand the role of remittances in Nepal’s real appreciation.

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ANNEX

Table A1. Impacts of bilateral RER and firm characteristics on exports

	(S4)	(S5)	(S6)	(S7)
Log(BRER)	-0.265 ** (0.109)	-0.298 *** (0.110)	-0.311 *** (0.112)	-0.294 *** (0.110)
Log(BRER) x Larger	-0.071 *** (0.011)			-0.083 *** (0.011)
Log(BRER) x Many Destinations		0.012 ** (0.006)		0.014 ** (0.006)
Log(BRER) x Many Products			0.035 *** (0.006)	0.047 *** (0.007)
Observations	91,408	91,408	91,408	91,408
R-squared	0.525	0.524	0.524	0.526
Fixed Effects	Baseline	Baseline	Baseline	Baseline

Notes. i) Dependent variable is the log of exports; ii) Robust standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.1

Table A2. Impacts of bilateral RER and additional firm characteristics on exports

	(S8)	(S9)	(S10)	(S11)	(S12)
Log(BRER)	-0.306 *** (0.107)	-0.299 ** (0.116)	-0.304 *** (0.114)	-0.338 *** (0.115)	-0.398 *** (0.119)
Log(BRER) x Agriculture/Food	0.063 (0.043)				
Log(BRER) x Depreciation		0.003 (0.004)			
Log(BRER) x Large Depreciation			0.008 (0.005)		
Log (BRER) x Homogeneous				0.046 (0.039)	
Log (BRER) x Ext. Finance Dependent					0.021 (0.037)
Observations	91,408	91,408	91,408	86,207	74,887
R-squared	0.524	0.524	0.524	0.520	0.518
Fixed Effects	Baseline	Baseline	Baseline	Baseline	Baseline

Notes. i) Dependent variable is the log of exports; ii) Robust standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.1

Table A3. Impact of lagged bilateral RER and India on exports

	(S13)	(S14)	(S15)
Log(BRER _{t-1})	-0.292 ** (0.112)	-0.295 *** (0.111)	-0.423* (0.227)
Log(BRER _{t-2})		0.0016 (0.004)	
Log(BRER _t)		0.0077 * (0.004)	
Log (BRER) x India	-0.935 *** (0.156)		
Observations	91,408	91,393	91,408
R-squared	0.524	0.524	0.735
Fixed Effects	Baseline	Baseline	Baseline

Notes. i) Dependent variable is the log of exports; ii) S15 uses weighted least squares regression that weights destinations according to their share of total exports; and (iii) Robust standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.1

Table A4. Impact of bilateral RER on the number of products exported

	(S16)	(S17)	(S18)
Log(BRER)	-0.077 * (0.047)		-0.054 (0.046)
Log(BRER), CPI		-0.069 (0.042)	
Observations	44,815	91,393	91,408
R-squared	0.334	0.524	0.735
Fixed Effects	Baseline	Baseline	Extended

Notes. i) Dependent variable is the log of number of products exported; ii) Robust standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.1

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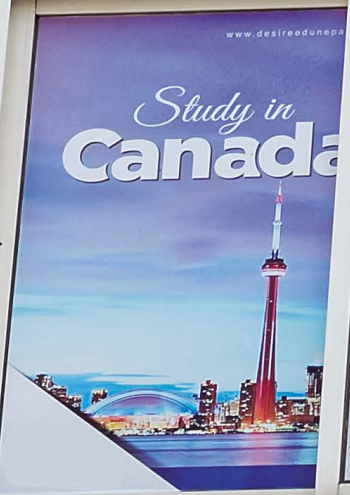
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Study in
USA

An advertisement for the USA featuring the Statue of Liberty, the American flag, and a city skyline. The text "Study in USA" is displayed, with "Study in" in a smaller, italicized font above "USA".



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