NEPAL DEVELOPMENT UPDATE

May 2016

Remittances at Risk

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Acknowledgements

The Nepal Development Update is produced twice-yearly with the following two main aims: to report on key economic developments over the preceding months, placing them in a longer term and global perspective and to examine (in the Special Focus section) topics of particular policy significance. The Update is intended for a wide audience including policy-makers, business leaders, the community of analysts and professionals engaged in economic debates, and the general public.

This Update was produced by the World Bank Macroeconomics and Fiscal Management team for Nepal consisting of Damir Cosic, Roshan Bajracharya, Sudyumna Dahal and Saurav Rana under guidance of Shubham Chaudhuri and Takuya Kamata. Sailesh Tiwari contributed to the Poverty Box. Dilip Ratha and Sonia Plaza, provided helpful guidance in preparation of the Special Focus. Rajib Upadhya and Trishna Thapa managed media relations and dissemination. Sunita Kumari Yadav ably managed the publication process.

The team is grateful for collaboration and data from various agencies and organization in Nepal. In particular, we would like to thank Suman Raj Aryal and Hem Raj Regmi (Central Bureau of Statistics), Pradeep Paudyal (Nepal Rastra Bank), Manika Manadhar (Nepal Oil Corporation), Dinesh Bhattarai (Department of Agriculture), Nabin Pokhrel (Nepal Tourism Board), Kedar Neupane and Gaurav Dhungel (Department Immigration), Surya Sedai and Binod Acharya (Department of Customs), Prabhat Kumar (UNDP), and Jimmy Oostrum (UNICEF).

Cut-off date for data included in this report was May 30, 2016.

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Executive summary: Remittances at Risk

During 2015, and in the span of six-months, Nepal was hit by two major shocks.

The first one was the April 2015 earthquakes that caused a huge loss of life and assets. The second shock has come in the form of a near complete disruption of external trade following the adoption of the new Constitution.

Nepal's political parties intensified their efforts to adopt a new constitution, after eight years of deliberations, spurred on by the shift in political priorities following the earthquakes. As the constitutional process drew to an unexpectedly rapid close, protests and clashes erupted in August 2015 across the country's southern belt bordering with India. Following the promulgation of the new constitution on September 20, 2015, protests intensified. A near-complete disruption in cross-border trade resulted in acute shortages of fuel and essential supplies across the country, which in turn has curtailed economic activity.

With varying intensity, the trade disruptions—which lasted more than four months from September 2015 through January 2016—have affected economic activity across the board. Industry came to a near stand-still due to shortage of fuel and raw materials and its proximity to protest-affected areas. Service sector was hit hard as tourism, trade, transport and bank lending were curtailed. Agriculture has been affected by lack of fertilizers and other inputs with production of rice, the largest crop, reaching a seven-year low. Government revenues fell sharply, given Nepal's large reliance on trade-related taxes, leading to a decline in public expenditures as well. Imports contracted for the first time in decades resulting in a sharply lower trade deficit. Remittances continued to grow, albeit at a slower pace, and together with the shrinking trade deficit have resulted high current account surplus and a record foreign reserves.

Reflecting both the earthquake and trade related disruptions, inflation spiked to over 12 percent (y/y) by mid-January rising 5 percentage points in just four months from mid-September 2015. This was the highest inflation level since FY2009, with increases in food and non-food prices contributing equally to the spike. As the trade disruptions ended, inflation has eased to back to single digits.

As a result, the overall growth rate for FY2016 is estimated to be 0.6 percent (at market prices), the lowest in 14 years. The impact of trade disruptions on economic activity has been nearly as large as the impact of earthquakes as growth slowed 2.2 percentage points from the previous year. Agriculture and services experienced some of the lowest growth rates in recent history while industry contracted for the first time in seven years.

The trade disruptions have further affected poverty reduction efforts which were already hampered by the earthquakes in 2015. Earlier estimations had suggested that the earthquakes could end up pushing an additional 0.7-1.0 million of Nepalis into poverty in FY2015 and FY2016. Poverty is expected to worsen as a result of trade disruptions affecting the livelihoods of millions of people across Nepal. Shortages of goods have pushed up prices with inflation inching into double digit territory affecting welfare with significant impact on the poor in Nepal, particularly in urban areas. Fuel related slowdown in economic activity together with the increase in transportation prices hurt casual wage workers that derive a bulk of their livelihoods from wages. Income from wages accounts for anywhere between 30-50 percent of the total income of urban Nepalis who are poor or vulnerable to falling into poverty.

Outlook

Following the two years of disappointing growth, activity is expected to rebound modestly. The rebound in growth in the forecast period is predicated on stabilization of the political process and the start of the earthquake rebuilding efforts. However, growth from FY2018 is expected to moderate in line with the country's potential. Manufacturing in particular is expected to get some boost starting from FY2017 with the apparels and garment industry getting a duty free access in the US market. The high inflation induced by the trade disruptions is expected to moderate towards the end of FY2016, but likely to remain elevated owing to persistent supply-side bottlenecks during the forecast period.

Fiscal and current account deficits are expected to widen during the forecast period, as the reconstruction efforts take full shape. Government's expenditure is expected to grow substantially after FY2016 owing to increase in earthquake-related cash assistance as well as increased capital expenditure. The revenues, however, are also expected to pick up, but at a slower pace, resulting in a fiscal deficit that is expected to narrow as reconstruction efforts are completed. Similarly, current account will likely remain in surplus in the near term, but is expected to turn to deficit as remittances taper off and imports grow driven by the larger reconstruction efforts.

Challenges

Normalizing fuel and other supplies to general public, along with effective mobilization of post-earthquake reconstruction are key short-term challenges, particularly in light of fast-approaching monsoon season. Additionally, the trade disruptions have highlighted the need to urgently diversify the Nepalese economy, particularly in terms of trade, transport options and supplies of key resources.

External environment is likely to be less favorable as well. With remittances comprising more than 30 percent of GDP, Nepalese economy is extremely dependent on these flows. Oil-exporting Gulf Cooperation Countries and Malaysia, which represent almost 97 percent of total Nepali migrants excluding India, are a key source of remittances. As oil prices in particular, and commodity prices in general, are likely to remain around their present levels during the forecast period, the possibility of a drop in remittances has increased. Given that remittances enable consumption-centric structure of the Nepalese economy and the government's reliance on taxation of imports as a major source of revenue, a sharp slowdown would have adverse effects on growth, fiscal and external accounts, in addition to curtailing economic opportunities for Nepalis abroad (see Special Focus of this update).

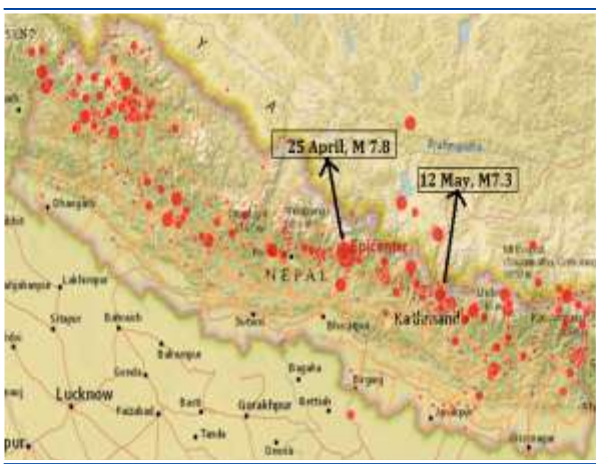
In the medium term, Nepal faces several simultaneous and daunting challenges ahead. From completion of political transition and setting up of a new federal structure to challenges of successful leveraging of its endowments (hydropower potential, human capital) to achieve a faster growth, increasing poverty reduction and creating economic opportunities for its citizens at home. Regaining domestic and foreign investors' confidence, particularly for hydropower development, is an added challenge after series of shocks for a country that does not have a favorable track-record in mobilizing large-scale private investment.

A. Recent Economic Developments

1. During 2015, and in the span of six-months, Nepal was hit by two major shocks.

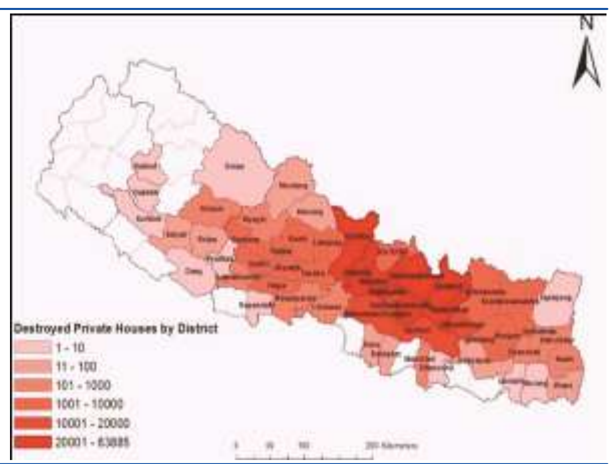
The first shock was the April 2015 earthquake and over 400 aftershocks that have caused a huge loss of life and assets (Figure 1). Total damage is estimated to be around USD 5 billion of which 60 percent is the damages in the housing sector according to the Post Disaster Needs Assessment (Figure 2). The earthquake not only caused physical destruction, but it has put a dent on a stellar record on poverty reduction. Simulations suggest that the earthquakes could end up pushing an additional 0.7-1.0 million of Nepalis into poverty during FY2015 and FY2016.

Figure 1: April 2015 earthquake and its many aftershocks



Source: National Seismological Center via esri.com

Figure 2: Majority of the damage was concentrated in the housing sector



Source: Ministry of Home Affairs and UNDP

The second shock followed in September 2015 in form of a near-complete disruption in cross -border trade. Nepal's political parties intensified their efforts to adopt a new constitution, after eight years of deliberations, spurred on by the shift in political priorities following the earthquakes. As the constitutional process drew to an unexpectedly rapid close, protests and clashes erupted in August 2015 across the country's southern belt bordering with India. Following the promulgation of the new constitution on September 20, 2015, protests intensified. A near-complete disruption in cross-border trade resulted in acute shortages of fuel and essential supplies across the country, which in turn has curtailed economic activity. While many in Nepal have accused India of barring shipments from entering Nepal and imposing an "unofficial blockade," India officially denied doing so, citing "unrest, protests and demonstrations on the Nepalese side" as a cause of the trade disruptions.

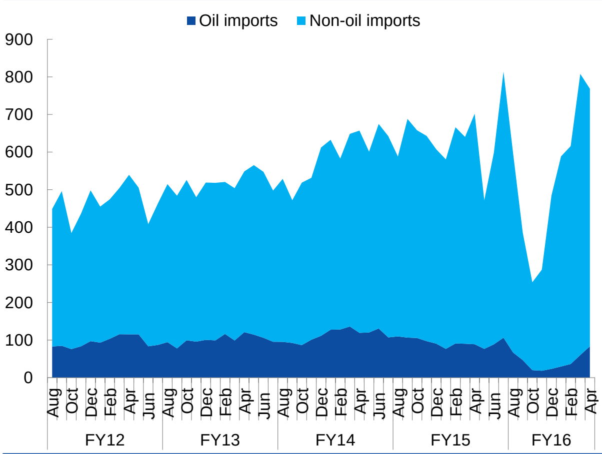
Trade disruptions sharply depressed both imports and exports, but the petroleum products have been hardest hit. Trade disruptions lasted almost five months—from mid-September 2015 until end-January 2016. At the peak of the disruption in mid-November, exports were reduced by half while imports were reduced by two thirds compared to their pre-disruption levels (Figure 3, Figure 4). Imports recorded a contraction for the first time in decades. With only about 20 percent of demand met through formal imports at the peak of the disruption, petroleum products were hardest hit. Consequently, prices of petrol in the black market went up by 300-600 percent, while Liquid Petroleum Gas (LPG) cylinders used for cooking and heating were not available in the market at the time.

Following the end of the trade shock, imports have recovered quickly while exports have not. Trade disruptions ended by the end-January 2016, and by mid-April, imports have recovered and have reached pre-disruption levels. However, exports are yet to recover (Figure 5). The recovery in imports was primarily led by non-oil imports while the formal imports of petroleum products are recovering more slowly (Figure 6). The slow recovery in the imports of petroleum products is evident with difficulty of refilling of LPG cylinders by households, with an approximate wait of 1-2 months for the refill even three months after the end of the trade disruptions. Normal supply of petroleum products at the pumping stations was established only by mid-March, two months after the end of the trade disruptions (Figure 7).

The main border crossing for foreign trade, *Birjung*, is yet to recover following the end of trade disruption India is Nepal's largest trading partner, accounting for 65 percent of Nepal's total trade, and the principal transit route as more than 85 percent of all imports enter through India irre-

Figure 3: Imports were reduced by two-thirds at the peak of disruptions

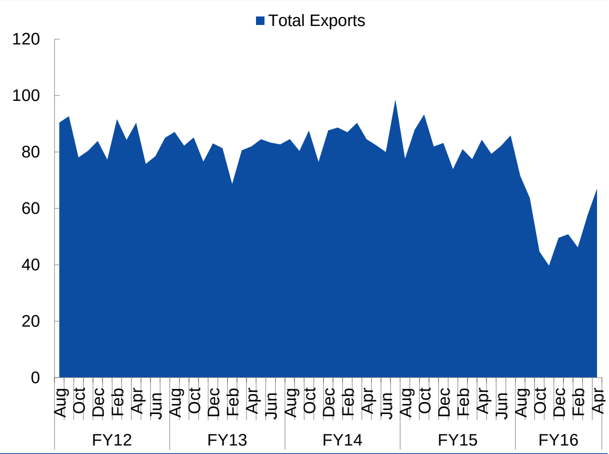
(in million USD)



Source: Nepal Rastra Bank (NRB)

Figure 4: While exports were reduced by half…

(in million USD)



Source: NRB

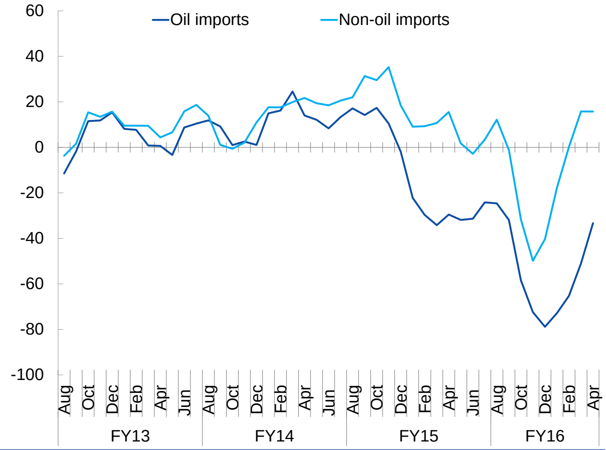
Figure 5: Although imports have recovered, exports have not

(percent change, 3-month moving average, yly)

Source: NRB and WB staff calculations

Figure 6: Recovery in imports are primarily led by non-oil imports

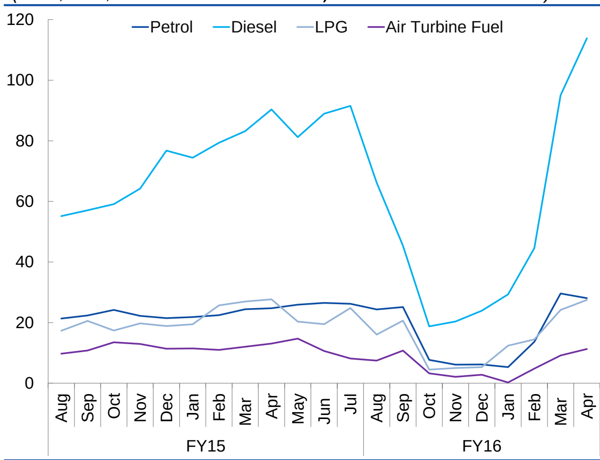
(percent change, 3-month moving average, yly)



Source: NRB and WB staff calculations

Figure 7: Imports of petroleum products have normalized three months following the end of trade disruptions.

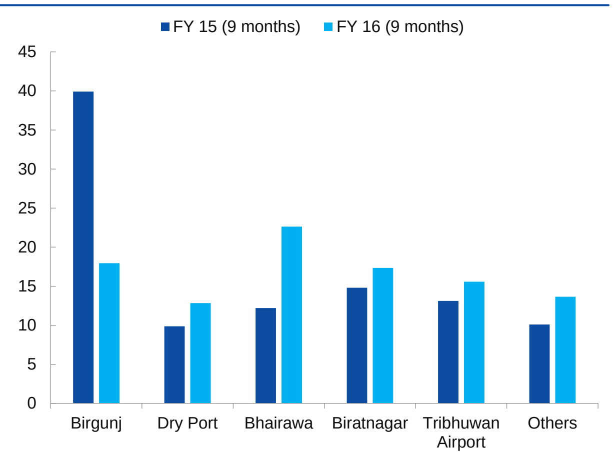
(Petrol, diesel, air fuel in thousand kiloliters; LPG in thousand metric tons)



Source: NOC and WB staff calculations

Figure 8: Trade was re-routed away from the main logistical border crossing at Birgunj

(percent, share of total customs revenue)



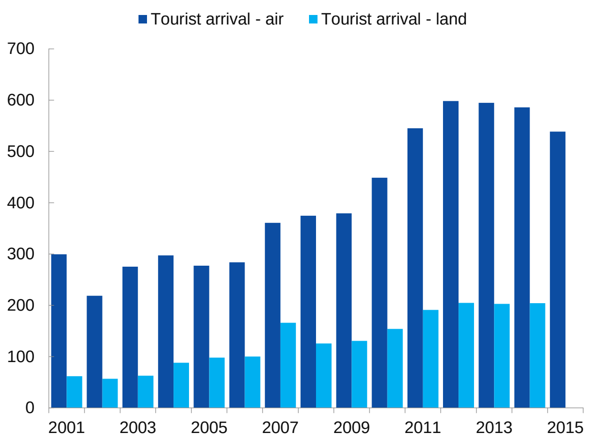
Source: NRB and WB staff calculations

spective of their country of origin. Out of this this, about 40 percent of trade is carried out through *Birjung* which came to standstill and was a focal point of trade disruptions. Consequently, trade was re-routed away from the main logistical border crossing at *Birgunj* which is yet to recover the disruptions, while trade going through other border points has increased significantly (Figure 8).

Contraction in tourist arrivals is estimated to be highest in 13 years. Tourist arrivals to Nepal have peaked in 2012 with growth stagnating for the last few years. The two shocks of 2015 have hit the industry hard. Preliminary estimates show that 2015 will post an 8 percent contraction of tourist arrivals via air, a largest contraction in 13 years (Figure 9) with the earthquake having a much larger effect on air arrivals than the trade disruptions (Figure 10). However, receipts from tourist arrivals are likely to contract even more as popular mountain climbing destinations were closed in the aftermath of the earthquake while hotels and restaurants curtailed their offerings during the trade disruptions. While data for arrivals via land is not yet available, it will likely show a negative contribution to the sector as well given scarcity of petroleum products.

Figure 9: Tourist arrivals by air had already peaked in 2012

(in thousands)



Source: Ministry of Tourism and Department of Immigration

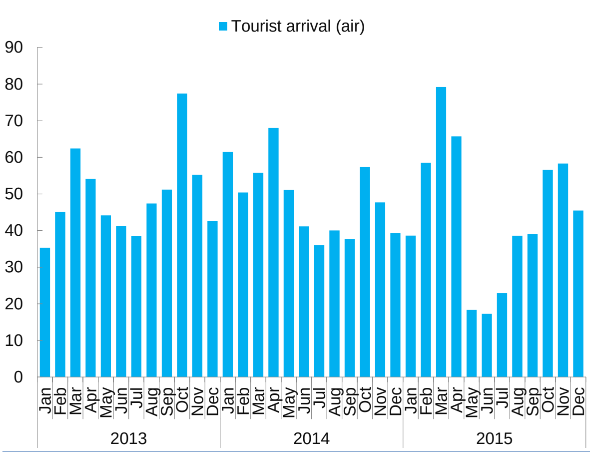
Industrial and commercial activity slowed sharply as well. Manufacturing, which was mostly unaffected by the earthquake, has been severely hit due to its close proximity to protests that have halted transport and availability of raw materials. At the peak of trade disruptions during October and November, reports indicated that the sector was operating at minimal capacity. As a proxy for activity, the electricity usage by industry contracted by 31 percent (y/y) at the peak of disruption in mid-December (Figure 11). The woes by manufacturing were further compounded by lack of diesel need for running of back-up generators. However, use of electricity by household surged, posting a growth of 16 percent in mid-December (y/y), as households switched to electricity for cooking given the unavailability of LPG.

2. These shocks have resulted in high inflation.

Both earthquake and trade disruptions have contributed to higher inflation. Although inflation had been moderating during FY2015, it spiked to over 12 percent (y/y) by mid-January 2016 rising 4.9 percentage points in just four months from mid-September 2015. This was the highest inflation level recorded since FY2009, reflecting both earthquake and trade related disruptions. Increases in food and non-food prices contributed equally to the spike in inflation. Inflation eased to 9.7 percent (y/y) in mid-April, as the trade disruptions ended (Figure 12).

Figure 10: Earthquake had higher impact on tourist arrivals by air then the trade disruptions

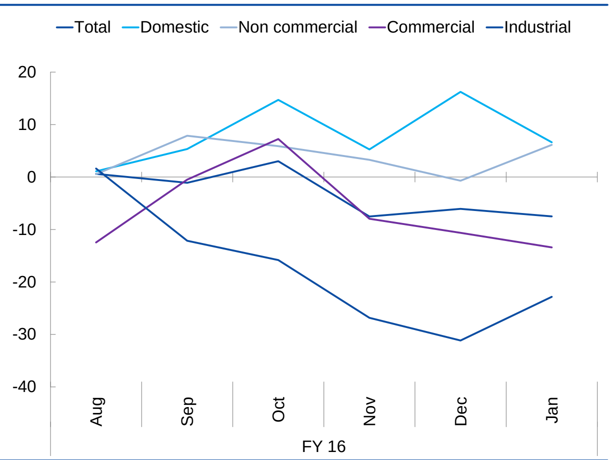
(in thousands, 3 month moving average)



Source: Ministry of Tourism and Department of Immigration

Figure 11: Electricity usage by industrial and commercial entities contracted

(percent change, y/y)



Source: Nepal Electricity Authority

Food inflation more than doubled during the first six months of the FY2016. It rose from 7.2 percent (y/y) in mid-August to 15.2 percent (y/y) in mid-January adversely affecting the purchasing power of consumers. Cereal grains inflation, which had been remaining stubbornly high on average owing to persistent supply bottlenecks within Nepal, ticked up once again even as cereal prices in India continued to decelerate. Imported foods like cooking oil experienced extreme price increase from 6.4 percent (mid-August) to peak at 42.4 percent in mid-December. Shortage of sugar at the onset of the annual festival season, when demand for sugar products from confectionaries is the highest, saw an increase in prices from -0.5 percent (y/y) in mid-August to 7.5 percent (y/y) in mid-December.

Non-food prices had been moderating over FY2015 but began experiencing upward pressure after the earthquake. They shot up from 6.6 percent in mid-August to 10.1 percent in mid-February. The trade shock also compounded the pressure on prices as goods stuck at the border created shortages in Nepal and as importers used alternative means of importing through other border points or by air. Similarly, the transportation sector was also hit as fuel imports dried up, precipitating the emergence of a black-market. As black-market diesel and petrol were available at premiums of 300 percent to 600 percent over pump price, input costs in the transportation sector rose and was passed on to the end consumer leading to a spike in transportation inflation.

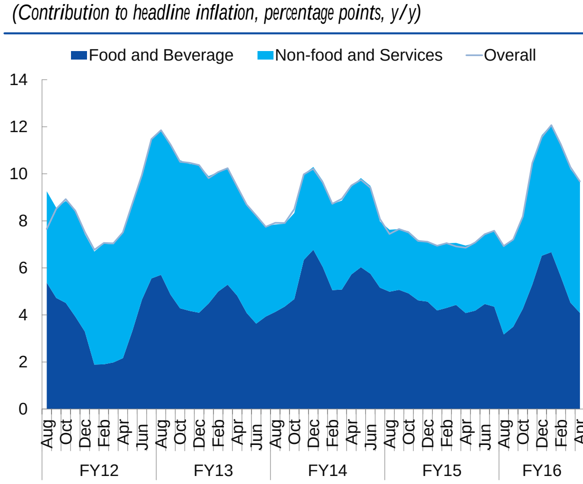
Spike in inflation in Nepal has led to higher divergence of inflation with India. Given the pegged exchange rate, inflation in Nepal is influenced by prices in India and generally follows the evolution of inflation in India with a lag. However, inflation in Nepal has been increasingly diverging from that of India's for the past eighteen months driven primarily by food prices in Nepal. By mid-February 2016, the gap in headline inflation was at peak with 6 percentage points (Figure 13). In addition, since the beginning of FY2016, non-food prices in Nepal have also started to diverge from non-food prices in India with a significant gap opening up by February 2016—up from almost no gap in June 2015 to a gap of 5.1 percentage points by mid-February (Figure 14). This has led to a depreciation of the real effective exchange rate by 14 percent, from the average level in FY2014 (Figure 15).

3. Suppression of trade has led to record foreign reserves.

As the trade disruptions normalize, the improvements in trade deficit are dissipating. As imports are nine times larger than exports, and given that trade disruptions have affected imports more than exports, the trade deficit narrowed

Figure 12: Supply disruptions have pushed inflation to a 7-year high

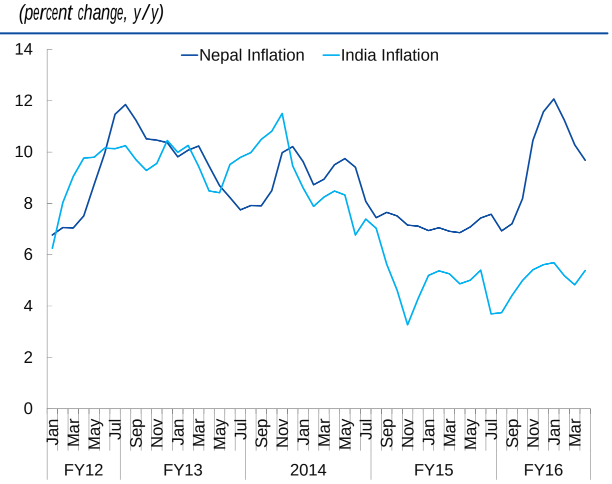
(Contribution to headline inflation, percentage points, y/y)



Source: NRB and WB staff calculations

Figure 13: Leading to a widening gap with India's inflation

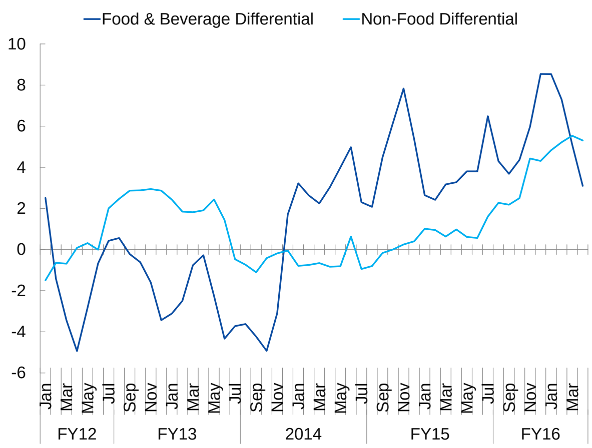
(percent change, y/y)



Source: NRB, CSO India and WB staff calculations sharply during FY2016. The trade deficit in the first nine months of FY2016 is down 14.6 percent (in dollar terms) compared to the same period of FY2015, however, this effect is fast dissipating going forward as the trade normalizes, in particular as imports have rebounded faster than exports. At the same time, remittance continued to expand, albeit at a slower pace, following a surge in remittances during the last quarter of FY2015 after the April/May earthquakes (Figure 16). The cumulative effect of the trade balance improvement and growing remittances has put the current account at a comfortable surplus of USD 1.3 billion for first nine months into FY2016. This has also led to a historic in Nepal's foreign reserves with over USD 9 billion being accumulated by mid-April 2016, covering 15 months of merchandise and services imports (Figure 17).

Figure 14: While differences in food prices with India have persisted, difference in non-food price has widened

(percentage points)



Source: NRB, CSO India and WB staff calculations

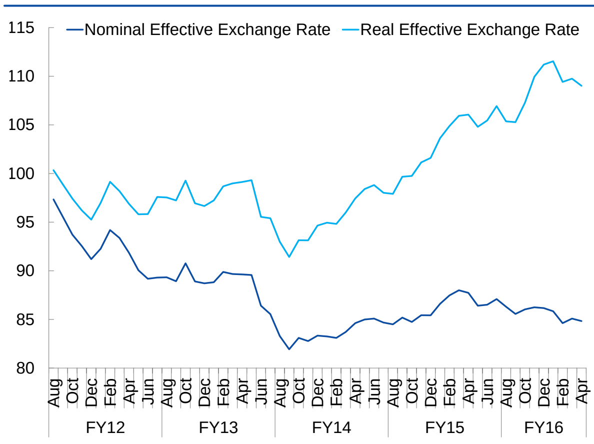
Decline in outflow of migrant works has persisted since the earthquake. Following the April earthquakes, outflows of migrant workers has declined consecutively for ten months. By mid-April they have contracted by 25 percent (y/y) (Figure 18). Two factors are affecting this trend: (i) in the aftermath of the earthquakes potential migrants are increasingly choosing to stay at home to support their families with rebuilding homes and livelihoods, and (ii) a weaker demand for worker from commodity exporting host countries where low commodity prices have dented their incomes and weakened their fiscal balances.

4. Growth in foreign reserves has been only partially sterilized translating to a rapid money supply growth.

The surplus current account has increased foreign reserves of the central bank (Nepal Rastra Bank, NRB) and fed the increase in net foreign assets

Figure 15: Leading to an appreciation of the real effective exchange rate

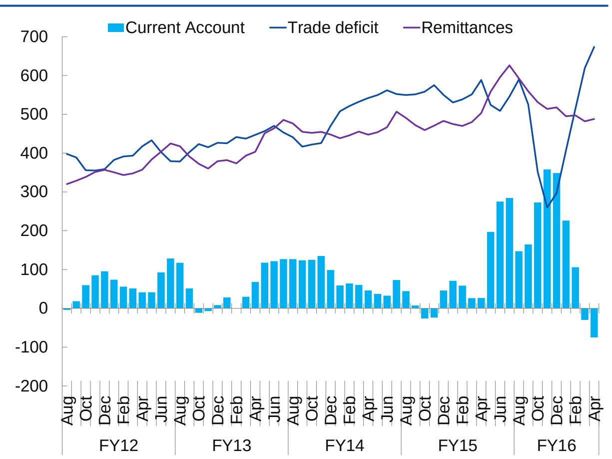
(index number, 2010=100)



Source: WB staff calculations

Figure 16: Trade deficit improved markedly, however, the effect is dissipating with trade normalization

(USD millions, 3-month moving average)

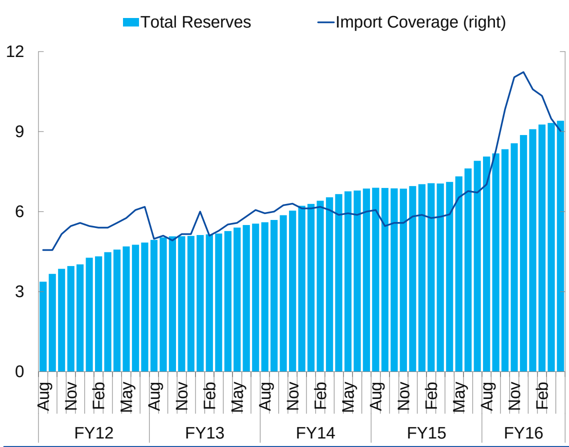


Source: NRB

which has been growing steadily since the last quarter of FY2015 (Figure 19). The upward pressure on money supply has led to NRB revising its money supply growth target FY2016 to 21.5 percent during its mid-year review from an initial expected growth rate of 18 percent at the beginning of FY2016. However, even this revised target has not been met as broad money supply grew by 25 percent (y/y) in mid-April as inflow of foreign reserves was only partially sterilized. The liquidity in the system did not translate into new credit given general uncertainty amid trade disruptions. New credit issuance growth has been contracting on y/y basis since June 2015 and has rebounded strongly following the end of trade disruptions at the end-January (Figure 20). During this period, NRB tried to contain excess liquidity in the system by conducting multiple rounds of reverse repos, totaling NPR

Figure 17: Resulting in historic high foreign reserves

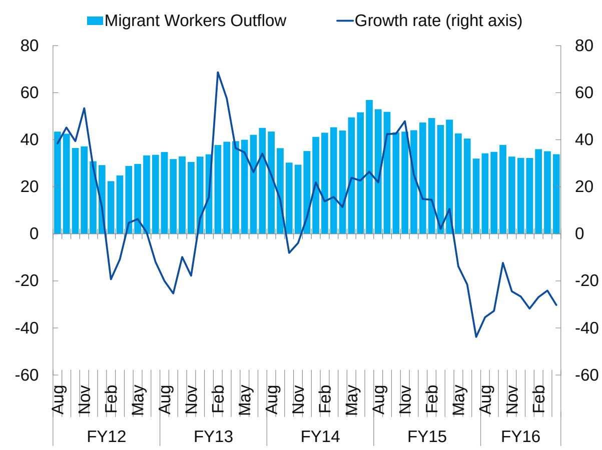
(LHS: USD billion; RHS: months)



Source: NRB

Figure 18: Outflow of migrant workers has contracted since the earthquake

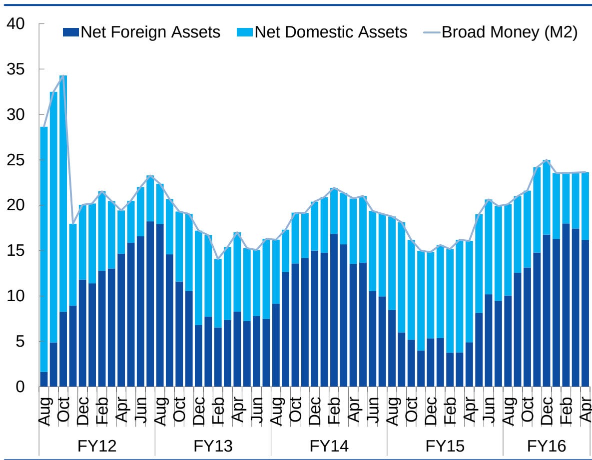
(LHS: in thousands, 3-month moving average, RHS: percent change, y/y)



Source: NRB

Figure 19 :Surplus current account has driven up Net Foreign Assets and money supply

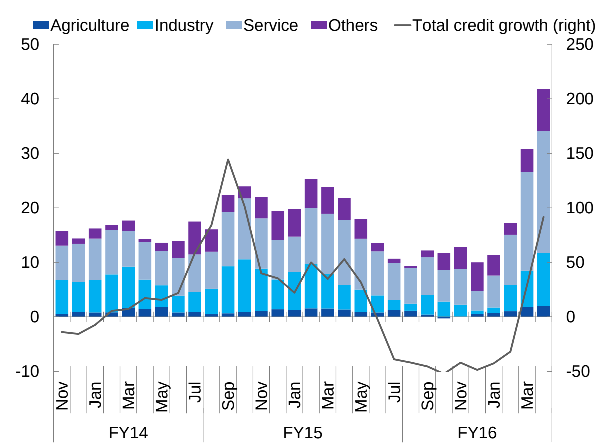
(contribution to M2 growth, percentage points, yly)



Source: NRB

Figure 20: However, new bank loan issuance was contracting since the earthquake and recovered only after trade disruptions ended

(LHS: NPR billion, 3-month moving average; RHS: percent change, y/y)



Source: NRB

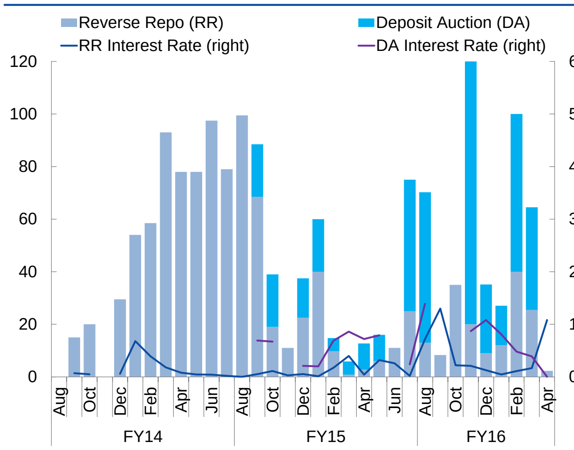
165 billion, as well as multiple deposit auctions amounting to NPR 297 billion, at very low interest rates (Figure 21).

5. Trade disruptions severely affected government revenue collection as well as spending.

Despite the recovery of government revenue, the shortfall in tax revenue is estimated to be significant . Government revenues fell sharply as a result of the trade disruptions, given Nepal's large reliance on trade-related taxes. Almost half of total revenue come from trade related taxes (Figure 23). Revenues have picked up significantly by mid-April 2016 as they registered a sharp recovery following the end of trade disruptions which is likely to have bolstered by large one off tax collection (Figure 22). Nonetheless, revenue shortfall (actual collection compared to plan) is estimated to be about USD150 million (about NPR15 billion) given that there is not

Figure 21: Central bank's interventions to contain money supply growth

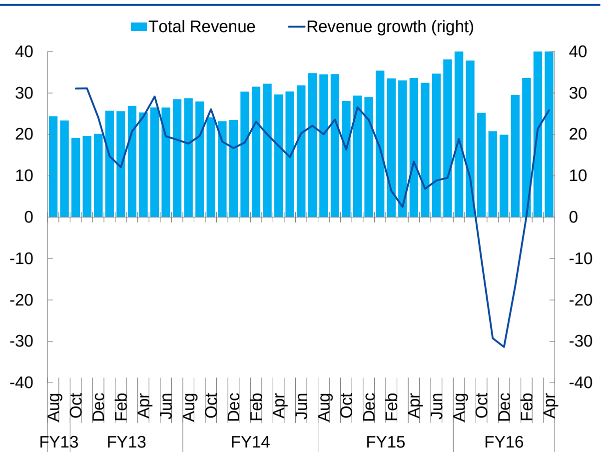
(LHS: NPR billion; RHS: percent)



Source: NRB

Figure 22: Despite sharp recovery of government revenue, shortfall is estimated to be significant

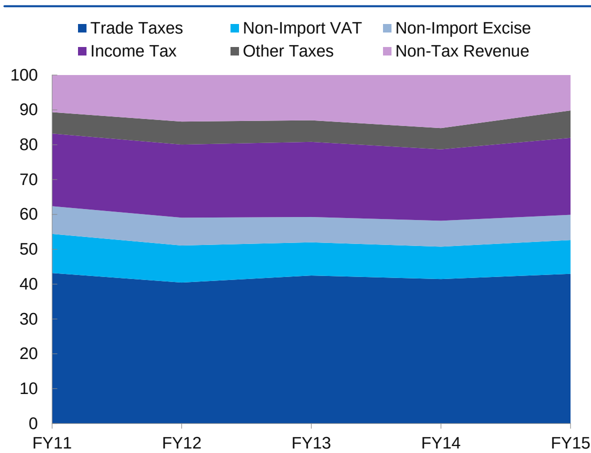
(LHS: in billion NPR, 3-month moving average, RHS: percent change, yly)



Source: NRB and WB staff calculations

Figure 23: Nearly half of government revenues depend on trade

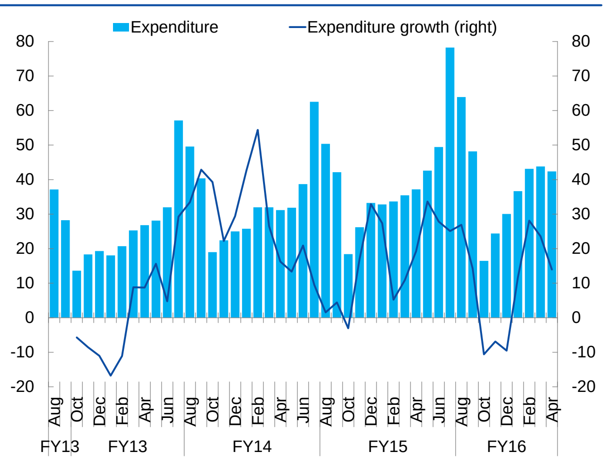
(percent, share of total revenue)



Source: MoF and WB staff calculations

Figure 24: Expenditure has picked up

(LHS: in billion NPR, 3-month moving average, RHS: percent change, yly)



Source: NRB and WB staff calculations

enough time in the fiscal year to make up the forgone revenue, particularly from the imports of goods like petroleum, vehicles and fertilizers.

Government spending has picked up faster, while capital spending is still lagging Government spending growth, which was negative during the disruptions, has registered a sharp rebound. The total expenditure is up 14 percent in three months ending mid-April 2016 compared to the same period in FY2015 (Figure 24). As the fiscal year is coming to an end, this growth is driven by both recurrent and capital expenditure which are up, 9 and 24 percent respectively (Figure 25). Budget for FY2016 called for near doubling of capital expenditure as a response to the devastation caused by the earthquakes which is now very unlikely to materialize. Consequently, by mid-May the amount spent on capital expenditure was just 20 percent of the total budgeted amount. Poor implementation of capital expenditure, which was country's systemic problem, has been further exacerbated by the trade disruptions.

6. In sum, FY2016 resulted in lowest growth in 14 years.

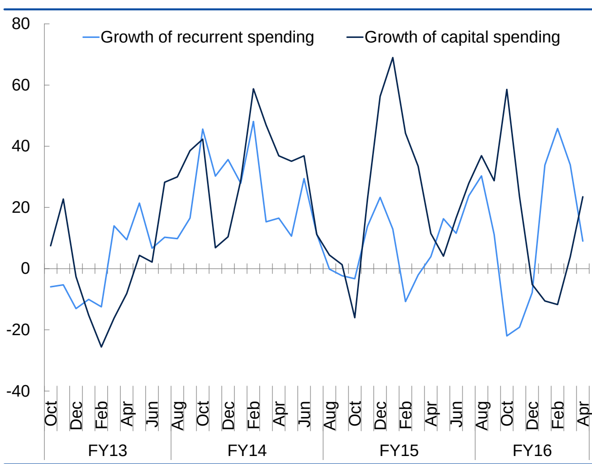
First estimate for FY2016 growth shows the economy barely escaped a recession growing only 0.6 percent (at market prices). This is the lowest growth in 14 years and is 1.1 percentage points lower than already weak growth in FY2015 of 2.7 percent (at market prices). The FY2015 estimate itself was revised down as well from a previous estimate of 3.4 percent.

Industry has contracted for the first time in seven years. All sub-sectors contracted in activity during FY2016. Manufacturing, which was mostly unaffected by the earthquake, has been hardest hit due to its close proximity to protests that have halted transport entirely. Reports indicated that the sub-sector was operating at only ¼ of capacity at the peak of trade disruptions. Construction also contracted as works were stopped due to lack of fuel and imported materials. Electricity production was affected as damages to generation capacity caused by the earthquake that could not be repaired. In total, industry contracted by 6.3 percent, down from meager growth of 1.5 percent in FY2015.

Services have been hit hard recording a lowest growth rate in 14 years. Tourism, which had started to rebound from April/May earthquakes, has taken another blow as peak tourist season (September to November) coincided with the peak trade disruptions. Hotels reported 30 percent occupancy rate (down from usual 85-90 percent rate during peak season), with many curtailing services or closing altogether. Wholesale and retail trade suffered a first contraction in nine years as trade disruption severely curtailed availability of goods. Transport and communications registered a lowest growth in a decade as fuel shortage af-

Figure 25: Driven by recurrent while capital spending is below last year's

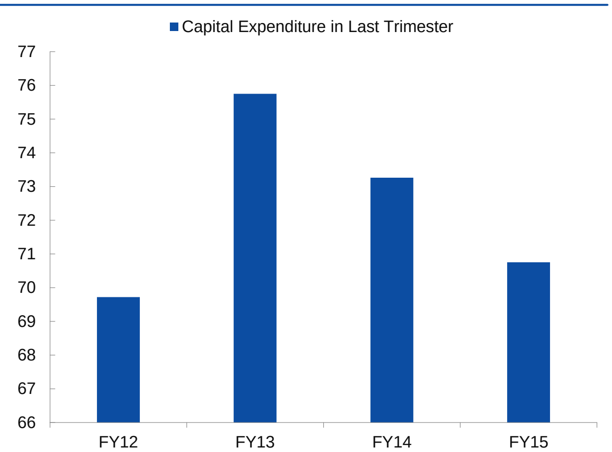
(percent change, 3-month moving average, y/y)



Source: NRB and WB staff calculations

Figure 26: As a result, bunching of capex likely to get worse in FY2016

(percent, share of GoN capex spent in final trimester)



Source: NRB and WB staff calculations

fected transport activities. In total, services registered a growth of 2.7 percent, down from 3.7 percent in FY2015.

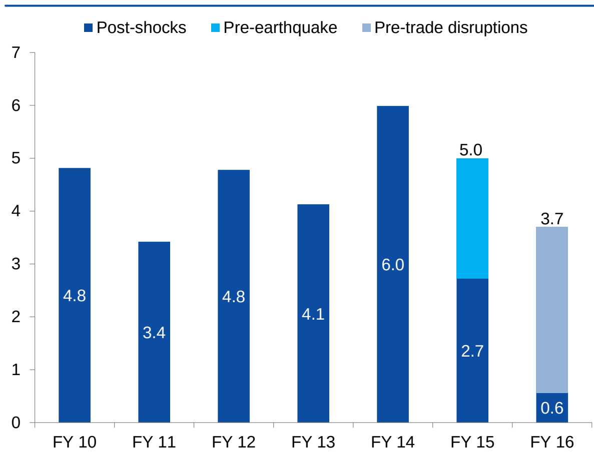
Agriculture output has suffered from the start. A majority of agricultural output is for subsistence purposes and was unaffected in the short-term by trade disruptions. However, it was still a weak year for agriculture with a growth rate that was less than a half of a 10-year historical average. Poor monsoon rainfall this year and earthquake-related destructions have contributed to weak agricultural output. In addition, negative effects were compounded by unavailability of fertilizers as a result of the trade disruptions. The production of rice, the main crop, is estimated to be lowest in the last 7 years. Furthermore, pronounced drought during the dry season (November through February) affected the winter crop production as well. In total, agriculture recorded a growth of 1.3 percent, up from 0.8 percent in FY2015.

Poverty impact and human costs of the trade disruptions were significant as well. The trade disruptions have further affected poverty reduction efforts which were already hampered by the earthquakes in 2015. Earlier estimations had suggested that the earthquakes could end up pushing an additional 0.7-1.0 million of Nepalis into poverty during FY2015 and FY2016. Shortages of goods have pushed up prices affecting welfare across the board with significant impact on the poor in Nepal, particularly those in urban areas.

Fuel related slowdown in economic activity together with the increase in transportation prices hurt casual wage workers that derive a bulk of their livelihoods from wages. Income from wages accounts for anywhere between 30-50 percent of the total income of urban Nepalis who are poor or vulnerable to falling into poverty. Social services were curtailed during the trade disruptions and transfers were not able to offset weakening purchasing power of vulnerable groups given price hikes induced by shortages. Furthermore, schools were reporting most of their bus fleet grounded and over two million children missed school for more than three months. Schools in the Terai region were particularly hard hit as the schools were forcibly closed due to strikes, long before the trade disruptions started. Out of minimum required school days of 180 in one year, schools were open only 128 days in the districts of Terai, according to the preliminary data from UNICEF.

Figure 27: Economic growth for FY2016 is at a 14-year low

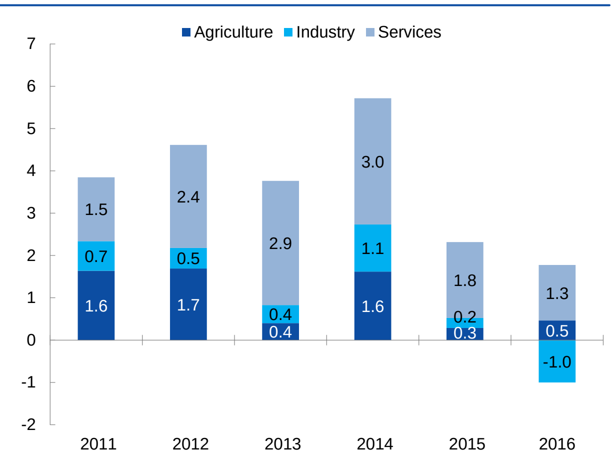
(percent)



Source: CBS and WB staff calculations

Figure 28: And growth slowed across all three sectors

(percentage points, contribution to growth)



Source: CBS and WB staff calculations

Box 1: New World Bank global poverty line

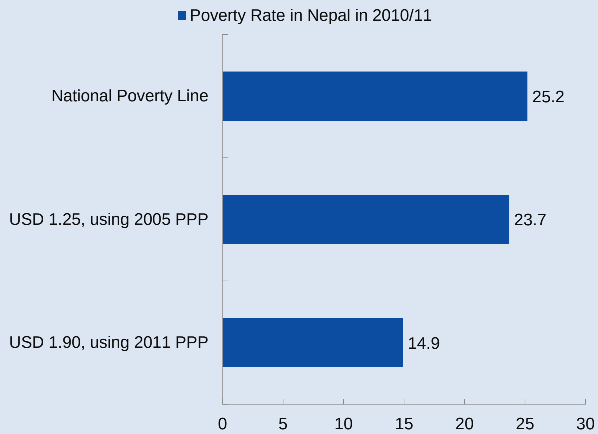
The World Bank has used $1.25 as the global absolute poverty line since 2008. This line was updated to $1.90 in October 2015. The primary reason for this update was to ensure that the global poverty line accurately reflects the evolving changes in the cost of living around the world. Cost of living across the world is tracked by Purchasing Power Parity rates and this update to the poverty rate was based on the most recent exercise done in 2011. PPPs enable each country's consumption data to be converted to internationally comparable dollars. Nominal exchange rates cannot be used for this purpose because they only reflect the relative value of goods that are traded between countries.

In Nepal, the national poverty line, established in 2010/11 represents the expenditure required to meet the minimum food and non-food needs in the country. Poverty has historically been measured using Nepal Living Standards Survey carried out by the Central Bureau of Statistics (CBS). As a result of the change in the global poverty line as well as the change in the PPP conversion factor for Nepal, the poverty rate measured at international poverty lines for Nepal has changed. Under the 2005 PPP factors and the $1.25 a day measure, 23.7 percent of Nepalis were poor. In comparison, under the 2011 PPP and the $1.90 a day poverty line, only 14.9 percent Nepalis were poor. The fact that poverty is lower under a higher poverty line appears counterintuitive. But the reason for that is that the 2011 PPPs reveal that the Nepali rupee's purchasing power, relative to the US dollar, is stronger than what we would have concluded based on 2005 PPPs and Nepal's CPI movement. In other words, it turns out that the living standards of Nepalis, evaluated in international terms using 2011 PPPs is actually better than what it was when evaluated using the 2005 PPP.

This should be interpreted as a recalibration as opposed to a decline in poverty rates using the international line. This does not affect the national poverty line, which should remain the primary benchmark for poverty monitoring, as well as identifying and targeting the poor in Nepal.

Figure 29: Comparison of poverty rates using different poverty lines.

(percent of the population)



Source: WB staff calculations

B. Outlook, Risks and Challenges

Following the two years of disappointing growth, activity is expected to rebound modestly. The rebound in growth is predicated on stabilization of the political process, start of the earthquake rebuilding efforts and the full normalization of supply of goods. Growth in FY2017 is forecasted to accelerate to 4.7 percent and is expected to moderate in line with the country's potential during FY2018 (Table 1).

On the supply-side, all sub-sectors are expected to perform better and grow in line with their historical averages. Agriculture output is expected to improve largely as the probability for a normal monsoon season has increased. Industry is expected to rebound in FY2017 as manufacturing, construction and electricity generation sub-sectors recover. Manufacturing in particular is expected to get a boost starting from FY2017 as the apparels and garment industry are getting a duty free access to the US market. As the reconstruction activities are expected to firmly take off in FY2017, the construction sector is expected to benefit. Hydropower projects which were delayed by earthquakes and trade disruptions are expected to be completed in FY2017 which will add a positive contribution from the electricity generation sub-sector as well. Services are expected to rebound in FY2017 with the revival of transport, tourism, and full normalization of wholesale and retail trade sub-sectors.

Fiscal deficit is expected to widen during the forecast, but to remain within manageable limits. Government's recurrent expenditure is expected to grow substantially in the forecast period owing to increase in earthquake related cash assistance and other social security expenditures. Slow pick up in capital expenditure, particularly those related to earthquake reconstruction, so far had limited the size of deficit in FY2016. However, starting from FY2017 and for the remainder of the forecast period, revenues are not expected to grow as fast as expenditures leading to a fiscal deficit as reconstruction efforts take full shape. Similarly, current account which had remained surplus in the past several years is expected to turn to deficit as remittances taper off and imports grow driven by the larger reconstruction efforts.

The high inflation induced by the trade disruptions is expected to moderate to single digits towards the end of FY2016 as the effects of trade disruptions on prices dissipate. Both global oil prices and prices in India are expected to remain around their present levels, providing a favorable external outlook for lower inflation in Nepal as well. However, inflation is likely to re-

Table 1 - Nepal Macroeconomic Outlook
(annual percent change unless noted otherwise)

	FY2013	FY2014	FY2015	FY2016	FY2017 f	FY2018 f
Real GDP growth, at constant market prices	4.1	6.0	2.7	0.6	4.7	4.4
Private Consumption	-6.7	10.0	7.4	-5.4	2.0	5.0
Government Consumption	2.7	4.2	2.9	-0.5	1.9	4.9
Gross Fixed Capital Investment	23.5	22.8	7.9	8.7	2.0	8.0
Exports, Goods and Services	10.3	18.8	6.8	-2.8	1.0	5.0
Imports, Goods and Services	14.1	21.0	9.6	3.3	15.0	5.0
Real GDP growth, at constant basic prices	3.8	5.7	2.3	0.8	4.7	4.4
Agriculture	1.1	4.5	0.8	1.3	3.0	3.0
Industry	2.7	7.1	1.5	-6.3	4.0	4.0
Services	6.2	6.1	3.7	2.7	6.0	5.5
Inflation (Consumer Price Index)	9.9	9.1	7.2	9.4	9.0	8.3
Current Account Balance (% of GDP)	3.4	4.6	5.1	5.0	0.5	-1.8
Fiscal Balance (% of GDP)	1.7	1.8	0.3	-0.1	-1.9	-1.5
Debt (% of GDP)	32.5	29.1	24.8	26.6	29.1	31.1
Primary Balance (% of GDP)	2.4	2.1	1.4	0.7	-1.3	-0.7

Sources: Central Bureau of Statistics and World Bank, Macroeconomics and Fiscal Management Global Practice for forecasts.
Notes: e = estimate, f = forecast.

main elevated owing to persistent supply-side bottlenecks, loose monetary policy and spending pressures arising from pick up in reconstruction activities and government spending during the forecast period.

Macroeconomic risks associated with this baseline forecasts are on the downside and are mostly of the domestic nature. The scale and pace of reconstruction is the largest source of uncertainty given persistent challenges surrounding the institutional set-up required for effective targeting of the aid to earthquake-affected households. Consequently, should the recovery effort suffer further delays, the outcome will disappoint. Furthermore, significant political risks still exists. The underlying causes of discontent that resulted in protests and blockades have not been met and could lead to further disruptions and disturbances.

External environment is expected to be less favorable as well. With remittances comprising around 30 percent of GDP, Nepalese economy is extremely dependent on these flows. Oil-exporting Gulf Co-operation Countries and Malaysia, which represent almost 97 percent of total Nepali migrants excluding India, are a key source of remittances. As oil prices in particular, and commodity prices in general, are expected to remain at their current levels during the forecast period, the possibility of a slowdown in remittances has increased. Given that remittances enable consumption-centric structure of the Nepalese economy and the government's reliance on taxation of imports as a major source of revenue, even a modest contraction in remittance would have adverse effects on growth, fiscal and external accounts, in addition to curtailing economic opportunities for Nepalis abroad.

There are several near- and medium-term challenges ahead for Nepal. Normalizing fuel and other supplies to general public, along with effective mobilization of post-earthquake reconstruction are key near-term challenges, particularly as the monsoon season approaches. Additionally, the trade disruptions have highlighted the need to urgently diversify the Nepalese economy, particularly in terms of trade, transport options.

In the medium-term, Nepal faces several simultaneous and daunting challenges ahead. From completion of political transition and setting up of a new federal structure to challenges of successful leveraging of its endowments (hydropower potential, human capital) to achieve a faster growth, increasing poverty reduction and creating economic opportunities for its citizens at home.

C. Special Focus: Remittances at Risk

Summary

- *Remittances play a pivotal role in the Nepalese economy and the near-term risk of a possible slowdown has increased.*
- *Growth of remittances at a global level has contracted in 2015—a first since 2008—primarily as a result of a fall in oil prices which has affected activity in remittance-sending countries.*
- *Inflows of remittances to South Asian economies has declined as well, but inflows to Nepal buckled the trend as remittances increased significantly in response to the earthquake in April 2015.*
- *However, prolonged contraction in departures of migrant workers is an early sign of a potential slowdown in remittances in Nepal. A potential slowdown of remittances poses a significant near term risk to Nepal because of its outsized role in the Nepalese economy.*
- *A similar episode occurred in 2011, following the global financial crisis in 2008-09.*
- *Should the slowdown in remittances occur, an appropriate monetary and fiscal policies responses are required as well as enhanced supervision of the financial sector.*
- *Furthermore, given the two shocks the country faced in 2015, Nepal's ability to absorb a potential third shock has diminished, requiring a concerted effort to weather it.*

1. The role of remittances in Nepal's economy

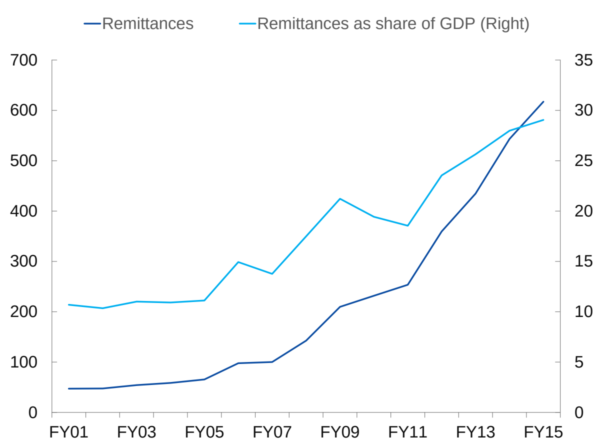
Around the turn of the century, Nepal's economic landscape has been re-shaped by migration and remittances. Based on the data from Nepal Living Standards Survey (NLSS), out of a total workforce of 14 million, some 4 million or 28 percent of work force are believed to be working overseas today. At the same time, the remittances have grown to more than 30 percent of GDP (Figure 30), making Nepal, among one of the highest remittances recipient countries in the world adjusted for the size of the economy.

On one hand, remittance inflows have enabled a higher growth of disposable income Gross National Disposable Income (GNDI) grew nearly 1.5 times faster than the overall national income (Gross Domestic Product of GDP). Between FY2000 to FY2016, average per capita GNDI growth was 3.8 percent per year, while average per capita GDP growth rate of 2.5 percent. In turn, this has not only fueled consumption, but also contributed to a dramatic reduction in poverty, which fell by 28 percentage points between 2003-04 and 2010-11. In addition, remittances contributed strongly to human development via investments in education and health. Furthermore, migration acted as a safety-valve for a labor market constrained by conflict, absorbing an ever greater share of new entrants into employment, particularly low skilled rural youth.

On the other hand, over the past decade and a half, Nepal has undergone atypical structural transformation. The movement of labor out of agriculture was not triggered by new urban jobs in emerging Nepali cities and

Figure 30: Remittances have grown to more than 30 percent of GDP

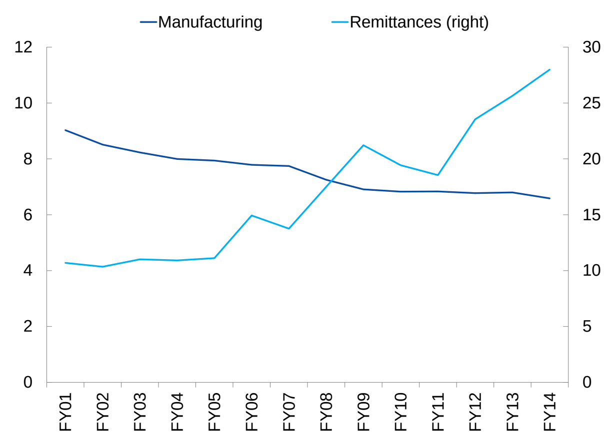
(LHS: NPR billion; RHS: percent of GDP)



Source: CBS, NRB and WB staff calculations

Figure 31: However, growth in remittances has coincided with decline in manufacturing sector

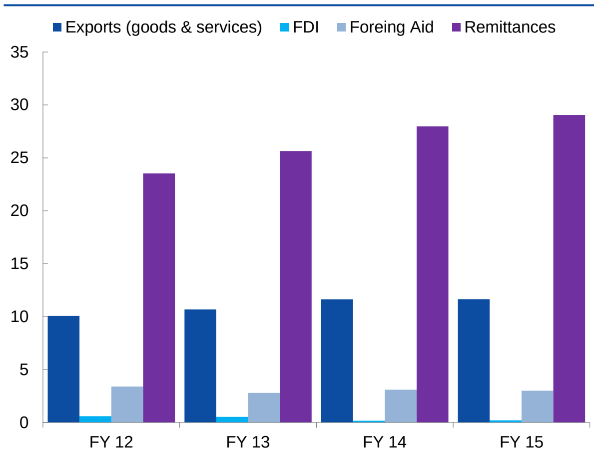
(percent of GDP)



Source: CBS, NRB and WB staff calculations

Figure 32: Remittances represent by far the most important external inflow for Nepal

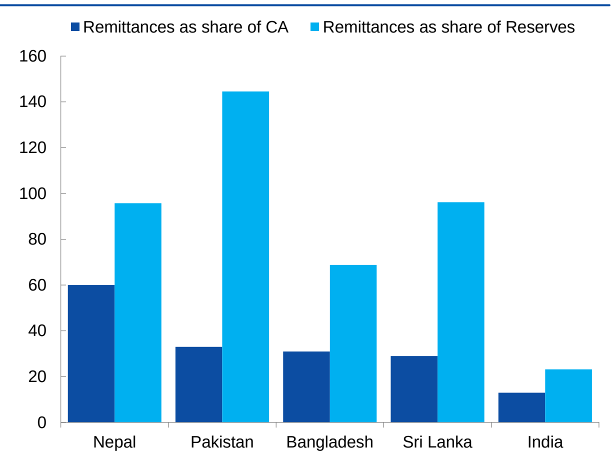
(percent of GDP)



Source: NRB and WB staff calculations

Figure 33: Remittance are crucial component of current account, highest in South Asia, and a significant portion of reserves in Nepal

(percent)



Source: WDI, NRB and WB staff calculations industries, but instead by foreign employment opportunities. In turn, the remitted earnings of Nepalis abroad have fueled an expansion of low skill services at home, while its manufacturing base has stagnated (Figure 31).

The reality is that remittances plays a pivotal role in the Nepalese economy. They are a major stabilizer of Nepal's current account, as remittance flows amounted to 6.1 billion USD in 2015. As such, they are 10 times larger than foreign aid and 2.5 times larger than total exports (Figure 32). In addition to being the largest component in current account of Nepal, they also play an important role is maintaining foreign reserves of Nepal (Figure 33). Remittances are the transformative flow for the Nepalese economy, as they support the domestic consumption, savings and overall growth in Nepal via ever growing service sector (50 percent of GDP). Remittances are estimated to constitute a quarter of the income of all households and almost two-thirds of the income for those receiving money from abroad.

2. Recent global trends in remittances

2015 has recorded the lowest growth rate of global remittances flow since 2008 financial crisis. The growth rate of remittances to developing countries have slowed down in 2015 to 0.4 percent from 3.2 percent in 2014 and is estimated to be lowest growth rate since the global financial crisis in 2008. The slowdown in growth is largely attributed to economic weakness in the major remittance-sending countries. Weak oil prices and currencies in many source countries further depressed remittance flows in U.S. dollar terms (World Bank, 2016).

Persistent weakness in oil and commodity prices are associated with the slowdown in remittances. The continuing weakness in the price of oil and commodities, which in turn in affecting economic activities in remittance-sending countries, is reducing the growth of remittances. Crude oil prices fell from around USD51 per barrel (bbl) in October 2015 to below USD30/bbl in January 2016, driven by robust production in the United States, unchanged OPEC policy, the earlier than expected resumption of Iranian oil exports following the ratification of the nuclear agreement with the United States, and lower demand, partly due to a mild winter in the northern hemisphere (World Bank, 2016).

Despite some initial resilience, there has been slowdown of remittances from the GCC countries too. Remittance outflows from the major oil-exporting countries of the GCC have held up in 2015 as they have used their substantial reserves to maintain spending levels, and also because the GCC currencies are linked to the U.S. dollar. Remittances from Saudi Arabia and Qatar, which account for around half of remittances sent from the GCC, increased by 7 percent through the third quarter of 2015. However, more recent data from the fourth quarter, indicate a slowdown in remittances from the GCC countries. If lower oil prices persist, remittance outflows from GCC countries are likely to slow further (IMF, 2015).

The outlook for the price of oil is a major downside risk to the remittances forecast. Moreover, in the face of the steep drop in the oil price, incomes in GCC countries have so far been supported by drawing down assets. A further decline in the oil price, or even growing expectation that the prices will not rise over the medium-term, could encourage authorities to adjust to lower oil prices. The result would be reduced incomes for migrants in these countries, and perhaps steps to restrict hiring of or even repatriate foreign workers. This could substantially reduce remittances outflows to the Middle East, South Asia, and East Asia and the Pacific (World Bank, 2016).

In 2015, remittances inflows declined in many countries in South Asia too, but Nepal was an exception. Remittances to South Asia rose by an estimated 2.0 percent in 2015. While remittances to India and Sri Lanka declined, flows to Nepal increased significantly in response to the earthquake in April-May. Remittances to India, the region's largest economy and the world's largest remittance recipient, decreased by 2.1 percent in 2015, to $68.9 billion. This marks the first decline in remittances since 2009. The growth of remittances in 2015 slowed from 8 percent in 2014 to 2.5 percent for Bangladesh, from

16.7 percent to 12.8 percent for Pakistan, and from 9.6 percent to –0.5 percent for Sri Lanka. Slower growth is estimated to have reflected the impact of falling oil prices on remittances particularly from GCC countries (World Bank, 2016).

3. Recent trends in Nepal

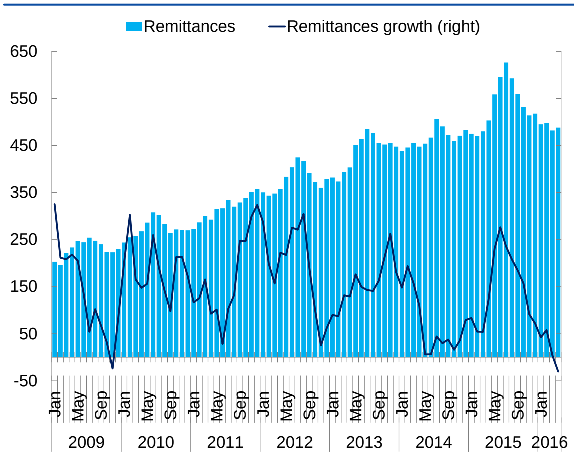
Remittance inflows to Nepal increased significantly in 2015 in response to the earthquake in April. Most empirical studies find that remittances tend to increase as a result of natural disasters. Disasters generate increased remittances if they are motivated by altruism, or reflect risk diversification by the household to cope with income volatility in the country of origin. Empirical work recently undertaken at the World Bank, including country case studies and regression analysis of cross-country data, indicate that remittances to developing countries tend to rise moderately following a disaster (World Bank, 2016). In the case of Nepal too, remittances growth rate which was 4.8 percent in March 2015 (y/y in dollar terms) prior to the earthquake jumped to 11.2 percent (y/y) in June after the earthquake in April.

However, post-earthquake jump in remittances is tapering off. Remittances to Nepal rose dramatically in response to the earthquake, growing by 27.6 percent in three months to June 2015 compared to the same period the year before. However, following this peak, inflow of remittances has slowed down registering a single digit growth by January 2016. In three months to April 2016, remittances have contracted by 5.3 percent (in US dollar terms) compared to the same period of previous year (Figure 34).

Furthermore, a sharp decline in outflow of migrant workers has occurred following the earthquake. Following the April earthquakes, outflows of migrant workers has declined significantly for ten months in a row with a contraction of 25 percent by April 2016 (y/y) (Figure 35). This is one of the steepest and longest decline of migrant workers outflow which has exceeded the migrants' worker contraction in 2009. One reason is the effect of earthquakes which led to potential migrants increasingly choosing to stay at home to support their families with rebuilding homes and livelihoods. In addition, a weaker demand for workers from oil/commodity producing host countries (e.g. GCC countries and Malaysia) is likely to have equally contributed to this decline (Figure 36). Malaysia in particular has even announced a moratorium of foreign workers until further notice. Reportedly policy

Figure 34: Growth in remittances has slowed down significantly since the peak in 2015

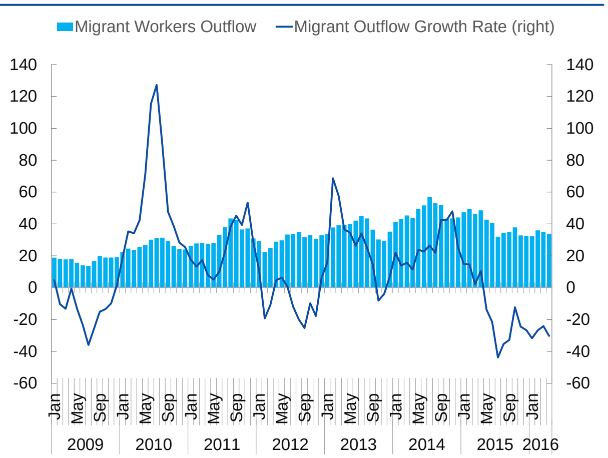
(LHS: in thousands, 3-month moving average, RHS: percent change, y/y)



Source: NRB and WB staff calculations

Figure 35: Outflow of migrant workers has continuously contracted since the earthquakes

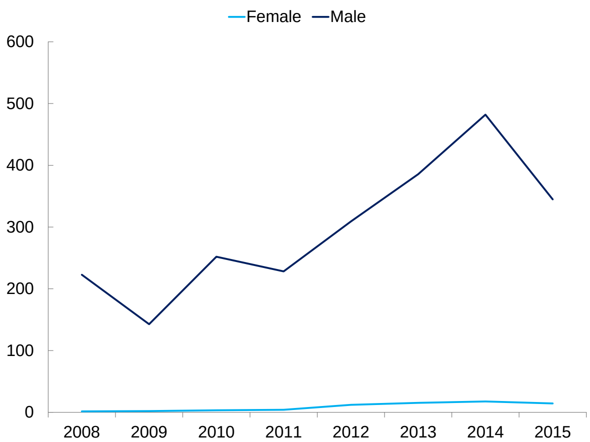
(LHS: in thousands, 3-month moving average, RHS: percent change, y/y)



Source: WDI, NRB and WB staff calculations

Figure 36: Significant drop in absolute number of registered migrant contracts in 2015

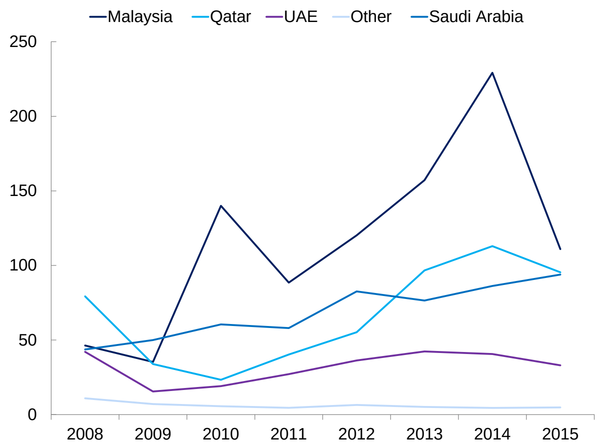
(in thousand)



Source: : World Bank staff estimates based on DOFE data

Figure 37: Driven largely by a slowdown in Malaysia

(male migrants, in thousand)



Source: World Bank staff estimates based on DOFE data

announcement by the Government of Nepal requiring a free visa and a return air ticket for migrant workers and opposition to this policy by manpower companies has further exacerbated the flow of migrant workers particularly those going to Malaysia. As a result, drop in migrant workers going to Malaysia has been very pronounced (Figure 37).

4. Risks to the Nepalese Economy

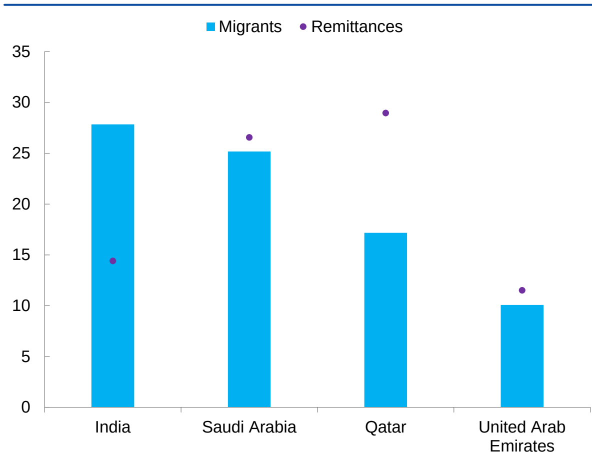
Slowing down of departures of migrant workers and potentially of remittances pose a significant near term risk. In addition to the large role of the remittances that can be measured through the formal channels, Nepal is also a recipient of a significant remittances that are received informally and are, consequently, difficult to quantify. Furthermore, India, which is one of the largest destinations for informal Nepalese migrants, is expected to grow more than 7 percent in FY2016. This may help to absorb some of the decline of migrants to GCC countries and Malaysia. Nonetheless, previous experience shows that a slowdown in formal remittances is likely to cause a significant pain in the Nepalese economy. In recent years, growing remittances have fueled consumption and growth, resulted in growing imports and trade deficit. Remittances were large enough to offset the trade deficit leading to current account surplus in Nepal (Figure 40). Given Nepal's large reliance on trade-related taxes, the possible slowdown in remittances will also slow revenue collection (Figure 41). In sum, a slowdown in remittances would not only slow economic growth, but also affect poverty reduction and public revenues as well.

Nepal experienced an episode of a slowdown in remittances in 2011 following the 2008-09 global financial crisis. The global financial crisis starting in 2008 led to massive growth slowdown across the world. Nepal was relatively unaffected by the crisis due to its narrow exposure to the global economy. However, the impact came via a remittance channel, albeit with some lag. Weighted average GCC and Malaysia's growth rate slowed to just 0.1 percent in 2009, down from a five years average of 7.3 percent prior to the crisis (Figure 39). The effect of the slowdown was clearly visible in t demand of Nepali migrant workers which started to wane from the end of 2008 and ultimately contracting in FY2009 (Figure 42). As a result, remittances—despite increasing in nominal terms—registered a considerable drop as a percentage of GDP. They went from 21.2 percent of GDP in FY2009 down to 18.5 percent of GDP in FY2011.

The effect of the drop in remittances in FY2011 was felt across the Nepalese economy. The import growth slowed down to 8 percent in FY2011, down from 37 percent in FY2010 and also down from a five-year average of 20 percent. As Nepal's revenue collection is highly dependent on trade taxes, the tax collection growth also slowed to just 1.1 percent (y/y) for FY2011. The slowdown in imports affected wholesale and retail trade sub-sector, the largest share of the service sector, as its growth rate dropped to 1.7 percent in FY2011, down from 6.7 percent in FY2010. The ultimate impact was visible in the overall GDP growth rate which came in at 3.4 percent for FY2011 despite a good year in agriculture and industry. Service sector contributed only 1.1 percentage points to the overall growth, with agriculture and industry contributing the rest. Slowdown in

Figure 38: GCC contribute largest share of remittances to Nepal

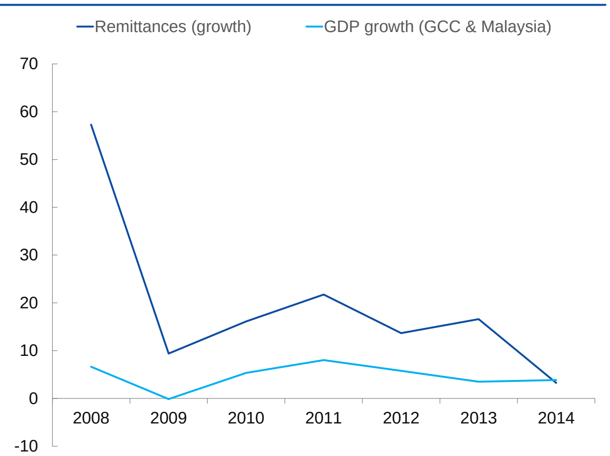
(percent, share in total migrant stock; percent, share in total remittances)



Source: WDI and WB staff calculations

Figure 39: Correlation between GDP growth rate of GCC & Malaysia and remittances inflow to Nepal

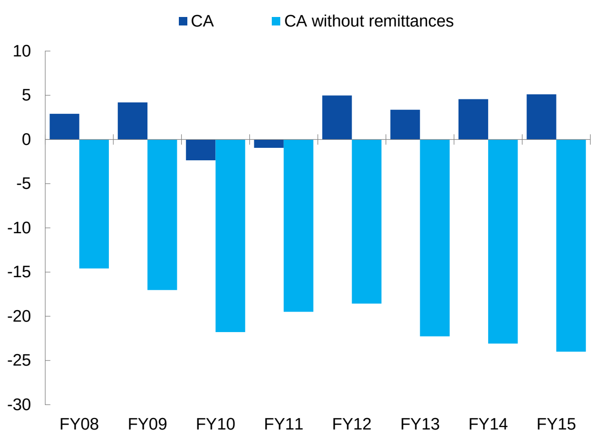
(percent change)



Source: KNOMAD, NRB and WB staff calculations

Figure 40: Without remittances current account would be in a significant deficit

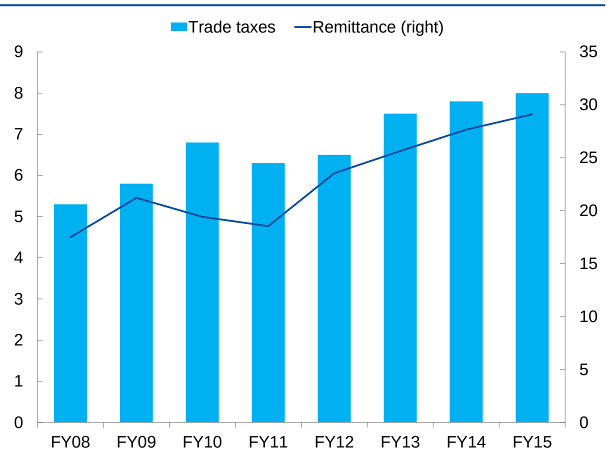
(percent of GDP)



Source: NRB, CBS and WB calculations

Figure 41: Trade taxes are highly dependent on imports which are fueled by remittances

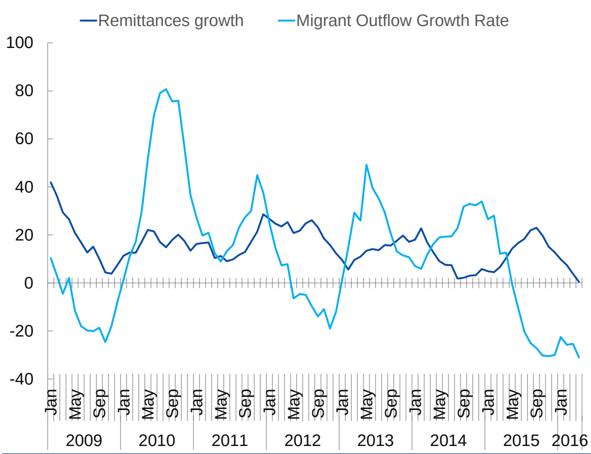
(percent of GDP)



Source: MoF, CBS and WB calculations

Figure 42: Recent slowdown in outward migration is larger than comparable one from 2009

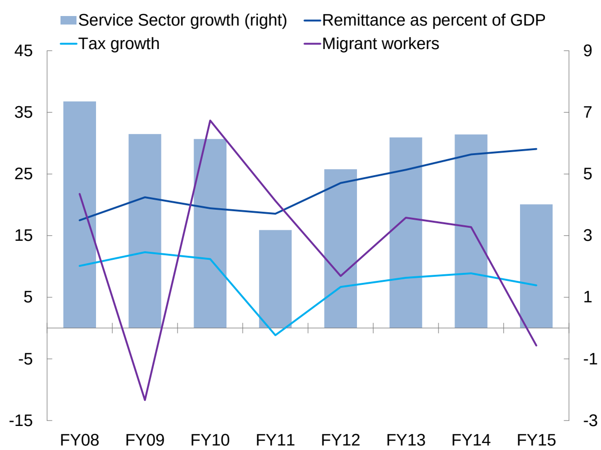
(percent change, y/y, 6-month moving average)



Source: DoFE, NRB and WB staff calculations

Figure 43: Slowdown in migrant workers in FY09, followed by remittances slowdown in FY10 and FY11 had widespread impact on the economy

(percent change, y/y)



Source: NRB and WB staff calculations

remittances slowed the growth in service sector to 3.2 percent, down from a five-year average of 5.7 percent, which ultimately slowed the overall growth rate as well.

5. Conclusion

A small decline in remittance can have large macroeconomic impacts. To be clear, we are not expecting a rapid drop in remittances in Nepal. However, given the large size of remittances, even a small slowdown in remittance for Nepal can have a broad macroeconomic, poverty and fiscal impacts.

In a hypothetical scenario of a 10 percent drop in remittances, the growth in Nepal could drop by up to 3 percentage points compared to the baseline forecast. Given that a 10 percent drop in remittances is equal to 3 percentage points of GDP, such slowdown would affect incomes, and in turn consumption as well as GDP, in a commensurate amount. This means that, for example, in this would occur in FY2018, economic growth could decline from 4.4 percent to just 1.4 percent, all other things being equal. Further, government revenues would decline by about 1.5 percentage points of GDP deepening the fiscal deficit as imports slow as well. A prolonged slowdown in remittances may have an adverse effect on poverty, while the resulting economic slowdown could increase the number of non-performing loans, requiring greater provisions and capital buffers in the banking sector. Obviously, should the reduction in remittances be more pronounced, or last longer, the effects would be larger.

Best response to such an exogenous shock would be a well-designed endogenous policy response. Historically, growth in Nepal depended on exogenous factors, such as a good monsoon for a bountiful harvest, or, more recently, increasing external demand for Nepal's labor that resulted in ever higher remittances. Development was also hindered by exogenous shocks, such as the April 2015 earthquake. Clearly, a well-designed domestic (endogenous) policy response to an external (exogenous) shocks can help Nepal not only weather a shock of slowdown in remittances, but also lay foundation for delinking Nepal's growth from external factors.

A classic policy response in time of an output shock would be a Keynesian-type fiscal policy response that increases capital spending. For example, this spending could be directed towards a construction of a national irrigation system that not only buffers effects on growth but also helps delink agricultural output from the effects of the monsoon. This could be financed though issuance on long-term bonds that has a monetary policy effect of reducing excess liquidity currently present. This would lower inflation and improve real effective exchange rate and external competitiveness. Complemented by a stronger supervision of the financial sector will strengthen banks' ability to buffer shocks.

However, in the medium and long term, Nepal needs to move out from an inherently risky strategy of relying on a single driver for growth that is vulnerable to external shocks. While healthy migration and related remittance flows will continue to play an important role for external balance and (disposable) income support, Nepal will need to leverage its key resources—human and natural capital—to attract investment and lay the foundations for creation of opportunities and economic diversification at home.

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