Strong rebound, mounting risks
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. However, in this edition, we are foregoing the Special Focus section due to an upcoming release of Nepal Country Economic Memorandum. The Update is intended for a wide audience including policymakers, 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 the guidance of Manuela Francisco and Takuya Kamata. Sabin Shrestha contributed to the analysis of the financial sector. Jayandra Shrestha provided data on hydropower sector. Volker Treichel provided helpful comments. Rajib Upadhyya and Richa Bhattacharii managed media relations and dissemination. Diane Stamm edited the document and Sunita Kumari Yadav managed the publication process.

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Executive Summary

Economic activity is rebounding strongly in Nepal following two challenging years.

On the back of one of the best monsoons in recent years, rice production is estimated to have reached a record high at 5.2 million tons, up from 4.2 million tons a year ago, boosting agricultural output. Postearthquake reconstruction activities are picking up after a slow start. All eligible houses—about half a million—have received the first of three tranches of the housing grant. The second tranche of the housing grant has started, and is expected to pick up by the end of FY2017. More than 100 megawatts (MW) of hydropower capacity, which was delayed by the earthquakes and trade disruptions, have come on-stream. There has been a revival of transport and full normalization of wholesale and retail trade. Tourism is also recovering as arrivals reached precrisis levels during the September–December 2016 tourist season.

As a result, growth has rebounded and has reached 7.5 percent in FY2017 (at market prices) according to the first estimate by the Central Bureau of Statistics (CBS). This is the highest growth rate since 1994 and is a result, in part, of a base-year effect, increased agricultural output, improved availability of electricity, and greater investment as earthquake reconstruction gathered speed. Base effect (lower growth in previous year) was a major contributor to the estimated growth rate in FY2017. Had the growth rate in FY2016 been in line with the average of recent years, the growth rate in FY2017 would not have been so spectacular.

This cyclical rebound follows two challenging years where real GDP growth fell to 3.3 percent in FY2015 due to the devastating earthquake and declined even further to a 14-year low of 0.4 percent in FY2016 due to a complete disruption in cross-border trade with India.

High inflation in the past two years induced by disruptions has moderated sharply in the first half of FY2017. Normalization of imports and a favorable external environment, particularly the moderating inflation in India as a result of demonetization, are the primary reasons for a deceleration of inflation. Food prices have also declined.

The new government has initiated a series of management reforms in electricity and health, with the most visible impact in the electricity sector with the elimination of power cuts in several major cities across Nepal. Efforts to reduce the financial and technical losses of the electricity utility, the Nepal Electricity Authority, are also showing results.
Government revenue and spending have also performed well. Revenue has exceeded the six-month target, and spending, including on capital goods, has also significantly picked up compared to previous years and is on par with revenue. Nevertheless, overly ambitious expenditure envisioned in the budget has not materialized, leaving previously accumulated government deposits (10 percent of GDP) intact.

Credit has grown rapidly over the past year, and growth reached its highest rate since 2012, while deposit growth slowed. However, banks are running up against prudential limits on lending. In addition, government’s large cash balances have had the effect of a monetary tightening at a time when the banks are trying to increase their capital base to meet the increased regulatory requirements for paid-up capital.

Imports, which, had rebounded quickly following the end of trade disruptions, have reached a record high. Exports, despite some recovery, are yet to reach their predisruption levels, particularly on account of sluggish recovery of exports to India. Exports recovery is also affected by continued appreciation of the real effective exchange rate. As a result, the trade deficit has continued to increase. The cumulative effect of a sharp trade balance deterioration and a slowdown of remittances has put the current account into deficit. Although still high, foreign reserve accumulation has slowed and the external sector pressure is building up.

Outlook

Looking ahead, the economic growth will remain strong, but it is expected to moderate in line with country’s potential, averaging 5 percent over the next two fiscal years. While healthy growth is expected to continue in agriculture, construction and industry sectors, the activity in remaining sectors is expected to be affected by uncertainty stemming from transition to the federal structure, several elections and the possibility of further slowdown in remittances. Inflation is expected to be below the central bank’s target of 7.5 percent for all of FY2017, but likely to pick up somewhat in FY2018 as the effect of demonetization tapers off in India.

The fiscal deficit is expected to widen during the forecast period; however, given the large cash balance on hand, financing is not expected to be a problem. The FY2017 budget called for an expenditure increase of nearly 15 percent of GDP over actual expenditures in FY2016. However, as in previous years, significant underspending of the budget will continue. The government’s recurrent expenditure is expected to continue to grow substantially in FY2018, particularly as a result of the implementation of the new federal constitution, which calls for creation of an entirely new level of government. The growth in revenues is expected to continue, but it will likely slow given sharp growth over the past couple of years. With increased government spending as a result of a new federal structure and earthquake reconstruction, the fiscal balance is expected to be negative in FY2018. Meanwhile, the current account, which had remained in surplus over the past several years, is expected to narrow and turn into a deficit as import growth is expected persist while remittances is expected to remain sluggish.

Challenges and Risks

There are an increasing number of downside risks to this forecast with domestic risks predominating. The political environment remains fluid as the term of the current government is coming to an end. In addition, a series of elections needs to be held by early 2018, as stipulated by the new constitution. Implementation of a new federal structure could pose a challenge. Despite improvements, the overall pace of earthquake reconstruction remains a concern too.

Increased vulnerability in the financial sector could add a challenge during the remainder of the forecast period. Banks are running up against regulatory limits for lending, and this risks a sudden halt in new credit.

The external environment is likely to be less favorable, as well. Continued underperformance of exports, despite the end of disruptions, remains a persistent challenge. Remittances account for nearly 1/3 of GDP, with the majority of migrants going to oil-exporting Gulf Cooperation Council (GCC) countries. Significant spending cuts, including on capital spending, announced in the GCC countries, and persistent contraction in departures of migrants, have contributed to lower growth of remittances and risk a possible sharper slowdown during the forecast period.
A. Recent Economic Developments

1. Global economic growth is low but turning around, while South Asia continues to outperform

After a disappointing year, a pickup in global growth is finally in sight. In 2016, global growth was at a postcrisis low, and the first six months of the year were characterized by especially weak growth in advanced economies. At 2.3 percent, on average, global growth in 2016 was 0.4 percentage points lower than in 2015. Uncertainty has been high, global trade has stalled, and investment has been weak. However, since the last quarter of 2016, there have been reasons for optimism. Economic activity in both emerging and advanced economies is strengthening. In the Euro area, unemployment has fallen to an eight-year low, and the United States is experiencing a broad-based upswing in manufacturing activity (World Bank 2017a).

It is estimated that officially recorded remittances to developing countries amounted to US$429 billion in 2016, a decline of 2.4 percent from US$440 billion in 2015. This is a trend not seen in three decades. Low oil prices and weak economic growth in the Gulf Cooperation Council (GCC) countries and the Russian Federation are taking a toll on remittance flows to South Asia and Central Asia, while weak growth in Europe has reduced flows to North Africa and Sub-Saharan Africa. As a result, many large remittance-receiving countries saw sharp declines in remittance flows (World Bank 2017b). This is certainly a concern for Nepal but not surprising, as the Nepal Development Update: Remittances at Risk (World Bank 2016) projected a slowdown in remittances to Nepal and associated risks.

South Asia has by now consolidated its position as the global leader in economic growth. While the pickup in growth in the first quarter of 2016 was only temporary, South Asia is still expected to have grown by an impressive 6.7 percent (year-over-year [y/y]) over the year as a whole. This strong performance was despite the temporary setback caused by India’s demonetization effort at the end of the year. Growth in South Asia was higher than in East Asia, where it stood at 6.3 percent. Other regions are growing either much more slowly or are even contracting (World Bank 2017a).

2. Activity is rebounding in Nepal, leading to a broad-based recovery for FY2017

Economic activity is picking up across the board. On the back of one of the best monsoons
in recent years, rice production is estimated to have reached a record high at 5.2 million tons, up from 4.2 million tons a year ago, boosting agricultural output (Figure 1). Postearthquake reconstruction yet again faced some challenges with the change in leadership. However, all eligible houses—about half a million—received the first of three tranches of the housing grant, and the disbursement of second tranche of housing grants has started, albeit at a slower pace. Hydropower projects, which were delayed by the earthquakes and trade disruptions, have started coming on-stream. As a result, more than 100 MW of hydro-power is expected to supply power to the grid in FY 2017, a record high hydropower capacity addition (Figure 2). Imports of electricity from India have also increased, which has helped regularize electricity supplies. There has been a revival of transport and full normalization of wholesale and retail trade. With the purchase of new aircraft by Nepal Airlines, the sector is expected to get a significant boost (Figure 3). The two shocks of 2015 that had hit the tourism industry hard, with the largest contraction in 13 years, is seeing a strong rebound. The tourism sector is recovering as arrivals reached the precrisis level during the Septem-
The new government has initiated a series of management reforms in electricity and health, with the most visible impact in the electricity sector. “Load-shedding,” or scheduled power blackouts, had been common all over Nepal in recent years, reaching up to 16 hours per day. However, with the proper management and optimization of power, including additional electricity imports from India, the new government was able to eliminate power cuts in several major cities across Nepal. Efforts to reduce the financial and technical losses of the electricity utility, Nepal Electricity Authority, are also showing results.

3. Inflation has slowed to a decade low

High inflation in the past two years induced by shocks and disruptions has moderated sharply. After the end of the trade disruptions in February 2016, it took almost seven months for inflation to moderate to predisruption levels. Normalization of imports and a bumper agricultural harvest were the primary reasons for this moderation. As a result, by October 2016, inflation had moderated to 6.9 percent (y/y). Inflation further sharply decelerated starting in November 2017, particularly due to a favorable external environment, that is, moderating inflation in India as a result of demonetization. Consequently, overall inflation declined to 2.9 percent (y/y) in the first eight months of the FY2017, reaching the lowest level in a decade (Figure 5).

Food prices have contracted while nonfood prices, despite a slowdown, still remain somewhat elevated. The contribution of food prices has contracted to a record low at 0.2 percent points (y/y). A sharp decline of food prices, in particular, has been a big relief to the Nepali population after two years of severe hardship and high prices. The contribution of nonfood inflation has also slowed from a high of 6 percent points (y/y) in July 2016 to 3.1 percent points (y/y) in March 2017. However, prices of housing rent and utilities continue to put upward pressure on nonfood inflation (Figure 6). The slow recovery and recon-
Strong rebound, mounting risks

Construction of the houses destroyed in the 2015 earthquakes (more than half a million houses) is likely adding pressures on the housing and utilities inflation.

Nepal’s inflation divergence with India is in negative territory, after more than two years. Nepal’s inflation gap with India had increased significantly since mid-2014, and had reached a record high of 6 percentage points during the time of trade disruptions in January 2016. The gap continued to narrow since the end of disruption and reached 0.4 percentage points in February 2017 (Figure 7). This is a record-low gap since November 2013, when Nepal’s inflation was 1.5 percentage points lower than India’s.

4. Government revenue and spending has performed well, but budget execution continues to underperform

Government revenue continues to perform extremely well. Government revenue collection has exceeded the six-month target, and all the revenue streams (value-added tax, customs, income tax, and nontax) are growing at a healthy rate. As a result, revenue growth was 20 percent (y/y) for the three months until March (Figure 8) and is expected to comfortably meet the FY2017 revenue target.

Government spending has increased considerably compared to previous years (Figure 9). Government spending in the first quarter was driven by housing grants, following which capital goods expenditure has significantly picked up. Capital spending has been a record high in the first eight months of the fiscal year, which is primarily driven by civil works (Figure 10).

With the increase in capital spending, the quality and effectiveness of spending is going to be a major concern going forward. Between 2001 to 2007, the incremental capital output ratio for Nepal was 5.7, the highest among comparator countries such as Bangladesh, Cambodia, and Vi-
Table 1: Selected Fiscal Indicators
(percent of GDP unless noted otherwise )

<table>
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<th></th>
<th>FY2013</th>
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<th>FY2016 e</th>
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<td>5.5</td>
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<td>6.5</td>
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<tr>
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<td>-0.8</td>
<td>-12.4</td>
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Sources: MoF, NRB for history and estimates; WB staff for forecasts.
Note: b=budget, e=estimate, f=forecast.

etnam. Inefficiency is clearly manifested in the public investment process, which fails to deliver completed productive assets and infrastructure. Some road and irrigation projects have even been ongoing for more than 30 years (World Bank 2017c, forthcoming). Experience from various countries indicates that higher public investment without commensurate improvement in the public investment system would benefit vested interests and lead to more waste (Warner 2014).

Budget deviation, however, has sharply deteriorated in the past two years due to unrealistic budget appropriations. Despite the increase in spending so far in FY2017, including record high capital spending, the ambitious expenditure envisioned in the budget is unlikely to materialize (see Table 1). Overly ambitious and unrealistic appropriations envisioned in the budget is the main culprit. For example, the capital spending in FY2017 was planned in the amount of NPR 312 billion, which is an increase of almost 6 percent of GDP of actual spending in FY2016. This has kept previously accumulated government deposits—approximately 10 percent of GDP—intact, which has exacerbated the shortage of loanable funds in the financial sector, as well (see Box 1).

5. Imports continue to grow while exports are still struggling to recover

Imports continue to increase and may have reached a new higher trend level. The trade disruptions ended in January 2016, and by mid-February of 2016, imports had recovered and reached the pre-disruption level. Imports have continued to grow strongly since then. Initially, import growth appeared to be a rebound effect of the trade disruption. However, imports reached a new, consistently higher level of more than US$650 million per month after the end of trade disruption, up from an average of US$550 million five-year average recorded previously, potentially indicating that this new level is likely to persist (Figure 11).

Import growth is primarily driven by nonoil imports as the oil imports have been relatively stable. Nonoil imports, in particular, have

Figure 11 Imports have reached a new higher trend level

(US$ millions, 3-month moving average) (Percent change, y/y)

Source: NRB and WB staff calculations.
been driven by the following subsectors: transport, goods and equipment, capital goods, industrial and agricultural supplies, and food and beverages. Private vehicles (motorcycles and cars) are the largest contributors within the transport subcategory, followed by buses and trucks. In addition, the purchase of aircraft from France by the Nepal Airlines Corporation has been the third-largest contributor. Within the industrial and agricultural subcategory, iron and steel, chemical fertilizer, and cement clinkers are the largest imports besides gold.

**Exports, which were seeing some recovery, have faltered again since October 2016, and the risk of a permanent decline is increasing.** After more than a year since the end of trade disruption, exports have not fully recovered. Exports were recovering until October 2016, but started contracting again. Exports hovering at a meager US$60 million per month, down from an already weak five-year average of US$84 million, clearly a signal of a worrisome trend (Figure 12).

**While exports to India continue to be weak, exports to other countries are recovering.** The slow recovery of overall exports is primarily due to the sluggish growth of exports to India (Figure 13), because India accounts for 70 percent of total exports. Industrial goods exports to India, in particular, have not been able to recover (see next paragraph). The demonetization is likely to have played a considerable role, which led to weaker Indian demand. There could also be other reasons for this slow recovery. Reportedly, the introduction of nontariff barriers has been cited as one of the major reasons why exports to India have been slow to recover. Also, a countervailing duty on jute exports—though recently lifted—could have been another reason. Exports to other countries are driven by pashmina, garments, and carpets. Overall, exports are also adversely affected by continued appreciation of the real effective exchange rate of the Nepali rupee (Figure 14).
Within exports, industrial goods exports have been the hardest hit and slowest to recover. Industrial goods exports are about 50 percent of total exports and are primarily exported to India. The share of consumer goods exports is about 29 percent of total exports, followed by food and beverage exports, at 22 percent. Consumer goods exports were the least affected and have rebounded to pre-disruption levels. Food and beverage exports were affected by the disruption, but the effect was not severe and they are only somewhat below the pre-disruption average. Industrial goods exports were the most affected by the trade disruption and have not been able to recover so far. From an average of US$38 million per month before the trade disruption, they have dropped to US$25 million per month (Figure 15). Textiles and iron (and their related products), followed by jute, are the three largest export categories that have been affected (Figure 16).

On a positive note, service exports may have fully recovered. Service exports, which had suffered by contracting in FY2016 after a robust growth averaging 25 percent per year between FY2011 and FY2015, are showing signs of full recovery. This is a result of strong tourist arrivals in the first half of the FY2017. Tourist arrivals reached precrisis levels of more than 75,000 per month during the peak season of September–December in FY2017.

6. External sector pressure is building up as the slowdown in remittances persists

As the trade deficit reaches a record high and remittances continue to slow, the pressure on the current account is mounting. Following the end of the disruption, the trade deficit quickly ballooned to above precrisis levels and had stabilized at this higher level by October 2016. However, as imports continued to rise sharply and exports faltered, the trade deficit surged further and reached a record high, crossing US$700 million per month for the first time in February 2017. At the same time, remittances, after stabilizing, slowed again. The cumulative effect of the trade balance deterioration and a slowdown of remittances has put the current account into a deficit in the first eight months of FY2017 compared to a huge surplus of US$1.3 billion during the same period last fiscal year. As a result, although still high at US$10.1 billion, foreign reserve accumulation has slowed, covering 12 months of merchandise and service imports from a peak of 19 months a year ago.

Growth of remittances has continued to slow. Using a standard statistical technique developed by the U.S. Census Bureau, we adjust the data on remittances by removing the effect of the seasonal variation. Analyzing seasonally adjusted data, we can observe that a contraction in remittances started in August
Departures of migrant workers have further fallen to a new level. A slowdown in departures of migrant workers predates the earthquake, but it has accelerated following the earthquake and has further fallen to a new level in the first six months of FY2017. From a six-month average of 47,000 in FY2015, it fell to 37,000 in FY2016. In the first six months of FY2017, the average further declined to 31,000. As a result, the growth rate became slightly negative when controlling for seasonal effects (Figure 18).

After Malaysia, workers leaving for Saudi Arabia saw the sharpest decline, while departures for Qatar are still holding up. Weaker demand for workers from oil and commodity producing host countries (for example, GCC countries and Malaysia) is likely to have contributed the most to this decline. For Malaysia, in particular, there could have been several other reasons, including a moratorium on foreign workers by the Government of Malaysia in 2016; a reported policy 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, further exacerbating the flow of migrant workers. As a result, the drop in migrant workers going to Malaysia has been the most pronounced. Recently, the Government of Nepal announced a moratorium for maid workers going to GCC countries, which will likely increase pressure on workers to use
illegal channels. Policy inconsistency by the Government of Nepal has added to the problem of the slowdown in migrant workers, which has already been affected by weaker demand from GCC countries (Figure 19).

7. Rapid credit growth and slowing deposits have contributed to the diminishing availability of loanable funds

Credit growth has soared to a five-year high. Credit growth reached a high of 31.9 percent (y/y) in February before tapering off to 27.9 percent (y/y) in March (Figure 20). It is well above the 25 percent growth in domestic credit targeted in the FY2017 monetary policy. Credit to all sectors has experienced strong growth in FY2017, with credit to the service sector contributing the largest share—13.3 percentage points in March (Figure 21).

Deposit growth is slowing in FY2017. Since the beginning of FY2017, deposit growth has slowed from 20.6 percent y/y in August 2016 to 16.8 percent y/y in March 2017 (Figure 22). Deposits from all sectors, with the exception of corpora-
tions, slowed during FY2017. Notably, the contribution of foreign deposits to total deposits declined from 0.71 percentage points in August 2016 to 0.09 percentage points in February 2017, while that of the “others” category, consisting of deposits of the private sector, local governments, nonprofit organizations, and miscellaneous, declined from 0.54 percentage points to -2.59 percentage points.

The cumulative effect of rapid credit growth and slowing deposit growth has contributed to the diminishing availability of loanable funds in the banking system (see Box 1). Banks’ credit to core capital plus deposit (CCD) ratios are being squeezed tight. NRB regulation caps banks’ CCD at 80 percent, but with credit growth outpacing deposit growth, at the end of Q2 FY2017, the CCD ratio of all commercial banks (Class A) reached 78.3 percent, the highest industry average since 2011 (Figure 23).

Government cash balances amounting to nearly 10 percent of GDP and parked in the government’s account at the NRB have further added to the credit crunch. The government’s large

Figure 24 Adding more funds to the treasury and soaking liquidity from the market

Figure 25 Pushing interest rates to a three-year high

Figure 26 Overdraft & margin loans may have been fueling speculative behavior in the stock market

Figure 27 The NEPSE remains disconnected from the regional market

Source: NRB. 
Source: NRB.

Source: NRB and WB Staff Calculations.
Source: Regional stock markets and WB staff calculation.
Background

Liquidity management in Nepal is seemingly becoming a persistent challenge. Nepal faced a liquidity crisis in FY2011, which was followed by a number of years of high liquidity. High liquidity was bolstered by high inflow of remittances that the central bank was not able to fully sterilize, and kept interest rates low. The Nepali economy is now contending with a credit crunch. In the last few months, the availability of loanable funds has steadily dried up in the banking system. The effect has been rising interest rates and, more pressingly, it has led to the deterioration of the liquidity ratio, computed as credit to core capital plus the deposit ratio (CCD)—close to the regulatory limit. Four primary factors have contributed to this: rapid expansion of credit, weak regulatory supervision, the government accumulating nearly 10 percent of GDP in the treasury, and a slowdown in remittances.

What happened

In January 2017, the Nepalese banking system started reporting shortages of loanable funds, although signs were already present when the lending rates started increasing in November 2016. Initially, it was thought that only a few banks were offering highly competitive interest rates to attract more deposits. While the remaining banks also increased their interest rates to maintain their deposit base, the speculation of a looming liquidity crisis was laid to rest when there was an undersubscription of repo worth NPR 30 billion issued by the Nepal Rastra Bank (NRB) to ease the shortage, which was followed by another NRB notice published on January 17 and 18, 2017, to buy back NRB bonds worth NPR 40 billion to inject liquidity. Few banks showed interest indicating that liquidity was not a problem. However, the shortage of “loanable funds” was real. As banks are allowed to lend only 80 percent of their deposit and core capital, they started offering higher interest rates to attract new deposits. New deposit rates offered were as high as 10 to 12 percent on fixed deposits and call deposit accounts, up from a range of 5 to 8 percent previously. Based on estimates shared by the Nepal Banking Association, by Q2 FY2017 (mid-January 2017), the CDD ratio (industry average) was estimated to have reached 78.3 percent, and it was reported that six banks had already reached or exceeded the regulatory requirement of 80 percent. Clearly, injecting liquidity through repos would have had little or no impact on banks facing a CCD squeeze, because banks required deposits to ease their CCD position more than cash holdings or borrowings.

Factors contributing to the credit crunch

**Rapid expansion of credit:** The initial growth in credit began on the back of an economic recovery following the end of the trade disruptions, but it has since been sustained by credit to sectors such as vehicle and margin loans (Figure 21). Between August 2016 and January 2017, the contribution of commercial loans (including term loans, working capital loans, import loans, deprived sector loans, and bill purchases) to overall credit growth increased from 11.8 percentage points to 13.3 percentage points. Simultaneously, banks have also been increasing their capital base over the last year and a half as mandated by the FY2016 monetary policy. This has provided them with more space to disburse more credit, but has also pushed banks to lend more aggressively to generate greater profit to maintain or increase the return on equity for shareholders.

**Weak regulatory supervision:** The rapid increase of credit to nonproductive purposes (for example, margin loans, real estate loans) should have been observed by the regulators and brought under control prior to the situation escalating. However, the NRB was relatively slow to react and initially carried out an unnecessary repo to ease the situation. Only in February 2017 did it introduce new restrictions and provide temporary relief measures in its midterm monetary policy review. To curtail credit toward “unproductive purposes”, the NRB has restricted banks from financing more than 50 percent of a vehicle through auto loans, and also reduced the limit of personal overdrafts from NPR 10...
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Box 1 Credit Crunch (continued)

million to NPR 7.5 million. In addition, to create space for more credit extension, NRB has allowed banks to calculate the CCD ratio by reducing the weightage applied to “productive purposes” by 50 percent until the end of FY2017. This, in effect, relaxes the current lending limit and may sustain the credit boom, which however, could adversely impact the overall quality of loans and stability of the banking system in the future. The measure should not be renewed when it expires at the end of the fiscal year.

The government’s fiscal and borrowing policy has been a major culprit, as well: Government borrowed heavily at the end of the previous fiscal year in anticipation of massive spending this fiscal year which it did not materialize. As a result, the Government’s cash surplus has remained locked up in the central bank. The situation was exacerbated in December 2016, when corporate taxpayers had to deposit 40 percent of their income tax by the end of Q2 as an advance amount to the treasury. This amount is estimated to be around NPR 36 billion, which was out of the banking system and further added to government deposits. As a result, by mid-January, the Government of Nepal had a cash surplus of more than NPR 200 billion (almost 10 percent of GDP) locked up at the Central Bank.

Slowdown of remittances: Remittances from migrant Nepali workers abroad have been a significant source of liquidity for the economy, and consequently deposits for the banking sector, in recent years. They continuously grew, providing a source that could be extended for credit. As a percentage of GDP, remittances more than doubled in a decade to almost 30 percent of GDP in FY2016. However, remittance growth has slowed, growing by only 0.8 percent (y/y, U.S. dollars) in FY2016. This trend has continued, and remittance growth rates in FY2017 have been the slowest in recent years. A weak investment environment and lack of investment opportunities has pushed the credit to nonproductive use, but lower liquidity inflow from external sources has slowed the deposit mobilization, as well.

Cash balances have had the effect of monetary tightening. As this balance is held at the NRB and out of the banking system, it has in effect “mopped up” nearly 10 percent of GDP of liquidity from the domestic market (Figure 24). As a result, with less liquidity in the market there are less deposits, which has created additional pressure on banks’ ability to disburse more credit.

Tighter liquidity in the banking system has pushed interest rates up. The first half of FY2017 has bucked the multiyear trend of declining interest rates (Figure 25), with both lending and deposit rates shooting up in the past few months. The weighted average lending rate rose from 8.9 percent in August 2016 to a three-year high of 10.6 percent in March 2017. Similarly, the weighted average deposit rate was up from 3.3 percent in August 2016 to 5 percent in March 2017—the highest rate since the beginning of FY2014.

Growth of broad money (M2) has slowed to 17.4 percent (y/y) and reached a two-year low. With the deceleration in remittances, the growth of net foreign assets has significantly slowed and has reached a four-and-a-half-year low. In contrast, credit to the private sector has reached a historic high and has driven the growth of M2. The contribution of net foreign assets in M2 growth has declined to 3.2 percentage points, while the contribution of private sector credit reached above 20 percentage points.

8. The stock market remains disconnected from the real economy

Proliferation of overdraft borrowing is a concern, because it may have led to speculation, including in the stock market. With NPR 341.3 billion in overdrafts in March 2017, it is approximately 18 percent of total loans outstanding, and it is the second-largest category of lending after working capital loans (21.2 percent in March 2017). In one year, the growth rate of overdraft tripled from 10.5 percent y/y in March 2016 to 31.7 percent y/y in FY2017. This has also coincided with the stellar rise of the Nepal Stock Exchange (NEPSE), raising concerns that funds acquired through overdrafts may be channeled into stock market speculation (Figure 26). Because no or few conditions are attached to overdrafts, it is a non-
transparent instrument. These funds can be diverted to risky and speculative activities such as stock market and real estate and land purchases, potentially fueling asset bubbles.

The stock market has moderated from its peak in October 2016, but still remains disconnected from the real economy and regional stock exchanges. NEPSE’s historic rise, which saw the NEPSE index peak at 1,820 in October 2016, has turned to a bear market. Since its peak in October, the NEPSE slid to 1,246 in February 2017, before recovering to 1,700 in mid-April. The credit crunch is likely to have impacted the stock market. A lower number of margin loans and overdrafts—which may be used in stock market speculation—might be driving the stock market down. The overall effect has been a lowering of the NEPSE growth rate. However, the stock market in Nepal still remains disconnected from the real economy, and from regional stock exchanges (Figure 27).

9. In sum, FY2017 resulted in highest growth since 1994

First estimate for FY2017 shows growth is expected to reach 7.5 percent in FY2017, the highest rate since 1994 (Figure 28). The rebound in growth is a result of base effect, increased agricultural output, increased availability of electricity, and greater investment as earthquake reconstruction gained speed.

Base effect was a major contributor to the estimated growth rate in FY2017. Growth in FY2016 was exceptionally weak, coming in at 0.4 percent after second revision by the CBS. This gives a very low base for comparing the growth in FY2017. Had the growth rate in FY2016 been in line with the average of recent years, the growth rate in FY2017 would not have been so spectacular. For example, if the GDP growth rate had been 4 percent instead of 0.4 percent in FY2016, growth in FY2017 would have been 3.8 percent in FY2017, implying that nearly half of the headline growth rate in FY2017 can be attributed to the low starting point of 2016. Similarly, the high growth recorded in FY2017 will set up a high base for next year and it will be difficult to sustain such high rates of growth in FY2018.

On the supply side, all three major sectors have grown at above trend rates in FY2017 (Figure 29). Agriculture grew at a rate of 5.3 percent on the back of a record high agriculture production which was mostly a result of very good monsoon. Industry’s growth has been high at 10.9 percent, but this comes after a contraction 6.3 percent in the previous year. Electricity with a record high hydropower capacity addition and construction on the back of earthquake reconstruction in particular drove the industry sector. Growth in service sector also has been above average at 6.9 percent. Wholesale/retail trade and hotels sub-sectors rebounded from the shocks of previous two years. Transport, communications
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and real estate particularly gave a significant boost to service sector in FY2017. Education and financial sector, however, have slowed down in FY2017.

On the demand side, gross investments contributed the most to headline growth. Gross fixed capital formation is estimated to have reached 25 percent of GDP in FY2017, up from 21 percent the year before. Private investment rebounded strongly reaching 20 percent of GDP with the remainder going to the public investment. Consumption, while it still the largest contributor to GDP, has shrunk to 89 percent of GDP, down from a 5-year average of 94 percent. However, growth in public consumption rebounded strongly at 12 percent while private consumption was more muted at 2.5 percent in FY2017. The quality of national accounts data, in particular from the expenditure side, remains weak as the “change in stock/statistical error” category account for 29 percent of GDP in FY2017, the highest level on record.
B. Outlook, Risks and Challenges

Looking ahead, the economic growth will remain strong, but it is expected to moderate in line with country’s potential, averaging 5 percent over the next two fiscal years. While healthy growth is expected to continue in agriculture, construction and industry sectors, the activity in remaining sectors is expected to be affected by uncertainty stemming from transition to the federal structure, several elections and the possibility of further slowdown in remittances.

On the supply side, the service sector is expected to continue driving the growth. Services are expected to grow at 6.2 percent, on average, during the forecast period driven by trade, transport, and tourism. The outlook in services is also dependent on remittances stabilizing at the present level, particularly in light of the large share of wholesale and retail trade subsectors. However, the boost in tourism, in particular, is expected to continue in the forecast period. The good harvest of agricultural products is expected to continue in FY 2018, as the monsoon is forecasted to be normal, that is, at the long-term average. Industry is likely to get a further boost in FY2018 as hydropower generation, manufacturing, and construction subsectors continue to perform relatively well. With the Upper Tamakoshi (465 MW) and Rasuwa (111 MW) hydropower projects expected to come online, FY2018 will have record-high hydropower generation in the country. Additional small hydropower projects will provide a further boost to the electricity subsector. As a result, electricity is also expected to bolster the manufacturing sector in FY2018. Reconstruction activities are expected to pick up at a relatively faster pace in FY2018, as they did not gather speed as expected in FY2017. This will benefit the construction sector.

On the demand side, gross investments are expected to drive the growth. Growth in gross fixed capital formation is expected to remain strong during the forecast period. In particular, private investment is expected to drive the growth with hydropower plants coming online and spurring investments in other private activities. Public investment on the other hand is likely to face challenges as the country implements a new political and bureaucratic structure. Growth in private consumption is expected to moderate during the forecast period in line with a more sanguine outlook for growth of remittances. Government consumption, however, is expected to grow substantially as the country starts transitioning towards the federal structure. In addition, federal and provincial elections scheduled in FY 2018 will further add to the government consumption. Exports of services are
expected to continue as tourism normalizes. Exports of goods are also expected to grow in FY2018 in light of increased power availability in Nepal, and with the normalization of demand in India as the demonetization effect subsides but expected to moderate in line with their long-term average thereafter.

The fiscal deficit is expected to widen during the forecast period; however, given the large cash balance on hand, financing is not expected to be a problem. The FY2017 budget called for an expenditure increase of nearly 15 percent of GDP over actual expenditures in FY2016. However, as in previous years, significant underspending of the budget will continue. Realizing this, the government’s midyear budget has already lowered the spending targets. Nevertheless, government spending will grow substantially in FY2017 owing to increases in earthquake-related cash assistance and proposed election-related spending, as well as measures introduced to increase civil servants’ compensation, pensions, and social protection. The government’s recurrent expenditure is expected to continue to grow substantially in the forecast period, particularly as a result of the implementation of the new federal constitution, which calls for creation of an entirely new level of government. The growth in revenues is expected to continue, but may slow if the inflow of remittances slows further. With increased government spending as a result of a new federal structure and earthquake reconstruction, the fiscal balance is expected to be negative in FY2018. Meanwhile, the current account, which had remained in surplus over the past several years, is expected to narrow and turn into a deficit as import growth is expected to remain high while remittances and exports are expected to slow.

From a significantly moderated rate of inflation is expected to pick up during the forecast period. Inflation will be much below the central bank’s target of 7.5 percent for all of FY2017. However, it is expected to pick up in FY2018 as the effect of demonetization tapers off in India. The sharp uptick in the prices of rental housing and utilities following the earthquake, which continued in FY2017 due to slow reconstruction, is expected to moderate somewhat in FY2018 as housing reconstruction is expected to gather speed.

Challenges and Risks

There are an increasing number of downside risks to this forecast with domestic risks predominating. The political environment remains fluid as the term of the current government—which was sworn in during July 2016 as part of the power-sharing agreement among the coalition partners—is coming to an end. A series of elec-
tions (local, provincial, federal) needs to be held by early 2018, as stipulated in the new constitution, with a date for local elections announced for May and June 2017.

**With the confusion surrounding budget approval for the upcoming fiscal year, elections, and the fiscal architecture in the new federal structure, budget execution is going to be particularly challenging in FY2018.** Budget execution has been a persistent problem in the past. This has been exacerbated since the FY2016 budget, which called for a substantial increase in expenditures driven to a large extent by increased needs in postearthquake reconstruction. However, the execution of this very large increase in budget appropriations did not materialize. This has continued in the FY2017, both in unrealistic budgeting and weak execution. FY2018 is going to be even more challenging because of the confusion around the second phase of local elections and the timing of budget approval, which are both scheduled for June. Furthermore, provincial and federal elections expected to be held during FY2018 as stipulated in the constitution, which will add further challenges for timely budget execution. Normally, the government stops all major activities in the runup to elections. In addition, as the country moves to a federal structure, there is lack of clarity of fiscal architecture in the federal context, which can cause unintended interruptions in service delivery and execution of capital projects.

Despite improvements, the pace of earthquake reconstruction remains a concern. The delay in disbursement of the second tranche of the housing reconstruction grant has meant that fewer than 1,000 households had received all three tranches of government subsidy for housing reconstruction by the second anniversary of the earthquake. Reconstruction in other sectors (cultural heritage, schools, hospital, public buildings, and so forth) has barely started. The Ministry of Finance has confirmed that nearly all of the money pledged during the donor conference has been committed by the donors, and the risk of nondelivery from the Nepali government is increasing.

**Increased vulnerability in the financial sector could pose a challenge in the remainder of the forecast period.** Banks that are running up against regulatory limits for lending may face additional pressure if deposit growth does not improve. Banks are allowed to lend up to 80 percent of their local currency deposits and core capital. As a result, the central bank announced regulatory measures to ease the constraints, and also warned six banks in mid-January that have breached the lending limit.

**The external environment is likely to be less favorable, as well.** Continued underperformance of exports despite the end of disruptions remains a persistent challenge. Remittances account for 30 percent of GDP, with the majority of migrants going to oil-exporting GCC countries. Significant spending cuts, including in capital spending announced in the GCC countries, and persistent contraction in departures of migrants, have contributed to lower growth of remittances and risk of a possible sharper slowdown during the forecast period.
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