



# Managing the Current Macroeconomic and Fiscal Challenges: Nepal's Options

---

Dr. Biswash Gauchan, FCA  
21 September 2022

# Macroeconomic Outlook

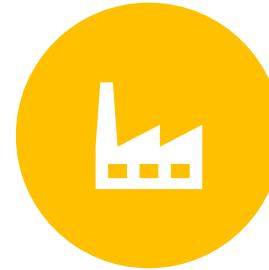
---



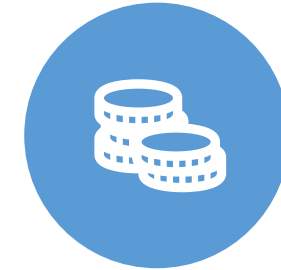
ECONOMIC  
GROWTH



PRICE STABILITY

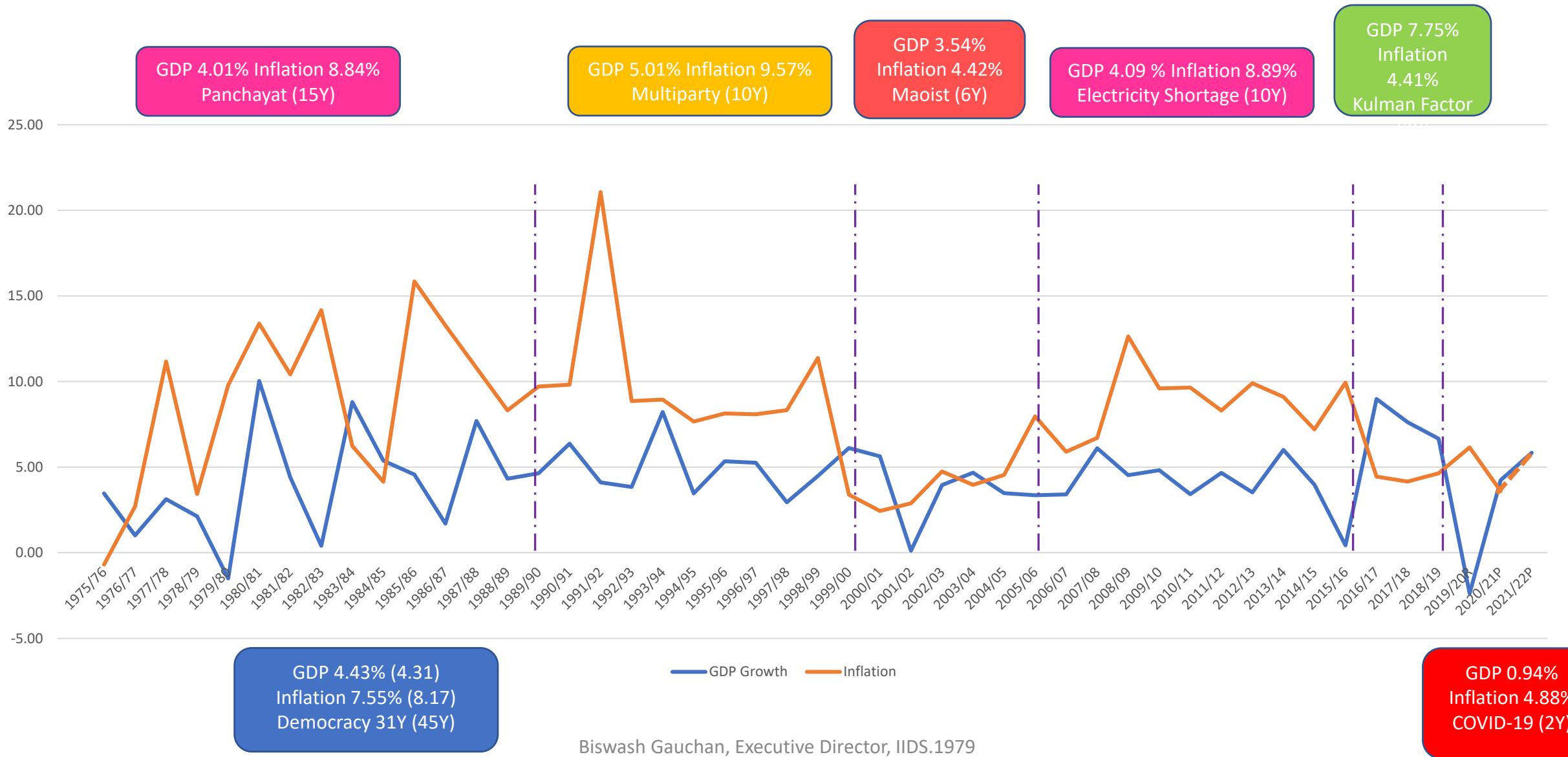


EXTERNAL  
SECTOR STABILITY



FINANCIAL  
SECTOR STABILITY

# Historical macroeconomic outlook of Nepal



# Global Shocks

Trade war (2018)

Covid-19 Pandemic (2020)

Supply chain disruptions

Ukraine Russia War (2022)

# Global and regional economic outlook

## Macros

- Economic Growth (World: 2.86; -ve 3.06; 6.1, 3.2% - 2019-22)
- Level of unemployment (US: 3.8 to 14.4 to 3.5%)
- Inflation (AE: 6.6 and EE/DE: 9.5% in 2022)

## Policy Responses

- Massive fiscal stimulus by advanced countries (28:6:2)
- Negative to zero policy rate in the aftermath of the pandemic
- Quantitative easing
- Monetary policy tightening in the aftermath of Ukraine crisis to reign very high inflation

## Impacts

- Heightened level of sovereign debt (120:66:50 in 2021)
- Debt sustainability
- Asset price
- Capital flows to Emerging economies
- Currency depreciation

# Transmission Channels

## Current Account

- Trade (44% GDP)
- Remittance (20.8% of GDP)
- Foreign Grant (0.7% of GDP 5YA)

## Capital Account

- Sovereign Debt (3.1% of GDP 5YA)
- Commercial Loan Stock (0.8% of GDP)
- FDI (0.4% of GDP)
- Portfolio (0%)

## Others

- Inflation
- Interest rate
- Exchange rate

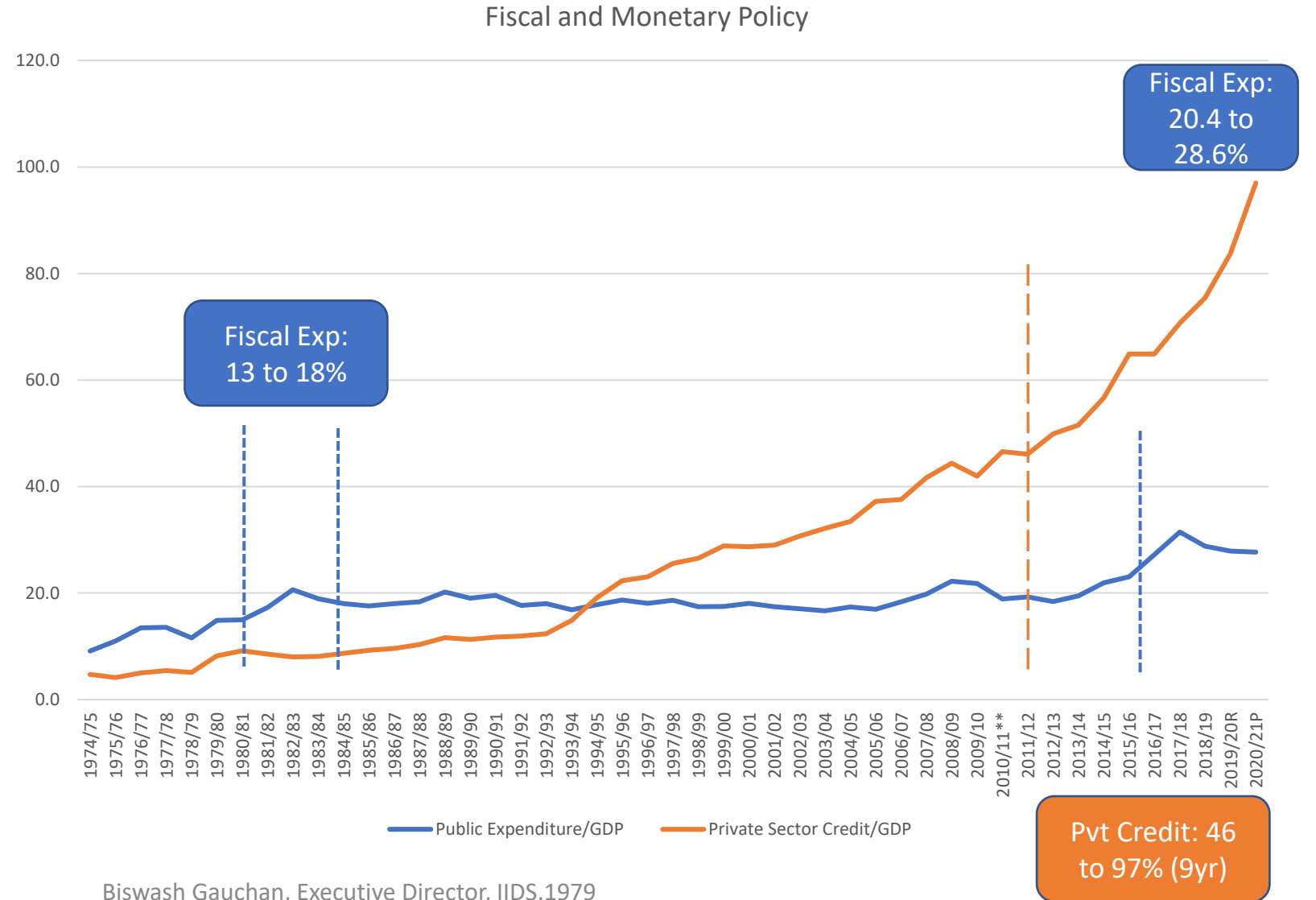
## Balance of Payment

- Trade Deficit (36.5% of GDP)
- Current Account Deficit (12.8% of GDP)
- BoP deficit (5.3% of GDP)

# Endogenous Factors

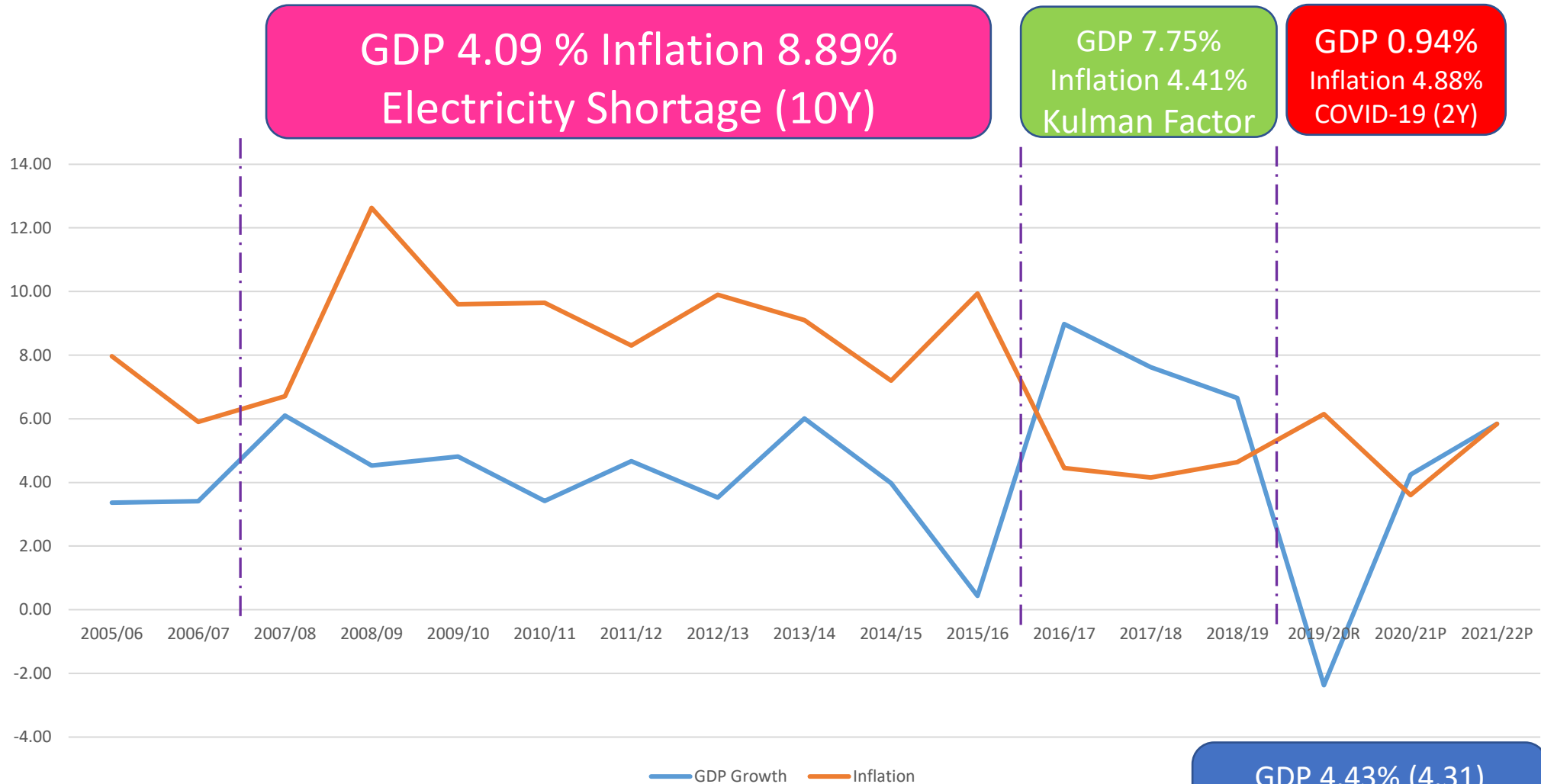
**Expansionary Fiscal Policy** added fuel to economic vulnerabilities

**Expansionary Monetary Policy** led to massive increase in private sector credit



# Macroeconomic outlook since CPA

(Nov 2006)



GDP 4.09 % Inflation 8.89%  
Electricity Shortage (10Y)

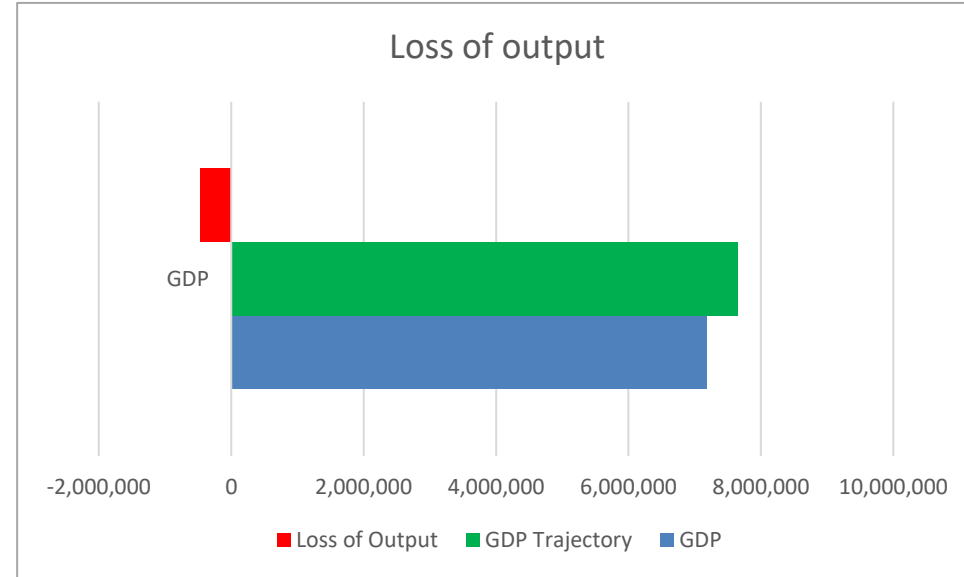
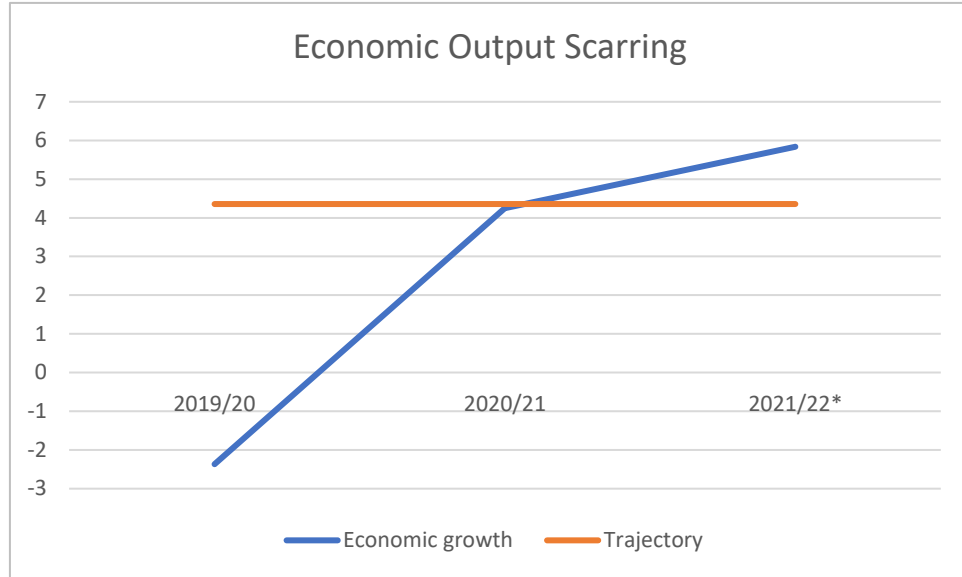
GDP 7.75%  
Inflation 4.41%  
Kulman Factor

GDP 0.94%  
Inflation 4.88%  
COVID-19 (2Y)

GDP 4.43% (4.31)  
Inflation 7.55% (8.17)  
Democracy 31Y (45Y)



# COVID Impact on Output

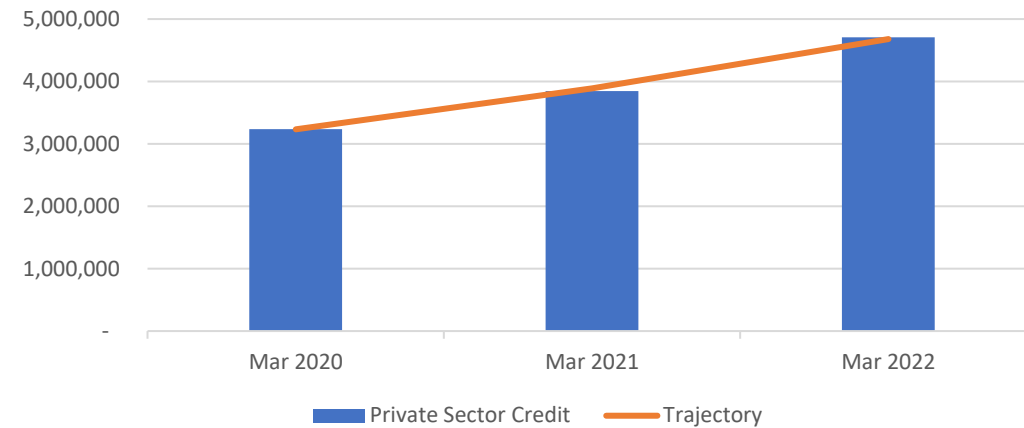


The economy is projected to permanently lose 6.6% of the total economic output due to the pandemic

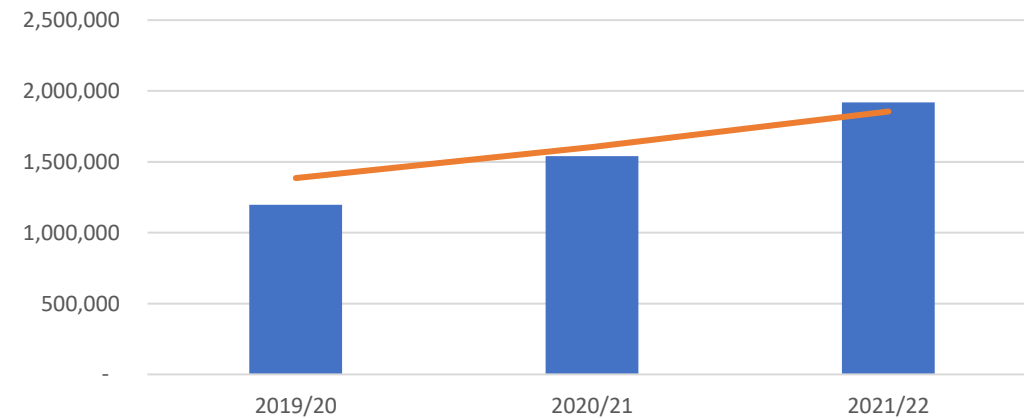
# Economic Recovery

- The private sector credit has fully recovered in the first two years of covid-19 by March 2022
- Import has recovered by 2021/22 excluding the shortfall in 2019/20

### Credit Recovery



### Import Recovery



# Economic Features of Nepal

Remittance

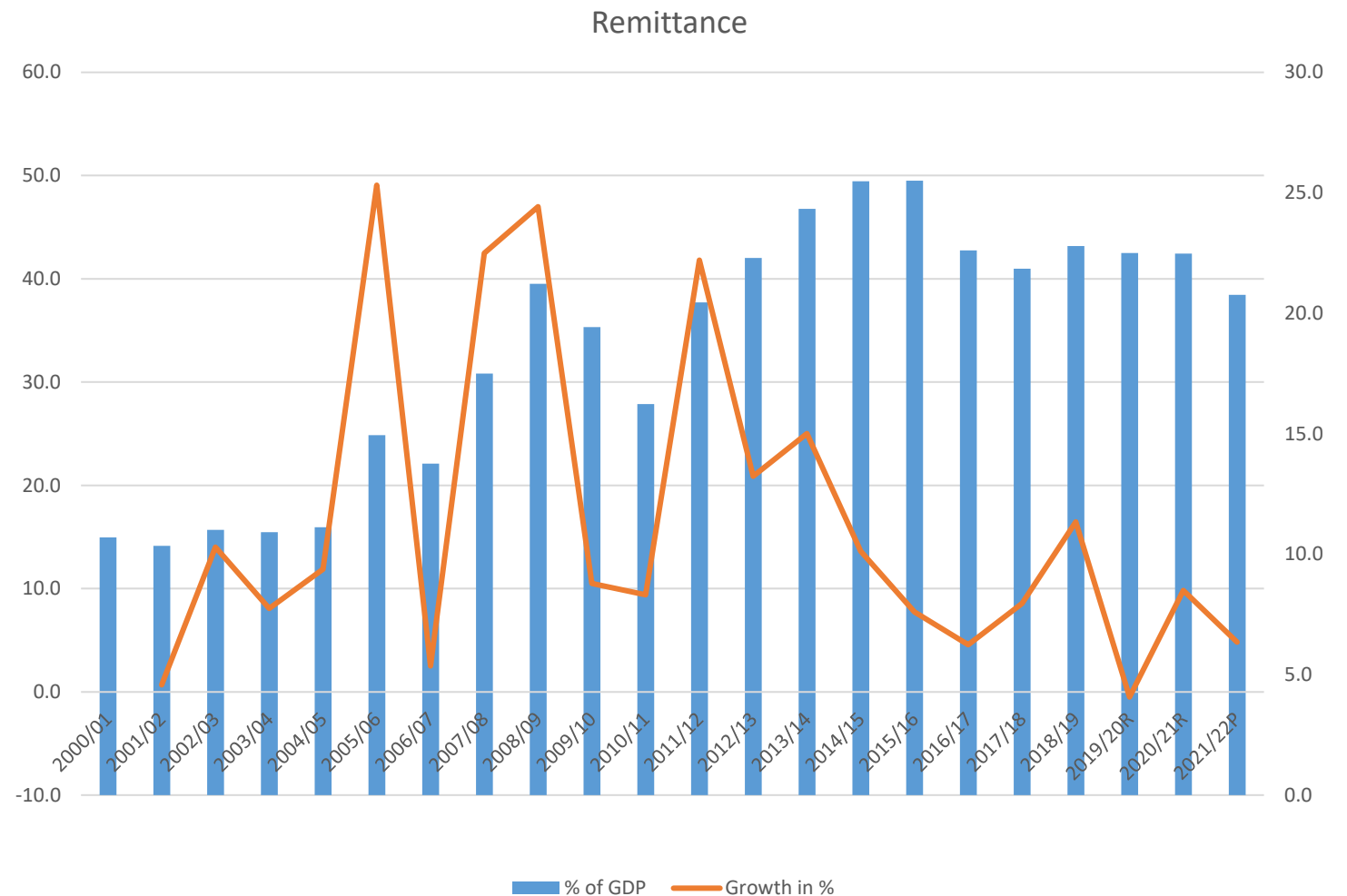
Credit

Import

Land Price

# Remittance

- Remittance is the largest source of FOREX earnings (56.4%)
- Remittance growth has declined from more than 20% in the previous 15 years to 7.3% in the last 6 years
- Remittance as a % of GDP peaked in 2015-17 reaching 25.5%, but has declined since then to 20.8% in 2021/22
- Every second household receive income from remittance (internal/external)
- Remittance has not been able to become a conduit of saving for capital formation
- Source of the largest remittance outflow compared to per capital income, income level and size of GDP



# Fervor for working/studying abroad

- No country where there is no Nepali
- NRN official networks in more than 80 countries
- Largest outflows of Nepali migrants compared to country's population
- Largest number of diaspora Nepali compared to size of country's population

# Private sector credit

## Average annual growth in the last 30 years

- Private sector credit: 20.3%
- Economic growth: 4.36%
- Inflation: 7.7%
- Import: 15.7%

## One percent private sector credit growth will lead to:

- Economic growth:
  - 0.23% in the long run
  - No short run impact
- Inflation:
  - 0.31% in the long run
  - No short run impact
- Import:
  - 0.71% in long run
  - 0.62% in short run

## Significance and direction of causality :

- Economic growth:
  - Significant
  - Bi-directional
- Inflation:
  - Significant
  - Unidirectional from credit to inflation
- Import:
  - Significant
  - Unidirectional from credit to import

# Private Sector Credit as a % of GDP in 2020

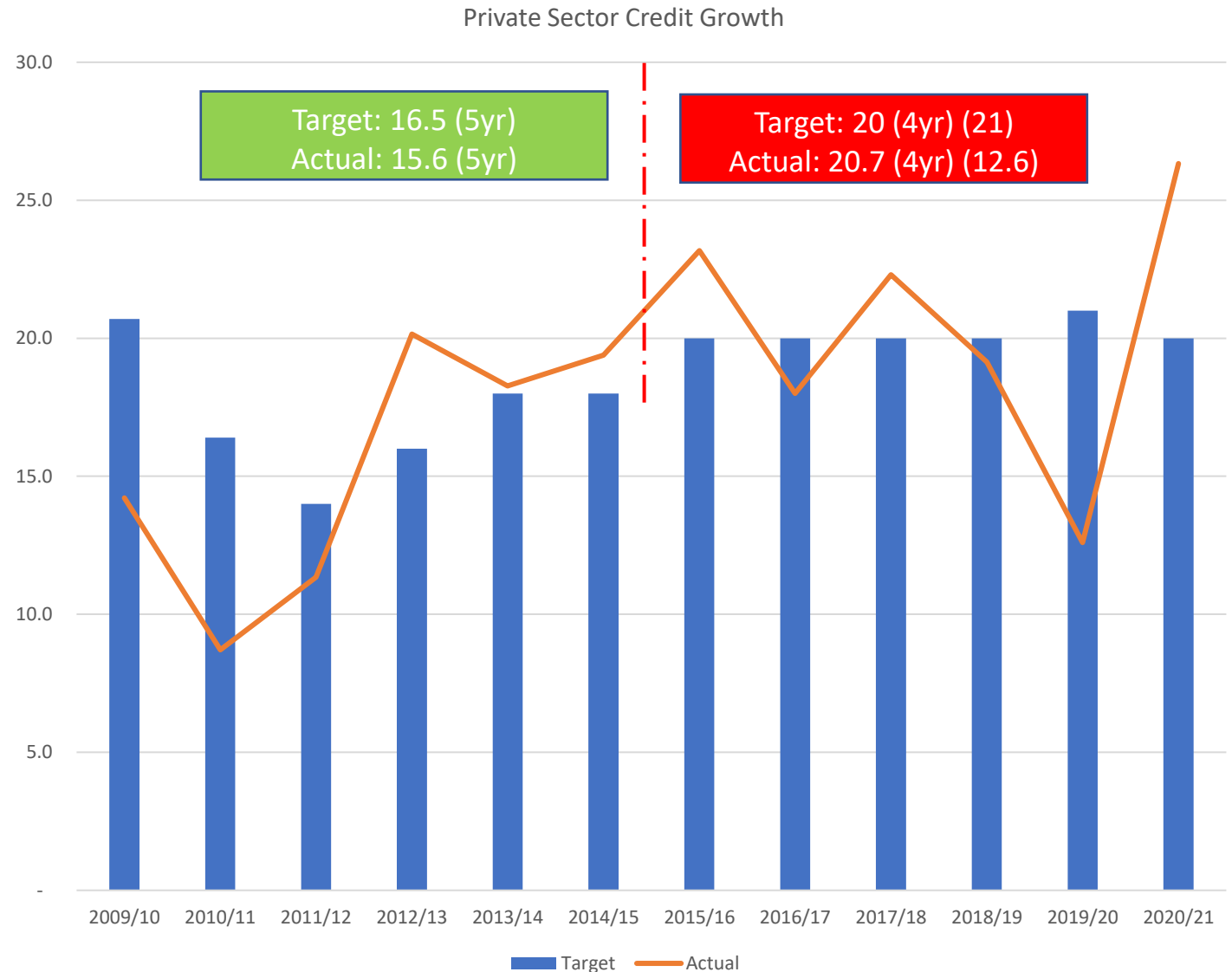
Countries	Broad Money (2)	Private Sector Credit	Income groups	Private Sector Credit
Afghanistan	37.2	3.01	LDC	31.2
Bangladesh	66.9	39.2	Low income	11.9
Bhutan	100.9	71.7	Lower middle income	45.9
India	88.2	54.7	Middle income	120.3
Maldives	71.9	52.9	Upper middle income	143.9
<b>Nepal</b>	<b>117</b>	<b>88.4</b>	High income	164.2
Pakistan	62.4	15	World	147.4
Sri Lanka	63	49.9		

Source: World Bank, 2022

- In the last nine years, the size of private sector credit has more than doubled from 46% to 97% of GDP
- Similarly, the private sector credit will become twice the size of the GDP in 11 years and four times larger in 22 years.

# Capital Hike of 2015

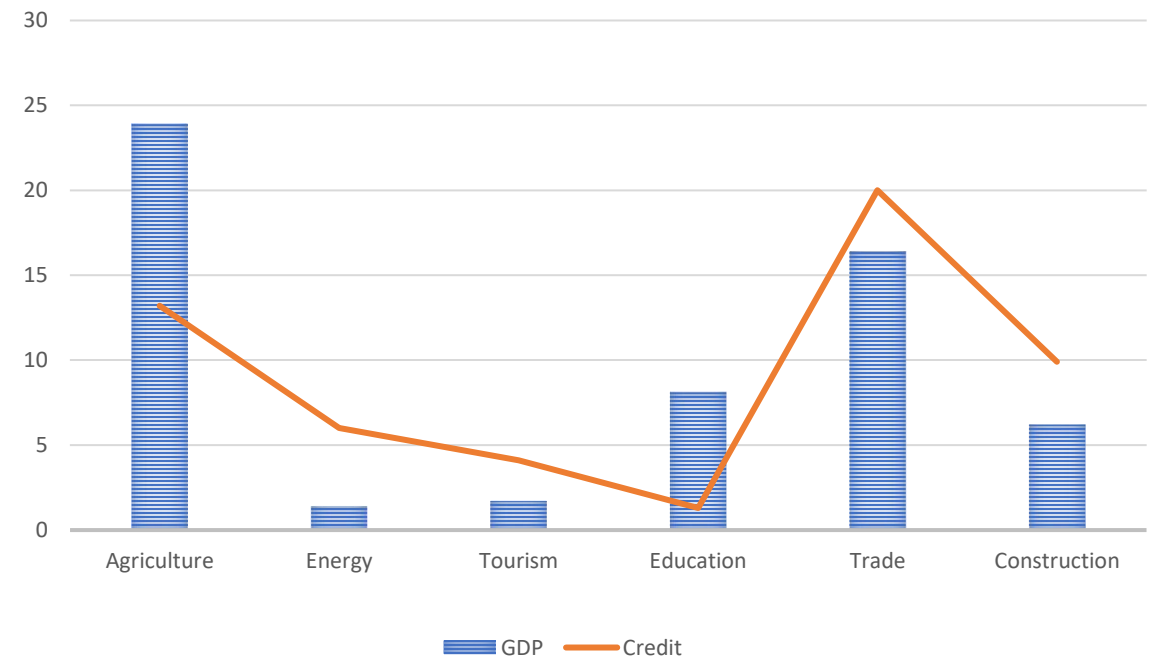
- Draconian measure to force M&A
- Failed in its objective to enforce M&A among Commercial Banks (30 to 27)
- Deluge of Tier 1 Capital in the banking sector led to misallocation of Capital in the economy
- Overcapitalization led to reckless lending to maintain 28% ROE after ROE plunged to 14%
- Equity was raised from the bank loan
- BFIs have enough capital buffers to lend for next three years
- Private credit rose by 27% of GDP during Governor Dr. Chiranjivi's term (56.7 – 83.7%)





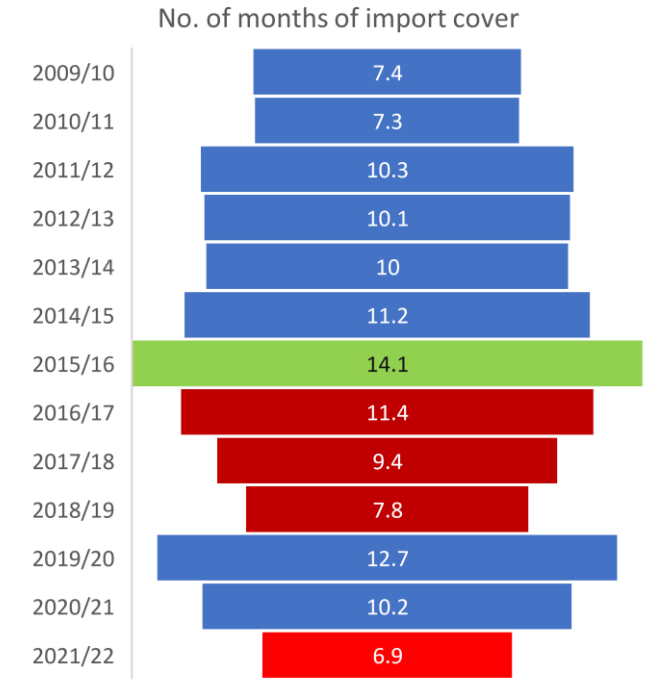
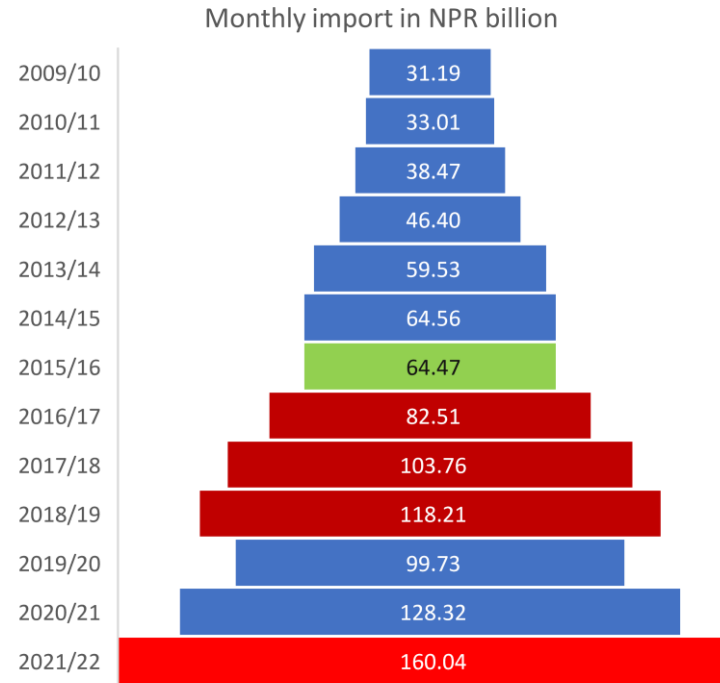
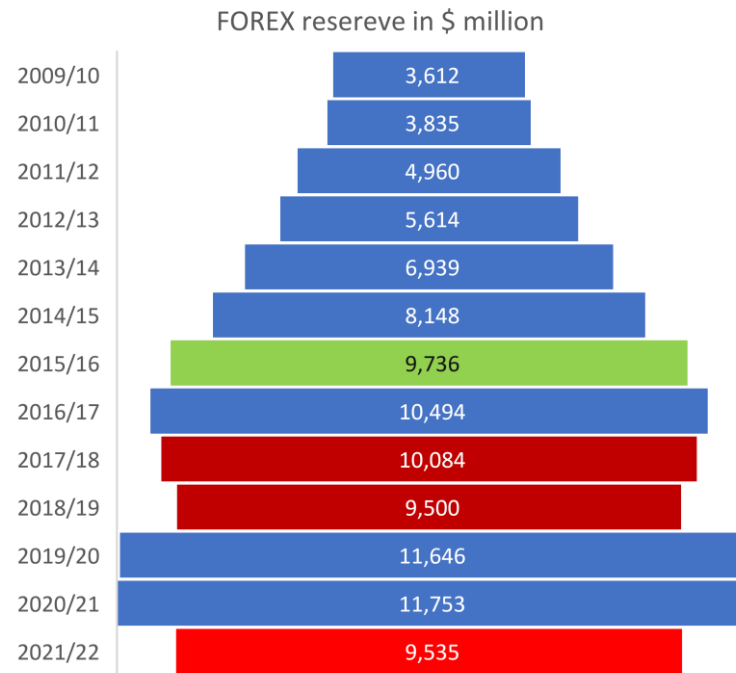
# Credit Allocation

Sectors	GDP	Credit
<ul style="list-style-type: none"> <li>• Agriculture:</li> <li>• Energy:</li> <li>• Tourism:</li> <li>• Education:</li> </ul>	23.9 1.4 1.7 8.1	13.2 5.1 3.9 1.2
<ul style="list-style-type: none"> <li>• Trade:</li> <li>• Construction:</li> </ul>	16.4 6.2	20.1 9.9 (?)



Agriwashing: Agriculture sector witnessed the largest growth of bank credit in the last 10 years by 11.3 times and in the last 5 years by 3.5 times. However, the average agriculture output growth in the last 10 years has declined to 2.8% from 3.5% in the previous 10 years

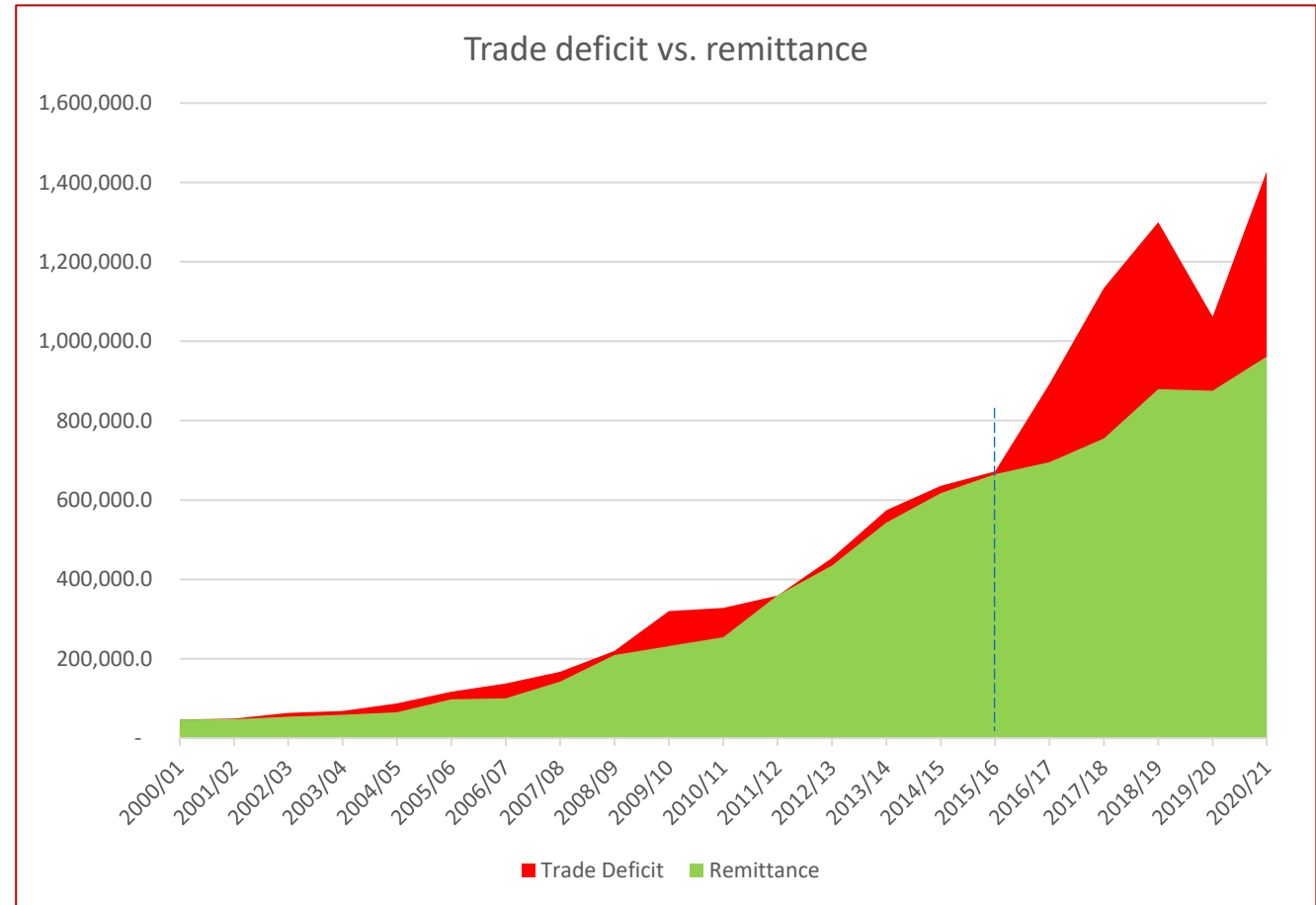
# Import



- In seven years, FOREX reserve increased by nearly \$ 7 billion from \$ 3.6 B in 2009/10 to \$ 10.5 B in 2016/17
- Since October 2017 (\$10.65 B), the country suffered consecutive BoP deficits until the covid-19 pandemic
- At the end of the LFY (\$9.535 B), the forex reserve dipped to 2015/16 and 2018/19 levels
- The monthly import has increased by 2.5 times from NPR 64.5 billion (2015/16) and 1.4 times from 118.2 billion (2018/19) to NPR 160 billion in the CFY
- The no. of months of imports dipped below 7 months from Mangsir 2078 (6.8 M from 7.2 M) setting the alarm bell
- FOREX reserve rose by a record 3.2 billion dollar during the first 10 months in the aftermath of the lockdown in March 2020, but declined by same amount in 14 months March 2022 posing challenges to the external sector balance

# Import vs. Remittance

- Until 2015/16, Remittance was able to cover trade deficit, leading to current account surplus (import 14% vs. remit 20.3%)
- In the last six years, widening remittance growth (7.3%), import growth (17.6%) and trade deficit growth (19.1%) led to sharp rise in current account deficit since 2016/17
- Exponential surge in import by 39% to NPR 160 billion per month in the LFY from Rs. 115 billion/month before the lockdown (NPR 188 billion in Mangsir 2078)
- Remittance that accounts for 56.4% of the total sources of FOREX earnings increased only marginally (2.2%) in 2021/22



# Land Price

---

Asset Price Inflation at par with Credit Growth

---

Profit/income used for buying and investing in land

---

Most convenient and effective means of formalizing unaccounted income

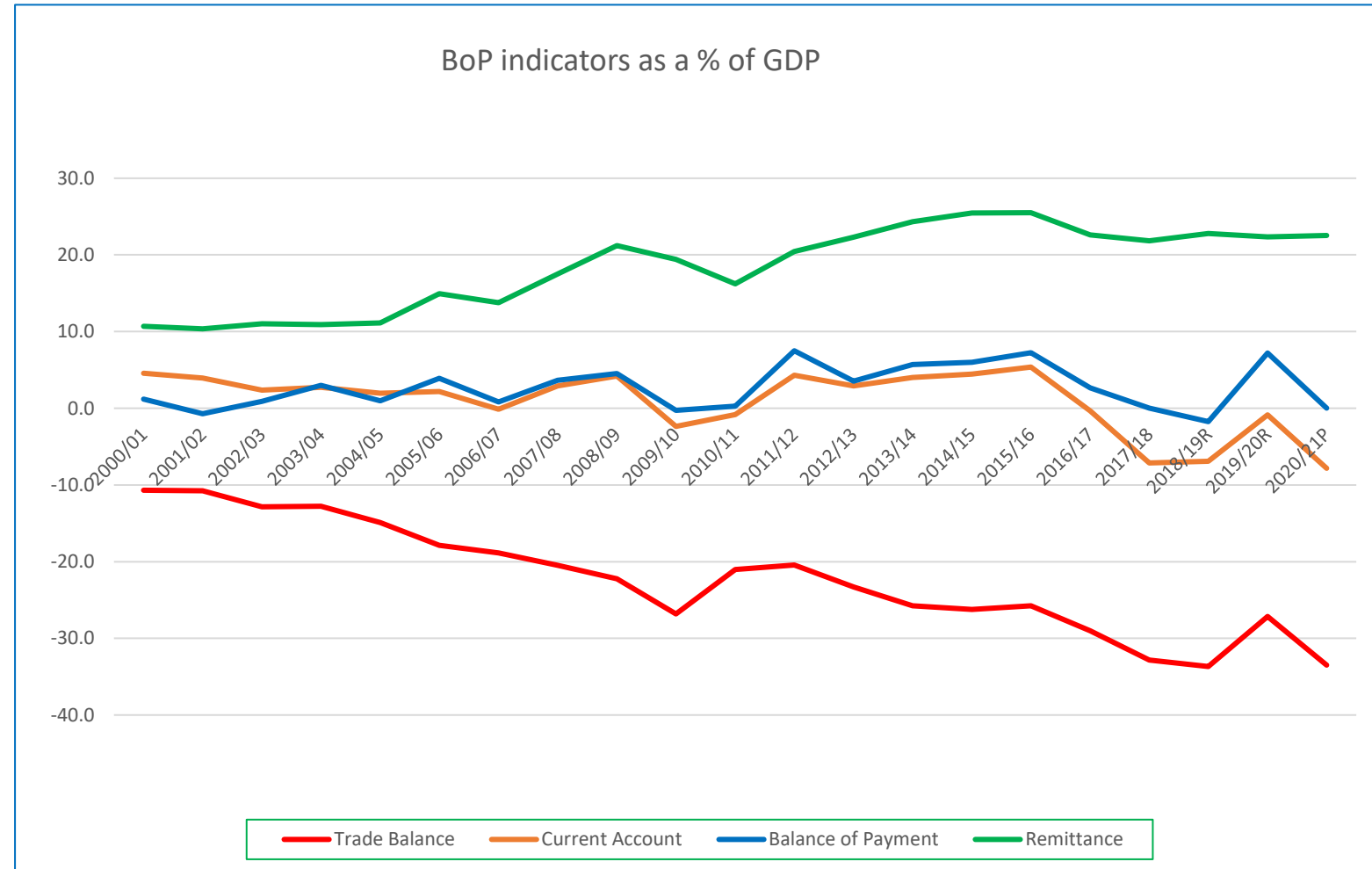
---

Monetization of land has inhibited capital formation

---

# External sector stability

- Trade deficit is 36% of GDP (NPR 1720 billion)
- Trade deficit on services 2.2% of GDP (NPR 108 billion )
- Current account deficit reached \$ 5.17 B, 12.85% of GDP
- Record BoP deficit of \$ 2.14B - 5.26% of GDP, the highest ever (2% during mid-eighties)
- FOREX reserve fell by 25% from its peak in Jan 2021 (\$12.77 B) to reach pre-covid level in March 2022



# Craze for studying abroad

---

Largest number of students going abroad compared to the size of the population (NOC - 117K in 2021/22 and 82K (440 per day) in the first six months of 2022)

---

Third largest in Australia and Japan and twelve largest in USA

---

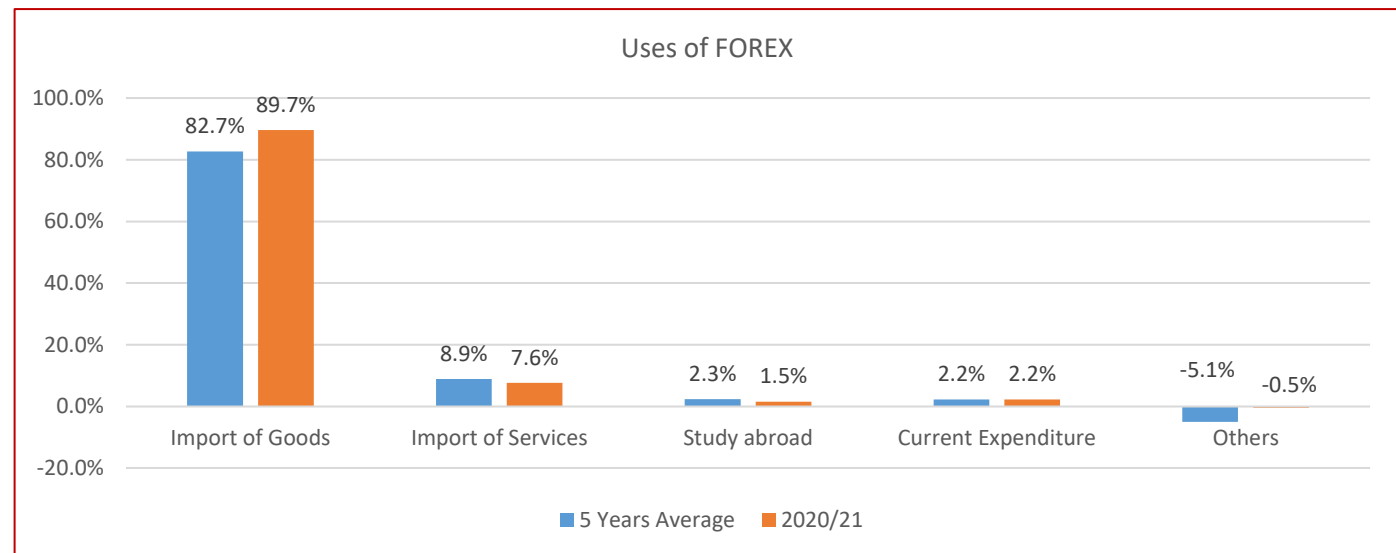
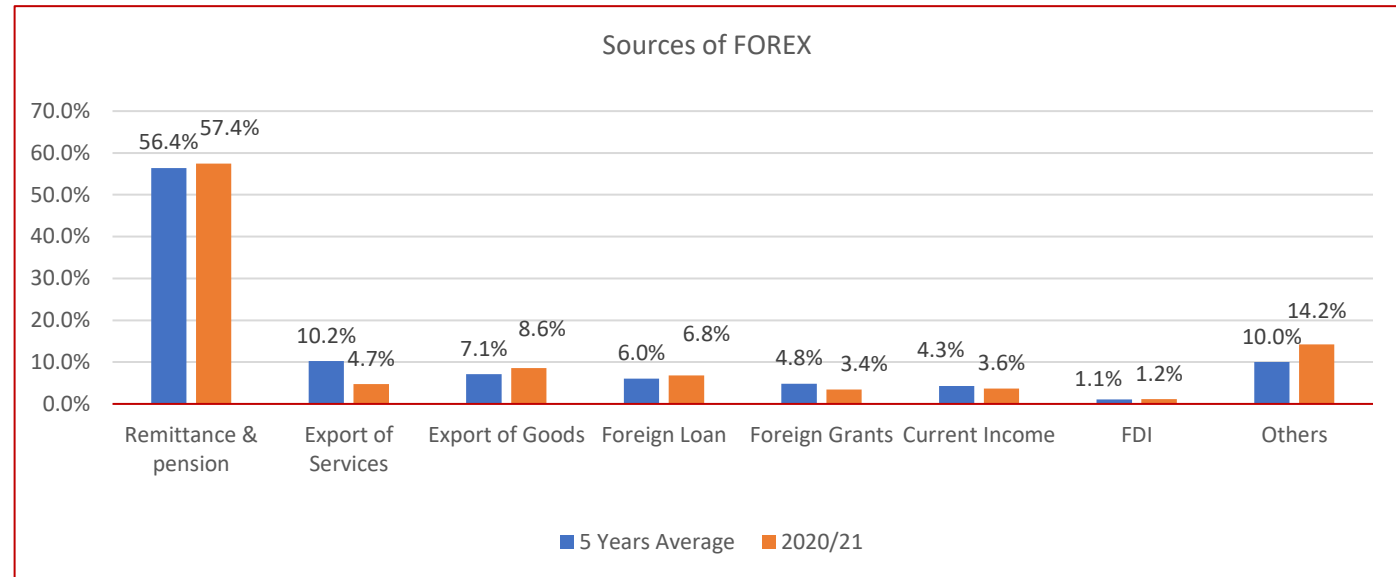
Highest outflows of FOREX (NPR 68 billion) for foreign studies compared to per capita income and size of GDP

---

# Sources and uses of Foreign Exchange

- Remittance is the largest source of FOREX earnings (56.4%)
- Foreign loan and grants together account for 11% of the FOREX inflows
- Export of services (10.2%) and export of goods (7.1%)

- FOREX is used largely for the import of goods (83%) and services (9%)
- Agriculture goods (24%), Petroleum products (13%) and vehicles (8%) account for 45% of the total merchandise import
- Capital goods (12%) Intermediary (52%) and Finished goods (36%)



# Sovereign Debt and ODA

## External Sovereign Debt

- 21.2% of GDP (\$ 8 billion = NPR 1027 billion)
- Currency depreciation of 7.1% in 2021/22 and 23.8% since 2017 have inflated the external debt in NPR terms by NPR 68 billion and NPR 198 billion respectively

## Official Development Assistance

- 11% of total FOREX inflows and 3.5% of GDP in L5Y
- ODA contributed 13% of annual budget in L10Y compared to 25% in L50Y and 70% of the capital expenditure in L10Y compared to 63% in L50Y
- Percentage of foreign grant declined from 40% in L50Y to 18% of ODA in L5Y



# Financial sector stability

Oversized banking sector

Movement of Land prices at par with credit growth

Evergreening of loans

Trade, Construction and Real Estate are the key beneficiaries of the bank loans

High capital adequacy

Low level of NPAs (1.18% for commercial banks)

Fixed Exchange Rate

No Capital Account Convertibility, (External commercial debt Rs. 40 billion)

# Liquidity

NRB's Credit policy for 2021/22:  
19% Pvt sector credit growth  
CCD (85%) to CD Ratio (90%)

Increase in Broad money (M2) by 3.5% and Deposit by 5.1% versus Pvt Sect Credit by 13.5% in the first ten months of the year shows liquidity drainage from the system/economy

Private sector credit fully recovered from 2018/19 in two years (12.6 & 26.3%) by 2020/21

The unprecedented level of SLF shows that the banking system is facing acute liquidity crunch

Excessive credit growth of 6.5% in the first two months (Rs. 204 billion – 26% of total annual target of Rs. 785B in Bhadra 2078)  
32.5% in last 12 months

The entire government cash balance of NPR 333 billion held by NRB is just enough to bring down CD ratio of BFIs to 90% by the end of the Year

# NRB Balance Sheet

- Reduction in FOREX (NPR 260B) in NRB balance sheet since its peak in Jan 2021 has been bridged by SLF (177B), Refinance (64B) and GON treasury (43B)
- Differential impacts of NRB's Balance Sheet:
  - Assets: FOREX/Treasuries & SLF
  - Liabilities: Reserve Money & Government Cash

Central Bank Survey				
Assets	2020 March	2022 March	Changes	
Foreign Assets	1,026,877	1,111,142	84,265	8.2%
Claims on Government	63,199	105,888	42,689	67.5%
<u>Claims on BFIs</u>				
- Refinance	18,377	134,107	<b>115,731</b>	629.8%
- SLF	-	176,907	<b>176,907</b>	
Others	69,000	62,900	(6,100)	-8.8%
<b>Liabilities</b>				
<u>Reserve Money</u>				
- Currency in circulation	521,503	632,949	<b>111,446</b>	21.4%
- CRR/Others	175,924	164,223	(11,701)	-6.7%
Government Deposits	213,946	335,336	<b>121,390</b>	56.7%
Foreign Liability	559	37,002	36,443	6525.2%
Capital Reserves	281,683	371,751	90,068	32.0%
Others	(16,162)	49,684	65,846	-407.4%
<b>Total Asset=Liabilities</b>	<b>1,177,452</b>	<b>1,590,944</b>	<b>413,492</b>	<b>35.1%</b>
% of Foreign Assets	87.2%	69.8%		

# Economic outlook

## Positives

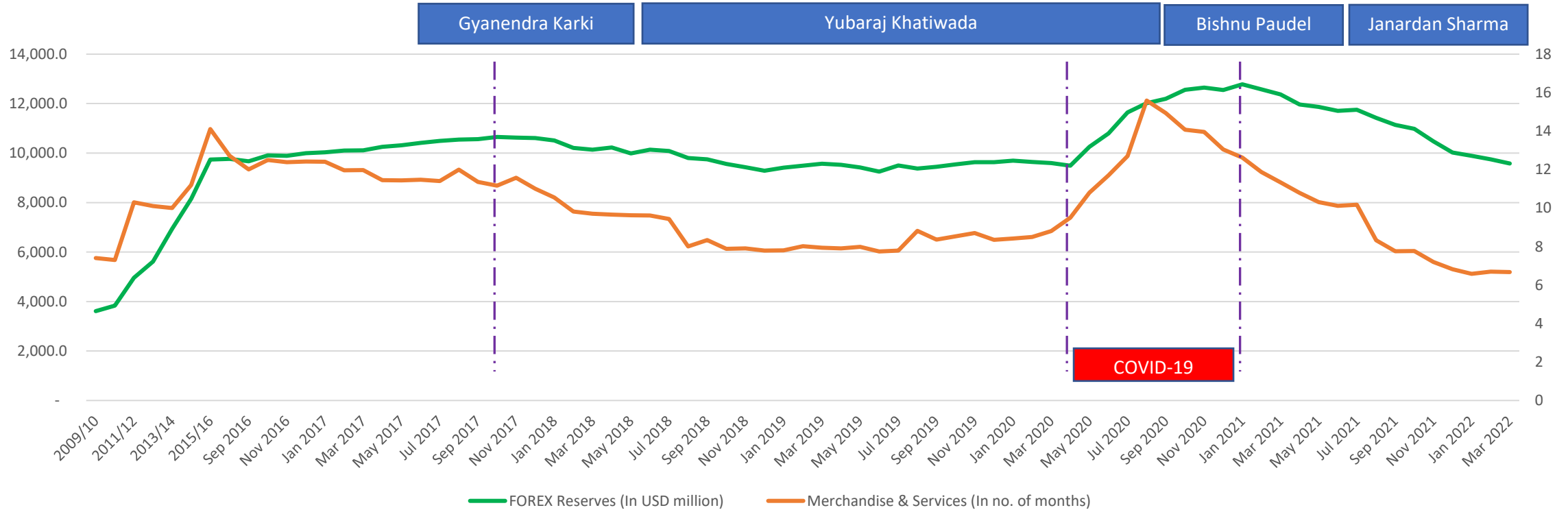
- Reasonable level of forex reserve of \$9.54 billion (25% of GDP)
- Import cover of 6.94 months
- Low sovereign debt of 41% of GDP with external debt around 21% of GDP (\$8.0 billion)
- Low level of external debt servicing
- Low level of exposure to external commercial debt of banking sector (NPR 40 billion)

## Negatives

- Trade deficit equivalent to 36% of GDP
- Current Account Deficit of nearly 13%
- BOP deficit of above 5%
- Fiscal deficit of 6.5% (5 yrs average)

# Politics over economy

Monthly FOREX Reserve



**Gyanendra Bahadur Karki**  
(Jun 2017 - Feb 2018)

- FOREX reserves declined by \$513 million from its peak in Oct 2017 during his 8 months term

**Yubraj Khatiwada**  
(Mar 2018 – Sep 2020)

- FOREX reserves declined by \$729 million before covid set in during his 30 months term

**Bishnu Paudel**  
(Oct 2020 – Jul 2021)

- FOREX reserves declined by \$ 1 billion from its peak in Jan 2021 during his 9 months term

**Janardan Sharma**  
(Jul 2021 - ongoing)

- FOREX reserves declined by \$2 billion during the last 9 months

# Economic Features of LDCs

Economic Features	Nepal
Low economic growth	√
High unemployment	√
High Inflation	√
Low per capita income	√
Agrarian Economy	√
Low Tax revenue	High
High Debt burden	Low
Low FOREX reserves	Moderate
Low domestic saving	√
Low level of Investment	√
Dependence on ODA for development budget	√
Excessive reliance on few products/services	√
Lack of capacity	√
Poor Infrastructure	√
Low level of productivity	√

# Fiscal Policy Goals

## Main goals

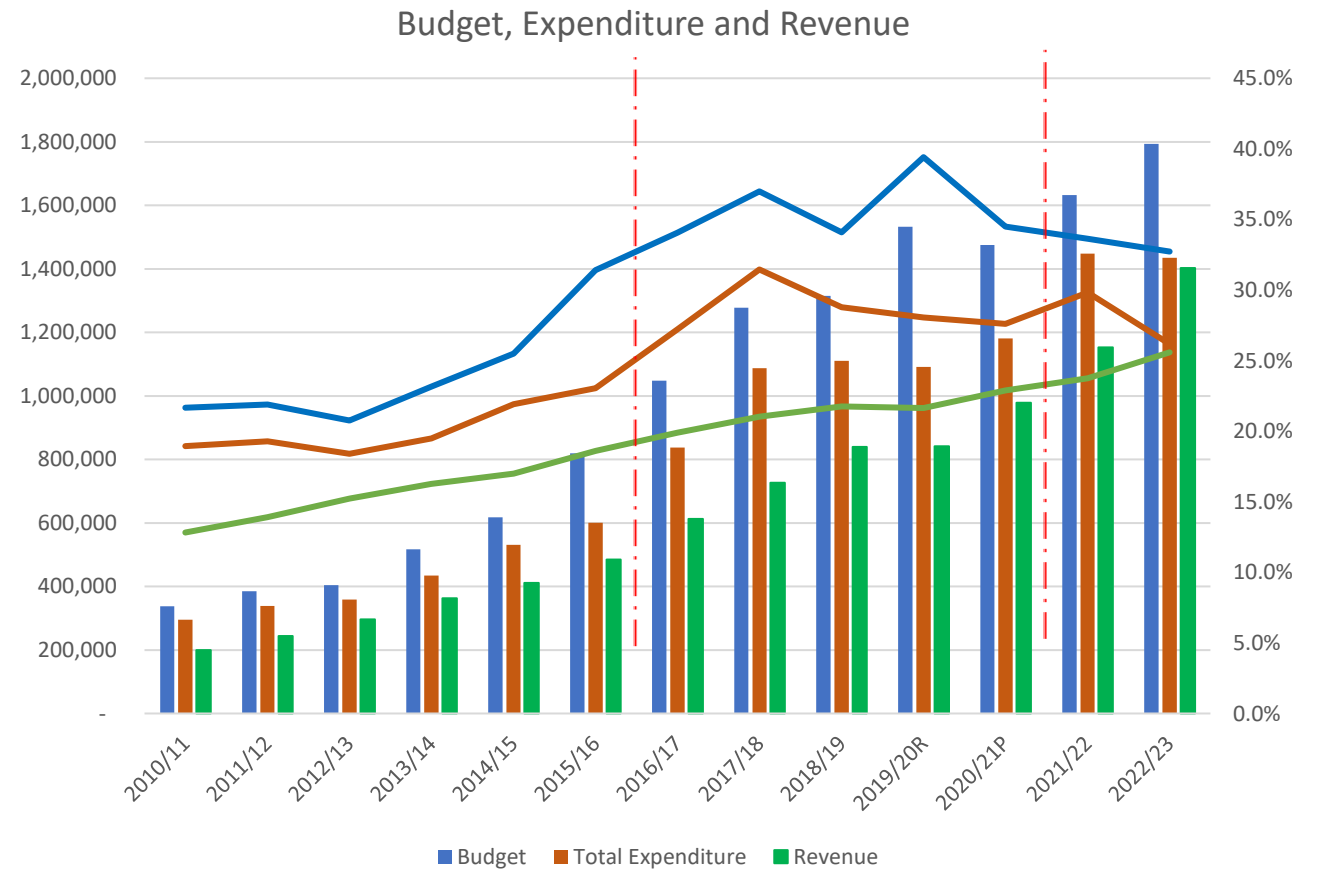
- 8% **GDP** growth
- 7% **Inflation**

## Other goals

- 30% **Employment** growth
- Increase **export** by 100% by next year (1yr)
- Increase **production** of basic food items by 30% (1yr)
- Decrease **import** by 20% and cereal imports by 30% (1yr) and achieve balanced trade in next 5 years
- Move 8 lakh people out of **poverty line** (when?)
- Improve **Human Development Index** (HDI) to 0.651 from 0.602 in 2019 (when?)
- Provide housing facilities to all the **landless Dalits** within next three years

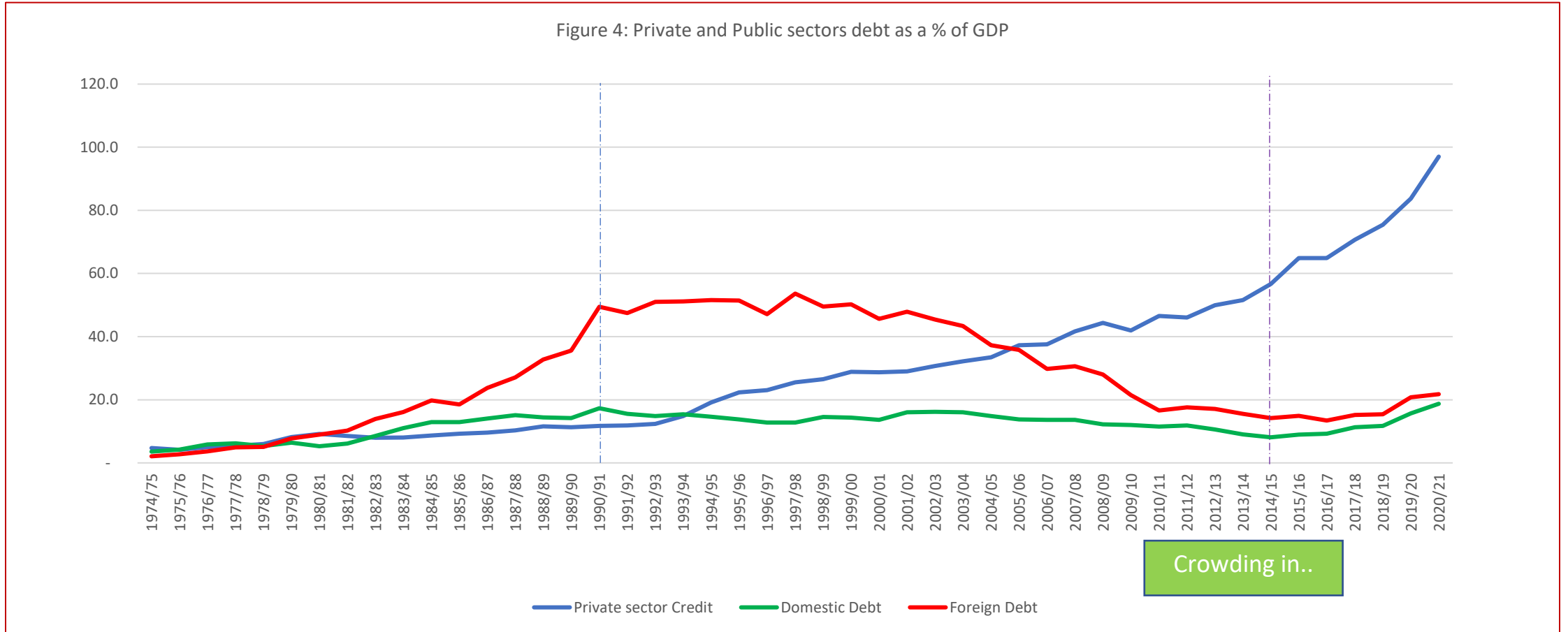
# Budget, Expenditure and Revenue

- Budget: NPR 1794 billion (32.7% of GDP)
- Gross Revenue: NPR 1403 billion (25.6%) – 21.7% increase
- Capital Expenditure: NPR 380 billion (6.9%)
- Budget Deficit: NPR 498 billion (9%)
- Five year's average (P5Y)
  - Budget: 35.8% (24.5)
  - Expenditure: 28.6% (20.4)
  - Gross Revenue: 21.4% (16.2)
  - Capital Expenditure: 6.2% (3.1)
- Peers: Expenditure vs. Revenue
  - Developing world: 18.4% vs. 14.8%
  - Emerging world: 31.6% vs. 27%
    - India: 27.5 vs. 20
    - China: 34 vs. 28
  - Advanced world: 38.6% vs. 35.6%





# Crowd in...



**2011-2017: Increasing FOREX, Average sovereign debt @ 26% of GDP, Budget @ 21% and Fiscal deficit @ 2.5%**

# Policy excesses

---

Senior citizen allowances (NPR 71 billion for 14.85 lakh people – 1.5% of GDP)

---

Disproportionate privilege to EV of up to 100 KW (Import duties- 260% vs. 30%)

---

Subsidy on Cooking Gas (one third households of urban middle class)

---

Assembly Plants and SEZ (Low value addition)

---

Highest minimum wage in the region and consecutive salary hike of government employees by 20% and 15%

# MACROECONOMIC POLICIES

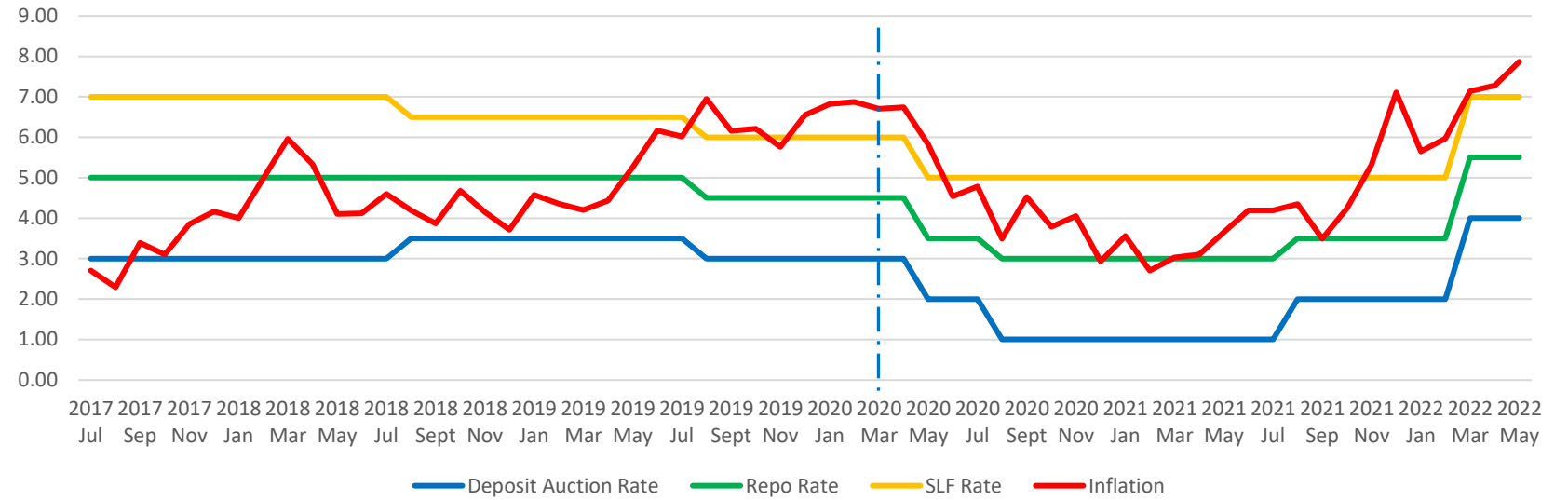
- **Fiscal Goals**
  - Economic Growth
  - Maximum Employment
  - Price stability
- **Measures**
  - Tax and Revenue Plans
  - Resource prioritization and allocation
  - Regular vs. Capital Expenditure
  - Subsidies, Social Transfers
  - Borrowing Plans

- **Monetary Policy Goals**
  - Price stability
  - External sector stability
- **Monetary Policy Tools**
  - Interest rate corridor (IRC)
  - Cash Reserve Ratio (CRR)
  - CD Ratio
  - Capital Adequacy Framework
  - Credit Risk Weightage
  - Spread rate
  - Credit policy
    - Priority lending
    - Concessional and refinancing facility

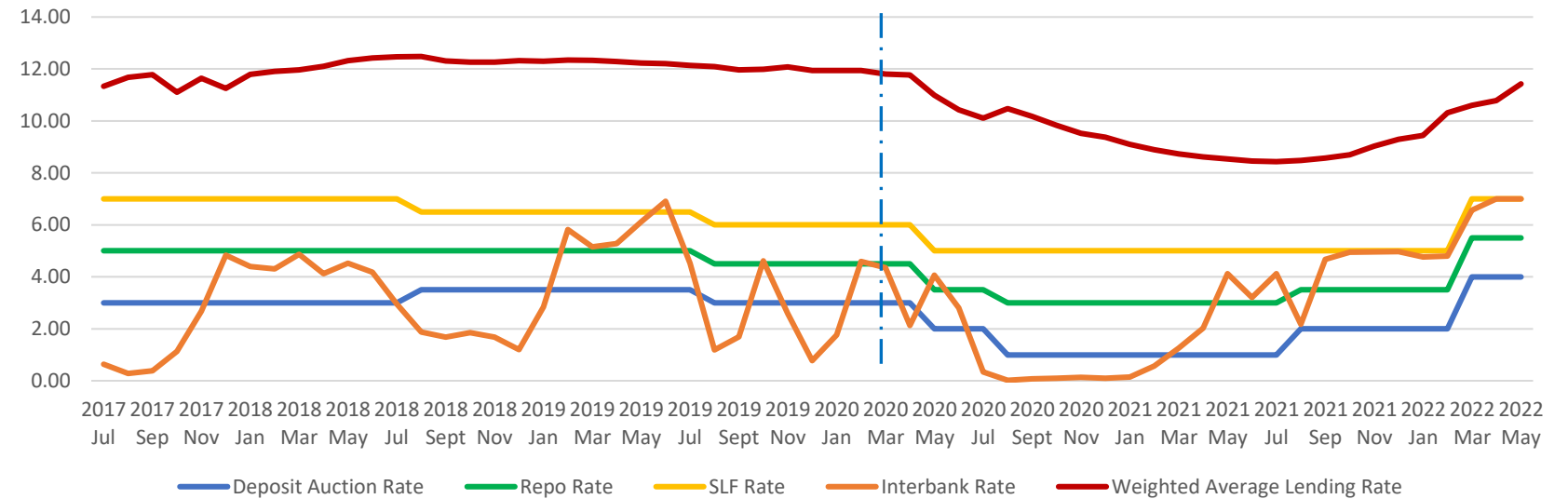
# Relevance of Interest rate corridor (IRC)

- Price stability
- Level of aggregate demand (AD) in the economy
- SLF rate, Repo rate and Deposit auction rate

Effectiveness of IRC on inflation



Effectiveness of IRC on money market



## Realities and Challenges

- Landlocked by India and China (Double landlocked?)
- Poor governance
- Poor infrastructure
- Unholy trinity - Low productivity, high price level and low domestic saving
- Dilapidated education system

# Key Strategies

- Control **bank credit**
- Control **land prices**
- Introduce **austerity** in public spending
- Promote **import substitution** on Agriproducts
- Promote **weightless and borderless** exports
- Transition from **labor export to service export**
- Reform **Education** system to build human capital that can become a part of the global value chain and workforce (IT, English, health professionals)
- Promote **electric cooking**
- Provide **foreign employment** opportunities to marginalized groups
- Promote industries that are based on **factor endowments**
- Crowd in **private** sector investment
- End the monopoly of **Indian migrant workers**
- Crack down on **informal flows** of foreign exchange and formalize outflows of remittance to India
- Outreach **beyond SAARC (Bangladesh)**
- Ensure **fuel security** at least for three months

# Key Priorities

---

A: Agriculture (Import Substitution)

---

B: Bangladesh (Beyond SAARC)

---

C: Carbon trade and Care Economy

---

D: Digital value chain (Weightless and Borderless)

---

E: Education (Skill, Employability and Enterprising)

---

F: Factor Endowments (Water, Minerals, Forest, Nature and Demography)

---

G: Green Economy



THANK YOU

