

Unit 4

Mixed Macroeconomic Performance of Nepal

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ABSTRACT

Nepal continues to remain an Least Developed Country (LDC) with a per capita income of around US \$ 300. The structure of the economy is fragile, the economic environment is not favorable, the performance of the economy is weak and the development indicators of the country are unfavorable. The economic problems and development challenges have remained as daunting as have been the efforts and measures required to mitigate them. The economy has mainly been characterized by a period of political transition and uncertain economic environment on account of the predominance of the non-economic factors in the economy. While the important sectors of the economy experienced slowdowns, imbalances, and even uncertainties, no clear symptoms so far appear to indicate the emergence of economic revival. Supply factors and constraints in supply management at times threatened the goal of price stability. Though there was sluggish output growth and higher inflation that portrayed symptoms of stagflation, the macroeconomic stability was not under threat even in such a difficult period, especially because of the prudence in fiscal management and the overall surplus situation in the external account.

Among the remarkable features of the economy, there have been positive developments in the front of resource mobilization by the government. Remittance flows worked as the lubricants for the sluggish economy. In the mean time, reduced external competitiveness of the economy, though made up by the remittance inflows, exhibited the structural deficiency of the economy to address which measures aimed at attracting investment and deploying resources toward export sector, employment generation and other productive purposes remain the main economic agenda. The slower and inadequate action on the part of the eight-party alliance that is at power but still lacks a common minimum agenda for addressing the fundamental national economic management problems makes it quite evident that the possibilities of early breakthroughs in reinvigorating the economy toward its desired ends are still remote. The recent macroeconomic performance could, therefore, be termed as the mixed one.

ECONOMIC GROWTH IN THE COMPARATIVE PERSPECTIVE

The comparative performance of Nepal in the context of the global economy as well as the Asian developing countries does not look comfortable. For example, world's real Gross Domestic Product (GDP) during the four-year period, 2003-2006, averaged 4.9 percent, with the Developing Asia (26 economies excluding these Asian economies, viz., Japan, Republic of Korea, Taiwan Province of China, Hong Kong Special Autonomous Region, Israel, and Singapore, which are categorized under the advanced economies, and 12 Middle East economies of Asia) recording a growth of 8.9 percent, according to the World Economic Outlook (WEO), April 2007, International Monetary Fund (IMF).

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The prominent economies in Developing Asia have been China, India, Indonesia, Thailand, Malaysia, Pakistan, Philippines, and so on. In South Asia also, the average annual GDP growth rate recorded by countries other than Nepal during 2003-2006 looks comfortable. The growth rate averaged 8.7 percent in Bhutan, 8.4 percent in India, 7.4 percent in Maldives, 6.6 percent in Pakistan, and 6.2 percent each in Bangladesh and Sri Lanka. Nepal's position, however, was unsatisfactory as the GDP growth rate during the four-year period, FY 2003/04 through FY 2006/07, averaged 3.3 percent (4.7 percent in FY 2003/04, 3.1 percent in FY 2004/05, 2.8 percent in FY 2005/06, and 2.5 percent in FY 2006/07). With the population growth rate estimated at 2.2 percent, the average annual per capita GDP growth during this period was 1.1 percent only. As for the future also, the scenario in Nepal is not projected as optimistic. According to the WEO, Developing Asia is projected to grow by 8.8 percent in 2007, with the South Asian economies also expected to register respectable growth rates: Bhutan 15.2 percent, India 8.4 percent, Sri Lanka 7.0 percent, Bangladesh 6.6 percent, and Pakistan 6.5 percent. Nepal, however, is projected to grow by 3.5 percent only, according to the WEO. For 2008 also, Developing Asia is projected to grow by 8.8 percent. The projections for South Asia in 2008 are: Bhutan 8.6 percent, India 7.8 percent, Sri Lanka 7.0 percent, and Bangladesh and Pakistan 6.5 percent each. Nepal's projection is still modest at 4.0 percent. Such weak growth performance and prospects reflect Nepal's serious development constraints characterizing deep structural problems and inadequate development efforts the solutions of which would call for the highest priority and urgent actions in the critical areas of the economic management.

EXTERNAL SECTOR

Besides the very low economic growth performance, another significant structural problem of the economy of Nepal lies in the weakness of the export sector. During FY 2006/07, exports to India rose by 2.8 percent while those for the other countries declined by 3.1 percent, with the aggregate exports rising by 0.9 percent as compared to the growth of 2.6 percent (India 4.6 percent and other countries -1.1 percent) in FY 2005/06. Major export commodities to the other countries like the ready-made garments, woolen carpets, and Pashmina experienced export declines by 16.1 percent, 4.1 percent and 41 percent respectively during FY 2006/07. The ratio of exports to imports, or the import financing capacity of the exports, fell to 31.7 percent in FY 2006/07 from 39.3 percent in FY 2004/05. The export/import ratio with India fell from 43.9 percent to 35.6 percent and that with the other countries from 32.5 percent to 25.6 percent between FY 2004/05 and FY 2006/07. This shows that not only the overall exports/imports ratio is weak but also that the exports/imports ratio for countries other than India has become more vulnerable over the years. The share of exports in total trade fell from 28.2 percent in FY 2004/05 to 24.1 percent in FY 2006/07, implying the corresponding rise in the share of imports in total trade, from 71.8 percent in FY 2004/05 to 75.9 percent in FY 2006/07. The exports/GDP ratio came down to 8.4 percent in FY 2006/07 from 10 percent in FY 2004/05. Accordingly, the trade deficit/GDP ratio rose from 15.4 percent in FY 2004/05 to 18.2 percent in FY 2006/07. Such weak export performance reflected the reduced competitiveness of the economy besides negatively affecting the economic growth of the country. Tourism receipts in FY 2006/07 rose by 6.0 percent over an 8.7 percent decline in FY 2005/06, signaling positive development in this sector. The tourism payments increased by 32 percent in FY 2006/07 compared to a rise of 23.4 percent in FY 2005/06. One unfavorable development with respect to tourism since FY 2005/06 has been the negative figure of the net tourism earnings, reflecting the excess of the tourism payments over the tourism receipts. The negative earning amounted to Rs 5.7 billion in FY 2006/07 (receipts Rs. 10.1 billion and payments Rs. 15.8 billion) from a negative Rs 2.4 billion (receipts Rs. 9.6 billion and payments Rs. 12 billion) in FY 2005/06, implying deterioration in the inflows vis-à-vis the outflows in this important sector of the economy in FY 2006/07. The Balance of Payments (BoP)

surplus narrowed down in FY 2006/07. The BoP surplus in FY 2005/06 was Rs 25.6 billion, which fell to a surplus of Rs 5.9 billion in FY 2006/07, marking a reduction of 77 percent in FY 2006/07 compared to the growth of 345.8 percent in FY 2005/06. The contraction in the BoP surplus resulted from the reduction in the current account surplus which was mainly attributed to the reduced growth in the current transfers. Though the workers' remittances rose by 2.5 percent to Rs 100.1 billion in FY 2006/07, the growth rate was far below the 49 percent to Rs 97.7 billion recorded in FY 2005/06. Despite the BoP surplus, the official forex reserve in the domestic currency terms saw zero rise to Rs. 165 billion in mid-July 2007, compared to the growth of 27 percent in mid-July 2006, due to the appreciation of the domestic currency. The reserve remained at Rs. 165.1 billion in mid-July 2007 and the merchandise import capacity of the reserve fell from 11.4 months in mid-July 2006 to 10.3 months in mid-July 2006. In US\$ terms, however, the forex reserve rose by 14.3 percent to US\$ 2.5 billion in mid-July 2007 compared to the growth of 20.6 percent to US\$ 2.2 billion in mid-July 2006. In a nutshell, the growth trends and the balances in the merchandise trade and other external sector transactions signal that the external competitiveness of the economy has weakened. However, the comfortable forex level despite the reduced BoP surplus implies that there are no immediate risks and vulnerabilities in the external sector of Nepal.

GOVERNMENT FINANCE

Growth in resource mobilization by the government has remained a favorable indicator during FY 2006/07. The revenue during FY 2005/06 was Rs 72.3 billion. The target for FY 2006/07 had been Rs 85.4 billion, an increment of 18.1 percent over the previous year's realization. The actual revenue mobilized during FY 2006/07 exceeded the target and aggregated Rs 87.3 billion, an increment of 20.8 percent over the 3.1 percent growth in FY 2005/06. As per the revised estimates of the budget, foreign grants witnessed a growth of 15.3 percent to Rs 16 billion in FY 2006/07 as compared to a decline of 3.9 percent in FY 2005/06. Speedier expansion of the recurrent expenditure and the capital outlays resulted in the growth of the total expenditure at a rate (18.9 percent) higher than the previous year's (8.1 percent). However, the rise in the non-debt resources by 18.6 percent in FY 2006/07 as compared to the lower rise of 1.9 percent in FY 2005/06 resulted in the slower fiscal deficit growth at 20.1 percent in FY 2006/07 compared to the rise of 37.3 percent in FY 2005/06. The domestic borrowing of Rs 17.9 billion by the government to meet the expenditure needs as well as the issue calendar targets so as to help improve the resource management and financial market conditions resulted in a treasury surplus of Rs 3.0 billion in mid-July 2007 over an overdraft of Rs 1.1 billion in mid-July 2006. Even in a difficult situation, the government has been able to maintain a fiscal deficit/GDP ratio at 4.1 percent in FY 2006/07 which was 3.8 percent in FY 2005/06. The welcome step on the public finance front in the year under review has been the progress made in the mobilization of resources through revenue and foreign grants and the control in the growth of the fiscal expansion. Notwithstanding this positive feature, the mobilized resources could not be deployed into the capital outlays to the extent envisaged on account of the problems facing the spending units in the government, hence affecting the productive utilization of these resources along with the economic growth scenario.

MONETARY SECTOR

The monetary policy for FY 2006/07 had targeted broad money and narrow money growth rates at 16.1 percent and 15.4 percent respectively. Similarly, the domestic credit growth was estimated at 15.8 percent and the private sector credit growth at 18 percent. The growth rate of the net foreign assets was estimated at 11.6 percent and that of the net domestic assets at 19.1 percent. Though the net foreign assets of the banking system in FY 2006/07 rose by a slower rate of 4.2 percent over the growth of 23.8 percent in FY 2005/06, the growth of the net domestic assets by 20.5 percent in FY 2006/07 over the 11.1 percent growth in FY 2005/06 resulted in a broad money growth of 14 percent in FY 2006/07 compared to

the growth of 15.6 percent in FY 2005/06. Banking system's claims on the private sector rose by 18.9 percent in FY 2006/07 over the 14.4 percent growth experienced in the previous year. FY 2006/07 also marked a significant rise in the banking system's claims on the private sector which, as percent of the domestic credit, reached 76.9 percent from 75.5 percent in the previous year. In FY 2006/07, the narrow money grew by 12.1 percent compared to the rise of 14.2 percent in FY 2005/06. The time deposits grew by 14.9 percent in FY 2006/07 compared to the rise of 16.4 percent in FY 2005/06. However, the larger domestic credit growth at 16.7 percent in FY 2006/07 compared to the growth of 11.7 percent in FY 2005/06 along with the larger private sector credit growth could not be transmitted into the output expansion as desired since the GDP growth is estimated to have been significantly squeezed to 2.5 percent in FY 2006/07. So, the credit expansion in relation with that of the previous year did not support output expansion in the country. However, there were some price implications of the credit expansion as well. The price rise remained at the relatively higher side despite the slower growth of the monetary aggregates vis-à-vis the estimates, signaling that the supply and the non-economic factors played a prominent role in bringing about the price uncertainties.

PRICE SITUATION

Though reduced from the previous year's level, the price situation in the country became unstable and remained at a higher side. As measured by the consumer price index, the average price rise during FY 2006/07 reached 6.4 percent, higher than the rate of 8 percent in the previous year. The price rise on a point-to-point basis during FY 2006/07 reached the peak at 8 percent in the seventh month followed by the gradual deceleration at 6.2 percent in the eighth month, 5.6 percent in the ninth month, 4.6 percent in the tenth month, and 4.5 percent in the eleventh month. The price rise, however, recorded slightly higher at 5.1 percent in the twelfth month, averaging 6.4 percent for the entire fiscal year. Groupwise, the food and beverages index rose by 7.2 percent in FY 2006/07 over the 7.8 percent rise in FY 2005/06. The non-food and services prices recorded a rise of 5.5 percent in FY 2006/07 over the 8.1 percent rise in FY 2005/06. The large price rise in the essential consumer items like pulses and spices in the food category and the consumer services like the transport in the non-food group would negatively affect the common people. The rate of core inflation at 6 percent in FY 2006/07 as compared to the rate of 4.5 percent in FY 2005/06 indicated that the items other than the rice, fruit, vegetables, energy and transport also played a prominent role in maintaining the inflation at 6.4 percent. The wholesale price index in FY 2006/07 rose by 9 percent similar to the 8.9 percent rise in FY 2005/06. The wholesale prices of the agricultural commodities, domestically manufactured commodities and the imported commodities in FY 2006/07 rose by 11.6 percent (9.9 percent in FY 2005/06), 8.5 percent (3.6 percent in FY 2005/06), and 5.6 percent (10.7 percent in FY 2005/06) respectively. Especially at a time when the output expansion and per capita GDP growth are considerably slow and the income inequality is significant, price rise above 5 percent level could adversely affect the purchasing power and living standards of the majority of the people who have insufficient income sources and need to procure most of the consumption items from the market.

CONCLUSION

Nepal's development problems and challenges remain complex and require both the intensive measures of correction and extensive measures of expansion. FY 2006/07 unfolded some symptoms of optimism in the form of increased resource mobilization by the government though the deployment of these resources for their optimal utilization could not occur as desired due to the constraints and challenges faced by the spending units of the government. The export sector shrank which, coupled with less than the expected growth in the capital outlays of the government account along with the banking system's credit expansion not supporting the domestic output growth, reduced the GDP growth and also could not positively impact the related development variables. The price rise remained at a relatively higher side. The expectations

with respect to the prospects of increased investment and growth in the economy could not materialize. Remittance became the major source of external sector receipts though the export shortfall and negative trends in the net tourism receipts exhibited symptoms of weaker external competitiveness of the economy. So, strong economic vision and the determination to steer the economy ahead for bringing about improvements in the resource mobilization, capital expenditure, employment generation, export promotion, economic growth, and external sector competitiveness have become the urgent priority actions.