Nepal Economy: Challenging Times Ahead in FY24

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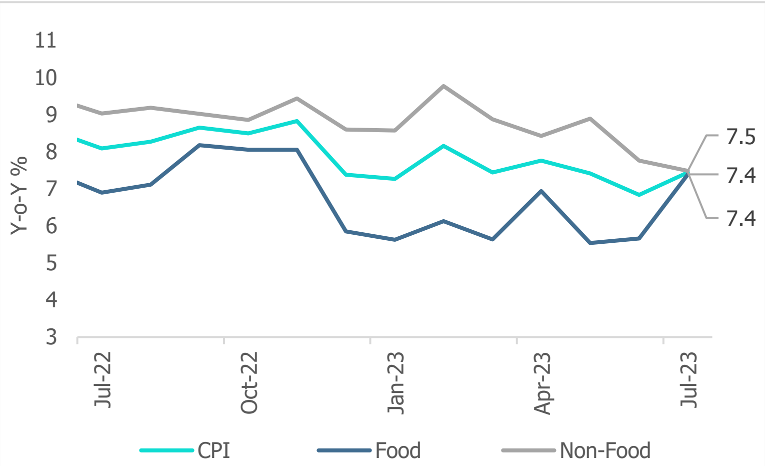
The path to Nepal's economic recovery in FY24 is likely to be a bumpy one. While a revival in the tourism industry, pick up in remittances and replenishing of forex reserves bodes well for the economy, there are several headwinds that could offset the positive impact. Elevated inflation, high import dependency amidst soaring global food prices, declining exports, and discouraging foreign direct investment flows pose a threat to the economic outlook.

Retail Inflation Averages 7.7% in FY23

Retail inflation rose to 7.4% y-o-y in July, from 6.8% a month ago, taking the fiscal year average to 7.7%, 70 bps higher than the central bank's target of 7%. The uptick in headline inflation in July was led by food inflation, driven by vegetable and protein items. Inflation in 'cereal grains and their products', which accounts for 11% of the CPI basket, however, eased marginally. In contrast, non-food and services inflation moderated to 7.5% y-o-y in July, from 7.8% in the previous month. In FY23, the increase in the prices of cereals, dairy products, spices, household consumables, imported goods, and fuel along with the depreciation of the Nepalese Rupee generated pressure on inflation. Going ahead, the uptick in global food prices, especially that of edible oils, and crude oil prices is likely to play out on imported inflation.

FY23 Average Inflation Overshoots Central Bank Target



Source: Nepal Rastra Bank

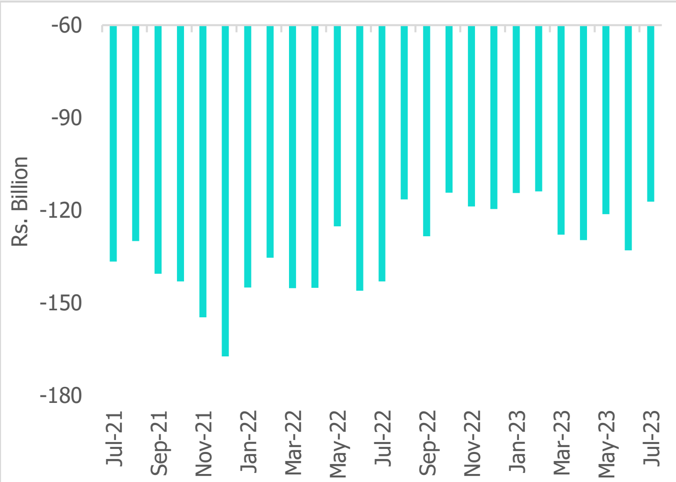
Lower Imports Improve Trade Balance in FY23

In FY23, Nepal's trade deficit narrowed to Rs 1,455 billion compared to a deficit of Rs 1,720 billion in the previous year. The narrowing of the deficit was on account of a fall in both exports (-21% y-o-y) and imports (-16% y-o-y). The decline in imports in FY23 can be attributed to the import bans that the government imposed in an effort to build its foreign exchange reserves and control inflation. A 33% (y-o-y) decline in crude oil prices in the international market in July has also supported the trade balance position. Improvement in the trade position helped Nepal's current account deficit narrow significantly this year. The current account deficit narrowed to Rs 72.16 billion in FY23, lower than the gap of Rs 623 billion reported last year.

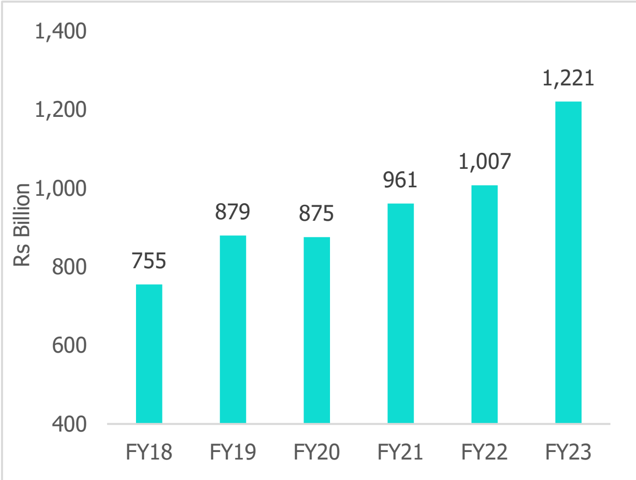
Meanwhile, remittances continued to record healthy growth in FY23. For the full fiscal year, workers' remittances stood at Rs 1,221 billion, up 21% from the previous year. This can be attributed to the 40% rise in the number of

Nepalese going for foreign employment. Going ahead however, Nepal Rastra Bank expects the growth rate of remittance inflows in 2023-24 to moderate given the higher base of remittance inflows in 2022-23.

Nepal's Trade Deficit Narrows in FY23



Workers' Remittances Rise 21% in FY23



Source: Nepal Rastra Bank

With the rise in remittances income, Nepal's foreign exchange reserves increased 23% (y-o-y) to USD 11.7 billion in July, the highest level since May 2021. The current level of forex reserve is sufficient to cover imports of goods and services for 10 months, up from 6.9 months a year ago. This augurs well for a country that is heavily dependent on imports. However, there remains a risk of downward pressure on FX reserves if remittances moderate and imports grow significantly in FY24. Keeping this in mind, NRB has aimed to prioritise export and tourism promotion, foreign investment, and remittance inflows through formal channels for sustainable improvements in the external sector. The decline in imports and increase in the flow of remittances has however improved the balance of payment position in FY23, even though foreign direct investment (FDI) flows remained depressed. FDI inflows declined 71% to USD 45 million in FY23. Nepal's balance of payments remained at a surplus of Rs 291 billion in the fiscal year, compared to a deficit of Rs 255 billion last year.

Tourism Industry Remains Supportive

In FY23, tourist arrivals totalled 8,62,992, up from 3,74,147 arrivals seen a year ago, following the easing of international travel restrictions after a pandemic-induced slump in the tourism industry in the previous two years. Nepal has designated 2025 as a 'special year for tourism', announcing efforts to support the recovery of the tourism industry. The government plans to revise tourism-related laws, develop infrastructure to promote destinations amongst the international community, identify and develop new tourist destinations, mitigate safety-related issues, promote film tourism, and create opportunities for adventure tourism. As a result, we could expect the positive contribution of the tourism industry to contact-intensive service sectors to continue in the near term.

Way Forward

The outlook for Nepal's economy in FY24 remains surrounded by challenges. A lot depends on the effective implementation of reforms and measures announced during the budget and a consequent improvement in government finances. Given the ongoing global slowdown, we may also see exports and remittances moderate. Moreover, imports are expected to further pick up given the recent rise in global prices of crude oil, edible oils, and essential food items, all of which are largely imported. Reports suggest that Nepal has requested supplies of paddy, rice, and sugar from the Indian government as a precautionary measure to address possible food shortages during the upcoming festive season. Apart from India's ban on exports of non-basmati rice on July 20, a 40% export duty by India on onions earlier this month could further exacerbate shortages of the item in Nepal. This implies that food inflation could move higher in the coming months, pulling the headline CPI inflation higher than NRB's target of an average of 6.5% for FY24. Moreover, higher imports would also put pressure on foreign exchange reserves in the year. As a result, declining import cover and stubborn inflation could test the central banks 'cautiously accommodative stance' adopted for FY24.

(Note: Data for July is for the month-ending mid-July)

Monthly Data of Key Economic Variables

Indicators (Mid-Month)	March 2023	April 2023	May 2023	June 2023	July 2023
Consumer price inflation (y-o-y%)	7.4	7.8	7.4	6.8	7.4
Wholesale price inflation (y-o-y%)	7.1	5.6	3.3	3.1	4.9
Export growth (y-o-y%)	-29	5	-1.2	1.58	-4.5
Import growth (y-o-y%)	-19	-9	-3	-8	-17
Trade deficit (Rs billion)	127.8	129.6	121.1	132.9	117.2
Worker's remittances (Rs billion)	794.3	903.3	1,005	1,112	1,220
Foreign exchange reserves ($ billion)	10.7	10.9	11.2	11.2	11.7
Domestic credit (y-o-y%)	8.1	8.6	8.4	8.8	8.7
Deposits (y-o-y%)	10.5	11.0	11.4	12.2	12.3
Bank rate (%)	8.5	8.5	7.5	7.5	7.5
Weighted average deposit rate (%)	8.4	8.3	8.1	8.0	7.8
Weighted average lending rates (%)	13.0	12.8	12.7	12.5	12.3

Source: Nepal Rastra Bank

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