

## **Recent Macroeconomic Development of Nepal**

### ***Imbalances, causes, and way forward***

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#### ***Abstract***

*This article analyzes Nepal's macroeconomic developments in the post-COVID-19 context, emphasizing key trends, emerging imbalances, and policy challenges. While the economy demonstrated resilience through a rapid recovery in GDP growth, it simultaneously encountered inflationary pressures, external sector stress, and rising fiscal deficits. The paper explores the structural roots of macroeconomic imbalances, such as expansionary monetary policies, excessive liquidity, growing public debt, and the current account deficit. It also contrasts Nepal's performance with South Asian neighbors and outlines actionable policy recommendations. These include fiscal and monetary reforms, better macroeconomic coordination, and the need for a second-generation economic reform agenda to ensure long-term stability and inclusive growth.*

**Keywords:** *Macroeconomic development, current account deficit, monetary policy, fiscal deficit, external sector, concessional loans, structural reform*

#### **Macroeconomic development after the COVID-19 pandemic**

- Let me discuss the post-COVID macroeconomic development. First, the economy which went into recession after the COVID-19 shock in 2020 has almost recovered recently. The recovery is reflected in the real GDP growth of 4.2 percent in 2021, and 5.8 percent in 2022. The quick rebound of the Nepalese economy is very impressive, indicating some

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degree of resiliency. Despite this recovery, the economy is under inflationary pressure after November 2021. The consumer price inflation averaged 8.17 percent in the first five months of the current fiscal year 2022/23.

- Second, the external sector is under pressure after August 2021. The balances of payments remained in deficit until October 2023 due to the surges in import demand, the slowdown in workers' remittances, and tourism income. For instance, the merchandise imports increased by 28.7 percent, and the remittances increased by only 9.8 percent in the fiscal year 2021. The drain on foreign exchange reserves began in August 2021. At its lowest level, the reserve was just enough to cover 6.6 months of imports of goods and services in mid-May 2022. When the reserves accumulated during the initial phase of the COVID-19 pandemic started depleting rapidly along with a balance of payments deficit, there was a deep policy concern about external sector stability just a few months ago. The issue of a potential external sector crisis took on the mouths of academicians, journalists, policymakers, and even the public. In the meantime, several policy measures have been introduced such as the reduction of the gold imports quota, cash margins on imports of certain products, and restriction on imports of certain goods.
- In recent months, the external sector shows some signs of improvement along with the slowdown in imports, and an uptick in workers' remittances. But the improvement is questionable: Is this sign just a temporary phenomenon or an outcome of the improvements in all macroeconomic fundamentals? Is it mainly supported by import restrictions on certain goods? For instance, merchandise imports declined by 23.3 percent, and workers' remittances increased by 23 percent in the first five months of 2022/23. As a result, the BOP is in surplus of Rs. 45.8 billion, and the reserve is sufficient to cover 8.7 months of imports of goods and services. These data suggest that we need to be careful before confidently saying that the external sector outlook is good.

- Third, the Nepalese financial system remained resilient during and after the COVID-19 pandemic, and the loose monetary and financial sector policies assisted the quick recovery after the COVID-19 lockdown. But there are several potential implications of the loose monetary and financial policies. Let me briefly discuss the monetary and financial sector development first. In response to the COVID-19 pandemic, Nepal Rastra Bank (NRB) took significant steps by implementing expansionary monetary policy and easing credit policies including macro prudential policies. The NRB reduced policy rates, and inject liquidity into the economy. As a result, the interbank rate remained very low below 2 percent from July 2020 to March 2021, and even less than 0.5 percentage points for five months. The banking system had huge excess liquidity during this period, even more than Rs. 200 billion around November 2020. This pushed the broad money supply to more than 20 percent around this period. This excess liquidity also pushed the private sector credit up, which reached its peak of 32.5 percent in mid-September 2021.
- To fight against potential economic damage that may come from the COVID-19 pandemic, the NRB massively provided refinancing facilities to support the business, and also loosened the credit policies, and relaxed many regulatory tools. The concessional loan has also increased in which the Government of Nepal provides interest rate subsidy. Likewise, the example of such policies includes the reduction of the loan-to-value ratio, loan restructuring/rescheduling, and loose margin lending policy.
- There are obvious implications of excess liquidity for the long-time period, large refinancing, continuing concessional loans, loose credit, and regulatory policies. Of course, these supported quick economic recovery through higher aggregate demand. The data shows that the stock market boom, import surges, and potential real estate prices boom followed after some time lag of the implementation of these policies. The stock index (NEPSE) began rising around July 2020 at a level of around 1200 points, reached its peak in August 2021 at about 3200, and

then declined to about 1800 in September 2022. The excessive import growth began around July 2021 and continued until May 2022. At the same time, excessive credit growth also occurred during the period of June 2021 to March 2022.

- Finally, the government of Nepal also continued its trend of rising expenditure, fiscal deficit, and public debt in recent years. The implementation of federalism in 2017 caused a break in recurrent government expenditure, fiscal deficit, and public debt. This new trend continued during and after the COVID-19 pandemic. For instance, government expenditure increased by 39.3 percent in 2017. In terms of the size of GDP, government expenditure increased from 23 percent in 2016 to 27 percent in 2017. On the other hand, the government revenue was just 20 percent of the GDP in 2017. Likewise, in terms of GDP, the government expenditure is 27 percent, and revenue was 23 percent of GDP in 2022. Accordingly, the fiscal deficit was about 7 percent in 2017, and about 6 percent in 2022. As a result, the public debt to GDP ratio was 22.7 percent in 2017, 27.2 percent in 2019, 36.9 percent in 2020, and 41.6 percent in 2022. This growing trend of recurrent expenditure, and public debt is a serious concern after the COVID-19 pandemic.

### **Potential macroeconomic imbalances**

- Now, let me discuss the recent macroeconomic development from the perspective of macroeconomic imbalances. We often do not talk about the root causes while portraying the macroeconomic problems. It is important to consider complex macroeconomic linkages here.
- One of the potential macroeconomic imbalances is the growing current account deficit. Nepal has been facing a current account deficit since 2017 and reached 12.8 percent of GDP in 2022. The deficit was 7.8 percent of GDP in 2021. In simple terms, the current account deficit means we are investing more than saving. It may be either by the private sector or the government. But the interesting case is the post-COVID situation. The deficit was so huge that the BOP deficit became very high, depleting foreign exchange reserves rapidly. Just to blame,

one can say at the surficial level that the deficit arises due to the surges in imports after the post-COVID recovery phase, and the slowdown in workers' remittances. No, we cannot stop here. We need to dig deeper into the fundamentals of this external sector imbalance and crisis.

- To understand this post-COVID external sector imbalance, one needs to look back at the monetary expansion, and eased credit policies too. In the external sector analysis, we always need to remember the exchange rate peg with India. How can a central bank expand the money supply in the pegged exchange rate system? Is there a limit on the monetary expansion given the exchange rate peg? Yes, there is a limit on the money supply by a central bank if there is an exchange rate peg. If a central bank implements too loose monetary policy, it will be reflected in increased aggregate demand through various channels such as asset prices, and Wealth effects. As a result, import demand will increase, creating pressure on the current account, the BOP, and overall external sector stability.
- Can we link the post-COVID rise in the current account to monetary expansion? Yes, as noted earlier, the surges in imports and the rise in the current deficit came late after the rapid monetary expansion immediately after the COVID-19 shock. On the one hand, the NRB injects liquidity through monetary operations, which keep the interest rates very low for more than a year. On the other hand, the NRB provided a refinancing facility massively which increased from Rs. 7.5 billion in mid-July 2020 to its peak at Rs. 158.4 billion in mid-January 2022. This refinancing is purely money supply from printing money. In addition, there is a huge concessional loan subsidized by the Government of Nepal. The concessional loan in which the government provided interest subsidy increased from Rs. 59.6 billion in mid-January 2020 to Rs. 209.3 billion in mid-December 2022. Obviously, the question is: where did this cheap money go? In the immediate aftermath of the COVID-19 pandemic, these policies assisted to boost demand, which speed up economic recovery and minimized the damage from the pandemic shock. But, these sources of cheap money

continued for a long time after COVID. Once available for a longer period, one can say that the cheap money may have gone to the stock market, real estate, and other asset markets, creating a boom in asset prices (such as the boom in Nepal Stock Exchange-NEPSE). The asset prices boom, especially stock and real estate prices, may have further boosted demand, which further raises the imports in the absence of domestic production. The resulting surges in import demand may be a cause of the excessive current deficit, and thus the BOP deficit after COVID-19.

- The second factor behind the external sector imbalances is the growing fiscal deficit and the public debt. In simple terms, the fiscal deficit is directly linked to the current account deficit which we call the ‘twin deficit’ problem. Growing fiscal deficit directly causes current account deficit through the surges in imports. The rising fiscal deficit after 2017 is directly pushing the current deficit up, and this problem became more severe after the post-COVID years. The debt- to-GDP ratio increased from 22.7 percent in 2017 to 41.5 percent in 2022. This trend is alarming in Nepal’s macroeconomic development which has implications for both domestic and external balances.
- The macroeconomic imbalances and potential factors discussed above may have several implications. For instance, the cheap money provided after COVID-19, especially refinancing and concessional loans, may have severe distributional consequences. If this cheap money is in the hands of the targeted group, it meets the goal of addressing poverty. If this cheap source of money (mostly taxpayers’ money) is misused and go into the wrong hands, it misallocates resources, wastes taxpayers’ money, and raises inequality. Since there is a huge information asymmetry in credit markets, including the weakness in the supervision and monitoring of such cheap money lending, we doubt this cheap funding. Thanks to the NRB for the fact that it has finally curtailed refinancing by a significant amount in January 2023. I think that it is high time to think about the outstanding concessional loan of Rs. 200 billion.

- One more implication I want to talk about is the worrying level of public debt. And, the trend of fiscal deficit, and public debt does not seem in the right direction in recent years. In simple terms, rising debt means that we are borrowing from future generations to spend today. But the question is: Where are we spending this borrowed money? After federalism, the government is just spending more on the recurrent part rather than on capital goods. If we are just consuming the borrowed money from future generations, this is a very sad part of the fiscal story. On the other hand, if we are investing in capital goods, it will increase production and growth which will better off the future generation and help pay back the debt incurred today.

### **Macroeconomic development in South Asia**

- South Asian economies also recovered quickly after the COVID-19 pandemic and showed strong resiliency. Bangladesh, Bhutan, India, Pakistan, and Sri Lanka grew by 7.2 percent, 6.9 percent, 8.7 percent, 5.7 percent, and 3.3 percent respectively in 2021. The IMF projects that India will grow by 6.8 percent, Bangladesh by 4.4 percent, Bhutan by 7.2 percent, and Pakistan by 6.7 percent in 2022. But Sri Lanka is projected to contract by 8.7 percent in 2022.
- South Asian region is under inflationary pressure along with oil price hikes, and the Russia- Ukraine war. In 2021, consumer price inflation was 5.6 percent in Bangladesh, 12.6 percent in Bhutan, 5.5 percent in India, 6 percent in Sri Lanka, and 8.9 percent in Pakistan. The IMF projection for 2022 is 6.1 percent for Bangladesh, 7.7 percent for Bhutan, 6.9 percent for India, 48.2 percent for Sri Lanka, and 12.1 percent for Pakistan.
- Despite heterogeneity and low regional integration, Nepal has very high integration with India in terms of trade, foreign investment, and labor mobility. Due to the exchange rate peg, Nepal's inflation is closely following India's inflation. Thus, the spillover from India to Nepal is high, and Nepal needs to consider this linkage.

## **The way forward**

- Now, I want to discuss some possible ways forward considering the recent macroeconomic development, and potential imbalances. I just highlight some key macro issues rather than talking about the details.
- First, it is important to comprehensively analyze, and implement fiscal reforms. Is Nepal's public debt exploding? Since 2017, the debt-to-GDP ratio is increasing at the average rate of about 4 percent of GDP. It is time to think about where we are heading at this rate of debt. Is it sustainable in the medium term? What are the implications of this huge debt? Where are we spending this borrowed money? Why is the tax revenue falling behind accelerating government expenditure? These are thoughtful questions. These fiscal imbalances appeared after the implementation of Federalism. As noted earlier, the fiscal imbalance has already appeared in external sector imbalances, a large current account deficit. Thus, if we ignore the fiscal reform, it will have a serious political question over the Federal system. The fiscal reform also requires comprehensive civil service reforms. For now, it is important to reform the government expenditure side, especially recurrent expenditure. At the same time, tax reform is crucial in order to expand revenue-generating capacity.
- Second, the timing of monetary and financial policies is really important. The NRB has used its tools at right time during the period of COVID-19. But there are questions about the timing of normalization or reversing back those policies. It is important for the NRB to analyze the time lag of the effects of its policies. The lagged effect of monetary and financial policies may range from months to years. As noted earlier, the stock market boom, the surges in imports, and the current account explosion appeared after a lag of the huge monetary expansion, including refinancing. If the reversal of the policies does not occur at the right time, it distorts the economy and creates imbalances.
- Third, it is time to rethink this huge amount of concessional loans provided by the Government of Nepal. Is this loan at the hand of the targeted group? Is there a possibility of misuse of this concessional



loan? As in developing countries, Nepal is also facing the problem of information asymmetry, weak governance, low transparency, and weakness in supervision/monitoring. I think that we need to reevaluate this concessional loan policy and make a strong governance mechanism for the continuation of this policy.

- Fourth, it is important to improve the coordination between macroeconomic policies, especially monetary, fiscal, and other policies. This year was an example of sad history in this regard. It is not good to play the blame game at the cost of public suffering. In the last year, the removal of the Governor shows a bad sign of the coordination among the policies during the period of heightened uncertainty and external sector pressure.
- Fifth, making the Nepalese monetary and financial policies forward-looking is crucial in the current situation of heightened uncertainty. The uncertainty is coming from the Russia-Ukraine war, oil price volatility, global inflationary pressure, and tight monetary policies by the central banks in advanced and emerging economies. The NRB needs to enhance its capacity to operate policies under uncertain environments.
- Finally, Nepal needs the next generation of economic reform, including the financial sector reform, to enhance productivity, and growth and remove the imbalances noted earlier. The gain from the comprehensive reform in the 1990s has already been reaped. Now, to kickstart the economy ahead in the high and sustained growth path, it is crucial to start a second generation of comprehensive reform including all parts of the economy.

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