CARE Ratings NEPAL

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Country: Nepal

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Background

Nepal, officially the Federal Democratic Republic of Nepal, is a landlocked country located in South Asia, bordered by China in the north and India in the south, east and west. The total area of Nepal is 1,47,181 sq km and is slightly larger than New York state. The estimated population of Nepal in July'2017 was 29.3 million making it the 45th populated country in the world. Hinduism is the dominant religion followed by 80% of the total population. As per the 2011 national census, there were 123 languages spoken, of which the major languages are Nepali (45%), Maithali (12%) and Bhojpuri (6%). Nepal has a federal parliamentary republic form of government and Kathmandu is the capital of Nepal.

Economic Overview

Nepal is one of the lesser developed countries in the world, with about one-quarter of its population living below the poverty line. Nepal is heavily dependent on remittances amounting to almost 30% of GDP, which however have declined in the last couple of years. Agriculture is the mainstay of the economy, providing a livelihood for almost two-thirds of the population but accounting for only one-third of GDP. About 20% of the total area is cultivable while another 40% is under forests and the rest is mountainous. Industrial activity mainly involves the processing of agricultural products, including pulses, jute, sugarcane, tobacco, and grain.

Major industries, as a proportion of gross value added are wholesale & retail activities (12%), real estate (10%), construction (7%) and education (6%). Nepal is a service led economy as 57% of the output comes from this sector.

Growth trends

GDP of Nepal (constant prices 2000-01) for the fiscal year 2017-18 (from 16 July, 2017 to 15 July, 2018) is Rs. 881.8 billion. The World Bank estimates of Nepal's GDP (at current prices) for the year 2017 is $24.5 billion. Nepal follows a fiscal year (FY) from 16 July to 15 July.

The economy rebounded strongly in FY17-18 following two challenging years in FY14-15 and FY15-16 on account of earthquake which led to supply disruptions and disturbances at the border point. Real GDP growth was at 7.4% in FY16-17, 7.2% higher than the growth witnessed in FY15-16. The provisional real growth estimates for FY17-18 is 5.9%, 1.5% lower than the previous fiscal. The floods in Nepal in the first half of FY17-18 has led to a sluggish agriculture growth estimate of 2.9%.

However, overall estimated growth for FY17-18 is driven by industrial output growth of 8.7% and services of 6.6%.

- The growth during FY16-17 was well dispersed across all the sectors: agriculture (5.3%), industry (12.4%), and services (7.5%).
- Rice production reached a record high, while growth in industry was driven by hydropower capacity and construction.
- Growth in services sector was driven by trade and hotel sub-sector while tourist arrivals reached its highest level.

Table 1: Growth Trends

Growth of Output	FY13-14	FY14-15	FY15-16	FY16-17R	FY17-18P
GDP real growth	5.7	2.9	0.2	7.4	5.9
Agriculture	4.6	1.1	0.2	5.3	2.9
Industry	6.9	1.4	-6.5	12.4	8.7
Services	6.2	4.6	2.4	7.5	6.6
Sectoral Composition					
Agriculture	33.2	32.4	32.2	29.4	28.2
Industry	14.3	14.2	13.6	14.1	14.2
Services	52.5	53.4	54.2	56.6	57.6

Source: Rastra Bank of Nepal; P- Preliminary Estimate; R- Revised Estimate

On the domestic front, successful conclusion of elections, formation of governments and the formulation of budget at all three levels of governments has the potential to create a positive environment for economic activities going forward.

However, the challenges to Nepal's growth include its landlocked geographic location, persistent power shortages, political gridlock and public protests and underdeveloped transportation infrastructure.

Savings

Gross national savings (as a % of GDP) has been increasing since the last 3 years and is estimated to stand at 43.9% in FY17-18 primarily due to remittance inflow.

Investment

Investment in Nepal, measured using Gross Fixed Capital Formation- GFCF (as a % of GDP) has witnessed a sustained increased from 20.7% in FY11-12 to 34.1% in FY17-18.

Inflation

Inflation, measured as Consumer Price Index (using the 2014-15 base year), which was as high as 8.5% during FY14-16 amid disruption caused by the earthquake, fell sharply to 4.5% and reached a decade-low rate by the end of FY16-17. As per the Central bank of Nepal, it is estimated to moderate further to 4.1% in FY17-18. The following table shows that in the last 5 years, the central bank has been able to achieve the inflation target for 3 out of the 5 years. Improvement in the supply chain management and lower level of inflation in India contributed to lower inflation in FY17-18. The central bank has set an inflation target of 6.5% in FY18-19.

Table 2: Inflation: Projected v/s Actuals

Fiscal Year	Projected Inflation	Actual Inflation
FY13-14	8.0	9.1
FY14-15	8.0	7.2
FY15-16	8.5	9.9
FY16-17	7.5	4.5
FY17-18	7.0	4.1

Source: Nepal Rastra Bank

Fiscal position

The total revenue of the government has witnessed a robust growth in the last 3 years. The tax revenue comprises almost 90% of the total revenue for the government. The two major taxes of the government are the Income tax and Value Added tax (VAT). The other sources of taxes collected by the government are excise and customs. The government also receives finance in the form of foreign grants, which is considered as the revenue of the government. There are three broad classifications of the government expenditure as given in the budget: Recurrent (70%), Capital (20%) and Financial (10%). To cover the deficit in the budget, the government resorts to different avenues like domestic borrowings (in the form of treasury bills, development bonds, and national savings certificates), overdrafts and foreign loans.

For FY17-18, the government revenue has increased 19.2% to Rs. 726.1 bn. The revenue collection is 99.5% of the budgeted target. The revenue to GDP ratio has increased to 24.1% in FY17-18 from 23.4% in FY16-17. The government expenditure increased 26.2% to Rs. 1029 bn in FY17-18. The total expenditure incurred in FY17-18 was 80.5% of the budget estimate. The budget deficit has increased to Rs. 268.9 bn from Rs. 188.7 bn in FY16-17. The ratio of the budget deficit to GDP stood at 8.9% in FY17-18.

Table 3: Snapshot of the Fiscal Indicators

Indicators	FY15-16	FY16-17	FY17-18
Total Revenue (Rs. Bn)	482.8	609.2	726.1
Total Expenditure (Rs Bn)	569.6	793.9	1,029.0
- Recurrent	356.5	501.6	680.3
- Capital	111.7	189.5	239.9
- Financial	101.4	102.8	108.8
Total Expenditure (as a % of GDP)	25.9	30.5	34.2
- Recurrent	16.2	19.3	22.6
- Capital	5.1	7.3	8.0
Revenue (as a % of GDP)	21.4	23.4	24.1
-Tax Revenue	18.7	21.1	21.8
Budget Deficit (as a % of GDP)	-2.2	-4.8	-8.5
Total Debt to GDP	27.4	26.4	29.7

Source: Nepal Rastra Bank

External Sector

Nepal is an open economy with a narrow export base which accounts for 8.9% of GDP. There is high dependence on imports which are 45% of GDP. Imports have witnessed a CAGR growth of 9% in the last 5 years and exports 4%. As the imports have surged and remittances slowed down pressure has mounted on current account balance of the economy. The

CAD (as a % of GDP) was 3.3% in 2017 as per World Bank database. Nepal has witnessed current account surplus during 2013-2015, following which was followed by current account deficit during 2016 and 2017.

The banking sector has sufficient foreign exchange reserves to sustain the import of goods and services for 9 months. Nepal had a current account surplus from 2013 to 2015, which has turned negative since 2016. Increasing trend of import is likely to continue for meeting investment demand required for higher growth.

Table 4: External Sector position

Calendar Year	Exports (US $ Million)	Imports (US $ Million)	Trade Deficit (US $ Million)	CAD (as % of GDP)
2013	998.0	6,542.9	5,544.9	6.02
2014	1,022.3	7,580.5	6,558.2	2.48
2015	813.2	6,510.7	5,697.6	11.43
2016	762.3	8,764.3	8,002.0	(0.79)
2017	839.7	10,000.3	9,160.7	(3.33)

Source: World Bank

- The major commodities exported are clothing, pulses, carpets, textiles and jute goods while the major commodities imported are petroleum products, machinery and equipment, gold medicine and electrical goods.
- The major trading partners of exports are India (53%), US (11%) and Turkey (7%)
- The major trading partners– for imports are India (70%) and China (7.5%).

External debt

The external debt of Nepal has been stable in the range of $ 4.03 Bn - $ 4.26 Bn for the period 2012 to 2016 and has widened in the year 2017 to $ 5.9 Bn.

Table 5: External debt

Year	Amount ($ Bn)
2012	4.25
2013	4.03
2014	4.17
2015	4.16
2016	4.26
2017*	5.90

Source: World Bank, *CIA Factbook

Forex reserves

The foreign exchange reserves have increased over the years indicative of the robust backing amid the widening current account deficit scenario in the country.

Table 6: Forex Reserves

Calendar Year	Amount ($ Bn)
2012	4.42
2013	5.43
2014	6.22
2015	8.15
2016	8.73

Source: World Bank

Currency movement

The Nepalese rupee, the local currency has depreciated by 15.5% against the US dollar from 92.99/$ to 107.4/$ during 2012-2016. The currency appreciated in the calendar year 2017 by 2.6% to be at an average exchange rate of Rs. 104.5/$. The current exchange rate is 113.2/ $.

Table 7: Movement of the Rs. against US dollar

Calendar Year	Period average Exchange rate (Rs per US dollar)
2013	92.99
2014	97.55
2015	102.40
2016	107.38
2017	104.51

Source: World Bank

Banking Sector

The financial system in Nepal began in 1937 with the establishment of the Nepal Bank Ltd as the first commercial bank of Nepal with the joint ownership of government and general public. The central bank of Nepal was established in 1956 and is called as the Nepal Rastra Bank. 1980 saw major structural change in the financial sector policies and regulations as the government emphasized the role of private sector in the financial sector. During the three decades since the reform, Nepal has witnessed an increase in the number of financial institutions.

The banking system in Nepal can be classified into four broad categories:

- Class A: Commercial Banks (28)
- Class B: Development Banks (33)
- Class C: Finance Companies (25)
- Class D: Micro Credits (63)

Apart from these broad classifications, there are savings and credit cooperatives limited and NGOs who perform activities of financial intermediaries.

Domestic credit picked up in FY17-18 by 29.8%, 9.2% higher than the growth witnessed in FY16-17. The private sector credit has witnessed a growth of 21% in mid-June 18, 1% higher than expected. The broad money supply in the economy witnessed a growth of 17.7% in FY17-18, 0.9% higher than the growth in FY16-17.

Table 8: Domestic bank credit

Indicator	Jul'15	Jul'16	July 17	Jul'18
Outstanding Domestic Credit (Rs. Bn)	1,527.3	1,805.7	2,177.8	2826.0
Growth (%)		**FY15-16**	**FY16-17**	**FY17-18**
Bank credit		18.2	20.6	29.8

Source: Nepal Rastra Bank

Deposits

Broad money is composed of the following aggregates:

- Total currency in circulation
- Demand deposits
- Savings and Call Deposits
- Time Deposits

As on June'18, out of the total broad money, ~40% of the aggregate is time deposits and 38% is savings and call deposits. Demand deposits are 7.4% of the total broad money. There has been a robust growth in all the components for FY17-18.

Table 9: Composition of Deposits

Indicators	Jun'15	Jun'16	Jun'2017	Jun'18P
Broad money (Rs. Bn)	1,801.7	2,143.7	2,504.6	2,947.2
a. Currency in circulation	260.8	316.5	352.0	404.5
b. Demand Deposits	136.3	156.7	186.0	216.9
c. Saving and Call Deposits	911.9	1,095.2	1,029.4	1,145.4
d. Time Deposits	492.7	575.3	937.2	1,180.4
Growth in Deposits (%)		**FY15-16**	**FY16-17**	**FY17-18**
a. Currency in circulation		21.3	11.2	15.5
b. Demand Deposits		14.9	18.7	14.9
c. Savings and Call Deposits		20.1	-6.0	11.3
d. Time Deposits		16.8	62.9	25.9

Source: Nepal Rastra Bank

P - Provisional

Monetary policy

Monetary policy FY17-18 had directed the commercial banks to allocate minimum 25% of total credit to priority sector, which includes a minimum of 10% to agriculture, 5% to hydropower, 5% to tourism and the remaining 5% to other designated sectors by mid-July 2018. Currently, the credit disbursed by commercial banks to priority sector is 24% of their outstanding loan.

Table 10: Latest banking indicators

Particulars	June-17	Sept-17	Dec-17	Mar-18	Jun-18
Total Deposit/GDP (%)	88.2	93.3	96.4	98.3	89.2
Total Credit/ GDP (%)	75.7	77.9	82.5	87.0	78.8
Total Credit/ Total Deposit (%)	85.8	83.5	85.5	88.5	88.3
Total Capital/ RWA (%)	14.1	15.4	15.4	15.4	14.8
Total Liquid Assets/ Total Deposits (%)	23.8	26.6	26.6	23.8	24.7
No of Branches (Nos)	3,069	3,222	3,273	3,576	4,053
Weighted Avg Interest on Deposits (%)	5.9	6.2	6.2	6.5	6.6
Weighted Avg Interest on Credit (%)	11.3	11.8	11.3	12.0	12.4
Repo Rate	5.0	5.0	5.0	5.0	5.0
Bank rate	7.0	7.0	7.0	7.0	7.0
Base Rate	9.4	10.1	9.9	10.4	10.4

Source: Rastra Bank of Nepal

Key Financial Sector Reforms for FY18-19:

- Necessary policies related to regulation, inspection and supervision will be formulated for the establishment and operation of infrastructure banks.
- The existing policy for opening branches of the BFIs will be revised to make the banking services further simplified and accessible.
- The campaign for opening bank accounts of all Nepali citizens within a year will be implemented effectively in coordination with concerned institutions
- The process of establishing Real Time Gross Settlement (RTGS) system has already been initiated. Necessary steps will be taken to establish National Payment Switch/Gateway.
- The merger and acquisition process will be further encouraged to check the unhealthy competition among commercial banks and further strengthen the financial sector stability.
- All commercial banks are required to arrange for institutional rating from FY18-19. Such a rating can be done from national or international credit rating agencies. In addition, commercial banks are required to use the credit rating of the borrower as a basis for credit disbursement and renewal for the loans exceeding Rs. 500 million.

Securities Market

The securities market in Nepal is regulated by the “Securities Board of Nepal” (SEBON) established by the government in 1993 under the Securities Act, 2006. Nepal has one stock exchange called the “Nepal Stock Exchange Ltd” which has four key indices (namely NEPSE Index, NEPSE Sensitive Index, NEPSE Float index and NEPSE Sensitive float index) and other sectoral indices. The Securities Board of Nepal has the authority to supervise and inspect the stock exchange, securities business person and listed companies.

Primary Market

The total amount mobilized through the primary market has increased four times from Rs. 14.4 Bn in FY14-15 to Rs. 59.3 Bn in FY16-17. It is observed that the companies are raising funds to the tune of almost 75% via rights issue. IPOs and FPOs are other routes from which the companies raise funds through the primary market. There was a sharp rise in FY16-17 mainly due to rights issuances.

Table 11: Primary Market Indicators

	FY14-15 Nos	FY14-15 Amount (Rs. Bn)	FY15-16 Nos	FY15-16 Amount (Rs. Bn)	FY16-17 Nos	FY16-17 Amount (Rs. Bn)
IPO	18	6.9	14	2.8	17	1.5
Right	22	2.3	37	37	76	45.6
FPO	0	0	3	3	4	8
MF	3	2.3	1	1	4	4.1
Debenture	5	2.9	0	0	0	0
Total	48	14.4	55	43.8	101	59.3

Source: Securities Board of Nepal

Secondary Market

The major indicators of the secondary market have witnessed a decline over the years except the turnover measures. The total number of listed companies on an average in FY17 was 215 and has further declined to 196 in Q1 of FY18. Banks and financial institutions dominate more than 80% of the listed companies. Out of the total trading, 95% of the trading is in equities, balance of which is in mutual funds units and corporates bonds. There are only domestic companies listed in the stock market and no cross border listing has been made. The market capitalization of the listed companies almost doubled in FY16 to Rs. 1,890 Bn. However, the market capitalization has witnessed a moderation in FY17 and continues in the first quarter of FY18. Data on sector-wise market capitalization shows that almost 65% of the total market capitalization is held by the banking and finance sector.

Table 12: Secondary Market Indicators

	FY14-15	FY15-16	FY16-17
No of Listed Companies	232	229	215
Turnover (Rs. Bn)	65.3	163.9	205.0
Average Daily Turnover (Rs. Mn)	0.3	0.7	1.00
Market Capitalization (Rs. Bn)	989.4	1,890.1	1,866.5
M-Cap/GDP (%)	46.6	84.0	71.8

Source: Securities Board of Nepal

A few major reforms in the securities markets are as follows:

- SEBON formulated the policy for regulation and development of the securities market in Nepal taking into consideration 14th 3-year plan and Five year financial sector development strategy. Based on this, the SEBON has published its annual policy and program
- It has increased the paid up capital of merchant banker by almost three times in order to minimize the prevailing risk in merchant banking business.

Bond Market

The bond market in Nepal is relatively small. Nepal Stock Exchange (NEPSE) is the only trading floor that trades mainly shares and comparatively low numbers of development bonds in the country.

The bond market is not well developed and the investors and borrowers still prefer bank loans. Even within the bond market government bonds dominate with a higher share. Further, within corporate bonds issuers, the banks and financial institutions are the major players.

Government bodies normally issue bonds to raise money either to purchase expensive plant and equipment or invest in big projects like hydropower (to generate electricity) and construction of mega buildings. The government bonds are s issued by the Nepal Rastra Bank and traded in NEPSE.

The government bonds issued are of 5 types:

- Development Bond
- Citizen Saving Bond
- Foreign bond
- Special Bond
- National Saving Bond

Among the different types of bonds issued, the development bond is the most popular form of government bond and the foreign bond is the least popular one among the four types of bonds. Even the listed securities comprise development bonds only. Out of the total source of financing required by the government for FY18, almost 50% is raised through development bonds while the balance is through treasury bills.

Economic Outlook

- The Government of Nepal (GoN) has announced a target growth rate of around 8% for FY18-19

- The monetary policy will facilitate the achievement of growth target by channeling resource towards employment promotion and entrepreneurial development. In addition, the monetary policy will focus on maintaining interest rate stability.

- In order to ensure easy access of all citizens to financial services, priority will be given to financial inclusion and financial literacy and the use of technology in payment system will be encouraged.

- Price stability has been the primary objective of monetary policy. The policy aims at containing consumer price inflation within 6.5% as stated in the GoN's Budget for FY18-19.

- Monetary management will be carried out to ensure adequate foreign exchange reserves to cover the prospective import of goods and services at least for 8 months in FY18-19.

- Domestic credit is projected to grow by 22.5% and the private sector credit is projected to grow by maximum 20%.