Macroeconomic Situation Report

First Quarter Update: FY 2022-23

Department of Macro-Fiscal and Development Finance

December 2022

Contents

Preface

The ***Macroeconomic Situation Report*** is a quarterly report produced by the Department of Macro-Fiscal and Development Finance (DMDF), Ministry of Finance (MoF) presenting a comprehensive macroeconomic performance and outlook of the economy based on the technical inputs from the Macroeconomic Framework Technical Committee (MFCTC) and strategic guidance from the Macroeconomic Framework Coordination Committee (MFCC). The report embodies the broad four sectors of the economy including the assessment of the risks from macroeconomic developments, examining the impact of new fiscal policies on fiscal developments and economic growth. The report also monitors the macro economy, fiscal policy implementations, and budget execution, in order to identify deviations from the annual budget forecasts.

The report presents various facets of the public finances of the State including revenue resources and expenditure trends, major fiscal indicators and also highlights some of the monetary aggregates. The report will provide economic advice to the government, as well as policy recommendations for economic development based on the macroeconomic risk and challenges, in order to ensure macroeconomic stability and inclusive growth. It can also be used as a reference document for policy makers, and those with a long-term interest in many aspects of the state's economy.

This report presents the state of the economy, fiscal position and current economic situation as of **30th September, 2022.**

1. GLOBAL & REGIONAL OUTLOOK

1.1 GLOBAL ECONOMIC SITUATION

The ongoing geopolitical tension between Ukraine and Russia and its effects on commodity markets, supply chains, inflation and rising cost-of-living, and China's frequent lockdown under its zero COVID policy have steepened the slowdown in the global economy. These challenges have caused the global economy to become unstable, weighing heavily on trade and related activities. Risks to the outlook remain unusually large and to the downside.

Global Growth: According to the IMF, World Economic Outlook, October 2022, global growth is projected to slow down from 6.0 percent in 2021 to 3.2 percent in 2022 and 2.7 percent in 2023. The fall in growth reflects a significant slowdown in largest economies - US GDP contraction in the first half of 2022, a euro area contraction in the second half of 2022 and prolonged COVID-19 outbreaks and lockdowns in China with a growing property sector crisis.

Inflation: Global inflation is forecasted to rise from 4.7 percent in 2021 to 8.8 percent in 2022 and decline to 6.5 percent in 2023 and to 4.1 percent by 2024. More energy and food price shocks might cause inflation to persist for longer.

Global economic prospects have worsened due to significant rise in overall uncertainties and risks. Higher inflation worldwide, especially in the United States and major European economies, a sharp tightening of global financial conditions in advanced economies, disruption of global supply chain due to economic slowdown in China, and ongoing geopolitical tension between Ukraine and Russia are forces shaping the global economic outlook. These strong headwinds are heightening the global risks and recession concerns.

1.2 REGIONAL ECONOMIC SITUATION

External challenges have also heightened for many emerging markets and developing economies. The sharp appreciation of USD has added significantly to domestic price pressures of these countries. Downside risks to the outlook remain elevated with the risk of monetary fiscal and financial policy showing signs of stress.

For emerging and developing Asia, the growth is estimated at 4.4 percent in 2022 and 4.9 percent in 2023, 0.2 and 0.1 percentage points lower than the previous forecast. The downgrade is mainly on account of the sharp slowdown of China's economy due to COVID-19 outbreaks and lockdowns in multiple cities, as well as worsening property market crisis. (WEO, October 2022).

- Due to the less positive outlook and the tighter financial environment, India's growth is anticipated to slow. In FY 2022/23 and FY 2023/24, the real GDP is projected to slow down to 6.8 percent and 6.1 percent respectively from 8.7 percent in FY 2021/22. Inflation is projected at 6.9 percent in FY 2022/2023, reflecting widespread pricing pressures, and is only likely to gradually decline over the following year. As a result of rising commodity prices and growing import demand, the current account deficit is anticipated to rise to 3.5 percent of GDP in FY 2022/23.

- Sri Lanka faces an unsustainable debt and severe balance of payments crisis, which is having a negative impact on growth. According to the Sri Lanka Development Update (World Bank, October 2022), Sri Lanka's real GDP is expected to fall from 3.3 percent in 2021 to -9.2 percent in 2022 and a further -4.2 percent in 2023 - as foreign exchange liquidity shortages continue, job and income losses intensify, and sully side constraints adversely affect production.

- In the case of Nepal, the forecast projects growth moderating to 5.1 percent in FY23 and 4.9 percent in FY24 from 5.8 percent in FY22, reflecting monetary policy normalization, the end of pandemic monetary support measures, and still relatively high commodity prices. A rebound in tourism is projected to support the services sector and industrial growth is expected to be strong due to increased hydroelectricity production and increased supply of electricity to other industrial sectors. (Nepal Development Update, World Bank, October 2022)

2. OVERVIEW

While the pandemic and the war in Ukraine are weighing on the near-term outlook, medium term growth is expected to be driven by a recovery in services, manufacturing, and hydropower. Hydropower generation capacity is expected to double, supporting growth, the current account balance, and the fiscal position. The fiscal deficit is expected to moderate as pandemic-related measures are gradually phased out and revenue reforms deepen. The current account deficit and reserve coverage are expected to *improve from declining hydropower-related imports and rising hydropower exports. However, amidst heightened global and regional uncertainties coupled with emerging issues within the domestic economy, downside risk to growth is anticipated. The consequences of rising geopolitical conflict and increasing food and energy prices and modest upturn in tourism will adversely impact the economy posing risks to growth prospects and debt dynamics.*

3. DOMESTIC ECONOMIC DEVELOPMENTS

3.1 GROWTH PERFORMANCE AND OUTLOOK

Economic growth of 4.8 percent is projected in 2022. The economy is projected to grow by 4.8 percent in 2022 as economic activities picked up supported by expansionary fiscal policy, monetary support and progressive relaxation of containment measures.

With the resumption of economic activities, the industry sector is estimated to grow at 4.3 percent in 2022, an increase of 2.3 percentage points from 2021 mainly attributed to improved performance in the manufacturing (4.0%), and construction (18.1%) sectors.

With the revival in retail trade, hotels and restaurants, and other domestic businesses, the service sector is estimated to grow by 5.1 percent in 2022, contributing around 46.0 percent to the GDP. The resumption of tourism in September 2022 is also anticipated to spur growth in the services industry.

Agriculture growth is projected to maintain a steady growth of 2.2 percent. The sub-sectors contributing to agriculture growth are crops (4.0%) and livestock production (2.0%). The production in the forestry and logging sector is estimated to decline by 2 percent.

Over the medium-term, growth is expected to be driven by a recovery in services and manufacturing and hydropower. Hydropower generation capacity is expected to double with the commissioning of Nikachu Hydro power (December 2023), PUNA-II (December 2024) and PUNA-I by 2028, supporting growth, the current account balance, and the fiscal position. Due to strong external demand, growth is anticipated to be export-driven and to average around 5.2 percent over the next five years. The growth trajectory is based on the assumption that there will be no emergence of new variants or mobility restrictions while government spending continues to boost aggregate demand and investments are implemented on time.

However, amidst heightened global and regional uncertainties coupled with emerging issues within the domestic economy, downside risk to growth is anticipated. The consequences of rising geopolitical conflict and increasing food and energy prices will adversely impact the economy posing risks to growth prospects. Other external risks include a sharper-than-expected global slowdown and/or a slowdown in India, including emergence of new pandemic waves, an intensification of geopolitical tensions, and a prolonged decline in tourism. Domestic risks include prolonged financial sector strains amid limited fiscal space, including from any contingent liabilities in the financial sector and delays in hydro projects, which would affect growth, external buffers, and debt dynamics.

Chart 3.1 GDP Growth (in %)

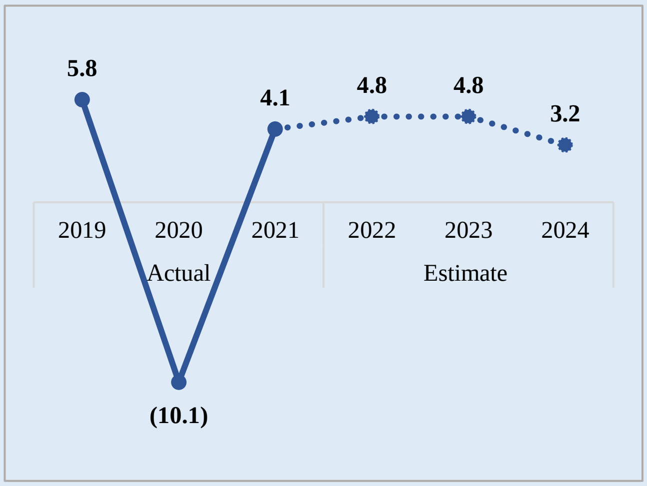


Table 3.1 Sectoral Update

Percent Change (YoY)	2020	2021	2022	2023
	Act.		*Est.*	
GDP Growth	**(10.01)**	**4.09**	**4.78**	**4.83**
Agriculture, Livestock & Forestry	4.57	2.05	2.18	3.23
Industry	(12.84)	1.96	4.28	5.38
Services	(6.93)	6.32	5.12	5.48
Net Taxes	(49.48)	2.73	16.83	-6.50

3.2 INFLATION

As of September 2022, inflation increased to 6.05 percent compared to September 2021 due to an increase in both food prices by 4.24 percent and non-food prices by 7.61 percent. With a 14.92 percent increase, transportation was the major driver, accounting for 37 percent of overall inflation. Food and alcoholic beverages increased by 4.42 percent, accounting for 33 percent of overall inflation.

Inflation is projected to remain elevated in the short to medium term, owing to continued supply disruptions and high oil and commodity prices. Under the baseline scenario, annual inflation is projected to remain elevated at 5.7 percent in current FY 2022-23 and 5.2 percent in FY 2023-24 given the economy's dependence on imports of both oil and food, whose prices are rising.

Chart 3.3 CPI Inflation Trend (YoY %)

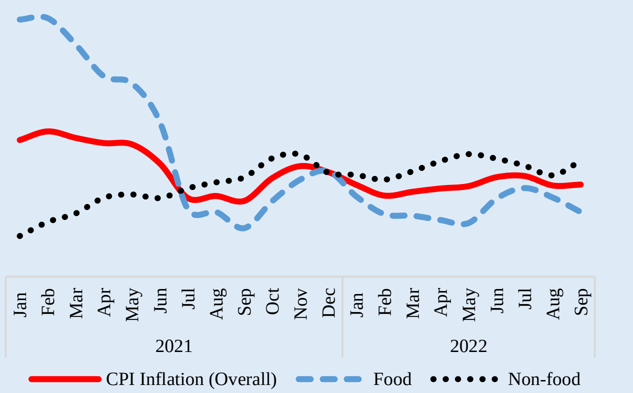
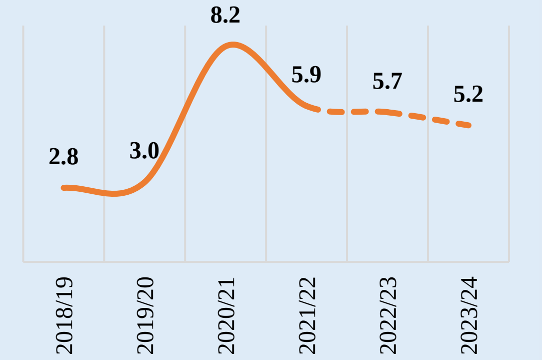


Chart 3.4 Headline CPI Inflation (% Change)



4. FISCAL DEVELOPMENTS

Domestic Revenue: The total domestic revenue realized during the FY 2021-22 was Nu. 39,043.07 million, an increase of 9.7 percent from the budgeted amount of Nu. 35,600.00 million. The increase in revenue growth was mostly due to an increase in Corporate Income Tax (Nu. 2,822.07 million), Sales Tax (Nu.1,498.07 million), and dividend receipts (Nu.1042.21 million), while taxes on international trade and transactions declined. (Customs and other import duties).

The revenue was sufficient to cover 56.46 percent of total expenditure in FY 2021-22, as against 50.46 percent in the previous FY. The improved coverage of expenditure by internal revenue in FY 2021-22 was the result of a drop in the percentage change of expenditure relative to an increase in the percentage change of revenue. While revenue increased by 8.89 percent in FY 2021-22 from the prior year, the total expenditure decreased by 2.72 percent. The ratio of domestic revenue to current expenditure for the FY 2021-22 is 113.4 compared to 112.4 in previous FY.

The total resource realized at the end of the 1st quarter for FY 2022-23 is 22.12 percent against the estimates. Of the total resources realized, domestic resource is 65.02 percent, external grant is 48.75 percent and other receipts is 45.97 percent. The external borrowings and recoveries realized is 3.17 percent and 0.98 percent respectively.

The total revenue for the FY 2022-23 is revised to Nu. 40,829 from the budgeted amount of Nu. 36,368 million, an increase of 12 percent. While marginal increases are seen in both direct and indirect tax, major increases are expected from profit transfer from MHP, DHI dividend and royalties from tourism.

An external grant of Nu. 14,872 million was budgeted in the FY 2022-23 which is the remaining amount of grants realized in the past FY from the total grants committed in the 12th FY by the donors and development partners. Of the total budgeted amount, grants from GoI constitute about 80 percent, and the remaining from the other bilateral and multilateral development partners. As of November 2022, the total external grant receipts stand at Nu. 7,343 million which is 49 percent of the budgeted amount. In addition, an internal grant of Nu. 67 million was received.

Expenditure: The current and capital expenditure accounted for 92.38 percent of total payments in FY 2021-22, with capital expenditure accounting for 46.37 percent of total expenditure. The composition of expenditure revealed an increase in capital expenditure (25.88%) and a decrease in current expenditure (-20.85%).

The major portions of the capital expenditure were for the construction of roads (23.83%) and buildings (18.51%). These two categories combined accounted for 42.34 percent of the total capital expenditure. Almost 97 percent of the budgeted current expenditure was utilized whereas capital expenditure utilization stands at 91 percent compared to the budgeted amount.

During the FY 2021-22, out of the total capital budget of Nu. 38,321 million, the actual expenditure reported is Nu. 34,711.896 million. The capital budget variance is Nu. 3,609 million excluding advances, which is 9 percent of the total capital budget.

The total expenditure for FY 2022-23 as per budget is Nu. 74,808 million of which the current expenditure is Nu. 36,341 million and capital expenditure is Nu. 38,467 million. The actual capital expenditure as of 30th September, 2022 is Nu. 3,919.848 million, a slight decrease of 0.10 percent as compared to the same period in FY 2021-22. The decrease in the capital budget was on account of rationalization measures put in place to reduce wasteful and non-economic spending. As such, expenditure on training, awareness and procurement of vehicles/plants/equipment/office furniture have decreased as compared to the same period in the previous FY.

Fiscal deficit remained elevated as resource mobilizations were lower compared to increased spending. While the total expenditure was Nu. 69,156.6 million, the total revenue realized was only Nu. 54,354.6 million for FY 2021-22. The total financing required was Nu. 15,032.0 million, translating to a fiscal deficit of 7.8 percent of GDP (Provisional). Under the review period, the fiscal deficit for the current FY is revised downward to 9.4 percent of GDP (Provisional) from 11. 5 percent of GDP (Budget) with the upward revision in domestic revenue by 12 percent. The financing requirement is estimated at Nu. 19,363.5 million.

Table 4.1 Fiscal Accounts

	Particulars (Nu. In Million)	2018/19	2019/20 Act.	2020/21	2021/22 Prov.	2022/23 Est.
A	**Resources**	**42,033**	**54,604**	**59,696**	**54,355**	**55,444**
1	**Domestic Revenue**	**34,708**	**36,219**	**35,855**	**39,043**	**40,829**
	Tax Revenue	27,171	22,793	20,662	25,843	27,056
	Non-tax Revenue	7,537	13,426	15,194	13,200	13,772
2	**Grants**	**10,516**	**16,426**	**14,882**	**15,312**	**14,615**
B	**Expenditure**	**44,777**	**57,989**	**70,836**	**69,157**	**74,808**
1	Current	27,769	35,525	43,516	34,445	36,341
2	Capital	16,285	22,047	27,576	34,712	38,467
C	**Fiscal Balance**	**(2,743)**	**(3,385)**	**(11,140)**	**(15,032)**	**(19,363)**
	Fiscal deficit (% of GDP)	**(1.6)**	**(1.9)**	**(6.2)**	**(7.8)**	**(9.4)**

Over the medium term in the next 5-year period, fiscal consolidation shall be inevitable given the large fiscal deficit in the current FY. Both the current and capital expenditure would require adjustment as the total revenue as a percentage of GDP is also expected to decline with the likely receipt of lower grants. With the consolidation path, the overall fiscal balance is projected at -3.4 percent of GDP on an average.

Table 4.2 Fiscal Framework over the Medium Term

	2023/24	2024/25	2025/26	2026/27	2027/28	5 Year
***A*. Revenue & Grants**	**53,056**	**64,652**	**80,723**	**78,790**	**73,507**	**350,727**
***1* Domestic Revenue**	**43,235**	**46,418**	**62,353**	**60,625**	**63,397**	**276,027**
i Tax revenue	30,488	33,398	39,594	42,051	43,999	**189,531**
ii Non-tax revenue	12,747	13,019	22,759	18,574	19,397	**86,496**
***2* Grants**	**9,821**	**18,234**	**18,370**	**18,165**	**10,110**	**74,700**
***B*. Outlay**	**70,827**	**75,363**	**91,264**	**79,698**	**74,646**	**391,798**
1 Current	43,320	44,620	45,959	47,337	48,757	**229,994**
2 Capital	27,507	30,743	45,305	32,361	25,889	**161,804**
***C*. Fiscal Balance**	**(17,771)**	**(10,711)**	**(10,541)**	**(909)**	**(1,140)**	**(41,071)**
Fiscal deficit (% of GDP)	**(8.0)**	**(4.4)**	**(3.9)**	**(0.3)**	**(0.4)**	**(3.4)**
***D*. Financing**	**17,771**	**10,711**	**10,541**	**909**	**1,140**	**41,071**
1 Net lending	(1,396)	(3,392)	(5,763)	(7,492)	(7,814)	**(25,856)**
2 Net External Borrowing	740	(3,834)	(5,499)	(7,584)	(9,007)	**(25,184)**
3 Net Domestic Borrowing	15,635	11,154	10,277	1,001	2,333	**40,399**
Nominal GDP est.	**221,213**	**243,313**	**270,810**	**294,692**	**318,339**	

Total public debt is estimated to increase although the overall risk is deemed manageable as the risk of debt distress is considered moderate. As a major portion of external debt is in hydropower projects, which are commercially viable and deemed self-liquidating, increase in debt ratio may not be a cause of concern. For FY 2021-22, total public debt stock stood at Nu. 257.6 billion, of which external debt stock comprised Nu. 229.6 billion. The domestic debt stock stood at Nu. 28.1 billion, an increase of 64.4 percent due to issuance of government bonds of Nu.8.5 billion.

As of September 2022, the public debt stock declined marginally by 526.0 million (0.20%) from the previous quarter due to a decline in external debt stock by 26.0 million (0.01%) and domestic debt by Nu. 500 million (1.78%). For FY 2022-23, total public debt stock is estimated to increase to Nu. 260 billion (128.0% of the GDP).

Table 4.3 Debt Situation

Particulars (Nu. In Million)	2018/19	2019/20	2020/21	2021/22	2022/23
	Act.				Est.
Total Public debt	**184,175**	**215,370**	**238,399**	**256,224**	**263,119**
% of GDP	*106.5*	*122.8*	*132.4*	*133.4*	*128.0*
1. Domestic debt	**5,060**	**1,987**	**17,074**	**28,061**	**28,627**
% of GDP	*2.9*	*1.1*	*9.5*	*14.6*	*13.9*
% of Total Public Debt	*2.7*	*0.9*	*7.2*	*11.0*	*10.9*
2. External debt	**179,115**	**213,383**	**221,324**	**228,163**	**234,493**
% of GDP	*103.6*	*121.6*	*122.9*	*118.7*	*114.0*
% of Total Public Debt	*97.3*	*99.1*	*92.8*	*89.0*	*89.1*
2.1 Hydro debt	137,005	159,360	162,359	164,219	167,107
2.2 Non-hydro debt	42,110	54,024	58,965	63,957	67,386
2.3 Rupee debt	131,433	152,197	155,005	156,673	159,689
2.4 CC Debt	47,682	61,186	66,320	71,504	74,804

Over the medium term, with the fiscal consolidation path, the total public debt stock as a percent of GDP will show a downward trajectory. By the end of the 12 FYP, the public debt is estimated at 126.9 percent of GDP and projected to decline to 109.2 percent of GDP by the end of next 5 years. In terms of an absolute value, the total public debt is estimated to increase by about 33.5 percent, largely due to projected increase in domestic debt by about 130 percent.

Table 4.4 Medium Term Public Debt Stock

Particulars (Nu. In Million)	FY 2022-23 (12th FYP END)	FY 2027-28 (5 Year END)	% Change
Total Public debt	**260,354**	**347,533**	**33.5**
% of GDP	*126.9*	*109.2*	
1. Domestic debt	**22,702**	**52,259**	
% of GDP	*11.1*	*16.4*	
% of Total Public Debt	*8.7*	*15.0*	
2. External debt	**237,651**	**295,274**	**24.0**
% of GDP	*115.8*	*92.8*	
% of Total Public Debt	*91.3*	*85.0*	
2.1 Hydro debt	164,708	223,482	35.7
2.2 Non-hydro debt	72,943	71,792	-1.6

5. BALANCE OF PAYMENT

The current account balance (CAB) widened from -11.9 percent in the FY 2020-21 to -33.0 percent in the FY 2021-22 as a result of widening trade deficit. With the normalization in the economic situation and resumption of economic activities, trade flows picked up significantly thereby increasing the trade deficit. Overall trade deficit increased from Nu. 21.02 billion to Nu. 59.6 billion in the FY 2021-22 translating to a trade deficit of 31 percent of GDP. In terms of capital account, it recorded an increase of Nu. 10.7 billion in the FY 2021-22 from Nu. 7.4 billion mainly on the account of increase in the receipt of budgetary grants. However, over the medium-term the capital account will have a declining trend with the decrease in grants from donor agencies upon the country's graduation from LDC status.

Trade performance: The overall import in 2022 (January- September) amounted to Nu. 93.0 billion, an increase of 52 percent compared to the same period in 2021. Whereas, overall exports as of September 2022 amounted to Nu. 26.5 billion an increase of 10.4 percent. If a similar trade pattern continues in the upcoming months, the baseline scenario projects that by the end of 2022, overall import value will stand at Nu. 125.3 billion and export at Nu. 59.7 billion. As the magnitude of increase in imports is much higher compared to exports, the trade deficit is expected to widen further.

As of September 2022, the reserve stood at US$ 729.7 million (Monthly Statistical Bulletin, RMA), which is much lower compared to September 2021. Of the total reserve, USD 619.4 million is CC and Rs. 8,995.6 million is denominated in INR. The reserve position is expected to decline with the unsustainable rate of increase in imports, persistent inflationary pressure and depreciation of local currency against dollars. Given the combination of low international reserve position and high imports,, it is critical for the economy to carry out external adjustment through the correction of external imbalance by not only curtailing imports but also by boosting exports, encouraging more FDIs and external grants. With this, alternative methods need to be explored and accessed but at the same time it will also require policy management.

The overall balance of payment situation is expected to worsen as current account balance deteriorates in the medium term. The net financial inflows which are used to finance the current account deficits over the period has been decreasing due to lower inflow of official grants, thereby impacting the gross international reserves**.** The gross international reserve depleted from US$ 1,335.4 million in FY 2020-21 to US$ 840.7 million in FY 2021-22.

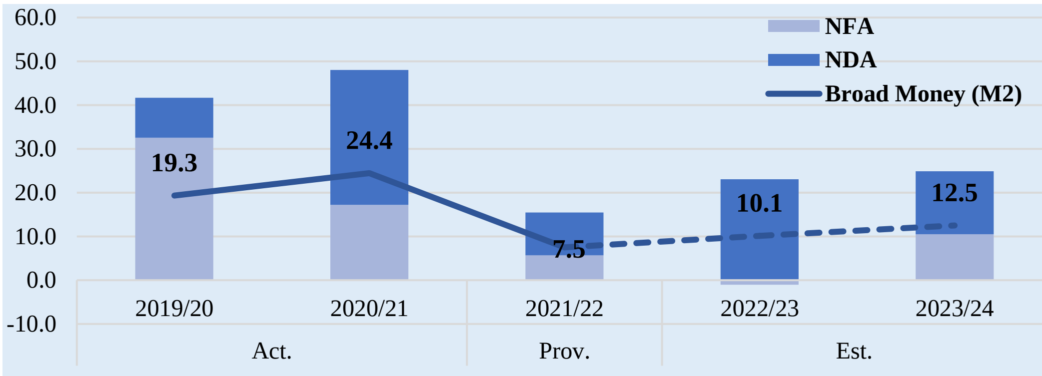
Table 5.1 External Accounts

Particulars (Nu. In Million)	2019/20	2020/21	2021/22	2022/23
	Act		Prov.	Est
Trade Balance	(29,321)	(21,021)	(59,584)	(51,097)
% of GDP	***(16.7)***	***(11.7)***	***(31.0)***	***(24.9)***
Current Account Balance	(27,712)	(21,405)	(63,404)	(53,723)
% of GDP	***(15.8)***	***(11.9)***	***(33.0)***	***(26.2)***
Capital Account	10,373	7,415	10,681	13,560
% of GDP	***5.9***	***4.1***	***5.6***	***6.6***
Financial Account	(27,252)	(20,331)	(20,710)	(14,503)
% of GDP	***(15.5)***	***(11.3)***	***(10.8)***	***(7.1)***
GIR (US$ in million)	**1,340**	**1,335**	**841**	**497**

6. MONETARY MANAGEMENT & FINANCIAL INTERMEDIATION

Despite slowdown in the economy and high inflation, the monetary and credit situation remained favorable, supported by accommodative monetary and expansionary fiscal policies. Money supply (M2), measured by broad money, is estimated to grow at 9.4 percent in the FY 2021-22, owing to an increase in total deposits (10.8 percent) held by the commercial banks, accounting for 94.6 percent of money supply components. On the asset side, growth in M2 is driven by improved performance in both net foreign assets (NFA) and net domestic assets (NDA). The money supply in FY 2022-23 is projected to grow by 11.5 percent.

Chart 6.1 Money Supply (YoY Change)



Domestic credit growth, which is determined by developments in the real sector and government expenditure, increased by 8.5 percent in the FY 2021-22 compared to 6.5 percent in the FY 2020-21. The growth was mostly accentuated in the trade & commerce, transport and construction sector reflecting pick up in the tertiary sector and also government spending on capital projects. Going forward, domestic credit is projected to grow at 16.7 percent in FY 2022-23 and 8.6 percent in FY 2023-24 in tandem with economic growth and supportive monetary measures.

In terms of soundness of the financial sector, the overall asset quality of the financial institutions improved with the decrease in NPL by 33.8 percent in the FY 2021-22. In terms of sectoral NPL, the highest was recorded in the service & tourism sector at 31.8 percent, followed by the manufacturing sector at 19.2 percent and trade & commerce sector at 17.9 percent showing an adverse impact of the pandemic on these sectors.

Supported by various policy measures, overall banking liquidity remains adequate to facilitate credit growth in FY 2022-23. The excess liquidity in the banking sector for FY 2021-22 was estimated at Nu. 19.9 billion (equivalent to 10.3 percent of money supply) compared to Nu. 32.2 billion in the FY 2020-21. The reduction was mainly on account of economic activities picking up and gradual fall in term deposits. However, the liquidity position in FY 2022-23 is expected to remain just adequate to meet the government's domestic borrowing. While continuity of expansionary monetary stance in the medium term is expected to pose risks in meeting the fiscal obligations with crowding out private credit.

Chart 6.2 Credit Growth (in %)

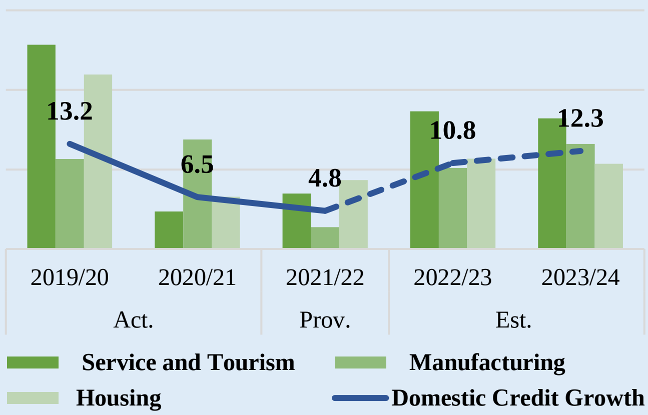
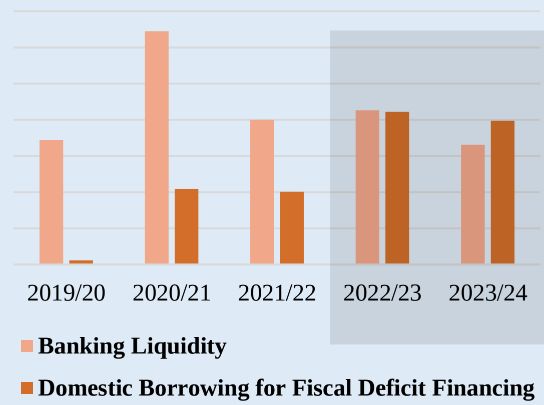


Table 6.1 Banking Liquidity & Domestic Borrowing (Nu. In billion)



7. RISKS AND CHALLENGES

With the recent on-going geopolitical conflict and high degree of uncertainty with the pandemic situation, risks to economic growth and recovery could emanate from both external and domestic environments. Besides the broad macroeconomic challenges such as economic diversification, vulnerabilities from climate change and unemployment, some of the possible risks and challenges to economic recovery based on the current update are listed below:

Widening current account deficit will put further strain on the overall reserve of the economy. As the economy returned to normalcy with the relaxation of containment measures, economic activities including public infrastructure as well as hydropower projects resumed resulting in significant imports. The growth in imports was much stronger than the exports, leading to deterioration of the trade balance and the CAB.

As the financial inflows are not adequate to meet the current account deficit, the negative balance of payments will lead to depletion of overall reserve assets posing risk to the constitutional mandate of meeting 12 months of essential imports. The macroeconomic imbalance emanating from the external sector is likely to spillover to other sectors of the economy eventually impacting growth prospects.

The rising geopolitical tension will aggravate the already existing inflationary pressure. Against the already turbulent backdrop of global inflationary pressures following the COVID-19 pandemic, the war between Russia and Ukraine has exacerbated supply chain disruptions leading to a spike in commodity prices and broadening price pressures. The geopolitical conflict is likely to have a prolonged impact especially on food and energy prices leading to demand-supply imbalances.

With the war-induced commodity price increase, the impact will be felt mostly through higher cost-push inflation weighing on all the economic sectors including households, businesses and government. As an import dependent economy, higher energy and food prices will increase the import prices resulting in an increase in prices of domestic production. Therefore, surge in prices combined with low growth and high unemployment may lead to stagflation crippling the economy.

8. POLICIES TO STRENGTHEN THE OUTLOOK

To increase policy space and support development goals, a gradual medium-term fiscal consolidation supported by increased expenditure efficiency and revenue mobilization is essential. A gradual but substantial growth-friendly fiscal consolidation will support macroeconomic stability by reducing debt vulnerabilities, while balancing the developmental needs. Revenue mobilization, including a gradual rationalization of tax exemptions, could help offset a projected decline in grants. Fiscal consolidation will be critical to support external rebalancing and bring the current account balance closer to its norm and help accumulate international reserves to more adequate levels.

As the recovery deepens and in light of inflationary pressures from supply-side shocks, monetary policy should gradually normalize. For the first time since 2015, the Cash Reserve Ratio (CRR) was lowered by 300 basis points to 7 percent in 2020 to promote liquidity and credit, along with other financial sector-related measures. While accommodative monetary policy has been appropriate amid elevated uncertainties, a gradual increase in the CRR, and close monitoring of excess liquidity and prices as well as addressing the NPLs in the banking sector will be critical.

Structural Reform is critical in supporting long-term growth. Further improvement in infrastructure development (both physical and digital) to help support domestic economic activity and improved skill matching should be continued to support development goals and economic transformation. Such measures with a focus on improving productivity should be prioritized.

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