INTERNATIONAL MONETARY FUND

NEPAL

REQUEST FOR DISBURSEMENT UNDER THE RAPID CREDIT FACILITY—DEBT SUSTAINABILITY ANALYSIS

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This low-income debt sustainability analysis (LIC DSA) updates the joint IMF/World Bank DSA from May 2014. Nepal's risk of debt distress continues to be assessed to be low. Generally prudent fiscal policy and low execution of capital spending budgets have continued to underpin declining levels of public debt.[1] *Higher financing requirements driven by post-earthquake reconstruction and higher public investment expenditures are expected to be manageable under the assumption that they are temporary and that financing terms are favorable. As a result, indicators of the public external debt stock and public debt service ratios remain comfortably within the policy-dependent indicative thresholds, even under stress tests, due to the assumed continued high level of concessionality of official borrowing.*[2]

BACKGROUND

1. **The April 25, 2015 earthquake was a major shock to the economy but the risk of debt distress is expected to remain low.** The earthquake is expected to have a significant short-term effect on growth, as key sectors of the economy have been affected, most notably

[1] The risk rating is determined using the LIC DSA framework. Nepal's fiscal year starts in mid-July. For example, fiscal year 2014 extends from mid-July 2013 until mid-July 2014.

[2] The thresholds are determined based on Nepal's policy performance rating, which is "medium" according to the CPIA score which averaged 3.31 in 2011–13. Nepal continues to receive large amounts of remittances, averaging 25.7 percent of GDP and 237.3 percent of exports of goods and services per annum during the past three years. As remittances exceed relevant thresholds (10 percent of GDP and 20 percent of exports of goods and services) they are incorporated into the analysis.

agriculture and tourism.[3] Reconstruction needs are significant and have pushed up gross external financing requirements over the next 4–5 years. The baseline scenario assumes that the financing gap will be filled primarily with loans. Even with the resulting increased borrowing, the risk of debt distress remains low, thanks to the low starting level of external debt and the high concessionality of new debt.

2. The present value of external debt undershot the 2014 projection in the previous DSA, but is expected to rise somewhat over the medium term. The previous DSA projected the present value (PV) of public and publicly-guaranteed (PPG) external debt to decline to 13.6 percent of GDP in 2014 and to fall by almost 2 percent of GDP over the next five projection years. This DSA compares as follows:

- The continued low execution of foreign-financed capital spending, higher-than-expected economic growth and a higher-than-expected GDP deflator in U.S. dollar terms pushed the PV of PPG external debt down to 10.7 percent of GDP in 2014, 2.9 percent of GDP lower than projected in the previous DSA. This provides the new base to project the path of external public debt in the current DSA.

- Unlike the decline over the medium term projected in the previous DSA, the PV of PPG external debt is now projected to rise by 1.4 percent of GDP over the next 6 projection years, to 12.1 percent of GDP by 2020, owing to the increased concessional external borrowing to help finance the post-earthquake reconstruction (Table 1a).

3. The total stock of public debt in Nepal declined in 2014 to 28.3 percent of GDP from 32.3 percent in 2013, largely reflecting prudent fiscal policy and favorable economic growth.

- External debt stood at 17.9 percent of GDP by the end of FY 2013/2014 (US$3.5 billion), of which 86 percent was concessional borrowing from the World Bank and the Asian Development Bank (ADB). Japan was the largest bilateral creditor, followed by Korea, India and China.

Nepal: Structure of External Public Debt, 2014

	Value (in million USD)	In percent of GDP	NPV (in million USD)
Public debt	3,531	17.9	2,468
Multilateral	3,215	16.3	2,435
Asian Development Bank	1,502	7.6	1,245
World Bank	1,582	8.0	1,028
IMF	36	0.2	32
Other	95	0.5	130
Official Bilateral	333	1.7	33
Paris Club	225	1.1	10
Non-Paris Club	108	0.5	23
Commerical	-	-	-

Source: Nepali authorities; Fund staff estimates.

- Domestic debt declined from 12.2 percent of GDP in 2012/13 to 10.4 percent by the end of FY2013/14, as low budget execution resulted in a budget surplus.

[3] The Post Disaster Needs Assessment estimates preliminary headline damage at around US$5bn (24 percent of GDP). Economic losses (e.g. the impact on the economy due to the slowdown in economic activities in the aftermath of the earthquake, such as through forgone revenue in tourism, etc.) are estimated at around 9 percent of GDP.

4. The authorities have taken several measures in recent years to enhance debt management capacity, but further improvement is needed in several areas. World Bank staff conducted a Debt Management Performance Assessment (DeMPA) in August 2014. Compared to an earlier assessment, in February 2010, it was found that progress had been made on cash flow forecasting and cash balance management, as well as on coordination with macro policy. On the latter, the assessment highlighted the recent creation of separate open market committees—for public debt management and monetary management. The DeMPA called for improving the effectiveness of managerial oversight on the debt management functions. It was also recommended to task one entity with the preparation of a comprehensive debt management strategy, analyze the cost and risks of the debt portfolio, and make debt service forecasts more robust.

Nepal: Public Domestic Debt 1/

(in billions of Nepalese rupees unless otherwise stated)

	2012	2013	2014
Government bonds 2/	209	207	202
Treasury Bills	131.6	136.5	136.5
Development Bonds	57.5	51.6	47.1
National Savings Bonds	15.7	15.7	16.6
Citizen Savings Bonds	4.1	3.2	1.5
Foreign Employment Bonds	0.0	0.1	0.1
Special Bonds	0.2	0.0	0.0
Memorandum items:			
Total domestic debt outstanding as percent of GDP	13.7	12.2	10.4
NRB overdrafts (+) / deposits (-)	-2	-14	-31

Source: Nepali authorities; Fund staff estimates

[1] Fiscal years ending in mid-July

MACROECONOMIC ASSUMPTIONS

5. Macroeconomic assumptions for the current DSA are consistent with the macroeconomic framework underlying the current Rapid Credit Facility (RCF) arrangement. The main differences from the previous DSA include (Box 1): (i) a deterioration in growth prospects; (ii) slower revenue gains relative to the previous DSA, reflecting short-run revenue losses related to the earthquake followed by a gradual recovery over the medium term; and (iii) a deteriorating current account in the near and medium term, driven by rising imports of reconstruction-related materials, which more than offset temporarily stronger remittances. In the long term, however, the current account is expected to recover somewhat.

- Real GDP growth is expected to fall from 5.4 percent in 2013/14 to 3.4 percent in 2014/15, due to significant economic losses resulting from the earthquake. Growth is expected to gradually recover over the medium term as reconstruction gains momentum. The baseline assumes improved budget execution of capital spending compared to the previous DSA in line with authorities' efforts in this area and with intensified reconstruction efforts. However, experience in other fragile countries struck by natural disaster suggests that potential growth is likely to be adversely affected by the earthquake. In light of this, growth in the medium and long run is projected around 4 percent, lower than the 4.5 percent assumed previously.

- Fiscal policy is expected to remain responsible. Revenue is expected to deteriorate in the short term and slowly recover thereafter, while the expenditure effect on the budget related to reconstruction and investment expenditure is expected to dominate over the medium term. The resulting higher fiscal deficits reflect these expenditures—the primary balance is expected to deteriorate from a surplus of 1.9 percent of GDP in 2014 to a deficit of 1.4 percent in 2035. Net incurrence of liabilities is projected to rise from -1.3 percent of GDP in 2013/14 to an average of 3.0 percent over the next five years, decreasing to 1.0 percent towards the end of the DSA horizon. This path is consistent with a stable debt profile. Financing of the deficit is expected to tilt increasingly towards domestic sources (net domestic financing rising to 1.7 percent of GDP in the long term), as public financial management improves and external loans decline relative to GDP.

Box 1. Macroeconomic Assumptions Table

	Previous DSA			Current DSA				Current vs. Previous	
	2014	**MT**	**LT**	**2014**	**2015**	**MT**	**LT**	**MT**	**LT**
Real growth (%)	4.8	4.7	4.5	5.4	3.4	4.2	4.0	-0.5	-0.5
Inflation (GDP deflator, %)	8.8	7.1	5.0	8.7	5.9	7.2	5.0	0.1	0.0
Revenues and grants (% GDP)	21.1	21.7	22.5	20.8	20.3	22.1	22.8	0.4	0.3
Grants (% GDP)	2.8	2.5	2.3	2.4	1.9	2.6	2.3	0.0	0.0
Primary expenditure (% GDP)	21.4	22.9	24.0	18.9	20.9	24.5	24.2	1.6	0.2
Net acquisition of non-financial assets (% GDP)	3.7	4.4	5.2	3.3	3.9	5.7	5.0	1.3	-0.2
Primary deficit (% GDP)	0.3	1.1	1.5	-1.9	0.6	2.3	1.4	1.2	-0.1
Net incurrence of liabilities	1.3	2.1	2.5	-1.3	0.6	3.0	1.0	0.9	-1.5
Net domestic financing (% GDP)	1.0	1.0	1.5	0.9	1.0	1.7	1.7	0.7	0.2
Exports of G&S (y/y growth)	4.1	7.2	6.0	12.0	-11.9	7.2	6.5	0.0	0.5
Imports of G&S (y/y growth)	10.9	10.2	6.1	13.2	7.0	10.1	7.6	-0.1	1.6
Remittances (y/y growth)	15.0	7.9	6.0	12.4	11.2	8.5	8.5	0.6	2.5
Current account balance (% GDP)	4.2	0.9	-0.8	4.6	2.8	-2.0	1.3	-2.9	2.1

Note: MT (medium term) is the average over the next 5 years, and LT (long term) is the average over the following 7-20 years.

- The external current account is projected to move from a sizeable surplus in 2013/14 to moderate deficits over the medium term. The exchange rate peg with the Indian rupee is assumed to remain at the current level over the projection period. Import growth is expected to moderate in line with remittances. Export growth is projected to increase only moderately, reflecting weak competitiveness due to significant infrastructure bottlenecks. As a consequence, the ratio of exports to GDP is expected to gradually decline over the medium term.

- Relative to the previous DSA, the baseline assumes additional external financing of approximately US$2.7 billion from 2015/16 to 2019/20 in order to meet post-earthquake reconstruction related financing needs. This is the amount of new pledges of financial assistance in the form of grants and loans announced by Nepal’s development partners in the context of the International Conference on Nepal's Reconstruction (ICNR) held in

Kathmandu on June 25, 2015 (See Table 6 in the accompanying Staff Report for Request for Disbursement under the Rapid Credit Facility). About forty percent of this additional financing is assumed to come in the form of grants and the remainder in the form of loans.

EXTERNAL DEBT SUSTAINABILITY

A. Baseline

6. **Under the baseline scenario, Nepal's external debt indicators remain well below indicative sustainability thresholds** (Figure 1 and Table 1b). As in the previous DSA, remittances are formally included in the analysis as inflows remained robust even before the earthquake, reaching 28 percent of GDP in 2013/14. However, debt dynamics may be susceptible to volatility in remittance flows, as captured under standard shocks, discussed below. Over the medium term, the present value (PV) of external debt stabilizes at a level equal to: 9 percent of GDP + remittances, 29 percent of exports + remittances, and 60 percent of revenues. The ratio of debt service-to-exports + remittances stabilizes at 2 percent over the medium term, while the ratio of debt service to revenues stabilizes at 3 percent.

B. Stress Tests and Alternative Scenarios

7. **Debt dynamics remain resilient to standard shocks**. These stress tests include shocks to GDP growth, exports, non-debt creating flows, and a combination of these shocks, as well as a onetime 30 percent nominal depreciation shock. Under the most severe shock (to non-debt creating flows, capturing a remittance shock), the PV of debt to exports + remittances rises rapidly over the next three years but stays below the threshold, and thereafter declines again, while all other indicators remain well below the thresholds.

PUBLIC DEBT SUSTAINABILITY

8. **Under the baseline, the ratio of public debt to GDP rises gradually from 28.3 percent in 2014 to 31.2 percent in 2035.** In PV terms, public debt to GDP also increases from 21.1 percent in 2014 to 25.6 percent by 2035, while as a ratio of revenues and grants, the PV of public debt rises from 101.5 percent in 2014 to 108.4 percent by 2035. As with the 2014 DSA, the composition of public debt is projected to tilt towards higher domestic debt, from 37 percent in 2014 to 51 percent of total public debt in 2035.

9. **Debt dynamics remain resilient under standard stress tests.** In the context of the PV of public debt-to-GDP ratio, the most extreme shocks are the real GDP growth at historical average minus one standard deviation and the permanently lower GDP growth. These tests result in the PV of public debt-to-GDP ratio increasing to 31 percent by 2035, again staying well below the 56 percent threshold.

10. Contingent liabilities arise mainly from the operations of state owned enterprises (SOEs), and rising pension costs need to be addressed to head off future risks:

- Nepal Oil Corporation (NOC) and Nepal Electricity Authority (NEA) have been the two biggest loss-making SOEs, on average making combined losses of 1½ percent of GDP a year, and needing frequent government bail-outs despite periodic (though not automatic) price adjustments to recover costs. However, as a result of the decline in international oil prices during the second half of 2014, NOC's losses have been reduced. In fact, in early 2015 retail prices exceeded NOC's breakeven prices.

- Civil service pension liabilities, currently at a modest 1¼ percent of GDP, rise to 1½ percent by 2025, and can be addressed through adequate parametric reforms in the medium term according to a 2014 IMF TA mission on pension reforms.

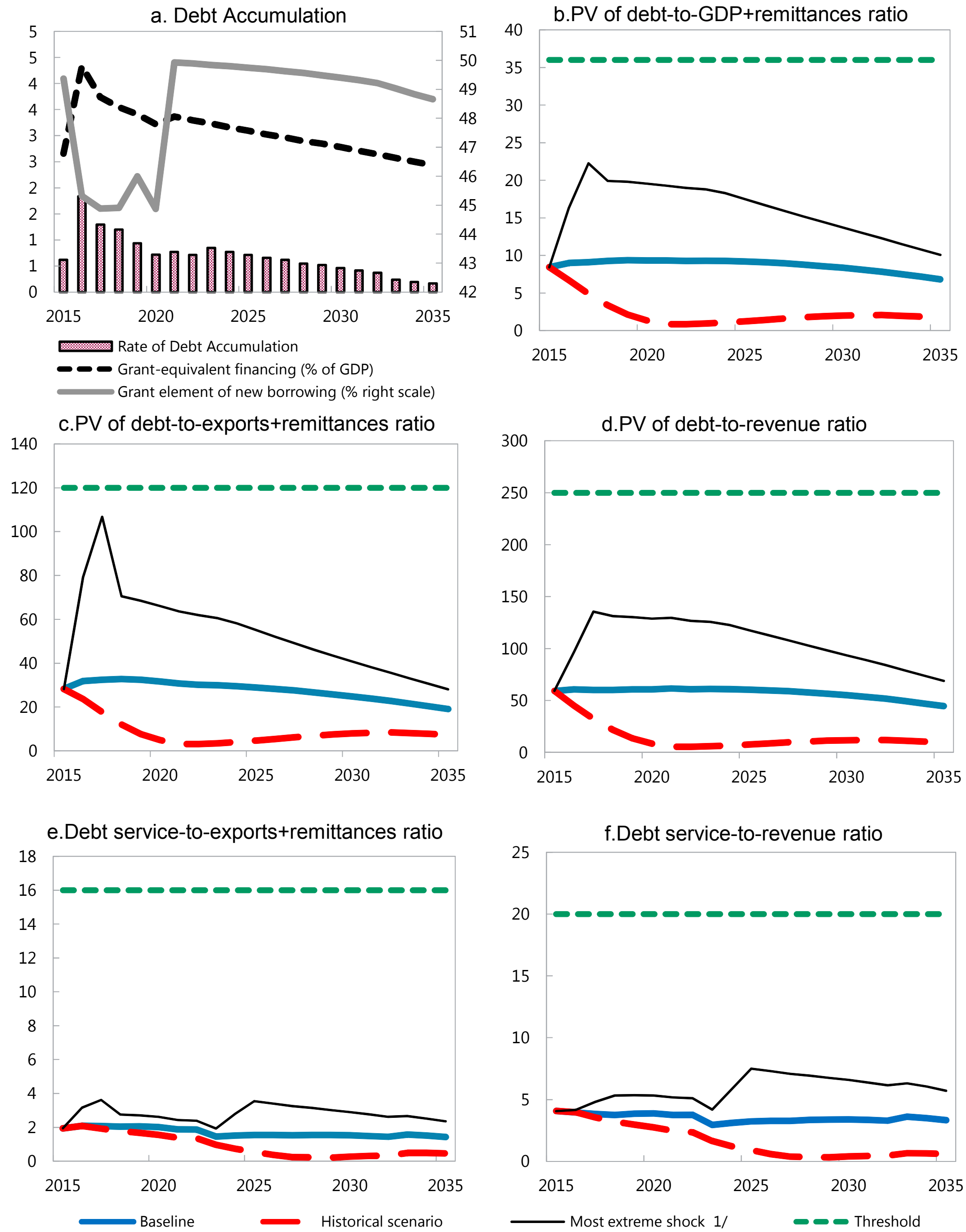
AUTHORITIES' VIEWS

11. The authorities broadly concurred with the findings of the DSA. While underscoring their commitment to a prudent borrowing policy, they noted the country's large reconstruction need in the aftermath of the earthquake. The authorities will seek to mobilize concessional borrowing to finance the reconstruction effort and put the economy on a path of higher growth and faster poverty reduction.

CONCLUSION

12. The DSA suggests Nepal's risk of debt distress is low. Generally prudent fiscal policy and low execution of capital spending budgets have continued to underpin declining levels of public debt. Higher financing requirements driven by post-earthquake reconstruction and higher public investment expenditures are expected to be manageable under the assumption that they are temporary and that financing terms are favorable. As a result, indicators of the public external debt stock and public debt service ratios remain comfortably within the policy-dependent indicative thresholds, even under stress tests, due to the assumed continued high level of concessionality of official borrowing.

Figure 1. Nepal: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2015–2035 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2025. In figure b. it corresponds to a Non-debt flows shock; in c. to a Non-debt flows shock; in d. to a Combination shock; in e. to a Non-debt flows shock and in figure f. to a Combination shock

Table 1a. Nepal: External Debt Sustainability Framework, Baseline Scenario, 2012–2035 1/

(In percent of GDP, unless otherwise indicated)

	Actual			Historical 6/ Average	Standard 6/ Deviation	Projections									
	2012	2013	2014			2015	2016	2017	2018	2019	2020	2015-2020 Average	2025	2035	2021-2035 Average
External debt (nominal) 1/	**22.9**	**20.2**	**17.9**			**18.0**	**19.2**	**19.3**	**19.5**	**19.8**	**19.7**		**19.8**	**15.2**	
of which: public and publicly guaranteed (PPG)	22.7	20.0	17.9			18.0	19.2	19.3	19.5	19.8	19.7		19.8	15.2	
Change in external debt	2.8	-2.7	-2.3			0.1	1.2	0.1	0.3	0.3	-0.1		-0.1	-0.7	
Identified net debt-creating flows	-5.2	-4.3	-5.2			-3.5	2.5	1.3	1.3	0.2	-1.0		-2.8	-2.8	
Non-interest current account deficit	**-5.0**	**-3.5**	**-5.0**	**-2.3**	**2.5**	**-2.8**	**3.4**	**2.5**	**2.2**	**1.1**	**0.2**		**-1.5**	**-1.7**	-1.5
Deficit in balance of goods and services	23.5	26.8	29.7			31.6	38.0	36.3	36.0	35.5	35.3		37.1	45.5	
Exports	10.1	10.7	11.7			9.6	7.8	8.0	8.2	8.6	8.9		9.4	9.4	
Imports	33.6	37.5	41.3			41.2	45.8	44.3	44.2	44.1	44.2		46.5	55.0	
Net current transfers (negative = inflow)	-27.5	-29.3	-32.6	-23.7	5.0	-32.8	-33.0	-32.2	-32.1	-32.7	-33.4		-36.9	-45.5	-39.5
of which: official	-2.1	-1.3	-1.8			-1.4	-2.3	-1.9	-1.8	-1.7	-1.7		-1.8	-2.0	
Other current account flows (negative = net inflow)	-1.0	-0.9	-2.1			-1.6	-1.6	-1.6	-1.6	-1.7	-1.7		-1.7	-1.7	
Net FDI (negative = inflow)	**-0.6**	**-0.5**	**-0.2**	**-0.2**	**0.2**	**-0.2**	**-0.3**	**-0.3**	**-0.3**	**-0.4**	**-0.7**		**-0.7**	**-0.7**	-0.7
Endogenous debt dynamics 2/	**0.4**	**-0.3**	**0.0**			**-0.5**	**-0.7**	**-0.9**	**-0.6**	**-0.6**	**-0.5**		**-0.6**	**-0.5**	
Contribution from nominal interest rate	0.2	0.2	0.5			0.0	0.0	0.1	0.1	0.1	0.2		0.2	0.1	
Contribution from real GDP growth	-1.0	-0.9	-1.1			-0.6	-0.7	-0.9	-0.7	-0.7	-0.7		-0.8	-0.6	
Contribution from price and exchange rate changes	1.1	0.4	0.5			...	...	...	...	...	...		...	...	
Residual (3-4) 3/	**8.0**	**1.6**	**2.9**			**3.7**	**-1.3**	**-1.2**	**-1.0**	**0.1**	**1.0**		**2.7**	**2.1**	
of which: exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 4/	...	...	10.7			10.9	11.5	11.7	11.9	12.1	12.1		12.2	9.6	
In percent of exports	...	...	92.0			113.8	147.1	145.2	144.2	139.8	135.2		129.9	102.1	
PV of PPG external debt	**...**	**...**	**10.7**			**10.9**	**11.5**	**11.7**	**11.9**	**12.1**	**12.1**		**12.2**	**9.6**	
In percent of exports	**...**	**...**	**92.0**			**113.8**	**147.1**	**145.2**	**144.2**	**139.8**	**135.2**		**129.9**	**102.1**	
In percent of government revenues	**...**	**...**	**58.4**			**59.2**	**60.5**	**60.2**	**60.2**	**60.7**	**60.6**		**60.4**	**44.6**	
Debt service-to-exports ratio (in percent)	**10.6**	**9.5**	**11.2**			**7.8**	**9.6**	**9.3**	**9.0**	**8.9**	**8.6**		**7.0**	**7.6**	
PPG debt service-to-exports ratio (in percent)	**10.6**	**9.5**	**11.2**			**7.8**	**9.6**	**9.3**	**9.0**	**8.9**	**8.6**		**7.0**	**7.6**	
PPG debt service-to-revenue ratio (in percent)	**6.7**	**5.8**	**7.1**			**4.1**	**4.0**	**3.8**	**3.8**	**3.8**	**3.9**		**3.2**	**3.3**	
Total gross financing need (Billions of U.S. dollars)	-0.6	-0.2	-0.7			-0.5	0.9	0.8	0.7	0.5	0.1		-0.7	-1.3	
Non-interest current account deficit that stabilizes debt ratio	-7.8	-0.8	-2.7			-2.9	2.2	2.4	1.9	0.9	0.3		-1.4	-1.0	
Key macroeconomic assumptions															
Real GDP growth (in percent)	4.8	4.1	5.4	4.3	0.9	3.4	4.4	5.4	3.9	3.8	3.8	4.1	4.0	4.0	4.0
GDP deflator in US dollar terms (change in percent)	-5.4	-1.8	-2.6	6.2	8.6	3.9	6.5	4.5	4.5	2.1	2.0	3.9	2.0	2.0	2.0
Effective interest rate (percent) 5/	0.9	0.9	2.5	1.1	0.5	0.1	0.3	0.3	0.5	0.7	1.0	0.5	1.0	1.0	1.0
Growth of exports of G&S (US dollar terms, in percent)	11.7	8.4	12.0	6.9	7.3	-11.9	-8.8	12.6	11.4	11.1	9.6	4.0	6.0	6.9	6.5
Growth of imports of G&S (US dollar terms, in percent)	0.6	14.0	13.2	14.7	9.0	7.0	23.8	6.5	8.3	5.8	6.0	9.6	7.8	8.0	7.6
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	49.4	45.3	44.9	44.9	46.0	44.9	45.9	49.7	48.7	49.5
Government revenues (excluding grants, in percent of GDP)	16.0	17.5	18.4			18.4	19.1	19.4	19.7	19.9	19.9		20.2	21.6	20.6
Aid flows (in Billions of US dollars) 7/	0.7	0.5	0.6			0.5	0.8	0.9	0.9	0.9	1.0		1.4	2.1	
of which: Grants	0.5	0.3	0.5			0.4	0.6	0.7	0.7	0.7	0.8		1.0	1.6	
of which: Concessional loans	0.2	0.1	0.1			0.1	0.2	0.2	0.2	0.2	0.2		0.4	0.6	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			2.7	4.3	3.7	3.5	3.4	3.2		3.1	2.4	2.9
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			76.7	69.3	72.7	73.0	75.7	78.5		80.4	85.8	81.9
Memorandum items:															
Nominal GDP (Billions of US dollars)	18.9	19.3	19.8			21.2	23.6	26.0	28.2	29.9	31.7		42.6	77.0	
Nominal dollar GDP growth	-0.8	2.2	2.6			7.4	11.2	10.1	8.6	6.0	5.8	8.2	6.1	6.1	6.1
PV of PPG external debt (in Billions of US dollars)			2.2			2.3	2.7	3.0	3.3	3.6	3.8		5.1	7.3	
(PVt-PVt-1)/GDPt-1 (in percent)						0.6	1.8	1.3	1.2	0.9	0.7	1.1	0.7	0.2	0.5
Gross workers' remittances (Billions of US dollars)	4.4	4.9	5.5			6.2	6.7	7.3	7.9	8.5	9.3		14.0	31.6	
PV of PPG external debt (in percent of GDP + remittances)	...	...	8.4			8.4	9.0	9.1	9.3	9.4	9.3		9.2	6.8	
PV of PPG external debt (in percent of exports + remittances)	...	...	27.0			28.2	31.9	32.4	32.8	32.4	31.6		29.0	19.1	
Debt service of PPG external debt (in percent of exports + remittances)	...	...	3.3			1.9	2.1	2.1	2.0	2.1	2.0		1.6	1.4	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

4/ Assumes that PV of private sector debt is equivalent to its face value.

5/ Current-year interest payments divided by previous period debt stock.

6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

7/ Defined as grants, concessional loans, and debt relief.

8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

Table 1b. Nepal: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2015–2035

(In percent)

	Projections							
	2015	2016	2017	2018	2019	2020	**2025**	2035
PV of debt-to-GDP+remittances ratio								
Baseline	8	9	9	9	9	9	**9**	7
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2015-2035 1/	8	7	5	3	2	1	**1**	2
A2. New public sector loans on less favorable terms in 2015-2035 2	8	9	10	11	11	11	**12**	11
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2016-2017	8	9	9	9	9	9	**9**	7
B2. Export value growth at historical average minus one standard deviation in 2016-2017 3/	8	9	9	9	9	9	**9**	7
B3. US dollar GDP deflator at historical average minus one standard deviation in 2016-2017	8	9	10	10	10	10	**10**	7
B4. Net non-debt creating flows at historical average minus one standard deviation in 2016-2017 4/	8	16	22	20	20	20	**18**	10
B5. Combination of B1-B4 using one-half standard deviation shocks	8	15	22	19	19	19	**17**	10
B6. One-time 30 percent nominal depreciation relative to the baseline in 2016 5/	8	11	11	12	12	12	**12**	8
PV of debt-to-exports+remittances ratio								
Baseline	28	32	32	33	32	32	**29**	19
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2015-2035 1/	28	24	18	12	8	5	**5**	7
A2. New public sector loans on less favorable terms in 2015-2035 2	28	34	36	38	38	38	**39**	30
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2016-2017	28	31	32	32	32	31	**29**	19
B2. Export value growth at historical average minus one standard deviation in 2016-2017 3/	28	30	32	32	32	31	**28**	19
B3. US dollar GDP deflator at historical average minus one standard deviation in 2016-2017	28	31	32	32	32	31	**29**	19
B4. Net non-debt creating flows at historical average minus one standard deviation in 2016-2017 4/	28	79	107	70	68	66	**55**	28
B5. Combination of B1-B4 using one-half standard deviation shocks	28	65	90	61	59	57	**48**	25
B6. One-time 30 percent nominal depreciation relative to the baseline in 2016 5/	28	31	32	32	32	31	**29**	19
PV of debt-to-revenue ratio								
Baseline	59	61	60	60	61	61	**60**	45
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2015-2035 1/	59	45	33	22	14	9	**8**	10
A2. New public sector loans on less favorable terms in 2015-2035 2	59	64	67	69	72	74	**81**	71
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2016-2017	59	60	61	61	62	61	**61**	45
B2. Export value growth at historical average minus one standard deviation in 2016-2017 3/	59	57	58	58	59	59	**59**	44
B3. US dollar GDP deflator at historical average minus one standard deviation in 2016-2017	59	65	69	69	70	70	**70**	51
B4. Net non-debt creating flows at historical average minus one standard deviation in 2016-2017 4/	59	99	134	129	128	127	**115**	66
B5. Combination of B1-B4 using one-half standard deviation shocks	59	97	135	131	130	129	**118**	69
B6. One-time 30 percent nominal depreciation relative to the baseline in 2016 5/	59	83	83	82	83	83	**83**	61

Table 1b. Nepal: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2015–2035 (continued)

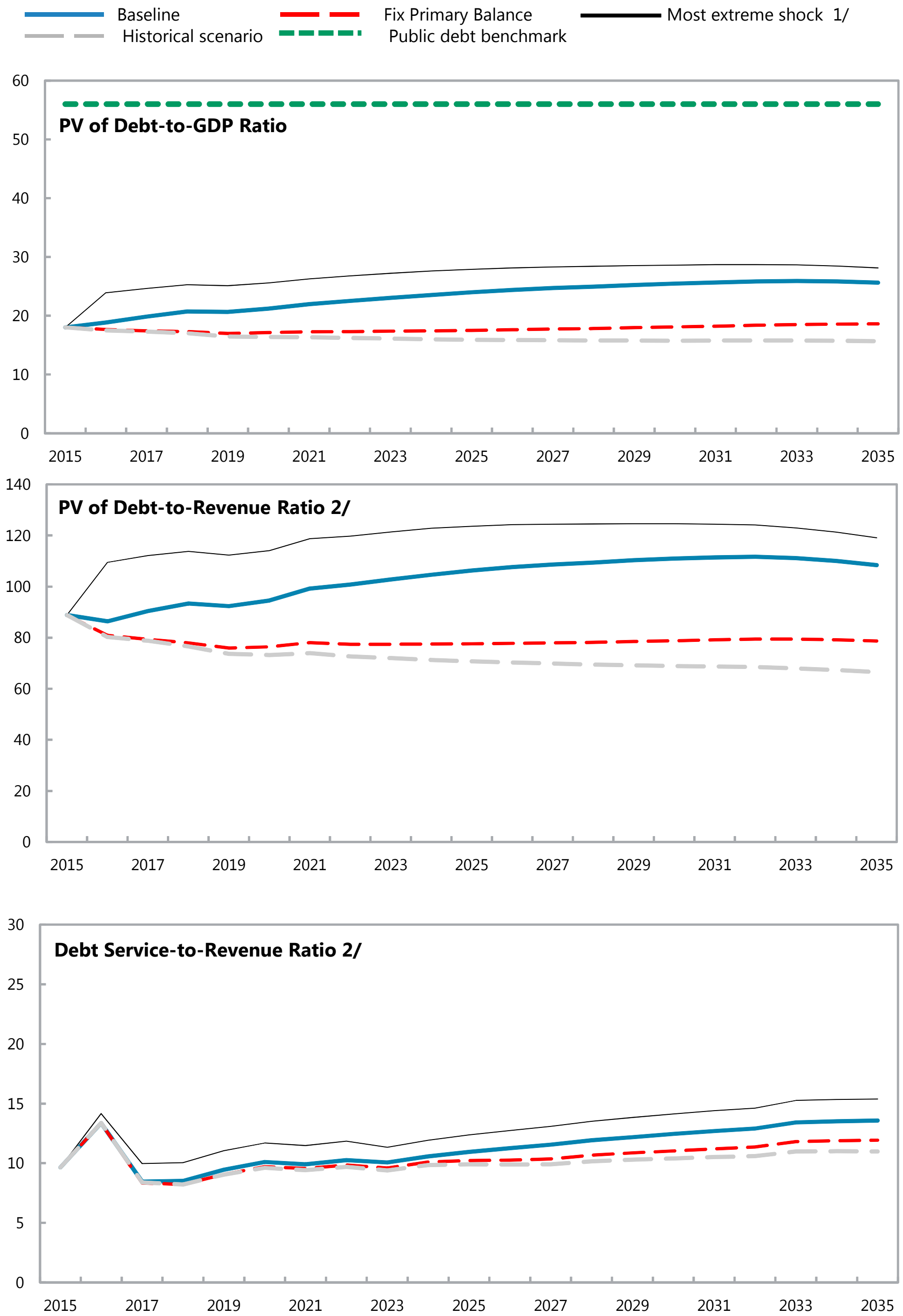
(In percent)

				Debt service-to-exports+remittances ratio				
Baseline	2	2	2	2	2	2	**2**	1
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2015-2035 1/	2	2	2	2	2	2	**1**	0
A2. New public sector loans on less favorable terms in 2015-2035 2	2	2	2	2	2	2	**2**	2
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2016-2017	2	2	2	2	2	2	**2**	1
B2. Export value growth at historical average minus one standard deviation in 2016-2017 3/	2	2	2	2	2	2	**2**	1
B3. US dollar GDP deflator at historical average minus one standard deviation in 2016-2017	2	2	2	2	2	2	**2**	1
B4. Net non-debt creating flows at historical average minus one standard deviation in 2016-2017 4/	2	3	4	3	3	3	**4**	2
B5. Combination of B1-B4 using one-half standard deviation shocks	2	3	3	2	2	2	**3**	2
B6. One-time 30 percent nominal depreciation relative to the baseline in 2016 5/	2	2	2	2	2	2	**2**	1
				Debt service-to-revenue ratio				
Baseline	4	4	4	4	4	4	**3**	3
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2015-2035 1/	4	4	4	3	3	3	**1**	1
A2. New public sector loans on less favorable terms in 2015-2035 2	4	4	4	4	4	5	**5**	5
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2016-2017	4	4	4	4	4	4	**3**	3
B2. Export value growth at historical average minus one standard deviation in 2016-2017 3/	4	4	4	4	4	4	**3**	3
B3. US dollar GDP deflator at historical average minus one standard deviation in 2016-2017	4	4	4	4	4	5	**4**	4
B4. Net non-debt creating flows at historical average minus one standard deviation in 2016-2017 4/	4	4	5	5	5	5	**7**	6
B5. Combination of B1-B4 using one-half standard deviation shocks	4	4	5	5	5	5	**7**	6
B6. One-time 30 percent nominal depreciation relative to the baseline in 2016 5/	4	6	5	5	5	5	**5**	5
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	48	48	48	48	48	48	**48**	48

Sources: Country authorities; and staff estimates and projections.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly a an offsetting adjustment in import levels).
4/ Includes official and private transfers and FDI.
5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.
6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Figure 2. Nepal: Indicators of Public Debt Under Alternative Seniors, 2015–2035 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2025.

2/ Revenues are defined inclusive of grants.

Table 2a. Nepal: Public Sector Debt Sustainability Framework, Baseline Scenario, 2012–2035

(In percent of GDP, unless otherwise indicated)

	Actual					Estimate	Projections								
	2012	2013	2014	Average 5/	Standard Deviation 5/	2015	2016	2017	2018	2019	2020	2015-20 Average	2025	2035	2021-35 Average
Public sector debt 1/	36.4	32.3	28.3			25.1	26.5	27.5	28.4	28.4	28.8		31.6	31.2	
of which: foreign-currency denominated	22.7	20.0	17.9			18.0	19.2	19.3	19.5	19.8	19.7		19.8	15.2	
Change in public sector debt	1.9	-4.2	-4.0			-3.1	1.4	1.0	0.9	0.0	0.5		0.4	-0.5	
Identified debt-creating flows	2.9	-3.1	-5.3			-1.0	1.3	0.9	0.9	0.0	0.5		0.4	-0.5	
Primary deficit	1.2	-1.8	-1.9	0.3	1.3	0.6	3.0	3.2	2.7	1.2	1.5	2.0	1.6	0.6	1.4
Revenue and grants	18.7	19.3	20.8			20.3	21.8	21.9	22.2	22.3	22.4		22.6	23.6	
of which: grants	2.7	1.8	2.4			1.9	2.7	2.6	2.5	2.5	2.5		2.4	2.0	
Primary (noninterest) expenditure	19.9	17.5	18.9			20.9	24.8	25.1	24.9	23.6	23.9		24.2	24.3	
Automatic debt dynamics	1.8	-1.3	-3.3			-1.6	-1.7	-2.2	-1.9	-1.3	-1.1		-1.2	-1.1	
Contribution from interest rate/growth differential	-1.8	-1.7	-2.2			-1.8	-1.1	-1.8	-1.4	-0.8	-1.1		-1.2	-1.1	
of which: contribution from average real interest rate	-0.2	-0.2	-0.6			-0.9	-0.1	-0.4	-0.4	0.2	0.0		0.0	0.1	
of which: contribution from real GDP growth	-1.6	-1.4	-1.6			-0.9	-1.1	-1.3	-1.0	-1.0	-1.0		-1.2	-1.2	
Contribution from real exchange rate depreciation	3.6	0.4	-1.1			0.2	-0.6	-0.5	-0.4	-0.4	0.0		...	...	
Other identified debt-creating flows	-0.1	-0.1	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	-0.1	-0.1	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	-1.0	-1.0	1.3			-2.1	0.1	0.0	0.0	0.0	0.0		0.0	0.0	
Other Sustainability Indicators															
PV of public sector debt	...	...	21.1			18.0	18.8	19.9	20.7	20.6	21.2		24.0	25.6	
of which: foreign-currency denominated	...	...	10.7			10.9	11.5	11.7	11.9	12.1	12.1		12.2	9.6	
of which: external	...	...	10.7			10.9	11.5	11.7	11.9	12.1	12.1		12.2	9.6	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	6.2	4.1	1.9			3.5	6.5	5.7	5.4	4.2	4.6		5.1	5.3	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	101.5			88.9	86.4	90.5	93.4	92.4	94.5		106.3	108.4	
PV of public sector debt-to-revenue ratio (in percent)	...	...	115.0			98.0	98.8	102.6	105.1	103.9	106.4		118.6	118.7	
of which: external 3/	...	...	58.4			59.2	60.5	60.2	60.2	60.7	60.6		60.4	44.6	
Debt service-to-revenue and grants ratio (in percent) 4/	12.4	15.0	13.3			9.7	13.4	8.5	8.5	9.5	10.1		10.9	13.6	
Debt service-to-revenue ratio (in percent) 4/	14.5	16.5	15.1			10.6	15.3	9.6	9.6	10.6	11.4		12.2	14.9	
Primary deficit that stabilizes the debt-to-GDP ratio	-0.7	2.4	2.1			3.7	1.6	2.2	1.8	1.2	1.0		1.2	1.1	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	4.8	4.1	5.4	4.3	0.9	3.4	4.4	5.4	3.9	3.8	3.8	4.1	4.0	4.0	4.0
Average nominal interest rate on forex debt (in percent)	1.0	1.9	3.4	1.3	0.8	0.1	0.3	0.3	0.5	0.7	1.0	0.5	1.0	1.0	1.0
Average real interest rate on domestic debt (in percent)	-0.4	-2.7	-8.0	-4.0	3.2	...	3.5	-1.6	-1.7	0.7	2.0	0.6	1.6	1.7	1.6
Real exchange rate depreciation (in percent, + indicates depreciation)	19.1	2.0	-5.6	-3.5	10.7	1.2	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	6.6	6.6	8.7	9.0	3.7	5.9	8.6	8.3	7.7	5.5	5.0	6.8	5.0	5.0	5.0
Growth of real primary spending (deflated by GDP deflator, in percent)	11.1	-8.5	14.0	1.7	6.3	13.9	24.2	6.7	3.1	-1.8	5.3	8.6	4.2	3.9	4.1
Grant element of new external borrowing (in percent)	...	...	...	...	...	49.4	45.3	44.9	44.9	46.0	44.9	45.9	49.7	48.7	...

Sources: Country authorities; and staff estimates and projections.

1/ [Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.]

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues excluding grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Statement by Marzunisham Omar, Executive Director for Nepal and Thomas Benjamin Marcelo, Senior Advisor to the Executive Director Executive Board Meeting July 31, 2015

On behalf of our Nepal authorities, we would like to thank the Managing Director for her commitment in supporting the recovery and reconstruction of Nepal following the devastating earthquakes in April and May 2015. We would also like to commend the staff for their prompt response and hard work in order to bring for the Board's consideration the request of Nepal for access under the Rapid Credit Facility (RCF) of the Poverty Reduction and Growth Trust (PRGT). The authorities are very much appreciative of the Fund's policy advice and technical assistance in key areas as well as the catalytic role that the Fund is playing in mobilizing support for Nepal.

The authorities strongly appreciate the outpourings of support received from the international community in response to the devastating earthquakes. This includes the swift and continuing provision of humanitarian aid by several countries and organizations. The authorities welcome the generous pledges by bilateral and multilateral donors of about US$4 billion in grants and concessional loans for the reconstruction efforts to be disbursed over a period of five years, as announced at the International Conference on Nepal's Reconstruction on 25 June 2015. The authorities reaffirm their commitment to ensure the effective use of these financial resources for the rehabilitation and reconstruction efforts.

Damage Assessment and Economic Outlook

An earthquake on April 25 and a powerful aftershock on May 12 devastated Nepal, resulting in extensive damage to two-thirds of the country's districts, particularly in the central and western parts of the country. More than 8,800 people lost their lives and more than 22,300 people were injured. Over half a million houses were destroyed and another quarter million was damaged, rendering three million people homeless. Around half a million buildings were also destroyed. The authorities estimate that an additional 3 percent of Nepal's population, as many as a million people, has been pushed into poverty as a direct result of the earthquakes, on top of the 25 percent who were estimated to already be living below the poverty line.

The total value of damages and losses in production are estimated at about US$7 billion, equivalent to nearly one-third of the country's GDP. The earthquakes are expected to result in an initial slowdown in economic activity and will strain Nepal's external position. As such, the disaster has set back efforts to further develop the economy and enable Nepal to graduate from least developed country status.

The economic growth rate of Nepal over the past five years averaged 4.5 percent. This year, the economy was initially projected to grow at 5.2 percent compared to the growth of 3.5 percent last year. The damage to property has adversely affected productive capacity. Further, the devastation caused by the earthquakes has particularly affected the agriculture and tourism sectors, and the growth outlook in 2014/2015 has been revised downwards to

3.04 percent, the lowest in eight years. The growth recovery will largely be determined by the vigor of the reconstruction effort. The authorities expect GDP growth to register 6 percent in 2015/2016 on account of the significant public and private sector investments in reconstruction and expansion in economic activities.

Inflation, which has averaged 9.3 percent in the past five years, had moderated to less than 7.5 percent in the eleven months of 2014/2015. Inflationary pressures are expected to build up on account of supply-side bottlenecks, an expansionary budget to finance reconstruction efforts, and upward pressure on wages of both skilled and unskilled workers. However, the authorities expect that inflation will be contained to a single digit.

Fiscal deficit is expected to emerge as revenues fall and expenditures rise reflecting efforts by authorities to provide assistance to earthquake-affected businesses and households, including vulnerable groups in the short-term, while supporting the reconstruction efforts.

The fall in foreign exchange receipts from exports and tourism and increased imports of reconstruction-related goods are expected to push the current account into deficit. This will strain Nepal's external position and the pace of public sector reconstruction will importantly depend on the amount of external financing that Nepal receives to rebuild. The authorities expect that without the mobilization of substantial grants and concessional loans, foreign reserves would decline significantly over the medium term even as they expect an increase in workers' remittances to support their families.

Request for Financial Assistance

The authorities would like to request for financial assistance under the RCF to address Nepal's urgent balance of payments need and mitigate the risks of economic disruption as reconstruction activity gets under way. The assistance would be a disbursement of SDR35.65 million (approximately US$50 million) under the RCF to ease the pressure on Nepal's fiscal resources and foreign exchange reserves. The authorities are requesting for the funds to be disbursed as budget support to the account of the Ministry of Finance at the Nepal Rastra Bank (NRB). The IMF's involvement is also expected to help catalyze further donor support for the reconstruction efforts.

Policy Framework

Fiscal Policy. The Nepal authorities have established the National Reconstruction Authority under the leadership of the Prime Minister to coordinate the swift and efficient implementation of rehabilitation and reconstruction activities in the next five years. The authorities recently unveiled the annual budget for 2015/2016, and allocated more than US$8 billion for reconstruction and development. Based on the annual budget, the authorities have allocated US$740 million to the National Reconstruction Fund. In addition to the reconstruction efforts, the authorities have prioritized budget allocation to agriculture, education, health, tourism, infrastructure development, connectivity and the construction of hydroelectric power plants.

The authorities welcome the debt sustainability analysis, which highlights that Nepal's risk of debt distress continues to remain low, underpinned by prudent debt management and fiscal policy. They acknowledge the urgency to accelerate public investment in the aftermath of the earthquakes. The authorities reaffirm their commitment to a prudent borrowing policy and will seek external grants and concessional loans to finance the reconstruction efforts and put the economy on a path of higher growth and faster poverty reduction.

The authorities will also strengthen public financial management to accelerate capital expenditure through improved budget planning, project selection, implementation and results monitoring. In particular, budget allocation for unimplemented and slow moving projects will be realigned to ongoing and better performing programs and projects. Projects that have detailed feasibility studies and whose environmental assessment and land acquisition requirements have been completed will be prioritized for implementation. The authorities have also allocated funds for project development. They are also introducing changes to the procurement law to fast track public procurement and facilitate project implementation. The authorities appreciate the technical assistance provided by the Fund in public financial management and will consider the recommendations to further improve Nepal's arrangements for capital budget management.

Monetary Policy. The Nepal authorities have adopted a cautious and balanced stance of monetary policy to support economic recovery as well as to contain inflationary pressure expected to arise from fiscal expansion.

Given the economic disruption, some increase in inflation is inevitable. Once economic conditions normalize, the authorities will aim to keep inflation close to that in India. The authorities will continue to maintain a pegged exchange rate to the Indian rupee, which has served well in minimizing market volatility.

Financial Sector Policy. To help ease the impact of the devastating earthquakes, the NRB has put in place regulatory relief for banks in the affected areas, so that the banks could extend the same to their customers. Among others, the temporary relief measures covers loan-loss provisioning and loan rescheduling. The NRB also waived approval to open a branch and launch mobile and branchless banking in the market center of selected earthquake-affected areas. An Economic and Rehabilitation Fund was also established under the NRB, to provide a refinancing facility and interest subsidy on loans extended to earthquake-affected areas covering residential construction, agriculture, business and tourism development.

Even before the earthquakes, the authorities were cognizant of the importance of financial inclusion and have pursued various policies and programs to improve access to financial services. These policies and programs include among others, branching policy outside of Kathmandu, provision of interest-free loans to facilitate the establishment of branches in underserved areas, introduction of branchless banking and mobile banking, and implementation of financial literacy and financial consumer protection initiatives. The authorities recently announced a nationwide campaign to encourage households to open at least one bank account by ensuring that cash transfers by the government will only be done through bank accounts.

The authorities will likewise continue to implement the financial sector reform program to strengthen the legal framework and institutional capacity for bank supervision and regulation and for financial crisis management and bank resolution.

Structural Reforms. The authorities are determined to implement its ambitious structural reform agenda under Nepal's 13th Development Plan (2013-2016), which aims at graduating from least developed country status by 2022. The authorities are undertaking the necessary structural reforms to improve competitiveness and the business environment. The authorities have identified as priority areas, infrastructure, especially transportation and energy, education and training, increasing SME access to finance, and strengthening social safety nets. The authorities acknowledge the importance of public-private partnerships in addressing the infrastructure gaps, particularly in increasing energy supply through hydroelectric power generation.

International Response

The Nepal authorities would like to reiterate their gratitude to staff for their productive engagement on policy and the speed and flexibility of their response in the aftermath of the earthquakes. The authorities have found the discussions productive, are grateful for the insightful analysis provided by staff, and will closely consider all aspects of the Fund's policy advice. The authorities are committed to undergo an update of the Safeguards Assessment undertaken by the Fund in 2011 in connection with the 2010 RCF disbursement. This will provide an opportunity to further examine the external audit mechanism and financial reporting framework of the NRB.

The Nepal authorities look forward to the Board's approval of a disbursement under the Rapid Credit Facility of the PRGT. This will assist the authorities in the enormous task of catalyzing further resources for rehabilitation and reconstruction. The appointment of a full-time IMF Resident Representative in Nepal to reinforce the effectiveness of the Fund's engagement with Nepal will likewise be much appreciated.

The authorities consent to the publication of the staff report and the Letter of Intent.