



# NEPAL

## SELECTED ISSUES

February 2019

This Selected Issues paper on Nepal was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on January 24, 2019.

Copies of this report are available to the public from

International Monetary Fund • Publication Services  
PO Box 92780 • Washington, D.C. 20090  
Telephone: (202) 623-7430 • Fax: (202) 623-7201  
E-mail: [publications@imf.org](mailto:publications@imf.org) Web: <http://www.imf.org>  
Price: \$18.00 per printed copy

**International Monetary Fund  
Washington, D.C.**



# NEPAL

## SELECTED ISSUES

January 24, 2019

Approved By  
**Asia and Pacific  
Department**

Prepared by a team comprising Patrick Blagrove and  
Piyaporn Sodsriwiboon (both APD)

## CONTENTS

<b>SUMMARY</b>	<b>3</b>
<b>INFLATION CO-MOVEMENT BETWEEN INDIA AND NEPAL</b>	<b>4</b>
A. Stylized Facts	4
B. Empirical Analysis of Inflation Co-Movement Determinants	5
C. Policy Implications	6
References	7
<b>TABLES</b>	
1. Inflation Correlation with India	4
2. Inflation Co-Movement Regression Results	5
<b>MANAGING EFFECTIVE FISCAL FEDERALISM</b>	<b>8</b>
A. Nepal's Fiscal Federalism Structure	8
B. Key Issues and Challenges	10
C. Policy Implications	13
References	16
<b>FIGURES</b>	
1. Transition to Federal Structure	8
2. Cross-Country Subnational Government Operations	11
<b>TABLE</b>	
1. General Government Operations Under Fiscal Federalism	15

<b>SUSTAINABLE FINANCE TO SUPPORT LONG-TERM GROWTH</b> _____	<b>17</b>
References _____	23

**FIGURE**

1. Financial Sector Structure _____	22
-------------------------------------	----

<b>FINANCIAL INCLUSION IN NEPAL: BRIDGING THE GAPS</b> _____	<b>24</b>
--	-----------

References _____	28
------------------	----

**FIGURE**

1. Financial Inclusion _____	25
------------------------------	----

## EXECUTIVE SUMMARY

Following prolonged tepid growth, economic activity in Nepal has picked up, amid greater political stability and enhanced supply of electricity. The improved outlook provides an opening to address deep-seated structural weaknesses and boost long-term growth prospects. However, fiscal spending pressures, including related to the rapid implementation of fiscal federalism, and excessive credit growth pose challenges to macroeconomic and financial stability. This background paper for the 2018 Article IV consultation with Nepal presents supporting analysis which underlies the policy recommendations in the staff report.

The first chapter shows that the considerable co-movement in headline inflation rates between India and Nepal is driven almost exclusively by food-inflation co-movement. By contrast, the role for inflation spillovers emanating from India in driving non-food inflation in Nepal appears limited. The implication is that Nepal should rely on domestic monetary policy rather than stable inflation in India to achieve stable domestic inflation.

The second chapter analyzes Nepal's newly-established fiscal federalism framework. It highlights that the rapid transition to fiscal federalism carries several pitfalls and can complicate fiscal and macroeconomic management. Managing effective fiscal federalism in Nepal will require strong efforts to strengthen public financial management and enhance the implementation capacity at all levels of government to mitigate risks to fiscal sustainability and improve allocative efficiency gains.

The third chapter highlights that Nepal's long-term economic development requires sustainable financial sector development. However, despite steps taken to address financial sector weaknesses, Nepal's banking sector remains exposed to several risks and vulnerabilities, exacerbated by the prolonged rapid credit expansion of the last few years. The financial cycle can be moderated, and risks contained by a combination of measures discussed in the chapter.

Financial inclusion is an important vehicle to promote inclusive growth and reduce poverty. The fourth chapter highlights that financial inclusion in Nepal has improved gradually over the past several years, but there are still large gaps between urban and rural areas and across genders. Going forward, it would be important for the implementation of Nepal's financial inclusion plan to focus on the underserved and progressively address financial inclusion gaps.

# INFLATION CO-MOVEMENT BETWEEN INDIA AND NEPAL<sup>1</sup>

Many countries in South Asia have strong economic ties to India—paramount among these, Nepal. This note examines the degree to which inflation co-moves between India and a panel of countries in Asia. Unlike much of the previous analysis on inflation co-movement, the approach taken here treats food and core inflation as distinct processes and allows for the possibility that apparent co-movement in food prices may reflect common shocks to weather patterns across countries—as such, inflation ‘spillovers’ may not be as large as some studies suggest.

## A. Stylized Facts

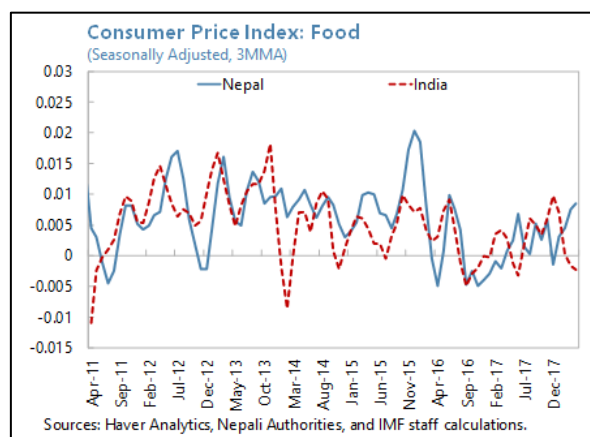
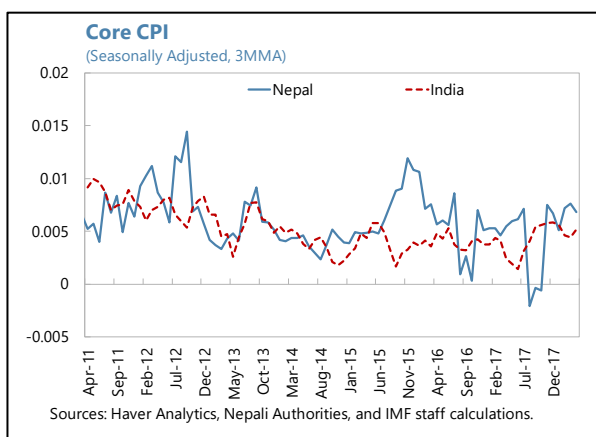
### 1. Although food-inflation co-movement between India and Nepal is relatively strong, for core inflation it is much weaker, especially in the recent period.

An examination of correlations between food and core inflation rates in India and a set of countries in Asia suggest that this result extends beyond just the India-Nepal case. In particular, Table 1 shows that for countries with strong trade ties to India (those for whom imports from India comprise a large share of total imports) headline inflation rates tend to be more highly correlated. However, this finding appears to be driven exclusively by higher correlation in food inflation rates. For core inflation, the countries who depend most on import from India (especially Bhutan and Nepal) do not exhibit core inflation rates which are highly correlated with those in India.

Table 1: Inflation Correlation with India

	Import share	Food CPI	Headline CPI	Core CPI
Bhutan	74.3	0.45	0.52	0.09
Nepal	57.8	0.73	0.65	0.18
Sri Lanka	20.4	0.27	0.24	N/A
Bangladesh	14.0	0.17	0.40	0.25
Pakistan	3.2	0.74	0.51	0.50
Indonesia	2.2	0.02	0.01	0.17
Singapore	2.1	-0.37	0.31	0.42
Vietnam	1.9	-0.20	0.02	0.50
Hong Kong SAR	1.8	-0.54	-0.17	0.02
Malaysia	1.6	-0.15	0.11	-0.16
Thailand	1.3	0.27	0.09	0.14
China	1.1	-0.45	-0.32	-0.08
Philippines	1.1	0.08	0.12	0.39
South Korea	1.1	-0.21	-0.15	0.21
Cambodia	1.0	0.50	0.35	0.38
Laos	0.4	0.40	0.14	N/A
Mongolia	0.4	-0.23	-0.04	N/A
top 1/3				
middle 1/3				
bottom 1/3				

Sources: Haver Analytics; National Authorities; IMF Information Notice System, International Financial Statistics, and Direction of Trade Statistics; The World Bank Group; IMF staff calculations.



<sup>1</sup> Prepared by Patrick Blagrove (APD). Methodology based on Blagrove, 2018, “Inflation Co-Movement in Asia: Blame it on the Rain?” IMF Working Paper, forthcoming.

## B. Empirical Analysis of Inflation Co-Movement Determinants

2. To assess the determinants of inflation co-movement between India and other countries in Asia, an instantaneous quasi-correlation measure is used, as employed by Duval and others (2016), among others:

$$QCORR_{i,India,t}^{\pi} = \frac{(\pi_{i,t} - \pi_i^*)(\pi_{India,t} - \pi_{India}^*)}{\sigma_i^{\pi} \sigma_{India}^{\pi}}$$

Here, co-movement between inflation ( $\pi$ ) in each country vis-à-vis India ( $i, India$ ) is assessed in each month ( $t$ ) based on the product of deviations of inflation in that period from some notion of equilibrium ( $\pi^*$ ) in the two countries, normalized by the product of the volatility of inflation in the two countries ( $\sigma_i^{\pi}$ ).<sup>2</sup>

3. A panel regression is estimated to quantify the determinants of inflation co-movement between India and its neighbors, similar to that of Auer and Mehrotra (2014):

$$QCORR_{ijt}^{\pi} = \alpha + \beta_1(Import_{ijt}) + \beta_2(QCORR_{ijt}^{M2}) + \beta_3(QCORR_{ijt}^{IP}) + \beta_4(QCORR_{ijt}^{Rainfall}) + \gamma_t + \varepsilon_{ijt},$$

for  $\pi$ : {food; core}

where  $Import_{ijt}$  is each ( $i$ ) country's share of imports from India ( $j$ ), relative to its total imports at each time,  $t$ . Other variables are quasi-correlations of broad money growth (M2), industrial production growth (IP), and deviations of rainfall from seasonal (monthly) norms, between India and other countries in the sample;  $\gamma_t$  captures time (monthly) fixed effects, which could be associated with common movements in global inflation determinants, such as demand conditions, or global energy or food prices. Analysis is conducted for food and core inflation, separately, and controls for time (monthly) fixed effects.

	(1) Food Inflation	(2) Core Inflation
Rainfall co-movement	1.095* (0.580)	0.651 (0.443)
Exchange-rate co-move	0.056* (0.030)	0.052 (0.032)
Import share, from India	0.003* (0.002)	-0.002 (0.002)
Observations	870	556
Number of countries	16	11
Time fixed effects?	yes	yes
Robust standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.1 Source: IMF staff calculations.		

<sup>2</sup> Quasi-correlations for dependent variables are calculated in the same way. The variable-specific notion of equilibrium used here is simply the period average, but results are robust to instead using the HP-filtered series to represent equilibrium values.

**4. The main takeaway from the results is that food inflation co-movement between India and other countries is higher in cases where the co-movement in rainfall deviations from seasonal norms is highest** (Table 2). Greater trade integration with India also plays a role in driving inflation co-movement in the case of food price inflation, as does nominal effective exchange-rate co-movement. Regression results for the determinants of core inflation co-movement are much less precisely estimated—neither rainfall (through possible second-round effects) nor trade integration, nor exchange-rate co-movement with India are found to have a statistically significant impact on core inflation co-movement. This suggests that core inflation is primarily determined by domestic (idiosyncratic) factors.<sup>3</sup>

### C. Policy Implications

**5. Despite the appearance of considerable co-movement in headline inflation rates between India and Nepal, this phenomenon is driven almost exclusively by food-inflation co-movement.** Analysis using a panel of Asian countries shows that food inflation co-movement is partly related to trade integration, as has been argued by others in the literature, but is also partly a function of similar responses to common weather shocks.

**6. The role for inflation spillovers emanating from India in driving non-food inflation in Nepal appears limited, suggesting a crucial role for monetary policy in tackling domestic inflationary pressures.** Although the results of this note do nothing to diminish the widely held view that headline inflation co-movement is strong between India and Nepal, they do suggest a need for nuance in this message, as food inflation co-movement is strong while core inflation co-movement is weak. In addition, common shocks such as rainfall patterns are likely partly responsible for food-inflation co-movement, suggesting that this is not exclusively driven by spillovers from India. Since core inflation co-movement is weak, idiosyncratic domestic factors such as economic slack, exchange-rate movements, and differing degrees of passthrough from food- and energy-price shocks (second-round effects) play an important role. This finding is critically important for monetary policy, especially since domestic policy is primarily effective only in controlling core inflation. Thus, domestic monetary policy needs to be calibrated to domestic inflationary pressures—Nepal cannot necessarily rely on stable inflation in India to achieve stable domestic inflation.

<sup>3</sup> In both food and core-inflation regressions, M2 and IP co-movement have no statistically significant impact on inflation co-movement (results not shown in Table 2, for brevity).

## References

- Auer, R., and A. Mehrotra, 2014, "Trade Linkages and the Globalisation of Inflation in Asia and the Pacific," *Journal of International Money and Finance*, Vol. 49, pp. 129–151.
- Blagrove, P., 2018, "Inflation Co-Movement in Asia: Blame it on the Rain?" IMF Working Paper, forthcoming.
- Duval, R., N. Li, R. Saraf, and D. Seneviratne, 2016, "Value-Added Trade and Business Cycle Synchronization," *Journal of International Economics*, Vol. 99, pp. 251–262.

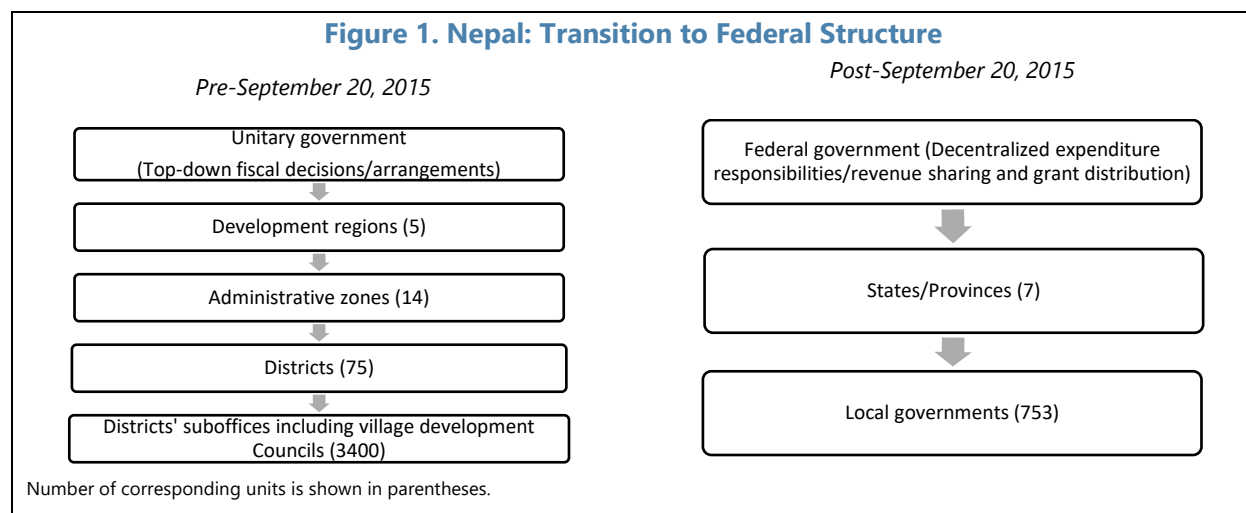


## MANAGING EFFECTIVE FISCAL FEDERALISM<sup>1</sup>

Nepal has been undergoing a swift transition to fiscal federalism in recent years. The new paradigm holds the promise of improved delivery of public services. However, the rapid transition to the new structure of government and government finances also carries pitfalls and complicates fiscal and macroeconomic management. Indeed, the introduction of fiscal federalism has been associated with a sharp deterioration of fiscal performance. The design of intergovernmental fiscal relations and the ambitious timetable to implement fiscal federalism have been shaped importantly by political-economy considerations that are outside the scope of this note. Instead, the focus is on analyzing Nepal's newly-established fiscal federalism framework, highlight gaps in the current structure and the potential economic impact, and discuss policy recommendations. Managing effective fiscal federalism in Nepal will require strong efforts to strengthen public financial management and enhance the implementation capacity at all levels of government to mitigate risks to fiscal sustainability and achieve allocative efficiency gains.

### A. Nepal's Fiscal Federalism Structure

**1. Nepal is transforming itself from a unitarian state into a federal democratic republic as mandated by the 2015 Constitution.** The transition to a federal system could help make policies more inclusive and improve the delivery of government services to people across Nepal. The new federal state structure comprises federal, provincial, and local governments (Figure 1).



**2. Fiscal and institutional arrangements have been re-designed and implemented to support the new federal structure.** A key objective is to create allocative efficiency gains and improve the delivery of public services, with local governments responsible for basic services including education, health, local transportation, and water and sanitation. The 2015 constitution sets out the provisions that govern the fiscal federalism framework, in particular the revenue and

<sup>1</sup> Prepared by Piyaporn Sodsriwiboon (APD).

expenditure assignments. The Parliament has also approved the Local Government Operations Act (2017) which will govern the operation and management of local governments. Under this Act, in the future, all financial resources allocated for local governments are to be deposited into the Local Consolidated Fund, which will enable the municipalities to manage their fiscal affairs. The Inter-Government Fiscal Transfers Act (2018) specifies the framework for public financial management. The National Natural Resources and Fiscal Commission (NNRFC) has been established per the constitution to recommend the arrangements related to inter-governmental fiscal transfers, internal borrowing, and natural resources utilization.

**3. With the current setup, Nepal's fiscal federalism is special in a number of aspects.** For instance, most spending assignments are handed down to the lowest level of government—local government, with limited roles for the central and provincial governments. Furthermore, the subnational levels have vast legislative powers which could create coordination challenges. The transition to fiscal federalism is being implemented over a short time span, rather than in a calibrated and sequenced manner, which adds to the transition challenges.

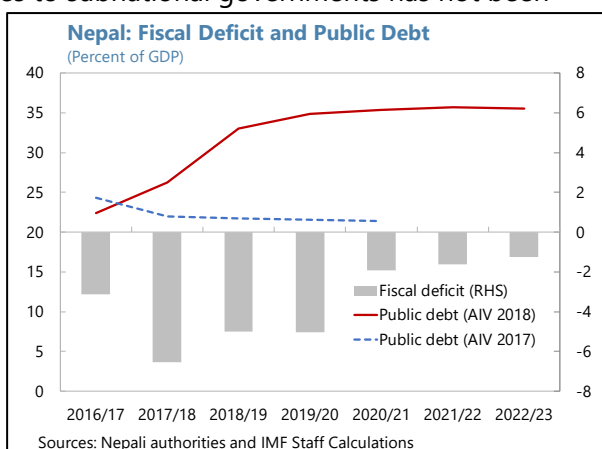
**4. Provincial and local governments' financial resources comprise of four key elements:**

- *Four categories of fiscal transfers:*
  - (i) Equalization grants: transfers of resources to the provincial and local governments based on population, development status, and the gap between expenditure needs and revenue potential. Transfers are effected in four installments (10<sup>th</sup> August, 19<sup>th</sup> October, 16<sup>th</sup> January, and 15<sup>th</sup> April);
  - (ii) Conditional grants: transfer of funds to provincial and local governments to implement projects related to national policies and standards. A quarter of the total budgeted amount is to be transferred on July 17. The rest is to be transferred on the first day of each trimester depending on implementation progress;
  - (iii) Complementary grants: transfer of funds to provincial and local governments to match the resources; and
  - (iv) Special grants: transfer of funds to provincial and local governments to support any special project related to the supply of services, emergency needs, and activities related to national development priorities.
- *Revenue-sharing:* VAT and internal excise tax revenues will be shared among federal, provincial, and local governments at the ratio of 70:15:15. Royalties will be shared at the ratio of 50:25:25.
- *Local revenue collection:* Taxes on property, rent and lease income, and vehicle registration fees will be collected by local governments for their own source revenues.
- *Internal borrowing and provision of loans by the center:* The legal framework and monetary instruments related to internal borrowing have not yet been finalized. Nevertheless, the NNRFC's

administrative decision suggest an upper limit for internal borrowing at 5 percent of GDP per annum for the federal government. Provincial and local governments could borrow up to 10 percent of the sum of their share of VAT and excise revenue locally-collected revenue.

## 5. The first two budgets under fiscal federalism entailed sizeable financial resources transferred to sub-national governments, resulting in a sharply wider fiscal deficits (Table 1).

- The operation of fiscal federalism commenced partially in FY2017/18, as the center began fiscal transfers to newly-established local governments. Transfers were limited to conditional and equalization grants and determined on an ad hoc basis by a simple formula.
- Subsequently, the NNRFC developed a revenue sharing formula. The establishment of provincial governments further operationalized fiscal federalism and the FY2018/19 budget envisages total financial resources for subnational governments of 14 percent of GDP.
- The transfer of a significant amount of resources to subnational governments has not been offset by an equivalent decline in central government spending. Therefore, the consolidated fiscal position has deteriorated sharply with the deficits reaching 6.5 percent of GDP in FY2017/18 and budgeted to expand further to about 8 percent of GDP in FY2018/19. As a result, even taking into account the likely under-implementation the budget, public debt is projected to rise to 33 percent of GDP in FY2018/19, up from 26 percent of GDP in FY2016/17.



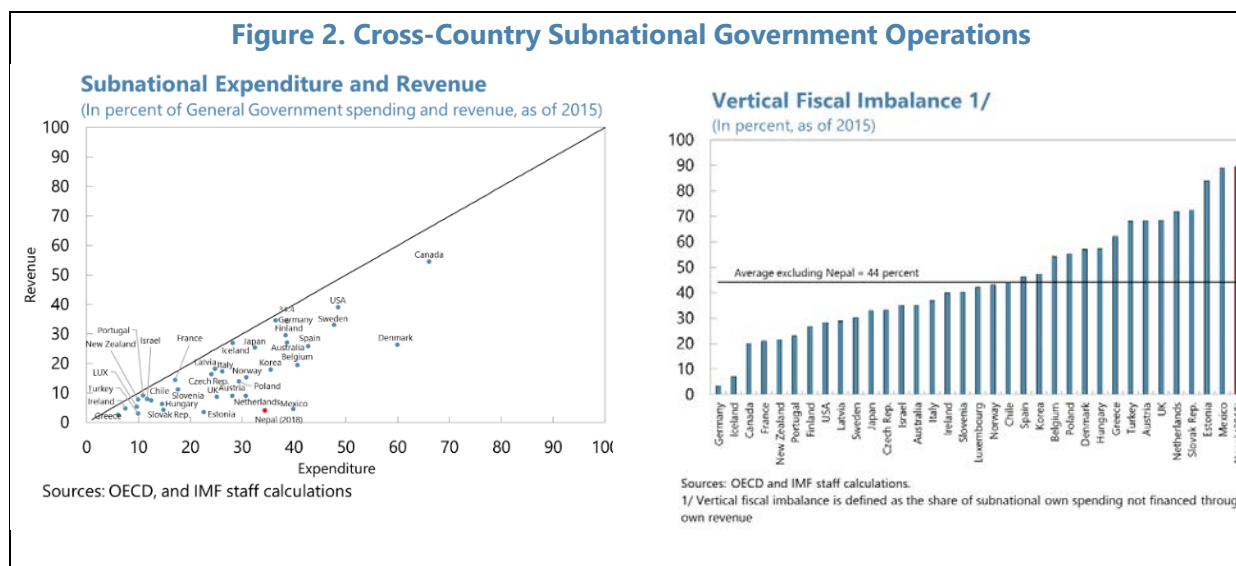
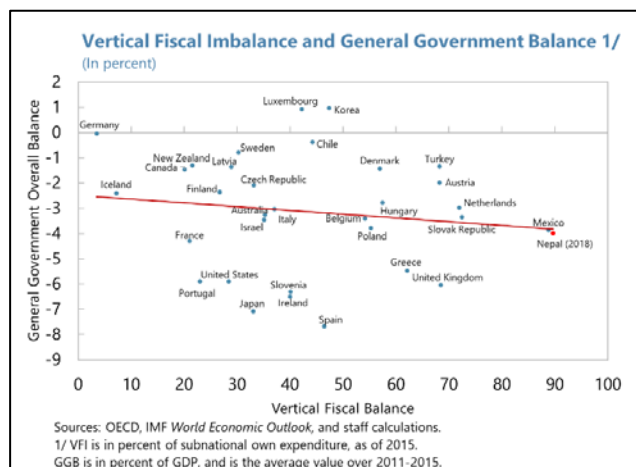
## B. Key Issues and Challenges

### *Macro-Fiscal Implications of Nepal's Current Fiscal Federalism Structure*

**6. Fiscal strains could be exacerbated in the absence of further adjustment of central government spending and medium-term budget planning.** A sizeable increase in the consolidated government's budget envelope and the lack of realistic medium-term fiscal framework, if persists, could risk fiscal sustainability, as this could lead to an unsustainable fiscal path amid persistent budget deficit and rising public debt. At present, Nepal's risk of debt distress remains low, but public debt is projected to rise sharply and reach 35 percent of GDP in the medium-term in the staff's baseline scenario, up from 22 percent of GDP in the staff report for the 2017 Article IV Consultation.

**7. The heavy reliance of the subnational governments on shared revenues and transfers from the center has put pressures on the fiscal balance and could risk fiscal sustainability.** Nepal's share of subnational spending in total general government spending of about 36 percent in

the FY2018/19 Budget is not exceptionally high, but the share of the subnational governments' own source revenue in their total revenue is very low, thus leading to very large vertical fiscal imbalance (VFI)—higher than in other countries (Figure 2). Cross-country experience suggests that large VFIs are associated with worse fiscal performance, in terms of general government balance, as it could relax the fiscal discipline of subnational governments (Eyraud and Lusinyan, 2011). More specifically, sub-national governments' dependency on shared revenues and transfers from the center may create incentive problems. The provincial and local governments face little incentive to raise revenue to finance their spending. Local authorities may fail to fully internalize the cost of local spending when they can finance their marginal expenditure with central transfers that are funded by taxpayers in other jurisdictions; therefore, this behavior can lead to overspending, relaxation of tax collection, low revenue, and weakening of fiscal balance (Sow and Razafimahefa, 2017).



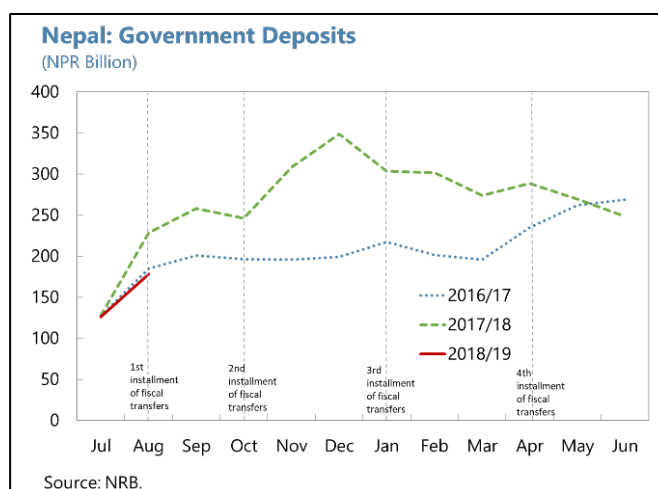
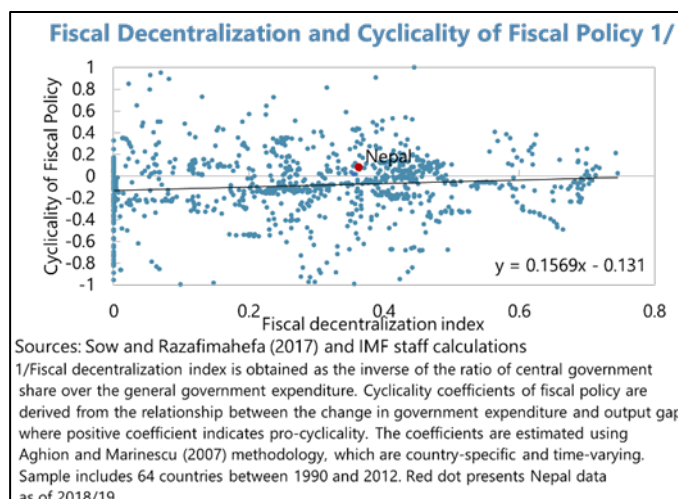
**8. Fiscal decentralization may impede the conduct and effectiveness of fiscal policy.** If a large share of taxes and spending is shifted to subnational governments, the central government's fiscal policy levers become less powerful. This could be an important issue given also that policy priorities often differ across government levels. Ter-Minassian (1997) noted that revenue-sharing arrangements on a tax-by-tax basis with fixed distribution coefficients like in Nepal tends to make fiscal policy more pro-cyclical: increases in shared revenues during a boom period increase the availability of resources for sub-national governments, and vice versa. This will tend to limit the ability of the central government to conduct counter-cyclical stabilization policies. Indeed, Sow and

Razafimahefa (2017) found fiscal decentralization to be associated with increased fiscal policy pro-cyclicality or reduced counter-cyclicality, thus suggesting that fiscal decentralization has a destabilizing effect on fiscal policy. This issue deserves attention in Nepal where fiscal policy in recent years tended to be pro-cyclical, and decentralization could further reduce the effectiveness of fiscal policies going forward.

### Capacity Issues

**9. Rapid devolvement of spending responsibilities and augmentation of resources to subnational governments could stretch the capacity at subnational levels, therefore limiting allocative efficiency gains.** Decentralization of expenditure responsibilities could lead to allocative efficiency gains, for example by allowing for better alignment of expenditure priorities with preferences of citizens. However, these gains may be negated in practice by administrative weaknesses and the lack of capacity at the subnational level (Ter-Minassian, 1997). In the case of Nepal,

- Rapid federalization carries the risk of disruption of public services. This could be exacerbated in case roles and responsibilities across the three levels of governments are not clearly defined.
- Subnational governments appear to have limited implementation capacity to fully utilize their resources. A substantial share of the resources transferred to provincial and local governments is often kept in government deposit accounts, as evidenced by a surge of government deposits during the fiscal year.
- The absence of well-developed public financial management systems at the subnational levels, including expenditure reporting and control systems, could raise the risk of misallocation and waste (Ahmad et al, 2006).



### **Framework and Institutional Design Issues**

**10. It is as yet unclear to what extent the current fiscal transfers and revenue-sharing will align with subnational governments' actual cost of public service delivery.** In principle, the design of revenue sharing<sup>2</sup> and grants<sup>3</sup> to subnational governments in Nepal appears to be broadly in line with practices in other countries. Nevertheless, the expected cost of service delivery remains unknown, as a comprehensive costing of subnational governments' expenditure assignments has not yet been completed. Therefore, there is a need to review and refine subnational governments' budget envelopes to bring them in line with the expected cost of service delivery.

**11. Gaps in the existing framework remain to be filled.** The framework for internal borrowing will need to be developed, with the criteria and borrowing limits to be set effectively. Cross-country experiences suggest such conditions will be crucial to enforce fiscal discipline and mitigate macro-fiscal risks arising from subnational levels.

### **C. Policy Implications**

**12. In sum, a rapid transition to fiscal federalism carries several pitfalls and can complicate fiscal and macroeconomic management.** Nepal's swift implementation of fiscal federalism has been associated with a marked deterioration of fiscal performance. At the same time, it is too soon to assess whether the new federal fiscal structure will help to improve the delivery of public services. Managing effective fiscal federalism in Nepal will require strong efforts to strengthen public financial management and enhance the implementation capacity at all levels of governments to mitigate risks to fiscal sustainability and improve allocative efficiency gains. These include:

#### *Short-term priorities:*

- Subnational governments' policy implementation capacity should be strengthened through training, standardization, and the use of technology.
- Public financial management systems at subnational levels should be established. Particularly, effective and transparent budgeting, accounting and reporting system at all levels should be developed. Nepal's Financial Comptroller General Office is taking steps to improve financial reporting at the subnational levels, and it is important that these efforts be intensified. Local consolidated funds should also be established, to help monitor the financial transactions of

<sup>2</sup> Revenue sharing criteria in Nepal is based on population, area, human development index, and under-development index factoring in infrastructure, cost of service delivery, and discrimination index. Similarly, India uses formulas that combine population, income per capita, state's own tax effort and under-development index. Brazil uses a set of coefficients loosely linked to relative per capita income levels of the states. Germany applies redistributive criteria for sharing VAT on per capita basis entailing to less affluent states (Ter-Minassian, 1997).

<sup>3</sup> Grant distribution in Nepal takes into account gaps between revenue potential and expenditure needs, cost of expenditure, human poverty index, and other dimension of poverty such as discrimination index and infrastructure index. As noted in Ter-Minassian (1997), Denmark, Japan, and Korea also use indicators of expenditure needs including demographic characteristics, population density, length of road, among others. In addition, countries such as the United States and Canada use block grant or special grant for the case of Nepal to close expenditure gaps.

subnational governments. Going forward, these funds should be made to act as stabilization funds—absorbing excess resources during boom while boosting spending during bust periods, in order to prevent more procyclical fiscal policy resulted from fiscal decentralization.

*Medium-term priorities:*

- The expenditure allocation should gradually adjust to reconcile with the responsibilities and needs. Fiscal Responsibility and Budget Management Bill (FRBMB) should be adopted to ensure fiscal discipline and increase accountability. A realistic medium-term expenditure framework should be reinstated, and medium-term budget planning should be developed to ensure fiscal prudence and consistency with broader macroeconomic management. The annual budget planning should be guided by the medium-term framework. A periodic spending review should be conducted to provide inputs to refine the methodology and formulas for revenue sharing and fiscal transfers.
- Fiscal discipline at subnational levels can be strengthened by better aligning subnational governments' taxation powers with their spending obligations, thus narrowing the vertical fiscal imbalances (Eyraud and Lusinyan, 2011). State and local taxes should be carefully selected, based on feasibility and efficiency considerations.
- The functional and revenue responsibilities should be clarified at all levels of government. It is crucial to ensure non-overlapping responsibilities between the center and local authorities, in order to avoid duplication and waste of public resources as well as to warrant better service quality (Ter-Minasian (1997) and Ahmad et al (2006)). A review of costs of delivering services in the federal structure should be conducted as a matter of priority.

**Table 1. Nepal: General Government Operations Under Fiscal Federalism**

	FY17/18 Actual		FY18/19 Budget	
	NPR million	%GDP	NPR million	%GDP
III. General government				
Revenue	767	25.5	1,045	31.1
Expenditure	963	32.0	1,314	39.2
Fiscal balance	-196	-6.5	-269	-8.0
I. Central government				
Revenue	517	17.2	562	16.7
Expenditure	713	23.7	831	24.8
Fiscal balance	-196	-6.5	-269	-8.0
II. State/local governments				
Revenue	250	8.3	483	14.4
Fiscal transfers	250	8.3	328	9.8
Fiscal equalization grants	155	5.1	136	4.0
Conditional grant	95	3.2	173	5.2
Complementary grant	0	0.0	10	0.3
Special grant	0	0.0	10	0.3
of which: Fiscal transfer to local level	246	8.2	205	6.1
Fiscal equalization grants	150	5.0	85	2.5
Conditional grant	95	3.2	110	3.3
Complementary grant	0	0.0	5	0.1
Special grant	0	0.0	5	0.1
Fiscal transfer to states	4	0.1	123	3.7
Fiscal equalization grants	4	0.1	50	1.5
Conditional grant	0	0.0	63	1.9
Complementary grant	0	0.0	5	0.1
Special grant	0	0.0	5	0.1
Revenue sharing	0	0.0	114	3.4
Own revenue collection	0	0.0	41	1.2
Internal borrowing	0	0.0	0	0
Expenditure	250	8.3	483	14.4
Fiscal balance	0	0.0	0	0.0

Sources: Nepali authorities and IMF staff projection



## References

- Ahmad, E., G. Brosio, and M. Gonzalez, 2006, "Uganda: Managing More Effective Decentralization," IMF Working Paper No. 06/279 (Washington: International Monetary Fund).
- Eyraud, L., and L. Lusinyan, 2011, "Decentralizing Spending More than Revenue: Does it Hurt Fiscal Performance?" IMF Working Paper No. 11/226 (Washington: International Monetary Fund).
- International Monetary Fund, 2012, "Pakistan: 2011 Article IV Consultation and Proposal for Post Program Monitoring," IMF Country Report No. 12/35 (Washington).
- National Natural Resources and Fiscal Commission, 2018, *Fiscal Federalism in Nepal: Journey so Far*, Official Presentation.
- Sow., M., and I. Razafimahefa, 2017, "Fiscal Decentralization and Fiscal Policy Performance," IMF Working Paper No. 17/64 (Washington: International Monetary Fund).
- Ter-Minasian, T., ed., 1997, *Fiscal Federalism in Theory and Practice* (Washington: World Bank).

# SUSTAINABLE FINANCE TO SUPPORT LONG-TERM GROWTH<sup>1</sup>

*Nepal's long-term economic development requires sustainable financial sector development. Despite steps taken to address financial sector weaknesses, Nepal's banking sector remains exposed to several risks and vulnerabilities. The prolonged rapid credit expansion of the last few years has likely led to a buildup of credit and liquidity risk. Going forward, financial sector reform efforts need to be reinforced, particularly to strengthen regulations and oversight and upgrade the financial sector infrastructure, which would yield payoffs in terms of reduced systemic risks amid enhanced financial deepening.*

**1. Since Nepal's 2014 participation in the IMF's Financial Sector Assessment Program (FSAP), steps have been taken to address financial sector weaknesses and enhance financial sector development.** The 2014 FSAP highlighted significant vulnerabilities, particularly macro-financial risks related to slowing remittance growth and real estate concentration, as well as a number of weaknesses in the legal and supervisory framework governing financial institutions. To date, the authorities have worked collaboratively with development partners including the World Bank in the context of Development Policy Credits, UK's Department for International Development, and the IMF. Key reforms include:

- *Financial stability.* A special inspection program to evaluate credit portfolios and determine the financial soundness of 54 bank and financial institutions (BFIs) was performed by an independent evaluator in 2015<sup>2</sup>. Following the results, Nepal Rastra Bank announced a four-fold increase in minimum paid-up capital. The capital increase was phased in between 2016 and 2018 and was effected mostly through issuance of outright shares, retained profits, and bank mergers.
- *Legal framework.* Nepal Rastra Bank Act Amendment (NRBAA) Bill and the new Deposit and Credit Guarantee Fund Act (DCGF) were approved by the Parliament in September 2016. These laws have helped clarify the bank resolution powers of the NRB and enhance the legal framework for the deposit insurance scheme. However, the NRBAA curtails the autonomy of the central bank and does not address two key FSAP recommendations, regarding granting explicit consolidated supervision powers and clarifying emergency liquidity assistance provisions.

<sup>1</sup> Prepared by Piyaporn Sodsriwiboon (APD).

<sup>2</sup> In the context of the World Bank/DFID-supported financial sector reform program, KPMG Portugal was hired to conduct a special inspection program (SIP) of selected banks. A key objective of the SIP was to follow up on concerns, including raised in the context of the 2014 FSAP, regarding the accuracy and reliability of banks' financial reports. Accordingly, the SIP determined the condition of a large number of banks and financial institutions (BFIs), including through an extensive review and evaluation of their credit portfolios. As described in Annex 4 of the World Bank's report for the 3rd Financial Sector Stability Development Policy Credit (see: <http://documents.worldbank.org/curated/en/793331490040216477/pdf/112766-REPLACEMENT-OUO-9.pdf>), the 54 BFIs included in the SIP represented more than 50 percent of total banking sector assets. Almost half of the banks (26 out of 54) were found to have CARs of less than the minimum required in 2014/15. Some of these banks were subjected to prompt corrective action and some others were merged.

Amendments to the Bank and Financial Institutions Act (BAFIA), which aim to strengthen the governance of commercial banks were passed in January 2017.

- *Financial sector oversight and infrastructure.* Nepal Rastra Bank adopted risk-based banking supervision in 2018, and gradually proceeded to full implementation. A Supervisory Information System is being developed. The recent transition to the Nepali Financial Reporting Standards (NFRS) which are consistent with International Accounting Standards (IAS) is expected to help improve the quality and accuracy of the statutory financial information of BFIs. The payments and clearing systems have been modernized, including the introduction of the Real-Time Gross Settlements (RTGS).

**2. Nevertheless, challenges remain.** Despite some mergers in recent years, Nepal's financial sector remains large and fragmented (Figure 1). With a credit-to-GDP ratio of 80 percent, financial deepening level appears to be high for Nepal's level of economic development. Nevertheless, credit is highly concentrated to specific groups and sectors, and access to financial services is uneven (see Chapter 4 for more details). There are important gaps in financial infrastructure that need to be addressed to support financial stability and deepening, such as the introduction of a collateral registry, the improvement of the Credit Information Bureau, and the effective implementation of debt enforcement and insolvency laws. This note reassesses key risks in Nepal's banking system taking into account also the development needs.

**3. Taking a holistic look, Nepal's long-term economic development requires sustainable financial sector development.** Nepal's longstanding development objectives are to graduate from less developed countries (LDC) status by 2022 and achieve middle income countries (MIC) status by 2030. This requires sustained strong broad-based growth and will need to be supported by sustainable financial sector development including sound credit provision. International experience also shows that too much credit and too fast financial deepening can lead to a buildup of financial sector risks and, in some cases, banking crises, which can be very costly and set back economic development for years. Therefore, an important policy implication would be to ensure financial deepening and inclusion, while addressing vulnerabilities and containing risks to financial stability.

**4. In Nepal, prolonged rapid credit expansion raises concerns about the quality of lending and underlying risks in the banking system.** Credit growth has been strong, averaging about 21 percent over the past three years, considerably exceeding trend growth of the past two decades. Large inflows of remittances coupled with accommodative monetary policy and lax supervision have contributed to rapid credit expansion. An important share of bank lending is channeled to real estate related lending, as well as overdrafts and working capital collateralized by land and real estate (Figure 1). As a consequence, the rapid credit growth has fueled a sustained rise in asset prices which may prompt future corrections, and likely built up substantial credit and liquidity risks in the banking system.

## 5. Key macro-financial risks pertain to significant real estate exposures and high reliance on remittance inflows.

- *Credit risks are related to large real estate exposures*, which account for about 70 percent of total lending. To some extent, high concentration of real estate exposures may be hard to avoid in the less-developed and less-diversified banking system. Nonetheless, this contributes to the buildup of vulnerabilities, and a real estate bust could trigger significant banking problems. In addition, despite the resilience of reported financial soundness indicators, asset quality is potentially overstated given weaknesses in banks' risk management and loan classification, in which half of banks' loan books comprise of overdraft and working capital loans which typically rollover continuously and whose loan quality is hard to establish. Assuming a financial shock propagated from a real estate bust to a broad economic crisis that triggers a sharp economic slowdown and the deterioration of asset quality, a simulation exercise replicating Nepal's historical shocks to real GDP growth<sup>3</sup> suggests that non-performing loans could rise sharply (Text Figure 1).
- *Liquidity risk is related to remittance inflows*. Liquidity risk remains a concern. Banks continue to rely heavily on remittance inflows as the main funding source for deposits (Text Figure 2). At times of strong inflows, accommodative monetary conditions and banks' poor risk management practices combine to strong credit growth. A liquidity stress test done by the NRB (NRB, 2018a) suggests 19 out of 28 commercial banks are vulnerable to liquidity pressures under scenarios of the withdrawal of customer deposits by 2, 5, and 10 percent for five consecutive days. International experience also shows a liquidity crisis can lead to a collapse in credit and spread out to a broader banking crisis.

**6. Gaps in financial sector oversight persists.** The NRB's Bank Supervision Report (NRB, 2018b) highlights important issues including poor risk management culture and weak control environments in banks, inadequate information sharing among banks making it difficult to assess repayment capacity and collateral adequacy for multiple financing, poor loan classification leading to inadequate loan-loss recognition and provisioning, and the need for capacity building for both banks and supervisors related to the implementation of risk-based supervision. Moreover, the enforcement of supervisory directions is often delayed or inadequate where banks often make excuses for not taking corrective measures on time.

---

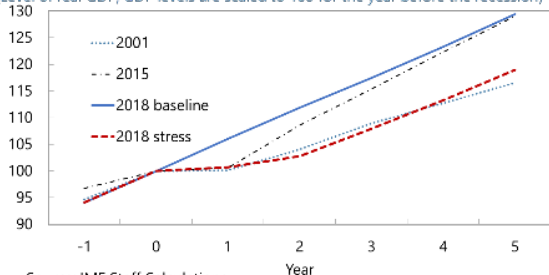
<sup>3</sup> The simulation exercise is modeled as a function of a set of macro-financial variables, in line with Nepal's 2014 FSAP practice (IMF, 2014). However, due to insufficient bank-by-bank and detailed bank balance sheet data, the analysis is limited to the aggregate level data.

### Text Figure 1. Nepal: Credit Risk

*A shock to growth can swiftly translate into a sharp rise in NPLs...*

**Nepal: Real GDP in Adverse Historical Episodes and Stress Scenario**

(Level of real GDP, GDP levels are scaled to 100 for the year before the recession) 1/

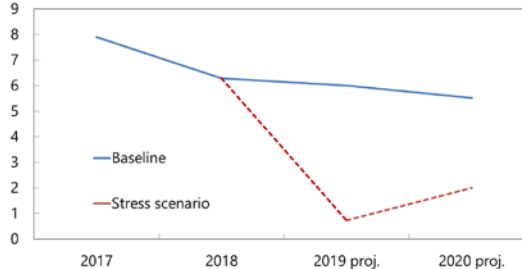


Source: IMF Staff Calculations.

1/ Baseline growth projections are consistent with strong policy scenario. Under stress scenario, growth projections reflect the deviation from baseline in line with historical shocks.

**Nepal: Real GDP Growth1/**

(Percent)



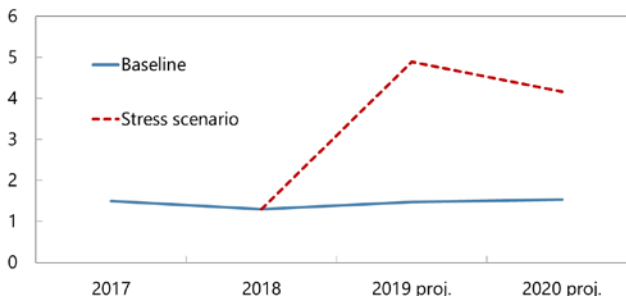
Source: IMF Staff Estimates.

1/ Baseline growth projections are consistent with strong policy scenario. Under stress scenario, growth projections reflect the deviation from baseline in line with historical shocks.

*...and additional capital and provisioning may be required.*

**Nepal: System-wide NPL Ratios 1/**

(Percent of total loans)



Source: IMF Staff Estimates.

1/ NPLs ratio model was modeled as a function of a set of macro-financial variables, consistent with 2014 FSAP. Explanatory variables include real GDP growth rate, loan growth and capital ratios. Macro assumptions are assumed to be in line with baseline and stress scenarios.

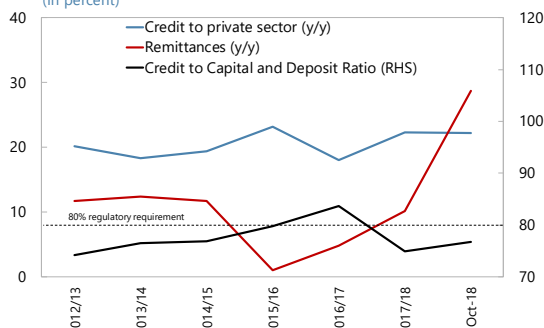
**7. Building sustainable finance to support long-term growth of Nepal requires further reform efforts**, particularly to strengthen financial sector oversight and upgrade Nepal’s financial sector infrastructure. The financial cycle can be moderated, and risks contained by a combination of measures:

- *Tightening macroprudential policies.* Macroprudential policies, including with regard to the credit-to-deposit (CCD) ratio, the loan-to-value ratio, and limits to real estate exposures, have helped to contain credit growth. They need to be tightened further. The carve-outs to the calculation of the CCD ratio should be phased out over time.
- *Strengthening banking supervision.* Underlying (and potentially rising) vulnerabilities suggest that banking supervision as well as risk assessments and monitoring should continue to be upgraded. Supervisors should be empowered to follow up on the findings of their inspections.

**Text Figure 2. Nepal: Liquidity Risk**

*An important source of liquidity risk relates to Nepal's heavy reliance on remittance inflows.*

**Growth of Remittances and Private Sector Credit**  
(In percent)

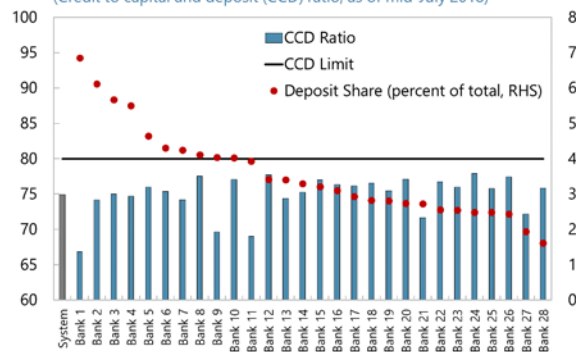


Sources: NRB, Nepali Authorities and IMF staff calculations.

*Strong remittance inflows in recent months have helped ease bank liquidity conditions.*

**Nepal: Liquidity Conditions**

(Credit to capital and deposit (CCD) ratio, as of mid-July 2018)



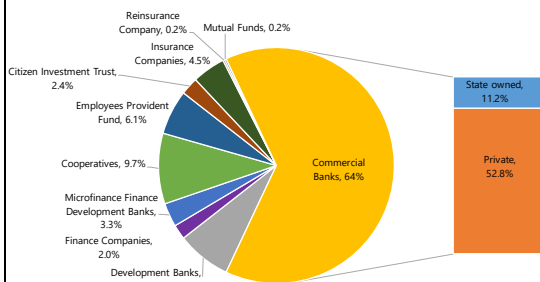
Sources: NRB and IMF Staff calculations.

- *Building buffers.* Additional capital and provisioning may be required to build buffers against potential losses, given data and supervisory weaknesses.
- *Updating crisis management.* The central bank's lender of last resort policy, last updated in 2011, needs to be further clarified and aligned with international central bank practices with respect to emergency liquidity assistance.
- *Upgrading financial infrastructure.* An accessible collateral registry needs to be developed urgently, along with the improvement of supervisory information system and credit bureau. Upgrading of these key elements of the financial infrastructure will help support financial stability and deepening.

**Figure 1. Nepal: Financial Sector Structure**

Nepal's financial sector continues to be dominated by banks but various other intermediaries are coming up..

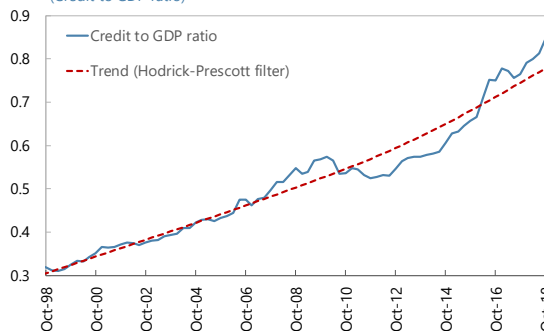
**Structure of the Nepalese Financial Sector**  
(Percent of total financial sector assets, as of mid-July 2017)



Source: NRB.

The credit-to-GDP ratio is higher than in peers and has been rising considerably above trend in recent years.

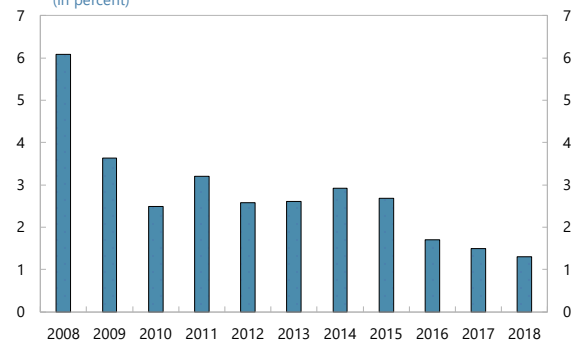
**Credit Gap Analysis, 1998-2018**  
(Credit to GDP ratio)



Sources: Nepali authorities and IMF staff calculations.

Commercial banks non-performing loans (NPLs) are lower than in peers and may be understated.

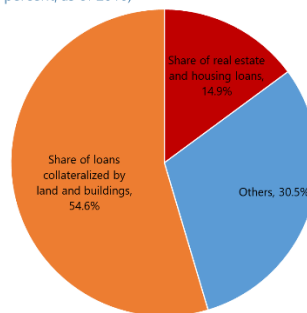
**NPL's to total loans**  
(In percent)



Source: NRB.

Real estate exposures are significant.

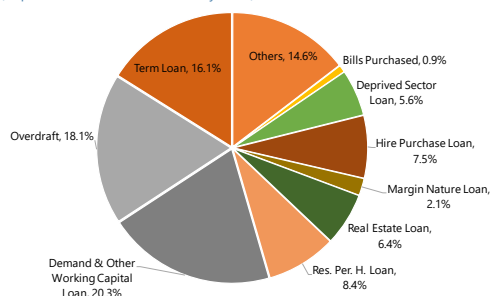
**Nepal: Real Estate Exposure**  
(In percent, as of 2016)



Source: NRB

Loan classification and underwriting standards appear weak, particularly when nearly half of banks' loan books comprise overdraft and working capital loans.

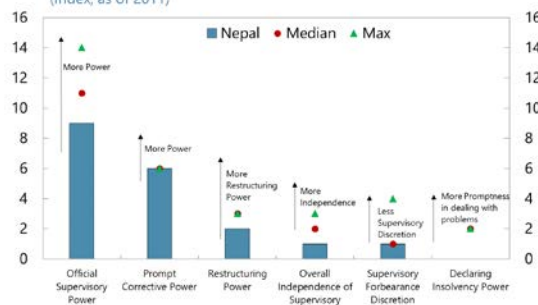
**Product Wise Lending of Bank and Financial Institutions**  
(In percent of total, as of mid-July 2017)



Sources: NRB.

Efforts have been made to strengthen banking regulations and oversight. But supervisory gaps remain.

**Nepal: Banking Supervision**  
(Index, as of 2011)



Source: Barth, James R., Caprio, Gerard, Jr., and Ross Levine. 2013. "Bank Regulation and Supervision in 180 Countries from 1999 to 2011." National Bureau of Economic Research Working Paper 18733. [http://faculty.haas.berkeley.edu/ross\\_levine/Regulation.htm](http://faculty.haas.berkeley.edu/ross_levine/Regulation.htm)

## References

International Monetary Fund, 2014, "Nepal—Financial System Stability Assessment," (Washington), unpublished.

Nepal Rastra Bank, 2018a, *Financial Stability Report of 2017* (Kathmandu: Nepal Rastra Bank).

———, 2018b, *Bank Supervision Report of 2017* (Kathmandu: Nepal Rastra Bank).



# FINANCIAL INCLUSION IN NEPAL: BRIDGING THE GAPS<sup>1</sup>

Financial inclusion is an important vehicle to promote inclusive growth and reduce poverty. Financial inclusion in Nepal has improved gradually over the past several years, but there are still large gaps between urban and rural areas and across genders. Going forward, it would be important for the implementation of Nepal's financial inclusion plan to focus on the underserved and progressively address financial inclusion gaps—targeting the rural population, low-income households, women, and geographically-remote communities.

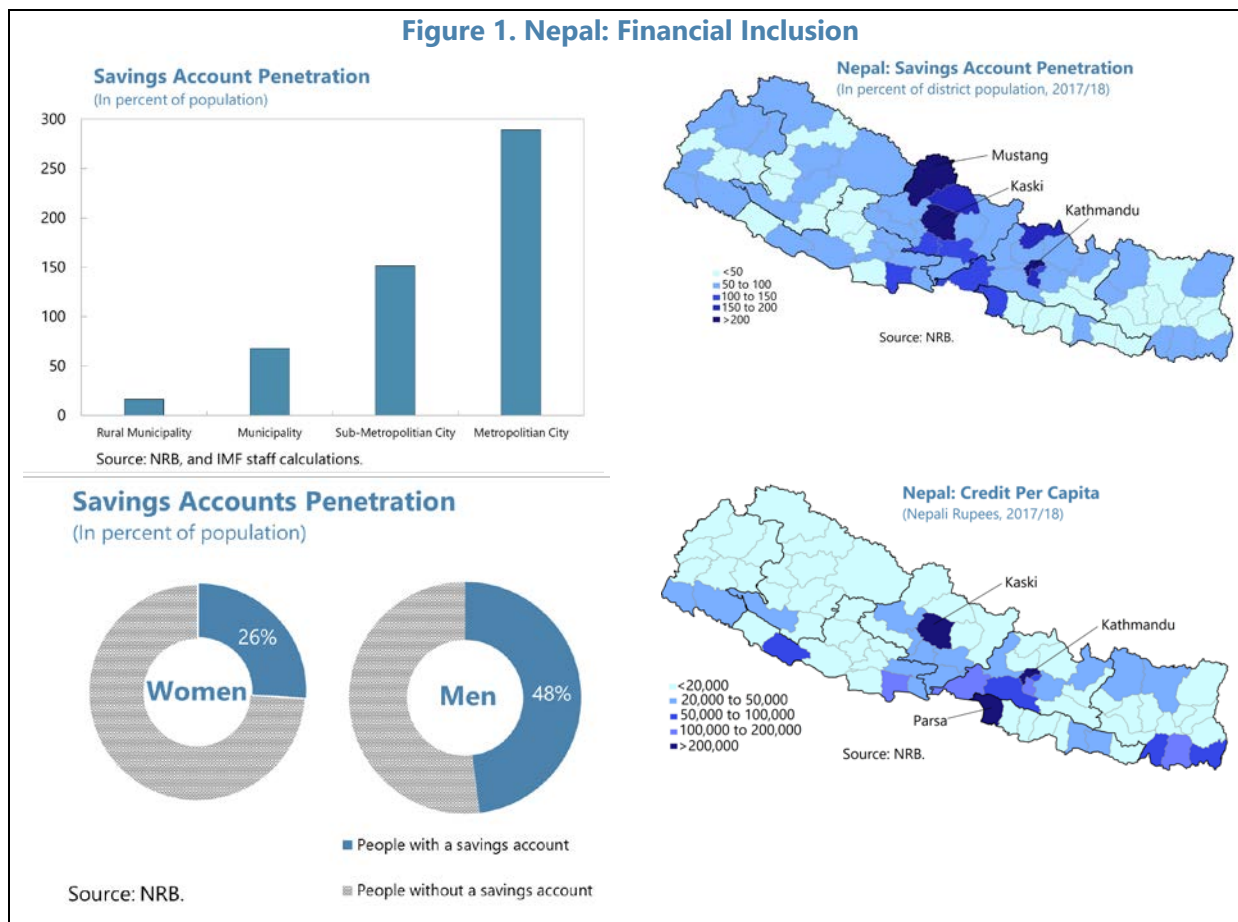
**1. Financial inclusion in Nepal has improved gradually over the past several years, but there is still a large gap between Nepal and other countries in Asia and the Pacific.** Based on the Financial Access Survey database, Nepal's number of deposit accounts rose from 446 to 657 accounts per 1000 adults between 2012 and 2016. Nevertheless, Nepal's deposit account per capita remained low, less than half of Thailand's level and only about a tenth of Japan's level in 2016. A composite measure of financial access also suggests that Nepal ranks only within the second quartile among 30 countries in Asia and the Pacific (see text table).

	Country	Rank	Country	Rank
Fourth Quartile	Singapore	1	New Zealand	16
	South Korea	2	Marshall Islands	17
	Japan	3	Fiji	18
	Maldives	4	Vietnam	19
	Thailand	5	Australia	20
	Brunei	6	Vanuatu	21
	Indonesia	7	Nepal	22
	Tonga	8		
Third Quartile	India	9	Mongolia	23
	China	10	Bhutan	24
	Sri Lanka	11	Cambodia	25
	Philippines	12	Timor-Leste	26
	Bangladesh	13	Lao P.D.R.	27
	Samoa	14	Solomon Islands	28
	Malaysia	15	Myanmar	29
		Papua New Guinea	30	

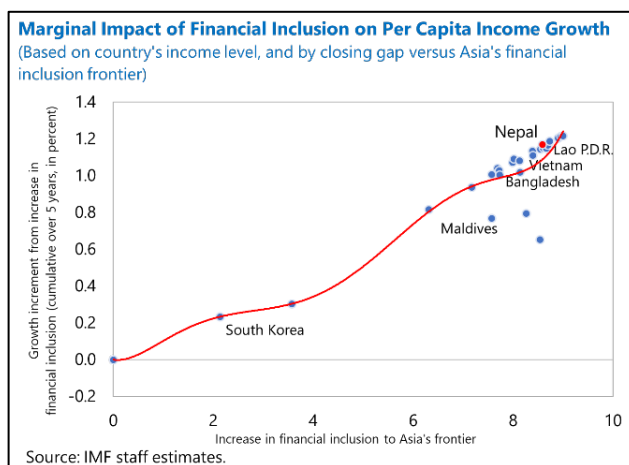
1/ The quartiles are based on the country rankings. Color indicates the index value, ranging from the highest (dark green) to lowest quartile (orange), with Malaysia representing the median level of financial inclusion among countries in Asia. The index is based on 3 indicators: ATMs per 100,000 adults, Bank branches per 100,000 adults, and Bank branches per 1,000 km<sup>2</sup> (Appendix 2). Thus, it mainly captures financial access. Limited country coverage of more indicators prevented construction of the index that could reflect additional aspects of financial inclusion.

**2. Despite recent improvements, financial inclusion gaps within Nepal remain significant with large disparities between urban and rural areas and across genders** (Figure 1). About two-thirds of the adult population has access to formal financial services, 21 percent of adults use only informal financial services, and 18 percent do not use any form of financial services. Moreover, formal credit is highly concentrated within only a few large districts in Nepal—Kathmandu, Parsa, and Kaski. While credit in the Kathmandu district amounts to about NPR550,000 per capita, credit in Nuwakot—a district within a 50-kilometer radius from Kathmandu—only amounts to about NPR1,300 per capita. Metropolitan areas average nearly 3 accounts per person, while rural areas average only 0.16 accounts per person. Savings account penetration in Kathmandu—Nepal's capital—is 10 times higher than in Baitadi—the far western district. Only 26 percent of women have a bank account, compared to nearly 50 percent of men.

<sup>1</sup> Prepared by Piyaporn Sodsriwiboon (APD).



**3. Financial inclusion can be an important vehicle to promote inclusive growth and reduce poverty.** Cross-country analysis points to potentially significant growth benefits from financial inclusion, especially for low-income countries like Nepal. For instance, estimation results in IMF (2018) suggest that bringing Nepal’s financial inclusion level to Singapore’s—as Asia’s financial inclusion frontier—is associated with a cumulative 1.1 percentage point increase in per capita income growth and lifting about 350,000 people out of poverty over a five-year period. Alternatively, raising Nepal’s financial inclusion level to that in India can be expected to raise per capita income growth by 0.2 percent over a five-year period.



**4. The authorities are taking steps to enhance financial inclusion in Nepal.** A financial inclusion action plan for Nepal has recently been approved by the NRB Board. The action plan aims to achieve “access to affordable finance for all by 2030, with increased access to formal financial

services". The plan aims to leverage the implementation of Nepal's longstanding priority sector lending and deprived sector lending policies, introduce long-term saving products with real returns, increase the usability of digital payments, and strengthen consumer protection and financial literacy. In addition, in the context of the transition to the new federalism structure there is a policy to require each of the 753 local governments to have at least one bank branch. This is expected to improve access to formal financial services across the country.

**5. Nevertheless, it would be crucial for Nepal's financial inclusion plan to focus on the underserved and progressively address financial inclusion gaps—targeting the rural population, low-income households, women, and geographically-remote communities.** Going forward, policy efforts should take a more holistic approach to financial inclusion with a view to expand access to formal bank accounts, create incentives to increase the utilization of financial products, expand the availability of credit to underserved segments, and allow for greater use of digital and mobile technology to support financial inclusion.

- The financial inclusion strategy should include the action plan to make available a wide range of financial products and services accessible to all. It is crucial to ensure that individual financial services are appropriately designed and priced to be widely used. Mobile banking and digital payments have also emerged as powerful enablers for financial inclusion, where they can be used to complement traditional banking channels for greater access to basic financial services.
- The approach to expand financial inclusion should move away from quantity-based policies such as priority sector and deprived sector lending policies that are distortive, and shift toward price-based mechanisms to correct for market failures. Credit constraints on small- and medium-sized enterprises (SMEs) and small borrowers generally result from information asymmetries and a lack of the types of collateral demanded by banks. Therefore, financial inclusion strategies should focus on establishing a robust financial sector infrastructure including credit information systems to provide more data on borrowers as well as secured-transactions registries for movable property to provide a wider range of collateralizable assets.
- The government initiatives to set up a Deposit and Credit Guarantee Fund (DCGF) should be operationalized. In line with the Financial Sector Development Strategy, credit guarantee schemes should be implemented to support SME lending. Such schemes should help de-risking flowing from the guarantee, thus lowering interest rates and making credit more accessible for SMEs. It is also critical that SME credit guarantee schemes be properly designed and carefully monitored to ensure their success.
- International experiences suggest a strong partnership and collaboration between the private and public sectors is important to ensure a cohesive approach to and success of national financial inclusion strategies. Therefore, establishing an organization dedicated to improving coordination across financial inclusion agencies in Nepal would be beneficial.

**6. Finally, trade-offs between financial inclusion and stability should be minimized.** Often, expanding financial inclusion and deepening especially without proper supervision increases economic and financial stability risks. This underscores the importance of adequate bank supervision, robust risk management practices at commercial banks, as well as more stringent loan classification and lending and underwriting standards in Nepal (See Chapter 3 for more details). The financial inclusion action plan's aim to establish a supervision mechanism for cooperatives is welcome, given the importance of cooperatives to provide financial services particularly in remote areas. In this context, it is opportune that the Cooperative Act is being revised to make it consistent with the new federalism structure, where the local and provincial authorities will supervise cooperatives operating in their jurisdictions and the Department of Cooperatives of the Ministry of Cooperatives and Poverty Alleviation will supervise cooperatives that operate throughout the country as well as the sector as a whole with a view to ensure financial stability. Meanwhile, the NRB will supervise the savings and credit cooperative banks licensed by the NRB.

## References

International Monetary Fund, 2018, "Financial Inclusion in Asia-Pacific," IMF Departmental Paper No.18/17 (Washington).

Nepal Rastra Bank, 2018, *Nepal Financial Inclusion Action Plan, UNNATI-Access to Finance (A2F) Project* (Kathmandu: Nepal).